The Unintended Consequences of Minimum Wage Increases on the Taxpayer: A Case Study of Services for Individuals with Developmental Disabilities

Jim Rounds
PRESIDENT
ROUNDS CONSULTING GROUP INC.
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Executive Summary

States such as Arizona that focus on operational efficiency through outsourcing programs achieve economic success, but the gains are disproportionately affected by artificial wage floors. To show exactly how the public can be negatively affected, the Goldwater Institute examined one such state program: Arizona's Division of Developmental Disabilities.

For over two decades, Arizona has outsourced the services the state provides to individuals with developmental disabilities. The Arizona Department of Economic Security, through its Division of Developmental Disabilities (DDD), acts as the managed care organization for more than 35,000 individuals with development disabilities throughout Arizona, delivering most services through a large network of providers.

As service providers pay employees with hourly rates ranging from minimum wage to modest levels above the minimum wage, they have experienced a history of high turnover, primarily because of the difficult nature of the work and the corresponding hourly wage.

Under Proposition 206, the Fair Wages and Healthy Families Act, Arizona minimum wage increased to $10 per hour in 2017 and $10.50 per hour in 2018, and will increase to $11 per hour in 2019 and $12 per hour in 2020. On January 1, 2021, the Arizona minimum wage will increase each year by the cost of living.

As a result of Prop. 206, DDD employees who were earning less than the newly established minimum wage received a pay adjustment in 2017 to meet the new compensation requirements. Employees who had been earning more than the new minimum wage required a limited pass-through amount that will decline as wages diverge from the new wage floor. The ability to adjust these wages, and hold service quality constant, is dependent on funding levels provided by the state.

Goldwater, working with Rounds Consulting Group, conducted a cost analysis based on data collected by the Arizona Association of Providers for People with Disabilities, which provided a sample set of 2,300 workers that we further extrapolated into the larger population. Our analysis concludes that Prop. 206 will cost the state—and thus the taxpayers—$45 million to maintain current staffing levels in state fiscal year 2018 for the DDD program alone. The overall cost to the state from the new minimum-wage law would be many times this amount when factoring in all the other industries affected. Our estimates relate only to the pay for low-wage workers and do not include associated employee-related expenses, general and administrative costs, and inflation in other costs such as rents, food, and other necessary inputs.

The Goldwater Institute does not take a position on funding for the developmental disabilities system of care for the state of Arizona. However, with other conditions remaining the same, Prop. 206 will leave taxpayers with either a greater financial burden or a lower-quality developmental disabilities program.

The Goldwater Institute will continue to monitor and examine how the new minimum-wage law impacts the state over time.

Introduction

Last year, Arizona enacted Proposition 206, the Fair Wages and Healthy Families Act, a mandatory $12-per-hour minimum-wage law. While well intentioned, the law is a misguided policy that harms the people it is supposed to help.

Much of the research on minimum-wage consequences relates to private sector business activity. This includes the ability of owners to earn a normal profit and be successful. It also includes the additional risks placed on employees as cost balances shift away from labor and into capital, and people lose their jobs.
However, the consequence to taxpayers is often overlooked. States that focus on government operational efficiencies—such as minimizing regulatory burdens and outsourcing programs when possible—will have a greater chance at economic success. It is these outsourced programs, however, that can be disproportionately affected by artificial wage floors. To show how mandatory minimum-wage increases add to the taxpayer’s burden, the Goldwater Institute prepared a case study focused on a government program that outsources services to individuals with disabilities.

This case study includes a brief description of the example program, an explanation of how the new minimum-wage law affects the ability to provide certain services, and an estimate of the state’s cost of maintaining current levels of services as a measure of increased taxpayer burden.

Note: The following information should be viewed as just one example of how minimum-wage adjustments can produce imbalances in the economy. The Goldwater Institute will continue to analyze and monitor the broader topic of minimum-wage distortions in our economy.

Prop. 206 Is a Law Against Jobs

Nearly all economists agree that minimum-wage laws slow economic growth, raise costs for consumers, and handicap job creation, particularly for entry-level or unskilled labor. The reason is simple: any policy that forces an increase in the cost of an input will have an affect on demand. Negative employment effects resulting from minimum-wage distortions are the manifestation of the most basic law in economics: supply and demand. This fundamental law of economics cannot be escaped (although it can be ignored or disguised for political reasons). While economists disagree about the details—some hold that small increases have no measurable impact on the economy due to the interference of other factors—there is virtually no dispute that making it more expensive to hire people means fewer people will be hired.

Since Prop. 206 will eventually forbid an employer from paying a worker less than $12 per hour, employers who wants to stay in business must seek employees whose work product will benefit them by at least $12 per hour. A prospective employee who—due perhaps to lack of experience—produces less than that will be at greater risk of losing her job. Before enactment of the $12 mandate, such a person might have persuaded an employer to hire her at a lower wage and to provide on-the-job training and experience. But a law forbidding employment at less than $12 per hour makes that practice illegal—closing off this avenue of opportunity.

One cannot argue that employers can simply raise prices or take less profit to make up the difference. In an industry like the restaurant business, demand is highly elastic—if a meal out gets more expensive, fewer people will eat out. Every time a restaurant charges more for a meal, it loses customers at the margin.

The line between “just right” and “too high” pricing is not dictated by the greed of owners. Among other factors, it is a complex calculation based on the cost of capital, cost of inputs, competition among restaurants, and alternative consumer spending options. If the profitability of restaurants declines because wage mandates make labor more expensive, investors will devote their funds to more profitable industries.

One reason the public is easily misled about the consequences of minimum-wage laws is a phenomenon economists call “unseen costs.” In short, minimum wages increase the wealth of workers who are able to keep their present jobs and enjoy a raise, but they impose costs in the form of lost opportunities—the jobs and the wealth that might have been created in the absence of this mandate. Workers who might have been employable at $10 or $11 per hour are deprived of those opportunities.

The consequences of minimum-wage distortions fall hardest on entry-level and unskilled workers because they are most likely to need on-the-job training and least likely to produce above the increased marginal cost of hiring. A law that purports to help workers by eliminating their job prospects does not help workers or the poor.
Mandated increases also create incentives for businesses to substitute machines for human labor. As the Congressional Budget Office reported in 2014, employers often are forced to respond to minimum-wage increases “by reducing their use of low-wage workers and shifting toward those other inputs. That is known as a substitution effect, and it reduces employment among low-wage workers but increases it among higher-wage workers.” These laws also hurt low-income consumers, who are more likely to shop at places that pay their employees the lowest rate.

In the words of Mark Wilson, former deputy assistant secretary of the U.S. Department of Labor: “There is no ‘free lunch’ when the government mandates a minimum wage. If the government requires that certain workers be paid higher wages, then businesses make adjustments to pay for the added costs, such as reducing hiring, cutting employee work hours, reducing benefits, and charging higher prices.”

Case Study Narrative: Services to Individuals with Developmental Disabilities, and Minimum-Wage Increases

Prop. 206 does not harm only low-income consumers and people who need jobs. It also harms those who rely on state services, and those who pay for them—the taxpayers. For example, let’s examine one program offered through the Arizona Department of Economic Security (DES): the Division of Developmental Disabilities (DDD), which provides support and services to over 35,000 people with developmental disabilities and their families throughout Arizona.

According to the DDD, which manages care for the system, services are provided throughout the lifespan of an eligible member. During the school years, services for children and young adults may include specific skills training, behavioral health services, assistance with daily activities, and assistance with transitioning from school to work or respite (caregiver relief). For adult members, DDD support may include training to get and keep a job, structured daytime activities, in-home assistance with daily activities, and residential placements.

According to data provided by the Arizona Association of Providers for People with Disabilities (AAPPD), the DDD program employs workers with hourly wage rates ranging from minimum wage to modest levels above the artificial wage floor. The association reports that the program historically has high turnover among employees because of the difficult nature of the work and the corresponding regulated wage rates. In some examples, the lowest offered wage was slightly above the previous minimum due to industry labor shortages but still fell below the new series of mandatory increases.

Under Prop. 206, Arizona minimum wage increased to $10 per hour in 2017 and $10.50 per hour in 2018, and will increase to $11 per hour in 2019 and $12 per hour in 2020. On January 1, 2021, the Arizona minimum wage will increase each year by the cost of living.

In addition, on November 8, 2016, Flagstaff citizens voted in support of Proposition 414, a citizen initiative to increase the minimum wage for employees working within the city limits of Flagstaff. Proposition 414 was proclaimed law by the mayor on November 28, 2016. On March 21, 2017, the city council elected to amend the timeline of the proposition to further its purposes by adjusting the future minimum wage increase. On January
1, 2018, Flagstaff’s minimum wage increased to $11 per hour. Effective each January 1 thereafter the minimum wage rate will be adjusted up to $15.50 by the year 2022.

The approved statewide increase to $10/hour on January 1, 2017, with additional stepped increases approved through $12/hour for the statewide increase, has consequences beyond simply increasing the wage of the lowest-paid individuals within the contracted DDD system. This is not just a government-program issue, it is the nature of how minimum-wage increases affect multiple levels of employees in both government and the private sector.

There are two primary issues that policymakers must consider in conducting a proper analysis. First, there is the legal matter of paying all employees an amount at least equal to the new minimum wage. In this scenario, only those employees earning less than the new wage floor of $10/hour would receive a pay adjustment for the first increase in the minimum-wage law; employees earning more than the new minimum wage would not receive any pay increase. This represents the lowest threshold of adjustment but also is complicated by what amounts to a deliberate change in public policy. Workers not properly included in the wage increase could become further disenfranchised with the program and move to private sector employment opportunities.

Numerous case studies examine how minimum-wage increases “pass through” from those making below minimum wage to individuals earning moderate amounts above the wage floor. This additional business cost is often overlooked. For example, one study that tracked the minimum-wage increase for retail workers found that while less than 10 percent of the workers studied earned below the newly adjusted minimum wage, more than 30 percent received an upward pay adjustment. Another study examining the impact of minimum-wage increases over multiple decades found that workers through the bottom 20 percent of all wage earners received some form of minimum-wage pass-through, with the pass-through declining as wages increased from the mandatory minimum to discretionary adjustments.

The overwhelming evidence is that minimum-wage increases place a burden on businesses beyond just those workers earning slightly below the minimum wage. This can have a significant impact on business profitability and even on longer-term viability.

Without a partial upward adjustment in pay to the staff that had been earning above the minimum wage due to tenure and experience, the DDD program will experience higher levels of turnover and program quality will decline. While this is indeed a budgetary option, policymakers must acknowledge that a deliberate decision is being made to reduce the DDD program’s quality under this approach.

The second issue relates to adjusting wages based on economic matters to maintain current levels of service and employee turnover. Under this option, providers calculate a pay schedule that has some limited wage pass-through. The new minimum wage will still have a disproportionate impact on the workers earning lesser amounts per hour, but some of the increase would “pass through” to those making above the minimum wage and would maintain a balance between adjustments in the program and those occurring in the private sector. The scenarios are clarified below:

- Example A: Under the new law, Worker #1 previously earned $8.50/hour and now makes $10. Worker #2, the more productive and experienced employee, previously made $10/hour and now makes the same as the entry-level individual. This worker will be at great risk of leaving the program, causing overall service quality to decline.

- Example B: Unlike the previous scenario where the individual already making $10/hour received no increase, a raise equal to a percentage of the overall minimum-wage increase would be provided. Worker #2 might instead make in the vicinity of $11/hour. The rate of pass-through declines according to designed formulas until approximately $15/hour is reached. Further increases in the minimum wage would have an impact on some individuals making in excess of $15/hour.
As previously described, this is not just an issue for government programs. Minimum-wage increases impact private sector pay for those previously earning below the new minimum wage as well as for people making several dollars per hour above the wage floor. This impacts multiple types of businesses, including restaurants and bars, hotels and resorts, general entertainment, and grocery stores.

Case Study Theory: Services to Individuals with Developmental Disabilities, and Minimum-Wage Increases

A portion of the minimum-wage increase will partially advance to the higher-wage employees at a declining rate until no further adjustments are needed to maintain previous levels of service. The rate of pass-through is also different at lower-wage levels as wage rates move from mandatory minimums to discretionary. This will be different for each industry but follows the same overall pattern.

The following chart displays a scenario where the minimum-wage increase impacts multiple levels of employee earnings. The minimum-wage pass-through declines based on a predictable pattern until no additional pass-through is required to maintain previous employee quality and turnover rates. Two wage compression curves are displayed to accommodate varying assumptions related to the wage pass-through.

Source: AAPPD; Rounds Consulting Group
Individuals previously at minimum wage would receive the full amount of the new statutory wage adjustment. This is where the displayed curves are at 100 percent. As businesses move to employee wage reviews that are just above the minimum but become increasingly discretionary, the curve displays a steeper rate of change. The rate of pass-through decay becomes more stable until those employees earning amounts well above the previous minimum wage receive either very modest adjustments or no adjustments. This event is sometimes identified as lower management levels. In the case of direct-care workers providing services to individuals with developmental disabilities, the pass-through could fully end somewhere near $15/hour for the initial statewide minimum-wage increase. This is where the curves decline to 0 percent.

**Case Study Calculations: Services to Individuals with Developmental Disabilities, and Minimum Wage Increases**

RCG/Goldwater looked at data collected by the Arizona Association of Providers for People with Disabilities (AAPPD), a 501(c) 4 statewide consortium of licensed providers that deliver services to individuals with developmental disabilities. Detailed wage data was provided by AAPPD for a sample set of more than 2,300 workers, and the results were extrapolated by Goldwater into the larger population of DDD workers.

Goldwater modified the information contained in the research and placed it into a model that transcribes minimum-wage adjustments at the individual-worker level. These adjustments were aggregated to provide guidance on the extent the new minimum-wage law would need to be applied to those making less than the new wage floor and to those making a higher-wage rate but with a progressively reduced impact as wages increase.

Using this more detailed “bottom up” approach to the calculation at the individual-worker level, the model shows that $45 million in state funding is needed to maintain current DDD staffing levels in state fiscal year 2018.

Alternatively, a second approach (“top down”) was utilized as a check on the aforementioned results and makes adjustments to previous full-program annual costs. This approach is consistent with AAPPD calculations but utilizes more conservative assumptions. In this second calculation, the unfunded liability is $44 million for state fiscal year 2019.

The Goldwater Institute does not take a position on funding for the developmental disabilities system of care for the state of Arizona. However, with other conditions remaining the same, Prop. 206 will leave taxpayers with either a greater financial burden or lower-quality developmental disabilities programs. The relevant range of unfunded costs to the DDD program as it pertains to the recent minimum-wage increases is between $45 million and—the most conservative figure identified in this case study—$44 million.

These estimates relate only to the hourly pay for low-wage workers and do not include associated employee-related expenses, general and administrative costs, and inflation in other costs such as rents, food, and other necessary inputs. The accuracy of the estimates is also based on the extent the survey data provided is representative of the larger population as reasonably expected.

**Conclusions and Further Considerations**

Minimum-wage increases often produce unintended consequences. The policy impacts business profitability, employment security, taxpayers, and government operations, as this case study identifies. The example program in this review, services to individuals with developmental disabilities, will require many millions of dollars in taxpayer funding to simply maintain current service levels. The overall cost to taxpayers throughout the state will be many multiples of this amount when including all potentially impacted state and local programs, and reductions in private sector economic output.
Unfortunately, the issue has been misrepresented by political activists. Minimum-wage increases affect business costs for more than just those employees earning at or near the minimum wage. A certain degree of pass-through wage adjustment occurs, which inflates business costs further and affects profitability and even viability. Poorly designed wage floors create new balances between capital and labor utilization, and the result is workers who find themselves without employment.

Furthermore, a person is not intended to remain in a minimum-wage job in lieu of advancing into a more productive career. Worker-training programs with private sector participation, combined with education access and flexibility, would more efficiently allow lower-wage workers to advance to more productive tasks and improve on their quality of life.

If these broader economic issues are not properly addressed in the future—and before any new, poorly designed policy is implemented—the taxpayer will continue to pay for the cost of economic inefficiency.


