The UK's National Minimum Wage arguably represents the Labour government's most significant intervention in the labour market. In the latest contribution to CEP's 'big ideas' series, **Alan Manning** describes the Centre's role in providing the intellectual context for the policy, advising on its implementation and evaluating its impact.

Big ide

The UK's National Minimum Wage

Academics in general and academic economists in particular are often accused of being in an ivory tower, of doing research of no practical relevance, perhaps claiming they are doing deep thinking but in reality writing on questions that are of interest only to a few like-minded eccentrics. When called on to offer insight into something like the current economic crisis, this line of criticism runs, they have little to say that is of value.

But most academic economists are not like that. They are interested in changing the way people think and, through that, to make the world a better place. And the 'people' are not just academics: eventually an idea must reach the mind of someone outside academia if it is to have any impact on the world.

At CEP, we have never lost sight of this goal as our series of 'big ideas' aims to demonstrate. This 'big idea' is the story of the interplay between academic research and policy that has resulted in the UK's National Minimum Wage. It is written from the perspective of someone who was involved in this process.

Some historical background and intellectual context

In 1909, Winston Churchill established 'wages councils' to protect the pay of workers in the so-called 'sweated' trades. The wages councils set minimum wage rates in a number of different industries. This system remained in place for over 80 years (covering varying numbers of industries over that period), even surviving Mrs Thatcher's onslaught on labour market regulation (though subject to some changes).

But by the early 1990s, abolition of the wages councils had become a policy of John Major's government. The argument was that, as the wages councils raised wages, they must necessarily reduce employment, though no evidence was put forward in support of this view. That was the point at which my CEP colleague Stephen Machin and I became interested in the subject.

The wider background to the debate over the future of the wages councils was the agenda of deregulating labour markets pursued by Mrs Thatcher and her successors. The basic argument used was simple but, nonetheless, powerful: that anything that raised wages must reduce employment and the most efficient labour market would be one that was completely deregulated.

The arguments typically deployed against this view struck me as particularly weak and ineffective, generally conceding the efficiency losses caused by labour market regulations but defending them on grounds of equity. But appeals to equity at that time seemed to carry less and less weight.

I wanted to provide a stronger general intellectual foundation for some form of labour market regulation. Starting in 1990, I became convinced that

'monopsony' is the appropriate way to think about labour markets. In essence, the idea is that in many circumstances, employers have considerable discretion to set wages. So the view that the labour market is close to the economist's ideal of a 'perfectly competitive' market is simply wrong. This line of research eventually led to my book *Monopsony in Motion* (Manning, 2003).

In a monopsonistic labour market, regulation is not necessarily harmful for employment. In the context of the minimum wage, the argument is that while a minimum wage might hurt the profitability of firms and reduce their demand for labour, it also increases the returns to work for workers so they might be expected to increase their supply of labour.

The argument that minimum wages must always cost jobs is based on a view that employment is determined solely by labour demand. The monopsony view suggests that the supply of labour might be as important if not more so, especially in low-wage labour markets.

But 'monopsony' is no idealistic view of the world: it suggests clear limits to what can be expected to be achieved by regulation in general and the minimum wage in particular. If the minimum wage were raised too much, there is no doubt that employment would fall. So ultimately it is evidence – not abstract theory – that should determine what are the likely effects of labour market regulation.

The fight to save the wages councils

During the 1990s, while I saw making the case for some labour market regulation as the big picture, the fight over the abolition of the wages councils was the first place these ideas got an airing in the policy arena.

Looking back, our early research on the impact of the wages councils on employment was based on some incredibly poor data but it was the best that was then available. The first published study concluded that there was no evidence that the activities of the wages councils had cost jobs (Machin and Manning, 1994).

In the run-up to the 1992 general election, at a time when opinion polls suggested that the Labour Party might win, the *Financial Times* wrote an article about this research, causing the Chief

Executive of Grand Metropolitan (a company with large interests in low-wage sectors like pubs and fast-food restaurants) to call the Director of the LSE to complain.

But the Conservatives won the election and the 1993 Trade Union Reform and Employment Rights Bill made good on their manifesto promise and abolished the remaining 26 wages councils. As a result, there were no longer minimum wages in any sector except agriculture, leaving the UK as the only European Union country without a formal or informal system of minimum wages.

Our research continued, much of it now with our CEP colleague Richard Dickens, writing papers about the effect of abolition (Dickens et al, 1993; Dickens and Manning, 1995) and using better data to assess the effects of the wages councils (Dickens et al, 1998, 1999).

Our central message was that the abolition of the wages councils had been a mistake – but it also represented an opportunity. There was no doubt that the wages councils had been anachronistic in many ways, covering obscure industries whose names (such as 'coffin and cerement making') conjured up images of their origins in Victorian Britain. The Labour Party under the leadership of Tony Blair and Gordon Brown did not propose a return to the wages councils – instead, they suggested a new National Minimum Wage.

The introduction of a National Minimum Wage became Labour Party policy while still in opposition. The Conservative government, aided by some sympathetic academic economists, argued that it would cost millions of jobs if introduced. These estimates were not based on any study of an actual minimum wage in operation but, in large part, a product of the simple assumption that a minimum wage had to cost jobs.

The Low Pay Commission and the birth of the National Minimum Wage

Following the Labour Party's 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 'monopsony' view of labour markets provides a rationale for regulation in general and the minimum wage in particular

the minimum wage should take (Manning, 1997).

My CEP colleague David Metcalf was one of the founding members of the Low Pay Commission, which first reported in June 1998, recommending a single minimum wage for all adults aged 22 and over and a lower rate for those aged 18-21. Most importantly, the case was strongly based on evidence (in line with wider government commitments to 'evidence-based policy-making'), a considerable part of which was research that had been done at CEP.

The initial rate was set at a modest level of £3.60 per hour, 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 lobbying organisation, 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.

From the beginning, the Low Pay Commission took an evidence-based approach, commissioning research on the impact on employment and other outcomes. All the initial studies failed to find any adverse effect of the minimum wage on employment. As a result, in subsequent years, the rate was raised faster than average earnings, and coverage was extended to younger workers. Metcalf (2008) and Brown (2009) provide excellent overviews of the research.

The impact on wage inequality

My interest in the minimum wage is now about its effects on wage inequality. In studies written with Richard Dickens, we find that the minimum wage raised the wages of those who would otherwise have been paid below it, but that there were no 'spillovers' onto the wages of workers who would have been paid more. And because the modest initial level of the minimum wage affected relatively small numbers of workers (perhaps about 7% of the workforce), the effect on overall wage inequality (and wage inflation) was modest (Dickens and Manning, 2004a, 2004b).

But the UK has seen a remarkable fall in wage inequality at the bottom end of the wage distribution in recent years. The gap between the median and the tenth percentile of the hourly wage distribution fell by about 8 log points in the ten years after 1997, reversing the rise in inequality seen in the decade prior to 1997 (though not undoing the increase since 1979).

It is an interesting question why this has happened, and it is tempting to believe that part of the answer must be the National Minimum Wage. But this can only be true if we think that the minimum wage has some effect on the wages of workers who are paid above the minimum. Richard Dickens and I are currently investigating whether this has been the case.

The National Minimum Wage today

The UK's National Minimum Wage is here to stay. Although the Conservative Party abolished the wages councils and fought the introduction of the minimum wage, they no longer propose to remove it. In an interview in the *Guardian* in 2005, David Cameron, then the new leader of the Conservatives, said 'I think the minimum wage has been a success' and 'it turned out much better than many people expected, including the CBI'.

In a 2008 lecture, the shadow chancellor, George Osborne, said that 'modern Conservatives acknowledge the fairness of a minimum wage'. And the Conservative Mayor of London, Boris Johnson has supported a 'living wage' for London, essentially a higher minimum wage to take account of higher living costs in London.

Many people have contributed to making the National Minimum Wage the success it is generally perceived to be today. Through careful, non-ideological research, academic economists have played their part.

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Ten years on, the UK's National Minimum Wage is widely perceived to be a success

Further reading

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