The minimum wage: a perspective

The Federal minimum wage was established in the depression conditions that gripped the United States economy in the late 1930's. Aimed at bolstering the paychecks of low-wage workers, the law not only has continued but has been expanded. Now, forty years after the initial legislation, the minimum wage provisions cover nearly two thirds of the nation's employees. More than 4½ million workers, or about one in every twenty workers, were directly affected by the 15 percent jump in the Federal minimum wage to $2.65 on January 1, 1978. While such increases in the legal wage floor have the beneficial effect of raising the earnings of particular segments of the working poor, they also entail certain social costs as well. Increases in the minimum wage contribute to raising the underlying rate of inflation. At the same time, because laws cannot mandate increases in worker productivity, a higher wage floor can exceed some employees' productivity so that employers cut back on their payrolls, creating unemployment for some. Recent research suggests that increases in the minimum wage serve to raise the joblessness of teenagers, particularly minority youths.

The minimum wage forty years later

The Fair Labor Standards Act (FLSA) of 1938 was designed to improve the working conditions of American labor. Among other features, the legislation introduced a minimum wage of 25 cents per hour that would serve as "a floor under wages". At first, the minimum wage was limited to employees in industries engaged in the production of goods for interstate commerce. It is estimated that initially the legislation covered about 11 million workers, or about 25 percent of total employment.

Over the ensuing forty years, various amendments and revisions raised the minimum wage (table). As a result of the 1977 amendments, the legal wage floor rose to $2.65 per hour and, on January 1, 1979, the wage floor is legislated to rise to $2.90 per hour. Subsequent increases are slated to bring it to $3.35 per hour at the beginning of 1981.

As the wage rate was raised over the years, the coverage of the legislation has been broadened to the point that coverage has expanded markedly in low-wage industries.[1] By 1976, some 56 million workers, or close to two thirds of total employment, were covered by Federal minimum wage legislation. The continued expansion of coverage of the minimum wage provision of the FLSA was reversed by a 1976 Supreme Court decision. In a ruling, referred to as the National League of Cities decision, the Court held that state and local government employees who are engaged in traditional governmental functions are not subject to the minimum wage provisions. As a consequence, an estimated 5 million workers were removed from the coverage of the legislation.

From the start, the FLSA allowed employers to apply the value of board, lodging, and other facilities traditionally furnished to employees toward meeting minimum wage requirements. In 1966, when the coverage of the minimum wage was extended to many workers whose compensation depended importantly on tips, the amendment permitted employers to count employees' tips as meeting up to one half of the minimum wage. In addition to raising the minimum wage, the 1977 amendment provided for a step-by-step reduction in this "tip credit" from the current 50 percent to 40 percent by 1980.

Coverage of the FLSA's minimum wage provisions

[1] As the coverage of the minimum wage has been expanded, the pay of newly covered workers has not been immediately brought into parity with the wages of those already covered. Instead, wage schedules have been established to bring the newly covered workers gradually into equality with the general minimum wage over a period of several years.

Chronology of Federal Minimum Wage and Worker Coverage, 1938-81

Effective date	Minimum wage ($ per hour)	Worker coverage (in thousands)
October 24, 1938	25	11,000
October 24, 1939	30	12,500
October 24, 1945	40	20,000
January 25, 1950	75	20,900
March 1, 1956	1.00	24,000
September 3, 1961	1.15	27,500
September 3, 1963	1.25	27,500
February 1, 1967	1.40	40,400
February 1, 1968	1.60	41,600
May 1, 1974	2.00	56,100
January 1, 1975	2.10	57,400
January 1, 1976	2.30	56,100
January 1, 1978	2.65	51,900*
January 1, 1979	2.90	†
January 1, 1980	3.10	†
January 1, 1981	3.35	†

* National League of Cities decision eliminated most state and local government coverage

† Not available

Source: United States Department of Labor, Employment Standards Administration

has always varied with respect to industry and occupational groups. In many industries, such as manufacturing and transportation, the coverage is nearly complete. Institutions of higher education, as well as certain other employers of full-time students on a part-time basis, may offer wage scales at special rates below the minimum. In addition, in order not to burden small businesses, the Congress exempted retail and service firms with annual sales of less than $250,000 from the minimum wage. As a result of the 1977 FLSA amendments, this sales level was raised to $275,000 on July 1, 1978 and is scheduled to rise further, ultimately reaching $365,500 on December 31, 1981. With respect to occupations, executive, administrative, professional, and outside sales jobs, as well as casual baby-sitting and serving as a companion for the aged and infirm, are exempt from minimum wage legislation.

Hurting some it aims to help

Concern for the well-being of low-income Americans led the Congress to enact and to expand the minimum wage legislation. Underlying these Congressional actions was the view that any employed American should be able to enjoy a standard of living above the poverty level. There is little question that, for the majority of workers whose wages are close to the minimum, an increase in the minimum wage increases their paychecks and they are better off than they would be otherwise. But that is only one effect of an increase in the minimum wage. While lawmakers can raise *wage rates*, incomes may not necessarily increase since the higher wage will result in some workers being unable to find jobs or working fewer hours. The central problem is that laws cannot mandate increased worker productivity.

If the minimum wage is raised above the pay level consistent with a worker's productivity, employers respond by reducing their payrolls. Who will bear the burden of the higher minimum? It will be the least productive, low-skilled workers—those whose productivity is below the hourly wage floor. In the jargon of economists, they are the "marginally productive" workers, many of whom are teenagers and minorities, who lack experience and suffer handicaps that lower their productivity.

For the most part, economic theory has always recognized that imposing a wage floor creates unemployment for some. What economists were unable to answer was whether the unemployment effects were large or small. For many years, numerous studies tried to evaluate the impact of the legislated wage on unemployment, but the results were inconclusive. The problem centered on isolating the effects associated with the minimum wage from the myriad of influences that affect unemployment. More recently, however, the inconclusive evidence of the past has given way to research that has established a clear link between unemployment among youths, especially minority youths, and increases in the minimum wage. The econometric evidence offered by Gramlich, Ragan, and Mincer, among others, has clearly established that teenagers' employment is adversely affected by the minimum wage legislation.[2] Establishing this relationship meant using advanced statistical tools that were designed to distinguish between the effects of the minimum wage and the influence of other factors, such as economic activity.

Why does the minimum wage affect teenagers? The answer is simple: most young people are low-wage earners and, as a result, raising the minimum wage can be expected to have a more pronounced impact on them than on other workers. In mid-1977, the average

[2] Edward M Gramlich, "Impact of Minimum Wages on Other Wages, Employment, and Family Incomes", *Brookings Papers on Economic Activity* (II, 1976), James F Ragan, Jr, "Minimum Wages and the Youth Labor Market", *Review of Economics and Statistics* (May 1977), Jacob Mincer, "Unemployment Effects of Minimum Wages", *Journal of Political Economy* (August 1976)

teenager was paid $2.58 per hour, some 28 cents above the 1977 minimum and 7 cents below the 1978 minimum. Black youths were paid even less, on average.

Although the estimates of the effect of a raise in the minimum wage on youth joblessness differ, a reasonable estimate suggests that by itself raising the minimum wage to $2.65 per hour added about 1 percentage point to the unemployment rate of all teenagers and 3 to 4 percentage points to the jobless rate of black youths. In addition, on the basis of historical experience, the increase in the minimum wage may be expected to reduce substantially full-time employment of teenagers and to force many of them into part-time employment.[3] Although these youths will be denied full-time employment, they will be employed on a part-time basis and will not be included among the jobless.

With increases in the minimum wage serving to reduce job gains, teenage joblessness, especially among minorities, remains an important social problem. In September 1978, the teenage unemployment rate stood at 16.6 percent, remaining unrelentingly high. Among black and other minority youths, the official rate of joblessness hovered close to 35 percent in September 1978. Moreover, the official rate of unemployment probably *understates* the actual unemployment of youths, particularly among blacks and other minorities. This understatement is because many minority youths, faced with such limited prospects of finding employment, simply withdraw from the labor force by ceasing to look for work, and thus are no longer counted among the unemployed. The result is that a much smaller proportion of minority youths are in the labor market. For example, the participation rate of young black males is around 40 percent, compared with some 65 percent of white youths who are in the labor force.[4]

A high rate of joblessness among youths is not new, nor is it unique to the United States.[5] The rate of unemployment among young people should be expected to be greater than for adults. In part, this is because youths are not closely tied to the labor market and are also searching alternative job opportunities.

[3] On this point, see Edward M. Gramlich, "Impact of Minimum Wages on Other Wages, Employment, and Family Incomes", *Brookings Papers on Economic Activity* (II, 1976).

[4] The labor force participation rate is the proportion of the noninstitutionalized population 16 years of age and above in the labor force, *i e*, the proportion of the population of working age who are either employed or seeking employment. The participation rate can be determined separately for the population as a whole or for any particular demographic group. For more on this topic, see "The Changing Composition of the Labor Force" in this Bank's *Quarterly Review* (Winter 1976).

[5] For an overview of this important social ill, see Walter E. Williams, *Youth and Minority Unemployment*, a study prepared for the Joint Economic Committee, July 6, 1977.

But the current rate of joblessness is unacceptably high. What is particularly distressing is that early experiences in the labor market are likely to affect lifetime earnings and employment behavior. Thus, the lack of jobs means failing to gain on-the-job training, work experience, and the opportunity to develop work habits. Government programs such as the minimum wage inhibit the efficient functioning of the markets, tending to raise the rate of unemployment.

The "need" to limit low-paying jobs

One point made by some in support of the Federal minimum wage is that increasing the legal wage floor is a way of eliminating menial, or so-called "dead-end", jobs. Employers respond to the increase in wages by substituting capital for labor inputs. Such capital outlays serve to raise productivity, or output per man-hour, which means a higher standard of living for the nation. Advances in the nation's potential to produce are to be desired, but the unemployment associated with such changes as the replacement of manually operated elevators by automatic elevators is not necessarily welcome. Many of today's high school seniors, let alone the large number of dropouts from school, lack the basic reading, writing, or computational ability necessary to obtain entry to skilled jobs. In view of these realities, there is clearly a need for jobs to accommodate the many youths who have but limited skills.

In any case, labeling jobs as dead-end positions is unwarranted. Jobs that are so labeled can be an important opportunity for many disadvantaged youths. Unskilled jobs are entry-level jobs, positions from which individuals can progress and advance. These jobs offer a chance for many of the nation's disadvantaged youths to obtain some of the rudimentary skills that many lack.

Inflation and the minimum wage

In addition to affecting employment, increases in the minimum wage also increase prices, since the rise in the wage floor represents an important rise in employers' wage costs. The Department of Labor estimates that the 1978 increase directly added more than $2 billion to the annual wage bill of the economy. In addition to the nearly 5 million workers whose wages were directly affected, the minimum wage can also lead to a rise in the wages of others as the entire pay structure of many firms or industries is adjusted to the higher base pay.[6] With labor productivity growth unlikely to be affected in the near term, these higher wage costs mean increased unit labor costs. This, in turn, leads to

[6] To some extent, this indirect effect could be offset by a lowering of wages in those sectors of the economy not covered by the legal minimum. This would be due to an inflow into those sectors of workers who were displaced by the higher wage

increased pressure on prices as businesses act to pass on these higher costs to customers.

How much have prices risen? While precise estimates are beyond economists' abilities, the M.I.T.-Penn-Social Science Research Council econometric model provides a rough measure. This large econometric model contains about 200 equations that attempt to capture the behavior of various economic sectors. Based on historical relationships embodied in the model, the measurable direct and indirect effects of the 1978 increase in the wage floor resulted in an increase in the overall level of prices of about ⅓ percent. Price pressures are, of course, relatively greater in those sectors that make greater use of low-wage labor. Thus, for example, prices of food away from home show larger increases since reportedly 30 percent of the food service industry's payroll is composed of low-wage teenagers.

In addition to these inflationary impacts, the minimum wage legislation also works against reducing inflation in other ways. By helping to cement inflationary expectations into the wage structure, it reinforces the persistence of inflation. The legislated wage increases through 1981 represent close to a 10 percent annual rate of increase, well above the 7 percent private sector wage growth posted in recent years. By confirming the prospects of continued wage hikes, it becomes increasingly difficult to reduce the rate of inflation, as inflation is a dynamic problem in which the conditions inherited from the past feed the inflation process. The process becomes sustained when the expectations are deeply ingrained in society's thinking—in its contracts and laws.

The jump in the legal minimum is only one of several governmental influences that have exacerbated the rising cost pressures on businesses. The 1978 rise came at a time when important payroll taxes—namely, social security and unemployment insurance—were also increased. While the impact on prices of each of these increases separately may be small, taken together these government-mandated increases are likely to have added as much as 1 percent to labor costs, thus widening the gap between compensation and productivity. Looking ahead, the 9.4 percent increase scheduled for 1979, which will raise the wage floor to $2.90 per hour, appears to be less inflationary than this year's 15 percent hike. However, after taking into account the level of wages of affected workers in relation to the minimum wage floor, the impact on the aggregate wage bill in 1979 will be about the same as this year.

Conclusion

The Federal minimum wage law raises the income of millions of marginally productive workers. But the benefits of the minimum wage are not without social costs. Among these costs are higher rates of youth joblessness and greater inflation. The price of ignoring these negative influences is high—both for the economy and for society. Unquestionably, people who lack the ability to earn a decent living must be helped. The issue is whether the minimum wage is an effective tool with which to alleviate poverty. While research may never be able to provide a definitive answer, it seems that increases in the legal wage floor offer at best an imperfect solution to important social concerns, since remedying the ills of some poor people comes at the expense of others who are equally impoverished. Clearly, alternatives need to be explored in greater depth. Attempting to ameliorate some of the harmful effects of the minimum wage legislation by allowing a subminimum differential for teenagers or newly hired workers is one possible solution. Another alternative might be a wage subsidy program, whereby the government pays part of the wages of low productivity workers. In any case, efforts to raise the level of marketable skills by improving and expanding training and educational programs should be intensified.

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