Edexcel

A Level

Economics

(Code: WEC11 01)

Unit 04-Section 4

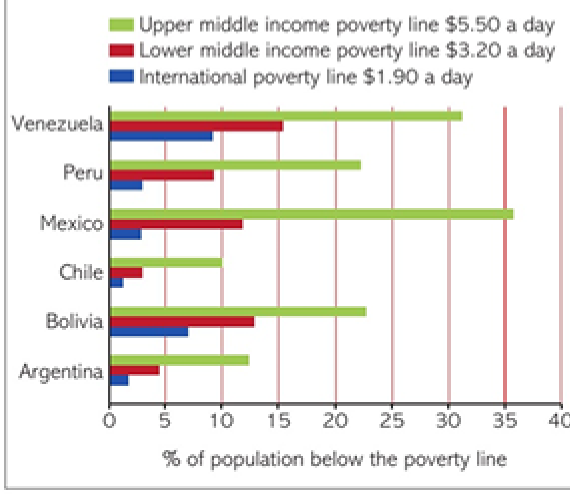
Poverty and inequality

MEANING AND MEASURES OF ABSOLUTE POVERTY

Absolute poverty occurs when individuals are not able to consume sufficient necessities to maintain life. In practice, this means individuals are hungry and suffer malnutrition (they may not have enough food to live and grow). An individual who is living in absolute poverty is living with extreme poverty. They tend to have very limited access to education and basic services. The amount of income needed not to be in absolute poverty varies from country to country. This means each country has its own national poverty line. A poverty line is the minimum income per day needed to escape extreme poverty. This usually reflects the line below which a person's minimum needs for food, clothing and shelter cannot be met in that country.

FIGURE 1

Measuring poverty: Percentage of population below the poverty line



Because most extreme poverty is concentrated in the poorest countries of the world, the poverty lines of the poorest 15 countries are used to set the international poverty line. The global or international poverty line is set at $1.90 a day (in 2011 **purchasing power parity).**

THE MULTIDIMENSIONAL POVERTY INDEX (MPI)

The Multidimensional Poverty Index (MPI) measures the percentage of the population that is multidimensionally poor. It uses data for health, education and the standard of living to provide an index number scoring. In total there are 10 indicators of poverty:

- education is measured by indicators of years of schooling and child school attendance data
- health is measured by indicators of child mortality and nutrition data
- standard of living is measured by availability of electricity, improved toilet facilities and safe drinking water to households, whether or not the floor of a house is made of dirt, sand or dung, cooking fuel used and assets owned such as a radio, telephone or fridge.

MEANING AND MEASURES OF RELATIVE POVERTY

If there is inequality in society, there will be relative poverty, but not necessarily absolute poverty. **Relative poverty** exists in all economies, whether they are high, middle or low-income economies. Individuals and households who suffer relative poverty are poor in comparison to others in their country or in other countries.

There is no exact accepted measure of relative poverty. However, there are two common ways of attempting to measure it.

The first method compares the poorest incomes with the **median household income** in a country. The median income is the level of income the middle household would receive if all households were ordered from the poorest income to the richest income.

A commonly quoted statistic for relative poverty used by the EU is the proportion of households living on less than 60 per cent of median household income and the total number of people living in those households. In 2015 (the most recent data available in 2017), 17.3 per cent of the EU population earned less than 60 per cent of their respective national median disposable income (after tax and social transfers). In most non-EU OECD countries, this value is between 20 and 25 per cent.

The OECD also publishes relative poverty data. The poverty rate is the ratio of the number of people who live in households whose income falls below half the median household income in an economy to the total population.

CAUSES OF CHANGES IN ABSOLUTE AND RELATIVE POVERTY

Most governments in developing countries want to reduce absolute poverty. However, economic policies are designed to manage the economy as a whole. These will influence absolute and relative poverty levels either directly or indirectly. The following factors are some of the main causes of changes in absolute and relative poverty for countries over time.

ECONOMIC GROWTH

Absolute poverty tends to fall as GDP rises. A large number of people who live in absolute or relative poverty are without jobs. Economic growth creates a derived demand for labour. Economic growth, by creating work, is therefore vital in reducing poverty.

However, rising GDP alone may not cause absolute poverty to disappear. The World Bank reports that increases in wages explain around 40 per cent of the drop in absolute poverty over the last decade. But there will always be groups who will never be able to work and earn money and who have no private sources of income; they have to depend either on charity or on the state. For example, the elderly and those too ill to work are two vulnerable groups. The elimination of absolute poverty is thus dependent on how well the state can reach those at risk and provide support.

EDUCATION AND TRAINING

• Education and training promote economic growth by increasing the quality of human capital. This will increase the long term trend rate of growth. Real GDP will increase as the long run aggregate supply curve shifts to the right. If real GDP per capita rises, this will tend to reduce absolute poverty.

• Since labour is a derived demand, an increase in real GDP will create jobs. As stated by the World Bank, 'Education is a powerful driver of development and one of the strongest instruments for reducing poverty.' A better educated individual has a higher chance of gaining employment and therefore earnings.

• Education and training also increase an individual's labour productivity, and in a competitive labour market, should increase their wage level.

There is a positive correlation, both within countries and between countries, between the number of years spent in education and the level of income of an individual.

To escape poverty, which is sometimes called the **cycle of poverty.** In many advanced economies, schools, which are funded by the government, are given more resources for every disadvantaged child who attends. The objective is to increase social mobility, so children from poor families have a real chance to escape the 'poverty cycle'.

WELFARE BENEFITS

Welfare benefits are government financial help for the poor and needy. They raise incomes. Welfare benefits are normally designed to ensure that households can afford the minimum acceptable basket of goods for the society in which they live.

In developing countries these can take many forms. Some examples include food hand-outs or cash transfers. These cash transfers might be conditional on families sending their children to school or attending health clinics. They have the effect of directly raising the income of the poor, which should reduce both absolute and relative poverty. The overall impact of welfare benefits on relative poverty, defined by reference to the median income, will depend on how generous these benefits are compared to the median income.

CHANGES IN TAX STRUCTURE

Taxation affects the level of absolute poverty and relative poverty in two important ways.

- If a government wants to reduce relative poverty, then it will make taxes more **progressive**. This means they will take a much higher percentage from the income of high income earners than from low income individuals.
- If a government can raise more tax revenue from those who are not in poverty, this tax revenue can be used to finance better access to high quality education and healthcare. Government spending on education and health is an important driver of development and economic growth.

STRUCTURAL CHANGES IN THE ECONOMY

Structural changes in the economy are basic changes in the way resources are allocated in an economy. They usually relate to the division of total output between the primary, secondary and tertiary sectors of the economy. For example, a subsistence economy may move towards a manufacturing economy. If jobs can be transferred from low to high productivity activities, this will generate higher wages. This will help to reduce absolute poverty and, if the incomes of the lowest paid are lifted, then relative poverty will fall too.

Structural change might also refer to changes in the distribution of jobs between the **formal and informal sectors.** The informal sector in an economy refers to those economic activities which are not recorded in national income statistics. Informal jobs have little or no legal protection for employees.

informal jobs are the main source of income for the poor. Economic growth which increases **formal jobs** will have a greater impact on reducing poverty.

FOREIGN AID

Foreign aid is the voluntary transfer of resources from one country to another. The term is normally assumed to involve the transfer of resources by a government, taking the form of money, goods and services. Foreign aid is one way to lift people out of absolute poverty.

Financial aid from richer countries can be used to help move people out of absolute poverty in either the short run or the long run. A natural disaster, such as severe flooding, may mean individuals do not have the resources to survive. However, for long term gain, aid will be more effective if it is directed at projects which target poverty reduction, such as health and education.

CIVIL WARS AND CONFLICT

Conflict is the leading cause of poverty globally, with extreme poverty expected to rise to over 60% by 2030. Conflict-affected countries lack access to essential services and food supplies, leading to high rates of diseases. Conflict destroys physical and human capital, negatively impacting economic growth and increasing poverty. Poverty, both absolute and relative, may increase the likelihood of civil war, making it difficult to reduce absolute poverty in some countries. The causes of conflict are complex, but poverty and under-development increase the risk of violence.

SUBJECT VOCABULARY

absolute poverty exists when individuals do not have the resources to be able to consume sufficient necessities to survive

child mortality the number of children who die; data normally focuses on children under the age of 14/15 and also specifically on the under 5s

cycle of poverty when poor children find it hard to escape poverty in adult life

formal jobs jobs in the formal sector; these jobs have employment contracts and employees are protected by employment laws

formal sector activities in the economy which are recorded in national income statistics

informal jobs jobs in the informal sector; informal jobs have little or no protection for employees, they are usually poorly paid with little training and low career progression

informal sector activities in the economy which are not recorded in national income statistics

median household income the level of income the middle household would receive if all households were ordered from the poorest income to the richest income

progressive taxes taxes which take a higher percentage from the income of high-income earners than they do from low-income individuals

purchasing power parity an exchange rate of one currency for another which compares the cost of a typical basket of goods in different countries

regressive taxes taxes which take a higher percentage from the income of low-income earners than they do from high-income earners

relative poverty poverty which is defined relative to existing living standards for the average individual; measurement of relative poverty often focuses on how the poorest incomes compare with the median household income in a country

structural changes in the economy any basic changes in the way resources are allocated in an economy

Chapter 33 – Inequality

INCOME

Income is a flow concept, as explained by the circular flow of income model discussed in Year 1 of this course. In a market economy, how much income an individual receives is based on the forces of supply and demand; individuals receive different incomes based on their ownership of the factors of production in the economy.

The factors of production are land, labour, capital and enterprise. Ownership of these factors of production will generate income in the form of rent, wages, interest and profits.

WEALTH

Wealth is a stock concept. Individuals own the stock of land, labour, capital and enterprise used to produce goods and services. Wealth for an individual can take a number of forms:

• Property wealth is the value of houses together with any commercial property that an individual might own, such as farming land and commercial buildings.

• Physical wealth is the value of physical objects apart from property. This includes personal items, such as antiques and furniture, as well as cars.

• Financial wealth is the value of monetary assets. These include personal savings, such as money saved in the bank or building society, and stocks and shares.

• Private pension wealth is locked up in pension funds. These could be pension funds linked to an occupation, such as teachers' pensions or doctors' pensions, or they could be personal pensions. In developed countries most individuals plan for their retirement by contributing to private pension schemes. This means when they retire, the wealth built up will generate an income. Private pension wealth is a form of personal savings.

MEASURING INEQUALITY

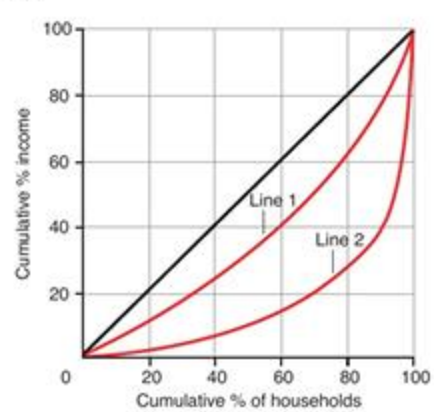
The Lorenz curve is a common method for measuring income inequality. It plots the cumulative percentage of households and income, showing total equality. Line 1 shows a relatively equal income distribution, with the bottom 20% receiving half the average income, while the top 10% receive twice. Line 2 shows a very unequal society, with the bottom 50% receiving only 10% of income, and the top 10% earning six times the average income.

One statistical measurement of the degree of inequality is the Gini coefficient. Mathematically, it is the ratio of the area between the 45° line and the Lorenz curve divided by the triangle representing the whole area under the 45° line. It has values between O and 1. The higher the **Gini coefficient**, the more unequal the distribution of income. If every person has equal income, the Gini coefficient is O. There is perfect equality of income. If the Gini coefficient is 1, then one person has all the income while everyone else has no income. Sometimes the Gini coefficient is measured as an index out of 100. The **Gini index** is simply the Gini coefficient multiplied by 100.

FIGURE 1

Lorenz curves

The Lorenz curve shows the degree of inequality of income in a society. The further the curve is from the line of equality (45° line), the greater the degree of inequality.



CAUSES OF INCOME INEQUALITY WITHIN COUNTRIES

Income inequality within countries has risen in many countries since the 1980s. In China, India and Russia, the rise in inequality has been very steep, while in most European countries it has been less extreme.

Income inequality within countries tends to be higher in developing countries than developed countries. Latin America, the Caribbean, and Sub- Saharan Africa have the highest levels of income inequality. Although the Latin American Gini coefficient has fallen over the last decade or so, it still remains one of the most unequal regions in the world.

THE IMPACT OF GLOBALISATION

Increased inequality in some developed countries has been blamed on globalisation. The wages of unskilled workers in the United States and other advanced economies are likely to have been depressed as a result of globalisation as these workers are competing more directly with an abundance of unskilled workers in poorer countries; in contrast, skilled workers in emerging economies are scarcer. This means wage differentials between skilled and unskilled workers are likely to have widened in many advanced economies. Immigration of unskilled labour in some economies also puts downward pressure on wages for those on low incomes.

TECHNOLOGICAL ADVANCES

Technology is often blamed for creating a skill premium in wages. Automation is increasingly destroying old jobs and creating new ones. There is an increasing need for skilled workers, as many low skilled jobs have been replaced by machines.

EDUCATION, TRAINING AND SKILLS

Differences in access to education can drive rising or high inequality in economies. Education and training increase an individual's productivity and make them more skilled. Skilled labour is more scarce than unskilled labour. As a result, wage differentials exist and can increase between skilled and unskilled workers. The earnings of those with certain qualifications will also increase more than others over time, as demand and supply of labour change in individual labour markets.

TYPES OF JOB

Since the mid-1990s, over half of new jobs in OECD countries have been non-traditional, including part-time, short-term work, and self-employment. These jobs often lack employment protection, hours, and training. Income inequality has increased in some OECD countries due to underemployment and zero-hour contracts. In emerging economies, many people work in the informal sector, which has no written contracts, low pay, limited training, and unpredictable earnings, leading to wide earnings disparities.

LABOUR MARKET DEREGULATION

Deregulation of labour markets is the process of removing government controls from labour markets. In general, this would be expected to increase income inequality. For example, new laws in an economy may weaken trade unions, reducing their wage negotiation influence, or laws may be passed to abolish minimum wages in an economy, widening income distribution.

TAX AND WELFARE BENEFITS

The tax and welfare system in an economy affects income inequality. In OECD countries, the system aims to make income distribution more equal, with higher income individuals paying more taxes. However, governments may introduce new taxes or lower welfare benefits, widening income inequality. Developing economies often have higher income inequality due to underdeveloped tax systems and inability to afford extensive welfare systems.

ECONOMIC SYSTEMS

In China and Russia, two former communist economies, and India, a highly regulated economy, inequality increased steeply once markets were allowed to allocate resources. Wages set by supply and demand caused widening wage differentials between individuals.

THE RISE OF THE VERY RICH - THE TOP 1%

There has been a widening of income distribution across many advanced economies and some developing economies. Recent analysis on the growth of inequality has focused on the share of national income of the top 10 per cent, 1 per cent and 0.1 per cent.

According to the economist Branko Milanovic, there are reasons why inequality seems to be increasing in many countries.

• Firstly, in rich countries, capital income (income generated from wealth rather than labour) is taking up a rising share of total income. Capital income is concentrated in the hands of a few very rich people.

• Secondly, those who tend to earn high incomes from labour also earn high incomes from capital. So, again, income is very concentrated among the few.

• Also driving inequality are social factors - the educated and rich marrying each other.

• Lastly, political influence from the rich leads to favourable tax rules which benefit the rich. This means the drive for redistributive policies falls.

CAUSES OF WEALTH INEQUALITY WITHIN COUNTRIES

Wealth inequalities are linked to income inequalities, as higher-income individuals can build wealth more easily. Inheritance taxes contribute to wealth inequality. Assets with higher benefits, such as stock market shares or high house prices, may also benefit some, but may make housing less affordable for younger generations. Additionally, less progressive wealth taxes on asset value may contribute to wealth inequality.

CAUSES OF INCOME INEQUALITY BETWEEN COUNTRIES

GNI per capita (average incomes) varies significantly between countries. Inequality between countries has fallen in recent decades. This was a period of rapid globalisation and high growth, particularly in China and India. Multiple factors explain income inequality between countries.

DIFFERENCES IN RESOURCE ENDOWMENT

The maximum output which an economy can produce will depend upon its resource endowment - the quality and quantity of factors of production (land, labour, capital and enterprise) within the economy. These differ between countries, so most causes of inequality between countries can be explained by this.

- Some countries have a natural resource advantage, for example, oil or copper.
- The quality of human capital differs greatly between advanced and developing economies. Most children in advanced economies will be in school or training until at least 18 years old. In developing countries, the completion of secondary school education and, in some cases, primary education can be very low.
- In some countries, a high proportion of skilled labour is lost due to emigration.
- Civil war in some countries will destroy physical and human resources.
- The lack of a fully functioning banking sector in some countries may also limit the availability of capital - this limits enterprise.

- The degree of technological change in a country will affect the productive capacity of an economy.

DIFFERENCES IN SECTORAL SHARE OF GDP

The share of different economic sectors is also likely to cause income differences between countries. Generally, countries are at a lower stage of development when agriculture makes up a higher percentage of GDP, compared to manufacturing and services. This is because parts of the agricultural sector often have low levels of productivity. Low levels of productivity will limit economic growth, so incomes will not rise as quickly as in other countries.

DIFFERENCES IN INFRASTRUCTURE

Infrastructure differs significantly between countries. Poor infrastructure, such as problems with electricity supply or poor transport links between places, will reduce production, raise costs and limit supply-side growth.

DIFFERENCES IN THE AMOUNT OF FOREIGN DIRECT INVESTMENT

As discussed in Chapter 21, FDI often creates a positive impact on growth for recipient countries.

THE DEGREE OF TRADE LIBERALISATION

Some economies benefit from being members of trading blocs. Membership of a trading bloc should reduce import costs and promote exports. Both will cause actual growth. At the same time, globalisation creates both winners and losers.

DIFFERENCE IN GOVERNMENTS

Good macroeconomic policies and good governance are crucial for achieving higher growth rates. Unstable governments can reduce business confidence and FDI. In weaker governments, property rights may be lacking, leading to lower investment and output. Corruption can also cause misallocation of resources. Additionally, bureaucracy and excessive regulation can hinder business activity. Arbitrary tax laws can also deter business activity.

CAUSES OF WEALTH INEQUALITY BETWEEN COUNTRIES

The average level of wealth held by individuals in a country will differ between countries. Individuals who live in less developed economies, with low incomes, will find it harder to build up their wealth compared to individuals in countries which have much higher average incomes. However, those in emerging economies that have experienced long periods of rapid economic growth will have seen faster rises in private wealth, so the gap will have narrowed with more advanced economies.

Some countries have also privatised many state- owned assets.

THE IMPACT OF INEQUALITY

ENTERPRISE

Economists argue that greater inequality can encourage entrepreneurship, as entrepreneurs are motivated by profit incentives. However, they also argue that greater inequality can reduce enterprise, as high relative poverty creates a cycle of low expectations and limits access to credit. This can lead to disadvantaged individuals not fulfilling their potential and entrepreneurs lacking the necessary resources to start businesses.

INCENTIVES

Some inequality increases incentives to work. The decision to invest in education and training is partly motivated by the likelihood of higher monetary rewards; usually the expectation that being skilled and more productive will lead to higher wages. The profit incentive also applies to entrepreneurs and their willingness to set up businesses and innovate. These incentives drive economic growth.

SAVINGS

Changes in inequality can impact savings in an economy. If income inequality falls because more income is being redistributed from the highest income earners to the lowest, the economy's savings ratio is likely to fall. This is because those on higher incomes tend to save a bigger proportion of their income. Those on high incomes have a high marginal propensity to save- they save a high proportion of their last $1 dollar earned. Redistributing the last dollars of income earned, from high income earners to low income earners, will therefore increase the marginal propensity to consume (MPC) in the economy.

EDUCATION

Inequality in education, particularly in developing countries, leads to many children not attending school or having many years in education. The World Bank's 2017 report highlighted the global 'learning crisis' due to corruption and poorly trained teachers. Income and wealth inequality also affect education in developed economies, with state schools in affluent areas and private schools providing better quality education. This creates a 'poverty cycle', where poorer children's educational outcomes are worse. Government policies can help improve the performance of disadvantaged children.

MIGRATION

Inequality between and within countries will affect which people choose to emigrate from a country and where they choose to emigrate to. The Migration Observatory at the University of Oxford has analysed what factors cause people to migrate to the UK and other OECD countries. For most international migration, wage and income differences between the origin country and the destination country seem to be the main factor.

LIFE EXPECTANCY

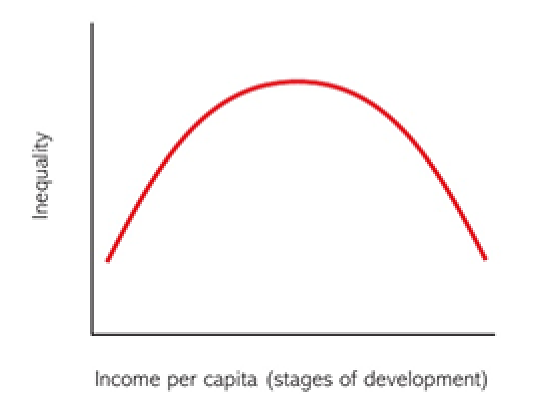
The United Nations reports that, in developing countries, children in the poorest 20 per cent of populations are still up to three times more likely to die before their fifth birthday than children in the richest quintiles. Women in rural areas in the majority of developing countries are still three times more likely to die while giving birth than women in urban centres. This data illustrates how income inequality, particularly if it causes absolute poverty, will reduce life expectancy. If economic growth is shared more equally, there should be less variation in life expectancy between different income and wealth groups.

THE IMPACT OF ECONOMIC CHANGE AND DEVELOPMENT ON INEQUALITY

The Kuznets curve, developed by economist Simon Kuznets in 1955, predicts a relationship between income per capita and income inequality. It suggests that inequality increases during early stages of development, but then falls due to better education, narrowing productivity differences, and increased demand for income redistribution. However, the widening income distribution in advanced and developing economies has led to questions about the relationship. Governments' measures to promote growth and development may have different impacts on inequality, making it difficult to predict their impact.

FIGURE 2

Kuznets curve



THE SIGNIFICANCE OF CAPITALISM FOR INEQUALITY

A free-market or capitalist economy solves economic problems through market mechanisms, determining labor prices and production and distribution. The state upholds property rights and provides goods. Land and capital are owned by private individuals, with the working class selling labor for wages. High incomes lead to wealth accumulation, which can be inherited and inherited by future generations. This results in wide income and wealth inequalities.

In 2013, the French economist Thomas Piketty published a book analysing how capitalism has affected income and wealth distribution. He analysed data since the beginning of the industrial revolution in Western Europe.

• Industrialisation slowly increased wages for workers, but pre-1914 economies were very unequal. In 1910, the top 10 per cent of European households' share of total wealth was almost 90 per cent. The income flows from rent and dividends, which come from the ownership of capital, contributed to high inequality.

• This system persisted until the chaos brought about by the Great Depression and the first and second world wars. Wealth then fell dramatically from this 'rich' group because of bankruptcies, physical destruction of capital, inflation and the growth of the tax and welfare state. There was then a period of more equal distribution of income and wealth.

• Since the 1970s, wealth-to-income ratio has increased, leading to income inequality. Piketty suggests a global tax to reduce wealth concentration, but critics argue that modern wealth is created through work and concentration may be unlikely, with more capital reducing returns. High economic growth or government intervention are needed to reduce wealth dominance.

SUBJECT VOCABULARY

Gini coefficient a statistical measure of inequality of income; its value ranges from 0, where there is perfect equality of income, to 1 where income is highly unequal with one person having all the income and everyone else having no income

Gini index the Gini coefficient times 100

life expectancy number of years a newborn infant could expect to live typically within a country, assuming patterns of death remain as they are

Lorenz curve a graphical representation of the degree of income or wealth inequality in society

subsidy a grant that lowers the price of a good, usually designed to encourage production or consumption of a good