CITY A.M.

Planned National Living Wage surges defy economic reality

Ryan Bourne

August 8, 2017

I expect that was the average reader's reaction to the weekend story that the Federation of Small Businesses (FSB) wanted forthcoming rises in the National Living Wage (NLW) to be delayed.

Currently £7.50, the NLW (effectively a higher minimum wage for over-25s) is projected to rise to £8.75 by 2020, under plans to automatically link the rate to 60 per cent of median hourly earnings from then on.

But strip away the self interest for a second, and the FSB has highlighted an extraordinary feature of the NLW: it takes no account of the health of the economy, or the ability of firms to pay. With GDP growth weak, and real incomes falling, the FSB believes further increases should be delayed.

In truth, this arbitrary target and its lack of any link to general economic conditions is a feature of the new way the living wage is set, not a bug.

For years, the National Minimum Wage was set by the independent Low Pay Commission (LPC), at a level they believed would not cause any negative effect on aggregate employment levels.

Then, in 2015, the chancellor George Osborne tore up this framework, simply decreeing that the NLW should be 60 per cent of median earnings by 2020, and relegating the LPC's role to advising the least economically damaging way to get there.

The key implication was that for the first time the government would be willing to impose a minimum wage rate it suspected would actually cause unemployment.

Indeed, the Office for Budget Responsibility estimated that the government's new framework would lead to 60,000 fewer people in employment by 2020, even if the economy continued to grow robustly.

Realistically, we know that in downturns nominal wages tend to prove sticky, meaning the impact could be far greater should the economy fall into recession.

And then there's the politics. Say there was a severe downturn in which median earnings fell, meaning that the NLW, set as it is at 60 per cent of median earnings, should supposedly fall too. Could one imagine a chancellor of the Exchequer standing up in parliament and announcing a significant nominal cut in the pay of poor workers?

It seems unlikely, particularly given that the pressure for higher minimum wages in the UK occurred during the period after a major recession.

So when Mike Cherry, the FSB's national chairman, says that "it's vital that the NLW is set at a level that the economy can afford, without job losses or harming job creation," he should recognise that this ship has sailed.

The government's framework already commits it to the opposite of this, and the only way to avoid the job losses would be to abandon the new framework entirely.

Such an approach would have much merit. Experiments in the United States are beginning to show the dangers of politicising pay setting and pushing for ever-higher minimum wages.

In Seattle, the minimum wage was raised from $9.47 (£7.40) to $11 per hour in 2015, then $13 per hour in 2016. New University of Washington research suggests that this second increase reduced hours worked by low-wage workers by nine per cent, with thousands of job losses and reduced hours for other workers.

So significant was the fall that overall payroll spending for low-wage workers actually fell, implying that the minimum wage hike had in fact reduced low-wage employees' earnings by an average of $125 per month in 2016.

This disastrous result is striking because of the extraordinarily rich new dataset which the researchers had access to.

Previous minimum wage studies (some of which had found little to no effect on employment) had by necessity focused on particular industries or demographic groups to circumvent data limitations. But the Washington work shows that the focus of many of these studies was too narrow. The restaurant sector might not shed jobs, for example, but the negative overall effects will be felt by the whole economy.

Hopefully, the FSB's call this weekend will be heeded, not because of the particular economic conditions we face right now, but because of the structural flaws in the new NLW. De-linking wage setting from economic conditions is dangerous, and Seattle provides a warning sign of committing to higher and higher minimum wage levels.

Yes, there would no doubt be a political cost faced by the government if it abandoned the plans, but given it has jettisoned its proposed energy price freeze already, why not cancel another economically damaging policy?

Ryan Bourne occupies the R Evan Scharf Chair in the Public Understanding of Economics at the Cato Institute in Washington DC.