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MINNPOST

Raising minimum wage seems best anti-poverty option, given political realities

By [Louis D. Johnston](#) | 02/21/13



REUTERS/Carlos Barria

It's still not clear in economic terms what the overall effect of a minimum wage increase will be, particularly on the American labor market.

With all the talk of raising both the state and federal minimum wages, supporters and opponents ought to pause for a bit and reflect on one reality:

For all the rhetoric, it's still not clear in economic terms what the overall effect of a minimum wage increase will be, particularly on the American labor market.

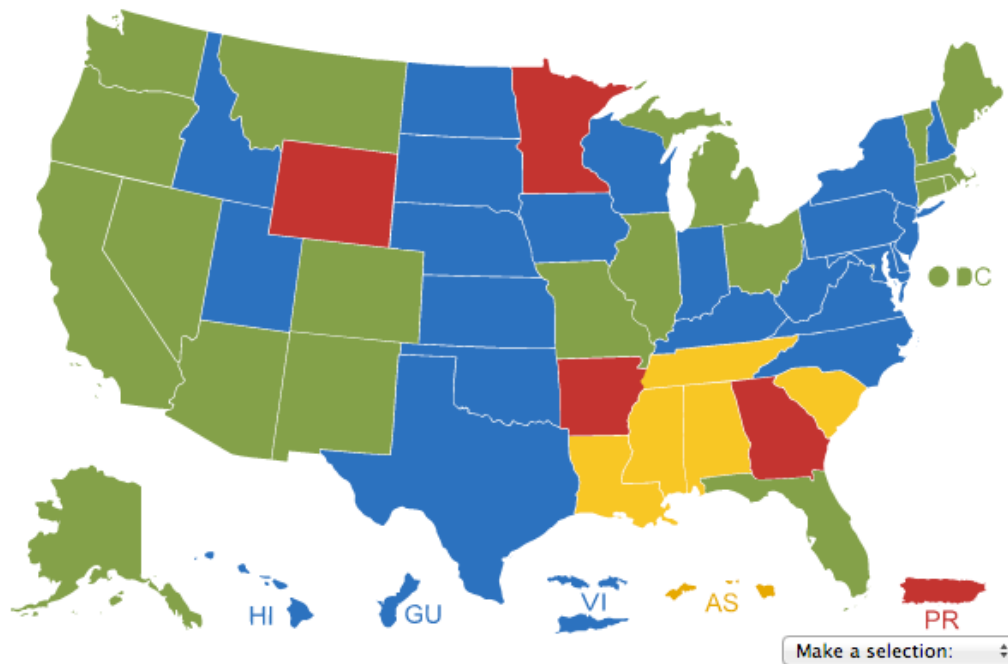
In his [State of the Union address](#), President Barack Obama proposed raising it from \$7.55 to \$9 and indexing the minimum wage to inflation.

[Gov. Mark Dayton](#), during a visit to the College of Saint Benedict and Saint John's University, endorsed the president's idea and bemoaned the fact that Minnesota's state-level minimum is below the national minimum.



The minimum wage in Minnesota is \$6.15 for companies with receipts of \$625,000 or more and \$5.25 for smaller companies. (Rachel Vilsack of Minnesota DEED nicely summarizes minimum wage coverage in Minnesota [here.](#))

The map below shows how minimum wages vary by state.



- States with minimum wage rates higher than the Federal
- States with minimum wage rates the same as the Federal
- States with no minimum wage law
- States with minimum wage rates lower than the Federal

Click to view interactive map of minimum wage rates in the United States. Minnesota is one of four states (and the territory of Puerto Rico) with a minimum wage below the federal wage, although most minimum-wage workers in Minnesota get paid the federal rate of \$7.25.

Nationally, Washington State leads the nation at \$9.19, while Alabama, Louisiana, Mississippi, South Carolina and Tennessee have not set a state-level minimum.

How we got here

The national minimum wage was enacted in 1938 as part of the Fair Labor Standards Act. It initially covered only workers engaged in interstate commerce, but by the 1960s it covered all workers. (The

evolution of the minimum wage and who is covered under the law is [here](#).)

With inflation taken into account, the minimum wage reached its maximum purchasing power in 1968 at \$4.60 in 1984 dollars and is currently at \$3.16 in 1984 dollars.

The “nominal” — not adjusted for inflation — minimum wage rose from 25 cents in 1938 to \$7.55 today.

However, when we take inflation into account, the minimum wage reached its maximum purchasing power in 1968 at \$4.60 in 1984 dollars and is currently at \$3.16 in 1984 dollars. (Rep. Marsha Blackburn (R-Tenn.) inadvertently reminded us of the importance of the distinction between “nominal” and “real” when she discussed the president's proposal [here](#).)

Two key questions

At the center of all debates about the minimum wage sit two important questions:

- What are the economic effects of a minimum wage?
- Why have a government-imposed minimum wage at all?

Economic theory points to a key relationship in understanding how wages are set: Firms hire workers until the value of the extra output produced by an additional hour of work is equal to the extra cost of hiring an additional hour of work.

This relationship differs, depending on whether or not the labor market is competitive.

Mixed effects of minimum wages

In a competitive market, companies and workers are on equal footing in terms of information and the ability to walk away from a wage bargain. In this case, the value of the extra output will equal the real wage paid to the worker, and all who want a job at that wage will have one.

A minimum wage interferes with this outcome by placing a floor on the wage above the level that private bargaining determines. This has two effects.

First, those who have a job see an increase in their income.

Second, workers enter the market in response to the higher wage while at the same time firms cut back on the number of jobs they offer. This creates unemployment because more people want to work at the new wage than there are jobs available.

This size of these two effects depends on the demand for and supply of labor in each particular labor market.

This is the standard story told in introductory economics texts and was the state of play in the field until the 1990s, when **David Card** and **Alan Krueger** asked a simple question:

What if the labor market is not competitive?

In this case, the wage paid to workers is less than the value of their extra production and fewer workers are hired than in the case of a competitive market. In this type of market, a minimum-wage increase actually increases employment since firms want to keep the wage as close to the value of extra output as possible.

Card and Krueger's work set off a furious debate and opened a fertile area of research that has yet to come to a clear conclusion. (A good summary is [here](#).)

In other words, it's not clear what the overall effect of a minimum wage increase will be on the American labor market.

Markets are human institutions

One of my favorite economics books is "Reinventing the Bazaar: A Natural History of Markets" by John McMillan.

McMillan was an economist at Stanford University and an expert in the field of market design.

He made an important point about markets that I emphasize to my students:

"The market is not omnipotent, omnipresent, or omniscient. It is a human invention with human imperfections. It does not necessarily work well. It does not work by magic or, for that matter, by voodoo. It works through institutions, procedures, rules, and

customs."

Given that markets don't always work well, and given that they are human-created institutions, is the minimum wage the best we can do to alleviate poverty in the U.S.?

In a perfect world, there is definitely a superior policy: a guaranteed basic income or negative income tax.

As proposed by Milton Friedman in "Capitalism and Freedom," this works very much like the current Earned Income Tax Credit (EITC), except that citizens would be eligible for the program even if they did not earn taxable income.

As it is, I haven't heard **Friedman's intellectual heirs** in Congress (Paul Ryan, for example) proposing a negative income tax.

So, a higher minimum wage — combined with an expanded EITC — is probably the best that can be done in an imperfect world.

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