

THE GREATEST DIVIDE

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**FABIAN
SOCIETY**

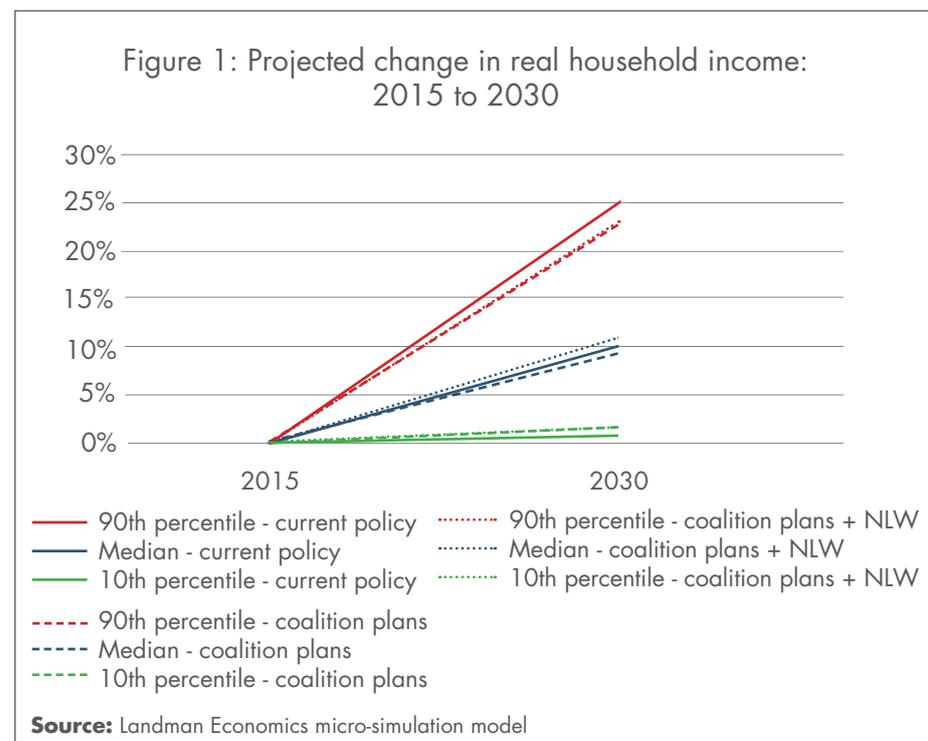
THE GREATEST DIVIDE

We have always been a divergent as well as a united kingdom. But the divisions within Britain are growing wider. On questions of our place in the world and the future of our nation, on identity, on belief, demography and culture, the differences between us become ever more obvious. The great challenge for our politics today is therefore to bind us together. On many of these fault-lines, however, politicians on left and right seem to be lost, in uncharted territory, uncertain of the route to take.

The greatest divide of all, however, is the growing gap between rich and poor. And here the political establishment is not helpless or powerless: to a very large extent, it is the cause of the problem. Yes, there are the anti-egalitarian currents of globalisation and automation. But over the next decade the gap will mainly widen because of political choices, according to new Fabian Society research, which examines the prospects for economic inequality in 2030.

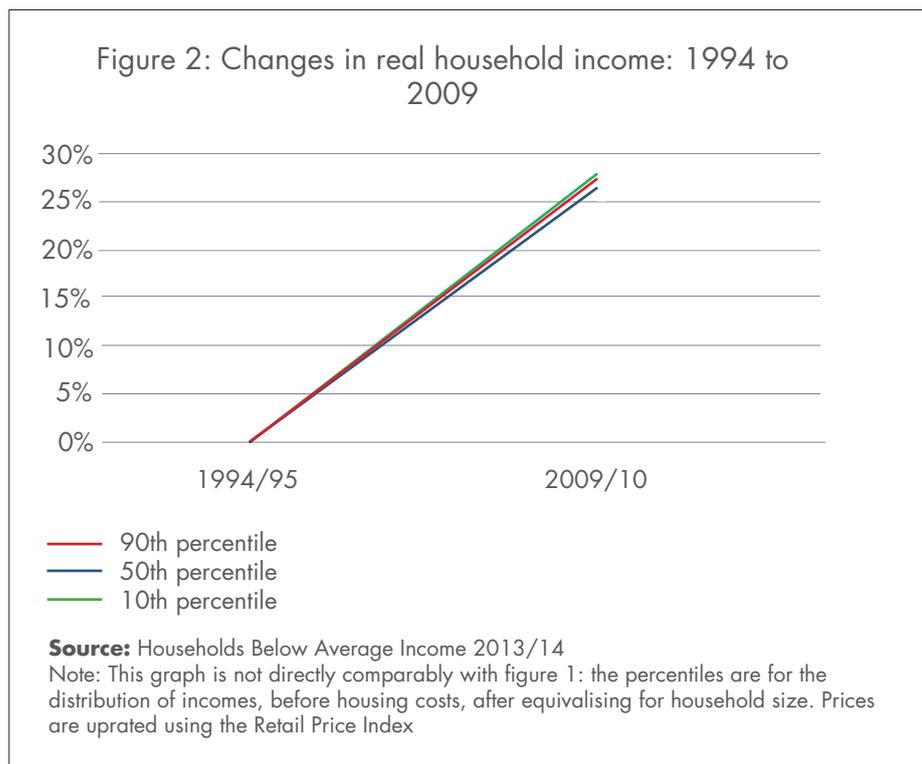
The modelling updates analysis conducted by Landman Economics for the Fabian Society's pre-election report *Inequality 2030*. In that report we projected that, between 2015 and 2030, the income of a household ten per cent from the top of the income distribution would rise by £12,900 per year (in 2014 prices) or 22 per cent, while a household 10 per cent from the bottom of the distribution would see an increase of only £230 per year (2 per cent).

Our new analysis takes account of the decisions taken since May and finds that, over the next 15 years, tax and social security policies will cause high incomes to rise by even more than we previously expected, and low incomes by even less. The projections (figure 1) show that a household 10 per cent from the top of the income distribution will see its real income rise by 25 per cent (£14,500 per year, in 2014 prices), but a household 10 per cent from the bottom will see barely any change at all (a rise of £90 per year or 1 per cent).



Most of our projected increase in inequality is the result of decisions that were already in place before the general election. But the effects of the decisions taken by the Conservatives since May will not be insignificant for incomes in 2030. Post-election announcements are projected to raise the income of a household 10 per cent from the top of the income distribution curve by £1,600 in 2030.

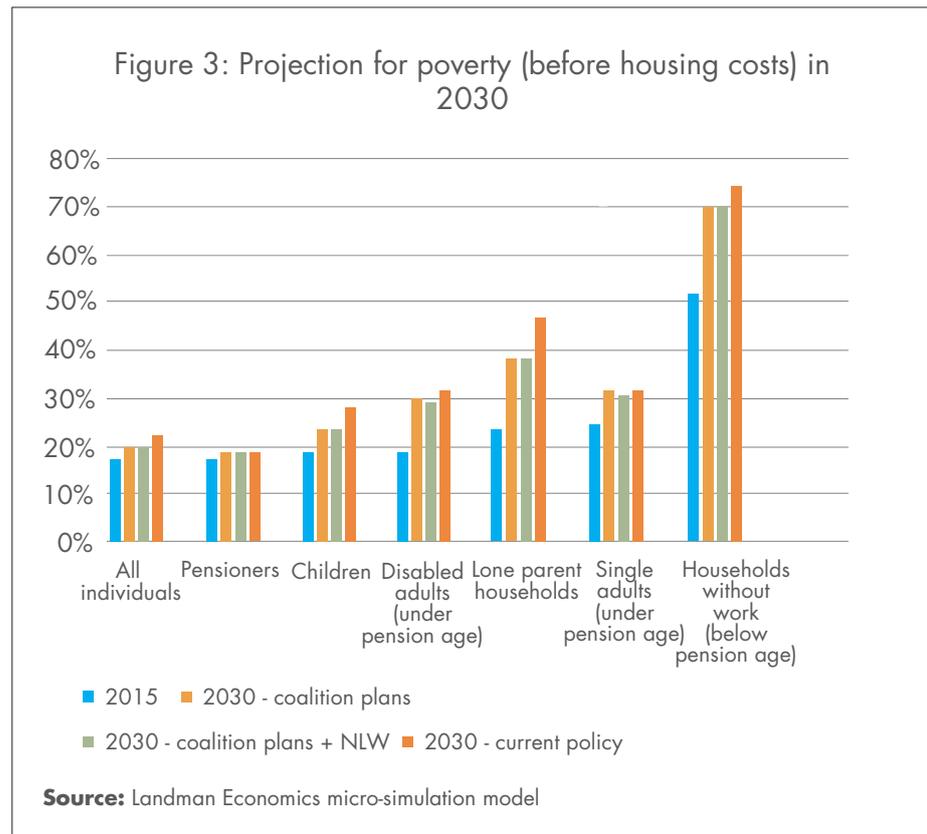
There is nothing inevitable about this polarisation. In the 15 years up to 2009 the incomes of rich and poor increased in proportion to each other, because Labour chose to share the proceeds of growth (see figure 2, which uses a slightly different measure of income from figure 1). By contrast, since 2010, Conservative and Liberal Democrat politicians have designed policies which give to the rich and take from the poor, mainly by cutting benefits and income tax side by side.



These statistics are projections not predictions. They are mainly calculated using ONS and Office for Budget Responsibility central-case assumptions and projections, as well as our extrapolation of historic trends. Actual outcomes will depend on the performance of the economy and labour market. However, the economic and demographic assumptions we use are the same for each policy scenario, so the model is a reliable way of understanding the implications of different political choices over 15 years. Different economic data would change the detail of the numbers, but lead to the same pattern of income divergence we report.

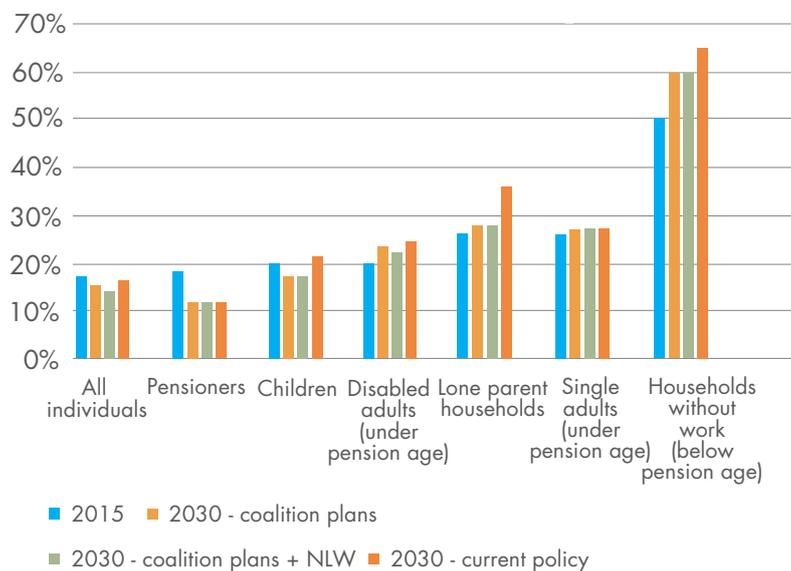
Poverty

The decisions taken since the election are projected to increase the proportion of people living in poverty in 2030 from 20 per cent to 22 per cent – an extra 1.4 million people. However, the story is particularly striking when it comes to child poverty, partly because the cuts this year have singled out lone parent families for pain. Before the election we projected that the proportion of children in poverty would rise from 19 per cent to 24 per cent over the next 15 years. Now the figure is 28 per cent (figure 3). As a result the number of children in poverty is projected to rise from 2.5 million today to 4.4 million to 2030.



These statistics use a standard definition of poverty in advanced economies, counting the number of people with living standards well below what is typical at that time, in that society. However the picture is so bad that we even expect that child poverty will rise when measured using a static benchmark, which takes no account of rising living standards across society: in 2030 we project that 800,000 more children than today will live with incomes below a fixed threshold which we already view as unacceptable (figure 4). Under the coalition's previous pre-election plans, child poverty using this measure was expected to decline, albeit modestly.

Figure 4: Projections for absolute poverty (ie a fixed poverty line, uprated only with inflation) in 2030



Source: Landman Economics micro-simulation model

Note: Poverty is defined as living in a household with an income below 60% of the contemporary median in 2010, before housing costs, after equivalising for household size

With this prognosis for poverty, it is hardly surprising that the government is in the midst of abandoning its current statutory targets for child poverty. But, as we will see shortly, large reductions in child poverty are still perfectly attainable if ministers adopt plausible policy alternatives.

The 'National Living Wage'

One striking feature of all these projections is how little difference is made by the introduction of the 'National Living Wage' (NLW) for people aged over 25: our projections for both household income and for poverty barely change when we examine the impact of adding the NLW to the coalition's previously announced policies.

The reason the NLW has so little impact is: first, because many of the financial gains of a higher minimum wage are lost through the withdrawal of tax and benefits; and second, because people earning a low hourly wage are spread quite widely across the distribution of household incomes. The policy therefore leads to a smaller increase in household incomes than in earnings, with the largest gains going to middle not low income households (figure 5).

Figure 5: Impact of the 'National Living Wage' in 2030 at different points on the distribution of earnings/household incomes

	Hourly earnings	Weekly earnings	Weekly Household income
10th percentile	20.4%	14.6%	0.3%
25th percentile	3%	8.9%	0.6%
Median	0%	0.5%	1.1%
75th percentile	0%	0%	0.7%
90th percentile	0%	0%	0.3%
Mean	1.6%	1.2%	0.6%

Source: Landman Economics micro-simulation model

Notes: The table shows the projected difference in earnings/incomes in 2030, comparing (1) the 2014 national minimum wage, uprated each year by CPI (2) a 'National Living Wage' for people aged over 25 fixed at 60 per cent of contemporary median hourly earnings. Our model assumes that in the long run a higher minimum wage boosts productivity and therefore economy-wide output and earnings.

This means that the 'Living Wage' partially offsets the damage of benefit and tax policies for middle income households (figure 1) but makes no noticeable difference to high or low income households. It is the other post-election policies that make the big difference to them: households 10 per cent from the top of the income distribution will be better off as a result of the income tax personal allowance rising to £12,500; and households 10 per cent from the bottom of the distribution will be worse off, following the new round of social security cuts.

The left's alternative

The left must shine a spotlight on the widening gulf between rich and poor, for which these Conservative and coalition policies are responsible. But it must also prove that an alternative is possible. After Labour's recent victory on tax credits (which delays the timing of the cuts) the party must turn its sights to universal credit, since post-election changes to this new benefit will slash the incomes of low-earning families. The universal credit reforms will come into force around the time of the next election and then have a lasting impact throughout the 2020s.

But beyond fighting individual cuts, Labour must make a principled case for a tax and benefit system that prevents widening inequality and shares rising national prosperity with low income families and children. This should be the starting point for a complete review of the operation and generosity of working-age social security. The inspiration should be the pensions system, where we now have generous but affordable social security, which can be expected in the future to protect most older people from poverty. If ministers imitated the approach they are taking for pensioners, the 2030 living standards of pre-retirement low and middle income households could be transformed.

An illustration of reform

As an illustration of what might be possible, we have modelled incomes in 2030, first on the basis of the coalition's April 2015 policies; and then with these amended to gradually double the real value of child benefit over 15 years and to uprate other working-age benefits in line with earnings (rather than prices). These two changes would result in an increase in low incomes of 13 per cent over the period, rather than the 2 per cent projected under coalition policies; and a rise in mid incomes of 18 per cent, not 9 per cent. As a result our projection for the percentage of children in poverty in 2030 would fall by half.

Figure 6: projections for household incomes and child poverty in 2030, comparing the tax and benefit policies in place in April 2014 with two alternatives

	April 2015 policies	...plus more generous social security	...plus labour market reforms
10th percentile	2%	13%	17%
25th percentile	6%	16%	19%
Median	9%	18%	23%
75th percentile	17%	20%	25%
90th percentile	22%	24%	27%
Mean	16%	20%	24%
Percentage of children in poverty	24%	12%	11%

Source: Landman Economics micro-simulation model

We also examined the effects of this more generous social security system alongside two labour market reforms: full employment (roughly 80 per cent of adults below pension age in work); and a significant reduction in low pay (through both a high minimum wage and take-up of a voluntary living wage). If these changes to the labour market were also achieved then typical household incomes would rise by a little more than with the social security reforms alone (mainly as a result of full employment).

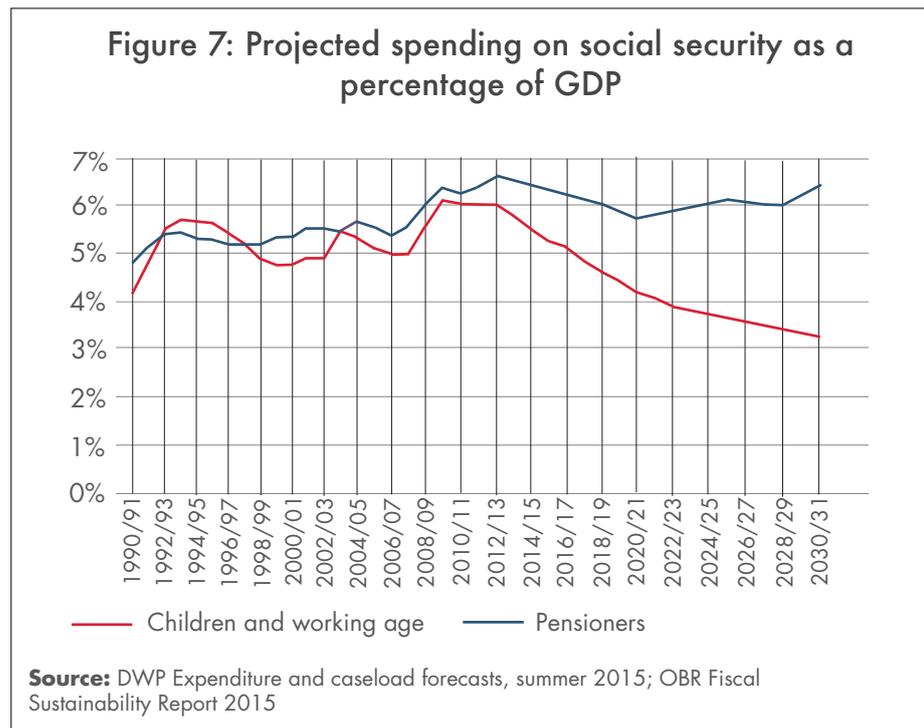
Importantly, these labour market reforms would also boost tax revenues and reduce benefit spending, and thereby almost pay for the cost of the more generous social security they would sit alongside. For this reason Inequality 2030 concluded that progressive labour market policies (so called 'pre-distribution'), while not transformative of household finances on their own, could help pay for redistribution on a significant scale.

Political priorities

This package of reforms is just an example, but it illustrates that it is possible to improve low and middle incomes, even with the tightest of fiscal constraints. However, in reality, talk of such constraints is largely political rhetoric. The current government prioritises working-age social security cuts, but it is not so worried about the deficit when it comes to tax cuts: the Landman Economics model shows that the decisions taken since the election will, in the long run, lead to more money being given away in income tax cuts than saved through social security.

The Fabian Society estimates that the total cost of increases to the personal allowance between 2010 and 2020 will eventually be in the region of £30 billion per year. Most of the benefits will go to households in the top half of the distribution, driving up inequality. Cuts can never be thought of as inevitable, when they are accompanied by tens of billions of pounds of tax giveaways to high income families.

In reality the government's aim is not to balance the public finances for its own sake, but to shrink overall levels of spending as a share of GDP. And within this broader retrenchment, working-age social security is a prime target. For, although George Osborne repeatedly complains that spending on welfare is out of control, the truth is that it is set to fall steeply (figure 7).



Cuts over the next 5 years will lead social security spending on children and working-age adults to fall from 5.5 per cent to 4.2 per cent of GDP, between 2014/15 and 2020/21. But even after that spending will continue to contract into the 2020s, if current policies remain unchanged, because most social security benefits will increase only in line with prices. This means that, by 2030, expenditure on working-age social security is expected to fall to just 3.3 per cent of GDP (according to OBR projections prepared on the basis of today's policies).

To a Treasury mandarin these savings are good news. But stronger public finances come at the cost of weaker family finances, since the proportion of national income which we transfer to low and middle income families strongly influences their living standards. With cuts of this magnitude, people whose household income partly or mainly comprises of benefits cannot possibly share proportionately in rising national prosperity. The inevitable consequence is the sharp rise in inequality and in poverty which we project.

There is a simple choice for Britain over the next 15 years: do we want to change course and distribute a roughly constant share of our national income to low and middle income families through the tax and benefit system? Or do we accept that their incomes and living standards should fall behind, that inequality should rise, and that millions more children should grow up in poverty?

It is a choice for the country, but also an obligation for the left. First the Labour party must understand itself that this is the choice; and then it must persuade the public that rising inequality is a not an inevitability but a question of political choice. Our politics can cleave people apart, or bind them together.

Technical note

The projections for 2030 were calculated using a micro-simulation model developed by Landman Economics, based on data from the Family Resources Survey 2011/12. The model uses OBR and ONS assumptions and projections. In addition to the OBR's macroeconomic projections, the model takes account of long-term trends regarding demographic change, employment, occupation structure, earnings differentials, and part-time and self-employed work. Results for different percentiles refer to the distribution of incomes, before housing costs, without equivalising for household size. Prices are uprated using the Consumer Prices Index.