Course: Economics I (macroeconomics)

Study text

12th Chapter

Income Policy

Author: Ing. Vendula Hynková, Ph.D.

12 Income policy

This chapter will deal with the possibilities of state income policy. Tools of income policy can be also used to influence macroeconomic variables. The basic objectives and instruments of income policy will be defined; the main attention will be focused on the measurement and display of inequality in the distribution of income among different groups of households, on the importance of secondary distribution or redistribution and on role of social policy in achieving the overall objectives of macroeconomic policy.

Also, through the income policy the main macroeconomic variables - employment and price level may be affected. Income policy can be defined as a wage or price policy because it can influence the amount of wages (input prices) and indirectly the price level.

12.1 Objectives and instruments of income policy

In an inflationary environment, it is possible to stabilize the price level through the instruments of the income policy. Governments could take this step if restrictive fiscal and monetary policies fail to reduce the increasing price level. These tools affect hardly the market mechanisms (market pricing and wages), therefore, reaps usually considerable criticism. We can appoint *these tools of the income policy* to preserve price stability:

- ***wage freeze*** – it is a tool of the government to restrain cost-push inflation, it means fixing of wages at a particular level approved by the Parliament and it is a hard instrument restraining the function of the market principle; although, the wage freeze is also defended by firms at the time of the unfavorable economic situation (recession) and trade unions play the role in negotiating about wage setting;

- ***statutory wage limits*** – we distinguish between absolute and relative wage limits; they mean limited freedom of movement in wages upwards; the absolute statutory limits are defined as the amount by which wages can be increased and the relative statutory limits reflect the percentage increase that is possible; employees can perceive the statutory limits as a requirement to increase their salaries;

- ***voluntary wage levels*** - these levels are not set by a legal norm and their character is only recommendatory.

Among other instruments we can appoint setting a minimum wage rate, regulating salaries in the public sector, price regulation of selected goods and services.

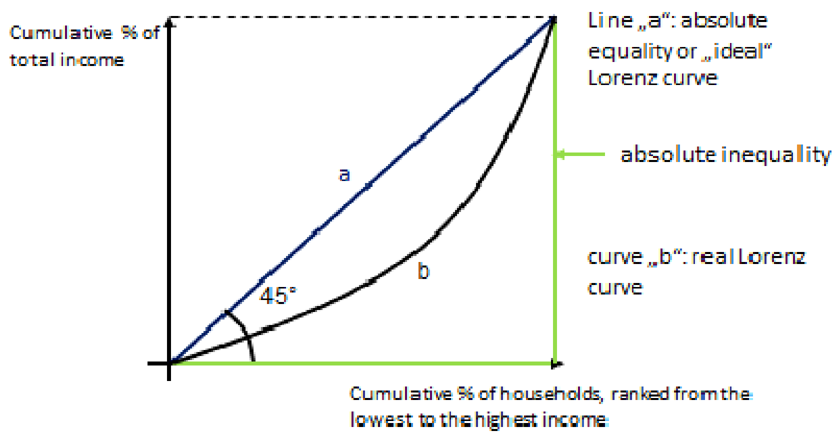
Opinions how to use various tools of the income policy are not uniform. The whole income policy is very questionable. Individual approaches attach different weight to income policy, set various tools and different goals. Economists agree in opinion, if wage increase do not cause the inflation, it must be accompanied by adequate growth of real output.

12.2 Problems and measurement of inequality in the distribution of household income

Income policy also addresses the issue of inequality in income. The initial distribution of income among households is affected by a number of circumstances. The mere fact that households own a different number of inputs, leads to inequalities in their income. The fact, that incomes are distributed via the market, is not a problem in terms of macroeconomic theory. The problem arises when workers are discriminated against and do not receive incomes they deserve. Most economists agree the opinion that it is necessary to address situations where the primary distribution of income causes some social hardships.

In economics, there are tools to measure inequality of income distribution (here we mean particularly the labor income). These inequalities can be captured using the Lorenz curve and Gini coefficient. In figure 12.1 the horizontal axis represents the households as income recipients, sorted by households with the lowest incomes to the highest, and the vertical axis represents their incomes received. Each point on the curve tells how the relevant percentage shares of the total household income. The line “a” represents the situation of absolute equality of income distribution and is referred to as the “ideal” Lorenz curve. It has its explanatory power and the adjective “perfect” here does not mean that such a distribution at all times desirable. Its counterpart is the absolute inequality shown by two lines - by the horizontal axis and the vertical line based on the last household (or group of households with all incomes). The actual Lorenz curve “b” is somewhere between these extremes.

Fig. 12.1 Measurement of inequality in income using the Lorenz curve and the Gini coefficient



Gini coefficient (G) is determined by the area under the real (actual) and the ideal Lorenz curve. If the content area under ideal Lorenz curve denoted with the letter A and the content area below the real (actual) Lorenz curve denoted B, then the calculation of the Gini coefficient is G = (A - B)/A. It takes values from zero to one. The maximum value of one (100 %) means absolute inequality of income distribution. Conversely, a value of zero (0 %) could be in the situation of an egalitarian distribution of income (ideal and real Lorenz curve would be merged).

We can find statistics about Gini coefficient (index) on the website of the World Bank (*http://data.worldbank.org/indicator/SI.POV.GINI*), where we have to notice the year of Gini index´s publication when comparing the percentages of individual states.

12.3 Primary and secondary distribution of income

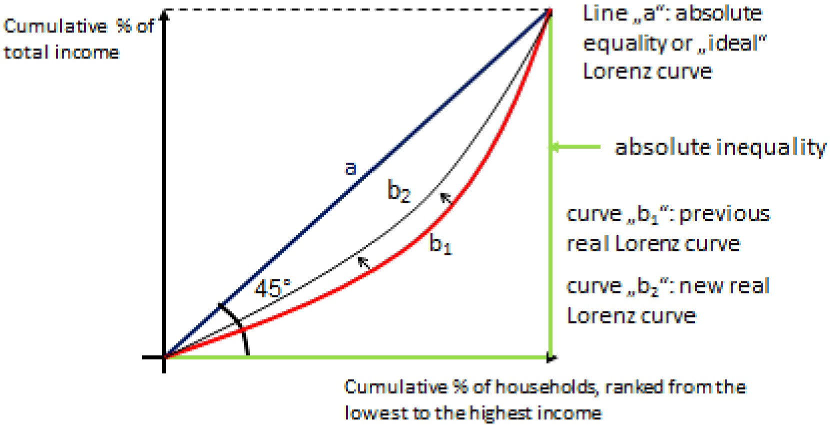
The initial distribution of incomes is the result of market mechanism. Households own the factors of production and receive wages, profits, interests and rents. We are talking about a market distribution of incomes.

In contrast to the initial distribution of income, there is also secondary distribution of income or **"redistribution"** that takes place through the state budget, social security and health insurance and municipal budgets.

The issue of income redistribution is a task of the state social policy that seeks how to reduce disparities in income among residents. We must point out the risks of area and generous social programs, reducing work effort, and causing inefficiency in the economy.

Using the tools of macroeconomic policy the state could reduce disparities in the distribution of the total income for each household group. Using the tools of fiscal policy, such as the implementation of progressive income taxation or increasing progression in this type of taxation, or through generous transfer payments for households from the state budget, may affect the position of the actual Lorenz curve. In this case, as can be seen in Figure 12.2, the actual curve Lorenz curve "b" is shifted towards the ideal Lorenz curve from position "b_1" to "b_2". Gini coefficient (G) is reduced and also the area (A - B).

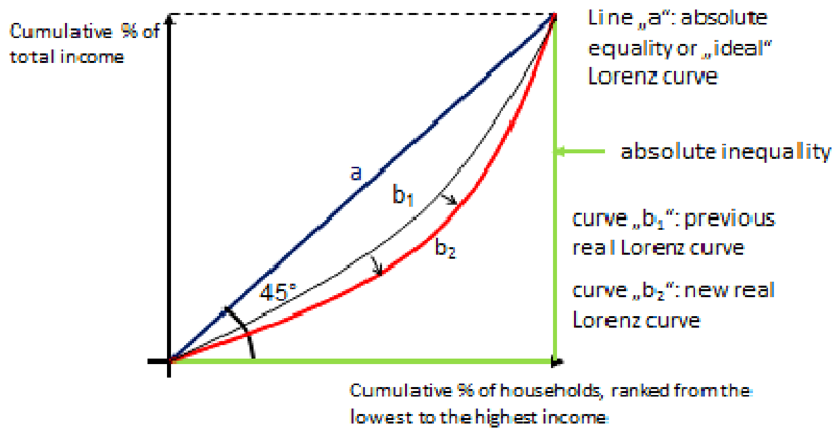
Fig. 12.2 Effect of macroeconomic policy on the position of the Lorenz curve (by reducing disparities in incomes).



The question of how to choose the degree of redistribution is very questionable, and usually there is no consensus in opinion of political parties. Most economists agree the approach that significant differences in the income distribution among various groups of households are not desirable. They realize the importance of induced consumption in an economy that depends on the amount of disposable incomes for households, and the importance of investment activity that can be increased due to growth in total domestic consumption. In the opposite trend, households with moderately high earnings are disappearing gradually and poorer households have to restrict their consumption induced.

The location of Lorenz curve does not change only due to changes in the settings of the instruments of fiscal (and social) policies, but also due to the overall changes in the structure of economic activities (regime change). After the 1989 revolution (in the Czech Republic) the central planning has changed in managing the economy through market principles. Private property was restored and anyone could start a business. The market mechanism started to set incomes for households. What happened to the Lorenz curve from 1989 to the present (2014), describes Fig. 3.12. Original Lorenz curve „b_1“ of 1989 has moved further away from the ideal Lorenz curve „a“ to „b_2“. This fact can be confirmed by statistics of the Gini coefficient for the Czech Republic, reported on the WB official website.

Fig. 12.3 Effect of changes in economic coordination on the position of the Lorenz curve for the Czech economy



Inequalities in the income distribution could be deepening during economic recessions (contractions), when declining disposable incomes for households due to decline in real output and an increase in the cyclical component of unemployment.

References:

FRANK, R. H., BERNANKE, B. S. *Principles of Macro-economics.* 3rd Edition. NY: McGraw-Hill/Irwin, 2007. 561 p. ISBN 978-0-07-325594-1.

FUCHS, K., TULEJA, P. *Principles of Economics.* 2nd expanded edition. Prague: Ekopress, 2005. 347 p. ISBN 80-86119-74-2.

HOLMAN, R. *Economics.* Fourth updated edition. Praha: CH Beck, 2005. 710 p. ISBN 80-7179-891-6.

HYNKOVÁ, V., NOVÝ, J. Macroeconomics I - for Bachelor, Part I. 1st ed. Brno: University of Defence, 2008. 125 p. ISBN 978-80-7231-278-8.

HYNKOVÁ, V., NOVÝ, J. Macroeconomics I - for Bachelor, Part II. 1st ed. Brno: University of Defence, 2009. 82 p. ISBN 978-80-7231-578-9.

HYNKOVÁ, V., NOVÝ, J. Macroeconomics I - for Bachelor, Part III. 1st ed. Brno: University of Defence, 2010. 75 p. ISBN 978-80-7231-734-9.

LIPSEY, R. G., CHRYSTAL, K. A. *Economics.* Tenth edition. Oxford, NY: Oxford University Press Inc., 2004. 699 p. ISBN 978-0-19-925-784-1.

MANKIW, G. N. *Principles of Economics.* 2nd edition. South-Western Educational Publishing, 2000. 888 p. 978-0030259517.

MANKIW, G. N. *Essentials of Economics.* Prague: Grada Publishing, 2000. 763 p. ISBN 80-7169-891-1.

McCONNELL, C. R., BRUE, S. L. *Macroeconomics: Principles, Problems, and Policies.* 7th ed. McGraw-Hill, Irwin, 2007. 380 p. ISBN 978-0-07-110144-6.

SAMUELSON, P. A., NORDHAUS, W. D. *Economics.* 15th ed. McGraw-Hill, 1995. 1013 p. ISBN 0-07-054981-9.

SCHILLER, B. R. *The Macro Economy Today*. 13th edition. McGraw-Hill, 2013. 544 p. ISBN 978-0077416478.