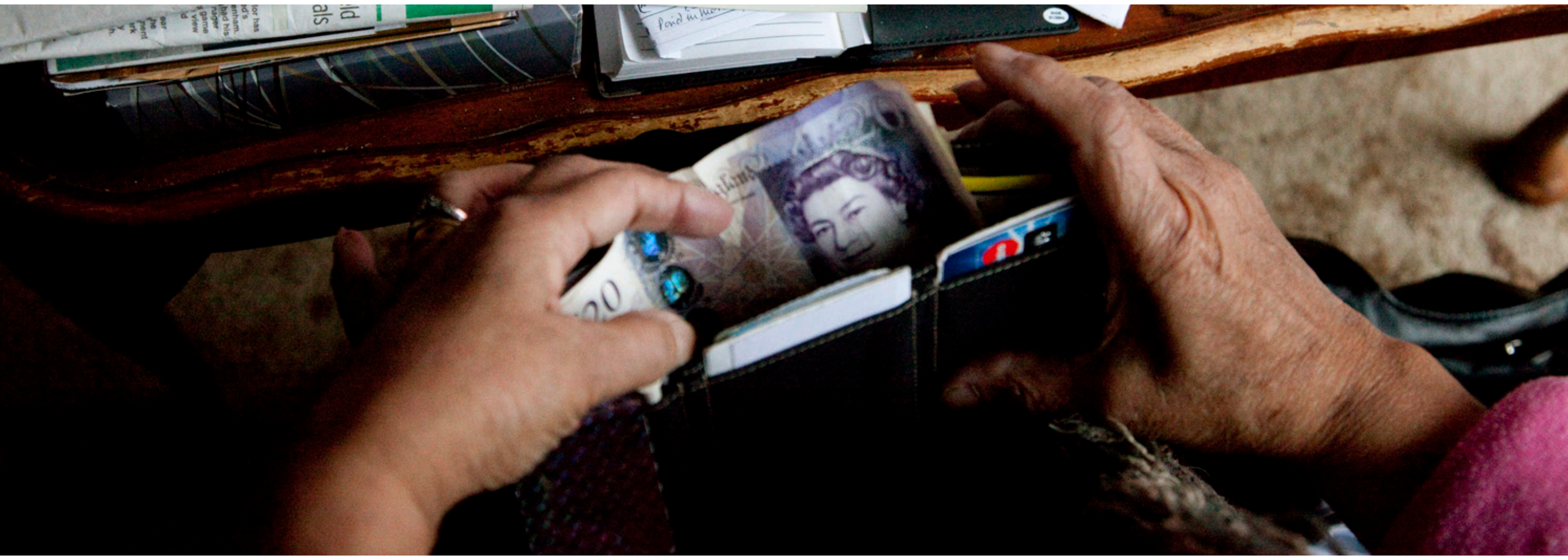

Will the 2015 Summer Budget improve living standards in 2020?

by Donald Hirsch

Since 2008, research on the Minimum Income Standard (MIS) has identified what different household types need for a minimum acceptable living standard, based on what goods and services members of the public say are needed. This study projects the disposable incomes of households on out-of-work benefits and minimum wages, comparing them with MIS between 2010 and 2020.

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Will the 2015 Summer Budget improve living standards in 2020?

Donald Hirsch

This report projects what current policies and economic projections will mean for the ability of households on safety-net benefits and on the new National Living Wage (NLW) to meet minimum needs in the present Parliament.

Fiscal austerity is likely to worsen the ability of many low-income households to make ends meet in the next few years, although some household types will be in a position to improve their living standards through general wage growth and through the rapid increase in minimum wages for over-25s through the NLW. Working-age households who are not working will find things ever tougher, as will working lone parents on low earnings, despite pay growth. Pensioners, single people on low pay and some couples with children where both parents work full-time are best positioned to make gains.

The report estimates:

- how far various types of non-working household will fall short of meeting a Minimum Income Standard in 2020, compared with 2010 and 2015;
- how the income of households where people work full-time on minimum wages will compare to this standard in 2020 compared with 2010 and 2015;
- the influence of public policy and inflation rates on these results.

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Contents

Executive summary

In the past five years, evidence on what households need for an acceptable living standard, according to the general public, shows that minimum costs have risen significantly faster than the incomes of non-working and low-paid families. This leaves them further short of the minimum required than before. This report projects how this situation will develop by 2020, based on current and newly announced policies and forecasts of inflation and earnings. It assumes Universal Credit will have been implemented, and considers the situation of newly claiming households according to their family composition and work status. The projections look at examples of the effects on a range of non-working household types, and at working households on low pay with certain working patterns. They do not attempt to count the overall number of winners and losers, rather they seek to show how levels of social protection are changing over the course of a decade.

Looking first at those who are not working and depend on 'safety net' benefits, the projections show a further deterioration for working-age families, but an improvement for pensioners. By 2020, pensioner benefits will be sufficient to bring incomes above the minimum needed, helped by their link to earnings growth. Working-age households will lose from a combination of a four-year freeze in cash benefits, a flat-rate loss of £10.45 a week for all new claimants without children from 2017 and a much bigger cut for new claims for more than two children. The result will be that non-working families will have only around half of what they need by 2020, compared with nearly two-thirds in 2010, and larger families will be worse off still. A single person's out-of-work benefits will have declined from just over 40 per cent to only 35 per cent of a minimum budget. In cash terms, the shortfall between disposable income and minimum budgets will have typically grown by around £3,000 a year for a family with one or two children, and by £6,000 for a couple with three children.

For working families on minimum pay rates, a more complex picture emerges. Real-terms cuts in in-work benefits and a reduction in the amount that can be earned before tax credits and the Universal Credit start being withdrawn will cause significant losses. Better support for childcare and higher minimum wages for the over-25s will produce offsetting gains. Overall:

- The NLW will produce the greatest increase in living standards for workers without children, who have little to lose in means-tested support, and for the first time a single person working full-time will have close to the minimum required.
- In some circumstances, couples with children on the NLW could become better off in 2020 than they would be on the national minimum wage (NMW) today, despite the cuts to in-work support. This depends on both partners working full-time to benefit fully from the pay increase, something a minority of families do. Those with full-time childcare will benefit from additional childcare support, while some families on the NLW without childcare will have earnings high enough to make them ineligible for in-work support, allowing them to benefit from further pay increases without losing benefits.
- Families who work part-time will be less well positioned to make gains, unless they change their working hours. The incentive to work full-time will be improved by higher wages and more childcare support, but parents working an additional hour will still be only slightly better off – by about £2 an hour on the NLW, or £1.35 if they pay for childcare for one child (or less if more than one child requires childcare).
- The biggest losses among working families will be felt by lone parents, by large families and by those with childcare costs that exceed maximum levels eligible for support – something that will become more common over time if past increases in the cost of childcare continue in future, unless those maximum levels are raised.
- These trends will lead to some significant gains and losses for working families. This is expressed in terms of the change in how far their disposable income falls short of meeting the Minimum Income Standard when each adult works full-time on the NLW in 2020, compared with on the NMW in 2010: for a couple with two young children, the shortfall is projected to be about £1,800 a year in 2020, £600 lower than it was in 2010. For a lone parent with a child under two, the shortfall is projected to grow to over £4,000 a year by 2020, a tenfold increase compared with 2010 when it

was £400. In these examples the working couple will maintain a living standard about 10 per cent below the minimum, whereas the working lone parent however will be about 30 per cent short by 2020 compared with only 3per cent in 2010.

- Overall, the changes will improve work incentives in most cases, although for families with children this is more because they have been made worse off out of work than better off in work. In particular, cuts in out-of-work benefits means that in most cases, the reward for working will grow even where in-work incomes fall too. For example, a working couple with three children will be £37 a week worse off in 2020 than in 2010, but out of work will be £117 a week worse off. An exception is a lone parent with a young child; the work incentive for this family type will be £23 a week lower in 2020 than it was 2010.

These projections are subject to various uncertainties, of which the most significant is the inflation rate. A freeze in benefit rates will be more harmful if inflation is higher than the low levels forecast. This could wipe out projected gains for some households, particularly those couples with children who are projected to be better off if the forecasts are correct.

In conclusion, the projections presented here show that the 2010s are likely to have seen big changes in living standards for many low-income households. Most clearcut is the substantial fall for those out of work, with families with children projected typically to have only half what they need at the end of the decade compared with two-thirds at the start. Pensioners and low-paid working households without children will make the clearest gains. Among working families, lone parents and families with three or more children in will be the biggest losers, while couples who both work could do better, depending on whether the benign projection of high wage increases but low inflation turns out to be correct. Overall, the freeze and cuts in benefits create risks for all families whose income is supported by the state, with even large pay rises not being guaranteed to make them better off overall.

1 Introduction

Following the economic downturn in 2008, there was a steady increase in the number of people in the United Kingdom in households falling below the Minimum Income Standard (Padley *et al.*, 2015). This standard is based on research into what things people need to buy as a minimum for a socially acceptable standard of living, as specified by members of the general public. Households that do not reach the standard include both those relying on out-of-work benefits and those where people work but are on low wages. Working-age benefits do not get close to raising households above the minimum standard, and the minimum wage is generally insufficient to get households to this level, even supplemented by in-work benefits. Moreover, the gap between both out-of-work and minimum-wage incomes and MIS has widened substantially in recent years (Hirsch, 2015a).

How is this likely to change in the next five years? Plans for the present Parliament set out in the Summer Budget 2015 provide a fairly detailed picture of how public policy will influence the incomes of worse-off households. Two main contradictory influences can be expected to affect the adequacy of the incomes of those relying on out-of-work benefits and on minimum-wage income. On the one hand, real wage growth and increases to the personal tax allowance are likely to improve working incomes relative to minimum household budgets. Between 2015 and 2020, consumer prices are projected to grow by just 9 per cent, but average earnings by over 20 per cent in cash terms (OBR, 2015). Moreover, the new NLW announced in the Summer Budget 2015, a supplement to the NMW for the over-25s, will raise minimum pay by nearly 40 per cent in cash terms by 2020. On the other hand, planned real-terms cuts in benefits, in and out of work, will pull in the opposite direction, although additional support for childcare should mitigate this for some families.

This report projects change between 2015 and 2020 in the amount by which various household types depending on out-of-work benefits and on the NMW/NLW fall short of meeting MIS, taking into account projected inflation, earnings increases and fiscal policies. It draws on economic forecasts by the Office for Budget Responsibility (OBR, 2015), on policies announced and confirmed in the Summer Budget), on announced policies of the newly elected government, mainly to 2019, and on stated scenarios for policies thereafter. For context, the report also shows what happened to income adequacy relative to MIS between 2010 and 2015.

The report therefore gives a picture of how policy and economic developments have affected the economic wellbeing of some of the UK's worst-off households over the recent difficult economic years, and how they might do so in a period where real wages growth returns but fiscal austerity continues.

The central projections make a series of assumptions about the economy and public policy, which are subject to unpredictable change. In this sense they are not intended as firm forecasts, but rather as an illustration of the current direction of travel. The main assumptions are that:

Prices

- Prices will rise as forecast by the Office for Budget Responsibility (OBR) (2015);
- Childcare costs will increase in line with forecast earnings growth and hence about 1–2 per cent per year faster than general prices, which is broadly in line with recent experience;
- MIS budgets will not change in content, and will rise in price at the same rate as the Consumer Prices Index. A variation on this assumption shows what would happen if they rose faster than this, by one percentage point a year, which is broadly in line with MIS findings to date. The past in this respect is not necessarily a guide to the future, but the inflation variation also takes into account the possibility that prices generally rise faster than the very low level forecast by the OBR.

Earnings

- Earnings will rise as forecast by the Office for Budget Responsibility (2015);

- The NLW will rise evenly from the announced level of £7.20 an hour in 2016 to £9.00 in 2020. (This is the 'headline' political commitment, although the benchmark on which it is based, 60 per cent of median pay for over-25s, is forecast to be slightly higher, £9.35.)

Tax

- Tax allowances will rise as announced to 2017/18 and steadily to the promised £12,500 a year by 2020/21.

Benefits

- Working-age benefits and the Universal Credit will be frozen until 2019 as announced. In 2020, the projections assume that benefit rates rise with prices;
- The amount you can earn before entitlement to benefits start to be reduced (the 'disregard', also called the work allowance in Universal Credit) will be reduced in 2016 (and abolished for those without children), as announced in the Summer Budget 2015, and then frozen. Stated policy is to freeze work allowances to 2019, but the projections assume that they also do not rise in 2020, as they have never systematically been linked to inflation;
- Policies for altering entitlements to in- and out-of-work benefits – such as removing the eligibility for Child Tax Credit for a third child – will follow the timing announced in the Summer Budget;
- Pension Credit will continue to increase in line with earnings (the present policy);
- Support for childcare in Universal Credit will rise to 85 per cent from 2016 as planned, but the limits on the level of childcare eligible for such support will remain frozen as they have since 2006.

Childcare

- The increase in free childcare for three- and four-year-olds from September 2017 will reduce childcare costs for families paying for childcare for children of these ages.

Note also that the projections consider benefit entitlements from the point of view of a new claimant each year. Some cuts in tax credits and Universal Credit being introduced in 2017 are not being applied to existing claimants (except when they have a third or subsequent child). However, the present analysis is concerned with how levels of social protection are changing over the long term, so does not take account of this transitional protection.

The following analysis considers the complex picture applying to different groups over the next five years in three sections.

Section 2 looks at the overall picture, showing how the percentage of MIS achieved by a range of different household types is projected to change by 2020 and how this compares with what they achieved in 2010. It shows some very different experiences in terms of how incomes relative to MIS are likely to grow or shrink.

Section 3 presents an account of how and why these changes differ substantially for various household types. It distinguishes three categories: those likely to see substantial increases in income over the next few years, those that might stand still or make modest gains and those likely to become significantly worse off. It identifies which policies are driving these differences.

Section 4 considers the extent to which inflation rates and upratings policies are influencing these results. It shows the effect of ending inflation-based upratings, and how much greater this effect might be if the cost of a minimum basket grows by more than the very modest inflation levels forecast.

Note: the role of scenario-based projections

The purpose of the projections in this report is to illustrate ways in which certain types of low-income households are likely to become better or worse off over the next five years. Unlike some projections modelling outcomes across the population, it is not intended to count the overall numbers of winners and losers, but rather to use scenarios to help understand the factors at work in different situations. Note in particular that:

- For working households, the example of a full-time worker has been used as a starting point even though families have a wide variety of working patterns with no single model prevailing. This helps show the *potential* for a family to earn an adequate living through work, which in the past has been limited for those on low wages. As a comparison, examples of part-time working are brought in later;
- For families with children, the examples start with those who pay for childcare, even though many families do not. Again, this is linked to showing whether families have opportunities to make ends meet, where childcare may be needed, and other examples where childcare is not required are also brought in for comparison.

It should also be pointed out that, even though these projections aim to show the situation taking account of the Summer Budget 2015, which set important policies for the present Parliament, unlike some 'budget analysis' it is not a 'before and after the Budget' comparison of how the future will look. Rather, it compares the future as it looks under Budget policies and projections to the present and the past. In other words, its perspective is wider than the effect of a set of policy announcements, looking at how the world will have changed from the start to the end of the present decade.

2 Overall patterns of income adequacy 2010–2020

Since its inception in 2008, the Minimum Income Standard has produced data for income requirements for a wide range of household types. Figures 1 and 2 look at a selection of households types, considering how their living standards have changed since 2010, and how they are projected to change between now and 2020. This is expressed in terms of how disposable income on out-of-work benefits and on the NMW/NLW compares with minimum required budgets. The graphs show income as a percentage of what is required, and the tables show the money values (expressed in 2015 £s) of the budget requirement, actual disposable income, and hence the surplus or shortfall that households experience. Throughout this report disposable income means income after payment of all direct taxes, receipt of benefits and tax credits/Universal Credit and payment of rent, childcare and Council Tax. It allows comparison between what households have available and the required budgets based on the lists of goods and services compiled by the public in the MIS research.

Figure 1 and Table 1 consider the situation for non-working households relying on safety net benefits. It shows that working-age households who are not working will have seen a dramatic fall during the present decade in how far they fall short of being able to afford a minimum living standard. Specifically, they show that:

- Pensioners, who started the decade with about enough to live on (if receiving the income guaranteed by the means-tested Pension Credit), will be in a similar situation in 2020, reversing a modest decline in the past five years. The recent decline occurred despite the fact that the Pension Credit rose roughly in line with the Consumer Prices Index (CPI) during this period. Essential costs such as heating and food and hence a minimum budget rose faster than this index. In the coming period, on the other hand, real earnings growth and the link of pensioner benefits to earnings should move things in the opposite direction.
- Out-of-work families with children, who started the decade with nearly two-thirds of the minimum, will have only around half of what they need by 2020. They too have been hit by rising costs, but whereas pensioner benefits have been increased in line with CPI, working-age benefits have fallen behind inflation. They have increased by 1 per cent per year since 2013 and from 2016 to 2019 will receive no increase at all. In addition, the benefits low-income families receive to provide help with the cost of raising children will reduce in cash terms for new claimants from 2017. No new claimants will receive the £10.45 per week family element of Child Tax Credit (CTC) or its equivalent in Universal Credit. The remaining child element will be paid for up to two children only. The family examples in Figure 1 have been selected to illustrate how the rate at which benefit adequacy declines for different families will be affected by these changes. The somewhat greater decline experienced by a two-person (lone parent plus one) compared with a four-person (couple plus two) family reflects the fact that the loss of the flat-rate family element impacts a smaller family more in proportion to their overall budget. On the other hand, any newly claiming family with three or more children will have more than £50 a week less after 2017, and in the three-child example shown, this causes a dramatic fall in income adequacy. A three-child family will receive a similar proportion of required income in benefits in 2020 as single people without children received in 2010: well under half of what they need, compared with over 60 per cent in 2010.
- An out-of-work single working age adult will fall even further short of being able to meet their needs by 2020 compared with now. Not only will Income Support be frozen at £73.10 a week, regardless of rising costs, but in addition, a single person (who in this example is assumed to live in private rented housing) is almost certain to have to pay part of this amount towards their rent. This is a result of the freeze in Local Housing Allowance, meaning that Housing Benefit is unlikely to cover their rent in full. For example, if someone renting a one-bedroom flat at the average LHA rate outside London of £102 a week (Valuation Office Agency, 2015) had a cumulative rent increase of nine per cent in the next five years (equal to the projected increase in CPI), they would have to pay £9 extra in rent out of

their £73.10 in basic benefit. This helps explain why a single person's benefit is expected to cover barely a third of minimum costs by the end of the decade, even with only modest inflation.

Figure 2 and the accompanying tables look at the more complex picture for working households on low wages. It looks at a benchmark of families where the parent/s work full-time. In practice, families with children have a wide variety of working patterns, and in only about three out of ten working families do both parents or a lone parent work full-time (Padley *et al.*, 2015). However, this benchmark based on full-time work indicates at least the *potential* for a family to achieve an acceptable living standard through work on the NMW/NLW. Figure 2 adds a comparison between the position under Universal Credit and the tax credit system, which was not necessary in Figure 1, since the two systems give the same entitlement for those not working.

Figure 2 expands the range of examples used in Figure 1, to illustrate the following phenomena, which can be observed by looking across household types:

- For those without children, while real-terms falls in wages since 2010 have made income less adequate, this will be more than compensated by projected real increases in earnings and in tax allowances, particularly for those who benefit from the new NLW. Indeed, a couple working full-time on that wage will be able to earn more than £35,000 between them, giving them a disposable income that is comfortably above the minimum needed for a decent living standard according to the public. A single person working full-time will be able to get close to MIS for the first time since the measure was first reported in 2008.
- Working lone parent families typically had nearly as much income as they needed as a minimum in 2010, but have faced a growing shortfall with deteriorating benefits and falling real wages. The switch to Universal Credit tends to reduce their disposable income (if working full-time), which in most cases is projected to fall further relative to the minimum by 2020. The exception in these examples is a lone parent family with two young children. This family's gain from better childcare support (the 30-hour free entitlement and the 85 per cent rate paid in Universal Credit) compensates for other cuts under Universal Credit, but still leaves them worse off than under tax credits.

Figure 1: Safety net benefits as a percentage of minimum budgets, 2010–2020

Income net of rent, childcare and Council Tax, relative to MIS budgets (100%=MIS level)

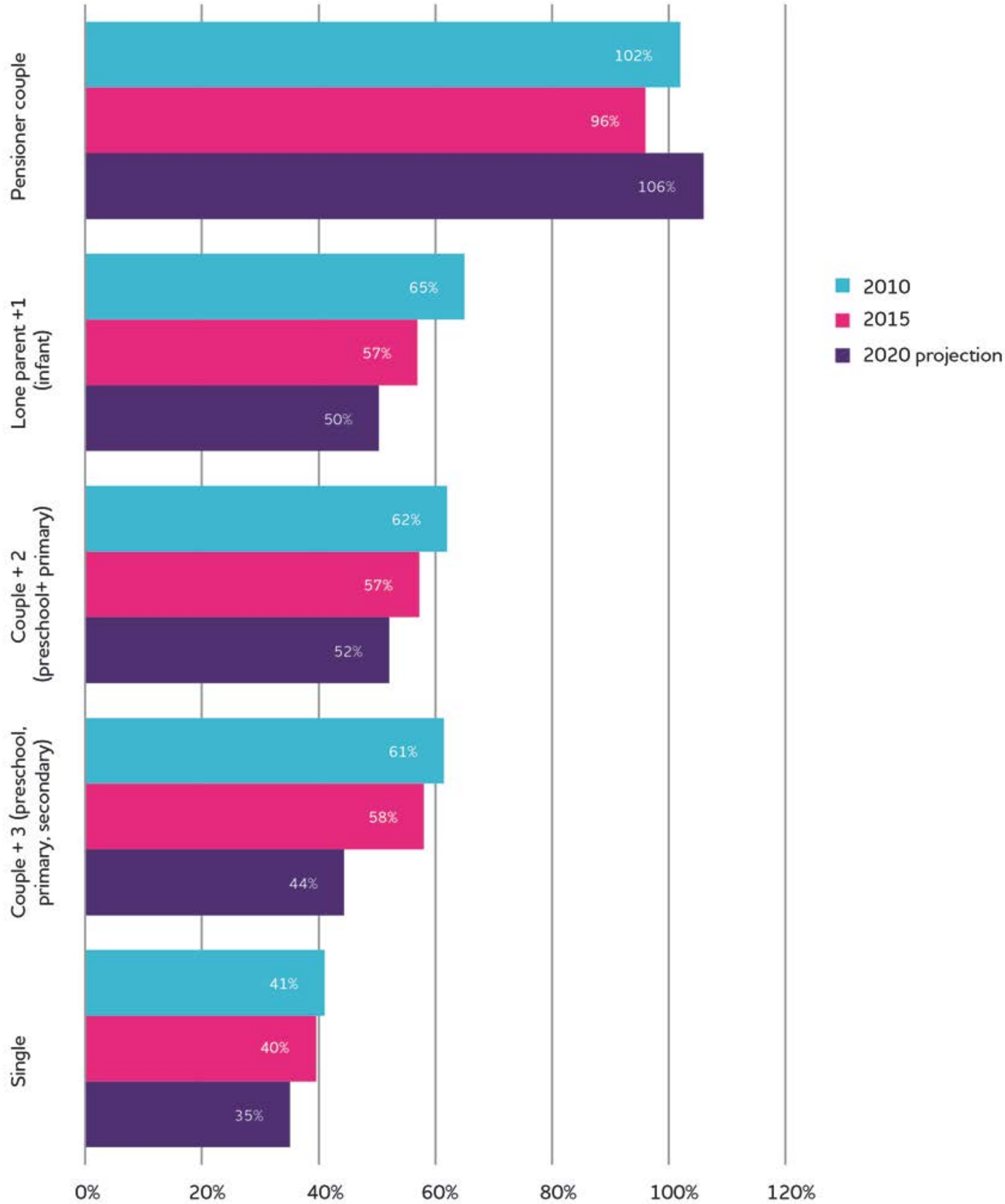


Table 1: Disposable income compared to MIS budget on out of work benefits (weekly, CPI-adjusted to 2015 prices)

Pensioner couple	2010	2015	2020 projection
MIS budget	£228	£244	£244
Income	£232	£235	£259
Surplus/shortfall	*£4*	*-£10*	*£15*
Lone parent +1 (infant)	2010	2015	2020 projection
MIS budget	£244	£274	£274
Income	£157	£156	£138
Surplus/shortfall	-£86	-£118	-£136
Couple + 2 (pre-school, primary)	2010	2015	2020 projection
MIS budget	£427	£462	£462
Income	£264	£264	£240
Surplus/shortfall	-£163	-£197	-£221
Couple + 3 (pre-school, primary, secondary)	2010	2015	2020 projection
MIS budget	£530	£571	£571
Income	£326	£331	£253
Surplus/shortfall	-£204	-£240	-£317
Single	2010	2015	2020 projection
MIS budget	£181	£181	£181
Income	£73	£72	£64
Surplus/shortfall	-£107	-£110	-£118

- Working couple families with children have tended to do better, helped by the fact that the wage increase applies in these examples to two parents, whereas most of the cuts in benefits are per family or per child. Couple families have also tended to do relatively better out of the change to Universal Credit, and this has been accentuated by the Summer Budget 2015, which moved from a higher work allowance for lone parents than couples to an equal one only slightly below the previous rate for couples.
- One influence, which affects which household types are winners and losers, will be better support for childcare. To contrast the fortunes of those with and without childcare costs, Figure 2 adds examples of families with secondary school children, for whom childcare is not needed. In the case of a lone parent with two children, the trend is more favourable in the case where they are younger and gain from the additional childcare support. For couples, however, there are also gains where childcare is not needed, for reasons explained below.

These multiple influences on the projected adequacy of incomes for working families over the next five years are explored further in the following section.

Figure 2: Disposable income on national minimum wage/National Living Wage relative to MIS, 2010–2020

Income after taxes, benefits, rent, childcare and Council Tax, relative to MIS budgets (100%=MIS level)

a) Working-age adult with and without children (ordered by % in 2010)

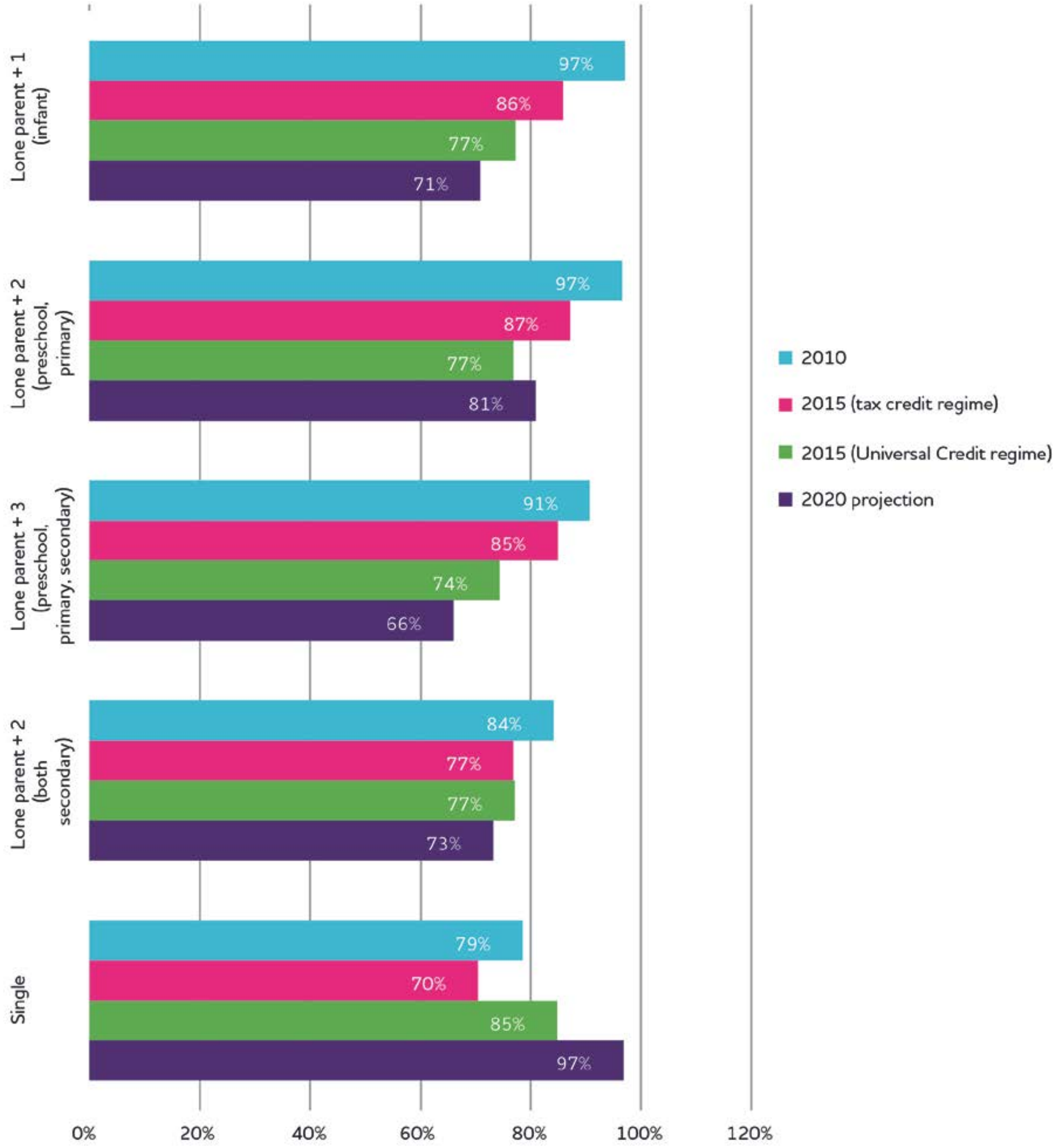


Table 2a: Disposable income compared to MIS budget working full-time on NMW/NLW (weekly, CPI-adjusted to 2015 prices)

Lone parent + 1 (infant)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£243.58	£273.92	£273.91	£273.91
Income	£236.55	£235.20	£211.68	£194.20
Surplus/shortfall	-£7	-£39	-£62	-£80
Lone parent + 2 (pre-school, primary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£327.36	£366.91	£366.91	£366.91
Income	£315.90	£319.73	£282.12	£296.72
Surplus/shortfall	-£11	-£47	-£85	-£70
Lone parent + 3 (pre-school, primary, secondary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£462.46	£469.59	£469.59	£469.59
Income	£419.32	£398.41	£349.02	£309.70
Surplus/shortfall	-£43	-£71	-£121	-£160
Lone parent + 2 (both secondary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£388.33	£422.06	£422.06	£422.06
Income	£326.58	£324.35	£325.24	£308.88
Surplus/shortfall	-£62	-£98	-£97	-£113
Single	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	-£180.78	£181.40	£181.39	£181.39
Income	-£141.93	£127.76	£153.73	£175.50
Surplus/shortfall	38.85245	-£54	-£28	-£6

b) Couple with and without children (ordered by % in 2010)

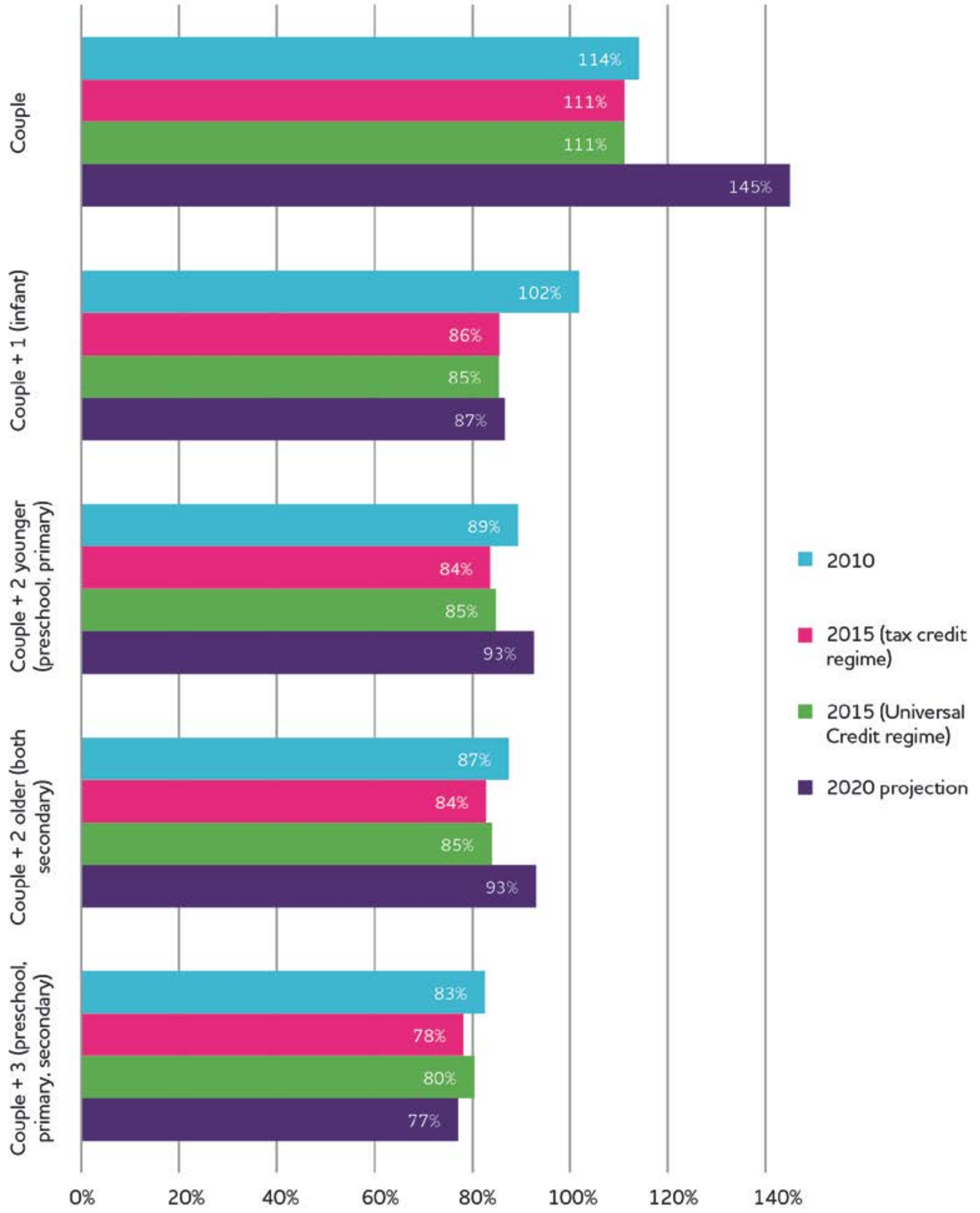


Table 2b: Disposable income compared to MIS budget working full-time on NMW/NLW (weekly, CPI-adjusted to 2015 prices)

Couple	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£284	£302	£302	£302
Income	£325	£336	£336	£440
Shortfall	£40	£34	£34	£137
Couple + 1 (infant)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	– £329	£375	£375	£375
Income	– £335	£321	£320	£325
Surplus/shortfall	-£6	-£54	-£55	-£50
Couple + 2 younger (pre-school, primary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£427	£462	£462	£462
Income	£382	£386	£391	£427
Surplus/shortfall	-£45	-£75	-£70	-£34
Couple + 2 older (both secondary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£487	£517	£517	£517
Income	£426	£428	£434	£481
Surplus/shortfall	-£61	-£89	-£83	-£36
Couple + 3 (pre-school, primary, secondary)	2010	2015 (tax credit regime)	2015 (Universal Credit regime)	2020 projection
MIS budget	£532	£571	£571	£571
Income	£439	£446	£458	£440
Surplus/shortfall	-£93	-£124	-£112	-£130

3 Winners and losers

This section considers in more detail the trajectory between 2015 and 2020 for three types of household situation. First, it considers those for whom a return to real earnings growth is likely to raise living standards substantially. Second, it looks at household types who may become a bit better or worse off by 2020, but not get much closer to closing a shortfall between their disposable income and what they need. Third, it considers those household types subject to deep cuts in already inadequate living standards. In each case, it identifies the main influences that produce these results. Most of the discussion compares the situation of households over time with working patterns held constant, but at the end of this section, some issues of work incentives, that could potentially change working patterns, are considered.

The graphs in this section illustrate the changing balance between wages and in-work benefits in contributing to household income, over the period 2015–20. In doing so, the analysis simplifies the picture in two ways that are important to note. First, it assumes all claimants are in receipt of Universal Credit. In reality, families are only gradually being moved on to this system, meaning that many will in fact continue to rely on the existing system for some time to come (and indeed they will do so under a tax credit regime that withdraws benefits more quickly with rising income, following changes introduced by the Summer Budget 2015). Second, the projections show the situation for new claimants only, while in reality there will be transitional protections in place for existing claimants. However, since the main emphasis of this report is to consider long-term changes and to capture how changes to the system are likely to impact on living standards over time, the graphs are restricted to showing how the wage/benefits balance will change under UC.

Winners

Between 2015 and 2020, a projected 22 per cent growth in earnings (OBR, 2015) will be nearly matched by an 18 per cent increase in tax allowances (on the Conservative Party manifesto pledge) producing take-home pay increases of around at least 20 per cent. This implies around 12 per cent growth in real incomes on present inflation projections. While any projection of healthy growth in real earnings five years ahead cannot be treated in any way as a reliable forecast, these figures show that among the general working population, there is a good prospect that many working people in the UK will become substantially better off.

Two big exceptions to this are clear. Public sector employees (other than those below the NLW) will be subject to tight pay restraint – generally to increases of only 1 per cent a year. And the three million working households who rely on in-work benefits will see cuts in the real levels of these benefits, together with their automatic reduction as pay rises, clawing back much of the gain. In other words, the worst-off working households who need help from the government in making ends meet can rely less than other households on favourable trends in market earnings to raise their living standards.

Nevertheless, the huge increase in the minimum hourly wage rate that must be paid to workers over 25, of 38 per cent between April 2015 and April 2020, together with a rising personal tax allowance, will mean that many of the biggest proportionate earnings increases will go to workers at the bottom end of the labour market. Many of these will be in households on modest incomes but that do not have significant entitlements to in-work benefits, so are in a position to be net winners.

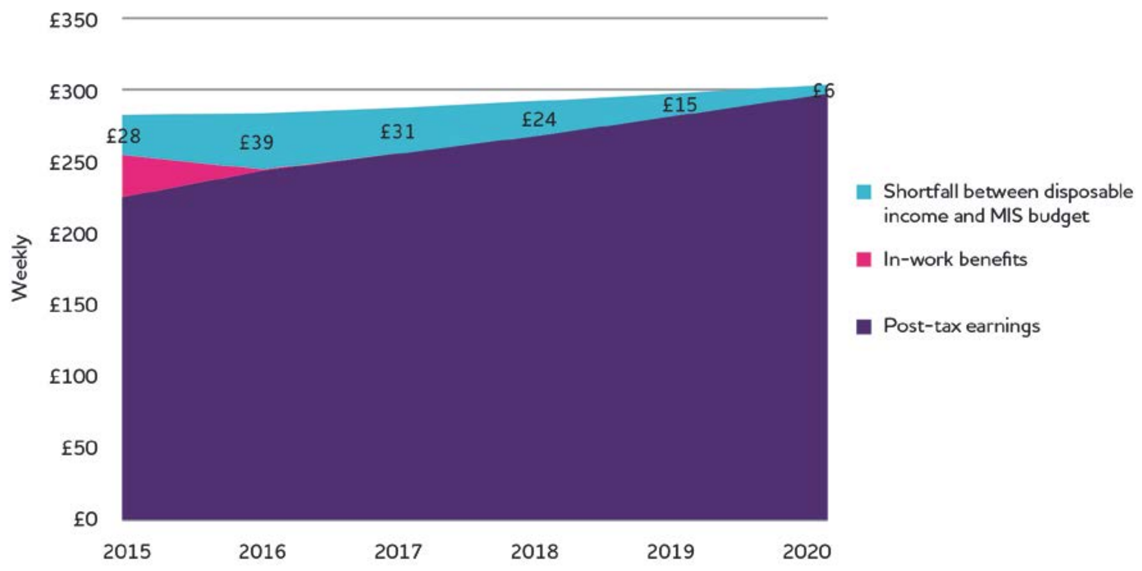
The most clear cut example is a couple without children, both working full-time on the NMW, who presently earn about £25,000 between them, with no entitlement to in-work benefits. While their income is modest, it is already above the amount needed for a minimum living standard. The NLW will pay them £35,000 in total in 2020, leaving them with over 20 per cent more post-tax income than now in real terms.

Other low-paid household types that will benefit from the move to the NLW are those who have a relatively small entitlement to in-work support at present. Significant increases in earnings could potentially ‘float’ these households off means-tested support, after which they will no longer be vulnerable either to cuts in this support or to the effect of the income taper that claws back further gains in pay. Two examples of such households are shown in Figure 3.

Figure 3: Some households working full-time on minimum wage ‘floated off’ Universal Credit by National Living Wage

Disposable income (£ per week, current prices) broken down by composition, and shortfall with MIS level

a) Single person aged over 25



b) Couple with two secondary school children

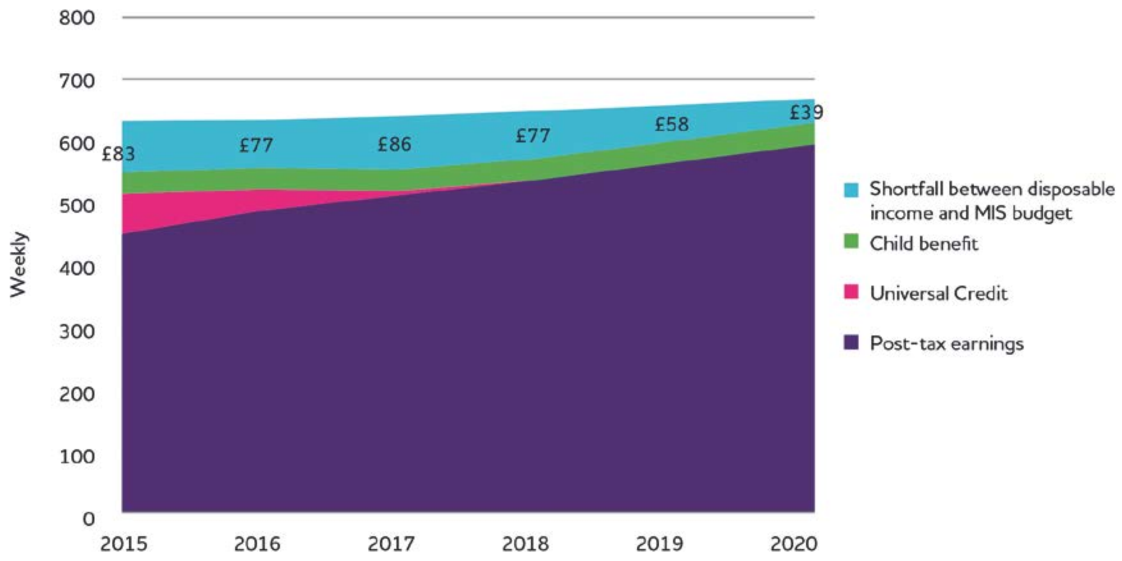


Figure 3a shows that a single person, who on the minimum wage working full-time is entitled to a small amount of help through Universal Credit, will soon have earnings that mean they are no longer entitled to help from Universal Credit when in work. This will be precipitated in 2016 by the abolition of the work allowance (disregarded earnings) for those without children, but this loss will quickly be compensated by the rapid increase in the NLW. This means that they will only have £6 less than MIS by 2020, compared with £28 today.

Moreover, some families with children on the NLW will be able to get clear of the level at which they receive Universal Credit by 2020, and in so doing quickly get significantly closer to the MIS level (although in most cases will not reach it). In particular, this applies to couples with one or two children, who neither pay for childcare nor have high rent entitlements under UC. The example shown in Figure 3b is a couple with two secondary school children, living in social housing. By 2018, their full-time earnings will be more than the amount that entitles them to Universal Credit. This is partly because their earnings will be higher, and partly because entitlement to UC will run out on a lower level of earnings, for two reasons: the baseline UC entitlement will be lower in real terms, and the work allowance (the amount you can earn before entitlement to benefits in work start to be reduced) will be lower. The important point to note is that once this means-tested element of income is no longer in play, increasing pay feeds much more effectively into improving living standards, as represented by the declining shortfall compared with MIS.

Two caveats to this second example need to be noted. One is that the calculation may be compromised by the fact that it assumes the family are paying a social rent, but the family will have joint earnings above the £30,000 threshold (outside of London), above which the Summer Budget states they will have to 'pay to stay' by paying a market rent or near market rent. However the details of this policy are still to be consulted upon. Another caveat is that this only applies to a case where both partners work full-time. With either a higher rent or lower joint wages, the family may still be entitled to some Universal Credit. Nevertheless, Figure 3b illustrates how higher wages and lower UC entitlements may reduce a family's UC to zero, reducing the scope for further cuts in in-work benefits harming them, and increasing the scope for rising wages to help them.

Specifically, any full-time working couple with children will have no UC entitlement by 2020 if they have no childcare costs and eligible rent below a certain level: around £190 a week with one child, or £130 with two or more children.

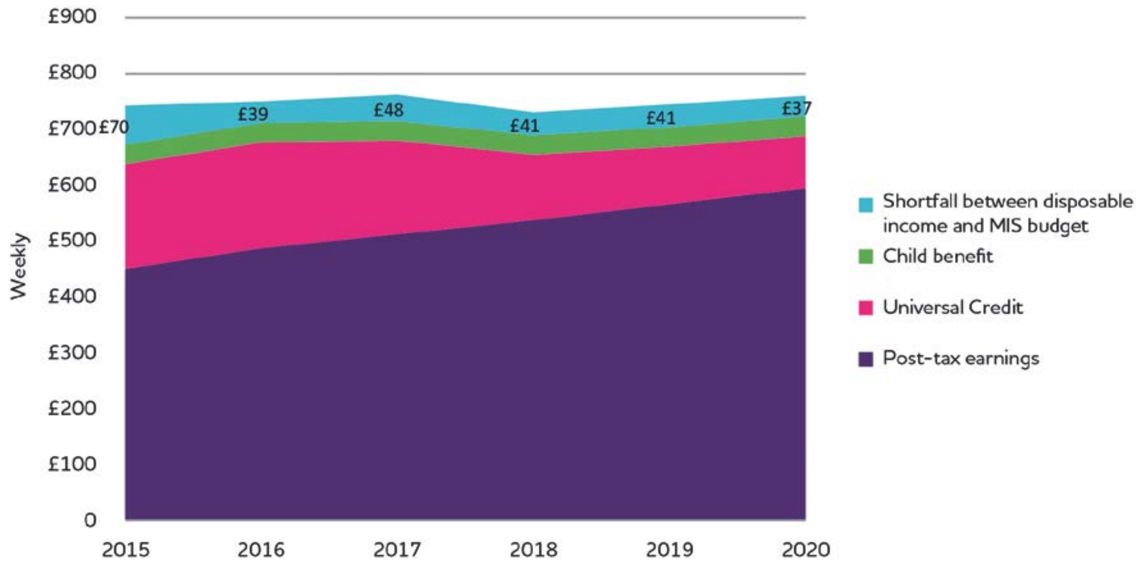
Another type of family where significant net gains could be made by 2020 is one able to benefit fully from the increase in support for childcare costs through the increased reimbursement rate in UC combined with the introduction of 30 hours' free childcare for three- and four-year-olds. Figure 4 shows how a couple with two children requiring childcare, one for a pre-school child, is projected to gain over the period. In 2016, the additional help with childcare costs available through UC increases the baseline UC entitlement for this family (which in practice means its UC entitlement stays stable despite an 11 per cent wage hike which would otherwise result in a lower UC entitlement as higher earnings result in UC income being tapered). From 2018, the additional free hours of childcare will also help to reduce the costs for this family type. These factors combine with the wage increase to create a net gain despite offsetting cuts in the real value of UC.

Note from the last two examples that a couple with up to two children can do relatively well in this period *either* because they have no childcare costs and therefore full-time wages on the NLW gets them clear of UC *or* because high childcare costs have become more affordable, enabling them to gain from working full-time with small children. The common factor here is two parents working full-time. One issue is therefore whether couples on low income will become better placed to increase their living standards by increasing their hours, as a result of higher wages and better support for childcare. At present, 25 per cent of all couples with children and just 6 per cent of those below the MIS level both work full-time. Not working full-time increases the risk of having an income below MIS, and over a third (36 per cent) of couple families with children where at least one parent works but not both full-time are below MIS (Padley *et al.*, 2015). These families could potentially get closer to an acceptable living standard by working extra hours – subject to appropriate work being available and this being compatible with family life. The section on work incentives below notes that rewards for increasing hours will improve.

Figure 4: A family made better off through improved wages and childcare support

Disposable income (£ per week, current prices) broken down by composition, and shortfall with MIS level

Couple, both working full-time, with two children, pre-school and primary age



Families balancing gains and losses

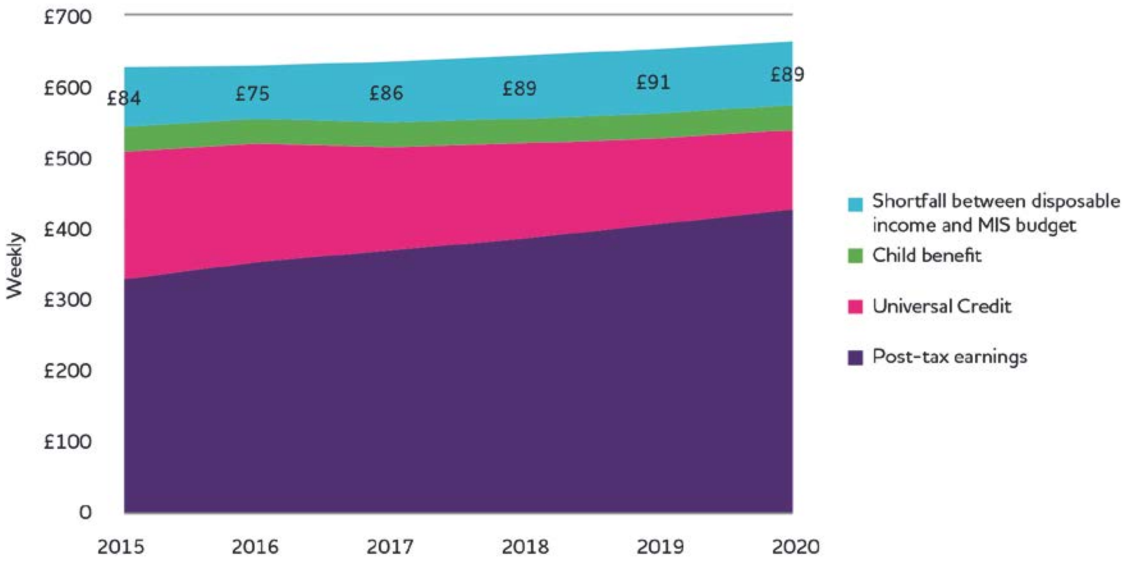
A second category under these projections is low-earning working families who have a mixture of gains and losses that may leave the balance positive or negative according to individual circumstances. Such families face less risk of further deterioration in living standards than those only subjected to benefit cuts with no offsetting gains, but less opportunity to raise their living standards than those described above. It is important to remember that, for families on low wages, this leaves them well short of meeting minimum needs.

Figure 5: Couples with children where higher wages offset by reduced benefits

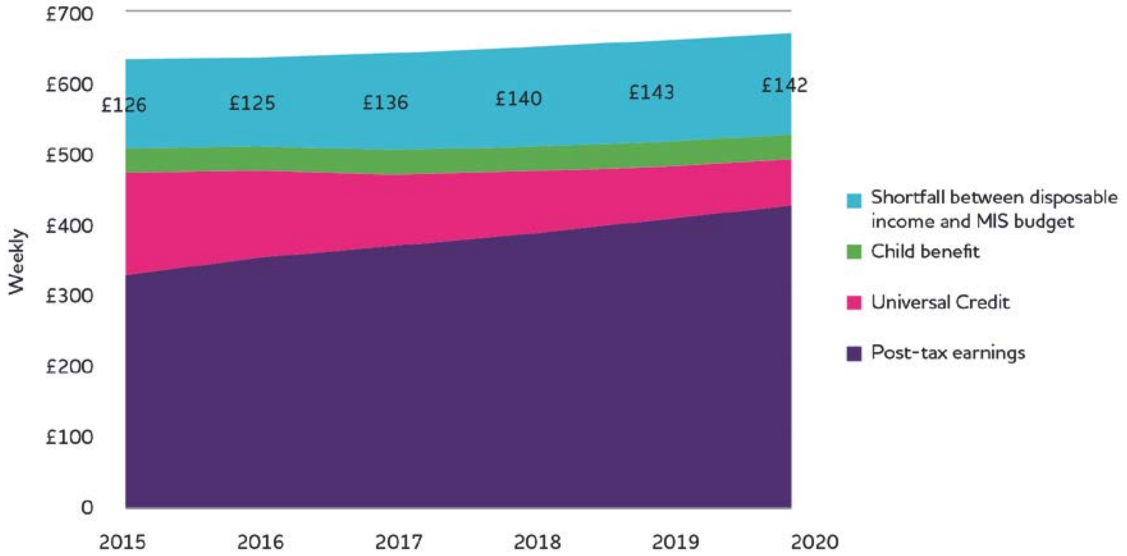
Disposable income (£ per week, current prices) broken down by composition, and shortfall with MIS level

Couple, one working full-time and one part-time, with two children

a) Younger children – pre-school and primary



b) Older children – both secondary



Typically, many low-earning working couples with children are likely to come into this category. As noted above, having two earners at the NLW rate boosts these families' earnings substantially. However, cuts in in-work support will not always be offset as much as in the example shown in Figure 4, which assumes substantial gains both from full-time earnings and from higher rates of support for childcare costs. Most families with children do not have two full-time workers, and relatively few on low earnings pay a large amount for their childcare (Hirsch and Valadez, 2015). Nevertheless it should be noted that better support may help more to take on paid childcare and work more hours, assuming suitable work and childcare are available. Figure 5 shows examples of couples with younger and with older children where one parent works full-time and one part-time. In these examples, there is a more or less even balance between gains and losses.

Figure 5 shows that for couples working less than full-time, gains are projected over the next five years as a result of rising wages, while losses occur from falling levels of Universal Credit. The net result is living standards staying fairly stable but at substantially less than the minimum required for a decent living standard. (Since this example is based on families with both earners in minimum wage jobs, who gain most from the NLW, it follows that couples working less than full time and on Universal Credit where at least one person earns above the minimum wage will become worse off, because their wages will not rise as much to compensate for cuts in support.) This is true for families with younger children and with older children. At present, a younger family has similar net income whether working shorter or longer hours on the minimum wage, since the net gain from more paid hours is similar to the net cost of more hours of childcare. Compared with the full-time working case (Figure 4), the part-time working case (Figure 5a), will be helped less by improved support for childcare, unless the family takes advantage of this support to increase its hours. Otherwise, it will continue to be more than £80 short of meeting the MIS budget. For a family with two older children (Figure 5b), non-childcare expenses are greater (for example their food and clothing budgets are higher), and this causes a larger shortfall for families not working full-time. This shortfall is projected to grow about in line with inflation, as rising earnings are offset by falling in-work benefits.

Losers

The two main categories of low-income household likely to be substantially worse off in 2020 than today (and who have also lost out since 2010) are working-age people on out-of-work benefits and working lone parents.

Figure 1 has already shown the picture for those relying on working-age benefits. As described earlier, they are falling ever further short of being able to afford the MIS budget.

Figure 2a shows a similar pattern for working lone parents. With only one income, a lone parent gains less than a working couple from the NLW, but has tended to lose more from the Summer Budget 2015 as a result of facing a bigger cut in the work allowance, increasing losses experienced in the switch to Universal Credit. Some families, such as a lone parent with a pre-school and primary school-aged child, will become a bit better off on Universal Credit in 2016 as a result of the increase in childcare provision, but will still be slightly worse off in 2020 than they are under tax credits today. Other working lone parent families will become substantially worse off than they are today, even with the benefit of a full-time NLW and increased personal tax allowance.

Figure 6 shows two examples of the greatest losers among working lone parents. One is a lone parent with a child under two requiring full-time childcare. This family will gain a bit of childcare support in 2016, but they will quickly exhaust the limit of help that is give through UC. This is because UC only helps with up to £175 per week in supported fees, but as childcare costs rise, a full-time working lone parent will have to pay childcare fees in excess of the limit. As a consequence, this family type faces a growing shortfall compared with MIS. In 2010 they would have been £6 a week short of meeting MIS; this increases to £62 in 2015 (under the UC regime), and they are projected to be a further £24 short by 2020, i.e. £86 per week. Such a family will barely be better off in 2020 working full-time than a non-working family with the same composition was in 2008 when MIS was first reported (a full-time NLW worker is projected to have 71 per cent of MIS in 2020, compared with 68 per cent in 2008 for an out-of-work family). Note that this result would look significantly different if the limit on childcare support in UC, which has not been uprated for a decade, were lifted. Without such a cap, the projected shortfall in 2020 would be £30 a week lower. The case for increasing the cap, and little or no cost, is discussed in Hirsch (2015b).

The second example in Figure 6, a lone parent with three children, will be much worse off from 2017 (as a new claimant) as a result of the restriction of UC support to two children. The higher NLW earnings paid to a single person will not nearly make up for this loss. With less than two-thirds of the disposable income that they need, such a family will be worse off by 2020 working full-time than some lone parents were on benefits in 2008. (But note that this does not constitute an erosion of work incentives since the same family not working will be far worse off still, getting only 46 per cent of the MIS budget rather than 66 per cent working full-time.)

Figure 6: Working families with a growing shortfall in disposable income compared with MIS

Disposable income (£ per week, current prices) broken down by composition, and shortfall with MIS level

Lone parent families working full-time

a) With one child aged under two

b) With three children, pre-school, primary and secondary school age

Work incentives

The above review of winners and losers has shown that all out-of-work working-age households will become worse off, while those in work will have mixed fortunes. This is likely in many cases to improve incentives to work. But it is worth looking more closely both at changes in the incentive to work overall and at incentives to work additional hours. This is important both because of the potential impact on working behaviours of such incentives, and also because rewards for work affect the ability of families who work more to increase their living standards, regardless of whether their behaviours are affected by such calculations.

Table 3 illustrates how the gap in disposable income between not working and working full-time on the NMW/NLW is projected to have changed during the current decade, for four household types.

Table 3: Changes in incentives to work, 2010–2020

	A. Difference between incomes in and out of work, £ per week 2015 prices		B. Increased work incentive 2010-2020	C. Change in income relative to MIS, 2010–20 (positive value indicates income has risen faster than MIS requirement). The difference between these columns is the increase in work incentive shown in Column B.	
	2010	2020		(i) Working incomes	(ii) Non-working incomes
Single	£79	£112	£33	£23	-£10
Lone parent + 1 (infant)	£79	£56	-£23	-£73	-£50
Couple +2 (pre-school, primary)	£118	£187	£69	£11	-£58
Couple + 3 (pre-school, primary, secondary)	£111	£187	£76	-£37	-£113

Table 3 shows a considerable improvement in work incentives for three out of the four household types shown. For a single person and a couple with two children, this reflects both an improvement in working incomes and a deterioration of out-of-work incomes, although for the couple with children the latter is much greater. For a couple with three children, both those in and out of work become worse off, hit by the reduction in child tax credit entitlements, and the improved 'incentive' is caused only because the loss for non-working household is greater. For the lone parent with one small child, there are also losses both in and out of work, but in this case it is the in-work family that loses more, mainly as a result of the capping of childcare support in Universal Credit (see above).

While this shows a varied picture overall, a generalisation is that where work incentives for families with children are improving, this is more because they have been made worse off out of work than better off in work. The NLW will in particular boost work incentives for those without children, but due to the very low living standards that these households face on benefits, their work incentives are already high.

A second feature of work incentives is whether it is worth a working family increasing its working hours. In this respect, work incentives have often been much weaker than the incentive to work at all especially for families with young children. This is because the cost of an additional hour of childcare is sometimes greater than an hour's additional wage, net of withdrawals through taxation and tax credit/Universal Credit withdrawal (Hirsch and Hartfree, 2013). Additional support for childcare and higher wages can both help reduce this effect.

Table 4 shows that workers depending on means-tested in-work support lose most of any additional earnings from working an extra hour, and this will remain the case. However relative to the present situation where they can keep well under £1 an hour if paying for childcare, the situation is set to improve, and this could encourage more families to work additional hours. Note that this roughly restores the work incentives to the level they were in 2010. Since then, rising childcare costs, falling state support for childcare and steeper tapering have reduced work incentives. By 2020, rising real wages and rising support for childcare reverses this situation.

Table 4: Hourly earnings retained, 2010–2020

Effect of working extra hour, for taxpayer in family receiving tax credits/Universal Credit (inflation-adjusted to 2015 prices)

	Minimum hourly wage (over 25s)	Combined withdrawal rate (tax, NI, taper)	Retained earnings, no childcare (per hour)	1 hour of childcare (outside London)	% childcare paid in tax credits/UC	Retained earnings after childcare (per hour)
2010	£6.50	70%	£1.95	£3.43	80%	£1.26
2015 tax credits	£6.50	73%	£1.76	£3.77	70%	£0.62
2015 Universal Credit	£6.50	76.2%	£1.55	£3.77	70%	£0.42
Projected 2020	£8.37	76.2%	£1.99	£4.26	85%	£1.35

4 The impact of inflation rates and upratings policy

An important driver of the results reported in these projections is the fact that working-age benefits are not being linked to inflation, and therefore their value is being eroded over time. This guarantees that people out of work become gradually worse off, and contributes to the reduction or elimination of any gains from higher wages and lower taxes experienced by those in work but receiving benefits from the state to top up their low income.

Moreover, the actual rate of inflation has become more directly important to the trend in living standards than it was when benefits were being uprated with reference to rising prices. The government has announced for four years ahead the amount by which working-age benefits will change (zero). This means the degree to which this represents a real terms cut in the value of benefits will vary according to whether inflation is high or low. It has also set targets for tax allowances and for the NLW quoted in cash terms, which if met will also be more beneficial the lower the actual inflation rate.

With this in mind, Table 5 reports on two variations of the current projections. First, it considers what will happen if the cost of a minimum budget increases by one percentage point a year faster than the inflation rate projected by the OBR. This could happen if some essential categories like food, which are more heavily represented in a minimum basket than in the average basket used to calculate the Consumer Prices Index, rise relatively rapidly in price. It could also occur if the historically low forecast of a cumulative 9 per cent inflation over five years turns out to be inaccurate. For context, between 2010 and 2015, CPI inflation was a cumulative 12 per cent and the cost of a MIS basket was estimated to have risen by 19 per cent. Hence, the alternative scenario shown, which involves the minimum cost of living growing by 14 rather than 9 per cent over the next five years, still represents only moderate inflation relative to recent experience.

Columns 2 to 4 of Table 5 show that under this higher inflation scenario, disposable income on benefits and low wages would be reduced, albeit by modest amounts. For many families this would come on top of falls already shown in the above projections. The most serious effect would be on a single person out of work, as a result of the assumption that they would not have access to social housing and therefore would have to cover rent rises through the non-housing part of benefits, since the Local Housing Allowance will not rise with inflation. This would push the out-of-work income available to below a third of what they need, which is likely to create severe hardship and difficulties in affording the most basic necessities of life. (While the current projections assume that a family with children lives in social housing, a family unable to access social housing and living in the private rented sector will suffer from a similar larger inflation effect.)

For context, the last two columns of Table 5 show how much effect not uprating will have on disposable incomes even if the modest inflation forecasts turn out to be an accurate prediction of basic costs. Again, the biggest effect is for single people because of the housing cut. Combining both sides of the table, it can be seen that a single person in private housing could be a fifth worse off on out-of-work benefits as a combined result of benefits not being uprated and having a higher than predicted inflation rate.

Table 5: Disposable income as a percent of MIS under alternative inflation and uprating scenarios

	A. 2015	B. 2020 with projected inflation, current uprating policy	C. 2020 with 1% a year higher inflation, current uprating policy	%age fall in disposable income from higher inflation rate (C compared to B)	D. 2020 with projected inflation, benefits uprated	%age gain in disposable income from inflation uprating (D compared to B)
c) On out of work d) benefits						
Single	40%	35%	32%	9%	39%	12%
Lone parent + 1	57%	50%	48%	4%	52%	4%
Couple +2	57%	52%	50%	4%	54%	4%
Pensioner	96%	106%	101%	5%	106%	0%
e) b) On NMW/NLW						
Single	85%	97%	90%	7%	97%	0%
Lone parent + 1	77%	71%	68%	4%	73%	3%
Couple +2	85%	93%	89%	4%	95%	2%

This section has shown that forecasts of winners as a result of a healthy growth in wages and very modest inflation need to be interpreted with caution. Projected gains, especially where shown for families receiving in-work benefits, could be reduced or disappear if inflation is above the forecast level. Furthermore, the variations shown above do not take account of the possibility that the level of the minimum may be influenced not just by changes in living costs but also by improvements in general prosperity. Since MIS measures the income needed to maintain a minimum standard appropriate to contemporary living, higher living standards generally could potentially influence the minimum set by members of the public. This is not inevitable, and it is important to note that what the public considered necessary for a decent standard of living did not systematically track living standards *downwards* when real incomes fell during the recession. It may be that social norms will be slow to change in a way that increases MIS as incomes start to rise again. However, when forecasting that some household incomes will start to catch up with MIS as a result of earnings rising faster than inflation, it is important to bear in mind that this benchmark may be a moving target.

5 Conclusion

The projections in this report show that many low-income families are set to experience substantial changes in their incomes by 2020, causing their living standards to be very different from their 2010 levels. Most of those with children who depend on state help, in or out of work, will have seen a big deterioration. Others, particularly those without children on low pay, but also some working couple families with children, could see significant gains.

The most consistent losers will be those depending mainly or entirely on working-age benefits, whose value is falling steadily. The worst hit are those affected by large additional cuts, including larger families and those relying on support for private rents. The result is that by 2020 some non-working families with children are projected to have less than half the disposable income that they need for what the public considers to be a minimum living standard, down from nearly two-thirds in 2010. For out-of-work singles, the value of benefits will fall from below half the minimum to around a third.

In contrast, for households whose income comes wholly or mainly from earnings living standards are forecast to rise. This also applies to pensioners, much of whose income from the state is set to rise in line with earnings.

For those whose income comes partly from earnings and partly from state transfers, the situation is more complex. Cuts in the value of in-work benefits are being mitigated, for those aged over 25 on low wages, by an exceptionally steep rise in the minimum wage to the NLW level of £9 by 2020. At the same time, an increase in support for childcare will help offset cuts in other state support for some families.

The biggest winners among low-paid workers of these changes will be those without children, who have little or no state benefits to lose, resulting in some becoming more than 20 per cent better off by 2020. Among families, the biggest gainers will be low-paid couples where both work full-time. For this type of household the gains from rising wages will more than offset cuts to in-work benefits, although with the value of in-work benefits frozen, much of their forecast gain could be wiped out if the minimum cost of living rises by more than the very modest amounts assumed in these projections. The need for childcare is also an influential factor in how far families with children see their living standards improve over the next five years. Those without childcare costs could see their incomes increase to the point where they are no longer eligible for in-work benefits (other than Child Benefit). For those that do need to pay for childcare, higher wages and increased childcare support may incentivise them to improve their incomes by increasing their hours, subject to the availability of work that is compatible with family life. This begins to address one of the problematic features of the Universal Credit system, whereby parents are much better off for the first few hours they work, but their disposable income barely increases with additional hours, especially where childcare costs also have to be paid. The increased support for childcare costs will be a welcome boost for many working families but does not eliminate the problem, and the amount of earnings retained from working additional hours for those needing to pay for childcare will still not be large.

Lone parent households are more likely to be losers from the combined changes in 2015–20, even if they are in work. A crucial change in the 2015 Summer Budget, which reduced overall rewards from work, was the substantial lowering of the work allowance in Universal Credit for lone parents. This means the amount of benefits they are entitled to when working begins to be reduced at a lower level of earnings. In addition, the gains from a higher wage and a higher tax allowance are less significant where there is just one earner in the family, and indeed the now-abolished higher work allowances for lone parents were intended to reflect that disadvantage. Moreover, flat rate cuts such as the abolition of the family element of Child Tax Credit hit smaller households harder. The resulting situation is that by 2020 some lone parents will be unable to get above about 70 per cent of MIS even by working full-time. This represents a dramatic change since the start of the decade. Then, a lone parent family had to struggle to get by on out-of-work benefits, which provided about two-thirds of a minimum budget, but if the parent worked full-time, even on the minimum wage, the family could almost get to the minimum. By 2020, even working full-time the family will have only just over two-thirds of what they need, with out-of-work benefits providing only half or less of the minimum budget. So while working lone parents will by 2020 have roughly the same living standards as non-working lone parents in 2010, work incentives will be retained through a steep decline in out-of-work incomes too.

Overall, then, among low-income households, most working lone parents and almost all non-working households of working age are likely to see their living standards decline in the next five years, while pensioners and working people without children are likely to see a substantial improvement. Low-income working couples with children will have mixed fortunes, depending to a large extent on how able and willing both parents are to work full-time. The NLW at least creates new opportunities for families working in lower paying occupations to provide more adequately for their families. However, in practice, most couples with children – particularly younger children – are likely to continue to have at least one person not working full-time. Thus the great majority of low-paid families with children are likely to see no improvement in income relative to their needs over the next five years, remaining substantially below a minimum standard of living, and in many cases seeing a serious further deterioration.

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About the author

Donald Hirsch is Director of CRSP, where he leads the Minimum Income Standard for the UK programme. A former journalist and writing and research consultant, he has been involved in MIS since its inception, and is responsible for the analysis of MIS data and its application in policy and practice. From 1998 to 2008 he was Poverty Adviser to JRF, where he wrote a number of major reports on child poverty, welfare reform, long-term care and the situation of older workers.

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Joseph Rowntree Foundation
The Homestead
40 Water End
York YO30 6WP
www.jrf.org.uk

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