CHAPTER **ONE**

End of an era?

The supply of low-wage labour is set to fall and its price is set to rise

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Labour markets change. They can do so slowly, in the face of deep-rooted structural trends; or quickly, following big policy moves or shifts in the economic cycle. Even before last year's Brexit vote the UK labour market was displaying signs of change on all three of these of fronts: long-term wage and employment relationships looked to be changing; a tightening labour market appeared to challenge the assumed permanency of some trends towards insecurity; and a huge policy shift was underway in the form of a significantly raised wage floor with the introduction of the National Living Wage (NLW). Add in the Brexit process, and in particular the prospect of a significant reduction in the availability of migrant labour, and the UK labour market starts to look as though it's approaching a potential tipping point.

Importantly, these developments appear to be concentrated towards the bottom end of the labour market. The pay squeeze that started after the financial crisis continues to be an issue across large parts of the earnings distribution, with the current decade on course to be the worst for average pay growth in over 200 years.[1] However, as we move down the earnings distribution we find that wages – and broader labour costs – are bucking the trend. It is also in that part of the labour market that migrant labour is concentrated and therefore where major post-Brexit migration policy shifts might have most impact.

For those firms reliant on relatively low paid labour, the impact of these two shifts will be significant: an era of seemingly limitless and relatively inexpensive low paid labour may be coming to an end. Understanding just what this potential tipping point might mean for firms' business models and our nation's labour market – rather than worries about the arrival of robots bringing an end to the world of work – should form the main focus of policy makers' attention as we prepare for post-Brexit Britain.

This book aims to chart the coming change. Not because the exact impact can be predicted, but because very different outcomes are possible on the basis of different decisions by government and firms that engage with, and shape, our labour market.

Much has changed in the UK labour market since 2008

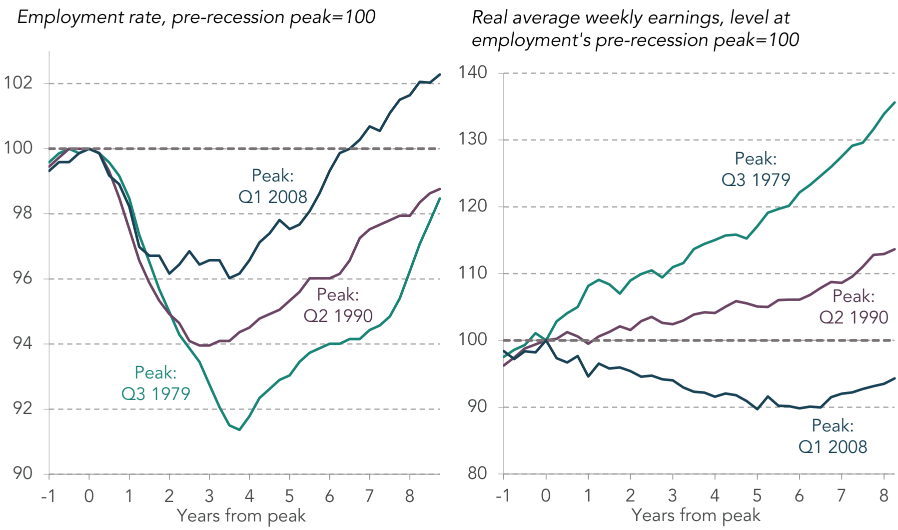
Digging into the changes that are underway in our labour market can save us from one of the most common errors in public policy making: assuming that tomorrow's battles look just like those of today. The importance of learning this lesson was brought out clearly by the post-financial crisis experience, which departed significantly from expectations.

In late-2008 it became clear that the UK was facing a significant recession, with output contracting by over 2 per cent in the final quarter of that year alone. All planning in Whitehall focused on what history told us would be the single biggest challenge from a recession on this scale – unemployment shooting up and topping three million, with lasting damage to the individuals concerned and the productive capacity of the UK economy.

Although unemployment did increase it never approached the highs recorded in the late 1970s, and as Figure 1 shows, employment returned to its pre-crisis peak much faster than in previous recessions. Clearly this was a welcome development, not least as rising employment benefitted those on lower incomes the most. Importantly, post-crisis employment growth has been about more than just unwinding cyclical unemployment. Rather, we have seen an increase in the number of people *participating* in the labour market, lifting the employment rate well above its pre-crisis levels.

The widespread availability of labour has been reinforced by an even faster growth in the number of hours worked per person. Both have been buttressed by a substantial rise in the labour supply coming from abroad during this period; migrants have accounted for two-thirds of the growth in employment over the past five years.

Figure 1: **A tale of three recessions: 1979, 1990 & 2008**



Source: RF analysis of Bank of England, *Three Centuries of Data*

Alongside the jobs 'boom' however, Britain has faced a post-crisis productivity and pay 'bust'. As the right-hand panel of Figure 1 makes clear, employees have endured an entirely unexpected and unprecedented period of not just slowing but falling wages. Only in Greece has the post-crisis squeeze on earnings been as dramatic.[2] Earnings remain 6 per cent lower than they were in early 2008 and productivity has only grown by 1.5 per cent in a decade, well below the 2.3 per cent annual growth experienced before the crisis. This was something unseen in previous recessions and something policy makers had made no preparations for.

Policy has also been slow to catch up with the large post-crisis rise in atypical or insecure work towards the bottom of the labour market. Since 2008 the number of people on zero hours contracts (ZHCs) has risen significantly to 900,000, agency workers have increased by 46 per cent, while some (but far from all) of the spectacular growth in self-employment has certainly been at the insecure end.

Taken together then, much has changed since the financial crisis. Unforeseen though it was in 2008, Britain has now got used to the idea that labour is available, that it is cheap and that – at the bottom of the labour market – it is prepared to work without the normal security of standard full-time employment.

More change is coming, thanks to a relative price shock at the bottom end of the labour market

Yet, just as policy makers were caught out by developments after 2008, so a failure to update our understanding of the labour market in light of more recent developments risks meaning we misdiagnose the challenges of the coming years. In particular, shifts at the bottom end of the workforce could underpin profound changes in the functioning of our labour market. Below we'll consider the effect of a potential labour supply shock associated with Brexit. But first we discuss the effects of a relative price shock that is already becoming apparent.

By 2020, we project that 15 per cent of all employees will be on the National Living Wage

While there is no sign of an end to the UK's overall pay squeeze,[3] there are good grounds for believing that firms who employ low paid workers will face fairly fast rises in their labour costs over the coming years.

First and foremost, the roll-out of the NLW imposes a direct cost on those hiring workers at or near the wage floor. The NLW is set to rise much more quickly than typical earnings over its first few years, such that its value reaches 60 per cent of median over-25 earnings in 2020 (after which it will rise in line with typical earnings growth). An expected real increase of 10 per cent between now and 2020 (taking it to £8.75) is significantly more rapid than either the 3.5 per cent expected for average earnings over the same period or the norm for the National Minimum Wage over the previous 15 years.

The scale of the impact of the NLW on relative labour costs is apparent in Figure 2. It shows that earnings rose by between 4 and 6 per cent for the bottom 30 per cent of the earnings distribution between April 2015 and April 2016 (the point at which the NLW was introduced). By 2020, we project that 15 per cent of all employees will be on the NLW, increasing the wage bill for those firms affected by £4.5 billion. Crucially, this will represent not just an absolute cost increase for firms but a relative one too, with employees at the bottom end of the labour market costing more relative to both higher paid workers and to capital.

Figure 2: **Pay growth has been strong for low earners: 2015-2016**

Source: RF analysis of ONS, *ASHE*

We would of course expect those sectors that rely most on cheap labour to be most affected by the lifting of the wage floor. In some industries, such as hospitality and retail, half of all employees look set to be affected by 2020. As such, wage bills in these sectors could rise by 3 per cent or more, as Table 1 shows. The early evidence we have suggests that labour costs are indeed rising most rapidly in those sectors listed at the top of Table 1. Real labour costs have risen by an average of 2.6 per cent in wholesale, retail, hotels and restaurants since the introduction of the NLW. They have also risen by 4 per cent in the construction sector, though given the large amount of self-employment in this sector other factors have likely played a part. By contrast they have risen by just 0.7 per cent for the private sector overall, and have fallen in finance and business services.[4]

Alongside the direct wage costs associated with the NLW, firms are also facing higher labour costs from other aspects of government policy – including the ramping up of auto-enrolment pension saving and the apprenticeship levy.[5] These represent more generalised costs than the NLW, but the former is likely to weigh heavier at the bottom of the labour market.

Since 2012, firms have been required to enrol all staff onto company pension schemes and to contribute to them. Larger firms were first to face the obligation, but all firms will by April 2018. The amount firms must contribute will also increase over time, from 1 per cent of an employee's earnings to 3 per cent. While firms do not have to contribute for those earning less than £5,876 per annum and those earning less than £10,000 or under 22 do not have to be enrolled (but can request to be), the evidence to date is that lower paid staff have benefited disproportionately from the move – presumably because higher earners were much more likely to already have access to an occupational pension scheme. For example, the number of people earning less than £300 a week and on a defined contribution pension scheme rose by 250 per cent between 2012 and 2016, compared with an increase of 86 per cent for those earning £500 or more.

The Department for Work and Pensions estimates that by 2019-20 employers will have to contribute an extra £6 billion annually in pension contributions as a result of the auto-enrolment policy. The scale of the impact is therefore likely to be equivalent to that of the NLW.

Coming together, these various – very welcome – policies will significantly raise the relative price of low-wage labour, compared to both higher-paid workers and the cost of capital. The impact of this shock will be felt differently across sectors, but will bring with it a strong incentive to think hard about how that labour is used.

The bottom end of the labour market may also be further affected by a labour supply shock associated with Brexit

The UK's recent jobs 'boom' owes something to both a rebound from the unemployment sparked by the financial crisis and increases in participation among older workers and other groups such as single parents. But it is also a product of sizeable increases in net migration over the past decade. The arrival of large numbers of foreign workers has provided a major boost to the UK's GDP and eased a wide range of labour shortages, both sectorally and geographically. Yet, as with costs at the bottom end of the labour market, things look to be changing.

Currently, residents of European Union (EU) and European Economic Area (EEA) countries can freely move to the UK. Since this right was enshrined in 1992, and particularly since the A8[6] countries joined the EU in 2004, many Europeans have come to the UK for work. Migrants from the EU and EEA account for only 7 per cent of all employment, yet workers from the continent have become an increasingly important part of the labour market, particularly since 2004. Since this point the number of people from the EU in work in the UK has increased by 1.6 million and migrants from the A8 countries have accounted for over 60 per cent of this increase. More recently, EU migrants have accounted for a third of the increase in employment since 2010.

In some sectors migrants are an even larger part of the labour force, forming a large proportion of employees in hospitality, agriculture and a large share of domestic workers. EU migrants form 15 per cent of employment in the food manufacturing industry, 13 per cent of hotel employees and 9 per cent of all restaurant and bar staff. The figures in Table 1 exclude the self-employed and so probably underrepresent the

Table 1: **Increasing costs for firms: 2016 & 2020**

Sector	Increase in wage bill in 2020 as a result of the NLW	EU migrants as a share of employees (2016)
Food and beverage service activities	3.6%	8.9%
Services to buildings and landscape	3.0%	8.5%
Accommodation	2.8%	12.5%
Residential care activities	2.8%	3.9%
Manufacture of wearing apparel	2.6%	6.6%
Security and investigation activities	2.3%	3.0%
Employment activities	2.0%	5.6%
Retail trade, except vehicles	2.0%	3.8%
Crop, animal production, hunting	1.9%	7.0%
Other personal service activities	1.9%	4.1%
Gambling and betting activities	1.8%	4.5%
Manufacture of textiles	1.8%	5.1%
Manufacture of food products	1.4%	15.2%
Domestic personnel	1.3%	16.9%
Manufacture of furniture	1.3%	5.9%
Social work without accommodation	1.3%	3.6%
Wholesale and retail trade	1.2%	3.0%
Sports, amusement, recreation	0.9%	3.9%
Manufacture of wood and wood products	0.8%	4.8%
Rental and leasing activities	0.8%	4.3%

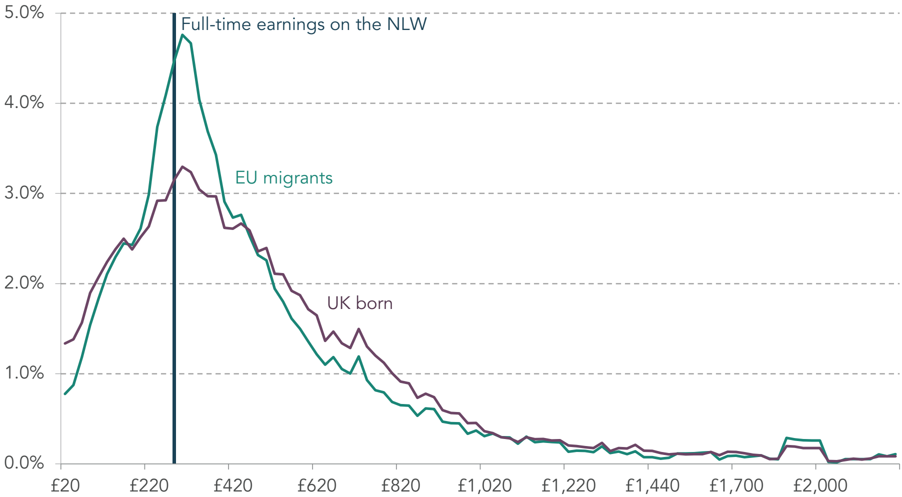
Source: RF analysis of ONS, *ASHE* and *LFS*

migrant workforce in some sectors – such as construction – where self-employment is common. Geographic concentration also means that in some parts of the country they form an even greater part of the workforce than this.

As well as the variation across the economy, what stands out is the extent to which many of the sectors most reliant on migrant labour are also significantly affected by the NLW. The sectors in Table 1 will be those most affected by changes in the labour market, they all have an above-average exposure to increases in the NLW and the majority of them also have an above-average proportion of EU migrant employees. Figure 3 reinforces the point that many lower paying sectors will feel the dual impact of a rising NLW and falling migration. The share of EU migrants earning between £220 and £340 (£60 a week either side of full-time earnings on NLW) is 50 per cent greater

Figure 3: **EU migrants tend to cluster towards the lower part of the earnings distribution: 2014 - 2016**

Share of earners by weekly earnings



Notes: Weekly earnings capped at those earning £3,000 or above.

Source: RF analysis of ONS, *LFS*

than that for natives. Around a third of EU migrants sit in this part of the distribution compared to a fifth of natives.

Migrants have therefore played an important role in the country's recent employment boom, increasing the availability of relatively skilled, flexible labour. In some sectors they carry out tasks that native workers cannot or do not wish to do. They have also increased the geographical mobility of labour in the UK, further boosting effective labour supply beyond the levels implied by the raw number of workers. This is both because they are more mobile once they are based in the UK but also because migrants tend to go to places that have tight labour markets in the first place.[7]

The impact of migration on wages is hotly debated. Our own evidence, in common with wider work, finds no effect on wages overall but a small effect on lower paid and lower skilled workers.[8] In any given year that effect is negligible and is clearly dominated by wider shifts in productivity or employment, but over a prolonged period it is not immaterial.

Looking to the future the combination of the decision to leave the European Union (EU), the fact that both Labour and the Conservatives have promised to end freedom of movement, and a tightening labour market in many European countries means that the years ahead are likely to bring big changes to the role of migration in the UK labour market.

While the full impact of the Brexit vote on immigration will not be felt for many years, there are some early signs that numbers are already easing off. Figures for the end of 2016 shows that net migration dropped below 250,000 for the first time in three years, National Insurance registrations for EU workers are flat, and there has been a plateauing in those born in the EU working in the UK.[9] While the data is not yet suggesting a dramatic drop in EU workers, some industries have suggested that they may soon face significant shortages.[10]

Further reductions are likely even ahead of any major migration policy changes if the wider European economy continues to perform strongly, the pound remains relatively weak and uncertainty exists about EU migrants' ability to stay in the UK long term.

In terms of the first of these factors – one that is often less discussed in the UK – the evidence is that over the past year labour markets in Europe have begun to tighten significantly. This is true both in countries such as Germany and other European nations that tend to attract economic migrants, but also in countries used to seeing significant emigration. Across the whole of the EU (excluding the UK) the unemployment rate has fallen from just below 10 per cent to just below 8 per cent, with some countries, particularly Poland and Bulgaria, experiencing a more significant decline (Figure 4).

Migrants have therefore played an important part in the country's recent employment boom

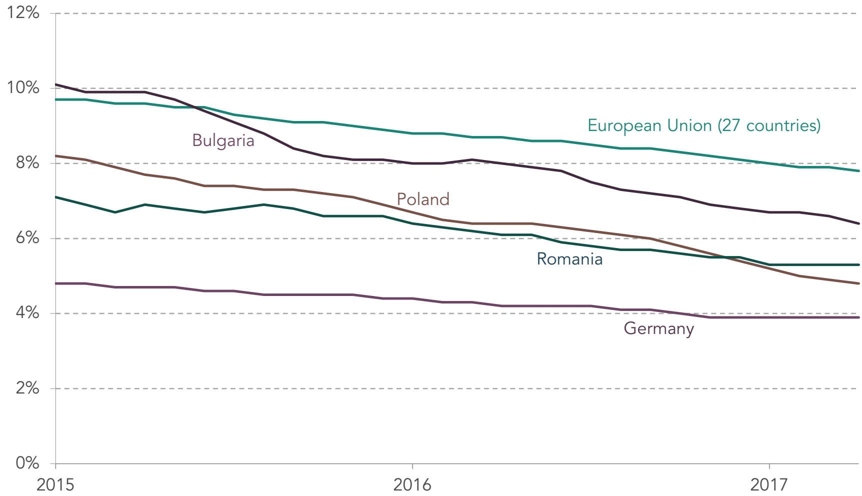
Given the continued strength of many European economies, further tightening in the future is likely, however regardless of conditions in Europe, eventually Brexit will provide the government with the policy flexibility to control immigration from the EU, further tightening the labour supply. The Conservatives have promised a significant reduction in migration as a key objective of the new government. The Labour party have not committed to a specific migration target or such a significant decline in migration, but nevertheless support the end of free movement.

The fact that lower paying sectors are currently most reliant on migrants means that this tightening of labour supply will overlap with the parts of the economy already seeing increased labour costs in the next few years. Indeed, the migrant earnings picture set out in Figure 3 would be even more skewed towards low earners if we restricted our analysis to temporary, or short-term migrants – those most likely to be affected by any future changes to the country's immigration system.

At the bottom end of the labour market, the supply shock associated with reduced migration will therefore compound the pressures already facing firms as a result of rising labour costs. The implication is that firms in the most affected sectors will need to make more significant changes to what they do or how they do it – be that replacing migrant

Figure 4: **A tightening labour market in Europe will further reduce migration**

Unemployment rates for the EU and selected EU countries



Source: RF analysis of Eurostat, *Unemployment*

workers with natives, substituting capital for labour or ceasing to produce certain things – than would be warranted by the presence of either a price or a supply shock in isolation.

A tighter labour market may already be affecting the types of jobs people are doing, if not their pay

The pressures associated with this dual shock can be expected to build over the coming years. Yet we may already be starting to see some effects manifest themselves in the form of a modest reversal in the trend towards atypical (or insecure) work.

Growth in insecure work over the course of the 21st century is often described as a product of either advancing technology or people's wish for more flexibility. The latter is viewed as empowering, while the former is usually considered demoralising. But both explanations are used to underpin an expectation that insecure work will simply grow year on year. Yet we have begun to see the number of people employed in atypical forms of work flattening out or even falling over the last 12 months.

The number of people on ZHCs reached 900,000 in early 2016, but has not risen since, while the number of agency workers has *fallen* to 800,000, having hit a high of 850,000 last year. And the share of all workers accounted for by self-employment has also started to fall since the turn of the year – reversing a previously consistently increasing trend. In contrast, those working full time for an employer have accounted for 97 per cent of the growth in employment in the past year.

While it is obviously early days, these numbers could be consistent with a tightening of the labour market. And to the extent that atypical working is often associated with lower paying roles, we might speculate that today's tightening is being felt most acutely at the bottom end of the labour market. Indeed, in interviews with businesses we've heard that some firms have responded to the introduction of the NLW by lowering their use of ZHCs, arguing that higher labour costs necessitate the establishment of more permanent – and higher quality – relationships with their workers.[11]

The presence of significant numbers of atypical jobs in the post-crisis labour market could help to explain why we haven't yet seen impressive reductions in unemployment drive up wages in any significant way. A lot of work has been done to try and explain this ongoing riddle,[12] with the most popular explanations highlighting subdued productivity growth and a range of reasons for believing there could be more slack in the labour market than the headline employment figures suggest.[13] However, it may well be that the raised level of atypical work in our economy post-crisis means that the labour market tightening is feeding through in the first instance to changes in the types of jobs people do, rather than their pay. That is, as workers gain more power and employers find it harder to fill vacancies, the first thing that is demanded and conceded is greater security rather than higher pay.

> The next five years will bring with them a raft of changes that will impact the UK's labour market

It is important to recognise that the level of insecure work remains too high in Britain today and that there are a range of areas where labour market regulation should be changed to tackle it, as Chapter 4 sets out. But, while recognising that fact, we need to be careful in assuming that a key feature of our labour market is ever-rising insecurity. Firms assuming they will simply be able to continue employing more people on such terms may well find themselves disappointed in the years ahead. This will necesitate adjustments not just in the contracts firms offer but in entire business models in some cases.

The times they are a-changin'

Discussions of the UK labour market have focused in recent years on the abundant supply of cheap labour, a growing proportion of which has been prepared to work with less security than many workers take for granted. These trends have been particularly pronounced at the bottom of the labour market. But just because that story has held in recent years, firms and policy makers shouldn't simply assume such trends will continue.

The next five years will bring with them a raft of changes that will impact the UK's labour market. We have highlighted some of the main ones that, combined, may well mean that we are at a tipping point when it comes to the availability and cost of low paid labour.[14] This represents a big change for our economy, and one we would do well to prepare for. The changes may bring welcome pay rises for millions of people and the opportunity to make some of our firms and sectors more productive and higher paying. But they also carry big risks of employment shifts, labour shortages and lost output if we get things wrong.

First and foremost, it is firms themselves that will respond to the increased cost of low paid labour and its reduced availability – changing what they produce and how they produce it. Quite how these employers will react is not yet clear. Focusing solely on the cost increases associated with the initial introduction of the NLW, our research has shown that around a third of firms raised prices, with around one in seven firms investing more in training and around one in eight investing more in technology.[15] This may be an indication of what firms will do when faced with wider price and supply pressures in the coming years, although over time a wider range of adjustment strategies should be available.

But government has a clear role too. Not only because it lies behind the scale and pace of several of the changes affecting firms, but also because the coming challenges raise broader questions for the country at large. Despite the uncertainty created by a hung parliament, the government owes business more clarity about the world in which they will be operating, and should be providing an impetus to the sectors most affected to get on with necessary adjustments.

Perhaps the most important issue that needs to be clarified soon is what the country's immigration system will be after we leave the EU (Chapter 2). Clarity will allow businesses to take long-term decisions around skills and investment (Chapter 3). Adjusting to a changing labour market also means grappling with new challenges. In a tight labour market increasing labour supply involves supporting those furthest from the labour market (Chapter 4), regulations and rights need to adjust to the new world of work (Chapter 5) and the UK's entrenched reliance on low pay remains a problem (Chapter 6). This section has outlined the changes that the UK economy is facing, but the rest of the book addresses the harder question of how it can rise to the challenges created.

1 M Whittaker et al., *Are we nearly there yet? Spring Budget 2017 and the 15 year squeeze on family and public finances,* Resolution Foundation, March 2017

2 S Clarke & C D'Arcy, *Low Pay Britain 2016,* Resolution Foundation, October 2016

3 M Whittaker et al., *Are we nearly there yet? Spring Budget 2017 and the 15 year squeeze on family and public finances,* Resolution Foundation, March 2017

4 ONS, *Index of Labour Costs per Hour (ILCH): Oct to Dec 2016,* June 2017

5 The Office for Budget Responsibility expects that the levy will bring in around £3 billion per annum. However, it will only affect firms with a pay bill of £3 million or above and will not have a differential effect on the cost of lower paid workers.

6 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

7 RF analysis of ONS, *LFS*

8 S Clarke, *A Brave New World: how reduced migration could affect earnings, employment and the labour market,* Resolution Foundation, August 2016

9 S Clarke, *First signs of falling migration after the Brexit vote,* March 2017

10 The Observer, "Record numbers of EU nurses quit NHS", 18 March 2017; The Guardian, "Farmers deliver stark warning over access to EU seasonal workers", 21 February 2017.

11 C D'Arcy & G Davies, *Weighing up the wage floor: Employer responses to the National Living Wage,* Resolution Foundation, February 2016

12 A Haldane, *'Twin Peaks', speech for Kenilworth Chamber of Trade Business Breakfast,* 17 October 2014

13 M Saunders, '*New Year, New Labour market? What does 2017 have to offer*', Keynote speech by MPC member Michael Saunders at the Resolution Foundation, January 2017

14 Other likely changes include shifts in the tax regime for the self-employed, a possible reform of the employee-worker distinction and the roll out of Universal Credit.

15 C D'Arcy & M Whittaker, *The first 100 days: early evidence on the impact of the National Living Wage,* July 2016