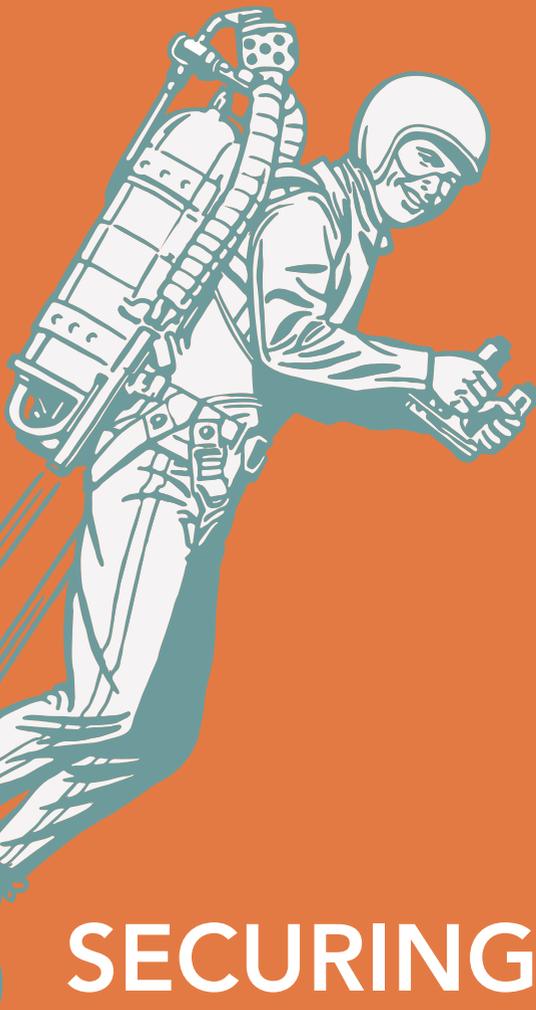


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BARONESS ALISON WOLF  
SIMON WREN-LEWIS



# SECURING A PAY RISE

THE PATH BACK TO  
SHARED WAGE GROWTH

EDITED BY GAVIN KELLY AND CONOR D'ARCY

Securing a pay rise:  
the path back to  
shared wage growth

Edited by Gavin Kelly and Conor D'Arcy



**The Resolution Foundation is an independent and  
award-winning think-tank that works to improve  
the living standards of those in Britain on  
low to middle incomes**

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2 Queen Anne's Gate,  
London SW1H 9AA.  
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# Biographies

**Gavin Kelly** is Chief Executive of the Resolution Foundation

**Matthew Whittaker** is Chief Economist of the Resolution Foundation

**Abigail McKnight** is Senior Research Fellow at the Centre for Analysis of Social Exclusion at the London School of Economics

**Laura Gardiner** is Senior Research and Policy Analyst at the Resolution Foundation

**John Van Reenen** is Professor in the Department of Economics and Director of the Centre for Economic Performance at the London School of Economics

**Andrew Smithers** is founder of Smithers & Co., a Financial Times blogger and author of *The Road to Recovery: How and Why Economic Policy Must Change*

**Baroness Alison Wolf** is Professor of Public Sector Management at King's College London and author of the Wolf Review of vocational education

**Stephen Machin** is Professor of Economics at University College London and Research Director of the Centre for Economic Performance at the London School of Economics

**Alan Manning** is Professor of Economics in the Department of Economics and Director of the Community Programme at the Centre for Economic Performance at the London School of Economics

**Simon Wren-Lewis** is Professor of Economic Policy, Blavatnik School of Government, Oxford University and a Fellow of Merton College, Oxford University

**Jared Bernstein** is Senior Fellow at the Center on Budget and Policy Priorities and former Chief Economist and Economic Adviser to Vice President Joseph Biden

**Chris Giles** is Economics Editor of the Financial Times

**Paul Gregg** is Professor of Economic and Social Policy and Director of the Centre for the Analysis of Social Policy at the University of Bath

**Susan Harkness** is Reader in Social Policy at the Centre for the Analysis of Social Policy at the University of Bath

**John Hawksworth** is Chief UK Economist at PwC and editor of its Economic Outlook publications

**Professor Sir George Bain** is the first chair of the Low Pay Commission and former President and Vice-Chancellor of Queen's University Belfast

**Conor D'Arcy** is Policy Analyst at the Resolution Foundation

**Arindrajit Dube** is Associate Professor, Department of Economics at the University of Massachusetts Amherst

**John Philpott** is Director of The Jobs Economist consultancy

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The views of each contributor do not necessarily reflect those of the Resolution Foundation.

# Rise, slowdown, collapse: what next for wage growth?

The theme of this book is very much rooted in the present. Ten years ago, worrying about securing steady wage growth would have felt irrelevant. Five years ago, with pay starting to plummet and the economy tanking, it would have been indulgent. Even five months ago it might have felt premature. But now, in spring 2015, with an election imminent and the economy steadily improving, it's the right time to both look back – in order to understand what really happened – and cast forward.

Given the unprecedented depth of the wage squeeze of recent years, it is natural that the still-modest signs of improvement emerging in the last few months of data have been met with a collective sigh of relief.

**B**ut there is little certainty about what happens next. In contrast to previous downturns, there's been no period of accelerated catch-up growth. Productivity remains on the floor. And there are plenty of underlying forces – from automation, to globalisation, financialisation and demography – generating pessimism about our pay prospects.

Yet the case for wage-gloom can be overdone. After all, it wasn't so long ago that growth of 2 per cent was the norm across the earnings distribution. And the persistent pay falls of recent times have played a key role in supporting employment. The UK jobs market has demonstrated remarkable resilience and, with investment picking up and unemployment tumbling to levels last seen pre-crisis, there will inevitably be a more positive wage response at some point. The question is: how big, secure and widely shared will it be?

### **The rise and fall of wages: how did we get where we are?**

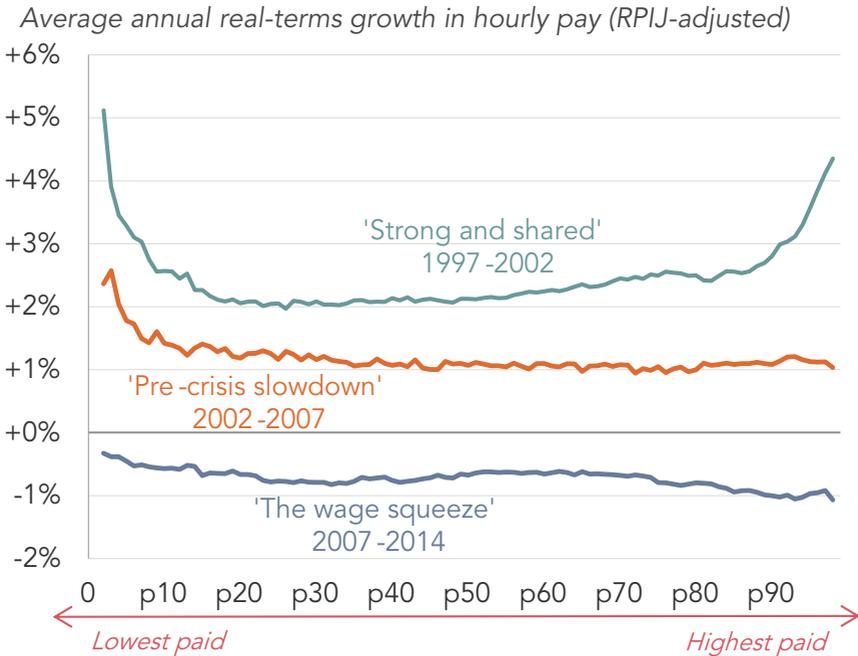
Before considering future possibilities, we must first take stock of what we've been through. Back in June 2010, the fledgling Office for Budget Responsibility projected that average wages would be around 6.5 per cent higher in real terms by 2015. In practice, they've fallen sharply. To say our labour market didn't perform as expected is something of an understatement.

To put this in perspective, consider the three distinct phases of wage growth over recent years (as shown in Figure 1). In the late 1990s and early 2000s, as the economy boomed and the minimum wage was brought in, hourly wages grew strongly in real terms across the earnings distribution. Those at the top and bottom fared best of all, but strong and shared growth was sustained over a number of years.

*During the post-crisis pay squeeze, average hourly earnings fell by just under 1 per cent a year*

But in the half-decade before the financial crisis hit, pay growth slowed down, averaging just 1 per cent a year in most parts of the distribution. Important trends that have been amplified through the downturn started to emerge, with men and the young facing the sharpest decelerations. During this period, unemployment's long march downward stalled and even started to reverse. And non-wage labour costs rose (with employer pension and National Insurance contributions rising rapidly), increasing the wedge between pay and overall compensation.

Yet this era of stagnant growth appears positively healthy in comparison with what followed. During the post-crisis pay squeeze, average hourly earnings fell by just under 1 per cent a year – and high-, middle- and low-earners were all hit in roughly equal measure.

**Figure 1: Strong, weak, falling: the story of wages, 1997-2014**

Notes: Figures for 2014 are based on reported changes in pay between 2013 and 2014 at selected percentiles. All other years cover the full distribution, though we truncate to remove extremes. Data refers to pay in April of each year.

Source: Annual Survey of Hours and Earnings, ONS

But look under the surface and it's clear that, despite this relative uniformity across the earnings distribution, the squeeze has been tighter for some than for others. As Figure 2 shows, male median pay fell by nearly 11 per cent between 2009 and 2014 compared to 7.6 per cent for women. The gender pay gap has narrowed, but not in the way we'd have wanted. Younger people have been hit even harder, with an eye-watering cumulative fall in median pay of nearly 13 per cent over just five years for workers in their twenties. Combined with pre-crisis stagnation, this means that hourly pay for 22-29 year-olds is now lower than at any time since 1998.

And if we look at weekly earnings – more relevant to the ultimate question of changing living standards – the falls are even steeper. Remarkably, typical earnings on this measure are lower than they were in 1997 for both younger workers and men.

**Figure 2: Divergent experiences of the great pay squeeze, 2009-2014**

Cumulative change in real-terms median pay 2009-2014  
(RPIJ-adjusted)



Source: Annual Survey of Hours and Earnings, ONS

Another contrast is between those who have remained continually in work over recent years and those who have had spells of unemployment, with the latter experiencing far bigger wage losses. However it's not true, as is often claimed, that those who continually stayed in work have been spared pay-pain. As McKnight and Gardiner show in the next chapter, more than half of those staying in the same job have experienced year-on-year freezes or falls.

Pay restraint in the public sector has been especially visible. Set alongside falling pay in the private sector, there has been relatively little change in the ratio of one to the other to date. But the divide will widen in the coming years. As Hawksworth points out, recovery in private sector pay will be highly challenging for planned pay control in the public sector.

### **Finding our way back: a far-reaching policy agenda**

Quite how these differing experiences play out during a period of wage recovery remains unclear. But we can be sure of three things. First, it's going to take a long time for wages to get back to where they were before the crisis (don't be expecting this much before the end of the decade). Second, some groups, such as young people, have lost so much ground that the fallout will shape our economy and society for decades to come. And third, the underlying problems that were in evidence before the crisis haven't gone away. The cyclical storm may be passing, but the structural shortcomings of low investment, weak productivity vis-à-vis competitors, poor use of skills in the workplace and pervasive low pay in large sectors remain. Indeed, they are likely to be deeper.

It is these three themes – securing wage recovery and steady growth, sharing that growth widely, and dealing with new and old structural issues in the UK labour market – that the essays in this collection attempt to address.

*No-one should delude themselves that all our investment problems are going to be easily self-correcting*

The ideas range from the macro to the micro, but many of the authors highlight the primacy of productivity growth. After all, there is no world in which wages can persistently outstrip it. Remedying this, as Van Reenen points out, rests on boosting public and private sector investment. On the public side, government must recognise the importance of infrastructure and back-up rhetoric with fiscal action; on the private side, he sets out a broad plan encompassing improving the quality of management in British firms and raising the effectiveness of our financial sector. And as Smithers shows, achieving high levels of business investment is going to mean concerted (and controversial) reform to tackle a system of executive reward that currently incentivises management to inflate short-term share

price (and thereby their own remuneration) at the cost of productive investment. No-one should delude themselves that all our investment problems are going to be easily self-correcting.

Raising productivity also means improving performance in relation to education and skills – a theme running through several of the contributions. The argument made by Wolf is that, if we truly care about the earnings prospects of the next generation, we should be rebalancing public investment and support so it does much more to help those who won't progress to university. Tackling this 'degree delusion' rests in part on raising the quality – rather than quantity – of apprenticeships. This in turn will require a new funding base, hence her proposal for a hypothecated, employer-levied 'apprenticeship tax'.

*Underpinning the UK's experience is, in part, the steady shift in the balance of power away from labour*

But we can't just rely upon a skills renaissance. For all her passion on the subject, it's salutary that a leading educationalist like Wolf channels the views of US economists like Larry Summers (and Bernstein in this collection) in warning that an over-reliance on education policy to remedy our future wage challenge is 'whistling past the graveyard'.

Part of this scepticism stems from a doubt as to whether a pick-up in productivity will automatically feed through into wages across the board. As several authors point out, median pay appeared to 'decouple' from productivity in the pre-crisis years. And, as Bernstein's assessment of the far more extreme US situation reminds us, this phenomenon is unlikely to unwind itself. Underpinning the UK's experience is, in part, the steady shift in the balance of power away from labour identified by Manning – with deregulation, intensified shareholder focus and waning union influence serving to weaken the position of employees over recent decades. Ensuring the rewards associated with future productivity gains reach the pockets of all workers requires some re-tilting of this balance.

This isn't about a simple rewinding of the clock. Increased flexibility in the labour market has both advantages and disadvantages so, in seeking to bolster the position of workers, we must be careful not to undermine the dynamism that our jobs market has recently demonstrated.

*Driving unemployment down will be vital. It's not just a moral imperative in its own right, it's also a crucial wage policy for low and modest earners*

Sustaining a high level of demand in the economy is certainly a pre-condition. As far as Wren-Lewis is concerned, the current macroeconomic consensus pays too little regard to wage growth. In the face of an apparent reluctance across the political spectrum to be seen to be stoking demand

through fiscal means, he believes that more must be done on the monetary side. To counter potential impotence among central banks facing the 'zero lower bound', he proposes a debate about the use of more unconventional approaches – including the dropping of helicopter money. This is a debate that needs to happen well before the next crisis hits.

Even in more normal economic times, driving unemployment down will be vital. It's not just a moral imperative in its own right; it's also a crucial wage policy for low and modest earners. Of course, further significant increases in employment among those at the fringes of the labour market would only redouble the need to find ways of simultaneously boosting productivity. But it is undoubtedly the case that tight labour markets, in which employers chase employees, are always labour's friend; just as slack ones are its enemy. The insight, discussed by Machin, that unemployment is likely to have to fall further than expected before wage growth is going to spark represents a challenge to policy-makers.

With employment rates already relatively high among many groups, reaching full employment is likely to require boosting work rates among those who are further away from the labour market – such as some single parents and the disabled. Gregg sets out a suite of measures designed to support these groups into decent jobs. More

*Standing still – due to either a belief that all will be well or a fear that there's nothing we can do – is not a genuine option*

generally, with the downturn accelerating an underlying rebalancing of earning in many families (especially low-income ones) – with more women becoming the primary breadwinner – Harkness argues that more can, and must, be done to raise female employment.

While higher employment should ultimately boost pay growth, we need to also have regard to potential power imbalances between different groups of employees. As Giles suggests, inequities in pay, pensions and opportunities between the old and young are particularly pronounced. There is no simple fix for this, but he suggests that the public sector could lead the way by offering differential (and higher) pay settlements to the young. More broadly, Philpott argues that the emergence of a British version of a dual labour market, in which those at the fringes are exposed to sharp employment practices and endemic precariousness, requires government to be prepared to crack-down on new forms of abuse as they emerge (a 'whack-a-mole' approach to policy).

Power can also be rebalanced by doing more to lift low pay. Minimum wages, by definition, can only be a very partial part of a pay strategy. But they do matter. And in the UK, after over 15 years of experience, the jury is now back in: the wage floor hasn't

cost jobs, but it has helped protect those at the bottom. As Bain and D'Arcy discuss, it's time to build on the success of the Low Pay Commission by broadening its role and remit. Rather than being restricted to agreeing the annual increment for the minimum wage, it should play a strategic part in setting out how to tackle low pay.

We should learn from abroad too. And nowhere is the debate on the potential (as well as the limits) of minimum wages more vibrant than in some big US cities, with ambitious new wage floors springing up. As Dube argues, there may well be implications for our own (relatively) high-wage, high-cost and highly-unequal cities – above all London.

### **The path back to shared wage growth**

Much of the heavy lifting on wage growth comes from getting wider economic policy right: securing strong GDP growth, rising productivity and a supportive tax and benefit system. This itself is no small task. But recent experience here and abroad suggests that establishing a benign economic backdrop, though crucial, might not suffice. We also need to tackle underlying weaknesses that have undermined the pay prospects of many groups and have loosened the link for many between overall growth and pay. With the economy picking up, and a new parliament beckoning, now is exactly the right time to consider how best to build upon nascent signs of economic and wage recovery.

The arguments set out in this collection will draw agreement and no doubt criticism too – and there is no shared manifesto across the authors. But, at their heart lies a common rejection of both sanguine and fatalistic accounts of our future wage prospects. Standing still – due to either a belief that all will be well or a fear that there's nothing we can do – is not a genuine option. The numerous, varied and ambitious policy proposals set out here offer an excellent starting point for a debate on improving the pay prospects of working people.

Abigail McKnight, London School of Economics,  
and Laura Gardiner, Resolution Foundation

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# Paying up: who's been getting pay rises, who hasn't, and will that change?

British workers may rightly feel confused about whether national pay statistics bear any relation to their own experience. Up until very recently, month after month of below-inflation growth in our most timely data has been used to paint a picture of a workforce clobbered by six straight years of falling pay. Yet based on the more robust data, published in November last year, we hear that for those full-time employees who held onto jobs, pay has typically grown faster than inflation in recent years, and rose by 4 per cent in 2014.

For the individual looking at how their pay packet has grown compared to others, it's very hard to tell whether to feel fortunate or hard done by.

While averages are extremely useful for measuring aggregate trends, they mask a variety of experiences, meaning it would never be possible to relate each individual outcome to the overall direction of travel. However, it is also the case that the public narrative has suffered from some highly inaccurate claims in relation to recent pay changes for those who've held onto jobs. The purpose of this essay is to clarify the extent and magnitude of pay rises over the course of the downturn, and point to what this can tell us about the prospects for pay rises in the coming years.<sup>1</sup>

### The extent of pay rises

Where does the confusion on the extent of pay rises stem from? Fundamentally, it relates to the mistaken interpretation of the change in median pay for employees remaining in work as being equivalent to the median change in pay. The distinction between these two statistics is subtle but significant.

The former – the change in median pay – might sound like it tells us about the typical experience of individuals. After all, it strips out the effects of people entering and exiting the workforce, and therefore isolates a group that remains the same over time. And it uses the median – comparing the 'typical' person in one year to the 'typical' person in the next – making it less sensitive to extreme changes than if the mean were used.

On this basis, it is easy to fall into the trap of thinking that the change in median pay represents the typical pay change (i.e. pay rise or pay cut) for stable employees. But it doesn't. This can only be derived by looking at the median change in pay.

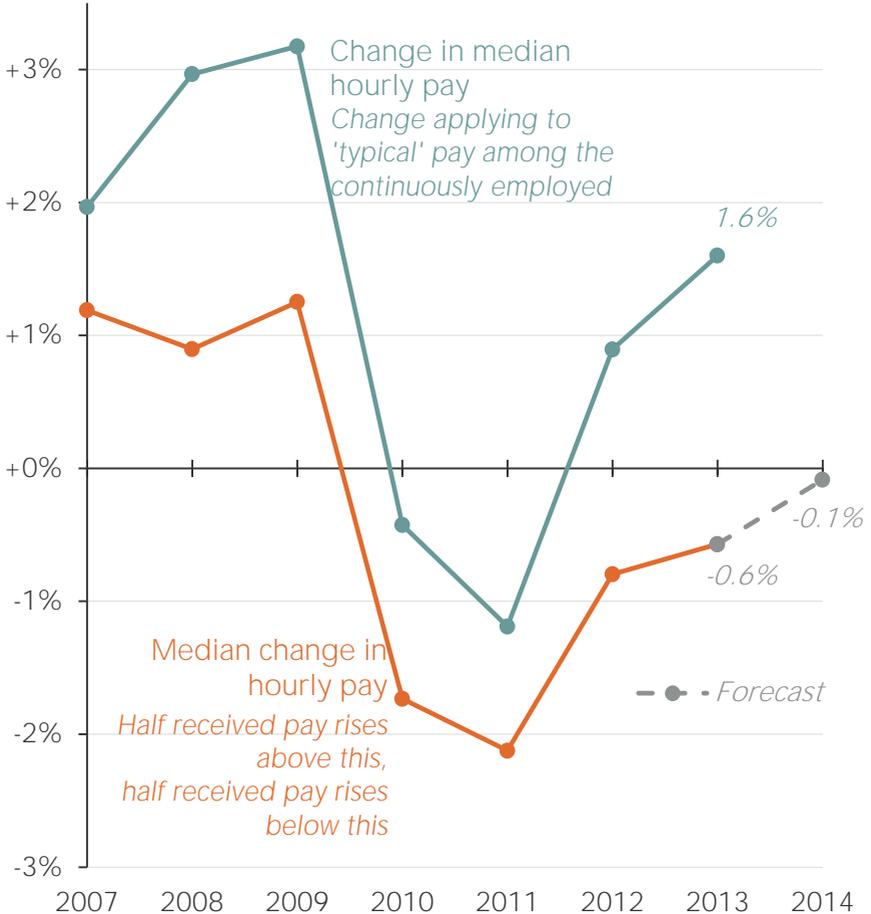
And as Figure 1 shows, the median change in pay experienced by those who remain in the same job is consistently lower than the change in the median for this group. This difference is driven by two factors. First, a minority of people receive quite big rises each year while the majority experience no or small changes. Second, pay rises are spread across the pay distribution, but are more pronounced for lower-paid workers.<sup>2</sup>

<sup>1</sup> In this essay we discuss changes in hourly pay rates, meaning that we are not capturing earnings growth that occurs when employees increase their working hours. The analysis in this essay draws on previous research published by each of the authors including: L. Gardiner, *Who's been getting a pay rise*, Resolution Foundation, March 2015; A. McKnight, *The Coalition's Record on Employment: Policy, Spending and Outcomes 2010-2015*, London School of Economics, January 2015; Confederation of British Industry (CBI), *Making Britain work for everyone: Facing up to challenges in our labour market*, July 2014; CBI, *A better off Britain: Improving lives by making growth work for everyone*, November 2014; A. McKnight, *Patterns of pay progression and employment retention 1991-2015*, London School of Economics, forthcoming

<sup>2</sup> For a fuller description of how these characteristics of pay changes cause the average to move differently to the typical change in pay for the continuously employed, see: Gardiner, 2015

**Figure 1: Pay has risen for some, but fallen for most; wage growth among the continuously employed, 2007-2014**

*Real-terms annual trends in pay for those continuously employed in the same job (CPI-adjusted)*



*Notes: Figures refer to April of each year. We forecast the median change in pay by assuming it follows the same path between 2013 and 2014 as a series published by the Office for National Statistics (ONS) showing the median change in pay in full-time positions, including people who changed jobs. For more details, see Figure 1 in: L. Gardiner, Who's been getting a pay rise, Resolution Foundation, March 2015. Source: Authors' analysis of Annual Survey of Hours and Earnings, ONS; I. Derrick, C. Taylor & P. Wales, Economic Review, March 2015, ONS, March 2015*

The implication here is that claims of above-inflation nominal pay rises averaging 4 per cent for employees who remain in work are wrong and overstated. In fact, the lower line in Figure 1 makes clear that in each year since 2010 the majority of employees actually experienced annual real pay cuts (the median real change is negative in each year). Our estimate is that, as recently as April 2014, around half of those in stable employment got a pay rise. This is an improvement on previous years – the typical experience was no real change in pay – but typical pay changes are still a way off the pre-downturn average of above 1 per cent.

### The size and incidence of pay rises

Establishing whether the typical pay change is positive or negative tells us whether the majority experienced a real pay rise or not, and gives an idea of the trend in pay rises. But although this kind of average gets us closer to individual experiences, it still conceals a great diversity of outcomes. In 2013, for example, more than one in five stable employees had a nominal pay cut. On the other hand, one in ten had a nominal pay increase above 15 per cent. This big spread in the pay rise distribution, in particular the extent and magnitude of nominal cuts, seems to hold over time. If we look at weekly pay rather than hourly the variance is even greater, as hours worked as well as pay levels can change from year to year.

In the context of this extremely broad range of pay outcomes for those who stay in their jobs, some groups fare better and some worse. For example, full-time employees generally do better. In 2013, real pay increased for 46 per cent of full-time employees compared to 39 per cent of part-time employees, a difference that has always existed but that has become slightly more marked in recent years.

Age is also a differentiating factor; more than half of stable employees aged

*Average wage levels have plummeted for younger cohorts despite the fact that the young remain more likely to get a pay rise than others*

under 35 had a real-terms annual pay increase in 2013, compared to 43 per cent of prime-age adults and 36 per cent of employees over 50. The higher likelihood of a pay rise when young is unsurprising given increases in productivity – more marked at the beginning of careers – are rewarded in pay packets. But importantly, while this pattern has held during the downturn, we shouldn't interpret it as the young getting off lightly. Hourly pay rises for young people (as for all age groups) are still far below their pre-downturn levels. And lower entry wages, reduced working hours, and a higher likelihood of moving or losing jobs (or not entering work in the first place), have hit young people in ways that don't show up when looking specifically at pay rises for

those staying put. Indeed, average wage levels have plummeted for younger cohorts despite the fact that the young remain more likely to get a pay rise than others.

For other groups, the chance of getting a pay rise for those remaining in post has been pretty even over the downturn. For example, the position of employees

*Individuals' experiences do not necessarily conform with broader changes affecting groups of employees*

in the initial wage distribution has made little difference, although the top 10 per cent highest paid were marginally less likely to see their pay increase in 2013. Experiences have been relatively similar

in different parts of the country, although Londoners are consistently slightly more likely to get a pay rise. And while the likelihood of a pay rise is higher in some industries than others, the differences are relatively small.

The one exception here is employees in the public sector. They were more likely to get a real pay rise than private sector employees over the early years of the downturn, but less likely after 2010, reflecting public sector wage restraint. However, it's worth highlighting that despite this policy context, more than one-third of public sector workers experienced real annual increases in their pay in 2013. Once again, this reminds us that individuals' experiences do not necessarily conform with broader changes affecting groups of employees.

## Securing a pay rise? Implications for pay rises in coming years

We have shown that attempts to determine average pay rises by tracking movements in average pay (even when confined to a constant group) are mistaken, and have

*Wage restraint will continue to limit pay rises for public sector employees*

overstated the extent of pay rises during the downturn. Further, we have shown that even a correct assessment of the typical annual pay rise for those who

stay in their jobs hides enormous variation in the size and direction of pay changes, and their incidence across groups. What might this varied picture tell us about the prospects for a pay rise in coming years?

First, wage restraint will continue to limit pay rises for public sector employees. The implication is that improvements in the overall pay rise position will be largely dependent on settlements in the private sector. The Prime Minister has recently called on businesses to deliver in this respect, and the consensus is that settlements will rise, although there are very different views about the likely pace of improvement. Whatever the outcome, however, it's clear that employees in different sectors of the economy will feel the effects of growth very differently.

Second, while the likelihood of a pay rise has been very even across the wage distribution over the downturn, we expect the lowest paid to fare better in coming years. This is because there are signals that the National Minimum Wage will regain some of the ground lost, having fallen for five straight years up to 2013. Indeed back in 2007, when the minimum wage was growing faster than inflation or earnings, nearly four-fifths of the lowest-paid employees (the bottom 10 per cent) got an annual pay rise, compared to around three-fifths of all employees. Pay rises for the very lowest earners are good news and the minimum wage is a crucial policy tool in this regard. However, such outcomes shouldn't detract attention from the wider challenge of ensuring that low earners can progress out of low pay. Current evidence suggests that even when aided by larger-than-average pay rises, only a minority of low-paid employees make significant progress up the earnings ladder.

Finally, there is the broader question of how far we might expect the recovery in

pay rises to go. A continuation of the recent improvements shown in Figure 1 would place us only a couple of years away from the pre-downturn position. However, a longer-term perspective reveals that the likelihood of a pay increase was falling (and the size of pay increases reducing) even in the pre-downturn years.<sup>3</sup> The challenge is therefore whether, and how, we can not only recover the ground lost during the downturn but also reverse the effects of the longer-term slowdown in pay rises. To a certain extent, this will be affected by the path that inflation takes. Beyond the impact of prices, productivity growth will be necessary, but not necessarily sufficient.<sup>4</sup> A range of policy levers, such as those outlined in this collection, could stimulate and complement such growth with the goal of bringing back the pay rises we were used to 15 years ago. Without it, our averages will continue to mask disappointing pay performance for too many.

*The challenge is whether, and how, we can not only recover the ground lost during the downturn but also reverse the effects of the longer-term slowdown in pay rises*

<sup>3</sup> I. Derrick, C. Taylor and P. Wales, *Economic Review*, March 2015, Office for National Statistics, March 2015

<sup>4</sup> Recent analysis has shown a decoupling of productivity and median pay, indicating that, when thinking about the incidence and size of future pay rises, we ought to consider productivity growth at the individual level as well as reported changes at the average. See: P. Gregg, S. Machin and M. Fernandez-Salgado, "The squeeze on real wages – and what it might take to end it", *National Institute Economic Review*, Vol 228 No 1: R3-16, May 2014

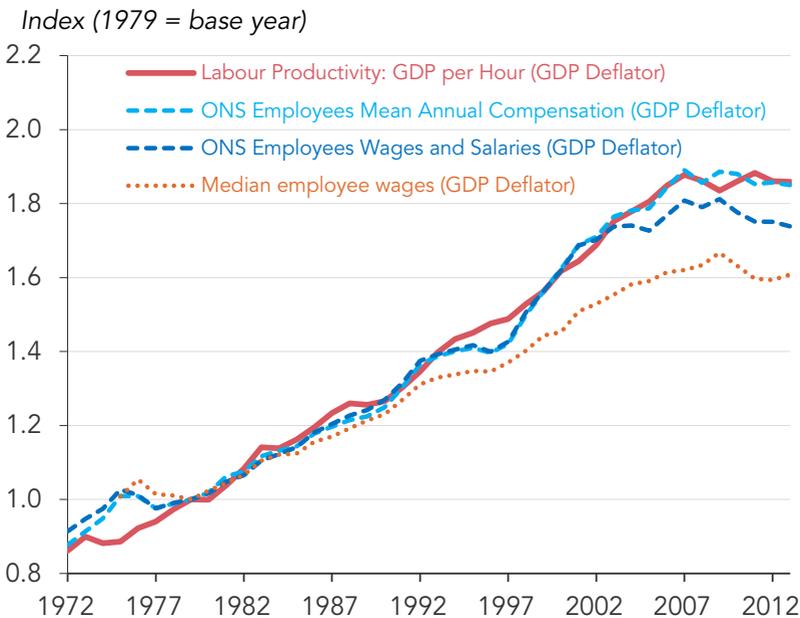
# Profiting from productivity: ensuring investment and productivity growth feed through to wages

In the long-run, countries grow wealthy and workers see their pay rise as a result of sustained productivity growth. In Britain, there continues to be a strong link between the growth of labour productivity (GDP per hour) and the growth of average worker compensation (wages, as well as non-wage labour costs like employer pension or National Insurance contributions).

Figure 1 shows that over the last 40 years there has been no ‘decoupling’ of these two trends. This is because the share of total income going to capital (that which is taken in profits) has not risen much.<sup>1</sup> This is in contrast to many other countries, like the US, where workers’ share of national income has fallen for reasons that are not well understood. Policies that focus on increasing the size of the economic pie are still, therefore, more likely to bring wage rises than battling over who can grab the biggest slice.

Yet Figure 1 also presents two more troubling recent developments. First, after many years of relative improvement, UK productivity stagnated dramatically after the global financial crisis in 2008 and is currently about 15 per cent below where we would expect on past trends.

Figure 1: The decoupling of productivity and median wages, 1972-2013



Notes: Productivity is GDP per hour, compensation and wages are annual; all values are expressed in real terms using the GDP deflator and indexed to be 1 in 1979, so a value of 2 indicates that the measure was twice as high in this year as 1979.

Source: Blue Book 2014, ONS

<sup>1</sup> J.P. Pessoa and J. Van Reenen, “Decoupling of Wage Growth and Productivity Growth? Myth and Reality”, CEP Discussion Paper 1246, January 2012

Secondly, while growth in total compensation continues to track productivity, a wedge has developed between this measure and median pay.

In part, this reflects rising employer pension costs (higher employer National Insurance contributions (NICs) have made a smaller contribution) linked to demographic changes. Rising life-expectancy and financial miscalculation has resulted in companies making insufficient provision for their pension liabilities, especially in defined benefit occupational schemes.

*An increasing fraction of productivity growth has been going towards paying for legacy pension costs*

Consequently, an increasing fraction of productivity growth has been going towards paying for legacy pension costs.

This growing gap between compensation and pay accounts for around half of the decoupling between productivity and median wages since 1972.<sup>2</sup> The other half stems from increasing wage inequality. This is mostly explained by higher returns to skills driven by technological changes such as the ICT revolution. For example, the graduate premium for full-time men rose from 39 per cent in 1980 to 56 per cent in 2011. The decline of unions also has a part to play in explaining the growth of wage inequality but research shows that neither globalisation<sup>3</sup> nor increasing CEO pay<sup>4</sup> have had a major effect on this inequality trend.

## Good policies to raise productivity and wages

If increasing workers' compensation depends on increasing GDP per hour, what can be done to improve productivity?<sup>5</sup> Although improvements in structural policies have helped reverse a century of relative economic decline, there remains a failure to invest sufficient resources effectively in infrastructure, human capital, innovation and management.

<sup>2</sup> Ibid.

<sup>3</sup> G. Michaels, A. Natraj and J. Van Reenen, "Has ICT Polarized Skill Demand? Evidence from Eleven Countries over 25 Years", *Review of Economics and Statistics*, Vol 96 No 1: 60–77, March 2014

<sup>4</sup> B. Bell and J. Van Reenen, "Extreme wage inequality: Pay at the very top", *American Economic Review Papers and Proceedings*, Vol 103 No 3: 153–157, 2013; B. Bell and J. Van Reenen, "Bankers' pay and extreme wage inequality in the UK", *Economic Journal* Vol 124 No 574: F1–F387, 2014

<sup>5</sup> The following recommendations draw upon T. Besley and J. Van Reenen, *Investing for Prosperity: Report of the LSE Growth Commission*, 2015

The UK's investment in transport, energy and housing is low by international standards. Political prevarication, policy reversals and under-funding explain much of that gap. During times of budgetary crisis for example, the fact that public investment cuts are less visible in the short run makes them more attractive to politicians: even with some reversal of austerity after 2012, public investment spending will fall by 11.9 per cent between 2010-11 and 2015-16. Going forward, fiscal plans should target balancing the cyclically adjusted current budget rather than aiming for a surplus in total budgets which may require unnecessary further squeezes on valuable public investments.

To deal with systemic problems, we need a new institutional architecture to finance and deliver national infrastructure plans. This should have independence from day-to-day political pressure, building on the successes of the Monetary

*There should be a permanent infrastructure strategy board to develop strategies based on the best evidence and expert views*

Policy Committee, the Office for Budget Responsibility and the National Institute for Health and Care Excellence. There should be a permanent infrastructure strategy board to develop strategies based on the best evidence and expert views, and a planning commission to implement these, including significant compensation for groups losing out to development. Supporting these should be an infrastructure bank which would provide stable finance, bring private sector expertise and reduce political risk.

Outdated planning regulations have helped created a housing shortage, ridiculously high housing prices in many parts of the country and retarded business growth. A way to reduce Nimbyism is to devolve powers to City-Regions who can internalise some of the benefits of economic development. The City Growth Commission has shown how this could be done practically, by allowing larger Combined Authorities to take control of large parts of their spending and tax-raising powers (for example through keeping property taxes). Some progress has been made to this end over recent years in Greater Manchester.

A big chunk of our productivity gap with countries like Germany is rooted in the failure to equip people with adequate intermediate skills. A two-pronged attack on the middle to low skilled problem is needed. First, the autonomy and accountability of the academy school system must be returned to the original emphasis on disadvantaged schools under Labour's city academy programme. Second, there must be an expansion of the apprenticeship system focused on young people rather than expanding credentials for those aged 25 and over (as the current system does).<sup>6</sup> Restoring the

<sup>6</sup> H. Steedman, "Apprenticeship policy in England: Increasing Skills versus Boosting Young People's Job Prospects", *CEP Policy Analysis*, December 2011

apprenticeship guarantee would be a first step towards such a reformed system.

There is a short-term bias in the British financial system that hampers long-run private investment and innovation. A contributing factor to this is weak competition among the large retail banks who have failed to build up relationships with innovative SMEs. There is also the continuing problem of the intermingling of investment and retail functions of banks, with the risk that they are still 'too big to fail' and focus too little attention on long-term investment. To fix our dysfunctional banking system, entry conditions should be made easier for challenger banks and the structural separation between the investment ('casino') and retail ('utility') parts of banking should be deepened. These problems have been recognised over the past seven years but existing policies appear to be making limited progress.

### *Entry conditions should be made easier for challenger banks*

Innovation would also be fostered by a greater use of equity over debt. The opportunity to write off interest payments from corporate tax liabilities biases firms

towards debt. An allowance for corporate equity would shift this bias.

Management quality in the UK lags behind that of world leaders such as the US, Germany and Japan.<sup>7</sup> Competition increases management quality so reviews of problematic industries (e.g. banking and energy) should promote this. And we should develop new trade agreements (like TTIP, the EU-US trade partnership) that help spread best practice across borders.

Distortive tax policies such as zero inheritance tax on business assets encourage the perpetuation of family firms, despite them typically having weaker management practices. More positively, the government should co-ordinate the spread of good management practices through its industrial strategy.

### **Bad policies**

Alongside doing good, we should avoid doing bad: too much current discussion focuses on policies that would be bad for productivity and so retard wage growth.

Whatever government is formed after May's election, the debate around the UK's membership of the EU is unlikely to disappear. Yet sticking with the EU is vital: reduced trade and immigration would slow productivity growth and therefore harm wages. Some estimates of the costs of exit suggest the fall in national income could be similar

<sup>7</sup> N. Bloom, R. Lemos, R. Sadun, D. Scur and J. Van Reenen, "The new empirical economics of management", *Journal of the European Economic Association*, Vol 12: 835–76, July 2014

in magnitude to those faced after the global financial crisis – a drop of over 6 per cent.<sup>8</sup>

Another set of poor policies is tinkering around with the tax system in place of principled reform. For example, we do need a land value tax on property wealth which would be good for equity and efficiency. The mansion tax is a welcome step in this direction but its focus is too narrow: we should revalue all homes (the current values are unchanged since 1991) and update taxes systematically.

Finally, there is a lot of wishful thinking. Having reasonable minimum wages and basic labour standards against exploitative employers is a mark of a civilized society and has provided a necessary floor since 1999. But as Bain and D'Arcy argue elsewhere in this collection, they will not by themselves get us back to sustained increases in median or average wages. To achieve that will require productivity growth, not just adding more business regulation. Raising the minimum wage higher and higher up in the earnings distribution will eventually cost jobs if we don't also improve productivity.

A truly progressive agenda should facilitate the ability of workers to earn a good return in the labour market and create the environment for dynamic and innovative firms to prosper.

Politicians and the public constantly look for policies to generate painless 'quick wins' on wages and productivity. Newsflash: there aren't any. Sound policies will take many years to feed through. In terms of priorities, the infrastructure proposals will have the largest effects in the long run, although the framework could be established quickly and would cost little. Reforms to skills would have a quicker impact on the labour market prospects of young people, but it will take many years for the newly skilled to replenish the stock of the low skilled. Yet these types of human capital policies are the best way to pull the median worker's wage upwards.

Productivity growth will continue to feed through into wages as it has done over the last hundred years. But ensuring this means dealing with pensions, skills and the level of demand in the economy.

<sup>8</sup> G. Ottaviano, J. Van Reenen and T. Sampson, "Brexit or Fixit? The Trade and Welfare Effects of Leaving the European Union", *CEP Policy Analysis 16*, May 2014

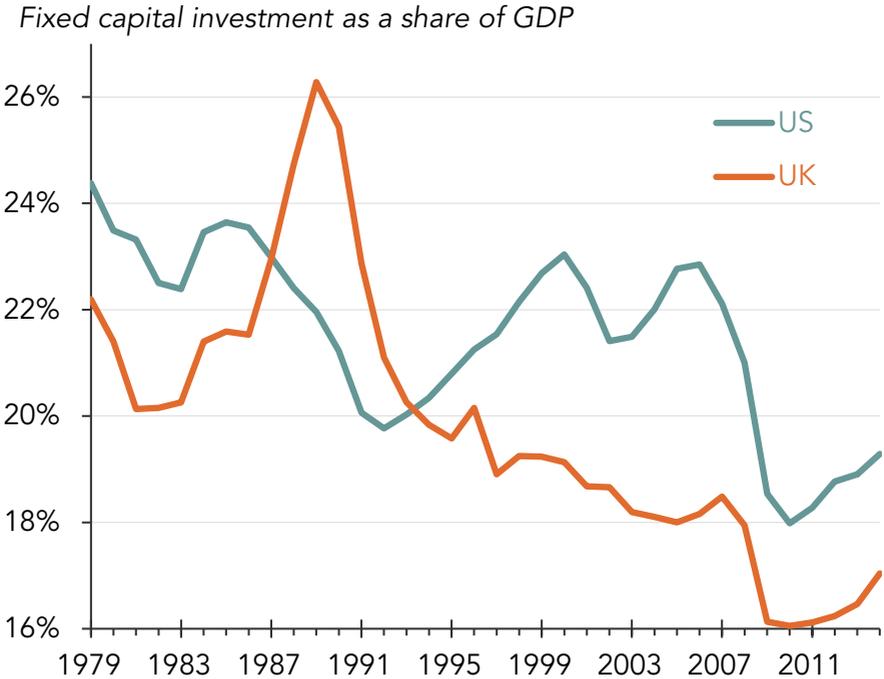
# Racing away? Correcting the damage done to wage growth by perverse management incentives

Developed economies have slowed since the financial crisis. Yet over the last two years, there have been sharp falls in unemployment in the UK and the US. Had unemployment not fallen in this way, we could blame weak growth on inadequate demand. As it is, we need to accept that the trend growth of developed economies has declined, due to two adverse changes: workforces are growing more slowly and improvements in labour productivity have stalled.

The fact that these changes occurred around the same time as the financial crisis has led many to assume, quite wrongly, that our current malaise is simply part of the aftermath.

Instead, the stagnation in real wages is largely the result of large declines in investment shown in Figure 1 that pre-date the crisis and which have damaged labour productivity. Turning around this malaise requires higher investment to get wage growth back on the agenda. To achieve this, far-reaching reform of management incentives is essential.

**Figure 1: Short sighted: the decline in investment in the UK and US, 1979-2014**



*Source: ONS; US National Income and Product Accounts, Bureau of Economic Analysis*

In contrast to the years before the financial crisis, total populations in advanced economies are now growing more rapidly than the number of working-age people. As a result, living standards are set to grow more slowly than productivity. Reversing this tendency for the dependency ratio to rise can be achieved either by lower unemployment or through more people being willing to join the labour force. Relatively little if any progress can, however, be expected on either of these fronts.

This makes the need to improve productivity all the more pressing.

A major cause of the decline in investment in recent years that has fed through more recently to falling productivity has been the change in the way senior executives are paid. The massive jump in their remuneration is largely due to the rise in incentive payments that are linked to short-term changes in profits and share prices. As such, management now has a much greater incentive than before to run companies in ways that will enhance these measures in the short term, even though the price is lower long-term investment.

Crucially, underinvestment enables companies to gain market share in the short term, as their consequent lower costs allow them to reduce their prices while maintaining the same margins and thus undercut their competitors.

Because companies usually have long life spans, we might expect them to take a more considered approach. However, chief executives can rationally expect only to be in office for a few years. The change in incentives has therefore shifted the balance of decisions away from the longer-term interests of companies to the shorter-term interests of management. The result has been a sharp decline in investment, an

*To shift from an economy characterised by low investment and stagnant productivity, we must alter the incentives that have produced it*

increased drive for higher margins and a preference for adding labour rather than capital equipment in response to rising demand. These preferences naturally results in weak labour productivity.

Since 1990, investment in the UK has fallen from 26 per cent to 17 per cent of GDP (Figure 1); productivity has also stopped rising since the crisis. Indeed, measured over the previous three years, it has been persistently negative since 2010 and even over the past five years has risen by only 0.2 per cent per annum. To shift from an economy characterised by low investment and stagnant productivity, we must alter the incentives that have produced it.

### **Boosting investment by changing incentives**

The first step is to recognise this underlying problem and accept that bold action is needed. The challenge is to alter incentives from those that damage the economy to those that help it, with persuasion likely to prove a better means of achieving this than proscription. Linking bonuses to increases in productivity fits this mould, with tax incentives offering an effective route in.

Shareholders want some benefit in return for bonuses. Improved incentives will therefore involve adding to profit criteria rather than replacing them. The added requirement should be that productivity must be enhanced by, say, one per cent per

annum to allow bonuses to be paid. Persuasion could take the form that bonuses, without the productivity requirement, would not be an allowable expense for corporation tax and would be subject to, say, an exceptional 80 per cent tax in the hands of the recipient.

Companies would therefore need to publish their output and the hours worked by their employees. Because output is simply the sum of employment costs and profits, measured before depreciation, interest and tax, these data are already known to companies and the need to publish them would involve almost no added expense.

### The scope for raising labour's share of GDP

A change in these incentive structures should also raise typical wages. This can be achieved in three ways: by leaving the current distribution of earnings unchanged while improving productivity; by increasing the labour share of output; or by reducing the disparity between senior management and other employees' remuneration.

In the US, corporate output is currently split 61 per cent to wages and 39 per cent to profits, compared to the post-war averages of 68 per cent and 32 per cent. (Output equals profit, broadly defined, plus employment costs, so that wages plus profits are equal to 100 per cent of output.) If current management incentives were moderated, we might reasonably expect some rise in US wages coming from an increase in the labour share of output. For example, a return to the post-war average level would itself allow a 12 per cent rise in real wages, without any change in output.

The same may be true in the UK, but profit margin data is not nearly as good here so we have no way of knowing for sure. One reason for pessimism in the UK is the relationship between real wages and the exchange rate. A decline in the

*The fiscal deficit might instead be helped by a rise in business investment but this too appears unlikely without the sort of reforms proposed here*

real exchange rate produces a fall in real wages and it is through the resulting fall in production costs that devaluations improve a country's competitive position. The UK currently runs large current account and fiscal deficits and it is improbable that the latter can fall significantly unless the former moves with it. The fiscal deficit might be significantly reduced by a compensating adjustment in the private sector from being a small lender to a large net borrower but this appears unlikely. Household balance sheets are still very highly leveraged today and household savings are low.

The fiscal deficit might instead be helped by a rise in business investment but this too appears unlikely without the sort of reforms proposed here. Instead, moving towards fiscal balance is likely to require an improvement in the trade deficit.

Achieving this points to the need for a lower real value for sterling. It thus seems unlikely that we can hope for much improvement in the labour share of output in the UK. But we can reasonably expect that better management incentives will mitigate the decline in real wages that would otherwise accompany a fall in sterling.

### **The fallout from reforming management incentives**

My suggestions for the reform of management incentives can perhaps be improved upon. Others may have better solutions and I will welcome them but the inevitable resistance such ideas will provoke should not scare us off the change which is required. Linking bonuses to productivity will naturally have its critics.

One potential objection is that it will restrict business unnecessarily. My aim is to end, by tax persuasion, the damage to the economy that is currently being done by business, which is decidedly necessary. This is very similar to preventing the damage done by allowing monopolies to flourish. Competition is the essence of capitalism and is of course disliked by businessmen, who seek to avoid it whenever they can.

#### *Changing incentives should help reverse the rise in top management remuneration relative to other employees*

We are right to preserve competition, which handcuffs businessmen by thwarting their ability to rent gouge, and we would be equally correct to avoid the damage done by perverse incentives.

Others may argue that my proposals would cause us to lose talent abroad. That is an outcome with which I am entirely comfortable. If talented businessmen leave our shores because they are less able to damage the economy, we should congratulate ourselves and sympathise with their new homes where they will be employing these destructive talents.

Improving productivity is the overwhelming requirement for stronger wage growth. The key is to change the incentives which currently encourage low investment and low productivity. This should also contribute to mitigating the downward push on real wages that will accompany a competitive sterling exchange rate. Changing incentives should help reverse the rise in top management remuneration relative to other employees, which appears to have brought no benefit to shareholders. Together, these outcomes should help to move the UK economy onto a prosperous and stable path, both economically and politically.



# Beyond the degree delusion: apprenticeships, skills and wage growth

Recessions are always bad for the young. Rising unemployment falls disproportionately on their shoulders: early low-quality, unstable employment has lasting effects on their careers because they acquire fewer skills or contacts. This is bad news for all young people but the lower down the academic totem pole, the worse it gets.

It is still possible – thank goodness – to leave school with unimpressive grades and do well in life via the workplace. But only when and if you get a decent start.

At present, four years after they leave full-time study, the unemployment rate for young people with no qualifications above GCSE level is 24 per cent. It is just 8 per cent for graduates.

Spending on education and training accounts for 13 per cent of current government expenditure – more if you count the cost of servicing student loans. How could this money help young people into jobs more effectively – and increase the productivity of the jobs market they are entering, as well raising the wages they will earn?

The most promising policy is, unquestionably, an improved and well-funded apprenticeship system. With all major parties signed up to apprenticeship's virtues, this might seem a done deal. But improved is the operative word. Otherwise, we will just repeat the disastrous failures of past decades. This looks all too possible.

We also need to reform current spending patterns more generally. The way adult (19+) 'skills' funding is allocated is deeply dysfunctional: we should change it. But we must also rebalance the budget. Universities have, year after year, been favoured systematically in post-compulsory education spending. The justification has been that this is obviously the economically productive choice. That is mistaken. Shifting resources and attention to reformed apprenticeships and 19+ funding more widely are far more likely to take percentage points off the youth unemployment rate and turn productivity growth, and ultimately earnings, upwards.

## Apprenticeship

Apprenticeship is one of those warm cuddly concepts of which everyone approves. This has not stopped us from destroying what was once a functioning system in the European mode. Decline started in the 1970s a result of recession; rising apprenticeship wages (the highest in Europe); and economic changes which reduced openings in traditional industries. Rather than updating apprenticeships in the face of these challenges, governments then largely and deliberately destroyed them. Instead, they launched a centrally-administered 'competence-based' system of National Vocational Qualifications which failed entirely to deliver the productivity miracle promised for them.<sup>1</sup>

In the late 1990s, policy on apprenticeships duly switched from antagonism to ignorant enthusiasm. Quantitative targets arrived and the parties started to vie with each other on how many they had or would 'deliver'. Civil servants duly found ways to meet targets quickly, cheaply, and never mind the quality. But quality is what makes apprenticeships 'work', both for the economy and for the individual concerned.

<sup>1</sup> A. Wolf, *Does Education Matter? Myths about education and economic growth*, Penguin, May 2002

Huge numbers of recent so-called ‘apprenticeships’ involved people – many of them well over 30 years old – who were already employed by a company. They received qualifications and some bits of training from a ‘provider’ paid by the government. This highly profitable business can be carried out with minimal involvement from, and at no real cost to, most employers. The modal apprentice under our current

*Most politicians have no idea how ineffective most current apprenticeships are, and how much needs to change*

system has been a supermarket employee in a pretty low-skill job, not the lucky 18 year-olds at Siemens or Rolls-Royce whose apprenticeships are super-competitive exceptions to the current UK norm.

In the 1950s over half of British male school leavers went into apprenticeships. No high-quality system can reach that scale again in the near future. We could, however, recreate an efficient system in the next 5 years. The Coalition government, partly in response to my own Vocational Education Review, commissioned a review from Doug Richard. This lays out a sensible blueprint for recreating apprenticeships that develop high skills and respond to economic change. And implementation has just begun.

So what is the problem? First, politics. Most politicians have no idea how ineffective most current apprenticeships are, and how much needs to change. But they love targets and speed. Promising ‘3 million apprenticeships’ in the next five years (Conservatives) or ‘an apprenticeship for every 18 year old’ (Labour) is a feel-good activity for them. It should be a heart-sink for anyone listening.

Second, funding. Traditional – ‘real’ – apprenticeships, the ones with high pay-offs for everyone concerned, take several years. They combine direct, intensive input from an employer with formal tuition; completing a full one is good for employment, pay and prospects.<sup>2</sup> This approach is effective and efficient because so much money, time and expertise come from employers. In return, they get an increasingly skilled employee who has excellent lifetime prospects. The traditional model is what people think of as apprenticeship but it is sadly not what most apprentices actually get.

Today’s employers have got used to a different system, where training is done at the government’s expense, not theirs. And many fear that, if they are the first to contribute more, their trained apprentices will just be poached by others. They also face a very different supply situation from their forerunners. They have vast numbers of highly subsidised graduates coming onto the market and a huge supply of other countries’ trained ex-apprentices has also arrived for them to choose from. In this

<sup>2</sup> S. McIntosh, *A cost-benefit analysis of apprenticeships and other vocational qualifications*, Department for Education and Skills, 2007

situation, the old system can't recreate itself, and won't.

In summary, we don't need more cheap, short apprenticeships. We need fewer in the short-term, and an eventual return to good, long ones. This demands government action and major subsidies, especially for formal tuition. And there is, clearly, no money.

But there could be. An obvious answer is an 'apprenticeship tax'.

Apprenticeship is one area in which a hypothecated tax is appropriate and feasible.

Employers know they need skills: finding good employees is an ongoing, constant concern. In some sectors, skill shortages are clear and well documented. Yet employers are demonstrably unwilling to pay for intensive training. Current tax incentives for corporations to spend on training are estimated, by the Trades

Union Congress, to cost the Treasury as much as £5 billion a year.<sup>3</sup> In spite of this, the volume of workplace training has been going down and down.<sup>4</sup>

A half per cent levy on payroll could realise £2.5 billion a year – considerably more than the whole combined current apprenticeship and adult skills budget. Apprenticeship levies of this type are used all over the world. They are not new and they are not unusual. They remove the free-rider problem: if you have an apprentice, you get subsidies, and if you don't, your levy goes to help support the training of other people's.

What is crucial is to tie the money clearly to apprenticeships. Also, employers need to decide where their money goes, and do so directly – not through some 'consultative' national body. Self-interest should then ensure funds are neither wasted nor diverted elsewhere by a hungry Treasury.

### Rebalancing the books

Rebalancing the books is, long term, equally important. A huge proportion of our post-19 expenditure goes to support full-time higher education students. This looks set to get worse in the short term, because of an ill-advised lifting of the 'numbers' cap for young full-time undergraduates, and the failures of the current loan model.

Politicians proclaim their commitment to vocational education, but their actions speak differently. Further education is consistently funded at lower rates than other

<sup>3</sup> H. Reed, *Tax relief on training: investigating the options for reform*, Unionlearn, March 2011

<sup>4</sup> F. Green, A. Felstead, D. Gallie, H. Inanc and N. Jewson, *What Has Been Happening to the Training of Workers in Britain?*, Llaques Research Paper 43, 2013

*Apprenticeship levies remove the free-rider problem: if you have an apprentice, you get subsidies, and if you don't, your levy goes to help support the training of other people's*

sectors, and is the first target in hard times: witness this year's large cuts to the skills budget. The situation is made worse by an unreformed system for post-19 expenditures, a cat's cradle of different funding rates and eligibility rules which chew up college managers' time, energy and attention. In addition, low attaining 19 year-olds in full-time education have suffered under the Coalition government. Their funding has been slashed unexpectedly, almost certainly, though no-one is admitting it, to pay for free school meals for middle class six year-olds.

The cuts for 19 year-olds needs reversing, because these are exactly the young people with poor job prospects for whom formal education can make a difference. But we also need to rethink broader economic arguments. Governments' enthusiasm for university expansion is based on a particular variant of supply-side thinking. It says that the most 'productive' form of education must be the one which gives individuals the highest personal returns. Positive returns to a university degree are seen as a conclusive argument for directing ever-more tax money into universities, to produce ever-more graduates, at the expense of other post-19 options.

*We should rethink our addiction to loading subsidies into full-time higher education rather than other post-compulsory routes*

Unfortunately, this argument – the degree delusion – does a great job of confusing relative advantage with concrete productivity. It looks at how much graduates earn, on average, compared to people with (typically) little formal education. It is perfectly possible for this gap to remain

large or even grow, without actual graduate earnings increasing at all, and to do so within an economy where productivity overall is flat or falling.

Actual, concrete payoffs to many degrees are plateauing and more and more graduates are in 'non-graduate' jobs. Meanwhile, get down to the specific, sectoral level, and you will find a sizeable group of vocational qualifications with large positive benefits.<sup>5</sup> Yet almost no assistance is on offer to people who would like to re-skill in this way, rather than a degree. As Larry Summers recently argued, pinning all our economic hopes on more and more people spending more and more years in formal (and higher) education is "largely whistling past the graveyard".

<sup>5</sup> D. Bibby, F. Buscha, A. Cerqua, D. Thomson and P. Unwin, *Estimation of the labour market returns to qualifications gained in English Further Education*, Department for Business Innovation and Skills, December 2014

Short term, we need to implement the Richard Review, aim for fewer and much better apprenticeships, and fund them with a new tax. If done well, this should help reduce unemployment rates for 19-24 year olds well before 2020. It should also start showing clear productivity gains in skills-shortage industries: our falling productivity in construction is a real and reversible scandal.

Long term, we need to address the way we distort people's choices. We should rethink our addiction to loading subsidies into full-time higher education rather than other post-compulsory routes, and offer individuals far more choice in where they can cash in state-funded support for their education and training. This will be a slow grind, but start now and we might have a skills system in place by 2020 that genuinely contributes to the economy.

# How low can we go: the changing relationship between unemployment and real wages

The real wages of the typical (median) UK worker have fallen by almost 10 per cent since 2008, the most persistent experience of falling wages in real terms since Victorian times.<sup>1</sup> Given these patterns, it is no surprise that debates about real wages and living standards – why they have fallen and what can be done to arrest and reverse these trends – have become prominent. The experience since 2008 has been very different from the 1980s and 1990s recessions. In those downturns, as unemployment rose real wage growth slowed down but did not turn negative.

This time as unemployment went up (albeit not as markedly as in the earlier recessions), real wages fell; and fell very significantly.

**I**t is important to note that these falls have damaged the earning power of almost all workers, as sizeable hits to real wages have occurred right across the distribution.<sup>2</sup>

As the earlier recessions ceased and unemployment fell, stronger real wage growth returned. However, there is much less evidence of lower unemployment driving a real wage pick-up this time around, and certainly not a substantive enough one to get wages back to their pre-recession levels anytime soon.

### The changing relationship

Figure 1 shows the way in which real wages have stagnated and then fallen in recent years. In contrast to the 'good times' of the late 1980s and late 1990s (when unemployment was low), there was little in the way of significant real wage growth in evidence in the early 2000s. Real wages edged up in most years, but not to the extent seen previously. This finding – that slower real wage growth for UK workers set in before the downturn that began in 2008 – chimes with earlier research.<sup>3</sup> Real wages grew by over 2 per cent a year on average between 1980 and 2001 (as the weekly median rose from £280 to £425). They grew much less rapidly between 2001 and 2008 and then fell very sharply indeed, so much so that the 2014 real median is just below the 2001 level.

The second key feature of the chart concerns the closeness of the relationship between changes in real wages and unemployment. In the 1980s and 1990s recessions, real wage growth slowed (but did not turn negative) as the unemployment rate went up, before rising again as unemployment fell. In the recent downturn, real wages stopped growing once unemployment started rising between 2008 and 2009. They then fell markedly and have stayed down, even as the unemployment rate recovered.

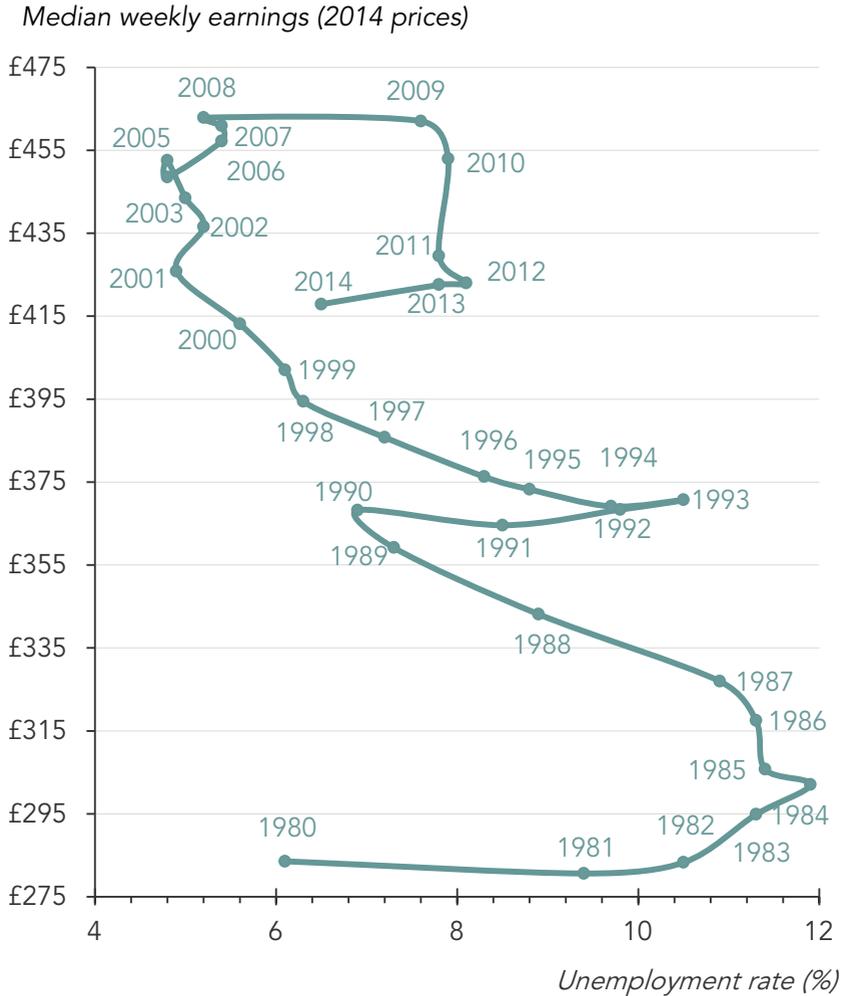
It seems that the fall in unemployment since 2012 has not produced any discernible improvement in real wage growth. Instead, median real wages have actually dropped a little as the unemployment rate has come down from its peak.

<sup>1</sup> TUC, *UK workers suffering the most severe squeeze in real earnings since Victorian times*, October 2014

<sup>2</sup> For more detail see: P. Gregg, S. Machin and M. Fernandez-Salgado "The Squeeze On Real Wages – And What It Might Take To End It", *National Institute Economic Review*, Vol 228 No 1: R3-16, May 2014; and the series of real wage updates by D. Blanchflower and S. Machin, *UK Real Wages: A Long Way to Go: CEP Real Wage Update 3*, December 2014

<sup>3</sup> Gregg, Machin and Fernandez-Salgado, 2014

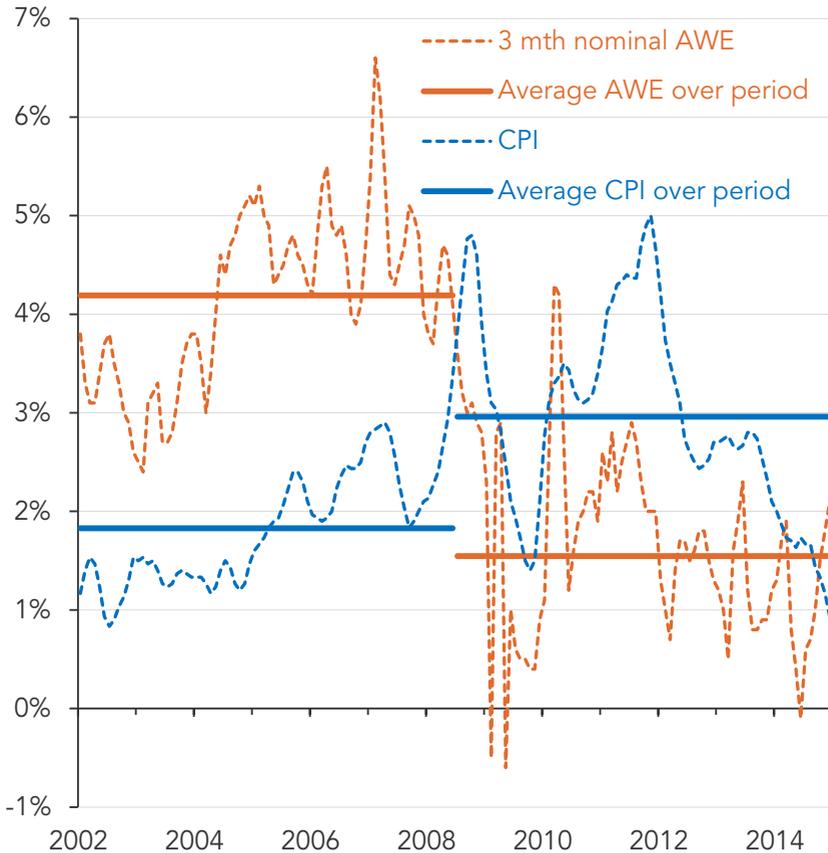
**Figure 1: Becoming less sensitive: the shifting relationship between real wages and unemployment, 1980-2014**



Source: ONS

Figure 2 presents the latest monthly figures on pay, as captured by the average weekly earnings (AWE) measure. While some have used these figures to point to a recent pick-up in pay, it is worth noting that the improvement is tiny compared to the overall pattern of falling real wages. This reinforces the notion that real wages do not seem to be responding as much to unemployment falling as they did in previous recessions.

**Figure 2: Crossed over: earnings growth and inflation, 2002-2014**



Notes: AWE and CPI numbers are three month averages.

Source: ONS

## Explanations

Why has this happened? In part, it reflects the so-called ‘productivity puzzle’, where workforce productivity has been so weak that it has not generated the same magnitude of wage gains as in the past.

But it seems there is more than this going on. Gregg, Machin and Fernandez-Salgado argue that the real wage falls are likely to have been driven, at least in part, by increased flexibility in the labour market. Individuals have ‘priced themselves into work’, with the result that the recent downturn has been characterised much more by falling real wages than by rising unemployment levels.<sup>4</sup> If the labour market has become more flexible then the natural rate of unemployment (the ‘full employment’ level that exists once cyclical variations are stripped out) may have come down, suggesting that unemployment needs to fall to ever lower levels to secure wage growth.

More flexibility has thus allowed employers to hold a stronger hand in wage setting and wage negotiations than before. There are probably two dimensions to this. The first is the longer-run weakening of labour market institutions, such as the coverage of trade unions and nationwide organisational pay scales. The second relates to the

*The number saying they want fewer hours has remained broadly flat, while the number saying they want more hours has risen sharply*

role of the state, with tax credits helping to partially maintain incomes in the face of lower wages, and active welfare policies making the unemployed closer substitutes for those in work.

Closely related to this is the question of the extent to which the unemployment rate is accurately capturing the strength of the labour market. Evidence on higher levels of underemployment seem to suggest more slack than the unemployment rate alone implies, a phenomenon that is different from the past.<sup>5</sup> Factoring this in produces a rate of underemployment that is higher than the observed unemployment rate.

The potential good news from the labour market is that the strength of recent employment growth (fostered at least in part by the lower wage levels) means that we may well be able to drive unemployment down towards the low level required for wage growth.

<sup>4</sup> Note, though, that young workers have suffered the double whammy of both. Unemployment rates have risen most among the young, even though their real wages have fallen by more than older workers (see Gregg, Machin and Fernandez-Salgado, 2014).

<sup>5</sup> B. Bell and D. Blanchflower, “Labour Market Slack in the UK”, *National Institute Economic Review*, Vol 229: F4-11, August 2014

Focusing on boosting employment as a means of driving pay would have the added advantage of providing a particularly strong fillip for those towards the bottom end of the income distribution who are typically most prone to unemployment risk. This is especially the case for young people, who have done particularly badly in the downturn, but also for other groups characterised by lower employment rates.

### Implications and policy

Currently there are a variety of piecemeal policies on the table that could improve real wages. Among the policies that have been discussed are: higher minimum wages; variations in minimum wages in places where they can be afforded; and employers taking on a responsibility to pay more or more generally sharing out rents with all workers. On family incomes and overall living standards, there are also the usual 'making work pay' arguments around taxes and benefits.

Each of the specific wage policies seems potentially useful and worthy of serious consideration. But the real key to generating substantial gains that could make serious in-roads into getting real wages back to 2008 levels is raising productivity. And, if a productivity boost does come, we should act to ensure that workers across the entire wage distribution share in the gains. One worrying feature of research in this area suggests that median wages had become 'decoupled' from productivity gains well before the downturn.<sup>6</sup> The discussion (despite its rather opportunistic nature) around raising the pay of workers in companies that have benefitted from the drop in the price of oil probably sets a useful precedent for thinking about how we might better share the gains of growth. The same is true of the 'Britain needs a pay rise' campaigns.

*Raising minimum wages and offering properly-funded apprenticeship and vocational skills programmes could play a big – and more immediate – role*

Finally, improving the labour market prospects and opportunities for young people is a vital policy aim. As has been noted elsewhere in this collection, they have done very badly in the downturn in terms of experiencing both bigger real wage falls and bigger unemployment increases. For the next generation, fixing this rests with improving education, especially in relation to basic and intermediate skills. However, for those already in the labour market, raising minimum wages and offering properly funded apprenticeship and vocational skills programmes could play a big – and more immediate – role in averting some of the damage done by the recession.

<sup>6</sup> See J.P. Pessoa and J. Van Reenen, "Wage Growth and Productivity Growth: The Myth and Reality of 'Decoupling'", *Centre for Economic Performance Discussion Paper 1246*, 2013 and Gregg, Machin and Fernandez-Salgado, 2014.

# Shifting the balance of power: workers, employers and wages over the next parliament

Forty years ago an improving labour market and prices rising faster than wages would have led trade unions to march into the boardroom demanding higher wages and threatening strike action if those demands were not met. Pretty soon, union leaders would have been invited round to Number 10 for beer and sandwiches to be cajoled into wage moderation to prevent an inflationary spiral taking hold.

A lot has changed in the past 40 years.

These days the Prosecco remains in the fridge and David Cameron used a speech to the British Chambers of Commerce in February to urge pay rises for workers, a somewhat surprising sight. But, there is a simple explanation. Since the crisis began, the average British worker has suffered a fall in living standards deeper and longer than anything experienced for more than a generation. The recent drop in oil prices and the resulting lower inflation will offer some respite but not much.

It will be the votes of average people that decide the outcome of the upcoming general election. As such, the leaders of all political parties would love to offer up policies designed to raise the living standards of the average worker. But there are not many ideas around on how to do this, hence David Cameron’s plea to business.

Comparing the situation now and 40 years ago, it is hard to escape the conclusion that there has been a fundamental shift in the balance of power from workers to employers and that perhaps this shift has gone too far and it is time to redress the balance somewhat.

Figure 1 presents the time series for nominal wage growth from 1975 to the present day.

**Figure 1: The new normal? Trends over 50 years of wage growth**



Source: Average Weekly Earnings, ONS, and earlier sources

The 1970s were a turbulent period but since the 1980s there seems to have been three distinct periods, each illustrated in Figure 1 with the three horizontal lines. From the early 1980s to the early 1990s through to 2008, nominal wage growth averaged about 8 per cent. Then from the early 1990s nominal wage growth averaged a bit over 4 per cent per annum. But following the crisis, this fell to 2 per cent and there it seems stuck. The three take-aways from this are that there are quite long periods in which norms in wage growth seem strong; change occurs only rarely; but when it does change it can be quite rapid. The recent low level of wage growth has probably had an up-side: the rise in unemployment has been less than would have been predicted given the severity of the recession and unemployment has been falling fast. Instead of the recession leading to unemployment for a minority but protected living standards for the majority, we have seen a general fall in real wages that may mean the pain of recession has been shared more equally but this has arguably been more difficult politically.

*Once workers would have been looking for the first opportunity to press for higher wages, now employers are looking at pay rises as a last resort*

In the past, the change in norms seems associated with changes in inflation expectations. But the low current norm for wage growth has been associated, until recently, with quite high inflation

and inflation expectations. It seems like something quite fundamental has changed.

When it comes to thinking about how wages are determined, these days one must think about things from the perspectives of employers as that is with whom the decision now lies. Once workers would have been looking for the first opportunity to press for higher wages, now employers are looking at pay rises as a last resort. What makes employers pay higher wages is when they are struggling to recruit and retain workers, as a result of competing for labour directly with other employers. One of the features of the labour market in recent years (and not just the UK, the US as well) is that the level of direct job-to-job moves has been falling – these days a higher proportion of new hires are from non-employment rather than from other jobs. And when your latest hire is from non-employment there is no other employer to compete directly with.

Figure 2 shows the relationship between the fraction of recruits who were previously employed and the unemployment rate.

**Figure 2: Increased competition for work: the changing relationship between unemployment and recruitment, 1992-2014**



Source: Labour Force Survey, ONS

There is a clear inverse relationship between the two – in a recession a lower fraction of hires were immediately previously employed. But, more interestingly, this relationship seems to have changed since about 2000. For a given level of unemployment the fraction of new hires who were previously employed is lower than it used to be. This would suggest that for a given unemployment rate there is now less pressure on employers to raise wages because there is not so much direct competition for workers with other employers.

We currently seem stuck in a situation where wage growth is very weak and employers seem very reluctant to move from this. This is a result of the shift in the balance of power. But this does not mean that we will necessarily be stuck in this situation for ever. If the labour market continues to recover and, more importantly, if productivity growth re-starts, then the pressures for wage growth will build and ultimately this will translate into higher wages. And

*Even if falling unemployment does shift bargaining power towards workers, ensuring an appropriate balance of power is still something we should be concerned about*

once there is a tick up in the going rate, norms may change very fast as Figure 1 has shown can happen.

But even if falling unemployment does shift bargaining power towards workers, ensuring an appropriate balance of power between worker and employer is still something we should be concerned about. In the belief that labour had become too powerful in the 1970s, the view became common that an unregulated labour market would automatically deliver a suitable balance of power.

*But without a solution, it is quite possible that the general air of discontent within our economy and institutions will continue to grow*

But there is an old view that this is not the case and that came to be forgotten. In the *Wealth of Nations*, Adam Smith wrote that “in the long-run the workman may be as necessary to his master as his master is to him; but the necessity is not

so immediate”. A similar view that the relationship between employer and worker was fundamentally one of unequals and some state intervention was necessary to redress the balance was behind the original introduction of most labour market regulation, from UK interventions in the early 1900s to the New Deal era legislation in the US. There are areas where it has been rediscovered in recent years; equal pay for women and the minimum wage were once extremely controversial policies but are now widely accepted as part of the furnishings of a fair and efficient labour market.

It is not just in wage determination that one observes the shift in the balance of power. We see employers trying to pay as little as possible for workers: the growth in zero-hours contracts; not paying for social care workers’ travel between client; perhaps forcing workers to become self-employed so they will not be covered by the minimum wage.

Those things happen at the bottom end of the labour market but there also seem to be similar changes at the top where employers are increasingly trying to appropriate knowledge that one might think is the property of the worker themselves. A law professor at UCSD, Orly Lobel has written a book titled *Talent wants to be Free* on the numerous ways in which American employers have tried to gain an advantage over their workers. Some household names in the tech sector (Adobe, Apple, Google, Intel, Intuit, Lucasfilm, Pixar) had mutual arrangements not to pro-actively recruit each other’s workers, something the US Department of Justice ruled anti-competitive. The resulting civil case seems to be coming to a conclusion with a sizeable pay-out for workers who were harmed by this. What we do not know is if this was an isolated instance (at least one similar case is currently working its way through the courts) among a few companies in a particular period of time or whether these cases are the tip of an iceberg.

If it is time to redress the balance of power between workers and employers, what can be done? There are several strands to a strategy.

First, and returning to a theme others in this collection have touched upon, make sure the unemployment rate is low to maximize the competition between employers for workers.

Second, use government regulation where necessary, for example as Philpott has argued to limit zero-hours contracts, to force employers to pay carers for the time spent travelling between clients.

Third, try to rejuvenate unions to provide some countervailing power. Unions have rarely raised the pay of the lowest-paid in society because they have little representation amongst these workers. But there is work to be done to convince workers that the solution to what they see as an individual problem (struggling to maintain their standard of living) lies in collective action. Amongst workers under the age of 25, under 5 per cent have ever been a member of a trade union compared to 20 per cent 20 years ago. An important part of people's identity was once their job and their union, and this sense of pride and solidarity needs to be re-created in the middling jobs in today's labour market – they are just as vital to the economy as the coal miners ever were.

Fourth, mobilise grassroots campaigns on specific pay issues. These have had some success not just in those employers who sign up to the Living Wage but have probably also played a role in, for example, Walmart's recent decision to raise its lowest hourly rate to \$9.00 per hour (though commercial considerations also loomed large). As Dube discusses, in the US there are now cities setting minimum wages at a level we have not seen for a generation (and possibly too high) as a result of such campaigns.

Solving the problem will not be easy – trust in government and faith in collective action to solve problems is not high at the moment. But without a solution, it is quite possible that the general air of discontent within our economy and institutions will continue to grow.

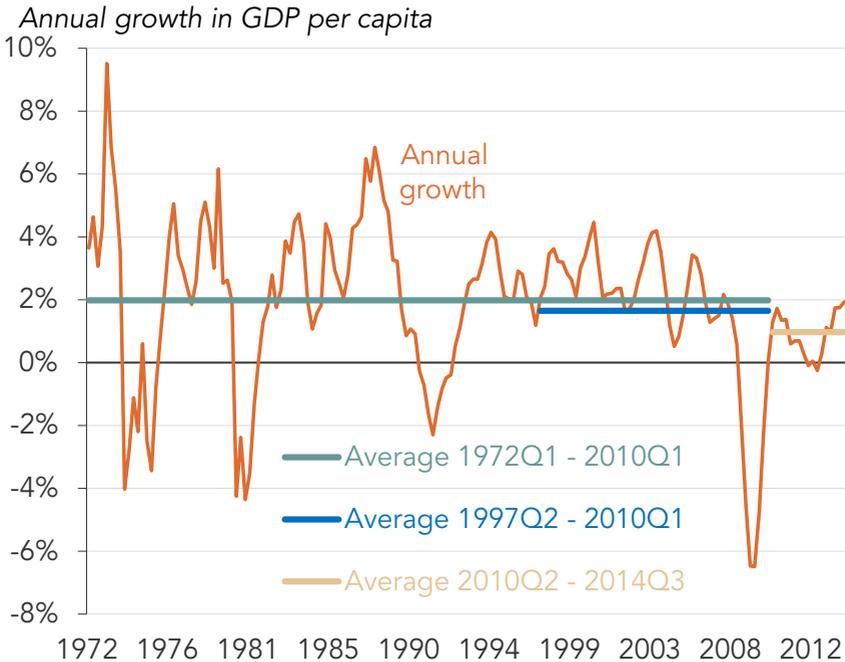
# Ready for takeoff: the role of helicopter money in supporting wage growth in future recessions

The unprecedented size of the fall in real wages in the UK since the Great Recession has been well documented. Part of this fall – perhaps more than you might think – is a result of a failed macroeconomic policy. I want to argue that this points to a fundamental flaw in the macroeconomic consensus that has governed policy in the UK and elsewhere for the last two decades.

I will suggest how this flaw can be corrected so that macroeconomic policy can be better used to support growth in wages and living standards.

**M**acroeconomic policy generally focuses on GDP rather than real wages, but the two are directly linked if we look at GDP per head rather than just GDP. Growth over the last four years has been unusually low, just at a time (recovery from a major recession) when you would expect above-average growth. The average rate of growth since the Coalition took power is 1 per cent, compared to a historical average before then of over 2 per cent, and even higher growth rates during recovery periods.

Figure 1: The disappointing recent growth of GDP per head, 1972-2014



Source: ONS

Why has this poor performance influenced wage growth? Real wages can only grow strongly without growth in GDP per head by squeezing profits, cutting taxes or through a strong currency appreciation. None of these are sustainable or, indeed, desirable in the longer run. So how much higher could both GDP per head and real wages have been if we had had a better macroeconomic policy? The Office for Budget Responsibility (OBR) estimates that fiscal austerity reduced GDP growth by 1 per cent in both 2010-11

and 2011-12. However there are a number of reasons to think this is very much a lower bound on the impact of austerity.

How much any particular change in government spending or taxation influences output is called a fiscal multiplier by economists. Normally, if changes to fiscal policy threatened the objectives of monetary policy-makers, they could raise or lower interest rates to counter the impact of fiscal changes on demand, thereby reducing the fiscal multiplier. However, since 2009 UK rates have been stuck at 0.5 per cent: what economists call a liquidity trap or interest rates being stuck at their zero lower bound (ZLB). As a result, monetary policy has found it much more difficult to offset the impact of austerity.

In these unusual circumstances, fiscal policy multipliers from changes in government consumption and investment could be much larger than the OBR assumed based on historical evidence. Using a quite plausible value of 1.5, for example, would mean that the austerity enacted in the first two years of the Coalition government could have reduced GDP by as much as 4 per cent, rather than the 2 per cent assumed by the OBR.<sup>1</sup> Furthermore, with interest rates stuck at the ZLB, there is no clear reason why this reduction in demand and output would not persist into later years, leading to a very large cumulative loss in income. Using the OBR's numbers, and making the most optimistic assumptions about how quickly the economy recovers, implies that austerity in the first two years of the Coalition government had, by the beginning of 2014, wasted resources equivalent to £1,500 for each adult and child in the UK. A more realistic calculation would raise that number to £4,000.<sup>2</sup>

It therefore seems clear that there has been a major failure of macroeconomic policy since the Great Recession. How do we put this right, both in the short term and looking further ahead? In the short term, the answer is pretty straightforward: bring fiscal austerity to an end while interest rates are at or near their lower bound. Even if the central forecast suggests that growth should be healthy (because, for example, oil prices are low).

<sup>1</sup> Some would argue that if GDP had been 4 per cent higher, inflation would also have been higher and so the Bank of England would have raised interest rates. That may or may not be true but if austerity had not happened, and interest rates had risen in 2011 as a result, I suspect we would now be talking about the damage caused by premature tightening of monetary policy instead of fiscal policy. The Eurozone and Sweden offer clear examples of premature monetary tightening. For more detail see S. Wren-Lewis, "The Macroeconomic Record of the Coalition Government", *National Institute Economic Review*, Vol 231 No 1 R5-R16, February 2015

<sup>2</sup> S. Wren-Lewis, *The size of the recent macro policy failure*, mainlymacro.blogspot.com, February 2015

The reason to delay austerity is straightforward: if growth is stronger than expected, interest rates can quickly be raised to contain inflation, but if growth is weaker than expected, the ZLB means monetary policy cannot support the economy, which is exactly what happened in 2010 and 2011. Regrettably none of the major political parties seem to recognise this implication of basic macroeconomic analysis, but clearly the Conservatives' fiscal plans take a greater risk with the economy than those of Labour.<sup>3</sup>

The fact that such an obvious macroeconomic proposition – do not undertake austerity in a liquidity trap – should be absent from the thinking of the major UK political parties and their equivalents abroad points to a deeper malaise. It is noticeable that most attempts to reduce deficits since 2010 have focused on cuts in public expenditure rather than increases in taxes. Deficit reduction may therefore be a convenient pretext to achieve a very different goal, which is to reduce the size of the state. If this is the underlying strategy, it has been remarkably successful. Its success

*It is a wise precaution to delay any attempt to reduce the government's debt-to-GDP ratio until interest rates are well into positive territory*

comes in part from inappropriate analogies between government and household budgets, which have a particular appeal when households are trying to reduce debt and government deficits are large. This leads to what I call 'mediamacro' – elevating deficit reduction far beyond its real importance – which forces those politicians who do not have an interest in a smaller state to follow the deficit reduction line.

These pressures have important implications for future macroeconomic policy. The next time we have a major recession and enter a liquidity trap it will once again be attractive for those that seek a smaller state to argue for deficit reduction when the appropriate policy is fiscal stimulus. We could once again see austerity delay a recovery from a large recession.

The delegation of monetary policy to independent central banks was in part designed to avoid politicians 'playing politics' with demand management. As a civil servant once told me, the then Chancellor knew full well that interest rates needed to rise to avoid an increase in inflation, but there was no way that was going to happen until after the party conference. Yet there was an Achilles heel in this plan to delegate demand management policy: the ZLB. At the ZLB central banks can no longer stimulate the economy sufficiently but it seems politicians cannot be trusted to do so either, and may actively make things worse through austerity.

<sup>3</sup> M. Whittaker and A. Corlett, *In the balance: public finances in the next parliament*, Resolution Foundation, November 2014

## Helicopter hang-ups

So how do we avoid this Achilles heel? Central banks have tried quantitative easing (QE), and this has had some effect, but it remains a very uncertain and ineffective policy. There is a simple and straightforward alternative which would be much more effective: creating money and giving it to people to spend. This is what economists call helicopter money, although some have recently called it QE for the people. QE involves creating large amounts of money to buy financial assets, with highly uncertain effects on demand. Helicopter money would involve creating much less money with a much more certain positive impact on demand.

Although a number of economists have suggested helicopter money (including Adair Turner generally and John Muellbauer for the Eurozone), it is taboo among central banks.<sup>4</sup> One reason is that banks fear that if they later need to restrict the money supply and raise interest rates, they will be unable to do so. I have explained elsewhere why these concerns are wide of the mark.<sup>5</sup>

Helicopter money is taboo elsewhere because of fears that it will lead to governments spending too much and, because this spending is financed by money creation, this will generate excess inflation. However, a key principle for helicopter money is that it should be initiated by independent central banks and not governments, and only when there is a substantial risk that interest rates will hit their ZLB. In these circumstances, inflation fears are unfounded.

After the election, the new UK government should initiate a debate on helicopter money,

*Introducing helicopter money could allow politicians to focus on steadily reducing the deficits that inevitably occur after a recession without derailing any recovery*

with the aim of putting in place this policy in some form. One key question that needs to be resolved is whether central banks should give money directly to the public (and if so, by what means), or whether it should be given to the government on condition that it is used to pay for some form of fiscal stimulus. We should begin this debate

now, while the failure of the current macroeconomic policy framework to generate a swift recovery from the Great Recession is fresh in people's minds.

<sup>4</sup> See A. Turner, "Printing money to fund the deficit is the fastest way to raise rates", *Financial Times*, 10 November 2014; J. Muellbauer, *Combatting Eurozone deflation: QE for the people*, [voxeu.org](http://voxeu.org), 23 December 2014

<sup>5</sup> S. Wren-Lewis, *Helicopter money and the government of central bank nightmares*, [mainlymacro.blogspot.com](http://mainlymacro.blogspot.com), 22 February 2015

Introducing helicopter money in some form, to be activated when interest rates came close to the ZLB, could allow politicians to focus on steadily reducing the deficits that inevitably occur after a recession without derailing any recovery. This should continue to be done in the context of medium-term rules, such as the broadly sensible five-year rolling deficit target introduced by the Coalition. In deciding what these medium-term targets should be, governments should increasingly rely on the advice of independent fiscal institutions like the OBR.

*Give the Bank of England some form of dual mandate, where the objective of achieving the maximum level of employment consistent with long-term inflation stability is given as much weight as achieving the inflation target*

To make sure that helicopter money is used expediently by central banks, it is in my view important to give the Bank of England some form of dual mandate, where the objective of achieving the maximum level of employment consistent with long-term inflation stability is given as much weight as achieving the inflation target. A number of macroeconomists have reacted to the failure of macroeconomic policy since the financial crisis by suggesting other radical changes, such as increasing the inflation target from 2 per cent to 4 per cent, or targeting the level of nominal income rather than inflation.

The problem with both these suggestions, which do have clear merits, is that their main appeal is in reducing the number of times we experience liquidity traps, rather than dealing with them when they occur.<sup>6</sup> The advantage of helicopter money is that it gives monetary policy an additional and effective policy instrument that it can deploy when a liquidity trap occurs, so such events no longer have more than a transitory impact on the ability of incomes and real wages to grow. In this regard at least, the existing macroeconomic consensus needs to be changed.

<sup>6</sup> S. Wren-Lewis, *My verdict on NGDP targets*, [mainlymacro.blogspot.com](http://mainlymacro.blogspot.com), 1 June 2013

# Reconnecting growth and wages: lessons from the US debate

This question of what UK policy-makers can learn from America about the path back to shared wage growth comes at an opportune time. For years, the American wage debate was almost completely monolithic. The problem was universally understood to be a deep skill-deficit among wage earners and the solution was thus training and education. Now, however, in part due to recent developments in US wage trends, the debate is potentially opening up in useful ways.

If there's a lesson for the UK in all this, and I believe there is, it's the importance of making that potentiality a reality.

**B**efore going any further, let me be crystal clear: skills are a key part of the earnings equation. Quite literally, in fact, as one of the most consistent findings in econometric wage equations is the all-else-equal wage premium associated with more education. But in our wage debate, the vital connection between macro and micro, between tight labour markets and wage outcomes, has been largely ignored for decades. That might not be a problem if we were at full employment most of the time. But that hasn't been the case by a long shot: according to standard estimates by our non-partisan Congressional Budget Office (CBO), over the period when real wage growth for many workers has been stagnant or worse, we were at full employment only 30 per cent of the time. Conversely, when wage growth was broadly shared, full employment prevailed 70 per cent of the time. And there are significant classes of workers who face wage challenges even at low unemployment. Thus, the path we seek most certainly passes through better access to skills acquisition, but that is not the only stop along the way.

### The short- and long-term views

There are two important features of the debate over wages in the US, one near term and one long term. The long-term story is very much one of 'growing together, growing apart'. From 1947 to 1979, the real annual earnings of the bottom 90 per cent of wage earners actually grew at about the same pace as the earnings of the top 1 per cent. Since then, the real earnings of the top 1 per cent are up about 140 per cent while those of the bottom 90 per cent are up only 15 per cent. And notably, 70 per cent of that post-1979 growth for the bottom 90 per cent occurred over just the five years from 1995-2000, the last time the US labour market clearly spent a number of years at full employment.

Since the 'growing apart' period corresponded to a time when productivity

slowed, some analysts suggest that slower productivity growth is the main culprit. However, while wages across the scale roughly grew with productivity from the late 1940s through the late 1970s, real median compensation grew only 9 per cent, while productivity post-mid-1970s, was up about 140 per cent.

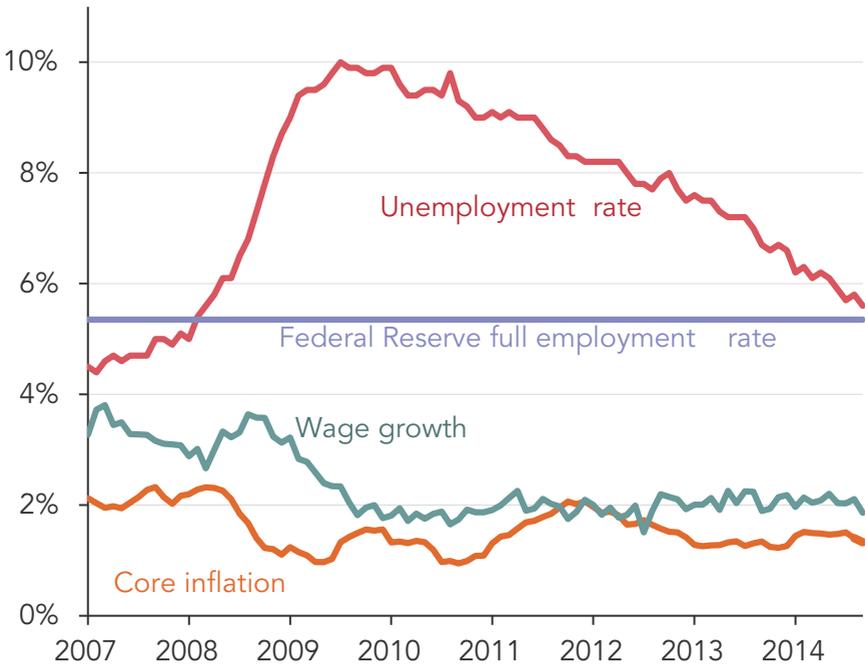
Moreover, in recent years a relatively new phenomenon can be observed in US wage data: a growing gap between average compensation and productivity. This suggests not just a skewing of the distribution within labour income but a shift in national income from compensation to profits. This long-term disconnection between growth and the earnings of large swaths of our labour force has now – I'd say "finally"

*US politicians vie for the affection of a middle class for whom economic growth has been more of a spectator sport than a participatory one*

– become a political issue of some salience as American politicians vie for the affection of a middle class for whom economic growth has been more of a spectator sport than a participatory one.

The near-term development in the US wage debate is this: as shown in Figure 1, despite the fact that our unemployment rate is close to the level that many US economists (and prominent institutions, including our CBO and Federal Reserve) consider to be the ‘natural rate’ – the lowest unemployment can fall without triggering inflationary pressures – nominal wage growth has not accelerated at all (nor have prices). Technically, at least given economists’ traditional understanding of such dynamics, this means that either the natural rate of unemployment is considerably lower than we think it is, we are mis-measuring labour market slack.

**Figure 1: Relationship breakdown: wages aren’t budging even as we near ‘full employment’**



Source: Bureau of Labour Statistics; Bureau of Economic Analysis

I believe we are making a number of mistakes. The natural rate is lower than we think (and very difficult to reliably estimate). There is more slack in the US job market than the measured unemployment rate reveals. Our 'traditional understanding of such dynamics' is incomplete. And we have historically paid too little attention to a key wage determinant: workers' bargaining power.

One more near-term development bears mentioning: as per the wage analysis of the Washington DC-based Economic Policy Institute, it's not just median- and low-wage workers facing stagnant paychecks.<sup>1</sup> The real pay of four-year college graduates has also been flat in recent years, and young college graduates have had a particularly tough time getting launched in the US labour market.

These factors – long-term wage stagnation and dispersion, near-term flat average wage growth even as the job market supposedly nears full employment, and the difficulty faced by even college-educated workers – have shaken the American wage debate up in useful ways.

*It's not just median- and low-wage workers facing stagnant paychecks; the real pay of four-year college graduates has also been flat in recent years*

Top American labour economists who have historically emphasised skill deficits amidst technologically-induced employer demands now argue that a broader scope is needed to understand and address these wage issues. Paul Krugman recently wrote: "while the education/inequality story may once have seemed plausible, it hasn't tracked reality for a long time." That's a sentiment echoed by prominent economists such as Larry Summers (the view that "there are all these jobs with skills" and all we need to do is "just train people a bit [and] they'll be able to get into them and the whole problem will go away" is "fundamentally an evasion") and David Autor. Federal Reserve chair Janet Yellen has consistently noted that wage growth is a key missing ingredient in the US recovery and recognises that its absence is related to persistent labour market slack.

### Lessons for the UK

As I write in early 2015, the debate is turning to what policy measures might help to help reconnect paychecks to macroeconomic growth. Put aside the fact of our gridlocked politics, as there are surely no lessons there to be learned. More usefully, I will tick off the policy lessons I believe are both most likely to actually help raise wages and are thus most relevant.

<sup>1</sup> E. Gould, *Why America's Workers Need Faster Wage Growth – And What We Can Do About It*, Economic Policy Institute, August 2014

Full employment is essential. As noted, the absence of full employment has been a key factor behind both real wage stagnation and inequality in the US for decades, and arguably in the UK since the latter part of the last decade. (Organisation for Economic Co-operation and Development (OECD) data show that UK unemployment averaged 7.8 per cent, 2009-2013, while their estimate of the natural rate averaged 6.4 per cent.) In my work with Dean Baker, we find that a 10 per cent decline in the unemployment rate is associated with a 10 per cent real wage gain for low-wage workers, 4 per cent for middle-wage workers, and 0 per cent for high-wage workers. In other words, these impacts are both positive in terms of real gains for many who've been left behind but are also inherently equalising. Especially given how little collective bargaining there is in the US, one of the only ways workers can glean any bargaining power is when product and labour demand are strong enough that employers must bid wages up to get and keep the workers they need.

And that takes demand-oriented monetary and fiscal policy. Those of us pulling for this agenda have stressed that our central bank faces 'asymmetric risks' right now. The damage done to the prospects of wage earners by a premature rate hike would likely be considerably larger than the risk of inflationary pressures. Similarly, one reason our recovery has finally picked up steam is because fiscal policy has turned from being a drag on growth to neutrality. Fiscal austerity in demand-deficient economies is the enemy of full employment and thus wage growth.

*Service sector unions successfully organised health care workers in California and are working aggressively with fast food workers in cities across the US*

We're also finally focusing on our trade deficit in this context. Particularly as we negotiate a large, multinational trade agreement, US policy-makers have been stressing global pressures on US wages. The emphasis has appropriately been on the fact that we've run sizeable trade deficits every year since the

mid-1970s (averaging -2.5 per cent of GDP), making it that much harder to achieve full employment. A major factor in our persistent trade deficits is the exchange rate, as some of our trading partners manage their currency values so as to essentially subsidise their exports to us and tax our exports to them. As a result, some US policy makers are insisting on a chapter against currency manipulation in the new treaty.

The erosion of labour standards associated with higher pay is another concern. As noted, minimum wages, overtime rules, and the right to bargain collectively have all eroded over time in the US. Given our political gridlock, an interesting development here is action at the subnational level. For example, 29 states and DC itself now have minimum wages above the federal level, a subject which Dube discusses in more

depth elsewhere in this collection. And while public sector unions are losing ground in Wisconsin, service sector unions successfully organised health care workers in California and are working aggressively with fast food workers in cities across the US.

And then there's the folks left behind. Even at full employment, we must recognise that some groups of workers will still face barriers to decent jobs and decent wages. Thus, we are debating: measures to help the millions of workers with criminal records to get a fair chance; direct job creation programmes for the unemployed and underemployed; and the expansion of pro-work, anti-poverty wage subsidies, like our Earned Income Tax Credit.

Improved access to learning and educational attainment is also crucial. There are many in the US workforce who face uniquely high barriers to both skill acquisition and to work. The latter includes the folks discussed above and many non-college educated 'prime-age' (25-54) men who, displaced from the tradable-goods sector, have prematurely left the labour market. Apprenticeship programmes of which we have few in this country relative to the UK and Europe – have surfaced in our debate as a useful policy intervention for these and other workers.

The former category – barriers to skill acquisition – demands reducing barriers to educational access for the least advantaged from pre-school through college. One important lesson for the US debate in this space is that policies that improve college access but stop there are too limited. Our college completion rates must also be boosted, especially for those with limited educational resources and backgrounds.

Though we've often not done enough to help the disadvantaged benefit from this insight, American policy-makers have long understood the importance of skills as a wage determinant as well the impact of skill deficits on negative wage trends. More recently, we're learning that a deep and persistent deficit in bargaining power is at least as important a determinant of wage outcomes, and that full employment must be part of the solution. Our dysfunctional politics may prevent these insights from full or even partial enactment as economic policies. But they still should guide the way.

# The generation game: boosting young people's wages, incomes and prospects

Being born in the 1980s and 1990s was not advisable for your income or wealth. Whatever data you use, however you cut it, by far the most significant change in living standards over the past decade is nothing to do with the fortunes of the rich and poor: the shifts are all about age.

Britain's future literally depends on understanding why the young have been hit so hard and on resolving the problem.

There is no doubt that working people have taken a huge hit in the recession and its aftermath. Andy Haldane, the Bank of England's chief economist, estimates the cumulative fall in real (inflation-adjusted) wages has been 8.2 per cent since 2007, a drop he says is "unprecedented since at least the mid-1800s".<sup>1</sup> But among those of working age, the young have been hit harder than other age groups. Between 2009 and 2014, Resolution Foundation figures show median earnings for those aged between 22 and 29 fell 12.7 per cent, compared with drops of around 10 per cent for workers in their thirties and forties (and 7.1 per cent for those in their fifties).

This pattern is stark enough alone but even more surprising considering that twenty-somethings in Britain are the most educated cohort we have ever produced. Some may be remaining in education longer and hence temporarily depressing their earning power. Regardless, we would have expected this group to have been at least slightly insulated (in aggregate) from downward wage pressure relative to the rest of the population in a well-functioning labour market.

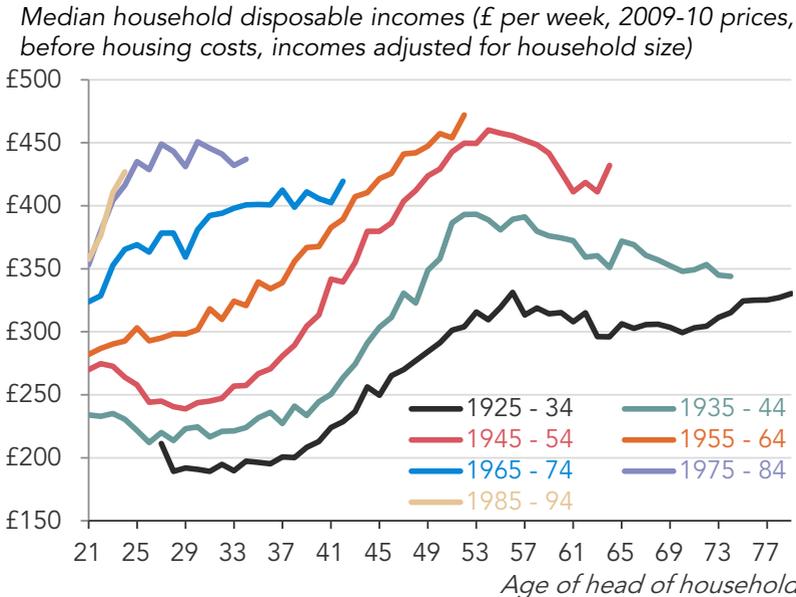
The problem of falling real wages is far from limited to the unskilled with little work experience. Financial Times (FT) research of student loan repayments in 2014 showed that university was no longer a golden ticket to a good job on graduation, with new graduates who earned enough to start repaying loans in 2011-12 earning 12 per cent less in real terms than graduates at the same stage of their careers in 2007-08.<sup>2</sup>

Wages are, of course, only one element of income so a wider analysis of living standards is necessary to see if something really has changed. The FT has shown what appears to be a jinxed generation – those born between 1985 and 1994 – who were the first not to be better off at the same stage of life than their forebears.<sup>3</sup>

<sup>1</sup> A. Haldane, *Twin Peaks*, Bank of England, October 2014

<sup>2</sup> S. O'Connor, "Graduate data reveal England's lost and indebted generation", *Financial Times*, 19 November 2013

<sup>3</sup> C. Giles, "Generations see fortunes reversed", *Financial Times*, 17 March 2012

**Figure 1: The jinxed generation? Disposable incomes across cohorts**

Source: *Financial Times* analysis of ONS data

One of the primary reasons for this shift is the increasing cost of housing. Though the same trends are clear in the before housing costs data, they are stronger after housing costs. Being born in the 1960s meant buying relatively cheap property for the vast majority of adults; coming into the world 20 or 30 years later means being shut out.

Normally, when there are big changes in the relative prosperity of different groups, you would expect public policy to attempt to mitigate the differences. Progressive taxes and benefits ensure that Britain's net income inequality rarely grows as much as the gap between high and low original market incomes.

With age- and cohort-based inequalities growing however, this government has chosen to reinforce these trends rather than fight them. Social security has been cut for those of working age while the basic state pension has been uprated faster than inflation under the triple-lock, which guarantees annual increases at the highest of inflation, earnings or 2.5 per cent. Capital investment has been cut while students must pay more for their higher education. The only policy that is definitively 'pro-young' has been the ambition for deficit reduction, although even here, the early focus on lower public investment reduces any benefits for future generations of lower debt.

## Should we care?

The most important question is, 'inter-generational income disparities are rising: so what?'. Powerful arguments have been made, not least by Jonathan Portes, that changes in fortune by age are small relative to inequalities within any age group.

This is a difficult case to answer, since the two are not directly comparable. But differences between rich and poor have not grown, while inter-generational inequalities are rapidly rising. It is not much comfort to a poorly-paid graduate to tell them, 'don't worry that you are doing much worse than your equivalent 10 years earlier because your equivalent 10 years earlier because your graduate premium is unchanged'.

That young people have done so badly in the labour market should also make us pause before we say Southern European economies need to reform their labour markets to abolish dual labour structures in which the young and inexperienced get a bad deal. The same happens in the UK. In the public sector, new entrants no longer get automatic increments each year; in the private sector many listen to their older colleagues calculating their final salary pensions. In neither case are wage negotiations structured so that those with worse terms and conditions receive larger increases. We have created a voluntary dual labour market in Britain by grandfathering past privileges.

There are two possible explanations. First, unlike a L'Oreal product, perhaps the young just aren't worth it and are getting a fair deal for their feeble product. But if that's the case, it points to a failure of the education system delivered by older generations, meaning responsibility should not just lie with the young. Alternatively, it might be that older generations are using the power of experience to defend their status, pushing all the pain of recent years on younger, more inexperienced people. If so, then there is a genuine grievance that requires public policy action. My sense is that the latter rings more true.

Without action, the consequences are almost all bad. If the young have been kept in jobs below their skill levels, the scarring is potentially worse than the long-term unemployment of the 1980s. The lack of owner-occupation is not much of a problem if wages and pensions enable secure renting in the private sector. But if housing costs are so high that renters will fall back on housing benefit in retirement, present calculations of future social security costs will be grossly underestimated.

Worst of all, there is every chance that the wealth that already exists in Britain will be passed on to future generations in a way that concentrates inequalities. It is not

*We have created a voluntary dual labour market in Britain by grandfathering past privileges*

*If the young have been kept in jobs below their skill levels, the scarring is potentially worse than the long-term unemployment of the 1980s*

an exaggeration to say that the danger from wealth accumulation in the current older generations is a miserable future two-tier society. Having rich grandparents, who benefitted from rising house prices, will mean housing security in your childbearing years. If you don't have that good fortune, you will be lucky to escape a life of insecurity in which bringing up children seems a burden too far.

The consequence could be that having children becomes something mostly for the wealthy or the feckless. Anyone who thinks this dystopia is impossible should take one look at Japan – where the parallel is having a salaried job rather than owning a home – and fertility rates have crashed.

### **What can be done**

The good news is that intergenerational problems are easy to fix – if only society has the will. The bad news is that many of the suggestions which seek to redistribute power, wealth or amenity from the rich elderly will face fierce opposition from large groups with a high likelihood of voting.

Before looking at what can be done, I will take issue with one idea that is often seen as the solution to the problem that many of today's retired have generous defined benefit pensions and tomorrow's pensioners will have meagre defined contribution plans. A third way has been proposed by government for the future – the defined ambition pension – which seeks to pool many current individual risks in defined contribution pensions across employees and generations. There is nothing inherently wrong with risk pooling (although recent changes to forced annuitisation move the UK system away from sharing risks) but there are significant risks for younger generations. Any shortfall in pensions in payment – for example through an increase in longevity – will fall on new scheme members currently paying in, as has been happening in the Netherlands in recent years. It is certainly not a magic solution to genuine intergenerational tensions.

Instead:

1. Young people should vote. Silent resentment does not bring change.
2. The government should publish outcome data from higher education. It is a scandal that the Student Loans Company data, which could inform students as to the value of prospective degrees, remains closed to outside analysis. This information should come alongside tighter regulation of university courses so that higher educational establishments cannot exploit their greater knowledge to lure unsuspecting students into worthless courses.
3. Pay increases in the public sector should include a premium for younger employees. Government should favour younger people and those with less secure pension rights in annual wage negotiations. Government is often most effective when demonstrating the possible to the wider public and challenging others to respond. Increasing pay by a flat cash sum rather than a proportionate increase for all would proxy such a move, but it would be better to be more explicit in deliberately targeting higher general pay increases on the young, as a partial compensation for the lack of automatic annual increments that many younger staff used to receive.
4. End the triple-lock on pension uprating. Since pensioners are now no more likely to be poor than non-pensioners, there is no need for a more generous uprating of their social security entitlements. At a minimum, the lock should be restated that earnings growth is the maximum increase, because Government should have an ambition to keep the basic state pension rising at least in line with earnings. But ambitions must also be subject to public finance pressures and pension increases should not be absolutely automatic.
5. Build more houses. With government able to borrow at negative real rates of interest, it should take the lead in borrowing and building houses to rent and for purchase. It should not worry about the public finance aspects of the policy as there will be sufficient income streams to cover borrowing and turn a profit.
6. Relax planning constraints. In areas of high housing demand, a similar gain to the young will come from privately-financed housing developments, so long as existing land owners do not reap the benefit of the changed planning status. This requires the use of taxation of planning gain or compulsory purchase of land at a modest premium to prevailing land prices.
7. Move inheritance tax to a charge on receipts rather than bequests. This would incentivise spreading wealth rather than concentrating it.

8. Increase inheritance taxes. This would stop the concentration of wealth down the generations.
9. Apply National Insurance contributions (NICs) to pensioners. With pensioners representing the fastest-growing part of the labour market, the anomaly that they pay no NICs on earnings while it is levied on non-pensioners has become increasingly anachronistic. We should recognise NICs as a general tax and eliminate the exemption for pensioner earnings.
10. Merge income tax and NICs. The logic of applying NICs to pensioner earnings could be extended to a full merger of income tax and employee NICs. This would further add levies on unearned investment income, creating an additional burden on the rich who receive the vast majority of income on interest and dividends and on the richer older people who have accumulated financial assets. It would give Britain a grown-up direct tax system which treats most income sources the same but applies an additional charge on non-pensioners and pensioners with large private incomes alike, and no additional charge on poorer pensioners and non-pensioners. The money raised could be used to reduce other taxation, ensuring a redistribution from the old and rich towards the young and poor.

This 10-point plan might seem like cloud-cuckoo land to politicians. But to economists, most of the changes improve efficiency and intergenerational fairness, getting rid of distortions. The alternative – in which we continue to fail our young – risks damaging our prospects for growth and rising living standards for generations to come. As such, this should be the platform of politicians with modern, liberal ambitions for Britain; ones we sadly do not seem to have at present.



# Making steady progress: policies to help long-term earnings growth

Most discussions of low pay are snapshots: they focus on a point in time and assess the role played by jobs, firms or sectors of the economy. This viewpoint of course brings many useful insights. But adopting a longer-term perspective of earnings over people's entire working lives offers additional lessons and new possibilities for policy interventions.

This essay considers pay progression, in particular the factors and events linked to lifetime earnings.

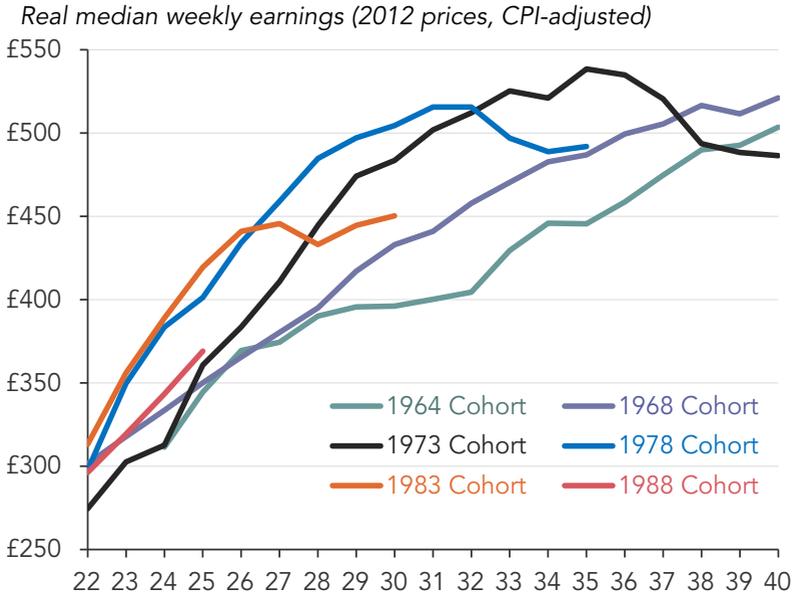
**C**oncentrating on younger people who have suffered most as a result of the recession, as well as those prone to spells out of the labour market, this essay makes recommendations aimed at minimising the impacts.

### Patterns of earnings progression

As people age, their earnings typically grow, as in Figure 1 where the pay profiles of six different cohorts based on their year of birth are shown. When young – the figure begins at age 22 by which point most people have entered the labour market – the majority are on a strong upward trajectory. Wages then plateau when people reach their late thirties, with this flattening occurring somewhat earlier for those with lower level qualifications and somewhat later for those with a degree. Alongside this, there is normally a steady underlying increase in real pay over time as productivity in the economy increases, meaning each generation earns more than the previous one did at the same age.

These profiles have been profoundly altered over the last seven years, as Figure 1 illustrates. Those born in 1973 and 1978 (aged 35 and 30 respectively when the recession began) had been earning more than the two earlier cohorts at the same age. But the recent wage falls mean that a decade of earnings growth has been lost. Likewise, wages among those born in 1983 (aged 25 in 2008) are now on a par with those born 15 years earlier, with all of the rapid earnings growth normally enjoyed by young people having evaporated. Rather than surpassing previous cohorts, those born in 1988 found themselves starting out at the same earnings level as those born in 1978, with weak earnings growth meaning that they now broadly track those born in 1973. The most recent two cohorts have seen the loss of a decade and a half of earnings growth.

Figure 1: Careering down: younger workers are worse off than their predecessors



Source: Annual Survey of Hours and Earnings, ONS, and earlier sources

These trends partially reflect the fact that young people have struggled to enter the labour market during the recession, with a minority having lengthy periods out of work. Research has underlined the importance of taking a long-term view of the effects of youth unemployment. It suggests that these impacts are long-felt, as this group suffer ‘scarring effects’, meaning they have lower wages and more frequent spells out of work as adults due to this early unemployment.<sup>1</sup>

But even those who haven’t experienced unemployment have been negatively affected by the recession. Lower starting salaries, as young people take jobs below their skill levels, are made worse by fewer promotion opportunities during a recession, reducing their chance of rising up the ladder. US evidence highlights that this applies even for graduates<sup>2</sup> and that this lost ground isn’t made up over time: they face lifetime wage penalties

<sup>1</sup> See for example P. Gregg, “The Impact of Youth Unemployment on Adult Unemployment in the NCDS”, *Economic Journal*, Vol 111 No 475: F626-653, November 2001

<sup>2</sup> P. Oreopolous, T. von Wachter and A. Heisz, “The Short- and Long-Term Career Effects of Graduating in a Recession: Hysteresis and Heterogeneity in the Market for College Graduates”, *American Economic Journal: Applied Economics*, Vol 4 No 1: 1-29, January 2012

compared to prior and later cohorts who enter the labour market in better economic conditions.

That, however, shouldn't lead us to believe that limited earnings progression is just a cyclical problem, with an unlucky cohort or two disadvantaged. Many do not age out of low pay, with Resolution Foundation research finding that three-quarters of the low paid fail to escape onto higher wages a decade later.<sup>3</sup> A number of factors seem to explain who progresses onto higher wages and who doesn't. When a person loses their job, this generally results in them being paid less in their new role than in their old one.<sup>4</sup> Wages do subsequently recover somewhat, but the longer a person spends out of work, the smaller that recovery is. If the risk of job loss was evenly spread across the workforce, this might appear to be less concerning. But job loss is not random. It is more common among the lower paid – resulting in what is known as the low pay-no pay cycle.

Another group for whom spells out of employment are common is mothers. Not

only does childbirth tend to result in time spent out of the workplace, it also increases the likelihood of part-time working and low hourly pay, both of which are associated with reduced lifetime earnings. Encouragingly in this regard, things have changed for the better as a result of policy shifts. The introduction and further extensions of maternity leave have given women the right to return to their employer up to a year after giving birth and the right to request part-time working. This has meant that far fewer women now have long periods out of work and when they return to their former employer, their wages do not suffer the same hit. Support with childcare costs has also led to higher employment rates among mothers, with more now choosing to work on a full-time basis. The key lesson here is that the maternity agenda has been so successful because it drew attention to the costs of lower female employment: not just to women and their families but also to firms and society in terms of the huge waste of productive potential it represented. There are important parallels with other groups – such as those with disabilities or ill-health – when thinking about policy reforms.

*The maternity agenda has been so successful because it drew attention to the costs of lower female employment*

<sup>3</sup> C. D'Arcy and A. Hurrell, *Escape Plan – understanding who progresses from low pay and who gets stuck*, Resolution Foundation, November 2014

<sup>4</sup> In contrast to those who choose to change job, who typically secure pay rises.

## Policy directions

For those interested in reducing the extent of low lifetime earnings, there are a number of policy lessons. First, getting the macroeconomic basics right is essential. Progression is faster in tight labour markets: part of the higher wages that are associated with falling unemployment stem from increased progression opportunities. This is especially important for the young and will assist them in moving out of low pay and returning their real wages to the much higher levels seen in 2008, as well as reducing the incidence of damaging youth unemployment and job loss among adults.

Second, sector-level progression policies could make a difference. In lower-paying industries, promotion opportunities do exist, particularly in larger organisations. But one paradox is that as the minimum wage rises, the returns to 'stepping stone' promotions are squeezed, with employers narrowing the divide between their lowest-paid staff and those on the next rung up. This can make taking on the extra responsibilities involved unattractive.<sup>5</sup> To counteract that, the Low Pay Commission should assess the potential for new pay 'steps' within certain industries. One option is to recommend fixed increments above the minimum wage below which a person with specific skills or qualifications (as is done in Australia) or tenure within the firm could not be paid. This would bring its own challenges. But a number of industries already have staff skill-level regulations, for instance childcare and its set staff-child ratios, and the security industry, which now has recognised qualification structures. These have resulted in higher pay in these low-wage industries.

Third, more support is needed to help mothers avoid long spells out of work. The narrowing of the gender pay gap over the last twenty years has been driven by the reduction in the numbers of women having extended periods out of the labour force and the growing

*Work allowances should be higher for people with disabilities and single parents*

acceptance of returning to the same job with the right to request part-time work.

There is still room for further support here, particularly in the one-year period

between the end of maternity leave and two years of age at which point childcare costs start to fall considerably. In addition, opening up more senior jobs to part-time working remains a major challenge to which further attention should be addressed.

Fourth is an area with some parallels to how maternity was once viewed in policy terms: ill-health and disability. After six months' paid sick leave, a person's employment contract is often ended. If they return to work after that, they typically do so part time and at far lower wages, as was formerly the case with mothers. Many who could return do not do so because of these penalties and the difficulty of overcoming employers' reticence to take on those with poor recent work histories. This is an area that is calling out for a major

<sup>5</sup> D'Arcy and Hurrell, 2014

overhaul along the lines of maternity decades ago. Obvious options include extending the right to return to your previous employer beyond six months without requiring higher-paid leave, establishing a right to return to part-time work and having workplace adaptation. As with mothers, this agenda should be driven by a recognition of the huge lost productive potential to the economy.

The fifth area worth considering is Universal Credit. This new merged version of six existing in- and out-of-work benefits introduces a 'work allowance' – an amount of money that each household can earn without any benefits being withdrawn. Work allowances create a stronger incentive to work than in the current system, but they need to be better focused on groups that have difficulties working longer hours and for whom working now raises the chances of working more in the future. They should be higher for people with disabilities and single parents in particular. Second earners in couples with children won't receive it and the introduction of one for them would be a further step towards improving female labour market attachment and with it, higher pay.

Finally, in considering the transition from education into employment, three elements are crucial. In order of importance they are experience in a closely-related job, a good reference from an employer and holding the relevant skills or qualifications. Young people often lack the first two and this puts them at a disadvantage compared with older workers. Policy initiatives in this area are numerous, and there is some good practice already in place: apprenticeships and potentially the new traineeships can offer a great way of gaining all three elements. But the system is still piecemeal: we are yet to build a coherent, overarching architecture for young people who do not go to university.

As the school-leaving age rises next year, the primary focus for young people up to the age of 18 will be continued education or training. But once young people reach 18, the system switches its attention to job search for those choosing not to stay on, and continued learning is restricted. This hard divide makes little sense. Once a person has secured 'level 2' qualifications in maths and English and has some vocational or work experience, it is sensible for job search to take primacy. When some of these ingredients are missing, however, building their skills alongside job search is a more reasonable approach. Functional maths skills in particular appear to be crucial to finding and sustaining lower-paying employment.<sup>6</sup> Policy discussions tend to go straight to schooling on this issue but, again, post-16 vocational courses may have an important additional role in raising skill levels.

There are many groups in society who are currently destined to earn far less than they should – all the more so after the Great Recession. Active policy can help to get them back on track.

<sup>6</sup> P. Gregg, L. Macmillan and C. Vittori, "Nonlinear Estimation of Lifetime Intergenerational Economic Mobility and the Role of Education", *University of Bath mimeo*, March 2015

# Second earner to primary breadwinner? Women's wages and employment

The recession has, on the surface at least, been good news for gender equality. In 2014, the pay gap reached a record low with the difference in earnings between men and women working full time just 9.4 per cent. Yet the reasons for the narrowing of the pay gap give little cause for celebration.

For both men and women, real wages have been falling, but these reductions have been less sharp for women.

Women's employment rates have held up over the course of the recession and today sit marginally above those of the boom years of 2007-08. Are there grounds to think the pay gap might narrow further in the next five years as a result of stronger female employment and earnings, rather than men's relative misfortune? This essay assesses this question and sets out some policy insights which could make a positive difference.

A necessary first step is to understand why women's wages have fallen less than those of men during the recession. One explanation is gender segregation; men dominate those industries most affected by cyclical variation in demand (including manufacturing and construction). Demand for those working in the service sector, in jobs which are often low waged and done by women, continues to grow. But while the recession has seen women's employment and earnings catch up a bit with men, large disparities remain. Women's employment rates still lag those of men.

These gaps vary widely between women too. For example, while there is virtually no difference in pay between men and women for the under thirties, or under forties if they work full time, as women age the pay gap opens. Fundamentally, it is motherhood, not age, that has the strongest influence on pay and employment. Once women have children, their earnings tend to stop growing. The earlier children arrive the more quickly their earnings profile flattens and their pay starts to fall behind that of men and women who haven't had children. Those with lower levels of education tend to have children earlier and their employment and earnings fall behind sooner.

*While 60 per cent of women with degrees work full time, only 30 per cent of those with just GCSEs do*

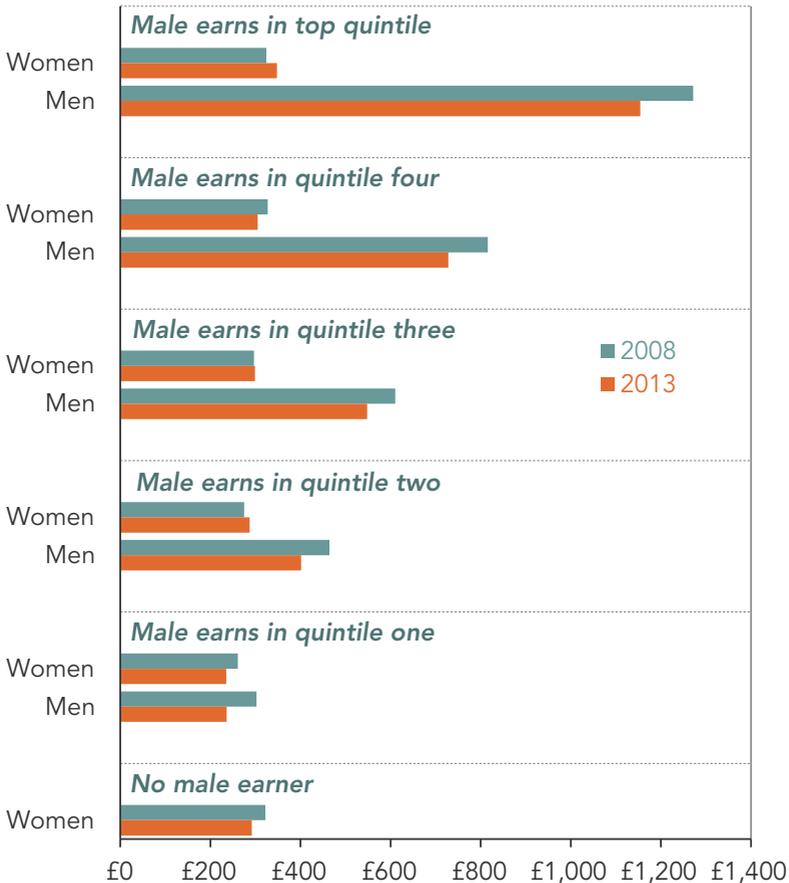
It is the rate of full-time employment that gives most cause for concern: while 60 per cent of women with degrees work full time, only 30 per cent of those with just GCSEs do. Among mothers, 44 per cent of those with degrees work full time compared with 18 per cent of those with just GCSEs. The gaps in employment rates between men and women with similar levels of education have barely changed since the early 1990s. The full-time pay gap is therefore a poor guide to pay equality.

While the evidence of a pay and employment gap is compelling, the question it raises is: why, specifically, does it matter? The answer is that low rates of female employment are a concern not only because of their influence on gender equality but also because female employment plays a more and more central role in supporting family income and reducing income inequality between households. For the households of the lowest-earning men, female earnings have become increasingly important to family income. The main driver of this has been that employment rates among women partnered to low-earning men have risen. As a result, women in low-income families are now contributing a much larger share of family earnings. Unlike couples with high-earning men, the earnings of mothers and fathers are similar in families where men are low earners.

The recession has sped up this rebalancing. Among men with the lowest earnings (in couples with children), almost one in three have a partner that outearns them. Among the highest-paid one-fifth of men, the comparable figure is just 2 per cent. So while intra-household inequality is improving, this change is being driven by falling male incomes and is concentrated among those with the lowest earnings.

**Figure 1: The importance of being earners: the increased relevance of women’s pay to household living standards**

*Weekly earnings, constant prices*



Source: Households Below Average Income, Department for Work and Pensions

## Second earner to primary breadwinner?

As well as the growing number of homes in which they are the main earner, women are increasingly taking on the role of sole breadwinner. Indeed, in 2013, the number of families with children headed by a sole female breadwinner (21 per cent) outstripped the share headed by a sole male earner (18 per cent). Families with a sole breadwinner at the helm are likely to be poor. In the past, economists and sociologists have described a 'gender paradox', with those that are low paid (and disproportionately female) sheltered from poverty because of who they live with. This paradox is no longer true. For the growing number of families headed by a lone mother, employment is particularly important. Yet even among those who work, few manage to escape from the bottom of the income distribution. Over 70 per cent of working lone mothers are in the bottom two quintiles of family income, and just 2 per cent make it to the top.

### Looking ahead and policy implications

As the economy returns to pre-recession levels of employment and output, women are continuing to benefit from growth in the service sector while manufacturing continues to underperform. For low-income women, employment and earnings look set to continue to gradually catch-up with those of men. In the poorest households, women's role as the main breadwinner seems likely to become increasingly important. So with women's employment and earnings now of greater importance to household incomes but still lagging men, what can government do to enable men and women to more equally share the balance of responsibility for work and care?

*Policy should instead focus on promoting a better work-life balance for both mothers and fathers*

First, we should be clear about what households want and what policy should aim to achieve. High rates of take-up of the right to request flexible working suggest there is little appetite within families for all adults to work full-time, long-hour jobs. Policy should instead focus on promoting a better work-life balance for both mothers and fathers. But reducing the hours that fathers work, while encouraging women to work longer hours, will require major changes in the workplace, relationships and institutions.

Second, and following on from that, breaking down gendered divisions in caring arrangements is critical to improving equality. New policy initiatives, such as the introduction of shared parental leave, signal a step in the right direction but changing attitudes and social norms around work and care will need much more substantial shifts. Men and women have, for example, since 2002 had equal access to the right to request flexible working but it is women who typically request it for childcare-related reasons. A recent report found that many fathers would like to spend more time caring

for their children but felt that requesting flexible working would have an impact on their prospects for promotion.<sup>1</sup> The fact that requesting the right to flexible work leads to a permanent contractual change (with no right to, for example, return to increased hours as children grow older) may present a further barrier to men caring and women returning to full-time work. Altering legislation to allow for this flexibility would be a positive next move.

Third, there needs to be a stronger focus on encouraging women into full-time work. The right to request part-time work, alongside welfare reforms which have encouraged

*Encouraging employers to offer better quality jobs on a part-time basis may help reduce women's labour market disadvantage*

lone parents and 'second earners' to work over 16 hours a week, have contributed to the growth in maternal employment over the last decade. This has been another step towards moving away from the male worker/female carer model of society. Yet

with so many mothers remaining in part-time work, progress towards equality has been limited. In Sweden and Denmark, the adverse effects of long years of part-time work are increasingly being recognised and policy has shifted towards encouraging full-time work through reforms to the tax and benefit system and the provision of affordable childcare.<sup>2</sup> As long as part-time work remains the main way in which mothers, but not fathers, reconcile work and family life, gender inequalities look set to persist.

Fourth, and with that said, alongside a push for more full-time working the quality of part-time roles should be improved. Part-time jobs typically offer few prospects for wage or career progression and remain concentrated in low-paying sectors. Encouraging employers to offer better quality jobs on a part-time basis may help reduce women's labour market disadvantage and organisations such as Timewise have demonstrated how progress can be made.

Fifth, in the UK, childcare remains a major barrier to employment, as a recent survey by the Resolution Foundation showed.<sup>3</sup> For those women who are not entitled to tax credits, very little support for childcare is available until children reach the age of three. New proposals for a childcare tax break, which will subsidise 20 per cent of the cost of a place, will make only a small dent in the cost of childcare which the Family and Childcare Trust currently estimate exceeds £10,000 a year for a full-time place for

<sup>1</sup> Equality and Human Rights Commission (EHRC), *Working better: fathers, family and work - contemporary perspectives*, October 2009

<sup>2</sup> A. Hegewisch, *Flexible working policies: a comparative review*, EHRC, March 2009

<sup>3</sup> G. Cory and V. Alakeson, *Careers and carers: Childcare and maternal labour supply*, Resolution Foundation, January 2014

## Second earner to primary breadwinner?

a child aged two. Evidence from other countries show that subsidies of the proposed size are unlikely to have much effect on women's employment. Among those on low incomes, Universal Credit will provide much more substantial support for childcare with (from April 2016) 85 per cent of costs covered, although high rates of benefit withdrawal mean that the incentives for low-earning women with working partners to progress will remain weak. The recommendation made by Gregg elsewhere in this collection to introduce a work allowance in Universal Credit for second earners would help to address this.

### **The right priorities**

The pay gap has been at the centre of the gender equality agenda since the 1970s. Far less attention has been paid to employment rates, in spite of the yawning gap between men and women particularly in relation to full-time work. Women in the UK continue to bear the main economic cost of having children. Many women, especially those with lower levels of education, struggle to maintain full-time employment following the birth of a first child. For them, the recent narrowing of the full-time pay gap holds little significance. Equality at work will need far more than the elimination of the pay gap defined this way. Reducing the employment gap between men and women will bring wider benefits too, reducing inequality between households and reducing the risk of poverty among lone mothers. Over time it will contribute towards reducing the pay gap too. This should be the policy priority and will have a much larger pay-off than reducing the official 'pay gap'.

# In the public domain: the challenge for public sector pay in the next parliament

Despite cuts of around half a million central and local government jobs over the past five years, the public sector still employs more than 5 million people, or just over a sixth of the total UK workforce. The public sector paybill accounts for around half of general government current spending and controlling this paybill is therefore critical to the overall programme of budget deficit reduction.

This needs to be balanced, however, against the potential damage to key public services like the NHS, social care, schools and the police if their paybills are squeezed too far.

Whatever the complexion of the government that emerges after the general election, some further real cuts in the public payroll seem likely in the next parliament, but there are important choices to be made on:

- The overall scale of the real cuts in the public sector payroll;
- How these are divided between employment cuts and real reductions in pay; and
- How these can best be achieved while minimising the adverse effects on the delivery of public services.

## Background to the debate

Public sector pay is significantly higher on average than private sector pay in absolute terms (by around 15 per cent as shown in Figure 1), but this gap shrinks to a relatively small difference of around 4 per cent once age, education and region are controlled for, according to research by the Institute for Fiscal Studies (IFS).<sup>1</sup> In general, this pay gap is larger for women and for workers on low to moderate incomes, while private sector pay is higher for those at the top of the income distribution.

As the dotted lines in Figure 1 show, analysis of projections by the Office for Budget Responsibility (OBR) suggests that the raw difference in average pay will decline progressively over the next few years.<sup>2</sup> If, for the sake of illustration, we apply the same trend to the adjusted differentials after controlling for education, age and region, then we find that the gap between public and private pay could be entirely eliminated by 2017-18 and become negative after that date (reaching around 2 per cent in 2019-20 on our estimates).

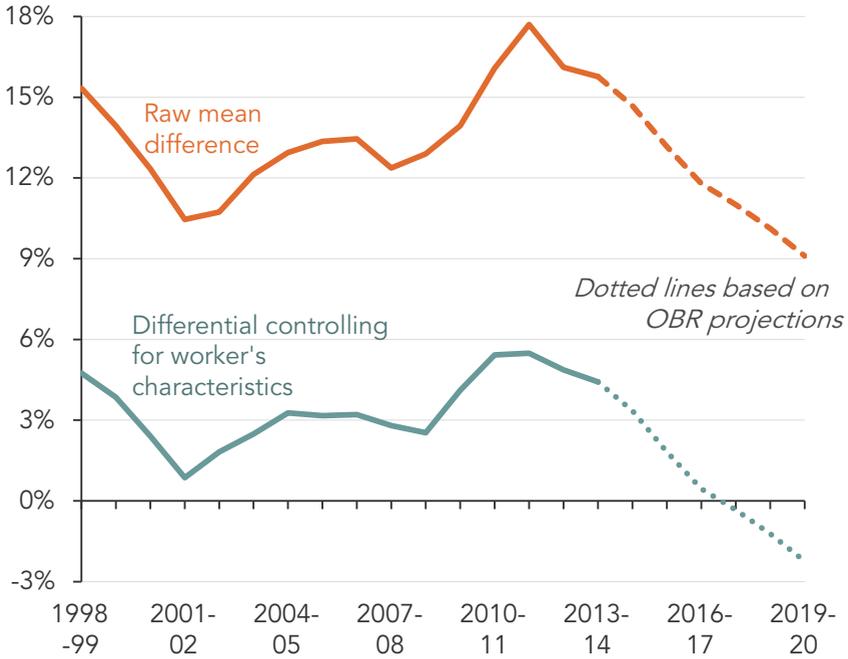
*This could lead to some problems attracting and retaining the right quality of staff in the public sector*

This could lead to some problems attracting and retaining the right quality of staff in the public sector, particularly in an environment of continuing pressure on staff numbers. Against this, public sector pensions and some other non-cash benefits (e.g. annual holiday allowances) remain more attractive on average than those in the private sector. However, these are not new factors and so may not prevent declines in the relative attractiveness of working in the public sector if the trends shown in Figure 1 were to occur.

<sup>1</sup> J. Cribb, C. Emmerson and L. Sibieta, *Public Sector Pay in the UK*, Institute for Fiscal Studies, October 2014

<sup>2</sup> OBR, *Economic and Fiscal Outlook*, December 2014. This is the source for all of the OBR projections referred to in this essay.

Figure 1: An end to the public sector pay premium? The public-private pay gap 1998-99 to 2019-20



Notes: Based on data from Labour Force Survey and illustrative projections by PwC using OBR forecasts from December 2014.

Source: J. Cribb, C. Emmerson and L. Sibieta, Public Sector Pay in the UK, IFS, October 2014

## Looking ahead to the next parliament

There seems to be general agreement across the main political parties on spending plans for 2015-16, which involve real cuts in departmental current spending of around 1-2 per cent. The OBR assumed that this would feed through into a similar cut in the real paybill, met mostly by a reduction of around 2 per cent in general government employment. The OBR estimated that there would then be further real cumulative cuts of around 14-15 per cent in the real general government paybill between 2015-16 and 2019-20, including around 900,000 net job cuts. This would be on top of estimated net job cuts of around 600,000 between 2010-11 and 2015-16<sup>3</sup>.

*These alternatives would widen the projected gap between private and public pay growth*

However, this also assumes a relaxation of public pay constraints, allowing real growth of just under 1 per cent per annum on average over this period. This would be less than the OBR assumes for private sector earnings growth (around 2 per cent real per annum), which explains the downward trend in the dotted lines in Figure 1. But allowing real public pay rises would still be relatively generous by the standards of the past few years and it would put further strain on job cuts to keep the public paybill under control.

There are alternatives here. If, instead, the real government pay rise was held at zero, the job cuts might be restricted to around 750,000 in the period from 2015-16 to 2019-20, or to around 600,000 if real public pay was to keep falling by 1 per cent per annum over this period. However, these alternatives would widen the projected gap between private and public pay growth, potentially making it harder to attract and retain the right quality of staff to the public sector.

There is also an important distributional issue here for lower-paid staff. The Coalition government protected these to some degree from the public pay freeze in 2011-12 and 2012-13 by giving an increase of £250 per year to most public sector workers earning under £21,000. A similar measure might be considered for low-paid workers to mitigate any future public pay freezes.

<sup>3</sup> After adjustment for classification changes of some organisations between the public and private sectors.

## Alternative fiscal policy options

In principle, the real growth of the paybill could be higher if the next government chose to pull one of the following four main levers for the period beyond 2015-16:

1. Adopt a less tough borrowing target: aiming for current budget balance by 2019-20 rather than a 1 per cent of GDP absolute budget surplus could reduce government job losses by around 500,000-600,000 up to 2020,<sup>4</sup> but would have downsides in a higher public debt-to-GDP ratio, albeit one that should still be falling in later years of the next parliament.
2. Raise taxes: no major party<sup>5</sup> is proposing specific significant net tax rises at present but, depending on the election outcome, the new government may seek to put some of the burden of further deficit reduction on net tax rises, which has been a common feature of post-election Budgets since the early 1990s.
3. Reduce welfare spending further than indicated in current plans: the Conservative Party has set a target of around £12 billion of further welfare cuts in the two years after 2015-16 (and may need to do more after that given their overall spending plans), while other parties have also indicated a desire to look further at the scope to cut welfare bills.
4. Reduce non-pay current spending of departments and local government relative to growth rates implied by current plans: this would leave less of the post-2015-16 cuts to be met from reduced public paybills.

It will be for the next government to decide which, if any, of these levers to pull. The key point to note here is that the squeeze on the public sector paybill may not need to be quite as severe as the current OBR projections indicate. This raises the question of how to achieve these further real cuts in a way that minimises damage to the quality of public services delivered.

<sup>4</sup> See Table 7.8 in Chapter 7 of IFS, *Green Budget 2015*, February 2015

<sup>5</sup> Although Vince Cable of the Liberal Democrats has indicated a general intention to make tax rises bear some of the burden of future fiscal consolidation.

## How to control public paybills with minimal damage to public service delivery

In many ways, this question comes down to the need to boost public sector productivity through new ways of working that can increase agility and efficiency through measures<sup>6</sup> such as:

- Deploying digital technology ‘by default’<sup>7</sup>: digital offers the opportunity for greater self-service, customisation of services and automation of transactions such as benefits and pensions. If designed in a user-friendly way, as the Government Digital Service has made its priority, this potentially saves on staff numbers while providing a better service to users;
- Collaborative working and sharing services across government departments and local authorities, including a broad range of ‘back office’ functions such as HR, finance and IT, but increasingly also in the ‘front office’, for example in customer contact functions; and
- Partnering in innovative ways with diverse providers including mutual organisations and social enterprises, enhancing procurement through initiatives such as the Digital Marketplace, and using outcome-based payments mechanisms where these outcomes can be defined in a sufficiently precise way.

This might allow the same or better services to be delivered with a smaller workforce, but there is also a need to improve the nature and quality of public sector employment through measures such as<sup>8</sup>:

- Better motivation and engagement of staff, with senior managers providing greater clarity on organisational purpose, objectives and outcomes;
- Improving staff adaptability through training and coaching programmes, and supporting more collaborative working both within and outside the public sector; and
- Making public sector organisations more user-centric and less hierarchical, with more encouragement and incentives for staff at all levels to come up with innovative ideas for performance improvement.

<sup>6</sup> These and other measures were discussed in more detail in PwC, *Under pressure: securing success, managing risk in public services*, 2012

<sup>7</sup> Some users may not have access to the internet, or may lack confidence in using this, so there will still need to be other options for the moment, though these could be phased down over time.

<sup>8</sup> PwC and Demos, *Productivity in the public sector: what makes a good job?*, July 2014

There may also be a case for greater decentralisation of public sector wage bargaining and determination to better match local economic and labour market conditions, which would be consistent with broader moves to greater devolution of

*There are no easy answers to the challenge of reducing the public sector paybill, but there are fiscal choices to be made that will affect the scale of the adjustment needed*

powers and funding across the UK. This might, for example, lead to higher public sector pay in areas like London and the South East where IFS research shows that private sector pay is relatively higher after adjusting for age and education, making it more difficult to get skilled staff like nurses and teachers to work in the NHS or state

schools. However, such local pay variations would make the system more complex, might limit staff mobility within the public sector and could lead to perceptions of unfairness across the country.<sup>9</sup>

In summary, there are no easy answers to the challenge of reducing the public sector paybill. But there are fiscal choices to be made that will affect the scale of the adjustment needed and there are also ways of mitigating the pain based on fewer, but more skilled and engaged government employees. This will also help to allow real pay increases in the next parliament that do not fall too far behind private sector levels so that high-quality staff can be attracted to, and retained in, public service.

<sup>9</sup> For a more detailed discussion of this topic, see Section 3.4 in Cribb, Emmerson and Sibieta, 2014



Professor Sir George Bain, first chair of the  
Low Pay Commission, and Conor D'Arcy,  
Resolution Foundation

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# Making more of the minimum wage: what role can it play in tackling low pay?

Those of us present at the birth of the National Minimum Wage (NMW) were under no illusions: the policy had a fight on its hands. The NMW's opponents were armed with warnings of a million jobs in jeopardy and its future looked far from guaranteed. Seventeen years later though, it is still standing. The Low Pay Commission's (LPC) evidence-based approach and annual uprating have seen the NMW more or less eliminate extreme low pay with little or no damage to employment.

With that achieved, has the time now come for our minimum wage policy to turn its attention to bigger battles?

To answer that, we assess how the NMW has affected those at the bottom as well as further up the earnings scale before setting out an agenda to enable the LPC and NMW to play an enhanced role in promoting wage growth. That said, we recognise both that there is only so much a minimum wage can do, as well as the well-deserved respect that the current system commands. As far as possible, we try to adhere to the credo of the first LPC: keep it simple, stupid.

### Strengths and weaknesses

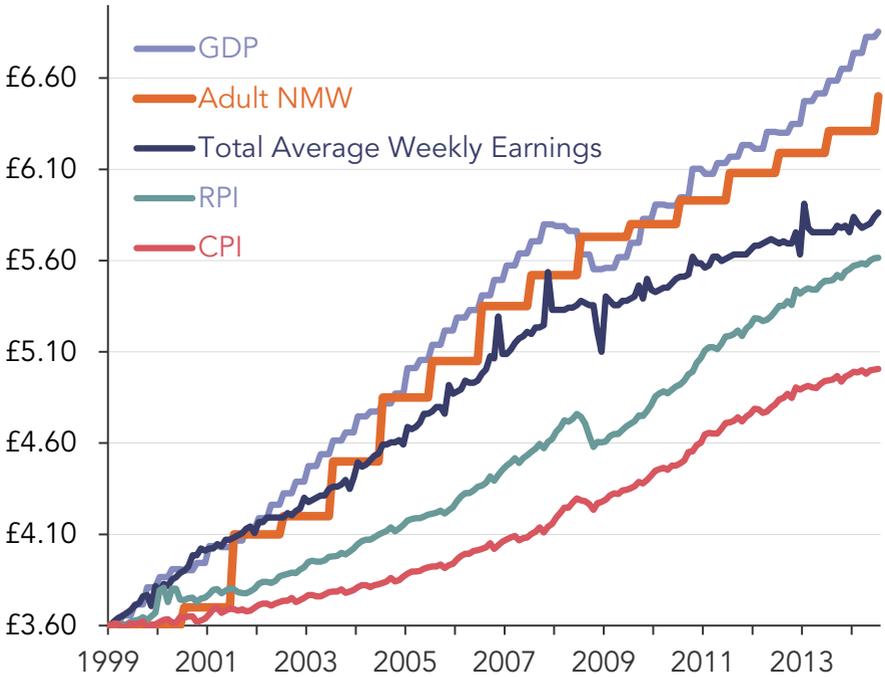
The years since the downturn in 2008 have highlighted both the triumphs and limitations of the NMW. One pleasant surprise has been the performance of employment, with unemployment rising more slowly and then falling more rapidly than expected. This was the first recession with the NMW in place, so it was reassuring that while some groups have struggled, the policy's overall impact on jobs has continued to be minimal.

With inflation racing ahead of pay, NMW workers saw their hourly wage drop in real terms by 5.6 per cent from 2008 to 2013. Importantly though, the NMW shielded them relative to average earnings which fell more rapidly. As a result, the NMW's 'bite' – its value as a percentage of median hourly earnings – rose, going from 52 per cent in 2008 to 54 per cent in 2014. This hasn't just affected those actually on the NMW: 30 per cent of workplaces – covering nearly one in four workers – say the NMW influences their pay settlements.<sup>1</sup> Exact estimates of the 'spill-over' from the NMW – the knock-on effect it has on the wages of workers above the NMW – vary but recent analysis suggests that its ripples could reach as high as the 25th percentile (that is, those earning 40 per cent above the level of the NMW).<sup>2</sup> As a policy, it is already punching above its weight.

<sup>1</sup> A. Bryson and P. Lucchino, *The Influence of the National Minimum Wage on Pay Settlements in Britain*, Low Pay Commission, February 2014

<sup>2</sup> T. Butcher, R. Dickens and A. Manning, "Minimum Wages and Wage Inequality: Some Theory and an Application to the UK", *CEP Discussion Paper 1177*, November 2012

**Figure 1: Giant leaps and baby steps: the rise of the National Minimum Wage, 1999-2014**



*Source: ONS with further data kindly provided by Yi Zhang of the Low Pay Commission*

More recently we have, however, seen the limitations of the current NMW framework. The move to its present level (£6.50) was the first real-terms increase in six years. With the recovery now on a firmer footing, employment rates at record highs and average earnings growth expected to gather pace (the Bank of England projects that nominal pay growth will reach 3½ per cent by the end of the year), the timing seemed right for a more ambitious increase as well as a longer-term discussion about its future trajectory. Despite these favourable conditions, the NMW will not now regain its peak value in real terms until October 2016 at the earliest. For a policy that was so pugnacious in its early years, it has become quite timid.

To date, the LPC’s focus has been on recommending the rate, with little concern for whether employers go further. It advises on annual, incremental amendments

to the rate without attempting to make in-roads into low pay over time. Yet across the workforce, one in five employees is low paid, making the UK among the worst performers internationally. Despite its name, its remit means the Low Pay Commission takes little interest in low pay more broadly.

Before setting out our thoughts on how it could be refined and made more ambitious, it is important to recall that the NMW has done exactly what was asked of it: raise wages without hurting employment. And the LPC has rightly won plaudits for being the best example of functioning social partnership in the UK's labour market, in which employer and worker representatives collaborate. Nonetheless, the sense of its untapped potential is hard to shake. Our plan centres on three criticisms of today's approach.<sup>3</sup>

### Narrow focus

About 5.2 million Britons are low paid. However ambitious we are, a minimum wage cannot solve that problem alone. The need for a genuine cross-government low-pay strategy is clear. With its depth of expertise, the LPC is the ideal body to lead that charge. To equip it to do so, it should have its remit broadened and strengthened, transforming it into a watchdog on low pay with the responsibility of devising ways to tackle the problem and reporting back on barriers to progress. This task of identifying and removing barriers to further increases would represent a more pro-active LPC, moving forward from the relatively passive stance it currently takes on low wages beyond the NMW.

Such a strategy would help guard against some of the potential risks that come with a rising wage floor. One of the ways

in which employers dealt with the NMW was to reduce the gap between their lowest paid workers and those slightly above, despite the spill-over effect. There is well-placed concern that, as the rate goes higher, an ever-larger share of the workforce will find themselves on the NMW with little scope to rise up the ranks. This is why a real low-pay strategy is so crucial. The policies outlined in other chapters of this book – most notably those of Gregg, Wolf and Philpott – on encouraging progression, reforming vocational education and improving security could form the pillars of such a plan.

*The Low Pay Commission should become a watchdog on low pay*

<sup>3</sup> The following recommendations are the result of a panel of labour market economists and policy experts hosted by the Resolution Foundation in 2013-14. For a fuller discussion see Resolution Foundation, *More than a Minimum: Final Report of the Resolution Foundation Review of the National Minimum Wage*, March 2014

## Short-term approach

When it was introduced, the NMW had a radical mission – to eliminate extreme low pay – but with that goal mostly achieved, it no longer has a transformative vision driving it forward. To counter that, the government should, consulting with the LPC, agree an ambition for the future of the NMW over the course of a parliament. To be clear, this doesn't mean picking a cash figure, as we have seen with the Chancellor's £7 and Labour's £8 how these can quickly go out of date as inflation and wage expectations shift. An ambition expressed as a percentage of the median wage is a far more sensible, if less intuitive, way of signalling what level the NMW should rise to. This would inject new ambition into the LPC while retaining its independence and evidence-based approach. Its recommendations would be free to deviate from

*We recommend that the LPC publish the rate that would be affordable within each area and sector*

the path needed to meet this ambition should economic indicators worsen – it would still determine what is possible each year.

As the rate edges higher, each increase is likely to be presented by some as pushing employers into the arms of technology, thereby knocking low-skill workers out of the workplace. In the long term, it is very difficult to say exactly what automation will mean for jobs and wages. But over the past two decades, it has primarily been routine mid-skill, mid-paying roles that have been replaced. The LPC should of course monitor the situation but technology should not be a serious headwind for the NMW.

## One-hit wonder

As the number of workers on the NMW has increased, the need for pressure points further up the pay scale has grown. The case can be made for setting specific minimum wages by regions; Dube's chapter in this collection shows how local wage-floors can be effective. Looking across the UK however, the only area in which a higher rate seems feasible is London. In most regions the NMW has a bite of between 50-60 per cent of median pay; in the capital, it is just 39 per cent. There is therefore a case to have the LPC assess and publish what rate would be affordable in London.

Another way of dividing up the workforce is by industry. Some sectors – banking is an obvious example – would experience only a negligible increase in total labour costs if the NMW was to rise substantially. Hence, we recommend that the LPC publish the rate that would be affordable within each sector. Again, to be clear, this would not be binding. It would act primarily as an information source for wage negotiations in the hope of spurring some upward momentum in a similar vein to the Living Wage.

But in those sectors where the NMW has become the going rate, more serious intervention will be needed. There are always limits to how high a minimum wage can go without endangering employment, and faster rises will undoubtedly be difficult to manage in occupations like cleaning or hospitality, in which three in ten employees are paid at or below the NMW.

This package of reforms would protect what is best about the today's system – its independence, expertise and responsive, annual cycle – while unleashing the potential of the NMW and LPC. What would all that mean over the next five years? Having sounded the alarm on the flaws of cash value projections, it would be hypocritical to discuss pounds and pence. Much will depend on how the recovery proceeds in the coming years. But, with that caveat in mind, if the NMW were to increase to 60 per cent of median hourly pay (a ratio that international evidence suggests is at the upper limit of what is affordable) by 2019-20, it would be worth about £1 more in today's prices. But again, that depends on inflation and economic circumstances: there can be no guarantees.

A steady march to that territory, as part of a low-pay strategy which for the first time takes the broader challenge of low pay seriously, should be both affordable for employers and provide a much-needed boost for our lowest earners as well as those immediately above them. In the late 1990s, some workers in Britain were paid £1 an hour. The NMW stopped it. Today's frontline is the fifth of Britain's workforce that is low paid. To stand a chance in this battle, the LPC and NMW will need new weapons.

# City limits: US city minimum wages and their relevance for the UK

The backdrop: the federal minimum wage became the binding standard for most US workers in 1938. But several decade-long bouts of federal inaction since then have propelled wage-setting at a more local level. Prior to the most recent federal increase in 2007, 37 states had minimum wages above the national rate.

Cities too have begun setting higher minimum wages, with city-level wage floors already in place in Albuquerque, Chicago, San Francisco, San Jose, Santa Fe, Seattle, and Washington, DC. Others such as Los Angeles are actively exploring possibilities.

This piece will discuss the US's experience with city minimum wages, reflecting on the evidence of their impact, potential and trade-offs. It will conclude by considering what such initiatives could mean for wages in the UK (and London in particular).

Does it make sense to institute standards at as granular a level as cities? As a starting point, it is useful to recognise how big cities are different. Perhaps no other city embodies the features and contradictions of big cities as clearly as San Francisco, the birthplace of the 'city mandates' movement in the United States. An historical abundance of highly-educated workers and the growth of high-paying sectors including finance, high-tech and biotech fuelled the city's takeoff during the 1990s. Labour productivity grew, owing to agglomeration and human capital externalities. Moreover, growth in the size and income of the high-skilled workforce sparked a demand for low-skilled service jobs, leading to a polarised labour market. At the same time, house prices soared, raising the cost of living in the city. In 2001, San Francisco began implementing what would eventually become a fairly comprehensive set of workplace mandates including a minimum wage, an employer health-spending requirement, and paid sick days. It was a mini-experiment in American social democracy. The successful implementation of this city-wide agenda laid the foundation for similar policies elsewhere.<sup>1</sup>

### The current landscape of city wage policies

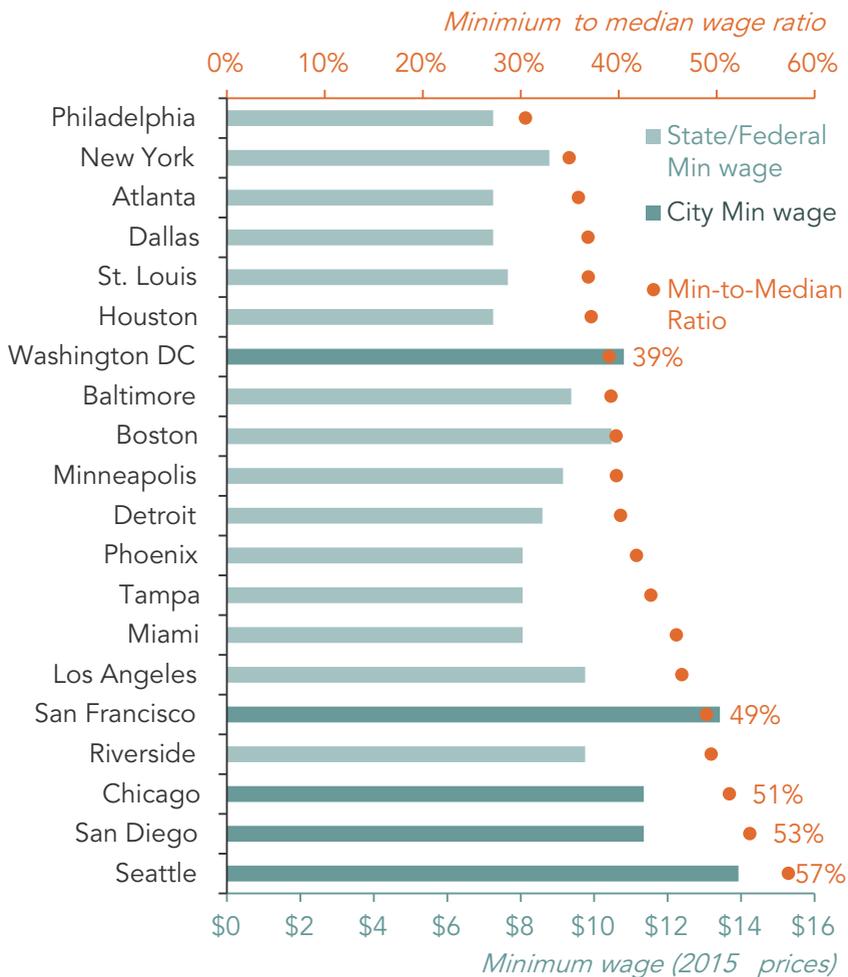
The most recent wave of city policies began in 2014, when Seattle's city council voted to implement a much higher standard, eventually reaching \$15 per hour (about £9.80). This came at the heels of organising of restaurant workers throughout the country: the \$15 target has been a focal point in both direct pressure campaigns on fast food chains on the one hand, and city-wide standards on the other. Within the past year, at least 14 additional cities or counties – including Chicago, Oakland, Louisville and San Diego – implemented a new minimum wage, while Washington DC and San Francisco substantially increased their existing standards.

How should we think about the ambition of these policies? The top-line numbers may be misleading for a few reasons. First, cities may have very different phase-in periods for the same eventual wage; inflation means the timing of when '\$15' is implemented has a big impact on its real-terms value. Second, the impact of a \$15 minimum depends on the local wage distribution. For example, setting the minimum wage to half the full-time median wage would produce a \$10 per hour policy nationally, but much higher figures in major metro areas such as Washington, DC (\$13.51),

<sup>1</sup> M. Reich, K. Jacobs and M. Dietz, *When Mandates Work: Raising Labor Standards at the Local Level*, University of California Press, 2014

San Francisco (\$13.37), Boston (\$12.85), New York (\$12.25) and Seattle (\$11.85).

**Figure 1: Biting back: minimum wages in the largest US metro areas and their relationship to median pay**



Notes: Data on median wages of full-time workers is adjusted to 2015 dollars. A 2.5 per cent inflation rate is assumed for converting future planned minimum wages to 2015 dollars.

Source: 2013 American Community Survey; National Conference of State Legislators; UC Berkley IRLE

Figure 1 shows the value of the prevailing or planned minimum wage, as well as the ratio of the minimum to the median wage of full-time workers, for the twenty largest metropolitan statistical areas (MSAs). In five of these metro areas (in dark green – Seattle, San Diego, Chicago, San Francisco, and Washington, DC), the prevailing minimum wage is the city one; in the other 15 metro areas (with the lighter shading), the relevant minimum wage is set at the state or federal levels. It shows that, being a high wage area, Washington DC's minimum wage likely corresponds to around 39 per cent of the city median. In contrast, Seattle's eventual minimum wage is likely to reach around 57 per cent of the median in that metro area. In general, most of the areas without a city minimum wage have minimums at or below 40 per cent of the median. (The latest data suggest the UK's minimum wage is worth 47 per cent of the full-time median hourly wage.)

*These policies can be expected to have a substantial effect on wages in the bottom half of the labour force*

It is useful to take a closer look at the policies in San Francisco, Seattle and San Diego to gauge their potential impact. In all cases, these policies have affected between one-fifth and one-quarter of the workforce. This does not mean a fifth or a quarter of the workforce will necessarily be on the minimum wage, but rather assumes that upward ripple effects will also benefit workers earning just above the wage floor. Nonetheless, the result will be a very sizeable section of the workforce in these cities being paid at or very close to the minimum wage. As a consequence, these policies can be expected to have a substantial effect on wages in the bottom half of the labour force.

It is notable that in all three cities, around two-thirds of the workforce are in the three core service industries (leisure and hospitality; retail and wholesale; and education, health and social services). The predominance of these service jobs – which are referred to as non-tradeable, meaning employers in these sectors have less to gain from moving to a lower-wage location – is important to bear in mind when thinking about how businesses may respond to the wage standards.<sup>2</sup>

<sup>2</sup> M. Reich, K. Jacobs, A. Bernhardt and I. Perry, "San Francisco's Proposed City Minimum Wage Law: A Prospective Impact Study", *IRLE Policy Brief*, August 2014; M. Reich, K. Jacobs, A. Bernhardt and I. Perry, "Fact Sheet: Estimated Impact of San Diego's Proposed Minimum Wage Law", *IRLE Policy Brief*, June 2014; M.M. Klawitter, M.C. Long, R.D. Plotnick, "Who Would be Affected by an Increase in Seattle's Minimum Wage?", *City of Seattle, Income Inequality Advisory Committee*, March 2014

## How will local labour markets respond to the mandates?

The weight of the recent evidence suggests that the employment effects of US minimum wage policies to date have been modest.<sup>3</sup> The evidence from high minimum wage cities like San Francisco, and other cities such as Santa Fe and Washington DC, also finds employment effects to date have been small.<sup>4</sup> The sizeable wage increases and small impact on employment lead to family incomes rising at the bottom.<sup>5</sup>

Now it is possible that the much larger increases in minimum wages currently being introduced may induce greater substitution of low-skilled labour with automation or higher-skilled workers, but as is discussed by Bain and D'Arcy elsewhere in this collection, those fears can be overstated. There are also some potential gains from higher wage-floors that might help offset some of the costs.

*Research indicates that low-wage workers substantially increase consumption in response to wage hikes*

A growing body of evidence shows there are sizeable reductions in labour turnover following a minimum wage hike.<sup>6</sup> Given the cost of recruiting and training new workers, reduction in

turnover can be expected to offset around one-fifth of the labour cost increases associated with minimum wage hikes in this range. The nature of high-cost metro areas means that a substantially higher minimum wage may allow more lower-wage workers to live closer to their place of work (inside the city) and reduce commuting time. This labour supply effect can also lower recruitment costs and improve the quality of the service workforce.

In part, the cost pressures from minimum wage increases are passed on to customers, especially in restaurants. Higher-income customers inside major cities

<sup>3</sup> A. Dube, T.W. Lester and M. Reich, "Minimum Wage Effects Across State Borders: Estimates Using Contiguous Counties", *IRLE Working Paper*, No 157-07, November 2011; S. Allegretto, A. Dube and M. Reich, "Do Minimum Wages Really Reduce Teen Employment? Accounting for Heterogeneity and Selectivity in State Panel Data", *IRLE Working Paper*, No 166-08, April 2011

<sup>4</sup> A. Dube, S. Naidu and M. Reich, "The Economic Effects of a Citywide Minimum Wage", *Industrial & Labor Relations Review*, Vol 60 No 4, July 2007; J. Schmitt and D. Rosnick, "The Wage and Employment Impact of Minimum-Wage Laws in Three Cities," *CEPR Reports and Issue Briefs*, July 2011

<sup>5</sup> A. Dube, *Minimum Wages and the Distribution of Family Incomes*, December 2013

<sup>6</sup> A. Dube, T.W. Lester and M. Reich, forthcoming

may be more able to absorb price increases without cutting back on demand. This is suggested by the limited evidence we have from San Francisco.<sup>7</sup> Finally, other research indicates that low-wage workers substantially increase consumption in response to wage hikes.<sup>8</sup> Sharp wage increases may lead to local multiplier effects in certain lower income neighbourhoods.

### International relevance of US city minimum wages

The lessons from the US city minimum wages may hold particular relevance in the UK and to London in particular. The two countries share a number of similarities when it comes to labour market institutions such as collective bargaining, employment protection laws and active labour market policies. And both have seen a sharp rise in wage inequality over recent decades. More specifically, the economic engine of London is similar to cities like San Francisco, Chicago, and Washington D.C: international in nature, with relatively high pay and including a large and increasingly global professional class whose demand for services has fuelled a growth in low-wage jobs.

How fertile a soil is the UK for such ideas to take root? In one sense, the US city example is a poor fit for the UK as it goes against a basic tenet of the popular and successful National Minimum Wage: that is, a single rate for the entire country. Nonetheless, it is interesting to note that the Living Wage, which has grown in salience and take-up in recent years, sets out a national rate and a higher London rate with little criticism.

Some groundwork has already been undertaken on the potential for London to have its own minimum wage above the level of the National Minimum Wage. The Bain review last year argued that the Low Pay Commission should be tasked with publishing a figure at which a London minimum wage would be set and, in due course, the Mayor could be delegated the formal power to accept or decline this higher rate. Research for Trust for London argued in 2013 that London could bear a higher minimum wage 40p above the national rate.<sup>9</sup> More research and discussion

<sup>7</sup> Dube, Naidu and Reich, 2007; C.H. Colla, W.H. Dow and A. Dube, "The labor market impact of employer health benefit mandates: evidence from San Francisco's health care security ordinance" *NBER Working Paper series*, July 2011

<sup>8</sup> D. Aaronson, S. Agarwal and E. French, "The Spending and Debt Response to Minimum Wage Hikes", *American Economic Review*, Vol 102 No 7: 3111-39, December 2012

<sup>9</sup> K. Ussher, *London Rising: the case for a London minimum wage*, Centre for London, November 2013

would obviously be required before such an idea could be put into practice. We don't really know what level a London minimum wage should reach but, to give an extreme example, were London to aim for a similar minimum-to-full-time-median ratio to Seattle (57 per cent), it would imply a minimum wage of close to £10, above even the current London Living Wage of £9.15.

More evidence will be needed from US cities before any firm judgment can be made on the impact of higher local wages. As more data from US cities comes in, observers from across the pond would do well to pay close attention to the impact of these policies.



# Bridging the divide: helping low earners in the UK's two-speed labour market

Pay inequality, the hollowed-out workforce, in-work poverty. An internet search on any of these terms will generate enough reading material on Britain alone to last an average human life span. Yet while such literature includes frequent references to an ever-wider gap between 'good jobs' and 'bad jobs', many economists baulk at the suggestion that Britain has a dual or two-tier labour market in which some workers get stuck in a low-wage, 'low-road' world while others prosper in a high-wage, 'high-road' environment.

This essay assesses the concept of the dual labour market and what it means for wage growth over the next five years.

Economists have for decades debated whether a divide between distinct types of business models lies at the root of pay outcomes. For example, might aspects of organisational behaviour help explain why, as Resolution Foundation research has highlighted, a very high proportion of low-paid workers remain stuck on low pay for years on end?<sup>1</sup> At present the dominant view is that, even if Britain might once have had some kind of dual labour market, today's deregulated, flexible jobs market displays less structural duality than in the past. As a result, there is lower structural unemployment, the rate at which workers climb the occupational job ladder is relatively high by European standards and, though it may be hard to escape low pay, the chance of doing so is greater than 30 years ago.<sup>2</sup>

Despite this, however, anyone who takes a close look at Britain's employment and pay landscape would surely agree that the divide between good jobs and bad jobs is wider than a generation ago. This is mostly discussed in relation to the characteristics of workers but is arguably also due in part to the impact of structural change on organisational behaviour, the acknowledgement of which has implications for employment policy.

### How changing organisational behaviour has widened the jobs divide

High-road employers used to offer workers good pay and conditions to protect investment in specific skills within internal labour markets. Nowadays they have to do even more to emphasise their brand as 'good employers' in order to attract and retain the most productive individuals in a highly mobile global talent pool. Intense competition has ratcheted up the pay of high fliers in these firms relative to other workers but made entry to the such roles even harder for those without very good transferable skills.

*The potential for upward mobility has been diminished still further because cost pressures have created two-tier workforces*

Indeed, the potential for upward mobility has been diminished still further because cost pressures have created two-tier workforces within these organisations. High-road firms either employ just core essential workers, hiring others only when needed from lower cost low-road contractors and employment agencies, or offer markedly different terms to directly-employed workers ranked according to skill, ability and effort. Many

<sup>1</sup> C. D'Arcy and A. Hurrell, *Escape Plan – understanding who progresses from low pay and who gets stuck*, Resolution Foundation, November 2014

<sup>2</sup> S. Thompson and I. Hatfield, *Employee progression in European labour markets*, IPPR, February 2015

workers who might once have been hired into decently-paid jobs – the pay and conditions of which were often not greatly inferior to those of core skilled workers – are thus increasingly relegated to the actual or de facto low-road, with the added indignity of spending their working day alongside much better-paid high-road co-workers.

The overall restructuring has been facilitated by neo-liberal economic policy, notably emasculation of trade union power, outsourcing of ancillary public sector jobs to low-road employers and the general encouragement of the growth of small organisations which are difficult to unionise.

What's been bad news for low-road workers has of course been good for their employers. Structural change has had less direct impact on their business models. But the harder it is for workers to escape the low-road and the more are displaced into it from the high-road, the easier it is to water down working conditions even further. This latter tendency has been exacerbated in recent years by a surge in the supply of labour available to employers, driven by a combination of welfare reform, immigration and more students and older people looking for routine part-time work. With new technology appearing to replace many routine jobs since the 1990s, pay pressures on this group have built still further.

### Can we bridge the jobs divide?

What could be done to bridge the gap between the two and boost the pay of those in low-road firms? A return to tighter conditions in the labour market, as both Machin and Bernstein discuss in this collection, would help narrow the divide by diminishing the

*Valuable progress might be achievable via pressure on high-road-type organisations to ensure they offer a better deal to low-road workers*

supply of workers. However, the structural jobs divide persisted during the years of low unemployment prior to the Great Recession which suggests we need to do more than achieve full employment.

Debate understandably tends to focus on improving transferable skills and the progression of individuals up the occupational and pay ladder. Less attention is given to how employers organise work, partly because interfering in the organisational 'black box' is a taboo to the dominant consensus. As a result, we get a lot of rhetoric about spreading the business case for 'making bad jobs better' – a laudable aspiration that falls prey to the logical fallacy that organisations with low-road business models can somehow be persuaded to adopt high-road human resources practices. Most won't because they have no incentive to do so.

This puts a serious question mark over voluntarist solutions to the low-pay problem,

including advocacy of the Living Wage or calls on low-road employers to provide workers with training and introduce pay progression systems. While such endeavours are worth pursuing, they are unlikely to influence more than a minority of employers. Valuable progress might be achievable via pressure on high-road-type organisations to ensure they offer a better deal to the low-road workers they either directly or indirectly employ. But any success will probably emerge from appeals to corporate social responsibility rather than to hard business logic.<sup>3</sup>

*There is also a strong case for punitive restrictions on some forms of employment practice such as zero-hours contracts*

While fine words may help some low-paid workers, aggressive policy intervention is likely to be the only way to improve the lot of most. This requires in particular far greater ambition in the approach to determining the level of the statutory National Minimum Wage. Although, as Bain and D'Arcy discuss in their chapter, it requires a stretch of the imagination to expect the legal minimum to ever reach the level of the Living Wage. This suggests an ongoing need for taxpayer subsidy to support the incomes of the working poor. In this respect, the key debate is whether that subsidy is best provided as now in the form of a system of means-tested tax credits or instead, and far more radically, through some kind of guaranteed basic income. While some might consider the latter to be unlikely, it's worth noting that Universal Credit will provide the basic mechanics required for such an approach.

Regardless of the level of the minimum wage there is also a strong case for punitive restrictions on some forms of employment practice such as zero-hours contracts. The increased use of such contracts in recent years appears to have become an ingrained feature of the UK labour market rather than a symptom of the recession. By failing to guarantee minimum hours of work, zero-hours contracts flout the spirit of the minimum wage and act as a disincentive to employers to improve working conditions.

*Improved employment rights of this kind will not help Britain's growing army of self-employed contractors*

Improved employment rights of this kind will not, however, help Britain's growing army of self-employed contractors because of their position as profit-earning micro-businesses rather than wage-earners. But with hourly income among such workers tending to be lower than among employees – and with some legitimately earning less than a minimum wage – practical business support should nonetheless be offered. Not least, there is a need for tougher regulation to ensure their clients pay up on time.

<sup>3</sup> J. Philpott, *Rewarding work for low paid workers*, Joseph Rowntree Foundation, April 2014

As for wage earners, it is arguable that improved individual employment rights should be bolstered by enhanced collective (in effect, trade union) rights. However, it is uncertain what this would do for pay and conditions in a low-road world dominated by small organisations. Indeed, stronger trade unions might push up pay and reduce job openings among high-road firms, thereby exacerbating the jobs divide.

### Challenging the counter-arguments

Either way, talk of further employment rights inevitably raises the subject of 'red tape' and, more importantly, the issue of a potential negative trade-off with jobs. This must always be of concern but, as the experience of the National Minimum Wage shows,

*We should think of employment regulation as akin to a game of 'whack-a-mole'*

such fears can be exaggerated, especially when the potential trade-offs associated with regulatory change are viewed in too narrow an economic context. For example, strict curbs on the use of

zero-hours contracts are opposed on the grounds that this will cost jobs. But the net economic value of these jobs is questionable.

People employed on zero-hours contracts are very unlikely to receive training, thereby restraining productivity growth. And these contracts are primarily of benefit to people without dependants and/or who aren't reliant on their zero-hours contract job for their entire regular income (notably full-time students and older people on a pension). As a result, the rise of zero-hours contracts presents a barrier to work for people with no other income and who need the security of a steady job that pays a regular wage. Even if tough regulation of zero-hours contracts were to cause employers to offer a smaller number of jobs overall, there would likely be offsetting economic gains from requiring all employment contracts to guarantee a minimum number of hours of work.

It can of course be argued that employers denied the ability to use zero-hours contracts will simply adopt some other bad practice instead. But this is precisely why we need an active and well enforced regulatory regime. We should think of employment regulation as akin to a game of 'whack-a-mole'. Each emerging bad practice should be knocked out as soon as it rears its ugly head, lest it become yet another insidious feature of the bad jobs segment of our divided labour market.



# Resolution Foundation

After the longest fall in modern history, real wages have moved into positive terrain and appear to be turning the corner. Yet the outlook for wages – how strong and shared pay growth might be in the years ahead – remains highly uncertain. What emerges will shape not just what happens to living standards but also the fiscal position and wider political choices that will define the next parliament and beyond.

To foster informed debate about these challenges and the policies best placed to respond to them, the Resolution Foundation has brought together contributions from leading economists straddling the worlds of academia, policy research and journalism. Rather than simply diagnosing the problem, each contribution points to possible policy responses.

Contributions include: **John Van Reenen** on raising productivity; **Alan Manning** on power and wages; **Chris Giles** on the generational challenge and pay; **Baroness Alison Wolf** on training and skills to boost young people's prospects; **Sir George Bain** and **Conor D'Arcy** on making the most of the minimum wage; **Susan Harkness** on women, wages and employment; **Jared Bernstein** on lessons from the US; and **Arindrajit Dube** on what the US debate on higher local minimum wages could mean for the UK.

REGISTERED OFFICE: RESOLUTION FOUNDATION, 2 QUEEN ANNE'S GATE, LONDON SW1H 9AA.  
REGISTERED IN ENGLAND AND WALES. COMPANY NUMBER: 5588883. CHARITY REGISTRATION  
NUMBER: 1114839.

@RESFOUNDATION // RESOLUTIONFOUNDATION.ORG  
INFO@RESOLUTIONFOUNDATION.ORG // +44 (0)20 3372 2960