{Section 3} Looking forward: Living standards to 2020

Chapter 8
Making a difference

Chapter summary

• Higher or lower wage inequality would significantly worsen or improve the prospects for low to middle income households. Yet income inequality is set to increase even if wage inequality falls.

• Ambitious action to raise female employment, improve skills in the bottom half of the workforce and reduce low pay make a difference but the effect of each is modest.

• However, if such changes are achieved together, outcomes materially improve, with a middle income household better off by £1,600 in 2020 compared with the baseline results set out in Chapter 7.

• For the lowest income households, it is possible to mitigate income declines but achieving income growth looks extremely difficult without direct state support.

The projections set out in the previous chapter suggest a bleak decade for households in the bottom half of the workforce, but they should not foster fatalism. Other countries – and Britain in the past – have struck upon recipes for shared growth.

With the aid of modelling, we can be more specific about the potential scale of impact that plausible interventions could make in the UK. First, we look briefly at how sensitive the outcomes in Chapter 7 are to changes in earnings inequality. Then we look at three additional scenarios for the UK labour market in 2020 which we would expect to deliver stronger earnings and income growth for low to middle income households:

• *increasing the female employment rate;*
• *boosting the quantity and quality of skills in the bottom half;*
• *acheiving stronger wage growth at the bottom (see Note 8.1 for further detail on scenarios).*

8a Testing the forecasts – good and bad worlds

Our discussion in Chapter 7 focused on how changes in the structure of the labour market are likely to feed through into living standards. As discussed, these results are based on the assumption that wage growth will be the same across different occupations. This is optimistic. In this section we look at two extreme scenarios for wage growth to understand the range of outcomes we could see over the next decade.

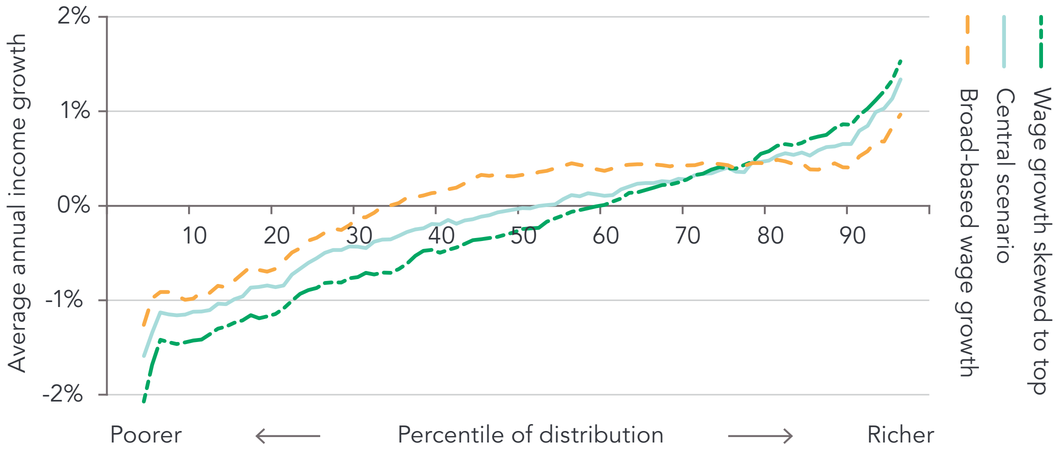
First, we look at what would happen if wage growth were highly skewed towards the top. To do so, we calculate the impact of a repeat in the kind of uneven wage growth seen in the UK from 1975 to 1985, the decade in recent UK history in which there was the single greatest rise in inequality.[1] Next, we look a scenario of very broad-based wage growth in which those in the bottom half do best. For this scenario, there is no benchmark in recent history because no recent period (for which there is detailed data) has seen big falls in inequality, although there were small falls in parts of the distribution in the last decade. We have therefore applied a fall in inequality of a scale that, though not based on historical experience, is the most that seems plausible in the space of a decade.[2]

As would be expected, increasing inequality in earnings feeds through into incomes, with a greater share of income growth going to the top. Stronger earnings growth in the bottom half of the workforce has the opposite effect. Under the scenario of falling earnings inequality, declines among low to middle income households roughly halve compared with the baseline, with average annual income growth going from -0.4 per cent to -0.2 per cent.

However, an important lesson from these results is that even an egalitarian pattern of wage growth struggles to counteract income inequality: even if the pay of cleaners or hotel attendants rises faster than the pay of managers and consultants over a sustained period of time, something that has not occurred in the UK for almost half a century, inequality in household incomes still rises. Figure 8.1 shows the impact of less or more equal wage growth in net household income for the decade from 2011-12.

[1]It is important to be clear that this is a static model and that does not tell us about any dynamic effects that some have claimed flow from inequality, from sharpened incentives to instability. [2] In practice, we have taken a decade in which there was modest growth in inequality (the 1990s) and have reversed this growth to create a fall in inequality on the same scale.

Figure 8.1: Average annual real growth in net household income among non-pensioner population in the UK between 2011-12 and 2020-21 under baseline scenario and rising and falling wage inequality, real terms (2008-09 prices)



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

Even with broad-based wage growth, most low to middle income households will be worse off in 2020 than in 2010.

This is partly because of the strength of the underlying dynamics that are driving inequality in household incomes, particularly structural changes in the UK jobs market. It also reflects the fact that changes in the earnings distribution do not translate directly into changes in household incomes. Households on the lowest incomes are more likely to be workless, and so see no upside from changes in earnings, while lower income households in general are more likely to have only one person in work rather than two in higher income households.

State support also explains these outcomes in two important ways. Because state support is due to rise much more slowly than earnings, households that receive more support from the state are set to fall behind *even if their earnings rise just as quickly as those above them*. In addition, as we saw in Chapter 6, households in the bottom half face high withdrawal rates. This means that they receive relatively little – on average around 55 per cent to 65 per cent – of any increase in earnings. This poses a major challenge to households on low and modest incomes as Britain moves to a world in which most gains in living standards need to come from employment income; households across the bottom half will be running uphill.

8b Changing path – skills, female employment and low pay

Next we look at whether there could be a better path for living standards, quantifying the impact that major improvements in a number of areas could have on household incomes from now to 2020.

First, we look at the effect on earnings and incomes of raising the quantity of basic skills and the quality and quantity of intermediate skills among the UK workforce. This gives a sense of the impact that might be achieved by enabling workers in the bottom half to get a better share of the new, good jobs that the UK economy is creating. This scenario reduces the proportion of workers with no qualifications, improves forecast progress on Level 3 qualifications and increases wage returns by comparison to the baseline scenario. (See Note 8.1 for further details on the scenarios.)

Second, we raise the level of female employment, lifting the performance of the UK to leading international benchmarks. Third, we imitate what might happen if the floor under wages were successfully raised, modelling very strong wage growth in the bottom 10 per cent of pay, rippling through to smaller improvements for those on modest pay. This hints at the outcome that might be expected from a successful strategy to combat low pay and enable a higher minimum wage. All three scenarios show how these changes would play out across the household income distribution between now and 2020.

In all cases, the scenarios are extremely broad brush. Nor do they capture dynamic effects. Raising skills and boosting female employment are both likely to have substantial positive knock-on effects and it is likely that we are therefore understating the results. The purpose of the scenarios is to give a sense of the scale of impact that ambitious changes can deliver and to help us understand how better pay or higher employment feed through into household income growth. This informs our later policy discussion.

Note 8.1: Further detail on the scenarios

The scenarios in this chapter draw lessons from other countries and from UK history about the conditions that can deliver shared growth. In each case we have tried to settle on a level of change that is highly ambitious but plausible over the course of a decade. The scenarios model:

- *Higher female employment*: This scenario raises the UK female employment rate to the average level among better performing countries in the OECD. This equates to an overall female employment to population ratio that is 4.8 per cent higher in 2020 than under the baseline.
- *Improved skills*: This scenario models a 50 per cent faster reduction in the proportion of people with no qualifications (compared with the baseline). It also increases by around 4 percentage points the share of people moving from Level 2 to Level 3 qualifications. It maintains current wage returns among Level 1 and 2 qualifications relative to mean earnings (returns which are expected to fall under the baseline).
- *Boosting low wages*: This scenario repeats the pattern of wage growth that was seen in the strongest decade for the UK minimum wage – the 10 years around the introduction of the National Minimum Wage from 1996 to 2006.[3]

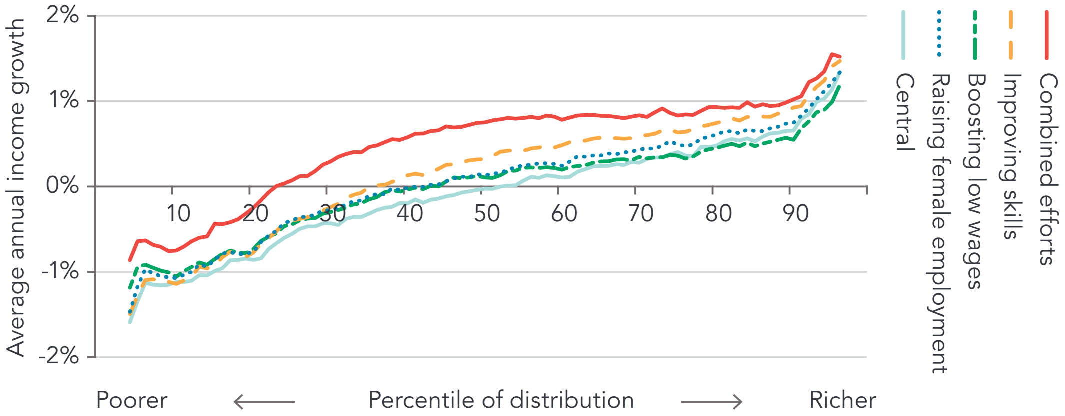
The final combined scenario runs these scenarios together, including any multiplying effects that they may have (for example, by increasing female employment *and* increasing the pay of low-paid female employees).

Ambitious action in individual areas only makes a modest difference

As Figure 8.2 shows, even fairly ambitious action in an individual area struggles to boost the incomes of ordinary working households significantly. In part this is because the changes tested in these scenarios are relatively broad in scope rather than targeted, For example we have improved intermediate skills universally rather than focusing support solely on those on low incomes. In practice, targeting is quite hard to achieve through policies aimed at boosting earnings. Policies focused on low earners or the low skilled are always likely to have a diffuse impact across the distribution of household income because many low-earning or low-skilled people live in middle or higher income households. In the absence of government cash transfers – which can be tightly targeted at certain income groups – it is much harder to boost incomes in the bottom half through employment income.

[3] Growth in pay at the bottom of the distribution was seen before the NMW was introduced in 1999.

Figure 8.2: Average annual growth in net household income among non-pensioner population in the UK between 2011-12 and 2020-21 under baseline scenario and successful interventions, real terms (2008-09 prices)



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

But combined action across a number of fronts can have a big impact

There is a more optimistic reading of Figure 8.2. By combining the three scenarios together we see that simultaneous action in a range of areas can have a big effect. The overall difference between the "combined" scenario and our baseline scenario is around 0.8 percentage points higher average annual income growth for the low to middle income group. Importantly, these figures relate to an annual average for every year from 2011-12 to 2020-21 and so have large cumulative effects. By 2020, this would translate into roughly an extra £1,600 a year for a typical middle income household.

The scale of this effect is partly explained by the fact that some of these changes interact with each other: they are more than the sum of their parts. For example, strong growth in wages at the bottom disproportionately helps female workers and therefore has a bigger impact when female employment is also strong. Again, it is likely that by missing the more dynamic aspects of these interactions we are understating the overall effect.