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# The Business of the Minimum Wage

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RAISING the minimum wage, as President Obama proposed in his [State of the Union address](#), tends to be more popular with the [general public](#) than with [economists](#).

I don't believe that's because economists care less about the plight of the poor — many economists are perfectly nice people who care deeply about poverty and [income inequality](#). Rather, economic analysis raises questions about whether a higher minimum wage will achieve better outcomes for the economy and reduce poverty.

First, what's the argument for having a minimum wage at all? Many of my students assume that government protection is the only thing ensuring decent wages for most American workers. But basic economics shows that competition between employers for workers can be very effective at preventing businesses from misbehaving. If every other store in town is paying workers \$9 an hour, one offering \$8 will find it hard to hire anyone — perhaps not when unemployment is high, but certainly in normal times. Robust competition is a powerful force helping to ensure that workers are paid what they contribute to their employers' bottom lines.

One argument for a minimum wage is that there sometimes isn't enough competition among employers. In our nation's history, there have been company towns where one employer truly dominated the local economy. As a result, that employer could affect the going wage for the entire area. In such a situation, a minimum wage can not only make workers better off but can also lead to more efficient levels of production and employment.

But I suspect that few people, including economists, find this argument compelling today. Company towns are largely a thing of the past in this country; even Wal-Mart Stores, the nation's largest employer, [faces substantial competition](#) for workers in most places. And many employers paying the minimum wage are small businesses that clearly face strong competition for workers.

Instead, most arguments for instituting or raising a minimum wage are based on fairness and redistribution. Even if workers are getting a competitive wage, many of us are deeply disturbed that some hard-working families still have very little. Though a desire to help the poor is largely a moral issue, economics can help us think about how successful a higher minimum wage would be at reducing poverty.

An important issue is who benefits. When the minimum wage rises, is income redistributed primarily to poor families, or do many families higher up the income ladder benefit as well?

It is true, as [conservative commentators often point out](#), that some minimum-wage workers are middle-class teenagers or secondary earners in fairly well-off households. But [the available data suggest](#) that roughly half the workers likely to be affected by the \$9-an-hour level proposed by the president are in families earning less than \$40,000 a year. So while raising the minimum wage from the current \$7.25 an hour may not be particularly well targeted as an anti-poverty proposal, it's not badly targeted, either.

A related issue is whether some low-income workers will lose their jobs when businesses have to pay a higher minimum wage. There's been a tremendous amount of research on this topic, and the bulk of the empirical analysis finds that [the overall adverse employment effects are small](#).

Some evidence suggests that employment doesn't fall much because the higher minimum wage [lowers labor turnover](#), which raises productivity and labor demand. But it's possible that productivity also rises because the higher minimum attracts more efficient workers to the labor pool. If these new workers are typically more affluent — perhaps middle-income spouses or retirees — and end up taking some jobs held by poorer workers, a higher minimum could harm the truly disadvantaged.

Another reason that employment may not fall is that businesses pass along some of the cost of a higher minimum wage to consumers [through higher prices](#). Often, the customers paying those prices — including some of the diners at McDonald's and the shoppers at Walmart — have very low family incomes. Thus this price effect may harm the very people whom a minimum wage is supposed to help.

It's precisely because the redistributive effects of a minimum wage are complicated that most economists prefer other ways to help low-income families. For example, the current tax system already subsidizes work by the poor via an earned-income tax credit. A low-income family with earned income gets a payment from the government that supplements its wages. This approach is [very well targeted](#) — the subsidy goes only to poor families — and could easily be made more generous.

By raising the reward for working, this tax credit also tends to increase the supply of labor. And that puts downward pressure on wages. As a result, [some of the benefits go to businesses](#), as would be the case with any wage subsidy. Though this mutes some of the direct redistributive value of the program — particularly if there's no constraining minimum wage — it also tends to increase employment. And a job may ultimately be the most valuable

thing for a family struggling to escape poverty.

What about the macroeconomic argument that is sometimes made for raising the minimum wage? Poorer people typically spend a larger fraction of their income than more affluent people. So if an increase in the minimum wage successfully redistributed some income to the poor, it could increase overall consumer spending — which could stimulate employment and output growth.

All of this is true, but the effects would probably be small. The president's proposal would raise annual income by \$3,500 for a full-time minimum-wage worker. A [recent analysis](#) found that 13 million workers earn less than \$9 an hour. If they were all working full time at the current minimum — and a majority are not — the income increase from the higher minimum wage would be only about \$50 billion. Even assuming that all of that higher income was redistributed from the wealthiest families, the [difference in spending behavior](#) between low-income and high-income consumers is likely to translate into only about an additional \$10 billion to \$20 billion in consumer purchases. That's not much in a \$15 trillion economy.

SO where does all of this leave us? The economics of the minimum wage are complicated, and it's far from obvious what an increase would accomplish. If a higher minimum wage were the only anti-poverty initiative available, I would support it. It helps some low-income workers, and the costs in terms of employment and inefficiency are likely small.

But we could do so much better if we were willing to spend some money. A more generous earned-income tax credit would provide more support for the working poor and would be pro-business at the same time. And pre-kindergarten education, which the president proposes to make universal, has been shown in [rigorous studies](#) to strengthen families and reduce poverty and crime. Why settle for half-measures when such truly first-rate policies are well understood and ready to go?

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