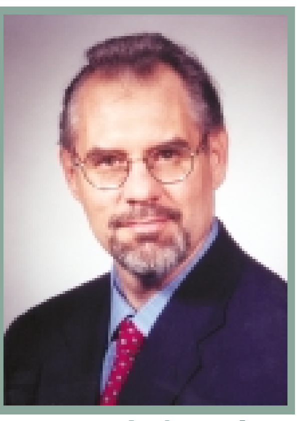
The Folly of a Higher Minimum Wage



By Michael L. Walden

In virtually every session of the U.S. Congress, there are calls for increases in the minimum wage rate. There is currently legislation introduced in Congress to increase the federal minimum wage by $1.50 over three years.

The calls for a higher minimum wage certainly strike a compassionate cord. Few of us can imagine raising a family on the earnings from working full-time at the minimum wage — an amount just shy of $11,000 per year.

Yet there are many misconceptions about who earns the minimum wage, what the impacts are of increasing the minimum wage, and whether people earning the minimum wage must survive on only those earnings. Let me try to set the record straight.

WHO EARNS THE MINIMUM WAGE?

The minimum wage rate was begun in 1938 at 25 cents per hour. Today, it is $5.15 per hour.

However, the minimum wage affects about 10 percent of the workforce and is overwhelmingly earned by very young and very old workers. Only 17 percent of men and 28 percent of women earning the minimum wage are aged 20 to 64. Approximately half of minimum wage earners are teenagers. It makes sense that teenagers earn low wages because they are inexperienced, temporary workers. The remainder of minimum wage workers are over age 65, many of whom are working part-time to supplement Social Security and pension income. So it's a myth that the typical minimum wage earner is a worker in the prime working years.

One criticism people make of economists is that we don't agree on much. Well, with respect to the impacts of the minimum wage, there is vast agreement among economists. Increasing the minimum wage reduces total employment for minimum wage workers, but for minimum wage workers who do keep their jobs, a higher minimum wage increases their income.

Any worker is paid a wage rate based on what the worker contributes to the company employing her. So, a worker paid $15 per hour is evaluated to contribute at least $15 worth of product per hour of work. Similarly, a worker paid only $5.15 per hour is evaluated to contribute only $5.15 worth of product to the company per hour of work.

Thus, when the minimum wage is increased from $5.15 per hour to $6.65 an hour, workers who aren't evaluated to be producing $6.65 of output per hour will be let go. However, not all minimum wage workers will be pink-slipped. As the number of minimum wage workers drops, the value of the remaining minimum wage workers goes up because their work will now be focused on more profitable tasks (this is a principle learned long ago by labor unions who realized that wage rates rise when the supply of workers is reduced).

In short, an increase in the minimum wage will motivate businesses to substitute machinery for labor. But this can't be accomplished all at once. In businesses, like the greenhouse industry, it will take time to reduce the use of higher-priced labor and employ more labor-saving devices and machinery. In the meantime, the higher costs imposed by the elevated minimum wage will be absorbed by a combination of higher product prices to consumers and reduced profits and margins to the industry.

LIVING ON MINIMUM WAGE

But this still begs the question of how we can expect anyone to live off minimum wage earnings? How could anyone working full-time and earning the minimum wage live off slightly less than $11,000 ($5.15 / hour x 40 hrs / week x 52 weeks) per year?

The first answer is that most minimum wage workers don't have to live on $11,000 per year and support a family. This is because, as noted above, no more than one quarter of minimum wage workers are aged 20-64. The overwhelming majority of minimum wage workers are teenagers or the elderly.

The second answer is that for the 25 percent of minimum wage adult households in their "prime" working years, there is substantial government assistance to supplement their minimum wage earnings. An adult with children working full-time at the minimum wage is eligible for the earned income tax credit, food stamps, Medicaid, assistance with housing costs and, if the children are in daycare, assistance with child care costs.

The often overlooked earned income tax credit (EITC) is cash assistance that can be received monthly. A worker who earns a minimum wage income of $11,000 and has two children can receive $3,900 in cash from the EITC, effectively increasing his hourly earnings to $7 per hour. Adding the effective financial value of the other assistance programs gives this minimum wage household a total purchasing power of over $17,000. This translates to an implicit wage rate of over $8 per hour. In other words, a minimum wage household with two children has their effective wage rate and purchasing power increased by 55 percent when all forms of public assistance are considered.

PUBLIC VS. PRIVATE

But why, you might still ask, don't we save the government and taxpayers all this money spent on programs helping minimum wage workers and simply require companies to pay workers a minimum of $8 per hour?

I've already given one reason. Increasing the minimum wage clearly and demonstratively reduces employment among minimum wage workers. So public assistance would still be needed for those minimum wage households without work.

Another reason is that low wage rates serve an important "signalling" function. They signal to the worker that his skills, although valuable, are not *highly* valued in the economy compared to the skills of other workers. This then serves as motivation for the worker to seek training and education that will improve his skills and make him more valuable to the economy.

As a compassionate society, we want to assist households at the low end of the income ladder. Yet we must also be aware of incentives — incentives for both businesses and workers. Business will only do what's in its self-interest, and this includes hiring workers. And workers will take steps to improve their financial condition if there are strong monetary incentives to do so.

The tricky task for public policy is to strike the right balance between the gift of compassion and the practicality of incentives. GPN

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