There's no such thing as a free minimum wage hike [1]

Written by **Sam Bowman** [2] | Friday 10 January 2014

Paul Kirby, who was head of the No. 10 Policy Unit until last year, has a long post calling for a ?dramatic, historic increase" to the minimum wage [3], bringing the levels from the current £6.10/hour to £10/hour in London and £8/hour in the rest of the country. It?s a bold post, but ultimately most of his arguments fail. In this post I try to address the key points he makes in favour of a hike.

> *Low wage earners are, overwhelmingly, providing services for domestic consumers within the UK economy. They work in shops, cafes and hotels. They cut our hair, they clean our houses, they look after our kids and they care for our elderly. They are not in manufacturing, competing on the price of their labour with other countries. What they do has to be done in this country. Nor is it tradable with other countries. If the Minimum Wage increases, it impacts equally on all of an employer?s competitors, so there is no disadvantage.*

Even though nobody can switch to a cheaper hairdresser in India, they can get their hair cut less often, or have their homes cleaned less frequently, or send their children to creches with fewer minders per child or their parents to care homes with fewer carers. Kirby is assuming that demand for domestic services is inelastic ? that is, it does not change much according to price. Obviously, this may differ between different services, but in without evidence to the contrary (Kirby gives none) it does not seem reasonable to assume that people?s demand for services will stay the same even if the prices of those services rise.

Bear in mind that a minimum wage increase would only affect the bottom of the market, where you would expect customers to be the most price-sensitive. The economic evidence suggests that increases in the minimum wage lead to slower job growth [4], particularly for young workers and in industries with a high proportion of low-paid staff.

> *Raising the lowest wages does not mean that employers simply have to, or will, just cut jobs or working hours to keep the wage bill constant. The evidence is clear that employers find a variety of solutions. Firstly, they restrain pay growth for their better paid staff. Secondly, they increase prices to consumers. Thirdly, they improve productivity and get more out of each hour that they are paying for. And then they squeeze their profits. Through productivity gains, they either earn more revenue or cut the amount of labour they need.*

Employers do not try to ?keep the wage bill constant?. They try to make a profit on the labour they hire. If hiring an extra manager led to extra profits, it wouldn?t matter that doing so also increased the overall wage bill. A minimum wage imposes a price floor on labour, so any worker whose total productivity is less than the minimum wage floor represents a net loss to their employer ? which a profit-maximising firm will respond to by firing the worker. It makes no difference whether or not that firm has ?restrained pay growth? for its other workers: if an employee is loss-making at the lowest wage a firm can pay them, a profit-maximising firm will fire them. (Or simply not hire additional workers who would be loss making on net.) Even if firms can only tell the average productivity of their workers, because of information problems, they will demand less labour in total.

On the possibility of raising prices to make the worker profitable, see the previous point: if demand for the service is price inelastic, this might work, but it?s quite a claim to say that this is the case for most minimum wage-supplied labour.

Wages are not the only cost of labour to firms, either. Firms may reduce costs in response to minimum wage increases by cutting back on perks like lunch breaks and sick leave, as Starbucks did [5] after it agreed to pay additional corporation tax in 2012.

> *Increasing low pay has a limited impact on the overall costs of most businesses. In some sectors, very few earn less than the living wage, e.g only 6% in manufacturing. Even in hotels and catering, which is one of the biggest sector for the Minimum Wage, only 17% of jobs are below the living wage and raising the Minimum Wage to the Living Wage would only add 6% to the wage bill. This is the highest impact for any sector. More importantly, labour is only a proportion of all costs, e.g. 25-35% for restaurants.*

Is a 2.1% increase in costs for labour-intensive firms not something to be concerned about? The fact that ?most businesses? would not be affected seems beside the point. (The reverse of this is true too: if Kirby?s other points were correct, would his suggested minimum wage hike be a bad idea because it would affect ?only? 17% of workers?)

> *There is no real evidence of any minimum wages in the world adversely effecting employment levels.*

This is totally wrong. In 2006 Neumark and Wascher reviewed over one hundred existing studies [6] of the employment impact of the minimum wage. Of these, two-thirds showed a relatively consistent indication that minimum wage increases cause increases in unemployment. Of the thirty-three strongest studies, 85 per cent showed unemployment effects. And ?when researchers focus on the least-skilled groups most likely to be adversely affected by minimum wages, the evidence for disemployment effects seems especially strong?.

Few people stay on low-wage jobs for their whole lives: minimum wage work is usually a stepping-stone to something better where employees can acquire human capital. There is evidence that suggests that minimum wages deter young workers from acquiring these skills [7] that allow them to get better jobs in the long run. Note also that minimum wages have been used explicitlyto kick away the ladder for minorities [8]: by whites in pre-Apartheid South Africa; by anti-Hispanic campaigner Ron Unz in California; and by, er, Polly Toynbee in a recent Guardian column [9].

Tyler Cowen reminds us [10] to make sure our views of sticky wages and minimum wages are consistent: if ?worker-imposed minimum wages? (sticky wages) lead to unemployment, as most Keynesians (among others, including me) believe, why would ?state-imposed minimum wages? not also do so? (?Have you no respect for the law (of demand)??, asks Will Wilkinson [11].)

Given that we know that minimum wage increases usually cause some unemployment, why take this chance when we could just give money to poor people directly? As we?ve been saying for years, the difference between the current pre-tax minimum wage and the post-tax ?living wage? is roughly as much as a minimum wage worker pays in income tax and national insurance: in other words, if that worker didn?t pay tax, they would be earning a living wage. It looks as if the personal allowance will soon rise to the minimum wage level, but the national insurance contribution threshold needs to rise too.

But let?s go even further: if we replaced the tax credit and welfare systems with a Negative Income Tax (or Basic Income [12] ? call it whatever you want), we would top-up the wages of low-paid workers directly. Jeremy Warner calls for this [13] in the Telegraph today, and Ioutlined something similar [12] a few weeks ago. Yes, I?d like all the standard supply-side deregulations as well, but a Negative Income Tax would act as an insurance policy against the potential down-sides of such deregulations, strengthening workers? bargaining power and addressing the fears of those who worry that deregulations will hurt some workers.

I understand that many Conservatives are coming to see a minimum wage hike as a political ?free lunch? ? a popular and surprising way of showing an interest in the welfare of the poor that does not affect the government?s balance sheet. I hope this is not true. Contrary to Kirby?s claims, there are good empirical and theoretical reasons to think that raising the floor on the price of labour will cause more unemployment. And unemployment destroys lives [14]. There are lots of things we can [15] and should [16] do to help [17] the poor right now. Raising the minimum wage isn't one of them.

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