



Inequality in Britain: an explanation of recent trends

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An economic approach to inequality

The gap between “rich” and “poor”

But how should we measure it?

Why should we care about inequality?

Can we explain recent trends?

How should we measure it?

Inequality of what?

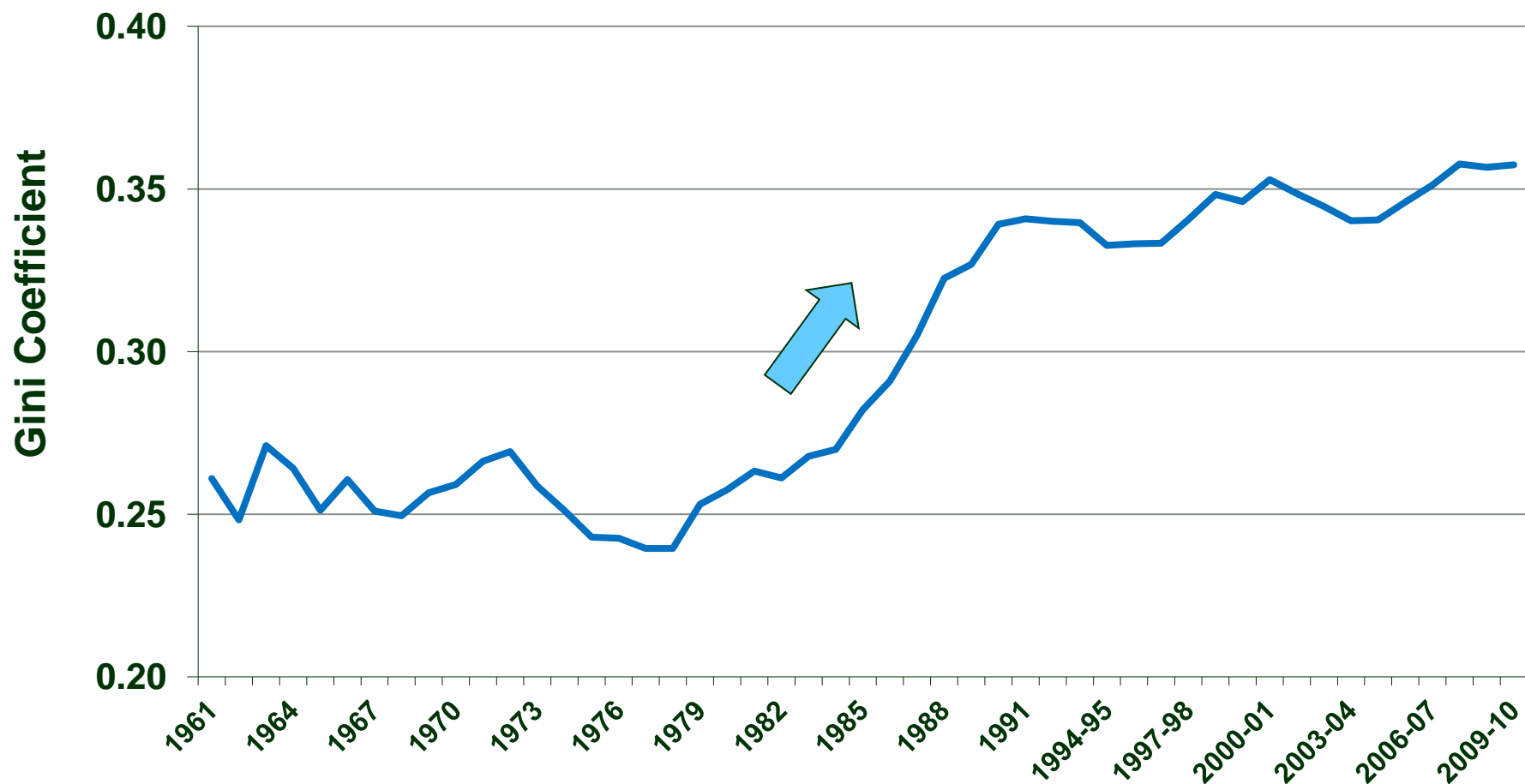
- Household income, earnings, wages, consumption, material living standards, utility?

Compare different points in the income distribution

Summary measures of the entire distribution with desirable properties

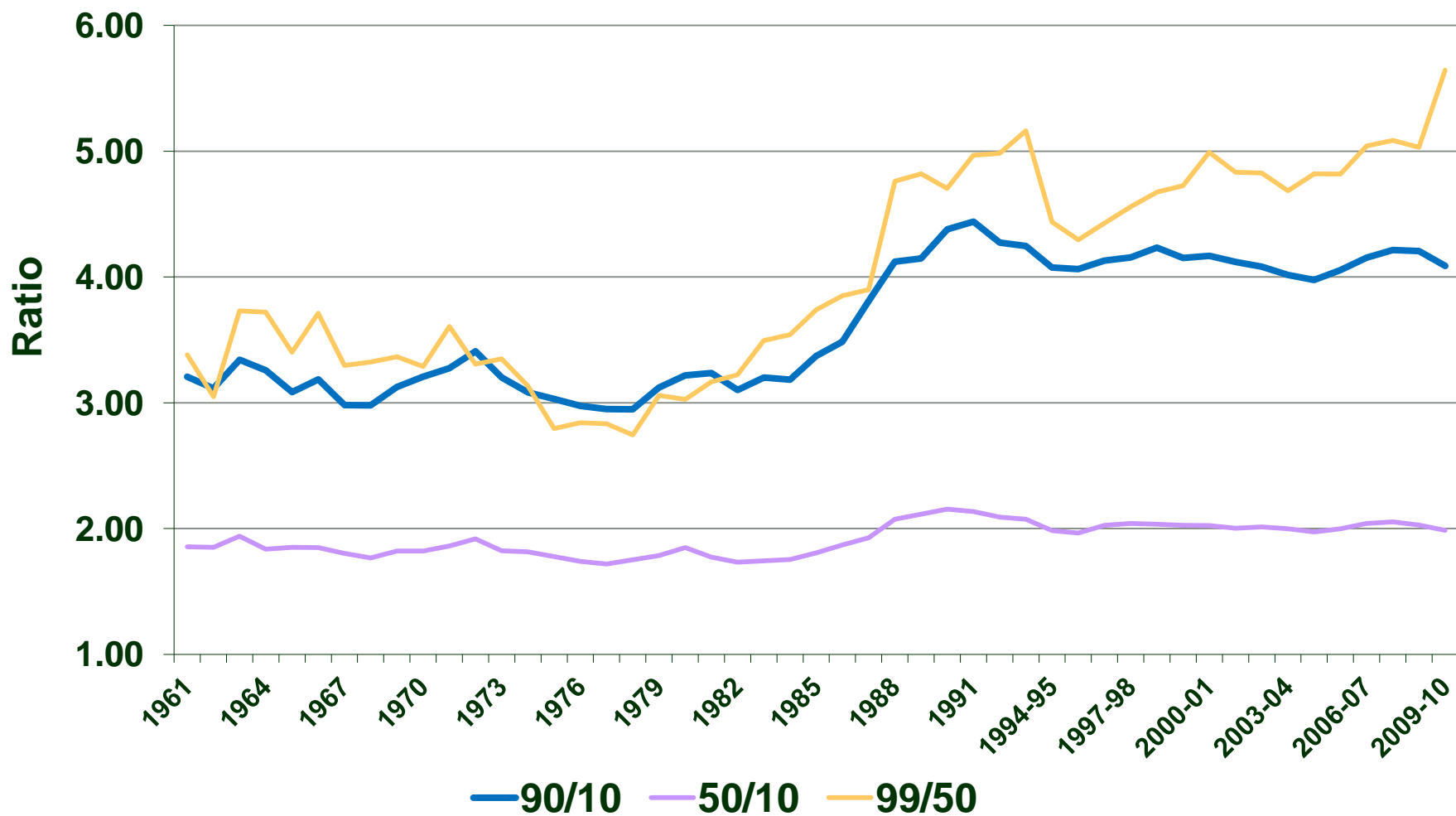
- E.g. Gini Coefficient, Mean Log Deviation

Substantial rise in inequality during the 1980s



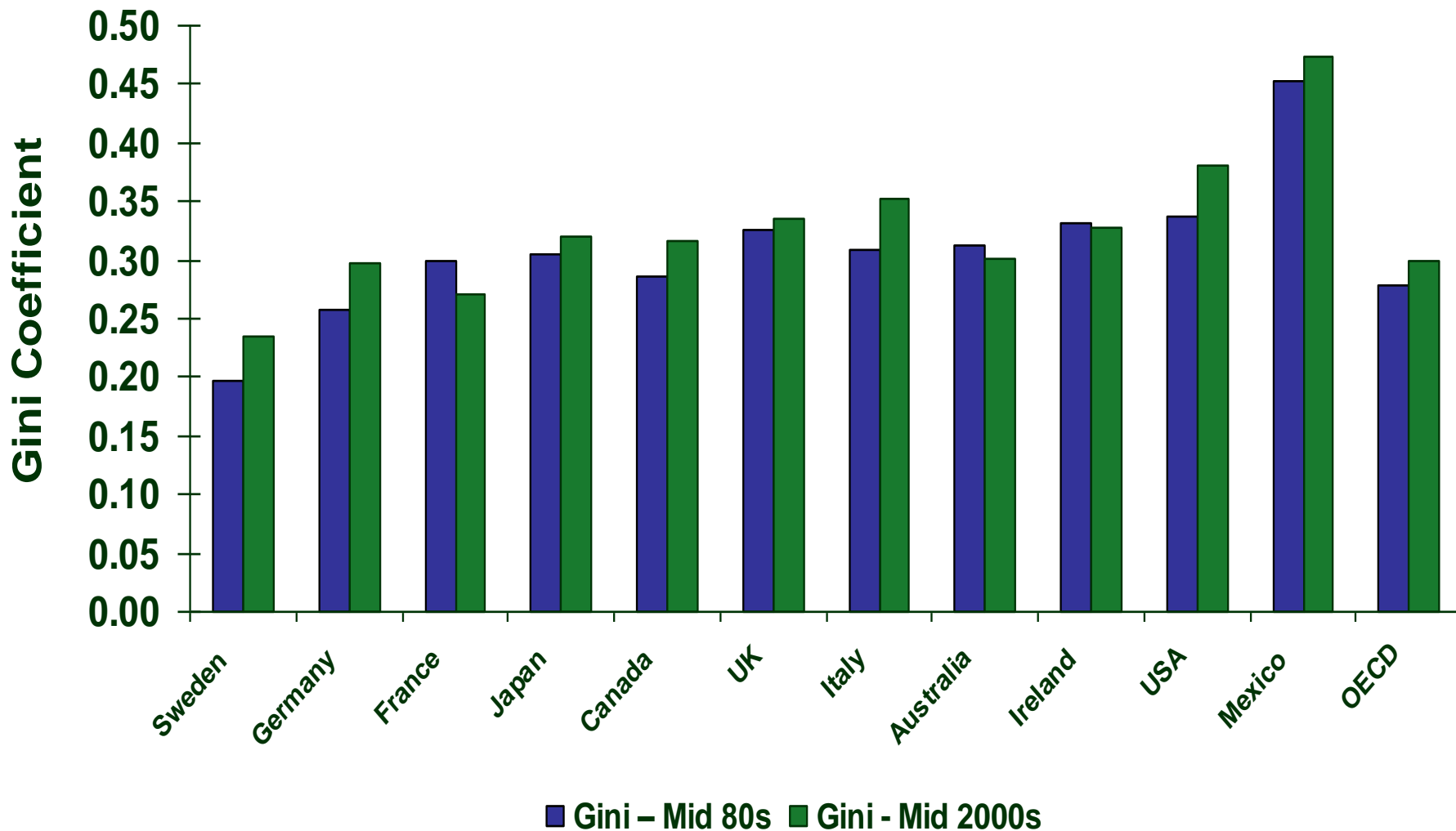
Source: IFS

Top of income distribution races away



Source: IFS

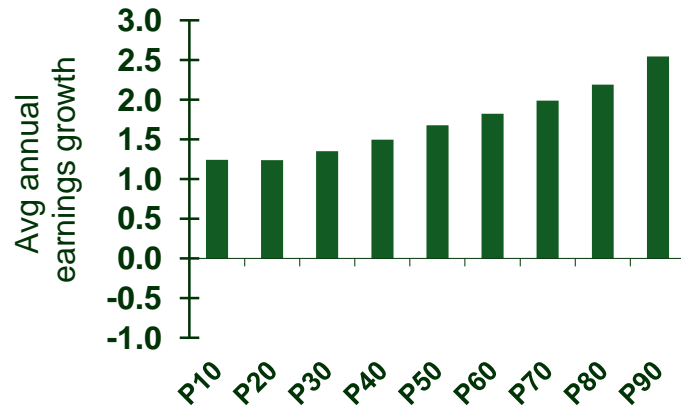
The Gini: international comparisons



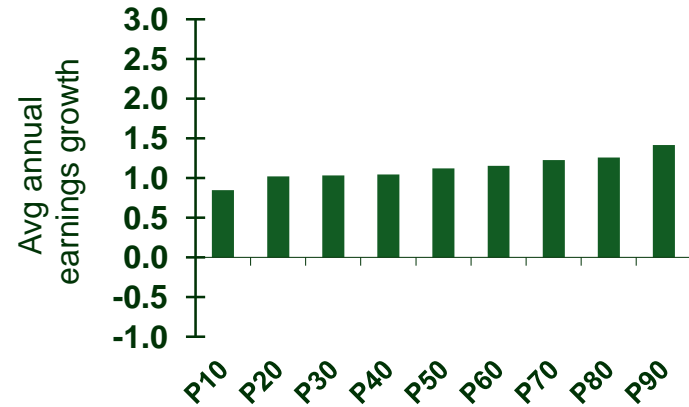
Source: OECD. Figures not directly comparable with those on other slides. Mid 80s Germany refers to West Germany.

Real earnings growth

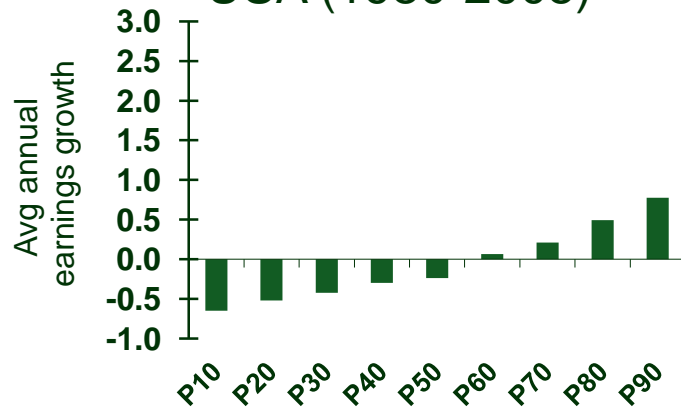
UK (1980-2005)



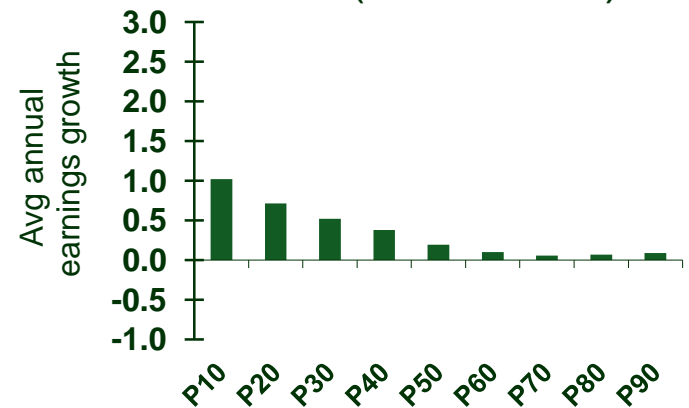
Sweden (1980-2005)



USA (1980-2005)



France (2000-2005)



Source: OECD

Notes: Full-time male workers only

Why should we care about inequality?

Economics largely focuses on ‘Efficiency’ and ‘Pareto optimality’, says very little about ‘Equity’

Efficiency considerations for valuing inequality

- Social unrest and crime, trust and social capital, long-term generational consequences
- But some benefits as a result of incentive effects

Welfare considerations of a social planner

- What is the optimal welfare metric?

Why has inequality gone up?

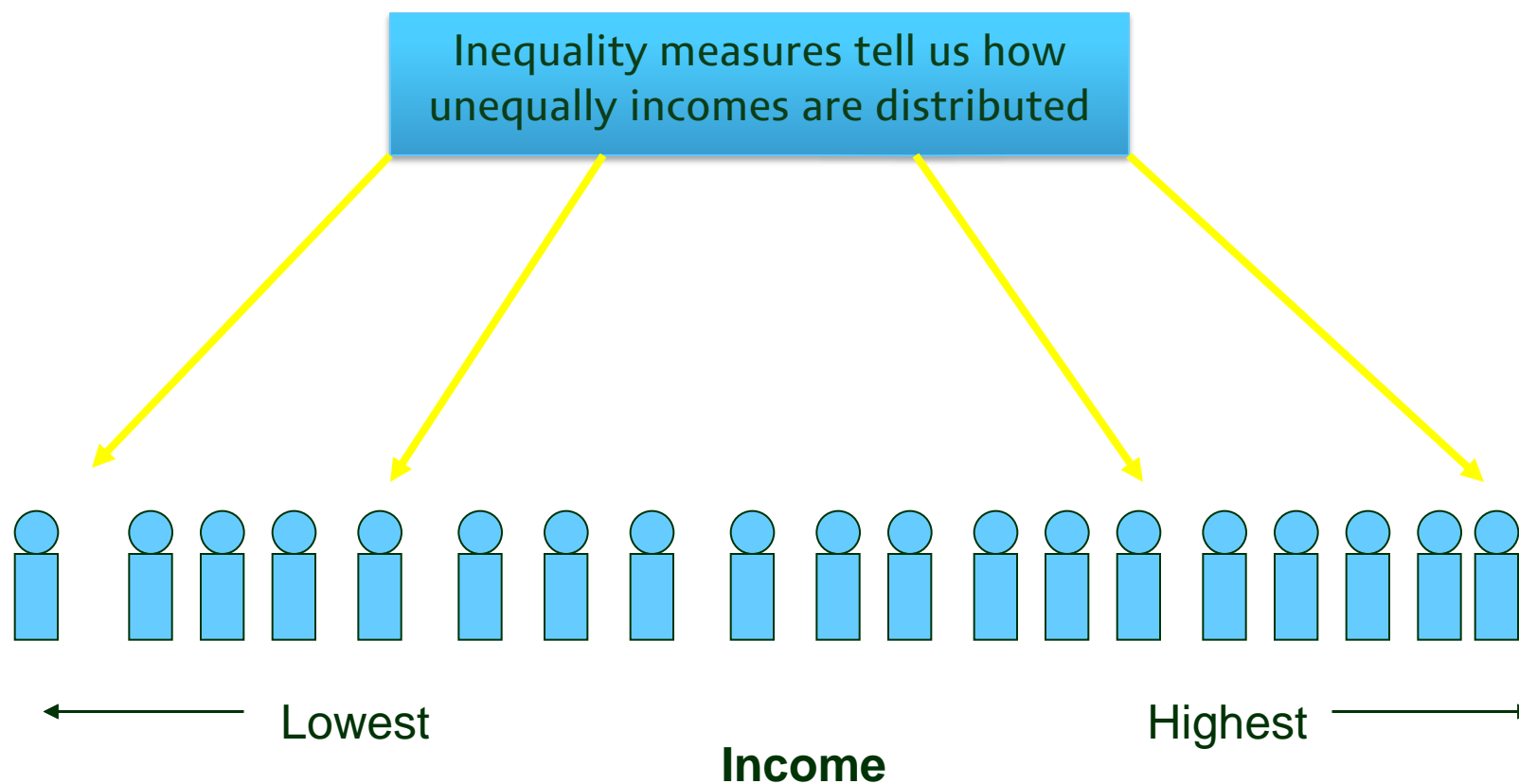
There are many competing explanations for changes in inequality, including:

- Changing industrial structure, etc.
- Returns to education
- Regional changes (North/South gap)
- Demographic Change

Statistical decompositions allow us to weigh up *some* of these competing explanations

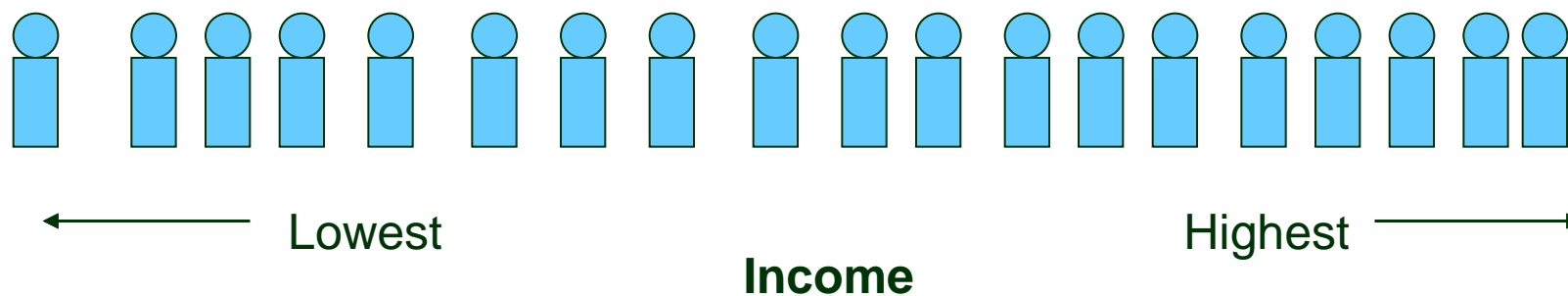
Results taken from Brewer, Muriel and Wren-Lewis (2010)

Inequality – subgroup decomposition



Inequality – subgroup decomposition

But suppose we divide the population into subgroups (e.g. ethnic groups, or employed vs. unemployed)

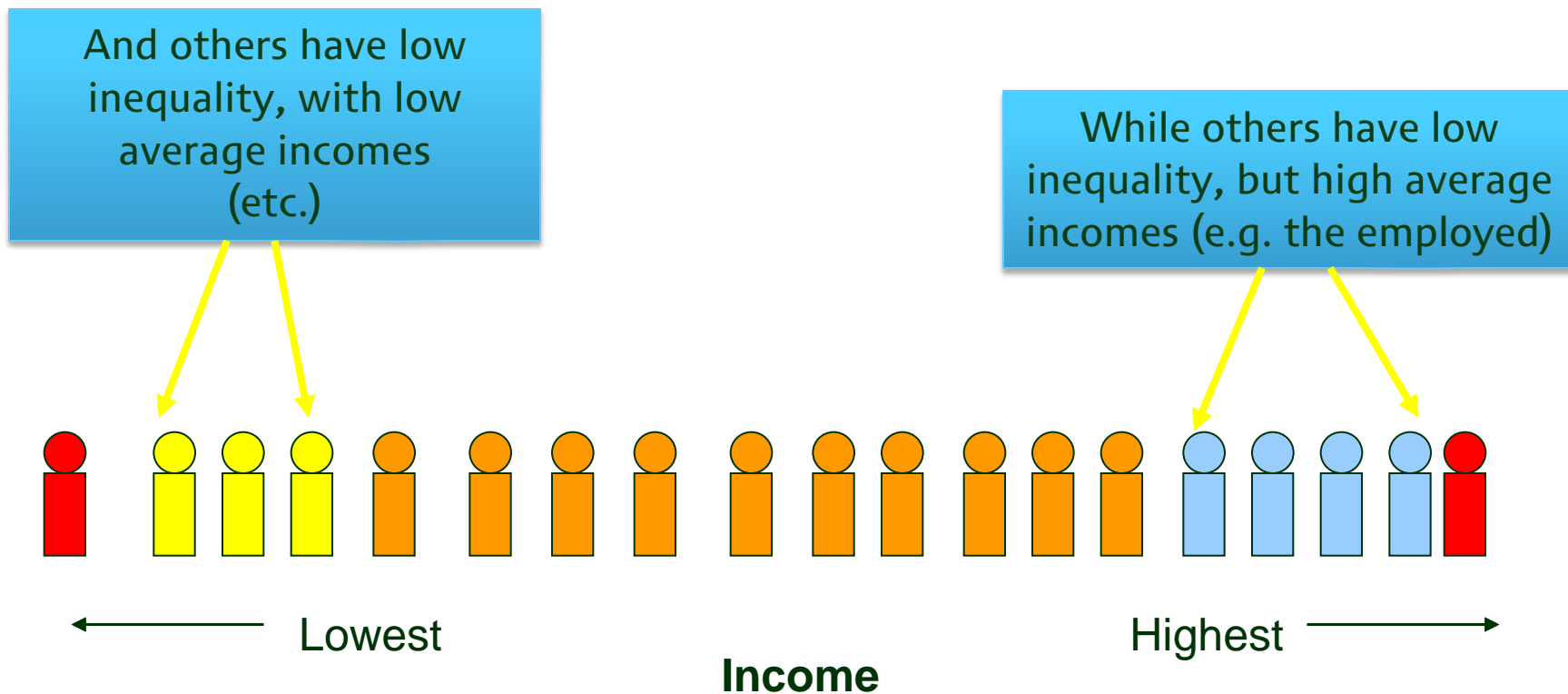


Inequality – subgroup decomposition

We see that some groups have very high inequality (e.g. the self-employed)



Inequality – subgroup decomposition

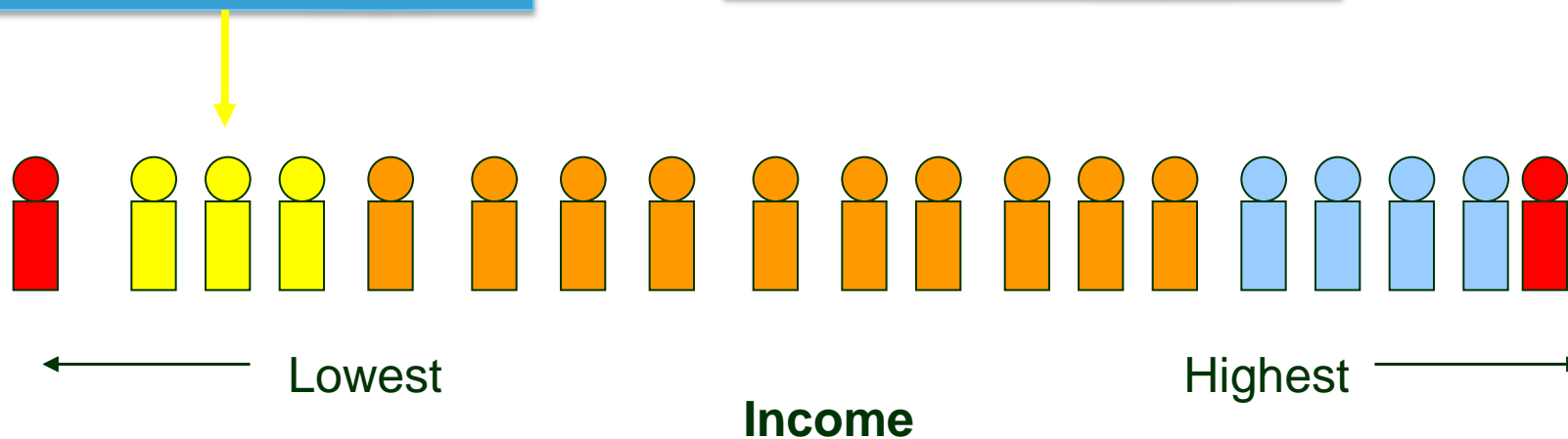


Inequality – subgroup decomposition

Increasing inequality could be caused by:

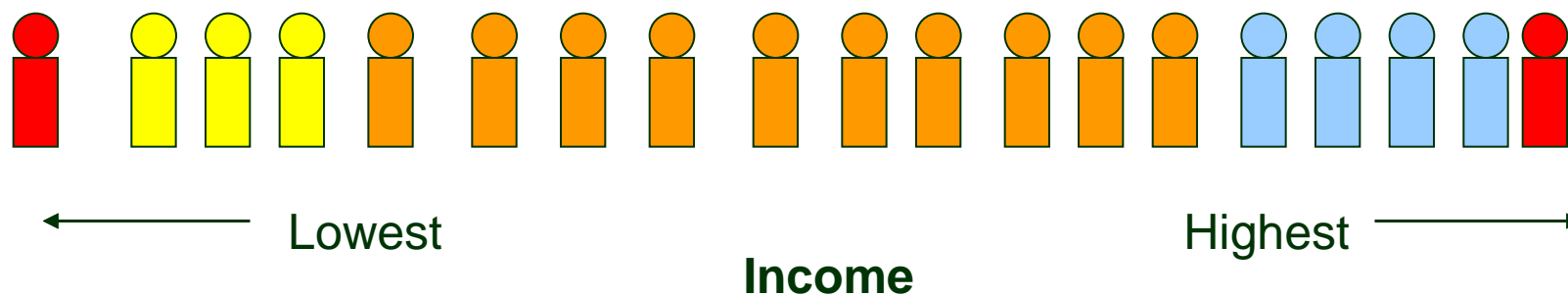
Inequality increasing *within* some groups:

= “Within-group inequality”
effect



Inequality – subgroup decomposition

Or increasing inequality *between* groups

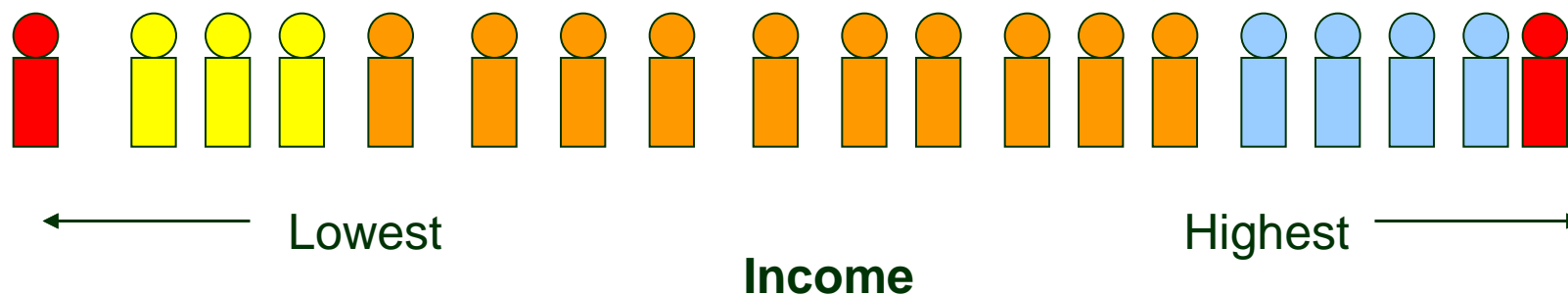


Inequality – subgroup decomposition

Or increasing inequality *between* groups

(i) because their average incomes change

= “Relative income effect”



Inequality – subgroup decomposition

Or increasing inequality *between* groups

(ii) because more people join a group with high inequality

= “Population change (within)” effect



Inequality – subgroup decomposition

Or increasing inequality *between* groups

(iii) because more people join groups with low (or high) incomes

= “Population change (mean)” effect



Subgroup decomposition example: by employment status of head of household

We divide the population into groups according to the schooling of the head of household:

- Left education aged 16 or under
- Left education aged 17-19
- Left education aged 20+
- Unknown or still in education

Decompose inequality changes into the four effects described earlier

Subgroup decomposition – by education level

Period	Change in overall inequality (I _o)	Within-group inequality	Between-group inequality		
			Population change (within)	Population change (mean)	Relative income
1978 - 84	18	13	0	1	4
1984 – 88	42	34	0	2	5
1988 – 91	18	16			1
1991 – 95-96	-12	-13			-2
1995-96 – 2000-01	11	10			-2
2000-01 – 04-05	-9	-10	1	1	-2
2004-05 – 06-07	10	10	1	1	-2

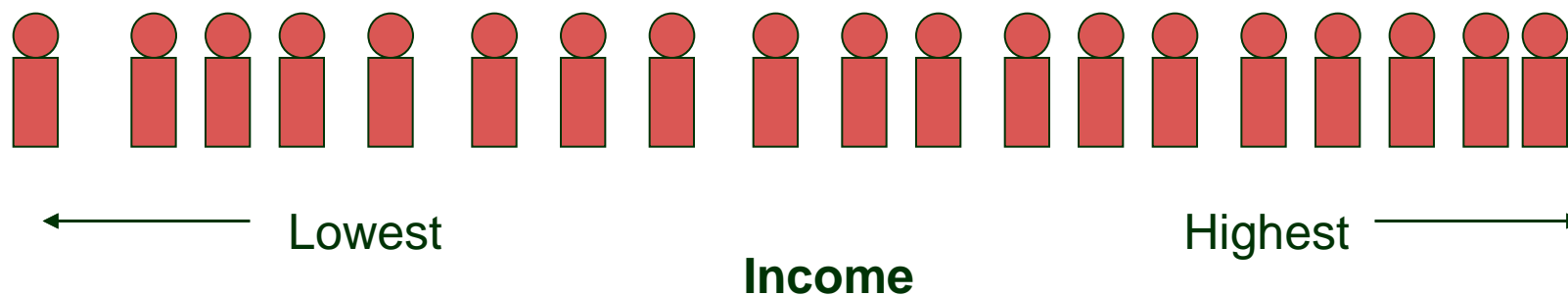
Mostly within group inequality

important during

1980s

Subgroup decompositions can be unclear

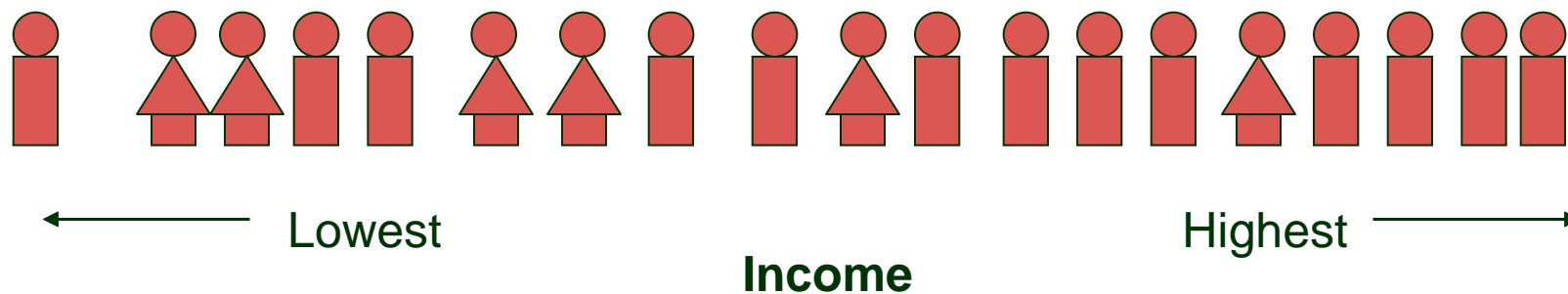
Suppose we have the following change:



Subgroup decompositions can be unclear

Gender subgroup decomposition....

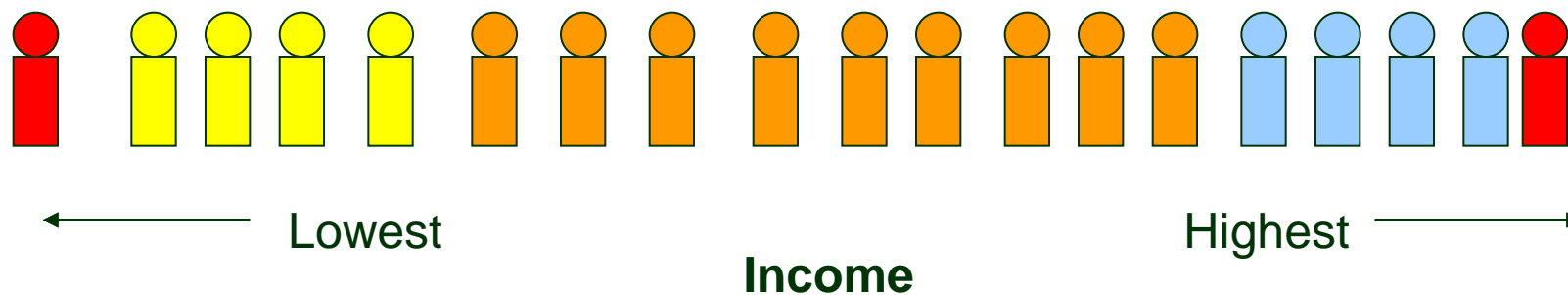
... would partly attribute it to decreasing female income



Subgroup decompositions can be unclear

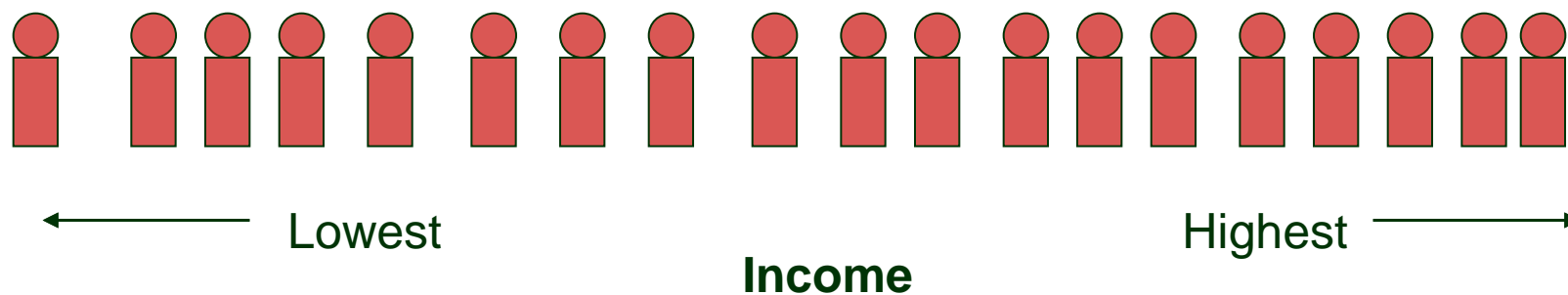
Colour subgroup decomposition....

... would partly attribute to decreasing yellow income



Subgroup decompositions can be unclear

Which factor is more important?



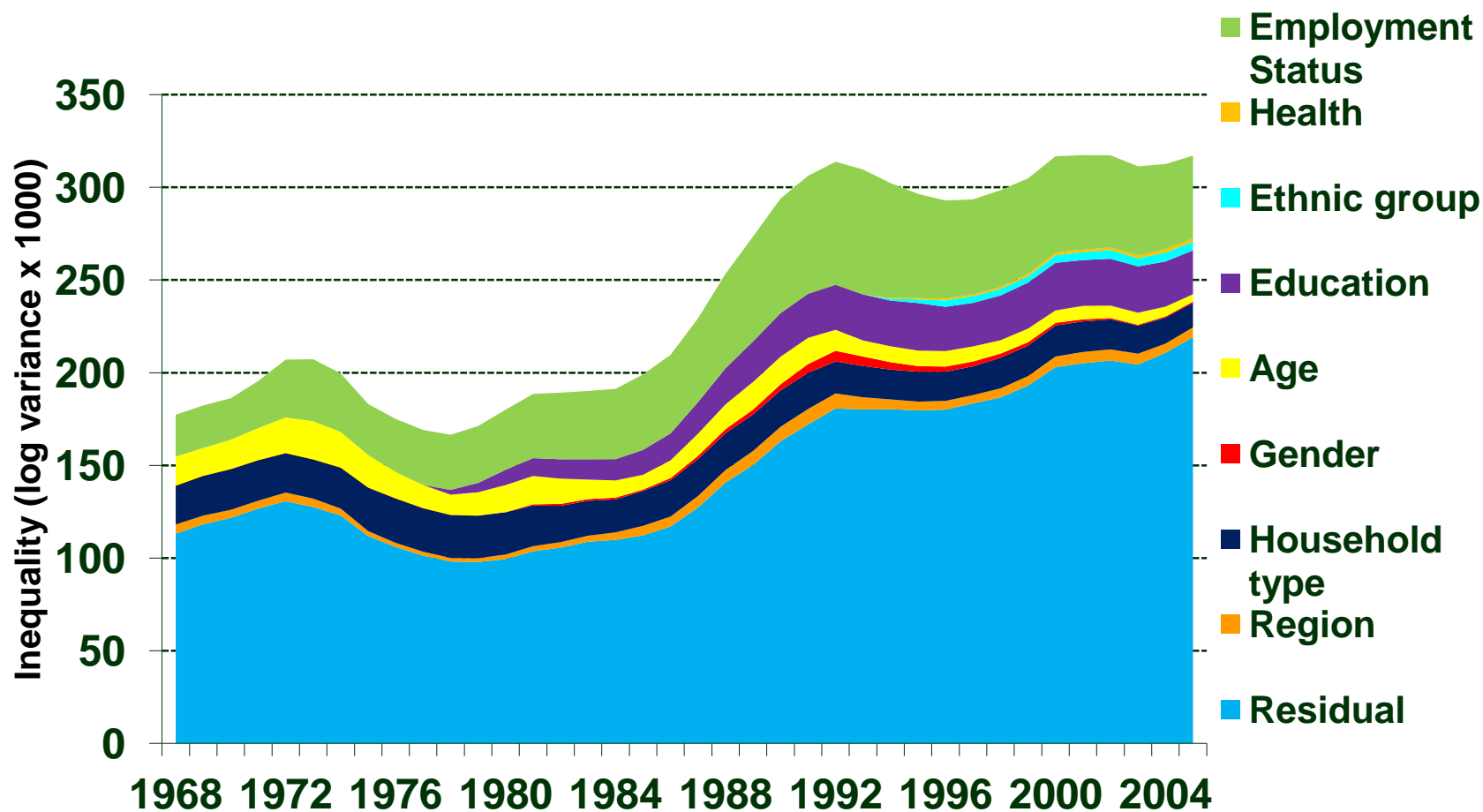
Subgroup decompositions can be unclear

Which factor is more important?

Factor decomposition allows us to consider all factors simultaneously



Income inequality – factor decomposition



Source: HBAI Data (FES and FRS) and authors' analysis

What we do not know (and why it matters)

There is much we do not understand! But the answer matters.

Different explanations for why inequality has increased have different implications for various ideas of ‘fairness’ or ‘justice’

Studies have examined whether increases in income inequality reflect :

- Higher volatility in people’s incomes from year to year.
- Or increases in ‘permanent inequality’ between people who are always poor and always rich (i.e. reductions in social mobility).

How much can government affect inequality?

Tax and state benefit system clearly makes a difference

But can be very costly to just rely on fiscal redistribution.

Countries with low inequality (e.g. Scandinavia) tend to have low 'pre tax and benefit' inequality; much of recent rise in inequality due to rise in pre-tax earnings inequality.

Income distribution shaped by the distribution of private incomes earned in the labour market.

How much can government affect labour market outcomes?

Depends what drives it!

But ultimately, people can not earn a lot in the labour market unless they have skills that employers value.

It is not surprising that the most equal societies are different to the most unequal ones from the bottom up, e.g. early educational achievements, health, etc.

It seems very difficult to only target equality in specific things (e.g. 'income'), because everything is connected!