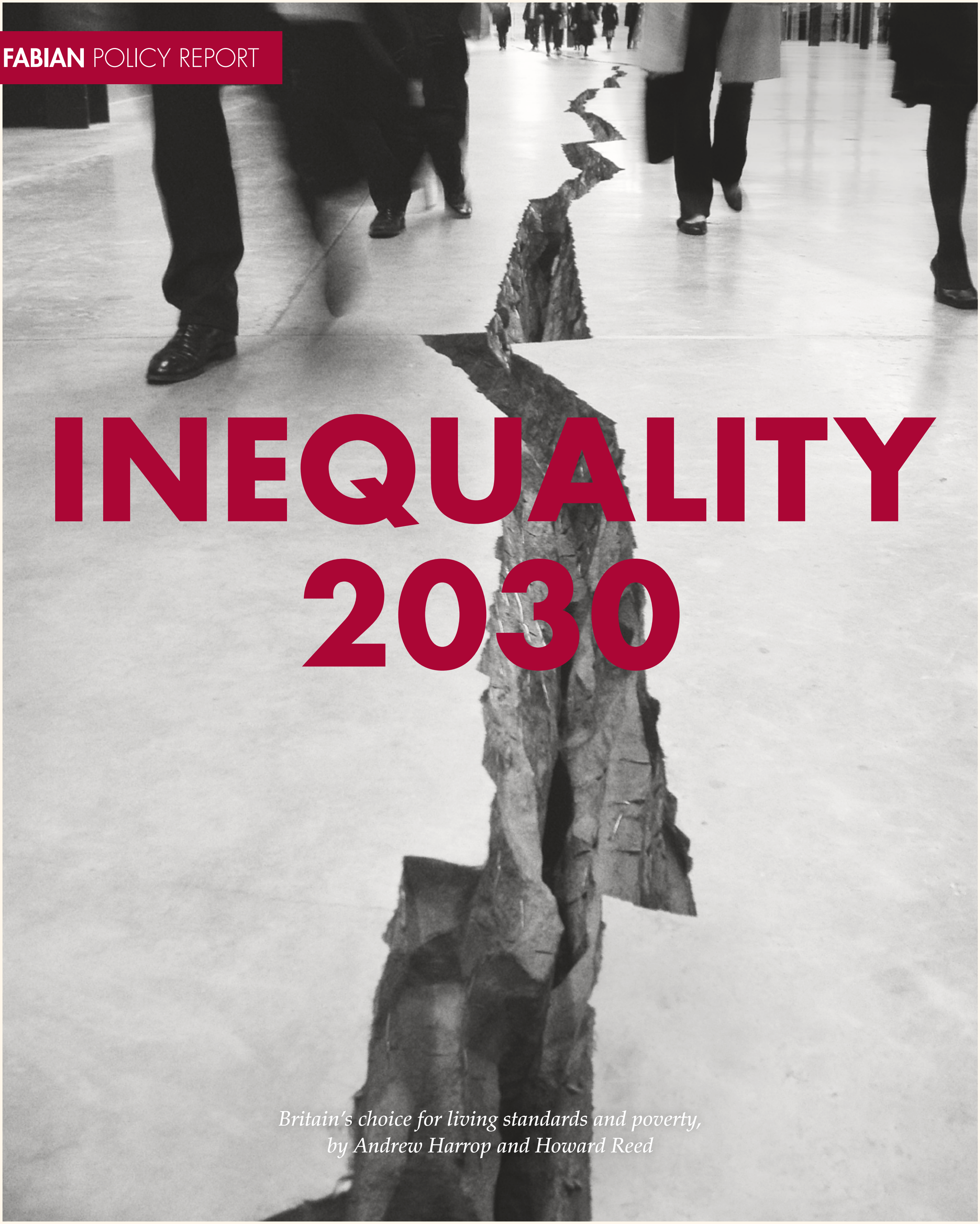
FABIAN POLICY REPORT



INEQUALITY 2030

Britain's choice for living standards and poverty,
by Andrew Harrop and Howard Reed

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SUMMARY

Inequality 2030

This report takes a long view of living standards and economic inequality, looking over a timeframe of 15 years. Its focus is on the incomes of low and middle income households, which means looking at both poverty and at inequality (including the gap between the middle and the top). It reports on new quantitative modelling, based on official projections, first examining the prospects for inequality and poverty under current policies; and then assessing the extent to which market reforms could deliver better outcomes.

The research shows that in 2030 living standards and the extent of inequality will be determined by political choices rather than by unstoppable economic forces. The report presents a plausible and affordable strategy for significantly improving living standards and reducing poverty. So this study restores hope.

Economic inequality will be higher in 2030 than today, unless we act

Unless the next government takes dramatic action, the UK will be much less equal in 2030 than it is today: the living standards of low income families will stagnate; middle income families will not share in rising prosperity; and inequality and poverty will grow worse. Our projection is that:

- Between 2015 and 2030 an extra 3.6 million people will fall into poverty, including 1.2 million children.
- The real disposable income of middle income households will rise by 9 per cent over the next 15 years; for low income households the figure will be just 2 per cent (GDP per capita will rise by 32 per cent over the period).
- The incomes of high income households will rise 11 times faster than the incomes of low income households.
- High earnings will rise twice as fast as low earnings.

These projections could even be optimistic: they are based on Office for Budget Responsibility (OBR) assumptions for the economy, which may be too positive; and they also ignore the possibility of further social security cuts or tax changes in the 2015 parliament.

There are two main causes of this rising poverty and income inequality – social security policies and growing earnings disparities. The first is more important with respect to the gap between the middle and the bottom (and therefore the incidence of poverty); the second is more important with respect to the gap between the middle and the top. Both are amenable to government intervention.

Some labour market reforms can directly slow the pace of rising inequality

'Predistribution' is a new word for an old idea – that inequality and poverty should first be tackled by reforming markets (for the purpose of this report, we mean the labour market, as our modelling does not consider the cost and quality of housing, goods and services).

One change to the labour market – achieving very high levels of employment – would have a noticeable impact on inequality and the living standards of low and middle income households. If, by 2030, the UK were to match the highest levels of employment in the developed world today, then poverty and inequality would still rise, but by less than we otherwise project. This rise in employment could only be achieved by significantly improving support and opportunities for parents, carers, disabled people and people in their 60s. With very high levels of employment, we project:

- *Household incomes* would rise slightly faster over the next 15 years. Real median net incomes would rise by 14 per cent, rather than 9 per cent as previously projected.
- *Poverty* would rise by a little less, but in 15 years' time there would still be 3.1 million more people in poverty than today, including 970,000 extra children.

Action to tackle low pay and reduce wage differentials would have a significant impact on earnings inequality, which is important for its own sake. But it would have a surprisingly small effect on living standards, income inequality and poverty, when measured in terms of net household incomes. With a radical package of reforms including a high minimum wage and widespread uptake of the living wage:

- *Earnings* for low paid workers would rise over the next 15 years by 49 per cent (in real terms) compared with 16 per cent without any intervention; median earnings would rise by 34 per cent instead of 26 per cent. The proportion of workers with low pay would be flat over the next 15 years, rather than rising.
- *Household incomes* for a median income household would rise by 13 per cent over the next 15 years.
- *Poverty* would be unchanged, compared to taking no action (since median as well as low incomes would be higher).

But the main benefit of predistribution is that it can pay for redistribution

Successful predistribution interventions will generate significant resources for the exchequer. If this money is recycled to low and middle income households, the proceeds of predistribution could have a much greater (indirect) effect on families than the original (direct) market effects. Ambitious but plausible reforms to bring about full employment, a high minimum wage and widespread take-up of the living wage would generate sufficient funds to make huge inroads into poverty in Britain.

To illustrate this point we show that:

- The proceeds of the minimum wage and living wage policies (£8bn combined) would cover most of the costs of doubling the real value of child benefit by 2030, lifting 900,000 people out of poverty.

- The proceeds of very high levels of employment (£30bn) would almost pay for benefits to be uprated by earnings not inflation, lifting 3.2 million people out of poverty.

If combined these interventions would lead to median household incomes rising more than twice as much as under our main projection; and there would be 2 million fewer people living in poverty in 2030. The incidence of child poverty would fall to 11 per cent, which is only just above the statutory target for 2020. This indicates that the child poverty target remains achievable and affordable, if the deadline for reaching it is extended.

If the economy underperforms the prospects for living standards are gloomy

Many people fear that over the next 15 years Britain's economy will not perform as well as in the past (official projections assume past trends will continue). So we examined the consequences of weak growth in productivity and employment. We found that weak employment growth would be bad for both living standards and inequality. In contrast, weak earnings growth would be bad for living standards – there would be virtually no improvement in real median incomes by 2030 – but would lead to poverty and inequality rising less.

> Unless the next government takes dramatic action, the UK will be much less equal in 2030 than it is today

Political action can still make a big difference. Even under pessimistic economic scenarios it will be possible to significantly increase living standards, reduce inequality and tackle poverty by introducing predistribution interventions and then recycling the proceeds into social security.

Recommendations

Although this report takes a 15-year outlook, action is essential in the next parliament in order to prevent inequality from rising. We recommend that the next government:

1. Recommits to the existing statutory child poverty targets, but extends the deadline for meeting them to 2030 – or earlier if possible.

2. Adopts a (non-statutory) set of goals and measures for monitoring the pursuit of sustainable prosperity and rising living standards.

3. Establishes a National Prosperity Commission to advise on strategies for achieving these goals for sustainable prosperity.

4. Aims for at least 80 per cent of adults below pension age to be in work by 2030 and acts to improve employment opportunities, support and incentives for mothers, disabled people and people in their 60s.

5. Raises the national minimum wage to 60 per cent of median earnings, ideally by 2020, with advice from the Low Pay Commission on implementation.

6. Legislates for all public sector jobs to pay the living wage; and forms a new partnership with business with the aim of halving the number of private sector jobs paid below the living wage.

7. Develops a radical cross-government strategy on pay and productivity, focusing on the middle of the labour market.

8. Rejects major cuts to benefits that would reduce the living standards of low and middle income households, following the 2015 election.

9. Institutes a 'Prosperity Fund' to redistribute to low and middle income households the proceeds arising each year from predistribution. The Office for Budget Responsibility and the proposed National Prosperity Commission should inform the fund's work.

10. Considers using the resources earmarked to the Prosperity Fund to pay for: (1) more generous uprating of all benefits and tax credits; (2) significant real increases to child benefit.

If successfully implemented, these recommendations will stop income inequality from rising and take the UK a long way towards achieving existing aspirations for the eradication of child poverty. After the general election the Fabian Society will publish research showing how to go even further.

INTRODUCTION

The UK has faced almost 10 years of falling living standards. Projections say poverty and inequality are on the rise.[1] And there is still a huge hole in the public finances which limits, for now, the scope for public spending to bring solutions. So it is easy to be gloomy. But too often politicians sound as if they no longer believe that government can rise to these challenges.

This report shows there is hope. It presents the findings of a quantitative assessment of the prospects for living standards and inequality over the coming years, using new modelling based on projections from the Office for Budget Responsibility (OBR) and the Office for National Statistics (ONS). The research shows that plausible and affordable government intervention can make a massive difference to the living standards of typical households and to future levels of poverty. But it also reveals that inaction will lead to stagnant living standards and a huge rise in poverty and inequality.

The implications of 15 years of flat incomes for low income families are hard to contemplate. Stagnant incomes would mean there would be no chance of reducing the number of families who are really struggling to make ends meet. Emergency food banks would move from being a temporary phenomenon of the economic crisis to an entrenched feature of British life. And people in rented accommodation would see their living standards fall the most, as an ever higher slice of their incomes would have to go towards housing costs before any other bills were paid. Although this report focuses on statistical analysis, no one should be under any illusions of the human consequences of our projections.

But political choices rather than unstoppable economic forces will determine the extent of inequality in 2030. We know there will be more years of very difficult fiscal decisions for whoever is elected in May 2015. But in this study we have raised our eyes to the horizon and asked what could be achieved over 15 years, from the start of the 2015–2020 parliament. Small purposeful steps, year after year, can transform the prospects for low and middle income families. So politicians must make the fight against inequality a priority from the very start of the new parliament.

Our projections suggest that plausible improvements to employment and to low earnings could generate sufficient sums to make huge strides towards the eradication of child poverty

The report presents a strategy for boosting living standards, preventing inequality from rising and making significant inroads into the incidence poverty. The strategy begins with 'predistribution' interventions to improve market outcomes. These include measures to significantly increase employment, tackle low pay and reduce wage differentials. Our modelling shows that these reforms are important but they are not enough: they slow the pace at which inequality will grow, but no more.

The second stage of our strategy is to *recycle* the considerable fiscal gains arising from predistribution back to low and mid income families. Higher employment and better pay equates to increased tax receipts and reduced benefit payments. We found that recycling these gains back to families has a far greater *indirect* effect on household incomes than the *direct* effects of predistribution on market outcomes. Indeed our projections suggest that plausible improvements to employment and to low earnings could generate sufficient sums to make huge strides towards the eradication of child poverty.

Our modelling also reveals the price of inaction by demonstrating how unchanged policy is not neutral in its effect. For without a change of course, inequality will rise. If this happens the living standards of people in the bottom half of the income distribution will stagnate, while in the top half they will increase. So government action is needed just to prevent the gap from widening, let alone to reduce poverty and inequality.

Worse still, the next parliament could bring policies that *accelerate* the rise of inequality. For example, the Conservative party has proposed £7bn in tax cuts (targeted overwhelmingly at the top half of the income distribution) and £12bn of social security cuts (which will mainly affect the bottom half of the distribution). The Liberal Democrats have proposed cutting £4bn from social security and Labour have not ruled cuts out. In our modelling we have not considered any of the changes proposed after 2015 – our projection is based on policy as it now stands. But if inaction is bad, a new package of regressive policy interventions would be a whole lot worse.

Our approach

The project's first aim was to 'umpire' an ongoing debate regarding the desirable balance between market interventions ('predistribution') and redistribution through tax and spending. In recent years many commentators have questioned why poverty pay should be subsidised by tax credits and have argued that better pay should be a higher priority than better social security.

This new emphasis on market outcomes is welcome: it is striking how little attention was paid to low pay in the New Labour era (even in Fabian Society reports). But there is an empirical question regarding how effective market interventions might be (especially as there will always be significant numbers who are not in a position to work because of caring responsibilities or disability).

Our hypothesis was that market reforms were necessary but not sufficient. The projections from our model confirmed this, showing that action on low pay has surprisingly weak effects on living standards and poverty – and that very high employment is helpful but not transformative. More positively we found that the revenue generated by predistribution is very significant and, if this income were to be recycled back to low and middle income families, it would give a large boost to living standards.

In our work we tested the impact of reforms to both personal taxation and social security. In principle we were open minded about using either to improve disposable incomes. However, our modelling showed that, when it comes to raising the living standards of low and middle income families, benefit and tax credit reform is much more effective than changing tax rates and thresholds. In future, more fundamental reform of the tax system could have a role to play in raising living standards, but a structural change to personal taxation would require many years of analysis, debate, planning and implementation. We will return to this topic in a future Fabian Society paper.

The research focused on poverty but also on inequality from top to bottom and the living standards of typical households. We wanted to understand how policies might: (1) improve the living standards of low and middle income families; (2) tackle rising inequality and (3) contribute to the eradication of poverty. This broad focus meant we examined policy options that would help people in the middle of the income or earnings distribution, as well as policies to prevent poverty (understood as an inability to meet essential needs and participate in modern life).

Our modelling proved that it is not possible to improve the lot of low and middle income households without also taking an interest in the gap between the middle and the top. The data shows that even if we have 15 years of good economic growth, we won't significantly improve the living standards of middle income families unless we prevent inequality from rising: a growing economic pie is not enough, if low and middle income families are receiving a shrinking slice.

We chose a 15 year timeframe for the project to vividly expose the harm of inaction. By looking more than a decade into the future, we illustrate what will happen if current policies and trends are allowed to continue over time. In particular we show how current indexation policies and labour market trends will lead not to stability but widening inequality, even after the final effects of the economic crisis are past.

But this long-term perspective also exposes the potential for government action, because it reveals how, over time, small incremental changes can make a decisive difference. In the current fiscal context ambitious goals like the statutory child poverty targets cannot be met by 2020: but we show they could be achieved over a longer period, instead of being diluted or abandoned.

The projections for 2030 were calculated using a micro-simulation model developed by Landman Economics and the Institute for Public Policy Research, based on data from the Family Resources Survey 2011/12. The model uses OBR and ONS assumptions and projections. In addition to the OBR's macroeconomic projections, the model takes account of long-term trends regarding demographic change, employment, occupation structure, earnings differentials, and part-time and self-employed work.

An accompanying technical report provides a full description of the assumptions and data sources used.

BOX 1: POVERTY

People face poverty when they are unable to meet minimum needs and participate in society due to a lack of material resources. What is taken to be poverty therefore varies with time and place, because minimum needs and the ability to participate are both dependent on a society's current norms: to be in poverty is to lack the resources for a modest standard of living according to contemporary norms. To reflect this idea of 'distance' from what is normal in each society, a poverty line is often set with respect to typical contemporary incomes (a threshold of 60 per cent of median income is standard in the UK and EU). Other approaches are also available, for example a threshold can be set by calculating the minimum income required to afford the goods and services which citizens in a society deem essential.[2] The precise measure does not always matter, as the direction of travel is often the same for different methods.

In this report poverty is reported using the most common UK measure: individuals living in households with incomes below 60 per cent of the contemporary median disposable income, before housing costs, after making an adjustment for family size.

Inequality matters

Over the 15 year timescale of this report, prospects for living standards are fundamentally linked to equality. The research shows that rising inequality will de-couple projected increases in GDP from increases in living standards. With rising inequality, typical living standards will only increase

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BOX 2: SCOPE OF THE ANALYSIS

The Family Resources Survey dataset that the model uses provides a snapshot of household finances and dwells mainly on income rather than expenditure, assets or debt. It also has limited coverage of very high income households. As a result there are methodological limitations to the scope of the research:

- **Expenditure:** we do not consider the opportunities for improving living standards by addressing the price or quality of housing, goods or services. Nor do we examine the possibility of different types of household experiencing different rates of inflation (except in the case of housing costs); or the implications of reforming consumption taxes.
- **Assets and debt**: although our interest is in economic inequality, we are only able to report on disposable incomes, not assets and debt. This probably means that we under-report the scale of rising inequality, since levels of net wealth have diverged by more than levels of income in recent decades. It also means that the model cannot shed light on the important issue of intergenerational equity.[3]
- **The 'top one per cent':** Household surveys do not provide accurate data on very high income households. Our findings could be *optimistic* as we may underestimate the extent to which the top 'one per cent' might continue to pull away from everyone else. This would reduce the proportion of economic output available to share between the other 99 per cent (for example, we use OBR projections which assume that total wages will rise at the same rate as GDP, leaving the ratio between wages and profits unchanged).[4]
- **Alternatives to household measurement:** Our analysis is focused on the household level, although this is only one prism through which to view inequality. This means that we do not look at the balance of money and power between men and women within households; nor do we reflect on inequalities arising at the level of extended families or geographic communities.
- **A view over time:** The data provides a snapshot of the distribution of economic resources, which is essential to understanding the overall structure of the economy. However, from the perspective of individuals, a longitudinal view is also important. A rounded assessment of people's economic prospects should take account of their opportunities for social mobility and the potential impacts of life events such as separation, disability, becoming a carer or retiring.

substantially if economic growth reaches very high levels that are unlikely to be sustainable.

So tackling inequality is the only plausible way to raise the living standard of British families on low and middling incomes. Without intervention, the disposable incomes of most households will hardly rise, even if the economy grows and richer families prosper. For this reason in 2014 a Fabian Society report proposed that the primary measure of national economic success should be median household incomes and not GDP.[5]

But all is not gloom. Our modelling shows that policy action can stop inequality getting any worse. Although a significant reduction in overall inequality would require measures beyond those considered in this report, stopping further rises would be an important success. And we show that greater progress *is* possible with respect to low incomes. The research shows that poverty is much more amenable to policy interventions than overall economic inequality. A far-reaching reduction in poverty is within the UK's grasp over the next 15 years.

1. INEQUALITY 2030

It is well known that Britain is more unequal today than 40 years ago. The Fabian Society's 2014 report *Measure for Measure* described the main trends:[6]

- **The top 'one per cent'** have pulled away from everyone else, in terms of earnings, incomes and wealth. Average household incomes at the 99th percentile of the income distribution have risen from being three times the median in the 1970s to more than five times the median today.

- **Median household incomes** have been rising more slowly than GDP per capita for decades; and they almost ground to a halt in the 2000s, even before the economic crisis. On one measure, real median incomes have increased by 1.4 per cent per year since the 1960s, while GDP per capita increased by 2.2 per cent. Today, median incomes are at the same level as in the early 2000s.

- **Poverty** increased rapidly from the late 1970s to the mid 1990s and then decreased gradually from the mid 1990s: in 1979, 13 per cent of children were in poverty, the figure peaked in the 1990s at 29 per cent and has now fallen to 17 per cent.

During the early stages of the economic crisis, inequality and the incidence of poverty fell: top incomes declined the most, followed by middle incomes, and then low incomes. But this is forecast to be a temporary hiatus, caused by a difference in timing of the effects of the crisis: low income households were initially protected by indexation rules and discretionary policy choices; this pattern was then reversed by the government's austerity measures and the weak and unbalanced economic recovery. A paper for the Institute for Fiscal Studies projects that by 2015 inequality will have returned to the levels seen in the late 2000s, with benefits and median pay both having lost value against inflation, while profits and high net incomes grew.[7]

This report picks up the story from there and asks whether the UK will keep growing more unequal. Our focus is not on the immediate aftermath of the economic crisis, but on what will happen over the longer term. We look at the next 15 years, looking at the trend, not the effects of economic cycles.

Over this period our modelling projects that inequality and poverty will rise noticeably, as the living standards of low and

BOX 3: MODELLING THE CONTINUATION OF LONG-TERM TRENDS

All the projections in this report share a number of assumptions in common regarding demographics and the evolution of the labour market.

Demographic change: all our scenarios adopt the demographic projections used by the OBR both for the sake of simplicity and because this enables us to apply OBR economic projections to our model. In reality the pace of population growth and of ageing is subject to a degree of uncertainty as a consequence of alternative scenarios for fertility, mortality and net migration. Fortunately, uncertainty regarding demographics does not have significant implications for labour market projections looking 15 years ahead.[8]

Labour market change: Making predictions about the development of the labour market over 15 years is a fraught task, especially today, when the long-term consequences of the financial crisis are still far from clear. There are however a number of ongoing trends, which the crisis does not appear to have interrupted. Our assumption is that these will continue:

- **Occupational structure:** Our model assumes that the economy will continue to create more high-skilled, white collar jobs alongside some growth in low-skilled work in service sectors, with few new mid skill manual and office-based jobs.[9] This leads to a modest rise in earnings inequality.

- **Patterns of employment:** Although we examine a variety of cases for overall employment levels, we assume that changes in the relative performance of different age groups and of men and women will reflect long-term trends. This will result in proportionately more mothers and people in their 60s being in work, for example.

- **Self-employment and part-time work:** In line with trends, we assume there will be fewer women and more men in part time work; and a gradual rise in levels of self-employment.

- **Wage differentials:** We assume that the long-term trend towards widening pay differentials will continue, over and above the effects of the previous three factors (which together lead to a moderate increase in weekly earnings inequality). This assumption has a much greater impact on earnings inequality than the others combined.[10]

middle income families fail to keep up with rising prosperity at the top. This is a consequence of *both* public policy choices *and* economic and demographic trends.

Our main projection uses OBR assumptions for earnings and employment growth, which roll forward long term trends. We apply similar assumptions with respect to the changing structure of the labour market and earnings inequality, using other data sources (see box 3). Under these assumptions, our modelling projects that:

- The living standards of low income families will stagnate (growing by just 2 per cent over 15 years).
- Middle income families will not share in rising prosperity, with median household incomes rising by 9 per cent, compared to a 32 per cent rise in GDP.
- Poverty and inequality will grow worse, with 3.6 million more people in poverty by 2030.
- Incomes will rise *11 times as fast* for high income households (at the 90th percentile of the income distribution) as for low income households (at the 10th percentile).
- Top earnings will rise *twice as fast* as low earnings (at the 90th and 10th percentiles of the weekly earnings distribution).

About the projections

These are projections, based on sensible assumptions, which describe one plausible future. We know they are unlikely to be an accurate forecast, because long-range projections almost always fail to predict future economic paths. But it would require a major deviation, in terms of policy and/or economic and demographic developments, for the broad pattern we report to change.

Moreover, these projections could be *optimistic*.[11] In particular the analysis assumes that all policies announced or legislated during the current parliament would be implemented, but it does not take account of proposals by political parties for the next parliament. The impact of further cuts, such as the £12bn of social security savings promised by the Conservatives, would significantly worsen the situation we report.

BOX 4: UNCHANGED POLICY

In this chapter we assume that government policy remains unchanged with respect to pay, social security and tax, before considering the implications of variations to policy in chapter 2. However, deciding what constitutes current policy involves judgement, especially when major reforms are already in train. Our principle has been to assume that all announced coalition reforms will be fully implemented.[12] This means we have assumed that reforms which will be incomplete by May 2015 will be implemented eventually (notably Universal Credit and Personal Independence Payment) and that scheduled pension reforms will take place.[13] The 2015 baseline, against which we compare our 2030 results, is based on policies in place in April 2015.

We assume that most tax and social security thresholds and entitlements and the national minimum wage are indexed to CPI inflation. For taxes and benefits this is the established default position (although in practice there is considerable variation, driven by policy choices). The major exception is the state pension, to which we apply the 'triple lock' (the higher of growth in average earnings, CPI inflation or 2.5 per cent).[14] Our assumption with respect to the national minimum wage reflects the trend of the last decade, even though the minimum wage is set on an annual basis on the recommendation of the Low Pay Commission.

> With such a benign macroeconomic outlook, our bleak projections for family incomes are even more striking

The projection's most important and uncertain assumption is with respect to the overall health of the economy: we followed the OBR in assuming that growth in productivity will return to its long-term trend. The OBR expects this to result in real GDP rising by 2.2 per cent per year (from the final years of this decade) and average real earnings for each worker rising by 1.8 per cent per year. This is a very significant improvement on the last ten years – and many believe these assumptions are too optimistic.

Indeed, with such benign macroeconomic assumptions, our bleak projections for family incomes are even more striking. In chapter 3, we consider the implications of more negative scenarios for the economy and show that the prospects for family living standards would be even worse.

The projections are also fairly optimistic with respect to employment growth. We project a long-term rise in the employment rate for people under pension age, from 74 per cent to 76 per cent. This is because the model assumes that long-term trends in the employment of men and women at different ages will continues into the future. This is a sensible central assumption, but it won't come to pass without policy interventions to ensure there is appropriate support, opportunities and incentives for mothers, carers, disabled people and people in their 60s.

2030 living standards

The main measure of living standards we use is real disposable household income. This comprises all of a family's earnings plus other sources of income (social security, private pensions, investment and savings income), after personal taxation has been paid, and taking account of inflation.[15] The Fabian Society's 2014 report *Measure for Measure* proposed that median income, measured on this basis, should replace GDP as the main headline indicator of the UK's economic performance.

On the basis of this yardstick the outlook for the next 15 years is very poor, with a projected rise in median incomes of just 9 per cent between 2015 and 2030. This equates to anaemic growth of 0.6 per cent per year.

Over the period high incomes are projected to rise 11 times faster than low incomes, with a 22 per cent increase for households at the 90th percentile, compared to just a 2 per cent for those at the 10th percentile. As a result, a household at the 90th percentile of the income distribution is projected to gain £12,900 per year, while one at the 10th percentile would gain just £230 per year (see figure 1).

There are several factors explaining the changes in living standards:

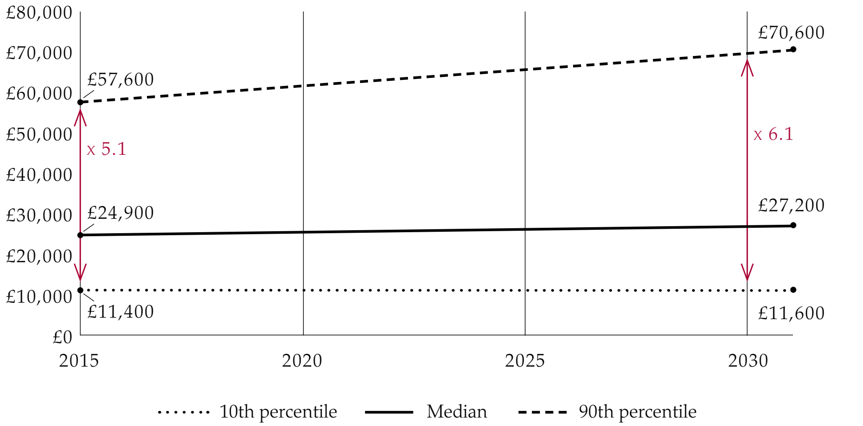
- *The ageing of the population (and the associated increase of the pension age)* has a negative impact on household incomes, other things being equal, as more people will be retired and fewer in work. This has a similar effect on all income groups.

- *Higher projected employment* has a (smaller) positive effect on the incomes of all income groups, partly as a result of people retiring later. This effect is strongest for middle income groups.

- *The increase in average earnings and in the (earnings-linked) state pension* is the largest driver of rising incomes. However, this change also widens inequality, because a large share of the income of poorer families comes from non-pension benefits, which are only linked to inflation. Rising earnings brings twice the benefit to families at the 90th percentile of the income distribution as it is does to those at the 10th percentile, with median households half-way between.

- *The evolution of the labour market* is an additional driver of inequality, especially between middle and top. Rising earnings inequality will push up household incomes at the top and have little effect on low and mid incomes.

FIGURE 1
Change in household net annual income (2014 prices)



A forecast rise in employment offers a modest boost; but the rise in the share of retired people has a negative influence on income growth

So we can now paint a picture of why low and middle income households are expected to do so badly. They are more likely to contain low-paid workers, whose earnings are projected to rise by less than those with higher wages. More importantly, a large share of the income of these families comes from social security, which in real terms will not increase in value, except for the state pension. Meanwhile, a forecast rise in employment offers a modest boost; but the rise in the share of retired people has a negative influence on income growth.

The overall effect is a modest increase in the living standards of middle income households. But in the case of the lowest income group, the downward pressure of demographic change almost completely offsets all the upward pull of increases in earnings, employment and the state pension – hence the prognosis of almost flat incomes over the next 15 years. And all this is under a 'good news' scenario for the economy, with decent average wage growth and real GDP increases of 2.2 per cent per year. Under this scenario Britain will become more prosperous, with GDP per capita rising 32 per cent by 2030. *But that prosperity won't be shared with low and middle income families.*

The implications of this projection hardly bear thinking about. Households who have the most today would see their purchasing power rise by around one quarter – watched by their poorer neighbours who would see no improvements at all. The UK would be a nation of turbo-charged inequality, with the food bank and the yacht club booming side-by-side. Indeed, people with low incomes would find life even harder than

BOX 5: RISING EMPLOYMENT

Over the next 15 years, rising employment is expected to drive improvements to the public finances and to household incomes (changes in living standards would be even more disappointing in the absence of improving employment levels). The employment rate is projected to rise on the basis of long-term trends in the employment of men and women of different ages.[16] These positive factors over-ride the slight negative influence of demographic changes (which result in a higher share of people in their 50s and 60s, who are less likely to be in work).[17] We project that in 2030, 76 per cent of adults under state pension age will be in work, compared to 74 per cent today. This is despite the state pension age having risen to 67. The result is that between 2015 and 2030 the dependency ratio (which we define as the employment rate for all adults) will remain unchanged at 59 per cent. This is very welcome news from the perspective of GDP per capita and fiscal sustainability, particularly as this period marks the retirement of the remainder of the baby boom cohort, which one would expect to place strain on the dependency ratio.

Parents: Rising employment has a particularly positive impact for parents. Employment for lone parents is projected to rise from 57 per cent to 63 per cent and for mothers of dependent children in couples from 71 per cent to 78 per cent. However, the continuation of current trends cannot be taken for granted but requires persistent action by government, employers and trade unions. It will depend on suitable childcare, public services, social security entitlements, flexible employment opportunities and evolving social attitudes.

Disabled and older workers: The employment rate for disabled adults below pension age is not projected to increase to the same extent. This is largely a result of the rising state pension age, since a high proportion of disabled adults are in their 60s (raising the pension age has the effect of knocking four percentage points off the disability employment rate).[18] Similarly, the percentage of non-pensioner households without work increases as the pension age rises, from 17 to 18 per cent (though it would have risen to 21 per cent without overall employment growth). This is a clear downside of raising the state pension age, to which policy makers should turn their attention. Unless there is adequate employment support and social security protection for people without work in their 60s, then further increases in the pension age will become increasingly problematic from an ethical and political perspective.

Projected employment rates for selected groups

	Baseline^v	2030	Change
Headline – adults below pension age^ *	74%	76%	+3%
Total employment rate (dependency ratio)	59%	59%	0%
Men below pension age^	76%	81%	+4%
Women below pension age^	70%	72%	+2%
Mothers in couples with dependent children	71%	78%	+7%
Lone parents	57%	63%	+7%
Disabled adults below pension age^	57%	57%	+1%
Pensioners^	10%	9%	0%
Non-pensioner households without work	17%	18%	0%

v Baseline data is for 2011/12 and has not been reweighted to take account of developments since then.
^ Pension age is 65 for men and 62½ for women in 2015; and 67 in 2030 so these are not comparisons between identical cohorts.
* This is not the same as the standard National Statistics headline measure of employment (ie for 16 to 64 year-olds), which is not useful when comparing years with significantly different pension ages.

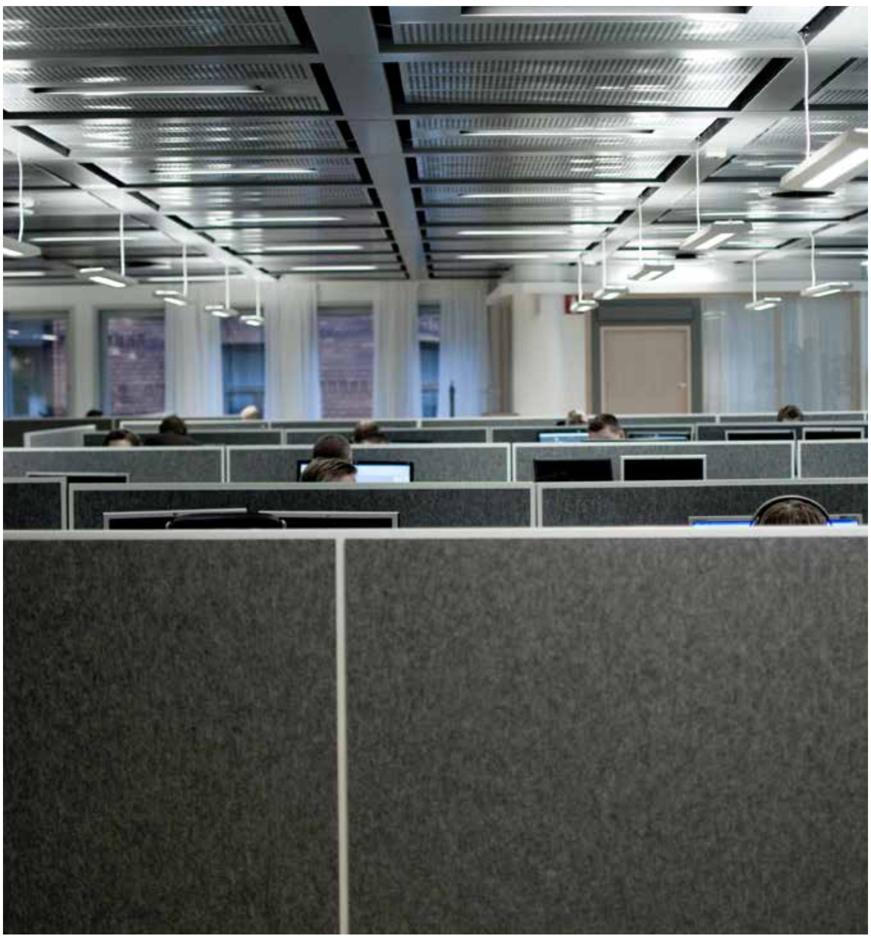
today. First, because they would be so far removed from the norms of consumption set by the wealthy. And, second, because their rents would eat up ever more of their incomes: flat disposable incomes would mean falling living standards, after housing costs. Rising inequality also implies more status insecurity, worse mental health and the fraying of social connections. It might leave Britain unable to meet its commitments on greenhouse gas emissions (since high incomes lead to more resource consumption); with a lop-sided economy ever more vulnerable to financial crisis.

2030 earnings

Between 2015 and 2030 average (mean) earnings are projected to grow by 29 per cent and median earnings by 26 per cent (see figure 2). The difference between these two figures arises because well-paid workers are projected to do better than the rest: high earners are expected to see their earnings rise *twice* as fast as low earners (a 36 per cent increase for people at the 90th percentile of the earnings distribution, compared to a 16 per cent increase at the

FIGURE 2
Central case projection for weekly earnings (2014 prices)

	2015	2030	Change
Weekly earnings			
10th percentile	£122	£141	16%
25th percentile	£237	£278	17%
Median	£385	£485	26%
75th percentile	£615	£815	33%
90th percentile	£921	£1,253	36%
Mean	£507	£657	29%
Earnings inequality (hourly pay)			
Low paid workers	21%	25%	4 ppnts
Earnings inequality (90/10 ratio)	3.8	4.8	1.0
Gender pay gap	20%	22%	2 ppnts



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10th percentile). This is the result of our assumption that earnings inequality will continue to widen.

Looking at hourly earnings, inequality is projected to rise so that pay at the 90th percentile of the distribution will be worth 4.8 times pay at the 10th percentile – compared to 3.8 times today. There are two reasons for this: first, because of change to the occupational structure, which creates more high-paid work; second (and more importantly) because of our assumption that wage differentials will continue to increase at the pace seen in recent decades.[19]

As a result the share of workers on low pay is projected to rise from 21 to 25 per cent (using the standard benchmark for low pay, two thirds of median hourly earnings). This will have a knock-on effect on the gender pay gap, which would grow from 20 to 22 per cent (ie the gap increases between men's and women's median hourly pay).

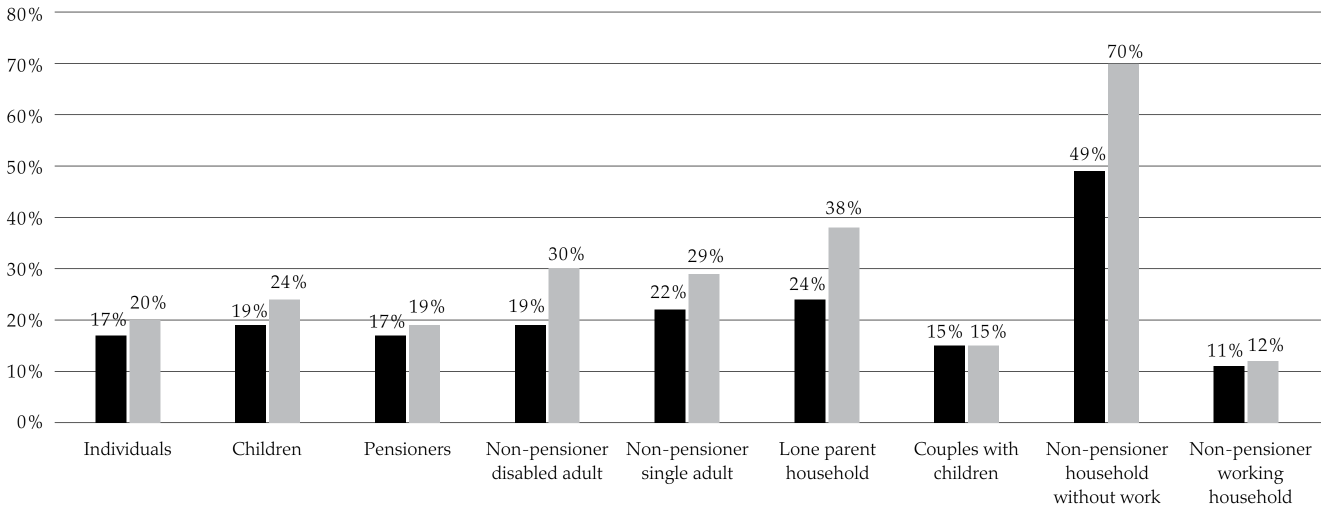
> Strong and stable growth will not transform the earnings outlook at the bottom of the labour market

Pay inequalities are projected to widen, but at least pay is expected to rise noticeably in real terms for individuals near the bottom of the distribution. This contrasts with the prognosis for disposable household incomes for poorer families and also with the pay stagnation of the last decade. This is a consequence of the OBR's assumption that growth in productivity and average earnings will return to its long-term trend. Even so, strong and stable growth will not transform the earnings outlook at the bottom of the labour market.

2030 poverty

The stagnation of low incomes will drive up the proportion of people living in poverty, with the number of people in poverty projected to rise from 17 per cent today

FIGURE 3
Projections for poverty in 2015 and 2030



Note: The definition of pensioners changes between 2015 and 2030 in response to the increase of the pension age

to 20 per cent by 2030 (see figure 3). Poverty is projected to increases for children (from 19 per cent to 24 per cent) and for non-pensioner adults (especially for households without someone in work).[20] Our measure of pov-erty tracks the percentage of people with a household income below a poverty line set at 60 per cent of the contemporary median. So this worsening picture is particularly noteworthy since we have already seen that growth in median income (and therefore the poverty line) is expected to be sluggish.

By far the most important cause of the worsening outlook for poverty is the divergence between rises in average wages and benefits. This completely overwhelms two other causes of rising poverty – demographic change and rising earnings inequality. Meanwhile the increase in employment we project has almost no effect on poverty since it benefits both median and low income families.

The cause of rising inequality (ie the gap from top to bottom) is slightly different. As before, employment growth has little impact. But the relative importance of the other factors differs between poverty and inequality. We have already seen, in the case of poverty, that the divergence between earnings and most benefits is far and away the most important cause of increases. By contrast, in the case of overall inequality, it is only slightly more important than the effect of rising earnings inequality.

We have already seen, in the case of poverty, that the divergence between earnings and most benefits is far and away the most important cause of increases

The increase in poverty is even more striking in numerical terms, since the population is also growing. The number of people in poverty will rise from 10.2 million in 2015 to 13.8 million in 2030, an increase of 3.6 million. For children the increase is 1.2 million, from 2.5 million to 3.7 million.[21]

The characteristics of poverty are also expected to change over the next 15 years. Children are projected to make up a higher proportion of those in poverty (a rise from 25 to 27 per cent). Pensioners will continue to represent the same share of people in poverty, despite their rising share of the overall population. And there would also be a slight shift away from in-work poverty towards poverty among households without work: today 52 per cent of households in poverty below pension age contain someone in work, but this will fall to 45 per cent, on the basis of the OBR's employment and earnings projections.

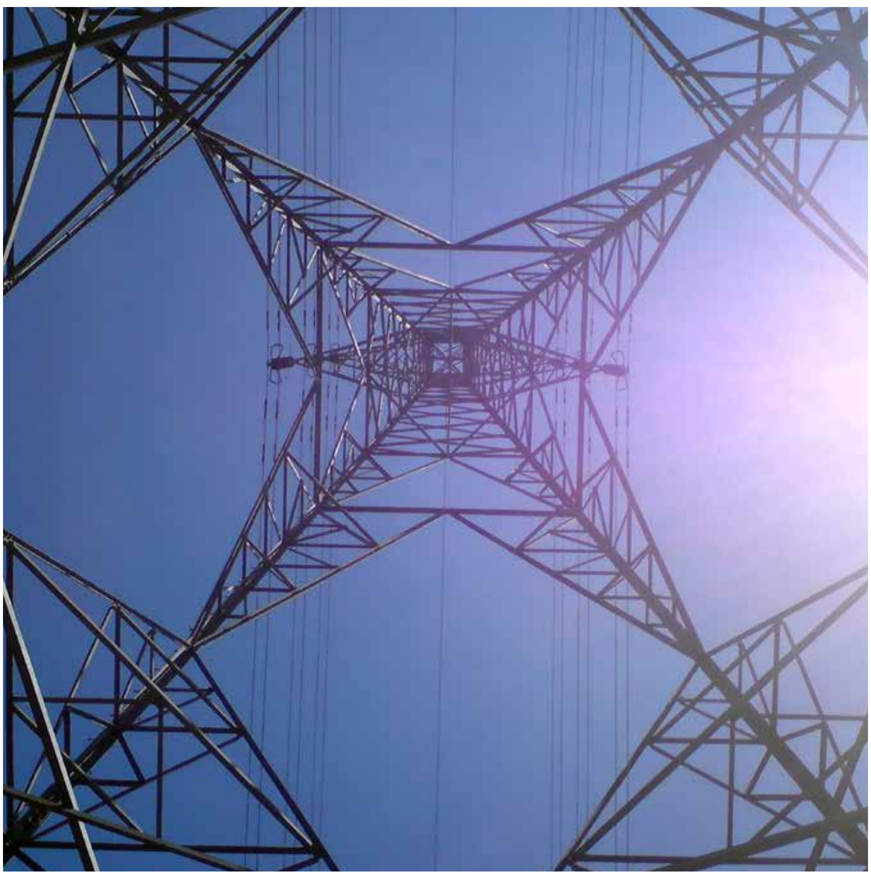
So doing nothing would have terrible consequences for Britain. But other policy choices are available. In the next chapter we consider an affordable strategy which could transform prospects for living standards and poverty.

2. CAN 'PREDISTRIBUTION' REDUCE INEQUALITY?

With more years of austerity perhaps still ahead, policymakers have been taking a keen interest in options for improving living standards and reducing inequality that do not require public spending or tax cuts. The idea of intervening to affect market outcomes had been christened 'predistribution' by the Yale University academic, Jacob Hacker.[22] There are three potential routes to improving living standards by changing market outcomes: (1) find ways to reduce the cost of living (an issue that is beyond the methodology used in this report); (2) pursue the traditional goal of 'full employment'; and (3) boost low and middle earnings.

In this chapter, we model what would happen if the government achieved ambitious but plausible change over the next 15 years, looking at both full employment and earnings inequality. Our findings show that taking action on employment and pay can have positive impacts (with full employment being more important than improved pay). However, we also demonstrate that action on both fronts is still insufficient to prevent inequality and poverty rising; or to enable the living standards of low and middle income groups to increase in line with GDP.

By itself, as a market intervention, predistribution turns out to be an inadequate strategy even for preventing the incidence of poverty from growing worse, let alone for making progress towards poverty eradication. However, we show that that predistribution offers much more promise if policymakers *also* recycle the revenue generated by predistribution back into redistributive measures.



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Full employment

We first considered what would happen if strong economic performance and successful government policies together led to the UK matching the best employment rates in the OECD today (ie 81 per cent of adults below state pension age in work).[23]

Matching the best in the OECD is conceivable, as long as it is prosecuted with a significant policy programme

This is not an implausible ambition given the country's success in job creation over the last five years and more generally since the early 1990s: Britain's economy is better at creating demand for jobs than most EU member states; long-term structural changes in labour market supply are likely to continue (eg the employment preferences of mothers and people in their 60s); and we have an established toolkit of policy for supporting employment growth drawn from the UK and overseas.

In other words, matching the best in the OECD is conceivable, as long as it is prosecuted with a significant policy programme. For example, in the case of maternal employment, options include: (1) extending the availability of free or sub-

FIGURE 4

Employment rates for selected groups under two 2030 employment scenarios.

	Baseline*	2030 – trend growth	2030 – best in OECD
Headline – adults below pension age^	74%	76%	81%
Total employment rate (dependency ratio)	59%	59%	63%
Men below pension age^	76%	81%	83%
Women below pension age^	70%	72%	78%
Mothers in couples	71%	78%	84%
Lone parents	57%	63%	72%
Disabled adults below pension age^	57%	57%	63%
Pensioners	10%	9%	13%
Non-pensioner households without work^	17%	18%	14%

* Baseline employment data is for 2011/12 and has not been reweighted to take account of developments since then

^ based on the pension age for 2015 (65 for men; 62 ½ for women) and 2030 (67).

sidised childcare, including wraparound care in primary schools; (2) designing parental leave, benefits and services to enable women to return to good work after maternity; (3) and revising the tax and benefits system to give extra support to families with children, compared to people without children.[24]

Matching the best employment rate in the OECD would have noticeable effects with respect to living standards and inequality. However it would not fundamentally alter the story we presented in chapter 1:

- *Household incomes* would rise slightly faster over the next 15 years. Real median net incomes would rise by 14 per cent, rather than 9 per cent as previously projected; low incomes (at the 10th percentile of the income distribution) would rise by 4 per cent, rather than 2 per cent.

- *Poverty* would rise by a little less, but in 15 years' time there would still be 3.1 million more people in poverty than today, including 970,000 extra children.

This high employment scenario leads to more working households and more two-earner households, and particularly benefits people with lower labour market participation today, including mothers and disabled adults below pension age (see figure 4).

Action on earnings

We also modelled three pay-related interventions geared particularly to the middle and bottom of the labour market. We considered:

- *A higher national minimum wage (NMW)*, with the national minimum wage set at 60 per cent of median earnings in 2030. Under our central case scenario, this would mean a minimum wage in 2030 of £9.04 per hour (in 2014 prices).[25]

- *Widespread uptake of the living wage*, with the living wage (and, in London, the London living wage) paid to all low-paid public sector workers and half of low-paid private sector workers.

- *Action to prevent wage differentials from rising*, so that earnings inequality only rises as a result of change in the occupational structure of the labour market.

BOX 6: EARNINGS DIFFERENTIALS

Our model did not test specific policy interventions to freeze wage differentials but assumed that a package of reforms successfully achieved this outcome. These policies might include: greater collective bargaining at firm and sector level; full transparency regarding differences in pay and in pay rises between executives and typical workers; corporate governance reform and more employee ownership; and high quality vocational training to improve the productivity of low and middle earners. We assumed that these reforms would lead to pay differentials being maintained at current levels, rather than rising. Although a compression of earnings inequality should be the ultimate goal, we were not confident in assuming a package of market interventions could achieve this result.

Taken together, these are three significant and politically ambitious interventions and they would succeed in preventing labour market inequality growing worse during the next 15 years: high earners would no longer pull away from those on low pay (see figure 5).

However, the effects on household incomes are far smaller than on earnings (see figure 6). Our model shows that successful predistribution reforms to stop *earnings* inequality from rising would not be enough to prevent *income* inequality and poverty increasing over the next 15 years in the absence of redistributive policies. With respect to family living standards, achieving full employment would have far more impact.

Earnings: each of the three interventions would result in pay at the bottom of the earnings distribution (10th percentile) rising in line with average earnings. This

FIGURE 5
Impact of three interventions on our 2030 earnings projections

Change since 2015	No change	Higher NMW	Living Wage widespread	Act on wage differentials	All three
Weekly earnings					
10th percentile	16%	32%	30%	31%	49%
25th percentile	17%	28%	29%	30%	41%
Median	26%	27%	27%	33%	34%
75th percentile	33%	33%	33%	32%	32%
90th percentile	36%	36%	36%	31%	31%
Mean	29%	31%	31%	30%	32%
2030 Earnings inequality (hourly pay)					
Low-paid workers (2015 = 21%)	25%	23%	23%	23%	21%
Earnings inequality (90/10) (2015 = 3.8)	4.8	4.0	4.1	3.9	3.4

is a significant achievement compared to recent trends. Successful action on wage differentials would have the same effect on median earnings (the other two reforms have little impact on middle earners). If all three reforms were combined, low-paid workers would see their projected weekly earnings rise by 49 per cent over the period; and middle earners would see a 34 per cent increase. Growth in low and middle pay would actually outstrip increases at the 90th percentile of the distribution (31 per cent) and GDP per capita (33 per cent).

These outcomes have important implications for earnings inequality. Under our 2030 central projection, we saw the proportion of workers earning below the low pay line (two-thirds of median hourly earnings) rise from 21 per cent to 25 per cent. This rise can be prevented if all three policy reforms are combined – the incidence of low pay will then remain broadly stable. Looking across the whole earnings distribution, the reforms are projected to do a bit better and actually reduce inequality relative to 2015. Today high-paid workers earn 3.8 times more than low-paid workers; under our main projection, this would rise to 4.8 by 2030; but with all three interventions combined, the ratio could fall to 3.4.

Pay is a topic of huge political and public anxiety, so it is reassuring to see that pre-distribution interventions can make a difference. However, it is also striking that it takes a very significant package of reforms such as this, *simply to prevent labour market inequality from worsening*. Even if these reforms are successfully implemented, the UK would still have very high earnings inequality and one of the worst levels of low pay in the OECD. The Labour party has said its goal is to halve the number of

FIGURE 6
Impacts of three labour market interventions on our 2030 household projections

	No change	Higher NMW	Living Wage widespread	Act on wage differentials	All three
Net household income – change since 2015					
10th percentile	2%	2%	2%	2%	3%
25th percentile	6%	7%	7%	7%	8%
Median	9%	11%	11%	12%	13%
75th percentile	17%	18%	18%	18%	20%
90th percentile	22%	23%	23%	21%	22%
Mean	16%	17%	17%	16%	17%
Inequality					
Gini	0.36	0.36	0.36	0.35	0.35
90/10 ratio	6.1	6.1	6.1	6.0	6.0
Poverty rate					
Individuals	20%	20%	20%	20%	20%
Children	24%	23%	24%	24%	24%
Impact of policy on numbers in poverty					
Individuals	-	-90k	- 30k	+200k	+10k
Children	-	-40k	-20k	+50k	-10k

people in low pay by 2025: this would be even harder to achieve than the results we present here.[26]

> Perhaps surprisingly, reforms designed to help *individuals* with low pay end up benefiting *households* in the middle and upper middle of the income distribution the most

Living standards: The effects of these pay interventions are far less dramatic with respect to household incomes. This is because earnings are only one component of a household's income (social security is also vital for low and middle income families); because households quite often have both low and high earners; and because more pay can lead to higher taxes and lower social security payments, leaving the net gain much lower than the gross pay rise.

Perhaps surprisingly, reforms designed to help *individuals* with low pay end up benefiting *households* in the middle and upper middle of the income distribution the most. With all three interventions in place, over 15 years, households at the median and 75th percentile of the distribution are projected to see their incomes grow by 13 per cent and 20 per cent respectively (compared to 9 per cent and 17 per cent without the interventions). By contrast, the poorest households would barely gain as they contain so few workers. Even with all three reforms, low-income households can expect to see their net incomes rise by just £2 per week on average (in 2014 prices). This is a real increase of just 3 per cent over 15 years, rather than the 2 per cent we project with no policy change.

Poverty and inequality: Together the three reforms would have almost *zero effect* on poverty: the minimum wage and living wage policies would together lead to a small reduction in poverty (60,000 fewer people in poverty); while action on wage differentials would increase poverty, as median incomes would rise (an extra 200,000 people in poverty); when combined the three interventions would cancel each other out. Meanwhile the packages have a modest downward effect on income inequality more broadly, compared to our main 2030 projection. However, under each option (or any combination) income inequality would remain much higher than today's levels.

Recycling the proceeds of predistribution

The direct benefits of predistribution interventions for family living standards

BOX 7: POVERTY PAY: THE WRONG PRIORITY?

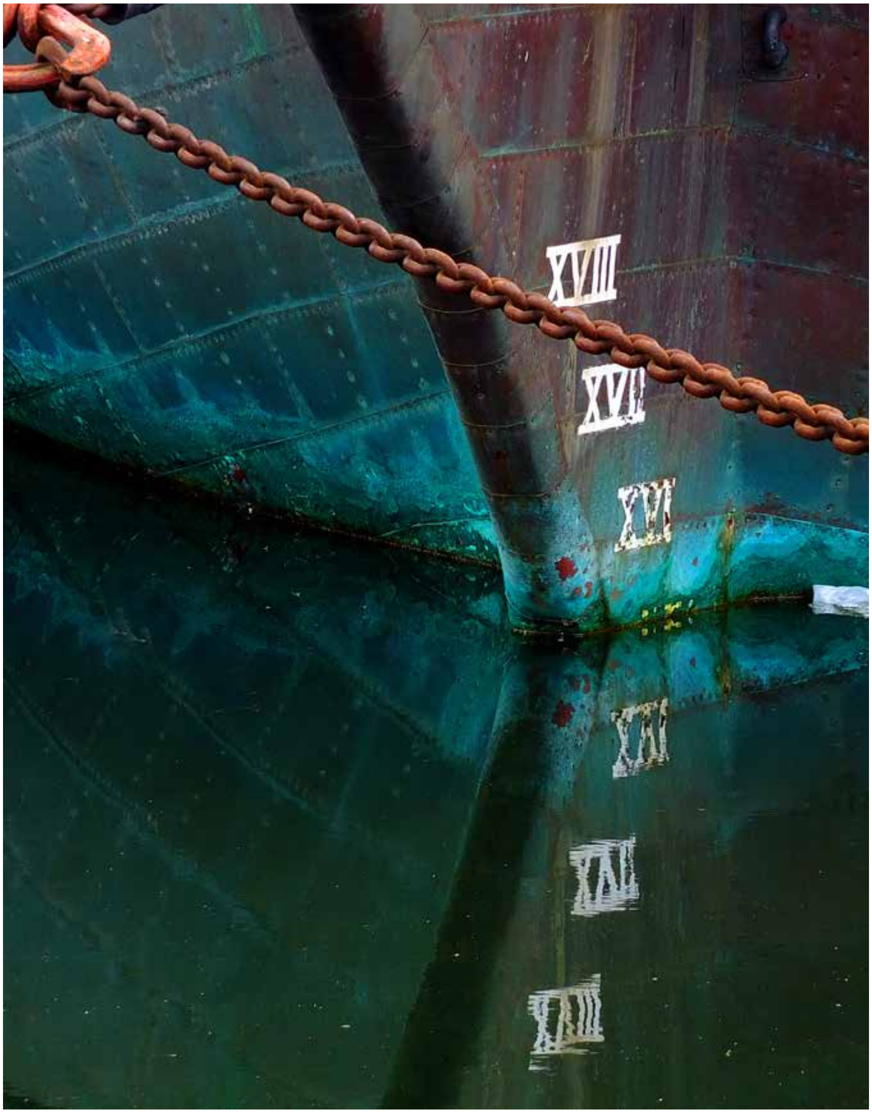
These findings are a disappointment for advocates of action on earnings inequality and low pay. But they are consistent with our earlier finding that rising earnings inequality is not a major driver of rising poverty in the years to 2030. However, pay reforms still have an important part to play – they are necessary, just not sufficient:

The lifecourse: Improving the earning power of low paid workers is important for tackling inequalities at household level *when the whole lifecourse is considered*. Many low paid women are the second earners in families with middle or upper-middle incomes but are vulnerable to poverty in the event of family separation, and in old age if they are not making adequate personal pension contributions.

The UK economic model: Tackling pay inequality should be an end in itself, irrespective of its contribution to living standards and income inequality. Labour market reforms are necessary to draw a line on the long-term rise in earnings inequality. Without action, rising pay inequality will over time lead to less consumer demand; rising insecurity, disconnection, stress and illness; a narrower and more vulnerable tax base; and the decline of public support for social security. Immediate action is needed to prevent the UK settling into a high employment, low pay, low productivity economic paradigm. Interventions on pay will help drive up productivity, as employers respond to upward wage pressures with innovation. This is even more important if the government is also seeking very high levels of employment (which will suppress earnings growth unless there is compensating action).

Employer responsibility: There is significant public disquiet regarding pay which is so low that workers need social security to top up their income. When benefits are seen to be subsidising poverty pay, it further diminishes public support for the principle of social security. This criticism is most well founded with regard to rates of pay that lead to full-time workers becoming entitled to support *regardless of their personal circumstances*. There will always be a case for providing social security to *some* people in low-paid work – because of the costs of children, housing or disability. However, when employers pay less than £7.20 per hour to a full-time worker, tax credits are needed, *even* for single adults with no extra living costs.

Work incentives: Action on pay improves work incentives for people receiving social security, by increasing the gap between benefits and entry-level earnings. This can be expected to improve labour supply. Alternatively, higher pay might make it possible to design a more generous social security system without reducing people's incentives to move into work or progress.



and inequality are limited (at least when looking at a single point in time rather than the whole lifecourse). By contrast, these policies bring significant benefits to the exchequer and this money could be recycled to boost family incomes. If this money was used well, these *indirect* benefits of the proceeds of predistribution, would be more significant than the direct effects.

- **Employment:** Employment growth generates the most significant fiscal benefits. Compared to our central case for 2030, achieving best-in-OECD levels of employment would generate £30bn for the exchequer (£20bn in extra tax and £10bn in reduced social security payments).
- **Action on pay:** A high national minimum wage and widespread take-up of the living wage would together generate an extra £8bn per year for the exchequer, compared to our central projection for 2030 (£6bn in higher taxes and £2bn in reduced social security).[27]

If all of this money was returned to low- and middle-income households there could be very significant impacts on living standards and poverty. For example:

- *£30bn* could cover most of the costs of indexing social security to earnings

FIGURE 7

Possible impact of recycling the proceeds of predistribution on our 2030 household projections

Impact of measure	Rise in median incomes over 15 years	Reduction in 2030 poverty, compared to main projection (poverty rate in brackets)	Reduction in 2030 child poverty, compared to main projection (poverty rate in brackets)
Predestribution: Full employment and action on low pay	16%	-500,000 (19%)	-200,000 (22%)
Redestribution: Double child benefit	11%	-900,000 (19%)	-500,000 (20%)
Redestribution: Index social security to earnings	16%	-3.2 million (15%)	-1.3 million (15%)
Combined: All three measures	23%	-4.2 million (14%)	-1.9 million (11%)

rather than inflation for the next 15 years. This would reduce the number expected to be in poverty in 2030 by 3.2 million.[28]

- *£8bn* could cover most of the costs of doubling child benefit over the next 15 years (the cost is £10bn). This would reduce the number of children in poverty in 2030 by half a million.

So cumulatively the direct impacts of predistribution interventions *and* the indirect effects of recycling the proceeds back to low- and middle-income families could have a big impact. It would *more than double* the pace at which middle incomes are projected to rise over the next 15 years. And it would lift over 4 million people out of poverty, compared to our 2030 central case (see figure 7).[29]

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BOX 8: OUR CHOICE OF BENEFIT REFORMS

We selected these two benefit reforms because they are similar in cost to the proceeds arising from the predistribution reforms. Both are broadly-targeted reforms with the potential to have an impact on a wide range of people and secure public consent.

Indexation of social security to earnings: this research has revealed that future increases in poverty will mainly result from earnings rising faster than most benefits. The obvious solution is to uprate benefits in line with earnings, which would provide a permanent mechanism for ensuring low-income households do not fall further behind everyone else. Earnings indexation has been implemented with respect to the state pension: the 'triple lock' now has cross-party support and is very popular with the public. By contrast, leading politicians have not campaigned for the same policy for other benefits, presumably due to the expense and the perceived unpopularity of working-age social security. However politicians could make the case for this reform by arguing that people from all backgrounds should share in rising prosperity – just as everyone has had to share the burden of the financial crisis. Most of the beneficiaries are likely to attract the public's sympathy (ie children, working households, people of all ages with disabilities and long-term conditions). Politicians could also point to the growing disparity in protection between retired and non-retired households.

Significant increases to child benefit: Analysis by the Institute for Fiscal Studies has shown that tax and benefit reforms over the last five years have distributed resources away from families with children to households without children.[30] Raising child benefit would redress that balance and strengthen the principle that government should play a role in distributing resources across the lifecycle – in this case, by giving more support to people when they are facing the costs of raising children. In other words, child benefit is equivalent to a tax allowance for children (and indeed it is the successor to a child tax allowance that existed from 1909 to 1979). A significant increase to child benefit is a well-targeted policy with respect to raising the living standards of mid income families and reducing child poverty. In the version of the reform we have modelled, the real value of child benefit would double over 15 years – an increase of around 5 per cent per year. We have given priority to making the benefit more generous over restoring its universal coverage, since the costs of offering child benefit to high income households *and* also doubling its value would be high.[31]

The impacts on child poverty are particularly noteworthy, because low income in childhood can have such debilitating impact on life chances. The UK's statutory child poverty target is that only 10 per cent of children should live below the poverty line we are using.

Figure 7 shows that, with all the interventions combined, the target could come very close to being met, with only 11 per cent of children in poverty.[32] This indicates that the child poverty target remains a totally achievable aspiration (albeit delayed by 10 years, from the original deadline of 2020).

The policies would have less of an impact on overall inequality – they would prevent income inequality from rising, but they would not reduce it.[33] This is because action to prevent wage differentials from rising was excluded from this scenario. As a result, while low and middle incomes are both higher than under our previous projection, top incomes are not lower.

Interventions covering employment, low pay and social security can make a vital contribution to defeating poverty. But they are insufficient to reduce overall inequality. Action on wage differentials between middle and top earners is needed too.

3. A LOST DECADE?

So far our results have been based on a rather rosy economic outlook, drawing on the central projections of the Office for Budget Responsibility. But over a 15 year period there is huge uncertainty regarding the development of the economy.

The OBR and our own modelling both imply there will be a reasonable rise in the overall employment rate in the next 15 years, and this assumption is built into our 2030 projection. This seems sensible given the strong performance of the labour market recently, but nothing can be guaranteed.

We have also adopted the OBR's assumption that productivity growth will return to its long-term trend, leading to good rates of growth for earnings and GDP. These projections may well prove optimistic. The OBR's forecast assumes that real earnings growth returns to a long-term trend of 1.8 per cent per year. However, wage rises could be much slower than this over the next 15 years – either because productivity growth fails to return to its pre-crisis trend or because a declining share of output is passed on to workers in pay.

In this chapter we look at what might happen if either earnings or employment growth considerably underperforms the OBR's projection.

The implications of a weak economy

So what are the implications of a weak economy for households, in the absence of any policy action? We found that worse outcomes for employment would be bad for both living standards and equality. In the case of disappointing productivity and earnings, the story is more complicated: weaker than expected earnings growth is bad for living standards but would result in inequality and poverty rising less quickly than under our main projection.

Living standards and inequality: In chapter 1 we saw that reasonable growth in GDP per capita had a very disappointing impact on the living standards of low- and middle-income families. But if the economy underperforms the OBR's long-term assumptions, the outcome for living standards will be even worse.

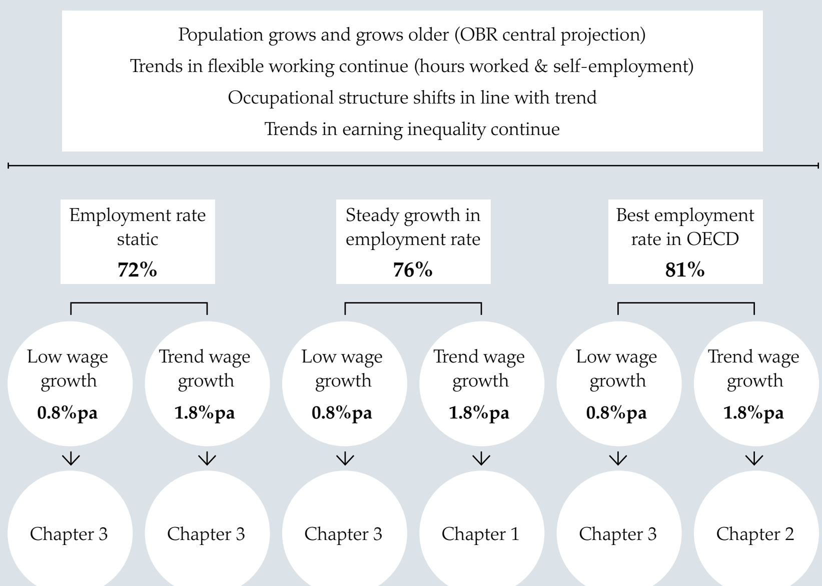
- Real median household incomes are projected to barely change over the next 15 years (a change of between -2 and +5 per cent, under our four pessimistic scenarios).

- The real incomes for households at the 10th percentile of the income distribution would probably fall (we project a

BOX 9: SIX SCENARIOS FOR THE 2030 LABOUR MARKET

In the last two chapters we looked at two scenarios with the same assumption regarding earnings growth (ie a neutral and an optimistic outlook for employment prospects). In total our modelling considered six possibilities: a combination of three employment scenarios and two earnings scenarios. As well as our main projection (based on the OBR's preferred assumptions) and our optimistic 'full employment' case, we looked at four, more pessimistic, scenarios to examine what might happen if employment and/or wage growth underperform. The pessimistic earnings scenario is for wages to rise by only 0.8 per cent per year in real terms, rather than 1.8 per cent; and the pessimistic employment scenario assumes no improvement in the employment rate over the next 15 years.

Economic assumptions in the model's six scenarios



change of between -6 per cent and zero, under the four pessimistic scenarios).

- Income inequality would rise compared to today under all four scenarios – but the increase is slower under the cases with a pessimistic outlook on earnings growth, because the gap between rises wages and social security would be smaller.

The story for poverty is complicated because each scenario has an impact on both median incomes (which raises the poverty line) and on the incomes of low-income households themselves. *Weak earnings growth* harms living standards overall but reduces poverty. On the other hand, *weak employment growth* leads to higher levels of poverty, as a result of there being more low-income families without anyone in work (see figure 8).

It is worth saying that, while these negative economic scenarios differ from the cases examined in the last two chapters, what unites all six scenarios is more important than their differences: *inequality and poverty are projected to rise from today under all six cases, whether the outlook for the economy is good or bad.*

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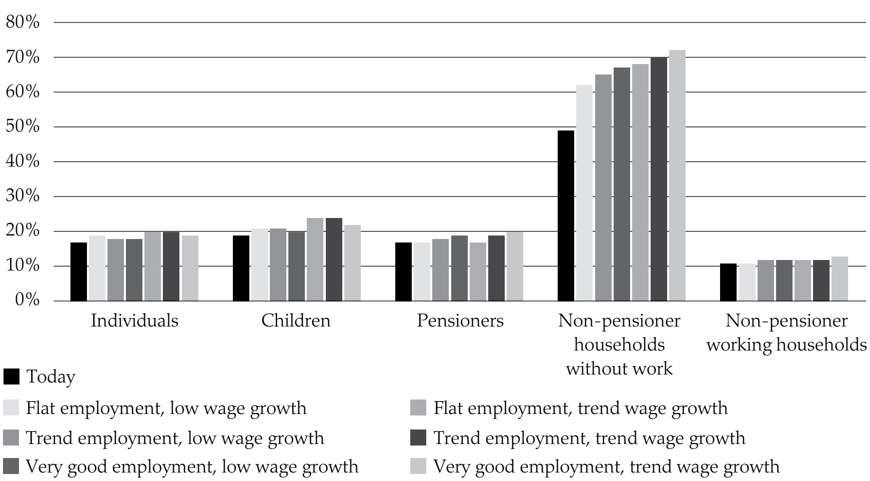
FIGURE 8
Incidence of poverty in 2030 under six economic scenarios, compared to 2015



If the economy underperforms, a predistribution strategy is still possible

Sluggish economic growth over the next 15 years is clearly bad news for low and middle income households. A smaller economic pie means that households can expect to receive less, whether that is through earnings or social security. But policy choices still have a major bearing on living standards, even if the government is unable to influence the pace of productivity growth. Even with low GDP and productivity growth, predistribution interventions can make a big difference to family incomes, so long as the proceeds are recycled into social security.

FIGURE 9
The impact of predistribution interventions on our 2030 household projections in a low growth economy

	No change	Higher NMW and living wage widespread	Very high employment	All three
Net household income – change since 2015				
10th percentile	-3	-2	0	1
25th percentile	0	1	2	3
Median	1	3	5	6
75th percentile	6	7	9	10
90th percentile	11	11	13	13
Mean	6	7	9	9
Inequality				
Gini	0.35	0.34	0.34	0.34
90/10 ratio	5.8	5.7	5.7	5.7
Poverty rate				
Individuals	19	18	18	18
Children	21	21	20	20
Fiscal impact				
	-	£6bn	£27bn	£33bn

Figure 9 shows that the *direct* effects of predistribution are once again relatively modest. Achieving very high employment, setting the national minimum wage at 60 per cent of earnings, and securing wide uptake of the living wage would (in combination) result in median incomes rising by 6 per cent over 15 years (as opposed to 1 per cent, without any intervention). Similarly incomes at the 10th percentile of the distribution would rise by 1 per cent rather than -3 per cent.

The two low pay interventions are projected to generate proceeds of £6bn for the exchequer; and very high levels of employment would generate £27bn. Both these figures are a little lower than the values presented in chapter 2, with stronger economic growth; but nevertheless they leave ample opportunity for recycling revenue.

We modelled the same combination of social security policies as in chapter 2: uprating benefits by earnings not inflation; and doubling the real value of child benefit. This time the reforms cost slightly less than the sum generated by the predistribution reforms (£29bn of new expenditure, compared to £33bn). But they would still have very significant effects:

- **Household incomes:** median household income are projected to rise by 11 per cent, compared to 1 per cent with no policy change; incomes at the 10th percentile of the distribution are projected to rise by 6 per cent, rather than falling by -3 per cent

- **Poverty:** the incidence of poverty among the whole population would fall to 15 per cent, compared to 19 per cent with no policy change; and child poverty would fall to 13 per cent, compared to 21 per cent.

Successfully prosecuting this predistribution strategy would do more to increase low and middle incomes than economy-wide improvements in productivity (ie an improvement in average annual earnings from 0.8 per cent to 1.8 per cent). In other words, for low and middle income groups, this package of reforms *would have a greater impact than solving the nation's productivity challenge.* Of course, in an ideal world, we would wish for both, but even if politicians face a 'lost decade', interventions to boost employment, tackle low pay and recycle the proceeds will bring huge benefits.

This strategy is of course dependent on a positive outcome with respect to low pay and especially employment growth. Its success cannot therefore be guaranteed. But the huge potential benefits should give politicians steel in advancing difficult market reforms. Our analysis of the 'lost decade' scenarios show that progress is possible even in difficult conditions and that political choices, not unstoppable economic forces, are key to raising living standards, reducing poverty and tackling inequality.

4. RECOMMENDATIONS

THIS REPORT DEMONSTRATES the heavy price of inaction – but also presents an affordable strategy for improving living standards, tackling poverty and preventing inequality from rising.

Our projections show it is possible to make significant progress even in a fiscally constrained environment – and that there is a plausible route towards a UK with much lower levels of poverty. This gives us confidence to recommend the adoption of stretching ambitions and policy measures.

Goals and institutions

Recommendation 1: The next government should recommit to the existing statutory child poverty targets, but extend the deadline for meeting them to 2030 – or an earlier date such as 2025 if conditions allow. This research shows how significant progress can be made towards the statutory targets, even without finding new money.

Recommendation 2: A future government should also adopt a (non-statutory) set of measures for monitoring the pursuit of sustainable prosperity – including indicators for poverty (covering all age-groups), low pay and income inequality. The pace of rising living standards should be the headline benchmark of success, measured as change in real disposable median income.[34]

Recommendation 3: A National Prosperity Commission should be established to advise on strategies for achieving the new goals for sustainable prosperity, and in particular for improved living standards for low and middle income households. The body would steer and integrate the work of existing, more focused bodies, such as the Social Mobility and Child Poverty Commission, the Low Pay Commission and the UK Commission for Employment and Skills. The Commission would support the delivery of the strategy proposed in this report, by advising on market interventions to boost prosperity; and on the most effective ways of recycling the proceeds for these interventions into tax or benefit reforms.

The labour market

Recommendation 4: Ministers should aim for at least 80 per cent of adults below pension age to be in work by 2030 and set challenging intermediate objectives for the next parliament. Early progress will be necessary to generate any significant sums for redistribution in the first years of the next parliament, when the public finances will be very tight. To pursue this goal, the government must lead continuing action to improve the opportunities, support and incentives for mothers, disabled people and people in their 60s to remain in work. They should also commission work to examine the support needs of people in their 60s who are unable to work.

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Recommendation 5: The government should seek to raise the national minimum wage to 60 per cent of median earnings at the earliest opportunity, ideally by 2020. It should amend the mandate of the Low Pay Commission to task it with advising on the practicalities and pace of implementation.

Recommendation 6: The government should legislate for all public sector jobs to pay the living wage; and form a new partnership with business to drive the take-up of the living wage in the private sector. The aim should be to halve the number of private sector jobs paid below the living wage by reforming public procurement and corporate reporting, and by negotiating deals with large employers in sectors like retail, food and hospitality.

Recommendation 7: Ministers should work with business and unions to develop a cross-government strategy on pay and productivity, focusing on the middle of the labour market. The strategy should include immediate and longer-term actions to expand the number of middle earning jobs and prevent wage differentials from widening. Measures might include: greater collective bargaining at firm and sector level; full transparency regarding differences in pay and in pay rises between executives and typical workers; corporate governance reform and more employee ownership; and high quality vocational training and apprenticeships. The UKCES and the proposed National Prosperity Commission should be tasked with providing advice and evidence.

Social security and tax

Recommendation 8: After the election, the Treasury should reject major cuts to benefits that would reduce the living standards of low and middle income households. This can be achieved if new fiscal rules are adopted premised on a slower pace of deficit reduction.

Recommendation 9: The prime minister should institute a 'Prosperity Fund' to be financed by the proceeds arising from 'predistribution' reforms.

- The Treasury and the OBR would be asked to agree a methodology for calculating the size of this fund each year – ie the gain to the exchequer arising from (non-cyclical) improvements in employment and low pay over the period. The OBR would also audit the use of the fund to verify that it was not being spent on previously forecast increases in social security spending or on cyclical 'automatic stabilisers'.

> If this strategy succeeds in full it will have a major impact on living standards and make great strides towards the eradication of child poverty

- Parliament would pass legislation mandating the government to return at least the value of the Prosperity Fund to low and middle income households, in a way ministers judge is best suited to increasing the disposable incomes of low and middle income households and to reducing poverty.

- The proposed National Prosperity Commission and the Social Mobility and Child Poverty Commission would advise ministers on effective strategies for using the fund. They would also play a role in educating the public about the role of social security in eradicating poverty and supporting the living standards of the majority of households.

Recommendation 10: As part of this process ministers should consider the case for implementing the two social security reforms modelled in this report:

- *A more generous basis for uprating all benefits and tax credits.* This would benefit a very wide range of low and middle income households.

- *Significant annual real increases to child benefit* which would increase the living standards of mid income families and reduce child poverty.

Initially, while the deficit was still being reduced, the generosity of these policies could be determined by the amount of money available each year through the Prosperity Fund (to avoid placing any increased burden on the public finances). Once the public finances were in balance other sources of funding might also become available.

If this strategy succeeds in full it will have a major impact on living standards and make great strides towards the eradication of child poverty. It is also the only way of making a quick start in the next parliament, when – without an earmarked revenue stream – there will be no prospect of finding new money for enhancements to social security. For example, if the OBR judges there had been a structural improvement to employment during 2015, it could calculate the proceeds accruing to the exchequer (ie the size of the Prosperity Fund) in time for ministers to announce new spending in the March 2016 budget.

Depending on the performance of the labour market, this strategy could deliver a huge amount. But if it proves insufficient there are other options at the government's disposal – and we will turn our attention to these in a subsequent report. In particular we will examine options which could be expected to *significantly diminish* income inequality and *eradicate* poverty.

These are second stage reforms, because they either require new money or major institutional reforms – neither of which will be an option in the first few years of the next parliament. By contrast, a strategy of *predistribution* that funds *redistribution* can be put in place as soon as the 2015 election is decided.

ENDNOTES

1. Brewer, M., Browne, J., Hood, A., Joyce, R. and Sibieta, L., 'The short- and medium-term impacts of the recession on the UK income distribution', *Fiscal Studies*, vol. 34, pp. 179–201 (2013).

2. Davis A, Hirsch D, Padley M. *A Minimum Income Standard for the UK in 2014*. Joseph Rowntree Foundation (2014)

3. This report is inappropriate for considering inter-generational inequality for a number of reasons: our assumptions about the outlook for pensioners' income over the next 15 years are fairly crude and should be considered indicative only; we report on disposable income, not net wealth; poverty is reported on the basis of disposable income, before housing costs, so does not distinguish between people who are liable for rent or mortgage payments and those who are not; we do not take account of the provision of services in kind; we do not make an assessment of net contributions and receipts over an entire lifetime.

4. In recent decades there has been an increase in the share of GDP going to profits rather than to earnings, and (within earnings) in the share going to the top one per cent of earners. This has been the topic of much discussion, especially since the publication of Thomas Picketty's *Capital in the 21st Century*, which argues that both these trends are a result of returns on capital exceeding GDP growth. Our modelling takes some account of rising top earnings, but does not assess the future direction of profits and asset prices at all.

5. Harrop, A and Tinker, R. *Measure for Measure: Economic indicators for a fair and prosperous society.* Fabian Society (2014)

6. *ibid.*

7. Brewer, M, Browne, J, Hood, A, Joyce, R and Sibieta, L. 'The short- and medium-term impacts of the recession on the UK income distribution' in *Fiscal Studies*, vol. 34, pp. 179–201. (2013)

8. *Fiscal Sustainability Report*, Office for Budget Responsibility (2014)

9. In our model of the 2030 labour market we have extrapolated forward projections produced by the UK Commission on Employment and Skills until 2022.

10. The only narrowing of wage differentials in recent decades was the result of the introduction of the national minimum wage, an explicit policy choice (in chapter 2 we consider the possible impact of a higher minimum wage and other policy interventions to reduce wage differentials).

11. As well as the possibility of the economy performing less well than the OBR assumes, our projections could be optimistic for two reasons: (1) they assume the share of GDP going to wages remains constant, when in recent decades this figure has been declining; (2) they model the effects of structural economic trends only, whereas it is likely that the current cyclical recovery is also increasing poverty and inequality.

12. The modelling does not include announcements in the 2014 Autumn Statement. The most significant change was a small increase in the income tax personal allowance which will exacerbate the inequalities we report.

13. The modelling of the implementation of the flat-rate state pension reforms is approximate, as we have not made assumptions regarding individual contribution records.

14. This is a different approach to the OBR's projections in the *Fiscal Sustainability Report*, which assume there will be major changes to indexation policies. Their approach may be an appropriate default for a 50 year time horizon but is not a sensible 'neutral' position when looking just 15 years ahead.

15. We use the Consumer Price Index because official long-term official assumptions regarding CPI are published. Ideally a better measure of inflation should be used, that takes account of housing costs.

16. The employment projections for different demographic groups are based on rolling forward past trends. Using this approach, our overall projection of the employment rate for adults below pension age (75.8 per cent) is very similar to that of the OBR, which uses a slightly different methodology (76.3 per cent). We have scaled up our sub-group projections so that total employment matches the OBR's pro-

jection in order to achieve consistency with its GDP and earnings projections.

17. Note this is a model for the supply of workers, rather than for employers' demand. However, over this 15 year time frame economists would expect changes in supply to be the dominant explanation for changes in employment. In chapter 2 and 3 we consider more positive and negative scenarios for employment, based on different assumptions regarding economic performance.

18. Results for disabled people are indicative only, as we do not directly model changing patterns of disability or employment participation by disabled people (changes are an effect of variations to other parameters). Methodologies taking account of these factors explicitly might produce a different central case projection for the employment rate for disabled adults in 2030; however, this has no implications for variations around the central case resulting from different economic scenarios or policy choices.

19. In chapter 2 we consider what impact stabilising wage differentials would have and how this might be achieved

20. There is also a slight rise in poverty for pensioners. However this is not a like-for-like comparison, since the pension age will be higher, so a group of more affluent people in their mid-60s are not counted.

21. The numbers are even more sobering when measuring poverty after housing costs. By 2030, 33 per cent of children will be in poverty using this measure (5.1 million); for all individuals, the figure is 25 per cent (16.6 million people).

22. The idea of predistribution being prior to redistribution is contested. Distribution through tax and public spending (public services and secure incomes for families) creates the context for market outcomes, so public spending is not just a compensatory mechanism.

23. We used the average of the highest three comparable employment rates in the OECD: men (Japan, Netherlands, Australia), women (Norway, Sweden, Netherlands).

24. Plunkett, J. *The missing million*. Resolution Foundation (2011)

25. A National Minimum Wage of 60 per cent of median earnings is likely to be around the highest rate that can be set without a significant effect on employment levels.

26. Speech by Rt Hon Ed Miliband MP to Labour Party Conference, September 2014

27. We do not consider the fiscal proceeds of action on wage differentials as this would actually be *disadvantageous* from a purely fiscal perspective (other things being equal) since tax proceeds from top income groups would be lower.

28. The cost of the policy is £34bn before taking account of the savings arising from more people being in work.

29. This precise combination of policies is not quite revenue neutral. In 2030 these two social security policies would have a cost of £5bn, over and above the proceeds of predistribution. Similar policies could be designed to be exactly revenue neutral, with only slightly smaller impacts on living standards and poverty.

30. Browne, J and Elming, W. 'The effect of the coalition's tax and benefit changes on household incomes and work incentives'. Briefing Note. Institute for Fiscal Studies (2015)

31. There is a good case for reviving *universal* child benefit, both to retain widespread commitment to social security; and to distribute resources across the lifecourse for families in high income groups. However restoring child benefit to high income groups should logically be paid for by increasing taxes on this group (so that it is a transfer in resources from high income households without children to those with children). Restoring universal child benefit does not strike us a suitable candidate for spending the proceeds of predistribution – since this policy would have no effect on poverty or median living standards.

32. The costs of introducing this permutation of the reforms would not quite be covered by the proceeds of predistribution, under these economic assumptions. However this example is intended to illustrate the potential of the strategy rather than be a definitive policy recommendation. Policy makers could adopt a slightly less generous version of one or both reforms to ensure the package was entirely revenue neutral.

33. Using the gini measure for household disposable income inequality

34. Harrop, A and Tinker, R. *Measure for Measure: Economic indicators for a fair and prosperous society*. Fabian Society (2014)