INDEXING THE MINIMUM WAGE:

A Vise on Entry-Level Wages

Employment Policies INSTITUTE

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Introduction

Policies that index the minimum wage to inflation are becoming politically popular. Whether enacted through ballot initiatives or added as provisions on traditional minimum wage proposals, advocates have stepped up their efforts in recent years to tie wage hikes to specific economic indicators, such as the Consumer Price Index (CPI). President Barack Obama's proposals to combat poverty include mandating a $9.50 minimum wage by 2011 and indexing the wage thereafter.[1]

The earliest example of an indexed wage policy was introduced in 1999, when Washington State voters passed a ballot initiative to begin automating annual wage hikes. Ballot initiatives in Oregon, Florida, and San Francisco, CA, soon followed Washington's lead. In 2006, voters approved minimum wage increases with automatic escalators in six states: Arizona, Colorado, Missouri, Montana, Nevada, and Ohio. These ballot initiatives were part of a larger, get-out-the-vote strategy devised by labor activists. Vermont is the only state to have passed automatic indexing through the legislative process, but it's happening at the local level as well; lawmakers in Santa Fe have also approved indexing their citywide minimum wage.

The arguments that favor indexing are simplistic. Advocates claim indexing helps low-wage workers keep up with the rising cost of living and and gives employers "certainty" regarding when to expect wage increases. Additionally, automatically raising the minimum wage every year keeps a divisive issue off the legislative calendar.

In spite of their popularity among voters, mandated wage increases have repeatedly proven to be vastly inefficient as a means of helping the entry-level workforce, particularly since the majority of those who benefit from minimum wage hikes are not impoverished or supporting a family. Moreover, there is a general consensus that forced wage hikes lead employers of entry-level workers to eliminate jobs or reduce hours. Even if jobs are not cut, companies respond to higher labor costs by shifting their hiring focus to skilled employees or more capital-intensive production, leaving the least skilled workers out of the labor market.[2]

In reality, indexing puts into motion an unending cycle of rising labor costs and reduced job growth, the annual disappearance of job opportunities for entry-level workers, and constant pressure on prices. Yet all these negative effects occur without any measurable reduction in poverty—the stated goal of supporters of minimum wage hikes.[3]

[1] http://www.barackobama.com/issues/poverty/

[2] See Neumark and Wascher (2008) for an overview of current minimum wage research on displacement and substitution effects of minimum wage increases.

[3] See Vedder and Gallaway (2001), which concludes that changes to the minimum wage have not had an effect on poverty.

1. State Level Experience with Indexed Minimum Wages

While wage advocates have recommended indexing policies for years, only now have the measurable effects resulting from those policy decisions become clear. Three states that have passed automatic escalators—Washington (in 1999), Oregon (in 2002), and Florida (in 2004)—are worth examining because they have had the longest time to adjust to these labor policies. Today their wage rates are $8.55, $8.40, and $7.21, respectively.

In Washington, teen unemployment (a typical marker for the health of the entry-level job market) skyrocketed by 58 percent since the state implemented indexing, 24 percent higher than the average for non-indexed states. When indexing started in 1999, Washington already had a teen unemployment rate above the national level at 19.7 percent. By 2008, the teen unemployment rate reached 31.2 percent, an increase that cannot be explained by looking at other labor market movements (During the same time period, the national teen unemployment rate went from 14 percent to 18.6 percent, meaning Washington's teen unemployment rate was over 1.5 times the national average.) If repeated minimum wage hikes have no impact on the entry-level job market, the ratio of teen unemployment to overall unemployment should stay consistent in response to economic shocks. But in Washington state, the ratio shot up from 3.02 in 2001 to 5.57 in 2008, indicating that teen unemployment was growing at a much faster rate than overall unemployment over this time period.

Oregon, often trumpeted as an indexing success story, now faces tough times. The state has seen consistent job losses with total unemployment rates surpassing most of the country. Since indexing has been in place, Oregon has experienced an average unemployment rate of 6.6 percent—well above the 5.3 percent average for non-indexed states. For a time, aided by a booming construction industry and demand that drew workers from California and Washington State, Oregon had managed to escape some of the negative effects of the minimum wage mandate. But with construction work drying up, Oregon is now becoming a classic example of damage caused by autopilot wage hikes triggered during an unfavorable economic climate. From December 2007 to December 2008, Oregon's unemployment grew from 5.4 percent to 9 percent, a 67 percent spike that substantially outpaced the national job loss. (During the same time period, the national unemployment rate went up from 4.9 percent to 7.2 percent, a 47 percent increase.)

Since indexing was implemented in Florida, that state's unemployment rate has gone up 14 percent, exceeding the national average of non-indexed states by 13 percent. In the current recession, Florida has taken a particularly large unemployment hit. From December 2007 to December 2008, Florida's unemployment increased by 80 percent (4.5 percent to 8.1 percent.) This increase exceeds the national average by over 25 percent.

As the evidence accumulates, it's clear that no matter how attractive it may be to index the minimum wage while the economy is booming, setting wages to go up automatically inevitably leads to calamitous results when the economy softens.

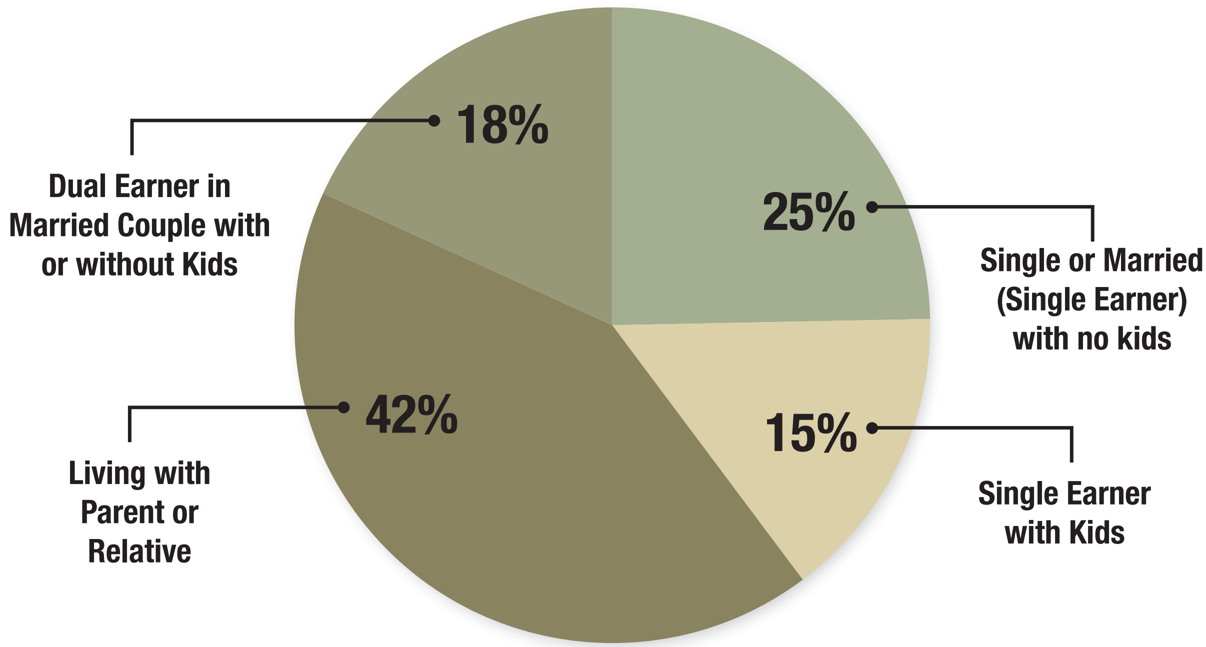
2. Targeting the Wrong People

Policymakers who wish to raise the minimum wage usually include it in their plans to combat poverty. However, upon closer examination, minimum wage laws fail to target those intended beneficiaries.

As Figure 1 shows, for every 100 workers affected by today's federal $6.55 minimum wage, only 14 are single parents who are supporting children. The other 86 workers—the actual if unintended "targets" of the policy—are either teenagers living at home with their parents, single adults, married childless adults, or from dual-income families with children.[4]

Indexing the minimum wage does not address the poorly targeted nature of the minimum wage program itself. The overwhelming beneficiaries of annual wage hikes will remain

Figure 1: Who Benefits from the Federal $6.55 Minimum Wage Hike?



Source: Current Population Survey Outgoing Rotation Group files from June 2007 to May 2008. Calculations based on the increase from $5.85 an hour to $6.55 an hour, which represents the second step in the federal minimum wage hike that was passed in 2007. The federal minimum wage will go up to $7.25 on July 24, 2009.

those who are neither living in poverty nor supporting children. On the contrary, the people most harmed as a result of such policies are typically the workers with the lowest skills or entry-level applicants.

3. Failing to Reduce Poverty

Economists David Neumark and William Wascher's 2008 book *Minimum Wages* lays out a comprehensive review of the minimum wage literature, both past and present. The authors state:

> In our view, the combined evidence is best summarized as indicating that an increase in the minimum wage largely results in a redistribution of income among low-income families, with some gaining as a result of the higher minimum wage and others losing as a result of the diminished employment opportunities or reduced hours, and some likelihood that, on net, poor or low-income families are made worse off. Were there compelling evidence that the families that gain are disproportionately those to which we might want to redistribute income—such as poor households with children—then it would be possible to imagine that the evidence masks some beneficial distributional effects. But there is, as yet, no evidence to support this contention either.[5]

The research on the inefficiency of minimum wage hikes to target poverty is not new. A 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."[6] Their research demonstrates that no matter which groups are examined, how poverty is defined, or where in the country the data is gathered, a rising minimum wage

[4] See Employment Policies Institute's "Minimum Wage Statistics", available at: http://www.epionline.org/mw_statistics_state.cfm
[5] See Neumark and Wascher (2008), p. 189.
[6] Vedder and Gallaway (2001), p. 1.

has had no beneficial effect on reducing poverty. The study examines all poor households and reveals poverty exists primarily among non-workers. In fact, the study shows that, for every full-time low-income worker, there are seven who either are not employed or work only part time.[7]

Recent studies on the effects of state and federal wage hikes over the past few years offer more evidence that these hikes fail as anti-poverty devices. According to Drs. Joseph Sabia of American University and Richard Burkhauser of Cornell University, minimum wage increases enacted between 2003 and 2007 had no measurable effect on state poverty rates, even when using a variety of definitions of poverty.[8] Their research echoes earlier assessments that show wage hikes implemented between 1988 and 2003 had similarly insignificant effects on poverty.[9]

Research repeatedly confirms that minimum wage hikes are blunt anti-poverty tools. Workers best achieve an escape from poverty by skill development, which leads to increased job opportunities and higher pay in full-time positions.

4. Overstating the Effects of Inflation

Foremost among the faulty arguments cited by indexing proponents are the effects of inflation on the real value of the minimum wage.[10]

Rich Jones, the director of policy and research at Colorado's Bell Policy Center, advocated indexing the minimum wage because "if we don't adjust it for inflation, these folks fall backward. This ensures low-wage workers' wages will keep pace with the cost of living in Colorado."

Jones' comments are echoed among other activists. Yet, taking this statement at face value means ignoring the data demonstrating that even without indexing it doesn't take long for minimum wage earners to enjoy substantial wage growth. The population of minimum wage workers is constantly in flux as entry-level employees gain experience and qualify for better jobs. The majority of minimum wage earners will soon be promoted or move on to jobs with better pay, and a new set of unskilled workers will immediately replenish their ranks.

Beyond the inflation argument, other inaccuracies exist in the reasoning behind an index wage. For one, the CPI is at best a crude tool that often overstates inflation. When the CPI overstates inflation, indexed minimum wages lead to greater unemployment and inflated prices in areas with high concentrations of minimum wage labor.

Figure 2 shows 2009 minimum wages in states and cities that have passed indexing policies. Prior to 2007, the CPI had grown an average of roughly 3 percent every year. But last year's spike in gas prices affected the monthly CPI changes that were used to determine 2009's wage rates. Depending on which data is used, the state calculations ranged from 3.4 percent percent to 6.21 percent—a dramatic jump from the previous year's wage hike. Even employers who could otherwise anticipate an indexing increase were caught unprepared for the spike in inflation, particularly since it coincided with reduced consumer spending and other commodity price increases that were reactions to the inflationary effects.

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[7] Ibid. 16.

[8] See Table 1 of Sabia and Burkhauser (2008).

[9] In a 2007 study, Burkhauser and Sabia used Card and Krueger's (1995) model and examined the effects of minimum wage increases on poverty rates using a panel of states and years from 1988 to 2003. Across many specifications, they found little evidence of a significant relationship between minimum wage increases and the overall state poverty rate. When comparing results between the 2007 study and the aforementioned work by Sabia and Burkhauser (2008), the authors find minimum wage increases between 2003 and 2007 have an even smaller effect than what was found in the examination of the 1988–2003 period:-0.052 in recent years vs. -0.082 in the earlier 15-year period.

[10] Milstead, David. (2008) "Inflation Report Means Pay will Rise Because of Provision in Constitution." *Rocky Mountain News*. August 14, 2008. Available at: http://m.rockymountainnews.com/news/2008/aug/14/colorado-minimum-wage-rise-thanks-inflation/

Figure 2: 2008 to 2009 Minimum Wage Increases in Indexed States/Localities

State	2008 Wage Rate	Annual Range for CPI Change	CPI Used	Calculated CPI	Preliminary Wage	Adjustments	2009 MW
Arizona	$6.90	Aug.–Aug.	All US City Average/ All Consumers	5.36%	$7.27	Rounded to the nearest 5 cents	$7.25
Colorado[1]	$7.02	1st half–1st half	Denver-Boulder-Greeley/ All Consumers	3.72%	$7.28		$7.28
Florida	$6.79	Aug.–Aug.	South Urban Average/ Urban and Clerical Workers	6.21%	$7.21		$7.21
Missouri	$6.65	Jul.–Jul.	Midwest Urban Average/ Urban and Clerical Workers	6.09%	$7.05		$7.05
Montana	$6.55	Aug.–Aug.	All US City Average/ All Consumers	5.36%	$6.90	Rounded to the nearest 5 cents	$6.90
Nevada[2]	$6.85	Dec.–Dec.	All US City Average/ All Consumers	3.40%	$7.08	Capped at 3%	$7.55
Ohio	$7.00	Average Sept.–Aug.	All US City Average/Urban and Clerical Workers	4.61%	$7.32	Rounded to the nearest 5 cents	$7.30
Oregon	$7.95	Aug.–Aug.	All US City Average/ All Consumers	5.36%	$8.38	Rounded to the nearest 5 cents	$8.40
Vermont	$7.68	Sept.–Aug.	All US City Average/Urban and Clerical Workers	5.50%	$8.10	Capped at 5%	$8.06
Washington	$8.07	Aug.–Aug.	All US City Average/Urban and Clerical Workers	5.90%	$8.55		$8.55
San Francisco, CA	$9.36	Aug.–Aug.	San Francisco / Urban and Clerical Workers	4.61%	$9.79		$9.79
Santa Fe, NM[3]	$9.50	Average Jan.–Dec.	Western Urban Average/Urban and Clerical Workers	3.70%	$9.85		$9.85

In each case, the minimum wage indexing law calls for the state's Department of Labor to review the change in the Consumer Price Index (CPI) between two specific time frames, one within the current year and a corresponding time frame of the preceding year (see the column titled "Annual Range for CPI Change"). The numbers above only reflect changes in the CPI as of February 1, 2009. We have noted which estimates are based on incomplete data and will be revised.

[1] Because of the way CPI is collected for cities in Colorado, this calculation was based on half-year datapoints. The average CPI for the first half of 2007 was compared to the average CPI for the first half of 2008.

[2] In April 2009, the Nevada Labor Commissioner announced the state's July 1 minimum wage hike would be $.70, tracking with the last step of the federal minimum wage hike scheduled to be implemented on July 24, 2009. (State law also allows employees who receive health benefits from their employer to be paid $1.00 lower than the minimum wage, notwithstanding federal law.)

[3] Originally, Santa Fe's 2009 wage increased by 4.46% to $9.92, based on the change in the average increase in the CPI between October 1, 2007 through September 30, 2008 and the average increase between October 1, 2006 through September 30, 2007. However, in January 2009, the council revised the provision and instead used 3.7%, the difference between the average increase in the CPI from January 1 through December 31, 2008 and the average increase in the CPI from January 1 through December 31, 2007.

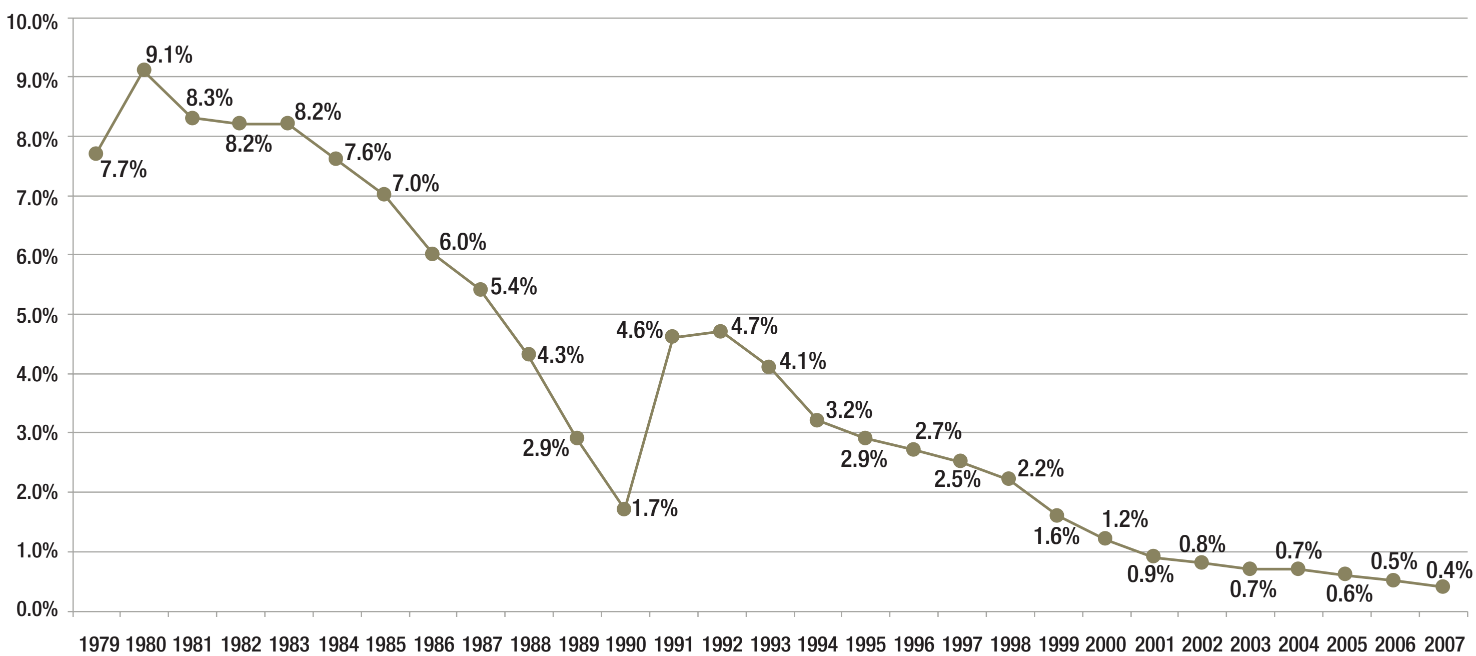
5. Ignoring "Natural" Wage Growth

At the heart of the case for indexing lies the inaccurate notion that the majority of those earning the minimum wage remains at a low pay level indefinitely, and earnings become eroded by inflationary pressures. In reality, few employees stay at the minimum wage year after year. Those who do may have serious skill deficiencies or other issues that cannot be solved by an indexed wage.

Wage rates for most workers rise quickly without any government intervention. Higher wages naturally follow increases in skill and experience levels, promotions, switching jobs, or improved educational credentials.

Research from Drs. William Even from Miami University of Ohio and David Macpherson of Florida State University shows that between 1979 and 2002, an average of 62.6 percent of minimum wage employees earned pay increases within one to twelve months of beginning employment, with typical wage growth exceeding 10.4 percent.[11] Even the most ardent indexing proponents have not suggested raising wages by a double-digit percentage every year, yet this is precisely what most minimum wage workers are able to accomplish on their own.

Figure 3: Percentage of Hourly Workers Earning the Minimum Wage



Note: The prevailing Federal minimum wage was $2.90 in 1979, $3.10 in 1980, and $3.35 in 1981-1989. The minimum wage rose to $3.80 in 1990, $4.25 in 1991, $4.75 in 1996, $5.15 in 1997, $5.85 in 2007, and to $6.55 in 2008. The Federal minimum was $4.25 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 for years 1979–2001. Publicly available on the BLS website are years 2002–2007.

6. Declining Numbers of Minimum Wage Employees

A corollary to the natural wage growth is the well-documented decline in the proportion of the population that earns the minimum wage. As seen in Figure 3, Bureau of Labor Statistics (BLS) data show the number of workers at the minimum wage declining steadily over the past sixteen years. In 1992, 4.7 percent of the workforce earned the minimum wage, whereas in 2007 that percentage fell to just 0.4 percent.[12]

Going back further reveals an even more dramatic decline. Between 1980—when 9.1 percent of the workforce was earning the minimum wage—and 2007, there was a 94 percent decline in the number of employees earning the minimum wage. In raw numbers, that totaled a drop of almost 4.5 million workers, but the workforce added more than 24 million more hourly jobs during the same time span.[13]

Merit-based pay raises earned by entry-level workers were the major factor contributing to the decline in minimum wage positions. The evidence underlines the fallacy of indexing as necessary to help minimum wage workers earn more money.

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

A study by Dr. Oren Levin-Waldman (1998) proposed linking the minimum wage to employee productivity, which the BLS has measured as growing an average of 2.7 percent annually since 1949.[14] As an alternative, he suggests tying the minimum wage to the median wage rate for low-skilled jobs so that the minimum wage does not surpass the wages of the least skilled. Under this scenario, the median wage of the lowest-paid workers acts as a proxy for worker productivity.

However, these solutions both have drawbacks. Consider the BLS statistics in Figure 4 for productivity in the eating and drinking industry (one of the largest employers of entry-level workers). The data clearly shows only marginal productivity gains in the industry since 1988.[15] When Dr. Levin-Waldman uses the median of low wage employees as a proxy for productivity linked to the $3.35 minimum wage of 1983, the estimated minimum wage index differed only $0.06 in 1997 from 2003's $5.15 minimum wage.[15]

This hardly backs the argument for indexing. On the contrary, from this analysis, the "declining value of the minimum wage" is nowhere to be found.

8. Risks of Economic Uncertainty

In times of economic uncertainty, policymakers become risk-averse regarding regulations that might increase the unemployment rate. Historically, minimum wage hikes have rarely been passed in the midst of recessions. Indexing the minimum wage forces policymakers to stay the course indefinitely without evaluating whether the current economic environment can support a hike. While the economy can likely absorb wage hikes during financial booms, it also means wages are forced to increase and joblessness escalates during periods of slow growth and already high unemployment rates.

The reality is that business cycles rise and fall over time, yet indexing measures (most often passed through public ballot initiatives) leave no provision for review when the economy

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[11] Even and Macpherson (2004).

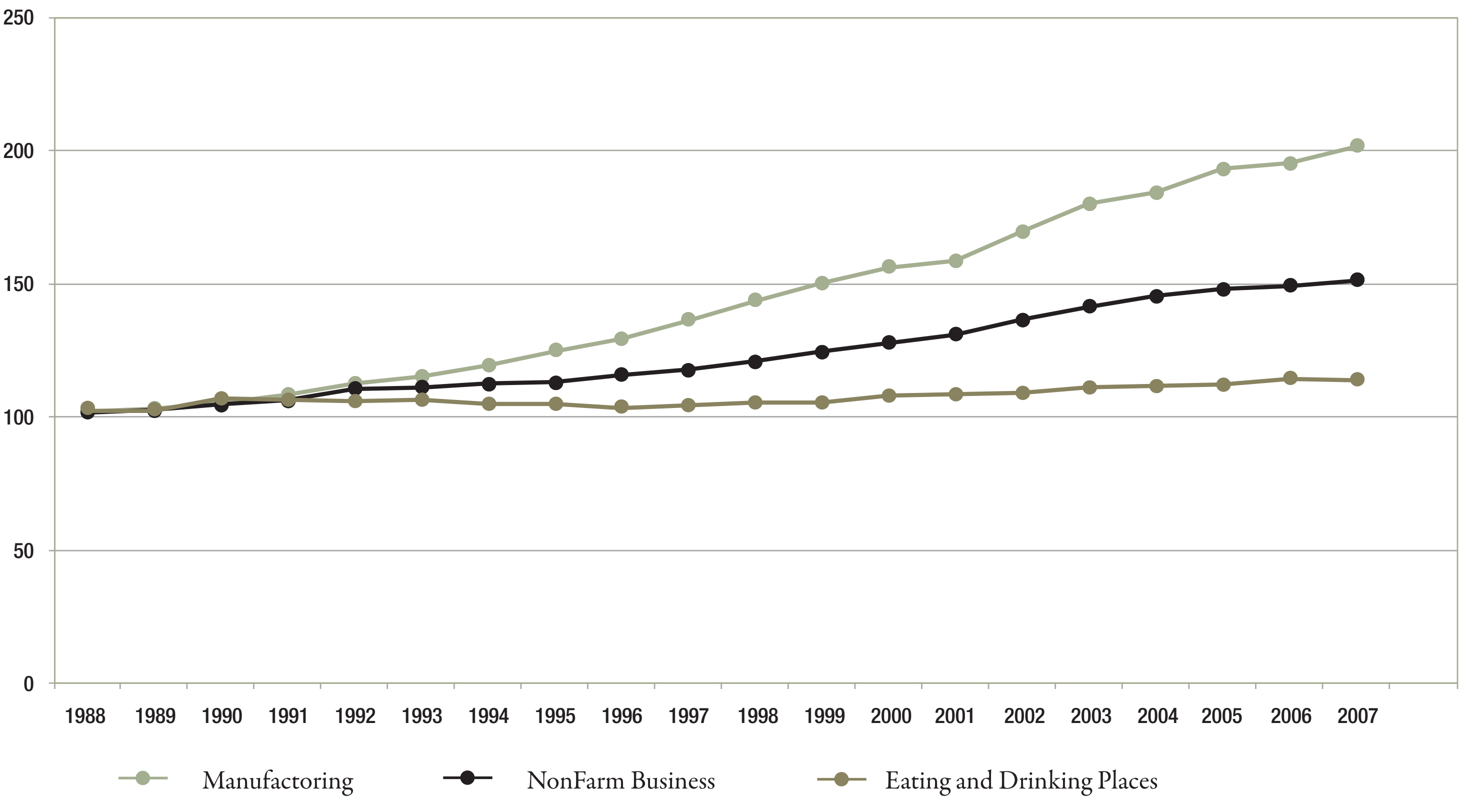
[12] The calculations are based on unpublished data from the U.S. Department of Labor, Bureau of Labor Statistics for the years 1979 to 2001. Years 2002 to 2007 are now publicly available on the BLS website, www.bls.gov.

[13] Bureau of Labor Statistics. "Table 10. Employed wage and salary workers paid hourly rates with earnings at or below the prevailing Federal minimum wage by sex, 1979–2007 annual averages." http://www.bls.gov/cps/minwage2007tbls.htm#10. Last accessed December 11, 2008.

[14] See Levin-Waldman (1998).

[15] Levin-Waldman, "Automatic Adjustment," 29.

Figure 4: Productivity Rates over Time, by Key Industries



Source: Figures access and calculated from Major Sector Productivity and Costs for the Nonfarm Business and Manufacturing Sector (index is 1992=100), available from Bureau of Labor Studies statistics databases (http://www.bls.gov/lpc/#data). Food Services and Drinking Places data is taken from Industry Productivity Indexes, August 21, 2008. (ftp://ftp.bls.gov/pub/special.requests/opt/dipts/ipr.aiin.txt)

is struggling. Indeed, the current state level indexation adjustments are unsophisticated and are based on upward fluctuations in the CPI.[16] These policies don't require determining a new wage rate based on a suitably diverse array of economic indicators—including important variables such as business growth and unemployment figures. Parsing the CPI while ignoring these highly relevant factors is a prescription for future disaster, especially considering how the minimum wage itself increases unemployment.

Lawmakers in states that have indexed their minimum wage are more limited in the policy options they can afford to implement to adjust to the current recession. Moreover, mandated annual wage hikes further limit the ability of employers to manage their labor decisions in a way that helps keep more jobs in the economy when faced with unforeseen circumstances. With an unpredictable economic environment, it is important to remember that the labor market needs a certain amount of flexibility to contend with evolving demands.

9. Targeted Programs Provide More Assistance

For the few single parents who are supporting families on minimum wage, there already exist a number of tightly focused programs that are far better suited to providing direct aid. In order to administer greater assistance to the poor, these programs should be better promoted, expanded, or combined.

Since 1968, several programs have been created or expanded with the goal of providing the poor with money. These governmental policies are superior to the minimum wage as they are specifically designed to target low-income households with children. Although advocates criticize the policies as a result of a low minimum wage, numerous studies have proven the inability of mandated wage hikes to effectively target or assist the needy.

Parents who are unable to provide for their children now have access to in-kind programs such as food stamps, Section 8 vouchers, public housing, Medicaid and the 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). Unlike minimum wage increases, the benefits of these programs go directly to the poor and do not unintentionally, profit middle-class and wealthy households with teenagers.

The EITC is a particularly effective poverty program. Those eligible for the tax credit (which is refundable at the federal level and most states) are those who are working, but who have incomes that fall short of the poverty level applicable to their family situation. The EITC closes that earnings gap while allowing low-skilled individuals to stay in the workforce, expand their skill level and earn greater economic independence over time. And, unlike wage mandates, EITC policies do not give employers a disincentive to hire those with the fewest skills.

Over the past 33 years, the EITC has been expanded at the federal level, while 23 states have implemented their own version. Figure 5 shows how EITC expansions increase hourly income for single full-time minimum wage workers by more than $2.00 per hour. This total of $4,824 is delivered directly to families with children, rather than being poorly targeted on workers who come from well-off families.

Wage indexing advocates would prefer that policymakers consider their proposal in a vacuum, ignoring effective income supplements for impoverished families. Expanding programs like the EITC would provide more poor workers with the money, health insurance, and food they need until they gain enough experience on the job to command higher wages and develop the means to exit poverty forever.

10. Siphoning Off Wage Increases

Indexing supporters rarely mention the benefits lost and additional taxes that families incur in the wake of mandated wage increases.

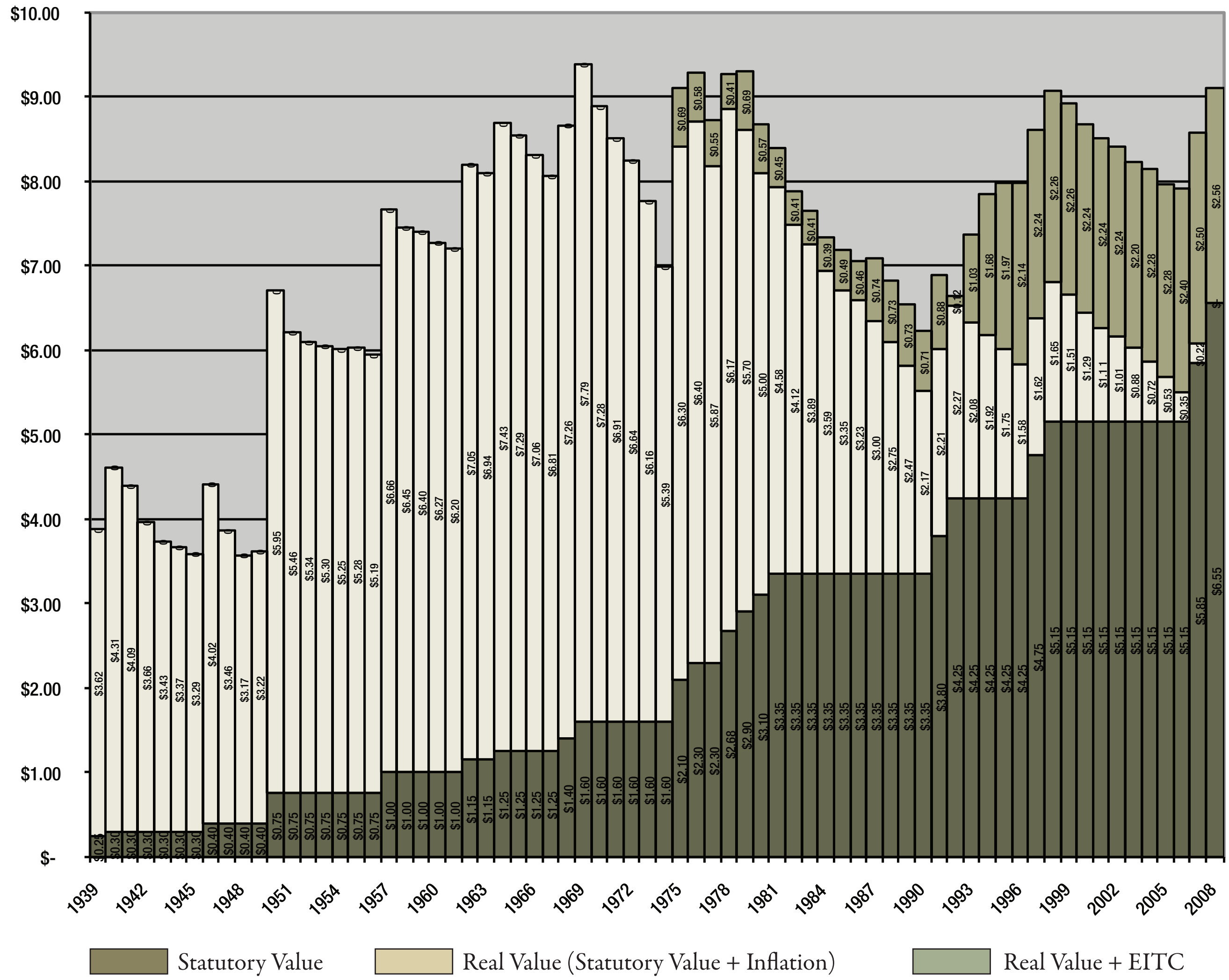
In 2008, a single minimum wage worker supporting two children could receive: a maximum of $4,824 through the refundable Earned Income Tax Credit (EITC) program; as much as $3,408 annually in food stamps; thousands of dollars in Section 8 vouchers (depending on qualifications); and free or low-cost health insurance for his or her children.

As wages rise, eligibility for these assistance programs is put at risk. A family taking advantage of all these programs and subsequently receiving a mandated increase in the minimum wage would lose 50 percent to 100 percent of every extra dollar earned (up to about $15.00 per hour).[17] In essence, the rise in wages serves as a hefty income tax. A 1999 study by Daniel Shaviro of New York University found the marginal effective tax rate in 1998 ranged from 61.3 percent to 109.2 percent.[18]

As the poorest households see their earnings increase, they lose many of the benefits that keep their families afloat. Even when the minimum wage succeeds in increasing the wages of an impoverished individual, the advantage pales in comparison to the monetary gain for a middle-class or rich teenager. Unlike poor people who rely on governmental assistance, a teenager who works for minimum wage and lives at home stands to lose substantially less in terms of benefits. Ultimately the total income of poor families either does not rise at all, or rises only marginally.

[16] Only Missouri provides a mechanism for decreasing the minimum wage if the cost of living goes down.
[17] Based on EPI's unpublished analysis of interactions of tax and benefit programs in a number of states.
[18] Shaviro, Daniel. (1999) *Effective Marginal Tax Rates on Low Income Households*, Washington D.C.: Employment Policies Institute.

Figure 5: Comparison of the Real and Statutory Value of the Minimum Wage Plus the Earned Income Tax Credit



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 targeted population?
- Is the CPI a proper tool for indexing wages? Could using the CPI concentrate price inflation and unemployment in poor areas?
- How will employers react to automatic increases in wages? Will they welcome the "certainty" offered by indexing? Or will employers seek out more efficient and productive employees, cut back jobs and hours, or switch to more capital-intensive production?

In the balance among government, families and employers, creating an environment where business is annually challenged by an aimless and unfunded mandate cannot have broad positive effects. Offering few benefits, foolishly targeted, and substantially risky to low-skill workers, an indexed minimum wage must be viewed for what it is: a political tool that hurts the very people its advocates intend to help.

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