Labour market flexibility

A ‘competitive, efficient and flexible labour market’ is the overarching aim of the government’s labour market policies. This study aims to assess whether the British labour market has indeed become more flexible. Flexibility is concerned with the market’s ability to adapt and respond to changing conditions. The paper considers relevant indicators, and whether trends are consistent with greater flexibility. The emphasis is on developments since the end of the 1970s.

Labour markets can adjust through quantities (employment or hours worked) or prices (wages). Relevant indicators of each are covered at both the microeconomic and the macroeconomic level.

Microeconomic indicators: quantity (employment) flexibility

Firms operate in an uncertain and changing environment. They can secure flexibility in two ways. **Flexibility on the extensive margin** is the ability of employers to change the number of people they employ. **Flexibility on the intensive margin** can be achieved through changes in working time, or in the range of tasks that employees perform.

Part-time, temporary and self-employed work may all enhance flexibility on the extensive margin, mainly by enabling the employer to achieve a more efficient match between labour supply and labour demand.

Part-time work has grown steadily over (at least) the past twenty years. Self-employment also increased very rapidly between 1979 and 1990 - by 1.2 million - after remaining broadly flat throughout the 1970s. In contrast, the increase in temporary work over the past decade has been relatively modest.

More generally, costs and other constraints associated with engagements and dismissals increase the (expected) fixed costs of taking on an employee and hence reduce flexibility on the extensive margin.

The trend in recruitment and training costs is uncertain. However, joint regulation (between management and employees) of recruitment and staffing levels declined considerably between 1980 and 1990.

British employers face relatively few legislative constraints compared with many of their competitors on their ability to make redundancies. The coverage of unfair dismissal legislation was narrowed during the first half of the 1980s, although use of the legislation has increased in recent years. The (limited) evidence suggests the effect of these regulations on employment levels has been relatively small compared with other factors. However, this may simply reflect the light burden placed on UK employers in this area.

The evidence suggests that British employers face relatively few constraints on their ability to exploit external flexibility. These constraints seem to have eased during the 1980s.
Working time can be a source of flexibility on the intensive margin.

Average hours worked were on a downwards trend for most of the post-War period, before levelling off during the 1980s. However, average hours fluctuate over the economic cycle, mainly because of variations in overtime.

Recent evidence suggests there is considerable diversity in working time patterns. Flexibility comes from a number of sources. These range from ‘traditional’ sources of flexibility, such as part-time work and shiftworking, to more novel arrangements contingent on demand (e.g. annual hours contracts, reservism). Less formal flexibilities were also available, such as flexitime.

The other source of flexibility on the intensive margin is functional flexibility, the firm’s ability to switch labour from task to task as circumstances arise.

‘Full-blown’ functional flexibility appears to be something of a rarity. There is evidence, however, that manufacturing firms took steps during the 1980s to increase flexibility, principally through the removal of barriers such as job demarcation. More generally, in 1990, managers in more than two thirds of workplaces felt there were no constraints on their ability to organise work as they saw fit.

Labour mobility is also essential to flexibility.

Among people in work, significant numbers of job moves (changes of employer) take place each year. Nearly half of all job moves involved a change of industry. Many involved a change of occupation, although people can change occupations without changing employer.

Each year, between 1.4 and 1.8 per cent (depending on the year) of the population move regions. Net flows (immigrants minus emigrants) tend to be more modest. The evidence suggests that net migration flows respond to economic signals - in both labour and housing markets.

Microeconomic indicators: price (wage) flexibility

Wage determination in Britain has become increasingly decentralised. By 1990, it is likely that less than half of employees were covered by collective bargaining arrangements. There was a sharp decline in industry-wide national agreements. These trends are not new, but they received a substantial boost during the second half of the 1980s.

Performance related pay (PRP) appears to have grown in importance during the 1980s. The evidence suggests that three quarters or more of medium/large organisations use some form of PRP. A third or more of employees may be covered by these arrangements.

Relative wage flexibility is important in enabling the labour market to adjust to imbalances in demand and supply. It is considered along three dimensions: region; industry; and human capital.

Outside the South East, average earnings vary little between regions. The regional earnings distribution has widened since 1979 because wage growth in the South East has been higher than elsewhere.

Nevertheless, there have been changes in the pattern of regional earnings. Some regions - the West Midlands and Wales in particular - have seen relative earnings decline. Other regions - such as East Anglia and the South West - have seen their position improve. These changes may have helped narrow regional unemployment disparities.

The distribution of earnings by industry narrowed during the second half of the 1970s. The 1980s and 1990s have seen wage differentials widen again.

Relative wages at the industry level are not greatly influenced by labour supply and demand features of the particular industry, nor by general economic conditions; however, there is some evidence that, since the early 1980s, relative wages at the industry level have become more responsive.

Relative wage flexibility is important if wages are to provide incentives for individuals and firms to invest in human capital i.e. the skills and experience people bring to their work. Human capital cannot be observed directly, so indirect measures are used: education; skill levels; and occupations.

Across all these measures, the evidence consistently points to a reduction in the returns to human capital during the second half of the 1970s, i.e. wage differentials narrowed. This was (more than) reversed during the 1980s.

As there has been a long term shift in labour demand, in favour of better educated and more highly skilled workers, the most convincing explanation for the narrowing of wage differentials during the 1970s is
that it was a distortion, possibly due to the effects of incomes policies and union bargaining strategies. Developments in the 1980s were partly an unravelling of this distortion.

**Macroeconomic indicators: quantity (employment) flexibility**

UK data for the last three cycles suggests there has been a change in the way the labour market has responded to recessions. During the early 1990s recession, the downturn in productivity was much less pronounced than in previous recessions. One possible explanation is less labour hoarding (i.e. firms keeping on excess staff when demand is weak).

More generally, most of the change in labour supply comes through changes in employment, rather than average hours worked. So the balance of adjustment is mainly on the extensive margin. Employment levels may have become more sensitive to demand conditions during the 1980s and 1990s.

**Assessment**

Taking all the evidence together, it can reasonably be concluded that the British labour market has become more flexible. A number of indicators point quite strongly towards this conclusion, such as measures of wage determination, or relative wage flexibility. Due to gaps in the data, the evidence is less clear on some of the others (e.g. labour mobility). But none of these indicators suggest the labour market has become less flexible.

There is also a gender dimension to labour market flexibility. Women are more likely than men to work part-time or on a temporary basis (and more often through choice). They are also more likely to move between jobs.

In general, the evidence is stronger at the micro level than the macro level. This may be because it takes time for changes at the micro level to become clearly visible at the macro level.

**International comparisons**

Wherever possible, an attempt is made to draw comparisons between the UK and other OECD countries. To a large extent, different means of securing flexibility have evolved in different countries:

- In the USA, the lack of labour market regulation means there is great scope for adjustment on the extensive margin, through varying employment levels. Labour is also highly mobile. Hence working time has needed to adjust less than elsewhere. Wages tend to be relatively flexible at the micro level, although this may not be the case at the macro level.

- Japan and Germany are similar in a number of respects. There is considerable flexibility on the intensive margin (working time, functional flexibility), especially in the larger enterprises. Together with aggregate real wage flexibility, this means that employment levels tend to remain relatively stable over the cycle.

- The Nordic economies (Denmark, Finland, Norway, Sweden) appear to exhibit little relative wage flexibility. They have traditionally compensated for this through aggregate real wage flexibility and high rates of mobility out of unemployment.
• In a number of EU member states regulation tends to limit flexibility at the micro level. The available evidence suggests this may not be compensated for at the macro level.

The UK appears to be in an intermediate position. Some features of its labour market resemble the USA. Others resemble its EU partners. The UK has probably moved closer to a US-style labour market since the end of the 1970s.

Biographical note

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“Labour Market Flexibility” by M Beatson, Employment Market Research Unit, Employment Department, was published by the Employment Department as Research Series No. 48.

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