

# ELECTION ANALYSIS

## **Inequality: Still Higher, But Labour's Policies Kept it Down**

- Overall income and wage inequality has risen dramatically in the UK over the last three decades. Although the fastest increase was during the 1980s, there was still some (small) increase after 1997.
- In 1979, a man in full-time work at the 90<sup>th</sup> percentile (10% from the top of the distribution) earned 2.5 times more per week than a man at the 10<sup>th</sup> percentile (10% from the bottom of the distribution). In 2009, the equivalent figure was 3.7 times more per week.
- The increase in wage inequality between 1980 and 1990 was much stronger in the UK and the United States than elsewhere. Since 2000, there have been increases in inequality across all richer countries (except France).
- Inequality is a tale of two halves. The top half of the wage distribution has continued to become more unequal steadily throughout the last three decades. The bottom half of the wage distribution ceased to become more unequal after 1997.
- The top 1% of the population has become considerably richer and this has had a large effect on the 'Gini coefficient', a widely used measure of overall inequality. In the decade since 1998, most of this change has been driven by the financial sector, especially bankers' bonuses.
- The changes in tax and spending policies that the Labour government has introduced since 1997 have significantly redistributed income to the less well off. Inequality would have been much higher otherwise.

## Introduction

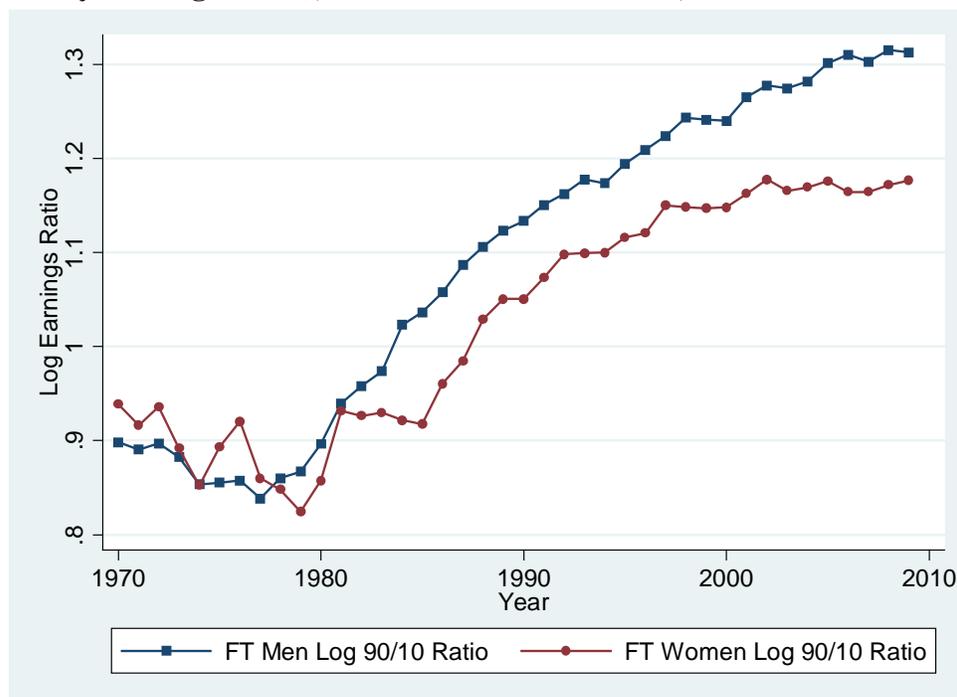
The Labour party came to power in 1997 partly in response to the sense that inequality had risen too much under 18 years of Conservative rule. So it must have been deeply shocking to many in the Labour party when David Cameron announced during the 2009 Conservative party conference that inequality had risen since 1997.

So what has happened? Individuals' pre-tax and benefit incomes mainly come from their activities in the labour market – that is, their wages. The government has some influence on these sources, for example, through minimum wage policies. But the government has a much greater influence through changing the tax and benefit system, which generally redistributes towards the poor and away from the wealthier.

## The rise in UK wage inequality: a tale of two halves

Figure 1 displays the evolution since 1970 of the 90-10 earnings differential for men and women in full-time work. The figure of 0.9 in 1979 means that a man at the 90<sup>th</sup> percentile (just in the richest tenth of workers) earned 2.5 times (0.9 log points) more than a man at the 10<sup>th</sup> percentile (just in the poorest tenth of workers). By 2009, the richer man would earn 3.7 times (1.3 log points) more than the poorer man.

**Figure 1: Difference in wages between the richest tenth and poorest tenth (90-10 log weekly earnings ratios), full-time men and women, 1970-2009**

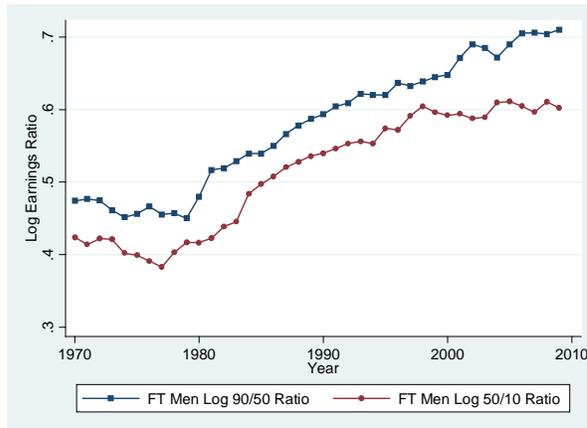


Source: Machin (2010): National Equality Panel Analysis; 1968-96 New Earnings Survey (NES) and 1997-2009 Annual Survey of Hours and Earnings (ASHE)

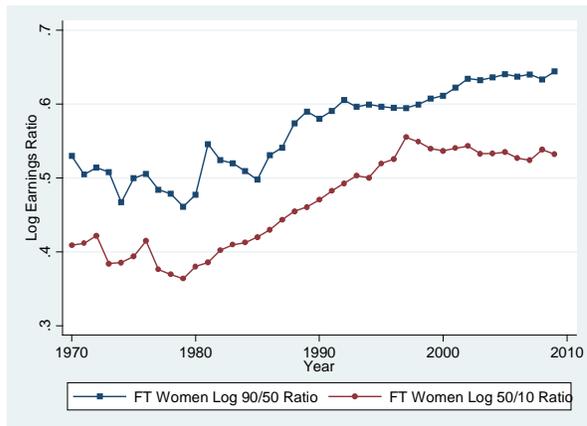
Figure 2 considers the upper and lower halves of the distribution separately. For men, the top half of the wage ladder (measured by the 90-50 wage ratio) rises sharply from the late 1970s, and this continues consistently throughout the entire period up until 2009. By contrast, the bottom half of the wage distribution (measured by the 50-10 wage ratio) increases until the mid-1990s and then flattens out.<sup>1</sup> The story for women from Figure 1 and 2 is similar to that for men, although the rise in inequality is more muted.

**Figure 2: Upper half (90-50 log earnings ratio) and lower half (50-10 log earnings ratio) inequality, full-time men and women, 1970-2009**

**a) Men**



**b) Women**



Source: Machin (2010)

<sup>1</sup> Similar patterns are evident in other data sources. Brewer et al (2009) find that in the 2000s, the Family Resources Survey suggests that the 50-10 differential is constant for full-time men and actually falls by 0.3 percentage points a year (up to 2008) for full-time women.

## After 1990, wage inequality rises throughout the richer countries

Table 1 shows data on male 90-10 wage ratios in 1970, 1980, 1990, 2000 and 2008 (or the closest year to that) for 12 countries. As is well known, during the 1980s, the United States and the UK stand out as having a very large increase in wage inequality.

By contrast, over the period 1990-2008, *every* country has experienced some increase in wage inequality (with the exception of France). Although the UK has the third highest level of inequality at the end of the period, the magnitude of the increase in pay gaps since 1990 is in line with the OECD averages.

**Table 1: Male 90-10 wage ratios across countries, 1970-2008**

	1970	1980	1990	2000	2008
Australia	2.4 <sup>a</sup>	2.7	2.7	3.1	3.5
Denmark		2.1	2.2	2.5	2.7 <sup>e</sup>
Finland	-	2.5	2.5	2.4	2.6 <sup>c</sup>
France	3.7	3.3	3.3	3.0	2.9 <sup>d</sup>
Germany	-	2.5 <sup>b</sup>	2.5	2.8	2.9 <sup>d</sup>
Japan	2.6 <sup>a</sup>	2.6	2.8	2.8	2.9
Netherlands	-	2.3 <sup>b</sup>	2.5	2.9	2.9 <sup>d</sup>
New Zealand	-	2.2	2.5	2.7	3.1
South Korea	-	4.1 <sup>b</sup>	3.2	3.7	4.7
Sweden	2.2 <sup>a</sup>	2.1	2.1	2.4	2.4 <sup>c</sup>
UK	2.7	2.7	3.3	3.4	3.7
United States	3.4	3.6	4.4	4.8	5.0

Source: OECD Stat Extracts website, <http://stats.oecd.org/index.aspx>. Data are from different years to the column header for some countries a – 1975; b – 1984; c – 2004; d – 2005; e – 2007

This suggests that there are similar global underlying forces driving up inequality. The fact that the supply of education has risen alongside increased wages for the university educated indicates that there has been an increase in the demand for skills. The obvious culprits are new technologies, which skilled workers find easier to use, or increased competition with developing countries like China.

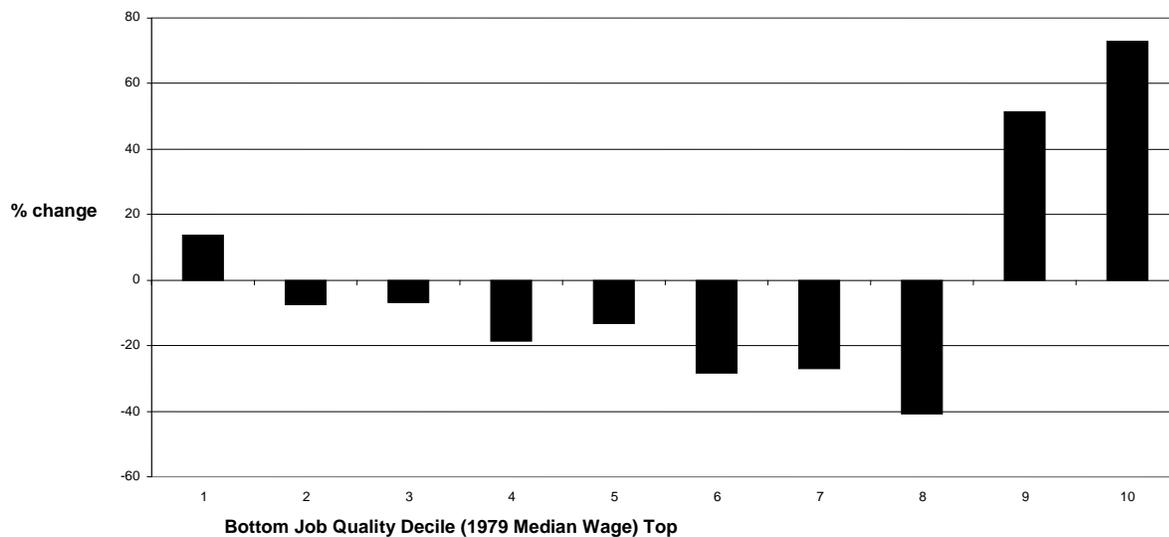
Machin and Van Reenen (1998, 2008) have argued that increases in the demand for skills are mainly due to new technologies, such as information and communication technologies (ICT). For example, throughout the developed world, the industries that have experienced the greatest increase in the demand for skills are also those that invested the most in ICT, not those with the greatest exposure to trade (Michaels et al, 2010).

On top of these structural factors, labour market policies can make a difference. The decline in unions and the fall in the real value of the minimum wage undoubtedly accelerated the increase in inequality in the United States and the UK in the 1980s. Similarly, the introduction of the UK's first National Minimum Wage in 1999 helped those near the bottom of the wage ladder.

### Polarisation

Figure 3 shows that increasingly, the middle group of workers is losing out to those at the bottom end and the top end. There is very rapid employment growth over time in the top two deciles of job quality (as measured by median occupational wages in 1979). Employment actually fell in the middle deciles but grew in the bottom decile.

**Figure 3: Polarisation of the UK labour market, 1979-2008**



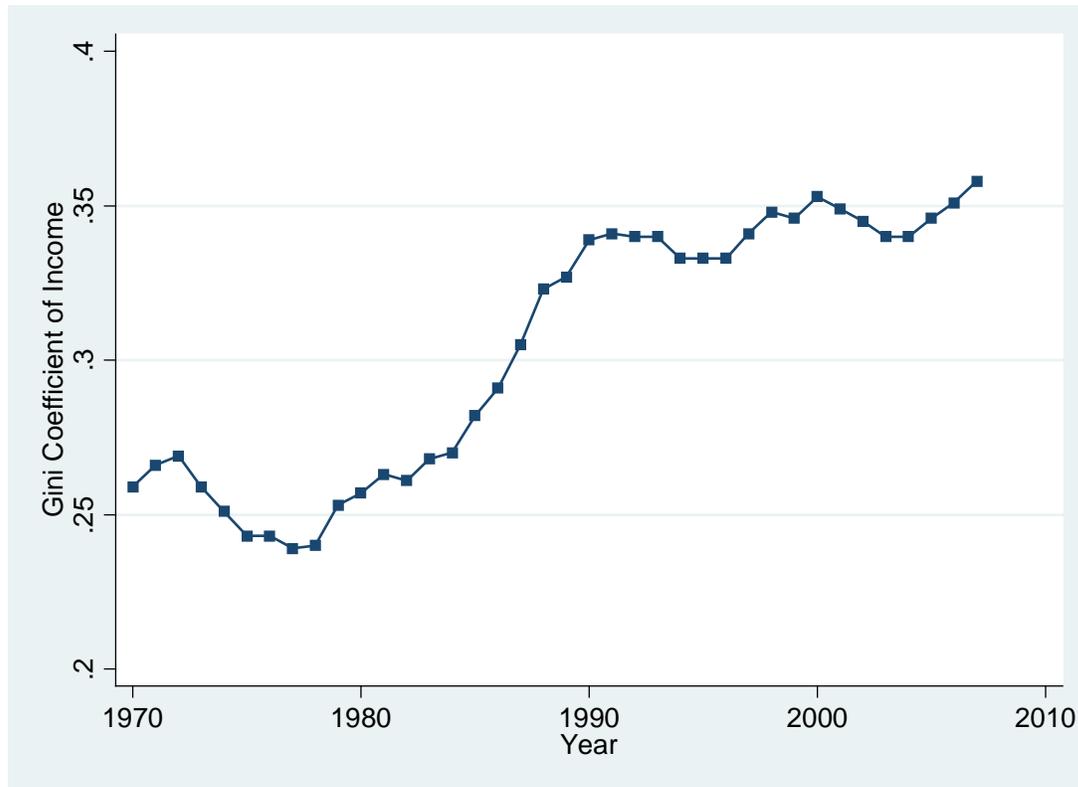
Source: Mieske (2009); percentage changes are for the entire period

### Household income

Household net income is a better measure than wages of the resources available to families for consumption (for example, it takes taxes and benefits into account). Figure 4 shows the trends for the Gini coefficient, which is an overall measure of inequality equal to 1 for complete inequality and zero for complete equality. Like wages, this shows some edging up of inequality under Labour, but nothing like the huge rise in the 1980s.

The Gini coefficient is heavily influenced by income growth among the top 10% of the distribution, and with more rapid income growth the higher the percentile point. Bell and Van Reenen (2010) show that the richest 1% of the population have increased their share of total income from 10% to 13% between 1998 and 2008, and this was mainly due to bonuses for financial sector workers.

**Figure 4: Trends in household income inequality, 1979-2008, Gini coefficient**



Source: IFS, <http://www.ifs.org.uk/bns/bn19figs.zip>, as used in Figure 2.13 of NEP (2010)

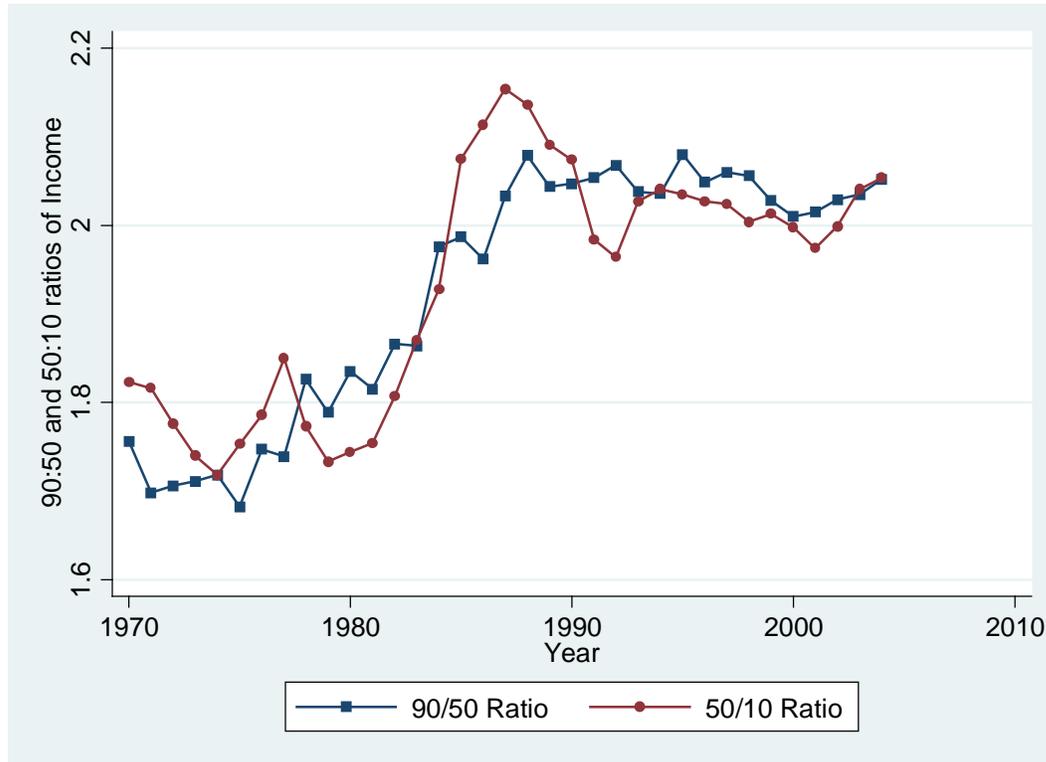
Figure 5 splits the income inequality trends into upper and lower halves, as Figure 2 did for wages. Unlike wages, the difference between the top half of the household income distribution did not continue to rise after the 1980s; in fact, it seemed to fall somewhat from the mid-1990s. Could Labour’s policies be having a redistributive effect, mitigating the secular increase in wage inequality?

**What has been the effect of Labour on inequality?**

The fact that inequality of the bottom half of the wage distribution and top half of the income distribution stopped growing after 1997 is suggestive of a policy shift. In terms of low wages, the main effect is likely to have been the National Minimum Wage

introduced in 1999, which appears to have had a large effect in raising the wages of low earners without many appreciable negative effects on jobs (see Stewart, 2010).

**Figure 5: Household income, trends in household upper half (90-50) and lower half (50-10) income inequality, 1970-2008**



Source: IFS, <http://www.ifs.org.uk/bns/bn19figs.zip>, as used in Figure 2.13 of NEP (2010)

For net household income, there have been many policies aimed at redistribution:

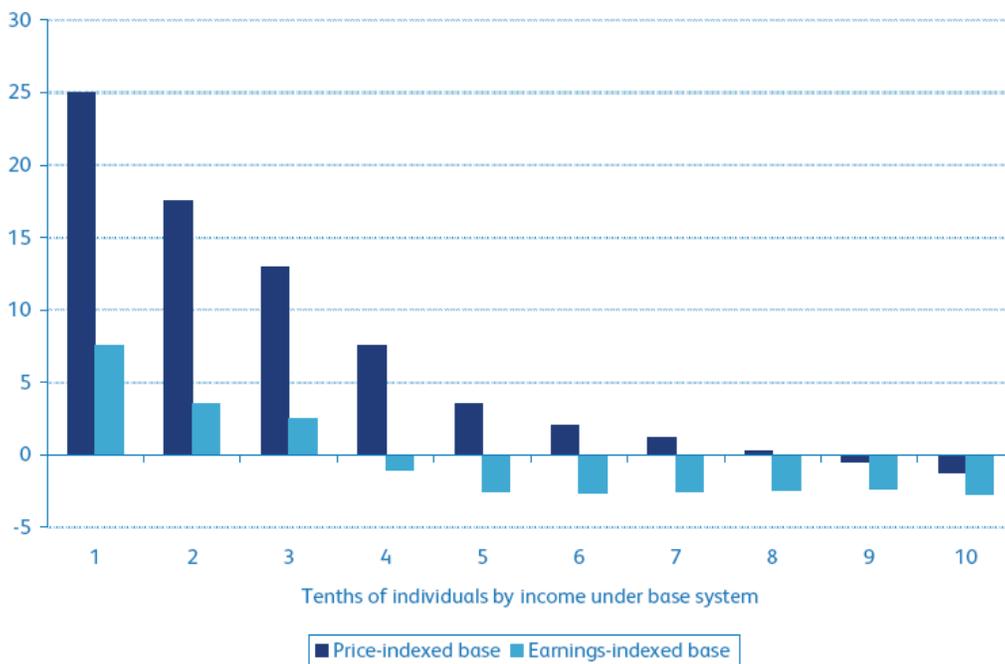
- the working families tax credit (now the Child and Working Tax Credits), an in-work benefit;
- increases in benefits levels, especially for families with children such as lone parents;
- increases in taxation on the relatively better off, such as the abolition of the upper earnings limit for individual National Insurance;
- more generous increases in pensions (for example, the Pensions Credit);
- and expansion of personal allowances, which disproportionately benefits those on lower earnings.

It is complex to factor in all these changes, but the report of the National Equality Panel (2010) attempted to do so. Figure 6 illustrates what the overall distributional effects of tax and benefit policy changes have been comparing 2008 with 1997.

This is done by making an assumption about how policies would have evolved in the absence of the Labour government. The net effect of changes introduced by the previous Conservative policies 1979-97 was to redistribute income towards richer groups (for example, the reduction of the highest 60% marginal rate of taxation to 40%).

But a fairer benchmark is perhaps to assume that benefits would simply have risen with prices. The darker shaded columns show that the sum of Labour’s policies implies substantial increases in distribution towards poorer people. The bottom tenth is 25% better off under Labour’s policies than they would have been under the ‘business as usual’ case of benefits simply rising with prices.

**Figure 6: Overall distributional effects of Labour’s tax benefit policies 1996/97 to 2007/08 compared with price and earnings indexation (percentage change in disposable income)**



Source: Sefton, Hills and Sutherland (2009), figure 2.5.

An alternative benchmark would be to assume that benefits rose in line with wages. This certainly has not been the stated aim of the Conservatives, but may be more realistic. This is shown in the lighter shaded columns in Figure 6. There is also much redistribution, but in this case the costs to the richer are greater and the benefits to the poorer are smaller.

Figure 6 does not include the withdrawal in personal allowances for those earning over £100,000 nor the new 50% tax rate on those earning over £150,000 (beginning April

2011). Although these changes only affect 2% of households, if these were also factored in, then there would be much larger losses for the top decile and even more redistribution.

## **Conclusions**

Overall wage and income inequality rose slightly under the Labour government since 1997. This was driven by the top half (especially the top 10%) of the income distribution. There was no change in inequality (and even falls on some measures) for those in the bottom half of the distribution.

The increase in wage inequality is an international phenomenon driven by increases in the demand for more skilled workers. There is relatively little that any government can do about this in the long term: the best policy is to keep improving the skills of the workforce through education and training.

The tax and benefit policies of the Labour governments have meant that inequality is considerably lower than it would have been under the previous Conservative administration, especially for those in the bottom 20%.

But since the inequality 'escalator' of pre-tax earnings has been moving upwards, the policies have at best kept inequality stable rather than significantly reducing it.

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### ***For further information***

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