Examining the Many Sides of The Minimum Wage Debate

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Abstract

For several years, the most strident opponents of increasing the minimum wage have been businesses. It seems that the idea of no job loss, and the idea that the minimum wage could actually stimulate economic growth, has changed the idea of how economics, and the world, works, and has helped shape these companies' renewed perspectives. I begin by exploring the broader question of whether there should be a minimum wage, then analyze the economics, and effects of increasing the minimum wage. Next, I discuss some alternate theories of determining the level of the minimum wage, then conclude with some suggestions for designing a more effective minimum wage policy.

Introduction

In July 2016, Brooklyn's iconic Del Rio Diner closed after forty years in business. In an interview, the diner's owner stated, "the minimum wage, that's what broke the camel's back. It killed us[1]." Elsewhere in New York state, beloved eateries like Bob and Ron's Fish Fry in Latham, Medici House in East Aurora, and Longway's Diner in Watertown, have either closed or have had to cut staff to adapt to the minimum wage hike. These are but a few of the several businesses featured on www.facesof15.com, a website that chronicles the stories of small business owners who have either had to close, or are struggling to survive, due to higher costs resulting from the minimum wage increase. But on the other side, there's also the story of Tenesha Huesta, a divorced mother of two, hoping for a minimum wage increase. Tenesha was forced to move back into her father's house, with her children, because her income from her full-time job as a shift manager at Burger King was insufficient to cover her family's basic needs.

[1] https://nypost.com/2016/07/24/the-latest-innocent-victim-of-the-fight-for-15/

In an interview she stated, “with a higher wage…I’d be able to buy things. Maybe I’d be able to move out of my father’s house. Maybe I could get off food stamps[2].”

The minimum wage is one of the most controversial and polarizing topics in political economy, and society at large. It pits democrats against republicans, neoclassical economists against institutional economists, and in some cases, workers against their employers. It’s a battle of ideas, as well as competing interests. In this paper, I examine the many ideas in, and sides of, the minimum wage debate

Should There be A Minimum Wage?

Libertarians argue that markets operate efficiently, and that firms should be allowed to set their own prices for labor with little government intervention. As Milton Friedman stated, “the scope of government must be limited. Its major function must be to protect our freedom both from the enemies outside our gates and from our fellow-citizens: to preserve law and order, to enforce private contracts, to foster competitive markets[3]”. Often invoking the case of Speenhamland, and the English Poor Laws, free market devotees have argued that government intervention may in fact engender negative, unintended, consequences. According to this perversity thesis, policies intended to alleviate poverty instead create welfare dependency and exploitation, exacerbating the very social ills that they were intended to remedy (Hirschman, 1991). Malthus’ scarcity theory, as well as the theory of social naturalism, lend further support to the libertarian belief that markets should be governed by the invisible hand, rather than the visible hand of the government. Malthus argued that the condition of scarcity motivates people to work and, that by providing a safety net, government would hinder productivity. Similarly, “social naturalism was at the root of Classical Economics’ ‘iron law of wages’ – the claim that if workers are paid more than subsistence, they will reproduce too quickly, and the

2 http://www.nytimes.com/2013/11/29/business/on-registers-other-side-little-money-to-spend.html?pagewanted=all

3 https://churchlayman.wordpress.com/2013/01/11/economist-milton-friedmans-view-re-government-action-and-economic-liberty-capitalism-and-freedom-2002/

population would outrun the supply of food. The iron law was abandoned by the mid-19th century but economists continued with the social naturalist assumption that labor is like any other commodity (priced by the laws of supply and demand and that its price should not be propped up by government)[4]."

Challenging the theory of social naturalism, Karl Polanyi argued that labor was not a commodity (only a fictitious one) and that attempts to disembed the labor market from society would ultimately result in social degradation. "Unlike soybeans or other commodities, employees know and care about their price, and when they are paid better, they tend to work harder, stay in jobs longer, and improve the employer's bottom line.[5]" Economists, and proponents of the minimum wage, also make the case for government intervention based on their claim that market failures are pervasive. As Acemoglu & Robinson state, "…the presence of market failures – like externalities, public goods, monopoly and imperfect competition – creates room for well-designed public interventions to improve social welfare" (Acemoglu & Robinson, 2013, p. 173). Indeed, government intervention into labor markets through the setting of a legal minimum wage helps to correct differences in bargaining power between workers and firms, prevents labor market discrimination, and contributes to a more egalitarian and just society.

The Economics of Increasing the Minimum Wage

"Debates about the economic effect and merits of the minimum wage date back at least as far as the establishment of the Department of Labor as a cabinet-level agency in 1913" (Neumark, 2014, p. 1). The neo-classical school argues that increasing the minimum wage requires an equity-efficiency tradeoff. They theorize, that in a perfectly competitive labor market where firms seek to maximize profits, and have no monopsony power, an increase in the minimum wage would reduce demand, increase supply, and result in unemployment and/or underemployment. While the workers who remain employed would be better off,

[4] https://www.ineteconomics.org/perspectives/blog/learning-from-karl-polanyi
[5] ibid

those who are worth less than the new minimum wage will be worse off (not pareto efficient). The magnitude of the reduction in employment depends upon the wage increase, as well as the elasticity of the labor demand.

However, several scholars, including Adam Smith, have emphasized that markets are not always perfectly competitive. In the competitive model, firms are assumed to already be operating at peak efficiency but in reality, many firms are not operating on their production possibility frontier, and could implement procedures to maximize efficiency. According to this alternate theory (the institutional theory) which draws on concepts in behavioral economics, moderate minimum wage increases may, in the short-run, have either no employment effect or a small positive effect (Wilson, 2012). Employers respond to minimum wage increases not by laying off workers but by searching for other ways in which to absorb increased labor costs. This could include expanding sales by increasing prices, enhancing customer service, or reducing organizational slack and increased productivity. In this model, equity and efficiency are complementary.

The institutional theory challenges the very foundation of modern economics – neoclassical price theory- and adds to the lingering question of whether some of the ideas in neo-classical economics have as great applicability and usefulness in economic and policy analysis as was once assumed. As Douglas North states, “there is a persistent tension between the theories we construct and the evidence we compile about human interactions in the world around us. It is most striking in economics, where the contrast between the logical implications of neoclassical theory and the performance of economics (however defined and measured) is startling[6].” It is this challenge to the usefulness of neoclassical theory that has helped the field of behavioral economics to gain greater prominence, as economists search for alternate explanations for important phenomena that the rational agent theory fails to explain.

The Employment Effects of Increasing the Minimum Wage

Over the past several decades, economists and statisticians, from both neo-classical and institutional schools of thought, have made important contributions to the empirical literature

[6] Professor Howell Lecture Notes, Douglas North – Institutions, Institutional Change and Economic Performance

on the economic effects of the minimum wage. Hundreds of studies, and meta-studies, have been conducted to examine the impact of minimum wage increases on different regions, industries, and types of workers. Findings have been diverse, ranging from dis-employment effects, to no effect on employment, to a positive effect of the minimum wage on employment.

In 1994, David Card and Alan Krueger, examining the impact of the 1992 increase in the New Jersey minimum wage on fast-food employment, were amongst the first of contemporary researchers to provide some evidence that increased minimum wage associated job loss was negligible. In 2006, David Neumark and Williams Wascher, after examining more that 100 minimum wage studies, found the opposite – they stated that the preponderance of evidence indicates that the minimum wage hike does indeed result in dis-employment. Consistent with the Card & Krueger findings, many recent studies have also found that moderate minimum wage increases tend to have little to no impact on job loss (e.g. Dube et al. 2010, Reich & West, 2014). According to this 'no job loss' theory, a higher minimum wage provides an incentive for more qualified people to enter the workforce, as well as for workers to be more productive. Higher pay (from the minimum wage directly as well as the spillover effects) also increases workers' buying power, which could have a multiplier effect; increased consumer spending could boost overall economic activity, stimulate economic growth, and create even more jobs. The 'no job loss theory' has been advanced by many labor economists, and has informed much recent minimum wage policy changes. San Francisco, Seattle, New York and Los Angeles have all enacted minimum wage increases. Many large corporations like McDonalds, TJ Maxx, The Gap, and Target have also voluntarily increased their base wage rate. The role of this 'no job loss' idea in spurring policymakers to action, interestingly, lends some support to Dani Rodrik's theory of ideas, his challenge to the notion that "there is a well-defined mapping from interests to outcomes" (Rodrik, 2014, p. 190), and demonstrates that interests are indeed malleable. For several years, the most strident opponents of increasing the minimum wage have been businesses. It seems that the idea of no job loss, and the idea that the minimum wage could actually stimulate economic growth, has changed the idea of how economics, and the world, works, and has helped shape these companies' renewed perspectives.

But the debate over the employment effects of the minimum wage is far from over and there have been cases where the 'no job loss' idea has failed to be effective. In August, Illinois' governor vetoed a bill to raise the minimum wage to $15. And, the National Restaurant Association, through legal means, lobbying efforts, and ads that warn of the disastrous consequences (job loss) that the minimum wage increase will engender, continues to fight against the minimum wage increase.

Other Effects of Increasing the Minimum Wage

As the debate over the employment effects of the minimum wage continues, each side also continues to publish its own studies replete with econometric models to support its position. A few months ago, a group of researchers at the University of Washington published a stud[7]y where they reported finding evidence that an increase in Seattle's minimum wage to $13, in 2016, led to loss of hours worked for low wage-workers[8]. One week before this negative study was published, another study by a different group of researchers was widely circulated in Seattle but instead this study cited favorable effects (no job loss) of raising the minimum wage[9].

Besides, or beyond, the issue of job loss, increasing the minimum wage could have some negative impacts on certain segments of the population. Policymakers need to consider these issues when implementing a minimum wage hike:

An increase in the minimum wage could negatively impact low-skilled workers. Several scholars (e.g. Wilson, 2012; Schmitt, 2013) have shown that employers respond to an increase in the minimum wage by replacing low-skilled workers with those with higher skills who are deemed to be more productive. Minorities and immigrants who tend to be less educated and trained, are more likely to be adversely affected by a minimum wage increase.

[7] This study has been highly criticized. Economists caution against drawing conclusions from this single study and also highlight, as do the study's researchers, that the study fails to account for independent contractors and 'off the book' employees.
[8] http://www.nber.org/papers/w23532
[9] https://www.forbes.com/sites/timworstall/2017/06/27/these-people-are-shameless-seattles-15-minimum-wage-is-worse-than-you-thought/#49ba822031ba

Higher bargaining power of employers, coupled with desperation amongst displaced lower-skilled employees may also create an uptick in the underground economy.

An increase in the minimum wage could exacerbate poverty. While policy makers have often invoked a higher minimum wage in their initiatives to diminish poverty, the minimum wage may actually do little to lessen poverty and in some cases, could even accentuate it. An estimated 63.5% of poor Americans (Wilson, 2012), are not in the workforce, so an increase in the minimum wage will have little impact on most of the people who live in poverty. Moreover, if a minimum wage increase is passed onto consumers in the form of increased prices, it will hurt the poor because they disproportionately suffer the effects of price inflation (Wilson, 2012). An increase in the wage rate may also result in low-income workers losing government benefits like food stamps and child care subsidies. As an example, an increase in the wage rate by only fifty cents from $15 to $15.50, in Indianapolis, would cause a low-income individual to lose almost $9,000 in childcare benefits[10].

An increase in the minimum wage could adversely affect businesses. In their theory that a minimum wage increase will have little to no discernible impact on job loss, economists postulate that businesses will find other means to adjust for labor cost increases. Most often stated is that businesses will increase prices, or that productivity increases will compensate for increased costs. However, for businesses to increase prices without a decline in sales, demand must be relatively inelastic; for productivity gains to compensate for losses, businesses must have operational slack (or at least to the extent that productivity gains would be greater than the increase in labor costs). These two assumptions may not hold true for many businesses who may instead be forced to absorb increased costs through lowered profit. This could ultimately result in lower reinvestment by firms which could adversely affect economic growth.

Increased labor costs could also force firms to reduce other employee benefit programs (which could adversely affect employee morale), or even result in cost cutting measures that could affect the quality of their services. An analysis of Seattle restaurants shows that as the

[10] https://www.theguardian.com/money/2014/jul/20/benefits-cliff-minimum-wage-increase-backfire-poverty

city raised the minimum wage for restaurant employees and other workers, restaurants responded by lowering hygiene standards[11].

While some businesses may be able to absorb higher labor costs, an increase in the minimum wage could force some businesses to close. This is especially true for small business since they oftentimes operate with little margin for error - anything that increases their costs can hurt these businesses[12]. Indeed, a recent survey done by Los Angeles County[13] to assess the impact of a minimum wage increase, found that smaller firms are more likely to employ minimum wage employees, and will be most impacted while having the fewest options for managing cost increases. It could be argued that the employees of small businesses that are thus forced to close could be absorbed by larger firms, and that the net benefits (increased pay for workers and attendant multiplier effects) may outweigh the costs (loss of some small businesses). But a policy that obliterates several small businesses creates a less competitive landscape, and one in which bigger firms may have more market share, and ultimately more power. This could potentially further increase the wealth at the higher end of the income scale, and further exacerbate inequality.

Examining Two Minimum Wage Proposals

A few years ago, President Obama proposed raising the federal minimum wage to $10.10 “to help lift working families out of poverty[14]” but was blocked by Republicans. In the face of federal inaction, some cities have instituted a gradual increase of their minimum wage to $15 an hour. The Economic Policy Institute has also proposed increasing the minimum wage to $12 by 2020. Now that the employment effect debate seems to be settled amongst those economists who believe the ‘no job loss’ theory, the latest controversary is over the magnitude of the increase of the minimum wage. David R. Howell, Kea Fiedler, and Stephanie Luce

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[11] https://www.npr.org/2017/09/13/550607377/how-the-minimum-wage-affects-restaurant-hygiene

[12] http://www.politifact.com/new-york/statements/2016/dec/23/michael-long/business-new-york-have-closed-because-minimum-wage/

[13] https://laedc.org/2015/06/15/laedc-study-considering-minimum-wage-policy-l-county/

[14] https://www.washingtontimes.com/news/2014/oct/11/obama-continues-1010-minimum-wage-push-gop-calls-h/

propose setting the minimum wage to a level that allows a worker to have a minimally decent standard of living. Arindrajit Dube proposes setting the minimum wage using the Kaitz Index. While both sets of scholars agree that the minimum wage could help solve broader social issues of inequality and stagnant wages, they seem to differ on what they believe the objective of the minimum wage should be. Dube seems to believe that employment effects should be paramount, and that the minimum wage should be set to a level where there is little to no job loss. Conversely, Howell et al. argue that the debate needs to move beyond no job loss, that job loss should be a secondary (though important) consideration, and that the policy's goal should be to ensure that full-time workers are able to support a minimally decent living standard.

According to Dube, a Kaitz Index of 0.5 indexed to inflation, and that also accounts for the cost of living in the local jurisdiction, should be used. He chooses 0.5 as the target level because of important historical precedence in the United States – the Kaitz Index averaged 0.5 between 1960 and 1979. Howell et al. critique Dube's use of the Kaitz Index for both setting the minimum wage, and as an indicator of job loss. As they state, using a ratio of 0.50 because, historically, that ratio resulted in no job loss, necessarily precludes the consideration of higher wage rates. Moreover, to counter Dube's claims that the Kaitz Index could predict employment effects, Howell et al. argue that what determines employer layoff decisions is the increased labor costs firms face - yet the Kaitz Index does not account for changes in firms' wage bills. Howell et al. also highlight that setting the minimum wage at the local jurisdiction level using the same Kaitz Index for each location, could result in great variability in the minimum wage within a narrow geographical area.

Howell et al. instead advance the use of a minimum living wage, the lowest wage that a worker needs for a minimally decent living standard based on a basic needs budget. They argue that employers that fail to pay a minimally self-sufficient wage are essentially imposing social costs onto the nation. That workers should be paid a minimum living wage, as Howell et al. advocate, is unassailable. In 1938, when the federal minimum wage was first established under Franklin D. Roosevelt's leadership, its goal was to provide workers with "a minimum standard of living necessary for the health, efficiency and well-being of workers without substantially curtailing employment of earning power[15].” While the federal minimum wage has been raised 22 times since then, adjusted for inflation, it is roughly the same as it was since the 1960s-1970s despite significant increases in the average living standards over that period. Setting the minimum wage at the level needed for a worker to be minimally self-sufficient, as Howell et al. propose, is consistent with what Roosevelt initially intended for the federal minimum wage to accomplish.

Suggestions For A More Effective Minimum Wage Policy

As has been previously discussed, raising the minimum wage, even in the case of no job loss, may not produce a pareto efficient outcome. While some workers will benefit from higher wages, and some previously unemployed higher skilled workers may enter the workforce, lower-skilled workers may be displaced and made worse off. Similarly, raising the minimum wage may disproportionately affect small businesses. Policy makers should also take greater account of the impact that an increased minimum wage may have on businesses since, ultimately, it is the impact on firms’ wage bills that will drive layoff decisions. The assumption that firms will adjust to increased labor costs through other channels may be too simplistic, as has been previously emphasized. In designing an effective minimum wage policy that includes a higher minimum wage, the following elements should be included:

Increased job training and education programs. This would help increase the skill levels of lower-skilled displaced workers, assist in making them more marketable, and getting them back into the workforce.

Equity for Small Businesses. According to the Small Business Administration (SBA), small businesses have provided 55% of all jobs and 66% of all net new jobs since the 1970s. In New York City, companies with fewer than 50 employees accounted for nearly 98% of the growth in business citywide from 2000 to 2013. Growth among businesses with more than 100 employees has been flat since 2008, and the number of businesses with more than 1000

[15] Fair Labor Standards Act 1938, article 202

employees decreased 1% during the same period[16]. As small businesses grow, they often add middle-wage positions and increase benefits for their workers, including paid sick leave, time off and subsidized healthcare. However, it is also true that a third of all small businesses fail within their first two years in businesses[17], adding to unemployment numbers. Two of the most cited reasons for failure are lack of finances, and not having an effective human resources team. Increased labor costs resulting from a higher minimum wage could, unfortunately, accelerate the plight of many new firms. But wage subsidies to small businesses could protect against the effect of the higher minimum wage, as well as provide these businesses with better skilled, and more productive workers. A higher minimum wage coupled with wage subsidies to small businesses could, therefore, potentially be beneficial to both workers and small businesses.

Large companies should pay for their negative externalities. Since the 1980s U.S., productivity has doubled while compensation has only increased by about 50%. Several businesses have earned super profits while their workers are receiving government assistance. As an example, a recent report showed that Walmart, in 2012, paid a minimum wage of $9,[18] had $405B in annual revenues yet America's taxpayers subsidize Walmart by paying for the healthcare costs, housing, and food of Walmart employees because Walmart does not pay its employees a living wage. Just one Wisconsin store costs taxpayers between $904,542 per year and $1,744,590 per year. In fact, Walmart employees have been one of the single largest group of Medicaid recipients in the United States[19]. Moreover, like many large corporations, Walmart pays less a much lower tax rate than small businesses because they are able to capitalize on tax loopholes. If our overall goal is the pursuit of equity and reduced inequality, besides increasing the minimum wage, policymakers need to ensure that large corporations pay their fair share - they should be taxed to a greater extent to compensate for these negative externalities.

[16] https://nycfuture.org/research/scale-up-new-york
[17] According to the SBA
[18] Its minimum wag is now $1 higher, at $10 but in some cities like New York City is must employees at least $11 per hour.
[19] http://www.truth-out.org/opinion/item/18065-if-a-business-wont-pay-a-living-wage-it-shouldnt-exist

Finally, a well-designed minimum wage policy should take into account other environment and economic factors that could make increasing the minimum wage particularly burdensome for businesses. As an example, in New York City, instituting a higher minimum wage at a time when commercial rents are escalating, could be extremely difficult for businesses to absorb.

Conclusion

The debate over the minimum wage is almost as old as the minimum wage itself, and is certainly far from over. The effects of increasing the legal price floor are far from conclusive. Instituting wage levels as high as $15, is threading into unchartered waters. We may see results that deviate from economists, on both sides, predict – it could be a boon for the economy, or a bust for jobs. Either way, policymakers need to be prepared, move beyond the no job loss debate, and engage in other necessary analyses. As this paper has demonstrated, the minimum wage debate is a battle of ideas. In some cases, ideas trump interests – ideas change interests. In some cases, the effect of ideas is still left to be seen.

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