HL IB Economics

Your notes

2.12 The Market's Inability to Achieve Equity

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Free Markets & Capitalism Cause Inequality

- **Capitalism** describes when **factors of production** such as capital are privately owned and workers are **paid wages by the owners of the capital**
  - Economies such as the United States and Singapore are classified as having some of the most capitalist economies in the world

- A **free market occurs when** the **price mechanism** determines the allocation of resources without any government intervention
- The free market can lead to **unequal distribution of income and wealth**
- Income can be classified as;
  - **Household income** – income of individuals
    - Income can be acquired in the form of wages and salaries, rent, interest and profit
  - **National income** – income of the whole economy

How Capitalism can Cause Inequality

1. Inheritance

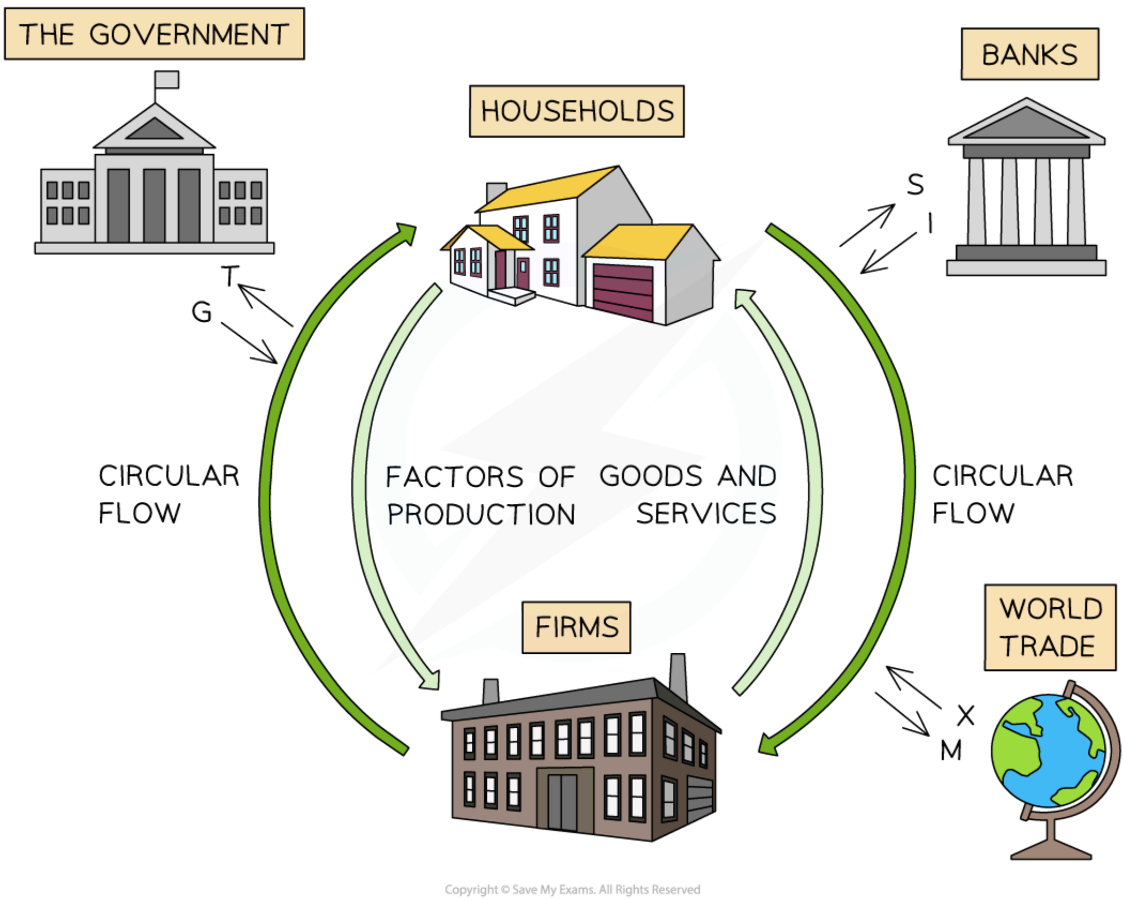
- Income and wealth can be **passed from one generation to another**
- If individuals and families have access to high levels of income and wealth, then they will have access to **better quality goods/services** such as education and healthcare
- This can also create inequality of outcomes such as **access to good schooling**

2. Access to Capital

- **Wealthier individuals** will be able to **purchase factors of production** such as land and capital **to set up businesses**
  - Business assets generate income in the form of **profit and dividends**
  - This allows these individuals to generate more wealth and income
  - A principle of capitalism is that individuals are **motivated by the profit incentive**

Using the Circular Flow to Explain the Reasons for the Inequality

- The **circular flow of income** helps us understand how income is generated, distributed, and spent in an economy
- Inequality in income arises from **differences in earning capacity, ownership of productive assets,** and the distribution of income sources
- Understanding these dynamics can **inform policy interventions** aimed at addressing income inequality and promoting more equitable outcomes



The circular flow of income in an open economy

- By analysing the circular flow of income, we can identify factors that contribute to income inequality

1. Households as earners and consumers

- In the circular flow model, **households are the primary source of labor and other factors of production**
  - They provide labor to businesses in exchange for wages, salaries, interest and rent
  - Households also consume goods and services produced by businesses, thereby spending their income
  - Not all households have **equal access to job opportunities or income-earning assets**, leading to differences in their earning capacities

2. Businesses as employers and producers

- Businesses employ the labor and other inputs **provided by households** to produce goods and services
  - In return, they pay wages, salaries, interest and rent to households
  - Businesses **generate revenue** from the sale of their products/services
  - Part of the profits are used to cover costs and the rest is profit

3. Income distribution

- The income earned by households includes **wages (and salaries), profits, interest, and rent**
- Income inequality arises from **differences in the distribution** of these sources of income
- Higher-skilled jobs tend to **command higher wages**, leading to income disparities **between different occupations**
- Ownership of capital assets (such as stocks, real estate, or businesses) can generate significant income for some households, while others **may rely solely on wages**

4. Saving, investment, and wealth accumulation

- Households have the option to **save a portion of their income**
- Households which are able to save **can invest n various assets** such as stocks, bonds, or real estate
- Over time, the accumulation of wealth through investment can **lead to further income inequality**

Using the Circular Flow to Explain How Governments Reduce Income Inequality

- **The circular flow of income model** can help us understand **how governments can intervene to reduce income inequality** within an economy

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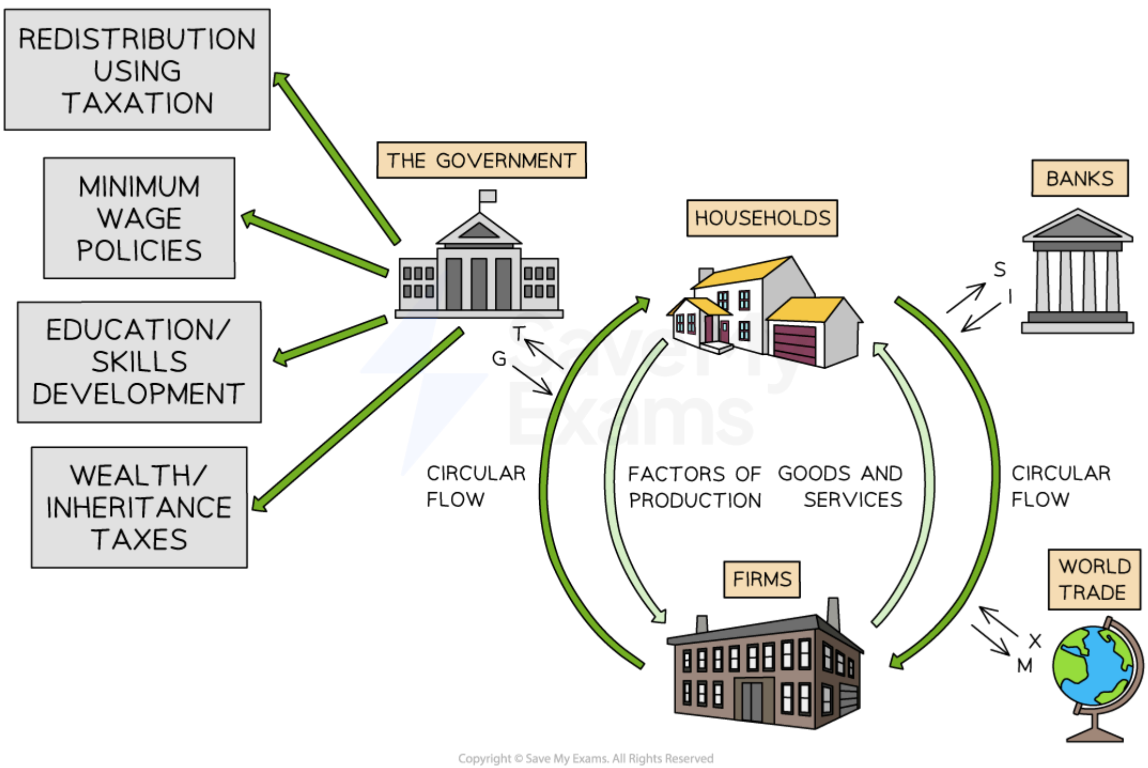
- Specific policies and their effectiveness in reducing inequality can vary across countries and contexts
- Governments need to consider a range of factors, including **economic conditions, political considerations,** and **societal preferences** when designing and implementing measures to address income inequality



The government is able to intervene in the circular flow in several ways so as to reduce income inequality

1. Redistribution through taxation

- Governments can use **progressive taxation** policies to reduce income inequality
- The additional tax revenue generated from the wealthy can be **used to fund social welfare programs** or invest in public goods and services that benefit lower-income groups
- By redistributing income through taxation, governments can **narrow the income gap** between the rich and the poor

2. Minimum wage policies

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- Governments can establish **minimum wage** regulations
- By ensuring that workers earn a certain **minimum income level,** fairer wages are paid and workers in some industries receive higher wages than they would have
- This helps to reduce income inequality

3. Education and skills development

- Governments can invest in education and skills development programs to **enhance human capital** and **improve income opportunities** for individuals from disadvantaged backgrounds
- By ensuring equal access to quality education or vocational training, governments can equip individuals with the skills and knowledge necessary to **secure higher-paying jobs**
- This will increase their earning potential

4. Labor market regulations

- Governments can implement labor market regulations to **protect workers' rights**, promote fair employment practices, and **reduce income disparities**
- These regulations may include laws on working conditions, overtime pay, anti-discrimination measures, and **collective bargaining rights**
- This can help create a more level playing field for workers and reduce income inequality stemming from **unchecked capitalism**