Creating a culture of fairness

A progressive response to income inequality in Britain

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policy network essay

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future of the welfare state

global europe, social europe

globalisation and social justice

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renewal of social democracy

In the mid-1990s, the leaders of New Labour made a fundamental policy choice. In government they would not explicitly prioritise a lessening of inequalities between top and bottom. Instead their social justice priorities would be to tackle poverty, worklessness and economic and social exclusion. This was a big change from what every previous Labour government had tried to do, but it barely caused a ripple at the time, such was the relief that for the first time in a generation progressives now had the credibility to challenge the dominating Conservative ideology that "there is no such thing as society".

The purpose of this piece is not to debate whether Labour was right to downplay the issue of inequality then. Several reasons were clearly important in Labour making this choice. Many ascribe the decision to electoral pragmatism and the role that "tax" played in Labour's 1992 defeat. The Conservatives had managed to turn the traditionally redistributive proposals of John Smith's shadow budget into a "bombshell" threatening ordinary families. But there was also a deeper sense that intellectually Thatcherite neoliberalism was triumphant, and that the post-war welfare state consensus had irretrievably broken down and could only be rebuilt on a basis that incentivised (and did not penalise) hard work at all levels of society.

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Labour's motives were primarily domestic. However, New Labour soon seized on the discourse of globalisation to provide a deeper intellectual rationale. In the mid-1990s, globalisation was a concept coming into fashion among sociologists; now it is part of popular vocabulary. New Labour portrayed globalisation as an inexorable force of nature beyond political control – making irrelevant old egalitarian and interventionist social democratic responses and requiring a thorough rethink of the means of achieving social justice, if not a redefinition of its goals. New Labour was right that the realities of globalisation justified a new round of revisionist thinking, but the embrace of globalisation was at times overenthusiastic and hubristic. It became seen as symbolic of New Labour's commitment to "modernity", intellectually justifying the policy stances that it had taken in shaping the original project in the 1990s as unchangeable tenets. On this view, traditional redistributive policies were, by implication, at best severely constrained in a bold new world of mobile capital and the footless wealthy. As Andrew Gamble[1] has pointed out, globalisation was seen as proof positive of the need for an "enabling" state that concentrated its efforts on "equipping people for change": though of course one should never forget that this was a progressive advance on neoliberal laisser faire.

Globalisation is undoubtedly the most powerful shaping factor of modern times. It clearly is changing the contours of politics. As Gordon Brown said in his first Lord Mayor's banquet speech,[2] the differences between "over here" and "over there" are eroding fast. Questions of migration, climate change and security are now at the centre of our domestic politics. And the economic consequences for the world of globalisation are profound, not least the rise of China as the "workshop of the world" and the potential of India to become one of the world's great economic powers. The US economist, Richard Freeman, has described this phenomenon as the "doubling of the global work force"[3]; in its latest analysis the IMF thinks this figure an underestimate in terms of the labour supply in newly industrialising and advanced economies. This, together with technology, is driving ever faster economic change in our societies, accelerating the shift to a knowledge and services economy, accentuating the disappearance of "traditional working-class jobs" and increasing the risks of polarisation between those with skills appropriate to the modern world and those without them.

1. Gamble, A 2007, 'Britain and the global economy', paper presented at a Policy Network seminar, London, 21 November.

2. Brown, G 2007, Lord Mayor's banquet speech, London, 12 November.

3. Freeman, R 2004, 'Doubling the global work force: the challenge of integrating China, India, and the former Soviet bloc into the world economy', Centre for Economic Performance, LSE.

But all that aside (and that is a very large "all"), does globalisation mean that we are condemned to live in a steadily more unequal society? In the mid-1990s the hope was that New Labour could gradually rebuild a new "progressive consensus" for a more socially just society. Do the harsh realities of globalisation mean that this hope has finally to be abandoned?

Across Policy Network's international network there is a raging debate around this question. In France globalisation is widely seen as a threat to citizens' values and living standards and the political debate between left and right is about how best to frame a political response that "protects" the French way of life. There are strong echoes of these fears of a "race to the bottom" in other parts of Europe.

In the US the question of inequality is now at the top of the political agenda. Equity concerns are no longer confined to the left. There is an increasing perception that the dynamic forces of today's economy are leading to new problems of income distribution. No less a figure than Ben Bernanke, the chairman of the Federal Reserve, has expressed concern that unless these perceptions are addressed, globalisation will become unsustainable because domestic politics will force governments into adopting defensive policies that put new barriers in the way of economic openness.[4] Bernanke quotes data for the US showing that, "while the earnings at the 50th percentile of the distribution rose 11.5 percentage points between 1979 and 2006, the wage at the tenth percentile rose just 4 points while the wage at the 90th percentile rose 34 points". As for shares of national income, that of " households in the top fifth of the income distribution rose from 42% in 1979 to 50% in 2004, while the share of income received by the bottom fifth declined from 7% to 5%." As for the top 1%, "the share of income garnered by the top 1% increased from 8% to 14%."

At a seminar that Policy Network held with the Centre for American Progress in Washington in October 2007,[5] former Clinton cabinet members of the seniority of Robert Rubin and Larry Summers spoke about rising inequality in the US with a frankness that it is difficult to imagine taking place in any British context today. The US has undergone a profound shift to a more unequal society since the end of the post-second world war "golden age" of Keynesian economic management: in terms of income equality, these were the glorious decades of the Great Compression that followed the Great Depression.[6] According to economist Larry Katz,[7] the 1980s were the decade of the "great widening", when those on low incomes fell behind the average. Now we are seeing a decade of the "great polarising" as the top races ahead of the middle.

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If the distribution of income in the US had remained as it was in 1979, then 80% of American families would today on average be around $7,000 a year better off. Of the productivity gains achieved in the US in the past generation, 50% have been appropriated by the top 10% of wage earners. The rise in US inequality is equivalent to 1% of US GDP being transferred to the top income groups every three years.

Many explanations have been offered for these extraordinary trends: a shift in the balance of power from labour to capital as a result of globalisation; "super league" competition between "superstars"; skill-biased technical change; the impact of migration on the bottom end of the distribution; the decline of union power; Reagan and Bush tax policies favouring the better off. But extensive research has failed to prove that singly or together these factors wholly explain the trends. However, as economists conduct their inconclusive debates, in the popular consciousness, globalisation is taking the blame. Protectionist sentiment in Congress has greatly strengthened since the last Clinton presidency, especially on the Democrat side of the aisle.

So, among our Policy Network partners on both sides of the Atlantic, a debate rages about rising inequality and the impact of globalisation. Yet there is an almost complete lack of consensus about the facts, the

4. Bernanke, B 2007, 'Remarks by Chairman Ben S Bernanke', Greater Omaha Chamber of Commerce, Omaha, Nebraska.

5. 'Globalisation, growth and social equity: American and European perspectives', Washington DC, US, 1 October 2007.

6. Goldin, C & Margot, RA 1992, 'The great compression: the wage structure in the United States at mid-century', *Quarterly Journal of Economics*, vol. 107, pp. 1-34.

7. Goldin, C & Katz, L 2007, Long-run changes in the US wage structure: narrowing, widening, polarising', NBER working paper, no. W13568.

causes and the policy implications. This is the reason that in 2007 Policy Network engaged in a major programme of research and cross-national debate around the theme of "globalisation and social justice". A big question for social democrats in Britain and the rest of Europe is whether the trends we see in the US are being repeated or are likely to be repeated on this side of the Atlantic – and what if anything we can do about it, if we don't want the same thing to happen here. If the causes of rising inequality in the US can mainly be attributed to globalisation, then truly we Europeans have something to fear: because in terms of trade and the relative openness of our economy the European Union is more exposed to new sources of competition than the US.

This is why Policy Network commissioned a dispassionate factual analysis of comparative income inequality from its researcher Sotirios Zartaloudis of the London School of Economics.[8] He finds that the contrasting levels of inequality within different EU nations and the US are significantly related to choices made by national governments in their taxation as well as broader economic and social policies. Universal trends such as globalisation and de-industrialisation, and increased competition with the developing economies in Asia and China, are not enough to explain the dramatic contrasts in levels of inequality between the US and European nations, though there is much diversity within Europe itself.

The paper argues that, for all the reforms that the European social model needs, European social protection offers the best explanation for the difference in levels of inequality between Europe and the US. When one considers the differences in levels of income inequality between European countries, Zartaloudis suggests that the different public policy choices in taxation, welfare provision, education and health provide the most reliable explanation. Mediterranean and eastern European countries show the highest levels of inequality; the UK the highest compared to the rest of rich EU members; continental countries are in the middle - just below the EU average - while the Scandinavian countries are the most equal societies in Europe and in the OECD as a whole.

Our societies are not hapless victims of global processes over which national politics can exert little control

For British social democrats there are two main conclusions to be drawn from Zartaloudis' analysis: one is optimistic, the other challenging. The optimistic conclusion is "three cheers for the European social model". Of course the social model has its problems and needs reform – as Policy Network has argued in its other work[9] – not least the legacy of an "employment rights" way of thinking that prioritises protection of the job over the employability of the individual. Yet for all the critique of where the European social model falls short, Europe is not following the pattern of the US. The Nordic countries have for decades been more equal than the rest and still are, despite some upturn in inequality since the economic reforms of the late 1980s and early 1990s. By contrast the southern Europeans have tended to higher levels of inequality – but these have not shown any great tendency to increase over time. France, Germany and other continental European countries fall somewhere in between. In France the income distribution narrowed in the 1970s and 1980s, and has remained broadly unchanged since. Germany witnessed a similar compression but the distribution now appears to be widening somewhat, though on nothing approaching a US scale.

Zartaloudis' evidence suggests that Europe's nation states still have considerable room for maneouvre about the political choices they make over distribution. Our societies are not hapless victims of global processes over which national politics can exert little control – or at least not yet: countries can choose to have more equal societies than the US and still make an economic success of them, as the Nordics continue to prove.

But for British social democrats there is a more challenging conclusion. If the European social model has broadly demonstrated its resilience in the face of whatever pressures that have led to the explosion in US

8. Zartaloudis, S 2007, 'Equality: a political choice: Income inequality in Europe and America: trends, causes and solutions', Policy Network essay, December.

9. Diamond, P et al 2006, *The Hampton Court agenda: a social modelk for Europe*, London, Policy Network. See also Giddens, A, Diamond, P & Liddle, R (eds.) 2006, *Global Europe, Social Europe*, Cambridge, Polity Press.

inequality, why after 10 years of Labour government has Britain not had more progress to a less unequal society?

In the UK there was a sharp rise in income inequality in the past generation, but it is important to stress that this mainly occurred before 1997. Atkinson[10] points to a very considerable increase in inequality in the 1980s, but he concludes that this was not so much evidence of a long-term trend, rather an episode. Atkinson calculates that the share of the top 1% in the UK income distribution - roughly 6% in 1980 - had more than doubled to 14% in 2000, almost completely reversing the trend towards greater equality in top incomes since the second world war. Clearly the rapid de-industrialisation, high unemployment, union reforms and tax cuts of the Thatcher era have played a role. Separate academic work shows how in the UK the 90/50 ratio increased from about 5.5 times in the 1970s to 7.8 by the mid-1990s: the 50/10 ratio rose from 4.9 to 5.9 over the same period.[11]

New Labour of course assumed that its wide portfolio of policies to tackle poverty and extend opportunities for the disadvantaged would in time reduce inequality. And indeed the combined impact of Labour policies over the last decade has narrowed the gap between median household incomes and poor families with children, the low waged and poor pensioners, notwithstanding that unemployed people of working age without children – many of whom suffer handicaps such as mental illness or drug addiction - have fared less well.

But at the same time as attacking poverty, New Labour always maintained a deliberate vagueness about whether it still cared about widening inequalities at the top. This may have reflected an assumption that after the sharp and controversial rise in the pay of privatised utility bosses in the 1990s, pay rises at the top would cease to grow at such a rapid pace. Given also New Labour's enthusiasm to embrace business, political awkwardness may have covered up intellectual confusion. Peter Mandelson was criticised for claiming that New Labour no longer cared whether people made themselves "filthy rich". But there was a logic in what he said, given the position New Labour had taken, and little explanation of what an alterative view might be. The mantra of "fairness and enterprise" proved an uncertain guidepost to policy.

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In face of the explosion in top executive pay, the government was careful not to condemn and took the view that its role should be confined to improving "transparency" so that institutional shareholders could take a more active view of whether the rewards paid by boards to top managers were justified by the market place. As chancellor, Gordon Brown's tax policies were strongly egalitarian at the bottom of the income distribution, but left the top barely touched. The top income tax rate remained 40%, except that in the 2002 budget it effectively became 41% as a result of the decision to remove partially the ceiling on increased national insurance rates in order to pay for some of the costs of increased NHS spending.

However, for entrepreneurs who set up new companies, the tax rate on capital gains on the eventual sale of their business stake was radically reduced, in practice to 10% from the maximum 40% that remained in place for other forms of capital gain (such as the increase in the value of individual shareholdings and second homes). New Labour boasted that for entrepreneurs it had created the most favourable capital gains tax regime in the world. Only when private equity firms moved to exploit this concession, and trade unions pointed out that these elements of the City were now paying lower rates of tax than their office cleaners, did Alastair Darling propose in the recent pre-budget report to apply a uniform capital gains tax rate of 18%. This has now been criticised by those affected as an 80%

10. Atkinson, AB & Piketty, T (eds.) 2007, *Top incomes over the 20th century: a contrast between European and English-speaking countries*, New York, Oxford, Oxford University Press.

11. Goos, M & Manning, A 2003, 'Lousy and lovely jobs: the rising polarisation of work in Britain', Centre for Economic Performance, London School of Economics.

increase in their tax bills, notwithstanding the significant cut in capital gains tax on second homes and shares.

The more mobile better-off (particularly in the parts of the country where house prices are high) paid more tax as a result of big increases in stamp duty as well as less than full indexation of the thresholds for the higher 40% income tax band. But the middle class and high earners were still able to claim tax relief at 40% on many forms of saving, especially for their pensions. When the Conservatives made a central issue of inheritance tax at their 2007 conference, the Brown government rushed in the pre-budget report to repair the perceived political damage, going to unusual lengths to establish that their proposal to raise the threshold for couples had been under ministerial consideration for months before the Conservatives first made their pitch.

For a redistributionalist, Labour's tax policy is open to the criticism that it has simply lacked courage. A 50% tax band for higher incomes above say a £100,000 threshold has been much talked about in the London world of thinktank seminars and policy working parties, but under Brown as chancellor, was never introduced. I would be surprised if the arguments that led to the proposal's rejection are seen to have changed much now. Were it to have done, the ideal time would have been when the step change in public spending took place in 2001/2002 and popular support for extra public expenditure to tackle the under-funding of public services was at its highest. Like it or not, that moment has clearly passed. In essence, the political problem is that British society has bought into the idea that individuals should be able to enjoy the rewards of their own success, subject to the need to fund decent levels of public services. At the moment the overwhelming perception is not that public services need more money than the government is presently planning to spend, but that they should achieve better value for the money they have available. Higher taxes on the higher paid for their own sake could easily be regarded as a tax on aspiration and hard work – and arguably not just by those who are already high paid, but by those who are working hard in an attempt to become so. In the UK, progressives have to find a different way into the debate about inequality and redistribution.

What is needed in the UK is a change in political culture and discourse about questions of income and wealth. In The Blair Revolution published over a decade ago, I wrote "New Labour should use the tax system to attack unjustified privilege, without weakening incentives for risk-taking and hard work." In crude and simple terms, we need to move from a society that is afraid to ask "How much have you got?", to one that is prepared to question "How did you get it?" This was how Winston Churchill as a radical Liberal sought to turn the political argument in defence of Lloyd George's redistributive 1909 budget. In the early 20th century it was landowners who were seen to enjoy gross excesses of income and wealth, for which in Neville Chamberlain's wonderful use of Biblical language "they toil not, neither do they spin". The gross excesses of 21st century Britain are in different social categories: directors whose compensation packages have little or no justification in terms of their contribution to the profits and success of the companies they lead; investors who take advantage of Britain's generous capital gains tax provisions but are not genuine risk takers, building a business from scratch through their own hard work; individuals who owe their comfortable circumstances to inheritance rather than their own efforts.

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How might public policy reflect this new approach to income and wealth? Here are a few ideas to generate debate:

- A Top Pay Commission to match the Low Pay Commission that would scrutinise pay awards to top executives in the private as well as public sector, with a remit to expose unnecessary excess and create a more open debate about just and proportionate rewards.

- A more radical reform of inheritance tax. The government's current proposals to raise thresholds and exempt the middle classes, whom the tax was never initially designed to hit, would go ahead. But there should equally be measures to tighten up on the passing on of large fortunes through taxing lifetime gifts more stringently. The proceeds should be used not for the purposes of general public expenditure but to establish a life chances fund – on the model of the national lottery funds - with a remit to extend opportunity in the most deprived communities through the support of locally based initiatives.

- Greater incentives for the better off to donate money for public purposes on the city academy model through the offsetting of such donations against gifts and inheritance tax liabilities.

- A capital gains tax regime that confines the most generous incentives to genuine start up businesses where the entrepreneurs have also committed to generous share incentives all round for their staff.

Shifting Britain from an individually acquisitive to a more egalitarian culture is no easy task, but simply because it is difficult, does not mean that no attempt should be made.

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