The Ups and Downs of Minimum Wage Policy: The Fair Labor Standards Act in Historical Perspective*

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Introduction

I provide here a historical overview of the impact of minimum wage legislation, enacted over 75 years ago in the Fair Labor Standards Act (FLSA) of 1938 and as amended subsequently on numerous occasions.

Given elected officials' caution today about raising the minimum wage in bad economic times, the timing of the passage of the FLSA is remarkable. After a long and heated political debate, Congress passed the FLSA in 1938, establishing a nationwide minimum wage of $0.25 per hour, with increases to $0.30 in 1939 and to $0.40 in 1945. Importantly, the federal minimum wage established a floor, not a ceiling. States and localities could enact higher minimum wages—although none did until the 1980s.

Similar to much other landmark legislation, the initial law represented a compromise with significant exemptions, many of which were closed only in subsequent decades. Nonetheless, in his Fireside Chat of June 24, 1938, just before he signed the bill, President Roosevelt had no doubts about the importance of the FLSA both for raising living standards and its effects on the economy. Roosevelt articulated these two key points as follows:

> Except perhaps for the Social Security Act, it [the FLSA] is the most far-reaching, far-sighted program for the benefit of workers ever adopted here or in any other country. Without question it starts us toward a better standard of living and increases purchasing power to buy the products of farm and factory.
>
> Do not let any calamity-howling executive with an income of $1,000.00 a day, who has been turning his employees over to the Government relief rolls in order to preserve his company's

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> undistributed reserves, tell you—using his stockholders' money to pay the postage for his personal opinions—tell you that a wage of $11.00 a week is going to have a disastrous effect on all American industry. (Roosevelt 1938)

Was President Roosevelt correct about the far-reaching effects of the minimum wage provisions of the FLSA? And was he correct that minimum wages would not have negative effects? In this brief historical overview I discuss why we need minimum wages and suggest that the national minimum wage has indeed had important and far-reaching economic effects. These effects have varied in different periods so I break down the distinct effects since 1938 as occurring in five different periods.

In the first period, from 1938 through World War II, the minimum wage had a major and positive transformative effect upon the national economy. By creating a floor that was projected to increase for several years, the FLSA in its early years helped stabilize the shaky condition of the U.S. economy. It also catalyzed the industrialization of the U.S. South.

In the second period, from the end of World War II through the 1970s, the real minimum wage rose from $0.75 in 1950 (about $4 in 2014 dollars) to a peak at a bit above $10 (in 2014 dollars) in the late 1960s.[1] In this period, real economic growth was stronger than before or since, real average wages grew, and wage growth occurred at about the same rate for low-paid workers as for higher paid workers. The minimum wage increases in this period were likely an important pillar supporting the nation's broadly shared prosperity.

In the third period, the decade of the 1980s, the real value of the federal minimum wage fell by about 30 percent—to about $7 in 2014 dollars. This substantial decline exerted downward spillover effects on a broader set of wages—as far as the 15th wage percentile. In this context, wages fell below poverty levels and bottom-half wage inequality grew steadily. Low minimum wages became embedded in the business plans of employers in a number of industries, notably restaurants, hotels, and retail.

In the fourth period, from 1990 to 2013, the real federal minimum wage fluctuated around an average level of about $7 (in 2015 dollars), the same level it had attained in 1950 and to which it fell by 1989. The seven federal increases in this period—the last in 2009—thus did not generate a long-term increase in the federal floor.

[1] Coverage was also extended: beyond workers engaged in interstate commerce, or producing goods for interstate commerce, to retail, local transit, construction, state and local government employees, other services, and to some domestic household workers.

In response, an increasing number of states and cities began to establish their own minimum standards. These increases were generally moderate, usually raising minimum wages to about a dollar or two above the federal level, and affecting about 5 percent of the covered workforce. The increases remained modest compared to local wage levels. In San Francisco, for example, which in 2013 had the highest minimum wage ($10.58) of any jurisdiction in the United States, the ratio of the minimum wage to the median full-time wage was 39 percent. The comparable ratio for the United States as a whole was also 39 percent.

Finally, in 2014 and 2015, a new minimum wage era seemed to be getting under way. A number of states began to raise their floors to the $10 or $11 levels. Many large cities aimed even higher, enacting floors of up to $15. These new floors exceed the real levels of the late 1960s. And the citywide experiments promise to reduce lower-half pay inequality by historic amounts.

I discuss the economic arguments against and for minimum wages in the next section. I then discuss the five historical periods, followed by a summary and discussion of future prospects for minimum wages in the United States.

Why Do We Have Minimum Wages?

The first national minimum wage laws were enacted in New Zealand in 1904, followed by Australia in 1907 and the UK in 1909 (Starr 1993). The United States followed in 1938. Most other countries' minimum wages were introduced in the post-World War II period. Today all but 8 of the 193 countries in the United Nations have minimum wage policies, fixed either through statutes or embedded in collective labor–management agreements.[2]

Why are minimum wages so nearly universal? It is not just that minimum wages enjoy popular appeal. The case for intervening in the employer-employee relationship also has an economic basis. In the standard model of perfect completion, employers will pay wages set by labor supply, wages equal the value of marginal products and any government regulations must reduce employment. But in modern labor market models, employers possess power to set wages, implying that wages will be less than the value of marginal products and minimum wages need not reduce employment.[3]

[2] The exceptions are Burundi, Guinea, Maldives, Nauru, Qatar, Tonga, the UAE, and Yemen.

[3] Minimum wages also need not reduce employment if technological possibilities for capital-labor substitution are weak or if they are mainly passed through to consumers as higher prices. Any reductions in consumer demand are likely to be offset by increased spending among low-income workers.

In the standard perfectly competitive model of the labor market, firms face downward-sloped labor demand curves and horizontal labor supply curves. Under these conditions, workers and employers each are free to choose to enter into employment contracts and the wage reflects the value of a worker's marginal product and nothing else. In this model, which was articulated by John Bates Clark in the 1870s, workers and employers are on an equal footing and there is no unemployment. Introducing minimum wage standards above the going market rate then reduces the quantity of labor demanded by firms and wages can be increased only by increasing worker productivity.

An early counterargument, by Sidney and Beatrice Webb, suggested exactly the opposite: that higher wages would raise worker productivity.[4] The Webbs argued that better paid workers would be more productive; i.e., "you get what you pay for." This possibility has become formalized in modern efficiency wage models (Bowles 1985; Shapiro and Stiglitz 1984). These models also explained why wages do not get competed down to a level that eliminates unemployment.

The persistence of unemployment provides the basis for another popular economic intuition that has justified minimum wages. In this approach, workers are so plentiful that their competition with each other lowers wages below a living wage level, one that is lower than what employers could afford to pay. Early empirical research on wage setting, including by Clark himself in the United States and by the Webbs in England, found that such "sweated" conditions were common. In his 1934 book, *The Theory of Wages*, Paul Douglas—of the famous Cobb–Douglas production function—presented systematic evidence that wages were lower than the value of marginal products in many industries.

The inequality between wages and marginal product has become a hallmark of modern monopsonistic labor-market models. These models, which emphasize the ubiquity of monopsony power, recognize that higher wages can induce a greater supply of workers to individual firms (Manning 2004). Higher minimum wages then reduce job vacancies and hiring costs. The monopsony model was already well known in the early 1930s, thanks to Joan Robinson (1933). It was then incorporated into Stigler's 1946 article, "The Economics of Minimum Wage Legislation" as a reason why minimum wages might not reduce employment. Some of the early research on minimum wages obtained exactly this result.[5]

[4] For a historical review of early debates about minimum wages, including the views of John Bates Clark, see Prasch (1998). See also Webb (1912).

[5] For example, Seltzer (2002) finds that the establishment of the FLSA led directly to high wages and higher employment in the Virginia tobacco industry in the late 1930s. Seltzer interprets these results using the monopsony model. In 1974, according to Gordon (1981), the extension of minimum wage coverage to housekeepers reduced employment declines in that occupation compared to similar jobs that remained uncovered.

A third intuition supporting the benefits of market intervention through minimum wage standards comes from modern search and matching models. In the "job ladder" versions of these models, firms choose between offering low wages and experiencing high turnover, or higher wages and lower turnover. A higher minimum wage then reduces quits among the lower-wage firms but does not reduce overall employment (Dube, Lester, and Reich 2016).

The Minimum Wage from 1938 through the 1970s

The original 1938 FLSA replaced a patchwork of 25 state minimum wages (mostly limited to women) with a uniform national floor covering about half of the workforce (agriculture and retail were excluded). The FLSA created a $.25 wage floor as well as the anticipation of scheduled further increases, to $0.30 in 1939 and to $0.40 in 1945. These standards helped end the downward spiral of money wages in the latter 1930s, changing macroeconomic relationships.[6]

As Keynes argued at the time, that downward spiral of wages and prices prolonged and deepened the Great Depression. Stabilizing wages (and therefore also prices) had been a major concern among many business executives. Most American economists in that period were not opposed to establishing a national wage floor. The then-current conventional macroeconomic wisdom, called the doctrine of high wages, argued that higher worker purchasing power would create more economic growth.

Many economists thought the Great Depression was largely over by 1937. Indeed, money wages were largely stable from 1933 to 1936. But an economic recession, which began in May 1937 and lasted until June 1938, reduced real GNP by 11 percent, a frightening number. Economic historians traditionally focused on fiscal tightening and changes in gold flows as the causes of the 1937–1938 recession, which then brought back another downward spiral of money wages and prices. But recent research also identifies changes in inflationary expectations as responsible for the subsequent recovery (Crafts and Fearon 2010). It therefore seems likely that the long debate over the FLSA in 1937–1938 and its ultimate passage in June 1938 helped stabilize both average money wages and wage expectations. These effects would help end the recession and help the United States exit the Great Depression.

[6] According to Welch (1973), these minimum wage levels represented 40.3 percent of the average manufacturing wage in 1938, 47.3 percent in 1939, and 39.4 percent in 1945. The increase from $0.40 to $0.75—an 88 percent nominal increase—in 1950 brought the ratio to 52.1 percent of the average manufacturing wage.

In the immediate postwar decades, increases in the floor brought its level as high as the equivalent of about $10.60 in 2013 dollars, or 46 percent higher than the current minimum of $7.25. Moreover, amendments in the 1960s and 1970s expanded coverage to nearly 80 percent of the nonagricultural private sector workforce by 1973 (Welch 1973, Table 2).[7]

In addition to helping reverse the downward national spiral of money wages, the national minimum wage helped transform many low-wage industries. These effects were most evident in the South, a region that was both much poorer than the rest of the United States and poorly integrated with the national economy. As the eminent Stanford economic historian Gavin Wright has shown, the FLSA-created floor was highly binding in Southern industry. Nonetheless, a more prosperous South, one with more employment growth and at higher wages, began to emerge after the passage of the Act (Wright 1986). The bill's opponents, many of whom represented Southern states and districts, did not foresee this transformation. An equally unexpected and dramatic upsurge in the South's fortunes occurred in the 1960s, after the FLSA extensions and the Civil Rights revolution (Wright 2013).

While the South gained relative to the national economy, all regions of the postwar United States experienced shared and rapid economic growth. Although it may seem surprising today, the magnitude of minimum wage increases then were explicitly designed not only to outpace inflation, but also to maintain equity with the growth of average wages—the wages received by the middle class. Indeed, as Figure 1 shows, from 1939 through the 1970s, the real federal minimum wage increased almost every 5 years. Moreover, as Figure 2 shows, with these increases the minimum wage averaged about 48 percent of the manufacturing production wage, versus 38 percent from the 1980s on (see also Welch 1973, Table 1; Dube 2013, Figure 6).

Minimum Wage Changes since the 1980s

The economic terrain shifted radically in the 1980s, to lower overall economic growth, stagnating real median wages, and higher wage inequality. The real federal minimum wage fell 30 percent in the 1980s; subsequent increases have not made up these losses. As a result, the ratio of the federal minimum wage to the median wage fell substantially, to a low of 32 percent in 2006.

[7] Later extensions increased coverage much further, to more retail and service workers, to public-sector workers, to medium and large farms, and to some domestic workers, although also adding a credit for tipped workers.

Figure 1

Nominal and Real Minimum Wages, 1938–2020

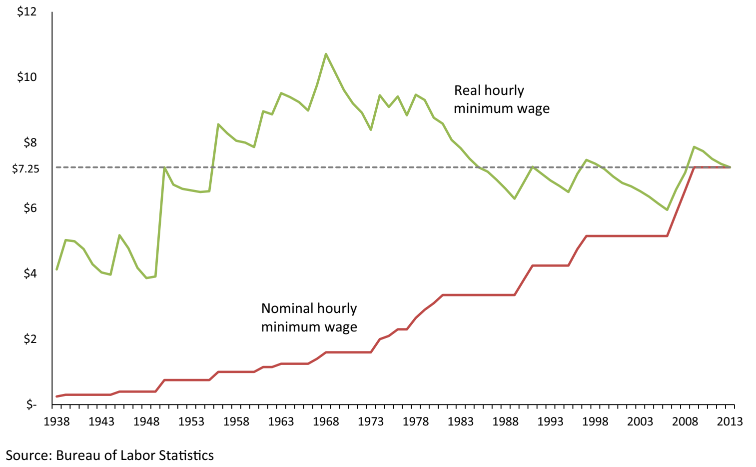
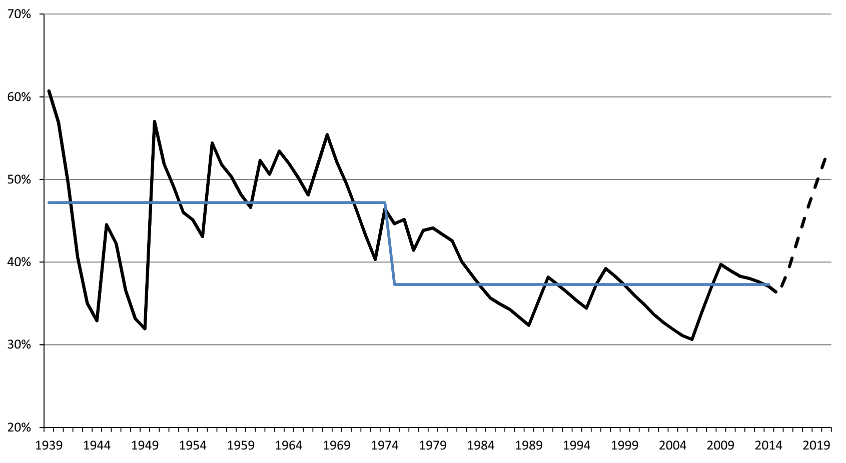


Figure 2

Federal Minimum Wage as a Percentage of Average Manufacturing Wages, 1939–2020 (Projected).



Source: FRED Economic Data (2015); Whittaker (2003).

Note: Projected data is based on "Raise the Wage Act of 2015" and an expected 2.5% annual increase in manufacturing wages in 2015–2020

The ratio stands at about 37 percent in 2015, much lower than the 48–55 percent range of four decades ago.

In response to the declining level and reach of the federal minimum wage, states have acted increasingly on their own. In 2015, 29 states and the District of Columbia had raised their minimum wages above the federal level. These increases were generally moderate, usually raising minimum wages to about a dollar or two above the federal level, and affecting about 5 percent of the covered workforce.

Indeed, in 2014 and 2015 a new wave of local minimum wage increases has apparently begun, raising pay standards well above previous peaks. San Francisco and Seattle, which are scheduled to institute $15 minimum wage standards in 2018 and 2021, respectively, represent examples of affluent cities with relatively high wages—and costs of living—that are in the vanguard of this movement. In these cities about a fifth of workers will receive pay increases, far higher than the typical 5 percent in the previous period.

In other cities, where average wages are not so high, such as Chicago, Oakland, and Los Angeles, minimum wage levels are scheduled to increase to $13, $12.25, and $15, respectively. The fraction of workers receiving pay increases are also high—about 20 percent in Chicago, 26 percent in Oakland, and 40 percent in Los Angeles.[8] If these policies succeed, they will greatly compress the bottom half of the wage distribution in major urban U.S. labor markets.

Summary and Future Prospects

This whirlwind review of minimum wage policy and effects since 1938 supports President Roosevelt's statements in his June 1938 Fireside Chat. The FLSA was both far-reaching and far-sighted. Minimum wage policy helped to eliminate the downward pattern of money wages in the 1930s, thereby removing one of the forces that had deepened and prolonged the Great Depression. In the immediate postwar decades, minimum wage increases were important in creating shared prosperity. Subsequently, their decline contributed to the widening of inequality.

The Great Recession and the subsequent slow job market recovery have eliminated or endangered millions of middle-class jobs. In this new era, young workers can no longer count so much on minimum wage jobs as stepping-stones into middle-class careers and middle-class workers are increasingly looking at minimum wage rates as key reference points for their own level of

[8] See Minimum Wage Working Group (2014); Reich et al. (2015).

economic security. This new context suggests that the pressure to increase minimum wages will continue.

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