Review of Paul Johnson’s talk on changes in wages and income

*By Tom Harris*

On Tuesday 12th November 2013, the Economist’s Society welcomed Paul Johnson, Director of the Institute for Fiscal Studies, to give an insightful talk on what has been happening to wages and income. I feel that this topic is particularly relevant, given how living standards and the ‘cost of living’ crisis have jumped to the top of the political agenda. In addition, Mr Johnson has enjoyed a tremendously successful career in economics, having worked at the HM Treasury, the Department for Education and the FSA. As a result, it was a pleasure for him to share his expertise and insightful views.

To start, Mr Johnson briefly described the ‘big picture’, showing how UK National income is still below its 2007 level which was driven almost wholly by falls in real earnings. Yet, fall in earnings has been accompanied by rising employment, which is completely different from previous recessions. Indeed, this conundrum lies at the heart of the ‘productivity puzzle’, a problem currently occupying economists’ thoughts. I felt that this was a good introduction to the talk, as it gave Mr Johnson a platform to delve into more detail.

Mr Johnson then went on to describe the trends in wages and income before 2008, explaining how incomes slowly rose from 2001 and expanded during the initial part of the recession, as the Labour government implemented, in the words of Alistair Darling, ‘a classic Keynesian response’ to the collapse of Lehman Brothers and slowdown in economic activity. This fiscal expansion manifested itself principally in the form of greater benefits and tax credits, which was interesting to hear, given how Keynesian economists often prefer direct increase in government spending, to ensure that there is an injection into the circular flow, instead of increased savings. More intuitively, Mr Johnson then went onto describe the sharp fall in incomes from 2009-2010, primarily driven by fall in earnings, although he commented that this recession was much more equal than in 1980’s. I found this really fascinating given that much of the political debate focuses on increased inequality and how often George Osborne’s statement "we're all in this together" is mocked. As a result, I now feel more inclined to check the data. However, Mr Johnson then went on to explain how inequality is likely to increase over the next few years as future spending cuts are likely to hit on the poor the hardest.

Age and median incomes were also discussed, with Mr Johnson showing how the elderly are doing better than the young in terms of real income as well as how the elderly incomes continue to rise. This constitutes to the increases in state pensions, final salary schemes and means tested benefits. Personally, I felt that this could well be a calculated political decision, given how pensioners are much more likely to vote, thereby incentivise politicians to adopt favourable policies that promote their interests – for instance the winter fuel allowance. However, given how the current government are so intent of cutting welfare spending, it seems foolish to focus mainly on unemployment benefit spending, given that pensions take up such a large proportion of the welfare bill.

Mr Johnson then went onto to discuss wages and employment, describing how median real wages had arguably become ‘decoupled’ from productivity during the 2000’s. This was explained by the increasing rewards for top earners, high pension and NI costs. I found this particularly interesting, having always been taught that there’s a causal relationship between wages and productivity, so the way to earn a higher wage is to become more productive, yet here the theory seems not to hold very strongly. Perhaps this could feed into the debate about reforming the way economics is taught? Following the recession, Mr Johnson illustrated how employment has risen whilst productivity has fallen, in contrast to previous recession, bringing about the so called ‘productivity puzzle’. I think this brings to light many important questions. For instance, has the UK economy suffered from a long term loss of productive capacity, which would imply inflation picking up at a faster rate and a less sustainable recovery, or are firms ‘hoarding’ workers whilst waiting for a pick-up in demand, which would suggest unemployment falling more slowly and a stronger recovery? Or has productivity simply been measured incorrectly? This has implications for the Bank of England’s ‘forward guidance’ as well as fiscal policy, which are principally why I feel it is so intriguing.

Mr Johnson explained how lone parents and older workers have seen robust employment levels (partly down to policy change e.g. Labour supply has increased among lone parents as a result of job search conditions attached to benefit claims and older workers are retiring later as a result of increased SPA for women) whereas younger workers have done much less well. However, Mr Johnson did not feel that this changing composition of the labour force could fully explain the fall in wages/productivity, although the new part time and self-employed workers may have contributed to the aggregate fall in productivity. Indeed, he indicated that there is a rise in number of better-qualified workers, which would suggest rising productivity. Although I am a little sceptical on this point as I don’t think that education and productivity are strongly correlated, but education level and ability are correlated, hence inducing employers pay them a higher wage.

One explanation for the ‘productivity puzzle’, described in the IFS Green Budget 2013, is ‘that workers are producing less per hour as a direct result of the fall in consumer demand and that this is restraining wages’. This seems very plausible and would suggest that firms are keeping workers employed with the expectation of greater demand in the future. In addition the IFS Green Budget 2013 suggests that ‘low investment may have reduced the level and the quality of capital that workers have access to. Firms may also have substituted labour for capital such that labour is now relatively cheaper and more flexible in face of uncertain demand. Lower levels of capital per worker, especially if the capital is of a lower quality, will reduce labour productivity.’ I feel that this presents a strong explanation for lower labour productivity and higher employment, as greater uncertainty may discourage investment in both capital goods and human capital which is likely to damage productivity. Indeed, I found this report very informative as it went into a lot more detail than Mr Johnson had time to in the talk. Looking forward, Mr Johnson argued that there is likely to be a period of low wages and relatively robust employment until productivity and investment catch up.

For the last part of his talk, Mr Johnson highlighted recent changes in consumption, explaining how cuts in expenditures had been deeper than previous recessions with unusually steep falls in spending on non-durables which suggests that individuals view the loss of income as permanent. Indeed, homeowners have made the largest cuts, causing a rise in saving ratios (although these are still lower than 1980’s and 1990’s), which could help explain the previously weak demand in the economy. Furthermore, Mr Johnson went on to explain how the data points to a permanent fall in living standards, especially amongst the young, although did indicate that those with an Economics degree from UCL have grounds to be a bit more optimistic!

To conclude, Mr Johnson’s talk was thoroughly enjoyable and intellectually stimulating. I’m sure everyone learnt a great detail and has a lot more fascinating questions to think about. Thus, it was a great honour to host this event, and on behalf on the Economist’s Society, I would like to again thank Mr Johnson for giving us his time to share his valuable insights and gracing us with his presence.

• Data points to expectation of permanent fall in living standards

– Especially among young and middle aged