POLICY BRIEF

Institute for Policy Research

UNIVERSITY OF BATH

What a drag: the chilling impact of unemployment on real wages

About this research

Research conducted in 2012 by Professors Paul Gregg (University of Bath) and Stephen Machin (University College London) on behalf of the Resolution Foundation, has found that the stagnation in real wage growth in the UK labour market in the period from around 2003 appears to be substantially due to the increased sensitivity of real wages to unemployment. Indeed, they estimate that real wages were driven down by five per cent more than would have been the case had the same trend in the relationship between real wage growth and unemployment seen in the 1990s recessions, continued. This equates to around an extra £800 a year wage loss compared to what would have occurred in earlier decades. The findings suggest that a return to real pay growth will only be generated in periods when unemployment falls significantly. So that even in periods when unemployment is low but stable, wage growth will be muted.

Research findings in context and policy implications

The general picture of steady real wage growth coupled with rising wage inequality, which dominated the UK labour market through the 1980s and 1990s, ended at some point in the early 2000s. Instead, from around 2003 real wages stagnated for the majority of earners, with only those at the very top of the wage distribution experiencing real pay growth. Since the recession, real wages - that is adjusted for prices - have been falling on a sustained basis for the first time, outside a period of government imposed wage controls, since WWII. Exploratory research conducted in 2012 by Professors Paul Gregg and Stephen Machin on behalf of the Resolution Foundation sought to determine whether this change represented a genuine break in trend real wage growth. Having established that it did, they explored whether unemployment levels played a more important role in determining wage growth among low to middle earners than among higher earners, and the extent to which current wage falls were being driven by an increased sensitivity to unemployment.

Key findings

The research found that:

- The slowdown and stagnation in real wage growth in the UK labour market in the period from around 2003 appears to be due to the increased sensitivity of real wages to unemployment.
- Real wage levels reduced by five per cent more than would have been the case had the same trend in the relationship between real wage growth and unemployment seen in the 1980s and 1990s recessions continued.
- Increased sensitivity of real wage levels to unemployment equates to around an extra £800 a year wage loss compared to what would have occurred in earlier decades, but may have limited the extent of job losses in the recent recession.
- The sensitivity of wages to unemployment was larger for low to middle wage workers than for higher wage workers.
- If the same real wage-unemployment relationship since 2003 remains in place, higher paid workers are likely to continue to see a modest upward trend in real wage growth with flat unemployment, but real wage growth for low and middle earners is unlikely to rise until unemployment starts to fall significantly.
- The kind of sustained real wage growth recorded through the 1980s and 1990s will not return if unemployment simply falls back to its pre-recession norm, potentially allowing policy makers to keep interest rates lower than in the past for similar levels of unemployment without fear of an inflationary wage-price spiral.
- If government wishes to boost the earnings of low and middle earners, it must focus not just on policies that influence pay directly, but also on driving down levels of unemployment.

The research found the slowdown and stagnation in real wage growth since around 2003 appears to be substantially due to the increased sensitivity of real wages to unemployment. Real wage levels in the UK labour market reduced by five per cent more than would have been the case had the same trend in the relationship between real wage growth and unemployment seen in the 1980s and 1990s recessions continued. However, the increased sensitivity of real wage levels to unemployment may be responsible for limiting the extent of job losses in the recent recession, and be behind the recent employment recovery. This sensitivity to unemployment was larger for low to middle wage workers than for higher wage workers. The reasons why unemployment sensitivity has increased were not directly addressed in the research, but may include weaker trade unions and the impact of welfare reforms which have made workers more prepared to forgo wages to protect their employment.

These findings suggest the importance of policy aimed at addressing unemployment levels. If the same real wage-unemployment relationship seen in the period from around 2003 remains in place, higher paid workers are likely to continue to see only a modest upward trend in real wage growth with low and stable unemployment, but real wage growth for low and middle earners is unlikely to increase until unemployment is falling significantly. This means that the kind of sustained real wage growth recorded through the 1980s and 1990s will not return if unemployment simply falls back to its pre-recession level. As a consequence policy makers will be able to keep interest rates lower than in the past for similar levels of unemployment without fear of an inflationary wage-price spiral. However, if government wishes to boost the earnings of low and middle earners it must focus not just on policies that influence pay directly, but also on driving down levels of unemployment.

Methodology

The estimation of the sensitivity of real wage growth to unemployment used in this research was based on a pooled regional panel regression analysis. By looking at the relationship between unemployment and real wages, the analysis enabled researchers to determine the proportional change in pay that is associated with a one per cent change in unemployment: that is, the elasticity of real wages to unemployment. The data source used for the regression analysis was employer-reported wages data from the New Earnings Survey/Annual Survey of Hours and Earnings (NES/ASHE) which contains statistical data from the Office for National Statistics (ONS).

The findings from this research have important implications for the goal of wage growth in economic recovery. Higher pay, particularly for low and middle earners, will only be generated when unemployment falls significantly. Therefore, if government wants to boost earnings it will need to directly address levels of unemployment.

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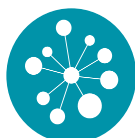
More on this research:

A full copy of the research report entitled, 'What a drag: the chilling impact of unemployment on real wages,' can be found at:
www.resolutionfoundation.org/media/media/downloads/What_a_drag_1.pdf



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