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What Difference Does a Minimum Wage Make?

The minimum wage and the Fifth District

In 1938, in the wake of the Great Depression, the Fair Labor Standards Act (FLSA) established the first federal minimum wage of 25 cents per hour. At that time, a limited number of states had minimum wage requirements, and even the 1938 act applied primarily to companies involved in interstate commerce or producing goods for interstate commerce. The most recent change in the federal minimum wage rate, enacted in 2007, raised the hourly rate from $5.15 to $7.25 by July 2009. But changes to minimum wage laws are neither consistent across states nor uncontroversial among economists. Many states, including some in the Fifth District, have enacted legislation in the last year to increase the minimum wage, and those increases will have both direct and indirect effects on workers, households, and businesses in the District. This article outlines both who will be affected and what those effects could be.

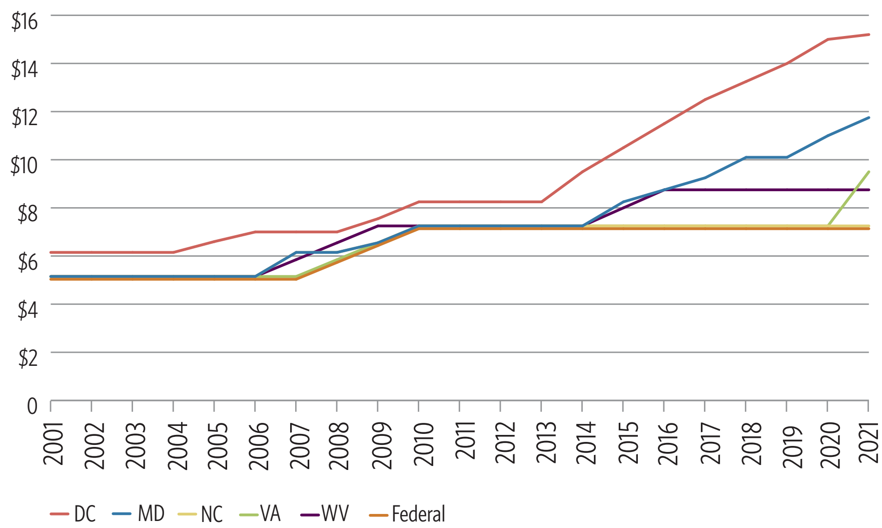
THE FIFTH DISTRICT AND ITS MINIMUM WAGES

State legislatures across the country have implemented their own minimum wages, and the number of states whose minimum wage exceeds the federal level has increased in the last decade. In January 2010, 13 states and the District of Columbia had minimum wage rates above the federal level; by July 1, 2021, 30 states had higher minimum wage rates, with the highest in Washington state ($13.69). As in the nation, minimum wage laws vary across Fifth District jurisdictions. The District of Columbia increased its minimum wage from $15 to $15.20 on July 1, 2021, while recent legislation in Maryland and Virginia committed to steadily increase the minimum wage over the next few years. West Virginia's minimum wage went from $8 to $8.75 in 2015. In the District, only South Carolina has no minimum wage law, but in effect, North Carolina has also ceded control to the federal government by setting its state's minimum to the federal level. (See chart.) More state-level increases in the Fifth District are slated. (See table on next page.)

As in federal minimum wage legislation, states can write occupational and industry exceptions, as well as accommodations for very small businesses, into their minimum wage requirements. In some states, localities can set local minimum wage rates that exceed the state and federal minimums. For example, in Maryland, Montgomery County (and until recently, Prince George's County) instituted a minimum wage above both the state and federal minimums. But local minimum wages are more the exception than the rule in the Fifth District: Court rulings and state laws in Virginia, North Carolina, and South Carolina prevent localities from setting their own minimum wage rates. In West Virginia, although no legislation prohibits localities from mandating higher minimum wages, no locality has ever implemented a higher minimum.

There are a number of reasons why states or localities might adopt their own minimum wage. First, the FLSA does not index the minimum wage to inflation. In fact, the buying power of the federal minimum wage peaked in 1968 when it was $1.60, which equates to $11.90 in 2020 dollars. Some states and localities across the country, including in the Fifth District, have indexed minimum wage increases

State-Level Minimum Wages in Fifth District Jurisdictions



NOTE: Rate changes are effective January of each year, with the exception of 2021 (rates are effective as of July 1). South Carolina has no state minimum wage law.
SOURCES: State Minimum Wage History, U.S. Department of Labor, Wage and Hour Division via FRED; State Minimum Wage Laws, U.S. Department of Labor, Wage and Hour Division

Minimum Wage Increases in the Fifth District

	2021 Minimum Wage	2020 Minimum Wage	Scheduled Increases	
			Set Rate Increases	Inflation Indexing
District of Columbia	$15.20[1]	$15.00[2]	None[3]	Annual indexing based on CPI-U (DC metro average) starting July 1, 2021
Maryland	$11.75	$11.00	January 1, 2022: $12.50[4] January 1, 2023: $13.25 January 1, 2024: $14.00 January 1, 2025: $15.00	None
South Carolina	$7.25[5]	$7.25	None	
North Carolina	$7.25	$7.25	None	
Virginia	$9.50[6]	$7.25	January 1, 2022: $11.00 January 1, 2023: $12.00 January 1, 2025: $13.50 January 1, 2026: $15.00	Annual indexing to CPI-U (US City average) begins January 1, 2027
West Virginia	$8.75	$8.75	None	

SOURCES: U.S. Department of Labor State Minimum Wage Laws; EPI Minimum Wage Tracker; Code of the District of Columbia; Maryland Department of Labor; Code of Virginia; West Virginia Division of Labor.

1 Effective July 1.
2 Effective July 1, 2020; previously $14.
3 If the federal minimum wage increases above the D.C. rate, the D.C. rate will increase to $1 above the federal minimum.
4 Stepwise increases for employers with <15 employees begin in 2022 with an increase to $12.20 and completes in January 2026 at $15.
5 South Carolina has no state minimum wage; federal limit applies. North Carolina's state minimum wage is set to equal the federal FLSA rate.
6 Effective May 1.

to a consumer price index to account for future price increases. Second, the federal minimum wage does not account for regional variations in the cost of living, which states can address through higher state minimums and by allowing local minimum wage rates above state requirements. Third, setting their own legislation can enable states to fine-tune their minimum wages, for example, by setting separate stepwise increases for small businesses.

EFFECTS OF A MINIMUM WAGE INCREASE

When trying to assess the potential impact of an increased minimum wage, the first step is to understand which workers are likely to be affected. In a 2019 article in the *Quarterly Journal of Economics*, Doruk Cengiz of the firm OMP and co-authors estimated employment and wage changes in reaction to 138 state-level minimum wage increases between 1979 and 2016. They found that spillovers in wage increases extend up to $3 above the minimum wage and represent around 40 percent of the overall wage increase from minimum wage changes. (They calculated a 6.8 percent increase in the average wages of affected workers.) In a February 2021 NBER working paper, Orley Ashenfelter of Princeton University and Štěpán Jurajda of the Center for Economic Research and Graduate Education - Economics Institute used price and wage data from McDonald's restaurants to find a strong relationship between the increase in the minimum wage and increase in restaurant wages. Although much of the wage increase was among workers near the effective minimum wage level, many restaurants sought to preserve their pay premium and thus increased wages regardless of whether the minimum wage was binding — that is, whether the minimum was higher than what their workers were already receiving.

Cengiz and his co-authors found that the benefits of wage spillovers accrue only to those who had a job before the minimum wage increase and not to new entrants. They argued that the spillovers were generated from concerns about relative pay — firms bumping up the pay of workers who were just above the minimum wage in order to preserve pay differentials within the firm — and not from the fact that the higher wage floor enticed nonemployed workers to take a job.

On one hand, if the minimum wage rises above a nonemployed worker's reservation wage (that is, the lowest wage at which a worker is willing to work), he or she will take a job. On the other hand, the rise in the minimum wage, or even the discussion of a possible minimum wage hike, could itself result in an increase in workers' reservation wages. The economy seems to be experiencing such an increase in reservation wages today — not just as a result of the $15 minimum wage discussion, but also as the result of a pandemic that had a disproportionately large impact on our lowest wage workers. (See "Do Employees Expect More Now?" p. 1.)

More controversial than the relationship between the minimum wage and average wages is the effect of an increase in the minimum wage on employment — at least using the minimum wage increases that have been observed in the United States. Economic theory from Econ 101 would imply that if the minimum wage acts as a price floor in a competitive labor market, then enacting a minimum wage will reduce labor demand and thus reduce employment. The evidence of an employment decline after a minimum wage increase, however, has been mixed. Broadly, the literature suggests limited aggregate employment effects but a negative employment effect for workers earning at or below the minimum wage prior to the increase. In their 2019 article, Cengiz and his co-authors found that an average minimum wage hike led to a large and statistically significant decrease in the number of jobs below the minimum wage in the five years after the minimum wage was implemented or changed. Those lost jobs were almost entirely offset by an increase in the number of jobs at or slightly above the minimum wage. This is what economists call a labor-labor substitution at the lower end of the wage distribution. The researchers found no indication of significant employment changes in the upper part of the wage distribution.

In a 2021 review of some of the literature, David Neumark of the University of California, Irvine and Peter Shirley of the West Virginia Legislature reported that 55.4 percent of the papers that they examined found employment effects that were negative and significant. They argued that the literature provides particularly compelling evidence for negative employment effects of an increased minimum wage for teens, young adults, the less educated, and the directly affected workers. On the other hand, in a 2021 *Journal of Economic Perspectives* article that analyzed the effect of the minimum wage on teens ages 16-19, Alan Manning of the London School of Economics and Political Science wrote that although the wage effect was sizable and robust, the employment effect was neither as easy to find nor consistent across estimations.

Thus, although the literature supports an effect on employment among the most affected workers, it does not appear to be as sizable as theory might suggest. But how else do employers respond to a forced increase in the cost of labor? For one, they could pass the cost increase along to customers — and there is some evidence for that. In a 2018 *ILR Review* article, Sylvia Allegretto and Michael Reich of the University of California, Berkeley found that minimum wage increases are largely absorbed by price increases. Daniel Cooper and María José Luengo-Prado of the Boston Fed and Jonathan Parker of the Massachusetts Institute of Technology concluded much the same in a 2020 article in the *Journal of Money, Credit, and Banking*.

There are other ways that employers could absorb the increased wage. For one, employers could cut nonwage compensation, such as health care benefits or vacation time. Alternatively, if raising wages lowers turnover among firms, they might find that labor costs increase substantially less than the increased wage would suggest — thus accounting for the smaller employment effect. Firms might also turn to automation in the face of rising labor costs.

Another possibility is that firms do not operate in a perfectly competitive labor market. For example, firms might have monopsony power, where a firm is the price-setter of wages rather than the price-taker. (See "Raise the Wage?" *Econ Focus*, Third Quarter 2014.) In this model, the employer faces an increasing marginal cost per worker and thus will underpay and underemploy given the productivity of the workforce; by setting a minimum wage above what the monopsonist chooses, the government imposes a constant marginal cost per worker, thus leading the firm to both employ and pay more.

WHO ARE THE MINIMUM WAGE WORKERS?

The complex and regional nature of minimum wage legislation makes it more complicated than one would think to understand exactly which workers are affected by minimum wage legislation. Roughly 139 million employees, or 85 percent of the U.S. workforce, qualify for FLSA protections. Employees in certain occupations and industries (for instance, individuals elected to state and local offices and their staffs) are not covered by the FLSA. Even for those who qualify for FLSA coverage, there are exemptions to the minimum wage requirement for some employees (for instance, employees in some computer-related occupations who pass salary and duties tests) and subminimum wage provisions for workers including new hires under age 20, full-time students, employees with disabilities, and tipped workers.

Nationwide, the share of U.S. workers earning at or below the minimum wage is small. According to the Bureau of Labor Statistics *Characteristics of Minimum Wage Workers* report, in 2020, 55.5 percent of all wage and salaried workers, or 73.3 million workers ages 16 and older, were paid hourly. Of these workers, 1.5 percent reported earning at or below the federal minimum wage in 2020, compared to 13.4 percent in 1979. According to the same report, in the Fifth District, the share of hourly workers at or below the federal minimum ranged from 1.8 percent in the District of Columbia and North Carolina to 4.4 percent in South Carolina. This can, of course, vary notably by age

Workers Affected by a $15 Federal Minimum Wage Increase

	Total Estimated Workforce	Directly Affected	Indirectly Affected	Total Share of Workforce Affected
District of Columbia	372,884	3,192	7,258	2.8%
Maryland	3,047,895	54,743	46,253	3.3%
North Carolina	4,572,109	1,072,696	436,771	33.0%
South Carolina	2,174,795	540,810	189,334	33.6%
Virginia	4,073,552	603,202	332,338	23.0%
West Virginia	714,738	188,799	61,614	35.0%
Fifth District Total	**14,955,973**	**2,463,442**	**1,073,568**	**23.6%**

SOURCE: State Demographic Tables, Economic Policy Institute Minimum Wage Simulation Model analysis of the 2021 Raise the Wage Act; authors' calculations.

group. According to Alan Manning in a 2021 *Journal of Economic Perspectives* article, more than 25 percent of teens reported an hourly wage at or below the minimum in 2019. Yet they represent only about 10 percent of all minimum wage workers in 2019 compared to about a third of minimum wage workers in 1979.

Understanding the effect of a $15 minimum wage requires figuring out the number of workers who make less than $15 per hour, not less than the current $7.25. Also, most minimum wage laws increase the wage over time, so any analysis would have to assess how many workers will make less than $15 in the future, thus requiring a forecast of market-based wage growth. For example, the Congressional Budget Office (CBO) analyzed the proposed Raise the Wage Act of 2021 — which would raise the federal minimum wage in annual increments to $15 by June 2025 and then increase it at the same rate as median hourly wages — and estimated that by 2025, 17 million workers, or 10 percent of the projected labor force, will earn less than $15 per hour during an average week in 2025.

In addition, the CBO — consistent with findings in the literature — assumed that the 10 million workers who would have wages only slightly higher than the proposed minimums would also be "potentially affected" on the basis that employers would retain some pay differences across their workforce. Therefore, according to this analysis, increasing the minimum wage to $15 through the proposed legislation would affect the pay of about 27 million workers nationwide.

Under different assumptions, particularly about nominal wage growth for low-wage workers, the Economic Policy Institute (EPI) Minimum Wage Simulation Model estimates that the Raise the Wage Act could affect the pay of roughly 32 million U.S. workers by 2025 — considerably more than the CBO estimate. Because of the act's provision to phase out the tipped worker subminimum wage — increasing it from $2.13 in 2021 to $12.95 by 2025 — even states that will have $15 per hour (or higher) minimum wages in 2025 will see an increase in the number of affected workers. EPI estimates that 2.46 million workers in the Fifth District would be directly affected by the Raise the Wage Act, as would the additional 1.07 million workers making between the new minimum wage and 115 percent of the new minimum. (The 1.07 million workers are comparable to the CBO's "potentially affected" workers.) West Virginia and the Carolinas, where the minimum wage is at or slightly above the prevailing federal level and where there are no planned increases, would see the largest share of their workforces affected by 2025. (See table.)

Of the estimated 3.54 million Fifth District workers who would see direct or indirect wage increases, 64 percent would be over 25 years old. Teenagers and young adults (age 16-24) comprise 15 percent of the workforce but would account for 36 percent of workers getting a wage boost. Twenty-eight percent of women working in the District would see a wage boost, compared with 19 percent of men. Employees across sectors would be affected by the minimum wage increase, but service industries like retail, restaurants, and accommodations would see some of the highest shares of their employees get wage boosts in the Fifth District. The ripple effect of the minimum wage increase would reach households across the income and education distribution, but low-income households would be most affected.

IS THE MINIMUM WAGE THE BEST POLICY?

Theoretically and empirically, a higher minimum wage brings many positive and negative forces to bear on employment. It is not always clear which ones will prevail, so judgments must be made in any analysis of the cost and benefit of minimum wage legislation. In the CBO's analysis of the Raise the Wage Act, two minimum-wage-related employment dampeners (higher prices reducing demand and labor-saving technology replacing labor) more than offset two employment enhancers (increased demand for goods due to increased income for low-income families and increased demand because of employer monopsony power), leading the CBO to conclude that on the whole the act would reduce employment nationally by 1.4 million in 2025.

The purpose of the minimum wage, of course, is to reduce poverty and enable workers in the lowest paying jobs to maintain a reasonable standard of living. The CBO, in fact, estimated that the Raise the Wage Act would lift 900,000 people out of poverty, which is what a minimum wage hike is generally intended to do. Ellora Derenoncourt and Claire Montialoux of the University of California, Berkeley argued in a 2021 *Quarterly Journal of Economics* article that by extending federal minimum wage coverage to industries such as agriculture, restaurants, and nursing homes — industries with about a third of black workers — the 1966 FLSA resulted in a sharp earnings increase for workers in newly covered industries. The effect was nearly twice as large for black workers as for white workers, with the result that the 1967 extension of the U.S. federal minimum wage explains more than 20 percent of the reduction in the racial earnings gap in the late 1960s and 1970s, without any effect on employment. Thus, they suggested that minimum wage policy can play a role in reducing racial economic disparities. A similar finding in a May NBER working paper by Niklas Engbom of the Stern School of Business at New York University and Christian Moser of the Columbia School of Business suggests that by compressing firm pay differences, increasing wages higher up the wage distribution, and reallocating workers to more productive employers, the institution of the minimum wage in Brazil greatly contributed to Brazil's decline in wage inequality from 1996 to 2012.

On the other hand, in a 2015 article in the *Journal of Political Economy*, Thomas MaCurdy of Stanford University argued that the minimum wage is an ineffective antipoverty policy because although on net the minimum wage redistributes income slightly in favor of lower-income households, many poor families suffer, and many rich families gain. The mechanism is through the increased prices: When a firm raises prices in response to the increased cost of labor imposed by a minimum wage hike, the rise in consumption costs is like a tax on the goods and services purchased disproportionately by low-income families.

Regardless of the potential costs and benefits of implementing or increasing a minimum wage, most economists argue that the minimum wage is, at best, a blunt tool for the more specific policy goals of ensuring that workers can earn enough income to provide for themselves and their households. And there are other tools available. The most used (and perhaps most efficient in terms of targeting financial resources to low-income households while minimizing the effect on the labor supply) is the earned income tax credit, which, for example, helped moved 5.6 million people out of poverty in 2018 and reduced the severity of poverty for 16.5 million. (See "The Payoff from the Earned Income Tax Credit," *Econ Focus*, Second Quarter 2016.) State and local policymakers are also considering guaranteed income programs or tools to help employers create a wage ladder that will enable workers to advance in their careers without facing sharp drops in income due to ineligibility for government benefits. Arguably, one selling point of the minimum wage is its coupling of a redistributive policy with an incentive to work — something that is a hallmark of the American welfare system. Perhaps the differences in minimum wage legislation among Fifth District jurisdictions and elsewhere will provide even more insight in future research. **EF**

OUR RELATED RESEARCH

"Workers for the Right Wage," Macro Minute blog, Aug. 3, 2021

"Special Survey of Wages and Hiring," Regional Matters blog, Aug. 5, 2021

"Male Labor Force Participation: Patterns and Trends," *Econ Focus*, First Quarter 2021

"High Labor Market Churn During the 2020 Recession," Economic Brief No. 21-06, February 2021

"The Benefits Cliff: Keeping Working Families from Falling Off the Edge," Speaking of the Economy podcast, Jan. 13, 2021

"Will America Get a Raise?" *Econ Focus*, First Quarter 2016