Economics of a Minimum Wage

Figure 3.2: Number and Proportion of Minimum Wage Jobs, by Low-paying Industry, UK, 2009

- Hairdressing: 20,000 (21%)
- Food processing: 19,000 (20%)
- Agriculture: 6,000 (6%)
- Textiles: 6,000 (6%)
- Security: 5,000 (5%)
- Leisure: 31,000 (33%)
- Cleaning: 54,000 (57%)
- Social care: 60,000 (62%)
- Retail: 194,000 (20%)
- Hospitality: 205,000 (22%)
- Non low-paying industries: 236,000 (25%)

- 20 cities in 19 countries
- 500 partners and 2,000 qualified lawyers
- 60% based outside the UK
- Now second largest law firm in the UK
### Industry/Occupation

<table>
<thead>
<tr>
<th>Industry/Occupation</th>
<th>April 2007</th>
<th>April 2008</th>
<th>April 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% Paid at £5.35</td>
<td>% Paid below £5.35</td>
<td>% Paid at £5.52</td>
</tr>
<tr>
<td>Retail</td>
<td>7.0</td>
<td>4.5</td>
<td>6.5</td>
</tr>
<tr>
<td>Hospitality</td>
<td>16.4</td>
<td>13.2</td>
<td>16.4</td>
</tr>
<tr>
<td>Leisure</td>
<td>6.1</td>
<td>6.8</td>
<td>5.1</td>
</tr>
<tr>
<td>Cleaning</td>
<td>19.2</td>
<td>2.9</td>
<td>22.2</td>
</tr>
<tr>
<td>Security</td>
<td>3.3</td>
<td>1.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Social care</td>
<td>4.1</td>
<td>2.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2.6</td>
<td>3.0</td>
<td>3.9</td>
</tr>
<tr>
<td>Textiles and clothing</td>
<td>7.7</td>
<td>2.6</td>
<td>6.0</td>
</tr>
<tr>
<td>Hairdressing</td>
<td>8.2</td>
<td>17.5</td>
<td>9.0</td>
</tr>
<tr>
<td>Food processing</td>
<td>3.9</td>
<td>0.5</td>
<td>4.3</td>
</tr>
<tr>
<td>Office work⁹</td>
<td>3.2</td>
<td>2.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Childcare⁹</td>
<td>3.8</td>
<td>7.5</td>
<td>4.5</td>
</tr>
<tr>
<td>All low-paying industries</td>
<td>8.2</td>
<td>5.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Whole economy</td>
<td>2.8</td>
<td>2.3</td>
<td>2.8</td>
</tr>
</tbody>
</table>

1/ What is a minimum wage?

A minimum wage is, legally, the lowest amount of money a worker can be paid in order for him/her to sell their own labour to an organisation or firm, and is calculated on an hourly basis. It is a price floor below which the market price may not fall and to be effective has to be set above the equilibrium price. These are the current NMW rates per hour:

- **£5.93 is the main rate for workers over the age of 21**
- **£4.92 is the rate for 18-20 year old workers**
- **£3.64 is the rate for workers of 16 and 17 (that have left school)**
- **£2.50 is the rate for apprentices.**

Some people still illegally receive pay rates under the minimum wage, and they are advised to contact a government help line in this case. Illegal immigrants are unlikely to report such a problem with the fear of being thrown out of the country, and subsequently live in poorer conditions with even less pay.

Restaurants have been accused of getting around the pay floor by **abusing the tip system**. Tips given electronically are pooled together and distributed, but do not, in some cases count as a bonus. So someone can be paid less than the minimum wage, but pooled tips are then redistributed, topping up these wages. The legality of this is questionable and the [law on this use of tipping has now changed](https://www.gov.uk/government/publications/multi-user-tip-pot-laws).  

However, not all countries are followers of the minimum wage concept. Scandinavian countries instead have encouraged **collective bargaining**, where trade unions **negotiate** with the businesses
they work for to figure out, amongst many things, the minimum wage they should be paid per hour, rather than having legislative action to pass a national minimum wage.

Trade Union membership in the UK is lower than in many European countries. In 2009 less than one worker in three was a member of a trade union. The collective bargaining power of many groups in low-paid jobs is weak.

Comparison of Minimum Wage Levels, by Country, 2009

<table>
<thead>
<tr>
<th>Country</th>
<th>In national currency expressed as hourly rate</th>
<th>In UK £, using:</th>
<th>Age full minimum wage usually applies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Exchange rates</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>AU$14.31</td>
<td>7.55</td>
<td>21</td>
</tr>
<tr>
<td>Belgium</td>
<td>€8.41</td>
<td>7.50</td>
<td>21</td>
</tr>
<tr>
<td>Canada</td>
<td>C$9.08</td>
<td>5.14</td>
<td>16</td>
</tr>
<tr>
<td>France</td>
<td>€8.82</td>
<td>7.87</td>
<td>18</td>
</tr>
<tr>
<td>Greece</td>
<td>€4.13</td>
<td>3.68</td>
<td>15</td>
</tr>
<tr>
<td>Ireland</td>
<td>€8.65</td>
<td>7.71</td>
<td>20</td>
</tr>
<tr>
<td>Japan</td>
<td>JPY713</td>
<td>4.78</td>
<td>15/18</td>
</tr>
<tr>
<td>Netherlands</td>
<td>€8.07</td>
<td>7.20</td>
<td>23</td>
</tr>
<tr>
<td>New Zealand</td>
<td>NZ$12.50</td>
<td>5.38</td>
<td>16</td>
</tr>
<tr>
<td>Portugal</td>
<td>€2.59</td>
<td>2.31</td>
<td>16</td>
</tr>
<tr>
<td>Spain</td>
<td>€4.89</td>
<td>4.36</td>
<td>16</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>£5.80</td>
<td>5.80</td>
<td>22</td>
</tr>
<tr>
<td>United States</td>
<td>US$7.25</td>
<td>4.44</td>
<td>20</td>
</tr>
</tbody>
</table>

Source: British Embassies, High Commissions and OECD Minimum Wage Database.

2/ When was the minimum wage introduced into the UK and what has happened to the minimum wage rate since then?

- The minimum wage was originally introduced to prevent sweat-shop industries, where manufacturers (including women and children) were being paid close to nothing, in dreadful factory conditions, for extensive hours every day. It was introduced so that these big industrial owners could treat workers fairly.
- The minimum wage was introduced in the UK in 1999 by the new Labour government
- It has been increased each year based on recommendations from the Low Pay Commission
- In October this year (2010), the minimum wage rose from £5.80 per hour to £5.93 and the main rate income age requirement was lowered from 22 to 21.

3/ The possibility of an International Minimum Wage?

Unemployment insurance, minimum wages and social programs are examples of stabilising factors in an economy. When a recession causes people to become unemployed or forced to receive less pay, they will no longer be able to consume as many goods and services as before, this generates
predictable cycles of recessions followed by recoveries. This is why these stabilising factors such as the enforcement of a minimum wage serve to prevent the cyclical degradation of the economy. Countries that make use of these strategies often have periods of slower, but steadier long term growth.

The concept of embracing the new idea of a ‘minimum standard of living’ to calculate a fair wage for each country based on the purchasing power parity (PPP) index sounds like a viable alternative. However, global average income is approximately $5300, which works out to be a global minimum wage of just $0.69/hour. These figures highlight the magnitude of global income disparities, so the idea of shifting to a minimum standard of living could disadvantage local companies in poorer countries who, unlike huge multinational companies, do not have the ability to pay wages higher than the $0.69 rate, and the domestic markets that they supply would not be able to accommodate the extra costs associated with a global scheme to improve living standards.

So without a united global economy, it would be a disaster to try and set a global minimum wage rate. Primarily because although the movement of goods and services is relatively free, the movement of labour is severely restricted due to political reasons and immigration laws. Instead of workers going to where the best paid jobs are, the jobs go to where the worst paid workers live. An alternative would be to monitor and regulate multinational companies more effectively and as they are not restricted geographically, they can afford to carry out practices in a foreign country that would be considered illegal in their home territory.

Minimum wages have been regulated around the world, but the standards have differed considerably. Minimum wages are set higher in industrial countries, but in third world countries where the labour force is often exploited and treated unfairly, they are not enforced at all.

4/ Build an economic and social case for having a minimum wage in an economy

Arguments for the minimum wage:

1) **Better standard of living** for those in the poorest paid jobs. The minimum wage ultimately reduces poverty nationally and provides a reliable and steady source of income for many, and without it, the social consequences would be far greater than if it were not to exist. (See point 4.)

2) **Higher tax revenue** as workers’ income increases, more people will pay taxes (as their income is above the £6,500 requirement to pay taxes), and NIC’s will also increase because of the rise in income.

3) **There is a greater incentive to work**, as citizens are less likely to fall into the unemployment trap, where it is less beneficial to work, as they can just claim welfare benefits. A minimum wage increases the gap between the total amount one can claim on benefits, and if they are in full-time or part-time employment. It will reduce unemployment in the long run, increasing the size of the economically active population.

Furthermore an increase in minimum wage could promote efficiency amongst workers. Higher wages could incentivize workers, as they may feel their work is more valuable. This could manifest itself through a decrease in absenteeism for example.
(4) **Reduces social deprivation and crime.** Minimum wages can be seen as a necessary evil - yes, it may be costly to firms; but the alternative is far worse. If there was no minimum wage, many would receive incomes that are insufficient to meet their most basic needs - accommodation and food and a rise in poverty-relate crime and social deprivation would be unavoidable.

(5) **Equity justification** - this issue revolves around a view that there should be a **fair rate of pay** and that it protects against unfair treatment and exploitation. What is fair / equitable involves making a **value judgement**. Supporters of a **living wage** argue that the current UK pay floor is too low and needs to be reformed.

(6) **Could lead to an increase in productivity**. If firms are forced to pay a higher wage to their employees, they will want get their money’s worth and to do this they may invest further in their capital or in training of employees. Some economists believe in the idea of **efficiency wages** where the performance of a worker is directly linked to their pay. Offering a decent wage provides an incentive for people in work to improve their performance and it nudges employers into ensuring that proper training is provided.

(7) **Benefits workers with families**. If a minimum wage is not in place employers will hire whosoever will work for least. This will benefit immigrants but would be a serious issue for older workers who need their job in order to support their families. Thus those workers who need their income most dearly will be punished.

(8) **Labour market discrimination**. - a pay floor may help to compensate for the effects of discrimination of low-paid female workers and young employees. Most of the worst-paid jobs are clustered in industries dominated by female and/or younger workers who have little or no trade union protection. For some evidence on the gender pay gap [use this link](#).

(9) **Reduced government spending on transfer payments**. If workers are being paid more per hour then they will be able to meet pay for their basic needs on their own, without the need for government to give them “top-up” welfare benefits.

(10) **The Keynesian argument for minimum wages** - this suggests that lower-income workers have a high propensity to consume, and that with the extra disposable income from minimum wage, they will spend a high portion the sum which will be injected back into the circular flow of income. In regions and localities where average incomes are low, a higher minimum pay rate can boost total demand for goods and services and create a positive multiplier effect - but much depends on the effect of a pay floor on how many people remain in work.

5/ **Identify and discuss some of the economic risks and disadvantages from having a national minimum wage**

**Argument against the minimum wage:**

(1) **A distortion to the free market:** Minimum wages are a **barrier to the free market**. If the minimum wage is set above the market clearing price, it will result in rising unemployment. Some firms will judge the opportunity cost of hiring an extra employee too high and this may prevent some workers from finding jobs who otherwise would normally find it. In a totally free market, they may be willing to accept lower wages.
However, even if the artificial barrier were not present, the action of trade unions would greatly limit the wage reduction that workers would tolerate. Rather than have the entirety of the workers in a union take a pay cut, it is more likely that some will be fired and the rest will continue work at the same wage rate. This means that even in a free market, the offer of lower wages can result in unemployment due to the effect of sticky wages.

Equally, in some cases, when wages drop too low, people are willing to forgo employment. This is because the benefits of being employed are hardly greater than the unemployment benefits they would receive otherwise. This is known as the unemployment trap and its result is that even in a free market, if the equilibrium price is too low, unemployment will rise.

For the two aforementioned reasons it is impossible to say that the imposition of a minimum wage will definitely cause higher unemployment than if wages were left to the invisible hand of the free market.

(2) **Shadow labour markets may develop**: Since minimum price is set above market clearing prices shadow markets are likely to develop. This is because at the minimum price there is a surplus of labour. Since more people are willing to work at the minimum price than employers are willing to hire, it is likely that workers will try to sell their services at illegally low prices. These workers are often, especially in America, illegal immigrants who are hired in favour of tax paying citizens. This will cause a decrease in tax revenue as more workers are not reporting their incomes, and an increase in the amount of unemployment benefits the government will have to pay out. The minimum wage benefits those who are employed at it and disadvantages those who loose out on potential employment because of employers hiring from a shadow labour market.

The effect of minimum wages on unemployment will depend on the elasticity of demand for labour. If the demand for labour is inelastic, the introduction of minimum wages will only increase unemployment a little. Job losses may simply be due to the increase in labour cost which would result in a lower demand for labour.

(5) **A pay floor and business costs**: Higher wages can increase the costs of a product. This reduces companies’ profits, leaving them with less incentive to supply. This can cause a contraction of AS, causing an inward shift of the short run curve. The lack of profitability will push investors and foreign influences elsewhere and thus reduce our competitiveness.

(6) **Effect on relative poverty** - Minimum wage has a limited effect in reducing poverty as those in the poorest sections of society, who tend to be those receiving Jobseeker’s Allowance and incapacity benefits, do not benefit from it.

(7) **Risk of inflation** - labour is a factor of production and an increase in the average cost of labour will push up the unit cost of products at the risk of causing inflation. This cost will then be absorbed by firms or more likely be passed on to consumers in the form of higher prices. This is an example of cost-push inflation.

**6/ Some groups are campaigning for a minimum wage to be replaced by a living wage. How strong do you think is the case for a living wage in the UK economy at the moment?**

The living wage is a replacement to the minimum wage, in that it is a measurement of the minimum
amount of money a worker needs to earn hourly in order to provide his/her family with the essential items of living a safe secure life for a prolonged period of time, such as water, food, electricity, shelter, etc.. The campaign for a living wage mainly stems from the fact that the minimum wage can fail to meet its objectives of reducing poverty and unemployment. The ‘Living Wage Campaign’ by Citizens UK has advocated a living wage rate of £7.85 an hour, a considerable increase from the current minimum wage (although part of this can easily be accounted for in the higher cost of living that occurs in London).

David Cameron, upon being elected to Prime Minister in May 2010, declared that the living wage was ‘an idea whose time had come.’ Certainly the macro-economy would receive a boost from the recession as a nationwide adoption of the living wage would result in an increase in disposable incomes and (depending on the marginal propensity to consume) an increase in consumer expenditure which would push up aggregate demand and lead to much-needed growth in the economy.

The UK labour market has a high proportion of workers below the low pay threshold (approx. 5.3 million - just over 20%) which is one of the highest in Europe and a clear indicator of severe wage inequality. And the amount owed by households to banks has tripled in the last ten years, highlighting a need for a living wage as the difference between disposable income and the cost of household essentials becomes an ever larger barrier, more difficult to be crossed as time goes on. A living wage would reduce the high levels of debt and have an impact on many deep-rooted social issues.

However, the increase from a minimum wage to a living wage might put a drain on the government’s finances and make the budget deficit even higher in the short run. The gap between revenue and spending is already more than 10 per cent of GDP.
Suggestions for wider reading

- Low Pay Commission http://www.lowpay.gov.uk/
- TUC campaign for a living wage: http://www.tuc.org.uk/economy/tuc-18491-f0.cfm
- Call for UK minimum wage to be increased: http://moneyfacts.co.uk/news/money/call-for-minimum-wage-to-be-increased/
- Living costs are higher in remote areas of the UK: http://www.bbc.co.uk/news/business-11812384

Suggestions for stronger evaluation arguments
There is plenty of good material in this collaborative essay - here are some suggestions for improving evaluation:

1. The national minimum wage on its own is insufficient to reduce poverty and improve work incentives - other policies may be needed such as investment in training and reforms to the welfare system
2. Always try to support your answers with evidence! Look to see if there are reports about the actual impact on prices, jobs and relative poverty.
3. Ireland has just opted to reduce the minimum wage in response to their financial crisis. The UK minimum wage has never been reduced - should there be more flexibility at different stages of the economic cycle?
4. As always in evaluation focus some of your comments on efficiency, effectiveness and equity issues - they are all relevant here!