National minimum wages improve productivity

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Quite unexpectedly, George Osborne, the Chancellor of the Exchequer at the time, used his first Conservative Budget, in July 2015 to slash benefits for low-paid workers – and simultaneously forced businesses to pay them more. The British Government's new National Living Wage became law on 1 April 2016. The wage starts at £7.20, increasing to £7.50 from April 2017, and rising to £9 an hour by 2020. These rates replace the £6.50 minimum wage.

Government has warned businesses that they need to ensure they are paying their staff correctly, as the National Living Wage will be enforced as strongly as the National Minimum Wage was. According to some commentators, the government rate has certainly given businesses a big problem. Many companies have already started looking into overcoming this by reducing their costs through better workforce management. In some cases their costs have already lowered despite the increase caused by the living wage. But could there be any other productivity enhancing effects of the National Living Wage?

With the new government goal to build a Britain that works for all and the post-Brexit uncertainty affecting businesses and consumers, the notion of 'living wages' remains a thorny issue in Britain's public debates. It is, of course, not just a matter of concern in a British context. **Low pay poses issues for managers internationally**. Debates around the recent introduction of a national minimum wage in Australia and Germany, discussions of the level of state and federal minima in the USA, calls for a European minimum wage and low pay concerns in multi-national supply chains have been important internationally.

In a similar vein, productivity concerns preoccupy many commentators, with evidence on the minimum wage-productivity link remaining scarce and inconclusive. Our new study now establishes a vital reference point in the debate. We show that **minimum wages generate positive productivity effects** and can thus reduce the number of working poor without any of the frequently assumed negative side effects. Specifically, we point to 'fair' wage-induced incentives and behavioural effects having a positive impact on productivity. Our study presents novel empirical evidence to show that the introduction of the National Minimum Wage in the UK resulted in improved productivity.

Even though the study uses British data, the findings also provide powerful lessons for other countries. Calls by the international trade union movement for improved minimum wages to counter the development of a working underclass are often greeted by scorn. Yet if a government is serious not just about neo-liberal austerity measures or industrial innovation, but also about the treatment of low-paid workers with productivity-enhancing benefits, then these calls should be treated with more respect.

The study is the first to provide empirical evidence in support of minimum wage-induced productivity enhancements. The findings show that the minimum wage impact is strongest in service sectors such as retail, cleaning and security services where labour input is relatively important and in larger organisations where wage differentials are usually greater. Total factor productivity improvements of up to 11 per cent became evident in large firms, while cleaning and security services recorded the highest productivity gains, with an increase of around 25 per cent.

The analysis shows that the introduction of the minimum wage in the UK led to improvements in total factor productivity across a variety of low-paying sectors. The results support suggestions that **public policy has not fully realised the potential benefits of a fair minimum wage**. What is more, managers who are focused on myopic cost-reduction strategies may not grasp the potential for significant productivity advances.

The explanatory argument here is rather simple from a behavioural perspective. If individuals perceive their wages to be below their felt-fair level, they will reciprocate with reduced effort. Productivity will consequently remain low, especially in labour intensive sectors. It follows that **a focus on low wage, cost-reduction strategies is counter-productive if discernible productivity growth is the ultimate goal**.

Technical Note

The study models the link between total factor productivity (TFP) and the National Minimum Wage (NMW) using a structural productivity estimation approach. Previous studies relating productivity to the NMW employed a two-step analysis where in the first step productivity is estimated without controlling for the NMW's effects and then, in a second step, the NMW's association with the productivity measures is analysed. The productivity measures estimated in the first step are likely to suffer from omitted variable bias.

The approach utilised explicitly models unobserved productivity and directly incorporates the effects of the NMW into an integrated semiparametric estimation algorithm. The analysis therefore generates robust empirical evidence on the relationship between NMW's introduction and improved productivity over time. The British FAME dataset used is highly representative and includes information on detailed unconsolidated firm-level financial statements, remuneration costs, ownership structure, and location of over 360,000 UK firms for the pre-Global Financial Crisis period of 1995-2008.

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Notes:

- *This blog post is based on the authors' paper The UK national minimum wage's impact on productivity. British Journal of Management, 27(4), 819-835. [open access enabled]: DOI: 10.1111/1467-8551.12171*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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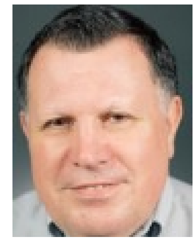

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