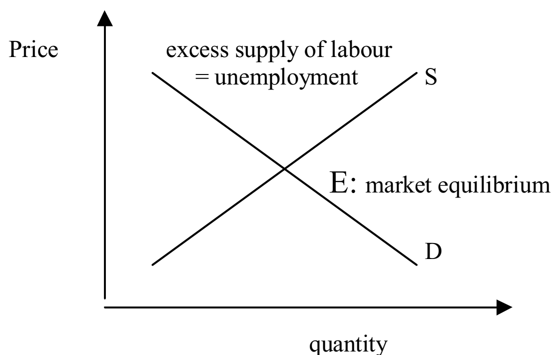
Economics

Suppose a Government wishes to raise the incomes of the working poor. It suggests the raising of the minimum wage. Use the demand and supply framework to evaluate the effect on the wage for unskilled workers, and the number of workers in employment and on the unemployment register. Discuss how demand and supply elasticities may effect these changes, both in the long-run and short-run. In the light of your discussion, do you believe the policy can be effective in meeting the Government's goal?

In October 2002, the Government put forth a new level for the minimum wage: £4.20 per hour for 22 year olds and over and £3.60 for the under 22 year olds. If the Government was to raise this minimum wage it would be to reduce poverty amongst the working poor, but this wouldn't necessarily happen. Other consequences would occur, firms would have to choose whether to employ at a higher price or not. This means that firms would have to compare paying higher prices on workforce with alternatives, such as machinery, and therefore demand elasticities will be affected. Supply elasticities will be affected in a much simpler way, supply of labour will increase as wages increase, the problem is to see where this extra supply of labour comes from.

Wages are dependant on price and cost structure, so a change in wage means that there will be consequences on prices and employment (Wilkinson, 1992). If wages increase, the consequence on prices would be inflation. This reasoning is on a macroeconomic level so we shall ignore this effect through the essay. On the other hand, when the minimum wage increases, its effect is that low paid workers are more expensive to employ and therefore demand for labour decreases leaving unemployment. The minimum wage is like a price floor: as the price of labour increases so does supply, but demand falls. As the figure below shows, what we are left with is excess supply and in this case it represents unemployment.



In contrast, studies have shown that it isn't always the case that when there is a rise in minimum wage (or a minimum wage imposed) it leads to unemployment. That is only the theoretical part to it. Members of the Low Pay Forum said that "a recent OECD study…found that the minimum wage had had no significant effect on wage inflation or unemployment", the studies being based in France where the minimum wage appeared in 1968. There are many different reasons to why this didn't result in unemployment, and

Keynes had a theory about it. Keynes based his studies on a macroeconomic level, but knew that whether what was happening in one firm had a positive or a negative effect, it didn't necessarily have the same effect on the economy as a whole. He said that when salaries (or only the minimum wage) increase in one firm, this leads to lower profits since the price of labour is more expensive, and therefore leads to unemployment. On the other hand, however, when the minimum wage increases on a macroeconomic level, this leads to a higher consumption, since the purchasing power of the working poor increases. Higher consumption means that the firms have to produce more, and therefore have to employ more staff, so raising the minimum wage doesn't necessarily lead to unemployment (Hicks, 1974).

Firms don't want to spend more money on wages, so when the minimum wage increases they will do their best to find a way around this problem. The firms will compare the price of increasing wages with alternatives, such as machinery for example (Wilkinson, 1992). If they can instead invest in capital equipment which will increase the productivity of the enterprise, this will most probably be the solution that they will adopt. This means that they will have to reduce the number of employees because the increase of wage will be used on the new machine, so unemployment increases. However, this isn't possible for all enterprises, there are some that rely on human capital and can't replace it with machinery, such as cleaners or catering staff. There isn't yet any technology that can replace a hotel room cleaner, so when the minimum wage increases it can't have any effect on these jobs, the amount of people employed will stay the same. Another alternative for firms when the minimum wage increases could be that they would rather employ workers with higher qualifications for a similar wage to the level at which the new minimum wage will be set at. This would mean that all of the employees that were working poor will be dismissed, and would have terrible consequences on the level of unemployment.

One last possibility for firms who want to get around the problem of paying higher wages would be to delocalise there enterprise. Many enterprises have already done this, especially in the clothing sector. Firms, for example Nike, have moved from the USA to Taiwan where the price of labour is much cheaper. If firms decide to do this when the minimum wage increases its effect on employment in its country of origin would be very bad. Contrarily, if the minimum wage increases, this won't have an effect on employment in the public sector since the government would be financing the costs. The only thing that might change would be that "the government might require a change in public expenditure policies" (Low Pay Forum, 1988).

The working poor consist mostly of young workers, women and ethnic minorities. When there is a raise in the minimum wage, demand and supply is highly elastic for these groups, meaning that if there is a change in wages there is likely to be a greater impact on demand and supply of labour, and therefore also employment in these groups. This elasticity is very high since these groups are unskilled, and firms don't want to pay higher prices for unskilled workers. Because of this, if the minimum wage increases it will result in unemployment for many members of these groups. To contrast this with inelastic demand for labour, we can take the example of highly paid labour. The demand for division leaders in a nuclear research centre will not change because the minimum wage is being increased, so this demand is inelastic to an increase in minimum wage. There will also be a high elasticity for supply of labour because it seems normal that when

wages increase the supply of labour will also increase. This extra supply of labour must come from somewhere; workers who had in the past put themselves into voluntary unemployment because the minimum wage was too low and wasn't that far away from the dole paid by the government will come back into the workforce, for example. Youngsters might be more motivated to not enter into higher education because they see that they can already start to work where the salary isn't that low, and more women could enter into the workforce.

In the short-run these elasticities might not be so high because these kinds of things take a long time to prepare. Demand elasticities will not be affected straight away because it will take the firms time to adapt to these changes; if they want to replace workforce by investing in capital equipment for example, this change will take some time. This time will not only involve the purchase and installation of the machinery, but these things have to be planned, statistics have to be drawn up and studied carefully. Afterwards, however, in the long-run elasticities will become high because the decision will have been made and therefore the demand for labour will have changed radically because of the change in the price of labour. The same will happen with the elasticities of supply of labour, it will take a certain amount of time before people can insert themselves into the workforce because, for example, it takes time to find a job. This means that in the short-run elasticities regarding the supply of labour will be low, but in the long-run will be high since these changes will have had the time to occur.

If the Government was to raise the minimum wage it would be to reduce poverty amongst the working poor, trying to maintain employment at the same rate if not increasing it. Keynes would approve of this Government's choice, but the Classicals wouldn't, claiming that it would lead to classic unemployment (Kregel, Matzner & Roncaglia, 1988). Whether or not this policy would work has been explained above, showing two different points of view. However, it is important to observe that with the economic crisis of the 70's and 80's, governments in Britain, France and the USA used Keynesian politics to help the growth of employment, and they proved to be unsuccessful. Because of this inefficiency, we saw the liberal thoughts coming back into the governments, with M.Thatcher in Britain, Mitterand in France and Reagan in the USA, to try to remedy this situation. It was in this context that globalisation started developing.

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