Reducing Inequality: Beliefs and the importance of taxes and benefits

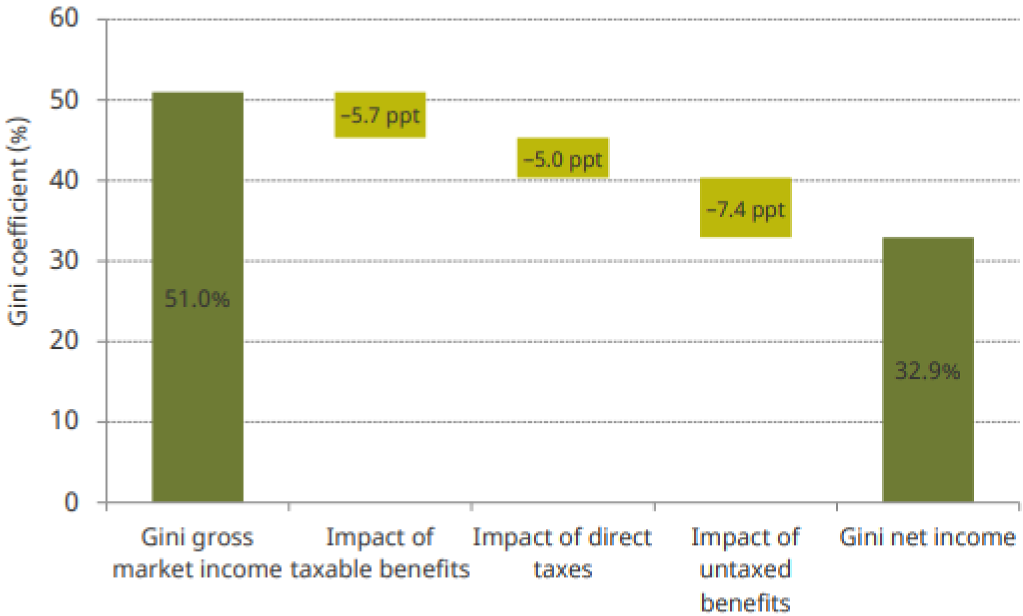
In an interview on the day before she became Prime Minister, Liz Truss said that she intended to cut taxes even though the cuts would benefit higher earners more than lower earners, and that this was fair. It is more important she said to grow the economy than to try to reduce economic inequalities. *"To look at everything through the lens of redistribution, I believe, is wrong. Because what I'm about, is growing the economy. And growing the economy benefits everybody.*" [1]

Recent studies have shown that there is no conflict between growing the economy and reducing inequality. Policies to redistribute income through government taxes and spending can in fact increase economic growth. High income inequality on the other hand can have adverse consequences both for how quickly the economy grows and for the length of time that growth can be sustained. One study estimated that inequality above a Gini coefficient of 0.245 is likely to result in lower growth. The UK coefficient is 0.34. [2]

Although Conservatives accept certain forms of equality such as equality before the law and the equal right to free speech, they have always rejected the case for greater equality of income and wealth. Their argument is that the pursuit of equality stifles individual freedom, restricts competition and creates disincentives both for investors to invest and for workers to look for jobs. The Conservative peer Ian Gilmore wrote in 1992, "*The Conservative Party has never sought to promote equality*." For Gilmour the pursuit of equality was the principal flaw of social democracy. [3]

The post-war Labour governments of Clement Attlee (1945-51), Harold Wilson (1964-70, 1974-76), James Callaghan (1976-79) were all committed to the pursuit of economic equality. However "*there was a clear ideological retreat from this……….during New Labour's tenure in office under Blair"*. [4] The talk was much more about promoting equality of opportunity than about the level of inequality as such. Nevertheless New Labour's increased spending on education and health,[5] as well as its considerable expansion of in-work benefits greatly contributed to the avoidance of any substantial increase in inequality between 1997 and 2010. Roy Hattersley has recently written that today's Labour Party should be prepared to declare and defend its belief that "*the creation of a more equal society is the primary object of its existence*. " [6]

The chart shows [7] the effects of taxes and benefits on inequality for the year 2016/17. Before taxes and benefits the Gini coefficient stands at 0.51. However after taxes are paid and benefits received it falls to 0.33. The chart also shows that benefits play a larger part in reducing inequality than taxes. Benefits reduce the Gini by about 13 percentage points while direct taxes reduce it by only 5 percentage points. Over the last few decades "*indirect taxes have become more regressive, with most of that change happening during the 1980s."* [8] Consequently, indirect taxes rather than direct taxes have made the largest contribution to income inequality. The poorest fifth of people paid on average 30.1% of their disposable income on indirect taxes compared with 11.3% for the richest fifth of people. [9]



In his book, ‘Back to the Future of Socialism’, Peter Hain recommends scrapping the reduced rate at which employees on high earnings pay national insurance contributions. For 2022-23 the standard rate of national insurance is 13.25% (12% from 6 November) and most employees pay this if they are earning at least £1,048.01 per month. On earnings above £4,189 per month however employees only pay 3.25% (2% from 6 November). Hain questions why people on high earnings should pay standard rate national insurance on only part of their earnings, when lower paid people have to pay national insurance on all of their earnings. The effect of scrapping the upper earnings limit (using the 6 November figures) would be to raise the top rate of income tax for those earning over £150,000 and national insurance combined, from 45% to 57% (46% to 58% in Scotland).[10]

In his book, ‘Inequality: What can be done?’, Tony Atkinson recommends that the top rate of tax should be even higher at 65%, for those on incomes over £200,000 and points out that this “*is not high by historical standards*.” [11] National insurance contributions would remain unchanged with those on higher earnings continuing to pay the reduced rate. He also recommends that the current practice of gradually withdrawing the personal allowance on incomes between £100,000 and £125,140 should be abolished.

Atkinson says that the welfare state has in the past played a major role in reducing inequalities, and that some current policies should be reversed if that is to continue. Two policies which are causing particular difficulties for people are the Benefits Cap and the Two-Child policy.[12] The first limits the total amount of benefit people can claim to £384.62 per week or £20,000 per year for a couple or single parent with children. The two-child benefit cap limits universal credit and tax credits to the first two children unless they were born before April 2017 when the policy was introduced.

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Notes

The Gini coefficient can have any value between 0 and 1. Zero indicates a perfectly equal distribution of income, while 1 represents complete inequality with one person receiving all the income available. So the higher the value the more unequal a country has become.

From April 2023 the top rate of 45% will be abolished leaving only the higher rate of 40% which will apply to all incomes above £50,270. It is not yet known whether the Scottish Government will follow the UK in abolishing the top rate which in Scotland is currently set at 46%. The higher rate in Scotland is 41% and applies to incomes above £43,662. In addition to the higher and top rates, Scotland has a starter rate of 19%, a basic rate of 20% and an intermediate rate of 21%. The Scottish Government cannot amend the personal allowance which is currently set at £12,570 and is reserved to the UK.