Minimum Prices

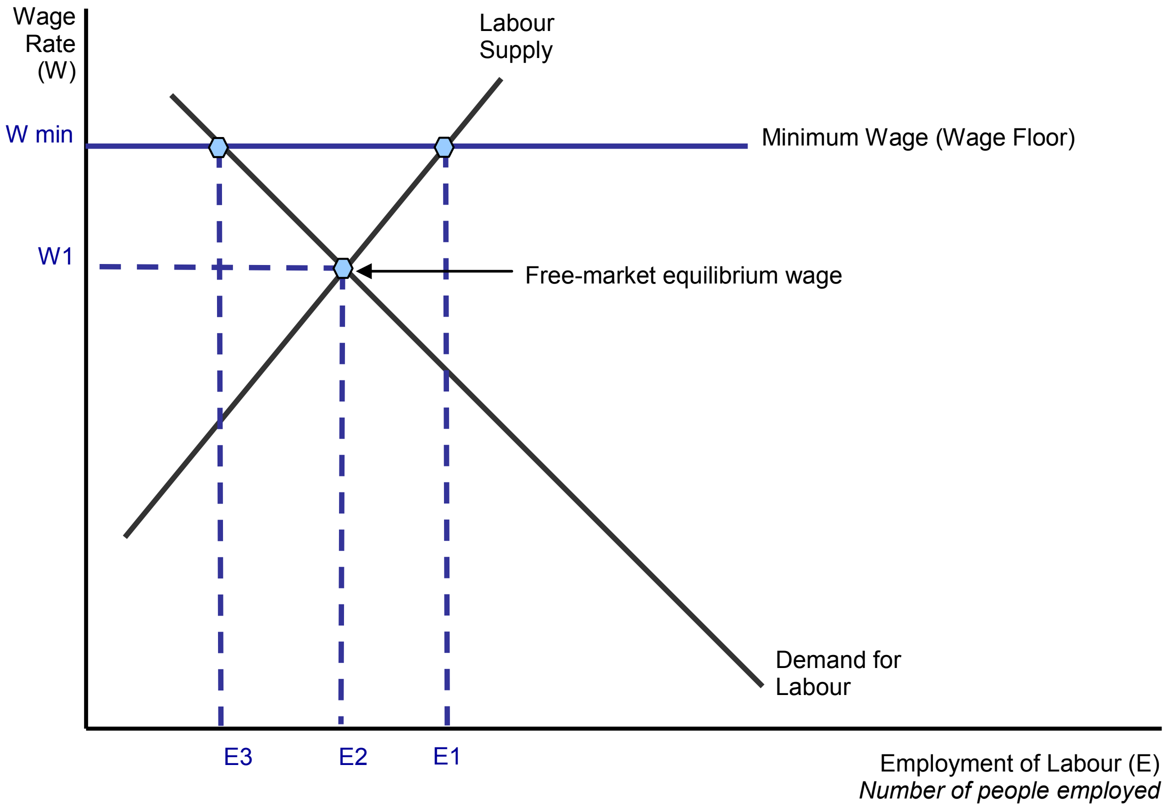
A minimum price is a **price floor** below which the market price cannot fall. To be effective the minimum price has to be set above the equilibrium price. Perhaps the best example of a minimum price is the minimum wage which was introduced into the UK ten years ago.

Adult Rate (for workers aged 22+)	
1 Apr 1999	£3.60
1 Oct 2000	£3.70
1 Oct 2001	£4.10
1 Oct 2002	£4.20
1 Oct 2003	£4.50
1 Oct 2004	£4.85
1 Oct 2005	£5.05
1 Oct 2006	£5.35
1 Oct 2007	£5.52
1 Oct 2008	£5.73

How does a minimum wage work?

Employers cannot legally undercut the current minimum wage rate per hour. This applies both to full-time and part-time workers.

A diagram showing the possible effects of a minimum wage is shown below. The market equilibrium wage for this particular labour market is at W1 (where demand = supply). If the minimum wage is set at Wmin, there will be an excess supply of labour equal to E3 – E2 because the supply of labour will expand (more workers will be willing and able to offer themselves for work at the higher wage than before) but there is a risk that the demand for workers from employers (businesses) will contract if the minimum wage is introduced.



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.
2. **Labour market incentives**: The NMW is designed to improve incentives for people to start looking for work – thereby boosting the economy's labour supply.

3. **Labour market discrimination**: The NMW is a tool designed to offset some of the effects of persistent discrimination of many low-paid female workers and younger employees.

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

1. **Competitiveness and Jobs:** Firstly a minimum wage may cost jobs because a rise in labour costs makes it more expensive to employ people and higher labour costs. It will be interesting to observe whether the minimum wage is said to have caused extra unemployment during the current economic downturn.

2. **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.

Can a minimum wage actually increase employment?

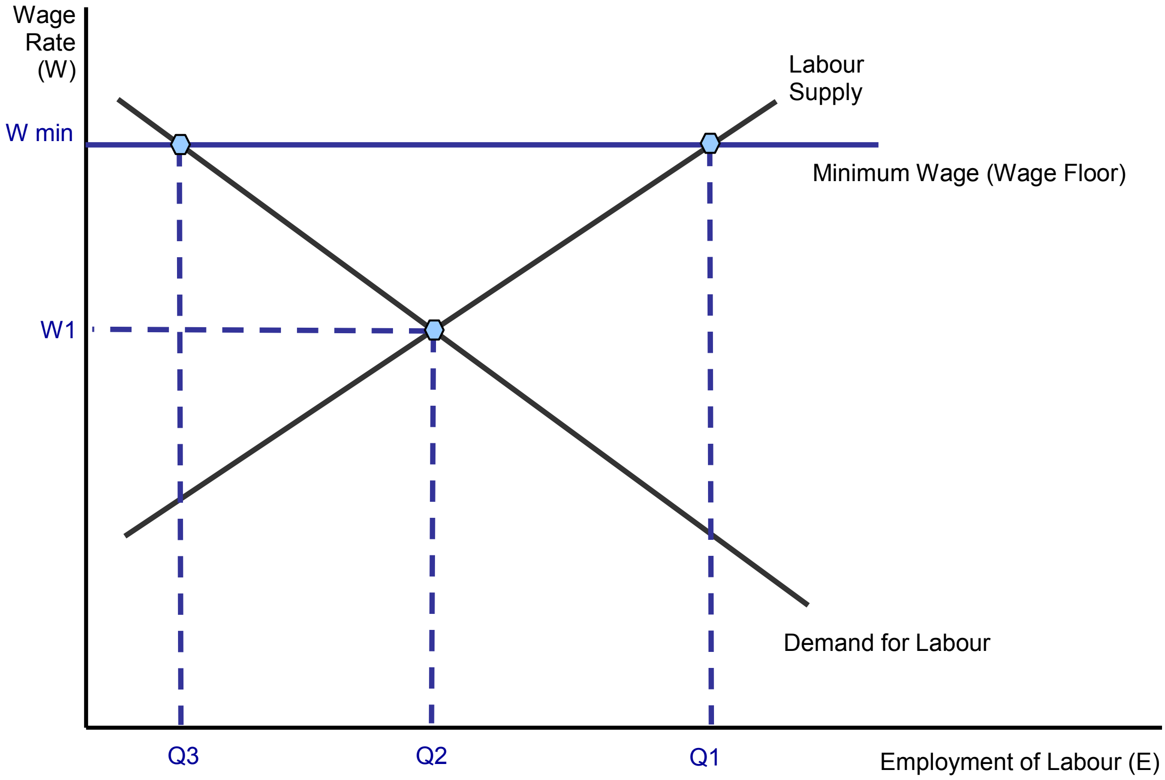
The answer is yes – depending on the circumstances in the labour market when a pay floor is introduced and also on what happens to the productivity of labour when a high (statutory) rate of pay is introduced. There are two main explanations for the possibility of higher employment

2. The **Keynesian argument** that higher wage rates will increase the disposable incomes of lower-paid workers many of whom have a **high propensity to consume**. Thus they will increase their spending and this will feed through the **circular flow of income and spending**
3. The **efficiency wage argument** that raising pay levels for low-paid employees may have a positive effect on their productivity. 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.

The importance of elasticity of demand and supply of labour

The impact of a minimum wage on employment levels depends in part on the elasticity of demand and elasticity of supply of labour in different industries. If labour demand is inelastic then the contraction in employment is likely to be less severe than if employers' demand for labour is elastic with respect to changes in the wage level.

In the next diagram we see the possible effects of a minimum wage when both labour demand and labour supply are elastic in response to a change in the market wage rate. The excess supply created is much higher than in the previous diagram.



Evidence on the minimum wage – has it worked?

1. **Employment:** For most of the years since the NMW was launched, unemployment has been falling. The jobless total is now increasing at a rapid rate but the main cause has been the domestic and global economic recession.
2. **Inflation:** In many sectors firms find it hard to pass on higher wage costs to final consumers – limiting the inflationary effect of the minimum wage
3. **Wage costs:** The minimum wage affects only a small proportion of workers and the effects on the 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
4. **Discrimination:** The minimum wage has had an impact on the earnings of part-time female workers.
5. **Productivity:** It is hard to identify any strong positive effect on labour productivity - but efficiency gains have been made in most low-paying industries, a trend which started before the minimum wage was introduced.