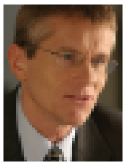
Why the pay dog hasn't barked



JOHN PHILPOTT RECONCILES ECONOMISTS' VIEWS ON THE LABOUR MARKET WITH EMPLOYERS' FEAR OVER A WAR FOR TALENT.

Casual observers of the UK employment scene can be forgiven for feeling confused. On the one hand there is constant talk of a war for talent, and the risk of rising pay costs. Yet at the same time economists point to higher unemployment and modest average pay rises. For example, David Blanchflower, a member of the Bank of England's Monetary Policy Committee (MPC), has recently concluded that the labour market is at present less tight than for several years and there is no sign of worsening skills shortages. This, he reckons, explains why wage inflation is the 'dog that hasn't barked' in the economy of late.

This apparent dichotomy comes from a difference of perception arising from whether one is analysing the labour market at big-picture level or instead experiencing at first hand.

SUPPLY OUTSTRIPS DEMAND According to the Office for National Statistics (ONS), the total number of UK employees increased by 178,000 in 2006 to around 25 million – a net rise of 0.7%. Self-employment increased by 95,000 (2.6%). Rising demand for labour is also evident in ONS figures which show that the number of job vacancies increased by 20% (to 0.63 million) while the level of redundancies fell by 5% (to 136,000 per quarter). Yet unemployment rose by 133,000 to almost 1.7 million (or 5.5% of the workforce).

This coincidence of rising employment and rising unemployment indicates that the higher jobless rate in 2006 was the result of relatively strong growth in labour supply rather than any underlying weakness in the economy. Indeed, 2006 was a year of strong economic recovery from the marked slowdown experienced in 2005.

Economists gauge changes in the total supply of labour available to employers by observing trends in the economically active population – that is, people in work or actively looking for jobs. This figure currently stands at over 30 million in the UK, having risen by 411,000 in 2006 – more than the rise in employment – boosted mainly by migrant workers, especially those from the eight central and eastern European countries which joined the EU in 2004. At least 600,000 people from these latter countries came to work in the UK in the first two and a half years following EU enlargement.

WHILE IN PRINCIPLE EMPLOYERS SHOULD HAVE BENEFITED FROM THE BIGGER POOL OF LABOUR AVAILABLE, IT APPEARS THAT THIS IS NOT PROVIDING ANYTHING LIKE A FULL SOLUTION TO RECRUITMENT DIFFICULTIES.

Executive summary

- Economists point to higher unemployment and modest average pay rises while employers complain about skill shortages and the risk of rising pay costs. The answer to this dichotomy lies in understanding the difference of perception arising from whether the labour market is analysed at big-picture level or experienced at first hand.

PAY SURGE FAILS TO MATERIALISE Unemployment rose in 2006 because the boost to labour supply outstripped the corresponding boost to labour demand. An increase in supply relative to demand in turn meant that the labour market overall was less tight. This helps explain why pay pressure – which is one indicator of the tightness of the market – remained subdued. According to the ONS, the annual rate of growth of regular pay (that is, excluding bonuses) dipped slightly from 3.8% to 3.6% during the course of 2006.

Significantly, the average rate of increase in pay did not keep pace with much higher price inflation, resulting in a squeeze in real incomes for most workers. For example, the annual rate of inflation as measured by the all-items Retail Prices Index (RPI) leapt from 2.4% at the start of 2006 to 4.4% by the year end. The pay squeeze surprised many not least because the cost of living, usually gauged by changes in the RPI, is a common reference point in pay setting (eight in 10 employers surveyed by the CIPD and KPMG each quarter say they take the cost of living into account when deciding the level of pay increase to offer their staff).

What is also clear from CIPD/KPMG quarterly surveys, however, is that the cost of living is a less important determinant of pay outcomes than labour market factors such as recruitment and retention pressures. The going rate in a particular local labour market or for a particular type of labour is a more significant reference point than the cost of living.

This finding is to some degree mediated by the presence of trade unions in pay bargaining. Unions are more likely to try to secure pay increases that match increases in the cost of living and more likely to seek broadly equivalent percentage pay increases for all grades of staff. This is significant given that CIPD/KPMG quarterly surveys also find that in 83% of private sector service companies and 62% of manufacturing companies, managers determine pay outcomes unencumbered by union influence. As a result people employed in the private sector – roughly 80% of UK employees – may find it more difficult to obtain inflation-matching pay increases.

The fact that the surge in price inflation in 2006 coincided with a period when the balance of labour supply and demand was conducive to modest average pay increases, and in the context of a less unionised workforce, enabled the economy to avoid an inflationary pay-price spiral. Pay inflation was indeed the dog that didn't bark in 2006.

SUBDUED JOBS GROWTH IN 2007 Increases in average regular pay remained subdued throughout the first half of this year too (running at just 3.4% in the three months to June) despite signs that unemployment had started to fall again (by over 30,000). It is clear, though, that the fall in unemployment was due to slower growth in the supply of labour relative to demand rather than much stronger demand *per se*, especially for employees.

The labour supply increased by just 5,000 while the total number of employees in employment barely changed at all, undermining the ability of employees to push for inflation-matching pay rises. What enabled unemployment to fall was a net rise in self-employment.

A TIGHT LABOUR MARKET? Given that the big picture shows conditions in the labour market to be relatively slack at present it is puzzling that employers constantly say they are engaged in an ever tougher war for talent.

One reason is that recruiters on the ground have to cope with the churn of workers moving from job to job. There are substantial flows of people around the labour market in any given year which dwarf the net changes in employment and unemployment discussed above. In 2006, for example, 4.4 million people left their jobs – that's almost one in five employees – and 80% of them quit voluntarily. Most voluntary leavers represent what employers will have experienced as their retention problem. Judging by what employers tell the CIPD, the problem generally got worse in 2006.

While one employer's retention problem is simply another's opportunity to recruit, and, in principle employers should have benefited from the bigger pool of labour available, it appears that this is not providing anything like a full solution to recruitment difficulties. The incidence of recruitment difficulties not only remained very high in 2006 (reported by 84% of employers) but got worse in all broad sectors of the economy, apart from the public services, even though the supply of labour was expanding.

It is likely that recruitment difficulties would have got worse still in the absence of large-scale migration. But it is also important to recognise that a bigger supply of labour does not necessarily mean that employers are finding it easier to recruit staff of the quality they are looking for.

Migrant workers, for example, sometimes have difficulty with English and don't always have the kinds of UK-accredited skills or work experience employers require. While migrants from the new EU member states have boosted the supply of workers willing to perform less skilled employment – 80% are employed in jobs offering under £6 an hour – their impact on reducing skills shortages has been limited. This may explain why the rate of growth in average earnings including bonus payments rose from 3.6% to 4% during 2006 even though growth in regular pay slowed. The greater availability of migrants to perform low-skilled jobs helped employers to contain basic pay settlements while offering higher reward to staff with the skills and experience they wanted to retain without having to greatly inflate the total wage bill.

With specialist skills and required experience still in short supply, and the market for the latter therefore tight even though the labour supply as a whole has expanded, it is little wonder that employers consider themselves engaged in a fierce struggle to retain and recruit staff – no matter what the economists say.

John Philpott is Chief Economist at the Chartered Institute of Personnel and Development (CIPD).
J.Philpott@cipd.co.uk
www.cipd.co.uk