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# ON LEGALLY ENFORCED MINIMUM WAGES

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## **Abstract**

*This paper offers a critique not only of raising government-enforced minimum wages but allowing them to continue in existence. This law makes it impossible for some unskilled workers to obtain employment and raises no one's wage in the long run. Minimum wages are defended, primarily, on the basis of an ethical (in our view, mistaken) point of view, not on economic grounds. We analyze the economics of wage determination and explain why minimum wages thwart the process of increasing capital formation and thus real wages. Hence, since wages are the result of discounted marginal revenue products, any intervention to artificially increase them not only ends up harming workers on the margin (those whose productivity is below levels mandated by law), but also distorts the labor market, capital allocation, and economic growth and development.*

**Keywords:** Minimum wage law; unemployment; justice.

## **INTRODUCTION**

Section I looks at this law from an ethical perspective while section II touches upon the corporate/private minimum wage and its characteristics. Section III deals with the minimum wage on a theoretical level. We conclude in the last section.

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## **SECTION I: APPEAL TO ETHICS**

Since the debate on legally enforced minimum wages is surrounded by ethical considerations, it is important to discuss them and their appeal to emotion. A growing trend among the comparatively unskilled and unexperienced is that large corporations represent evil and lead to growing wage inequality in the nation. How can it be just that a corporate CEO earns over a thousand times more than the struggling factory worker who has to support his family? Is this great disparity not an example of the failings of the capitalist state? The proper way of analyzing the



subject is by resorting to methodological individualism. Instead of decrying such a disparity, we should focus on what factors determine salary. And that, clearly, is productivity. The reason LeBron James earns so much money<sup>1</sup> is that, due to his efforts, his employer adds substantively to his bottom line. The reason a CEO is worth so much is that, according to the market, he, too, brings home the bacon. Both contribute great value to a company, and if their salaries did not reflect that primordial fact, competitors would snap them up, both of them, and pay them well

Yet, the comparatively rich CEO is not the person we are concerned about earning a living wage. A living wage is defined as the minimum amount that an individual would need to sustain himself with housing and food. So, let's introduce two characters who will help demonstrate the value of the individual. Sam and Max are both 18 years old and work at a generic store. We know nothing of their work ethic and neither have any previous experience so they are both hired at the minimum wage,<sup>2</sup> for this example we will say \$8 dollars an hour. Two years later Sam makes \$8.50 an hour and Max makes \$16 dollars an hour. Is this unjust? What makes Max so special? Could it be that Max was always at work on time, was cleanly dressed, satisfied customers, cheerfully obeyed the manager's instructions? What if Sam was a decent employee but just didn't do anything to stand out? The generic store has to have valued Max more and raised his wages in order to reflect his increased productivity. Now let us change the scenario so that after a year of the two being employed, a new \$10 minimum wage was enacted. At the end of the year, two Max still earns \$16 dollars an hour while Sam has lost his job. This is no fault of Sam's and the generic store

would still like to have him employed at the \$8.50-hour price.

Some might argue that the owner is being stingy and that he could surely have paid Sam that \$1.50 an hour from his own funds, or, at least from Max's pay. However, if he does the former, once too often, he will go broke, and not be in a position to hire anyone. If he does the latter, his competitor will offer Max \$16 an hour and woo him away from his present employer. The company must do what is competitively best in order to remain in business

From a libertarian perspective, a minimum wage policy also violates the rule of freedom of association. If an employer and employee agree on a deal, it should not be the government's role to intervene. If at \$6 an hour an employer wants to hire someone to sit in a chair to stare at paint drying and an employee accepts, it should be a legitimate decision. At \$7.25 the employer will no longer value someone staring at the wall; he will then have to deal with looking at an empty chair. Sam would rather work for \$6.50 or even \$6 dollars again if it means he still would be employed. Jobs are lost that would have been created or retained if the government didn't interfere in the interaction of these two consenting parties.

From a utilitarian perspective, it also makes sense to allow for freedom of contract enforced by the ethics that define a society. If the majority of customers of a business are upset at a decision in the company, there will tend to be repercussions. There will be critical news articles, people in the industry cutting ties, consumers who boycott the product/ service, and investors who start to trade against<sup>3</sup> and thus devalue the stock of the company.

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<sup>1</sup> This is an amount easily the equivalent of a well-paid CEO, or more. And, yet, for some strange reason, no one ever complains about the multiple of his pay vis a vis the man who sweeps the basketball court after the game. Maybe it is not so strange. Perhaps this is because even the meanest intelligence can appreciate his contribution to society. That of the CEO is possibly more difficult to appreciate.

<sup>2</sup> The idea that the minimum wage does not have negative effects on employment can be traced in its

modern form to Card and Krueger (1994). A critique can be seen in Neumark and Wascher (2000). This debate continued in several works, among which can be seen in Dube, Lester and Reich (2010), Neumark, Salas and Wascher (2014), Jardim, et. al. (2017), Harasztosi and Lindner (2019), Reich, Nadler, Allegretto, and Godoy (2018).

<sup>3</sup> Sell short

We invest heavily in private charity and help those who are downtrodden in a community. This is done for the benefit and good feeling that is created and supported (as Adam Smith (1759) explained, *sympathy*). Employers want to keep their employees happy and productive; this is why we see other forms of payment in addition to wages. Hence, companies will hold retreats, buy comfortable chairs, put in a fish tank, etc. They do so in order to retain talented employees. To be sure, there are also-miserable unhappy dead-end jobs that physically and emotionally drain their employees. But, someone has to wash the dishes, pick up the garbage. To the extent these job slots are considered onerous, additional pay will be offered to compensate workers.

## SECTION II: CORPORATE/PRIVATE MINIMUM WAGE

There are politicians who point to examples of large corporations providing their own private minimum wage as indicative of support for legislation mandating this state of affairs. The difference between a privately undertaken minimum wage and publicly enforced one is significant for multiple reasons. Whereas the latter creates unemployment for unskilled workers, the former creates competitive benefits for a company. Additionally, the public minimum wage is forced upon a corporation, while a private one is voluntary.

Ikea freely decided to incorporate a minimum wage of \$10.76 for all its U.S employees (Hellman, 2014; Jamieson, 2015).<sup>4</sup> Unlike the public counterpart, this private minimum wage may have lucrative effects for the company. A higher base wage for the company renders present and potential employees more eager to work there. This could mean a more motivated staff which would attain for itself a competitive advantage. The marginal productivity of the workers employed might possibly arise as a result of this practice. Hence, the reasons for establishing a voluntary floor for wages inside a

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<sup>4</sup> That is one way of putting the matter. A more accurate one would be merely to say that this company engaged in a wage increase. In contrast, a real minimum wage is compulsory. To violate it is to incur criminal penalties. In contrast, if Ikea lowered its wage, as long as it

company do *still* take into account the essential factor at work when determining wages: discounted marginal revenue products.

## SECTION III: WAGES AND THE MINIMUM WAGE

Market prices guide a rational allocation of resources (Mises, 1949). Minimum wages are, indeed, a price. If they are imposed on, labor, in this case, they do not rationally allocate society's resources.

As the price of a factor of production, the analysis of wages is not different than that of other factors. That is, their price responds to the theory of imputation. In other words, the level of wages depends on the service produced by the employee. The more homogeneous a specific work is, then the less scarce, and the less valuable in relative terms it is. Thus, the wage is lower. The opposite happens when it is extremely specialized, and highly scarce, again, other things equal.

In technical terms, wages are a reflection of discounted marginal revenue products (Block, 1990). As such, the key is which product they produce. To dissociate the final product (hence, the marginal revenue product) from the work of labor, is to turn the concept of wage meaningless in economic terms. Where does the value of labor come from? If it is not arbitrary, then it stems from marginal revenue product. Since productive processes take time, and time preference is indeed relevant, then, we need to discount it<sup>5</sup>. And what, in turn, is this based upon? Discounted marginal revenue product (DMRP) is predicated upon the quantity and quality of the capital equipment with which labor works. Mexicans, in that country, have low DMRPs, and hence low wages, since the sophistication, and quantity of the capital with which they work is low. When they arrive in the US, their internal human capital (Becker, 1964) changes not one whit, but the machinery and tools available certainly does. And why, in turn, is there more and better capital

remained above the level required by law, it would suffer no legal penalty.

<sup>5</sup> That is an important difference between the neoclassical and Austrian approach (Block, 1990).

available north of the Rio Grande rather than south? This is explained by the different levels of economic freedom prevailing in the two countries (Gwartney, et al., 1976).

Proponents of minimum wage often claim that workers and business owners do not negotiate on the basis of equal power. However, in reality, workers do not face any such asymmetric situation. It is not, as the cartoons like to show, the fat capitalist facing a poor wage earner. Quite the opposite is the case. The real situation is that workers compete with other workers for a specific position, and at the same time, employers compete with other employers in order to employ a given worker. In that sense, in terms of Böhm Bawek's (1888 [1930]) dynamics, wages are the result of, like any other market price in this context, bilateral competition, and marginal pairs.<sup>6</sup>

Therefore, the relative scarcity of labor supply in a specific industry, with respect to its demand elsewhere, is one determinant of wage rates. And the bidding by employers takes into account, then, discounted marginal revenue products.

More specifically, the supply of labor of any specific industry depends on the demand for labor of competing industries. Thus, when a worker can earn  $x$  in industry  $A$ , while industry  $B$  offers  $x+1$ , then he will tend to leave  $A$  for  $B$ .<sup>7</sup> However, if  $B$  wants to attract workers, it will have to increase wages. And, of course, the higher the quantity and quality of capital in any area, the greater the wages, other things equal, due to competition for workers among employers. This is why cities tend to have higher wages, in relative terms, than in the countryside.

Why would  $B$  increase wages in the first place? This is because they see a profit opportunity: the

gap between production costs and sale price, always suitably discounted.

If industry  $B$  produces 100 units of product  $z$  and has one worker whose wage is \$100, then each unit of  $z$  costs \$1 of labor. However,  $B$  acquires capital in order to enhance its production process. Now, it produces 200 units. Posit that labor costs associated with the production of  $z$  were reduced by 50%! Hence, industry  $B$  may very well increase the wages it pays to its worker, in order to preclude him from going elsewhere. It may attract another worker in order to produce more with the new capital, for instance, 400 units. How does it attract another worker? By increasing its wage to  $x+1$  or more (being  $x$  the wage of the new worker in the non  $B$  industry).

Observe that everyone wins, when capital accumulation takes place. But minimum wage laws disrupt this process since it negatively impacts every step of the previously explained virtuous circle. It creates fewer jobs available (workers' DMRPs do not justify higher wages), fewer companies appear since they cannot sustain themselves, job benefits decrease because employers tend to reduce non-monetary compensations (vacation, health insurance, etc.), job desirability is reduced, because of other cheaper labor conditions apart from wage are established in order to sustain the company.

Further, there is an incentive to invest in automation, since this law renders it *relatively* cheaper. Minimum wage, then, paradoxically (although logically) ends up benefiting high skilled labor, rather than low skilled labor, precisely that labor that the minimum wage was presumably<sup>8</sup> set to protect.

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<sup>6</sup> The only counter argument to this is labor monopsony or oligopsony. This is a very weak argument, with the possible exception of highly skilled scientists, engineers, chemists, who have only one or a very few potential employers in their narrow fields. However, their salaries are way above and beyond minimum wage levels, so this possible counter example is not apropos. For a critique of monopsony in general, see Block and Barnett (2009).

<sup>7</sup> The impetus for this can either be a "push" from the employees' side, who seeks greener fields, or a "pull"

from other employers, who are now "raiding" the firm that pays inordinately low wages.

<sup>8</sup> There is a heavy emphasis on this word, since in point of fact, the most vociferous supporters and beneficiaries of this pernicious legislation are labor unions, who are in competition with low wage labor. How better to drive them from the labor market than to reduce, by law, their ability to compete with higher skilled union labor?

Minimum-wage supporters often resort to the argument that those jobs which pay low wages are bad from a moral perspective. Not so, not so. The minimum wage will create a *lower* wage, of zero, for all those workers whose productivity falls below the level stipulated by this legislation. If by pure enactment we could actually raise wages, why not advocate \$100,000 an hour? Then, we would all be rich, beyond the dreams of avarice. Supporters of minimum wage laws fail to respond to this objection. Subconsciously, they do know that there is a relation between productivity and wage rates, although they believe that small, compulsory marginal changes to low wages (thus establishing minimum wages) barely affect the

situation of low scale workers. In reality, because it affects precisely those on the *margin*, legislators do not pay attention to those who are rendered unemployable.

## CONCLUSION

What is the best way to increase real wages? Reduce taxes, which increases capital accumulation, production and reduces prices. Eliminate taxes on labor. Abolish the welfare state, that distorts incentives to work, accumulate capital, and produce. In sum, free markets, not minimum wage laws.

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