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DATE: June 30, 2004  
TO: Budget Project Friends  
FROM: Stephen Levy  
SUBJECT: Raising the Minimum Wage in California

The legislature is considering a bill to raise the minimum wage in California from \$6.75 an hour to \$7.25 in 2005 and \$7.75 in 2006.

Debates about raising the minimum wage are usually partisan and ideological. Republicans accuse Democrats of promoting “job killer” legislation. Democrats reply that Republicans don’t have any problem using the power of government as long as it supports corporations or high-income residents.

There are two simple questions that can help people decide whether to adopt the current proposal to increase California’s minimum wage:

- 1) Do you favor having a minimum wage at all? Why? Why not?? Most debates about increasing the minimum wage turn out, upon careful examination, to actually be debates about whether to have a minimum wage at all.
- 2) What standards should be used for when and by how much to increase the minimum wage? If not now, then when? If not by the amount currently proposed, then by how much?

### **The Role of Government in a Free Market Economy**

The United States economy operates on a private enterprise, free market foundation. Most jobs are in the private sector. Our laws, free capital markets, and entrepreneurial spirit have made the United States a magnet for talented people and investors willing to risk their capital to start businesses in the United States.

But the lessons of the Great Depression and our increasingly complicated world have established the need for public policies whose goal is to “soften the edges” of a completely free market system. As a result, we have laws prohibiting child

labor, laws protecting the safety of workers and laws requiring environmental protection. We have laws protecting the right of workers to organize into unions.

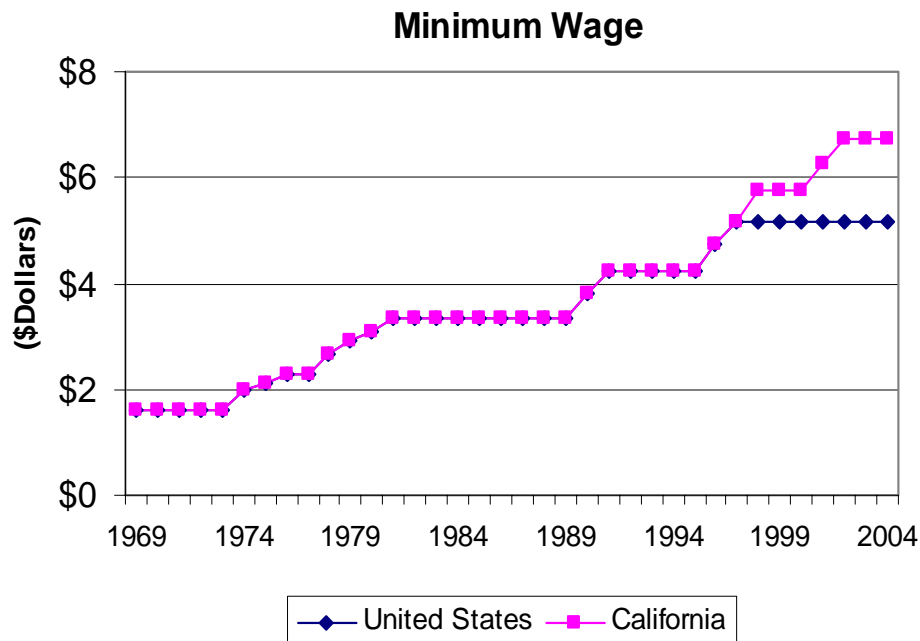
We also have laws that act to provide a “safety net” for families within the context of a private enterprise system. Many of these laws were established as part of President Roosevelt’s New Deal in the depth of the 1930s Great Depression. The Social Security system and Unemployment Insurance system were established in 1935. The Medicare and Medicaid programs were added to the Social Security Act in 1965.

The federal minimum wage was established in 1938 as part of the Fair Labor Standards Act. The original minimum wage was \$0.25 per hour. The state and federal minimum wage were similar until the late 1990s when several states, including California, raised their minimum wage while the federal minimum has remained at \$5.15 an hour since 1997.

**The minimum wage is part of a long established “social compact” in America about offering minimum protections and safety nets to soften the edges of a private enterprise system that is the foundation of our economic success.**

### The History of Increases in the Minimum Wage

The federal minimum wage has been raised 11 times since 1969, from \$1.60 to \$5.15 with the last raise in 1997. California’s minimum wage has been raised three additional times since 1997 ending with an increase to \$6.75 on January 1, 2002.



**Increases in the minimum wage are not automatic.** Federal or state legislators must act to increase the minimum wage. In contrast, social security benefits are raised automatically each year to keep pace with the cost of living. The use of automatic cost of living adjustments is fairly common in both the public and private sectors.

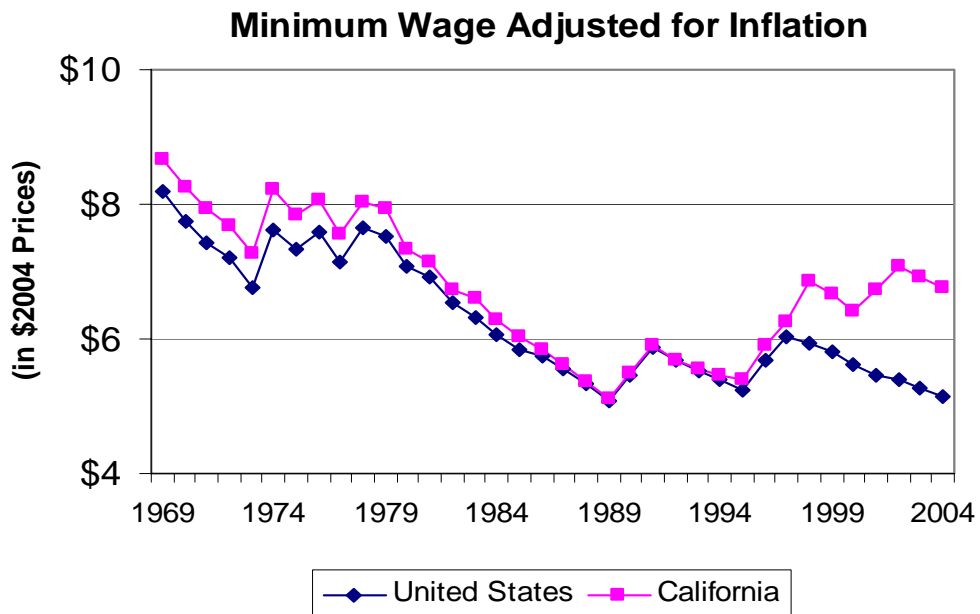
The California income tax code adjusts income brackets each year so that taxpayers will not pay more tax simply because consumer prices are rising. In addition, Governor Schwarzenegger has asked the legislature this year to adopt a plan for steady increases in college tuition fees to keep pace with the growth in per capita personal income.

**When Should the Minimum Wage be Increased and by How Much?**

Three possible guidelines for determining the size of a fair increase in the minimum wage are explored below. The first guideline is to keep pace with inflation, i.e., the cost of living. The second guideline is to keep pace with average wage gains. The third guideline, keeping pace with the growth in per capita income, was suggested by Governor Schwarzenegger as a method for selecting the rate of growth in tuition at California’s public colleges and universities.

The second and third guidelines embrace the concept that the minimum wage should keep pace with the real growth of wages and the standard of living in California.

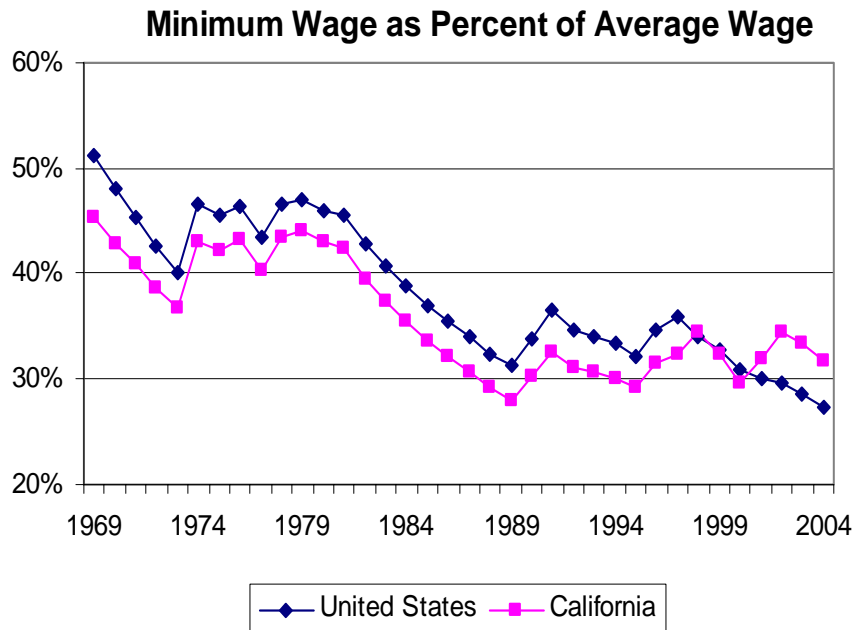
**Both the federal and state minimum wages have failed to keep pace with inflation over the past 35 years.**



The federal minimum has fallen in value from \$8.20 in 1969 (measured in 2004 prices) to \$5.15 today. Adjusted for inflation, there has only been one year (1989) when the value of the federal minimum wage was lower and that was following eight years of no increase.

California's minimum wage has fallen in value from \$8.65 in 1969 to \$6.75 in 2004. Recent raises have pushed California's minimum wage up in real value from the low levels of the 1980s and early 1990s. However, the 2004 minimum wage is still 22% below what it was in 1969, adjusted for inflation.

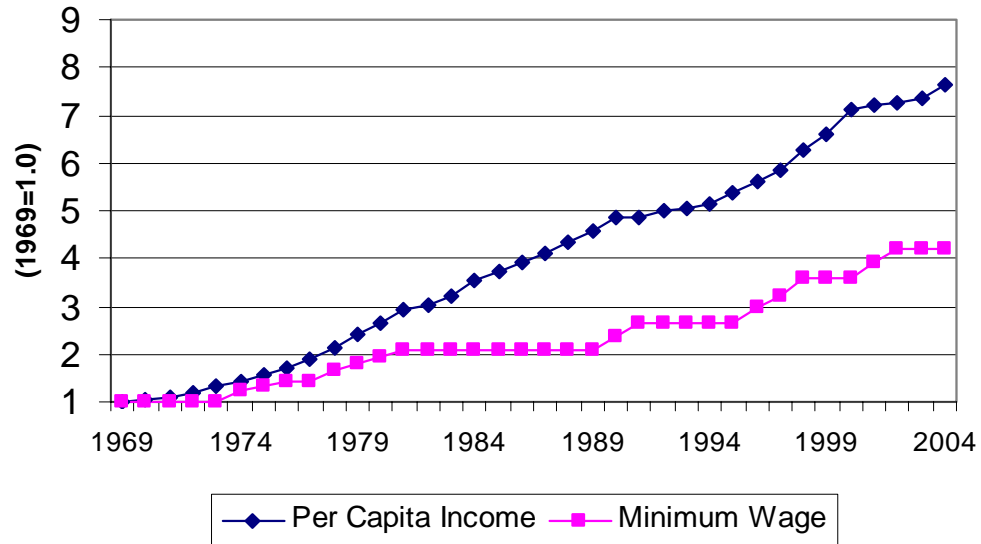
**The state and federal minimum wage have fallen even more in relation to average wages since 1969.** The federal minimum wage was close to half as large (51%) as the average wage in 1969. By 2004, the federal minimum wage was equal to only 27% of the average wage.



The California minimum wage has been keeping pace with average wages since the late 1980s, but overall has fallen in relation to average wages since 1969. California's minimum wage is 32% of the average wage in 2004, up from 28% in 1989 but far below the 45% of 1969.

Per capita income, the standard suggested by Governor Schwarzenegger for raising college tuition each year, has grown by even more than consumer prices or the average wage. Since the late 1970s, growth in the minimum wage has fallen steadily behind the growth in per capita income in California.

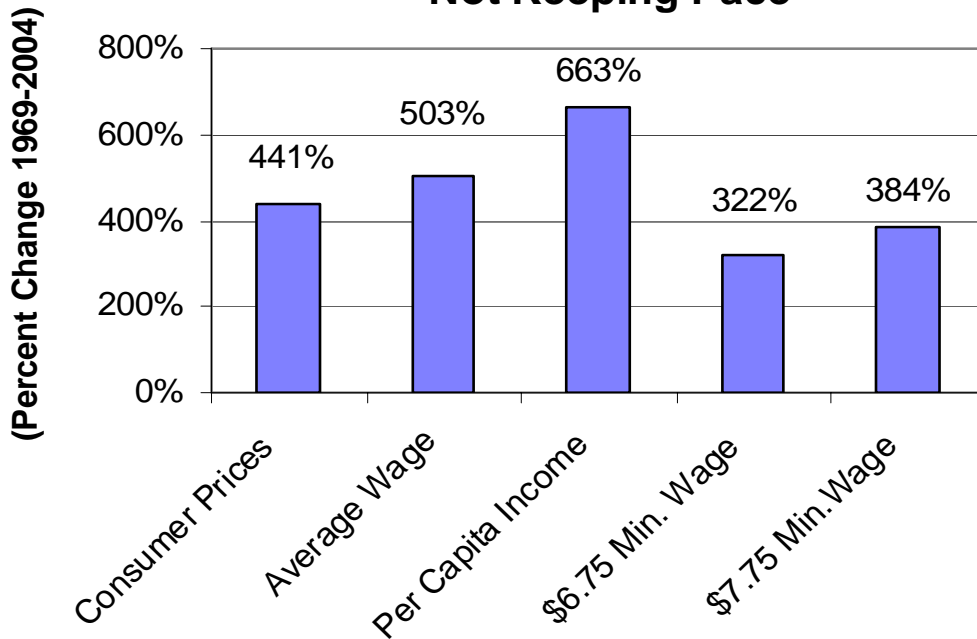
## Growth in Minimum Wage and Per Capita Income



An increase to \$7.75 in California’s minimum wage is easily justified as fair under any of these three standards. The current minimum wage of \$6.75 is 322% above the 1969 level while California consumer prices have increased by 441% and average wages in the state have grown by 503%. Per capita income in California has increased by 663% during this same period.

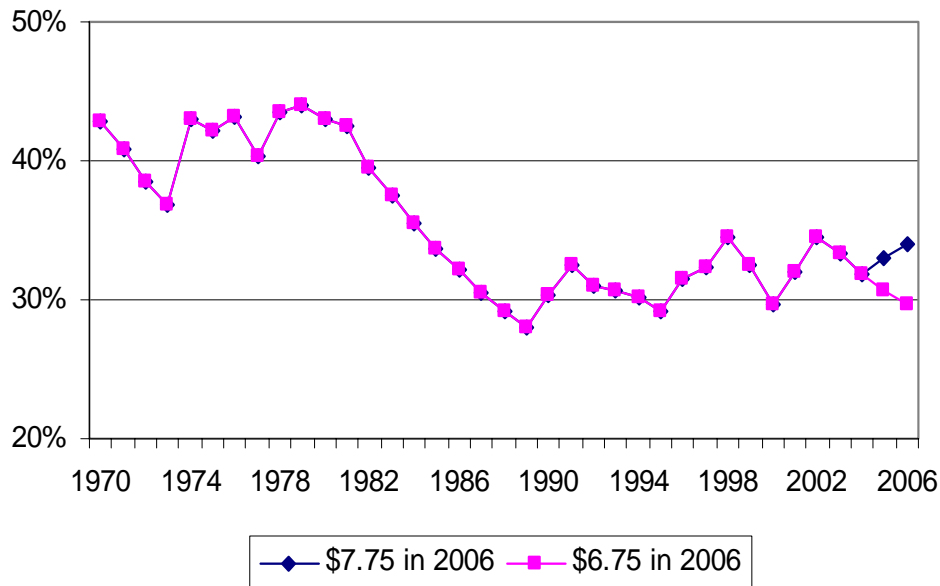
So, California’s minimum wage earners have lost ground to inflation, average wages and per capita income over the past 35 years.

## Not Keeping Pace



If a \$7.75 an hour minimum wage were enacted tomorrow, it would still leave the minimum wage lower, adjusted for inflation, than it was in 1969. And the \$7.75 minimum wage is scheduled for 2006 when average wages and consumer prices will be higher than now.

### Minimum Wage as Percent of Average Wage in California



If the minimum wage remains at \$6.75 an hour in 2006, it will equal less than 30% of the average wage. The minimum wage has only been that low three times in the past 35 years.

If the minimum wage is raised to \$7.75 in 2006, it will be equal to 34% of California’s average wage. That will be well below the long-term average share and, by 2007, will already be back below the average share since 1995.

**What would the minimum wage be in 2006 to keep pace with inflation, average wages or per capita income since 1969?** To keep pace with increases in the California Consumer Price Index since 1969, the minimum wage would need to be \$9.05 in 2006. To keep pace with average wage gains since 1969, the minimum wage in 2006 would need to be \$10.35. And, to keep pace with gains in per capita income, the minimum wage in 2006 would need to be \$13.05.

The minimum wage is part of our “social compact” and fairness requires that the minimum wage be adjusted periodically to maintain equity for minimum wage earners.

Governor Schwarzenegger has called our attention to the principles of “social compact” and fairness in his call for increases in college fees and for having college fees keep pace with income growth through regular yearly increases. The principle of regular yearly increases to keep pace with income and cost of living growth applies to the minimum wage as well.

### **Arguments Against Raising the Minimum Wage**

Most of the arguments against raising the minimum wage revolve around the impacts of the minimum wage on job creation. For example, the California Chamber of Commerce has labeled the proposal increasing the minimum wage as a “job killer”.

#### **Threatening California’s Economic Recovery**

One argument voiced against raising the minimum is that the minimum wage increase will threaten California’s economic recovery.

There are at least three counter-arguments. First, the minimum wage increase is not scheduled until 2005 and 2006. Economic forecasts anticipate that the California economy will be at its strongest in 2005 and 2006. If not next year, then when is the “right time”?

Second, as the previous charts illustrate, the nation has increased the minimum wage even during a recession and the following years brought long economic booms. For example, the minimum wage was increased in 1990 and 1991 and the nation thereafter had our longest period of economic expansion. There is no evidence that minimum wage increases prevent strong economic expansions from occurring.

Third, the state and nation do not have a history of pitting “fairness” versus “the economy”. We do not suspend child labor laws or smog standards to boost the rate of economic growth. The essential questions are 1) whether having a minimum wage is sound social and economic policy and 2) whether having the minimum wage increased periodically is part of maintaining fairness in social and economic policies.

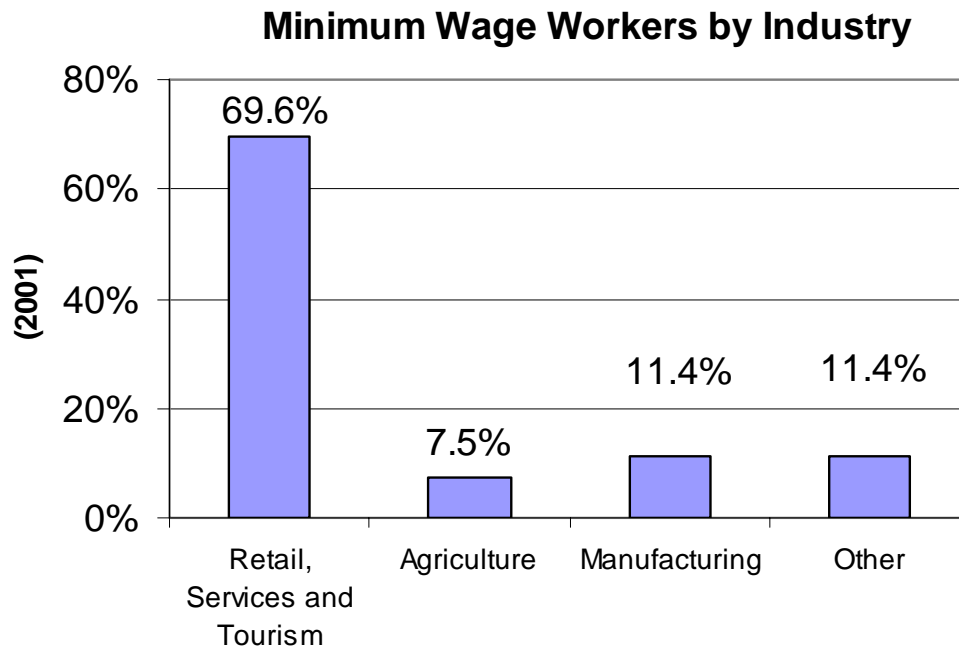
#### **Impacts on Industries and Workers**

The main contention of the “job killer” argument is that anything that raises business costs reduces the number of jobs. This is certainly true in some situations. To evaluate the magnitude of the connection between wage increases and job levels, it is necessary to distinguish between industries that serve mainly

national and international markets (i.e., “export” industries) and industries that serve mainly local markets.

Industries that primarily export goods and services, in theory, have a choice of where to locate production facilities. Industries like biotech and motion pictures have a choice of where to locate and these choices are affected by a variety of cost considerations as well as other factors like the education and transportation systems and general quality of life.

Some California minimum wage workers are in export industries, i.e., industries subject to interstate or international competition. But, most low-wage workers are employed in retail, food service, health services, childcare and hotel industries. According to data from the California Budget Project, nearly 70% of low-wage workers are in the retail, services and tourism sectors.



The most likely result from increasing the minimum wage in these local population-serving industries is some modest price increases.

Wage costs are the largest component of cost in most service industries and the normal response to rising wage costs (if they are not offset by productivity gains) is to increase prices. Our fast food meals and dry cleaning may cost a few cents more as a result of raising the minimum wage.

There is no difference between the impact of a general increase in wages and an increase in the minimum wage in these industries. In fact, the economic impact models used by organizations like the South Coast Air Quality Management

District explicitly model the impact of a rise in wages in population-serving industries as leading to price increases and not job losses.

It is true that wage increases in industries facing interstate or international competition can affect the amount of production conducted in California. But this is not the case for industries that primarily serve local residents, which are the industries where most minimum wages workers are employed. Their customers remain in California. Residents are not likely to go to Nevada or Oregon to save a few cents for fast food or dry cleaning. Actually, Oregon has a minimum wage near ours and already has regular annual increases.

The same dynamic is true for most of the goods and services we buy. We will not go to a hospital in Nevada because the wages of nurses' aides are lower. And if all (or nearly all) restaurants, grocery stores, "big box " stores face the same rising costs, the result will be a small increase in prices.

Normally, people understand when the price of a restaurant meal or dry cleaning goes up because costs go up. **So, the basic question remains one of fairness. If the minimum wage is supposed to keep up with inflation, the level of average wages or per capita income growth, the resulting cost increases are just part of implementing a fair policy.**

Good public policy sometimes adds a bit to costs as with smog devices or plant safety programs. Most residents understand and accept the increased cost of cars that have effective smog control devices. Most residents understand and accept the higher costs that might arise from implementing safety regulations or prohibiting child labor.

And, the same fairness that suggests reviewing public pension arrangements to see if current public sector pension benefits are "out of line" with private sector benefits also suggests increasing the minimum wage so that it does not become "out of line" with the growth of average wages, inflation or per capita income.

### **Industries That Face Out-of-State Competition**

Some low-wage workers are in industries that are directly in competition with firms located in other states and countries. As shown on page 8, just over 10% of low-wage workers are employed in California's manufacturing sector and another 7% are employed in agriculture.

There is an ongoing debate about the economic competitiveness of California firms and the role of public policy in either increasing or decreasing the state's "economic competitiveness". Some groups argue that the state imposes above-average business costs on firms in areas including workers' compensation, energy, housing and regulations.

State policymakers have struggled with these cost issues for many years. In the past year, two sets of workers' compensation reforms have been adopted and proposals to reduce energy costs are currently being debated. California's

housing costs are much higher than in other states, but this problem has been difficult to address.

A higher minimum wage in California would add to the differential in costs facing some firms in export industries.

### **Not all Minimum Wage Workers Live in Poor Households**

It is true that not all minimum wage workers live in poor households. But it has been true throughout most of the post World War II period while the minimum wage has been raised regularly. If policymakers want to debate whether the minimum wage should be restricted only to workers living in poor or near-poor households, they are free to do so. But, that is a **completely different debate from whether now is an appropriate time to raise California's minimum wage.**

More than 60% of all minimum wage earners in California are working full time and more than 60% are over 25. And many do live in poor families.

### **The Bottom Line**

The two questions posed at the beginning of the memo remain:

- 1) Do you favor having a minimum wage as part of the nation's public policy?

The answer depends on each individual's perspective on the role of government in developing policies to "soften the edges" of a completely free market economy and for providing minimum standards under which the free market economy operates.

- 2) What standards should be used to decide when and by how much to increase the minimum wage?

People who answer yes to question 1 must answer this question.

The Fair Labor Standards Act of 1938 gives general direction about the rationale for the minimum wage ("to provide for the establishment of fair labor standards in employments in and affecting interstate commerce") but does not set specific rules for increases.

The most common standard applied to increases in safety net program payments has been to keep pace with increases in the cost of living (i.e.,

general inflation). Payments in these programs are increased through the application of COLAs or Cost Of Living Adjustments.

For example, Social Security benefits are increased each year to take account of increases in the cost of living. COLAs are used in many other safety net programs as well as in many private and public sector labor agreements. California uses COLAs to adjust state income tax brackets so that residents do not pay higher taxes simply as a result of inflation.

Recently, Governor Schwarzenegger has extended the concept of “keeping pace” to developing a guideline for regular increases in tuition and fees at the state’s public colleges and universities. The Governor has suggested using per capita income growth as a guideline. Using the growth in per capita income as a guideline would provide for larger increases in tuition and minimum wages than would occur if growth in the cost of living were used.

Currently, federal and California law does not require regular cost of living adjustments to the minimum wage. Two states, Oregon and Washington, have recently adopted such rules.

So, the pattern and extent of minimum wage increase remains a political decision guided by the general concept of fairness.

**If fairness includes the concept of keeping pace with increases in the cost of living, there is a strong “fairness” case for raising the minimum wage in California at least to the level proposed in current legislation--\$7.25 in 2005 and \$7.75 in 2006.**