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Minimum Wage: Good Intentions and Bad Results

Those rightly concerned with helping the working poor naturally turn to wage controls as a tool for boosting workers' incomes. The claim that raising the minimum wage helps the working poor appears obviously true. In fact, the claim relies on four economic fallacies that, together, cause the minimum wage to hurt the very people it is intended to help.

First, minimum wage proponents get the causality of wages backward. A market price, of which a wage is one example, reflects the value of the underlying good or service. A worker with a particular skill set, experience, education, and work ethic can provide value to an employer. The employer who hires the worker produces a product that the employer sells to consumers. The more consumers value the employer's product, the more they will be willing to pay to obtain the product. The more consumers are willing to pay to obtain the product, the more the employer will be willing to pay to hire the workers who can produce the product.

Increasing the minimum wage does not increase the value the consumer places on the product the worker produces. But it does increase the cost of employing the worker. The effect is to reduce the value of the minimum wage worker to the employer. A counterargument is that employers would like to pay their workers as little as possible, and that a minimum wage ensures that the employer will not be allowed to pay virtually zero. Yet, the data refute this counterargument. If the counterargument were true, then all employers would pay exactly the minimum wage, as there is no law requiring employers to pay more than the minimum. But this is not what we observe. In the United States, over 97% of workers earn more than the minimum wage.[1] In 2013, the median wage in the United States was $16.87 per hour, meaning that more than half of U.S. workers were earning more than twice the minimum wage.[2]

Second, minimum wage proponents claim that many employers can afford to pay the increased wage. Even if true, whether the employer is willing to pay an increased wage has less to do with what the employer can afford than it does with the value of the worker's labor and the difficulty of replacing the worker. Certainly major fast food chains can afford to pay their workers more. But the managerial question is not whether the money exists to pay the workers more, but whether the money is best spent paying the workers more or paying for something else instead.

The recent trend of replacing cashiers in supermarkets and fast food restaurants with machinery is an example. At $5 per hour, cashiers were less expensive than automated checkout machines. As the minimum wage rose to $7.25 per hour, supermarkets started to replace cashiers with machines. A counterargument is that the reason supermarkets added automated checkout machines was simply to speed up processing. But, supermarkets could also have sped up processing by adding more cashiers. What's noteworthy is that they chose to

[1] Characteristics of Minimum Wage Workers: 2013, Bureau of Labor Statistics, US Department of Labor. (www.bls.gov/cps/minwage2013.pdf)
[2] May 2013 National Occupational Employment and Wage Estimates United States, Occupational Employment Statistics, Bureau of Labor Statistics, US Department of Labor. (www.bls.gov/oes/current/oes_nat.htm)

add machines. The increased minimum wage made the machines the lower cost alternative. Similarly, as politicians push for a $10 per hour minimum wage, fast food restaurants are experimenting with touchscreen consoles that will replace workers who take food orders. When the employer could obtain labor for $7.25 per hour, the touchscreen consoles were not cost effective. But when labor costs $10 per hour, the touchscreen consoles become the lower cost alternative. The minimum wage workers lose their jobs not because the employer can't afford them but because, by comparison, the machines have become the better investment.

Throughout, the issue is not whether the employer can pay the increased price but whether the employer is better off paying the increased price or paying for something else instead. Note that this choice is identical to the choice consumers face when deciding how to spend their money. Hybrid cars are more expensive than comparable gasoline-powered cars. The question a car buyer faces often isn't whether he can afford the more expensive hybrid, but whether he would rather buy a less expensive gasoline-powered car and spend the saved money on something else. As the price of gas rises, the hybrid becomes the more attractive choice. As the minimum wage rises, machines become the more attractive choice.

Third, minimum wage proponents often treat workers as homogeneous. There is no single "market for labor." There are many markets for labor. There is a market for unskilled labor, a market for skilled labor, a market educated labor, a market for experienced labor, and markets for each type and combination of skill, education, and experience. But the minimum wage cuts across all these labor markets as if they were one. The result is that the minimum wage has quantitatively different effects in different labor markets. Increasing the minimum wage has little effect on employment in markets for experienced, skilled, and educated labor – high productivity labor – because the wage rates in those markets are usually much higher than the minimum. But the minimum wage has a significant effect on employment in unskilled labor markets. Because higher productivity workers can do everything lower productivity workers can do, plus more, competition for jobs across the two markets is not symmetric. If he had to, the engineer could compete with the janitor for the janitor's job, but the janitor cannot compete with the engineer for the engineer's job. The higher the minimum wage goes, the more costly workers become and so the less incentive employers have to hire workers. Because high productivity workers can do everything low productivity workers can do, plus more, the majority of the unemployment effects fall on the low productivity workers.

The unemployment effects of the minimum wage across different labor markets are shown in Figure 1. The figure shows, for 1975 through 2012, unemployment among workers of various educational backgrounds compared to the relative minimum wage (the minimum wage as a fraction of the average hourly wage). Changes in the minimum wage appear to have no effect on unemployment among college educated workers. An increased minimum wage is associated with a little more unemployment among high school educated workers, much more unemployment among workers without high school diplomas, and more unemployment still among young workers without high school diplomas.

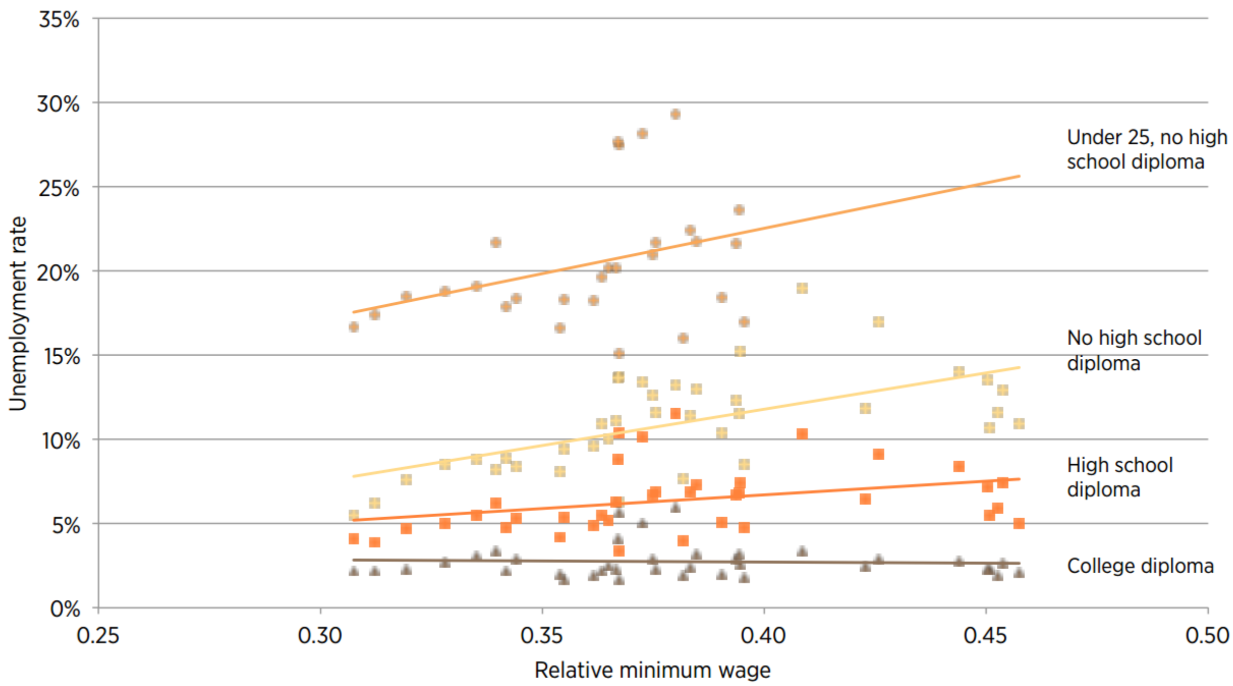

Figure 1. Minimum wage (relative to the average hourly wage) as compared to the unemployment rates for workers with different levels of education (1975-2012; data for workers under 25 with no high school diploma, 1985-2012).[3]

Fourth, minimum wage proponents often portray minimum wage jobs as dead ends. The argument is that low productivity workers can't acquire education and training because, at the minimum wage, they have to devote all their time to working just to stay alive. If only they could earn more, they could afford to devote some time to acquiring valuable skills. But this argument ignores the fact the minimum wage job itself increases the value of the worker's labor. Simply by establishing a track record of showing up for work and performing the job's tasks, the worker increases the value of his labor. This is borne out in the data. Of workers who start out working for the minimum wage, almost 50% end up earning more than the minimum

[3] Davies, A., 2013. Unintended Consequences of Raising the Minimum Wage, Mercatus Research.

wage within one year. Within three years, 97% are earning more than the minimum wage.[4] Certainly, there are some workers who are perpetually stuck in minimum wage jobs. But those workers are a very small minority. For almost all workers, the minimum wage job is a stepping stone from which the worker gains experience that increases the value of his labor and the wage his labor commands in the market. Conversely, raising the minimum wage makes the worker more expensive and so discourages employers from giving that first chance at a job to untried workers. In a very real sense, the minimum wage removes the first rungs in the income ladder the worker will spend his career climbing.

Yet, the minimum wage is not entirely bad. The minimum wage helps some workers. Because workers with more skills and experience are more valuable to employers, as the minimum wage rises, employers will tend to layoff less skilled and less experienced workers and use the cost savings to pay the increased wage to the more skilled and experienced workers. In the end, the minimum wage does not help workers at the expense of employers, but helps more productive workers at the expense of less productive workers.

[4] Carrington, W.J. and B.C. Fallick, 2001. Do Some Workers Have Minimum Wage Careers? Monthly Labor Review, May. (www.bls.gov/opub/mlr/2001/05/art2full.pdf)