

Should we abolish the minimum wage?

Introduction

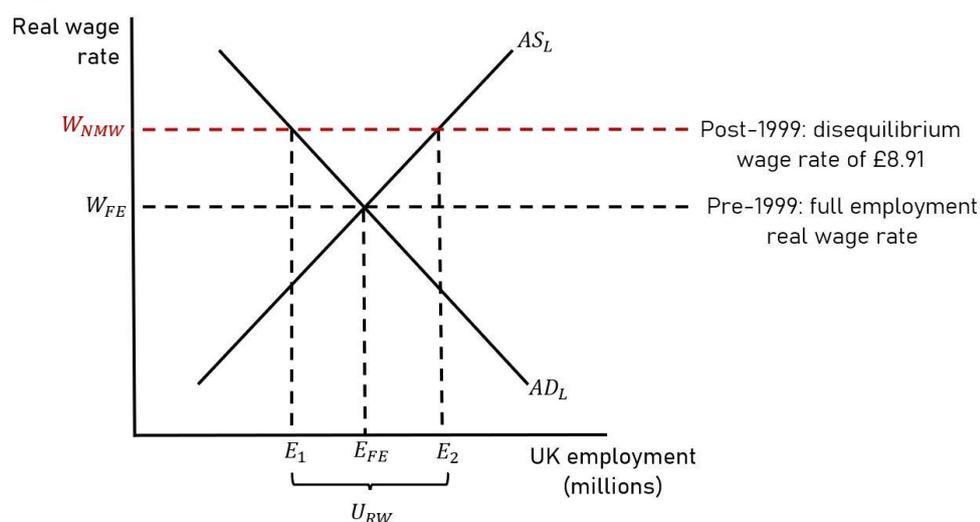
The national minimum wage (NMW), a price floor that sets the lowest remuneration an employer must legally pay employees, is a contentious debate, popularised by numerous empirical studies. The purpose of the UK's 1998 National Minimum Wage Act was to reduce poverty but classical economic thought, contextualised by such studies, makes a strong case for reducing the NMW to maximise societal welfare.¹

By distorting labour markets, the NMW has differing effects on economic agents in the economy, each acting to maximise their own stakeholder objectives. For this reason, this essay will seek to interpret the evidence from the perspective of the government, who controls the NMW and enacts public policy to maximise net economic welfare on the aggregate scale. The impact of abolishing the NMW, therefore, can be analysed within the context of the following three closely-linked macroeconomic objectives crucial to labour market regulation: reducing unemployment; alleviating poverty and exploitation of workers; and reducing income inequality.

Unemployment

According to free market economist Milton Friedman, the primary benefit of abolishing the NMW would be a reduction in unemployment.² The effect of a NMW, currently at £8.91 for ages 23 and over, is to create real-wage unemployment.³ In competitive labour markets, the market wage must equal, for rational firms, the marginal product of labour and, for the labour force, the highest reservation wage of workers. Before April 1999, assuming no market

Figure 1



¹ Due to the quantity of considerations and variations across labour markets, this essay will focus primarily on the UK's NMW policy, although data from the US (where much of prevailing research has been conducted) will be considered.

² (Friedman, 1966)

³ (The Department for Business, Energy and Industrial Strategy, n.d.)

imperfections persisted, wages adjusted to clear labour markets achieving an equilibrium depicted at $W_{FE}E_{FE}$ in Figure 1.⁴ Now, in markets with a full-employment equilibrium wage rate W_{FE} below £8.91, the NMW becomes binding. Labour is more expensive but not necessarily more productive; were higher wages to incentivise increased productivity beyond the cost of the increase, firms would voluntarily raise wages. Instead, at this fixed rate, employers wish to hire E_1 workers but E_2 workers wish to supply their labour, creating an excess supply (unemployment U_{RW}) of $E_2 - E_1$.

In 1976, a survey by the American Economic Association revealed that 90% of its members agreed that raising minimum wages decreases employment for less-skilled workers.⁵ This consensus is widespread: roughly 3/4 of the published research highlights such job loss.⁶ In fact, the values of U_{RW} in different economies can be quantified: the Congressional Budget Office (CBO) concluded that a \$15 federal minimum wage would “cost 1.4 million jobs and increase the deficit by \$54bn.”⁷ Furthermore, in 2018, research by LSE and the University of California found that a “10% increase in the minimum wage” considerably decreased the “share of automatable jobs done by low-skilled workers,” accelerating the trend towards automation.⁸ It follows that abolishing the NMW would remove this disequilibrium, allowing competitive forces to bid down the market wage to W_{FE} helping to reduce the UK’s 4.8% unemployment rate.

Revisionist empirical studies, however, have disputed this view. A 2010 study across 316 county borders by economist Arin Dube found “no negative employment effects” after an increase in the NMW.⁹ Until recently, much of the research had focused on specific subgroups and cities or used proxies. Others lack hours data so when firms responded to a NMW by reducing working hours instead of laying off workers it becomes “a reaction that is invisible in most data sets.”¹⁰ These factors exaggerate the overall unemployment created. Furthermore, a NMW incentivises increased participation in the labour force by amplifying the divergence between benefits and employment income. This shifts the active jobseeker’ curve right (shown in Figure 2) from AJ_1 to AJ_2 , decreasing the natural rate of unemployment from U_{NR1} to U_{NR2} . Evidently, there is a case against increasing the NMW further, but the effect on total unemployment since 1999 has been negligible (shown in Figure 3). Consequently, the employment gains from abolishing the NMW would be minimal compared to the income loss.

⁴ All diagrams were constructed by me in Microsoft Word based of diagrams depicted in (Powell & Powell, 2019) with data applied obtained from the relevant sources cited

⁵ (The Flexibility of Wages and Prices, 1976)

⁶ (Vigdor, Freakonomics: The True Story of the Minimum-Wage Fight (Ep. 460), 2021)

⁷ (Congressional Budget Office, 2021)

⁸ (Lordan, 2018)

⁹ (Arindrajit Dube, 2010)

¹⁰Quote by Jacob Vigdor (Vigdor, Freakonomics: The True Story of the Minimum-Wage Fight (Ep. 460), 2021)

Figure 2

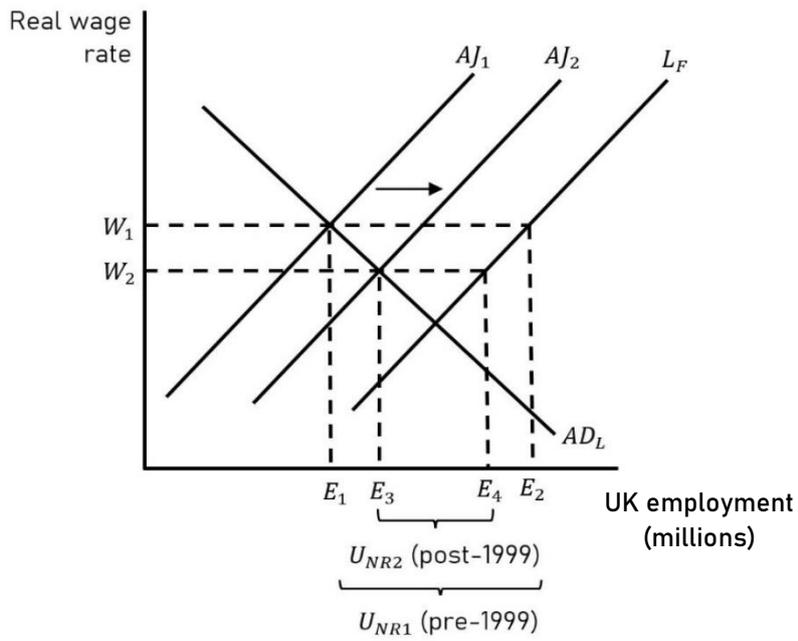
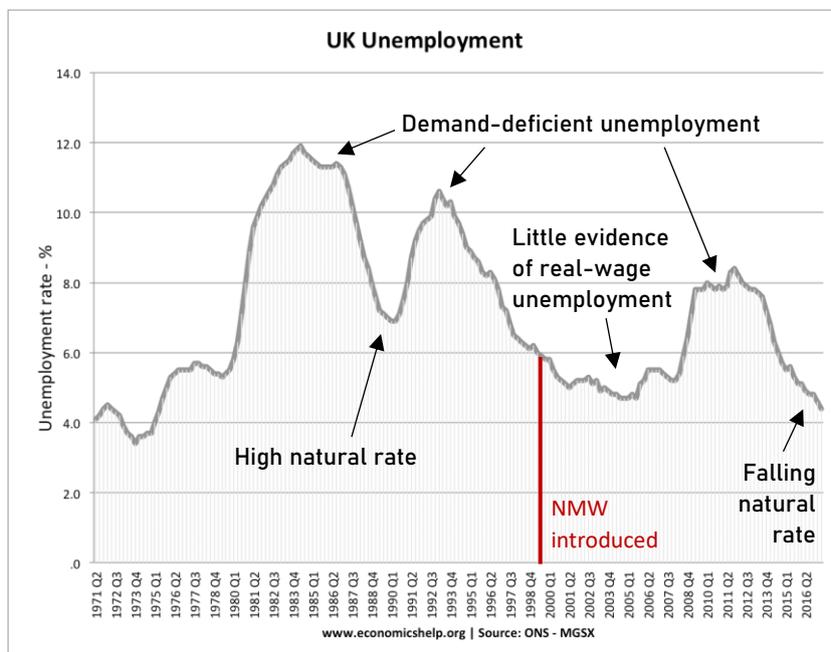


Figure 3



Poverty and exploitation of workers

In light of the economic hardship imposed on the working class by COVID 19, there is a strong moral case for maintaining the NMW to prevent widespread poverty. In 2019, 7% of UK workers were on the NMW, many of whom made up the 8.4% of the UK labour force who work in hospitality or tourism sectors.¹¹ The NMW ensures that the lowest paid in society possess sufficient real disposable income to purchase material comfort and increase their living standards. To illustrate, the CBO also concluded that a \$15 minimum wage would lift 900,000 families out of poverty, increasing the incomes of 16.5 million low-wage workers in the US.¹² Furthermore, this creates a 'ripple effect' in internal wage structures whereby firms increase the wages of those just above the minimum wage to preserve premiums enjoyed by more experienced workers. Therefore, abruptly abolishing the NMW, which has pertained for 22 years, would likely lead to industrial action in protest of this exploitation of labour and perceived unfairness of the 'inhumanly low' market wages.

Moreover, markets are not perfectly competitive. The presence of market imperfections warrant the NMW as a means of preventing worker exploitation in employer-dominated labour markets. The economic consensus on a NMW was originally overturned in a paper by Alen Krueger and David Card in 1994, in which they found that a new minimum wage in New

¹¹ (Francis-Devine, 2021)

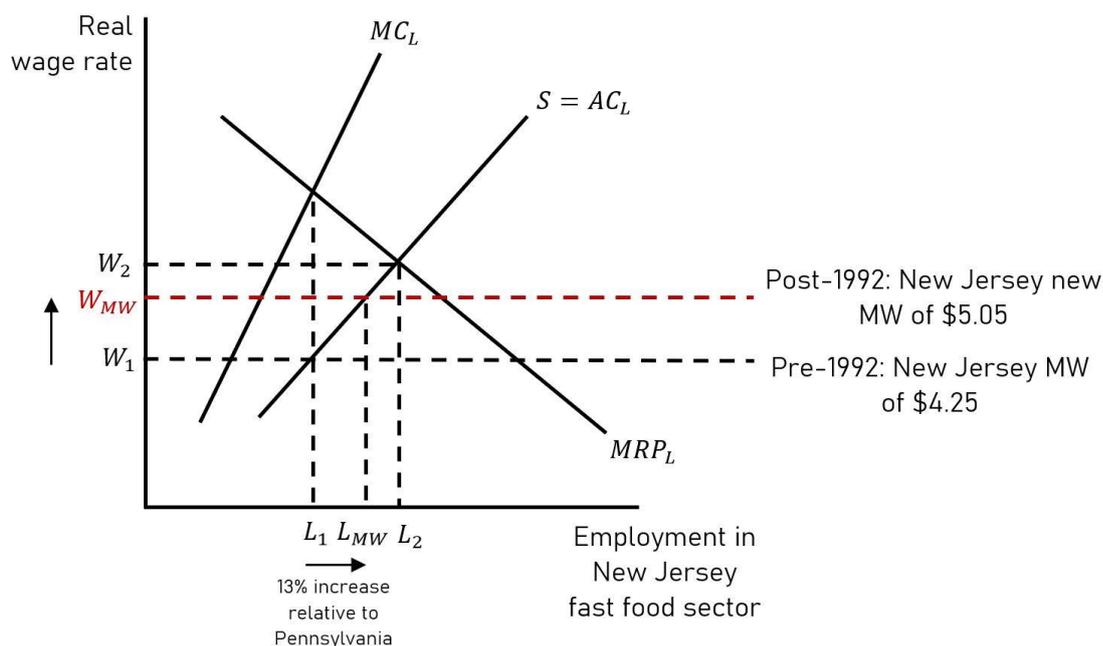
¹² (Congressional Budget Office, 2021)

Jersey increased earnings of low-income workers, compared to neighbouring Pennsylvania, without reducing employment.¹³

The theory of monopsonies, first introduced in Joan Robinson's 1933 classic *The Economics of Imperfect Competition*, explains this contradiction.¹⁴ Here, fast food chains set wages to maximise revenue by hiring at the point where marginal revenue of product (MRP_L) equals the marginal cost of labour (MC_L) at employment L_1 (shown in Figure 4). A monopsony, however, cannot hire as many workers as desired at a constant wage; employing more workers means they must increase wages both for marginal workers and all workers, meaning the market supply curve of labour (S) equals the firm's average cost of labour (AC_L). Taking the wage of the AC_L curve, monopsony labour market outcomes prevail at wage W_1 and employment L_1 , differing from the competitive labour market outcomes W_2 and L_2 ; monopsonies exploit workers by offering wages much lower than their marginal revenue of product, under-employing at L_1 compared to competitive levels. Therefore, when wages were increased to \$5.05 per hour, this imperfect outcome was partly solved with employment increasing by 13% to more competitive levels (L_{MW}). In the absence of trade union power, the MNW is an effective tool to prevent such exploitation.

¹³ (Card & Krueger, 1994)

¹⁴ (Robinson, 1933)

Figure 4

With regards to long-term deprivation, the NMW can cause significant youth unemployment leading to hysteresis. Less experienced workers, aged 18-25, are disproportionately harmed, often being the first victims of real-wage unemployment. By analysing Washington state data, economist Jacob Vidger found that the 2014 increase in Seattle's minimum wage led employers to treat teenagers as greater "risks:" they are perceived as less reliable employees, thus are shunned when labour costs increase.¹⁵ The reduction of entry-level jobs needed to gain traction in the labour market has long-run adverse implications on the human capital accumulation. These workers cannot obtain the skills or experience necessary to become employable, instead becoming structurally unemployed. Many receive income support despite preferring to work. In their 2014 briefing for the Institute of Economic Affairs, Ryan Bourne and J.R Shackleton argued that this effect has materialised in the UK where the 18-24-year-old unemployment rate has risen from 11.5% in April 1999 to 17.9%. Alarmingly, for those unemployed in this age group "the proportion out of work for more than 12 months has risen, from 14.4% in 1999 to 31.8% in 2013."¹⁶ This is strong evidence to remove the NMW, particularly following the plight of these workers during the COVID pandemic, ¼ of whom have been furloughed or lost employment.¹⁷

To evaluate this trade-off, the prevalence of monopsonies in the UK should be considered. As George Stigler noted in 1946, the monopsony model has bounded relevance to the NMW as the competitive wage required varies considerably from industry to industry.¹⁸ Furthermore,

¹⁵ (Vidger, et al., 2017)

¹⁶ (Bourne & Shackleton, 2014)

¹⁷ (Gustafsson, 2020)

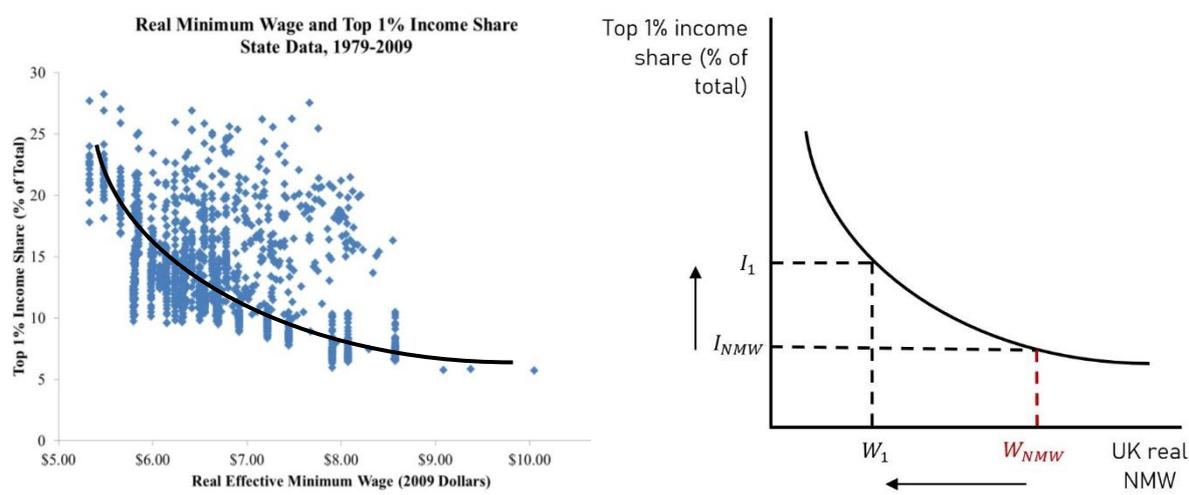
¹⁸ (Stigler, 1946)

monopsony power in the UK is concentrated in the public sector where the government controls the pay policy regardless of the NMW. Much akin to the unemployment outcomes, therefore, the relatively radical policy of abolishing of the NMW should not be undertaken in order to support those on the lowest incomes in society but likewise rapid increases would be detrimental to long-term prosperity rates.

Income inequality

An important rationale behind the NMW was to reduce income inequalities. Accordingly, the net effect of removing the NMW should be considered with regards to the distribution of income not just poverty itself. The NMW is used as a vehicle for redistributing a portion of firm profits to its workers at the bottom of the wage distribution. Although a value judgement is required, “disproportionate COVID 19 burden as well as intensive financial hardship,” have sharply focussed public opinion on the rising global Gini Index.¹⁹ For a more equitable distribution of income to prevail, it seems that removing this policy, which benefits low-wage workers at the expense of executive pay, would be a public policy blunder. In fact, the UK’s distribution of pay has compressed as the NMW has risen since 1999. As made evident by research from Liam Malloy of the University of Rhode Island (shown in Figure 5), a reduction in the NMW could cause the percentage of income received by the top 1% to increase.²⁰ Were the NMW to be abolished to increase long-term employment prospects, it could create a macroeconomic policy conflict with the objective of reducing inequality.

Figure 5



Source: Frank (2009), U.S. Department of Labor

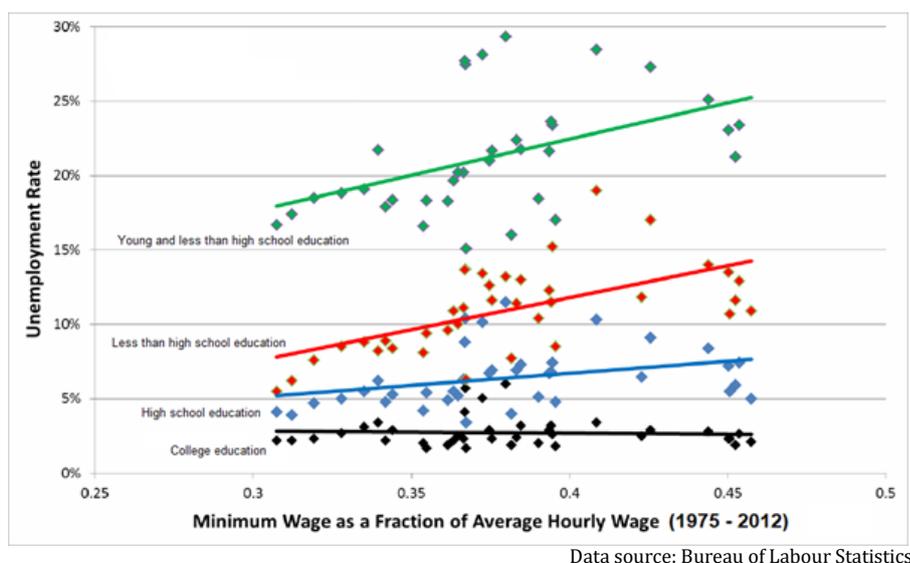
This depends on the extent to which the NMW is the most effective policy for reducing inequality. Economist David Neumark, who is renowned for his extensive research on the issue,

¹⁹ Quote taken from an article by The Health Foundation (The Health Foundation, 2020)

²⁰ (Malloy, 2016)

contends that the NMW is a target inefficient method compared to directly subsidising household incomes (for instance through tax credits).²¹ There are two reasons for this. Firstly, the reality is that the NMW disadvantages not only young workers but also the most marginalised workers and those with lower educational qualifications (shown in Figure 6). When a firm's costs rise, less-skilled or educated employees, with lower productivity levels, are made redundant first. Another unintended consequence is cost-push inflation which disproportionately harms low-income consumers. Secondly, there is not a direct link between

Figure 6



household poverty and working on the NMW. Many teenagers who work on the NMW originate from middle-class households with incomes well above the poverty line. Moreover, it is a “blunt instrument” according to Neumark where “more than half of poor families have zero workers” participating in labour markets.²² Quite simply, there are more efficient alternatives to be employed, were the NMW to be removed.

Conclusion

“Poverty is a circumstance, not a value judgement,” observed journalist Darlena. If this is to be believed then it is less the normative pervasion of NMW policy that has produced such diverse responses amongst the economic literature, but the research methodology applied to grapple with the institutional variations and labour market conditions specific to individual regions. Yet, as shown, cost-benefit analysis can be applied to the UK and put into perspective by recent trends. Firstly, evidence suggests that there are considerable societal costs to excessively raising the NMW but these have not transpired to a great extent in the UK. Thus, attempting to reverse such effects by abolishing the NMW would yield little employment or welfare gains.

²¹ (Neumark & Wascher, Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research, 2006)

²² (Neumark, 2021)

Secondly, going forward, given that 55% of jobs that do not require college degrees are at risk of being automated, there is serious cause for concern were the NMW to be raised.²³ Here wages should be increased by enhancing the value of labour through education and experience, which a NMW hinders, to improve employability prospects and occupational mobility of labour in the age of automation. Thirdly, given the impact of COVID 19 on poverty and inequality, the NMW should remain in order to provide security for current low-income workers. Overall, the NMW at its current level should not be abolished, but instead the real NMW should be allowed to gradually decline as the government deploys more efficient welfare policies where extreme poverty persists.

²³ (Chang & Huynh, 2017)

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Henry Young

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