

## TOPIC 2.2

### Equity and Policies towards Income and Wealth Redistribution

#### MCQ Section

#### HELPS to MCQ

1. The government of a country decides to increase the proportion of its tax revenue that it obtains from income tax and to reduce the proportion it obtains from indirect taxes. Total tax revenue is left unchanged.

What is likely to be the impact on the distribution of income and on work incentives?

	distribution of income	work incentives
A	more equal	increase
B	more equal	decrease
C	less equal	increase
D	less equal	decrease

[J08/P3/Q14]

2. A tax is said to be regressive when
- A low income earners pay a higher proportion of their income in tax than high income earners.
  - B marginal tax rates exceed average tax rates.
  - C the cost of collecting the tax exceeds the revenue raised.
  - D the marginal rate of tax is higher for high income earners than low income earners.

[N10/P3/Q13]

3. The government of a country decides to increase the proportion of its tax revenue it obtains from direct taxes and to reduce the proportion it obtains from indirect taxes.

What is likely to be the impact on the distribution of income and on work incentives?

	distribution of income	work incentives
A	less equal	decrease
B	less equal	increase
C	more equal	decrease
D	more equal	increase

[N10/P3/Q29]

4. Which tax is most likely to be regressive?

- A an inheritance tax
- B a property tax
- C a sales tax
- D income tax

[J11/P3/Q25]

5. The government of a country decides to increase the proportion of its tax revenue that it obtains from indirect taxes and to reduce the proportion it obtains from income tax.

Total tax revenue is left unchanged.

What is likely to be the impact on the distribution of income and on work incentives?

	distribution of income	work incentives
A	less equal	decrease
B	less equal	increase
C	more equal	decrease
D	more equal	increase

[N11/P3/Q14]

1. **B** Income tax is usually progressive and redistributes income in favour of poor. Whereas, indirect taxes are regressive and create disparity of income. Therefore, distribution of income becomes fair but higher tax rates will have a negative effect on work incentive.

2. **A** A tax is said to be regressive when burden of tax (proportion of income in tax) is higher on low income earners than high income earners. Options B & D suggest progressive tax while C is irrelevant.

3. **C** Indirect taxes are regressive in effect while direct taxes usually are progressive thus distribution of income is likely to improve but higher direct taxes will have negative effect on work incentive.

4. **C** A sales tax is the fixed proportion of the price of a product; therefore it takes a larger proportion of the incomes of poor and a smaller proportion of the incomes of rich i.e. regressive.

6. Assuming no change in tax rates or tax-free allowances, for which tax would the amount paid in tax become a smaller proportion of taxpayers' income during a period of wage and price inflation?

- A a progressive income tax
- B a specific tax on tobacco
- C capital gains tax
- D value added tax

[N11/P3/Q29]

7. What is most likely to be regressive?

- A corporate profit taxes
- B state pension benefits
- C specific tax on cigarettes
- D unemployment benefits

[N12/P3/Q15]

8. The table shows the marginal tax rates paid by a country's taxpayers at different levels of income.

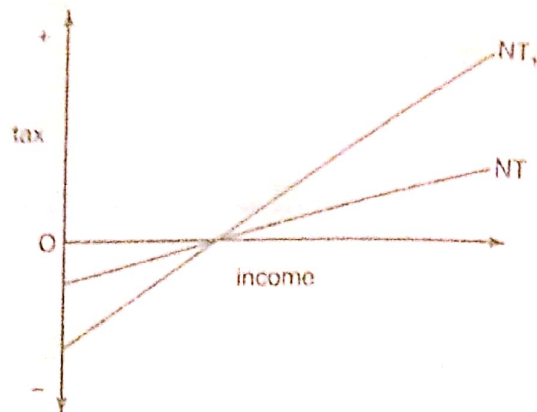
income	tax rate
first \$4000	zero
\$4001 - \$20 000	20 %
above \$20 000	40 %

What correctly describes this tax?

- A It is regressive over the entire range of income.
- B It is proportional over the income range \$4001 - \$20 000.
- C It is proportional over the range of income above \$20 000.
- D It is progressive over the range of income above \$4000.

[J13/P3/Q15]

9. A country has a negative income tax. The curve NT in the diagram shows the country's initial tax schedule.



A change in the tax rate causes the schedule to shift to NT<sub>1</sub>.

How will this affect work incentives and the after-tax distribution of income?

	work incentives	distribution of income
A	strengthen	more equal
B	strengthen	less equal
C	weaken	less equal
D	weaken	more equal

[N13/P3/Q14]

10. What is most likely to contribute to households finding themselves in a poverty trap?

- A means-tested benefits
- B progressive taxation
- C regressive taxation
- D universal benefits

[N13/P3/Q15]

11. A country's government reduces the specific tax on packets of cigarettes.

What could explain why this leads to an increase in tax revenue from cigarette sales?

- A Consumers switch to dearer brands.
- B The demand for cigarettes is price-inelastic.
- C The price of cigarettes falls by less than the reduction in tax.
- D There is a reduction in illegal imports of cigarettes.

[J14/P3/Q13]

HELPS to MCQ

5. B Indirect taxes are regressive in effect while income tax is usually progressive, therefore, it is likely to redistribute income from rich to poor. Thus, distribution of income is likely to be more equal but higher tax rates will have a negative effect on work incentive.

6. B A specific tax is a fixed amount per unit and in a period of price and wage inflation, the demand for tobacco is not expected to change significantly. Therefore the proportion of income spent on tobacco is expected to fall.

7. C Percentage of income spent by lower income smokers will be higher than those of relatively rich smokers.

8. D An increase in tax rate with increase in income suggests progressive tax thus all other options are incorrect.

9. D NT<sub>1</sub> represents higher tax rate on a marginal increase in income. It, therefore, strengthens disincentive but reduces income differentials.

10. A Means-tested benefits target only the poor, therefore, they have a strong income redistributive effect in favour of poor. Alone progressive taxation or universal benefits will have a relatively weaker impact while regressive taxation redistributes incomes in favour of rich.

11. D It will reduce the prices of local cigarettes leading to an increase in their sales and therefore a fall in illegal imports of cigarettes.

12. What will be the impact of an increase in marginal tax rates?

- A an increase in the propensity to save
- B an increase in the value of the investment multiplier
- C a strengthening of work incentives
- D a strengthening in the operation of automatic stabilisers

[J14/P3/Q27]

13. A government introduces tax incentives which promote effort and enterprise. They also redistribute income from those who receive a higher marginal utility from money to those with a lower marginal utility from money.

What effect will these tax incentives have on efficiency and equity?

	efficiency	equity
A	increase	increase
B	increase	reduce
C	reduce	increase
D	reduce	reduce

[N14/P3/Q17]

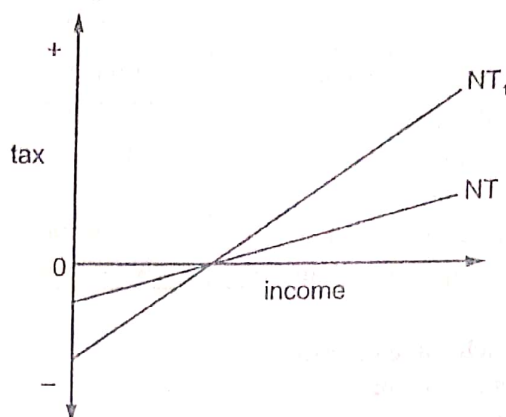
14. When will a society have achieved an equitable distribution of income?

- A when all individuals have equal job opportunities
- B when all workers are paid wages equal to their marginal value product
- C when the incomes within the society are equally distributed
- D when the society believes that the distribution of income is fair

[J15/P3/Q14]

15. A country has a negative income tax.

In the diagram, the curve NT shows the country's initial tax schedule.



What could cause the tax schedule to shift to NT<sub>1</sub>?

- A a higher marginal tax rate
- B a more equal distribution of income
- C an increase in household disposable income
- D an increase in the marginal propensity to consume

[N15/P3/Q17]

16. Which policy would be most effective in achieving a more equal distribution of disposable incomes between households?

- A government support for trade unions
- B import duties on manufactured goods
- C minimum wage policy
- D progressive income taxes

[J16/P3/Q17]

17. Which measure is least likely to help a household out of the poverty trap?

- A changing a universal benefit to a means-tested benefit
- B increasing the threshold at which income tax is paid
- C introducing a national minimum wage
- D reducing the basic rate of income tax

[N16/P3/Q16]

HELPS to MCQ

12. D It will help to reduce fluctuations in NY. A rising MPT will act as a disincentive, therefore D is incorrect. It may not reduce MPS, however, a rising MPT reduces the value of multiplier, therefore, A & B are incorrect.

13. B Tax incentives will promote efficiency while redistribution of income from poor (higher MU) to rich (lower MU) will reduce equity.

14. D By definition.

15. A Slope of the tax function indicates marginal tax rate. So the higher the slope the higher is the marginal rate of tax.

16. D It means that the relatively rich people pay a higher proportion of their income as tax as compared to the relatively poor people.

17. A Being on welfare payments is least likely to uplift economic conditions of people. All other options suggest measures which will increase incomes of relatively poor people.

18. Which statement is most likely to explain why a government decides to increase the highest rates of tax on personal income?

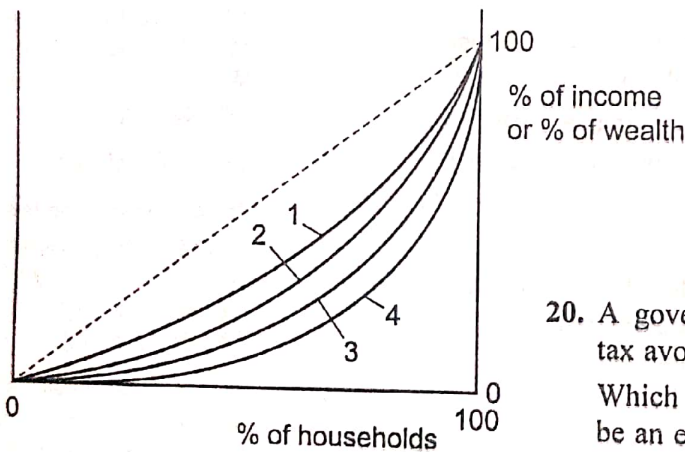
- A It expects total tax revenue to be unaffected by the policy change.
- B It is concerned about the possibility of emigration by some high earning individuals.
- C It regards equity considerations as being more important than efficiency ones.
- D It wishes to switch the emphasis of its tax system from direct to indirect taxation.

[J17/P3/Q14]

	distribution of income	distribution of wealth
A	shift from curve 1 to curve 2	shift from curve 4 to curve 3
B	shift from curve 2 to curve 1	shift from curve 3 to curve 4
C	shift from curve 3 to curve 4	shift from curve 2 to curve 1
D	shift from curve 4 to curve 3	shift from curve 1 to curve 2

[J17/P3/Q15]

19. The Lorenz curves in the diagram show different distributions of income and of wealth.



Income in a country is more equally distributed than wealth.

In a period the distribution of income becomes more unequal but the distribution of wealth becomes more equal.

Which movement would show the effects of these changes on the distribution of income and wealth within the country?

20. A government wishes to discourage tax avoidance.

Which policy to achieve this would be an example of the behavioural approach of nudge theory?

- A compelling direct tax deduction by employers
- B making random inspections of individual tax records
- C providing information on how the tax is spent by the government
- D using penalties, such as fines and imprisonment for tax avoidance

[J17/P3/Q16]

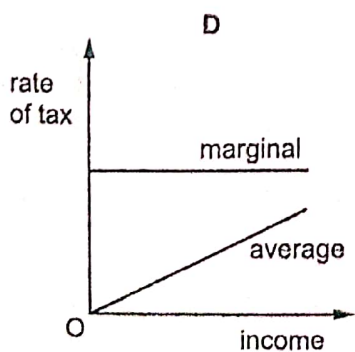
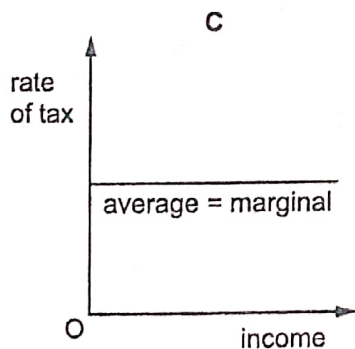
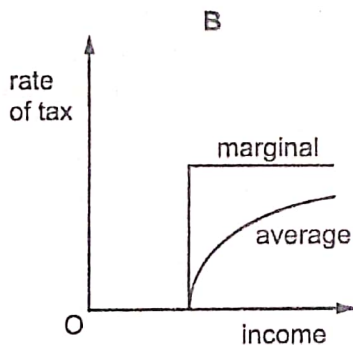
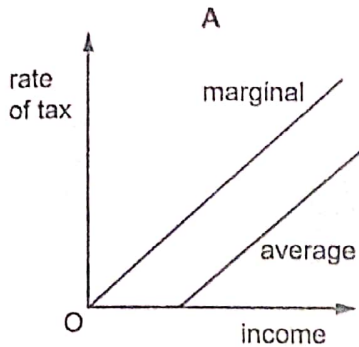
18. C Options A & D clearly contradict the statement, while B is incorrect because the policy would encourage emigration.

19. A Further the curve drawn on the left of 45 degree line the more is the unfair distribution of income and wealth and vice versa.

20. C Nudge theory proposes positive but indirect suggestions to try and achieve non-forced compliance of groups and individuals. Options A, B & D suggest compliance by force, therefore, they are incorrect.

21. A tax system allows people to earn a certain sum of income free of income tax. On income above this level, tax is levied at a constant rate.

Which diagram correctly shows how marginal and average rates of tax vary with income?



[N17/P3/Q15]

22. What is the best example of nudge theory as applied to the prevention of tax evasion?

- A employing an extensive administration to ensure detection of evasion
- B imposing heavy penalties to deter offending behaviour
- C providing information to taxpayers about the undesirable effects of tax evasion
- D requiring employers to inform the tax authorities of workers' pay

[N17/P3/Q16]

23. In many countries it has been observed that, when high marginal rates of income tax imposed on richer groups are reduced, the tax revenue raised increases.

What is an implication of this observation?

- A Government policy should aim to minimise the income tax.
- B Sales taxes are always superior to income taxes as a means of raising revenue for the government.
- C Tax policy intended to reduce income tax on the rich may make the poor better off.
- D The government should always levy proportional rather than progressive income taxes.

[N17/P3/Q17]

24. Which tax would help a government achieve a more equal distribution of income after tax?

- A a constant rate sales tax applicable to all goods and services
- B a constant rate tax per person
- C an income tax with a constant marginal rate over the whole income range
- D an income tax with a tax-free allowance and a constant marginal rate thereafter

[J18/P3/Q18]

HELPS to MCQ

21. B In all other options marginal tax rate applies to all income levels.

22. C Options A, B & D force the people through administrative regulations.

23. C Increasing tax revenues by charging lower tax rate will enable the government to give higher benefits to people.

24. D Tax free allowance would eliminate tax burden on relatively low income groups. All other options suggest regressive taxation i.e. a higher tax burden on relatively low income groups; therefore they are likely to lead to a more unequal distribution of income after tax.

## TOPIC 2.2

### Equity and Policies towards Income and Wealth Redistribution

#### ESSAY Section

#### LIST OF QUESTIONS

Q1 (J13/P4/Q2)

(b) Discuss how a government might achieve a more equal distribution of income. [13]

Q2 (N14/P4/Q6)

My higher income will make me happier. It will make other people unhappy.

(b) Discuss whether the main aim of government policy should be to achieve a more equal distribution of income. [13]

## Question 1

Discuss how a government might achieve a more equal distribution of income. [13]

[J13/P4/Q2(b)]

## Essay

For any government whether the current distribution of income is desirable or not is a normative issue. However, if the government in the office feels that some members of society have more money than they need, whereas others struggle to afford even basic necessities then there is an unfair income inequality. Government can adopt various measures, ranging from taxation to regulation and welfare benefits, in order to redistribute income from rich to poor.

It is mainly through taxes a government collects money that it needs to pay for its expenditures. Taxes can be divided into those paid directly to the authorities (direct taxes) e.g. personal income tax, tax on capital and wealth and those paid via a middle person (indirect taxes). Indirect taxes include GST (general sales tax), excise and custom duties. A tax that raises the money by taking a larger percentage of income from the rich than the poor is called a progressive tax. Alternatively, if a larger percentage of income is taken from the poor than the rich, it is called a regressive tax and the same percentage of income paid in tax is called proportional. Thus progressive taxes have the effect of reducing inequality while regressive taxes increase it.

A government with the aim of reducing income inequality can tax the rich proportionately more than the poor in order to create vertical equity. At the same time it can enhance the personal tax allowances to ensure horizontal equity. Horizontal equity entails that the size of the allowance must vary according to the person's circumstances. Individuals with more dependents, for instance, should be entitled with higher tax allowance than the individuals with less number of dependents. Vertical equity, on the other hand, means that the burden of tax on different individuals with different income should be fair. So, the redistribution effect depends on the degree of progressiveness of the tax. The more steeply progressive they are, the bigger is the reduction in inequality.

On the other hand, taxes on goods and services are generally regressive; therefore, the government must reduce their rates. It will benefit the poor proportionately more than the rich. In order to make

them more effective the government must cut the rate mostly on those goods consumed relatively by poor people.

However using taxes to redistribute income has various limitations. First, any rigorous redistribution from rich to poor may seriously reduce growth and efficiency by undermining work incentives. Second, high taxes on the rich may encourage tax evasion or avoidance. Thus using taxes to reduce inequality involves costs.

On the expenditure side government can use a range of welfare benefits. These benefits can be in cash or in kind. Cash benefits can be further classified into means-tested or universal. Benefits such as income support, particularly transferring income from rich to poor are referred to as income targeted or means-tested benefits while universal benefits such as state pension are provided to everyone, irrespective of their incomes.

Alternatively benefits that individual receive not as direct cash payments but in the form of goods and services provided free or at subsidized rates. The two examples in most countries are education and health care.

Means-tested benefits are more efficient in terms of reducing income inequality. However the government needs to make the procedure simple to make it fully effective. Thus the government must combine progressive taxation with maximum of means-tested benefits in order to reduce income inequality.

Other policies of government may focus on increasing the earnings of those with lower incomes. One way of tackling low incomes is to enforce minimum wage rates on employers. This is seen as an indirect way of increasing incomes of low earners. However, the theory predicts that the policy might lead to an increase in unemployment as firms may choose to hire fewer workers. Similarly government may enact equal pay legislation particularly designed to raise the wages of workers who are discriminated against. Again economic theory suggests that this will have the effect as the imposition of a minimum wage. Thus there is a direct trade-off between higher pay and fewer jobs.

Alternatively government may focus on policies particularly designed to reduce unemployment. In the long term, effective policies to reduce the total level of unemployment could help reduce income inequalities. These policies include providing training in order to improve the employability of labour - so that the unemployed have the right skills to take up the available job opportunities.

Thus it follows that government needs to formulate an integrated program comprising of tax, benefits and other market oriented policies in order to reduce income inequality.

### Question 2

My higher income will make me happier. It will make other people unhappy.

Discuss whether the main aim of government policy should be to achieve a more equal distribution of income. [13]

[N14/P4/Q6(b)]

### Essay

Traditionally, main macro-economic aims of government policy can be seen as the achievement of full employment, price stability, economic growth and a balance of payments equilibrium. In addition to these governments also aim at achieving high degree of efficiency in the use of nation's scarce resources and a fairly acceptable level of distribution of income and wealth. Though not all governments will share these objectives, yet it is also true that there will be trade-offs and potential conflicts between the objectives, and different governments will attach differing priorities to them.

Firstly, it is important to keep unemployment levels as low as possible. High unemployment is expensive for the government and, therefore, for the taxpayer. For every unemployed person, there are two costs to the government. First, the unemployed workers will be entitled to benefit. Secondly, there is the less obvious cost of the loss of tax revenues, both from direct and indirect taxes, which the workers would have paid in work. Then there is the cost to the whole economy as unemployment involves a loss of potential output and hence lower living standard in general. Young unemployed workers may inflict other external costs on the society, crime for example.

Secondly, control of inflation is important because if inflation gets out of control, the economy stops growing. The authorities are forced to raise interest rates to counter inflation. At higher interest rate consumers stop borrowing to spend and firms also reduce borrowing to invest. Exports become less competitive and the economy may well drop into a recession.

Thirdly, economic growth is a measure of rate of

change of real GDP over a period of time. High rate of growth can be achieved by bringing unemployed resources at work or alternatively, by improving productivity of existing resources. Governments seek to achieve high but sustainable growth rate mainly because it leads to improved living standards and economic stability.

Fourthly, BOP is a summary of all economic transactions of a country with other nations over one year time period. A persistent BOP deficit initially results in a decline of a nation's foreign currency reserves and a run on its exchange rate. Ultimately, it necessitates borrowing and the country accumulates foreign debts, which have to be repaid with interest in future. The ideal situation represents a position where, at least over a number of years, the nation spends and invests abroad no more than other nations spend or invest in it.

In addition to these macro-economic objectives governments also aim to eliminate inefficiencies and inequitable distribution of income and wealth.

For any government whether the current distribution of income is desirable or not is a normative issue. However, if the government in the office feels that some members of society have more money than they need, whereas other struggle to afford even basic necessities then there is an unfair income inequality. Government can adopt various measures, ranging from taxation to regulation and welfare benefits, in order to redistribute income from rich to poor.

It is mainly through taxes a government collects money that it needs to pay for its expenditures. A tax that raises the money by taking a larger percentage of income from the rich than the poor is called a progressive tax and it has the effect of reducing inequalities. Thus a government with the aim of achieving equity can tax the rich proportionately more than the poor in order to create vertical equity. At the same time it can enhance the personal tax allowances to ensure horizontal equity. However higher tax rates can create a disincentive effect and therefore can reduce the level of consumer spending and investment leading to a fall in growth rate and a rise in unemployment.

Practically, the objectives are determined by the political ends of the government. But in theory, at least, it depends on the current state of the economy. In times of recession, for instance, the priority objectives are growth and unemployment rather than more equal distribution of income. In times of high growth rate, however, government can adopt the policies to redistribute income and wealth.