CASE
Centre for Analysis of Social Exclusion
An ESRC Research Centre

CASEbrief 26 October 2004

Inequality and the State

- In a new book, *Inequality and the State*, John Hills examines trends in inequality in the UK, how the State affects distribution through its spending programmes and through taxation, and what the public thinks of all three.

- The book analyses the dramatic widening of the UK income distribution since the end of the 1970s, the growth of poverty, and the factors that have driven them. It examines how government affects distribution through social spending and taxes, and how this has changed under New Labour. It describes the constraints and pressures on future policies, and the dilemmas facing policy-makers as they try to reduce poverty and inequality, alongside competing and growing demands on social spending.

- The change in the distribution of income in the last quarter century has been dramatic. While relative poverty is now falling slowly, it remains at twice the level of the 1960s and 1970s. At the top, 40 per cent of the total increase in the country's real net income between 1979 and 2002-03 went to the top tenth. About 17 per cent of the total increase between 1979 and 1999 went to the top 1 per cent, and about 13 per cent went to the top half per cent.

- Policy matters: the scale and structure of social spending and the taxes that pay for it have major effects on inequality. In some countries, policies resisted inequality growth over the last 25 years; in the UK and USA they did not. However, policy changes since 1997 have reduced child poverty and have benefited the bottom half of the income distribution.

- The dilemmas facing policy-makers are likely to become more acute over coming decades. For instance, the total of education, health, and social security spending would have to be 4.5 per cent of GDP greater than in 2001, to maintain today's levels of social spending at any given age in relation to incomes, given the forecast age structure of 2051.

- Given such pressures, policy-makers face an uncomfortable trade-off between accepting rising costs and taxes in the long-term, reductions in generosity that increase relative poverty, or changes in structure that increase reliance on means-testing and reduce the value of services for those with middle incomes.

Further Information

This CASEbrief summarises findings from *Inequality and the State* by John Hills, published by Oxford University Press (Paperback ISBN 0-19-927664-1, £20; hardcover ISBN 019-927663-3, £60). The book is available from booksellers or from the Oxford University Press (24 hour credit card hotline: +44 (0) 1536 454 534; email: bookorders.uk@oup.com; P&P: UK:£3; Europe:£6; elsewhere £9).

STICERD
TOYOTA CENTRE
Suntory and Toyota International Centres for Economics and Related Disciplines

London School of Economics
Houghton Street
London WC2A 2AE
Tel: 020 7955 6679

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

Inequality and poverty: extent and trends

That Britain became more unequal in the last quarter century is well known; the scale of change, less so. At the end of the 1970s, the richest tenth received 21 per cent of total disposable income. This rose to 28-29 per cent by 2002-03, as much as the whole of the bottom half. More than half of this increase was accounted for by the top one per cent, and most of this by the top half a per cent. Whatever one's opinion of this, the numbers involved are very large: two-fifths of the total real increase in personal incomes between 1979 and 1999 went to the top ten per cent; more than a sixth went to the top one per cent; and about an eighth went to the top half a per cent. Partly as a result, after two decades of stability, the distribution of wealth became sharply more unequal after 1995. By 2001, the shares of the top one per cent and the top ten per cent of marketable wealth-holders appeared to be as great as at any time since the early 1970s.

The changes at the bottom were equally dramatic. At the end of the 1970s, the poorest tenth received about 4 per cent of disposable income. By the early 1990s this share had fallen by more than a third to between 2 and 3 per cent, where it has stayed. By the early 1990s, relative poverty was twice the level it had been in the 1960s, and three times what it had been in the late 1970s. By the end of the 1990s of fifteen industrialised countries: only the USA had and Ireland had higher relative poverty overall; only the USA had worse child poverty; and only Ireland worse pensioner poverty. Despite Britain's comparatively high overall income, even using a fixed international poverty line (based on the US poverty line), a larger proportion of children in the UK were poor in the mid-1990s than in any of eleven other EU countries apart from Italy and Spain. In EU terms, the UK also has high persistent poverty, high income inequality, and a particularly high proportion of the population in jobless households.

The pattern of change has not been uniform. In the early 1980s poverty rose against a fixed as well as a relative standard. In the following decade absolute poverty fell, but relative poverty rose rapidly. For a short period in the mid-1990s both fell. Since 1997 relative poverty has fallen a little and poverty against a fixed standard has fallen quite rapidly, particularly for children.

The growth in inequality and poverty has resulted from a series of interlinked factors. While most of these pushed in the same way in the 1980s, the pattern since the mid-1990s has been more complicated, with some pushing one way and some the other. As a result, the pattern of change has also become more complex, with some low-income groups catching up on the middle, even at a time of growth in general living standards, but other groups still being left behind, and the very top continuing to accelerate away from the rest.

The impact of policy

While factors such as technological change have affected the gap between high and low pay in many countries, in some countries the gap narrowed or grew only slowly. Even where it widened, rising *income* inequality is not inevitable. In some countries the tax and benefit system has offset rising earnings dispersion; in the UK and USA it has not. In the late 1970s and early 1980s, benefits appeared to restrain inequality growth, but they have not done so since many benefit levels became linked to prices rather than incomes in the early 1980s. Those dependent on such benefits fell behind the rest of the population, particularly when average incomes were growing strongly in the second halves of the 1980s and 1990s.

None the less, the combination of state transfers and taxation does much to narrow the income distribution in the UK. The narrowing results from the combination of transfers and services that are generally *pro-poor* in their impact (worth more in absolute terms to those with lower than with higher incomes), together with a tax system that is generally *proportional*. As a result, looking at a single point in time, those on low incomes tend to be net gainers from the combination, and those on high incomes, net losers.

Since 1997, policy change has equalised some aspects of the income distribution. Reforms to taxes and benefits for families with children have equalised cash support for children upwards between one and two parent families, younger and older children, and those in and out of work. The share of national income going on cash support for children had risen by 0.5 per cent of GDP by 2003, with half as much again for other measures aimed at lower-income families with children. These reforms reduced the worst of the 'poverty trap', improved the position of those with relatively low incomes both in and out of work, and increased the gain from working for some ranges of earnings. However, this was partly at the cost of extending somewhat milder disincentives to a much larger group. A family with two children can now face combined tax and tax credit withdrawal rates of 70 per cent over an income range that extends up to beyond median earnings.

Other reforms have moved support for pensioners towards a flatter system, less related to previous earnings, benefiting lower-income pensioners. In contrast to the explicitly flat-rate state pension system applying up to the late 1970s, the emerging system involves a wider spread of means-testing.

Overall inequality of incomes and earnings continued to rise over New Labour's first term, driven particularly by inequality at the top. However, those with low incomes began slowly to catch up on the middle, and relative poverty to fall, particularly for children. By 2001-02, relative child poverty on one measure was down to 21 per cent, compared to 25 per cent in 1996-97. Against a US-style threshold fixed in real terms, child poverty more than halved between the two years. As a result, indicators of deprivation for families with children are now showing sharp reductions: for instance, the proportion of lone parents who 'never have any money left over' fell from 48 to only 17 per cent between 1999 and 2002. Projections suggest that relative child poverty may fall by enough to hit the Government's target of reducing it by a quarter between 1998-99 and 2004-05.

Comparing the 2004-05 tax and benefit system with the 1997 system adjusted for *price* inflation, the poorest tenth are on average 24 per cent better off than they would have been, and the top tenth slightly worse off. Against an alternative comparator of the 1997 system indexed by *earnings* growth but without reform, the structural changes of the last seven years are more clearly redistributive: the bottom tenth is 11 per cent better off than it would have been with this alternative, but the top four tenths are worse off.

Public attitudes to inequality, social spending and taxation

The current degree of inequality is not popular, but most social spending is. Large proportions of the population believe that the gap between rich and poor is too large and that it is government's responsibility to reduce it. Most people substantially underestimate the pay of highly paid occupations, but still think such pay should be lower. People say the tax system should be progressive (which the UK system is not). They also believe that the income levels that many social security benefits actually allow are too little to live on. But people are sceptical about increases in 'welfare benefits', reflecting worries about fraud and incentives, as well as over-estimation of benefit levels and of the proportion of social security that goes to unemployed people.

Most people believe that there is 'quite a lot of real poverty' in Britain, and give views that are consistent with notions of a poverty line that rises over time as society becomes more affluent. Fewer than a quarter of the population blame 'laziness or lack of willpower' on the part of the poor for their low income (although the proportion doing so is more than in the past, and more than in any other EU country apart from Portugal, but still much less than in the USA).

Explicit support for 'redistribution' towards those with low incomes as a way of achieving this has, while still positive, declined since the early 1990s. However, people support structures with flat rate benefits and progressive taxation, and appear to support the redistribution which results as a by-product of the two.

Future constraints and pressures

Recent official forecasts suggest that public spending can remain broadly the same share of national income, despite the pressures from an ageing population. This assumes, however, that public spending on pensions can be held to a constant share of GDP, and that other benefit rates are increased only in line with prices, implying they would fall more than three-fifths relative to other incomes over the next 50 years.

An alternative calculation suggests that the total of education, health, and social security spending would have to be 4.5 per cent of GDP greater than it was in 2001, to maintain today's levels of social spending at any given age in relation to incomes given the forecast age structure of 2051. This represents an increase in such spending of only 0.4 per cent per year. However, paying for it would eventually require all tax rates to be an eighth higher than now.

Economic growth is less help in relieving the conflict between tax constraints and such upward pressures on social spending than often supposed. Higher real incomes in general put upward pressure on public sector pay, and rising living standards lead to raised expectations for the quality of public services. Demand for health care and education appears to rise faster than income growth, and if policy is aimed at reducing relative poverty, benefits may well have to rise at least with real income growth.

Faced with these pressures, one can set out five strategies, each of which is being followed in the UK at present in respect of one or more aspects of social spending. But each has draw-backs when measured against Britain's problems of poverty and inequality, and public attitudes towards their solutions:

(1) Reduce or limit social spending in relation to national income. For most social security benefits for the working age population current policy is to link their values to prices, so that they fall back in relation to average incomes and their relative cost falls. But unless other developments radically reduce the proportion of the population dependent on benefits, this implies rising and deepening relative poverty.

(2) Maintain social spending, but concentrate it on the poor. This is the current strategy for higher education and for future state pensions. However, this implies more means-testing in some way, which is in general unpopular. While incentive problems can be exaggerated, the combined effect of means-tests from different aspects of policy may be reaching its limits. Second, this strategy - of more for the poor within a fixed total - implies less for those in the middle of the distribution. This may hit voter resistance and tighten the tax constraint.

(3) Maintain spending for most with selective increases for the poor. This has been the policy followed for tax credits and other benefits for children since 1999, with some success in reducing child poverty. This still involves some means-testing, with the potential problems discussed above. More difficult in political terms, the strategy implies that taxes would eventually have to rise (or other spending be squeezed), but without improvements in services for those in the middle.

(4) Increase spending across the board to keep up with demographic and other pressures. This has been the approach to school spending in recent years. If applied across social spending, it ultimately implies higher taxes. This is not necessarily inherently unpopular, but people's willingness to pay may be limited to certain services and to visible improvements in them. Second, this strategy may involve quite large increases in spending, and hence taxes, just to 'stand still' in terms of the service received in any particular circumstance. This may be seen as involving increased spending, but 'little to show for it'.

(5) Increase spending faster than the external pressures so that services can improve. Current policy towards NHS spending is for a rate of growth faster than implied either by demographic pressure or by the need to keep health service salaries up with others. Both the quality of services and the amount available for given needs should improve. As a general strategy - for instance to achieve not just static but falling relative poverty - it clearly implies higher costs, and higher taxes, beyond those implied by purely demographic pressures.

It would be very optimistic to think that we can escape some combination of these five strategies, despite their sometimes politically unpalatable side-effects. To achieve that will require better public understanding that these *are* the available options, and that a choice has to be made between them. The decisions we make as a society are open to choice, and are not driven by inexorable external or technological determinants. Policies matter, and we are free to choose between them. To do this, we need to make those choices with our eyes open.

About the study

The book draws on research carried out by the author and colleagues at CASE, much of it supported by core funding from the Economic and Social Research Council, and on research supported by the Joseph Rowntree Foundation. Access to the *Family Resources Survey* and HBAI dataset was granted by the Data Archive at Essex University and the Department for Work and Pensions, and to the British Social Attitudes survey by the National Centre for Social Research.

ISSN: 1460-9770