



Raise the Minimum Wage?

Guest: Robert P. Murphy

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Bob Murphy holds a Ph.D. in economics from New York University. He is the author of *Chaos Theory, The Politically Incorrect Guide to Capitalism, The Politically Incorrect Guide to the Great Depression and the New Deal, and Lessons for the Young Economist*. He blogs at consultingbyrpm.com/blog.

WOODS: All right, Bob. I have solicited questions for you. Before we get to those questions, though, I want you to talk to us about something you wrote about recently over on your blog at consultingbyrpm.com. Because we've been hearing a lot about the minimum wage and the need to increase it. Now there's a sense you get from reading the newspaper that the momentum behind it seems just unstoppable. Everybody, even the Republicans, favor it. Or this or that candidate favors it. Or you hear that economists, so-called, favor it, including, in a recent letter, seven Nobel laureates. And you went and took this apart in a blog post. So I wonder if you can take a step-by-step through the arguments you made there.

MURPHY: Okay, sure. As you say, this is an area where it's sort of shocking to me, because it used to be, 15 years ago or something, I would think if you had said, hey, what are issues where economists generally agree? I think most people would have said free trade and price controls, generally, or minimum wage in particular. Even so-called liberal, left-wing economists would've agreed that, yeah, raising the minimum wage is going to increase unemployment. I would've thought that would've been the consensus. But now things have shifted, so it's no longer the case that you have to just be a completely emotional person who's ignorant of economic theory to plausibly say that raising the minimum wage helps poor, unskilled workers.

So what happened is, there have been some studies coming out, I think this trend started in the 90s. I'm sorry, let me just back up. Up until the '90s, the consensus in the empirical literature was, duh, raising the price of low-skilled labor makes employers reduce the quantity demanded of it. And it also makes more workers try to work at those wages, and so that's what causes unemployment. So that's the standard thing. Literally, textbooks that economists across the country use to teach an intro student say that the minimum wage will cause unemployment among the various groups of people that you're allegedly helping with it. So you've got to keep that in mind. You can't ignore that huge downside. Since the '90s, though, there's been a new wave of literature seemingly overturning this result, to the point now where you've got guys like Paul Krugman, as you said, and 75 other economists, cause actually I don't think Krugman signed that letter for some reason, saying that actually, the evidence shows that there is hardly any effect, if any, on low-skilled employment, unemployment among the people of low skills, from raising the minimum wage. So hey, there's no downside. All we're basically doing is taking money from rich employers and giving it to poor people. We're not even making it harder for them to get a job. So why wouldn't we do that? Do you want to get into how they come up with that?

WOODS: Well, I remember from your blog post, you were saying that, look, I haven't looked at these studies but I highly doubt that they involve such a substantial increase in the minimum wage. Right?

MURPHY: Okay. Let's just stipulate for the sake of argument that these empirical studies are correct and we've been wrong for all these years thinking that it's going to reduce the quantity of labor that employers want. First of all, these studies—I've looked at a few of them—are couched in terms of a modest increase in the minimum wage, and you can see some of the more careful economists, when they write op-eds and things, they will say, indeed, the cutting-edge literature says that a modest hike in the minimum wage will not significantly impair the growth of teen employment. Things like that. So that's kind of a nuanced phrasing. And yet, the policy prescription they're recommending wants to raise the minimum wage from the current amount of \$7.25 an hour to \$10.10 by 2016. So that was a 39 percent increase. None of these studies toss out the result in the regression analysis saying if you raise the minimum wage 39 percent don't worry about it, it doesn't do anything. So I'm saying, even if these studies were all gospel, it wouldn't follow that Obama should go ahead with what they are planning on doing.

Another point is, let's say these studies are exactly true. What they're measuring is the absolute growth in teen employment, or perhaps low-skilled employment. They're not looking at the unemployment *rate*. They're looking at the absolute growth in the number of people that have jobs. So I made the point in that blog post you're alluding to that, even if that were all true, it still means, or it's still consistent with, the unemployment rate going up. And if you say, well, how can that be? Well, because more

people now might be trying to get those jobs working at Burger King and Wendy's if they're getting paid \$10 an hour instead of \$7.25 an hour. Even if it's true that the employers hire the same number of Burger King workers and see, look, same number of kids working as there would've been at \$7.25 an hour, so obviously it didn't hurt anybody. But the type that you hire at \$10 an hour might be different. So maybe the managers on the front end, when they're interviewing people knowing we're going up to pay them \$10 an hour, are pickier. Maybe they, just throwing out an example, speaking in broad strokes, it's possible that now it's college kids who are home for the summer who are the ones who end up getting it. You know, rich white kids from the suburbs go and take a part-time job because they're getting paid \$10 an hour, whereas if it were \$7.25 an hour, maybe they wouldn't be likely to do that. So it would be the truly poor people who really need the source of income and now it's harder for them to get a job.

WOODS: Right. So in other words, you might be less likely as an employer to say, you know what, I'll roll the dice and take a chance on this kid who seems a little iffy but probably needs the job, and maybe if he shows up every day and he's punctual, maybe he'll learn some job skills. But maybe you don't feel like rolling the dice when the minimum wage goes up that high. Is that what you're saying?

MURPHY: Yeah, exactly. So again, what we're speculating is: even if these studies were exactly true and we just looked and said, you know, Burger King had eight kids on the shift before at \$7.25, now they raised it to \$10 and I count up still eight kids on the shift, so clearly that didn't hurt poor kids. But now it's maybe middle-class kids who are working, whereas it might have been poor kids before. And that's perfectly consistent, even if these studies are true—do you want to get into the super-geeky thing about why those studies might not even be true?

WOODS: I'd like to go super-geeky cause, you know, here we are on a podcast. We're not on the air. People, when they subscribed to the show, they knew what they were getting. They knew there was going to be some geekiness here. So let's have the geekiness. And then we'll go to listener questions.

MURPHY: Well, we should say, if anyone's driving while listening to this, they should probably pull over. We don't want to be responsible.

WOODS: Okay. With that caveat behind us, let's go.

MURPHY: I'll try to boil it down, obviously. So with the caveat that I have not immersed myself in dozens of hours in these things, I believe what is happening is, in these new revisionist studies, saying wait a minute, this original consensus is wrong. Here's what happens. They will look at counties, because the problem is controlling, getting a control group and then an experimental test group. So what they'll do to try to hold other things equal is they'll say, let's look at counties that are adjacent to each other but happen to fall in different states. Since some states have a minimum wage higher than the federal level and other ones don't, that will give you some variation within the samples. You can run a regression on that and see that you'll have some states raise the minimum wage, whereas the county right next to it in a different state doesn't raise the minimum wage. So that seems like, okay, that's a good thing. Just doing that, the answer still pops out, yeah, raising the minimum wage seems to hurt the growth of teen employment. So what's the problem here? We're even looking at just adjacent states. Clearly you think that's a smoking gun. And these latest studies have said, oh, but wait a minute. What if it just so happens that the states that tend not to raise the minimum wage above the federal level happen to be located in areas of the country, like in the South, where there's nice weather that the people are flocking to. So maybe the reason employment grows in states that tend to not raise the minimum wage above the federal level is just that those states are in areas where the population's grown. So of course, you're going to see growth in Burger King employment higher in those states than somewhere in Minnesota or wherever. In New York state, for example. The population is not growing as quickly and they have a higher minimum wage at the federal level. Maybe we're unfairly blaming it on the minimum wage. So they correct for that. And at this point, I think I should stop with the econometrics of it, but I'm just saying, that's what's going on. They're introducing dummy variables to try to say, well, what if it was in a different region? Well even on the naive analysis looking at pairwise counties, it does pop out that the minimum wage seems to impact it, and so then it's just now you've got economists arguing about the econometrics and if they put in more bells and whistles, the effect seems to almost go away in certain treatments. So I am working on it for people who want to follow my blog. I will post more on that, if you want to see. So my point is, I don't even accept the fact that using all the bells and whistles and correctly done, the effect disappears. The point is, even as we talked about, even if the effect were true that they're saying, it still is completely plausible that they are hurting the employment opportunities for truly low-skilled workers. But I think what they're showing is not true. In the grand scheme, Tom, what I'm saying, and what the textbooks used to say, is that if you make low-skilled labor more expensive, employers will buy less of it. And these 75 economists are coming out and saying, no, maybe that's not true. They're saying, maybe demand curves don't slope downward for low-skilled labor, even though we think they basically slope downward for everything else.

WOODS: That, to me, is the key thing. That if it's true that minimum wage doesn't have any negative effects, then why don't we have minimum prices for lumber? Right? Then the lumber industry would be made better off, and there won't be any effects because apparently nobody looks at prices when it comes to lumber.

MURPHY: Right. And by the same token, too, it's not a one-to-one correspondence, but many of these economists I suspect also

favor a carbon tax to make Americans drive less. But how do we know they're going to drive less? Maybe all these other things that they think happened with these employers with minimum wage, you know, why would you think making carbon more expensive would make Americans use less carbon?

WOODS: I want to ask you now a few questions that people have submitted. They submitted almost 200 questions. So I have a funny feeling we're not—

MURPHY: We have 199 more to get through?

WOODS: That first one was from me. I picked out a few that are either interesting or I feel like the person is trying to figure something out and I want to help him out. The first one, though, is a very common one. People want to know about how the market could deal with so-called negative externalities. Can you explain, first of all, what a negative externality is? And why is it that almost any economist other than an Austrian one, immediately goes to: now here's how we devise government policy to cope with it?

MURPHY: Okay sure. So the term *externality* in this context means it's something that is not captured in a normal market transaction. An externality could be positive or negative. It's something that two parties are doing in the market through a commercial transaction, and if it hurts other people, that's a negative externality. If it helps other people, that's a positive externality. So standard textbook examples: if I buy tulips and plant them in my front garden and my neighbors like that, then that's a positive externality. Because I'm paying for the tulips and I'm getting benefits from it but I'm not taking into account how much my neighbors like it, and so actually I'm not planting enough tulips, in terms of economic efficiency. For a negative externality, the obvious one is a factory that's dumping chemicals into the river that's messing with people's drinking water or they can't go swimming, and so the company, when it figures out how many television sets to produce, it's looking at the money it's getting from its customers and how much it has to pay its workers and its utility bills, but it's not taking into account the fact that, oh, if we produce more television sets, that messes up the drinking water for people downstream. So they're producing too many television sets compared to what the efficient number would be because they're ignoring certain costs that are borne by others because of their activity.

The original standard response for mainstream economists was established by Pigou, the economist Pigou, and so is called a Pigovian, either tax or subsidy. So if it's a negative externality, he said the government should come in and levy a tax to make the offending party internalize the externality. That doesn't mean the factory that's dumping chemicals in the river should be shut down, because maybe those TVs should be produced, it's just producing too many TVs, above the optimal amount. And so if the government comes and imposes a one dollar per television set tax, now the incentives are aligned correctly and they produce the optimal amount of TVs. They're still dumping chemicals into the river but they're dumping fewer, and it just so happens that the gain to the consumers from getting more TVs gets to the point where the marginal benefits and costs work out, and that's what you want to do. That's the standard Pigovian framework. The reason a lot of economists talk about that is that they don't want to appear as ideologues. They want to say, yes, the market in general is great for allocating resources but they want to say, it only works if the incentives are aligned correctly. And that's where the invisible hand flourishes and does its magic if people are not, if the price they're getting from customers does not fully reflect benefits or if the expenses they have to pay the workers and for inputs do not fully reflect how they're draining society, as it were, from their operations, then they're not going to produce the right amount. So that's what you need, this Pigovian tax to come in.

The Austrian response—I think Murray Rothbard wrote the definitive one on it—is, that's a Pandora's box. You could sit there and come up with a list of all kinds of positive and negative externalities for any activity. There's no such thing as a truly private, internalized market transaction. Rothbard noted that the analysis applied to things as silly as if I wear smelly socks to work—well, I'm imposing harm on all my co-workers and so should the government tax me for doing that? Or this is my example, if somebody's really funny at work and he cracks jokes all the time and people just enjoy working with him, well technically should he be getting subsidized by the government every time he tells a joke? He's producing a suboptimal amount of jokes. Everything you do has spillover effects on others. So the problem is, in reality, if you give politicians that power, either tax or subsidize, they can come up with a case and just start counting all the good things and the bad things and then say, see, that's why we need to either tax this or subsidize it. It's not like it's some scientific answer. You can always come up with more on one side or the other, depending on what you wanted beforehand.

WOODS: Often you'll hear there's a positive externality associated with having an educated public. Right? That you and I benefit if our fellow citizens are literate and they're more productive. We benefit from that even though we don't contribute to their tuition payments. So education will be underproduced on the market because we get the benefits, we can free ride off them, without contributing. So we should all be forced to contribute, and that's why we have tax-funded education. But you could just as easily say that all the wonderful personality traits that you and I have acquired laboriously over the years also benefit society, and yet I wasn't subsidized in that. You know, when I took those etiquette courses. I took those on my own dime. Why aren't we subsidizing etiquette courses? You're right, there's no logical stopping point.

The problem, though, is that Rothbard's approach to pollution is going to seem unrealistic to people. They can't imagine how a legal rather than a regulatory approach can work. And since the government monopolizes the legal system, and every case takes five years, my kids will all be dead from poisoned water by then. As a theorist of the stateless society, Bob Murphy, how do you deal with the standard case of a smokestack emitting pollution?

MURPHY: Okay. That's a great point you raise there. Just for people who don't know, it was not the case that, historically, factories could do whatever they wanted and dump chemicals in the river and so on, and people were just sitting there dropping over dead, and then, thank goodness, finally, because Pigou published this paper, all these regulators and tax authorities got together and said, holy cow, we can help. What can we do to save poor kids from drinking dirty water? And then they started levying taxes and finally the corporations were brought to heel. That's not what happened historically.

What happened is that under the common law, if you were downstream from the factory, you could bring an injunction against them and say, look, they're violating my property rights. I'm supposed to be able to get the drinking water. That was, historically, clearly something I would have been entitled to when I bought the property, and clearly the factory is aggressing against—I don't know what the legal terminology would be, just as if somebody came onto your property and just started ripping boards off your house and saying, well, we need to burn this in order to make TVs, it would be stealing from you and you would have a legal case against them. They can't do that. And as Rothbard explains, in the Industrial Revolution these local governments thought they needed to promote industrialization, and that they didn't want to discourage these factories. Oh, that's too inefficient, if some factory can be stopped in its tracks because some homeowner downstream brings a court case against it, that seems crazy. And so it was government action that threw out the precedent from the common-law tradition. So, as so often happens, let's say the government needs to come in and tax to make them internalize the externality, that's the government just correcting the previous government mistake when they guessed wrong the other way and thought they should do the other thing.

More generally, look, people aren't stupid. It's not like there's a bunch of people in the marketplace just sitting around looking at the factory dumping chemicals in saying, well, I guess that's just life. It's not as if interventionists are the only people who can perceive problems and try to come up with solutions. There's all kinds of things that would happen in response to that. Developers who are buying land and going to build a subdivision of homes and then try to sell them to homeowners, they would, in order to sell property, offer as one of the perks that they can guarantee you that if you come in here, you have the legal ability to not have a bunch of tar dumped into your pool in the backyard. Just the way the market works, people would come up with ways to contractually make sure that they were getting what they thought they were getting. And so yes, there would be cases in which the public might be outraged by something, but then they would quickly work to get around that. It's certainly not a panacea to say, oh let's just have the government fix it. And the last thing is you can see that some of the most polluted areas on earth were in the former Soviet Union, because the Soviet government thought that industrializing was more important to achieve its objective than the health of some kids living in some podunk town that they didn't really care about, that weren't members of the party. So this idea that because there are powerful bad people out there who don't care about the little guy, therefore let's give more power to the government, it's just an absurd non sequitur. I mean, we don't have to deny that there are environmental problems to say giving more power to the government is surely not the way to solve them.

WOODS: I want to recommend that people read the article you mentioned, Murray Rothbard's "Law, Property Rights and Air Pollution." You can Google it and read it. I want to keep you longer, Bob, if you don't mind. I want to ask you a couple questions that probably are going to seem easy or elementary, but that I bet a lot of people would benefit from. Somebody asks how the Federal Reserve artificially adjusts interest rates. And also, when the Fed creates money, where does it inject that money?

MURPHY: When the Fed so-called sets interest rates, it's not the same way that the government would set the minimum wage, for example. Say the federal funds rate is at six percent and they want to lower it to five percent, it's not that they say, we're going to throw you in jail or fine you if we catch you charging somebody above five percent. It's a market rate, and I put market in air quotation marks here on the phone with you. The way they do it, though, is they adjust the quantity of what's called reserves in the system. So the Fed, if it wants to push down interest rates, will buy assets and, in the process, inject money into the economy. Now the banks have more reserves to be able to lend to each other, so the interest rate they charge on those loans tends to go down because the supply increased. And if the Fed wants to raise interest rates, they will sell off assets from its books and thereby suck money out of the system. Now the banks have fewer reserves. So when they're making those loans to each other of reserves, they tend to charge a higher rate of interest. So that's the way it adjusts the interest rate: by adjusting the quantity of the reserves that are the thing being lent for those rates that you see quoted.

As far as when it wants to inject money into the economy, how does it do it? It happens in the process of when the Fed buys assets. So on the one hand, it's quite simple, but on the other hand, when I explain this to a lay audience, just normal people who have never heard this stuff before, they think that I'm giving them a metaphor, that I'm dumbing it down somehow because they can't believe this is what happens. If the Fed wants to buy \$1 billion in Treasuries, they'll give a check to somebody, it will probably be electronic, to the dealer who has it, and so now the Fed takes those billion dollars in Treasuries onto its assets, into its books, and now that person has a check for \$1 billion. It deposits it in a commercial bank, the commercial bank says to the Fed, hey, we've got a check here to Goldman Sachs for \$1 billion drawn on you. Is this legitimate? The Fed says, yes, it is. And they say, okay, we're going

to credit Goldman Sachs' account for \$1 billion. And now the commercial bank says to the Fed: our account with you will now have \$1 billion more in it because we're giving you this check. And the Fed says, that's exactly right. And they change it on the computers and boom, that's what happens. The money directly comes in the act of buying an asset. The Federal Reserve creates that money. It's not like there's an account somewhere with the Fed's money that gets drawn down when they buy stuff. No. The Fed literally just creates that money in the act of buying an asset. When that check gets deposited somewhere, that commercial bank then it sees its account with the Fed get credited with that amount.

WOODS: I've got a question here from somebody who wants to know how interest rates are interrelated. This is several questions, so try and balance them in your head. He says, how do interest rates on government debt affect interest rates on our savings accounts? How are they related? Why are credit card and mortgage rates different? If government rates are below 0%, why aren't other rates for borrowing that low?

MURPHY: The last one is the easiest one to answer. Whether you think it's right or wrong, clearly the federal government is in a much stronger position to be able to repay its debts than a company, or let alone an individual. So Treasuries are much safer in terms of default risk than other types of bonds, simply because the government can tax people, and it ultimately has the Federal Reserve at its disposal. So people who are lending money are much more confident that if the federal government says, we're going to give you a thousand dollars next year, that they'll be able to do that, compared to GE, or let alone compared to a 22-year-old who has a credit card and wants to buy something worth \$1000 and charge it. So that's why you will see a spread, and riskier bonds and IOUs will have a higher interest rate. Obviously if the federal government is willing to pay 10 percent on one year, well you know, the federal government is willing to borrow from you at 10 percent, nobody would lend to somebody riskier than the federal government for less than that. So that's kind of the way it works. As the equilibrium gets established in one market, that kind of ripples out into the other ones. And of course there's arbitrage opportunities: they can't have something that's pretty safe yielding five percent over here and something that's only a little bit riskier yielding 20 percent over there. That's a huge spread and somebody would come in and exploit that. So they are connected to each other, but they're not going to end up being exactly identical because they have different characteristics. Some of them pay off earlier than others and there are different risks involved.

WOODS: There's more to talk about but I think we really are at the end. Next time we're going to have to talk about the question people keep asking about: is it possible to avoid a dollar collapse? And it's so interesting to raise that question when so many people today would say, what are you, crazy? Of all things to be concerned about when we should be worried about, if anything, maybe disinflation or even deflation! We should be concerned about sluggishness in the economy. But of all things to be worried about, the collapse of the dollar. So I want to look at, next time, why is that a reason for concern, and is there anything that can be done about it. But Bob, you've already been very generous with your time. You've given us good, detailed answers to these questions. So next time, just, what—196, 197 more questions to go and we should be square.

MURPHY: Well, great. Thanks for having me, Tom. I love this show. And if the dollar collapses before I come back, then I don't have to answer that one.