Minimum wage macroeconomics

The government has taken several policy initiatives to address the current economic slowdown. These important and necessary measures to ameliorate the slowdown have addressed (1) sentiment, (2) the credit pipeline, (3) policy misinterpretations, and (4) sector specific issues. However, if, as I have been arguing, the roots of the slowdown lie in deficient structural demand, then other measures are needed.

The structural demand problem has its roots in the historic pattern of growth since 1991, which is powered by the goods consumed by the top 150 million, reflected in the fact that high frequency leading indicators of the economy measure items only these people consume. At the heart of the structural demand problem is the fact that (1) the vector of relative prices is not conducive to broad-basing aggregate home market demand, (2) low productivity limits the scope for a substantial increase in exports and, in the case of mass market textiles, inhibits import substitution, ceding home market demand to Bangladesh and Vietnam. In the first case, relative prices of things that the top 150 million consume — automobiles, air conditioners, etc — have hugely decreased over the past 20 years; thus an air conditioner that would have cost an entry-level civil servant a year's salary in 1989 now costs less than a month's salary. However, the same is not true of things consumed by those earning incomes at, or even triple, the minimum wage, such as nutritious food items, affordable housing, healthcare and education.

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When relative prices do not serve the national good, then there is a case for government intervention, especially when distorted relative prices are a driver of macroeconomic slowdown. This case was made by John Maynard Keynes for developed countries and was part of the standard macroeconomic toolbox until 40 years ago. It is back in the toolbox as neo-liberal macroeconomics is in discredited tatters after the 2008 crisis. In essence, the macroeconomic role of wages is expressed through linking the wage share to consumption and, transitively, to aggregate demand. The wage share could rise as unemployment falls and/or wage rates rise. This relationship is mediated through an incomes policy, which acts to secure relative prices of labour and capital that are consonant with macroeconomic stability.

In developing countries, the problem was often expressed in terms of a wage good constraint limiting home market demand, driven, often, by low returns to agriculture employment. But India is now a market-driven economy and, therefore, a contemporary incomes policy mediates relative prices through a national floor minimum wage (NFMW). For this reason, I welcomed the code on wages, 2019, which stipulated a NFMW. This key reform uses the consumption power of the *aam aadmi* to leverage economic growth.

"In principle" objections to this measure come from neo-liberal economists who are out of date. The balance of contemporary theoretical[1] and empirical[2] research establishes that NFMW contributes positively to aggregate economic welfare and growth, and that any negative employment effects are offset by the positive impact on human capital formation and the stability and magnitude of aggregate home market demand.

Micro principles vs macro approach

Arguments for a minimum wage in the Indian context have been based not on macroeconomic reasoning but on some notion of a safety net and Victorian notions of relative status. The calculation of the proposed NFMW is based on the basic needs that a family would need to feed, clothe, and house itself at a basic level with some additional amount for emergencies. Thus, the proposed NFMW allows for a net intake of 2,700 calories per household member, which is not significantly higher than the intake used to define the poverty line. At the same time (as I discovered as a member of the Seventh Central Pay Commission), the Government of India used a 1950s metric called the Aykroyd formula, which provides for a more diverse and better quality basket of consumption in line with the supposedly higher status of a government employee. This tends to be 40-50 per cent higher than the minimum wage stipulated for everyone else.

This approach is attractive to an old-fashioned socialist or feudal who sees minimum wages through a prism of class struggle/class hierarchy but not very helpful if the minimum wage is seen as the cornerstone of a macroeconomic incomes policy. There is no literature on this subject since it is only now with this government that we have a NFMW.

The NFMW should be determined based on macroeconomic considerations, namely (1) whether the NFMW would increase aggregate demand for mass market consumption. (2) Whether there are supply bottlenecks in responding to such aggregate demand and, if so, calibrate the NFMW to not cause inflationary pressures by driving up demand that would not elicit a domestic supply response—mass market textiles is a good example. (3) The impact of the minimum wage on the factor distribution of income— that is, wage and profit shares should be a key consideration not from the point of view of equity, but from that of macroeconomic stability and growth optimisation. (4) Subnational minimum wages could be set above the floor as desired with other considerations in mind.

Bear in mind that this approach has macroeconomic trade-offs. A higher NFMW may mean lower profits and, therefore, lower taxes and lower public expenditures/fiscal stress. The NFMW may be lower than desired by those concerned with household welfare, dignity of labour, etc. Political pressures to raise the NFMW may defeat the macroeconomic purpose in economies with weak political buffers. So these complexities will need to be addressed. But they do not detract from the need for an incomes policy, anchored in a NFMW determined by macroeconomic considerations, which is of urgent importance in the face of the structural demand slowdown. -

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1. Cahuc and Michel (1995); See Fanti and Gori (2010); Askenazy (2003)

2. Dube et al. (2007); Belser and Rani (2012); full references in the web version on nipfp.org.in