Does National Minimum Wage reduce poverty?

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Abstract:

The objective of this essay is to find out whether the National Minimum Wage reduces poverty. The term "poverty" is the pronounced deprivation of wellbeing. It is the inability to satisfy one's basic needs because of a lack of income to buy services or from lack of access to services. ("Handbook on Poverty and Inequality," Jonathan Haughton and Shahidur Khandker.) Throughout the essay I will use economic theory to explain the effects of the National Minimum Wage on low paid workers. In addition, statistics will be presented from around the year 2000 when the Minimum Wage was established, and dates when the Minimum Wage has increased, to show the effects it had on incomes and unemployment. Statistics show that poverty and unemployment fell and economic growth increased around the year 2000, just after the introduction of the Minimum Wage. This conveys the direct correlation that the Minimum Wage has on fighting poverty and aiding the economy's welfare.

Introduction:

The National Minimum Wage is the most significant labour market intervention that the Labour government implemented In April 1999. They introduced the policy with the view of trying to reduce poverty, exploitation and increase investment and productivity, following recommendations from the Low Pay Commission. The National Minimum Wage Act 1998 creates "a minimum wage across the United Kingdom, currently £6.19 per hour for workers aged 21 years and older, £4.98 per hour for workers aged 18–20" (Directgov, "The National Minimum Wage rates.") The National Minimum wage aims to fund the average living standards of the population and to eradicate the problem of "poverty pay," which arises when people earn insufficient wages to push them out of poverty.

Economic principles:

In this discussion, I intend to review arguments for and against the national minimum wage and illustrate evidence to prove that the policy does reduce poverty. I also intend to discuss the economic principle of a price floor created by the national minimum wage, in which I will refute the argument that it creates unemployment. In addition, I will present the work-leisure model (which is shown by indifference curves and budget lines), which will show the positive income effect of the national minimum wage for low earners.

Criticisms:

The economic theory of the National Minimum Wage (NMW) is that it sets a price floor which "The price is not allowed to fall below this level, although it is allowed to rise above it."(Essentials of Economics, Sloman and Garratt, 2010.) The graph (*appendix 1*) shows the NMW price floor at w1, above the equilibrium level at w0. Orthodox economists argue that the difference between Q(b) and Q(a) represents unemployment caused by the price floor. This unemployment is said to be a result of higher wages contributing to increased costs for businesses, hence workers would be laid off.

However, research conducted by Card and Krueger (1992) saw that New Jersey increased their NMW from $4.25 to $5.05 per hour. The result of the study showed that actually employment increased in New Jersey, disputing the idea that the NMW causes unemployment. (*David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania," American Economic Review.)* This notion of the NMW causing unemployment could be seen to be contradictory, as this would eradicate the problem of the "poverty trap," that employers would be offering people more money than any unemployment benefits would, hence encouraging more of the population to renter the labour market and get a better standard of living.

Effects of National Minimum Wage:

Generally, most orthodox economists dominated the argument with the view that there should be a free market approach when determining wages, as well as prices of goods. However, this is not the most efficient approach to wages, as there has been an increase in the standard of living and hence living costs to the population in recent decades, so wages need to reflect this increase in costs to the household because if they do not more people in society will find themselves in poverty. As inflation increases (increasing the cost of goods,) a low earner will have less purchasing power in order to buy everyday commodities, hence poverty will prevail. Therefore, NMW attempts to align wages and prices in order for the population to afford the rising cost of living. For example, in April 1999 the minimum wage was set at £3.60 for workers over the age of 22, compared to the current minimum wage of £6.19. Suppose an individual works 40 hours a week on £3.60 an hour, they would make

£144 a week, opposed to £247.60 a week if they received £6.19 an hour. This shows that as time passes, money losses its value and hence wages need to be increased to represent prices and living standards in society, if left to the mechanism of demand and supply workers would have less purchasing power.

The basic work-leisure model can explain how low paid workers fully benefit from NMW. If wages increased, due to NMW, then lower paid workers will substitute their leisure time, because of its higher opportunity cost (cost of forgoing the next best thing), for work time in order to take advantage of the increase in income which can be made ("Contemporary Labour Economics", 4th edition, McConnell, Brue, 1995, appendix 2). Hence, due to the lowest earners receiving more income, their budget line expands outwards so they are able to spend more on a combination of goods x and y, which is known as the income effect.(as shown in appendix 3.)

Poverty statistics:

In the Joseph Rowtree Foundation "progress on poverty" report (1997–2003/4), it stated that between 1996/97 and 2000/01 relative poverty (which refers to being below some relative income threshold) had fallen, in which overall poverty fell by approximately 1 million, including about half a million fewer children in poverty. This is the lowest poverty figures since 1979. Figures showed that over a third of low paid workers had children that depended on them, which shows that NMW has a correlation with helping child poverty. This is due to the minimum wage being of most benefit to young, female, part-time workers. The increase of the NMW on the 1st October 2008 saw that two-thirds of the workers benefiting from it were women. (Report from Trades Union Congress) This makes it possible for women to bring a second income into the household, or in the case of single mothers this could make working worthwhile, while putting children into child care facilities. For example: “a lone parent with two children, one aged 14 and the other aged five, needs £258 to take them above the after housing costs poverty line. The amount of benefit that this family would get if the parent was out of work is £219, which is well below the poverty line.” (Barnardo's calculation based on Jobseeker’s Allowance, Child Benefit and Child Tax Credit rates from April 2012.) Hence, this shows that NMW is imperative to help lone parents and children out of poverty.

In addition, the economy grew for the ninth consecutive year in 2000, as well as the unemployment rate falling to 4%, which is its lowest level in more than three decades. (http://www.cbpp.org/cms/?fa=view&id=677) This illustrates that the NMW has had a positive effect on society as it has allowed people to work for a living whilst maintaining a good standard of living, rather than having to live off state benefits. This also reduces costs on the government for providing state benefits which allows the government to spend some money regulating and improving the minimum wage laws, for example, by aiding smaller companies to employ people as they may not be able to afford to employ workers due to the increase in wages from the NMW laws.

Conclusion:

In conclusion, this essay has answered the question posed at the beginning: "does the national minimum wage reduce poverty?" The minimum wage clearly boosts the wages of those who are on the lowest pay in the economy, hence giving them more income to spend, pushing them out of poverty. The rate of the NMW has changed throughout the years in order to represent the increased cost of living, so purchasing power will remain the same for low paid workers. It has been proposed by economists that NMW causes unemployment, however the study by Card and Krueger (1992) portrays that there is no direct correlation between unemployment and NMW. I personally, being on minimum wage, don't feel minimum wage has increased enough, however it has provided strong foundations for future governments to work on more policies in order to help people in this country, and around the world, out of poverty.

Appendices:

Appendix 1

National Minimum Wage

[Figure removed due to copyright restrictions. Please see: http://www.bized.co.uk/learn/economics/wages/influences/minwage/tutor.htm]

Appendix 2

[Figure removed due to copyright restrictions. Please see: https://upload.wikimedia.org/wikipedia/commons/6/61/Labour_supply_income_and_substitution_effects_small.png]

Compensating variation

The concept of compensating variation refers to the amount of additional money an individual would need to reach its initial utility after a change in price, or in this case wages. Assume the individual is on the indifference curve labelled IC1, maximising utility at point A. As a result of the National Minimum Wage, wage rates increase and the budget constraint will shift outwards to point C, on indifference curve 2 (IC2.) Due to the increase in potential earnings individuals can make now, they will substitute more of their leisure time for work time, hence pivoting the budget constraint to point B, remaining on indifference curve 2 (IC2.)

(Mcconnell. C. R, Brue. S. L, Macpherson. D, 2009, Contemporary Labour Economics, McGraw-Hill Higher Education, 4th edition.)

Appendix 3

[Figure removed due to copyright restrictions. Please see: http://www.bized.co.uk/virtual/vla/theories/indifference_curve.htm]

The income effect

The income effect describes the situation when an individual's disposable income (amount of money available for someone to spend or save after tax has been deducted,) has been increased, hence they can afford more goods and services, which is represented by an outward shift in the budget constraint. As shown in the graph above, the individual can now afford 90 units of good y, opposed to previously only 60 units of good y. As well as good y, the individual can now afford 45 units of good x, contrasting with the previous amount of only 30 units of good x.

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