PAPER **EA030**

CENTRE *for* ECONOMIC PERFORMANCE

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

A series of background briefings on the policy issues in the May 2015 UK General Election

#ElectionEconomics

Inequality: Are we really 'all in this together'?

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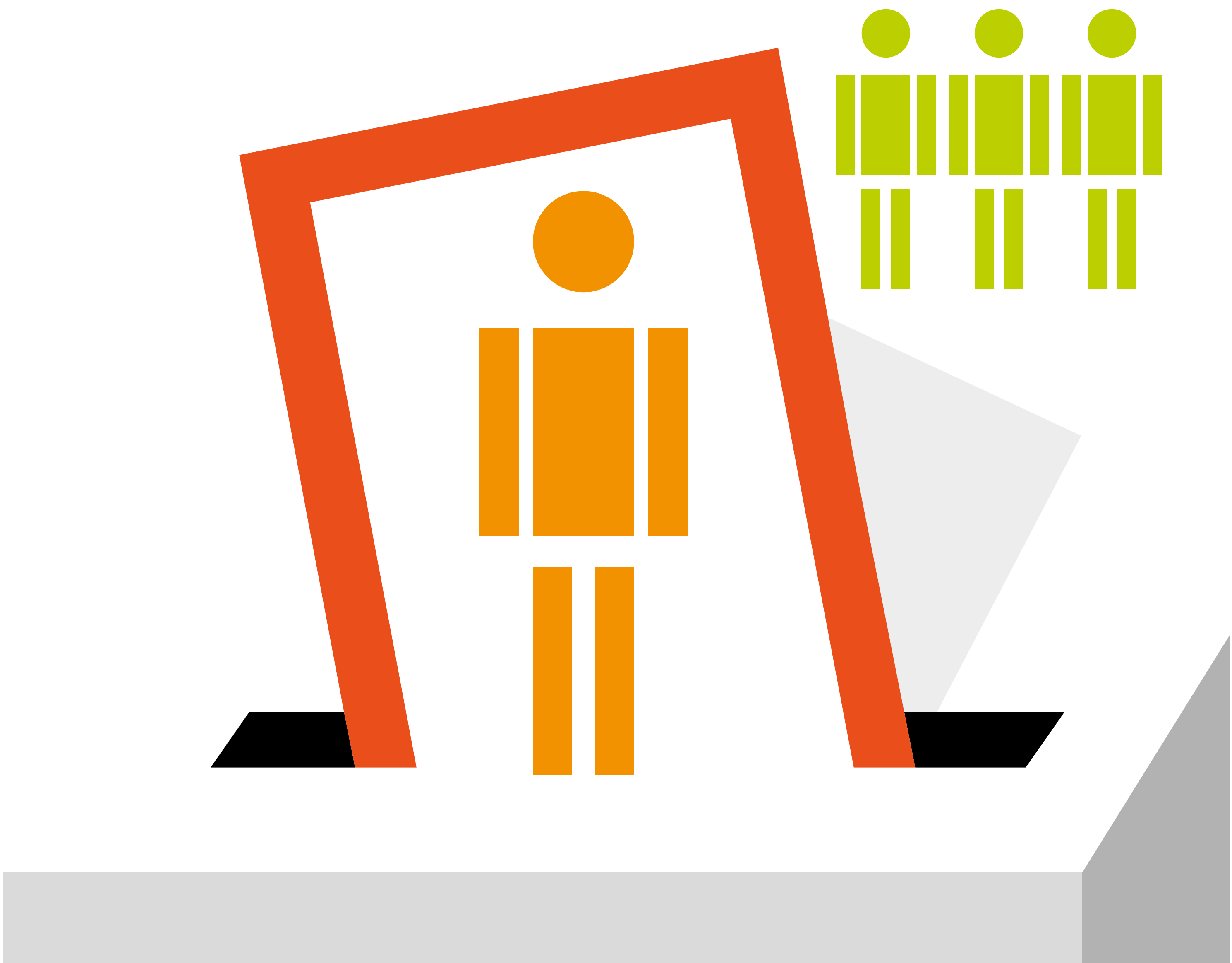

CEP ELECTION ANALYSIS

Inequality: Are we really 'all in this together?'

- The UK's richest 1% have between 12.5% and 15.5% of all income. This is mid-way between the United States (with a top 1% share of 20%) and continental Europe (where in France and Spain, it is 8%). The income share of the UK's top 1% has been rising steadily since the late 1970s, mainly due to labour income (wages) but also with a role for capital income (dividends, capital gains, housing rents, etc.).
- Wage inequality has steadily escalated for the top half of the earnings distribution. In 1978, the top 10% earned 1.6 times those in the middle. By 2013, this had risen to a factor of three to one.
- For the bottom half of wage earners, inequality expanded rapidly in the 1980s before stabilising for men from the mid-1990s and actually falling for women.
- Changing wage inequality is partly due to increased demand for skilled workers because of new technologies. But institutions such as unions and minimum wages also matter.
- In the 2008-09 crisis, inequality fell but it has been stable since then. Average wages and incomes have fallen for just about every group since the crisis. It is too soon to tell whether inequality will resume its rising trend as the economy fully recovers.
- Net income (after tax and benefits) is more equally distributed than pre-tax and benefit income. The richest fifth have 15 times the pre-tax income of the poorest fifth, but only four times as much after taxes and benefits. Nevertheless, the increase in post-tax income inequality has followed the same trends as that of pre-tax inequality.
- Modelling changes to direct taxes, tax credits and benefits since the coalition government came to power shows that overall policies have been mainly regressive. The bottom half of the income distribution lost more from cuts to tax credit and benefits than they gained from higher income tax allowances. Pensioners have done especially well compared with the young.
- The top 1% enjoy about 40% of capital income *flows.* There is much uncertainty on the *stock* of wealth inequality. Wealth will be increasingly important for inequality as it is rising faster than aggregate income, and the concentration of capital income is much greater than the concentration of labour income.
- To combat wage inequality, increasing skills, especially for the disadvantaged, is vital. In terms of capital inequality, Labour's proposals to abolish non-domiciled residents' tax status will reduce inequality, whereas the Conservatives' policy of boosting inheritance tax allowances will increase inequality.

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Introduction

In his March 2015 Budget speech, Chancellor George Osborne emphasised that austerity measures over the 2010-15 Parliament had been fairly shared: inequality had fallen and the British people were 'all in this together'. This Election Analysis examines how the UK stands in terms of the levels and changes in inequality of pre-tax and benefit income, net incomes and wealth. It also explores the role of the coalition government's policies in influencing these outcomes.

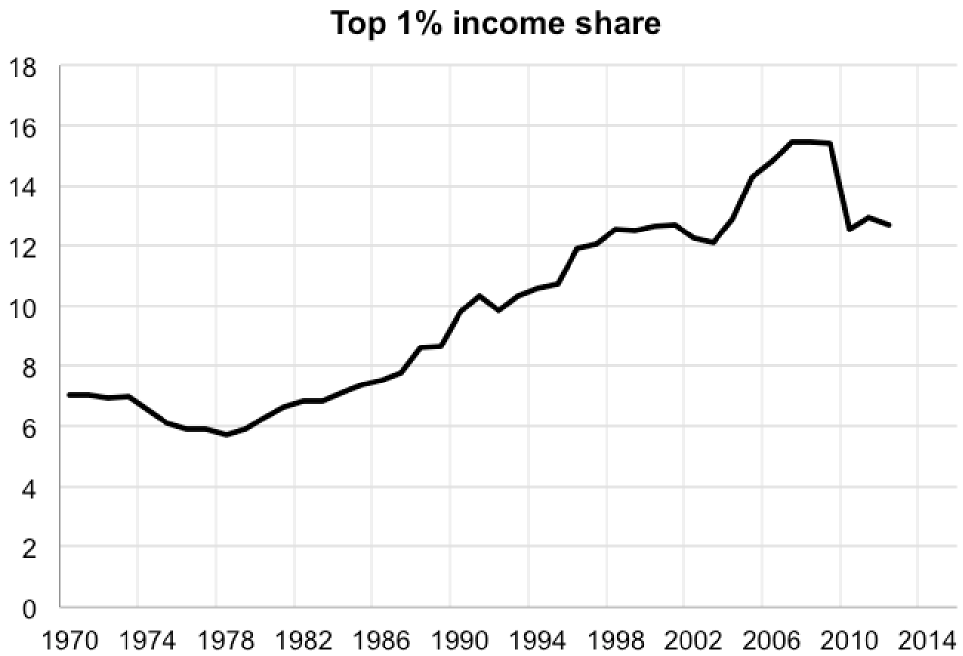
Trends in the distribution of pre-tax and benefit income

The UK has a high level of pre-tax income inequality. The share of taxable income earned by adults in the top 1% of the distribution has been in the range of 12.5% to 15.5% (see Figure 1). This is much higher than in most continental European countries – in France and Spain, for example, the income share of the top 1% is about 8% – but it is lower than in the United States, where the share is about 20%.

The share of the top 1% was about 6% in the 1970s, but it has been rising ever since. There was a particularly strong rise in the decade leading up to the financial crisis of 2008-09. Two thirds of the growth in the share of the top 1% appears to be due to bonuses in the financial sector (Bell and Van Reenen, 2014).

The measured share of the top 1% fell in 2009-10, but this was heavily influenced by bringing forward income in advance of the introduction of the tax on bankers' bonuses and the new 50% additional tax rate. The shares for the following years were correspondingly reduced (see CEP's Election Analysis on top taxes – Manning, 2015). It is too soon to tell whether the financial crisis marks the end of increasing shares of the top 1% or if inequality will resume its rising trend once aggregate wages start growing again.

Figure 1: Rising pre-tax and transfer income inequality in the UK, 1970 to 2011



Notes: Data from the World Top Income Database (http://topincomes.parisschoolofeconomics.eu/). The series has a break in 1990 (change in tax units from family to individual basis). The top income shares estimates for 2009-10 were affected by a significant bringing forward in that year in advance of the introduction of the 50% top tax rate; the shares for the following years were correspondingly reduced.

Tax data are likely to underestimate the extent of inequality among residents of the UK. Non-domiciled (‘non-dom’) residents who choose to be taxed on a ‘remittance basis‘ only pay taxes on the (possibly very low) fraction of their income brought into the UK. In other words, the dividends, interest, and capital gains earned on their foreign stocks and bonds are tax-exempt if not transferred to a UK bank account. There is no other large economy with a comparable tax provision.

The number of non-doms has risen from 83,000 in 1997 to 114,800 in 2012-13.[1] The 46,700 non-doms who use the remittance basis must pay an annual flat tax (£30,000 if resident for seven years, £60,000 after 12 years and £90,000 after 17 years). This status is obviously only advantageous to wealthy individuals. With the data currently available, it is not possible to estimate the worldwide income of non-doms, but it might be large enough to affect the top 1% income share reported in Figure 1 significantly.

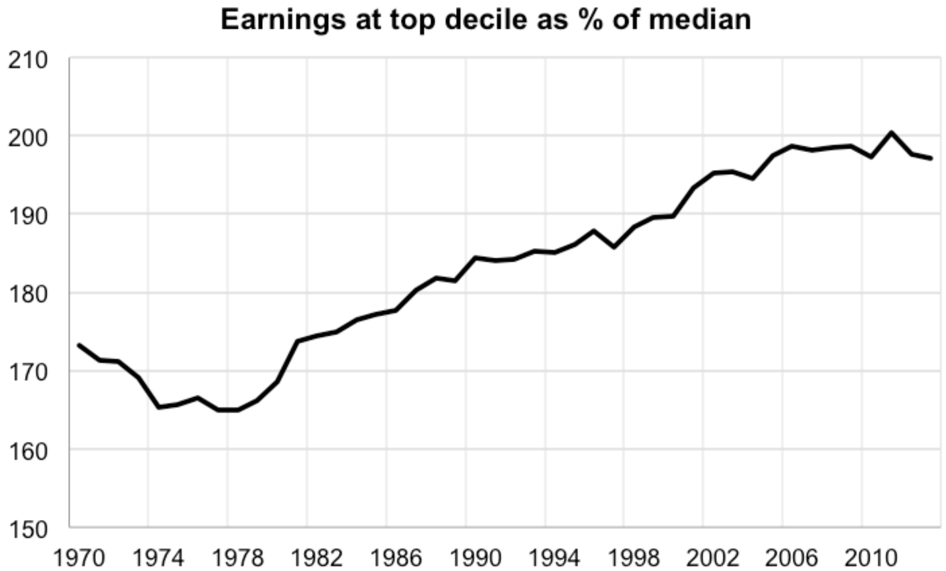
Labour have promised to abolish non-dom status except for short-term residents. This could potentially raise revenue of £1 billion and end an anachronistic system. But some non-doms might respond by leaving the country, although there is no compelling evidence that such migration responses would be large. This would reduce wealth inequality, but it would also reduce tax revenues.

[1] http://blogs.channel4.com/factcheck/factcheck-qa-nondoms-dodging-tax/20681

Rising labour income inequality

The rise of overall inequality is clearly related to a rise in wage earnings inequality. Figure 2 shows the ratio of earnings at the top decile (the person 10% from the top) to the median earnings (the person in the middle of the distribution) expressed as a percentage. Earnings at the top of the distribution have been rising faster than median earnings: the 90-50 ratio has increased from 165% in 1978 to 197% in 2013.

Figure 2: Rising wage inequality at the top in the UK, 1970 to 2013



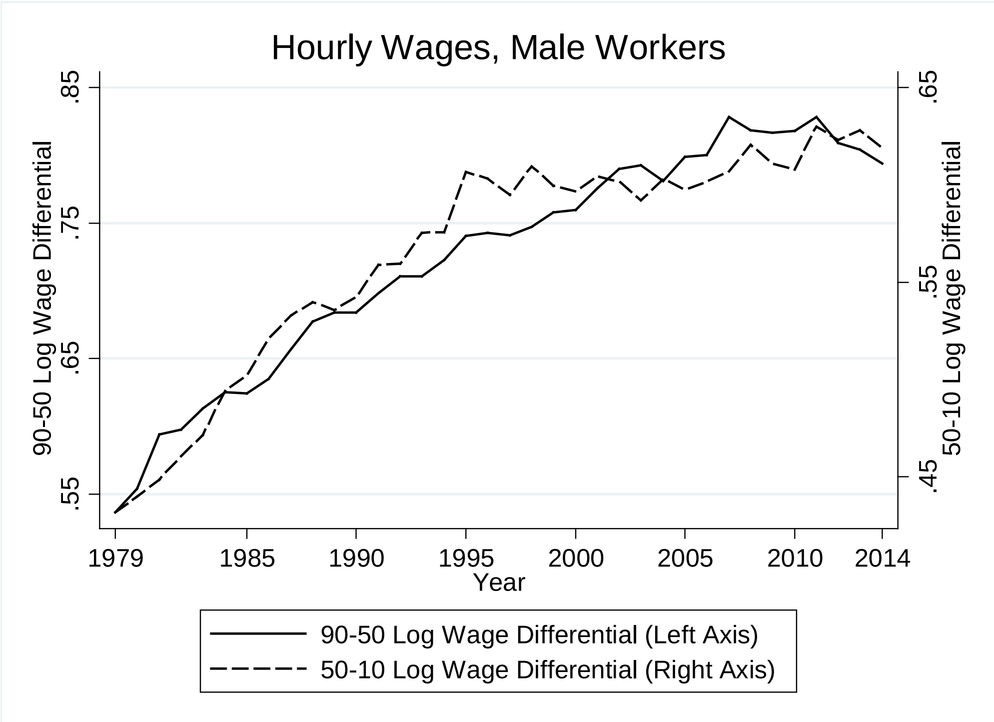
Source: Chartbook of Economic Inequality (http://www.chartbookofeconomicinequality.com). Data are from the Annual Survey of Hours and Earnings (ASHE), covering all full-time workers on adult rates whose pay for the survey period was not affected by absence, linked backwards to take account of changes in methodology.

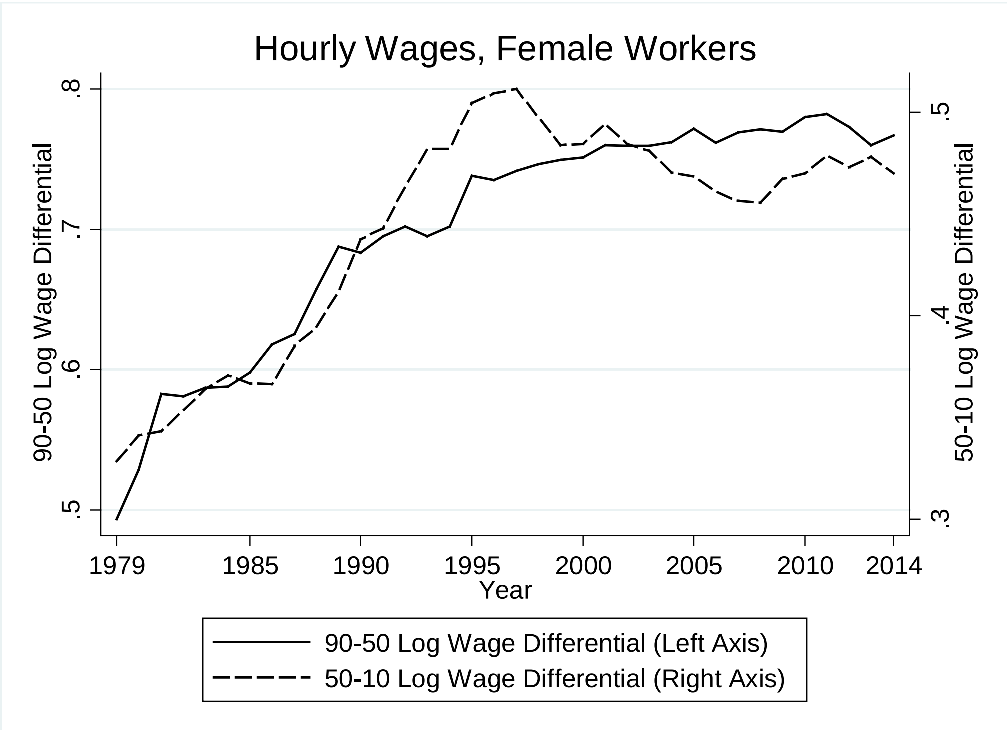
The picture is more nuanced in the bottom half of the earnings distribution. Figure 3 compares inequality of hourly wages for those in the top half ('90-50' as in Figure 2) with inequality in the bottom half, the median relative to the bottom 10% ('50-10') for men and women separately.

Inequality in both halves of the distribution moved in tandem in the 1980s. But from the mid-1990s, inequality stopped rising in the bottom half of the distribution for men and it actually fell for women. The introduction of the National Minimum Wage in 1999 has been an important factor in reducing inequality for low paid women (especially part-timers).[2]

[2] See CEP's Election Analysis on gender gaps in the labour market for more details – Azmat, 2015.

Figure 3: Inequality of hourly wages in the top half ('90-50') and bottom half ('50-10') of the earnings distribution





Source: NES/ASHE. The 90-50 is the proportionate difference of hourly wages for workers at the 90th percentile of the distribution compared with those at the median. The 50-10 is the proportionate difference of hourly wages for workers at the median of the distribution compared with those at the 10th percentile of the distribution.

An important factor in rising inequality is an increase in the wage premium for higher education. This has come in spite of an enormous increase in the fraction of workers with an undergraduate degree (which went from 4.7% in 1979 to 28.5% in 2011 – see CEP's Election Analysis on higher education – Wyness, 2015). This indicates that the demand for human capital has continued to rise strongly over the last 40 years. This seems to be less a result of increasing trade with less developed countries like China, but is mainly linked to technological change, which has tended to increase the value of general skills (see, for example, Michaels et al, 2014).

During the financial crisis and its aftermath, real wages fell across the spectrum, as Table 1 shows. For all workers, median real wages fell by 10% between 2008 and 2014, and the fall was roughly the same at the 10th and 90th percentiles of the distribution. The most heavily affected group was workers aged 25 and younger, for whom median real wages fell 16% (see CEP's Election Analysis on real wages and living standards – Machin, 2015).

Table 1: Percentage falls in median real wages by group since 2008, ASHE

All	-10%
Men	-12%
Women	-7%
Age 18-24	-16%
10th percentile	-10%
90th percentile	-11%

Notes: Updated numbers from Gregg et al (2014). The Table uses Annual Survey of Hours and Earnings (ASHE) data.

Rising capital inequality

Capital is poorly reported in survey data and we know less about trends in capital inequality than trends in labour income inequality. Taxable capital income is extremely concentrated. Using a sample of tax returns (the Survey of Personal Income), Alvaredo et al (2015) find that the top 1% individuals earned about 40% of all taxable capital income in 2010 (the latest available data point), whereas the share was only 35% in the late 1990s. This is as much as in the United States, a country with considerable capital income and wealth concentration (Saez and Zucman, 2014).

Does the large concentration of capital income (a *flow*) mean that wealth (a *stock*) is also very unequally distributed? Capital income is equal to wealth times the rate of return to wealth. The high and rising concentration of capital income therefore has two possible causes: either the inequality of wealth is high and rising; or the inequality of rates of return to wealth is high and rising (or both). With the data currently available, it is not possible to disentangle the two possible effects.[3]

[3] In the Wealth and Asset Survey, the top 1% share of wealth is about 13%. This is much lower than capital income and may be because the survey does not get enough responses from the richest individuals (the overall response rate was 64% in 2010-2012). For more analysis on the Wealth and Asset Survey, see CEP's Inequality video: https://www.youtube.com/watch?v=tvN8zvovDrY.

Capital may well play an increasingly important role in the distribution of economic resources in the future (Piketty, 2014). At the macroeconomic level, the ratio of wealth to income has grown significantly in the UK over the past decades (see Figure 4). In the 1970s, private wealth was the equivalent of three years of national income (the wealth/income ratio was 300%); this ratio has increased to 560% in 2013.

One of the key factors behind the rise in the wealth-income ratio is the increase in house prices (see CEP's Election Analysis on Housing – Hilber, 2015). The rising importance of real estate means that a growing fraction of national income derives from housing rents. In the early 1970s, rents accounted for 2% of national income, but this had risen to 7% by 2013. The growth has accelerated in recent years, as housing rents increased much faster than national income during the crisis.

Apart from the non-dom issue discussed above, another policy to reduce wealth inequality would be to increase inheritance taxes. The Conservatives' policy is to move in the opposite direction, allowing main residences to be exempt from inheritance tax when they are passed on to children – a total allowance of £1 million for a couple, twice as generous as today's levels. The children of those with estates in the £1-2 million range will benefit most from these changes, which will benefit families at top of the distribution the most and therefore aggravate wealth inequality.

Figure 4: Rising wealth-to-income ratio in the UK, 1970 to 2013

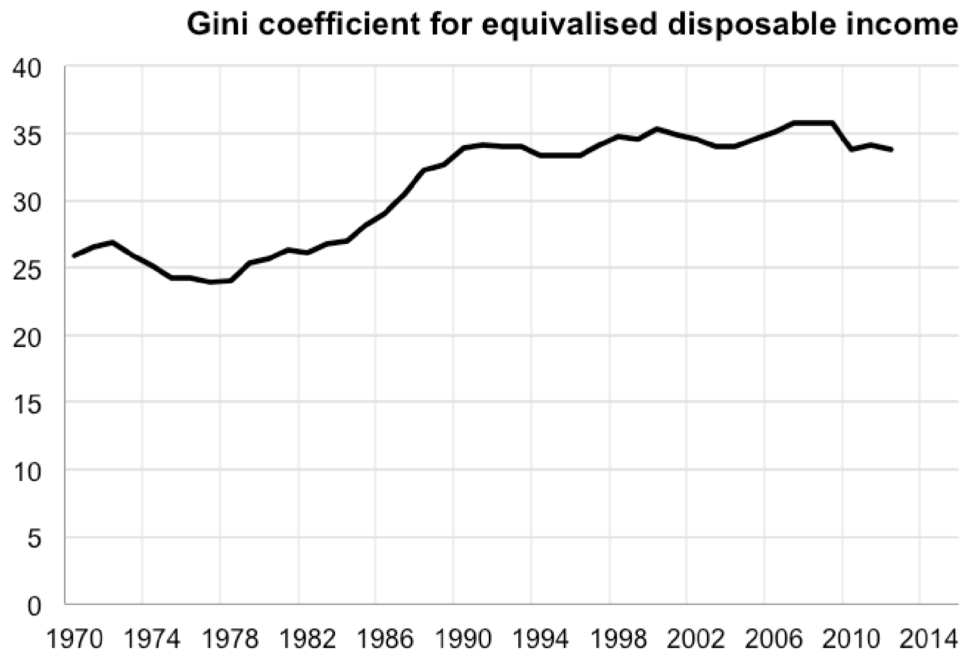
Notes: Figures updated from Piketty and Zucman (2014).

Trends in net income inequality (post-tax and transfer)

Taxes and benefits lead to income being shared more equally between households. Before taxes and benefits, the richest fifth of households have incomes almost 15 times greater than the poorest fifth, but after all taxes and benefits are taken into account, this ratio is reduced to four-to-one.

As with pre-tax income, inequality of disposable income has risen since the 1970s. It increased a lot in the 1980s, and then was stable, growing only slightly. As Figure 5 shows, the Gini coefficient[4] is now around 10 percentage points higher than in 1980.

Figure 5: Rising inequality of disposable (after tax and benefit) income

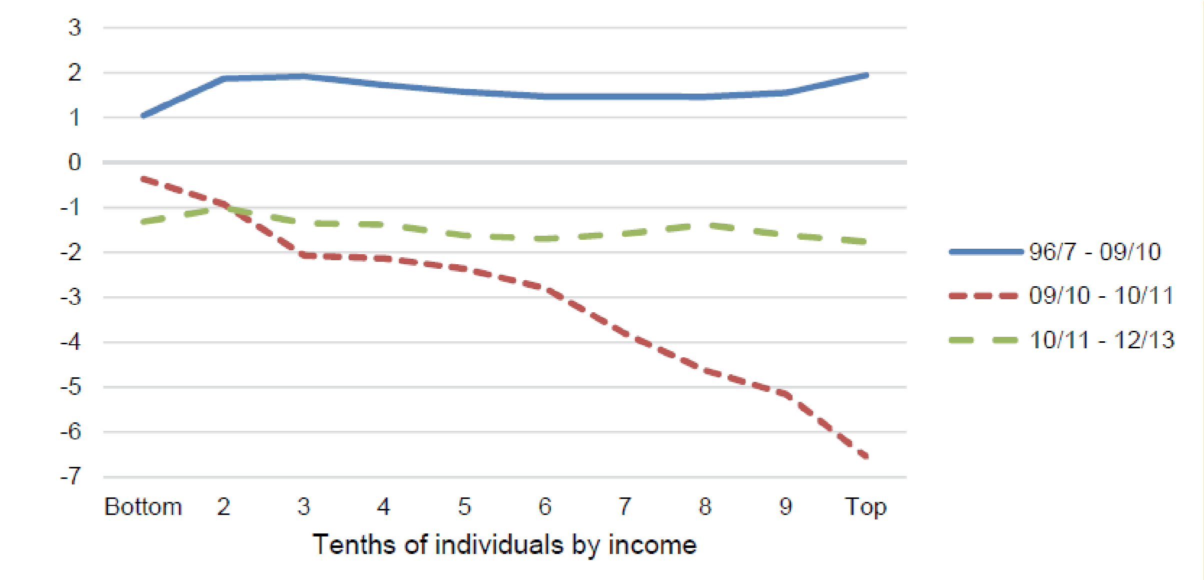


Notes: Gini coefficient of equalised (modified OECD scale) disposable household income for all persons in the UK (Great Britain up to 2001-02) from Family Expenditure Survey from 1961 up to financial year 1993/4 (calendar years up to 1992), thereafter from the Family Resources Survey.

Breaking this down in more detail, Figure 6 shows that between 1996-97 and 2009-10, there was a moderate increase in inequality. Although income rose across the distribution, it was slowest in the bottom decile (1% per year) and fastest in the top decile (2% per year). In contrast, inequality fell in the depths of the Great Recession, with the bottom decile staying the same and the top decile taking a 7% cut in net income. Between 2010-11 and 2012-13, incomes fell by 1-2% yearly almost equally across the entire distribution.

[4] The Gini coefficient is a measure of income inequality: Gini coefficients can vary between 0 and 100 and the lower the value, the more equally household income is distributed.

Figure 6: Changes in net income across the distribution in Great Britain



Source: Hills (2015), Table 5
Notes: Lines at mid-point of each decile group. Incomes are equalised for each group.

The effect of policies on net income distribution

Although there has been little change in inequality since the coalition government came to power, this outcome is due to a combination of changes in the economy, policies inherited from Labour and new policies introduced. The latter are hard to assess fully since detailed distribution data is only available through to 2012-13.

There have been several important policy changes (see Hills, 2015, for more details):

- First, the personal allowance has been steadily increased (to £10,500 in 2015-16).

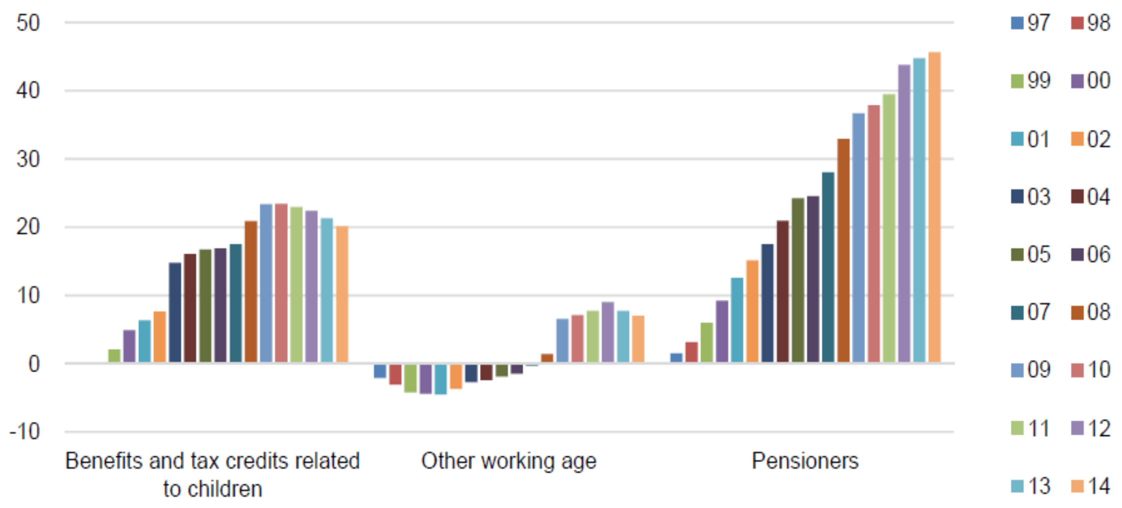
- Second, the uprating of working age benefits was tied to the consumer prices index (CPI) rather than the retail prices index (RPI) since 2010. Since the CPI increases more slowly than the RPI, this will reduce the value of benefits. But since real wages have fallen by 8-10% since 2008 (see Table 1), uprating benefits with prices protected these groups more than workers.

- Third, the state pension is under a 'triple lock', increasing by whatever is greater among the CPI, average wages or 2.5%. This has led to a generous deal for pensioners.

- Fourth, working age benefits were cut in real terms from 2012.

Figure 7 shows changes in real spending across three groups: families with children, other working age benefits and pensioners since 1997. Pensioners have had steady increases in real spending throughout this time period, although there is a larger upwards blip at the end. Families with children did very well during the Labour years thanks to increased in-work benefits (Working Family Tax Credit and its successors) and lone parent benefits. Since 2010, these benefits have been scaled back. Real spending on families with children has fallen. Finally, other adult benefits fell 1997-2007 due to a strong labour market and reduced generosity of unemployment benefits. By contrast, when the recession hit, spending on these benefits increased as more people were unemployed.

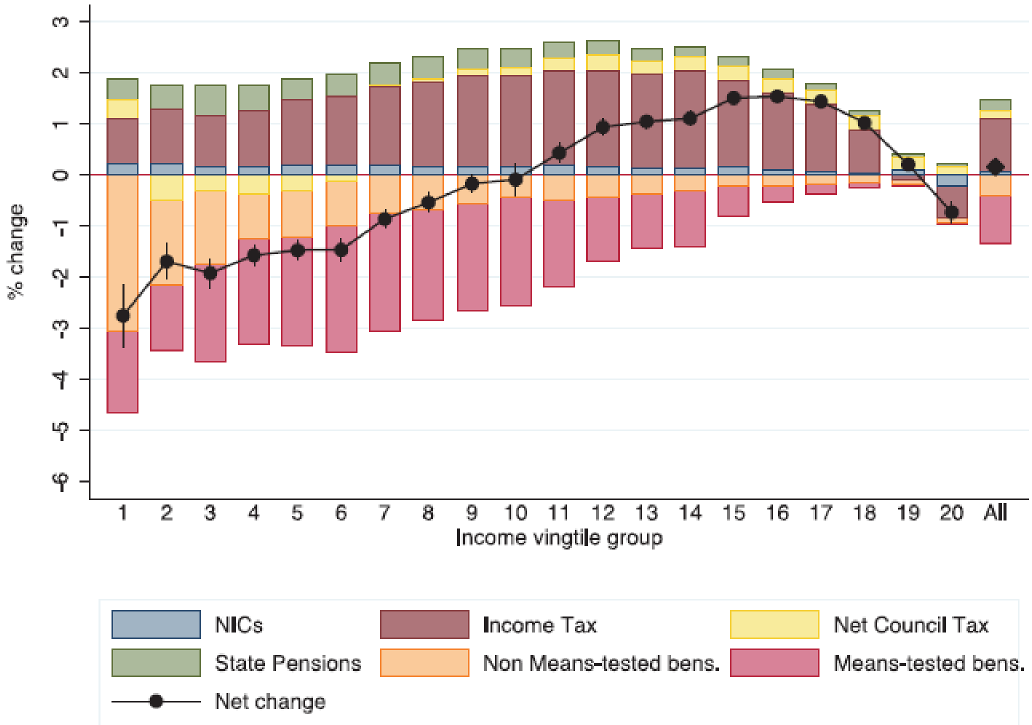
Figure 7: Changes in spending on social security and tax credits since 1996-97 (Great Britain)



Source: Hills (2015), Figure 1(b) http://www.casedata.org.uk/show-chart?id=cash-benefits/full/figure/1b
Notes: Shows changes in spending from direct taxes, tax credits and benefits relative to 1996-97. £billion in 2009-10 prices.

Hills (2015) reports a simulation model of the effects of tax and benefit policy changes from May 2010 onwards (see Figure 8). The measures have been mainly regressive. On average, those below median income have suffered losses due to policy changes, especially the bottom 10%. The main gains are those above the median to around the 90th percentile. The top 5% are about the same and the next 5% have slightly lost out.

Figure 8: Percentage change in household disposable income by income vingtile (5%) group due to policy change, May 2010 to 2014-15



Source: Hills (2015) Figure 9(b)
Notes: Modelled effects of coalition policies (direct taxes, tax credits and benefits) relative to 1996-97. £billion in 2009-10 prices) starting from May 2010. Observations are grouped in vingtiles (from poorest 5% to richest 5%) using household disposable income in 2010 equalised using the modified OECD scales. 95% confidence intervals (bootstrap method) around the net change shown. EUROMOD G1.5 used.

Looking ahead, there are several changes that are likely to make net income inequality worse. For example, there will be a cap on the overall level of welfare and a £26,000 limit on how much benefits can be claimed per household. The effects of tying benefits to the CPI will depress the real value of the benefits as wages start recovering.

Conclusions

Inequality in pre- and post-tax income has risen remarkably in the UK since the late 1970s. Much of this was because of changes in labour market income, but increasing capital income inequality is also becoming important. Inequality growth was strongest in the 1980s, but has continued steadily for those in the top half of the income distribution (especially the top 1%).

Inequality of net income fell in the crisis as the welfare system 'did its job'. But there are signs that it is rising once again and the tax and benefit changes since 2010 have been largely regressive. Perhaps the main cleavage is between pensioners who have done relatively well compared with those of working age, especially the young and households with children.

Further reading

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Bell, B and J Van Reenen (2014) 'Bankers' Pay and Extreme Wage Inequality in the UK', *Economic Journal* 124(574): F1-387 (http://cep.lse.ac.uk/textonly/_new/staff/vanreenen/pdf/2014_02_25_EJ_Bbonus.pdf).

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