Minimum wages are increasingly popular with politicians and the public; even most economists now agree that they have little or no negative effect on employment. **Alan Manning** discusses this newfound enthusiasm – and the likelihood that it will lead to much higher minimum wages in some parts of the world.

Minimum wages: the economics and the politics

There was a time when the minimum wage was seen as a backwater of labour market policy, an appendix for which the best one could hope would be that it did not cause any problems. But no longer: in many countries, there is now a strong movement to raise minimum wages.

In November last year, Angela Merkel finally announced that Germany would be introducing a minimum wage, replacing or supplementing the current system that sets minima in a small number of low-paying sectors and collective bargaining that sets minima in some other industries. In May this year, Swiss voters will be asked to vote on the world's highest minimum wage – 22 Swiss francs an hour (about £15) – with one canton already having voted for that rate in principle though another has rejected it. And in 2011, the free market redoubt of Hong Kong introduced a national minimum wage.

In the United States, President Obama seems to have given up hope of his proposal to raise the federal minimum wage to $10 per hour in the face of an impasse in Congress. But he has recently used his executive power to impose a $10.10 minimum wage on the few hundred thousand people who work on federal contracts.

The president is also actively encouraging states and cities to raise their local minimum wages, thus bypassing the obstacles in Washington. Increasing numbers of them are doing so, and some are going further: Seattle's mayor, for example, proposes a $15 minimum wage. Minimum wages at this level – about 60% of median hourly earnings – are pushing the envelope of what has ever before been attempted with the minimum wage.

The UK is not immune from this newfound enthusiasm for the minimum wage, with all the main political parties seemingly falling over themselves to find some way to inject new vigour into the National Minimum Wage. Last autumn, the business secretary Vince Cable wrote to the Low Pay Commission (LPC), asking it to consider the economic circumstances in which the minimum wage could be increased at a rate above inflation. And the Labour Party has set up a Low Pay Review to consider options.

Not to be outdone, Chancellor George Osborne in January expressed the opinion that the nascent recovery means that the minimum wage can now be increased substantially. Without quite saying it in so many words, he dropped a heavy hint that he thought £7 an hour would be reasonable within 18 months, which would be a 10% increase from the current rate of £6.31.

I was a member of an expert panel convened by the Resolution Foundation and chaired by the LPC's first chairman George Bain to reinvigorate the National Minimum Wage. Central to our ideas was that the LPC has been very successful in doing a limited thing – setting a minimum wage to tackle extreme low pay. But the wider problem of low pay remains as serious as ever and – in spite of its name – the LPC has never attempted to develop a strategy for this bigger problem. The LPC seems to have convinced itself that the minimum wage could not be pushed much higher without threatening jobs, but the consequence is that we can never learn whether that judgment is correct.

So what explains this widespread enthusiasm for the minimum wage? In my view, both economics and politics are at play.

The economics of minimum wages

A generation ago, the vast majority of economists would have said that a rise in the minimum wage inevitably costs jobs. This has changed, with two strands of research having the biggest impact. In the United States, the work of David Card and Alan Krueger, then both at Princeton University, shattered the cosy consensus and argued that the actual evidence linking the minimum wage to job losses was weak. Although their findings were controversial (and the debates rumble on to the present day), there has been a large shift in the weight of academic opinion.

The other strand of research that has been very influential examined the UK experience, with CEP researchers playing a sizeable role, though not the only one. Some people predicted that the introduction of the National Minimum Wage in 1999 would cause hundreds of thousands of job losses, but this simply did not materialise. Any impact on employment seemed to be tiny and LPC research has reached similar conclusions for subsequent years when the minimum wage rose faster than average earnings.

In spite of this accumulating empirical evidence, it is still common to find economists falling back on the argument that a minimum wage must cost jobs because demand curves for labour inevitably slope downwards. Faced with a conflict between the evidence and twentieth century economic models, they reject the evidence rather than the theory – not an ideal template for scientific endeavour. But there are, in fact,

The driving force behind higher minimum wages is that they are very popular with voters

uncomplicated theoretical reasons why the minimum wage set at modest levels has little or no effect on employment.

First, the increase in total labour costs associated with a given increase in the legal minimum wage is often considerably smaller than the numbers suggest. As the minimum wage rises and work becomes more attractive, labour turnover rates and absenteeism tend to decline. Moreover, the cost associated with losing a job rises; so, arguably, workers are inclined to work a bit harder and need less monitoring. Of course, an employer could voluntarily choose to pay higher wages if net labour costs actually fell, so a reasonable guess here is that these offsetting economies reduce, but do not eliminate, the impact of a rise in wage rates.

Then there's the gap between employer perception and reality. Individual employers often view a rise in wages with horror, assuming it will drive them out of business. But all too often, they are implicitly assuming that they alone will suffer the cost inflation when it affects their competitors as well. Prices rise a bit and the effect on employment is only through the effect of a fall in sales, which may well be minimal.

But there is a more fundamental reason why there is no evidence of the job losses predicted by standard economic theory. The key assumption – that labour markets are highly competitive – is often wrong. The view of the labour market that underlies 'Economics 101' is not one that many people would recognise. For in this hypothetical world, losing a job is no big deal because finding an identical job is no harder than discovering that the local Sainsbury's is out of milk and going to Tesco instead.

But that is not most people's experience of labour markets. The reality is that competition for workers is not as strong as many economists would have you believe. An employer who cuts wages will find that most employees are unhappy, but that few will just walk out of the door. So it may make economic sense for employers to pay workers less than the marginal worker adds to revenues. In this more realistic world, a rise in the minimum wage will not necessarily price the marginal worker out of their job.

The politics of minimum wages

Academics might like to think their research has a big influence over public policy, but the driving force behind higher minimum wages is that they are very popular. Many people think there is something very wrong with an economic system in which someone who works hard is still unable to provide an adequate standard of living for themselves and their families. Such views have always been common, but they are much more common after the crisis when living standards are threatened and the link between growth and living standards seems to have been severed.

So in most countries of the world, voters (including right-wing voters) support rises in the minimum wage. In the UK, a poll in January 2014 found 66% favouring a substantial increase in the minimum wage – with majorities among supporters of all main political parties. In the United States, a poll in March 2013 found 71% in favour of raising the minimum wage, including 50% of Republicans. In Switzerland, voters seem to support the record-breaking minimum wage even as it is opposed by their government.

In some places, these political pressures will almost certainly lead to much higher minimum wages than we have seen in recent experience – perhaps to around the 60% of median earnings mark. This is the point at which many economists get nervous that negative effects on employment must surely kick in, but we do not have many studies to know whether these concerns are valid. There are only a few countries around this level currently – Australia and New Zealand (with low current unemployment rates) and France (with a more dysfunctional labour market) – so this is hardly conclusive one way or the other. But it seems likely we may be about to find out.

Alan Manning is professor of economics at LSE and director of CEP's community research programme.

His 2003 book, *Monopsony in Motion: Imperfect Competition in Labour Markets* (Princeton University Press), explains the theory behind minimum wages; and his 2009 *CentrePiece* article 'The UK's National Minimum Wage' describes CEP's role in providing the intellectual context for the policy, advising on its implementation and evaluating its impact (http://cep.lse.ac.uk/pubs/download/cp290.pdf).

'More than a Minimum: The Resolution Foundation Review of the Future of the National Minimum Wage', published in March 2014, is available here: http://www.resolutionfoundation.org/publications/more-minimum-review-minimum-wage-final-report

The UK's minimum wage has tackled extreme low pay – but the wider problem of low pay remains as serious as ever