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Soft-Hearted Economists Need Clear Heads

by Bart Frazier

One of the issues at stake in the 2006 midterm elections was a raise in the minimum wage. Voters in six states had minimum-wage increases on the ballot, and unfortunately all of the initiatives passed. This is not surprising, however. On the surface, it appears that requiring employers to pay at least a “subsistence living” is the key to eliminating poverty. But economics has proven that theory wrong.

To any student of economics, including the self-educated, one of the most basic tenets of economics is that the pricing system, left on its own, will inevitably allocate resources to those who place the highest value on them. When the price system is short-circuited through government intervention, as with wage or price controls, the signals get distorted.

A minimum-wage law, which places a price floor on the labor rate, short-circuits the pricing system for the labor market. The first and obvious effect is the change in the behavior of employers. With a mandated pay hike, employers now have increased expenses and make less of a profit. There are several ways to regain that profit, but one of the easiest is to reduce labor costs. What the firm was doing before with ten employees, it might well attempt to do with nine.

And of course, basic economic analysis would predict this behavior. One of the first lessons in Economics 101 is that as the price of a good increases, the demand for that good decreases. This applies just as well to the market for labor as it does to the market for automobiles or video games.

Less obvious is the effect the wage hike has on the potential workers, i.e., the suppliers of labor. Some people who would not look for work at the natural wage rate now have the incentive to start looking for work at the artificial rate. This just compounds the unemployment problem. The combination of layoffs and induced job search creates an oversupply of labor in certain sectors of the market that would not have existed if a free market had been allowed to prevail.

Again, this is Economics 101. As the price of a good increases, the supply of that good increases because it has become more profitable to sell it. As wages increase in an industry, more

workers flow into that industry, encouraged by the better living standards that the higher wage affords.

A perverse consequence of a minimum wage is that the unemployment it causes oftentimes falls disproportionately on those whom the law was supposedly intended to help — the unskilled. It is the marginally profitable employees, those who provide the least amount of value for their service, who will be laid off first.

If an employee is worth \$5.50 per hour to an employer and he is paid \$5 per hour, the employer makes a profit of 50 cents per hour on his labor. However, if the government mandates a \$6 per hour minimum wage, the employer has no choice but to fire the employee because he would be taking a loss of 50 cents per hour were he to keep him employed.

Economists and the minimum wage

Economic writing is filled with one warning after another about the adverse effect of minimum-wage laws.

Murray Rothbard stated in *Man, Economy, and State*,

[A] restrictionist wage raises costs of production for the firms in the industry. This means that marginal firms in the industry — the ones whose entrepreneurs earn only a bare rent — will be driven out of business.... Displacement and unemployment, of course, also impair the general standard of living.

James Gwartney and Richard Stroup wrote in *Economics: Private and Public Choice*,

Minimum wage legislation is intended to help the working poor. There is good reason to question, however, whether it actually does so.... The minimum wage will price the services of the least productive (and therefore lowest-wage) workers out of the market.

Henry Hazlitt observed in *Economics in One Lesson*,

Yet it ought to be clear that a minimum wage law is, at best, a limited weapon for combating the evil of low wages.... The more ambitious such a law is, the larger the number of workers it attempts to cover, and the more it attempts to raise their wages, the more certain are its harmful effects to exceed any possible good effects.

Ludwig von Mises stated in *Human Action*,

If a government decree or labor union pressure and compulsion fix wage rates above the height of the potential market rates, institutional unemployment results.

Milton Friedman, winner of the Nobel Prize in economics, and Rose Friedman, pointed out in *Free to Choose*,

The high rate of unemployment among teenagers, and especially black teenagers, is both a scandal and a serious source of social unrest. Yet it is largely the result of minimum wage laws.

Nobel laureate Friedrich A. Hayek wrote in *The Constitution of Liberty*,

Workers can raise real wages above the level that would prevail on a free market only by limiting the supply, that is, by withholding part of labor. The interest of those who will get employment at the higher wage will therefore always be opposed to the interest of those who, in consequence, will find employment only in the less highly paid jobs or who will not be employed at all.

Economics and ethics

With the effects of wage controls so thoroughly worked out over the years, it is astounding that more than 650 economists, including several Nobel laureates, recently signed a petition calling for an increase in the minimum wage. What gives? It is hard to say. Peter Boettke, economist at George Mason University, may have the simplest answer — soft hearts getting the better of clear heads. Boettke says,

I argue that when intellectuals use the language of economics to pursue policy agendas of a soft heart, with a soft head they produce counter-intuitively horrendous consequences for the very people they are trying to help.

Perhaps the best argument against the minimum wage is not pragmatic, but ethical. Let's assume that minimum-wage laws do help the poor and it is economically beneficial to implement them. Would it be morally right to do so? What right does the government have to implement them? If a man is willing to flip burgers for \$5 per hour and someone agrees to pay him that amount for his labor, is it moral for the state to tell them they can't strike the bargain?

Obviously, the answer is no. Governments are instituted to protect individual liberty, and that liberty includes the right to contract with whomever one wishes on whatever terms the two can agree to. That is the essence of the free market and justice.

Government officials should rid themselves once and for all of the notion that they can legislate away poverty with minimum-wage laws. Such laws distort the market for labor and they harm the very people they are intended to help. Worst of all, minimum-wage laws violate one of the basic principles that government is created to protect — liberty of contract.

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