

Brexit and immigration

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- *Despite a context of low unemployment but also low productivity and chronic skill shortages, restricting immigration from the EU is a defining objective of the major UK political parties for Brexit*
- *The economic gains – principally in the form of higher wages for nationals – are likely to be transitory and may be offset by automation*
- *For restrictions on unskilled labour migration from the EU to have a material impact on the structure and levels of output and productivity will take time and complementary reforms that so far have proved illusory*
- *Tighter immigration policy (and allied political rhetoric) risks deterring high skill migrants whom – all parties agree on this – the UK economy still needs to attract*
- *Trading off lower unskilled migration against single market access seems a poor bargain*

Issues

Immigration vitally affects the way in which Brexit is playing out. Both major political parties in the UK have interpreted the June 2016 referendum as primarily a vote against immigration, although at first blush hostility to immigration might appear surprising with unemployment at historic lows of just over 4%. Equally implacably, the EU27 remain opposed to dilution of the right to freedom of movement. With little apparent sign of compromise in sight, the UK will have few options but to leave the single market and customs union.

These incompatible views of labour mobility have clouded much of the debate and made it more difficult to identify the net consequences for the UK economy, particularly the direct implications of reduced immigration. This note looks at whether there has indeed to be this stark trade-off: political gain but economic pain or whether lower migration could potentially benefit, or come with limited cost to, the UK.

Why is immigration such a hot issue?

There are two factors at work here - scale and consequences.

How many migrants?

The first concerns the scale and speed at which migration to the UK from the EU has occurred. Migration from the EU accelerated rapidly after 2004 and again in 2014 with the lifting of restrictions on Bulgarians and Romanians. Presently, EU migrants comprise over 7% of UK employment and 60% are from the Eastern European states. There is no doubt that major UK urban centres – but also agricultural regions - have seen a dramatic and visible rise in the number of EU

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migrants. This has not proved popular, particularly – but not exclusively – among working class voters.

The UK's Office of National Statistics' (ONS) data for 2016 show that the current stock of EU migrants in employment in the UK is nearly 2.2 million of which 1.3 million are from Eastern Europe. Workers from the EU are mainly employed in financial and business services and wholesale and retail trade while also comprising approximately 4% of the total NHS labour force. For the less skilled part – mainly Eastern Europeans – their exposure is mainly to manufacturing, trade (including hotels and restaurants) and construction. The occupational breakdown indicates that in 18 industries EU workers account for over 20% of the labour force and in some (such as fruit, vegetable, meat and fish processing) the share reaches as high as 40-50%, while for agriculture it is around a third. In hotels and catering, the EU share is 14%. For East Europeans, in particular, most are concentrated in so-called elementary occupations, as well as plant or machine operatives in manufacturing. As a rough approximation, around 55-60% of the current stock of EU migrants in the UK is in low skill, low productivity jobs. Most are relatively over-qualified and work longer hours than locals. Higher skill EU nationals – largely from Western Europe – tend to be clustered in finance and business services. For this broad group, there seems to be consensus regarding the need to retain and continue to attract.

Consequences

A second factor concerns the consequences of immigration. A key distinction is whether migrants are substitutes or complements to locals. If the former, the impact on the latter is more likely to be adverse. In the UK instance, there is actually a fairly broad consensus among experts that EU nationals have not significantly displaced Britons from jobs (although among the general public, the largest share appear to believe the contrary). What is more widely agreed, however, is that large order immigration has put downward pressure on wages and hence on incomes, particularly at the low skill end of the labour market where Eastern Europeans have mostly slotted in. With flexible labour markets, the impact has been taken through wages rather than employment.

But it should be noted that UK median household income has increased very gradually in real terms since the early 2000s. For most, average annual increases in real terms have been in the range of 0.3-1.6%. Part of this can, of course, be attributed to the fallout from the financial crisis of 2007/8. Further, data (ASHE) at 2 digit level for sectors, as well as for occupations, from the early 2000s to 2016 show that median hourly earnings for sectors and occupations in which EU migrants have high exposure have grown at rates comparable to other sectors and occupations in which their exposure is lower.

Perhaps more relevant is the fact that the period has also seen the proliferation of new forms of labour contracts and forms of working in the UK that have been associated with growth in fragile and low wage employment. The correlate of the UK's low unemployment has been the proliferation of low quality jobs. It is also well understood that the UK's productivity performance has been very poor. This can be attributed to a combination of factors including, low skill levels,

inadequate training, management shortcomings and chronic spatial disparities. In the public's perception, it seems as if these wider changes, and the allied deterioration in contractual and other status, have been widely associated with immigration. Those dissatisfied with freedom of EU movement have also highlighted the additional pressure on public services – especially housing, schooling and healthcare. These pressures have been hugely accentuated by a decade of fiscal contraction. Finally, there is also the wider consideration of social cohesion which some – again, across the political spectrum – feel has been diluted by large order immigration. Although the economic dimensions of the debate are obviously important, the reality is that immigration encompasses far wider social and cultural considerations. This conflation makes designing policy peculiarly tricky. These difficulties have been aggravated by bad or non-existent statistics, as well as a tendency for preferences to trump facts.

Possible benefits from lower migration

The benefits are normally presented as improved incomes for local workers through curbing low skill migration, as well as securing sovereign control over borders. And there is an additional question of relevance that is little discussed. Has large order unskilled migration (mainly from Eastern Europe) also skewed the UK's output and employment structure towards activities with relatively low skill content and poor productivity? If that were the case, an adverse labour supply shock via lower migration could possibly promote reallocation towards higher value added activity and a much-needed boost to the UK's dismal productivity.

UK's emerging policy

Although the exact details of the UK Government's likely stance on migration are still hazy, recent leaked Home Office documents suggest that the main objective will be to reduce sharply lower skill migration from the EU. There appears to be consensus that the stock of current migrants will be allowed to stay. The depreciation of sterling (and the tone of the political debate) will also encourage some current migrants to leave. So the main changes will be on future flows. Given the large income gaps between the UK and most Eastern European economies, migration controls would undoubtedly lower flows relative to an unconstrained (i.e., current) regime. What would be the consequences for the labour market of this approach?

Attracting high skill talent will be severely penalised if the costs and time for securing permits/visas jumps substantially and/or the duration and flexibility of work permits gets curtailed. But it seems likely that any UK government will try to avoid throttling off the flows of talent. The position for low skill migrants is murkier. UK employers mostly complain that severely curtailing EU migration will backfire. Their view is that construction and hospitality sectors will struggle to recruit, particularly in London and the South East. Controls will exacerbate chronic skill shortages in manufacturing and engineering and continue to have an adverse impact on agriculture where seasonal labour shortages in 2017 have already induced 10%+ wage hikes.

The complaints of employers have some foundation. Even if local workers were in principle available in sufficient numbers to substitute EU nationals in the short term – a doubtful proposition with little slack in the labour market - there are also other factors – such as skills and lack of spatial mobility - that will take time to address. These factors combined suggest that the timing of any adjustment path will be critical. Tighten quickly and the consequence will surely be some nominal wage inflation and that may well be positive for some British workers. But an adverse labour supply shock can also lead employers to accelerate the substitution of capital for labour, as through automation. Although cost-side increases would indeed weed out less profitable firms and, in the short run, squeeze profits in others, the expected gain to locals' incomes and employment is likely not to be persistent without the sorts of labour market interventions – notably to raise skill levels, enhance mobility and provide better incentives for training – that have so far largely eluded the UK. A sharp contraction in the supply of EU labour would particularly affect London and the South East where productivity levels are higher than elsewhere.

Implications for output structure

As to whether EU migration has helped skew the structure of the economy towards low productivity activity, this is difficult to measure accurately given the obvious difficulties in establishing appropriate counterfactuals. Nevertheless, a simple comparison of pre-mass EU migration and now shows that sectors and activities in which EU migrants have particularly high exposure have not grown disproportionately. Indeed, manufacturing has continued to shrink at the same time as the share of East European workers has grown significantly. What is more likely is that the relevant changes are occurring at lower levels of aggregation and within branches. Here, it is quite possible to consider that an enhanced supply of low wage labour over the last 15 years has affected the viability of particular activities and the choice of technology. This aspect would deserve greater, detailed study.

Conclusion

Curbing migration from the EU will address an important constituency of Brexit voters. In the short run, (and the electoral imperative, as we know, is mainly short run) a shock to labour supply should raise wage pressure at the base of the wage pyramid. It may also induce some reallocations of labour but this cannot be assumed when employment and labour force participation levels are already very high. It is unlikely to have any material impact on the factors that have promoted precarious, low wage jobs. In the medium term, employers – faced with rising labour costs – will respond in a variety of ways, some aimed at improving productivity. In manufacturing and some other elementary occupations, the attractions of automation will rise. While automation may well not be job-destroying, it is likely to shift the skill content of jobs and in directions that do not favour low skilled locals.

As to whether lower migration will induce major reallocation and a shift in output structure towards more productive activities, the picture is less clear and warrants closer investigation. But some of the factors behind the proliferation of low productivity jobs will not be easily addressed quickly. The enduring

problems of the UK's labour market – low and/or inappropriate skill levels; inadequate training, chronic spatial segmentation and more fuzzy motivational issues – need to be addressed by other policy instruments. The likelihood of that happening could, of course, be accelerated by a decline in migrant inflows. But that would surely be a curious and costly way of addressing these limitations.

Set against the benefits of continuing access to the single market and the possibility that a more drawn-out negotiation over free movement with the EU could lead to some qualification of the existing rules, a political approach giving priority to reducing immigration seems counterproductive for the economy but not necessarily for the politicians.