

Burkhauser, Richard V.

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Richard V. Burkhauser

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Richard V. Burkhauser

*Cornell University
and IZA*

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IZA

P.O. Box 7240
53072 Bonn
Germany

Phone: +49-228-3894-0
Fax: +49-228-3894-180
E-mail: iza@iza.org

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ABSTRACT

Why Minimum Wage Increases Are a Poor Way to Help the Working Poor^{*}

Minimum wage increases are not a very effective mechanism for reducing poverty. They are not related to decreases in poverty rates. They can cost some low-income workers their jobs. And most minimum wage earners who gain from a higher minimum wage do not live in poor (or near-poor) families. A better tool for reducing poverty, and at lower cost, is the earned income tax credit. It is a much more targeted way to provide income to workers in poor families. It raises the wages of only workers in low-income families and rises with the number of dependent children in a family.

JEL Classification: J31, J41, J42

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Corresponding author:

Richard V. Burkhauser
Cornell University
Department of Policy Analysis and Management
259 MVR Hall
Ithaca, NY 14853-4401
USA
E-mail: rvb1@cornell.edu

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Recently Archbishop Wenski, on behalf of the U.S. Conference of Catholic Bishops, wrote: “while they are not economists or labor market experts... they see the pain and struggles caused by an economy that simply does not produce enough jobs with a just wage.” They do propose one solution—a raise in the federal minimum wage—because currently it fails “to provide sufficient resources for individuals to form and support families. A full-year, full-time worker making the minimum wage does not make enough money to raise a child free from poverty.”

Neither the Bishops’ concern over the economic plight of the working poor nor the economic policy prescription they support is a surprise. Each is consistent with the views expressed by the American priest John A. Ryan in his 1906 book *A Living Wage*, which includes an introduction by former American Economic Association President Richard T. Ely. The Bishops’ support for a liveable minimum wage is also consistent with the views of early 20th century American progressives, who supported giving the legislature the authority to impose maximum hours and minimum wage laws on the marketplace—something they were excluded from doing by the 1906 U.S. Supreme Court decision in *Lochner vs. New York*, which ruled such regulations unconstitutional interferences with an individual’s right to contract. Father Ryan was there when President Roosevelt signed the Fair Labor Standards Act of 1938 achieving the goal of a single federal minimum wage of \$0.25 per hour. The legislature can now directly intervene in the marketplace in this way. But when and how should they do so?

In his seminal *American Economic Review* article, future University of Chicago economist and Nobel Prize winner George Stigler used marginalist theory for the first time to argue against further increases in the nominal minimum wage, writing, “The minimum wage provisions of the Fair Labor Standards Act of 1938 had been repealed by inflation... and ...the elimination of extreme poverty is not seriously debatable.” But he then went on to say: “The important questions are rather: (1) Does such legislation diminish poverty? And, (2) Are there efficient alternatives?”

I was one of seven economists the Congressional Budget Office (CBO) asked to read the first draft of their report on *The Effects of a Minimum-Wage Increase on Employment and Family Income* and comment on its assumptions and methods. I urged the CBO to better answer Stigler’s two questions. They did so in their final report published in February 2014.

With respect to Stigler’s first question, the CBO estimated that a federal minimum wage increase from \$7.25 to \$10.10 per hour, when fully implemented in 2016, would reduce total employment by

about 500,000 workers, or about 0.3 percent, with a two-thirds chance that the actual value would be between a very slight reduction and 1,000,000 workers. On the other hand, it would increase the wages of 16.5 million workers who remained employed. But it would only reduce the number of people (not workers) in poverty by 900,000, or about two percent.

Hence for those most concerned about the working poor, this minimum wage increase is not a very effective mechanism for reducing poverty. That was Stigler's conclusion in 1946 for exactly the same microeconomic reasons given by the CBO. Efforts to artificially increase the wages of low-skilled workers above the wage rate established in the competitive marketplace by the forces of supply and demand will reduce the number of workers employed at this higher wage.

The CBO's central demand elasticity estimate for affected teenagers was -0.1. That is, a 10 percent increase in the minimum wage will reduce employment by 1 percent. They reported the likely range for this elasticity to be from slightly negative to -0.2 and provided a central estimate of -0.067 for affected adults. These elasticities are behind the CBO's prediction that fewer rather than more workers will be employed because of this 39 percent increase in the federal minimum wage rate.

In addition to these microeconomic demand effects, the CBO also includes macroeconomic effects that take into account the increase in aggregate demand that they argue will occur because of the more general distributional effects of this minimum wage increase. This to some degree reduces the negative microeconomic effects on employment they predict.

Importantly, the CBO findings are not based on their own causal modelling. Rather the key demand elasticities used in their micro-simulations are based on their view of the best evidence using modern causal models. In 1982, Brown, Gilroy, and Kohen, in their *Journal of Economic Literature* review, argued that the consensus in the economics profession was that job markets for low-skilled adults and teenagers were competitive and that in such markets, minimum wage increases will come at the cost of modest but significant reductions in employment (demand elasticities in the range of -0.2) of such workers.

Card and Krueger's iconoclastic Princeton University Press book *Myth and Measurement: The New Economics of the Minimum Wage* in 1995 shattered this decade-old consensus using innovative difference-in-difference or natural experimental designs. Using these designs they found no evidence of a negative effect on employment—but they did find some evidence of a positive effect.

In their MIT Press book *Minimum Wage* in 2008, Neumark and Wascher review the post-Card and Krueger literature using these innovative natural experimental designs, mostly focusing on research using variation in minimum wage increases across states. They conclude that these increases have small but significant negative employment effects close to the previous consensus values. One reason for the change in findings is that the federal minimum wage remained relatively low after 1995; with more states increasing their minimum wage above it, hence allowing for greater variation in the data to identify the effects of this policy. The intense debate has continued in recent years.

Dube, Lester, and Reich, in *Review of Economics and Statistics* (2010), argued that only employment trends for contiguous counties across borders of states that had differing minimum wages are appropriate treatment and control units—a condition not imposed by Card and Krueger or anyone else in this literature. Doing so, they found no evidence that minimum wage increases caused adverse employment effects. Neumark, Salas, and Wascher, in *Industrial and Labor Relations Review* (forthcoming), replicate the Dube et al. findings and show that their exclusion of alternate non-border counties as controls is not justified because, based on their observable characteristics, non-border counties across state lines appear to be at least as similar, and sometimes more similar, to the treatment counties as the border counties used as controls. They also show the Dube et al. findings are sensitive to the number of leads and lags of the minimum wage included in their empirical model. When Neumark et al. use matched pairs of nearby counties and states that are plausibly better controls than the ones used by Dube et al., negative employment effects from minimum wage increases reemerge.

To get a quick sense of the intensity of the empirical debate, compare my review of the Neumark and Wascher book in *Industrial and Labor Relations Review* (2010, v. 64, 1) with Dube's review in the *Journal of Economic Literature* (2011, v. 49, 3). For an excellent reference list of the current literature, see Appendix B of the CBO Report (2014).

In contrast, the evidence that minimum wage increases are not very effective in reducing poverty is much less contentious. Card and Krueger (1995) find that minimum wage increases are not related to decreases in poverty rates and argue that this is because most people living in poverty do not work. Neumark and Washer (2008) reach the same conclusions. The movement of families onto the poverty rolls because their wage earnings are negatively affected by minimum wage increases more than offsets the movement out of poverty of families whose wage earnings are positively

affected. Sabia and I (*Southern Economic Journal* 2010), using methods similar to Card and Krueger (1995) but for more recent times, also find no relationship between minimum wage increases and poverty rates even for the working poor. Recently Dube (December 2013 working paper) has argued that under certain conditions, when labor demand is growing during expansions of the business cycle and minimum-wage-induced employment effects are small, minimum wage increases can reduce poverty.

But what about Stigler's second question: Are there efficient alternatives to minimum wage increases? On this issue there is very little disagreement. A much less reported finding of the CBO Report is that the Earned Income Tax Credit (EITC) is a far superior way to provide additional income to workers who live in poor families. In its new report, the CBO refers to its 2007 report, which compared the cost to employers of a change in the minimum wage that increased the income of poor families by a given amount to the cost to the federal government of an EITC enhancement that increased the income of poor families by roughly the same amount. The cost to employers (and the consumers who purchased their products) of a minimum wage increase was much larger than the cost to the federal government (and the taxpayers who provided these revenues) of an EITC enhancement.

What is not mentioned in the CBO Report, but the careful reader of Table 1 of the report can see, is how much better an EITC enhancement would increase the effective wage earnings of the working poor. In Table 1, a \$10.10 minimum wage costs families with incomes six times the poverty line or more \$17 billion and an additional \$2 billion comes from the macro effects of the redistribution of this income to all other families. But only \$5 billion of this \$19 billion in "new revenue" goes to working poor families.

The reason for this is because most minimum wage workers who gain from an increase in the minimum wage do not live in poor or even in near-poor families. And, some workers who do live in poor families have wage rates above the proposed minimum. They just don't work full time.

The EITC is much more target-effective policy because it only raises the wage rate of those workers who live in lower income families, and it depends on the number of dependent children in those families. Thus, those living in lower income families receive the vast majority of benefits. We could dramatically improve the lives of the working poor if the real economic costs of the minimum wage were instead used to finance an EITC expansion. In addition, an EITC expansion would have

a far less negative effect on the employment of low-skilled workers and the positive macroeconomic effects would be greater because, presumably, the working poor have the greatest propensity to consume. Furthermore, the negative microeconomic effect on employment would also be less because the EITC is paid for via the federal income tax rather than directly by the employer.

In the language of the Catholic Church, the goal of “just remuneration” is to provide income “sufficient for the needs of a family,” in the words of Pope John Paul II. Pope John Paul saw that grants targeted toward “the specific needs of families,” like “the number of dependents” were an alternative for achieving the goals of just remuneration (*Laborem Exercens*, 19). In precisely this way, the EITC is a much more effective way to convert wage rates determined by supply and demand in competitive markets into living wages that lift the otherwise working poor out of poverty, all without reducing employment.

Why, it’s almost a miracle!

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