



Inequality: what can the Scottish Government do?

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Inequality: the Scottish Government view

‘Scotland is currently part of a UK economic model and society which is one of the most unequal in the OECD. Inequality within the UK has increased in recent decades. Such patterns of inequality will continue to have a negative impact on growth and prosperity over the long-term.’ (Scottish Government, 2013)

Scottish Government Economic Strategy 2015:

- Two key pillars: increasing competitiveness and tackling inequality.
- *“Reducing inequality is not only important in itself, but is vital to creating the conditions to deliver sustainable economic growth over the long term.”*

=> Reducing inequality is a key priority of the Scottish Government



Scottish debate part of a wider concern about the effects of inequality

IMF (2013): 'higher inequality seems to lower growth'

OECD (2011): 'inequality can stifle social mobility, making it harder for talented and hard-working people to get the rewards they deserve'.

Carney (2014): 'There is growing evidence that relative equality is good for growth. At a minimum, few would disagree that a society that provides opportunity to all of its citizens is more likely to thrive than one which favours an elite, however defined.'

Why the concern about inequality?

Explanation 1: Changing view on link between inequality and growth

Traditional view of trickle-down economics:

- those at the bottom of the income distribution benefit from gains made at the top

Growing evidence that inequality is detrimental for growth beyond a certain point:

- Poor may be less able to invest in education
- Inequality may stifle motivation and productivity
- Undermines trust in institutions
- Rich may be able to influence policy in a way to entrench position and stifle growth
- Lack of investment and innovation
- Some evidence for inequality as driver of the recession

Link between inequality and social mobility

Changing perspectives on the underlying causes of inequality

Why the concern about inequality?

Explanation 2: Changing perspectives on the underlying causes of inequality

Traditional view: interaction of technical change and globalisation

- At top, returns to talent are high and rising: 'superstar effects'
- At bottom, globalisation has reduced demand for unskilled workers which has pushed down their wages

Alternative view: failures of markets, regulations and policy

- Structure of executive pay-setting
- Barriers to entry and monopoly control
- Implicit subsidies and rent-seeking
- Shift in balance of power from workers to firms
- Belief that the democratic process may be subverted to advance the interests of those with market power



Areas for Scottish Government action

CURRENT AND PROSPECTIVE POWERS

- Some taxes
- Some benefits
- Spending programmes
- Moral suasion?

NO POWER

- Other taxes
- Other benefits including Universal Credit
- Labour market regulation
- Product market regulation
- Capital market
- International taxation agreements



Areas for Scottish Government action on inequality: timing of effects

SHORT RUN

- Taxes
- Benefits
- Moral suasion
- Monetary policy

LONG-RUN

- Labour market regulation
- Some spending (e.g. education)
- Product market regulation
- Capital market
- International taxation agreements

The design of inequality-reducing policies: recent perspectives

Tony Atkinson (Senior Research Fellow of Nuffield College, Oxford, Nobel prize?)

“Inequality: what can be done?”

Joseph Stiglitz (Nobel Prize, Council Of Economic Advisers)

“Re-writing the rules”

François Bourguignon (former Chief Economist of the World Bank)

“The Globalization of Inequality”



Atkinson: Inequality – what can be done?

‘Inequality is embedded in our social and economic structure, and a significant reduction requires us to examine all aspects of our society’

Policies:

- Explicit consideration of distributional dimension of all government policies;
- More egalitarian distribution of wealth (minimum inheritance guarantee and lifetime inheritance tax),
- More progressive taxation,
- Greater use of universal and contributory benefits,
- Increased minimum wage
- More power for workers in wage bargaining

Stiglitz: “Rewriting the rules”

‘Inequality is not inevitable’, but is a ‘choice we make with the rules we create to structure our economy’

Existing rules limit competition, encourage monopolistic rent-extraction (esp. in finance), incentivise short-term profit seeking over investment, weaken employee rights and policy influence

Policies:

- Stronger regulation of finance sector
- Reform of CEO pay
- Increasing competition, particularly in financial services
- More progressive tax system
- Strengthening minimum wage and employee pay-bargaining
- Stronger investment in early years education
- Different emphasis in trade agreements

Bourguignon: The globalisation of inequality

Perspective matters – world, Europe, UK, Scotland?

- **world inequality is falling!**
- ‘within-country’ inequality is rising

The scale of within-country rises in inequality varies significantly across countries...

...thus the forces driving inequality are strong, but cannot be overwhelming

Drivers: globalisation, technological trade, financial liberalisation, rise of winner-takes-all markets, rent extraction



What issues does this suggest might be important for Scottish Government inequality policy?

Scotland – a small open economy

- Ability to regulate markets limited especially where external trading relationships involved
- Unlikely to be particularly influential on international taxation/market regulation agreements
- Regulation imposes costs – more onerous in smaller economy
- Lack of control over capital market – vital for upper tail inequality
- Power of moral suasion may be greater within a smaller jurisdiction

Inequality: Detailed Trends



Measuring the inequality of income



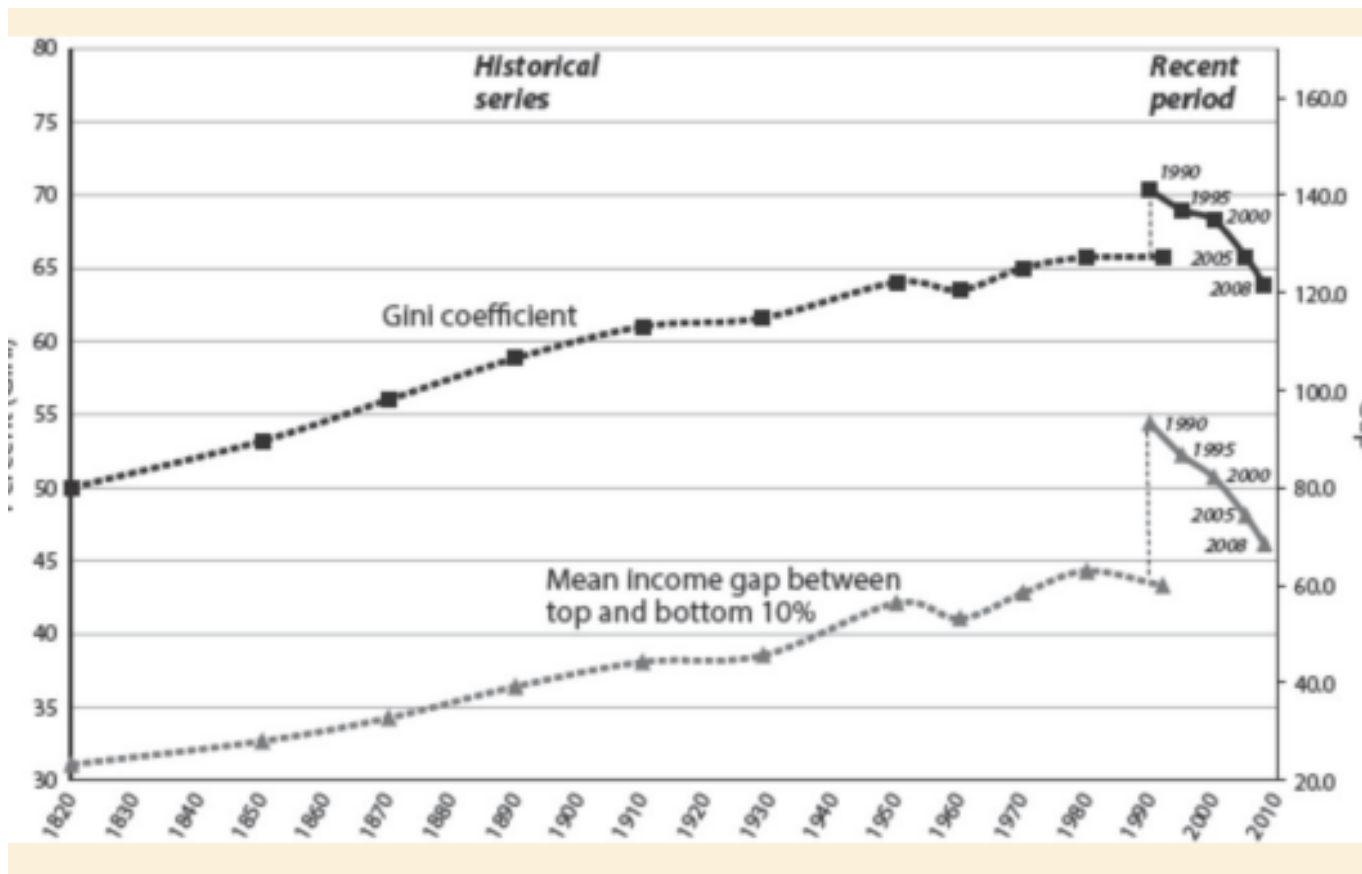
Which measure?

- Hourly, weekly, annual, lifetime
- Taking account of non-wage benefits
- Individual or household
- Before or after taxes and benefits

Which statistic?

- Gini coefficient
- Percentile ratios
- Atkinson indices
- Decomposable measures

Bourguignon: The globalisation of inequality



Bourguignon: The globalisation of inequality

Year	1990	1995	2000	2005	2008	2010
Mean income per capita in sample In PPP 2005 USD	6950	7210	8070	9025	9890	10070
Share of global population accounted for (%)	92.3	92.2	92.2	92.1	92.0	92.0
Share of global income accounted for (%)	94.3	94.4	94.3	94.0	93.8	93.7
Global inequality						
Gini	0.703	0.690	0.683	0.658	0.638	0.623
Theil	0.949	0.918	0.903	0.827	0.763	0.723
Mean income gap between richest and poorest 10%	93.1	86.7	82.1	74.3	68.5	63.5
Inequality between countries (Theil)	0.734	0.696	0.681	0.600	0.529	0.479
Inequality within countries (Theil)	0.215	0.222	0.222	0.227	0.234	0.244

^a Inequality computed on income (or consumption expenditure) per capita in PPP 2005 USD after rescaling by national GDP per capita; Povcal and OECD secondary sources used. Constant sample of 106 countries.

Inequality: Within Country Increase

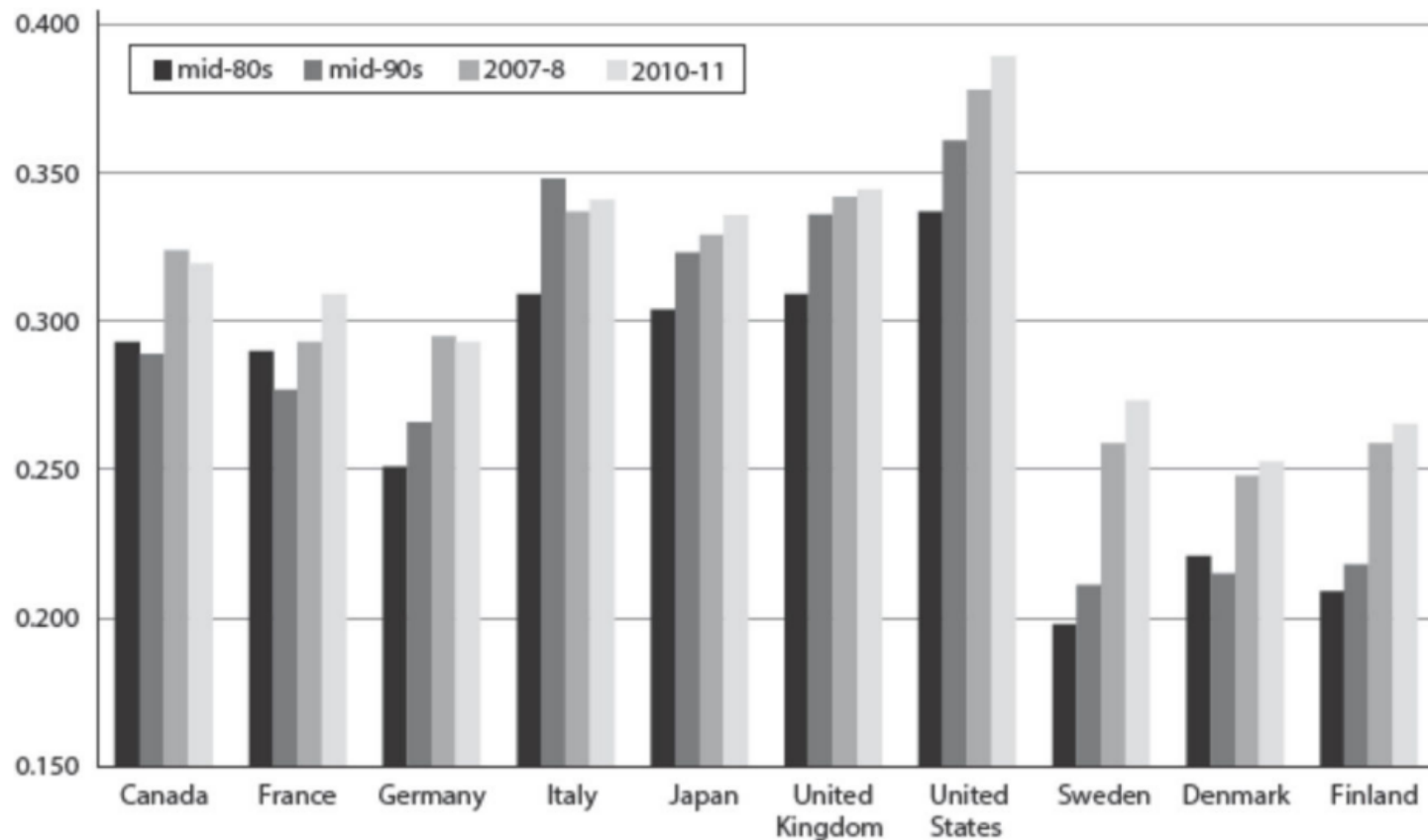
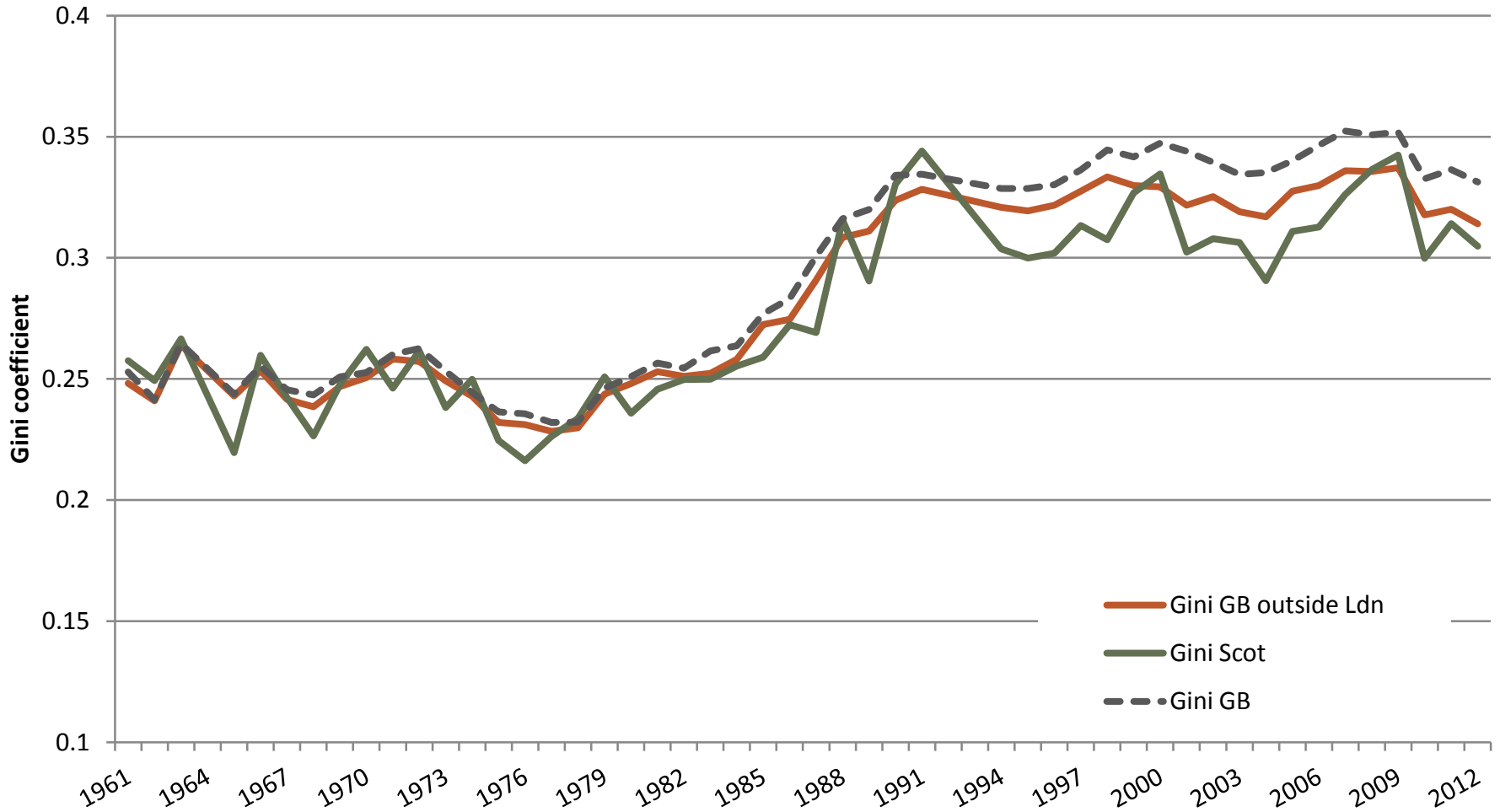


Figure 3. The increase in inequality in selected OECD countries.

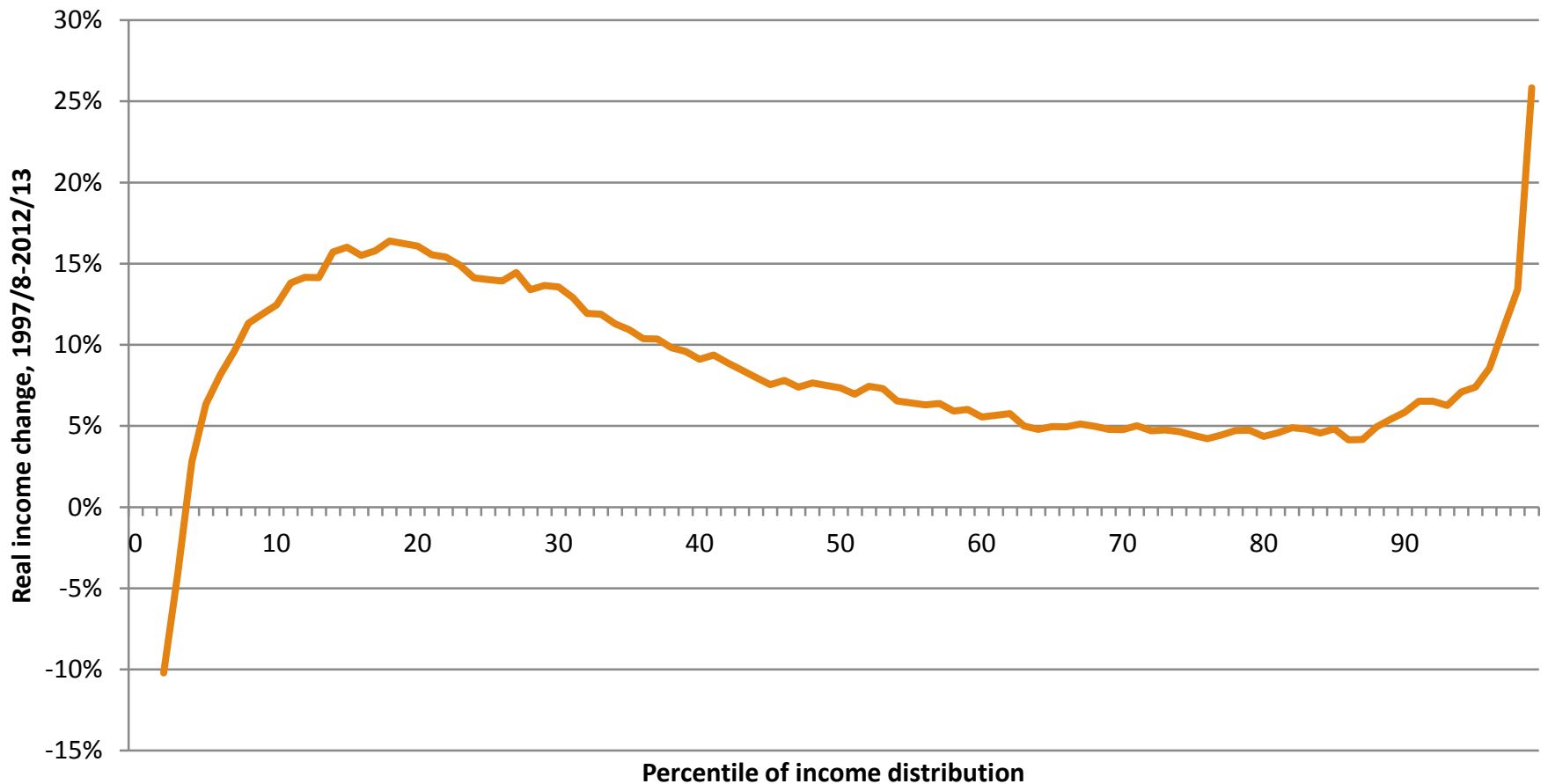
Note: Gini coefficient of disposable income per adult equivalent, 1985-2010.

UK: big increase in inequality during the 1980s

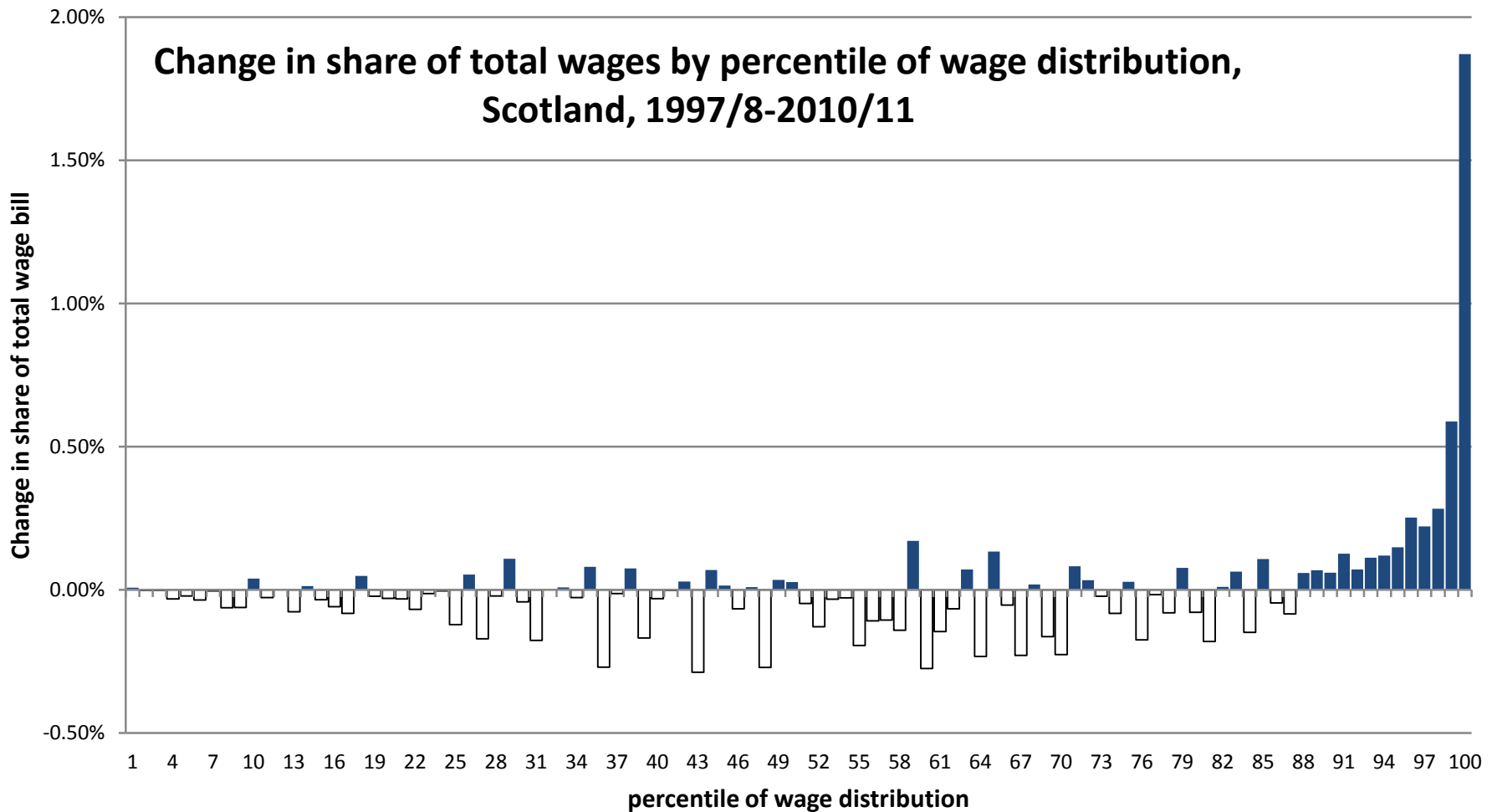


But the evolution of the income distribution is more subtle than the Gini coefficient implies

Real income change, 1997/9 - 2012/13



The 2% of earners have appropriated an every-greater share of total earnings



Drivers of inequality trends

1980s and early 1990s:

- Deindustrialisation and technological change
- Financial deregulation
- Labour market deregulation and TU decline
- Reduction in top tax rates

Since late 1990s:

- Continuing technological change and globalisation
- Increase in PT and temporary working, underemployment
- Increase in self-employment
- **Moderating effects:**
- Introduction of minimum wage
- Increase in in-work support (tax credits) and benefits for families and pensioners



Inequality since the recession. Three components:

Real wage falls across the distribution

- Has helped to mitigate inequality increase
- But are wage falls structural /permanent or cyclical/temporary?

Fiscal policy changes

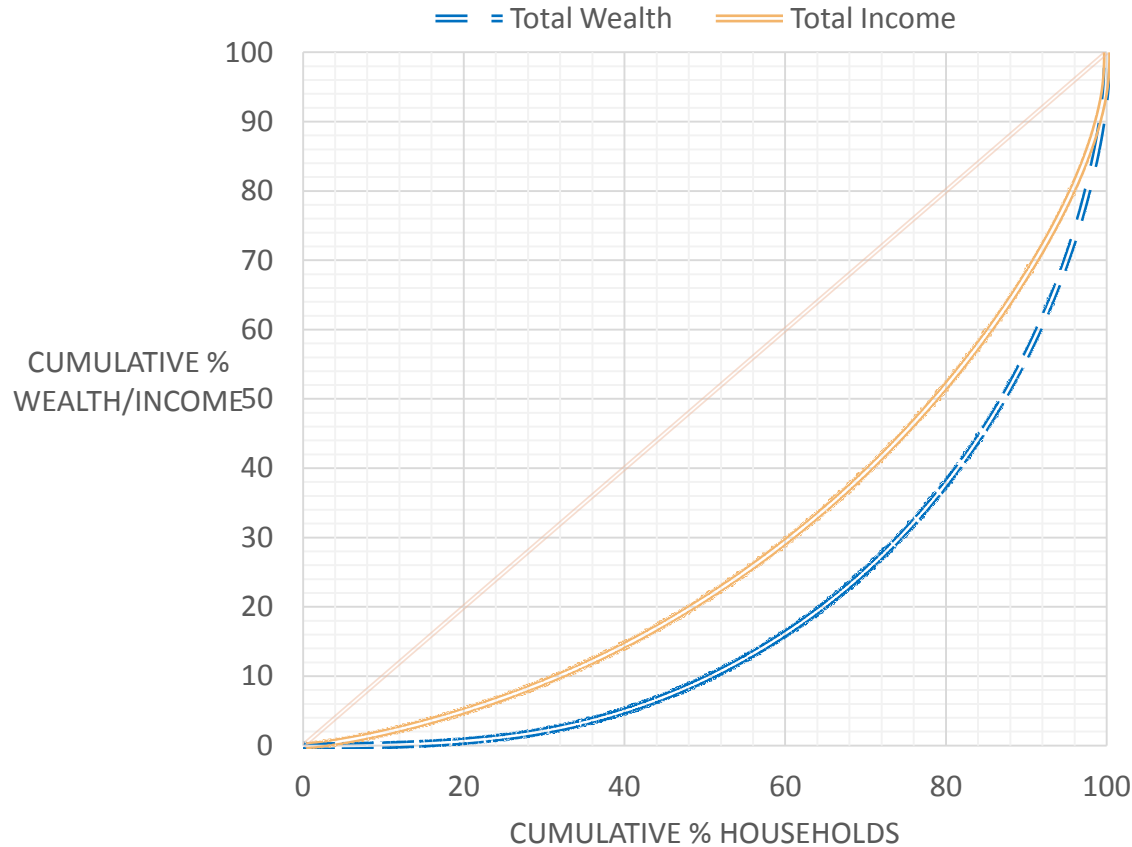
- Many working age benefits fallen in real terms, although pensioner benefits protected
- Rises in income tax personal allowance benefit higher income households more than lower income households (but top decile households lose from freezing of upper rate threshold)
- Council tax freeze combined with cut in Council Tax Benefit: helps the better off

Monetary policy

- Quantitative easing raises asset prices, substantially increasing household wealth
- But holdings are 'heavily skewed, with the top 5% of households holding 40% of these assets' (BoE)

Inequality of Wealth

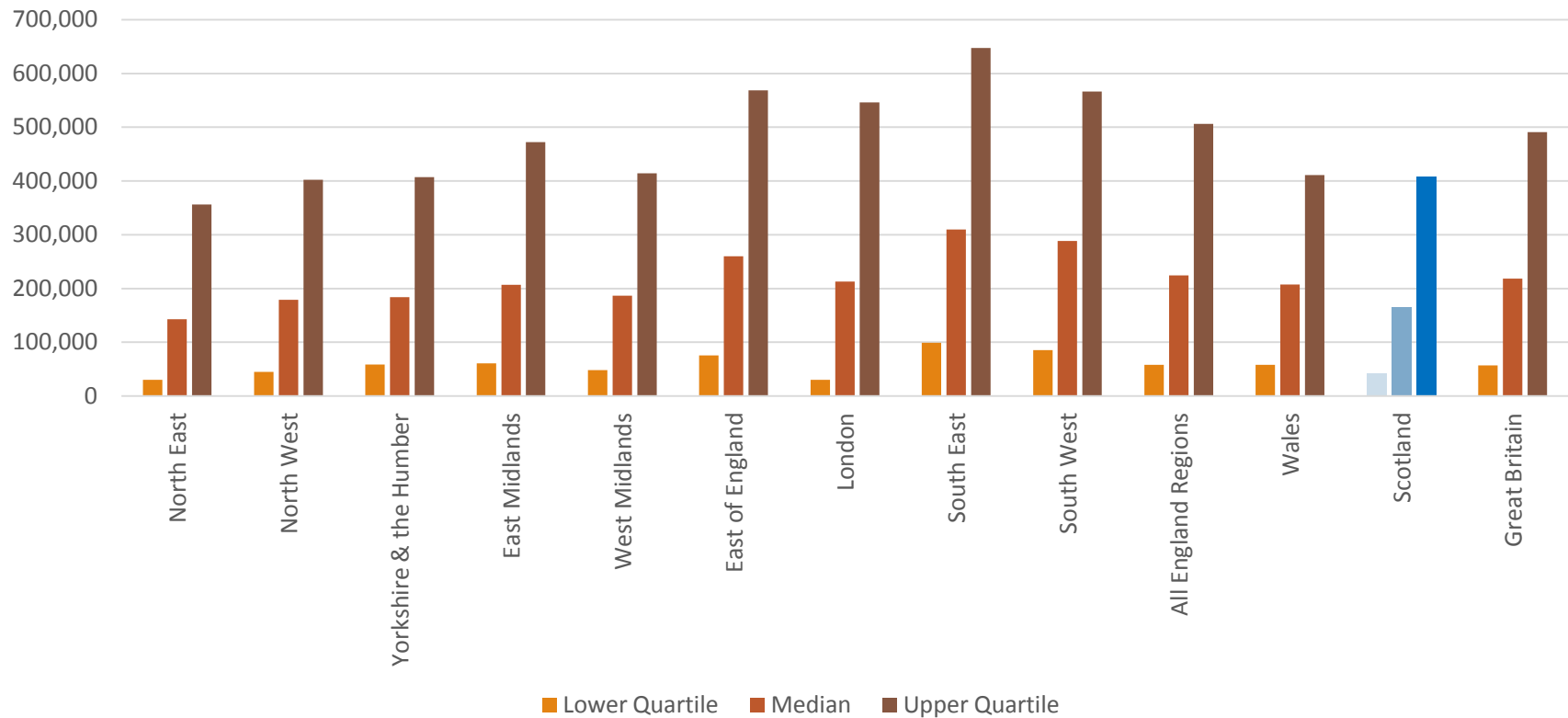
Wealth is More Unequally Distributed Than Income



Data for 2010-12

Source: Wealth and Assets Survey, Office for National Statistics

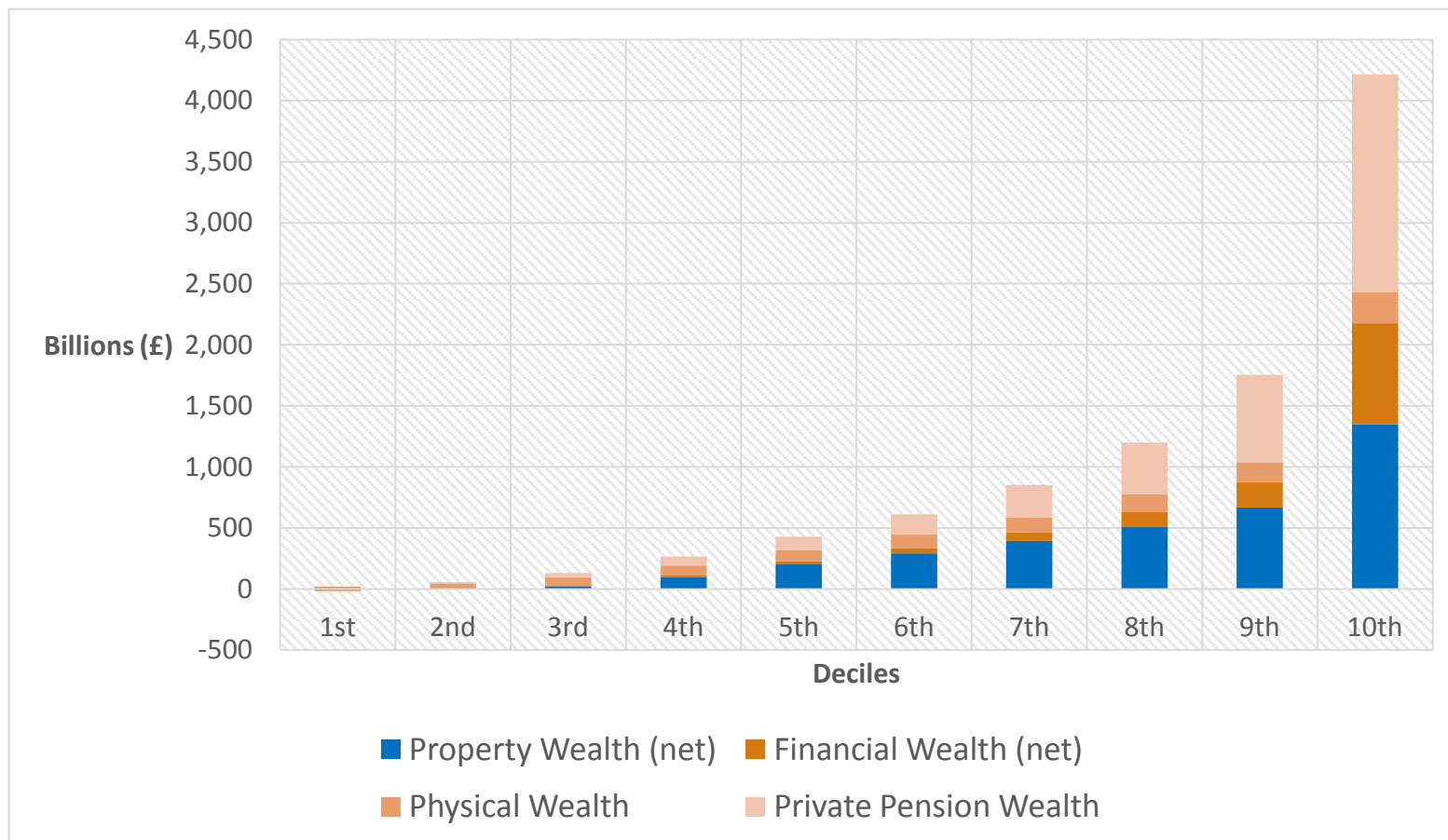
The Distribution of Wealth is Highly Unequal



Data for 2010-12

Source: *Wealth and Assets Survey, Office for National Statistics*

Property and pensions are the main components of household wealth



Data for Great Britain 2010-12

Source: Wealth and Assets Survey, Office for National Statistics

Property taxation



Taxing Property

Council tax is a mixture of property, income and poll tax

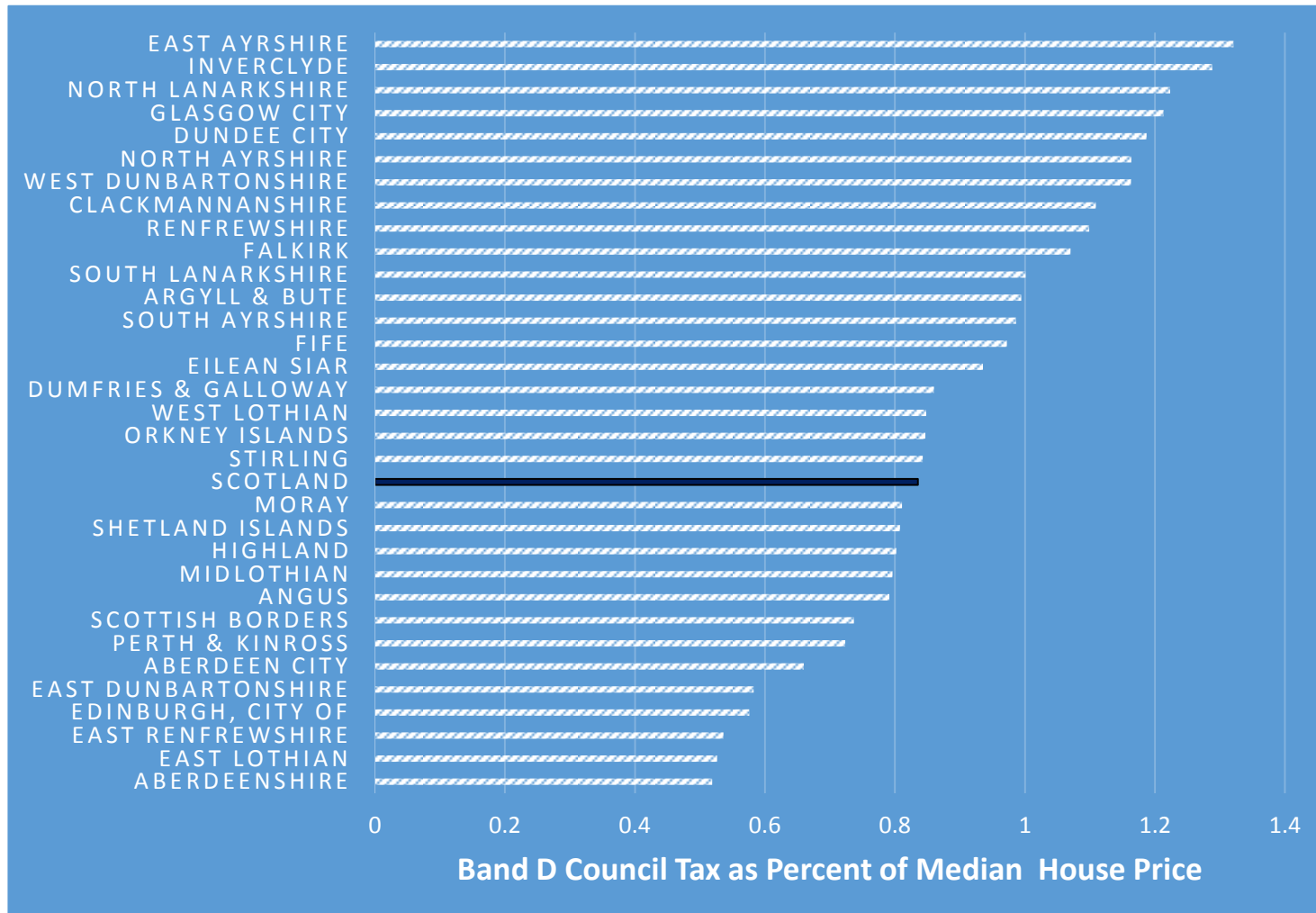
Land and buildings transactions tax is a disincentive to mobility – bad for labour market

What aspects of property wealth should be taxed?

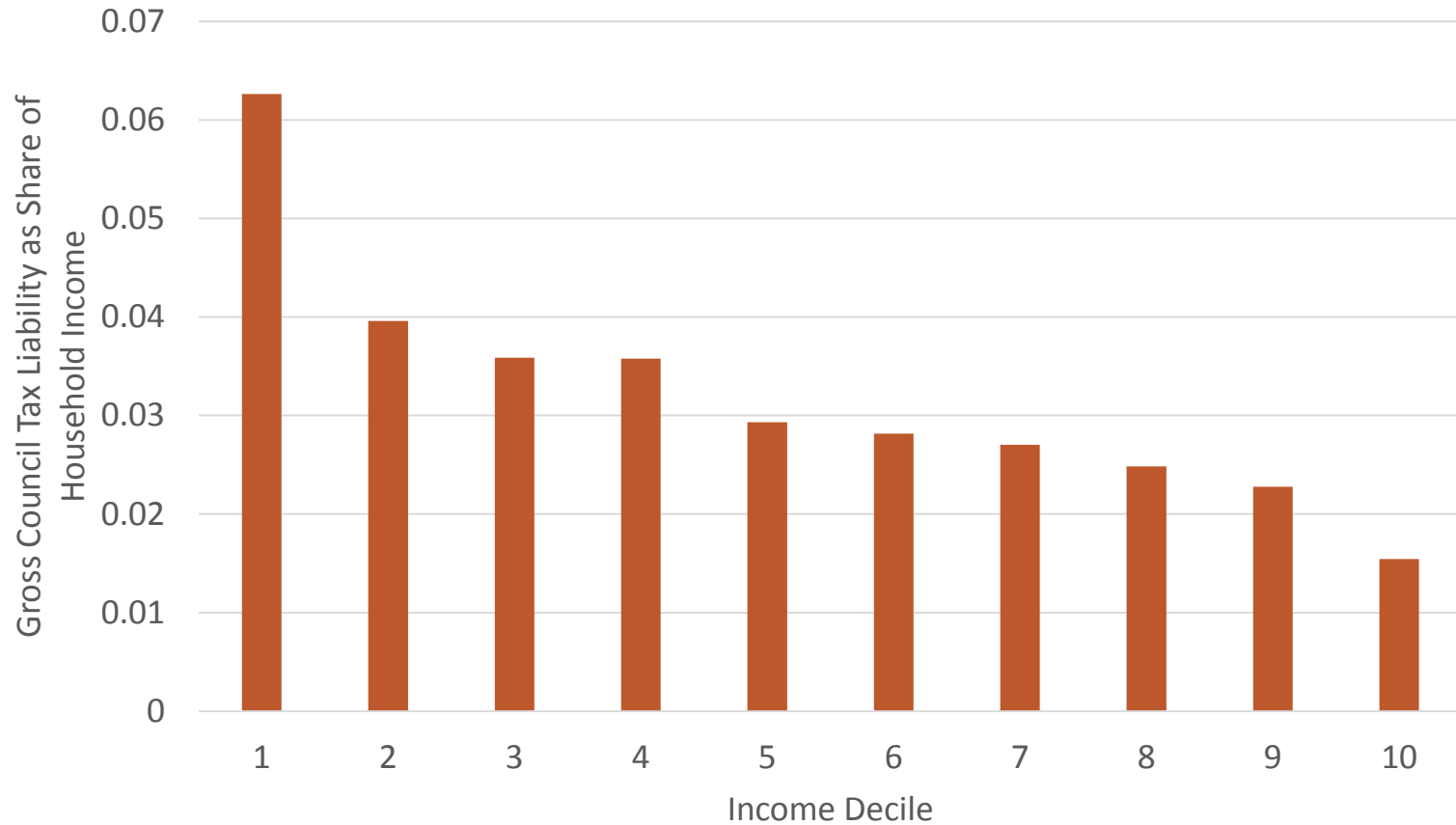
- Consumption value of housing - – just as the consumption value of other goods and services is taxed
- Capital gains on housing transactions - – focussing investor activity in the property market does not increase the UK's productive capacity



Council tax is poorly related to housing wealth



Council tax is regressive



Source: Understanding Society

A Land Value Tax?

Band	Current Total CT	CT% of Total	LVT Total at 3.16p	% of Total CT	Council Tax	Land Value Tax	Change
A	£399,528,234	15.6%	£268,070,342	11.1%	£766	£513	- 32.9%
B	£503,998,811	19.6%	£358,780,982	14.8%	£894	£636	- 28.8%
C	£380,088,060	14.8%	£304,157,274	12.6%	£1,021	£820	- 20.0%
D	£342,927,083	13.3%	£315,162,667	13.0%	£1,149	£1,056	- 8.1%
E	£429,204,672	16.7%	£433,055,773	17.9%	£1,404	£1,415	+ 0.9%
F	£279,103,062	10.9%	£320,989,760	13.2%	£1,660	£1,908	+ 15.1%
G	£207,355,350	8.1%	£351,994,719	14.5%	£1,915	£3,261	+ 69.7%
H	£26,538,346	1.0%	£70,449,882	2.9%	£2,298	£6,153	+ 165.5%
Total	£2,568,743,618	100%	£2,422,661,399	100%	n/a	n/a	n/a

Source: A Wightman: A Land Value Tax for Scotland



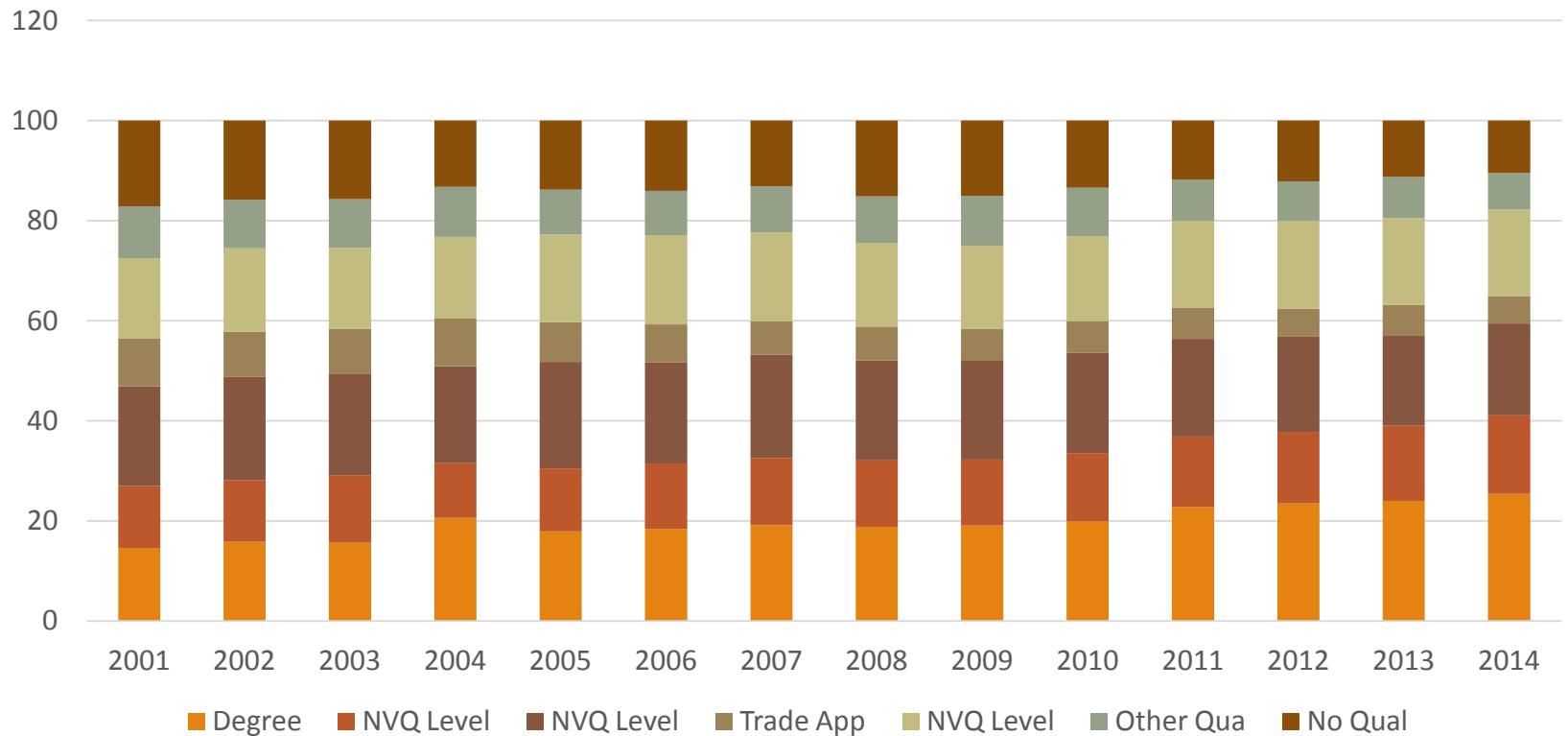
Taxing Property - Conclusion

- Loss aversion – losers will feel their loss more keenly than will those who gain feel the benefit
- Reference effects – comparisons with property taxes in England
- What will be the effect on the housing market
- What are the implications for business start-ups?
- Separate capital gains tax – or lifetime accruals as in Ireland?

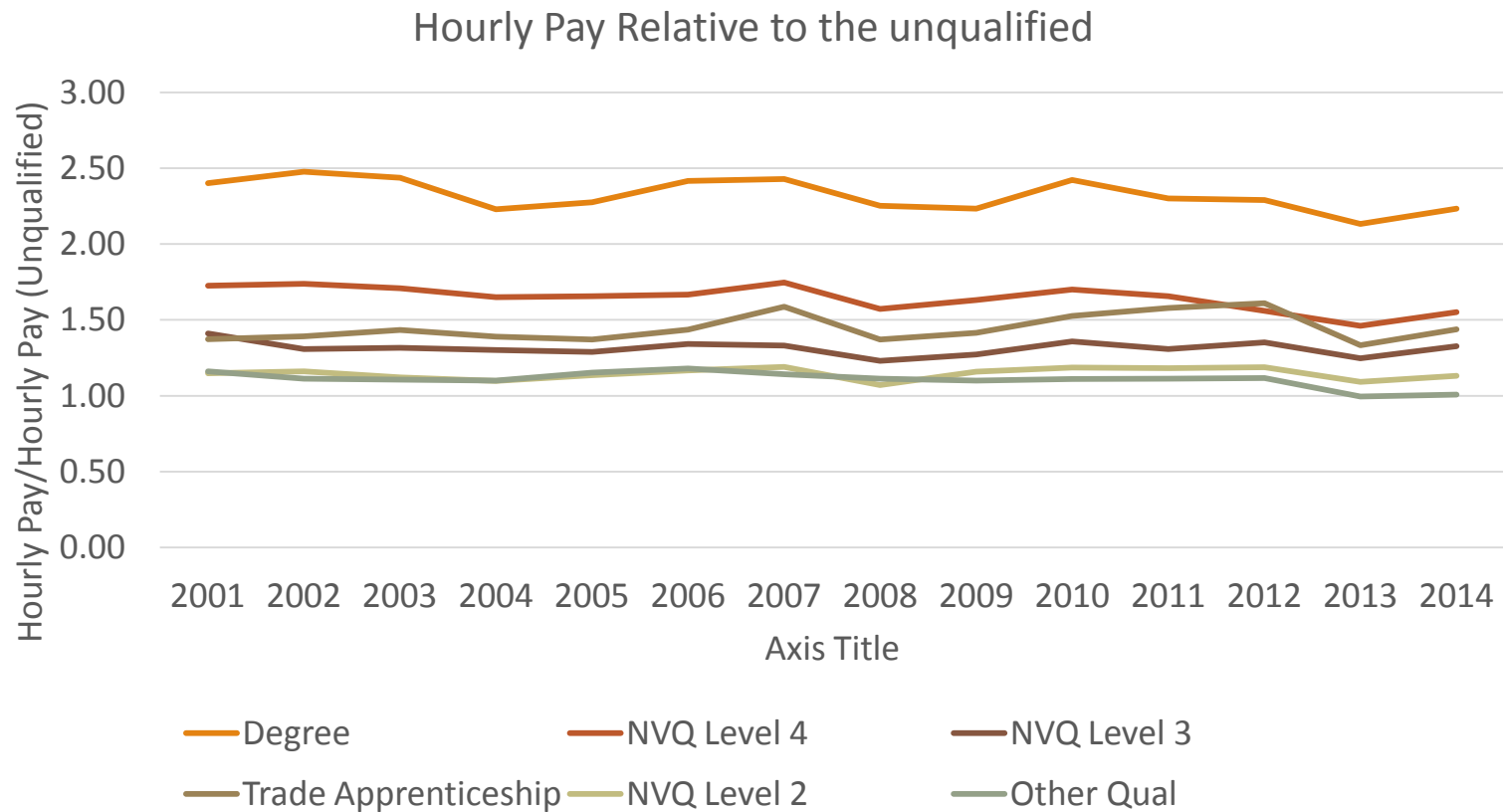
Education and skills

More education – but no change in inequality?

Changing Educational Composition of Scottish Population



More education = higher pay?





Can investment in education address inequality?

View 1: Technological change is 'skill-biased'

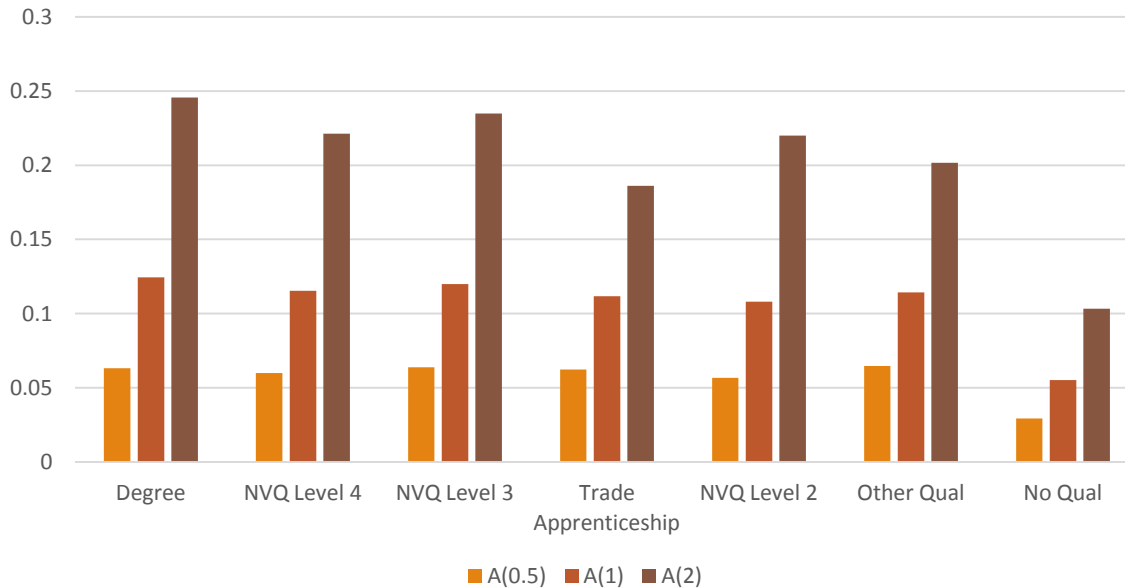
- Growing inequality is the result of a race between the demand for and supply of skills
- Investment in education mitigates rising skill premium

View 2: Most of the rise in inequality has been 'within education group'

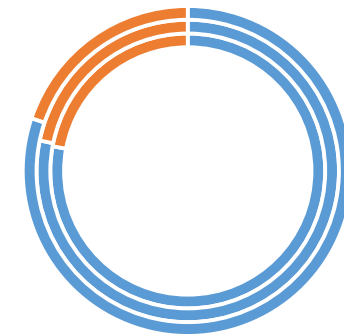
- Graduate earnings becoming increasingly dispersed
- Does not undermine argument for investing in skills...
- ...But won't necessarily stem rise in within-group inequality

Inequality within and between educational groups

Within group inequality by educational qual.



Within and between group inequality by educational qual. (A(0.5), A(1) and A(2))



■ Within-group inequality ■ Between-group inequality

A Thought Experiment

What if half of those who are currently unqualified achieved degree level education?

And in consequence the graduate premium fell by 20 per cent

What would be the effect on inequality?

Statistic	Before	After
P(90)/P(10)	3.736	3.636
P(90)/P(50)	2.114	1.978
P(10)/P(50)	0.566	0.544
Gini Coefficient	0.319	0.299

For a similar exercise see the [Hamilton Project](#)



Role of education in addressing inequality

Bourguignon: “The results of the PISA survey of educational performance, which clearly demonstrate the relationship between student outcomes and students’ social backgrounds, leave little doubt as to the importance of education in the fight against inequality.”

Bourguignon: “The public interest (is) served by creating a system of preschool education that is high-quality and open to all, such as the one developed in Finland, a country which, interestingly enough, happens to be at the top of the PISA rankings, both in terms of the average score and the lowest dispersion of that score.”

Summers: “to suggest that improving education is the solution to inequality is, I think, an evasion.” (Washington Post)

Even if the educational qualifications of the poor are improved, the effect on inequality in the short and long-run is unclear. Education may improve access to education: it does not address inequality driven by market wage differentials.

Income tax

Income tax

Under Smith proposals, SG will gain almost full control over income tax

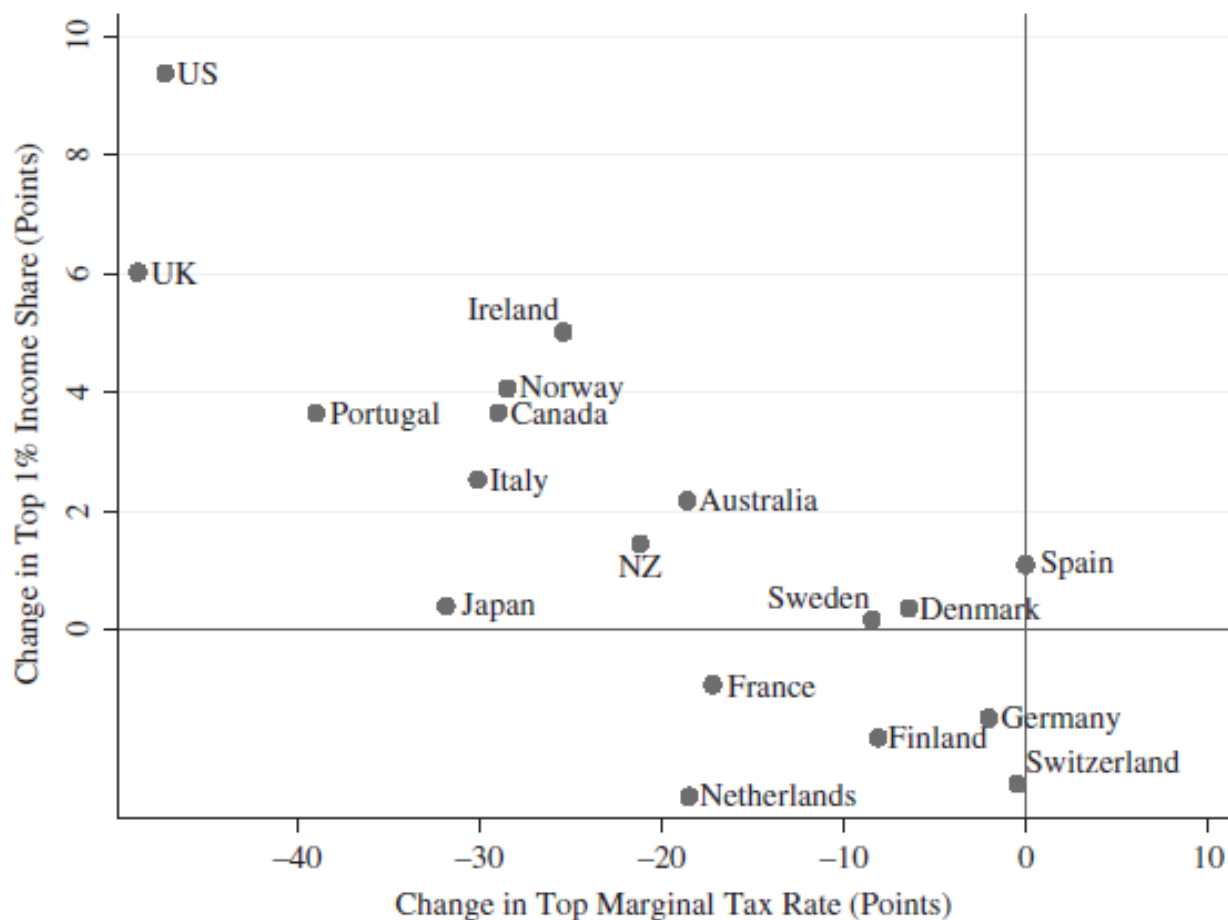
Further rise to the personal allowance?

- Coalition raise PA from £6,475 in 2010/11 to £10,500 in 2015/16
- Now 17% lowest paid workers pay no income tax
- Main effect of further rises in PA is to provide tax cut to all those with earnings above PA... further PA rises, less progressive it is

Raising additional tax rate to 50% (from 45%)?

- This would affect the 0.5% of Scottish taxpayers (0.3% of population) who pay the additional rate (income > £150,000)... virtually no impact on Gini coefficient

Changes in top income shares and top marginal tax rates... do cuts in the top rate lead to an increase work effort, or compensation bargaining?





But the implications of returning to higher marginal rates remain uncertain

Most OECD marginal tax rates on highest incomes are around 40–50%.
Dividends and capital gains are taxed at around 30%

In France, the effective deduction from wages for each additional 100 euros in the top income bracket (already subject to the highest marginal income tax rate of 45%) is between 60 and 75 euros, depending on whether or not we consider social contributions to wage income (particularly for retirement) as deferred income.

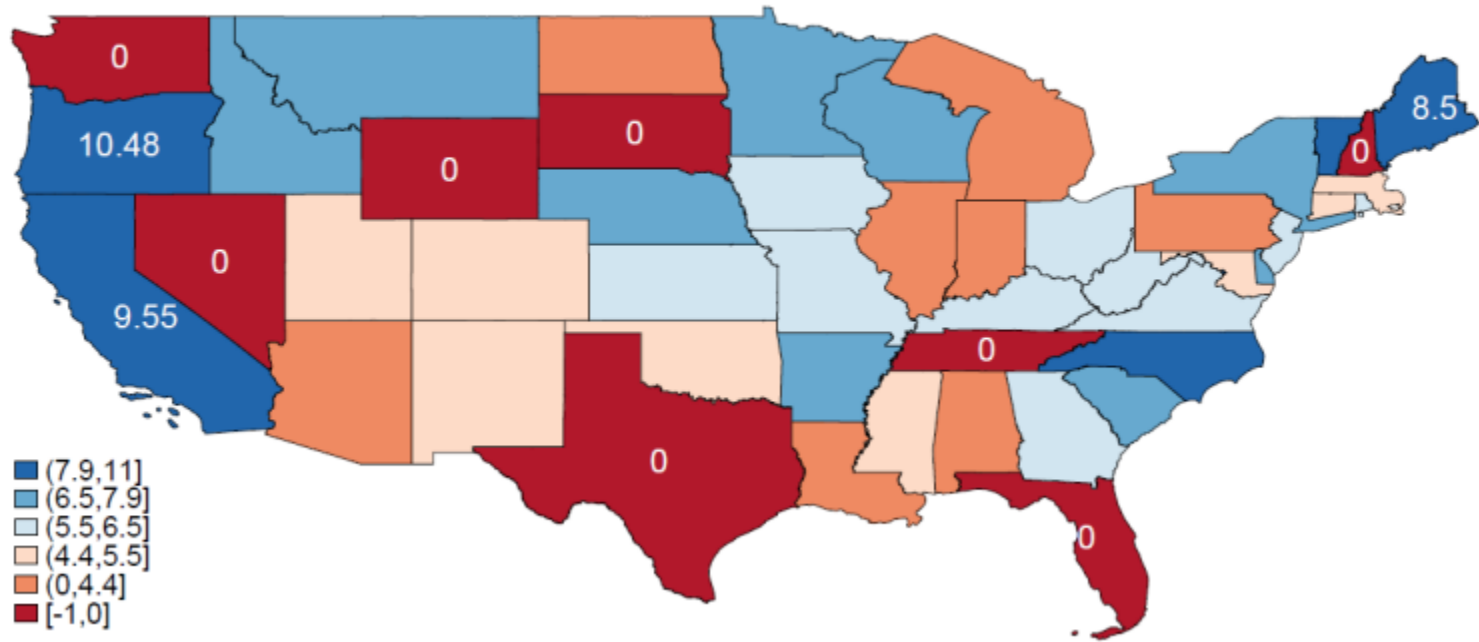
Can we really go any further without significantly shrinking the tax base—either because of tax avoidance of varying degrees of legality, or because of a drop in the economic activity of these taxpayers—not to mention the risk that these individuals might leave the country altogether for a country with a lighter tax burden?

In the United States, the average tax rate on the richest 1% is only 35%. Billionaire Warren Buffett recently announced that he had been surprised to learn that he was paying, at the margin, a lower tax rate than his secretary.

(Bourguignon)

USA: variation in state income tax

Figure 1
Marginal Tax Rate, 2010



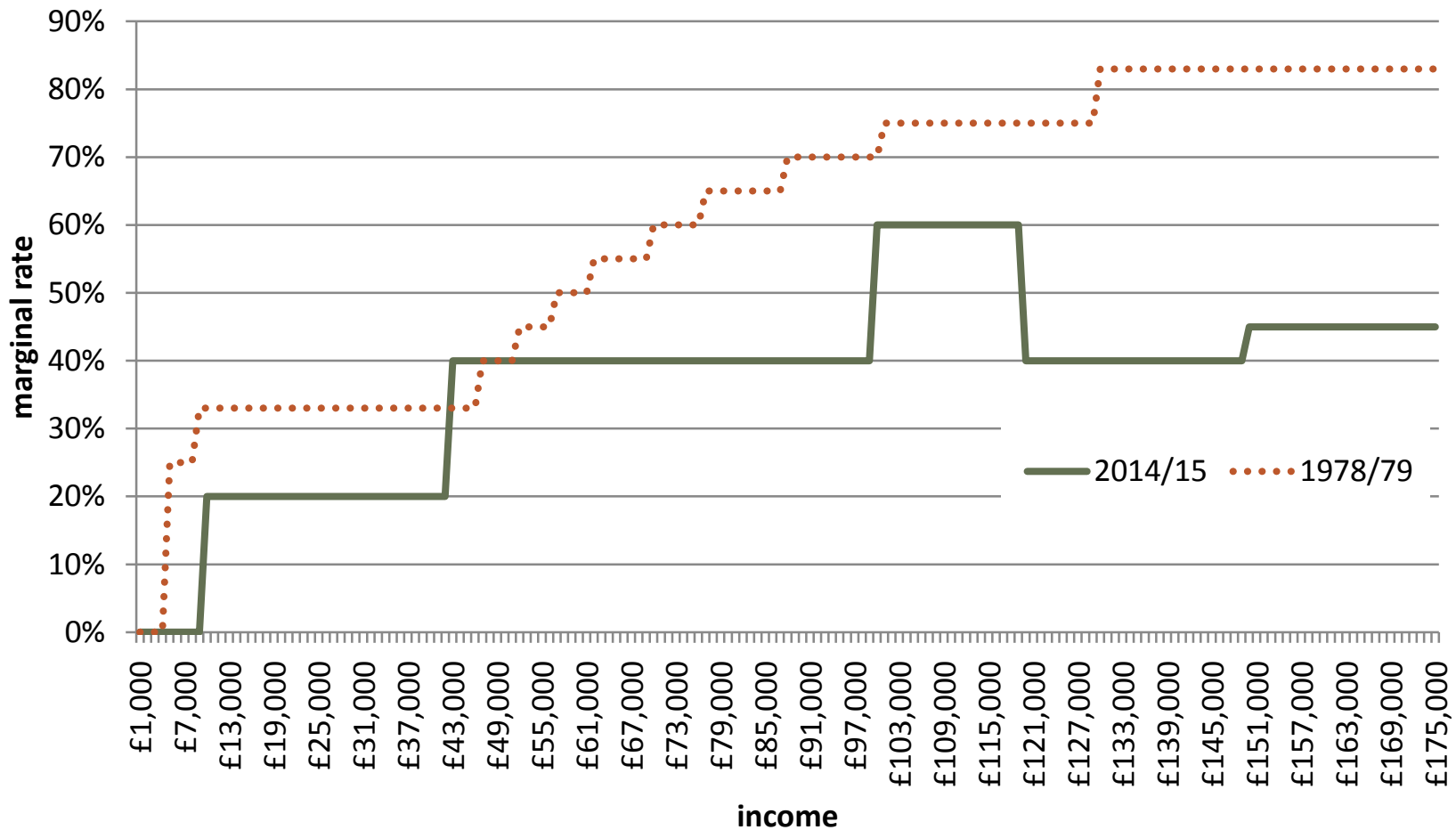


A US perspective – differences in state income tax rates matter

“Overall, we conclude that state taxes have significant effect of the geographical location of star scientists and possibly other highly skilled workers. While there are many other factors that drive when innovative individual and innovative companies decide to locate, there are enough firms and workers on the margin that relative taxes matter.”

Moretti, Enrico, and Daniel Wilson. 2015. “The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists.” Federal Reserve Bank of San Francisco Working Paper 2015-06.
<http://www.frbsf.org/economicresearch/publications/working-papers/wp2015-06.pdf>

Income tax schedule, 1978 and 2014; not only the top rate which has fallen



Top tax rates in Nordic countries: apply much further down the income distribution

Country	Top marginal tax rate	Threshold at which top rate is payable, expressed as multiple of average wage
UK	47	4.2
Finland	57	2.5
Sweden	57	1.5
Norway	47	1.6
Denmark	56	1.2



Interaction between IT and NI

NICs act as a further tax on earnings – linkage between NICs made by an individual and the rights to benefits that the individual is entitled to has largely disappeared

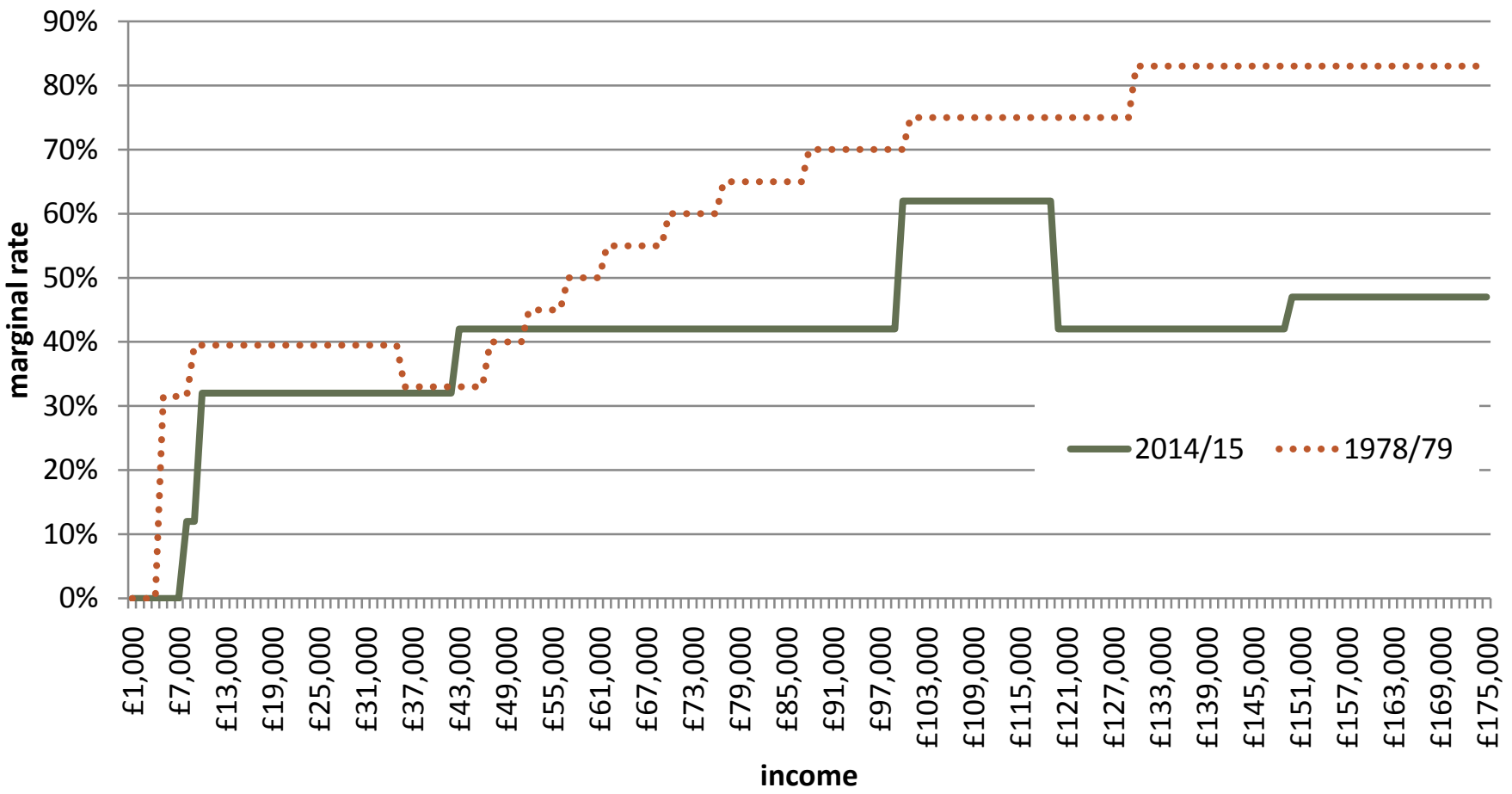
But threshold for paying NICs has risen more slowly than threshold for IT; threshold for NICs now £8,500 v. £10,500 for IT

Increasing calls for NICs thresholds to be aligned with IT thresholds (and possibly even combined)

Also anomalies in employer NICs: e.g. employer NICs not due on pension contributions... benefits those who can afford to take larger contribution of salary as pension, (and costs Exchequer £18bn/yr!)

What scope for devolution of NICs to Scotland?

Combined income tax and NI schedule, 1978 and 2014





What about the behavioural response to increased income tax/national insurance?

Great uncertainty around the 'revenue maximising' top rate of income tax... HMRC estimate anywhere between 42-57%

Employment income relatively insensitive to changes in tax rate, most effect via dividend income

But even where tax rises do reduce income, this appears mainly due to avoidance, rather than a reduction in work effort

Narrowing of UK tax base (exemptions and deductions) makes avoidance easier... Nordics can support higher tax rates partly because tax base is broader



Other approaches for addressing pay inequality

Publication of pay ratios to adjust social norms?

- 'Self-centred bias' in perception of income distribution

Promote employee-ownership?

Reform structure of remuneration committees?

Increasing competition (e.g. through improved access to finance) to reduce rents?

Addressing low pay

Devolving the minimum wage to Scotland?

Since introduced in 1997, NMW has reduced wage inequality; and little evidence to suggest it has reduced employment

Good rationale for devolving minimum wage given regional variation in labour markets

Minimum wages devolved to states in US, Australia, Canada

But what scope for increasing the minimum wage in Scotland?

One view is that the minimum wage can reach about 60% of median without having detrimental employment effects...

...This implies a sustainable minimum wage in Scotland could be just over £7 (compared to £6.50 currently)

Minimum wage limitations

Not a panacea for poverty:

- Big driver of in-work poverty is growth of part-time, temporary and insecure working, and agency 'self-employment'
- A reasonable proportion of low-paid workers are not from low-income households (second earners, young adults living at home)

Interaction with UK benefits system:

- For workers eligible for tax credits, a higher minimum wage will in some cases shift cost from UK Exchequer to private sector

Interaction of minimum wage with tax/ benefit system

Hypothetical illustration of case of single adult working 30 hours per week at the minimum wage

		Min. wage £6.50	Min. wage £7	Difference
Employee	Wage	£195.00	£210.00	
	Tax credits	£22.98	£16.83	
	NICs	-£5.04	-£6.84	
	net pay	£212.94	£219.99	£7.05
Employer	Wage bill	£195.00	£210.00	
	Employer NICs	£5.80	£7.87	
	Total	£200.80	£217.87	-£17.07
UK exchequer	Tax credits	£22.98	£16.83	
	Employee NICs	-£5.04	-£6.84	
	employer	-£5.80	-£7.87	
	Total	£12.14	£2.12	£10.02



Other strategies for addressing low-pay

Broader, integrated low-pay Strategy encompassing:

- Jobmatch
- Progression opportunities
- Training/ skills development for those out of work
- Addressing barriers to employment

Scope for legislative change around aspects of zero-hours contracts and self-employment out-sourcing

Promoting opportunities for collective bargaining

Pursuit of full-employment

Maintaining/ strengthening level of in-work support through tax credits/ Universal Credit

...Only some of these under the direct control of Scottish Government



Conclusions

The Scottish Government has – or will soon gain – significant fiscal policy levers with which to address inequality

Particular scope for reform of land taxation and income taxation

Behavioural effects of taxing labour income uncertain

More limited scope for addressing low-pay/poverty

Powers for addressing market inequality limited

Significant political and economic barriers to implementation



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Financial Services Rent Seeking

“In summary, the available evidence is most consistent with the rent sharing explanation for the finance sector pay premium.”

Lindley, J and S McIntosh (2014), “[Finance Sector Wage Growth and the Role of Human Capital](#)”, Sheffield Economics Research Paper 2014002