EMPLOYMENT POLICIES INSTITUTE

Indexing the Minimum Wage: A Vise on Entry-Level Wages

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Introduction

Indexing the minimum wage is a rising trend at the state and local levels. Whether through a ballot initiative, as in Washington and Oregon, or state legislature, as was the case in Alaska, efforts have increased in the recent years to tie minimum wage increases to specific economic indicators such as the Consumer Price Index (CPI).

Washington, Oregon, and Alaska all have minimum wages exceeding the federal standard that also increase annually based on changes in the CPI. In the 2001 legislative session, 24 other states considered increasing their minimum wages, and 15 of these considered linking those increases to indexing.

The arguments in favor of indexing are deceptively simple. Advocates argue indexing helps low-wage workers keep up with inflation and gives "certainty" to employers about wage increases. And besides, raising the minimum wage every year keeps a divisive issue off the legislative calendar.

But mandated wage increases are proven to be vastly inefficient. Moreover, there is a general consensus that forced wage hikes lead entry-level employers to eliminate jobs or reduce work hours. Even if jobs are not cut, employers respond to higher labor costs by shifting their hiring focus to better skilled employees or more capital-intensive production, leaving the least skilled out of the labor market.[1]

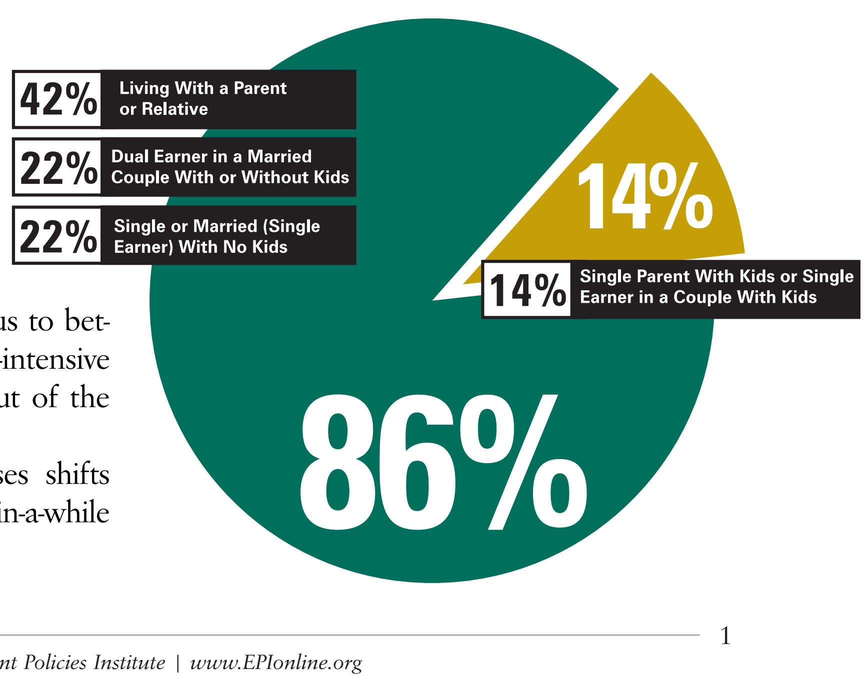
Automating minimum wage increases shifts these negative effects from a once-in-a-while occurrence to an annual event, albeit in an incremental fashion. Indexing is little more than an effort to institutionalize on auto-pilot a cycle of rising labor costs leading to reduced job growth, annual harm to job opportunities for the least skilled, and constant inflationary pressure, all without any measurable reduction in poverty.[2]

1. Targeting the Wrong People

Few people will deny that the stated goal of increasing the minimum wage is to get more money to families who are supported only by a minimum wage earner. However, even a casual examination of recent minimum wage proposals shows that minimum wages fail to target the families they are intended to help.

For instance, as seen in Figure 1, of every 100 workers affected by the $6.65 minimum

Figure 1 Distribution of Workers Affected by a Proposed $6.65 Minimum Wage



wage recently proposed in Congress, only 14 are single parents supporting children with just that low-wage job. The other 86 beneficiaries–who by definition are the actual "target" of the policy–are either teenagers living with their parents, single adults, married adults without children or one of multiple workers in a family with children.[3]

Indexing the minimum wage does not address the poorly targeted nature of the program itself. The overwhelming majority of "new dollars" created by annual wage hikes will still be delivered to people who are neither living in poverty nor supporting children.

2. Failing to Reduce Poverty

The 2001 study *Does the Minimum Wage Reduce Poverty?* conducted by Drs. Richard K. Vedder and Lowell E. Gallaway of Ohio University shows conclusively, "that minimum wage laws cannot be justified as a poverty-reducing device."[4] Their research shows that no matter which groups are examined, how one defines poverty or where in the country you look, minimum wages have had no negative effect on poverty.

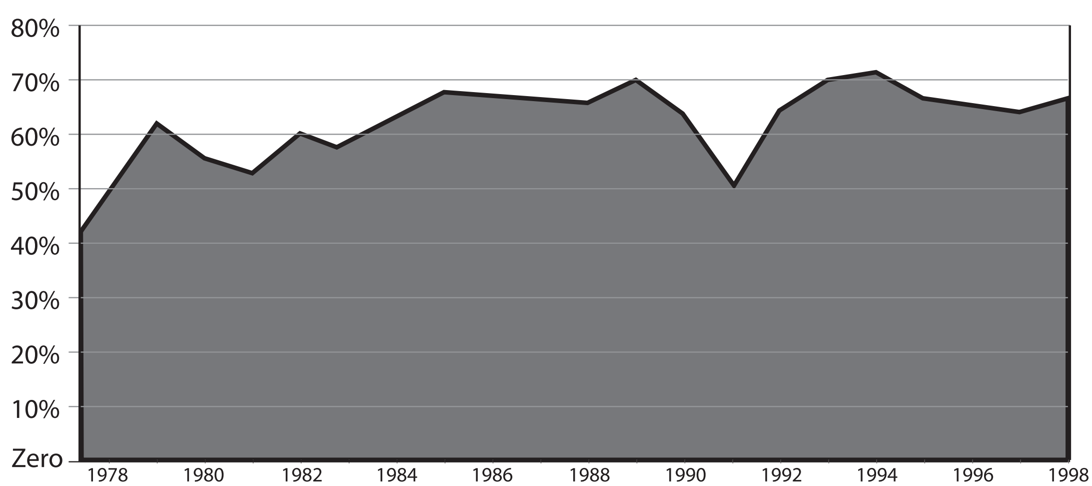
This study examines all poor households, and reveals that poverty exists primarily among nonworkers. In fact, for every full-time poor worker, there are seven who either do not work or only work part time. These people are helped out of poverty through first getting employed, improving their skills and then having increased job opportunities.[5]

3. Ignoring "Natural" Wage Growth

At the heart of the case for indexing is the notion that the bulk of minimum wage workers remain at the minimum wage and experience increasing financial strains brought on solely by annual inflationary pressures. In reality, it is difficult to find employees who stay at the minimum wage year after year. Those who do often have serious skill deficiencies or other problems that will not be solved with an indexed minimum wage.

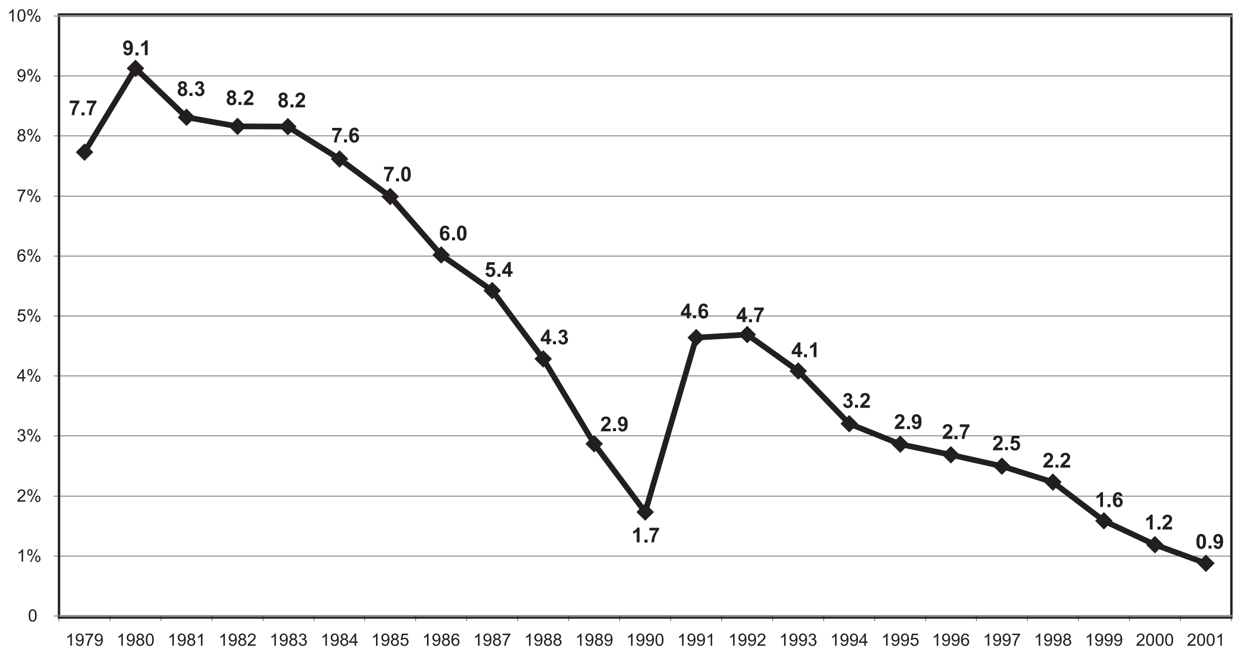
The fact is that wages for most minimum wage workers rise quickly without any intervention from the government. These wage increases come as workers increase their skill and experience levels, switch jobs, take on more responsibility, or improve their educational credentials.

Figure 2 **Time Line of Exit Rates* from 1977-1997**



* The "exit rate" is defined as the percentage of minimum wage workers that have sufficient wage growth to earn above the minimum wage one year later. If the minimum wage increases over the year, a person's wage must increase beyond the level of the new minimum to be counted as an exit.

Figure 3 Percentage of Hourly Workers Earning the Minimum Wage



*The prevailing Federal minimum wage was $2.90 in 1979, $3.10 in 1980, and $3.35 in 1981-89. The minimum wage rose to $3.80 in April 1990, to $4.25 in April 1991, to $4.75 in October 1996, and to $5.15 in September 1997. Thus, the Federal minimum was $4.25 for the 1992-95 period, and $5.15 in 1998-2001. Data for 1990-91 and 1996-97 reflect changes in the minimum wage that took place in those years.
SOURCE: Unpublished tabulations from the Current Population Survey (CPS), Bureau of Labor Statistics.

Research from Dr. William E. Even from Miami University of Ohio and Dr. David Macpherson from Florida State University shows in Figure 2 that between 1977 and 1997, on average 65% of minimum wage employees made more than that wage the following year, with typical wage growth exceeding 10%.[6] Even the most ardent proponents of indexing have not suggested raising wages by 10% per year, yet this is exactly what most minimum wage workers accomplish on their own.

4. Declining Numbers of Minimum Wage Employees

A corollary to the natural wage growth described above is the well-documented decline in the share of the population that is even affected by the minimum wage. Bureau of Labor Statistics (BLS) data show that the number of workers at the minimum wage has been declining steadily over the past decade as seen in Figure 3. In 1992, 4.7% of the workforce was at the minimum wage, while in 2001 just 0.9% of workers earned the minimum wage.[7]

Between 1980, when 9.1% of the workforce was earning the minimum wage, and 2001, there was an 86% decline in the number of employees working at the minimum wage — a drop of over 4 million workers. During the same time span the workforce added over 21 million more hourly workers.[8]

This decline can be attributed largely to the wage hikes earned by entry-level workers. It also points out the fallacy behind the argument that indexing is necessary if the government is to "help" minimum wage workers.

5. Overstating the Effects of Inflation

Foremost among the faulty arguments cited by indexing proponents is the one referencing the effects of inflation on the real value of the minimum wage.

A representative of the Oregon Center for Public Policy (a left-leaning advocate of indexing) said, “Each year families working at or close to the minimum wage find it harder to make ends meet because prices go up. Indexing the minimum wage to inflation stops the erosion of its value.”[9]

Accepting this statement at face value means ignoring the substantial wage growth that minimum wage workers experience each year. The population of minimum wage employees is a constantly-changing mix of labor market entrants. As noted above, to suggest that folks who are earning the minimum wage today are the same people who earned this wage last year or the year before is demonstrably false.

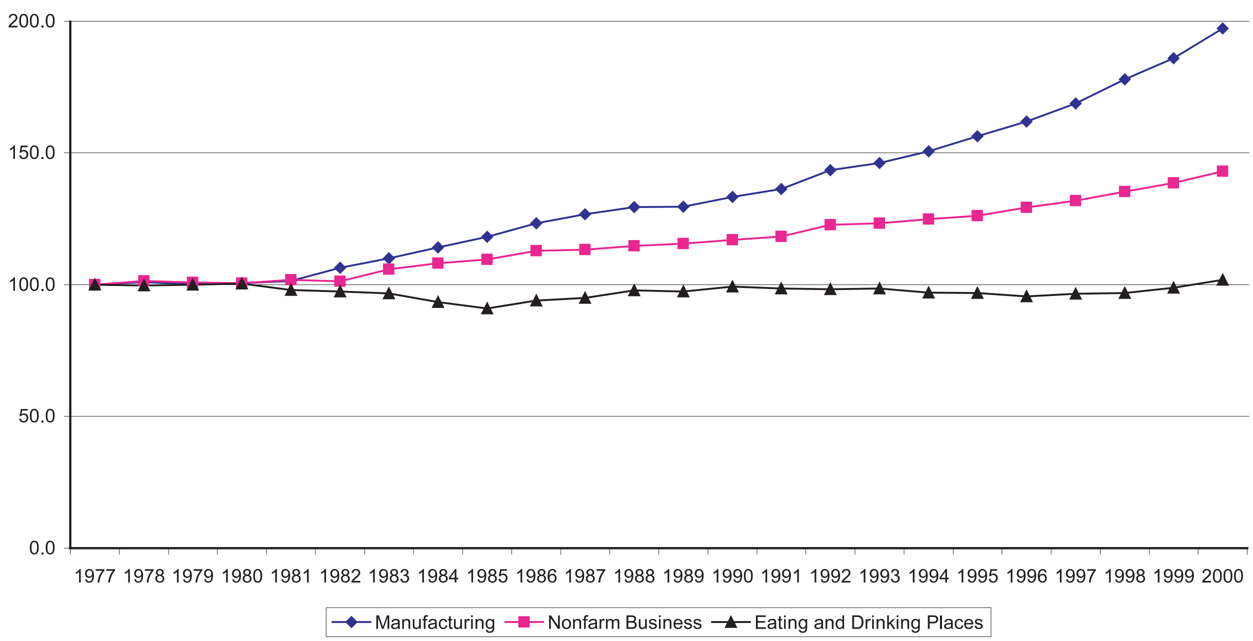
But the pitfalls of the inflation argument go beyond the composition of the minimum wage workforce. Even if one accepts constant inflationary pressures on minimum wage workers, the fact remains that the CPI is a crude tool for indexing because it has been shown to overstate inflation. Even some proponents of minimum wage increases have denounced linking automatic wage increases to the CPI as it does not accurately reflect market-caused price increases.[10,11]

If the CPI overstates inflation as research has shown, then indexed minimum wages based on the CPI would actually cause inflation, creating the need for greater and greater minimum wage increases every year.

6. Productivity of Low-Skill Workers Fails to Justify Indexing

A study by Oren M. Levin-Waldman (1998) proposes to instead link the minimum wage to productivity increases which the BLS has measured

Figure 4 Productivity Indexes for Various Sectors (1977 = 100)



as increasing by an average of 2.7% annually since 1949.[12] Alternatively, this paper suggests adjusting the minimum wages by tying them to the median wages for low-skilled jobs, so minimum wages do not increase too far out of line with wages of the least skilled. Under this scenario, the median wage of the lowest-wage workers is used as a proxy for the productivity of the least skilled workers.

However, this approach also has serious pitfalls. If one examines the Bureau of Labor Statistics measures of productivity in the eating and drinking industry (one of the largest employers of entry-level workers), it is clear from Figure 4 that since 1977 the eating and drinking industry has seen only a negligible increase in productivity.[13] In fact, when Dr. Levin-Waldman uses the median wages of low-wage employees as a proxy for productivity linked to the $3.35 minimum wage of 1983, the estimated minimum wage index was only $0.06 different in 1997 than the current $5.15 minimum wage.[14]

This is hardly a sound basis for arguing the need for indexing. On the contrary, from this analysis, it would seem that suggestions of the "declining value of the minimum wage" are simply untrue.

7. Siphoning Off Wage Increases

Supporters of indexing also rarely mention the lost benefits and additional taxes families incur following mandated wage increases.

In 2002, families supported by a single minimum wage employee with two children could receive $4,140 in refundable Earned Income Tax Credit benefits, about $3,500 annually ($300 monthly) in food stamp benefits, thousands of dollars in Section 8 benefits if they qualify, and free or low-cost health insurance for their children in every state.

Any family taking advantage of all these programs and subsequently "benefiting" from a mandated increase in the minimum wage would lose between 50% and 100% of every extra dollar they earn (up to about $15.00 per hour).[15] This is because eligibility for these well-targeted assistance programs falls rapidly as wages rise. In the end, the overall income available to poor families does not rise at all, or rises just marginally, after an indexed wage hike takes effect.

8. Risks of Economic Uncertainty

In times of economic uncertainty, policymakers are motivated by a desire to enhance job creation and improve the business environment. Thus, minimum wage hikes rarely pass in the midst of a recession. Indexing the minimum wage would change that. Indexing puts minimum wage hikes on automatic pilot, forcing labor costs to rise even during times when no rational public servant would force this kind of mandate, such as periods of high unemployment or otherwise slow economic growth.

Historically, business cycles rise and fall over time. This has become evident (again) in recent years. With an unpredictable economic environment, it is important to remember that the labor market needs a certain amount of flexibility to deal with changing demands.

9. Better Targeted Programs Save Money and Provide More Assistance

For the small number of individuals who are supporting children on a minimum wage income, there already exist a number of tightly-focused programs that are far better suited to delivering income to those in need. These programs can either be better promoted, expanded or combined to provide even more assistance to poor families.

Since 1968 several programs have been created or expanded that are vastly more efficient than the minimum wage at getting money to the poorest and most needy families. However, proponents of wage mandates wrongly criticize these programs as reasons for wage increases. Robert Pollin, often called the father of the living wage movement, said in the December 2002 *Journal of Economic Issues,* "[T]he need for such programs to support families which include full-time workers only emphasizes further the low level to which the national minimum wage has fallen."[16]

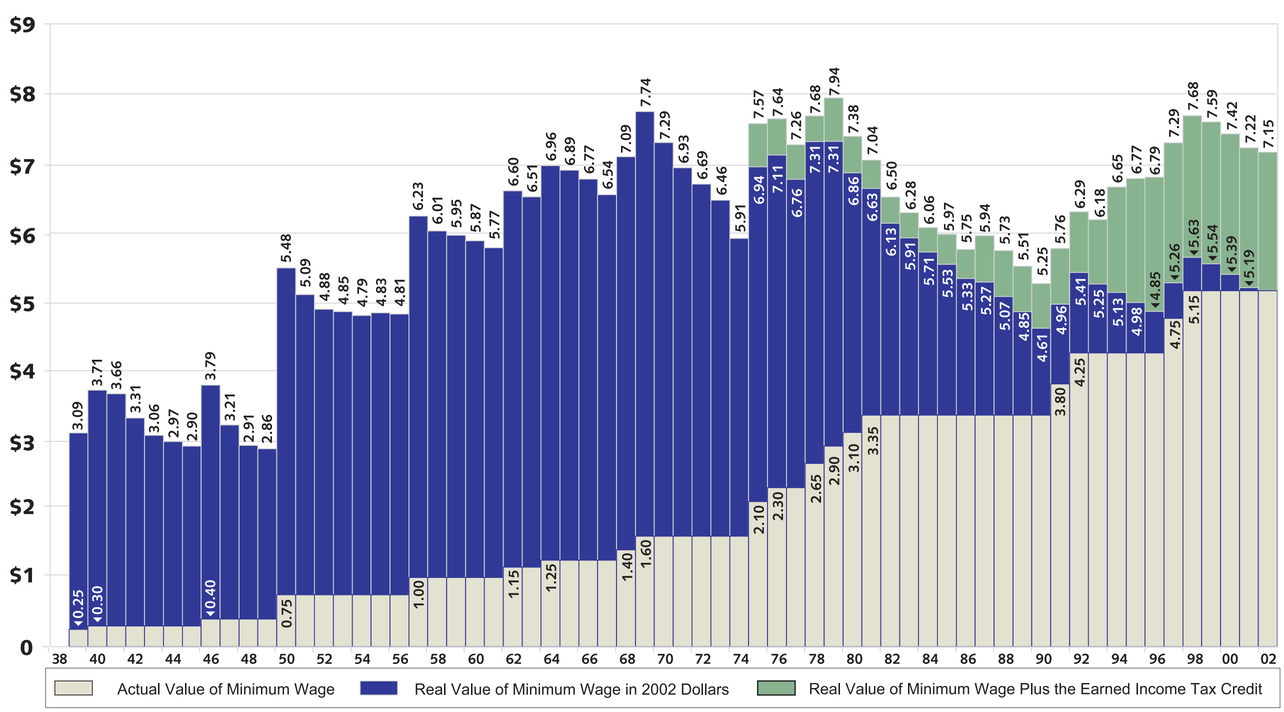
What Mr. Pollin fails to acknowledge is that these programs are not a symptom of the national minimum wage, but well-targeted policies superior to the minimum wage, specifically designed to target poor families with children. The programs that exist are far more efficient and cost effective than the general wage mandates he proposes.

Parents who cannot provide for their children with their earnings now have access to in-kind programs such as food stamps, Section 8 or public housing, Medicaid and state Children's Health Insurance Programs (sCHIP), as well as cash-benefit programs like Temporary Aid for Needy Families (TANF) and the refundable Earned Income Tax Credit (EITC). Funds from each of these programs are targeted solely to low-income families with children, unlike minimum wage increases where a substantial portion of the benefit goes to middle and upper class families or teenagers.

Restricting one's focus to the inflation-adjusted value of the minimum wage fails to take account of the EITC which has expanded greatly over the past 25 years. Expansions of the EITC increase hourly income for a single full-time minimum wage worker by over $2.00 per hour as seen in Figure 5. This $4,000 is delivered directly to families with children, rather than wasted on individuals and families outside of those most in need.

Unfortunately, advocates of indexing would prefer that policymakers consider their proposal in a vacuum, ignoring the reality that poor families have a wide variety of resources available to supplement their incomes until their skill levels rise to a point where they can command higher wages.

Figure 5 Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit (as of January 1st each year)



Conclusion

There are several key questions legislators should ask when considering indexing wage mandates:

- Who are we trying to help by indexing wages?

- Is wage indexing an efficient way to deliver assistance to the target population?

- Is the CPI the proper tool for indexing wages, or could using the CPI cause more inflation or exacerbate unemployment?

- How will employers react to automatic increases in the wages they pay? Will they welcome the "certainty" offered by indexation? Or will employers seek out more efficient and productive employees, cut back on jobs and hours or switch to more capital intensive production?

In the balance between government, families and employers, creating an environment where business is challenged annually through an untargeted and unfunded mandate cannot have positive effects for any party. Because it offers few benefits, is foolishly targeted to those individuals who are not in need, and substantially increases risks for low-skill workers, indexing must be viewed for what it is: a politically-motivated tool with no place in a balanced approach to assisting the working poor.

Endnotes

1 See David Neumark, Mark Schweitzer and William Wascher, *The Effects of Minimum Wages Throughout the Wage Distribution,* Working Paper 9919 (Cleveland: Federal Reserve Bank of Cleveland, December 1999), for an overview of current minimum wage research on displacement and substitution effects of minimum wage increases.

2 See Richard K. Vedder and Lowell E. Gallaway, *Does the Minimum Wage Reduce Poverty?* (Washington, D.C.: Employment Policies Institute, 2001), which concludes that changes to the minimum wage have not had an effect on poverty.

3 See Employment Policies Institute, *Winners and Losers of Federal and State Minimum Wages,* October 2002; available from http://www.epi-online.org /50states_all.html; accessed 22 January 2003.

4 Vedder and Gallaway, Minimum Wage, 1.

5 Ibid. 16.

6 See William Even and David Macpherson, *Rising Above the Minimum Wage,* (Washington, D.C.: Employment Policies Institute, 2000).

7 These calculations are based on unpublished data from the U.S. Department of Labor, Bureau of Labor Statistics.

8 Ibid.

9 Jeff Thompson as quoted in Oregon Center for Public Policy, "Good Economic News for the New Year: Thousands of Low Wage Oregonians Will get a Raise on January 1st," 30 December 2002; available from http://www.ocpp.org/2002/nr021230.htm; accessed 22 January 2003.

10 See Michael J. Boskin, et al., "Toward a More Accurate Measure of the Cost of Living," (Washington, D.C.: Advisory Commission to Study the Consumer Price Index, U.S. Senate, 1996).

11 See Dimitri B. Papadimitriou and L Randall Wray, *Targeting Inflation: The Effects of Monetary Policy on the CPI and Its Housing Component,* Public Policy Brief no. 27 (Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute, 1996).

12 See Oren M. Levin-Waldman, Automatic *Adjustment of the Minimum Wage: Linking the Minimum Wage to Productivity,* Public Policy Brief no. 42 (Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute, 1998).

13 Figures calculated using published statistics by the U.S. Department of Labor, Bureau of Labor Statistics, "Industry Productivity Data Tables," 16 October 2001; available from http://www.bls.gov /lpc/iprdata1.htm; accessed 22 January 2003.

14 Waldman, Automatic Adjustment, 29.

15 Based on unpublished analysis of interactions of tax and benefit programs in a number of states.

16 See Robert Pollin, Mark Brenner, and Stephanie Luce, "Intended Versus Unintended Consequences: Evaluating the New Orleans Living Wage Ordinance," Journal of Economic Issues 36, no. 4 (December 2002), 843-876.

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