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The Minimum Wage Is a Price-Control Debate

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The recent successful state and local efforts to increase the minimum wage, more than doubling the current federal minimum wage of $7.25 per hour in some instances, is reviving the notion that government can arbitrarily set the price of goods and services, including workers' labor, with little or no economic downside. Indeed, the growing mantra is that such actions significantly benefit workers, employers and the economy.

This trend cannot end well and is likely a result of forgetting what was well understood by most economists for years: price controls don't work.

A Price Is Information

The most important thing to understand about a price is that it is a powerful conveyor of information, both from sellers to buyers and from buyers to sellers.

While vendors set the price they want, buyers must confirm that decision by purchasing the products or services. If they are resistant to a price, vendors have the flexibility to lower it to a point where consumers are willing to spend their money—or the venders will go out of business.

With some products and services, however, consumers may be willing to pay more than the list price for highly desirable or limited-availability goods. For example, in tight housing markets potential buyers may offer more than the list price to secure a house. But when houses are plentiful consumers will offer less.

And the same can be said of labor: When workers are plentiful and there is little differentiation between their skills, the price of labor (i.e., wages) may fall—or at least not rise. But specialized workers in very high demand—professional athletes may be the clearest example—can demand very high prices … and get them.

Both low and high prices convey information about buyers, sellers and the economy. When the government attempts to manipulate prices through arbitrary price controls, it distorts that flow of information making it harder for the economy to respond appropriately.

Price Controls Distort Consumer Decisions

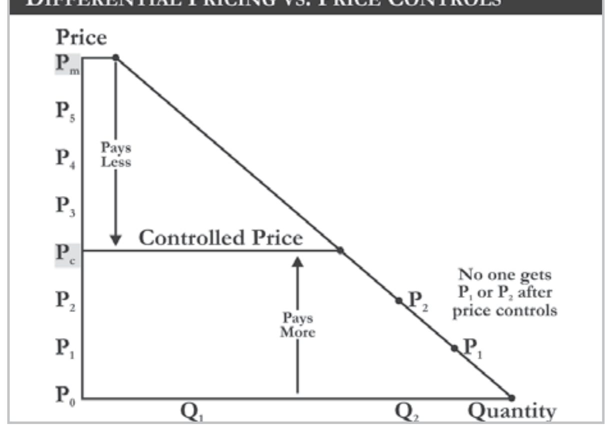
Price controls are always promoted as a way to help people, especially the poor. When price controls are imposed on products, they are supposed to help consumers by keeping prices low. By contrast, minimum wage price controls are supposed to ensure that wages are higher than they otherwise would be.

Artificially low prices encourage people to consume more of a product or service than they otherwise would, just as artificially high prices (e.g., minimum wage) discourage people, including employers, from consuming as much as they otherwise would.

Market Pricing Helps the Poor

It is market pricing, not price controls, that best helps the poor. To understand why, examine the price curve in the figure below.

Differential Pricing vs. Price Controls



Sellers set a price (Pm) for their products or services that they believe will maximize revenue. Since that price may be higher than many people can or are willing to pay, sellers may look for ways to discount their products or services—also referred to as "differential pricing"—to increase market share. As the price falls on the demand curve the quantity sold increases (from to Q1 to Q2), maximizing the number of units sold.

Retailers regularly engage in differential pricing. At the beginning of a season, new designer garments are marked at the full retail price (Pm). Later in the season, retailers may discount items by, say, 25 percent (P4), then 50 percent (P2) and maybe eventually 75 percent (P1). At some point, the price is low enough that almost anyone can afford high-end clothing—if they are willing to wait and settle for a limited selection.

Price Controls Hurt the Poor

In contrast to differential pricing, which increases the poor's access to products and services, price controls hurt access.

When politicians decide to impose price controls (Pc), they usually pick a level that is lower than the top price (Pm) sellers would like to sell at, but higher than the lowest price (P0) buyers would like to pay.

As a result, consumers who were willing and able to pay the full price actually get a better deal, while less-able consumers must pay a higher price than they otherwise would—and may chose not to buy at all.

Minimum Wage Laws Are Just Price Controls

Minimum wage laws are price controls on labor, only they set an artificially high price. When politicians take that approach, only those employers best able to pay that artificially high price will consume (hire) that labor, and only if they think the labor is worth Pc, which means some people willing to work (even at wages P1 and P2) will not be hired. If wages were allowed to fall naturally down the demand curve, more workers (Q3) would be hired.

Ironically, just about everyone understands these economic facts when it comes to products and services; it is only when the same situation is applied to labor and wages that they deny the correlation.

Minimum Wage Laws Are Inflationary

If the local coffee shop were required by law to double the price of a basic cup of coffee, that action would drive up the price of other selections, since the top menu item should cost more than the basic one. The same is true with minimum wage laws. A significant wage increase means that all of those workers whose skills and responsibilities let them make more than the old minimum wage but not as much as the new wage will (reasonably) want an equivalent increase. But without an increase in productivity, employers are simply paying more for the same product, which is inflationary.

Size and Location Matter

There has been a raging debate between economists and policymakers over whether minimum wage laws reduce hiring and kill jobs. But these debates often ignore the fact that size matters. A very small increase in the minimum wage—from $7.25 an hour to, say, $7.30—would likely make very little difference in employers' hiring decisions, just as a nickel increase in a $7.00 consumer item would likely discourage few buyers.

However, an increase to $15.00 an hour, as many are demanding, would have a much greater negative impact on job availability. Add another roughly $4,000 a year that employers will have to pay for their employees' health coverage, and we're looking at an increase from about $15,000 a year under the current minimum wage to, perhaps, $35,000 under the proposals with health insurance added in. Just ask how many consumers would have bought their last car if price controls had doubled its price.

In addition, a minimum wage increase in a high-cost area—say, New York City or San Francisco—would likely have a smaller negative economic impact than in a less affluent area, such as rural Mississippi.

Margins Matter

Minor increases have a minor impact; major increases have a major impact. No serious advocate is calling for a minimum wage increase to $50.00 per hour. And yet if all the current justifying arguments are correct—i.e., it increases worker morale and productivity and stimulates the economy because workers would spend the money—they would be even truer at the higher wage. So why stop at $15.00 an hour?

But yet if it is conceded that employers might not hire many low-skilled workers at $50.00, then isn't it also true that some of the least skilled workers, those at the margins, won't be hired at $15.00?

Alternatives Exist

If employers had no alternative but to pay the higher minimum wage, they might do it—just as consumers sometimes will agree to buy an overpriced item.

But many employers have the option of moving to labor-saving technology, such as software, kiosks or robots, that take an employee's place. And whereas those alternatives might not be financially feasible under a lower minimum wage, a dramatically higher wage could—and, indeed, already are—make them an option.

Conclusion

Price controls, whether for products or labor, do not work. They distort important information that consumers and employers use to make decisions, and instead of helping the poor, they almost always hurt them.

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