Policy Analysis

Cato Institute Policy Analysis No. 106: The Minimum Wage: Washington's Perennial Myth

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Executive Summary

Thanks to the political clout of organized labor, a number of Washington's lawmakers have once again proposed to substantially raise the minimum wage employers may pay workers.[1] Proposals from Sen. Edward Kennedy (D-Mass.) and Rep. Augustus Hawkins (D-Calif.) would raise the present minimum wage, $3.35, by nearly 40 percent, to $4.65, by 1990. An amendment to the House version of the bill, sponsored by Rep. Carl Perkins (D- Ky.), is even more generous; it would raise the minimum wage to $5.05 by 1992.

Members of Congress who support an increase in the minimum wage have all but monopolized the ethical high ground, using an appeal to simple economic justice as the single important justification for their position. The proponents argue for a "fair" minimum wage, as though government could simply legislate wealth into existence. Kennedy finds it "unacceptable" that the present minimum wage "does not permit full-time workers to provide the bare necessities for their families."[2]

In reality, full-time employees make up only a small percentage of the total number of people earning the minimum wage. The proponents' use of such straw men not only confuses the issue but also suggests that there are other, less sincere motivations for supporting an increase in the minimum wage.

Minimum-wage legislation is and always has been the result of special-interest politics. Behind the rhetoric of economic justice and fairness lie purely self-serving political considerations. A particularly glib admission of this fact was recently made by a Democratic House aide, who claimed during a congressional battle over increases in the minimum wage that Democratic proponents would "throw numbers out till nobody can have faith in the numbers, and then political considerations will win. That's how we do it every time."[3]

The simple truth about the issue is that any minimum-wage rate that is forced onto the market will have only negative effects on the distribution of economic justice. Minimum-wage legislation, by its very nature, benefits some at the expense of the least experienced, least productive, and poorest workers.

The Determination of Wages in a Market Economy

The supply of and demand for particular skills determine the market price of an individual's labor--that is, his wage. Employers attempt to purchase the specific skills they need at the lowest available price, while individuals selling their labor attempt to find the highest-bidding employer.

Every market price, including a wage, is simply the outward expression of what employers perceive to be consumers' preferences. If consumers do not value a particular good or service offered on the market, labor, as well as the other factors involved in producing the good, will be worth little. Thus, it is the individual--the sovereign consumer--who has the final say in determining wages.

Aside from a shift in consumers' preferences, there is only one noncoercive method through which real wages can rise: workers must become more productive. The most obvious way for workers to enhance their productivity is to increase or improve their skills through education, experience, and effort.

Wage rates can also be improved if employers increase their investment in future production. Increased capital investment renders labor more productive by providing workers with better tools. A simple example of this principle is the case of two equally productive workers assigned to clear a wooded lot. The first worker is given a shovel and an ax, the second, a bulldozer. Obviously, the second worker will be much more productive, which illustrates that all the hard work in the world cannot compete with a high rate of capital investment.

To increase wage rates without either an increase in productivity or a shift in consumer preferences requires coercion. It is quite possible to raise certain wages by excluding competing labor from the relevant markets. This distinction between voluntary and coercive methods of increasing wages is essentially a difference between creating wealth and redistributing wealth.

Contrary to the claims of many members of Congress, government cannot create wealth by simply passing new laws. Otherwise, Congress would long ago have passed laws prohibiting poverty and establishing a minimum wage of $100, or even $1,000, an hour. In such a world, everyone could be a millionaire. But ours is a world of scarcity, and wealth is a product of the market process, not of legislative fiat.

The Economic Effects of Minimum-Wage Laws

Simply stated, if the government coercively raises the price of some good (such as labor) above its market value, the demand for that good will fall, and some of the supply will become "disemployed." Unfortunately, in the case of minimum wages, the disemployed goods are human beings. The worker who is not quite worth the newly imposed price loses out. Typically, the losers include young workers who have too little experience to be worth the new minimum and marginal workers who, for whatever reason, cannot produce very much. First and foremost, minimum-wage legislation hurts the least employable by making them unemployable, in effect pricing them out of the market.

An individual will not be hired at $5.05 an hour if an employer feels that he is unlikely to produce at least that much value for the firm. This is common business sense. Thus, individuals whom employers perceive to be incapable of producing value at the arbitrarily set minimum rate are not hired at all, and people who could have been employed at market wages are put on the street.

Some opponents of the minimum wage argue that it aggravates inflation by pushing up the costs of individual businesses. [4] Those businesses, unwilling or unable to absorb such costs, pass them on to consumers in the form of higher prices. In this view, any artificial increase in labor costs can produce so-called cost-push inflation.

There are several problems with the notion of cost-push inflation. The primary error in this analysis is that it confuses a shift in the structure of relative prices with a general rise in the level of prices. If the labor costs of businesses are increased and they succeed in passing on the costs to consumers in the form of higher prices, they will have managed to change the structure of relative prices at the expense of businesses that are unable to raise their prices because of more-intense competition. This is quite distinct from a general increase in the level of prices, which would be possible only if the real supply of money was increased.

Many firms, however, may be unable to pass on their increased costs to consumers. It is consumers who ultimately determine the price of any good on the market, and they may decide that a business's product is not worth a higher price. Producers cannot force consumers to buy what they produce, and businesses cannot always arbitrarily increase the prices of their products simply because the government has arbitrarily increased their costs.

This fact has important implications. If a business cannot simply pass along its new labor costs, it must somehow absorb them--by eliminating workers rendered unproductive by the new minimum wage, by replacing labor with more-productive machines, or by cutting back production. Those jobs not eliminated will be more demanding, as employers will use fewer people to produce the same amount of work.

Teenagers suffer most from the adjustments required by an increase in the minimum-wage rate. These workers are generally the least experienced, least skilled, and least productive. According to the Bureau of Labor Statistics, the present unemployment rate for all teenagers actively seeking jobs is 16.5 percent, and the unemployment rate for black teenagers is 36.9 percent, more than double the overall average.[5] The existing minimum wage has contributed significantly to producing these abhorrent levels of unemployment.

The damage done to teenagers is twofold. First, they lose income immediately. Second, because minimum-wage legislation has rendered them unemployable, teenagers cannot gain the ex- perience and skills that would make them employable at higher wages later. If there were no floor price on labor, teenagers could offer to work for a lower price until they had gained the training, experience, and skills they needed to command a higher wage.

The damage done to minority teenagers is far worse. By establishing an arbitrary minimum, government reduces the costs of discrimination. In The State against Blacks, economist Walter Williams described how minimum-wage legislation alters the incentives of employers:

> Suppose that an employer has a preference for white employees over black employees. And for expository simplicity, assume the employees from which he chooses are identical in terms of productivity. If there is a law, such as the minimum wage law, that requires that employers pay the same wage no matter who is hired, what are his incentives? His incentives are [those] of preference indulgence. He must pay the black $3.35 an hour and he must pay the white $3.35 an hour. He must find some basis for choice. The minimum wage law says that his choice will not be based on economic criteria. Therefore, it must be based on noneconomic criteria. If he wishes, the employer can discriminate against the black worker at zero cost.[6]

Because no one is allowed to work for less than a set minimum, those who can command only the minimum and are discriminated against have no way to fight the problem. If wages were not fixed at a certain minimum, those who were discriminated against could compensate by offering their labor at a cheaper price. This would effectively increase the costs of discrimination for those employers who wished to practice it.

Many proponents of higher minimum-wage rates insist that the teenager and minority argument is bogus. Minimum-wage legislation, they claim, is primarily intended to help adults trying to support a family. The minimum-wage earner trying to make ends meet with an annual income of $6,968 and three or four mouths to feed is often used as an example.

A cursory study of demographic statistics suggests that this example does not accurately reflect the minimum-wage-earning population. According to the Census Bureau's "Current Population Survey," over 76 percent of all minimum-wage earners are not heads of households. Furthermore, the Bureau of Labor Statistics found that only 2.2 percent of working adults are earning the minimum waqe.

But what about those who are actually struggling to live on the bottom rung of the economic ladder? Is the government helping them by arbitrarily establishing the minimum living wage? As noted earlier, government cannot create wealth simply by passing laws. Such laws succeed only in redistributing the existing wealth of society. The distortions caused by fixing the price of labor produce definite losers and winners; it is the least employable, the truly needy, who lose their jobs, and the winners either earn wages above the new fixed price or have protected jobs.

Minimum-wage legislation fosters economic inequalities by creating a gap in the economic ladder: those on the bottom rung are kicked off, but those on higher rungs climb up. By no means are such government-created inequalities fair or just.

Theory, Statistics, and Econometrics

Economic theory demonstrates that minimum-wage legislation will inevitably create unemployment. It cannot, by its very nature, indicate how much unemployment will be generated in any particular instance. However, numerous statistical studies are in rare agreement in their support of a causal relationship between minimum wages and unemployment. For example, the 1983 Report to the U.S. Senate Committee on Labor and Human Resources of the General Accounting Office

> found virtually total agreement that employment is lower than it would have been if no minimum wage existed. This is the case even in periods of substantial economic growth. . . . The severity of the employment loss varies among different age, gender, and racial groups in the population. Teenage workers, for instance, have greater job losses, relative to their share of the population or the em- ployed work force, than adults.[7]

According to the 1981 Report of the Minimum Waqe Study Commission, the 46 percent rise in the minimum wage between 1977 and 1981 destroyed 644,000 jobs among teenagers alone. "The evidence is now in, and the findings of dozens of major economic studies show that the damage done by the minimum wage has been far more severe than even the critics . . . predicted." [8] A 1983 survey, "Time-Series Evidence of the Effect of the Minimum Wage on Youth Employment," found that studies conducted between 1973 and 1983 generally agreed that a 10 percent increase in the minimum wage would result in a 1 to 3 percent reduction in teenage employment.[9] Given these findings, the proposal to raise the minimum wage by nearly 40 percent could result in a 4 to 12 percent drop in the employment of teens.

A recent study by Clemson University economists Richard B. McKenzie and Curtis Simon estimated that an increase in the minimum wage to $4.65 by 1990 would cost 764,000 jobs by that year and 1.9 million jobs by 1995. The economic output lost in 1995 would total $70 billion (in 1982 dollars).[10] The political embarrassment created by such estimates was graphically illustrated recently when the House Democratic leadership suppressed a Congressional Budget Office study that predicted a loss of 250,000 to 500,000 jobs if the minimum wage was increased to $5.05. The majority staff of the House Education and Labor Committee sent the study back and asked for a new version that lacked any reference to the bill's prospective impact on unemployment and inflation. The majority staff director explained that the CBO had "provided information that was not requested."[11]

The Senate Republican Policy Committee, citing a General Accounting Office study, estimated that increasing the minimum wage from $3.35 to $4.61, as suggested by AFL-CIO president Lane Kirkland, would eliminate between 124,000 and 619,000 jobs.[12]

It is not surprising that AFL-CIO economist John L. Zalusky disputes these findings. He predicts that a $1 increase in the minimum wage would eliminate very few jobs, and his "hunch is that a wage hike would provide a mild stimulus" to economic growth.[13] According to Zalusky's model, created for the union by the econometrics firm Data Resources Inc. (DRI), a $1 increase would eliminate 450,000 jobs during the next eight years. However, Zalusky says, this loss has little importance when compared with the 11 million jobs that the model predicts would be created in the same period.[14] Zalusky claims that such "real world evidence" casts doubt on the "theoretical constructs" of economics.

Zalusky's casual dismissal of theoretical constructs implies that his model is somehow theory-free and concerned with only the objective numbers. This is simply not the case. Any statistical or econometric model requires that some theory be used to determine what data are needed to test it.[15] In fact, two theoretical assumptions of Zalusky's model make its results quite deceptive.

First, the DRI model ignores potential workers who are not seeking employment and therefore are not counted in the official unemployment statistics. But one of the most destructive aspects of wage fixing is that it discourages a large number of potential workers from looking for jobs. A proper accounting would include all unemployed workers, not just those seeking employment.

An even greater problem with the model is that it ignores the increase in employment that might have occurred if a minimum wage had not been imposed in the first place. A growing economy creates jobs. It is misleading to claim that a minimum wage does not create a net decrease in the total number of jobs. A net decrease would indicate that the minimum wage had destroyed more jobs than the market process had been able to create in the same period. Such a scenario, although possible if the minimum was fixed high enough, has not yet occurred. The market has somehow compensated for past legislative foolishness. A more accurate accounting would compare the number of jobs created under minimum-wage restrictions with the number of jobs that might have been created inthe absence of those restrictions.

Such considerations strongly suggest that most studies, including the DRI model, have underestimated the destructive effect of minimum-wage legislation on employment. Minimum wages may generate considerably more unemployment than such studies estimate. The difficulty of putting numerical values on what would have happened had the government not interfered, compounded by the proponents' willingness to "throw numbers out till nobody can have faith in the numbers," indicates that the numbers have not captured and cannot capture the whole story.

Who Benefits from Minimum-Wage Legislation?

Labor unions and their members are the most obvious beneficiaries of government-imposed minimum wages. As the established elite of the workforce, union members are on the receiving end of the minimum wage's redistribution process. To fully understand how unions gain from minimum-wage legislation, one must consider the essential nature of unions.

The success of a union depends on its ability to maintain higher-than-market wages and provide secure jobs for its members. If it cannot offer the benefit of higher wages, a union will quickly lose its members. Higher wages can be obtained only by excluding some workers from the relevant labor markets. As F. A. Hayek has pointed out, "Unions have not achieved their present magnitude and power by merely achieving the right of association. They have become what they are largely in consequence of the grant, by legislation and jurisdiction, of unique privileges which no other associations or individuals enjoy."[16]

A labor union's ability to maintain special privileges for its members is reflected in the income data of the Bureau of Labor Statistics. According to a 1987 document entitled "Employment and Earnings," the median weekly wage for union members is $439; for nonunion workers, it is $325. Based on a 40-hour week, the hourly wage is $10.97 versus $8.12.

Unions attempt to fix or limit the supply of labor in a particular market, which raises the value or price of the labor available within that market. In this sense, a union functions as a redistributive institution. The winners are those still included in the labor market, the union members. The losers are those excluded from the market, the unemployed.

As would be expected, labor unions are the main political force behind minimum-wage legislation. Although unions already hold privileged positions in labor markets, minimum wages further increase their gains by raising employers' labor costs. As long as union members earn wages above the minimum rate, their positions are made more secure by the government policy that eliminates those who might undercut the union wage. People willing to work for less than the government's minimum are not allowed into the labor market at all. Indeed, union leader Edward T. Hanley stated in a catering industry employees' publication, "The purpose of the minimum wage is to . . . provide a floor from which we can upgrade your compensation through collective bargaining."[17]

A second barrier tends to insulate union members from the changes that a minimum-wage increase requires of others. Because union members already enjoy institutionally protected jobs, there is a good chance that they will be the last fired in any cost-cutting campaign by businesses trying to cope with the new costs imposed by a higher minimum wage.

It is not surprising that the AFL-CIO, representing 90 percent of all unions, has lobbied hard for another increase in the minimum wage. Political pressure from the AFL-CIO is the factor primarily responsible for breathing new life into the debate over the minimum wage. "Congressional Democrats, under pressure from organized labor, will try to move forcefully on the [minimum-wage] issue. Unions played an important role in helping the party take back the Senate, and labor leaders want to see progress now that Democrats control both chambers."[18]

It is Big Labor and its political representatives that perpetuate the minimum-wage myth. The advocates of minimum-wage laws--shrouded in the rhetoric of fairness and economic justice--always come back to roost in Washington. As James Buchanan pointed out, "People who are damaged by minimum-wage legislation are not an effective pressure group, whereas the groups that support minimum wages, namely the labor union interests being protected, are much more effective in the political process."[19]

Conclusion

Regardless of the intentions of its supporters, the proposed minimum-wage legislation cannot achieve their stated goal of raising the real income of the poor to a more livable level. Indeed, it is an extremely shortsighted policy that can only breed destruction, by eliminating the jobs of those who need work most: the poor, the young, and those suffering from discrimination.

What has been touted as a matter of basic economic justice turns out to be a self-serving issue for many of its supporters. If the minimum wage is increased, labor unions and their influential friends in Congress will make big gains. Unfortunately, everyone else will lose.

In the long run, however, such policies will hurt every-one. As unemployment increases, business becomes more and more unproductive, and the overall quality of life declines, all Americans will suffer.

FOOTNOTES

[1] originally intended to take place in summer 1987, the congressional battle over an increase in the minimum wage was postponed until 1988. Democrats hope to increase their political gains by having the battle take place during an election year. See Forum Notes, Washington Forum, September 4, 1987, p. 1.

[2] "Maximizing the Minimum," April 6, 1987, p. 55.

[3] "Minimum Wage Getting Maximum Attention," Congressional quarterly, March 7, 1987, p. 406.

[4] See, for example, Bruce Bartlett, "How the Minimum Wage Destroys Jobs," Heritage Foundation Backgrounder, February 19, 1987.

[5] Bureau of Labor Statistics, seasonally adjusted figures, March 1988.

[6] Walter Williams, The State against Blacks (New York: New Press, McGraw-Hill, 1982), p. 42.

[7] General Accounting Office, "Minimum Wage Policy Questions Persist," in Report to the U.S. Senate Committee on Labor and Human Resources (Washington: General Accounting Office, 1983).

[8] "Minority Report of Commissioner S. Warne Robinson," in Report of the Minimum Wage Study Commission, vol. 1 (Washington: GPO, 1981), p. 182.

[9] Charles Brown, Curtis Gilroy, and Andrew Cohen, "Time-Series Evidence of the Effect of the Minimum Wage on Youth Employment," Journal of Human Resources (Winter 1983).

[10] Richard B. McKenzie and Curtis L. Simon, "The Proposed Minimum Wage Increase: Associated Job Loss by State, Region, and Industry" (Washington: National Chamber Foundation, 1988).

[11] "Minimum Wage, Maximum Cover-Up," Wall Street Journal, May 3, 1988.

[12] Senate Republican Policy Committee, "The Minimum Wage: A Case of Special Interest Politics versus Jobs," March 26, 1987.

[13] "Raising the Floor," National Journal, March 21, 1987, p. 702.

[14] Ibid.

[15] In fact, such models usually attempt to represent human action as a series of functional relationships. Models of the market process based on such deterministic assumptions are, at the very least, open to the question of relevance.

[16] F. A. Hayek, "Unions, Inflation and Profits," in Studies in Philosoihv. Politics and Economics (New York: Simon and Schuster, 1969), p. 281.

[17] Catering Industry EmDlovee, December 1977, p. 3. Cited in Belton M. Fleisher, Minimum Waae Reaulation in the United States (Washington: National Chamber Foundation, 1983), p. 9.

[18] "Minimum Wage Getting Maximum Attention," p. 403. [19] "The Budget Chief Talks with the Nobel Laureate," Conser-vative Digest, July-August 1987, p. 31.

[19] "The Budget Chief Talks with the Nobel Lauteate," Conservative Digest, July-Auguest 1987, p. 31.