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HOW CAN MARYLAND HELP THE WORKING POOR?

A Primer on the Minimum Wage

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EXECUTIVE SUMMARY

LAWMAKERS IN ANNAPOLIS AND WASHINGTON, D.C. are considering raising the minimum wage, which currently is $7.25 an hour under both Maryland and federal law. Supporters of an increase argue that it would help the working poor by boosting their income; opponents argue that it would weaken employment for low-skill and first-time workers by artificially raising labor costs.

This paper examines the economic theories and empirical evidence that both sides use to support their positions. It concludes that there is substantial evidence that raising the minimum wage would weaken employment for low-income and new workers. It further notes that indexing the increased wage to inflation, which is part of the Maryland proposal, would be especially harmful to those workers' employment prospects. However, some policy activists may accept those negative effects in return for other perceived benefits of raising the wage. The paper concludes by suggesting three alternative policies that offer more promise for helping low-income households.

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1. INTRODUCTION

On both the federal level and in Maryland, lawmakers are considering raising the minimum wage. The current federal and Maryland minimum wage of $7.25 an hour has been in effect since the summer of 2009, in accordance with federal legislation adopted in 2007. Supporters of increasing the wage argue that it would help the working poor at a time of high living costs and high income inequality. Opponents respond that an increase would harm entry-level employment at a time when low-skill and new workers are especially burdened with high, persistent joblessness.[1] Both sides appear to be earnest in their concerns, and both sides point to economic theories and empirical analyses to support their positions.

A careful, impartial reading of the arguments and economic data concerning the minimum wage raises questions as to why these political fights are so fierce. Even if there are no negative employment effects from increasing the wage, the benefits from proposals like the ones now under consideration in Annapolis and Washington would be small and poorly targeted toward low-income households. Political fights over the minimum wage thus seem to follow the old adage about disagreements between academics: the fights are so bitter because the stakes are so low. The problem is, the poor are the victims of these fights.

This paper reviews and evaluates the theories and evidence on both sides of the minimum wage debate. It concludes by offering three policy alternatives that would seem to offer greater benefits than the current "low stakes" minimum wage proposals.

2. THEORY

Both supporters and critics of raising the minimum wage use concepts from classical economics to support their positions. The arguments, in turn, depend on important assumptions about the real-world condition of labor supply and demand. When considering these theories, readers should pay special attention to their assumptions and plausibility.

2.1 Supporters' theory: Labor monopsony Supporters of raising the minimum wage often lead their argument with the claim that workers cannot live and support a family on the current wage. That certainly resonates; at $7.25 an hour, a minimum-wage employee working 40 hours a week for 52 weeks a year would earn just over $15,000 annually—before taxes. Compare that to the $86,056 median annual household income in Maryland over the period 2009–2011[2] and the poverty threshold of $23,550 for a family of four in the 48 contiguous states in 2013.[3]

However, simply saying that workers cannot live on $15,000 a year is not sufficient to justify raising the minimum wage. Supporters must also demonstrate that it is *economically feasible* for minimum-wage employers to pay their workers more, keeping in mind that higher labor costs reduce employers' profitability and ability to expand their workforces, all else being equal.

More thoughtful supporters of raising the wage argue that minimum-wage workers typically produce far more value for their employers than the employers would lose from paying a higher wage. Thus, they say, employers can afford a higher minimum wage. In this view, workers cannot achieve a higher wage through normal market competition

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for labor because the demand for unskilled labor is low relative to its supply. As a result, minimum-wage employers act as a labor *monopsony*—a dominant consumer that can set artificially low wages in much the same way that a monopoly producer can set artificially high prices for its product. Hence, these supporters say, a minimum wage law is necessary—and an increase in the wage is now appropriate—to protect low-skill and new workers from the monopsony.

There is a worrisome corollary to this monopsony claim. If in fact there is a large, enduring mismatch between low-skill labor supply and demand, then a large segment of the low-skill population is condemned to bouts of long-term unemployment. If this is correct, then the minimum wage should be abandoned in order to allow the creation of low-skill jobs in industries that are not profitable at the current minimum wage.

2.2 Opponents' theory: Law of Demand Critics of raising the minimum wage dispute the notion that the cost of employing low-skill and new workers is significantly lower than the value those workers produce for their employers. The critics note that the cost of employment is much higher than workers' wages: workers often require training, which is costly, and employers are saddled with additional labor costs such as Social Security, Medicare, and unemployment insurance taxes, as well as new federally mandated worker health care costs. Further, the critics say, minimum-wage workers are risky to employ because many of them are first-time workers with no history, including teenagers who often prove to be unreliable. All of those costs and risks make low-skill workers costly to employ.

The critics thus argue that raising the government-mandated minimum wage would discourage low-profit-margin employers from employing low-wage workers and could result in layoffs as some low-skill employment becomes uneconomical.[4] Citing the economic principle known as the Law of Demand, which asserts that (all else equal) an increase in the price of a good will reduce the quantity of that good demanded, the critics charge that a minimum wage increase would weaken employment for low-skill and new workers, hurting the very people that the increase is intended to help.

3. THE EMPIRICAL EVIDENCE

As outlined in Section 2, both proponents and critics of raising the minimum wage have economic theories to support their positions. This section considers empirical research into the minimum wage to determine which side's theories and assumptions better describe the real-world effects of raising the wage.

Over the past half-century, numerous empirical studies have attempted to identify the employment effects of implementing or raising the minimum wage. The studies face a difficult challenge: in trying to determine the effect of a change in policy, how can they compare the real-world situation to a hypothetical world where the change doesn't occur? The studies use different strategies to overcome that challenge. Some compare employment levels for nearby geographic areas where the minimum wage recently increased in one area but not another. Others compare the employment level in a geographic area in the time period just before a minimum wage increase to the employment level in the time period right after the change. Still other studies use other methods. The discussion below considers the results of that research.

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3.1 Literature reviews There have been two major literature reviews of empirical studies on the minimum wage. The first was undertaken in the late 1970s by Charles Brown, Curtis Gilroy, and Andrew Kohen, who were senior staff economists for the Minimum Wage Study Commission convened by the U.S. Congress in 1977.[5] After examining more than 30 empirical studies, Brown, Gilroy, and Kohen determined:

- For teenagers, who comprise a large share of minimum-wage workers, studies typically found a 10 percent increase in the minimum wage resulted in a decrease in employment of 1–3 percent. The authors add that "the lower half of that range is to be preferred."[6]
- For young adults age 20–24, who comprise another large share of minimum-wage workers, studies found the employment effect "is negative and smaller than that for teenagers."[7]
- For adults over 24, who are a minority of minimum-wage workers, the employment effect "is uncertain."[8]

The commission's report apparently soured Congress's enthusiasm for raising the federal minimum wage, as lawmakers did not seriously consider another increase until the end of the decade. However, several states chose to enact or bolster their own minimum wage laws during the interval. Those policy changes gave economists the opportunity to use cross-state analysis to determine the employment effects of the increase.

A flurry of new research ensued, the most famous of which was David Card and Alan Krueger's study of Philadelphia-area fast-food restaurants following New Jersey's 1992 wage increase.[9] Card and Krueger found no evidence that the increase had an adverse effect on employment; in fact, the numbers suggested the increase correlated with an *increase* in fast food employment in the New Jersey part of the Philadelphia metro area relative to the Pennsylvania part. However, a separate empirical analysis of the same wage increase in the same area did find evidence of negative employment effects.[10]

In 2006, economists David Neumark and William Wascher produced an exhaustive review of the new research.[11] They found that "nearly two-thirds [of the 102 analyses reviewed] give a relatively consistent (although by no means always statistically significant) indication of negative employment effects of minimum wages while only eight give a relatively consistent indication of positive employment effects."[12] Further, of the 33 analyses that Neumark and Wascher

> *view as providing the most credible evidence; 28 (85 percent) of these point to negative employment effects. Moreover, when researchers focus on the least-skilled groups most likely to be adversely affected by minimum wages, the evidence for disemployment effects seems especially strong.*[13]

They conclude, "[W]e view the literature—when read broadly and critically—as largely solidifying the conventional view that minimum wages reduce employment among low-skilled workers."[14]

3.2 After the lit reviews So far, the empirical analyses have largely supported the view that raising the minimum wage results in lower employment for low-skill and new workers. However, in recent years, two developments in the empirical literature have given support to proponents of raising the wage. One development is evidence[15] for the assertion (originally made by Card and Krueger[16]) that "publication bias" has resulted in the publishing of more studies showing negative employment effects of the minimum wage—which, in turn, would result in over-representation of those studies in literature reviews. The other development is a new empirical research strategy that, when first employed, showed much weaker—if any—negative employment effects from increasing the minimum wage.[17] Though interesting, neither of these developments has significantly altered the debate over the employment effects of the minimum wage.

However, a very recent paper employing a new research strategy *is* having an effect on the academic debate.[18] Instead of looking at the levels of employment before and after a minimum wage increase, or after a minimum wage change in one place but not another, this study examines the *rate of change* in employment during the time periods before and after an increase. That is, it examines whether employment grew faster or slower in areas affected by the change.

The paper's authors find that, though an increased minimum wage typically does not appear to result in outright job losses, the *rate of job creation* slows in areas that have recently increased their minimum wage relative to areas that have not. This weakened job growth is most pronounced in retail and construction—job sectors that are especially important to low-skill and new workers.

This study includes additional worrisome news for the Maryland minimum wage proposal. The proposal would permanently index the proposed new wage to inflation. In the study, areas that adopted higher minimum wages, but did not index them to inflation, experienced an initial weakening in the rate of job creation. However, that weakness dissipated over time as inflation eroded the higher minimum wage's harmful effect. If Maryland adopts inflation-indexing, that offsetting effect will not occur and the weaker job growth will be permanent.

3.3 Consensus of economists Given the reliance on economic theory and empirical research by both sides of the minimum wage debate, it is sensible to ask whether either side's argument has become the consensus view of economists. American economists are regularly surveyed on their views of important economic topics. What do those surveys show about their thoughts on the minimum wage?

In both 1990 and 2000, members of the American Economic Association—the nation's largest professional organization of economists—were asked if they agree with the statement, "Minimum wages increase unemployment among young and unskilled workers." [19] In 1990, 81.9 percent of respondents agreed with that statement, though 19.5 percent "agreed with provisos"; just 17.5 percent disagreed. That sentiment softened a bit by 2000, but not much: 73.5 percent agreed with the statement, though 27.9 percent "agreed with provisos"; 26.9 percent disagreed. For both surveys, the authors characterized the level of agreement as "substantial."

Though economists typically believe a minimum wage law hurts employment, that does not mean that all those economists oppose such a law. Some may see the lost employment as a regrettable but acceptable tradeoff for other benefits. For instance, some economists believe the lost employment is partly offset by increased employment for higher-skill (and thus better-paid) workers, which they consider preferable.[20] Others believe the benefit of higher wages for some low-skill workers as a result of the minimum wage is worth the loss of employment for other low-skill workers.[21] That belief is certainly debatable, but it is understandable.

In summary, there is a general consensus among economists that minimum wage laws lower employment for low-skill and new workers. However, that does not mean that all economists believe that minimum wage laws should be repealed or wage increases halted.

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3.4 Beyond the studies As noted at the beginning of Section 3, empirical studies of the employment effects of the minimum wage typically examine data from relatively short time periods before and/or after a wage increase. This research design may miss the most significant employment effects of the minimum wage: increasing labor costs may result in a slow-to-emerge but long-term reduction in employment opportunities for low-skill and new workers.

In a 2011 interview on the morning television program *Today*, President Obama made an important observation:

> *[T]here are some structural issues with our economy where a lot of businesses have learned to become much more efficient with a lot fewer workers. …[Y]ou see it when you go to a bank: you use the [automatic teller machine]; you don't go to a bank teller. Or you go to the airport and you use a kiosk instead of checking in at the gate. So all these things have created changes in the economy….*[22]

Conservatives were quick to criticize the president's comments, noting (not incorrectly) that technological change leads to a higher standard of living for workers over the long run because they can produce more value per unit of labor. (Consider the work done in an hour by a backhoe operator vs. a laborer with a shovel.) However, the president's observation is important: technological change often eliminates jobs that were filled by low-skill workers.

The adoption of a new technology is not purely the product of random innovation. Change occurs when the cost of developing, installing, and operating some new technology to accomplish a task becomes less than the cost of traditional labor-intensive methods for accomplishing that task. ATMs replace bank tellers once the machines become cheaper than the workers, automated kiosks likewise replace counter attendants, snack and soda machines replace canteen employees, and automated phone systems replace switchboard operators.

Increasing the minimum wage raises the cost of using traditional labor-intensive methods that employ low-skill workers. The higher labor cost provides opportunity for technology to supplant the labor-intensive methods. Thus the minimum wage's most important negative employment effects may not be detectable by empirical studies that examine short time periods, but those effects are nonetheless real.

3.5 Conclusions from the research Proponents of raising the minimum wage often claim that it has not been definitively proven that increasing the wage hurts employment.[23] That is true—but then, many things have not been "definitively proven," yet policymakers (and people in general) nonetheless act in accordance with the preponderance of the theoretical and empirical evidence. In this case, there is substantial evidence that a higher minimum wage (and especially a wage indexed to inflation) will weaken employment for low-skill and new workers.

However, even though an increase in the minimum wage will weaken employment, that does not necessarily mean that policymakers should not raise the wage. Some policymakers may decide that job losses are worthwhile in order to ensure that those workers who are employed receive a good wage—in essence, outlawing low-paying jobs. (Those policymakers had better be prepared to provide public assistance to the would-be workers who are harmed by the wage increase.) Other policymakers may see other benefits from raising the wage that they believe outweigh the misery of lower employment. As in other areas of public policy, science (whether social or "hard") is not normative—it does not tell the policymaker what policy he or she should adopt. Rather, science can only indicate what will likely happen if various policies are adopted.

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4. RAISING THE 'STAKES'

Both supporters and critics of raising the minimum wage have economic theories and empirical evidence that they can use to support their theories. Further, they claim to be motivated by concern for public welfare, especially for low-income families. And support or opposition to the minimum wage can hinge on two respectable goals: the desire to improve workers' wages versus the desire to boost workers' employment opportunities. Given those facts, one would expect the debate over raising the minimum wage to be thoughtful, cordial, and charitable to opposing views. Unfortunately, the opposite is more often the truth; political fights over the minimum wage are some of the nastiest battles in politics.

This is especially regrettable because, given data on the minimum wage's effects, it seems to be a poor tool for improving public welfare. Relatively few workers earn the minimum wage and they typically don't earn it for very long before receiving a raise. [24] Moreover, minimum wage workers generally are not from poor households and raising the wage appears to have no effect on lifting U.S. households out of poverty.[25]

In 2012, only 1.1 percent of U.S. workers earned the federal minimum wage, including less than 0.4 percent of full-timers.[26] Another 1.4 percent of workers—including 0.7 percent of full-timers—earned sub-minimum wages, though they typically also earned tips.[27] Some 55 percent of minimum-wage workers were under age 25 and the average minimum-wage employee worked 27 hours a week.[28] Those workers usually weren't heads of households—nearly two-thirds were in high school or college.[29] Roughly half of the workers who would benefit from the proposed federal increase in the minimum wage lived in households earning $40,000 or more a year.[30]

Currently, both Annapolis and Washington are considering raising the minimum wage to $10.10 an hour through a series of increases over three years. (It is unclear what reason—if any—policymakers had for selecting $10.10.) If that increase were adopted, it would yield a disappointingly small amount of money to minimum-wage workers.

The three increases would each add just $25.65 each week to the minimum-wage worker's paycheck—before taxes. Even after the three years, when the total increase is almost $77 per weekly check (before taxes), that's still not much help. Remembering our minimum-wage worker from Section 2.1, who works 40 hours a week for 52 weeks a year, the $10.10 minimum wage would provide him an annual income of just over $21,000 a year. That would still not be enough to lift his four-person household out of poverty and would leave him woefully behind the $86,000 median annual income for Maryland households.

Given those meager effects, policymakers should look for alternative policies that would yield much greater benefits to low-income households. Below are three alternatives that seemingly would yield much greater benefits.

4.1 Preferred alternative: Abandon the minimum wage and improve the EITC The problems with using the minimum wage to help poor families have been described above: it doesn't provide much help, it is poorly targeted toward the poor, and it leads to weakened employment for low-skill and new workers. Fortunately, there is a different policy tool that avoids all of those problems: the earned-income tax credit (EITC).

The EITC, which exists on both the federal and Maryland levels, provides tax credits specifically to low-income, working families. Importantly, for many EITC recipients, the size of the credit *increases* as workers gain skills and begin earning better wages. That way, the credit rewards workers for improving their earning power. Because the EITC is financed by shifting the federal and state tax burdens onto higher-income households, it is progressive—much more progressive than raising the minimum wage, which often simply shifts costs onto low-income consumers and low-profit-margin businesses.[31]

Unfortunately, the designs of both the Maryland and federal EITC limit their effectiveness in helping the working poor. The credits are small, especially for childless households. In Maryland, only a small portion of the credit is refundable, meaning that it does little to increase a worker's gross income. Finally, what cash can be collected is only received in a lump-sum after the recipient has filed his or her tax return. Fortunately, in Washington there is now consideration of addressing those shortcomings.[32] Unfortunately, there appears to be no such considerations in Annapolis.

The EITC is not free from criticism. It is a "tax expenditure"—that is, it is a de facto government expenditure disguised as a tax provision, which reduces scrutiny of the spending. As a result of the credit, recipients don't pay their fair share for the government services they receive, which distorts political demand for those services. Though the EITC encourages many recipients to pursue better pay, it does dampen that incentive for some—and it is difficult and costly to engineer the program to minimize that effect. Finally, the federal EITC has often been a source of tax fraud.[33]

Despite those shortcomings, this analysis considers a restructured and expanded EITC to be the best policy for Maryland if it wants to help the working poor.[34]

4.2 Alternative 2: A much larger minimum wage increase In an effort to underscore Law of Demand concerns, critics of raising the minimum wage often challenge supporters to adopt a much higher wage than what is typically proposed. The critics' bellicosity aside, they do have a point: $10.10 may be a 40 percent increase over current law, but it's still not much money.

If proponents of raising the minimum wage are willing to accept weaker employment for other perceived benefits of a higher minimum wage (or they honestly believe there are no negative employment effects from raising the wage), then they really should pursue an increase that would significantly benefit low-income households. A wage of $20 an hour seems attractive. If that were implemented, the typical minimum-wage worker would see an increase of just over $330 in his weekly paycheck before taxes. The full-time minimum-wage worker from Section 2.1 would earn enough to lift his household to 175 percent of the poverty level, though his annual income of $41,600 would still leave him well below Maryland's median household income. At $20 an hour, minimum-wage workers would be better able to afford the state's high cost of living.

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4.3 Alternative 3: An experiment From this analysis's perspective, improving and expanding the EITC is clearly preferable to increasing the minimum wage as a way to help the working poor. The EITC better targets low-income households, is more economically progressive, and doesn't raise concerns about lowering employment opportunities for low-skill and new workers. However, this analysis recognizes that some policymakers—for whatever reason—may still prefer to raise the minimum wage.

This analysis thus suggests a policy experiment: Maryland could implement a higher minimum wage in some parts of the state and offer an improved EITC in other parts. The state could randomly assign the policies to different counties, or else allow county governments to voluntarily adopt one or the other. Admittedly, neither of these approaches would produce an ideal social science experiment (which would have a large random sample that allows for the statistical control of outside influences), but this exercise could still provide useful insight into which policy is more effective at improving public welfare and which policy is more politically acceptable.

5. CONCLUSION

This paper has examined theoretical and empirical evidence to determine the likely effects that current proposals to raise the minimum wage would have on low-income households. At best, the positive effects are meager and poorly targeted toward the working poor. Worse, there is substantial evidence that raising the minimum wage would result in a further weakening of the already poor job market for low-skill and new workers. If policymakers are concerned about the welfare of the working poor, and if they respect the insights provided by social science, then they should abandon consideration of raising the minimum wage (and perhaps consider repealing the minimum wage law) and instead look for better policies to help low-income households.

This analysis concludes by suggesting that both Maryland and the federal government consider revising and increasing the EITC in order to help those households. However, if lawmakers are unwilling to use this effective, efficient, and progressive policy tool, and instead want to use the minimum wage law (despite the social science evidence of its employment effects), then this analysis suggests adopting a much larger increase than what is currently being considered. Or, if Maryland policymakers are undecided between the two policies, this analysis suggests that they attempt a social science experiment in which some parts of the state will have an expanded EITC while other parts will have a much higher minimum wage.

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