

Inequality under Labour

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Labour introduced a package of tax and benefit policies over its first two terms in government. These reforms have clearly been progressive, benefiting the less-well-off relative to the better-off. It is interesting, therefore, to ask how effective these reforms have been in reducing inequality. In this article, we assess what has happened to inequality under Labour, and estimate the impact on inequality of Labour's redistributive policies.

But first, why care about inequality? Isn't it enough for a country to be wealthy, regardless of how that wealth is distributed? There are two sets of reasons why inequality may be important: *equity* reasons and *efficiency* reasons. A concern for inequality on grounds of *equity* means that inequality is an important outcome in itself – one that should be taken into account when evaluating, say, the success of a policy or circumstances of a country.

A concern for inequality on *efficiency* grounds means that inequality is important because it affects something else we are concerned about. A good example is economic growth. In an unequal society, some individuals are inevitably poorer than others. Inequality may retard growth if market failures mean that poor individuals find it hard to finance education or set up a business. On the other hand, inequality may lead to faster growth because individuals have a greater incentive to work hard and improve their circumstances. For current purposes, the direction in which inequality works doesn't matter – all that is relevant is that inequality affects growth.

Both of these sets of reasons provide strong justification for studying inequality.

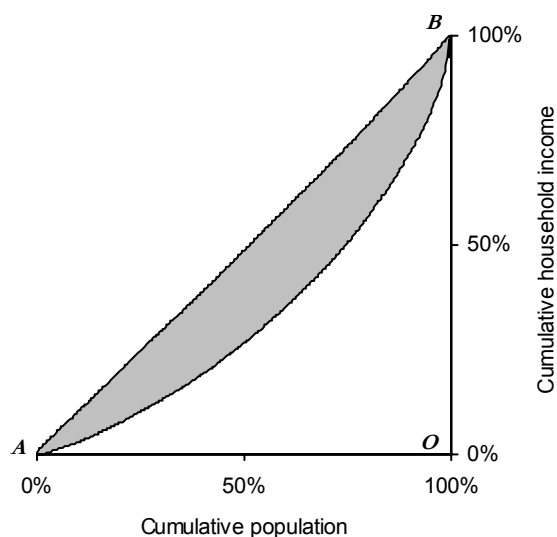
Economists often would like to measure inequality of *living standards*, but many things that are important for living standards – health and happiness for example – are very difficult to measure, let alone combine into a single index. Instead, it is common to focus on material living standards and use income as a proxy. Although this misses out lots of things that most people would consider important, it does give an idea of the resources available to achieve a certain standard of living – and is much easier to measure (but is by no means without problems!)

The definition of income used in this article is a snapshot measure, added up across all members of the household, but rescaled (or *equivalised*) to take into account the fact that households of different sizes have different needs. One problem with snapshot definitions of income is that they need not reflect accurately individuals' more permanent circumstances. When the focus is inequality in longer-run outcomes, expenditure is often used in preference to income; we stick, however, to a snapshot income definition. Because we are interested in disposable income, income is measured after taxes have been deducted and benefits and tax credits added. It is common to look at income both before and after housing costs have been deducted, but here we focus only on before housing costs income. The information for constructing this income measure comes from a survey of around 25,000 households in Great Britain, and the most recent information covers the financial year 2003/04.

Given this definition of income, how is inequality measured? Measuring inequality is simple when there are only two individuals: if one individual earns £400 per week and the other individual £100 per week, this is clearly less equal than the case where one earns £300 and the other £200. But with three or more individuals, things are considerably more complicated: for example, are incomes of £300, £100 and £100 more or less unequal than incomes of £250, £200 and £50? The possibility that people could take different views about which of these alternatives is more unequal leads to the conclusion that there is more than one measure (in fact, many measures) of inequality.

Perhaps the most popular measure of inequality is the Gini coefficient, a measure of inequality that has a nice geometric interpretation in terms of the Lorenz curve (see Figure 1). Individuals are arranged from poorest to richest along the horizontal axis. On the vertical axis is cumulative income. The Lorenz curve shows the proportion of total income in the economy earned by the poorest 10 percent of the population, the proportion earned by the poorest 20 per cent, and so on. If income is distributed perfectly equally, then the poorest 10 per cent would earn 10 per cent of income, the poorest 20 per cent 20 per cent of income, etc – so the Lorenz curve would be the 45 degree line. In reality, however, income is not equally distributed. In this case, the Lorenz bows outwards because, for example, the poorest 10 per cent earn less than 10 per cent of total income. The Lorenz curve in Figure 1 is drawn for Great Britain in 2003/04.

Figure 1. The Lorenz curve and Gini coefficient, 2003/04

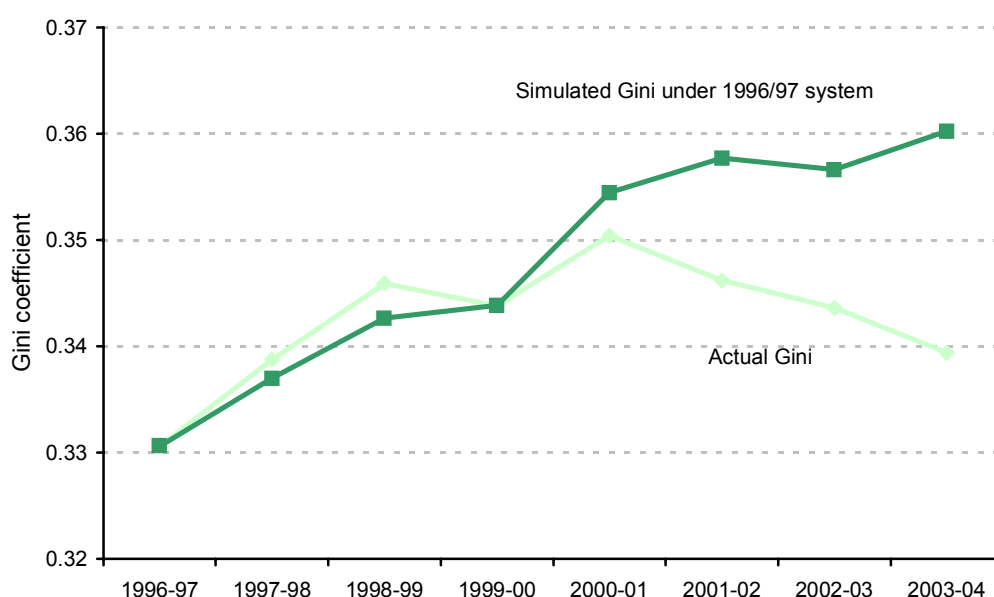


Source: Author's calculations using Family Resources Survey, 2003/04.

The Gini coefficient is equal to the ratio of the shaded area to the whole triangle ABO. When there is perfect equality, the size of the shaded area will be zero, implying that the Gini coefficient is also zero. Conversely, when there is complete inequality (one individual having command over the income of the entire economy), the shaded area will coincide with ABO, so the Gini coefficient will be 1.

In Figure 2 the light green line shows that, according to the Gini coefficient, inequality in Great Britain currently stands at around 0.34. It also shows what has happened to inequality during Labour's time in government. Over Labour's first term (1997-2001), the Gini coefficient increased by 2 percentage points. During Labour's second term (2001-2005), however, the Gini has been falling, so that inequality in 2003-04 is at a similar level to what it was in 1997-98. Therefore, despite some quite marked changes in inequality, the net effect of eight years of Labour government is to leave inequality effectively unchanged. This pattern is in sharp contrast with what happened during the 1980s, when inequality rose rapidly from 0.25 in 1979 to 0.34 in 1990.

Figure 5. Simulated and actual Gini coefficient



Notes: Incomes have been measured before housing costs have been deducted. Simulated income series has been calibrated to align it to the actual income series.

Source: Author's calculations using Family Resources Survey, various years.

Given the fact that Labour's tax and benefit reforms have tended to benefit poorer households at the expense of richer ones, it might seem surprising that income inequality isn't any lower than it was in 1996-97. To begin understanding why this is, we can compare the observed change in inequality with what would have happened if the tax and benefit system had remained unchanged. We use the IFS tax and benefit model, TAXBEN, to calculate what incomes would have been under an appropriately uprated April 1996 tax and benefit system ('uprating' means increasing thresholds in line with inflation). From this simulated income series, the Gini coefficient and other inequality measures may be constructed.

In Figure 2, we compare the actual Gini coefficient from 1996-97 to 2003-04 (the light green line) and the simulated Gini under the uprated April 1996 tax and benefit system (dark green line). This suggests that from 1996-97 to 1999-2000, Labour's tax and benefit reforms did little to affect inequality compared with what would have been observed had the April 1996 system simply been uprated. However, since 2000-01, there has been a notable departure between actual inequality and the simulated level under the April 1996 system. This coincides

with the introduction of large increases in means-tested benefits and tax credits, particularly those aimed at families with children and at pensioners. While the actual level of inequality as measured by the Gini coefficient is similar in 2003–04 to what it was six years earlier, the simulations suggest that the Gini coefficient would have increased considerably if the tax and benefit system had remained unchanged.

One possible explanation for this pattern is rising inequality in the *underlying* distribution of income; that is, the distribution of income before taxes have been deducted and benefits and tax credits added. But if we calculate the Gini coefficient for the underlying income distribution, we find that it has remained at a fairly steady level over this period. In other words, the underlying income distribution doesn't seem to be becoming more unequal. This suggests that the rise in the simulated Gini in Figure 2 is caused by an unchanged tax and benefits system becoming less and less redistributive over time. This might happen as a result of economic and demographic changes. For example, one way in which the tax and benefits system redistributes income is through unemployment benefits. If unemployment falls (as it has done), fewer people are paid these benefits so, other things remaining unchanged, the tax and benefits system does less redistribution.

What are the prospects for inequality during Labour's third term? The government has ambitious targets for child poverty and has stated its desire to tackle pensioner poverty. These objectives could mean that more redistribution from rich to poor is likely, helping to reduce inequality. But the focus of government policy on pensioners and children, rather than the population as a whole, means that a return to levels of inequality last seen in the early 1980s seems unlikely.