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# Economics of the National Minimum Wage

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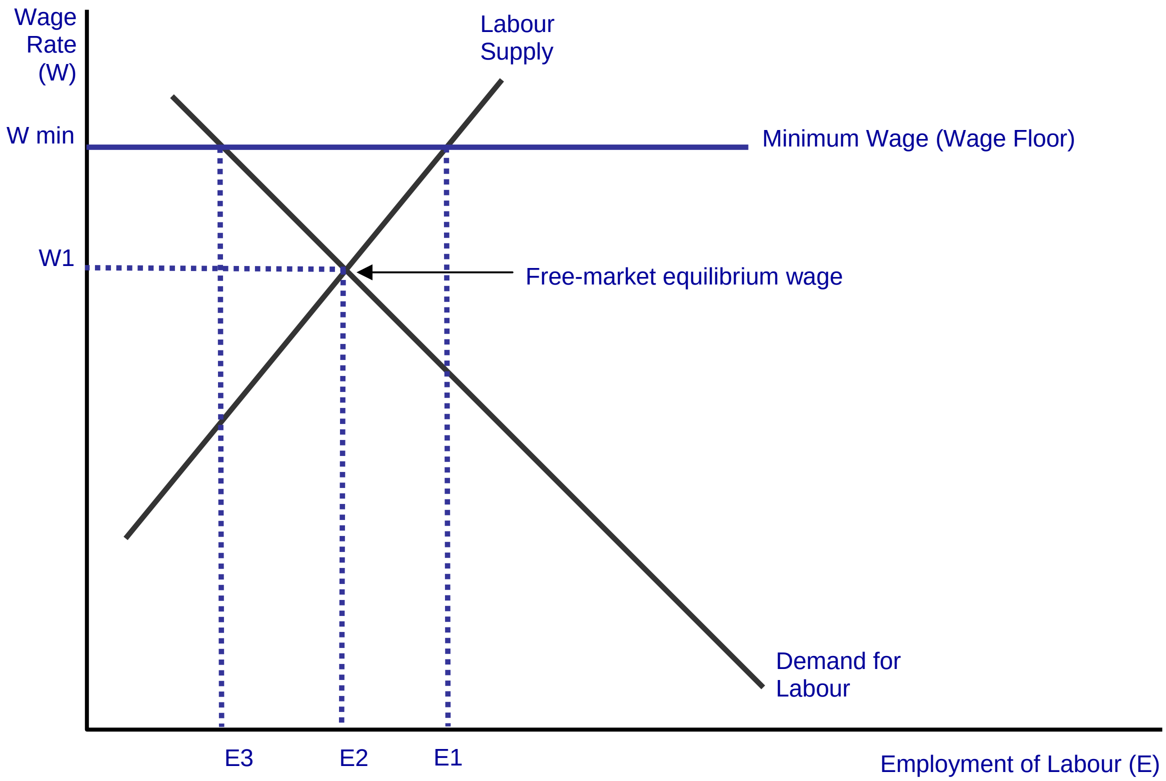
# Revision Focus on the Economics of the National Minimum Wage

The **national minimum wage** was introduced into the UK in 1999. It is an intervention in the labour market designed to increase the pay of lower-paid workers and thereby influence the distribution of income in society.

**The main aims of the minimum wage**

1. **The equity justification**: That every job should offer a fair rate of pay commensurate with the skills and experience of an employee and that a "fair rate of pay" should prevent poverty wages being paid
2. **Labour market incentives**: The NMW is designed to improve the incentives for people currently outside the active workforce to start looking for work – thereby boosting the economy's available labour supply. Encouraging people to search for work may help to reduce dependency on state welfare payments and therefore cut the cost of the welfare state to the government, allowing more money to be spent on public and merit goods.
3. **Labour market discrimination**: The NMW is a tool designed to offset some of the effects of persistent labour market discrimination, for example in the treatment(possible exploitation) of many low-paid female workers and younger employees. The minimum wage might be seen as a counter-weight to the **monopsony power** of employers in certain industries.

**How does a minimum wage work?**
The minimum wage is a **price floor** – employers cannot legally undercut the current minimum wage rate per hour. This applies both to full-time and part-time workers. Labour supply and demand curve analysis can be used to show the effects.




**Possible disadvantages of a minimum wage**

Although all political parties are now committed to keeping the minimum wage, there are still plenty of economists who believe that setting a pay floor represents a distortion to the way the labour market works because it reduces the flexibility of the labour market

> **Competitiveness and Jobs:** Firstly a minimum wage may cost jobs in some industries because a rise in labour costs makes it more expensive to employ people and higher labour costs might damage the international competitiveness of British producers. To the extent that rising unemployment worsens the living standards of those affected it has a negative impact on poverty.
>
> **Effect on relative poverty:** Is the minimum wage the most effective policy to reduce relative poverty? There is evidence that it tends to boost the incomes of middle-income households where more than one household member is already in work whereas the greatest risk of relative poverty is among the unemployed, elderly and single parent families where the parent is not employed. Other policies might be better to target financial help on the nation's poorest households.

**Can a minimum wage actually increase employment?**

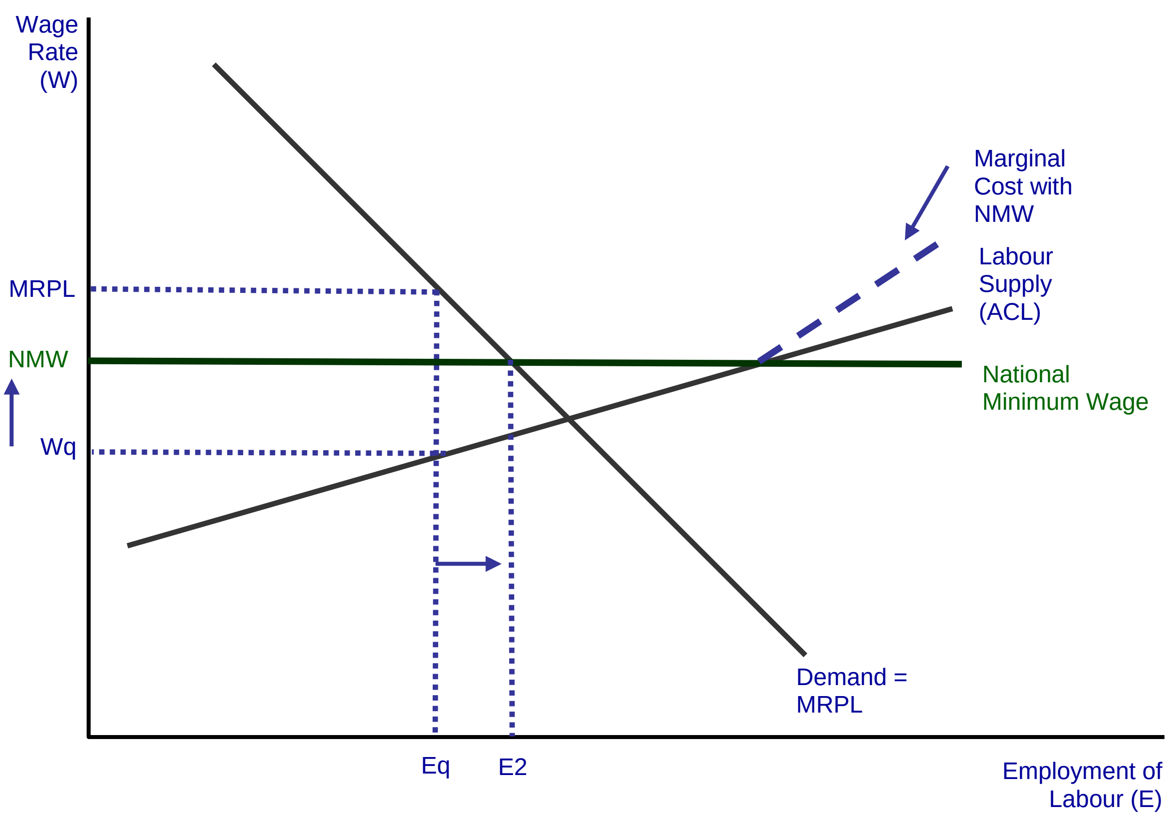
The answer is yes – depending on the circumstances in the labour market when a pay floor is introduced and also on what happens to the productivity of labour when a high (statutory) rate of pay is introduced

There are three main explanations for the possibility of higher employment

1. The **Keynesian argument** that higher wage rates will increase the real disposable incomes of lower-paid workers many of whom have a **high marginal propensity to consume**. Thus they will increase their own spending and this will feed through the circular flow of income and spending
2. The **efficiency wage argument** that raising pay levels for low-paid employees may have a positive effect on their productivity and efficiency. In addition to the psychological benefits of being paid more, businesses may take steps to improve production processes, workplace training etc if they know that they must pay at least the statutory pay floor.
3. The **monopsony argument** – when there is a powerful monopsony employer in the labour market, it is possible to show that imposing a wage floor above the wage rate that a monopsonist might offer can actually raise the equilibrium level of employment. This is shown in the next diagram

Because the minimum wage is a pay floor, the monopsonist cannot pay a wage below it, so the NMW effectively becomes the marginal and average cost curve for hiring workers up to employment level Emin. Thereafter to hire additional staff, the wage rate must be bid up, again creating a divergence between the average and marginal cost of labour.

The effect on the diagram is that with an appropriately set rate, the profit maximising level of employment after a minimum wage is higher (E2) and the wage rate paid to labour has also increased (W2). So in this particular example, a minimum wage might actually boost total employment and secure higher factor incomes for workers in occupations and industries where there is some monopsonistic power among the buyers of labour.




**Evidence on the minimum wage – has it worked?**

1. **Employment:** Since the minimum wage was introduced, unemployment has continued to fall and the level of employment in the British economy is now at a record high. It should be remembered that the National Minimum Wage was introduced in a tight labour market, with employment rising

and unemployment falling. The true test of a pay floor is probably when the economy experiences recession.

   a. The sectors most directly affected by the minimum wage are in hospitality, leisure, textiles and social care. Even here, the employment effects are small – and they might easily be explained by changes in competition (e.g. from overseas) and from the effects of technological change on labour demand

2. **Inflation:** There have been negligible adverse effects on wage and price inflation. Other factors affecting inflationary pressure have been broadly favourable for the UK in recent years. In many sectors firms find it hard to pass on higher wage costs to final consumers – again limiting the inflationary effect of the minimum wage
3. **Compliance:** From being a controversial policy in the late 1990s, the minimum wage is now accepted by all of the main political parties and by business organisations – it was introduced smoothly and has been up-rated on several occasions
4. **Wage costs:** The minimum wage affects only a small proportion of workers and the effects on the total wage bills of most businesses is not a significant factor in their employment decisions. In the short term, the demand for labour tends to be inelastic with respect to changes in wages
5. **Discrimination:** The minimum wage has had a significant impact on the gender pay gap at the bottom of the earnings distribution – especially the earnings of part-time female workers. The government has announced that a minimum wage for youth workers will be introduced in October 2004.
6. **Productivity:** It is hard to identify any strong positive effect on labour productivity - but productivity gains have been made in most low-paying industries, a trend which started before the minimum wage was introduced. Higher productivity can come from increased capital investment spending and also the competitive pressures within domestic and international markets