

The minimum wage

A blunt instrument

Oct 26th 2006 | WASHINGTON, DC
From The Economist print edition

A higher minimum wage may not kill many jobs, but won't help many poor people

IF THE mid-term elections have one central economic issue, it is higher minimum wages. Nancy Pelosi, the leading Democrat in the House of Representatives, has vowed that if her party wins control of that chamber on November 7th, she will introduce legislation to raise the federal minimum wage from \$5.15 to \$7.25 an hour within her first 100 hours as speaker. In six states, including the swing states of Ohio and Missouri, voters will also decide on whether to raise their state minimum wage. Democrats hope the presence of such initiatives on the ballot will lure their supporters to the polls.

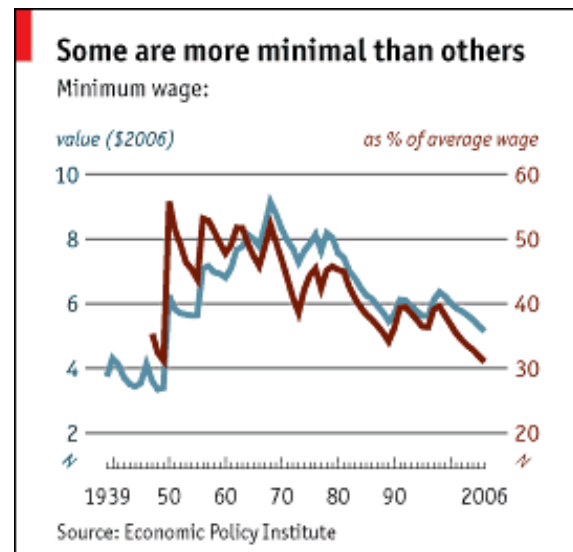
Politically, the strategy makes sense. Americans are hugely in favour of raising minimum wages. In one recent poll 85% of respondents said they supported the idea. Over half said they would be more likely to vote for a candidate if they found out that he supported introducing a rise.

Advocates claim more than politics on their side. They argue that a higher minimum wage also makes economic sense. The Economic Policy Institute (EPI), a left-wing think-tank, recently published a letter signed by over 650 economists, including five Nobel prizewinners, which advocated a rise. Since the federal minimum wage was last raised in 1997 its real value has eroded dramatically. It is now less than in 1951 (see chart). Not only would a modest rise have "very little or no effect" on employment, the letter said, it would be an important tool in fighting poverty.

Strong stuff. But, laureates notwithstanding, it does not reflect a consensus among the dismal scientists. Overall, economists have become less worried about the job-destroying effects of a modest hike in the minimum wage. But most still reckon that it is at best a blunt instrument for fighting poverty.

The academic argument—and there has been plenty of it in recent years—has focused on the employment effects. Elementary economics would suggest that if you raise the cost of employing the lowest-skilled workers by increasing the minimum wage, employers will demand fewer of them. This used to be the consensus view. But a series of studies in the 1990s—including a famous analysis of fast-food restaurants in New Jersey and Pennsylvania by David Card at Berkeley and Alan Krueger of Princeton University—challenged that consensus, finding evidence that employment in fast-food restaurants actually rose after a minimum-wage hike. Other studies though, particularly those by David Neumark of the University of California at Irvine and William Wascher at the Federal Reserve, consistently found the opposite. Today's consensus, insofar as there is one, seems to be that raising minimum wages has minor negative effects at worst. Lawrence Katz, an economist at Harvard University and signatory of the EPI's letter, agrees that "most reasonably well-done estimates show small negative effects on employment among teenagers".

So the academic debate has shifted elsewhere, although the division between sceptics and advocates remains much the same. Mr Neumark, perhaps the leading sceptic about the minimum wage, has published several papers arguing that employers spend less on training their workers as their labour costs rise; that more students drop out of school, lured by fatter pay-packets; and that workers in their late twenties earn less if they were exposed to high minimum wages as teenagers. Other studies, however, do not find this.



Where most economists agree is that the higher minimum wage does not do much to relieve poverty. That is partly because many poor people would not gain (since they do not work); partly because some of the costs of higher minimum wages are shifted onto poor consumers; but mainly because many minimum-wage workers are not poor. Only 5% of the workforce—some 6.6m people—will gain directly from a rise in the minimum wage, and 30% of those are teenagers, many from families that are not poor. Supporters of an increase, though, argue that once you include the “spillover” effects on workers who earn just above the minimum wage (but whose wages would rise as a result), the income gains from a hike are concentrated among poor families.

Not surprisingly, studies that try directly to measure the distributional consequences reach divergent conclusions. Several studies of the 1990s find that higher minimum wages helped reduce poverty, albeit modestly. Mr Neumark, unsurprisingly perhaps, finds the opposite result. He claims that increased minimum wages actually increased slightly the number of families in poverty (presumably because these workers disproportionately lost their jobs while well-off teenagers got higher wages).

Either way a better tool exists for helping the working poor: the earned-income tax credit (EITC). This tax subsidy, a “negative income tax” that tops up the earnings of the low-paid, was introduced in the 1970s and has been expanded four times since. Its benefits are currently focused on families with children. Single men get little from the EITC. Some left-leaning economists argue that it is important both to raise the minimum wage and expand the EITC. But a big EITC expansion is politically hard (unlike raising the minimum wage, it involves spending taxpayers’ money). So others support a higher minimum wage as a second-best solution. If it were up to the economists though, fatter tax subsidies would be top of the list for helping the working poor.