FEE Stories

The Effects of Minimum Wage on Productivity

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A distortionary labor market is bad for productivity.

It's no secret that minimum wage laws lower employment for low-skilled workers, especially for teenagers seeking entry-level employment. The Congressional Budget Office's (CBO) own projections point to substantial losses in weekly employment given an increase in the national minimum wage. There are thousands of studies that seek to determine the effects of minimum wage hikes on employment outcomes, with mixed results.

Most studies still find significant negative employment effects when minimum wage laws are enacted. Yet after President Biden signed into law a $15 federal minimum wage, and given the unruly inflation caused by massive government spending during and following the pandemic, calls for more wage hikes persist.

It's important, therefore, to analyze minimum wage from all possible angles. One such angle is to look at what happens to worker productivity when minimum wage laws are passed. To do this, we often look at what happens to workers with different skill levels when the minimum wage is increased.

As mentioned, low-skilled workers feel the brunt impact of minimum wage hikes as firms reduce employment for their least productive employees. Medium-skilled workers, on the other hand, often benefit because they are the ones most likely to act as substitutes for their relatively more expensive, low-skilled counterparts. Because high-skilled workers function less as substitutes, the employment effects for them are more ambiguous.

One study by Terry Gregory and Ulrich Zierahn assesses the impact of a 1997 minimum wage law in Germany on its construction sector. They find that employers hired fewer high-skilled workers due to sinking revenues (lower productivity) among firms.

They also observe that the flow of high-skilled workers entering the industry declined by over 9 percent, which towered in comparison to the 0.5 percent increase in medium-skilled labor. This finding indicates overlooked *dynamic* effects on low and high-skilled labor supply, which can cut productivity to even lower levels.

Another study by Joseph J. Sabia finds that minimum wage laws have no significant effect (positive or negative) on state gross domestic product (GDP). However, among low-skilled industries like wholesale trade and manufacturing, he discovers a mild to significant drop in productivity relative to high-skilled industries like finance or real estate.

Overall, he says, "the findings in this study suggest little evidence of aggregate productivity gains from minimum wage increases, and some evidence that low-skilled relative to high-skilled GDP may fall in response to minimum wage hikes." The productivity shock is greatest in the short term, suggesting that minimum wages can't stimulate sudden bursts of growth in productivity.
Certain studies do, in fact, observe increases in productivity among individual workers. Unfortunately, these studies only focus on the static effects of minimum wage hikes for a particular group — usually low-skilled workers. Some economists credit efficiency wages as the source of productivity gains in the wake of minimum wage boosts. Efficiency wages are the idea that higher pay results in better employee morale, lower turnover, and an improved applicant pool, which raise productivity among workers directly affected by the wage increase.

Efficiency wages are also interpreted as enhancing worker productivity because low-skilled workers fear the prospect of termination. But any policy predicated on the fear of being fired spells unhealthy outcomes in terms of the long run. In all these cases, the analyses fix their gaze on one group of workers and neglect the dynamic effects of minimum wage laws.

For example, economists Jonathan Meer and Jeremy West use a dynamic model to test the effects of minimum wage on employment growth. They discover that "the minimum wage reduces employment over a longer period of time than has been previously examined in the literature." The negative impact of minimum wage on employment and productivity amplify once the analysis is broadened to include a longer time horizon.

One paper by Isaac Sorkin uses various statistical methods to determine the long-run effects of minimum wage on employment growth outcomes. Sorkin shows that when minimum wages are permanent — as when the minimum wage is indexed to inflation — the negative employment effects far outweigh those observed when the minimum wage is temporary. Sorkin attributes these effects to employers beginning the early process of substituting away from labor and towards capital, reducing employment growth for the least well off.

The last angle that receives less attention is the interplay between low-skilled and high-skilled workers. In an article for the Institute of Labor Economics (IZA), Abdurrahman Aydemir describes the complementarity between low and high-skilled immigrants on native worker productivity. "Immigration of low-skilled workers reduces the earning of low-skilled workers and enhances the productivity of high-skilled workers and capital in their host countries," he writes. The same applies for high-skilled workers, too.

Alex Nowrasteh, director of economic and social policy studies at the Cato Institute, illustrates how immigrants can increase productivity among native workers. He cites a study by Giovanni Peri and Mette Foged: "The immigrants incentivized native-born Danish workers and other Europeans to pursue communications-intensive occupations inside of firms … As a result, Danish wages actually increased after about 5 or 6 years because the Danish workers became more productive."

If the mutual advantages between relative skill levels among workers applies in the context of immigration, it should also apply to domestic minimum wage policy. That is, relatively higherskilled workers can become less productive when low-skilled workers are disemployed because of minimum wage policy.

For instance, consider what might happen to a car mechanic who must spend more time filing paperwork or scheduling appointments when the receptionist becomes too expensive to keep on payroll. Or ponder what might happen to the owner of a restaurant who will have to assume greater service duties now that she can't afford to pay the greeter at the door or the kitchenhand cleaning the tables.

A distortionary labor market is bad for productivity because it shuts out the poorest workers from learning career-advancing skills on the job, while also depriving high-skilled workers with the low-skilled labor that makes them more efficient.

Minimum wage policy is wrapped in noble language that mostly harms the people it's intended to help. As Don Boudreaux and the late Walter Williams once wrote in *The Wall Street Journal*, "All these good intentions of the champions of minimum-wage raises do nothing to cure these evil consequences … compassionate policy requires that we think with our brains and not with our untutored hearts."