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HIGHLIGHTS

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Automatic Adjustment of the Minimum Wage

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Proposals for raising the minimum wage are frequently brought before Congress. A bill introduced in the summer of 1997 proposed raising the minimum wage to $7.25 an hour by 2002. Another only a couple of months later called for an increase to $6.65 by the year 2000. Two introduced in March of this year, and currently languishing in Congress, propose raising the minimum from its current $5.15 to $6.15 over the next two years. This flurry of legislative activity, along with President Clinton's call for an increase in his 1998 State of the Union address, clearly indicates that policymakers recognize the difficulty of supporting a family on a minimum wage. Yet despite this awareness, Congress seems incapable of acting to raise the wage to a level that can lift families out of poverty.

The difficulty in adopting an increase lies in the fact that the minimum wage is such a divisive political issue. Proposals for an increase are immediately supported by those who argue that it is impossible for families to survive at the current rate, but the proposals are just as quickly opposed by those who believe a higher wage will do more harm than good because the resulting higher labor costs will force businesses to shed workers. By the time Congress does manage to act, it is discovered that inflation has eroded the value of the minimum wage, leaving it insufficient to live on, and it must be increased again. That each hike in the wage requires an act of Congress means that the wisdom of having a minimum wage is repeatedly returned to the political arena as the subject of debate. The ensuing battle drags on for so long that when Congress finally does act, the political compromise is an increase that is far too small to be of much benefit to workers.

In the past when Congress raised the minimum wage, it often restored it to around 50 percent of the average hourly wage, but to bring the wage to that level now would require an increase of about 20 percent, and a larger increase would be required for each year that Congress does nothing about the minimum wage.[1] The larger the increase in the minimum wage, the more of a shock it is bound to be to that sector of the economy that hires most minimum-wage workers and the more resistance by vested interests and by legislators to its passage. Herein lies the political problem that has been driving the decline in the value of the minimum wage.

The solution to this problem is to meet it head on and resolve it once and for all. This can be done by instituting a mechanism for the automatic adjustment of the wage. With such a mechanism, one that provides for regular and incremental increases, Congress will no longer be forced to revisit the issue periodically, employers will not be confronted by sudden and large increases, and the purchasing power of the wage will be maintained.

Automatic adjustment of the minimum wage has been considered by Congress (Levin-Waldman 1998). The 1997 bill that called for an increase to $7.25 also called for indexing the minimum wage to the consumer price index (CPI); the minimum wage, once set at a level deemed able to lift families out of poverty, would rise each

year with any increase in the CPI, so that its value would keep up with inflation. There are, however, problems with linking minimum wage levels to the CPI. Studies have shown that the CPI overstates the rate of inflation and does not accurately reflect market-caused price increases (Boskin 1996; Papadimitriou and Wray 1996). An index that increases wages at a rate greater than (or even different from) the actual inflation rate will exacerbate inflationary pressures.

A better index would link the minimum wage and productivity. The problem with a productivity index is that productivity is hard to define, let alone measure. Nevertheless, there is an approach that would not require getting lost in the labyrinth of a productivity definition. Wage hikes, in general, are the result of private sector decisions about wages that are based on past price hikes and productivity gains. Indexing the minimum wage to some measure of overall wage gains could, therefore, reflect a private sector view of productivity gains.

An optimal adjustment mechanism would allow the minimum wage to rise with gains in productivity of minimum-wage workers and would prevent the erosion of the wage's value due to inflation. Because most minimum-wage workers are employed in the lowest-wage sector of the economy (essentially, the food service and retail sales industries), it would make sense to base an index on that sector's median hourly wage. The median would serve as a reference point and, for all practical purposes, would be the putative minimum wage. Whatever percentage increase there was in the median wage of the lowest-wage sector would be applied to the statutory minimum wage. This would allow the sector that has the most at stake (because it has so many minimum-wage employees) to have the most say in determining the rate of increase of the statutory wage (through its wage level as determined by its perception of productivity increases). Because the statutory increases would be linked to private sector decisions about wages, ultimately, instead of the government's deciding on the rate of increase, the private sector would be doing so.

Table 1 shows the minimum wage rate that would have existed in past years had this method of setting the rate been in place. Although the 1997 indexed wage does not come out much higher than the actual minimum in that year (and would not have offered much assistance to low-wage workers), had it been in place over the years it would have had the advantage of changing gradually and regularly, which would have removed the shock attendant to most increases set by current procedures. Even though minimum-wage workers would not have been much better off today than they are under the current statutory minimum wage, they would at least have seen some increases in their earnings in past years (where differences are somewhat larger) and experienced a slowdown in the decline in the value of their wages.[2] Critics of indexation schemes often claim that such measures are inflationary, but, because in our lowest-wage sector scheme the statutory minimum wage is so far below the putative minimum wage of the lowest-wage sector and because such a small percentage of the workforce (6.2 percent in 1994) actually are paid the minimum, it is hard to see how increasing the minimum wage at the same rate as the lowest-wage median could exert much inflationary pressure.

Table 1 Minimum Wage Indexed to Median Wage of the Lowest-Wage Sector

Year	Median Hourly Wage of Lowest-Wage Sector	Percent Increase	Indexed Minimum Wage	Actual Minimum Wage	Difference	Percent Difference
1983	4.70	—	—	3.35	—	—
1984	5.00	6.4	3.56	3.35	0.21	6.3
1985	5.00	—	3.56	3.35	0.21	6.3
1986	5.13	2.6	3.65	3.35	0.30	9.0
1987	5.33	3.9	3.79	3.35	0.44	13.1
1988	5.53	3.8	3.93	3.35	0.58	17.3
1989	5.75	4.0	4.09	3.35	0.70	20.9
1990[a]	6.13	6.6	4.36	3.80	0.56	14.7
1991[a]	6.40	4.4	4.55	4.25	0.30	7.1
1992	6.48	1.3	4.61	4.25	0.36	8.5
1993	6.68	3.1	4.78	4.25	0.53	12.5
1994	6.68	—	4.78	4.25	0.53	12.5
1995	6.85	2.5	4.90	4.25	0.65	15.3
1996[a]	7.08	3.4	5.06	4.70	0.36	7.7
1997[a]	7.29[b]	3.0	5.21	5.15	0.06	1.2

[a]Years in which increases in the statutory minimum wage took effect.
[b]The figure for 1997 is an estimate based on a 3.0 percent increase.
Source: Author's calculations based on data in unpublished tables from the U.S. Department of Labor Statistics for the years 1993 to 1996.

Establishing an automatic adjustment mechanism would create a public-private partnership in which government implements a new wage rate based on what is happening in the private sector. The decision of how much to raise the minimum wage would be made on the basis of a consensus arrived at through the collectivity of private decisions, instead of its being made by the government. Annual increases in the minimum wage would reduce much of the shock that many employers of minimum-wage workers are said to experience each time Congress implements a new minimum wage. Because of the long delays in enacting changes, Congress has at times had to increase the wage by as much as 25 percent just to bring it to about 50 percent of the average hourly wage and by over 11 percent even when it was still below that percentage. Such increases are considerably larger than any increases mandated through an indexation mechanism. Would not gradual increases have a lesser impact on a firm's cost structure? And even if the minimum-wage worker were so fortunate as to obtain as much as an 11 percent increase, any increase under an indexation scheme linked to wages would be a function of higher productivity levels, not a form of largess that rewards inefficiency. Also, because the wages of those at the bottom would be rising along with everybody else's, the disparity between the top and the bottom would cease to expand. Automatic indexation would remove the issue from politics and ensure that those at the low end of the wage scale can continue to earn a wage that maintains its value.

Notes

1. In 1996 the average hourly wage was $11.81; an estimated increase in the average of 3 percent for 1997 and 1998 brings it to $12.54. The minimum wage of $5.15 would need to be increased by about 20 percent to reach 50 percent of the hourly wage.

2. This has great relevance to new welfare-to-work regulations that require states to impose mandatory work requirements on 50 percent of recipients by 2002. If the states are to succeed in moving welfare recipients into the labor market and keeping them there, the workers need to see tangible evidence that their wages will grow and that working offers greater rewards in terms of income than public assistance.

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Oren M. Levin-Waldman is a resident scholar at The Jerome Levy Economics Institute. His projects focus on transforming the welfare and unemployment insurance systems in order to achieve greater efficiency, equity, and effectiveness in the delivery of service and on developing a methodology for analyzing public policy that relies on the application of political philosophy as well as cost-benefit analysis. Recently, he has been examining the effects of a change in the minimum wage, worker displacement due to plant closures, welfare reform and the potential for workforce development, and political realignment in the electorate. He is the author of *Plant Closure, Regulation, and Liberalism: The Limits to Liberal Public Philosophy* (University Press of America); *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* (University of Pittsburg Press); *The Consolidated Assistance Program* (Public Policy Brief No. 21); *Making Unemployment Insurance Work* (Public Policy Brief No. 26); and *A New Path from Welfare to Work* (Public Policy Brief No. 31). Levin-Waldman received a B.A. in history, an M.A. in urban studies, and a Ph.D. in political science from Temple University.

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