

# President Obama and the Minimum Wage – A Politico-economic Bargain

The minimum wage in the United States has generated more political infighting compared to its impact on the labor market than any other government policy affecting workers. And economists, many of whom appear to have been driven as much by ideology as by evidence, have been fighting the “Minimum Wage Wars” for many decades. (I know – I’ve been a long-time soldier, perhaps even an officer, in these wars, although I like to think that my comments have been driven solely by evidence!)

We know with a fairly high degree of certainty that raising the minimum wage will reduce employment (although a few proponents still fail to recognize that the demand for unskilled labor responds negatively to higher labor costs). Thoughtful students also recognize that the cuts in employment induced by raising the minimum wage will result in few if any people losing their jobs. An increase in the minimum wage does not increase the unemployment rate; instead, it reduces employment, as jobs that would otherwise have been created are not created, and some workers simply are not hired.

With the federal minimum wage currently at \$7.25 per hour and an average wage nationally around \$20 per hour, President Obama’s proposed increase to \$9 per hour will not affect most workers. In fact, it will not even affect unskilled workers. There just are not that many workers who would be paid this little. But it will affect some. It will raise some current workers’ wages, but it will to some small extent reduce the employment levels of other low-skilled workers. My own best guess is that after two years it will cost perhaps 100,000 or 200,000 jobs that would otherwise have been created. In an economy approaching 150 million jobs, this is a drop in the bucket. Moreover, with economic growth accelerating, as it now is in the US, a loss of this relatively tiny number of jobs will not be noticed.

The Obama proposal will make things slightly worse for the few unskilled workers who do not get the jobs that they otherwise would have obtained, and that is unfortunate. For this reason – because it reduces employment and job opportunities – I dislike the minimum wage. In a better world, one in which people were more sensible about economic policy, we would abolish it entirely; in the world we live in, that is not going to happen. So even though the net effect of the proposed increase on the economy is small (but negative), and even though its proponents have an ostrich-like view of econometric evidence and, more importantly, of basic economic theory, I would like to see the proposed increase enacted *if* – and this is a very big *if* – President Obama’s other minimum-wage proposal is enacted simultaneously.

Almost unnoticed in the discussion of the President’s State of the Union message was his proposal for indexing the minimum wage – allowing it to increase with inflation. In 1974 the US House of Representatives came within one vote of passing a bill that would have done precisely that, but since then the idea has been almost entirely ignored. Why would its enactment be a good thing?

Most importantly, it would almost surely obviate the periodic discussions about raising the minimum wage that have typically occurred when the minimum falls by about five percent relative to average wages. (If you graph the minimum relative to the average wage since 1938, when the Fair Labor Standards Act created the federal minimum wage, you will see that it looks like a series of saw-teeth with a slight downward trend). These discussions take up a tremendous amount of congressional and other

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energies. More importantly, they provide rallying points for conservative legislators to extort money from business groups and for liberal legislators to extort funds from trade unions and similar organizations. The Minimum Wage Wars thus contribute to the polarization of American politics and to its total immersion in money to an extent far greater than the importance of the legislation would dictate.

Until the early 1980s, Social Security (public retirement) benefits were increased periodically after much discussion in Congress, just as the minimum wage has been. We had the good sense to index these benefits to price inflation, with the desirable result of minimizing debates over the size of increases. Each January every Social Security recipient (including this 69-year-old beneficiary) receives a slightly higher check than in the previous month. No Congressional time is wasted discussing this increase, and interest groups are not spurred to fund legislators based on their willingness or unwillingness to raise benefits. Since these benefits maintain consumption, indexing them to prices makes sense – doing so maintains their purchasing power (although it is pretty clear that the indexing has been over-generous because it has used an incorrect measure of inflation).

We can do a similar thing with the minimum wage. Each year, as the President proposes, we should raise the minimum by some measure of inflation. This will end the Minimum Wage Wars, which will allow Congress to spend its time more productively by removing one of the regrettably many issues that have contributed to big-money politics in Washington.

The only question is *how* to index the minimum wage. President Obama proposes using the consumer price index. I disagree – a better way to index the minimum wage would be to use the growth in the average wage, so that the minimum remains unchanged relative to the average. Since over the long haul wages rise more rapidly than prices (the average real wage has increased over the last several decades), my proposal would raise labor costs more than the President's. But it is logically better and fairer: the minimum wage is, after all, the price of an hour of time of a (low-skilled) worker, so indexing it to average wage growth parallels indexing a consumption-maintenance scheme like Social Security to the price of consumption goods.

The United Kingdom and France both index their minimum wages. Not surprisingly, therefore, we have not seen the periodic debates over the appropriate level of the minimum in either of those countries that we have in the US. Indexation has reduced the importance of the minimum wage as a subject of political discussion, at least as compared to the US.

Thus for politico-economic reasons, the President's proposals should *both* be adopted, with my slight modification to the method of indexation. (Much less importantly, and aside from the political benefits, enacting them will give economic researchers an incentive to spend their time more usefully, by concentrating on other, more important research topics.) The costs in terms of jobs not created are small, and in terms of improving a faltering political system, the gains should not be underestimated.