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# POLICY

## BRIEFING

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### THE ECONOMIC EFFECTS OF MINIMUM WAGES

#### WHAT MIGHT MISSOURI EXPECT FROM PASSAGE OF PROPOSITION B?

*By David Neumark*

The federal minimum wage has been \$5.15 since 1997, but 18 states and the District of Columbia have minimum wages higher than the federal level. Missouri will join those states if voters approve Proposition B in November, which would raise the state's minimum wage to \$6.50 and index it to the Consumer Price Index (CPI) thereafter.

Proponents claim that the proposal is an effective way to fight poverty. They say that minimum wage laws help poor workers move up the economic ladder. But the best economic studies suggest otherwise. Economic theory says that when the price of unskilled labor rises, employers look for cheaper alternatives. For example, a manager at McDonald's might respond to a minimum wage hike by replacing three less-skilled workers with two more-skilled workers, or by investing in equipment that allows the restaurant to produce the same amount of food with fewer workers. The

empirical evidence tends to confirm these predictions. Although measuring the exact impact of changes in the minimum wage can be challenging, the best empirical research suggests that increases in the minimum wage tend to reduce the employment of low-wage workers.

Even worse, minimum wages tend to reduce the education, work experience, and job training of low-income workers over the long-term. As a result, fewer will be able to eventually obtain better-paying jobs. Missouri lawmakers and voters should take these factors into account before increasing the state's minimum wage.

#### **Who Benefits from Higher Minimum Wages?**

When a minimum wage goes up, the higher wages don't always go to the workers who need them most. Minimum wage laws create winners and losers—

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**Economic research shows that minimum wages destroy jobs for the workers who need them most.**

the minimum wage on poverty have found that the minimum wage either has no effect on poverty, or actually increases it.

Hence, the evidence suggests that higher minimum wages tend to help low-wage workers in higher-income families, such as teenagers in middle-class families, while causing some workers close to the poverty line to slip below it due to fewer work opportunities. The minimum wage is a “blunt instrument,” poorly targeted toward poor workers, which seems to actually do them more harm than good.

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the winners see their wages and incomes rise, while the losers are unable to find jobs or to work as many hours as they would like. If the winners were mostly unskilled workers in poor families, a minimum wage increase might be worthwhile. Unfortunately, this doesn't seem to be the case.

Low-wage workers (earning between \$5.00 and \$6.25 per hour) are found in households across the income spectrum. While 14.2 percent of low-wage workers are in poor families, more than 40 percent are in families in the top half of the income distribution. Many of those workers are teenagers who earn low wages only until they acquire the skills that lead to higher-paying jobs.

In a 2005 paper, I examined data from 1986 to 1995 and found that a 10 percent increase in the minimum wage tended to cause a nearly three-quarter percentage point increase in the poverty rate. Other studies that have examined the effects of

## **National Time-series Studies**

Over the last half-century, there have been many studies of the effects of minimum wage laws on employment. Most of those studies fall into one of three broad categories: time-series studies of the federal minimum wage, studies examining the effects of variations in the minimum wage across states, and case studies that focus on one or a few states.

The first generation of empirical minimum wage studies used aggregate time-series data to determine whether changes in the federal minimum wage affected employment rates of young people. The consensus of these studies was that for every 10 percent increase in the minimum wage, the employment rate of teenagers fell by 1 to 3 percent.

Although these findings were challenged in the 1980s and 1990s, more recent studies confirm them. A recent time-series study found strong evidence



that the minimum wage decreased the teenage job rate in both the short- and long-term. Moreover, it found that this job-reduction effect has been relatively constant over time.

## Studies of State-level Variations

Individual states began passing their own minimum wage laws beginning in the late 1980s because the federal minimum wage hadn't increased for several years. The new variation in state-level minimum wages made it easier for researchers to examine the effects of minimum wages on jobs, as well as to hold constant the effects of the business cycle. Researchers looked at the effects of the federal minimum wage combined with the effects of various state minimum wages.

Several of these initial studies found that every minimum wage increase of 10 percent led to a drop in teenage employment between 1 percent and 2 percent. Later studies looked at school enrollment trends among teenagers and found that, for the most part, increases in the minimum wage caused some teenagers to leave school for a job. The teenagers who found jobs often replaced other unskilled workers who had also dropped out of school.

**A higher minimum wage can be an inducement to drop out of school.**

## Case Studies

The third group of studies examined individual states to see how minimum wage increases affected the low-wage job market. The most famous of these—and the one most often cited by minimum wage supporters—is Card and Krueger's (1994) study of an increase in New Jersey's minimum wage. Their study focused on the fast-food industry in New Jersey, where the minimum wage was increased to \$5.15 in 1992, and in eastern Pennsylvania, where the minimum wage stayed the same. Card and Krueger found statistically significant evidence that the higher minimum wage increased job growth in New Jersey relative to Pennsylvania.

Critics of the Card and Krueger study pointed out serious flaws in their survey methods. Card and Krueger collected their data by conducting two rounds of phone interviews with the managers of area fast-food restaurants. Critics charged that ambiguities in the survey questions made the survey results unreliable. In a

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pair of studies in 2000, Card and Krueger were unable to replicate their results using government payroll data, and an analysis of payroll records obtained directly from the fast-food restaurants found that New Jersey's minimum wage increase led to employment declines.

Other case studies have found that higher minimum wages do indeed lower the job prospects of young workers. A 2006 study replicated Card and Krueger's "case study" technique in a study of the effects of an increase in Illinois's minimum wage between 2003 and 2005. They found that the increase reduced employment in restaurants in Illinois compared to restaurants across the border in Indiana. Another 2006 study of employment along the Oregon-Washington border found that minimum wage hikes reduced employment in the restaurant sector and had mixed results in the hotel sector.

## **Long-term Consequences**

Some of the cross-state surveys looked at whether increases in the minimum wage could have more serious long-term effects. Employee turnover in industries that rely on unskilled labor is generally high, and many employers can respond to a minimum wage increase quickly by firing workers they can no longer afford. However, some companies take longer to react. Some firms might opt to buy labor-saving equipment, change production methods, or use higher-skilled

labor that would require new hiring and training. All of these changes take time. Much of the evidence points to a lag effect on job losses due to a minimum wage hike. Drops in teenage employment caused by a higher minimum wage are sharper over the long-term.

Moreover, there is evidence that minimum wage hikes have negative long-term impacts on low-wage workers. The literature on the long-term effects of minimum wages is less extensive than the literature on the short-term effects, but some studies show that minimum wages reduce formal job training among young workers, training which would increase their wages in the future. Minimum wage laws can also reduce school enrollment. One study found that adult workers who were subject to minimum wages at younger ages had lower wages and earnings than other workers; this is likely due to reductions in training, experience and schooling that might have allowed them to take higher-wage jobs.

Hence, the evidence suggests that minimum wages hurt the very workers that they're supposed to help. Rather than pursuing a policy that would discourage low-wage work and take jobs away from those who need them the most, Missouri policymakers and voters should focus on policies that are narrowly targeted at helping workers who live in poverty.

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***For more details, please see Show-Me Policy Study no. 2, which is available at [www.showmeinstitute.org](http://www.showmeinstitute.org).***



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