{Section 3} Looking forward: Living standards to 2020

Chapter 7
Our current path

Chapter summary

- Even on optimistic growth assumptions, low income households in 2020 now look likely to have incomes 15 percent below those in 2008, a level last seen in 1993.
- Middle income households in 2020 look likely to have incomes around 3 percent lower than in 2008, a level last seen in 2001.
- These lost years for living standards, ranging from 27 to 19 years across low to middle income households, would be unprecedented in modern times.
- Growth is set to be skewed towards higher income households as jobs are created at the top and bottom while declining in the middle.
- Existing plans for cuts to state support will accentuate the squeeze on lower income households, while middle income households with children will see their incomes grow at less than one-third of the pace of those without children from 2011-2020.
- Doing what we can to constrain the prices of essential goods will be crucial if lower income households are to avoid long-running declines in their real incomes.

A key question for the Commission has been how we expect household incomes to develop over the coming decade, assuming the economy returns to growth. Clearly if there is no or very low growth living standards are likely to further deteriorate. But if there is growth, can it be expected to raise low to middle income households above their pre-crisis income levels? Or will economic growth be skewed towards the top, leaving state support struggling to compensate households in the bottom half of the wage distribution, leading to stagnation or decline?

This chapter starts by sketching out how, on our current path, the balance between different occupations, sectors and skills is likely to affect household incomes. We are particularly interested in whether changes in the kinds of jobs being created and the polarisation of employment are set to continue, and what this means for household earnings and incomes.[1] The findings build on a major piece of work funded by the Joseph Rowntree Foundation (JRF) and the UK Commission for Employment and Skills (UKCES), combining the most sophisticated economic modelling yet undertaken of the future of the labour market with expected changes in UK tax and benefit policy and household composition.[2]

7a Household incomes to 2020 – our approach

We give a brief overview of our methodology on page 77. The projections and scenarios set out in this section are of course stylised. While they allow us to sketch out the likely shape of growth and to get a sense of scale, they should not be seen as predicting the precise levels of income in 2020 to the nearest pound.

What we set out in this chapter

This chapter sketches out possible paths for household incomes up to 2020 on the basis of research for the Commission conducted by the Institute for Employment Research (IER) and the IFS that builds on work funded by the JRF and the UKCES. It combines forecast changes in the UK labour market, with expected changes in tax and benefit policy and household composition.

On pages 77-80 we present the baseline scenario, forecasting the UK labour market to 2020. This illustrates how the changes in the UK labour market look set to impact on household incomes. It assumes, rather optimistically, that wages grow at the same rate for all jobs. (See Note 7.1 for a full account of the underlying assumptions of the work.)

On pages 84-85 we then look at the impact of rising or falling wage inequality. This discussion presents two scenarios that modify the baseline scenario by assuming that pay grows faster at the top than at the bottom, and vice versa. This gives a sense of the impact of changes to wage inequality on household incomes. Specifically, we look at how:

- a repeat of the rapid *increase* in wage inequality observed in the period 1975 to 1985 would affect household incomes
- a modest fall in wage inequality (based on a level that seems viable in a decade) would affect household incomes

Finally, on pages 86-87 we look at what changes could make a difference to household incomes. On the basis of international examples and historical experience in the UK, we model the impact of:

- *higher female employment*: raising UK female employment to the average level among OECD countries that outperform us on female employment
- *improved skills*: modeling ambitious improvements in skills in the bottom half of the workforce; specifically, this model reduces the share of people with no skills, increases the share with intermediate skills, and raises the wage return to intermediate skills
- *boosting low wages*: illustrating the possible impact of a concerted strategy to address low pay. This scenario repeats the pattern of wage growth that was seen in the decade around the time the UK minimum wage was introduced.

We conclude by examining a combined scenario in which the impact of improvements in female employment, skills and low wages are combined.

[1] Institute for Employment Research and Institute for Fiscal Studies, (2012), The Impact of the UK's Changing Employment Structure on Low to Middle Income Households in 2020, Resolution Foundation, London. [2]For the full report of these findings see Institute for Employment Studies and Institute for Fiscal Studies, (2012), The Prospects for Low to Middle Income Households in the Next Decade, Resolution Foundation, London.

7b Where the UK is headed on our current path

Our baseline scenario predicts a difficult decade for low to middle income households

According to our baseline scenario, the decade to 2020 looks set to be unprecedentedly hard for low to middle income households. Figure 7.1 summarises the results from our baseline scenario. It shows the annual average growth rates for household income between 2011-12 and 2020-21 at different points in the household income distribution. Two things stand out:

- *In 2020, incomes across the entire bottom half of the distribution will be lower than they were in 2011-12.*
- *The pattern of income growth over the decade is set to be skewed towards the top.*

Note 7.1: Projecting living standards to 2020 – assumptions and methodology

The underlying methodology used by the IER and the IFS in these scenarios is set out in detail in an accompanying full report for the Resolution Foundation.[3] While the final output of the economic model is a projection of working-age household incomes to 2020, it is important to understand the building blocks that underpin the projection:[4]

First, the macroeconomic picture underpinning the projections is generated by a model of the macro economy run by Cambridge Econometrics. The central GDP projections in this model, generated around a year ago, were an average of 1.9 per cent growth between now and 2011 (more optimistic than today's forecasts), rising to a long-run average of 2.5 per cent from 2015 to 2020. This model is used to forecast for 2020 employment in different sectors, occupations, skill levels and regions, whether these jobs will be undertaken by men or women, and whether they will be full or part time.

Second, the IER uses detailed earnings data to assign wages to each of these jobs. The baseline scenario assumes a constant rate of wage growth across all job types on the basis of earnings projections from the OBR's November 2011 forecasts.[5] This means that the baseline scenario holds constant the relative pay gaps between different jobs. Put another way, it focuses on whether the UK labour market is creating more bankers, cleaners or care workers rather than on whether the pay gaps *between* these jobs are changing. (We then test the impact of changing pay differentials separately in scenarios that look at rising and falling wage inequality.)

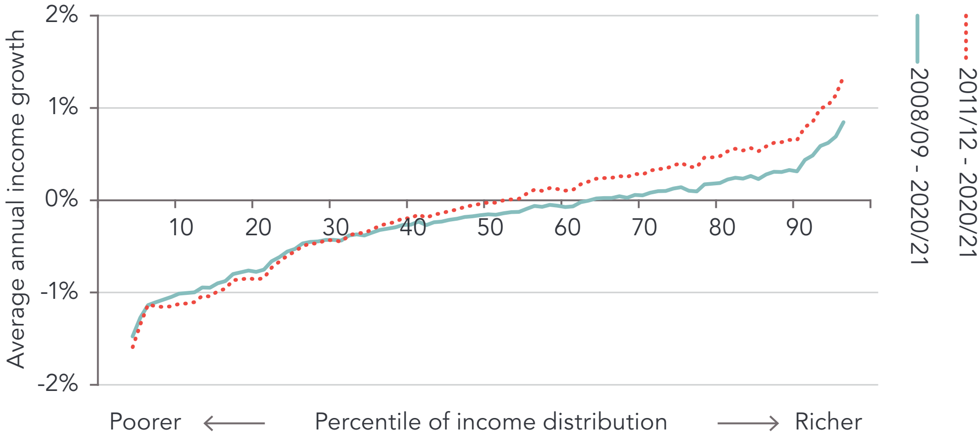
Third, this pattern of wages is fed through a model of the UK tax and benefit system run by the IFS. To do this, the model projects how workers are spread between households across the distribution. Once these household earnings are run through the tax and benefit system, this creates forecasts for household income after state redistribution. This takes account of all planned cuts announced by the time of the Chancellor's 2011 Autumn Statement. Importantly, it assumes no further cuts (and does not therefore include the mooted additional £10 billion reduction in welfare spending).

In general, the assumptions underlying the model and the "baseline scenario" – on GDP, the distribution of wage growth and the tax and benefit system – are optimistic. Given uncertainty about medium-term growth forecasts, our intention was to err on the side of optimism, stress testing the view that once the overall economic picture improves, steady growth in living standards will resume.

[3] Institute for Employment Research and Institute for Fiscal Studies, The Impact of the UK's Changing Employment Structure on Low to Middle Income Households in 2020. [4] For a full description of the assumption used in this work see Wilson, R. A. and Homenidou, K., (2012), Working Futures 2010–2020: Main Report, Institute for Employment Research, Coventry; and similar forecasts sketching out the implications for poverty see Wilson, R. A. et al., (2012), The Impact of Employment Changes on Poverty in 2020, Joseph Rowntree Foundation, York. [5]Job types are defined by the combination of occupation, industry, full time/part time, gender, region and qualifications level. The model increases wages across all job types at a constant rate which, when combined with changes in the relative numbers of people in each of these different job types, result is 3.6 per cent nominal growth in average earnings (in real terms this equates to about 0.2 per cent over the period as a whole).

Figure 7.1 also shows how the results look if we include the immediate post-crisis 2008-09 to 2020-21 period (the dashed line). The effect is not as dramatic as one might expect. Including these years makes the picture worse overall and reduces incomes particularly significantly in the top half. This is because initially in the post-crisis period lower income households were protected by state support.

Figure 7.1: Average annual real growth in net household income among non-pensioner population in the UK, 2011-12 to 2020-2021



Notes: The top and bottom 3 percentile points are not shown owing to high levels of uncertainty from sampling and measurement error. Net household income is measured after taxes, inclusive of benefits, before the deduction of housing costs, at the household level, and equivalised using the modified OECD equivalence scale. Data includes workless households. Sources: IER and IFS calculations for the Resolution Foundation, using Family Resources Survey 2008-09, TAXBEN, and assumptions specified in the text

What does this mean for households?

To understand what these forecasts mean for typical households we can translate them into cash terms.[6] A low income household in 2008-09 (at the 10th percentile) had an income of £10,600 a year.[7] By 2020-21, the forecasts predict that a similar household will have an income of just £9,000 a year (in 2008-09 prices), a real-terms decline of 15 per cent. A decline of this depth and duration would be unprecedented in modern times and would return income at the 10th percentile to a level last seen in 1993, nearly three decades earlier.

The picture is slightly better when we look at a typical middle income household (at the 50th percentile). This reflects the fact that higher income households tend to receive less of their income from the state, and as a result will be relatively insulated from the significant decline in state support that is forecast to take place over this period. Even so, median income falls from £22,900 per year in 2008-09 to £22,100 in 2020-21, a real-terms fall of 3 per cent. This would return median income to a level last seen in 2001, two decades earlier, again an unprecedented period of no income gain.

These projections give a sense of the likely strength and shape of income growth in the coming decade, bearing in mind that the macroeconomic assumptions underlying the results can be considered optimistic. They confirm the findings of earlier work, which suggest that relative poverty is set to rise in the 10 years to 2020, along with child poverty and other measures of relative earnings and income inequality.[8]

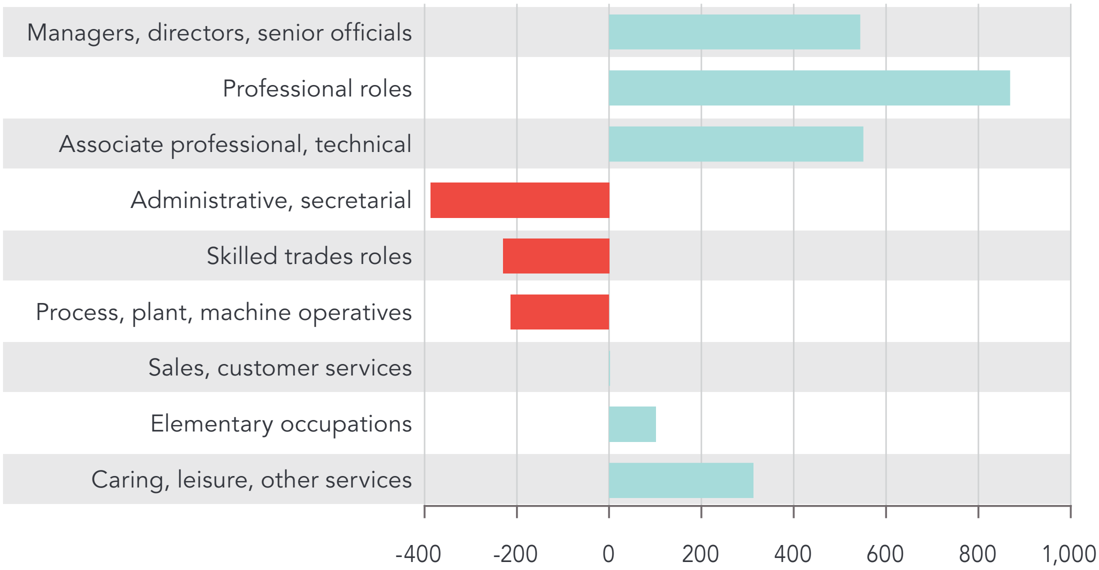
[6] We rely on data for the 2008-09 to 2020-21 period rather than starting in 2011-12, although as we see from the above results, the situation would not be significantly different had we started in 2011-12. [7] For a couple with no children. [8] Brewer, M. et al., (2012), Poverty and Inequality in 2020: The impact of changes in the structure of employment, Joseph Rowntree Foundation, York.

7c Ongoing polarisation in the UK labour market

The polarisation of the labour market is set to continue

How much are these outcomes being driven by changes in the structure of the jobs market? Figure 7.2 shows what happens to employment in different occupations under the baseline scenario. The story is one of a jobs market moving towards service roles that are, as currently designed, relatively low paid, and away from mid-level jobs that helped to drive past periods of prosperity. Employment growth is set to be strong in top professional occupations and also moderately strong in poorly paid service roles in caring and leisure. There will be growth in the retail and distribution sector while white collar roles in public administration are likely to decline. Mid-level occupations in administration and skilled trades are also set for further declines. These trends will accentuate the patterns seen in the last 10 to 20 years.

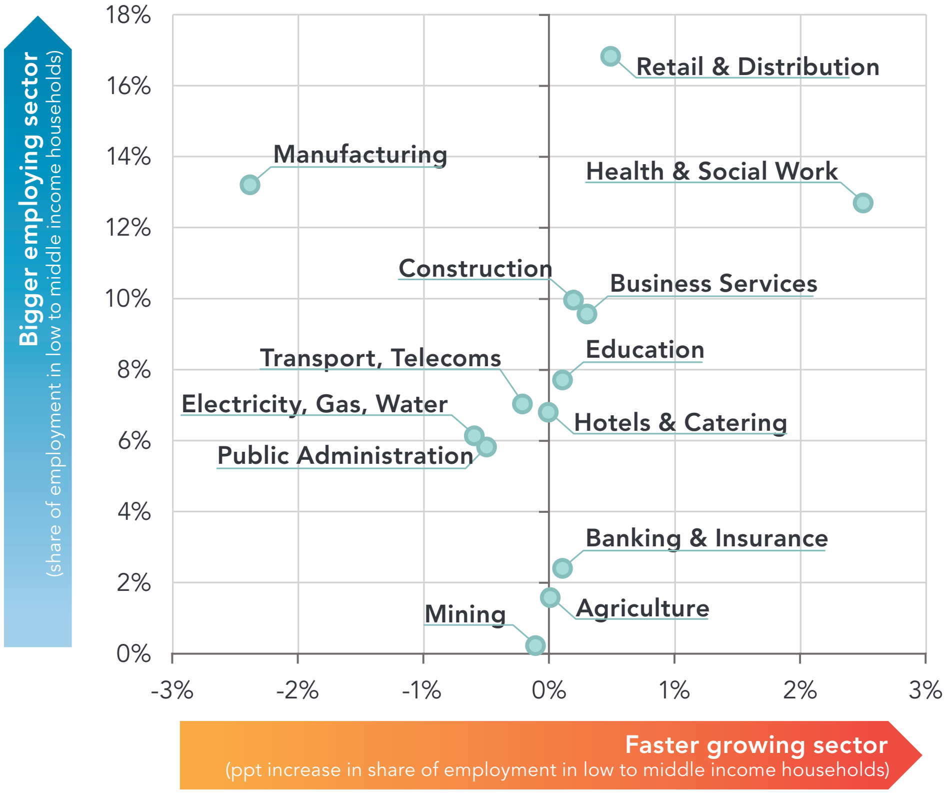
Figure 7.2: Net change in employment by occupation, UK, 2010–2020, thousands of jobs



Source: IER and IFS, The Impact of the UK's Changing Employment Structure on Low to Middle Income Households in 2020, based on central projections from Wilson, R. A. and Homenidou, K., (2012), Working Futures 2010–2020: Main Report

Figure 7.3 demonstrates how this will impact on the sectors that are important for low to middle income households. From top to bottom it shows which industries are the biggest employers of people in low to middle income households. From left to right it shows which industries are growing fastest in terms of their share of employment in low to middle income households. Industries in the top right quadrant – in particular retail and social care – are large and of growing importance. These are both generally low paying sectors. Meanwhile manufacturing is set for ongoing declines. While business services is set to grow quickly overall, relatively few of these jobs are set to be captured by low to middle income households.

Figure 7.3: Share of employment in low to middle income households in 2008-09 against growth in employment in that sector, UK, 2008-09 to 2020-21



Source: Resolution Foundation analysis; data from IER and IFS

The projections also show that the overall skills profile of the workforce is set to improve, but that large gaps will persist between the low to middle income group and those on higher incomes. In our baseline scenario, of those in employment in the low to middle income group in 2020, 30 per cent will have a degree level qualification or better compared with 59 per cent of those in higher income households. For adults living on low to middle incomes, low and intermediate skills will continue to dominate, with 42 per cent set to have a Level 1 or 2 qualification and 15 per cent a Level 3 qualification. Given the wide gaps in wage returns between these different qualification levels, this will have an important impact on the distribution of earnings and, therefore, income growth in the coming years.

Structural changes in the labour market will raise incomes but also inequality

How far does the changing structure of employment explain the patterns we see? While the forecast pattern of job creation is good for most households, it is also set to significantly increase inequality, boosting incomes at the top far more than lower down. Thus most people are benefiting to some degree from the good jobs being created in our economy but higher income households capture far more of the gains, widening the gap between themselves and those on lower incomes. Unlike in the 1990s and 2000s, state support is accentuating this weak and unequal growth in incomes. The average share of income that low to middle income households receive from the state falls from just over 20 per cent in 2008-09 to just over 16 per cent in 2020-21.

7d Future trends in the cost of living

The discussion above gives a sense of the likely scale and shape of income growth over the next decade. Throughout, incomes are controlled for inflation and so show real changes over time. Yet we also learned in Chapter 3 that inflation matters greatly, not just in terms of its headline rate (CPI or RPI) but also its profile between different categories of goods and services. When the balance of inflation is tilted towards essential goods, even a benign environment for average inflation can hurt lower income households whose members spend a bigger share of their income on essentials.

Trends in prices will be crucial for living standards in the coming years

Such changes have had significant impacts in recent years as the cost of essentials has soared. These trends are potentially important since they are the most direct way that people notice weak income growth. When slow nominal income growth pushes people up against spiking prices, it is the spikes they notice first. This is why public discussion about living standards plays out through concern about the prices of essentials like fuel, childcare and transport more than through concern about incomes or earnings. Demand for action to control prices in all of these areas is likely to rise to new heights as the squeeze on incomes enters its second decade.

If recent trends continue, low to middle income households will fall further behind

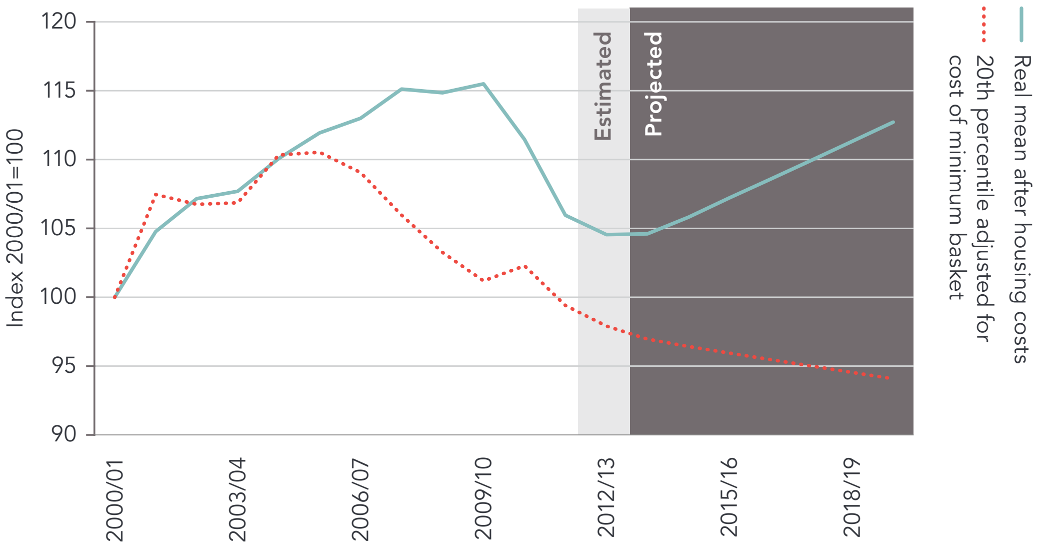
Projecting inflation is one of the most treacherous areas of economic forecasting and we can do no more than give a rough sense of the scale of the impact if recent price dynamics continued. In Figure 7.3, the solid line shows likely trends in average household income adjusted for CPI, with projections forward on the basis of forecasts from the OBR. (See Note 7.2 for detail on underlying assumptions.) The dotted line shows real household income at the 20th percentile adjusted by a measure based on the price of a basket of essential goods. These projections are purely stylistic; they put to one side all changes in the labour market discussed above and assume a relatively benign labour market.

The result of taking the rising cost of essentials into account is that income at the 20th percentile erodes in value over the next decade, ending lower in 2020 than it was in 2000. If strong growth in the price of essentials became the norm, low income households would be less able to afford a basic basket of goods in 2020 than they were 20 years earlier. This scenario is not comparable with the forecasts above but it gives us a different take on the squeeze in the coming decade, showing the great importance of relative prices.

Note 7.2: Assumptions behind the inflation modelling

The striking results set out in Figure 7.3 are based on a number of highly uncertain but not improbable assumptions.[9] We assume that that the cost of essential goods continues to outpace general inflation by the same amount it has in the past five years and that incomes grow at the rate projected for earnings by the OBR in November 2011. This is an optimistic assumption given that cuts in state support mean incomes will grow significantly slower than earnings and inflation, and appears even more optimistic now that OBR projections have been downgraded. Finally, income growth for households at the 20th percentile is weighted to account for the fact that their benefit and tax credit income will only grow at the rate of CPI inflation.

Figure 7.3: Inflation adjusted incomes under a scenario in which the price of essential goods continues to outpace average inflation; average income adjusted for average CPI inflation (solid line) and incomes at the 20th percentile adjusted for changes in the price of a basket of essential goods (dashed line)



Notes: Assumes cost of essential goods outpaces general inflation by the same amount as from 2005 to 2010; income growth at rate of OBR projections, weighted for households at the 20th percentile to account for slower CPI growth in benefit income. Basket of essentials is the Minimum Income Standard basket as defined in Hirsch, Plunkett and Beckhelling, Priced Out. Source: Hirsch, Plunkett and Beckhelling, Priced Out.

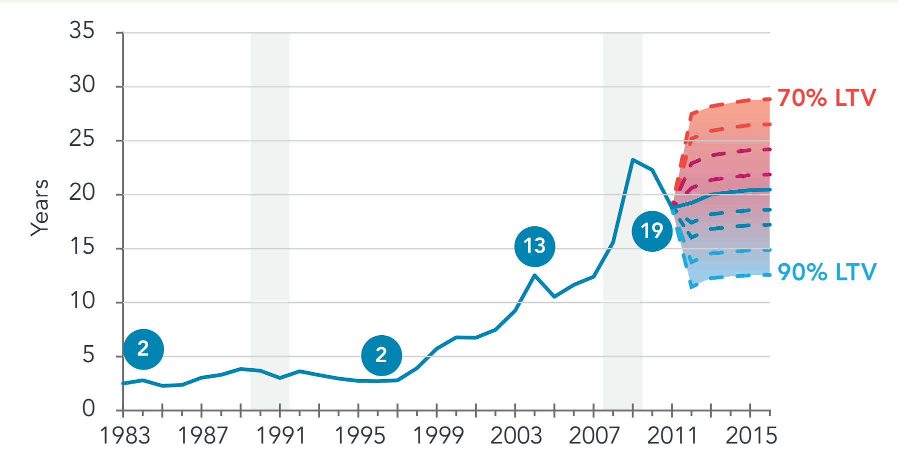
[9] For full details of this work see Hirsch, Plunkett and Beckhelling, Priced Out.

Price rises in some of these key goods have already eased in the past year relative to average inflation. Nonetheless, this analysis reminds us not to neglect the composition of inflation, which can have big distributional effects even when headline figures appear to be benign. If we consider the forces that sit behind recent price dynamics – from the growing spending power of China's vast middle class to the growing extraction costs of natural resources – it is not implausible that pressure on the cost of essential goods will continue into the medium term.[10]

In depth 7.1: Is the dream of home ownership over?

An income squeeze of the duration and intensity suggested by our projections will have an impact across a broad range of domains. From the ability to pay energy bills to pressures from transport or childcare costs, life on a low to middle income in Britain is set to get much harder. One of the most salient effects is likely to take place in our housing market, as weak income growth pushes home ownership beyond the reach of those on low to middle incomes, and particularly younger first-time buyers. Already the number of years it takes to save for a deposit has soared to historic highs.

Figure 7.4: Number of years required to save typical first-time buyer deposit by the average low-to-middle income household: UK 1983 -2016



Notes: Deposit costs are calculated by applying applying median first-time buyer LTVs recorded in each year to mix-adjusted average (mean) first-time buyer house prices. An appropriate stamp duty charge is then added to the deposit requirement. Savings are assumed to be equivalent to either 5 per cent or 10 per cent of average annual LMI disposable incomes. These savings receive a rate of return equivalent to three-quarters of the base rate (taken as a five-year average). The lines show the number of years' saving required to meet the deposit and stamp duty requirements. Bands show projections on basis of future LTVs in the range 70%-90%. Average low-to-middle income household disposable income based on ONS definition: see Chapter 7. House price projections for 2011-2015 are based on UK level projections from the OBR. Low-to-middle income household income projections follow the same methodology as those presented in Chart 6.4. Future deposit rates are based on Bank of England projections for the base rate. Sources: RF analysis of ONS, The effect of taxes and benefits on household incomes; Lloyds Banking Group, Halifax House Price Index, Historical data FTB (ANN); CML, Table ML2; OBR, Economic and fiscal outlook, November 2011; Bank of England, Inflation Report, November 2011

New research for the Commission has examined how the tenure mix in the UK housing market is likely to change as a result of different strengths of economic recovery.[11] It shows that the path to home ownership for the low to middle income group is fragile. Under a stagnant growth scenario (in which moderate real income growth only takes hold by 2018, alongside improvements in the availability of mortgage finance and in the development of new housing), 18 per cent of households in England will live in the private rented sector by 2025 and 33 per cent will own with a mortgage. Under an even weaker economic scenario in which strong real income growth does not return until 2025, private renting will reach 22 per cent by 2025. Mortgaged home ownership among low to middle income families will fall consistently over the next decade as more and more families are forced into the private rented sector.

Given the importance of housing to labour mobility, ensuring that supply can respond to projected patterns of demand will be very important not just to living standards but also to economic growth. Even so, it seems likely that under any reasonable scenario many more low to middle income households will find themselves raising children in rented accommodation. This will necessitate a change in the quality and security that the rented sector is able to offer.

7e Conclusion

The UK now faces an extremely challenging decade for living standards, even on positive assumptions about growth and recovery. Incomes are set to decline, on average, for low to middle income households by between 3 per cent (for households at the top of the group) and 15 per cent (for households at the bottom). The picture is somewhat better for higher income households with the result that income inequality is set to increase. The outlook for employment income growth is bleak, with earnings declining across much of the distribution over this period. Patterns of inflation will have a heavy bearing on whether these overall trends are even worse, or slightly better, for lower income households.

These are stark conclusions, but they *are* avoidable. In the next chapter we test the sensitivity of these results, looking at different trends in wage inequality. We then look more specifically at the difference that specific changes could make.

[10] See, for example, OECD and FAO, (2012), *Agricultural Outlook 2012-2021*, OECD and FAO, Paris. See also Bain & Company, Inc., (2011), *The Great Eight: Trillion-dollar growth trends to 2020*, which forecasts that "volatility and commodity price inflation will intensify as… key inputs are increasingly linked by new uses and as demand rises". [11] Whitehead, C. et al., (2012), *Housing in Transition: Understanding the dynamics of tenure change*, Resolution Foundation and Shelter, London.