CHAPTER **SIX**

Moving on up

Enabling earnings progression in the UK labour market

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The state we're in	What should we do?
Many people already struggle to progress out of low pay – three-in-four low paid workers are still there a decade later	Make progression a core part of ongoing government policy, in the same way that raising employment underpins the actions of departments beyond the DWP
The National Living Wage will mean that 4.4 million employees will be earning at, or close, to the wage floor by 2020, compared to 1.5 million in 2015	Reduce the UC taper rate to increase the incentives for pay progression
Universal Credit (UC) will not solve weak financial incentives to progress at work, many people will keep only 25p of each additional pound they earn	Trial and introduce practical support to help people progress, including job seeking support, skills matching and job brokerage

Government labour market policy has focused on two key challenges in recent decades: getting people into work and tackling the worst extremes of low pay. As we've discussed elsewhere in this book, more can and should be done in both these areas. But as the labour market moves into a new era, the country faces a third public policy challenge: boosting the progression of low paid workers onto higher wages, in order to prevent a growing part of the workforce being stuck on the legal minimum.

The National Living Wage (NLW) is building on the success of the National Minimum Wage and helping to reduce the scale of relative low pay in the UK. This is a big shift for the UK labour market, not only because of the change in the relative price of low paid labour discussed in Chapter 1, but also because it will significantly increase the share of the workforce for whom the lower bound represents something of a going rate.

Beyond increasing the number of people on the legal minimum, big rises in the NLW also risk reducing incentives for workers to take on the promotions and job moves that are essential in moving up the pay scale. That is because, with firms facing a variety of labour cost pressures, the risk is that they opt to squeeze wage differentials in the bottom half of the labour market. This matters for the individuals concerned but also has wider implications for firms and national productivity, potentially undermining job matching in the economy.

Building on efforts to bring more people into the labour market by focusing on full employment (Chapter 4) and job quality (Chapter 5), in this chapter we consider what more the government can do to boost pay progression for those already in work.

The UK's policy focus on raising employment and tackling low pay has borne fruit in recent decades

Increasing employment levels and avoiding the long term unemployment and inactivity that emerged in the 1980s has been a core focus of UK labour market and welfare policy for the last two decades. Policy reform has included: stricter work-search requirements and tailored practical support via Jobcentre Plus; improved financial incentives via the tax credit and childcare systems; and labour market regulation to ensure greater equality (such as the right to return to work for mothers). Taken together, these initiatives have proven very successful at both supporting higher employment and ensuring that groups previously at risk of long-term inactivity – particularly single parents – have benefitted.

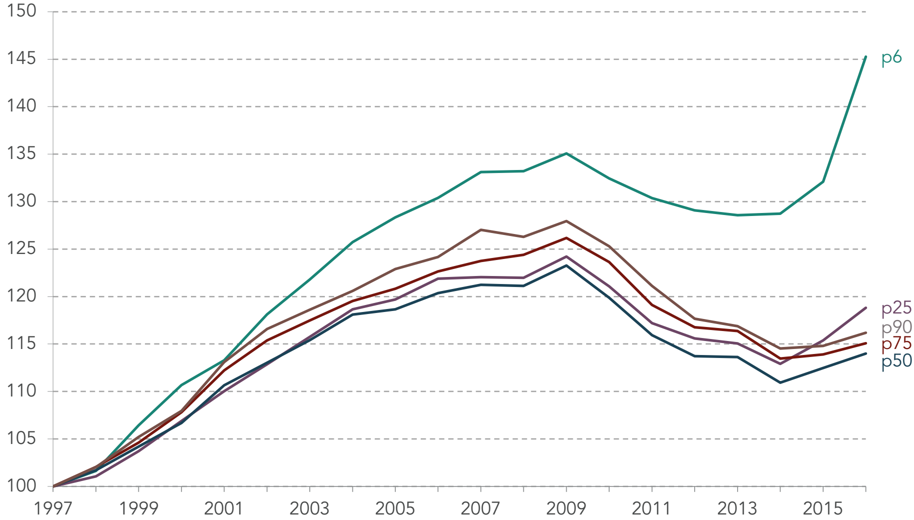
The UK's remarkable post-crisis jobs recovery has been built on these labour market reforms. As we noted in Chapter 1 however, pay and productivity performance has been much poorer, with average pay not set to return to its previous peak until 2022. Yet the squeeze has been much less pronounced at the bottom end of the labour market, with minimum wage policies helping to protect the pay of the very lowest earners. Indeed, as Figure 1 shows, hourly pay growth towards the bottom (percentile 6; the percentile paid the NLW of £7.20 in 2016 and where pay is higher than 6 per cent of all workers but lower than for 94 per cent) has consistently outpaced growth elsewhere in the distribution (other than the very top which is not shown) since the late-1990s. Each percentile shown represents a position in the distribution of hourly pay for workers across the UK: 'p50' relates to the median or the hourly rate of pay with 50 per cent of workers earning more or less than the amount; 'p90' is the point at which wages are higher than for 90 per cent of employees, but lower than for the top 10 per cent.

> The UK continues to sit at the wrong end of the low pay league table

This period of course coincides with the introduction of the NMW in April 1999, with large real-terms increases in the wage floor during the early-2000s also clearly visible

Figure 1: **Pay growth across the distribution since 1997**

Indices of real-terms hourly pay in different parts of the earnings distribution: 1997 = 100 (CPIH-adjusted)



Source: Resolution Foundation analysis of ONS, *ASHE & NESPD*

from the chart. Yet despite the progress provided in terms of eradicating the extremes of low pay, the UK's NMW did little over time to reduce the roughly one-in-five employees considered to be 'low paid' (earning less than two thirds of median pay). Internationally, the UK continues to sit at the wrong end of the low pay league table, with the proportions earning less than two-thirds of median standing at 18 per cent in Germany, 17 per cent in Australia and just 8 per cent in Italy.

Faced with such entrenched low pay, the last government introduced a supplement to the wage floor for those aged 25 and over from April 2016 in the form of the NLW. As discussed in Chapter 1, its influence will grow over the next few years as its value rises relative to typical pay. But even its initial rate provided a significant pay rise for millions, as is clear in Figure 1. Pay at the sixth percentile of the hourly earnings distribution jumped by 10 per cent in real-terms in 2016, compared with growth of 1.3 per cent at the median and 1.2 per cent at the 90th percentile.

A significantly higher wage floor will compress wages at the bottom

By 2020, the lifting of the value of the NLW to the equivalent of 60 per cent of median pay among the over-24s is expected to produce a pay rise for up to six million workers and the first significant reduction in the UK's level of low pay in the last 30 years.[1]

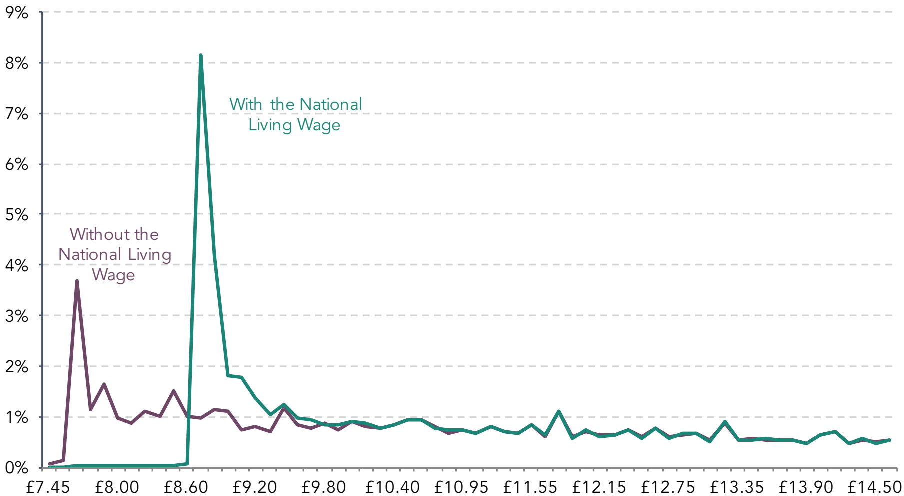
However, its potential effects on productivity and progression are less clear.

Figure 2 shows how, once fully in place, the NLW is likely to affect the pay distribution for workers over-24. Significantly increased bunching at the new floor is clearly apparent, with roughly 8 per cent of employees over-24 expected to be earning £8.75 an hour. In addition, we expect some spillover gains for those paid a little above the floor increasing the total number of affected workers.

This is a major change for the UK labour market that will mean a big rise in the number of people paid at or near the wage floor. Back in 2000 only around 2 per cent of the workforce (400,000 employees) were on or near the legal minimum (within 1 per cent of it). Even before the introduction of the NLW that figure had already substantially risen to reach 6 per cent (1.5 million) by 2015. It is now set to almost triple to 15 per cent (4.4 million) of all employees by 2020.

Figure 2: **Decreasing returns to progression from low pay compression**

Proportion of workers aged over-24 by pay band

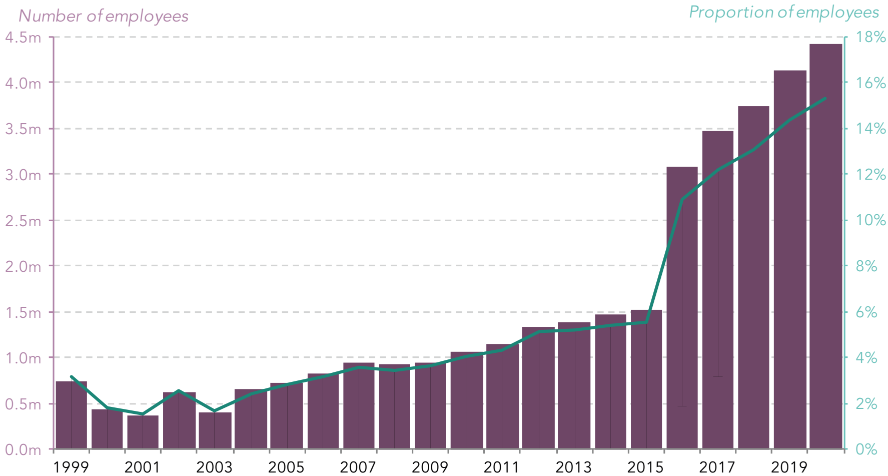


Notes: For detail of assumptions underpinning the impact of the National Living Wage on the pay distribution see A Corlett, et al, Higher Ground, Resolution Foundation, September 2015

Source: Resolution Foundation analysis of ONS, *ASHE & NESPD*

In some sectors and regions of our economy the impact of the wage floor and the risk of wage compression will be even more significant. In wholesale and retail the proportion of the workforce paid at the NLW by 2020 is expected to exceed one in four (27 per cent), while the figure for agriculture and fishing is 24 per cent. However, the greatest effect

Figure 3: **Increasing the share of the workforce paid at or near the wage floor**



Notes: 'Near the wage floor' is defined as hourly pay being within 1 per cent of the national minimum/living wage

Source: Resolution Foundation analysis using ONS, ASHE, 2015

is expected within the accommodation and food services sector where the already high one in four workers (25 per cent) paid at the wage floor is expected to rise to almost one in two (45 per cent). Such variation is also a factor geographically. In some regions, such as the East Midlands and Wales, a fifth of workers are expected to be on the wage floor by 2020, rising from 8 and 7 per cent respectively.

A growing share of our workforce being on the legal minimum raises new progression challenges

Why does it matter if the general level of pay received by lower earners is so much higher than it would otherwise be and we see a very welcome reduction in overall pay inequality in Britain? The answer lies within the dynamic nature of the labour market.

Earning relatively little – whether just below or just above the official 'low pay' line – is clearly less of a problem for those for whom it is a staging post on the way to higher earnings. But a lack of progression from low pay was already a problem in Britain before the introduction of the NLW. For too many workers, low pay is a lasting norm. Previous Resolution Foundation research has shown that three-quarters of low paid employees are still in low pay a decade later.[2] Key factors to escaping this position include moving job, consistently remaining in employment and obtaining a degree. However, as we move into a new era for the labour market, the first appears to be occurring less frequently than it used to and the wage returns associated with the second and third have been falling.[3]

Further compression of the pay scale could make it harder still to move away from the wage floor, with important rungs in the pay ladder effectively stripped out. To the extent that narrower pay differentials reduce the returns associated with taking on additional responsibilities following promotion or a job change, the higher wage floor might also act as an unintended disincentive to progression.[4] Likewise, wage compression could reduce the signalling effect associated with wages. This would mean reduced labour mobility, with workers less likely to move into roles that best match their talents, and negative implications for aggregate productivity.

Of course, the flip side to this is that the lifting of the wage floor could serve as a spur to productivity gains. As we have discussed throughout this book, increases in labour costs towards the bottom end of the labour market should be providing firms with a clear incentive to invest in technology and human capital in order to boost output per hour worked. But the fact that firms are facing a number of labour market challenges simultaneously – including auto-enrolment roll-out, the introduction of the apprenticeship levy and a labour supply shock following the EU referendum – means that one potential response is to meet extra costs at the bottom end of the workforce by squeezing pay and conditions in the middle of the distribution.

> The lifting of the wage floor could serve as a spur to productivity gains

Government can clearly help in this area – both in terms of reviewing the interaction between pay and welfare and in terms of practical career progression support services. At the very least, government should take this growing issue seriously as a major new challenge for our labour market and avoid making things worse – something that current policy direction is in danger of doing.

Creating the right incentives to progress

The current (though soon to be superseded by Universal Credit (UC)) tax credit regime has shortcomings, but played an important role in both raising the incomes of families with children and increasing employment since it was developed in the early-2000s. A strong financial incentive to enter work (in the form of an additional in-work payment for recipients once they meet an 'hours rule' requirement for certain hours of work per week) has helped boost employment. Single parents in particular have responded strongly, with significant numbers working precisely the 16 hours a week required to achieve the extra payment.[5]

The next natural step for welfare reform to take, that of supporting people to move into full-time work and to progress, started to be trialled in the mid-2000s. This came in the form of the Employment Retention and Advancement (ERA) initiative a key part of which comprised time-limited payments conditional on people remaining in full-time work

These moves took a backseat with the onset of the financial crisis, but need restarting now in reaction to the changes that are underway in our labour market. The good news is that we can be fairly confident that a mix of incentives, conditions and support for those in work can have an impact. Indeed recent findings from one part of the ERA trials, in which single parents entering work were paid a time-limited credit if they remained in full-time work for a specific period of time, showed that those in the trial were not only more likely to work but to work full-time, rather than part-time, hours. It was not just the size, but the shape of incentive that proved important to its success.[6]

Future government action to support progression will take place in the context of the new benefits system – Universal Credit. UC remains a vehicle for possible radical reform, with its key objective of combining six different benefits into one, potentially offering big gains in terms of simplicity and in easing the transition into work. We discussed how incentives in UC can be improved for people entering work in Chapter 4 – including ensuring that we do not see big reductions in the average hours new entrants choose to work – but more could also be done to improve incentives to progress once employment is secured.

As with current in-work support, UC entitlement is reduced as a family's earnings increase. Originally this was intended to be at a rate of 55 per cent, but this 'taper' currently sits at 63 per cent. That means that a worker keeps only 37p of each additional pound earned, falling to 25p when also paying income tax and National Insurance. For some (those currently entitled to housing benefit and tax credits) this means incentives to progress onto higher rates of pay have been increased, given some very high taper rates in the existing benefits system. However, incentives to progress for many of those receiving UC can remain every bit as weak as those under tax credits and, in the case of second earners, can be weaker.

Universal Credit remains a vehicle for possible radical reform

By way of example, Figure 4 sets out the gains to net income from hourly pay rises for a full time worker on the wage floor (assumed to be £8.75 in 2020) who is in a couple with two children. The figure depicts two scenarios, one where only tax and National insurance are paid on additional earnings, the other where they are also on UC and seeing their benefit entitlement reduced as net earnings rise.

Because we assume the main earner is already in full-time work, there is no remaining work allowance (the amount a family can earn before their UC award starts to be withdrawn). With the UC taper therefore applying to every extra pound earned, alongside tax and National Insurance deductions, they keep as little as 25p of each additional pound earned. For example, across a year a pay rise of £1 an hour would mean an increase in gross earnings of £1,950 a year but an increase to net income of only £500.

This stands in stark contrast to the example of a person who increases their hourly pay but is not on UC. In this scenario, paying only income tax (20 per cent rate) and National Insurance (12 per cent rate) the worker keeps 68p an hour of each extra £1 an hour earned. If working full-time and across a year that equates to an increase in net income of £1,350 from the same annual gross pay rise of £1,950. The incentive to progress and secure a £1 pay rise above the legal minimum is nearly three times weaker in this example for someone on UC than it is for a worker not receiving UC.

In order to assess what shape and size of financial incentive is most effective in encouraging progression at work, the government should commit to a long term program of trials to ascertain the impact of such rewards. Such trials should begin as soon as possible given that they are likely to take time. In the shorter term the government should reduce the UC taper from 63 per cent.

Figure 4: **The return to a pay rise under Universal Credit**

Net income gain per hour worked for given hourly pay rise for a main earner on the wage floor in a couple with two children and rent of £130 a week

Source: Resolution Foundation analysis using the RF microsimulation model

Going beyond the job centre

It is important to note that in one key respect the government has already moved to set progression within the labour market, rather than simply entry into it, more firmly on the agenda. UC introduces a concept of in-work conditionality. Put simply this extends the work-search requirements currently imposed on unemployed people claiming benefits to those with low levels of earnings. The primary aim is to set an expectation that benefit recipients achieve a level of earnings equivalent to full-time hours at the minimum wage, or part-time if the individual has caring responsibilities or is deemed to have limited capability for work.

This element of UC means that Job Centre Plus (JCP) will play a new role in encouraging progression for those receiving benefits in work, rather than focusing solely on the unemployed. However this welcome shift is likely to be limited by a number of factors. First, the focus of support remains on hours worked which, while an important route to progression for some, is too narrow and is likely to miss the key question of this chapter – how to deliver pay progression. Secondly, it is unclear if JCP has the resources to fully fund a program of in-work support given ongoing cuts to the DWP budget and a potential push to reach full employment. Finally, there are valid concerns about the extent to which working people are reluctant to continue interactions with JCP once they have found work.

Crucially a push on progression requires going beyond DWP customers. Although UC provides an opportunity to facilitate interaction with many low paid workers, some of whom will previously have had little or no contact with JCP, not all people in need of a pay boost will be entitled to UC and so many will remain outside of the system. For example, many workers on the wage floor with low housing costs and without children will not be in receipt of UC, but are a key group likely to be affected by the growing progression challenge set out above.

Crucially a push on progression requires going beyond DWP customers

Progression support for people in work is not widely available either in the UK or internationally, but it does exist. Some of this is run by the public sector, with the aforementioned UK trials having some successes and providing a base of evidence on which to build.[7]

In other cases private initiatives have had an impact: the Living Wage Foundation provide support for participating employers to maximise the gains for their business of voluntarily paying wages above the legal minimum through increased productivity and improved retention. Similarly, Timewise helps workers, usually mothers, to find better paid forms of part-time or flexible work, often utilising a job brokerage model to encourage employers to adapt advertised roles into flexible ones where they have a ready supply of skilled applicants. Such initiatives recognise both that the role of employers is vital in rising to the progression challenge, and that for many people progression will come as a result of moving jobs.

It might be argued that given these wider considerations, JCPs new focus on in-work conditionality should be extended to providing wider progression support. We do not support such an approach however. We recommend that JCP retains a focus on supporting sustained employment outcomes but we do not believe it should be the main provider of progression support. Planning a career trajectory should form a core part of the conversation between out-of-work recipients and JCP, as should maximising pay when searching for a role, but the focus in this relationship should remain primarily on finding employment.

One clear additional role the UC system should play is in actively identifying long-term low paid individuals – especially at key life transition points (such as when a youngest child starts school) – who are not subject to in-work conditionality (for example because they are already working full time on the NLW) to offer and direct them to wider progression support.

Beyond UC, an ambitious and extensive co-ordinated programme of progression trials should be started. Providers would aim to deliver a sustained boost to earnings for individuals, drawing on the past success of programmes such as ERA in the UK and others internationally, and linking practical support to the right mix of financial incentives and conditionality.

Importantly, although being entitled to UC or earning below a given conditionality threshold should not preclude an individual from engaging with pay progression support, such activity should not be mandated by JCP. [8]

It is likely that many of these trials will be run locally, however there are concerns over the capacity of local areas to deliver such new forms of support at scale. Given this, close ties to JCP and Local Enterprise Partnerships (LEPs) are needed alongside forms of national oversight.

Progression on a national level

Alongside these local collaborations, a national body should oversee and commission new forms of support, build a strong evidence base (perhaps in conjunction with a What Works Centre for progression), and promote best practice. In addition such a body could ensure that progression is recognised as a key area of government policy, as boosting employment is now. Such an approach would recognise both the importance of this progression challenge for our economy, but also the fact that while we have some knowledge of what works there is much more to learn.

In the UK a National Careers Service already exists, although provision is often considered to be ineffective. This is emblematic of a deeper historical problem in the UK where – with the exception of graduates in some fields – we have continuously failed to provide an effective link between education and employment. We discussed the role of non-graduate training and career routes in Chapter 3, but it is clear that more also needs to be done, particularly to provide guidance for people outside of any formal education or training.

> Beyond Universal Credit, an ambitious and extensive co-ordinated programme of progression trials should be started

The national progression body could help address this problem. The body could provide clear and accurate information about opportunities and rewards to progression through specific career paths, and at a far more granular level than the advice currently provided by the National Careers Service. A detailed assessment of the number of jobs, vacancies and pay scales of different roles within sectors would help raise individuals' awareness of opportunities. Such provision is possible; the Career Pathway Maps developed by the Minneapolis innovation network being one such example.[9] Such a service could make it easier for people to look for work outside of their local area, something low-paid workers rarely do.

A further, crucial, role for this body would involve engagement with employers. Current engagement tends to occur at a local level, which makes sense when considering opportunities in local labour markets. But the incidence of low pay is highest in specific sectors, and these cut across regional boundaries. To effect change at a national level it is therefore vital that employers are engaged at a sectoral rather than local level, to ensure that progression is built into future workforce plans.

Meeting the new policy challenge of the new era

Having once been an international laggard on employment, the UK now enjoys an enviable reputation for getting people into work. This turnaround hasn't occurred by accident, but is a product of sustained proactive intervention which has evolved over time. The UK has also taken a lead on tackling low pay via the development first of the NMW and now the NLW. The country's low pay problem has far from disappeared, but the strength of effective labour market institutions has been demonstrated very clearly once again.

With the labour market undergoing profound change – driven by rising costs at the bottom end of the market and a significant labour supply shock associated with Brexit – it is time for public policy to stand up again. In particular, government must react to a new challenge – that of progression. To do so, a change in mind-set is needed, and with this a change in the direction of policy. Reform will take time. After all, it took two decades to get the high employment flexible labour market of today, and it may take another two to shift business models towards higher paying approaches. But there is no reason why the UK cannot once more stand in the vanguard of progress.

Summary of recommendations

— Universal Credit

Recommendation 1 **Improve financial incentives in UC by gradually reducing the taper while testing different levels and shapes of financial incentive.**

Recommendation 2 **The role of in-work conditionality within UC should be limited to full-time working, with reduced hours for those with caring responsibilities or limited capability for work, rather than relying on JCP to take on a wider progression role.**

Recommendation 3 **Out-of-work UC recipients should be encouraged to consider any work search requirements as a step on a longer career path to a higher rate of pay or number of hours worked.**

Recommendation 4 **Use Universal Credit administrative data to identify long term low paid individuals, or those at risk of low pay, and signpost them to progression support, targeting individuals at key life stages.**

— Practical support to progress

Recommendation 5 **Deliver, trial and test practical forms of support to help people progress, drawing on what UK evidence already exists, and examples from elsewhere. Delivery should overlay current channels via Local Authorities, Local Employment Partnerships and JCP.**

Recommendation 6 **Dramatically improve the career guidance information available to individuals including far greater mapping of jobs, vacancies and pay scales by sector and occupation.**

— Focusing on progression at a national level

Recommendation 7 **Create a national body to oversee progression trials, ensuring that they are of high quality and keeping track of what works to ensure best practice methods are spread.**

Recommendation 8 **Work with employers at a sectoral, rather than simply local, level to ensure that progression is built into future workforce plans.**

Recommendation 9 **Ensure that progression is a core part of ongoing government policy, in the same way that employment underpins the actions of departments beyond the DWP.**

1 C D'Arcy & A Corlett, *Taking up the floor: Exploring the impact of the National Living Wage on employers*, Resolution Foundation, September 2015

2 C D'Arcy & A Hurrell, *Escape Plan: Understanding who progresses from low pay and who gets stuck*, Resolution Foundation, November 2014

3 L Gardiner & P Gregg, *Study, Work, Progress, Repeat? How and why pay and progression outcomes have differed across cohorts*, Resolution Foundation, February 2017

4 C D'Arcy & A Hurrell, *Escape Plan: Understanding who progresses from low pay and who gets stuck*, Resolution Foundation, November 2014

5 The 'sweet spot' we discussed in Chapter 4.

6 M Brewer & J Cribb, *Lone parents, time-limited in-work credits and the dynamics of work and welfare?*, Institute for Social and Economic Reseach, January 2017

7 Ibid.

8 Although time used to engage with such support should be taken into account when setting work search requirements.

9 Minneapolis Saint Paul Regional Workforce Innovation Network, *Career Pathway Maps*, 2017