

Tax and benefit reforms due in 2012-13, and the outlook for household incomes

IFS Briefing Note BN126

Robert Joyce

Tax and benefit reforms due in 2012–13, and the outlook for household incomes

*Robert Joyce**

Institute for Fiscal Studies

March 2012

1. Introduction

This Briefing Note is intended to provide background to the Chancellor's Budget on 21 March 2012. It first gives an overview of the tax and benefit reforms currently planned for the coming financial year and their likely impact on household incomes. It then considers the outlook for household incomes in the near future more broadly, given current macroeconomic forecasts of variables such as employment and earnings as well as planned tax and benefit policy.

Section 2 sets out the estimated impacts on household incomes of tax and benefit reforms due to be implemented in 2012–13. These amount to a net 'takeaway' of about £4.1 billion (an average of £160 per household) in that year, rising to about £9.8 billion (£370 per household) in 2013–14 once all the revenue from tax liabilities accruing in 2012–13 has been collected and once the full-year effects of changes to fuel duties and Child Benefit (in August 2012 and January 2013 respectively) are felt. This comes on top of the effect of indirect tax rises (in particular the rise in the main rate of VAT from 17.5% to 20%) in January 2011, totalling about £12.8 billion per year

* This work was funded by the ESRC Centre for the Microeconomic Analysis of Public Policy at the Institute for Fiscal Studies (RES-544-28-5001). The author would like to thank his colleagues James Browne, Carl Emmerson and Paul Johnson for modelling advice and drafting suggestions. The Family Resources Survey was made available by the Department for Work and Pensions, which bears no responsibility for the interpretation of the data in this Briefing Note.

The analysis presented here is similar to that underlying some of IFS's post-Autumn-Statement briefing on 30 November 2011 (see slides 10–14 of the presentation by Robert Joyce at <http://www.ifs.org.uk/publications/5930>) and IFS analysis by James Browne in January 2012 of the prospects for incomes among households with children (<http://www.ifs.org.uk/publications/5973>), but it makes use of more recent data.

(£480 per household), and a net takeaway of about £3.9 billion (£150 per household) in 2011–12 from tax and benefit reforms introduced during that year. The largest average losses from the 2012–13 reforms as a percentage of income will be among those in the bottom half of the income distribution. Households with children are set to lose the most from the reforms, and pensioner households are the one major demographic group who will gain from them, on average.

Section 3 considers the outlook for household incomes more generally, accounting for the Office for Budget Responsibility's (OBR's) latest macroeconomic forecasts of variables such as employment and earnings, as well as tax and benefit policy. It suggests that the UK is experiencing a fall in average living standards (as measured by real household incomes) that is large by historical standards, but, if current macroeconomic forecasts are correct, much of the peak-to-trough decline has now happened. Nevertheless, real growth in median household income is forecast to remain comfortably below its historical average rate until beyond 2015–16. Projections of income poverty suggest that, on average, those on lower incomes are set to fare even worse in terms of changes in real income than those on middle incomes; in particular, the government's child poverty targets continue to be utterly unrealistic under current policies.

2. Tax and benefit reforms due in 2012–13

Estimated revenue effects

The post-recession fiscal tightening is under way, and reforms to the tax and benefit system are playing their part: about 20% of the reduction in government borrowing by 2016–17 is planned to come from tax increases, and a further 14% from welfare cuts.¹ Following indirect tax rises (in particular the rise in the main rate of VAT from 17.5% to 20%) in January 2011, totalling about £12.8 billion per year² (about £480 per household,

¹ See chapter 3 of *The IFS Green Budget: February 2012*, available at <http://www.ifs.org.uk/publications/6003>.

² See chapter 12 of *The IFS Green Budget: February 2011*, available at <http://www.ifs.org.uk/publications/5460>.

on average), and a net ‘takeaway’ of about £3.9 billion³ (£150 per household) in 2011–12 from tax and benefit reforms introduced during that year, a further net takeaway of about £4.1 billion (£160 per household) is planned for 2012–13 as a result of additional tax and benefit reforms. Note that the takeaway from these same reforms will rise substantially to about £9.8 billion (£370 per household) in 2013–14, once all the revenue from tax liabilities accruing in 2012–13 has been collected and once the full-year effects of changes to fuel duties and Child Benefit (in August 2012 and January 2013 respectively) are felt.

This April will be the second time that the consumer price index (CPI) rather than the retail price index (RPI) or the Rossi index is used to uprate most benefits and tax credits; and there will be various additional benefit and tax credit cuts. But there will be some giveaways too: the income tax personal allowance for those aged under 65 will be increased in real terms; the Basic State Pension will increase by more than it would otherwise have done because of this government’s so-called ‘triple lock’ guarantee (see later); and council tax in England will be cut in real terms (frozen in cash terms).

Table 1 lists the main reforms due to be implemented in 2012–13, showing the estimated revenue effects in both 2012–13 and 2013–14.⁴ Those in italics are excluded from the subsequent analysis of the effects of tax and benefit reforms, as they cannot be robustly attributed to particular households with the data available. The table shows that there is to be a net ‘takeaway’ of around £4.1 billion from tax and benefit reforms to be

³ Based on the ‘2011–12’ columns of tables 2.1 and 2.2 of HM Treasury, *Budget 2011* (http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf) and table 2.1 of HM Treasury, *Autumn Statement 2011* (http://cdn.hm-treasury.gov.uk/autumn_statement.pdf).

⁴ Revenue effects for both years are included for two reasons. First, there are to be changes in fuel duties and Child Benefit in the middle of financial year 2012–13, so the revenue estimates for 2013–14 give the reader an idea of the full-year effects of these measures. Second, the Treasury presents costs on a ‘National Accounts’ basis. For corporate taxes, self-assessment income tax and inheritance tax, this means that revenues are accounted for when revenue is actually received by the government rather than when liability accrues. In these cases, the figures listed for 2012–13 understate the long-run impacts of reforms, as a significant part of the revenue will not be received until the following year, and this is instead captured in the figures listed for 2013–14.

introduced in 2012–13 (with some additional takeaway in 2013–14 in respect of tax increases that have been imposed in 2012–13). This comprises a gross takeaway of about £8.2 billion and a gross giveaway of about £4.1 billion.

Table 1. Estimated revenue effects of tax and benefit reforms due in 2012–13

	<i>2012–13 estimated revenue effect (£ million)</i>	<i>2013–14 estimated revenue effect (£ million)</i>
<i>Announced by previous government</i>	+935	+1,715
Freeze higher-rate income tax threshold	+590	+1,310
<i>Freeze inheritance tax threshold</i>	<i>+55</i>	<i>+145</i>
Tobacco duty escalator	+50	+30
Alcohol duty escalator	+120	+110
<i>Company car tax: extend bands</i>	<i>+120</i>	<i>+120</i>
<i>Announced in June 2010 Budget</i>	+2,415	+4,655
Tax credits		
Taper family element of Child Tax Credit immediately after child element	+475	+445
Introduce disregard of £2,500 for falls in annual income	+245	+510
Reduce backdating for new claims and changes of circumstances from 3 months to 1 month	+345	+355
Abolish 50+ element of Working Tax Credit	+45	+50
Benefits		
CPI-index most benefits and tax credits (<i>and public sector pensions</i>)	+1,375	+1,405
Increase Basic State Pension by highest of average earnings growth, CPI inflation and 2.5%	–1,570	–1,610
Freeze Child Benefit	+625	+625
Index Housing Benefit deductions for non-dependants with prices	+75	+75
Corporate taxes		
<i>Capital allowances: decrease main rate to 18% and special rate to 8%</i>	<i>+600</i>	<i>+1,600</i>
<i>Reduce Annual Investment Allowance to £25,000</i>	<i>+200</i>	<i>+1,200</i>

	<i>2012–13 estimated revenue effect (£ million)</i>	<i>2013–14 estimated revenue effect (£ million)</i>
<i>Announced in 2010 Spending Review</i>	+2,190	+4,385
Time-limit contributory Employment and Support Allowance to one year for those in Work-Related Activity Group	+455	+820
Freeze maximum Savings Credit award	+55	+55
Withdraw Child Benefit from families containing a higher-rate income taxpayer from January 2013	+600	+2,435
Freeze basic and 30-hour elements of Working Tax Credit	+565	+565
Increase work requirement for Working Tax Credit to 24 hours per week for couples with children	+515	+510
<i>Announced in 2011 Budget</i>	-965	-1,785
Income tax and National Insurance		
Increase personal allowance and cut basic-rate limit by £630 (so higher-rate threshold is unaffected)	-920	-1,060
CPI-index some direct tax thresholds	+45	+45
Reduce contracted-out National Insurance rebates	+640	+630
Corporation tax		
<i>Reduce main rate to 25%</i>	<i>-400</i>	<i>-700</i>
<i>Other tax and benefit changes</i>	<i>-330</i>	<i>-700</i>
<i>Announced in 2011 Autumn Statement</i>	-475	+850
Freeze council tax in England	-675	0
Freeze fuel duties until 1 August 2012; then raise by 3.02p per litre	+90	+525
Freeze couple and lone parent elements of Working Tax Credit	+265	+290
Pension Credit: increase standard minimum income guarantee and raise Savings Credit threshold	negligible	negligible
<i>Other tax changes</i>	<i>-155</i>	<i>+35</i>
Total ‘giveaway’	-4,050	-4,070
Total ‘takeaway’	+8,150	+13,890
Grand total	+4,100	+9,820

Notes and sources: See next page.

Notes and Sources for Table 1

Notes: This table includes only reforms to be introduced during 2012–13, and revenue estimates relate only to those reforms. For example, Child Benefit is due to be frozen in both April 2012 and April 2013, but the revenue estimates here only incorporate the effect of the freeze in April 2012. Reforms that were announced but subsequently cancelled before implementation are not listed. Reforms that were announced but subsequently modified only appear once, in their modified form. For example, the cut to the main rate of corporation tax to 26% in 2012–13 announced in the June 2010 Budget does not appear, because the cut was subsequently revised to 25% in the March 2011 Budget. For reforms announced before the Autumn Statement 2011, the most recently published Treasury revenue estimates were based on OBR inflation forecasts that have now been superseded – where possible, the estimates here have been adjusted in an attempt to account for this.

Sources: Author's calculations using table 2.1 of HM Treasury, *Autumn Statement 2011* (http://cdn.hm-treasury.gov.uk/autumn_statement.pdf); tables 2.1 and 2.2 of HM Treasury, *Budget 2011* (http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf); table 1.6 of *HMRC Statistics* (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf); table 4.3 of OBR, *Economic and Fiscal Outlook: March 2011* (http://budgetresponsibility.independent.gov.uk/wordpress/docs/economic_and_fiscal_outlook_23032011.pdf), and supplementary document showing OBR's Rossi inflation forecasts (<http://budgetresponsibility.independent.gov.uk/wordpress/docs/ROSSI.pdf>); tables 4.3 and 4.18 of OBR, *Economic and Fiscal Outlook: November 2011* (http://cdn.budgetresponsibility.independent.gov.uk/Autumn2011EFO_web_version138469072346.pdf), and supplementary document showing OBR's Rossi inflation forecasts (<http://budgetresponsibility.independent.gov.uk/wordpress/docs/ROSSIDec2011.pdf>).

Distributional impact

This subsection presents estimates of the distributional impact of the reforms listed in Table 1. To do this, the estimated distribution of net income under the planned 2012–13 tax and benefit system is compared with the corresponding distribution under a 'counterfactual' system. The counterfactual is a system where tax and benefit withdrawal rates remain unchanged from their levels in 2011–12, and benefit amounts and tax thresholds are updated from their 2011–12 levels in line with the public finance defaults set down by the previous government.⁵

It is important to note that behaviour and pre-tax prices are held constant in the proceeding distributional analysis. This is consistent with HM

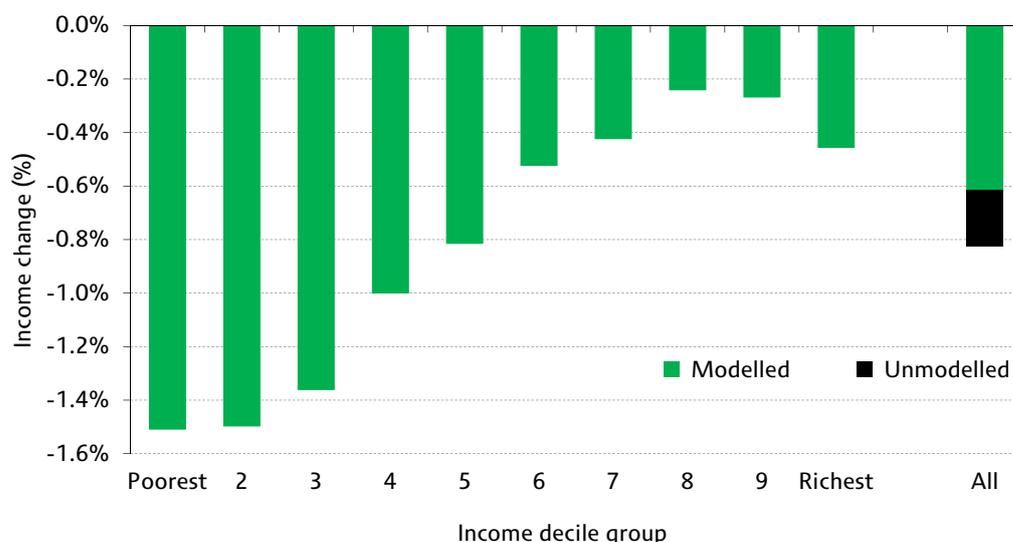
⁵ See annex A of HM Treasury's June Budget 2010 policy costings document (http://www.hm-treasury.gov.uk/d/junebudget_costings.pdf). It is something of a moot point how long the changes to indexation policy announced by this government should be treated as a 'reform' in modelling exercises such as this. A change to indexation policy is fundamentally different from a one-off change to the level of a benefit or tax threshold: it is in fact an infinite sequence of year-on-year changes to those levels. Treating an indexation change as a change to benefit and tax threshold levels only in the first year of the new indexation regime would fail to recognise this extremely important distinction. April 2012 will be the second time that benefits and tax credits have risen in line with CPI inflation rather than RPI or Rossi inflation, and the first time that some direct tax thresholds have risen in line with CPI inflation rather than RPI inflation. It is therefore certainly appropriate to continue to treat the indexation switch as a reform in this analysis.

Treasury's distributional analysis (most recently alongside the Autumn Statement of November 2011), but not with the revenue estimates in Table 1, which do allow for some behavioural responses. It is probably not realistic that households' behaviour would be completely unaffected by these tax and benefit changes, but this does not mean that incorporating behavioural responses would yield a better impression of the impact on people's welfare. For example, people may move into work in response to lower out-of-work benefit entitlements, but this implies a welfare cost for those individuals as well as the benefit of extra earnings (otherwise they would presumably have chosen to work even before the reform in question).

The assumption that pre-tax prices are unaffected by tax and benefit reforms may affect the estimated distributional impacts of those reforms. For example, it implies that retailers fully pass on to consumers the real increases in tobacco and alcohol duty in the form of higher retail prices, but in practice they may not, and the impact of the higher duties may therefore be to reduce shareholder returns or employee wages instead.

With these caveats in mind, Figure 1 shows the distributional impact of reforms to be introduced in 2012–13, by income decile group. The total monetary gain or loss for each group – income gained or lost plus decreases or increases in indirect taxes paid – is given as a proportion of its net income. The figure excludes the impact of those reforms in italics in Table 1, such as the reduction in the main rate of corporation tax, which cannot be allocated to particular households precisely enough with the data available. But all of these tax and benefit changes will ultimately affect households, so the reforms that we are unable to allocate to particular households are shown in the 'all' series and labelled 'unmodelled'. The effects of reforms on incomes are modelled as though taxes are paid when liability accrues, rather than on a National Accounts basis (e.g. Figure 1 captures the full long-run impact of freezing the higher-rate income tax threshold, even though the government will not actually receive much of the revenue from this until the following year). Analysis is presented at the household level.

Figure 1. Distributional impact of tax and benefit reforms to be introduced in 2012–13, by income decile group



Notes: Income decile groups are derived by dividing all households into 10 equally-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Figure assumes full take-up of means-tested benefits and tax credits.

Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2009–10 Family Resources Survey and the 2009 Living Costs and Food Survey.

The largest average losses as a fraction of net income from the modelled tax and benefit reforms to be introduced in 2012–13 are among those in the bottom half of the income distribution. The lowest-income fifth of households will lose about 1.5% of their net income from these reforms, on average. Within the bottom eight income decile groups, the losses as a percentage of income are decreasing with income, with an average loss in the eighth decile group of 0.2% of income; but the losses in the ninth and (particularly) the tenth decile groups are greater than in the eighth (although still substantially smaller as a percentage of income than in the bottom half of the distribution).

Households towards the bottom of the income distribution lose out particularly from the lower benefit rates that arise from using the CPI to uprate them rather than the RPI or the Rossi index, from the time-limiting of contributory Employment and Support Allowance (ESA) to one year for those in the Work-Related Activity Group (the majority of ESA recipients who are assessed to be less severely disabled) and from the cash freezes to Child Benefit⁶ and Working Tax Credit amounts. These households also

⁶ In cash terms, the losses from the cash freeze to Child Benefit are quite uniform across the income distribution (unsurprisingly, because it is currently a universal benefit for

tend to benefit relatively little from the increase in the income tax personal allowance, as many individuals in these households would have had a personal income below the allowance (i.e. they would have paid no income tax) even without the increase, or from the cash freeze to council tax in England, since many of them are in receipt of Council Tax Benefit and hence unaffected by changes to council tax. Households in the middle and upper-middle of the income distribution benefit the most as a percentage of income from the increase in the personal allowance and the real reduction in council tax. Households towards the top of the income distribution lose out from the real cut to the higher-rate income tax threshold, which increases the range of income over which affected individuals pay income tax at 40%, and from the withdrawal of Child Benefit from families containing a higher-rate income taxpayer (but this policy will be introduced in January 2013, so only about one-quarter of its long-run impact is captured in this analysis, which focuses on 2012–13).

Figure 2 shows how the pattern varies by household type and work status. On average, the gainers from the modelled reforms are pensioner households. Pensioners benefit from the so-called ‘triple lock’ guarantee for the Basic State Pension, which ensures that it rises each April by the highest of CPI inflation, average earnings growth and 2.5%. In April 2012, this means that it will rise by 5.2% (CPI inflation), whereas under the indexation rules inherited by this government it would have risen by 1.9% (average earnings growth).⁷ It is worth noting that even this triple lock will be less generous in the long run than a triple lock that used the RPI (rather than the CPI) as the measure of prices, because RPI inflation tends to be higher. Also, in the short run, a triple lock that uses the CPI as the measure of prices (i.e. the current policy) is less generous than straightforward RPI indexation, which was formerly the policy (the previous government had planned to switch to earnings indexation from 2011–12). But this is a peculiarity of the present, as real earnings are falling: typically, average

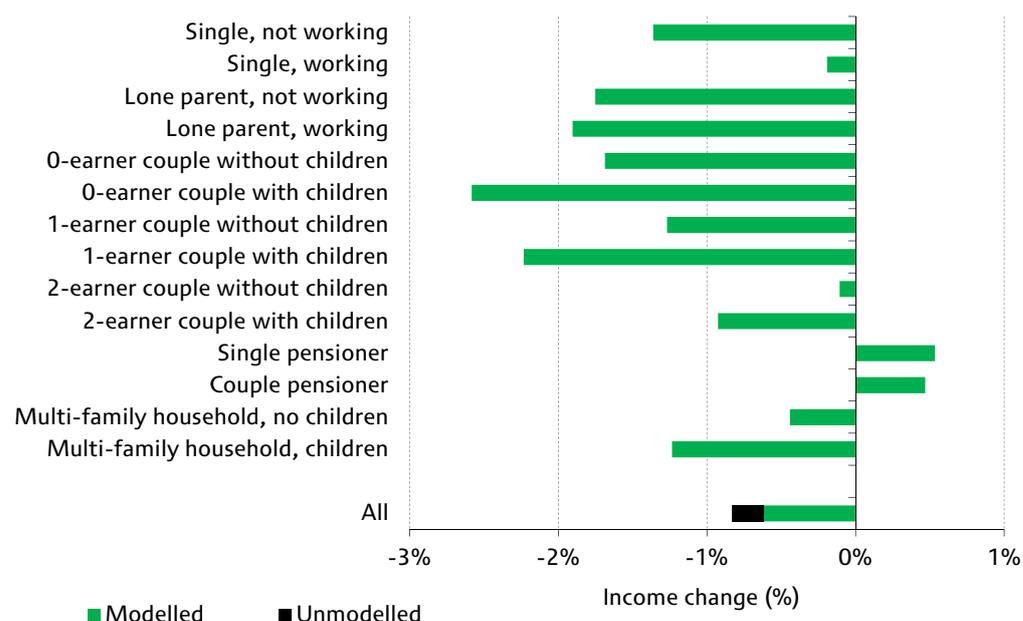
families with children). As a percentage of income, the losses are therefore larger towards the bottom of the distribution.

⁷ Note, however, that the switch to CPI indexation from RPI indexation for public sector pensions is one of the reforms that we are unable to model due to the lack of required data. These pensions will rise by 5.2% in April 2012; under the previous indexation rule, they would have risen by 5.6%.

earnings grow more quickly than the RPI, and the triple lock will therefore be more generous than RPI indexation.

Among working-age households, the most striking pattern to emerge from Figure 2 is the difference between those with and without children. On average, households with children lose the most from these reforms as a percentage of income. Explanatory factors include the cash freeze to Child Benefit and various tax credit cuts: the withdrawal of the family element of the Child Tax Credit beginning at lower income levels than before; an increase in the weekly working hours requirement in Working Tax Credit from 16 to 24 for couples with children; the introduction of a disregard for within-year falls in income, which would previously have triggered increases in tax credit entitlements; and reductions in backdating of tax credit claims.

Figure 2. Distributional impact of tax and benefit reforms to be introduced in 2012–13, by household type and work status



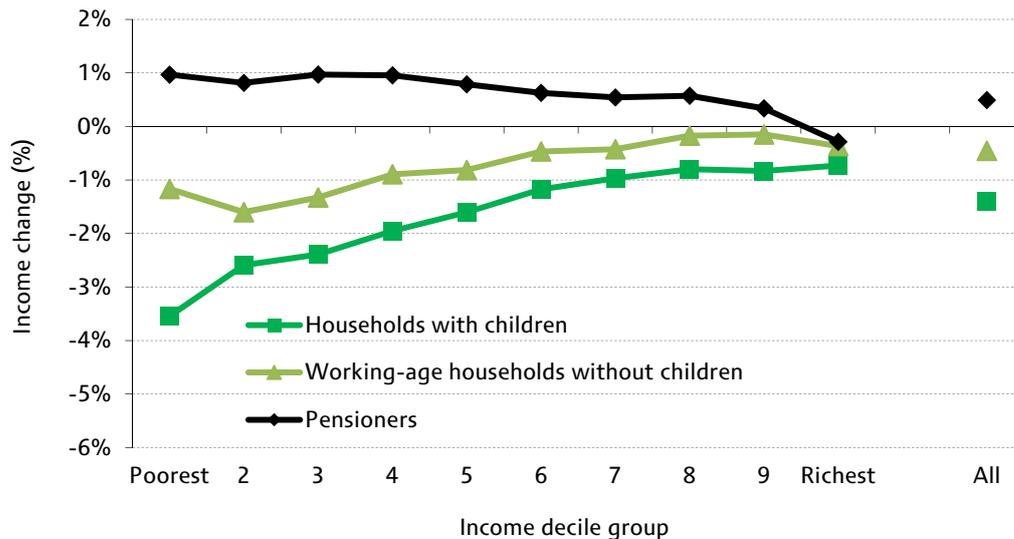
Note: Assumes full take-up of means-tested benefits and tax credits.

Source: As for Figure 1.

Finally, Figure 3 shows the average loss as a percentage of income by household type and income decile group. It confirms that, at least for those reforms that we are able to model, households with children will tend to lose the most: on average, they will lose about 1.4% of their net income (about £530 per year) as a result of the modelled reforms; working-age households without children will, on average, lose about 0.5% of their net income (about £150 per year); and pensioner households will, on average,

gain about 0.5% of their net income (about £110 per year). The figure also shows that the aggregate differences by household type are driven largely by differences between lower-income households. In particular, it is low-income households with children who are principally affected by the tax credit cuts, and it is low-income pensioners who gain the most as a percentage of income from the 'triple lock' for the Basic State Pension.

Figure 3. Distributional impact of tax and benefit reforms to be introduced in 2012–13, by income decile group and household type (modelled reforms only)



Notes and source: As for Figure 1.

Under the previous Labour government, low-income families with children and pensioners were the major demographic groups heavily favoured by tax and benefit reforms. In the context of recent history, then, the reforms planned for the coming year continue the trend of favouring pensioners, and run counter to the trend of increasing generosity towards households with children, although they only partially unwind the large increase in generosity towards that group under Labour.⁸

Of course, this analysis has simply isolated the impact of tax and benefit policy changes on incomes. There are other factors, many of which are not so directly related to policy, that are very important for the evolution of incomes: for example, working households have been suffering from real falls in their earnings. The next section therefore looks at household

⁸ See J. Browne and D. Phillips, 'Tax and benefit reforms under Labour', IFS Briefing Note 88 (<http://www.ifs.org.uk/publications/4807>).

incomes more generally, accounting for macroeconomic trends as well as tax and benefit policy.

3. The outlook for household incomes

This section takes a broader look at the prospects for household incomes, taking account not just of tax and benefit policy in isolation but also of macroeconomic forecasts. The analysis presented draws on a model that combines macroeconomic forecasts with official forecasts of demographic variables and stated tax and benefit policy,⁹ in order to project the future distribution of income. The methods and assumptions used are set out in detail in appendix A of Brewer, Browne and Joyce (2011).¹⁰ The measure of household income used is as in the government's statistics on the income distribution¹¹ – net of taxes and inclusive of benefits and tax credits, adjusted for household size and structure, and (when comparing incomes over time) converted from cash terms to real terms using a deflator based on the RPI.

Of particular importance for household incomes are the outlooks for employment, earnings and inflation. The latest forecasts of these and other key macroeconomic variables from the OBR are reproduced in Table 2. Average earnings among workers this year are not forecast to keep pace with inflation – real average earnings are forecast to fall by 1.3% – but the expected shortfall is substantially less than seen over 2010 and 2011, when there was a cumulative fall in real average earnings of 6.7%. Real

⁹ There are two tax credit cuts listed in Table 1 that were modelled for the analysis in Section 2 but are not incorporated in the projections set out here. The reforms in question are the introduction of an annual £2,500 disregard for within-year falls in income, which would previously have triggered increases in tax credit entitlements, and reductions in backdating of tax credit claims from 3 months to 1 month. It is judged that, although their effects can be allocated to particular households precisely enough for distributional analysis by broad subgroup, this cannot be done precisely enough for capturing changes in the distribution of income at a finer level.

¹⁰ M. Brewer, J. Browne and R. Joyce, *Child and Working-Age Poverty from 2010 to 2020*, IFS Commentary 121, 2011 (<http://www.ifs.org.uk/publications/5711>).

¹¹ See Department for Work and Pensions, *Households Below Average Income: An Analysis of the Income Distribution 1994/95–2009/10*, 2011 (<http://research.dwp.gov.uk/asd/hbai/hbai2010/index.php?page=contents>).

average earnings are currently forecast to stop falling in 2013, although even then their recovery is expected to be slow.

Table 2 also highlights the importance (in the short run) of the fact that benefit rates and direct tax thresholds are, by default, uprated each April in line with a lagged measure of inflation (from the previous September). This means that, if inflation is lower during a financial year than it was in the previous September, benefits and tax thresholds that are uprated in the default way will be higher in real terms compared with the previous year. This clearly matters a lot at the moment. Inflation in September 2011 was relatively high, so benefits and direct tax thresholds will, by default, rise by 5.2% in April 2012 (despite the change to CPI indexation for benefits and some direct tax thresholds, which is less generous than the previous indexation policy). If the OBR's inflation forecasts are correct, this implies that the benefits and tax thresholds that are uprated in this way will rise by about 2% in real terms in 2012–13.

Table 2. Macroeconomic forecasts from the Office for Budget Responsibility

	2010	2011	2012	2013	2014	2015
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7
Average earnings growth	2.1%	0.9%	2.0%	3.1%	4.3%	4.5%
Annual RPI inflation (whole year)	4.6%	5.2%	3.3%	2.9%	3.1%	3.6%
Annual RPI inflation to September	4.6%	5.6%	3.1%	2.9%	3.1%	3.6%
Annual CPI inflation to September	3.1%	5.2%	2.5%	2.1%	2.0%	2.0%
Nominal GDP growth	4.6%	3.4%	3.5%	4.6%	5.3%	5.6%

Source: OBR, *Economic and Fiscal Outlook: November 2011*

(http://cdn.budgetresponsibility.independent.gov.uk/Autumn2011EFO_web_version138469072346.pdf).

Table 3 shows projected household income statistics for 2012–13 and, to place them in context, the same statistics for the previous two financial years and the following three. (These are all projections, as the latest published official data on the income distribution are for 2009–10.) The focus here is twofold. First, median income gives a measure of average

living standards.¹² Second, measures of absolute and relative low income poverty give a sense of how the incomes of the poor are faring, in absolute terms and relative to those on middle incomes respectively. These measures are of particular policy relevance because the government has committed to reducing them substantially among children by 2020–21.

Table 3. Projected household income statistics, 2010–11 to 2015–16

	<i>Real annual median income change (%)</i>	<i>Child poverty</i>		<i>Poverty among working-age adults without dependent children</i>	
		<i>Relative low income (%)</i>	<i>Absolute low income (%)</i>	<i>Relative low income (%)</i>	<i>Absolute low income (%)</i>
2010–11	–3.7	19.1	19.1	15.4	15.4
2011–12	–2.8	18.7	20.7	15.4	16.3
2012–13	–0.6	19.6	22.1	16.0	17.1
2013–14	–0.1	20.9	23.5	16.3	17.5
2014–15	+1.2	21.4	23.1	17.0	17.5
2015–16	+0.9	21.9	23.1	16.8	17.2

Notes: Relative low income line is 60% of contemporary median income. Absolute low income line is 60% of the 2010–11 median in real terms (deflated using the RPI).

Source: Author’s calculations based on Family Resources Survey 2009–10, using TAXBEN and assumptions specified in Brewer, Browne and Joyce (2011) – see <http://www.ifs.org.uk/publications/5711>.

The outlooks for median income and income poverty are now summarised in turn.

Median income

If all individuals are lined up in order of household income, median income is the household income of the person in the middle, who is richer on this basis than half of the population and poorer than the other half. Household incomes are adjusted, or ‘equivalised’, to account for the fact that households of different sizes and structures need different income levels in order to achieve the same living standards.¹³ To give the reader a sense

¹² Another measure of average living standards would be mean income, but this depends crucially on incomes at the very top of the income distribution, which cannot be modelled robustly because the underlying survey data on very high-income individuals are poor.

¹³ The equivalence scale used is the modified OECD equivalence scale; see Department for Work and Pensions, *Households Below Average Income: An Analysis of the Income Distribution 1994/95–2009/10*, 2011 (<http://research.dwp.gov.uk/asd/hbai/hbai2010/index.php?page=contents>).

of monetary amounts, Table 4 therefore reports projected median household income in 2012–13 in terms of the equivalent incomes for different household types. For example, an individual at the median would have a household income of £438 per week if they lived in a childless couple or of £613 per week if they lived in a couple with two dependent children aged under 14.

Table 4. Projected cash-terms median household income in 2012–13: equivalent weekly amounts for different household types

	<i>Number of dependent children (aged under 14)</i>			
	<i>None</i>	<i>One</i>	<i>Two</i>	<i>Three</i>
Single	£293	£381	£468	£556
Couple	£438	£525	£613	£700

Source: As for Table 3.

In 2012–13, the coming financial year, median income is projected to fall by 0.6% in real terms. This is certainly not the norm – since consistent records began in 1961, real median income has grown at an average annual rate of 1.6% – but it is notably less dramatic than over the previous two years, when real median income fell by a projected 6.4%. In the following year, real median income is expected to remain flat, and then finally to return to positive growth from 2014–15 (although still slower growth than the historical average).

There are three key conclusions from this. First, as pointed out by IFS researchers before,¹⁴ the UK is experiencing a fall in average living standards (as measured by real household incomes) that is large by historical standards. The peak-to-trough decline in real median income between 2009–10 and 2013–14 is projected to be 7.1%. This is the largest such decline since the 7.5% fall between 1974 and 1977. Second, and more happily, most of this decline has now occurred: having fallen by a projected 6.4% over the previous two financial years, real median income is expected to fall by only a further 0.7% over the next two (as ever, this is conditional on the current macroeconomic forecasts being correct – these projected patterns are clearly closely related to the OBR’s forecasts of real earnings shown in Table 2). Third, and less happily once again, the recovery is expected to be slow even once the trough is passed: annual

¹⁴ For example, see the presentation by Robert Joyce at IFS’s post-Autumn-Statement briefing on 30 November 2011 (<http://www.ifs.org.uk/publications/5930>).

growth in real median income is projected to remain below its historical average of 1.6% until beyond 2015–16. As noted previously,¹⁵ this slow expected recovery following the sharp peak-to-trough fall implies that median income will be lower in real terms in 2015–16 than in 2002–03 – an unprecedented period of no growth in average living standards since records began in 1961. Had the historical average growth rate continued over those 13 years, real median income would have grown by 22% over the period.

Income poverty

The government's official statistics on the distribution of income use particular measures of income poverty to track the fortunes of those on lower incomes. Some of these are also of direct relevance for policy, in that they form the basis of the child poverty targets laid down in the Child Poverty Act 2010, to which this government has committed. Two such measures are modelled here. Relative low income poverty counts those whose household income is less than 60% of the median. The relative poverty line therefore changes whenever median income changes, which is what makes it a relative (rather than absolute) poverty measure. Absolute low income poverty counts those whose household income is less than a particular level that is fixed in real terms over time. The Child Poverty Act specified that the absolute low income line will be benchmarked to the 2010–11 relative low income line. Poverty projections are presented for children¹⁶ and for working-age adults without children.

The projections of absolute low income poverty in Table 3 show that the real incomes of those on lower incomes are projected to fall (as is the case for those around the median): absolute low income poverty is currently rising, particularly among children, and will continue to rise until 2013–14.

The projections of relative low income poverty indicate how the changes in real incomes experienced by those on lower incomes are likely to compare with the changes experienced by those in the middle of the income distribution. Having remained broadly flat this year (suggesting

¹⁵ See footnote 14.

¹⁶ Child poverty is a more policy-relevant statistic than poverty among working-age parents, because of the government's child poverty targets.

that the real incomes of the poor have been falling at similar rates to those for people on middle incomes), relative low income poverty is expected to rise in the coming financial year, and again over the three years to 2015–16, particularly among children. Relative poverty measures often increase when earnings grow in real terms – as is expected to be the case from 2013–14 (see Table 2) – because real earnings growth tends to benefit middle-income households more than lower-income households, who are less likely to get a large proportion of their income from the labour market (and more likely to receive a large proportion from state benefits and tax credits). But previous work has also shown that planned tax and benefit reforms contribute to the expected rise in income poverty.¹⁷

As pointed out by IFS researchers before,¹⁸ of most immediate relevance for policy is the dramatic mismatch between these projections and the government’s stated commitment to reduce relative and absolute low income poverty among children to 10% and 5% respectively by 2020–21. This was always extremely ambitious, but, according to these projections, the trajectory of child poverty will be upwards rather than downwards in the years ahead, making it inconceivable under current policies that the targets could be achieved (or even got close to). Given this, there seem to be two constructive ways forward: the government could reveal a credible plan for meeting the targets that it has signed up to; or it could set different targets which reflect its view of what is both desirable and achievable, and set out how it plans to meet those.

¹⁷ See M. Brewer, J. Browne and R. Joyce, *Child and Working-Age Poverty from 2010 to 2020*, IFS Commentary 121, 2011 (<http://www.ifs.org.uk/publications/5711>).

¹⁸ See footnote 14.