*Minimum Wages and Poverty: An Evaluation of Policy Alternatives*
**John P. Formby, John A. Bishop and Hoseong Kim**
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One of the problems with the economic analysis of social policy is the tendency of researchers to consider policies in isolation from one another. While *Econlit* contains over 2000 articles and books on minimum wages, and over 150 on Earned Income Tax Credits (EITCs), only 20 articles or books deal with the two topics together.

While this 'silo' approach encourages in-depth analysis of individual policies, it often presents a problem to policymakers, who need to know which is the more cost-effective. Since politicians and bureaucrats must typically decide between alternative policies, studies that focus only on a single policy may not provide enough information to make a careful decision. Faced with two studies of different policies, each purporting to show that the benefit outweighs the cost, how is a decision-maker to go about choosing between them?

*Minimum Wages and Poverty: An Evaluation of Policy Alternatives*, by US economists Formby, Bishop and Kim, deals with this problem directly. The authors compare three popular policies, all with the same societal cost: a $1 per hour increase in the minimum wage, an equiproportional increase in the EITC, and an equiproportional rebate of payroll taxes paid by low-income working families.

Each of these policies has been advocated as a means of curtailing the growth in inequality at the bottom of the distribution. Since the 1970s, the earnings of full-time US men in the bottom decile fell from 51% of median earnings in 1976 to 45% of median earnings today. Over the same period, earnings of Australian men in the bottom decile dropped from 73% of median earnings to 60% of median earnings. Turning to household income inequality, the 10/50 ratio for household incomes has also fallen in both countries over the past thirty years, but the change has not been as substantial.

Assessing policies can often depend to a large extent on one's assumptions, and Formby, Bishop and Kim are refreshingly open about theirs. The initial chapters of the book are devoted to discussing the main factors that affect how their proposed policies will affect the poverty rate: the relationship between low-wage work and low-income households, the elasticity of labour demand with respect to the minimum wage, and the elasticity of labour supply with respect to the after-tax wage.

The first issue – where low-wage workers fall in the household income distribution – was raised by Nobel laureate George Stigler in a 1946 paper that stated "The connection between hourly wages and the standard of living of the family is thus remote and fuzzy." Formby, Bishop and Kim argue that the link is not as tenuous as Stigler asserted. They find that poor households are indeed more likely to earn near-minimum wages, but estimate that the earnings of low-wage workers accounted for only 10-15% of the disposable income of low-income families. Similar results have been found in the Australian context (Richardson and Harding 1999; Leigh 2005).

The second factor is the elasticity of labour demand with respect to the minimum wage. While noting research by Card and Krueger (1995) suggesting that raising the minimum wage has no disemployment effect, Formby, Bishop and Kim present additional evidence from state panel data suggesting that labour demand elasticities differ not only by age, but also by race and sex, ranging between -0.1 to -0.65 for workers aged between 16 and 24 (their largest elasticities are for black teenagers). In their preferred estimates, they simulate the effect of a minimum wage rise, allowing elasticities to differ by age, race and sex.

The third parameter affecting the choice of policies is the impact that a negative income tax (or lower payroll tax) will have on labour supply, taking into account both substitution and income effects. As the authors note, the natural experiment literature has tended to find that boosting the EITC has a large positive effect on labour supply among single women, and a small negative effect on labour supply of married women. It is therefore somewhat surprising that the trio choose to model the policy on the assumption that boosting the EITC has no effect on the labour supply of single women, but may reduce the labour supply of married women. Given the evidence, such an approach seems akin to handicapping the EITC horse from the start.

Yet this seems to make little difference to the eventual results. Across a suite of simulations, Formby, Bishop and Kim find that the EITC has the highest social welfare gain, and is the most effective program at reducing poverty. Indeed, even if the Card and Krueger (1995) are taken to be correct in their finding that a higher minimum wage has no disemployment effect, it remains true that spending the same amount of money on boosting the EITC will deliver a greater benefit to the poor.

The authors argue that even with their preferred labour demand elasticities, a minimum wage rise will not hurt the poor. However, they find that a minimum wage rise is poorly targeted – with 45-49% of the benefits accruing to those in the top three quintiles of the income distribution. By contrast, since the EITC is based on family incomes, spending the same amount on an EITC increase does a better job of improving the wellbeing of those at the very bottom of the income distribution.

In the case of a targeted payroll tax cut, the authors find that the benefits would accrue mostly to those clustered around 150-200% of the poverty line. While a targeted payroll tax cut does not benefit the rich, neither does it provide much assistance to the very poor. They conclude that whether one should prefer a payroll tax cut to a minimum wage rise depends on whether the target group is the moderately poor or the very poor.

I had only minor quibbles with this book. The three policies do not receive equal coverage: too much space is devoted to the minimum wage, and not enough to the other two policies. The authors assume that the incidence of a payroll tax cut or an EITC falls entirely on the worker, despite evidence to the contrary in both cases (see Gruber and

Krueger 1991 on the incidence of wage taxes; Leigh 2004 on the incidence of the EITC). And the book feels as though it was last revised in 2002, citing working paper versions of now-published journal articles, and omitting some of the most recent literature.

But these are minor points. *Minimum Wages and Poverty: An Evaluation of Policy Alternatives* delivers on its promise – to critically compare three anti-poverty programs. For academics and policymakers alike, this book should is a valuable guide to targeting scarce resources towards fighting poverty and reducing inequality.

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