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MINIMUM WAGE LEGISLATION

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Abstract

Economists have traditionally been hostile to minimum wage legislation, seeing it as an unwarranted interference with the operation of the market and a cause of unemployment among the less skilled. Recent evidence from the USA and the UK claims to show, however, that employment *rises* when minimum wage laws are introduced and *falls* when such laws are repealed. A number of explanations have been offered for these findings, ranging from monopsony effects to labour market segmentation. There are trade-offs between short-run adjustment costs and long-run improvements to productivity and performance which are, however, difficult to assess. From the point of view of the economics of law, the minimum wage studies show how important empirical work is in testing and reshaping economic theory.
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1. Introduction

Most developed economies (and many developing ones) set a legal minimum level to wages, either through statute or by giving legal force to the terms of collective agreements negotiated between employers and trade unions. Economists, however, have traditionally been hostile to minimum wage legislation and to labour standards more generally, seeing them as an unwarranted interference with the operation of the market and a cause of unemployment among the less skilled. Recent evidence from the USA and the UK claims to show, however, that employment *rises* when minimum wage laws are introduced (Card and Krueger, 1995) and *falls* when such laws are repealed (Dickens et al., 1993). The story of how these findings have been evaluated by the economics profession is of considerable interest in itself for what it tells us about the present state of economic theory and the way in which it intersects with the law.

2. The Traditional Neoclassical Account

In the traditional neoclassical account of the labour market, competition between firms for labour, and between workers for jobs, ensures that wage rates for labour of comparable productivity are more or less equal throughout the market and beyond the power of any individual economic actor to affect. The movement of the market towards equilibrium acts as an implicit regulator of individual decisions on whether to trade and at what price. Firms which attempt to pay below the market rate risk losing their workers to competitors, in the same way that workers who attempt to force up wages above the competitive level risk losing their jobs as firms at the margin substitute labour for capital or cease to trade.

Repeated empirical studies - surveys and case-studies of firms dating back to the first large-scale studies of low pay in Britain and the USA - have shown that, in reality, labour markets do not display these characteristics (see Nolan, 1983). Firms do not automatically adjust wages to changes in demand for labour, and there is considerable divergence in the pay and conditions offered by different employers to workers doing similar jobs. Neoclassical theory tries to explain away these findings by the argument that freely competitive markets *tend towards* equilibrium. Limitations upon the flow of information and upon the mobility and substitutability of factors of production are overcome in time by the unravelling of competitive market forces. The market itself is seen as a powerful force for equality: under conditions of perfect competition, equal pay for work of equal value would follow from the operation of supply and demand. Where apparent inequalities in pay persist, they are viewed as the result of pre-market factors: differences between individuals in terms of endowment and ability, differences in individuals' 'tastes' for work, training or leisure, or differences in employers' 'tastes' for discrimination (Becker, 1957).

Regulation is also seen as an exogenous cause of inequality, preventing market clearing. Public choice theory regards labour legislation as the outcome of organised pressure-group activity (Heldman, Bennett and Johnson, 1981; Rowley, 1985). Trade unions, according to this point of view, are labour monopolists seeking to cartelise the labour market. By driving wages above the market or equilibrium rate, they depress demand for employment and divert resources into wasteful rent-seeking. The costs of trade union activity are borne by consumers, in the form of artificially high prices, and the unemployed, who are 'priced out' of work. Trade union legislation, by supporting collective bargaining and the right to strike, ensures that these inefficient monopoly practices are protected against the market forces which would otherwise drive them out (Posner, 1984). On similar grounds, it is predicted that minimum wage laws would have a disproportionately adverse impact on the young, those without formal training or qualifications, and those re-entering the labour market after a long absence (such as the long-term unemployed) (Minford, 1985).

3. Empirical Evidence

The minimum wage has given rise to a vast empirical literature. Until recently, the consensus was that the introduction of a minimum wage and subsequent rises in its level would both almost certainly lead to increases in youth unemployment, and sometimes to increases in adult unemployment (Brown, Gilroy and Kohen, 1982). However, this conclusion rested mainly upon time-series studies using long-term aggregate data of teenage unemployment derived from a single source, the US Current Population Survey. Critics suggested that these studies could not be regarded as definitive since the estimated employment effects are small and also highly sensitive to the choice of sample period (Card, 1991).

Case studies by Card, Katz and Krueger examining the implementation of minimum wage reforms in various US states in the late 1980s and early 1990s presented a different picture (see Card, 1991; Card, Katz and Krueger, 1993; Card and Krueger, 1995). The research took advantage of the opportunity for comparative study which arose from the variations in rates of increase between states, and by the decision of the US Congress in the late 1980s to raise the federal minimum wage after a period of several years when its nominal value remained constant and its real value declined. One study examined the effects of raising the minimum wage in California in 1987, comparing teenage employment rates with those in states which did not increase their minima at the same time. It was found that both the earnings and the employment of teenagers in California increased after the minimum wage was raised, despite over half the teenage employees in the state being affected, a very high compliance rate, and few exemptions being allowed in the legislation. Similarly, a study comparing New Jersey, which increased its minimum wage, with Pennsylvania, which did not, found evidence of increasing employment in the former state. An analysis of the implementation of changes in the federal law in the fast food industry in Texas, a sector employing mostly part-time workers and with labour turnover rates in excess of 300 percent per annum, found that most employers observed the new adult rates for the minimum wage but that few took advantage of the possibility of paying a teenage sub-minimum. Over 70 percent of the firms interviewed did not report responding to the new rates by either dismissing workers or cutting fringe benefits.

In Britain during the same period, minimum wage regulation was being weakened as a consequence of legislation which cut back the powers of the Wages Councils (wage-setting bodies operating at industry level in certain sectors). After 1986 they were prevented from setting rates for younger workers and in 1993 their powers to set wages and conditions were completely removed. Prior to the 1986 Act it was ‘confidently postulated’ that the abolition of the Wages Councils would ‘serve to expand employment [and] offer competitive wages for the socially disadvantaged’ (Minford, 1985, p. 122). However, econometric studies found that employment in low-paying service sectors declined as a result of the decreasing effectiveness of the Wages Councils (Machin and Manning, 1994; Dickens et al., 1993). In a similar vein, studies of the UK Equal Pay Act 1970 found that while the legislation was responsible for a considerable narrowing of the male-female gap, this was accompanied without a fall in female employment levels (Zabalza and Tzannatos, 1985).

4. Alternative Theoretical Perspectives

The US findings on the positive impact upon employment of minimum wage increases produced a stormy debate. Some critics argued against the use of a comparative case study methodology, while others sought to provide different explanations for the observed employment effects (see Keenan, 1995; Neumark and Wascher, 1995). However, when the findings are taken together with the British research which demonstrates the converse effect - the negative consequences of weakening minimum wage enforcement - they can be seen to have far-reaching implications for the conventional understanding of how labour market regulation works. Under these circumstances, it is not surprising that attention has focused on alternative theoretical perspectives.

One possibility which is compatible with orthodox neoclassical theory is that employers in low-wage sectors are monopsonists holding a degree of market power over their employees. This enables them to keep their wages below the equilibrium or external market rate. It would be in the interests of such employers to avoid taking on new employees at the market rate if they then felt obliged, on the grounds of equity, to raise the wages of their existing employees. Under such conditions, a limited rise in the minimum wage would necessarily lead to a rise in employment, as the higher wages attracted new recruits into the industry concerned. Too large a rise, on the other hand, would lead to unemployment, particularly where there were wide variations in the degree of monopsony power which individual firms possessed (Stigler, 1946).

A more radical departure from the orthodox account is provided by theories of labour market segmentation. These focus on the link between low pay and industrial structure, and take a historical and institutional perspective which is to some degree compatible with theories of path dependence or institutional lock-in. It is argued that since low pay is concentrated in particular occupations and industries, pay inequality cannot be wholly explained by differences in the skill and quality of individual workers (Craig et al., 1982). Rather, low pay comes to be associated with jobs which are socially undervalued or which are performed by workers who are accorded a low labour market status. 'Undervaluation' is a consequence of a number of factors including employer strategies, differences in the effectiveness of worker organisation, and the division of labour within the household. For example, one effect of the sexual division of labour is that skills traditionally associated with women's non-waged labour in the home, such as caring and cleaning, command lower pay in the labour market than other comparable 'male' skills. Linking women's pay to skill levels is, in practice, highly problematic. Studies comparing male and female earnings across a range of occupations have suggested that as much as three quarters of the wage gap between men and women in comparable jobs could not be put down to skill-related factors (Horrell, Burchell and Rubery, 1989).

A labour market segmentation perspective leads to a very different view of minimum wage legislation (Deakin and Wilkinson, 1992). Rather than it being an 'artificial' interference in the free market, it becomes just one form of regulation which, together with other conventions, norms and customary practices, governs the way in which labour is contracted. The case for legislation is that as a consequence of segmentation, certain groups in the labour market will not have access to voluntary means of labour organisation, such as collective bargaining or the protection of professional rules governing entry and access to jobs. Hence the industries in which low pay is endemic are those in which there are structural factors, such as ease of entry by both firms (the result of low capital requirements) and workers (the result of the failure to develop and enforce formal skills and qualification requirements), which impede the effective organisation of labour and hence the application of common terms and conditions. Although these sectors appear more than any other to resemble the neoclassical 'norm' of free competition, in fact they are the exception. The persistence of these conditions creates the basis for a fundamental disequilibrium: low pay is in effect a subsidy, enabling otherwise uncompetitive firms and industries to survive. Minimum wage regulation is therefore necessary in order to help create an environment in which firms compete not on the basis of low pay but instead through high labour quality and product and process innovation (Deakin and Wilkinson, 1999). Equally, placing a floor under wages can augment the purchasing power of workers and so underpin effective demand (Michie, 1987; Prasch, 1996). These macroeconomic effects have indeed been prominent among the justifications offered for the introduction of minimum wage regulation in most of the systems adopting it.

5. Dynamic Effects of Introducing and Raising the Minimum Wage

The general case for retaining a minimum wage, if one is in place, is distinct from more specific arguments for and against introducing or reintroducing minimum wage regulation. A fundamental change of this kind in the regulatory framework may well have far-reaching effects which cannot be precisely predicted. Moreover, it is unlikely that the effects will all be in one direction. Although an argument can be made, as we have just seen, for long-term efficiencies arising from the presence of a statutory wage floor, these may have to be traded off against short-run adjustment costs as some enterprises go out of businesses and workers retrain. Other matters to be decided include the level at which the minimum wage is set, and the mechanism through which it is subsequently varied.

Many of these issues have been the focus of intense debate in Britain since the election of a Labour government in 1997 which was committed to reintroducing minimum wage regulation after an interval of four years during which no minimum wages of any kind were in operation. The government-appointed Low Pay Commission (LPC), which reported in June 1998, recommended the introduction of a national minimum wage (previously minimum rates only had the force of law in certain industries) (LPC, 1998). The proposed rate was towards the lower end of the range put forward by advocates of the minimum wage, namely £3.60 per hour from April 1999, rising to £3.70 in June 2000. The £3.60 figure represented about 45 percent of median earnings and was expected to affect about 11 percent of the working population over the age of 20. Sixteen and 17 year olds were to be exempt and 18-20 year olds were to receive a lower rate of £3.20 per hour from April 1999, rising to £3.30 in June 2000. The Commission estimated that the effect of introducing these reforms would be to add 0.6 percent to the total national wage bill; the sectors most heavily affected would be cleaning, catering and security, while the groups to benefit most included women workers and homeworkers. The government accepted the

Commission's recommendations for adult workers but set the starting rate for 18-20 year olds at £3.00 per hour, rising to £3.20 by June 2000.

The work of the UK Low Pay Commission represents an interesting example of the use of economic evidence to aid public policy. The Commission was sympathetic to the monopsony model, noting its implication that 'moderate minima can be introduced without destroying jobs' (LPC, 1998, p. 114), while at the same time noting the broader 'undervaluation' argument in particular as it applied to female labour (LPC, 1998, p. 115). It also considered that the introduction of a minimum wage could have an impact on industrial structure:

> Whatever the nature of the labour market, it is likely that a National Minimum Wage will have a greater effect on the structure of employment than on its level. Businesses which are inefficient or which produce low value-added goods may need to reorganise working practices. If the National Minimum Wage is properly enforced, business and employment are likely to transfer to more efficient firms or to those offering higher value-added products and services … minimum wages may cause a transfer of jobs between groups such as the substitution of more skilled for less skilled workers … . (LPC, 1998, 115)

It is debatable whether the level set by the Low Pay Commission is sufficiently high to realise these potentially beneficial effects of reintroducing a minimum wage. A minimum wage set at about 45 percent of median earnings is low by international standards (the minimum wage in France, for example, is 57 percent of the median), although it is higher than the US federal minimum. In setting the rate at a low level, the Commission *may* have minimised the short-run adjustment costs of low-paying employers, at the expense of forfeiting a longer run improvement in productivity and economic performance from this source.

A significant feature of the new UK legislation is that no provision is made for automatic increases of the minimum wage in future years. In the USA, a similar lack of automatic uprating has led to stagnation and decline in the level of the federal minimum, and has turned the level of the minimum wage into a hotly debated political issue, so arguably increasing the scope for wasteful pressure group activity (Sachdev and Wilkinson, 1999). In France, by contrast, legislation embodies a formula whereby the 'minimum growth wage', the *salaire minimum interprofessionel de croissance* or SMIC, rises automatically with prices and with at least half the increase in the purchasing power of the average wage. This has ensured that, alone of minimum wage systems in western Europe, the SMIC has retained its real value since the mid-1980s (OECD, 1998, chapter 2).

6. The Minimum Wage, Household Poverty and Work Incentives

The minimum wage, it is sometimes said, disproportionately benefits households with more than one person in employment, some of whom are so-called 'secondary' earners (typically wives and children of a male 'breadwinner'). In practice, the employment of 'secondary' earners is often essential to improving the living standards of multiple earner households. A more important objection is that minimum wage appears at first sight to offer no means of relieving poverty in households with no member in employment. In practice, however, the minimum wage may assist the unemployed by improving work incentives. This depends upon how the minimum wage interacts with the benefits system. The contribution of the minimum wage to alleviating poverty and inequality needs to be set in the context of other, complementary measures, in particular those operating through the social security system.

The institutional choice here is whether to have a system based on wage-substitutes, such as an extended negative income tax, or whether to use the minimum wage in conjunction with social security benefits to provide incentives for the non-employed to re-enter the labour market at a wage level which makes it worth their while to work. In Britain, the former system was in operation between 1986 and 1997. Social security benefits were targeted on low-paid earners with families at the same time as the minimum wage was abolished. Because these benefits were (unavoidably) means tested, they were progressively withdrawn as earnings from wages increased, so extending the 'poverty trap' which reduces the incentive for workers to take better paid jobs or jobs involving longer hours (Deakin and Wilkinson, 1991).

Moreover, since employers could reduce wage levels or at least avoid increasing them in the knowledge that the difference would be met by social security, the state was in a position of subsidising low-paying firms which were often among the least efficient in terms of productivity. This reinvention of the Speenhamland system (see Polanyi, 1944) soon led to huge increases in state expenditure on benefits for the low paid.

After 1997, the election of a new government led to a change in emphasis. Benefits to the low paid were retained but restructured with the intention of building on the level set by the minimum wage rather than directly substituting for it. As part of these reforms, taxes and social security contributions for the lower paid were substantially reduced. The aim of the reforms was to 'demonstrate the rewards of work over welfare' (Treasury, 1998).

7. Conclusion

The recent debate over the minimum wage demonstrates the remarkably tenacious hold which orthodox neoclassical theory has over the economics profession, even when confronted with evidence which, to say the least, puts in doubt the predictive capacity of that theory. From the point of view of the economics of law, the minimum wage studies show how important empirical work is in testing and reshaping economic theory. The hostility of mainstream law and economics towards labour regulation, as exemplified by the symposium on labour market published in the *University of Chicago Law Review* in 1984, is just one of many instances in which apparently clear-cut normative conclusions were drawn from models which had only a weak link to real-world conditions. From an institutional perspective such as that which can be drawn from the theory of labour market segmentation, the effects of the minimum wage - in particular, the consequences of introducing or raising the minimum - can be seen to be highly complex. There are trade-offs between short-run adjustment costs and long-run improvements to productivity and performance which are, however, difficult to assess. This may lead us to conclude that while the economic analysis of labour standards may help improve our understanding of how such laws operate, in and of itself it does not provide clear normative guidance to policy makers. At the end of the day, the case for social policy interventions will continue to be made on broader, ethical grounds.

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