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California's Minimum Wage

California recently established a new, higher minimum wage, increasing the minimum for most workers covered by the state law from $3.35 to $4.25 per hour. This *Letter* analyzes the anticipated effect of this change on wages and employment in California, and finds that average wages could rise by more than one percent, causing aggregate employment to fall by at least a quarter to a half percent in the state. Moreover, the effects of the new minimum wage will be felt disproportionately more by low-wage workers, including the young and those in such low-wage sectors as apparel manufacturing and retail trade.

California's new minimum wage

On July 1, 1988, California's minimum wage rose from $3.35 to $4.25 per hour—a 27 percent increase for those previously earning the $3.35 minimum wage rate. For workers whose jobs are covered by both state and federal minimum wage laws, the state minimum supersedes the federal minimum wage, which remains $3.35 per hour. The state law covers most workers in California, with three noteworthy exceptions. First, it covers only private employees, and so does not directly affect federal, state, and local government workers. Another exception to the $4.25 minimum is that, as in the past, minors and "learners" are subject to a minimum of 85 percent of the standard level.

In addition, California's law currently includes a $3.50 "sub-minimum" for workers who earn at least $60 per month in tips. However, a lawsuit was filed after the new minimum wage schedule was announced, charging that the sub-minimum violates the California Labor Code's provisions regarding tip credits. The Appeals Court ruled that the sub-minimum is illegal, but the matter now is before the State Supreme Court and will be ruled on an expedited schedule.

Minimum wage studies

Economic theory suggests that an increase in the minimum wage leads to higher wages and lower employment in most labor markets with binding minimum wages. These effects, moreover, are likely to be felt almost exclusively among workers whose wages before the change were less than or near the new, higher minimum. However, the magnitude of these effects is a matter of some debate. For example, there is a dispute whether an increase in the minimum wage causes a *significant* decrease in the number of jobs available to low-wage workers.

Most of the minimum wage studies conducted during the 1970s take into account business cycle and labor force factors that affect employment, in order to isolate the effects of an increase in the minimum wage. These studies suggest that a 27 percent increase in the minimum wage, such as the recent increase in California, could reduce the number of teenagers employed by about three to eight percent, and the number of young adults (ages 20 to 24) employed by about one to 2½ percent. According to these studies, the effect on prime-age adults (age 25 and over) would be negligible, although some low-wage workers might be replaced by other, more skilled workers in the same age group.

More recently, economist Wellington reproduced the 1970s studies to account for the higher average wage (relative to the minimum rate) and the smaller proportion of teenagers in the labor force during the 1980s. Her empirical work suggests much smaller employment losses—one and a half percent for teenagers, and no significant loss for young adults.

California vs. the nation

These economic studies all examine changes in the *national* minimum wage. However, there are reasons to expect that the effect of a change in the minimum wage in California might be somewhat different from the effect of a comparable change nationally. For one thing, because wages in California tend to be higher than those in the rest of the nation, the change would affect a smaller proportion of California workers. Whereas 15.3 percent of U.S. workers were paid $5 per hour or less in 1987, only 11.6 per-

cent of California workers received less than $5 per hour. Consequently, the recent minimum wage hike in California may result in smaller wage increases than would a comparable increase elsewhere in the nation. Therefore, results from studies that use national data may overstate the impact of a change in the minimum wage in California on both wages and employment.

On the other hand, any change in cost structures is likely to have a larger impact if it affects only one state rather than the entire nation, since firms can shift production from one state to another more readily than they can from one nation to another. Of course, these effects may be smaller in a large state like California than they would be in a smaller state, but its neighboring states (Arizona, Nevada, and Oregon) all offer firms lower wages and lower costs of living, as well as relatively good access to California's large markets. Moreover, with its minimum wage now the highest in the nation, California could earn (or reinforce) a reputation as a high-cost place to do business.

To sort out the net impact of these considerations, it is useful to estimate the effects of the minimum wage increase on wage rates and employment in various industries in California. The estimates presented below reflect conservative assumptions, which yield conservative estimates of wage effects. These estimated wage changes, along with information about the average responsiveness of employment to wage changes, provide estimates of the employment effects by industry. Aggregating these employment effects then yields an estimate of the effect on California as a whole.

Wage changes

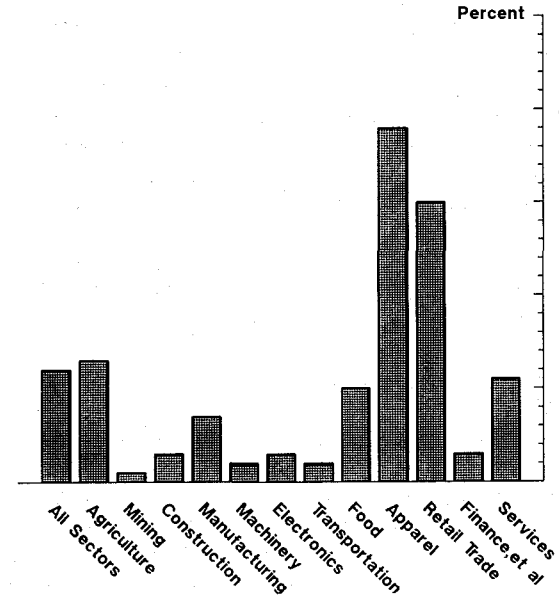
Calculating the average wage change for each industry is a critical step in this analysis. To do so, the higher minimum wage is assumed to increase wages for those previously earning $3.35 per hour by 27 percent, with smaller increases for workers earning up to $4.50 per hour. These assumptions, along with data on the number of workers earning various wage rates, were used to calculate an average wage increase for each industry group.

These estimates include no "spillover" effects among workers who earn more than $4.50 per hour. In fact, however, workers earning as much as $5 or $6 per hour could experience wage hikes with the higher minimum wage, since attempts frequently are made to preserve pay differentials between the lowest-paid workers and those who earn somewhat more.

The estimated wage increase for retail workers includes a smaller wage increase for restaurant workers than for other retail workers on the assumption that the current $3.50 "sub-minimum" wage for workers who receive tips remains in force. These calculations also assume that all government workers' wages remain unchanged. (In fact, however, political and competitive considerations may lead some state agencies and local governments to increase wages as private-sector wages rise.)

The Chart shows that the wage impact of the increase in California's minimum wage varies across industry groups. For example, wages would rise by much more in industries that have large proportions of low-wage workers, including retail trade (a three percent increase) and apparel manufacturing (3.8 percent). Aggregating these changes across all of California's industries suggests that wages should rise overall by about 1.2 percent as a result of the minimum wage hike.

Effect of the Minimum Wage Increase on Average Wage, by Industry



Employment changes

Studies that measure the responsiveness of employment to wage changes reveal that, as a general rule, wage increases of 10 percent are associated with two to four percent reductions in employment. Using this information, along with the estimates of wage increases by industry dis-

cussed above, one can derive an estimate of the change in employment that would result from the minimum wage change.

Because the relative magnitudes of the employment changes across industries reflect the relative magnitudes of the wage changes, some industries would experience relatively large employment losses. Employment losses could be particularly large in retail trade (0.6 to 1.2 percent) and apparel manufacturing (0.8 to 1.5 percent). Such calculations suggest that overall employment would fall by a quarter to a half percent, or 24,000 to 48,000 jobs.

When total changes are disaggregated demographically rather than by industry categories, the relatively large impact on young, minority, and female workers becomes apparent. Employment falls by at least one percent for teenagers of all races and genders. Moreover, for all young adult (aged 20–24) groups, as well as for adult minority women, percentage job losses are greater than the overall average.

A larger effect?

It is possible that both the wage and employment effects of the new minimum wage could be larger than these estimates suggest. "Spillover" effects on workers with wages somewhat higher than the current $4.25 minimum wage could add significantly to the "baseline" estimates. A further five percent wage hike for all workers in the $4 to $5 range would cause overall wages to rise by 0.2 percent more than in the base-case scenario, resulting in a somewhat larger employment loss of 0.3 to 0.6 percent, for a total of 28,000 to 55,000 jobs. Many argue that the spillover effects are likely to be even larger than this, since workers earning as much as $6 per hour may be affected.

The wage and employment changes also would be larger if the sub-minimum wage for tipped workers is ruled invalid by the State Supreme Court. In that event, average wages in retail trade would rise by more than four percent, compared with the three percent increase assumed in the "base-case" scenario, thereby increasing the overall wage hike from 1.2 percent to 1.5 percent. This also would result in a larger decline in employment than under the base case assumptions.

Combining the spillover and sub-minimum wage considerations, wages could rise by as much as 1.6 percent, yielding an employment loss of 0.3 to 0.7 percent, or 32,000 to 65,000 jobs. These effects are significantly larger than those calculated using the "base case" assumptions. Moreover, these calculations do not account for the fact that a state's employment level may be more sensitive to wage changes than national employment would be, as discussed earlier.

Offsetting effect?

On the other hand, it also is possible that the minimum wage could have smaller effects than these estimates suggest. For example, employers faced with higher wage bills could cut benefits in order to hold down the increase in total compensation costs. If employers' compensation costs rise by a smaller amount than the wage estimates imply, employment should fall by a correspondingly smaller amount.

In addition, employers faced with higher costs for their lowest-paid, and presumably least skilled, workers could substitute a smaller number of more highly skilled (and more highly paid) workers. In this circumstance, a particular average wage increase would cause a smaller reduction in the number of workers employed, but the impact on low-wage, relatively unskilled workers would be as large as the baseline calculations suggest.

Significant impact

The analysis presented here suggests that the recent increase in California's minimum wage could result in a one-time average wage increase of more than one percent and an employment decline of at least a quarter to a half percent. In a state where the average hourly wage has risen by an average of 2.3 percent a year since 1982, and employment has grown by an average of 3.2 percent, effects of these magnitudes are significant. In addition, disproportionately larger effects on both wages and employment are likely for low-wage workers, including the young and those in such low-wage sectors as apparel manufacturing and retail trade.

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