CENTRE for ECONOMIC PERFORMANCE

CEP REAL WAGES UPDATE – December 2014

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UK real wages: a long way to go

Prospects for a boost in the real wages of UK workers remain bleak, despite some commentators still continuing to paint a more optimistic picture. This report, the latest in a new series of *CEP Real Wages Updates*, notes that the most recent wage numbers (for the year to October 2014) show signs of a small pick-up – to nominal growth of 1.4%. But the main reason why the real wage position looks a little better than previously is because price inflation has been falling.

Nominal wage growth is still weak and its future outlook does not look rosy. Placed in the context of how much real wages have fallen, the tiny 0.1% real pick-up contributes essentially nothing to generate a return to where wages were in real terms prior to the fall. The reality remains there is still a long way to go.

In addition, the report:

- Discusses the shortcomings of some of the available wage statistics (pointing out that their coverage is not as representative as should be expected), and considers the implications of this for the overall picture.
- Notes that recent falls in unemployment have fed through to wages only slowly, and argues that given the extent of labour market slack, this may still take some time.
- Documents the weakness of UK real wage growth compared with other countries.
- Sets the findings in the context of current policy discussions about real wages.

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UK real wages: a long way to go

Prospects for a major boost in the real wages of UK workers remain bleak, despite some commentators still continuing to paint a more optimistic picture. While the most recent wage numbers (for the year to October 2014) show signs of a small pick-up, the main reason why the real wage position looks a little better than previously is because price inflation has been falling.

But nominal wage growth is weak and its future outlook does not look rosy. Placed in the context of how much real wages have fallen, the tiny 0.1% real pick-up contributes essentially nothing to generate a return to where wages and earnings were in real terms prior to the fall. The reality remains there is still a long way to go.

Wage statistics from the Annual Survey of Hours and Earnings (ASHE), which is a sample of National Insurance numbers, were released in November for the year to April 2014. The headline numbers do not make good reading – and they stand in stark contrast with the numbers from a year ago that the government greeted with such delight, saying they showed that the crisis in living standards was over.

For the financial year 2014 (with last year's numbers in parentheses), median annual earnings for all workers grew by 0.9% (1.6%); median weekly earnings grew by 0.6% (2.3%); median hourly earnings grew by 0.2% (2.7%) and mean hourly earnings fell by 0.1% (1.9%). Consumer price inflation in the year to April 2014 was 1.7%, so real earnings growth was -0.8% (median annual), -1.1% (median weekly), -1.5% (median hourly) and -1.6% (mean hourly).

Moreover, the growth rates of private sector earnings also slowed sharply. Median gross annual earnings in the private sector were up 0.8% compared with 2.2% a year ago. Mean weekly earnings in the private sector were down 0.2% in 2014 compared with going up 2.5% in 2013. Median hourly earnings of part-timers were up 1.1% whereas for full-timers they were up only 0.2%.

With price inflation of 1.7%, these correspond to real wage falls. It is because price inflation is coming down, not because nominal wage growth is growing any faster, that the real wage position is not even more drastic. Indeed, this generates a further worry: if prices continue to fall, then firms may well lower their wage offers to reflect changes in the prices of their goods. Deflation is not likely to be good for workers as firms' ability to pay diminishes.

These numbers reinforce the picture of falling real wages that our previous reports have highlighted (Blanchflower and Machin, 2014a, 2014b). Charts 1 and 2 show the most recent numbers on the change in average weekly earnings (AWE), the UK's national statistic on pay, published monthly in the *Labour Market Statistics* release, and from the quarterly Labour Force Survey (LFS), a random sample of employees.

They confirm the weak real wage growth position. Interestingly, it appears that the fall in earnings is even greater in the LFS than in the AWE, which may be explained by the former's broader coverage of workers in small firms.[1]

[1] Note also that despite the fact that the ONS believes the median is the most appropriate measure of wages (because it is not influenced by outliers), an ONS spokesman told us that raw AWE data do not include a distribution of earnings. Due to the nature of the data collected, 'it is not possible to produce medians from the AWE'.

Coverage of workers by firm size in wage statistics

The Office for National Statistics (ONS) has provided us with ASHE wage numbers broken down by firm size. This is of particular interest because the AWE excludes workers in firms of under 20 employees and is then adjusted retrospectively based on the ASHE findings. It turns out that this is important because recently wages in the smallest workplaces have grown by less than elsewhere.

Table 1 shows that median gross weekly earnings of all employees – noting that the median is the preferred ONS measure – in 2014 grew overall by 0.6% but in the smallest firms of under 20 workers, they ***fell*** by a huge 2.8%. Last year there was little difference with the overall number of 2.3% compared to 2.0% for firms with fewer than 20 workers. In 2013, mean weekly earnings for all employees for the smallest firms grew at the same rate, 2.0% as overall; this year the overall growth rate of -0.1% compared with a ***drop*** of 1.9% in firms with fewer than 20 workers.

Thus the AWE is biased upwards and the 2014 numbers will probably have to be revised down in light of this new evidence. The UK Statistics Authority, which monitors the ONS, is currently undertaking an inquiry into the wage and earnings data and seems likely to conclude that they are fundamentally flawed.

What has happened since April 2014? If we look at the AWE, we see that total pay in April 2014 was £482 compared with £483 in October. According to the LFS, median weekly earnings were £480 in the first quarter of 2014, £481 in the second quarter and £481 in the third quarter. There is no evidence from either survey of any major wage pick-up.

Moreover, the ONS experimental new whole economy Index of Labour Costs per Hour (ILCH) increased by 1.3% in the third quarter of 2014 compared with the same quarter of 2013. And the most recent REC/KPMG jobs report showed that permanent staff salaries increased in October at the weakest rate since February, while temporary/contract staff pay growth eased to a five-month low (REC/KPMG, 2014).

This is entirely consistent with the most recent Bank of England Agents' December 2014 report, with pay settlements remaining modest and with 40% of firms anticipating upward pressure on pay bills (so that 60% do not) (Bank of England, 2014a). On the former, in the latest *Inflation Report*, the Monetary Policy Committee (MPC) reported that pay settlements were 2.1% in the first two quarters of 2014 and 2.2% in the third quarter (Bank of England, 2014b). In that report, the majority view of the MPC (that of seven of the nine members) was that 'Recent signs of a pick-up in wage growth were promising. But, as yet, pay growth was only roughly in line with, rather than in excess of, productivity growth.'

Falling unemployment

The unemployment rate (for those aged 16 and over) has come down from its peak of 8.6% in September 2011 to 6.0% by October 2014. Chart 3 plots ASHE median real earnings from April each year against the corresponding (March-May) unemployment rate between 1979 and

2014.[2] Unlike the recessionary periods of the early 1980s and 1990s, when real wages grew as unemployment came down, it is clear that this has just not happened this time. Median real wages have actually dropped a little as the unemployment rate has come down from its peak during the last downturn.

Why might this be? First of all, some wage growth is likely to come in due course from the unemployment fall, as research suggests that wage growth tends to respond to lagged changes in unemployment (see, for example, Gregg et al, 2014). But the obvious explanation is that there is more labour market slack than the unemployment rate suggests, a phenomenon that is different from the past (Bell and Blanchflower, 2014).

In the LFS, workers report whether they would like different hours from those they are currently working, at the going wage. This makes it possible to sum up the total number of hours of those who say they want fewer hours as well as those who want more.

In the period from 2000 to 2008, the two series were approximately equal. Since then, the number saying they want fewer hours has remained broadly flat, while the number saying they want more hours has risen sharply. A good proportion of these workers are part-time who say they want full-time jobs, but approximately a third are in full-time jobs. Those who say they are underemployed are disproportionately, young, self-employed and of short tenure. Older workers on average say they want fewer hours.

In the latest data we have, for the second quarter of 2014, the underemployment rate is approximately 8%. This puts the extra desired hours into unemployment terms; the decline in the underemployment rate has been slower than the decline in the unemployment rate. The 8% is made up of 6.2% unemployed and the equivalent of a further 1.8% translated from underemployed hours.

This substantial labour market slack continues to push down on wages. One possibility is that the relationship between wage growth and the underemployment rate – the so-called wage curve (Blanchflower and Oswald, 1994) – is highly non-linear.

Chart 4 shows an illustration of this: there is little impact on wage growth for a decline in the underemployment rate from 9% to 8% or even as low as 5%; wage growth remains steady at 1%. Once the unemployment rate reaches somewhere close to full employment – say when the underemployment gap has closed, below 5% – then and only then is there a rise in wage growth, working through a conventional wage curve. In these stylised circumstances, a drop in the underemployment rate from 8% to 5% has no impact on wage growth.

The international picture

Chart 5 shows that the UK's international relative position on real wage growth between 2010 and 2013 is not promising either. For comparable data, real hourly wages fell by 6.4% in the UK. This is well below the euro area average of slightly negative real wage growth and the OECD average of slightly positive real wage growth. Out of 26 countries, the UK is in 22nd

[2] Wages are deflated by the ONS backdated CPI series, hence the reason why the early 1980s recession is included. A similar pattern (in qualitative terms, although magnitudes differ a little) is seen if RPI is used as the deflator.

position, with only Spain, Portugal (at -7.2% and -7.3%), Ireland (-9.2%) and Greece (-26.0%) faring worse.

Thus, UK workers' real wages are dropping significantly relative to those in other labour markets. Since May 2010, for example, UK real wages have significantly fallen, whereas in the United States they have remained roughly flat.

Conclusion

In its latest *Inflation Report*, the MPC predicts that wage growth will be 3.25% in 2015 and 3.75% in 2016 (Bank of England, 2014b). At the MPC meeting held on 3/4 December 2014, two members – Ian McCafferty and Martin Weale – voted for rate rises. In the minutes of the meeting, they argued, as they did at the previous meeting, that 'survey evidence of a tightening in the labour market suggested that wage growth might pick up sharply as slack was absorbed. Indeed, the most recent data regarding private sector average weekly earnings raised the possibility that this process was already in train.'

Our reading of the wage growth position and the scope for a significant wage boost to come is different. Any real wage pick-up so far is tiny and more to do with falling prices than to do with rising wages.

In a capitalist economy, there will always be skill shortages as firms die and new ones (with better technology) are born, and there will be shortages of workers with new skills for the new technology. If there were skill shortages, this should be reflected in the price of labour: if the going price of an engineer is £50,000 and the job is advertised at £30,000, there may well be a shortage of applicants. If there was a real shortage, we would observe offers of £60,000 and higher – and we simply are not seeing this.

In any case the distribution of wages is highly skewed – it is log-linear with a long right-hand tail – and a mean of 1% can be consistent with a few workers obtaining large wage gains (like 10 or 20%), while others receive zero (or less). The scale of any wage pick-up so far is miniscule and, when (as it should be) it is placed in the context of how much real wages have fallen, the reality is that the current wage growth position means *there remains a long way to go*.

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Further reading

Bank of England (2014a) 'Agent's Summary of Business Conditions, December 2014', http://www.bankofengland.co.uk/publications/Documents/agentssummary/2014/agsum14dec.pdf

Bank of England (2014b) *Inflation Report*, November 2014, http://www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14nov.pdf

Bell, David and David Blanchflower (2014) 'Labour Market Slack in the UK', *National Institute Economic Review* 229: F4-11.

Blanchflower, David and Stephen Machin (2014a) 'Falling Real Wages in the UK', http://www.voxeu.org/article/falling-real-wages-uk

Blanchflower, David and Stephen Machin (2014b) 'Real Wages Continue to Fall in the UK', http://www.voxeu.org/article/real-wages-continue-fall-uk

Blanchflower, David and Andrew Oswald (1994) *The Wage Curve*, MIT Press.

Gregg, Paul, Stephen Machin and Marina Fernandez-Salgado (2014) 'Real Wages and Unemployment in the Big Squeeze', *Economic Journal* 124: 408-32.

Recruitment and Employment Confederation (REC) and KPMG Report on Jobs, December 2014, https://www.rec.uk.com/news-and-policy/press-releases/reckpmg-report-on-jobs-placements-rise-further,-but-rate-of-growth-slows-again-amid-candidate-shortages.

Table 1: ASHE earnings growth by firm size

	All firm sizes	Under 20 workers
2012		
Median gross weekly earnings	1.5%	1.0%
Mean gross weekly earnings	0.8%	0.0%
2013		
Median gross weekly earnings	2.3%	2.0%
Mean gross weekly earnings	2.0%	2.0%
2014		
Median gross weekly earnings	0.6%	-2.8%
Mean gross weekly earnings	-0.1%	-1.9%

Chart 1:
Three-month nominal AWE, CPI and RPI growth

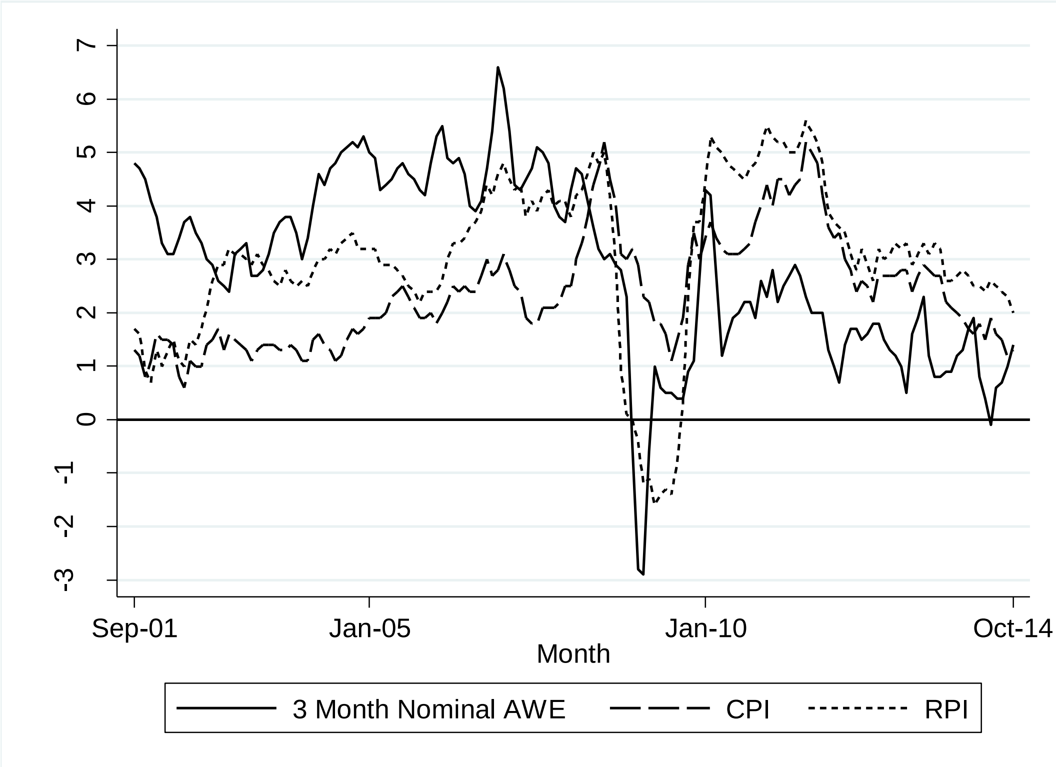


Chart 2:
LFS annual weekly nominal earnings growth

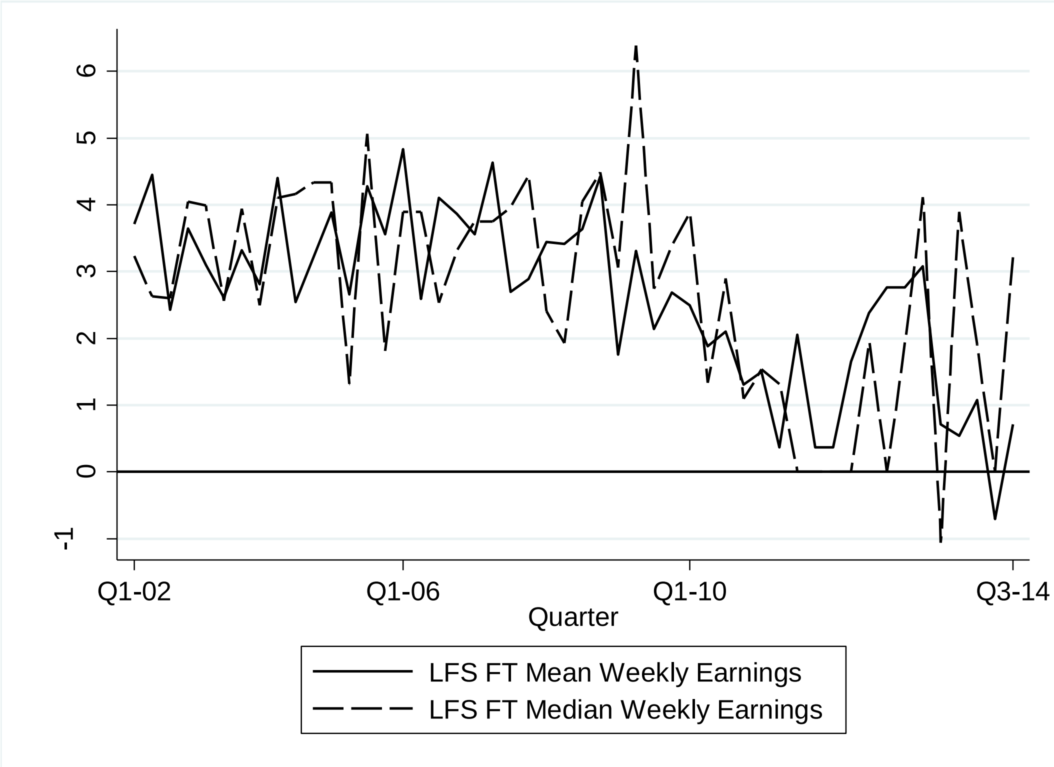
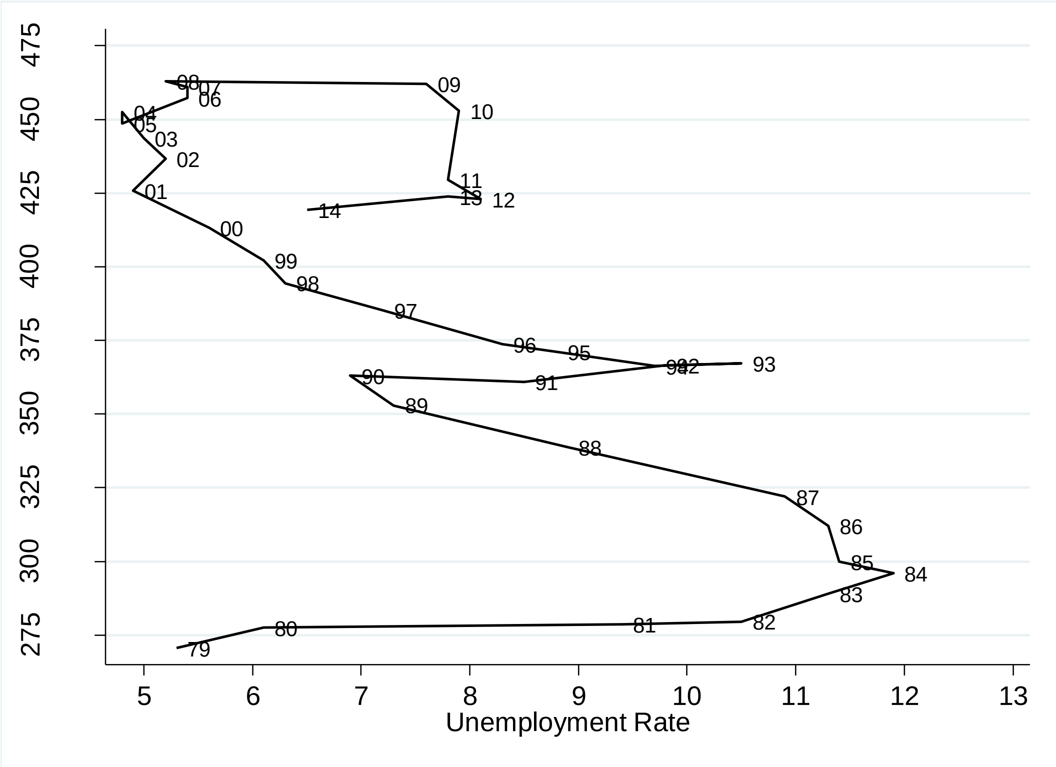


Chart 3:
Median real wages and the unemployment rate, 1979-2014



Notes: Median wages from ASHE, ILO unemployment rates from ONS.

Chart 4:
Example of a non-linear wage curve

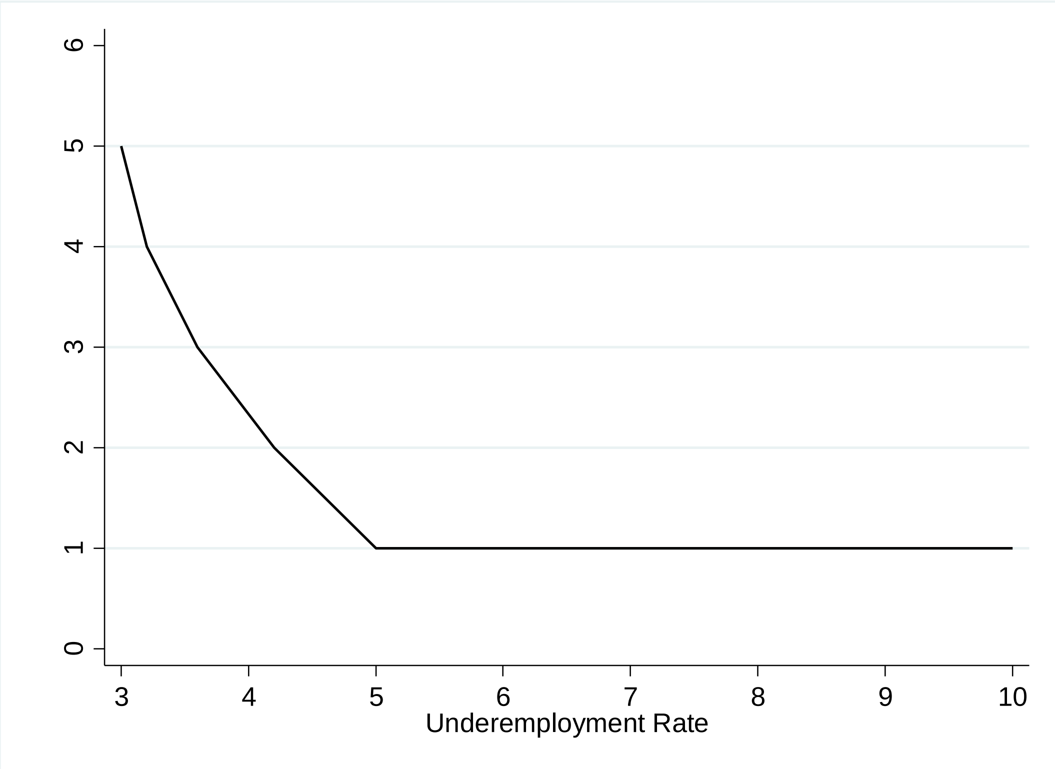
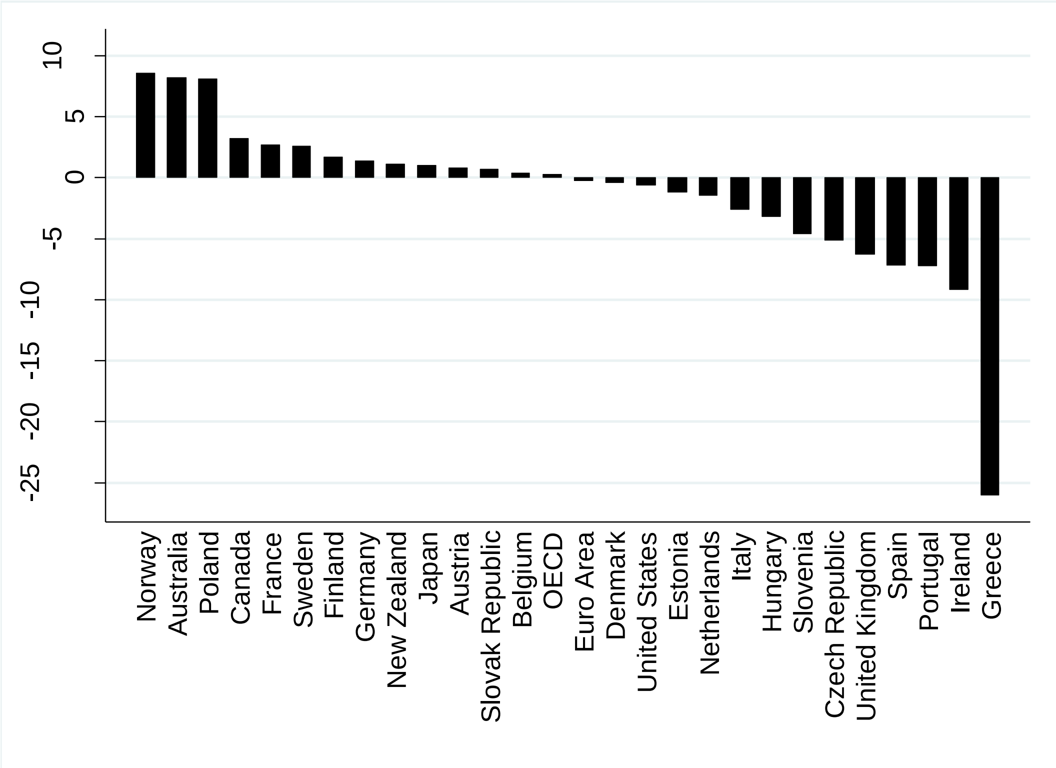


Chart 5:
International real hourly earnings growth, 2010-13



Notes: From OECD Employment Outlook, 2014.