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**Article (Accepted version)
(Refereed)**

Original citation:

Manning, Alan (2013) *Minimum wages: a view from the UK*. [Perspektiven Der Wirtschaftspolitik](#), 14 (1-2). pp. 57-66. ISSN 1465-6493

DOI: [10.1111/pers.12004](https://doi.org/10.1111/pers.12004)

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Minimum Wages: A View from the UK¹
Alan Manning
February 2013

Introduction

Germany is one of the few industrialised countries not to have a minimum wage in all parts of the economy. It has mostly relied in the past on minimum rates negotiated in collective bargaining though in a small but increasing number of sectors (starting with construction in 1997) these sectoral minimum wages cover all workers whether or not their employers are party to the agreement. But proposals to have a universal minimum wage have been discussed very actively in both political and academic circles and looks increasingly likely to happen in the near future.

Germany is not alone in actively considering or introducing a national minimum wage e.g. that stalwart of laissez faire economics, Hong Kong, introduced a minimum wage in 2011. Everywhere the pressures are much the same. Rising inequality and slow overall productivity growth have led in many countries to stagnant or even falling real wages among the low-skilled. And minimum wages tend to be very popular - even among those who generally hold 'right wing' views think are many who think there is something wrong with a society in which someone who works hard cannot earn enough to provide an acceptable standard of living for their family. In addition, in many countries the fear of an influx of immigrants prepared to work for low wages has caused countries to want to limit the extent of competition on wages. It was probably this fear in respect of workers from Eastern Europe that led Germany to introduce a minimum wage in construction in 1997 and extend it to other sectors subsequently.

But just because there is political momentum behind an idea doesn't mean it is a good idea. In the past economists were generally hostile to the idea of a

¹ This article is based on a lecture given at the Verein für Socialpolitik conference in Göttingen in September 2012. It draws on wider research I have done elsewhere. I would like to thank Michael Burda for his invitation.

minimum wage regarding those who supported the policy as being economically illiterate. But the balance of professional opinion has also shifted. For example the IMF, OECD, ILO and World Bank (not always bed-fellows when it comes to labour market policy) produced a joint report in 2012 for the G20 Conference stated that “a statutory minimum wage set at an appropriate level may raise labour force participation at the margin, without adversely affecting demand, thus having a net positive impact especially for workers weakly attached to the labour market” (ILO, 2012).

In this article I will describe the evidence that has led to this position, largely seen through the experience of the UK with the introduction of its National Minimum Wage (NMW) in 1999. The article will set out a brief history of minimum wages in the UK, then summarize the evidence on the impact of the NMW on employment and wage inequality and then briefly describe the lessons that might be learned for Germany.

1. A Brief History of the UK's NMW

Minimum wages were first introduced to the UK by Winston Churchill in 1909 who established the Wages Boards. These set minimum wages in a number of low-wage sectors (the so-called ‘sweated’ trades) and continued in the form of the Wages Councils who set a lot of minimum wage rates for different occupations, ages and regions in the covered industries (perhaps these were not totally dissimilar from the current system of minimum wages through collective bargaining in Germany). The Conservative government abolished the Wages Council in 1993 arguing that the minimum wages they set destroyed jobs. This left the UK with no minimum wages except in agriculture.

In the 1997 general election Tony Blair’s Labour Party proposed to introduce a national minimum wage if elected while the incumbent Conservative Party opposed it. The debate about the merits of the proposal was mostly around the question of the impact of a minimum wage on jobs. Those opposed to the minimum wage argued that anything that raised the cost of labour must necessarily reduce employment and some economists estimated that, if

introduced, the minimum wage would destroy hundreds of thousands (even millions) of jobs. On the other side those who supported the minimum wage pointed to the then relatively recent research by Card and Krueger (1995) and studies of the impact of the Wages Councils (Machin and Manning, 1994; Dickens, Machin and Manning, 1999) that indicated that the job losses caused by minimum wages were very modest if they existed at all. That the main argument surrounding minimum wages should be about their consequences for jobs is pretty much the same everywhere, including Germany.

Following the Labour Party's landslide victory in the 1997 election, the introduction of the National Minimum Wage became government policy. But rather than legislate directly, the new government set up an independent Low Pay Commission in July 1997 to make recommendations on the appropriate form and level that the minimum wage should take. This first reported in June 1998 (LPC, 1998), recommending a single minimum wage for all adults aged 22 and over and a lower rate for those aged 18-21. Initially, no minimum wage was set for those aged 16-17. Over time the adult minimum has been up-rated and a minimum wage extended to those aged 16-17.

The initial minimum wage was set at a modest level of £3.60 per hour – about 40% of median hourly earnings, reflecting a feeling that it was best to start low and evaluate its effects rather than run the risk of setting it too high. Employers and their main confederation, the Confederation of British Industry (CBI), were very concerned about job losses, and the Bank of England was worried about the potential effect on inflation. But what actually happened?

2. The National Minimum Wage and Employment

It soon became apparent that any effect of the minimum wage on aggregate employment was so small as to be of no great importance. Of the research conducted into the impact of the NMW on employment (see, for example, Stewart 2004a,b) only the study of Machin, Manning and Rahman (2003) found any negative impact at all and that study was of a labour market (care workers in retirement homes) where about 30% of workers were directly

affected, where there was little or no ability to pass on higher costs in the form of higher prices and where the owners of the home could often substitute their own labour for that of paid workers. Even then the negative impact was very small.

As the research indicated (see Metcalf (2007) and Brown (2009) for excellent overviews) the fears of large job losses were exaggerated, and in subsequent years, the LPC raised the adult minimum wage was raised faster than average earnings, and coverage was extended to younger workers. In the more uncertain economic times of recent years, the LPC has again recommended only modest increases in the minimum wage. Figure 1 shows the evolution of the adult minimum wage as a percentage of median hourly earnings.

But in this account there is one issue that many still find surprising – how is it that a minimum wage can have no effect on employment. Surely, the argument goes, anything that raises the cost of labour can only destroy jobs as it reduces the demand for below. I will argue below that this focus on the demand for labour is one-sided but even if one just thinks about labour demand there are reasons to think the effect of a modest minimum wage will not be large.

In OECD countries like Germany and UK there are essentially no traded goods industries left that are competing on the basis of labour costs with firms in China for the simple reason that it is impossible to win that competition. So sectors that employ a lot of low-wage workers are almost all non-traded sectors like restaurants and shops etc. Individual employers often feel they will be forced out of business if they are forced to pay higher wages but a minimum wage affects all employers in the sector so that their relative competitive advantage is not eroded. If labour costs go up one of the consequences is that prices rise although typically by a modest amount. The demand for labour also falls by a small amount.

Apart from the sectors that use a lot of low-wage workers every sector employs some e.g. as cleaners. The low-wage workers in these sectors represent a very small share of labour costs and the demand for their services is not very sensitive to their wage. An investment bank in London or Frankfurt is unlikely to cut back on cleaning services because the wage it has to pay its

cleaners goes up by 20%. In fact, in London, many investment banks have voluntarily agreed to pay a higher 'living wage' because they view the good publicity from this outweighs the very small effect on their total wage bill.

All of these are reasons why the impact on labour demand may not be very large. But more important is the realization that employment is not just determined by labour demand alone. For a worker to be in a job the employer must want to employ the worker (this is labour demand) but it must also be the case that the worker wants the job i.e. labour supply considerations may also be important. Because it is costly for workers to change jobs and they have imperfect information about labour market opportunities employers have some degree of monopsony power over their workers (Manning, 2003). Profit maximization then leads them to pay a wage less than the marginal product. In this situation a minimum wage which forces some employers to pay higher wages will not necessarily make the employment of the worker unprofitable and the effect on labour costs may be muted because turnover costs are reduced. With this perspective on labour markets it is not surprising if the minimum wage has little or no effect on employment.

Of course, this all depends on the level at the minimum wage is set and most of this research relates to the US and the UK where minimum wages are about 45% of median adult hourly earnings. But if the NMW has had little effect on employment, does this mean it has had no effect at all. It now seems likely that the most important effect is on wage inequality.

3. The Minimum Wage and Wage Inequality in the UK

What has been the effect of the NMW on UK wage inequality? I start with some background on the evolution of UK wage inequality. Figure 2 presents the evolution of low-end UK wage inequality in hourly earnings for the period 1975-2010 inclusive using data from the New Earnings Survey (NES) and its successor, the Annual Survey of Hours and Earnings (ASHE). Figure 3 does the same but for high-end wage inequality. The basic facts are well-known but will be summarized here.

At the top of the earnings distribution, represented here by the 90-50 and 99-95 ratio in Figure 3, shows an almost uninterrupted increase from 1977 to 2010. There is perhaps some indication of a slowdown in the rate of growth after about 2005. Nevertheless, it is still more or less accurate to say the past 35 years have seen the high-paid pulling ever further away from the average. The picture for the bottom part of the earnings distribution, summarized by the 50-10 and 50-5 ratio in Figure 3, shows a rather different picture. From 1977 to the mid 1990s there was a rise in lower-tail wage inequality that more or less mirrors the rise in upper-tail wage inequality. But after the mid 1990s something different seemed to happen – there has been a fall in lower-tail wage inequality with most of the change after 1997. This fall has not reversed all of the earlier rise – lower-tail wage inequality is now at about 1990 levels but has not reversed the rise seen in the 1980s. The seemingly inexorable rise in upper tail pay inequality has not occurred at the lower tail.

I will not provide here a complete explanation of these changes in wage inequality – see Machin (2011) for an overview of that. What I want to focus on is the role – if any – of the NMW in explaining the fall in wage inequality since the mid-1990s. It is tempting to think that the NMW has something to do with the fall in lower-tail wage inequality since the 1990s but does such a claim stand up to scrutiny?

There are a number of potential problems with arguing that the NMW can explain an important part of the fall in lower-tail wage inequality. First, the timing does not seem to be quite right with the peak in lower-tail wage inequality occurring before the introduction of the NMW. However most of the fall in lower-tail wage inequality occurred after the introduction in 1999 so this criticism is not fatal².

To investigate this a little further, Figure 4 plots the change in the log 50-10 ratio against the change in the log NMW for each year after 2000. Logs are used to show proportional changes in the ratio and the NMW – these are

² It should be noted that NES/ASHE collects its data for one week in April each year. As the NMW was introduced in April 1999 it is widely believed that it is not entirely clear whether the 1999 data is better thought of as before or after the NMW is in place – it is probably a mixture of both.

approximately equal to percentage changes. Each data point is marked with the year in which the minimum is raised – which is always in October. If the minimum wage affects the 50-10 ratio we would expect years with a big increase in the minimum wage to be associated with smaller than average changes in the ratio i.e. to see a negative relationship in Figure 4. A regression shows the relationship is negative with a coefficient that is significantly different from zero. However, this aggregate evidence is hardly conclusive. But as is shown in Butcher, Dickens and Manning (2012) one also sees a larger fall in wage inequality in segments where the level of pay is lower – there is a larger fall for women than men, for young workers as compared to older workers and in low-wage regions (e.g. Wales) as compared to high-wage regions (e.g. London). This all adds up to a convincing case that the NMW has had a substantial effect on lower-tail wage inequality in the UK.

But there is a puzzle here – although the NMW seems to have a large impact on the 50-10 ratio, the best estimates of the number of workers directly affected by the minimum wage is never as high as 10%. When the NMW was first introduced estimates of how many workers would be directly affected were around 7-8% but it subsequently became clear that this was an over-estimate, the product of the problems with the earnings statistics in the LFS³ (see Stewart, 2011). Since then, the LPC has produced estimates of the numbers affected which are generally no higher than 5%. For example the 2009 report of the LPC estimated that in April 2008 only 3.4% of workers aged 22 and above were paid at or below the minimum wage and that 5.3% would be affected by the increase that had already been accepted for October 2008. Because earnings grow over time, that estimate of the numbers directly affected in October 2008 is almost certainly an over-estimate. And the LPC expressed the view that this was the highest number of workers directly affected that had been seen to date.

The studies of the initial impact of the NMW on the wage distribution (Dickens and Manning, 2004a,b) found the minimum wage had a very modest

³ The initial estimate was an average of 10% that came from the LFS and 5% from the NES. It subsequently became clear that the LFS estimate was an over-estimate caused by measurement problems in the construction of hourly earnings in the LFS.

impact, affecting only those who were directly affected. But the more recent studies find a wider impact – if, as described above, the NMW affects the 50-10 ratio it must be affecting the earnings of the 10th percentile, who the LPC estimated in 2008 were paid 10% above the minimum wage i.e. there must be spill-overs so that the impact of minimum wages on wage inequality is larger than one would expect given the numbers of workers directly affected. There are a number of studies suggesting that this is the case e.g. Dinardo et al (1996), Lee (1999) and Autor, Manning and Smith (2009) for the US and Butcher, Dickens and Manning (2012) for the UK.

Although the minimum wage does seem to have a larger effect on wage inequality than one might expect it is important to remember that this is not the same as household income inequality which we might reasonably think is the aim of public policy. The poorest households tend to be those with no-one in work and the minimum wage does nothing to help them. And there is no direct link between a low hourly wage and low per capita household income – the number of working adults, the number of dependents and the total number of hours worked are all important. Add in the fact that in many studies it is hard to identify minimum wage workers with any great precision (because the hourly wage is often derived as weekly or monthly earnings divided by hours worked) and the effect of minimum wages on income inequality is often found to be small. But the minimum wage does tend to benefit the lowest-earning working households though nobody should conclude that it alone can solve in-work poverty.

4. The UK NMW: Lessons for Germany

The current debates in Germany remind me a lot of the situation in the UK in the 1990s. There is a lot of discussion among policy-makers about introducing a universal minimum wage and it is inevitable that economists want to contribute to that debate. So there is quite a lot of research into the impact of the sectoral minimum wages that Germany currently has (see, for example, Aretz et al, 2012, Boockmann et al, 2012, Bachman et 2008, 2012, Konig and Moller, 2009; Moller and Konig, 2012, Rattenhuber, 2011) with a variety of conclusions. I don't think

that the authors of any of these studies think the data with which they work is ideal (a particular problem is the difficulty of identifying minimum wage workers in the absence of high-quality data on hourly wages); it is simply a case of doing the best one can on a topic where there is a very active policy debate in which many expressed opinions have no evidence base at all. This is very like the situation was in the UK in 1990s with the studies of the operation of the Wages Councils (Machin and Manning, 1994; Dickens, Machin and Manning, 1999). But I do think the studies that attempt to exploit actual variation in minimum wages are considerably better than those simulations that purport to estimate the impact of minimum wages on employment without any actual data on minimum wages. It was that methodology that performed so badly in the UK debate in the 1990s.

But while the introduction of a universal minimum wage now seems all but inevitable, there is still a lot of detail to be resolved – about the level and form it should take and institutions to decide upon it. An important question is how much variation in the minimum wage there should be. In principle one should tailor the level of the minimum wage to the prevailing level of wages in different labour markets. So the minimum wage might be lower for younger workers, higher in high-wage industries or high-wage regions. However, this needs to be set against the virtue of simplicity. The UK has a relatively system with an adult rate for those aged 21 and above, and lower youth rates for those aged 16-17 and 18-20. There is also a lower rate for apprentices. I would think something similar would work in Germany though possibly with the addition of some regional variation to take account of different economic circumstances in West and East.

Finally there are the institutions for setting the minimum wage. The UK uses a Low Pay Commission, independent of government. One of the important consequences of the introduction of the NMW was the serious loss of credibility of those who had predicted large job losses from the minimum wage based on research that had not actually studied the impact of minimum wages, studies that had typically simply assumed a certain elasticity in the demand for labour. From the start the LPC adopted an evidence-based approach that has

limited the scope for political posturing in discussions about the appropriate level and form of the minimum wage. It continues to commission and monitor research into the impact of the minimum wages it recommends. This evidence-based approach of the LPC was in line with wider government commitments to 'evidence-based policy-making', though this probably had more staying-power in the LPC than in government more generally. As a result the LPC has a lot of respect and credibility, while formally, the LPC only makes recommendations to the government who then decides whether or not to accept them but in practice its recommendations have been almost wholly accepted.

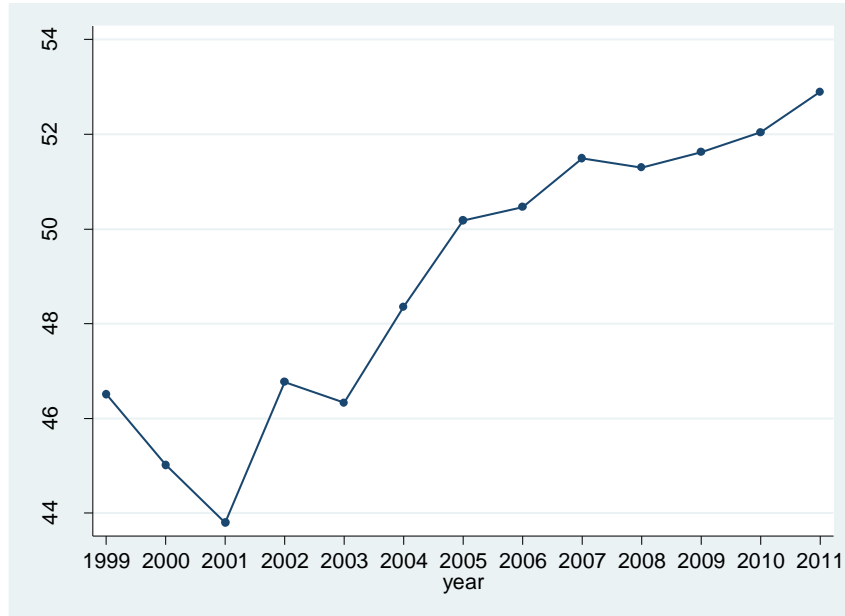
The end result is that the NMW is widely perceived as extremely successful and now attracts a high level of political consensus. Although the Conservative Party remained committed to the abolition of the NMW for some years this eventually changed. By 2005 David Cameron, then the new leader of the Conservatives said that 'I think the minimum wage has been a success' and the current Chancellor, George Osborne said in 2008 that "Modern Conservatives acknowledge the fairness of a minimum wage". There is now no sizeable lobby in the UK campaigning for the abolition of the minimum wage, although differences in opinion remain about the appropriate level. In a poll of political experts by the Institute of Government, the minimum wage was voted the most successful UK government policy of the past 30 years ahead of the Northern Ireland peace process, though that might represent a certain amount of hyperbole.

5. Conclusion

In the current debate about minimum wages in Germany, I think a number of conclusions should be kept in mind. First, economic theory does not have unambiguous predictions about the impact of a minimum wage and it is seriously misleading to think otherwise. So there is a need for empirical evidence but that from other countries may not be relevant and the current evidence for Germany less than ideal (from data problems more than researcher inadequacy). So there is inevitably some leap of faith in introducing a minimum wage. But a lot of the

debates strike me as very similar to those we had in the UK in the 1990s. There the NMW has gone from being a highly controversial policy to one commanding universal support from all the main political parties and the main employer organizations and unions. Differences in opinion are about the appropriate level of the minimum wage and are fairly small. It is now universally agreed that the NMW has modest benefit without significant harm, though it is important that NMW set at modest level using an evidence-based approach and that institutions allow that. But the minimum wage is no panacea for all our troubles surrounding inequality – it is but one part of a wider strategy.

Figure 1
Adult Minimum Wage as Percentage of Median Hourly Earnings



Source: Butcher, Dickens and Manning (2012)

Figure 2
High-End Wage Inequality 1975-2010

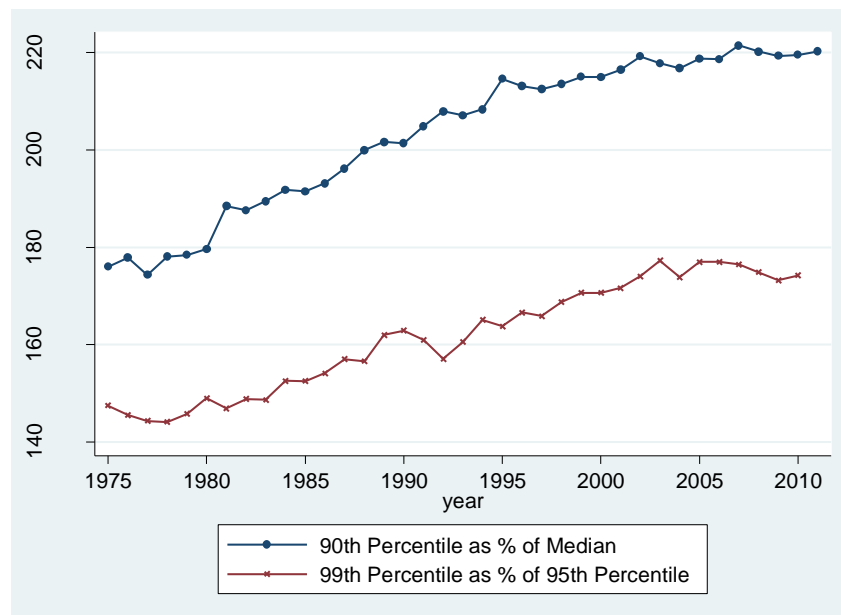


Figure 3
Low-End Wage Inequality, 1975-2010

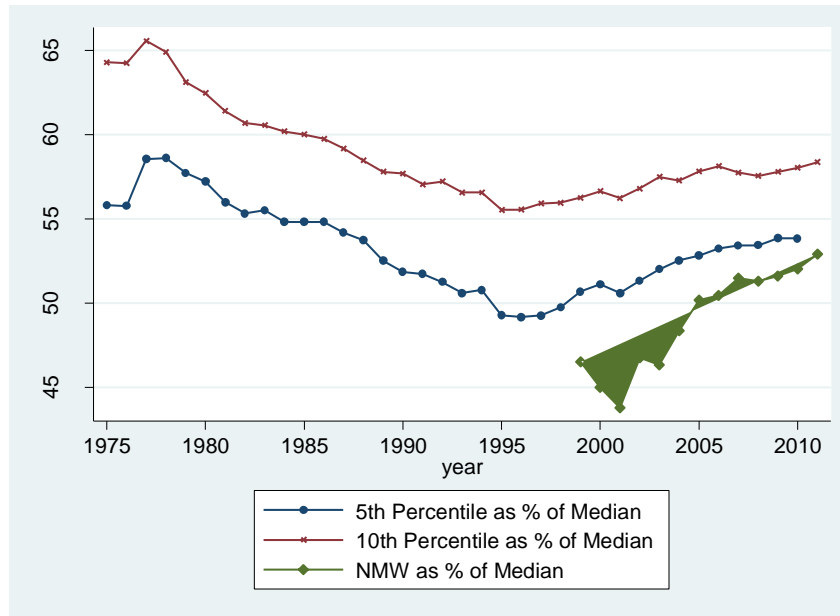
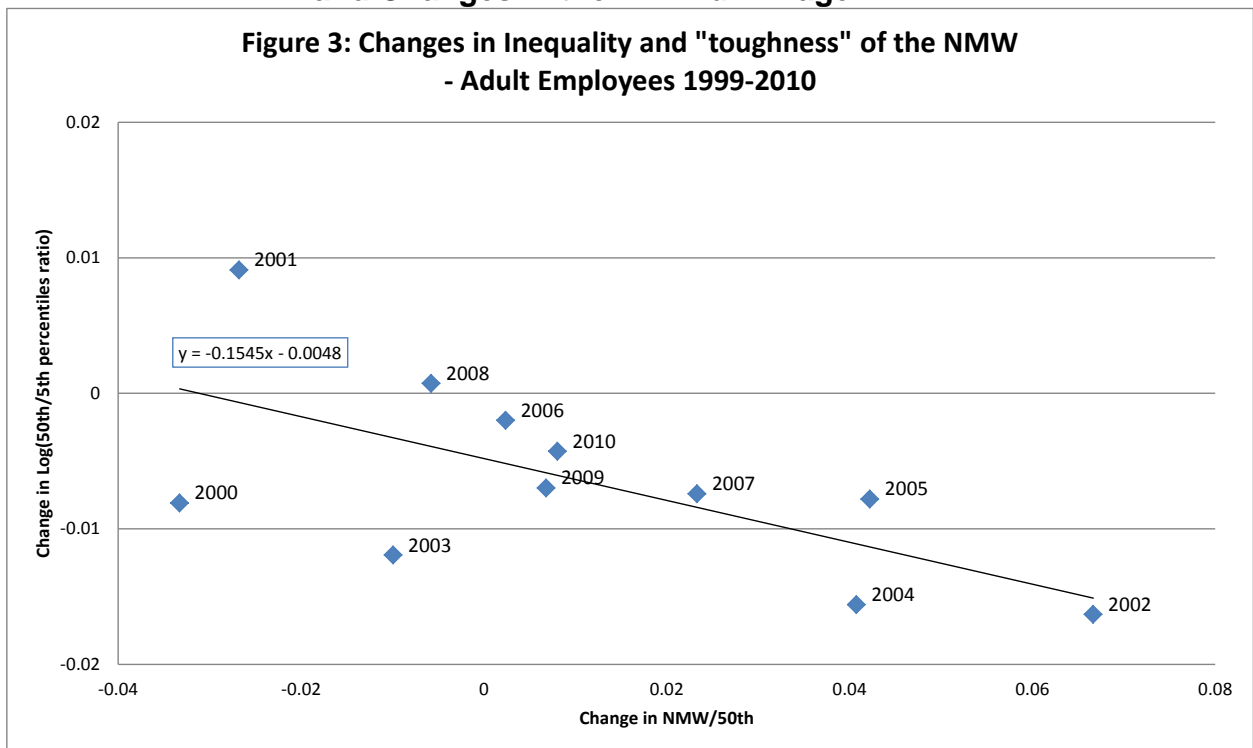


Figure 4
The Relationship Between Changes in Lower-Tail Wage Inequality and Changes in the Minimum Wage



Source: Butcher, Dickens and Manning (2012)

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