What does the recession mean for the income distribution?

*The fall in UK living standards which is following the recession has been widely acknowledged but the question of how this is impacting on different groups within society remains profoundly contentious. **Robert Joyce** offers an analysis of these changes and argues that we are seeing significant real decline across the income distribution.*

It is now old news that the UK recently experienced its deepest recession since the Second World War. A peak-to-trough fall in national income of 7%, followed by painfully slow recovery, clearly has consequences for households' living standards. But – more interestingly – when, how, and for whom?

The *timing* of changes in households' incomes since the onset of recession has so far been very different from the timing of changes in GDP. Unemployment rose as the economy contracted, but so initially did the real earnings of those in work, on average. This is perhaps less surprising when one considers the very low and sharply falling inflation of the time – in large part due to a discretionary fiscal stimulus measure implemented in response to the recession, namely the temporary cut to the main rate of VAT. RPI inflation was negative throughout much of 2009, implying that real wage reductions would have required substantial wage cuts in cash terms. And real incomes held up even more strongly during that period towards the bottom of the distribution, where benefits and tax credits are important income sources. There were some discretionary welfare increases, but a crucial factor was the decline in inflation, which temporarily boosts real welfare entitlements since they are fixed in cash terms in the short run (some of this boost was in fact permanent, as RPI-indexed benefits were not cut in cash terms in April 2010, even though the relevant measure of RPI inflation had been negative in 2009).

Inevitably, the pain was delayed rather than avoided. The crash in real incomes began in 2010-11, after the economy had stopped shrinking (for the time being). The harsh collision of households with economic reality in that year at least partly reflected the unwinding of factors that were always going to be transitory. The end of the temporary VAT cut contributed to high and rising inflation, eroding the real value of welfare payments and probably making it easier for firms to implement real wage cuts. And the scale of the damage done to the public finances meant that, at some point, household incomes would be hit by a combination of tax rises and welfare cuts. This began in April 2010 for the very richest, with the top marginal income tax rate rising from 40% to 50% for those on more than £150,000 per year and the personal tax allowance being withdrawn from those on more than £100,000 per year; and in January 2011 for everyone else, with the rise in the main rate of VAT from 17.5% to 20%.

The income falls occurred across the distribution in 2010-11, but not uniformly. Right in the middle, household incomes fell by 3.1% in real terms – the largest single-year fall for 29 years. This reduction was greater than towards the bottom (1.1% at the 10th percentile) and smaller than towards the top (5.1% at the 90th percentile). The major reason for this was, in short, that earnings fell faster than welfare entitlements. So income inequality was reduced substantially, though clearly not in the way that proponents of greater equality would have wished.

Due to the lag with which data on the household income distribution become available, that's still the last official data we have. But we have much more relevant information. We know from other sources what has been happening to employment patterns, and the earnings of those in work. And we know the numerous changes to tax and welfare policy that have already been implemented as the fiscal consolidation has got underway. There are also forecasts (around which there is huge uncertainty, of course) of how earnings and employment will evolve as we move further into the post-recession period, and the government has set out detailed plans for personal tax and welfare policy up to the end of the parliament. This allows us to say a lot about what has happened to the household income distribution up to the present and what *would* happen over the next few years if current macroeconomic forecasts – or indeed some specified alternative scenarios – are correct. Ongoing modelling work by colleagues and I attempts to quantify all this (a short recent presentation of some work-in-progress is available here).

Over the last two years we expect the data to show further substantial real falls in middle and high incomes, because we know that the earnings of workers have generally been rising far more slowly than prices. There is a group of mostly middle and upper-middle income families who have gained from the significant rises in the point at which income tax starts to be paid (particularly two-earner couples, who gain twice over) without being much affected by the cuts to benefits and tax credits (see below). So for them the blow would have been cushioned somewhat. But for those with high earnings, the net impact of tax changes has generally been to reduce take-home pay even further, as rises in the income tax allowance are more than offset by rises in National Insurance and real reductions in the point at which the higher rate income tax kicks in. And the very richest (approximately the top 1%) have been hit particularly hard, although the lack of good data on that group, and uncertainty over how their economic behaviour has changed in response to additional tax rises, makes it harder to be precise about just how much their net incomes have fallen.

All else equal, large falls in real earnings would normally mean that higher-income households fare worse than those on lower incomes, who are more likely to be entitled to state welfare which is by default kept constant in real terms from year to year. But we are also seeing a broad-based package of welfare cuts being implemented over the current parliament – almost entirely for the working-age population – as one significant component of the fiscal tightening. Inevitably this largely hits those towards the bottom of the income distribution (although not exclusively, with the main obvious exception being the withdrawal of Child Benefit from higher-income families from next month); and it is particularly affecting families with children, on whom a large chunk of the working-age welfare budget is spent. This is all true both for those out-of-work and for those in-work with relatively low earnings who receive (mostly) tax credits.

We have yet to update our income projections since last week's Autumn Statement (or indeed the March 2012 Budget, largely because that changed relatively little in terms of policy or macroeconomic forecasts). But with further downward revisions to real earnings growth forecasts and another £4.4 billion per year of welfare cuts announced by 2017-18, the outlook for household incomes has not have got any better at either end of the distribution.

Needless to say, huge uncertainty remains. The outlook for the UK economy has deteriorated considerably over the last eighteen months, and it may change again. But sensitivity analysis we have done suggests that things would have to turn out very much better than currently expected in order for real incomes in 2015-16 to be as high as they were in 2007-08. Frankly the most likely reason why that statement may need revising is that the Office for National Statistics is (for good reason) considering changing the RPI measure of inflation that is currently used to compare incomes in real terms over time. But even that would not change the historical record: calculating household incomes in a consistent way all the way back to 1961, we have not previously seen a period of more than five years when real median income has not grown.

Putting all this together, the picture we expect to see unfolding is one of significant real declines in income right across the distribution, but with the drivers of this pattern varying depending on where precisely in the distribution you look. As the IFS Director, Paul Johnson, put it after the Autumn Statement: "In that limited and rather unhappy sense most of us [the working-age population] really are in this together."

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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