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Indexing the minimum wage is a good idea — by any measure

By Louis D. Johnston | 03/27/14

MinnPost photo by Briana Bierschbach

Supporters of raising the state minimum wage held a rally in the Capitol Rotunda on Feb. 25.

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To index or not index?

That is the question that seems to be keeping the Minnesota Senate and House apart on the issue of raising the minimum wage. On Tuesday, the House proposed a compromise: Index the wage, but use the implicit price deflator for personal consumption expenditures to measure inflation instead of the Consumer Price Index.

How are these two measures different? And what difference would this make for the minimum wage?

What the CPI assumes

The Consumer Price Index (CPI) measures the general level of prices for goods and services that a typical household purchases each month. (A nice summary of the details is here.) The Bureau of Labor Statistics calculates the CPI by measuring the cost of purchasing a fixed basket of goods and services over time, with the goods and services consisting of the typical stuff a household purchases every month. (The specific categories are food and beverages, housing, apparel, transportation, medical care, recreation, education/communication, and other goods and services.)

Inflation is a rise in the general level of prices as measured by a price index like the CPI. So, one way to measure the inflation rate is to calculate the percentage change in the CPI from one year to the next. For instance, from 2012 to 2013 the CPI rose by 1.46 percent, so inflation was about 1.5 percent as measured by the CPI.

So why not just stop there and index the minimum wage using the CPI? Economists usually focus on two problems with the CPI.

First, the CPI doesn't take into account changes in the quality of goods and services over time. For instance, suppose we observe that the price of a particular make and model car in 2013 is higher than it was in 2012. Are the two cars really the same? Perhaps the 2013 car has better brakes, a more efficient fuel pump, or a better sound system as part of the standard equipment. The 2013 model isn't just more expensive, it's a better car and the price reflects this. The CPI doesn't differentiate between identical goods becoming more expensive and goods improving in quality and thus might lead us to think that prices are rising faster than they really are.

Second, the CPI incorporates something economists call "substitution bias." For example, if the price of chicken rises, a typical consumer will probably substitute pork, beef, or some other protein and purchase less chicken. The CPI, however, assumes that when prices change households continue to buy the same amounts of goods and services that they did before the price changes. This makes the CPI rise more than it should and leads to an overstatement of inflation.

The differences

The implicit price deflator for personal consumption expenditures differs from the CPI in a variety of ways. Two important differences are:

- The implicit price deflator includes a wider range of goods and services than does the CPI.
- The implicit price deflator takes account of substitution bias by using the actual quantities of goods and services households purchase over time in the calculation rather than using fixed quantities as is done in the CPI.

Effect on the minimum wage

It turns out that it doesn't make too much difference which index you choose. Here's a way to see this:

Suppose that Minnesota's minimum wage had been indexed starting in 2004. The minimum wage that year was $5.15. Using the CPI as an index, it would be $6.35 today, whereas using the implicit price deflator, it would be $6.16. That's about a 3 percent difference over 10 years, with the gap widening over time. This is probably what would happen over the next 10 years if we choose the implicit deflator rather than the CPI.

So why the resistance to indexing the wage? On the one hand, indexing the minimum wage reduces the uncertainty businesses face regarding their labor costs by taking changes in the minimum wage out of the political arena. On the other hand, it takes away something for which the Legislature can take credit: an increase in people's paychecks. Further, if businesses are counting on the ability to get more productivity from their workforce without increasing their workers' real pay, firms will also resist indexing the minimum wage.

Which brings us back to the original question: Should we index the minimum wage? Yes, we should, in order to reduce business uncertainty about their costs and so that workers' wages reflect their productivity. It doesn't matter which price measure we use to do it.

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Louis Johnston writes Macro, Micro, Minnesota for MinnPost, reporting on economic developments in the news and what those developments mean to Minnesota. He is Joseph P. Farry professor in the Eugene J. McCarthy Center for Public Policy and Civic Engagement at Saint John's University. He is also a professor of economics at the university.