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PUBLIC INTEREST COMMENT

Establishing a Minimum Wage for Contractors
Docket ID: WHD-2014-0001

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Department of Labor, Wage and Hour Division
RIN: 1235-AA10
Submitted July 28, 2014
Comment period closes July 28, 2014

INTRODUCTION

The Regulatory Studies Program of the Mercatus Center at George Mason University is dedicated to advancing knowledge about the effects of regulation on society. As part of its mission, the program conducts careful and independent analyses that employ contemporary economic scholarship to assess rulemaking proposals and their effects on the economic opportunities and social well-being available to all members of American society.

This comment addresses the efficiency and efficacy of this proposed rule from an economic point of view. Specifically, it examines how the proposed rule may be improved by more closely examining the societal goals the rule intends to achieve and whether this proposed regulation will successfully achieve those goals. In many instances, regulations can be substantially improved by choosing more effective regulatory options or more carefully assessing the actual societal problem.

SUMMARY

The Department of Labor's (DOL) proposed rule, "Establishing a Minimum Wage for Contractors,"[1] is intended to implement Executive Order 13658. The stated purpose of the Executive Order is to increase efficiency and cost savings in work performed by federal contractors by raising the hourly minimum wage that contractors pay their workers.[2] The proposed rule establishes standards and procedures for implementing and enforcing the minimum wage protections for federal contractors required by Executive Order 13658.

Review of the research cited in the proposal indicates that the proposed rule is unlikely to achieve its stated goal. The cited research suggests that increased wages do accompany increased productivity. The research does not,

1. US Department of Labor, "Establishing a Minimum Wage for Contractors," proposed rule, July 8, 2014,http://www.gpo.gov/fdsys/pkg/FR-2014-07-08/pdf/2014-15767.pdf..
2. Exec. Order No. 13658, 79 Fed. Reg. 34 (February 20, 2014), Section 1.

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however, indicate that the value of the increased productivity exceeds the cost of the increased wage. This comparison is pivotal to the stated purpose of the Executive Order. The proposal suggests that an increased wage causes increased productivity. But the research is either agnostic as to causal direction or indicates that the causality runs in the opposite direction. The direction of causality is pivotal to the estimates of the proposed rule's benefits; thus, the cited research fails to support the fundamental premise of the proposed rule.

In addition, there are two important unintended consequences of raising the federal contractor minimum wage: first, it can adversely affect the most vulnerable workers; and second, the rule as currently stated could be enforced in a manner so that its impact would extend to far more businesses than originally intended.

DEPARTMENT OF LABOR'S CLAIMS

In seeking to implement Executive Order 13658, the proposed rule states that:

> There is evidence that boosting low wages can reduce turnover and absenteeism in the workplace, while also improving moral and incentives for workers, thereby leading to higher productivity overall.[3]

The proposal, however, misinterprets the research, inappropriately generalizes results, fails to mention important caveats, attributes gains from other factors to increases in the minimum wage, and fails to take into account tradeoffs or evidence from the marketplace. More importantly, the proposal assumes that higher wages cause greater productivity. This is not a common understanding of the relationship. Standard economic theory maintains that higher productivity causes higher wages.[4] Whether and under what circumstances the causality might run in the opposite direction is a matter for empirical study and is not accepted as a general economic rule.

A. The proposal takes evidence of causality and assumes the reverse causality.

Highly productive workers, on average, command higher wages than do less productive workers. This is because profit-seeking employers see that highly productive workers can contribute more value, and so they compete for these workers by offering higher wages. Productivity causes wages. While higher wages accompany higher productivity, it does not follow that higher wages cause higher productivity. This reverse-causal assumption underlies the arguments laid out in the proposal, yet is absent from the arguments laid out in the research the proposal cites.

B. The proposal misapplies the research results.

The proposed rule states that absenteeism will decline with an increased wage:

> Research shows that absenteeism is negatively correlated with wages, meaning that better-paid workers are absent less frequently (Dionne and Dostie 2007; Pfeifer 2010).[5]

Dionne and Dostie find that "the use of incentive pay . . . had ambiguous effects on (workplace) absences . . ." The researchers' primary finding does not involve the effect of pay on productivity but the effect of work arrangements (work-at-home options, reduced work weeks, shift work) on workplace absences. They found no clear evidence that higher wages accompanied greater productivity.[6]

C. The proposal misinterprets the research results.

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3. DOL, Proposed Rule, 34570.
4. TRichard G. Anderson, "How Well Do Wages Follow Productivity Growth?" Federal Reserve Bank of St. Louis, March 2007, https://research.stlouisfed.org/publications/net/20070301/cover.pdf (accessed 7/21/14).
5. DOL, Proposed Rule, 34597.
6. Georges Dionne and Benoit Dostie, "New Evidence on the Determinants of Absenteeism Using Linked Employer-Employee Data," *Industrial and Labor Relations Review* 61, no. 1 (2007).

The proposal also states:

> Pfeifer (2010) finds that a one percent increase in wages is associated with a reduction in absenteeism of about one percent.[7]

What Pfeifer finds is that "a positive relative wage of 1 percent decreases absenteeism by 0.01 days," where "relative wage" means the worker's wage as a fraction of workers' average wages.[8] Since Pfeifer is measuring absenteeism on a days-per-month basis, a decline in absenteeism of 0.01 days out of a 20 day month is a decline of less than one-tenth of one percent, not one percent. Thus, correctly stated, Pfeifer finds that a one percent increase in wages is associated with a reduction in absenteeism of about one-tenth of one percent. Further, Pfeifer's findings assume that the increase in wages is not absolute but relative to the average. In other words, the more of a contractor's workers the rule affects, the less the reduction in absenteeism.

D. The proposal inappropriately generalizes specific research results outside the context to which they apply.

The proposed rule states that worker turnover will decline with an increased wage:

> A higher minimum wage is also associated with reduced worker turnover (Reich, Hall, and Jacobs 2003; Fairris, Runstein, Briones, and Goodheart 2005; Dube, Lester, and Reich 2013; Brochu and Green 2013).[9]

Reich et al. find that a higher minimum wage is associated with reduced turnover. However, they look only at workers at the San Francisco airport. These findings are not generalizable to the population of workers at large.[10] Fairris et al. find that absenteeism decreased following passage of a living wage ordinance. But the authors sample only Los Angeles workers. Even then, 64 percent of the data set consisted of airport workers—virtually all of whom were interviewed shortly after 9/11. Any generalization of results based on this survey is highly suspect.[11]

E. The proposal does not mention important caveats.

Brochu and Green find that, while a higher minimum wage is associated with a lower job separation rate, it is also associated with a lower hiring rate. Their conclusion is that the higher wage rate results in jobs that are more stable but harder to obtain, and that, for older workers, these two effects almost exactly offset one another.[12] Further, Reich et al. find that decreased turnover only partially offsets increased labor costs and that firms pass on the additional costs to consumers, other workers, and taxpayers. This suggests that the net benefit to society is zero.

F. The proposal attributes benefits to increased wages that were caused by other factors.

The proposed rule states that an increased wage will cause turnover to decline:

> In a study of homecare workers in San Francisco, Howes (2005) found that the turnover rate fell by 57 percent following implementation of a living wage policy.[13]

Howes does find that the turnover rate among homecare workers in San Francisco fell by 57 percent.[14] However,

7. DOL, Proposed Rule, 34597.
8. Christian Pfeifer, "Impact of Wages and Job Levels on Worker Absenteeism," *International Journal of Manpower* 31, no. 1 (2010): 59–72. See 69.
9. DOL, Proposed Rule, 34597.
10. Michael Reich, Peter Hall, and Ken Jacobs, "Living Wages and Economic Performance: The San Francisco Airport Model," Institute of Industrial Relations, University of California, Berkeley, March 2003.
11. David Fairris, David Runstein, Carolina Briones, and Jessica Goodheart, "Examining the Evidence: The Impact of the Los Angeles Living Wage Ordinance on Workers and Businesses," *LAANE*, 2005.
12. Pierre Brochu and David Green, "The Impact of Minimum Wages on Labor Market Transitions," *The Economic Journal* 123, no. 573 (December 2013): 1203–35.
13. DOL, Proposed Rule, 34597.
14. Candace Howes, "Living Wages and Retention of Homecare Workers in San Francisco," *Industrial Relations* 44, no. 1 (2005): 139–63.

Howes states that this decline wasn't the result of a living wage but the combination of a living wage, unionization of homecare workers, extension of healthcare benefits, extension of dental benefits, and extension of vision benefits to both full- and part-time homecare workers. Howes finds that the impact of insurance benefits on the reduction of the turnover rate was three times the impact of the increased wage on the turnover rate.

The proposal does correctly state Howes's estimate that an increase in the wage rate from $8 to $9 would reduce the probability of turnover by 17 percentage points. However, as with other cited studies, Howes's results are not generalizable beyond workers performing one specific job in one specific geographic area.

G. The proposal does not weigh the benefit of increased productivity against the cost of attaining the increased productivity.

> Akerlof (1982, 1984) contends that higher wages increase employee morale, which raises employee productivity.[15]

Akerlof finds that higher wages can lead to greater productivity but offers no evidence as to whether the value of the increased productivity is worth the cost of the increased wage.[16]

H. The proposal infers causality that is beyond the researchers' stated conclusions.

> Furthermore, higher productivity can have a positive spillover effect, boosting the productivity of coworkers (Mas and Moretti 2009). This means that raising the minimum wage of Federal contract workers may not only increase the productivity of Federal contract workers, but may also improve the productivity of Federal workers.[17]

Mas and Moretti find that introducing high-productivity workers into work groups increases the productivities of other members of the group. They conclude that "the return to a high-productivity worker is therefore greater than her individual direct contribution, and efficient compensation should take it into account."[18] In other words, Mas and Moretti argue that higher-productivity should drive a higher wage, not that a higher wage causes a higher-productivity worker.

I. The proposal ignores evidence from the marketplace.

> The Department notes, however, that much of the evidence supporting these predicted outcomes—encapsulated in the papers cited above—examines why firms voluntarily pay high wages.[19]

While increased productivity is a desirable goal, what matters is whether the value of increased productivity exceeds the cost of attaining the increased productivity. For-profit firms will actively seek out productivity increases whose benefits exceed their costs and actively avoid productivity increases whose costs exceed their benefits. That is, for-profit firms don't merely seek productivity improvements; they seek *sustainable* productivity improvements. Firms that cannot or do not do this will be supplanted by firms that can and do.

Nowhere does the proposed rule look to the marketplace for guidance from (or even evidence of) contractors considering the balance of improved productivity benefits with improved productivity costs. Rather, the proposal simply assumes that contractors have either not considered this balance or have considered it and come to the wrong conclusion.

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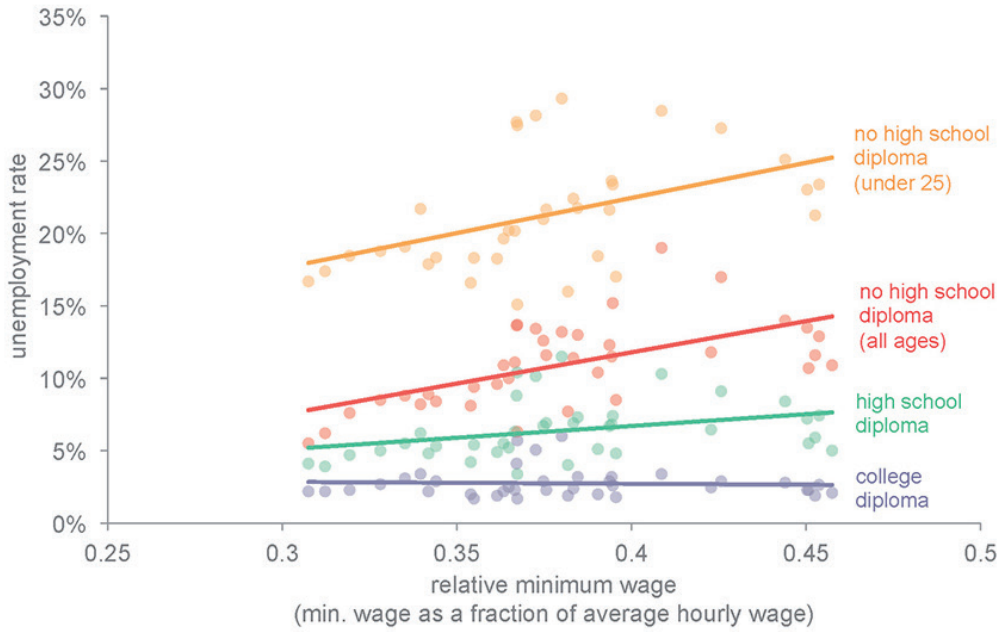
15. DOL, Proposed Rule, 34597.
16. George Akerlof, "Gift Exchange and Efficiency-Wage Theory: Four Views," *American Economic Review* 74, no. 2 (1984): 79–83.
17. DOL, Proposed Rule, 34597.
18. Alexandre Mas and Enrico Moretti, "Peers at Work," *American Economic Review* 99, no. 1 (2009): 143.
19. DOL, Proposed Rule, 34598.

UNINTENDED CONSEQUENCES: UNEMPLOYMENT

Figure 1 shows the relationship between the relative minimum wage (the minimum wage as a fraction of the average hourly wage) and unemployment rates for workers with different educational attainments. Historically, as the relative minimum wage has risen, unemployment among college-educated workers has not changed, unemployment among high-school-educated workers has risen slightly, unemployment among workers without high school diplomas has increased moderately, and unemployment among young workers without high school diplomas has increased dramatically.

While employers make hiring decisions on the basis of more than simply education, education tends to be highly correlated with many of the factors employers do consider, including intelligence, experience, training, and work ethic. Ultimately, all of these factors are themselves proxies for the single factor that concerns the employer: productivity. That is, to what extent a worker contributes value to the employer's business.

Figure 1. The relationship between the minimum wage (relative to the average hourly wage rate) and unemployment among workers of different educational attainments.[20]



Source: Bureau of Labor Statistics, Table A-4. Accessed August 25, 2013.
Note: Data are for nationwide unemployment rates, 1975–2012. Data for workers under 25 with no high school diploma are for 1985–2012.
Produced by Antony Davies and Rizqi Rachmat, Mercatus Center at George Mason University. July 28, 2014.

Raising the minimum wage is an incentive to employers to lay off less productive workers. As these less productive workers become unemployed, the average productivity of the remaining (employed) workers increases, because these workers are more productive.

The effect is analogous to the average age of a population rising after the outbreak of a virulent childhood disease. Simultaneously, the disease causes life expectancy to fall and the average age of the population to rise. The apparent contradiction lies in the fact that the childhood disease does not cause people to live longer; rather, it increases

20. Antony Davies, "Unintended Consequences of Raising the Minimum Wage" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 25, 2013).

the average age by removing the young from the population. So too, an increase in the minimum wage does not cause workers to become more productive; rather it increases average productivity by removing less productive workers from the ranks of the employed. Advocating an increase in the minimum wage to raise productivity is like advocating a childhood disease to make people live longer.

UNINTENDED CONSEQUENCES: OVERREACH

The rule calls for the minimum wage to be applied to federal contractors and defines a contract as:

> Contract or contract-like instrument means an agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law. This definition includes, but is not limited to, a mutually binding legal relationship obligating one party to furnish services (including construction) and another party to pay for them. The term contract includes all contracts and any subcontracts of any tier thereunder, whether negotiated or advertised, including any procurement actions, lease agreements, cooperative agreements, provider agreements, intergovernmental service agreements, service agreements, licenses, permits, or any other type of agreement, regardless of nomenclature, type, or particular form, and whether entered into verbally or in writing.[21]

This paragraph, particularly the phrase "any other type of agreement, regardless of nomenclature, type, or particular form, and whether entered into verbally or in writing," could be interpreted broadly so as to apply to any firm with whom a federal contractor conducts business. For example, if a federal contractor ordered materials from construction materials retailer, it is conceivable that the rule could be applied to the retailer. If so applied, the retailer would then be construed to be a subcontractor and, due to the phrase "subcontracts of any tier thereunder," any supplier from whom the retailer purchased would also be considered bound by the rule.

CONCLUSION

The rule is unlikely to achieve the Executive Order's stated goal because:

1. The causality claimed in the rule is largely backward. Workers who are more productive command higher wages because employers compete for these valuable workers by offering them higher wages. The correct direction of causality is that increased productivity causes a higher wage. Raising the minimum wage does not necessarily increase *worker* productivity.

2. However, raising the minimum wage can increase *employed worker* productivity because it gives employers an incentive either to lay off less productive workers or not to hire them in the first place. This implies that the rule will largely benefit more productive workers at the expense of less productive workers.

3. By not comparing the value of increased productivity with the cost of achieving the increased productivity, the DOL cannot say whether the rule will be a net benefit or detriment to the economy at large.

4. By ignoring the fact that businesses perform precisely this comparison every time they hire, promote, lay off, or otherwise evaluate employees, the DOL fails to consider that Federal contractors weigh the costs and benefits of increased productivity. If it were true that a higher wage increased productivity, and that the value of the increased productivity exceeded the cost of the increased wage, we should observe Federal contractors voluntarily raising wage rates.

21. DOL, Proposed Rule, 34611.