



THE WAGE FLAW

...why minimum pay
ISN'T WORKING

There has been a serious decline in labour market prospects for the most vulnerable groups since the minimum wage was introduced in the UK. There isn't sufficient UK evidence yet to pin the blame for this entirely on the minimum wage, but the international evidence points in that direction. Proposals for imposing a "living wage" by soft or hard coercion could be seriously damaging, says **W.S.SIEBERT...**

The UK's minimum wage began in April 1999, fulfilling a promise of Tony Blair's Labour government. Blair was responding to popular demand, since the Conservative government in 1993 had ended the old system of minimum wages. Michael Forsyth, the Employment Minister at the time said: "The biggest source of poverty is not low pay; it is having no job. Wages councils destroy employment". Most people, then and now, believe that there is a moral basis for a minimum wage. Certainly, the minimum wage is a popular policy, and the coalition government has not moved close to changing it.

The national minimum wage (NMW) system has some interesting features. Firstly, it is set in a technocratic way by experts who rely on research. Although the Low Pay Commission has both TUC and CBI members, it also has academic members, and an independent chair. Hence, a careful sifting of the evidence on how the NMW bears on business – including business in the regions – plays a large part in the debate. As such, changes in the NMW have responded closely to changes in the health of the economy. The biggest exception to this was in 2001 when the thrusting Stephen Byers saw electoral advantage in pushing the youth rate up considerably prior to the May 2001 election. The important point here is that the NMW is set explicitly to weigh as little on unemployment as possible.

Secondly, the minimum wage is "national", with no regional differentiation. The Low Pay

Commission's terms of reference from the beginning excluded such differentiation. Hence, arguably, the level has always been too high for the north, and too low for the London area. The NMW does, however, have several age categories, with a youth sub-minimum, and an even lower apprentice sub-minimum. Thus, it has been sensibly conceded that young workers and apprentices are less productive. Again, we see an effort to mute the unemployment consequences of the minimum.

Despite this, the UK labour market is performing poorly for unskilled workers, as shown in *Table 1*, and the question must arise about the NMW's role in this. The table gives statistics for the 16-24 group, and we see that this group's unemployment rate has almost doubled to 24.7 per cent over the period since 1999. The working age population as a whole have not done nearly as badly as this. In addition, as the lower panel shows, unemployment duration for the young age group has worsened, to the point where 28.2 per cent of the youth unemployed have been unemployed for over one year. This figure compares with only 15.3 per cent in 1999. In fact, in many respects, the UK's youth labour market is now putting in a worse performance than that of France. This comparison is made in the last column.

Employment effects: UK evidence

The minimum wage has been raised considerably over the period since 1999. Hence, it makes a lot of difference to unskilled workers'

earnings, and one would expect unemployment consequences unless counter-balanced by strong growth. The impact of the minimum wage can be seen in *Figure 1*, which compares the earnings distributions in both 1997 and 2010. The 2010 distribution has had its lower tail cut off compared with 1997, and there is also a concentration of workers at the minimum. The large increases in the NMW over time are shown in *Table 2*. It has increased by 72 per cent since 1999, considerably more than the average worker's wage, which has increased only by 50 per cent, which, in turn, just outpaced price increases of 45 per cent.

What effect has this had on job opportunities for the unskilled? There are inherent statistical difficulties of identifying the impacts of a policy that covers the whole of the UK. One way to judge this issue is to examine regional variation, since the NMW has more "bite" in poor than rich areas as shown in *Figure 2* which compares the hypothetical effect in a district such as Cambridge with one such as Liverpool. Assume that productivity and the demand for labour is lower in Liverpool. The NMW requirement would move unskilled employment from *point d* (dictated by the level of welfare benefits) to *point c* (the demand for labour at the minimum wage). Meanwhile, employment in Cambridge is barely affected. This result, of course, depends upon the demand (D) for labour curves not shifting over time.

The first person to conduct this type of study was Mark Stewart (2002), who used data for changes in wages and employment in about

		All working age	No qualifications	16-24	France 15-24
Unemployment rate (%)	1999	6.3	12.1	13.8	24.2
	2011	8.1	17.0	24.7	22.1
	Change 1999-2011 (percentage points)	1.8	7.9	10.9	-2.1
		All working age	No qualifications	16-24	France total
Unemployment duration (% of unemployed > 12 months)	1999	28.7	NA	15.3	40.3
	2011	33.3	NA	28.2	41.4
	Change 1999-2011 (percentage points)	4.6	NA	12.9	1.1

Table 1: Adverse Changes in Employment for Unskilled Workers

Sources: Low Pay Commission (2012, Table 2.10), ONS (2012) and OECD (2000, 2012)

Hourly earnings distribution for employees aged 22 and over, by 25 pence band, UK, 1997 and 2010

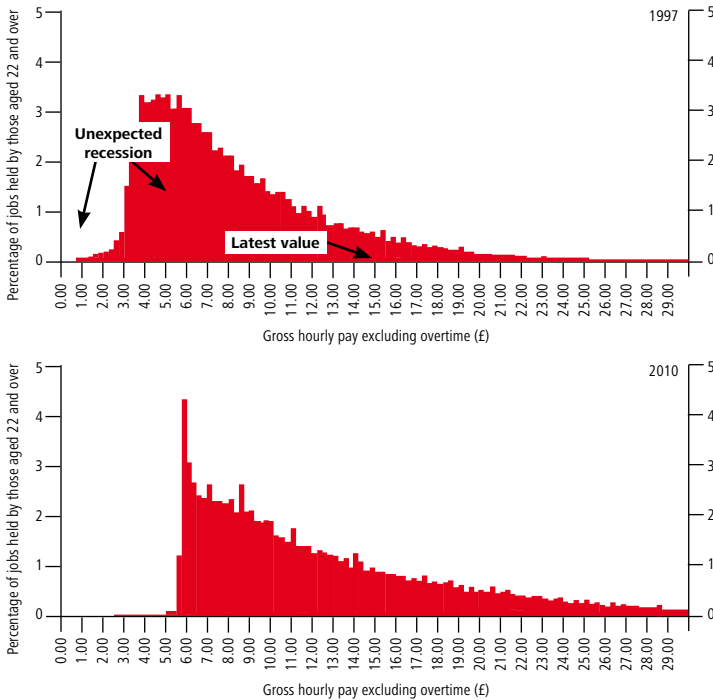


Figure 1: Changes in the Earnings Distribution due to the NMW
Source: Low Pay Commission (2011)

150 UK regions for the first year of the NMW. He found no adverse effect, but with only one data point per region he could not allow for region-specific trends or long-run effects. His work has recently been updated (Dolton et al 2008, 2010), this time experimenting with a lagged minimum wage variable so as to capture long-run effects. Again, while little effect on employment is found, there is a significant increase in claimant unemployment.

An alternative approach is to compare workers who have their wages raised by the NMW with workers paid just above that level (say, up to 10 per cent above the minimum). These workers should have similar skills, and welfare benefit options. This method was also pioneered for the UK by Stewart (2004). He again found no adverse NMW employment effects. However, in more recent work (Stewart and

Swaffield 2008), he has found evidence that the NMW causes a cut in working hours of between 1 and 2 hours per week.

The latest work using this approach is by Dickens and Riley (2012), using data up to 2010 and encompassing recession years which hit unskilled workers harder. This research finds that the probability of remaining in a job (employment retention) is reduced by about three percentage points by the NMW for part-time women, the group who are most affected by the NMW. This result is important because a 3 point reduction is in fact quite large when measured against an average retention rate (i.e. probability of remaining in employment for one year) of around 70 per cent. About 10 per cent of female part-timers are paid the minimum compared with only 2-3 per cent for male and female full-timers.

So, the UK employment picture for

the most vulnerable has deteriorated rapidly since the introduction of the minimum wage. However, there is not enough data to draw firm conclusions as to the cause as yet. What does the international evidence suggest?

International evidence

Studying a panel of countries or states (for example in the USA) offers a better way of analysing minimum wages since there is more variation in the minimum wage and more sophisticated statistical techniques can be used. An important study of long-run effects is that by Baker et al (1999) for nine Canadian provinces for 1975-93. He found that a 10 per cent increase in the minimum wage reduces teenage employment by 2.5 per cent and that it takes about six years for this result to be revealed.

There have been several further international panel studies, all finding serious adverse employment effects. Neumark and Wascher's (2004) analysis of 17 OECD countries for the period 1975-2000 finds that a 10 per cent increase in the minimum wage leads to a two per cent reduction in the employment rate for younger people (aged 15-24). More recent work by Dolton and Bondiabene (2012) confirms these estimates and also suggests that the much lower impact of minimum wages on adults tends to double during a recession.

Finally, the work by Addison and Ozturk (2012) on a similar sample concentrates on employment outcomes for adult women. They estimate that a 10 per cent increase in the minimum wage will reduce employment by 1.5 per cent.

In sum, while the UK evidence is thinner due to statistical problems, the research overall points to the minimum wage reducing employment as conventional economic theory predicts. In other words, the minimum wage undermines employment for the least productive whilst raising wages for others. The research also suggests that the workers who benefit are the better-off: where there is high

		Level, Oct 2012, £/hour	Increase since 1999 %
National Minimum Wage	Age categories:	22+ (21+ from 2010)	72
		18-21(20 from 2010)	66

Table 2: Minimum Wage Trends

unemployment there is heightened competition for jobs, with the better connected workers rather than the poor finding them. Thus, Ahn et al's (2011) research shows that, as the minimum wage increases, there is a shift in employment towards teenagers in families with highly educated heads and away from poorer groups.

Morality and new proposals for a "living wage"

Going beyond the NMW, the Joseph Rowntree Foundation and others are calling for a "living wage" of £7.45 an hour. This would be achieved by moral persuasion and possibly implicit and explicit government pressure. We are told that "the moral pressures are winning out over the economic pressures" (Hirsh 2012). Yet what moral virtue is there in a policy that causes the loss of jobs for low-wage, low-skill workers or which causes the lengthening of unemployment terms? Countries with high minimum wages and/or high social costs – such as France – have high long-term unemployment (nearly half the unemployed have been jobless for longer than a year in France). As unemployment terms lengthen, productivity declines and it becomes ever more difficult for people to find work once priced out by a high minimum wage.

The living wage would be tied only to living costs and median incomes and not to labour market conditions. As we have seen, the unemployment effect of the UK minimum wage has been reduced because of the pragmatism of those

Wage

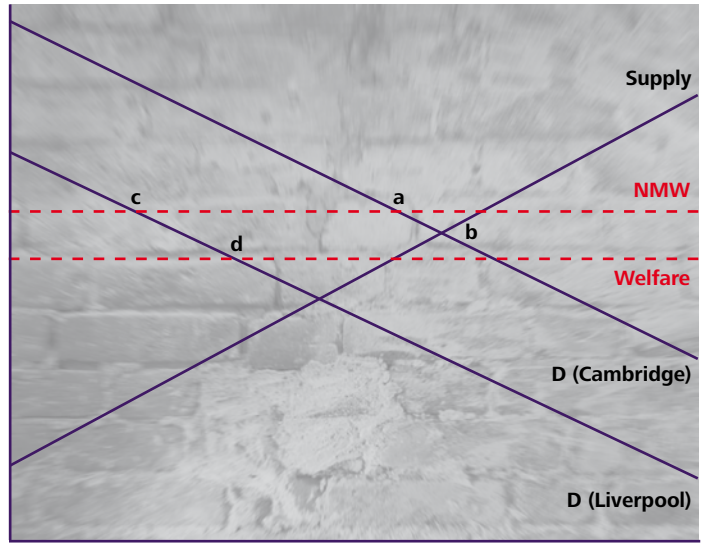


Figure 2: Assessment of NMW Effects

setting the rate. The imposition of the living wage – regardless of labour market conditions – would be a recipe for hugely increased long-term unemployment.

A functioning market would have lower wages in Liverpool than in Cambridge, which would attract business, and relieve poor unemployed people. If the market were allowed to work – which would require lower benefits as well as lower wages since benefits form a floor under wages – then businesses would move north. Of course, it is difficult to take on the benefit system, but even tax breaks for businesses in development areas

would be better than a living wage. Such a policy would have its problems, but it would be better than living wages. The living wage is simply the worst solution to an admittedly serious problem – the high cost of living and high tax burden in the UK. In fact, as discussed elsewhere in this magazine, there are other policies, such as reduced regulation and taxes, that could reduce living costs and thus turn existing wage levels into "living wages" •

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