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A NEW LIVING STANDARDS ESCALATOR?

Improving the safety net through long term growth

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Key points:

- Working age safety net benefits are at dangerously low levels, and at present there is no plan to raise them in real terms.

- One potential solution is to increase them in line with earnings, preferably with a "double lock" to ensure that they never fall in real terms, while benefiting when earnings rise.

- A problem with such earnings linking is that earnings themselves have risen and are forecast to rise only slowly and intermittently in real terms.

- As a consequence, with a simple earnings link it could take decades for benefits to reach levels sufficient to avoid severe hardship. A double lock can do better if it produces a "ratchet" effect shielding claimants from real earnings falls but enabling them to benefit from subsequent sharp rises. However, this risks seeming unfair to people in work, and becoming politically toxic.

- An alternative proposed in this paper is to link benefits to inflation plus growth in GDP per capita as and when it occurs. This would ensure the worst-off households get a share in rising prosperity.

- Such a system would raise benefits most when this was most affordable because of rising tax revenues in periods of growth. If measures to get more people into work succeed, this will help raise GDP and will make more adequate benefits for the remaining caseload more affordable.

- To enable the income of the worst-off working-age households to turn the corner and start rising, some kind of long-term system for inflation-plus upratings will be essential.

Introduction: addressing the need for a more adequate safety net

In 2024, basic benefit levels are far too low to sustain a decent life, for working age individuals and for their families. The rise in the use of food banks, of food insecurity and of destitution are some of the starkest symptoms of an inadequate social safety net, while wider symptoms include indebtedness and inadequate diets among many of those relying on such support. Quite simply, the worst-off people in society are getting insufficient financial support to make ends meet.

Can this be remedied in the foreseeable future? It is now clear that there is no immediate prospect of the new government introducing a substantial raising of the level of the safety net, which would cost billions of pounds. But given that the current dire situation results from a long period in which benefits have not been keeping up with minimum living costs, what are the prospects of putting this process into reverse? If rather than gradually falling relative to living costs, benefits started to rise in real terms, it may be possible to make substantial progress towards more adequate benefit levels over the next decade. And if the present government's ambition of bringing renewed growth were achieved, it is in principle possible to direct some the fruits of this growth (which would bring higher tax receipts) towards raising living standards for households in the greatest need.

There have been a number of calls for a renewed commitment to uprating that doesn't just guarantee inflation adjustments, but systematically increases benefits at least as fast as earnings. This is justified partly on the basis of maintaining the protection of income relative to wages for those who lose their jobs[1], but can also be seen as a way of reversing the decline in absolute living standards. Would such a strategy be effective, and how quickly might it improve benefits so that they are closer to adequate levels?

The answer would obviously be contingent on how much earnings growth we see. This is unknown in advance. However, it is important to acknowledge the effect of changes in the levels of income and earnings growth that we might reasonably hope for or expect through earnings-based uprating were it to be implemented. We need to consider whether earnings uprating in itself would be sufficient to reverse recent real-terms cuts in benefits within a reasonable timeframe.

In the mid-2000s, policy discussions over earnings links appeared to promise a rapid escalator to higher living standards. Over the previous decade, earnings had grown steadily, by a total over a quarter in real terms[2]. Already applied to the child element of the Child Tax Credit, an earnings link was being developed for pensions by the Turner Commission. Such policies, on their own, would have been insufficient to tackle relative poverty, since earnings growth was also pushing up the median income benchmark against which relative poverty is measured. Nevertheless, they were a clear route to rising living standards, in absolute terms, and ensured that in a growth period, low-income groups would benefit from growth rather than falling behind.

However, since that time the story has changed dramatically. Earnings relative to the Consumer Prices Index stopped growing in the late 2000s, since then alternating periods of real earnings

[1] See for example https://blogs.lse.ac.uk/inequalities/2024/03/19/benefits-need-to-rise-in-line-with-wages/

[2] Author calculations, using ONS average weekly earnings data and Consumer Prices Index. From January 1995 to January 2005, the CPI-deflated increase in average weekly earnings was 28%.

decline and modest earnings growth have left average weekly earnings at a very similar level in real terms to what they were in 2004. Relative to the Consumer Prices Index they are 9% higher, and relative to a prices index weighted by household consumption of people at the 20th income percentile (ie around the border of poverty[3]), average earnings are actually 1% lower than they were 20 years ago.

Under these conditions, a simple earnings link over the past two decades would have left benefits only slightly higher than if they had been strictly indexed to CPI, and no higher at all than if they had been raised to reflect the actual cost of living for people on low incomes. Looking ahead, forecasts for the next four years are not optimistic about future growth rates. Based on the rate of productivity growth, for example, the Office for Budget Responsibility puts real earnings growth at around 1% at its forecast horizon[4]. This suggests that, even if things do not go wrong, an earnings escalator to higher living standards for those relying on benefits may be less than half as fast as it was 20-30 years ago. With the Standard Allowance of Universal Credit for a single person currently one-third below the most basic of thresholds of need – Joseph Rowntree Foundation's £120 a week "essentials guarantee", an escalator that only raised real incomes by just over 10% over a decade may be considered much too slow.

The next section illustrates the effects of various policies by considering what their effect would have been had they been applied over the past 20 years, during which real earnings have grown by widely varying rates at different times.

Changing fortunes, 2004-2024

Over the past 20 years, there have been periods of earnings growth, of earnings stagnation and of earnings decline. While the past does not predict the future, it is worth considering what effects different upratings policies would have had on real benefit levels, to illustrate potential outcomes of such policies under different conditions.

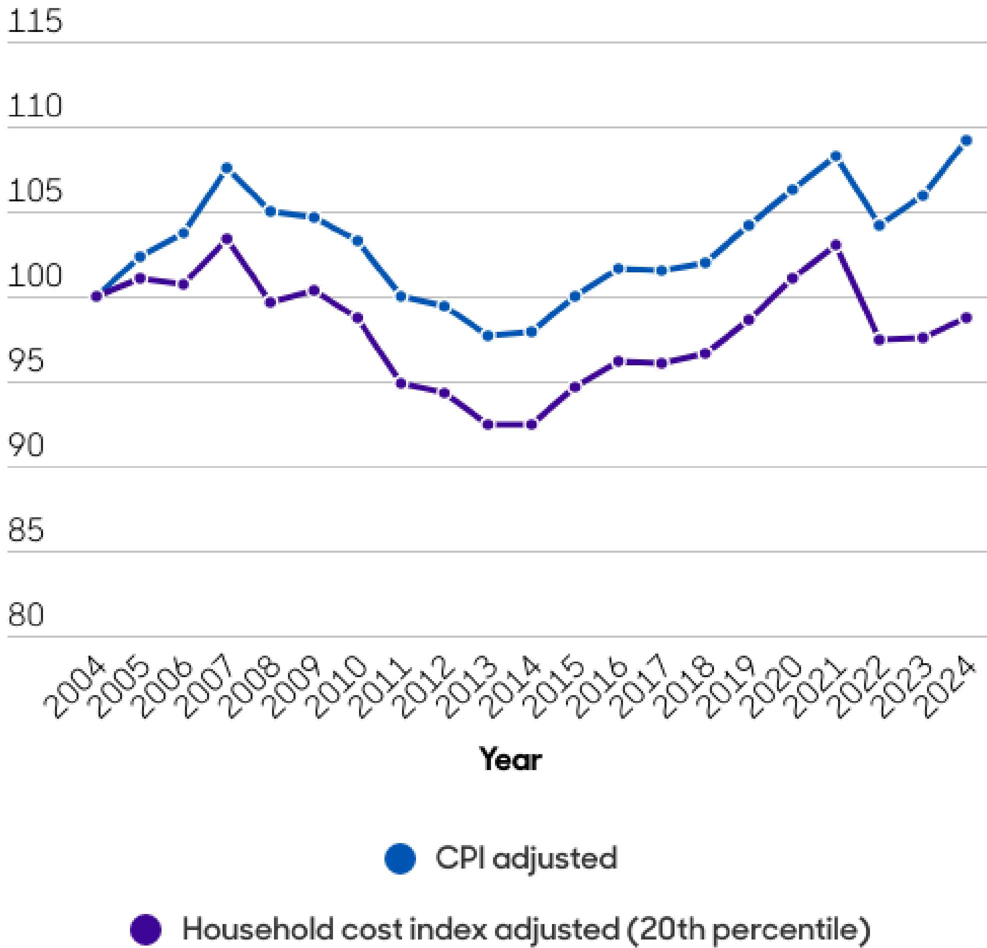
Figure 1a compares changes in average weekly earnings since 2004 with changes in prices according to two separate measures. Earnings growth has been sluggish overall. In real terms, average earnings fell between 2007 and 2013 and between 2021 and 2022, with the fall being greater when using an index based on expenditure patterns of low income households than when using the Consumer Prices Index. To understand the patterns more fully, figure 1b presents the overall change in each of four five-year periods.

In the first period, ending in 2009, real earnings growth was maintained in CPI terms, although at the slow average rate of about 1% a year. During this period, inflation started to pick up, driven by rising commodity prices, which influenced basic items such as food, producing higher-than-CPI inflation for lower-income households, which wiped out the earnings gains when comparing them with the low-income measure of inflation. From 2009 to 2014, earnings growth slowed, with modest inflation maintained on both measures, causing a substantial fall in real earnings. In contrast, 2014-19 saw faster earnings growth and slower price rises. This was the only period when real earnings rose on both inflation measures; it was also the only one where inflation was slightly lower, rather than significantly higher than CPI for low-income households. This was linked to the fact that food prices actually fell from 2014 to 2016, and were at a similar level by 2019 as five years previously.

[3]This is the experimental Household Costs Index, which average price changes relative to expenditure patterns by various household groups. The version of the index used in this paper is based on what inflation rate would be felt by a household with spending patterns typical of a household on the 20th income percentile, ie whose income is higher than 20% and lower than 80% of all households.
[4]OBR Economic and Fiscal Outlook, March 2024, 2.38

Finally, the latest five years have been dominated by high inflation, with earnings also growing, but in real terms by only the same rates as in 2004/09: by an average of 1% a year using CPI and by a negligible amount using the Household Costs Index.

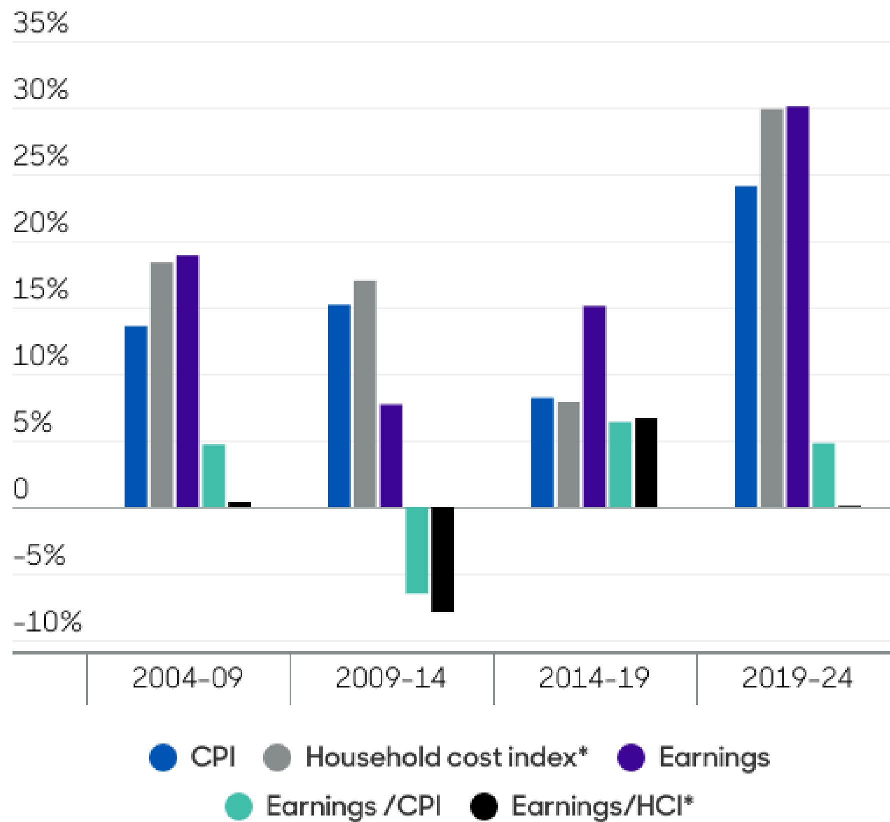
Fig 1a: Real earnings over two decades (2004=100)



Notes:

1. Figures show change to September in each year (the basis for uprating).
2. Household cost index figures adjust for an inflation rate based on low income households' spending patterns: specifically, those of households at the 20th income percentile, which is close to the poverty line

Fig 1b: 20 years of earnings growth and inflation, by five-year period



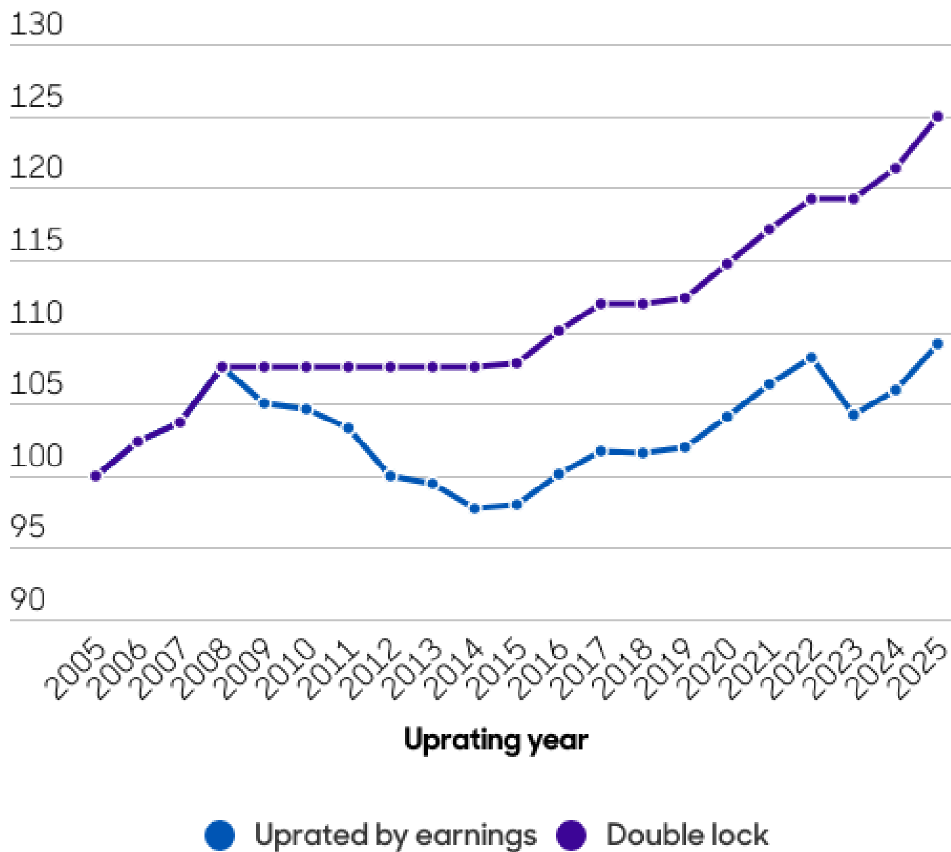
These fluctuating relationships between earnings growth and prices growth would have produced a variety of outcomes under various upratings policies over the past 20 years. Crucially, there is a difference between real earnings growth that is steady, and that which is intermittent, in terms of what kind of policy is most likely to produce improvements in living standards among those depending on benefits.

Figure 2 shows first of all that simply linking benefits to earnings in recent years would have caused their value to fluctuate rather than to rise reliably in real terms, even when adjusted for CPI rather than a measure of inflation reflecting higher price rises for lower-income groups. As reflected in Figure 1a above, in terms of this latter measure of inflation, an earnings link would have failed to increase the real level of benefits at all.

The “double lock” policy shown in Figure 2 would raise benefits annually by growth in average earnings or by CPI inflation, whichever is the higher. This policy increases real benefits when earnings are rising faster than prices, and locks in these gains when real earnings fall – as shown by the flat portions of the double lock line between 2008 and 2015 and between 2022 and 2023. Such a policy causes benefits to rise much faster than earnings overall during a period in which benefits sometimes fall – for example rising by 25% rather than 9% in real terms over the 20 years shown here.

To put these figures into perspective, the single person’s Standard Allowance in Universal Credit, which is presently worth £90.50 a week, would be £96.70 if CPI-uprated since 2005, £102.50 if uprated by earnings and £117.30 if uprated by the double lock. Thus over 20 years of the latter policy, benefits would have got close to the level of the JRF/Trussell Trust’s “Essentials Guarantee” (£120) with a double lock under these circumstances.

Fig 2: The effect of earnings upratings v double lock, if they had been applied 2005-25



Benefit level, CPI adjusted, 2005= 100
(April in year shown, applying previous September's inflation)

Yet the double lock does not always produce such an additional boost, as can be seen in the first years shown in Figure 2: where there is a gradual but uninterrupted real increase in earnings, upratings under the two policies shown will be identical.

Figure 3 considers other policies that might boost benefits in real terms, and how they would have affected benefits in two contrasting periods. Specifically, it looks at the effect of systematically increasing benefits faster than earnings, on the basis that slow real earnings growth may be insufficient to raise inadequate living standards quickly enough. Firstly, in the period when real earnings were falling, between uprating years 2009 and 2015 (Figure 3a), even increasing benefits by one percentage point faster than earnings each year would have seen a fall. Doing so with the additional protection of not allowing benefits to fall in real terms in any given year would have allowed some modest growth in this period, in contrast to the flat real-terms benefit levels under the double lock.

Fig 3a: Uprating by double lock or earning-plus, applied in a period of falling real earnings, 2008-15

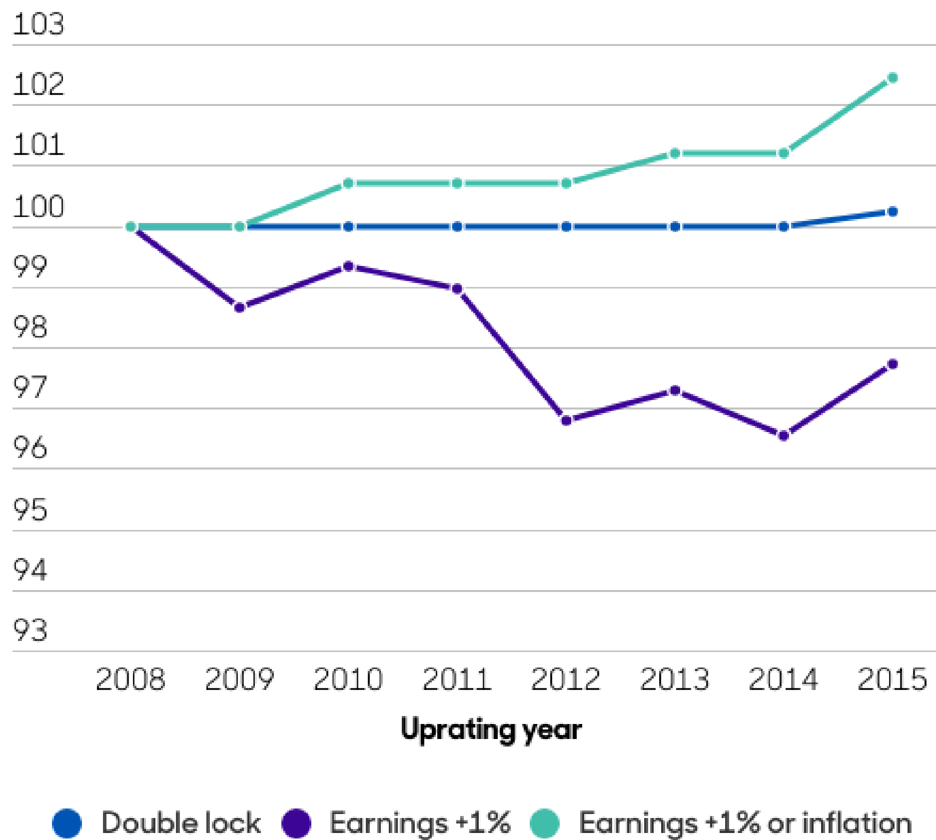
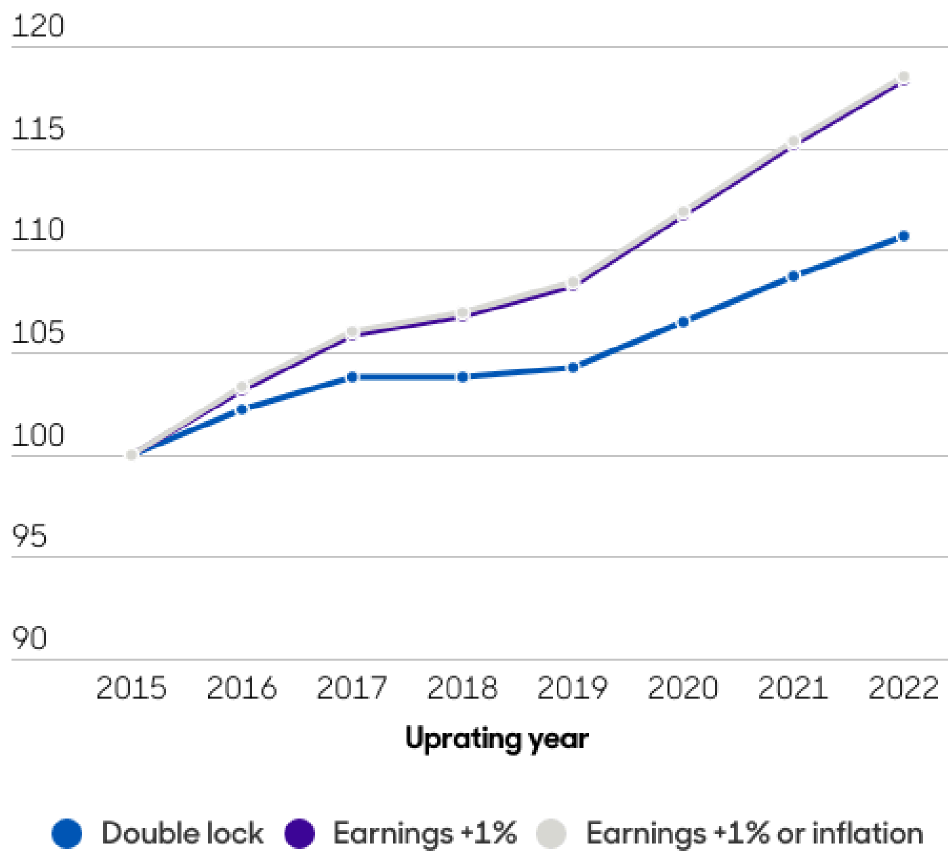


Figure 3b looks separately at such over-indexing options in the more favourable period from 2015 to 2022 when earnings rose modestly in real terms. In this case, over-indexing by 1% would have brought significant real-terms growth, with or without protection against falls when inflation exceeded earnings growth. In this case the average increase in earnings would be almost 2% a year, equivalent to nearly one-quarter over the period of a decade.

Fig 3b: Uprating by double lock or earning-plus, applied in a period of rising real earnings, 2015-22



Benefit level, CPI adjusted, 2015= 100
(April in year shown, applying previous September's inflation)

Figures 3a and 3b demonstrate that whereas some form of double lock is particularly important in times of falling or fluctuating real earnings, under a period of steady but very modest earnings growth, over-indexing against earnings is required to make substantial progress in raising living standards for those depending on safety net benefits.

It is worth noting in this context that in the case of pensions, the triple lock guarantee has, accidentally, provided more substantial increases in pension levels than would have been the case with a simple earnings link. This is because of the ratcheting effect of relatively healthy earnings growth in some years not being offset by real-terms falls in others. This was accidental in the sense that under the conditions that preceded the pension reform – substantial real earnings growth in most years, with at most short-lived falls during recessions – uprating pensions by the higher of prices or earnings was principally designed to stop pensions falling behind earnings, not substantially to outstrip them. Such conditions have not existed for two decades, and it would be optimistic to expect them to return.

Rethinking an earnings link

The above analysis raises serious issues about whether it is feasible to use an earnings link to raise benefits to more adequate levels. Three obstacles are:

-That a link to slowly rising earnings will take a very long time to make up the cuts of recent years.
If benefits had risen in line with the prices experienced by low income households since 2012 (the year before automatic inflation-uprating was stopped), they would be 13% higher for a single person and 19% higher for a couple with two children[5] than they actually are now. For the single person, they are a third less than the JRF/Trussel Trust's "essentials guarantee", representing a bare minimum to live on. Increasing by just 1% a year in real terms (which is now above what the OBR forecasts up to 2028[6]), it would take well over a decade to make up recent cuts and close to three decades to get the single person's rate to the essentials level.

-Relying on a double lock type formula to boost benefits may or may not be effective, and is politically problematic.
As shown in the above analysis, uprating benefit increases by the higher of earnings or prices can be particularly beneficial if real earnings fluctuate, sometimes rising by less than inflation and sometimes by more. But there would be two problems with relying on such a double lock to enhance real-terms increases in benefits over time. First, it would rely on an outcome that is in other respects politically and economically undesirable: an unstable environment in which earnings growth is not sustained but sporadic. Pensioners have done particularly well under the triple lock because of the roller-coaster ride of the past decade which nobody would have wanted, and certainly could not be relied on to occur in the future.

The second problem is political. A double lock would mean that, as well as keeping up with earnings as they grow, out of work claimants would be protected against inflation at times when earnings are rising more slowly than prices. While it seems just that the poorest should be fully protected against inflation, this can be politically difficult to maintain if real wages are being substantially eroded. In 2013, the government justified a break in the long-term default uprating of benefits by at least inflation with a new definition of "fairness". Introducing a 1% flat rate uprating, Work and Pensions Secretary Iain Duncan Smith argued that it was "unfair" for benefits to rise faster than private sector wages, at a time when inflation was eroding the value of the latter, given that the taxes of those who work are underwriting benefits for those who do not. A government committed to restoring benefits to adequate levels could argue differently, emphasising the importance of its mission to recreate an adequate safety net. It could also point out that many people receiving Universal Credit are working, and this would help compensate for their real wage reduction. Such arguments may be politically sustainable even during a short-lived dip in real wages. However, a double lock for working age benefits could be politically hard to sustain precisely in the conditions where it would have most impact on living standards: when earnings growth fails to match inflation in multiple years of an economic cycle, catching up rapidly in other years but showing little long-term upward movement.

[5] This includes not just the effect of sub-inflation upratings, but also the phasing out of the "family element" of Child Tax Credit, and its equivalent in Universal Credit.
[6] See OBR Economic and Fiscal Outlook October 2024, paragraph 2.39. The OBR forecasts a stalling of real earnings growth in 2026/27 as firms rebuild margins and pass on the cost of higher employer NICs, but suggests real earnings could grow with productivity increases of about 1% beyond its forecast horizon.

-An “earnings plus” formula may seem more rational, but would also be politically problematic. A government that succeeded in creating steady but modest growth in real earnings, say by 1% a year, would need to over-index benefits against earnings in order to raise living standards to an adequate level within a reasonable timeframe. For example, with steady 1% annual growth in earnings, plus a 1% “earnings plus” premium, the 19% cut in the value of family benefits referred to above would be fully reversed within eight to nine years, rather than 17-18 years with a simple earnings link. However, this could create an even starker political difficulty than the double lock. A policy that systematically increased benefits faster than earnings could be portrayed by its opponents as unfair to working people who pay taxes to support non-working people, regardless of arguments about the need for cuts in living standards to be reversed and about the overlap between people receiving wages and Universal Credit. The potential effect on work incentives would also be a significant issue.

An alternative – a link to GDP growth

As this paper has made clear, the case for improvements in the real level of benefits over the coming years starts with the recent decline in living standards for the poorest households, who depend on these benefits, causing severe hardship and leading to widespread use of food banks. But the case is strengthened when also related to future affordability. If general earnings, incomes and living standards can be raised, there is the chance to ensure that a fair share of such growth is used to improve the living standards of the worst off. This justification has a financial and not just a moral dimension. Higher incomes generate greater public revenues through taxation, making it fiscally feasible to divert more resources for this purpose.

In this context, the overall financial resources produced by the country, as opposed to the average earnings per worker, is a useful benchmark. GDP growth includes incomes not just from wages but also from other sources like rents and company profits. And unlike the average earnings of those in work, it increases when more people are working, so reflects positive outcomes of back-to-work policies. Total GDP also grows when the population rises, and GDP per capita is therefore a more useful indicator of resources available to raise per-person entitlements. Since rising GDP directly affects tax revenues, benefit increases linked to per capita GDP growth can take the emphasis away from comparisons between working and non-working incomes, and instead be based on a more affluent country being able to afford to help its worst-off citizens reach an adequate standard of living.

In fact, GDP per capita has tended to rise faster than average earnings in recent years. For example, in the 2010s, weekly earnings adjusted by CPI barely changed, growing by less than 1% over the entire decade[7]. In contrast GDP per capita, measured in terms of real output, grew by about 14% across the 2010s[8]. The OBR forecasts annual per capita growth of 1.4% in 2025 falling to around 1% from 2027 onwards[9]. The Resolution Foundation points out that were the government to live up to its ambition of boosting productivity to make the UK the fastest-growing G7 economy, this could raise per capita growth from around 1% to 1.5%[10]. This would raise an extra £30 billion in public revenues, and still be below the 2.2% annual growth achieved from 1997 to 2007.

[7] Author calculations comparing average weekly earnings in December 2009 and December 2020, and deflating by CPI, which shows growth of just 0.2%.
[8] Based on GDP per head measured as chain linked value at market prices, which estimates increased in domestic production taking out the effect of price changes. Growth from Q4 in 2009 to Q4 in 2019 was 13.8%. Source: https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihxw/pn2
[9] OBR Economic and Fiscal Outlook October 2024, Table A1.
[10] Resolution Foundation briefing September 2024: The growth mindset, Emily Fry & Gregory Thwaites

This suggests that three elements to a formula for raising the value of the main working-age and children's benefits over time could be:
-As a baseline, always uprate benefits at least in line with inflation as experienced by the least well-off groups. A new indicator such as the Household Costs Index for low-income households should ideally be used.

-Whenever GDP per capita grows in real terms, the rate of growth should be added to the inflationary benefit uprating in the following year, to enable benefits to grow regularly in real terms.

-It may also be possible to consider going beyond this automatic link with GDP growth in some years, particularly if return-to-work policies succeed in bringing claimant counts down. Average real growth of about 2% a year would be needed to reverse the worst effects of previous benefit cuts over a decade, therefore increasing benefits by nearly one quarter (22%, including the effect of compounding).

Linking benefit increases to prices plus any GDP growth in this way would not in itself rule out there being occasions when benefits rose faster than earnings: this is true of any system that starts with a prices link. This can make it politically difficult to maintain at least a prices link in any period of falling living standards, especially over a sustained period. But there is an advantage in the fact that GDP growth tends to be less volatile than earnings growth, as it depends on many different influences and not just labour market conditions. For example, in the 2010s, real average earnings either rose or fell by at least two percentage points (rounded) in seven years out of ten, but GDP per capita in only two. This reduces the risk of what might seem like an unreasonable "ratchet" effect associated with a prices-and-earnings double lock, whereby benefits are protected against a real earnings fall in one year but get the full benefit of a compensating rise in the next. More generally, a system that appears designed to enable benefits to outstrip earnings has greater risk of seeming unfair than one linked to a more general level of prosperity.

Conclusion

This paper has argued that a strategy for lifting minimum benefits is urgently needed to address the hardship and destitution that have resulted from cuts over the past decade. While accepting that a big one-off boost is not fiscally feasible, it suggests that a systematic strategy for improving real benefits over time needs spelling out now. Such a “living standards escalator” means regularly uprating benefits by more than just inflation. It should embody the principle of sharing the fruits of economic growth.

While earnings-linked upratings have in the past seemed like a good way of hitching benefit increases to growing prosperity, the paper cautions against relying on such a mechanism in the present context. Real earnings have grown painfully slowly, with no sudden increase forecast. Benefit upratings designed specifically to outstrip earnings growth can create political friction. Instead, the paper proposes the growth of GDP per capita as a reference point for increasing benefits in real terms. This captures growth across the economy, not just in average individual earnings, and can be justified via the extra public revenues it brings in.

The paper has suggested one version of a living standards escalator, starting with a better measure of cost increases faced by the poorest, adding to this a real-terms uplift based on growth in GDP per head, and allowing for top-ups, where affordable, to allow the safety net to move towards an adequate level within a reasonable time frame.

This is just an example of a formula for steadily improving the living standards of the country’s worst-off households. The broader conclusion is that some such ambition needs to be articulated now, in order to map a path to tackling the deep poverty and destitution that sees two million people every year relying on the charity of food banks just to eat, and seven million in total facing food insecurity. The downward path in their living standards in recent years needs to be replaced by an upward escalator.

abrdn Financial Fairness Trust

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