

# Economic Effects of the Minimum Wage

The minimum wage is important to many workers at some (or many) points in their working lives.

I was in that pool during my earliest years in the labor market, but, like many, have moved up the wage scale since then.

The U.S. minimum wage, at almost 75 years old, remains the topic of many academic studies and much policy debate despite the fact that only about 5 percent

of hourly employees are currently paid at or below the federal minimum. The federal minimum wage started in the United States with the Fair Labor Standards Act of 1938 at \$0.25 per hour. It is not indexed to inflation, increases only through new legislation, and now stands at \$7.25 per hour. (See Figure 1.) Although legislation has increased the minimum wage 29-fold since 1938, the inflation-adjusted (real) minimum wage has exhibited dramatic variation. The real value of the minimum wage fell by more than 20 percent from 1997 to 2006. The high-water mark for its purchasing power was 1968. The inflation-adjusted value of the minimum wage is now about the same level as it was in 1982.

## Employment Effects of the Minimum Wage in Theory

There are many possible and interesting economic effects of the minimum wage. The issue that has received by far the most attention is whether increasing the minimum wage has a negative effect on employment, and if so, for whom and by how much. Economists first approach this question through the basic theory of a perfectly competitive labor market where all workers are identical and perfectly interchangeable (same skills and abilities) and all firms (thousands of employers) are also identical and perfectly interchangeable (same organizational structure, culture, employee experience, etc.). None has more bargaining power than another. In this core model, the supply of workers (the number of people looking for work) equals the demand for workers by employers and there is no unemployment. This happens at an equilibrium or market wage,  $W$ . In this basic model, because all employees and all employers



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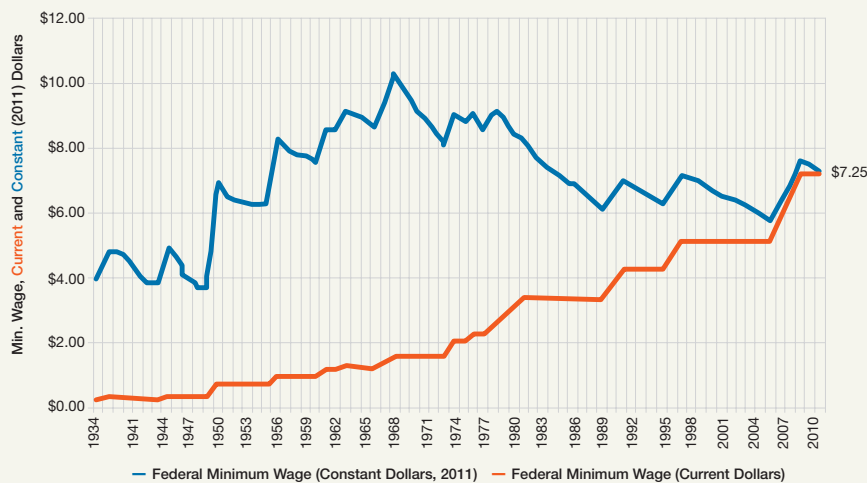
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Figure 1 | U.S. Federal Minimum Wage



Sources: Constant dollar computations and charting: Institute for Compensation Studies at Cornell's ILR School; Federal nominal minimum wage data: U.S. Department of Labor, [www.dol.gov/whd/minwage/chart.htm](http://www.dol.gov/whd/minwage/chart.htm); Consumer Price Index data: U.S. Bureau of Labor Statistics (CPI-U), [ftp://ftp.bls.gov/pub/special.requests/cpi/cpiait.txt](http://ftp.bls.gov/pub/special.requests/cpi/cpiait.txt)

are the same, there isn't even unemployment caused by employees or employers seeking better job matches. If the government then institutes a minimum wage above  $W$ , the number of people wanting to work will be greater than the number of jobs and there will be unemployment. This is the framing for debate over the minimum wage. Does the minimum wage create unemployment in the real world like in the theoretical model, and if so, how much? And what other impacts of the minimum wage need to be measured?

### Studying the Data

To think about the real world outcomes, take for example 1950 when the minimum wage increased by 88 percent (from \$0.40 to \$0.70), and the most recent increase in the federal minimum wage (July 24, 2009) when it increased from \$6.55 to \$7.25 — a jump of 11 percent. In 1950, national unemployment fell; in 2011, it rose. So how do researchers isolate the role played by the minimum wage? It turns out that this is quite a bit more difficult to study than it would appear at first blush. The reason is that, as I have indicated in other columns, we really want to be able to hold all else equal and change just the factor of interest, in this case, the minimum wage. But this is very hard to do. Ideally, we would compare what happens in the case when the minimum wage changes to what happens in the case when it doesn't. But these sorts of situations are incredibly rare.

One famous example by David Card and Alan B. Krueger executed this kind of clever analysis ("Minimum Wages and Employment: A Case Study of the Fast Food Industry in New Jersey and Pennsylvania," *The American Economic Review*,

September 1994). Card and Krueger studied 410 fast food restaurants in New Jersey and Pennsylvania before and after the April 1992 increase in the New Jersey minimum wage. They compared employment in the treatment (New Jersey) stores where the minimum wage had been raised to that in control (neighboring Pennsylvania) stores where it hadn't. They found no evidence that the increase in the minimum wage led to employment declines. Interestingly, through a different study that analyzed company stock prices of firms likely to be employing many minimum wage workers (e.g., fast food restaurants, movie theaters, hotels), Card and Krueger found that increases in the minimum wage were not good for the market value of firms employing minimum wage workers (Myth and Measurement: The New Economics of the Minimum Wage, 1995).

### Other Effects of the Minimum Wage

Card's and Krueger's work launched a wave of subsequent studies by other researchers seeking additional evidence on the effects of the minimum wage, including impacts on take-home pay of minimum wage earners (do hours decline as wages rise?), the skills of employed workers (are low-skilled workers pushed out in favor of higher-skilled workers?), and who pays the cost of a higher wage bill (do consumer prices rise or business profits fall?). Nearly two decades after the Card and Krueger study, economists are still finding new approaches to studying the minimum wage.

### Going Forward

This column will be published right around the time of the 2012 presidential election. Given the candidates' differing views of government's roles and responsibilities in setting rules for workers and organizations in the U.S. labor market, I expect interest in the impacts of minimum wage legislation will only increase during, and likely after, this presidential campaign. **WS**



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