

Low-Wage Workers and the Minimum Wage

John Garen

Department Chair and Gatton Endowed Professor of Economics, University of Kentucky

August 4, 2006

There's a proposal before Congress to incrementally raise the U.S. minimum wage from its present \$5.15 per hour to \$7.25. Though it's not clear whether this proposal will pass into law, let's consider aspects of minimum wage legislation in general and this proposal in particular. Before getting into details, consider the presumed rationale and objectives for the minimum wage in order to establish criteria for judging the success of such a policy. Presumably, a primary purpose stems from an altruistic desire to help the poor. A big reason poor people are poor is that they lack labor market skills, leading to low wages. A natural reaction to remedy this is mandating a higher minimum wage. A second purpose of minimum wage is related to the first. We may wish to establish a social safety net that "catches" any of us who may fall into poverty. A minimum wage sets a lower bound on the wage earned if life's circumstances relegate one to a lousy job. Finally, a higher minimum wage may be intended to encourage low-wage individuals to keep working to build labor market skills and their future prospects.

There are two main problems with minimum wage legislation in meeting these objectives: targeting the poor and effects on employers. The first applies in spades to the current proposed legislation. According to Richard Burkhauser of Cornell University and Joseph Sabia of the University of Georgia, in 2003 only 17 percent of low-wage workers were living in poor households. Additionally, only 9 percent of low-wage employees headed poor households. If every low-wage worker got a raise due to a hike in the minimum wage, only a small fraction of the money would go to poor households. This probably doesn't come as surprise to most people. Many of us held low-end jobs as kids but did not live in poverty. I'll bet that most readers know teenagers from middle-class or well-to-do families who work flipping burgers. A government-mandated wage hike for this group of people can't be sold as an anti-poverty program.

The second problem with minimum wage is that, while it makes employment more attractive for low-wage workers, it does not do so for potential employers. As a matter of fact, it does the opposite. A minimum wage law that raises the price of unskilled labor is, to the employer, equivalent to a tax on the use of unskilled workers . . . both raise the price of this type of labor service. "Taxing" firms for hiring unskilled workers creates a financial penalty for their use. Thus, firms will seek ways to reduce hiring and employment prospects for unskilled workers become dimmer. To be sure, there will be a group of workers who retain employment at the higher wage who benefit from it. But there's another group who clearly lose out because they won't be able to find work at all as a result of the wage minimum. That's a dysfunctional outcome if one wishes to improve the prospects of low-wage workers as a whole.

As it turns out, the currently proposed legislation may not be as important nor have as big effects as one might think. Minimum wage proponents note that the current

federal minimum of \$5.15 is very low compared to the past . . . it's only about 30 percent of the average wage in the U.S. compared to a historical average of 45 to 50 percent. However, this is not a relevant comparison. What's relevant is how much low-wage workers are actually making. Not many firms can get away with paying \$5.15 per hour. The job market dictates that unskilled workers are making around \$7.00 per hour without a higher minimum wage. Thus, ratcheting up minimum wage over the next two years to \$7.25 will not have much of an effect.

Since I've criticized minimum wage as an anti-poverty program, a good question to ask at this point is what kind of government programs will help low-income workers. Fortunately, there's a pretty good answer . . . the Earned Income Tax Credit (EITC). EITC is essentially a subsidy to work. You have to be a low-income household to qualify, so it is well-targeted to the poor. Additionally, it encourages labor force participation of unskilled workers. Finally, it does not penalize firms for hiring low-wage workers.

As a final comment, it should be noted that the ultimate cause of low wages is low productivity. Thus, equally important policies to consider are those that can raise the productivity of unskilled workers, thus reducing the need for poverty programs. Minimum wage legislation is a "feel good" exercise that distracts us from the really hard thinking and hard work of devising and implementing effective poverty programs and raising productivity.

(A version of this article appeared in *Business Lexington*, August 11, 2006.)