CENTRE for ECONOMIC PERFORMANCE

POLICY ANALYSIS

The National Minimum Wage:
The Evidence of its Impact on Jobs and Inequality

- The National Minimum Wage is one of the most significant labour market interventions that the Labour government has made, raising the pay of well over one million low paid workers by about 15% overnight at the point of introduction.
- Since 1999, the minimum wage has been increased from £3.60 at it its introduction in April 1999 to £5.73 in October 2008. This represents an increase of 59% in nominal terms and over 20% after adjusting for changes in the retail price index. When compared with average earnings, which have increased by over 30% in nominal terms since 1999, the increase in the minimum wage has been even more dramatic.
- Prior to the introduction of the minimum wage, there were claims that it would not only destroy up to two million jobs but also push up inflation and interest rates as better paid workers sought similar pay increases to their low paid colleagues.
- None of these fears have materialised. So far, there is no evidence of significant job losses for the workers most affected by the minimum wage and there have been no obvious knock-on effects on the wages of better paid workers.
- The political controversy surrounding the minimum wage in the 1990s has now been transformed into a consensus. In the 2005 General Election campaign, the Conservative Party promised that, if elected, it would implement the government's recommendation for a minimum wage of £5.35 an hour by 2006. The period since 2005 has seen no major changes in the Conservative Party's position on the minimum wage.
- Since 1997, wage inequality has fallen slightly among workers in the bottom 50% of the labour force. The minimum wage has almost certainly played a role in this, but its precise contribution is hard to disentangle from other factors influencing UK wage inequality, such as immigration, technological change and rising educational attainment.
- Many of the poorest households will not be affected by the minimum wage because they do not have anyone in work. In addition, many of those who benefit, such as second earners and teenagers living at home, do not live in poor households. So the minimum wage is a very blunt tool for reducing poverty.
- The minimum wage is part of a wider package of *welfare to work* reforms designed to 'make work pay'. The centrepiece of these reforms is a tax credit that boosts low wage workers' take-home pay. The minimum wage is an integral part of these reforms because it stops employers from cutting wages knowing that workers will not be any worse off.

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Introduction

The National Minimum Wage arguably represents the Labour government's most significant intervention in the labour market. The aim of the policy has been to deliver a fairer wage to low paid workers without limiting their employment opportunities or harming the efficiency of business.

Since its introduction in 1999, the minimum wage has been progressively increased. In March 2008, the government accepted the Low Pay Commission's recommendation that the minimum wage be increased to £5.73 in October 2008. This will represent a 59.2% increase in nominal terms and over 20% in real terms since 1999.[1] This increase is well above that of average earnings, which have increased by over 30% in nominal terms since 1999.

The Conservative Party's policy on the minimum wage has changed over the years. As Employment Secretary in 1991, Michael Howard declared that a minimum wage would cost two million jobs[2] and the wages councils, which set minimum wages for about two million workers, were abolished in 1993. By contrast, during the 2005 General Election campaign, then Shadow Chancellor Oliver Letwin announced that a Conservative government would implement the latest recommended increases in the minimum wage. Since this time, neither David Cameron nor George Osborne has indicated that the Conservative Party plans to change its position on the minimum wage. The Liberal Democrats also supported these recommended increases.

How many workers have been affected by the minimum wage?

Research has identified three major dimensions to the coverage of the minimum wage. These relate to the overall number of workers affected; the importance of the minimum wage in the female workforce; and the extent of 'spillover' effects among workers not directly affected by the minimum wage.

First, the minimum wage raised the pay of about 5-6% of workers (1.2-1.3 million) by about 15% on average.[3] This was less than the government had expected. Initial estimates by the Low Pay Commission suggested that approximately 9% of workers (or two million people) would receive a wage increase as a result of the minimum wage. This lower wage effect limits the scope for the minimum wage to affect the level of employment or indeed overall wage inequality.

Second, as Figure 1 shows, these figures conceal the higher proportion of female workers affected by the minimum wage. Approximately 8.5% of all female workers were affected by the introduction of the minimum wage compared with only 3.2% of males, with these proportions falling to 5.6% and 1.5% for the 2003 increase (or 'uprating' as it is called).[4]

[1] The real increase is calculated as the nominal increase up to October 2008 deflated by the retail price index (RPI) between March 1999 and January 2008 (the latest available figure).

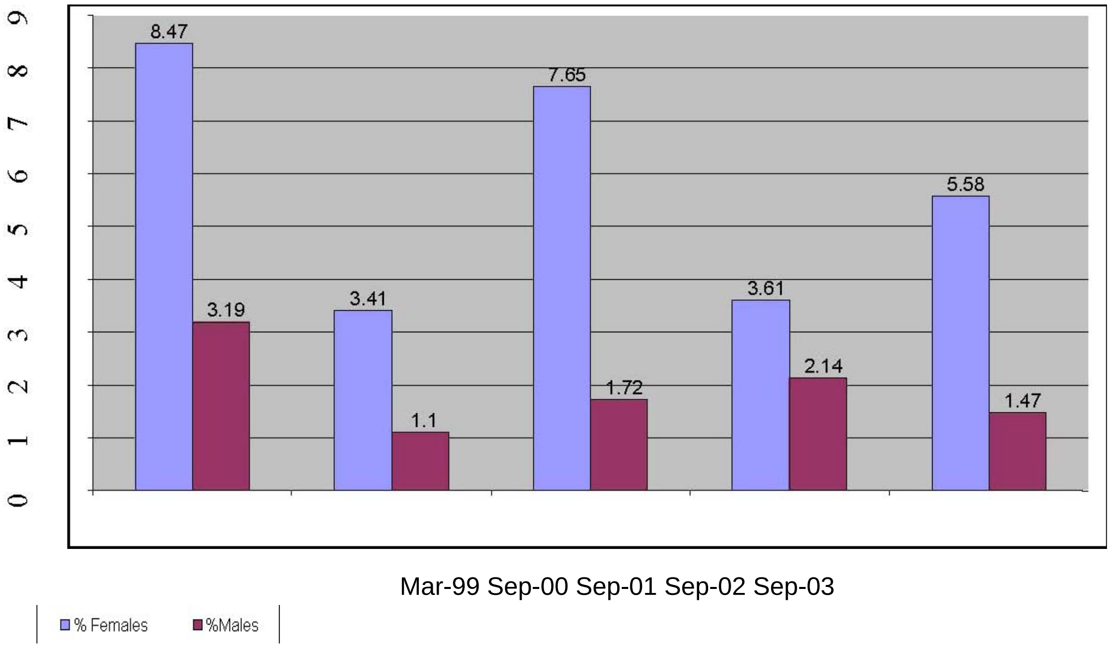
[2] See White (2000) for an account of this statement and the later change in the Conservative Party's policy on the minimum wage.

[3] Dickens and Manning (2004).

[4] Dickens and Draca (2004).

Finally, the minimum wage does not appear to have had ‘spillover’ or knock-on effects on wages higher up the distribution.[5] Spillover effects are important because they create the possibility that more workers than those immediately affected by the minimum wage may be at risk of losing their jobs. This finding is interesting since the potential for wage spillovers was a key assumption underlying the previous Conservative government’s estimates of potential job losses due to a minimum wage.

Figure 1: Proportion of workers affected by the minimum wage, 1999-2003



[5] This is apparent for both the introduction of the minimum wage and subsequent upratings – see Dickens and Manning (2004) and Dickens and Draca (2004).

Has the minimum wage reduced employment?

The potential employment effects of the minimum wage are its most controversial feature. The traditional economist's view of this issue is that when faced with increases in the *price* of labour due to the minimum wage, firms will reduce the *quantity* of labour they employ (the 'law of demand'). An alternative view is that some firms set wages that are below the prevailing wage ('monopsony') and forcing them to pay higher wages could encourage more employment.[6]

Research in the UK and overseas has not found strong negative (or positive) effects of minimum wages on jobs. This work has basically assessed whether workers more affected by the minimum wage experience higher rates of job loss compared with workers less affected by the minimum wage. Studies looking at outcomes across the economy find no significant evidence of negative employment effects for either the introduction of the minimum or subsequent upratings, although there is some evidence that employers may have cut hours of work in response to the minimum wage.[7]

Other studies have focused specifically on heavily affected parts of the economy, such as the care homes sector, where only modest evidence of negative employment effects has been found.[8] A possible reason for this is that firms respond in other ways to the minimum wage, for example, by increasing training.[9]

Has the minimum wage reduced labour market inequality?

It is widely recognised that wage inequality has been rising since the 1970s, with rapid increases in the 1980s followed by a slowdown in the 1990s. In particular, during the 1990s, increasing inequality at the top of the distribution ('the rich getting richer') was tempered by a pause in the level of inequality at the lower end of the distribution. For example, the differential between workers paid at the 50% point of the wage distribution and those paid at the 10% point did not rise in the 1990s.[10]

While the minimum wage has delivered higher wages to the lowest paid workers, it has only had a limited impact on overall wage inequality at the lower end. Specifically, while the introduction of the minimum wage boosted the wages of low paid workers relative to workers at the median wage by about 11.5%, average earnings increased by 8.3% between 1999 and 2001. In turn, the October 2001 uprating to £4.10 played an important role in restoring the relative position of low paid workers to their level in 1999.

So rather than reducing labour market inequality *per se*, the minimum wage seems to have had an effect in preventing wage inequality from rising further since 1999. This may be a signal that the wage inequality between middle and low earners may be rising again after the pause in the 1990s.

[6] Manning (2003).

[7] See Stewart (2002, 2004) for the introduction and 2000-2002 upratings; Dickens and Draca (2004) for the 2003 uprating; and Stewart and Swaffield (2004) for the impact on hours.

[8] Machin et al (2003), Machin and Wilson (2004).

[9] Arulampalam et al (2004): an increase in training is compatible with the idea that employers may invest in a more efficient workforce when faced with a minimum wage. Note, however, that this study of training does not directly explore the issue of employment effects.

[10] Machin (2003).

It is worth remembering that many of the poorest households will not be affected by the minimum wage because they do not have anyone in the labour market. Low income groups – such as pensioners, the unemployed, those on disability benefits and single mothers on income support – are not directly affected by the minimum wage. Similarly, many of those who benefit may be in higher income households. Thus, the minimum wage is a very blunt tool for reducing poverty.

Nevertheless, the minimum wage should be seen in the context of a wider package of welfare to work reforms, including the Working Tax Credit, changes to National Insurance for low wage workers and the various New Deals. Together these policies are designed to 'make work pay' for low wage workers.

The Working Tax Credit does this by increasing the take home pay of low wage workers to a guaranteed level. As a consequence of this policy, unscrupulous employers could cut low wage workers' pay in the knowledge that their overall income would not fall. The minimum wage plays an important role in preventing this.

Conclusions

The minimum wage was introduced nationally for the first time in UK history in 1999. The evidence suggests that the minimum wage successfully raised wages for the poorest workers without leading to large job losses. Wage inequality has not significantly fallen – although it is likely that inequality would have risen by even more in the absence of the minimum wage.

For further information

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