BRIEFING PAPER

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Just Rewards

Why taking the poor out of tax makes economic and moral sense

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Introduction

One fifth of workers in Britain are paid less than the so-called Living Wage, according to a recent KPMG report. In addition, 7.9% of the labour force is unemployed, including 20.3% of 16-25 year olds. Low pay is a serious issue, particularly as the UK's economic performance continues to sag, causing real-terms declines in living standards. The question this paper is how we can address this problem without risking the negative unintended consequences often associated with economic regulation and, particularly, minimum wages.

In this paper, we review some of the evidence around the employment effects of minimum wage increases, noting that these increases are often associated with increased unemployment among young people and the unskilled. Mindful of the harmful employment effects of mandatory minimum wage laws, we propose an alternative reform designed to increase net wages of low-income earners: raising the tax-free personal allowance to the National Minimum Wage rate.

The purpose of this paper is to provoke debate about the best means available to achieve the goal of increasing net wages and living standards for low-paid workers. We will argue that mandatory increases to minimum wages have a harmful impact on employment, and those on low incomes are better served either by direct cash transfers to low-earners or, in our preferred option, tax reductions.

The risk of minimum wage increases

One of the biggest problems with regulation is the danger of harmful unintended consequences being compounded across an economy, without the capacity for experimentation by individual firms, entrepreneurs or workers. The most publicly-understood negative consequence of higher minimum wages is 'greater costs on businesses'.

The Living Wage Foundation's approach has largely rejected political campaigning, perhaps aware of the harmful effects of mandatory minimum wage laws on employment among low-skilled workers, discussed below. Instead, it has relied on the power of positive PR to encourage businesses to sign up to pay their staff a Living Wage. This is to be applauded, and it highlights the power of consumer action to effect improvements in working conditions.

While we support the Living Wage Foundation's efforts to increase pay for low-paid workers by working in cooperation with private firms, we fear that well-intentioned actions by Living Wage campaigners may lead to increases in the National Minimum Wage which price low-skilled workers out of the jobs market altogether, increasing long-term unemployment.

However, the biggest danger is that minimum wage laws will harm those workers it is intended to help, by making them unemployable even to businesses with money to spare. Minimum wage is, in effect, a price floor on the price of labour. A price floor will create a shortfall in demand for a product – in the case of labour, this shortfall in demand is known as unemployment. This is not a function of firms' ability to pay, but the workers' ability to produce at least what they cost in wages.

This particularly affects young and unskilled workers, who are likely to be the least productive. This danger is well known to economists. A 2000 survey of members of the American Economics Association found that 73.5% either generally agreed or agreed with provisions with the statement that "A minimum wage increases unemployment among young and unskilled workers".[1] 26.5% generally disagreed.

The empirical impact of minimum wage laws on youth unemployment has been documented extensively, such as in studies by Profs David Neumark and William Wascher. In a 2000 paper, Neumark and Wascher reviewed the payroll records from fast food restaurants in New Jersey and Pennsylvania to determine the impact of minimum wage increases on youth employment in those restaurants.[2] his study contradicted a well-known 1994 paper by Card and Krueger which found that there was no unemployment effect.

The main reason for this difference may be that Card and Krueger's earlier study relied on poor quality data and took a narrow view of employment. Neumark and Wascher argue that the Card and Krueger study was based on unreliable survey methods of phoning restaurants up and asking about employee numbers, which could be at risk of being misunderstood by shift managers.[3] Card and Krueger's study measured employment in terms of the number of employees rather than employment hours, and consequentially did not factor in the potential for workers being shifted on to fewer hours without being fired outright. With new payroll data, this omission was corrected in the Neumark and Wascher study.

Neumark and Wascher's study found that the elasticity of employment with respect to the minimum wage was -0.24. In other words, a 10% increase in the minimum wage led to a 2.4% decrease in the demand for labour.

We should not expect this precise price elasticity to hold across industries, countries and time periods. However, a 2007 meta-study (ie, a survey of many existing studies) of 102 studies by Neumark and Wascher is indicative of the direction and magnitude of the employment effects of changes in the minimum wage.[4] Of the 102 studies surveyed, two-thirds give a "relatively consistent … indication of negative employment effects of minimum wages".[5] Of the 33 studies that Neumark and Wascher highlight as being the most credible, 28 (or 85%) suggest negative employment effects associated with increases in the minimum wage, particularly among the young and unskilled.

It is important to note that the complexity of the economy means that no definite projection of the employment effects of minimum wage laws can be made. Indeeed, the empirical relationship is not conclusive and the complexity of the labour market is such that no firm predictions of employer behaviour can ever be made. There are scenarios in which an increase in the minimum wage could actually increase net employment – such as in the case of a monopsonist employer (where one buyer faces many sellers).

However, that this could theoretically be the case is far from the same thing as this actually being the case. In all likelihood, an increase in the minimum wage would have harmful employment effects. Policymakers seeking to improve the lot of low-paid workers should not take this chance.

In Britain, the Low Pay Commission, which is responsible for advising the government on minimum wage increases, recommended a freeze in the youth rate of minimum wage last year (2011). It now seems set to do so for a second year.[6] Business groups such as the British Chamber of Commerce have also endorsed such a freeze.

However, focusing on the youth rate of minimum wage ignores unskilled workers who are over 21. The theory and evidence about minimum wage laws suggests that these workers are likely to be affected just as badly as young people by increases to the minimum wage, albeit less obviously.

Low-paid jobs can be socially useful, as well as being a necessary reflection of the market value of worker productivity. For people without a significant employment history (for example, young people, the long-term unemployed, and newly-arrived immigrants), a low-paid job can have positive non-monetary benefits, such as workplace experience.

Getting a foot on the job ladder is an important first step in long-term employment. For a new entrant to the job market, proving that you can show up to work on time and be a productive employee is crucial to your employment prospects. Gaining experience and making contacts are also important non-monetary gains from work, and they may be more important to some workers (such as young people who live at home) than the wages themselves.

This may explain the rise in unpaid internships in recent years. Our minimum wage laws have effectively prohibited formal employment for less than £6.19 per hour for 21 year olds and over, so the only alternative is to work for nothing at all (some firms get around this by paying expenses to their interns). The perverse consequence of the National Minimum Wage has been to give employers two options: either employing a worker at £6.19 per hour, or employing them at, effectively, £0.00 per hour. The fact that so many young people still take jobs at £0.00 per hour should highlight the value of low-paid work to many people, and the speciousness of claims of some defenders of the

National Minimum Wage that unemployment is preferable to some low-paid work.

Furthermore, even if all of these employment effects did not apply, even a simple increase in gross wages may not be as beneficial to workers as some claim. As the economist Chris Dillow has pointed out, an increase in gross wages will be offset by the withdrawal of tax credits and higher income tax payments.[7] This, he says, could mean that low-earners would only see a net increase in their wages of 30p for every extra £1 rise in wages.[8]

None of this is to say that low pay is not a problem. But the approach taken should be mindful that attempts to prohibit low pay may end up harming the very people they are intended to help.

With all this in mind, it seems foolish at best for anybody to advocate increasing the National Minimum Wage to meet the Living Wage level. While some workers would see an increase in their net income, the overall effect is likely to be a negative one, as net employment decreases and young and unskilled workers are particularly harmed by not being able to get their foot on the ladder.

Therefore, we believe that increasing the National Minimum Wage is not an effective way of improving living standards for those on low pay. Whatever benefits there are for a few workers would come at the cost of a net increase in unemployment. Efforts to increase low-paid workers' gross income should instead focus on voluntary schemes by large firms and, possibly, promotion of worker training schemes to improve the skills and productivity of low-paid workers. In the next section, we argue that the focus ought to be on workers' net pay, and on market-friendly reforms to that effect that have a positive impact on employment.

Leave the poor alone

The focus on gross income for low-paid workers is misleading. What matters to a person's standard of living is their net pay and, possibly to a greater extent, their disposable income. (That is, their income after fixed living costs such as food and rent, which can vary greatly depending on location.) In this section we discuss our preferred option for increasing low-paid workers' net income without risking the negative employment effects identified above – raising the tax-free personal allowance and pegging it to the National Minimum Wage rate.

There are two primary ways to increase low-paid workers' net income. The first is a direct cash transfer to those on a certain income – in other words, an increase in tax credits.

This would be preferable to a rise in the National Minimum Wage, as the extra costs would not be imposed onto the cost of employing an additional worker. However, this approach does have some significant flaws: it would create another diminishing marginal cost to increased earnings for low-paid workers, further disincentivizing work versus leisure. (A problem that the government seems determined to tackle with its welfare reforms.) The current tax credits system is notoriously difficult to navigate and requires radical simplification in order to work effectively for those who are most in need of income supplements. Increasing tax credits would also increase the tax burden on an already highly-taxed economy that is struggling with recovery. For these reasons, we do not judge the tax credit route as being viable.

A far more attractive and viable option, in our view, is to reduce the tax burden on low-paid workers. As Table 1 shows below, the post-tax Living Wage is actually lower than the pre-tax National Minimum Wage for a worker on 40 hours a week for 52 weeks a year. In other words, if workers earning the NMW did not pay tax, they would be earning the Living Wage.

This fact should be central to all discussion of low pay, the NMW and the Living Wage. The net Living Wage income would already be in the pockets of all NMW workers if they were not paying 12% of their total income in tax.

Scenario	Gross Wage	Income tax paid	National Insurance paid	Total tax paid	Net wage
NMW (current taxes)	£12,875.20	£954.04	£633.98	£1,588.02	£11,287.18
Living Wage (current taxes)	£14,976.00	£1,374.20	£886.08	£2,260.28	£12,715.72
NMW (no taxes)	£12,875.20	N/A	N/A	N/A	£12,875.20

Thus, the government is presented with a very easy and very effective way of effecting a Living Wage for all NMW workers: raise the tax-free personal allowance to £12,875 per annum, and henceforth peg it to at least the minimum wage rate. As Tim Worstall has pointed out, there is a paradox in taxing NMW workers in the first place: "if the State says that it's immoral for you to earn less than that then why does the State get to stick its hand in your pocket and steal some of that?"[9]

The government is already committed to raising the tax-free personal allowance to £10,000 per annum. HMRC has estimated that every rise in the personal allowance of £100 means approximately £500m less in tax raised per annum.[10] Therefore, the additional cost of raising it to £12,875 would be to reduce tax revenues by approximately £14.4bn per annum.

The consequence of this move would be to increase the take-home pay of everybody earning under £100,000 by £575. It would take the up to 1,297,000 people working on minimum wage or lower out of the tax system altogether.[11]

This is not an insignificant sum, but it has to be put in context of wider government expenditures. In 2013, the UK government will spend £676.6bn, of which £116.4 billion will be spent on welfare (excluding pensions). If the government cannot find additional savings of £14.4bn from a budget of £676.6bn (a 2% cut) in order to take the lowest earners out of tax altogether (and give people earning less than £100,000 per annum a modest tax cut as well), we are in very dire straits indeed.

We oppose the idea of 'balancing' this reform by increasing taxes elsewhere. It would be possible to increase the basic rate of tax commensurately so that only minimum wage earners felt the benefit of this reform; this would require an increase to the basic rate of approximately 2.7%. However, this would steepen the marginal disincentive effect of the basic rate on minimum wage earners and should be rejected in favour of further spending cuts.

In all likelihood, the actual cost of this measure would be substantially less than HMRC's estimates. The threshold rise would incentivise work, complementing the government's welfare reforms aimed at 'making work pay', and thereby reduce welfare expenditures and boost tax receipts overall. To a Keynesian, this cut would have a significant stimulatory impact, as low-income earners are most likely to spend the extra money taken home.

A common objection made against raising the tax-free threshold is that increasing the number of people who do not pay income tax will create a greater number of people prepared to vote for higher taxes on those who do pay income tax. We believe that this fear is misplaced.

The idea that raised tax thresholds will lead to more electoral pressure to raise taxes on the rich seems to be based on a misunderstanding of public choice economics, which focuses on the incentives for small groups with common interests to lobby the government for protection or subsidy without opposition from taxpayers – the marginal cost to the latter group being outweighed by the cost of counter-lobbying the small group seeking subsidy.

This surely could not apply to the hundreds of thousands of people earning minimum wage – this group is far too large for public choice-style lobbying to be a viable option. Furthermore, the idea that people vote solely based on their own pocketbooks seems, to us, highly simplistic and in contradiction of much of the evidence.[12] If economies are complex and unpredictable, the inner workings of voters' heads are even more so. Objecting to a measure that will increase low-income earners' take-home pay on the grounds that they will vote, zombie-like, for a bigger state seems misguided in the extreme. This is most surprising when it comes from libertarians who believe tax to be unjust in and of itself -

While we have focused our discussion on the net income of NMW earners, a significant burden on workers in the South East and, in particular, London is the cost of housing. These costs are rising as supply fails to keep up with demand. Without significant liberalization of the planning system (such as that outlined in Tom Papworth's 'Planning in a Free Society') to allow more housing to be built, these costs seem set to rise and rise.[13]

Conclusion

The public debate about how to improve conditions for people on low incomes must be informed by economic theory and empirical observations about the impact of minimum wage increases on employment among marginal groups. It should also focus on net and disposable incomes not gross income, which is scarcely a useful measure to someone paying a large portion of that gross in tax.

The elephant in the room of the Living Wage and low pay debate is the amount of money taken from low income earners in tax. The very fact that the Living Wage foundation's estimates about the basic wage level needed to live decently comes so close to the pre-tax National Minimum Wage must be no mistake: HMRC's confiscation of taxes from minimum wage earners must be to blame for the shortfall in NMW-earners' living standards.

As we have argued, the solution is to raise the basic tax threshold to the minimum wage level, so that only the first pound above the minimum wage is taxed. This would also affect other taxpayers earning up to £100,000 a year (anyone earning above which does not receive a personal allowance), but, crucially, the amount of extra money kept by each worker would be the same. In essence, this would be a progressive tax cut that favoured low- and middle-income earners over the wealthy. Allowing people at the bottom of the employment ladder to keep what they earn would complement the government's welfare agenda, improve living standards and, above all, restore some justice to our tax regime.

Endnotes

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6. "Minimum wage for young people may affect jobs", Daily Telegraph, 25 Oct 2012: http://www.telegraph.co.uk/news/politics/9634448/Minimum-wage-for-young-people-may-impact-jobs.html
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9. T. Worstall, "On getting very annoyed indeed about this living wage thing", 22 Jan 2012: http://www.adamsmith.org/blog/economics/on-getting-very-annoyed-indeed-about-this-living-wage-thing. Tim Worstall is the first person I have read who pointed out this discrepancy between gross NMW earnings and net Living Wage earnings.
10. www.hmrc.gov.uk/stats/tax_expenditures/table1-6.xls
11. Low Pay Commission, *National Minimum Wage – Low Pay Commission Report 2012*, Cm 8302 (2012), p. 38.
12. For instance, L. Lewin, *Self Interest and Public Interest in Western Politics* (1991).
13. T. Papworth, "Planning in a free society: London as a case study for a spontaneously planned future", Adam Smith Institute (2012).