

How Do We Make Minimum Wages Effective?

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It has long been evident that the unrestricted operation of markets does not necessarily provide workers with wages sufficient to provide socially acceptable standards of living. The extreme poverty associated with unregulated low pay can have serious adverse social consequences. It can affect health, anti-social behaviour, and children's life chances. In the late 19th century, governments in New Zealand and Australia pioneered the introduction of legally enforceable minimum wages to deal with this problem. Many countries were to follow their example. Minimum wages as a major instrument of policy were generally eclipsed during the mid-20th century by the growth of collective bargaining. But the more recent collapse of collective bargaining outside the public sector in most developed countries has reversed this. Statutory minimum wages are once again a central policy issue. The challenge is how to make them effective. This chapter discusses why this has occurred and some of the necessary conditions for them to be effective, drawing on the British experience of introducing its first National Minimum Wage in 1999 (Brown, 2009).

The collapse of collective bargaining

For much of the 20th century, pressure from trade unions pushed up the wages of workers in developed countries. It was not that the workforces in all sectors were organised by trade unions. Far from it. But some of the most profitable sectors were organised, including those associated with the rapid increase in labour productivity that accompanies technological advance. The markets for most products are imperfect, and this is especially true for those benefiting from the faster technical progress. Imperfect competition is associated with exceptional profitability. In the 20th century highly profitable sectors attracted trade union organisation, which went on to win a share of these profits for their members. Collective bargaining also helped to spread the gains beyond these more profitable sectors, both in private and public employment, through the use of comparability arguments.

There were strong economic and political reasons for the general acceptance of trade unions' upward pressure on wages. So long as wage increases did not exceed overall productivity increases and provoke inflation, governments welcomed a prosperous electorate and a high level of consumer demand. The development of comprehensive collective bargaining was associated with a decline in disruptive industrial disputes and, if not an equal society, tacit acceptance of its contained inequality and procedural norms. The stable systems of collective bargaining that dominated most of the developed world in the post-war era owed much to the fact that the markets for the majority of goods and services were confined to individual countries. Nationally bounded product markets provided a sound basis for the nationally bounded industrial pay agreements on which collective bargaining was based.

Collective bargaining based on national product markets suited employers because it meant they did not have to compete on the painfully sensitive issue of wages; by following the appropriate agreement they would be seen to be 'doing the right thing' by their workers. In many countries it fitted well with nationally regulated systems of skills training which discouraged free-riding employers. In some it encouraged a centralised, 'social partnership' style of trade union interaction with employers which helped keep worker aspirations in step with national economic realities. Employers were reassured so long as two conditions were met. The first condition was that there was effective enforcement of industrial pay agreements by employers' associations and unions. This was essential if they were not to be undercut by competitors, within the country, choosing to pay their workers at lower rates. The second condition was that the goods and services they produced could not be imported from other countries at lower prices because those countries had lower labour costs.

Subject to these conditions, it suited governments, employers, and trade unions in many countries to nurture comprehensive collective bargaining. It delivered levels of prosperity and relative income equality that were historically unprecedented. It provided procedural constraints to industrial conflict. At best it protected skill acquisition and provided a consensual means of national economic management that could be internationally competitive.

After a few decades of stability, this system is under threat or has collapsed in many countries. Competition has become more intense and more pervasive, primarily because it has become more international. For several decades now, world trade has expanded at twice the rate of world gross product, encroaching deeper on a widening range of sectors in most countries. An important aspect of this is the emergence of China, India and the old Soviet countries as major players, broadly doubling the size of the workforce competing for jobs associated with international trade in just a couple of decades. Another aspect has been the internationalisation of the ownership of the means of production. For several decades, foreign direct investment worldwide has increased at twice the annual rate of increase of world trade. Outside public employment,

there is a steadily increasing probability that the ownership of enterprises is not based within the country of employment, but in another country or, indeed, in no particular country, scattered among shareholders across the globe. Employers have become increasingly footloose, able to relocate their activities to wherever in the world unit wage costs are lower. Even public sectors, at first sight safely insulated from normal competitive forces, have increasingly been subject to privatisation or pressure to outsource jobs to the private sector. As a result of all this, the second condition for employer solidarity in collective bargaining is crumbling. Employers are becoming exposed to international competition. It is, consequently, more and more difficult for employers to collude with each other at the national level in order to sustain the agreements that uphold common domestic labour standards.

The consequence has been the widespread collapse of collective bargaining outside public employment. The British position is not unusual. In the 30 years since 1980, the coverage of the private sector workforce by collective agreements has fallen from 55 per cent to 18 per cent. The proportion of British private sector workers who are members of trade unions has fallen from 57 per cent to 17 per cent over the same period. The cause of this collapse has been clearly demonstrated from the regular surveys of British workplaces that have been carried out since the 1980s (Brown et al, 2009). Collective bargaining has been used more in those sectors where competitive pressure has been perceived to be less intense, and where profitability has been highest. The decline of collective bargaining has been greater in those sectors where profitability has been lower and where the decline in relative profitability has been greater. There is no reason to expect a revival of collective bargaining in private employment because there is no reason to expect competitive pressures to slacken. Indeed, they are more likely to intensify.

The return of statutory minimum wages

The decline of collective bargaining has had a substantial effect upon wages. It is difficult to identify the magnitude of the effect, as distinct from that of the encroachment of international competition that in part lies behind it. But in Britain the income distribution began to widen steadily after about 1980. It is evident from Figure 1 that wages below the median were increasing slower than wages above the median during the mid-1990s, and especially for the lowest decile. A point of particular concern to policy makers was that the proportion of children who were growing up in poverty, having been fairly stable since the war, started to increase rapidly in the 1980s, an increase that continued into the 1990s.

Pressure to introduce a statutory minimum in Britain came from three distinct sources: trade unions, employers and the government. Although the reasons were in many ways particular to Britain, the underlying forces are to be found elsewhere. For trade unions, reconciliation to a statutory

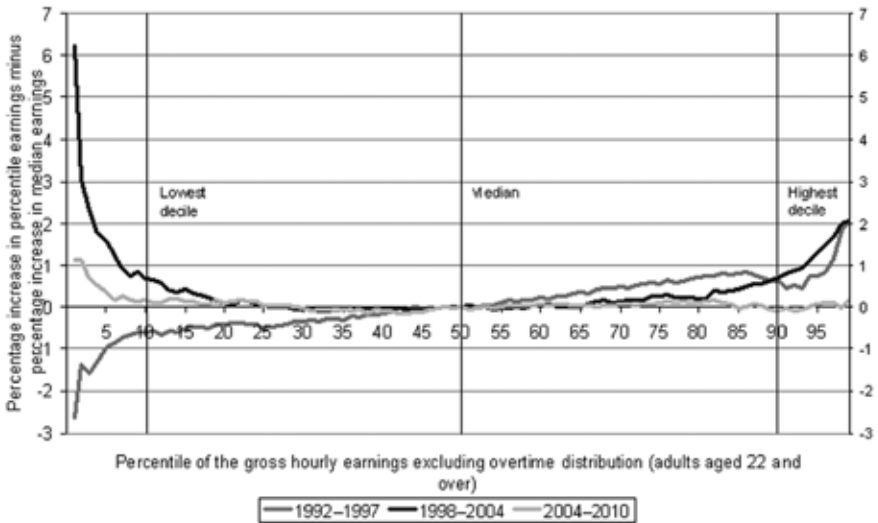
minimum was, perhaps paradoxically, especially difficult. For decades they had opposed the idea in the belief that it would undermine collective bargaining and reduce the incentive for workers to join trade unions. In the end it was a public sector union that led the campaign to introduce a minimum wage, driven in part by the threat posed by outsourcing jobs to low paid private sector workers. By the 1990s, the private sector unions were aware that the success of collective bargaining was more threatened by the fact that an unregulated labour market was making it difficult for employers to stick with collective agreements. It is difficult for employers to uphold collective bargaining when their non-unionised competitors can get labour at a much cheaper rate. In the end it was the unions that forced the minimum wage policy on the Labour Party.

Employers needed less persuasion to accept a statutory minimum wage, so long as it was not too high. They were, after all, traditionally comfortable with the idea of industrial collective agreements that, as the old phrase had it, 'took wages out of competition' by establishing agreed wage rates. Most employers (and certainly most of those who engage in employer associations) want to be seen as 'good employers', treating their employees 'fairly'. If there is no enforceable agreed wage rate, they are aware that they can be out-competed by 'bad' employers who achieve low unit wage costs by paying low rates. The question then becomes how 'good' employers can be protected, and a well-enforced statutory minimum wage is next best to an effective collective agreement.

For governments, there are strong practical justifications for a statutory minimum wage when collective bargaining is failing. If society expects the state to protect its citizens, and especially children, from extreme poverty, then when free-market wages fall too low, it is the government that has to step in with in-work social benefit payments. The cost of these to the taxpayer was rising dramatically as pay inequalities deepened in the 1990s. In the absence of a statutory minimum, many firms were able to get away with extremely low pay, in the knowledge that their employees could 'make it up' with state benefit payments. A more political reason for governments to value minimum wages is simply that extreme inequality can be socially divisive and generate collateral costs arising from criminality and disruption. Making minimum wages effective has recently become a central concern of the Chinese government for this reason; the inequalities associated with rampant capitalism are seen to be threatening to the harmony of their society.

Britain introduced its comprehensive National Minimum Wage in 1999. Figure 2 shows how it was to reshape the national hourly wage distribution. The income distribution in 2010 acquired an abruptly truncated lower end by comparison with 1997, before statutory intervention. As Figure 1 shows, the impact on the lower income groups was impressive. Over the early years of the National Minimum Wage, the lowest decile of wage earners experienced increases substantially greater than the median. And when the minimum

Figure 1: Deviations of pay increases from the median by percentile for the United Kingdom, 1992 to 2010



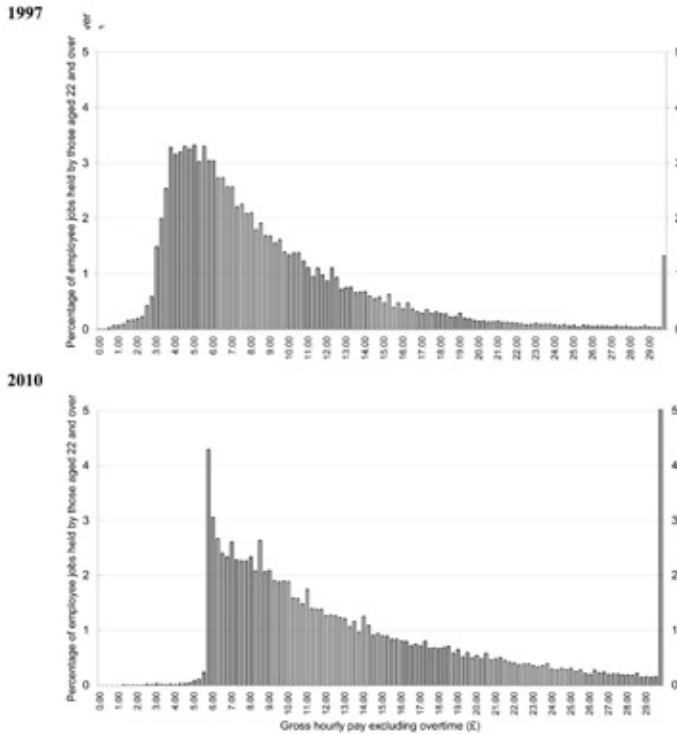
Source: [LPC \[AQ: spell out?\]](#) estimates based on New Earnings Survey, unweighted, UK, April 1992-1997; ASHE [\[AQ: spell out?\]](#) without supplementary information, standard weights, UK, April 1998-2004; ASHE with supplementary information, standard weights, UK, April 2004-2005; and ASHE 2007 methodology, standard weights, UK, April 2006-2010. *[NB: figure does not work well in black and white – possible to resupply with differentiated lines?]*

Note: Comparisons have been made here for illustrative purposes only as no consistent earnings time series data are available from 1992 to 2009. These series are not strictly comparable. [Employees whose pay for the survey pay period was not affected by absence. \[AQ: incomplete sentence?\]](#)

wage had settled in, this lowest decile continued to do relatively well, in marked contrast to the experience before the wage was introduced. Because the majority of the workers directly affected were women, this had the effect of substantially narrowing the gender wage gap. It is also notable that there have been very limited knock on effects further up the income distribution; the direct effects have been very largely restricted to those for whom they were intended.

Anxieties about adverse consequences of a statutory minimum wage have not been fulfilled. Although the Low Pay Commission, which manages the minimum wage, has commissioned extensive independent research into these consequences, no significant adverse employment effects have been detected (Metcalf, 2008). In part this is because the vast majority of jobs affected are in service industries sheltered from foreign competition. While prices have been forced up in some sectors, these effects have been very limited and without significant national inflationary consequences. There is some evidence that pressure to pay more has forced those employers who

Figure 2: Distribution of hourly income in the United Kingdom, all adults, before and after the introduction of the National Minimum Wage, 1997 and 2010



Source: LPC estimates based on ASHE without supplementary information, standard weights, UK, April 1997 and ASHE 2007 methodology, standard weights, UK, April 2010.

relied on low wage rates to compete either to go out of business, or to manage their labour better. For those forced out of business, their market share and the workers involved have generally moved on to better managers. For others, the workers have seen their existing employer manage them better, in terms of training, equipment or organisation. In short, the minimum wage has been a stimulus to improved management among the predominantly small firms primarily affected. As a general rule, the productivity of less skilled labour owes more to how it is managed and motivated than to anything intrinsic to the workers themselves. Incentives to managers to manage better are the best means for getting workers to work more productively.

There is no denying that a statutory minimum wage is a poor substitute for strong and comprehensive collective bargaining in terms of achieving a high and relatively egalitarian distribution of pay. It would be absurd to argue otherwise. It is not only that the exercise of collective labour strength at the point of employment has historically proved to be so effective. It is also because collective bargaining can extract a share of profits from highly

profitable sectors and, through comparability claims, spread some of their benefit more widely. Minimum wages can do no more than bump up the bottom of the income distribution and prevent it collapsing. They do not have the leverage to redistribute profits as strong collective bargaining can.

It would, however, be foolish to condemn statutory minimum wages on the basis that they are less effective than private sector collective bargaining, at a time when collective bargaining has collapsed and has no prospect of recovery. The important point for policy purposes is that statutory minimum wages can have a substantial beneficial effect in protecting the weakest in the workforce and in limiting the inequality of societies, and that they can do so without evident adverse side effects. How can policy make the best of this, and make minimum wages effective?

How can minimum wages be made effective?

The challenge of making minimum wages effective is both economic and political in nature. In the previous section the unusually well documented 'natural experiment' of the British case was used to argue that, in terms of economic behaviour, statutory minimum wages can achieve their objectives in terms of income protection without adverse unemployment or inflationary consequences. Clearly this requires subtle judgment. Anyone can set a minimum wage so low that it has no significant effect; Russia and Indonesia are examples of countries with ineffective minima. Similarly, it is not difficult to set a minimum wage so high that it has a damaging employment effect; the current youth minimum rate in France has been accused of that. The economic skill lies in keeping the minimum rate sufficiently high that it presses up to, but does not break through, the level where it might have adverse employment and inflationary consequences. It is a question of keeping the minimum wage both economically safe and economically effective. But there is also a political skill in producing a minimum wage that is felt by society as a whole to be in some sense fair. How are these objectives to be achieved?

Minimum wages are best not left solely under the control of governments. If the decision is purely political, as in the United States' federal minimum, increases tend to be infrequent and somewhat arbitrary, over-influenced by the pressure groups behind the party in power. The results may be economically safe, but they are for long periods not very effective. If, as in France, the government determines the rate according to a formula, typically taking account of cost-of-living increases and/or average earnings increases, implementation may be dangerously insensitive to other relevant issues, such as the state of the business cycle and of unemployment. Undemocratic governments are tempted to keep minimum wages unrealistically low and democratic governments, given the chance, are tempted to raise minimum wages in advance of elections.

The international consensus, reflected in countries' institutions, would appear to be that minimum wages are best kept at arm's length from government. The bodies that fix them are typically made up of individuals who do not stand to gain directly from the outcome and are seen as having the national interest at heart. And, since the 'national interest' is a famously controversial notion, it is generally seen as important to have balanced representation from employer and trade union groups – in Europe termed the 'social partners'. This provides the basis for a de facto bargain which, in the case of the British Low Pay Commission, is conducted annually over a weekend-long meeting, and after careful preparation. Although there are exceptions, such as Australia, governments are generally reluctant to surrender total control over so important an economic instrument. So they typically make the minimum wage fixing body advisory, but with the implicit assumption that the advice will usually be accepted because otherwise it would soon cease to have serious purpose.

It is of the essence of independent minimum wage fixing bodies that they have to make, and be seen to make, sensitive economic judgments, otherwise decisions are no better than the exercise of government whim or a mechanical formula. For this reason it is important that they consult widely with those affected by the outcome, and especially with the employers who will bear the cost of minimum wage increases. Taking formal evidence from representative bodies is politically necessary because they are official representatives and pressure groups. But the Low Pay Commission placed particular value in its early years on travelling the country to visit individual employers at their place of work, and especially those who had voiced relevant complaints or were seen as influential by key pressure groups. These visits enabled the Commission to develop a well-informed policy towards complex issues, such as the payment of home-workers, of people with disabilities, or engaged in therapeutic work. They also provided early insights into emerging labour market issues – such as the big increase in immigration (much of it illegal) of the early 2000s – long before they became a matter of public comment or academic research.

Minimum wage fixing arrangements cannot be any better than the statistical data they have to work with. Accurate and timely survey data on both pay and employment are essential if there is to be confidence in both the safety and the effectiveness of a minimum wage recommendation. The Low Pay Commission had already made its initial recommendation, and seen it implemented, before it discovered just how defective the existing British pay survey data were when it came to measuring the pay of part-time and other low paid workers. It took four years before the surveys could be restructured to command confidence. It was only then that it was possible to raise the minimum wage consistently at a greater rate than average earnings, thereby increasing its effectiveness in terms of the number of workers benefiting.

The use made of good statistical data is dependent on the quality of its analysis. It is important that this should be independent, not only of government and the many interested pressure groups, but also, for some issues, independent of the agency managing the minimum wage. It is also important that the rigour of the research is irreproachable. It must command the respect of the analysts advising interested parties such as the government, central bank, and overseas investors. The Low Pay Commission competitively commissioned over 70 research projects on different aspects of the impact of the minimum wage in its first 10 years. Some were carried out by business consultancy firms, but most by academic teams, chosen in part for being at the cutting edge of the relevant analytic techniques. Her Majesty's Treasury employs well-trained economists, and it was crucial for the credibility of the Commission's recommendations with government that they could not fault the underlying research.

Protecting the good employer

It was noted earlier that getting the support of employers for statutory minimum wages is not, in principle, difficult. Most employers know they can get the best out of their employees if they are seen to be treating them fairly. They have material as well as moral reasons to want to be seen to be 'good' employers. Payment according to a statutory minimum wage may not be as generous as paying according to a collective agreement, but it has indisputable legitimacy. The difficulty is that hard-pressed employers will be tempted to cheat on it if they believe their competitors are doing so.

Enforcement is, consequently, central to the integrity of a statutory minimum wage. Its success depends upon a general perception that it is being enforced. The British made the department concerned with gathering taxes – HM Revenue and Customs – responsible for enforcement, and it is seen to be experienced and effective. It routinely carries out targeted checks based on past experience of tax evasion, and it is informed also by whistleblower help-phone lines on which both employees and employers can report suspected breaches of the minimum wage. There are around 50,000 help-phone inquiries and 5000 investigations a year. About a third of inquiries result in an employer having to make remedial payments, and there have been some prosecutions. Complete enforcement is not possible. The most common way of cheating is to under-record the amount of time an employee works in order to inflate the apparent hourly wage earned. But the evidence is that the minimum wage is widely known by those affected, and widely believed to be effectively enforced.

It is not only government authority that can protect the good employer. Employers who recognise trade unions have tended to observe individual employment rights better than comparable, non-unionised employers (Brown et al, 2000). There is a growing tendency for trade unions and others

to use pressures, sometimes called 'triangulation', to encourage enterprises to make the observation of decent labour standards a condition of subcontracting. An example is the London Living Wage campaign, which seeks to get London employers to pay a rate, currently 40 per cent higher than the National Minimum Wage, reflecting the higher costs of life in the metropolis. Trade unions, campaigners, and even successive London Mayors, have been successful in getting a high proportion of public sector employers, such as schools, universities, and local councils, to make the Living Wage a contractual condition.

Consumer pressure is proving to be another valuable resource. Since the 1990s there has been a succession of consumer campaigns, hugely facilitated by the spread of electronic social networking. These have targeted firms accused of sourcing their goods from suppliers with poor labour standards. In particular, they have targeted the expensively marketed reputation of firms' brand names. So effective has this been that both the brand name companies themselves and the international supermarket chains that distribute their products have started to invest in 'ethical audits' of their suppliers and subcontractors. Reports on ethical audits have become a regular feature of corporate websites. The Ethical Trading Initiative was established in 1998 with support from the Confederation of British Industry and the Trades Union Congress to carry out independent audits of British firms. Internationally, the Global Compliance Programme was initiated in 2006 by major supermarket chains to develop a statement of agreed international minimum labour standards for their suppliers. Faced with the risk of public embarrassment over charges of profiting from poor labour standards, both firms and retailers are increasingly seeking to be seen to be 'doing the right thing' by their customers as well as their employees.

Consumer pressure can only ever be a limited means of enforcement. Many consumers are too poor to have the luxury of choice. Many disreputable employers can hide in untraceable supply chains. Ethical auditors and industrial and retailer purchasers are corruptible. But what matters for the current argument is that consumer pressure is only effective when it has well defined labour standards against which to benchmark employers. Central to these is the local statutory minimum wage. Without an internationally comprehensive system of national minimum wages, set at levels that make a real difference in protecting the weak, the scope for protecting labour standards in individual countries will be constrained.

In a world where markets are losing their geographical boundaries and traditional collective bargaining is losing its bite, the significance of minimum wages for policy will grow. They are necessary, if not sufficient, to protect weak workers and good employers. But to be well-founded they need to be independent of government, politically engaged with the low payers and the low paid, well-informed on the labour market, active in research, and

supported by strong enforcement. Those developing them will be well aware that there are severe social costs if minimum wages become ineffective.

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