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The UK's new National Living Wage: Likely impact on employment, wages, and prices

Wouter den Haan, Martin Ellison, Ethan Ilzetzki, Michael McMahon, Ricardo Reis

A new National Living Wage (NLW) replaces the UK's National Minimum Wage from April. This column reports the views of leading experts on its likely effects on employment, wages, and prices. A majority of respondents in the monthly Centre for Macroeconomics survey believe that the NLW will not lead to significantly lower employment; similarly, a majority of respondents believe that the NLW will only have a muted effect on wages and prices. The key unknown for many in considering the overall economic impact of the NLW is how quickly the UK economy will grow over the coming years.

In July 2015, UK Chancellor George Osborne announced that a new National Living Wage (NLW) would replace the National Minimum Wage (NMW) for those aged 25 and over starting from 1 April 2016. The NLW will initially be set at a level of £7.20 per hour – 50 pence higher than the prevailing NMW. By 2020, the Chancellor expects the NLW to reach £9 per hour, which is 13% higher than the £8 previously planned. The new remit of the Low Pay Commission (LPC) asks them to recommend the future path of the NLW, with a target of the total wage reaching 60% of median earnings by 2020. On Office for Budget Responsibility forecasts, a full-time NMW worker will earn over £4,800 more by 2020 from the NLW in cash terms.

Many firms, particularly those in traditionally low-wage sectors such as pubs, restaurants and social care, have expressed concerns about the impact of this significant rise in labour costs. There are a lot of empirical studies that examine the employment effects of minimum wages, and the Royal Economic Society (RES) annual conference in March organised two sessions on this topic.[1]

Watch Alan Krueger discuss minimum wages in an interview recorded at the RES annual conference

Schmitt (2013) summarises the academic evidence on the employment effects of minimum wages, starting from the suggestion of the 1977 review by the Minimum Wage Study Commission that the effects of the minimum wage in the US and Canada were small and almost exclusively limited to teenagers and possibly other young workers. Similar suppositions were also drawn by the 'New Minimum Wage' research agenda, most famously when Card and Krueger (1994, 1995) found no evidence of reduced employment at US fast-food restaurants during the 'natural experiment' of 1992 when New Jersey increased its minimum wage relative to that in neighbouring Pennsylvania.

Card and Krueger's work inspired a host of research more critical of the minimum wage, at the forefront of which is Neumark and Wascher's (2008) book, which argues that "the preponderance of evidence supports the view that minimum wages reduce the employment of low-wage workers".

At one of the RES conference sessions, the papers by Aaronson *et al*. (2015) and Harasztosi and Lindner (2015) argue against large employment effects, whereas the papers by Allegretto *et al* (2015) and Baskaya and Rubinstein (2012) claim substantial disemployment effects of minimum wages, at least on teenagers.[2]

Research on the channels by which firms can adjust to the NLW is less developed. Schmitt (2013) identifies 11 possible channels:

- Reduction in hours worked
- Reductions in non-wage benefits
- Reductions in training
- Changes in employment composition ('upgrading' the skill level of their workforce)
- Higher prices
- Improvements in efficiency
- 'Efficiency wage' responses from workers (workers are motivated to work harder)
- Wage compression (cutting earnings of higher-wage workers)
- Reduction in profits
- Increases in demand (minimum wage as stimulus)
- Reduced turnover (of workers)

Of these channels, Schmitt (2013) concludes that reduced labour turnover, improvements in organisational efficiency, wage compression and small price increases are the most important margins of adjustment.

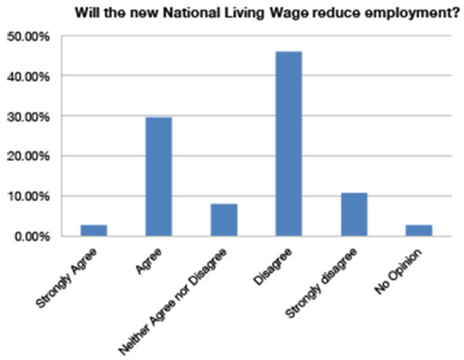
In the papers at the RES conference sessions, Aaronson *et al*. (2015) see increases in the minimum wage driving up both entry and exit rates in the US restaurant market, with labour-intensive restaurants being replaced by capital-intensive ones. Harasztosi and Lindner (2015) find that the costs of the minimum wage in Hungary were passed on to customers such that there was no evidence of lower profitability among low-wage employers.

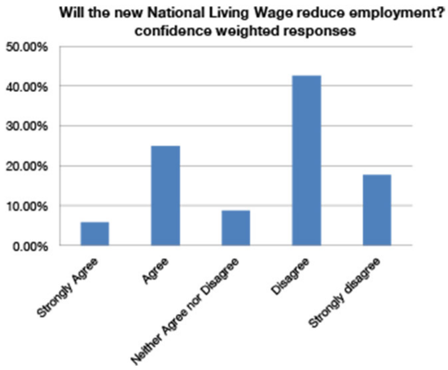
In research on the UK, Bell and Machin (2016) find that the stock market value of companies likely to be constrained by the NLW fell when the policy was first announced, but the reduction was nowhere near big enough to suggest anything other than temporary problems.[3]

The National Living Wage and its impact on employment

The first question in this Centre for Macroeconomics (CFM) survey[4] asked panel members whether the National Living Wage (NLW) is likely to lead to significantly lower employment.

Question 1: Do you agree that the new National Living Wage is likely to lead to significantly lower employment?





Thirty-seven panel members answered this question. A small majority of respondents (57%) either disagree or strongly disagree that the NLW is likely to lead to significantly lower employment. A minority (33%) agree or strongly agree that it would, with 11% of respondents neither agreeing nor disagreeing, or having no opinion. The percentage of respondents disagreeing that the NLW leads to lower employment rises to 61% when the self-reported confidence of participants' opinions is taken into account.

Many of those participants who disagree that the NLW would lower employment stress that it only covers a small fraction of the labour force, so it is unlikely to have a significant effect on aggregate unemployment. Michael McMahon (Warwick) argues that "the total number of employees earning the minimum wage is a relatively small proportion of total employment".

Another significant factor for many of those who disagree is a belief that UK productivity may respond positively to the NLW. While neither agreeing nor disagreeing that the NLW will lower employment, Andrew Mountford (Royal Holloway) summarises the argument by stating that "if the National Living Wage causes firms to invest in the productivity of their workforce and workers to invest in themselves, then it will have a significantly positive effect on UK economic performance in the longer run".

The participants who agree that the NLW would reduce employment highlight the likely effects on specific sectors that have a large number of employees on minimum wages. Two particular examples are the residential and social care sectors, where it may be particularly difficult to pass on higher wage costs into prices that are controlled by government. As Simon Wren-Lewis (Oxford) puts it, "I suspect that it will lead to significant reductions in employment in the residential care sector, because here the scope for squeezing profits is small and the government partly fixes the price".

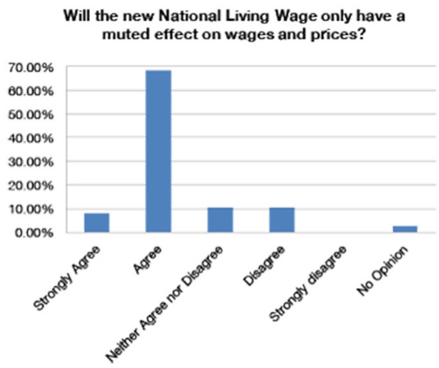
David Bell (Stirling) agrees, arguing that the social care sector "is already subject to considerable financial pressure due to the effects of austerity budgets on local authority funding. There is little room for productivity improvement in this sector, or for firms to cut profits. I would not be surprised if there were significant job losses in this sector." Morten Ravn (University College London) is concerned about distributional effects and believes that "it would seem rather fairytale-like to believe that a large increase in wages at the bottom of the distribution could be implemented at no cost of employment of the workers concerned".

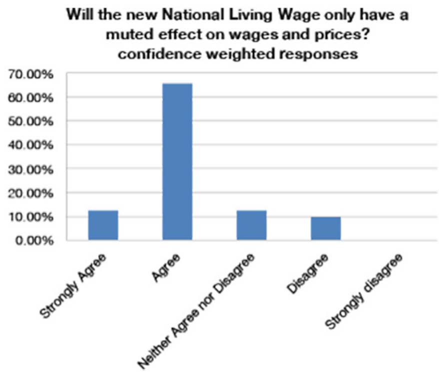
Two participants on opposite sides of the argument comment on the relationship between the new policy and the work of the LPC. John Van Reenen (London School of Economics, LSE), who disagrees that the NLW will lower employment, laments "the bad thing about the Living Wage Policy is that it over-rode the work of the Low Pay Commission, which was an internationally praised, independent, expert body recommending the level of the minimum wage". Patrick Minford (Cardiff), who agrees that the NLW will lower employment, is similarly unhappy and considers it "important that a future Conservative government restores the authority of the Low Pay Commission to set the minimum wage according to its original remit".

The National Living Wage and its impact on wages and prices

The second question in this CFM survey asked panel members whether the new NLW will have a muted effect on wages and prices.

Question 2: Do you agree that the new NLW will have a muted effect on wages and prices?





Thirty-eight panel members answered this question. A large majority of respondents (76%) either agree or strongly agree that the NLW will only have a muted effect on wages and prices. A small minority (11%) disagree. No one strongly disagrees and 14% of respondents neither agree nor disagree, or have no opinion. The percentage of respondents agreeing that the NLW will have a muted effect on wages and prices reaches 78% when the self-reported confidence of participants' opinions is taken into account.

There is a significant overlap between those participants who agree that the NLW will have a muted effect on wages and prices and those participants who in the first question disagree that the NLW would lead to significantly lower employment. For many, this reflects a belief that any pass-through of wage costs into prices would be limited because only a small fraction of firms and workers are directly affected by the NLW. As Christopher Pissarides (LSE) puts it, "the main effect will be on prices but given the number of workers on the minimum wage and the overall share of labour in costs the impact will be muted". Jonathan Portes (National Institute of Economic and Social Research) points out that while the aggregate effect on wages and prices may be small, "it will have a significant impact on wages for some workers and hence some companies".

Several participants who agree that the response of prices and wage will be muted reason that even if wage costs and inflationary pressures did rise significantly due to the NLW, it is likely that monetary policy will react to limit the overall effects on wages and prices. Nick Oulton (LSE) explains that '"nflation will be determined by monetary policy and any external shocks which the MPC decides to accommodate, not by domestic shocks like the NLW". Similarly, Ray Barrell (Brunel) says that "the impact on prices depends on the Bank's reaction. If it is wise, there will be no effect."

Those participants who disagree that the effect on wages and prices will be muted argue that the NLW would also have an impact on higher paid workers as they seek to maintain their pay differentials. Jagjit Chadha (Kent) states that "in order to maintain relativities, firms may reduce both overall labour hours or total employment numbers and the increase in the wage bill may drive up firms' costs, which may increase the overall price level and lead to temporarily higher inflation". The strongest opposition to the NLW is expressed by Patrick Minford, who argues that "with such a large rise in low-paid wages, there will be effects right up the wage scale… This will also put upward pressure on prices."

Michael McMahon (Warwick) echoes the views of some participants that "some small upward pressure on inflation is potentially to be welcomed, given how close to deflation we are at a time that interest rates are already low". Chris Martin (Bath) takes this further by suggesting that the NLW might get the UK out of what he sees as a low-wage/low-pay trap, because "raising the cost of labour gives more incentive for firms to invest in skills, an area where the UK is chronically weak at the bottom end of the wage distribution".

The key unknown for many participants is how quickly the UK economy will grow in the coming years. Putting both sides of the argument, Wouter Den Haan (LSE) writes that "if the UK economy grows rapidly, then the increase in the NLW is unlikely to matter very much for anything except low-wage workers. If the UK economy does not grow rapidly, then the increase in the NLW could have an impact on employment, but inflationary pressure is unlikely in such an environment."

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Endnotes

[1] A video of one session with Alan Krueger, Arin Dube, Stephen Machin and Richard Blundell is available here.

[2] More information on the second RES conference session is avaiable here.

[3] Metcalf (2006) also examines the effect of the minimum wage on the UK economy.

[4] Full survey results are available here.

About CAGE

Established in January 2010, CAGE is a research centre in the Department of Economics at the University of Warwick. Funded by the Economic and Social Research Council (ESRC), CAGE is carrying out a five year programme of innovative research.

The Centre's research programme is focused on how countries succeed in achieving key economic objectives, such as improving living standards, raising productivity and maintaining international competitiveness, which are central to the economic well-being of their citizens.

CAGE's research analyses the reasons for economic outcomes both in developed economies such as the UK and emerging economies such as China and India. The Centre aims to develop a better understanding of how to promote institutions and policies that are conducive to successful economic performance and endeavours to draw lessons for policy-makers from economic history as well as the contemporary world.

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