REDUCING INEQUALITIES

Russell Jones* and John Llewellyn*

Executive Summary

A backlash against numerous inequalities – and in particular against perceived unfairness in society – is a significant driver of the UK's current political malaise. Addressing inequalities between income groups, regions and generations will thus be key to re-establishing faith in government and avoiding further decline or even the threat of social unrest.

In income terms, the UK has become much more unequal than in the immediate post-war decades, and it should be a goal to reverse that trend – targeting the OECD average for income inequality and a halving of the number of those living below the poverty line. Measures to deal with perceived unfairnesses could include tighter scrutiny of competition in high-yielding sectors such as technology, and incentives for the appointment of worker representatives to company boards. But a government intent on tackling inequalities will inescapably need to raise public spending and direct taxation of income and capital from their current historically low levels. In particular spending on education and active labour market policies needs to increase, while gaps in the benefits system and regional imbalances are addressed.

Given the scale of technological change and the severe implications for the labour market, the risk is that policy will be insufficiently bold to deal with widespread disenchantment, which could ultimately pose a threat to democracy.

Introduction

Inequality is patently a moral issue; and one that can have major economic, financial, social, and political consequences. For all these reasons, inequalities have to be taken seriously.

A fact of life in all market economies, inequalities take many forms: inequalities of income, inequalities of wealth; inequalities across activities, regions, generations; and more.

Progressive tax systems go some way to reducing inequalities of income and wealth; and sustained improvements in real incomes and living standards help further by financing infrastructure, education, health services and more, which are available – in principle – to society at large.

Notwithstanding these various policies, however, UK society today is riven, socially and politically. In a complex world there is seldom a single cause for anything. But it is hard to escape the conclusion that, behind all the anger that is laid at the door of conventionally-measured inequalities, lies something even more fundamental: disillusionment at *unfairness*. A range of perceived unfairnesses – from lack of educational opportunity to uneven access to health and social care; from sub-standard housing to inadequate access to training – produce for many an environment from which they feel that they, and even more importantly their children, cannot escape. And these perceptions of unfairness become amplified in the era of social media.

*Llewellyn Consulting. E-mails: russell.jones@llewellyn-consulting.com, john.llewellyn@llewelyn-consulting.com.This paper has benefited from significant and substantive comments from Angus Deaton (Princeton University). Disclaimer: The views, judgements and policy proposals expressed in this chapter are those of the authors, but not necessarily those of the critical commentator, Gatehouse Advisory Partners, Llewellyn Consulting, the Federal Reserve Bank of San Francisco or the National Institute of Economic and Social Research.

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

Not surprisingly, the UK, like a number of other countries, now faces a backlash, and is at a point of inflexion, a point of decision. Over the coming five to ten years the countries that best address this backlash against inequalities, in the broadest sense, stand to be the best placed to escape populism. Those that fail may well experience relative, or even absolute, decline – and, at worst, social and political disruption.

It will take major and enduring policy action across a number of areas not only to make UK society less unfair, but also for it to be perceived as such. And, to be effective, the requisite policies will need to be based on evidence, whether from home or abroad, of what works and what does not.

This paper first considers inequalities as conventionally measured – mainly income, wealth, regional, and generational. Other papers consider other dimensions, including importantly housing, infrastructure, and industrial policies.

Income inequalities

In the initial post-war decades the UK became, in income terms, a much less unequal nation. However, this changed in the late 1970s and 1980s. Like many advanced economies during this period, the country experienced a significant increase in overall income inequality, driven primarily by the rapidly rising earnings of those at the top, and especially at the very top, of the distribution.

Since the early 1990s, changes in post-tax income inequality have been less dramatic. After falling slightly over the early to mid-1990s, overall income inequality reached a new peak in 2009–10, before easing back somewhat. It has been relatively stable since.

The Global Financial Crisis (GFC) is often credited, in popular discussion at least, with having caused a widening of inequalities of various forms. Contrary to this belief, however, the GFC exerted only a comparatively small effect overall. Income inequality, for example, is currently a little lower than it was just before the crisis.

However, all this does not change the fact that, in income terms, Britain remains a much less equal society than in the 1950s, 60s, and mid-70s. Moreover, with a disposable income Gini coefficient of around 0.34 per cent before housing costs, and 39 per cent after housing costs, the UK is by this standard now much more unequal than the average OECD society. Indeed, its distribution of income is more akin to some developing economies. Since 1980, the share of total income going to the top 1 per cent has more than doubled, to around 8 per cent, much as in the US.

Policy proposal

- *Target average levels of OECD income inequality, or a return to levels of UK inequality in 1980.*

Meanwhile, the United Nations has recently suggested that, with the poverty line set at 55 per cent of median disposable income, some 14 million people, one-fifth of the UK population, live in poverty, while 1.5 million experienced what it described as 'destitution' in 2017.

Policy proposal

- *Target a halving of those below the poverty line.*

Health is also important for well-being, and it is noteworthy that continually-rising life-expectancy, long taken for granted, has recently begun to reverse. Stress, depression, and obesity have been on the rise. Middle-age mortality rates have increased. Deaths from suicide and those related to drug and alcohol abuse have multiplied. In these respects, the UK seems to be following in the unfortunate footsteps of the US.

Regional inequalities

Income inequality is but one dimension of inequality; and inequalities of different sorts – income, wealth, health, regional, generational – are likely to reinforce each other.

The UK's inequalities are certainly substantial at the regional level. London has grown significantly faster than other areas of the country over recent decades and, on the basis of gross value added (GVA) per head, is by far the richest region, followed by its South Eastern hinterland. All other regions fall below the national average, with Wales, the North East, Northern Ireland, and Yorkshire at the bottom of the pile.

Opportunities for social mobility too are higher in the capital. Meanwhile, in Britain's old industrial towns, many of which are located in the north, employment rates lag behind the national average, and 1 in 12 of working-age people receives incapacity benefits for poor health.

All this is having political consequences. Resentment of London and the South East is palpable in the UK's poorer regions. And the 2016 EU referendum outcome, while the result of a number of factors, was in part an expression

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

of discontent with the growing divide between London and the rest of the country: pro-Brexit voting patterns correlate closely with relative regional poverty.

Inter-generational equality

Then there is the issue of inter-generational inequalities. Notwithstanding the efforts of the Bank of England, young adults were hit the hardest, in terms both of pay and employment, by the 2008 financial and economic crisis. Millennials born in the 1980s are the first post-war generation to have lower incomes during early adulthood than the previous cohort. Over the past two decades young people, reflecting their (relative) decline in homeownership, are accumulating significantly less wealth than did previous generations.

Inequalities between generations can bleed into the following generation. Elderly households are now much wealthier than were their counterparts a decade or two ago, and are more likely to leave a large inheritance. With today's young relatively slow to accumulate wealth, and older generations wealthier than before, inheritances are increasingly important to the living standards of the young. Those with wealthy parents can expect a substantial increment to their lifetime wealth.

The sense of injustice that these various forms of inequality have engendered has been deepened by sluggish growth in disposable incomes, which in turn has been exacerbated by extended fiscal austerity. The aggregate UK fiscal stance was tightened by some 7 percentage points of GDP between 2009 and 2018, with a particular focus on restraining public sector pay, and reductions in welfare spending and local government funding. Household disposable incomes fell sharply in the post-crisis period, and then took an extended period to recover the ground lost. Aspirations have not been realised; savings buffers are lower; the vulnerability to income or employment shocks much greater.

Back to the future

In reviewing this catalogue of inequalities, some have gone so far as to conclude that the five social evils identified by Sir William Beveridge 75 or so years ago – want, disease, ignorance, squalor, and idleness – continue to stalk the land, even if their precise make-up has changed (Blanchflower, 2019).

Forces acting

No doubt, these trends in inequalities have been influenced in part by powerful structural forces, many of which have been operating at the global level.

Globalisation. Greater economic integration has had a range of effects. For example, competition for internationally mobile executives has driven top incomes higher, while import competition and offshoring have reduced blue-collar employment and job and income security.

Import competition has also encouraged technological progress and innovation, and shifted employment towards high-tech firms. These forces seem to have been particularly costly for male employees, female employment being more focussed in the service sector.

Technological change. Advances in computing and the internet have made skilled workers more productive, so that earnings growth at the top of the income distribution has been much faster than in the middle, while real earnings have actually fallen for low-paid men. At the same time, changes in production technology have made it more attractive to automate some workplace tasks. Manufacturing jobs, or at least important elements of them, have increasingly been replaced by machines, or by new pieces of software.

Increased market power of large firms. Product market concentration has tended to increase over recent decades. The share of turnover captured by the 100 largest UK firms has risen by more than one-third since the late 1990s. Corporate mark-ups have also risen on average since the 1980s, with much of the increase traceable to a small number of highly profitable, rapidly expanding entities. New technology industries often exhibit strong network effects and economies of scale, which encourage a 'winner takes all', or at least 'a winner takes most' effect, allowing so-called 'superstar' firms to capture an increasing share of a global market. This is especially the case where these firms are aggressive in entrenching their position through predatory buyouts, etc.

The question is whether this simply reflects returns to innovation, which could be argued to be fair reward for effort and success, or whether it reflects opportunistic and unfair abuse of market power – in which case it represents a failure of competition policy.

Declining trade union membership. Trade union membership has declined, from more than 50 per cent of the UK workforce in 1980 to less than half of this figure today. In the private sector, less than 15 per cent of the workforce is now unionised. This reflects both the relative decline of manufacturing and a less sympathetic legislative environment for organised labour since the early 1980s. Manufacturing's share of UK GVA is now around 10 per cent, as against closer

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

to one third in the 1960s. Meanwhile, the trade union reforms of the Thatcher government, which shifted the balance of power against workers, remain largely in place.

Falling union density appears to have reduced the limitations on wage dispersion, increased the share of profits going to executives, and more generally reduced the political power of the average worker.

New forms of employment have also reduced the bargaining power of workers at the lower end of the income scale. Many low-paid workers today are self-employed contractors, not covered by standard employee protections. The rise of the 'gig-economy', and the trend towards outsourcing of low and semi-skilled jobs to large agencies, may also make it harder to bargain collectively for higher wages.

Meanwhile, at the top end of the pay spectrum, the increased importance of bonuses and stock options in total remuneration seems to have afforded top executives a greater ability to extract a higher share of company profits.

Policy choices

The major trends in UK inequalities have also been driven by domestic policy choices in a number of areas, including financial integration, regulation, and government spending and taxation.

Financial sector favouritism. From 1979, successive UK governments have viewed the financial sector, the greater part of which is located in London, as an important source of economic growth, export earnings, and tax revenue, while also seeking to keep regulation of financial services in general at unobtrusive levels.

Competition policy. The current competition regime, while impressive on many levels, was designed largely for the goods markets, as they functioned a generation or so ago. It is less appropriate for the new technologies. Standard market definitions struggle, for example, to come to terms with the competitive ramifications of one social media firm acquiring another.

The way that patents are used can also result in excessive market power. High tech firms have spent heavily on patent purchases and litigation. The threat of the latter can act as a major deterrent to new entrants into the tech sector, blunting competition and innovation. Political lobbying may also have contributed to a weakening of competitive forces.

Policy proposal

- *Tighten competition rules for tech companies.*

Labour market policy. Given that the trade union legislation of the 1980s was a key element in the blunting of the power of organised labour, a constructive strengthening of the trade unions could encourage the pendulum to swing back. In the Nordic countries, for example, where inequalities are less pronounced, and less of a burning political issue, anything between 50 per cent (Norway) and 85 per cent (Iceland) of the workforce is unionised.

Having workers on company boards, as is mandatory in Germany, could also have a similar rebalancing effect.

Policy proposal

- *Provide new incentives for the appointment of workers to company boards.*

Increases to the UK's minimum, and living wage, standards represent a further mechanism whereby workers' bargaining power can be embellished. These initiatives have already raised earnings at the bottom of the income distribution, with to date no obvious harmful effects on employment. That said, minimum wages in the UK are now already quite high in an international context, and may be approaching a threshold where that may no longer be the case. This could be particularly so should increases in minimum wages begin seriously to affect the attractiveness of those in relatively 'automatable' jobs. (These issues are taken up further in the papers *Maintaining stable macroeconomic conditions* and *Supporting dynamic economic adjustment*.)

Policy proposal

- *Continue the strategy of progressively raising the minimum wage.*

Monetary policy. Monetary policy changes always generate real and financial side-effects, not least on resource allocation, asset prices, risk tolerance, and the distribution of income and wealth. Where the latter is concerned, it is widely believed that the unconventional initiatives employed during the GFC and its aftermath added significantly to inequalities in the UK.

As ever, however, the construction of the counterfactual can be revealing (Bunn *et al.*, 2018). It has been estimated

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

for example that, in the absence of the Bank of England's unconventional policy response, real GDP would have been some 8 per cent lower, and the jobless rate 4 per cent higher. The balance of household interest payments and receipts would have been more onerous. Equity prices, house prices, and pension wealth would all have been markedly lower in real terms.

The average household would have been 5 per cent worse off in the absence of the BOE's interventions, the dominant positive impact of which was on jobs and wages. The average UK household thereby gained in income terms by an estimated GBP 1,500 per year, or close to GBP 9,000 cumulatively.

The gains were reasonably evenly spread as a proportion of income, although they were slightly smaller among lower-income households and, troublingly, they were negative for the lowest income decile. The balance of benefits was spread rather more unevenly: the initial distribution of wealth meant that the absolute monetary gains were skewed towards upper income groups.

In proportionate terms, the income gains were greatest among the young, largely because of their improved employment prospects. Older cohorts lost out because of lower interest earnings on their savings. Wealth gains, in contrast, were fairly evenly spread across the age distribution in percentage terms, although the elderly benefitted most in money terms because of the impact of higher asset prices on the value of pensions and housing assets.

By region, the benefits of BOE policy were evenly spread in percentage terms, and there was no significant widening of regional inequality as a result. However, given the unequal initial distribution, the absolute monetary gains were heavily skewed towards London and the South East. It has perhaps been the initial unequal distribution of income and wealth, and the manifest variation in absolute monetary, rather than percentage, gains that has coloured perceptions and bred misinterpretation of BOE policy during the crisis.

Fiscal policy. Besides its important role in encouraging macroeconomic and financial stability, which can contribute importantly to solving distributive issues, fiscal policy is a particularly powerful weapon in redistribution, working through three, sometimes conflicting, channels:

- Progressive direct taxes and transfers act directly on disposable-income inequalities.
- Indirect taxation, while essentially regressive, can fund progressive state spending.
- In-kind outlays on education and health ameliorate inequalities, improve the stock of human capital, and promote social mobility, thereby addressing, to some extent at least, issues of perceived unfairness.

The overall effect of fiscal policy depends on the magnitudes of these three considerations, and their progressivity.

The 1980s saw significant increases in initial income-exemption thresholds, reduced top rates of income tax, and increases in VAT rates. At 20 per cent, the standard rate of the latter is now double its initial 1973 level. Since the 1980s there has also been rapid growth of capital income – profits, interest, and capital gains – which is generally distributed more unequally than labour income, and is taxed at a lower rate than labour income. This reflects two main considerations: first, to tax capital income similarly to labour income is effectively to tax future consumption at a higher rate than current consumption, and thereby to discourage savings, investment, and economic growth; second, capital income is more elastic with respect to taxation than is labour income. Hence, lower capital taxation can influence the location of business activities.

The share of total tax revenue accounted for by direct levies on income, profits, capital gains, social security contributions, and payroll taxes is about 56 per cent, which is around 5 percentage points below the OECD average, and some 15 points below Sweden, Germany, Switzerland, and Japan.

The primary reason for the reduction in tax progressivity has been that it is considered to undermine incentives and economic growth, although the evidence for this is questionable until tax progressivity reaches truly elevated levels.

On average in the advanced economies, direct transfers and taxes reduce income inequalities by approaching one-third. About three-quarters of the effect comes via transfers, with public pensions accounting for around half of this. Britain broadly fits this pattern. However, today, the UK redistributes less than the OECD average via fiscal policy.

Policy proposal

- *Increase the level of direct income, and especially capital income, taxation towards the OECD average.*

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

At the very least, this will involve broad-based efforts to reduce opportunities for tax avoidance and evasion; capping or eliminating deductions, such as the favoured status of fringe benefits, or unlimited tax deductibility of medical insurance or mortgage interest; and reducing the scope for labour income to be presented as capital income.

Universal basic income. To achieve their distributional objectives, most governments employ a mix of means-tested and universal measures. Means-tested income support programmes are used to realise a minimum income guarantee, but they are combined with universal family benefits such as child allowances and public pensions.

To cap the disincentives inherent in means-tested transfers, eligibility on participation in active labour market policies is conditioned, while wage subsidies are also used increasingly to raise work incentives for the lowest income householders, normally the most responsive to financial incentives. Nevertheless, there is ample scope for reform.

The introduction of a Universal Basic Income (UBI) – a common cash transfer made to all individuals – is increasingly being discussed. This has the potential both to overcome the information constraints and administrative costs involved in means-tested systems, which leave them prone to errors of inclusion and exclusion, and to reduce the stigma associated with state income support, which can significantly reduce take-up. UBI is also seen as a possible answer to the income uncertainty that comes with technological advancement, and as a means to build support for structural reforms, such as the removal of food and energy subsidies, or the broadening of the indirect taxation base.

UBI would however be extremely expensive; its benefits would extend to the wealthy, raising issues of fairness; it could significantly loosen the link between income and worker participation; and, by potentially sustaining high levels of unemployment, it could undermine social cohesion, if not directly encourage social decay.

The ultimate costs of UBI would depend on its level, and how the broader tax and benefit systems evolved in its wake. Estimates have however been made. The IMF has calculated that, were UBI to be set at 25 per cent of median per capita income, the direct cost would amount to some 6–7 per cent of GDP in OECD economies, and 3–4 per cent in emerging-market economies. That said, the impact on inequality would be dramatic in all economies: on average, Gini coefficients would likely drop by some 5 percentage points (Francise and Prady, 2018).

Overall, UBI would seem to be better suited to emerging-market countries wishing to develop a more comprehensive social safety net. In advanced economies such as the UK, where benefits are already comprehensive, and progressivity is widely embedded, the introduction of UBI could sharply reduce the targeted benefits already received by many low-income families, or drain resources from other social support systems. It might be more feasible to try to close the gaps in the existing system due to eligibility rules or incomplete take up, while providing well-designed wage subsidies to raise work incentives.

Education and health spending

Unlike explicit redistributive fiscal policies, which target inequality of disposable income, government outlays on education and health impinge on underlying market income inequality. The two are strongly correlated and, although by relaxing individuals' budget constraints they can deliver a conjunctural distributional effect, their real benefit is felt over the longer term. They enhance human capital and productivity, raise growth potential, and encourage greater equality of opportunity. In this way they can reduce the persistence of inequalities over time.

Public education spending in advanced economies like the UK tends to favour the poor, although this is not the case for outlays on tertiary education, which accrue mainly to the well-off.

In the UK, participation in higher education has risen rapidly since the 1980s, and there is less of a wage premium for graduates than there is in the US, for example. Nevertheless, the ratio of earnings of tertiary educated workers relative to those with upper secondary education is higher than in most advanced economies.

High-quality vocational education can improve the prospects for those who do not follow an academic path, while retraining is vital to develop new skills and help workers displaced by globalisation and technological change. (This issue is considered also in the paper *Supporting dynamic adjustment*.)

Policy proposal

- *Increase spending on education, but especially on vocational training, and active labour market policies in general.*

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

Disparities in health are strongly linked to socioeconomic status. Nor is there much evidence of these disparities narrowing. Indeed, on a number of metrics, gaps have been widening. Government efforts to address geographical inequality have been patchy, episodic, and have lacked sufficient coherence, funding, and vision. Numerous initiatives have come and gone over the years, yet progress has been limited.

There would appear to be a strong case for more devolution, and co-ordinated long-term investment in areas such as transport, research and development, and skills training. It has also been suggested that greater efforts should be made to relocate some national administrative functions to the regions, and to encourage more regional cultural activities. All this would appear to be fertile ground for a National Investment Bank. (This issue is considered in greater detail in the paper *Improving infrastructure*.)

Policy proposal

- *Establish a National Investment Bank, or broader development bank, to coordinate long-term infrastructure investment, and encourage it better to allocate health related spending across regions.*

Turning the tide

Whatever the nuances of inequalities in the UK, there is little doubt that they are causing resentment in the population. This is especially the case among those whose real incomes have stagnated, and whose job security has ebbed. Political intolerance, fragmentation, and polarisation have followed.

Without wishing to be unwarrantedly alarmist, our judgement is that inequalities represent a burgeoning threat to political and economic stability. Extended episodes of growing inequalities are nothing new – they have been a feature not just of recent centuries, but of civilisation since the Stone Age. The concern is that typically they are brought to an end only by violent events – wars, transformative revolutions, or state collapse.

The risk is of too timid a response to inequalities, especially given increasingly disruptive technological change, and the bleak outlook for many unskilled workers. This would particularly be the case should today's elites, as they have done through much of world history, become ever more determined to seize whatever they can for themselves. The unpleasant conclusion is that democracy itself may come under increasing threat unless governments work more aggressively to redress inequalities in the distribution of income, wealth, and opportunities.

Fiscal policy can be a powerful tool to moderate inequalities, both conjuncturally and over the longer term. But its design necessarily has to reflect social preferences, administrative capacity, and fiscal space: and these can be powerful constraints. The oft-expressed concern that increasing the progressivity of taxation will harm economic growth potential seems to be exaggerated. There is scant evidence for this, unless it is taken to extremes.

UBI is one possible option, but it has significant drawbacks, and is an unlikely panacea. A more efficient and cost-effective approach would be to close the gaps in existing benefit systems, return to more progressive income taxation, and supplement these measures with further minimum wage increases (until they exert a more discernible cost on employment) and additional levies on wealth. More generally, however, governments will need to think more seriously about the future of work and income, what it means to societies, and how they will manage it.

This is nothing less than a matter of survival. Whatever method or methods are adopted, offsetting the tendency for the distribution of income to become progressively more unequal will not be easy. There stands to be strong opposition from entrenched interests. But it seems highly likely that if Britain handles this issue well, it will enjoy a more stable economic environment, that allows the private sector to prosper. If it fails to tackle the issue successfully, it will likely experience political disturbance and perhaps even, ultimately, social upheaval.

To target and address income inequalities would not require that the mixed economy model be overturned. Notwithstanding its shortcomings, this model has brought much progress and development to the vast majority of mankind. Rather, the point is that future UK governments may increasingly find that, in order to sustain the mixed economy, they will have to take inequalities more seriously.

At some 37 per cent and 38 per cent of GDP respectively, the proportions of UK general government revenue and expenditure are relatively and historically low at this juncture. It seems unavoidable that they will have to rise towards the European averages of 46 per cent and

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press

47 per cent of GDP, and that greater sacrifices will have to be made by the wealthy on behalf of the poor, and by the old on behalf of the young.

Policy proposal

Accept a significant rise in the proportions of taxation and public spending in national income, with the European averages reasonable targets.

NOTE

1 This chapter draws extensively on the work of the Institute for Fiscal Studies on UK inequality. For the various papers used, see www.ifs.org.uk.

REFERENCES

Blanchflower, D. (2019), 'Not Working. Where have all the good jobs gone?', Princeton University.

Bunn, P., Pugh. A. and Yeates. C. (2018), 'How does monetary policy affect the distribution of income and wealth?', Bank Underground blog, 27 March.

Francise, M. and Prady, D. (2018), 'Universal basic income: debate and impact assessment', IMF Working paper WP/18/273, December.

https://doi.org/10.1177/002795011925000121 Published online by Cambridge University Press