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The responsiveness of wages to labour market conditions in the UK

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Abstract

If wages are more flexible in the sense that pay is more responsive to labour market conditions, this has important implications for the workings of the aggregate economy. First, the real fluctuations generated by both demand and supply shocks are smaller and, second, the economy can operate at a higher level of activity relative to potential without adverse inflationary consequences (i.e. the NAIRU is lower).

Our empirical analysis of wage flexibility suggests that UK wages have become more responsive to labour market conditions since the mid-1980s, at least relative to the previous decade. Furthermore, this has happened within certain industrial sectors. Finally, a part of this move towards greater responsiveness has been due to the decline in national pay bargaining over the relevant period. However, the majority of this change is due to some other factors.

Keywords: Wages; Flexibility; Unions

1. Introduction

Wage flexibility is generally thought to be an important part of labour market flexibility which is, in its turn, generally deemed to be "a good thing". Wage flexibility

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has two aspects. The first aspect is concerned with the responsiveness of wages to labour market conditions. The second aspect relates to the responsiveness of wages within a firm to idiosyncratic shocks, for example, shocks to the firm's productivity or the demand for its output.

Here, we focus only on wage flexibility of the first type. This form of wage flexibility has important consequences for macroeconomic fluctuations. In particular, the more responsive are wages to labour market conditions, the lower are the real fluctuations generated by macroeconomic shocks of all kinds (e.g. nominal demand shocks, pricing shocks, wage shocks). Furthermore, the economy can operate at a higher level of activity relative to potential without adverse inflationary consequences if this type of wage flexibility is higher[1].

In this paper, we use microdata on wages in the UK to investigate variations in wage flexibility both over time and across sectors. This is worth doing because in Bell et al. (2002) it is noted that the impact of (log) unemployment on male wages in the UK is significantly higher after 1986 than before. By contrast, Schweitzer (2001) finds that the impact of unemployment on wages is no higher after 1992 than before. Here, therefore, we pursue this issue in more detail because of the importance of this type of wage flexibility in the workings of the macroeconomy in the UK. In particular, we analyse whether the decline in national wage bargaining in the UK since the 1970s has generated any increase in wage flexibility over this period. In the next section we demonstrate, in the context of a simple model, the truth of the statements made in the introduction concerning the role of wage flexibility in determining the scale of macroeconomic fluctuations. Then, in Section 3, we describe the decline in national wage bargaining since the 1970s and follow this in Section 4 with a description of the data and empirical methods that we use. Then we present our analysis of the question whether or not wage flexibility has increased over the last 25 years in the UK and how flexibility varies over different industrial sectors. Finally, in Section 6, we analyse the extent to which changes in wage flexibility are related to the significant declines in national wage bargaining over the same period. We conclude with a summary of our findings.

2. A simple model

We assert in the Introduction that wage flexibility is a key determinant of the size of the real fluctuations generated by any given macroeconomic shock. To illustrate this point, consider the following simple log-linear model which focuses on labour market behaviour. Wage setting:

$$w_t = E(p_t \mid I_t) - \beta u_t + z_{wt} + \varepsilon_{wt} \tag{1}$$

[1] This type of wage flexibility is intimately related to the notions of real wage rigidity and the sacrifice ratio (the number of percentage point years of unemployment required to bring down inflation by 1 percentage point). More particularly, a higher level of wage flexibility of this kind will reduce real wage rigidity and lower the sacrifice ratio (see Section 2).