

Evaluate the possible microeconomic and macroeconomic effects on the UK economy of an increase in the minimum wage.

In 2015, the (former) Chancellor of the Exchequer, George Osborne, declared that "Britain deserves a pay rise" as he unveiled a new compulsory Living Wage, set well above the National Minimum Wage. The compulsory Living Wage for working people aged 25 and over is due to rise to £9 per hour by 2020. It will have numerous effects across the economy, especially in labour markets and for labour-intensive firms. Ultimately, the impact on employment, and therefore growth, in the UK will depend on the trade-off between the increased incentive to work and rising business costs. In other words, the macro outcomes will be strongly affected by micro decisions by economic agents.

First and foremost, UK firms will see their labour costs increase due to the Living Wage increases. In the goods markets, the supply curve will shift to the left (S to S1) which causes a contraction along the demand curve from A to B, resulting in an increase in price to P1 but a fall in sales to Q1. Assuming that the good is not price inelastic, this will inevitably mean less revenue (and profit) for the firm; revenue falls from area OPAQ to area OP1BQ1. This limits the funds available to a firm for reinvestment, and consequently limits future business and economic growth. For some firms, particularly in low-wage sectors, they may well be unable to cope with the additional pressure of increased costs and may have to close. This would cause significant unemployment.

This argument is supported by the classical NMW diagram in which there is a vertical upwards shift of the NMW line, so it is even further above the equilibrium wage. There is a further contraction along the labour demand curve, which causes a reduction in the number of workers being demanded. The gap between labour supply and labour demand at the new Living Wage is unemployment (or 'excess supply' of labour), and is higher than the level of unemployment under the NMW. The increase in unemployment is even greater if the demand and supply of labour is relatively wage elastic.

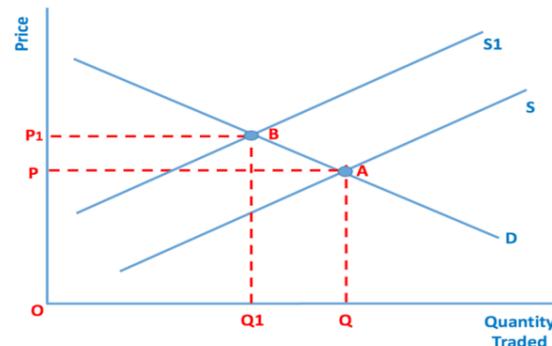
A further impact can be shown on an AD/AS diagram, in which the SRAS curve shifts upwards since the price of resources (labour) has increased. This causes cost-push inflation in the economy, which in turn may also mean that UK exports may become less competitive and those people on low-incomes are pushed into poverty because their income has less purchasing power than before. Cost-push inflation is also associated with a widening of a negative output gap, particularly undesirably in the UK since the economy remains fragile after the Great Recession, and because of the potential recessionary risks associated with Brexit.

On the other hand, the UK is not a low-wage economy (like Bangladesh for example) and recent studies have shown that only 5% of the labour force are earning minimum wage. Therefore, it could be argued that the inflationary impact on the entire economy is not expected to be terribly significant. That said, the impact in certain areas (such as the North-East or Wales) is likely to be greater than elsewhere in the UK because of the high concentration of low-wage industries in those areas. The effect in South-East England, however, is going to be much lower since most people are paid above the Living Wage.

As the minimum wage rises then more people will become minimum wage earners. The increase to £9 an hour is a significant increase and the same studies as quoted above have

Good contextual background.

This sets an overarching perspective to the question, and helpfully considers and combines micro and macro elements.

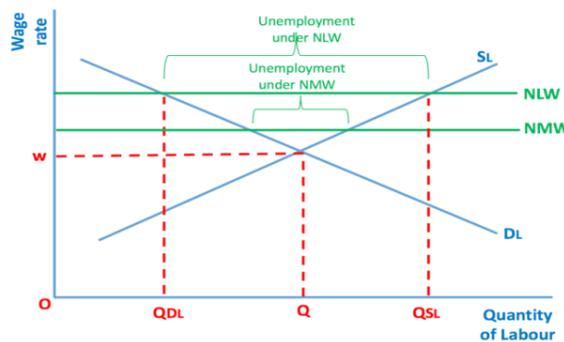


It is good to see some analysis of how a new equilibrium is reached, especially by considering the link between product and labour markets.

This is an effective way of using a diagram in a more complex way to build analysis marks.

Good connection between micro and macro concepts.

Another useful diagram that is not merely a 'repeat' of a basic diagram, but instead focuses on the idea of an increase in the minimum wage.



The same point is now considered in the light of macro consequences – highly synoptic! Good use of the UK context to provide weight to the argument / judgement.

Evaluating by examining different perspectives (in this case, different regions) is an

also shown that 3.2m (equal to 10% of the labour force) will be on that minimum wage by 2020. Given that it is such a large rise, it is fair to argue that those workers who now earn minimum wage will have greater disposable which they can spend in the economy. Low-income earners tend to have a high marginal propensity to consume and so the multiplier effect from this spending is likely to be very high, causing a strong increase in AD and therefore a strong increase in real GDP. What's more, more people will be taken out of poverty because the minimum wage increases the wage of the very lowest paid.

That said, whether relative poverty will decrease will depend on the impact on wage differentials i.e. people currently paid above the minimum wage may request wage increases to maintain the difference between themselves and the lowest earners. The subsequent demand-pull inflation may ultimately depress real wages again (although nominal wages will certainly have increased), and the economy may return to the natural rate of unemployment but at a higher wage rate, as suggested by the long-run Phillips Curve.

Of course, many firms are more likely to be focussed on their profit margins rather than the welfare of their workers (e.g. the infamous case of Sports Direct). Firms that are concerned by the expected price rises may well seek alternative investment opportunities elsewhere where labour costs are lower (e.g. the recent decision of Nestle to move production of classic British biscuits such as Blue Ribands to Poland). As a result, the UK could see an exodus of low-wage firms. This will result in fewer job opportunities for the UK's low-skilled. The extent to which this will occur will depend on the other factors, though, such as the availability of transport networks and infrastructure, or access to trading blocs such as the EU. The UK may remain a desirable place to operate low-wage industry if it remains cheaper to produce in the UK than export to the UK from elsewhere (e.g. cheaper to produce chocolate Easter eggs in the UK for domestic consumption than to transport them into the UK for consumption because of the high relative cost associated with transporting the empty air inside the eggs!).

Alternatively, firms may simply look for other ways of avoiding compliance with the Living Wage regulations. For example, there is likely to be a rise in the use of zero-hours contracts, so that firms only have to pay the £9 an hour when they absolutely need to. Workplace benefits such as pension contributions, holiday pay, free-lunches (if they exist!) may also be curtailed in order to find enough money to pay the higher basic wage. Firms may even resort to paying their workers in cash more often, in order to avoid detection by the Government that they are paying below minimum wage. These factors combine to reduce worker rights, and may ultimately reduce the incentive to work which can increase the government's fiscal burden. The best way of mitigating this risk is for the government to also introduce stronger labour market protection legislation; this will be essential once the UK leaves the EU and is no longer bound by EU Labour Market Directives such as the Working Time Directive and Agency Worker Directive.

In contrast to the previous point, an oft-cited advantage is that a higher minimum wage should actually act as an incentive to work – increasing the labour force participation which should increase the economy's potential output (i.e. LRAS shifts right). It should also incentivise workers to work harder and thereby increase labour productivity. This is the efficiency wage theory. There are holes, however, in this argument, not least that firms may instead take the opportunity to automate/ mechanise their production processes which would increase (technological) unemployment in the country as production becomes more capital-intensive.

In conclusion, the impact of the minimum wage is highly contested but it does seem that unemployment is almost inevitable, at least in the short-term. Firms will be unable to retain their entire workforce at an increased wage, especially given the level of this particular increase. They will either cut their staff and hope to increase productivity from the remaining workers or simply replace workers altogether with machines. This will counter-balance the inflationary impact to some extent as will the fact that only 5% of the UK labour force is affected by the minimum wage but, ironically, if inflation does take hold it will still be the low-income earners that are most affected. The increased minimum wage should, in theory, increase standards of living for those in work but the Government needs to ensure that they also look after (meaning, a real increase in level of benefits) those people who lose their jobs as a result of this policy.

excellent way to evaluate.

There is a very wide range of economic knowledge shown here as well as sound understanding of features of the UK economy.

A sophisticated point!

The examples included throughout this paragraph really help to show how relevant the argument is to 'real life', and this in turn lifts the quality of the answer.

There is significant practical understanding of the labour market shown in this paragraph, indicating that the candidate has gone beyond the mere theory.

Good use of the current UK context.

Providing two reasons why LRAS might rise (higher participation rate and higher productivity) shows excellent depth of understanding.

A clear judgement is reached, followed by some justification