

MINIMUM WAGES: AMERICAN EVIDENCE OF THEIR IMPACT ON WAGE INEQUALITY

A reduction in the minimum wage significantly increases wage inequality, according to a study of US data for the 1970s and 1980s by Professor **Coen Teulings** of the Tinbergen Institute in the Netherlands.

The research, which is published in the October 2003 *Economic Journal*, shows that a reduction of the minimum wage by 10% leads to a decrease in the wages of people who earned initially slightly more than the minimum by as much as 8%.

The higher someone's initial wage, the smaller this negative effect. But the negative spillover effect of a minimum wage reduction affects all wages up to the average wage. Only wages above the average are not affected.

The reduction of the real minimum wage can explain all of the huge increase in US income inequality in the lower half of the wage distribution during the 1980s. These conclusions are surprising since most economists have downplayed the impact of the minimum wage on the wage distribution, particularly for the United States.

Teulings' research analyses the effects of changes in the real minimum wage in the United States during the period 1973-91, a time when it varied widely. The real minimum wage rose up to 1979, by which time 5% of workers earned the minimum. But in the next 10 years, the minimum was not adjusted for inflation, leading to a fall in real terms of 30%. At the end of that period, less than 2% of workers earned the minimum. In 1992, the Clinton administration raised the minimum again. The study analyses the effect of this variation in the minimum wage on the wage distribution.

Since the federal minimum wage applies nation-wide, its bite is much stronger in the southern part of the United States where nominal wages are on average 10% lower. The effect of minimum wages can therefore be derived by comparing the shape of the wage distribution in the South to its shape in other parts of the country. The research shows that the high effective minimum wage in the South yields a more compressed, more equal wage distribution in that part of the country.

The study also analyses the effect of changes in the minimum wage on wage differentials between various skill groups, for example, men with and without a high school diploma. It concludes that a reduction in the minimum leads to a large increase in these wage differentials, particularly for wage levels just above the minimum.

In general, these conclusions are in line with those of other researchers, notably David Lee of Berkeley. He uses data only from the 1980s, but he exploits the fact that some states have their own statutory minimum wage, different from the federal minimum.

Lee too finds that the fall in the real minimum wage explains most of the increase in wage inequality in the lower half of the wage distribution during the 1980s. But Lee does not find much effect of minimum wages of wage differentials by level of education. Teulings' work shows that Lee's finding of no effect on wage differentials by education is due to the fact that he does not differentiate this effect by the initial wage level.

Teulings' results explain why the positive effect of a reduction in the minimum wage is usually found to be much smaller than one would expect on the basis of simple theoretical models. These models take the relative productivity of various skill groups to be fixed. Too high a minimum then pushes the least skilled workers out of employment, simply because their productivity does not exceed the minimum wage, so that firms cannot employ them profitably.

But when a reduction of the minimum wage makes the employment of these low skilled workers profitable for firms, this increases the effective supply of these skill types, thereby reducing their relative wages. A large part of the reduction in the minimum wage is therefore absorbed by the fall in relative wages for these groups.

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Notes for Editors: 'The Contribution of Minimum Wages to Reducing Wage Inequality' by Coen Teulings is published in the October 2003 issue of the *Economic Journal*.

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