Bournemouth University

Regional Economic Development
Local Economy Briefing 5

The Living Wage

In his July Budget, Chancellor George Osborne announced that, from April 2016, the government will introduce a compulsory ‘living wage’ that will be paid to all full-time and part-time workers aged 25 and above.

Initially, it will be set at £7.20 an hour, with a target of it reaching more than £9 an hour by 2020. Workers under 25 will still get the ‘minimum wage’, (increased to £6.70 an hour this month). The Low Pay Commission will review and recommend what the living wage will be each year thereafter.

The ‘Living Wage’ will give a pay rise (7.5% in percentage terms and 50p an hour) to six million workers. Those who keep their jobs and all their hours will welcome the rise in incomes and spending power.

The Office of Budget Responsibility estimates, however, that it will forfeit 60,000 jobs and reduce hours worked by four million a week. Several business groups conclude that the ‘Living Wage’ will cut employment opportunities for low-paid people because it will undermine profitability for many SMEs.

Basic economics would suggest an increase in labour costs will tend to reduce employment demand, increase output prices and reduce overall economic activity. It is not always quite that simple in a dynamic real world.

First, **timing is everything**.

If wage rates increase when the economy is strong (orders, outputs and incomes), the change may be absorbed with relatively little disruption to product or service plans, investment and activity levels. In the near term, there may be an adverse shock on supply.

The eventual, net effects of the ‘living wage’, however, will depend on how it is moved thereafter. Presumably, the target will be to move it in line with trends in other real earnings in order to attain and then maintain the desired 60% of median earnings target.

The worry would be that taking the market out of the labour costs base will create a market rigidity that might lead, in time, to a higher ‘natural rate of unemployment’. Whether that is a price worth paying is a political as well as an economic question.

Second, **sector is everything**.

Lots of firms are worried about the effects of the ‘living wage’ on profit margins in a non-inflationary environment when cost increases can not be passed up the supply chain. It will be harder to absorb in some industries than others: the impact on low-paid jobs and services in, amongst others, Dorset’s leisure industries (catering and tourism) and on health and social care may be relevant here.

Perhaps, however, a shift in income shares from profits to wages is warranted right now. Since the Great Recession (2008+), wages have gone up very slowly, if at all, for many workers. Some rebalancing of income shares from profits to wages may be a net economic gain right now. The ‘living wage’ may merely start to restore a more positive situation in terms of the distribution of spending power.

Since ‘living wage’ recipients may be expected to spend rather than save the pay increase, it may stimulate more consumption and, thereby, help the recovery. Businesses may get back the ‘living wage’ in higher sales.

Third, **productivity is everything**.

The real questions are: will low-wage workers respond to being paid more by working harder and better; and will firms seek other ways to manage costs?

There may be fewer jobs in the short term but this may be offset by a boost to capital investment, better labour force management, and increased productivity over the medium term. Given the UK’s poor relative productivity, the ‘living wage’ incentive to invest in more productive working practices, might yield positive net benefits over time.

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Generally, assuming no negative externalities/market failures, economists prefer market-determined prices where all relevant information can be considered implicitly. The problem with the ‘living wage’ is that it may impose a relatively ‘big’ wage increase in a year when growth is already slowing. In 2016, it may dampen jobs and growth prospects compared with what otherwise might have happened.

Advocates of the ‘living wage’ however, suggest that market failures, particularly with respect to imbalances in market power on the two sides of wage bargaining, are in evidence and need correction.

Whether or not market imperfections are important or not, the economy will adjust to the new regime in time. Indeed, the ‘living wage’ may well pay for itself by boosting sales and productivity. Our main concern would be that it becomes a subjective political football rather than a tool for objective economic success.

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