THE
ECONOMY 2030
INQUIRY
SHAPING A DECADE OF CHANGE

Sharing the benefits

Can Britain secure broadly shared prosperity?

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July 2023

Centre for Economic Performance

Resolution Foundation

Funded by

Nuffield Foundation

Acknowledgements

We thank Alex Beer, Torsten Bell, Gavin Kelly, Lindsay Judge, Stephen Machin and Henry Overman for comments on this report. All errors remain the authors' own. Karl Handscomb contributed to this report while he was an employee of the Resolution Foundation.

Citation

If you are using this document in your own writing, our preferred citation is:

M Brewer, K Handscomb, C Pacitti & L Try, *Sharing the benefits: Can Britain secure broadly shared prosperity?,* Resolution Foundation, July 2023

The Economy 2030 Inquiry

The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

The Nuffield Foundation

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Contents

Executive summary

The UK has been living through a period of relative decline. Stagnant productivity and income growth have been the defining feature of the last decade and a half. The combination of that recent low growth with longer lasting high inequality has proved toxic for those on low-to-middle incomes: poorer households in the UK are now a full fifth poorer than their counterparts in France.

Against that backdrop, this report asks what it would take for the UK's future to improve upon that past – is there still a plausible path to steadily rising shared prosperity and, if so, what does it look like. With both main parties now focusing on the need for a return to economic, and specifically productivity, growth, this report examines what this would, and wouldn't, deliver for living standards. Specifically, the report engages with important public debates including whether a return to growth will feed through to ordinary people's wages, what it would mean over time for the level of income inequality, and what the other necessary components are of a shared prosperity agenda. It does this as part of the Economy 2030 Inquiry, which is developing an economic strategy for the UK to underpin higher growth and lower inequality.

It rejects arguments that growth should not be a central objective of the UK's economic strategy, but it also explains why growth is a necessary but far from sufficient condition for success. It goes on to show that growth combined with a significant, but achievable, policy agenda covering both predistribution (including ensuring the rewards from the labour market are widely shared) and redistribution (including benefits system reform) offers a plausible path to rising and shared prosperity. A richer and fairer future is not automatic, but is certainly possible.

Stronger growth is essential if household living standards are to rise

There are some who say that growth is undesirable or at least irrelevant for living standards, with claims that it does not feed through into wage growth for the typical worker. The economics profession has been part of this debate in some cases, driven by the experience of the US where typical wages grew materially more slowly than productivity during parts of the last half century. But this concern is not a good guide to economic policy makers in the UK today.

There are, of course, reasons why the relationship between productivity growth and growth in wages of typical workers isn't perfect at all times. In the UK, there have been phases when growth in wages has been skewed towards the bottom or the top (weakening the link between productivity growth and a typical worker's wages). Sometimes, higher productivity is seen not in higher wages but instead in higher pension contributions or other non-wage compensation: the share of compensation that shows up in employers' pension contributions and National Insurance payments did rise in the 1990s and 2000s (but has since fallen back slightly). And periods of rising import prices can make the country as a whole poorer by reducing the buying power of workers' wages, as we are currently seeing.

These are all important, but are best seen as obscuring rather than – as is sometimes claimed – fundamentally severing the relationship between higher productivity and higher living standards.

If policy makers were in any doubt, they should just look around the world. Differences in productivity are the fundamental reason wage levels are higher in the US and Germany than in Mexico and Greece. The UK's own experience is also telling: weak productivity growth in recent times has been the key driver of our unprecedented wage stagnation. In the decade before 2005, GDP per capita and average wages grew by 29 and 30 per cent in real terms; in the decade before 2020, growth in both plummeted to just 8 and 4 per cent respectively.

So productivity growth is irreplaceable, rather than irrelevant, to ordinary workers. Its return is the central precondition for a return to rising wages which, in turn, has always been the main motor of increasing living standards.

But the labour market alone cannot provide shared growth…

Just as we must be clear eyed that growth is essential for rising wages, we should also be clear about what it won't bring about on its own: broadly shared prosperity. Why? Because not all household income comes from today's labour market.

The most obvious group this applies to are pensioners. But there are also 11 million individuals in working-age households where employment income makes up less than half of household income, with benefit income the dominant other component. Almost half of these (nearly 5 million) are in working households. Of the 6.1 million in households in which no-one works, the majority (3.6 million) are in households with someone who is long-term sick or disabled, and 1.2 million are in households with dependent children. Only 0.9 million are traditionally unemployed. These households are disproportionately poorer households: those in the bottom fifth of the income distribution get just over half their income from the labour market, compared to almost 94 per cent among the richest fifth.

This tells us what growth will not do: when growth drives rising wages but doesn't feed through into other forms of income, there is a real danger that inequality will rise as we leave behind large numbers of older and poorer individuals. The UK has experience of this: in the 1980s, pensioner poverty soared (from 14 to 41 per cent from 1983 to 1989) as rapid economic growth boosted wages for those in work but pensions (then rising in line with prices, rather than earnings) lagged behind. Subsequent pensions policy from the late 1990s onwards showed how changes in inequality are a choice rather than an unstoppable force. With broad political support, UK governments deliberately linked pensioners' incomes to broader economic growth by using earnings-indexation, first for the means-tested support for pensioners, and then for the basic state pension, ensuring future growth wouldn't leave pensioners behind.

As a result of these deliberate policy choices, the situation of the over-65s now is very different from that facing some individuals in working-age households who remain at risk of being left behind by growth. To understand the scale of this issue, we use modelling to consider what might happen to living standards were the UK to return to a more normal period of productivity growth: given the Office for Budget Responsibility's current view of the potential of the UK economy, that would increase average wages by 16 per cent in real terms between 2025-26 and 2035-36. If we assume no change in earnings inequality, this would translate into a rise in typical household incomes of 12 per cent in real terms, and slightly more (14 per cent) in the top income quintile. However, incomes at the bottom of the income distribution would see average growth of just 2 per cent, reflecting the smaller contribution of earnings to household income. The higher inequality this represents would mean relative poverty rising by 1.8 million (1 million children) and the income gap between a typical and poorer (bottom fifth of household income distribution) household rising from £18,000 to £21,000.

This growing 'prosperity gap' would be a direct result of the UK's approach to benefit income, which is supposed to have a default of rising in line with prices rather than wages, though in practice it has often fallen short of inflation over the last decade. The goal of such an uprating policy is to provide stable living standards and, in today's highly unusual period of high inflation, this approach has protected low- and middle-income households. But in the longer term, it means disconnecting the living standards of poorer households (principally those with a disability or children) from the rest of the population. Increasing the value of core working-age benefits at most in line with inflation (as generosity of wider support for children or housing costs has ebbed and flowed) means the basic benefit support for an adult is today at the same level in real terms as it was in 1992, despite growth in GDP per capita of 51 per cent. Continuing with this approach would see the Universal Credit (UC) standard allowance – the amount of support for a single unemployed adult – fall from 14 per cent of earnings in 2025-26 to 12 per cent in 2035-36 and 10 per cent in 2045-46, down from 17 per cent in 2000-01.

…and some will face rising costs rather than incomes

An economy that grows in the way the UK's is projected to grow will not raise living standards for everyone, but will increase inequality. Some argue this is fine, dismissing rising inequality and poverty on the grounds that incomes would rise for most and no-one's incomes would actually fall. But this misses a second key problem that even if incomes won't rise for everyone with growth, something else will: housing costs.

The current sharp rise in interest rates is leading to a correction in the housing market, but in the long-run, it is clear that housing costs – especially for those renting – rise in real terms as the economy and average incomes grow: between 1994-95 and 2018-19, incomes grew by 276 per cent in nominal terms, while housing costs grew by 237 per cent (compared to CPIH inflation of 163 per cent). In areas that grow quickly, housing costs do so as well – rental costs in the fastest-growing local authorities have increased twice as much since 2011 compared to local authorities with the slowest economic growth. And over time we see these cost pressures feeding through to the social rented sector (as policy makers respond to growing gaps between private and social rents) and mortgage costs (impacting those purchasing properties as house prices rise, while existing owners are largely protected).

The result of poorer households seeing their incomes fail to keep pace with growth in typical earnings, but their housing costs very much doing so, is that living standards (measured after housing costs) would actually fall for some. We can illustrate this by returning to our modelling of income gains, but adding housing costs rising broadly in line with earnings growth into the picture. Over the decade, this reduces the real-terms living standards gains for high-income households by about 2 percentage points (because existing homeowners are protected), but households in the bottom quintile of the income distribution see a larger income penalty from rising housing costs: a living standards drag of 4 percentage points over 10 years. These rising housing costs therefore erode the benefits of growth for most (with the benefit accruing to landlords and existing owners in the form of higher house prices), but for those not seeing any or much income growth, they drive actual falls in living standards. Even those totally relaxed about rising inequality should recognise this is not what shared prosperity looks like.

Again, this partly reflects choices about the number and nature of houses that are built, and the nature of our benefits system. Support with rent is governed by Local Housing Allowance (LHA) rates, which determine the maximum amount households in a certain area can receive. These rates are currently frozen in nominal terms – which is clearly unsustainable – but even if governments return to the default policy of the 2010s and index them to inflation, then long-term increases in housing costs will still outpace income growth at the bottom of the income distribution.

Unequal growth is not inevitable

Productivity growth is, then, necessary but not sufficient for shared prosperity – pushing up wages, but not the incomes or living standards of everyone – especially families with children and people with long-term disabilities that are unable to work who risk being disconnected from growth. A broader policy agenda is clearly required if the ultimate objective is to see growth rise and inequality fall.

This paper's argument is that such an outcome is plausible, but will require a rejection of the tendency to set agendas of those who think we should only pursue predistribution (strategies for achieving a more equal distribution of market incomes) and those who think we should only pursue redistribution (how our tax and benefit systems reduce the inequality of those market outcomes) against each other. That tendency is common across the political spectrum: for example, in the idea that raising the minimum wage is an alternative, rather than complement, to the provision of welfare support to lower income working families. Combining growth with predistribution and redistribution policies is the only plausible route to rising prosperity and falling inequality.

We illustrate this by further developing our modelling of income gains to demonstrate what a combined predistribution and redistribution strategy could deliver.

Among the core objectives of a predistribution strategy is higher employment, which will disproportionately raise the incomes of poorer households, as it did during the 2010s. Since 2009-10, the employment rate has increased by 6 percentage points among working-age adults in the bottom half of the income distribution, and hasn't changed at all for those in the top half. An ambitious but plausible strategy would target repeating the success of the last decade with a further 3 percentage point (or 1.2 million people) rise in employment over ten years. This is likely to require a particular focus on three groups – older workers, women with children, and those affected by rising ill-health and disability – and, if successful, our modelling suggests this approach could take around 500,000 out of poverty.

The second core predistribution component is progressive wage growth – with those on lower and middle wages seeing faster growth than those at the top. A strategy to realise that would go beyond a higher minimum wage (which has contributed to a consistent fall in hourly wage inequality for the past 20 years), with a broader focus on the nature and quantity of good work, including certainty of hours worked, progression, education and training. To consider what this might plausibly achieve, we model the impact of wages over ten years growing at the bottom by 28 per cent in real terms, at the median by 20 per cent and at the top by 11 per cent, a change that would cut the number in low pay by around a fifth.

Taken together, productivity growth – whether from higher investment, skills, increased dynamism, or a focus on high-value-add services – higher employment and progressive wage growth ensure higher incomes for all parts of the income distribution. Unlike uniform wage growth, the main winners are now middle-income households who would see income gains of 18 per cent over a decade, compared to 14 per cent among richer households. But poorer households would still see the slowest income gains (10 per cent), falling short of achieving shared prosperity.

This is because a shared growth strategy must see predistribution as an essential complement to redistribution, not an alternative to it. There will always be large parts of our society, who do not receive the majority of their income from the labour market, for whom different mechanisms for ensuring they share in the benefits of growth are required. Ultimately this can only be achieved by social security benefits growing in line with wages rather than prices, and support for housing costs in the benefit system keeping up with growth in housing costs. This would be a big change, but it is also an unavoidable component of any plausible future that sees rising prosperity and falling inequality in Britain.

The standard critiques of such a shift – that it is unaffordable or hugely weakens work incentives – are overdone. In the long term, total spending on working-age benefits as a proportion of GDP would still be 0.4 percentage points lower in 2041-42 (at 4.2 per cent of GDP) than in 2026-27. In reality, the long-term pressure on social security spending comes from our aging population – and the policy of indexing the state pension faster than average earnings via the triple lock. Moving the State Pension onto the same uprating approach we propose for working age benefits (a smoothed earnings-linked uprating: where inflation is used in years when it is higher than earnings growth, but uprating tracks earnings in the long-run) would reduce future spending by around 0.5 per cent of GDP by 2041-42, offsetting over half (52 per cent) of the long-term costs of earnings-uprating working-age benefits.

Strong work incentives are important, but we don't need to rely on ever-decreasing benefits relative to wages to sharpen work incentives. Benefits rising in line with average wages while the minimum wage is rising at least as fast would do nothing to weaken work incentives (or to extend the proportion of the population receiving those benefits) from where they have been in recent years – years in which employment reached record highs.

International and past UK experience tells us that earnings-uprating for working-age benefits is a realistic ambition. New Zealand has recently joined Germany, Belgium, and the Netherlands in uprating benefits with reference to changes in earnings (or GDP). In the UK we moved towards this approach to benefits for the over-65s around two decades ago, and a careful reading of social security policy shows that it is not true that the UK has managed in the past with only price uprating of benefits. In the 1990s and 2000s governments increased extra-cost related (e.g child-related) benefits substantially, in part to compensate for extended periods of not allowing core benefit levels to keep pace with earnings, but it's not sustainable in the long-run to use the extra-cost benefits to solve a problem of overall (in)adequacy in the benefits system.

A similar two-pronged – pre and redistribution – approach will also be needed on housing, increasing supply, especially in fast-growing areas of the country, and ensuring social security support with rent payments tracks the actual cost of housing.

A combination of progressive earnings growth and maintaining the value of benefits will achieve the shared prosperity the UK needs

The prize here is large. Combining a return to modest productivity growth with higher employment, progressive pay growth, and a social security system that links benefits to average earnings and rent levels to actual housing costs, would mean after housing costs incomes for the poorest households rising by 19 per cent over 10 years. This would exceed the gains seen by middle income households (17 per cent) while the top would still see gains but on a smaller scale (13 per cent). The difference between business-as-usual and this combination of predistribution and redistribution is sizable: these changes would result in annual incomes at the 20th percentile being £3,000 (14 per cent) higher, and child poverty could be 6 percentage points lower.

Politicians from all sides are, rightly, united in identifying that the UK needs more growth. They are right to ignore those saying that growth is no use, but they would be wrong to think that only achieving more growth would achieve rising living standards for all. This note sketches out the broader agenda required to deliver on that ambition. It shows what shared prosperity looks like, and how we can realistically get there.

Section 1

Introduction

Growth is having a resurgence in British politics, with the leaders of both the main parties united in their desire to boost economic growth in the UK. The first of Keir Starmer's five missions is to "secure the highest sustained growth in the G7",[1] and, when he was Chancellor, Rishi Sunak said that "the biggest challenge the free market faces today is where new growth will come from".[2]

This unified focus is welcome, and understandable. Stagnant productivity and income growth have been the defining features of the last decade and a half. As Figure 1 shows, growth in real GDP per capita has been persistently lower than its long-term average since 2008. Over the last 15 years, annual growth has languished at an average of 0.3 per cent per year, seven times less than the annual growth rate over the previous 50 years (2.3 per cent from 1958 to 2008). Labour productivity, the driver of economic growth in the long term, has fared no better: annual growth rates in economic output per worker hour are eight times lower (0.3 per cent compared to 2.7 per cent).[3]

The future risks the UK doing little better. According to the latest forecasts from the Office for Budget Responsibility, the UK economy is set to be growing at an annual rate of just 1.5 per cent by 2027. And the Bank of England suggests that GDP per capita will be growing by 0.8 per cent by 2026, nearly a third of the growth rate experienced over the 1958 to 2008 period.

1 Labour Party, 5 Missions for a better Britain, accessed 4 May 2023.
2 HM Treasury, Chancellor Rishi Sunak's Mais Lecture 2022, February 2022.
3 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022. Growth in GDP per head can only come about through a higher employment-to-population rate, workers working longer hours, or increases in output produced per hour worked (i.e. labour productivity). Of these, the last is the most important in the long-run, although the same may not be true in the short run. See: N Oulton, The Productivity-Welfare Linkage: A Decomposition, ESCoE Discussion Paper 2022-07, March 2022.

FIGURE 1: **The recent record on growth is the worst for nearly a century**

Five-year growth rates for labour productivity per hour and GDP per person: UK

NOTES: Each data point covers the five years ending in the date shown.
SOURCE: Analysis of Bank of England, A millennium of macroeconomic data; OBR, Economic and Fiscal Outlook - March 2023.

This mission for the UK to raise its game on growth comes from a desire to have a prosperous economy that delivers higher living standards for households. Given this shared ambition, it is critical that we examine what we can realistically expect higher economic growth to actually deliver. In this paper, we engage with important public debates: on whether growth is necessary for household living standards; on whether productivity growth does actually feed through into ordinary people's wages (the so-called 'decoupling' debate); and what the implications would be for income inequality if a faster-growing economy is coupled with our current tax and benefit system, something of particular import given the UK is the most unequal large economy in Europe.[4]

This paper's assessment of how the UK is likely to experience future growth forms a part of the wider Economy 2030 Inquiry – a joint collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, and funded by the Nuffield Foundation.[5] The aim of the Inquiry as a whole is to set out a plausible plan for how the UK can achieve both higher growth and lower inequality in the decades ahead. Understanding the current path that future economic growth will set us on is an important step towards this plan. We will set out this plan in

4 Figures for 2019, taken from: OECD Data, Income inequality, accessed 3 April 2023.
5 All Economy 2030 Inquiry reports, and further details about the project can be found at: economy2030.resolutionfoundation.org/reports. The project's interim findings can be found in: Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.

detail at the end of the Inquiry, where we will bring together our recommendations across a number of critical areas of economic policy.

The remainder of this report is set out as follows:

- Section 2 analyses what higher economic growth is likely to achieve for living standards.
- Section 3 examines what economic growth alone will not deliver for broader living standards.
- Section 4 sets out how the UK might achieve more inclusive economic growth and shared prosperity. It also explains why such policy proposals are – in contrast to received wisdom – far more realistic, and indeed inevitable, than the existing discourse suggests.
- Section 5 concludes, and an Annex contains technical details on the modelling we use in this report.

Section 2

A growing economy will deliver higher wages and more employment

Some argue that growth should not be a central objective of the UK's economic strategy. This is wrong: economic growth – or rather, growth in productivity – is essential if we are to achieve higher wages for the typical worker. There has been a recent debate over whether the relationship between productivity growth and wage growth still holds, in part inspired by the experience of the US. Temporary factors such as the distribution of gains among workers and capital owners, higher pension and National Insurance (NI) contributions, and the terms of trade the UK faces have been behind apparent disconnect in the recent past. But productivity growth remains the most important factor for wage growth over the long term, and this is where policy makers must focus their efforts if they want to boost pay packets going forward.

This section looks at what we can expect growth to deliver. Some claim that we should stop our focus on economic growth, on the grounds that it doesn't deliver for the typical worker.[6] But in this section we argue that, although there can be times when the link between productivity and wages weakens, productivity growth is the central precondition for wages to rise, and the absence of productivity growth is the driving force behind our terrible record on wage growth – and, therefore, household living standards, in recent years. Of course, some past episodes of growth in the UK have seen the gains very unevenly shared; the response to that – as we are doing in the Economy 2030 project – is

6 Arguments are sometimes made that economic growth threatens our environmental commitments. On greenhouse gas emissions, the most recent CCC report shows that emissions in 2022 were 46 per cent lower than in 1990, a period over which GDP per capita has risen by 46 per cent (see: Climate Change Committee, Progress in reducing emissions: 2023 Report to Parliament, June 2023.

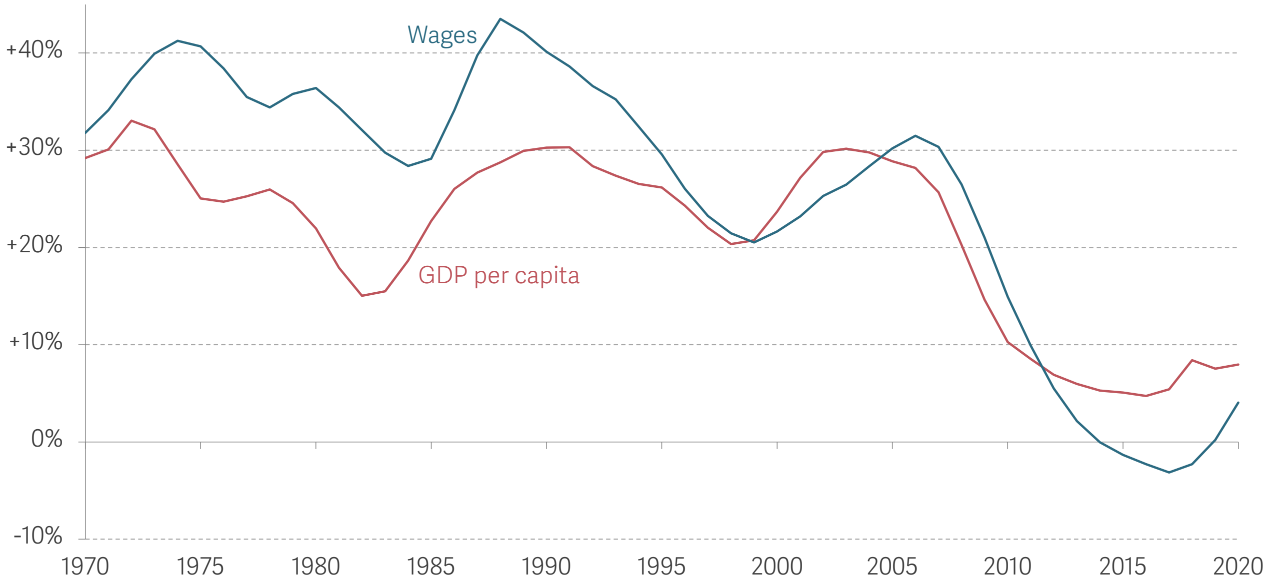
to consider what governments have to do to get shared growth, and not to reject growth altogether, something that would all but ensure further stagnation of living standards.[7]

Recent experience has cast doubt on whether productivity growth delivers higher wages for the typical worker, but temporary factors are predominately to blame for the disconnect between growth and wages

The apparent underperformance of wage growth relative to economic or productivity growth since the financial crisis has spurred the idea of a productivity disconnect: that somehow some countries have entered a new economic phase where productivity growth no longer feeds through into higher workers' wages. As a result, some spurn the idea that productivity growth is a solution to boosting wages and household incomes.

FIGURE 2: **The pre-pandemic fall in wages was even worse than the dismal levels of productivity growth**

Annualised decadal growth rates of real wages and real GDP per capita: GB/UK



NOTES: Rolling average of each variable in the three years centred on the date shown, compared to the three years centred on the date 10 years previous. For example, the data point for 2020 shows growth between 2009-2011 and 2019-2021. UK data for GDP, GB data for wages.
SOURCE: Analysis of Bank of England, Millennium of Macroeconomic Data; OBR, Economic and Fiscal Outlook - March 2023; ONS, RHDI; ONS, UK resident population.

7 For more on the UK's record, see: Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022; J Muellbauer & D Soskice, The Thatcher Legacy: Lessons for the future of the UK economy, The Resolution Foundation, November 2022; P Bourquin, M Brewer & T Wernham, Trends in income and wealth inequalities, IFS Deaton Review of Inequalities, November 2022

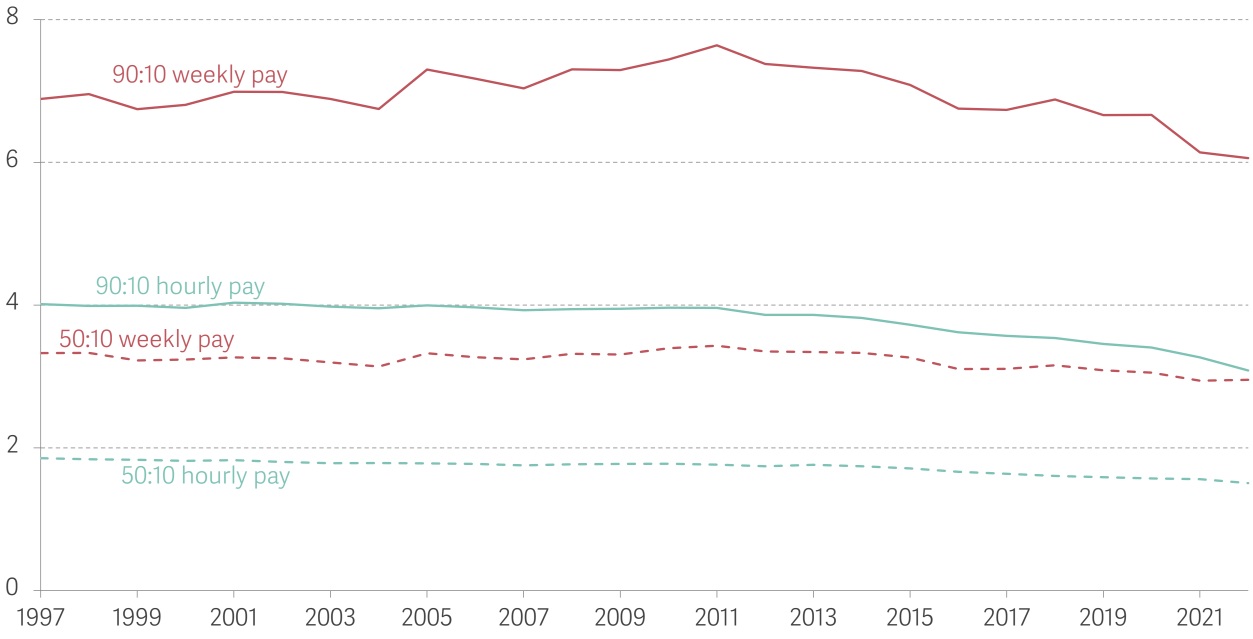
Economic research, too, has tuned in on this apparent disconnect between productivity and wage growth – seeking to understand why average wages in the UK grew at around half the rate of GDP per capita in the 2010s (see Figure 2). In the decade before 2005, GDP per capita and average wages grew by 29 and 30 per cent in real terms; in the decade before 2020, growth in both plummeted to just 8 and 4 per cent respectively.

Research tells us that the relationship between wages and economic growth is far from perfect, often having distortions across specific time periods.[8] These can come from a variety of different sources, both as a result of policy and economic issues, and we highlight three below.

First, changes in the distribution of who benefits from productivity gains can change over time. For example, gains can be captured by a higher profit share of income (as opposed to the labour share), and the earnings distribution can change, through changes in hourly wages or hours worked. The labour share of income has remained constant since 2000, and both wage and earnings inequality fell in the 2010s, making it more likely that productivity growth is seen in the pay packet of a typical worker (see Figure 3).[9]

FIGURE 3: **Earnings inequality in the UK is no longer rising**

90:10 and 50:10 ratios of hourly wage and gross weekly pay: UK



SOURCE: ONS, Annual Survey of Hours and Earnings.

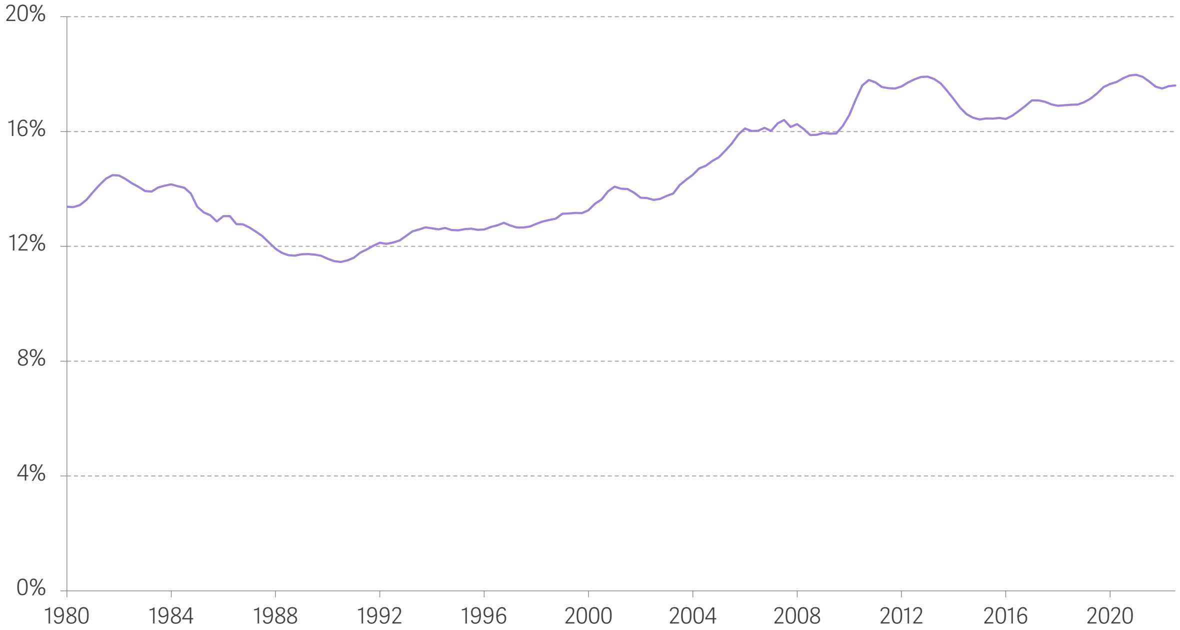
8 N Oulton, The Productivity-Welfare Linkage: A Decomposition, ESCoE Discussion Paper 2022-07, March 2022.

9 From 2000 to 2021, the labour share of income has fluctuated between 58 and 61 per cent. Source: ONS, Labour share of income (FZLN). One complicating factor is the shift in the proportion of workers who are self-employed: the growth in the number of 'solo' self-employed workers (who tend to have lower pay) and the larger reduction in hours worked by self-employed workers than employees can explain why total employment income growth has not kept pace with employee wages or labour productivity. See: A Teichgraeber & J Van Reenen, Have productivity and pay decoupled in the UK?, CEP discussion paper CEPDP1812, November 2021. For evidence on the effect of the rising minimum wage on wages at the bottom of the distribution, see U Altunbuken et al., Power plays: the shifting balance of employer and worker power in the UK labour market, Resolution Foundation, July 2022.

Second, the proportion of total labour income that goes directly to workers in the form of wages – as opposed to employers' contributions to pensions and employer NI payments – can change over time. In particular, as Figure 4 shows, the fraction of labour income that is non-wage compensation grew from 13.4 per cent in 1980 to 17.2 per cent in 2022. This accounts for a third of the divergence between productivity growth and median wage growth during that time period.[10]

FIGURE 4: **Growth in non-wage compensation accounts for some of the divergence between productivity and wage growth**

Employer social contributions as a proportion of total employee compensation: UK



SOURCE: Analysis of ONS, National Accounts.

Finally, the UK's terms of trade (the relative price of the imports we buy and consume compared to the price of exports we sell and produce) also matters for the value of workers' wages.[11] Since 2008, this effect has reduced the purchasing power of wages by 6 per cent.[12]

These are all important factors that have had a significant effect on workers' wages, and it is not surprising that people have focused on the apparent disconnect given that the UK has been struggling to achieve any median wage growth at all in recent years. But the

10 This updates previous analysis in: M Whittaker, Follow the money: Exploring the link between UK growth and workers' pay packets, Resolution Foundation, August 2019.

11 For example, the UK is a net importer of energy, and so during the current energy price shock as a result of the war in Ukraine, UK consumer prices (equivalent to the CPI deflator) rose faster than UK producer prices (equivalent to the GVA deflator). (In 2021, 38 per cent of the energy used in the UK was imported. See: Department for Business, Energy & Industrial Strategy, UK energy in brief 2022, July 2022.)

12 Authors' calculations based on the difference between the UK's GVA and CPIH deflators between 2008 and 2022. Source: ONS, National Accounts; ONS, Inflation and price indices.

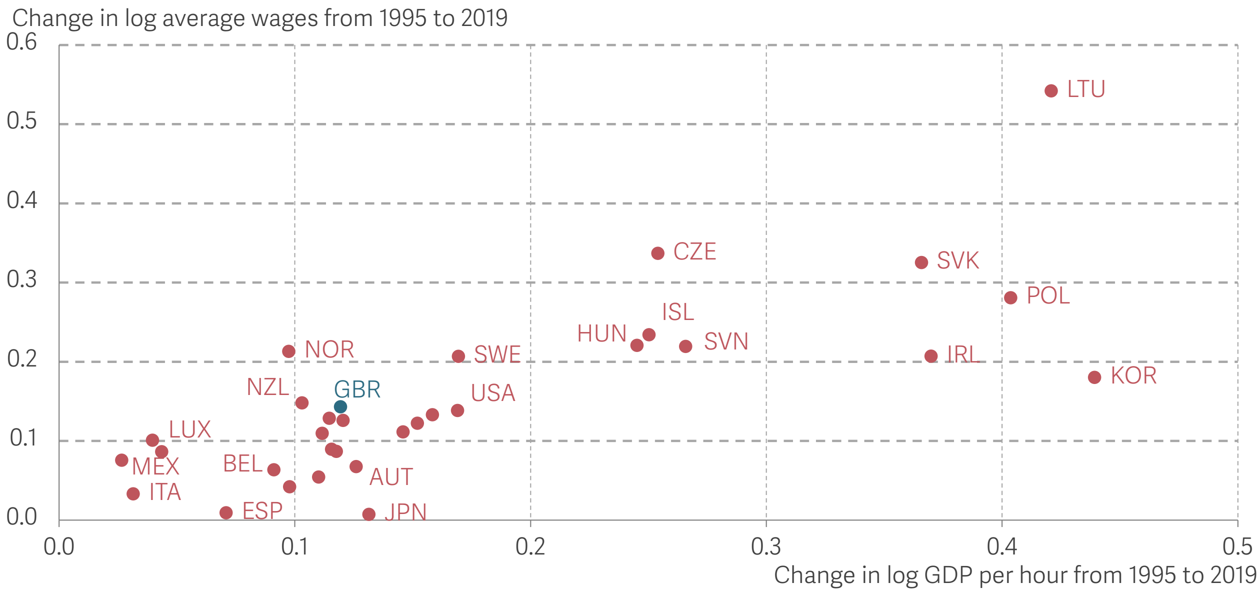
diagnosis that there is some other permanent extraneous factor limiting wage growth is misplaced. The main reason wage growth has been so low in recent years (as Figure 2 makes clear), is the period of terrible productivity growth: in the 12 years following the financial crisis, the UK has seen dismal labour productivity growth of just 0.4 per cent per year, compared to an average of 0.9 per cent in the 25 richest OECD countries.[13]

A growing economy will mean higher wages

The truth is that, although the factors that we discussed above can influence workers' take-home pay, it is still productivity growth that is the main determinant of wage growth. High-earning nations such as Germany and the United States also have high levels of productivity, and countries with low typical earnings also tend to have low productivity, such as Mexico and Greece. And Figure 5 also shows a strong correlation between changes in productivity and changes in average annual wages – this confirms that recent weak growth in productivity has been behind the UK's poor performance on wages (as shown in detail for the UK in Figure 2).

FIGURE 5: **High earnings are correlated with high productivity**

Change in log GDP per hour and log average annual wages, by country: 1995-2019



NOTES: Excludes Iceland.
SOURCE: Analysis of OECD, Productivity Database; OECD, Annual Average Wages database.

Even in the United States – where policy makers are far more anxious about the apparent decoupling – recent research shows that marginal increases in productivity do feed through to wage growth. The authors of a recent paper conclude that, although there

13 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.

may be factors supressing average compensation, the relationship between productivity growth and growth in average compensation remains steady.[14]

So productivity growth is irreplaceable, rather than irrelevant, to ordinary workers. Its return is the central precondition for a return to rising wages which, in turn, has always been the main motor of increasing living standards. However, just as we must be clear eyed that growth is essential for rising wages, we should also be clear that, on its own, boosting wages won't bring about broadly shared prosperity.

14 A Stansbury & L Summers, Productivity and Pay: Is the Link Broken?, Peterson Institute for International Economics Working Paper No. 18-5, June 2018.

Section 3

Growth alone will not deliver truly shared prosperity

We can be confident that a return to productivity growth will deliver rising wages and higher employment – but will that be enough to deliver shared prosperity? Key to understanding the answer to this is to recognise that not all income comes directly from the labour market. This most obviously applies to those who have retired, but there are also 11 million people in working-age households for whom income from the labour market provides less than half of their disposable income. This is a group that is primarily low income, and disproportionately likely to include single parents, people with disabilities, or certain minority-ethnic groups.

Relying only on productivity growth to drive household income growth will mean these low-income households see their living standards fall further behind. This is exactly what happened to pensioners in the 1980s and 1990s, when the labour market gave strong income growth to those in work, but the older population was left behind because the State Pension was rising only in line with inflation. This is not tenable in the longer term, and so governments of both parties have since taken a different approach, linking benefits for pensioners to growth in earnings.

In future, we risk seeing the 1980s experience of pensioners happening again, but for the working-age population. If we achieved a decade of real-terms growth in earnings at levels deemed achievable by the OBR, then median income would increase by 12 per cent in real-terms, and top incomes by 14 per cent, but incomes at the bottom of the income distribution, reflecting the lower importance of earnings to household income, would see average growth of just 2 per cent. This is all driven by our approach to uprating working-age benefits by no more than price inflation, meaning that they will fall ever further behind when productivity and earnings growth return.

Economic growth is likely to also push up living costs – specifically housing costs. This happens across the UK, but is particularly noticeable in fast-growing cities, where increased housing costs typically outpace earnings growth for low-wage workers. Even if we assume that support for housing rises with inflation – it is currently frozen, which is clearly unsustainable – then, if housing costs continue the historical pattern and rise in line with earnings growth, this will take about 2 percentage points off income gains at top of the income distribution over a decade, with the poorest fifth of households seeing incomes fall by 4 percentage points.

In the previous section, we showed that we can be confident that a return to productivity growth will lead to rising wages and higher employment: indeed, that growth is irreplaceable, rather than irrelevant, to ordinary workers.

But there are two broad reasons why that alone will not be enough to ensure shared prosperity. First, today's labour market does not directly support everyone's incomes. In particular, there are two key groups who are most likely to be reliant on other sources of incomes: pensioners, and those in working-age households who receive social security benefits.[15] Second, renewed growth is likely to push up costs, meaning that higher incomes may not translate into higher living standards. Both these issues are explored below.

We cannot rely on a strengthening labour market to deliver shared prosperity

In today's economy, it is not enough to hope that stronger growth in earnings will lift the incomes of all households: it will not, for the central reason that not all household income is directly derived from today's labour market.

The most obvious group for which income is not directly derived from the labour market are those aged over the state pension age, where 62 per cent of pensioners have over half their income from the State Pension or other benefits, and 29 per cent having more than 90 per cent of their income from the state.[16] Indeed, the experience of pensioners over the past few decades is an excellent case study in shared prosperity, and we discuss it more below.

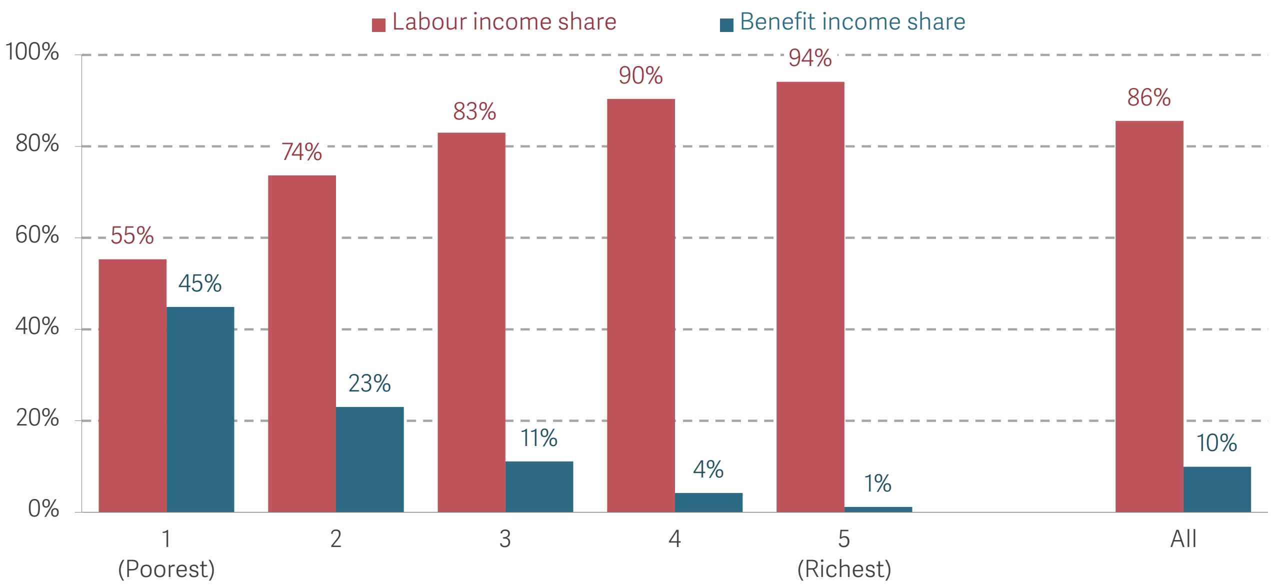
But for non-pensioner households, income directly from the labour market is by far the most important source of income. It amounts to 86 per cent of all household income, but is unevenly spread across the income distribution (see Figure 6). Working-

15 Students are a third group, but we do not discuss their incomes in this report.
16 Analysis of DWP, Households Below Average Income, 2019-20.

age households in the bottom fifth of the income distribution get just over half their income from the labour market, compared to almost 94 per cent for the richest fifth of households. Of the remaining 14 per cent of household income that is not from the labour market, 10 per cent comes from social security benefits. As we would expect, this income is very unevenly spread: working-age individuals in the poorest fifth of the income distribution have an income share from benefits that is four-times higher than those in the middle fifth of incomes (45 per cent compared to 11 per cent). This presents a risk to future shared prosperity, as there is no guarantee that people who are reliant on other, non-market, incomes will see their living standards grow in line with the economy.

FIGURE 6: **Lower-income households have a lower labour share of income than higher-income households**

Proportion of income by source for non-pensioner households by income quintile: 2019-20, UK



NOTES: Other sources of income not included, so totals do not sum to 100 per cent. Income shown is as a proportion of before housing cost income, by income quintile, with the income quintiles having been calculated using after housing cost income.
SOURCE: Analysis of DWP, Households Below Average Income.

11 million individuals in non-pensioner households can't solely rely on earnings for future income growth

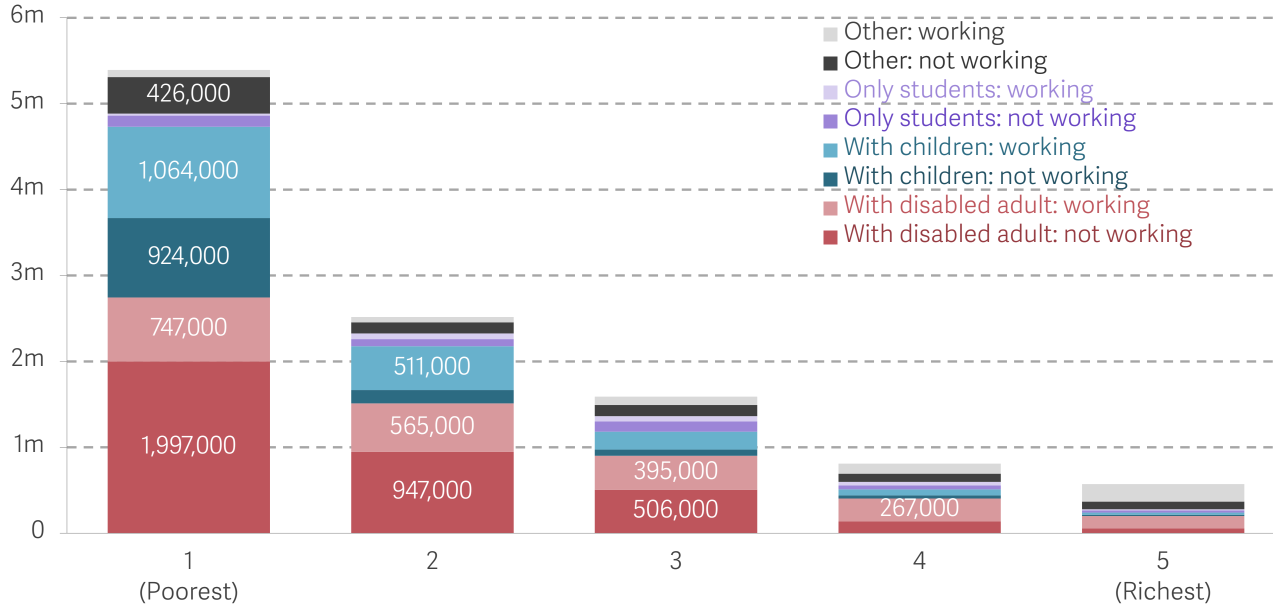
The analysis above shows the broad trends, but to highlight this issue in a more detailed way, we focus below on households where income from the labour market (i.e. earnings plus self-employment income) makes up less than half the total income of the household (as a fraction of income measured before housing costs). In fact, as Figure 7 shows, there are 10.9 million individuals in working-age households (one-in-five of all individuals aged under 66) in this situation.

This might seem to contradict the story that the UK has high employment, and near-record-low unemployment. But, as Figure 7 shows, the vast majority of these individuals are not unemployed. Of the 10.9 million, 6.1 million are in households where no-one is in paid work, but this includes 3.6 million in households with someone who is long-term sick or disabled, 1.2 million in households with dependent children, and 0.4 million who are students, leaving only 0.9 million who are traditionally unemployed.

The remaining 4.8 million individuals are in households that contain someone in paid work, but where earnings are less than half the total income of the household: 2.1 million of these are in households with someone who is long-term sick or disabled, 1.9 million in households with dependent children, and 0.2 million are students. This is a product of the fact that parts of our social security system are designed to provide benefits to offset the extra costs of having children or living with a disability or health condition.[17]

FIGURE 7: **Almost 11 million people live in working-age households where less than half of household income comes from earnings**

Number of individuals in working-age households where earnings are less than half of the total household income, by household status and income quintile: UK, 2019-20



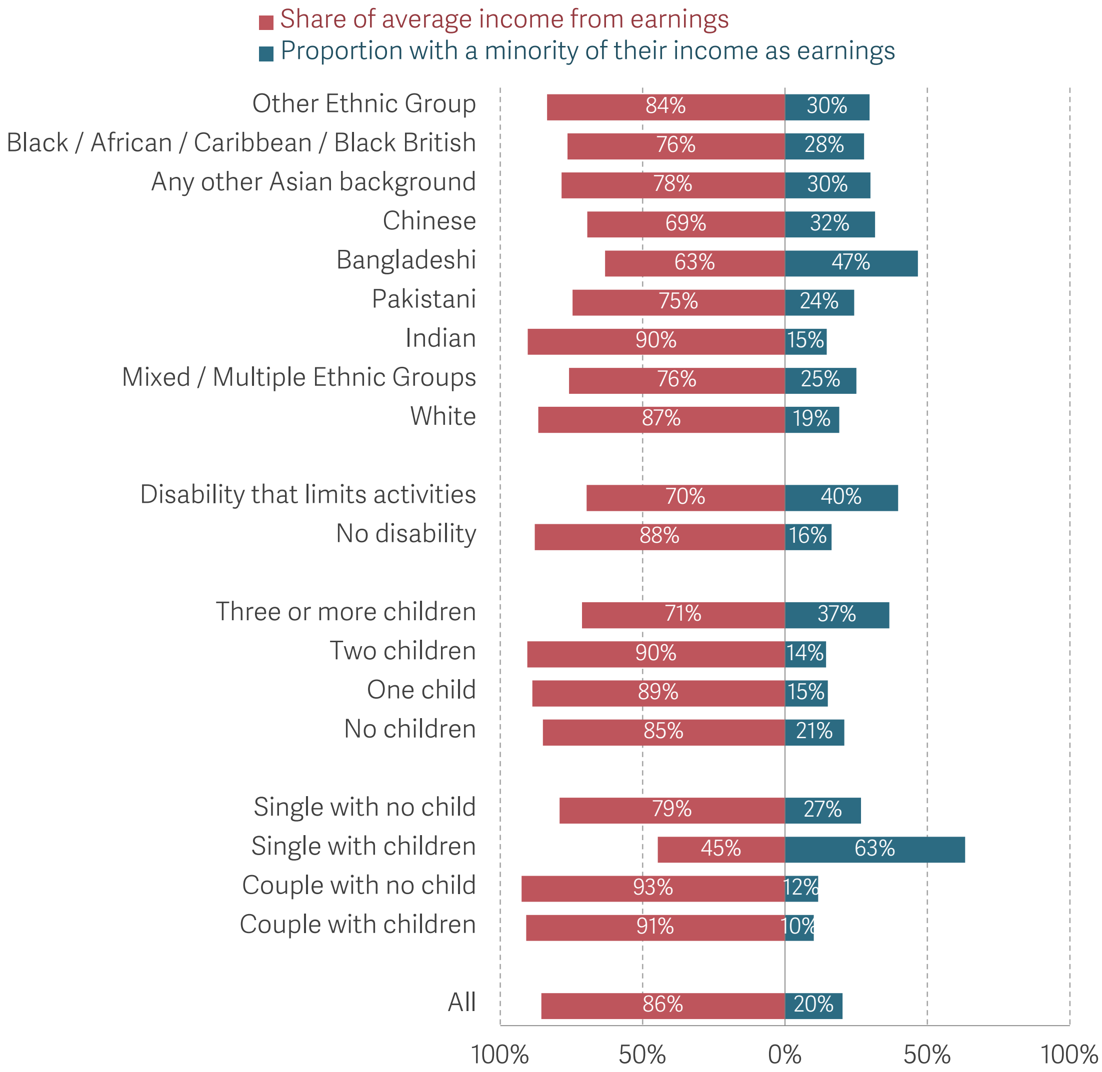
NOTES: Income quintile calculated on equivalised after housing cost income. Earnings calculated as a fraction of before housing costs income. Where multiple household status apply, individuals are counted in households with a disabled adult first, then in a household with children, then an only student household.
SOURCE: Analysis of DWP, Households Below Average Income.

17 For example, a single parent with two children and entitled to housing support of £200 per week is entitled to £17,000 of UC and £2,900 of Child Benefit when earning £13,500 per year. (Source: authors' calculations). The way that the social security system directs support to those with children or in rental accommodation is set out in: M Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, The Economy 2030 Inquiry, January 2022.

It's also clear from Figure 7 that households with less than half their income from earnings are concentrated in the bottom of the income distribution: 5.4 million people in this situation are in the poorest fifth of the income distribution, and they make up 47 per cent of all non-pensioners in the bottom income quintile, compared to 15 per cent of individuals in the middle quintile.

FIGURE 8: **People from certain ethnic groups, those with disabilities, and single parents receive a lower proportion of their household income from earnings than the population as a whole**

Proportion of household income from the labour market and proportion of population where labour market income is a minority of overall household income, non-pensioner households: UK, 2019-20



NOTES: Income before housing costs. Minority earnings income means less than 50 per cent of the household income from net earnings.
SOURCE: Analysis of DWP, Households Below Average Income.

It's also the case that these households are more likely to come from certain ethnic groups or family types. As the right-band bars of Figure 8 show, single parents stand out, as almost two-thirds (63 per cent) receive less than half their income from the labour market, reflecting the importance of child-related support through the social security system. Other notable groups are people of Bangladeshi ethnicity (47 per cent), and those with a disability (40 per cent), both of which are at least twice as likely as the population as a whole (20 per cent) to be in a household where a minority of income comes from the labour market. However, for all groups shown in Figure 8 other than single parents, the left-hand bars show that more than 60 per cent of income, on average, does come from earnings.

Pensioners were locked out from shared prosperity in the past

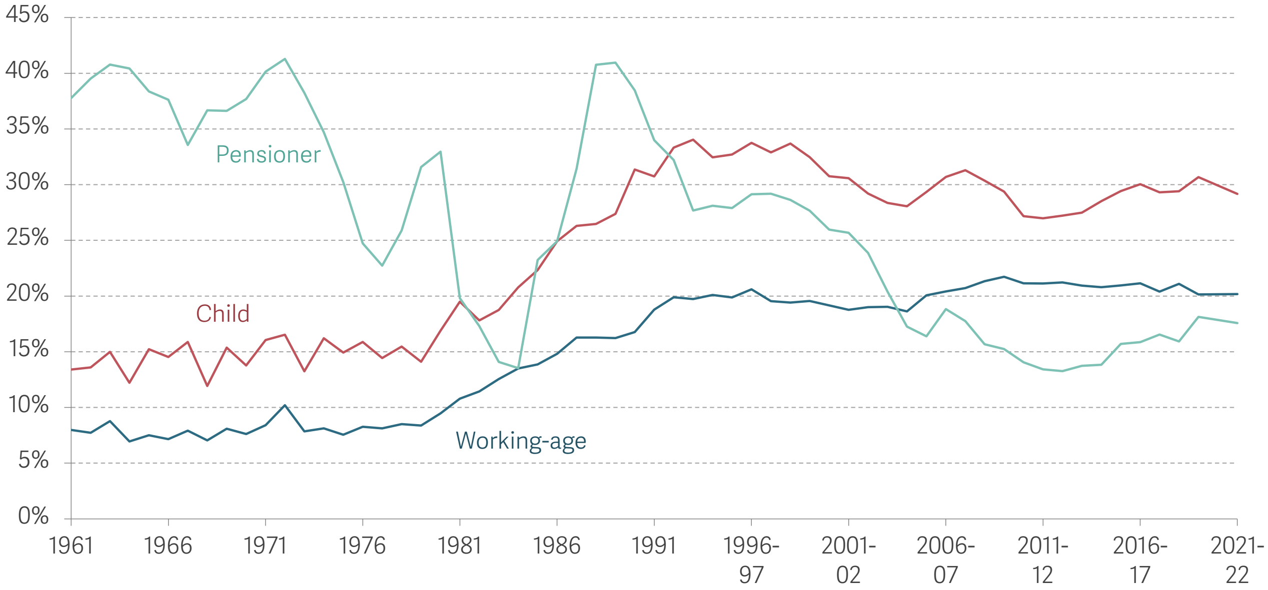
Alongside the 11 million people in working-age households who get less than half their income from the labour market, there are also 10 million people in pensioner households in the same situation (indeed, 3 million get more than 90 per cent of their income from the state). Indeed, the experience of pensioners provides a very good case study of how relying on the labour market alone to drive increased prosperity can lock whole parts of society out of rising prosperity. In particular, rapid growth in GDP and earnings took place between 1982 to 1992, but so too did a huge rise in pensioner poverty, measured using the relative-income benchmark.[18] As shown in Figure 9, after falling during the 1970s, pensioner poverty rose from 14 per cent in 1983 to 28 per cent in 1993.

The reason that pensioner incomes grew more slowly than typical incomes during the 1980s boom (leading to the higher rates of pensioner poverty) is a policy change made at the start of that decade in how the State Pension was uprated. From 1980, the State Pension was uprated in line with price inflation, rather than earnings growth.[19] But this meant it fell far behind during the near-record wage growth in the 1980s: the value of the basic State Pension fell from 30 per cent of average weekly earnings in 1980 to 24 per cent in 1990.[20]

18 J Muellbauer & D Soskice, The Thatcher Legacy: Lessons for the future of the UK economy, The Resolution Foundation, November 2022.
19 DWP, Abstract of Statistics.
20 M. Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, The Economy 2030 Inquiry, January 2022.

FIGURE 9: **Poverty is less concentrated among pensioners today compared to previous generations**

Proportion of people in relative poverty, by age group: UK, 1961 to 2019-20



NOTES: GB before 2002-03.
SOURCE: Analysis of IFS, Family Expenditure Survey; DWP, Households Below Average Income.

But the policy of uprating the State Pension (and other benefits for pensioners) in line with inflation was not tenable in the longer-term. A series of above-inflation increases in the State Pension (in 1994, 2001, 2002 and 2003), the decision to link the means-tested support for pensioners (what is now the Pension Credit) to growth in earnings, effectively, from 1999, and the restoration of the earnings-linked uprating in 2011 (along with the additional 'triple lock' guarantee), has meant that the State Pension has since recovered to 26 per cent of average weekly earnings, from a low of 22 per cent in 2007.[21] As a result (alongside improved private pensions), far fewer pensioners are in poverty today: with less than one-in-five (18 per cent) having an income below the poverty threshold in 2021-22. Had we continued to index pensioner benefits to price inflation, our simulations suggest that the pensioner poverty rate would be 7 percentage points higher and an extra 800,000 pensioners would be in poverty.[22]

Our current tax and benefit policy will mean the poorest see a small fraction of the future growth in typical incomes

Policy makers embracing the need for growth need to recognise what the experience of pensioners tells us about the limitations of growth: when growth drives rising wages, but

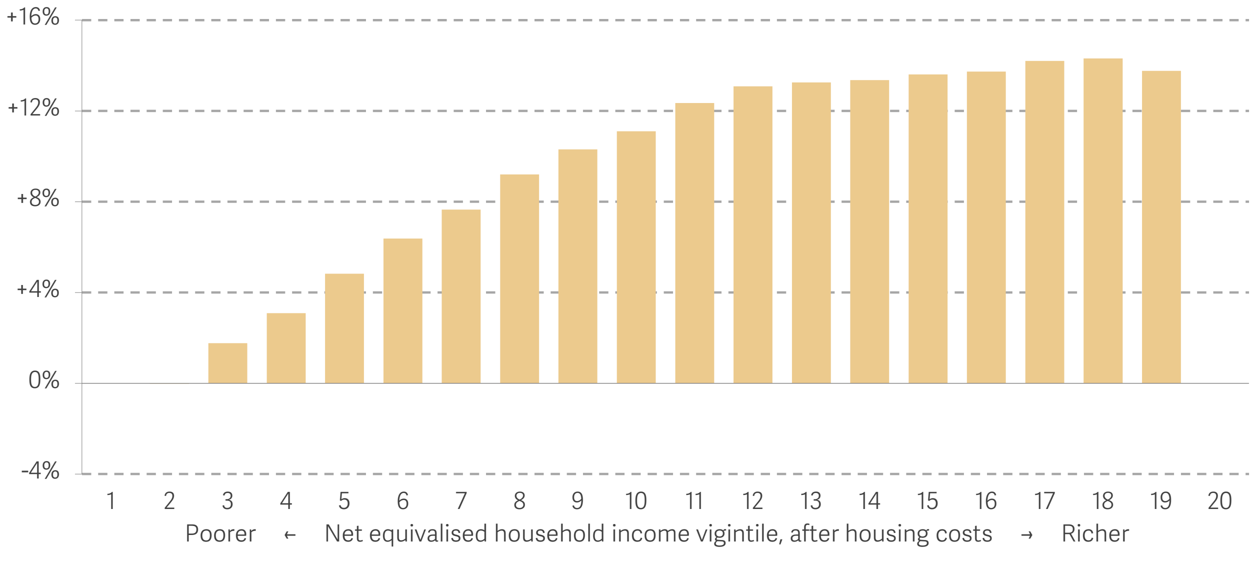
21 M. Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, The Economy 2030 Inquiry, January 2022.
22 Analysis of ONS, CPI; ONS, RPI; ONS, Rossi; DWP, Family Resources Survey using the IPPR tax-benefit model. The State Pension, Pensioner Housing Benefit and Pensioner Council Tax Reduction (and all related elements uprated using RPI until 2010, then CPI thereafter. Pension Credit (and all related elements) uprated using Rossi until 2010, then CPI thereafter.

doesn't feed through into other forms of income, there is a real danger that inequality will rise as we leave behind large numbers of older and poorer individuals. But the experience also shows us that, faced with the reality of pensioner incomes forever falling behind, we collectively decided to make policy changes that mean that growth and higher wages are translated into higher incomes for pensioners. (Indeed, as we discuss later, the vagaries of the triple lock in fact mean that pensioner incomes typically grow faster than earnings).

This is a very different situation from that facing some individuals in working-age households now. As we showed above, a fifth of the non-pensioner population gets less than half their household income from the labour market. To understand what this means for shared growth, we have undertaken a modelling exercise to consider the implications of a decade of real growth in earnings at a level consistent with the OBR's current assumptions for the UK's long-term economic performance (the Annex explains our approach in more detail), and where this is shared evenly across the earnings distribution.[23]

FIGURE 10: **A return to earnings growth would not raise living standards for lower-income households**

10-year real-terms non-pensioner after housing costs income growth projection, by income vigintile



NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Benefits, tax thresholds and housing costs assumed to increase in line with CPI. Earnings and other incomes assumed to increase in line with Average Weekly Earnings. The top- and bottom-income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, allowing for households to move up and down the distribution.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Fiscal Sustainability Report.

23 This is intended as a neutral assumption: wage and earnings inequality have been falling recently, but wage and earnings inequality grew rapidly during the period of very high growth in the 1980s, although that was likely the product of many interacting policy changes, and not just faster growth. See: J Muellbauer & D Soskice, The Thatcher Legacy: Lessons for the future of the UK economy, The Resolution Foundation, November 2022.

Figure 10 shows the results. A decade of earnings growth (assumed to begin in 2025) would increase average wages by 16 per cent, in real terms. This would translate into a rise in median income of 12 per cent in real terms, and a rise of 14 per cent in the top income quintile.[24] However, incomes at the bottom of the income distribution, reflecting the lower importance of earnings to household income (as shown earlier in Figure 6), will see average growth of just 2 per cent.[25] The higher inequality this implies would mean relative poverty rising by 1.8 million (1 million children) and the income gap between a typical and poorer (bottom fifth of household income distribution) household rising from £18,000 to £21,000.

The fact that middle- and high-income households can expect six times the income growth of low-income households shows what happens when productivity improvements feed through to earnings growth, but not to other income growth. Specifically, that is a result of what happens to working-age households' income from social security benefits, which, under the current uprating policy, is set to see zero real-terms growth, as we discuss in Box 1.[26]

BOX 1: **Current uprating policy for social security benefits**

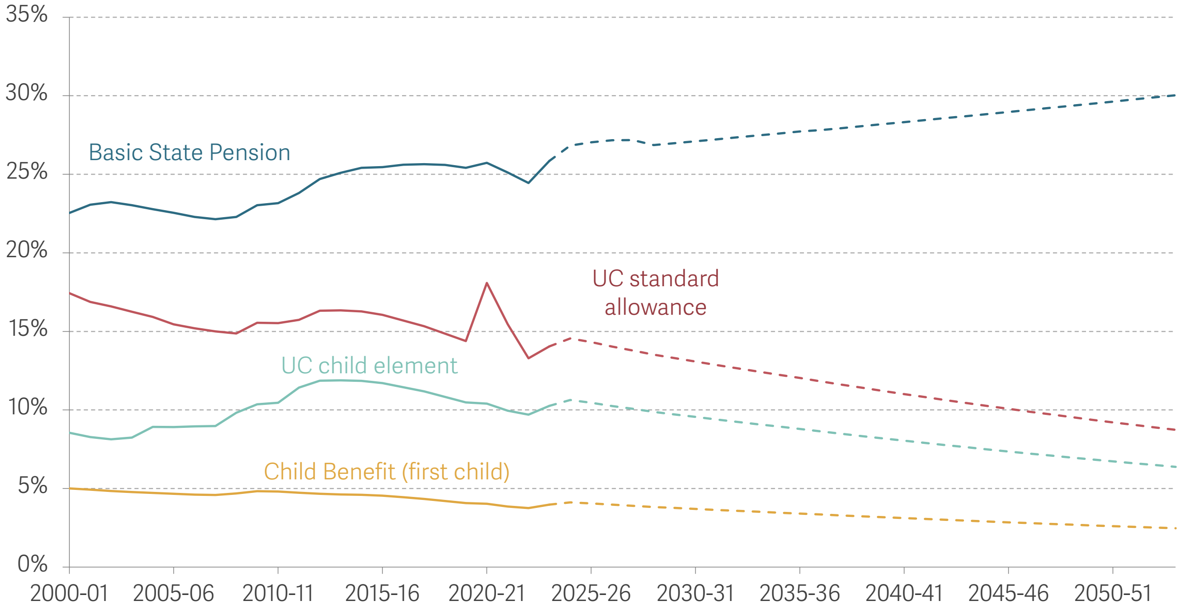
At present, most working-age benefits are uprated each April using the previous September's rate of CPI inflation. By law, the Secretary of State for Work and Pensions is required to review the level of benefits each year, and present a draft uprating order to Parliament.[27] This uprating order must increase certain benefits, including disability benefits (PIP, DLA, Attendance Allowance) and the Additional State Pension by the change in the CPI as a minimum, and must increase the new State Pension, basic State Pension and Pension Credit standard minimum guarantee by the growth in average earnings as a minimum. The uprating order may also include increases to other benefits, such as UC and its legacy system equivalents. The default expectation (but, since 2011, certainly not the norm) is that they are uprated using CPI inflation.[28]

24 Disposable income grows by more than average earnings because we are using an after housing costs measure of income and assuming that housing costs do not rise in real-terms. See the Annex for a detailed explanation.
25 Income growth for the second vigintile is 0 per cent in Figure 11.
26 The lower income growth at the bottom also reflects that workers in low-income households can face higher marginal effective tax rates than those in middle-income households.
27 E Kirk-Wade & R Harker, Benefits uprating 2023/24, House of Commons Library, December 2022.
28 This default expectation has been the exception, rather than the norm, in recent years. In the 2010s, benefits were uprated by only 1 per cent a year for 3 years, then were frozen in nominal terms for 4 years. As a result, before the pandemic, unemployment benefits were at their lowest rate in real terms since 1991-92 (source: M. Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, The Economy 2030 Inquiry, January 2022).

Figure 11 shows in more detail how benefit uprating policy means the value of benefits is set to evolve relative to earnings in the future. In line with the OBR's long-term economic determinants, non-pensioner benefits would lose 11 per cent of their value relative to earnings over the next decade (and 26 per cent over 20 years). More specifically: the UC standard allowance – the amount of support for a single unemployed adult – would fall from 14 per cent of earnings in 2025-26 to 12 per cent in 2035-36 and 10 per cent in 2045-46, down from 17 per cent in 2000-01. This reflects that the policy objective of uprating benefits has been to stabilise living standards in the face of rising prices. Indeed, this approach has protected low- and middle-income households during today's highly unusual period of high inflation. But, although the difference between indexing to price or earnings may make only a small difference in any given year, in the longer term our current approach means disconnecting the living standards of poorer households (principally those with a disability or children) from the rest of the population.

FIGURE 11: **Current uprating policy will ensure working-age benefits lose their value relative to earnings over time**

Projected value of selected benefits as a proportion of average weekly earnings: UK



NOTES: Assumes State Pension increases in line with the OBR's assumption on the long-run impact of the triple lock, and other benefits increase in line with CPI.
SOURCE: Analysis of DWP, Abstract of Statistics; OBR, Economic and Fiscal Outlook, March 2023; OBR, Fiscal Risks and Sustainability, July 2022.

This is the key reason that our modelling shows lower income growth for poorer households: earnings are projected to grow by 16 per cent in real terms over 10 years, but income from social security benefits see no real-terms growth. And, as shown in Figure 6, poorer households receive a greater proportion of their income from benefits.

Overall, then, this analysis shows that we cannot rely on the labour market to deliver shared prosperity. Previous governments have addressed this for pensioners, but current policy towards working-age households risks locking out many working-age individuals and children from the benefits of any future growth.

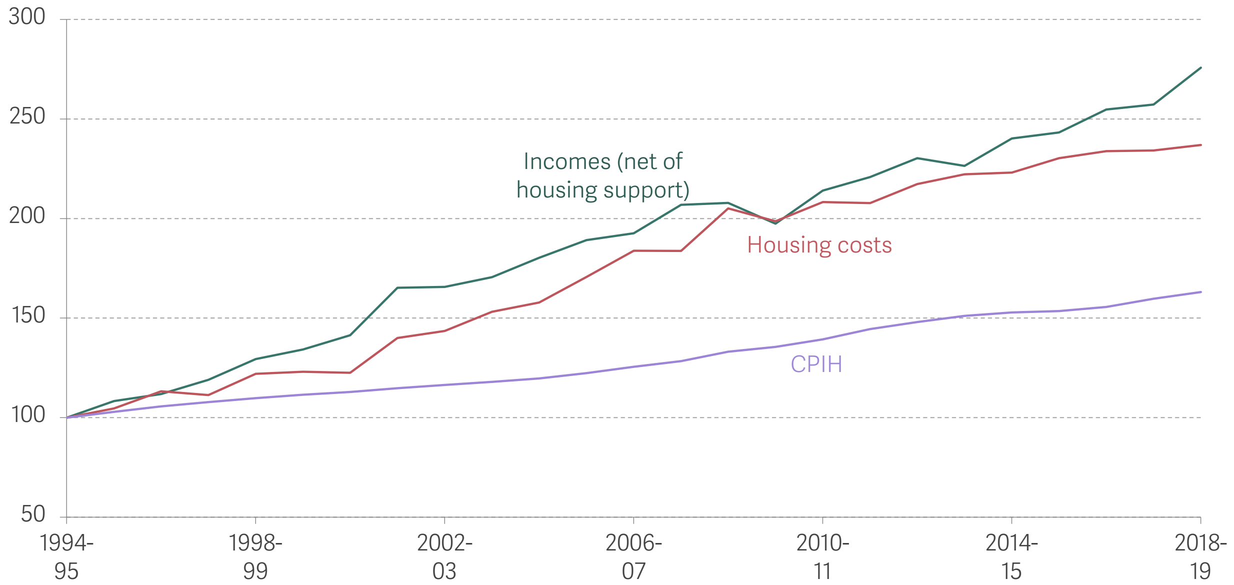
A growing economy is likely to push up essential housing costs

The second broad reason why the labour market will not deliver prosperity is that growth is likely to push up costs, and especially housing costs, meaning that higher incomes may not translate into higher living standards.

This is particularly noticeable for renting costs: as Figure 12 shows, housing costs and incomes for private renters at a national level have tended to grow broadly in line with each other. Between 1994-95 and 2018-19, incomes grew by 276 per cent in nominal terms, while housing costs grew by 237 per cent (and CPIH inflation grew by 163 per cent). We can also expect these cost pressures to be reflected in the social rented sector and in mortgage costs over time as the different markets interact with each other (as well as other factors such as interest rates).[29]

FIGURE 12: **Incomes and housing costs for private renters have broadly grown in line with each other and much faster than prices**

Index of median total housing costs and before housing cost incomes for private renters (1994 = 100) and CPIH: GB, 1994-95 to 2018-19



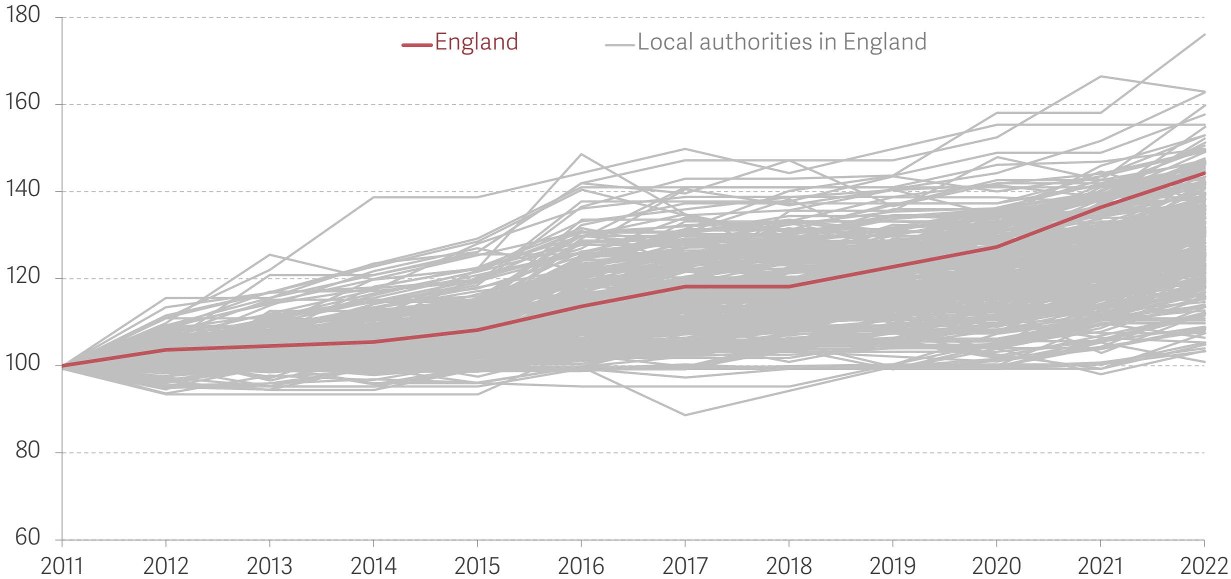
NOTES: Incomes and housing costs in nominal terms. Housing costs include those paid through housing benefits. Income excludes any housing support.
SOURCE: Analysis of DWP, Households Below Average Income; DWP, Family Resources Survey.

29 Existing owners are, of course, protected against changes reflecting the fact that, at one level, buying a house is a leveraged hedge against changes in rental costs.

However, although rising rents at a national level are a near certainty, different places see very different rates of housing cost growth, reflecting the varying forces of supply and demand across the country over time. If aggregate income growth comes with changes in the relative income levels between places, then it will also lead to changes in the spatial distribution of housing costs. Indeed, history tells us that rental price growth already diverges significantly across the country, with Figure 13 illustrating the nearly 75-percentage-point range in rental price growth between local authorities in England over the past eleven years.

FIGURE 13: **Rental price growth has diverged significantly across the country**

Indices of median private rental sector prices (2011 = 100): England and English local authorities, 2011-2022



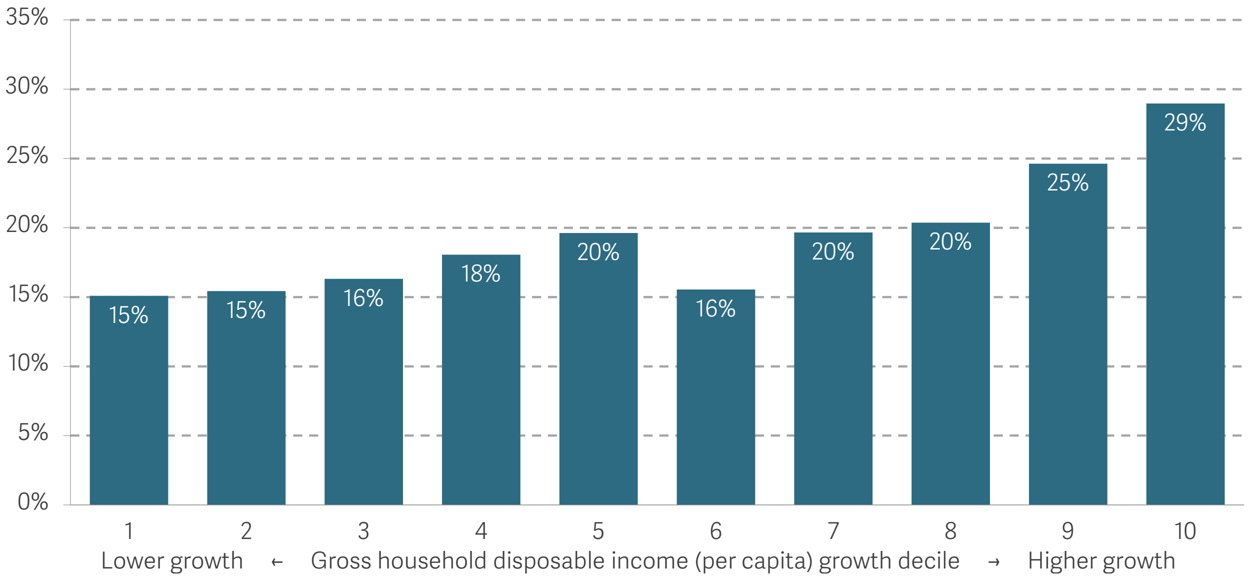
SOURCE: Analysis of ONS, Private rental market summary statistics.

In addition, past evidence clearly shows that the rate of local economic growth is correlated with these divergent paths for housing costs. As Figure 14 sets out, areas with the fastest income growth since 2011 (i.e. the fastest-growing fifth of local authorities) have experienced more significant rises in rents than areas with low-to-middle levels of growth.[30] Therefore, if we pursue an economic strategy that seeks to improve productivity in major cities across the UK, we should expect higher productivity areas with higher wage and income growth to see the most significant rises in rental prices.

30 The link between the level of rental prices and the level of average wages at the local level is similar, and is shown in: H Overman & X Xu, Spatial disparities across labour markets, IFS Deaton Review of Inequalities, February 2022.

FIGURE 14: **Areas with high levels of income growth experienced higher rent rises**

Average growth in median private rental price, by deciles of LA-specific growth in income per capita: English local authorities, England, 2011 to 2019



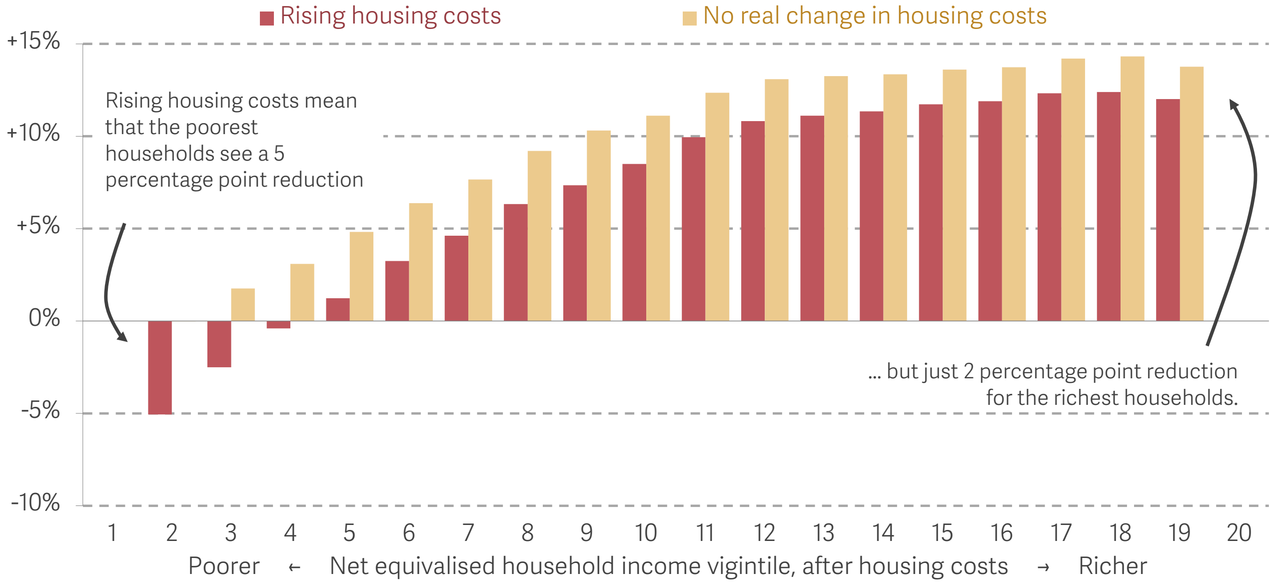
NOTES: Analysis uses a GDHI cash measure derived using the methodology set out in Box 1 of L Judge & C McCurdy, Income Outcomes: Assessing income gaps between places across the UK, Resolution Foundation, June 2022.
SOURCE: Analysis of ONS, Private rental market summary statistics; ONS, Gross Disposable Household Income.

Rising housing costs will mean incomes fall for the poorest

So, although incomes won't rise for everyone with growth, it is far more likely that housing costs will. To see the impact of this, we return to our modelling of future incomes. This time, in Figure 15, we look at incomes after housing costs having accounted for the likely real-terms growth in those housing costs. Allowing for housing costs to grow in line with earnings growth has a small impact on disposable incomes of high-income households (with a reduction in income growth of about 2 percentage points towards the top of the income distribution), but households in the bottom half of the income distribution (especially towards the very bottom) see a much larger income penalty from rising housing costs, with the poorest fifth of households seeing incomes fall by 4 percentage points, on average, after a decade of growth. Rising housing costs therefore erode the benefits of growth for most (with the benefit accruing to landlords and existing owners in the form of higher house prices), but for those not seeing any or much income growth, they drive actual falls in living standards. Even those totally relaxed about rising inequality should recognise this is not what shared prosperity looks like.

FIGURE 15: **Rising housing costs will hold back living standards for low-income households much more than for high-income households**

10-year real-terms non-pensioner after housing costs income growth projection with and without housing cost growth, by income vigintile



NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Benefits, tax thresholds assumed to increase in line with CPI. Earnings and other incomes assumed to increase in line with Average Weekly Earnings. The top and bottom income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, therefore allowing for households to move up and down the distribution.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Fiscal Sustainability Report.

Key to understanding this pattern is the way that the benefits system provides support for those facing rising housing costs. This is currently governed by Local Housing Allowance (LHA) rates, which determine the maximum amount of housing support that can be paid to households of a certain size in a certain area. As we describe in Box 2, the method used to uprate LHA rates has ranged from a full freeze (as has currently been in place since April 2020), to uprating in line with CPI, or in line with local rents (pre-2013). The current freeze is undoubtedly damaging and makes housing more and more unaffordable for benefit recipients each year – recent IFS research shows that in Q1 of 2023, just 5 per cent of private rented properties listed on Zoopla were affordable for housing benefit recipients.[31] In Figure 15, we assumed that LHA rates rise in line with CPI (which has been the default assumption for the public finance forecasts since 2013).

What this analysis shows is that further growth is likely to lead to housing costs growing in line with earnings and incomes for the top half, but outpacing income growth at the bottom. Not only is the labour market not delivering shared prosperity, but the way that it pushes up costs means that stronger growth risks worsening living standards for low-income households.

31 T Waters & T Wernham, Housing quality and affordability for lower-income households, Institute for Fiscal Studies, June 2023.

BOX 2: **Current uprating policy for housing support**

For housing support, LHA rates are used to calculate the amount of housing support that private renters on UC or its legacy equivalents can receive. Before April 2011, rates were set at the median of local rents. From April 2011, rates were set at the 30th percentile of local rents, with the introduction of national caps (that only affected central London). In 2013-14, LHA rates were increased in line with CPI inflation, before being uprated uniformly by 1 per cent in 2014-15 and 2015-16. From April 2016, the rates were frozen in cash-terms, until April 2020, when they were reset to the 30th percentile of local rents. Since then, they have been frozen again.[32]

This section has shown that, although we can be confident that a return to productivity growth will deliver rising wages, we must not assume that growth alone will deliver shared prosperity. In the next section, we look at what else needs to happen if we are to see all households benefit from a growing economy.

32 W Wilson, F Hobson & R Harker, Local Housing Allowance (LHA): help with rent for private tenants, House of Commons Library, March 2023.

Section 4

Achieving growth for all

Productivity growth is necessary but not sufficient for shared prosperity: productivity gains will strengthen the labour market but too many will be disconnected from that, and renewed growth will push up housing costs.

A broader policy agenda is required if the ultimate objective is to see growth rise and inequality fall. Such an outcome is plausible, but will require a rejection of the tendency to set agendas of predistribution (strategies for achieving a more equal distribution of market incomes) and redistribution (how our tax and benefit systems reduce the inequality of those market outcomes) against each other.

Taken together, productivity growth, higher employment and progressive wage growth could ensure higher incomes for all parts of the income distribution. Unlike uniform wage growth alone, the main winners are now middle-income households who would see income gains of 17 per cent over a decade, compared to 13 per cent amongst richer households. But poorer households would still see the slowest income gains (9 per cent), falling short of achieving shared prosperity, and inequality would still rise.

This is because a lower inequality strategy must see predistribution as an essential complement to redistribution, not an alternative to it. There will always be large parts of our society who do not receive the majority of their income from the labour market for whom different mechanisms for ensuring they share in the benefits of growth are required. Ultimately this means social security benefits growing in line with wages rather than prices, and support for housing costs in the benefit system keeping up with growth in housing costs. This would be a big change, but it is also an unavoidable component of any plausible future that sees rising prosperity and falling inequality in Britain. And the standard critiques of such a shift – that it is unaffordable or hugely weakens work incentives – are overdone.

Combining a return to modest productivity growth with higher employment, progressive pay growth, and a social security system that links benefits to average earnings and rent levels to actual housing costs could mean after housing costs incomes for the poorest households rising by 19 per cent over 10 years, greater than gains seen by middle-income (17 per cent) and high-income (13 per cent). The difference between business-as-usual and this combination of predistribution and redistribution is sizable: these changes would result in annual incomes at the 20th percentile being £3,000 (14 per cent) higher, and child poverty could be 6 percentage points lower. Overall, the difference would amount to a 0.02 point fall in the Gini coefficient over a decade, equivalent to the increase in the UK's Gini coefficient between 1997 and 2008.

The previous two sections have shown that productivity growth is a necessary condition for higher incomes, but that, by itself, it is not sufficient to deliver income growth across the income distribution. Higher productivity will lead to higher wages, but this doesn't help households who get most of the income from other sources, and stronger growth will push up housing costs, which will have greatest impacts on those towards the bottom of the distribution.

A broader policy agenda is clearly required if the ultimate objective is to see growth rise and inequality fall. In formulating this agenda, we need to not rule out the idea that we can achieve a fairer set of outcomes from the labour market, but we must also not assume that the labour market alone can ever drive shared prosperity. Instead, we will need both predistribution and redistribution. In this section, we show what we can expect such a strategy to deliver.

The UK needs to share out rewards from the labour market more equally

In the previous section, our assessment of what a period of renewed productivity growth would deliver took the distribution of earnings and employment as a given. But we should not accept that the outcomes from our current labour market are fair. Even though low pay is falling, and measures of earnings inequality peaked in the 1990s, the UK's labour market is still highly unequal, and it is right that we should try to share the rewards more equally. Other reports in the Economy 2030 project are setting out how these might be achieved[33] – as well as how we can reduce inequalities in some of the non-financial

33 N Cominetti et al, Low Pay Britain 2023: Improving low-paid work through higher minimum standards, Resolution Foundation, April 2023; L Judge & H Slaughter, Enforce for good: Effectively enforcing labour market rights in the 2020s and beyond, Resolution Foundation, April 2023.

aspects of our working lives, such as feelings of control and autonomy, or stress.[34] Below we sketch out what such changes might mean for household incomes.

Among the core objectives of a predistribution strategy is higher employment, which will disproportionately raise the incomes of poorer households, as it did during the 2010s (see Box 3). An ambitious but plausible strategy would target repeating the success of the last decade with a further 3 percentage point (or 1.2 million people) rise in employment over ten years. We do not attempt to say how this might be achieved, but it is likely to require a particular focus on three groups – older workers, women with children, and those affected by rising levels of ill-health and disability.[35] Our modelling suggests that a rise of this size, even if it wasn't specifically focused on low-income households, could take around 500,000 out of poverty.

BOX 3: **Recent employment growth has been bottom heavy**

Higher employment can have one of many varying impacts on inequality. If the employment gains are captured by individuals already living in relatively high-income households, then the distribution of household-level market incomes can become less equal. This has happened in the UK in the past, but, as Figure 16 shows, recent employment gains have been progressive.[36] Increases in the working-age UK employment rate since 2009-10 have been concentrated exclusively at the bottom of the income distribution, with the employment rate increasing by 6 percentage points among working-age adults in the bottom half of the income distribution, and no change on average for those in the top half.

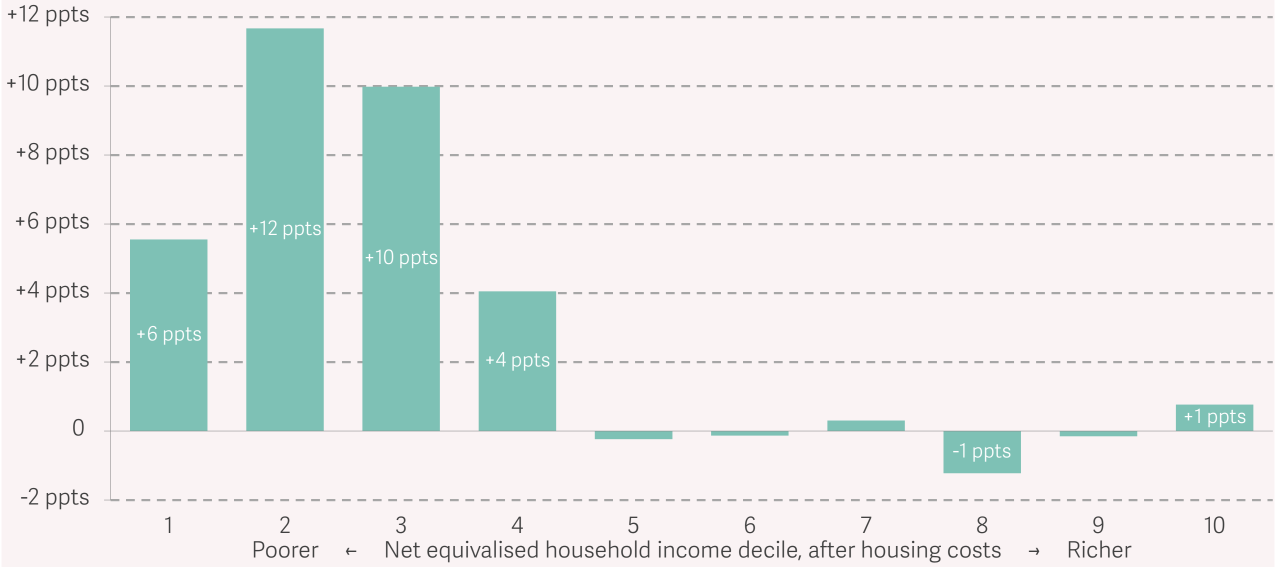
This past experience, plus the fact that over 90 per cent of adults in better-off households are now in work, suggests that further gains in employment are likely to be concentrated among poorer households.[37] This is not to say that we shouldn't worry about whether sustained further employment growth will be a given with more economic growth – the recent rise in inactivity due to ill-health certainly presents a challenge, and there is a limit to how much the employment rate can

34 K Shah & D Tomlinson, Work experiences: Changes in the subjective experience of work, Resolution Foundation, May 2021; U Altunbuken et al, Power plays: The shifting balance of employer and worker power in the UK labour market, Resolution Foundation, July 2022.
35 L Murphy & G Thwaites, Post-pandemic participation: Exploring labour force participation in the UK, from the Covid-19 pandemic to the decade ahead, Resolution Foundation, February 2023.
36 For analysis of how past changes in employment have affected inequality, see: P Bourquin, M Brewer & T Wernham, Trends in income and wealth inequalities, IFS Deaton Review of Inequalities, November 2022; J Cribb, R Joyce & T Wernham, Twenty-five years of income inequality in Britain: the role of wages, household earnings and redistribution, Institute for Fiscal Studies, March 2022.
37 91 per cent of working-age adults living in the richest 30 per cent of households are in work. Source: DWP, Households Below Average Income, 2019-20.

increase, as people with long-term health conditions and disabilities (who are more likely to be on a low income) that prevent them from working won't be able to enter the labour market.

FIGURE 16: **Employment growth in recent years has been concentrated at the bottom of the income distribution**

Change in working-age employment rate by after housing cost income decile: UK, 2009-10 to 2019-20



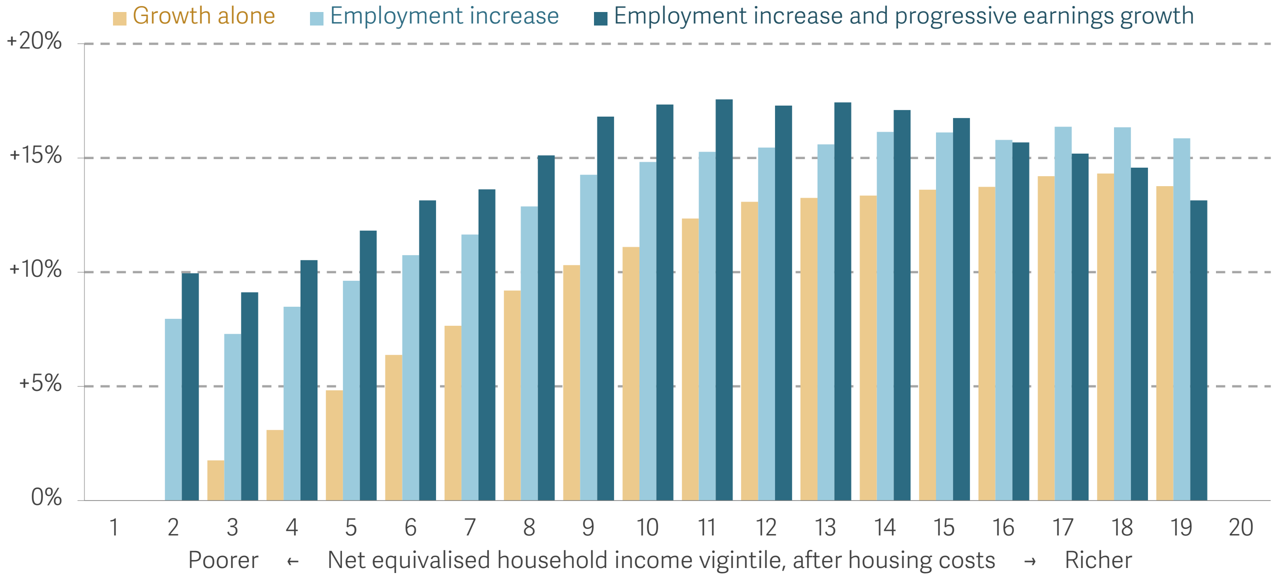
SOURCE: Analysis of DWP, Households Below Average Income and Family Resources Survey.

The second core predistribution component is progressive wage growth – with those on lower and middle wages seeing faster growth than those at the top. A strategy to realise that would go beyond a higher minimum wage (which has seen hourly wage inequality fall consistently for the past 20 years), with a broader focus on the nature and quantity of good work, including certainty of hours worked, progression, education and training. To consider what this might plausibly achieve, we model the impact of wages over ten years growing at the bottom by 28 per cent, at the median by 20 per cent and at the top by 11 per cent (we hold average (mean) wage growth at the same level as before). This would cut the number in low pay by around a fifth, and reduce the Gini coefficient from 0.38 to 0.37.

If we ignore the effect of these changes on housing costs (i.e. we assume they remain constant in real terms), then Figure 17 shows that bottom-heavy wage growth and higher employment would lead to more progressive income growth, with the predistribution adding 10 percentage points to income growth for the bottom fifth. However, the main winners are now middle-income households who would see income gains of 18 per cent over a decade, compared to 14 per cent among richer households. And it would still fall short of achieving shared prosperity: incomes for the poorest fifth of households would grow by around half (56 per cent) of the rate of growth for middle-income households.

FIGURE 17: **A more progressive labour market will still leave low-income households with around half the rate of typical income-growth**

10-year real-terms non-pensioner after housing costs income growth projection under different scenarios, by income vigintile



NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Benefits, housing costs, and tax thresholds assumed to increase in line with CPI. Employment increase modelled as a random 3 percentage point increase in the working-age employment rate. Progressive earnings increase modelled as a 28 per cent real-terms rise for the lowest wage earners with a linear change falling to a 11 per cent real-terms rise for the highest wage earners. Mean average earnings increase by 16 per cent overall, in line with Average Weekly Earnings. Other incomes assumed to increase in line with Average Weekly Earnings. The top and bottom income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, allowing for households to move up and down the distribution.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Fiscal Sustainability Report.

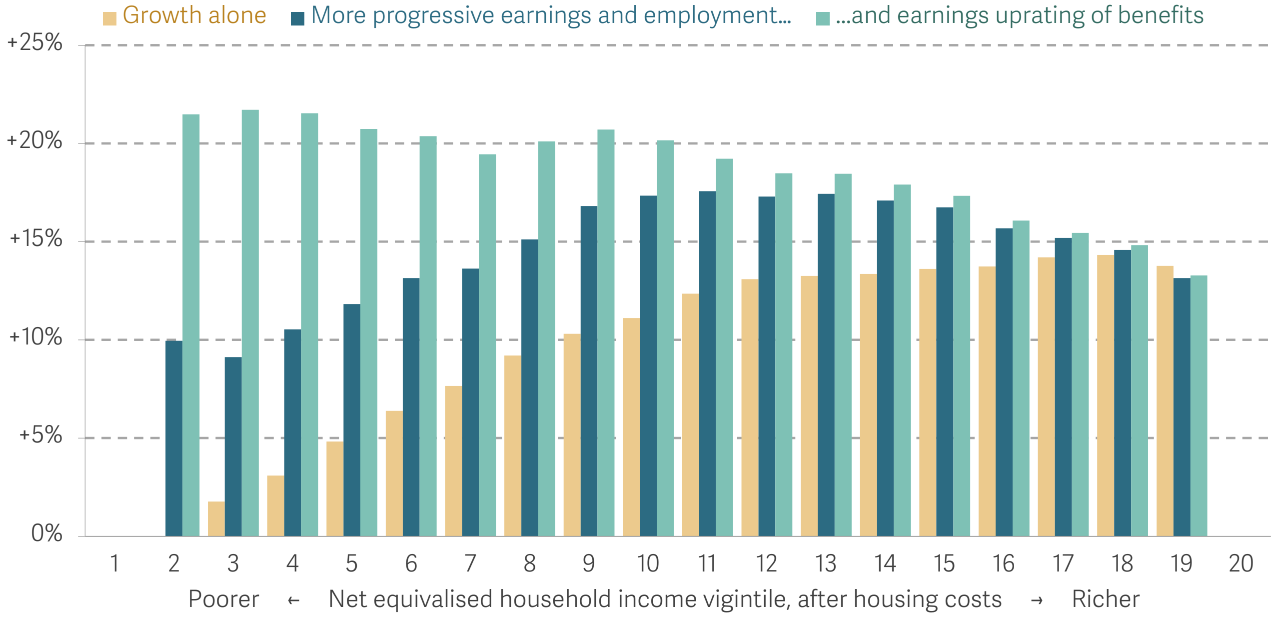
But combining growth with predistribution and redistribution is the only plausible route to rising prosperity and falling inequality

Even a plausible but optimistic scenario for how earnings and employment could change is not enough, then, to ensure that all households across the income distribution have an equal share in future economic growth. To achieve truly shared prosperity, we need to ensure that other sources of income also keep up with broader economic growth. In particular, this means the value of social security benefits for working-age households should keep pace with earnings growth. In doing so, we can ensure that households that are unable to work, or where earnings make up a minority of their income, are not left behind when the UK's economy returns to sustained growth.

Income growth under such a scenario is shown in Figure 18: uprating benefits in line with earnings over the next decade – in addition to progressive growth in labour market incomes – would see income growth for the poorest fifth of non-pensioners (22 per cent) broadly match growth at the median (20 per cent).[38]

FIGURE 18: **If we ignore housing costs, then earnings uprating of working-age benefits is enough to ensure shared prosperity**

10-year real-terms non-pensioner after housing costs income growth projections with different benefit policy and with no increase in housing costs, by income vigintile



NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Housing costs, and tax thresholds assumed to increase in line with CPI. Employment increase modelled as a random 3 percentage point increase in the working-age employment rate. Progressive earnings increase modelled as a 28 per cent real-terms rise for the lowest wage earners with a linear change falling to a 11 per cent real-terms rise for the highest wage earners. Mean average earnings increase by 16 per cent overall, in line with Average Weekly Earnings. Other incomes assumed to increase in line with Average Weekly Earnings. The top and bottom income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, therefore allowing for households to move up and down the distribution.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Fiscal Sustainability Report.

38 We do not consider how such a policy would be funded nor the impact of that decision on the distribution of household income. As we show later, earnings-uprating of working-age benefits is consistent with spending on working-age benefits declining as a proportion of GDP in the medium-run. However, earnings-uprating of working-age benefits would increase spending compared to the short-term spending baseline currently used by the DWP and OBR. If such an increase were funded by a rise in general taxation, then we might expect the impact to be a roughly equal percentage decline in incomes across the distribution (see Table 1 of: ONS, Effects of taxes and benefits on household income, July 2022). We also abstract from any behavioural responses to these changes, or second-round (or general equilibrium) impacts on employment or earnings.

Rising housing costs also threaten shared prosperity – so we should ensure that support keeps pace

However, earnings uprating of the main rates of benefits only helps us to achieve shared growth if housing costs do not rise in real terms. As we showed in Section 3, it is very likely that housing costs will also rise as the economy grows, meaning that low-income households are likely to see declines in real living standards when measuring income after housing costs.

Just as we did when thinking about who gains from the labour market, we can address the inequality-increasing headwind of rising housing costs with action on the market costs of housing. Housing costs are partly determined by a lack of supply, and this problem is particularly acute for cities where we might expect faster economic growth and higher growth in housing costs. Given this, the UK must build more homes in areas where demand is outmatching supply – doing so will help limit further rises in housing costs (and we will discuss how this should happen in future Economy 2030 reports).

But we must also address government support for housing costs, and avoid allowing the amount of housing support on offer to fall behind the rising cost of housing.[39] The most straightforward approach to doing this would be to permanently link the amount of housing support provided through LHA and Housing Benefit to local rents, by setting the maximum LHA rates in each area to the 30th percentile of rents, rather than having LHA rise in line with overall inflation (or be frozen in nominal terms, as it is now). In addition, the benefit cap must also rise in line with earnings, as the current policy of having it frozen will also prevent housing support from keeping pace with housing costs (see Box 3).

The impact of doing this on incomes is shown in Figure 19: in a scenario with rises in employment, a reduction in low pay, and where social security benefits are linked to average earnings and LHA rates linked to actual housing costs (specifically: to the 30th percentile of rents), then incomes for the poorest households would now rise (by 19 per cent). This is slightly more than income growth in the same scenario for median households (17 per cent). This broad and credible policy approach to housing will stop the housing market from turning future economic growth into a drag on living standards for low-income households.[40]

39 A longer-term perspective on government support for housing costs is given by: I. Mulheirn, J. Browne & C. Tsoukalis, Housing affordability since 1979: Determinants and solutions, Joseph Rowntree Foundation, January 2023.
40 Again, we abstract from any behavioural responses to these changes, or second-round (or general equilibrium) impacts on employment, earnings or rental costs.

FIGURE 19: **Improved housing support is needed to prevent rising housing costs from getting in the way of shared prosperity**

10-year real-terms non-pensioner after housing costs income growth projection with progressive employment and earnings growth and earnings-linked uprating of benefits and housing support, by income vigintile

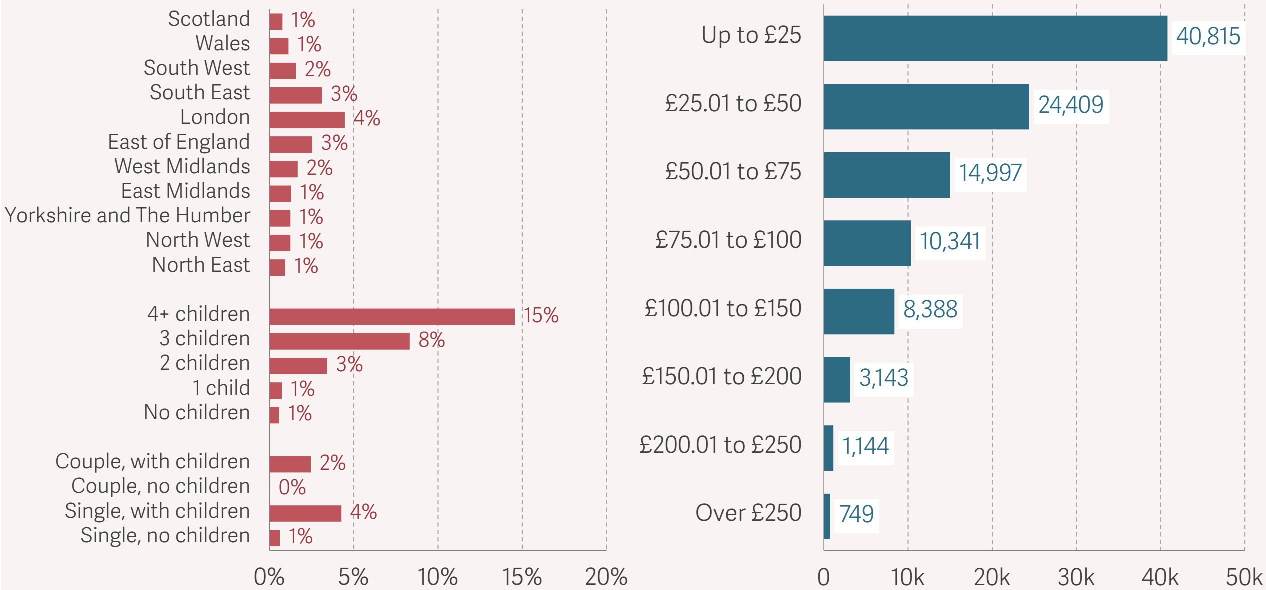
NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Tax thresholds assumed to increase in line with CPI. Employment increase modelled as a random 3 percentage point increase in the working-age employment rate. Progressive earnings increase modelled as a 28 per cent real-terms rise for the lowest wage earners with a linear change falling to a 11 per cent real-terms rise for the highest wage earners. Mean average earnings increase by 16 per cent overall, in line with Average Weekly Earnings. Housing costs and other incomes assumed to increase in line with Average Weekly Earnings. The top and bottom income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, therefore allowing for households to move up and down the distribution.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Fiscal Sustainability Report.

BOX 3: **The benefit cap is explicitly designed to prevent shared growth, and should be reformed**

Due to additional rules in the benefit system, any decision to uprate benefits in line with earnings and relate LHA to local housing costs will not feel like a rise in living standards for certain families. The benefit cap, introduced in April 2013 but now standing at a substantially lower level in real-terms, puts a limit on benefit entitlement for families where no-one is in paid work. This typically affects those with high housing costs, or larger families. In February 2023, around 104,000 households on UC were capped, with 13,000 households on UC capped by over £100 a week. Families in London and the South East, families with multiple children and single parents are the most likely to be affected by the benefit cap (see Figure 20). Of the 104,000 households subject to the benefit cap in February 2023, 86 per cent had children.

FIGURE 20: **Single parents, large families and Londoners are the most likely to be benefit capped**

Proportion of UC households capped by characteristic and number of UC households capped by weekly amount: GB, February 2023



SOURCE: DWP, Stat-Xplore.

The Government uprated the benefit cap in April 2023 in line with inflation – a welcome, but one-off, decision that prevented significantly more families from breaching the cap following the April 2023 benefit uprating. But the cap remains 15 per cent lower in real terms than it was in November 2016. Without further increases, some families will not only see income from benefits lag behind that of the general population, but would also see entitlements fall in real-terms. The benefit cap should, therefore, continue to be indexed at least in line with growth in typical benefit entitlements.

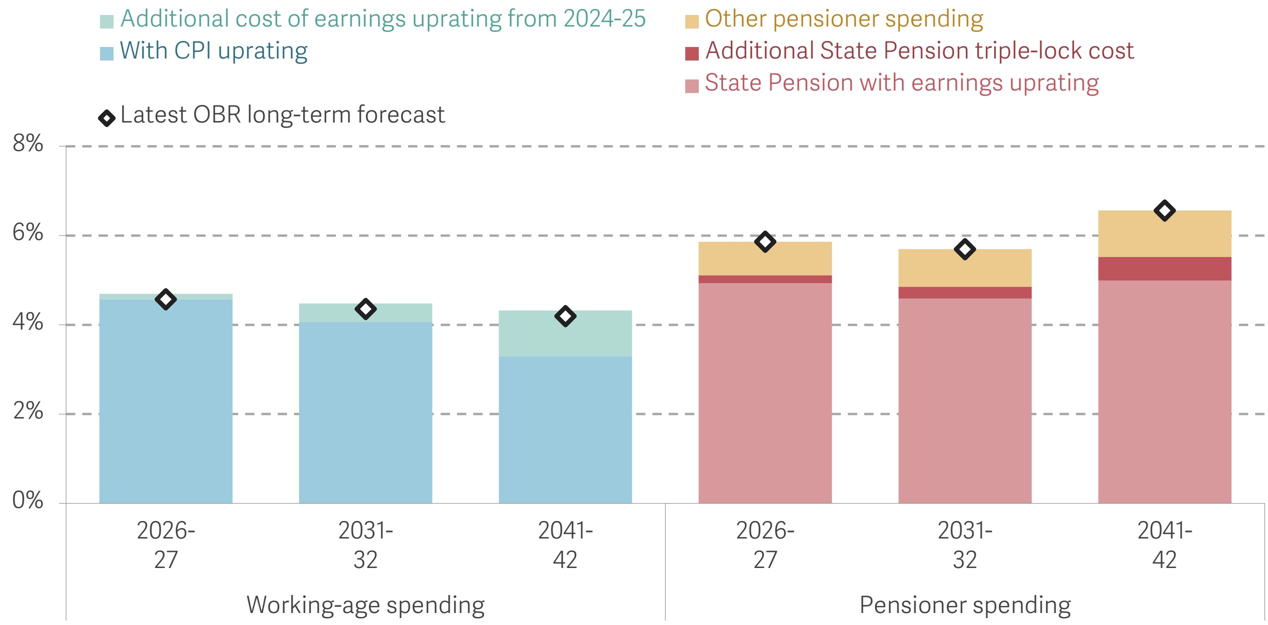
Objections to earnings-uprating of benefits are misplaced

The analysis so far has shown that achieving shared prosperity among working-age households will not be possible if some income sources are held back as the economy grows. This can be addressed, just as we dealt with the rise in pensioner poverty in the 1980s and 1990s, by linking working-age benefits to growth in average earnings, and linking housing support to in housing costs.

But some will say that earnings-uprating working-age benefits is unrealistic, because it's unaffordable or would weaken work incentives. However, these objections – while noteworthy – are not all that convincing. And a closer look over the past few decades shows that earnings-uprating happens in similar economics, and that earnings-uprating working-age benefits would be less of a break from longstanding policy than some might imagine.

FIGURE 21: **Working-age benefit spending would fall as a proportion of GDP even if benefits are indexed to earnings**

Working-age and pensioner welfare spending as a proportion of GDP: UK



NOTES: Categories are in line with those in the OBR Fiscal Risks and Sustainability report. Working-age spending includes spending directed at children. We assume the default OBR uprating is the triple lock for the State Pension, and CPI for all other welfare spending until 2026-27, and then by average earnings thereafter. We assume other pensioner spending remains unchanged compared to the original OBR projection. The cost estimate of earnings uprating includes restoring LHA rates to the 30th percentile of local rents and earnings-uprating the benefit cap.
SOURCE: Analysis of OBR, Fiscal Risks and Sustainability report - July 2022; OBR, Economic and Fiscal Outlook - March 2023.

Taking the first objection on cost: in fact, the Office for Budget Responsibility (OBR) currently projects that welfare spending directed at working-age households would fall as a proportion of GDP under a policy of indexing benefits in line with average earnings. As shown in Figure 21, its forecasts imply that total spending on working-age benefits would amount to 4.2 per cent of GDP in 2041-42, 0.4 percentage points lower than in 2026-27, driven by demographic changes.

The same set of OBR forecasts show that it's not working-age welfare that is increasing over time: it's social security spending on those above the state pension age, where the combination of demographic changes, the triple lock on the state pension, and the move the new single-tier State Pension will push spending as a proportion of GDP up from 5.9 per cent in 2026-27 to 6.6 per cent by 2041-42.

A second objection suggests that we should be wary of increasing the generosity of benefits, as – all things equal – it would discourage some individuals from working. It is clearly important to maintain strong financial incentives to work, but we don't need to rely on ever-decreasing benefit generosity relative to wages to ensure that individuals are financially rewarded for working. In fact, uprating benefits in line with earnings simply preserves the strength of current work incentives: if someone is five times as well off in work today compared to not working, then they will be five times as well off in work in a decade's time if benefits and earnings increase at the same rate.[41] Indeed, any strategy for shared growth would entail having the National Living Wage grow at least as fast as average earnings, and so financial incentives to work for those in low-paid work will be maintained, if not strengthened, even if benefits were indexed to earnings.[42] It's also true that the unemployment rate (currently 3.8 per cent[43]) is near record lows, and the remaining workless population (as we showed earlier in Figure 7) face other, more challenging, barriers to work. Research also shows that the quality of work available in low-paid jobs matters as well as the pay on offer.[44] Finally, when it comes to work incentives, there are more pressing concerns in the social security and tax system as a whole that the UK should address, not least the ongoing collision between UC and the High Income Child Benefit Charge can lead to absurdly high marginal effective tax rates.[45]

More fundamentally, it's just not the case that earnings-uprating of working-age benefits is an unrealistic or outlandish policy. It is true that unemployment benefits in the UK have

41 Weekly earnings of 40 hours at the National Living Wage (£417) are currently 4.9 times greater than the weekly standard allowance for UC (£85).

42 N. Cominetti et al., Low Pay Britain 2023: Improving low-paid work through higher minimum standards, Resolution Foundation, April 2023.

43 ONS, A01: Summary of labour market statistics, June 2023.

44 See: K Shah & D Tomlinson, Work experiences: Changes in the subjective experience of work, Resolution Foundation, May 2021; and, K Handscomb, L Judge & H Slaughter, Listen up: Individual experiences of work, consumption and society, Resolution Foundation, May 2022.

45 For a detailed explanation, see: M Brewer, K Handscomb & G Kelly, Inconsistent Incentives: How the overlap between Universal Credit and the High Income Child Benefit Charge limits work incentives, Resolution Foundation, December 2022.

been uprated by (at best) inflation since 1982, but benefits for children rose considerably in generosity in the 1990s and 2000s, as did support for low-income working families, in part because governments recognised that inequalities and poverty would grow otherwise.[46] Since 2010, of course, child benefits have been cut back, and all benefits have been increased by less than inflation, on average; the outcome has been terrible for poverty: the relative poverty rate has risen from 21 per cent in 2010-11 to 22 per cent in 2019-20, while the child poverty rate astonishingly rose from 27 per cent in 2010-11 to 31 per cent in 2019-20. An international comparison also shows that earnings-uprating of benefits would not be so strange after all. For example, New Zealand has recently moved to indexing working-age social security benefits to earnings, and Germany, Belgium and the Netherlands all uprate their equivalent to the UK's means-tested benefits with reference to a combination of changes in earnings or GDP and prices.[47]

There are, of course, some disadvantages to a purely earnings-uprating system. Most notable, it would be imprudent for a government to reduce benefit rates during an economic downturn – this would reduce the ability of the social security system to provide macroeconomic stabilisation.[48] In addition, uprating benefits using earnings would result in a real-terms fall in benefit income following years where inflation is higher than earnings growth, as was the case in 2022-23.[49] However, this apparent shortcoming is easily remedied (as many of the countries above do) by committing to uprating benefits by at least price inflation in any given year, while committing to follow an index of earnings in the longer-run – a so-called 'smoothed' earnings lock – which the UK must also apply to the uprating of benefits.[50] Indeed, there is scope for the governments to make savings here: changing the uprating rules for the State Pension so it followed a 'smoothed' earnings lock, and was not subject to the triple lock, would reduce welfare spending in 2041-42 by some 0.5 percent of GDP – or £14 billion in today's terms – this could actually recoup 52 per cent of the £27 billion cost (in 2041-42) of uprating working-age benefits by earnings, rather than CPI.

46 M. Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, The Economy 2030 Inquiry, January 2022.

47 The most recent uprating decision in New Zealand, where benefits were increased the higher of inflation and earnings growth, is announced here: Ministry of Work and Income, Changes to Payments from 1 April 2023, and approach is described here: Ministry of Social Development, Annual General Adjustment 2022 and related regulatory changes, February 2022. Those countries that uprate social assistance by more than prices are summarised on page 6 of: OECD, Income support for working-age individuals and their families, December 2022. Full details are at: https://www.missoc.org/missoc-database/comparative-tables/

48 J Smith et al., Recession ready?: Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.

49 A Corlett & L Try, The Long Squeeze: Benefit uprating policy for April 2023, Resolution Foundation, October 2022.

50 If, after a period of real-terms growth in earnings, price inflation exceeded earnings growth (as it is now), then a smoothed earnings lock would see benefits rise in line with prices temporarily, protecting the real value of income from benefits. However, when growth in earnings rose back above the level of price inflation, a smoothed earnings link would not immediately use earnings growth to increase benefits (as would happen under a 'double lock' policy, but would increase benefits in line with price inflation until the value of benefits had returned to the same fraction of average earnings as it had before the real decline in average earnings.

A combination of progressive earnings growth and maintaining the value of benefits will achieve the shared prosperity the UK needs

This section has looked at how the UK should achieve higher living standards without increasing inequality. A credible strategy will need to reject the choice between more progressive growth in labour market incomes and more redistribution through benefits. Instead, the UK must aim to achieve both. This means, just as we did for pensioner benefits in the late 1990s and 2000s, accepting that earnings uprating of working-age benefits is both affordable and necessary to ensure shared prosperity.

Under current policy, income changes over a decade of economic growth would be inequality-increasing. Instead, we can pursue policies to give greater rewards from the labour market to low-wage workers, raise employment, and ensure our benefit system keeps pace with a growing economy. Then we can see rising incomes across the board, and not just shared prosperity but falling inequality. However, reforming the way benefits are indexed isn't the only change to the social security system needed to ensure shared prosperity. We discussed above how the benefit cap would also need reform, and a further policy that drags on income growth among families with children is the two-child limit, which we discuss in Box 4. There are very strong grounds for removing the two-child limit, which is one of the worst aspects of the current social security system.

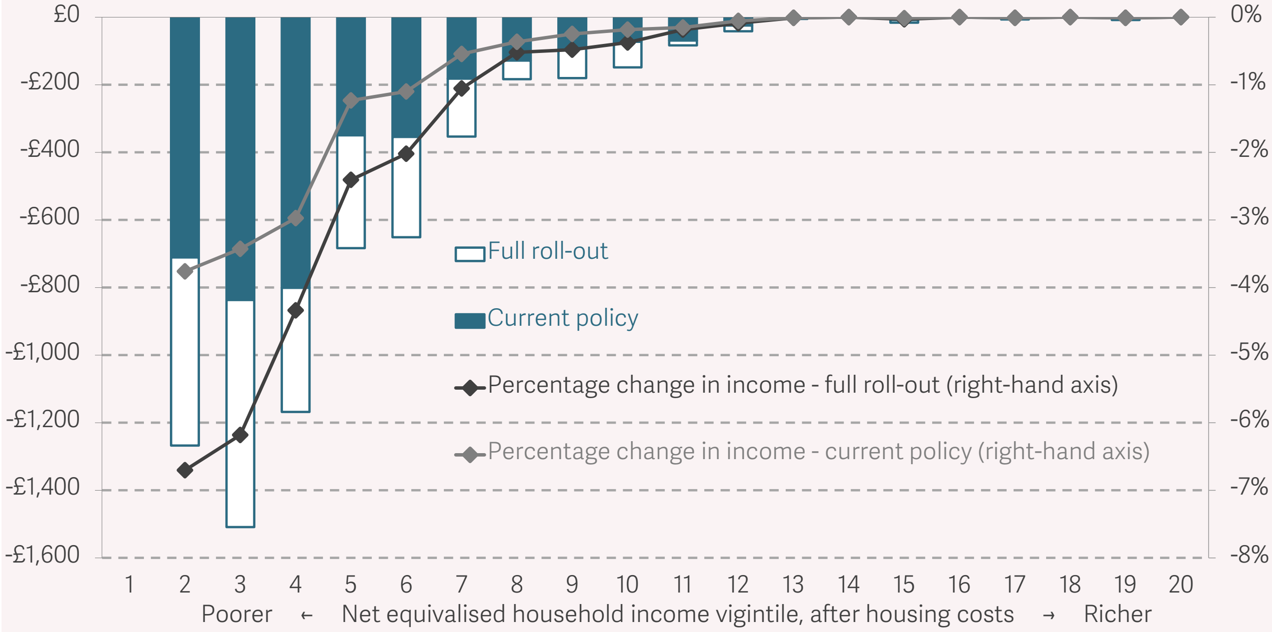
BOX 4: **As well as the benefit cap, the two-child limit will also limit shared growth**

Introduced in 2017, the two-child limit prevents families receiving benefits from receiving child-related benefits for any children had after their first two (although there are exclusions from the policy in certain circumstances). The UK's position on families receiving benefits with over two children exists contrary to other European countries' welfare policies; indeed, countries including France and Germany make higher welfare payments for the third or subsequent children.[51] Figure 22 shows the impact of the policy on household incomes at present, and the impact it will have when fully rolled-out (the policy affects children born after April 2017, meaning the policy won't be fully rolled-out until 2035). At present, the policy means that, on average, the bottom 20 per cent of working-age households are £780 a year worse off. Under a fully rolled-out policy, it will be reducing incomes in the bottom 20 per cent of households by an average of £1,310 a year.

51 M Reader & M Curran, The UK is now falling behind both European countries and the US in its support for larger families, LSE, April 2021.

FIGURE 22: **The two-child limit is leaving low-income families hundreds of pounds poorer, and is set to get worse as roll-out continues**

Impact of the current and a fully-rolled out two-child limit policy on non-pensioner annual household incomes, by income vigintile: UK, 2023-24



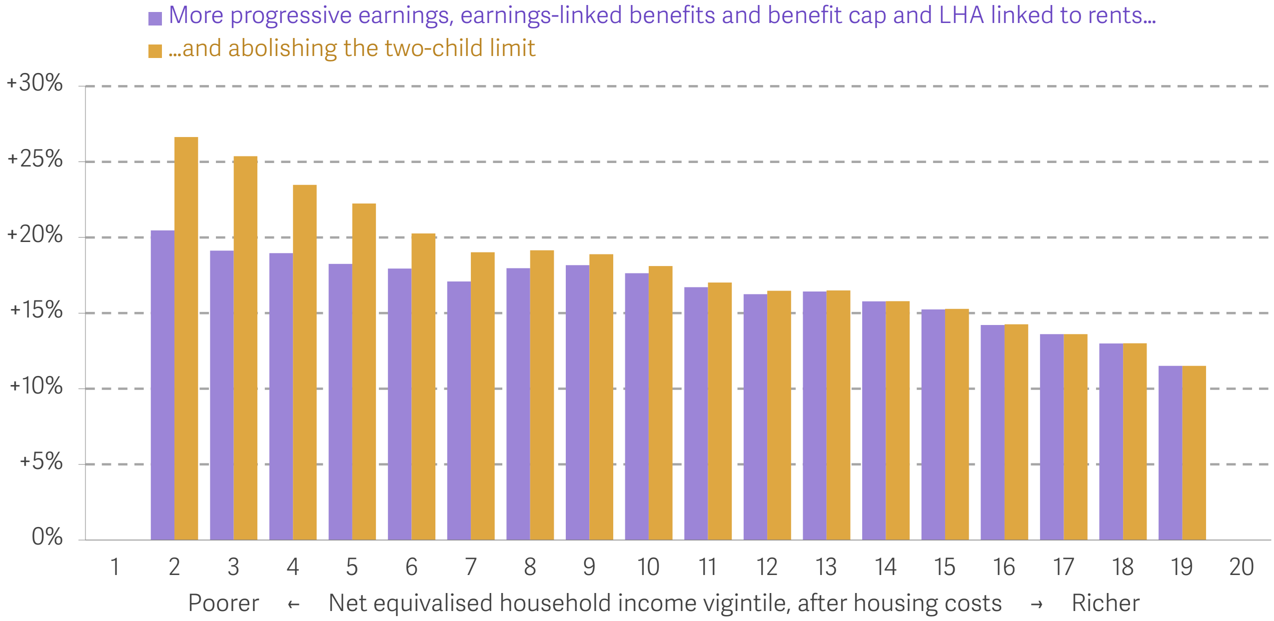
NOTES: Counterfactual is if the two-child limit did not exist. The bottom vigintile is excluded from our analysis due to concerns about the reliability of data.
SOURCE: Analysis of DWP, Family Resources Survey using the IPPR tax-benefit model.

The prize that awaits us is shown in Figure 23, which shows how incomes might change across the distribution after a decade of productivity growth, higher employment, earnings growth that is skewed towards the low earners, ensuring our benefit system keeps pace with a growing economy, and removing the benefit cap and two-child limit. Making these changes would result in progressive income growth, even without the removal of the two-child limit. After housing costs incomes for the poorest households would rise by 19 per cent over 10 years. This would exceed the gains seen by middle income households (17 per cent) while the top would still see gains but on a smaller scale (13 per cent).

Compared to business-as-usual, the difference is sizable: these changes would result in annual incomes at the 20th percentile being £3,000 (14 per cent) higher, and child poverty could be 6 percentage points lower (or 9 percentage points if we also abolished the two-child limit). Overall, the difference would amount to a 0.02 point fall in the Gini coefficient, equivalent to the increase in the Gini coefficient between 1997 and 2008.

FIGURE 23: **Predistribution and redistribution are both necessary to achieve shared growth**

10-year real-terms non-pensioner after housing costs income growth projection with progressive employment and earnings growth and earnings-linked uprating of benefits, benefit cap and housing support and abolition of the two-child limit, by income vigintile



NOTES: Income growth from 2025-26 to 2035-36, deflated using CPI. Tax thresholds assumed to increase in line with CPI. Employment increase modelled as a random 3 percentage point increase in the working-age employment rate. Progressive earnings increase modelled as a 28 per cent real-terms rise for the lowest wage earners with a linear change falling to a 11 per cent real-terms rise for the highest wage earners. Mean average earnings increase by 16 per cent overall. Housing costs and other incomes assumed to increase in line with Average Weekly Earnings. The top and bottom income vigintiles are excluded due to data and modelling reliability concerns. Income growth calculation is based on the mean income of each vigintile in both the base year and the comparison year, allowing for households to move up and down the distribution.
SOURCE: Analysis of IPPR Tax Benefit Model; DWP, Family Resources Survey, 2019-20; OBR, Fiscal Sustainability Report.

The UK managed to avoid higher inequality in the late 1990s and 2000s by increasing social security support for pensioners and children while introducing – and then increasing – the National Living Wage. In the 2010s, employment gains for lower-income families helped offset real-terms cuts to benefits, meaning that overall inequality remained stable, but relative child poverty rose by 680,000, and growth in living standards was lacklustre. Looking ahead, the UK needs a more ambitious strategy – it needs to return to stronger economic growth and find a way to reduce inequality for all citizens. We must ignore those saying that growth is no use, and those saying it's everything. Achieving stronger productivity is the essential precondition to achieving growth, but we must recognise this needs to come alongside changes to the way we think about and support those outside of the labour market if we are to get the shared prosperity the UK needs.

Section 5

Conclusion

The UK has been living through a period of relative decline. Stagnant productivity and income growth have been the defining feature of the last decade and a half. The combination of recent low growth with longer-lasting high inequality has proved toxic for those on low-to-middle incomes: poorer households in the UK are now a full fifth poorer than their counterparts in France.

Both main parties are now, thankfully, focusing on the need for a return to economic, specifically productivity, growth. But economic growth should only be a means to an end: what the ultimate goal should be is rising shared prosperity. This report has therefore asked what it would take for the UK's future to improve upon our past, and what the path to shared prosperity looks like.

We have rejected arguments that growth should not be a central objective of the UK's economic strategy, but shown that growth is far from a sufficient condition for success. Instead, growth combined with a significant, but achievable, policy agenda covering both predistribution (including ensuring the rewards from the labour market are widely shared) and redistribution (including benefits system reform) offers a plausible path to rising and shared prosperity. We need to stop viewing the idea that (say) raising the minimum wage is an alternative to the provision of welfare support to lower income working families, and see them as complements.

What might contribute to both renewed economic growth and predistribution is the subject of companion reports in the Economy 2030 inquiry, some of which are already published and others will follow over the next few months.[52] This report has shown that what is key for the redistribution part of the agenda is that social security benefits growing in line with wages, rather than prices, and support for housing costs in the

52 Two reports have asked how we can get the UK out of the low investment rut (F Odamtten and J Smith, Cutting the Cuts: How the public sector can play its part in ending the UK's low-investment rut, Resolution Foundation, March 2023; P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023), and one has considered how to improve the quality of work for low-paid workers (N Cominetti et al, Low Pay Britain 2023: Improving low-paid work through higher minimum standards, Resolution Foundation, April 2023; L Judge & H Slaughter, Enforce for good: Effectively enforcing labour market rights in the 2020s and beyond, Resolution Foundation, April 2023). These all build on the diagnoses made in the interim report (Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022).

benefit system keeping up with growth in housing costs. This would be a big change, but it is also an unavoidable component of any plausible future that sees rising prosperity and falling inequality in Britain. We also showed that the standard critiques of such a shift – that it is unaffordable or hugely weakens work incentives – are overdone.

The prize here is large. Combining a return to modest productivity growth with higher employment, progressive pay growth, and a social security system that links benefits to average earnings and rent levels to actual housing costs, would mean falls in measures of inequality, contributing to falling gaps between the bottom and the middle, and substantial falls in child poverty. Having chosen to address pensioner poverty in the 1990s and 2000s, we also need to recognise that future changes in inequality are a choice rather than an unstoppable force.

This report has focused on the big picture approach to our working-age social security system, and how it needs to play its part in delivering shared prosperity. Our focus on annual uprating should not be taken as meaning that no other parts of the social security system need to change; similarly, we do not accept that no more progress can be made in increasing employment. But what we have done here is show how a richer and fairer future is not automatic, but is certainly possible.

Annex

This annex provides more detail about our modelling approach to long-term income growth.

Our modelling assumptions use the OBR's medium and long-term economic forecasts and projections, which are for annual earnings growth to rise by 3.8 per cent and CPI inflation to be 2 per cent. We assume all benefit rates and tax thresholds (including the additional-rate threshold) are uprated in line with CPI, other than the State Pension, which is uprated in line with the OBR triple lock long-term determinant of 4.3 per cent per year.

These economic and policy assumptions are then inputted in a microsimulation model which is based on the Family Resource Survey and Household Below Average Income data for 2019-20 (to obviate any temporary pandemic effects). In effect, all income sources (and deductions) are uprated by one of either average earnings, CPI, or not uprated at all (depending on current government policy).

We exclude the top vigintile from our modelling as the situation for very high-income households is more complicated than our modelling here can account for. We exclude the bottom vigintile due to concerns about under-reporting of income.[53]

Our analysis shows income growth for households at different point of the (after-housing cost) income distribution. Income growth is calculated between the same point in the income distribution after accounting for any changes in the income distribution as a result of the modelling.

We also model a possible increase in employment, and bottom-heavy wage growth. To model the higher employment, we simulate individuals in the base microdata moving into employment by matching them to individuals that are already in employment, and copying across their employment status and earnings; we match individuals based on a number of personal and household characteristics which are correlated with employment and earnings. We assume employment growth over the next 10 years of 3 percentage points: this is equivalent to 1.2 million more people in work and a rise in the labour market activity rate to 82 per cent (2.5 percentage points higher than the peak activity rate in 2019).

To model bottom-heavy wage growth, we increase wages by an additional linear (by the value of wages) factor ranging from 10 per cent for wages at the national minimum wage, to a fall of 6 per cent for wages above the 80th percentile (on top of the 3.8 per cent a year growth). This ensures that the mean average wage growth remains in line with the OBR's long-term projections.

53 M Brewer, B Etheridge & C O'Dea, Why are Households that Report the Lowest Incomes So Well-off?. Economic Journal, 127, 2017.

THE
ECONOMY 2030
INQUIRY
SHAPING A DECADE OF CHANGE

The UK is on the brink of a decade of huge economic change – from the Covid-19 recovery, to exiting the EU and transitioning towards a Net Zero future. The Economy 2030 Inquiry will examine this decisive decade for Britain, and set out a plan for how we can successfully navigate it.

The Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics. It is funded by the Nuffield Foundation.

For more information on The Economy 2030 Inquiry, visit
economy2030.resolutionfoundation.org.

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