

THE MINIMUM WAGE DEBATE: ALWAYS OFF COURSE

A Commentary by Richard B. McKenzie

POLITICAL SUPPORT IS growing in Congress for another hike in the federal minimum wage. In response to President Clinton's 1999 State of the Union message call for a minimum wage increase, bills now before Congress would raise the minimum hourly wage by \$1, from \$5.15 to \$6.15, in two steps over the next year and a half.¹

The proposed increase will bring, as always, reactions from both sides of the aisle. Supporters and detractors in this heated and probably unavoidable debate will earnestly restate old arguments and past claims, and again both sides will be off course in the likely employment consequences of a minimum wage increase. In considering a new round of increases, all sides need to examine how a minimum wage hike will affect labor market incentives and how conditions of employment will react to whatever Congress legislates.

below its level of \$5.25 in 1999 dollars when it was raised at the start of 1950. In recent years, the minimum wage has fallen only slightly in real terms, from \$5.25 in October 1997, when the minimum wage was last raised, to \$5.15.²

Two Sides to an Old Debate

When the next minimum wage bill reaches the floor of Congress, it is all but certain that opponents and proponents in and out of Congress will once again lock political horns, no matter what increase is proposed. Outside interests, citing studies and statistics, will stand ready to promote or denounce the legislation. On the one side, Bob Herbert, a *New York Times* columnist and minimum wage supporter, cites a study by Bernstein and Schmitt (1998) of the Economic Policy Institute, a Wash-

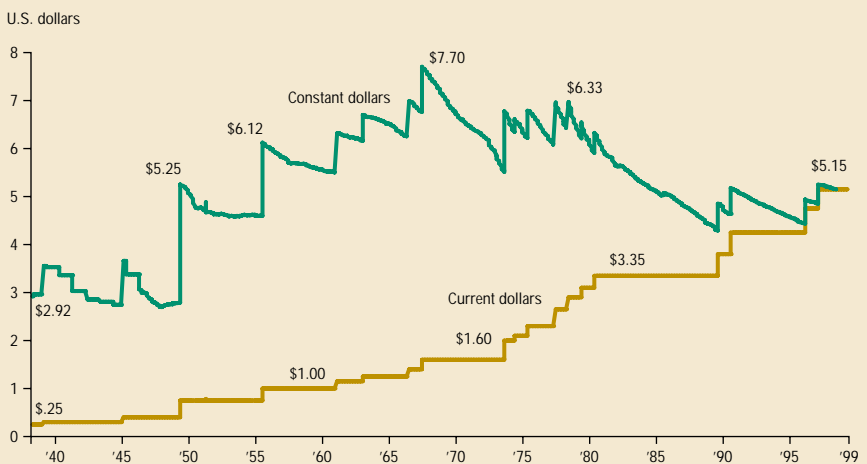
ington, D.C.-based think tank, that finds the last approved minimum wage hike raised the incomes of 10 million Americans. Herbert writes, "The benefits of the increase disproportionately help those working households at the bottom of the income scale. Although households in the bottom 20 percent (whose average income was \$15,728 in 1996) received only 5 percent of total national income, 35 percent of the benefits from the minimum wage increase went to these workers. In this regard, the increase had the intended effect of raising the earnings and incomes of low-wage workers and their households."³ Moreover, in the growing debate proponents like Herbert will continue to cite statistical studies that show a minimum wage hike will have no (or minimal) impact on the low-wage job count, reinforcing Bernstein and Schmitt's findings.

Herbert is convinced that such find-

The Minimum Wage in Current and Constant Dollars

In the emerging debate, much will likely be made of how the current federal minimum wage of \$5.15 an hour has no more purchasing power than the minimum wage of the early 1950s. As seen in Chart 1, the minimum wage in current dollars has risen in a series of 19 steps from 25 cents an hour in October 1938, when the first federal minimum wage took effect, to \$5.15 currently. However, in constant (February 1999) dollars the hourly minimum wage rose irregularly from \$2.92 in October 1938 to \$7.70 in 1968, then fell irregularly to its current level of \$5.15, a third less than the 1968 peak. The real value of the minimum wage in 1999 is slightly

Chart 1
Hourly Minimum Wage in Current and Constant (1999) Dollars
(October 1938–February 1999)



NOTES: 1938 data as of October; constant dollars based on February 1999 data.

ings should give minimum wage critics reason to eat their words. Herbert reminds his readers of comments by William A. Niskanen, chairman of the Cato Institute, former acting chairman of President Reagan's Council of Economic Advisors and an opponent of minimum wage increases, during the previous debate over increasing the minimum wage: "It is hard to explain the continued support for increasing the minimum wage by those interested in helping the working poor" (Bernstein and Schmitt 1998). Herbert and other minimum wage supporters will point anew to the empirical work of Princeton University's David Card and Alan Krueger (1994, 1995), who conclude that increases in the federal minimum wage in the early 1990s had no measurable negative effect on employment in New Jersey fast-food restaurants (and may have increased employment slightly). These same authors contend in a 1998 *Washington Post* article (Card and Krueger 1998) that more recent employment data from the Bureau of Labor Statistics corroborate their earlier findings.

Nevertheless, opponents will continue to argue that if Congress raises the cost of low-skilled labor, less than a fifth of the wage gains will go to households with incomes below the poverty level and more than half of the wage gains will go to households with more than twice the poverty income threshold (Couch 1999). They will also stress that several hundred thousand jobs are bound to be lost. Some employers will not be able to afford as many workers, and other employers can be expected to automate low-skill jobs out of existence. The opponents will back up their claims with statistics showing that some low-skilled workers will be better off (those who keep their jobs), but only because other low-skilled workers will be worse off (those who are unemployed).⁴ For example, a study by the Employment Policies Institute (Macpherson 1998), another Washington, D.C.-based think tank, concludes that a \$1.35 increase in the minimum wage could be expected to eliminate 7,431 jobs in the state of Washington by 2000, causing the affected workers to lose \$64 million in annual income.

Both sides will again err in their

assessments of the minimum wage increase because both fail to recognize that employers are a lot smarter and are pressed far more by labor market forces than the legislators think. Neither side seems to realize that Washington simply doesn't have the requisite power over markets to significantly improve worker welfare by wage decrees, no matter how well intended the legislation may be. This is why so many empirical studies show minimum wage increases have had a relatively small impact on employment. Indeed, most studies undertaken over the past three or four

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decades have found that a 10 percent increase in the minimum wage will lower the employment of teenagers (the group of workers most likely to be adversely affected by the minimum wage) by a surprisingly small percentage—anywhere from 0.5 percent to 3 percent.⁵ Further, a tight labor market, such as currently exists in the United States, implies relatively smaller reductions in the number of lost jobs with any given percentage increase in the minimum wage.⁶ When labor economists were asked to give their personal estimate of the effect on employment of a 10 percent increase in the minimum wage, they projected, on average, a decline in teen employment of 2.1 percent.⁷

Minimum Wage Hikes' Effect on Employment

Why have the percentage estimates of job losses been so low? The simple answer is the labor markets for low-skilled workers are highly competitive, which explains the low wages paid workers with limited skills in the first place. Many employers of low-skilled workers would love to be able to pay their workers more, but they have to face a market reality: if they pay more, then their competitors would have a cost advantage in pricing their products.

When Congress forces employers to pay more in money wages, it causes them to pay less in other forms, most notably in fringe benefits. And if there are few fringes to take away, the employers can always increase work requirements.

Why would employers curb benefits and increase work requirements? First, because they *can* do it. A minimum wage hike will attract a greater number of workers (and workers who are more productive). It will also cause some employers to question whether they can hire as many workers as they currently employ unless adjustments are made. Hence, in a tight labor market the forced wage hike strengthens the employers' bargaining position. Employers can tell prospective workers, "If you don't like it, I can hire someone else. Your replacements are lined up at my personnel office door."⁸ Employers will make the adjustments for an *offensive* reason—to improve their profits (or curb losses).

Second, and perhaps more important, employers of covered workers must cut fringes and/or increase work requirements or face the threat of losing their market positions as their competitors take these same actions. Employers will make adjustments for *defensive* reasons—to prevent their market rivals from taking a portion of their markets and causing their profits to fall (or losses to mount).

Third, if employers don't cut fringes and/or increase work requirements, the value of the company's stock will suffer, opening up opportunities for investors

Competitive market pressures will force firms to do what is right by their bottom lines and their workers. This means that when the minimum wage is raised, the value to the workers of the fringe benefits and less onerous work requirements they are forced to give up will be greater than the value of the additional money income.

to buy the firm, change the firm's benefit/work requirements policies, improve the firm's profitability and then sell the firm at a higher market value. Employers—either the original or new owners—will make the adjustments for *financial* reasons—to maximize their firms' share values.⁹

The net effect of the adjustments in fringes and work requirements is to largely neutralize the cost impact of the minimum wage hike. For example, when the minimum wage increases by \$1, the cost of labor may, on balance, rise by only 5 cents. Such an adjustment explains why Card and Krueger (1994, 1995) and more than a hundred other statistical studies have found that minimum wage hikes have caused a small, if not negligible, percentage drop in jobs even among that group of workers—teenagers working at fast-food restaurants—whose jobs are most likely to be cut.¹⁰

This line of argument can also help us understand why workers who retain their jobs are unlikely to be any better off. They get more money, but they also get fewer fringes and have to work harder for their pay. The covered workers who retain their jobs will be worse off—at least marginally so—because the only reason an employer intent on making as much profit as possible would offer the fringes and less onerous work requirements in the first place is that the workers valued the nonmonetary work benefits more highly than they valued the money wages they had to give up to get those benefits. And profit-maximizing employers aren't about to offer workers anything that's costly unless they get something in return, like greater output per hour or a lower wage bill.

If a firm offers costly benefits that do not lower wages or fails to offer benefits that *could* lower wages, then that firm becomes vulnerable to takeover. Some savvy investor can be expected to buy the firm, change its benefit policies and lower wages by more than other costs rise—thereby improving the firm's profitability—and then sell the firm for a higher price.

Make no mistake about it, profit-maximizing firms do not "give" fringes to their workers; they require their workers to pay for the fringes through wage-

rate reductions. The wage-rate reductions can be expected because if workers value the fringes, the supply of workers will go up, forcing the money wage rate down.

It follows that competitive market pressures will force firms to do what is right by their bottom lines *and* their workers. This means that when the minimum wage is raised, the value to the workers of the fringe benefits and less onerous work requirements they are forced to give up will be greater than the value of the additional money income.

Put another way, the workers who retain their jobs are made worse off (perhaps marginally so) despite the money-wage increase. Employment in low-skill jobs may go down (albeit ever so slightly) in face of minimum wage increases not so much because the employers don't want to offer the jobs (as traditionally argued), but because not as many workers want the minimum wage jobs that are offered.¹¹

Empirical Evidence

Have the expected effects been seen in empirical studies? The most compelling evidence is captured in the many studies already cited that indicate job losses from a minimum wage increase tend to be small, even within the worker groups most likely to be adversely affected. However, other studies over the past two decades have attempted to directly assess the impact of minimum wage increases on fringes and work requirements, as well as the overall value of jobs:

- Hashimoto (1982) finds that under the 1967 minimum wage hike, workers gained 32 cents per hour in money income but lost 41 cents per hour in training (a net loss of 9 cents per hour in full-income compensation).
- Leighton and Mincer (1981) conclude that minimum wage increases reduce on-the-job training and, as a result, dampen growth in the real long-run income of covered workers.
- Wessels (1987) finds that the mini-

imum wage caused retail establishments in New York to increase work requirements. In response to a minimum wage increase, only 714 of the surveyed stores cut back store hours, but 4,827 stores reduced the number of workers and/or the hours they worked. Thus, in most stores, fewer workers were given fewer hours to do the same work as before.¹²

- Research by Fleisher (1981), Alpert (1986) and Dunn (1985) shows that minimum wage increases lead to large reductions in fringe benefits and to worsening working conditions.

If the minimum wage does not cause employers to make substantial reductions in nonmoney benefits, then we would expect increases in the minimum wage to cause (1) an increase in the labor-force participation rates of covered workers (because workers would be moving up their supply-of-labor curves), (2) a reduction in the rate at which covered workers quit their jobs (because their jobs would then be more attractive) and (3) a significant increase in prices of production processes heavily dependent on covered minimum wage workers. However, Wessels (1987) finds little empirical support for such conclusions drawn from conventional theory. Indeed, in general, he finds that minimum wage increases had the exact opposite effect: (1) participation rates went down, (2) quit rates went up and (3) prices did not rise appreciably—findings consistent only with the view that minimum wage increases make workers worse off. With regard to quit rates, Wessels writes:

I could find no industry which had a significant decrease in their quit rates. Two industries had a significant increase in their quit rates....These results are only consistent with a lower full compensation. I also found that quit rates went up more in those industries with the average lowest wages, the more full compensation is reduced. I also found that in the long run, several industries experienced a significantly large increase in the quit rate: a result only possible if minimum wages reduce full compensation.

From this perspective, the figures cited by Herbert on the added income received by 10 million workers are grossly misleading because the figures suggest the affected workers are better off, which is not likely to be the case, given their loss of fringe benefits and their increased work requirements. The fact that Card and Krueger (1994, 1995) also find no loss of jobs suggests the market may have forced nonwage adjustments on the fast-food restaurants studied.

Although economists might speculate that the job reductions have been small because the low-skilled labor market exhibits a low elasticity of demand (or low responsiveness among employers to a wage hike), such an explanation is hardly compelling. The demand elasticity for anything, including labor, is related to the number of substitutes the good (or labor) has: the greater the number of substitutes, the greater the ability of buyers (employers) to move away from the good (labor) when the price (wage rate) is raised and, hence, the greater the responsiveness of buyers (employers), or elasticity of demand.

The problem with this explanation is that no labor group has more substitutes than low-skilled (minimum wage) workers, especially now that firms have so much flexibility to automate jobs out of existence or to replace domestic workers with foreign workers by way of imports. The elasticity of demand for low-skilled labor must be relatively high; hence, the relatively small decline in the number of low-skilled workers in response to a minimum wage hike points to one central conclusion: the mandated wage hike is offset in large measure by other adjustments in the affected workers' compensation packages.

Minimum Wage Consequences Over Time

This line of argument does not lead to the conclusion that minimum wage increases of given amounts should always have the same employment effect no matter when they are legislated. Look-

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ing back at Chart 1, we might reason that as the real minimum wage rose between 1938 and 1968, employers did what they were pressed to do to moderate their labor cost increases: take away progressively more fringe benefits and add progressively more work requirements (compared with what they would have done). Thus, as time passed we would expect the employment effects of a given minimum wage increase to go up as 1968 approached simply because there were fewer ways for employers to adjust to the wage hike.

Conversely, as the minimum wage fell irregularly after 1968, we would expect employers to respond by gradually adding back more fringe benefits and relaxing work requirements (a trend that has likely accelerated with the increasingly tight labor market in the late 1990s). The result would be that in the 1990s employers would have had more ways to adjust to a minimum wage hike than they had in, say, the late 1960s. As a consequence, we should not be surprised that Card and Krueger (1994, 1995) find little or no employment effect in the early 1990s, whereas studies in the 1960s find larger effects.¹³ Nor should we be surprised if future studies of the impact of any 1999 minimum wage increase show similarly negligible negative employment effects.

Conclusion

Congress and the president need to recognize a simple fact of modern economics: you can't fool the market as much as you imagine, at least not all the time. Legislators simply do not have as much power to manipulate markets as they think. Thus, we can anticipate that, once again, the chosen increase in the minimum wage will have minimum employment consequences for two reasons. First, Congress will choose a fairly small increase in the minimum wage because of political groups working against the bill. Second, market forces will largely neutralize the potential negative employment effects of whatever wage increase is legislated.

Notes

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- ¹ The companion bills, if passed, would raise the minimum wage from \$5.15 to \$5.65 per hour on September 1, 1999, and to \$6.15 per hour on September 1, 2000 (Fair Minimum Wage Act of 1999, 106th Cong., 1st sess., H.R. 325, S.R. 192). Another bill would delay the full \$1 increase until September 1, 2001, but it would go one step further and raise the minimum wage annually by the Consumer Price Index after September 1, 2002 (Long Term Minimum Wage Adjustment Act of 1999, 106th Cong., 1st sess., H.R. 964).
- ² The percentage of nonsupervisory workers covered by the federal minimum wage rose from 57 percent in 1950 to 87 percent in 1988 (the latest year of available data). This rise in coverage should have caused any increase in the minimum wage to have a progressively greater negative employment effect over the years, which is what economist Marvin Kosters finds (see Kosters 1989).
- ³ See Herbert (1998).
- ⁴ Several recent statistical studies on the negative employment and income impacts of state and federal minimum wage hikes can be found on the Employment Policies Institute web site, <http://www.epionline.org/research_frame.htm>.
- ⁵ For reviews of the minimum wage literature, see Brown, Gilroy and Kohlen (1982) and Brown (1988). In more recent studies in the 1990s, the reported employment effects among teenagers continue to be relatively small (see Burkhauser and Wittenburg 1998).
- ⁶ These estimates of labor market responsiveness to minimum wage hikes are independent of labor market tightness. If the country's labor markets remain relatively tight over the next year or so, the number of low-skilled workers covered by the minimum wage can be expected to fall as market-determined wage rates for low-skilled workers rise past the proposed new levels for the minimum wage. (Currently, only about 4 million Americans work at the federal minimum wage.) Hence, while the percentage reduction in the number of minimum wage jobs may remain more or less in line with past studies, it stands to reason that the actual number of minimum wage jobs will fall as the number of covered workers shrinks.
- ⁷ See Fuchs, Krueger and Poterba (1998).
- ⁸ Tight labor markets, like the ones in the United States in 1999, can cause wages and fringe benefits to rise, even for low-skilled workers, and can cause the number of workers affected by any minimum wage hike to fall. However, the point that minimum wage hikes increase the relative bargaining power of employers still holds for those workers remaining at the minimum wage. Moreover, if employers have responded to their tight labor markets by increasing their workers' fringe benefits, then there will be more benefits for employers to take away when faced with a hike in the mandated money wage rate.
- ⁹ Indeed, it may be interesting to note that, at least conceptually, minimum wage workers might contemplate the prospects of buying their firms if their firms did not make compensation and work adjustments and if they, the minimum wage workers, could make the purchase. The point here is that even worker groups can see the financial benefits of adjusting fringe benefits and work requirements in light of a minimum wage increase.
- ¹⁰ Even the Employment Policies Institute study (Macpherson 1998), which contains estimates of employment losses that are on the high side of the expected range, shows a reduction in Washington's total employment (2.7 million workers) of less than 0.3 percent in response to a proposed 26 percent increase in the state's minimum wage. It can be noted that if Washington has the average percentage of minimum wage workers—8.8 percent—then the Macpherson study suggests that each 10 percent increase in the minimum wage

would lower the employment of covered workers by, at most, 1.2 percent.

¹¹ Granted, not all low-skilled workers have many fringe benefits that can be taken away, and some minimum wage workers may be working very hard. The argument that is being developed suggests that the negative employment effects of a minimum wage increase will be concentrated among this group of particularly disadvantaged workers.

¹² For more details, see Wessels (1980).

¹³ The implication of the theory that a minimum wage hike will have a greater impact on employment when the minimum wage is high, compared with when it is low, has not been rigorously tested. However, it is interesting to note that through the 1950s, 1960s and early 1970s the *New York Times* staunchly supported increases in the minimum wage, mainly because the evidence on the negative employment effect was not strong. However, as the evidence mounted in the 1960s that minimum wage hikes had a negative employment effect, especially among minority teenagers, the newspaper began to shift its editorial stance. By the mid-1980s, it favored a minimum wage of "\$0.00." The *New York Times* has since shifted its editorial stance back to support for minimum wage hikes, mainly because the negative employment effects have been shown to be nil in recent studies. See McKenzie (1994).

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