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In Support of Raising the Minimum Wage

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Abstract

The minimum wage is back on top of the economic policy agenda. President Obama supports an increase at the federal level, legislation has been introduced in Congress, and many states and localities with minimum wage laws are seriously considering increases. Raising the federal minimum wage has pros and cons, but on net it would provide a meaningful boost to the incomes of low-income workers without hurting the job market or economy.

In Support of Raising the Minimum Wage

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The minimum wage is back on top of the economic policy agenda. President Obama supports an increase at the federal level, legislation has been introduced in Congress, and many states and localities with minimum wage laws are seriously considering increases. Raising the federal minimum wage has pros and cons, but on net it would provide a meaningful boost to the incomes of low-income workers without hurting the job market or economy.

The Federal Minimum Wage Act introduced by Senator Tom Harkin (D-IA) is a reasonable starting point for debate. It would raise the federal minimum wage from $7.25 to $10.10 per hour over three years, and then index it to inflation. The FMWA would also raise the subminimum wage paid to workers who receive tips, from close to 35% of the minimum currently to 70%.

Given the difficult economy and job market, the FMWA provides for too large an increase in the minimum wage too quickly. Many small businesses would struggle to adjust to such a sharp increase in their wage costs. More economically palatable, and also comparable to other OECD countries, would be to phase in the increase to $10.10 per hour over five years. The minimum wage should be indexed to inflation, but Congress may want to consider indexing it to the chained consumer price index—the most accurate inflation measure. The subminimum wage should also be increased to 50% of the minimum wage, about the level when it was first introduced.

Haves and have-nots

The principal benefit of increasing the minimum wage is help for the working poor. Their incomes are falling further behind, exacerbating the growing divide between the haves and the have-nots in America.

This divide is evident in income and wealth, but perhaps most importantly in consumer spending. Those in the bottom 40% of the income distribution account for only 10% of all personal outlays, compared with 35% spent by those in the top 5% of the income distribution. Those who are well-off have seen their share steadily increase over the past 15 years, while all other income groups have seen their shares fall (see Chart 1).

Strong economic forces are driving this trend. Technological change and globalization benefit those with more talent, education and training, enabling them to sell what they produce to consumers across the globe. Those with lesser skills and education are hurt, as they must compete with lower-paid workers in the rest of the world.

Fewer Americans are able to move up the income ladder. Lower-income households are not receiving the education and training necessary to win the jobs that would improve their financial situations. Intense financial and social pressure breaks many households apart, reinforcing income and wealth gaps across generations.

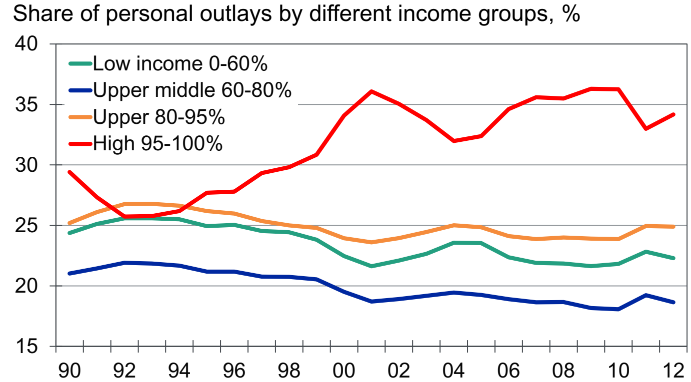
Since the federal minimum wage is currently not tied to inflation and was last increased in 2009 to its current $7.25 per hour, it is becoming steadily less helpful to low-income workers. Today 3.5 million workers earn the federal minimum wage or less, accounting for fewer than 5% of workers.

The minimum wage is also failing to keep workers out of poverty. A single parent working full time year-round and earning the federal minimum wage is below the poverty line. In the late 1960s, when the minimum wage was at its highest level in real, inflation-adjusted terms, it lifted a family of three out of poverty.[1]

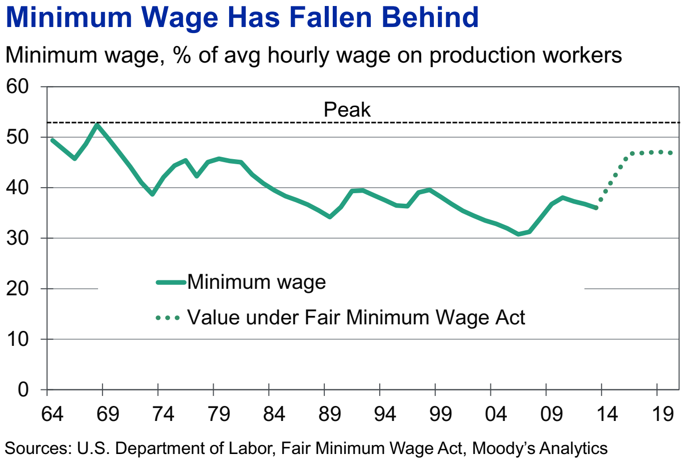
And those earning the minimum wage are falling further behind the typical American worker. In the late 1960s, someone receiving the minimum wage earned about

Increasingly Skewed Distribution

Share of personal outlays by different income groups, %



Sources: Federal Reserve, Moody's Analytics



half the average wage of production and nonmanagerial workers. By the mid-2000s, at its low in real terms, the minimum wage was only 30% of the average wage (see Chart 2). It rose in the last round of minimum wage hikes between 2006 and 2009, but it is still low compared with minimum wages in more than 60 OECD countries. On average across these countries, the minimum wage is close to 45% of the average wage in that country.

The erosion in the minimum wage compared with the average wage explains as much as two-thirds of the skewing in the bottom half of the income distribution. Not only are high-income households pulling away from those at the bottom, but so too are middle-income households. This is especially true for female workers.

Overstated job effects

Arguments that lifting the minimum wage will cost low-income workers their jobs are significantly overstated. It sounds intuitive—if businesses must pay workers more they will employ fewer workers—but historically the increases have been too modest to have much impact on jobs.

Few economic policies have received more attention from economists. The federal minimum has been raised dozens of times over the years, and nearly half the states have minimums above the federal level, creating many real-world experiments through which to gauge its impact.[2] The bottom line is that while raising the minimum wage has probably eliminated some jobs for very low-skilled workers, this loss has been marginal.

The impact is marginal for many reasons. Chief among them is that the higher wage significantly reduces turnover and absenteeism, two very significant costs for businesses that employ low-skilled workers. The higher wage provides a strong incentive for workers to stay in their jobs and perform well. There is also evidence that it encourages more effort while on the job.

Another factor mitigating any negative fallout is the incentive a higher minimum wage creates for unemployed and discouraged workers to search for open positions, and to take a position when offered. A higher minimum wage is more likely to be above workers' "reservation wage," the amount needed to pay for commuting, childcare, and other pecuniary and nonpecuniary costs of working. This could help reduce the growing number of vacant job positions and the currently high level of long-term unemployment.

Since a higher minimum wage boosts the incomes of low-income workers, many of whom live paycheck to paycheck, it also lifts overall consumer spending. Some effects offset this such as businesses raising prices to recoup some of the higher wage costs. But on net, raising the minimum wage provides a dose of economic stimulus. Perhaps an even more important point was made a century ago by Henry Ford, who famously said he paid his workers enough to purchase the Model T cars they produced.

A higher minimum wage does put significant financial pressure on some firms, and even precipitates some business failures. Evidence suggests, however, that reducing the number of struggling businesses fighting to hang on lessens pressure on stronger, more innovative firms. It also clears the way for new business births. The overall impact on jobs is negligible.[3]

Who benefits?

Low-income workers are the significant beneficiaries of a higher minimum wage: Few jobs are lost and their incomes are meaningfully increased. Worries that this benefit mostly goes to teenagers working part time, and not to low-wage workers trying to support families, are overdone.

A vast majority of those who receive the minimum wage or less are at least 20 years old, and half are over 30. For those younger than 20, under current law, an employer can pay a minimum of $4.25 an hour for the first 90 consecutive days of employment, after which the full minimum wage must be paid.[4]

About half of those earning the minimum wage are full-timers working at least 35 hours per week, and almost all work at least 20 hours per week. Those with some college education outnumber those who dropped out of high school by more than twice.

More than half the benefits of higher minimum wages go to those with incomes in the bottom third of the workforce, those with family incomes below $40,000. One-fourth of the benefits go to the bottom tenth of the workforce, those making less than $20,000. The typical minimum wage earner is responsible for bringing home half of his or her family's earnings.

These statistics strongly suggest that the majority of minimum wage workers are adults who work full time and rely on their minimum wage jobs as primary sources of income.

Adjusting FMWA

The Fair Minimum Wage Act is a reasonable starting point for debate over increasing the minimum wage. It would result in wage increases for some 16.5 million workers and lift almost 1 million workers above the poverty line by 2016.[5]

Yet FMWA is overly aggressive given the halting economic recovery. The law would increase the minimum wage almost 40% three years after enactment, equaling an increase of 13% per year.

Although this is roughly equivalent to the increase in the minimum wage between

2006 and 2009, the minimum wage was much lower on a real basis at that time. Thus, despite the sizable increase, market wages were still clearly higher in most parts of the country. Given the damage done to the job market in the Great Recession and the stagnant real wage growth since then, the FMWA's proposed increase will be meaningfully harder for businesses and the job market to digest gracefully. The law would decrease employment by an estimated 420,000 jobs by year-end 2016.

To help with the adjustment, the minimum wage should be increased to $10.10 per hour as proposed by FMWA, but over five years beginning in 2015. This would translate into an 8% per year increase in the minimum wage—still a significant increase but manageable, especially if the job market improves as expected. At the current pace of improvement, unemployment and labor force participation will return to near levels consistent with full employment by 2017. Real market wages should be rising consistently by then. Pushing the first increase in the minimum wage to 2015 would also provide businesses more time to prepare and adjust.

At $10.10 per hour, the minimum wage at the start of 2020 would also make it comparable to the minimum wage in the average OECD country. Under reasonable assumptions about future U.S. and global wage growth, the U.S. minimum wage would be approximately equal to 45% of the average U.S. wage for production and nonmanagerial workers. This would be squarely in the middle of the distribution of OECD countries.

After 2020, the minimum wage should be indexed to inflation. This would provide some certainty both to employers and workers. It would also reduce wage volatility, preventing real wages from falling over long periods until lawmakers act to raise them sharply. Indexation would make the adjustment process predictable and thus less costly.

Lawmakers should also consider using the chained consumer price index to adjust the minimum wage. While controversial, given recent failed legislative efforts to adopt the chain index to calculate increases in Social Security benefits, it is a more accurate inflation measure than the conventional CPI. The chained index increases at a pace more consistent with the prices businesses are able to charge. Using it to index the minimum wage will thus ensure that the minimum wage maintains real purchasing power but does not cut into businesses' profit margins and their ability to hire.

Fixing the subminimum wage for workers to 50% of the minimum wage would also bring it back near its original level in real terms. This is less than the 70% wage proposed in the FMWA, but well above the current 35%.

Making these adjustments to the FMWA would mean fewer low-wage workers would be lifted out of poverty, but it would significantly mitigate any employment effects. By the end of 2016, employment would be reduced by an estimated close to 80,000 jobs. By 2020, the impact on employment would not be statistically significant from zero.

Earned income tax credit

There are ways to help the working poor other than raising the minimum wage. The most obvious would be to expand the earned income tax credit. The credit encourages work, since to claim it, a taxpayer must have income from a job. It helps low-income workers because it is refundable, meaning that if the credit exceeds a low-wage worker's income tax liability, the taxpayer still receives the balance.

The tax credit mainly benefits working parents with children. The expansion of the EITC in the 1990s significantly increased labor force participation among single mothers. This makes it especially appealing today, when many women are leaving the workforce. Children in families that received the tax credit do better in school, are likely to attend college, and earn more as adults.

Another benefit of the EITC is that the cost is borne by all taxpayers, especially those with high incomes who pay more taxes. A hike in the minimum wage is paid mostly by businesses, particularly retailers, restaurants and similar firms that employ many minimum wage earners. These industries include large companies but also many small firms that operate on thin profit margins and will be squeezed when wages rise.

Increasing the EITC for childless workers would be especially helpful. The average credit for childless workers who qualify is less than $300, or one-tenth the average for filers with children. In addition, the childless workers' EITC begins phasing out when earnings exceed about $8,000, or just 55% of full-time, minimum wage earnings. As a result, a childless adult working full time at the current minimum wage, and thus earning $14,500, does not receive an earned income tax credit.

Yet while expanding the EITC would be good policy, it is not a replacement for a higher minimum wage. Employers capture a meaningful share of the credit by paying lower wages, due to the increased supply of low-income workers encouraged by the credit to enter the labor force. A higher minimum wage would complement the EITC by ensuring workers get the full benefit of the credit.

It is also important to note that the benefit of the earned income tax credit comes in the form of a tax refund once a year. A higher minimum wage helps low-income workers year-round with expenses.

Employment subsidies

Another way to help low-income workers is through subsidized jobs. Thirty-nine states and the District of Columbia established subsidized jobs programs for jobless low-income parents and youths during the recession. The program was funded by the Recovery Act, but funding ended in 2010.

Many states worked directly with private employers, requiring them to contribute to the cost of the job subsidy. States took various approaches to setting maximum wage levels and duration for subsidized jobs. Typically, employers created positions that low-income parents or youths filled from six months to a year. Later assessments found the programs' results have been good.

A subsidized jobs program may be especially useful today with so many workers unemployed long term. Being out of work for extended periods has eroded these workers' skills and marketability, exacerbating their problems. A subsidy to hire the long-term unemployed could encourage employers to give them a chance.

Conclusions

An increase in the minimum wage is overdue. Bringing the minimum wage back in line with middle-income wages and minimum wages in other countries would provide a significant boost for low-income workers, without hurting the broader economy. Businesses that employ low-wage workers will need to adjust to the higher minimum wage, but historically they have done this gracefully. With a few judicious changes to the FMWA, this time should be no different.

(Endnotes)

1 At $7.25 per hour, a single parent with one child working full time earns $14,500, below the poverty threshold of $15,130. For context, when the minimum wage was at its highest in real terms in 1968, such a worker would have earned $21,200 in today's dollars.

2 The most influential study demonstrating this is found in "Minimum Wage Effects Across State Borders: Estimates Using Contiguous Counties," Dube, Lester and Reich. Review of Economics and Statistics, 2010, vol. 92, no. 4, pp 945-964.

3 This is demonstrated in "Firm Dynamics and the Minimum Wage: A Putty-Clay Approach." Aaronson, French and Sorkin. Federal Reserve Board of Chicago Working Paper, November 2013.

4 Full-time students (regardless of age) employed at retail, service stores, farms or colleges can be paid 85% of the minimum wage, but work hours are also limited while school is in session. High school students at least 16 years old can be paid 75% of the minimum wage as long as they are enrolled in vocational school.

5 Estimates of the economic impact of the FMWA and the proposed changes to the FMWA are based on the analysis and macroeconometric models of Moody's Analytics. They differ from those estimated by the CBO in "The Effects of a Minimum Wage Increase on Employment and Family Income," CBO, February 2014.

About the Authors

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Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his B.S. from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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