THE RF EARNINGS OUTLOOK

A look beyond the headline data on the forces behind current developments in pay, how the fruits are shared, and the short- and longer-term drivers of earnings growth

The publication last month of the most reliable and comprehensive source on earnings presented a more muted picture of the early stages of the pay recovery than the more timely monthly series had indicated. More encouraging was the information below the headlines, particularly the fact that the recovery was strongest among the lowest earners.

In recent months average weekly earnings growth has started to tail off, and our near-term projection for the December labour market figures suggests real growth of 2.1-2.2%. That's back to or below the pre-crisis trend, despite inflation remaining ultra-low. This window of opportunity from low inflation has remained open longer than expected, but will start to close in coming months.

In this regular briefing we use 13 key indicators to take a more detailed look at underlying trends and prospects for the future.

Analysis from Laura Gardiner:

"A look at the labour market headlines suggests a more uncertain picture for recent and current wage growth than we had a couple of months ago, with our best sources giving more muted results than our most timely ones, and the impact of the changing make-up of the workforce cast back into doubt.

"However the picture beneath the headlines is much more encouraging, with faster wage growth for lower earners contributing to falling earnings inequality, although we mustn't forget that the self-employed are absent from this picture.

"A tightening labour market and ultra-low inflation were big drivers in the first year of the pay recovery, but there are signs of flattening in measures of slack, and the expectation remains that inflation will soon start rising. Productivity will have to do far more of the legwork in 2016 and beyond if the pay rebound is to be maintained."

Our **earnings breakdown** suggests pay settlements for employees continuously in work have risen over the course of 2015, feeding into relatively steady nominal pay growth. On the other hand, the impact of the changing make-up of the workforce is again dragging slightly and remains a way short the usual boosting effect. Because last year's compositional drag still forms the base of the calculation this may well improve in coming months. But returning to a sustained boost appears further off than previously expected. More encouragingly, faster wage growth for the lowest earners has led to a reduction in employee earnings inequality in 2015 on both of our measures.

Our analysis of **pay pressures and slack** shows tightening slowing slightly. But these indicators tend to lead nominal wages and had been improving in the main until recently, so we might expect continued upward pressure on pay growth in the coming months. These measures – which include underemployment and labour mobility – are well short of their tightest levels this century, however, reminding us that some spare capacity remains.

Our review of **longer-term labour market health and efficiency** shows flat participation (which will be the key driver of employment growth as unemployment approaches its norm), gently rising productivity, and further deterioration in the training investment and qualification-job matching measures that may help us to understand both the development of productive capacity and the efficiency with which it is put to use. Reflecting on the importance of productivity gains in determining real pay growth in 2016 and beyond as inflation returns to target, our 'Spotlight' article highlights the range of pay growth results that realistic productivity and inflation outcomes next year point to.

 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator, including data visualisation, is available at www.resolutionfoundation.org/earningsoutlook.

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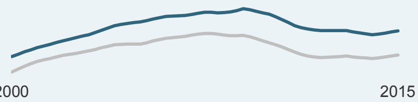
The Scorecard: Q2 2015

What's happened: The earnings breakdown

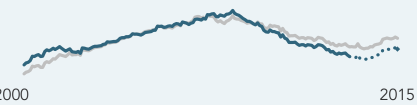
MEDIAN EMPLOYEE EARNINGS



↑ 1.6% on yr (all)
↑ 1.5% on yr (private sector)

Pay growth has been helped by ultra-low inflation. Real median hourly pay is growing at roughly the same pace in the private sector as it is across the economy.

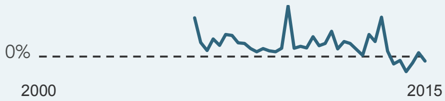
ALL WORKER EARNINGS



Employee earnings and all worker earnings gap →

An enduring squeeze on self-employed earnings means the gap between average weekly earnings for all workers and employees has persisted since 2012.

EARNINGS DECOMPOSITION



→ on yr

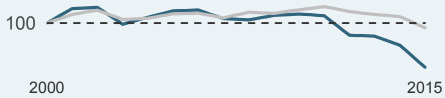
The compositional effect on average weekly pay has dipped back below zero, and remains well below its long-term norm.

PAY RISES

↑ 0.9ppts on yr

The typical real hourly pay change for employees staying in work over a year is 1.2%, marking a continuation of the previous year's improvements.

EARNINGS INEQUALITY

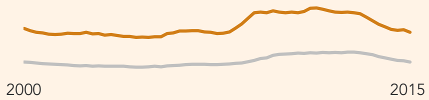


r75:25 ↓ 1.4% on yr
r90:10 ↓ 2.7% on yr

Hourly pay inequality between the upper-middle and lower-middle (r75:25) has been falling, with a sharper decline in inequality between the top and bottom (r90:10).

What's round the corner: Pay pressures and slack

UNEMPLOYMENT BY DURATION



↓ 0.7ppts on yr (all)
↓ 0.5ppts on yr (long-term)

The unemployment rate continues to fall, although at a gentler pace. It remains 20% above its post-2000 low-point. Long-term (+6 months) unemployment continues to fall.

UNDER-EMPLOYMENT

↓ 16% on yr

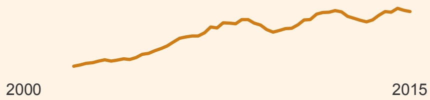
Underemployment (net hours desired by those in work as well as the unemployed) is falling, although more gently than it was. It remains 57% above its post-2000 low.

JOB-TO-JOB MOVES

↑ 16% on yr

Job-to-job moves, which are a key mechanism of pay progression and can reflect worker confidence, have risen steadily. They remain 35% below their post-2000 peak.

MIGRANT JOB ENTRY

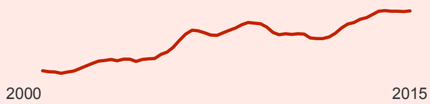


→ on yr

Employment from abroad expands labour supply, dampening pay's sensitivity to falls in domestic slack. The share of job entries made up by migrants is flat.

What's in the pipeline: Longer-term labour market health and efficiency

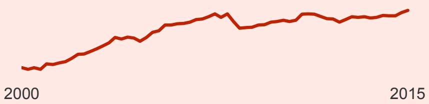
WORKFORCE PARTICIPATION



→ on yr

Boosting participation is key to full employment (although it can constrain pay growth in the short term). The 18-69 participation rate is flat.

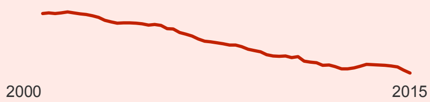
LABOUR PRODUCTIVITY



↑ 1.3% on yr

Labour productivity is the principal long-term driver of real pay. It is rising gently (below trend), having been more-or-less flat in recent years.

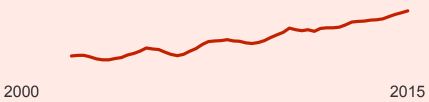
TRAINING INTENSITY



↓ 5% on yr

Training can boost individual productivity and may reflect employer confidence. While 'off-the-job' training rates are falling, the pace of decline has slowed in recent years.

GRADUATES IN NON-GRADUATE OCCUPATIONS



↑ 2% on yr

Grads in non-grad roles reflect mismatches between qualifications and jobs, and may constrain productivity. The rate of established grads in such roles continues to rise.

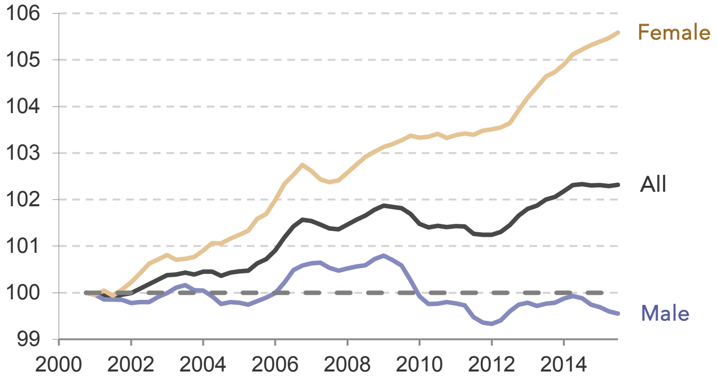
 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator, including data visualisation, is available at www.resolutionfoundation.org/earningsoutlook.

THE RF EARNINGS OUTLOOK

Lifting the lid: The picture across different groups and areas

Here we explore a few of the most interesting developments for different groups of workers and different parts of the country. But there's plenty more: a comprehensive breakdown of each indicator is available on the RF Earnings Outlook website: www.resolutionfoundation.org/earningsoutlook

Figure 1: Workforce participation by sex, 18-69 year olds (Index: 2000=100)



Notes: See notes on Indicator 10: Workforce Participation at www.resolutionfoundation.org/data/sources-and-methods

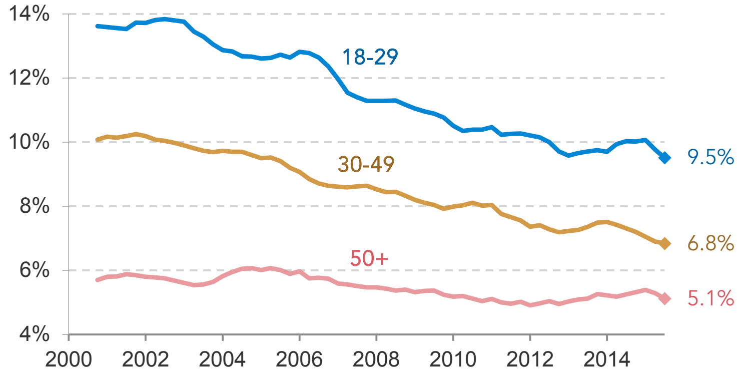
Male participation approaching 21st century low

Record participation masks very different trajectories for men and women. Female participation has risen continuously (to 69.1%) largely uninterrupted by the recession. But male participation, at 80.4%, lies a percentage point below peak and is trending down towards its lowest level this century.

While falling participation can boost pay growth in the short term as the pool of available labour diminishes, the impact of recent trends across the sexes could be more complex. If rising male inactivity is composed of those still quite close to the jobs market and with fewer barriers than the wider inactive population, then there may be more spare capacity than 'active' measures like un- and under-employment show. Either way, achieving the government's full employment ambitions will involve both reversing recent trends for men and furthering progress for women.

Figure 2: Training intensity by age

Share of employees receiving 'off-the-job' training in past 4 wks



Notes: See notes on Indicator 12: Training Intensity at www.resolutionfoundation.org/data/sources-and-methods

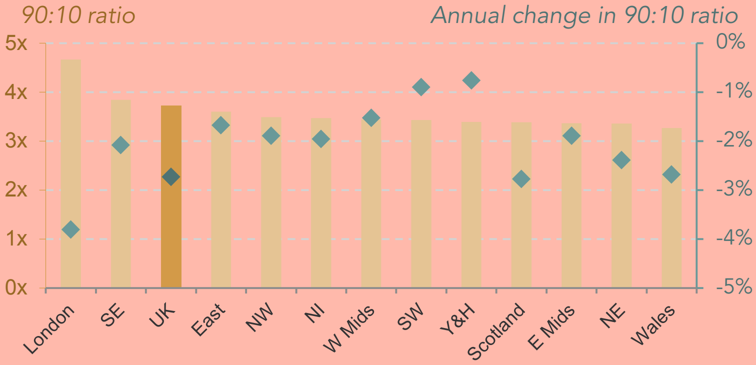
Young and prime-age workers bear brunt of training squeeze

The ongoing deterioration in training rates has been mainly felt by employees aged under 50. While training intensity has always declined with age this gap has narrowed: training rates are over 30% below their 21st century peak for 18-29 year olds and 30-49 year olds, but only 16% down for those aged 50 and over.

The maintenance of training for older workers is a positive trend: boosting productive work among the over-50s will be key to ensuring our economy keeps pace with demographics. But falling training investment for the under-30s – when workplace skills are least developed and productivity gains are usually most rapid – raises concerns about long-term skills and earnings potential, with both individual and macroeconomic implications.

The regional perspective

Figure 3: Regional earnings inequality, Apr-15



Notes: See notes on Indicator 5: Earnings Inequality at www.resolutionfoundation.org/data/sources-and-methods

Earnings inequality falling in every region and nation

We now know that there was a welcome skew to the first year of the earnings recovery, with pay at the bottom of the distribution rising more quickly than at the top in April 2015.

This was mirrored in each region and nation of the UK, shown by the falling 90:10 ratios in Figure 3, with the biggest fall in the most unequal region – London. In a large part, falling inequality across the country has been driven by widely-shared strong pay growth for the lowest earners. Growth at the tenth percentile was at least 2.5% everywhere, including those parts of the country where typical (median) pay continued to fall – London, the East Midlands and Wales.

 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator, including data visualisation, is available at www.resolutionfoundation.org/earningsoutlook.

Spotlight: The race on pay in 2016 – productivity versus inflation

Laura Gardiner, Resolution Foundation

With labour market tightening likely to play a gradually diminishing role, the principal determinants of pay growth next year and beyond will be productivity and inflation. Here we present a stylised 'thought experiment' that considers what different paths for each could mean for typical hourly pay growth in Q4 2016.

For a view on the future path of real wages, an obvious starting point is forecasts for average (mean) earnings and inflation provided by the Office for Budget Responsibility. These give little hope for a sustained 'catch-up', with real pay growth dipping back below the pre-crisis trend relatively swiftly as inflation returns to target – and converting to typical (median) pay leads to a similar conclusion. [1]

But to understand the upside and downside risks around such a view, we can break wage growth down a bit further into its constituent drivers. In simplified terms, these are inflation, levels of and changes in slack, and productivity.

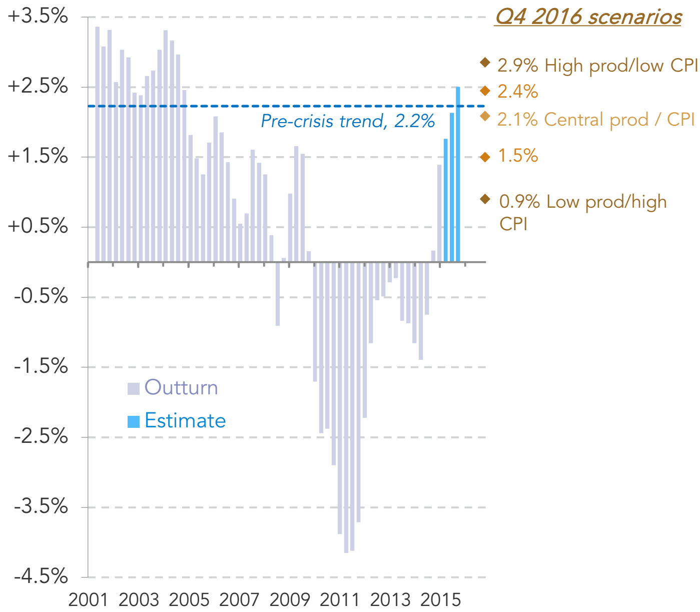
With our slack indicators stabilising in the latest data and their effects on pay taking some time to fully work through, we might think of the role of spare capacity in this very simplified wage model as both largely nailed down by outturns in 2015 and likely to gradually diminish in importance. That leaves us with inflation and productivity growth as the major unknowns (although developments in the latter also take time to feed through into pay growth – we find the highest correlation when productivity leads by six months).

On this basis, we create an experiment for the path of future typical hourly pay growth which banks the slack effect (using the relationship between pay and unemployment as a proxy) based on outturns and projections, and then considers different scenarios for both productivity and inflation. We assume that the pre-2008 relationship between productivity and pay holds. It is important to stress the extent of simplification here. For example, the productivity-pay relationship has changed in the past and may not be the same in future,[2] and we take no account of the potential inflationary effects of different nominal pay outturns, or the role of external factors like the new National Living Wage.

With such caveats in place, the results of our modelling, summarised in Figure 4, suggest that a stronger-than-expected productivity pick-up in coming months might be needed to maintain the typical pay rebound through to the end of next year should inflation follow its expected path – our central scenario has pay growth back down to 2.1% by the end of 2016.

Figure 4: Typical pay growth under different productivity and inflation scenarios

Year-on-year growth in median hourly pay (CPI-adjusted)



Notes: Based on ONS, Annual Survey for Hours and Earnings and Office for Budget Responsibility (OBR) data.

All five scenarios assume the pre-2008 relationship between pay growth and productivity growth holds, with pay growth lagging productivity growth by six months.

Each scenario is further adjusted to reflect the impact of historical and modest further reductions in slack on pay (based on OBR unemployment projections).

The OBR's central projection for productivity growth rises to 1.7% by the final quarter of 2016. Our 'high' and 'low' scenarios are 2% and 1.3% (the current growth rate) respectively.

The OBR's central projection for CPI inflation rises to 1.4% by the final quarter of 2016. Our 'high' and 'low' scenarios are 2% and 1% respectively.

The second and fourth scenarios reflect high/low productivity / central inflation, and central productivity / low/high inflation.

On the extreme upside, if stronger productivity growth (trending to 2% by Q4 2016, still below the long-term expectation of 2.2%) was coupled with somewhat slower inflation (1% rather than 1.4% by Q4 2016), the result could be the fastest typical pay growth in over a decade. On the other hand, flat productivity growth coupled with more rapid inflation could spell anaemic median pay growth – falling below 1%.

Our very illustrative scenarios show the range of pay growth results that realistic upside and downside outcomes for productivity and inflation might point to. The return of real pay growth in 2015 owed much to a tightening labour market and the window of opportunity – largely created by global factors – presented by ultra-low inflation. Looking to 2016 and beyond, hanging our hopes on either of these would be both a roll of the dice and an exercise in diminishing returns, highlighting the importance of productivity keeping pace with inflation in the longer term.

1 M Whittaker, *O, Blessed Revisions*, Resolution Foundation, November 2015
2 M Whittaker, *A recovery for all?*, Resolution Foundation, September 2015

 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator, including data visualisation, is available at www.resolutionfoundation.org/earningsoutlook.