SCOTLAND’S ECONOMIC FUTURE POST-2014
SUBMISSION FROM DAVID EISER

This evidence is submitted with regard to the ‘welfare and equality’ element of the Committee’s Terms of Reference. It focuses in particular on income inequality.

Introduction: Income inequality in Scotland
Income inequality in the UK is high relative to international comparators, but this is largely the result of a ‘London-effect’. Inequality in Scotland is roughly average compared to OECD countries, but is slightly higher than the European average, and notably higher than in the Nordics.

Figure 1: Household net income inequality in OECD countries, 2010

Inequality of household disposable incomes in Scotland has seen little overall change since the late 1990s. During the early and mid 2000s, this was because increases in welfare spending and the introduction of tax credits compensated for some (relatively small) increases in market earnings inequality. Since the recession, falls in higher earnings have offset the initial phases of the real terms reductions in welfare spending. Many commentators expect that inequality will begin to increase soon, as economic recovery combines with the UK Government’s welfare reforms.


2 The measure of income used here is household disposable income (i.e. after taxes and transfers), where incomes have been ‘equivalised’ to take account of household composition. There are a number of ways of measuring income inequality. In this short paper I use the GINI coefficient to measure inequality, unless otherwise stated.
The role of personal taxation and benefits in addressing inequality
The UK’s tax and benefit system is equally as redistributive as the average tax and benefit system in OECD countries. In the UK, taxes and social transfers have the effect of reducing the market income (i.e. pre tax and transfer) GINI coefficient by 13 percentage points, (across OECD countries as a whole, the effect of taxes and social transfers is to reduce the market income GINI coefficient by 12 percentage points).

The Nordic countries have slightly more redistributive tax and benefit systems than the UK, which reduce the market income GINI coefficient by 13, 14, and 15 percentage points in Norway, Denmark, and Finland respectively (Sweden=12).

To what extent could varying particular tax and benefit policies influence the level of net income inequality in Scotland? My colleague David Comerford and I have modelled the effects of various hypothetical tax and benefit changes on levels of net income inequality in Scotland\(^3\). The results are shown in the table below. For each policy lever, the first column shows the effect on net household income inequality in Scotland, as measured by the GINI coefficient. The second column shows the ‘direct’ revenue to the Government of implementing each policy, (ignoring the knock-on effects of changes in indirect tax revenues – VAT, alcohol and tobacco duties, etc.).

The first three policies consider fiscal levers that the Scottish Government has (or will soon gain access to through the Scotland Act); the second three are income tax levers that will remain reserved following the Scotland Act (including the ability to vary thresholds, or rates individually across bands); the final two are example changes to out-of-work/ low-income benefits. For example, the table shows that adding 1p to the Scottish Rate of Income Tax (i.e. 1p to each tax band) would raise £370m in revenue and reduce the GINI by 0.2%; an increase in the rate of Jobseekers Allowance would cost £74m and reduce the GINI by 0.15%.

The key point to note is the relatively small impact that each of these levers has on reducing inequality. To put it in perspective, inequality in Scotland, measured by the GINI, is about 5 percentage points higher than in the Nordics. But none of these tax and benefit changes – some of which would be politically difficult and some of which would cost a substantial amount – reduce the GINI by more than 0.3 percentage points. Even if several of these policies were combined, it is unlikely in itself to reduce more than a fifth of the inequality gap to the Nordics.

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\(^3\) This analysis is undertaken using a detailed model of the Scottish economy, developed at the University of Stirling. For more details, see http://esrcscotecon.files.wordpress.com/2013/05/constitutional-change-and-inequality-revised-140127.pdf
Table 1: Impacts on inequality and government revenues from various fiscal policies

<table>
<thead>
<tr>
<th>Policy</th>
<th>Change GINI</th>
<th>Direct revenue implication (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Council tax revaluation</td>
<td>-0.017%</td>
<td>8</td>
</tr>
<tr>
<td>Council tax rise of 10%</td>
<td>0.029%</td>
<td>185</td>
</tr>
<tr>
<td>1p on SRIT (basic, higher, additional)</td>
<td>-0.239%</td>
<td>370</td>
</tr>
<tr>
<td>1p on basic rate</td>
<td>-0.149%</td>
<td>343</td>
</tr>
<tr>
<td>1p on higher rate</td>
<td>-0.068%</td>
<td>32</td>
</tr>
<tr>
<td>Additional rate threshold reduced to £100,000</td>
<td>-0.122%</td>
<td>26</td>
</tr>
<tr>
<td>Increase rates of IS/JSA by 10%</td>
<td>-0.150%</td>
<td>-74</td>
</tr>
<tr>
<td>Increase basic and 30-hour elements of WTC 10%</td>
<td>-0.069%</td>
<td>-84</td>
</tr>
</tbody>
</table>

The concluding message from this section is particularly important: *inequality is higher in Scotland than in Nordic countries not because the UK’s tax and benefit system is much less redistributive than the Nordics, but because the inequality of market (pre tax and transfer) incomes is higher in Scotland. Fiscal policy levers can help address inequality, but they are not in themselves a panacea.*

Market earnings inequality

The reasons why market income inequality is particularly high in the UK is due in part to historical factors. Most of the increase in market income inequality occurred during the 1980s. De-industrialisation led to falling demand for lower and middle paying jobs, and combined with labour market deregulation this bid down real wages in the lower part of the income distribution. In the 1990s and 2000s, the trend of ‘polarisation’ of the labour force has continued – there has been a decline in demand for those semi-skilled jobs that can be mechanised and/or off-shored. Although demand for low-paid jobs has increased, the changing nature of job demands (greater flexibility of working hours), and further labour-market deregulation (e.g. zero-hours contracts) has meant that many of these new jobs are part-time. Indeed, most of the increase in market weekly earnings inequality in recent years has resulted from increasing variation in hours worked, rather than an increase in inequality of hourly pay (the average hours worked by those in low-paid jobs has tended to fall, relative to the average hours worked by those in higher-paid jobs).

Those in favour of addressing high levels of in-work poverty, and inequality generally, often make calls to address low-pay through increases in the minimum wage or adoption of a living wage. Both of these arguments have merit, but it is important to remember that in-work poverty is determined by hours worked as much as it is by hourly pay.

Figure 2 below shows the median hourly wage and median hours worked by the mainearner (i.e. the highest earner) in each household, for each decile of the net household income distribution (analysis restricted to working households only). If the poverty line is defined as being households with net income below 60% of the median, then the poverty line encompasses nearly all households in the bottom two deciles. It is apparent from Figure 2 that, in the lower third of the income distribution,
households’ position in the distribution is determined by hours worked as much as it is by hourly pay. Tackling in-work poverty and inequality at the lower end of the income distribution requires us to look at the barriers faced by those who cannot work as many hours as they would like.

Figure 2: Median hourly wage and weekly hours worked of household main earner, Scotland

As well as these changes at the lower-end of the income distribution, the very highest paid 1-2% of workers have seen particularly large increases in their market earnings. The richest 1% of Scotland’s adult population earned 6.3% of total pre-tax incomes in 1997, rising to 9.4% in 2009. There is continued debate around the causes and social desirability of this trend – does it reflect the skills and risk-taking flair of these individuals and the value that they bring to an economy, or does it reflect the ability of these individuals (often managers in complex organisations where performance might be difficult to measure) to effectively bargain for an increased share of wages, at the expense of others?

Summary
This evidence note has sought to make the following points:

- Net income inequality in Scotland is average relative to OECD countries, but high relative to Nordic comparators
- There has been little change in inequality in Scotland since 1997 across most of the distribution; but the poorest 5-10% of households have tended to fall further behind the median, and the richest 1-2% have seen continued relative income growth.
- The reason for Scotland’s higher net income inequality than the Nordic countries is mainly due to the fact that market (pre tax and benefit) incomes
are higher in Scotland. As a result, tax and benefit changes can only go so far in addressing Scotland’s inequality gap.

- Addressing inequality means tackling not only low-pay but also the barriers faced by people who want to work longer hours.

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