

## Higher wages lead to more efficient service provision

# The impact of living wage ordinances on the public contracting process

by Jared Bernstein

The purpose of this document is to explore questions of competitiveness engendered by recent living wage ordinances. The central focus is whether and to what extent the introduction of a living wage ordinance in a locality would be expected to either reduce the competitiveness of the contracting process or introduce economic distortions into the local economy. Both the theory and the evidence point to the following conclusions:

- Any regulation that affects all firms puts no one firm at a competitive disadvantage.
- No current living wage ordinance covers more than 1% of its locality's workforce. Similarly, for most firms, the increase in labor costs is expected to be less than 2% of total production costs. Therefore, no credible analysis could argue that the policy will have a significant negative impact on a locality's economy.
- It is reasonable, however, to ask if living wage ordinances might have a negative sectoral effect; the evidence from existing living wage evaluations and the economics literature on the impact of exogenous (i.e., policy-induced) wage increases fails to find evidence of these effects.
- The most likely explanations for these results are 1) like living wage ordinances, existing wage policies tend to affect a small share of the workforce, and 2) firms tend to absorb the higher costs through efficiency gains.
- Such efficiency gains are realized through lower turnover, vacancy, and accident rates, and improvement in the quality of the low-wage workforce, all of which lead to higher quality provision of goods and services.

The rest of this document discusses these findings in greater detail. The first section asks what economic theory would predict when a living wage ordinance is introduced. The next section presents a brief overview of related economics literature on the impact of policies which raise sectoral wage rates. This section includes results from the only two studies (with which I am familiar) that have systematically evaluated the impact of a living wage ordinance (the Baltimore ordinance). The third section explains the finding that firms tend to absorb these increases through efficiency gains, and the final section concludes. In this last section, I mention a set of indirect effects of living wage ordinances that are likely to have a positive effect on local economies.

### What would economic theory predict when a living wage ordinance is introduced?

First, it is important to establish the extent to which living wage ordinances a) put any given firm at a competitive disadvantage, and b) actually increase labor costs.

Regarding the first point, it is essential to recognize that any policy or regulation that affects all firms puts no single firm at a competitive disadvantage. This means that were a locality to pass a living wage ordinance, all firms who bid for a locality's contracts would face the same wage floor; no firm could underbid the wage floor set by the living wage. This no more creates a competitive disadvantage within the locality than any other regulation, such as a requirement that firms may not practice discriminatory hiring practices.

Second, the impact of a living wage on the cost of contracting depends on the extent to which the increase actually "bites" into the wage scale at the affected firms. If the mandated wage level is below that of wages already paid to workers covered under local contracts, then of course there would be no impact at all. Interestingly, research on existing living wage ordinances in various cities shows that the number of workers affected tends to be quite small, either in absolute numbers or as a share of the workforce. In no case of which I am aware does the ordinance extend to more than 1% of the locality's total workforce. Similarly, according to Pollin and Luce (1998), who offer the most detailed analysis of living wages to date, most ordinances will increase affected firms' labor cost by less than 2% of production costs (i.e., labor plus capital costs).

Thus, no reasonable economic model would predict that the introduction of a living wage ordinance could possibly have a major distortionary effect on a local economy. A more relevant question is whether the ordinance would be likely to generate a negative sectoral impact. That is, while it is logically insupportable to argue that the law would disrupt the locality's overall economy, it is not unreasonable to wonder about the impact on those sectors of the locality's economy affected by the increase.

Here, economic theory is instructive. An increase in labor costs would be expected to be absorbed through one (or a combination) of the following four channels: prices, employment, profits, or productivity/efficiency gains. On the price side, employers attempting to absorb the increase in labor costs may try to pass the price forward to buyers in the form of higher prices. Or, as has commonly been raised in the minimum wage debate, the wage increase might lead employers to cut employment, either through cutting hours or the number of employees on the payroll. Profit margins may also shrink to absorb the increase. Finally, and this has turned out to be key to understanding employer's responses, firms can absorb the wage

increase through efficiency gains.

#### **What does the evidence show?**

Which, or what combination, of the "absorption channels" do we observe when wages are increased by fiat?

Various strains of empirical labor economics literature are revealing. The following presents a brief overview of three policies, including living wages, that lead to higher labor costs (through higher wages) than would exist in the absence of the policy.

*Increases in the Federal Minimum Wage:* This, along with unionization, is by far the most studied wage policy. Summarizing a large literature, economists find that moderate national minimum wage increases, like those we have experienced over the sixty-five years that the policy has been in place, have few, if any, identifiable distortionary effects. The most common prediction regarding the impact of an increase is that the employment of workers affected by the increase will decline. But significant negative effects have never been consistently found; some studies have even found positive employment effects. A good estimate of the negative employment effects from this extensive literature would be between very small and zero. The state of economists' understanding of the issue was summed up by Nobel laureate Robert Solow, who said, "the main thing about this research is that the evidence of job loss is weak. And the fact that the evidence is weak suggests that the impact on jobs is small."

Similarly, there is little evidence of a price or profit effect. Thus, we are left with efficiency gains as the main channel through which minimum wage increases are absorbed.

*Prevailing Wage Laws:* These laws state that under federal (or in some cases, state) contracts, construction workers (Davis-Bacon Act) or service workers (Service Contract Act) must be paid the "prevailing wage" for such workers in that area. The motivation for this legislation was both to insure that workers on government projects could earn a living wage, and to insure against low-quality work by low-bidding contractors. Thus, these laws are clearly similar to living wage ordinances, with the exception that the ordinances rarely differentiate who is covered by occupation.

The impact of Davis-Bacon laws have been investigated quite carefully by labor analysts. Regarding competitiveness, this research found that by providing for a level playing field, responsible, higher-quality contractors, were able to compete successfully with "lowball bidders." In addition, the research shows that increased labor costs were generally absorbed through more efficient production. Under so-called "little Davis-Bacons" (state versions of the federal law), training of employees increased substantially and as a result, occupational injuries fell. Contracts were completed more efficiently and with fewer delays. One study of the effect of repealing the little Davis Bacon in Utah revealed that total cost overruns on state highway construction tripled after the act was repealed.

A new study of building services is particularly relevant to living wage ordinances, since, unlike construction, these occupations are closer to those typically covered by the ordinance. This study examines the competition between low-ball bidders and higher paying contractors (some of whom are covered by living wage ordinances) in building services. The study finds that higher-wage contractors provide higher quality services leading to improved occupancy rates, a higher probability of lease extension by major tenants, and greater physical integrity of the property. The contractors paying higher wages had less turnover and offered more training, leading to higher customer satisfaction among tenants.

*Living Wage Ordinances:* Living wage ordinances are a relatively recent phenomenon, and there is thus little evidence of their impact on jobs or economic activity.

The most thorough evaluations (of which I am aware) are two separate studies of the Baltimore living wage ordinance, which was approved by the city council in December of 1994. The main findings of these studies are:

- As far as these studies could discern, the cost increase to the city after the living wage ordinance went into effect (1.2% for the contracts examined) was less than the rate of inflation over this period;
- Workers interviewed for one of the studies reported no change in employment levels at their workplaces in response to the wage increases;
- There was a small decrease-concentrated among smaller firms-in the number of bids per contract after the ordinance went into effect; this small decline, however, did not appear to lower competitiveness or raise contract costs;
- Interviews and case studies with affected employers suggests some absorption of labor cost increases through efficiency gains, particularly lower turnover;
- While there is evidence that the ordinance raised wages for those at the bottom of the wage scale, the affected group appears to be small (less than 2,000).

The Los Angeles living wage ordinance, which passed in 1997, was recently examined by Richard Sander of UCLA and Sean

Lokey for the Fair Housing Institute). Their research took place when the ordinance had been in effect for 18 months. Much of the report focuses on administrative problems with enforcement of the law. Apparently, 59% of companies had been granted exemptions when the study was undertaken, and only 675 workers received a wage increase. Thus, these findings are less informative than those from Baltimore, where the ordinance has been in effect long enough to reliably measure its impact.

With those caveats, the LA study found that in 17 of the 30 covered firms, the costs of the contracts did not change, and employment levels dropped modestly, if at all. In 8 of the 30 firms, the cost was passed on to the city (in these cases there was no competitive bidding). In 5 of the 30 firms, the scope of the contract was reduced, resulting in less employment on the contracts; the researchers estimate that total employment on city contracts was reduced by about 3%. Implementation costs were approximately \$500,000 for an ordinance that brought wage benefits to workers of about \$2.5 million.

In sum, the empirical research finds that none of these policies have been found to lower competitiveness or raise costs in any significant way, and, in some cases, such policies seem to be associated with higher levels of efficiency. I turn now to this issue.

### **Wage increases and efficiency gains**

It has been stated throughout that firms appear to have consistently absorbed these wage increases through productivity, or efficiency gains. This result is related to both the small magnitude of the increase in labor costs engendered by the ordinance, and to a number of facts that characterize the production practices of firms which contract with municipalities.

The fact that living wage ordinances tend to represent a small share (usually less than 2% of affected firms' production costs) means that rather than leave the market, firms will try to absorb the increase. In some cases, for example, with concessionaires, this may take the form of trying to pass higher prices through to consumers. However, these firms operate in a competitive market, and, especially given the current deflationary environment, such pricing practices will be difficult. Thus firms will try to absorb the increase through efficiency gains. Essentially, the price increase forces firms to "cut the fat" out of their production processes, and low-wage firms—who are, by definition, more likely to be affected by the ordinance—tend to have more to cut than other firms. That is because these firms typically have higher than average levels of turnover, leading to increased training costs. A related problem disproportionately faced by lower-wage firms is higher vacancy rates, which increase production costs due to advertising and interviewing costs. Finally, by increasing wages, thus lowering turnovers and vacancies, employment stability increases at affected firms, and this tends to raise employee morale, productivity, and workmanship.

Labor market analysts have examined the effect of wages on efficiency in the context of the "efficiency wage hypothesis," which maintains that "labor productivity depends on the real wage paid by the firm." The seminal research, by Akerlof and Yellen (1987), identifies "four benefits of higher wage payments: reduced shirking of work by employees due to a higher cost of job loss, lower turnover, improvement in the average quality of job applicants, and improved morale," (pg. 2). In the context of the living wage debate, one implication of this research is that if wages are "too low," i.e., below the efficiency level, service provision to the city will be less efficient than if wages were raised.

The above research identifies turnover as a significant cost to firms. This is particularly the case in the low-wage sector, where turnover is much higher than in better paying segments of the labor market. Evidence of this relationship is cited in the second citation just noted and, in the context of unions, in Freeman and Medoff (1984, Chapter 11). This latter citation provides evidence that productivity/efficiency is higher in unionized workplaces, and that "reduced exit behavior" (lower turnover) is one reason why this is the case.

Finally, a new report by the business network *Responsible Wealth* is particularly instructive regarding this question of wages and efficiency. In "Choosing the High Road: Businesses that Pay a Living Wage and Prosper," the authors give numerous case study examples, including employers' testimonies, of firms that pay living wages in order to reap the efficiency gains discovered by the literature reviewed above.

Of course, it is also likely that these efficiency gains are combined with other absorption channels. Pollin and Luce (1998, p. 123) stress the fact that in the face of a "negligible cost increase" most firms are unlikely to relinquish historically profitable relationships with municipalities. Thus, they may sacrifice some of their profit margins, which according to these authors range from 10 to 20 percent of production, compared to less than the 2% effect of the living wage ordinance. They also may reduce ancillary costs which tend to pad budgets, such as lobbying and legal fees.

### **Conclusion**

In considering the impact of the living wage ordinance on the competitiveness of a locality's contracting process, a number of factors should be considered. First, as with any other procurement regulation, since the higher wage floor applies to all firms that bid with the locality, no one firm is at a competitive disadvantage. Second, since the living wage is likely to affect a small share of the workforce (typically less than 1%), and to represent a small share of affected firms production costs (typically less than 2%), it is not credible to argue that the policy will distort a municipality's economy.

It is reasonable, however, to be concerned about the impact on the locality's contracting process. The analysis presented in this report, which includes the results from two studies of the impact of the Baltimore living wage ordinance, argues that firms tend to absorb the wage increase mainly through efficiency gains, specifically through lower rates of turnover and vacancies, leading to

increased employment stability, and thus raising both employee morale and productivity.

Thus, a living wage ordinance can be expected to result in the provision of higher quality and more efficient services to the locality.

This report does not explore other important salutary effects of living wage ordinances, as they are second order effects and not directly related to competition. These effects, however, should not be discounted when considering the impact of the ordinance. First, while I have argued that the policy affects few workers as a share of the workforce, most of those who are affected are low-wage workers from low-income families. These workers are by far the most likely in the workforce to generate social costs by using public programs such as food stamps, publicly-provided cash assistance, and unemployment insurance. To the extent that wage ordinance raises their earnings, these social costs are reduced. Also, since low-income workers are very likely to consume, as opposed to save, their extra earnings, there are multiplier effects which will generate extra economic activity and raise the income of the communities where these workers reside. Finally, these effects will tend to improve the economic conditions of those workers who have done least well over the past few decades, thus helping to counteract the long-term rise in the inequality of economic outcomes.

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