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A Living Wage or a Death for Small Enterprise?

A case against raising the UK Minimum Wage

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"Because we're working through our plan, I believe Britain can afford above-inflation increases in the minimum wage." George Osborne, 16th January 2014.

In what appears to have been an attempt to derail Ed Miliband's keynote speech on banking reform the following day, George Osborne sought to steal the headlines by going on record as supporting an above inflation increase in the minimum wage between now and 2015.

In this briefing note, it is argued that George Osborne's assertion that an above inflation rise is something "Britain can afford" is misguided. With the recovery in GDP growth having only just gathered steam, there remain challenges to be overcome. Namely, these are:

- Improving productivity.
- Increasing exports in an attempt to remedy the UK's poor balance of payments position.
- Resolving the problem of chronic youth unemployment.

The aforementioned weaknesses in the UK recovery to date were in fact acknowledged by Osborne during his autumn statement in 2013. Yet, as this briefing highlights, the proposed above inflation hike of the national minimum wage could pose a threat to all three of these challenges that are yet to be resolved before it can be confidently asserted the British economy has firmly recovered from the calamity of years of excess. Unfortunately, it appears that this may well be a politically motivated maneuver. If so, it is of concern that George Osborne and the government are manipulating the economy for political gains in the run up to 2015.

Furthermore, George Osborne's willingness to surrender to populism in an attempt to occupy the ground of the Labour party as opposed to taking the fight to Labour on their principles will make it problematic for the Conservative Party to assert that the Labour party were poor stewards of the economy during their time in office.

The announcement was delivered following a number of other announcements that could be deemed populist in so far as their economic rationale is open to doubt whilst posing a more obvious electoral benefit. Such measures now include a steadfast refusal to even contemplate revising any welfare provisions for over 65s, inflating the property market via Help to Buy, raising the banking levy in every budget, and now supporting the hiking of the national minimum wage.

This briefing will consider the key economic risks to raising the minimum wage along the lines proposed by George Osborne, as well as highlighting the success enjoyed in instances where no minimum wage exists.

The Implications for UK Business

The dangers of raising the minimum wage

"We seek a responsible recovery. A responsible recovery where we don't pretend we can make this nation better off by writing cheques to ourselves, and instead make the hard choices." George Osborne, Autumn Statement Speech on December 5th 2013.

Following George Osborne's letter to the Low Pay Commission, there are reasons to be concerned that raising the minimum wage could damage Britain's prospects as a business friendly location and put at risk the restoration of our competitiveness. It is unfortunate that having only recently set out his desire to see a "responsible recovery" he proposes to ignore poor productivity growth and instead link a minimum wage increase to inflation- a hallmark of the previous Labour government.

Osborne's suggestion that he would like to see the minimum wage hiked almost 11 percent from £6.31 to £7.00 would see the UK leapfrog both France and Ireland with the one of the highest minimum wages in Europe (on an annualised basis). Given Osborne's speech in the same week declaring that he believes the European Union needs to become more competitive[1], it seems perplexing that he now believes our low-wage labour market should be among the most expensive in the same region that is ridden with sclerotic growth and high unemployment. Indeed, the UK isn't starting from a low position here. Its minimum wage is *already* one of the highest in the EU on an annualised basis, as highlighted in Figure 1.

[1] http://www.bbc.co.uk/news/uk-25740462

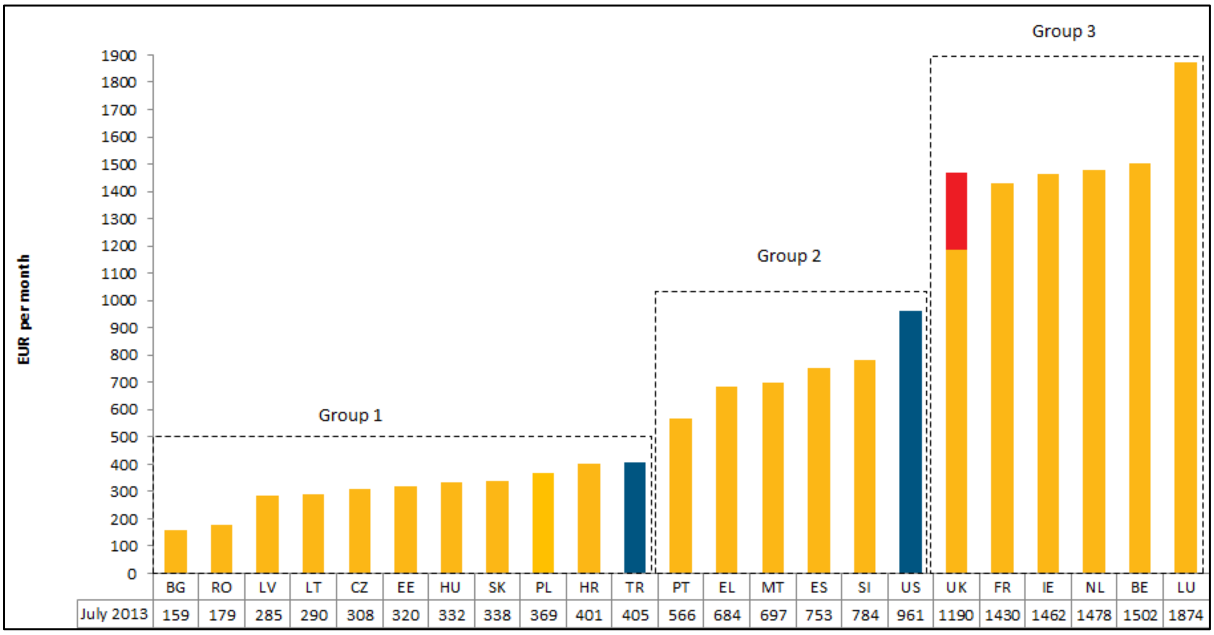

Figure 1: The UK before the rise, with red highlighting UK's new position. New monthly figure would be €1,477 based on €/£ exchange rate on 17/1/2014. Figures from Eurostat.

There are a number of potential dangers to both the long term recovery and the labour market posed by a large increase in the minimum wage. Chiefly, these are as follows:

1) Damaging the balance of payments position: Given that the UK continues to run a large balance of payments deficit, there is a risk of inflicting damage to the revival of exports. A threat already exists owing to the UK's strengthening exchange rate, and this should be factored in when determining domestic wages in Sterling terms. Although the UK's unit labour cost was substantially reduced in US Dollar terms following a sharp devaluation of Sterling in, this has started to reverse of late with Sterling appreciating against the US Dollar by 9.8 percent (Figure 2) since July 2013. With semi-skilled and & unskilled labour in manufacturing among the lowest paid areas of the job market and thus potentially most affected by such a rise, the combination of a period of appreciation in the exchange rate and an increase in the cost of labour in Sterling terms could thwart efforts to rebalance the UK economy in favour of exporting more goods.

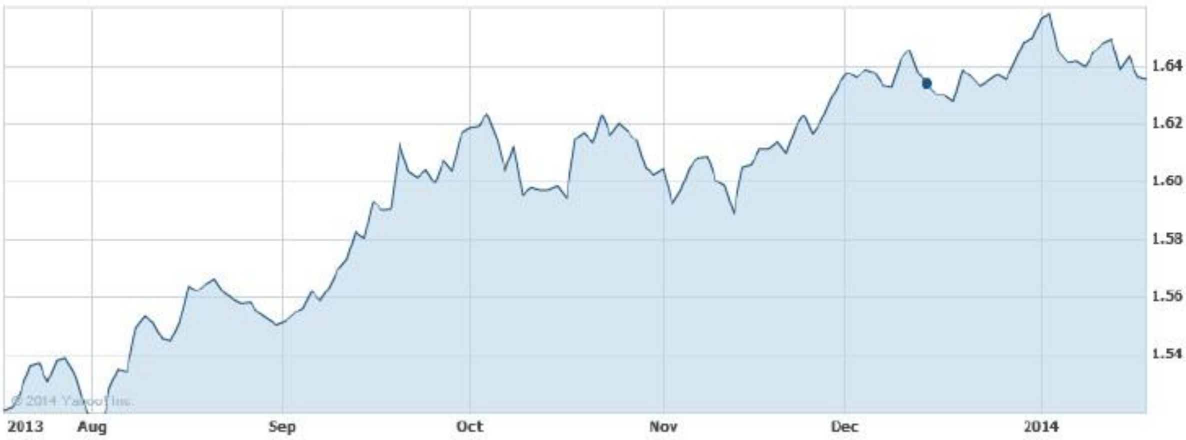

Figure 2: GBP/USD Exchange rate from July 2013-January 2014.

Increasing wages and thus stimulating demand may also have the added effect of potentially filtering through to an increased demand for imports, which would be especially true if the 10.9

percent increase were to be used as a benchmark for negotiations across the board. This would also be detrimental to the balance of payments position.

2) A risk to job security for the unskilled: As Ryan Bourne[2] has also pointed out, there is a risk to job security for unskilled labour in that it may well accelerate the pace of deployment of capital for menial and repetitive jobs. The end result of the imposition of a high minimum wage could well be a reduction in the headcount of labour performing such jobs, particularly workers who are deemed to be marginally less productive.

In the industries that this has the potential to affect- such as retail- margins are already remarkably tight. Major retailers are among the largest employers of low cost labour, yet the likes of Tesco & J Sainsbury operate on a profit margin of approximately 3% (before tax). If the cost of labour starts to encroach on their wafer thin margins, it is likely that we would see even more self-service checkouts taking the place of till staff, together with moves to reduce headcounts and employ staff on contracts with less clearly defined hours. It would also threaten to snuff out the nascent recovery that small businesses are enjoying as the benefits of low interest rates finally get passed on to them.

3) Exacerbating youth unemployment: There have been suggestions that this should be coupled with a cut in business rates to compensate businesses for the slippage in profit from higher labour costs. This ignores the fact that the labour market is not uniform in its productivity, and raising the cost of labour necessitates a more productive labour market. Unfortunately, the 'marginally less productive' workers referred to will often mean those less than 24 years of age. In reality, those in this age category are all too often coming out of their years in education lacking the practical and vocational experience required for the jobs they seek to enter. As such, they are likely to be less productive in the early years during their training and accumulation of on the job experience, which would make them an obvious sacrifice for a firm seeking to reduce its headcount if the cost of their employment became burdensome.

The result of the minimum wage on unemployment of 15-24 year olds is laid bare in Eurozone statistics. Of the countries in the highest bracket (highlighted in Group 3 of Figure 1), including the UK, most fail their youth miserably with regards to ensuring their employability, with over 18.5 percent of them unemployed in most instances. The one exception to this (Holland) has an abnormally high portion of its young in part-time and temporary work, with temporary contracts accounting for 47.8 percent of all employment of under 24s compared to 13.5 percent for the UK, and part time accounting for 65.8 percent against 37 percent in the UK. What this illustrates is that where a high minimum wage can be accommodated, it entails a sacrifice of being on equal terms in terms of employment rights.

4) Inflationary risk: There is also potential for inflationary risk to manifest itself. The minimum wage in itself is unlikely trickle through to substantial inflationary pressure from wages, but the 10.9 percent figure may well set a benchmark for pay demands elsewhere. Given that productivity growth in the UK remains static, this could lead to inflationary pressure if the ensuing increase in demand is not being met with an increase in supply resulting from the output of the labour force.

[2] http://www.cityam.com/article/1389659419/technology-and-minimum-wage-big-rise-could-harm-lowest-skilled

There is another way

Meanwhile, the two countries with the lowest youth unemployment in the whole of the Eurozone (Figure 3) are those that have not adopted a minimum wage whilst combining the flexibility of the Dutch labour market with a highly successful education system which attaches importance to vocational training and apprenticeships. The two states I refer to are Austria and Germany, where youth unemployment stands at 8.7 percent and 7.9 percent respectively. Furthermore, these countries are the only ones with economies where youth unemployment consistently fell during the Eurozone crisis from 2010-2012, as well as being part of a small few where youth unemployment was lower after the crisis than it was before.

	Youth unemployment rate				Youth unemployment ratio		
	2010	2011	2012	2012Q4*	2010	2011	2012
EU-27	21.1	21.4	22.8	23.2	9.0	9.1	9.7
Euro area	20.9	20.8	23.0	23.7	8.7	8.7	9.6
Belgium	22.4	18.7	19.8	22.0	7.3	6.0	6.2
Bulgaria	21.8	25.0	28.1	28.4	6.7	7.4	8.5
Czech Republic	18.3	18.1	19.5	19.3	5.7	5.4	6.1
Denmark	14.0	14.2	14.1	14.2	9.4	9.6	9.1
Germany	9.9	8.6	8.1	7.9	5.1	4.5	4.1
Estonia	32.9	22.3	20.9	19.3	12.6	9.1	8.7
Ireland	27.6	29.1	30.4	29.4	12.0	12.1	12.3
Greece	32.9	44.4	55.3	57.9	10.0	13.0	16.1
Spain	41.6	46.4	53.2	55.2	17.8	19.0	20.6
France	23.6	22.8	24.3	25.4	8.9	8.4	9.0
Italy	27.8	29.1	35.3	36.9	7.9	8.0	10.1
Cyprus	16.6	22.4	27.8	31.8	6.7	8.7	10.8
Latvia	37.2	31.0	28.4	24.7	13.9	11.6	11.4
Lithuania	35.3	32.2	26.4	24.2	10.4	9.0	7.7
Luxembourg	15.8	16.4	18.1	18.5	3.5	4.2	5.0
Hungary	26.6	26.1	28.1	28.8	6.6	6.4	7.3
Malta	13.1	13.8	14.2	14.5	6.7	7.1	7.2
Netherlands	8.7	7.6	9.5	9.8	6.0	5.3	6.6
Austria	8.8	8.3	8.7	8.7	5.2	5.0	5.2
Poland	23.7	25.8	26.5	27.5	8.2	8.7	8.9
Portugal	27.7e	30.1	37.7	38.4	8.2	11.7	14.3
Romania	22.1	23.7	22.7	22.2	6.9	7.4	7.0
Slovenia	14.7	15.7	20.6	23.2	5.9	5.9	7.1
Slovakia	33.9	33.5	34.0	35.1	10.4	10.0	10.4
Finland	21.4	20.1	19.0	19.3	10.6	10.1	9.8
Sweden	24.8	22.8	23.7	24.1	12.8	12.1	12.4
United Kingdom	19.6	21.1	21.0	20.7	11.6	12.4	12.4

* The quarterly youth unemployment rate is seasonally adjusted.

e: estimate

Figure 3: Unemployment of U24s during the Eurozone crisis, Eurostat

This would suggest that having no minimum wage can be a supportive factor in ensuring companies are not deterred from recruiting new, young workers and shouldering the ensuing cost of training them.

In the instance of Germany, it is also significant that wage increases are often pegged to growth in productivity and not inflation as illustrated in Figure 4. This is not a point that should be lost on George Osborne, nor should the experience of the countries that have deviated from this principle (although the UK retains the ability to rectify imbalances by debunking its currency). Given that UK productivity is largely unchanged since 2008, the case for raising wages by 11% is not compatible with this principle.

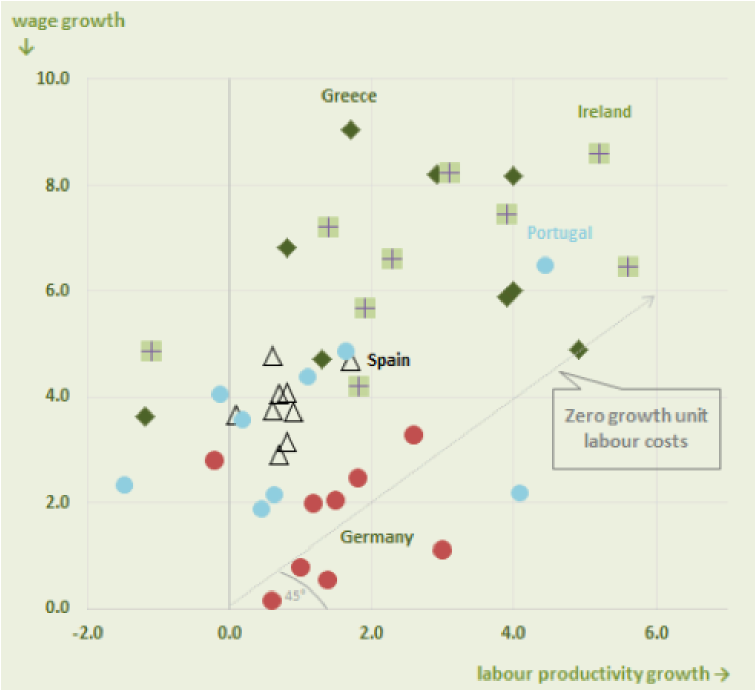

Figure 4: Illustration of productivity growth and wage increases from 2000 to 2008. Provided by Peeters and Den Reijer (2011) based on OECD and EU.

It should, of course, be noted that this only holds true where a labour market is flexible and relatively unhindered by disruptive unionisation as well as providing a large enough labour force that is in possession of good vocational skills following their departure from education and in to the work force. Given that vocational education remains an area of weakness in the UK and one of common complaint for businesses[3] seeking skilled workers, it would be unwise to increase the cost for businesses training their workers following a failure in the education system to do so sufficiently.

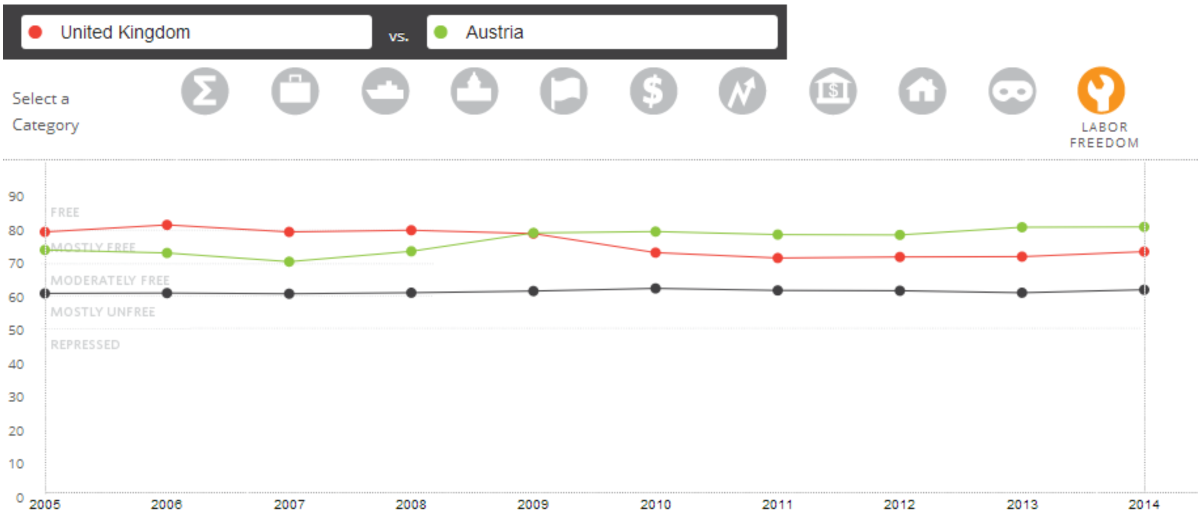

Figure 5: Index of Economic Freedom Labour Freedom Rankings 2006-2014

[3] http://www.cipd.co.uk/pm/peoplemanagement/b/weblog/archive/2013/04/29/skills-gap-hampering-business-growth-say-65-per-cent-of-uk-leaders.aspx

Furthermore, the 2014 Index of Economic Freedom (Figure 5) shows that the United Kingdom has fallen from 9th position in 2009 to 14th position today, being downgraded from the "free" to "mostly free" category.

The index of Labour Freedom equally demonstrates the United Kingdom falling from 23rd in the global rankings in 2009 to 53rd today, with Austria overtaking the UK in 2010, in part due to its resistance to a minimum wage.

The Political Implications

The issue for Osborne is that on this, as with too many issues, he had already conceded that Labour were in the right in employing a minimum wage in the first place. Upon doing so he had equally conceded that the minimum wage should at least rise with inflation.

The Conservative Party argued against the implementation of the minimum wage in 1999, raising similar concerns that it would prove a detriment to business growth and employment. Whilst these concerns were not realised, the legislation was brought forth in the year (1999-2000) when the United Kingdom posted its strongest growth statistics to date, and London's financial centre entered its most recent boom. Though growth slowed once the legislation came into effect, the wider trends towards expansion in the UK economy at the time masked the underlying dangers that a minimum wage holds for employment and small business growth.

Figure 6: UK Economic Growth 1988-2006

The argument as to the net effect of a national minimum wage has not been returned to since, and as such, having now let the genie out of the bottle and espoused his wholehearted endorsement of a rising minimum wage, Osborne has attempted to pitch his tent on the Labour Party's traditional turf. He should in fact be presenting a clear and consistent narrative that this is a business friendly government focused on a clear long term vision to make the UK one of the most competitive economies in the world.

Indeed, there are conservative ways to improve the plight of the lowest paid that were, and still are, open to Osborne should he wish to change course. First and foremost, he could link rises in the exempt band of income tax to inflation rather than the minimum wage and firmly set his stall in the tax cut camp in the run up to the election. Second, he could redouble efforts to ensure employers are both supported and obliged in training young workers, which is an area of success for the Dutch model.

On this occasion, it is unfortunate that he appears to have opted for the comfortable option of going to any lengths to steal the headline on the day of Ed Miliband's keynote speech on banking reform. If Osborne wishes to be remembered as a great Conservative Chancellor, he must show he is made of sterner stuff and discard populism in favour of maintaining a clear and consistent conservative-principled narrative. Only then can he hope to win the respect of the electorate, as well as having some hope of winning the fight against Labour by going on the offensive against their principles.

The alternative of simply trying to ape Labour by occupying their territory in a manner befitting of Tony Blair's 'Third Way' politics that has inflicted so much damage to the UK is not what Conservative voters wanted when they went to the ballot box in 2010, and is little reason to suspect they will in 2015.

The Bow Group

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