Why the Rich are Getting Richer

The determinants of economic inequality

Contents

Report Summary

Economic inequality in the UK grew dramatically during the 1980s and 90s and has remained at historically high levels. A cycle linking wealth, education, the labour market and globalisation has created the conditions for inequality to flourish and feed on itself. By examining the policies of more equal countries, we find that inequality is not inevitable and that it can be effectively tackled by addressing its root causes.

The controversy surrounding the recent England riots was the latest event to bring the issue of inequality into the public debate. Whether or not the riots were triggered by social inequality is highly contested. Nonetheless, the sight of looting and rioting on the streets of deprived parts of our cities was a stark reminder of the scale of those disparities. This reminder comes at a time when inequality is increasingly being singled out as a negative influence on a variety of social and economic phenomena, from over-consumption and strains on environmental resources to the debt crisis and on-going financial instability. **nef** has recently published a summary, *Ten Reasons to Care About Economic Inequality*, to bring together these arguments.

While it is becoming progressively difficult to deny that inequality is corrosive for our society, it has remained off the political and policy agenda. There is currently no stated goal to reverse, or even slow, economic disparities between the rich and the poor.

But even if the Coalition Government were to begin to directly address economic inequality, where would it start? Taxation is the obvious route, but the 50p tax on incomes over £150,000 is already under scrutiny, highlighting how redistribution is not a popular route and vulnerable to political persuasions. The scale of the problem also makes taxation inadequate for the task.

nef's research sets out to consider how to tackle inequality at its source. It explores pre-tax or market income inequality, bringing together the academic literature that identifies the key factors and processes that have caused inequality to grow in the UK. It also considers how more equal countries have successfully addressed causal factors. Finally, it uses these findings to highlight policy areas that offer potential direction for change.

Findings

There are multiple reasons why inequality has grown, and varying degrees to which each factor has mattered. In order to sort and make sense of these factors we have grouped them under five headings:

1. **Initial conditions:** the economic situation that people are born into, including wealth and asset ownership.
2. **Channels of influence in early life:** the routes that could potentially inflate unequal starting points, most notably early childhood education and care, primary and secondary education.

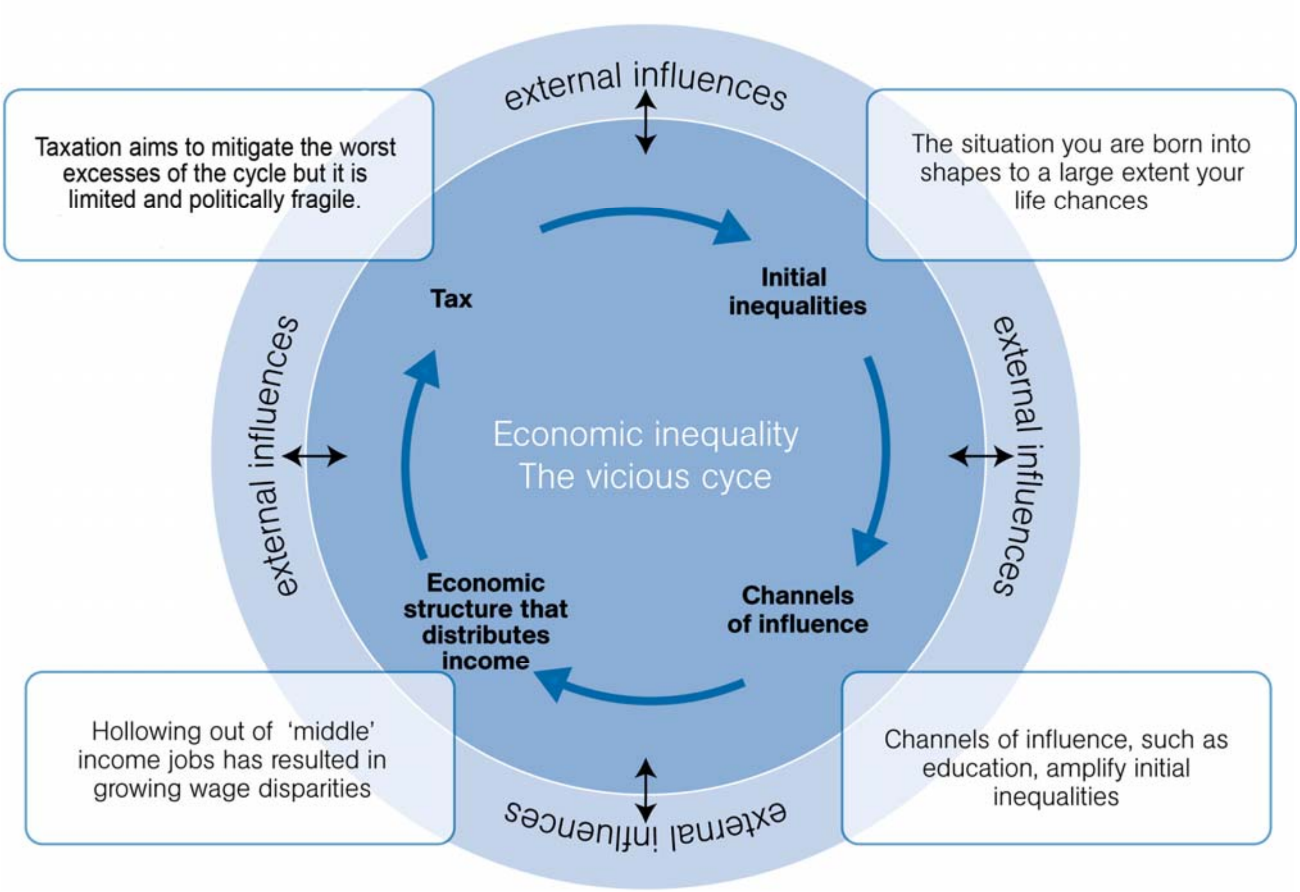
3. **External influences:** globalisation and liberalisation are two major external forces that have both directly fuelled inequality and played a considerable role in shaping the UK economy and labour market.
4. **The national economic system:** including the make-up of sectors and profile of the labour market.
5. **The political system and tax:** the type of political system, namely if it is proportionally representative or not, dictates the likelihood of governments tackling inequality. This in turn influences the progressive or regressive tilt of tax policy.

The connection between these groups of factors is best illustrated through a circular diagram, where initial wealth inequalities then dictate the channels of influence in early childhood. Included in this cycle are external influences, such as globalisation, which have pushed the economic system to develop in an uneven way. This unbalanced economy has resulted in an increasingly polarised labour market, causing outcomes to diverge further. Finally, the structure of taxes further entrenches inequalities for this and the next generation.

With each rotation of the cycle, or with the change of each generation, the momentum of un-equalising processes increase. For example, once there are considerable wealth and income disparities, different socio-economic groups begin to segregate spatially. Once this occurs, access to decent childcare and education becomes less likely for the poorest which in turn amplifies the next stages in the cycle. This means that the longer this cycle continues the harder and more expensive it becomes to bring it to a halt, let alone reverse it.

The interplay of factors driving inequality means that there is no easy resolution. But it is clear from international examples that UK levels of inequality are not inevitable. Some developed countries have successfully

Figure 1: The vicious cycle of inequality



designed policies to help mitigate inequality, even in the face of strong global forces. However, this report concludes that it is not enough to intervene at the end of this cycle through redistributing tax. To break the cycle and prevent inequality, interventions are needed throughout.

Policy implications

These findings shed light over several current government policy positions, and in particular demonstrate that the continued talk of equality of opportunity and on poverty reduction is unlikely to bear any fruit. Three policy areas are especially undermined by the failure to acknowledge or tackle economic inequality:

Social mobility

The Coalition Government has made increasing social mobility its key policy priority. To achieve this it has developed interventions throughout the life-course, which in part mirror the cycle of inequality we have described here. However, the strategy is flawed. Firstly because public spending cuts will hit the poorest the hardest. Secondly, this approach does not tackle wealth inequalities, leaving the wealthy to convey their advantages to their children. Second, initiatives are not universal, meaning that the richest will still segregate spatially and/ or opt into private alternatives. This will protect and reproduce the existing hierarchies in education and the labour market.

Child Poverty Strategy

The Coalition Government's approach to child poverty is to tackle the 'root causes', which they believe lie within family life and the early years, as well as in lack of incentives to work. Our research shows that these are important, however, they are only one part of the picture, which is undermined for example by a lack of decent work at the lower end of the income distribution.

Re-balancing the economy

The aim of re-balancing the economy both geographically and industrially is a noble goal. However, the North-South divide is the consequence of deep-seated trends, most notably de-industrialisation. In the face of this shift, current policies encouraging enterprise growth are not enough to loosen the stranglehold either of London and the South East or of the finance sector.

Intervening to break the cycle

Returning to a more equal socio-economic structure does not mean reviving policies of the 1970s. We accept that top-down redistributive policies that rely too heavily on tax are unlikely to be effective on their own. Tax cannot provide a definitive solution while inequalities continue to grow, because this would require further tax increases.

The aim then must be to encourage structural change that prevents high levels of economic inequality from arising in the first place.

How can this be done? The analysis of the root causes of inequality suggests scope for action in five main areas primarily. Below is an overview, but further research is needed to explore and refine ideas in each area. This will be the focus of **nef**'s programme of continuing work on economic inequality.

1. **The Labour Market:**
   a. High income differentials are at the frontline in perpetuating economic inequality and the stark divisions that exist in our society

in terms of access to resources, decision-making and opportunity. Possible solutions include the Living Wage and/or the introduction of maximum wage ratios within companies and organisations.

b. The hollowing out of skilled and semi-skilled jobs in the economy means there is a shortage of adequately paid jobs. Innovative policies are needed through an industrial policy which recognises the importance of creating meaningful employment, while at the same time pushing production into more green and sustainable areas. **nef**'s new programme of work, *Good Jobs*, aims to consider industrial strategies that would produce a more equal labour market.

c. Just as income and assets are very unequally distributed in the UK, so too are work and time. We need to see working hours better distributed. Of course this needs to be done in a way that does not leave people on low incomes short-changed. **nef** has work in progress to examine such a shift.

2. **Education:**
   a. The initial conditions that a person is born into are exacerbated in our system by unequal access to the best education. Thus, child-care and education systems are central to flattening differences at the beginning of life. We must look more to the universal child-care models used in countries such as Sweden to prevent inequalities based on parental incomes from emerging.

   b. A small number of schools, mainly independent, confer dramatic advantages in terms of entry to the best jobs and positions of authority. Currently we focus on improving schools at the bottom end of the education system, but resources will never be level if independent schools continue to increase fees. Tackling the resource differentials in education could require capping the amount spent per pupil.

   c. Vocational training needs to be built into the fabric of businesses, such that many more are involved in taking on apprentices and training them. Alongside this shift, more must be done to improve the respect afforded to vocational qualifications, this point is linked to re-balancing the economy.

3. **Structures of ownership:**
   a. To give everyone a more equal share in society, the ownership of assets needs to be more equally distributed. Ideas for how this could be achieved include introducing a mechanism to broaden the distribution of shares to workers and to communities.

   b. Changing the ownership of assets also allows us to consider the spread of profits among and between individuals. The distribution of unearned income is another vital component of economic inequality.

4. **Tax:**
   While tax cannot continue to take centre-stage in tackling inequality, it does play an important role in entrenching inequalities at the end of the cycle depicted above. A land-value tax and a form of citizen's endowment could offer a more effective way to tax and fairly redistribute wealth.

5. **Structures of democracy:**
   We need to examine further the relationship between different voting systems and economic inequality. In particular, we need to look at how to give a more equal voice to those with less economic resources.

1. Introduction

In 1979 the UK was one of the most equal of industrialised countries, today it is one of the most unequal.[1] The only rise in inequality comparable to Britain in the 1980s was in Russia in the ten years following the collapse of the Soviet Union, a period characterised by the 'fire-sale' of state assets and the rise of the infamous 'oligarchs'. This report is about understanding the political, economic and demographic processes that led to this transformation in the UK.

This report takes as its starting point that inequality is undesirable. During the last decade there has been a renewed interest in this issue from a range of disciplines, which have moved beyond traditional 'moral' objections. There are those who argue that inequality was fundamental in driving the financial crisis;[2] is itself a break on efforts to reduce poverty;[3] those that see it as a determinant of other social problems such as poorer health and well-being;[4] and those that are concerned about potential social unrest and atomisation from ever-widening income gaps.[5,6,7]

Furthermore, traditional arguments used to support economic inequality, such as it is a necessary precondition for entrepreneurialism, innovation, and hence economic growth, are increasingly being questioned. For example, psychological research has shown that excessive money rewards are actually detrimental to performance on cognitive tasks.[8] In addition, the economic performance of more equal economies in Scandinavia and East Asia has debunked the belief that high levels of inequality are a necessary condition for economic success. For an overview of these positions see **nef**'s recent publication *Ten Reasons to Care About Economic Inequality*.[9]

This evidence has started to make in-roads into the political sphere where the topic of economic inequality has been virtually ignored by successive governments since the election of Margaret Thatcher in 1979. At that time Britain's economic and social system was widely considered to be too inflexible. The Conservative Government embarked upon a process of radical change that at best sidelined impacts on inequality and at worse encouraged it. New Labour policy further fostered income disparities by embracing a 'trickle down' philosophy, focusing on maximising growth and employment to fund public services and reduce poverty. The acquisition of vast fortunes was considered to be socially acceptable and a sustainable way in which to pay for public services.

The financial crash in 2007, which has ushered in an era of debt crisis, austerity and economic stagnation, has led many to question the economic wisdom that dictated policy for the past 30 years. However, while the fortunes of the rich are no longer justified by politicians, the rhetoric has failed to translate into policy that promotes economic equality. Still, it is at least rare to hear suggestions that inequality is positive.

What we need now is a serious debate on the underlying drivers of economic inequality in the UK. In this report we explore the factors driving inequality in order to consider ways to tackle inequality at its roots, drawing on examples from a diverse range of countries. There is clearly not an ideal blueprint that can be copied, but there are valuable lessons that can be learned from the relative effectiveness of specific policies and the conditions that seem to influence their impact on inequality.

The report is organised as follows:

Section 2 outlines our approach and methodology.

Sections 3 to 7 split the literature on the causes of inequality into sensible and sequential parts, using case studies to illustrate how these drivers have been tackled elsewhere.

Section 8 distils the lessons from this review into a framework for thinking about inequality in developed countries, enabling us to identify policy implications, which are set out in Section 9.

Finally, we conclude the study and consider next steps for policy research and formation.

2. Our Approach

Across research looking at patterns of inequality the focus is almost always on post-tax inequality, that is, final disposable incomes. While this is helpful in understanding inequality in incomes, it hides the true levels of inequality that exist in the market or at source and tends to limit ideas about reducing inequality to taxation. This in turn results in curative, rather than preventative, approaches to tackling economic inequality. For this study we focus on the drivers of *market* incomes (i.e. pre-tax incomes), rather than final disposable incomes. Figure 2 illustrates this through the difference between these in a range of countries.

As we can see, France has higher market income inequality than the UK, but through a more redistributive tax system, disposable incomes are considerably more equal. On the other hand, South Korea's relatively equal disposable income distribution is largely because market inequalities are low, rather than the result of redistribution.

Despite its effectiveness, however, an over reliance on redistribution is quite a fragile way of reducing inequality, and may be becoming more so for three reasons. First, redistribution requires the consent of the relatively wealthy and is at the mercy of changes to the political landscape. Second, it is becoming more difficult to finance redistributive services. Even before the losses incurred by the banking crisis and the subsequent recession, pressure on public finances was mounting: all affluent countries have aging populations and generous pension systems, and most also have government-funded health-care programs. In the future, more will need to be spent on the elderly, leaving less for the young and working population.[10]

Third, as we can see from Figure 3, most countries have seen an increase in market income inequality, meaning that more redistribution will be required just to maintain the same level of disposable income inequality.

The OECD made a similar case, noting that the pace at which redistribution is offsetting market-income inequality has reduced. They argue that taxing and spending can only be a temporary measure and that the only sustainable way to reduce inequality is to stop the "underlying widening of wages from income and capital."[11]

Figure 2: Comparing disposable and market income Ginis (2006)

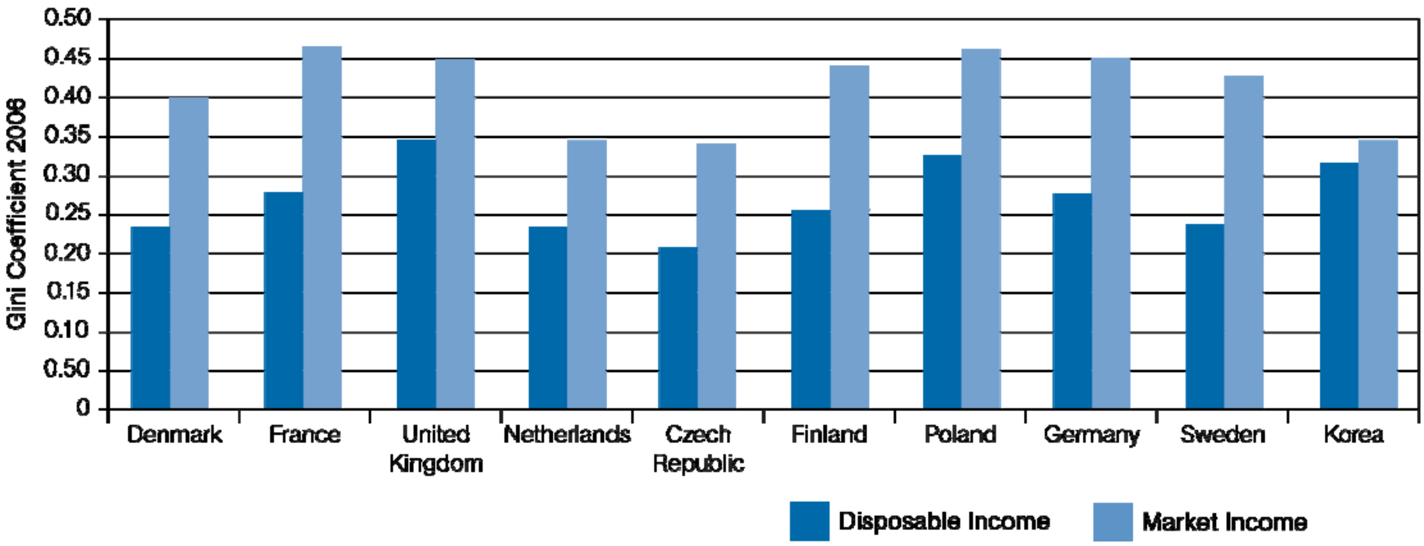
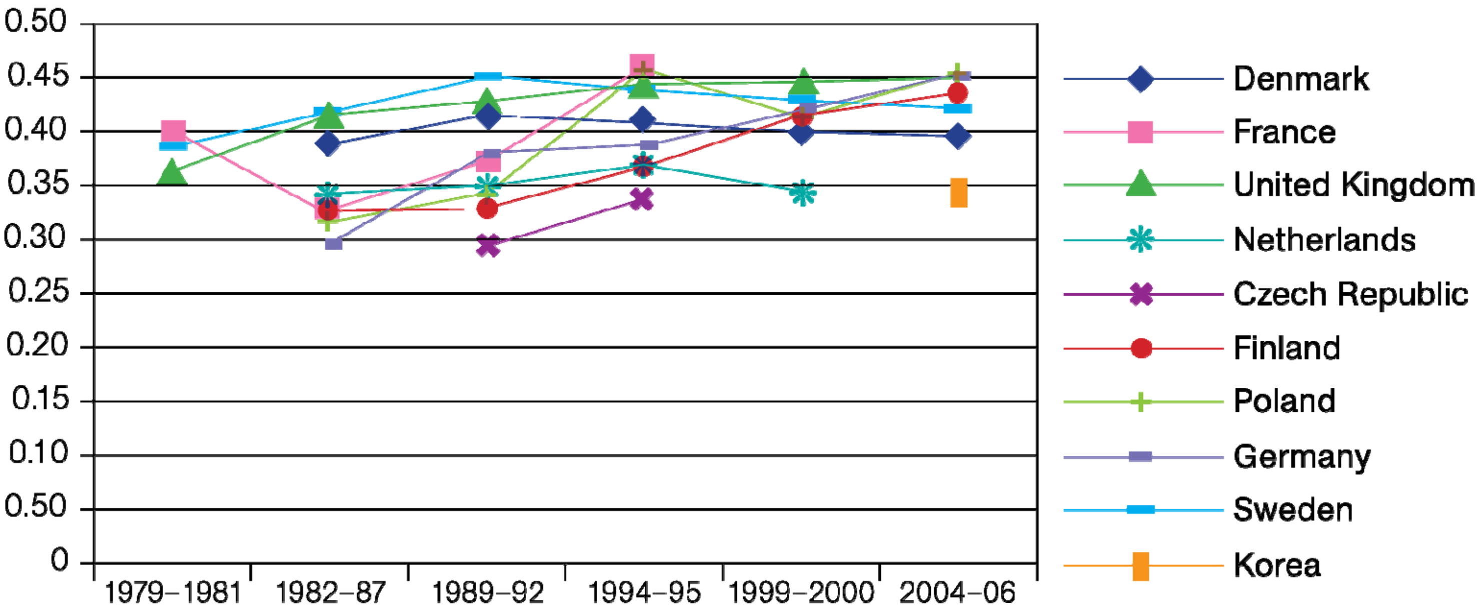


Figure 3: Trends in market income Gini for all countries (1979–2006)



Box 1: Measuring inequality

Our preferred measure for measuring inequality is the Gini coefficient. The Gini coefficient is a number between zero and one that measures the degree of inequality in the distribution of income in a given society. In a perfectly equal society where everyone had the same income, wealth, or land the Gini would be 0.0, whereas in a perfectly unequal one, where one person received it all, the Gini would be 1.0. We recognise that there are many different approaches to measuring inequality in all its forms. For reasons of brevity, however, we do not review these here.

Where possible, we have drawn our data from the Luxembourg Income Survey (LIS), explicitly established to provide comparable survey data from industrialised and emerging market countries. However, this data is only harmonised across countries up to 2006. Where other data limitations remain we have provided caveats within the text.

A systematic approach to the literature

The fundamental task in this research was to review and collate the wealth of literature that exists on the drivers of inequality. What is clear is that there is no one factor or policy that drives inequality up or down in complex societies. Determinants are intertwined and vary in effect across time and place – what may have a positive impact in one region, can do the opposite in another. This is compounded by the interplay between horizontal[12] and vertical[13] inequality. For instance, women's labour market participation can be good for gender equality but not always for income inequality.

While recognising these interactions, we have sought to identify the most cited determinants from the literature, particularly those most relevant to the UK. In order to make sense of these multiple factors for the reader, we grouped the factors into five categories:

1. **Initial conditions:** essentially what people are born into including wealth and asset inequalities.
2. **Channels of influence in early life:** the ways that early childhood care and education may further build on unequal initial conditions.
3. **External influences:** these include fundamental influences on our economic system such as globalisation and liberalisation.
4. **The national economic system:** The structure of the UK economy and its ability to withstand or bow to external influences, including Industrial policy/deregulation as well as demographics and family structure.
5. **The role of political systems and related tax structures.**

Each of these groups are explored in turn in the proceeding five chapters.

3. Initial Conditions

'Initial conditions' (or 'endowments') describe how assets were distributed at some point in the past, either historically (e.g. when industrialisation began) or at the start of each generation. By 'assets' we mean things of value that can be expected to yield a financial return. The most obvious example is land, as well as the natural resources that may lie within it. There is also physical capital (buildings and machinery), financial capital (required investment to marshal such resources) human capital (education and skills) and social capital (networks and contacts). We focus in this section on land and wealth, although recognise the interplay with other assets.

3.1 Some observations from the data[14]

Land inequality across a group of developed countries is more concentrated and characterised by greater cross-country variation than that of income, with mean Gini coefficients of 0.63 and 0.37, and standard deviations of 0.19 and 0.9, respectively. Even more pronounced are Gini values for wealth inequality, which usually range between 0.65 and 0.75 and sometimes exceed 0.80. As illustrated in Figure 4, there appears to be a positive association between land inequality and market income inequality for our sample. The exception is Finland where land is relatively equally distributed, although it is possible that when the value of the land is considered, the positive benefits of this equal distribution are reduced.

The patterns in Figure 4 change considerably with after-tax Gini coefficients as shown in Figure 5, although both plots suggest a positive relationship.

Figure 4: Land concentration and market income inequality (2006)

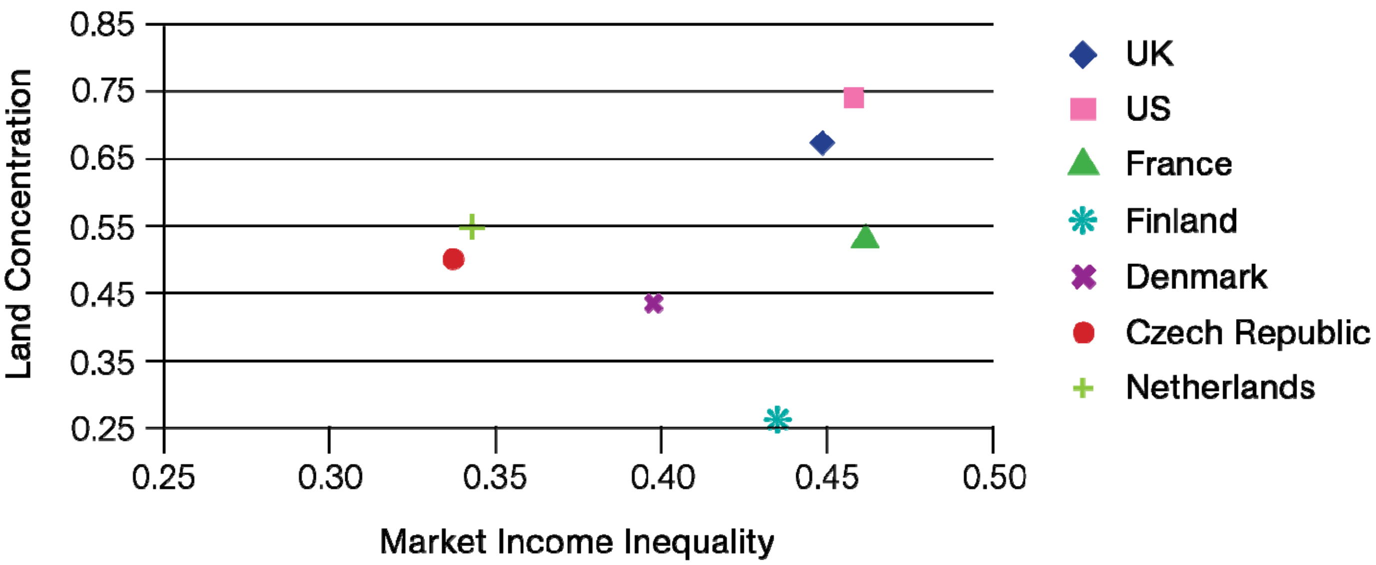
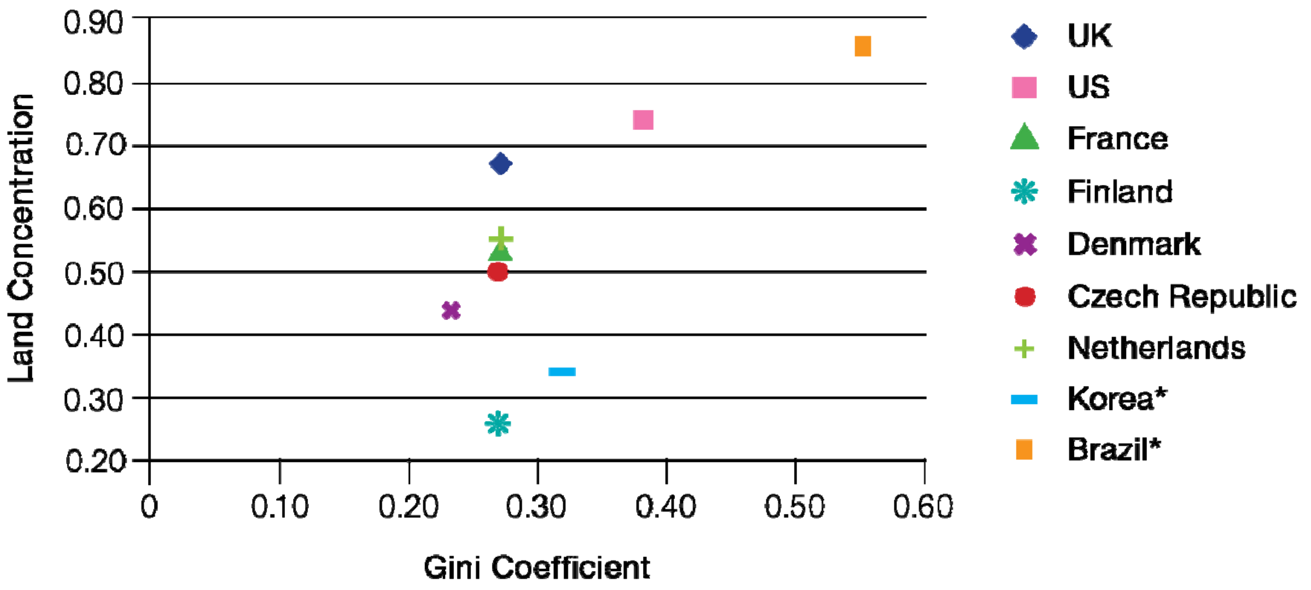


Figure 5: Land concentration and (post-tax) Gini (2006)



In the first instance, the Netherlands and France have similar concentrations of land ownership, but this is associated with far higher market income inequality in France than in the Netherlands. These differences suggest that there are factors that influence the extent to which asset inequality is translated into income inequality – we might call these 'countervailing forces'.

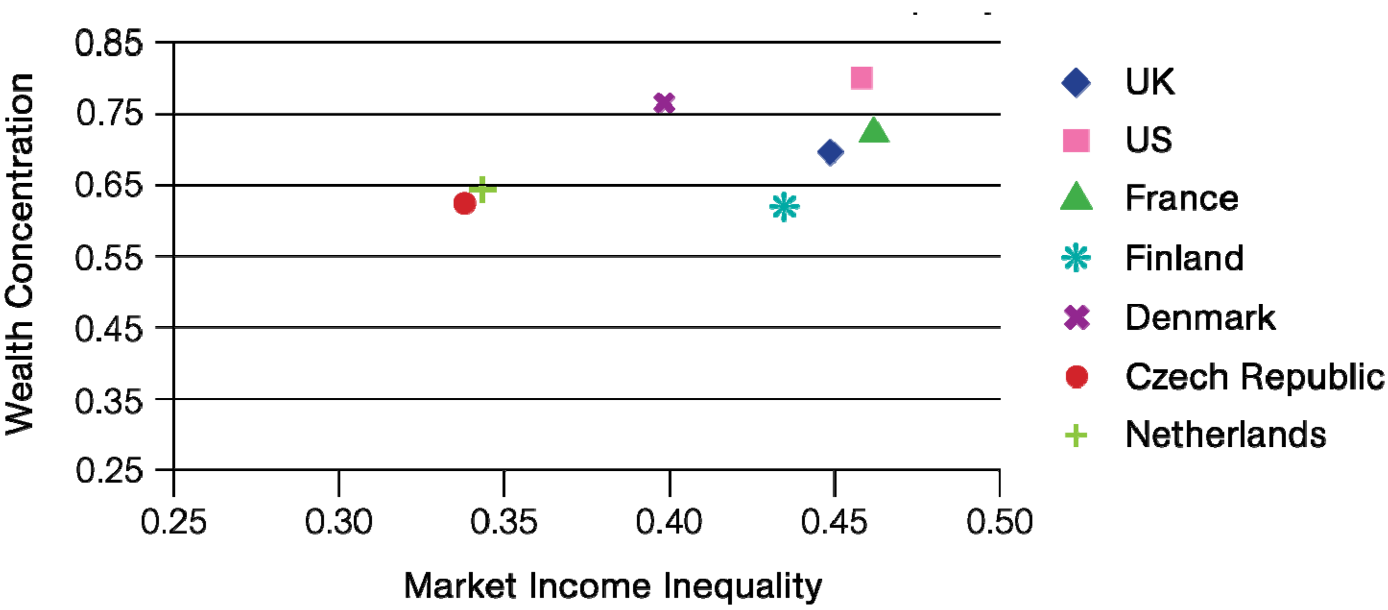
When we look at post-tax income a similar comparison can be made between the US and UK. Both have similar levels of land concentration, which were translated into broadly similar levels of market inequality as shown in Figure 4. The after tax distribution is very different, however, highlighting the greater use of redistribution through the tax and spending system in the UK as compared to the US. Tax is the most obvious example of a 'countervailing force', though it is unlikely to be the only one.

Figure 6 compares the distribution of wealth with market income inequality, and reveals two interesting features. First, there seems to be a correlation of wealth concentration with market income inequality for the US, UK, Finland and France. This is unsurprising of course, since we would expect unequally distributed wealth to increase the probability of unequally distributed incomes and vice versa. Second, Denmark appears to buck this trend: while market inequaliy is significantly lower than in other countries, wealth concentration remains high.

This would suggest strong countervailing forces in Denmark which are preventing this concentration of wealth being translated into unequal market incomes to the same degree as in other affluent nations. The fact that we are referring to market (rather than disposable) income inequality makes it clear that these forces are distinct from the tax and benefit system, at least with respect to incomes.

There are, however, a number of (non-income) tax mechanisms that can be used to obstruct the extent to which wealth inequalities are translated into income inequalities (see Box 2). In different ways, these alter or 'reset' initial conditions, particularly in an intergenerational sense.

Figure 6: Wealth concentration and market income inequality (2006)



Box 2: Initial conditions and taxation systems

Inheritance taxes which refer to all downstream capital transfers between generations, including lifetime (i.e. pre-death) gifts, and usually includes all duties and wealth, i.e. the net value of the personal sector's financial and physical assets, exclusive of pension rights. Inheritance taxes are believed to have two positive effects from an inequality reduction perspective, relative to other taxes. First, more intensive use of estate and gift taxation increases the progressiveness of fiscal systems with less impairment of economic incentives than in the case of other taxes such as income tax. Second, inheritance tax may increase economic efficiency by allocating resources on ability grounds, rather than because of accidents of birth. In some countries the thresholds for inheritance tax is so high that few pay it. This is the case in the UK where only about 6 per cent of estates actually qualify.

Land value taxes are different from property or real estate taxes because it ignores the value of buildings, improvements and personal property, and taxes only the value of land. The tax is paid by the owner of the land and, given that its supply is fixed, it does not have any substitution effect, and therefore no deadweight loss. These features make land an ideal basis of taxation from an efficiency point of view, which perhaps explains its long-standing popularity with economists. In terms of spatial inequality, relatively deprived areas would have lower land value taxes (and vice versa), potentially acting as an equalising spur to business activity. Land value tax can function both as a redistributive and revenue raising tax – Hong Kong generates more than 35 per cent of government revenue from land-value tax.

A **wealth tax** is generally based on the aggregate value of all household holdings accumulated as purchasing power stock (rather than flow), including owner-occupied housing; cash, bank deposits, money funds, and savings in insurance and pension plans; investment in real estate and unincorporated businesses; and corporate stock, financial securities, and personal trusts. The argument for the implementation of a wealth tax is that income alone is not a sufficient gauge of taxable capacity. Holding income constant, a wealthier family will have more independence, greater security in times of economic stress, and additional liquidity for advantageous purchases. Both land value and direct wealth taxes encourage investors to turn idle land or assets into more productive or income-yielding forms.

Of these three options, wealth and inheritance tax are the most easily and routinely evaded, as wealth can be easily underreported (with a low valuation of assets). This is not the case with land value tax mainly because land cannot be 'hidden'. In the case of wealth, tax is avoided by setting up trust funds with children as beneficiaries; in the case of inheritance, gift exclusions allow a considerable amount of assets to be passed on before death, which are generally exempt from taxation.

Table 1: Land ownership in the UK

Rank	Group	Acres
1	The top 40,000 agricultural landowners in the UK	28,180,212
2	The 16,800,000 private homeowners in the UK	2,800,000
3	Forestry Commission	2,400,000
4	The Ministry of Defence	750,000
5	The lands controlled and owned by the Royal family (Crown Estate, Duchies of Cornwall and Lancashire, and private)	677,000

Source: Cahill, K. (2001). *Who Owns Britain: The hidden facts behind landownership in the UK and Ireland.* Edinburgh: Canongate Books.

To summarise, our first look at the data suggests that initial conditions such as the distribution of wealth and land ownership are correlated with both market and post-tax income inequalities. However, the strength of the relationship varies considerably from country to country. We can hypothesise that it is the presence (or absence) of constraints on the ability of those with wealth to use these advantages that determines the extent of this influence on economic inequality. In the next section we review the literature on these channels of transmission, and consider the 'countervailing forces' that may be employed to obstruct these channels.

3.2 Initial conditions in the UK

As shown above, asset inequality in the UK outstrips income inequality in its severity. The wealth Gini in the UK is 0.697 – almost double that for income and above the OECD average. Table 1 provides a breakdown of land owners in the UK. Cahill (2009) estimates that around 40 million acres of countryside is shared by only 189,000 families.[15] This land has barely changed hands since the 1872 Return of Owners of Land recordings.

It has long been recognised in the literature that it may be the distribution of assets, rather than income *per se*, that shapes access to opportunities. The most fundamental asset is land, and the importance of its distribution is reflected in repeated historical attempts at land redistribution, the effects of which have been extensively researched.

For Griffin, Khan and Ickowitz (2002) land redistribution improves overall allocative efficiency, raising total output and average incomes.[16] Land redistribution also impacts on urban inequalities: the incomes of the rural poor set a floor for urban wages, and people will not migrate from the countryside to the city unless they expect to benefit from doing so.

Looking at the historical record, the most successful examples of land reform can be found in East Asia, some aspects of which are described in Box 3. Land reform should be treated with caution however as there are many examples of failed attempts at land redistribution, Zimbabwe and the Philippines being well-known examples.

The importance of the distribution of assets extends well beyond the issue of land, however. Even in industrialised countries with well-developed credit markets, a lack of assets may obstruct access to credit markets and thus the ability to finance productive investments. As discussed in Box 4, the

Box 3. Land reform in East Asia and Latin America

Until the middle of the twentieth century, a small number of the ruling class possessed most of the agricultural land in Korea. High rental rates impeded economic development and concentrated income and wealth in the hands of landowners. Land reform was listed in the Constitution of the Republic of Korea in 1948 and encouraged by the occupying American forces, which had replaced the previous colonial power, Japan. The land reform process saw the government purchase land from landlords and then sell the land to tenants who made payments with rice. The terms of the purchases and sales were such as to redistribute wealth from landlords to tenants, with very positive effects on inequality.[17]

However, as Adams (1995) points out, the underlying purpose of land reform may have been more to “break up feudal estates and prevent the advance of communist revolution”.[18]This did not just happen in Korea but throughout the region, though it was pursued in different ways in different countries. In Japan, for example, the occupying US power enforced reform to break up the power of the large landowners, whilst that in Korea was initiated in response to the Communist threat from the North. For Taiwan, the exiled Kuomintang imposed land reform themselves. In each case, however, the result was the creation of a “class of independent property-owning peasants”.

This was important in three main ways. First, the breaking – and dispersal – of the power of the landholding elites was instrumental in freeing the state from the influence of these groups – i.e. increasing autonomy. Secondly, the distribution of assets created a strong base of domestic demand to support the subsequent domestic economic development. Thirdly, and most importantly for this paper, the relatively equitable nature of East Asian growth was strongly influenced by this redistribution of assets at the outset: ‘initial conditions’ were reset.

initial distribution of assets is an important determinant of individuals’ ability to start up enterprises.[19]

Finally, home ownership has further widened inequalities as the UK has experienced a long-term upward trend in real house prices, with an average increase of 2.4 per cent per annum over the last 30 years.[20] Higher house prices result in a transfer of resources from first-time buyers and those excluded from the housing market to existing home-owners and landowners, aiding asset and wealth inequalities.

In summary, initial conditions set both the starting point for the economic system as well as for individuals. For some countries, such as Denmark, unequal wealth and land ownership has not resulted in greater overall inequality. This may reflect more effective tax policies, but is also likely to do with other equalising forces, such as those delivered through education policy and the structure of the labour market.

Box 4. Access to finance and inequality in the United States

As far back as 1990, 81 per cent of those in the top 1 per cent of the wealth distribution in the United States were entrepreneurs, despite representing only 7.6 per cent of the population. An important determinant of whether or not people become entrepreneurs is their ability to access capital to start business ventures, and this is strongly influenced by their relative socioeconomic status.

Research using US micro data shows that people with greater family assets are more likely to start a business and those with lesser family assets are less likely to do so because of constraints on obtaining credit.[21] As well as the negative effects on both vertical inequality and social mobility, this has serious impacts on horizontal inequality in the US. Robb and Fairlie (2007) explore this issue in relation to African Americans. The authors find that African Americans are much less likely to start businesses than are whites, and even for those who are successful in starting businesses, much less capital is invested to start businesses than is the case with white entrepreneurs. The lack of access to start-up capital contributes to “higher failure rates, lower sales and profits, less employment among black-owned businesses, and less survivability of the business.”[22]

Those from relatively affluent backgrounds are more likely to be able to access finance than those from relatively deprived backgrounds, contributing to the intergenerational transmission of outcomes (in terms of social mobility), but also to widening inequality, where those that have more get more and vice versa. Where socioeconomic status has a racial (or gender) component, we are likely to see widening horizontal as well as vertical inequality.

4. Channels of Influence in Early Life

In this part of the report we shift the focus to the channels of influence in early life through which unequal distributions of power and wealth may (or may not) translate into inequalities of income. These include a consideration of provision for early childhood care and education.

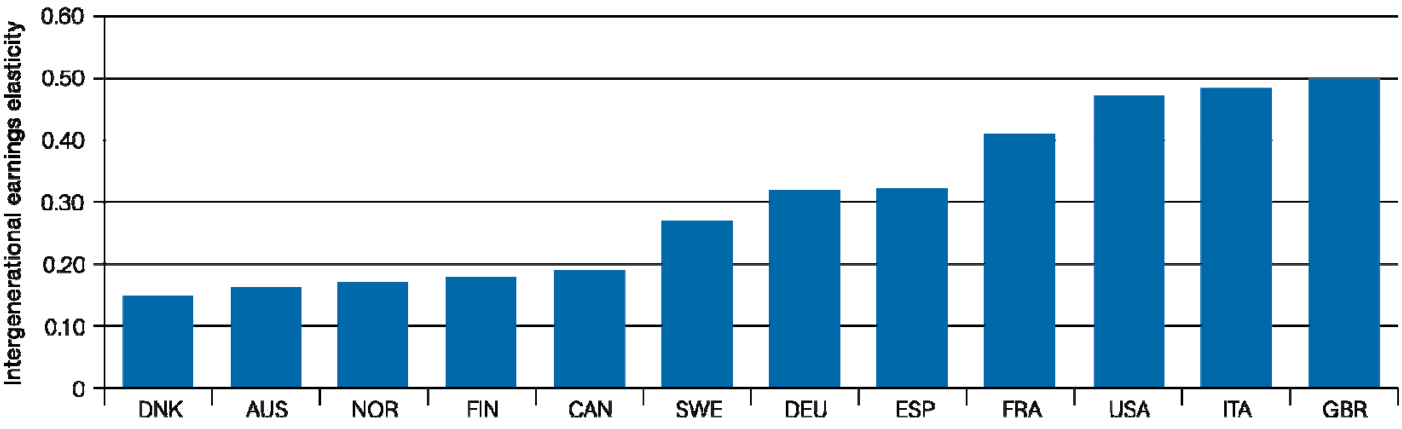
4.1 Social mobility

The extent to which initial conditions are determinants of future outcomes are often measured by levels of inter- and intra-generational social mobility within any particular country. The UK has one of the lowest levels of social mobility in the developed world.[23] This is highlighted by Figure 7, which shows that 50 per cent of relative difference in parental earning is transmitted to their children. In the UK only one in ten young people acquiring a degree are from the poorest fifth of households, compared to more than six in ten, from the richest 20 per cent.[24]

Intra-generational social mobility, that is moving up in occupation and pay over a lifetime, is also relatively low in the UK. This is especially the case if an individual starts off in the bottom 20 per cent of earners.[25] Recent research has shown that those who are female, work part-time, do not have a degree and are not in London are more vulnerable to staying on low incomes over their lifetimes.[26] These findings are related to shifts in the labour markets, as will be discussed in Section 6.

Though inextricably linked, and often used interchangeably, it is important to distinguish between social mobility and inequality. Box 5 describes what we mean by these terms and how they are used in this report. The UK

Figure 7: Estimates of the intergenerational earnings elasticity for selected OECD countries



Source: OECD (2008) *Growing Unequal*, using D'Addio (2007) based on Corak (2006) for all countries except Italy, Spain and Australia. For these latter countries, estimates are from Leigh (2006) for Australia; Hugalde Sanchèz (2004) for Spain; and Piraino (2006) for Italy. [27]

Box 5: Forms of inequality and social mobility

Although related concepts, it is useful to treat economic inequality and social mobility separately. Economic inequality refers to the difference in the net worth, or earnings of individuals at any one point in time. Calculating total economic inequality would require combining total earnings (i.e. wages) with the value of initial asset inequality. Economic inequality can in turn be a determinant of other kinds of inequalities – of education and skills, of social connections, of place, of profession – the probability that you will end up in a particular place on any of those spectrums of inequality can be as a result of your place in the economic pecking order. Social mobility refers to people's ability to transcend this. Broadly speaking, promoting social mobility has always been perceived to be a more politically acceptable issue in the UK, hence successive governments' emphasis on 'fairness'. Whilst they are clearly different and should be treated so, it is difficult to establish the extent to which they influence each other.

Studies have shown that countries with higher levels of inequality are also most likely to have lower social mobility – the longer the ladder, the harder it is to climb.[28] Denmark can lay claim to being the most socially mobile and the most equal country in the world. However, it is difficult to prove causality here. It may also be that more social mobility promoted through high quality universal childcare and education also leads to lower eventual inequalities.

Coalition Government has made achieving greater social mobility its key social policy goal. A strategy was published in May 2011 that outlined how it aimed to do this.[29] The document explicitly dismissed the need to address economic inequality to achieve higher social mobility. This strategy will be discussed in detail in Section 9.

4.2 Early childhood education and care (ECEC)

In the last decade, many OECD countries have seen sharp increases in the numbers of infants being cared for outside their home. According to a study by UNICEF in 2008, 80 per cent of the rich world's 3-to-6 year olds are now in some form of early childhood education and care. It follows that any inequality in the provision of childcare could have a widespread and significant affect on the early experience of life, which in turn has been shown to greatly influence health and education outcomes later in life.[30]

There has been a growing body of literature that suggests a correlation between income inequality and patterns of childcare use. A longitudinal study of ECEC from the Columbia University concludes that the rise in women's employment is associated with a substantial increase in the use of non-parental childcare.[31] While this may not in itself be seen to be a problem, this increased use of non-parental childcare coincides with rising wage inequality and falling wages for the least-skilled workers, which in particular has affected single mums. As such, an increasing number of families are placing their children in non-parental care with very limited financial resources.

The implications of this are significant for three reasons. Firstly, ECEC costs may impose unequal cost burdens on families, increasing income inequality. Until children reach primary-school age most ECEC arrangements are privately financed by parents and privately provided by individuals, or nurseries. This is offset to a greater or lesser extent by subsidies (i.e. childcare vouchers in the UK). Nonetheless, purchasing these services imposes a disproportionately high burden on families with low incomes.

Secondly, childcare expenses may also contribute indirectly to inequality by depressing maternal labour supply and earnings, particularly among lower-skilled workers for whom childcare expenses represent a particularly steep marginal tax.

In this context it is inevitable that patterns of care will differ substantially by income, race/ethnicity, location, and other family characteristics. Disadvantaged children are less likely than their more advantaged peers to receive care in high-quality formal arrangements, and are less likely to be enrolled in educationally orientated programmes during the preschool years. Thus, the third reason that disparities in childcare are so important is because these differentials may reinforce existing economic and social inequalities by limiting the access of children from lower-income households to beneficial forms of early education.

Box 6. Childcare in Sweden: the great leveller

Along with the parental insurance and child benefit systems, child care has been a cornerstone of Swedish family welfare policy while at the same time having an explicitly educational orientation. The system has two overarching aims: first, to support and encourage children's development and learning under conditions that are conducive to their well-being; and second, to make it possible for parents to combine parenthood with employment or studies. This dual-purpose approach was officially laid down in the early 1970s with the launching of a large-scale development program for Swedish childcare.

By law, all children from 1 to 12 have a right to childcare, as long as both parents work or study. Private day-care provision by parent and personnel co-operatives, churches, corporations and other providers, also exists for 13 per cent of children.[32] Except for parental fees, private provision is funded by the municipalities and contractually, is expected to meet the basic standards of public childcare, although without the obligation to follow the curriculum. To reduce disparities between municipalities and provide greater support to families with young children, universal pre-school for 4- and 5-year olds was introduced in 2003. Universal pre-school is free of charge and entitles children to at least 525 hours of pre-school a year.[33]

The Swedish childcare system, along with generous paid parental leave and reduced working hours for parents with young children, has allowed costs to remain low for most families. The costs of these policies to the State are not prohibitive: public spending on parental leave costs 0.8 per cent of GDP and formal day-care 2 per cent of GDP, contributing to a tax-to-GDP ratio of over 50 per cent, one of the highest in the OECD.[34] This is especially important as some impressive outcomes have been attributed to the support provided: 73 per cent of women work – only 3 percentage points below male employment rates; 97 per cent of households with children have someone in work; more than 70 per cent of the mothers with children and 80 per cent of sole mothers have jobs.[35]

Such outcomes are helped by the fact that 85 per cent of 2-year olds use formal childcare and many Swedish mothers reduce their working hours when children are young. Such high maternal employment rates keep child poverty rates very low – at just 4 per cent, and overall fertility rates have held up comparatively well.[36]

The impact for developmental and early educational inequalities are made clear by the growing evidence highlighting that children's early experiences matter, and that attendance at pre-school confers cognitive advantage on children before they enter school.[37] Research suggests that inequality in cognitive skills goes right back to the health of mothers during pregnancy and is strongly linked to social disadvantage and income inequality in later life.[38] The evidence also suggests that intervention at an early stage through early education programmes narrow educational outcomes in later life.[39] This makes the early years the most cost effective time to intervene. In the light of this evidence, many European countries have introduced accredited and subsidised ECEC services, although it is often patchy in coverage.

To mitigate these early structural drivers of inequality and to truly give everyone a fair start, Sweden introduced a universal childcare system (see Box 6). The argument for this is that it neutralises unequal human capital between children, not just by reducing disadvantage but by ensuring that the opportunities to buy better care are not available to the wealthy.[40]

The principle of universality is particularly important in this regard, the use of targeting, which has been more popular in the UK, can alienate high-income groups, pushing them to opt out of public services towards private alternatives and to vote against parties that support redistribution.[41] While, targeting is favoured in the UK because it helps reduce public expenditure, it could actually be costing the state more in the longer term. For example, while Nordic countries spend more on the non-poor than any other country, they also have the best outcomes for the poor.

4.3 Education

Spending on education has long been seen as the most effective weapon against rising inequality, so much so that in much of the literature it is often used itself as a proxy for income inequality. Improvements in education have been seen to lead to improvements in other social outcomes such as improved health and reduced crime.[42] There is consensus, therefore, that inequalities are likely to decline under a publicly funded, universally available education system.[43] Box 7 explores this issue with regard to the public funding of schools in Finland.

However, whilst from an individual's perspective the returns to education are high[44], in the aggregate, the existence of a publicly funded education system is not in itself a panacea.

Historically, spending on education has been much lower in the UK than in other European countries: in 2000 spending per child at primary school was just over half that of Denmark.[45] However, the last decade has seen a 56 per cent increase in spending across the system.[46] Not only has this not translated into equivalent improvements in educational outcomes, the sensitivity of educational outcomes to parents earnings has also been increasing.[47]

More recent research does show improvements in the likelihood of young people from poorer backgrounds attending university, and some limited progress on narrowing education attainment gaps.[48] It is too early to say, however, whether this will translate into more equal access to the professions and ultimately earnings. For now, disparities in education still dominate the UK's social geography. The Sutton Trust (2008) found that only 5.1 per cent of the students at the 200 top academic schools qualify for free school meals, compared with a national average of 13.6 per cent[49] and the Milburn Report (2009) found that whilst only 7 per cent of the population attend independent schools, they dominate the top professions.[50] While

Box 7. A fully public system in Finland

While both France and the Netherlands are able to achieve relatively equitable outcomes with a considerable role for privately run schools, Finland does even better, achieving very high participation and completion rates and good educational outcomes. The Finnish system is almost entirely publicly funded. While the proportion of public expenditure on primary, secondary and post-secondary education has dropped slightly, it is still very high at 99.2 per cent of all expenditure. Across all educational sectors it is almost 98 per cent, well above the OECD average. This includes large expenditure on tertiary education, as well as generous loan schemes and grants. The result is a 76 per cent participation rate at the tertiary level.

Although, spending on tertiary education can be seen as a transfer to the already-advantaged, in Finland, as in other Nordic countries, these generous terms are paid back in later life as individuals earning more are also taxed progressively.

welcome, increases in attainment for lower income groups seem small compared to the size of the problem. More generally, the literature suggests that, internationally, education's role in mediating mobility is in decline.[51]

A number of explanations have been put forward for this in relation to the UK. Firstly it is argued that the balance of spending is not sufficiently skewed towards the least well-off. Although, more is spent per pupil in the bottom decile[52], this may be insufficient. The Coalition Government's commitment to introduce a 'pupil premium' for children from low-income families is thus a welcome development. Whether this will go far enough, particularly whether it is funded sufficiently to make a difference, remains to be seen.

Secondly, there is the complex case of tertiary education. While Cesi (2006) finds that public investment in higher education can reduce the educational gap,[53] Bergh and Fink (2006) argue that this is regressive because the returns are concentrated amongst those that are already advantaged, whilst being funded by all sections of society.[54] Blanden *et al.* (2003) show that the removal of subsidies for higher education for poor families, and the increasingly regressive nature of its funding, has amplified educational inequality.[55]

The introduction of a 'graduate tax' to help fund tertiary education would on this evidence have some merit. The current reforms to fees do not act as a graduate tax, even though some believe it is the equivalent.[56] The 'fees' approach means students will feel that they are taking on debt, and there is evidence that those from poorer backgrounds are more averse to risk of this nature.[57] A breakdown of 2012 university applications will help shed light on whether new reforms will deter young people from low-income households.

Finally, there is the role of private resources in enabling people to buy a 'better education', whether through the public school system or by purchasing houses in the catchment areas of good schools. The latter is referred to in the literature as 'colonisation', and it has been found to have a homogenising effect on intake. As schools become more homogenised socio-economically this entrenches stratification by social class.[58] In total, the UK spends 16.4 per cent of private resources on education, compared with 1.5 per cent in Norway.[59]

It is difficult to establish empirically the magnitude of the impact that this leveraging of private resources has on unequal outcomes and social mobility, but it is clearly important. The current government plans for 'free schools' should therefore be treated with caution. Unless there are plans to cap spending per child, it seems likely that this will increase opportunities to buy better education, or dilute the talent in the state system.

Crucially, however, this does not mean the abolition of non-state education. Empirically, the governance, ethos or culture of schools seem to be of less importance than the amount spent per child. As Box 8 demonstrates, it is possible to contain these homogenising forces, whilst also retaining diversity.

In the next section we look at skills, often posited as the alternative to education when the goal of narrowing inequalities has not been achieved.

Box 8. Combining diversity, equality and mobility – France and the Netherlands

It is commonly believed, outside France, that virtually all schools in France are state schools, but this is a misconception. While over 80 per cent of school pupils are in state schools, this leaves a substantial (and growing) minority of almost 20 per cent who attend private schools. It would also surprise many to know that almost 70 per cent of schools in the Netherlands are administered and governed by private school boards. For comparison, just 7 per cent of children in the United Kingdom attend private schools, with the figure for the United States being 11 per cent. Despite this, inequality is considerably lower (and social mobility higher) in both France and the Netherlands than in either the UK or the US, suggesting that a large private component to schooling does not necessarily lead to high inequality and low mobility. Having said that, it is clear that this can be the case, with the UK being a striking example of this, particularly with respect to social mobility.

The example of France and the Netherlands suggests that it is the type of private schooling that matters, as well as its relationship with the public sector. In almost all private schools in France, for example, the state pays the teachers. Also, schools only charge symbolic or very low fees, and are accessible to pupils from all sectors of society, not just to those whose parents are well-off. There are only a handful of fee-paying boarding schools in France, similar to English 'public schools'. In the Netherlands, public and private schools are government funded on an equal footing, but schools are given considerable freedom over curriculum and admissions. While this has been criticised for the way it has segmented Dutch society[60], in practice most private schools pursue non-restrictive admissions policies. There is, despite school choice and diversity of supply, no significant elite school sector.

In both France and the Netherlands, therefore, private schools are geared towards delivering a diversity of educational models, with religious (primarily Catholic) schools being particularly important in France, where state schools are determinedly secular. This is very different from the UK's approach to private schooling, and more resembles 'faith-based' schooling. The key differences, however, is that private schooling in the UK is a) expensive, and b) much better resourced than the public sector. The motivation in the UK is thus more to purchase a 'better' education, than in France and the Netherlands, where it is more likely to be to acquire a 'different' education.

4.4 Training and skills

An increased focus on skills and training is regularly proposed as a way to increase low incomes. However, apart from a handful of countries where vocational qualifications are given equal parity (see Box 9), it is often seen as a low status learning route specifically for entrance into low level occupations.[61]

Whilst the nature of vocational programmes vary widely between developed countries[62], there is a general agreement that vocational training constitutes an alternative route into work to academic qualifications – a 'second-chance' for adults with no or low formal qualifications who are looking for a new career, or as a bridge back into work for the unemployed. Traditionally it is associated with learning a trade 'on the job' – for example, through being an apprentice to a blacksmith, plumber or an electrician. However, vocational pathways have expanded outwards to incorporate service sector occupations, such as those in beauty therapy or childcare, and are not always strongly work-based, frequently taking place in the classroom.

Training has been presented as one method by which the wage gap between the skilled and unskilled could be narrowed.[63] The presumption is that because training increases productivity and individual human capital, it should also increase a worker's wages, and hence help bolster the bottom end of the income spectrum. However, whilst there is evidence to suggest that wages do rise as an outcome of vocational training, in most countries there is still a gulf between the returns on vocational and higher level academic qualifications.[64]

Three interdependent explanations for this are put forward in the literature. First, job growth in the economy has become increasingly skewed towards occupations that require a combination of high level literacy, numeracy, information technology and 'soft' skills. Academic qualifications are thought to equip students with higher competencies in these areas.

Second, the social and economic status associated with following the academic 'golden route' stigmatises those who chose the vocational route.[65] In reality vocational training routes are for those young people and adults who are not seen to be academically gifted.[66] It is no surprise then that a lower status learning pathway results in lower wages.

Third, is the lack of credibility that vocational qualifications hold among many employers.[67] Those with university and non-university educations are not thought of as substitutes, and hence wages differ.

Because of the lower status of vocational qualifications amongst middle and upper classes, those taking up vocational pathways are most likely to be from lower income households[68] – further reinforcing barriers to social mobility.

Changing this situation has proved difficult. Academics and practitioners looking for ways to improve their skills system often look to the German or Swedish training models.[69] However, the large investment in these schemes, the role of unions in negotiating fair wages and protection for those involved, and the strong business training cultures in these countries make it difficult for others to adopt the same model.[70]

Skills training in the UK has – and continues to be – focused on deprived areas with successive rounds of training programmes aimed in particular at reducing concentrations of unemployment. Unfortunately, these programmes have been unable to overcome demand side problems in these areas – making people more 'employable' is of limited value if there

Box 9. The German 'dual-system'

The German apprenticeship system is commonly referred to as 'the dual system of education' as it combines on-the-job training with theory taught in state schools one or two days per week.

Nearly two thirds of young people enter apprenticeship training and the supply of places typically exceeds demand from young people. There is scope within the apprenticeship framework for young people of all different abilities, including academic high-fliers. This means that the programme does not brand those entering it as academic 'failures'.

The costs of the dual educational system are shared by regional governments, private companies, and the apprentices themselves. The government pays for the costs of the public education side of training, while the companies pay for all of the costs associated with the on-the-job training. The system is highly diversified and decentralised, such that they are run by the employers, by companies' works councils and by the local Chambers of Commerce with very little Federal interference.

The German apprenticeship programme is the envy of world and underpins the country's high levels of productivity, low levels of unemployment and lower wage inequalities by fostering high quality, skilled jobs that are relatively well-paid.

is no work available where they live. Where they have put people into work there has been a high incidence of return, dubbed as the 'low-pay no-pay' cycle. The quality of the training has not led to mobility in the labour market.[71] The new welfare-to-work initiative, named the Work Programme, again focuses on the supply-side only.

In summary, whilst skills and training could help to lower wage inequalities, their ability to do so has been seriously hampered by the roles they prepare individuals for, a low status among higher income groups and businesses and lack of investment. In practice, skills and training have, in many countries, only widened the differences in labour market outcomes for those with and without higher level academic qualifications.

Overall, the evidence suggests that our system of education and care can mean that inequalities in early life interplay with inequalities in initial conditions to compound both advantage and disadvantage. Worse still, these layers of inequalities put individuals at very different starting points as they enter the labour market. Before looking at detail at this next life stage, we first explore the external influences shaping our economic system.

5. External Influences

Since the mid-1980s returns to workers – i.e. factor shares – have been declining internationally. This suggests global forces are encouraging economic inequality to grow. Below we describe the impact of globalisation on economic inequality internationally.

5.1 The role of liberalisation

Many of the trends that will be described in this section, in relation to globalisation, migration and changes to labour markets can be related to the economic and financial liberalisation that has occurred in virtually all countries, to a greater or lesser extent, from the 1980s onwards.

The ideology that underpinned this trend was that free and competitive markets, with prices determined by the interplay of market actors would allocate economic resources efficiently and to their most productive use. From this perspective, it was the interference of government in the workings of the market that prevented these optimal outcomes being achieved. This has included a move to floating exchange rates, a reduction of restrictions on international trade (such as import tariffs and quotas) and global capital movements, and there has been a significant liberalisation of the financial markets.

As a consequence of these changes, the role of governments in monitoring and influencing economic development has been progressively moderated. This has significantly reduced the policy autonomy available at the national level, so that as the scale of international trade and international finance has grown, countries have become increasingly affected by global forces over which they have little influence. Furthermore, it is now very difficult for countries to a) protect particular industrial sectors from competition, and b) tilt policy towards supporting industrial development in any sector, or though any company (i.e. ‘national champions’).

In broad terms, liberalisation is associated with increased levels of inequality. There are plenty of examples, particularly in Latin America, where liberalisation has led directly to higher levels of inequality, for example by increasing the demand for skilled labour (as will be discussed in more detail in proceeding sections).[72] It can also be observed that inequalities have generally risen in virtually all countries since liberalisation began in earnest in the 1980s.

However, the extent of these rises has differed significantly, suggesting again that while policy autonomy has been reduced by globalisation it has not been eliminated.

Box 10. Resisting the liberalisation trend: East Asia and Scandinavia

While some countries – notably the US and UK – have embraced liberalisation wholeheartedly, others – such as the Nordic economies and East Asia – have not. What these latter countries share is a continuing willingness for government intervention and more collectivist approaches. In the Nordic economies, a highly progressive and redistributive tax and benefits system is used to turn unequal market incomes into a more equal distribution of disposable incomes. In East Asia market incomes are more equal, reflecting a more collectivised approach to employment, where corporate profits are more equally shared amongst the workforce than in Anglo-Saxon countries.

In both Scandinavia and East Asia, most countries are highly engaged in international trade, yet by not embracing liberalisation as fully as the Anglo-Saxon economies, inequalities have not risen to anything like the same levels. What this seems to demonstrate is that, while globalisation has had – and will continue to have – major effects on the distribution of incomes in developed economies, governments can still maintain effective 'countervailing forces' that work to mitigate the forces increasing income inequalities.

5.2 Globalisation and international trade

Since the early 1980s globalisation has spread to all corners of the world, affecting what is produced, how it is financed, where it is produced, who produces it and at what cost. This has affected the scale and pattern of world trade and capital flows, the nature of the transnational corporation (TNC) and flows of international migration.

Many of the assumptions about the causes and consequences of increased international trade have proven to be unfounded, or at least considerably less important than had been thought.[73] For example, proponents of the major international free trade agreements such as the North American Free Trade Area (NAFTA) argued that they would provide a major boost to trade and to economic activity in all participating countries. Critics argued that such agreements would create a 'race to the bottom', with falling wages and rising inequalities the likely result.

In fact, the evidence suggests that agreements of this form, including free trade in Europe, have had little impact on the scale of overall trade or the distribution of its consequences, especially when set against three major drivers of change[74], beginning with the growth in the global labour supply.

Firstly, in the last two decades the global supply of workers has doubled from 1.46 billion to 2.93 billion as a direct result of the collapse of the Soviet Union and the integration of China and India into the global capitalist system. At the global level, the increase has reduced the capital/labour ratio by 40 per cent. Furthermore, this huge expansion has been primarily of low-skilled workers, so that there has been a similar proportional fall in the ratio of skilled to unskilled workers at the global level. As a consequence, producers have the option to shift production to lower-wage and so lower-cost areas in the new entrants. Even if they do not, wages in incumbent economies can be depressed by the threat that this will happen. Economists have long debated whether the actual impact of 'offshoring' (or the threat of it) would be significant in developed economies. It is now clear that the effect is real and likely to become more so.[75]

The second driver of globalisation is the speed of modern information and communication technology. Not so long ago economists drew a clear distinction between the tradable goods sector and the non-tradable service sector. As the global outsourcing of production and direct competition from emerging economies reduced the importance of manufacturing in developed economies, this would be offset by 'insulated' jobs in the service sectors. The internet has changed this fundamentally. In 2006, the Institute of Directors (IOD) hammered home the point: *"In theory, anything that does not demand physical contact with a customer can be outsourced to anywhere on the globe."*[76] It is estimated that a third of total US employment is vulnerable to outsourcing.[77]

The third key driver of globalisation is a rapid acceleration in knowledge and technology transfer, which may explain why inequality has risen in developing countries, contrary to expectations. An important factor has been technology transfer by TNCs operating in developing countries and using the most advanced production techniques and technologies. In 2006, for example, TNCs established more than 700 research and development (R&D) centres in China and India.[78] As well as exploiting this technology and knowledge transfer; developing countries have also been expanding their own capacity. University enrolments in developing countries have increased rapidly. By 2010 China alone will produce more PhDs in science and engineering than the United States.[79]

What is clear is that globalisation appears to have reduced the extent to which governments are able to intervene in their economic systems. The huge increase in the global supply of labour has put downward pressure on wages in developed economies, not least through the ability of firms to relocate production to lower-wage economies, or the threat of doing so. Furthermore, the fragmentation of production through the globalised sourcing of inputs adds to this pressure.

That said these effects are not as large as is often supposed. While some studies have found a significant effect on wage inequality[80], the consensus from the literature is that trade has played a relatively modest role. While it is impossible to be precise on this, it has been calculated that around 20 per cent of the rise in the skilled/unskilled wage ratio was the result of increased trade and immigration.[81]

5.3 Migration

The impact of immigration is another important factor to consider when looking at global forces that impact on inequality. Although this is a highly politically charged and sensitive issue, there has been significant empirical investigation into the key question that dominates tabloid headlines: do immigrants depress wages and increase unemployment among native workers? The evidence broadly suggests a tentative 'no,' with some studies suggesting that increased labour supply can make it cheaper for business to produce goods and services, leading to an expansion of production and so an increase in total demand.[82]

An interesting case study is the impact of migration from Eastern Europe into the UK, where one million migrants that have come to work disproportionately in low skilled jobs – manufacturing, retail and leisure and tourism, as well as in construction.[83] Some have claimed that this has been detrimental to British workers because the skills of these migrant workers make them substitutes, not complements, to the host labour force. The bulk of the evidence does not seem to support this claim, however. For example, Gilpin *et al* (2006), find no statistical evidence to suggest that migration from countries that had recently joined the EU had contributed to the rise in claimant unemployment in the UK.[84]

But this is obviously not a clear-cut issue. Other research suggests that by increasing supply more than demand, migration has reduced inflationary pressure on wages and the 'natural rate of unemployment'.[85] If this is so, the influx of workers into low skilled jobs may have increased inequality by depressing wages at the bottom end of the income scale, but the impact on inequality overall is likely to be small due to the positive effects on total employment and inflation.

Whether or not immigration has a positive impact on inequality also appears to be dependent on the education levels, socio-economic status and demographics of incoming groups, and the extent to which these characteristics are complementary to the host labour market.[86]

Migration, like global trade has affected all countries, yet inequalities have increased in countries to very differing degrees. We argue that this is in large part this is the result of policy decisions. Liberalisation, and the commitment to it, may be very important in this regard.

6. The National Economic System

This part of the report looks at the nature of the national economic system. This is, or course, not divorced from the external influences discussed in the previous section. However, the variation in inequality levels between countries suggests that national policies can aid or hinder its influence. At one extreme are those countries, most notably the US, who mostly went with the grain of global trends, at the other are countries, such as those in East Asia, who deliberately tried to influence the structure of their economies.

Below we discuss how these global trends have shaped the UK economic structure, and in particular its labour market – a key vehicle for growing income inequality. Much of the literature describes a widening gap in developed countries between high and low skilled workers in these decades, and this is most marked in the US, but also relatively high in the UK.

6.1 Baumol's curse and the missing middle

Research into the relationship between economic structures and inequality at the national level has a long history. From a development perspective, the economist Simon Kuznets (1955) purported to show empirically that inequality would inevitably rise in the early stages of development, before declining thereafter.[87] However, in the last 50 years or more we have seen another trend in developed economies which is that manufacturing has become less and less important for employment, while the service sector has grown steadily.

Fuchs (1968) was one of the first to draw attention to this, pointing out that while 17 million jobs were added to the US economy between 1947 and 1967, the overwhelming majority of these were in the service sector.[88] Fuchs suggested three reasons for this. First, services can be seen as a form of 'luxury good', so that as incomes rise the demand for services rises disproportionately. Second, as manufacturing companies becomes more specialised, they outsource various service functions that were formerly performed in-house, again increasing the total size of the service sector.

Fuch's third explanation had been identified a year earlier, and has come to be known as 'Baumol's curse'. Baumol (1967) argued that productivity in the service sector would inevitably lag behind that achievable in manufacturing.[89] That is, whereas technological improvements can potentially improve manufacturing productivity indefinitely, the same is not true for many services. For example, teaching someone to play the violin is not much different today in terms of the time needed than was the case in the seventeenth century. These productivity differences mean that, over time, employment will shrink in manufacturing – as fewer and fewer workers are needed to produce the same output – but not in services.

Unfortunately, however, it is productivity improvements that are most likely to drive up real wages. As a result, a shift from manufacturing to services will over the longer term drive down average wages. Today, the service sector accounts for at least two thirds of jobs in the OECD, and considerably more in some countries.

This shift has been magnified by skills-biased growth, another cited determinant of income disparities. Here the process of modern economic development has seen demand for high-skilled workers rise, leading to an increase in their relative wages and so higher income inequality. This has been accelerated by computerisation, which has raised the demand for the skills used by educated professionals and reduced demand for routine analytical skills and the manual skills of many previously high-paid manufacturing jobs.[90]

The missing middle

These trends have led to a polarisation of the labour market, as relatively well paid manufacturing jobs are replaced by less well-paid jobs in the service sector. In the US this was termed the 'declining middle'.[91] The fact that the term has now morphed into the 'missing middle' gives a sense of how much further advanced the process is today.

Despite these trends, and the impact of globalisation described in the previous section, some developed economies have retained a sizeable manufacturing sector. As we can see, from Table 2, it is the UK and US that have seen the largest proportional decline in manufacturing, falling by 60 per cent between 1979 and 2009.

At 23 per cent of GDP, Germany retains the largest manufacturing sector of the major economies listed in the table above. Box 11 below considers the importance of the 'Mittelstand' in this.

As well as simply retaining the high value (i.e. design) components of manufacturing, there are also advantages in maintaining national supply chains, exploiting the value of industrial clusters and networks. Other countries did not take this route and have generally seen manufacturing decline more rapidly than those that did. The UK is perhaps the most striking example of this, where the focus has been on developing the financial rather than maintaining the manufacturing sector.

Table 2: Scale of decline in manufacturing in seven countries

	% of workforce in manufacturing		
	1979	2009	% change
Germany	40	23	43
Italy	28	22	21
Japan	27	18	33
France	28	16	43
Britain	35	14	60
Canada	22	14	36
US	25	10	60

Box 11. The German 'Mittelstand'

According to the Institute for Mittelstand Studies (Institut fur Mittelstandsforschung Bonn)[92], the term itself refers to small and medium sized enterprises (SMEs), although it conceptually encompasses more than just a simple definition of company size. As the IFM Bonn claims, some characteristics of the 'mittelstand' are not directly measurable because they include a whole range of social, behavioural, and attitudinal issues, such as the positive value attached to having an 'independent' economic activity that makes it not just an economic actor but also a social institution. The literal translation of the term itself is "middle class."

In addition to these 'soft' characteristics, the 'mittelstand' has a significant economic impact. The OECD estimates that SMEs account for approximately 49 per cent of gross national value added in Germany, employ about 70 per cent of all employees, contribute 53 per cent to the gross profit of all enterprises and 44.7 per cent to the gross national product (including the state), and account for 45.4 per cent of gross investments.[93]

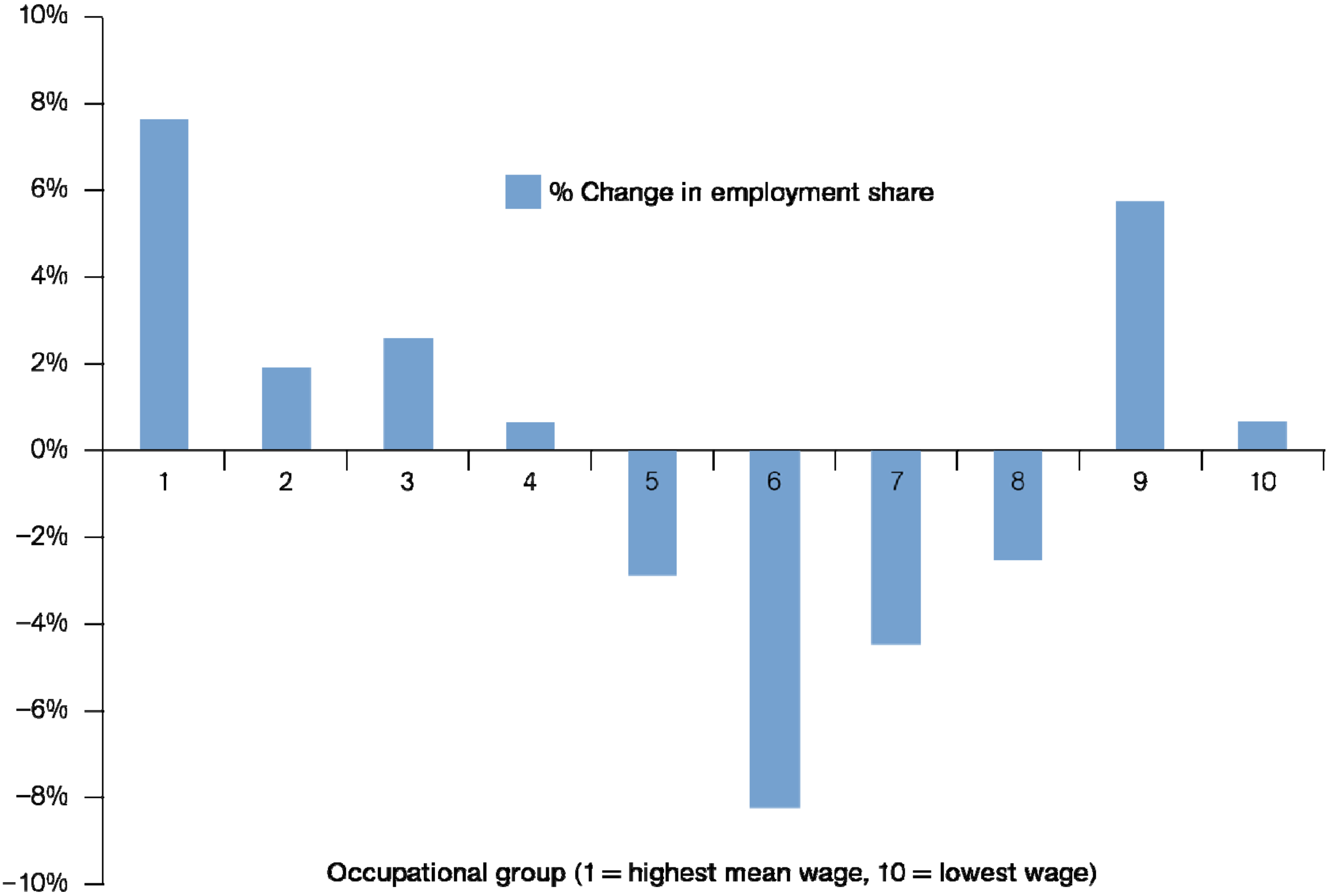
An important characteristic of SMEs in Germany is their labour intensive nature. This can be explained by the specialised and often customer-centred mode of production that characterises these companies, which can only be achieved with a highly skilled labour force. SMEs in fact provide more than 80 per cent of the vocational training-places in Germany, which in many ways is the unique advantage of the country in traditional sectors of industry and trade.[94] Finally, the mittelstand's impact and importance was recently reinforced even further with structural shifts from the manufacturing sector towards the service industry, which is characterised by much smaller firms with larger turnovers.

6.2 Deindustrialisation and financialisation in the UK

As highlighted in Table 2, manufacturing in the UK experienced a 60 per cent decline between 1979 and 2009. However, the story of dwindling middle rung jobs and wage disparities cannot be fully understood by just focusing on this decline in industrial production. The collapse in the industrial sector was matched with a rapid increase in the service industry and high-end technological occupations. This growth demanded a newly skilled workforce. However, with half of its workforce with no formal qualifications, the UK found it hard to meet this new demand.[95] High demand and low supply meant that the wages of skilled workers rose relative to those of unskilled workers, and the latter fell in real terms.[96]

As the process of de-industrialisation slowed and the workforce became better educated, some hoped that this polarisation would also slow. However, the growth of the service sector is extending this trend. Britain, and in particular London, has experienced a hollowing out of job creation in the medium-skilled occupations, with low and high-skilled jobs experiencing growth of similar proportions to each other (see Figure 8).[97] These new low-skilled jobs are service orientated and more likely to be part time, temporary and low paid.[98] The ladders that operated in many traditional industries, enabling poorly qualified individuals to progress during their career, are increasingly rare.

Figure 8: Polarisation in the labour market



Source: Holmes, C. using the Labour Force Survey 1981-2004.[103]

Box 12. Deindustrialisation and spatial inequality

There are two characteristics of the UK's economic geography that make inequality a partly spatial phenomenon. Firstly, industrial centres were concentrated in the Midlands and the North, whilst the service industry was focused on the South East, splitting the UK's wealth and jobs into the well known North-South divide. Secondly, after a large proportion of social housing was sold off through the 1980s right-to-buy policy, only the least desirable social housing, in the least desirable locations, remained. This spatially concentrated the very poor, even within affluent cities like London. Whilst spatial inequalities can be seen as the outcome of income dispersion, spatial sorting has further intensified disparities making it a driver of inequality in its own right, such that where you live defines your life outcomes far more now than at any time since the 1930s.[99]

In the 1970s and 80s, any town or city heavily reliant on heavy industry, such as coal mining or ports, saw these industries collapse. Whole areas of the country were left without a core job source. Without incomes, the local population were no longer able to buy from local shops and this generated a negative multiplier effect, with town and city centres left deserted. Many of these places have never recovered.[100] The impact of this specialisation is evident from the clear differences between wages in the South East and London and the rest of the country.

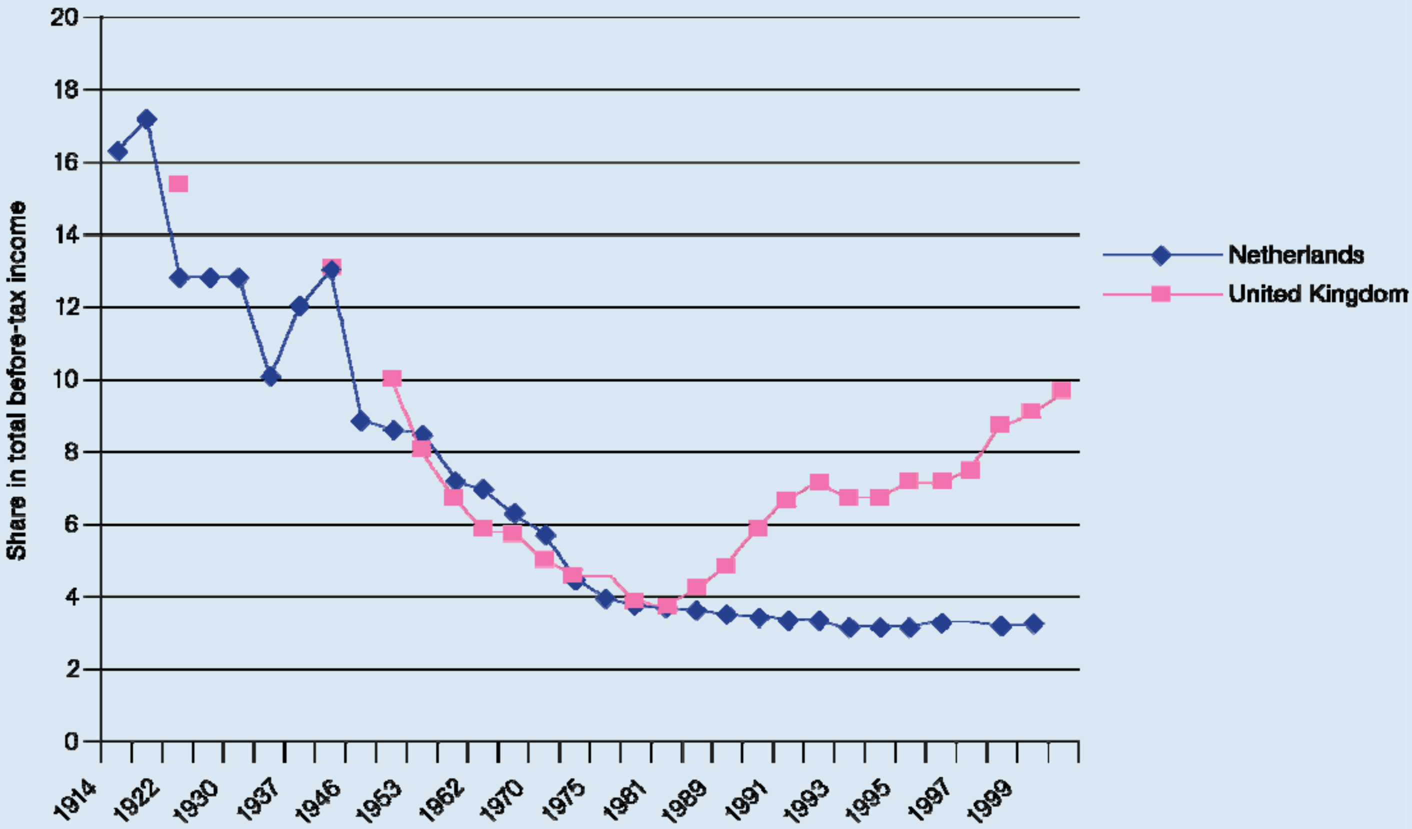
Alongside disparities in incomes between regions, there has also been growing dispersion within regions and cities. This divide is at its starkest in London. Globalisation theorist Saskia Sassen believes that cities with a burgeoning service sector will see a disappearance of middle rank occupations, with mainly low skilled and high skilled vacancies.[101] Similarly, social housing and cheaper housing in cities is concentrated in the poorest areas, as those are often the only houses that poor people can afford. The most deprived fifth of all neighbourhoods contain half of all social housing.[102]

Box 13. Top incomes in the Netherlands vs. the UK

Figure 8 shows that distributions of top incomes in both Netherlands and the UK countries evolved almost identically from 1914 to 1977. From that point on, however, they diverge to a degree that is equally striking. Top shares rose sharply in the UK after 1977, whereas there is little apparent change in the Netherlands. In terms of similarity to other countries, for the last part of the century the UK resembled the US and the Netherlands resembled France.[104]

There is some disagreement in the literature about how to explain the relative stability of top incomes, but it is clear that Dutch policymakers cannot take sole credit. Three factors are generally cited as being important: (1) language; (2) progressive taxation; and (3) the sectoral composition of the economy.

Figure 9: Change in incomes for top 0.5 per cent in Netherlands and the UK



For language, it is suggested that returns to high-fliers in the Netherlands have not reached the astronomical sums seen in the UK and America because competition for top posts occurs, to some extent, outside English-speaking Anglo-American circuits where potential employees have been demanding higher salaries. This explanation has some credibility in that it may also partly explain why other continental European countries, such as France and Germany, have not seen runaway salaries at the top.

There is some debate about the role of progressive taxation. While it undoubtedly plays a role, as discussed in Section 2, it is difficult to quantify just how much difference it made to growth in top pay.

Perhaps the most obvious contributor is the sectoral composition of the UK economy and, specifically, the degree of 'financialisation'. While financial services in the Netherlands now make up a bigger share of total value added than they did three decades ago, the growth has been far less than in the UK. Between 1998 and 2007 financial and business services in the Netherlands increased their total share of value added by just 1.7 per cent, compared to 5.6 per cent in the UK. Much of this spurt of growth in the UK would have occurred in those areas of financial services, such as derivatives, that came to be associated with high salaries and bonuses.

The 'Big Bang' of the 1980s brought electronic communication to the financial sector, and in the process wiped out many middle-ranking jobs in finance. While profit levels exploded, fewer workers captured them. International competition drove salaries at the top end ever higher – the opposite of the impact of globalisation in other sectors – causing inequalities to rise significantly in countries with large financial sectors.

Successive governments since have enacted policies to aid the growth of the financial sector. When New York overtook the City of London as the biggest financial centre in the 1980s, the Thatcher government decided to lower regulation on the financial markets. Since then, the pressure on financial sector regulation remained downwards, culminating in the global financial crisis of 2008, which many put down to lax or inappropriate regulation.[105]

This sectoral shift coupled with increasing wages for the highly skilled (see Box 12), has had considerable ripple effects on the socio-economic geography of the UK (see Box 13). The spatial clustering of high-yielding sectors in the South East has resulted in growing spatial inequality. Formally these were tempered by public sector jobs, but the austerity drive will now limit job opportunities in this sector.

6.3 The unintended consequence of increased female participation

One outcome of the increased importance of cognitive skills relative to physical labour has been a larger participation of women in the workforce.[106] This has led to changes to family structure, which has also impacted on inequality. Research finds find that between 1979 and 1993 two-earner professional households have been the biggest gainers in financial terms, while at the other end of the economic scale, the proportion of households with no earners has grown rapidly.[107] Table 3 shows how starkly this has impacted on lone mothers in the UK compared with other countries.

Alongside this, people are likely to seek partners with similar education and earnings. Esping-Andersen has termed this 'assortative mating', and it is often cited as an important factor in rising inequality. As unemployment also tends to come in couples, a high-skilled double earner couple will race ahead, particularly when unemployment is high.[108] This has led to a divergence between 'work-rich' households with multiple earners, and 'workless' households with no earners.[109]

The other key variable relates to childbirth. More highly educated women tend to have fewer children, have these children later and take less time off, reducing the impact upon lifetime earnings.

6.4 Labour market institutions

Academic research has long noted an empirical relationship between wage-setting via collective bargaining and the compression of pay differentials. On the contrary, the UK has seen a significant decline in union membership since 1980 (see Table 4), which was partly the result of deliberate policy to reduce union power by the Conservative government in the 1980s. This decline has removed an effective barrier to the growth of wage disparities.

Labour market institutional reform has been found to account for about a fifth of the increase in inequality during the 1980s.[110] Furthermore, labour market institutions are seen to have been central to containing incidence of low pay.[111]

Table 3: Per cent of households receiving no labour income in seven countries by income class and marital status, 1999-2000

	% households receiving no labour income*						
	Austria	Belgium	Canada	Germany	Spain	UK	US
All households							
Income class of household head:							
Bottom	30	53	31	31	24	58	24
Second	10	12	5	8	7	20	4
Middle	7	5	2	5	2	6	2
Fourth	7	4	2	3	2	2	1
Top	3	2	1	2	1	2	1
All	*13*	*17*	*9*	*11*	*8*	*20*	*7*
Single female-headed households containing children							
Income class of household head:							
Bottom	31	53	33	35	23	71	19
Second	3	5	3	5	0	20	1
Middle	0	10	0	3	0	4	1
All	*19*	*36*	*20*	*26*	*14*	*52*	*11*

* All data from 2000 except for the UK which is from 1999.
Source: Burtless *et al.* (2008). p.37.

Table 4: Union membership rates among wage and salary workers in the UK

Year	% of workforce member of a union
1960	41.3
1970	48.2
1980	52.9
1990	40.0
1999	29.5

Source: data for 1960-1990 are from Metcalf (1994, Table 4.1);
1999 observation is from Hicks (2000, Table 2).

The nature of union activity varies across countries, making it possible to identify processes that are more successful than others – i.e. that reduce inequality without undermining other social objectives. In some countries, unions adopt a more collectivist and coordinated approach, whereas in others there is more sectionalism, with individual unions taking more unilateral action (see Box 13). Checchi and Garcia-Penalosa (2005) find that negative effects on inequality are much less likely if unions and employers coordinate their wage bargaining activities.[112]

There is also some evidence that while a more collectivist approach to the labour market may reduce inequalities amongst workers (i.e. incumbents) it can sometimes reduce total employment in the process. In this instance the impact on total inequality will be mixed due to higher numbers of unemployed – this applies to union coverage as well as the minimum wage. Checchi and Garcia-Penalosa (2005) suggest that it is possible to offset other labour market rigidities to mitigate against an increase in unemployment. For example, combining high unemployment benefit with active labour market policies and legislation on labour market standards as is the case in Sweden.

Box 13. Collective bargaining rather than union coverage

A comparative review of the British and continental European experiences of unionisation suggests that fundamental differences in societal culture between countries are reflected in the approach of and to the unions. A more adversarial approach between workers and management in Britain compares with strenuous and persistent efforts at mutual collaboration and trust in other countries, particularly in Scandinavia.[113] A structured incomes policy to address wage drift could have helped align union and management interests, but it remained elusive in Britain.

Throughout much of the twentieth century, the so-called ‘Swedish Model’ of labour relations was characterised by centralised collective bargaining, an active government labour market policy, the goal of full employment, mutual responsibility for the macro-economy and an objective to compress wage differentials. The pursuit of labour peace resulted in relatively few disputes. Following the German model, Scandinavian countries also implemented co-determination, whereby workers are involved in company decisions and development, and trade unions have a legal right, depending on the size of firm, to representation on the board of directors. Even with the demise of centralised collective bargaining in Sweden in the 1990s, collective action at the sectoral level preserved conciliation through national agreements. Labour market and social policy regimes, with trade unions at their base, were preserved in Scandinavia in the face of the advance of neo-liberalism elsewhere. In Finland, wages are set through coordinated wage bargaining between employers’ organisations and unions. The bargained wages apply to all workers even if they are not union members. In the Netherlands, union coverage is only about 25 per cent but the agreements apply to nearly 80 per cent of the workforce.[114]

According to the Scandinavian view, the stronger the collective negotiation positions are, the easier it is to combine a response to market pressures with social protection. “The labour market organisations are both policy-makers and policy-takers; they act as major transmission belts between the labour market and the state, as banks of knowledge and information, as conflict mediators and as social stabilisation agents”.[115]

The Netherlands is a continental European country with a set of policies and institutions that, even more than the Nordic countries, are not conventionally viewed as conducive to a healthy employment outcome. However, active labour market programs such as retraining and job-placement assistance improve the efficiency of the private-sector labour market, and the public sector employs a comparatively large share of the population, which is inequality reducing.

A second important labour market institution employed in many developed countries is a statutory minimum wage. The UK is an interesting case study of its benefits and limitations. In the 1990s, the 26 wage councils, which set legally enforceable minimum wages were abolished by Major's Conservative government. This policy was reversed by Labour who introduced a National Minimum Wage (NMW).

While some have found that the NMW increased the wages of a substantial number of low-paid workers[116], others have found that the benefits were minimal. Manning and Dickens (2002) find that the impact of the NMW on wage distribution was limited because it was set at a very low level. As a result, only 6–7 per cent of workers were directly affected and no impact on the pay of workers higher up the income distribution has been detected. Furthermore, the overwhelming majority of the effects occurred within just two months of introduction in April 1999, with the impact declining rapidly thereafter as the minimum wage did not rise in line with average earnings (Manning and Dickens, 2002).[117]

6.5 Intra-firm inequality

The impact of a privatised, deregulated and de-unionised economic system, where CEOs have increased bargaining power compared to workers has unsurprisingly led to increased intra-firm wage dispersion. When John Rawls was writing his *Theory of Justice* in the 1960s, the CEOs of the 100 top companies averaged forty times the average pay of a full-time worker in the American economy. Forty years later these CEOs averaged four hundred times the average worker's income.[118]

Intra-firm inequality offers an interesting insight into the impact of wage inequality as a microcosm of the economy, but is also a driver of inequality in its own right. By allowing wages to stretch to new highs within firms, intra-firm inequality is driving the 'super-rich' trend (see Box 13 for discussion). One study found that once those at the top of an organisation earned fourteen or more times what was paid to those at the bottom, staff morale, commitment and product quality declined.[119]

This can be viewed as a component of broader structural issues relating to the forms of company ownership that predominate in an economy. While SMEs may generate the majority of jobs[120], failure rates are high in the UK, meaning that many of these jobs may not be sustained. Biggs (2002) shows that when this is taken into account, it is large companies that generate most permanent, stable jobs in the UK.[121] However, large, publicly-listed companies are under continuing pressure to compete nationally and internationally and to generate increasing returns for shareholders. Efficiency gains are thus constantly sought, putting downward pressure on both wages and total employment. Other ownership structures may be more insulated from these pressures, however.

As well as smaller, privately owned companies, mutual or cooperative structures are able to spread risks among stakeholders more easily. That is, the first reaction to an economic downturn may not be to lay-off workers so as to maintain profitability and deliver high returns for shareholders, but to spread the burden across stakeholders.

There is some evidence to suggest that mutual models may be positive from an inequality perspective. Jones and Kalmi (2009) find that higher levels of inequality are associated with lower incidence of co-operatively owned workplaces. The authors suggest that inequality itself may inhibit the formation of co-operatives due to lower levels of trust and a concentration of capital – and access to it – which may reduce the scope for people to form cooperatives.[122]

Box 15. The Meidner Plan and economic democracy

The concept of economic democracy is that ownership or control of firms and businesses is placed in the hands of those with a long-term relationship with these organisations, i.e. principally those who work in them, but also those who use and need their services. The employees and customers of a firm will rely on it for all or part of their livelihood, which means they are likely to have an interest in the long-term sustainability of the business. By contrast, the incentives for typically remote shareholders are different. Without involvement in the operation of a business and being less dependent on it as a primary source of income or input, they are less likely to look at long-term sustainability, maintaining their interest and investment only so long as it pays out profits from one period to the next. Employee-owned firms are unlikely to tolerate the levels of intra-firm wage inequality that we have seen emerge in recent decades.

Robert Meidner was one of the architects of the Swedish welfare state. He saw that an ageing and increasingly educated society would require social expenditure on an unprecedented scale. Meidner came to believe in the need to establish strategic social funds – 'wage-earner funds' – to be financed by a share levy. This was hugely controversial and was never properly implemented. According to the original plan every company with more than 50 employees was obliged to issue new shares every year equivalent to 20 per cent of its profits. The newly issued shares – which could not be sold – were to be given to the network of 'wage earner funds', representing workers and local authorities. The latter would hold the shares, and reinvest the income they yielded from dividends, in order to finance future social expenditure. As the wage earner funds grew they would be able to play an increasing part in directing policy in the corporations which they owned.

The more ownership is dispersed, the more likely it is that the effects on tackling inequality will be positive. If taken to its ultimate conclusion, such a process of dispersal would create what is known as ‘economic democracy’. While there are no examples internationally of experiments with economic democracy, the Meidner Plan in Sweden in the 1980s, came closest (see Box 15).

In short, the nature and structure of the labour market is clearly a key determinant of wage inequality. What seems to emerge from the literature is that reforms to the labour market can reduce inequalities, but only if they move towards more collective rather than individual approaches, which can be seen in terms of dispersing *risk*. For example, less flexible labour markets, through strong trade unions for instance, make it more difficult for firms to ‘hire and fire’, thus spreading – or collectivising – the risks associated with changing market conditions. This provides workers with more protection.

As well as risk, a similar argument can be made with respect to *returns*. A minimum wage provides a minimum level of ‘return’ to all workers, and centralised wage-setting allocates total returns across the workforce more equally than would a more individualised process.

7. The Role of the Political System and Taxation

The political system influences equality outcomes primarily because it is the heart of policy making. Different political parties, either to the right or the left of the political spectrum can have differing positions on economic inequality, with the left traditionally being more concerned. However, in reality these positions are chosen to attract the most voters, and this in turn relates to the type of electoral system a country has. This short section looks at electoral systems that best promote equality and the links to attitudes to taxation and taxation policy.

7.1 Proportional representation

The link between electoral systems and inequality has been empirically established and there is a very strong correlation between countries with more Proportional Representation (PR) and greater economic equality.[123] Whether this is also a causal link has been more difficult to decipher. However, studies do show that as the proportionality of a system increases, inequality decreases[124], suggesting it is changes to the political system that leads to the economic outcome. It has also been shown that more redistribution takes place in countries with more pure forms of PR.[125]

Birchfield and Crepaz (2004) have also found that consensual political institutions are systematically related to lower income inequalities, while the reverse is true for majoritarian institutions.[126] This means that contrary to the predictions of rational choice theory, as inequality increases appetite for redistributive policies falls, rather than the other way around. Nowhere is this more evident than in the US, where low-income groups (particularly white men) tend to vote against their economic interests (e.g. supporting the tax cuts of the Bush administration).

The reasons for this are complex but demonstrate that while equality increases with the introduction of democracy it does not hold that inequalities will continue to be eroded over time as the interests of the median voter are being pursued. New literature from the US focuses on the way the wealthy have been able to buy policy in their favour through the use of lobbying. A recent book, *Winner takes all politics*,[127] finds that corporate interest groups have been very effective at changing regulations and tax rules to increase their share of the national income. This has driven regressive taxation, as well as other inequality promoting policies in the US.

While one way to hinder this influence is through lowering economic inequality, this can only be achieved by introducing the right policies. To this end, a more consensual, or proportional system, which represents a broader set of interests than those of the median voter, can act as a countervailing force against policies and interest groups which can increase inequality.

Box 18 Attitudes to economic inequality

The UK has one of the most majoritarian political systems in the world. It combines a first past the post electoral system with significant powers concentrated in the premiership. This has led to a two-party system effectively, which means less accountability to the legislature and fewer checks on the power of the executive than any other developed economy. This is combined with no written constitution such that an elected government with a majority in the House of Commons is free to pass any legislation, even though they may only have been elected by a minority of the population. In such a system, parties supporting minority groups or issues are highly marginalised. This encourages a short-termism approach to policy, and a convergence on the centre, with parties supporting minority groups or issues highly marginalised. Parties know that a spell in opposition may be a long one, with limited ability to affect policy. In a PR system, they may be able to form new coalitions and have a greater chance of being in the next government. This could in theory promote longer-term decision-making.

Inequality, which is not an issue of concern to the median voter, fell out of favour politically in the UK, and will be hard to resurrect unless it gains political currency. Signs of this are not promising. Georgiadis and Manning (2007) find that the demand for redistribution rose in the period 1983-1995 to 51 per cent when income inequality was rising fastest, but the demand for redistribution has fallen by almost a third since 1995, even though there has been no fall in income inequality over this period.[128] They explain this by referring to data showing that the public have a greater belief in the importance of incentives to work and achieve.

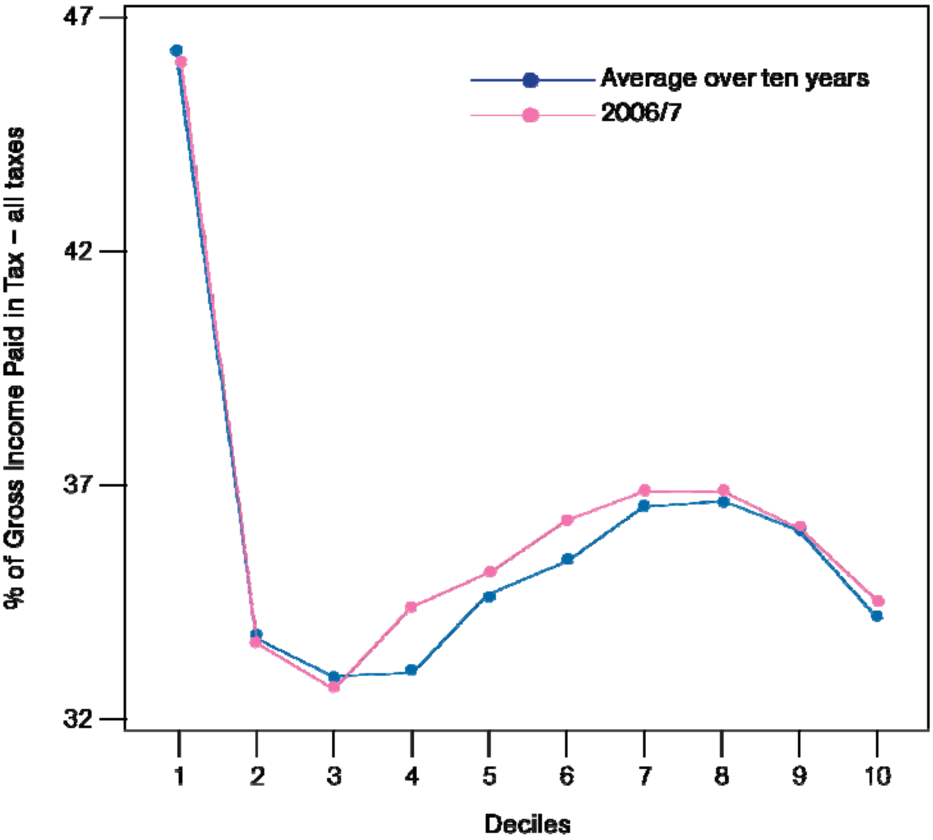
7.2 Taxation

As touched on above, taxation policy is defined by politics and political systems. While tax is used in many countries as the primary means of reducing inequality, it can also act to increase or entrench economic inequalities. Leigh (2007) points out that top tax rates are a more powerful determinant of the wages and wealth of the top 1 per cent than the top ten per cent as a whole.[129] As this report is about identifying the factors that influence final wages, it is important to consider the role of tax.

The extent to which taxation is progressive is obviously important, but the multiple forms of tax used in many high-income countries can make it difficult to judge the true progressive nature of a tax system. Taxes on consumption, for example, are more regressive, whereas higher taxes on wealth are particularly relevant for the top 5 per cent where inheritance is a more important explanation of income share.

Looking across the taxation system, the UK does not score well in terms of equality. As well as paying a larger proportion of their incomes on the consumption tax, value-added tax (VAT), those in the lowest income decile in the UK pay about 8 per cent of their income on council tax, compared to only 3 per cent in the highest income decile.[130] The overall burden of taxation is presented in Figure 10. When a regression line is fitted onto this data, the UK is found to have had a slightly regressive tax system overall.[131]

Figure 10: The average distribution of the tax burden[132]



Another reason that the lowest decile pays a larger proportion of its income in tax is because the incomes of those dependent on benefits have fallen substantially in relative terms. Pensions and other benefits are index linked, rising in line with inflation, whilst wages tend to increase faster than inflation, thus leaving those on pensions and benefits with reduced real incomes.

On average, across high-income countries, taxes on unearned income and profits total 15 per cent of GDP, compared to 20 per cent for taxes on payroll and consumption. This creates a high marginal tax rates for the poor.[133] The implications of these findings for current tax policy are discussed in Section 9.

8. A Framework for Understanding Growing Inequality

The period between the mid 1970s to late 1980s in the UK provided near perfect conditions for inequality to flourish. Driven by liberalisation, globalisation and the related polarisation between sectors, there has been a clustering of the rich and poor at the individual, household and neighbourhood level. This has been compounded by the removal of mechanisms to disperse incomes such as collective bargaining.

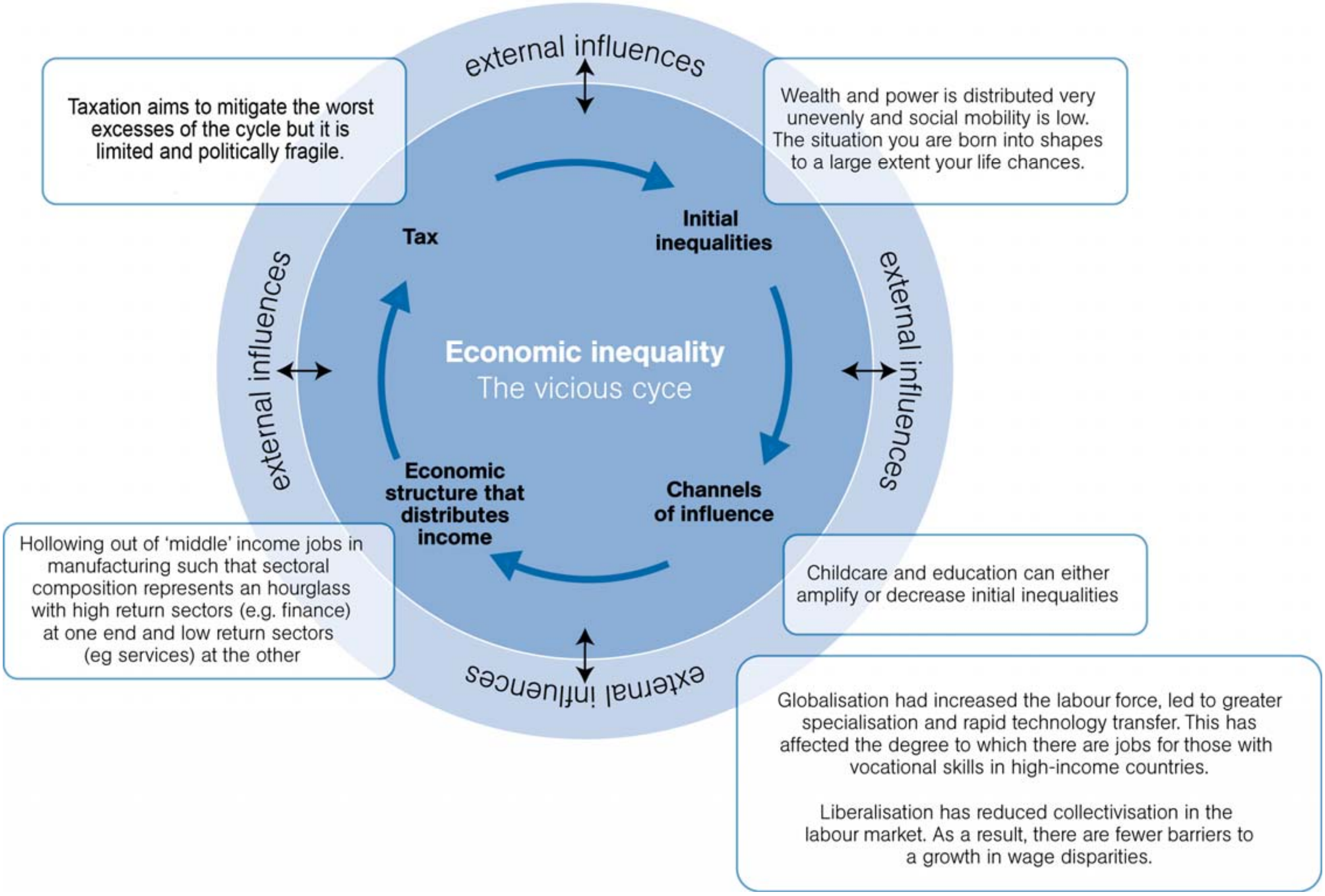
In advance of setting out policy implications and conclusions we first introduce a framework that draws together the preceding analysis.

Our analysis of the evidence suggests that we can think of there being four stages in a cycle where inequality is transmitted through the generations. External influences play a part throughout the cycle, in particular by impacting on the national economic system and labour market. If unequal starting points are left unchecked, those that are currently 'winners' will pull away from the rest, while 'losers' will fall further behind.

The determinants of inequalities in each of these stages are deeply interrelated. First, and most fundamentally, inequalities of income are a function of prior inequalities of *wealth*. Second, for these conditions to translate into income inequalities, it is necessary for people to be able to use their advantages to 'game the system' and *influence* their own (and their offspring's) circumstances. Third, there is the economic *system* itself, by which we mean the pattern and distribution of income-sources in an economy. Finally, while disposable income inequalities can be affected through the tax system, the more unequal a society is the less support there is for redistributive policies. These factors appear to operate in a circular way. This 'vicious circle' can be summarised in Figure 11 below.

This framework is used in the next section to critique current government initiatives which aim to reduce social inequalities and encourage job growth.

Figure 11: The vicious cycle of inequality



9. Policy Implications

Reducing economic inequality is not the explicit aim of any current government policy, but there are overlaps in several policy areas – most notably in increasing social mobility, but also in reducing child poverty and re-balancing the economy.

This section uses the inequality framework illustrated in Figure 10 along with findings detailed in this report, to reflect on the likelihood of the Government achieving its explicit or implicit targets in these three policy areas. We find that the continued fixation on equality of opportunity, and a narrow focus on poverty while ignoring economic inequality, means that attempts to address low social mobility and child poverty can only go so far and that the aim to rebalance the economy will not be met.

Social mobility

The Coalition Government, and in particular the Deputy Prime Minister, Nick Clegg, has strongly emphasised the role of social mobility in promoting *fairness* in society:

> *"Fairness is one of the fundamental values of the Coalition Government. A fair society is an open society where everybody is free to flourish and where birth is never destiny."* [134]

If, they argue, people cannot move up and earn more even though they work hard and have talent, there is a need for government intervention. This thinking culminated in the release of a social mobility strategy, *Opening Doors, Breaking Barriers*[135], in May 2011. This document details a number of initiatives that seek to lower the bias in the system towards those living in affluent neighbourhoods and/or with rich parents. Specific initiatives include:

- **Child care:** 15 hours a week of free pre-school education for disadvantaged two-year-olds
- **Schools:** a Pupil Premium which will provide extra funding for the most disadvantaged
- **Skills:** an increase in apprenticeships at all ages by more than 360,000 in 2011/12
- **Higher education:** more demands on top universities to take young people from disadvantaged backgrounds
- **Labour market:** pressure on employers to provide more open internship and work experience programmes, with the civil service creating a new internship initiative.

This life-cycle approach fits well with the cycle of inequality outlined in the previous section. It also begins to tackle the stratification within the education system. However, when comparing the points of intervention with the vicious cycle of inequality illustrated in Figure 10, there is a very noticeable gap – wealth.

If, as currently, those born to families in the top 10 per cent have levels of wealth 100 times those of the bottom 10 per cent, then the richest will continue to confer advantages, and compensatory reforms such as the Pupil Premium will be unable to compete with this. This rationale also applies to the differences in incomes between the poorest and the richest. The National Equality Panel wrote:

> *"A fundamental aim of those people with differing political perspectives is to achieve 'equality of opportunity', but doing so is very hard when there are such wide differences in the resources which people and their families have to help them develop their talents and fulfil their diverse potentials."*[136]

A discussion about the need for reform within the labour market is also largely absent, with only a mention of the un-balanced nature of the economy. Instead there is an assertion that the forecasted growth in demand for the highly skilled will allow some young people to move up. This fails to acknowledge that other major areas of job growth are in the social care sector and hotels and catering,[137] which are notoriously low-paid. Also, this approach offers little hope for social mobility for those who do not go to university.

The strategy explicitly side steps the issue of economic inequality by highlighting that there are countries, such as Australia and Spain, with high economic inequality and high social mobility and stating that *"the drivers of social mobility are complex, and income alone does not determine future outcomes."*

It is true that income is not the only determinant of future outcomes, but there is significant evidence to show that it is a major factor.[138] This is why the *majority* of high-income countries with higher social mobility do have lower income and wealth disparities. It is only a handful of countries that manage to buck the trend and have high social mobility with relatively high levels of economic inequality. The question should then be: why is it that the UK fails to appreciate the methods of the *majority* of countries who do strive for greater economic equality to achieve greater social mobility?

Child poverty strategy

The social mobility strategy was published alongside the child poverty strategy, *A New Approach to Child Poverty: Tackling the Causes of Disadvantage and Transforming Families' Lives*, with the two seen as highly complementary to each other.

To tackle the 'causes' of poverty, instead of relying on income transfers similar to the previous Labour government, the Coalition Government advocate strengthening families through enhanced support; encouraging responsibility and promoting work by reforming welfare and incentives to work; guaranteeing fairness through the social mobility strategy, and; providing support to the most vulnerable, especially to those families with physical disabilities.

We would agree that the previous Labour government's narrow focus on income targets meant that they poured resources into tackling the symptoms of poverty instead of focusing on the causes. However, analysis in this report has shown that the suggested 'roots' of the problem are not the same as the child poverty strategy suggests.

In the process of uncovering causes of inequality this report has shed light on some of the causes of poverty, in particular the growing polarisation in the labour market. This undermines the belief that poverty can be addressed without considering inequality, as summarised in a quote from UNICEF:

> *"…policies aimed at limiting poverty in all its forms must also confront the changes in the wider world that are tending to bring about widening economic inequality in a large majority of OECD countries."* [139]

The child poverty strategy speaks explicitly about a 'vicious cycle of poverty' where families are dependent on benefits and where incentives to work are skewed. However, we have found that the heart of the problem lies in the fact that there are fewer decent, well-paid jobs for those that did not go to university and in the process by which markets are disproportionately benefiting families with already high incomes.

This report has found that these changes in the labour market are the result of both external forces, such as globalisation and liberalisation, as well as a decline in industry and collective bargaining. The need then, is to address these structural drivers. Welfare reform will not fix the problem of the lack of decent work.

Re-balancing the economy

Within the first few months of the Coalition Government being formed, the Prime Minister, Chancellor and Business Secretary, had all recognised that *"our economy has become more and more unbalanced, with our fortunes hitched to a few industries in one corner of the country."* [140]

As discussed earlier in this report, the decline of industry and growth of the finance sector has greatly tilted economic prosperity to London and the South East. To remedy this clear spatial disparity, the Coalition Government has introduced a series of initiatives, including Enterprise Zones and National Insurance Contribution (NIC) holidays for those employers starting new businesses outside London and the South East.

These programmes are inadequate because they do not deal with a fundamental lack of demand and money in these areas.[141] The take up of a break on NICs for instance, reached only 5,137 between September 2010 and June 2011. This is a small fraction of the 132,000 enterprises expected to sign up for this scheme in its first 12 months.[142] The Government has reacted to this disappointing take-up by putting out an advert. However, it is unlikely that it is a communication failure that is driving the poor reception to the NICs tax break.[143]

Looking at other, more equal, countries, we find that manufacturing and industry are key to balancing the economy and providing middle-rung jobs. A strategy to increase enterprise or 'knowledge' industries, such as those related to service and information technology, will not produce the type of labour-absorbing businesses needed. There is a desperate need to think more creatively and radically if the North-South divide is to be broken.

The analysis of government policy using the findings of this report has revealed some considerable stumbling blocks, most notably the growing disparities in the labour market, and inequalities in wealth. By ignoring these factors the Government is not truly addressing the root causes of child poverty, low social mobility or spatial disparities.

10. Conclusions and Next Steps

In this report we have examined the determinants of economic inequality in the UK, with a view to highlighting points for intervention towards breaking the inequality cycle and preventing future inequalities from emerging in the first place. Our approach has been comparative, in that we have reviewed the extensive literature on the drivers of inequality and illustrated this review with case studies from a number of countries.

Overall, we have learnt that *in the absence of countervailing forces*, inequalities of power and wealth will be translated into income inequalities, setting up a vicious circle where both wealth and income inequalities progressively widen. Currently, any attempts to lower inequalities in life outcomes in the UK ignore the role of economic inequality and in particular the need to address wealth disparities and the demand-side challenges in the labour market.

Learning from others: collectivising risks and returns

While most countries have seen income inequalities rise in recent decades, this has been from very different starting points and has progressed at different speeds. In some countries, such as the US and UK, policies have gone with the grain of liberalisation and globalisation and policymakers have dismantled many of the countervailing forces which existed. The result has been unprecedented increases in inequality. In other countries, however, efforts have been made to push against these trends: liberalisation – in the sense of 'individualisation' – has been resisted.

A common theme in how countries have resisted external forces is the use of a collectivist approach. This includes efforts to provide universal childcare, encourage businesses to train more young people and undertake collective wage bargaining, as well as to increase employee ownership of companies. These efforts collectivise risks, through spreading the costs of training etc., but also ensure that more can share in the returns.

The difference between an individualistic and collective approach can be illustrated by thinking through the differences in outcomes. For example, if many middle class parents opt out of the state school system it (a) sets up an elite and (b) affects the relative quality of the education that those who do attend state schools will receive. Similarly, if those in a relatively strong negotiating position vis-à-vis their employers do not enter a collective bargaining process with others in a less advantageous position, but instead choose to negotiate individually, this will impact on the wider outcomes that it is possible to achieve. Individual decisions thus have consequences far beyond those directly affected.

Where inequality is kept low by direct and indirect state intervention to pool risk and returns (or where there are corporate interventions to achieve the same ends), there is less to be gained by 'gaming the system'. If income differentials are relatively low, there is less need to ensure your children are equipped to maintain the advantages you have enjoyed. Also, if public services are excellent and universally provided, the gains that your money can buy for the next generation are more limited.

In conclusion, the extent to which initial inequalities are fully or partially translated will be determined by the degree to which both risks and returns are individualised or collectivised at each stage of the cycle. This strongly suggests that rising inequality is not inevitable and policy measures taken at the national level can still be effective in a globalising world. It is true that globalisation makes it more difficult to implement and maintain such policies, but it can be done.

The growing need to tackle economic inequality

The recession and recent austerity measures are likely to make inequality worse still. For example, the Trades Union Council (TUC), finds that the majority of the two million jobs lost since the beginning of the recession in 2008 were in low paid sectors.[144] Furthermore, public sector job cuts will disproportionately impact on the least well-off parts of Britain, which are far more dependent on this sector. These also tend to be the same areas that were the main losers from the process of deindustrialisation.[145]

Cuts to services and the tax rises such as in VAT are also hitting the poorest hardest. Despite claims to 'progressiveness', spending cuts on the scale currently being enacted have been deemed to be regressive.[146] The 50p tax on those earning £150,000, which may have gone part way to balance the burden of paying back government debt, may be scrapped. One reason for this is the lack of funds that are being collected through the measure. This is because the richest can often hide or shift incomes to avoid tax.

Our analysis has further highlighted that as the vicious cycle rotates, inequality grows at a faster pace. Furthermore, external forces arising from globalisation – as well as demographic trends – appear to be amplifying the transmission mechanisms within this vicious circle, making it both more difficult to maintain countervailing forces, as well as for existing interventions to maintain their effectiveness.

As the forces of inequality gather pace, so too does public anger, as is currently being demonstrated by the Occupy Movement. While the movement does not have one unified message, a dominant slogan is "we are the 99 per cent" – referring to the growing economic and political clout of the top 1 per cent. This changing public attitude will perhaps provide the Government with the mandate to begin to address inequality. If it does not, and the Government continue to leave inequality unchecked, we risk seeing the ballooning of not only economic inequality, but associated inequalities in health, education and life outcomes, as well as further social unrest.

Finally, the onset of rising energy prices is already uncovering a possible new mechanism in the vicious cycle of inequality related to the planet's finite resources and climate change. Fuel poverty is on the increase as more and more households struggle to keep up with heating bills. Without greater equality, poorer households will face the squeeze of depleting resources much more than richer households. This could place them in a more disadvantaged position, for example by limiting their access to transport. Intervening now to level income and wealth would help to avert this new type of disparity from surfacing.

Next steps

The first step in addressing economic inequality is recognising its importance. To date the focus has almost always been on poverty, not inequality. Of course poverty matters, but unless economic development is biased towards the poor, i.e. inequality reducing, it is a highly inefficient way of reducing poverty. Successive governments have tried to have it both ways: implementing inequality-increasing reforms, whilst expanding services in the hope that the latter would cancel out the worst excesses of the former. This was always intellectually problematic but with cuts to these services now underway, this approach has also been dealt a practical blow.

Returning to a more equal socio-economic structure does not mean reviving policies of the 1970s. We accept that top-down redistributive policies that rely too heavily on tax are unlikely to be effective on their own. Tax cannot provide a definitive solution while inequalities continue to grow, because this would require further tax increases. The aim then must be to encourage structural change that prevents high levels of economic inequality from arising in the first place.

How can this be done? The analysis of the root causes of inequality suggests scope for action in five main areas primarily. Below is an overview, but further research is needed to explore and refine ideas in each area. This will be the focus of **nef**'s programme of continuing work on economic inequality.

1. The Labour Market:

a. High income differentials are at the frontline in perpetuating economic inequality and the stark divisions that exist in our society in terms of access to resources, decision-making and opportunity. Possible solutions include the Living Wage and/or the introduction of maximum wage ratios within companies and organisations.

b. The hollowing out of skilled and semi-skilled jobs in the economy means there is a shortage of adequately paid jobs. Innovative policies are needed through an industrial policy which recognises the importance of creating meaningful employment, while at the same time pushing production into more green and sustainable areas. **nef's** new programme of work, *Good Jobs*, aims to consider industrial strategies that would produce a more equal labour market.

c. Just as income and assets are very unequally distributed in the UK, so too are work and time. We need to see working hours better distributed. Of course this needs to be done in a way that does not leave people on low incomes short-changed. **nef** has work in progress to examine such a shift.[147]

2. Education:

a. The initial conditions that a person is born into are exacerbated in our system by unequal access to the best education. Thus, child-care and education systems are central to flattening differences at the beginning of life. We must look more to the universal child-care models used in countries such as Sweden to prevent inequalities based on parental incomes from emerging.

b. A small number of schools, mainly independent, confer dramatic advantages in terms of entry to the best jobs and positions of authority. Currently we focus on improving schools at the bottom end of the education system, but must consider how to level resources between all schools. This could mean capping the amount spent per pupil.

c. Vocational training needs to be built into the fabric of businesses, such that many more are involved in taking on apprentices and training them. Alongside this shift, more must be done to make the vocational route more valued, this point is linked to re-balancing the economy.

3. Structures of ownership:

a. To give everyone a more equal share in society, the ownership of assets needs to be more equally distributed. Ideas for how this could be achieved include introducing a mechanism to broaden the distribution of shares to workers and to communities.

b. Changing the ownership of assets also allows us to consider the spread of profits among and between individuals. The distribution of unearned income is another vital component of economic inequality.

4. Tax:

While tax cannot continue to take centre-stage in tackling inequality, it does play an important role in entrenching inequalities at the end of the vicious cycle of inequality. A land-value tax and a form of citizen's endowment could offer a more effective way to tax and fairly redistribute wealth.

5. Structures of democracy:

We need to examine further the relationship between different voting systems and economic inequality. In particular, we need to look at how to give a more equal voice to those with less economic resources.

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Written by: Eilis Lawlor, Stephen Spratt, Faiza Shaheen and Daiana Beitler

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new economics foundation
3 Jonathan Street
London SE11 5NH
United Kingdom

Telephone: +44 (0)20 7822 6300
Facsimile: +44 (0)2078206301
E-mail: info@neweconomics.org
www.neweconomics.org

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