Why Do Wages Increase?

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My last post comparing the standard of living of George Vanderbilt with that enjoyed by most Americans today has inspired a fair amount of debate, which has recently centered on the question of what has caused the incredible increase in real wages over the past hundred plus years: free markets or unions and government intervention. Instead of simply writing another comment in the thread, I decided to address this in another full blog post because this question gets to some of the most fundamental differences between those, like myself, who want minimal government control over markets and those who believe that governments need instead to steer markets and engineer desired outcomes.

Before I explain the factors that cause wages to increase, let's look at two factors that do not increase wages but are commonly assumed to do so: minimum wages and unions. Elementary economics holds that a price floor will cause a surplus; in this case, the minimum wage sets a price floor for labor and results in excess unemployment. Throughout the 1990s, supporters of the minimum wage frequently trotted out a study by economists David Card and Alan Kreuger that purported to show an increase in employment in New Jersey after the passage of a higher minimum wage. Unfortunately, Card and Kreuger relied on surveys of business owners to establish employment data, and
when other economists attempted to replicate their results by looking at the actual payroll data, employment was found to have fallen after the increase in the minimum wage, just as standard economic theory predicted.

More recently, David Neumark and William Wascher wrote the book *Minimum Wages*, published by MIT Press in 2008, analyzing more than 300 studies of the minimum wage. They found that the vast majority of the studies showed a negative effect on employment. As Neumark wrote in a 2009 *Wall Street Journal* editorial:

> Despite a few exceptions that are tirelessly (and selectively) cited by advocates of a higher minimum wage, the bulk of the evidence -- from scores of studies, using data mainly from the U.S. but also from many other countries -- clearly shows that minimum wages reduce employment of young, low-skilled people. The best estimates from studies since the early 1990s suggest that the 11% minimum wage increase scheduled for this summer will lead to the loss of an additional 300,000 jobs among teens and young adults. This is on top of the continuing job losses the recession is likely to throw our way.

> The reduction in jobs for youths might be an acceptable price to pay if a higher minimum wage delivered other important benefits. Many people believe, for instance, that it helps low-income families. Here, too, the evidence is discouraging. There is no research supporting the claim that minimum wages reduce the proportion of families living in poverty. Research I've done with William Wascher of the Federal Reserve Board and Mark Schweitzer of the Cleveland Fed indicates that minimum wages increase poverty.

The minimum wage can raise the wages of some low-skilled workers, but others will lose their jobs altogether because they lack sufficient skills to make their labor worth the higher legislated price. This more than wipes out any societal gains that might result from an extra dollar or two per hour for the workers who remain employed. The minimum wage's effect on aggregate wages is neutral at best — merely transferring wages from some low-income workers to other low-income workers who possess better skills. More often, the effect is negative.

Unions are not necessarily as detrimental as a minimum wage, but they are still a zero-sum game at best. A union's gains must be another group's loss. One commenter on my previous blog entry, Dempster Holland, admitted as much when he wrote that "Unions have hist[o]rically shifted money from business owners to the workers who make their business work." That's certainly possible, and I even agree that sometimes unions have been useful in achieving greater equity for themselves. However, those gains come at a cost, and therefore cannot explain generally rising standards of living. If George Vanderbilt's employees took everything he owned for themselves, they might be personally wealthier...
than they would have been otherwise, but society would still have the same amount of wealth — redistribution of existing wealth doesn't create new wealth. It is simply not possible that we achieved a standard of living for the average American that is higher than Vanderbilt's in many ways simply by dividing up his wealth, or the wealth of others like him, among far greater numbers of people.

Furthermore, a union’s ability to redistribute money from business owners is limited. In most enterprises, there aren’t many owners relative to workers, so taking money from them to give to the workers would yield limited dividends. More commonly, unions benefit their members by dividing a given amount of wages among fewer people, by limiting the labor pool. A large survey of unions and employment in 17 OECD countries from 1960 to 1996 revealed that although unions increased the wages of prime age men, they led to greater unemployment among women, youth, and older men. In short, union activity does not result in wages going up across the board — it merely reshuffles existing wealth, from workers outside the union to those inside it.

If unions and minimum wages don't make us richer as a society, what does? Higher productivity. In order for people to enjoy more goods and services, we have to produce more goods and services, and that means more capital — both physical and human. Faster computers, more efficient machines, improved delivery techniques, and more efficient methods for synthesizing drugs all enable each worker to produce more wealth than he could otherwise, and businesses need no encouragement from the government to pursue any of those strategies. Thanks to the profit and loss system, businesses have an automatic incentive to do more with less, because in the short run this will increase their profits. However, as their competitors also adopt the same innovations, those profits are competed away and instead translate into both higher wages for workers and lower prices for consumers, which also contributes to an increased standard of living.

It's important to note that this process of maximizing efficiency in order to produce more with less is a positive-sum game, unlike the zero-sum (or negative-sum) game of redistribution through minimum wage laws or unions. That means that new wealth is created where there was none before, rather than simply moving existing wealth from one person or group to another. Only through this kind of positive-sum activity can the standard of living increase throughout society over time. There are policies that government officials can pursue that help to maximize productivity gains, but there is no magic wand that they can wave to make everyone richer by fiat. Economic growth is a dynamic process that cannot be planned or controlled from the top down.

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