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## Bad Economic Justifications for Minimum Wage Hikes

BY RYAN BOURNE

**W**hat is the economic case for increasing the federal minimum wage? To even posit that question sounds odd. Proponents of a higher minimum wage claim that the policy change could alleviate all sorts of economic and social ills. But it's worth assessing, from first principles, the economic arguments advanced for how the minimum wage level should be set.

### A SOLUTION TO A MARKET FAILURE?

Traditionally, government interventions tend to be justified as helping correct “market failures.” In certain situations, the private interactions of companies and consumers are said to produce economically inefficient outcomes. Policymakers often imply that a regulation, tax, or subsidy can improve matters, raising societal welfare.<sup>1</sup>

Labor markets can theoretically suffer from market failures too. One example is a monopsony—an instance where one firm is the single purchaser of labor.

As the sole buyer, a monopsony company's demand for workers *is* the market demand. Rather than hiring the staff it needs at the prevailing wage, the monopsonist's hiring decisions therefore actually determine the market wage. This power leads the company to hire fewer workers than it would in a competitive market and at a lower wage rate.

Why is this? Since the supply of workers is sensitive to the wage the firm offers, increasing pay to attract an additional

worker would mean having to pay this wage increment to all current workers too. For a monopsonist firm, the total marginal cost of hiring someone therefore exceeds the marginal cost of the additional worker's wages alone.

A profit-maximizing monopsonist will therefore only hire to the point where its demand for workers is equal to the *total* marginal cost of hiring. In other words, to maximize profits, the company will hold down the wage it pays to all its workers by limiting the number of people it hires. This results in economic inefficiency—workers don't find employment even where their productivity for the firm would exceed the individual marginal cost of hiring them. Wages and employment are below those seen in a competitive market.

Where monopsony power exists, a minimum wage floor skillfully set at the competitive wage rate can therefore improve economic efficiency. By removing the monopsonist's wage-setting power, it will both end pay suppression and actually raise employment (since the firm will now have no reason to restrict how much labor it hires).

In the past two decades, there has been extensive empirical back-and-forth on whether minimum wage increases do reduce employment (as the competitive model of the labor market would predict).<sup>2</sup> Although minimum wage campaigners exaggerate the balance of the literature, some studies have found that modest minimum wage hikes can have very small to no apparent negative direct effects on employment levels.<sup>3</sup> Monopsony power is held up as a potential explanation for these results, although very few papers find a *positive* impact on employment, as the monopsony model would imply.

But those advocating for a federal minimum wage hike to \$15 per hour today do not argue for higher wage floors on the basis of monopsony power, probably for good reason.

Bureau of Labor Statistics data show that 80.3 percent of employees who are paid at or below the federal minimum wage work in three industries: retail, leisure and hospitality, and education and health services.<sup>4</sup> These industries do not tend to be characterized by companies dominating local labor markets. Indeed, using monopsony power as justification for a substantial federal minimum wage hike necessitates a much broader claim: that all U.S. employers of low-wage workers have a degree of monopsony power.<sup>5</sup>

No, federal minimum wage hike advocates today argue that the level of the wage floor should be raised to fulfill other social policy objectives, such as reducing poverty or inequality, or that it should simply be pegged to another metric, such as economy-wide labor productivity or the cost of living.

As an example, Democratic presidential primary candidate Elizabeth Warren recently claimed:

When I was a kid, a minimum wage job in America would support a family of three. It would pay a mortgage, keep the utilities on and put food on the table. Today, a minimum-wage job in America will not keep a mama and a baby out of poverty.<sup>6</sup>

Her implication here is that policymakers should set the federal minimum wage not according to the health of the economy, or its impact on labor markets, but to maintain the purchasing power of full-time minimum wage employees.

Other economists and thinkers use different comparator metrics. In his 2013 testimony before the U.S. Senate Committee on Health, Education, Labor, and Pensions, University of Massachusetts economist Arindrajit Dube's first three arguments in favor of a federal minimum wage increase were that the minimum wage had not tracked the trend in aggregate labor productivity, rising living costs, or the path of median wages, respectively.<sup>7</sup>

In testimony for state committees, David Cooper of the Economic Policy Institute regularly documents how current minimum wage rates have not "kept up" with average wages or economy-wide productivity levels and that minimum wages currently provide incomes for full-time workers below various poverty thresholds.<sup>8</sup>

This bulletin does not dispute those claims. But it argues that such comparisons are not appropriate for judging an appropriate level for minimum wage rates. Devoid of broader context, not least the labor market and firms' ability to pay

higher wages, making such comparisons might lead to damaging policy conclusions.

## TO KEEP PACE WITH PRODUCTIVITY TRENDS?

Economy-wide labor productivity has risen faster than the federal minimum wage over the past 50 years. Given a basic tenet of economics is that compensation tracks productivity levels (i.e., output per hour worked), economists and campaigners for a higher minimum wage hold up this observation as supporting evidence for raising the wage floor.

In his 2013 Senate testimony, for example, Dube said, "It is quite remarkable that had the minimum wage kept up with overall productivity [from 1960], it would have been \$22 per hour in 2011."

Although Dube stressed that he was not suggesting that the minimum wage be increased to that level, the comparison is clearly used to imply that the minimum wage could be increased significantly without adverse consequences. The comparison implies that the underlying productivity of the affected workers has been increasing, but their pay has not, perhaps because of increased market power on the part of employers.

Comparing the federal minimum wage to aggregate productivity trends in this way is problematic, though, for two reasons.

First, state, local, and city governments across the country already often set minimum wages significantly higher than the federal level, particularly in higher-productivity regions.

Right now, 29 states and the District of Columbia have minimum wages higher than the \$7.25 per hour federal level. Washington and Massachusetts, for example, have \$12 minimum wage laws. In cities, wage floors are often higher still. New York City has a \$15 minimum wage, and the minimum wage is \$16.09 in SeaTac, Washington. Economist Ernie Tedeschi has estimated that, as a result, the average effective minimum wage across the whole United States is \$11.80 per hour for 2019.<sup>9</sup>

Even if minimum wages are considered a worthy policy tool and productivity a good guide to setting their level, setting minimum wages in line with the productivity conditions within a locality makes more sense than setting a homogenous higher wage floor for the whole country. Country-wide productivity statistics mask vast productivity discrepancies across regions.

But a more important flaw in linking the minimum wage to economy-wide labor productivity is that the productivity

performance of all workers tells us little about the productivity performance of minimum wage workers. Different industries, different companies, and even different workers within organizations are likely to experience different productivity growth rates over time.

A productivity growth series solely for minimum wage workers is not available and would be nearly impossible to put together. Examining industry productivity data from 1987 through 2017, however, highlights that using aggregate productivity trends to estimate what the minimum wage level should be is problematic.

The federal minimum wage in 1987 was \$3.35, which is \$7.32 in 2017 dollars.<sup>10</sup> Since then, private nonfarm labor productivity has increased by an average of just under 2 percent per year.<sup>11</sup> If the federal minimum wage had increased in line with trend productivity over that period, it would have increased to \$13.22 by 2017 (see Figure 1).

Yet labor productivity in the restaurant sector (often regarded as a better proxy for a typical minimum wage industry) rose by an average of just 0.4 percent per year between 1987 and 2017 (with unit labor costs increasing by 3.3 percent per year).<sup>12</sup> If pegged instead to this productivity measure, the minimum wage would have increased by just 13 percent in real terms over three decades, rising to \$8.25 by 2017.

Given that the actual federal minimum wage was \$7.25 in 2017 and that 22 states had minimum wages higher than \$8.25, this productivity series and start date imply that minimum wages were higher in 2017 than justified by restaurant productivity trends since 1987 in much of the country.<sup>13</sup>

Some subsectors have had even worse productivity performances. Labor productivity in “drinking places for alcoholic beverages” (i.e., bars and pubs) actually fell, on average, by 0.2 percent per year since 1987. If pegged to this trend productivity rate, the federal minimum wage would have fallen,

Figure 1

**Real federal minimum wage versus counterfactuals tracking long-term productivity trends, 1987–2017**



Sources: Department of Labor Wage and Hour Division, “History of Federal Minimum Wage Rates Under the Fair Labor Standards Act,” 1938–2009; and Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, “Private Non-Farm Business Sector Labor Productivity, Index 2012=100, Annual, Not Seasonally Adjusted.”

too, to \$6.89 in 2017 (see Figure 1).

None of this proves that current minimum wage rates in many parts of the country are too high. Nor does it tell us what the minimum wage “should be,” in the sense of the true productivity levels of workers in individual companies or sectors, or whether employers have market power to pay workers below competitive market rates. We might also, of course, expect improving productivity in manufacturing sectors to “spill over” somewhat into other low-productivity minimum wage sectors due to competition for labor, as outlined in William Baumol’s “cost disease” thesis.<sup>14</sup>

What this scenario analysis does show, though, is the danger of spurious comparisons between economy-wide productivity and the level of the federal minimum wage. Making the link between the two explicit might lead us to deliver much higher wage floors than are justified by the productivity of workers in certain sectors or regions, causing significant localized job losses or other economic adjustments.

## COST OF LIVING

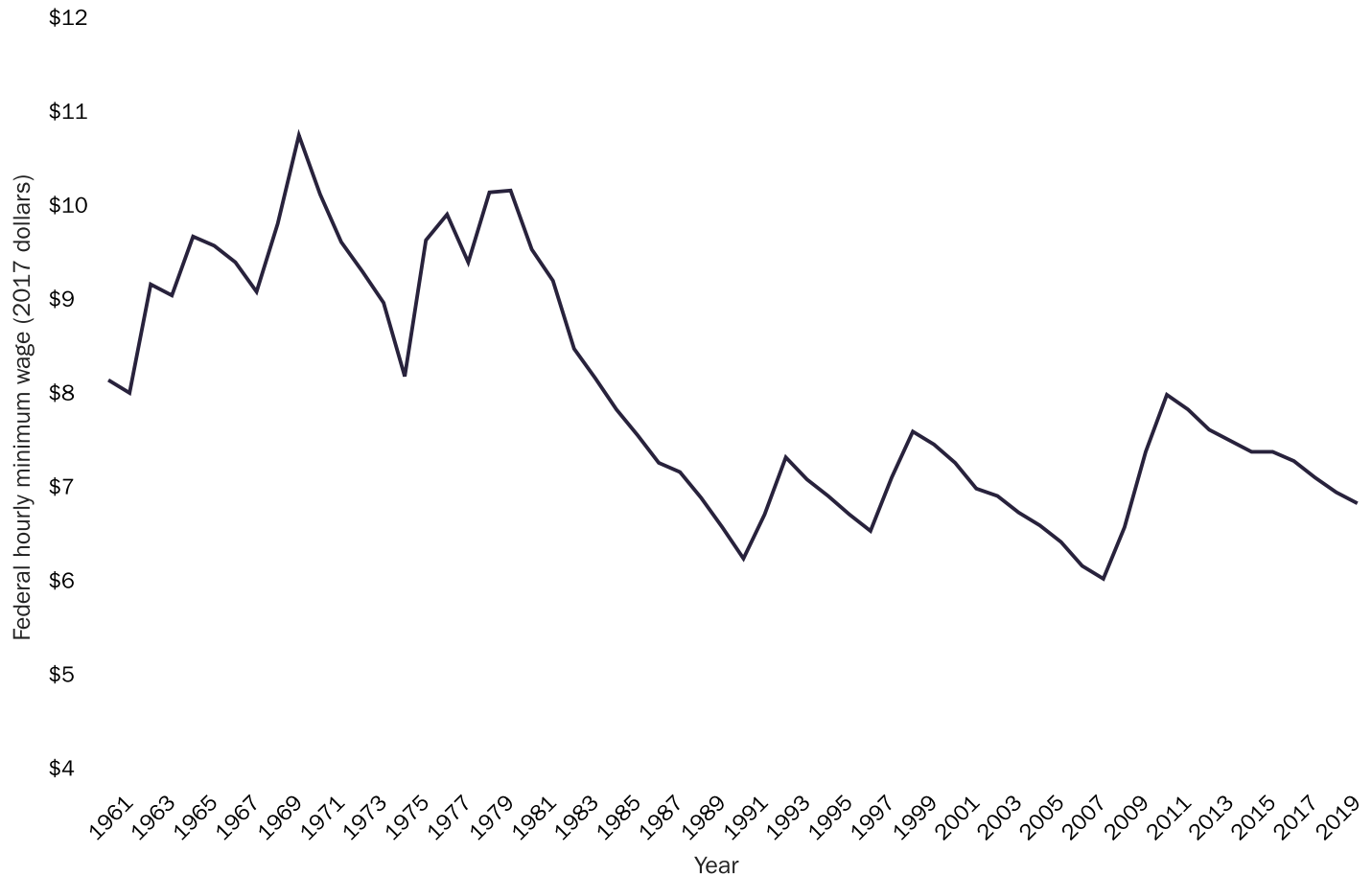
Minimum wage hike campaigners often compare the federal minimum wage to living costs. Sometimes they compare it to economy-wide inflation trends, but often they consider the cost of specific “essentials,” too, such as housing or childcare.

Minimum wage hike proponents have a point that if one believes a federal minimum wage is necessary to solve a market failure, it should be set at the “right” level to fix the failure in real terms. In practical policy, index linking the minimum wage so that it tracks the general price level in the economy therefore makes some economic sense in theory (even if, in reality, recent evidence suggests that such linking leads to larger negative effects on employment than nominal adjustments).<sup>15</sup>

As Figure 2 shows, however, the real value of the minimum wage in 2017 dollars has fluctuated wildly over the past six decades, peaking in 1969 at \$10.91 per hour and troughing at \$6.18 per hour in 2007. The real level of the federal minimum

Figure 2

### Evolution of the real federal minimum wage, 1960–2019



Source: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, “Federal Minimum Hourly Wage for Nonfarm Workers for the United States, Dollars per Hour, Monthly, Not Seasonally Adjusted.”

wage today is similar to that seen in 1994, 2002, and 2008.

Yet when campaigners compare the real level of the minimum wage from the 1960s to that of today, they are implicitly saying that the real level in the 1960s was the “right” one. This, clearly, has not been the call of numerous administrations and Congresses, which have considered that level to have deleterious labor market consequences and so have allowed the minimum wage to fall in real terms to reduce those consequences. Allowing the real minimum wage to fall by keeping its nominal value fixed is probably a more politically palatable tool than complete abolition of the minimum wage.

The long and short, then, is this: index linking the minimum wage to the price level makes sense if you are confident that the wage is currently at the right real level to alleviate any market failure. But any claim as to the latter statement is controversial, as numerous surveys of economists show.<sup>16</sup>

It makes no sense whatsoever, though, to imply that the federal minimum wage should be raised to reimburse workers for highly localized living costs (such as expensive housing or childcare).

It is important to remember that employers pay employees for the perceived value of the work the employees undertake, not to compensate the employees for their rent, food, energy, transportation, clothes, or childcare bills (which differ hugely by family and locality and are beyond employers’ control).

High living costs are, of course, a very underdiscussed cause of economic hardship in the United States. My own research has found that typical poor American households face high prices for essential goods and services because of misguided interventions and regulations. These regulations can cost them anywhere between \$800 and \$3,500 in total per year.<sup>17</sup>

Rather than tackle the structural causes of these high prices, minimum wage hike campaigners want businesses to bear the cost of compensating workers for their high living expenses. That is not economically sensible. Putting the full burden of the cost of living on shareholders and customers of the firms hiring low-wage workers—in other words, willingly divorcing pay rates from the work employees undertake, market conditions, or firms’ ability to pay their employees—could risk a significant diminution in low-wage job opportunities.

## POVERTY

Another metric used by advocates for higher federal minimum wages is to compare earnings for full-time minimum

wage workers with various poverty thresholds (which differ by household composition). The rationale here, again, is that the minimum wage should be used for targeted poverty reduction rather than just to correct market failure.

Someone working full-time (40 hours per week) earning the hourly federal minimum wage in 2017 would have obtained a pretax income of \$15,080. That income was below the federal poverty threshold for a one-parent under-65 household with a dependent child, which is \$16,985.<sup>18</sup> Minimum wage hike campaigners’ conclusions are therefore simple: raise the statutory hourly wage floor to raise the income levels of these full-time earners.

It is certainly true that for the minimum wage workers who kept their jobs and hours, raising the hourly wage floor significantly could lift them above the relevant poverty line. Yet poverty is measured at the household level. The very reason why minimum wages have not been used as a primary tool to reduce poverty *for households* is that they were not considered particularly well targeted or effective for that purpose.

First, people who earn around the minimum wage are often not from households in poverty. A 2017 Government Accountability Office (GAO) report found that just 13 percent of families with a worker earning an hourly wage between the federal minimum wage and \$12 per hour were in poverty.<sup>19</sup> Many people earning around the current minimum wage are second earners (particularly part-time workers) or young people who live in households with parents who are not poor.

Second, minimum wage hikes could have adverse consequences on employment prospects by reducing labor demand. The GAO report shows that minimum wage earners are more likely to work fewer hours than those earning higher hourly rates. The risk, then, is that higher minimum wages reduce demand for labor hours from low-productivity workers with already weak labor market attachment, as analysis found after Seattle’s minimum wage hike to \$13.<sup>20</sup>

These observations are why economists have long concluded that in-work income transfers to families with children through programs such as the earned income tax credit (EITC) are better targeted at reducing poverty. These transfers encourage work among recipients while boosting incomes of poor households, rather than discouraging employers from hiring.<sup>21</sup>

Yet federal poverty thresholds ignore the EITC and other transfers that have expanded in recent decades. Comparing the income for a full-time minimum wage earner to poverty thresholds can therefore paint a very misleading picture of the living standards faced by households below the poverty line.<sup>22</sup>

## CONCLUSION

The metrics that \$15 minimum wage advocates use to make the case for substantial minimum wage hikes are not, on their own, economically sensible benchmarks by which to set minimum wage rates.

Economy-wide productivity growth can be a poor guide to productivity trends for minimum wage workers and different localities, and it tells us little about whether firms have the power to set below-market wage levels.

Housing and childcare costs are unrelated to firms' ability

to pay or the value of the work minimum wage employees undertake. And comparing the income of someone working full-time at the federal minimum wage to existing poverty thresholds ignores the role of anti-poverty programs and the fact that many minimum wage earners are not poor.

Campaigners' arguments often imply that minimum wages should be linked to productivity measures, living costs, or poverty thresholds. The evidence presented above suggests that translating these arguments into policy could produce damaging labor market outcomes.

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