

Recessions, income inequality and the role of the tax and benefit system

Andrew Hood

1. The effects of past recessions on living standards

- What explains their different impacts on income inequality?
- What is the role of the tax and benefit system?

2. The protection households have against the next recession

- To what extent will the tax and benefit system help different groups?
- How will working-age benefit changes being rolled out affect that?

Use long-running household survey data...

- Family Expenditure Survey (1979-1993), Family Resources Survey (1994-95 to 2015-16) – currently around 20,000 households each year
- These are the data underlying official income distribution statistics

... in combination with the IFS tax and benefit simulator TAXBEN

- Allows us to separate out the effect of tax and benefit changes
- And to look at the long-run impact of policies currently being rolled out

Looking back to past recessions...

Past three UK recessions had very different impacts on household income inequality

- Inequality up sharply during early '80s and early '90s recessions, but fell during the Great Recession

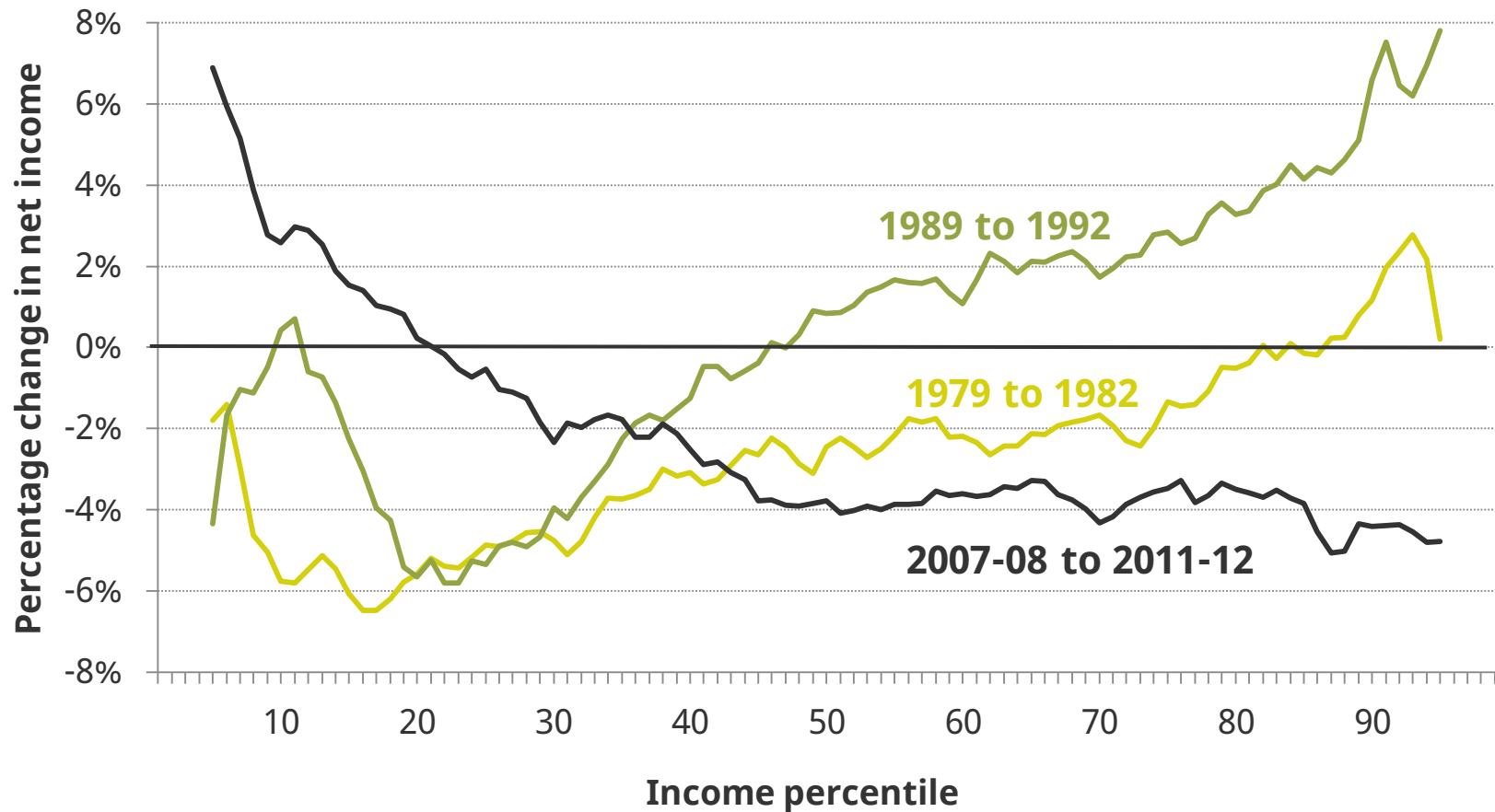
Key explanation is differences in nature of labour market downturn

- Earnings falls tend to reduce inequality, employment falls tend to increase it

Tax and benefit system did play a role in reducing inequality during the Great Recession

- Both 'automatic stabilisers' and policy reforms

The impact of the last three recessions on the income distribution



Note: Incomes measured net of taxes and benefits, at the household level and adjusted for household size.

Source: Figure 2.1 of 'Recessions, income inequality and the role of the tax and benefit system'

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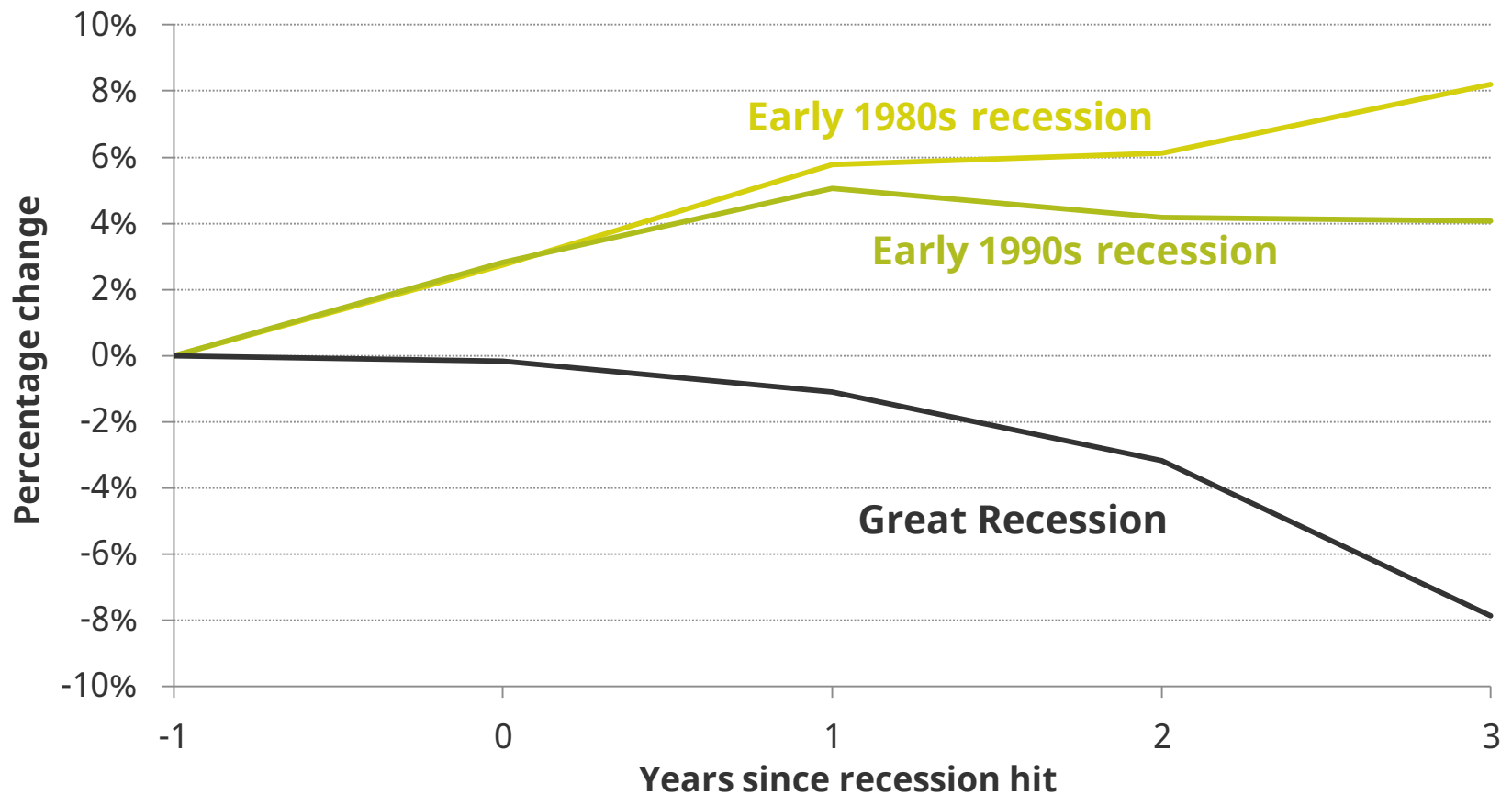
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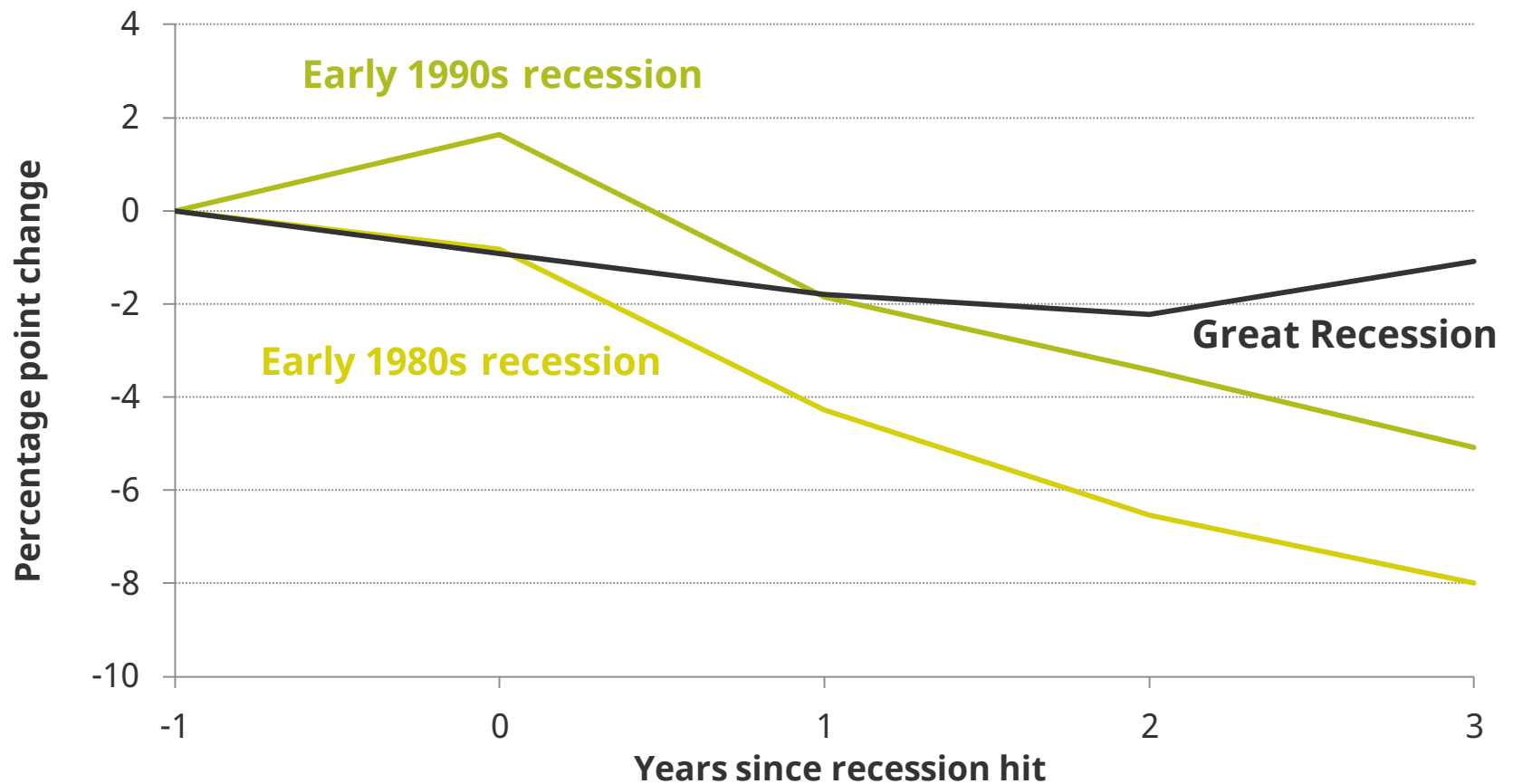
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Differences in labour market downturns: median real weekly earnings



Source: Figure 2.2 of 'Recessions, income inequality and the role of the tax and benefit system'

Differences in labour market downturns: employment rate



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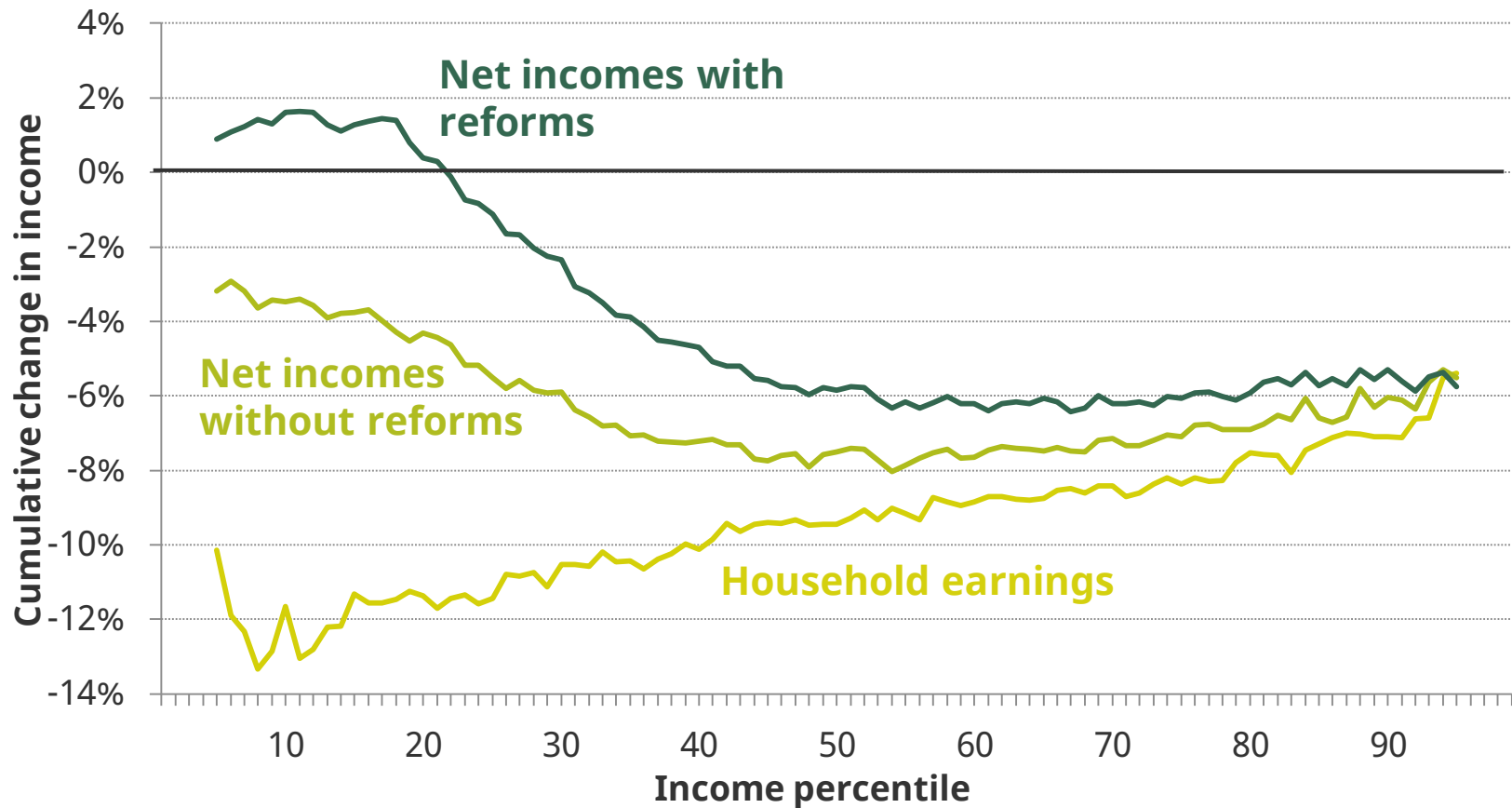
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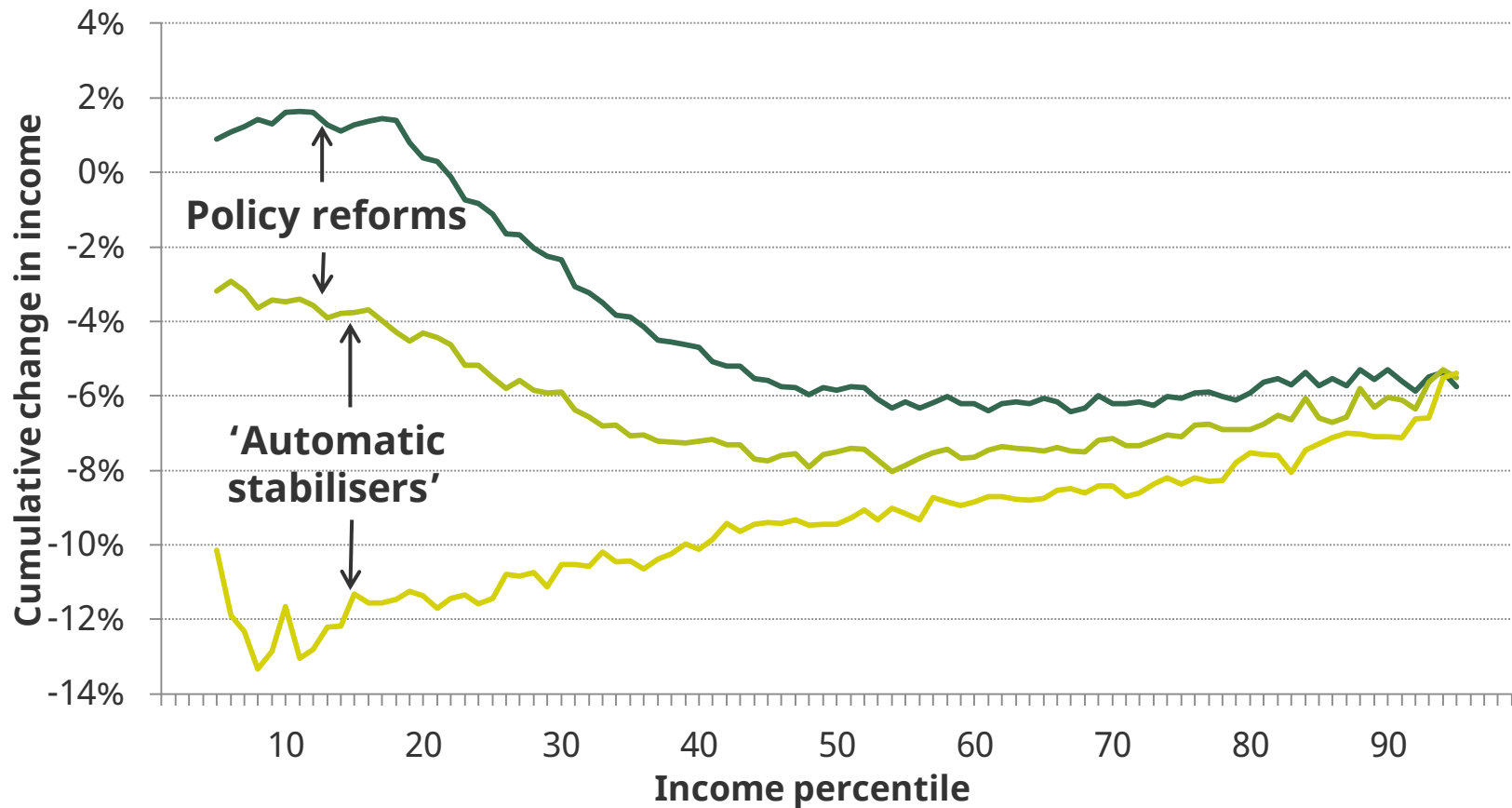
The role of the tax and benefit system: 2007-08 to 2011-12



Note: Earnings and incomes measured at the household level.

Source: Figures 2.5 and 2.7 of 'Recessions, income inequality and the role of the tax and benefit system'

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Looking to the next recession...

Tax and benefit system provides an important source of insurance to households against the next recession

- Overall, system provides more insurance against earnings falls and less against employment falls than in the past
- Most insurance for groups least able to insure themselves against a temporary shock – e.g. low-income households

Benefit cuts being rolled out will significantly reduce insurance

- Particularly for low-income working-age households
- Leaving them more exposed when the next recession hits

2 different kinds/measures of state insurance

1. Employment/earnings 'pass-through'

- Answers the question: what proportion of the fall in earned income is 'passed through' to net income?

Measures of state insurance – an example



- Before recession: earns £150, pays £50 in tax
 - Net earnings = £100 a week
- After recession: earns £135, pays £45 in tax
 - Net earnings = £90 a week
- **Pass through rate = 67%**

2 different kinds/measures of state insurance

1. Employment/earnings 'pass-through'

- Answers the question: what proportion of the fall in earned income is 'passed through' to net income?

2. 'Sensitivity' of net income to labour market shocks

- Answers the question: for a given % fall in my labour income, by what % does my net income change?
- Accounts for income from non-means-tested benefits and other sources of income

Measures of state insurance – an example



- Before recession: earns £150, pays £50 in tax
 - Net earnings = £100 a week
- After recession: earns £135, pays £45 in tax
 - Net earnings = £90 a week
- **Pass through rate = 67%**

- Also receives £100 a week in disability benefits
 - Net income before recession = £200 a week
 - Net income after recession = £190 a week
- **Net income sensitivity = 50%**

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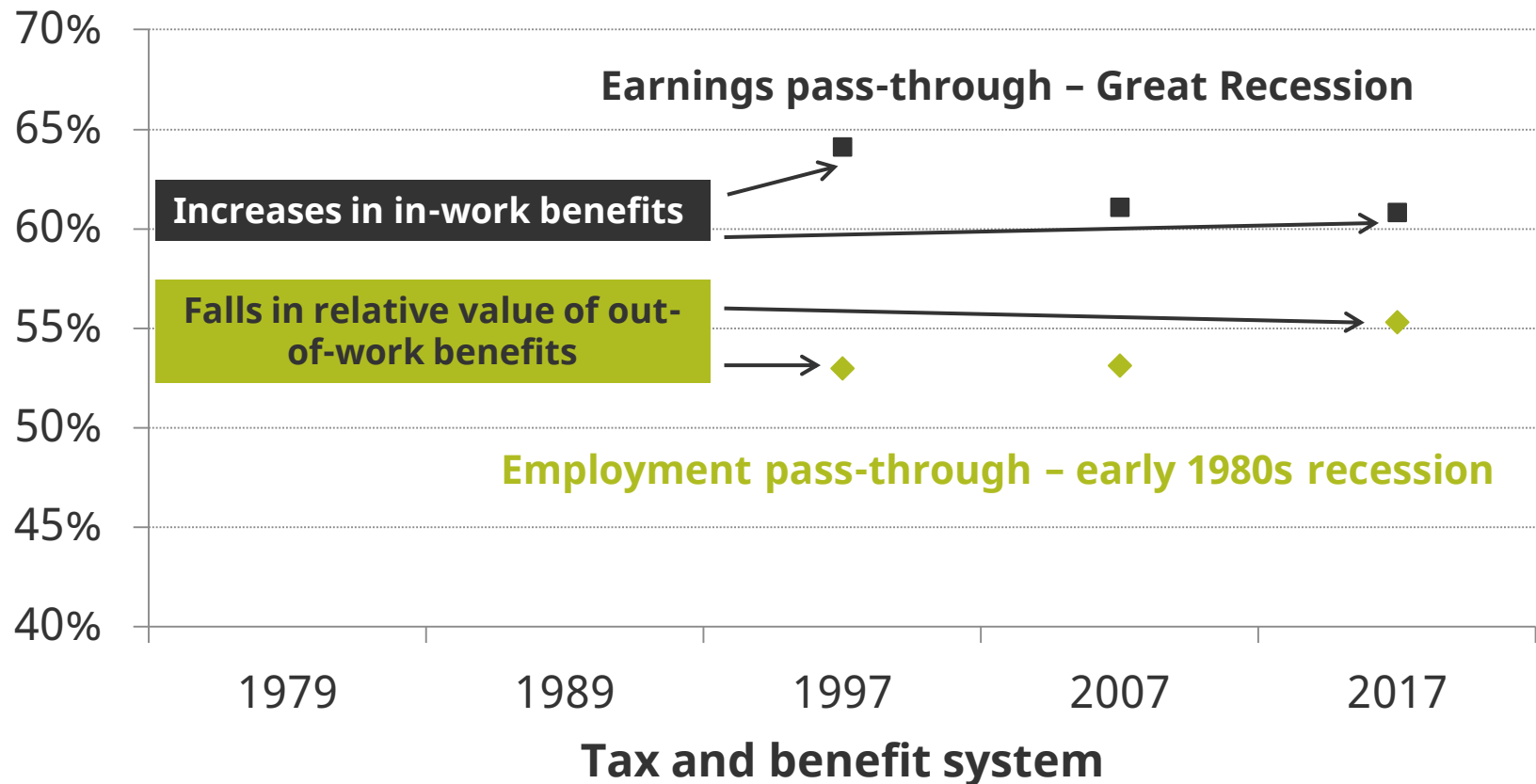
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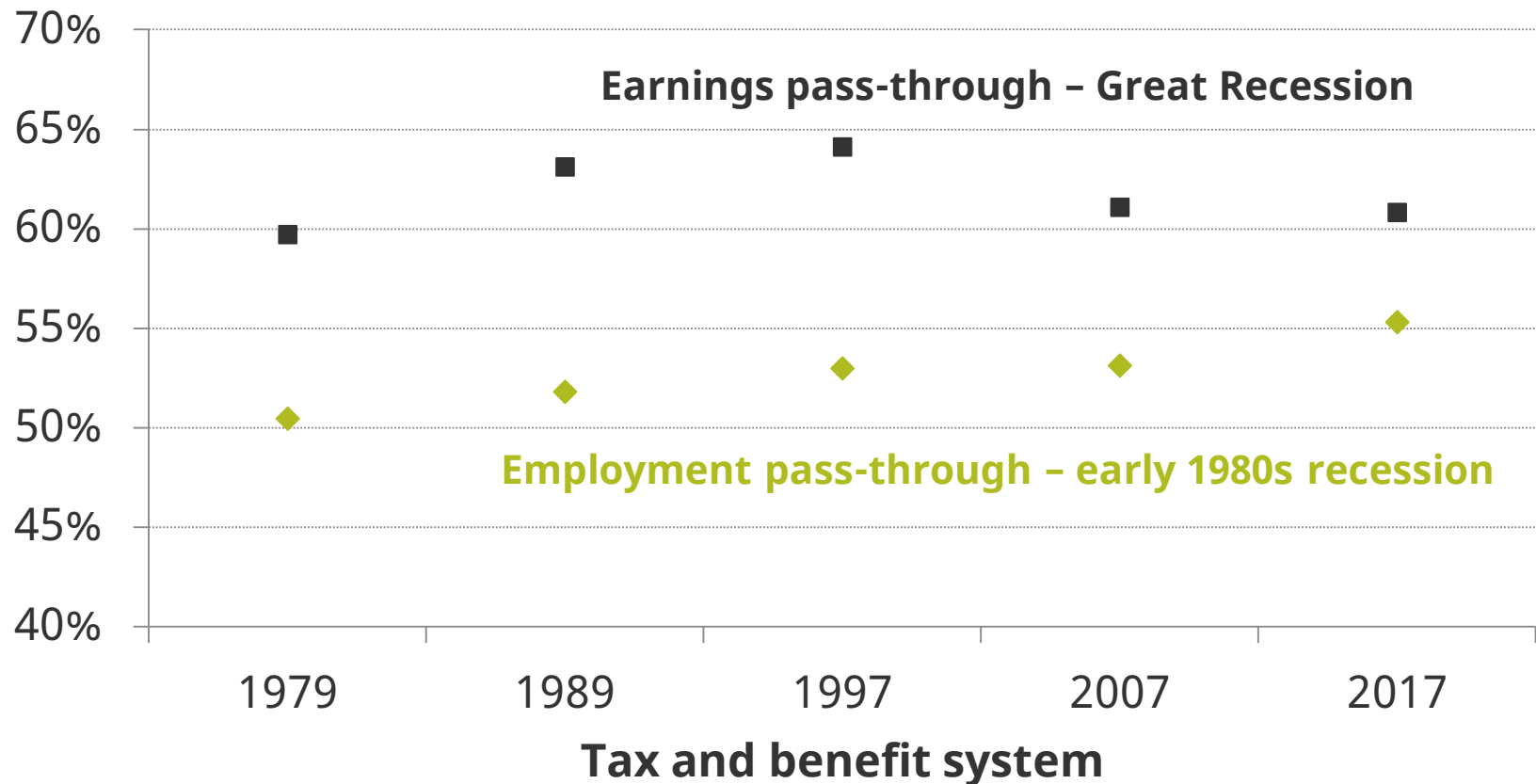
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Pass-through rates under different historical tax and benefit systems



Source: Figure 3.1 of 'Recessions, income inequality and the role of the tax and benefit system'

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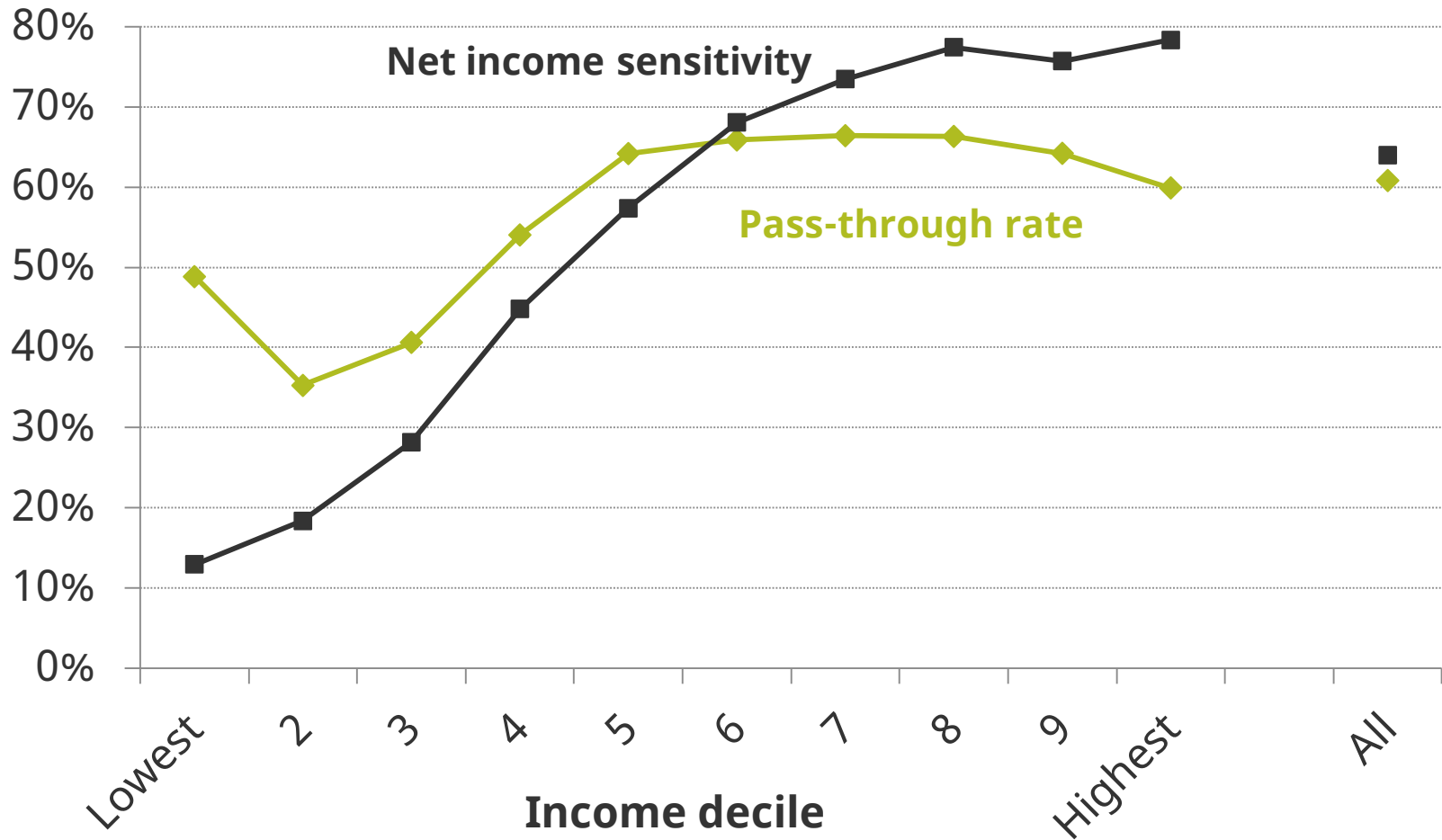
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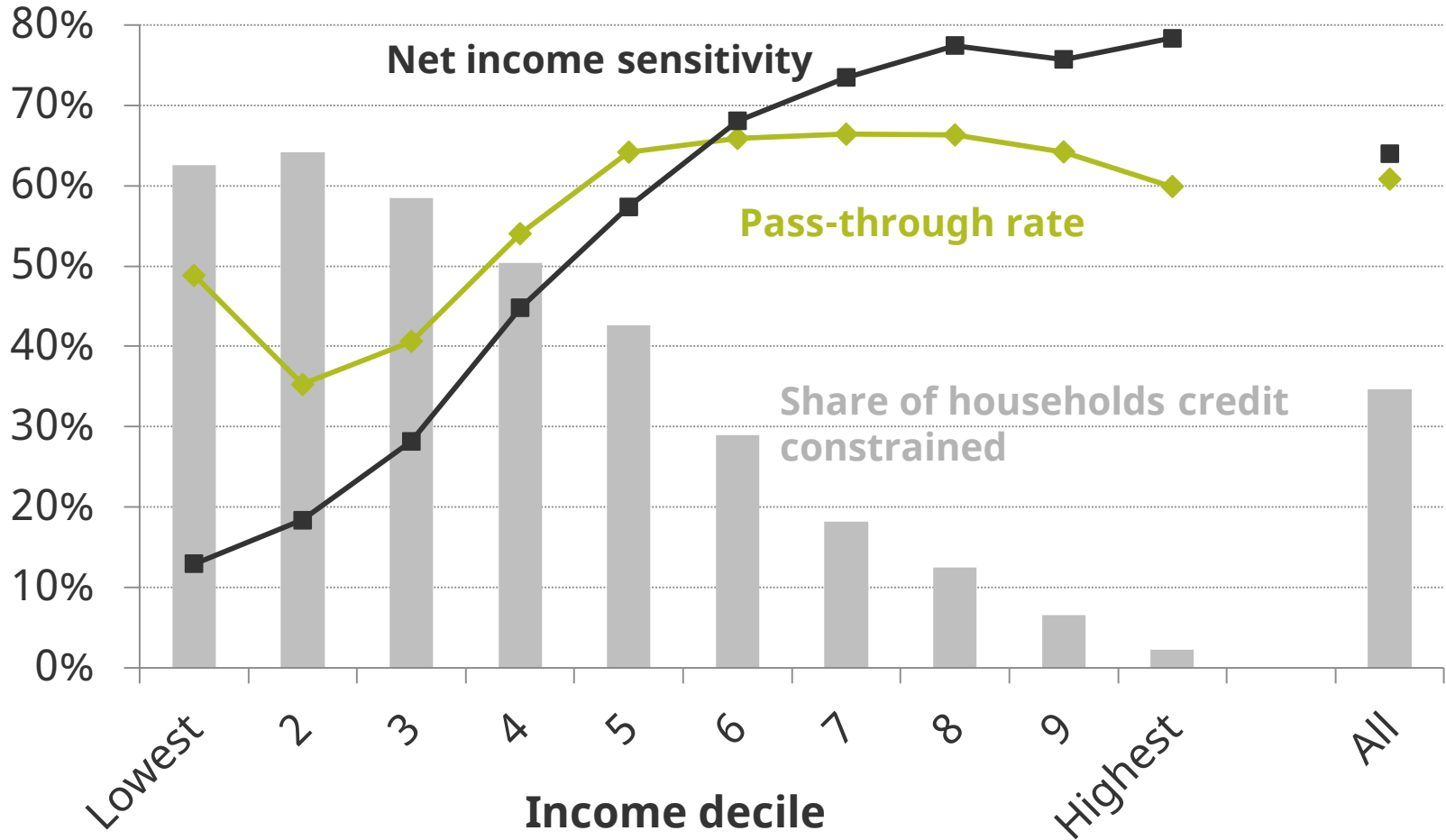
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Pass through, sensitivity and credit constraints by income decile (earnings shock)



Source: Figure 3.3 of 'Recessions, income inequality and the role of the tax and benefit system'

Pass through, sensitivity and credit constraints by income decile (earnings shock)



Note: Household credit constrained if has less than £1,500 financial assets and report being unable to finance unexpected expense of £750.
 Source: Figure 3.3 of 'Recessions, income inequality and the role of the tax and benefit system'.

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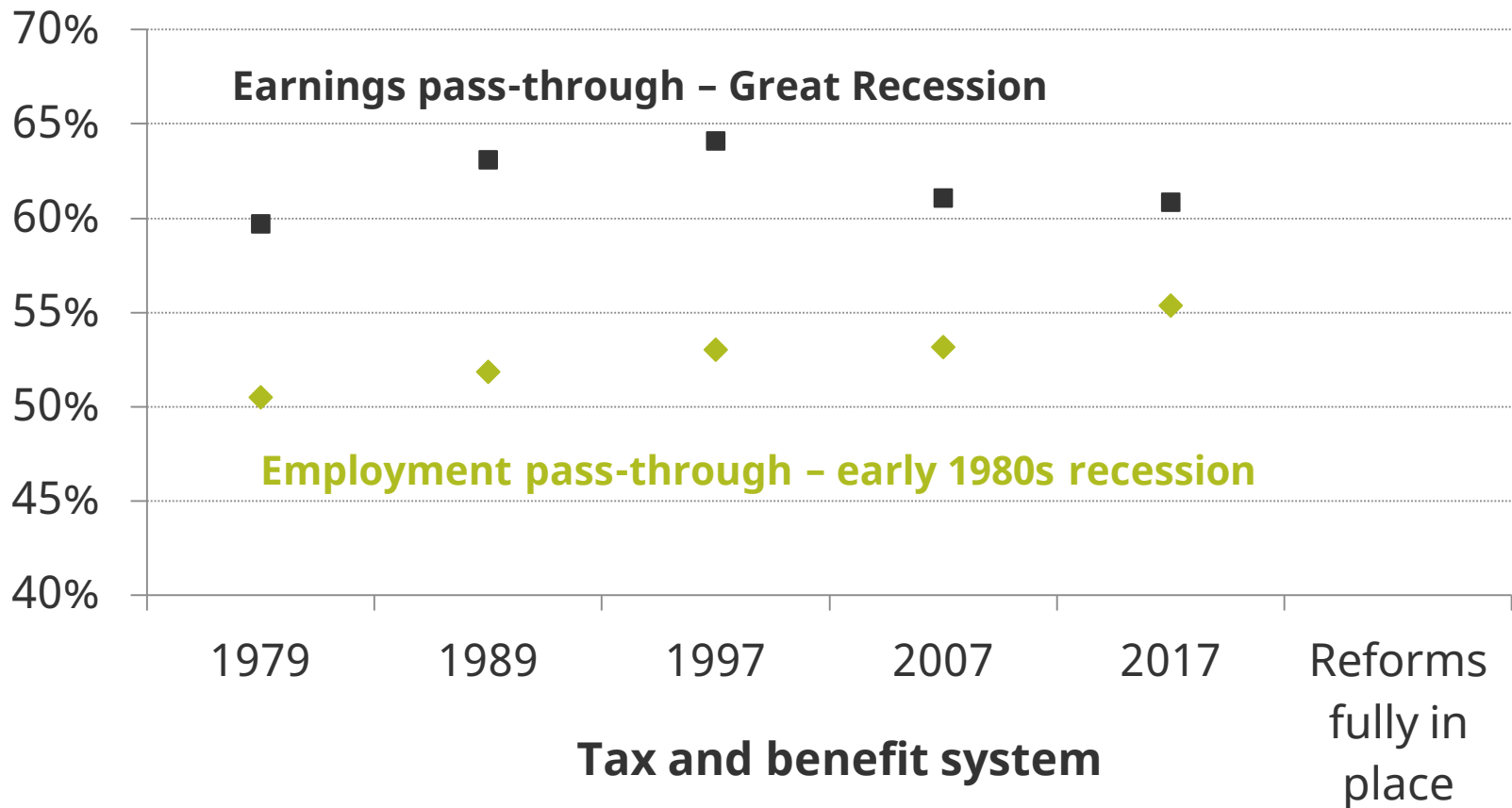
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The impact of reforms planned or being rolled out

What are the key reforms included in our analysis?

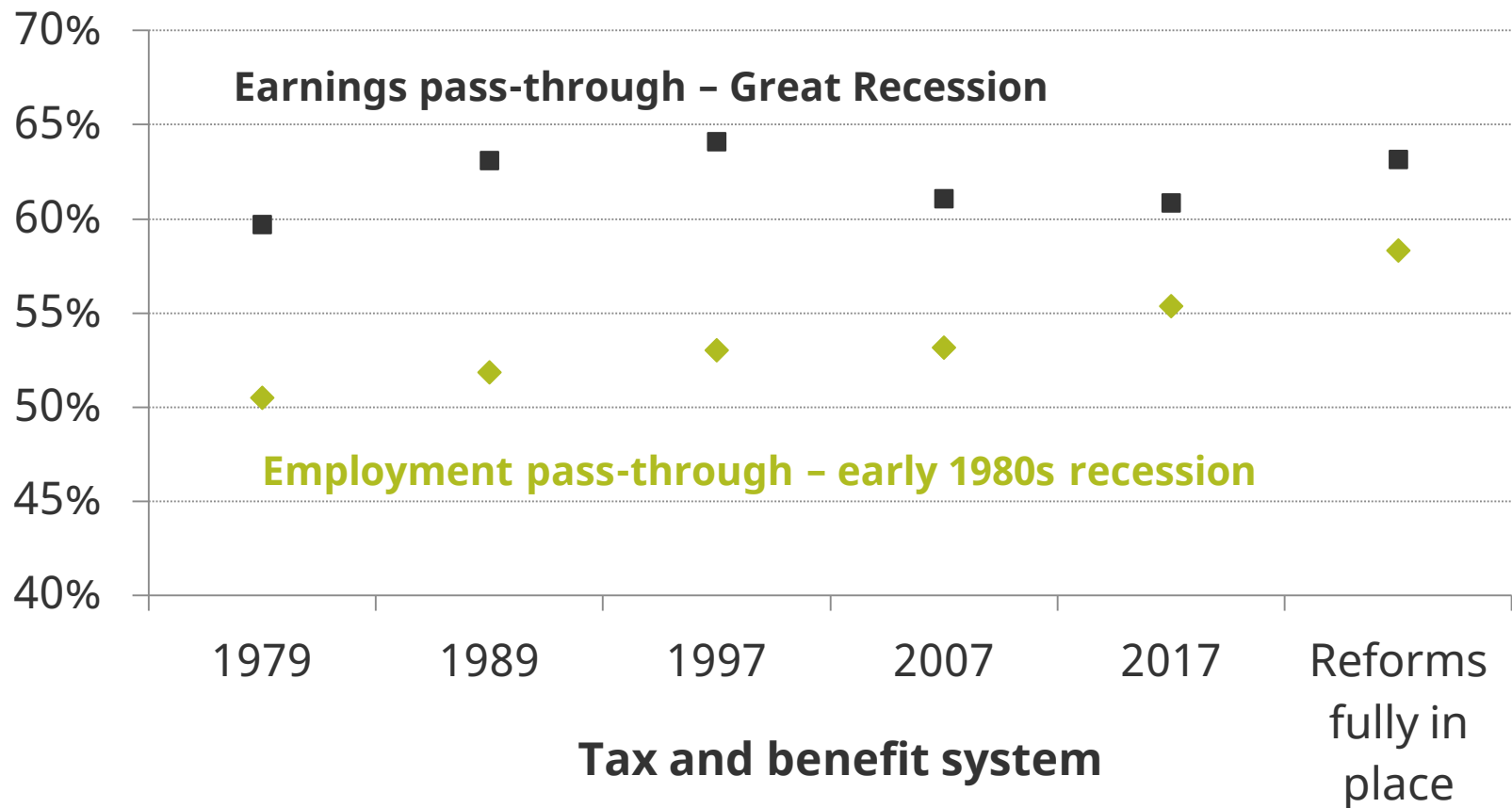
- Continued **freeze in most working-age benefit rates** until April 2020
 - Expected to reduce govt. spending by over £3bn a year
- **Cuts to the generosity of child tax credit** – limiting entitlement to the first two children and removing the family element
 - Expected to reduce govt. spending by £5bn a year in the long run
- Roll-out of **universal credit**
 - Reduces benefit entitlements by £5bn a year in the long run

Pass-through rates under different historical and future tax and benefit systems



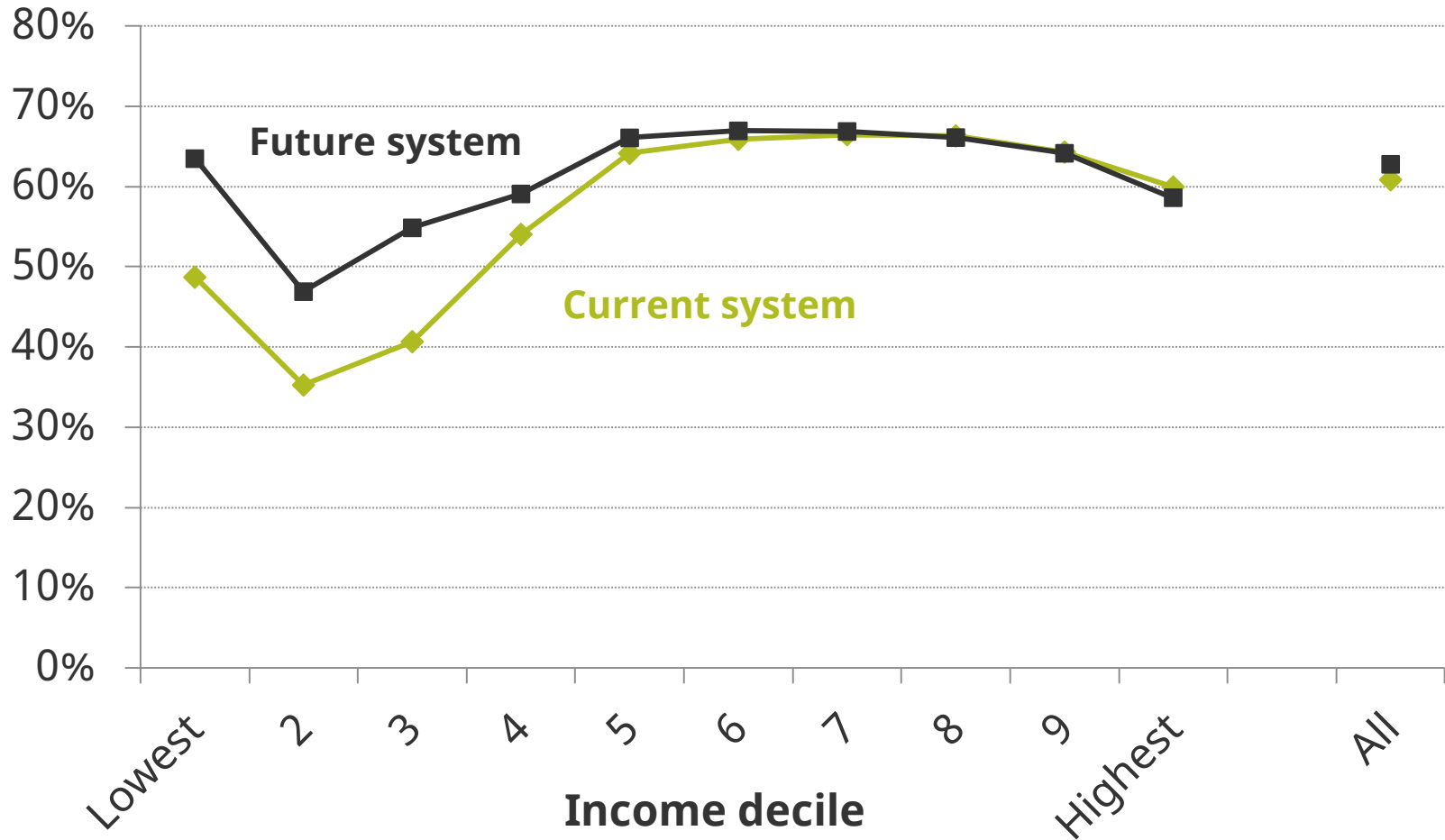
Source: Figures 3.1 and 3.6 of 'Recessions, income inequality and the role of the tax and benefit system'

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Impact of reforms on pass-through rate by income decile (earnings shock)



Source: Figure 3.8 of 'Recessions, income inequality and the role of the tax and benefit system'

Conclusion

Insurance provided by taxes and benefits should be considered when designing and reforming the system

- Only one of many factors/trade-offs to be considered

The tax and benefit system matters less than the nature of the labour market downturn for the effect of recessions on inequality

- Employment falls likely to be more regressive than falls in earnings
- Particularly given decline in the relative value of out-of-work benefits

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