Fiscal policy and inequality

John Hills, London School of Economics

Bank of England, 18th May 2017
Chief Economists Workshop: The distributional effects of central bank policies

LSE International Inequalities Institute

CASE
CENTRE FOR ANALYSIS OF SOCIAL EXCLUSION

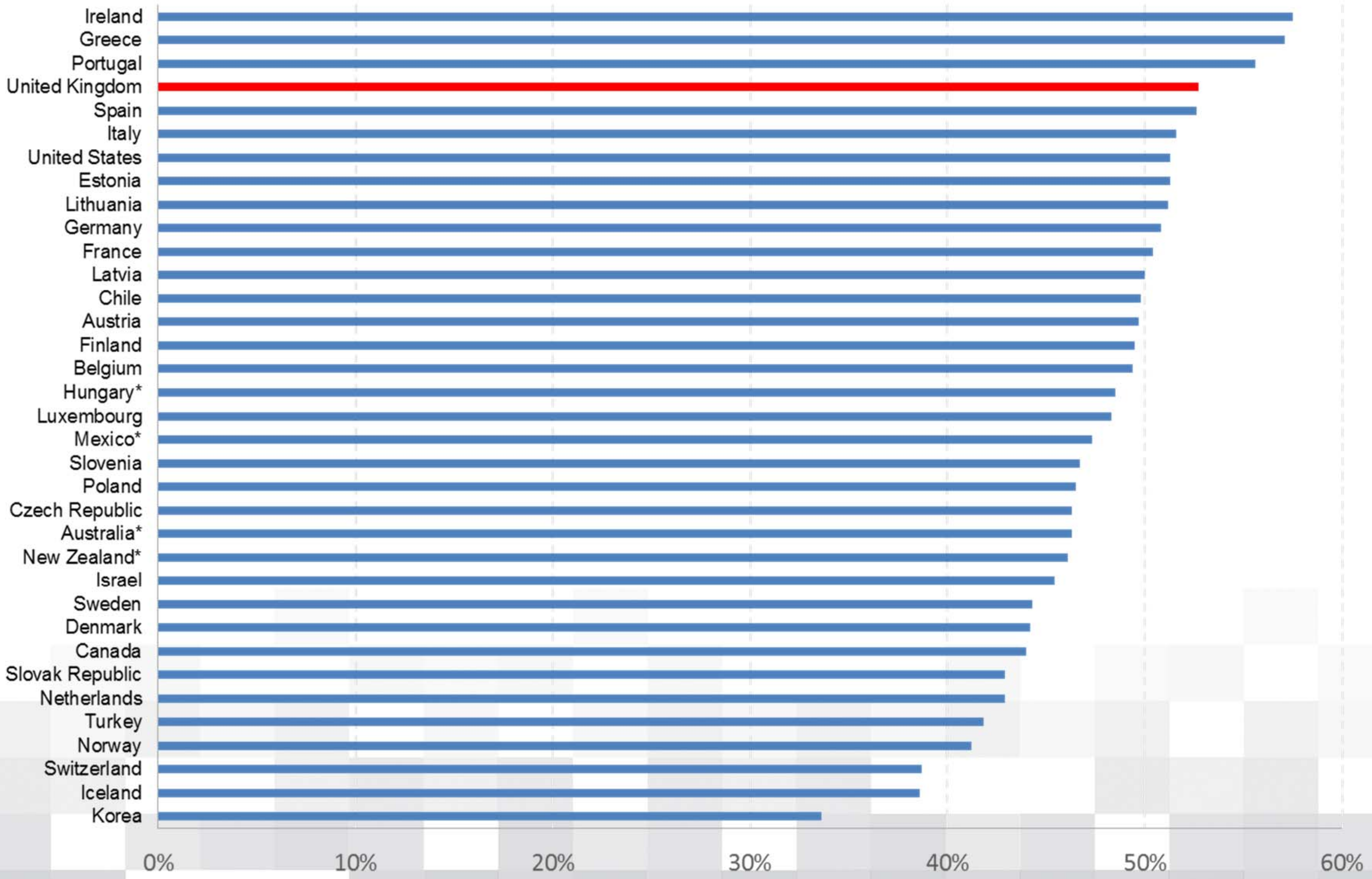
Structure of talk

Talk focuses on the distributional effects of fiscal policy instruments (taxes and transfers), *not* the long-run distributional effects of public borrowing or changes in it:

- Inequalities in market and disposable incomes
- 'Redistribution' and public attitudes
- Effects of tax-benefit policy changes in EU countries before and after the crisis: choices matter
- And instruments matter – with their starting point mattering in each country
- Recent UK experiences and the current outlook

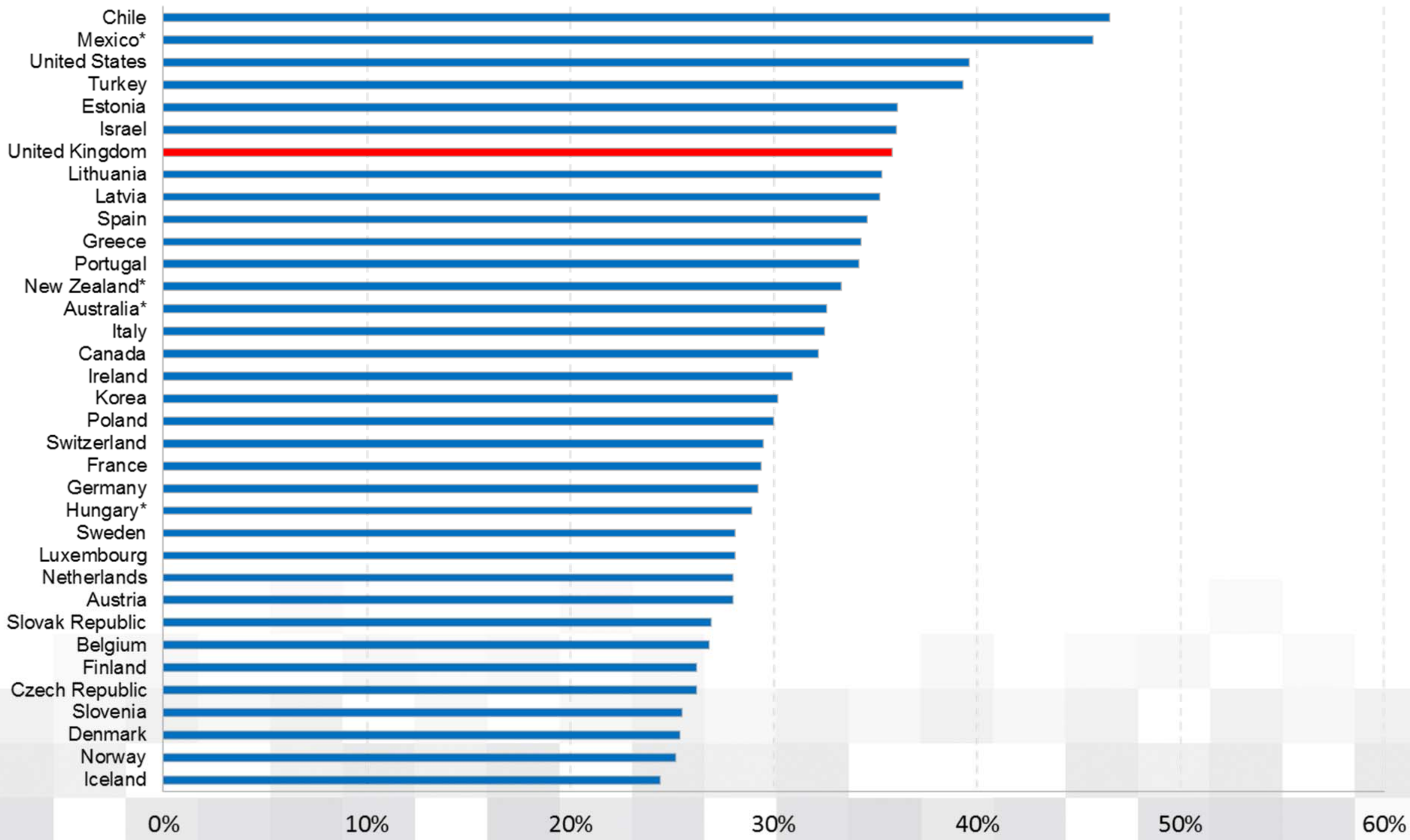
It draws on analysis carried out for the European Commission FP7-funded *Improving Poverty Reduction in Europe (ImPRovE*) programme: http://improve-research.eu/ (including a forthcoming OUP book edited by Bea Cantillon, Tim Goedemé and John Hills), and the LSE-led programme *Social Policy in a Cold Climate* *http://sticerd.lse.ac.uk/case/_new/research/Social_Policy_in_a_Cold_Climate.asp*

Inequality in *market* incomes in OECD countries, 2013



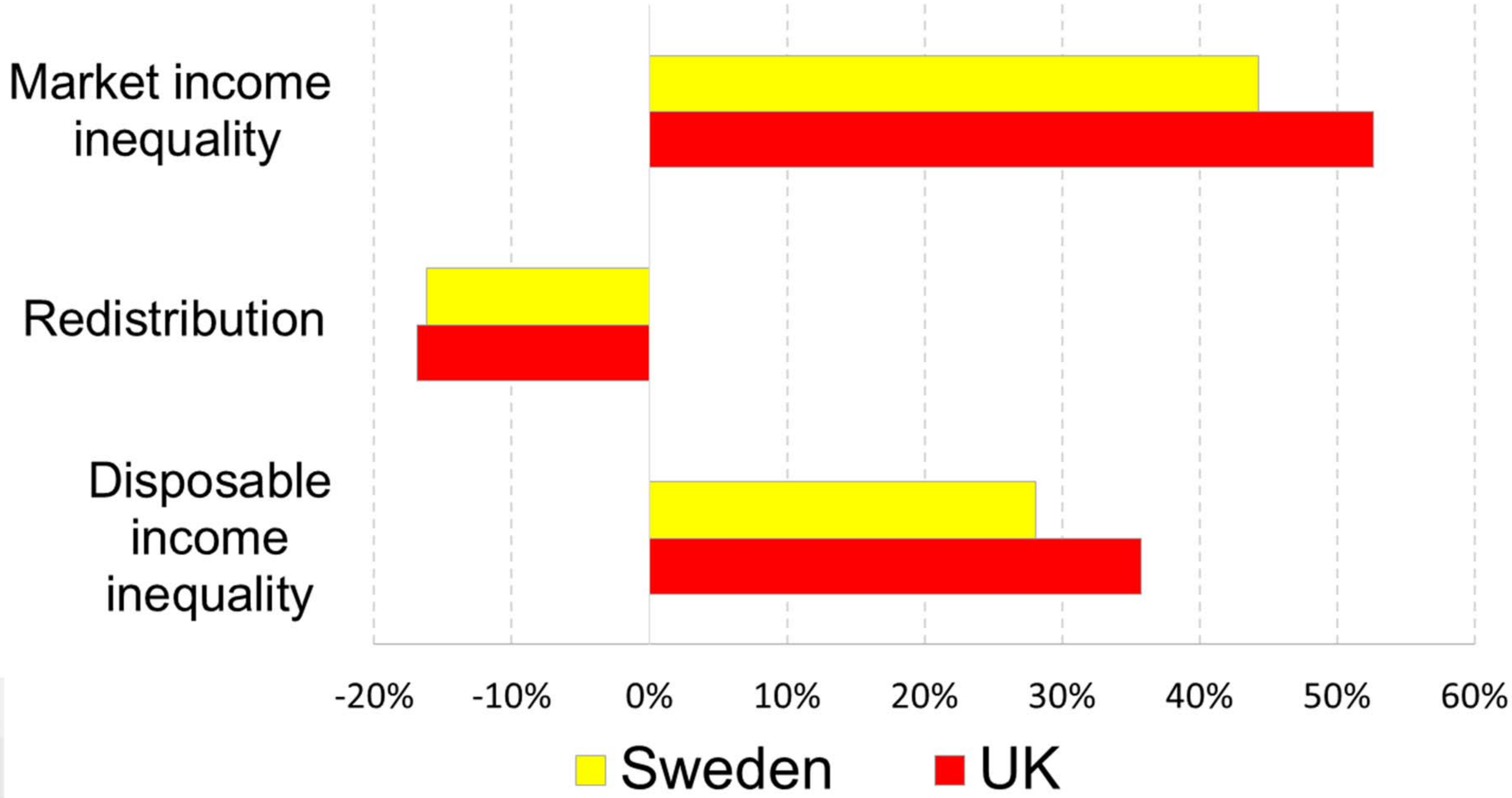
Source: OECD statistical database on income distribution and poverty, Gini coefficients

Inequality in *disposable* incomes in OECD countries, 2013



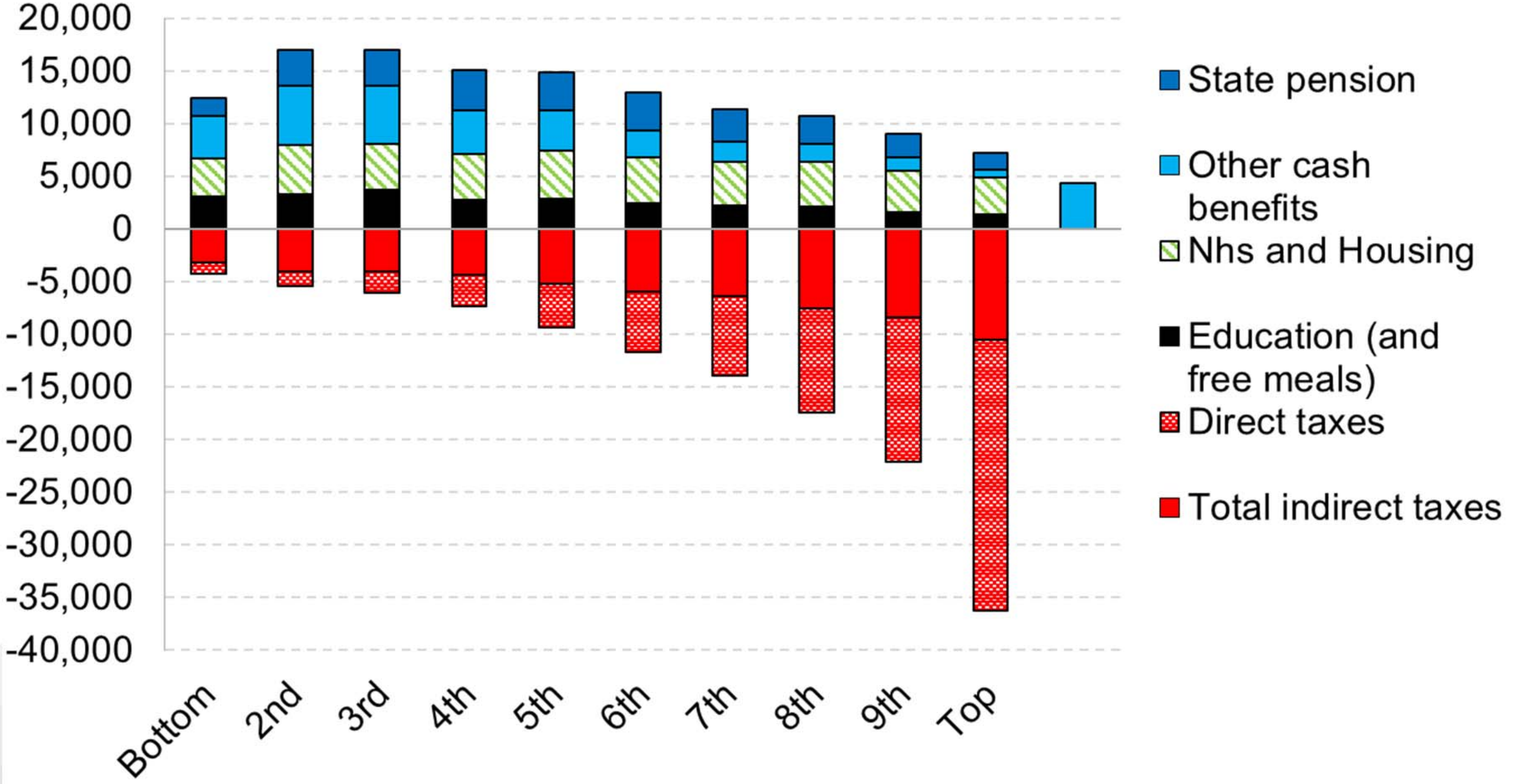
Source: OECD statistical database on income distribution and poverty, Gini coefficients

But more 'redistribution' does not necessarily mean more equality in disposable incomes…



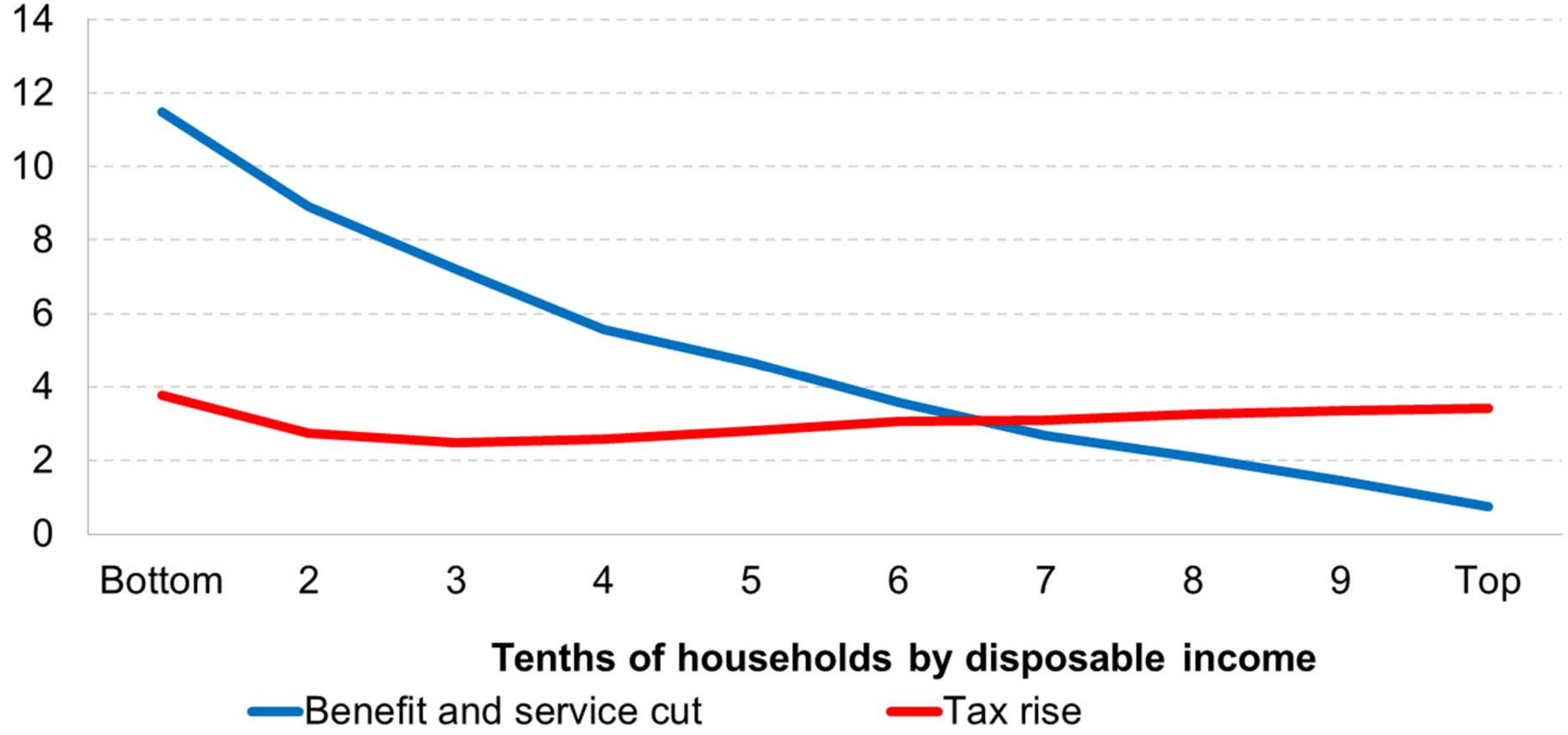
Source: J. Hills, *Good Times, Bad Times*, second edition, figure 2.9, 2013 figures (Gini coefficients).

And even proportional taxes funding flat rate benefits are redistributive: UK welfare services and taxes by income group (£, 2013-14)



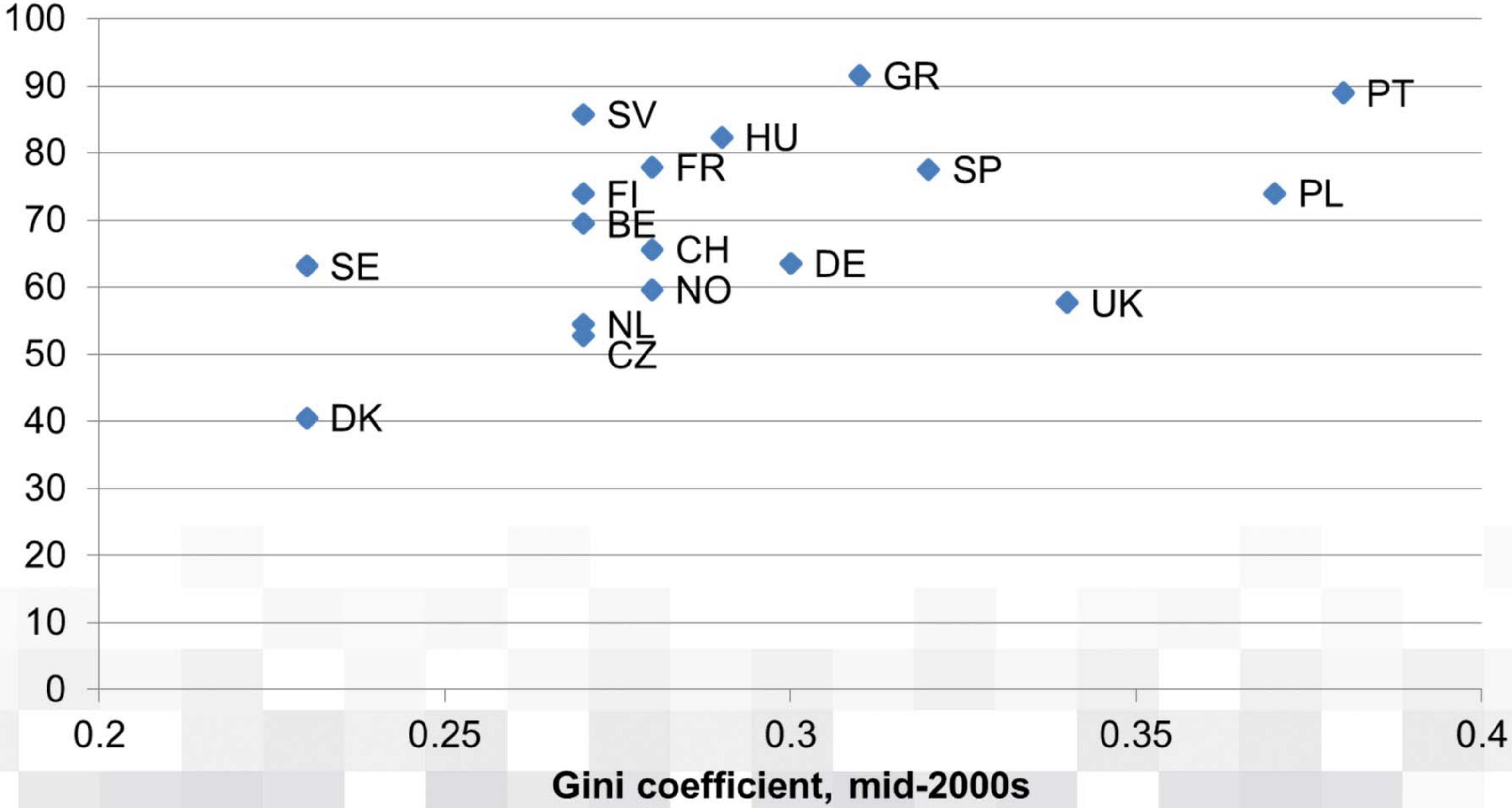
Source: Office for National Statistics (2015)

So proportional tax rises are distributionally neutral, but proportionate cuts in services and benefits are regressive: Loss as % income (UK, 2013-14)



Source: Office for National Statistics (2015)

Before the crisis, *explicit* public support for ‘redistribution’ varied: % agreeing government should reduce income differences, 2008



Source: European Social Survey Round 4, 2008; Gini coefficients are for mid-2000s from OECD (2008).

But there was very strong *implicit* support for redistribution based on views of fairness on two sides of government budget – 11 EU members

Views on distribution of benefit spending	Views on appropriate structures of taxation		
	Regressive	Proportional	Progressive
Earnings-related	2	25	22
Flat-rate/universal	3	15	18
Means-tested	1	5	9

Source: J. Hills, *Good Times, Bad Times*, second edition, based on European Social Survey (2008)

But there was very strong *implicit* support for redistribution based on views of fairness on two sides of government budget – UK

Views on distribution of benefit spending	Views on appropriate structures of taxation		
	Regressive	Proportional	Progressive
Earnings-related	3	10	8
Flat-rate/universal	7	25	27
Means-tested	2	6	11

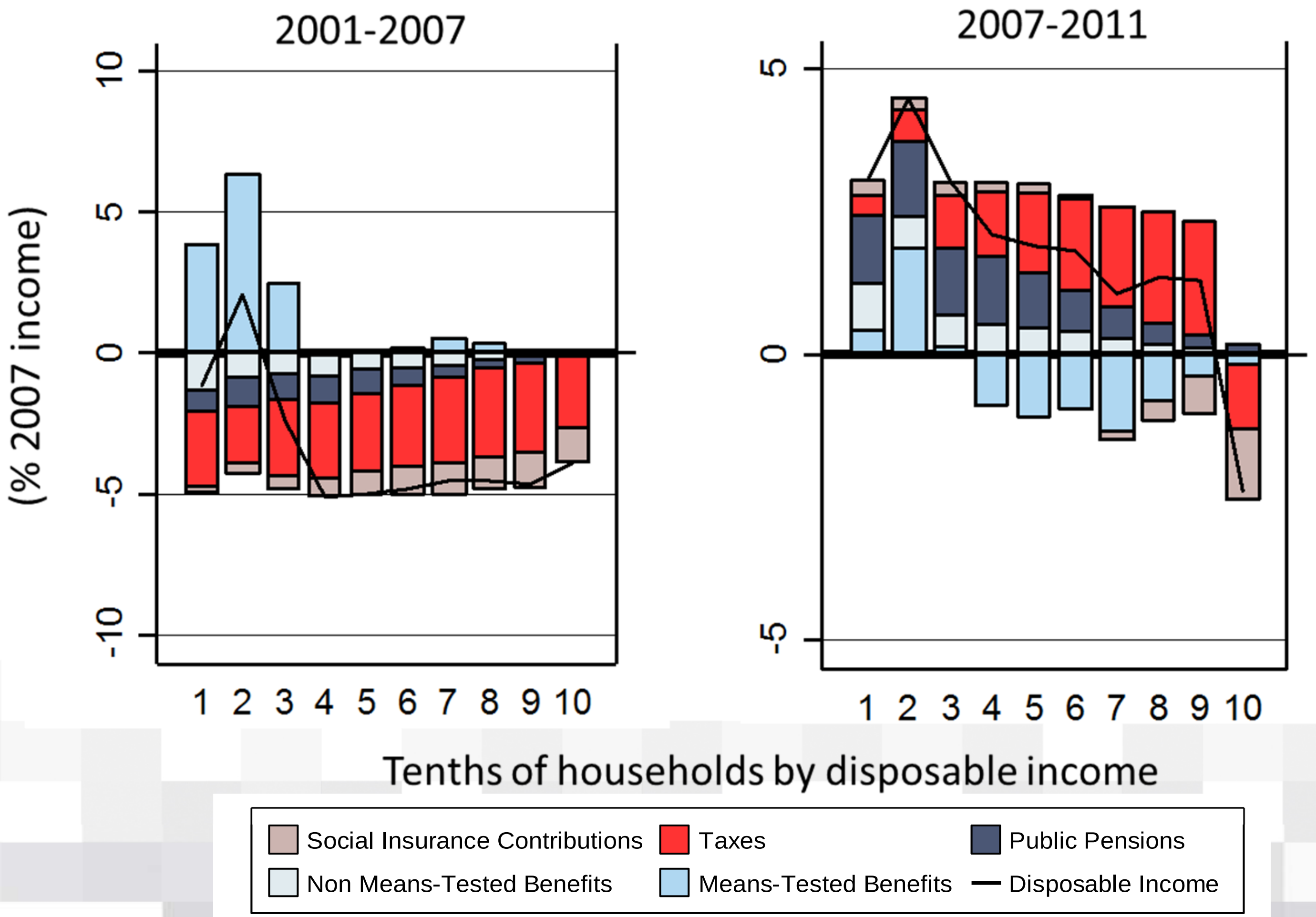
Source: J. Hills, *Good Times, Bad Times*, second edition, based on European Social Survey (2008)

Effects of changes to tax and benefit systems in seven EU countries before and after the crisis

- Many factors affect poverty and inequality. As part of the *ImPRovE* programme, our analysis isolated direct effects of changes in governments' (direct) tax and benefit policy on household disposable incomes
- We did this by comparing the systems in place in 2001, 2007, 2011 (but using constant populations, as in 2007), so we can contrast pre- and post-crisis changes
- The results come from the simulation model EUROMOD, and cover 7 countries: Belgium, Bulgaria, Estonia, Greece, Hungary, Italy and the UK
- A critical issue is what <u>unchanged</u> policy would look like? Results show effects if benefits, etc were linked to average market <u>incomes</u> in 'unchanged' comparator (paper also compares with <u>price</u>-linked base)
- We looked at both <u>structural</u> reforms and <u>indexation</u> effects

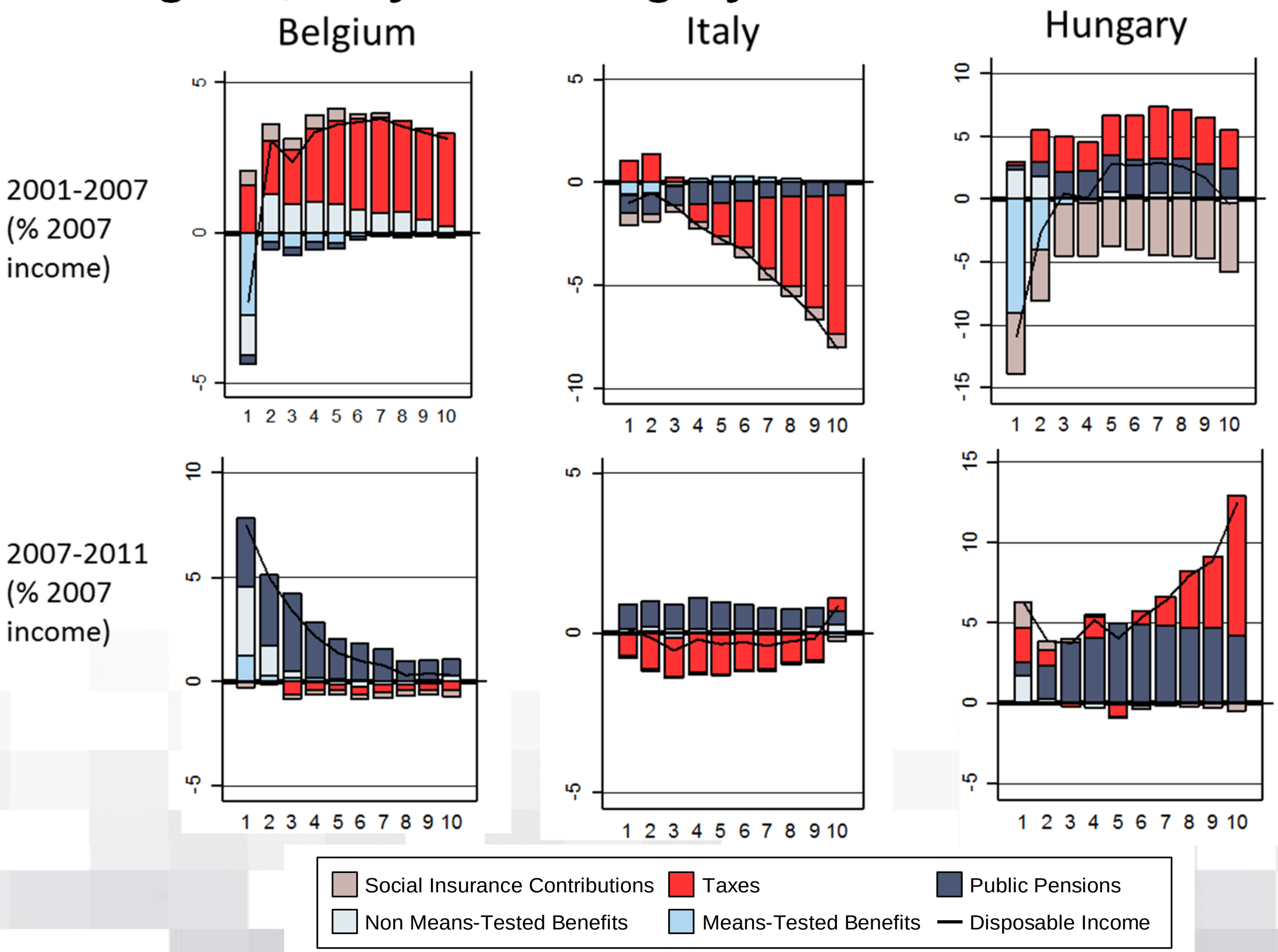
See J. Hills, A. Paulus, H. Sutherland and I. Tasseva "A lost decade? Decomposing the effect of 2001-11 tax-benefit policy changes on the income distribution in EU countries", *ImPRovE Discussion Paper* 14/03, June 2014 http://improve-research.eu/?page_id=37

Distributional effects of tax-benefit changes in the UK (compared to income-uprated system)



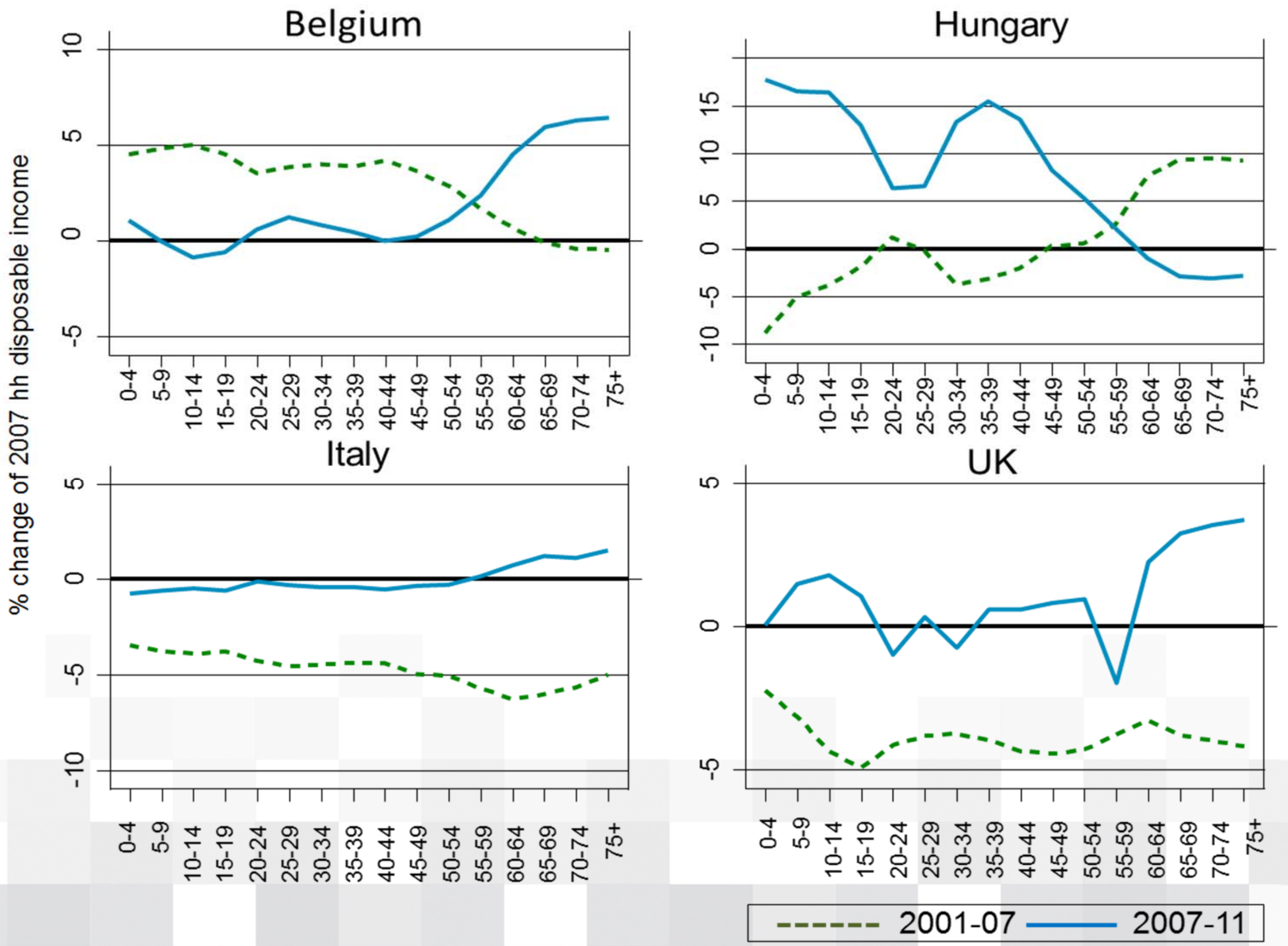
Source: Hills, Paulus, Sutherland and Tasseva (2014) figures 21 and 22.

Distributional effects of tax and benefit changes in Belgium, Italy and Hungary



Source: Hills, Paulus, Sutherland and Tasseva (2014) figures 21 and 22.

Effects of tax and benefit reforms compared to income-adjusted systems by *age* group

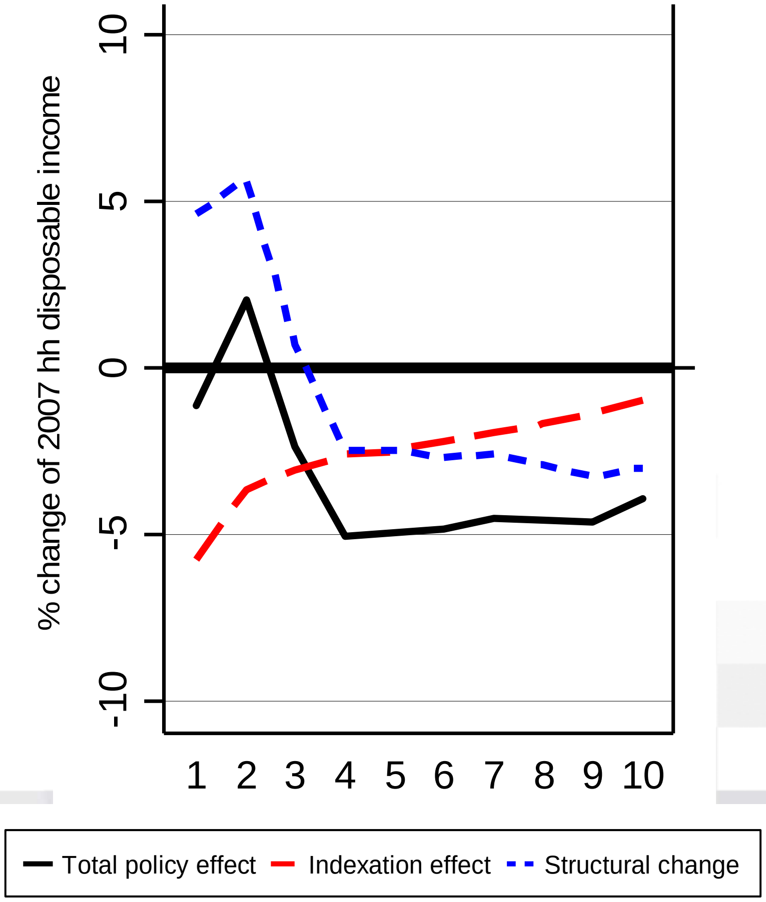


Source: Hills, Paulus, Sutherland and Tasseva (2014) figures 17 and 18.

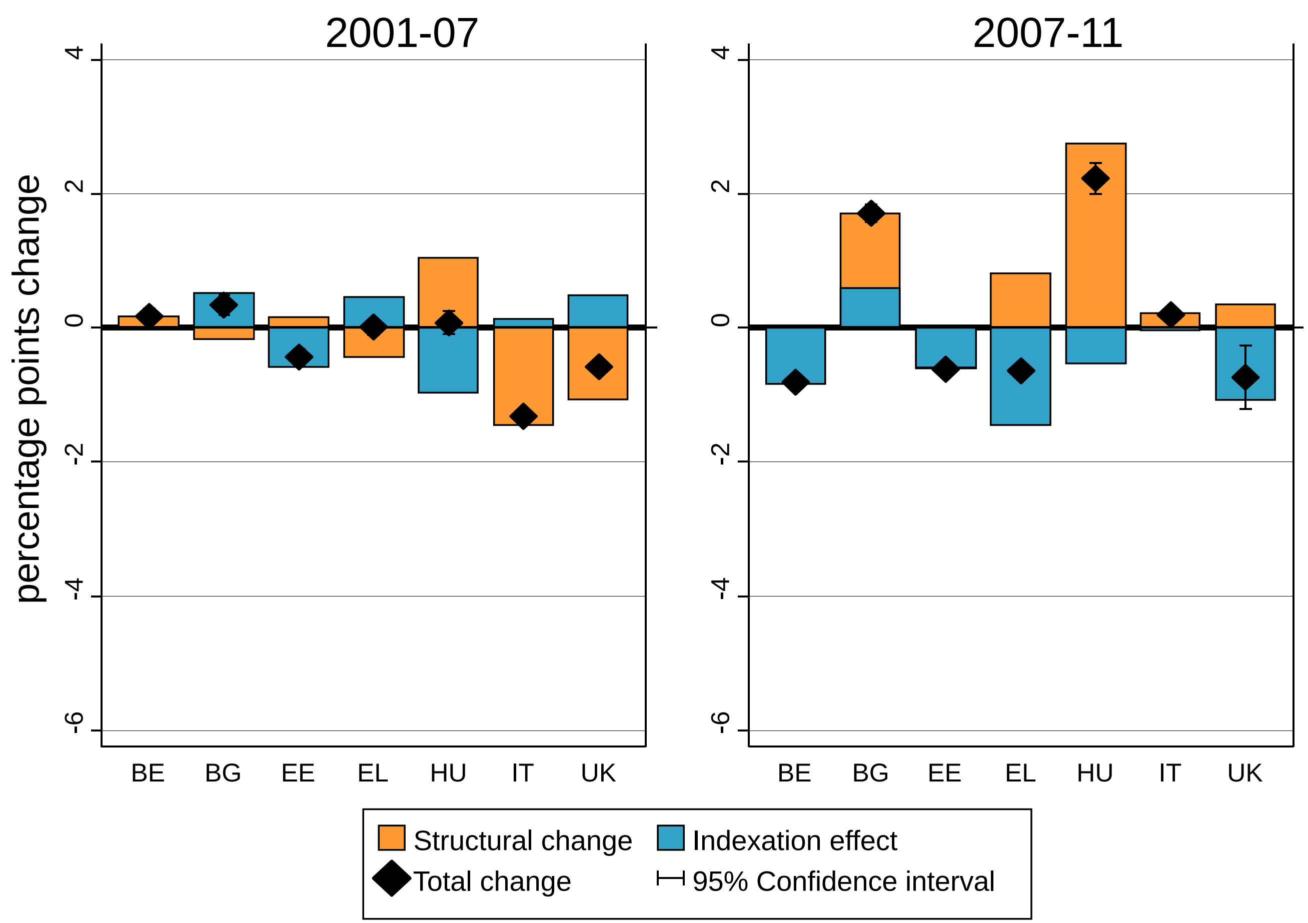
Sources of the change: Structural change and indexation effects

- We separate two components of policy change:
  - *Indexation effect* – due to changes (or not) in levels of benefit payments, tax thresholds etc which we might expect to keep pace with the evolution of economic variables; includes both "silent" regular indexation and more visible ad hoc increases.
  - *Structural changes* – major reforms to the structure of the system or to changes in e.g. tax/withdrawal rates

UK, 2001-2007 (vs income-indexed base)

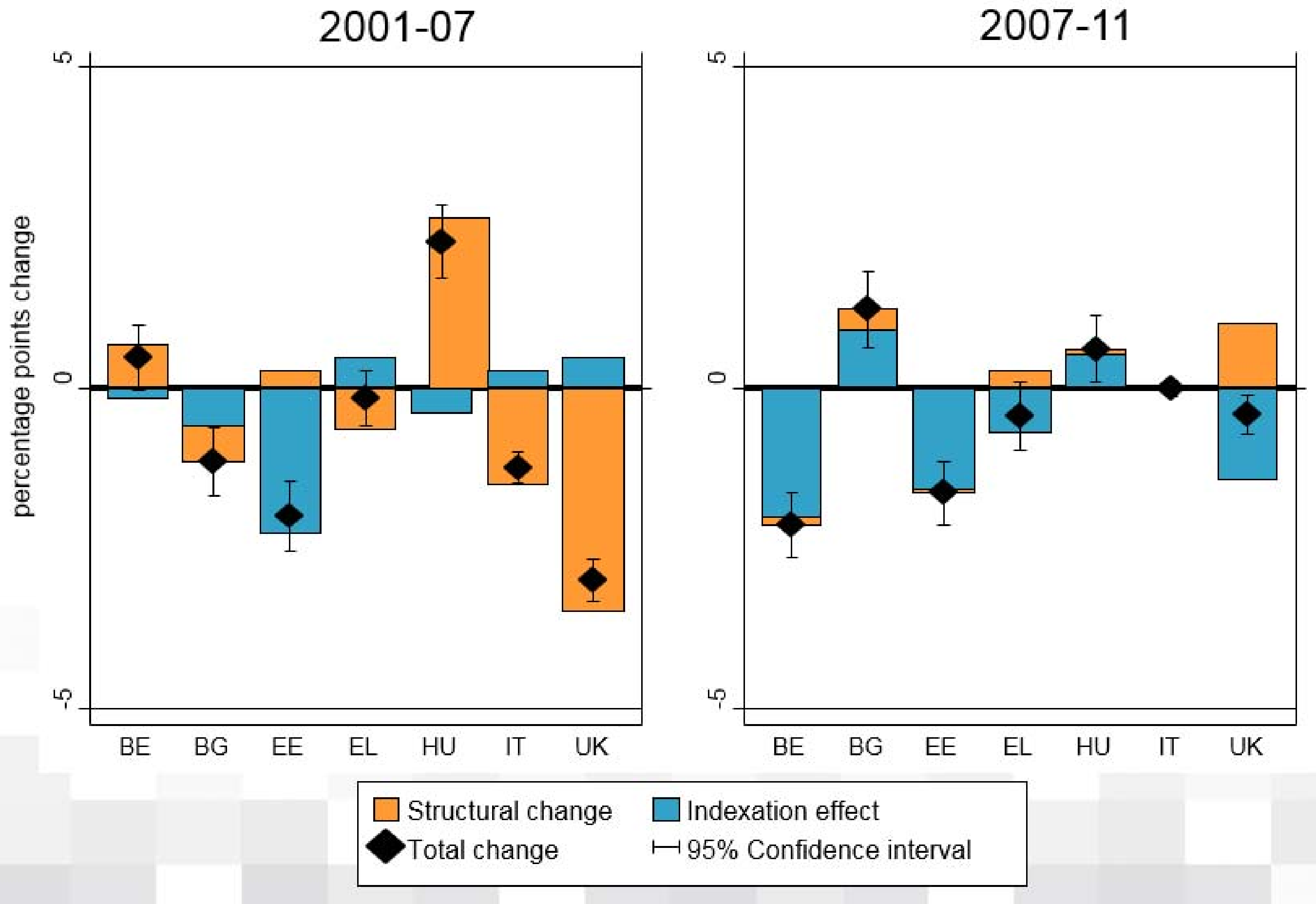


Effect of policy changes relative to income indexation on income inequality (Gini)



Source: Hills, Paulus, Sutherland and Tasseva (2014) figure 9.

Effects of tax and benefit changes compared to income indexation on poverty rates



Source: Hills, Paulus, Sutherland and Tasseva (2014), figure 6.

Before and after the Crisis: Summary

- It is helpful to isolate policy effects from out-turn trends. This can give an different impression of policy effort. In this case, 2001-11 was <u>not</u> an entirely “lost decade” for poverty reduction *policies* for the countries considered, despite disappointing trends in actual out-turns: in six of them, tax and benefit policy changes were poverty-reducing
- Structural (advertised) reforms are sometimes much less important than (possibly hidden) indexation effects/conventions. For instance, if benefits/ thresholds do not keep up, other types of poverty-reducing policy have to work much harder..
- As well as effects by income group, the onset of the Crisis saw some sharp reversals in the balance of policy effects between *age* groups.
- More was achieved in most (but not all) of the countries examined in the ‘good times’ before 2007 than immediately after the crisis
- Changes to different components of the system can have opposite effects: they need to be seen together., rather than analysed one-by-one

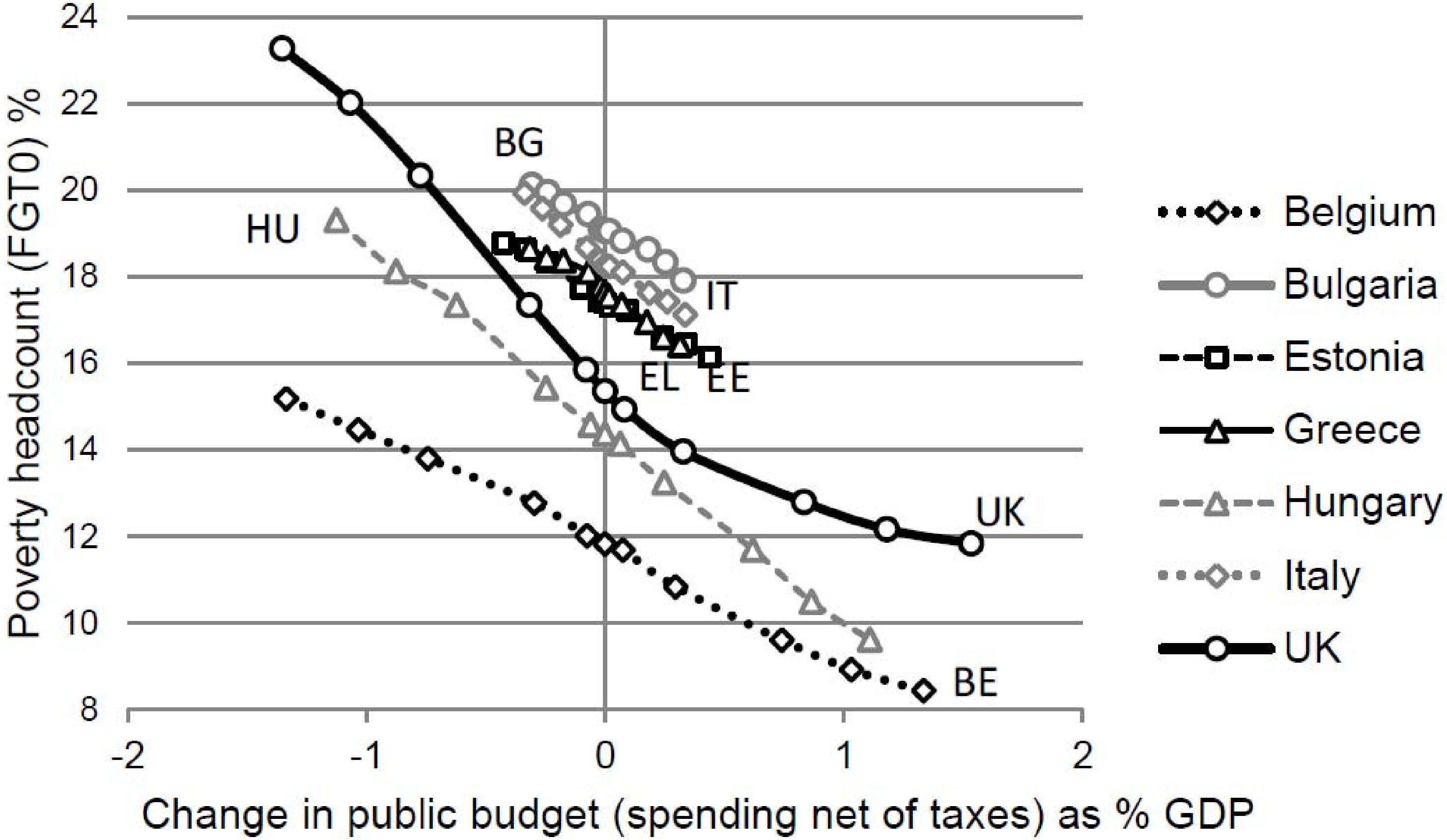
See Hills J., A. Paulus, H. Sutherland and I. Tasseva “The effects of tax and benefit policy changes on poverty and income distribution, 2001 to 2011: Some lessons for the future”, ImPRovE Policy Brief 02 http://improve-research.eu/?page_id=1928

But the effects of instruments varies widely – and between countries

- Using the microsimulation model EUROMOD, Leventi, Sutherland and Tasseva recently compared the effectiveness of different fiscal instruments in reducing poverty, given national starting points.
- They examine the effect of changes in the values of particular benefits and tax thresholds, normalised in relation to fiscal cost as a percentage of GDP.
- They also look at 'whole system' change, with all monetary parameters increased or decreased in proportion (illustrating fiscal drag/ benefit erosion if indexation does not match evolution of incomes).
- They look at both poverty *headcount* effects and those on poverty *gaps*, using thresholds drawn at 60% of median (adjusted) household incomes.

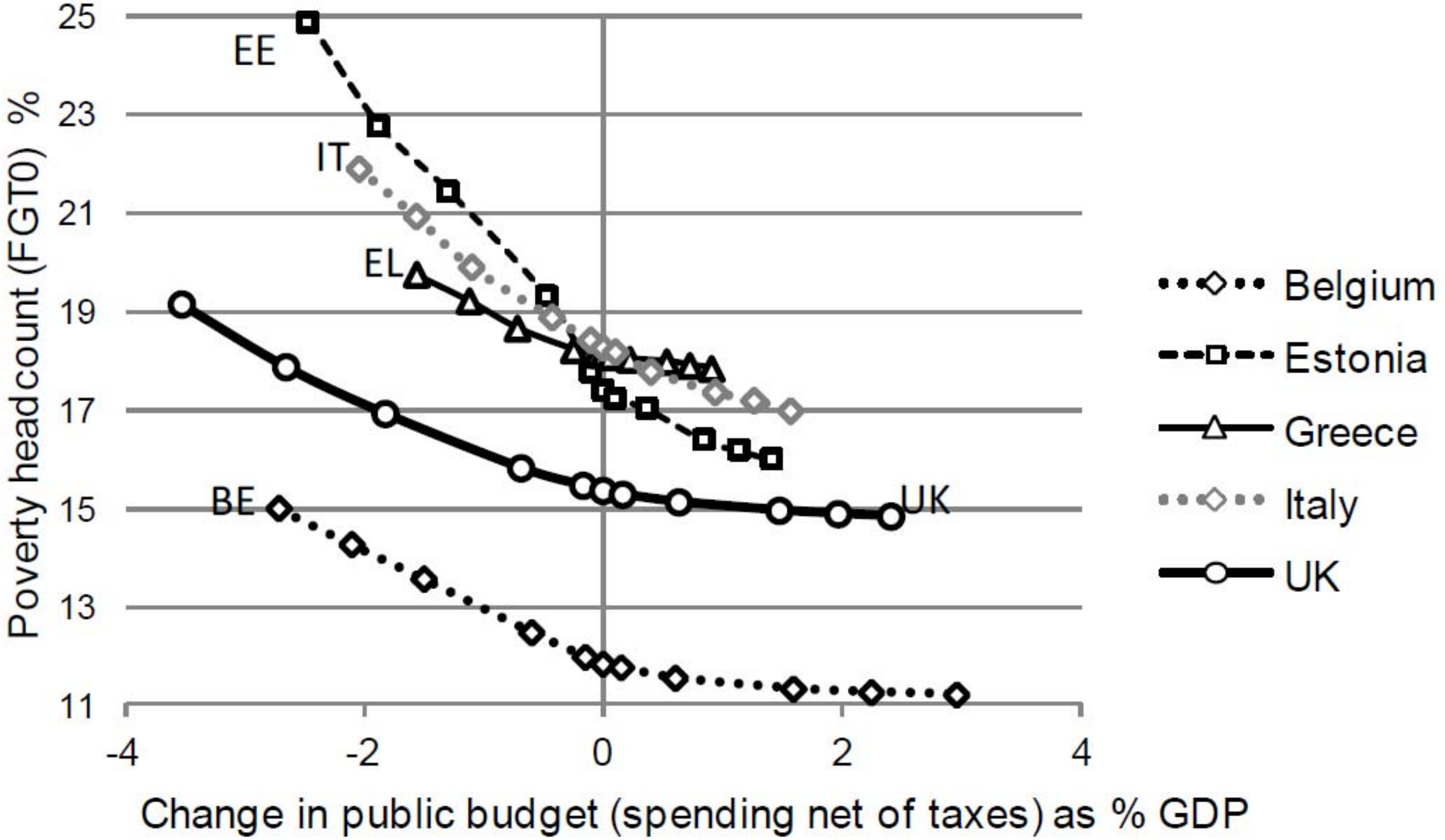
See C. Leventi, H. Sutherland and I. Tasseva, *Improving Poverty Reduction in Europe: What works best where?* EUROMOD Working Paper EM8/17 (May 2017) https://www.euromod.ac.uk/publications/improving-poverty-reduction-europe-what-works-best-where-0

Child benefit levels: poverty effectiveness versus cost – poverty headcount



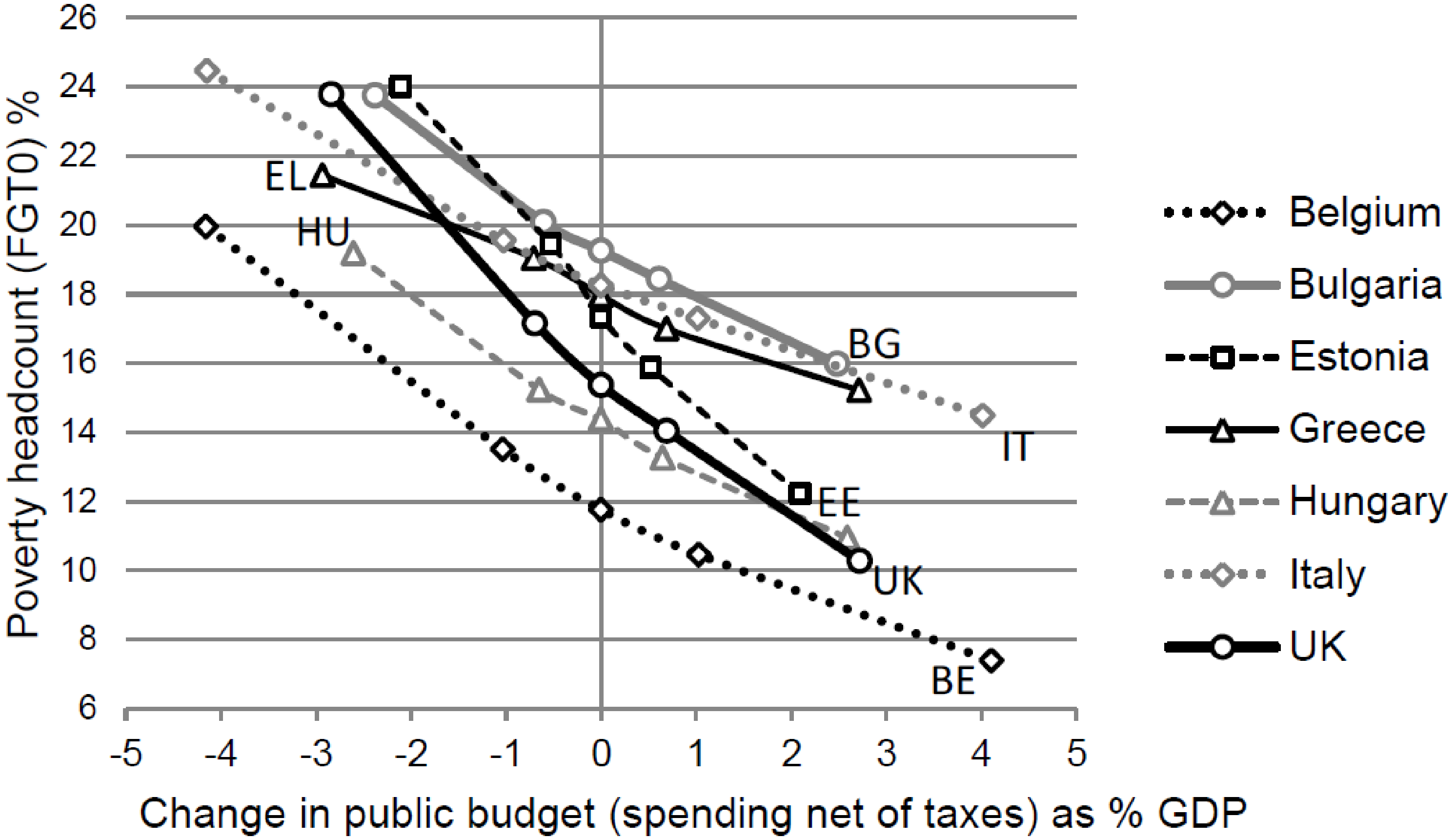
Source: Leventi, Sutherland and Tasseva (2017) EUROMOD working paper EM 8/17

Income tax thresholds: poverty effectiveness versus cost – poverty headcount



Source: Leventi, Sutherland and Tasseva (2017) EUROMOD working paper EM 8/17

Whole system contraction/expansion: poverty effectiveness versus cost – poverty headcount



Source: Leventi, Sutherland and Tasseva (2017) EUROMOD working paper EM 8/17

But the effects of instruments varies widely and between countries: summary

Modelling the effects of different interventions in seven countries shows great variation in their cost effectiveness – 'one size doesn't fit all':

- Making instruments *more* generous can have smaller effects than making them *less* generous (eg tax allowances in UK, BE or Child allowances in Belgium)
- Relative effects differ between countries – for instance, more spending on child benefits has more effect in Hungary than in Belgium
- Assessment should look at poverty gaps as well as headcounts – improving social assistance reduces the former in Estonia, not the latter
- The poverty-reducing effect of changes costing 1% of GDP varies from 0.4 % points from greater income tax allowances in the UK to 6.5 % points from more generous social assistance in Belgium.
- Across all 7 countries, higher income tax allowances are much less effective than greater social benefits (including through indexation rules) or minimum wages
- Straightforward increases in social assistance floors (means-tested minimum incomes) can look most cost effective – *but* avoiding 'unemployment trap' effects by spreading benefits to low-paid workers can double their cost (see D. Collado *et al. The end of cheap talk about poverty reduction, EUROMOD working paper EM5/17* https://www.euromod.ac.uk/publications/end-cheap-talk-about-poverty-reduction-cost-closing-poverty-gap-while-maintaining-work).

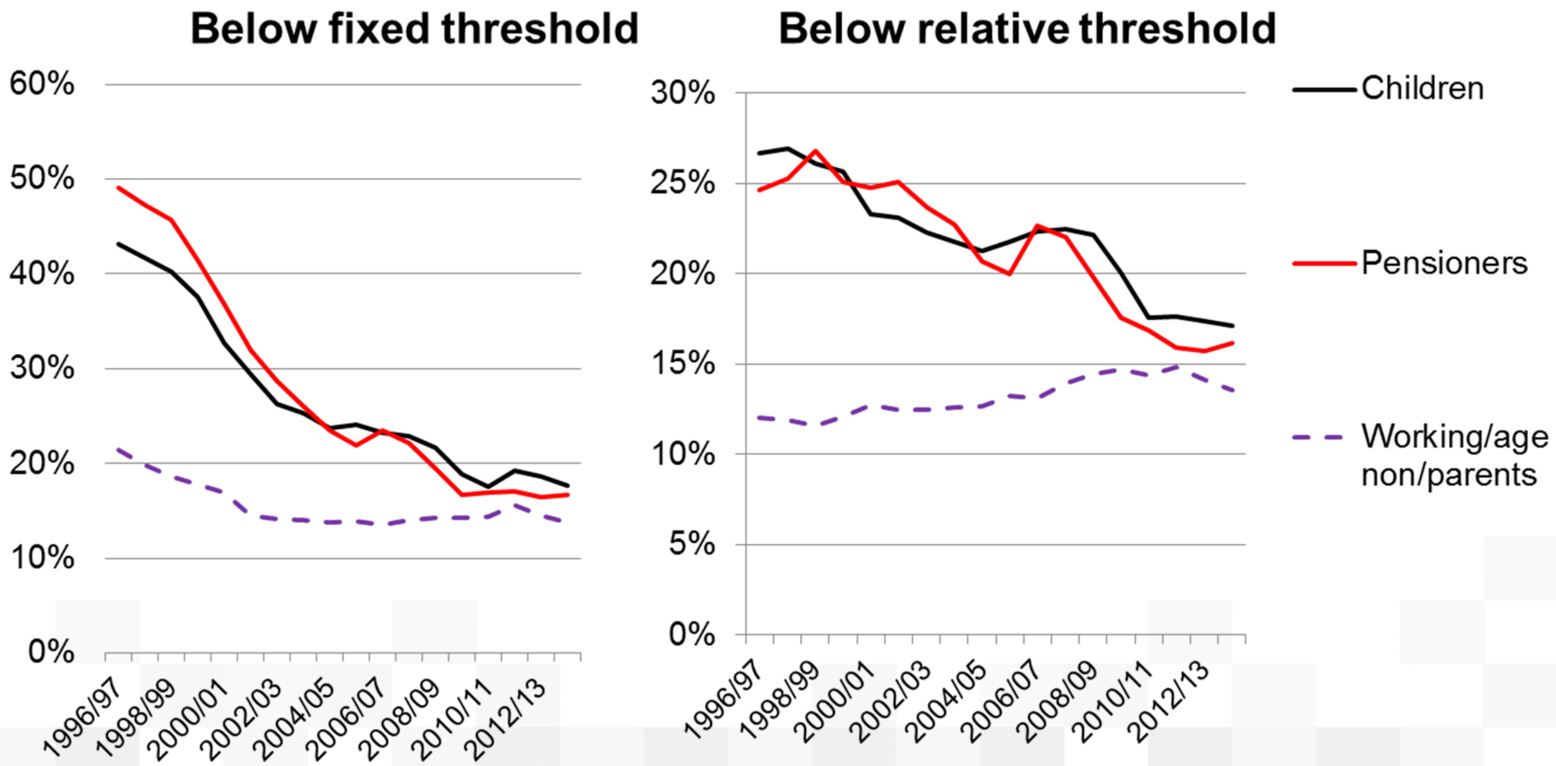
Recent experience: UK fiscal policies since 2010

- After 2010, the priority of fiscal policy was to cut the deficit – and the decision was that 80% of this should come from spending cuts, only 20% from tax increases. In fact, income tax allowances were increased, benefiting the top half of the distribution most (but offset by increases in indirect taxes).

- And a series of ‘welfare’ cuts were brought in: less generous indexation from year to year (and now a 5 year cash freeze); Council Benefit cuts for working age people; limits on total benefits; ‘Bedroom Tax’ penalties on some social tenants and ever-tightening Housing Benefit limits for private tenants; with further reductions in the generosity of in- and out-of-work benefits/tax credits (especially for larger families).

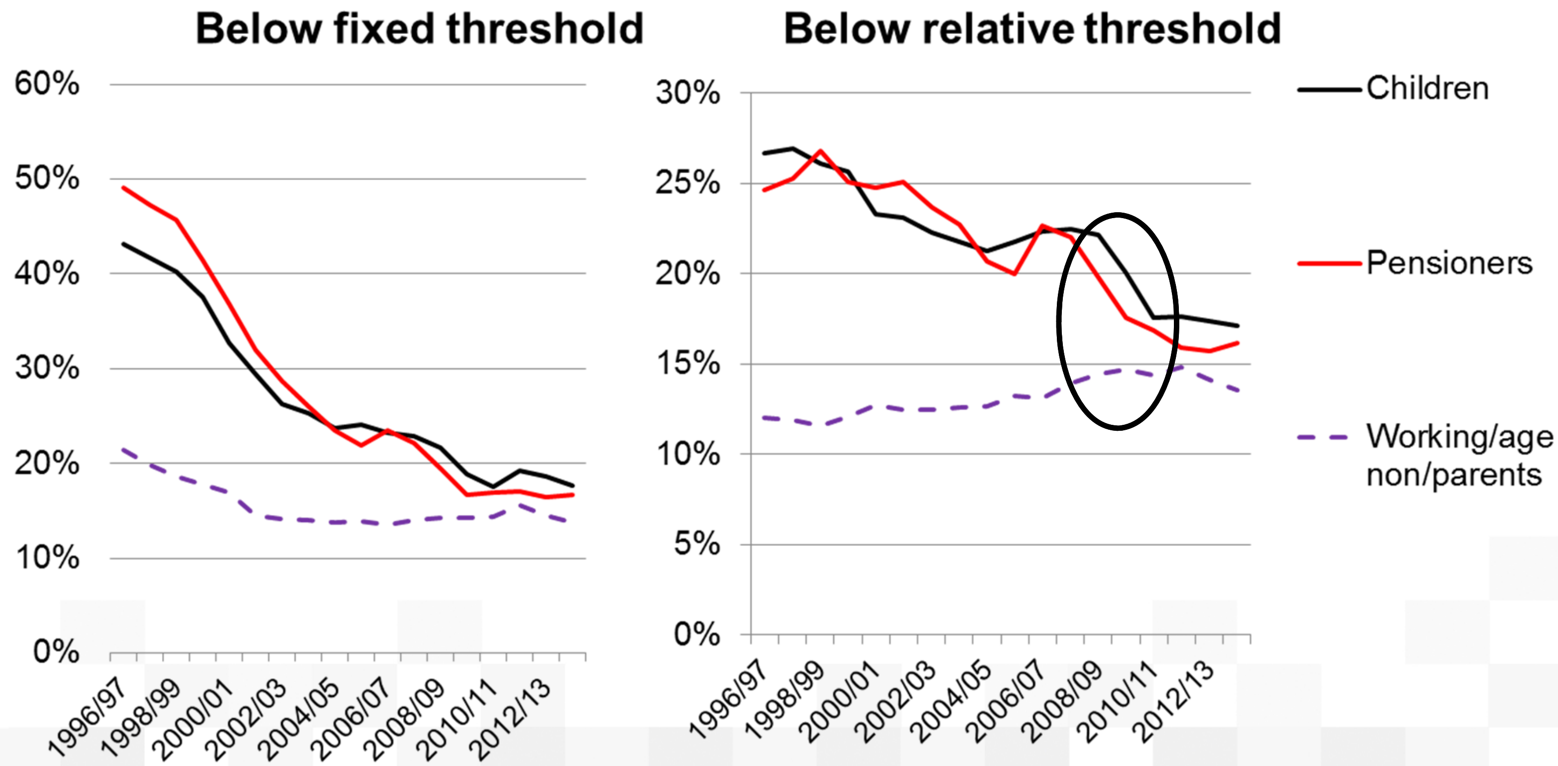
- But *initially* after the crisis cash benefits remained protected against price-inflation (and state pensions more generously indexed). As real wages and general living standards were falling, inequality and relative poverty fell, especially comparing 2009-10 and 2010-11.

Relative and absolute poverty by age group, 1996/97 to 2013/14



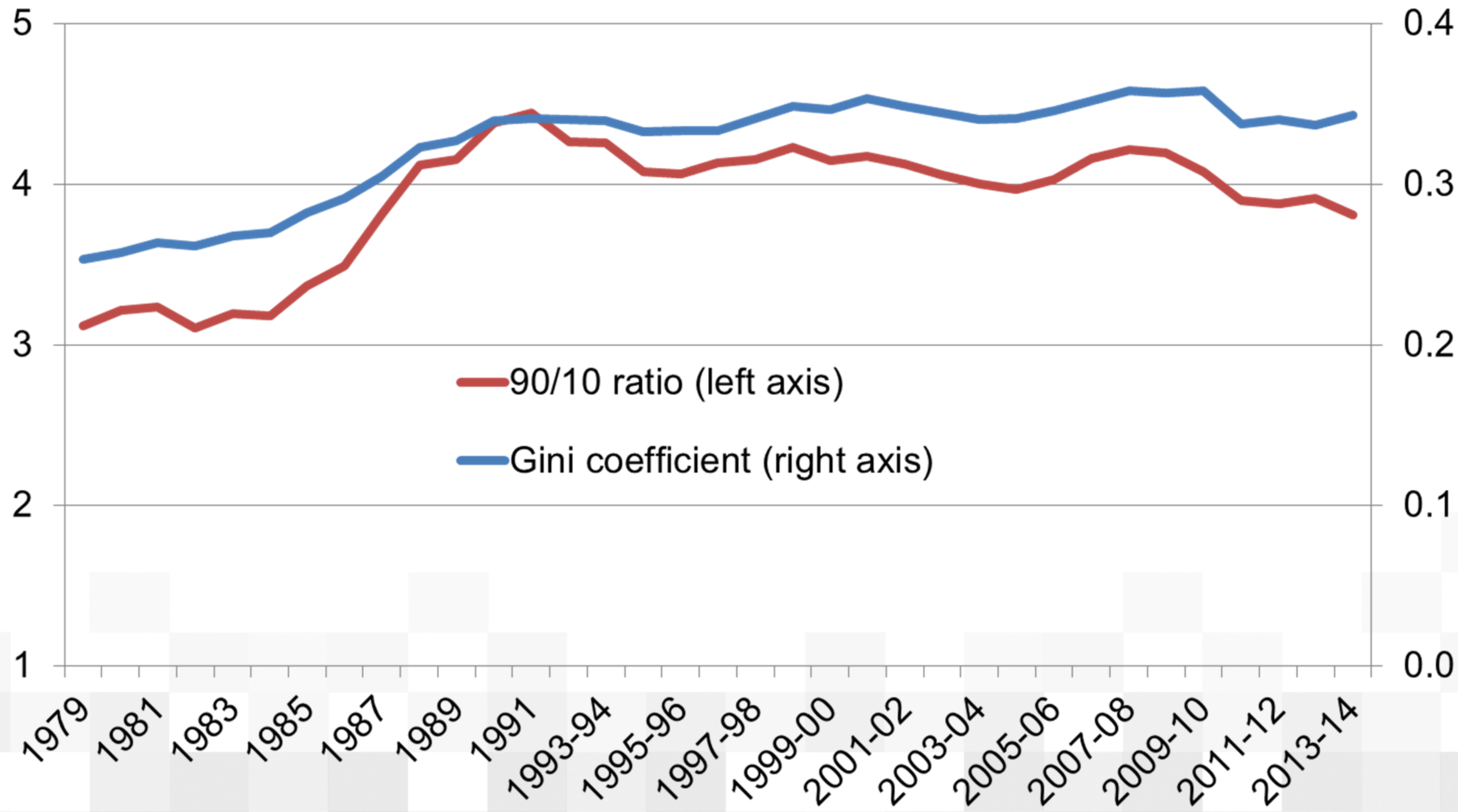
Source: Social Policy in a Cold Climate: Policies and their Consequences since the Crisis (April 2016). Proportions of population with incomes below 60% of 2010/11 median income in real terms and below 60% of contemporary income by population group, Before Housing Costs

Relative and absolute poverty by age group, 1996/97 to 2013/14



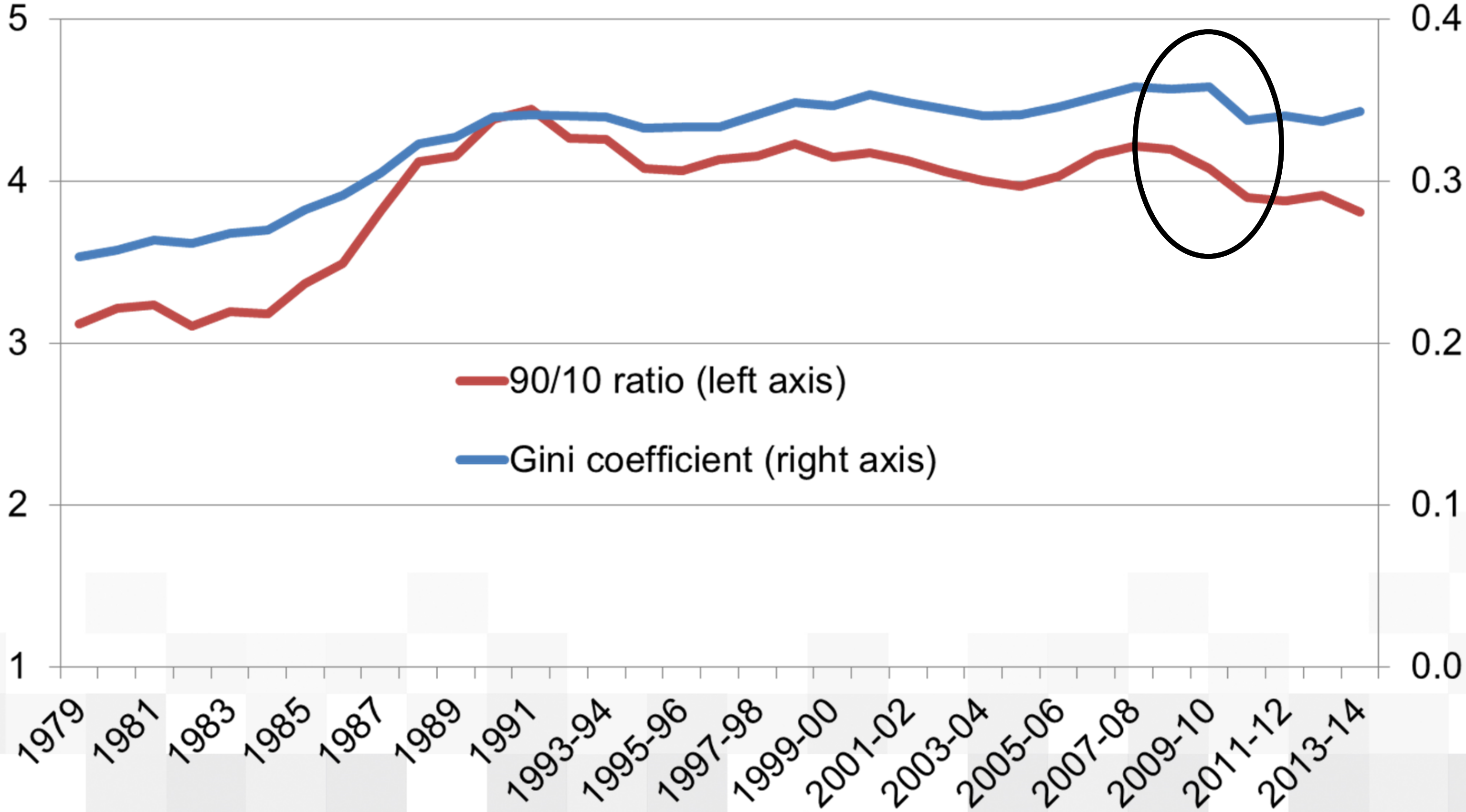
Source: Social Policy in a Cold Climate: Policies and their Consequences since the Crisis (April 2016). Proportions of population with incomes below 60% of 2010/11 median income in real terms and below 60% of contemporary income by population group, Before Housing Costs

Income inequality 1979 to 2013/14 (GB): 90:10 ratio and Gini coefficient



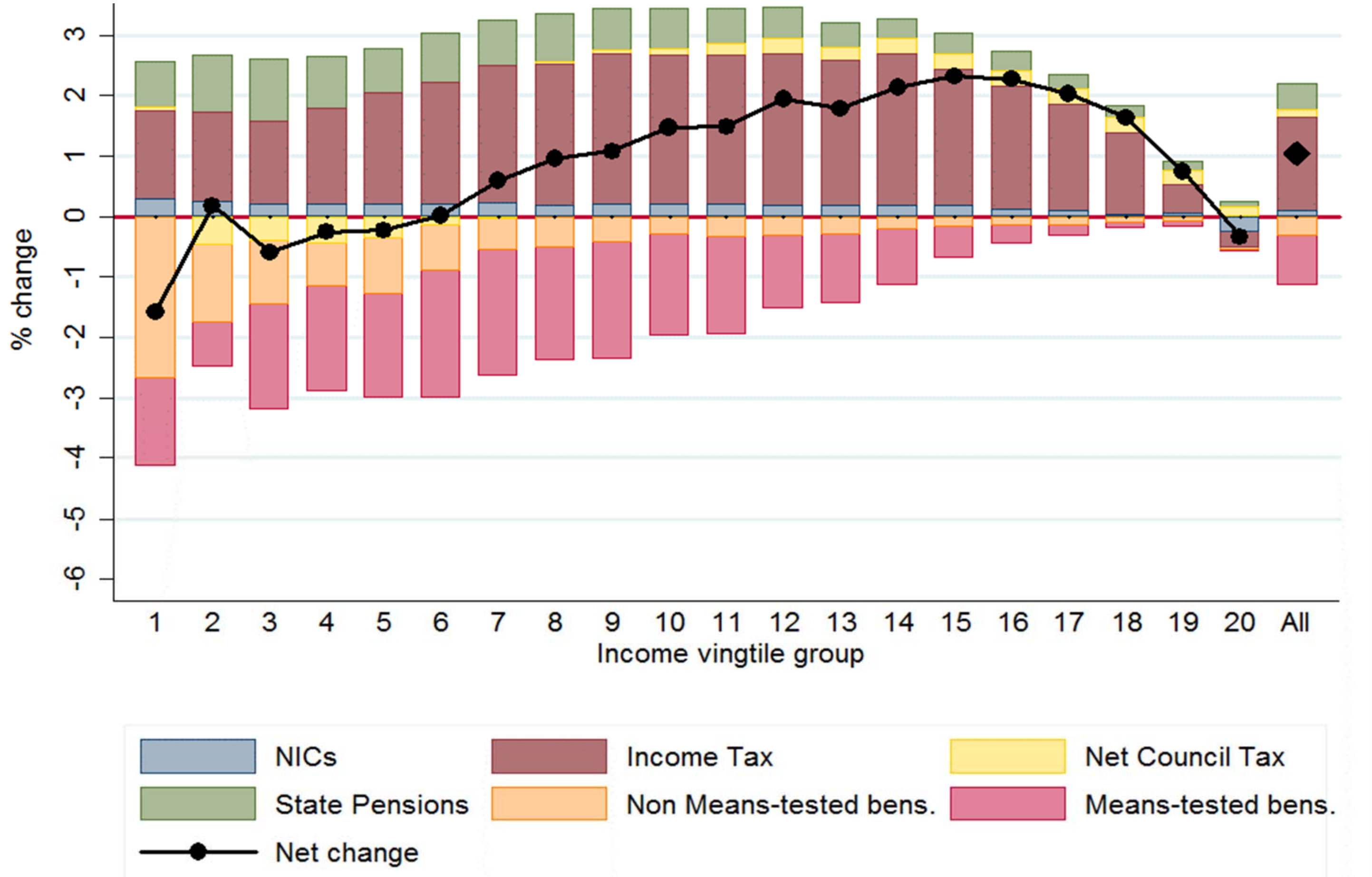
Source: IFS Inequality and Poverty spreadsheet, 2015. Incomes before housing costs.

Income inequality 1979 to 2013/14 (GB): 90:10 ratio and Gini coefficient



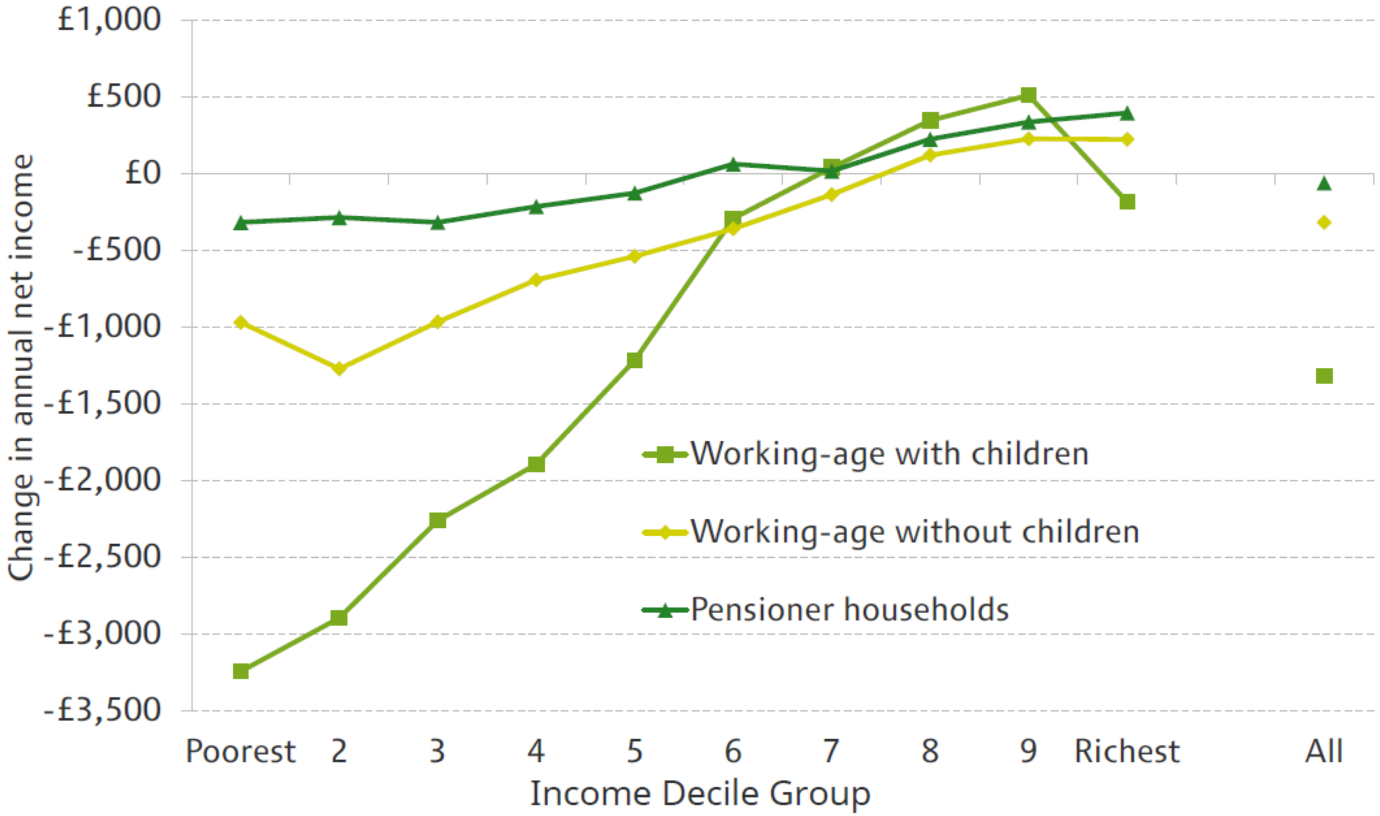
Source: IFS Inequality and Poverty spreadsheet, 2015. Incomes before housing costs.

Longer-term outlook is less positive: Effects of UK *direct* tax/ benefit reforms (% change by income group, May 2010–May 2015)



Source: De Agostini, Hills and Sutherland (2015) Changes to 2015-16 compared to CPI-linked base.
http://sticerd.lse.ac.uk/dps/case/spcc/wp22.pdf

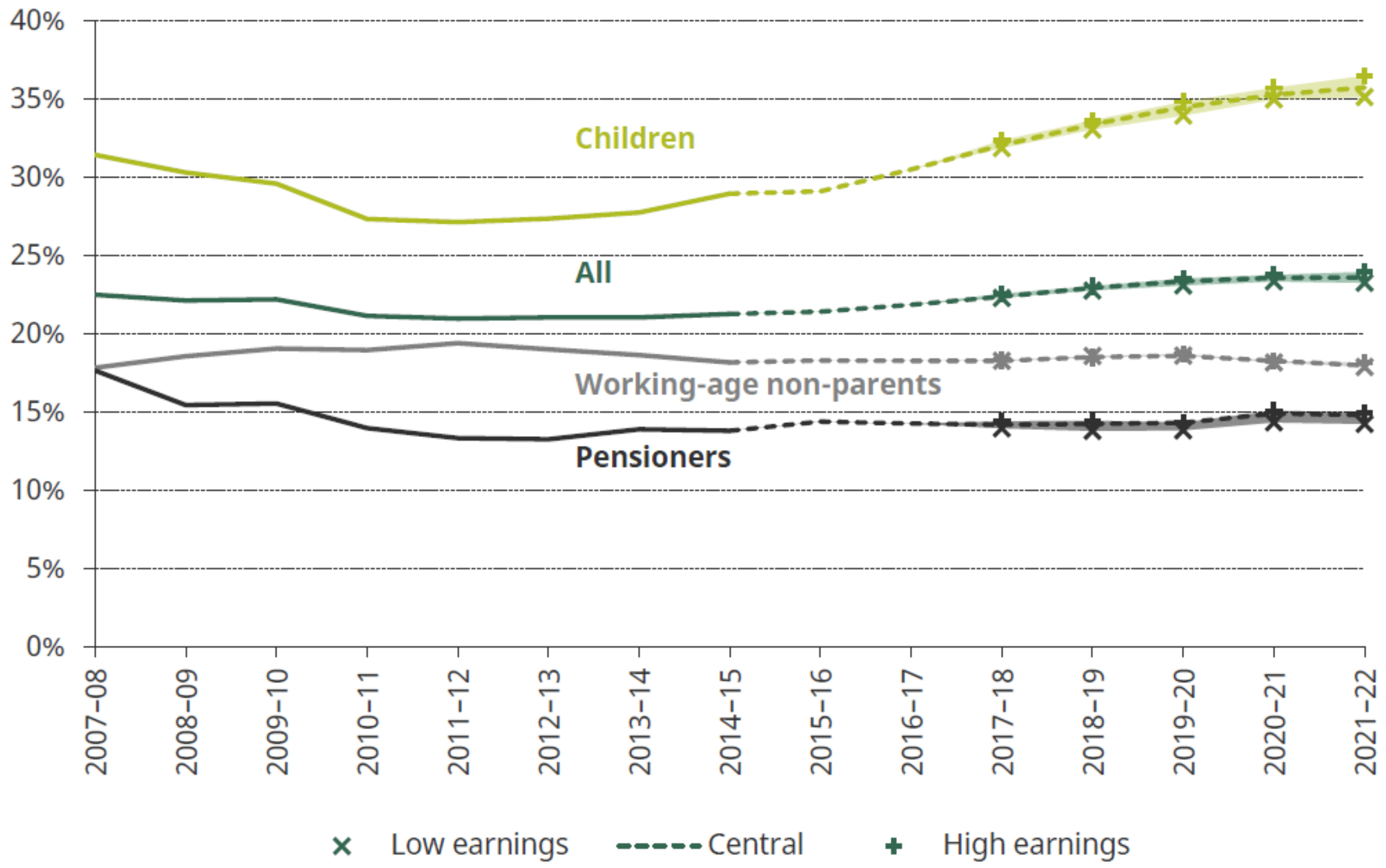
Impact of planned tax and benefit reforms May 2015 to April 2020: IFS analysis



Note: Assumes full take-up of means-tested benefits and tax credits and all changes fully in place

Source: IFS Budget Analysis, March 2017(includes indirect taxes)
https://www.ifs.org.uk/uploads/budgets/budget2017/budget2017_tw.pdf

IFS forecasts of relative poverty rates: 2007-08 to 2021-22 (after housing costs)



Source: Hood and Waters IFS Report R114 (March 2017). Figure 3.5
https://www.ifs.org.uk/uploads/publications/comms/R127.pdf

Conclusions

- In nearly all OECD countries, fiscal policy – taxes and transfers combined – reduces inequality (looking cross-sectionally; lifetime effects will differ)
- This is true even if taxes as a whole (direct and indirect) are largely proportional, rather than progressive, while transfers and social benefits are largely flat rate (as in the UK)
- By implication, simple fiscal retrenchment uniformly across taxes and transfers will be regressive, and will be more so, the greater weight is placed on social spending cuts
- In practice, EU governments chose reforms with contrasting effects on inequality both before and after the crisis
- Often invisible decisions on how to adjust (index) transfer levels and tax brackets and allowances from year to year had greater effects than more visible and better-advertised 'reforms'

In the UK case, for example, contrast the inequality-*reducing* effects of default-indexation of benefits and pensions to *prices* when real earnings were falling 2008-2011, with the inequality-*increasing* effects of the planned cash freeze in working-age benefits from 2015-2020.

Conclusions

- The very different effects of particular fiscal instruments mean that detailed design choices matter – and their effects on poverty and inequality depend on each country's starting point (as well as being asymmetric between increases and decreases in generosity).
- For example, increases in UK income tax allowances have negligible effects on poverty, but cutting allowances in other countries would increase poverty
- It is very hard to avoid regressive effects from cuts in social benefits and services without adverse poverty trap and unemployment effects, if the poorest are protected.

A dilemma for central banks comes if fiscal retrenchment – likely to be regressive, increasing *income* inequality – is combined with expansionary monetary policies achieved via instruments such as QE, with its effects on raising asset prices, and so potentially also increasing *wealth* inequalities and the importance of – more unequal – personal wealth relative to incomes.