

Evidence is mounting that moderate minimum wages can do more good than harm

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Minimum-wage laws have a long history and enduring political appeal. New Zealand pioneered the first national pay floor in 1894. America's federal minimum wage dates from 1938. Most countries now have a statutory pay floor—and the ranks are still swelling. Even Germany, one of the few big countries without, may at last introduce a national one. And in an era of budget austerity and widening inequality, the political temptation to prop up wages at the bottom by fiat may well grow.

Economists have tended to oppose minimum wages on the grounds that they reduce employment, hurting many of those they are supposed to help. Milton Friedman called them a form of discrimination against low-skilled workers. In standard models of competitive markets, anything that artificially raises the price of labour will curb demand for it, and the first to lose their jobs will be the least-skilled workers.

Yet economic theory allows for the possibility that wage floors can boost both employment and pay. If employers have monopsony power as buyers of labour and are able to set wages, for instance, they can keep pay below its competitive rate. Academic supporters of wage floors, mainly economists on the left, appealed to this logic. But most of their colleagues disagreed; and until about 1990, most empirical studies found that higher minimum wages cost jobs, particularly among young workers.

Then a pioneering case study by two noted labour economists, David Card and Alan

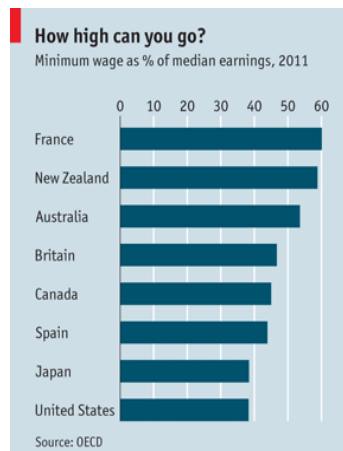
Krueger, examined the response of fast-food restaurants to a rise in New Jersey's state minimum wage. It found that this had actually increased employment. The paper spawned a flood of similar "case-study" research, a flurry of revisionist thinking and a heated academic debate. The most prominent critics of the new research were David Neumark of the University of California at Irvine and William Wascher of the Federal Reserve. They disputed Messrs Card and Krueger's findings for New Jersey and argued that a comparison

of different states over time showed that higher minimum wages hurt jobs.

Almost two decades later, the minimum-wage debate has matured, not least because policy changes have brought heaps of new evidence to analyse. Britain introduced a national minimum wage in 1999. America's states saw numerous adjustments in their minimum wages, and the federal

floor was raised by 40% between 2007 and 2009.

America's academics still do not agree on the employment effects. But both sides have honed their methods and, in some ways, the gap between them has shrunk. Messrs Card and Krueger moved on to other work, but Arindrajit Dube at the University of Massachusetts-Amherst and Michael Reich of the University of California at Berkeley have generalised the case-study approach, comparing restaurant employment across all contiguous counties with different minimum-wage levels between 1990 and 2006. They found no adverse effects on employment from a higher minimum wage. They also argue that



if research showed such effects, these mostly reflected other differences between American states and had nothing to do with the minimum wage.

Messrs Neumark and Wascher still demur. They have published stacks of studies (and a book) purporting to show that minimum wages hit jobs. In a forthcoming paper they defend their methods and argue that the evidence still favours their view. But even they are no longer blanket opponents. In a 2011 paper they pointed out that a higher minimum wage along with the Earned Income Tax Credit (which tops up income for poor workers in America) boosted both employment and earnings for single women with children (though it cost less-skilled, minority men jobs).

Britain's experience offers another set of insights. The country's national minimum wage was introduced at 46% of the median wage, slightly higher than America's. A lower floor applied to young people. Both are adjusted annually on the advice of the Low Pay Commission. Before the law took effect, worries about potential damage to employment were widespread. Yet today the consensus is that Britain's minimum wage has done little or no harm.

The most striking impact of Britain's minimum wage has been on the spread of wages. Not only has it pushed up pay for the bottom 5% of workers, but it also seems to have boosted earnings further up the income scale—and thus reduced wage inequality. Wage gaps in the bottom half of Britain's pay scale have shrunk sharply since the late 1990s.

A new study by a trio of British labour-market economists (including one at the Low Pay Commission) attributes much of that contraction to the minimum wage. Wage inequality fell more for women (a higher proportion of whom are on the minimum wage) than for men and the effect was most pronounced in low-wage parts of Britain.

The British way versus the American way

This new evidence leaves economists with lots of unanswered questions. What exactly is going on in labour markets if minimum wages do not hurt employment but reduce wage gaps? Are firms cutting costs by squeezing wages elsewhere? Are they improving the productivity of the lowest-wage workers? Some of the newest studies suggest firms employ a variety of strategies to deal with a higher minimum wage, from modestly raising prices to saving money from lower turnover.

Policymakers face practical issues. Bastions of orthodoxy, such as the OECD, a rich-country think-tank, and the International Monetary Fund, now assert that a moderate minimum wage probably does not do much harm and may do some good. Their definition of moderate is 30-40% of the median wage. Britain's experience suggests it might even be a bit higher. The success of the Low Pay Commission points to the importance of technocrats rather than politicians setting wage floors. Britain's small, regular changes may be easier for firms to absorb than America's infrequent but hefty minimum-wage increases. Whatever their flaws, minimum wages are here to stay.