

The History of Economic Thought on the Minimum Wage*

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I was in the audience at the State of the Union address in February 2013 when President Obama announced, “Tonight, let’s declare that in the wealthiest nation on Earth, no one who works full time should have to live in poverty, and raise the federal minimum wage to \$9.00 an hour.”

The thought that ran through my head at that time was, “Wow, it’s remarkable that economic thinking has come full circle on the minimum wage.” Let me take you on a quick tour of 75 years of the history of economic thought on the minimum wage. This history demonstrates that periodically raising the minimum wage to help low-wage workers is not only the right thing to do, it is also the smart thing to do.

Economists were largely supportive of the minimum wage when it was enacted as part of the Fair Labor Standards Act (FLSA) in 1938.

Economists in the 1930s and 1940s understood the logic that said demand curves sloped downward, but they also were aware that labor markets were imperfect, and that workers lacked bargaining power. The fact that wages and working conditions varied for workers of equal skill and training in a locality suggested that employers had some discretion to set pay. Companies were more than passive wage takers, as the simple theory of labor demand requires. Economists from Princeton’s Richard Lester to the University of Chicago’s Paul Douglas—who became a distinguished Senator from Illinois—supported minimum-wage hikes.

They recognized that there was nothing optimal in the way that employers set wages, and that the economy would function better if the minimum wage set a floor below which wages could not fall. An adequate wage floor would also improve employee morale and bring more workers into the job market. When employers have monopsony power over workers because of frictions in the job market, a skillfully set minimum wage could provide a standard that clears the market, and raises the purchasing power of households to buy, as

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Franklin Roosevelt put it, “the products of farm and factory.” The institutional school of labor economics, led by Lester, John Dunlop, Clark Kerr, and others, recognized that wage setting in the real world involved a complex balance of concerns about morale, employee loyalty, turnover, bargaining power, and concerns about relative pay—as well as supply and demand.

Indeed, the idea that private markets left to their own devices might result in pay that was too low goes all the way back to Adam Smith, the father of economics. In 1776, Smith worried that employers were “always and everywhere” in a tacit conspiracy to keep wages as low as possible. This led him to the conclusion that, “When the regulation, therefore, is in support of the workmen, it is always just and equitable; but it is sometimes otherwise when in favour of the masters” (Smith 1776/2003: Book I, Chapter 10).

Mind you, all of these arguments say that the economy functions better with a fair minimum wage. But there are also compelling moral and equity arguments in favor of a minimum wage.

Indeed, Smith argued, “No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they who feed, clothe and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, clothed and lodged” (Smith 1776/2003: Book I, Chapter 10).

In the 1940s, the Chicago economist George Stigler led a backlash against the institutionalist view that the minimum wage could reduce poverty and improve the economy. Stigler argued that economists should be “outspoken, and singularly agreed” that the minimum wage reduces employment and does not reduce poverty (Stigler 1946).

The view of the “institutional” economists who argued that the minimum wage would not hurt employment was based on observations of actual businesses’ behavior and discussions with executives. By contrast, George Stigler and the so-called “marginalists” deduced their conclusions from a set of assumptions about the way competitive markets should function. In these idealized markets companies had no discretion to set pay and all workers were paid their contribution to output.

In the 1960s and 1970s, with the spread of computer technology and accumulation of data, a new approach was applied to the minimum wage: econometrics.

The most common approach was to relate movements in the value of the minimum wage relative to the average wage (with some adjustment for coverage of the minimum wage) to teenage employment. A comprehensive article written in 1982 by Charles Brown and coauthors (Brown, Gilroy, and Kohen

1982) concluded that a 10-percent increase in the minimum wage was associated with 1 to 3 percent lower teen employment.

Based partly on these studies and Stigler's argument, the Reagan administration refused to allow the minimum wage to increase from 1981 to 1989. The purchasing power of the minimum wage fell 27 percent in this period. There was a real risk that the minimum wage would become irrelevant, a relic of history.

Then a funny thing happened. As more years of data were added to re-estimate the exact same econometric models, the effect became weaker. In fact, by the early 1990s the time-series estimates were finding no statistical evidence of an effect of the minimum wage on employment (see Wellington 1991). This is not what is supposed to happen. More data is supposed to make it easier to detect effects in statistics, not make them go away.

This is where David Card and I entered the picture. Personally, I never put much stock in the time-series evidence. There are too many things that change over time to believe that the time-series studies truly isolated the effect of the minimum wage.

Instead, David Card and I conceived of a different way to study the issue. In our best-known but least-understood study (Card and Krueger 1994), we examined employment at fast-food restaurants in New Jersey and across the border in Pennsylvania, before and after New Jersey raised its state minimum wage from \$4.25 to \$5.05 per hour in 1992. To our surprise, we found that employment did not fall in New Jersey compared to Pennsylvania. Moreover, when we compared the restaurants in New Jersey that were required to raise their wages the most by the minimum wage hike to other restaurants in New Jersey that already exceeded the higher minimum wage, we again failed to find disemployment effects.

In another set of studies, Card examined employment growth in states that were more or less affected by the federal minimum wage (Card 1992a, 1992b). In some states, like Louisiana and South Dakota, more than 70 percent of teenagers had their pay increased when the federal minimum rose in 1991, while in other states that had high state minimum wages, such as California and Massachusetts, under 20 percent of teenagers got a raise. Card found that employment did not grow less strongly in states that initially had lower wages, although wages rose and poverty declined.

These studies have been replicated and extended. A particularly compelling recent study by Michael Reich and his coauthors takes my approach with Card a step further by comparing *all* local differences in the minimum wage across contiguous county-pairs in the United States that straddle state borders from 1990 to 2006 (Dube, Lester, and Reich 2010, forthcoming). This research shows that workers benefited in states that increased their minimum wage, such as California, Rhode Island, New York, Vermont, and Washington,

relative to similar workers across the state borders. The study concluded, “for cross-state contiguous counties, we find strong earnings effects and no employment effects of minimum wage increases.”

A meta-analysis by Doucouliagos and Stanley (2009) of sixty-four studies on the minimum wage published between 1972 and 2007, encompassing over one thousand estimates, finds that most estimates are concentrated around zero, indicating no detectable effect. The authors concluded that the available research finds “no evidence of a meaningful adverse employment effect” of the minimum wage.

I said that we have come full circle. The federal minimum wage has been raised five times since David Card and I published our study. President Obama has proposed raising the minimum wage back to where it was in 1981, after adjusting for inflation, erasing all of the decline from the Reagan years. A survey of prominent economists conducted by the University of Chicago found that by a ratio of 4 to 1 they thought it would be desirable to raise the minimum wage to \$9 per hour and index it to inflation.¹

In his Fireside Chat on June 24, 1938, President Roosevelt warned, “Do not let any calamity-howling executive with an income of \$1,000 a day, who has been turning his employees over to the Government relief rolls in order to preserve his company’s undistributed reserves . . . tell you that a wage of \$11.00 a week is going to have a disastrous effect on all American industry.”² Well, 75 years of history have shown us that the minimum wage did not have a disastrous effect. Do not let any calamity-howling economist tell you otherwise. Instead, throughout its 75-year history in the United States, the federal minimum wage has helped to provide workers with dignity and to ensure that honest work is rewarded with honest pay.

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¹ http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_br0IEq5a9E77NMV (accessed April 9, 2015).

² See <http://www.presidency.ucsb.edu/ws/?pid=15662> (accessed April 9, 2015).

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