<u>Assess the economic benefits and costs of Government Intervention which aims to make the distribution of income CONSIDERABLY more equal.</u>

Market failure occurs when the free market fails to allocate resources in the most efficient manner and therefore the government intervened in order to correct this market failure. Income is a flow of earnings generated or received over a period of time. Income inequality is often seen as market failure and thus there are many different approaches that the government can take in order to try to redistribute income more equally. They could simply introduce welfare-to-work strategies or increase benefits in kind; however, to make a more dramatic impact they would have to change the welfare benefit structure or tax structure.

Welfare benefits are cash payments to those entitled to it, also called transfer payments. They can be universal or means tested. If they are universal, it means that everyone is entitled to it, irrespective of income. For example, JSA and child benefits are universal benefits. Means tested benefits are targeted at those entitled to it. Entitlement depends on financial circumstances, i.e. income and savings, examples are income support, housing benefit and EMA. Means tested benefits are an effective way of redistributing income in the short term as they are targeted at specific groups. Universal benefits are therefore less effective as they are not targeted at those who need them. However, there are disadvantages implicated with using benefits to redistribute income. Firstly, they are not a long term solution and can be a disincentive to work. Benefit fraud can be a huge problem as they also cost the government a huge amount.

The other primary method the government uses is by changing taxes. There are 2 types of taxes, direct taxes are a tax on income that are progressive, so as income rises, a higher proportion is paid. Indirect taxes are taxes on consumption. They are regressive, so as income falls, a higher proportion is paid, which is deemed to be unfair.

In order to narrow income inequality, the government could raise taxes for higher income earners. By raising taxes, the government is able to redistribute income by spending the money on education, training and buildings etc that people on lower incomes can use – it is redistributed in an indirect way. However this may have the effect of people working less due to the back-bending labour supply curve as shown below.

The supply curve above shows the optimum level of taxation with the maximum level of hours worked. If the level of tax is risen, then output will fall, and also if the level of taxation falls, due to the theory of the substitution effect. A real example of a change in direct taxes, however had the reverse effect, was the removal of the 10p tax band in 2008, which will have the effect of raising poverty as the poorest sector of society will now have to be paying a higher level of tax than previously. This will have negative effects on society by widening income distribution and also creating disincentives to get out of the poverty and unemployment traps.

By lowering indirect taxes, income distribution will also narrow. The main sources of indirect taxation are VAT and specific unit duties. The main economic argument towards raising these is that it creates incentice to work by reducing income tax as a consequence. However, as they are regressive, this will widen the distribution of income. Therefore, lowering indirect taxes will temporarily narrow distribution, however it affects everyone so is not overall going to be that effective.

Therefore the most significant benefit of increasing welfare benefits to narrow income distribution is that in the short term, it will be effective, however the greatest disadvantage is that in the long term it will not be effective as is likely to act as a disincentive to work. The greatest advantage of changing the UK tax structure to narrow income distribution is that it is a long term solution. By lowering income tax to the lowest band of income earners will significantly increase their income and thus narrow distribution. However, by lowering income tax, the government may have to raise indirect, regressive taxes, which will not help the lower income earners, taking up more of their disposable income. Having weighed up the benefits and costs of both methods, a change of the tax structure in the UK is the best long term solution to equalise the distribution of income in the UK with the least amount of costs to society.