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The Minimum Wage: A Community Economic Development Aid or Hindrance?

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One of the most troublesome issues facing citizens concerned with community economic development is the increase in the number of people classified as the working poor (see the September 2004 issue of *CEN*). As our economy grows, there is strong evidence that there is a widening gap between the rich and poor. In other words, there is growing pressure on the traditional middle class. One policy option that is receiving significant attention within Wisconsin and across several states is an increase in the minimum wage. Since 1997, the minimum wage as set by the federal government is $5.15. For a person working a 40 hour workweek, that translates into $206 per week, before taxes. Since 1997, inflation has reduced the real value of the minimum wage by about 74 cents. If poverty reduction or help for the working poor is a goal of policy a natural question is why not increase the minimum wage.

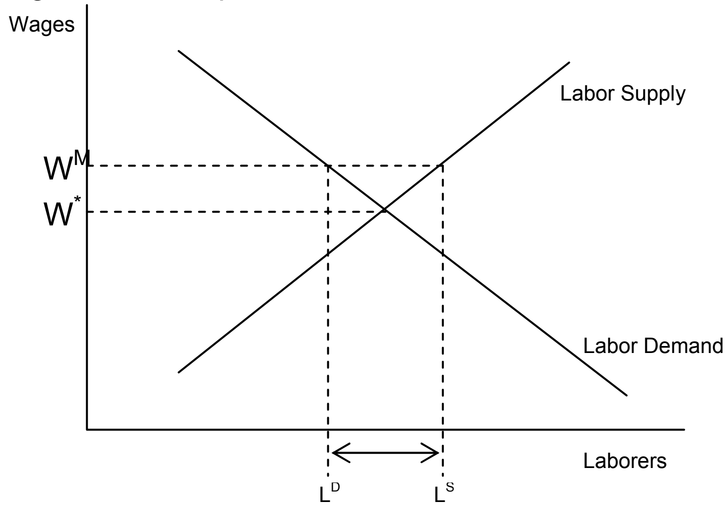
It has long been orthodoxy in economics that increases in the minimum wage will result in reductions in employment. Based on a strong theoretical construct with strong policy implications, this orthodoxy has been buttressed by numerous studies showing that employment does decrease, particularly in the teen labor market. As Milton Friedman once put it, “minimum wage laws are about as clear a case as one can find of a measure the effects of which are precisely the opposite of those intended by the men of good will who support it.”

Consider a simple demand and supply model of labor markets (Figure 1). As wages increase, more people are willing to enter the labor market or work longer hours (upward sloping labor supply). At the same time, higher wages mean that firms will demand less labor and perhaps substitute capital for labor or reduce output (downward sloping labor demand). In a perfectly competitive market, there will be a market equilibrium at a wage (W* in Figure 1); all people who are willing to work can find work. But if society deemed this market determined level to be too low, then policy can be crafted to place a “floor” on wages (W^M in Figure 1). As demonstrated in the figure, at the minimum wage there will be more people willing to work than there will be firms willing to pay that wage. The orthodoxy is that employment will decline, and unemployment at the level L^S minus L^D will prevail.

If the aim of policy is to help those working at the poverty level, then raising the minimum wage will negatively affect a portion of those it is intended to help. It is also widely argued that smaller firms are most likely to be negatively affected because they are often in markets that are more competitive and have lower profit margins. In addition, if labor is paid equal to the value of their contribution to output (i.e., more productive people are paid more than less productive people) then it is possible that work demands placed on those working at the new higher minimum wage will be increased. In other words, if wages are artificially inflated, managers may try to force higher levels of productivity from minimum wage workers. Smaller firms that cannot absorb higher wage costs will either layoff those workers whose value is less than the minimum or require low-efficiency workers improve their productivity.

The empirical research, however, does not uniformly support or confirm the predictions of neoclassical theory. Much of the empirical research suggest that most of those working at the minimum wage tend to be youth workers and are not the primary breadwinners of a family or household. Indeed, the view is so prevalent in the labor economics literature that most empirical studies of the impact of minimum wage policies have focused almost exclusively on the youth market. If the predominance of minimum wage workers are youth then why worry about the minimum wage at all? The Economic Policy Institute estimates that 623,000 single mothers with children under 18 would be affected from a minimum wage increase to $7.00. In other words, the impact of an increase in the minimum wage in an environment of a growing number of working poor is not fully understood.

Figure 1: A simple model of labor markets



The argument that smaller firms are least likely to be able to adapt to an increase in the minimum wage is also not always supported by the empirical research. In a study of the impact of the national minimum wage in England on small clothing manufacturing, hotel and catering firms, Arrowsmith (2003) and his colleagues found no evidence of systematic loss of employment or firm profitability. Because of the individualization and indeterminacy of pay they conclude that impact of employment regulations, such as a minimum wage increase on small firms, are not easily predictable in advance. Managers and employees of small firms tend to have a closer working relationship that greatly complicates the "cleanness" of economics orthodoxy. Finally, from a community economic development perspective, if a firm is unable to sustain modest increases in labor costs the long-term viability of the firm to contribute to the well-being of the community could be challenged.

Another dimension that complicates the conclusions of the economics orthodoxy is related to employee turnover levels. Studies have estimated that firms experiencing high levels of turnover can see their labor costs increase by 30 percent. Studies have also shown that employee turnover rates tend to be higher amongst lower paid workers. If the wages are increased, turnover rates should decline thus lowering costs to low wage firms. The balance between increased costs due to the minimum wage increase and lower costs due to reduced employee turnover rates will vary by firm. Blanket generalizations are difficult to make.

In the end, is the minimum wage a hindrance or an aid to community economic development? As with much of economics, there is no definitive answer. From an economic growth perspective, increasing the minimum wage may see the loss of a few low paying jobs. From an economic development perspective, increasing the minimum wage will help address the growing problem of the working poor.

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