

MINIMUM INCOME STANDARDS - WORKING PAPER

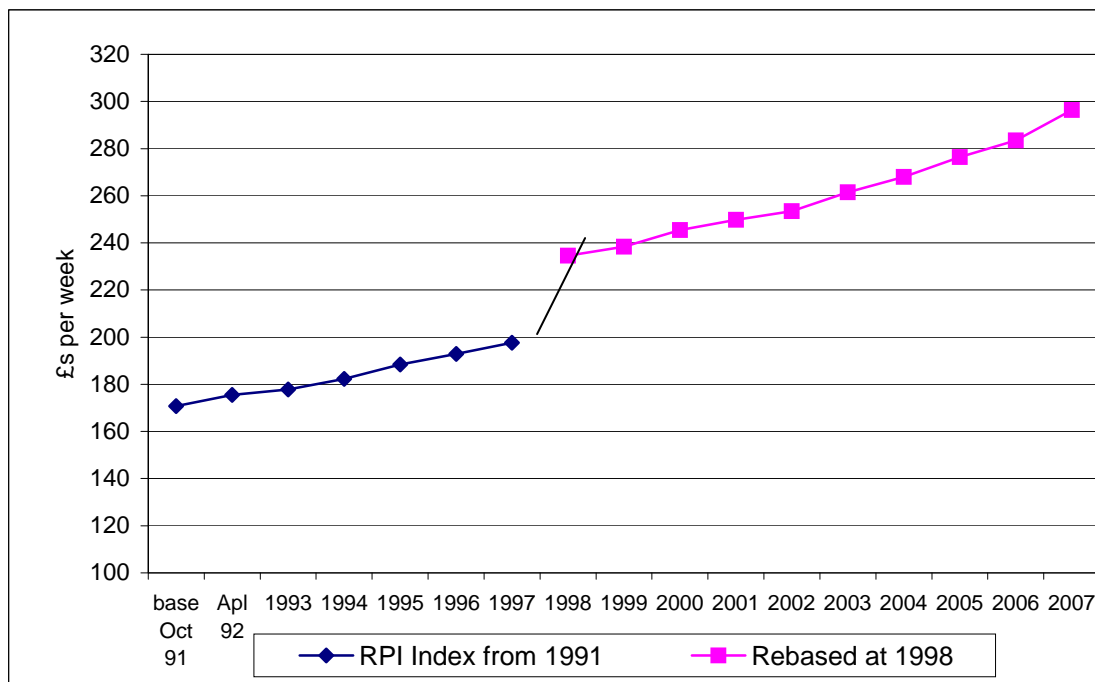
UPDATING AND REBASING MINIMUM INCOME STANDARDS

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Background

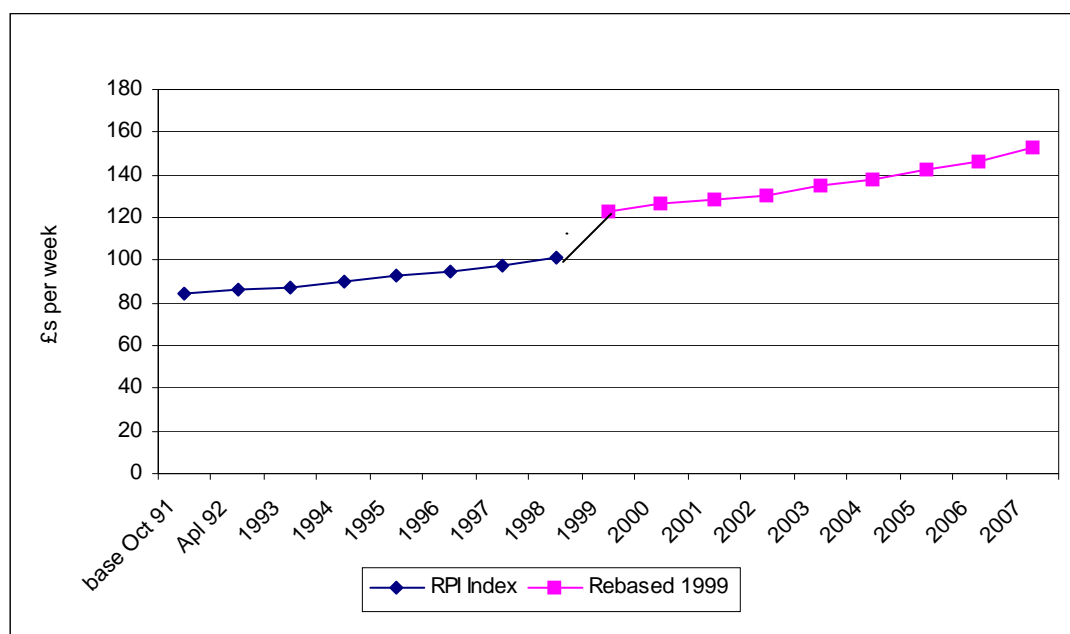
One of the problems with budget standards methods that we sought to tackle during this research project was the fact that as time passes the standard may lose touch with general living standards. This has been the experience of the Family Budget Unit's budget standards. The original budgets were priced in 1991 (Bradshaw 1993). We then uprated the budgets by movements in the commodity Retail Price Index (RPI). But by 1998 we felt that the budgets needed to be rebased from scratch. The 1991 budgets took no account of alcohol, childcare, the costs of eating out and assumed full housing benefit and community charge rebate. In 1998 focus groups were introduced to review lifestyle choices on which the budgets were based (Parker 2000a). Chart 1 shows the consequent hike that suddenly occurred in the budget standard

Chart 1: Couple with two children FBU budget standard rebased 1998
(1991 budgets adjusted to include housing and community charge)



The budgets for pensioners were rebased in 1999 and Chart 2 shows the result.

Chart 2: Single pensioner FBU budget standard rebased 1999.
(1991 budgets adjusted to include housing and community charge)



When the budgets were rebased they were above the social assistance (Income Support/MIG/ Pension Credit) scale rates for families with children and pensioners. However uprated by the commodity RPI they soon fell below the social assistance scales. This was partly because the Labour Government made substantial real improvement in the child scale rates of Income Support and Child Benefit and then introduced Child Tax Credit, which have all been linked to movements in earnings. Pensioners on Income Support had real increases in their living standard with the introduction of Minimum Income Guarantee and again when this was replaced by Pension Credit. Pension Credit was also linked to movements in earnings.

The issue of how to uprate a standard is not one restricted to budget standards. JRF commissioned a project (Sutherland et al., 2008) designed to establish “A better basis for uprating benefits” – partly on the grounds that the present arrangements for uprating benefits for children and pensioners by earnings, some other benefits by prices, and still others by the Rossi Index has opened up large differentials in benefit levels which have no basis in judgements about relative needs and are unsustainable in the long term. There has also been a longstanding debate about poverty thresholds. The threshold based on 60 per cent of the median moves with the median. But other thresholds such as the 60 per cent threshold fixed at a point in time or the proposed threshold of less than 70 per cent of the median and lacking certain necessities, will need to be revised from time to time.

The fact that the FBU budgets were out of date was one of the reasons for embarking on this new project to develop Minimum Income Standards. But if the MIS is going to be a useful tool of policy into the future, a better basis for uprating is needed. In the proposal for the MIS project we said we would tackle this issue and this paper is a longer explanation of the decisions about this that we set out in Chapter Six of the MIS report.

We are seeking to tackle two questions.

1. How should budget standards be routinely revised over the short term so that they reflect rising living standards? This we call uprating.
2. How should budgets be rebased from time to time to deal with the changes in patterns of consumption, tastes and the introduction of new commodities such as a mobile phone – they did not exist in 1991, ownership rates were still low in 1998 but today they have been included in the MIS. This we call rebasing.

Uprating

Chart 3 takes the FBU budget for a couple with two children and compares what it would be in April 2007 if we had uprated it in different ways. The FBU budgets have been uprated since the budget was last rebased in 1998 by the Detailed Retail Price Index (Commodity sub-groups), which is the line on the chart third from bottom. This method of uprating has given a slightly higher budget than it would have been if it had been uprated by the Rossi index (RPI (all item) less rents, local taxes and mortgage interest payments) or the Consumer Price Index – (based on similar principles to the RPI, includes additional items such as university accommodation fees, foreign student University fees, unit trusts, shares etc and excludes mortgage interest, council tax, house depreciation, road tax, building insurance and health service costs). The RPI (all item index) would have given a slightly higher budget.

The three lines at the top of the chart are

- movement in net disposable income after housing costs of a similar family with one earner on average earnings,
- the same for a family on two-thirds average earnings and
- the Income Support scale rates for a couple with two children.

It is clear that the budget standard has fallen substantially behind movement in these indices. However this is partly because during this period the government made substantial improvements in the scale rates of Income Support and introduced Child Tax Credit. In “normal” times there may be good arguments in favour of using movements in net disposable income to uprate MIS. Net disposable income is what families have left to spend after deductions – it takes account of the impact of movements in taxes and benefits, not just earnings, and thus is arguably a better indicator of purchasing power. There is the additional argument - that policy makers might not want to have a MIS that was uprated faster than net incomes from work, in case it came too close to, or overtook in-work incomes and undermined work incentives.

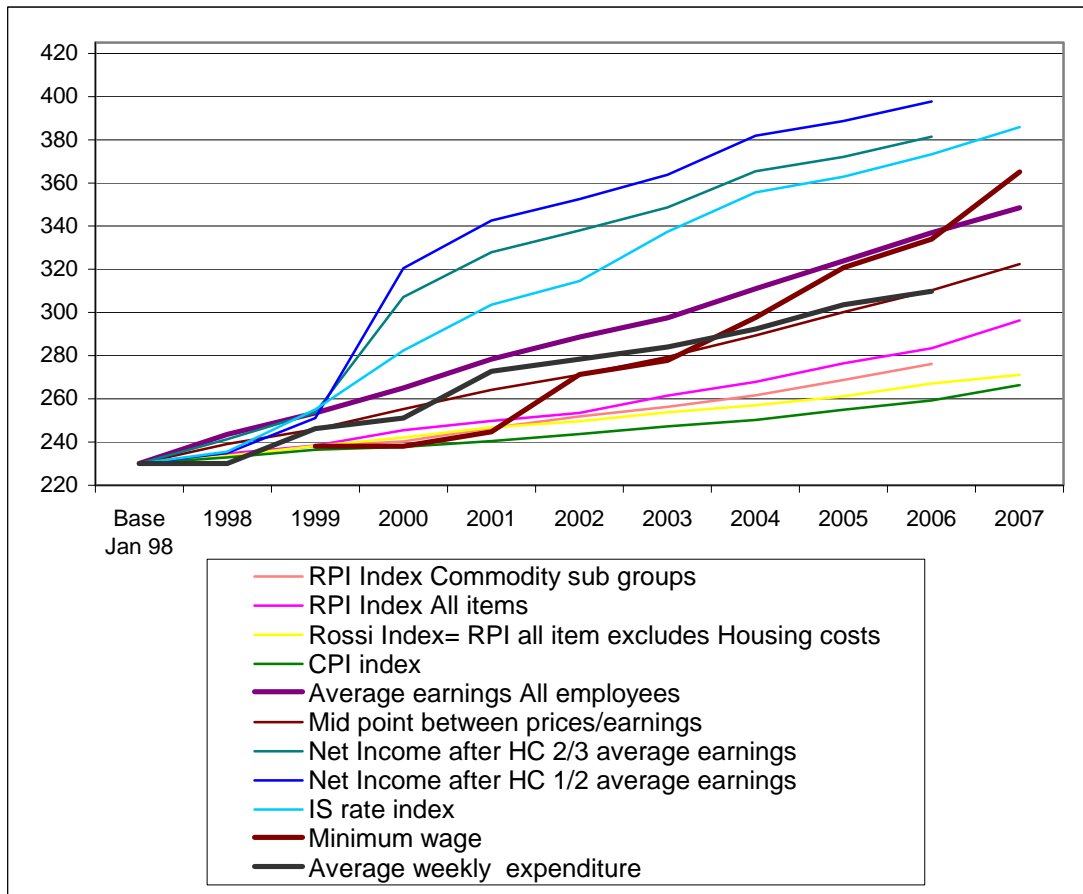
There is also an argument in favour of tracking movements in Income Support – this is the benefit that determines the minimum level of living that the state has decided

people out of employment should live on – the equivalent of an income guarantee. Therefore if a MIS is the right standard at T1 it should be not less than the MIS plus how the state has increased the guarantee at T2. Note this is not to argue that Income Support should be the MIS – just that the MIS might be updated by movement in the guarantee. However between 1980 and 2001 Income Support was updated in line with the either the RPI or the Rossi Index and if the MIS had tracked Income Support over that period it would have fallen substantially behind earnings and net disposable income.

There are three other lines on the graph that fall between net disposable income at the top and the CPI at the bottom. These are updating by

- the index of average earnings – this is an established index, used to update Pension Credit and Child Tax Credit and reflects growth in real living standards, at least during times (almost all times since 1948) when average earnings move upwards faster than the RPI. There is room for argument about whether a MIS should be linked to earnings at all (or net disposable income – see arguments above) and/or whether it would be better for it to be linked to low earnings.
- the Statutory Minimum Wage - this was introduced in 1999 and since then has moved upwards faster than the earnings index. One argument in favour of the Minimum Wage as an index is that it is not purely the result of the vagaries of wage inflation but the product of deliberations by the Low Pay Commission, who will (we hope) be having some regard to social justice for those at the bottom of the earnings distribution. One argument against using the Minimum Wage is that the Low Pay Commission should be having regard to the MIS not the other way round.
- average expenditure - on the grounds that average expenditure is a better indicator of command over resources, a more direct indicator of consumption patterns, than average earnings or the Minimum Wage. In fact average expenditure has been running very close to average earnings during the period covered. The main difficulty with this measure is that expenditure figures are available from the Expenditure and Food Survey two years out of date.
- average of movements in prices and earnings. It is an index that has no other justification than that it is (in this period) more than prices and less than earnings.

**Chart 3: Couple plus 2 FBU budget uprating 1998-2007 Base 1998=100
£s per week.**



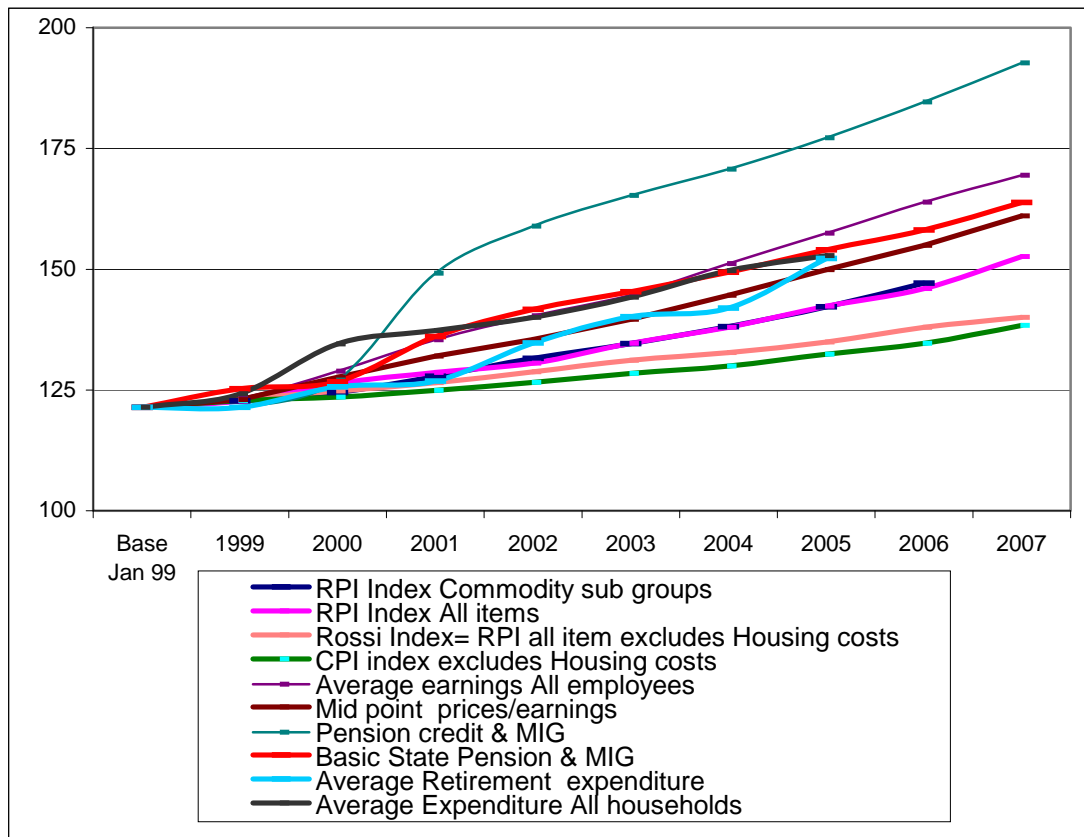
The same analysis is presented in Chart 4 for a single pensioner. The top line on the chart shows what would have happened if the budget standard had been increased in line with movements in MIG/Pension Credit. This reveals the substantial improvement that has taken place recently in the living standards of the poorest pensioners. The FBU standard has actually been uprated by the RPI Commodity subgroup Index and there is very little difference between that and the RPI index (as one might expect). The Rossi index and the CPI both give lower increases.

The next line up gives the average expenditure of retirement pensioners and although we only have data up to 2004 it indicates that pensioners' expenditure increases more slowly than their incomes, and is on average lower than their incomes (the subject of a recent study by our colleagues Finch and Kemp (2006)). Next up we have as before the average of the earnings and prices index and then average expenditure. The Basic Retirement Pension comes next – it has been uprated by a good deal more than movements in prices since 2000 and somewhat haphazardly, despite the fact that formally it is supposed to be linked to prices. Finally there is the earnings index.

In making a choice between the options presented for uprating pensioners MIS, regard needs to be had to the arguments presented in relations to families with children above. Clearly none of the price indices would give pensioners a share in rising living standards and neither does their behaviour in terms of expenditure. The Pension

Credit might do in the future but during this period it was uprated by substantially more than movements in earnings (in 2007 it was more than £23 more than it would have been if uprated since 1999 by movements in earnings).

Chart 4: Single female pensioner. FBU budget Uprating 1999-2007 using various indices. 1999=100. £s per week



We have observed that over the past decade, actual expenditure has risen somewhere between prices and earnings, and since MIS is related to spending, we think that a best estimate of each year's rise in expenditure could be used as an uprating basis. Since actual spending figures are about two years out of date, we could use the real-terms increase in spending in the most recent year available (annual change up to two years ago), applied to the current inflation rate.

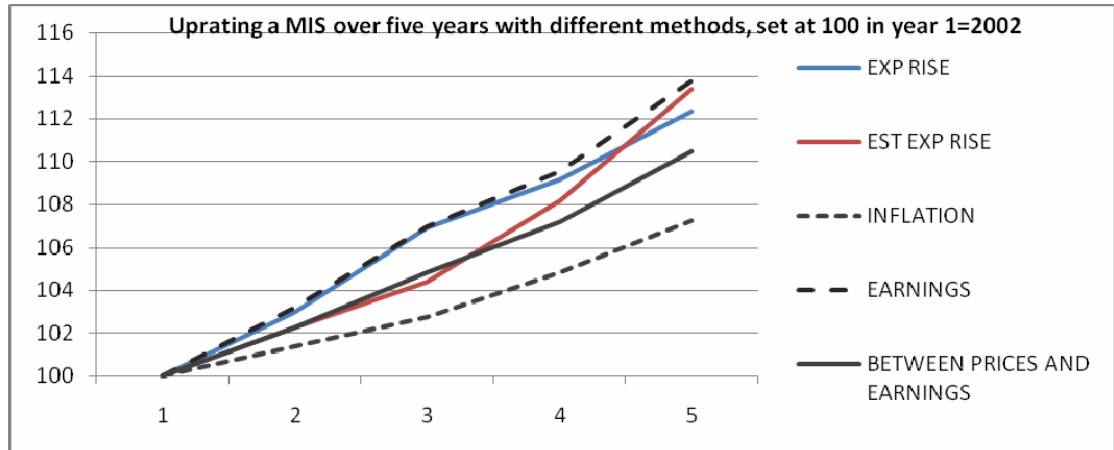
Chart 5 shows what would have happened on this basis if we had set a MIS in 2002 and rebased it in 2007, uprating it in the four intervening years. The gap between the blue and red line represents the cumulative inaccuracy – i.e. how much different the estimate of an expenditure-based uprating would be from an uprating based on the actual change in expenditure in the relevant year. This cumulative inaccuracy is mainly in the range 1-2%, with a peak in Year 3 at 2.4%. These contrasts with a cumulative error by the end of the period of just over 5% were we to rely on prices only – and clearly this would grow larger if there were a longer delay before rebasing.

The graph also shows what happened to earnings. In this period, unlike in some other periods in the past decade, expenditure rose at a similar rate to earnings other than in

the final year. On the other hand, our lagged estimate of expenditure rises keeps mainly within the boundary of 50% to 100% of the real rise in earnings.

Despite its imperfections this index ensures that the MIS keeps some touch with what people are actually spending; it is a cautious estimate of the extent to which rising earnings feed into rising spending norms; and it will operate as a crude way of hypothesising some real rise in MIS over time, and thus avoiding a big jump when it is rebased.

Chart 5: Uprating a MIS over five years with different methods, set at 100 in year 1=2002



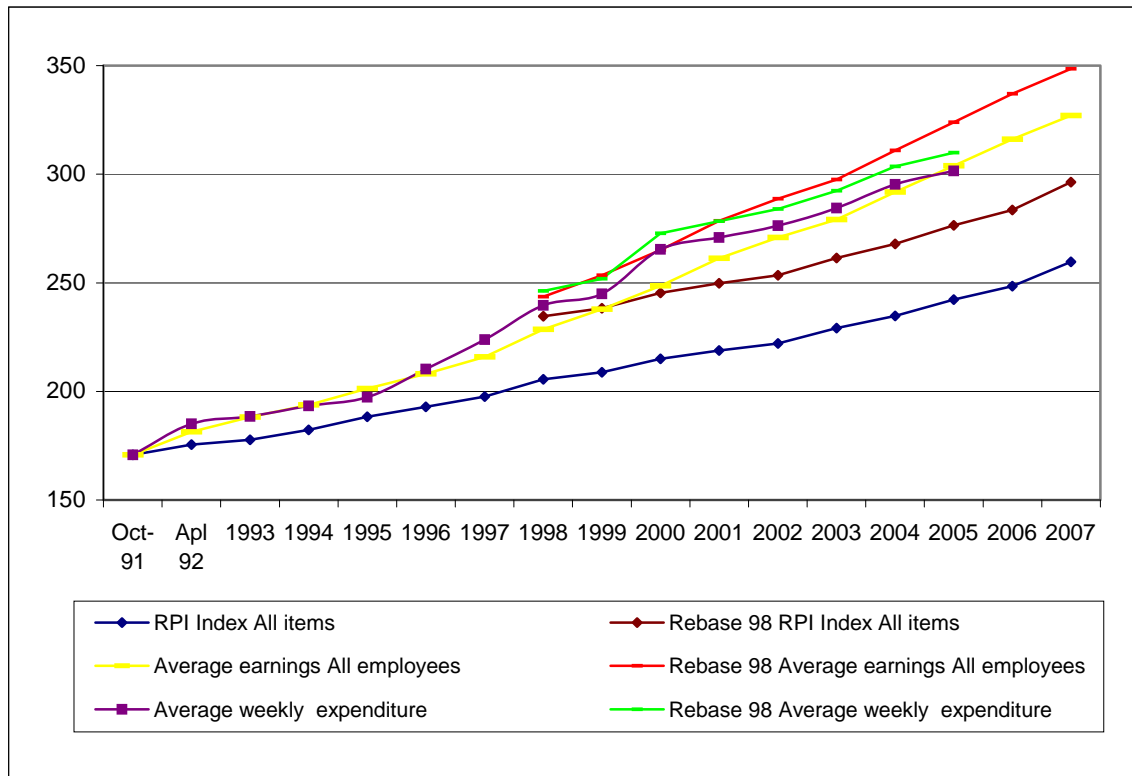
Obviously this decision will have to be reconsidered if there were sharp year-to-year fluctuations incomes that might affect expenditure.

Rebasing

To illustrate the problem, in Charts 6 and 7 we show the pattern of uprating and rebasing that the FBU has experienced and might have experienced given various uprating methods. In Chart 6 if the FBU budget had been uprated from 1991-2007 in line with the RPI all items index it would have been £260 in 2007 compared to £171 in 1991 but thanks to rebasing in 1998 it was £296 a difference in 2007 of £36.

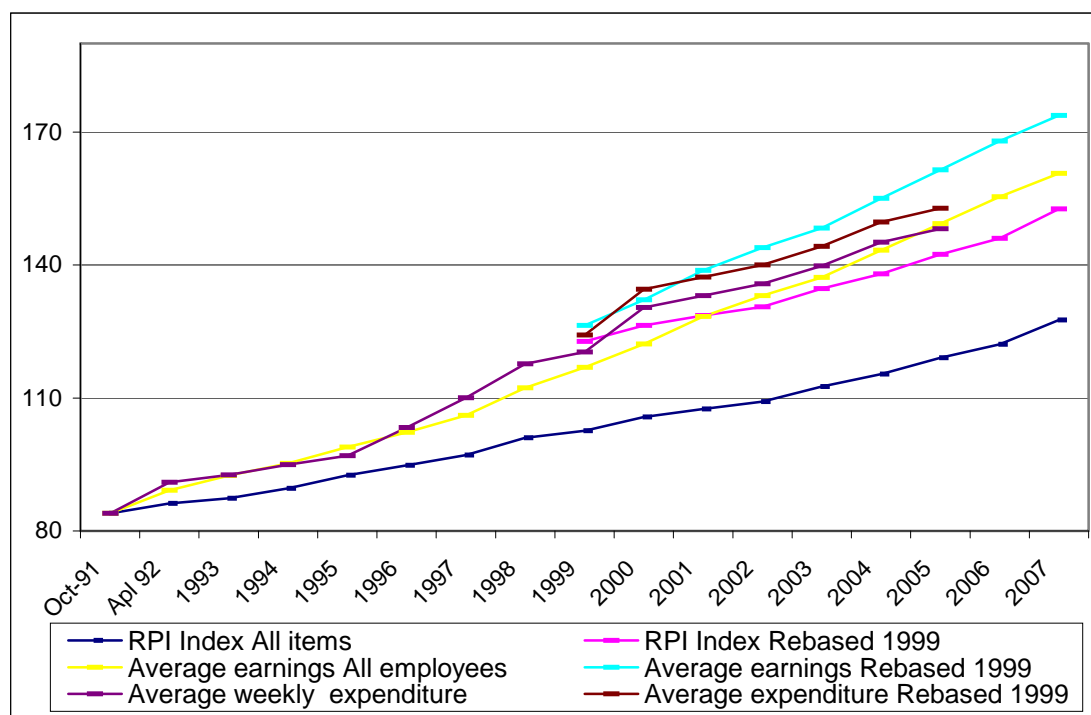
Similarly if the FBU budget had been uprated by an earnings index between 1991 and 2007 it would have been £319 compared to £171 in 1991. But after rebasing in 1998 it was £336, a difference of £17.

**Chart 6: FBU Couple plus two children. Uprating and rebasing 1991-2007
£s per week**



Similarly in Chart 7 for the single pensioner, their budget was £84 in 1991. If it had been uprated by prices it would have been £128 in 2007 and if uprated by earnings £161. However thanks to rebasing in 1999 it was £153 for prices and £174 for earnings – a difference of £25 and £13 respectively.

Chart 7: FBU single pensioner. Uprating and rebasing 1991-2007
£s per week



So rebasing is necessary from time to time.

Of course the best way to rebase a MIS is to rebase it for all standard family types using the kind of methods that we employed in this project. But that is a major undertaking and the purpose of this section of the paper is to investigate whether there is a method that could be used short of a complete rebase. There are a number of options

- One relatively easy option would be re price the original MIS. That is unlikely to deliver a new MIS which is more in touch with changes in living standards or consumption patterns as the list of commodities will be the same. It is also unlikely to improve on uprating using the Commodity Retail Price Index, unless there have been substantial differences in the relative prices of commodities in the RPI and the MIS.
- An alternative would be to introduce/replace commodities in the budget that are known to have changed. So, to take an obscure example, if a miraculous new oven cleaner had been introduced since the last rebasing and it was now dominant in the market, it could replace the brand that was included in the earlier MIS. This method is the one that the FBU effectively used when it rebased their budgets for families with children in 1998 and pensioners in 1999. The problems with it are that it is entirely normative; and the empirical evidence on consumption patterns to help to inform the normative judgements is not extensive and not always very up to date.
- An alternative which retains some of the benefits of the consensual method is to reduce the complexity of the groups – perhaps to drop one of more of the

stages of the focus groups. We shall be able to review the methods at the end of the MIS project and establish whether any of the stages in this project were redundant or could be reduced in scope.

- However probably a better way of shortening the rebasing method would be to reduce the number of family types that are covered by the focus groups. Thus, we could take one or more standard family types and rebase a budget using the MIS methods for that family type and then extrapolate the MISs for other family types. The obvious way to extrapolate is to use an equivalence scale. Equivalence scales are used to adjust income (or expenditure) so that it is equivalent for a given family type and takes account of economies of scale. So for example if a single person needs £100 then a couple with two children might need £210 to reach the same living standard.

In Table 1 we have attempted this technique using Family Budget Unit data. Column A gives the FBU budget standard for 1999. Column B gives the equivalence scale that this implies. Column C merely uprates the budgets by an index – in this case the all items RPI. However in 2006 we (hypothetically) rebase the budget for a couple with two children and find that it is in fact (say) £290 in column D. We then use that amount to estimate what the budgets for the other family types should be, given the FBU equivalence scale in column E. The final column shows the differences between the uprated budgets and the equivalent rebased budgets in £s per week.

Table 1: Hypothetical rebasing method.

	A 1999 budget standard	B equivalence scale	C 2006 uprated by RPI	D 2006 rebased budget	E equivalence applied to rebase	Difference E - C
Based couple+2=1						
Couple, 2 children	238.14	1.00	273.12	290.00	290.0	16.88
One adult, 2 children	229.47	0.96	262.19		278.4	16.21
Single female pensioner	121.42	0.51	139.29		147.9	8.61
Single male pensioner	125.30	0.53	144.76		153.7	8.94
Couple pensioner	184.14	0.77	210.3		223.3	13.00
Single young man	131.51	0.55	150.22		159.5	9.28

In using this method we are making a number of assumptions:

- First that the equivalence scale has stayed constant during the passage of seven years. Or rather the equivalence ratio between a couple with two children and all the other family types has remained constant. In defence of this assumption we can point out that the McClements' scale has never been revised since it was first used in the 1970s, and although the OECD equivalence scale was modified, it was modified for reasons that had nothing to do with the fact that over time it had become an inaccurate reflection of relative needs. Economists tend to use the square root of the number of people in the household, which has no basis in science but is just convenient.

- Second is the FBU scale correct? It is very different to McClements and the Modified OECD scale as can be seen in Table 2. The main difference is for the one adult with two children - because the FBU budget for this family includes the costs of full-time childcare. The MIS project has come up with an alternative estimate of equivalence, and that indeed is one of the purposes of the project (see the working paper on the MIS website: A new equivalence scale). The officially used equivalence scales, the Modified OECD - has less claim for validity than the MIS equivalence scale. The MIS scale will be much more up to date, derived using systematic methods, with a much stronger basis in science, and it will be a scale that reflects the relative needs of different types of families at the bottom end of the distribution, unlike the other scales which are the average across the distribution. The only problem with these arguments is that if we go on using the original MIS equivalence scale in rebasings it also will become set in stone. Sooner or later it will be necessary to rebase MIS for all family types.

In the meantime, five yearly rebasing for two family types would allow some assessment of whether to revise the scales. One way of doing this would be to consider three main household types – pensioners, families with children and working-age adults without children. By looking at pairs of these on a rolling basis each five years, the relative weighting between the three types could be gradually adjusted.

Table 2: Comparison of equivalence scales

	FBU	McClements Couple=1.00	McClements Couple+2=1.00	Modified OECD Couple=1.00	Modified OECD Couple+2=1.00
Couple, 2 children	1	1.39	1	1.58	1
One adult, 2 children	1.17	0.92	0.66	1.17	0.74
Single female pensioner	0.52	0.53	0.38	0.59	0.37
Single male pensioner	0.53	0.53	0.38	0.59	0.37
Couple pensioner	0.78	1	0.72	1	0.63
Single young man	0.55	0.53	0.38	0.59	0.37

Conclusion

This paper reviews our thinking on the issues of uprating and rebasing. We propose that the MIS is uprated annually using an index of average expenditure. Rebasings every five years (or so, depending on changes in living standards) will be undertaken for two family types and adjustments made for other family types using the MIS equivalence scale. The uprating method can be reassessed in the light of the results of the rebasing.

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