

CUTTING WAGES BY CUTTING WELFARE

THE IMPACT OF REFORM ON THE LOW-WAGE LABOR MARKET

by Lawrence Mishel & John Schmitt

The leading welfare reform proposals rely on time limits and work requirements to lead recipients from welfare to work. Little public attention has been paid, however, to whether the low-wage labor market can absorb a sizeable increase in new or returning workers. In other words, will former welfare recipients be able to find jobs, and what effect will an influx of workers have on the earnings of the existing low-wage workforce?

That recent welfare reform legislation ignores these issues is curious, since it is well known that the low-wage labor market is suffering greatly. In 1994, workers with less than a high school education, for example, had an unemployment rate of 12.4%, more than double the national rate of 5.8%. For women aged 18 to 30 with less than a high school degree, the unemployment rate reached 21.3%. At the same time, the wages of low-wage workers have fallen by 11.7% since 1979, 1.6% since 1989.⁷

If current congressional proposals for reform are enacted, it is likely that many welfare recipients subject to the new work requirements will face long spells of unemployment before they find intermittent, low-paid work that is insufficient to support their families. Many of those who find work will probably do so only by displacing existing workers, creating unforeseen problems for the working poor.

While widespread unemployment and job displacement are the most likely outcomes, this paper takes congressional welfare reform at face value and asks, if the huge influx of former welfare recipients successfully finds jobs without displacing current workers, what will happen to the wages of existing low-wage workers now forced to compete head-to-head with former welfare recipients? Using conventional economic analysis, we find that, for the economy to absorb almost 1 million more workers:

- Nationally, the wages of low-wage workers (defined here as the bottom 30% of workers—about 31 million men and women who earn less than \$7.19 per hour) will have to fall by 11.9%.
- Wages for low-wage workers in states with relatively large welfare populations will have to fall by even more: in California, by 17.8%; in New York, by 17.1%.

Thus, the working poor, praised by welfare reformers as an example to be followed by current welfare recipients, will foot the bill for “fixing” the system. Those now struggling in precarious, low-paying jobs will have to compete directly with former welfare recipients in a labor market that cannot even provide adequately for the existing workforce. We estimate that, nationally, this new competition will cost workers earning less than \$7.19 per hour about \$36 billion a year in income—about \$8.5 billion more than the entire federal and state expenditure on the Aid to Families With Dependent Children program in 1994.² These lost wages amount to \$38,800 per welfare recipient entering or returning to work under the reform plan.

The belief that the private sector, on its own, is capable of providing a living wage for all those willing to work lies behind most current welfare reform proposals. This view has led policy makers to ignore the substantial barriers that current recipients face in seeking work: a macroeconomic climate that has penalized the less-skilled; a lack of child-care services; a lack of access to health-care benefits while working; and a lack of job skills among many welfare recipients. Individual employers will not, nor in many cases should they be expected to, address these issues themselves.

Genuine welfare reform must view the nation’s safety net in relation to broader economic conditions, particularly those affecting the low-wage workers who disproportionately rely on welfare and related programs. The barriers that stand between recipients and jobs suggest the need for policies to address child care, health care, education and training, and job creation in inner-city and rural areas. Likewise, the enormous downward pressure on wages implicit in current welfare reform schemes suggests the need for alternative reform measures coupled with policies to enhance productivity and build higher wages for current low-wage workers. As a start, it is helpful to remember that full employment in conjunction with a higher minimum wage have boosted the earnings of low-wage workers significantly in the past.

Given that the current political climate is unlikely to produce much in the way of any of these kinds of policies, it is particularly worrisome that Congress may soon consider a significant scaling back in the Earned Income Tax Credit (EITC), which acts as an important work-based subsidy to the incomes of the working poor. The estimates presented here indicate that the EITC should be strengthened, not weakened, if it is to soften some of the negative spillover effects of welfare reform on the 31 million working Americans who earned less than \$7.19 an hour in 1994.

The remainder of this paper explains how these figures were calculated and provides comparable estimates for each of the 50 states and the District of Columbia. We begin with a discussion of some of the basic assumptions. We then summarize the calculations for the United States as a whole and, later, those at the state level.

METHODOLOGY

The results reported here are estimates of the impact that the Senate Republican leadership's reform plan would have had, had it been fully implemented, in 1994, the latest year for which the necessary data are available. All calculations depend on three basic assumptions about welfare reform and the economy: (1) the number of welfare-to-work transitions; (2) the identification of the segment (and size) of the labor market that will be affected by new competition from former welfare recipients; and (3) the scale of the economic tradeoff between labor supply and wages in a situation where all of the increase in supply is employed and none of the existing workforce is replaced. The impact of welfare reform on wages depends on the number of welfare-to-work transitions relative to the size of the low-wage labor market and the extent to which wages respond to an increase in the labor supply in the face of constant demand. After establishing these parameters, the analysis that follows generally mirrors other areas of economic research on the low-wage labor market, including those that find that increasing the minimum wage can reduce employment or that immigrant labor can lower the wages of competing workers in the United States.

REDUCTION IN WELFARE ROLLS

The estimates here of the number of welfare recipients added to the labor market are based on an analysis of the Senate Republican leadership plan (S. 1120) conducted by the Department of Health and Human Services (HHS) in August 1995 (Assistant Secretary for Planning and Evaluation 1995). According to HHS calculations, in fiscal year 2000 the Senate bill would require just over 1 million recipients to work. We have adjusted this figure downward in line with the size of the welfare rolls in 1994, our base year. Under the new rules, by our estimate 928,000 recipients would have been required to work in 1994.³

To emphasize the "toughness" of the legislation, many Republicans have argued that the increase in welfare-to-work transitions will be about double the estimates used here. These larger numbers, however, in part reflect ongoing welfare roll fluctuations (i.e., those who would drop from the rolls anyway or who already work while receiving benefits) and not any *net increase* in welfare-to-work transitions generated by the reform legislation.⁴ We have chosen to use the lower figure to arrive at a more conservative estimate of the impact on wages. If welfare-to-work transitions are twice what we assume, the negative impact on the low-wage labor market would be twice as large as estimated.⁵

DEFINING THE LOW-WAGE LABOR MARKET

Welfare recipients generally have lower levels of formal education, less on-the-job experience, and fewer job skills than the general population. Only half of single mothers on welfare, for example, have a high school diploma; just 13% have any education beyond high school (Burtless 1994). Therefore, we expect that welfare recipients entering or returning to the labor market will be compet-

ing with the least-paid segment of the current workforce. For the purposes of this paper, as noted above, we have defined the low-wage labor market as the lowest 30% of wage earners nationally and within each state. For the country as a whole, this group's earnings range from below the minimum wage of \$4.25 per hour (not all workers are legally covered, nor is the law always enforced) to \$7.19 per hour in 1994 dollars.⁶

Our results do not change qualitatively with alternative definitions of the low-wage labor market. A narrower definition produces a steeper decline in wages that is concentrated on a smaller sector of the population. A broader definition yields smaller wage declines that affect more workers.

The data on wages and employment in the low-wage labor market come from the U.S. government's Current Population Survey (CPS) for the years 1993 and 1994, with all wages converted to 1994 dollars. We have combined the data for 1993 and 1994 in order to improve the accuracy of data for states with smaller populations; these states may have relatively few respondents in the CPS in any single year. This is not likely to have any significant impact on the estimates.

ELASTICITY OF DEMAND FOR LOW-WAGE LABOR

Once the size of the net increase in welfare-to-work transitions and of the low-wage labor market has been determined, we need to gauge the effect of this increase in employment on wages. Here, we explicitly assume—as do proponents of the Senate welfare reform bill—that all those required to work under the new legislation actually find jobs, and that these new or returning workers do not simply displace existing workers (directly, or indirectly as wage declines induce current job holders to abandon work).⁷ In these circumstances, economists rely on statistical estimates of the elasticity of demand for labor, which tells how much wages are likely to go up or down in response to the number of people in the workforce.

Since elasticities for different kinds of labor can vary, it is necessary to use an elasticity estimate for workers with characteristics similar to current welfare recipients. We therefore take our estimate from the extensive literature on workers at or near the minimum wage. While a great deal of recent research finds labor demand elasticities for minimum-wage workers in the range of zero to -0.1 (see Spriggs and Schmitt 1996 for a brief review), we have decided to use a more conservative estimate of -0.25 (see Neumark and Wascher 1995 and Brown, Gilroy, and Kohen 1982).⁸

The logic employed to produce the principal results is nearly identical to that used by many economists who have analyzed the minimum wage. In the context of the minimum wage, the elasticity of -0.25 has been used to suggest that a 10% increase in the minimum wage would reduce employment by 2.5%. Here, we are using the same relationship to ask what would happen to wages if employment were to increase by a given amount. By the same thinking, a 2.5% increase in employment would require a 10% *fall* in wages.⁹

NATIONAL RESULTS

Under the three basic assumptions outlined above, we estimate that the welfare reform package passed in the Senate in September will depress the wages of the 31 million Americans earning less than \$7.19 per hour by an average of 11.9%. The table (see next page) summarizes how these estimates are reached. Column 1 reports the top pay rates for the relevant “low-wage” labor market, first for the United States as a whole and then separately for each of the states. Column 2 shows the average wage, in 1994 dollars, for this group during the period 1993-94 (\$5.47 per hour). Column 3 presents our estimate of the influx of welfare recipients into work that would have been required if the recently passed welfare regime were in place in 1994. This inflow represents an increase in the low-wage labor supply of 3.0% (928,000 divided by 31 million). Column 4 shows that, under the assumption of a low-skilled labor demand elasticity of -0.25, wages for all low-wage workers would have to fall by 11.9% to absorb the 3.0% growth in the labor pool. Column 5 translates this percentage decline into dollar terms: average wages would have to fall by 65 cents per hour, pushing the average wage for the bottom 30% to just \$4.82 per hour.¹⁰

The last column in the table expresses these costs in a different way. The 65-cent decline in hourly wages can be multiplied by 1773 hours (the average hours worked per year by low-wage earners), and then multiplied by the total number of affected workers (31 million), to calculate the total loss in wages for low-wage workers: \$36 billion per year, more than the total cost of AFDC in 1994.

STATE DATA

The remaining rows in the table report similar results for each of the states and the District of Columbia. Results are similar to those for the nation as a whole. States with proportionately larger welfare populations relative to the size of their low-wage labor pool, however, can expect to suffer bigger wage declines than the national average. The average wage for low-wage workers in California, for example, should drop by 17.8%. Other states with above-average welfare shares should see similar declines: New York (17.1%) Illinois (12.9%), Georgia (12.9%). Even states with proportionately fewer recipients will still experience large falls in wages for the less skilled: Texas (9.2%), Florida (11.3%), Kansas (7.4%).

CONCLUSION

Even if the private sector could find work for a huge inflow of welfare recipients without displacing those currently in work, it can do so only at a wage that is considerably below the already depressed earnings levels prevailing in the low-wage labor market. Moreover, the required wage declines will not be limited to former welfare recipients. The vast body of low-wage workers, already earning low and falling wages, will also see their wages pushed down. The working poor will thus pay an enormous price for so-called “reform.”

September 1995

**The Cost of Welfare-to-Work Requirements
to Wages of Less-Skilled Workers
1994**

	(1)	(2)	(3)	(4)	(5)	(6)
	Wage Level for 30th Percentile	Average Pre-Reform Wage Level for Workers at or Below 30th Percentile	Welfare Recipients Required to Work	Induced Change in Wage Percent	Dollars	Total Lost Wages @Millions)
United States	\$7.19	\$5.47	928,409	-11.9%	-\$0.65	\$36,054
Alabama	6.28	4.93	7,723	-6.2	-0.31	278
Alaska	9.64	7.21	2,633	-13.3	-0.96	135
Arizona	6.91	5.25	12,813	-11.7	-0.61	479
Arkansas	6.12	4.93	4,300	-6.1	-0.30	151
California	7.67	5.69	159,371	-17.8	-1.02	6,435
Colorado	7.33	5.49	7,986	-6.8	-0.37	307
Connecticut	8.98	6.69	11,848	-11.0	-0.74	552
Delaware	7.48	5.79	1,931	-8.1	-0.47	78
District of Columbia	8.20	6.23	5,090	-27.3	-1.70	237
Florida	6.73	5.18	44,845	-11.3	-0.58	1,696
Georgia	6.88	5.34	25,889	-12.9	-0.69	1,021
Hawaii	8.33	6.50	4,212	-11.9	-0.77	198
Idaho	6.62	5.22	1,667	-5.2	-0.27	60
Illinois	7.59	5.66	46,864	-12.9	-0.73	1,874
Indiana	6.98	5.47	14,217	-7.9	-0.43	556
Iowa	6.77	5.30	7,723	-8.6	-0.45	276
Kansas	6.95	5.36	5,880	-7.4	-0.40	225
Kentucky	6.25	4.91	14,656	-13.6	-0.67	497
Louisiana	6.09	4.74	15,182	-13.8	-0.66	480
Maine	7.01	5.41	4,827	-13.9	-0.75	171
Maryland	8.28	6.14	15,358	-9.1	-0.56	696
Massachusetts	8.76	6.54	21,764	-11.6	-0.76	979
Michigan	7.49	5.55	45,459	-15.7	-0.87	1,711
Minnesota	7.51	5.72	12,725	-8.4	-0.48	487
Mississippi	5.93	4.69	9,390	-12.2	-0.57	326
Missouri	6.71	5.16	17,991	-11.1	-0.57	656
Montana	6.12	4.97	2,457	-10.3	-0.51	79
Nebraska	6.49	5.20	2,633	-5.0	-0.26	93
Nevada	7.30	5.74	2,370	-5.0	-0.29	101
New Hampshire	7.86	6.05	2,282	-6.0	-0.36	93

**The Cost of Welfare-to-Work Requirements
to Wages of Less-Skilled Workers (cont.)
1994**

	(1)	(2)	(3)	(4)	(5)	(6)
	Wage Level for 30th Percentile	Average Pre-Reform Wage Level for Workers at or Below 30th Percentile	Welfare Recipients Required to Work	Induced Change in Wage Percent	Dollars	Total Lost Wages (\$Millions)
New Jersey	\$8.76	\$6.44	23,081	-9.5%	-\$0.62	\$1,053
New Mexico	6.35	4.93	6,406	-14.8	-0.73	222
New York	8.07	6.00	88,549	-17.1	-1.03	3,728
North Carolina	6.96	5.44	23,695	-10.5	-0.57	939
North Dakota	5.87	4.81	1,229	-6.6	-0.32	36
Ohio	7.32	5.49	46,513	-13.5	-0.74	1,763
Oklahoma	6.28	5.02	9,127	-10.4	-0.52	324
Oregon	7.47	5.82	7,723	-8.2	-0.48	313
Pennsylvania	7.45	5.61	41,774	-11.7	-0.66	1,598
Rhode Island	7.67	5.87	4,563	-15.4	-0.90	180
South Carolina	6.64	5.15	8,249	-7.1	-0.36	298
South Dakota	6.13	4.98	1,229	-5.8	-0.29	42
Tennessee	6.61	5.14	20,536	-12.6	-0.65	754
Texas	6.34	4.97	51,866	-9.2	-0.46	1,908
Utah	6.73	5.26	3,423	-6.0	-0.32	119
Vermont	7.40	5.72	2,018	-11.6	-0.66	81
Virginia	7.40	5.61	13,164	-6.5	-0.36	532
Washington	8.33	6.35	19,746	-12.5	-0.79	863
West Virginia	6.14	4.72	7,986	-17.2	-0.81	254
Wisconsin	7.27	5.64	14,305	-8.3	-0.47	546
Wyoming	6.25	4.91	1,141	-8.4	-0.41	37

NOTES

1. The unemployment rates are calculated using data from the Outgoing Rotation Group of the Current Population Survey for 1994. The wage figures refer to the earnings of workers in the 20th percentile of the wage distribution, workers who all lie within the low-wage labor market we use in the main calculations below. For a thorough discussion of the deterioration in the low-wage labor market, see Mishel and Bernstein 1994.
2. Total federal and state AFDC costs in 1994 were \$27.6 billion (\$22.8 billion for assistance payments plus \$3.2 billion for administrative costs plus \$1.6 in emergency assistance payments). See Aid to Families With Dependent Children Information and Measurement Branch 1995.
3. We have deflated HHS's national figure for the year 2000 using the 2.2% annual growth rate in caseloads that is implicit in Table 1 of ASPE 1995.
4. The HHS figures here are the "projected number required to participate in work" less the "projected number of leavers, combiners and sanctioners that count towards participation [in work]," or what HHS has called the "projected number required to actually participate in work program." (See ASPE 1995, Table 1, columns 1, 2, and 3.)
5. Separate proposals to attach a work requirement to the Food Stamp program would further raise the supply of new and returning workers to the low-wage labor market. This analysis does not factor these additional workers into its calculations, again making these estimates more conservative.
6. It is difficult to gauge precisely the wage levels that current welfare recipients can expect when they enter or return to employment. A recent study of welfare-to-work transitions in California reported an average wage in that state of \$6.00 per hour (Riccio et al. 1994) Wages from the combined Outgoing Rotation Groups from the Current Population Surveys in 1993 and 1994 for the bottom 30% of workers in California ranged from less than \$4.25 per hour to \$7.67 per hour, with an average of \$5.69 (all in 1994 dollars). Other recent transition data for Utah show an average wage of \$5.16 per hour (telephone conversation with LaDonna Pavetti of the Urban Institute, September 1995). The average in our sample for Utah is \$5.26.

Bernstein (1994) finds a strong relationship between the 20th percentile of the wage distribution and changes in state welfare caseloads, providing further evidence that our definition of the low-wage labor market includes levels that capture the earnings opportunities of the welfare population.

Data reported by Burtless (1994) are not encouraging about the wage prospects of former welfare recipients, even years after they make the welfare-to-work transition. Using data from the National Longitudinal Survey of Youth, Burtless determined that by 1990 the average real wage of women who had received AFDC between 1979 and 1981 (and who were then between 18 and 22 years old) was only \$6.85, compared to \$10.00 per hour for a group of similar women who were not on welfare in the initial period. Burtless's data are in 1991 dollars, deflated using a special wage deflator described in Burtless (1994). He notes that if he had used the CPI-U, a more common deflator for judging changes in buying power, the real hourly earnings of the AFDC group would have actually been lower in 1990 than in 1979.
7. This assumption eliminates the need for an explicit treatment of the supply side of the simple,

competitive model of the labor market. In essence? we trace a movement along the existing labor demand curve until all welfare recipients required to work find jobs, at the same time that all previous workers remain employed. A more sophisticated and more realistic model would allow for unemployment and labor force withdrawal in response to declining wages.

8. We believe that these estimates are representative of elasticities over the range of wages in the low-wage labor market as defined here. In 1979, the real value of the minimum wage was about \$6.00 per hour in 1995 dollars, a level near the 20th percentile in the 1994 wage distribution. Estimates of the elasticity based on data for the 1950s, 1960s, and 1970s were between -0.1 and -0.3 (see Brown, Gilroy, and Kohen 1982). As the real value has fallen to its current level, so too have elasticity estimates (see Wellington 1991 and Card and Krueger 1995), again suggesting that our estimates are conservative.

9. An elasticity of -0.1 would imply that expanding low-wage employment by 1% would require a 10% fall in wages, significantly increasing the negative wage effects estimated here.

10. Five of the states in the table show an average wage decline that would put them below the federal minimum of \$4.25 per hour in 1994—Kentucky (\$4.24), Louisiana (\$4.09), Mississippi (\$4.12), New Mexico (\$4.20), and West Virginia (\$3.91). With no new increases in the minimum wage, even a 3% annual inflation rate will erode the real value of the minimum wage to below the predicted levels by 1996 (all but West Virginia) or 1997 (West Virginia). At a 3% inflation rate, the \$4.25 per hour minimum wage will be worth only \$3.55 per hour, in 1994 dollars, by the year 2000.

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