

Do Living Wages Accomplish Their *Intended* Purpose?

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Key Issues

Much of the economic focus is on the policy's *unintended consequences*:

- Do living wages cause unemployment?
- Do firms move out of a city to avoid the living wage?
- Do firms subcontract to avoid paying the living wage?
- Do consumer prices increase to pay for the living wage?

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The motivation for asking these questions largely come from the more established minimum wage literature.

Key Issues

Other, less explored *unintended consequences*:

- Displacement effects – “labor-labor substitution”
- “Gaming the system” – Ordinance exceptions
- Human capital accumulation

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In addition to the real possibility of jobs disappearing, there are several other unintended consequences that do not get nearly as much attention, but are worth discussing. The first is often called “labor-labor substitution.” One key area that even advocates for the living wage will readily agree to is the possibility and reality of substitution of more-skilled for less-skilled labor. Living wage supporter Dr. Robert Pollin conducted a December 2000 study on a New Orleans wage increase and reported that “openings for the covered New Orleans jobs would likely attract workers with somewhat better credentials, on average, than those in the existing labor pool.” Dr. David Neumark found that increases in the minimum wage attract more highly skilled applicants to traditionally low-skill jobs, concluding “Increases in the minimum wage ... raise the probability that more-skilled teenagers leave school and displace lower-skilled workers from their jobs.”

A second issue that does not get nearly the attention it should is that the intricate details of the living wage ordinances often create economic incentives to “game” the system. Actual living wage provisions oftentimes treat employers differently based on the total number of employees, total revenue (or government revenue), and worker’s age. The Atlanta living wage ordinance is a case-in-point. The ordinance exempts employers with fewer than 15 employees. The ordinance clearly states that part-time workers, full-time workers, temporary workers, and subcontractors are included in the 15-employee limit. This is simply a headcount, not work effort. An employer with 28 part-time employees could quickly become a firm with 14 full-time employees to avoid losing money. This arbitrary cutoff creates needless distortions without commensurate benefit. Another issue is how are number of employees measured – is the “notch” at 15 employees measured as: An annual average? The lowest number employed during the year or quarter? The highest number employed during the year or quarter? On a particular day? We can all imagine the “gaming” that could and would go on. This measurement issue inherently creates a costly, bureaucratic, and intrusive local government system to monitor employers. Although advocates for the living wage would like us to believe that these responses are modest or irrelevant, think about the cost of hiring the 15th worker in Atlanta, moving up from the federal minimum wage of \$5.15 to the proposed \$12 living wage in Atlanta. ***The marginal cost of the 15th worker isn’t \$12 an hour, but rather \$108 an hour.*** The reason is that all other 14 workers (the inframarginal employees) also have their wages raised from \$5.15 to \$12. Assuming that all 15 employees were full time, the annual labor cost would be \$360,000, while hiring only 14 employees results in an annual labor cost of \$144,200. Hiring that 15th employee raises costs by 250%. Except to the ardent supporters of the living wage, I think that this kind of tradeoff in costs is unacceptable. One could make similar arguments about the problems with other provisions. In part, economists haven’t had adequate data or perhaps the interest to study these issues in the context of the living wage. In a different context, I found that California’s recent health insurance mandate (known as SB-2) was much more costly to business than anyone, including California’s Chamber of Commerce, realized, and the marginal cost of hiring the 200th employee at a firm could easily be \$1,000,000 a year. This work was published on *Employment Policies Institute* in October 2003.

The third, and perhaps most important unintended consequence over the long-run, relates to human capital accumulation. Imagine that an 18-year-old is considering attending a junior college or taking an entry-level job. The opportunity cost of attending college increases with the living wage, and not attending could have long term consequences on the person’s wage trajectory. One can imagine situations, and “behavioral” economists have become increasing skilled at modeling them, where the 18-year-old rationally takes what seem like impulsive actions such as choosing the “dead-end” job which offers immediate gratification rather than going to college which offers delayed gratification. Although living wage advocates might counter that working at a higher paying job could reduce the liquidity constraints of college attendance, the key problem is that both public subsidies (like Pell Grants and Guaranteed Student Loans) and private scholarships often tax both current income flows and wealth stocks at very high tax rates. Thus, increased earnings fail to translate into increased liquidity.

Key Issues

Economists focus relatively less attention on the policy's ***intended consequences***. This discussion will focus on whether a living wage achieves its intended consequences.

Key Issues

Living wage is often motivated by concerns about poverty alleviation. Natural questions:

- What “***tax rates***” do low-income households face?
- Should ***income*** be defined as “cash income” or something else?
- How does the living wage affect ***total family income*** and earnings?
- Is the living wage ***well-targeted***?

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It is useful to explain at this point how I entered into the living wage dialogue. My work, ever since graduate school, has largely focused on how the welfare system affects work behavior and household well-being. I started by exploring the work disincentives from Medicaid public health insurance, and have moved on to examine virtually all of the largest government transfer programs. Part of my work emphasizes that poor households are often eligible for many welfare programs, not just one, and these programs do not operate in a vacuum.

I would contend that the broad public’s appetite for the living wage is based on poverty alleviation. Returning to the Atlanta example, a pro-living wage organization known as the *Atlanta Living Wage Coalition* has as one of its two principles that “People who work full time should be able to support a family above the poverty line.” As we will see later, the *Coalition* inevitably uses single-parent families with children as the “winner” from living wage ordinances in their Op-Ed pieces, on their websites, and in testimonials in front of policy makers. Ask yourself: how many times is a healthy, single, 18-year-old male with no obligations to anyone but himself used as a “winner” by living wage advocates? The answer, of course, is zero, because it wouldn’t fly with the median voter. Reducing poverty sells with the voters and policy makers.

The other principle that the *Coalition* puts forth is “Employers who receive public dollars should be required to pay workers a living wage,” – basically that the City of Atlanta should not only worry about the output it receives, but about the inputs as well. If the second motivation held (that is, forcing local governments hold businesses that receive public subsidies “accountable”), but not the first, then advocates for the living wage would absolutely, positively promise to not expand the ordinances to private businesses that do not receive any local government subsidies. Their sense of fairness would also limit the “tax” from the living wage to the actual subsidy amount. If, instead, advocates believed that “business should pay a *full* wage,” there would not be exemptions to the ordinance. If paying a “fair wage” for an hour’s worth of work is the guiding factor, a teenager should be treated the same as a prime-age worker or a senior citizen, and a small employer should be treated the same as a large one. It is my belief that “forcing business to pay a ‘fair’ wage” doesn’t resound with voters the way poverty alleviation does.

Key Issues

Much of this presentation will draw on two recent studies:

Toikka, Yelowitz, and Neveu (forthcoming 2004, *Economic Development Quarterly*)

Yelowitz and Toikka (work-in-progress, discussion paper for *Employment Policies Institute*)

Tax Rates

Many poor households take up transfer programs:

- Temporary Assistance to Needy Families (TANF)
- Food Stamps
- Public Housing
- Medicaid
- Numerous smaller programs

**These program impose high tax rates
(illustrated in table 1)**

Table 1
Earnings and benefits after four months on job for a mother with two children with day care expenses, 1996 – Philadelphia, Pennsylvania.

Earnings	EITC	AFDC	Food Stamps	Medicaid \$3307	Eligible for public housing	Housing subsidy, 2 bedrooms	Total Income
0	0	5052	2722	Yes	Yes	8136	19217
5000	2000	2492	2590	Yes	Yes	7224	20730
10000	3556	0	2438	No	Yes	6024	18253
15000	2842	0	1538	No	Yes	4824	18436
20000	1789	0	0	No	Yes	3624	18123
25000	736	0	0	No	No	0	16929
30000	0	0	0	No	No	0	19837
50000	0	0	0	No	No	0	34188

Notes: In adding the numbers across each row to get total income, negative values are in parentheses. *Social Security taxes, federal and state income taxes, and work expenses are also factored into the calculations but not included to save space.*

Imagine taking a female headed household from \$0 of earnings to \$30,000 of earnings, equivalent of a full-time, full-year job at \$15-per-hour. Total income only goes up by a mere \$600, after accounting for the details of various welfare programs.

It is also important to note that local government is making businesses pay more in labor costs and the employee does not much benefit. What is happening is that the local “tax” on business is mainly flowing out to the federal government and also the state government. The EITC and food stamps are completely federally financed, as is the majority of Medicaid expenditure and much of public housing.

Tax Rates

Assuming **full take-up** of programs:

- Average tax rate on first \$30k of earnings was **98%**
- The **composition** of income changes
- Poverty rates change based on cash definition

Tax Rates

- Recently offered testimony on Atlanta living wage ordinance (\$12/hour without benefits)
- The Atlanta Living Wage Coalition has testimony from **Santina Story**, a 33-year-old mother of three, who worked full time and earned \$6.75 an hour at the Crowne Plaza Hotel in Atlanta
- She likely faces tax rates of **75%** on additional earnings (EITC, food stamps, federal+state, OASDI)

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The Atlanta provision had many other nuances as well. It had a ‘vacation mandate’ of 12 days per year, equal pay provisions for men and women, and mandates on domestic partner benefits. Clearly many of these provisions alone, such as domestic partner mandates, would be a political minefield if considered separately, so they are packaged together with a politically more palatable living wage ordinance.

For every \$100 of increased earnings for Santina, \$69 immediately flows out of the community to the federal government, and another \$6 flows out of the community to the state.

Defining Income

The *composition* of income changes in Table 1, which leads to changes in poverty rates based on the cash definition.

- At \$0 earnings, 26% of total income was cash
- At \$10,000 earnings, 54% of total income was cash
- At \$22,000 about 83% of total income was cash (not shown)

Advocates might argue that the composition of income matters. For example, isn't a \$1.00 of earnings more desirable than a \$1.00 of transfer income? Isn't changing the composition important for the inherent dignity of less-skilled workers. Although it would be called wages or earnings instead of welfare, this is simply a matter of semantics. It is still a government transfer, just mandated through employers. We should not fool ourselves into thinking that the person's "market worth" has changed overnight.

Defining Income

- Although total incomes are relatively unchanged at \$0, \$10,000, or \$22,000 in earnings, ***the poverty classification does change***
- Poverty definition is based on cash-income
- ***Illusory effect*** – “well-being” not changed much

Effect on Family Income

In Yelowitz and Toikka (work-in-progress), we compare vulnerable households in cities that implemented a living wage to those that did not.

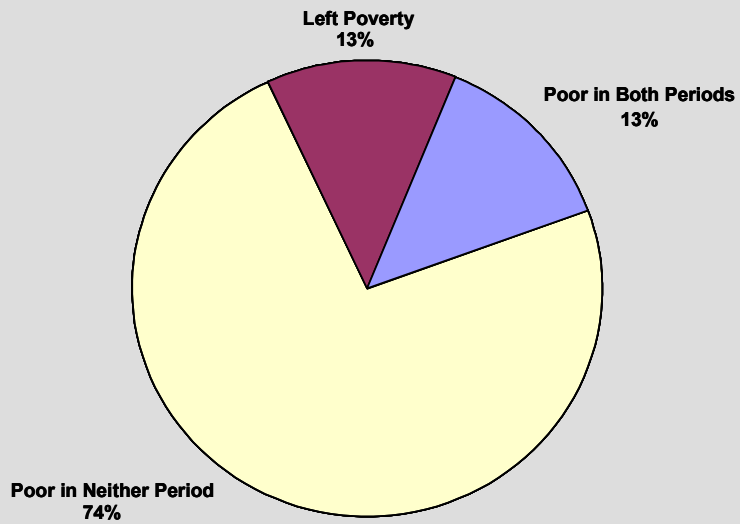
The living wage had statistically insignificant effects on household total income and earnings.

Moreover, for every \$1.00 of increased earnings, cash transfers fell by \$0.44.

Targeting

- Toikka, Yelowitz, and Neveu simulate the effects of a living wage across a number of large cities
- Of those affected by living wage, **75% did *not* live in poverty**
- Of those affected by living wage, **40% had incomes *greater than 200%* of poverty line**

Figure 2. Fraction of increased wages received by household poverty status



Targeting

- The data suggests that even using a cash-based measure of poverty, the living wage is not well-targeted
- Living wage targets *individual earnings*, not *family income*
- May benefit single individuals, teens, others who are not “at-risk”

Alternatives

Are there *alternatives* to the living wage that lead to more desirable outcomes? One popular proposal is a state-level ***Earned Income Tax Credit (EITC)***.

Center on Budget and Policy Priorities reports:

- Twelve states have refundable state-EITCs
- Five states have non-refundable EITCs

Alternatives

EITC often is not counted as income for transfer programs. EITC, therefore, does not “crowd-out” transfer assistance which is composed of both federal and state dollars.

Alternatives

EITC and living wage are ***not complements*** to each other; rather they are ***substitutes***. The marginal earnings from the living wage end up in the EITC ***phase-out range*** of 21%.

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Also, some have argued that the EITC cannot deal with the day-to-day liquidity problems that the poor face. Although almost all of the recipients of the EITC take it in lump sum when they file their tax return, they certainly have the *option* of taking advanced payments over the course of the year. If the main criticism of the EITC was its lumpiness, outreach could be used to increase use of the advanced payments.

Conclusions

My research indicates that the living wage is a very blunt policy instrument for achieving its policy objectives.

*A better solution is a state Earned Income Tax Credit. EITC could target **family income** rather than **individual earnings**, and could target vulnerable households in a way the living wage cannot.*

Conclusions

**I am delighted to answer questions,
either today or in the future.**

- Aaron Yelowitz's email: aaron@uky.edu
- The full studies (and data) available at:
<http://gatton.uky.edu/faculty/yelowitz/>
- Thank you!