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Pointmaker

THE CASE AGAINST RAISING THE MINIMUM WAGE

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SUMMARY

- The Government committed in its manifesto to raising the National Living Wage to two-thirds of earnings, and extending it to cover those aged 21-25.
- The Office for Budget Responsibility was already forecasting significant damage to employment from minimum wage increases. But the pandemic makes the situation much worse.
- The sectors worst-hit by the coronavirus – hospitality, retail, social care, and so on – are also those where the increased employment costs of a higher minimum wage are most likely to be felt.
- Extending the wage to those aged 21 rather than 25 will also discourage firms from hiring young people at precisely the time when we should be doing everything we can to create new jobs and avoid the scarring effects of long-term unemployment.
- There will also be a significant cost to the public finances from the planned increase, of at least £2.4 billion.
- Given the overwhelming importance of creating and preserving jobs in the recession, the Government must put its planned NLW extension on hold to avoid increasing employment costs for the most vulnerable at the worst possible time.

INTRODUCTION

The creation, and expansion, of the National Minimum Wage represents one of the most dramatic changes in the UK employment market in recent decades.

Since its introduction in 1999, the minimum wage for those aged 25 or over has increased from £3.60 to £8.72 an hour – with the Conservative Party manifesto promising a further increase to two-thirds of average earnings, estimated at £10.50 an hour, as well as an expansion of this higher rate to cover those aged 21-25 as well.[1] It already affects a sixth of the labour market, and is set to encompass a full quarter.[2]

Prophecies that the introduction of a minimum wage would damage employment have so far proved wide of the mark. The unemployment rate in the UK, before the coronavirus crisis, had reached its lowest in decades. Economically, it is logical that if you make it more expensive to hire workers, firms will hire fewer of them. But these effects appear to have been outweighed by the fundamental strengths of Britain's flexible employment model.

However, even before the pandemic, it was clear that rises in the National Living Wage (which replaced the National Minimum Wage in 2016 for over-25s) were being driven more by political imperatives than the economic data. The Institute for Fiscal Studies, for example, warned that "we do not know what the effects of a minimum wage at two thirds of the median would be" and that Britain was entering "uncharted waters".[3] The evidence suggested that previous increases to the NLW had already hit sectors such as social care and hospitality extremely hard. The Office for Budget Responsibility forecast that the NLW increase in April 2020 would increase unemployment by 50,000 and reduce real GDP by 0.1%.[4]

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In the wake of the coronavirus, the Government's absolute priority must be to protect jobs and job creation – particularly in those sectors hardest-hit by the pandemic, and among younger workers just entering the labour market and facing the scarring, lifelong effects of youth unemployment.

Yet as this paper will show, increasing the National Living Wage so sharply, and extending it to cover those aged 21-25, is a policy that could be precision-engineered to damage those sectors and those workers. It will impose heavy costs on those businesses that are already the hardest hit, discourage job creation and incentivise employers to discriminate against the young. It will also have a heavy cost to the state, particularly in terms of staffing costs in the social care sector.

The generosity of the impulse behind raising and expanding the National Living Wage can only be applauded. But going ahead with the current plans will harm the very people they are designed to help.

THE BACKGROUND

The National Minimum Wage (NMW) was first introduced in April 1999, with two rates: £3.00 for those aged 18-21 and the main rate of £3.60 for all those aged 22 or older. Since then the number of rates has grown to five. The main one, introduced in 2016, is the National Living Wage (NLW), which covers all workers aged 25 years or older. After uprating in April 2020 it stands at £8.72 per hour.[5]

When it created the NMW, the government tasked the Low Pay Commission (LPC) with increasing the minimum wage by the maximum amount possible annually without causing unemployment.[6] Most of the existing evidence suggests that the LPC has broadly succeeded in this task. Certainly the introduction of the NMW and its uprating has not led to large spikes in unemployment. However, recent research has raised alarming questions about how robust the LPC's evidence base is – and how well we understand the link between the NMW and the labour market.[7]

Figure 1 - History of the NMW/NLW

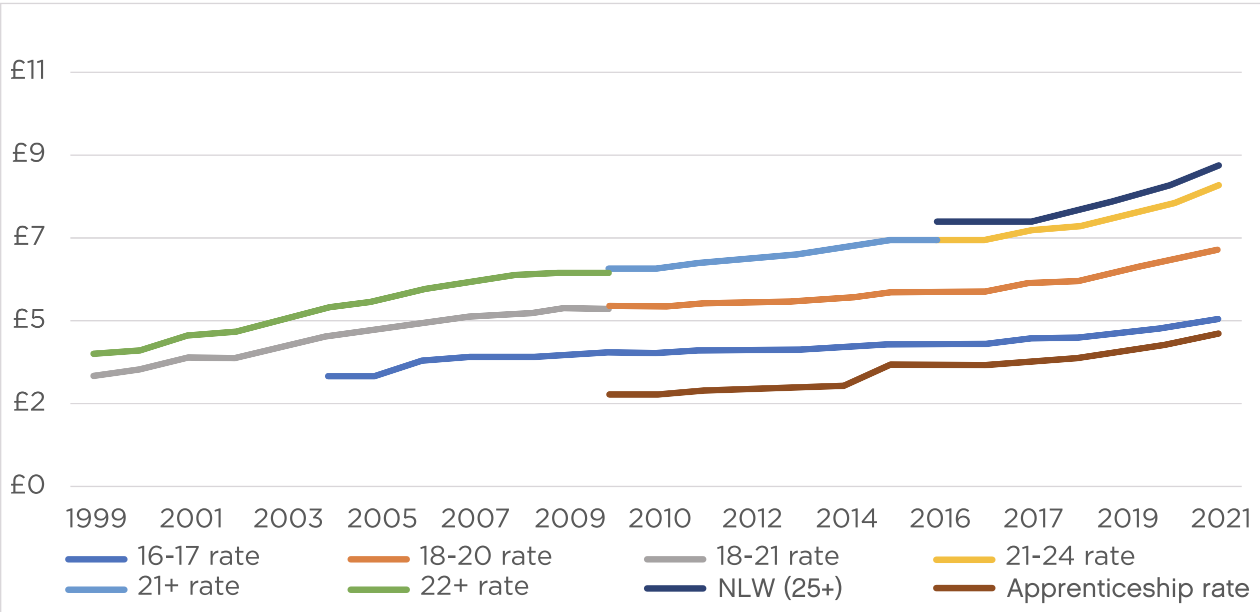
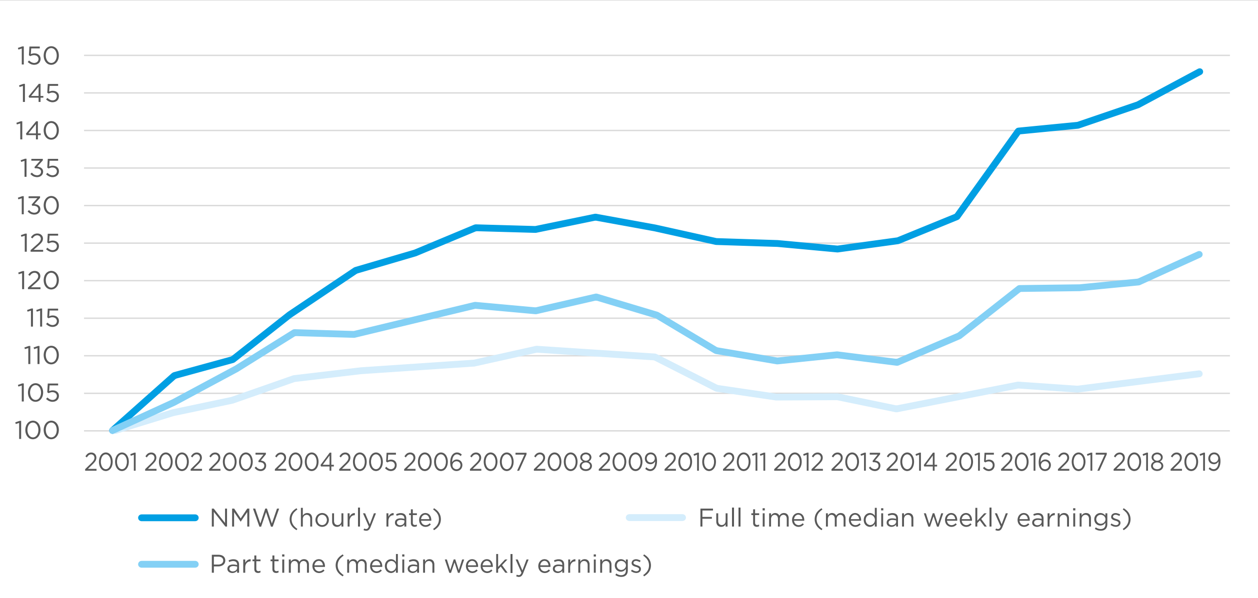


Figure 2 - Real-terms value of minimum wage vs median earnings[8]



After the introduction of the NLW in 2016, the LPC was further tasked with increasing it to 60% of median earnings by 2020. The Conservative manifesto promised a further increase to "two thirds of average earnings, currently forecast at £10.50 an hour" as well as its widening to everyone over 21: "That means an average pay rise of £4,000 per year for four million people by 2024."[9] In December, ministers duly announced an increase in the basic rate from £8.21 to £8.72, more than four times the rate of inflation.[10] In the 2020 Budget, the LPC's mandate was formally adjusted to reflect this new target.[11]

Because the NMW and NLW have increased more rapidly than earnings (see figure 2 above) the share of the workforce earning at or close to the level has increased significantly. ONS analysis of the Annual Survey of Hours and Earnings suggests that the percentage of employees earning at or close to the NMW/NLW has risen from about 5% in 2004 to about 11% in 2019.[12]

Figure 3 - Distribution of jobs by hourly pay (% of jobs)

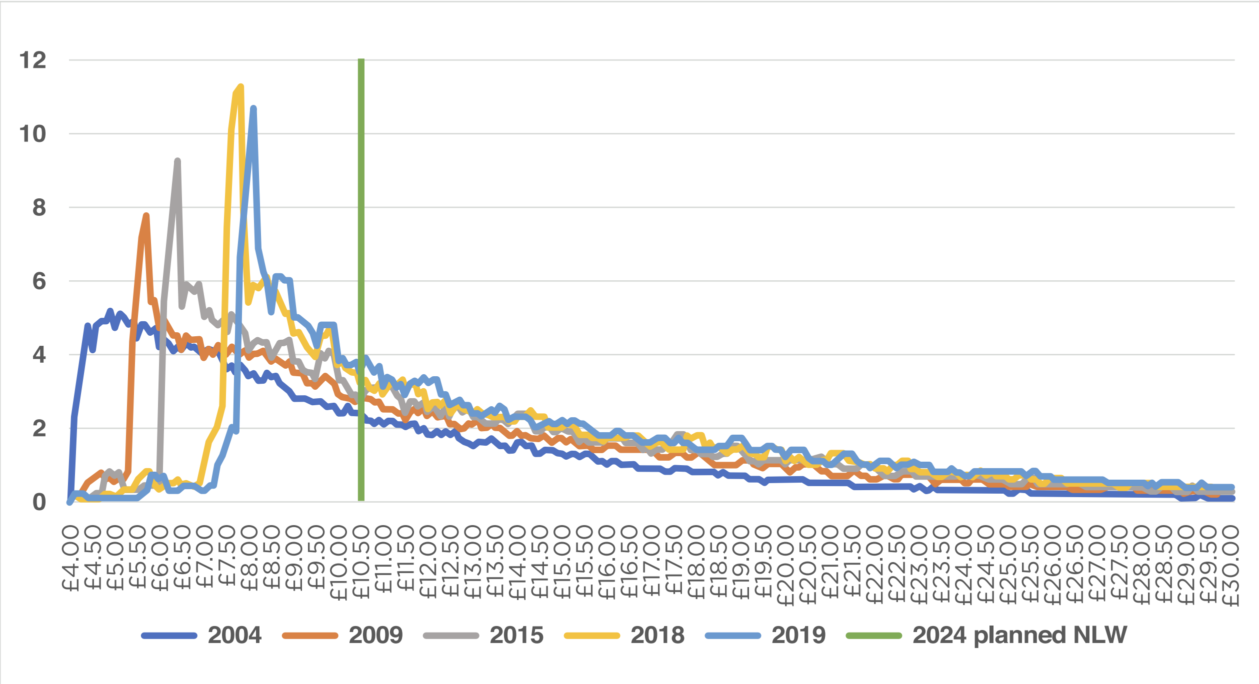
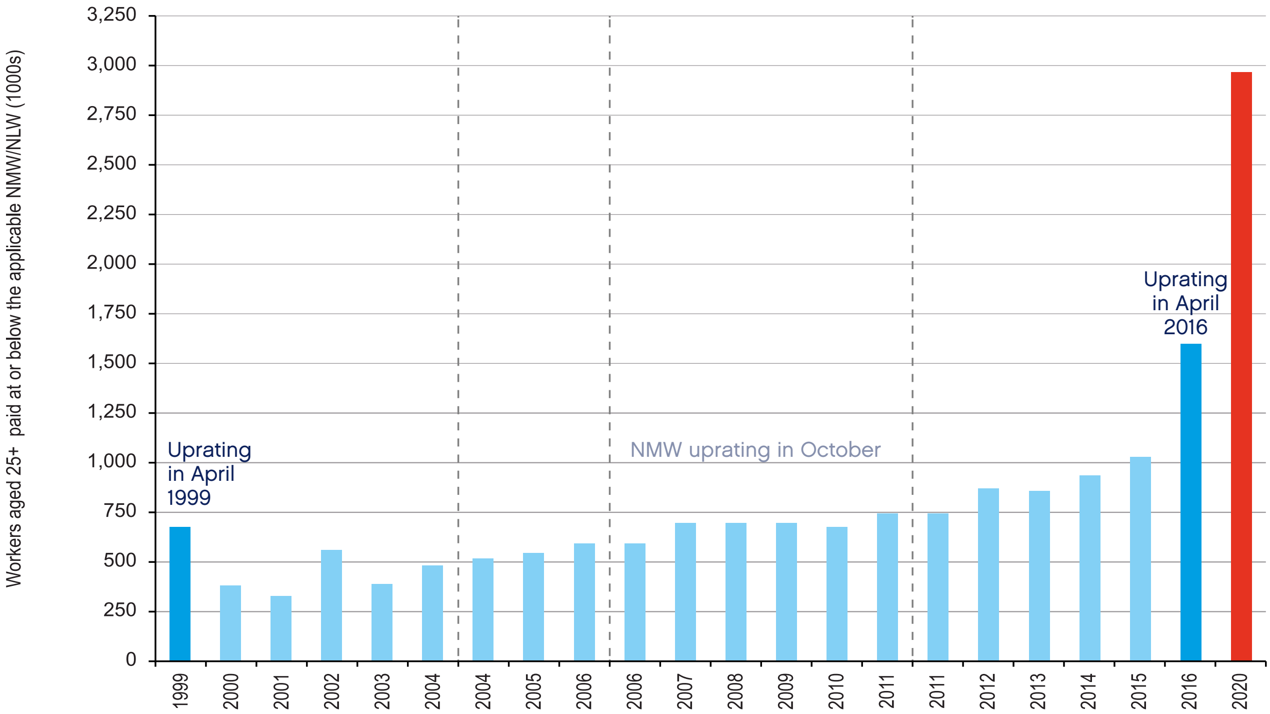


Figure 4 - Number of workers (aged 25+) paid at or below the NMW/NLW[13]



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THE DANGERS OF FURTHER INCREASES

Even before the pandemic, there were good reasons to argue that caution was required when deciding on further increases in the NMW/NLW.

The LPC claims that past increases in the NMW and NLW have not led to higher unemployment, and the research it has commissioned has backed this conclusion up. However, there are questions about how robust this evidence is.

Recent research by the Institute of Fiscal Studies suggests that the econometric methods used in the existing literature are of very low statistical power. In particular, prior research has focused too heavily on a yes/no evaluation of the central hypothesis (whether increases have impacted the labour market) without attention to the range of possible impacts on employment. When researchers reanalysed the data, they found large negative and small positive impacts of NMW increases on employment, suggesting that the existing body of research offers little clear guidance for policymakers about whether higher minimum wages have led to unemployment in the past, and will lead to unemployment in future.[14]

One reason why it is difficult to determine whether NMW increases have impacted the labour market is that any unemployment may have been hidden. Firing people is costly, so faced with increased labour costs, firms may have simply reduced the number of people they hire compared to the counterfactual. Or they may have opted to reduce hours and non-pecuniary benefits – for example by switching to zero-hour contracts.[15] Indeed, when researchers at the LSE looked at the impact of the introduction of the higher NLW, they found a significant switch to zero-hour contracts, especially in low pay sectors such as social care.[16]

It can also take time for policy impacts to become apparent. In the short term, an increase in the NMW may have a negligible impact. But over the medium and long term, the impact can be substantial, as the cost increase of a higher NMW forces unproductive firms to leave the market and more capital-intensive firms to take their place. Research from the US has found that the long-term impact of minimum wage hikes could be 3-5 times larger than the short-term.[17]

One reason why it is difficult to determine whether NMW increases have impacted the labour market is that any unemployment may have been hidden.

In the run-up to the last election, the IFS was already warning that there was a clear need for caution in further increases to the NMW/NLW, and that "previous evidence is of very limited use when assessing the likely impacts of large additional increases". In assessing the Tory and Labour manifestos, it said that "both parties' plans would take us well into uncharted waters for the UK".[18] There was a clear danger that the issue was becoming a political competition between the parties over who could be most ambitious in planned increases, as opposed to the previous approach of evidence-based changes determined by an independent commission.

There is consensus across the political spectrum that at some point, a high enough minimum wage will increase unemployment, although it is unknown at what exact level the threshold lies.[19] The problem is that dramatic increases in the NLW leave little room for the Government to change track if they prove mistaken. Even before the pandemic, the OBR was forecasting that the NLW increase in April 2020 would increase unemployment by 50,000 and reduce real GDP by 0.1%.[20] Given the economic damage of the pandemic, the figure now will very probably be much higher, in all likelihood in the hundreds of thousands.

As far back as 2016, the CBI warned – in a comment on the Low Pay Commission's annual report – that George Osborne's original living wage hike was "a real stretch" and "out of step with pay growth in the lower-paying industries and the economy as a whole". The most affected sectors, it said, are "generally labour-intensive, low-margin and price-taking sectors where the challenge of paying higher wages is compounded by little room to pass on increases in costs to customers and limited scope to boost productivity in the near-term".

THE LABOUR MARKET IMPACT

Generally, commentary on the NMW/NLW has focused on the level at which it is set. But it is also important to consider the extent to which it dictates the labour market.

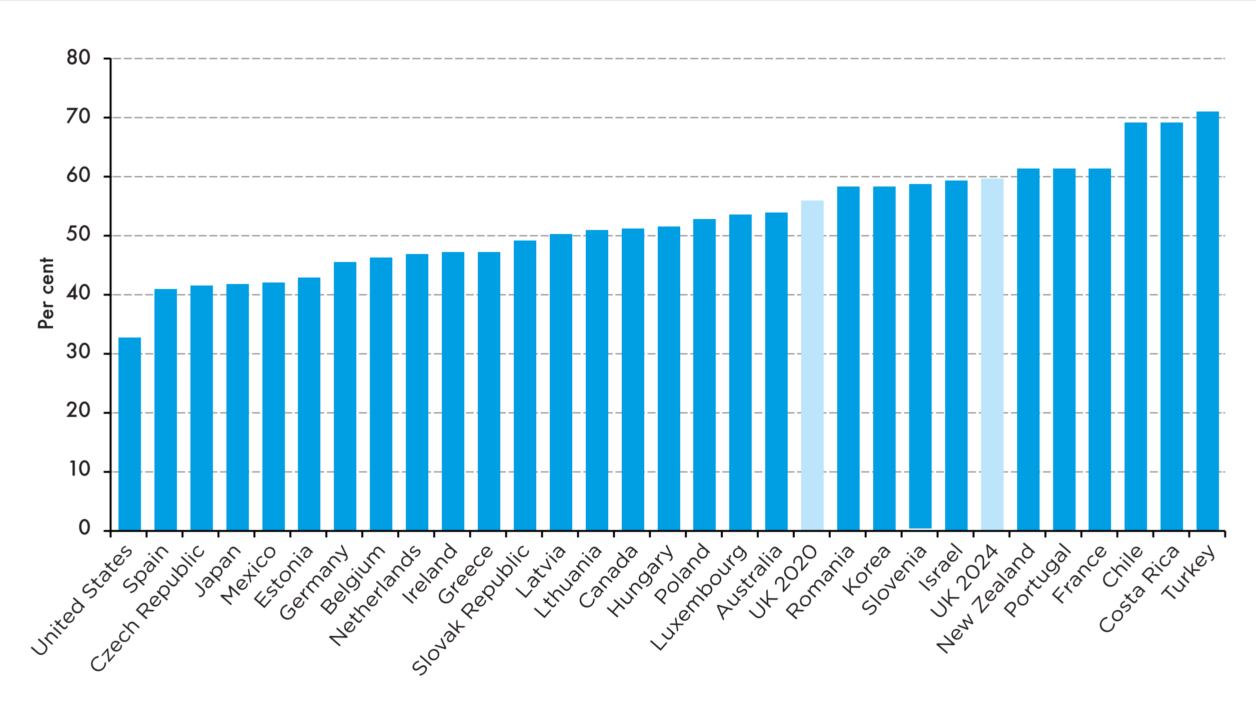
At 60% of median earnings the NLW already covers about one-sixth of all workers. If it increases to two-thirds of median earnings then it would likely affect an entire quarter of the UK workforce.[21] This is a large intervention in the labour market by any measure, but the impact is not equal across all parts of the economy. The greater the prevalence of low-paid work in a given sector, the higher the coverage – for example, significantly larger proportions of employees in hair and beauty, retail, social care, cleaning and hospitality are on the minimum wage.

There is obviously a question about whether we think it is a good idea that the state is implicitly determining the earnings of such a large segment of the UK workforce. This was not the original purpose of the NMW, which was to ensure that low-paid workers weren't being exploited and to try to increase their earnings without increasing unemployment. We should also remember that the public sector directly employs 16.7% of the workforce. While there will be some crossover with those on the minimum wage, this means the state will be setting salaries for a very significant proportion of workers.'[22]

There are dangers that the larger the segment of the workforce covered by the NMW/NLW, the harder it is for the government to resist increases. But more fundamentally, if the Government is setting the wages of a large segment of the workforce, it is bound to introduce distortions in the labour market. For one thing it is likely to lead to a flattening of pay differentials at least at the bottom of the pay scale, which will impact promotion incentives.

When the NMW was introduced in 1999, the UK was in the middle of the pack compared to other countries in terms of its 'bite' – that is, the level of minimum wage to median earnings – but as it has risen the UK has climbed the league table. As the OBR data in Figure 5 shows,[23] the UK NMW is already more generous than most other developed countries, and the plans to raise it further will push us above almost all of our peers.[24] So there are few international precedents to draw on to estimate the potential impacts.

Figure 5 - Adult minimum wage relative to full-time median earnings in 2018[25]



Source: HM Treasury calculations, OECD, ONS

Additionally, the 'bite' of the NMW/NLW is not uniform across the country. It will be lower in higher-productivity areas (where wages are higher) than lower-productivity areas (where wages are lower). In London, for example, the bite is 45%, whereas in regions such as the East Midlands, Wales and Northern Ireland it is over 65%.[26]

Another way to think of this is to look at the number of jobs that are paid at or below the NMW. In London it is 4%, but in Northern Ireland the figure is 11% and in the North East it is 10%.[27]

This isn't simply a regional issue: it is also a local one. Within regions, the return to labour will be higher in certain areas than others, so we would expect the bite of the NMW/NLW to be lower in central Manchester than in rural areas of the North West. The danger is that once the threshold above which the NMW/NLW starts to significantly impact on the labour market is exceeded, it is in the high bite areas where the impact will be most immediate and significant.

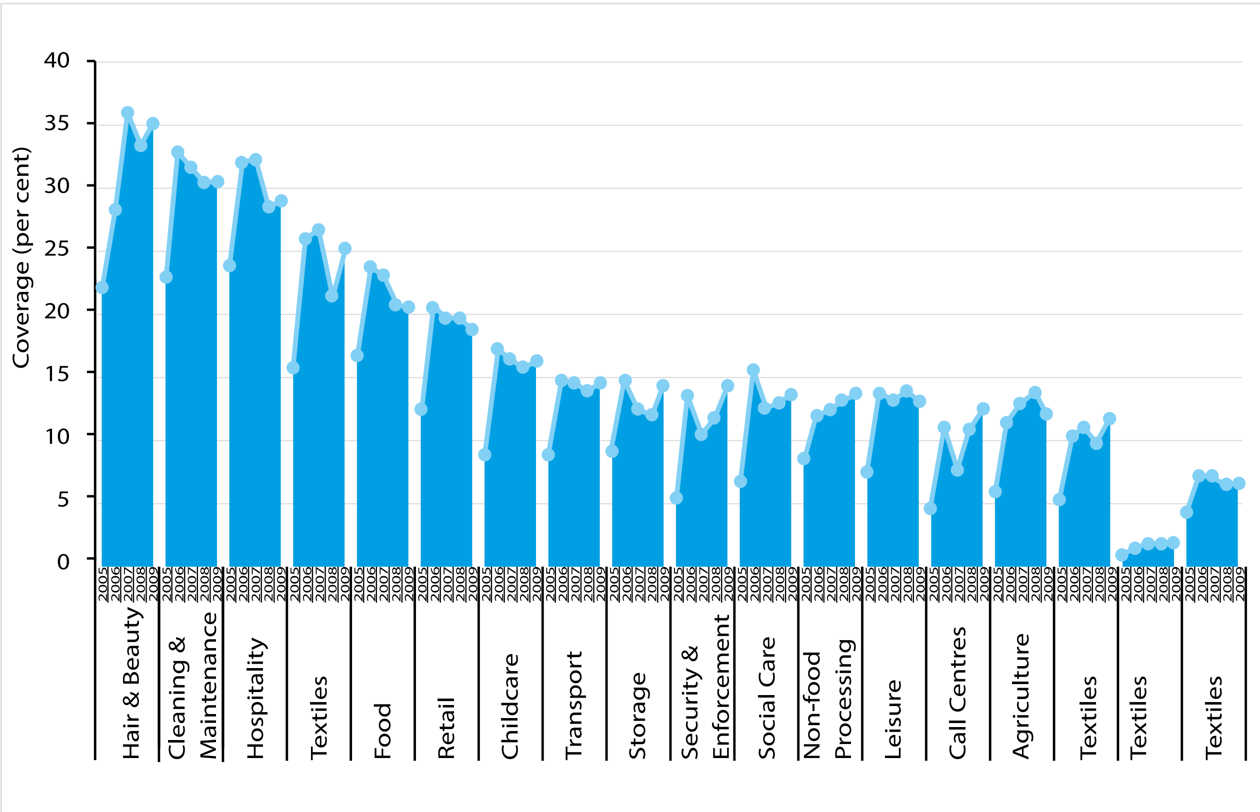
As well as a geographical impact, there is also an age-related one. Young people tend to start out at the lower end of the pay scale, or in sectors that tend to be lower-paid, such as retail or hospitality.[28] Those born in the 1980s, for example, are more likely to start out as customer service assistants or nursery workers, rather than in better-paying roles in manufacturing or administration, as would have been the norm previously. And as discussed below, such sectors are also those most damaged by the pandemic.

Younger workers also tend to be less experienced and lower-skilled, purely by nature of their youth. This is the reason why the minimum wage has been set at a lower level for younger workers: in order to incentivise employers to continue hiring them rather than defaulting to those with more experience. Expanding the NLW to cover those aged 21 sharply increases the cost of employing young people at precisely the time when businesses are likely to be most reluctant to hire, and most concerned about minimising costs.

There is also a very strong sectoral impact. The chart below, taken from the Low Pay Commission's latest report, shows that the bite of the NLW in low-paid sectors now covers a very significant proportion of the workforce.

And while the increases since 1999 and the introduction of the NLW do not appear to have had a large impact on the economy as a whole, some sectors have suffered significantly. The social care system is a particular example.

Figure 6 - Coverage of the NMW/NLW for workers aged 25 and over, by occupation, UK, 2015-2019[29]



Source: LPC estimates using ASHE 2010 methodology, standard weights. UK, 2015-2019.
Note: Data exclude first year apprentices.

Social care is very labour intensive, so staff costs make up the majority of costs in the sector. The CMA estimates that wage costs represent 50-60% of care providers' revenue.[30] Once taxes and pension contributions are accounted for, staff costs make up about two-thirds of total costs in the sector.[31] Furthermore, a large proportion of social care workers, 12.7%, are covered by the NMW, and the figure is even higher for workers over 25 covered by the NLW, at 13.6%.[32]

Increases in the NMW and especially the introduction and uprating of the NLW have therefore had a disproportionate impact on the social care sector. Margins have been squeezed ever tighter, and unlike other sectors where firms can pass on cost increases, care providers are less able to do so due to the market power government has in commissioning care.

Some evidence suggests that care providers have absorbed the higher staff costs by switching more to zero-hour contracts,[33] but they have also held down the overall wage bill by compressing pay differentials, so that today someone with 20 years' worth of experience earns just £0.15 more per hour than someone with less than a year in the sector.[34] This has obviously contributed to a drain of talented staff, which helps to explain the sector's shockingly bad productivity statistics. Equally worryingly, the sector appears to have dealt with extra costs through a reduction in the quality of care provided.[35]

There is also evidence that the cost increases caused by NMW/NLW rises are making the sector unviable for many providers to operate in. The LPC itself has found that the higher NLW has led to more firms exiting the social care sector and fewer new entrants to the market.[36] This compares to other low pay industries (where prices are far more flexible than the social care sector) in which the NLW has not increased firm exits or led to fewer new entrants.

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The cost of the introduction of the NLW has already been significant, with the Local Government Association estimating before its introduction that it would cost £1 billion by 2020. The Resolution Foundation, meanwhile, estimated that the requisite public spending needed to meet NMW and NLW commitments in the social care sector would be £2.3bn by 2020. Further increases in the NLW to meet the two-thirds of median earnings target by 2024 will impose significant extra costs – of almost £500 million a year, by our estimate.[37] This figure is likely an underestimate, since although there has been significant pay compression in the social care sector as the NMW/NLW has risen, it is likely that the need to maintain pay differentials will still cause salaries higher up the pay scale to rise.

THE THREAT OF AUTOMATION

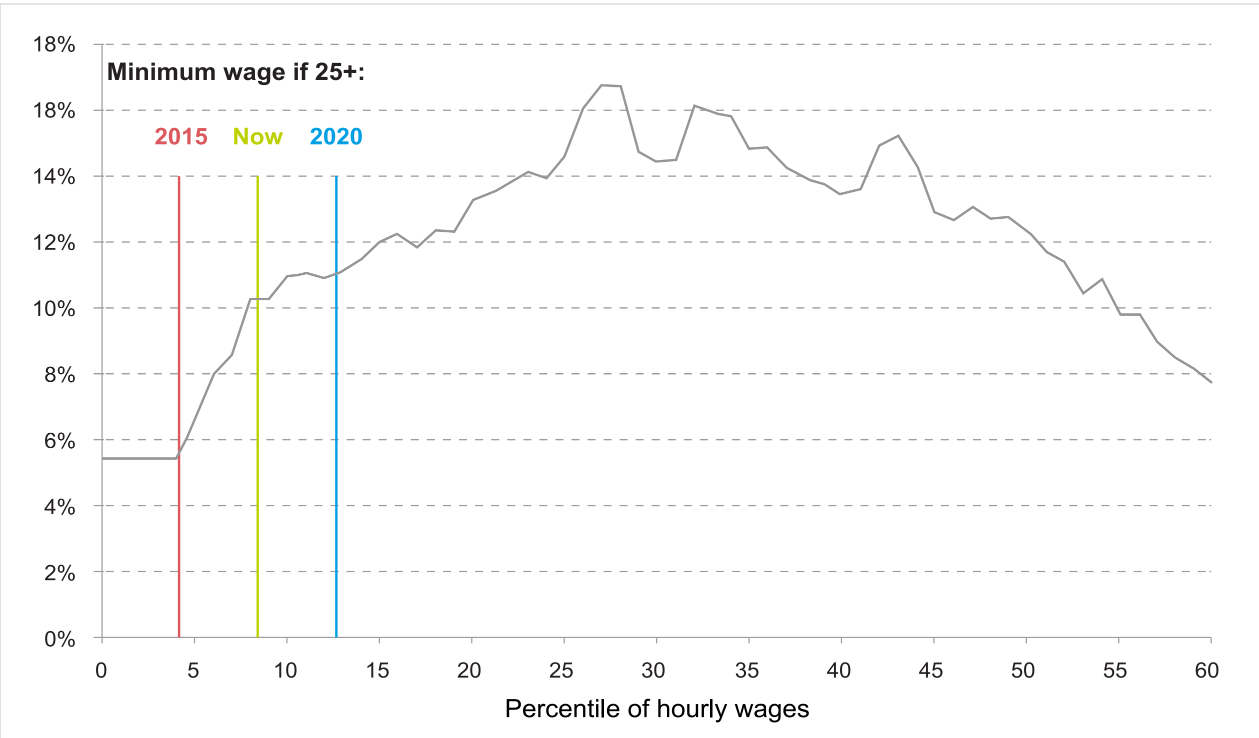
The key danger of increasing the NMW/NLW is that it drives the cost of labour too high, so that firms decide to substitute capital instead by automating work and either laying off workers or hiring fewer going forward. Looking at previous increases in NMW/NLW, the evidence is indeed clear that these have led to increased automation and the destruction of jobs.[38] This can take time, with some evidence suggesting that minimum wage increases tend not to alter the labour-capital balance of existing firms, but instead speed up the process of high-labour firms exiting the market and encouraging new entrants to be more capital-intensive.[39]

Moreover, the idea that automation primarily impacts roles at the bottom of the wage scale is incorrect. As the IFS has found, "Ease of automation actually rises as one looks somewhat further up the wage distribution, reaching a peak about a quarter of the way up… the fact that the higher minimum will increasingly affect jobs that appear to be more automatable is an additional reason why extremely careful monitoring is required".[40]

For example, of those workers set to be brought under the NMW/NLW in 2020, 11% were in the top 10% of most easily automated occupations – such as retail cashier or receptionist – compared to just 5% of those already paid the minimum wage in 2015. Plans to push the NLW to two-thirds of median earnings by 2024 will only accelerate this trend and potentially precipitate large numbers of jobs both old and new being automated.

Of course, it should be stressed that automation per se is not an issue, and the government should certainly not try to prevent firms from automating if it is in their economic interest to do so. Rather, the issue is that the government may be pushing firms to automate by raising the NMW/NLW too high and thus artificially inflating the cost of labour relative to capital.

Figure 7 - Percentage of employees aged 25+ in the most automatable jobs (top 10% of routine task intensity)[41]



THE PANDEMIC RAISES THE STAKES

There were significant concerns about further rises in the NMW/NLW before the pandemic. However, its massive economic repercussions have substantially raised the stakes. It is now clear that significant numbers of jobs are going to be lost as the economy goes through an inevitable readjustment process, something which the second lockdown (and any further that are imposed after that) will only exacerbate.

In light of this, the emphasis of government policy must surely be on maximising the creation of new jobs. Yet tying the LPC to an arbitrary target of raising the NLW to two-thirds of median earnings in present circumstances, and for the foreseeable future, risks undermining this policy objective.

For one thing, as already outlined, the key risk of jobs being automated occurs primarily through churn, as less productive, labour-intensive firms exit the market and new, more productive, capital-intensive firms take their place. We are about to go through an intense period of economic churn as lots of now unviable firms exit the market (or reengineer their production process/business model so as to regain competitiveness) and are replaced by lots of new, more productive firms.

Continuing to raise the NMW/NLW risks raising the cost of labour so that existing and new firms reduce the amount of labour they demand and substitute extra capital investment instead. In other words, we risk ending up with fewer jobs being created in the post-pandemic recovery and higher unemployment.

The pandemic has also impacted certain industries and age groups worse than others. Indeed, it is because they are more likely to work in the hardest-hit industries (like hospitality) that young people have suffered the worst of the economic damage so far. Furthermore, during the second lockdown it will be precisely these industries like hospitality which will be hit most severely again. And as outlined above, it is young people that further increases to the NMW/NLW are likely to impact the most, because they tend to have least experience and lower productivity. As a result, the bite of the NMW is much larger for this age group than for older, more experienced workers.

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Back in late March, in the early stages of the pandemic, the IFS was already calling for a pause in further increases in the NMW and NLW: "If the absolute focus is on keeping people in paid work and attached to their employers, delaying next month's rise in the NLW could be a sensible move... Given the costs this will impose on employers this increase is now less desirable and there is a case for it being deferred".[42] In fact, they went as far as suggesting that the government should consider the case for a temporary cut in minimum wages. The LPC itself has suggested that it may need to pull its 'emergency brake', either by moving back the deadline for hitting the two-thirds target or keeping the deadline but introducing the wage rises later in the parliament.[43]

Given that we are entering another lockdown and we now know the pandemic is likely to last until well into next year and perhaps longer, and that the UK economy will remain under significant strain, with suppressed demand and higher unemployment, the case for a continued pause in further rises in the NMW and NLW seems just as strong today as at the beginning of the crisis in March. Crucially, it will not just make it easier for hard-pressed businesses to keep on existing staff, but avoid making it more expensive for them to employ more people in future – which as we have seen is the main way in which minimum wage increases tend to impact negatively on the labour market. Indeed, as the Centre for Policy Studies suggested in our joint paper with the Rt Hon. Sajid Javid MP, 'After the Virus', lowering the cost of employment and barriers to it should be the Government's primary policy focus in the wake of the pandemic, for example via cuts to Employer's National Insurance.

THE IMPACT ON THE PUBLIC FINANCES

It is not just the private sector that would benefit from a pause in the planned NMW/NLW extension, however. There would also be substantial savings for the state – which is after all the single largest employer in the country, and which is currently under severe fiscal pressure.

As we set out earlier, the expansion of the National Living Wage has already had significant costs for the care sector. The same is true of other government-controlled or government-subsidised sectors such as nursing or childcare. Based on the number of full-time equivalent public sector workers, and the proportion who are currently covered by NMW/NLW, we estimate more than 550,000 public sector workers would see their pay increase as a direct result of further increases in the NMW/NLW – which equates to about £1.89bn in extra public spending.[44] And as with social care, this is almost certainly an underestimate, as in order to preserve pay differentials, increases in the NMW/NLW are likely to filter up the pay scale and see many more public sector workers see their pay increase. There are also sectors such as social care where government funds the industry without employing many of the workers directly, but would either have to absorb the higher salary costs or see the quality of care suffer accordingly. We estimate that considering social care alone, raising the NMW/NLW in line with the current target of two-thirds of median earnings would likely cost the taxpayer at least £2.4bn in additional annual spending by 2024.

Again, it is not a bad thing at all that workers should receive more money – especially those who have been on the front line of fighting the pandemic. But there is, inevitably, a cost to such generosity – not to mention a significant element of unfairness, given that the pandemic has already opened up huge disparities between private and public sector workers in terms of salary impact and job security.

CONCLUSION

The Government has committed the LPC to raising the NLW to two-thirds of median earnings by 2024.

But policy during and after the last recession represents a precedent that the government and LPC can and should look to in the current circumstances. Given the uncertain economic conditions and the large rise in unemployment that occurred around the financial crisis, the NMW hardly increased in real terms between 2007 and 2015. In fact, in the four-year period 2009-2013 its real value actually declined.

Given that unemployment is already forecast to increase significantly this year and potentially remain elevated for the next few years,[45] maximising job creation must be the Government's primary policy objective. Just as in the last recession and recovery, this would be compromised if the Government continues with its plans to raise NMW/NLW in the immediate future.

Such a policy would not only threaten to increase unemployment, but would hit precisely those sectors, regions and age groups that have already suffered the most from the coronavirus (and are about to be hit again by the second lockdown), not to mention imposing a significant additional cost on the Treasury. It would also increase the burden on businesses at a time when their burdens are heavier than at any time in living memory. If anything, we should be cutting the cost of employment, not increasing it.

We therefore urge ministers to put on hold the planned increase in the National Living Wage, as well as its expansion to those under 25. Even before the pandemic, the evidence base behind such an increase looked slim. Under the current circumstances, this would increase employment costs for the hardest-hit at the worst possible time – and potentially blight the employment prospects of those affected for decades to come.

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estimated that to raise NLW to 2/3 of median earnings by 2024 it would rise to £10.50 (HM Treasury, "Government announces pay rise for 2.8 million people", Gov.uk, December 31, 2019, https://www.gov.uk/government/news/government-announces-pay-rise-for-28-million-people), so the per hour cost of the increase for staff covered by NMW/NLW = £10.50 - £8.72 = £1.78 * 147,320 = £262,230. Per week cost of increase: £262,230 *37 = £9.7 million. So, the annual cost is £9.7million * 52 = £504.4million.

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