

Briefing

Resolution Foundation | Commission on Living Standards

Priced Out *The new inflation and its impact on living standards*

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The Resolution Foundation Commission on Living Standards:

Improving the lives of people on low to middle incomes

The Commission on Living Standards is an independent and wide ranging investigation into the pressures facing people on low to middle incomes in modern Britain. Its work is focused on the long term economic trends that are changing the reality of life on a low to middle income, from trends in the jobs market and tax-benefit system, to new pressures from the cost of living and modern working patterns.

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Introduction

The squeeze on living standards: a longer view

The great majority of households in Britain are currently experiencing a fall in the buying power of their incomes. Put simply, inflation is running around 5%, and few households have seen their incomes rise by this amount in the past year. But for those people lucky enough to have jobs, is this causing a fundamental reduction in living standards, or is it just a matter of making relatively small adjustments in our lifestyles? To what extent is the squeeze a temporary consequence of the recession and its aftermath, and to what extent is it the result of deeper changes in our economy? And are households on lower incomes being affected any differently from the average household, or are they simply being swept along on the ebb and flow of the economic tide?

This paper identifies new evidence that, because of a new inflation environment, hard times started significantly earlier for households on lower incomes than for the average UK household. Because the costs of essential goods and services have been rising much faster than standard rates of inflation for some time, households on modest incomes have fared far worse than official data suggests. More and more are struggling to achieve a minimum standard of living. Looking forwards, these lower-income households could largely miss out on the fruits of a slow recovery; following a substantial decline in their living standards, they may see little or no improvement during the next decade.

The story to date

In the past year, work from the Resolution Foundation has developed a growing understanding of some key aspects of the present squeeze on living standards. It is now clear that growth in wages in the bottom half of the distribution was weak long before the recession. Median wages have been flat in real terms since around 2002 or 2003, while wages at the 10th percentile have performed better, but have been relatively flat since around 2005. These are worrying trends, contrasting with steady real wage growth from the early 1990s to the early 2000s. Yet until recently, the impact of these trends on household *income* has been moderated by government support. In fact, even during the 2008-2009 recession, average household incomes did not fall, helped by low inflation offsetting the effect of flat wages, and by some initially favourable aspects of the tax and benefits system – including increases in support through tax credits, especially for families with children.¹

Today, on the other hand, a combination of falling real earnings, falling government support and substantial rises in the cost of items from food to petrol and household energy are hitting the living standards of people across the income spectrum, with the Institute for Fiscal Studies estimating that real household incomes fell 3.5% last year.² For the average household that stays in work, real disposable income could be 9% lower a year from now than it was two years ago.³ Given that between 2000 and 2008, average real disposable income grew by about 15%, this could be seen as an adjustment rather than a collapse in overall living standards. With lower inflation promised soon, the erosion of buying power is set to level off, and even a slow return to growth could prevent a further fall in average real household income beyond 2013 (although forecasts beyond that point remain subject to huge uncertainty). Even so, such a significant fall in income is unprecedented in the post Second World War period. Overall, a story emerges of government support helping to moderate the squeeze during the recession, but since then having been outpaced by events.

¹ See for example Robert Joyce, “Bleak outlook for living standards”, *Public Finance*, 15 September 2011

² Robert Joyce, “Bleak outlook for living standards”, *Public Finance*, 15 September 2011

³ See projections presented below

The importance of inflation

However, for many families, especially those on relatively modest means, this story of a squeeze on incomes that began only after the recession, and which should start to reverse in due course, is less plausible. For them, the squeeze in living standards is not just a fact of the present but has roots in the past and could persist into the future. This paper explains why. Specifically, it adds a deeper understanding of two critical factors to the Resolution Foundation's past analysis:

First, the slowing of growth in state transfer income – benefits but, in particular tax credits – for low to middle income households. The current government has pegged these to the Consumer Prices Index (CPI), a lower index of inflation than has been used in the past. Moreover, given the tight control over public spending projected for the next few years, the large increases above indexation to some benefits seen at various times since 1998 look unlikely to be repeated. Indeed, following the recent cancellation of an above-inflation increase in the child element of Child Tax Credit, together with the freezing of Working Tax Credit and a wide range of other cuts, support through tax credits is now set to fall rather than rise in real terms for the foreseeable future. While income transfers are often seen as affecting mainly people out of work, they now account for a substantial share of the income of many working families on low earnings, especially those with children.⁴ These changes will substantially reduce the adequacy of state protection for low earners against poor wage performance and higher inflation. Their full impact is only now becoming apparent.

Second, and just as importantly, the structure of inflation has changed. The prices of commodities, including food and fuel, and of some other items comprising a disproportionate share of lower-income households' spending, like public transport and council tax, have been rising faster than average. The result is that the cost of a basket of essential goods has, for some time, been rising faster than general inflation. The effect is that the cost of a minimum living standard of living is rising faster than the average cost of living. As a consequence, people on lower incomes are doing worse, relative to such a standard, than is implied by income statistics using general inflation indices to represent changes in "real terms". Even before the shift to CPI uprating, and before the recession, this effect appears to have caused a significant fall in the buying power of these groups' incomes. Importantly, this shift appears to be less the result of the impact of the downturn, and more the result of a new inflation environment. As such, it may well endure over the long term, rather than being specific to any single inflationary period such as that experienced in 2011.

Throughout the analysis, the paper looks at the situation for households with low to middle incomes - those not in deep poverty, but with living standards not far from an acceptable minimum. For them, the squeeze on incomes typically started in around 2005, might already have reduced the value of incomes by about 10% and could continue to erode living standards well after a return to growth in real wages. Thus, while everyone is having to tighten their belts during tough economic times, we risk seeing a long-term divergence of living standards in which people on below average incomes experience a longer and deeper decline than the better off.

This paper:

- Considers the origin of and future prospects for price trends that are pushing up the relative cost of affording the essentials of life

⁴ See Mike Brewer and Liam Wren-Lewis, *Why did Britain's households get richer? Decomposing UK household income growth between 1968 and 2008-09* (IFS analysis for the Resolution Foundation), 2011.

- Uses new analysis to measure what happened to the ability of people on modest means to afford a minimum acceptable living standard between 2000 and 2009
- Gives some indicative future scenarios
- Sketches out some implications for the kinds of policy areas that will become increasingly central to living standards

Section 1: Recent trends in the prices of basic goods

"Inflation", wrote David Piachaud in 1978, "acts neither as Robin Hood nor as Robber Baron: neither the poor nor the rich are affected in a uniform way".⁵ He went on to note, however, that the distributional impact of inflation will be linked to its underlying causes, which may be different in various places and times. He also pointed out that, other things being equal, lower income groups may find it harder to cope with shifting prices because they have less capacity to switch their patterns of consumption in response.

Inflation has returned as a significant economic phenomenon for the first time in 20 years. Its character and causes have changed greatly since double-digit rises dominated the economic news in the late 1970s. Then, there were debates about whether "wage-push" or "demand-pull" factors were most important, but both were tied up with structural features of the domestic UK economy. Today, the dominant feature causing inflation to run at over double its target rate is rising world commodity prices, including the price of energy. These prices have been highly volatile over recent years, and will continue to be so, suggesting that high inflation rates are becoming a recurring rather than permanent feature of the UK economy (in 2012 they are forecast to be in abeyance). However, the long-term trend has been upwards, and is likely to continue to be so. The growth of China, India and other emerging economies, combined with supply-related and environment-related constraints on the extraction and use of fossil fuels, are pushing up the price of raw materials and energy. None of those underlying drivers is likely to disappear in the foreseeable future, and we should certainly expect them to be active in the next ten years.⁶

The effect of these global price rises on the cost of physical essentials in the UK has two main consequences relevant to the distributional impact of inflation. The first is that people on low incomes tend to consume more than the average amount of such essentials as a proportion of their incomes. We can therefore expect them to suffer higher than average inflation rates when these items are going up faster than others. In other words, a global inflation environment that puts pressures on key goods like food and fuel has serious long-term consequences for the living standards of people on low and modest incomes over and above the simple consequences that are seen in a higher headline rate of inflation.

The second is that the standard economic response of consumers to changing relative prices – to shift consumption away from things that have become more expensive – may not be an option, especially for the worst off. If the price of some kinds of non-essential items rises quickly, households can readily switch away from these items to spend more on other things that are becoming relatively cheaper, and thus limit the overall rise in the cost of a "shopping basket" with a given overall value. This is because, for example, eating out may be a valid alternative to going to the cinema as a way of enjoying an evening. By stark contrast, a family spending just enough on food to have an acceptable diet cannot shift expenditure to, say, electronic goods if they become cheaper while food becomes more expensive, without damaging their living standards. In simple terms, consuming other things does not substitute for buying enough food. The result is that, as well as being relatively disadvantaged by a global inflation environment that pushes up the prices of basic goods, families on low and middle incomes may also be less able to adapt.

⁵ David Piachaud (1978), "Inflation and Income Distribution" in Fred Hirsch and John H Goldthorpe (eds), *The Political Economy of Inflation*, Salisbury: Martin Robertson

⁶ For further discussion of these trends and their effects on the price of essentials in the UK, see Donald Hirsch and Kim Perren and Viet-Hai Phung (2011), *Global influences on the cost of a minimum standard of living in the UK*, York: Joseph Rowntree Foundation

Box 1: What is a minimum standard of living – and how much does it cost?

A key difficulty in studying the impact of our economic environment on living standards over time is finding a measure that captures changes in the kind of life that households can afford to live. One important concern is whether people's income gets them above a basic acceptable threshold. But what should this threshold be? Traditionally, a common measure has been a threshold of "relative poverty", set arbitrarily at 60% of median income, which helps to track over time whether people on low incomes are falling behind everyone else. This "relative" approach is justified by the fact that over the long term, social norms change and so does the definition of an acceptable minimum income. However, for short-term changes, another measure – an "absolute" poverty line – whose level does not change in real terms, can also be useful in showing whether more or fewer people can afford a fixed set of goods and services.

The problem in both cases is knowing whether the level selected really does represent a socially acceptable minimum standard of living. The Minimum Income Standard project tries to provide a useful measure to help with this problem.* Since 2008, it has used focus groups to identify what the British public consider to be the basket of goods that is necessary for a minimum acceptable standard of living. This basket of goods has been developed for a wide range of different household types – couples and single people, those with and without children, and those who are retired and not. To give an example, the basket of goods for a couple with two children includes:

- £104 of food a week
- Travel by bus, but no car
- A week's self-catering holiday a year in the UK
- Very occasional treats for children like going to the cinema, buying a comic book or eating out at McDonalds – adding up to £15 a month for a primary school child

This basic 'minimum standard of living' basket of goods (the 'MIS basket') is useful in helping us understand changes in living standards over time. Specifically, it performs several functions. It can be used to understand how the price of a minimum standard of living is changing over time in a non-arbitrary way, including whether these changes are different from the overall average of price changes in the economy. It helps us understand how many people are able to afford a minimum standard of living, and how this is changing over time. And, for groups in society that spend most of their income on this basket (groups, in general, with low or modest incomes), it helps us understand how they are experiencing different price pressures than others.

* See www.minimumincomestandard.org This research was initially carried out in 2008 by the Centre for Research in Social Policy (CRSP) at Loughborough University with the Family Budget Unit at the University of York, and is updated regularly by CRSP in line with rising prices and changing attitudes towards contemporary minimum needs.

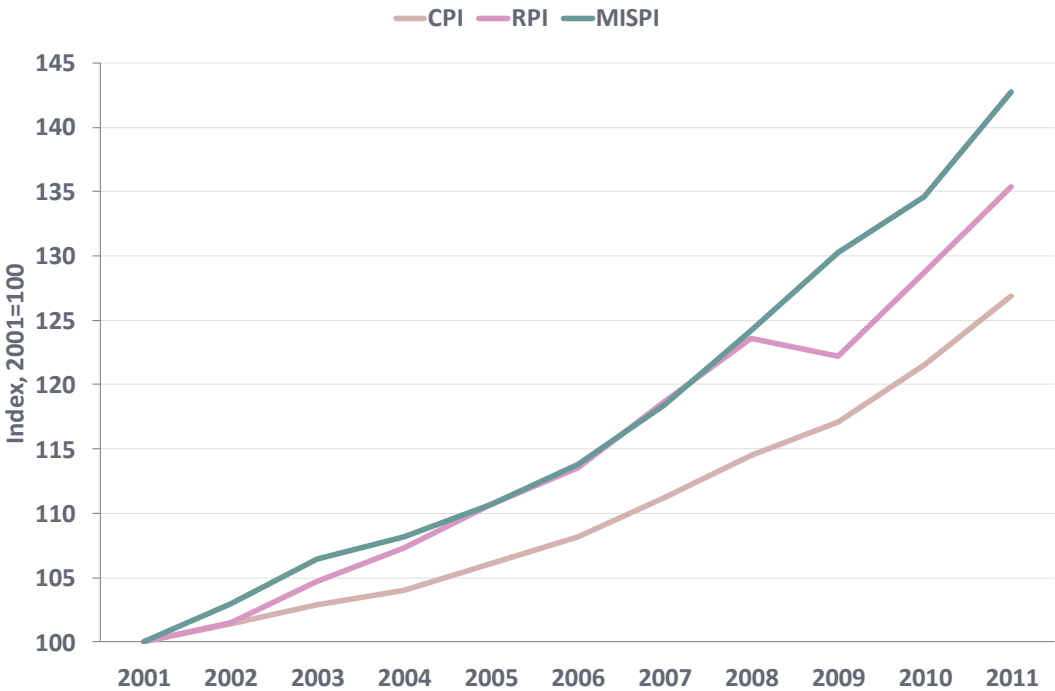
But how serious overall are higher rates of inflation for lower income groups, and to what extent have relative gains in some years offset relative losses in others? Most headline statistics on wages and incomes do little to help us to answer this important question. That's because, although they take into account inflation, they are based on average measures like the CPI or RPI. As such, although they help us to differentiate between the impact on living standards of periods of high and low inflation, they do not distinguish the relative effects on different groups due to the prices of different categories of goods and services rising at different rates. This paper therefore uses a different concept, the

'minimum income standard' (MIS), to help us understand the impact of these important trends on families with relatively low incomes. (See Box 1.) The MIS is a concept, developed by the Centre for Research in Social Policy (CRSP) at Loughborough University with the Family Budget Unit at the University of York, which uses public consensus to identify the basket of goods that is needed to reach a minimum standard of living. In simple terms, it is the basic basket of goods that households need to buy to make ends meet. One important use of this concept is that it gives us a benchmark to consider how price movements have changed the cost of a minimum acceptable living standard over recent years. This method does not take account of how the basket itself might have changed over time as social norms change, but instead isolates the effect of inflation on a constant basket. It gives a reasonable basis for considering the overall inflation rate for people on modest incomes, based on the proportion of the minimum household budget that is allocated to different broad spending categories such as food, household goods and clothing, and on the published inflation rates for these categories. For these low and modest income households, changes in the cost of the 'MIS basket' are a much better representation of changes in their costs of living than either the CPI or RPI rate of inflation.

Figure 1 uses the minimum basket of goods – which, as explained in Box 1, we can call the 'MIS' basket – to show how the prices of this group of essential goods has changed by comparison to the overall rates of inflation as shown in the RPI and CPI. The "MISPI" is an index of price movements based on spending categories weighted according to the Minimum Income Standard budgets of 2008. This index focuses on disposable income requirements, and does not include housing costs. The results confirm that the price of a minimum basket of goods has been rising faster than inflation indices that reflect average levels of spending, and not just in the recent past.

Figure 1 shows that over the past decade, the cost of the minimum basket has risen 43% while the RPI basket costs 35% more than it did in 2001 and the CPI basket, the future basis for benefit and tax credit ratings, has appreciated only by 27%. The divergence between MISPI and CPI has been consistent, while the increase relative to RPI has been more recent, based largely on the fact that cheaper mortgages due to lower interest rates are reflected in RPI but not in the other two indices shown here.

Figure 1: The rising price of a basic basket of goods compared to CPI and RPI
Index, 2001 = 100, 2001-2011

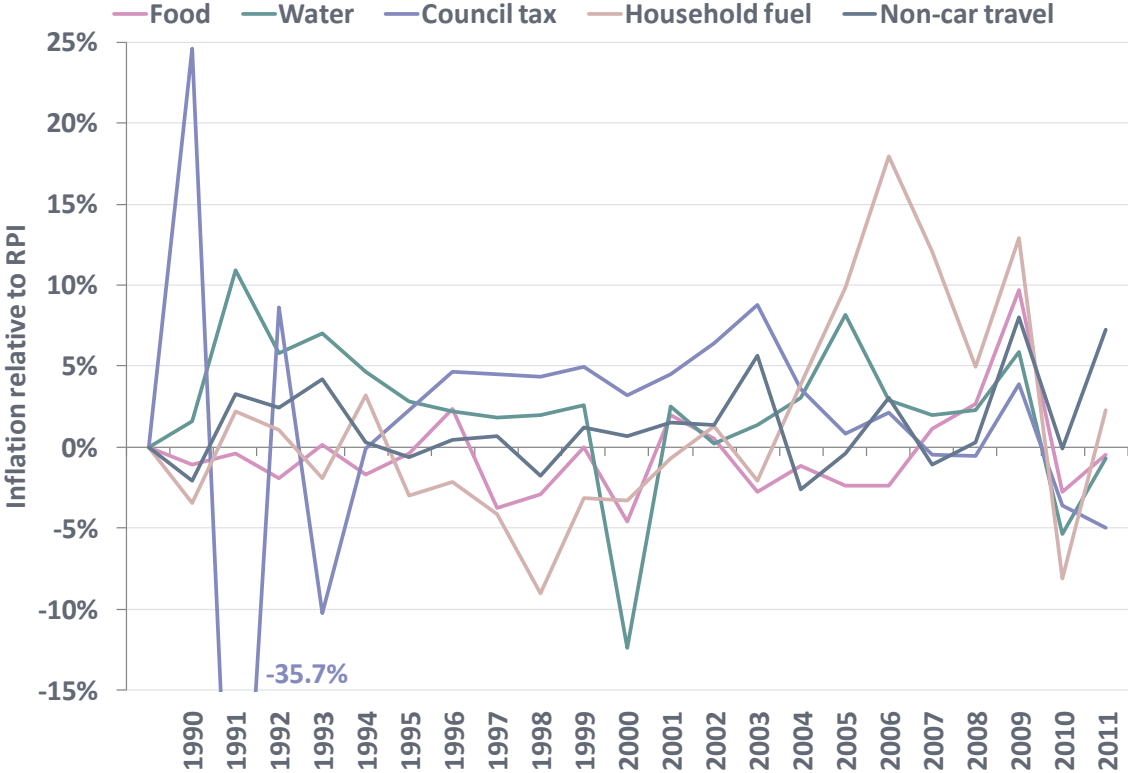


Which categories of goods and services have driven this shift? The rising relative price of several categories of commodity in particular have pushed up the growing cost of a minimum basket of goods compared to an average household budget over the past decade. The rising prices of food, domestic fuel, water, council tax and public transport prices have been the most important. Figures 2 and 3 show how these prices have risen, relative to RPI inflation, during the past decade and, for comparison, the previous decade.⁷

Figures 2 and 3 show that while all five of these categories rose in price faster than overall RPI in the 2000s, the detailed pattern is more complex. The graphs show first that commodity-driven inflation is a relatively new phenomenon. Food has been rising fastest since 2008 and fuel since 2004. Both these categories fell relative to general inflation in the 1990s, a time of steady real income growth, meaning that overall they became much more affordable. For example, the cost of food was about a quarter lower, relative to average incomes, in 2000 than in 1990. These trends have now started to reverse. Even though the cumulative rise in the relative cost of food has so far been modest compared to some other items shown here, the high share of food in a minimum budget means the impact is considerable.

Figure 2: Annual inflation rates in key categories relative to overall RPI

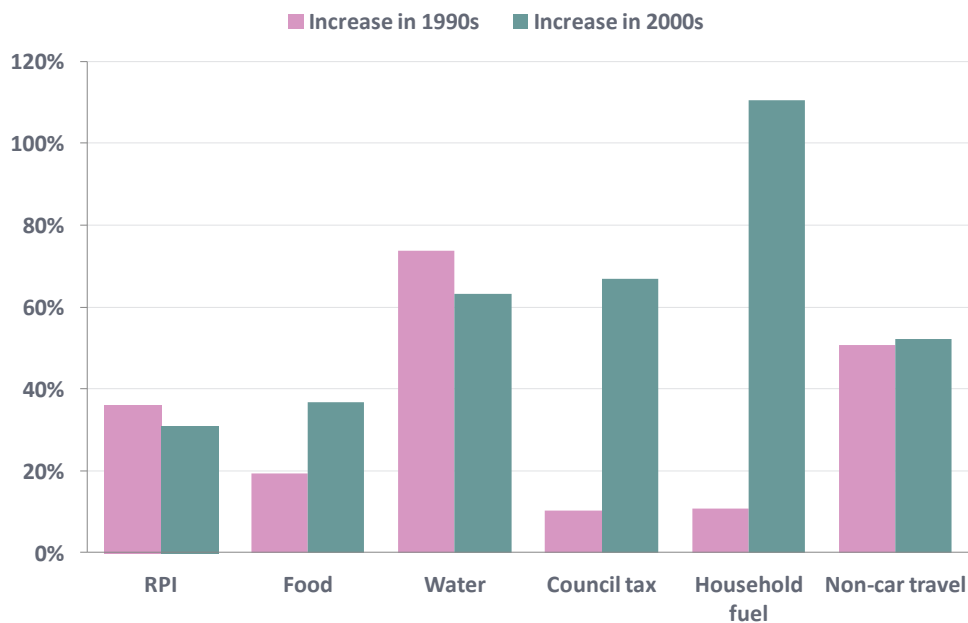
Category-level inflation relative to RPI, 1990-2011



⁷ Since inflation rates shown here are based on RPI categories and calculations, a comparison with the RPI index gives a better idea than with CPI of whether inflation is faster than average impact on each category.

Figure 3: Cumulative price rises in key categories in the 1990s and 2000s

Percentage change



This finding is very important to the story of living standards in the past 20 years and, if these trends were to continue, will be similarly important in the coming decades. In simple terms, it means that, in the 1990s, changes in the price of food, council tax and household fuel, were positive forces, making people on low and modest incomes feel better off than might have been expected from headline figures for incomes and inflation. In the 2000s this dynamic has reversed, with all of the essential categories outlined above increasing the pressure on low to modest income households.

A second striking feature of Figures 2 and 3 is that some categories consumed disproportionately by people on modest incomes have been rising fairly steadily in relative price for a very long time. These include public transport and water, which have been getting more expensive for at least two decades, and council tax, which had inflation-busting increases more often than not between 1995 and 2009. To some extent, these persistent and cumulative increases are linked to reductions in (central government) subsidies, influenced by pressure to contain public spending (for water, which was privatised in 1989, this remains indirectly so, because of the burden on consumers of paying for infrastructure investments that previous governments had failed to make). Importantly, looking ahead to the next few years, there seems little prospect that this trend will reverse. Higher costs for people on low incomes are thus being influenced not just by higher commodity prices but also by the greater than average burden on lower income groups of paying the rising private cost of services which the government has withdrawn.

Section 2: The impact of the new inflation on living standards

What impact has the relatively high increase in the cost of a minimum basket of goods and services had on the living standards of people on modest incomes during the past decade? We can answer this question by comparing changes in the cost of the MIS basket of goods explained above with trends in the incomes of different types of households. At a headline level, we find that many households in Britain, including many containing people in work, struggle to afford an acceptable standard of living. Roughly 30% of working-age households have incomes too low to afford the very basic basket of goods and services that is commonly believed to be a reasonable minimum.

Importantly, for households with incomes close to this level, the MIS-based prices index we set out in Figure 1 is a closer representation of the actual rise in the cost of living than indices such as CPI, which are based on the distribution of average spending. This allows us to use the new inflation figure defined above – the MISPI – to understand what has really happened to the spending power of low to modest income households in the past decade.

To consider the effect of inflation and income levels on such groups, the following analysis looks at two groups of working-age households. One group is around the 40th percentile of the overall income distribution (adjusted for household size), towards the upper end of the ‘low to middle income’ (LMI) group focused on by the Resolution Foundation. This group typically has disposable income around 20-25% higher than the price of our basic basket of goods; in other words, they are able to buy this basket each month and have a little left over. Another group is around the 20th percentile of the distribution, towards the lower end of the Resolution Foundation’s LMI group. People on these incomes typically have disposable income 15-20% too low to afford the MIS basket of goods. In other words, they have to forego some very basic items that would widely be deemed necessary for a minimum standard of living.

It is revealing that both of these groups do *much* less well relative to the minimum standard than a household on average income. Because of the way that household income is distributed, the average household is far better off than a household at the 40th percentile, and has disposable income around 70% higher than the price of our MIS basket. One important result of this fact, which is central to the analysis of this paper, is that the price of a basic basket of goods is therefore likely to represent the spending patterns of an average income household *far* less well than it does the spending patterns of our low to modest income households. In other words, indices based on average spending, like the CPI or RPI, are *much* more appropriate for households at the average than for households on lower incomes.

A household around the 40th percentile, then – one with less income, adjusted for household size, than three fifths of the population - has considerably less than mean average income, but somewhat more than enough to afford a minimum acceptable living standard. Such households can be characterised as being on “modest” means - able to keep their heads above water, but with not much to spare. The issue for them, over time, is the extent to which they can enjoy a lifestyle above the bare minimum: how much “headroom” do they have after covering the basics in life. Since individual needs vary greatly, there will be many households in this category with greater than minimum costs who are still struggling to get by. Critically, as we will see, very small movements around this level can feel very significant in terms of how their day to day life relates to a minimum standard of living.

A household around the 20th percentile, on the other hand, is likely not to be able to meet its needs adequately. While its members may not live in dire hardship, they will have to forego things that are normally expected as part of life in modern Britain. A child in such a household, for example, may never get a holiday, even in the UK, or may lack opportunities such as taking part in after school activities that

are taken for granted by his or her peers. The amount that such a family will have to forego may grow or shrink over time according to how far they are below the minimum standard. Again, small changes in the extent to which a household is below this minimum standard have very big impacts on how much they have to forego, as we will see.

The analysis therefore considers how the average income of people in these groups currently somewhat above and somewhat below MIS has been changing relative to the cost of the minimum basket. It looks at net income after the household has paid tax and national insurance, received tax credits and benefits and paid rent or mortgage and any childcare costs. Thus it compares the household’s disposable income to what it needs to spend to reach the minimum standard. Details of how this calculation has been made and what exactly it represents are in Appendix 1.

Figure 4 shows the overall results between the beginning of the century to financial year 2008/09, the most recent year for which detailed data on household incomes are currently available.⁸

Figure 4: How incomes at the 20th and 40th percentile compare to a basic basket of goods
Percentage income is above or below the cost of a ‘MIS’ basket of goods, all working age households



The results show clearly that households with modest incomes saw their incomes improve in terms of their ability to afford a fixed minimum basket of goods and services during the first half of last decade, but saw a deterioration in this respect in the second half. The fall began around 2005, well before the onset of the recession (the effects of which are not shown here). Households at the 40th percentile, which were able to buy 20% more than the minimum in 2000, could buy 30% more by mid-decade, while those further down the distribution saw a 20% shortfall almost half during this period to 10 percent. Yet, as the chart shows, in both cases nearly three-quarters of these gains had been lost by 2008/09 as a result of the new inflation environment.

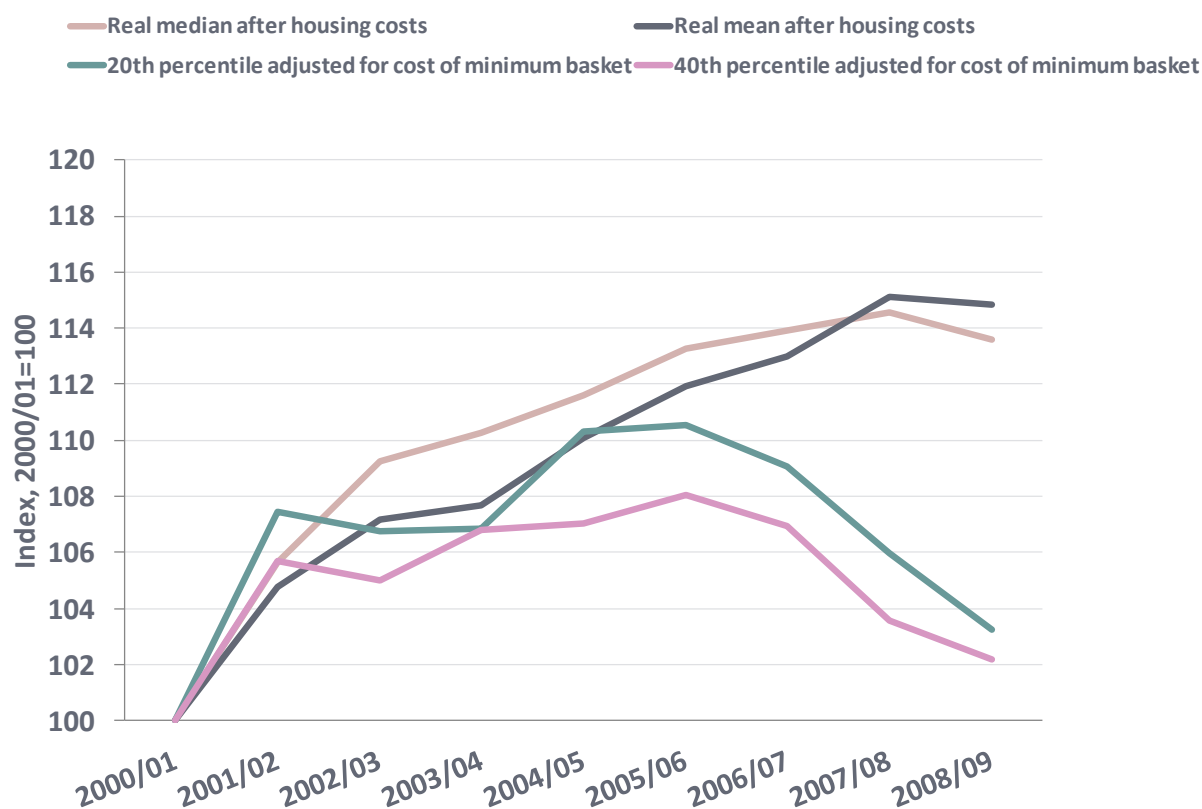
⁸ Overall income data are available for 2009/10, and these are referred to below, but the detail has not yet been released in a form that allows close analysis

As suggested above, an important feature of these results is that what otherwise may look like a relatively minor change in income level can have substantial effects on the ability to meet one's needs. For example, a single person whose weekly disposable income goes from £208 a week (120 percent of the price of the basic basket of goods) to being [189 pounds a week] (110 percent) might seem to have only seen a small reduction in their standard of living. In fact, they have seen the amount of income they have leftover after buying a minimum basket of goods – what might be called their 'discretionary cash' – cut in half. As we have found above, dramatic changes of this type have indeed taken place since 2005 in the UK. A household at the 40th percentile, for example, has seen their breathing room above the basic minimum basket fall from 30 percent to 23 percent – a reduction by a quarter in their discretionary cash in just three years. More starkly still, the shortfall below the minimum faced by households at the 20th percentile has grown from 11% to 17% in the same period, an increase by one half in the value of essential items that such families must go without. Critically, these changes took place before the onset of the 2008/09 recession, and are principally the result of recent changes in the nature of inflation that are not fully captured in the headline rate. Because of a general reliance on average measures of inflation, the scale of these shifts in living standards are not commonly understood.

Figure 5 puts these changes in context by comparing what has happened to average incomes in the same period. It compares average incomes adjusted for the RPI (the most appropriate measure for these households) with low and modest incomes adjusted for the MISPI (which is, as we have seen, the most appropriate measure for these households). In the first half of the decade, the rate of improvement was similar at the mean to that of the 20th percentile (though somewhat faster than the 40th percentile). But since 2005, average incomes flattened in real terms, while the value of modest incomes fell very dramatically. The result is that average households went into the recession around 15% better off than they had been in 2000 while, by stark contrast, lower income households entered the downturn little better off than they had been in 2000.

Figure 5: Changes in the real value of incomes

Average incomes controlled for average inflation compared to low and modest income controlled for the changing price of a basket of goods



This pattern of living standards is not seen in official income distribution statistics, which compare real incomes against an index based on average spending patterns. In other words, families with close to minimum incomes did worse between 2005 and 2009, not because their actual incomes grew more slowly but because the more rapid rise in the cost of what they consume meant that they could buy fewer goods and services. Families on higher incomes have done relatively better in this pre-recession period not simply because their incomes have performed better, but because their spending habits have left them less vulnerable to trends in inflation.⁹

How have these trends played out for different types of household? Figures 6 and 7 show that for households without children, the gains earlier in the decade were smaller, and the proportion of these gains subsequently lost was greater, than families with children. This particularly applies to the 40th percentile, where the gain from 2000 to 2005 for families without children was worth the equivalent of 7% of a minimum budget, whereas for families with children it was worth 13%. For both groups, the subsequent decline was worth 7% of a minimum budget, meaning that those without children were back at the same position relative to this budget as they had been in 2000, while families with children retained nearly half of the gain. At the 20th percentile, these differences were less stark, with families with children losing 60% of their initial gain compared to 80% for households without children.

Figure 6: How incomes in households without children at the 20th and 40th percentiles compare to the cost of a minimum basket of goods

⁹ One important point in understanding Figure 5 is that the comparisons with a minimum standard are based on the changing cost of a minimum basket of goods and services as defined at a point in time, 2008. It does not take account of potential changes in the level of the minimum as a result of the continued growth in general affluence in the first part of the decade. Had the MIS research been carried out in 2000, it might have identified a more modest level of income, required to reach a minimum acceptable standard of living in relatively less prosperous times. To the extent that growth in general living standards causes the minimum to grow, it is possible that low income households did not improve their position relative to the minimum during 2000-2005, even while enjoying an absolute improvement in living standards. In relative terms, they were considerably worse off around the end of the decade than at the beginning.

Percentage above or below the cost of the basic basket of goods

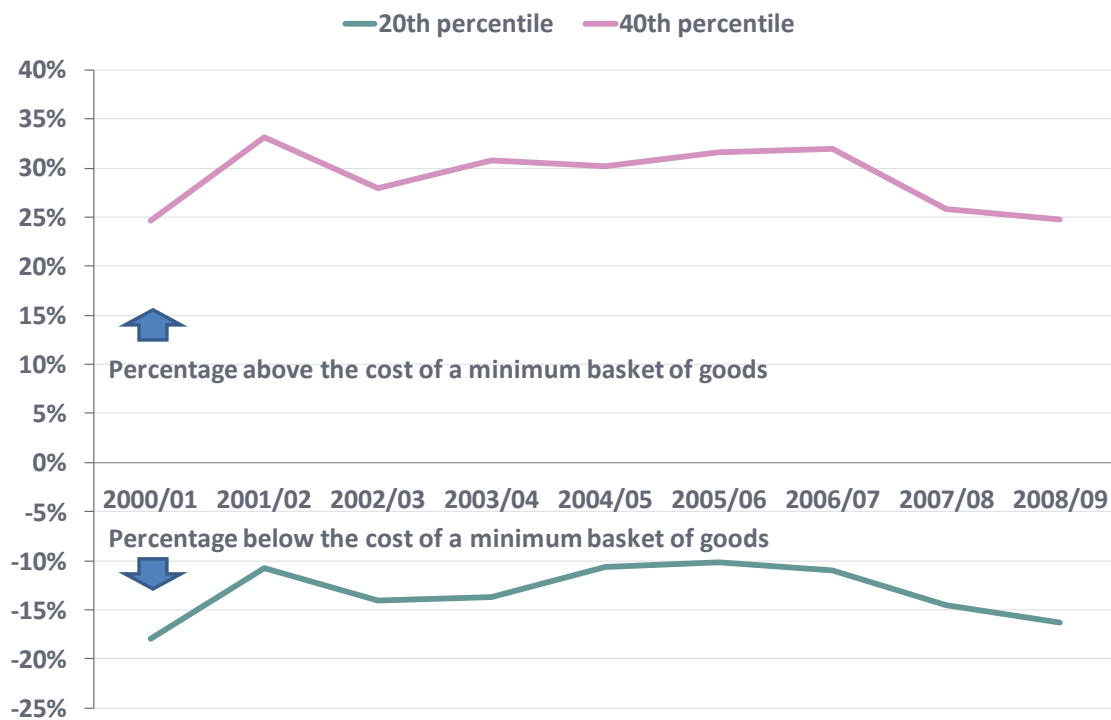
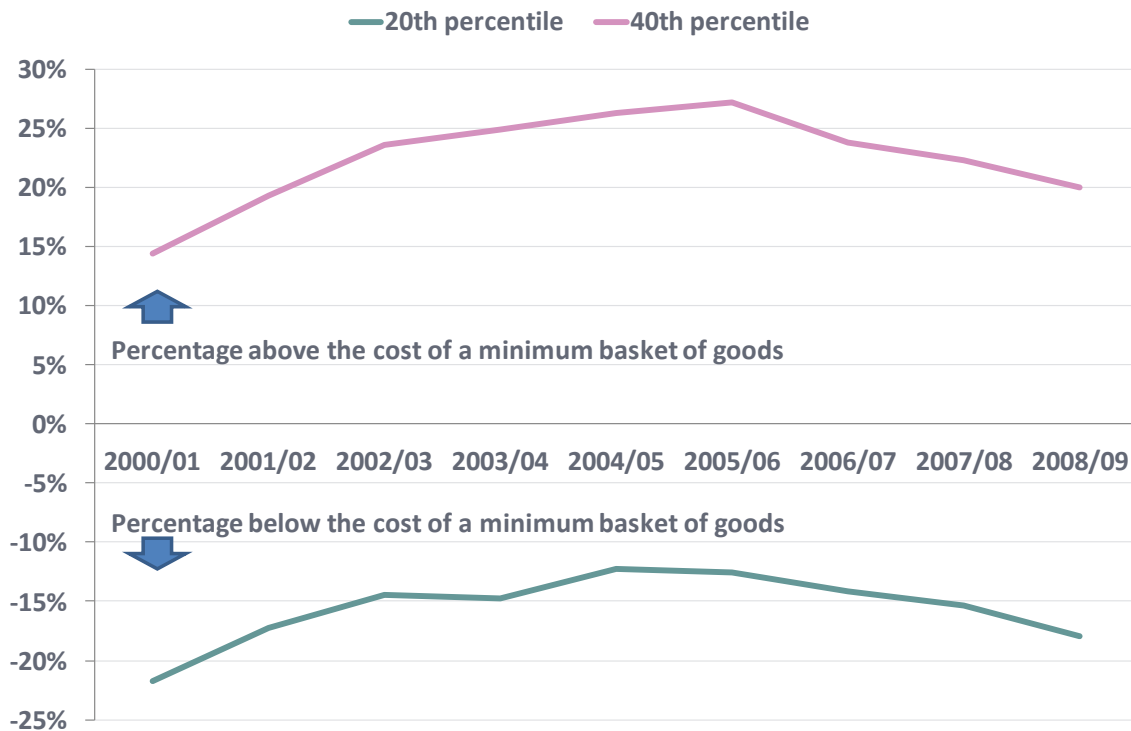


Figure 6: How incomes in households with children at the 20th and 40th percentiles compare to the cost of a minimum basket of goods

Percentage above or below the cost of the basic basket of goods



These differences correspond to the fact that the Government substantially increased support for families on modest incomes through the tax credit system during the early part of the decade, and again from

2008 onwards. While some adults without children became eligible for tax credits in 2003, the bulk of the benefit has gone to families with children. Increasing participation rates among lone parents early in the decade also boosted incomes among this group, whose overall income profile is tilted towards the lower end of the overall distribution.

These effects can be seen more clearly for different household types in Figures 8 and 9. Lone parents whose incomes are currently around the 20th percentile and the 40th percentile of the overall distribution both saw much greater relative rises early in the decade than other groups, although in the case of the 40th percentile there was a significant offsetting loss more recently.¹⁰ In contrast, single people on modest incomes saw no gain in their ability to afford a minimum budget over the period as a whole, and in the case of those at the 40th percentile, losses from 2005 to 2009 outweighed earlier gains. Among families with children, couples with one child have done worst. Since the most generous increases for families with children have been through the child element of the Child Tax Credit, an amount that varies per child, these gains have the least impact in households where the ratio of children to adults is the lowest. Overall, among low to modest income households, in the eight years leading up to the recession, only lone parents and couples with large numbers of children saw a significant overall improvement in their living standards, with these groups seeing sufficiently substantial increases in government assistance to offset the malign effects of poor earnings performance and a more malign inflation environment.

Figure 8: Change in incomes at the 20th percentile relative to the cost of a basic basket of goods
Percentage change in the period, controlled for changes in the price of a basic basket of goods

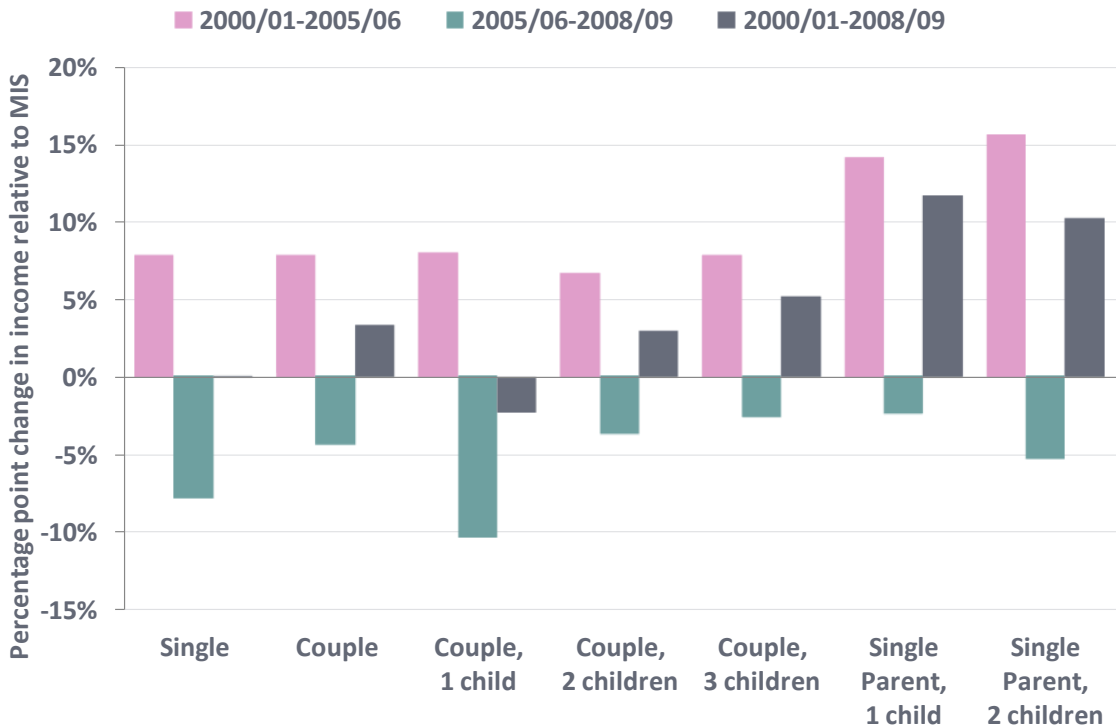


Figure 8: Change in incomes at the 40th percentile relative to the cost of a basic basket of goods
Percentage change in the period, controlled for changes in the price of a basic basket of goods

¹⁰ Note that the definition of each group is calibrated around the overall income distribution in 2008/9. In practice, among a group that has gained relative position in this distribution, the section whose incomes are being compared over time will have started at a lower part of the overall distribution. See Appendix 1.



Section 3: Looking to the future

The above analysis shows that in the years leading up to the recession, the ability of households on modest incomes to afford an acceptable living standard had started to decline, at a time when average household incomes were flat in real terms but not falling. Even before the recession hit, a very significant change in the inflation environment had wiped out much of the gain in real incomes achieved in the last decade.

One immediate question that arises from this striking finding is whether this new inflation environment is here to stay? That is a difficult question to answer. But current data do allow us to estimate what has happened since the 2008/09 recession hit and, from respected forecasts of the next few years, to show illustrative projections of what could happen in the years ahead. In both cases, it must be emphasised that the following are not forecasts, but rather illustrations based on some stated assumptions. Their purpose is not to predict the future but to show how, structurally, the effect of current economic conditions and policies could affect the absolute and relative living standards of people on modest incomes.

In the case of the recent past, this analysis is based on estimates from the Institute for Fiscal Studies (IFS) and, up to 2015, on Office for Budget Responsibility (OBR) forecasts and the assumption (also adopted by the IFS in its modelling) that changes in prices and earnings from 2015 to 2020 remain at the 2015 rate.

In applying these estimates to project changes in living standards, three main additional assumptions are made:

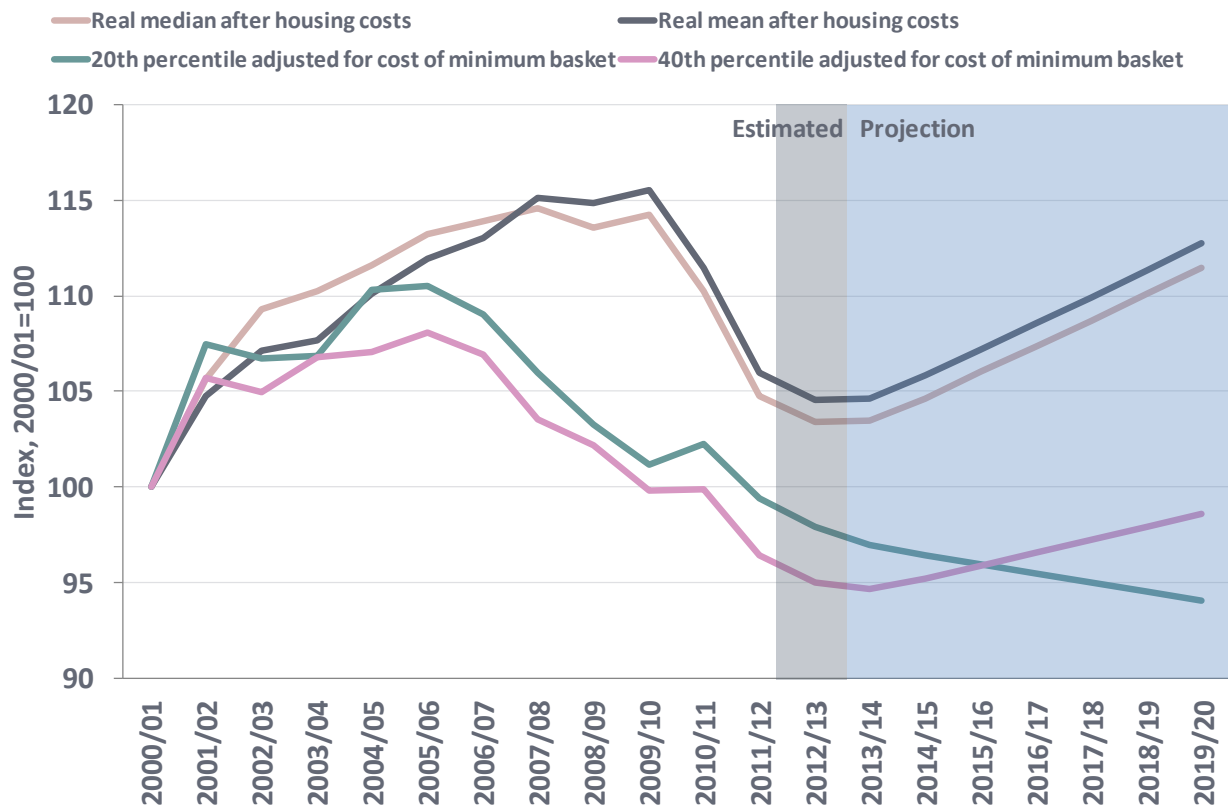
- That the difference between CPI inflation and MIS inflation remains the same in future as the average for the past five years
- That cash incomes on average grow at the same rate as the cash earnings projections made by the OBR
- That cash incomes for people on below average incomes grow in proportion to a weighted average of earnings and CPI (representing growth in benefits), with the assumption that households at the 40th percentile get twice as much income in earnings than benefits, and at the 20th percentile the reverse.

The basis for the projections is set out in more detail in Appendix 2, and the sensitivity of the following analysis to the accuracy of the assumptions that underlie the projections is discussed below. Figure 10 shows the results of these projections, extending the trends shown in Figure 5 above.

These estimates and projections suggest first that we are presently in a period of rapid contraction in average incomes, likely to be particularly severe in 2010-11 and 2011-12. Further falls for people on modest incomes could be less severe than average, since those with some benefit and tax credit income, pegged to prices, will have part of their incomes protected in real terms (and also because the “MIS inflation” rate is presently low relative to the ROSSI inflation rate used when calculating real disposable incomes). However, by 2013, when real earnings are forecast by the OBR to start rising again, average living standards for people on modest incomes could have fallen to below their 2000 levels, while those on average incomes remain better off than at the beginning of this century.

Figure 10: Projected changes in the real value of incomes

Average incomes controlled for average inflation compared to low and modest income controlled for the changing price of a basket of goods



Looking further ahead, Figure 10 illustrates how a return to modest earnings growth of about 1.5% in real terms on average could leave people on modest incomes with living standards that remain low compared to previous levels: on this projection, still below what they were in 2000. This is due to the combined effect of higher than average inflation rates and having part of household income pegged to an inflation index that lags well behind both earnings and the real extra costs that these households face. In the case of households at the 20th percentile of income, the higher component of assumed benefit income could mean that living standards continue to decline for the foreseeable future.

How plausible are these projections as an illustration of the pattern of change in living standards in the coming years? As with any projections, particularly in the present uncertain economic environment, huge uncertainty surrounds the assumptions on which they are based. The projections are not therefore forecasts, but we can distinguish two aspects of how helpful they are in envisaging the future: the timing of a return to growth and the distribution of the fruits of that growth.

On the first of these, we must acknowledge that nobody can accurately predict when or how rapidly there may be a return to growth that causes overall living standards to rise in real terms. The OBR forecasts that by the middle of this decade, wages will be growing by 4.5% a year and inflation will be 2-3% on different measures. The uncertainty over world economic conditions makes it hard to be confident that this will be the case. However, it may be reasonable to assume that at *some* point in the next few years the tide will turn in this direction. Therefore, the right-hand side of Figure 10 may be taken as a picture of who will benefit from a return to growth, rather than a forecast of precisely when this will occur.

But how accurate is that pattern – showing a divergence between the fortunes of average and lower-income households – likely to be? This depends on the accuracy of two further assumptions. First, that

incomes for households relying heavily on benefits and tax credits will diverge from those of the average household. This assumption is heavily subject to future policy decisions, but present signs are not looking good. The long-term pegging of benefits and tax credits to the Consumer Prices Index, which systematically rises more slowly than other inflation indices, signals the Government's desire to contain increases in the welfare bill. Were the CPI to be rising at 2% and wages at 4.5% as forecast by the OBR, the "default" policy position would be for the incomes of people heavily dependent on state transfers (including many people in work and in receipt of tax credits) to fall substantially relative to those of people just dependent on wage income.

The second assumption driving this divergence is that the cost of essentials will rise relative to overall inflation, causing those whose spending is mainly on essentials to do poorly relative to the average. This assumption is subject to more uncertainty, especially from one year to the next, as prices of commodities have been highly volatile. However, as argued in Section 2 above, long-term pressures in the world economy make it highly likely that over the next decade the global price of resources and especially energy will continue on an upward trend. This makes the differential inflation rates used in these projections highly plausible in projecting the long terms pattern of living standards, even though the year to year projections are likely to be inaccurate. At the very least, these illustrations show the extent to which the living standards of people on low incomes in the UK will be highly vulnerable to global influences.

Implications for policy

What are the implications for policy of the analysis set out in this paper? Even before our findings about differential inflation rates are taken into account, recent trends in earnings, income and general inflation present us with some inescapable facts about future trends in living standards for low to middle income households that paint a very pessimistic picture.

First, because households on lower incomes now receive large proportions of their income from government support, even if future wage growth is even across the economy (rather than highly unequal as it has been in recent decades), households on lower incomes will fall behind unless government support also rises in line with earnings. Second, the government's decision to move from the RPI to the CPI measure of inflation as the uprating mechanism for most benefits and tax credits means that government support will in fact now rise more slowly than in the past, and much more slowly than earnings. Third, planned real reductions in government support over and above this indexing change will mean that many aspects of support will rise even more slowly than CPI, seeing real terms cuts.

Put another way, in order to believe that low to middle income households will not fall further and further behind higher income households in the coming years, we would need to believe one or more of the following:

- That wages will grow more quickly at the lower end of the distribution than they do at the top for a sustained period of time, in a way they have not in the last three decades
- That there will be a sudden and dramatic reversal of government policy on benefits and tax credits (and therefore a change in the government's overall fiscal policy), reversing not only the shift from RPI to CPI (which saves £11 billion by 2015-16) but also pledging substantial above-inflation increases in spend
- That employment rates and/or hours worked will, over a sustained period of time, rise far more quickly in low income households than they do in higher income households

Overall, then, there is little reason to believe that disposable incomes will perform well, even against standard, average measures of inflation. Our findings on the impact of a new, more malign inflation environment add an additional challenge. They mean that the task of preventing low to middle income households from falling behind now faces even stronger headwinds. With the cost of an essential basket of goods now rising significantly faster than general inflation, more and more low to middle income households will not just fall behind those above them, but also behind what is widely considered to be a minimum acceptable standard of living. For those who can currently afford this basket of goods, their breathing space will get increasingly restricted. For the surprising numbers of households who are already below this standard, more and more basic goods will have to be foregone. Before the 2008/09 recession, this new inflation environment had already wiped out all the gains in living standards that lower income households had achieved in the early 2000s. If they continue, living standards will be appreciably lower come 2020.

When it comes to policy - especially in the context of severe fiscal constraints - the new importance of inflation for social outcomes should cause the Government to look for every feasible way of keeping the price of essential goods and services down. Of course, in reality very significant parts of this picture are beyond the control of UK policymakers. Global price pressures on commodities, for example, will not yield to policy decisions in the UK. This makes it all the more important that everything possible is done in the

few areas in which we do have purchase. What aspects of government policy become more important in this environment?

For one, it is important that we are not naïve to the impact on living standards of reduced public subsidies for key goods and services where these reductions feed through into higher prices for consumers. This shift from public to private expenditure has been a key dynamic of the past 30 years and its full implications for living standards have been obscured by a general tendency to focus only on headline rates of inflation. To take one example, in the case of public transport, far more priority could be given to maximising the use of public subsidies and franchising agreements to control costs for low to middle income consumers, in particular for those reliant on public transport for work.

Other areas of public policy may also deserve a higher priority. Efforts to exert downward pressure on energy prices, whether through increased competition or the greater use of redistributive mechanisms like social tariffs, are one. Another may be the reform of Council Tax to reduce pressures on low income households, a group that have suffered from above inflation increases in Council Tax at the bottom coupled with the failure of rates to keep track with rising property prices at the top.

Ultimately, the only sure way for a government to preserve the living standards of those relying on payments from the state and facing high inflation rates is to ensure that these payments rise in line with people's real living costs. This would mean using an uprating index that reflects these costs much more fairly than the Consumer Prices Index. In the short term, fiscal austerity would make such a change extremely difficult. At the very least, the Government should be acutely aware of the increased importance of inflation in influencing inequalities. Prices are today a more salient issue for social policy than they have been for many years.

Appendix 1: How incomes around the 20th and 40th percentiles are compared to MIS requirements

This paper has set out to track the incomes, relative to need, of households at particular points of the income distribution – namely those with income, adjusted for household composition, that is higher than about a fifth and lower than four fifths of households (20th percentile) and those with income higher than two fifths and lower than three fifths of households (40th percentile). This calculation has been made based on the Family Resources Survey (FRS) for each year between 2000/01 and 2008/10. We have looked at the “after housing cost” definition of income used in that survey, which also deducts direct taxes and council taxes from reported income, and in addition we have deducted reported childcare costs, to give a “net” figure comparable to the basic weekly budgets specified in MIS.

One possibility would have been to consider in each year a set of households whose adjusted incomes are close to the relevant points in the distribution (e.g. close to the 20th percentile), and work out for each of them how their actual incomes compared to the needs specified for that household in MIS. The problem with this method is that it would not have been effective in tracking changes in the relative fortunes of different groups over time. If for example single adults on low incomes became worse off relative to other household types from one year to the next, our selection of single adults at the 20th percentile of the overall distribution would simply be further up the distribution of single adults in the later year, since more single adults would be relatively far down the overall distribution. At a particular percentile of the adjusted distribution, all household types will always seem about equally well off: that is the point of the adjustment (“equivalisation”).

Another possibility would have been to look consistently at households at or around the 20th percentile of each household group. This would have allowed us to look at a comparable group of people from one year to the next, and to note where worse-off people within one household type are doing better or worse over time than worse-off people in another type of household. However, this would have meant comparing households at very different levels of living standards in different household types. Most lone parents have relatively low incomes: the majority have below 70% median income after housing costs, the approximate level of MIS, meaning that a household at the 40th percentile of lone parent incomes has significantly less than its minimum needs. On the other hand, couples without children have a relatively prosperous income profile, with only one in six below 70% median, so even at the 20th percentile such families are above the minimum requirement. This makes such a method a poor way of comparing how effectively different groups with just above or just below minimum incomes are managing to keep their heads above water.

Instead, we used the following method. For each of a number of household types (all of working age), we considered about where in the distribution of incomes of those households someone would be if they were on 20 per cent of adjusted incomes in 2008/09. For example, we found that 29% of single people had adjusted incomes below the 20th percentile of all households – i.e. the 29th percentile of single people’s incomes coincides with the 20th percentile of all incomes. We therefore were interested in a group of single people close to the 29th percentile of single person households. To get a reasonable sized sample, we looked at the average income of single person households between the 25th and 35th percentile of such households – representing a sample of 10% of single people with incomes close to the 20th percentile of the overall distribution. We repeated this selection for all households, using a sample bounded by percentiles divisible by 5, e.g. 10th-20th, 15th-25th, 20th-30th etc, according to which of these decile groups the equivalent percentile was closest to the centre of. The following groups were used:

Family type	Decile group around the 20 th	Decile group around 40 th
	Percentile of all incomes	Percentile of all incomes
Single adult working age	25th-35 th	40th-50 th
Couple working age	5th-15 th	15th-25 th
Couple 1 child	10th-20 th	25th-35 th
Couple 2 children	10th-20 th	30th-40 th
Couple 3 children	20th-40 th	55th-65 th
Lone parent 1 child	40th-50 th	60th-70 th
Lone parent 2 children	40th-50 th	65th-75 th

The analysis looked only at “single-unit” households, i.e. those with a single person or a couple plus any dependent children. We excluded couples with four or more and singles with three or more children, which involved much smaller samples for which we could not report statistically reliable comparisons of average incomes.

For each household type, we then compared average actual income in each year to the cost of the 2008 MIS budget requirement, adjusted for changes in prices using components of the Retail Prices Index. The average percentage difference between actual incomes in the relevant decile group and the MIS requirement is reported here.

These percentages should be interpreted as showing the changing fortunes of the 10% of households in each type who were close to the 20th and 40th percentiles of the overall distribution in 2008/09. However, it is not valid to compare the precise position of this average across groups in any one year (e.g. to attach meaning to the fact that single people around the 20th percentile were 18% below and couples 20% below MIS in 2008/09), for two reasons. One is that the method looks at a group of people whose position in the overall distribution is not identical for each group – the commonality is that in each case it is 10% of that group, in a range that includes the 20th percentile overall. The other is that the relationship between the “equivalised” incomes using the official scales for adjusting for family size is not identical to the relative needs of families as measured in MIS, so part of the difference relates to the inaccuracy of equivalisation rather than differences in the fortunes of different groups. However, the *change* in the adequacy of incomes of different groups relative to MIS is directly comparable. In each case the data show how much better or worse off a section of the population in broadly the same position in the overall income distribution has become over time.

Appendix 2: The basis for the illustrative projections

The estimates of present values and future projections shown in Figure 10 are not intended as forecasts as an illustration of how a number of factors could influence the relative movement of living standards for average and for lower income households. They were compiled on the basis of the following data and assumptions:

- Average earnings, the Consumer Prices Index and the ROSSI index increase as observed up to calendar year 2010, as forecast for whole calendar years by the Office for Budget Responsibility for 2011-15 and at the same rate as 2015 for future years.¹¹
- MIS inflation is as observed to 2011 and thereafter at a rate equivalent to the forecast increase in the Consumer Prices Index for each calendar year plus the average difference between MISPI and CPI for the past five years (2006-2011), which is a “MIS inflation premium” of 1.33%.
- Changes in mean and median household incomes are as reported in the HBAI figures for 2009/10, as estimated by the Institute for Fiscal Studies (-3.5%) for 2010/11 and thereafter at the projected rate of increase in real earnings, based on OBR calendar year projections for earnings and ROSSI inflation. (This means that from 2011/12 onwards the increases are estimated based on the main calendar year comprising each financial year – e.g. the 2011 forecast is used to estimate the situation in 2011/12)
- Changes in cash incomes at the 20th and 40th percentiles are assumed to be weighted averages of projected earnings increases and the projected rise in the Consumer Prices Index, representing benefit income. The weightings used are 2:1 in favour of CPI/Benefits for the 20th percentile and 2:1 in favour of earnings at the 40th percentile.¹² The resulting estimates of cash income changes are then divided by MIS inflation to estimate the change in the value of income relative to MIS.

¹¹ OBR March 2011 *Economic and Fiscal Outlook*; OBR March 2011, *ROSSI inflation forecast*

¹² Based on author estimates of the approximate distribution of income sources from http://clients.squareeye.com/uploads/2020/documents/ESRC_preston%20FINAL.PDF page 13

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- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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