# The perfect storm

The current focus of UK political and policy debate is quite rightly securing a recovery. But the UK economy also faces a longer standing, structural problem in relation to living standards[1]

Even in the boom years leading up to 2008, incomes were faltering for a broad swath of working households. GDP growth was strong, employment was high and inflation was moderate. Yet from 2003 to 2008 median wages flat-lined, average disposable incomes fell in every English region outside London and spikes in the prices of essential goods squeezed family budgets.

What happened in these years broke the familiar rhythm of growth and gain for ordinary working households. For most of the 20th century, living standards fell in periodic recessions and, for all except the poorest, rose again solidly in times of growth. But from 2003, millions of people on low to middle incomes – not the very poorest and overwhelmingly in work – found life unexpectedly hard during years of supposed prosperity. Then they were hit by the financial crisis and the worst recession in modern times, a blow from which they are still struggling to recover.

This breaks the familiar rhythm of growth and gain for ordinary working households

This pre-crisis stagnation in living standards for much of working Britain echoed much longer running trends elsewhere. In the US, typical wages have been stagnant for a generation. In Germany and Canada they have barely risen for 10 and 20 years respectively.

In the UK, the pre-crisis years were a perfect storm. Wages stagnated because the share of national income going to labour fell as profits rose, emulating longer running falls in other countries. At the same time, rising pension costs and National Insurance Contributions (NICs) – linked partly to policy choices but also to the demands of an ageing society – squeezed the share of compensation that finally reached pay packets. The changing nature of inflation accentuated the problem for lower income households as prices for staple foods and fuel soared, meaning that official measures of inflation understated the pressures they experienced. By the time the crisis struck, these shifts in the nature of inflation meant that low to middle income households were typically paying a £400 premium on their annual shopping bills compared with those on higher incomes.

# Storing up trouble

These relatively recent developments are concerning. But they come on the back of more established trends that don't bode well in terms of the prospects for shared prosperity over the next generation. Low to middle income households get better off over time for three reasons: hourly wages grow, employment or working hours go up, or state support becomes more generous. Even before the financial crisis struck these motors of rising living standards had faltered.

**Weak wages in the bottom half**

As the result of a mixture of historical circumstance, policy choices, and global trends, the UK has arrived at an economic model in which a relatively small proportion of overall GDP growth trickles down to the wages of the bottom half of the working population. The UK's direction of travel is not unique; over the last generation, inequality has risen across the developed world as new technologies have boosted demand for skilled workers and labour market institutions like collective bargaining have eroded. But the UK stands out in important ways. Only 12 pence of every pound of UK GDP now goes to wages in the bottom half, down 25 per cent in the last three decades.

Meanwhile, low pay is pervasive. One in five workers in Britain is paid below two-thirds of the median wage (below £7.49 an hour or £13,600 a year for full-time work) compared with fewer than one in 10 in some other European countries. The UK pays a high price for this scale of low pay. This price is paid most directly by the individuals and families reliant on low pay. But the taxpayer is affected too - by as much £4 billion a year through in-work cash transfers. This too is partly a global phenomenon. But while insecure work, for instance in personal and caring services, has grown across the developed world, the UK labour market has created worse paying, lower status versions of these jobs than most other advanced economies.

A key reason for these outcomes is that the UK has an institutional setup that encourages employers, particularly in some sectors, to seek low-paid, low-skilled routes to business success. Employers are pulled in this direction by three characteristics of the UK labour market in particular: a chronic lack of skills in the bottom half of the UK workforce; a lack of structure in the jobs market, both for employers trying to make long-term plans about skills and for young people making the transition from education into work; and a lack of counterveiling pressure for employers to pay above the bare minimum, even when they can afford to.

The whole population pays a price for this economic model. But the costs to individuals fall particularly heavily on people who don't go to university and have few formal qualifications, who find themselves struggling – more than they would in many other countries – to progress or secure a decent standard of living. The costs are particularly high for employees in the UK's large and

[1] Much of the analysis outlined in this report applies to the UK as a whole. In relation to policy, some areas of government responsibility extend across England, Northern Ireland, Scotland and Wales while others are devolved, in differing settlements, to the administrations in Northern Ireland, Scotland and Wales. While the broad arguments of the report are likely to apply across the UK, we would anticipate that the Devolved Administrations would tailor their approaches to meet the specific needs of their countries.

growing, non-traded, low status service sectors, above all for those working part-time. More often than not this means women, who in the UK face a higher risk of low pay than in most other advanced economies.

**Changing patterns of employment**

For a time the impact of these pressures were, to some degree, offset by trends in employment. In the latter half of the 20th century, female employment soared. Employment income from women provided more than a quarter of income growth in low to middle income households from 1968 to 2008 while men's work provided less than a tenth. Second earners came to provide a bigger share of household income. Meanwhile, as employment among older workers became increasingly important, the UK began to reverse a long-term fall in the employment rates of this crucial group.

Far from softening the malign trends in wages and employment, state support is now going to amplify them

Now the rise of female employment has stalled, increasing just 1 percentage point in each of the last two decades at the same time as male employment has continued to decline. Such trends are not facts of life in mature economies; the UK under-performs. The UK ranks 15th in the Organisation for Economic Co-operation and Development (OECD) on female employment, largely because of underperformance among women in their early 30s, who are most likely to have dependent children; as well as poor performance among those over 50. Compared with the best performing economies, around 1 million women are missing from UK workplace.

For women with children, the UK's underperformance stems from a toxic mixture of unusually high childcare costs, a lack of high quality part-time work and a poorly designed tax and benefit system. Together these factors mean that work simply doesn't pay for many women in modern Britain. A full-time second earner with two young children in a typical middle income household on a salary of £19,550 keeps just £1,060 a year after childcare costs, taxes and lost benefits – just £20 a week.

Meanwhile, employment rates among older men and women in other countries continue to outperform those in the UK, despite our recent improvements. The UK is a middling performer internationally but lags better performing countries by big margins, particularly for older men. This underperformance arises partly from the UK's particular pattern of deindustrialisation. But policy choices also matter. Financial incentives affect older workers strongly and in the UK they are weak. Meanwhile, patchy and inadequate social care prevents many over 55s from working, as they care for elderly parents or partners.

The UK's under-performance on all of these fronts is worsened by the calibre of part-time work. In many other countries part-time work offers parents with dependent age children, and older workers, flexibility and a satisfactory way to achieve work-life balance. In the UK, part-time work is still often synonymous with insecurity and low pay.

**Declining state support**

Together these trends in wages and employment have left the state providing a large portion of recent income growth in low to middle income households, particularly through tax credits. Now fiscal constraints severely limit this source of rising living standards. These constraints stretch well beyond current plans for deficit reduction as longer term pressures from an ageing society start to bite. The result is that, far from softening the blow from stagnant wages and employment, the state is set to add to that pressure as support declines, leaving households on low and middle incomes to fall behind.

Worse, because such large numbers of households now receive substantial means-tested support, many low income households take home only around 55 to 65 pence of every extra £1 of earned income. As income from employment becomes the only significant source of rising incomes in the coming years, these households will be running up a steep hill.

# The big choice

Together, these trends now confront us with a stark choice. On the UK's current path, come 2020, household incomes across the bottom half of the working-age population look likely to be lower than they are today. A typical low income household in 2020 is set to have an income 15 per cent lower than an equivalent household in 2008, a return to income levels not seen since 1993. A typical middle income household in 2020 is set to have an income 3 per cent below that of 2008, a return to income levels last seen in 2001. These declines, representing between two and three decades of missed income growth, do not arise from a doomsday scenario. They are premised on GDP growth averaging 1.9 per cent from 2010 to 2015 – more optimistic than many current forecasts – and 2.5 per cent from 2015 to 2020.

Declining living standards are not a fact of life in all maturing economies

Britain has not seen declines of such duration and depth – particularly during a period of growth – in living memory. Although they now look far from unlikely, they could still be avoidable. There is, of course, always much uncertainty about future projections. But alternative choices could be made. Were the UK to boost skills in the bottom half of the workforce to an ambitious but plausible degree, raise female employment so that it matches leading international benchmarks, and repeat the scale of past successes in combating low pay, the combined effect on household incomes could be highly significant. In a scenario that combines success on each of these fronts, a typical middle income household looks set to have an income roughly £1,600 higher in 2020 than on the UK's current path, a 7 per cent improvement that turns steady decline into gradual progress.

Achieving broader-based growth of this kind will be hard but not impossible. Faltering living standards are not a fact of life in maturing economies. Other countries, from the Netherlands' record of fast-growing employment among women in the past two decades, to the US's tight labour market of the mid to late 1990s, as well as the UK's own experience in the late 1990s, have struck upon recipes for shared growth. The key lesson is the need to not only secure steady growth but also to shape that growth so that it benefits the broad majority. Indeed, headline GDP growth figures have not been a good predictor of how well low to middle income households have fared in mature economies over the last generation. Growth is obviously essential, but not all growth is shared.

# A new approach

In the environment the UK is now entering, this will require quite a different approach to strategies pursued in the past. While in-work cash transfers for low income working households are now an important fact of life in mature economies as diverse as the US and Sweden, the central task is to rebalance income growth in low to middle income households away from state support towards employment income. This is a massive challenge. It will be exceptionally hard to achieve this while avoiding sustained year on year declines in living standards for a broad swath of the working population, particularly those with children. The only way to square this circle is to be far more active and ambitious in supporting growth in wages, employment and working hours in low to middle income households.

While the UK focuses on what children achieve by 16, other advanced economies have moved to focusing on outcomes by 18

**New ways to boost pay among the bottom half of earners**

In the case of wages, skills policy will be key, particularly in the way that it responds to today's labour market trends. Employment is now growing fast in top jobs, declining in middle-skilled jobs, and gradually growing in low skilled, low status service sector roles, effectively polarising the UK labour market. Skills policy alone cannot turn back tides like these. But the skills profile of a workforce can mitigate the impact that these structural trends have on wages and it may be able to slow them down – or at least avoid amplifying them, as the UK's weak performance on intermediate skills does at present. It can help ensure that the opportunities and rewards that will continue to arise in the jobs market will be shared more widely.

In practice this means two things. First, the UK must improve skills supply, above all for young people. With a growing proportion of good jobs coming from hi-skilled, knowledge sectors, it is vital that more young people who don't go to university are able to compete for these traditionally graduate-only roles. Improving the quantity and quality of intermediate skills is the defining skills challenge of this generation and the main route to more broadly shared prosperity. At the same time, it is increasingly untenable for the UK workforce to contain such a long tail of people without basic literacy and numeracy, leaving so many to languish in elementary service roles with little chance of progression.

As things stand, national debate about the UK's formal education system focuses on what children achieve by 16. Meanwhile other advanced economies have moved on to focus on outcomes by 18, leaving the UK behind. The government is about to raise the leaving age for education to 18 and yet there is little clarity about what this will achieve, or what children will be expected to learn. A higher leaving age presents a crucial opportunity to require all young people to study English and maths to age 18, ensuring that everyone leaves education with the basic abilities needed to function in a modern labour market. Longer term, the aim should be a standard leaving exam at 18 focused on increasing the proportion of young people who leave education with the skills they need to secure a strong footing in the jobs market, as well as university readiness for the growing numbers proceeding to higher education.

But there is now a broad consensus that, in a polarising labour market in which low skilled service roles are expanding, simply increasing skills supply is not enough. The second plank of 21st century skills policy must be action to boost demand for skills and, however gradually, to encourage more employers to seek higher skilled, higher paying routes to success. This is hard, slow work and ultimately comes down to institutional innovation. The end goal is that employers in the UK's major sectors work together, through powerful sector-based institutions, to identify skills gaps and to design structured routes into the sector for young people.

Government has a direct role in helping establish these institutions and they need real, practical powers, such as the remit to license occupations. Such institutions are particularly important for encouraging employers to invest in today's adult workforce, which makes up more than 80 percent of the workforce of 2020 and so will determine much of the skills profile of the future UK workforce. Of equal importance are more structured transitions for young people into work, particularly through high quality apprenticeships.

**More direct labour market policy**

The more active use of skills policy must be part of a broader strategy to reduce, over time, the UK's reliance on low pay. This also requires more direct labour market policy, particularly by strengthening and broadening the architecture of the National Minimum Wage. For too long UK policymakers have mistaken a minimum wage for a wider strategy to reduce low pay. They are not the same thing. Many sectors in the UK economy could, even now, afford to pay more to their lowest paid workers. The Low Pay Commission should be strengthened, tasked with taking a regular view on whether some sectors could sustain an "affordable wage" higher than the legal minimum; advising on blockages to securing a higher National Minimum Wage over time; and more generally on how to reduce the incidence of low pay. With the taxpayer footing the bill for low pay, not least through the billions spent on in-work cash benefits, government should be obliged to respond to such advice.

The state must do less of some things as it does more of others

The government should also foster innovation in local areas and from employers, as is happening in other countries, recognising that regulation won't provide all the answers. This may mean working with specific cities or sectors to trial new ways to help employers reduce their reliance on low pay. And the state should reinforce changing attitudes to pay by requiring companies to report the proportion of their workforce paid below thresholds like the Living Wage. Combating low pay and reducing its costs will require these kinds of actions across a broad range of fronts.

**New efforts to broaden employment**

Practical steps to bolster pay in the bottom half of the workforce must run alongside new efforts to boost employment in low to middle income households. Right now this means emergency steps to reduce unemployment, particularly among the young. Longer term it means both government and employers adapting to the changing nature of the UK workforce.

The UK needs pro-employment public services. Over the last decade or so, much progress has been made building a system of childcare. But there is still a long way to go before the childcare in the UK supports a proper balance between higher employment levels and good quality care. This is in part because early progress on childcare focused almost exclusively on child development. This was a good first step but it meant big shortcomings in relation to the objective of supporting parental employment. Today's 15 hours of free care for three and four year olds (and some two year olds) is simply not enough to cover the part-time jobs that many parents prefer. Nor does the current offer cover school holidays, when many parents struggle to find cover.

The free places should be extended to 25 hours a week, 47 weeks a year. The new hours should be charged at a regulated £1 an hour to make sure they are valued, and should be provided flexibly. The cost to government would be £2.2 billion. For parents, the result would be a childcare system in which the equivalent of three days a week of childcare, enough to cover many part-time jobs, would cost £10 a week. This would substantially improve work incentives, resulting in a significant boost to the take home pay of a typical middle income second earner.

Supporting employment in a world of fiscal constraints also requires a smarter tax and benefit system. Parents typically want to work more hours as their children get older so the government should target more cash support at those with younger children and give relatively less once children start school (this could be done in a revenue neutral way). This means front-loading the Child Tax Credit and its replacement, the Universal Credit. There would be a strong case for backing this reform with the gradual expansion of childcare during school holidays, provision which is currently woefully inadequate and a major barrier to full-time work for parents of older children.

Such steps run with social trends rather than against them. The same arguments apply to welfare reform. The government is about to move to a system for second earners premised on a single (normally male) breadwinner model of work. By withdrawing support from the first pound that second earners are paid, Universal Credit will put an effective tax rate of 65 per cent on some of the lowest paid women in the UK. Second earners should keep more of their pay. We suggest that they should be allowed to earn the same amount as the first earner (£1,920) before support is withdrawn, at a cost of £700 million. This would increase the share of pay that is actually taken home by a typical low-paid, part-time second earner from a third to a half.

These arguments also apply to encouraging employment among older workers. As society has aged, the government has moved towards an approach that relies mainly on new obligations, such as the higher state pension age, at the same time as existing entitlements are preserved. Our view is that a different settlement with those over 50 is needed. As part of this the government should finally put social care on a sustainable footing by implementing the reforms proposed by the Dilnot

Commission. More help should also be given with barriers to work, from retraining to tailored job search. And, as with parents, the tax and benefit system needs to do more to encourage employment. For example, people become more responsive to financial incentives as they near retirement. In response, we support taxing older workers less, raising the annual threshold for employee NICs on the over 55s to £10,000 to promote continued working. Older workers present one of the great opportunities for raising living standards in the coming decades.

In return, the older generation, largely spared from fiscal consolidation, would have to see a change in some of its tax and benefit entitlements. In particular, the prevailing view of the Commission is that government should means-test universal non-pension benefits, raising £1.4 billion, though some would prefer a different balance of revenue, raising relatively more by restricting pension tax relief (see below). Likewise, National Insurance payments should be extended beyond the State Pension Age (SPA), raising around £800 million per year.

**Funding a new settlement**

All of these choices are limited by fiscal constraints. This requires honesty about the priorities we choose. Every costing we provide for our recommendations is conservative, not banking a penny from the likely upsides such as increased tax revenues from higher female employment. Even so, we have sought to identify revenue sources commensurate with the new priorities identified in this report. This is because, while we have not sought a common position on deficit reduction, our view is clear: whatever one's position on the deficit, there are things that can be done to alter the trajectory of living standards.

This means that the state must do less of some things as it does more of others. One thing it should do less of is giving generous pension tax reliefs to the very wealthy. The lifetime allowance for pension contributions should be reduced from £1.5 million to £1 million, saving between £1bn and £1.5bn (the higher figure being more likely) – money better spent on making childcare highly affordable for working parents.

But as we have seen, the role of the tax and benefit system is about more than just moving money around. When resources are tight, both households and government can afford flawed and regressive taxes less than ever. Perhaps the most egregious of these is Council Tax, falling squarely on low to middle income households, resulting in a bill that eats up 5 per cent of disposable income on average and that rose 67 per cent during the 2000s. We propose that several new Council Tax bands for higher value properties should be added to pay for a cut in rates for lower value homes.

# Conclusion

The road to shared growth will be paved with practical steps like these, boosting wages and employment while focusing relentlessly on material living standards for low to middle income households. This does nothing to diminish the urgency of securing a recovery. Without sustained growth, rising productivity and growing employment we will get nowhere.

But while benign macroeconomic conditions provide the potential for widespread prosperity, they may not be enough to guarantee it. All too often today, loud arguments about securing a recovery betray the sanguine view that steady growth is sufficient. The evidence we have studied suggests that shared growth in 21st-century Britain will not emerge by accident. But it also suggests that the right steps, taken boldly enough, can help to build it.