The Impacts Of Minimum Wage

The economic recovery has resulted in little to no wage gains for many workers. Low-wage workers are finding it increasingly difficult to escape poverty.

To alleviate low wages for unskilled workers, local and state minimum-wage increases are in vogue. The national minimum wage was implemented in 1938 and increased 23 times.

The national minimum wage is $7.25 an hour and was last increased in 2009. Democratic presidential candidates are proposing to increase the rate to $12 or $15 an hour. In Michigan, the minimum wage is $8.50 an hour, and it is scheduled to increase to $9.25 an hour in 2018. Seattle has implemented a $15-an-hour floor on wages.

Mandating that employers pay more for labor is a counterproductive way to help the poor. Although some workers gain, others lose out on jobs altogether, while consumers, many of whom are poor, face higher prices.

Increasing the minimum wage changes the behavior of workers and employers. For employers, a minimum wage increase raises labor costs and reduces hiring. It creates an incentive to substitute capital for labor (e.g. using tablet computers in a restaurant to take orders and pay the bill) or to raise prices.

For workers, it increases the numbers who are willing to work at the higher wage.

The difference between the reduced workers that employers want to hire and the increased workers available at the higher minimum wage ultimately means that more workers are unemployed.

Economists refer to this as structural unemployment or unemployment that results because the number of jobs available is insufficient to provide a job for everyone who wants one.

If the wage is kept above the equilibrium level by government mandate, the result is unemployment.

While there is not much disagreement that mandated government wages above the equilibrium wage cause unemployment to rise, the magnitude of unemployment is subject to debate. It will depend on the amount of the increase above the market clearing or equilibrium wage.

Raising the minimum wage in Michigan to $15 an hour will result in more unemployment than the scheduled increase to $9.25 an hour.

The extent of unemployment will also depend on the responsiveness of employers and workers to the mandated wage increase. If employers are sensitive to a mandated wage increase, their response in hiring fewer workers will be greater than if they were not. If workers are sensitive to wage increases, more will be willing to work at the higher wage.

An alternative to an increased minimum wage is to modify the earned-income tax credit. This credit, paid to low-income households as a tax refund, increases as income initially grows and then decreases as income goes above the poverty level. It has the advantage of providing low-wage workers with additional income without interfering in the labor market and causing employers to reduce hiring or increase prices.

The earned-income tax credit is not without disadvantages. For instance, the worker receives an after-the-fact lump sum, many eligible households fail to claim the credit and the credit phases out as earnings increase causing a disincentive to work longer hours or have another family member work.

A more effective policy to help the working poor than the minimum wage or the earned-income tax credit is a direct wage subsidy. A direct wage subsidy pays additional dollars-per-hour to low-wage workers. From the workers perspective, it is like a minimum wage increase. From the government perspective, it is like the earned-income tax credit.

A direct wage subsidy has several key advantages. It does not distort the labor market like minimum wage increases. It reduces the disincentive to work in the earned-income tax credit and workers receive a weekly pay gain.

In addition, the cost of the direct wage subsidy is more transparent than the earned-income tax credit. It is borne by taxpayers, disproportionally higher-income households, rather than by some combination of employers, other workers and customers with a minimum wage increase.

The minimum wage is a blunt, counterproductive way to help low-wage workers. The earned-income tax credit is preferable, and a direct wage subsidy is the better policy for government to directly increase wages for the working poor.

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