Resolution Foundation

The Resolution Foundation Labour Market Outlook

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Over the course of 2023, the labour market has been gradually cooling on most measures. Even ignoring data from the Labour Force Survey that has recently been called into question, vacancies have been falling for 16 consecutive months and growth in payrolled employment has slowed. But nominal wage growth has remained resilient – even, since June, outpacing still-high inflation. In this Outlook's spotlight, we explore what is happening to wages, and how long we can expect high wage growth to last.

Looking ahead, recent forecasts from both the Office for Budget Responsibility and the Bank of England have the labour market continuing to loosen over the course of 2024. But there is some good news from the policy side in the form of another increase in the National Living Wage (NLW), which this coming April will reach the Low Pay Commission's target of two-thirds of typical hourly pay.

In the Lifting the Lid section, we explore recent statistics on the ethnicity pay gap, how labour market tightness varies across different industries, and the highest- and lowest-paid local authorities from the latest Annual Survey of Hours and Earnings release.

Spotlight | What's happening to pay growth?

Against a backdrop of sluggish growth and stagnating living standards, wage growth has been bucking the economic trend in recent months. Private sector regular pay has been growing more than twice as quickly as before the pandemic – by more than 7 per cent a year since Q4 2022 and standing at 7.8 per cent in the three months to September 2023, compared to an average of 3.4 per cent a year in the two years before the pandemic. Such exceptional growth has been a cause for concern for the Bank of England – understandably, given that it is likely contributing to inflation staying higher for longer in the UK than elsewhere.[1] In this spotlight, we explore the reasons behind recent record-high pay growth, why it has remained high even as the economy has slowed in recent months, and what we can expect to happen to it in the near future.

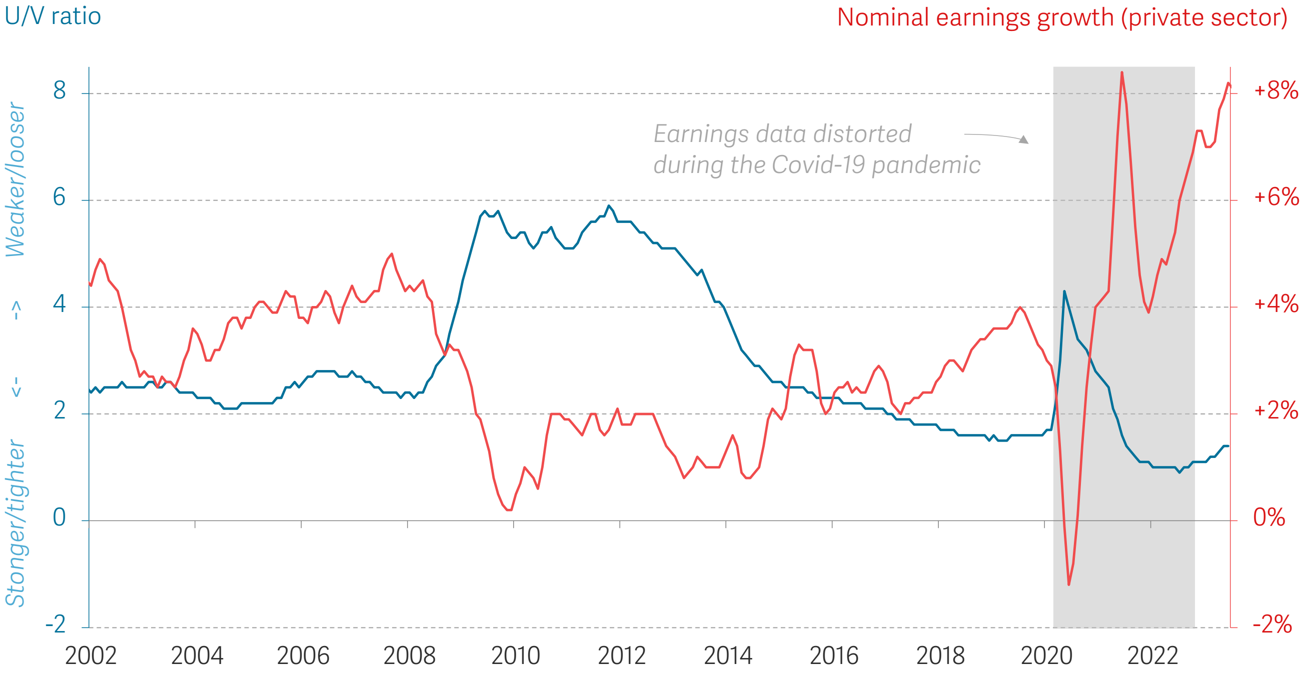
The tightness of the labour market is an important driver of wage growth

Much of the recent discussion around the strength of pay growth has pointed to the role of a strong labour market in driving up wage growth. Intuitively, when the pool of jobseekers is low relative to the number of job vacancies (i.e. the labour market is 'tight'), wages should go up, as employers need to offer better pay to attract new workers and retain the ones they have. As Figure 1 shows, a tight labour market has historically been associated with stronger wage growth. But while this could be good news for individual workers in the short term, it is concerning if employers have to put up prices to fund large pay rises, fuelling further inflation and harming living standards for everyone.

1 Throughout this spotlight, we focus on nominal pay growth for private sector employees unless otherwise stated. Our Labour Market Outlook for Q2 2023 focused on public sector pay.

FIGURE 1: **When the labour market is tighter, pay tends to grow more quickly**

Number of unemployed people per vacancy (left axis) and private sector average weekly earnings growth (right axis): GB/UK



NOTES: Unemployed people per vacancy series excludes agriculture, forestry & fishing and covers the whole of the UK. Private sector average weekly earnings growth is year-on-year change in the three-month average of private sector regular pay, i.e. excluding bonuses and arrears, and covers Great Britain only.
SOURCE: RF analysis of ONS, Labour market statistics.

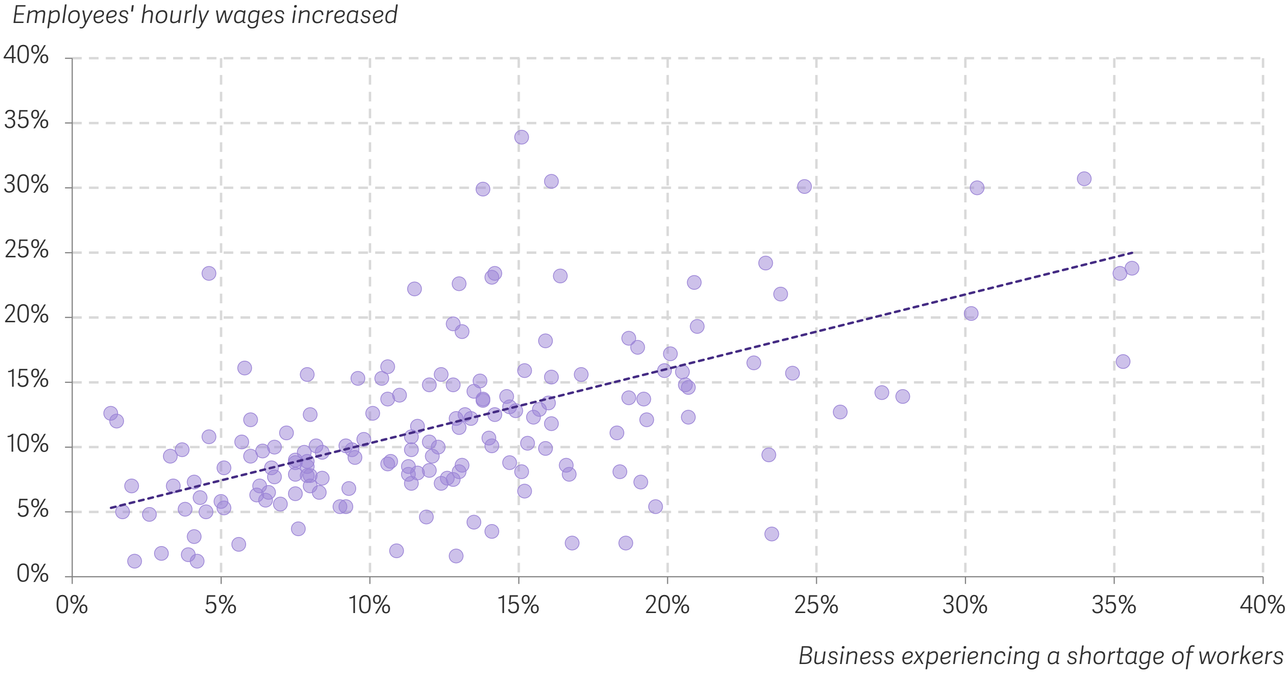
Indeed, since the post-Covid-19 reopening in 2021, a collective rush to recruit and a smaller workforce have combined to put worker shortages in the spotlight. Even as the post-pandemic pandemonium has eased, vacancies remain higher than pre-pandemic while unemployment (as best we can tell) is close to record lows, as the blue line in Figure 1 shows.

The contribution of the recent tight labour market to higher wage growth is confirmed when we look at patterns across sectors. As Figure 2 shows, for example, sectors where businesses report a shortage of workers – another proxy for tight labour market conditions – are more likely to also report increases to their workers' hourly wages. On average, an increase of 10 percentage points in the share of businesses who face worker shortages is associated with a 5.7-percentage-point rise in the share giving their workers a pay rise.[2]

2 This relationship is statistically significant, and holds after controlling for wave and industry fixed effects.

FIGURE 2: **Wage increases tend to go hand in hand with worker shortages**

Proportion of businesses reporting a shortage of workers (horizontal axis) and proportion of businesses reporting their employees' hourly wages have increased over the past month (vertical axis), by industry and survey wave: UK, July 2022-September 2023



NOTES: Each data point represents an industry-survey wave combination. Includes data from all waves where both questions were asked.
SOURCE: RF analysis of ONS, Business Impacts and Conditions Survey.

We can expect a looser labour market to feed through slowly into wage growth

There have been some early signs of labour-market loosening: vacancies are falling, growth in payrolled employment is cooling, and businesses are reporting fewer difficulties in recruiting. And there is clear precedent for a softening labour market dampening wage growth. When the financial crisis hit, the number of unemployed people per vacancy rose from 2.4 (in Q1 2008) to a peak of 5.8 (in Q3 2009); over the same period, annual private sector pay growth fell from 4.3 per cent to 0.8 per cent. But the labour market remains tight by historical standards: we would need a lot more loosening for this to have a meaningful impact on wage growth, and any loosening will also take a while to have an effect.

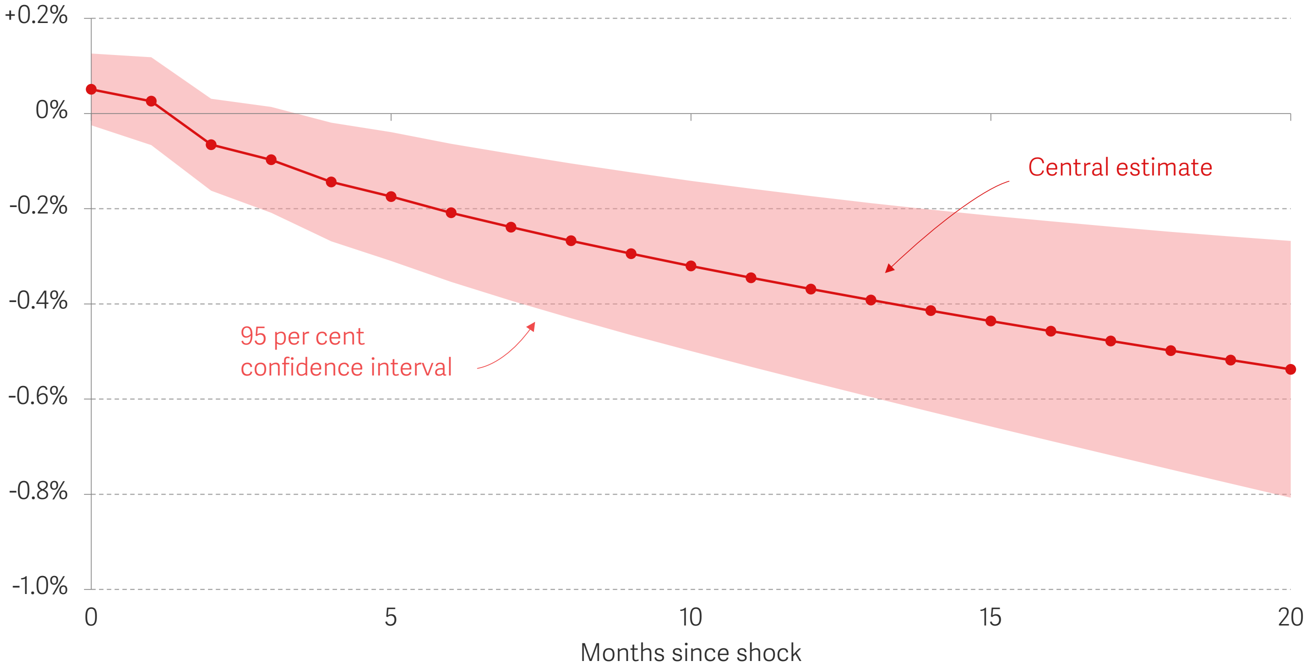
To illustrate this, Figure 3 shows what has happened in the past when there has been a shock to labour market tightness (here measured as an increase in the ratio of jobseekers to vacancies, or U/V) of the scale of labour market loosening we've seen since last summer. Between July 2022 and June 2023, the U/V ratio has increased by 0.5, from 0.9 to 1.4. (We stop in June due to the experimental nature of the data beyond this point.)

Figure 3 shows, first, that labour market tightness begins to affect wages quickly, with a negative impact after just two months. But the full effects take time to build: we would expect a shock of +0.5

to the U/V ratio to have lowered wages by around 0.1 per cent after two months, building to five times that (0.5 per cent) after twenty months. The impact of a shock is relatively small, implying that the labour market would have to loosen a lot for the loosening to bring wage growth down to normal levels by itself. Figure 3 suggests we can expect the labour market loosening that took place over the 11 months from July 2022 to June 2023 to have pushed down wages by 0.35 per cent; over that period, but private sector pay in fact grew by 7.6 per cent.

FIGURE 3: **The impact of a shock to labour market tightness on wage growth starts quickly and builds over time**

Cumulative response of nominal private sector wages to a shock of +0.5 to the unemployment/vacancy ratio, by months since the shock: GB, 2002-2019



NOTES: An increase of the U/V ratio of +0.5 is equivalent to that seen between June 2022 and July 2023. Chart shows the cumulative orthogonalised impulse response function, where the impulse is the unemployment/vacancy ratio and the response is the month-on-month growth rate of nominal private sector wages.
SOURCE: RF analysis of ONS, Vacancies and unemployment; ONS, Average weekly earnings.

On this basis, the prospects for a loose labour market to drive an imminent slowing in wage growth might seem concerning for the Bank of England. And of course, there is a huge trade-off involved through this channel: higher unemployment, while potentially necessary to prevent inflationary pressure that pushes down everyone's living standards, is not a desirable outcome for those who face job loss.

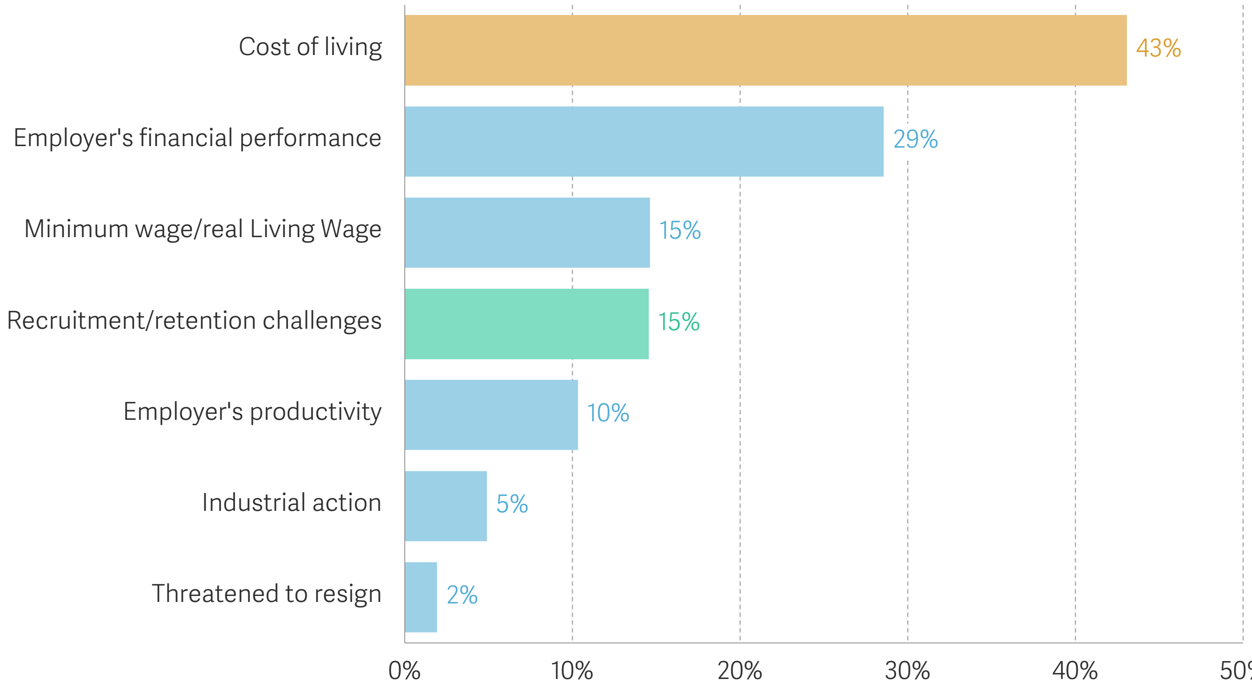
But the rising cost of living is also fuelling nominal pay growth

There is, however, some good news for policy makers concerned about the strength of wage growth: much of the upward pressure on wages in fact came from inflation itself. As a wave of strikes earlier this year laid bare, workers are increasingly demanding pay rises to offset the rising prices that are eroding their pay packets in real terms. This suggests that mass job losses may not be necessary to unwind wage growth.

These two drivers are, of course, not mutually exclusive: a tight labour market might make it easier for workers to bargain for wage rises, while high inflation gives them greater motivation to do so. And they have been moving in the same direction for much of the recent past. But to the extent we can disentangle them, some evidence suggests the cost of living itself may be a bigger driver than labour market conditions. The Bank of England estimates that labour market slack explained around an eighth (13 per cent) of private sector pay growth in Q3 2023, while inflation expectations (which are highly correlated with the actual rate of inflation) accounted for over half (52 per cent).

FIGURE 4: **Workers think the cost of living has been the main driver of pay rises**

Reported reasons for recent pay awards, among private sector employees whose pay rose in the past year, excluding those who moved jobs, received a promotion or changed their working hours: UK, 13-17 October 2023



NOTES: Base = private sector employees aged 18+ whose pay had risen over the past year, excluding those who had been promoted, changed their working hours, or moved employers over that time (n=505). Categories are not mutually exclusive as multiple responses were allowed. Question wording: 'Which, if any, of the following factors do you think influenced the decision over your most recent pay award or most recent pay rise?' Full response options: 'Changes in the cost of living', 'The financial performance of the organisation or workplace', 'National Minimum Wage or National Living Wage', 'My employer's ability to recruit or retain employees', 'Productivity levels within the organisation or workplace', 'Industrial action threatened or taken', 'I expressed my intent to resign'. Further response options not shown on the chart: 'Pay is set externally (e.g. Pay review body)', 'Other factors', 'Don't know', 'Not applicable – I have never had a pay award or pay rise'. These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, Cost of living survey autumn 2023.

Employees' views are consistent with this. In October 2023, we asked workers who got a pay rise about the reasons behind them (excluding those who had received a promotion, increased their hours, or changed employers so as to focus on regular pay increases).[3] As Figure 4 shows, the private sector employees we surveyed were more than twice likely to think that their pay rises were related to the

3 This research uses data from an online survey conducted by YouGov and funded by the Health Foundation. Fieldwork was undertaken online during 13-17 October 2023, and the total sample size was 8,378 UK adults aged 18 and over. All figures have been weighted and are representative of all UK adults. The figures presented from the online survey have been analysed independently by the Resolution Foundation. The views expressed here are not the views of YouGov or the Health Foundation.

rising cost of living than to their employer's struggle to recruit or retain workers: among those who got a pay rise, more than two-fifths (43 per cent) thought the cost of living was a factor, almost three times more than thought it was linked to worker shortages (15 per cent).[4]

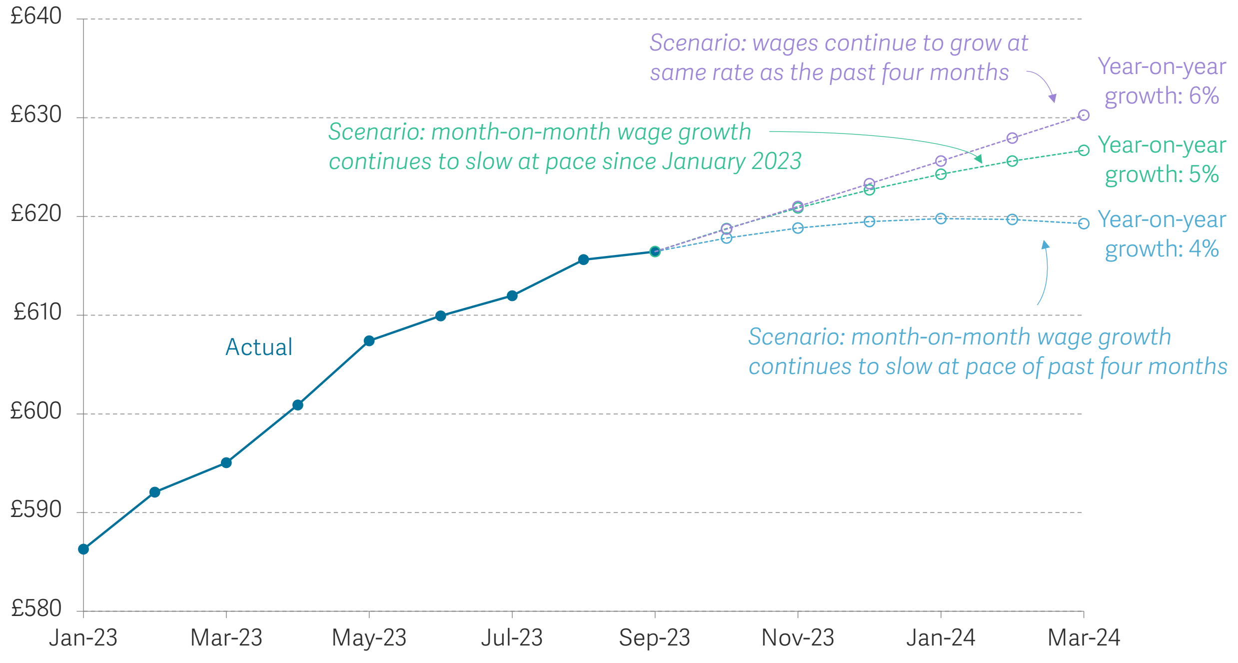
There are some signs that wage growth is already starting to slow

As we have shown elsewhere, wage growth is clearly too high to be sustainable without driving further inflationary pressure. The traditional view is that a looser labour market will be the main driver of slowing wage growth going forward. But the cost of living crisis has been a bigger driver of pay rises to date – and falls in inflation are likely to have more impact on future wage growth.

Some indicators are already showing signs of wage growth slowing. The typical pay settlement has fallen from 6 per cent to around 5 per cent since the start of the year, and posted wages in job adverts have been gradually slowing since the summer. Both the Bank of England and the Office for Budget Responsibility predict wage growth easing over the next few months. And employers' own expectations for future pay awards are cooling somewhat: in the three months to October 2023, firms expected their employees' pay to grow by an average of 5.1 per cent over the next year – still high compared to historic observed wage growth, but down from 5.7 per cent a year earlier.[5]

FIGURE 5: **Wage growth appears to be cooling**

Private sector average weekly earnings (nominal terms), outturn and scenarios based on recent trends: GB



NOTES: The two scenarios based on recent month-on-month wage growth continuing to slow at its recent pace takes a linear extrapolation of the month-on-month growth rates over the relevant period until March 2024 and applies these to the level of average weekly earnings.
SOURCE: RF analysis of ONS, Average weekly earnings.

4 These figures exclude workers who received a promotion/moved up a pay band, increased or decreased their working hours, or moved employers over the past year – i.e. they focus on people who received a regular pay award/uplift, rather than a change in their employment circumstances. But the story is very similar when we include these workers: 41 per cent of all private sector employees who got a pay rise thought it was linked to the cost of living, while 17 per cent thought it was linked to their employer's ability to recruit and retain workers. Base = all private sector employees whose pay went up over the past year (n=1,010).

5 It is worth not putting too much weight on the exact numbers here, however. Over the three months to October 2023, the Decision Maker Panel's realised wage growth over the past year was 6.9 per cent – higher than the 5.7 per cent expected by the same panel a year earlier.

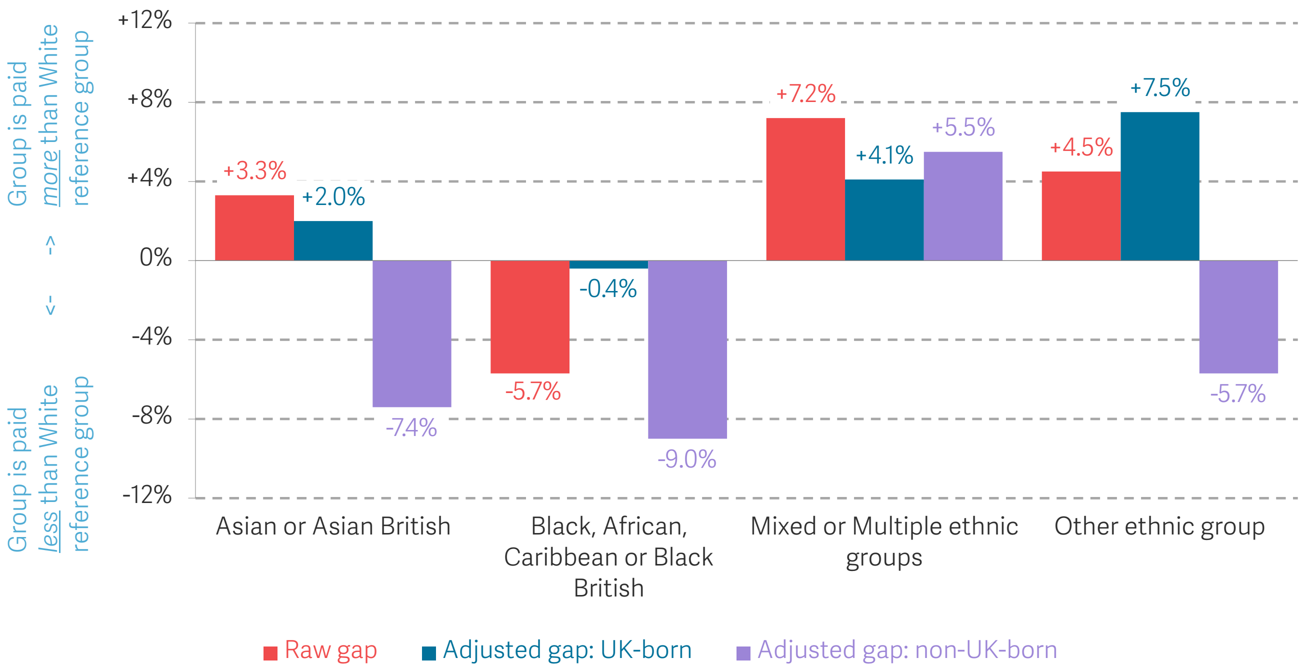
Finally, looking at shorter-term changes in wages, the pace of growth is stalling (Figure 5). Between January and May, wages went up by an average of 0.8 per cent each month; between June and September, the month-on-month growth rate had halved to average 0.4 per cent. If this continues, headline year-on-year wage growth could also come down relatively soon: if wage growth keeps slowing at the rate it has been slowing for the past four months for example (i.e. if we extrapolate recent changes in the rate of wage growth), this would take the annual growth rate down to 4 per cent by March. These trends provide some hope that reducing pay growth (and so inflationary pressure) may not require significant labour market loosening – and the pain that would entail.

Lifting the lid | The picture across different groups and areas

Here we explore a few of the most interesting labour market developments for different groups of workers and different parts of the country.

FIGURE 6: **Black workers who were born outside the UK face a 9 per cent pay penalty compared to White British workers**

Raw and adjusted ethnicity pay gap, by ethnicity: UK, 2022

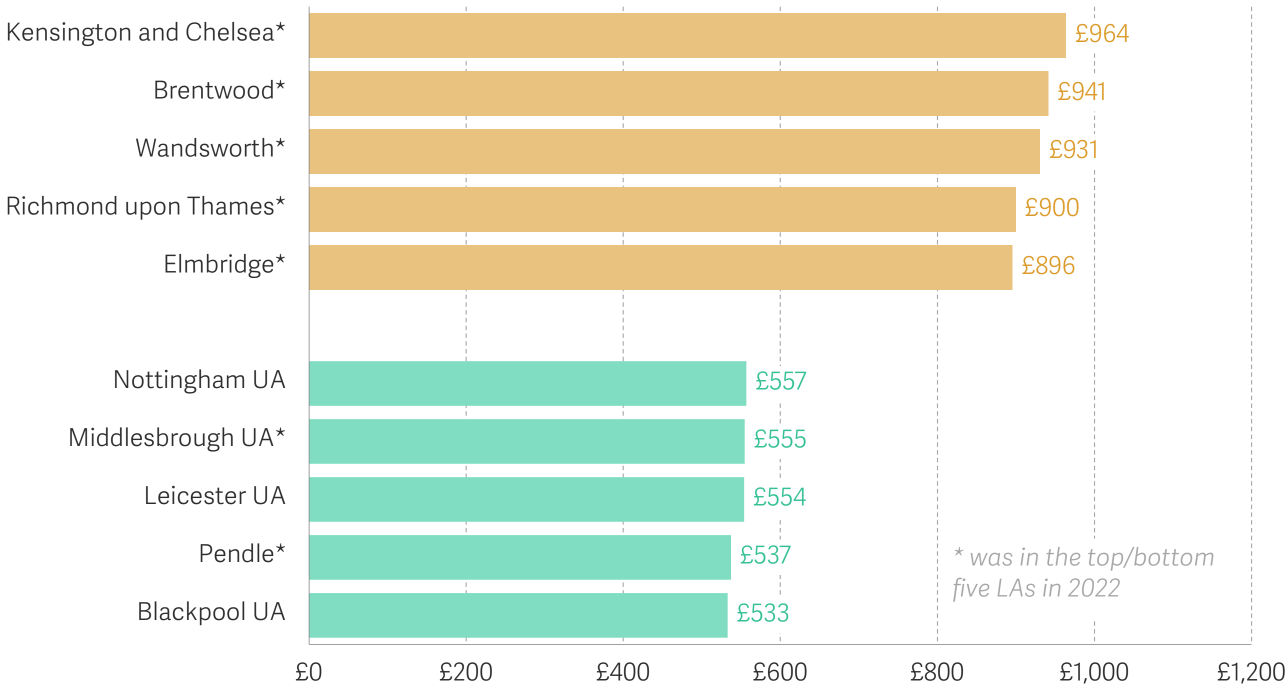


NOTES: Pay gaps are defined relative to a White (or White British, for the adjusted pay gaps) reference group.
SOURCE: ONS, Ethnicity pay gaps, UK: 2012 to 2022.

Last month, the ONS released their latest estimates of pay gaps for different ethnic groups. Figure 6 shows the headline differences in typical pay between each of four ethnic groups (the most-granular breakdown available for the whole of the UK). The red bars present the raw gaps: on this measure, while most ethnic groups receive higher pay, on average, than the White British reference group, the typical Black worker is paid 5.7 per cent less than the typical White worker. The blue bars then show the effect after controlling for other characteristics, such as age, sex, qualification level, working pattern and occupation. The adjusted pay gap for UK-born Black workers shrinks on this measure to just 0.4 per cent.[6] Finally, the purple bars also show the adjusted pay gaps for each ethnic group, but focusing on workers born outside the UK. Among this group, all ethnicity categories except the 'Mixed or Multiple ethnic groups' category face a pay penalty compared to White British workers: of 7.4 per cent for Asian workers, 9.0 per cent for Black workers, and 5.7 per cent for workers in the 'Other ethnic group' category. There are many more important insights into how trends in ethnicity pay gaps are evolving in the ONS' article, and a far fuller discussion of ethnic inequalities in the labour market in the IFS' Deaton Review of Inequalities.

FIGURE 7: **All of the five highest-earning local authorities are in or bordering London**

Local authorities with the highest and lowest median full-time gross weekly earnings: GB, April 2023



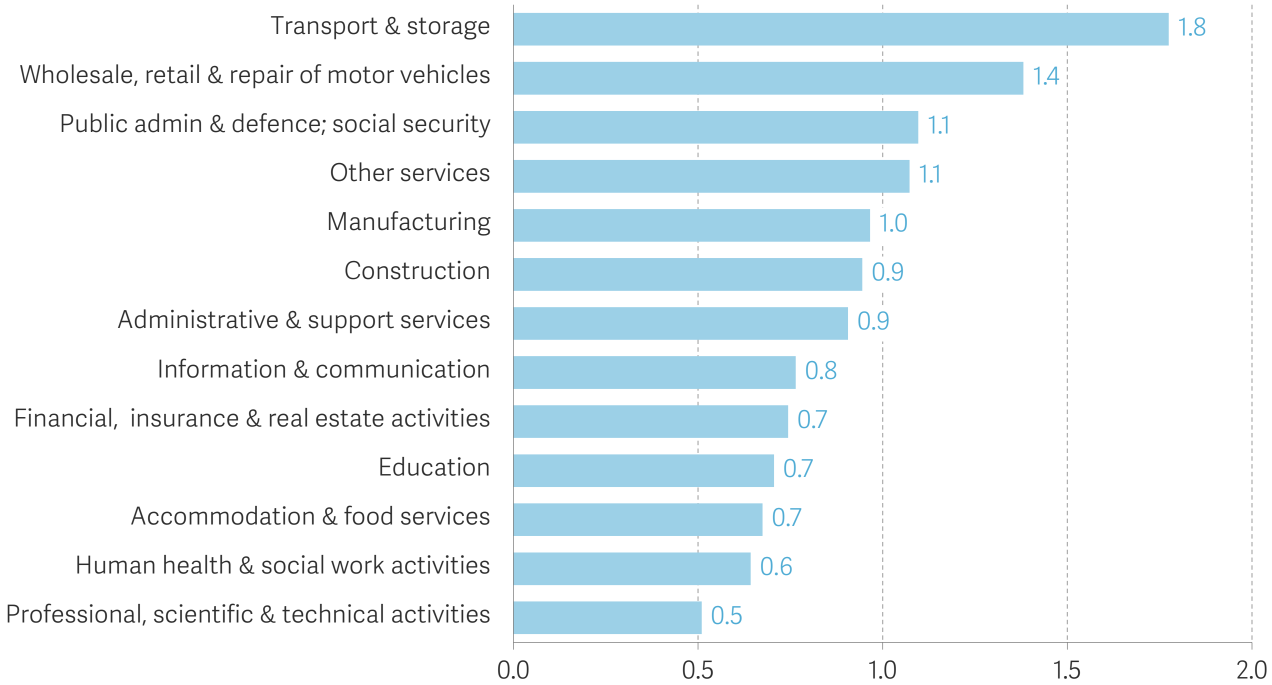
NOTES: Employees are assigned to local authorities by place of residence. The ONS excludes local authorities with very small numbers of jobs or where the median figure was considered unreliable, and defines full-time as employees working more than 30 paid hours per week (or 25 or more for the teaching professions). Asterisks denote local authorities that were also among the five with the highest or lowest median earnings in 2022.
SOURCE: ONS, Annual Survey of Hours and Earnings time series of selected estimates.

Figure 7 shows the local authorities (LAs) with the highest and lowest weekly earnings in the latest Annual Survey of Hours and Earnings, which was carried out in April 2023. Of the five highest-earning LAs, three were in London – and the other two (Brentwood in Essex and Elmbridge in Surrey) directly border London boroughs. The five highest-earning LAs are also unchanged since last year. At the other end of the scale, the five LAs with the lowest typical earnings were spread across the Midlands (Nottingham and Leicester), North East (Middlesbrough) and North West (Pendle and Blackpool). Of these, Middlesbrough and Pendle were in the five lowest-paid LAs in 2022 as well; the other three were all in the twenty lowest earning LAs last year.

6 It is important to note, however, that this adjustment strips out some factors that are instrumental in driving differential labour market outcomes between different ethnic groups. For example, if Black workers are over-represented in low-paying occupations, then controlling for occupation will strip out this effect – despite the fact that occupational mix is a relevant driver of different rates of pay between ethnic groups.

FIGURE 8: **Labour market tightness varies across industries**

Number of unemployed people per vacancy, by industry: UK, August 2022-July 2023



NOTES: Measure defined as the level of unemployment by industry of last job divided by vacancies in that industry. Both measures are averaged over the year to July 2023 (the latest period for which unemployment by previous industry data is available) to eliminate seasonality.
SOURCE: RF analysis of ONS, Unemployment by previous industrial sector; ONS, Vacancies by industry.

The spotlight of this Outlook discussed the tightness of the labour market overall. But the hiring pressures faced by firms, and job prospects faced by workers, are not necessarily the same across the economy. In Figure 8, we proxy for labour market tightness in each industry by dividing the number of unemployed people whose last job was in that sector by the sector's number of vacancies. (This is of course imperfect, given that people do not always return to the same sector as they worked in previously after a spell of unemployment, but gives us a sense of the sectoral variation in labour market conditions.) All the industries in Figure 8 have a relatively low number of unemployed former workers relative to vacancies (U/V) – all are below 2 (roughly pre-pandemic levels; see Figure 1). But the sector with the highest U/V (transport and storage, at 1.8) has three-and-a-half times the U/V ratio of the sector with the lowest (professional services, at 0.5). The sectors with the lowest U/V ratios include both high-paying service sectors (professional services, finance, and IT) and public sector industries with high vacancy rates (health and social work, education), as well as hospitality, where staff shortages continue to bite.

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We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

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