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REPORT

Under New Management

Options for supporting 'just managing' families at the Autumn Statement

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Executive Summary

To date, the attention focused on 'just managing' families – those working families on low to middle incomes who are just about getting by – by Theresa May and her new government has been made up of important words but, understandably so early into a new government, little by way of action. The Autumn Statement on 23 November offers a first concrete chance to set out just how the government intends to support the group. Given the headwinds facing the 'just managing', it is vital that the new Chancellor Philip Hammond delivers, both for the families concerned and for the chances of the government having a record that matches their ambitions in this area .

The need for support is clear – and growing. Average incomes in the low to middle income group were no higher in 2014-15 than in 2004-05, reflecting not just the turmoil of the post-crisis period but also a sharp pre-crisis slowdown in income growth.

At various points over this 'lost decade' of growth, incomes were propped up by social security (with the development of tax credits helping to boost employment and incomes during the mid-2000s) and by employment (with the post-crisis recovery proving particularly strong in this regard). But the outlook on both these fronts – and on earnings too – looks less secure going forward, raising questions over where future income growth might come from.

Pay growth picked up strongly in 2016, helped both by ultra-low inflation and by the introduction of the National Living Wage which has significantly raised the wage floor for those aged 25 and over. But this risks being something of a blip, with the UK's chronic productivity performance meaning a return to widespread wage-led growth looks unlikely, not least given the end of a period of near zero inflation. On employment there is of course some scope for more gains in the coming years but, given the record number of people already in work, it seems unlikely that low to middle income households will be able to count on achieving quite such rapid improvement in employment rates over this parliament as they saw in the last.

That economic outlook has also darkened over the course of the past year. Looking across the average of independent forecasters, we find that projections for unemployment have been revised up since the March Budget, following the recent referendum. Likewise, real pay growth is now projected to be lower than previously thought – a product of both lower nominal pay growth and higher inflation. The scale of change indicated by these forecasts is of course very uncertain – particularly in relation to employment and pay, with higher inflation a more certain reaction to the drop in the value of sterling – but there is a clear consensus that the next few years look more difficult than previously thought.

Yet even before accounting for this changed economic climate, the coming years already looked tough for the 'just managing' thanks to £12 billion of working-age benefit cuts introduced in the aftermath of the 2015 election. These cuts, concentrated on working households in the bottom half of the income distribution, more than offset the gains associated with the welcome introduction of the National Living Wage (which provides a big boost for the low paid but spreads gains across the household income distribution) and less welcome income tax cuts (where the clear majority of gains flow to the top half of the distribution).

As a result of both these policy-induced and economically-determined headwinds, projections for income growth in the current parliament point to real terms *reductions* for the poorest two-fifths of households, with losses of roughly 0.6 per cent a year at the 25th percentile and 1.2 per cent a year at the 10th percentile. Even for those higher income households who *do* look set to achieve income growth over this parliament, increases of just 0.5 per cent a year are weak by historic standards.

Yet in considering how to change this picture in his Autumn Statement, the Chancellor faces a difficult backdrop. Earlier in our series of pre-Autumn Statement papers we estimated that changes in economic circumstances - some associated with post-referendum fallout, some arising even before the referendum - were set to increase government borrowing relative to plans at the March Budget by around £84 billion over the course of this parliament. In theory that provides the Chancellor with significantly less fiscal room for manoeuvre than he would have hoped for. But, by indicating that there is a need for a fiscal 'reset' in which his predecessor's target for overall surplus in 2019-20 is abandoned, he has given himself the opportunity to establish significant (our estimate is up to £17 billion), if uncertain, headroom.

He also has the ability to reprioritise within existing fiscal plans - and we have suggested pressing pause on income tax and corporation tax cuts as a way of releasing roughly £4 billion for more targeted support for the economy in general and 'just managing' families in particular.

While the choices are hard, what appears clear is that the Chancellor does have options: the extent to which he utilises them will go a long way to determining just how serious the government's focus on the 'just managing' is.

His response will rightly include a focus on investment and productivity growth, with this being the key to boosting living standards in the long-run. But he also has a chance to make a more immediate impact on the living standards of the 'just managing' by revisiting some of the key welfare policies he has inherited including:

» ***Cuts to Universal Credit (UC) work allowances:*** This policy has reduced the amount that families can earn before their UC award starts being tapered away, both reducing incomes among working families and lowering incentives to work. It is due to save almost £3 billion by 2020-21, but will reduce incomes in the poorest half of the income distribution by an average of 0.8 per cent when UC is fully rolled-out, with annual losses of up to £2,800 for a working single parent for example.

» ***The four-year cash freeze to working-age benefits:*** This freeze replaced the default uprating of benefits in line with CPI inflation from April 2016. It has had no effect this year because the reference rate of inflation was negative, meaning benefits would have been unchanged even in the absence of the freeze, but its bite is set to grow. It had been expected to save £3.6 billion by 2020-21, but the outlook for higher inflation means we now estimate the savings will rise to £4.6 billion. The effect on the bottom half of households is to reduce incomes by 1 per cent on average.

» ***Removing the 'family element' in UC:*** This flat £545 award is still payable to all recipients with children, but it has been removed for all new claims. It is expected to save £0.6 billion in 2020-21, building to almost £2 billion a year once affecting all recipients.

» ***The introduction of a two-child policy:*** This move has limited support to a maximum of two children within the family for new claimants (and for existing claimants who give birth to an additional child), costing those who miss out £2,800 per extra child a year. This move is expected to save £1.6 billion by 2020-21, raising child poverty by an estimated 200,000 once fully in effect.

Action on all of these policy areas would be welcome for some family incomes, but boosting work allowances is potentially the most targeted way to support low to middle income households that make up the government's 'just managing' cohort. That's particularly true for second earners and single parents who have shown themselves sensitive to incentives in the tax credit system. Alongside raising the value of existing allowances, the Chancellor should therefore explore options for introducing a meaningful work allowance for second earners in couples. Currently second earners in receipt of UC are set to lose 65p of every £1 earned from the moment they enter work, acting as a significant disincentive to enter employment.

Reversing the four-year freeze would also improve the outlook for the 'just managing' as well as those out of work. As a minimum, the Chancellor should look to compensate recipients for the fact that inflation is set to be higher than was predicted when the policy was introduced. By pressing pause on this policy and allowing benefits to rise in line with CPI next April, he could provide some protection against the expected sterling-induced spike in inflation by recycling roughly the additional amount of savings estimated to be delivered in 2020 by the change in inflation projections.

Fiscal realities may mean that any support in this first fiscal statement is relatively modest, but it is important that the Chancellor provides genuine help to those on low to middle incomes. Longer-term, much will depend on the details of the eventual Brexit delivered. Measures relating to investment, the new industrial strategy and the UK's housing crisis will all be critical parts of the Chancellor's plan too - with each having a direct bearing on future outcomes for all parts of society. But, after a decade in which their incomes have failed to improve and in the face of potentially strong headwinds in the coming years, it is vital that the Autumn Statement converts the government's good intentions on 'just managing' families into real action.

Section 1

Introduction

The Chancellor's first fiscal statement will be a landmark moment for a number of reasons. He has already indicated that he will press the 'reset' button, abandoning the fiscal targets put in place by his predecessor and thereby moving away from the Conservative party's pre-election focus on delivering an overall surplus in this parliament. The precise nature of the new rules he adopts will say a lot about the backdrop the government intends to set itself over the coming years. We'll also hear more about the government's new industrial strategy and about the Chancellor's plans for raising investment spending, putting hard numbers to his desire to move the UK away from the "bottom of the developed-countries' league table" on infrastructure.[1]

The Autumn Statement will also provide a key indication of just how seriously the government is taking its intention to support 'just managing' families, those low to middle income households who are in work but find themselves living on the edge, vulnerable to even modest changes in their circumstances.[2]

The new Prime Minister has been very clear in her determination to put the interests of this group at the heart of her government,[3] but she has inherited tax and benefit plans which are set to lower incomes for many in the group over the remainder of the parliament. With post-EU referendum revisions to projections for jobs, earnings and inflation pointing to slower levels of income growth in the coming years, the outlook for those who are just about managing looks even tougher than we forecast at the time of the March Budget.

In this note, the third and final paper in our pre-Autumn Statement series,[4] we set out both the scale of the challenge facing the Chancellor and some specific options for providing targeted support. More specifically:

- Section 2 reviews recent experience of those on low to middle incomes and considers the range of headwinds facing them in the coming years;
- Section 3 looks in more detail at the tax and benefit policies introduced since the 2015 election and the extent to which each one is expected to boost or drag on incomes across the distribution;
- In Section 4 we consider a number of options for undoing some of the damage associated with the policies inherited by the new Chancellor; and
- Section 5 presents some brief conclusions.

[1] P Hammond, "An economy that works for everyone", *Speech to Conservative Party Conference*, 3 October 2016

[2] See D Finch, *Hanging on: The stresses and strains of Britain's 'just managing' families*, Resolution Foundation, September 2016 for a description of this group and a detailed discussion of the challenges faced by its members.

[3] See *Statement from the new Prime Minister Theresa May*, 13 July 2016

[4] See also M Whittaker, *Pressing the reset button: the public finance options facing the new Chancellor at the Autumn Statement*, Resolution Foundation, October 2016 and M Whittaker, *Changing Tax: pressing reset on the UK's tax policy*, Resolution Foundation, November 2016

Section 2

An unwelcome inheritance

The squeeze affecting British households since the financial crisis of 2008 has been relatively evenly felt, with incomes falling sharply and subsequently recovering slowly across all parts of the distribution. Yet for those on low to middle incomes, it arrived on the back of a significant pre-crisis slowdown in income growth. While the development of tax credits helped to support incomes for members of this group in the early- and mid-2000s, stagnation in wages meant that they did not fully share in the benefits of economic growth in the period. As a result, average incomes within this group were no higher in 2014-15 than they were in 2004-05, marking a decade of 'lost growth'.

Low to middle income households face a particularly uncertain outlook. The tax and benefit policies introduced by George Osborne after the 2015 election and now inherited by Philip Hammond are set to raise incomes in the top half of the distribution but lower them in the bottom half. Revisions to the economic outlook – in part reflecting post-EU referendum concerns, with the fall in the value of sterling set to feed through to significantly higher inflation for instance – darken prospects for low to middle income households further.

In this section we look backwards and forwards in order to assess both the living standards backdrop and outlook facing the 'just managing' families that Theresa May has put at the heart of her government's focus.

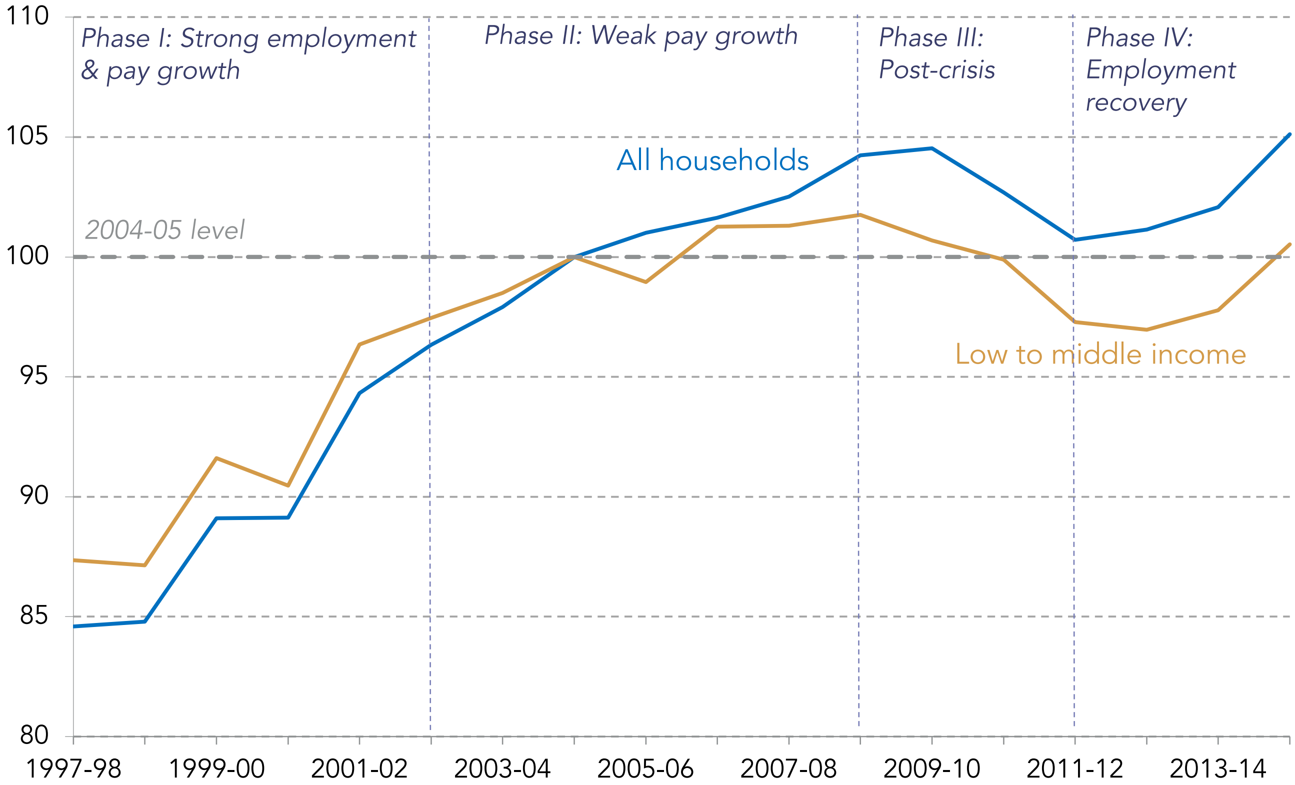
A decade of income stagnation for the 'just managing'

Living standards have been at the top of the political agenda ever since the financial crisis hit. As Figure 1 shows, typical incomes fell sharply and are have only recently climbed back to their peak. Income losses in this period have been relatively evenly felt across the income distribution, though there has been a clear divide between harder hit younger households and relatively protected (though still affected) pensioners.[5]

[5] In part this outcome reflects pensioners' insulation from changes to employment and earnings. There is also a compositional effect, with more recent arrivals in the group tending to have higher incomes than older pensioners – thereby boosting the average. But pensioner benefits have also been largely protected by the coalition and Conservative governments, not least through the 'triple lock' on state pensions.

Figure 1: Median income trends

Indices of median net equivalised weekly household income before housing costs, 2004-05=100 (CPI (BHC) adjusted)



Source: RF analysis of DWP, *Family Resources Survey*

But what Figure 1 also highlights is that disposable incomes were stagnating among those on low to middle incomes even before the crisis landed. The latest official data shows that median income within the group was no higher in 2014-15 than it was a decade earlier.

Looking at the drivers of income growth among those on low to middle incomes over four key phases we find that different elements of the living standards equation have come to the fore in different periods:

» Phase I: Relatively strong income growth in the 1997-2002 period was the product of both rising employment and rapid pay increases.

» Phase II: Incomes grew more slowly in the period 2002-2007 , with income gains slowing and pay growth only just covering inflation. Social security played a larger role in income growth in this period, with the development of tax credits proving a particularly important measure of support for working households on low to middle incomes.

» Phase III: Income falls in the 2007-2011 period were clearly driven by the onset of the financial crisis, with employment falls in particular dragging on growth. Higher inflation also served to reduce the boost provided by earnings growth.

» Phase IV: The story of the 2011-2015 period is one of strong employment growth but very weak pay growth.

In general, the employment-rich, pay-weak shape of the recent downturn and recovery has been better for lower income households than the more traditional experience of resilient pay growth but high unemployment. However, there are reasons for thinking that the modest recovery in incomes achieved since 2012-13 may be about to shift into reverse once more.

Policy and economic headwinds in the coming years

Partly because the UK's employment recovery in recent years has been so remarkable, the risk is that we see a slower pace of employment growth in the coming years . Just as employment growth plateaued in the mid-2000s following strong growth in the late-1990s, so we might expect low to middle income households to achieve fewer income gains from this source over the next few years. Productivity stagnation in recent years is also a cause for concern, with the OBR now factoring in lower growth in output per hour as a structural change in the UK economy with serious implications for wage growth.

Such concerns meant that there were headwinds to the outlook for low to middle income families even at the start of this parliament. While earnings growth in the first year of the parliament was relatively strong, this owed much to ultra-low inflation and the risk is that it is something of a blip. Real-terms average weekly earnings grew slightly above their pre-crisis trend of 2.2 per cent between April and September 2015, but nominal pay growth has remained well down on the level prevailing before 2008. Even modest increases in inflation over the course of 2016 have pushed real-terms wage growth back below trend.

Adding to these problems, two further headwinds – one policy-related and one associated with changes in the economic backdrop – mean that prospects for the 'just managing' look somewhat darker as we approach the Autumn Statement.

The first, policy-related, cause for pessimism is that the tax and benefit plans set out by George Osborne after the 2015 election are due to drag significantly on incomes in the bottom half of the distribution. The introduction of the National Living Wage (NLW) provides a welcome boost for lower paid individuals and income tax cuts will further raise disposable incomes for those basic and higher rate taxpayers who benefit, but these gains are more than offset for many low to middle income households by the very sizeable cuts to working-age benefits – incorporating cash freezes in generosity, cuts to Universal Credit (UC)[6] work allowances and tightening of eligibility criteria for families with children – that will bite in the coming years.

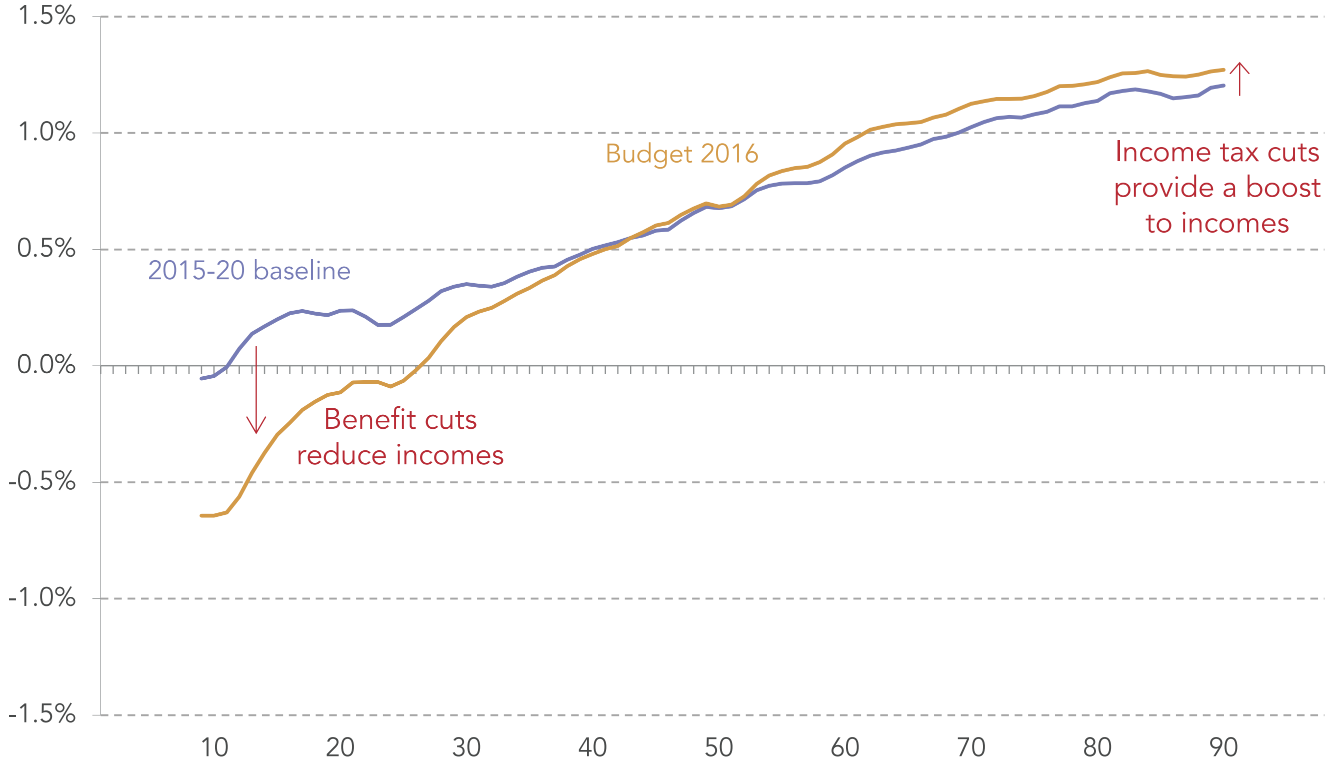
Figure 2 sets out projections for income growth over the course of the current parliament from 2015 to 2020 based on two scenarios:

- ***2015-20 baseline***: This scenario assumes no change in policy following the 2015 election, but takes the economic forecast prevailing at the time of the March 2016 Budget as its baseline.
- ***Post-Budget 2016:*** This scenario adopts the same economic backdrop as the first, but also accounts for all policy decisions announced at Summer Budget 2015, Autumn Statement 2015 and Budget 2016.

[6] UC represents a major structural reform to the welfare system, rolling six working-age benefits into one. Delays in the UC roll-out mean we don't expect to see significant numbers of claimants receiving it until the end of the decade but when they do, the scheme they experience will be far less generous than both the one initially envisaged and the current tax credit system.. See D Finch, *Making the most of UC: Final report of the Resolution Foundation review of Universal Credit*, Resolution Foundation, June 2015

Figure 2: Income growth projections for the current parliament at Budget 2016

Average annual growth in real disposable household income by percentile (CPI-adjusted)



Notes: Assumes partial implementation of UC by 2020 with 80 per cent of families in receipt.[7] Benefit cuts in place include the four-year benefit freeze, work allowance cuts, the removal of the family element for new claims and limiting support to two child families for new births/claims. Tax measures are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating. NLW is assumed to be in place by 2020. Measures affecting the generosity of child elements for new births/claims are assumed to be half in place. Estimates assume full-take up of entitlements.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, OBR, *Universal Credit caseload forecasts, July 2016*, OBR, *Economic and Fiscal Outlook March 2016*

Accounting only for the expected path of inflation and earnings anticipated in March, the '2015-20 baseline' scenario paints an already disappointing picture for the parliament. Incomes were expected to grow in real terms by an annual average of between 0 per cent (for the poorest households) and 1.25 per cent (for the richest), well below historic averages even for those faring well. The skewed nature of this growth reflects the fact that income from earnings was expected to outpace inflation whereas income from benefits was expected to simply keep pace with it (in line with default uprating).

Relative to the '2015-20 baseline', the 'post-Budget 2016' scenario shows that policy changes were due to boost income growth slightly for those in the top half of the income distribution but reduce it significantly among those in the bottom third, leading to a projection that incomes would *fall* over the course of the parliament in the bottom quarter of the distribution, with those at the 10th percentile experiencing an average annual drop in income of more than 0.5 per cent a year.

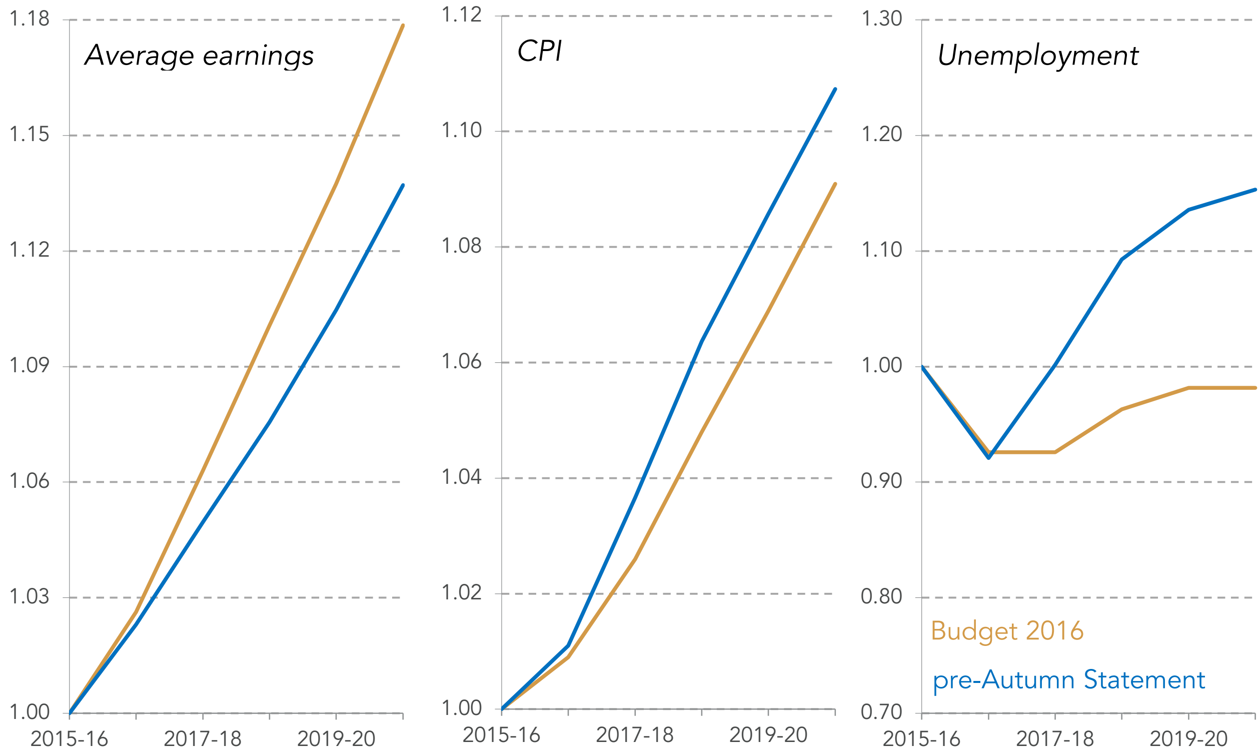
The second new headwind affecting our income growth projections relates to the downward revisions economic forecasts that have occurred over the course of 2016. While there is of course much uncertainty over the long-term impact of Brexit, there is a strong consensus among economists that growth is set to slow as a result of the referendum result, particularly in the near-term. In Figure 3 we show how average projections for unemployment, nominal

[7] This assumption is based on taking the mid-point for estimated roll-out between 2019-20 and 2020-21 to account for further announced delays to UC roll-out in a written statement by Damian Green on 20 July 2016.

pay and earnings have shifted across a range of independent forecasters in the period since the referendum. With unemployment set to rise, nominal pay growth to slow and inflation to rise higher, prospects for either strong employment- or wage-led income growth appear weak.

Figure 3: Pre- and post-referendum projections for inflation, pay and unemployment: UK

Indices of growth from 2015-16 base year



Source: RF analysis of HMT, *Forecasts for the UK economy and OBR economic assumptions from Budget 2016*

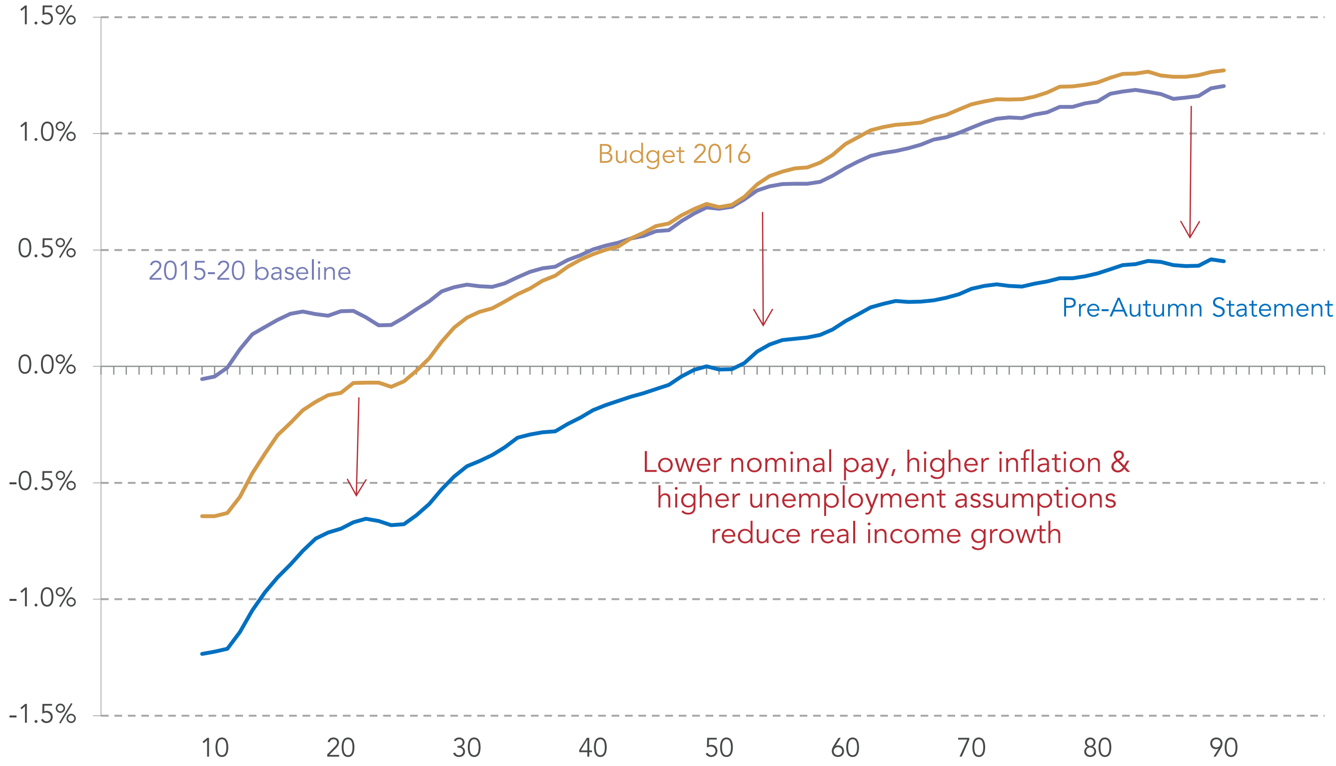
Figure 4 continues the process of considering income growth over the current parliament begun in Figure 2. Now we add the effect of the shift in the economic backdrop influenced in part – though by no means in whole – by the referendum vote, with an additional scenario:

» ***Pre-Autumn Statement:*** This scenario updates the post-Budget 2016 one to account for changes in economic forecasts in the period since March. In large part these reflect changes associated with the EU referendum.

The subsequent economic revisions captured in the 'pre-Autumn Statement' scenario lower income growth expectations across the entire distribution. This is a result of lower wage growth (with lower nominal pay increases reinforced by higher inflation) and a tighter benefit squeeze (with cash-terms freezes hurting more as inflation rises). Heading into the Autumn Statement, this most up to date projection therefore suggests that incomes will fall in real terms over the parliament for almost half of the population, and by more than 0.5 per cent a year for a quarter. In the bottom ten percent incomes are set to fall by over 1 per cent a year on average.

Figure 4: Income growth projections for the current parliament

Average annual growth in real disposable household income by percentile (CPI-adjusted)



Notes: See notes to Figure 2.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Universal Credit caseload forecasts, July 2016*, OBR, *Economic and Fiscal Outlook March 2016*

Overall then, this 'pre-Autumn Statement' scenario sets out a much gloomier projection of income growth than the one prevailing in our '2015-20 baseline'. By way of illustration, we can consider the relative importance of policy changes and economic revisions at different points in the distribution by considering how far income growth expectations shift from the baseline in each of our two scenarios.

Table 1: Percentage point change in average annual income growth forecast in different scenarios

	10th	20th	30th	40th	50th	60th	70th	80th	90th
Change from previous scenario									
From baseline to 'post-Budget 2016'	-0.6%	-0.3%	-0.2%	-0.0%	+0.0%	+0.1%	+0.1%	+0.1%	+0.1%
from post-Budget 2016 to 'pre-Autumn Statement	-0.6%	-0.6%	-0.6%	-0.7%	-0.7%	-0.8%	-0.8%	-0.8%	-0.8%
Overall change from '2015-20 baseline'									
Pre-Autumn Statement	-1.2%	-0.9%	-0.8%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%

Notes: See Figure 4.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Universal Credit caseload forecasts, July 2016*, OBR, *Economic and Fiscal Outlook, March 2016*

It shows that across the distribution revisions to economic assumptions reduce growth but that post-election policy changes are also significant for the lower half of the distribution – with those at the 10th percentile experiencing a 1.2 percentage point reduction in growth expectations between the baseline and the pre-Autumn Statement scenario, comprising a 0.6 percentage reduction due to policy and a 0.6 percentage point reduction due to economic revisions.

In contrast, among households at the top end of the distribution, deterioration in income growth prospects rests entirely with changed economic circumstances. For those at the 90th percentile for example, post-election policy changes actually *increased* income growth expectations by 0.1 percentage points (reflecting the gains associated with tax cuts and the introduction of the NLW), but economic revisions since March 2016 lower the forecast by 0.8 percentage points.

The upshot of all this is that the already disappointing baseline picture becomes materially worse in the latest forecast. If it is borne out in practice, then low to middle income households will end the parliament with average incomes back to levels seen at the turn of the century, having lost nearly two decades of growth. Given this backdrop, we should expect Philip Hammond to be thinking hard about what he might do to offer more support to this 'just managing' group when he delivers the Autumn Statement on 23 November.

Section 3

Supporting the 'just managing'

The policy changes that are set to drag on income growth among 'just managing' families in the coming years stem from the £12 billion of welfare cuts announced by George Osborne as part of his attempt to close the government's budget deficit. With the outlook for the public finances set to be subject to a significant deterioration ahead of the Autumn Statement, the new Chancellor might be considered to have limited room for manoeuvre. But he does have options. He has already indicated that he will press the fiscal 'reset' button, thereby potentially providing himself with some additional headroom. He can also reprioritise within existing programmes and policies, including by thinking again about the efficacy of pursuing expensive and poorly targeted tax cuts.

In this section we pick in turn through the scale and impact of each of the relevant welfare cuts and set out why the Chancellor needs to change direction when he stands up on 23 November if he truly wants to support 'just managing' families.

Understanding the policy changes already in place

In considering what government might do to mitigate the dual effects on the living standards prospects of low to middle income households of policy changes and shifts in the economic landscape, it is easier to envisage action in the former rather than the latter.

By raising investment, the Chancellor could improve longer-term growth prospects and labour productivity, but – while this is obviously a good thing to do – any effects will take time to feed through. It also seems unlikely that he will opt for any form of significant active demand stimulation, as we discussed in *Pressing the reset button*.[8] In any event, such forms of support are unlikely to be visibly targeted on those on low to middle incomes. Direct near-term support for 'just managing' families is therefore much more likely to take the form of changes in tax and benefit policies.

To understand what options might be open to him – and the extent to which different measures would focus support on the right part of the income distribution – it is worth looking in more detail at the impact of the policy announcements introduced since last year's election.

Figure 5 shows the impact of each tax and benefit measure in isolation.[9] The gains and losses shown are relative to the tax and benefit system in place immediately before the 2015 election. To capture the longer term impact of these policy decisions, given the transitory nature of some of the proposals, we also assume that UC is fully rolled out and cuts to benefits are fully in place in both scenarios, using relative changes in earnings and inflation to 2020 from revised pre-Autumn

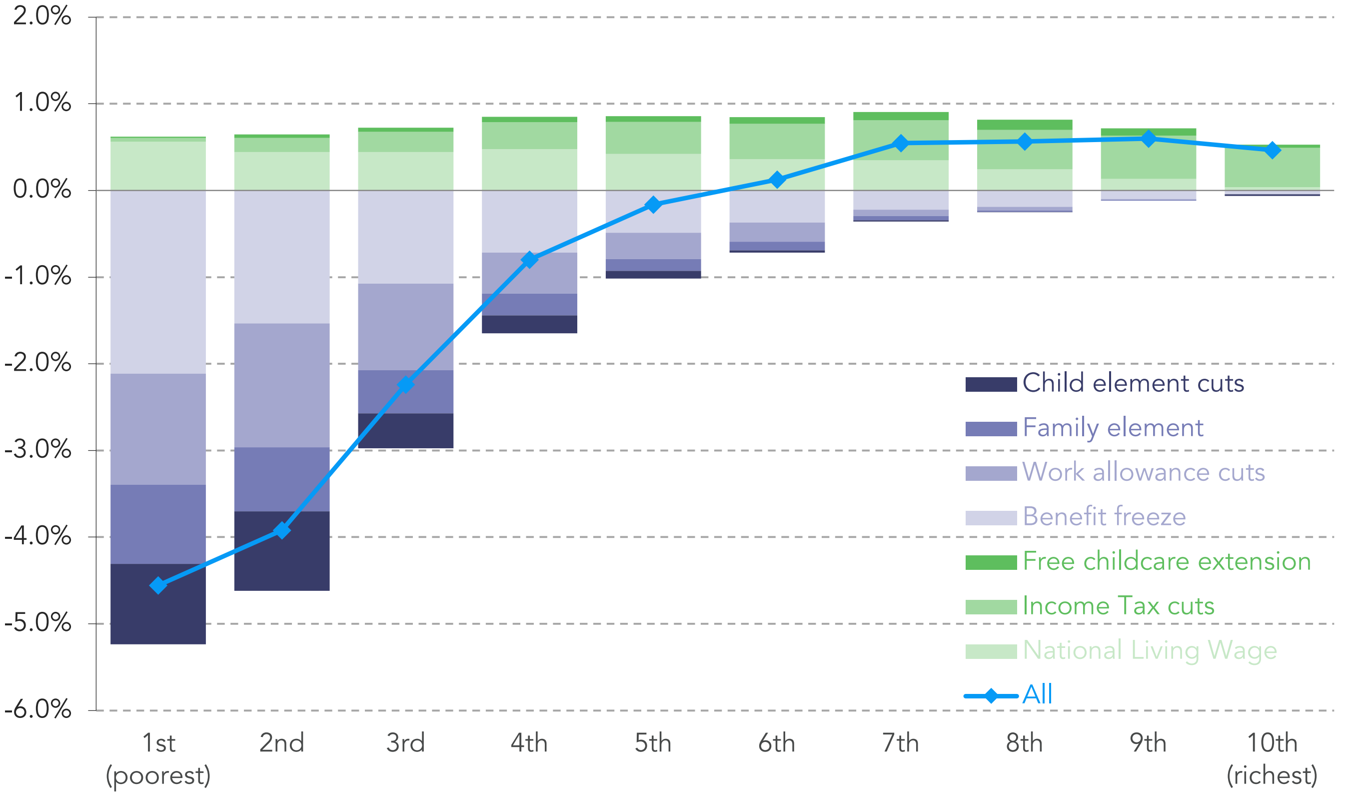
[8] M Whittaker, *Pressing the reset button: the public finance options facing the new Chancellor at the Autumn Statement*, Resolution Foundation, October 2016

[9] It should be noted that the order in which measures are taken into account will affect the precise size of their impact, although we do not consider this to significantly affect the overall scale and shape of these changes.

Statement economic assumptions.[10] The net effect is for the third of households with the lowest incomes to be worse off by an average of 3.6 per cent relative to a counterfactual in which no policy changes are implemented. For the low to middle income households in deciles two to five who broadly represent the 'just managing', the impact is to be worse off by a net 1.9 per cent.

Figure 5: Distributional impact of tax and benefit measures announced in the current parliament

Percentage change in income by net equalised household income decile



Notes: Assumes full implementation of UC by 2020 and the full impact of the tax, benefit and childcare policies shown in the legend. Income tax measures are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating. Full gains from the NLW are taken in to account. Estimates assume full-take up of entitlements.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Economic and Fiscal Outlook March 2016*

These net effects comprise a combination of income boosts and income drags. In relation to the former, there are three key policies:

- The NLW represents a new – significantly higher – wage floor for those aged 25 and over. It was introduced in April 2016 at £7.20 and our projection is that it will reach £8.60 by 2020. The policy is playing an important role in reducing levels of low pay in the UK but, as Figure 5 shows, its impact is broadly spread across the distribution reflecting the fact that lower paid employees are similarly spread across households.
- Income tax cuts – delivered in the form of raising the personal tax allowance (the point at which income tax becomes payable) to £11,500 and the higher rate threshold (the point at which the 40p rate begins) to £45,000 in April 2017– provide a boost to the majority of taxpayers. Roughly

[10] This is different to the assumptions we use in Figure 3, in which we assume that UC is only partially implemented and where we compare overall income growth between 2015 and 2020 (including for instance growth in earnings). As such, the two charts are not directly comparable. We take this approach in order to present the full impact of announced changes in steady-state (once UC is fully rolled out) by way of illustrating the final magnitude of the effect of these measures.

four-fifths of the gains flow to the richest half of households however, reflecting both the fact that the lowest paid five million already pay no income tax and the double gains enjoyed by dual earning households who tend to be higher up the income distribution.

» Finally, extra support with childcare costs is available through the provision of an additional 15 hours a week of free childcare hours for working parents of three and four year olds. While welcome for those benefiting, this provides a much smaller and specifically targeted boost overall, with gains again concentrated in the top half of the income distribution.

We show four main measures that act as a drag on income growth, all forming part (but not all)[11] of the £12 billion welfare savings set out by George Osborne following the general election. These include:

» A four year cash-terms freeze in rates of the majority of working-age benefits. This measure was expected to save £3.6 billion by 2020-21, with that figure rising by a further £1 billion due to higher rates of inflation now anticipated pre-Autumn Statement. It is expected to reduce incomes, relative to the counterfactual in which these benefits are uprated in line with CPI inflation, by up to 2.1 per cent among the poorest tenth of households.

» Cuts to work allowances in UC – that is, the level of income a household in receipt of UC can earn before their award starts getting tapered away – are estimated to save £3 billion by 2020 (despite further roll out delays)[12] and a total of almost £4 billion in the steady-state shown here. This policy is set to reduce incomes by up to 1.4 per cent in the second decile, 0.8 per cent across deciles two to five.

» The removal of the family element from UC (worth £545 a year) is expected to save the government £0.6 billion by 2020, eventually building to almost £2 billion once all families are affected – at which point we estimate losses across the bottom half of the income distribution will average around 0.5 per cent.

» Limiting the child element of UC (which is worth £2,780 per child) to a maximum of two children for new births (and in the instance of existing large families for new claims) is set to save £1.6 billion by 2020, with further savings to come in steady-state. The impact of this policy is more targeted than the removal of the family element, with losses of 0.9 per cent in the bottom fifth of the income distribution.

As well as varying across the income distribution, the impact of the government's policies will differ from family type to family type. They will also be greater when simply considering in isolation those families entitled to UC, with the losses discussed above being the average across all households.

Table 2 sets out the average losses for different family types entitled to UC in 2020 with those in-work representing the lowest income working families at the core of those who are 'just managing'. The table shows that working families with children are on average the largest cash losers from the overall package, losing an average of over £2,500 each when all the cuts are fully rolled out.

[11] We exclude those cuts which either represent relatively small savings for the government or have less direct impact on household incomes. For example, we do not show the impact of the benefit cap. A reduced cap will come into effect on 7 November 2016, saving a total of £360m by 2020 from in the region of 100,000 households (see Welfare and Reform Act 2016 Impact Assessment). Evidence to date suggests that while some families affected by the cap may have been prompted to move into work, the vast majority affected neither moved into work or moved house (IFS (2014) *Coping with the cap?*). Further savings, totalling approximately £3.2 billion are being made from housing benefit where social rents are now being reduced by 1 per cent a year, instead of the previous formula of CPI plus 1 per cent. We estimate that higher expected inflation will mean that expected savings from this policy will increase by £0.4 billion by 2020.

[12] Based on table in OBR publication and that it is managed migration that has been delayed rather than new flows to the scheme where majority of savings appear to be coming from in the short term.

The impact of the work allowance cuts alone is to make working families entitled to UC worse off by an average of £800 a year. That figure rises to £1,300 when we include the impact of the benefit freeze (£1,500 for families with children) in 2020.And that is before accounting for the cuts to the family element and limiting support to two children that affect new claims.

All these losses are after accounting for any gains from the NLW, income tax cuts and childcare support.

Table 2: Impact of tax and benefit measures announced in the current parliament by family type

Family type	Benefit cuts taken into account: Freeze and work allowance	Benefit cuts taken into account: Freeze, work allowance, family and child element	Number of families
In-work			
Couple parents	-£1,370	-£2,580	1,800,000
Single parent	-£1,760	-£2,600	1,000,000
Singles & couples without childr	-£790	-£790	1,200,000
Out-of-work			
Couple parents	-£440	-£1,260	300,000
Single parent	-£470	-£1,300	800,000
Singles & couples without childr	-£240	-£240	2,600,000

Notes: Assumes full roll-out of UC in 2020 and the full impact of the benefit freeze, cuts to work allowances, and where indicated removal of the family element and limiting support to two children. Income tax measures are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating. Full gains from the NLW are taken into account. Estimates assume full-take up of entitlements, therefore the number of working families without children is likely to be an over-estimate compared to the actual number of recipients.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts,2016*, OBR, *Economic and Fiscal Outlook March 2016*

At the same time some families are expected to gain – especially those in work, on the wage floor and without children – because they have either no or very little income from UC and so achieve gains from income tax cuts and the NLW with minimal offset.

To better understand the underlying changes to income for different household types Table 3 sets out a range of case studies showing how, with UC in place, their incomes will change in 2020 as a result of policy changes:

» A single worker in their 30s, with no children, earning on the wage floor, will be £1,200 a year better off than they would have been. Despite losing entitlement to UC at lower levels of earnings the combination of the NLW and income tax cuts provides a boost to income.

» A dual earning couple, where the main earner works full-time above the minimum and their partner works part-time on the wage floor, with two children will be £2,200 worse off than they would have been, with income tax cuts and the NLW boost failing to offset cuts to benefits.

Table 3: Impact of tax and benefit measures announced in the current parliament for family case studies, 2020

	Gross earnings	Net earnings	Benefit income	Net income	Percentage change
Single, aged 25, no children, works full-time at the wage floor, rent of £70 a week					
Pre-policy change	£15,300	£13,800	£0	£13,800	
Post-policy change	£16,800	£15,000	£0	£15,000	
Change	£1,600	£1,200	£0	£1,200	+8.4%
Single parent, aged 30, with one child aged under 5, single earner working full-time in low pay					
Pre-policy change	£15,300	£13,800	£6,000	£19,700	
Post-policy change	£16,800	£15,000	£1,300	£16,200	
Change	£1,600	£1,200	-£4,700	-£3,500	-17.8%
Couple, both aged 28, with a baby, single earner working full-time in low pay, rent £100 a week					
Pre-policy change	£15,300	£13,800	£9,700	£23,500	
Post-policy change	£16,800	£15,000	£7,100	£22,000	
Change	£1,600	£1,200	-£2,600	-£1,400	-6.2%
Couple, both aged 35, with two children, dual earners, working full-time in low pay & part-time at wage floor					
Pre-policy change	£25,100	£22,600	£4,800	£27,400	
Post-policy change	£25,700	£23,300	£1,800	£25,200	
Change	£700	£800	-£3,000	-£2,200	-8.0%
Couple, both aged 35, with three children including a baby, dual earners, working full-time in low pay & part-time at wage floor					
Pre-policy change	£25,100	£22,600	£8,600	£31,100	
Post-policy change	£25,700	£23,300	£1,800	£25,200	
Change	£700	£800	-£6,700	-£6,000	-19.2%

Notes: Estimates show the change in income in 2020 relative to a pre-and post- policy scenario. Scenarios compare the full impact of the benefit freeze, cuts to work allowances, and where a child under the age of 5, removal of the family element and limiting support to two children. Income tax measures are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating. Full gains from the NLW are taken into account.

Source: Resolution Foundation analysis using the RF microsimulation model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts,2016*, OBR, *Economic and Fiscal Outlook March 2016*

Why 'more of the same' won't work

One response to the need to offer more support to low and middle income households is to double down on the giveaways favoured by the Coalition Government and David Cameron's administration.

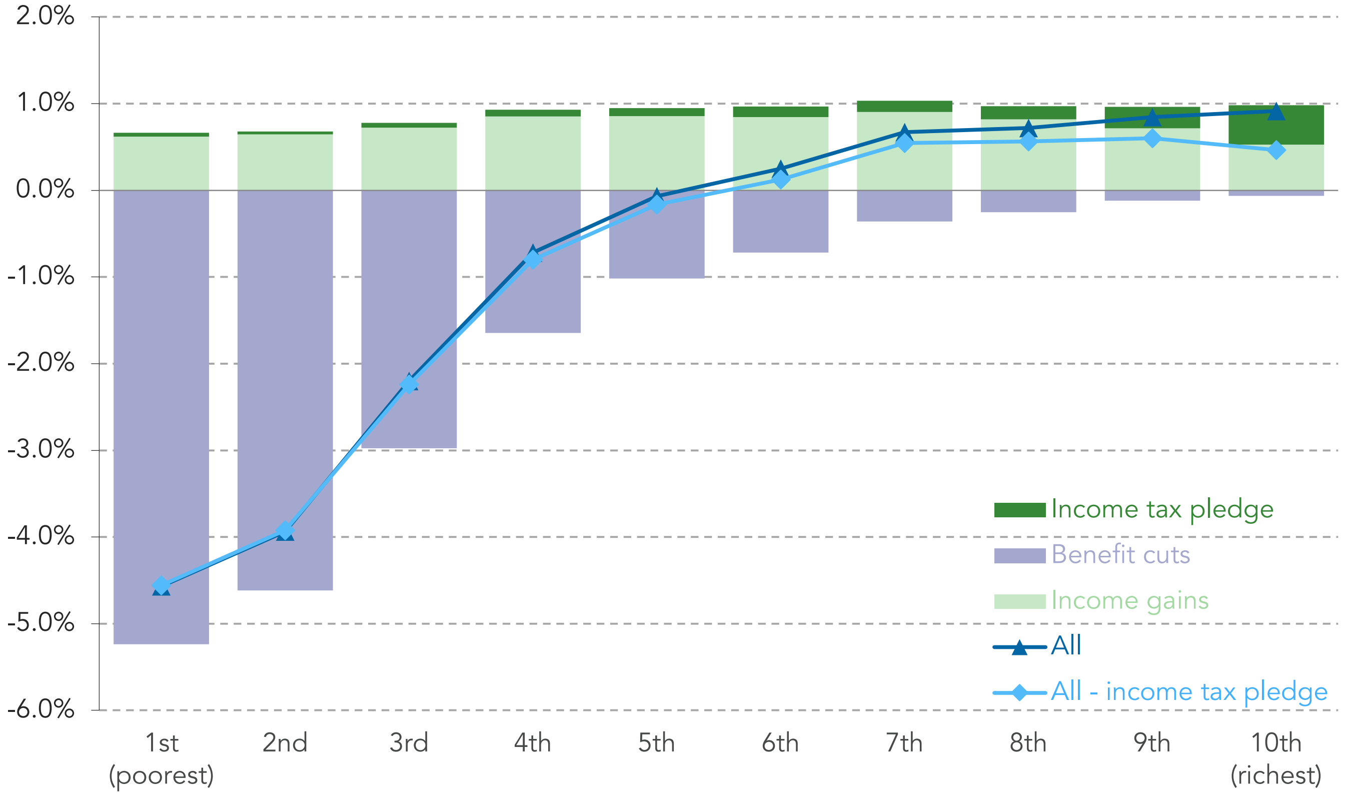
For example, there may be calls to push the NLW higher, thereby requiring businesses to foot the bill for raising incomes to off-set benefit cuts. That would be a mistake, however. Because the level of the NLW is linked to the performance of median pay, it has an adjustment mechanism built into it. That is, if pay growth in the economy as a whole slows, so too does the pace of increase in the wage floor; but if the economy does well, then the NLW rises accordingly. Given the uncertainty facing the economy at the moment, an attempt to overwrite this adjustment even before the NLW has bedded in would be unwise. In any case, as Figure 5 showed, while the NLW is a useful tool for tackling low pay, its gains are relatively evenly spread across the income distribution.

A second potential approach might involve offering further tax cuts. Indeed, the Conservative party's election manifesto included pledges to push the personal tax allowance and higher rate threshold to £12,500 and £50,000 respectively by the end of the parliament – simply delivering on this would obviously provide some boost to incomes. As we've already noted however, this policy has diverted disproportional gains to the top half of the income distribution and is therefore not a well targeted approach to supporting the 'just managing'.

Our estimate is that delivering on the manifesto pledges by 2020-21 would cost the Chancellor roughly £2 billion (in 2015-16 prices). As Figure 6 shows, over 85 per cent of the gains from this (or £1.7 billion) would flow to the richest half of households. Indeed, two fifths would go to the top 10 per cent of households alone. And regardless of the share of gains going to the bottom half, the size of those gains are simply too small to offset losses from benefit cuts.

Figure 6: Distributional impact of announced tax and benefit polices and further raising the personal tax allowance to £12,500 and the higher rate threshold to £50,000 in 2020-21

Percentage change in income by net equalised household income decile



Notes: Assumes full roll-out of UC in 2020. Income cuts are the full impact of the benefit freeze, cuts to work allowances, and where indicated removal of the family element and limiting support to two children. Income gains are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating and full gains from the NLW. The income tax pledge further raises the personal tax allowance to £12,500 and the higher rate threshold to £50,000. Estimates assume full-take up of entitlements.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Economic and Fiscal Outlook March 2016*

As UC is rolled out, tax cuts become an increasingly ineffective way of supporting the 'just managing' because – unlike in the current tax credit system – UC awards are reduced on the basis of after-tax income. As such, any net income gains associated with a tax cut face being reduced by up to 65 per cent for UC recipients thanks to the tapering away of support.

The Chancellor could of course choose to focus on an alternative aspect of tax – by raising the point at which employee National Insurance becomes payable or lowering VAT for instance – but all measures based on broad-based taxes face similar issues of targeting. Targeted support is instead much more likely to come from focusing on the very aspects of working-age support which have been subject to cuts in recent years. This will of course bring resource implications however.

Funding a package of support

The benefit cuts discussed above form a key part of the £12 billion reduction in welfare spending promised by the Conservative party ahead of the 2015 election and subsequently set out by George Osborne over the course of three fiscal statements. This £12 billion in turn was central to the government's pledge to run an overall budget surplus in 'normal economic times'.[13]

But, as we showed in the first of our series of pre-Autumn Statement papers,[14] the new Chancellor has already indicated that he intends to introduce new fiscal rules – acknowledging that changed circumstances mean the old ones are no longer relevant. Our work showed that the reintroduction of a focus on current budget balance (excluding spending on investment from the annual borrowing constraint) would provide the Chancellor with up to £17 billion of fiscal headroom in 2019-20. While it seems very unlikely that he would want to take full advantage of that room - instead leaving some fiscal margin for error - we showed that he could reverse all UC-related cuts and still be able to target a current budget surplus of more than £10 billion.

Additionally, the second of our series of papers focused on potential savings he might make within existing plans by pressing pause on pledged tax cuts.[15] As we discussed above, raising the personal tax allowance and higher rate threshold to the levels pledged in the Conservative manifesto is set to cost £2 billion and have only minimal effect on the 'just managing'. We recommended scrapping this promise in the changed circumstances we now find ourselves in and using the resources for more targeted forms of support instead.

We also called for the Chancellor to reverse George Osborne's decision to lower the corporation tax rate to 17 per cent in 2020. The former Chancellor lowered the UK's rate from 28 per cent in 2010 to 20 per cent in 2015, at a cost of £8 billion this year. That already puts the UK rate well below averages in the EU, OECD and world, making it unclear why the government would want to push the rate lower still. Cancelling the move to 17 per cent would save the Chancellor roughly £2 billion (in 2015-16 prices).

A further source of potential revenue stems from the changed economic outlook. As we noted in Figure 4, part of the reason our projection of income growth worsens between the 'post-Budget 2016' scenario and the 'post-referendum' one is that higher inflation makes the four-year cash-terms freeze on benefits squeeze harder. This in turn delivers additional savings to the government: our estimate is that the freeze will lower real-term spending on the affected elements of the working age benefit system by 6.1 per cent by 2019, significantly more than the 4.4 per cent projected by the OBR at the time of the March Budget.

Given that this was unforeseen when the policy was introduced, it seems reasonable to assume that the new Chancellor could – as a minimum – choose to forgo these additional savings amounting to around £1 billion.

Putting a precise estimate on the amount of resource that Philip Hammond might consider at his disposal is of course impossible, and he will undoubtedly want to show that the new government is as committed to fiscal discipline as the last, albeit on a different timetable and in different circumstances. But what's clear from the above is that he has options available to him for releasing new funds or reprioritising existing ones should he wish to take them. His choice will go a long way to displaying how seriously the government is taking the plight of 'just managing' families. We consider some specific options for support in the next section.

[13] The Charter for Budget Responsibility stated that "normal times" would be assumed to apply unless the OBR assessed that the UK faced a "significant negative shock" in the most recent period or during the relevant forecast period. This shock was defined as real GDP growth of less than 1 per cent on a rolling four-quarter on four-quarter basis. HM Treasury, *Charter for Budget Responsibility: Summer Budget 2015 update*, July 2015

[14] M Whittaker, *Pressing the reset button: the public finance options facing the new Chancellor at the Autumn Statement*, Resolution Foundation, October 2016

[15] M Whittaker, *Changing Tax: pressing reset on the UK's tax policy*, Resolution Foundation, November 2016

Section 4

Options for targeted support

There are of course any number of options for either reversing the announced cuts or mitigating them by boosting alternative forms of support, and the choice of any support 'package' will depend on how much the Chancellor is prepared to allocate to this important task. Our starting point is a preference for more support rather than less but, by way of illustrating the trade-offs associated with different approaches, in this section we take a non-exhaustive look at some specific options for change. We focus on four areas of direct relevance to UC recipients: uprating of awards, the treatment of children, work allowances and the rate at which awards are tapered.

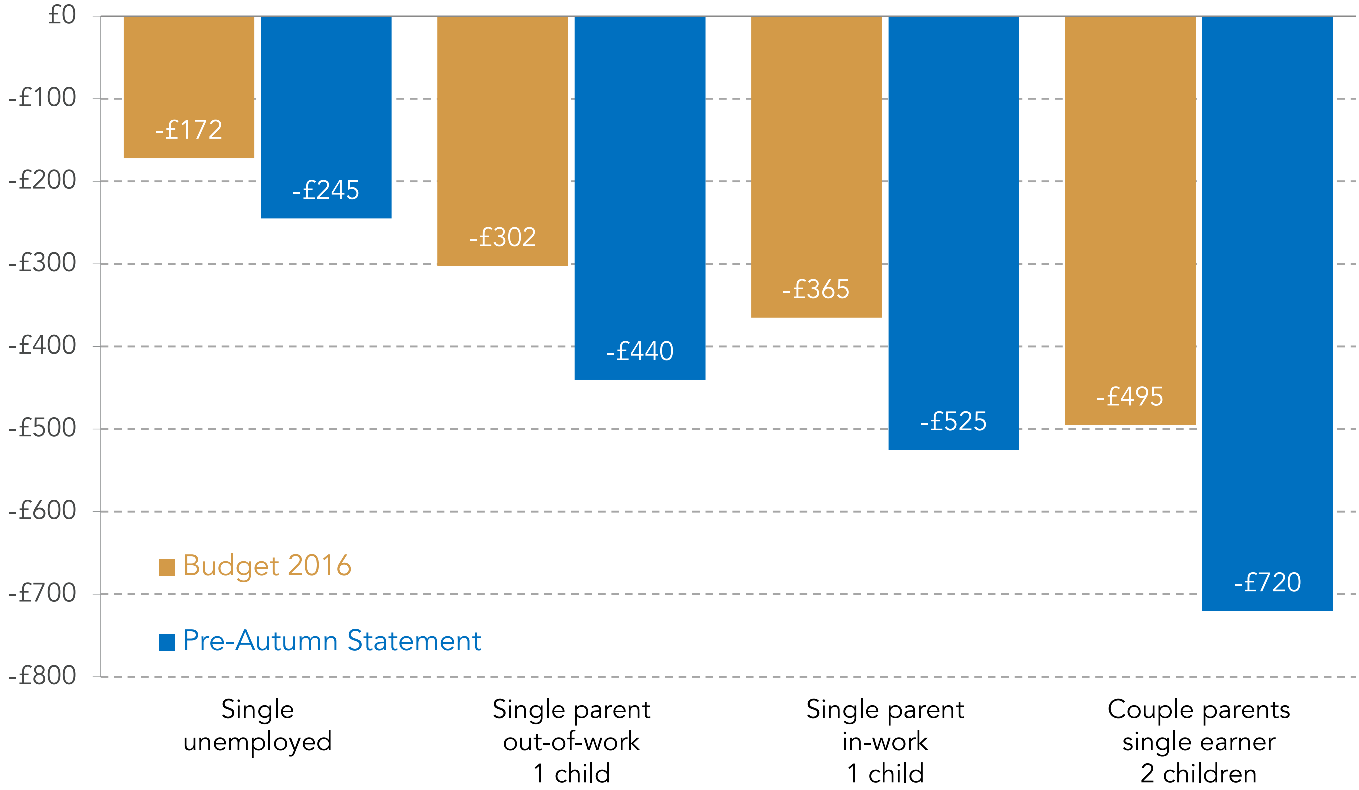
Uprating options

As discussed above, the government introduced a four-year freeze on most working-age benefits starting in April 2016. This is due to affect 11 million families (including 3 million higher income families with Child Benefit), although the first year's freeze had no material effect because CPI inflation was negative in the reference month, meaning the value of working-age benefits would have been unchanged even in the absence of the freeze. Nevertheless, the size of the squeeze associated with the freeze is set to grow – even more so given post-referendum expectations of higher inflation.

As Source: Resolution Foundation analysis using HMT, Budget 2016, March 2016, HMT, Forecasts for the UK economy: a comparison of independent forecasts, 2016, OBR, Economic and Fiscal Outlook March 20167 shows, the cash impact varies by family type. The greatest cash losses fall on working families with children because they have the greater underlying entitlements. For example, a single earning couple with two children is set to be made £720 a year worse off in 2020 - with £225 of this coming purely as a result of inflation rising more rapidly than was expected when the policy was introduced.

Figure 7: Impact of four-year benefits freeze on different family types

Change in income, £ annual



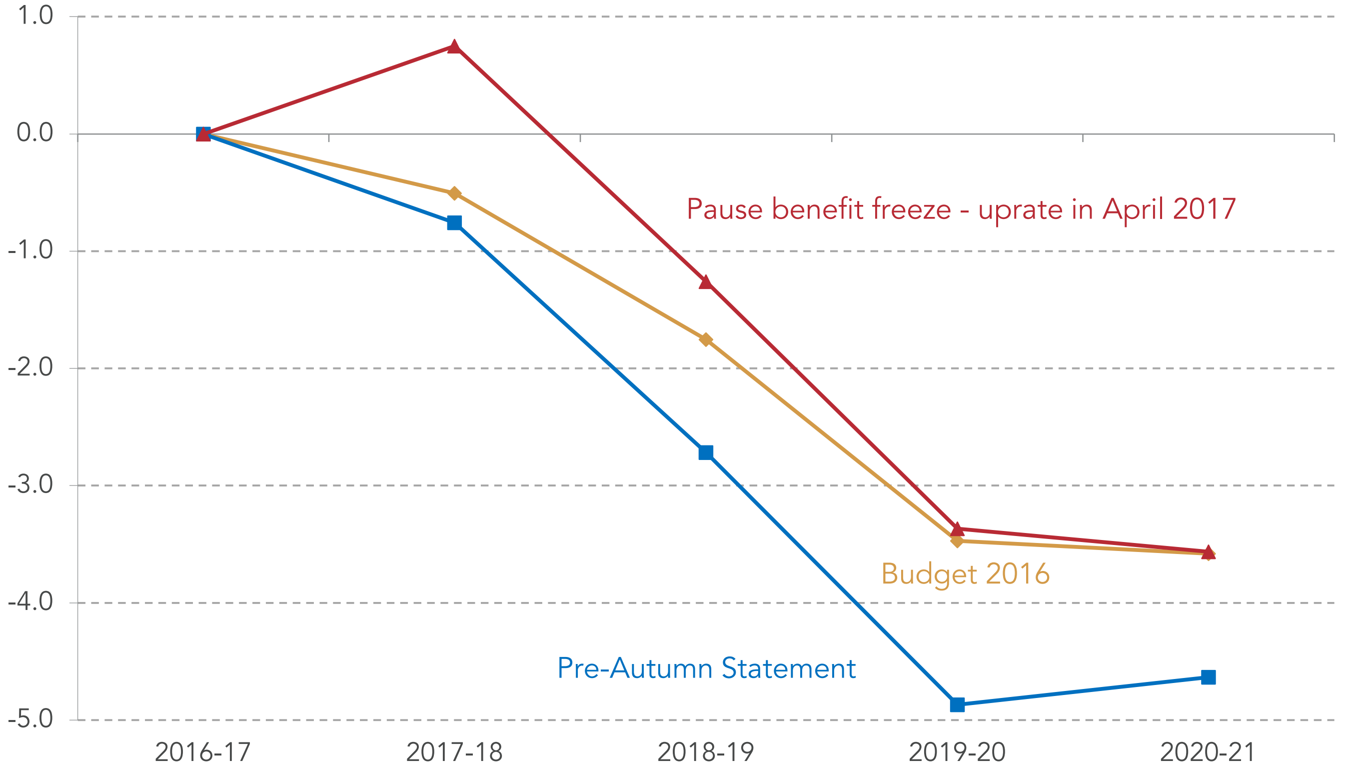
Source: Resolution Foundation analysis using, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Economic and Fiscal Outlook March 2016*

Mitigating the overall impact of the freeze could take two basic forms. The simplest approach would of course be to just reverse the decision, reinstating the default inflation-linked increase in benefit awards each year. This would recognise the need to support lower income families at a time of uncertainty and faster rising prices than expected. It would however cost an estimated £4.6 billion in 2020.

A second option might be to focus on protecting recipients from the effects of higher than anticipated inflation by recycling the additional savings this is due to generate for the government. One way of doing this is to announce a temporary pause in the freeze in April 2017, such that benefits rise in line with the September 2016 CPI of 1%. This would provide some immediate relief from the worst effects of the expected spike in inflation next year and, as Figure 8 shows, despite the estimated cost of the temporary pause and additional spending in 2017-18 (gold line), savings in 2019-20 and 2020-21 would still broadly match those originally expected at Budget 2016.

Figure 8: Impact on government spending of a one-year pause in the four-year benefit freeze

In-year savings, £ billion



Source: Resolution Foundation analysis using HMT, *Budget 2016*, March 2016, HMT, *Forecasts for the UK economy: a comparison of independent forecasts, 2016*, OBR, *Economic and Fiscal Outlook March 2016*

The treatment of children

The existing cuts hit families with children in two ways. First, the removal of the 'family element' of UC – payable to all claimants with children – represents a flat £545 cut. As Figure 5 showed, the flat nature of this cut means that the proportional impact of this cut rises as the income of the recipient falls, although the magnitude of the cut is smaller than some of the others we consider here.

The second cut facing larger families is the decision to limit support to the first two children in a family. This means that new claimants with more than two children and existing ones giving birth to additional children will miss out on up to £2,800 per extra child. Our estimate is that this cut has a particularly large potential impact on child poverty, raising the number in relative income poverty by around 200,000 when the cut is fully in place.

Given the relative scale and concentration of these two cuts, we believe it makes more sense to focus any mitigation the Chancellor wishes to apply in this area on reversing the decision to restrict support to a maximum of two children, rather than restoring the family element

Work allowances in UC

George Osborne's U-turn on tax credit cuts at last year's Autumn Statement did nothing to change planned cuts to work allowances in UC which will have a similar effect once the new benefit system has been rolled out. In steady state, we estimate the cuts to work allowances will save almost £4 billion a year. The size of the cuts will also mean that once fully in place UC will overall be less generous to working families on average than the current tax credit system.[16]

The impact is not immediate, because continual delays to the roll-out of UC mean that only 339,000 people were in receipt in September 2016 – and the majority of those are simple out-of-work cases. But by the end of the parliament the pace of roll-out is expected to pick up, with the new system fully in place by 2022, when almost 7 million families are expected to be entitled.

The last published estimates from the OBR showed that the work allowance measure was still expected to save £3 billion in 2020 (even accounting for offsetting transitional protection[17] payments). Since then the roll-out of UC has been further delayed. However, this primarily relates to the point at which families are actively moved from the current tax credit system to UC – the 'managed migration'. Such families would not be immediately affected by the work allowance cuts, which apply to new claims to the system or where current tax credit claimants moved onto UC face a change in circumstances. The flow of new claims is less affected by the latest delays to roll-out, meaning we can still expect savings of close to £3 billion from UC work allowances in 2020, taking the expected impact in 2019 as a lower bound estimate (£2.9 billion)[18]. Taking a similar approach, we could expect in the region of 80 per cent of the eventually entitled working families to be in receipt by 2020.[19]

For individuals, the reduction in work allowances will mean that the approximately 3.5 million working families previously expected to be entitled to UC when fully in place are substantially worse off than they would have been under the previous design of UC (which was already expected to be significantly less generous than the initial UC proposal).[20] Work allowances are effectively an earnings disregard (similar to the personal tax allowance), with every pound of post-tax earnings beyond their level reducing UC awards by 65p.

Table 4 sets out the value of work allowances both before and after Summer Budget 2016. It shows their expected value in 2020 alongside the number of hours of work at the wage floor the work allowance is equivalent to. It also shows the maximum loss such a reduction can cause to each family type – ranging from £1,220 for a couple with children and £2,840 for a single parent where neither rent to £2800 for couple parents who do rent (and therefore have housing costs).

Table 4: Change in value of work allowances and maximum loss, 2020

	Pre-Summer Budget			Pre-Autumn Statement			Income loss
	Annual limit	Weekly hours at NMW	Weekly hours at NLW	Annual limit	Weekly hours at NMW	Weekly hours at NLW	
Higher work allowance - without housing costs							
Single parent	£9,200	22	20	£4,900	12	11	-£2,840
Couple with children	£6,700	16	14	£4,900	12	11	-£1,220
No dependent children	£1,400	3	3	£0	0	0	-£920
Limited capability for work	£8,100	20	17	£4,900	12	11	-£2,120
Lower work allowance - with housing costs							
Single parent	£3,300	8	7	£2,400	6	5	-£620
Couple with children	£2,800	7	6	£2,400	6	5	-£280
No dependent children	£1,400	3	3	£0	0	0	-£920
Limited capability for work	£2,400	6	5	£2,400	6	5	-£40

Notes: Annual equivalent work allowance limits are rounded to the nearest £100, with maximum potential losses rounded to the nearest £10. Revised economic assumptions for the Pre-Autumn Statement period are used to project values to 2020.

Source: Resolution Foundation analysis using HMT, Forecasts for the UK economy: a comparison of independent forecasts, 2016, OBR, Economic and Fiscal Outlook March 2016

[16] D Finch (2016) *Universal Challenge – making a success of Universal Credit*, Resolution Foundation

[17] Which provide a cash top-up for families actively moved to the UC system from the current tax credit system

[18] HMT (2016) *Budget 2016*, March 2016

[19] OBR (2016) *Universal Credit caseload forecasts*, 21 July 2016

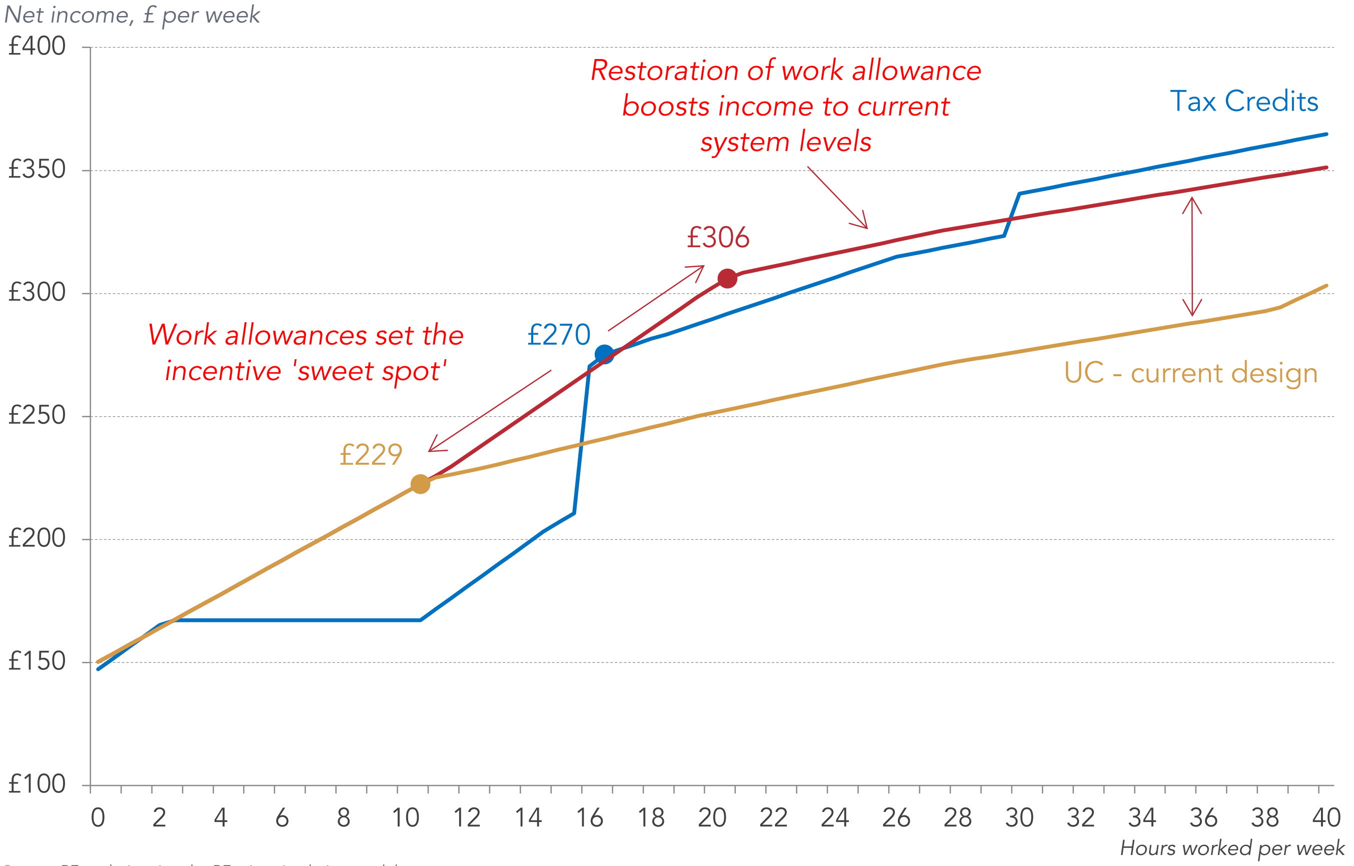
[20] V Alakeson, M Brewer & D Finch (2015) Credit where its due? Assessing the benefits and risks of Universal Credit, Resolution Foundation

However, the changes to work allowances go beyond the mere level of generosity; they also undermine the very work incentives that UC was meant to improve. Given the record of tax credits on supporting increased employment among single parents[21] it is important to ensure that UC does not represent a backwards step in this regard.

To illustrate the implications of these changes Figure 9 takes the example of a home-owning single parent earning at the wage floor with one child and shows their income as their hours of work increase in both the current tax credit system and UC. It shows that the current system provides a boost at 16 hours of work which is not apparent under the latest version of UC. Instead, the 'sweet spot' for this UC recipient comes at around 11 hours of work. Beyond this point, each additional hour of work is worth just £3 in net income (compared to a £8.60 an hour gross wage) falling to £2.05 when also paying income tax and NI.

Restoring the work allowance to its pre-election level changes this however. At 16 hours of work it leaves this individual only slightly worse off than in the tax credit system and provides an incentive to move to a 'sweet spot' of roughly 23 hours of work, with each pound earned below this level representing a straight increase in their income.

Figure 9: Work incentives for a single parent with one child on the wage floor under proposed work allowance cuts, 2020



Source: RF analysis using the RF microsimulation model

[21] R Blundell, M Brewer & A Shepard (2005) *Evaluating the labour market impact of Working Families' Tax Credit*, IFS

As highlighted by the tax credit experience, we know that single parents, such as the one highlighted in this example, are sensitive to such incentives (20 per cent of single parent renters in receipt of working tax credit currently work precisely 16 hours a week[22] and half of all single parents on tax credits work between 16 and 23 hours)[23]. We would expect the same to be true of second earners, who face a withdrawal rate of 65p from the moment they start work thanks to their working partner having already exhausted the family's work allowance.

Therefore, in considering what might be done on work allowances to boost both incomes and incentives, the Chancellor should prioritise restoration of previous levels of generosity for single parents and the introduction of additional allowances for second earners.

The UC taper rate

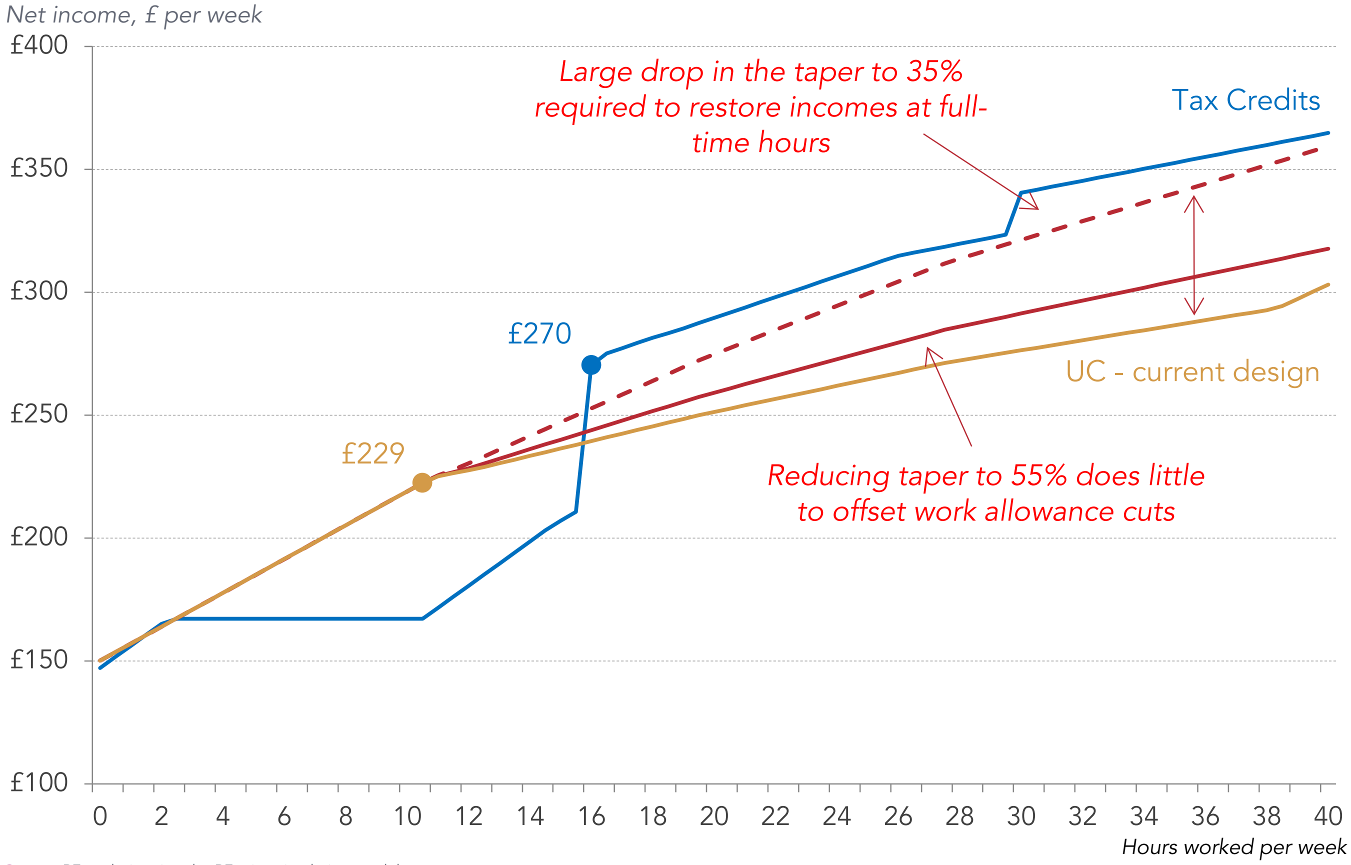
When first conceived the UC taper was set to be no higher than 55 per cent. However fiscal constraint meant it was instead introduced at 65 per cent, the result being that a taxpayer will keep as little as 24p for every extra pound they earn (after accounting for income tax and National Insurance as well as UC withdrawal). This matters because workers sensitive to such incentives, like single parents and second earners, are not likely to seek progression opportunities with little financial reward. Therefore, one option the Chancellor might consider for support the 'just managing' is to maintain existing benefit cuts but focus new resource on lowering the taper rate.

However, the scale of reduction in the taper needed to significantly boost incentives to progress and offset the negative effects on incomes of lower work allowances is very sizeable. As Figure 10 shows, a 10 per cent reduction in the taper – which we estimate to cost almost £4 billion in a UC steady state – boosts incentives relative to current UC design but leaves the individual with significantly lower income and incentives than exist in the current tax credit system.

[22] For further detail relating to this discussion see: V Alakeson, M Brewer & D Finch (2015) Credit where its due? Assessing the benefits and risks of Universal Credit, Resolution Foundation

[23] HMRC (2016) *Personal tax credits :provisional statistics*, April 2016

Figure 10: Work incentives for a single parent with one child on the wage floor under different UC taper scenarios



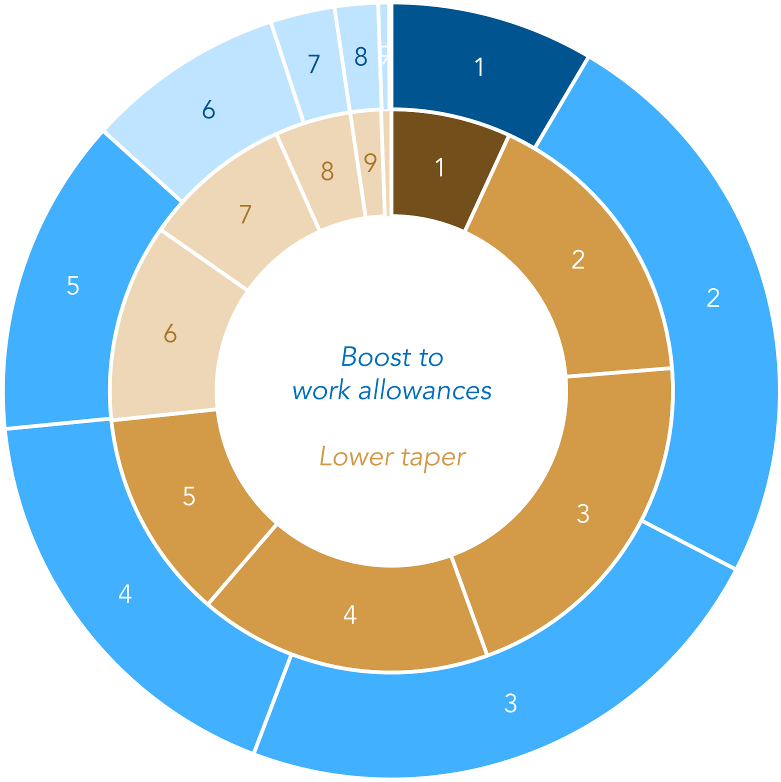
Source: RF analysis using the RF microsimulation model

Instead, the taper would need to be lowered to somewhere in the region of 35 per cent in order to restore income at full-time levels of work to those that prevail currently. This would create an overall tax rate of 44 per cent which would be simply unaffordable, costing much more than the initial UC cuts were meant to save in the first place.

While there is significant merit in lowering the taper in order to reduce disincentives to progress, it is worth noting that this approach is less effective at targeting additional support on the lowest earners and those with children, instead improving generosity for families higher up the income distribution and increasing the overall population of UC recipients – including those without children who are less affected by cuts to work allowances.

Comparing the gains associated with lowering the taper rate with those flowing from increasing work allowances for each decile of the household income distribution, Figure 11 presents a distributional assessment of a £4 billion investment in both approaches. It highlights the proportion of gains flowing to deciles two to five – which broadly represents the 'just managing' - showing that almost four-fifths of the gains from work allowances go to deciles two to five, compared to two-thirds of the gains from the taper increase.

Figure 11: Share of gains across the distribution from boosting work allowances or lowering the taper in UC



Notes: Taper option reduces the UC taper to 55 per cent. The work allowance option restores work allowances for families with children and introduces a small second earner work allowance.

Source: RF analysis using the IPPR tax-benefit model

Our assessment is that any extra investment should be targeted at boosting work allowances for families with children in the first instance, lifting them to the equivalent of around 15 hours a week. This will ensure that additional support is focused on the most disadvantaged, lowest income working families, while also helping the relatively higher income families entitled to UC who are losing out.

Clearly progression matters too however – particularly as the introduction of the NLW is likely to create additional wage compression in many industries. In the short term, we believe that lower tapers should be tested in pilots in order to understand the impact of the improved incentives on both progression and the Exchequer, with a view to adjusting this rate in the coming years as resources allow.

We have also previously called for the introduction of practical support to help people progress.[24] As with the taper, we favour the introduction of pilots in order to test the effectiveness of different approaches.

Support with childcare support is also an important consideration and would offer more targeted support than adjusting the UC taper. Childcare costs have a big bearing on work incentives, for instance a second earner in a couple with two pre-school aged children and entitled to UC returning to work at full-time hours on the NLW could keep only £3,000 of their £17,000 gross earnings. Their earnings are immediately subject to the 65 per cent taper and after paying tax and National Insurance they would keep only £5,000 extra but the cost of childcare would reduce this further to only £3,000 - 20 per cent of their earnings.

[24] D Finch (2015) *Making the most of UC: Final report of the Resolution Foundation review of Universal Credit*, Resolution Foundation

The return to working additional hours is also significantly weakened by the cost of childcare. Once any free childcare is exhausted and a parent is paying income tax, paying for an hour of childcare to work an additional hour at the wage floor can leave them with only £1.30 for that hour of work. That is an effective marginal tax rate of 85 per cent, rising to 93 per cent if they pay for two children at the same time.

Support in this area can be very carefully targeted – therefore limiting the cost relative to some other short term support options. Longer term the government should consider the extent to which current plans for childcare provision are simple, integrated and provide enough support for parents to work the hours they require.

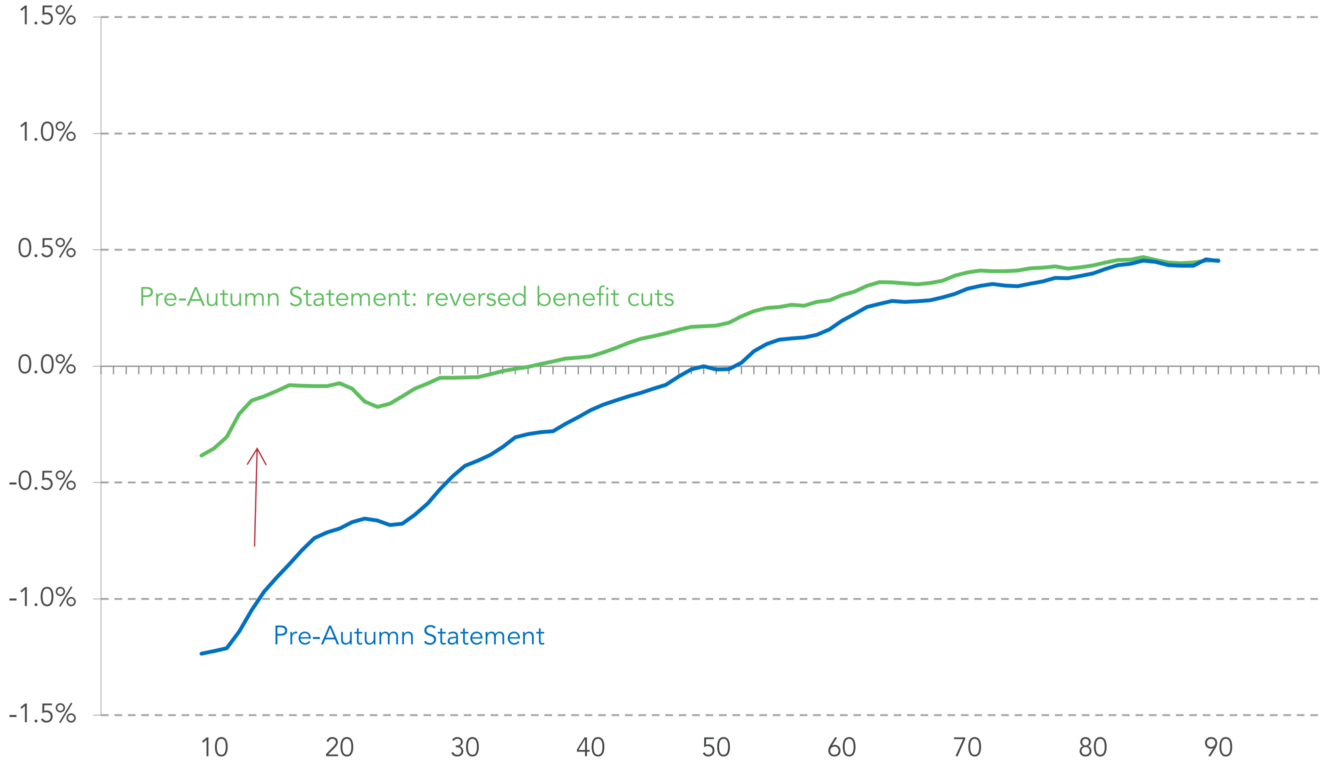
The need to go further

The options for consideration we have set out in this section are deliberately limited in ambition, recognising the tight fiscal realities facing the Chancellor. But if the government truly wishes to support the 'just about managing' then it will need to consider much bolder options over the course of the parliament.

This is brought home by Figure 12, which shows the effect on the income projection we set out in Figure 4 of reversing *all* of the welfare cuts announced since the 2015 election. Even in this bold scenario – which the Chancellor has given no indication might be on the agenda – we find that incomes are set to be flat or falling across the bottom two-fifths of the income distribution.

Figure 12: Income growth projections for the current parliament under different scenarios

Average annual growth in real disposable household income by percentile (CPI-adjusted)



Notes: Assumes partial implementation of UC by 2020 with 80 per cent of families in receipt.[25] Benefit cuts in place (and reversed) include the four-year benefit freeze, work allowance cuts, the removal of the family element for new claims and limiting support to two child families for new births/claims. Tax measures are the increase in PTA to £11,500, increase in HRT to £45,000 by April 2017 and thereafter inflation uprating. NLW is assumed to be in place by 2020. Measures affecting the generosity of child elements for new births/claims are assumed to be half in place. Estimates assume full-take up of entitlements.

Source: Resolution Foundation analysis using the IPPR tax-benefit model, HMT, *Forecasts for the UK economy: a comparison of independent forecasts*, 2016, OBR, *Universal Credit caseload forecasts, July 2016*

This picture bears some similarity to the pre-crisis years shown in Figure 1, in which average incomes within the low to middle income group were broadly flat. This highlights that a government that wishes to tackle what appears to be a structural problem for the 'just managing' will require efforts going far beyond the tax and benefit system, with steps to boost productivity and push still further on employment gains. There is also a need to consider the housing landscape – not touched on in this report – with rising housing costs acting as a major drag on the living standards of low and middle income households in recent years[25]

Making progress on these issues will not be easy. And much will depend on the economic backdrop provided by the particular details of the eventual path to Brexit pursued by the government. But Theresa May has made it clear that it is on such measures that she wishes her time as Prime Minister to be judged.

[25] S Clarke, A Corlett & L Judge, *The housing headwind: the impact of rising housing costs on UK living standards*, June 2016

Section 5

Conclusion

The new Chancellor of the Exchequer has inherited a tough economic legacy. His job has been made more challenging still by the welcome determination of the Prime Minister to improve outcomes for the 'just managing' – those low to middle income households who are in work but who struggle to get by. Projections based on the tax and benefit plans and latest economic outlook inherited by the new government, show that incomes within this group are set to fall over the course of this parliament – risking roughly two lost decades of growth since the early 2000s. The Chancellor must therefore simultaneously deal with an expected £84 billion deterioration in his public finances and put in place new measures designed to change the picture for those in the bottom half of the income distribution.

As we have shown across three pre-Autumn Statement papers, he has choices. His fiscal 'reset' has the potential to provide some new headroom, allowing him to introduce some modest increases in spending on investment, public services and welfare while still retaining some fiscal margin. He is also likely to have to reprioritise within existing fiscal totals, with our recommendation being that he presses pause on further income tax and corporation tax cuts and instead diverts these resources to targeted support for those on low and middle incomes.

As a result of such actions, he has scope to reverse many, if not all, elements of the benefit cuts introduced by his predecessor. As a minimum he should prioritise improving incentives as well as incomes, by doing more on UC work allowances, restoring previous levels for single parents and introducing new allowances for second earners in couples. We believe he should forgo additional unintended savings associated with the benefit freeze in an era of higher than expected inflation to give recipients a year off – uprating in line with CPI inflation in April 2017. Reconsidering the two-child limit in UC would have a significant impact in avoiding a sharp increase in child poverty numbers.

These are modest and incremental changes, grounded in what we believe to be feasible given the fiscal and economic backdrop. Longer-term however, the Chancellor and the government more generally will need to show much greater ambition in order to deal with a living standards squeeze on low to middle income households that predates the financial crisis. The country may be under new management, but the problems facing the 'just managing' are all too familiar: dealing with them will be as big a mark of the new government's success as its ability to deliver an effective Brexit.

Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

» *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*

» *developing practical and effective policy proposals; and*

» *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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