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The consequences of minimum wage laws Some new theoretical ideas

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Abstract

Economists generally agree that the effect of a binding minimum wage law is to move firms backward along the demand curve for low skill workers. However, this prediction of worker displacement depends critically on the assumption that the productivity of firms' labor is not dependent on the wage. In this paper we show that in a conventional efficiency wage model, a minimum wage may increase the level of employment in low wage jobs. The formal logic of our model is similar to the case of labor demand under monopsony, but arises in a model with a large number of employers.

Key words: Minimum wage; Efficiency wages

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1. Introduction

No public policy entails as simple and direct an application of economic theory as minimum wage legislation. Setting a minimum wage above the prevailing wage in competitive labor markets increases both the average and marginal cost of labor. These cost increases will, all else equal, cause firms to reduce the quantity of labor demanded.

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