Squeezed Britain

2013

The Resolution Foundation

The Resolution Foundation is an independent think tank that aims to improve the lives of households on low to middle incomes. This annual report sets out the economic position of the group, traces the origins of today's squeeze on living standards and charts the long road to recovery for ordinary working households in Britain. The analysis relates primarily to 2010-11, reflecting the latest large scale survey data that is available.

A list of sources can be found at the end of this publication. The accompanying website contains further information and additional data, along with full details of the various definitions and methodologies used.

http://squeezedbritain.resolutionfoundation.org

Introduction

The challenge is how we ensure that the benefits of future growth are fairly shared

We now know that the squeeze on living standards will be longer and deeper than projected this time last year. Average wages are not expected to rise in real terms until late 2014 after a period of stagnation and decline. Despite stronger than expected job growth in the private sector, many people continue to work fewer hours than they would like, putting downward pressure on household incomes.

If this were not gloomy enough, further problems are being stored up. The incremental impact of changes to the uprating of benefits and tax credits will become visible over time in poverty statistics. And with further reductions in public spending anticipated in this year's spending review, there will be profound challenges for services, as well as deeper cuts to welfare spending.

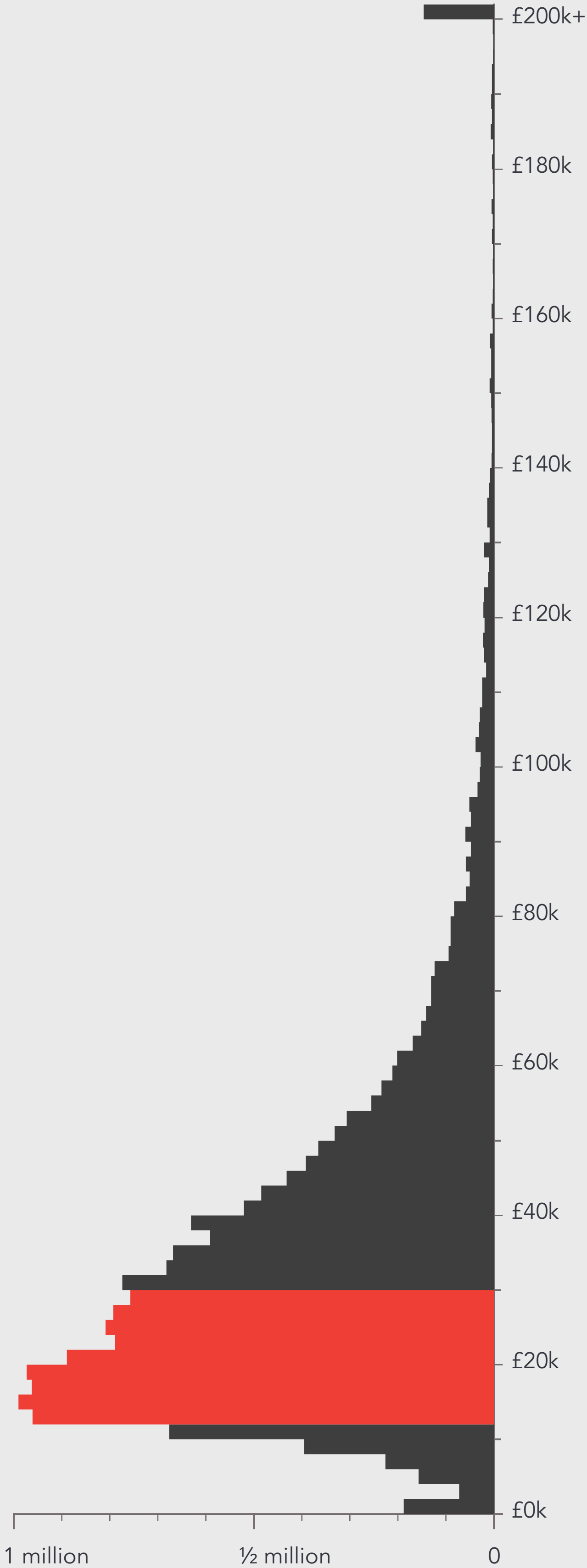
The upshot of this on-going economic malaise for Britain's households is that an already difficult situation will get worse before it gets better. To some extent, all families have been affected since the recession. Indeed, new data shows that, although the very wealthiest have pulled away from low, middle and upper-middle income households over the longer term, in 2010-11 real incomes fell right across the income distribution and most of all at the very top rather than in the middle or bottom. And, while tax and benefit changes have in general hit poorer working-age households harder than richer households, particularly those with children, it is the very richest that have seen the biggest falls of all since 2010. As a result, the latest year saw the biggest decline in income inequality in the last 50 years. Whether this pattern will be replicated in future years remains to be seen.

Of course, households in work but on below middle income, especially those with children, start with far less than the better off, making any squeeze particularly hard to cope with. With wages falling and tax credits no longer providing the support they did in the 2000s, these households with an average income of only £21,000 after tax face a daily struggle to keep up with the rising costs of essentials. Meanwhile, longer term goals such as saving or buying a home are drifting further from reach. These households are the focus of this report.

The causes of the economic challenges facing households are complex and entrenched. It is, therefore, inaccurate and unhelpful to imply that the current squeeze on households is all down to 'austerity'. The origins of this story stretch back before the recession and cannot be attributed to a single period of government. The challenge is structural as well as cyclical. In the five years prior to the financial crisis of 2008, all but the richest 10% of households failed to benefit adequately from economic growth. Looking forward, we have a long way to go simply to get back to where we were before the downturn, to bring living standards back to their level in the mid-2000s. Above all, the challenge is, as we inch towards a long awaited recovery, how to ensure that the benefits of future growth are fairly shared.

In most instances our analysis focuses on median earnings and incomes rather than mean. In order to best capture changes in the cost of living pressures faced by low to middle income households, we use the Retail Prices Index (RPI) measure of inflation which incorporates a broader range of goods than the Consumer Prices Index (CPI) used by the government to uprate benefits. Substituting CPI for RPI in the analysis included in this report reduces the apparent pace of slowdown in median earnings and incomes identified from 2003 onwards, though the overall trend is similar. A detailed discussion of the effects of adopting different measures and deflators is provided in *Trends in Wages and Incomes: 2003-08* available on our website.

Squeezed Britain



Low-to-middle income households struggle to keep up with the rising cost of essentials, while longer term goals drift further from reach; these households are the focus of this report

Who's in low to middle income Britain

1 in 3
working-age households

9,800,000
adults

5,000,000
children

7,800,000
workers

This report focuses on a group that makes up nearly one third of working-age households in Britain. Half of the households in the group have dependent children. Overwhelmingly in work, these households nevertheless manage on relatively modest incomes, leaving them susceptible to something as simple as an unexpectedly large fuel bill.

Households on low to middle incomes are defined by the Resolution Foundation as those of working age and relying primarily on their own earned resources but with incomes below the median (middle) in the UK. The definition does not include the poorest 10% of households and those who receive more than one fifth of their gross household income from means tested benefits, who we define as 'benefit-reliant'.[1] In practice this means a couple without children living on a gross annual household income of between £12,000 and £30,000; a single parent with two children on £13,000 to £32,000; and a couple with two children on between £17,000 and £41,000.[2] On average, this group has seen a 2.4% real terms fall in post-tax incomes between 2009-10 and 2010-11. We define those above the middle as 'higher income'.

Prior to 2010, wages for workers in the bottom half stagnated but household incomes in this group were propped up by growing tax credits. With the retrenchment of public spending in full swing, tax credits now make a smaller but still highly significant contribution to income for these families and their contribution is likely to continue to decline over future years.

Home ownership among this group is also in decline, while private renting is becoming more common. Nearly a quarter of the group now live in a privately rented home compared to the national average of 17%. Meanwhile, numbers in the social rented sector have flat-lined, as social housing has become increasingly targeted at the most vulnerable.

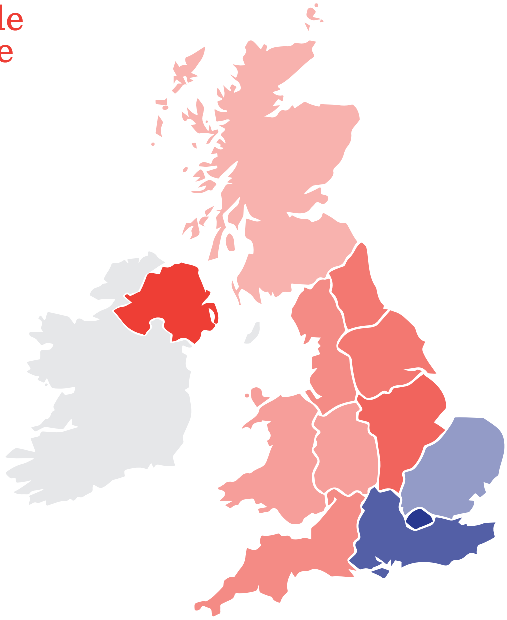
1 Means-tested benefits exclude tax credits

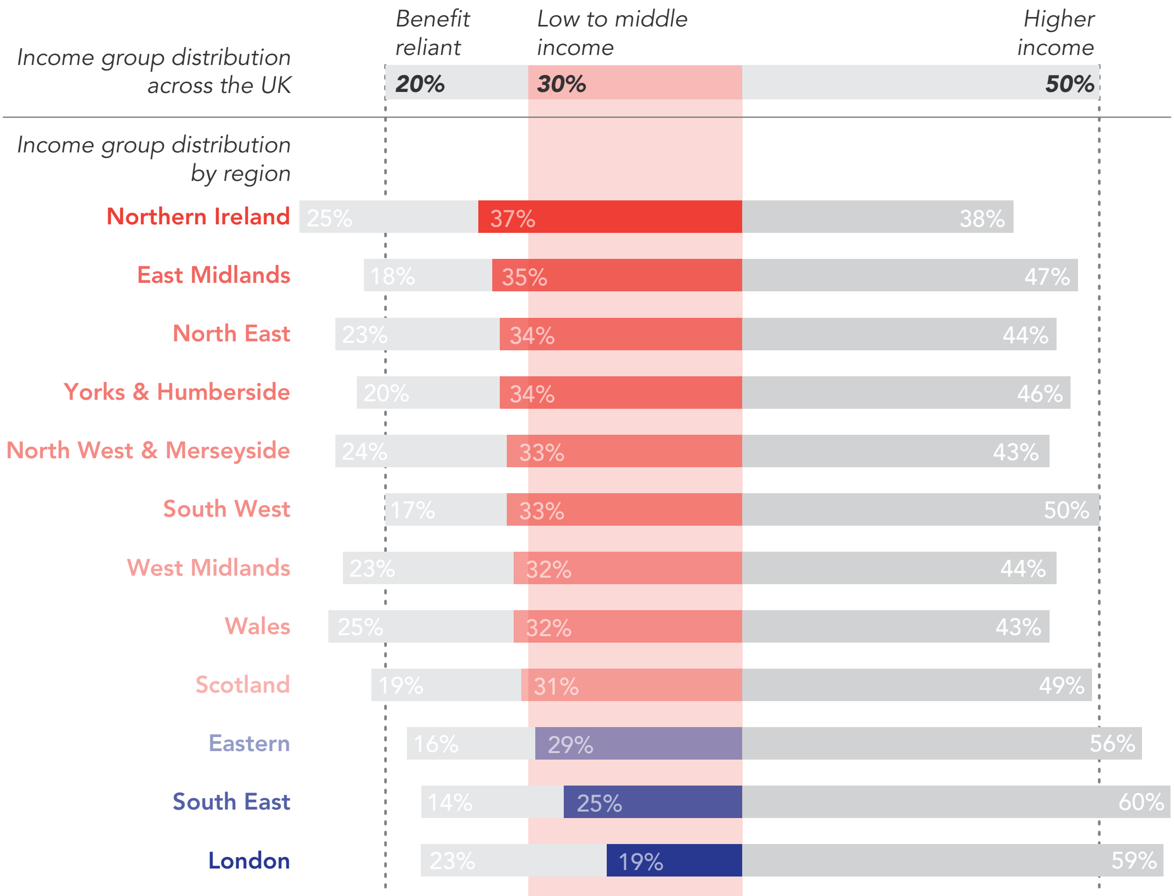
2 Household incomes calculated on an equivalised basis.

Who lives in each income group

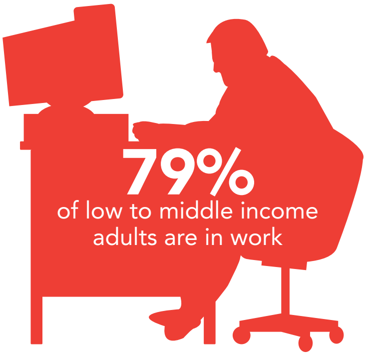
benefit-reliant	low to middle income	higher income
3.8m households	5.6m households	9.5m households
45% (1.7m)	52% (2.9m)	33% (3.1m)
55% (2.1m)	48% (2.7m)	67% (6.4m)
most common household: **single male** (33%)	most common household: **couple with children** (30%)	most common household: **couple w/o children** (36%)
8.3m people	**14.8m people**	**22.8m people**
2.6m men	5m men	9.5m men
2.7m women	4.8m women	8.4m women
3m children	5m children	4.9m children

Where low to middle income families live



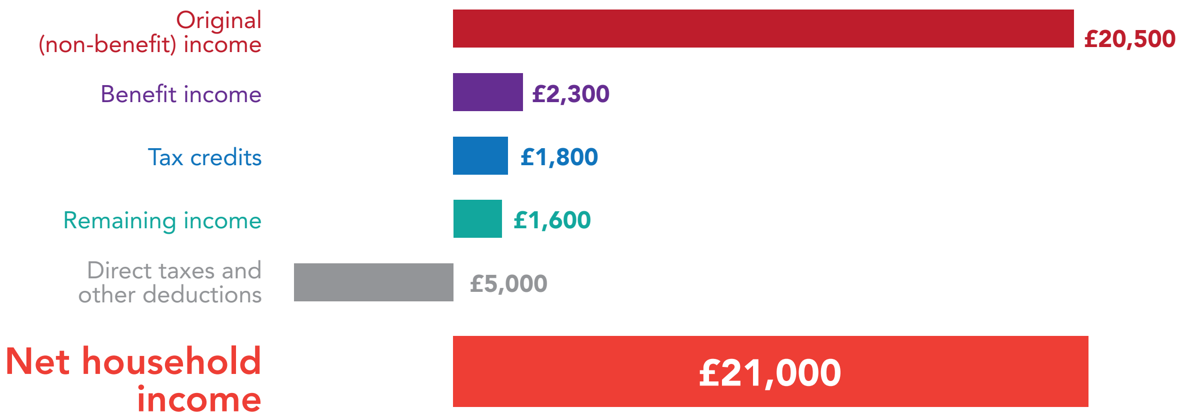


Employment in the low to middle income group



22%
work **part-time**
(employed or
self-employed)

Average annual household income in the low to middle income group



Housing tenure in the low to middle income group

home owners

60%

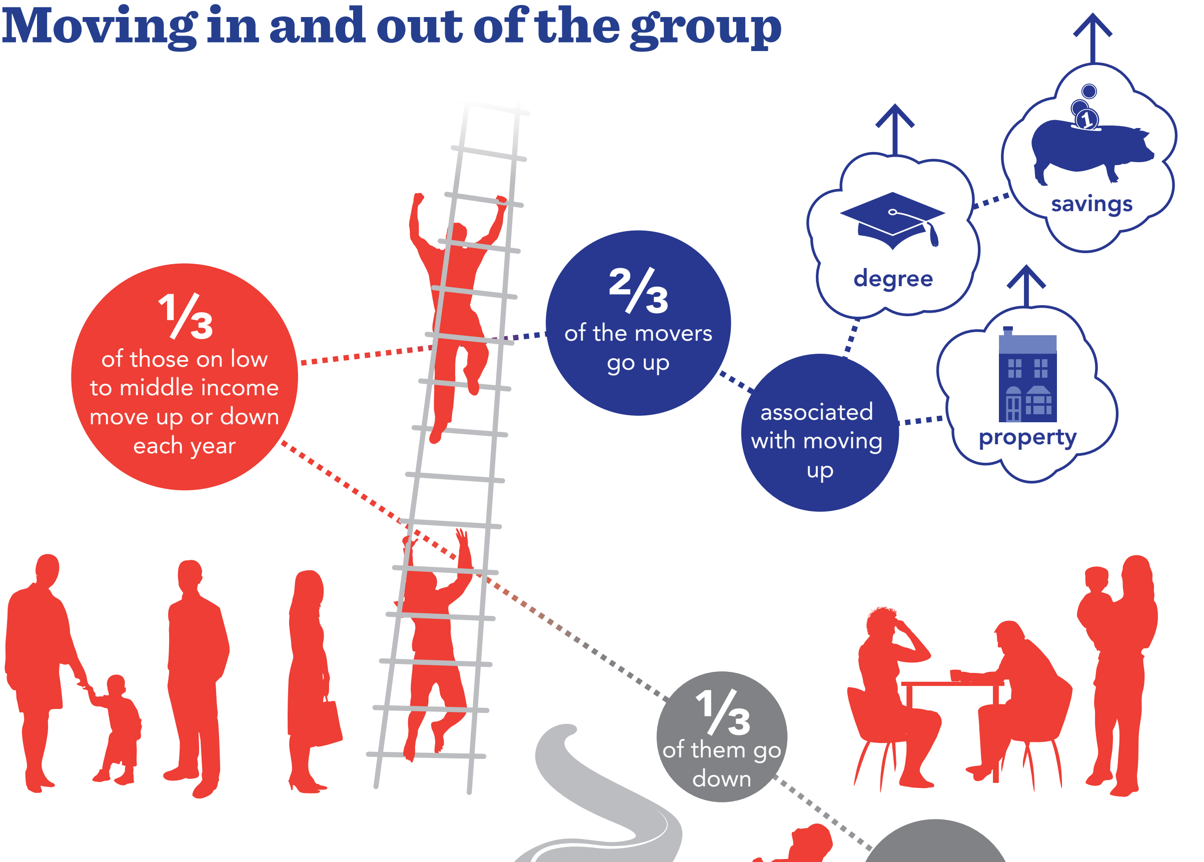
private renters

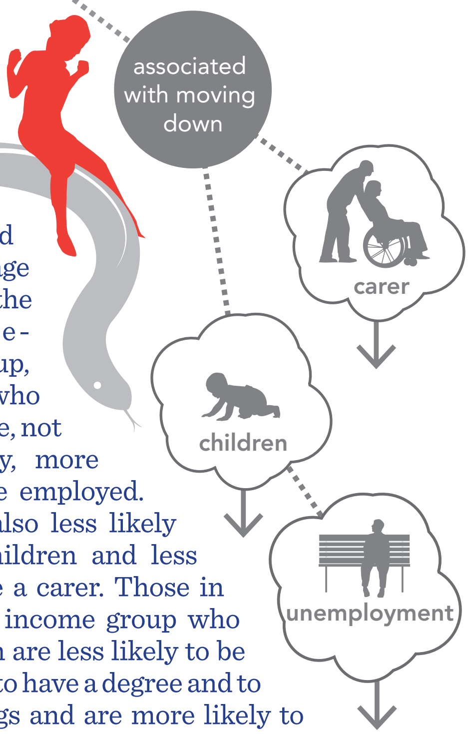
24%

social housing tenants

16%

Moving in and out of the group





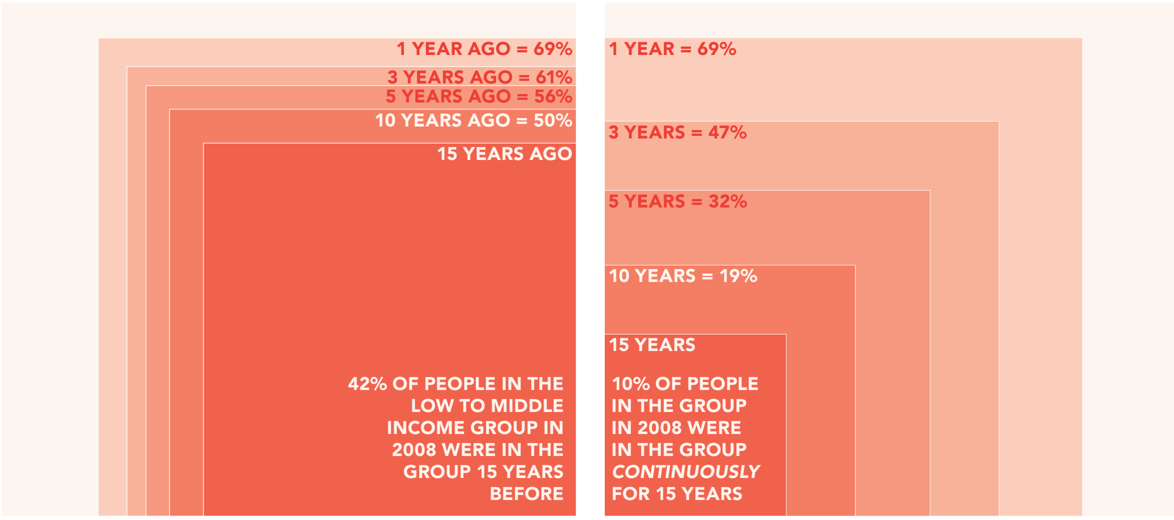
Of course, the low to middle income group is not fixed over time. In any one year, around one-third of people leave the group. Of those who leave, nearly two-thirds move up to the higher income group, while close to one-third fall into the benefit-reliant group. A very small number move into pensioner households. These proportions have not changed significantly over time. To some extent, they reflect the natural progression as people age and their earnings rise and fall over the life-cycle.

Compared to the average person in a low to middle income household, those who fall down into the benefit-reliant group are more likely to have children and are less likely to own their own home. Not surprisingly, those who move up are more likely to be employed than the average, to have a degree, own their own home and have savings. They are also less likely to have children.

Those who leave the low to middle income group are replaced in similar proportions by people falling down from the higher income group or climbing up from the benefit-reliant group. Compared to the average person in the benefit-reliant group, those who move up are, not surprisingly, more likely to be employed. They are also less likely to have children and less likely to be a carer. Those in the higher income group who move down are less likely to be employed, to have a degree and to have savings and are more likely to have children.

Looking back from 2008, over a four year period, more than 50% of working-age people find themselves living on a low to

How long people stay in the low to middle income group



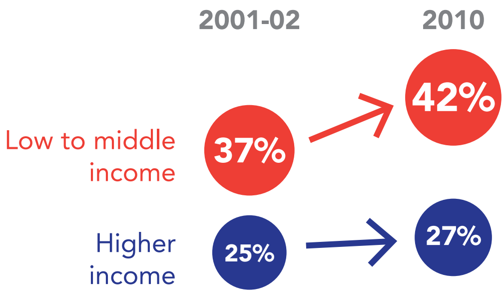
middle income for at least one year. Compared to those who do not spend any time in the group, those who are there for one year or more are more likely to have children and live in a larger family. They are less likely to have a degree and less likely to have savings.

Going further back, we see that 61% of those who were in the group in 2008 were also in the group three years earlier. 50% were there 10 years earlier and 42% were in the group 15 years earlier. This does not mean that they remained consistently in the group in every year of this period. There is a lot of churn so in many cases, they will have moved out and returned. A smaller proportion will remain year on year in the group. In 2008, 47% of people in low to middle income households had remained 'stuck' in the group continously for the previous three years.

Over a four year period, more than 50% of working age people find themselves living on a low to middle income for at least one year

Living with the squeeze

Percentage of disposable income spent on essentials



Annual spending power of low to middle income households is down by **£280**

Percentage of low to middle income group who would like, but can't afford...

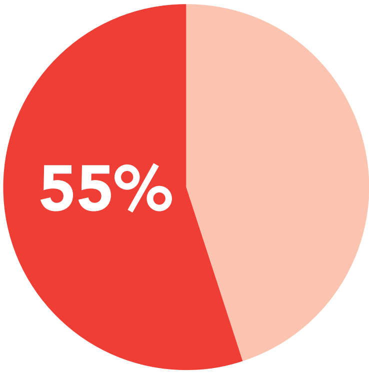
New polling conducted by Ipsos Mori for the Resolution Foundation in February 2013 reveals how widespread the living standards squeeze has now become. Nearly seven out of ten people (68%) said that they are cutting back on spending, with women far more likely to be cutting back than men (74% vs. 62%).

Polling conducted by IPSOS Mori from 1 February to 3 February 2013 with a telephone sample of 1005 people.

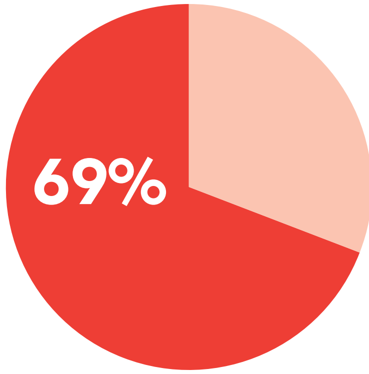
Although household incomes for all groups have fallen in real terms since the recession, low to middle income households feel the squeeze particularly acutely because they spend a greater proportion of their income on essentials than higher income households. The cost of essentials such as food, fuel and transport have risen much faster than inflation in the overall economy in the last decade, leaving the group facing an 'inflation premium'. This 'inflation premium' means their annual spending power was £280 lower in 2012 than it would have been had they faced the same inflation rate as higher income households from 2003.

With more of their disposable income going towards essentials, cost pressures take their toll. Nearly 60% of the group is struggling to keep up with bills either sometimes or all of the time, with a further 7% being behind with at least one household bill. Families in the group frequently have to go without things more affluent families take for granted. 40% say that they cannot afford to replace worn out furniture, compared with 14% on higher incomes and 46% say that they cannot afford a week's holiday compared with 18% among higher income households.

Low to middle income households find it hard to save because daily living costs eat up nearly all of their monthly income. Just over half have no savings at all and two-thirds have less than a month's income in savings. This leaves them vulnerable to even small shocks such as an unexpectedly large bill. Major shocks such as illness or unemployment can be catastrophic and a large proportion of



no savings



no pension

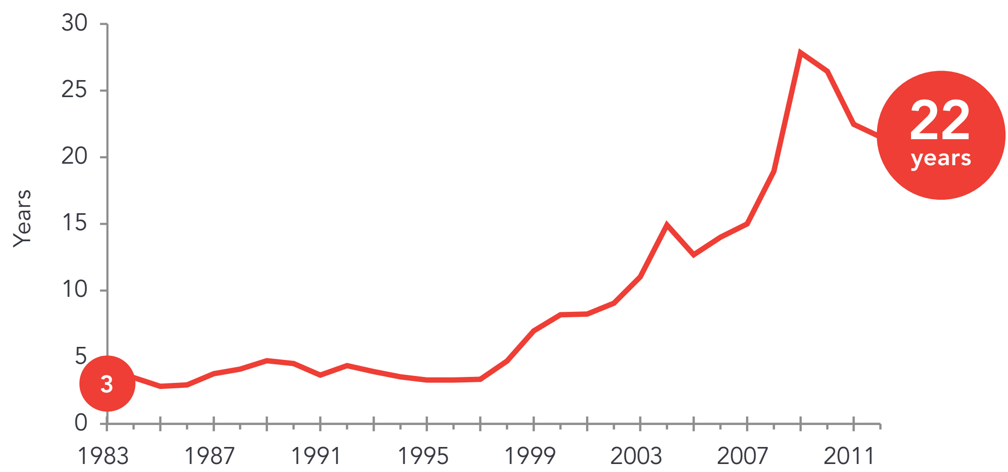
the group is at risk of poverty in old age. Over two-thirds of households in the group have no pension or a frozen pension compared with 41% among the higher income group. In fact, the percentage of people actively contributing to a pension has fallen over time across all groups.

With little ability to save and 100% mortgages no longer available, the aspiration of home ownership is moving out of reach, especially for younger people in the group who are unable to accumulate a typical first time buyer deposit. For the first time, the majority of under 35s in the low to middle income group now live in the private rented sector.

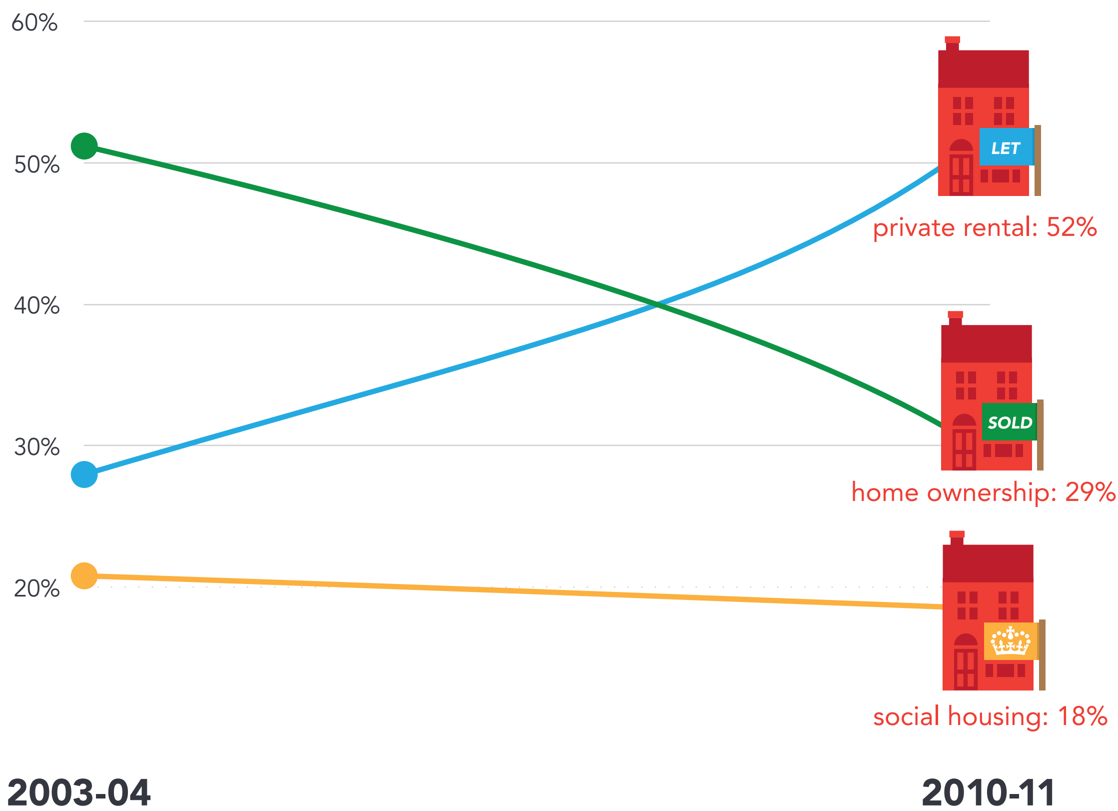
Where low to middle income households do manage to buy their own home, they often remain in a vulnerable position. Around one-quarter of mortgage holders in the group are already paying more than 25% of their income in mortgage payments. This figure is little changed from the late 1990s, despite the historically low level of today's interest rates. It is driven in part by the extent to which families have stretched themselves to get on the housing ladder in recent years and in part by the fact that mortgage lenders have not passed on the full extent of record low interest rates to these customers. As a result, many exposed households could face severe financial difficulty once interest rates finally rise.

Overall, debt repayment presents a growing burden among low to middle income households. Among all households with some form of debt in the bottom half of the income distribution, 30% can be considered 'debt-loaded'; that is, their repayments account for more than a quarter of their gross household income. Just 14% of debtors in the top half are in this position.

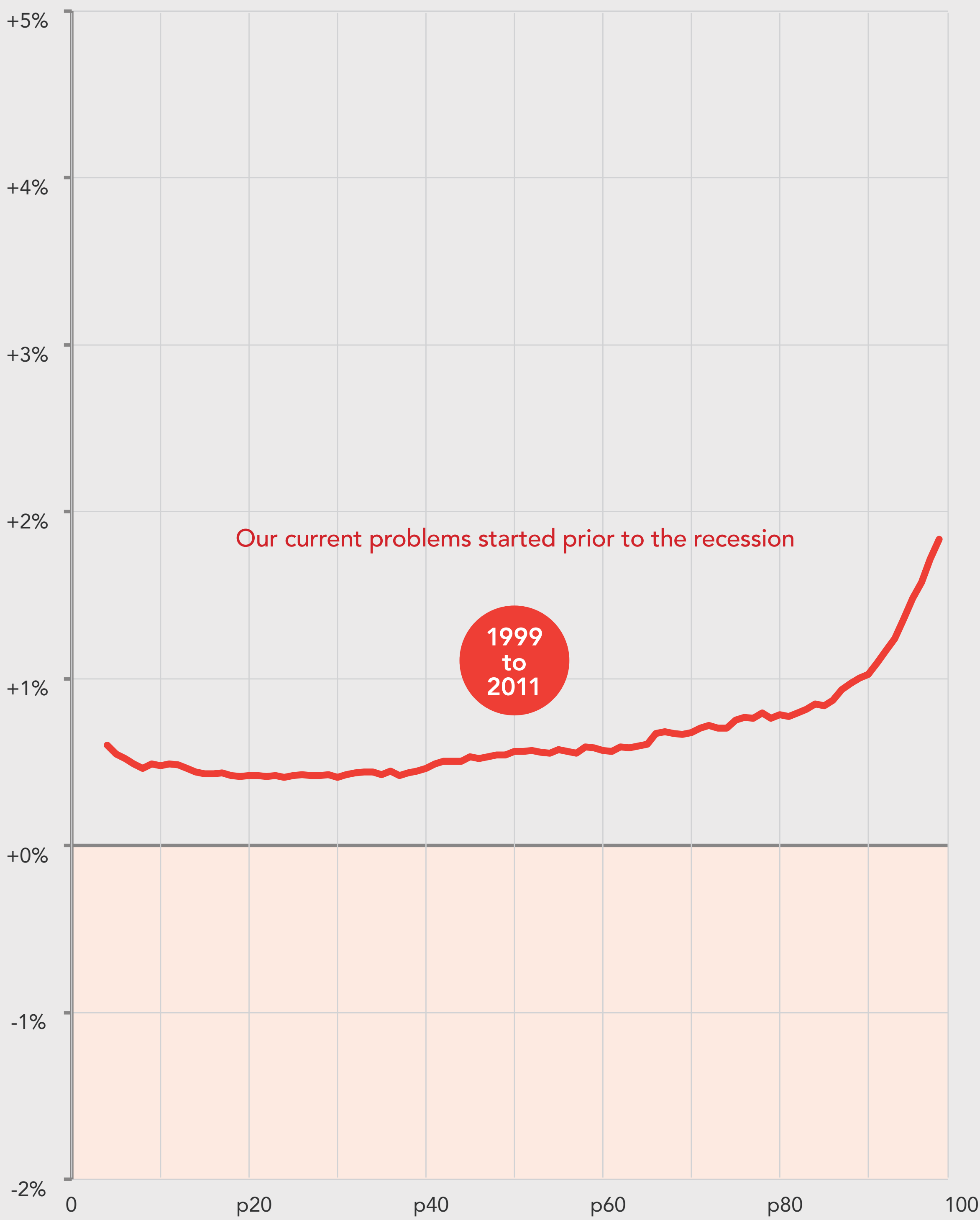
Number of years required for low to middle income households to save for typical first time buyer deposit



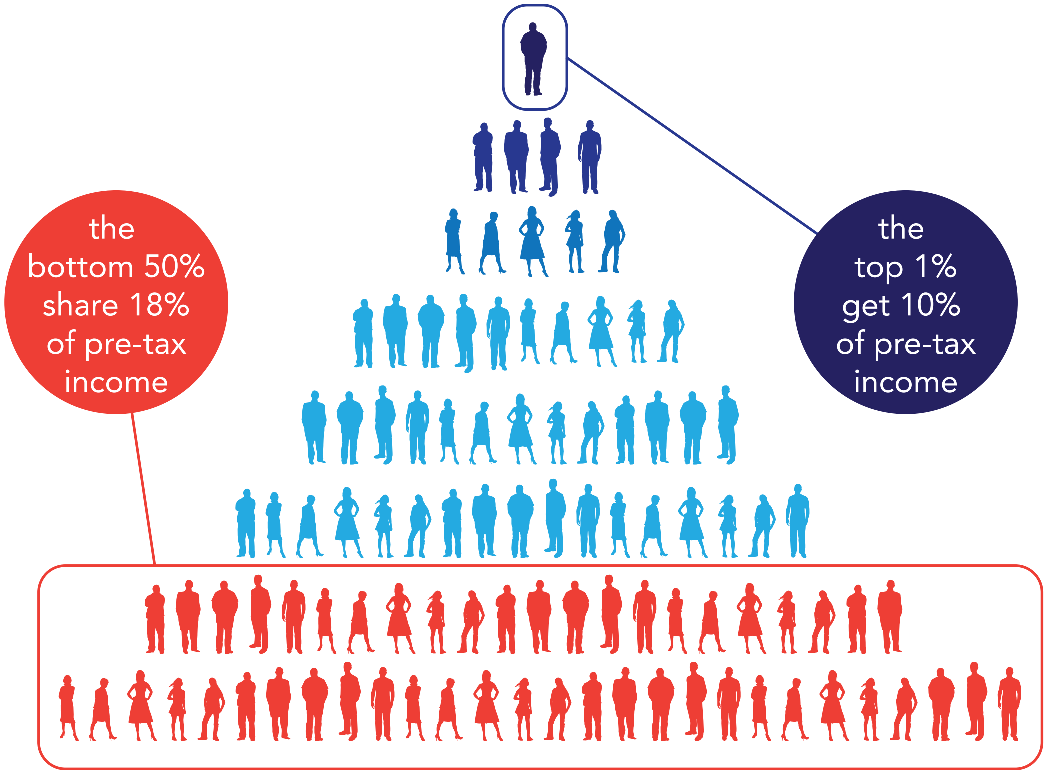
Change in tenure among under-35 year-old low to middle income households



The origins of the squeeze



Who benefits from growth?



While real-terms wage growth was negative across the board from 2008 to 2011 as the financial crisis tipped into a protracted downturn, the five years prior tell a different story. The wages of ordinary full-time workers barely grew during this period and were negative for the lowest earners, despite relatively healthy economic growth. Even workers in the top half saw their wages grow only slowly. It was only the very richest – those in the top 5% - who experienced growth of more than 1% a year.

This pattern of wage growth among individuals contributed to a growing polarisation in household incomes.

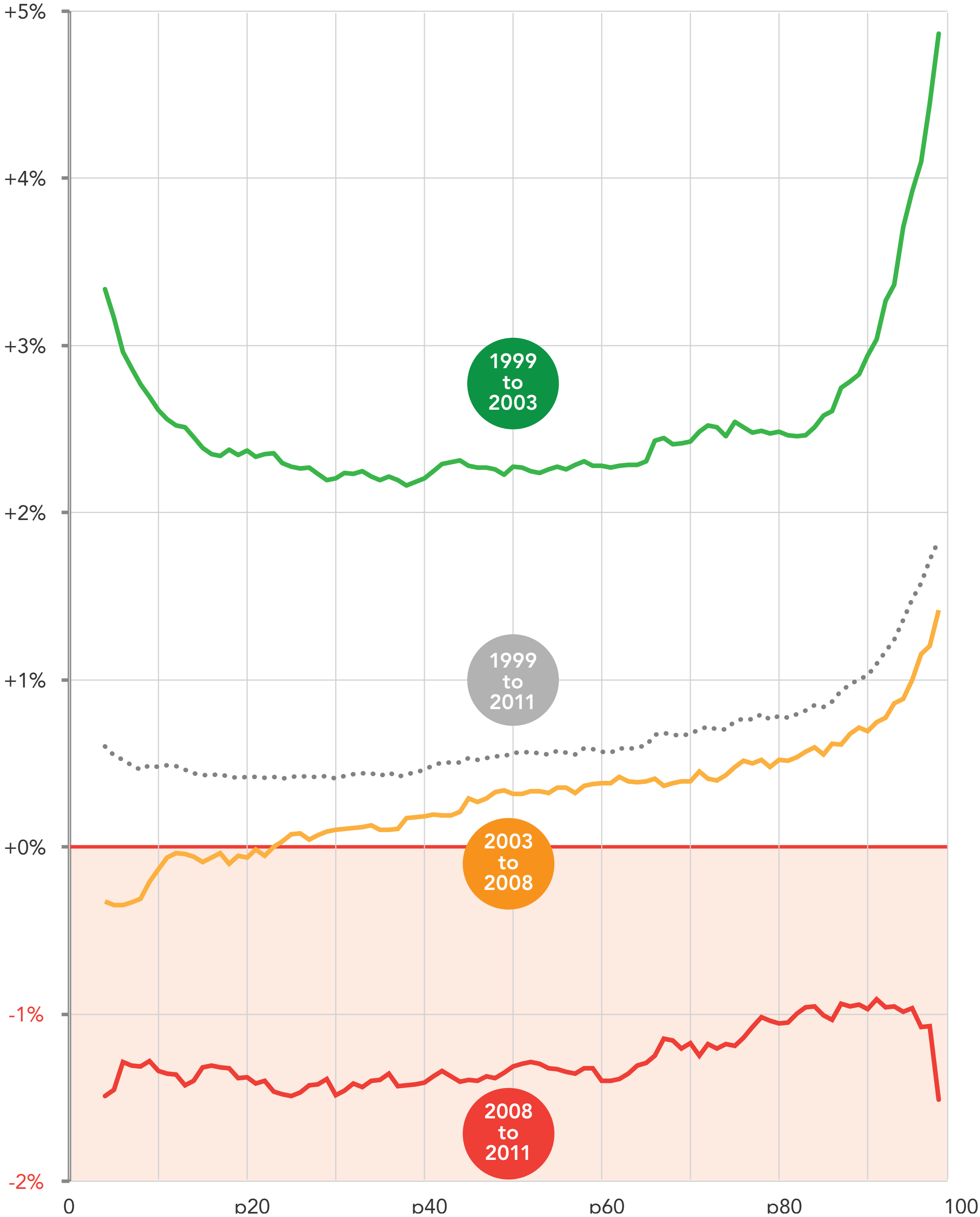
Households in the top 10% of the working-age income distribution accounted for 37% of the overall growth in gross income from employment and investments between 1994-95 and 2010-11, with the top 1% alone taking 13%. In contrast, those in the bottom half accounted for just 17 per cent of overall income growth.

As such, the top 1% of households accounted for more than 10% of the share of total working-age employment and investment income in 2010-11, up from 7 per cent in 1994-95. The bottom half's share dropped from 19% to 18%. But many in the top half also lost out. The proportion accounted for by those between the 50th and 90th percentile actually fell from 52% to 49%. The very richest in Britain thus moved ever further away from the vast majority in society over the past two decades.

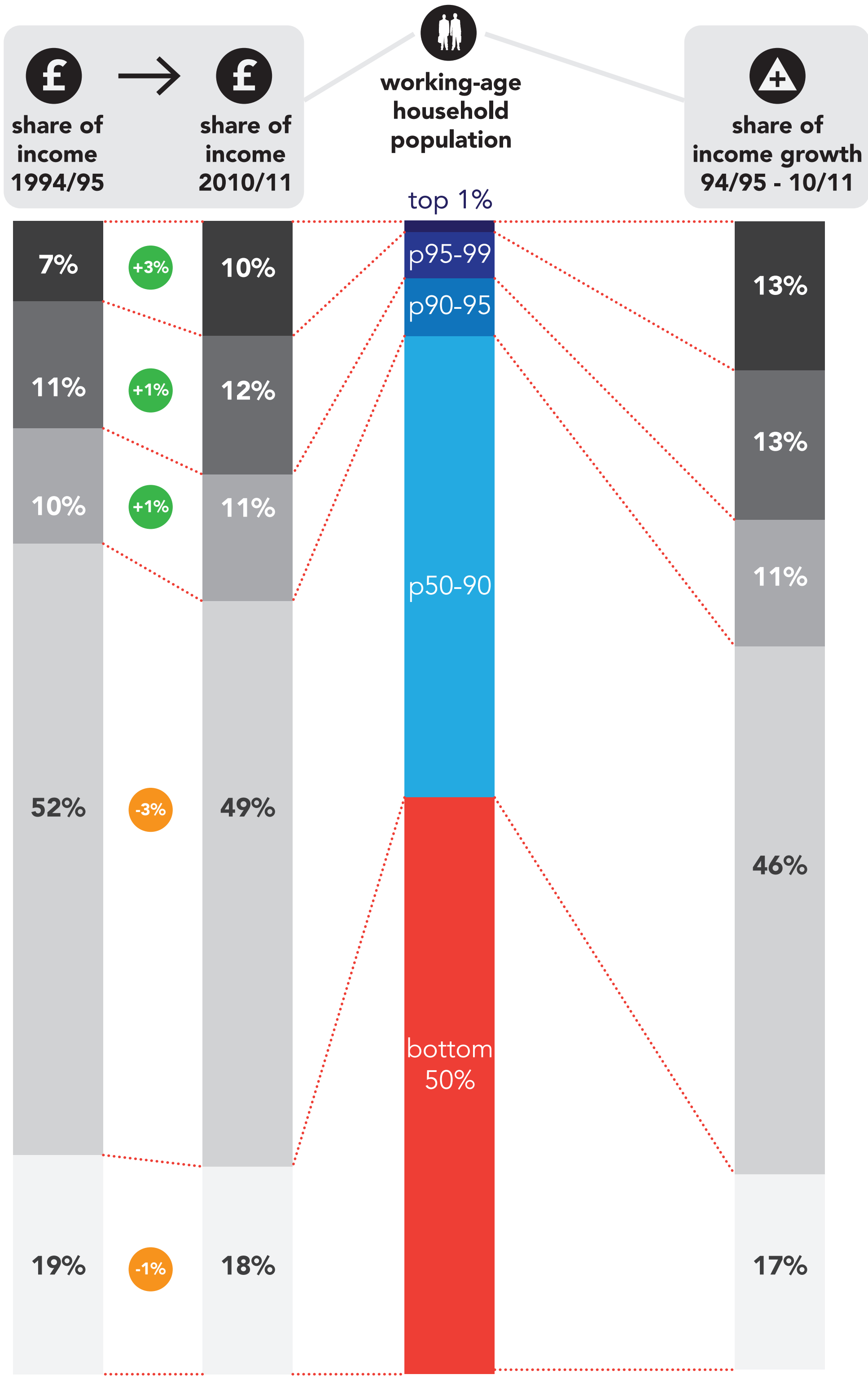
Measured after taxes and benefits these divergences look less marked, but the pattern of growth at the very top and declines elsewhere still remains. The share of post-tax and benefit income going to the bottom half still fell from 29% in 1994-95 to 28% in 2010-11. Again, those in the top half but outside of the top 10% also experienced a falling share: from 47% to 45%. On a post-tax basis, the share going to the top 1% increased from just under 6% to over 7%,

The picture looked more extreme in 2009-10, with many of the highest earners bringing forward future income in order to reduce their liability for the 50p tax that came into force from April 2010. The top 1% accounted for 16% of the growth in income from employment and investments from 1994-95 to 2009-10 – the same as the bottom 50%. It remains to be seen whether the share of the top 1% rebounds in 2012-13 and thereafter.

Average annual growth across the earnings distribution among full-time employees (real-terms annual earnings)



How is pre-tax and pre-benefit income shared across the working-age household income distribution?

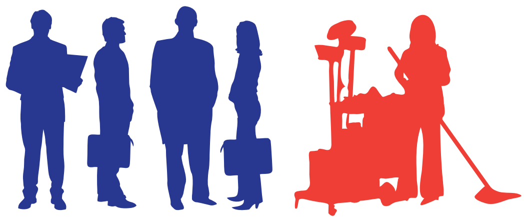


Low Pay Britain

the UK has the

2nd largest

share of low paid work in the developed world



just over

1 in 5

in the UK are low paid, particularly women

Britain has one of the largest low wage economies in the developed world. Only the US has a greater share of low paid workers. Based on the OECD's threshold (two-thirds of median pay), 21% of people in the UK are low paid. Using the Living Wage of £7.45 (£8.55 in London) as an alternative threshold, 20% of people are low paid. In contrast to the National Minimum Wage which is set at a level so as to avoid any undue impact on employment, the Living Wage is set at a level adequate to provide a minimum standard of living, assuming full take up of benefits and tax credits.[1]

Low pay is prevalent across the economy, in all regions and among the public and private sectors. It particularly affects women, those who work part-time and those doing agency work or other kinds of temporary employment.

The sector with the highest proportion of low paid workers in Britain is hotels and restaurants where just over two-thirds of workers are low paid. This is followed by wholesale and retail, administration and the arts, each of which has just over a third of workers who are low paid. These four sectors combined account for a third of all jobs held by those in the low to middle income group. Just over half of low paid workers as defined by the OECD are in low to middle income households.

If earnings are to make up some of the ground left by reduced state support, wages will need to rise more strongly in coming years. Analysis suggests that large firms in some sectors could afford to bear such increases. In construction, banking, software and computing and food production, it is estimated that large firms would see no more than a 1% rise in their wage bills, if all workers currently paid below the Living Wage had their pay increased up to the Living Wage. In low wage sectors such as retail and bars and restaurants, the cost for large firms would be greater - close to or in excess of 5%. This assumes that they make no adjustments to the way they operate to absorb additional costs. In practice, evidence from the

1 Both the UK and London Living Wage rates are explicitly premised on the full take-up of tax credits and other means-tested benefits (such as housing benefit and council tax benefit). If take-up of such entitlements was not factored into Living Wage calculations, the appropriate rates would be far higher.

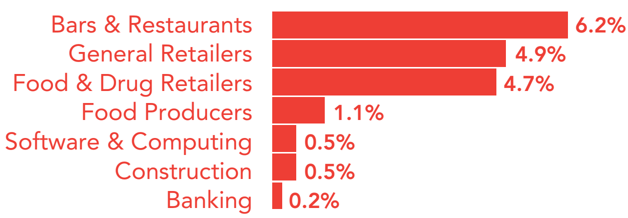
	number of low to middle income jobs	share of all low to middle income jobs	low to middle income jobs as share of total
Retail, wholesale & repair of motor vehicles	1,330,000	17%	39%
Health & social work	1,070,000	13%	31%
Manufacturing	850,000	11%	33%
Construction	690,000	9%	34%
Education	620,000	8%	24%
Hotels & restaurants	550,000	7%	45%
Admin. & support services	520,000	7%	40%
Transportation & storage	490,000	6%	37%
Public admin, defence & social security	410,000	5%	20%
Professional, scientific & technical	380,000	5%	22%
Other service activities	250,000	3%	37%
Arts, entertainment & recreation	190,000	2%	34%
Financial & insurance activities	180,000	2%	17%
Information & communication	170,000	2%	18%
Agriculture, forestry & fishing	90,000	1%	40%
Real estate activities	50,000	1%	22%
All other industries	110,000	1%	24%
	7,950,000	100%	31%

National Minimum Wage suggests that firms do adapt to higher costs.

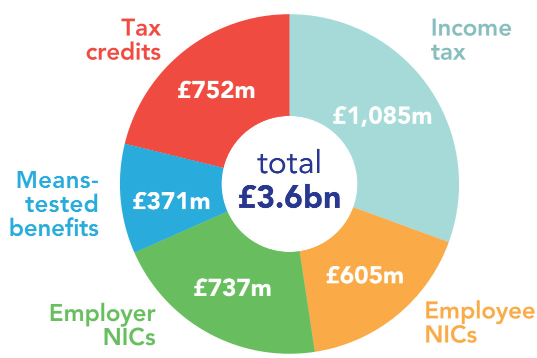
Higher wages do not only benefit workers. They also benefit the public purse. To take an extreme example, if all employers paid the Living Wage, the estimated savings to the government in terms of lower spending on tax credits and in-work benefits and higher revenues from tax and national insurance would be £3.6 billion. Factoring in the cost of higher wages in the public sector from a hypothetical shift to the Living Wage would result in an overall net saving to government of £2.2 billion.

Households that directly benefit from the Living Wage would be on average around £850 a year better off with the greatest proportionate gains going to the least well off. However, since low earners are spread across the household income distribution, the gain would not be restricted to households in the bottom half. For lower income households, even with higher wages there would be an ongoing need for sustained spending on tax credits to adequately support living standards.

Average firm-level wage bill increase from raising all low paid workers to the Living Wage by industrial sub-sector



Breakdown of potential public sector savings from raising all low paid workers to the Living Wage



Families and work

Share of household income in the low to middle income group provided by male and female employment

Alongside wages, employment levels are the other major driver of living standards. Over the last 40 years, the gender composition of household income among the low to middle income group has been transformed. In 1968, female employment made up only 11% of income in the average household in the group and men's work made up 71%. Today, female employment makes up 24% and men's work makes up 40%. These changing patterns have pushed issues such as the cost of childcare up the political and policy agenda.

As the proportion of working men in low to middle income households declined in the run up to and during the recession, women's employment held steady and the employment gap between men and women started to close. However, more recent reductions in public sector jobs have affected women in the group more than men which has seen the employment gap start to widen again.

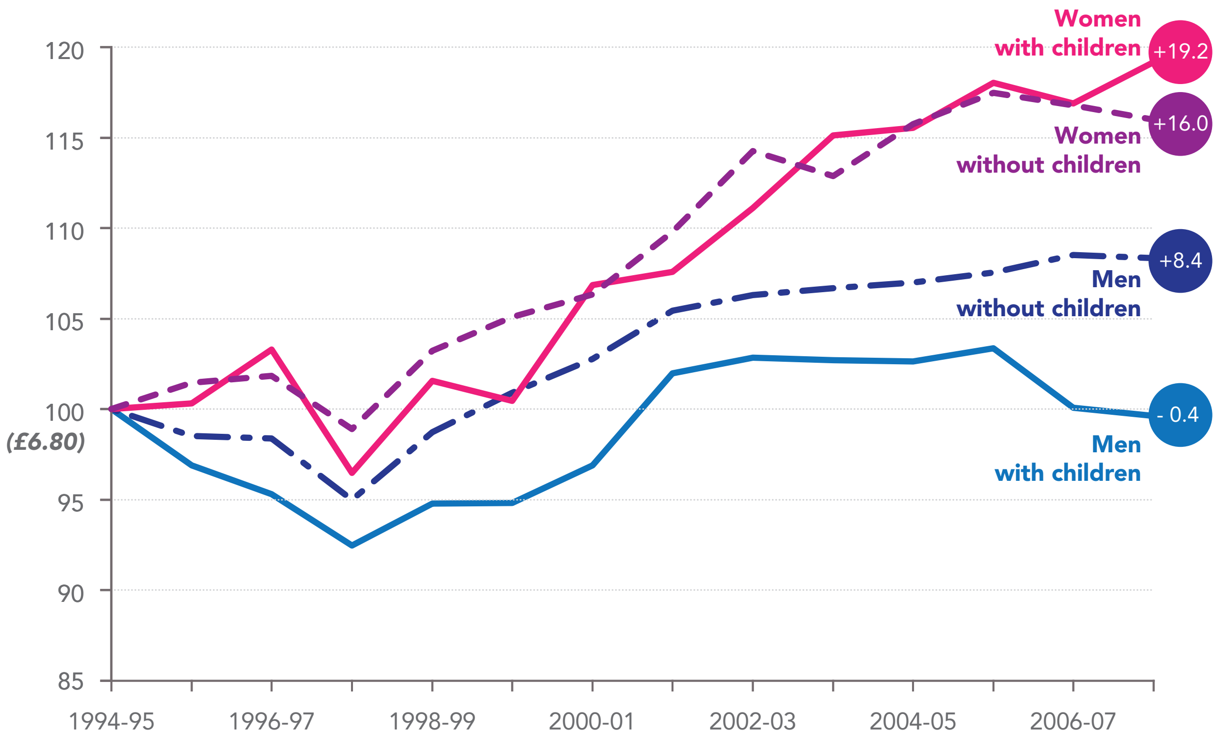
Men are far more likely to be self-employed than women, although self-employment has grown among both genders. In fact, the overall increase in self-employment in the economy as a whole since 2000 has been largely driven by low to middle income households, accounting for 70% of the overall change.

The wages of mothers grew more quickly than those of other women between 1994-95 and 2007-08. By contrast, fathers lost out compared to other men. As a result, the wage gap between mothers and fathers has narrowed. Full-time working fathers at the 25th percentile experienced a slight fall in hourly wages between 1994-95 and 2007-08 compared to 19% growth for full-time working mothers who were at the same position in the wage distribution in 1994-95.

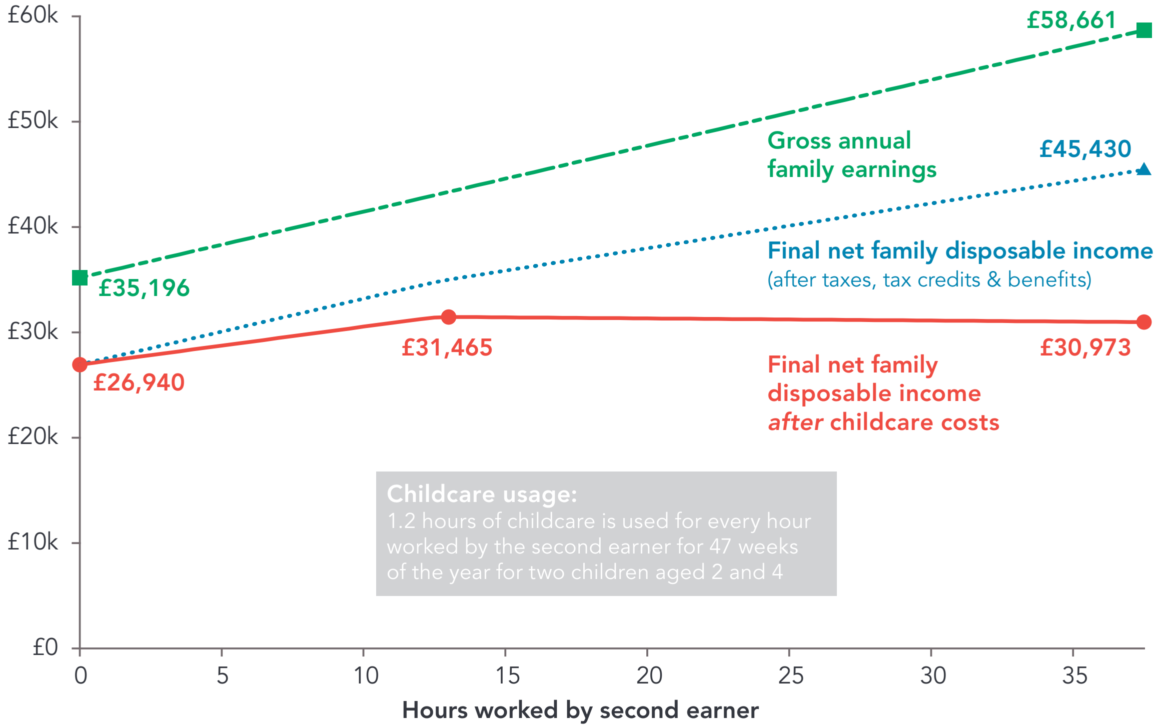
This shift in earnings dynamics within families helps explain the changing pattern of child poverty. Since the late 1990s, overall child poverty has been on a downward trajectory, but an increasing proportion of families in poverty are in work. Single-earner, typically male breadwinner, families now account for the largest share of children growing up in poverty. Dual-earning acts as an important source of protection against poverty.

Percentage of men and women in the low to middle income group who are...

Real terms wage growth by parental status among full time workers starting the period on £6.80 an hour



Childcare and the hours trap



Despite strong progress over 40 years, female employment in Britain has plateaued in recent years. Making additional progress over the next decade will be critical for living standards. Britain is a middling performer by international standards, ranking 15th in the OECD for female employment. Other countries perform far better, suggesting that there is significant room for improvement. Britain does particularly poorly for women of child bearing age and for women over the age of 50. If female employment levels in Britain matched those of the best performers, one million more women would be in the workforce.

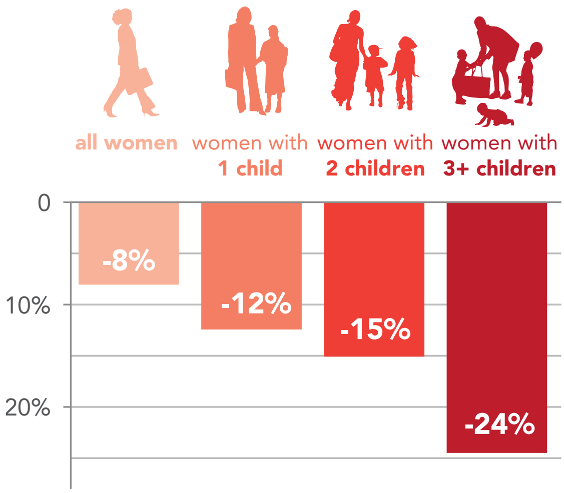
The high cost of formal childcare in Britain has been highlighted as a significant barrier to female employment. It is not surprising then that grandparents are the most common type of childcare used by low to middle income families with children under five. High costs of formal childcare mean that families are often worse off if the second earner works more hours.

As a result of these high childcare costs, a typical middle income family with two children under five would be no better off if the mother worked full-time than if she worked only 13 hours a week, assuming her partner already works full-time. This is because, once she exceeds the 15 hours of free childcare provided for all three and four year olds, the costs of childcare on top of the effects of the tax-benefit system, would eat away a large chunk of her full-time earnings. If childcare costs are calculated after families have paid for housing, the picture is particularly bleak. For a typical middle income family, childcare for two under fives in full-time care accounts for 41% of net income after housing costs.

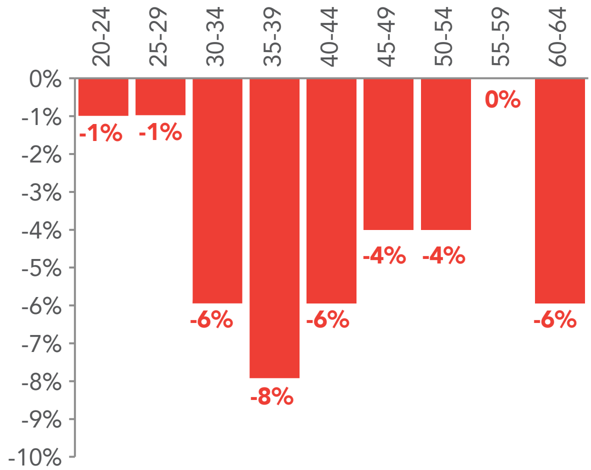
The impact of childcare costs on work incentives for second earners affects almost all working families with young children but is most acute for those with three or more children. Here, the gap between maternal employment in Britain and the top performers in the OECD is very large –24 percentage points.

The introduction of Universal Credit will help those who want to enter work or work only a few hours. This contrasts favourably with the existing tax credit system where parents are not eligible for support with childcare unless they work at least 16 hours a week. However,

Gap in maternal employment rate between UK and best OECD performers by number of children



Gap in female employment rate between UK and better OECD performers by age of woman

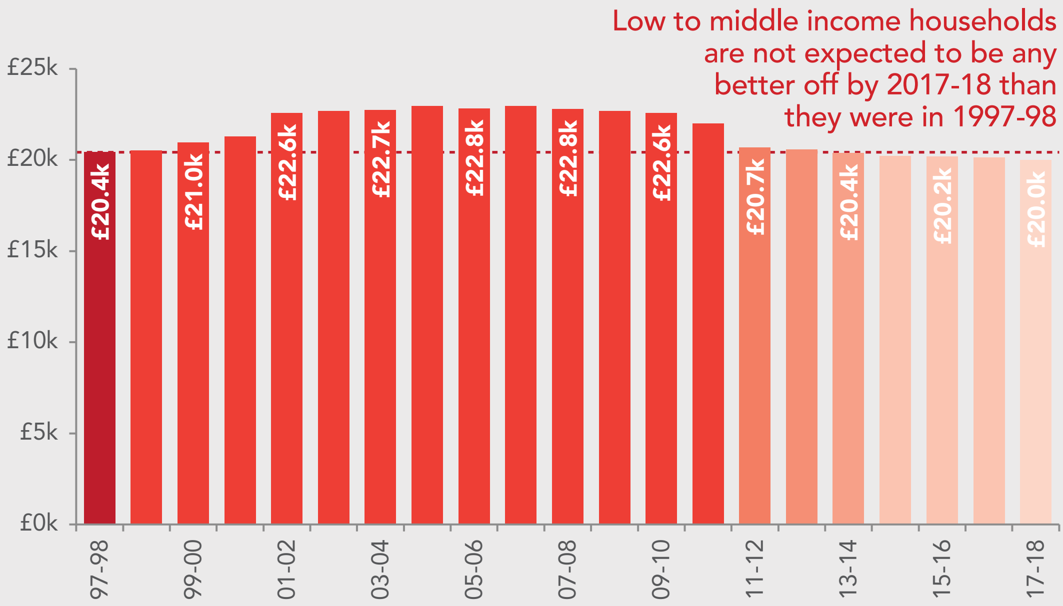


women who are already working part-time will face greater disincentives to progress in work and extend their hours under Universal Credit because support will be withdrawn more quickly than under the current system. This will act as a brake on living standards for low to middle income families for whom female employment will remain critical.

Alongside maternal employment, Britain also falls behind compared to other leading nations among female older workers. It is welcome that the overall employment rate for older workers has risen over the last 20 years, yet Britain started to fall behind our international competitors from 2008. An aging population and the rise in the state pension age make employment among the over 55s an urgent priority, particularly for women. Without supporting people to remain in work for longer to increase their pension savings, the rise in the state pension age will see many older people facing poverty in their later years.

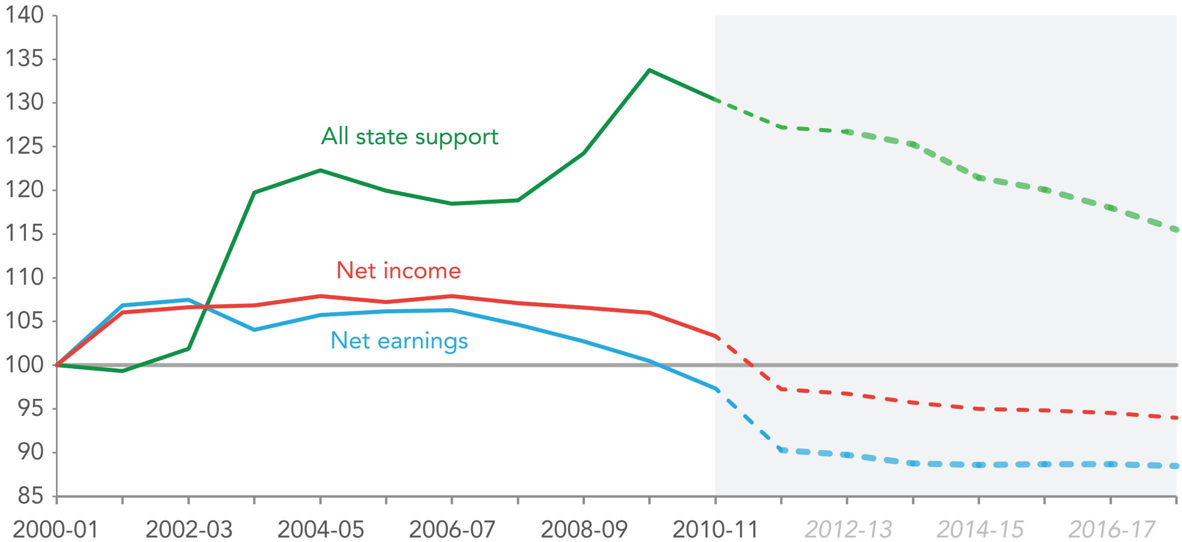
Successfully extending working lives will depend on a large number of factors, including improving financial incentives to remain in work and increasing the availability of flexible working to allow older people to balance work and caring responsibilities or to continue working if they have a long term health problem. This is particularly important for older people in the low to middle income group who are far more likely to suffer from ill health than those on higher incomes. In this context, Universal Credit presents an opportunity: it will provide support if people work fewer than 16 hours per week, leaving them better off than under the current system if they choose to cut back their hours as they age.

The decade ahead



The decade ahead

Real terms change in average income from employment and state support in low to middle income households



New polling for the Resolution Foundation reveals a cautious outlook among the electorate as to the prospects for the economy. The public is divided about how long it will take for growth to return.

More than a third of people (36%) do not believe that the economy will be growing again by 2015, expecting instead two more years without growth on top of the nearly five years to date. Nearly half (47%) are more optimistic that economic growth will have returned by 2015.

Four in ten people expect to be no better off in 2015 than they are today as the squeeze on wages, employment and government support continues to bite. However, almost the same number (42%) think that they will be better off in 2015 than they are today.

Polling conducted by IPSOS Mori from 1 February to 3 February 2013 with a telephone sample of 1005 people.

With typical wages stagnant from 2003 and then falling in the downturn, low to middle income households have been increasingly reliant on state support to protect their living standards. But the growing role of tax credits went into reverse in 2011-12 when a series of reductions in in-work benefits began. Recently this has been compounded by the decision to uprate benefits by 1% rather than in line with inflation for the next three years. This will see state support for low to middle income households steadily decline over the coming years.

Low to middle income households face a long and painful road to recovery. The average post-tax household income of the group is projected to fall to only £20,000 over the coming four years.

Case studies

								CHANGE FROM 2010-11		
		GROSS EARNINGS	POST-TAX EARNINGS	WORKING TAX CREDIT	CHILD TAX CREDIT	CHILD BENEFIT	**TOTAL INCOME**	WAGE SQUEEZE	TAX/BENEFIT SQUEEZE	**CHANGE**
Aaron & Sophie **3 children** *3, 5 and 7* **single-earner** *(35hr/wk)* 	**2012-13**	**£45,147**	£32,694	N/A	£0	£2,449	**£35,413**	- £3,702	+ £194	**- 9.0%**
	2013-14	**£44,692**	£32,681		£0	£2,378	**£35,059**	- £4,158	+ £295	**- 9.9%**
	2014-15	**£44,646**	£32,629		£0	£2,342	**£34,971**	- £4,203	+ £253	**- 10.1%**
	2015-16	**£44,732**	£32,605		£0	£2,296	**£34,900**	- £4,117	+ £96	**- 10.3%**
Ben & Mandie **2 children** *under 1 and 4* **dual-earners** *(42hr/wk total)* 	**2012-13**	**£39,127**	£31,671	£2,170	£5,925	£1,752	**£41,518**	- £3,209	- £1,490	**- 10.2%**
	2013-14	**£38,733**	£31,810	£1,864	£5,811	£1,701	**£41,186**	- £3,603	- £1,427	**- 10.9%**
	2014-15	**£38,694**	£31,805	£1,478	£5,720	£1,675	**£40,679**	- £3,642	- £1,895	**- 12.0%**
	2015-16	**£38,768**	£31,824	£ 972	£5,603	£1,642	**£40,041**	- £3,568	- £2,607	**- 13.4%**
Nikki **2 children** *3 and 17 (in education)* **single parent** *(32½hr/wk total)* 	**2012-13**	**£28,092**	£21,634	£2,145	£5,925	£1,752	**£31,456**	- £2,304	- £ 972	**- 9.4%**
	2013-14	**£27,808**	£21,645	£1,926	£5,811	£1,701	**£31,083**	- £2,587	- £1,062	**- 10.5%**
	2014-15	**£27,780**	£21,637	£1,647	£5,720	£1,675	**£30,680**	- £2,615	- £1,437	**- 11.7%**
	2015-16	**£27,833**	£21,658	£1,279	£5,603	£1,642	**£30,182**	- £2,562	- £1,989	**- 13.1%**

By 2015-16, the impact on household incomes of the wage squeeze combined with the tax benefit squeeze since 2010-11 can be expected to affect individual families in the following ways:

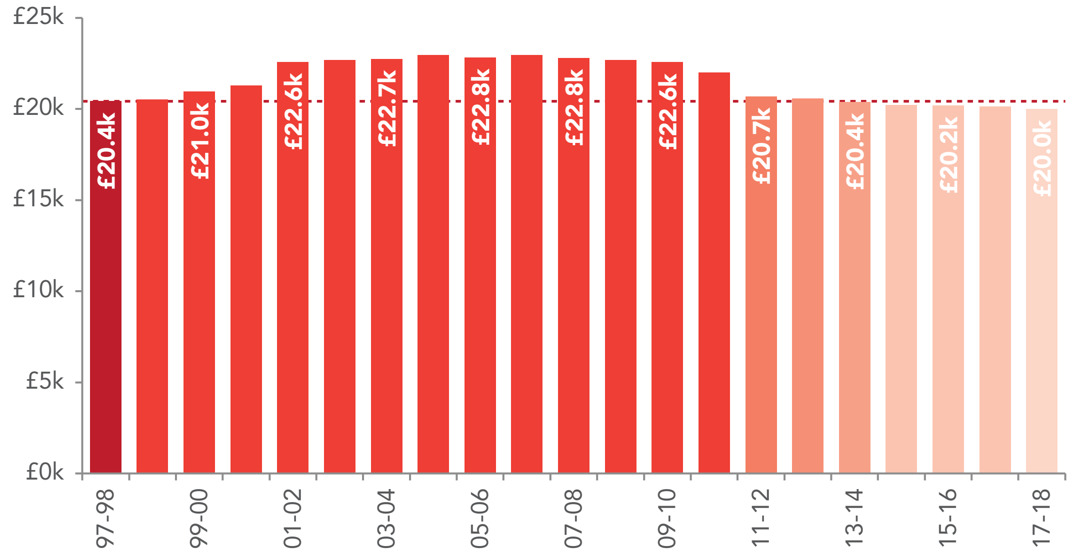
Aaron and Sophie who have three children can expect their household income to be £34,900 (in 2012-13 prices), £4,000 lower than it was in 2010-11. For them, a wage squeeze of £4,100 is slightly offset by the tax benefit system which contributes £100 more to their household income in 2015-16 than in 2010-11.

Ben and Mandie and their two children can expect a household income in 2015-16 of £40,000 (in 2012-13 prices), £6,200 lower than in 2010-11. Of this overall fall, they lose £3,600 in wages and £2,600 in state support.

Nikki, a single parent with two children, will see her family income fall by 13.1% between 2010-11 and 2015-16 to £30,200 (in 2012-13 prices). Of this, £2,000 will be lost in state support and £2,600 in wages.

The long road back to better living standards

Average post-tax income among low to middle income households



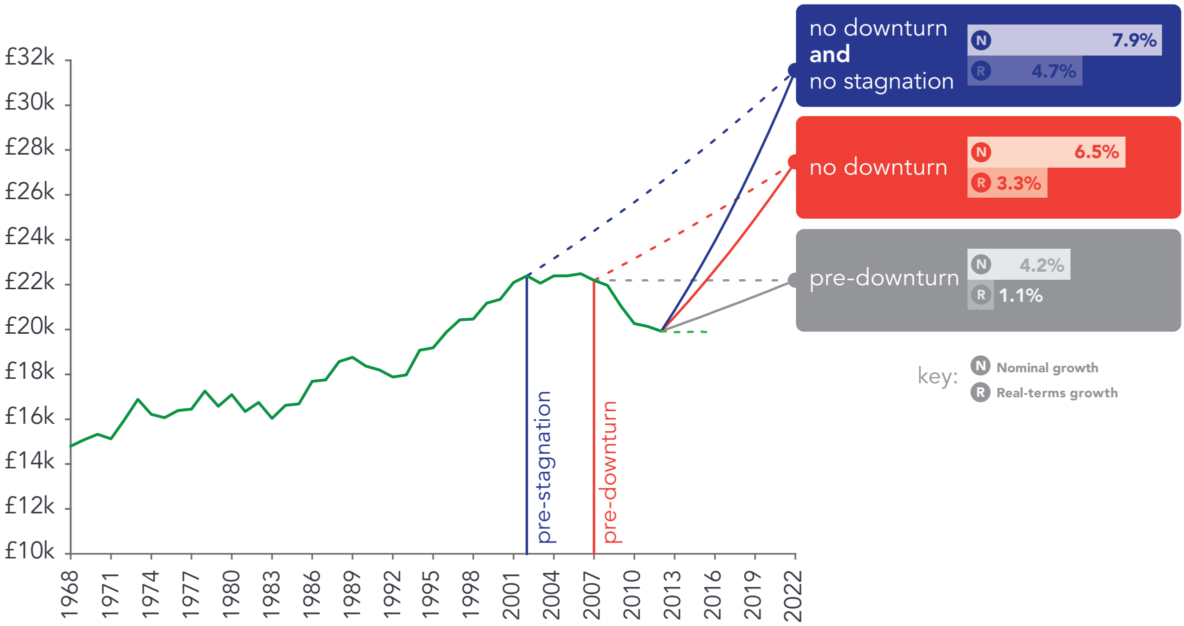
Based on current projections, the typical low to middle income household is expected to be no better off by 2017-18 than it was in 1997-98. A rise in living standards will primarily depend on one of two things: stronger wage growth or increasing employment – whether through more people working or more hours for those already in work. It is hard to see a resumption of rising tax credits and benefits propping up household incomes. Forecasts for the size of the structural deficit and the scale of the implied cuts to departmental spending post-2015 mean that this is very likely to remain the case regardless of the outcome of the 2015 election.

As we have seen, there are major challenges to raising wages or employment, given Britain's large low wage labour market and the tailing off of growth in female employment over the last decade. The significance of unexpectedly high labour demand in the private sector over the last year for future employment growth remains uncertain.

To better understand the challenge ahead we can consider what would have to happen to growth in employment income to make up lost ground. For a start, what would it take over the coming decade for the low to middle income group to get back to where it was before the recession? In 2008 household income from employment among the group was £22,000. To get back to this level by 2022-23, household level earnings would have to grow by 1.1% a year in real terms. This should be achievable by historical standards. But given the likely decline in earnings over the next few years and ongoing macro-economic uncertainty, it is hardly guaranteed. And this would do nothing more than get low to middle income households back to where they were pre-recession. Furthermore, this does not take into account reductions in household income that can be expected as a result of declining support from tax credits and benefits.

For households in the group to get back to the level of employment income they would have enjoyed in the absence of a prolonged downturn - that is, to recover the lost ground - would require a rate of real terms earnings growth of 3.3% a year over the next decade. This would

Average annual growth in household employment income required to close the earnings gap in the low to middle income group



see household income from employment in the group reach £27,500. This rate of growth seems highly improbable given where the economy is today and by historical standards. Low to middle income households have not achieved this level of real terms earnings growth in more than two consecutive years since the late 1960s. Households in the group are likely to face a permanent hit to their life time earnings as a result of the prolonged downturn.

To take a more extreme example, if there are those that once assumed that incomes would keep growing at the rate they did from the 1980s until the early 2000s, they will need to adjust to even greater disappointment. If neither the post 2008 downturn, nor the preceding period of wage stagnation had occurred, and earnings had continued their uninterrupted rise, employment income would now be £31,500 – £11,000 higher than it is today. To make up the necessary ground over the next decade to achieve this hypothetical level of employment income would require an annual rate of earnings growth among low to middle income households that far outstrips anything that has been achieved in Britain over the last 40 years. It isn't going to happen.

The road back to higher living standards for low to middle income households will be long, and some of the lost ground cannot be made up. The scale of the loss will depend in no small part on how quickly and stably the overall economy recovers. But as the years before the recession illustrate, low to middle income households were standing still even while the economy grew. Ensuring that those in the bottom half take their fair share of the benefits of a return to growth will be one of the key challenges for all political parties, and the country, in the decade ahead.

Citations and references

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