The Heritage Foundation Backgrounder

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WHY RAISING THE MINIMUM WAGE IS A BAD IDEA

INTRODUCTION

President Bill Clinton has urged Congress to pass legislation to raise the minimum wage from $4.25 to $5.15 over two years. Although the President and others argue that a higher minimum wage is needed to achieve "a minimum decent living wage" for working Americans, a minimum wage hike in fact will destroy entry-level job opportunities for the very unskilled Americans proponents claim to be helping.[1] Further, it will do nothing to increase the income of nonworking families while raising prices for both the poor and non-poor. Congress should instead focus on tax and regulatory reforms to increase take-home pay and reduce the cost of creating jobs, both to promote economic growth with low inflation and to increase employment opportunities and wages for all Americans.[2]

President Clinton's argument is emotionally appealing. In his announcement, the President notes the need to ensure that there is a strong incentive to choose work over welfare and argues that increasing the minimum wage is an effective way to fight poverty, especially when combined with the Earned Income Tax Credit (EITC). The President claims his proposal will raise the hourly wage for between 11 million and 14 million workers, many of whom are the sole breadwinners in their families. Secretary of Labor Robert B. Reich cites the need to maintain the historic value of work and suggests that recent empirical evidence shows that moderate increases in the minimum wage do not cost jobs.

1 There is a subtle but important distinction between lost "jobs" and "job opportunities." Lost jobs refers to a decline in the actual number of jobs or hours of employment. Lost job opportunities refers to jobs that are not created by employers but that otherwise would have been created without an increase in the minimum wage.

2 See Daniel J. Mitchell, "An Action Plan to Create Jobs," Heritage Foundation *Memo To: President-Elect Clinton* No. 1, December 14, 1992.

While these arguments seem plausible, they are misleading. The President states that an increase in the minimum wage will help the working poor, but it will have the opposite effect for many more Americans. It also is an inefficient way to boost the income of poor households. Among the reasons:

- ✘ **Raising the minimum wage will harm the nonworking poor by raising prices and destroying entry-level job opportunities.**[3] Job opportunities disappear because the low output of many lower-skilled workers makes it uneconomic to employ them at the higher minimum wage.

- ✘ **Raising the minimum wage does not generally help low-income households.** Over half (54 percent) of the increased income for minimum wage jobs would go to workers in families earning two or more times the poverty level, rather to than poor minimum wage workers.[4]

- ✘ **Employers will respond to an increase in the minimum wage in a number of ways that harm workers.** For instance, they will reduce the rate of new hiring and postpone the replacement of employees who quit. They will reduce workers' hours (particularly the hours of unskilled workers). Or they will replace lower-skilled workers with higher-skilled workers as low-skilled workers quit. They also may consider reducing or eliminating the pay raises and bonuses for their other employees.

- ✘ **Increasing the minimum wage to $5.15 will result in around 400,000 lost entry-level job opportunities.** Depending on the overall economy, total employment may increase, but there will be fewer unskilled job opportunities available for Americans than there otherwise would have been.

Economic growth and increasing productivity in the past few years have produced lower unemployment, but they have not raised average real wages significantly. Economists and policy analysts have advanced a variety of potential explanations for this. They point to the effects of increasing regulatory burdens, international competition, corporate downsizing, the rising costs of fringe benefits, changes in employment between industries and occupations, and demographic changes. But raising prices and destroying entry-level job opportunities is not a sensible response to these influences on wages.

Instead of raising the minimum wage, Congress and the Administration should focus on policies that increase job opportunities and wages for all Americans. Specifically, Congress should:

- ✔ **Leave decisions on setting minimum wages to the states.** Although minimum wage laws are unwise policy, even proponents should recognize that rates should be set at the state or local level, not at the national level. Given the signifi-

3 Ronald B. Mincy ("Raising the minimum wage: effects on family poverty," *Monthly Labor Review*, July 1990) has estimated that a 90 cent increase in the minimum wage may reduce the number of poor families by only 2.2 to 6.3 percent. Mincy also acknowledges that his model ignores changes in hours and prices and therefore overestimates the poverty-reducing effect of a higher minimum wage.

4 Heritage Foundation estimates and analysis unless otherwise noted.

cant differences in state cost of living and wage levels,[5] governors and state legislators committed to the notion of a minimum wage are in a better position than Congress to determine what is appropriate for their areas. State legislators better understand the living and working conditions of workers in their state and how business conditions and jobs would be affected by a certain minimum wage level.

- ✔ **Enact significant regulatory reform to reduce the cost of labor.** The explosion of new regulations since 1988 has raised the cost of labor and capital, created barriers to the formation of new companies and jobs, and placed a greater burden on Americans trying to compete in the global economy. There are at least three million fewer jobs in the American economy today because of the growth of regulation over the last 20 years.[6] The regulatory bureaucracy needs to be rolled back and job-killing labor regulations eliminated.

- ✔ **Promote school choice legislation and other real education reforms to improve skills.** Despite record spending of taxpayers' dollars, America's public schools continue to turn out far too many high school graduates who lack not only basic skills, but also the communication skills and work attitudes that employers are demanding. One of the best ways to ensure a more productive and better-paid workforce in the long run would be to enact school choice legislation to provide the incentive for schools to improve.

- ✔ **Cut the capital gains tax.** Cutting the capital gains tax would reduce investment disincentives, increase wages by raising productivity, and increase small business formation and associated job opportunities.

- ✔ **Limit benefits to decrease the incentive to remain on welfare.** The combined state and federal efforts to reduce welfare dependency are an important component of the minimum wage debate. Welfare was never supposed to be more attractive than an entry-level job; nor was it to be a permanent alternative to employment.[7]

PROPOSALS FROM THE ADMINISTRATION AND CONGRESS

A number of bills to raise the minimum wage have been introduced in both houses of Congress this year. They range from the "modest" 90 cents per hour increase over two years proposed by the President to a one-time increase of $2.25 (to $6.50) proposed by Representative Martin Sabo (D-MN). The Joint Economic Committee held a hearing on the President's proposal in February. Further hearings on raising the minimum wage are likely, as are hearings on alternatives for promoting job creation and increasing wages.

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5 Randall W. Eberts and Mark E. Schweitzer, "Regional Wage Convergence and Divergence: Adjusting Wages for Cost-of-Living Differences," *Economic Review* (FRB-Cleveland), Vol. 30, No. 2 (July 1994), pp. 26-37.

6 William G. Laffer III, "How Regulation Is Destroying American Jobs," Heritage Foundation *Backgrounder* No. 926, February 1993.

7 Robert Rector, "Combatting Family Disintegration, Crime, and Dependence: Welfare Reform and Beyond," Heritage Foundation *Backgrounder* No. 983, updated March 17, 1995.

The President's Bill. The Administration's proposal was introduced in both the House and Senate on February 14, 1995. The White House legislation, the Working Wage Increase Act of 1995, was introduced in the Senate (S. 413) by Senator Thomas Daschle (D-SD) and in the House (H.R. 940) by Representative Richard Gephardt (D-MO). This legislation would raise the minimum wage to $4.70 on July 3, 1995, and to $5.15 on July 3, 1996.

The Kennedy Bill. Another bill to raise the federal minimum wage and amend the Fair Labor Standards Act of 1938 (FLSA) has been introduced in the Senate by Senator Edward Kennedy (D-MA). The American Family Fair Minimum Wage Act of 1995 (S. 203) would increase the minimum wage from $4.25 to $5.75 in 50 cent increments over three years, beginning September 1, 1995. S. 203 also would establish another Commission on the Minimum Wage.[8] The Commission would conduct a study and make recommendations to Congress on how to restore the minimum wage to the level relative to the average hourly wage that existed during the period 1950 to 1980. The legislation also requires the Commission to suggest the means by which to maintain such a level with minimum disruption to the general economy through regular and periodic adjustments (indexing).

In the House, a number of bills have been introduced.

The Sanders Bill. The Livable Wage Act of 1995 (H.R. 363), introduced by Representative Bernard Sanders (I-VT), would increase the minimum wage to $5.50 in one step on December 30, 1995, and index it to the Consumer Price Index.

The Sabo Bills. The Minimum Wage Amendments of 1995 (H.R. 619), introduced by Representative Sabo, would increase the minimum wage to $6.50 in one step, effective 90 days after enactment. The Income Equity Act of 1995 (H.R. 620), also introduced by Representative Sabo, provides for the same increase but also would amend Section 162 of the Internal Revenue Code of 1986 to limit the deduction for payments of "excessive" compensation. Excessive compensation is defined in H.R. 620 as 25 times what the lowest paid employee earns.[9]

The Wynn Bill. The Fair Labor Standards Amendments of 1995 (H.R. 764), introduced by Representative Albert Wynn (D-MD), would increase the minimum wage to $5.25 in 25 cent increments over four years, beginning six months after enactment.

The Gutierrez Bill. The No Maximum Wage for Congress Without a New Minimum Wage for America Act of 1995 (H.R. 876), introduced by Representative Luis Gutierrez (D-IL), would reduce the pay rate for Members of Congress by 2.6 percent per year until the minimum wage is raised to $5.15.

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8 The 1977 amendments to the Fair Labor Standards Act of 1938 established the first Minimum Wage Commission. The Commission completed its three-year study of the minimum wage in 1981, concluding that increases in the minimum wage have a negative effect on employment.

9 The calculation also would include part-year employees (computed on an annualized basis).

Why Proponents Want to Increase the Minimum Wage.

Congress enacted the Fair Labor Standards Act of 1938 (FLSA), which established the minimum wage, in part to prevent a repetition of the deflationary wage spiral that occurred in the 1930s as workers bid down wages in an effort to find gainful employment.[10] The trauma of the Great Depression strengthened the view that government had a responsibility to develop policies and programs to stabilize the economy by maintaining income flows. The minimum wage was to serve as one part of the New Deal safety net. However, since 1940, unemployment insurance, monetary policy, and state minimum wage laws have undercut the justification for a federal minimum wage.

Today's proponents of a higher minimum wage generally center their arguments on the need to set "a decent living wage" and address income inequality.[11] For example, the Administration argues for an increase in the minimum wage to:

- ✔ **Maintain** the historic value of work;
- ✔ **Help** adult workers, most of whom rely on their jobs to support their families;
- ✔ **Ensure** that there is a strong incentive to choose work over welfare; and
- ✔ **Help** fight poverty by combining a higher minimum wage with the Earned Income Tax Credit.

The Administration maintains that increasing the minimum wage by a moderate amount will not cost jobs. It also points out that the last minimum wage increase passed with strong bipartisan support.[12]

Other proponents point out that some 80 percent of Americans agree that a higher minimum wage increase is warranted.[13] They also observe that the real value of the minimum wage is 27 percent lower than it was in 1979, while corporate profits have risen by 155 percent and executive pay by 514 percent.[14] Some proponents further claim that the free market does not work for women and ethnic minorities as it does for men and that government has a role in establishing a floor for wages.[15]

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10 One of Congress's stated intentions in enacting the FLSA and minimum wage was to eliminate the spreading and perpetuation of detrimental labor conditions among the workers of several states.

11 Another reason why Congress enacted the FLSA and minimum wage was to correct, and as rapidly as practical to eliminate, labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and the general well-being of workers.

12 See U.S. Department of Labor, Minimum Wage Press Release Package, February 1995.

13 From statement of Representative Major Owens (D-NY) before the Joint Economic Committee, February 22, 1995.

14 From statement of Senator Edward Kennedy (D-MA) before the Joint Economic Committee, February 22, 1995.

15 From statement of Audrey Haynes, Executive Director, Business and Professional Women/USA, before the Joint Economic Committee, February 22, 1995.

RECENT STUDIES ON THE MINIMUM WAGE

Raising the minimum wage, like mandating universal health insurance coverage, does not come without cost. The question is: Where are the costs incurred, and do they outweigh the benefits?

Recent academic economic research on the employment effects of raising the minimum wage has produced seemingly confusing results. Proponents of a higher minimum wage point to a few recent studies that suggest moderate increases may not have an overall negative employment effect and might very well increase total employment.[16] Meanwhile, opponents cite the preponderance of previous academic studies that conclude there is a negative employment effect and observe that other recent studies continue to find that raising the minimum wage results in lost jobs.[17] The best conclusion that a layman or policymaker can draw is that although further research is needed, the evidence continues to support the conventional view that increasing the minimum wage means employment losses for low-skilled workers. More recently, one of the key studies used by the Clinton Administration to bolster its claim that a higher minimum wage does not cause job losses has been found to contain serious flaws.[18]

Even though a few recent studies disagree on the employment effects of increasing the minimum wage, most economists do agree on several key points.

- ✔ Raising the minimum wage will reduce entry-level job opportunities, particularly for low-skilled Americans. Some of the entry-level jobs that would be created in a growing economy will not be created.
- ✔ There may be a labor supply effect that results in a measured increase in total employment, but labor demand certainly will be altered. Americans may apply for minimum wage jobs in greater numbers, but employers will hire only the most skilled among them.
- ✔ Raising the minimum wage may reduce poverty slightly for workers who keep their jobs,[19] but it will do nothing for the vast majority of poor who do not work.

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16 David Card and Alan Krueger, *Myth and Measurement: The New Economics of the Minimum Wage*, Princeton University Press, forthcoming; Allison Wellington, "Effects of the Minimum Wage on the Employment Status of Youths: An Update," *Journal of Human Resources*, Winter 1991; Richard Freeman, "Minimum Wages—Again!," paper presented at the Conference on Economic Analysis of Base Salaries and Effects of Minimum Wages, September 1993; and others.

17 Card and Krueger, *Myth and Measurement: The New Economics of the Minimum Wage*, Chapter 6, Evaluation of Time-Series Evidence; David Neumark and William Wascher, "Employment Effects of Minimum and Subminimum Wages: Panel Data on State Minimum Wage Laws," *Industrial and Labor Relations Review*, Vol. XLVI, No. 1 (October 1992); Finis Welch, Donald Deere, and Kevin Murphy, "Employment and the 1990/91 Minimum Wage Hike," Annual Proceeding of the American Economic Review, forthcoming; Janet Currie and Bruce Fallick, "A Note on the New Minimum Wage Research," NBER Working Paper No. 4348, April 1993; and others.

18 The telephone survey data used in the study cited most often by the Administration have been shown to contain catastrophic flaws. Redoing the analysis using accurate payroll records completely reverses the results of the Administration-cited study and finds a negative effect on employment when the minimum wage is raised. See David Neumark and William Wascher, "The Effects of New Jersey's Minimum Wage Increase on Fast Food Employment," unpublished study presented to the Joint Economic Committee, March 1995.

✔ Employers will raise prices for the poor and non-poor alike to offset increased labor costs.

Factors operating interactively on both the demand and supply sides of the labor market will determine the magnitude and incidence of any effects of increasing the minimum wage. The magnitude also will be affected by the growth rate of the economy at the time. In a growing economy with significant gains in productivity, increases in the minimum wage can be absorbed by some firms without necessarily decreasing employment. However, as President George Bush discovered, raising the minimum wage during a recession can place a significant brake on employment growth—which probably contributed to his now infamous "job-less" recovery.

Increases in the minimum wage do affect a firm's employment, prices, and profits, although the pattern of these effects will vary from company to company. Studies indicate that firms facing higher labor costs, and therefore a change in the relative costs of labor and capital, respond in up to three ways, all of which hurt Americans.

❶ Firms may raise prices.

If an increase in the minimum wage is phased in during a period of above-average inflation, employers may find it easier to pass increased labor costs on to consumers. However, in periods of relative price stability, employers may not have this option (at least to the same degree) and will seek instead to cut other production or sales costs. Firms facing stagnate demand for their goods and services and not readily able to adjust their production and sales costs will have little choice but to raise prices or cut profits. Economic models of the U.S. economy indicate that even a 75 cent increase in the minimum wage over three years adds 0.2 percentage points to the Consumer Price Index.[20]

❷ Firms may reduce or eliminate pay raises, bonuses, or benefits for their other employees or reduce other costs.

Besides reducing compensation for non-minimum wage workers, firms may try to negotiate lower prices from their suppliers. They also may take steps to increase productivity by reducing the rate of new hiring and postponing the replacement of employees who quit, by reducing working hours (particularly for unskilled workers), or by replacing lower skilled workers with higher skilled workers as low-skilled workers quit. Employers also will likely try to replace some workers with machines.

❸ Firms may accept lower profits in the short run.

Some lawmakers contend that an increase in the minimum wage could be accommodated easily without layoffs or price rises because profits are up. But profits, as a share of the Gross Domestic Product (GDP), have only just returned to their long-run average level (see chart on next page) after a ten-year period of below-average

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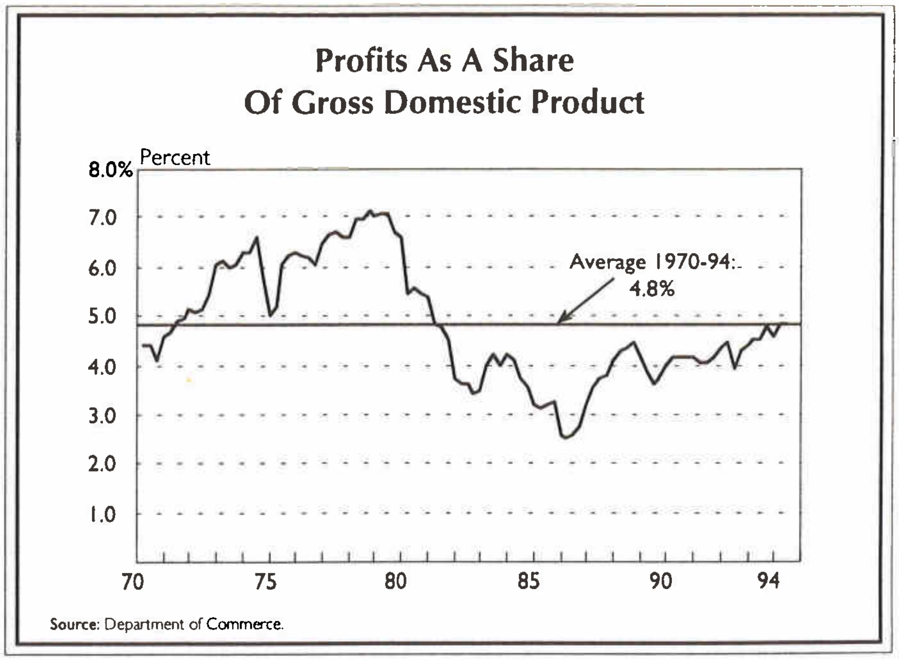
19 Mincy, "Raising the minimum wage: effects on family poverty."

20 Simulations conducted by Laurence H. Meyers and Associates Ltd. using the Washington University Macro Model, January 1995.

profits, and many industries are still reporting mixed profit results.[21] And, of course, industries with generally low profit margins in any case will have a hard time finding the earnings to pay for an increase in the minimum wage.



ESTIMATES OF POTENTIAL JOB LOSSES

Estimates of the disemployment effect of raising the minimum wage can be done in a number of ways. Different job loss numbers are derived, for instance, when considering different employment groups or using different methodologies. Focusing only on teen agers, and using the average disemployment effects found in Card and Krueger, suggests a job loss estimate for teens of 51,000 to 99,000.[22] If one considers both teenagers and young adults (ages 16 to 24), raising the minimum wage to $5.15 would result in about 508,000 to 677,000 jobs lost for this group of workers, according to a study by Neumark and Wascher.[23] A macroeconomic computer model of the U.S. economy indicates that increasing the minimum wage will result in creation of 400,000 fewer jobs by the year 2000.[24]

Another way to estimate the number of lost entry-level job opportunities would be to calculate the total cost of the increase in labor costs from raising the minimum wage and then to divide that total by the average cost of an existing minimum wage worker. A 97 cents per hour rise (mandated increase plus employer-paid FICA and FUTA taxes) in the

21 "Annual Report on American Industry," *Forbes*, January 2, 1995.

22 Card and Krueger reviewed recent time-series studies and provide a range of .-52 to .-99 for the teenage employment effects of a 10 percent increase in the minimum wage.

23 Neumark and Wascher, "Employment Effects of Minimum and Subminimum Wages: Panel Data on State Minimum Wage Laws." Their analysis estimated an employment loss of 1.5 to 2.0 percent for every 10 percent increase in the minimum wage for 16 to 24 year olds.

24 Simulations conducted by Laurence H. Meyers and Associates Ltd. using the Washington University Macro Model, January 1995. Their simultaneous equation model of the U.S. economy estimated that total employment will grow by 400,000 less than it would have had the minimum wage not been increased. This estimate of lost job opportunities differs from the previous estimates of job losses based on labor supply/demand elasticities.

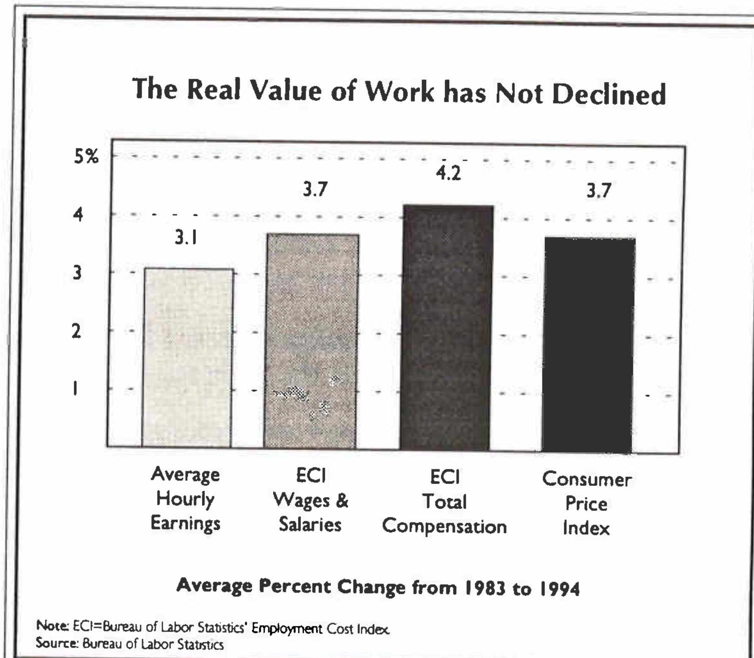
minimum wage times 25 hours per week, times 38 weeks per year, times 2.738 million minimum wage workers equals a $2.191 billion increase in labor costs for employers.[25] This $2.2 billion increase in labor costs is roughly what employers would need to create 576,000 *new* minimum wage job opportunities for low-skilled workers at $4.25 per hour.[26]

It also is important to note that the effect of increasing in the minimum wage may be influenced by other legislation and regulatory actions that affect the relative cost of labor and capital. Federally mandated benefits and OSHA-proposed regulations, such as ergonomics, interact with a higher minimum wage to increase the cost of labor relative to capital. Combined, these could permanently reduce the demand for low-skilled, low-wage entry-level jobs as employers substitute capital and other efficiencies in sales and production for labor hours.

THE FAULTY RATIONALE FOR RAISING THE MINIMUM WAGE

Aside from the costs associated with raising the minimum wage, proponents present an emotionally appealing case. However, close economic analysis reveals that their premises are faulty. Examples:

✘ **Since 1983, the historic value of work has not declined.** In fact, the real value of total compensation—wages plus fringe benefits—has increased. From 1983 to 1994, the employment cost index[27] for wages and salaries increased an average of 3.7 percent per year, and average hourly earnings[28] increased 3.1 percent. To be sure, during that period, inflation averaged 3.7 percent. But fringe benefits have risen more rapidly than earnings, so the employment cost in-



25 Minimum wage workers work an average of 25 hours per week and 38 weeks per year.

26 $2.191 billion divided by 25 hours per week, divided by 38 weeks per year, equals about 576,000 new minimum wage workers that could have been hired.

27 The Employment Cost Index is a measure of the change in the cost of labor, free from the influence of employment shifts among occupations and industries, that is estimated by the Bureau of Labor Statistics. Wages and salaries are defined as the hourly straight-time wage rate (reported or computed) and benefit costs are defined on a cents-per-hour-worked basis. The hourly straight-time wage rate excludes premium pay for overtime, shift differentials, and non-production bonuses.

28 Average hourly earnings are not adjusted for shifts between occupations and industries.

dex for *total* compensation[29] per hour increased faster than inflation over the same period (4.2 percent).

Further, there is now widespread consensus that the CPI significantly overstates the rate of increase in the cost of living. Without the upward bias in the CPI, even real wages would have grown since 1983.

✘ **Raising the minimum wage does not help primarily adult workers who rely on their jobs to support their families.** For the most part, the 2.7 million workers who earn the minimum wage can be broken down into two broad groups.

About half are teenagers or young adults aged 21 or less, and most (68.2 percent) live in families with incomes two or more times the official poverty level for their family size.[30] The average family income of a teenage minimum wage worker is around $47,000. Only 12 percent of these young workers live in poor families.

The other half are workers ages 22 and higher. More of these workers live in poor families (27 percent or 367,000 have family incomes below the poverty level) or near poverty (44 percent have family incomes less than one and a half times the poverty level). However, even among this half of the minimum wage population, 39 percent live in families with incomes two or more times the poverty level, and the average family income of minimum wage workers aged 25 to 61 is around $25,000.

Contrary to Labor Secretary Reich's claim that a 90 cent increase in the minimum wage will not cost any jobs, a recent study indicates that a similar increase in 1990/91 caused a significant employment loss for both groups. According to the study, which was conducted by Finis Welch of Texas A&M University and others,[31] employment declined by 7.3 percent and 11.4 percent for teenage men and women, and 3.1 percent and 5.2 percent for adult high school dropouts.

✘ **Minimum wage workers for the most part are secondary earners in their families, not the primary earners.**

Only 23 percent of minimum wage workers were the sole breadwinners in their families in the previous year. The wage and salary earnings of 56 percent of minimum wage workers account for 25 percent or less of their families' total wage and salary incomes.

Only 16 percent of minimum wage workers are full-year/full-time employees. Thirty-three percent are part-year/part-time employees, and almost half (48.5 percent) are voluntary part time workers.[32]

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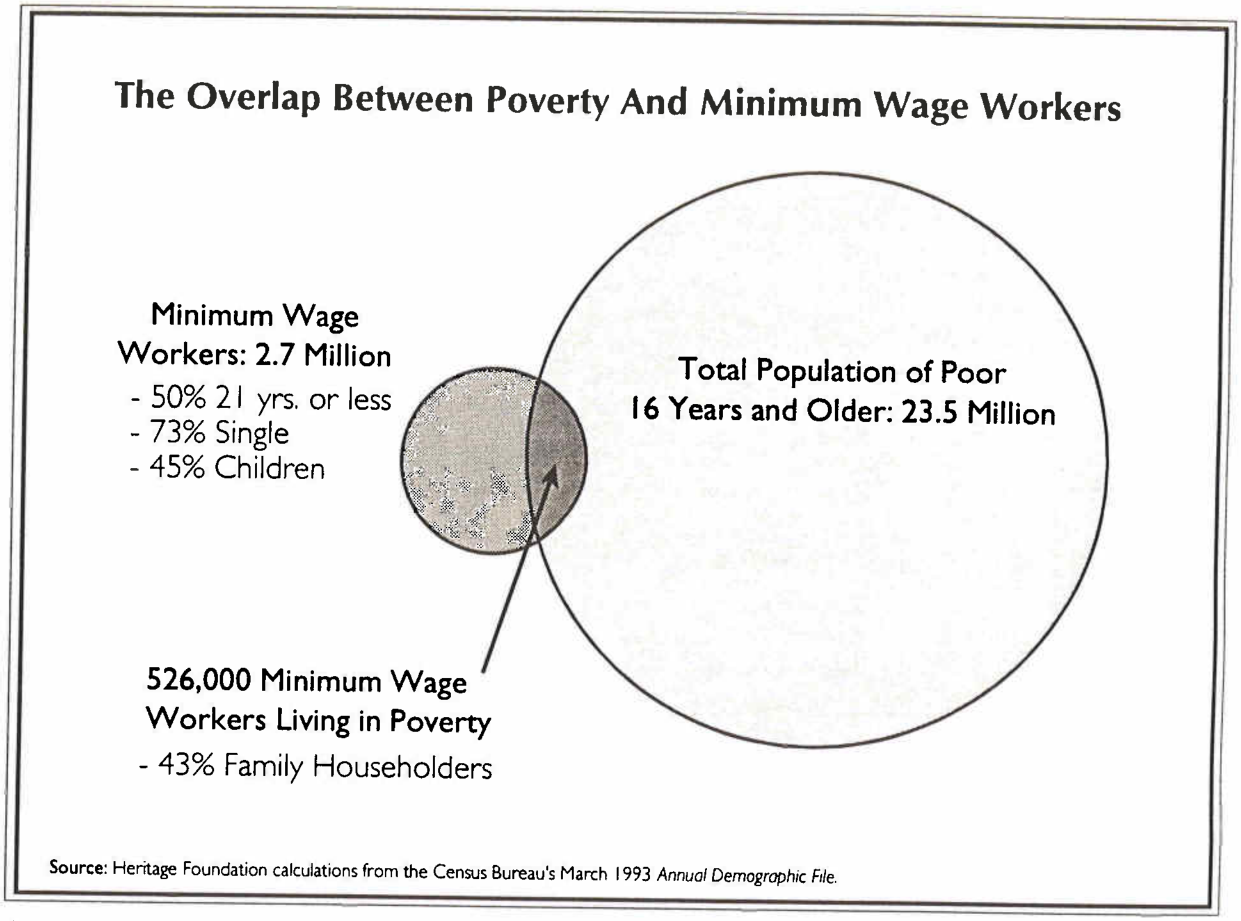
29 Total compensation is wages and salaries plus benefits. Benefits included in the ECI are paid leave; overtime and lump-sum payments; insurance benefits; retirement and savings benefits; legally required benefits (Social Security, Unemployment Insurance, Workers' Compensation, etc.); and other benefits.

30 The poverty rate in 1994 was $7,543 for a single person and $15,148 for a family of four.

31 Finis Welch, Donald Deere, and Kevin Murphy, "Minimum Wages in the Spotlight," Annual Proceedings of the American Economic Review, forthcoming. The estimated employment losses are for teenagers ages 15 to 19 and adult high school dropouts ages 20 to 54.



Almost 40 percent of the sole breadwinners earning the minimum wage are voluntary part-time workers, while only 18.8 percent of all minimum wage workers are family heads or spouses working full-time.[33]

ALTERNATIVES TO RAISING THE MINIMUM WAGE

Contrary to assertions by practitioners of class warfare, employers do not—indeed cannot—unfairly keep down the wages of their lower-skilled and entry-level employees. Employers, as well as employees, operate within a competitive labor market in which wage rates broadly reflect the productivity of workers—*less* the costs of government-imposed mandates and taxes associated with employing a worker. Raising prices and destroying entry-level job opportunities is not the sensible way to increase real wages. Instead of raising the minimum wage, Congress and the Administration should focus on policies that will increase wages and job opportunities for Americans by improving labor productivity and reducing the cost of employing workers. Specifically:

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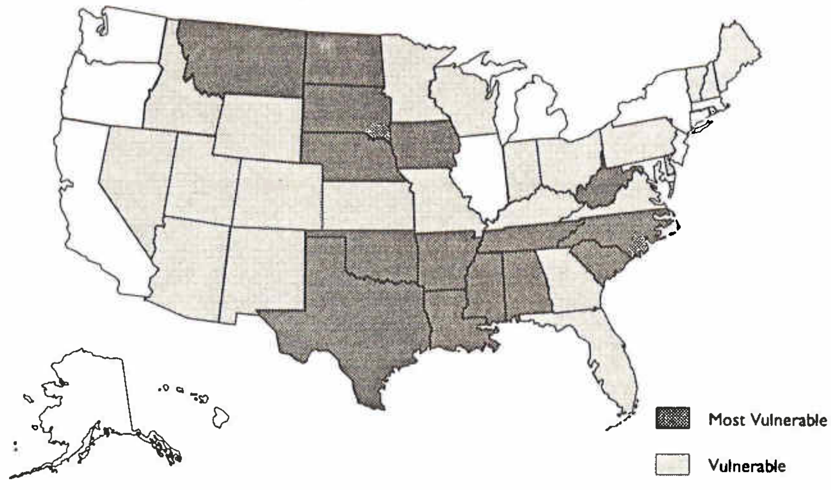
32 Heritage Foundation tabulations from the March 1994 Current Population Survey.
33 Heritage Foundation tabulations.

States Vulnerable to Employment Losses by Increasing the Minimum Wage



Note: Vulnerability is measured as the ratio of the state's average hourly wage and $4.25 per hour.
Source: Bureau of Labor Statistics.

✔ To the extent that government continues to set minimum wages, responsibility for setting minimum wage levels and enforcing the other provisions of the Fair Labor Standards Act (FLSA) should be turned over to the states.

Minimum wage laws presume that politicians are morally justified in destroying some people's jobs in order to inflate other people's wages. The current minimum wage effectively prohibits people from working unless their labor is worth at least $4.25 an hour. On this basis alone, the minimum wage should be abolished. However, if there is a minimum wage, it should at least reflect the real labor cost and market differences in different regions of the country.

There are significant differences in the cost of living and general wage levels between states and even within states. To date, nine states and the District of Columbia have recognized this fact and have enacted minimum wages that are higher than the federal minimum, while ten states have a lower minimum wage for small employers and employees not covered by the FLSA. Significantly, the federal government officially recognizes regional differences in costs and general wage rates when paying its own employees.[34]

Recent studies have found significant variations in regional wage distributions and cost of living levels and trends.[35] Raising the federal minimum wage thus would have different negative impacts on individual state employment opportunities and price levels. In areas where the labor market is tight and implicit regional "wage floors"[36] effectively have raised the minimum wage already, there would be little or

34 Federal locality pay differentials have been in place since 1993.
35 Eberts and Schweitzer, "Regional Wage Convergence and Divergence: Adjusting Wages for Cost-of-Living Differences."
36 Wage levels below which employers find it very difficult to attract qualified entry-level workers.

no effect. However, in other areas of the country, there would be significant negative effects.

Almost 44 percent of minimum wage workers live in the South, while only 10.4 percent live in the Northeast. Over 40 percent of the workers who would be affected directly by the Administration's proposal live in the South.

Abolishing the federal minimum wage would allow governors and state legislators to determine the minimums for their own states if they believe such action to be helpful.[37] This would allow proponents to set minimum wages according to local labor market conditions and living costs while taking into account how business and employment conditions would be affected. Having a national minimum wage makes as much sense as requiring the federal government to pay the same wage for entry-level jobs New York City and Fargo, North Dakota.

✔ Enact significant regulatory reform.

The explosion of new regulations since 1988 has raised the cost of labor and capital, created barriers to the formation of new companies and jobs, and raised the cost of employing Americans. This higher cost of employment in turn means that, in a competitive economy, the return to labor in the form of wages is reduced. Some government regulation is desirable and necessary, but the plethora of new regulations has placed a significant burden on businesses' ability to create jobs for unskilled workers. This burden needs to be rolled back,. not only to allow wages to rise, but also to decrease the cost of hiring workers.

Although fixing the precise cost of federal regulations is difficult, estimates indicate the cost of complying was at least $500 billion in 1993.[38]

There are at least three million fewer jobs in the American economy today because of the growth of regulation over the last 20 years.[39]

A 1990 study estimated that environmental regulations alone had caused a national employment level that was 1.2 percent less in 1990 than it otherwise would have been.[40]

✔ Promote education reforms that will raise the skills and productivity of entry-level workers.

Employers cannot pay wages that exceed the revenue generated by a worker—at least not if they intend to stay in business. Thus, one way to raise wages without job losses and other costs is to raise the skills and productivity of workers, especially entry-level workers, through radical reform of the nation's schools.

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37 Sixteen states and the District of Columbia have minimum wages that are linked to the level in the federal Fair Labor Standards Act. If the federal minimum wage was abolished, they would have to set their own minimum wage levels.

38 See *Issues '94, The Candidate's Briefing Book* (Washington, D.C.: The Heritage Foundation, 1994), Chapter 4, Regulation.

39 Laffer, "How Regulation Is Destroying American Jobs."

40 Michael Hazilla and Raymond J. Kopp, "Social Cost of Environmental Quality Regulations: A General Equilibrium Analysis," *Journal of Political Economy*, Vol. 98, No. 4 (1990), p. 867.

Despite record spending of taxpayers' dollars, America's public schools continue to turn out far too many high school graduates who lack not only basic skills, but also the communication skills and work attitudes that employers need. This depresses the wages these workers can earn. It is not unreasonable for employers to expect that after 12 years of schooling individuals should have a reasonable competence in basic core skills (verbal communication, reading, writing, arithmetic, and basic sciences). Public schools routinely fail to prepare people for work, and then government minimum wage laws prohibit them from working.

A strong core curriculum should be taught in all high schools, and real testing should be instituted to indicate to parents whether or not their children's schools are achieving acceptable standards. School choice legislation is needed to give schools the financial incentive to respond to demands by parents that they meet these standards.

✔ Reduce the Capital Gains Tax.

The United States taxes corporate income twice: first at the corporate level, then at the personal level. Recognizing this, many other industrial nations have eliminated or reduced the taxation of these gains. The capital gains tax affects wages because it reduces capital spending, technological innovation, and new ventures. This hurts labor productivity and wages in the long run.

Although reducing capital gains taxes is portrayed by the practitioners of class warfare as benefiting only the rich, the benefits flow to all workers. Well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000. Over 73 percent had incomes of less than $75,000.[41]

Often overlooked benefits include:

- ☞ On average, wage earners receive $12 after taxes for every $1 of after-tax income received by investors. More than 90 percent of the benefits of new investment would flow to wage earners, not to owners of capital.
- ☞ Past reductions in the capital gains tax rate (1978 and 1981) stimulated the start-up of new businesses and the expansion of job opportunities.
- ☞ A lower capital gains tax would raise the expected rate of return on investment in the U.S. and provide an incentive for both American and foreign firms to put their capital to work here with American workers.

✔ Enact Significant Welfare Reform.

An important component of the minimum wage debate is the issue of reducing welfare dependency. Proponents of a higher minimum wage often argue that a higher minimum wage is needed to make work more attractive by improving the monetary incentive to choose work over welfare. They go on to argue that, to permit people to

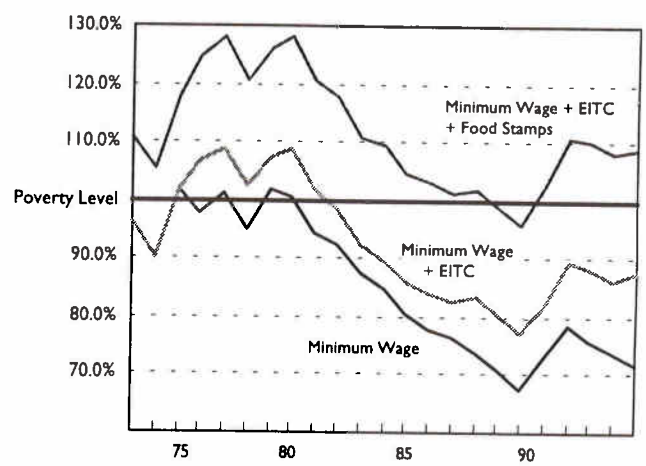
41 John C. Goodman, National Center for Policy Analysis, "Capital Gains Tax Reform and Investment in Small Business," testimony before the Committee on Small Business, U.S. House of Representatives, January 26,1995.

choose work over welfare, employers should be required to pay a "living wage" for even their lowest-skilled entry-level job opportunities.

The problem with this line of reasoning is that it ignores basic economics—wages for entry-level jobs reflect the skills and productivity of entry-level workers. Although raising the minimum wage may narrow the incentive gap for the welfare beneficiary in choosing work over welfare, it also reduces the willingness of employers to offer low-skill positions.

Rather than the phony "solution" of raising the minimum wage, a better approach would be to decrease the incentive to remain on welfare by limiting the level and duration of benefits. Welfare benefits are much higher than Americans generally assume. In 1992, welfare benefits and services amounted to $11,470 for every "poor" household.[42] While not every poor household received that level of non-cash aid, welfare bribes many individuals to stay out of the labor force.

The Minimum Wage When Combined With The EITC Nearly Lifts a Family of 3 Out of Poverty



Source: Heritage Foundation estimates.

Compared with these generous benefits, the income from full-time work at the minimum wage looks unattractive. Nevertheless, the current minimum wage when combined with the 1992 expansion of the EITC nearly lifts a family of three out of poverty. If the value of food stamps is included, the income of a family of three rises above the poverty level. Moreover, it is incorrect to portray entry-level minimum wage jobs as lifetime "dead-end jobs." They should be recognized as opportunities for most people to establish a track record of work and a springboard to better paying jobs. More than 60 percent of all workers can point to a minimum wage job as their first job experience.[43] Some 40 percent of workers starting a minimum wage job will receive their first raise within 4 months, and 63 percent will be earning 20 percent more than the minimum wage within 12 months.[44]

42 Robert Rector, "How The Poor Really Live: Lessons For Welfare Reform," Heritage Foundation *Backgrounder* No. 875, January 31, 1992.

43 Card and Krueger, *Myth and Measurement: The New Economics of the Minimum Wage.*

44 Ralph E. Smith and Bruce Vavrichek, "The Wage Mobility of Minimum Wage Workers," *Industrial Relations and Labor Review*, Vol. XLVI, No. 1 (October 1992), pp. 82-88.

The wise reform is to encourage welfare recipients to accept these minimum wage jobs by limiting the availability of more generous welfare payments. Raising the minimum wage, on the other hand, would be counterproductive (although, as noted earlier, reducing other costs of living could allow entry-level wages to rise without detrimental effects). A recent study has found that when other characteristics of welfare mothers are held constant, the level of the minimum wage and increases in the minimum wage may reduce the rate of exit from the AFDC program.[45]

CONCLUSION

Raising the minimum wage appeals to the American sense of decency and compassion. But it would be a mistake. Raising the minimum wage would impose significant costs, primarily on those unskilled Americans a minimum wage hike is suppose to help. It also would raise prices for both the poor and non-poor. It would destroy entry-level job opportunities that otherwise would have been created; and although it could raise some workers' family incomes above poverty, it would do so at the cost of denying jobs to many more.

To raise the standard of living of minimum wage workers without imposing these costs, Congress should focus on policies that raise worker productivity while reducing government-imposed labor costs on employers.

Mark Wilson
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45 Peter D. Brandon, *Jobs Taken by Mothers Moving from Welfare to Work and the Effects of Minimum Wages on This Transition*, Employment Policies Institute, January 1995. The study also suggests that the birth of additional children during AFDC participation also influences AFDC exit rates.