1 of 1 DOCUMENT

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The Big Squeeze

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It's called the Big Squeeze. Not the title of a pastiche Raymond Chandler novel but shorthand for what has happened to UK real wages in the past few years-though the extensive economic detective work this has triggered rivals anything Philip Marlowe ever had to grapple with. Before the financial crisis most of us took an annual above-inflation pay rise for granted, even in tough economic times. Not any more. The recession saw many private sector workers suffer pay cuts, freezes or reduced hours.

And the subsequent economic recovery has brought little respite, despite a record breaking pace of job creation, enough to have the Chancellor of the Exchequer, George Osborne, already talking of a return to full employment. Five years ago most economists thought unemployment would top three million and stick close to that level for some time. But remarkably, the headline number of unemployed people and those seeking work has already fallen below two million (a jobless rate of 6 per cent) and is dropping like a stone toward the pre-recession level of 1.6m. The Office for National Statistics (ONS) estimates that the fall in unemployment in the year to summer 2014 was the largest since comparable records began in 1972. Fewer than one million people are claiming jobseeker's allowance. And while youth unemployment remains a major cause of concern, the current jobless rate of 16 per cent for 16-24 year olds is well down on the 2011 figure of 22.5 per cent. Meanwhile the employment rate-the proportion of people of working age in a job-is now equal to the previous high of 73 per cent, with unfilled job vacancies close to a record number too. Despite the sharp negative impact of fiscal austerity on public employment, the private sector has added 1.7m jobs in the past three years, two-thirds of these for employees, the remainder causing the ranks of the self-employed to reach an unprecedented 4.5m. At the outset of the recovery the balance of job creation was weighted heavily toward part-time positions, with employers also making considerable use of temp workers and employing increasing numbers of staff on a casual basis. Official estimates put the number of zero-hours contracts in the economy at around 1.4m, covering up to 700,000 people (some individuals will be employed without guaranteed hours of work by more than one business). However, the strengthening of the economy over the past year has been accompanied by a resurgence of growth in full-time jobs, which is now outpacing part-time job creation. This has not only helped to cut unemployment but also eased another post-recession phenomenon, high underemployment. In the past year, the number of people working part-time because they are unable to find a full-time job has fallen by more 100,000 to 1.35m.The jobs recovery has been widespread across the private sector, encompassing manufacturing, construction and business services sectors-hardest hit by the economic crisis-as well as consumer services sectors. Neither has the good news been confined to the most prosperous regions. Employment rates have of late been increasing strongly in regions where unemployment is relatively high, preventing the recovery from widening the north-south divide. All in all, the United Kingdom has been enjoying the kind of jobs boom that in the past would have had bosses falling over themselves to offer higher pay to attract and retain staff. Yet this is proving to be a jobs boom like we've never seen before. Not only is pay pressure not rising, real wages are still falling. Growth in average weekly private sector pay, which according to the ONS increased by just 1.2 per cent in cash terms (excluding bonuses) in the year to August, is barely managing to keep pace with a moderating rate of consumer price inflation. Factor in the effect of fiscal austerity, which has resulted in sub-inflation pay rises for the majority of public sector employees since 2011, and the average weekly earnings of UK employees are around 8 per cent lower in real terms than in 2007. There hasn't been a real wage squeeze like this since Victorian times. "As best we can tell," Andrew Haldane, Chief Economist at the Bank of England, told a business audience earlier this year, "the length and depth of this fall (in UK real wages) is unprecedented since at least the mid-1800s."The squeeze is of course partly due to what politicians like to call "the cost of living crisis." Until recently, the annual rate of price inflation has been running well above the government's 2 per cent target. But whereas pay would once have risen to at least compensate workers for this, the present recovery has instead been characterised by pay inertia. No wonder then that the popular rhetorical backdrop to economic policy debate has changed from "Britain isn't Working," which a generation ago expressed widespread despair at mass unemployment, to "Britain Needs a Pay Rise." But are we about to get one? The view of the Bank of England and the Office for Budget Responsibility (OBR) is that rapidly falling unemployment and lower underemployment means a return to real wage growth is just around the corner. This will occur some time within the next 12 months, at least in the private sector, though even optimists think it could take until the end of this decade before average real pay gets back to its pre-crisis level. Yet a nagging doubt remains. What if in our relatively deregulated flexible labour market-where the balance of workplace power favours bosses, many people are engaged on flexible performance-based contracts, and new technology is sweeping away jobs that once paid well-there will never be a return to the days when workers of every type could always rely on a pay rise? Economists such as David Blanchflower, one-time member of the Bank of England's Monetary Policy Committee, and Stephen Machin, who currently sits on the Low Pay Commission which makes recommendations on the level of the hourly minimum wage, point to the experience of the United States, which gave us the blueprint for labour market de-regulation. The real median weekly wage for full-time US employees has more or less flatlined since the 1970s, proving that pay stagnation is not beyond the realm of possibility. Indeed, the ONS reports that the UK's rate of real weekly wage growth during the same period, while remaining mostly positive, has been on a steadily downward path decade on decade, averaging 2.9 per cent per year in the 1970s and 1980s, 1.5 per cent in the 1990s, and 1.2 per cent in the 2000s, before the dramatic post-recession squeeze. So could the UK also be about to experience a period of prolonged pay anaemia, and how much should that prospect worry us? Economists reckon the key to unlocking real wage growth is faster growth in labour productivity: the value of goods and services produced in the economy for every hour worked. Employers pay their staff in relation to how productive they are. Improvement in technology and skills boosts hourly productivity over time, enabling people to earn more for any given amount of effort. This makes the rate of growth in productivity crucial to raising a country's overall standard of living. But UK labour productivity, which typically grows at an underlying trend rate of around 2 per cent per year, slumped during the recession and has barely recovered since, dragging the rate of pay growth down with it. Although there are now well over 30m people in work-one million more than the previous peak in employment in spring 2008, despite big public sector job cuts-Britain is getting around 2 per cent less out of each hour worked than we did six years ago (and a whopping 16 per cent less than we would have managed if productivity had continued to increase at the pre-recession rate). This outcome, labelled the productivity puzzle, has had economists scratching their heads. The major recessions of the 1980s and 1990s saw no sustained fall in productivity; indeed both productivity and pay growth were strong. Pay analysts Incomes Data Services, in a study for the Trade Union Congress, suggest that a solution to the puzzle could lie in the fact that the recession hit output and jobs hardest in highly productive sectors like manufacturing and financial services, with subsequent job creation heavily weighted to low productivity private service sector activities, such as fast food outlets. At the outset of the recovery, the depressing effect of this shift in the employment mix on average weekly pay was compounded by a preponderance of part-time jobs in these job creating sectors. However, the fall in productivity and pay has been generic, affecting most sectors, which suggests a more deep-seated cause. Some commentators attribute falling productivity and pay to the particular impact of the global financial crisis that triggered the recession. This for a time both demolished economic confidence and cut the easy availability of credit, especially to small firms and start-ups, so businesses became less willing or able to invest in new kit or staff training. If a dearth of what JM Keynes once famously called the animal spirits lies at the root of the productivity puzzle, then a sustained resurgence in UK business confidence of the kind seen over the past year-enough to trigger a double digit increase in business investment-should at some point kickstart productivity growth. This is one reason why many economic forecasters are optimistic about the outlook for pay as well. Yet it nonetheless remains puzzling that the private sector has created so many new jobs in an economy until recently stuck in the confidence doldrums. In previous major recessions the practice of UK PLC has been to maintain productivity and pay by slashing jobs, increasing the workload on those remaining in work and causing unemployment to soar. The fact that this is the exact opposite of what's happened in recent years suggests that some change in the operation of the labour market also helps explain the current weakness of pay and maybe holds a clue to the future of pay. Long gone is the British labour problem, evident in the 1960s, 1970s and early 1980s, when wage settlements sky-rocketed even when unemployment was high. Trade unions were fingered then as the main culprits, along with onerous employment regulations and a welfare system that meant for many people a life on benefits was preferable to a low-paid job. Whether this is an accurate depiction of the causes of UK unemployment a generation ago remains a matter of debate. But the policy prescription that followed from it, notably placing strict curbs on the activities of trade unions, reducing red tape and introducing increasingly tough welfare-to-work measures, has transformed Britain's employment and pay landscape, the introduction of the national minimum wage in 1999 being the only significant deviation from the general direction of travel. Insofar as the primary objective of the British flexible labour market model has been to curb the economic and social pain of unemployment, it can be said to have proved spectacularly successful. As two of Britain's leading labour market economists Paul Gregg and Stephen Machin outlined in a report published by the Resolution Foundation, a think tank, far less unemployment is now needed to bear down on inflationary wage and price pressures. The broad consensus is that a rate of unemployment consistent with stable inflation has halved in the past 30 years-down from 10 per cent of the workforce to around 5 per cent at the outset of the recession-with some economists speculating that the figure could be even lower. The improvement in labour market flexibility explains why unemployment has peaked at a successively lower rate following each of the major recessions since the 1980s (around 12 per cent in the latter decade, around 10 per cent in the 1990s and 8.5 per cent in this decade). But it also means that unemployment now has to fall to a really low level before pay starts to rise noticeably again. If the unemployment rate has to fall below 5 per cent to trigger higher inflation, it shouldn't be too surprising that the fall in unemployment from the most recent peak of 8.5 per cent (2.71m) in autumn 2011 to 6 per cent (1.97m) in summer 2014 has not resulted in rising pay pressure, especially when one accounts for the corresponding weakness of labour productivity. A flexible labour market that favours jobs over pay during tough times is clearly preferable to one that results in the economic and social pain of mass unemployment. Better still, if the economic recovery is sustained long enough to combine a continued fall in unemployment with strengthening productivity growth, we could be on the verge of the kind of labour market scenario George Osborne must dream of: full employment and rising real living standards. However, this positive picture doesn't necessarily translate into an equally rosy outlook for pay. One reason, as research by John van Reenan, Director of the **Centre for Economic Performance** at the London School of Economics, has shown, is that even when productivity rises employers are nowadays more likely to improve non-wage elements of reward packages-which include contributions to staff pensions and health insurance, plus employers' national insurance contributions-at the expense of pay increases. The Treasury calculates that the proportion of total employee compensation in the UK represented by non-wage elements increased from 13 per cent to more than 17 per cent in the decade to 2010. The trend is likely to have continued, especially because of the effect of the major auto-enrolment pension reform. This began in 2012 and requires employers to contribute at least a statutory minimum percentage of earnings to the pension schemes of employees who remain enrolled. More fundamental still is the effect of widening pay inequality. The Bank of England's Haldane notes that Britain's employment structure has been hollowed out in recent decades under the influence of technological change and intense global market competition. Routine blue collar and white collar jobs continue to disappear, replaced by a mix of high-skilled knowledge jobs, found in most sectors, and low skilled jobs in fast expanding personalised services sectors. But whereas growing demand for people with higher level knowledge and skills is generally outstripping a growing supply, causing pay to rise at the top of the earnings league, there is an excess supply of people seeking work in routine jobs or less skilled jobs. This keeps the lid on pay at the middle and lower reaches of the league. Consequently, real wages for the top 10 per cent of earners are currently 20 per cent higher than in the late 1990s, and those for the bottom 20 per cent of earners about the same.Despite year-on-year increases in the supply of knowledge skills, with robotics and digital technology continuing to cut a swathe through routine jobs, more low-skilled people being shunted off welfare to look for jobs, and growing numbers of women, older people and migrants seeking whatever jobs they can find, there is little sign of this trend abating. So even if we see a return to full employment, stronger productivity growth and low stable inflation, it's likely that the star players, rather than the middle ranked workers and those below them in the pecking order, will continue to grab the biggest slice of the pay pie. This would be enough to boost the mean average measure of real wage growth, which is pulled up by pay hikes for high fliers, thereby fulfilling the expectations of optimistic forecasters, but have less if any impact on growth at or below the real median wage, which might be a better guide to the underlying economic feel-good factor. Should it worry us that our flexible labour market is proving better at potentially creating jobs for all than giving a pay rise to all? After all, the UK's "jobs rich, wage poor" recovery has already gained sufficient momentum to enable our economic growth rate to outpace that of most other developed countries this year. Moreover, the US remains the world's richest economy, despite having a similarly hollowed out jobs market and experiencing decades of median wage stagnation.However, many remain uneasy that although the minimum wage protects around a million UK employees from even greater downward pressure on pay, 15 years after its introduction, one-in-five employees (five million) earns less than two-thirds of median hourly earnings, placing Britain second behind the US in the OECD league table of low-wage economies. The 700,000 or so people employed on "zero-hours" contracts can't even rely on the minimum wage at times when their bosses keep them on standby without work. Just as US commentators lament the demise of the American Dream of a generalised rise in prosperity, British angst is fuelled by widespread income insecurity and especially the prospect of many young people never being able to earn enough to get a foot on the housing ladder.Yet it's not only workers who'd like a bit more oomph in pay. Meagre pay growth curbs the beneficial impact of the economic recovery on the Treasury's efforts to cut the fiscal deficit. Robert Chote, Chairman of the Office for Budget Responsibility, recently drew attention to the paucity of tax revenue from the jobs boom; too many new jobs don't pay above the current £10,000 annual personal tax allowance, a particular issue when it comes to the self-employed, whose share of total employment has soared from 13 per cent to 15 per cent since the start of the recession. Chote might have added that such jobs are expensive. With low pay now a bigger cause of poverty than worklessness, many households rely on tax credits to top up their earnings to a de facto living wage, which amounts to an implicit taxpayer subsidy to low-wage employers. Most worryingly of all, chronic pay anaemia could harm sustainable economic growth: in the short-term by limiting household spending power and in the long-run by employers become so hooked on cheap labour that they invest less in technology and skills. The latter scenario raises the spectre of perennially low investment, and of a labour intensive UK economy with endemically slow growth in both productivity and pay. It is the bleakest version of what's sometimes called the post-recession economic new normal. This would be a Dorian Gray economy, the admired façade of full employment hiding a less than perfect reality. In view of all this, it's not surprising that there are calls for a hike in the minimum wage, or the restoration of yesteryear's trade union rights to change the momentum on pay. But there's little sign of radical action any time soon, not least because mainstream politicians of every stripe are wary of being seen as putting jobs at risk. The Labour Party's pledge to raise the hourly minimum wage from £6 today to £8 in 2020 if returned to power may be the most ambitious currently on offer, but it's hardly radical. Britain's flexible labour market model has been a generation in the making and for the time being appears ideologically resistant to a fundamental overhaul. While the Big Squeeze on pay may soon be over, the future of pay remains an open question.

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