

Addressing inequality in Scotland: what can be done?

A Paper for the David Hume Institute

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Executive Summary

Concern about inequality

Inequality – the gap between rich and poor – has become a central issue in Scottish and UK politics during the past few years.

There are several explanations for the growth in concern about inequality.

- First, there is growing evidence that inequality may have detrimental effects on economic growth. Many economists and politicians have traditionally been unconcerned about inequality, believing that it would stimulate growth thus benefiting society as a whole. But research from both the IMF and OECD has indicated that, beyond a certain point, inequality can be detrimental to growth. Inequality may also have been a contributory factor in causing the economic crisis.
- Second, there is growing evidence of a link between income inequality and other forms of inequality, notably inequality of opportunity. Higher income inequality in the present results in family background playing a stronger role in determining the adult outcomes of young people, with their own hard work playing a commensurately weaker role. This offends many people on the basis of what is fair, and risks creating a society which is dynastic rather than dynamic.
- Third, there has been a shift in perspective about the underlying causes of inequality. The traditional neoclassical view is that technological change and globalisation cause a shift in the demand for, and supply of, different types of skills. Under this interpretation, there is a certain inevitability about the growth of inequality. But there is a growing view that increasing inequality is also driven by a range of market and policy failures. These include the nature of pay-setting arrangements, the presence of monopolies in some sectors which result in excess profits, a tax and regulatory system that confers advantages to certain individuals and groups, the presence of implicit government subsidies in some sectors, and a more general shift in the balance of power from workers to firms.

There has also been significant academic and policy interest in inequality over the past two years. The report reviews major contributions by authors including Anthony Atkinson, Joseph Stiglitz and Francois Bourguignon. The ethos of these works is that inequality is not inevitable, but is something that society can influence by the policy choices that it makes.

Inequality trends

Income inequality in Scotland (and the UK) was low and stable throughout the 1960s and 1970s. The 1980s saw a significant increase in inequality, driven by factors including deindustrialisation, technological change, the erosion of wage bargaining arrangements, and labour market and financial deregulation. At the same time there was a significant rolling back of the progressivity of the welfare state, including a reduction in the generosity of both out-of-work benefits and the State Pension, and a reduction in the progressivity of income tax rates.

During the 1990s and early 2000s, inequality grew more slowly (mitigated in part by the introduction of the minimum wage in 1997). And increases in the generosity of the State Pension, benefits for families with children, and the introduction of tax credits to supplement the incomes of the low-paid also helped to stem any increase in overall income inequality.

However, the picture is more nuanced when we look into the detail. Since the late 1990s, the very poorest 5% of households have become even poorer. The richest 1-2% of individuals have seen their incomes grow far more rapidly than any other group, largely driven by pay increases in the financial and business services sectors.

It seems likely that inequality will have increased in the past few years (our latest data is for 2012/13). There has been an increase in the proportion of insecure work – part time work, temporary work, and out-sourced agency self-employment.

Changes to fiscal policy are also likely to have increased inequality. Many working-age benefits have been cut in real terms. And although rises in the income tax personal allowance have taken some people out of income tax altogether, they have also provided a tax cut for all individuals earning above the personal allowance.

One of the side effects of the quantitative easing policy pursued by the Bank of England is that it raises the prices of assets, including housing, pensions and other financial assets. These types of assets are not evenly distributed, but heavily skewed. The QE policy is thus likely to have raised levels of wealth inequality.

The role for the Scottish Government

Tackling inequality is one of the core policy objectives of the Scottish Government. But what powers does the Scottish Government have at its disposal now for addressing inequality?

It already has powers over land and property taxes, and under the Smith Commission proposals, it will gain almost full control over income tax. It has substantial control over public spending programmes, notably on education and early years and on health and social care. It has, or will gain under the Smith proposals, control over some benefits (although it remains unclear however how much ability it will have to vary these benefits or target them differently). Finally, the Scottish Government has ‘power’ in relation to moral suasion – its ability to influence the behaviour of firms, organisations and individuals.

There remain a number of areas over which the Scottish Government has only limited, or no control. These include labour market regulation (on the minimum wage, or issues around employment legislation); the broader range of taxes and benefits; product market regulation (competition policy, etc.); capital market regulation (including the financial sector); nor does the Scottish Government have any role in respect of the negotiation of international agreements on taxation or regulation.

Addressing wage inequality at the top

Under the Smith Commission proposals, the Scottish Government will gain the ability to vary tax rates and thresholds for non-savings income.

The structure of income tax in the UK has changed dramatically since the late 1970s. Tax rates now are not only substantially lower at the top (45% now compared to 83% in 1978) but are lower across most of the income distribution. In 1978, somebody earning £65,000 in today’s prices would pay an income tax rate of 55%. This point is made to highlight how far tax policy has changed in a short space of time, but also that tax reform needn’t just be about rises for the top 0.5%.

Only around 0.5% of Scottish income taxpayers pay tax at the additional rate. So raising the rate from 45% to 50% will not have a large effect on the overall distribution of income, and it may not raise much additional tax for the Scottish Government. A more 'Nordic' style of income tax would not involve a significantly higher top rate, but also a higher rate of tax extending further down the income distribution.

The extent to which income tax is an effective tool to address income inequality depends in part on the extent to which rises in top rates will alter the distribution of market (pre-tax) incomes in non-distortionary ways. If rises in top tax rates reduce in-migration of skilled migrants, or disincentivizes entrepreneurship, then the effect of higher tax rates may largely be to reduce long-run economic growth, with ambiguous effects on inequality. But if top incomes reflect rent-seeking, then taxing them more may achieve a more equal distribution of pre-tax incomes without detrimental effects on growth.

There is significant uncertainty around what the behavioural effects of income tax changes might be. The effect of tax rises on revenues depends in part on how broadly the tax base is defined. This is an issue for the UK Government rather than the Scottish Government. It also depends on how mobile incomes are between Scotland and rUK, if tax rises in Scotland are not matched by the Westminster Government. The international evidence is not conclusive on this point, but it seems likely that employment income is not as mobile as is often assumed.

Non-tax mechanisms for reducing pay inequality at the top may include encouraging more transparent and inclusive approaches to wage-setting. Publicising pay ratios and reforming remuneration committees provide two examples. Where excessive pay results in part from monopoly power, improving competition (for example by improving access to support and finance) may help to reduce inequality.

At UK level there are likely to be many other policies which could be implemented to address excessive income growth at the top. We do not cover these policies in any detail in this report (which is focussed on the powers of the Scottish Government), but they could include issues such as financial sector regulation and pay-setting including the taxation of bankers bonuses; competition policy; taxation of inheritances; and the tax treatment of pension contributions.

Policies to help the low-paid

Of all working age adults living in poverty in Scotland in 2012/13, some 52% were in 'in-work poverty', i.e. they were living in households where at least one member of the household worked at least part-time.

One measure of low-pay is to consider people who earn less than the living wage as being low-paid. The living wage is an hourly rate of pay that has been identified as the amount an individual needs to earn to cover the basic costs of living and to achieve an agreed minimum income standard. Around one fifth of workers in Scotland earn less than the Scottish living wage of £7.85.

But low pay is a function of hours worked as well as the hourly wage. In recent years there has been a significant increase in the proportion of workers who are involuntarily on part-time, temporary, or zero-hours contracts, and a rise in the number of workers who are undertaking self-employed agency work.

Low-pay increasingly reflects a shift in the bargaining power of workers relative to employers. Workers have increasingly seen their bargaining power eroded as a result of deunionisation, the decline in the use of national pay-scales, outsourcing of activities to smaller employers that are harder to regulate, increased use of very flexible contracts, and so on.

The Scottish Government's new income tax powers are unlikely to be very helpful in addressing the issue of low pay. Recent rises in the personal allowance mean that the lowest paid 17% of workers already pay no income tax; further rises simply provide a tax cut to those earning above the personal allowance. (If the aim is to address poverty, it would make more sense to raise the threshold for paying National Insurance Contributions, which effectively acts as a second tax on earnings, but which is not currently being devolved).

The Scottish Government has called for devolution of powers over the minimum wage. In many ways there is a good case for devolving the minimum wage within the UK. Powers over the minimum wage are devolved in US States and Canadian Provinces. There is some evidence to suggest that there may be scope for a small increase in the minimum wage (to around £7 per hour) in Scotland without major negative employment effects.

At UK level, there is likely to be a role for employment regulation and legislation, combined with scope for a strengthened minimum wage. Retaining and strengthening the incentives inherent in in-work benefits is also important in limiting the rise of in-work poverty.

Currently, much of what the Scottish Government can do relies on the influence and moral suasion it can exercise over employers. It is already doing this through the adoption and promotion of the Living Wage. Its Fair Work Convention could provide an effective mechanism to develop this role, as long as it is based on genuine partnership and that there is an element of conditionality on employers for taking part (i.e. support to employers from government agencies is in some way contingent on participation in the Convention). In the longer-term, it would be hoped that the Convention can catalyse a resurgence of industry-level wage bargaining arrangements, particularly for those sectors which rely heavily on public sector procurement and/or where wages are low.

There are likely to be limits to voluntarist approaches to tackling low-pay and insecure working. Labour market regulation is generally a reserved matter for the UK Government (e.g. in relation to zero-hours contracts, or agency self-employment). But the Scottish Government can play a role in mobilising support for reform, encouraging best-practice, and making the case for reform of UK policy at Westminster.

Land and property taxation

Land and property taxation in Scotland is under the control of the Scottish Government. The existing taxation of land and property is however flawed. Council tax is regressive, charged at a lower percentage of property value for high value properties than for low value properties. Stamp Duty (and its successor in Scotland, the Land and Buildings Transactions Tax) is inefficient in that it dissuades people from making beneficial transactions.

Moreover, the whole system of property taxation is biased in favour of the acquisition of property as an asset. This bias in favour of owner occupation is a contributing factor in significant house price

increases (which embed intergenerational housing and wealth inequalities), deprives investment in other parts of the economy, and has a number of other undesirable economic side effects.

In thinking about how housing should be taxed, it is important to recognise that housing has two attributes that are relevant for tax design:

- First, housing provides a flow of services which should be taxed in the same way that consumption of other types of goods and services are taxed;
- Second, housing provides an asset for homeowners, the value of which can go up or down.

The existing council tax should be reformed as a proportional tax on property value, for example, by taxing property at 1% of its value (in the longer term it may be preferable to base the tax on land value rather than property value, but basing the tax on property value would be more practicable in the short term). There would be a number of 'losers' from such a policy, and transition arrangements are likely to be required.

Under the current system, increases in the asset value of owner-occupied homes are not taxed. This is important because of what it means for the intergenerational transfer of wealth. A housing asset which increases in value whilst it is held and generates an (untaxed) profit once it is sold effectively imposes an implicit tax on succeeding generations. The result may be that succeeding generations find it more difficult to get on the housing ladder, and become increasingly reliant on inheritances to enable them to afford to buy a home – with the result that inter-generational inequality can 'feed' higher intra-generational inequality in succeeding generations. The logical tax reform – some form of capital gains tax – would be difficult to implement politically.

The problem of rising house prices is accentuated by failures in the planning and housing markets. Tackling barriers to housing supply is also part of the policy response to addressing inequalities in the housing market.

Education and skills policy

Investing in education and skills is often seen as a key policy response to increased inequality. The argument hinges on a view that technological change is 'skill-biased'. If the supply of educated workers does not keep up with the increase in demand, then the earnings premium associated with a given level of education is likely to increase, leading to a widening of the wage differential between more and less educated workers.

However, in recent years there has been little evidence of a fall in the graduate premium (the earnings premium associated with having a degree), despite the large increase in the number of graduates. Instead, there has been a rise in 'within-group' inequality among graduates. In other words, the earnings of graduates have become increasingly dispersed.

The fact that overall inequality is largely explained by inequality within education groups rather than between them does not undermine the argument that we should be investing more in education, or promoting policies which improve access and attainment among disadvantaged groups. But it does indicate that efforts to upskill the workforce are not a silver-bullet for addressing inequality.

Early years education policy

Poverty and socio-economic disadvantage are major influencers of pupil attainment. It is well recognised that there is already an attainment gap between children from disadvantaged backgrounds and their peers when they start school, and that this gap continues throughout school. The attainment gap has a direct impact on school-leaver destinations, future labour market success and the potential to determine income levels in adulthood.

There is still relatively little consensus around which interventions are most effective at raising attainment generally, and closing the attainment gap specifically. There is a need to better understand the effectiveness of different types of interventions, and this implies a strong emphasis on the use of pilot projects, and on monitoring and evaluation. Sharing best practice and evidence of what works should also be promoted.

Access to Higher Education

The Scottish Government's commitment to free university tuition for eligible full-time undergraduate Scottish students is one of its keystone policies.

However, the distributional consequences of different HE funding systems are more complex than is often portrayed. The Scottish system of free tuition means that Scottish students graduate with less debt on average than their English counterparts. But the English system offers more generous grants and bursaries for the poorest students, with the result that the poorest students graduate with relatively less debt in England than Scotland.

Moreover, because the repayment of tuition fee loans in England is income-contingent, low-earning students in England often do not repay their loan in full. This means that the taxpayer will still meet a large proportion of tuition costs in England, in the form of unpaid loans. By shifting student support from a model of directly funded tuition to the provision of unsecured loans, the UK government is effectively shifting some of the funding of current students into the future.

The debate around higher education funding – and particular how to maintain the quality of the university sector without creating barriers to HE participation for the most disadvantaged – is extremely complex. There is unlikely to be a 'right' answer, but politicians should be prepared to have a more open and honest debate around the advantages and disadvantages of different funding systems.

Conclusions

Many of the policy prescriptions to address inequality will be politically difficult to implement as they tend to create losers as well as winners. Arguments will always be made that redistributive policy will stifle growth. In some cases this may be true, but we may decide that this is the price worth paying for a more inclusive society. But on the whole, policy can be designed to minimise effects on growth, partly by targeting interventions where market failures exist, and partly by focussing interventions where behavioural responses to policy change are relatively insensitive.

Scotland's high level of economic integration with rUK may make policy distinctiveness even more politically difficult to achieve. But the Scottish Government is not passive to developments in rUK or further afield, and can help shape the direction of policy reform. Whether it chooses to do so remains to be seen, but it already has a number of policy tools with which it could signal serious resolve to tackle inequality.

1. Introduction

Inequality – the gap between rich and poor – has become a central issue in Scottish and UK politics during the past few years. During the Scottish referendum campaign, the Scottish Government cited high levels of inequality in the UK as an argument for seeking independence. Continuing this theme, its recently launched Economic Strategy identifies ‘tackling inequality’ as one of two key pillars (the other being ‘increasing competitiveness’), arguing ‘reducing inequality is not only important in itself, but is vital to creating the conditions to deliver sustainable economic growth over the long term’ (Scottish Government, 2015).

The inequality theme has also been prevalent at UK level. During its term in office, the Coalition Government has been keen to assert that ‘the richest households will make the biggest contribution to reducing the deficit, both in cash terms and as a proportion of their income’ (March Budget 2015). Mark Carney, Governor of the Bank of England, has argued that ‘There is growing evidence that relative equality is good for growth. At a minimum, few would disagree that a society that provides opportunity to all of its citizens is more likely to thrive than one which favours an elite, however defined.’

As the quotes in Box 1 demonstrate, concern about the growth and potential implications of inequality has not been confined to the UK. Influential figures from organisations including the US Federal Reserve, the IMF and OECD – organisations which are traditionally associated with a free-market orthodoxy that focuses on economic growth as the ultimate policy objective – have also been keen to stress the downsides of growing inequality.

Box 1: Concern about inequality

‘Rising inequalities have negatively impacted economic growth, thwarting opportunity and cutting vulnerable groups off from the heartbeat of our economies. The result is stifled economic growth over the long term.’ Angel Gurría, OECD Secretary-General

‘In far too many countries the benefits of growth are being enjoyed by far too few people. This is not a recipe for stability and sustainability.’ Christine Lagarde, Managing Director of the International Monetary Fund

‘It is no secret that the past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority. I think it is appropriate to ask whether this trend is compatible with values rooted in our nation’s history, among them the high value Americans have traditionally placed on equality of opportunity.’ Janet Yellen, Chair, Board of Governors of the Federal Reserve System

Why should we be concerned about inequality?

Explanations for why we should be concerned by rising inequality can be categorised into three groups: first, growing evidence that inequality may have detrimental effects on economic growth; second, evidence of closer links between income inequality and other forms of inequality, notably inequality of opportunity; and third, a changing perspective about the underlying causes of inequality. Let’s consider each of these explanations in turn.

Inequality and growth

Many economists and politicians have traditionally been unconcerned about inequality, believing that it would stimulate growth thus benefiting society as a whole. But research from both the IMF and OECD has indicated that, beyond a certain point, inequality can be detrimental to growth (Ostry et al. 2014; OECD, 2015). The OECD (2015) for example estimates that the rise in the average Gini coefficient of two percentage points across 19 OECD countries between 1985-2005 took 4.7 percentage points off cumulative GDP growth over the period.

The mechanisms through which inequality can be bad for growth are multi-faceted. They include issues around skill acquisition in unequal societies which limit opportunities and entrench inequality across generations; the erosion of trust in politicians and institutions that occurs in unequal societies, and which can lead to polarisation of political opinion, tension manifesting in unrest such as the 2011 riots; a decline in productivity due to worker demotivation or unhappiness; or a lack of innovation and investment as the rich over-invest in protecting their privilege through IP protection (Hutton, 2015; Stiglitz, 2013).

Concerns about the role of inequality in undermining growth came to a head during the financial crisis, as disproportionate income gains by the rich were invested in the financial markets, increasing the supply of credit to lower income households, who became increasingly indebted as they tried to maintain their relative standard of living (Wisman 2013, Kumhof et al. 2015; Stockhammer, 2015; Goda and Lasandrou, 2014).

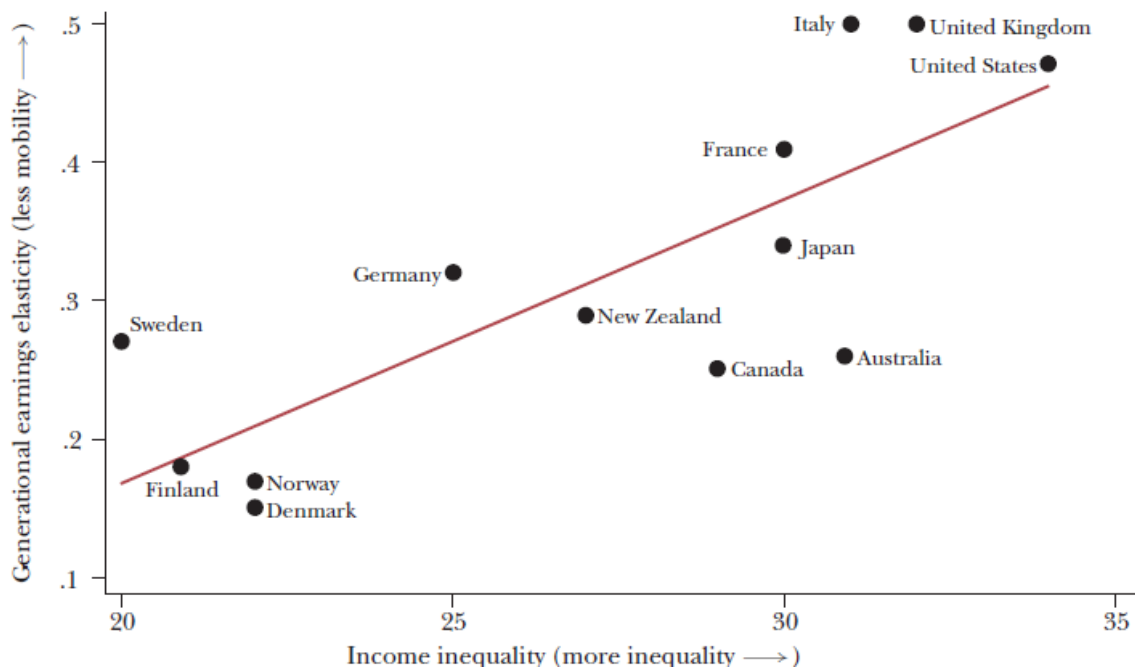
Inequality and opportunity

It is inevitable that there is some level of inequality in society, reflecting individuals' varying levels of skills, ability, effort and entrepreneurialism. Income inequality is the outcome of both circumstances beyond which we have no control (family background, etc.) and 'effort', for which an individual can be held responsible. There is an argument that we should concern ourselves only with ensuring that there is (ex ante) equality of opportunity, and not whether there is inequality of outcome (income in this case).

But as Atkinson (2015) notes, there are several reasons why we should still be concerned about equality of outcome: some individuals may make 'effort', but fail due to sheer bad luck; the structure of the income distribution (i.e. why some jobs are paid more than others) is partly a social construct; and most importantly, inequality of outcome in the present influences the equality of opportunity for the next generation.

This point can be illustrated by the 'Great Gatsby Curve' (Figure 1.1), the correlation between income inequality and social immobility across countries. Higher income inequality in the present results in family background playing a stronger role in determining the adult outcomes of young people, with their own hard work playing a commensurately weaker role (Corak, 2013). This offends many people on the basis of what is fair, and risks creating a society which is dynastic rather than dynamic. Of course, this describes a correlation and there is nothing inevitable about the relationship – Australia manages to have a relatively low level of social immobility despite relatively high income inequality for example – but the UK is currently at the 'wrong end' of both axes.

Figure 1.1: The Great Gatsby curve



Source: reproduced from Corak (2013)

Causes of inequality

Growing concern about inequality also reflects a shift in perspective about the underlying causes of inequality. A traditional neoclassical view is that growing inequality is driven by the interaction between technological change and globalisation. At the top end of the income distribution, globalisation increases demand for the most skilled and talented CEOs, innovators, sportspeople and creatives. Because these ‘superstars’ are not perfect substitutes for one another, globalisation enables them to leverage their ability across a globalised market enabling them to command an ever higher earnings premium. Simultaneously, superstar managers in the finance sector have seen a substantial rise in the size of capital they are able to trade with. At the lower end of the earnings spectrum, technological change has reduced the demand for many types of manual and semi-skilled work, whilst globalisation has increased the supply of labour that is able to perform these occupations, with both effects pushing down on wages. Under this ‘technological change and globalisation’ interpretation, there is a certain inevitability about the growth of inequality, and the policy response focusses on upskilling.

But there is a growing view that increasing inequality – particularly in terms of incomes at the top – is also driven by a range of market and policy failures:

- Growth in Executive-pay doesn’t simply reflect the value that top executives bring to the companies they work for, but also reflects the ability of managers to set their own pay or lobby shareholders for pay increases in firms where performance is difficult or impossible to reliably measure¹. It also reflects a belief by Boards that they can identify the best managers

¹ Related to this point, Bell and Van Reenan (2013) find that the structure of corporate ownership influences the pay-performance relationship of CEOs. Specifically, firms with higher institutional ownership [e.g. pension funds] have a symmetric pay- performance relationship, rewarding CEOs when performance is strong but

for their firms, and underestimate the role of luck in determining performance. Even the Financial Times ran an article in May 2015 with the sub-headline 'even fervent defenders of free markets think top pay is out of control'. This is part of a series of FT articles arguing that the links between CEO achievement and reward are opaque and may even damage companies by incentivising under-investment to achieve short-term share targets.

- Tervio (2009) argues that high incomes in professions such as entertainment, management, and entrepreneurship, may be explained by the nature of the talent revelation process, rather than by an underlying scarcity of talent. A manager can only show his ability by having worked with expensive assets. As a result, firms bid excessively for the pool of incumbent workers at the expense of trying out new talent.
- Excess profits in some sectors are maintained by policy or economic factors which limit barriers to entry and competition. Related to this is the idea that powerful interest groups or businesses can secure changes to the regulatory framework or tax system that confer advantage (Stiglitz, 2013).
- Implicit subsidies are made by the government to some sectors. The public sector provides an implicit subsidy to the banking sector, lowering banks' borrowing costs and incentivising risk-taking. Noss and Sowerbutts (2012) estimate that this subsidy could be as high as £100bn.

Across the rest of the distribution, there has been a gradual shift in power from workers to firms over the past few years and decades, as a result of labour market deregulation, the erosion of wage bargaining arrangements, the decline of nationally set pay scales and 'norms', and general economic stagnation which has resulted in an excess supply of labour. The view that inequality arises not only because of 'fair' variation in wages but also reflects the exercise of market or political power by the richest combined with a lack of 'countervailing power' among the rest has even gained traction among organisations traditionally associated with a more liberal philosophy. The IMF has recently published research showing that declines in unionisation are associated with increases in top income shares, and argue that weaker earnings for middle- and low-income workers engendered through deunionisation necessarily increases the income share of corporate managers' pay and shareholder returns (Jaumotte and Osorio, 2015).

The fact that growing inequality does not simply reflect the operation of some rational forces of labour supply and demand, but is likely to be driven at least in part by market and policy failures, strengthens the case for governments to 'do something' about it.

Recent academic and policy interest in inequality

Thomas Piketty's 2014 book 'Capital in the 21st Century' brought the issue of inequality to the forefront of current policy debates. Already in 2015, three major new studies on inequality have been published, each of which contains more detail on potential policy responses to inequality. These books are:

- 'Inequality: what can be done?' by Anthony Atkinson
- 'Rewriting the rules of the American economy' by Joseph Stiglitz

penalizing them equally as aggressively when corporate performance falters. By contrast, firms with more dispersed reward performance asymmetrically – positive performance is rewarded slightly more strongly than other firms, but negative performance is not punished by lower pay.

- ‘The globalisation of inequality’ by Francois Bourguignon

We review the main recommendations of each of these works below.

Inequality: what can be done? By Anthony Atkinson

Atkinson proposes specific policies for the UK context, which he believes will bring about a genuine shift in the distribution of income towards less inequality. The ethos of the book is that ‘the world faces great problems, but collectively we are not helpless in the face of forces outside our control. The future is very much in our hands.’ Another key message of the book is that inequality is not just a matter for fiscal redistribution but should be a ‘priority for everyone... it is a matter for competition policy as well as labour-market reform... inequality is embedded in our social and economic structure, and a significant reduction requires us to examine all aspects of our society.’ He argues for the importance of policies that render incomes less unequal before taxes and transfers. ‘Securing full employment, with a fairer distribution of pay, and a more egalitarian ownership of capital are essential elements of any strategy to reduce inequality’.

Atkinson recommends new policies in five areas: technology, employment, social security, the sharing of capital, and taxation. Atkinson believes that government can play a much stronger role in influencing the direction of technological change in such a way that increases employment opportunities, and that competition policy should include an explicitly distributional dimension. The government should pursue an explicit target to reduce unemployment, set a statutory minimum wage at the level of the Living Wage, strengthen collective bargaining arrangements, and provide guaranteed employment to everyone who seeks it. On wealth, he recommends a capital endowment (minimum inheritance) paid to all at adulthood in order to temper differences in inheritances, and that the government should offer savings bonds with a guaranteed real rate of interest. He recommends a much more progressive structure of taxation: income tax rates should increase in steps up to a top rate of 65%; council tax should be replaced by a proportional tax on values; and inheritance tax should be replaced by a lifetime capital receipts tax. On social security, Atkinson favours a strengthening of contributory benefits, a strengthened universal Child Benefit, and moves towards a participation income.

Atkinson devotes the final section of his book to dealing with likely objections to his proposals. He argues that redistribution does not necessarily shrink the size of the economic cake given that markets are not always perfectly competitive, and that many policies can be efficiency-enhancing. He illustrates this point empirically by pointing out that there is no evidence that more unequal countries have higher growth. He also argues strongly against the view that globalisation prevents action: he is ‘mildly optimistic’ about the prospects for international cooperation, and argues that globalisation does not impose limits on how we design the welfare state. Indeed, he argues that the growth of the welfare states in European countries coincided with the 19th Century period of globalisation.

Rewriting the rules of the American economy by Joseph Stiglitz

Like Atkinson, the starting point for Stiglitz is to argue that ‘inequality is not inevitable’, but is a ‘choice we make with the rules we create to structure our economy’. The ethos of Stiglitz’ work is that rules and regulations that underpin the economy – around corporate formation, labour law,

competition policy, monetary and fiscal policy – have increasingly shifted the balance of power towards an ever smaller group of privileged elites and undermined healthy growth.

Institutions and rules are required to force markets to behave competitively, for the benefit of all, argues Stiglitz. But various policies have limited competition, encouraged monopolistic rent-seeking (the practice of obtaining wealth not through economically valuable activity but by extracting it from others), and encouraged short-termism in corporate governance. Failure to regulate the finance sector has resulted in it becoming relatively less effective in its essential function of allocating capital to productive uses, instead focussed on short-term profit seeking. CEO pay structures linked to stock options have led to weaker investment. Weakened unions have given corporations the upper hand in the labour market, weakening wages and working conditions, and leaving managers and owners with a larger share of profits. Corporations have a stronger political influence, leading to a sinking floor of labour standards.

The report sets out a diverse range of reforms to ‘promote stronger growth and broadly shared prosperity’, both around ‘Taming the top’ and ‘Growing the middle’. Under ‘taming the top’ policies include stronger regulation of the financial sector, restructuring CEO pay to incentivize long-term business growth, making markets more competitive (through reforms to IP protection and global trade agreements), and raising the progressivity of the tax system. Under ‘Growing the middle’ policies include making full-employment an explicit policy goal; empowering workers by strengthening the right to bargain and the minimum wage; enhance employment opportunities through for example expanded childcare provision; and expanding economic security by better investment in early education, reforming the finance of HE, and adopting a more universal health care provision.

The globalisation of inequality by Francois Bourguignon

The *Globalisation of Inequality* focuses on global trends in inequality, rather than policy prescriptions. Bourguignon points out that global inequality is falling, as the middle classes in major developing countries such as India and China have benefited from relatively more rapid income growth than has been observed in developed countries.

At the same time however, inequality is increasing within most countries of the world, regardless of whether they are more or less developed. The drivers of inequality are argued to include globalisation, technological trade, financial liberalisation, the rise of winner-takes-all markets, and rent extraction.

However, while inequality is increasing in most countries, Bourguignon points out that countries at similar levels of development display very different levels of inequality. Thus he argues that while the forces driving inequality are strong, they cannot be overwhelming, and there must by implication be a strong role for policy in mitigating inequality trends.

Summary

The common thread running through all three works is that the forces driving increased inequality are not insurmountable. In terms of specific policy prescriptions, there are many similarities between the Atkinson and Stiglitz reports. Both argue that reducing inequality is not just about redistribution, but also the distribution of incomes before taxes and transfers. Both argue that there

is no inevitable trade-off between addressing inequality and growth, but instead that concentrated wealth can hurt economic performance. And both argue that globalisation is not a reason not to act.

In terms of specific policies, both Atkinson and Stiglitz are in favour of more progressive taxation, a stronger minimum wage and role for collective bargaining, and the setting of an explicit full employment goal for policy. They are both in favour of stronger child benefits and a more universalist system of public benefit provision, although Atkinson goes much further on this in relation to ideas around social insurance and a 'participants income'. Stiglitz contains much more detail on specific policies on financial sector regulation and corporate governance reform, which Atkinson does not go heavily into. In contrast, Atkinson gives more consideration to how the distribution of wealth can be made more equal.

Inequality trends in Scotland

So what can we say about inequality in Scotland?

Figure 1.2 shows how wage inequality has evolved in Scotland since 1975. The significant increase in inequality, for men and women, occurred during the 1980s. A number of factors underpin this: deindustrialisation and technological change caused a fall in demand for many middle and lower-skilled occupations, and this combined with an erosion of trade union power and labour market deregulation led to a relative decline in wages at the lower end of the distribution. Financial deregulation and a reduction in top rates of income tax contributed to a rise in salaries at the upper end. Since the 1990s, the rise in inequality has been much slower, and has been driven to an extent by changes in the distribution of hours worked, rather than changes in hourly wage inequality. Evidence also suggests that the introduction of the minimum wage in 1997 has had a positive role in negating further increases in hourly wage inequality.

Figure 1.3 shows how net household income inequality has evolved in Scotland. The measure of net income measures household income after taxes to and transfers from government (income tax and national insurance, council tax, and welfare benefits including benefits for those with sickness or disability, looking for work, in work on low incomes, and the elderly, including the State Pension). Inequality of net household income largely follows the trend of pre-tax wage inequality:

- During the 1960s and 1970s, the expansion of the welfare state mitigated what rise in market income inequality there was.
- During the 1980s, the increase in wage inequality coincided with a significant rolling back of the progressivity of the welfare state, including a reduction in the generosity of both out-of-work benefits and the State Pension, and a reduction in the progressivity of income tax rates. The result was a significant increase in inequality.
- Since the 1990s, increases in the generosity of the State Pension, benefits for families with children, and the introduction of tax credits to supplement the incomes of the low-paid, have helped to offset the (slower) increase in market income inequality.

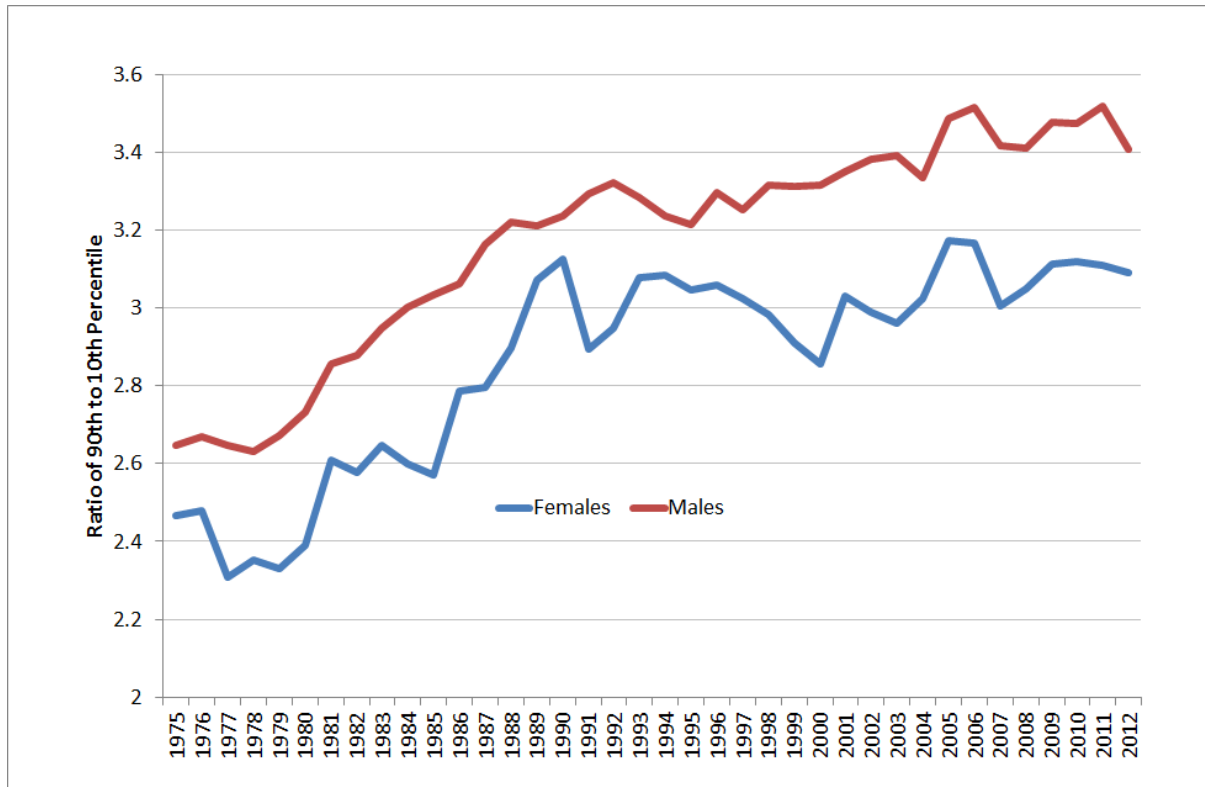
Although there has been only limited increase in overall inequality since the mid-1990s, the Gini coefficient is insensitive to the evolution of changes in specific parts of the income distribution. Figure 1.4 shows how real incomes have changed between 1997/8 and 2012/13 for each percentile

of the income distribution. Across much of the distribution, inequality has narrowed: the net incomes of deciles 2-5 have grown more rapidly than those of deciles 6-9. At the tails however is a different picture: greater conditionality attached to benefits means that the bottom five per cent have experienced falling real incomes, while incomes have grown most significantly for the top 5%.

Figure 1.5 looks at the change in top wages in Scotland in more detail. It plots the change in the share of the wage bill by percentile. The rise in concentration of pay in the top 1-2% is clear. As discussed above, the causes of the top wage growth are debated; they might be seen as 'fair' in that they reflect the marginal revenue product of the most talented individuals in a global market place; or they might reflect particularities of the way in which top managers' pay is set, and exploitation of market power.

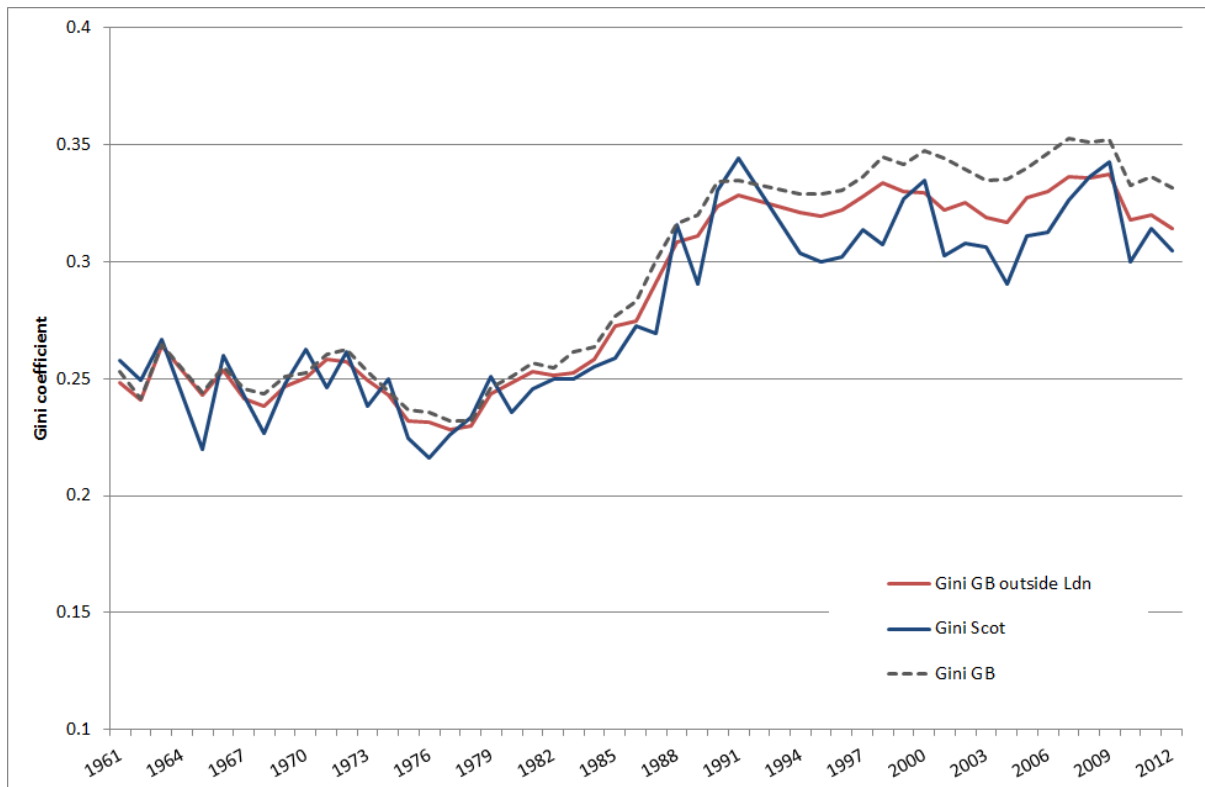
Bell and Van Reenan (2013) show that, for the UK as a whole, the financial sector accounts for over three quarters of the rise in the share of the top 1% between 1999-2008, and that virtually the entire gain to the top percentile was a result of increased bonus payments rather than through regular pay. Our analysis for Scotland (available on request) suggests that financial services and business services combined accounted for 1.3 percentage points of the 1.5 percentage point rise in the share of the top 1% between 1998-2008 (a change in the industrial classification makes comparisons after 2008 problematic).

Figure 1.2: Weekly earnings inequality of FT workers in Scotland



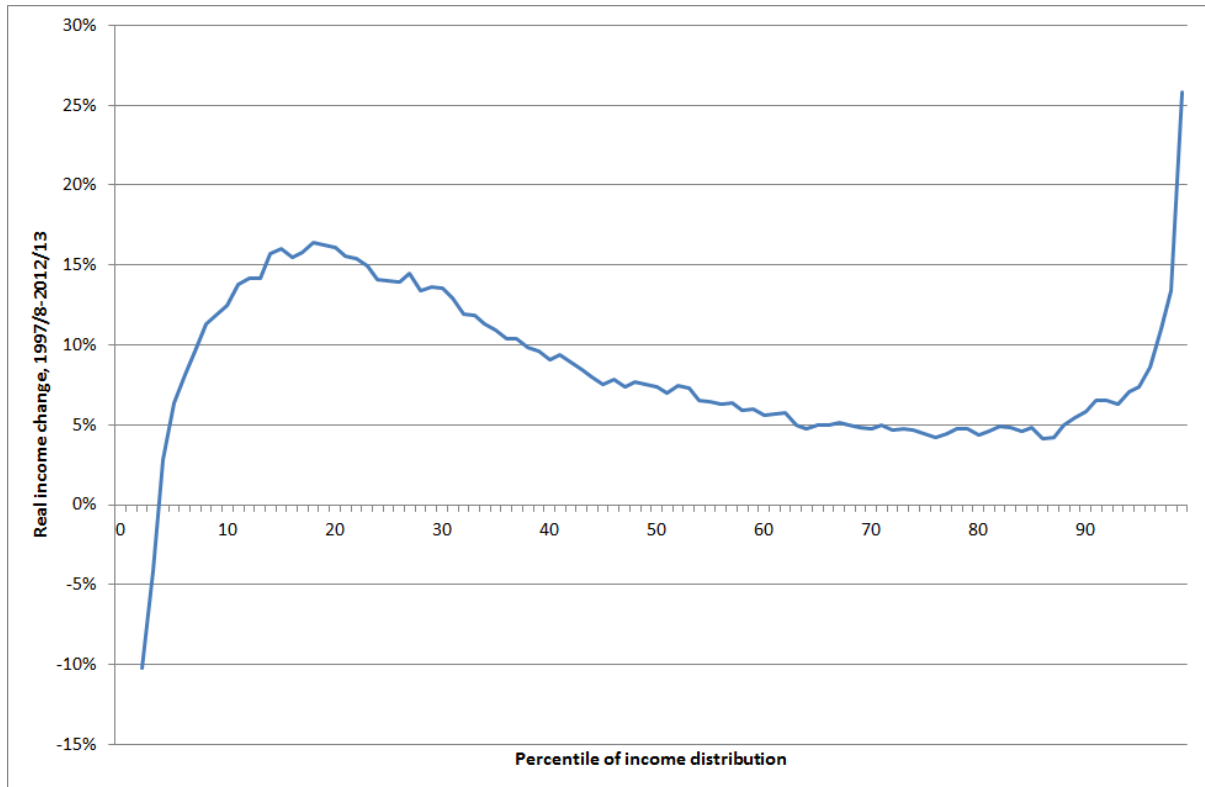
Source: Annual Survey of Hours and Earnings

Figure 1.3: Inequality of household net income, 1961-2012



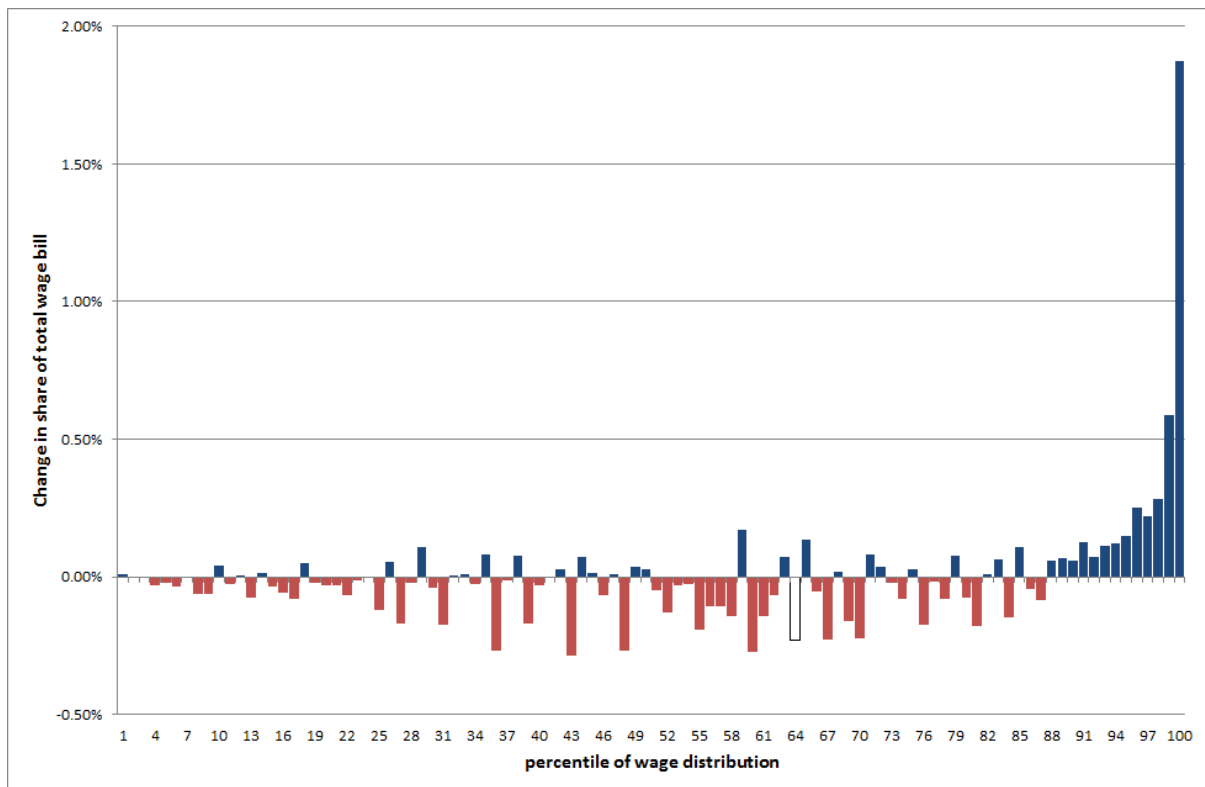
Source: Households Below Average Income

Figure 1.4: Real income change by percentile of income distribution, UK, 1997/8 – 2012/13



Source: HBAI

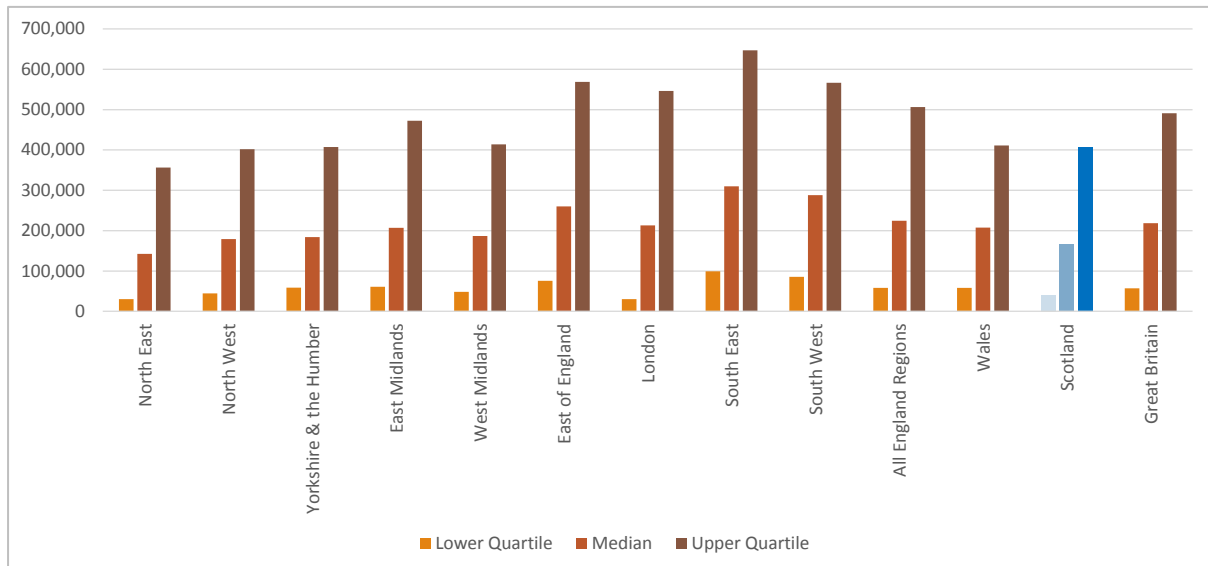
Figure 1.5: Change in share of total wage bill in Scotland by percentile of distribution, 1996/7-2010/11, Scotland



Source: Survey of Personal Incomes

Wealth is distributed slightly more unequally in Scotland than in Great Britain (Figure 1.6). The ratio of the 75th to the 25th percentile of wealth is 10 in Scotland, compared to 8.6 nationally. Private pensions and property form the largest components of wealth (each accounting for around 38% of total wealth), with financial and physical wealth accounting for 14% and 12% of the total respectively).

Figure 1.6: The distribution of wealth in UK regions

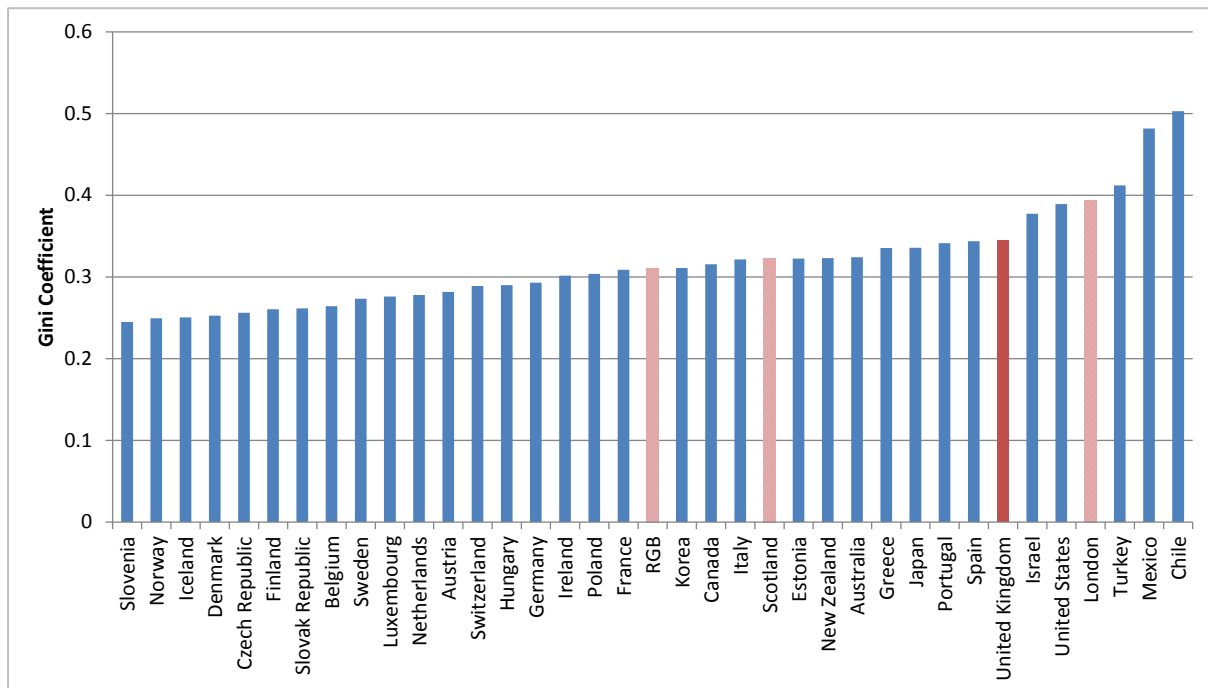


Source: *Wealth and Assets Survey, 2010-12*

What about international comparisons? Net household income in the UK is relatively high compared to other OECD countries (Figure 1.7). To an extent, this result is driven by particularly high levels of inequality in London. Inequality in the UK outside of London is much more average in the context of OECD countries. If Scotland was an independent country, then it too would have an approximately average level of net income inequality, similar to that in Italy or Australia (although higher than the Nordic countries).

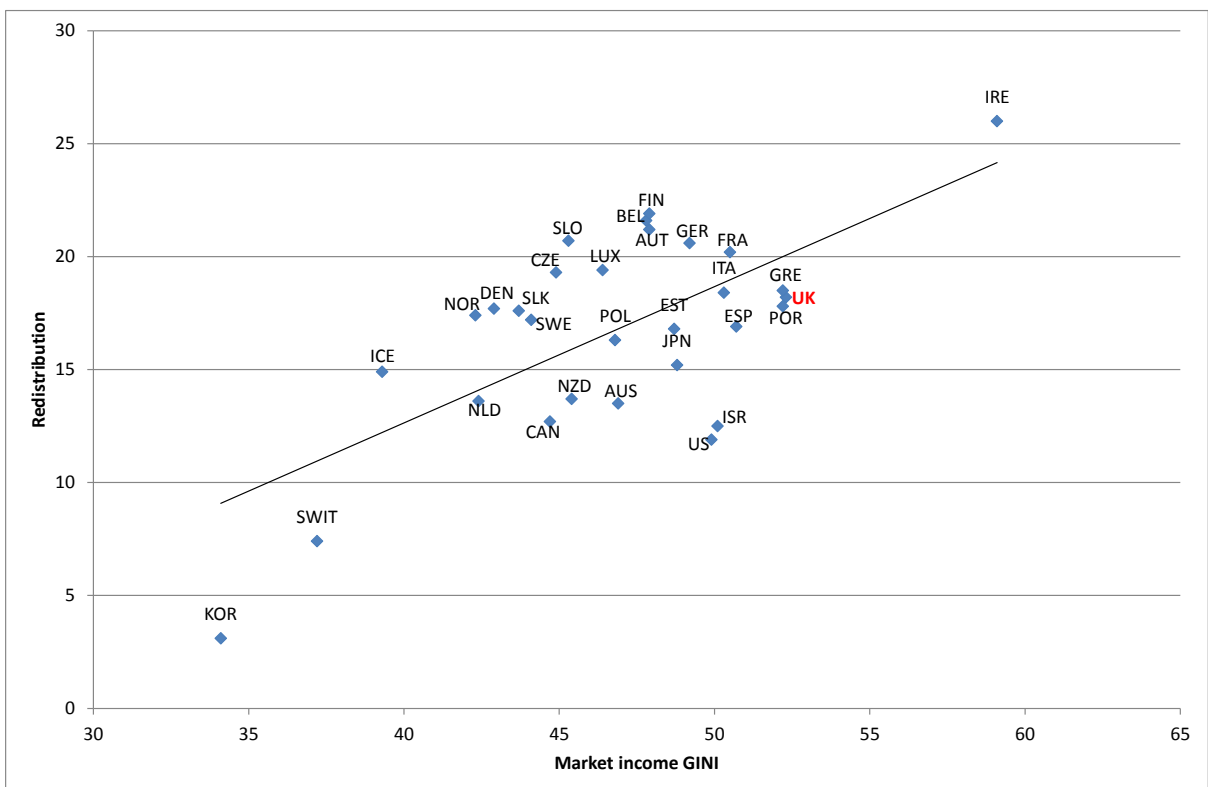
In making international comparisons, it is important to consider the role that governments play in reducing inequality through direct taxes and transfers (i.e. welfare payments). The x-axis of Figure 1.8 shows market income inequality in OECD countries. The UK has a particularly high level of market income inequality. The y-axis shows the level of redistribution achieved by tax and transfer systems in each country, i.e. the difference between the market income Gini and the net income Gini. The level of redistribution in the UK looks broadly average: taxes and transfers reduce the market Gini by around 17 points. However, a given tax and benefit system becomes more redistributive as the distribution of market income inequality widens. Thus, given its relatively high level of market income inequality, it could be argued that the UK's tax and transfer system is less redistributive than we might expect it to be, relative to other countries. In summary, there are two points to take from Figure 1.8: first, inequality in the UK is high largely because market income inequality is high, not because the tax and transfer system is not very redistributive; but second, this does not mean that there is no scope to achieve further redistribution through taxes and transfers in the UK.

Figure 1.7: Net income inequality in OECD countries, 2010



Source: OECD, HBAI.

Figure 1.8: Relationship between market income inequality and redistribution for OECD countries, 2010



Source: OECD, HBAI.

Inequality during the recession

What has happened to inequality since the recession? There are perhaps three key issues to discuss: first, the decline in real wages that has been observed across the distribution; second, the Coalition Government's changes to taxes and benefits since 2010; third, the monetary policy response to the recession.

Wages began stagnating as UK went into recession, and have fallen in real terms by around 10% since 2010 (Gregg et al. 2014). The fall in real wages seems to have been fairly ubiquitous across the income distribution, across industries, and across occupations. Thus on one level, real wage falls – although having implications for living standards generally – might not have a direct bearing on inequality. However, it remains unclear whether these wage falls are largely cyclical and will pick up soon; or whether they imply a more permanent shift towards a lower share of wages in national income.

What has been the effect of the Coalition government's tax and benefit changes on the net income distribution? During the first two years of the parliament, benefits continued to increase with inflation, and so with falling wages, inequality actually fell. Since 2012, many working age benefits have been cut in real terms, although pensioner benefits have continued to increase in line with inflation. In terms of income tax, the personal allowance has risen much faster than inflation, taking some people out of tax altogether, but also providing a tax cut for all those earning above the personal allowance.

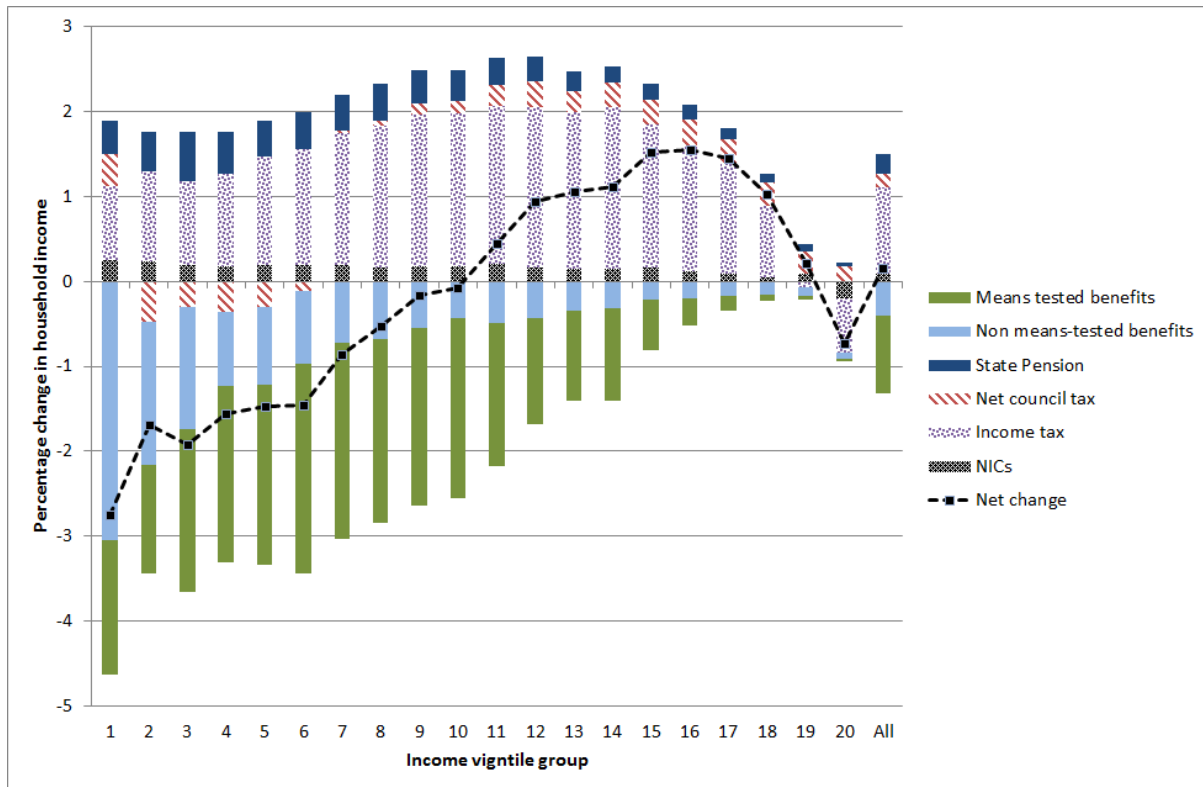
Figure 1.9 models the effect of all Coalition government tax and benefit policy changes from 2010 – 2014/15, taken from de Agostini et al. (2014). It shows average gains or losses from six broad parts of the direct tax and benefit systems, and (as the solid line) the net effect of all of them together. Results are broken down by vignette (twentieths) of the household income distribution.

Overall, tax and benefit changes since 2010 have been regressive over most of the distribution. Benefits have been cut in real terms, whilst income tax changes have benefitted the upper half of the distribution by relatively more than the lower half. Council tax has been frozen in real terms (benefiting the upper two-thirds who pay council tax) although Council Tax Benefit has become less generous, disadvantaging the bottom third². The exception to this general regressive pattern is that the top 2-3 vignettes have done somewhat worse than those in the rest of the top half, and the highest income vignette has actually seen a fall in income on average – this is a result of falling real terms thresholds for the upper and additional rates of income tax, and the withdrawal of Child Benefit from individuals earning over £50,000.

The general message in Figure 1.9 is robust to different assumptions, for example, whether the baseline policy is to uprate all tax thresholds and benefits by inflation or by average earnings. The IFS has also undertaken a distributional analysis of Coalition policy including the effect of changes to VAT and other indirect taxes. This slightly increases the regressivity of tax and benefit changes made by the Coalition.

² In England, Council Tax Benefit was cut by 10%, but the Scottish Government has mitigated the effects of this cut with additional funding.

Figure 1.9: Percentage change in household disposable income by income vingtile group due to policy changes 2010 to 2014-15 compared with May 2010 policies uprated to 2014/15 using CPI



Source: de Agositini et al. (2013)

In addition to the fiscal policy response, the other aspect of the policy response to the recession has been an expansionary monetary policy. The Bank Rate has remained at a historic low of 0.5% since March 2009. And the Bank of England has purchased £375bn of assets through its programme of Quantitative Easing (QE).

Both QE and the low Bank Rate are aimed at boosting nominal spending and achieving the inflation target. But QE in particular has distributional consequences. QE raises asset prices, including government and corporate bonds and equities, and boosts dividend payments (Bank of England, 2012). The larger the share of these types of assets in households' portfolios, the greater the boost from QE relative to reduced interest payments on money held in the form of deposits. The Bank of England (2012) estimates that the total increase in household wealth stemming from the Bank's £325 billion of asset purchases could equate to £600 billion, equivalent to around £10,000 per person if assets were evenly distributed across the population. However, as the BoE itself notes, holdings of these assets are not evenly distributed, but are 'heavily skewed, with the top 5% of households holding 40% of these assets'.

Although we have no way to formally model the impact of QE on incomes across the distribution, it seems clear that, in combination, the effect of direct and indirect tax and benefit changes, together with the effect of QE on asset values, means that inequality of net household income will have increased since the recession. The only two things that have mitigated against this trend are: the real terms increase in pensions spending (which reduces inequality very marginally), and the dramatic fall in real wages, which was clearly not a deliberate policy choice.

Designing policy to address inequality: some considerations

There are a large number of potential complications and trade-offs in designing policy to address inequality. We will touch on these throughout the report, but it is worth flagging up some of the issues here.

Measures of income: Even if we restrict ourselves to income inequality (rather than wealth, or other forms of inequality), there are a number of ways of measuring income. We might consider incomes at individual level, with income including earnings from employment, self-employment, and income from investments or pensions. Alternatively, we might want to consider incomes at household level, adjusting for the number of individuals in each household (equivalisation). We may want to consider incomes before taxes are paid and benefits are received, or after. The measure of income inequality used can make a difference to the conclusion that is reached about the effectiveness of specific policies. For example, a policy to raise the wages of the lowest paid (such as a rise in the minimum wage) is likely to reduce inequality of market income among those in work. But it may actually raise inequality of household net income. This is because of the way that low-pay is distributed among households: many low-paid workers live in households in the middle of the distribution of net household income, and many of the households at the lower end of the income distribution are either workless or work relatively fewer hours – thus these households may benefit less on average than households further up the distribution.

Behavioural effects: For many policy interventions, it is relatively straightforward to assess the impacts of policy on the distribution of income, assuming that behaviours do not change. For example, we can assess the static effect of a rise in income tax on the distribution of net income by assuming that no worker changes their working pattern in response to the tax change. In reality, most policies will induce some form of behavioural change; indeed, behavioural change is often the explicit objective of policy. A rise in income tax may induce some people to work more, and others to work less, leading to a change in the distribution of gross income (it may also lead to an increase in tax avoidance measures). Similarly, employers may respond to a rise in employer NICs or the minimum wage by reducing employment. There is a lot of uncertainty surrounding the estimation of behavioural effects, but behavioural responses play an important role in determining the effectiveness of policy to reduce inequality.

Temporal issues: Most measures of inequality are ‘snapshots’, taken at one moment in time. But individual and household incomes can vary over time. The extent to which incomes are transitory or permanent – and the extent to which households are mobile across the income distribution over time – can change our perspective about inequality. Rising inequality due to increased transitory inequality is consistent with income mobility, perhaps due to greater job turnover, with households being able to smooth income differences over time through borrowing. On the other hand, if rising inequality is due to increased permanent income inequality, then it may have been driven by factors that permanently shift the fortunes of some groups in society. A recent report by the ONS (ONS 2015) found that levels of persistent poverty (defined as being in relative income poverty both in the current year and at least two out of the three preceding years) have tended to be lower in the UK than in most EU countries, suggesting that incomes are relatively mobile for many families in the lower half of the distribution. On a completely different temporal scale, Clark and Cummins (2015)

find that familial wealth is relatively persistent across generations, so much so that there is a significant correlation between the wealth of families five generations apart.

Incomes also evolve significantly over lifetime. From a lifecycle perspective, overall inequality appears somewhat lower than it does if we take a snapshot, and the role of redistribution can be seen in part as achieving a redistribution of income across the lifetime, as opposed to simply redistributing between individuals (Roantree and Shaw, 2014).

The role for the Scottish Government

Tackling inequality is one of the core policy objectives of the Scottish Government. Prior to the Referendum, the Scottish Government frequently made the case that independence would enable it to more effectively tackle inequality. More recently, its new Economic Strategy places ‘Tackling Inequality’ explicitly at the centre of its policy objectives (Box 2).

But what powers does the Scottish Government have at its disposal now for addressing inequality? As Table 1.1 shows, it already has some powers over land and property taxes, and under the Smith Commission proposals, it will gain almost full control over income tax. It has substantial control over public spending programmes, notably on education and early years and on health and social care. It has, or will gain under the Smith proposals, control over benefits including Council Tax Benefit, Disability Living Allowance (and its successor, the Personal Independence Payment) and Discretionary Housing Payment. It remains unclear however how much ability it will have to vary these benefits or target them differently. Finally, the Scottish Government has ‘power’ in relation to moral suasion – its ability to influence the behaviour of firms, organisations and individuals.

There remain a number of areas over which the Scottish Government has only limited, or no control. These include labour market regulation (on the minimum wage, or issues around employment legislation); the broader range of taxes and benefits; product market regulation (competition policy, etc.); capital market regulation (including the financial sector); nor does the Scottish Government have any role in respect of the negotiation of international agreements on taxation or regulation.

It is worth noting that even if it was independent, as a small open economy there is likely to be a limit to the extent that Scotland would be able to exercise the powers on the right-hand side of Table 1.1. Ability to vary levers is constrained by international agreements on taxation and regulation, as well as considerations around international competitiveness.

Table 1.1: Areas for Scottish Government action

Current and prospective powers	No power
<ul style="list-style-type: none"> • Some taxes (property taxes inc. council tax and business rates; and income tax forthcoming) • Some benefits (Council Tax Benefit, DLA/PIP, Attendance Allowance, Carer’s Allowance, Discretionary Housing Payment) • Spending programmes (including health and education) • Moral suasion 	<ul style="list-style-type: none"> • Other taxes • Other benefits • Labour market regulation • Product market regulation • Capital market regulation

Box 2: Scottish Government Economic Strategy 2015

'Tackling inequality' is one of two key pillars of the Scottish Government Economic Strategy, published in March this year. The Strategy recognises the link between inequality and economic growth, and between inequality and opportunity. It states: 'Ensuring that the benefits of economic growth are shared more equally across society is just as important as boosting overall growth... The inequalities that exist between households and between different regions across Scotland prevent individuals and communities from maximising their potential.'

A key part of the Strategy's attempt to address inequality is the 'Fair Work' agenda which encompasses 'job security, fair reward, and opportunities for personal and workplace development.' The Strategy recognises that many of the features of the UK labour market framework are set at UK level, but also that 'there is substantial scope to take a different approach in Scotland'. Identified policies include promoting the Living Wage; establish a Fair Work Convention to promote dialogue between employers, employees and trade unions, public bodies and the Scottish Government on matters relating to 'Fair Work'; and by encouraging a private-sector commitment to a range of business and social policies, including paying living wage, promoting workforce engagement, not using zero-hours contracts and so on.

The Strategy also recognises the importance of longer-term investments in health and education as part of an integrated strategy to promote inclusive growth. It recognises that 'an individual's socioeconomic background can also have a significant impact on their education prospects', and that giving 'all children the best possible start in life is crucial to improved health, social, educational and economic outcomes in later life.' The Strategy's policy relating to education is discussed further in Section 5 of this report.

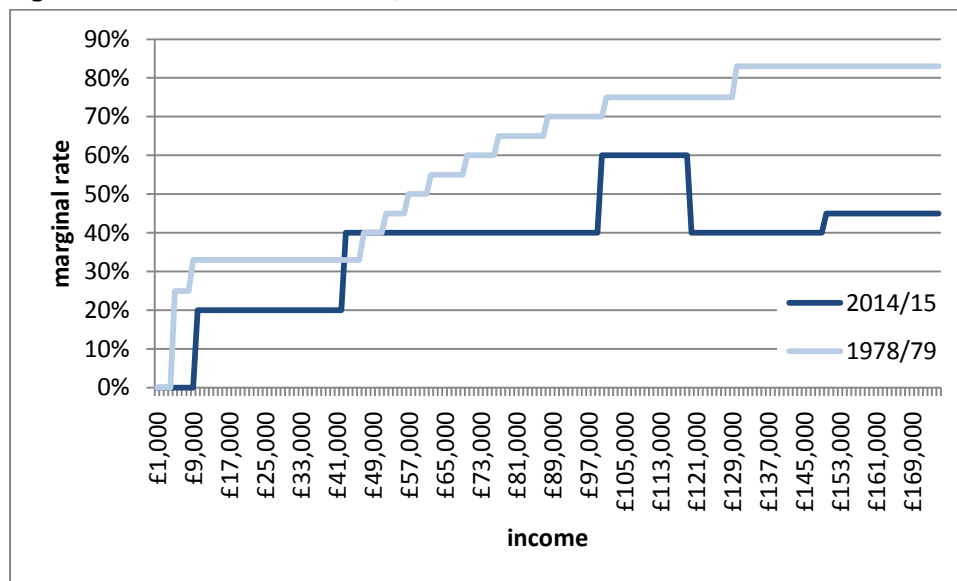
2. Addressing wage inequality at the top

Income tax

Under the Smith Commission proposals, the Scottish Government will gain the ability to vary tax rates and thresholds for non-savings income. What might the Scottish Parliament do with these powers, and what would be the effect on inequality?

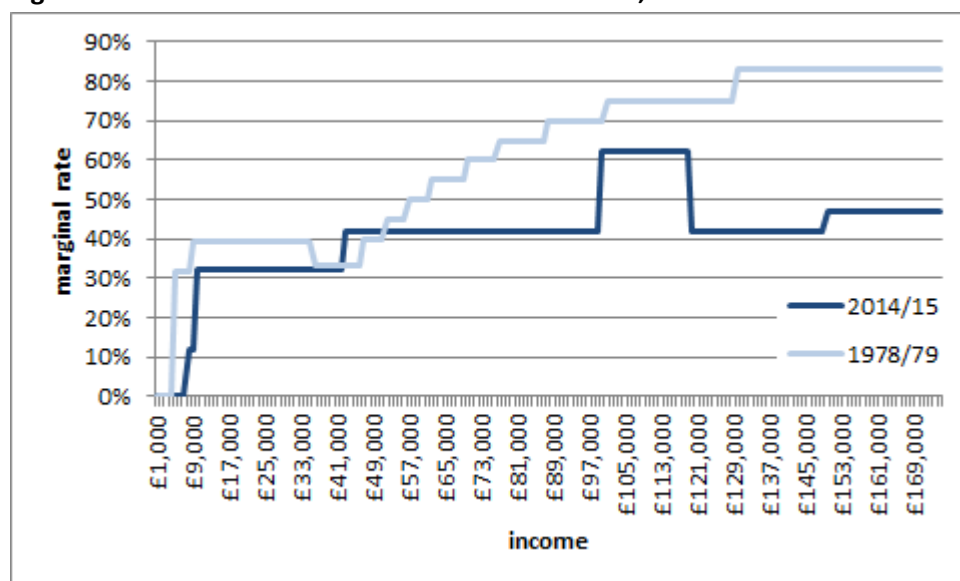
To provide some context to this, it is useful to consider some recent history. Figure 2.1 compares the income tax schedule in 2014/15 with that of 1978/79 (expressed in 2014/15 prices). The present system has a personal allowance of £10,000, a basic rate of 20% on the first £32,000 of taxable income above the personal allowance, and a 40% higher rate. The marginal tax rate of 60% occurs because the personal allowance is tapered away at incomes above £100,000 (a marginal rate of 60% also occurs between £50,000 and £60,000 for those with children, as child benefit is tapered away – see Johnson (2014) for a more in-depth discussion of the income tax schedule), and the additional rate of 45% starts at £150,000. In 1978 the personal allowance was lower and the starting rate higher, but the system was substantially more progressive at incomes above £50,000, with a top rate of 83%.

Figure 2.1: Income tax schedule, 1978 and 2014



The income tax schedule doesn't tell the whole story however, as National Insurance Contributions (NICs) act as a further tax on earnings. As the IFS' Paul Johnson (2014) remarks: 'It is now a common view, accepted by virtually all tax experts outside of HMRC and HM Treasury, that NICs are no more than an additional tax on earnings. There is just the slightest relationship between whether they are paid and rights to some benefits. There is almost no relationship at all between how much is paid and rights to anything. They are a tax.' But as politicians have increased the income tax personal allowance and reduced basic rate income tax, they have tended to increase NICs. Employee NICs were 6.5% in 1978/79; they now start at 12%. The combined income tax and employee NICs schedule is shown in Figure 2.2.

Figure 2.2: Combined income tax and NICs schedule, 1978 and 2014



Given this context, what policy options does the Scottish Government have? The first point to note is that small changes to the existing tax system are unlikely to have substantial impacts on the distribution of household net income. Comerford and Eiser (2014) for example show that raising the basic rate to 21p would reduce the Gini coefficient by less than a fifth of one percent, while raising the higher rate to 41p would reduce the Gini by less than a tenth of one percent. To put this in context, Scotland’s Gini coefficient is five percentage points higher than the Nordic countries, so these policy changes are closing less than 5% of Scotland’s inequality gap.

Nicola Sturgeon has expressed support for the idea of raising the additional rate of tax from 45% back to 50% (the additional rate was introduced at 50% in April 2010, having been announced by Alasdair Darling in the 2009 Budget, before being reduced by George Osborne in the 2013 Budget). From a static perspective, this would have a fairly marginal effect on inequality as only 0.5% of income taxpayers in Scotland (0.3% of the population) pay the additional rate. However, there might still be a rationale for increasing top tax rates if that changes the distribution of pre-tax income.

Most countries have reduced top rates of income tax since the 1980s. But the UK and US have reduced top rates more significantly than most other countries. Piketty et al. (2014) show that there is a strong correlation across countries between reductions in top tax rates and the growth of pre-tax income inequality – the income share of the top 1% has grown most in countries which have cut top income tax rates most. Atkinson (2015) also shows that this relationship holds within the UK over time – the share of income going to the top 1% in the UK fell throughout the first half of the 20th century as the top income tax rate increased; it then increased markedly during the 1980s and 1990s as the top tax rate was reduced.

Thus there is some evidence that changes in rates of income tax can affect inequality not only because of the static effect on net (after tax) incomes, but also because of the effect on market (pre-tax) incomes. There are two potential explanations for this: one is that lower top tax rates encourage work effort and business creation among the most talented; another is that lower top tax rates

might simply increase the incentives for high-paid individuals to bargain for higher pay. In the first case the increase in top incomes reflects ‘work effort’, which may stimulate wider economic growth which could be inequality reducing, whereas in the second case the increase in top incomes comes purely from top earners taking a larger share of the pie (rent-seeking), unambiguously increasing inequality. Piketty et al. (2014) find evidence that the second effect dominates, implying that top rates of income tax could be increased without detrimental effects on economic growth.

How high could top rates of income tax be? Piketty et al. (2014) have suggested top rates could return to the pre-1980s levels of 80% without detrimental effects on growth; Atkinson (2015) has proposed a progressive rate schedule for the UK increasing in steps up to 65%. Such high rates are not on the political agenda currently. Indeed, even Nordic countries – which have not reduced top tax rates nearly as much as most others in recent decades - do not have income tax rates above 57% (Table 2.1). But what distinguishes these countries is that the top rates start much closer to average levels of income – and thus affect a far greater proportion of taxpayers – than is the case in the UK (Table 2.1). So Nordic countries have only slightly higher top rates of tax, but they have higher average tax rates throughout the income distribution, which, as we have seen, was also the case in the UK 30 years ago. This suggests that a more progressive system of income taxation in Scotland would involve not simply an increase in the additional rate, but the additional rate starting lower down the income distribution – a higher average income tax rate.

Table 2.1: top marginal tax rates in UK and Nordic countries

Country	Top marginal tax rate	Threshold at which top rate is payable, expressed as multiple of average wage
UK	47	4.2
Finland	57	2.5
Sweden	57	1.5
Norway	47	1.6
Denmark	56	1.2

Notes: top marginal tax rate is the ‘all-in’ rate (i.e. combining personal income tax and employee social security contributions) paid by employees. Source: OECD tax database

The usual objection to a proposed rise in the top rate of income tax is that top earners will simply reduce their income in response, with the result that the policy would be unlikely to raise any additional revenue for the Scottish Government, and may even reduce government revenue if we are already at the top of the ‘Laffer curve’. The Laffer curve measures the relationship between income tax rates and government revenue. The supposition is that it is inverse-U shaped – at low levels of tax rates, increasing the tax rate would lead to additional revenue, but above a certain point, further increases in the tax rate would lead to falling revenues as a result of behavioural responses to increased tax rates.

The behavioural responses that cause revenues to fall beyond a certain point may include working less (either in terms of hours worked, or some other measure of effort), engaging in more tax avoidance or evasion, or a reduction in rent-seeking by higher earners. There is significant uncertainty in what the revenue-maximising tax rate might be, not least because different people respond differently to tax rate changes, and these behavioural responses are difficult to observe.

HMRC (2012) shows that the revenue maximising top tax rate in the UK could lie anywhere between 42% and 57%, with a core estimate of 48%.

The behavioural responses of top taxpayers to changes in top tax rates was discussed in a series of papers during a special session of the 2015 Royal Economic Society Conference. Manning presented evidence that there is little credible evidence of a labour-supply response to changes in top tax rates, either in terms of hours worked or more nuanced measures of work 'effort'. But there is clear evidence of an avoidance effect, i.e. when top tax rates increase, high earners put more effort into avoiding tax. This point was also made by Kleven in comparing the Danish and US experiences to changing top tax rates – US incomes appear much more sensitive to tax changes than Danish incomes, but this is largely because there is much greater scope for avoidance in the US; the US system, like the UK's, is characterised by a narrower definition of the tax base, with significant scope for exempting certain income from tax.

Blundell et al. reiterated this point by presenting evidence of the effects of the introduction of the 50p tax rate in the UK. Top earners were able to forestall (bring forward) a significant proportion of their earnings to avoid paying the additional rate tax when it was introduced. Importantly however, employment income was relatively insensitive to changes in the tax rate, with the behavioural response largely coming through dividend income.

This is clearly of relevance given that it is only employment income that is proposed for devolution to Scotland under the Smith proposals (although the highest earners may be able to reclassify employment income to dividend income relatively easily). The danger of course for Scotland is that the responsiveness of top earners to changes in tax rates would be particularly high if those tax changes are not matched in rUK. Research suggest that higher tax rates may discourage in-migration of high-skilled workers from overseas, but have a relatively small effect on out-migration of nationals from the country of residence. It is less clear whether these findings are applicable in a Scottish context (i.e. to a region within a country).

However, it is also worth noting that differential tax rates exist within many federal countries. In Canada for example, income tax is shared between the federal and provincial governments, with each level of government setting a rate. Different provincial governments set different tax structures. British Columbia for example sets rates of between 5% and 17%, with the result that residents in BC pay a combined (federal plus provincial) tax rate of between 20% - 46%. Neighbouring Alberta sets a largely flat tax of between 10-11%, with the result that residents pay a combined rate of between 25-29%. The system works because of strict rules on residency.

This discussion focuses on the very highest earners, but what might be the behavioural effects of higher average and marginal tax rates lower down the distribution? Proponents of increasing tax rates would again point to the Scandinavian countries, and argue that those countries have higher average rates of taxation whilst simultaneously having higher rates of employment participation and economic growth. However it remains unclear whether this is possible largely because of a particular set of cultural values or norms in these countries that do not exist in Scotland; or whether Scottish taxpayers would tolerate higher tax rates if they could see the benefits in relation to improved public services. Again, the importance of broadening the tax base and reducing the scope for avoidance would be critical in determining the success of the policy. These are of course issues for the

Westminster Government rather than the Holyrood Government, but Scottish MPs can play a role in making the case for a simplification of the tax code.

Other policies to address top-end earnings inequality

There are other ways to influence the distribution of pay at the top of the income distribution other than through income tax.

Publication of pay ratios

One idea is to encourage employers to disclose the ratio between the highest paid and median or lowest paid employees in their organisations (proposed in the LibDem election manifesto). Although this may appear a ‘tame’ policy in that it doesn’t necessarily entail change in the distribution of pay, there is evidence that many people have a woefully inadequate perception of their own place in the income distribution. Top-earning CEOs over-estimate the number of people who earn as much or more than they do, while the lower paid similarly underestimate the number of people who earn more than they do. Toynbee and Walker (2009) for example asked high earning London-based lawyers and bankers about their perceptions of the income distribution. The lawyers and bankers over-estimated by a factor of four the income required to be in the top decile, and estimated that the poverty line would be just under median pay.

This ‘self-centred bias’ implies that an individual’s beliefs about the rest of the population depend on his or her own position in that distribution. In this respect, publishing information about the distribution of pay within organisations could play a useful role in moderating pay-demands at the top, as well as empowering workers lower down the distribution to push for pay increases. Although the Scottish Government cannot insist on the publication of such data by any one organisation, it could exert significant leverage on businesses as part of its proposed ‘Fair Work Convention’, particularly in the case of public sector employers in Scotland.

Another way to moderate within-firm pay inequality may be to promote business models based on employee ownership and control (a role already played by Co-operative Development Scotland). Employee ownership may moderate the variance of within-firm pay (although the pay policy adopted by John Lewis is that the company director should not be paid more than 75 times the average salary (Atkinson, 2015), which is arguably not particularly restrained).

Reforming the structure of remuneration committees

Related to this is the idea of giving worker representatives a seat on remuneration committees, a policy which Labour committed to in its election manifesto. Again, the idea would be that this would moderate pay increases at the top. Evidence from behavioural economics and psychology suggests that the act of communicating with people causes us to treat them more generously, but we treat people more meanly if we haven’t communicated with them. This observation has been used to explain why remuneration committees are happy to endorse CEO pay increases whilst simultaneously freezing other workers’ salaries.

Improving competition

Recent research using data from British firms shows that within-firm wage inequality is increasing in firm size (Mueller et al. 2015). In other words, inequality is greater in bigger firms. Economies of

scale allow larger firms to be more productive than small firms, but these benefits of scale are not shared equally among all workers.

The authors suggest two possible explanations for these findings. First, larger firms should find it easier to automate tasks than smaller ones, and may therefore find it easier to resist demands for pay rises from relatively unskilled workers who could be replaced by machines. In addition, entry-level workers in the middle of the income distribution may be willing to accept lower pay from big firms since in the long run the chances of winning a promotion are greater than at small firms.

The relationship between firm size and inequality is important because, over time, the proportion of workers employed in the largest firms is rising. Indeed, across countries, there is a correlation between the increase in the proportion of workers in the largest firms, and the rise in inequality (countries experiencing a smaller increase in employment share of large companies are also those which have seen a lower increase in inequality).

Small firms often face barriers to entry in markets dominated by larger incumbents. Policies to reduce barriers to entry in these markets may therefore help to address inequality in the longer run. A key intervention in this respect is likely to include improving access to finance for SMEs and start-ups. This can include raising awareness of the opportunities available through alternative sources of finance, such as peer-to-peer lending and crowdfunding. Although the opportunities created by such funding sources are large, many SMEs lack awareness about what the opportunities are and how to access them. Policy to reduce barriers to entry can also consider where market regulation creates unnecessary barriers to entry, but there is clearly a delicate balance to be struck between improving competition on the one hand, and protecting necessary regulation on the environment, food safety, privacy, etc., on the other hand.

Summary

The extent to which income tax is an effective tool to address income inequality depends on the extent to which rises in top rates will alter the distribution of market (pre-tax) incomes in non-distortionary ways. If rises in top tax rates reduce in-migration of skilled migrants, or disincentivizes entrepreneurship, then the effect of higher tax rates may largely be to reduce long-run economic growth, with ambiguous effects on inequality. But if top incomes reflect rent-seeking, then taxing them more may achieve a more equal distribution of pre-tax incomes without detrimental effects on growth.

The effect of tax rises on revenues depends in part on how broadly the tax base is defined. This is an issue for the UK Government rather than the Scottish Government. It also depends on how mobile incomes are between Scotland and rUK, if tax rises in Scotland are not matched by the Westminster Government. The international evidence is not conclusive on this point, but it seems likely that employment income is not as mobile as is often assumed.

Non-tax mechanisms for reducing pay inequality at the top may include adopting a more transparent and inclusive approach to wage-setting.

At UK level there are likely to be many other policies which could be implemented to address excessive income growth at the top. We do not cover these policies in any detail in this report (which is focussed on the powers of the Scottish Government), but they could include issues such as

financial sector regulation and pay-setting including the taxation of bankers bonuses; competition policy; taxation of inheritances; and the tax treatment of pension contributions.

3. Policies to help the low-paid

The OECD (2015) argues that it is the gap between the lowest earners and the rest that is largely behind the fact the inequality creates a drag on growth. Addressing inequality at the lower end of the income distribution is thus important from a dispassionate perspective, notwithstanding any moral arguments.

A favourite mantra of politicians from all sides of the political spectrum is that employment offers the best route out of poverty. The reality is slightly different. Of all working age adults living in poverty in Scotland in 2012/13, some 52% were in 'in-work poverty', i.e. they were living in households where at least one member of the household worked at least part-time. This proportion has increased slightly since 1998. Of children living in poverty, 59 per cent were living in families where at least one adult was in employment, and this proportion has increased quite significantly (from 40%) since 1998 (this is in part due to the fact that the benefit system now exerts greater pressure on families with children, particularly lone parents, to enter employment, and provides greater in-work support through tax credits as compensation for taking low-wage work).

How should we define low-pay? One measure of low-pay is to consider people who earn less than the living wage as being low-paid. The living wage is an hourly rate of pay that has been identified as the amount an individual needs to earn to cover the basic costs of living and to achieve an agreed minimum income standard. Around one fifth of workers in Scotland earn less than the Scottish living wage of £7.85.

To an extent, low-pay reflects low productivity. But low-pay increasingly reflects a shift in the bargaining power of workers relative to employers. Workers have increasingly seen their bargaining power eroded as a result of deunionisation, the decline in the use of national pay-scales, outsourcing of activities to smaller employers that are harder to regulate, increased use of very flexible contracts, and so on. Another important source of the decline in worker bargaining power is the increasing use of conditionality and sanctions in the benefit system. This is one of the factors behind a rise in the proportion of new hires that are from non-employment rather than from other jobs; as Manning (2015) points out, when an employer's latest hire is from non-employment there is no other employer to compete directly with.

But low pay is a function of hours worked as well as the hourly wage. The Living Wage is calculated on the assumption that workers work a fairly standard full-time job. In reality, an increasing amount of work is non-standard. In recent years there has been a significant increase in the proportion of jobs that are part-time and the number of temporary positions. An increasing number of jobs also offer workers variable hours from week to week, often through 'zero-hours' contracts, or by compelling workers to become self-employed. A clear example of the latter effect was when the delivery firm City Link went into administration in 2014 and it emerged that around one quarter of its 4000 drivers were self-employed; the use of so-called 'bogus self-employment' seems to be on the rise in a number of sectors.

Tackling low-pay is thus at least in part about redressing the balance of power between workers and employers. This view is likely to sound unattractive to some, but it can be justified if employers' market power is such that workers in some sectors are paid less than their productivity. Indeed, in such cases, improving worker conditions through improved pay or more secure contracts is likely to

increase productivity, generating benefits for the employer. There is likely to be a role here for improving the scope for collective wage bargaining, particularly in sectors (such as social care) where the prevalence of low-pay is high, and the public sector plays a key role in procurement.

Labour market regulation is generally a reserved matter for the UK Government. But the Scottish Government can play a role in mobilising support for reform, encouraging best-practice, and making the case for reform of UK policy at Westminster.

A further point on income tax

The previous section discussed the possibility of income tax change as a way of mitigating wage inequality at the top. It is worth briefly discussing the role of income tax in addressing inequality at the lower end of the income distribution.

Politicians of varying hue seem keen to further raise the personal allowance. (Under the Smith proposals, the Scottish Government cannot vary the Personal Allowance, they can effectively raise it by setting a starting rate of tax at 0%.) The Coalition Government has raised the Personal Allowance (PA) from £6,475 in 2010/11 to £10,500 in 2015/16. This has taken 2.4m people in the UK out of income tax (Adam, 2015). However, the policy is not as progressive as politicians sometimes claim, given that a rise in the PA acts as a tax cut for all individuals earning above the allowance (other than for those earning over £100,000, from whom the PA is withdrawn). The further the PA is increased in real terms, the less progressive future increases become. The lowest paid 17% of workers are already below the PA and thus pay no income tax; consequently, IFS analysis shows that a rise in the PA from £10,500 to £12,000 would be regressive: households in the middle and upper deciles would see their incomes increase by relatively more on average than those in the bottom half of the distribution.

Thus rises in the PA are not a particularly effective policy in reducing inequality (although, if employee NICs were devolved to the Scottish Government, raising the NICs threshold to align it with the PA would be a more sensible policy; the employee NICs threshold is currently £7,600, far below the £10,500 threshold for income tax).

Minimum wage and living wage

The national minimum wage (NMW) was introduced in the UK in 1999. Despite fears that it would cause unemployment, research to-date suggests that it has not. But at least two studies, using different methodologies, have found that the NMW has reduced wage inequality. Dolton et al. (2012) exploit geographical and temporal variation in the 'bite' of the minimum wage (i.e. the fact that there is variation over time and across space in the level of the NMW relative to the median wage) to show that the NMW has reduced lower-tail inequality in each year since its introduction. Butcher et al. (2012) exploit variation in the proportion of NMW-affected workers by sector to show that as much as 40% of the reduction in the 50/10 wage ratio between 1998-2010 can be ascribed to the NMW.

The SNP has called for devolution of powers over the minimum wage, both in their election manifesto and in subsequent announcements. In many ways there is a good case for devolving the minimum wage within the UK. Wages vary substantially across the country, so a national minimum has very different effects in London than in Wales. And a large proportion of minimum wage employees work in 'non-tradable' service sectors such as retail, care and personal services which rely

on face-to-face transactions and thus cannot easily be transferred away from the customer base. Indeed, US and Australian States, and Canadian Provinces, have the power to set a higher minimum wage than that mandated by the national government.

But what scope would there be to raise the minimum wage in Scotland, if it was devolved? One way to think about this is to consider the 'bite' of the minimum wage, where the bite is the minimum wage as a percentage of the median wage for a full-time worker. In 2014, the NMW of £6.50 was 49% of the median FT Scottish wage of £13.23. The minimum wage in Scotland is broadly average in relation to international comparators (OECD, 2015). In Germany, Netherlands and Ireland, the bite of the minimum wage is also around 47-48%. In the US, the bite of the minimum wage varies from 31-57% across cities and States (Dube, 2015). The minimum wage bite in Australia is higher, at around 54%. Of European countries, France has the highest bite at 62%. Scandinavian countries do not have a statutory minimum wage; instead they have far more comprehensive collective wage bargaining arrangements across industries.

A recent review of the NMW in the UK recommended that the medium term ambition for the NMW should be for it to reach 60% of the UK median wage, as this level would be unlikely to have negative employment effects (Bain et al., 2014). But the Committee was explicit that the 60% target refers to the median wage for *all* workers, not just FT workers (the median wage for all workers in Scotland is £11.76 compared to £13.23 for FT workers only).

On this basis, if the minimum wage was devolved to Scotland and a similar level of ambition were applied, it might be argued that there is scope for a small increase in the minimum wage in Scotland without major negative employment effects: 60% of Scotland's median is around £7.06 (equivalent to 54% of the FT median). (If the minimum wage was devolved to Scotland, responsibility for recommending a level for it would presumably reside with a committee with employer and employee representative organisations, along the lines of the UK Low Pay Commission). But regardless of the specific level of a Scottish minimum wage, there are at least a couple of complications.

First is the interaction with working tax credits (WTC), assuming WTC remain reserved at Westminster. For workers currently eligible for WTC, a higher minimum wage will, in some cases, shift some of the costs of their employment from the government (via reduced WTC payments) to the employer. But the benefit in terms of reduced WTC expenditure (and higher national insurance contributions) will flow to the Westminster Government. (These arguments will also apply to Universal Credit, once it has replaced WTC.) If a strict interpretation of the Smith Commission's 'no detriment' clause is applied, the Scottish Government might argue that it should receive some form of transfer payment from Westminster to reflect the value of the Exchequer saving.

The second complication is the extent to which the higher minimum wage would address poverty. As already noted, not all of the benefits of a higher minimum wage are likely to be felt by employees, as some of the effect is simply to transfer costs from government to the private sector. More importantly, a large part of the reason why rates of in-work poverty are increasing is because of the growth in part-time, temporary and insecure working arrangements which mean that many employees are not working the hours they would like; increasing hourly pay can only go so far in addressing this problem. It is also worth noting that around a third of low-paid workers live with

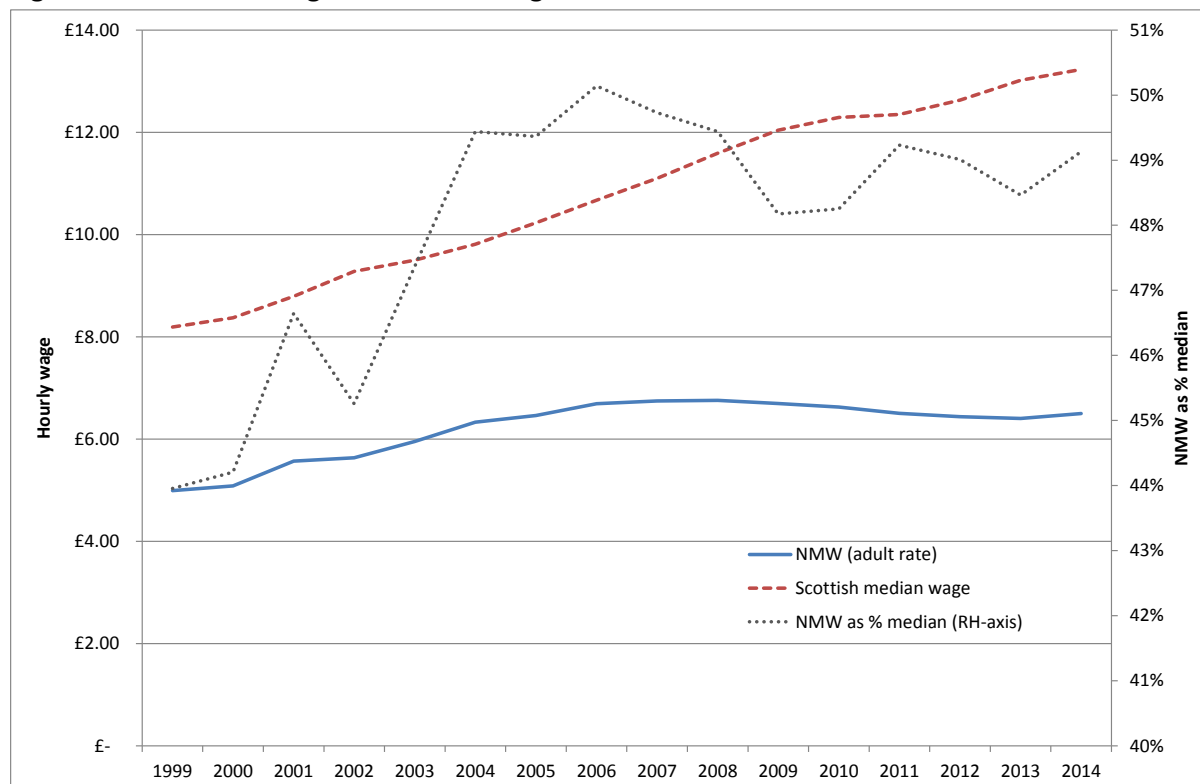
partners who are not low paid, thus a higher minimum wage doesn't only benefit the lowest-paid households.

In reality, the level of a sustainable minimum wage is likely to vary from one sector to another, and from one employer to another. The Scottish Government has a role in engaging with employers to encourage fair pay where this is sustainable. It is already doing this through the adoption and promotion of the Living Wage. Its target is to have 500 accredited Scots Living Wage employers by March 2016. This is more ambitious than it sounds, as accreditation requires not only that the employer pays its own staff the Living Wage, but that contractors and suppliers also pay the Living Wage. To date, 200 employers have been accredited. The Scottish Government hopes that momentum will grow, particularly as high-profile organisations gain accreditation.

There is however likely to be a limit as to how many employers will commit to pay the Living Wage under a voluntarist approach. At £7.85 per hour, the Living Wage is set at 67% of the Scottish (all worker) median wage. Is there any way in which employers could be more directly incentivised to pay the Living Wage?

In its manifesto, the Labour Party proposed to incentivise firms to pay the living wage by offering a tax rebate to Living Wage accredited employers. Under the proposal, employers that increase the wages of all their workers to the Living Wage or higher and become accredited Living Wage employers in the first year of a Labour government would receive a tax rebate for one year, equal to 32p for every £1 increase in wages up to the level of the Living Wage (the rebate would not be available to employers who already pay the Living Wage to all employees). This type of incentivisation strategy is not an option for the Scottish Government under current devolution plans, but it may wish to consider how it might operationalise such a scheme in making the case for further fiscal devolution. However, it is extremely difficult to anticipate the revenue implications of such a policy (would the costs of the rebate be outweighed by increased employer NICs and reduced expenditure on tax credits, and to what extent would benefits persist beyond the first year of the temporary tax rebate?)

Figure 3.1: Minimum wage and median wage in Scotland



Source: Annual Survey of Hours and Earnings

A low-wage strategy

One of the potential risks of a higher minimum wage, or Living Wage, is that it results in a greater proportion of employees paid at the minimum, and less scope for progression on the job. Thus there is a need for a broader low-pay strategy which encourages employers to identify progression routes and invest in training. Linked to this, there is potentially scope to improve ‘jobmatch’ – inappropriately matching employees to jobs is one factor contributing to a ‘low pay – no pay’ cycle that affects around 5% of the workforce. Under the Smith Commission proposals, the Work Programme will be devolved to the Scottish Government, and this may provide scope to learn from the implementation of the Work Programme since its introduction in 2011. Finally, the low-pay strategy should identify how more support can be provided to people who are out of work, particularly the young, mothers, and those made redundant from declining industries, to ensure that skills are not lost and training opportunities are offered which fit with available opportunities and individual aspirations. These objectives will be enabled through better integration of employment and skills services, and in this respect, the devolution of the Work Programme should help facilitate this integration.

Legislative change

There are likely to be real limits to voluntarist approaches to tackling low-pay. As Philpott (2015) notes, there is ‘a lot of rhetoric about spreading the business case for “making bad jobs better” – a laudable aspiration that falls prey to the logical fallacy that organisations with low-road business models can somehow be persuaded to adopt high-road human resources practices.’

There is therefore likely to be a role for legislation in addressing some of the issues around job security discussed above. The Scottish Government cannot pass legislation in this sphere directly,

but Scottish MPs may be able to influence the passage of legislation through Westminster. While not wanting to dwell overly on this issue in this report, here are two areas where legislation may be beneficial:

- The Onshore Employment Intermediaries legislation was passed in April 2014 in an attempt to close some of the loopholes around ‘false’ self-employment, but new loopholes are already emerging through ‘umbrella companies’.
- The Zero Hours Contracts Bill 2014/15 was introduced as a private members bill, but was prorogued in November 2014 prior to the election.

In-work benefits

Given the likely limits of the minimum wage or Living Wage in fully addressing low-pay, particularly given the prevalence of ‘non-standard’ work, there is a clear ongoing need for taxpayer subsidy to support the incomes of the working poor. In-work tax credits are not currently devolved to the Scottish Parliament, but they may become so in future, and there may be scope for Scottish MPs to influence their design in the interim.

There is a general debate as to whether the wages of the working poor are best supported as currently in the form of a system of means tested tax credits, or through a universal guaranteed basic income. In the near future, the Conservative Government clearly favours the former, and plans to introduce Universal Credit, a new means tested benefit which brings together six existing in and out of work benefits.

There may be scope to improve the design of UC by strengthening work incentives for some groups. In the immediate term however, the obvious danger is that the Conservative Government will simply cut spending on Universal Credit as part of its manifesto commitment to reduce welfare spending by £12.5bn. If cuts are focussed on in-work support (for example by reducing the work allowances – the amount of money a household can earn before benefits are withdrawn), this is likely to increase the prevalence of in-work poverty.

Summary

There are unlikely to be easy solutions to the problem of low-pay, especially given the way that patterns of work are changing, influenced by globalisation and technological change. But it is clear that more can be done to influence the balance of power between workers and employers.

At UK level, there is likely to be a role for employment regulation and legislation, combined with scope for a strengthened minimum wage. Retaining and strengthening the incentives inherent in in-work benefits is also important in limiting the rise of in-work poverty.

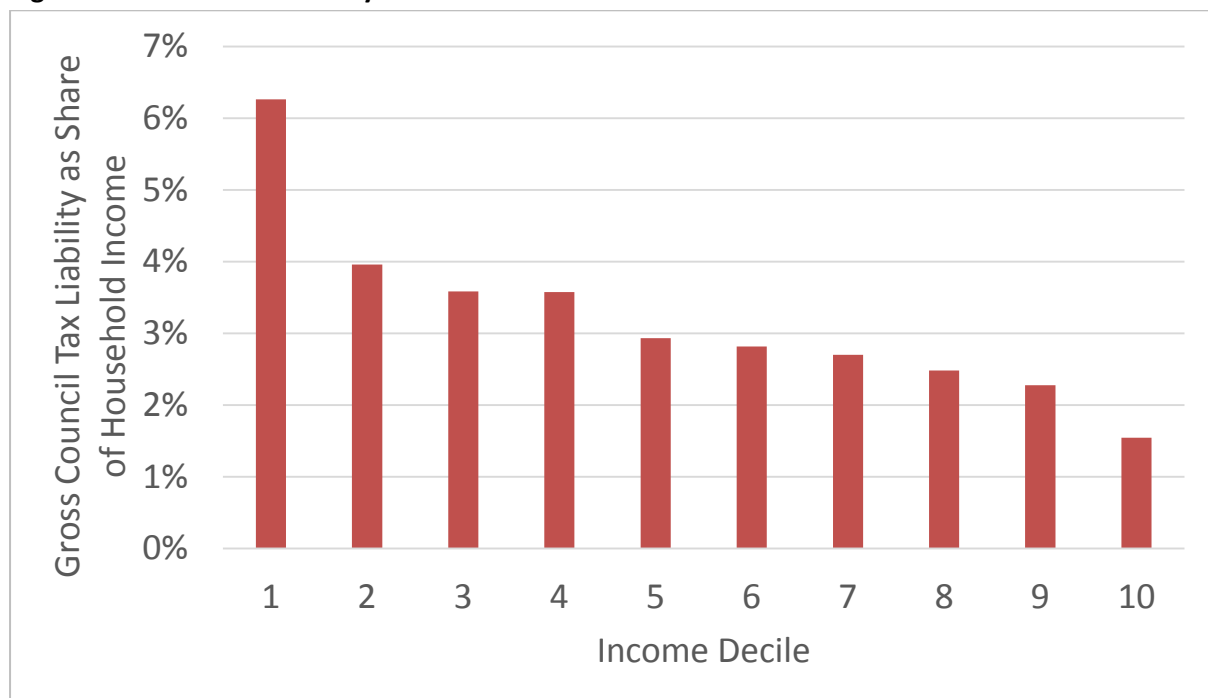
Currently, much of what the Scottish Government can do relies on the influence and moral suasion it can exercise over employers. Its Fair Work Convention could provide an effective mechanism for this to happen, as long as it is based on genuine partnership and that there is an element of conditionality on employers for taking part (i.e. support to employers from government agencies is in some way contingent on participation in the Convention). In the longer-term, it would be hoped that the Convention can catalyse a resurgence of industry-level wage bargaining arrangements, particularly for those sectors which rely heavily on public sector procurement and/or where wages are low.

4. Land and property taxation, and housing markets

Land and property taxation in Scotland is under the control of the Scottish Government. The fact that the supply of land and property is both relatively insensitive to price (which means it can be taxed without distorting behaviour), and fixed geographically, makes it a good tax base for devolved government or local authorities to control.

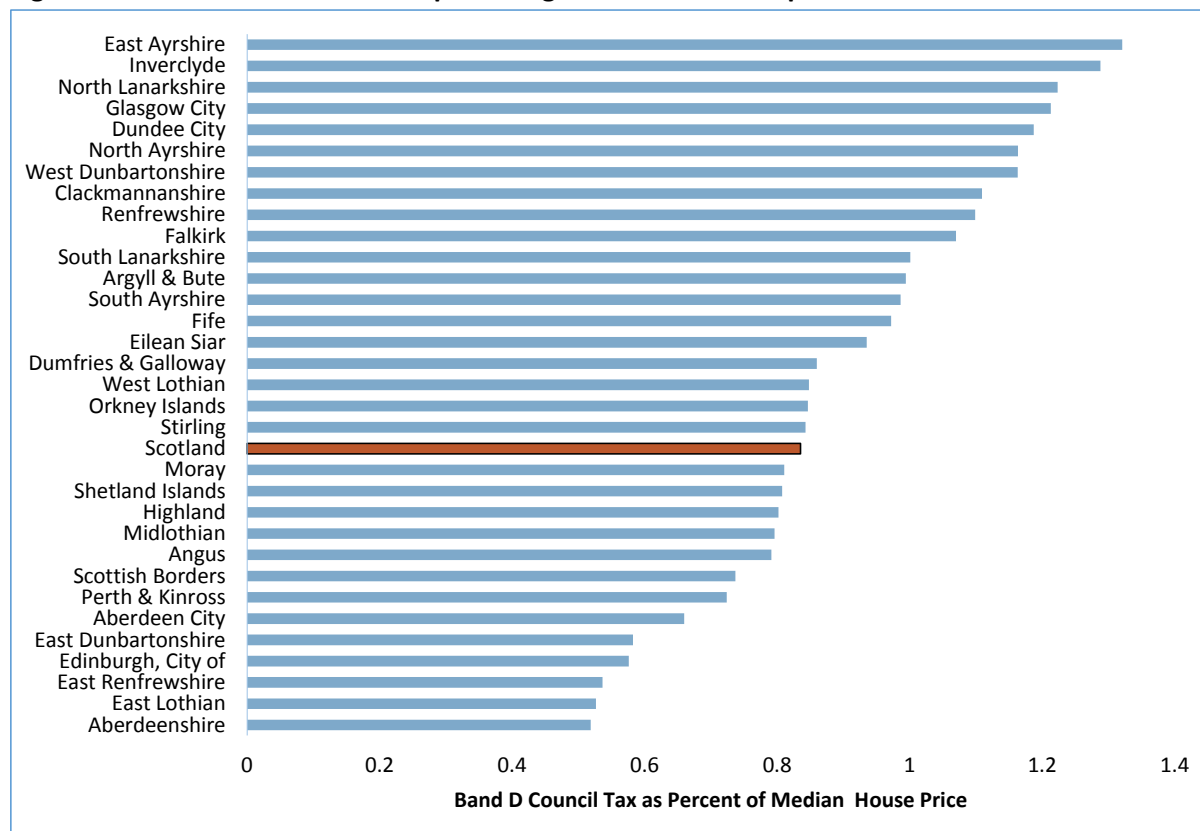
The existing taxation of land and property is however flawed. Council tax is regressive (Figure 4.1). It is also poorly related to house price, even at local authority level (Figure 4.2). Stamp Duty (and its successor in Scotland, the Land and Buildings Transactions Tax) is inefficient in that it dissuades people from making beneficial transactions, and the whole system is biased in favour of the acquisition of property as an asset. This bias in favour of owner occupation is a contributing factor in significant house price increases (which embed intergenerational housing and wealth inequalities), deprives investment in other parts of the economy, and has a number of other undesirable economic side effects.

Figure 4.1: Council tax liability as a share of household income



Notes: Does not show the effects of Council Tax Benefit. Source: Understanding Society

Figure 4.2: Band D Council tax as a percentage of median house price



The taxation of business property through Non-Domestic Rates (NDR) is also undesirable from an economic perspective, as business property is an input to the production process. Furthermore, NDR encourages the inefficient use of land, as underused or undeveloped sites are either not taxed or taxed at a reduced rate. It would be far more desirable to have a tax on land value. In this section however, we focus on reform of taxation of housing land and property, rather than business property.

In thinking about how housing should be taxed, it is important to recognise that housing has two attributes that are relevant for tax design (Mirrlees et al. 2007):

- First, housing provides a flow of services which should be taxed in the same way that consumption of other types of goods and services are taxed;
- Second, housing provides an asset for homeowners, the value of which can go up or down.

Taxation of the consumption value of housing

At present, the ‘consumption value of housing’ is taxed through Council Tax. The limitations of council tax are well known, and include:

- Council tax is regressive³, charged at a lower percentage of property value for high value properties than for low value properties (the structure of council tax bands themselves is regressive, and furthermore there is no variation in council tax bill within each band);

³ That council tax is regressive is partly because it is trying to do two things. On the one hand it is a ‘benefit tax’, reflecting the value of local authority services that each household consumes (and which do not rise proportionately with property value); on the other hand it is partially based on the ‘ability to pay’ principle.

- The discounts for single people, second homes and unused homes encourage inefficient use of the housing stock;
- It is based on property values in 1991, favouring properties that have seen disproportionate rises since then.

There is thus a strong case for replacing council tax with a tax on the annual flow of housing services. The Mirrlees Review proposed a Housing Services Tax, a proportional tax on property values. Most local governments in the US impose a property tax, typically based on a constant tax rate applied to a specified proportion of the market value of the property (Atkinson, 2015), and similar tax structures are also applied in the Netherlands and Denmark (Oxley and Haffner, 2010) among other countries.

There is some debate as to whether such a tax should be based on (up to date) property values, or land values. There is certainly some merit in a national system of land value taxation that would cover all land in Scotland (Wightman, undated), although, given the practicalities in establishing such a system, a tax based on property values may be a more practicable first step.

One objection to a more proportional system of property taxation is that individuals who are ‘asset rich but cash poor’ may find payment difficult. A solution would be to allow payment of the property tax in the form of an equity stake in the value of the house.

The Mirrlees Review estimated that a tax of 0.5-0.6% of property value would provide a revenue neutral alternative to council tax in England. Clearly there would be a significant number of ‘winners’ and ‘losers’ from any new system. In the case of a land value tax, Wightman (undated) shows that a land value of tax of 3.16% would provide a revenue neutral alternative to Council Tax in Scotland. As shown in Table 4.1, such a tax would result in properties in council tax bands A-D (75% of properties in Scotland) being better off on average, but properties in bands E-H being worse off, in some cases significantly so (properties in Band H would see their bills almost triple on average). The political aspects of reform would be difficult, and some kind of transition arrangements would presumably be necessary.

Table 4.1: Council tax compared to a Land Value Tax of 3.16%

Band	Current total CT	% of total	LVT total @ 3.16p/£	% of total	Council Tax	Land Value Tax	+/-
A	£399,528,234	15.6%	£268,070,342	11.1%	£766	£513	- 32.9%
B	£503,998,811	19.6%	£358,780,982	14.8%	£894	£636	- 28.8%
C	£380,088,060	14.8%	£304,157,274	12.6%	£1,021	£820	- 20.0%
D	£342,927,083	13.3%	£315,162,667	13.0%	£1,149	£1,056	- 8.1%
E	£429,204,672	16.7%	£433,055,773	17.9%	£1,404	£1,415	+ 0.9%
F	£279,103,062	10.9%	£320,989,760	13.2%	£1,660	£1,908	+ 15.1%
G	£207,355,350	8.1%	£351,994,719	14.5%	£1,915	£3,261	+ 69.7%
H	£26,538,346	1.0%	£70,449,882	2.9%	£2,298	£6,153	+ 165.5%
Total	£2,568,743,618	100%	£2,422,661,399	100%	n/a	n/a	n/a

Source: Wightman, *A land value tax for Scotland: fair, efficient, sustainable*. <http://www.andywightman.com/docs/LVREPORT.pdf>

To summarise, there are strong grounds for replacing the existing council tax with a proportional tax on property value. How high this tax should be set is a matter for debate. A relatively low rate would be revenue neutral in respect of existing council tax revenues. There is a case for a higher rate, both on the grounds that a higher rate is unlikely to be distortionary, and because of theoretical grounds

for taxing the consumption value of housing at the same rate that other types of consumption are taxed. This latter argument would imply a tax equivalent to 20% (i.e. the rate of VAT) of the annual rental value of the property, regardless of whether the property is rented or owner-occupied. This criteria would imply a higher tax rate on property value than the 0.5-0.6% revenue neutral rate. But it would raise a somewhat separate question as to whether such a tax should be wholly under the control of local government, or split between central and local government.

It is worth noting that Labour and the SNP have proposed the introduction of a 'mansion tax' in their election manifestos. For Labour, this would be a tax on properties worth over £2m, with an additional charge for properties over £3m. Whilst such a policy could be seen as a general move in the right direction, the logic of adding such a tax to an unreformed council tax could be questioned. It would make more sense to 'follow through' with council tax reform based on up to date property values.

Taxation of housing as an asset

The previous section discussed the taxation of the consumption of housing services. Here we discuss the taxation of the consumption that a property purchase finances.

Theory suggests that taxation of owner occupied housing should be at least as high as for other forms of investment, and it should be tenure neutral between renters and owner-occupiers (Evans, 2012). Current UK tax policy provides a strong set of incentives to enter and then remain in homeownership. Owner occupiers are not taxed on the imputed rent of the property they occupy⁴. Owner occupiers do not pay tax on any capital gain resulting from price rises, whether through capital gains tax (which is not applicable to owner occupied homes) or inheritance tax (the threshold for which is now effectively £1m for couples). In contrast, those buying property to rent pay tax on any rent received, and a capital gains tax on disposal. Those renting property pay rent, and clearly do not benefit from any capital gain.

The Land and Business Transactions Tax (LBTT) does not in itself fully address the bias towards owner occupation; and as a 'transactions' tax it is inefficient as it disincentives people from making mutually beneficial transactions (Davidoff and Leigh (2013) for example show that a 10 per cent increase in stamp duty lowers turnover by 3 per cent in the first year, and by 6 per cent if sustained over a 3 year period). A tax on land or property value, of the type discussed above, would also not address this bias; as property prices rise, both owner-occupiers and renters would pay more tax (for the renters this would be capitalised into rent), while only the owner occupier would benefit from any capital gain.

O'Sullivan and Gibb (2012) review the evidence for the micro and macro-economic benefits of home ownership. Whilst the effects of home-ownership are certainly not unambiguously negative, it is clear that home-ownership is associated with some downsides. For example, by limiting mobility it can increase unemployment, and, by concentrating wealth in housing, it diverts capital that could have been used to fund investment in productive capital.

⁴ To see the logic of imputed rent consider this example. Suppose an individual buys a property which she rents out. She will pay tax on the rental income from that property. But if she lives in the property herself then she does not have to pay tax on what is, in effect, the rent paid as occupier to oneself, as owner. In the UK, imputed rents on the family home were taxed until 1963.

The under taxation of owner-occupied housing has been a significant contributing factor to house prices increases in recent decades. In turn, the rise in house prices has been the main factor driving the rise in the ratio of wealth to income in the UK in recent decades (Hilber, 2015; Rognlie, 2014).

From the perspective of inequality, the favoured tax treatment of housing capital gains is important because of what it means for the intergenerational transfer of wealth. A housing asset which increases in value whilst it is held and generates an (untaxed) profit once it is sold effectively imposes an implicit tax on succeeding generations (Evans, 2012). The result may be that succeeding generations find it more difficult to get on the housing ladder, and become increasingly reliant on inheritances to enable them to afford to buy a home – with the result that inter-generational inequality can ‘feed’ higher intra-generational inequality in succeeding generations.

There is some evidence that such a scenario is emerging in Scotland. Between 1994/5 and 2011/12 the number of owner-occupier households increased by 344,000 (Table 4.2). But over half of this increase was accounted for by households where the head of the household was aged 65 or over, and the remainder was accounted for by households aged over 45. Amongst those aged under 45 there was a net decline in home ownership. Despite this however, there was an increase in the number of younger households who owned their home outright (as opposed to with a mortgage) – this provides suggestive evidence of an increase in inequality of property wealth within the younger generation, and is consistent with a similar finding for the UK as a whole (Hood and Joyce, 2013). The Generation Rent report from Halifax, published in June 2015, showed that 57 per cent of parents who own a property reported to having contributed, or planning to contribute, towards their child’s deposit, compared with just 24 per cent of parents who rent.

Table 4.2: Changes in the number of owner-occupier households by age of head and ownership status, Scotland 1994-2011

Age of head of household	Change no. households owned with mortgage	Change no. households owned outright	Net change
16-24	-47,245	21,450	-25,795
25-34	-84,268	8,721	-75,547
35-44	489	22,130	22,619
45-54	53,045	58,694	111,739
55-64	16,995	92,713	109,708
65+	-2,181	203,201	201,020
Total	-63,165	406,909	343,744

Source: HBAI

How should the problem of excessive long-term real rates of capital gain from owning be addressed? There is a strong argument for adopting a more tenure-neutral form of housing taxation. At the moment, owner-occupied housing is effectively under-taxed – no tax is payable on any returns or at point of sale, and it thus fails to capture any excess return that may arise as a result of either sheer luck, or effort and skill. In contrast, housing that is bought to rent is subject to tax on rental income and capital gains.

The Mirrlees Review recommended the introduction of a tax on the imputed rent of owner-occupied housing, together with a tax on the capital gain on disposal⁵. Of course such reforms will be even less politically palatable than the reform of council tax. And the introduction of a capital gains tax may limit mobility in the same way that the existing LBTT does. Nonetheless, it is useful to set out how far removed our existing system of housing taxation is from the ideal.

Housing supply

It should also be noted that volatile house prices in the UK are not simply the result of the under-taxation of owner-occupation, but also the way in which land supply is restricted through the planning system, and the way that housing sites are developed within what is a fairly oligopolistic house-building market.

The Scottish Government estimated in 2007 that Scotland needed to be building 25,000 homes per year over the period 2010-35 to meet demand. Even before the recession, house building in Scotland peaked at 21,000 in 2006, but it has since fallen by over half. Similar challenges exist in relation to social housing – Audit Scotland estimates Scotland should be building around 10,000 affordable homes per year, with current levels of building around half this (partly as a result of significant falls in the capital spending budget, which declined by 29% between 2008/9 and 2011/12).

The Scottish Government's Land Reform Review Group (LRRG) argue that Scotland's housing supply challenge arises from a combination of three factors: accessing land (how land is made or becomes available for housing); the price of land for housing development; and the operation of the planning system. According to the LRRG, the planning system and the public sector needs to play a more proactive role in acquiring and developing sites for housing. It also stresses the issues arising from the fact that housing supply is dominated by a small number of major house-builders, whose business model is predicated on land-banking and slow release of sites onto the market.

Summary

The taxation of land and property is devolved to the Scottish Government. The existing system is highly deficient, with a regressive council tax, an inefficient housing transactions tax, and a wider tax system that favours owner-occupation and is thus cementing inter-generational inequalities.

At very least, the existing council tax should be reformed as a proportional tax on house value. There would be a number of 'losers' from such a policy, and transition arrangements are likely to be required.

The bias in favour of owner occupation is politically more difficult to fix. But the problem of rapidly rising property values – as a result of which younger generations now have to devote a large proportion of savings to property, if they can afford property at all – is also due to market and policy failures in the planning and housing markets. Tackling barriers to housing supply is a key part of addressing inequalities in the housing market, and through housing, inequalities in wealth.

⁵ Mirrlees also recommended the introduction of a rate of return allowance (RRA) for both rental and owner-occupied housing. This would involve only taxing the returns over a 'normal' rate of return, and is justified on the basis of the fact that housing assets are (normally) acquired out of taxed income. The introduction of a RRA would of course complicate the issue of the design of the tax, and could involve the government making refunds to property owners who had made below the normal rate of return.

Addressing issues of housing supply may require reform to the planning system, and reform to the system of local government finance so that local authorities have more of an incentive to promote housing development (Hilber, 2015).

The Commission on Housing and Wellbeing (2015), which released its report on 10th June 2015 argued for a similar set of policies as those proposed here: namely, to replace Council Tax with a land value or property value based tax and/or a Capital Gains Tax to reduce the bias in favour of owner occupation; and to improve the supply of land for housing. In line with the latter objective, the Commission on Housing and Welfare suggests the establishment of a Scottish Land Corporation to acquire land, install infrastructure, and dispose to developers, ensuring that the public should benefit from the uplift in land values resulting from decisions by planning authorities.

It is worth noting that none of the parties' manifestos contained policies which are likely to address the housing market challenges described here. The 'mansion tax' proposed by Labour, the LibDems and the SNP goes only a fraction of the way towards the needed reform of council tax; policies such as 'help-to-buy' will, in supply-constrained markets create further pressure on prices which may outweigh the value any subsidy; and Labour's proposal to temporarily remove stamp-duty for first time buyers introduces a new set of inefficient distortions into the taxation of housing (Adam et al. 2015). Most damaging of all are the Conservatives proposals to effectively increase the inheritance tax (IHT) threshold to £1 million for married couples whose main residence is worth at least £350,000 and is bequeathed to their children or grandchildren; as the IFS notes (Adam et al. 2015), it is hard to see the economic or social issue for which this policy is the answer – it is a tax cut for the most wealthy which will push-up prices and discourage downsizing.

Finally it is worth noting that, under the Smith Commission proposals, the Scottish Government will gain powers to vary the housing cost elements of Universal Credit, including the ability to vary the under-occupancy charge (bedroom tax), eligible rent, and deductions for non-dependents. However, these are essentially powers to vary Housing Benefit at the margin; the Scottish Government would not be able to redesign Housing Benefit, particularly given the way that it is linked with other means tested benefits. Indeed, the practical difficulties of adopting a divergent Housing Benefit policy within a more generally reserved Universal Credit system have led others to question the extent to which this 'power' to vary Housing Benefit will be used (Stephens et al. 2015).

5. Education and skills policy

Investing in education and skills is often seen as a key policy response to the increase in inequality. The argument hinges on a view that technological change is 'skill-biased'. In other words, technological change increases the demand for workers with relatively high levels of education. If the supply of educated workers does not keep up with the increase in demand, then the earnings premium associated with a given level of education is likely to increase, leading to a widening of the wage differential between more and less educated workers. Investing in education to maintain the supply of high-skilled workers is thus a key strategy in mitigating inequality.

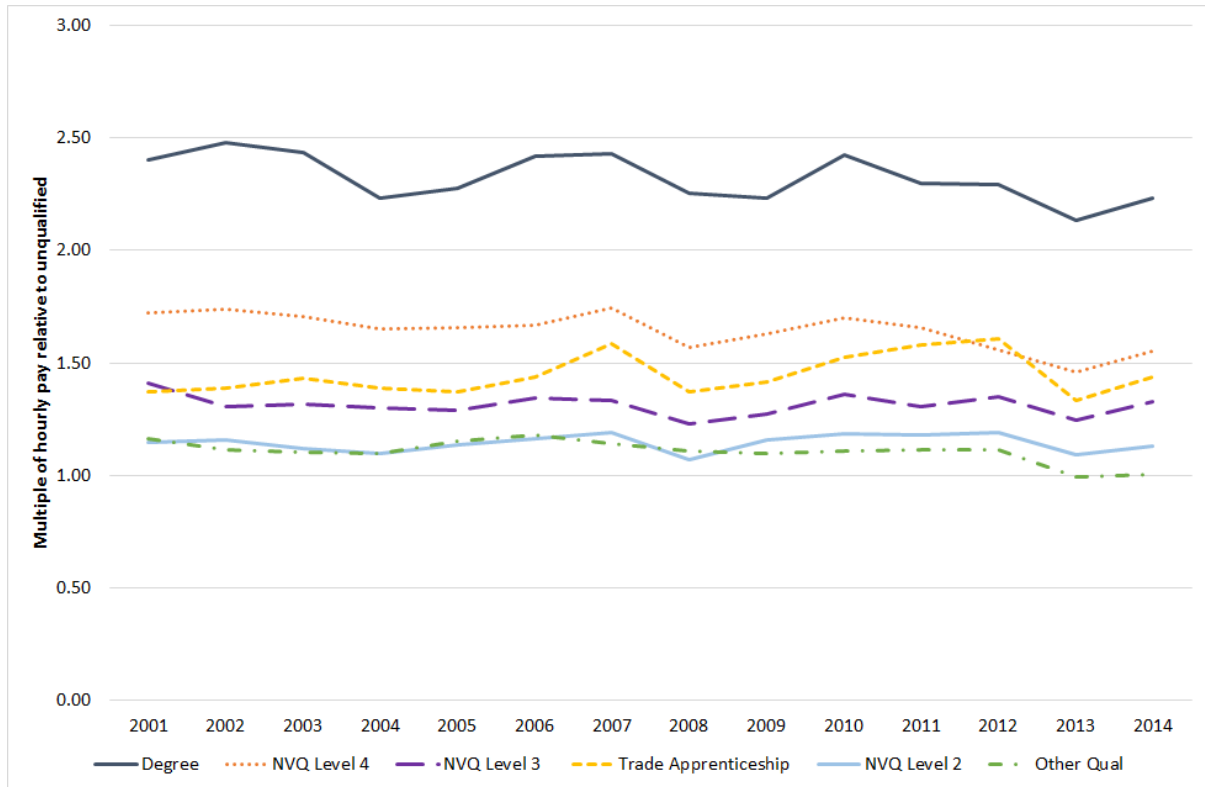
Between 2001-14, the proportion of the Scottish population educated to degree level increased from 15-25%, while the proportion with no qualifications fell from 10% to 5%. But this does not seem to have led to a marked fall in inequality between those with and without a degree. Between 2001-14, the graduate premium (the earnings premium associated with having a degree) fell only slightly – in 2001, those with a degree earned 2.4 times as much as those with no qualifications on average, and this had only fallen to 2.2 by 2014 (Figure 5.1).

While inequality between education groups has not increased during the past 15 years, there has been an increase in 'within-group' inequality. In other words, the earnings of graduates have become increasingly dispersed. 'Within education group' inequality now accounts for over three-quarters of the total inequality among workers (Figure 5.2). It follows that further increases in education might not in themselves reduce inequality.

In Table 5.1 we conduct an experiment: we assume that half of those with no qualifications gain a degree, and that the graduate premium falls by 20%. Both of these things would be expected to reduce inequality: raising the incomes of those who earn least, and simultaneously reducing the incomes of all those who earn most. Inequality does indeed fall in this experiment, but perhaps not by as much as may be expected. The reason that inequality does not fall by more is that within-group inequality is the dominant factor driving overall inequality.

A number of studies have looked at within-group inequality in greater detail. Holmes and Mayhew (2012) for example find that the graduate premium in the UK has risen much faster for the top 20% earning graduates than for other graduates. Brown et al. (2010) suggest that this observation may be explained by the fact that the market for graduate labour has become increasingly global; this has helped to keep wages in check for most graduates, but for a small few, the global 'war for talent' among large multi-national companies which place huge resources in attracting the top graduates, has continued to drive up the wages of the highest calibre graduates.

Figure 5.1: Hourly pay relative to the unqualified, 2001-14, Scotland



Source: author calculations using Labour Force Survey.

Figure 5.2: Inequality within and between education groups, Scotland



Source: author calculations using Labour Force Survey.

Table 5.1: The effect on inequality of a rise in the proportion of individuals with a degree and a fall in the graduate premium, Scotland

Statistic	Current	Experiment
P(90)/P(10)	3.736	3.636
P(90)/P(50)	2.114	1.978
P(50)/P(10)	0.566	0.544
Gini Coefficient	0.319	0.299

Source: author calculations using the Labour Force Survey

The fact that within group inequality is rising at least as strongly as overall inequality does not undermine the argument that we should be investing more in education. Indeed, a high-skilled workforce is a key part of ensuring that productivity, and hence wages, continue to rise. But it does indicate that efforts to upskill the workforce are not a silver-bullet for addressing inequality, particularly in terms of the growth in inequality between the ‘top-1%’ and the rest.

Another way of looking at this is to say that education might not play a major role in influencing inequality of outcome, because outcomes (i.e. income) are not strongly correlated with education. But education policy does influence inequality of opportunity: if we get education policy wrong, then the outcomes of higher education might not be available to all in society.

The Scottish Government’s Economic Strategy places a significant emphasis on addressing inequalities in education. It states a belief in ‘access to higher education based on the ability to learn and not the ability to pay’. The commitment to free tuition for eligible full-time undergraduate Scottish students is a key policy in this regard. But the Strategy also recognises that many educational inequalities arise before university, noting ‘students from the most deprived fifth of our communities only account for one-seventh of our university Undergraduates’. It aims to close this participation gap, in part through establishing a Commission on Widening Access to ‘advise on meaningful milestones, targets and actions required to ensure more students from disadvantaged backgrounds can access higher education and attain the qualifications they need to help them develop a successful career and fulfil their potential’.

The rest of this section considers the design of education policy to reduce inequality in more detail.

Early years and school education

Poverty and socio-economic disadvantage are major influencers of pupil attainment. It is well recognised that there is already an attainment gap between children from disadvantaged backgrounds and their peers when they start school. This is one of the reasons that the Christie Commission argued for a presumption in favour of preventative action in tackling inequalities. There is also evidence that concentrated poverty in particular neighbourhoods can aggravate poor attainment (Glennister, 2002). A report by the Joseph Rowntree Foundation (Sosu and Ellis, 2014) concluded that:

‘There is clear evidence of a persistent attainment gap between pupils from the richest and poorest household in Scotland. This gap starts in preschool years and continues throughout primary and secondary school. In most cases, it widens as pupils progress through the school years. Most

importantly, the poverty attainment gap has a direct impact on school-leaver destinations, future labour market success and the potential to determine income levels in adulthood.'

The OECD (2015) notes that this general pattern is observed in most, if not all, OECD countries, but stress that the relationship can run in both ways. Not only does inequality of education accentuate differences in life chances, but higher income inequality is associated with less equal education outcomes: 'in unequal societies, the poor get less education, but they also get less out of their education'.

What should be done? One obvious approach is to direct more resources to schools which serve the most disadvantaged pupils. There is a long-running debate however around the extent to which there is an association between higher education resources and higher attainment. Proving the existence of a causative relationship is difficult given the likely endogeneity of school resources (i.e. higher levels of resources tend to be directed at schools with more educationally challenged pupils, making identification of the true relationship between resources and attainment problematic). There is some evidence of a causative, albeit modest, role for school resources in influencing attainment in England (Holmlund et al., 2010; Machin et al., 2010; Gibbons et al. 2011). Jenkins et al. (2006) found evidence of a positive association between school expenditure and GCSE point score (as well as GCSE science and maths results), and Steele et al. (2007), using a different methodology, found that additional resources have a positive effect on attainment in mathematics and science but not for English.

Clearly however, the way in which resources are spent is more important than the level of resources per se, but there is still relatively little consensus around which interventions are most effective at raising attainment generally, and closing the attainment gap specifically (Hanushek, 2008). Some of the key debates are around: the importance of school autonomy in determining priorities for action; the role of 'teacher quality' versus 'school quality' in raising attainment, and how to improve the measurement of effectiveness and 'value-added' of both teachers and schools; and the role of 'peer effects' in determining school outcomes, and the implications for school catchments and streaming.

In its recent review of the attainment gap in Scotland, the JRF (Sosu and Ellis, 2014) identified the following interventions as having a positive effect on closing the attainment gap; (many of these concepts are also iterated by the OECD (2015) in its latest review of inequality):

- Effective parental involvement programmes that focus on helping parents to use appropriate strategies to support their children's learning at home rather than simply seeking to raise aspirations for their children's education;
- Carefully implemented nurture groups and programmes to increase social, emotional and behavioural competencies;
- High-quality, full-day preschool education for children from disadvantaged backgrounds;
- Collaborative work in small groups if effective collaboration is thoroughly taught across the school and facilitated by teachers;
- Peer-tutoring, metacognitive training and one-to-one tutoring using qualified teachers, trained teaching assistants, or trained volunteers;
- Literacy instruction that has a responsive learning mix of decoding, fluency, comprehension, engagement and digital literacy research skills;

- Whole-school reforms, particularly those that are informed by research evidence and focus on improving attainment by using effective pedagogies, have a shared strategic plan that encompasses academic, social and emotional learning, are supported by significant staff development and are data-driven, multi-faceted and consistently monitor impact on attainment;
- High-quality, evidence-informed, context-specific, intensive and longterm professional development;
- Mentoring schemes that adhere to particular characteristics associated with efficacy;
- Academically focused after-school activities such as study support.

The Scottish Government is already pursuing a number of policies which fit within the ethos of these recommendations, including strategies to raise family engagement in children's education, improving teacher education through the Scotland's Future programme, and closing the attainment gap through programmes such as the Literacy Action Plan. Holyrood's Education Committee is currently undertaking an inquiry into the Education Attainment Gap which should lead to further policy recommendations.

It is not within the scope of this report to provide an analytical overview of existing policy to close Scotland's attainment gap. But it is clear that there is a need to better understand the effectiveness of different types of interventions, and this implies a strong emphasis on the use of pilot projects, and on monitoring and evaluation. Sharing best practice and evidence of what works should also be promoted, building on existing approaches such as the 'Raising Attainment for All' programme. Improving the educational outcomes of pupils from economically disadvantaged backgrounds should be a priority in all local authority and school development plans.

Access to Higher Education

The Scottish Government's commitment to free university tuition for eligible full-time undergraduate Scottish students is one of its keystone policies. The commitment to free tuition is reiterated in the 2015 Economic Strategy. It also formed an important part of the independence debate, with the Scottish Government's White Paper stating: 'Free education for those able to benefit from it is a core part of Scotland's educational system. One of the major achievements of devolved government in Scotland has been to restore this right to Scottish domiciled undergraduate students.' (p.198). In contrast, the English approach to funding HE, where students are eligible for tuition fees of up to £9,000 per annum, is characterised as being 'market-driven' and 'socially divisive'. Shifting the responsibility of for supporting higher education from the public purse to the individual graduate 'discriminates against the poorest, puts barriers in the way of learning and would over time massively diminish the potential of Scottish society. It directly contradicts our longstanding belief in the common weal and fatally undermines the social contract that citizens in Scotland have with the state.'

However, the perception of Scottish higher education as being freely available to all young people, whilst the English system is based purely on an 'ability to pay' basis is based on somewhat disingenuous claims (Riddell et al. 2015), for at least two reasons.

- First, tuition fees are just one element of the cost associated with studying at university. Students also face living costs while studying. As Hunter-Blackburn (2014) has shown, the

system of maintenance support is less progressive in Scotland than in England and Wales. In Scotland, maintenance grants for students from the poorest backgrounds are less generous than those in England and Wales, and there has been a trend in Scotland to replace non-repayable grants with repayable loans. As a result, although Scottish students graduate with less debt overall than their English or Welsh counterparts, Scottish students from the poorest backgrounds graduate with more debt than those from better-off backgrounds, a pattern which is reversed in England and Wales.

- Second, HE tuition in England and Wales does not require the ‘upfront’ payment of fees, as loans are available to all students. Importantly, the repayment profile of loans is income contingent, with repayments charged as a proportion of income over a particular threshold (£21,000 in 2014), and with the rate of interest also rising with income (MacPherson and Liddell, 2013); any outstanding loan is written off after 30 years if it has not been repaid by then. As a result, the IPPR (2013) has shown that the bottom four deciles of male graduate earners *never* repay their full loans, and only the top two deciles of female graduates actually do so. The IFS estimates that only one quarter of graduates will repay their loans in full. The English system is thus not as regressive as is sometimes portrayed, and the loan system is relatively generous. (This is why Labour’s election proposal to cap annual tuition fees at £6,000 would actually have been relatively regressive compared to the status quo – it would have predominantly benefited the better-off students who currently repay their loans in full.)

The debate about whether the Scottish system of free tuition with less generous grants for maintenance is more progressive than the English system of income-contingent loans and relatively more generous grants and bursaries for the poorest students is thus more complex than is often portrayed. Interestingly however, evidence suggests that in England, the gap in HE participation between students from the poorest backgrounds and the rest has closed since the tuition fee cap was increased to £9,000 in 2012 (IFS, 2015). In contrast, the HE participation gap in Scotland does not seem to have closed (Riddell et al. 2015).

Universities face a long-run funding challenge, a detailed assessment of which is beyond the scope of this report. This, and the fact that university is not a universal service (given that participation is strongly linked to school attainment and social background) has underpinned the move in England and Wales towards a fee and loan system. But the generosity of this system means that the taxpayer will still meet a large proportion of tuition costs – the IFS estimates that, for each £1 the government lends English-domiciled students entering university to study full-time for a first degree in 2012, it will incur a future taxpayer cost of 43p in unpaid loans. But by shifting student support from a model of directly funding tuition to the provision of unsecured loans, the government is effectively shunting the funding of current students into the future. Student loans do not count as departmental expenditure, but do add to government debt liabilities.

Thus as well as the debate around which HE funding method is most progressive across the current cohort of students, there is also an inter-generational aspect of the move towards tuition fees. Dorling (2014) argues that the introduction of tuition fees means that the older generation ‘is opting out of an obligation to pay to fully educate the much smaller generation behind it’. Portes (2014) on the other hand argues that the introduction of income-contingent fees represents a more progressive way of distributing the taxpayer subsidy to students, arguing that ‘the idea that the pre-

tuition fee regime, with far fewer students receiving higher subsidies, and going on to receive excellent labour market returns, was in any sense "fairer" seems difficult to maintain.'

The debate around higher education funding – and particular how to maintain the quality of the university sector without creating barriers to HE participation for the most disadvantaged, and without simply shunting the risks onto future taxpayers – is extremely complex. There is unlikely to be a 'right' answer, but politicians should be prepared to have a more open and honest debate around the advantages and disadvantages of different funding systems.

Other aspects of education policy

The discussion so far has focussed on early years and school education on the one hand, and access to Higher Education on the other hand. Other aspects of education and skills policy are also relevant to the inequality debate, and might include for example:

- Ensuring wide and appropriate access to Further Education
- Ensuring appropriate opportunities exist for vocational education and training, including working with employers to develop apprenticeships
- Improving student experience of the school-to-work transition, and minimising drop-out at this stage by identifying and working with those at most risk of becoming 'NEET' (not in employment, education or training)
- Ensuring that the provision of FE, HE and lifelong learning is well aligned with the best estimates of the current and future skills needs of employers
- Supporting SMEs to provide training and development opportunities for employees

The scope of the agenda is clearly wide, and it is not within the scope of this report to review current policy in this area and provide detailed recommendations. But skills and education policy is clearly a major determinant of the distribution of income in the long-run, and is wholly devolved to the Scottish Government.

6. Conclusions

A growing consensus that something should be done to address high and rising levels of inequality can be attributed to changing perspectives about both the causes and the consequences of inequality.

- On the causes, the prevailing view that rising inequality is the inevitable consequence of changes in the returns to different types of jobs as a result of technological change and globalisation has given way to an acceptance that inequality is as much the result of deliberate policy choices and market and policy failures. These include deficiencies in corporate governance, over-protection of intellectual property, insufficient attention on addressing monopoly power, land use regulations that raise the wealth of owner-occupiers, and labour market changes that have shifted the balance of wage-setting power in favour of firms and senior executives at the expense of those with weaker bargaining capacity.
- On the consequences, the view that greater equality can only be achieved by trading off economic growth has increasingly been challenged. Recognition that markets are rarely perfectly competitive means that equity and efficiency policy objectives can point in the same direction.

Thus the OECD argues that ‘there is nothing inevitable about growing inequalities’ (OECD, 2015), while the IMF states that ‘equality-enhancing interventions could actually help growth: think of taxes on negative externalities paid mostly by the rich (perhaps excessive risk taking in the financial sector)’ (Ostry et al. 2014).

The Scottish Parliament already has significant tools with which to influence the distribution of income. These include direct control of important taxes, including all land and property taxes, and, under the Smith Commission proposals, almost full control over income tax. The Scottish Government also has significant ability to effect the behaviour of firms through leveraging its strategic influence in a variety of ways. And in the longer-term, devolved control for skills and education provide the Scottish Government with significant influence in how inequality trends play out in subsequent generations.

There is scope to raise top tax rates in Scotland once they are devolved. The aim of adopting a more progressive rate structure is not simply to change the distribution of after-tax incomes, but importantly to influence the distribution of market (pre-tax) incomes over the longer term.

The objection to such a policy will be the risk of revenue loss and more importantly the risk of out-migration of Scotland’s most productive entrepreneurs, particularly if the policy is not followed in rUK. But evidence suggests that employment income (as opposed to dividend income) is relatively unresponsive to changes in tax rates, and what response there is comes largely through avoidance rather than reductions in work ‘effort’. Nonetheless, there is a clear need to establish clear and unambiguous rules about the income tax liabilities of ‘Scottish’ and ‘rUK’ taxpayers to minimise the possibility of these distortionary effects. And at UK level more generally, efforts should be made to broaden the tax base and remove unnecessary exemptions where possible.

There are other tools available to address excessive pay at the top end. Some of these rely on changing behaviour by influencing perceptions, such as the proposal to encourage publication of payscales. Others rely on improving competition by improving access to finance.

There are a wide range of tax reforms that could be implemented at UK level, ranging from the structure of NICs to the treatment of pension contributions in the tax system, and the structure of inheritance tax. This report focusses on things that the Scottish Government could do to address inequality, so we do not dwell too heavily on the multitude of UK level tax changes that could be implemented, but there is clearly a role for Scottish MPs (and the Scottish Government and Scottish civil society) to play in making the case for UK reform. Also in this vein are significant opportunities to reform wage setting in publicly listed companies, and the financial sector in particular.

Tackling low-pay is arguably more challenging, partly because it is in part caused by a rise in the proportion of employment in sectors that rely on forms of 'non-standard' temporary, part-time, and generally insecure work. Inevitably, part of the policy response is about improving transferable skills. But more fundamentally it is about redressing the balance of power between workers and employers, which many economists believe has shifted too far in the direction of employers in recent years and decades. Strengthening the minimum wage and promoting the living wage is part of the response, but is by no means a panacea given the increasing prevalence of part-time and temporary work and use of self-employment. Some legislative change is likely to be necessary, the control of which resides at Westminster; and it is particularly important that in-work benefits are strengthened rather than weakened. But the Scottish Government retains an important role in promoting and leveraging best practice in employment within the public sector, public sector suppliers and contractors, and the multitude of businesses which benefit from some form of public sector support.

There is also scope to substantially revise the taxation of land and property in Scotland. The existing system is highly deficient, with a regressive council tax, an inefficient housing transactions tax, and a wider tax system that favours owner-occupation and is thus cementing inter-generational inequalities. At very least, the existing council tax should be reformed as a proportional tax on house value. Such reforms are less likely to create risk of outmigration than reforms to income tax, but will nonetheless be difficult politically. Market and policy failures in the housing market are also embedding both inter- and intra-generational inequalities in access to housing as an asset. Addressing this issue requires reform of the taxation of owner-occupied taxation, potentially combined with reform of the planning system.

In the long-run, the way in which we invest in education and skills will play a critical role in how inequality trends play out. Knowing precisely how technological change will influence the demand for skills in future is however very difficult. The pessimistic view is that large swathes of jobs in the middle and lower end of the income distribution (and perhaps even a good proportion of high-skill jobs) will be wiped out by advances in technology, the development of robots and artificial intelligence. The key question is whether technological change complements or substitutes for particular workers. What is clear is that technological change will change specific job roles and how they interact with technology (the rise of taxi firm Uber is just one example of how this might play out).

The message for education policy is that we need to ensure wide access to high quality tertiary education, combined with a comprehensive rise in soft skills, transferable skills, and literacy and numeracy across the population. With limited resources, the question as to which aspects of

education and training should be universally provided, and which should be funded through means-tested support, will remain a hot topic.

Many of the policy prescriptions to address inequality will be politically difficult to implement. This is simply a result of the fact that any redistributive policy will involve losers as well as winners. But arguments will always be made that redistributive policy will shrink the overall size of the cake (economy) and/or be rendered impossible by the nature of the globalised economy that we are part of.

Some policies to reduce inequality may reduce growth, but in some cases we may decide that this is the price worth paying for a more inclusive society. But on the whole, policy can be designed to minimise effects on growth, partly by targeting interventions where market failures exist, and partly by focussing interventions where behavioural responses to policy change are relatively insensitive. Scotland's high level of economic integration with rUK may make policy distinctiveness even more politically difficult to achieve. But the Scottish Government is not passive to developments in rUK or further afield, and can help shape the direction of policy reform. Whether it chooses to do so remains to be seen, but it already has a number of policy tools with which it could signal serious resolve to tackle inequality.

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