RF

Resolution Foundation
REPORT

The Living Standards Outlook 2019

Adam Corlett
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Executive Summary

The prospects for people's living standards are a function of two things: the outlook for overall economic growth and the outlook for how different households will share in the gains of that growth. These two elements are in turn the product of both market-based and policy-driven developments. There is of course much uncertainty in both areas – especially in the current pre-Brexit setting – but casting forward as best we can is useful both to prepare for what might be about to come and to inform policy changes that might positively alter the outlook.

In this, our second dedicated annual *Living Standards Outlook,* we project levels and distributions of household income growth up to 2023-24, based on current economic and policy forecasts. On the economy, we take Office for Budget Responsibility (OBR) projections as given where possible and make use of Office for National Statistics demographic projections. On policy we factor in all decisions announced at or before Autumn Budget 2018 (with little at this stage to suggest that the Chancellor intends to make any significant changes at the upcoming Spring Statement).

Our projections suggest the Article 50 period (so far) has been poor for living standards and poverty…

Our projections begin with a 'nowcast' for the years 2017-18 and 2018-19, reflecting the fact that detailed survey data about household incomes is only available with a considerable lag. The nowcast benefits from being able to draw on a variety of real-life data relating to recent employment, pay, inflation and tax and benefit policy. It is therefore likely to provide a good sense of the direction of travel over the past two years, even if the precise growth figures must be treated with some caution. We refer to the past two years as the 'Article 50 period' in recognition of the unusual political circumstances between 29 March 2017 and 29 March 2019.

The picture painted by our nowcast is a disappointing one. Following healthy post-crisis growth in typical non-pensioner incomes from 2013-14 through to 2016-17, **real income growth appears to have stalled in 2017-18 and 2018-19**, with zero growth. Things look worse still in the poorer half of the distribution, with real incomes contracting over the past two years. As a result, it looks **likely that child poverty has also continued to increase over this period**, with an estimated 4 percentage point rise between 2016-17

and 2018-19. We also estimate that overall income inequality has increased slightly over the Article 50 period.

…and the outlook for the next five years is also weak

There has been some better news for households recently. Inflation has fallen back to around its 2 per cent target, nominal annual pay growth is at its highest since 2008 (though still low by earlier standards), and the employment rate has remained high. There are also signs of a small recovery in home ownership rates, and a slowing of private rent increases.

Even with these trends (and without assuming a 'no deal' Brexit) however, the outlook for household incomes is set to remain very challenging. Our projection is that **meaningful non-pensioner median income growth is not set to return for several years**, with growth remaining close to zero over 2019-20 and 2020-21 as a whole and averaging only 0.7 per cent a year in the following three years.

For some groups the outlook is even weaker: **projected growth is lowest for parents, the out-of-work, low to middle income working households, social renters, mortgagors, and single adults**. The typical income for all families with children is forecast to fall by 1 per cent between 2016-17 and 2023-24, compared to a rise of 4 per cent for households without children. Strikingly, with a new stagnation coming on top of the financial crisis and (for many) a pre-crisis slowdown, total income growth over the entire 20 years from 2003-04 to 2023-24 is currently projected to be close to zero for some groups – including low to middle income working households.

Our **projections suggest child poverty will rise to record levels within the next five years**, and will be 6 percentage points higher in 2023-24 than in 2016-17: equivalent to an extra 1 million children in poverty. Of course, economic projections will not be perfectly accurate (and this one will hopefully be proved wrong), but the direction of travel on poverty is all too clear.

While official poverty statistics are in need of revision (with previous Resolution Foundation work demonstrating important inaccuracies in the way in which benefit income is captured), taking the current benchmark as given we find that **among some household groups – children with single parents, families with three or more children, households where no-one is in work, and private or social renters – more than half of children are projected be in poverty by 2023-24**. Poverty rates are also projected to rise for other groups. The child poverty rate for working households averaged 20 per cent between 1996-97 and 2013-14 but is projected to increase to 29 per cent by 2023-24. And the poverty rate for children living with two parents may

have already hit a record high of over one in four in 2017-18 or 2018-19. The proportion of parents living in poverty is also forecast to reach a record high.

The UK is also not projected to meet its Sustainable Development Goal target on inequality over the forecast period, with income growth for the poorest 40 per cent expected to remain lower than overall growth rather than exceeding it.

This is the result of both economic and policy problems…

The economic element of our nowcast and forecast is of course dominated by Brexit. What leaving the EU might mean going forward remains hugely uncertain at this stage (and much will depend on the precise terms of new trading arrangements), but we can already observe an effect on the economy and incomes.

While recent economic news has been gloomy across most major economies, the UK has undoubtedly faced additional challenges during the Article 50 period. Heightened uncertainty has fed through into weak business investment – some of which we might expect to be merely postponed until such time as the outlook becomes clearer but some of which may be permanently lost. This effect helps to explain why the UK has slipped down the international growth rankings over the last two years.

But the impact on household incomes has been more marked still. That's because the sharp devaluation of the pound immediately after the referendum fed into a spike in consumer inflation in 2017 that reduced households' purchasing power in a way that doesn't show up in GDP data immediately.

Overall, **average real household income in late 2018 was some £1,500 lower than had been projected in pre-referendum forecasts.** Changing global economic conditions might be argued to explain some of this, but global growth has actually out-performed previous expectations over the post-referendum period as a whole. That is, the UK's major trading partners may have undergone a marked slowing of growth in the last year, but this has been more than offset by upside performance in the earlier part of the Article 50 period. The global economy has therefore provided the UK with more of a tailwind than a headwind in the post-referendum period as a whole.

Crucially for our forecast, the OBR assumes a continuation of the UK's weak post-crisis pay and productivity growth. How much of this trend is down to Brexit-related effects and how much reflects broader structural issues in the UK economy is an open question. Yet, while no one can definitively state how much of the weaker income performance in the Article 50 period has

been driven by Brexit, UK exceptionalism in this period suggests that it is undoubtedly the single biggest factor.

The policy element of the nowcast and forecast is dominated by the roll out of benefit cuts announced as part of the 2015 Summer Budget. For example, **the benefit freeze – which was compounded by the post-referendum consumer inflation spike – is about to enter its fourth year and will leave households £4.4 billion a year worse off overall**. The two child limit will take up to £2,800 a year per child from many families, and the abolition of the 'family element' will take up to £545 from each family on tax credits or Universal Credit (UC). In contrast, tax changes play a relatively small role in the outlook, except for a large income tax cut for higher earners and rises in council tax bills. Increases in minimum pension contributions through auto-enrolment are proving important, however, with welcome boosts to saving for the long term weighing on disposable incomes in the short term.

...but this implies there are ways to beat the outlook

Given the combination of a Brexit headwind and actively regressive tax and benefit policy, it is perhaps unsurprising that our figures are as gloomy as they are. Worryingly, they could feasibly be worse still. One pressing possibility is that a no-deal Brexit could bring abrupt economic dislocation, a further devaluation of the pound and immediate increases in tariffs. Even in the absence of this, we should note that any persistence of the global economic slowdown could drag on UK growth prospects. More broadly, to assume (as we do) that there will have been no recession from 2009 Q3 to 2024 Q1 may be optimistic, with the Bank of England putting the odds of a recession in 2019 at around one in four. Politicians should of course work to avoid or limit such shocks.

However, it is also easy to imagine economic or policy changes that would improve the outlook. In terms of Brexit, the flipside of today's uncertainty is that securing a smooth transition could release pent-up capital investment potential and generate a sense of relief large enough to boost both business and consumer confidence. In the short term it may also be that inflation, private rent and mortgage cost projections are revised down (even if this is more likely to reflect economic weakness rather than strength). The government of course also has the ability to directly affect distributional outcomes by shifting its policies on taxes and benefits.

Given that a large part of our motivation for undertaking living standards outlooks is to encourage action that means they are beaten, we look at the potential impact of a number of positive scenarios on the next five years. These show that **large improvement in the outlook for typical non-**

pensioner incomes will only come from higher real earnings growth, while any hope of preventing child poverty rising must come from a change in welfare policies.

The OBR forecasts average pay growth of around 3 per cent a year – well below the pre-crisis average of around 4 per cent. Were pay to grow 1 percentage point a year faster than the OBR forecast (meaning an extra 5 per cent boost by 2023-24) then median working-age disposable income would grow by 6.1 per cent in total over the next five years, rather than our meagre central projection of 1.9 per cent. Such a boost to the economic outlook would also provide more tax revenue than expected. Allowing some of this revenue to be used to raise benefit levels would further increase the five-year growth outlook to 7.0 per cent.

Less encouragingly, scenarios in which either the employment rate rises beyond its already record level or benefit policy is changed – while both desirable – are shown to be unlikely in isolation to greatly strengthen median income growth.

Substantial benefit change does, however, provide the only means in the scenarios we model of preventing a rise in child poverty between 2018-19 and 2023-24. We model a focused package of policy changes to help parents and children: cancelling the two child limit and the abolition of the family element, while boosting UC's work allowances for single parents and second earners with children. This would significantly improve the outlook for the bottom half of the income distribution.

In contrast to our main projection of a rise in child poverty of 3.0 percentage points between 2018-19 and 2023-24, these policy changes would lead to a fall in child poverty of 1.2 percentage points (though even this fall would not return child poverty to where it was in 2016-17). At a cost of around £5 billion a year, this package would require tough choices to be made, but there are few good ways in which the child poverty outlook can be improved without similar action.

Conclusion

The living standards outlook for low and middle income households looks difficult. As and when detailed survey data becomes available for 2017-18 and 2018-19, we expect it to confirm our take that the Article 50 period has been one in which Brexit-related uncertainty and high inflation have eroded the value of household incomes. The government's deliberate policy choices have then compounded the distributional impact, helping to drive a sharp increase in child poverty.

The risk now is that the next few years are just as tough. An apparent global slowdown and the continued uncertainty of Brexit merely add to the living standards challenge. But the outlook we have set out is not inevitable. There is substantial room for upside economic surprises – particularly if the worst elements of Brexit uncertainty can be removed. And the government has direct control over the distribution of growth – whether weak overall or otherwise – giving it the potential to significantly alter the picture for low to middle income households. But if the same factors that have made the Article 50 period a poor time for living standards are left unchanged, we should not be surprised if the result is a continuation of weak income growth and rising poverty.

Section 1

Introduction

This is our second annual 'Living Standards Outlook', dedicated to projecting levels and distributions of household income into the future based on current policies and economic forecasts.[1]

In early 2019 economic uncertainty is particularly high, both near term and long term, nationally and globally. At the time of writing, it is not certain how or when (or even if) the nation will leave the European Union. Already, ships departing from many parts of the world to the UK (or vice versa) do not know for sure what trade arrangements will apply when they arrive. But on current plans we are only weeks from a new era outside the EU, making this an apt time for a stock-take of household finances and their expected trajectories.

This report includes our latest 'nowcast' and assessment of the 'Article 50 period' so far (the financial years 2017-18 and 2018-19) which, despite some positive trends, appears to have been a strikingly poor time for living standards improvements, due to high post-referendum inflation, an absence of productivity growth and welfare cuts.

Building on this, we project living standards over the next five years: from 2019-20 through to 2023-24. For both our nowcasting and projections we combine the latest Office for Budget Responsibility (OBR) forecasts with other trends and government tax and benefit policies. Using these, we are able to roll forward the latest detailed household income data from 2016-17 in order to model living standards in each subsequent year. By providing an overview of the state of the country's living standards and the likely direction of travel over the coming years, we hope to better inform debate about what course corrections we need to plot.

[1]   See A Corlett, S Clarke, C D'Arcy & J Wood, The Living Standards Audit 2018, Resolution Foundation, July 2018 for a greater focus on the past; and C D'Arcy, Low Pay Britain 2018, Resolution Foundation, July 2018 for a greater focus on the past, present and future of wages.

The document is structured as follows. First, we look at some of the big trends underpinning household incomes:

- **Section 2** explores what has happened and might happen in the **labour market** in terms of employment and earnings; and

- **Section 3** looks at the other main determinants of household income, particularly **benefits, taxes and housing costs.**

We then use forecasts of these components to build projections for household incomes:

- **Section 4** presents our projections for **median household incomes** up to 2023-24, including 'nowcasts' of 2017-18 and 2018-19 (the Article 50 period so far);

- **Section 5** looks beyond averages to projections for all parts of the **income distribution** and for different groups; and

- **Section 6** shows what these patterns of growth would mean for measures of **poverty and inequality**.

Finally, reflecting our hope that our projections form a basis for debate about future policy priorities, we discuss how this outlook might be improved:

- **Section 7** presents alternative **scenarios**, asking how we might 'beat the outlook' through either improved economic forecasts or a shift in government policy;

- **Section 8** offers some **concluding thoughts.**

Three annexes provide more information: **Annex 1** gives details of our nowcasting and forecasting methodologies; **Annex 2** compares previous Resolution Foundation projections with subsequently released outturn data; and **Annex 3** gives alternative versions of earlier charts, using a different income measure (excluding the impacts of housing costs).

Section 2

Prospects for market incomes

Real wages and employment rates are the primary determinants of material living standards for working-age households. The last two years have largely followed the familiar post-crisis pattern of disappointment on the first of these measures and upside surprises on the second, but the expectation is that things will change over the forecast period. In this section we look at recent trends in jobs and pay, and at forecasts for the next five years.

Employment rates are not expected to continue rising, but have surprised before

This report shows a worrying stalling of economic progress on some fronts. But current employment rates are unambiguously good news. Some 61.3 per cent of people over 15 (i.e. including those in education or retirement) and 75.8 per cent of 16 to 64 year olds are in employment: both record highs. Conversely, an unemployment rate of 4 per cent is the lowest since the 1970s.[2] Large employment increases since the financial crisis-inspired recession of 2008-09 have boosted national output and average household incomes.

However, as Figure 1 shows, the pace at which employment and participation rates increased in 2018 slowed relative to previous years. And the OBR expects only very limited further improvement (while its unemployment rate forecast of 3.9 per cent for 2018-19 as a whole now looks very slightly optimistic). Indeed, beyond 2020 the OBR forecasts a *fall* in the employment rate, driven primarily by a fall in the participation rate.[3]

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[2]   Note that this partly mirrors international trends, e.g. historically low unemployment rates in the US, Canada, Japan, Germany and Poland. ONS, *Labour market table A10: International comparisons of employment and unemployment*, February 2019

[3]   The participation rate refers to the proportion of the population who are actively engaged with the labour market, either by working or looking for work: i.e. it includes the unemployed as well as the employed.

Figure 1: The OBR expects employment rates to plateau and then fall – though it has been too pessimistic before

Proportion of people age 16+ in employment / the work force
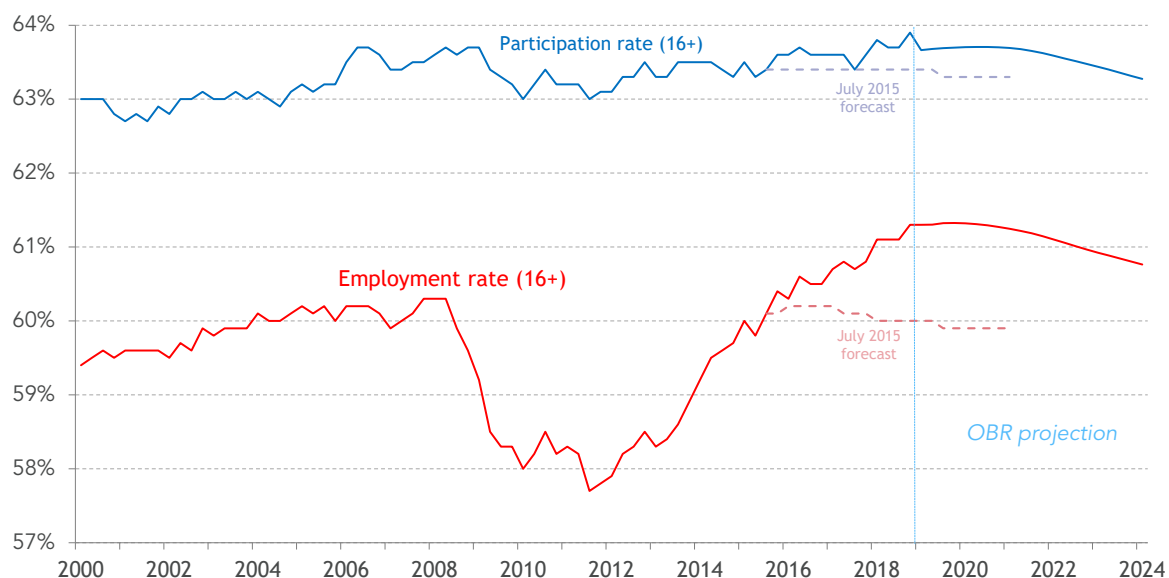
Source: ONS; and OBR, *Economic and Fiscal Outlook*

Forecasts have been too pessimistic before, however, and Figure 1 also shows the OBR's July 2015 forecasts for comparison. Section 7 discusses a more optimistic (but less likely) employment scenario, but the higher the employment rate goes the harder it is to believe that we can continue to rely on further increases to support income growth. This is particularly true given the demographic pressures now looming (as discussed in Box 1).

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i Box 1:   The UK's coming demographic pressures

The overall employment rate matters for living standards, and is partly a function of demographics. The UK – like most richer nations – is ageing, with the mean age projected to rise from 40.5 in 2016 to 41.4 in 2023, and 42.5 by 2030.[4] Importantly, the immediate post-war baby boom cohort has now reached state pension age, and the baby boom of the 1960s will start to do so in the late 2020s.[5]

However, increases in the state pension age are keeping dependency ratios down.

As Figure 2 shows, the number of pension-age adults per working-age adult is actually falling at present – as the pension age rises to 66 – and will dip again in 2027 and 2028 – when it rises to 67.

In general, however, from 2020 onwards the old-age dependency ratio will grow (though potentially partially offset by declines in the number of under-16s), increasing the cost of health, social care and pensions in particular.

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[4]   ONS, *2016-based population projections*, October 2017
[5]   D Finch, *Live long and prosper? Demographic trends and their implications for living standards*, January 2017

Figure 2: From 2020, the old-age dependency ratio will generally rise

Number of pension-age adults per working-age adult
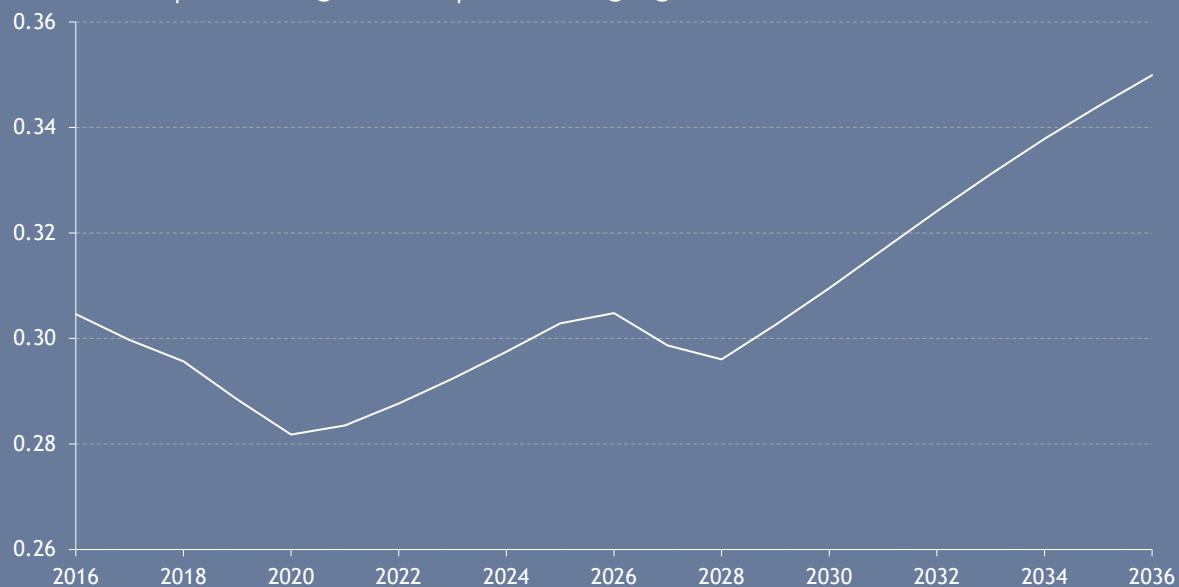
Source: ONS, *2016-based National Population Projections*

To give a better sense of the competing trends at play and the scope – or otherwise – for further employment gains, Figure 3 sets out employment rate trends by age and gender.

Figure 3: Employment rates for many groups are near record highs

Proportion of group in work
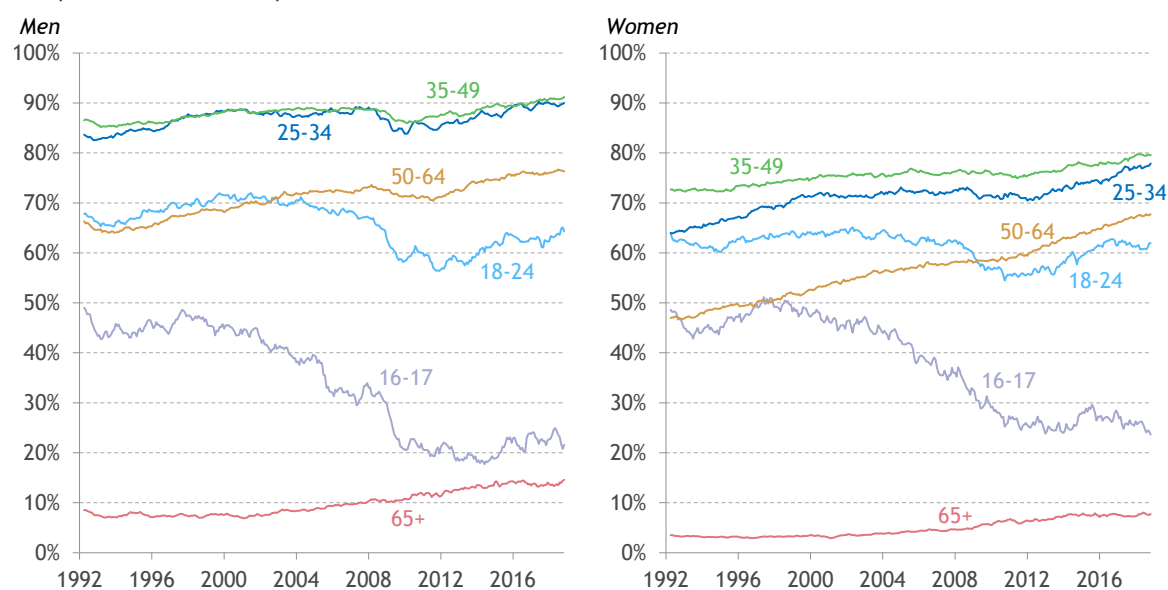
Notes: 16-24 year olds in particular may not be in employment due to being in full-time education. The state pension age for women has risen since 2010.
Source: ONS, *UK Labour Market*

Several things stand out. It should be noted, for example, that employment rates for 16-17 year olds and 18-24 year olds (of both genders) are far from record highs. However, this reflects increased participation in education and we shouldn't expected any reversal of the trend in the coming years.

For ages 25-34 and 35-49, employment rates among women have risen substantially, but are still more than 11 percentage points below those of men (79.6 per cent versus 91.2 per cent at age 35-49). This suggests potential room for further growth, but perhaps only if the gender balance of parenting responsibilities changes, which might in turn mean men of these age groups working less.

The largest employment rate increases have been among women age 50-64. In part, this is a direct result of an increase in the female state pension age since 2010, from 60 to 65. But there is still significant scope for increases among 50-64 year olds, both male and female. Rates for both this age range and the 65+ group may now edge up further as the state pension age slowly increases from 65 to 66 by 2020.

The size of these age groups is not fixed, however. It is the ageing profile of the UK population which we discuss in Box 1 that drives the OBR's forecast of a secular decline in the 16+ employment rate. (It should also be noted that this forecast is sensitive to levels of migration, with a central net migration assumption of 165,000 per year. Were net migration to fall significantly below this, the employment rate forecast would also be reduced.)[6] So while there is room for further employment increases,[7] there are good reasons to believe the trend of the last few years will not continue over the next five.

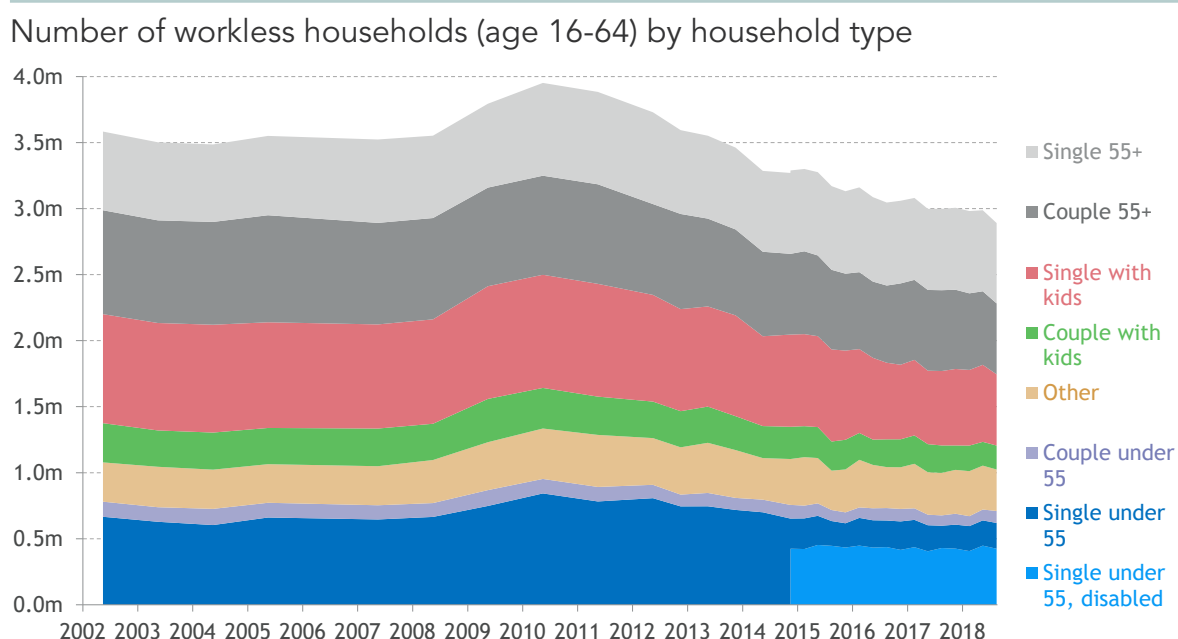## Household-level worklessness has also fallen

How jobs are distributed across households matters too. A lack of employment may be easier for people with a working partner, and household worklessness may be particularly problematic for those with children. This is also an indicator of how progressive recent employment increases have been – i.e. the extent to which these increases have been within lower- or higher-income households. And as employment rates have increased, the proportion of working-age households (age 16-64) where someone is in work has also increased.[8] Figure 4 shows the decline in the number of workless households – from 3.6 million in Q2 2002 to 2.9 million in Q3 2018 – in detail. It highlights some striking changes, but also the heterogeneity of 'workless' households – with worklessness likely to mean quite different things to different groups.

[6]   OBR, *Fiscal sustainability report*, *July 2018*
[7]   See also P Gregg & L Gardiner, *The road to full employment: what the journey looks like and how to make progress*, *March 2016*
[8]   ONS, *Working and workless households in the UK: July to September 2018*, *November 2018*

Figure 4: The number of workless households has fallen, driven particularly by single parents and those age 55+

Number of workless households (age 16-64) by household type

Notes: From 2015 we are able to divide singles under 55 into (Equality Act definition) disabled and non-disabled
Source: RF analysis of *Household Labour Force Survey*

It highlights especially that couples under 55 and non-disabled single adults without children – those groups that we might expect to have fewest barriers to entering work – already comprise a small share of the 'workless household' population

Instead, a large number of workless households (comprising 40 per cent of the total) are those headed by someone age 55+.[9] But, because the official measure includes all households in which at least one person is age 16-64, we might expect a sizeable share of people in this group to be voluntarily retired (particularly prior to the state pension age rising to 65). The highest worklessness rate (56 per cent) is recorded by single disabled adults aged under-55.[10] This group therefore comprises a significant (but falling) share of the workless household population, and it is unclear how much lower we might expect this figure to fall. Likewise we might expect only limited further reductions in the number of workless single parent households. The figure currently stands at 500,000, having already fallen markedly from 25 per cent of single parent households in 2003 to 15 per cent today. Among these remaining workless single parents, around half have children under 5.

This is not to say we shouldn't target *any* further improvement in worklessness, and policy changes could certainly improve incomes and work incentives for single parents (see Section 7) along with employment opportunities for disabled people. But for many in the UK's much-reduced workless population, employment will inevitably remain either undesirable or unfeasible.

[9]   Using the 'household reference person' in the Labour Force Survey.
[10]   Using the Equality Act definition.

Opportunities for boosting household income growth might instead be more readily available in relation to getting more second earners into work (again see Section 7) and – above all – in relation to lifting the wages of those already in work.

Real wage growth has returned after a period of high inflation, and current forecasts may be too pessimistic

Assuming no large surprises in employment, the primary determinant of the strength of future household income growth will of course be what happens to real earnings. As with much else at the moment, this outlook is subject to considerable uncertainty.

Figure 5 sets out real pay growth from 2001 onwards, including the trajectory implied by the OBR's last *Outlook* for the period through to 2024. It shows that the first half of the Article 50 period was characterised by a return to the pay squeeze that defined so much of the post-crisis decade. This was driven by the referendum-related spike in inflation in 2017, but also by the failure of nominal pay growth to return to pre-crisis norms.

Figure 5: The OBR assumes that nominal pay growth will not return to pre-crisis norms, and may even fall in the year ahead

Year-on-year growth in earnings and prices
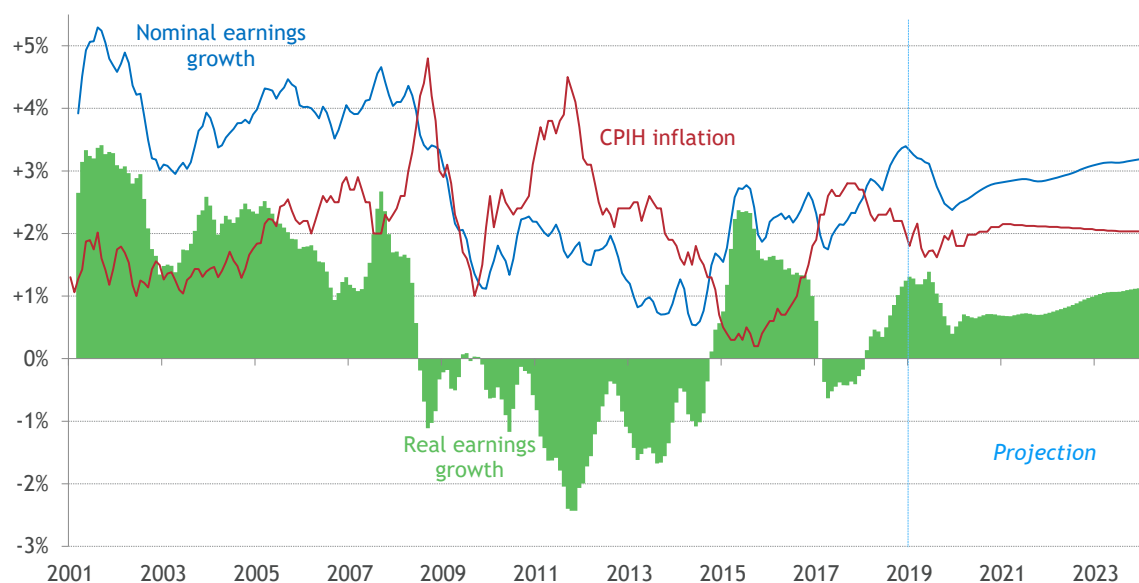
Notes: We apply OBR average pay growth rates to outturn regular pay data, with an adjustment for any recent divergence. CPIH is assumed to increase in line with CPI.
Source: RF analysis of ONS, *UK labour market*; and OBR, *Economic and fiscal outlook*

However, real-wage growth picked up over 2018, thanks to inflation falling back towards target and nominal pay growth building. Nominal growth has topped 3 per cent in recent months, lifting real-terms growth back above 1 per cent for the first time since the end of 2016.

This is a better performance than the OBR envisioned when it produced its latest set of projections back in October, and might give us cause to question whether the forecast trajectory set out in Figure 5 might end up being revised upwards when the OBR next opines on 13 March.[11]

However, there is good reason for supposing any such revision won't be large. In part, that's because the OBR assumes growth will ease in 2019 as a result of policies such as pension auto-enrolment (with minimum employer contributions set to rise in April 2019, as explored in Section 3) which remain unchanged.[12] There is also an expectation that the recent drop in inflation below its 2 per cent target is due at least in part to temporary effects associated with oil price movements.[13] And, fundamentally, the OBR's outlook is based on its expectation that the very disappointing productivity performance of recent years will be sustained over the forecast period too.

In any event, average earnings are still more than £500 a year below their pre-crisis peak (in 2007) after accounting for inflation. And, while the forecast may have improved slightly recently, our last projection was that the pre-crisis peak would not be recovered until 2024 – meaning 17 years of lost pay growth.[14] It's also worth noting that the Bank of England's indicative average earnings projection, while slightly stronger than the OBR's, has in fact just been revised down and also predicts a fall in real pay in 2019.[15]

The distribution of wage growth presents a mixed picture

Despite this overall weakness in wage growth, pay for the lowest earners has risen strongly in recent years. Increases in the National Minimum Wage followed by the April 2016 introduction of – and subsequent rises in – the National Living Wage (NLW) have delivered large pay rises for the lowest paid. Although this is a change in the hourly pay floor, Figure 6 shows that *weekly* pay growth in 2015 and 2016 was also extremely progressive.

However, data from April 2017 and April 2018 (the latter being provisional) shows a different picture, with earnings at the top bouncing back and apparently weak growth for the bottom of the weekly pay distribution. In 2017 this takes the form of increases at the bottom which are only very slightly higher than in the middle; but in 2018 we observe a pattern of pay growth falling as we move down the bottom half of the distribution.

More work is required to understand quite what is happening here, and it is worth noting that other data sources suggest that weekly pay growth remained progressive in 2018. Given that the NLW will continue to rise faster than average pay in April 2019 and April 2020 (to hit a target of 60 per cent of the median pay of those age 25+ in 2020), we assume in our projections (see Section 4) that weekly wage growth will again be progressive in these years.

[11]   Also see Resolution Foundation, *Earnings Outlook Q3 2018*, February 2019
[12]   OBR, *Economic and fiscal outlook*, October 2018
[13]   Resolution Foundation, *The Economic Outlook: Speech by MPC member Gertjan Vlieghe*, February 2019
[14]   Resolution Foundation, *How to spend it: Autumn Budget 2018 response*, October 2018
[15]   Bank of England, *Inflation Report*, February 2019

Figure 6: Earnings growth had been very progressive in 2015 and 2016, but recent growth has been more regressive

Annual change in average real (CPIH-adjusted) weekly pay by percentile
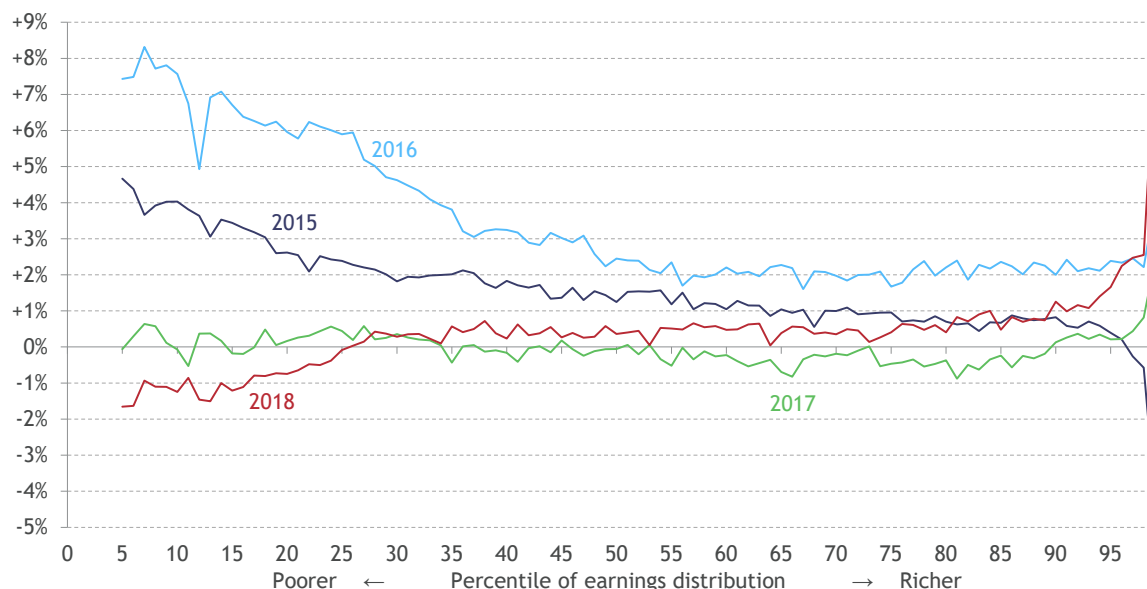
Notes: Figures refer to income growth from April to April. Bottom five per cent not shown.
Source: RF analysis of Office for National Statistics. (2018). *Annual Survey of Hours and Earnings*, 1997-2018: Secure Access. [data collection]. 13th Edition. UK Data Service. SN: 6689, http://doi.org/10.5255/UKDA-SN-6689-12[16]

Beyond 2020-21 we must assume that no group records faster earnings growth than any other. However, the government has announced an aspiration to continue raising the NLW relative to typical pay, perhaps to two thirds of the median.[17] This has the potential to improve the outlook for low earners, though not necessarily those on low household incomes per se (it is not well targeted on those with children, for example). But there is not yet any timeframe or detail for this aspiration.[18] And the OBR has indicated that it would likely increase its unemployment forecast (by perhaps 140,000) and reduce its average hours forecast (by 0.4 per cent) if policy were changed in this way.[19] So until this policy is confirmed, we do not incorporate it into our outlook.

The question of whether progressive employment and earnings trends continue is particularly important given that the tax and benefit system is set to hinder rather than help low income households' living standards growth over coming years, as the next section shows.

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[16]   This work contains statistical data from ONS which is Crown Copyright. The use of the ONS statistical data in this work does not imply the endorsement of the ONS in relation to the interpretation or analysis of the statistical data. This work uses research datasets which may not exactly reproduce National Statistics aggregates.
[17]   HMT, *Budget 2018*, October 2018
[18]   C D'Arcy, *Never mind the end of austerity, what about the end of low pay?*, Resolution Foundation blog, November 2018
[19]   OBR, *Economic and fiscal outlook*, October 2018

Section 3

Prospects for social security, taxes and housing

Earnings and employment are the primary drivers of overall household income growth, but the distribution of that growth is strongly affected by tax and benefit policy. Such policy has weighed on low to middle income household income growth in recent years, and is set to continue to do so. In this section we set out the scale of this effect, highlighting the impact of the four-year benefit freeze, the introduction of the two child limit, the abolition of the family element, and the broader effects of the switch to Universal Credit (UC). We consider too the impact of income tax cuts and council tax rises.

Additionally, we highlight other cost pressures that might play out differently across the income distribution. We focus particularly on the effect of increased pension contribution rates under auto-enrolment and potential changes in the housing costs faced by different groups.

Benefit policy will continue to squeeze poorer working-age households

The substantial package of benefit cuts announced in 2015 has had an increasing effect over the past two years. And, although there have been some limited U-turns (most recently on the generosity of UC work allowances), further large cuts are still to come in 2019-20 and beyond. Chief among these are the continued benefit freeze, the 'two child limit' and the abolition of the 'family element'.

A four year cash freeze for most benefits is proving particularly impactful. With inflation being on average higher (thanks in large part to the referendum-related spike) than was projected when the policy was first announced, this freeze has already cut the real value of Child Benefit, Universal Credit, (non-disability) Tax Credits, Housing Benefit limits, Jobseeker's Allowance, Income Support, and Employment and Support Allowance (except the support group component) by around 4 per cent.

Large real cuts in 2017 and 2018 will – as Figure 7 shows – be compounded by the fourth and final year of the freeze beginning in April 2019. This will save the government a further £1.5 billion, while taking the cumulative real benefit cut to around 6 per cent.[20]

Figure 7: A further benefit freeze in April 2019 is set to take another £1.5 billion from lower-income households

Estimated government savings from the benefit freeze (nominal)
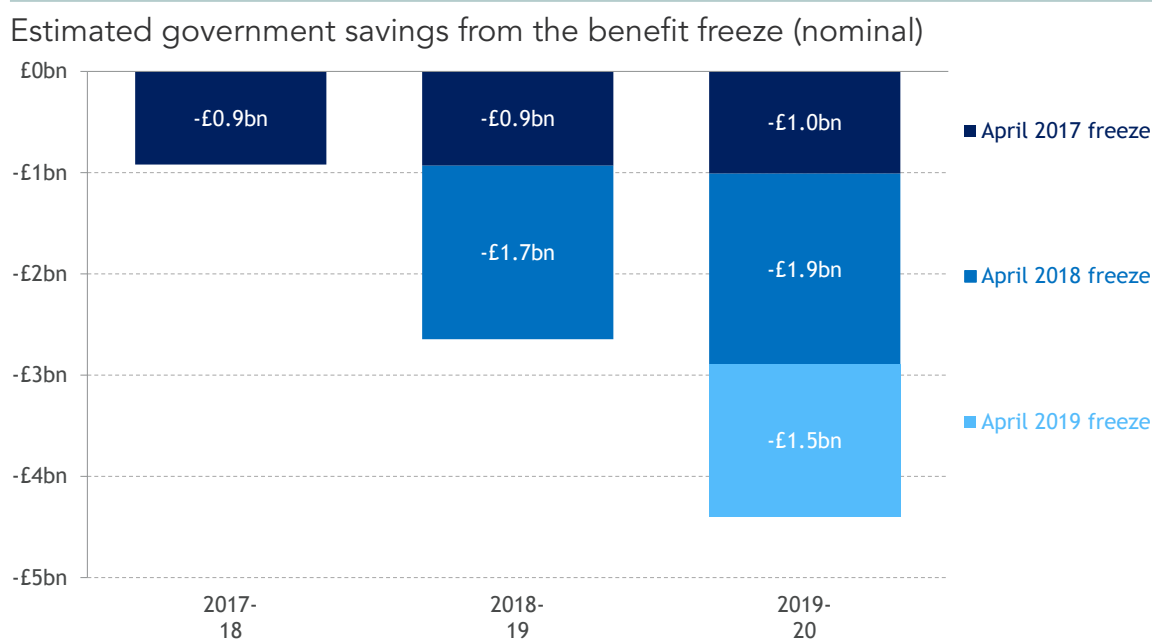
Source: RF analysis using the IPPR tax-benefit model

This four-year freeze has come on top of earlier cuts, including the permanent switch from RPI to CPI-uprating from 2011. Together these have held back or even reversed growth in the real value of the social safety net.

As Figure 8 shows, the basic level of support for the unemployed in 2019-20 will be its lowest since 1990-91 – getting on for 30 years without any improvement in the nation's living standards floor. Child Benefit beyond the first child will be worth less than when it was fully introduced in 1979 (though it was temporarily worth less in the 1990s). And the value of means-tested support for families – using the example of a family with one child – will have fallen back to where it was in 2002, prior to the introduction of Working and Child Tax Credits.

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[20]   Although the freeze also applied in 2016-17, inflation in September 2015 was below zero so no uprating would have taken place in any case.

Figure 8: The real value of benefits has fallen over the last two years, and is set to fall further in 2019

Selected major benefits per week, adjusted for CPI inflation (January 2019 prices)
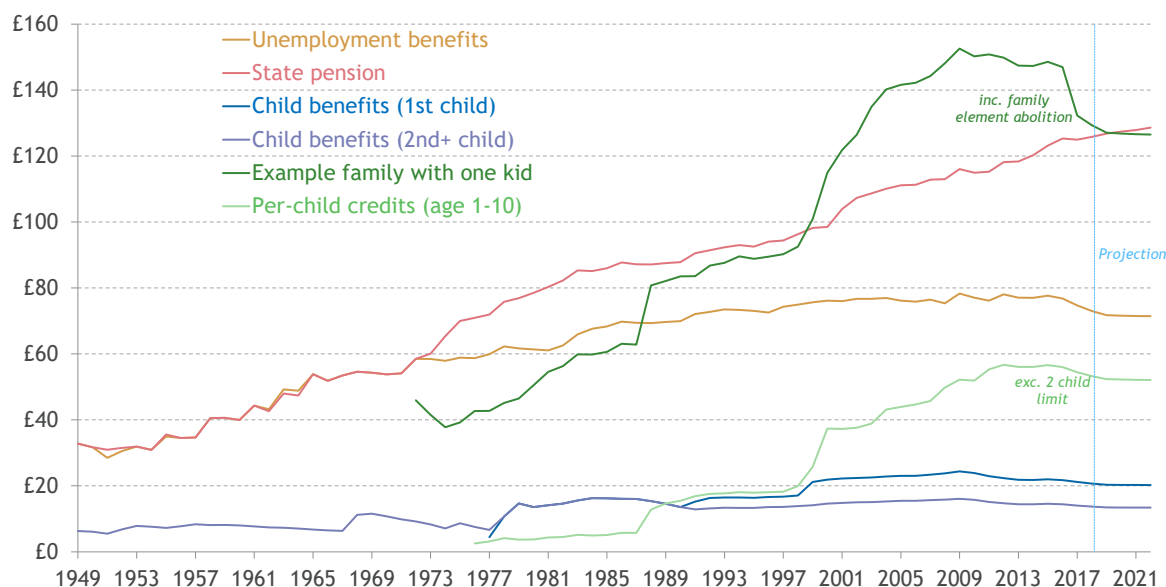
Source: RF analysis of IFS Fiscal Facts, ONS, Bank of England, and OBR EFO

The decline or stagnation of absolute benefit values should be disappointing. But their value relative to average earnings also matters, and is shown in Figure 9. Basic support for jobseekers, for example, will be equivalent to around 14.5 per cent of average earnings in 2019-20, its lowest ever. Child Benefit for a first child, at 4.1 per cent, will be lower than at any point – except 1990 – since its full introduction in 1979. And for families with two children its value has never been lower. Unless policy changes, these declines can be expected to continue over the forecast period.

One caveat is that while cash benefits have been cut, there has been a continuing trend of increased state support for childcare. Most recently, this has included the introduction of 'Tax-Free Childcare' from April 2017 (and phasing out of childcare vouchers) and the extension of an additional 15 hours of free childcare to working parents of three and four year olds from September 2017. However, these (like most public services) do not affect our disposable income forecasts.[21]

But an overall reduction in support for parents and children is clear (with equally clear impacts on the nowcast and forecast results presented in later sections). In addition to the erosion of support through inflation are other substantial cuts. The 'family element' in tax credits and its equivalent in UC have been abolished for new parents from April 2017, costing families up to £545 a year each. And the two child limit for per-child credits will cost larger families up to £2,800 per additional child (and £3,000 by 2023-24), where those children are born after March 2017.

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[21] Note that there is a case for subtracting childcare costs from disposable incomes, as set out in *A new measure of poverty for the UK: the final report of the Social Metrics Commission*, September 2018

Figure 9: Some benefits are reaching record lows relative to average pay

Selected major benefits as a share of average earnings
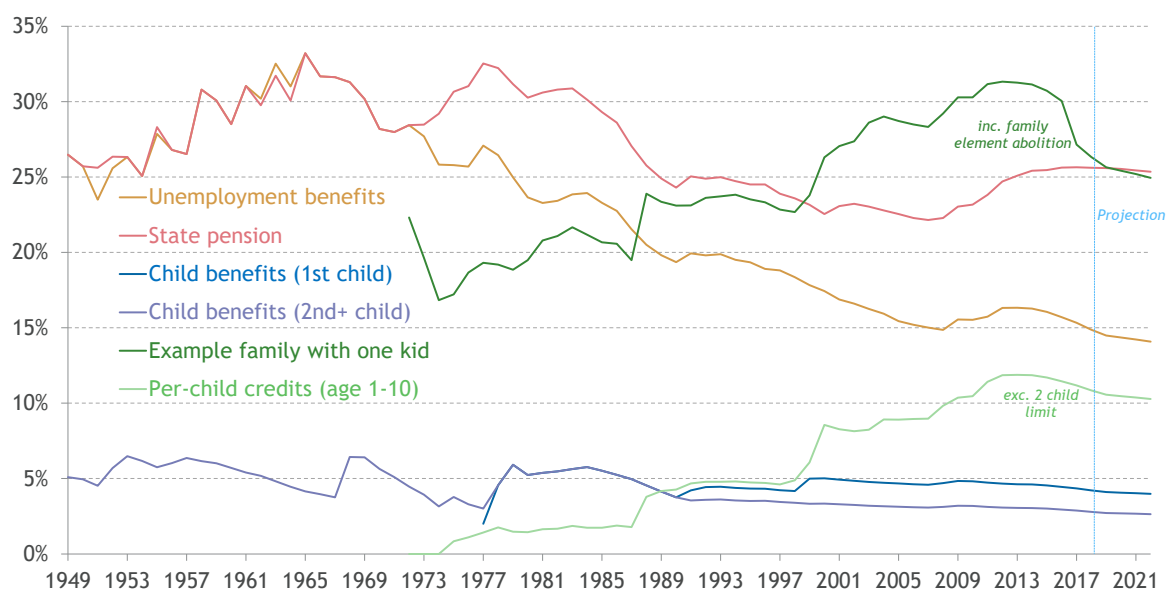
Source: RF analysis of IFS *Fiscal Facts*, ONS, Bank of England, and OBR EFO

These policies will take time to have their full effect, particularly following a recent decision not to apply the two child limit to all new UC claims. They will therefore drag on income growth throughout our forecast period, with the phasing out of the family element in particular expected to take well into the 2030s.

In addition to these cuts to child-focused support, other benefit policies will also continue to weigh on disposable income growth. The 'work-related activity group' component of Employment and Support Allowance (and its equivalent in UC) was also abolished for new claims from April 2017, reducing support by £1,500 a year. And even after the benefit freeze, Housing Benefit caps will rise only in line with CPI inflation rather than with local rents. Given that rents (discussed below) are projected to rise faster than CPI inflation – and almost certainly will in some parts of the country at least – this means Housing Benefit will increasingly not match private tenants' needs.

## Universal Credit is projected to have a positive impact, but with much uncertainty

Over 1.5 million adults are now on UC.[22] But even on the government's stated (and perhaps optimistic) timetable its roll-out will not be complete until December 2023. Most of the cuts discussed above – such as the benefit freeze, two child limit and family element abolition – apply both to UC and the benefits it replaces. But, as with any far-reaching benefit reform, UC will be more generous than the current system for some claimants and less generous for others. The balance between these two is expected to have shifted following Budget 2018, with a partial reversal of cuts to the new system's work allowances. Nevertheless, UC's impacts will be both mixed and uncertain.

[22]   http://stat-xplore.dwp.gov.uk, December 2018

A key unknown is whether, or by how much, the combination of multiple benefits into one under UC will boost benefit take-up. Indeed, the answer to this question may prove to be the difference between UC being more or less costly to the government than the benefits it replaces.[23] Figure 10 presents our modelled impact of a full switch from the legacy benefits to UC, including a significant increase in take-up rates.

Figure 10: Universal Credit will have mixed impacts, but if it increases benefit take-up it might reduce poverty

Modelled mean impact of UC (in 2023-24) by working-age family type and overall income deciles, including take-up changes
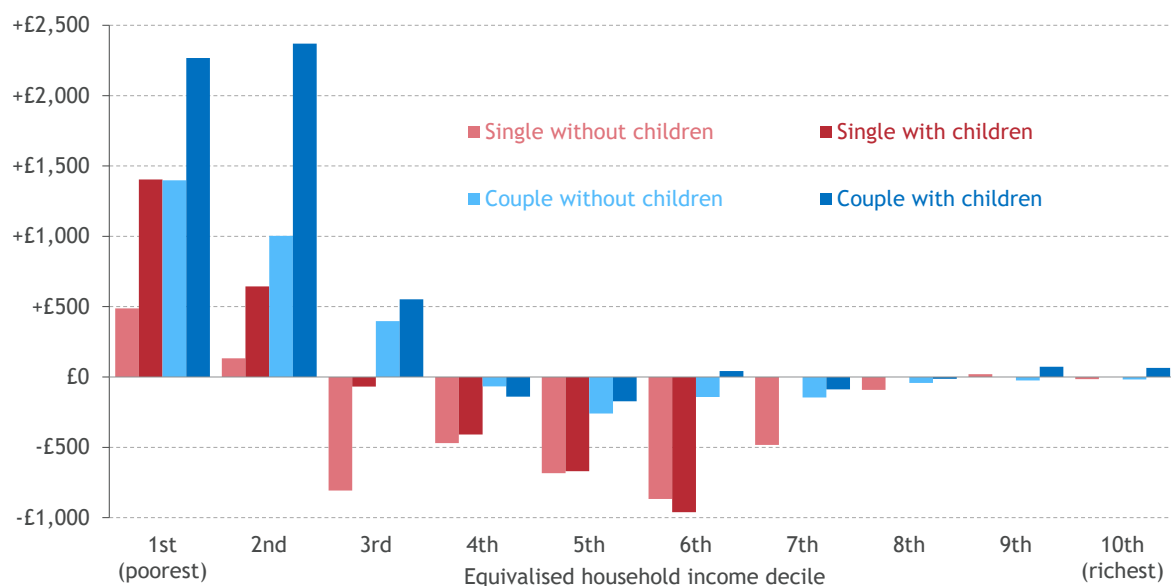
Notes: Assumes that UC increases take-up. Family types are not equally represented in each decile – e.g. single parents are much more likely to be in the bottom deciles and couples without children much less likely. Single parents in the top deciles are not shown due to small sample sizes.
Source: RF analysis using the IPPR tax-benefit model

This provides a boost in incomes among the poorest, many of whom are assumed to be currently missing out on benefits they are entitled to (though there is also uncertainty about this).[24] The potential impacts of higher take-up are discussed further in Section 7, because this is an important area of uncertainty for future living standards and our forecasting.

Putting questions of take-up to one side, entitlements under UC will vary across groups. They are expected to increase on average for working couples with children, but typically make single parents and non-parents worse off. Even within these groups though, wide variations are expected.[25] These impacts will gradually affect household incomes over our forecast period.

[23]   OBR, _Economic and fiscal outlook_, October 2018
[24]   G Bangham & A Corlett, _Boosting benefit take-up is critical to the success of Universal Credit, but we might not be able to measure whether it's working_, Resolution Foundation blog, December 2018
[25]   D Finch & L Gardiner, _Back in credit? Universal Credit after Budget 2018_, Resolution Foundation, November 2018; M Brewer, D Finch & D Tomlinson, _Universal Remedy: Ensuring Universal Credit is fit for purpose_, Resolution Foundation, October 2017

Beyond monthly cash differences between UC and the benefits it replaces, it is important to note that the delivery of UC will remain a crucial topic over the next five years. For example, our modelling does not include any reflection of the five-week waiting period, or levels of sanctions (beyond their impact on overall take-up), or specific behavioural impacts. And the 'managed migration' process retains the potential to be detrimental to families' incomes and stability if implemented badly. How UC will eventually be seen remains to be determined.

Planned tax changes will primarily benefit richer households

In contrast to the wide array of benefit changes that are taking place, there are relatively few significant direct tax changes on the horizon. Two separate changes to National Insurance for the self-employed – abolition of Class 2 and an increase in the Class 4 rate – have been cancelled. Scotland is to have cross-party talks on replacing Council Tax, but nothing is yet confirmed. More immediately, Council Tax rates in England and Wales increased significantly over the past two years and may continue to do so, with the average English rate projected to rise by 3.8 per cent in 2019-20[26] (or more if police precepts also rise).[27]

However, Budget 2018 announced that longstanding Conservative targets to increase Income Tax thresholds would be hit. The Personal Tax Allowance is to rise to £12,500 in April 2019, and the Higher Rate Threshold to £50,000, though both will then be frozen in 2020-21. The tax cut for individual basic rate taxpayers will be small – only £26 per year but, as Figure 7 shows, the Higher Rate Threshold change will be more significant.[28]

Figure 11: Income tax thresholds will rise in April 2019, but will then be frozen in 2020-21

Real value (2019-20 terms)
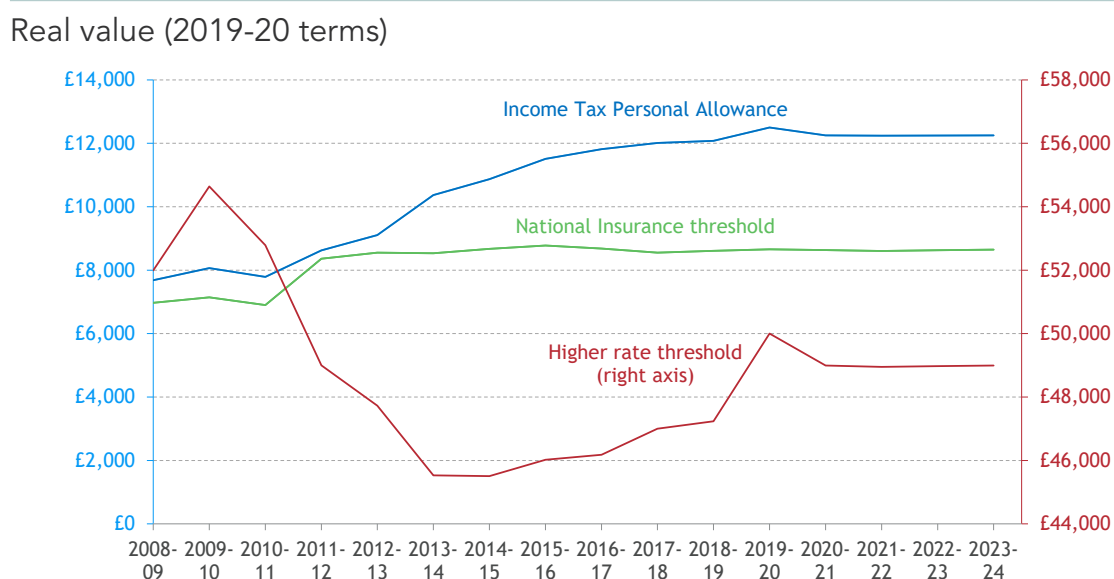
Source: RF analysis

[26]   OBR, Economic and fiscal outlook, October 2018
[27]   Gov.uk, Police to get largest funding increase since 2010, December 2018
[28]   (Note in Scotland the HRT is frozen again in 2019-20)

These policies will together boost incomes by around £2.8 billion in 2019-20, and £1.9 billion in 2020-21.[29] But, as we have shown previously,[30] these tax cuts will act to increase inequality. As per Figure 12, the highest income two deciles will receive the greatest benefit –around 0.2 per cent extra income growth – while poorer households will receive negligible gains.

Figure 12: Planned Income Tax cuts will benefit higher-income households more, both in cash terms and as a proportion of income

Impact of Income Tax cuts announced in Budget 2018 by equivalised household income decile
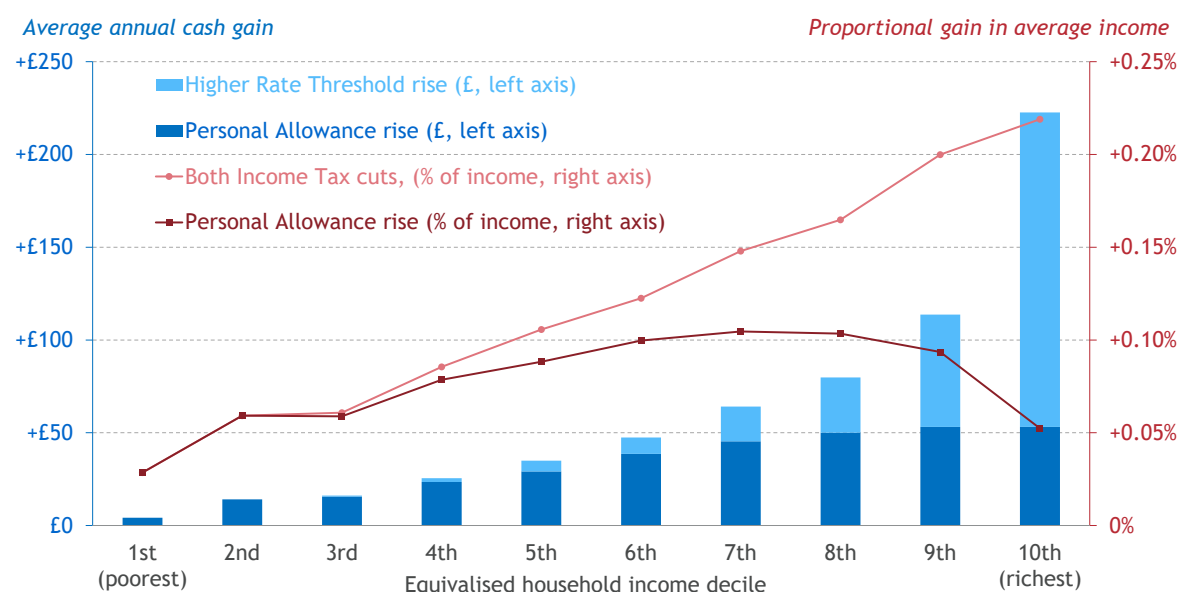
Notes: Includes related National Insurance changes
Source: RF analysis using the IPPR tax-benefit model

Pension auto-enrolment and student loan repayments remain important for disposable incomes

Perhaps more important than Income Tax cuts in 2019-20 will be a further rise in auto-enrolment pension contributions. In April 2018, minimum employee contributions under the scheme rose from 1 per cent of salary to 3 per cent (above a threshold, and including tax relief). In April 2019, with the scheme now covering over 10 million employees, the minimum will rise again to 5 per cent, as Figure 13 shows. Although this is a deferral of income, and will boost pensioner living standards in the long term, these are significant impacts for disposable incomes at a time when wages are not rising rapidly.

[29]   HMT, *Budget 2018: policy costings*, October 2018
[30]   Resolution Foundation, *How to spend it: Autumn Budget 2018 response*, October 2018

Figure 13: Following its roll-out to around 10 million workers, minimum auto-enrolment contributions increased in April 2018 and will rise again in April 2019

The roll-out of pension auto-enrolment
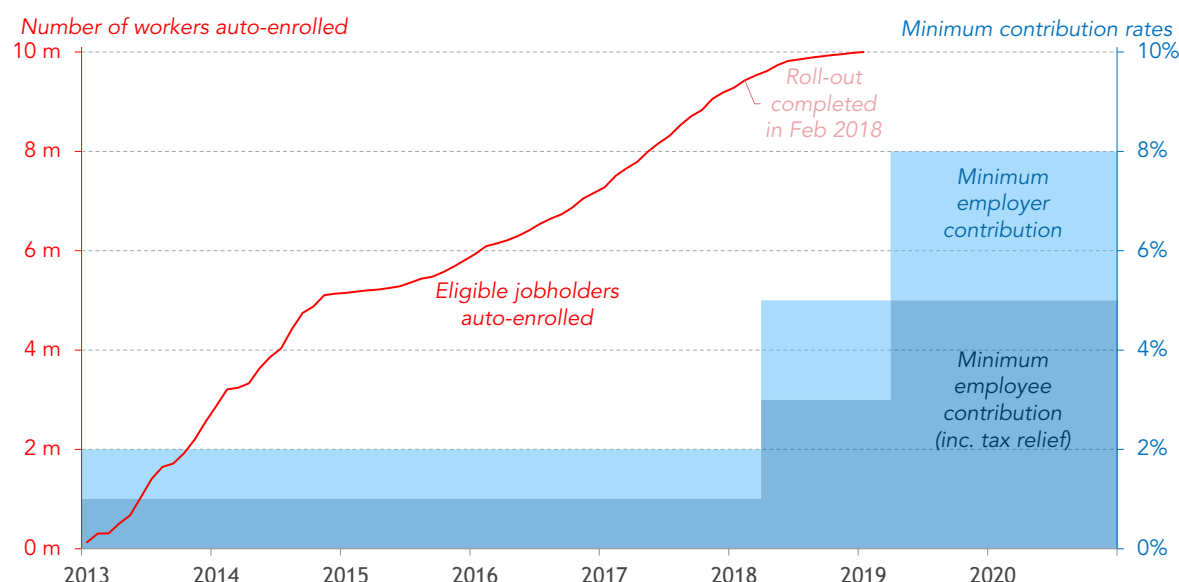
Source: The Pensions Regulator

As discussed in Section 2, in addition to this direct effect of auto-enrolment on employees, another increase in the minimum contribution rate for employers also weighs on the OBR's wage growth forecast, providing an indirect hit to living standards in the short term.[31]

For some, student loan repayments will also be an important wedge between gross and take-home earnings. As new cohorts graduate, making higher levels of repayments than in the past, net income growth will be depressed. This is not included in our modelling, but the effect on average growth will be small in the near-term.[32]

Mortgage costs may rise, but so might home ownership

For many, housing costs are high and inflexible. So it is worth considering their impact on disposable incomes too.[33]

Average mortgage interest costs fell precipitously in 2008 and 2009 as the Bank Rate was slashed, and mortgagors have enjoyed relatively low costs since then. But the latest OBR forecast projected a partial bounce back in costs, as Figure 14 shows. However, with inflation falling and concerns about both the global and national economy, it seems likely that this projection will be revised down in the OBR's next outlook.

[31]   For more discussion of auto-enrolment, see A Corlett, G Bangham & D Finch, _The Living Standards Outlook 2018_, Resolution Foundation, February 2018
[32]   A Corlett, G Bangham & D Finch, _The Living Standards Outlook 2018_, Resolution Foundation, February 2018; and OBR, _Fiscal sustainability report – July 2018_
[33]   See Box 3 in Section 4 for further discussion of how income measures should best account for housing costs.

Figure 14:   Rents are growing slower than earnings but mortgage costs are projected to rise more rapidly

Projected annual average growth
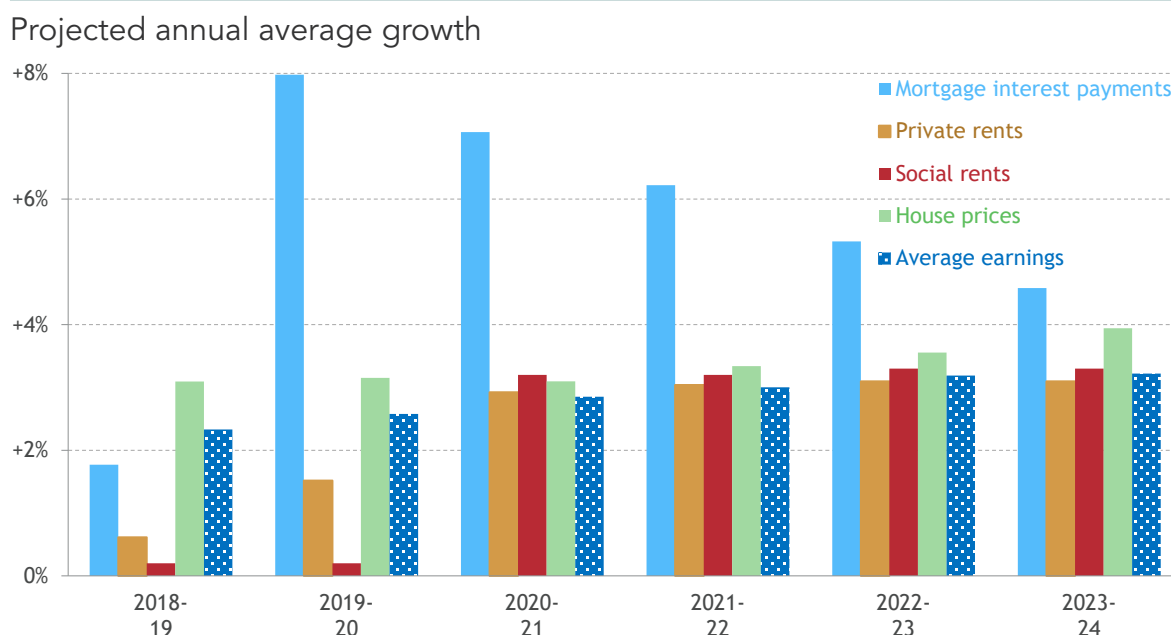
Source: OBR

Figure 14 also shows that rents are currently rising slower than average earnings. In the social sector, this is a direct result of government policy – cutting rents by 1 per cent a year for four years. But private rent inflation has also been low,[34] with near-zero rises in London especially mirroring a flattening of house prices there. Beyond the short term, however, the OBR assumes that private rents rise in line with average earnings, while from April 2020 social rents in England will be able to rise by CPI inflation plus 1 percentage point each year.

Of course, compositional changes across households also affect how housing cost changes lay out. There are, for instance, far more private renters than there were 10 or 20 years ago, along with a shift from mortgaged home ownership to outright ownership. These changes have implications for housing's impact on overall income growth, as well as for the level of security people enjoy.

But over our nowcast period there is evidence of a small rise in home ownership, recovering from a low of 51 per cent of potential homebuyers owning a home in 2016 to 53 per cent in late 2018.[35] Figure 15 shows that this is particularly evident for the 25-34 year old age group, though their home ownership rate remains little more than half its historic peak and little higher than in the early 1960s. In our forecast, therefore, we assume a continued slow recovery in home ownership rates and a fall in private renting.

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[34]   ONS, *Index of Private Housing Rental Prices,* UK: January 2019, February 2019
[35]   For more detail about these statistics see https://www.resolutionfoundation.org/data/housing/

Figure 15: Home ownership trends are hard to predict, but there are some tentatively encouraging changes for the young

Proportion of families (singles or couples) owning their own home
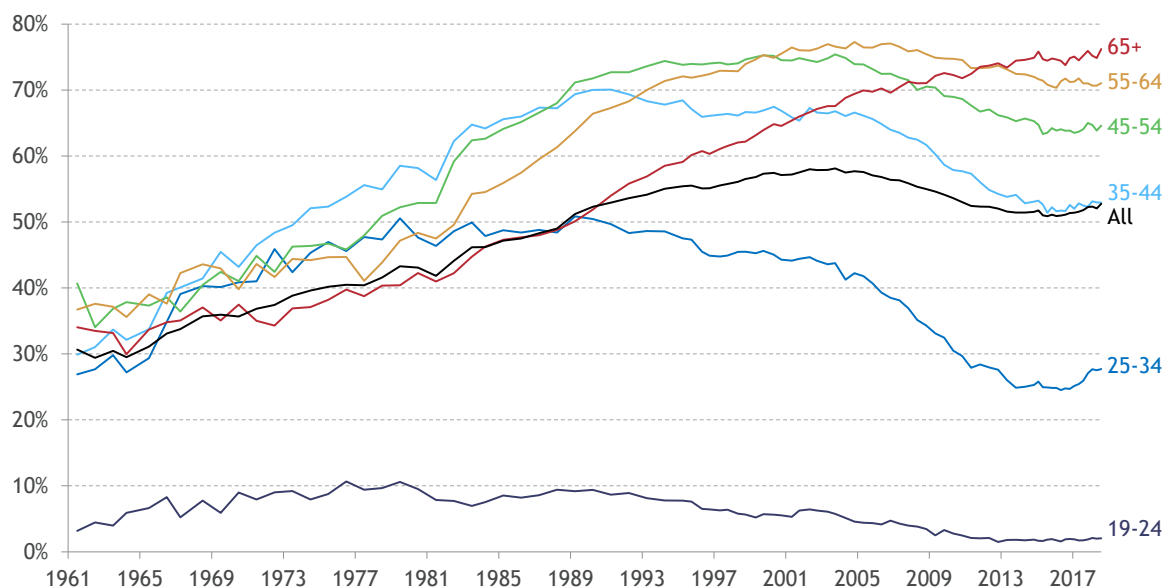
Source: RF analysis of *Household Labour Force Survey*; and IFS, *Households Below Average Income* 1961-1991

Putting together these projections for housing, benefits, taxes, earnings, employment and more, we now turn to the overall outlook for disposable incomes.

Section 4

Projecting average incomes

The trends set out in the last two sections – in relation to jobs, pay, housing, taxes and benefits – matter in their own right. But they matter too for how they interact and underpin growth in disposable household income. In the next section, we'll consider how the various elements come together to determine differing outlooks across the income distribution. But as a precursor we concentrate, in this section, on prospects for overall growth levels.

In doing so, we explore the extent to which the Brexit effect has dragged on income growth over the course of the Article 50 period, alongside considering what other factors are at play. Then, looking forward, we use the assumptions already detailed in relation to the different components of household income to set out our projection of what we can expect to happen in the period through to 2023-24.

Brexit appears to have dragged on income growth over the course of our 'nowcast' period

As set out in Section 1, our living standards outlook follows a two-step process. First we 'nowcast' household incomes to roll forward the latest available household survey data (2016-17) to today, making use of outturn information on the various elements that comprise household incomes, such as employment, pay and inflation. Second, we use OBR projections to take our nowcast forward, developing a projection for the five years to 2023-24. Both stages are of course subject to uncertainty, and are only ever designed to offer an illustrative sense of the direction of travel. But the former is at least made easier by the ability to compare our modelling with published economic metrics.

One such metric is the National Accounts estimation of mean real household disposable income (RHDI) per head. This measure lacks any of the nuance we find in household survey data, but it does provide us with a timely means of checking in on the broad shape of overall income growth. That's particularly the case when we focus on the 'cash basis' version of the measure. This excludes various elements of National Accounts income – most importantly 'imputed rent' which ascribes owner occupying households with an income equivalent to the rent they would need to pay to live in their own home – and therefore more closely matches the concept of 'income' captured by survey data.

Figure 16 sets out the evolution of this measure since 1998. The impact of the financial crisis is obvious, with average household income falling sharply. Also visible, is a flat-lining of the subsequent recovery from the start of 2016 and a generally stagnant picture during the post-referendum period (a fall of 1.8 per cent in 2016-17, followed by modest growth of 0.8 per cent in 2017-18).

Figure 16: Incomes per head recently recovered from the recession – and fell post-referendum

Real household disposable income per head ('cash basis', annual)
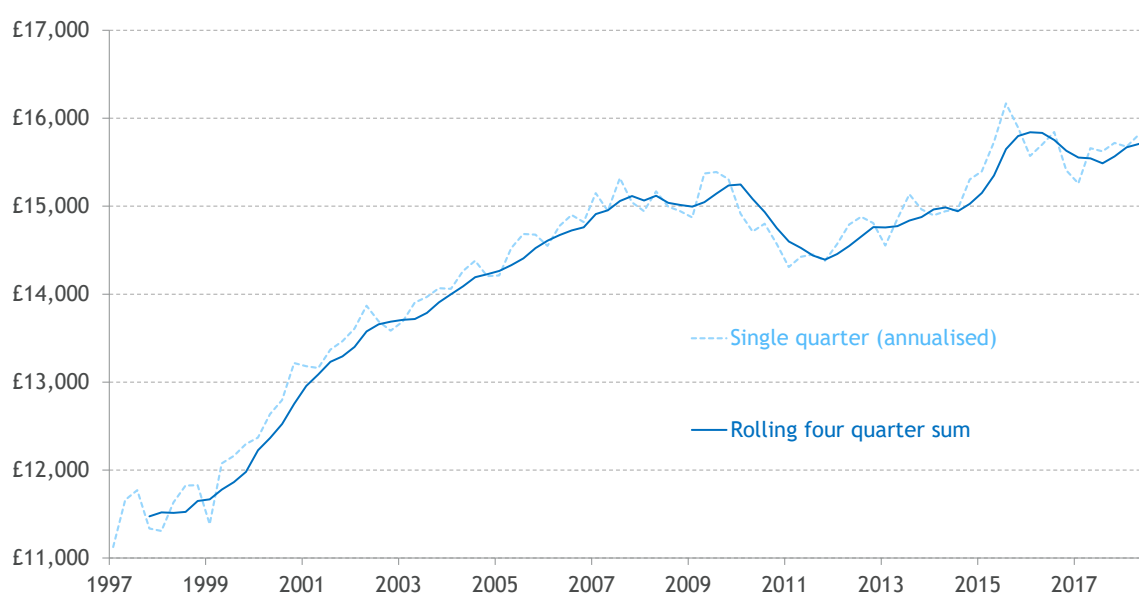
Source: ONS

These averages have, however, been influenced by changes in the timing of dividend payments (largely accruing to high income households). In response to changes in the tax treatment of such revenues, households brought payments forward into 2015-16 (artificially boosting the RHDI measure) from 2016-17 (thereby lowering the RHDI measure in this year). Nevertheless, even if we 'look through' this timing effect we can see that the overall pattern described in Figure 16 is one of weak income growth at best.

Consider, for example, that employment income (adjusted for taxes and benefits) is believed to have ended 2018 some £1,500 lower per household than the OBR projected back in March 2016.[36] What explains this performance? There will of course be many factors at play, but it's hard to avoid the conclusion that the UK's decision to leave the EU is having a significant impact. Box 2 provides more detail of developments in this period.

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[36]   J Smith, _Counting the cost_, Resolution Foundation, February 2019. We exclude non-labour income such as imputed rents and dividend income.

i Box 2:   The economic context since the EU referendum

The UK's economic growth has proved weaker than the OBR expected in the period since the EU referendum. Comparing the OBR's March 2016 forecast, which assumed explicitly that the UK would remain in the EU, with the latest available ONS data, today's UK economy appears to be 1.2 per cent (or roughly £24 billion) smaller than anticipated.[37] Simple comparisons of this kind are difficult to interpret however, given the variety of influences that bear on an economy over time. While some may want to attribute all of this downside to the impact of Brexit, there is no way to observe precisely how the economy would have evolved absent the referendum result. Nevertheless, deeper digging suggests there's good reason to suppose that Brexit is playing a major role.

In part, this reflects the absence of any other plausible explanation for an undershoot of this magnitude. There has of course been a marked slowing in world growth over the last 12 months,[38] which will undoubtedly be acting as a drag on UK growth (and could continue to do so in coming months). But this weakness is a relatively recent phenomenon.

Looking back over the period since the referendum as a whole, world growth has surprised to the upside. The OBR's October 2018 forecast for the size of the UK's export markets was around 0.8 per cent higher than that made in March 2016. In fact, far from the UK's slower growth over the past two years being driven by a wider global slowdown, the UK slowed down while others sped up. Since the referendum, the UK has moved from being about the strongest growing G7 economy to one of the weakest. This suggests that, if anything, global growth has been a tailwind for UK growth in this period, rather than a headwind. This is in-line with research that finds the impact of Brexit on the UK economy is actually larger than would be implied by a simple comparison with pre-referendum forecasts.[39]

And the Brexit impact is likely to be even more marked when we move from measures of GDP to those of household income. That's because the most visible immediate impact of the referendum was to cause a very sizeable depreciation in the value of the pound. That forced up import prices and, in turn, led to a spike in consumer inflation over the course of 2017. It was this inflation spike that was at the heart of the renewed squeeze on wages endured over the course of 2017.

Overall then, the EU referendum result appears to have already significantly affected the economy and household living standards. While it is impossible to be precise about exactly how large that effect is, the depreciation in sterling means that the impact has been bigger on households' real incomes

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[37]   J Smith, *Counting the cost*, Resolution Foundation, February 2019
[38]   See for example IMF, *World Economic Outlook Update*, January 2019
[39]   See for example Centre for European Reform, *w*, June 2018

than on GDP. That depreciation will reflect expectations about the long-term economic impact of the new trading relationship with the EU. But it is not just the long-term impact that matters; the process for getting to that new relationship will also matter. That is because higher uncertainty will lead to investment being postponed.

And if that uncertainty persists, there is a risk that it is lost permanently. In that case, there will be a permanent effect on capital stock and our living standards. All of this should encourage policymakers to recognise how much is at stake in the UK at present – and that how the country moves forward, not just where it is heading to, matters for living standards.

Our projection period is dominated by the OBR's assumption of weak productivity growth, resulting in a further flat-lining of typical incomes

What about prospects for the next few years? Brexit assumptions are again hugely important – and especially uncertain given we still don't know quite where we're heading. But for the purposes of modelling, we follow the OBR approach and assume an orderly transition period.

Building on our nowcast, we plug in the various OBR projections for demographic change, employment, earnings, housing costs and inflation, and apply all announced changes in tax and benefit policy, in order to model typical (median) household income growth through to 2023-24.[40] In doing so we focus on the non-pensioner population. Full details of the methodology we follow are provided in Annex 1.

Figure 17 presents the results, detailing median non-pensioner incomes before and after housing costs (largely rent and mortgage interest, see Box 3 for further discussion of this distinction).[41]

The two measures differ in level – typical non-pensioner household income before housing costs in 2016-17 was £27,700 (in 2018-19 terms), whereas after housing costs it was £23,400 – but the patterns they describe are almost identical. Taking the nowcast and forecast periods together, our overall projection is basically flat.

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[40]   We shift to median income rather than average here to avoid the distorting effect that movement at the extremes can have (such as that evidenced by movements in dividend payments in recent years). Additionally, household incomes are 'equivalised' here. The stated medians refer to the disposable incomes of two-person households without children. A single adult would need less money to reach this standard of living, whereas a couple with three kids would need more.

[41]   Note that we do not attempt to account for the value of public services.

Figure 17: Typical working-age incomes are higher than ever, but little growth is projected in the short term

Real (CPI-adjusted, 2018-19 terms)[42] median non-pensioner equivalised disposable household income
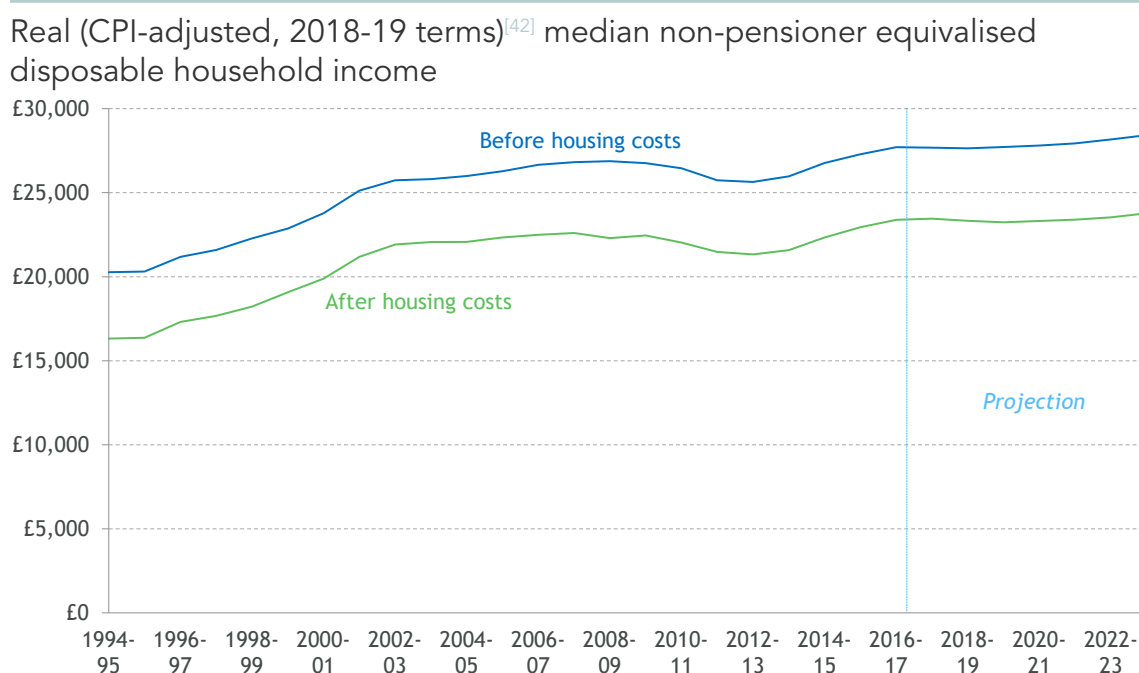
Source: RF analysis of DWP, *Households Below Average Income, and RF projection*

Typical incomes after housing costs are projected to be no higher in 2021-22 than in 2016-17, meaning we are roughly half way through a potential five year stagnation. Thereafter, our projection shows typical incomes after housing costs rising slightly, reaching a new high of £23,800 by 2023-24. That would represent an improvement of just 8 per cent on 2003-04, as compared to growth of 35 per cent over the nine years from 1994-95 to 2003-04 alone.

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i Box 3: Income before and after housing costs

The DWP's *Households Below Average Income* (HBAI) data features two definitions of disposable income: before and after housing costs (BHC and AHC). While both have merit (as do other alternatives), in this report we focus primarily on incomes AHC, because we believe the BHC measure is less representative of households' lived experiences and is more likely to create perverse results. For example:

• A rise in home ownership can lead to a fall in BHC incomes, as housing benefit income and landlord's incomes fall. Measuring incomes AHC gets closer to the notion of accounting for the imputed rental income of homeowners.

• Similarly, a neutral shift from state-subsidised housing towards housing benefit (as indeed happened historically) would be recorded as

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[42]   For incomes 'after housing costs', a variant of CPI is used which excludes housing costs (to avoid double counting their impact), as used in HBAI. For incomes 'before housing costs' another CPI variant is used that more fully reflects changes in living standards by incorporating additional housing costs.

an increase in BHC incomes; and recent cuts in social rents would be recorded as falls in BHC incomes, again due to the role of housing benefit. [43]

- The BHC measure does account for housing costs but it does so through its price deflator. This means that falls in mortgage interest costs, for example, are assumed to benefit all households. Although there is a

theoretical argument for this, it is generally better to account for the fact that different groups (e.g. by age, region or income) are more likely to be benefit from this than others (e.g. by being mortgagors).

From here on we focus on AHC incomes, and our projections include forecasts for housing costs and housing tenure. For comparison, Annex 3 presents projections for BHC incomes.

Figure 18 makes the projected stagnation clearer, giving our working-age growth projections for each individual year and comparing these with what we've seen historically. Note that precise single year changes should be treated with caution, with even final survey-based outturn results proving volatile (we discuss our track record of predictions in Annex 2). But the overall picture is unambiguously a weak one.

Figure 18: Our projection includes a five-year income stagnation for working-age households

Annual real growth (CPI-adjusted) in median non-pensioner equivalised disposable household income (after housing costs)
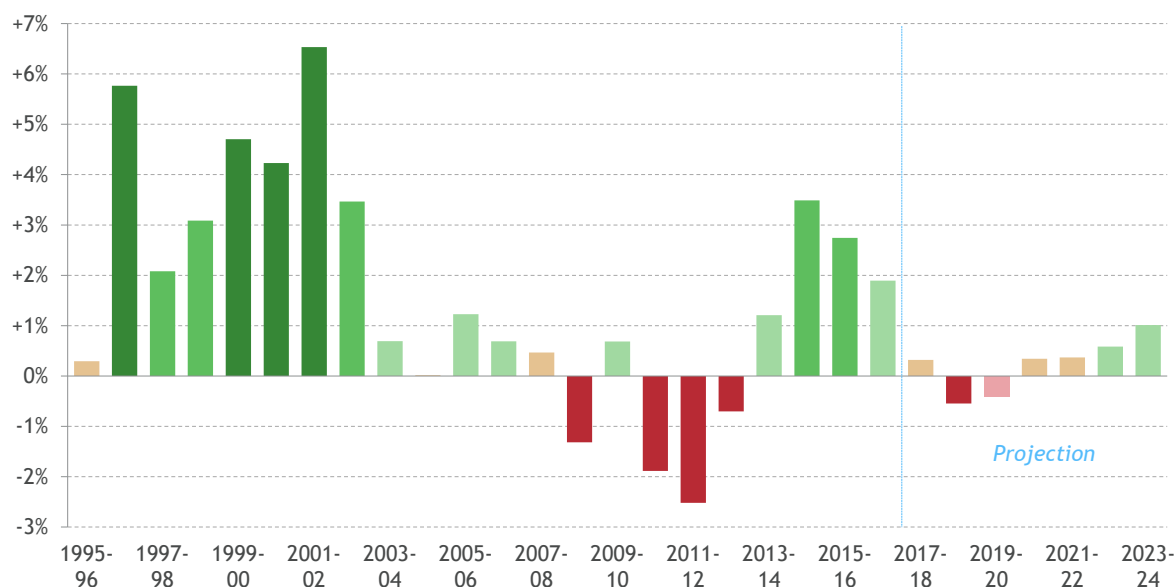
Source: RF analysis of DWP, Households Below Average Income, and RF projection

[43]   A Hood & T Waters, _Living standards, poverty and inequality in the UK: 2017–18 to 2021–22_, November 2017

This weak outlook comes despite the projected end of above-target inflation, and an assumption that we avoid any Brexit cliff-edge. As set out in Sections 2 and 3, it is driven by a number of factors present in the OBR's central case assumptions:

- That productivity growth remains weak, with a trend rate that falls well below the pre-crisis level;

- That there is limited room for further employment growth;

- That the direct and indirect effects of auto-enrolment drag on take-home pay in the short term (especially 2018-19 and 2019-20); and

- That mortgage interest costs rise (from a low base) as the Bank of England gradually tightens its stance.

- In addition, it is a function of current tax and benefit policy, which is itself in part a product of a focus on deficit reduction.

Revealing though this modelling is, it is worth remembering that the median is just one point (the person in the middle of the population, when ranked by household income) and can therefore be unrepresentative of what different individuals are experiencing. As the next section shows, our income stagnation will not be felt equally across the income distribution: for some groups, the outlook is worse still.

Section 5

The distribution of growth

The last section presented a weak outlook for median non-pensioner income growth. But it is important to look at the outlook for all income groups. While no group is projected to experience particularly strong growth, our outlook is weakest for lower-income non-pensioners. This includes real income falls in 2017-18 and 2018-19. The outlook for the next five years is not as negative, but remains very weak. For some groups, including low to middle income working households, out-of-work households, single parents and single adults, projected real income growth over the whole two decades from 2003-04 to 2023-24 looks close to zero.

The growth outlook is worse for the bottom half of the income distribution

As Figure 19 makes clear, the disappointing picture for overall income growth set out in the last section is set to be replicated across much of the income distribution. The outlook is, however, projected to be worse still for some. For instance, 'p10' – a point that is one-tenth of the way up the income distribution – has already underperformed relative to the median in the period since 2003-04.[44] It now looks set to do so again over the course of our nowcast and forecast periods.

Our projection suggests that incomes at p10 are set fall by 5 per cent between 2016-17 and 2023-24, leaving them 2 per cent down on their position a full two decades earlier. Incomes at p20 are also projected to fall across our nowcast and forecast, standing 2 per cent lower in 2023-24 than they were in 2016-17. This would represent growth of 5 per cent on 2003-04, but this should still be considered catastrophic. For comparison, growth of 2 per cent a year – slower than the average recorded between 1994-95 and 2003-04 – would mean 50 per cent growth over 20 years.

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[44]   Note that a growing under-reporting of benefit income in the 2000s may have reduced recorded income growth over this period. See A Corlett, S Clarke, C D'Arcy & J Wood, The Living Standards Audit 2018, Resolution Foundation, July 2018

Figure 19: Pre-crisis problems, the recession, post-referendum inflation and policy have combined to cause a prolonged real income stagnation for many

Cumulative change in real (CPI-adjusted non-pensioner equivalised disposable household income (after housing costs) since 2003-04
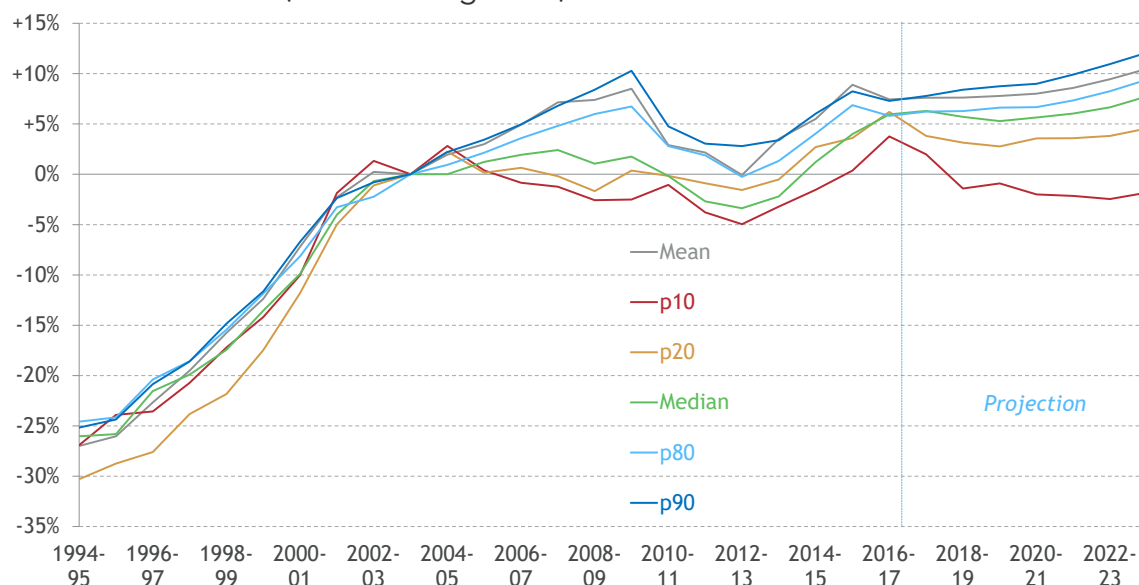
Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Other parts of the income distribution are projected to fare a little better in our forecast, but nowhere is growth expected to be anywhere close to previous norms. Even the best performing part of the distribution – p90, or nine-tenths of the way up the distribution – is projected to reach 2023-24 just 4 per cent up on 2016-17 and a modest 12 per cent richer than two decades earlier in 2003-04.

The last two years – our 'nowcasted' Article 50 period – look to have been particularly bad for living standards. Box 4 discusses alternative data sources for what may have happened to living standards for lower- and higher-income households over this period, none of which have suggested strong growth for those on lower incomes.

***i* Box 4: There is tentative evidence of unequal growth in 2017 and 2018**

Our nowcast for 2017-18 and 2018-19 suggests that parts of the income distribution became worse off after accounting for inflation. Although we don't yet have full survey data for these years, there are some additional sources that also point to weakness. The NMG survey for the Bank of

England is not as large or robust as HBAI,[45] but it is quick: data is now available not only for September 2017, but also September 2018.

Figure 20 shows our analysis of this data. The results are noisy, with often unrealistically large changes, and only

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[45]   Bank of England, *The financial position of British households: evidence from the 2018 NMG Consulting survey*, December 2018w

show 'pre-tax' income.[46] But it does appear to point to a rise, rather than a fall, in income inequality in 2017 and 2018.

Additionally, two releases from the ONS – their nowcast and their data on consumption – provide further tentative evidence that income (and consumption) growth in 2017-18 was weaker for lower-income households than for higher-income ones.[47]

Figure 20: NMG survey data may point to a rise in inequality in 2017 and 2018

Annual real growth (CPIH-adjusted) in mean equivalised pre-tax household income by income percentile
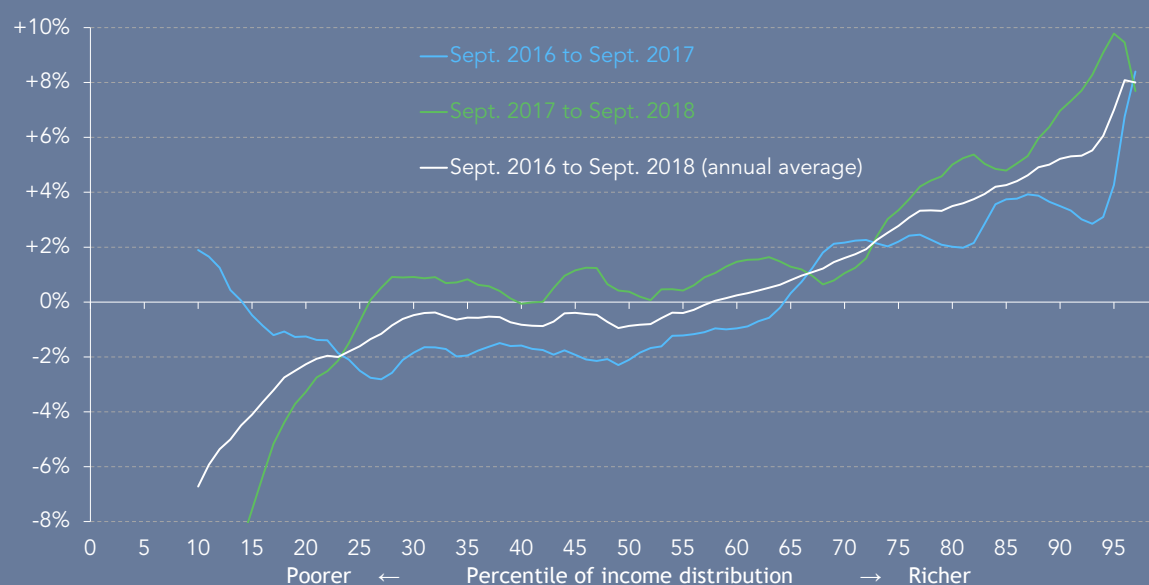
Source: RF analysis of NMG

Figure 21 shows our full 'growth incidence curve' for this period and others. Although only a rough indication of what survey data may ultimately show, large parts of the non-pensioner income distribution may have been worse off in 2018-19 than in 2016-17. In a sense, this should not be surprising, given we know average wages fell in real terms in 2017-18 and that the real value of benefits has fallen substantially over this period. Incomes at the top may have performed better, with a rebound in dividend income and a rise in earnings only partly offset (with great uncertainty) by a weak nowcast for self-employment income. Projected growth over the next three years, to 2021-22, is not as calamitous, but is barely above zero for all parts of the income distribution.

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[46]   Survey respondents may make their own judgement as to what forms of income this should include.
[47]   ONS, _Effects of taxes and benefits on UK household income – flash estimate: financial year ending 2018_, July 2018; and L Gardiner, _Five key takeaways on UK household spending_, Resolution Foundation blog, January 2019

Figure 21: The last two years may have left lower-income non-pensioner households worse off than in 2016-17, while future growth is projected to be weak

Average annual real (CPI-adjusted) growth in mean equivalised disposable household income (after housing costs) by non-pensioner income percentile
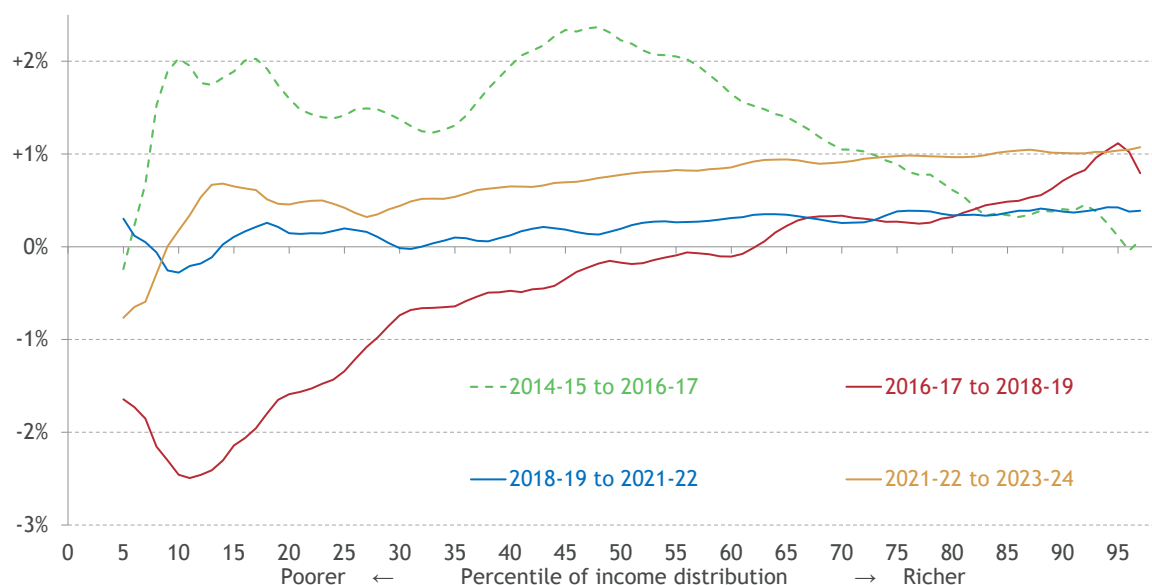
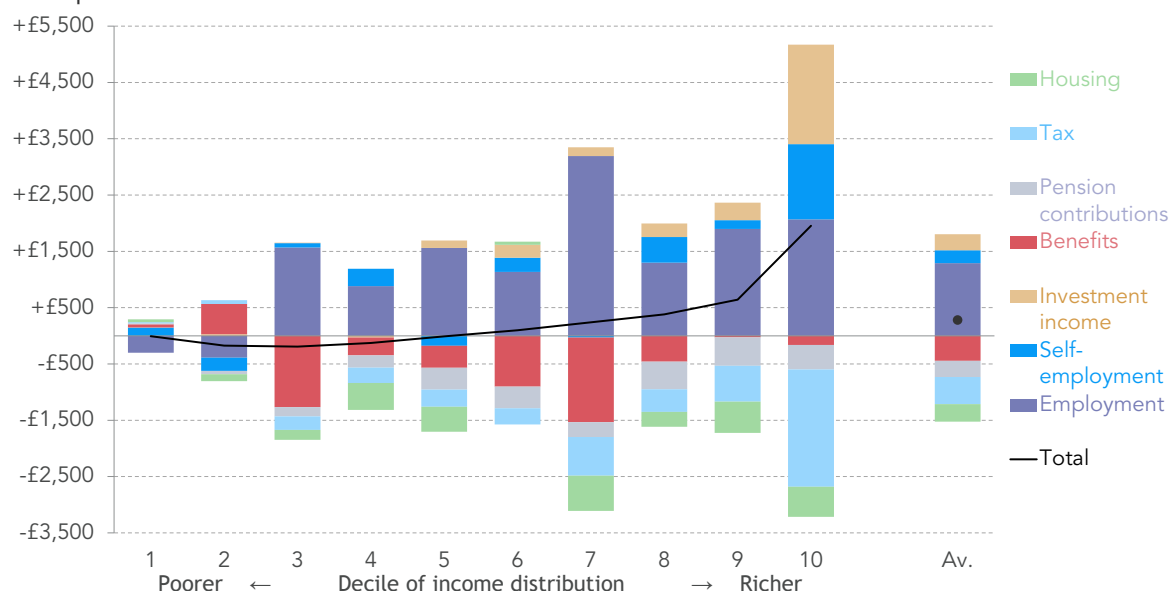Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Figure 22 helps illustrate the reasons for the weak outlook by exploring each component of disposable incomes. It also shows absolute (£) changes, which should be considered alongside the proportional (per cent) changes above.

Overall, average income is set to be little higher in 2021-22 than in 2017-18. But this is a result of offsetting forces. It can be seen that employment, self-employment and investment income are set to grow (albeit weakly); but this is set to be offset by rises in pension contributions, taxes paid and housing costs (some of which happen naturally as earnings or investment income rise), and a fall in benefit income. The average non-pensioner household will lose £400 in real benefit income, weighing on low and middle incomes in particular.[48]

[48]   Note that the make-up of the deciles is not fixed over time. So a rise (or lack of a fall) in benefit income towards the bottom of the income distribution may represent a change in ordering – with benefit-receiving households sorting towards the bottom – even if the value of benefits is reduced.

Figure 22: For many, employment income rises will be more than offset by benefit cuts and expenses

Projected real (CPI-adjusted) change in average annual income component by non-pensioner income decile, 2017-18 to 2021-22

Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Within this overall distributional picture, some groups face a tougher outlook than others

Lower-income households are clearly projected to fare worse than the top half of the income distribution, in general. But the outlook also varies by other characteristics, such as employment status, age, family type and housing tenure.

Figure 23 shows historical and projected median incomes for four groupings. Non-working households (in the bottom half of the working-age distribution) and working 'low to middle income' households are both projected to be worse off in 2023-24 than in 2016-17.[49] And those low to middle income households – who might also be referred to as the 'just about managing' group[50] – are also projected to be worse off than 20 years earlier.[51] Pensioners and higher-income working-age households, on the other hand, have both done better and are expected to do better.

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[49]   See A Corlett, S Clarke, C D'Arcy & J Wood, The Living Standards Audit 2018, Resolution Foundation, July 2018 for more detail on our 'low to middle income' definition.
[50]   D Finch, Hanging on: the stresses and strains of Britain's 'just managing' families, Resolution Foundation, September 2016
[51]   Note that a growing under-reporting of benefit income in the 2000s may have reduced recorded income growth over this period. See A Corlett, S Clarke, C D'Arcy & J Wood, The Living Standards Audit 2018, Resolution Foundation, July 2018

Figure 23: The typical real income of working low to middle income households is projected to be no higher in 2023-24 than two decades earlier

Real (CPI-adjusted, 2018-19 terms) median equivalised disposable household income (after housing costs), by group
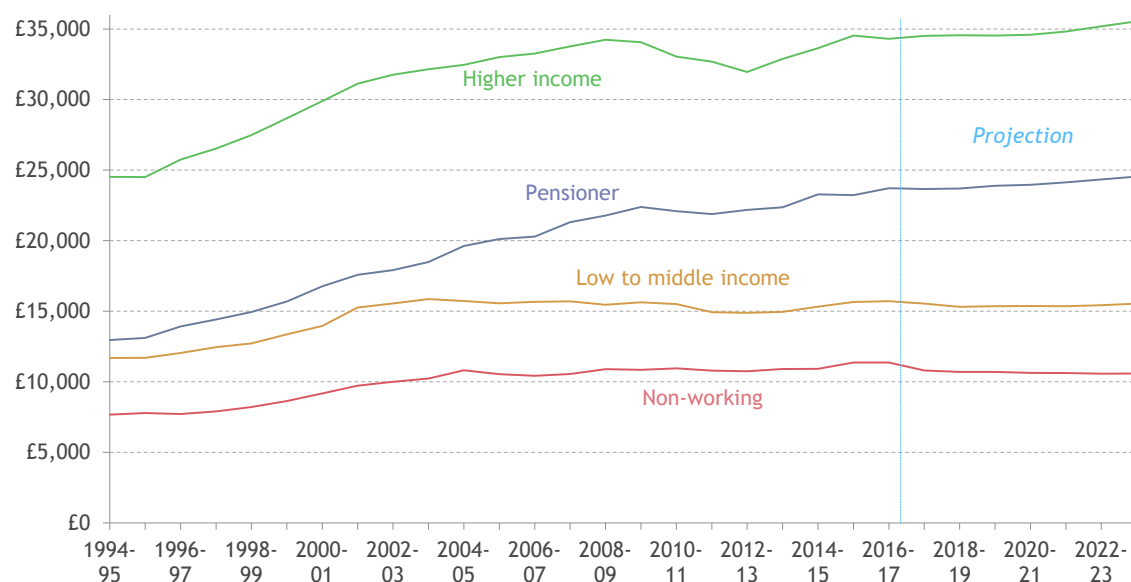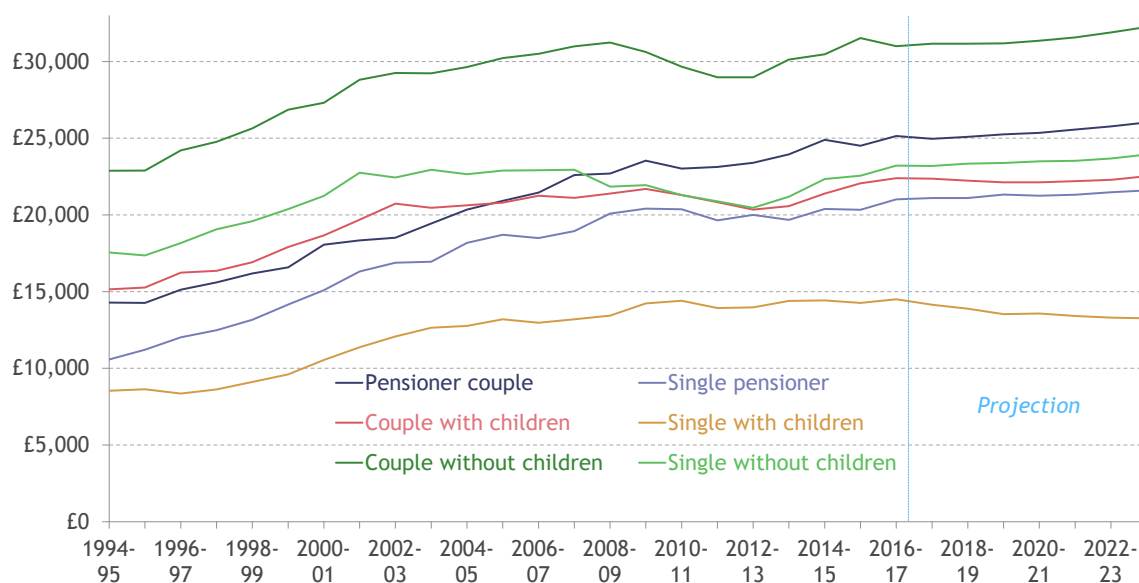

Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Relatedly, the family types projected to experience the lowest income growth over our nowcast and forecast periods are single parents and couples with children, as Figure 24 shows.

Figure 24: The outlook is particularly poor for single parents

Real (CPI-adjusted, 2018-19 terms) median equivalised disposable household income (after housing costs), by group
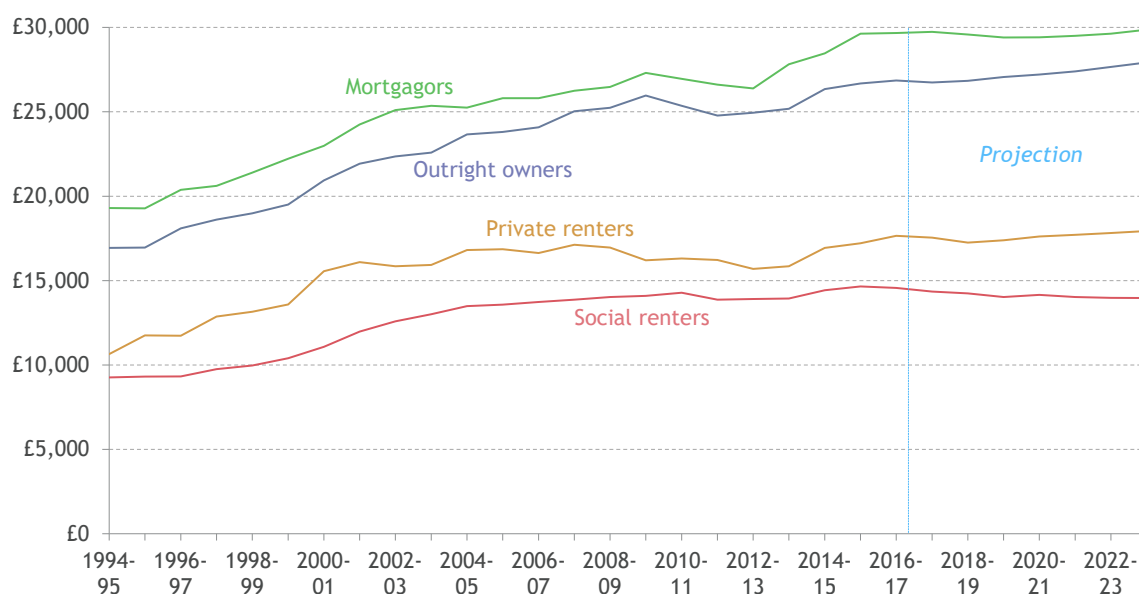

Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Indeed, the typical income for all families with children is forecast to fall by 1 per cent between 2016-17 and 2023-24, compared to a rise of 4 per cent for households without children. But single people without children – similarly to single parents – are projected to be little better off in 2023-24 than in 2003-04, with a rising housing cost burden for single people a likely cause.

Finally, looking at typical incomes (after housing costs) by housing tenure, incomes are projected to rise fastest for outright homeowners. The lowest growth is projected for social renters – despite reductions in social rents – and for mortgagors. As interest rates are forecast to increase, average housing costs as a share of income for mortgagors are projected to rise from a low of 5.8 per cent in 2017-18 to 6.7 per cent in 2023-24, but this would still be lower than at any time from 1994-95 to 2012-13.[52]

Figure 25: Incomes may plateau for mortgagors as rock bottom interest rates end, while social renters will be most affected by benefit cuts

Real (CPI-adjusted, 2018-19 terms) median equivalised disposable household income (after housing costs), by group

Source: RF analysis of DWP, *Households Below Average Income,* and RF projection

An income growth outlook that is especially weak at the bottom end of the distribution is likely to have significant implications for inequality and poverty. We turn to look at what our outlook means for some common measures of these in the next section.

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[52]   Note that these figures exclude mortgage capital repayments.

Section 6

Poverty and inequality

Section 5 showed that growth is expected to be slowest – or even negative in some years – for lower-income households. This section looks at what this would mean for inequality metrics. Most strikingly, relative child poverty is projected to rise from 30 per cent in 2016-17 to a record high of 37 per cent in 2023-24. Income growth for the bottom 40 per cent of households is also projected to be lower than overall growth, implying that the UK will not meet the Sustainable Development Goal Target 10.1 over this period. And the Gini measure of inequality is projected to rise from its 2016-17 level (depressed as it was by likely temporary factors), despite projected falls in 'market income' inequality.

Child poverty risks hitting record highs

The latest official data on child poverty covers 2016-17 – a period that is now 23 to 34 months ago – with the 2017-18 data expected to follow in the next few weeks.[53] As Figure 26 shows, the 2016-17 estimate suggests that 30.3 per cent of children lived in relative poverty (i.e. in a household with an equivalised disposable income after housing costs of below 60 per cent of the median). This was up from a low of 27.1 per cent in 2011-12, but below the highs of the 1990s (a peak of 34.1 per cent) and very early 2000s.

Although limited weight should be put on single-year changes, our projections imply rising poverty in 2017-18, 2018-19 and 2019-20, along with smaller rises thereafter. On these figures, the proportion of children in poverty is on course to hit a record high, perhaps even as soon as 2019-20 (at 34.8 per cent). It is then projected to reach 37 per cent by 2023-24. This would represent a rise from 4.1 million children in 2016-17, to 5.2 million by 2023-24: an extra 1.1 million children in poverty.

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[53]   DWP, *Household Below Average Income*, forthcoming (March 2019)

Figure 26: Child poverty is heading back to highs not seen since the mid-90s, and may even surpass them

Proportion of children living in relative poverty (after housing costs)
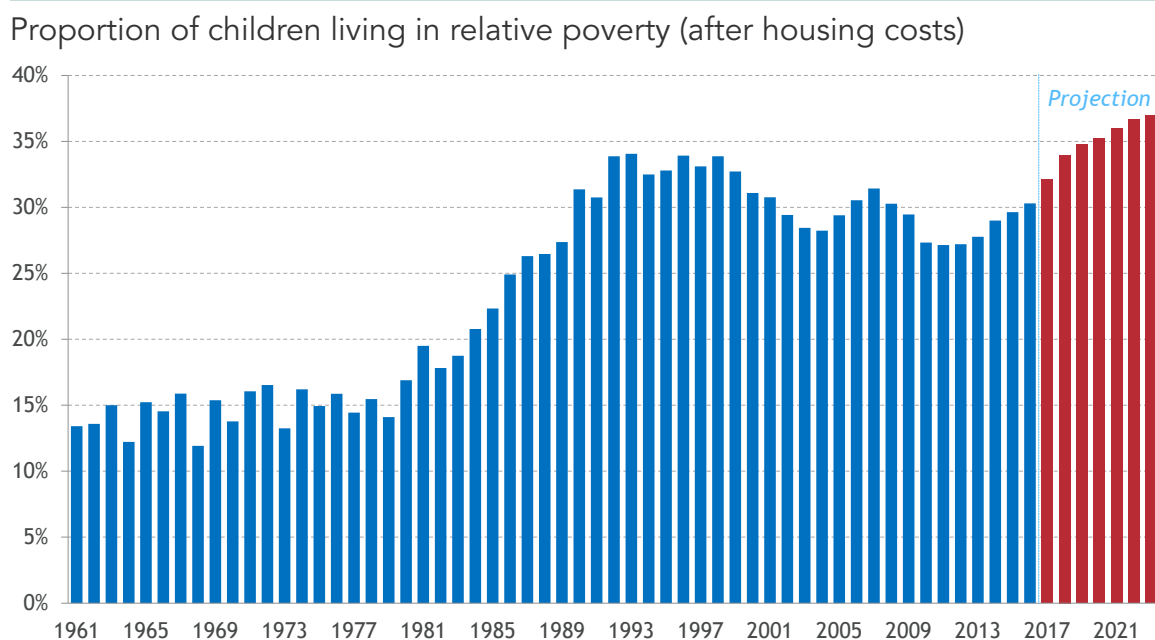
Notes: Financial years after 1993. GB only before 2002-03.
Source: RF analysis of DWP, *Households Below Average Income*; RF projection; and IFS, *Living Standards, Inequality and Poverty*

In line with this, the proportion of parents living in poverty is also projected to hit (or have already hit) record highs. Figure 27 shows that it is projected to reach 28 per cent by the end of the forecast period.[54] Poverty rates for pensioners and working-age non-parents are not projected to increase overall, but rates for disabled adults are.[55]

[54] From here on we look only at data since 1994-95. 'Parents' here means adults in benefit units (singles or couples) with dependent children.
[55] However, we do not model the changing make-up of the disabled population or changes in disability benefits in detail so this finding should be treated with particular caution.

Figure 27: In addition to children, poverty among parents and disabled adults is projected to rise

Proportion of people living in relative poverty (after housing costs)
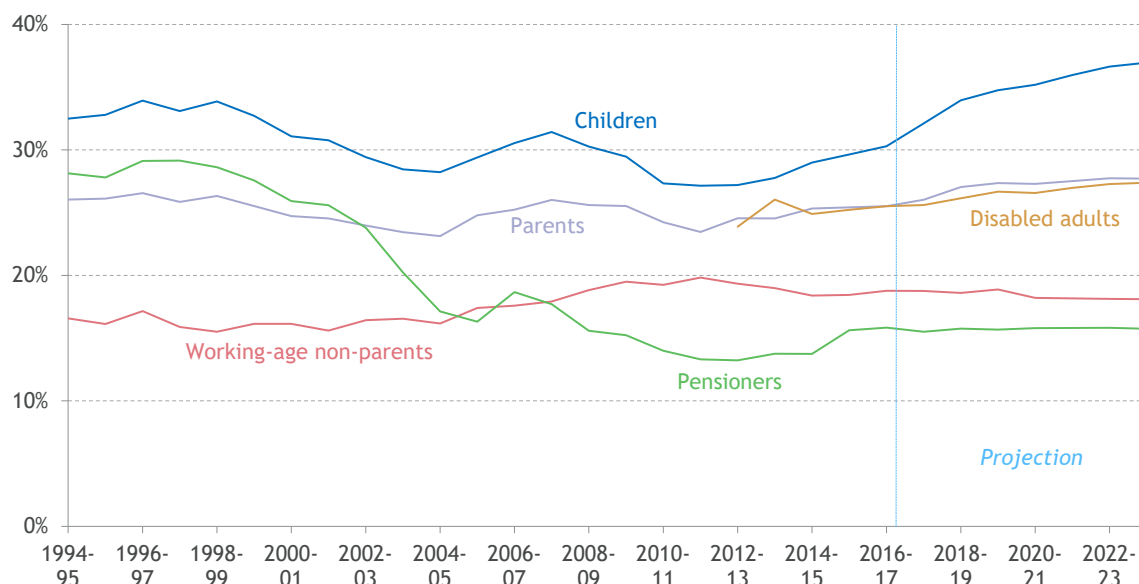
Notes: GB only before 2002-03.
Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

As discussed in Box 5, however, there are some known measurement problems with the official poverty figures that our projections build on. It seems likely that rates of poverty may be revised down at some point in the future, meaning that our projections would change too. But the *trends* we forecast – of a marked increase in child poverty, for instance – would continue to apply.

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i Box 5: Mismeasurement of poverty

The Households Below Average Income (HBAI) dataset is currently the best source for detailed household income information. We use it both for analysis up to 2016-17 and as a basis for our projections thereafter. But in the *Living Standards Audit 2018* we looked at how this dataset (and others like it) significantly underestimate benefit incomes.[56] For one reason or another, around £40 billion of known benefit spending is missing in the latest data. This error is likely to have

an impact on poverty statistics.

In that paper we presented an attempt to correct for this missing income. This suggested that poverty (in Great Britain) may be overestimated by 2.5 million people; that child poverty fell faster in the 2000s than previously thought; and may have risen more rapidly recently than recorded.

A more accurate picture will require government statisticians to make use of administrative data, which may

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[56]   A Corlett, S Clarke, C D'Arcy & J Wood, *The Living Standards Audit 2018*, Resolution Foundation, July 2018

happen over the next few years.[57] But Figure 28 shows the history of child poverty rates with and without

our rough correction, along with our projection.

Figure 28: Future statistical revisions may change child poverty levels and trends

Proportion of children living in relative poverty (after housing costs)
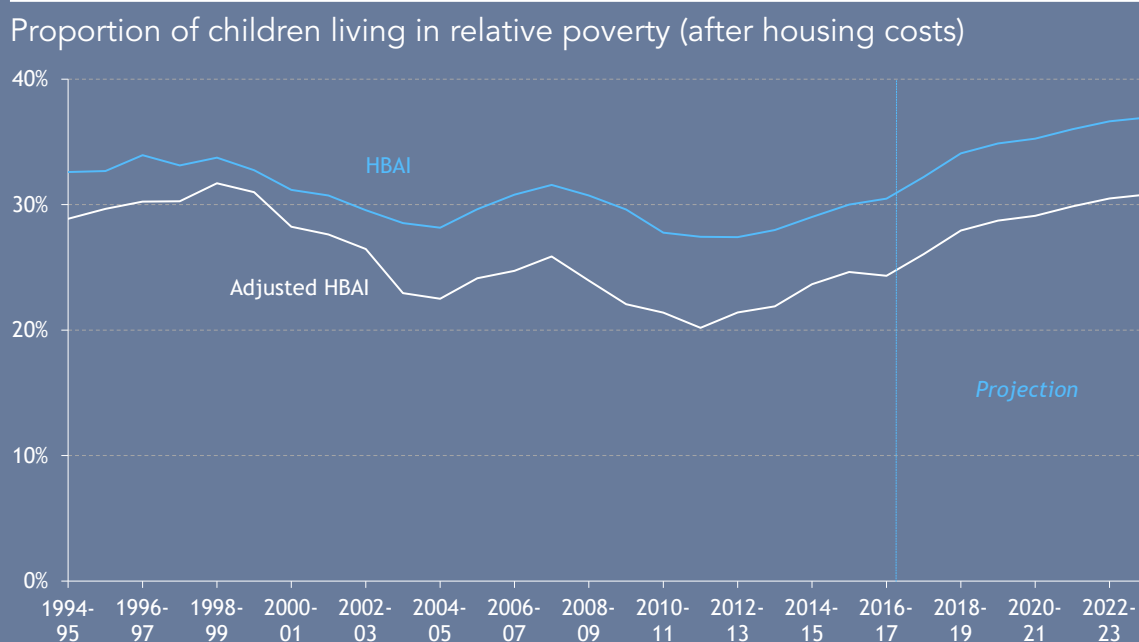
Notes: GB only.
Source: RF analysis of DWP, H*ouseholds Below Average Income*; RF projection; and RF adjustment from *The Living Standards Audit 2018*

So revisions may lead to a reduction in official child poverty rates – by around 6 percentage points in our rough modelling.[58] It may also be that *increases* in child poverty are not recorded properly, due to this under-reporting of benefit income. DWP and ONS must continue to work

on radically improving the data, but until that happens we must make do with the existing time series. In our methodology, therefore, we project changes in poverty rates and then add these on to the existing HBAI rates for 2016-17.

[57]   DWP "have developed a high level 3-year work programme" to realise the benefits of administrative data for the FRS and related outputs. D Burke & P Matejic, *Family Resources Survey and related series – update and developments*, DWP, June 2018. ONS, Transformation of ONS household financial statistics: ONS statistical outputs workplan, 2018 to 2019, June 2018: after "the development of an adjustment for the income of high earners" … "research into coverage and values reported at the lower end of the income distribution will be prioritised".

[58]   See also: the case for conceptual changes in how poverty is measured, as set out in *A new measure of poverty for the UK: the final report of the Social Metrics Commission*, September 2018

Looking in more detail at the child poverty figures, it's clear that some groups are much more likely to be in poverty than the overall average implies, as Figure 29 demonstrates. In our projection, the majority (i.e. more than 50 per cent) of children who either have a single parent; are one of three or more dependent children; are in a household where no-one is in work; or live in private or social rented housing, are expected to be in poverty by 2023-24.

Figure 29: Some groups are more likely to experience child poverty than others, but increases are projected for all groups

Proportion of children living in relative poverty (after housing costs), by household status
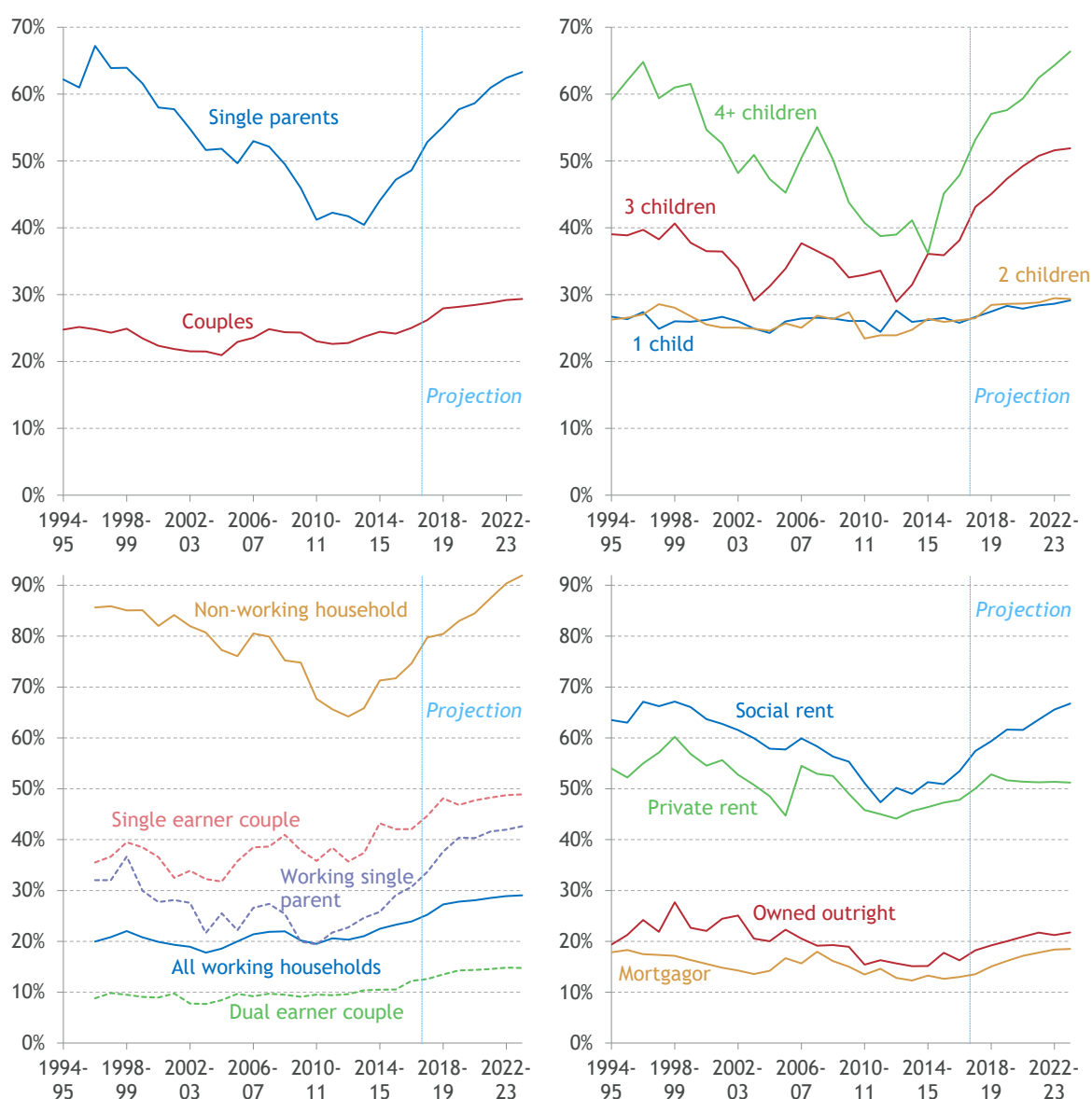
Notes: GB only before 2002-03.
Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

But poverty rates for other groups are also projected to rise. For example, the child poverty rate for working households averaged 20 per cent between 1996-97 and 2013-14, but is projected to increase to 29 per cent by 2023-24. The poverty rate for children living with two parents may well have hit a record high in 2017-18 or 2018-19.

What should we think about relative child poverty reaching – or even simply nearing – its highest rate since good data collection began in 1961 (and note there is no reason to think that such levels of inequality would have been surpassed in the decades prior to that)?[59]

It is not a matter of absolute deprivation: living standards have certainly improved overall since the 1960s. And factors other than household income matter too – such as health, education and childcare. But it does matter if a growing proportion of parents and children have resources significantly below present-day norms: both for their immediate well-being and potentially also for those children's futures. If there is a role for the state in supporting parents (and future taxpayers) at an important, expensive, and often stressful period of their lives, we don't seem to be making a good job of it.

The UK is not expected to meet its Sustainable Development Goal target on inequality

Connected to relative poverty, the UK (like every UN member) has committed itself to a package of 2030 Sustainable Development Goals that includes an inequality target to "progressively achieve and sustain income growth of the bottom 40 per cent of the population at a rate higher than the national average" (Target 10.1).[60] The Prime Minister has said that the UK government "will be at the forefront of delivering [the Goals] in the UK and around the world."[61]

Figure 30 follows an approach set out by the ONS for measuring progress against this target, and shows that the UK is not projected to meet it over the coming years. Instead, the bottom 40 per cent are projected to fall slightly further behind.[62] For example, between 2016-17 and 2021-22 real average income is projected to grow by (only) 0.3 per cent a year on average, but is projected to *fall* by 0.1 per cent a year for the bottom four deciles.

[59]   I Gazeley et al., *The poor and the poorest, 50 years on: evidence from British Household Expenditure surveys of the 1950s and 1960s*, 2016

[60]   https://sustainabledevelopment.un.org/sdg10

[61]   *Letter from the Prime Minister to 84 companies*, February 2017

[62]   ONS, *Measuring inequalities in the UK for the Sustainable Development Goals*, July 2018. We copy the ONS by using equivalised incomes after housing costs and annualised five-year growth rates. However, our analysis is based on HBAI rather than the Living Costs and Food Survey, and note that five-year averages may not be needed in future if larger-sample surveys are used.

Figure 30: The UK is not expected to meet the Sustainable Development Goals' target 10.1, for income growth of the poorest 40 per cent to be above-average

Rolling five-year average annual growth rate (by final year) in real (CPI-adjusted) equivalised disposable household incomes (after housing costs)
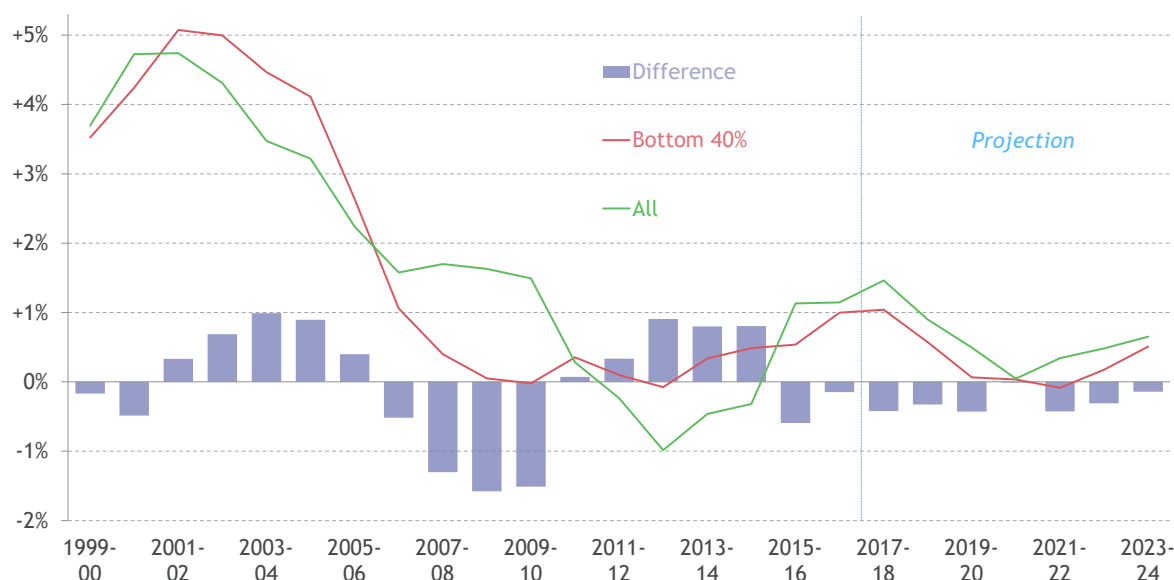
Notes: GB only before 2002-03.
Source: RF analysis of DWP, *Households Below Average Income, and RF projection*

Inequality is expected to remain high

In keeping with this projected failure to meet the Sustainable Development Goal target, the poorest 40 per cent's share of disposable income is not projected to grow, as Figure 31 shows. As such, the richest 4 per cent of the population are projected to continue to have a greater share of income than the entire bottom 40 per cent.[63]

Overall, our projection does not include large changes in income shares, though it should be noted that the future wages, self-employment income and investment income of the very richest are very hard to predict.[64] (And, as noted in Section 2, we assume that recent figures showing top employee income pulling away from the rest will not be repeated.) The big picture, therefore, is simply that the large rise in the income share of the top 10 per cent over the 1980s and 1990s (and to some extent the 2000s) does not look set to be reversed.

[63]   Note however that we continue to use equivalised income here.
[64]   They are also hard to measure. Top incomes may be revised up in future by making better use of administrative tax data. See ONS, *Household disposable income: adjustments to improve the measurement of the top earners' income*, forthcoming (February 2019), and A Corlett, *Unequal results: improving and reconciling the UK's household income statistics*, December 2017.

Figure 31: The top 4 per cent receive as much income as the bottom 40 per cent, and this is projected to continue

Share of total household income (equivalised, after housing costs)
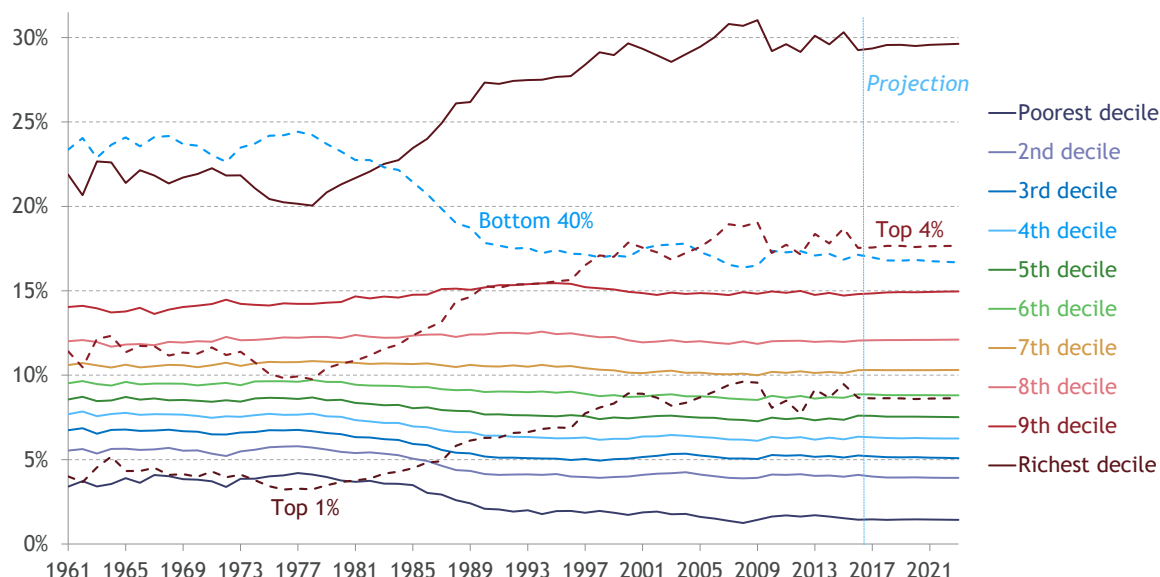
Notes: Financial years from 1994-95 onwards. GB only from 1994-95 to 2001-02. 1992 and 1993 interpolated.
Source: RF analysis of DWP, *Households Below Average Income*; RF projection; and IFS, *Households Below Average Income 1961-1991*

As Figure 32 shows, we *do* project a small rise in inequality – as measured by the Gini coefficient – in the short term.

Figure 32: Inequality measures are projected to rise slightly after 2016-17, remaining high by historic standards

Inequality measures, after housing costs
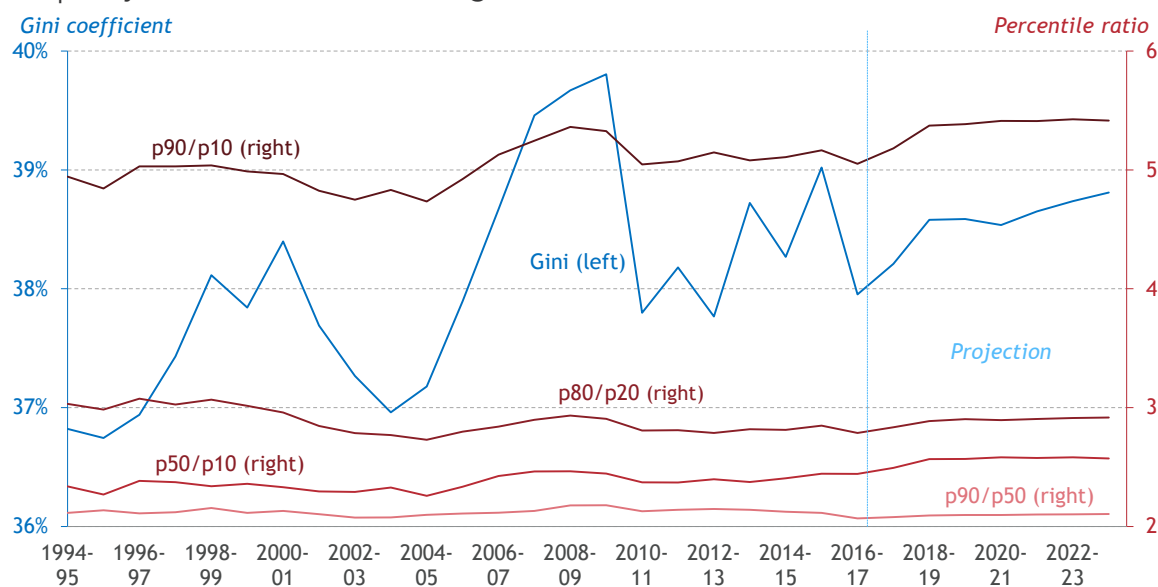
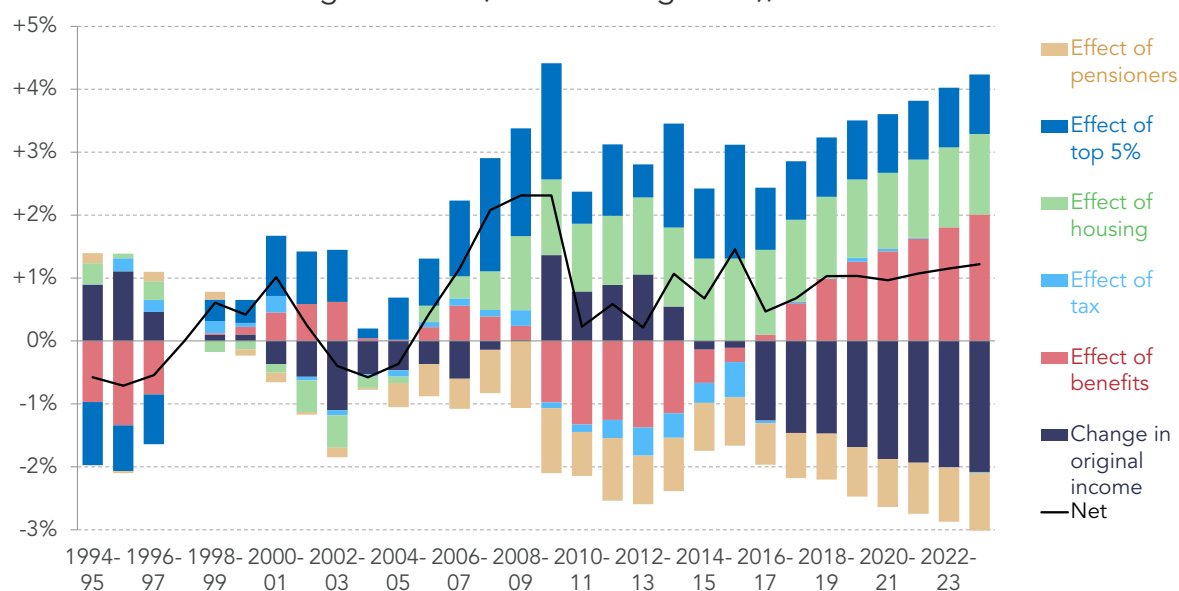Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Over the almost three decades shown in Figure 32, the overall trend is of a slight rise in the Gini coefficient for incomes after housing costs (see Annex 3 for the equivalent before housing costs trend, which is flatter). But again the big picture is that the large inequality increases of the 1980s and 1990s have simply not been reversed.

However, the ratio between the middle of the income distribution (p50) and the bottom (p10, poorer than 90 per cent of the population) is forecast to rise. This is perhaps unsurprising given this measure is conceptually similar to relative poverty.

What explains the past and projected future of overall inequality? Figure 33 presents one of way of decomposing changes in the Gini measure. The blue bars show that market income (before benefits and taxes) for the bottom 95 per cent of non-pensioners has become more equal – or at least has not become more unequal since 1997-98. This partly reflects the rise in employment over this period. The redistributive role of taxes and benefits (also for the bottom 95 per cent of non-pensioners only) has also not changed greatly, though this is driven by changes in original income as much as by policy (e.g. a rise in employment will reduce the role played by benefits). But accounting for housing costs, and adding in the top 5 per cent, leads to a larger rise in inequality; while adding in pensioners provides a somewhat offsetting fall as the gap between pensioners and non-pensioners closes.

Figure 33: Original income inequality is not forecast to rise, but changes in benefits are projected to push up inequality

Contributions to changes in Gini (after housing costs), since 1997-98

Note: Original income, benefits, tax and housing figures refer to the bottom 95 per cent of the non-pensioner population only.
Source: RF analysis of DWP, *Households Below Average Income*, and RF projection

Looking at the projection period, assumptions of progressive pay growth further reduce market income inequality among the bottom 95 per cent. But benefits are set to play a smaller redistributive role, pushing up the Gini (all else equal). As the historical data shows, the position of the top 5 per cent has an important impact on the Gini measure.

And on this our forecast is uncertain. Changes in the outlook for top incomes could easily change this Gini forecast. Even in our nowcast, a rise in dividend income in 2017-18 and 2018-19 (alongside high pay growth for top earners) pushes up inequality by boosting higher-income households,[65] but is offset by a weak but highly uncertain nowcast for those households' self-employment income.

Overall then, the nowcast and forecast we have modelled points to a tough living standards outlook: one in which income growth is weak overall, with particular strain among low to middle income households. Inequality is set to edge up, and child poverty is projected to reach record highs. Yet the assumptions underpinning these forecasts are not set in stone, and a large part of the reason for developing such projections is in order to encourage action designed to prove them wrong. The following section therefore explores how sensitive our outlook is to changes in economic assumptions or potential policy changes.

[65]   This reflects a low point for dividend income in 2016-17, due to tax avoidance, which is expected to be reversed.

Section 7

Beating the outlook

The projections presented in the last three sections are certainly not immutable. Different outcomes may arise either as a result of economic trends diverging from today's forecasts or as a result of deliberate policy change. In this section we consider a number of alternative scenarios that beat our central outlook, both as a means of testing the sensitivity of our projections and so as to ascertain what change in direction might make most difference to income growth and child poverty.

Scenario 1: Higher earnings growth has the potential to make a sizeable difference to household income growth

As we have seen, 2017-18 and 2018-19 appear to have been bad years both for incomes and for child poverty. But our projections for the next five years, while also disappointing, can – and hopefully will – change for the better.

One way in which our central projection might be beaten is for real wages to rise faster than expected. In October, the OBR forecast that average nominal pay would be 16 per cent higher in 2023-24 than in 2018-19. This annual average growth rate of 3 per cent would be below the pre-crisis average of around 4 per cent, reflecting the OBR's assumption that productivity growth will remain weak. Even with inflation projected to be only around 2 per cent, real growth of around 1 per cent per year would also be well below historic norms.

But productivity growth is extremely hard to predict.[66] There is a case for medium-term technological optimism, with widespread speculation about the potential for new technologies and further automation.[67] And nominal pay growth has been picking up, with average regular pay in November 2018 (the latest available) 3.4 per cent higher than a year earlier. As discussed in Section 2, the OBR's forecast for 2019-20 in particular, of 2.6 per cent growth, is therefore looking somewhat pessimistic.

If we were to assume that growth were 1 percentage point a year higher than forecast – and therefore in line with the pre-crisis norm of 4 per cent – then average pay would be an extra 5 per cent higher in 2023-24.

[66]   N Crafts & T Mills, Trend TFP Growth in the United States: Forecasts versus Outcomes, 2017
[67]   A Corlett, 'The rise of the robots' and 'productivity pessimism' can't both be right, Resolution Foundation blog, December 2017

On the assumption that this stronger wage growth is felt equally across all workers, Figure 34 shows how this would affect households across the income distribution, with the outlook greatly improved overall.[68]

Figure 34: Faster earnings growth could substantially improve the growth outlook

Total real (CPI-adjusted) growth in equivalised disposable income (after housing costs) between 2018-19 and 2023-24
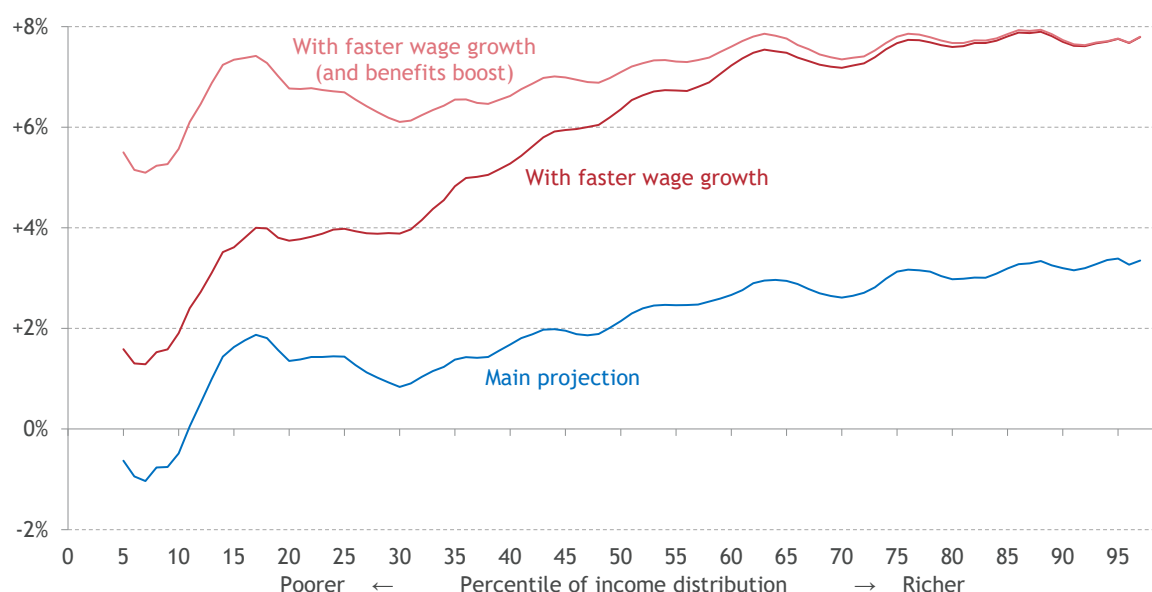
Source: RF projections

Scenario 2: Recycling the additional government revenue generated as a result of higher earnings growth into benefit generosity has the potential to boost income growth in a more evenly shared way

While very clearly welcome, higher earnings growth in isolation would increase inequality. Lower-income households get a lower proportion of their income from employment or self-employment – and also face high effective marginal tax rates – so do not see the same proportional gains from earnings growth as higher-income households.

However, higher pay growth has the secondary advantage of raising additional revenue for the government. In this case, Income Tax and National Insurance revenues, combined with a lower need for means-tested benefits, would add around an extra £28 billion a year to the public coffers (before accounting for the cost of higher public sector wages, but also before considering the impact on other taxes such as VAT).

[68]   Note that we do not model any changes in private rents, interest rates or other economic factors that would likely change if earnings were to rise faster than expected.

Due to the 'triple lock', the state pension would automatically rise further if pay growth outperformed. But there would also be the desirable option of using some of the revenue boost to increase other benefits – ensuring that they are not too greatly devalued relative to earnings. So Figure 33 also shows the impact of higher earnings when combined with this secondary effect of potentially funding increases in major benefits (raising UC and its predecessors, Child Benefit, the State Pension, Disability Living Allowance and Attendance Allowance by 5 per cent). The result is income growth that is much more evenly shared. And, costing under £9 billion, this would still leave room for further public spending, tax cuts or deficit reduction in this scenario.

Scenario 3: Very high employment could boost living standards, but there is limited room for further improvement

Another area where the forecast could easily prove too pessimistic is on employment. As shown in Section 2, using OBR figures we assume a plateauing then decline of the 16+ employment rate, based on assumptions that unemployment can't go much lower and that demographics will push down on labour market participation. Note that the Bank of England considers that unemployment is already below its equilibrium rate (of 4.25 per cent).[69] But (as also shown in Section 2) employment and unemployment have continually outperformed expectations in recent years.

We therefore model a very optimistic scenario in which the employment rate trend of 2017 and 2018 continues for the forecast period. Rather than a slight fall in the 16+ employment rate from 61.2 per cent to 60.8 per cent by 2023-24, this scenario would give an unprecedentedly high rate of 62.5 per cent. This would mean around an extra 900,000 people in work, (via an assumed 300,000 fall in unemployment and 600,000 fall in non-participation). For simplicity, we also assume all become private sector employees.

It should be noted that this is more or less a one-off income boost, that cannot be sustainably repeated. In the long term, employment increases cannot substitute for earnings growth. But, as Figure 35 shows, the impact on average incomes by percentile is both significant and progressive.

[69]   Bank of England, Inflation Report, February 2019

Figure 35: Higher than forecast employment would be a progressive boost to incomes, but cannot drive long-term growth alone

Total real (CPI-adjusted) growth in equivalised disposable income (after housing costs) between 2018-19 and 2023-24
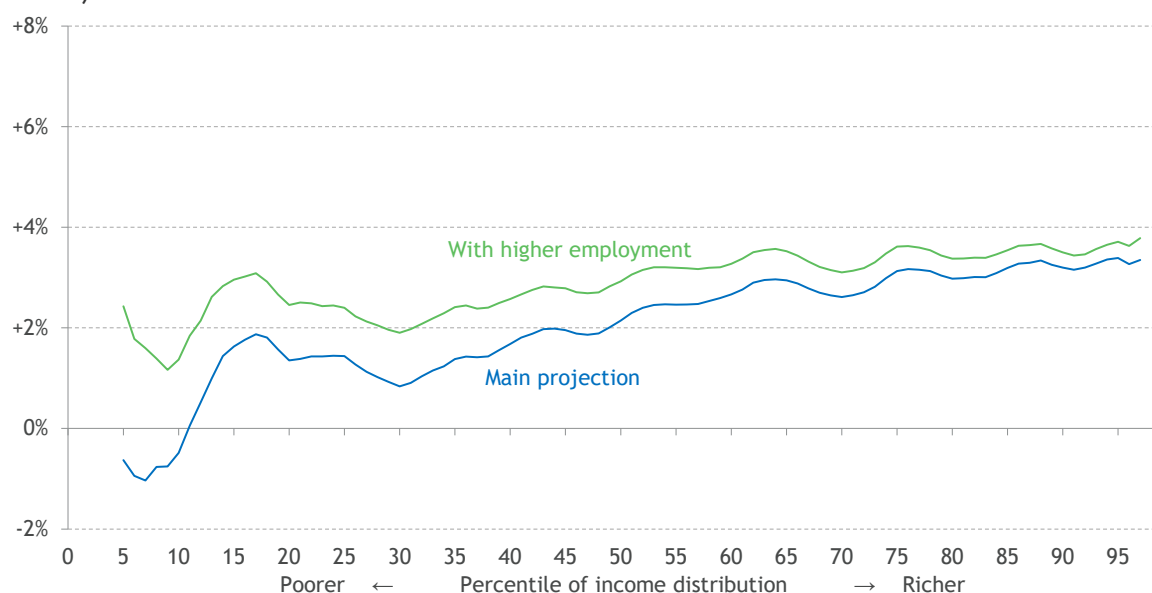
Source: RF projections

Scenario 4: Increases in the generosity of benefits would make a large difference

Levels of earnings and employment are not things that government can quickly and easily improve. In contrast, benefits policy is a choice. To improve the outlook for low to middle incomes, and for child poverty especially, different choices could be made. We've already looked in Scenario 2 at the way in which an improved earnings (or employment) forecast could provide the revenue to boost benefits. But even without such economic fortune, changes should be made (though these would of course imply the making of tough choices in relation to some combination of increasing taxes, cutting other forms of spending or borrowing more).

To test what impact this approach might have, we model a package of reforms:

- Cancelling the two child limit;

- Cancelling the abolition of the family element;

- Increasing the UC work allowance for single parents (to the equivalent of 15 hours a week on the National Living Wage); and

- Introducing a UC work allowance for second earners with children (equivalent to 7 hours a week on the National Living Wage).

This would not be cheap, costing around £5 billion in 2023-24.[70] But nor would it even fully reverse the 2015 package of welfare cuts overall. Figure 36 shows our five-year growth projection with and without those changes, with a large impact on low income households.

Figure 36: Making UC more generous than planned for parents would give a progressive boost to incomes (as would higher take-up)

Total real (CPI-adjusted) growth in equivalised disposable income (after housing costs) between 2018-19 and 2023-24
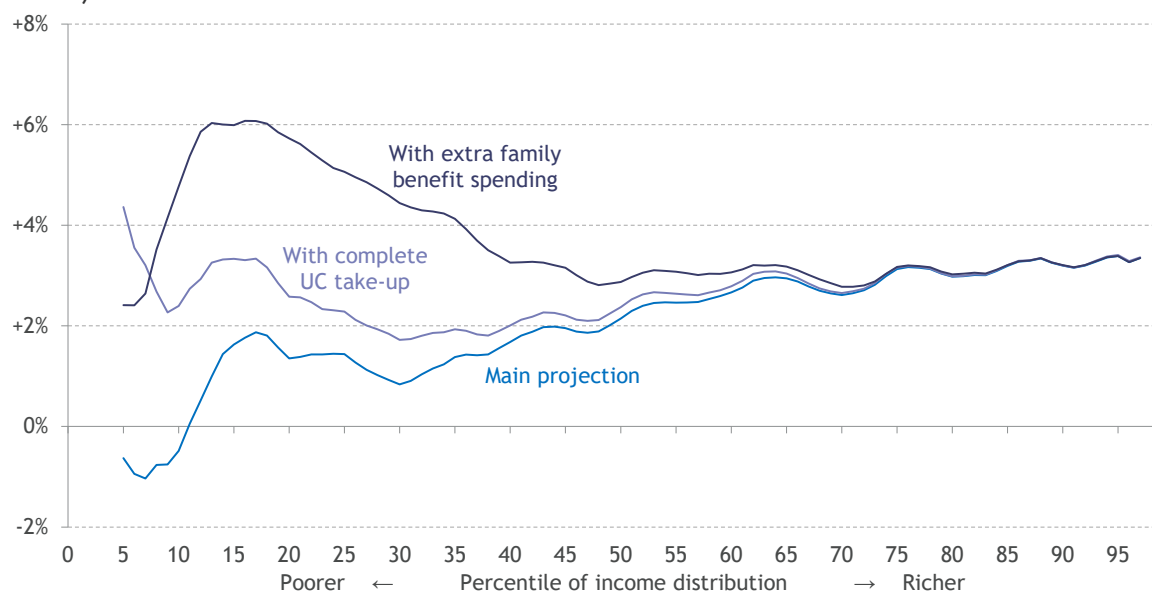
Source: RF projections

Scenario 5: A rise in benefit take up as a result of the switch to UC also has the potential to make a difference to lower income families

Figure 36 also shows the impact that an even higher take-up assumption for UC would have in isolation. As discussed in Section 3, UC's impact on take-up is highly uncertain: it is not clear what existing benefit take-up rates are,[71] UC is expected to increase take-up for some groups and reduce it for others,[72] managed migration may kick some people off benefits if done badly, and the modelling challenges are formidable. So for illustration of these uncertainties, we show how an assumption of 100 per cent UC take-up would change our modelling, resulting in an additional £3 billion boost for the poorest.[73]

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[70]   This cost would increase thereafter given that UC, the two child limit and the family element policy are not fully rolled out in 2023-24.

[71]   G Bangham & A Corlett, _Boosting benefit take-up is critical to the success of Universal Credit, but we might not be able to measure whether it's working_, Resolution Foundation blog, December 2018

[72]   OBR, _Welfare trends report – January 2018_

[73]   Note that our central take-up assumption for UC is already quite high.

Both Scenario 4 and Scenario 5 demonstrate ways in which the roll-out of UC could be made into a (more) positive thing for lower-income households in general. But it is important to note that the growth rates above are relative to 2018-19, and would mostly only be undoing damage done in 2017-18 and 2018-19 if our nowcast proves accurate.

To truly 'beat the outlook' we need a combination of significant improvements in the economic outlook and positive policy changes

The five alternative scenarios presented here, together with our main projection, help show the range of possible outcomes for the next five years. Concentrating on two headline measures – of real median working-age income and child poverty rates – Figure 37 shows the five-year change in each scenario as well as our main projection.

It shows that five-year growth in typical incomes is likely to be poor without a large change in the earnings outlook, and that child poverty is very likely to rise without serious new spending or the cancellation of planned cuts. Neither of these is impossible, but both would mark significant changes in direction. And of course, we have deliberately given no thought in this section to how things might swing the other way instead, with the economy *underperforming* against expectations.

Figure 37: Higher earnings growth is needed to boost typical incomes, but changes in benefit policy are needed to prevent further child poverty increases

Projected 2018-19 to 2023-24 change
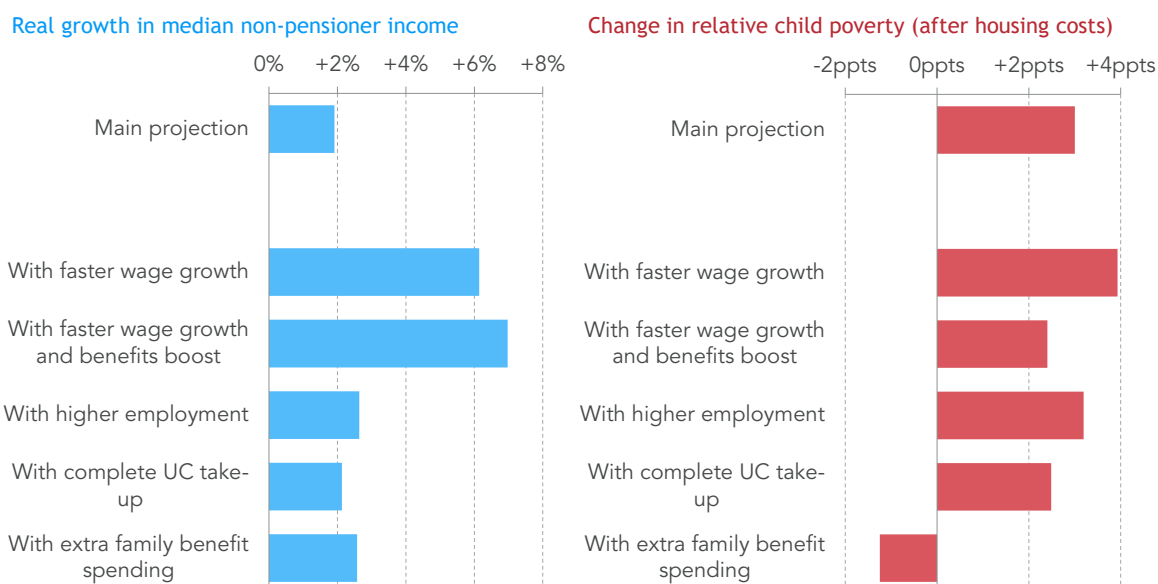
Source: RF projections

Given how difficult much of the post-crisis period has been for living standards in general and for low to middle income households in particular, it's important that policy makers do what they can to improve the outlook for the coming years: by focusing on growth, by providing a more secure and certain backdrop, and by changing the picture on the distribution of the gains of growth.

Section 8

Conclusion

Stepping back, it is worth noting that living standards in Britain are at record highs, or very close. By historical and global standards, current income levels are not to be sniffed at. And there are many technologies that offer at least the potential for future productivity and living standards improvements.

But only the most complacent of observers should be happy with Britain's household income growth over the last decade or so. Average wages are still worth less than they were pre-crisis, and households have faced the double whammy of the financial crisis fallout and a post-referendum inflation spike. Instead of the 20 per cent or more decadal income growth that would be normal by historical standards, many groups have recorded zero. If productivity growth continues – as expected – to be weak, the forecast too looks poor. And that's before we consider what might happen in the event of a new (overdue by historical standards) recession, or a 'no deal' Brexit.

Any prospect of the UK hitting two decades without real income growth – at least for some – should focus minds. Higher productivity growth cannot be produced by fiat, and there are some justifiable pressures on disposable incomes, such as fiscal deficit reduction and increases in long-term pension saving. But the absolute uncertainty over how Brexit will be implemented is undoubtedly an additional self-inflicted blow, and politicians' choices in that debate will continue to affect people's lives up and down the UK.

Beyond Brexit, the need for long-term investment in infrastructure, research, reducing housing pressures, education and yet-higher employment is as strong as ever. And big questions remain about how to fund the maintenance (let alone improvement) of other public services amid an ageing population.[74]

But at the same time, we can and should make choices about what levels of poverty are acceptable, and so cancel cuts in support for children and parents. Policy changes could also make sure that Universal Credit is a tool for poverty reduction, rather than one that risks further hardship. This will require tough choices in tax policy and elsewhere, particularly without improvements to the growth outlook. But such trade-offs are the bread and butter of politics.

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[74]   Resolution Foundation, *A New Generational Contract: the final report of the Intergenerational Commission*, May 2018

Annex 1. Nowcasting and forecasting methodology

As set out in this paper, there are many factors that influence household disposable incomes and therefore need to be modelled when casting forward the latest household income data (DWP, Family Resources Survey / Households Below Average Income, 2016-17). Our approach for projections is as follows.

Uprating market incomes

- **Weekly earnings** are increased through a mixture of methods.

- For the 2017-18 and 2018-19 nowcasts, employees are divided into 10 groups based on gender and position in the earnings distribution. For example, men in the second quintile of the 2016-17 Family Resources Survey male earnings distribution have their earnings increased using relevant data from the April 2016 and April 2017 Annual Survey of Hours and Earnings (ASHE),[75] to give their nowcasted earnings in 2017-18.[76]

- For 2019-20 and 2020-21 there is of course no ASHE data available. But a rising NLW is expected to reduce earnings inequality, so a progressive distribution of earnings growth is assumed, as discussed in Section 2.

- For all of these years, the overall rise in earnings is constrained to match outturn or forecast average earnings growth.

- For 2021-22, 2022-23 and 2023-24, uprating is simpler. As the NLW will not (on current policy) rise faster than median earnings, we apply the OBR's earnings growth forecast to all employees.

- For **self-employment income** we use figures implied by the OBR's projections for mixed income and numbers of self-employed workers. For future years these match average employee earnings growth.

[75] Office for National Statistics. (2018). *Annual Survey of Hours and Earnings, 1997-2018:* Secure Access. [data collection]. 13th Edition. UK Data Service. SN: 6689, http://doi.org/10.5255/UKDA-SN-6689-12

[76] Specifically, we use five earnings groups with relatively little internal variation: p1-p20, p21-p40, p41-p70, p71-p95 and p96-p100. Growth in average earnings from ASHE is used for each of these, except for the top group for which growth rates for each percentile are averaged to reduce the impact of the volatile top one per cent.

- **Outturn dividend income** is increased in line with the ONS's household sector dividends series, which is rolled forwards using NGDP per adult.

- **Private pension incomes** are uprated using the previous September's RPI inflation (but see also: *Adjusting the make-up of the population*, below).

- **Other private income sources** are uprated in line with the OBR's average earnings forecast.

- As discussed in Section 3, we do not model growth in **student loan repayments**.

- We model expected increases in **private pension contributions** due to auto-enrolment. See Section 3 for more details of these increases, and *Outlook 2018* for more details of our methodology.[77]

Modelling taxes and benefits

- We model the tax and benefit system in future years using stated government policy (e.g. 2019-20 tax thresholds) and default policy (e.g. CPI uprating in many cases).

- We model a mix of UC and legacy benefit systems, based on OBR projections of UC's roll-out. We do not account for the 'transitional protection' policy that will apply to some cases who would otherwise lose out when moved to the new scheme, but this is likely to be limited and will depend on the uncertain managed migration process.[78]

- We assume incomplete take-up of the main means-tested benefits, including UC.

- A number of policies are modelled as being gradually rolled out:

  - *The two child limit is applied to children born from April 2017 onwards, and so affects a growing proportion of the caseload each year.*

  - *The abolition of the family element of tax credits and UC works in the same way. However, the 'family premium' in housing benefit has been abolished for new claims as well as for births after 1 May 2016. We model this by phasing out the premium over a five year period.*

  - *The Work-Related Activity Component of Employment and Support Allowance (and its equivalent in UC) has also been ended for new claimants from April 2017. We model this*

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[77]   A Corlett, G Bangham & D Finch, *The Living Standards Outlook 2018*, Resolution Foundation, February 2018
[78]   At present (OBR, *Economic and fiscal outlook*, October 2018), the OBR forecasts that transitional protection will have a maximum impact of £1.7 billion, in 2022-23 (falling rapidly to £1 billion in 2023-24). But recent delays to managed migration mean this is likely to be both reduced (due to increased 'natural migration', not qualifying for protection) and delayed.

by phasing out the component over a five year period.

- *As the benefit cap was lowered beginning in November 2016 – part way through the financial year – we model this policy as being partially in place in 2016-17.*

- *The replacement of Disability Living Allowance with Personal Independence Payments is not modelled, and nor is the introduction of the Single Tier Pension.*

- Council Tax is assumed to rise in line with OBR forecasts by nation. Detailed changes to Council Tax Support by nation and local authority are not modelled.

To model changes in disposable household incomes using all the inputs and policies above, we use the IPPR tax benefit model.

There are a number of smaller policies that we have not modelled, but which might also affect household incomes. These include:

- The switch of mortgage interest support from a benefit (which would have been worth £270 million in 2018-19) into a loan (which has had very low take-up).[79]

- The tightening of eligibility for Pension Credit from 15 May 2019, with some newly claiming couples instead getting less-generous Universal Credit. This will save the government £220 million a year by 2021-22.[80]

- The introduction of £1,000 tax allowances for trading and property income; and the phasing out of above-basic-rate tax relief for landlords' mortgage interest costs.

- Scotland's Best Start Grant and increased Carer's Allowance (and a proposed but as-yet-unspecified 'income supplement').

- Income in the form of Help to Buy ISA, Lifetime ISA and Help to Save bonuses.

- The likely possibility of changes to free TV licenses (for those above 75) from June 2020.

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[79]   OBR, *Economic and fiscal outlook*, October 2018
[80]   House of Commons, *Pension Credit: Written question – 212389*, January 2019

Projecting costs and housing spending

- We create specific household income deflators for both the 'before' and 'after housing costs' income measures, in line with DWP definitions. To project these we use OBR forecasts for CPI, mortgage interest payments and actual rents.

- Mortgage interest is uprated uniformly using OBR projections.

- Private rents are assumed to rise in line with average earnings in future, matching the OBR's assumption. Ground rents and service charges are assumed to do the same. No regional variation is assumed beyond 2018, with the ONS's *Index of Private Housing Rental Prices* used in our nowcasting. Eligible private rents (the amounts covered by housing benefit) are uprated using OBR forecasts.

- Social rents are uprated using OBR forecasts for eligible social rents.

- Other housing costs are uprated using the OBR's CPI forecast.

Adjusting the make-up of the population

In addition to directly casting forward households' incomes and costs, we also adjust the make-up of the population to model other demographic and economic changes.

- We reweight the population to match ONS forecasts for demographic change by age, gender and region.

- For the first time, we also model changes in the numbers of dependent children of each age, using ONS forecasts.

- We use the OBR's forecasts for private employment, public sector employment, self-employment, unemployment and the non-participating population.

- Changes in the state pension age are also modelled specifically using OBR forecasts of participation rates by gender for 60-64 year olds and 65-69 year olds.[81]

- The proportion of women age 70+ who have private pension income is also adjusted each year, rising in line with past *Family Resources Survey* trends (while there has been broadly no change among men).

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[81]   OBR, *Fiscal sustainability report*, July 2018

- For 2017-18, outturn *Labour Force Survey* data is used to adjust for changes in employment rates by region; family type; household employment status; and housing tenure.

- We assume recent *Labour Force Survey* trends in housing tenure continue linearly into the future, with outright home ownership rising and the private rented sector shrinking.

Annex 2. Previous projections

Nowcasts and forecasts of household income have now appeared in a number of our reports, with comparable figures first produced in 2017.[82] Due to the lag of survey-based results, we are only now beginning to be able to compare past projections against outturn statistics. This section explores this emerging track record.

First, however, it should be noted that – in addition to limitations in our modelling – the survey data itself is not perfect. For example, the HBAI publication only says with 95 per cent confidence that real BHC income at the 50th percentile grew in 2016-17 by between -1.0 per cent and +4.9 per cent.[83] And as noted in previous work there may also be structural problems in the data, such as an underestimation of benefit income.[84] Our aim is not strictly to predict what HBAI will say, but to predict what has really happened or might in future.

In addition, our projections (beyond our nowcasts) are not necessarily the Resolution Foundation's view of what will happen. They are based on current policy if no changes are made, and on OBR forecasts (where possible). The latter will certainly change, and the former may quite possibly (and sometimes we actively call for such change). However, it is useful nonetheless to know where we are heading based on current assumptions.

With those caveats aside, however, the data so far lends support to this use of nowcasting/forecasting. *The Living Standards Outlook 2018* included a 2016-17 nowcast showing 1.8 per cent growth in real median income after housing costs, a figure that matched the eventual outturn.[85] For non-pensioners, our nowcast was 2 per cent, compared to the final result of 1.8 per cent shown in Figure 38. (The iterative nature of our projections should also be noted, with the outlook changing as more data becomes available, methods are improved, and OBR figures change.)

[82]   A Corlett & S Clarke, *Living Standards 2017: The past, present and possible future of UK incomes*, Resolution Foundation, February 2017
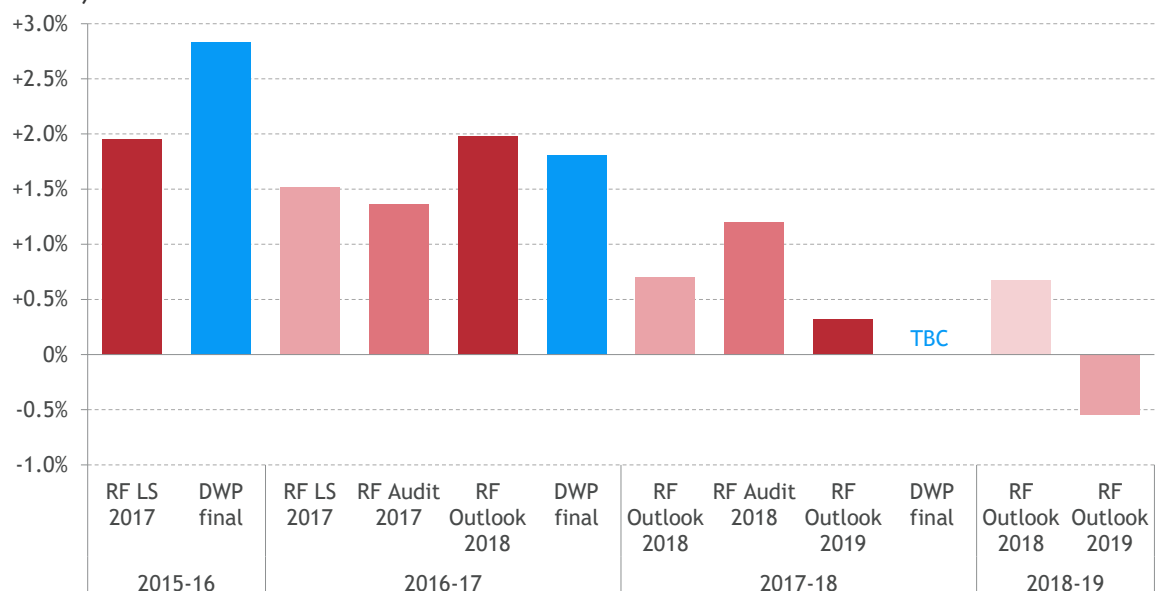[83]   DWP, *Households Below Average Income*, March 2018
[84]   A Corlett, S Clarke, C D'Arcy & J Wood, *The Living Standards Audit 2018*, Resolution Foundation, July 2018
[85]   A Corlett, G Bangham & D Finch, *The Living Standards Outlook 2018*, Resolution Foundation, February 2018

Figure 38: Our median income forecasts were relatively good predictions of HBAI results in 2015-16 in 2016-17

Projected and outturn real median non-pensioner income growth (after housing costs)

Source: RF (*Living Standards 2017, The Living Standards Audit 2017, The Living Standards Outlook 2018, The Living Standards Audit 2018, The Living Standards Outlook 2019*); and RF analysis of DWP, *Households Below Average Income*

Mean income growth has come in further away from our projections. For example, our final nowcast for 2016-17 mean income growth (before housing costs) was 1.0 per cent, but HBAI then showed a fall of 1.0 per cent. This HBAI result was driven by a "reduction in investment income from the SPI adjustment" – related to a forestalling of dividend income – whereas our method did not have the ability to model top incomes and dividends well.[86] Note though that the outturn ONS survey data – which had similar limitations – showed 2.6 per cent growth in real mean income.

In addition, we have noted that pensioner incomes are harder to predict than non-pensioner ones, and this is one reason for our focus on the latter. In part this will reflect the smaller size, and therefore higher volatility, of the survey's pensioner sample. But it also reflects the heterogeneity of private and public pension entitlement, and a higher rate of turnover in the pensioner population.

Ours is not the only household income nowcast. Most notably, the ONS produces 'flash estimates' for its Effects of taxes and benefits on UK household income survey.[87] Its nowcast for 2017-18 is more positive than ours, but still weak. For example, it shows 0.6 per cent growth in the median non-retired household's disposable income (before housing costs). That data does, however, differ in its deflators, age groups, income definition and more. With a small sample (before 2017-18), this survey has not always given similar results to the DWP's, let alone to nowcasts, as Figure 39 shows.

[86]   DWP, *Households Below Average Income (HBAI) Quality and Methodology Information Report 2016-17*, March 2018
[87]   ONS, *Effects of taxes and benefits on UK household income – flash estimate: financial year ending 2018*, July 2018

Figure 39: DWP and ONS sources have not always agreed about outturn growth rates

Projected and outturn real median non-pensioner income growth (after housing costs) for 2016-17
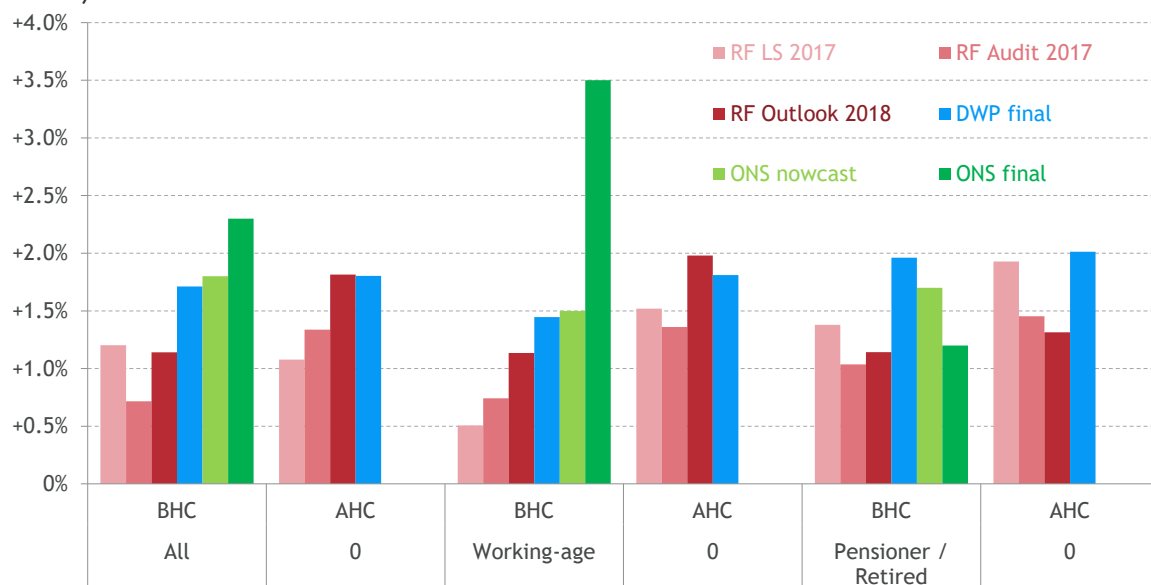
Source: RF (*Living Standards 2017, The Living Standards Audit 2017, The Living Standards Outlook 2018*); RF analysis of DWP, *Households Below Average Income*; RF analysis of ONS

As more years of data becomes available, methods improve, and the data itself improves, we hope to develop a more detailed assessment of what can and cannot be nowcasted or forecasted with accuracy.

Annex 3. Disposable incomes before housing costs

As set out in Box 3, in this paper we focus on disposable incomes after housing costs (primarily rents and mortgage interest), as arguably the best (or least problematic) measure of living standards.

A common alternative is to use income before housing costs – and both are used in the DWP microdata which we ultimately base our analysis on. In terms of levels, incomes are of course higher before housing costs (see Figure 17). But there is no such obvious distinction for growth rates.

Importantly, each measure uses a different deflator. The 'after housing costs' deflator excludes housing costs, so as not to double count those. But the 'before housing costs' deflator includes housing costs. So changes in housing costs do also affect real income growth on the 'before housing costs' measure.

The choice does matter, however, for the distribution of growth. Changes in the deflator have a uniform effect, so all households in the data are assumed to benefit from mortgage falls, for example, regardless of whether or not they have a mortgage. There are complex questions about the pros and cons of each measure, but we present 'before housing costs' results here for completeness.

Figure 40 shows our growth projection for the median non-pensioner. It does not differ hugely from its 'after housing costs' counterpart (Figure 18), though projected growth in 2018-19 and 2019-20 is slightly stronger 'before housing costs'.

Figure 40: Growth in median income is also projected to be weak using the 'before housing costs' income measure

Annual real (CPI-adjusted) growth in median non-pensioner equivalised disposable household income (before housing costs)
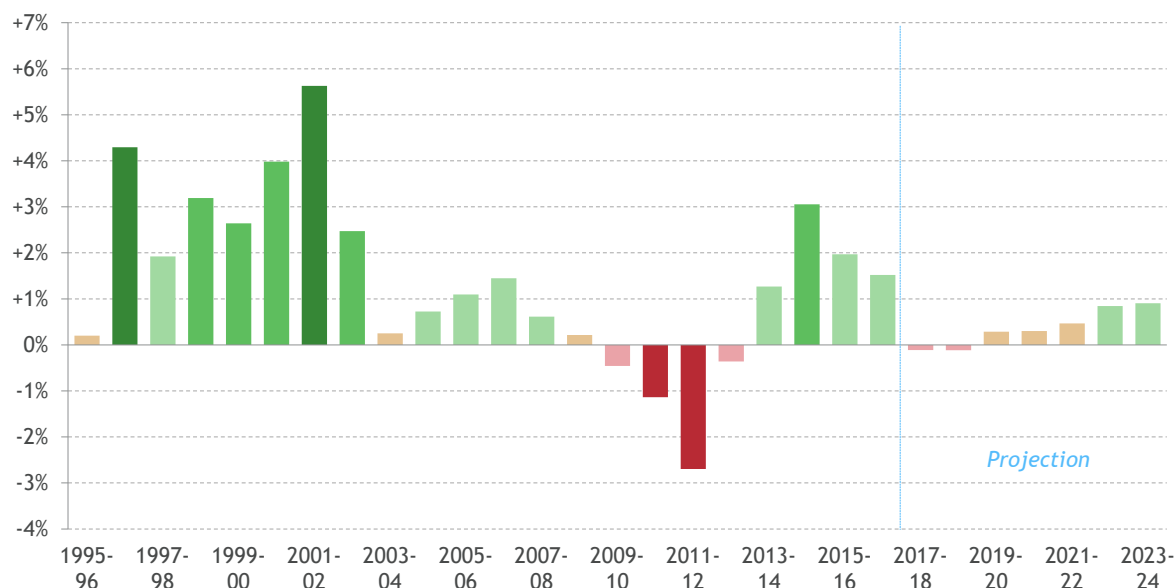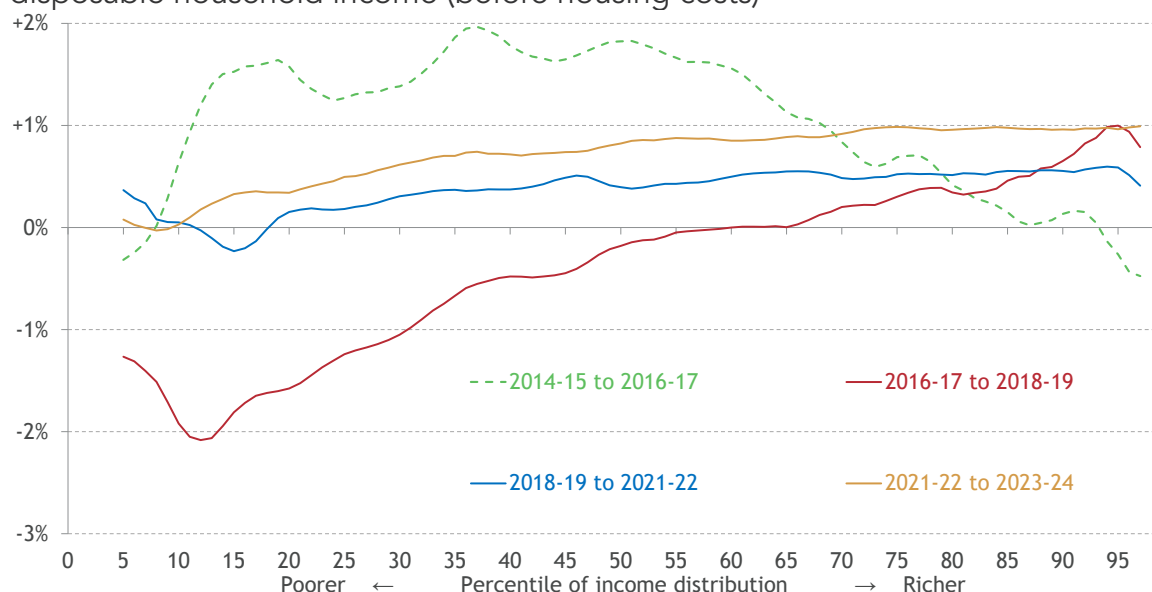

Source: RF analysis of DWP, *Households Below Average Income, and RF projection*

Looking at the full non-pensioner income distribution, Figure 41 shows weak growth both in our nowcast period and beyond (similar to Figure 21). However, growth is slightly stronger in our forecast to 2021-22 than under the 'after housing costs' measure, potentially related to the projected rapid growth in mortgage interest costs over this period.

Figure 41: Growth is also projected to be weak and unequal using the 'before housing costs' income measure

Average annual real (CPI-adjusted) growth in non-pensioner equivalised disposable household income (before housing costs)
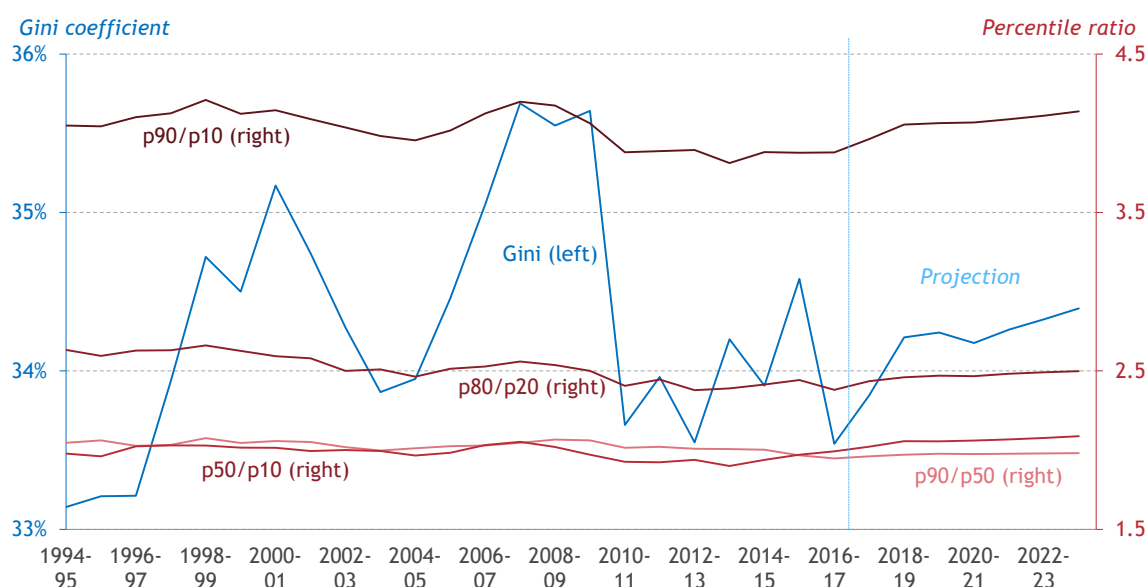

Source: RF analysis of DWP, *Households Below Average Income, and RF projection*

Finally, Figure 42 shows a similar projected trend for inequality as Figure 32 did. However, the results for the last two decades differ somewhat. Whereas income inequality 'after housing costs' has trended upwards slightly over time, the 'before housing costs' measure shows a flatter trend or even a slight decline up to 2016-17. But on both measures it is fair to say that overall income inequality has been largely flat over the last two decades, but remains high by pre-1990s standards.

Figure 42: Income inequality is also projected to rise after 2016-17 using the 'before housing costs' income measure, but has been flatter over the last two decades than the 'after housing costs' measure suggests

Inequality measures (before housing costs)

Source: RF analysis of DWP, *Households Below Average Income,* and RF projection

Resolution Foundation

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- 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.

For more information on this report, contact:

Adam Corlett, Senior Economic Analyst
adam.corlett@resolutionfoundation.org   020 3372 2983

info@resolutionfoundation.org +44 (0)203 372 2960 @resfoundation resolutionfoundation.org