

## New Minimum Wage Affects More Than Low-Wage Employees

*Law360, New York (March 27, 2014, 1:06 PM ET)* -- On Feb. 12, 2014, President Obama signed an executive order raising the minimum wage for federal contractors to \$10.10 per hour, starting Jan. 1, 2015. For federal contractors who have employees that earn less than \$10.10 per hour, this executive order has the potential to impact much more than the wage rates of their lowest paid employees. Employers may need to increase the wages of more than just their lowest paid employees, due to equity and other considerations.

The policy change may therefore have a broader effect on firms' compensation policies, including increasing the total amount the firms pay to workers, above and beyond the amount necessary to be compliant with the new law. These changes may also affect the relative wages of protected group members (e.g., women relative to men or minorities relative to whites) and thereby have important implications for company-led diversity efforts, as well as possible litigation threats. Depending on their current structure and how they choose to adjust their employees' wages, the impact of the increased minimum wage on the business of federal contractors may vary widely.

### Payroll Situation in 2014

Company XYZ currently has 20 full-time hourly employees, 10 men and 10 women, who are paid at one of three hourly rates: \$8.50, \$10 and \$11.50. Five women and two men receive the lowest hourly rate, four women and three men receive the middle hourly rate, and one woman and five men receive the highest hourly rate. Simple calculations show that the average female wage is \$9.40 and the average male wage is \$10.45. The female average is \$1.05, or 10 percent lower than the male average. Overall, the average wage rate of these 20 employees is \$9.93. Assuming that all of them are employed full time in 2014, the total payroll cost is \$412,880 (i.e., \$9.93 multiplied by 20 employees by 40 hours per week by 52 weeks).

### Wage Adjustment in 2015

There are many different ways of adjusting the wage rates of these 20 employees on Jan. 1, 2015, to be compliant with the new law. Here we will consider three options. The first option is increasing the wage rate to \$10.10 for all employees whose rate is below \$10.10. There will be no wage adjustment for the rest of the employees. The second option is increasing the wage rate for all employees by \$1.60, so that the lowest wage rate would be exactly \$10.10. The last option is increasing the lowest pay rate to \$10.10, and then increasing the other wage rates by smaller amounts, which will make the highest rate \$12.00. In the following, I will review each option separately.

#### Option 1 (Minimal Adjustment) — Raising Wage Rates of Employees Earning Less Than \$10.10 to

## **\$10.10**

This option will cost Company XYZ the lowest amount among the three options considered here. Employees who used to make \$8.50 and \$10 will all earn \$10.10 starting in 2015, whereas employees who used to earn \$11.50 won't see a pay increase. Under this option, there are only two wage rates in 2015, \$10.10 and \$11.50. The difference between the lowest and highest hourly wage is \$1.40, compared to \$3 in 2014. The total annual wage cost will increase by 6 percent from \$412,880 in 2014, to \$437,632 in 2015.

Because more women than men earned below the new federal minimum (nine as compared to five), more women will receive pay increases in this scenario. The average wage rate will go up by \$0.35 (or 2 percent) to \$10.80 for men, and by \$0.84 (or 8 percent) to \$10.24 for women. This will reduce the gender pay rate difference from \$1.05 to 56 cents in dollar terms, and from 10 percent to 5.2 percent in percentage terms.

This option is the least expensive among the three options considered here, and results in a positive side effect of reducing gender pay rate differences. However, there might be some difficulties in implementing this option. Employees who do not receive a pay increase in 2015 are likely to be disappointed with the pay adjustments that are applied to their lower paid coworkers. Even the employees whose pay rate changes from \$10 to \$10.10 may not be satisfied with the pay adjustment process, knowing that employees who used to be paid less than them in 2014 will be paid the same rate as them in 2015.

Giving a companywide pay increase to some employees but not to all may not be received positively by the employees who are not benefiting from this adjustment. If Company XYZ realizes that the first option will make some employees unhappy, then it can adopt alternative options where all employees receive a pay increase. Obviously, these options will be more costly to Company XYZ than the first option.

### **Option 2 (Equal Amount Increase) — Raising Wage Rates of All Employees by \$1.60**

This option will increase the wage rates of all employees by the same amount of \$1.60. Now the lowest pay rate is the new minimum wage rate of \$10.10, followed by \$11.60, and \$13.10. By construction, the average wage rate will increase by \$1.60 — from \$9.40 to \$11 for women, from \$10.45 to \$12.05 for men, and from \$9.93 to \$11.53 overall. The dollar difference in the average wage rate between women and men will stay the same at \$1.05, but the percentage difference will decrease from 10 percent to 8.7 percent. This is because the \$1.05 gap is now a smaller portion of the increased average wage rate. The total annual wage cost will increase by 16 percent, from \$412,880 in 2014 to \$479,440 in 2015. This costs 10 percent more than option 1.

### **Option 3 (Compressed Increase) — Larger Pay Increases to Lower Paid Employees**

Option 2 does not have the problem that option 1 has — a pay increase for some but not all. It is likely that it will be viewed as more balanced or less selective than option 1, but it has another problem. Company XYZ's payroll cost will increase by 16% compared to only a 6% increase in option 1. Furthermore, it does not have the positive side effect of decreasing the average wage rate difference between women and men as in option 1. Option 3 tries to avoid the problem in option 1, while reducing the significant payroll cost increase seen in option 2.

Under this option, everyone will get a pay increase, but the dollar amount of the wage rate increase will differ across employees. First, the lowest paid employees at \$8.50 will get a pay increase of \$1.60, or 19 percent, to \$10.10. The highest paid employees will also see a pay increase, but by a much smaller amount and a lower percentage. Their wage rate will go up by \$0.50, or by 4 percent, from \$11.50 to \$12. Employees with the middle wage rate, \$10, in 2014 will receive a pay increase of \$1.05 (or 11 percent) to \$11.05. In 2015, the three wage rates are separated by \$0.95 compared to \$1.50 in 2014.

In other words, the 2015 wage distribution is compressed relative to the 2014 wage distribution, although the wage compression is not as strong as in option 1. Thus, we expect to see a decrease in the average wage rate difference between male and female employees in 2015 compared to 2014. The average wage of females rises by \$1.27 (or by 18 percent) from \$9.40 to \$10.67, whereas the male average wage goes up only by \$0.89 (or by 14 percent) from \$10.45 to \$11.34. Therefore, the female average in 2015 is 66 cents less (or 5.9 percent lower) than the male average. The total payroll cost will increase by 11 percent to \$457,704, which is still higher than the 6 percent increase in option 1, but significantly lower than the 16 percent in option 2.

However, this option is still susceptible to some of the same problems as option 1, if the compressed wage distribution does not reflect the skill and experience differences across employees. Suppose that 2014 wages correctly compensate employees according to their contribution to Company XYZ. It means, for example, that the highest paid employees (\$11.50 per hour) are \$3, or 35 percent, more valuable to the firm than the lowest paid employees (\$8.50 per hour). However, in 2015, the highest compensated employees are paid only \$1.90, or 19 percent, more than the lowest paid employees. This may disappoint the highest paid employees and can lead to a lower retention rate among the high skilled and more experienced employees. This may not be optimal for Company XYZ in the long run.

## **Conclusion**

In response to a new executive order, federal contractors may have to adjust the wage rates of their lowest paid employees in 2015. They will have several options for doing so. This article reviewed three options and their impacts on human resources policy, payroll costs and differences in wages between two groups of employees. Each method has strengths and weaknesses, and there is no option that dominates in all aspects. The structure of wages for each federal contractor is unique and therefore the best option may differ from one to another. This article demonstrates why it will be important for federal contractors to consider the implications of the various wage adjustment options, before implementing one in 2015.

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