14.1 Efficiency and Equity

1. *(Efficiency / Equity)* is achieved when total social surplus is maximised.

2. The issue of equity is about the fairness of distributing income or output. It *(involves / does not involve)* value judgements.

14.2 Measuring Income Inequality

3. Income distribution can be presented in two ways: by monthly individual or household income, and by decile group.

4. If percentage of the total income earned by the higher income decile groups increases while that earned by the lower income decile groups decreases, this means that income distribution becomes more *(even / uneven)*.

5. The Lorenz curve expresses the relationship between the cumulative percentage of households and the cumulative percentage of income.

6. Refer to the following diagram. Line A is called the line of perfect income inequality, while line B is called the line of perfect income equality.

7. When the income of an economy is distributed more evenly, the Lorenz curve will be closer to *(the line of perfect income equality / the line of perfect income inequality)*.

8.

$$\text{Gini coefficient} = \frac{\text{Area between the line of perfect income equality and the Lorenz curve}}{\text{Area under the line of perfect income equality}}$$

9. The value of Gini coefficient ranges between zero and one. The higher the value, the more *(even / uneven)* the income distribution is.

14.3 Sources of Income Inequality

10. Basically, household income is affected by three major factors:

- income from providing human effort (wage income)
- income from holding assets (capital income)
- government taxes and transfers

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11. Which of the following events will widen the income gap among individuals?

☑ The stock market is bullish.

☑ There is a decrease in the basic allowance of the salaries tax.

☐ There is an increase in the amount of transfer payment to the poor.

☑ There is a decrease in the progressivity of the salaries tax.

14.4 Two Principles of Equity

12. Equalising income is an idea of fairness which seeks to reduce or eliminate differences in income among individuals or households in an economy.

13. Equalising opportunities is an idea of fairness that ensures different people in similar situations are treated similarly.

14. Determine if each of the following policies help equalise income or equalise opportunities.

Policy	Equalising income	Equalising opportunities
(a) imposing a new tax on luxury goods	✓	
(b) providing grants for post-secondary students		✓
(c) building more public housing	✓	
(d) enforcing new laws to prevent employment discrimination		✓

15. Imposing taxes or providing benefits to reduce income inequality may have adverse effects, such as disincentive on working, saving and investment.

14.5 Trade-off between Equity and Efficiency

16. Trade-off between equity and efficiency often exists.

- If a government adopts policies that redistribute income from the rich to the poor, such policies *(raise / lower)* the incentive to seek a higher income. In this case, we give up *(equity / efficiency)* in exchange for *(equity / efficiency)*.
- If a government adopts policies that encourage competition in the market, the policies may worsen income inequality. In this case, we give up *(equity / efficiency)* in exchange for *(equity / efficiency)*.

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