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

> ### *Analysis from Nye Cominetti:*
> *"Britain has experienced a truly horrendous decade for pay, but an increasingly tight labour market is finally starting to deliver a pay recovery.*
>
> *"There remains a lot of ground to make up before we return to pre-crisis pay levels. Workers in their 30s still earn 7 per cent less than thirty-somethings did on the eve of the crisis. This shows that the scarring effects of coming of age at the height at the financial crisis are still being felt today."*

Late 2018 saw nominal pay growth break the 3 per cent barrier, where it has since stayed. With inflation tracking down towards its 2 per cent target, it was a positive end to the year for workers, welcome after the pay squeeze of 2017. With the labour market still tight (and on some measures still tightening) 2019 has the potential to continue this positive trend.

In our *Spotlight* piece (see page 4) we discuss whether recent higher nominal growth is a 'new dawn' (nominal pay growth staying above 3 per cent - as the Bank of England seems to think) or a 'false dawn' (with nominal pay growth falling away, as the Office for Budget Responsibility (OBR) seems to think). The OBR's reasoning is that wages will be held down by higher pensions contributions under auto-enrolment, and the apprenticeship levy. This may be true, but the data available since their forecast suggest that nominal growth is continuing to strengthen. At the moment there is more support for a 'new dawn'.

Good news! But before we relax, we should remember that current growth rates are still well below pre-crisis norms, when nominal pay growth of 4 per cent (and real growth of 2 per cent) was typical. The key difference between then and now is, of course, productivity, the main driver of pay over the medium term. In the third quarter of 2018, productivity growth (as measured by output per hour) slowed to just 0.2 per cent, the weakest for two years. This places a limit on pay growth, even in a tight labour market. The current uncertainty surrounding Brexit is untimely, as (according to the OBR and Bank of England) it is depressing business investment, which in turn will have a negative impact on productivity. But productivity growth has been a problem for 10 years now, so Brexit is hardly the only culprit.

We usually think about pay as 'downstream' from productivity – with higher productivity giving employers the room to increase pay. However, in the short run, causality can also run in the other direction, with higher pay incentivising greater use of capital, thereby increasing productivity. An optimist might see the recent increases in nominal pay growth as the kick-start to a virtuous circle of higher investment, higher productivity and higher pay. Unfortunately there is no sign of that yet.

Our **earnings breakdown** shows that the squeeze on real pay ended in 2018, but with real pay growth still low by historical standards. As usual, pay growth is higher for those changing jobs, with a 'disloyalty bonus' of 4 percentage points.

Our analysis of **pay pressures and slack** shows that the labour market remains tight. Unemployment remains at a 40-year low, and underemployment is below pre-crisis levels. Job-to-job moves have been steadily increasing since the crisis, but fell slightly in the latest data.

Our review of **longer-term labour market health** shows areas of concern. Productivity growth is very low, as is the level of workplace training (which could improve productivity). There is better news in labour force participation, which 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 is available at www.resolutionfoundation.org/earningsoutlook. This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.

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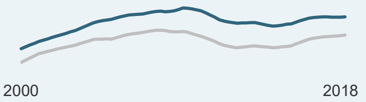
The Scorecard: Q3 2018

What's happened: The earnings breakdown

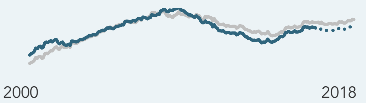
MEDIAN EMPLOYEE EARNINGS



↑ 1.16% on yr (all)
↑ 2.4% on yr (private sector)

The most timely pay data showed median real pay growth continued to strengthen into 2018 Q3, but remains subdued compared to 2015-17 and low by historical standards.

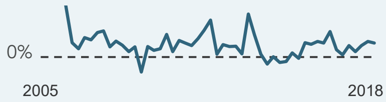
ALL WORKER EARNINGS



All worker earnings 1.8% below employee earnings

Strong self-employed earnings growth in 2014-15 narrowed the gap between the employee average and the all worker measure, with the estimated gap staying the same since then.

EARNINGS DECOMPOSITION



↑ 0.1ppts on yr

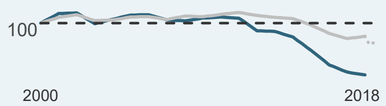
The compositional boost to pay associated with a changing workforce is low by historical standards, but rose in 2018 and in Q3 was up 0.1 percentage points on the year.

PAY RISES

↑ 1.4ppts on yr

Median year-on-year real hourly pay growth for employees in work over a year (both job stayers and changers) stood at 0.8% in April 2018, an increase on 2017.

EARNINGS INEQUALITY

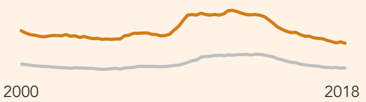


r75:25 ↓ 0.9% on yr
r90:10 ↓ 0.6% on yr

Hourly pay inequality between the upper- and lower-middle (r75:25) continued its fall after briefly ticking upwards. The r90:10 ratio continued to fall.

What's round the corner: Pay pressures and slack

UNEMPLOYMENT BY DURATION



↓ 0.2ppts on yr (all)
↓ 0.1ppts on yr (long-term)

The unemployment rate continued to fall in Q3 2018. Long-term unemployment also continues to fall, but with signs that levels are plateauing.

UNDER-EMPLOYMENT

↓ 9% on yr

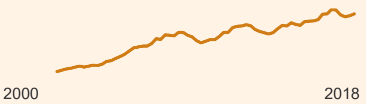
Under-employment (net hours desired by those in work as well as the unemployed) increased slightly in Q3, but is still low, and below pre-recession levels.

JOB-TO-JOB MOVES

↓ 14% on yr

Voluntary job-to-job moves (an indicator of a healthy labour market and worker confidence) fell in Q3 2018, bucking the trend of recent years.

MIGRANT JOB ENTRY

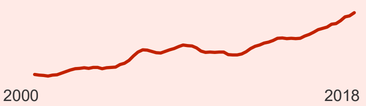


↓ 3% on yr

In 2018 net migration stabilised (at 273k in June) after the post referendum fall. In Q3 the share of job entries made up by migrants was down slightly on the year.

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

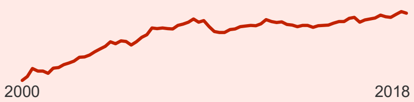
WORKFORCE PARTICIPATION



↑ 0.7% on yr

Labour force participation continues to rise, as it has for the every quarter since summer 2012. In Q3 2018 the rate was 0.7% up on the year.

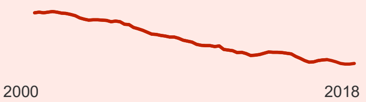
LABOUR PRODUCTIVITY



↑ 0.9% on yr

In Q3 2018 labour productivity was up on the quarter and year (by 0.9%). However in the latest data (for November) productivity growth slowed to just 0.2%.

TRAINING INTENSITY



↓ 1% on yr

'Off-the-job' training was up slightly on the previous quarter, but down on the year. The long-term fall in training intensity appears to have plateaued.

GRADUATES IN NON-GRADUATE OCCUPATIONS

↑ 2% on yr

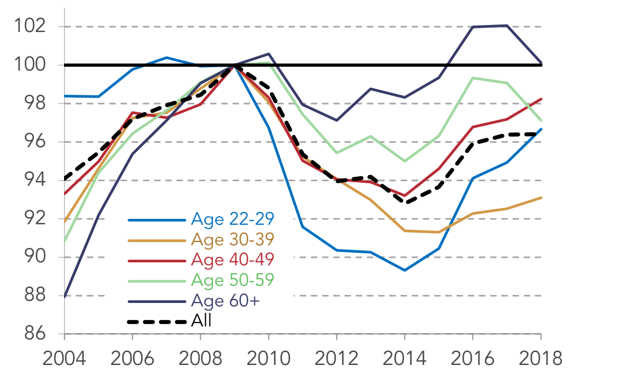
Grads in non-grad roles can reflect skills mismatch, and may keep individual productivity below potential. The rate of established grads in such roles continues to rise gently.

 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 is available at www.resolutionfoundation.org/earningsoutlook. This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.

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: Index of median real pay by age band (2009=100)

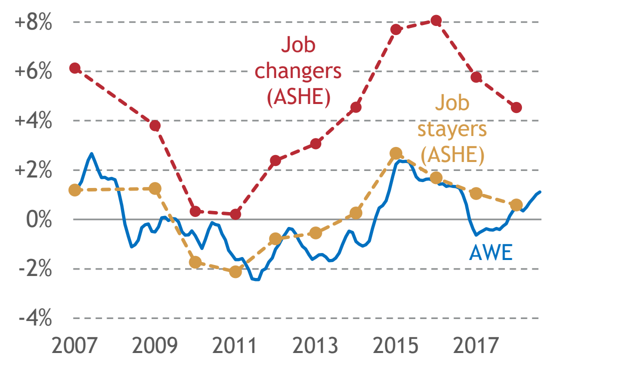


Source: RF analysis of ONS, Annual Survey of Hours and Earnings

Thirty-somethings may be being left behind

Young people's wages were hit hardest in the recession. By 2014, average wages for 22-29 year-olds were 11 per cent down on 2009 levels, compared to 7 per cent down for wages overall. But twenty-somethings have been catching up, so that in 2018, it was average wages for thirty-somethings that were furthest from their pre-recession peak. Wages were 7 per cent down for this group, compared to 3 per cent down for all workers. The cohort that are in their early thirties now were in their twenties in the aftermath of recession. The data in this figure is cross-sectional – not longitudinal – and so we can't directly observe this cohort. But we can infer from these trends that the young people whose pay was squeezed in the aftermath of the recession then carried the effects into their thirties, depressing average pay for thirty-somethings.

Figure 2: Median real pay rises for job changers and stayers, and headline average earnings growth



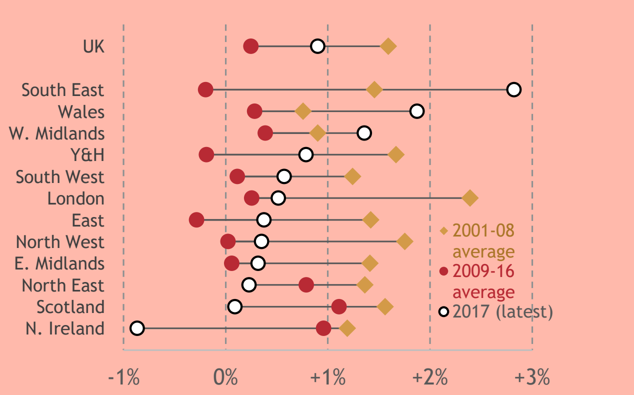
Source: RF analysis of ONS, Annual Survey of Hours and Earnings; ONS, Labour Market Statistics

People changing jobs get a 4 percentage point 'disloyalty' bonus

Pay rises are higher for people that change jobs. In April 2018, of employees that had been in employment for a year or more, people staying in the same job typically saw a 0.6 per cent real pay increase, compared to 4.5 per cent for people changing jobs. The pay rises enjoyed by job changers were 4 percentage points higher than for stayers. This 'disloyalty bonus' means the rate at which people change jobs is an important driver of aggregate pay growth – both because job changers earn more, and because their previous employer faces pressure to increase pay to retain staff. Individual pay rises for both stayers and changers were lower in 2018 than in recent years, but the more timely average weekly earnings (AWE) series increased throughout 2018. We would expect pay rises for changers and stayers to follow suit.

The regional perspective

Figure 3: Productivity growth (output per hour) by region



Source: RF analysis of ONS, Labour Market Productivity

Earnings are below their pre-recession peak in all regions and nations, but some are closer than others

Productivity growth drives pay growth, and weak productivity growth is the main reason for the country's pay squeeze post-crisis. 10 years on, productivity growth remains weak, which is a bad sign for pay growth in the coming years. Last month the ONS published regional productivity data (unfortunately there is a hefty lag). The good news is that in 2017, nine out of twelve regions saw productivity growth above their *post*-crisis average – suggesting a recovery of sorts. However, this leaves three regions (Northern Ireland, Scotland and the North East) with productivity growth below their *post*-crisis average. The further bad news is that in all but three regions (South East, Wales, and West Midlands) productivity growth in 2017 was below the *pre*-crisis average.

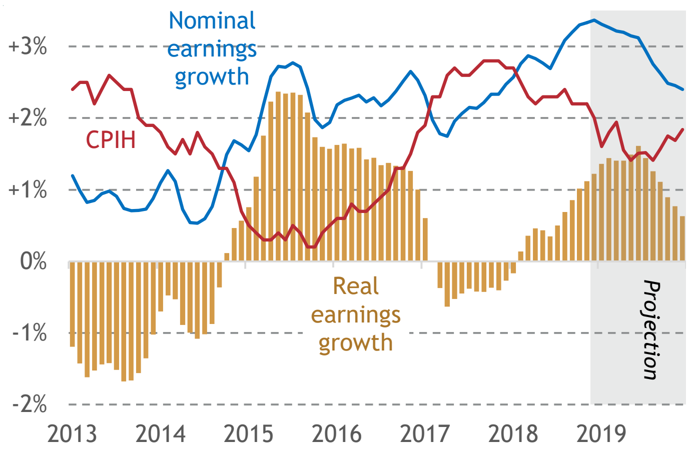
 Source: RF analysis of ONS/DWP datasets. Notes: all real-terms series are CPI-adjusted; for further details of data sources and methods go to www.resolutionfoundation.org/data/sources-and-methods. A full breakdown of each indicator is available at www.resolutionfoundation.org/earningsoutlook. This project was funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily those of the Foundation.

Spotlight: A new dawn in 2019?

What does 2019 have in store for pay? 2018 was the year in which we left behind the pay squeeze of 2017. Nominal growth increased throughout the year, reaching 3 per cent for the first time in a decade. Will this momentum continue into 2019? The Bank of England thinks so. It forecasts average pay growth increasing in 2019 (from 2.75 to 3.25 per cent on their measure) .[1] The Office for Budget Responsibility (OBR), by contrast, thinks pay will cool slightly in 2019 (from 2.58 to 2.52 per cent on their measure). [2] In October, the Bank's chief economist Andy Haldane heralded a 'new dawn' in pay.[3] The OBR's more pessimistic outlook could be labelled 'false dawn'. So who is right? Brexit uncertainty notwithstanding, at present there seems more support for a 'new dawn' – stronger pay growth throughout 2019.

To illustrate the OBR's projections, in the chart below we use the OBR's projections and convert these into AWE, the headline measure of pay. According to this projection, nominal pay growth has peaked, and will fall back below the 3 per cent threshold in the summer. The OBR cites policy effects; it thinks the increase in costs associated with higher auto-enrolment pensions contributions, and the apprenticeship levy, will both be partly borne by workers, and will therefore bear down on wages.

Figure 4: Earnings growth and inflation, out-turn and OBR projection



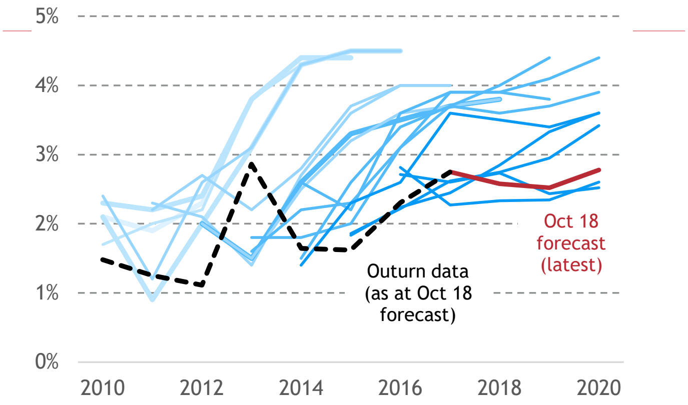
Source: RF analysis of ONS, Annual Survey of Hours and Earnings

However, the OBR might be being overly pessimistic. Since their latest projection (published in the October 2018 budget) we have had an additional four months of data. In these months (giving us data up to November 2018) pay growth increased, reaching a high of 3.3 per cent, whereas the OBR expected average earnings growth to fall in the final quarter of 2018. Therefore, having got the short-term direction of travel wrong, we might expect pay growth in 2019 to be stronger than the OBR expected in October.

The problem is that the OBR is not normally pessimistic on pay - they have tended to be the opposite. Of the OBR's 19 pay forecasts since June 2010, only one has been an underestimate.

The Bank of England has a similar record of overestimating pay growth. In both cases, the main reason has been an overestimation of productivity growth. [4]

Figure 5: Successive OBR forecasts of average pay



Source: RF analysis of OBR

So where does this leave us? One the one hand, the lesson of the last decade has been that we should stop expecting a return to pre-crisis norms in productivity and pay growth. Forecasts that reflect the last decade's dismal record, as the OBR and Bank's forecasts increasingly do, are surely more plausible. And yet, the latest data suggests the OBR are now being overly pessimistic about prospects for pay growth in 2019. And given the tightness of the labour market, we would expect strong nominal pay growth to continue. Unemployment fell again in the latest data, and other measures of labour market slack continue to fall.

With this in mind, it seems unlikely that nominal pay growth will drop back below 3 per cent in 2019. The OBR are right about the potential pay-dampening effects of auto-enrolment and the apprenticeship levy, but the effects might simply be smaller or more diffuse than expected. The Bank's expectation of increasing nominal pay growth in 2019 – a 'new dawn' in pay – seems the likelier bet.

This is good news. With inflation expected to track down towards its 2 per cent target, this means real pay growth would remain well above 1 per cent. The only other period since the recession with real pay growth above 1 per cent was in 2015-16, and that was largely due to a bout of very low inflation. Today, in contrast, real pay growth is on firmer ground – stemming from higher nominal increases.

However, although prospects for the year ahead are positive, the 'new dawn' comes with two warning notes. First is that this dawn is still not very bright. Pre-2008, 4 per cent nominal pay growth was the norm – we are heralding 3 per cent. The second patch of darkness is Brexit. The OBR and Bank forecasts discussed here assume a smooth Brexit, and no changes in trading arrangements until 2021. With no withdrawal agreement yet secured, and the March deadline looming, that assumption is increasingly under threat. Perhaps uncertainty is the only sure bet for 2019.

1 Bank of England,: Inflation Report, November 2019. Note that the Bank and the OBR's measures of average pay are not identical to the headline 'average weekly regular earnings' (AWE) measure we use, meaning growth rates are not directly comparable.
2 Office for Budget Responsibility Economic and fiscal outlook, October 2018
3 Andy Haldane speech: 'Pay power', Bank of England, 10 October 2018
4 Calculated by taking the cumulative impact of the forecasts (using annual data), up to year 2017 and comparing this to the path of the outturn in the same period.

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