SANTA MONICA LIVING WAGE STUDY: RESPONSE TO PEER REVIEWS AND BUSINESS CRITICS

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In this memorandum, I will begin by responding to the peer reviews by Professors Richard Freeman of the Department of Economics, Harvard University and David Neumark, Department of Economics, Michigan State University. I will then consider the business-financed critiques offered by Professor Richard Sander of the UCLA Law School and his colleagues, and Mr. Tom Larmore of the Santa Monica Chamber of Commerce/JOBS. The memorandum then closes with brief summary comments on what I regard as the important issues that have emerged through this process of review and response.

Response to Peer Reviews

Background for Peer Reviews

The idea that the City engage peer reviewers to provide me with suggestions for research and an independent evaluation of my final product was first proposed by me in a letter of January 23, 2000 to Council Member Michael Feinstein. My specific proposal was that the City hire two economists of distinction—one who would tend to be relatively sympathetic to living wage proposals and the other relatively unsympathetic—to provide suggestions for our work and to provide a written evaluation of our final product. It seemed clear to me that our final product would come out a stronger piece of work through this arrangement. After our work was completed, the City would then also have a broader range of serious professional opinion available to them in deciding how to proceed.

I proposed Professors Freeman and Neumark as my two first choices for this project. Both living wage proponents with SMART and opponents with JOBS agreed that these were excellent and balanced choices. I understood from Susan McCarthy that some members of the City Council and/or professional staff were concerned about the viability of the idea. However, in the end, we did all agree to proceed with the plan. We were also very fortunate that my two top choices, Profs. Freeman and Neumark, did agree to participate, despite many other demands on their time.

Profs. Freeman and Neumark contributed to the project at three important points. First, on March 12, I provided both of them with a general description of how we intended to conduct the research project. I also provided them with rough drafts of both our business and worker surveys. Both of them offered constructive comments on the
materials I sent them. As much as seemed feasible and appropriate, we incorporated their suggestions in our work.

Second, on July 26, I sent both of them copies of the confidential preliminary draft of the study. They both sent back constructive comments and criticisms—and did so, I should add, in a timely fashion. Again, given the time constraints of this research project, we tried to respond to their points to the maximum extent in the final draft of the study in ways that we considered appropriate.

Finally, on August 28, I sent both of them copies of the final draft of the study. They both then sent their final evaluations to the City Manager Susan McCarthy subsequent to receiving my final draft. You have had these evaluations on hand since early September.

Overall Peer Evaluations

Given that I had explicitly sought out as peer reviewers professional economists who are not only highly qualified, but ones that would also likely provide contrasting perspectives on our work, it is not surprising that the final evaluations of Profs. Freeman and Neumark did indeed differ sharply.

As his summary statement on our study, Prof. Neumark writes as follows:

“I have enough criticisms of this study to believe that it provides an insufficient basis to draw strong conclusions about the likely effects of the living wage proposal. In contrast, I think the authors often overreach, and draw conclusions that cannot be supported by the data and methods they use.”

Alternatively, Prof. Freeman concluded:

“This study covers the main issues involved in assessing a living wage in an even-handed way with as much data as can be obtained. I find the results to be quite sensible. Overall, this is a fine piece of applied economic analysis. I hope the City finds it as informative as I did.”

I am aware that some policy makers find it disturbing when even highly qualified economists cannot reach a professional consensus on an important policy issue. However, in considering the Santa Monica living wage proposal, it should not be surprising that such differences in professional judgments have emerged. As the members of the Santa Monica City Council know well, the living wage proposal that the Council asked me to study is truly pathbreaking: no close precedent for it exists anywhere in the country. When a professional consensus forms over an important economic policy issue, it results only slowly over time, after the matter has been observed, studied, and debated in a serious way. Precisely because it is a pathbreaking
measure, the Santa Monica proposal cannot, by definition, benefit from this longer term process of professional evaluation.

Nevertheless, even under the existing circumstances, the evaluations of Profs. Neumark and Freeman are extremely useful in pinpointing major areas of concern for your consideration. This is the spirit in which I now turn to the central issues that each of them raises.

Detailed Comments on Prof. Neumark

Prof. Neumark’s overall contributions to our research and his evaluation of the final study have been very constructive. At the same time, I have to express disappointment in the manner in which he presented his final comments, in his August 31, 2000 letter to Susan McCarthy. Approximately half of his letter does not address material presented in the final draft of the study. It rather addresses my preliminary draft of the study and a private letter I sent to him. In proceeding as such, Prof. Neumark chose not to adhere to my request that the contents of the preliminary draft remain confidential. Indeed, the title page of the preliminary draft states clearly, “Confidential Preliminary Draft: Not for Circulation or Attribution.” This exact same request is then repeated as a running head on every page of the preliminary draft.

As for my private letter to Prof. Neumark from which he quotes and then discusses, I did not—and normally would not—feel compelled to express myself with the same degree of care in such a communication as I would in publicly circulated final document. Rather, I assumed I was writing privately to a colleague, and thus free to use a professional shorthand and refer without explanation to technical terms. In the final, public draft of the study, I had made the same points in non-technical terms as those he quotes from in my private letter to him (see p. 63 of PERI study). Prof. Neumark was obviously free to quote from this final public document at will.

Though I disagree with Prof. Neumark’s actions here, I do not consider them as highly serious breaches of confidence. At the same time, because his August 31 letter weaves together responses to our preliminary draft and my private letter along with his evaluation of our final public report, it becomes more difficult to identify exactly what his concerns are with the only document that matters for the public discussion—i.e. the final, public draft of the study.

Once we properly put aside Prof. Neumark’s discussions of the confidential preliminary draft and my private letter to him, it appears to me that he is raising three basic criticisms of the final draft of the study. These concern 1) our discussions of employment losses; 2) our evaluation of the capacity of hotels to raise prices in response to higher living wage costs; and 3) our presentation of evidence on low-wage families. I discuss these in turn.

1. Impact of Employment Losses
Prof. Neumark seems to believe that our explicitly stated “pessimistic” estimate of potential employment losses, through a $10.75 Coastal Zone ordinance, as presented most fully in Table 5.11 and the accompanying text (pp. 97-102 of PERI study) is a reliable exercise. However, he criticizes what he calls our effort “to try to trivialize these employment losses (p. 4 of his 8/31 letter). He emphasized this point again in his public testimony to the City Council on September 12.

He argues that we trivialize these employment losses in two ways. The first is through pointing out that a very high turnover rate exists for most of these jobs. Specifically, we found that, according to the Santa Monica firms that we surveyed, on an average annual basis, somewhere on the order of 50 percent of all low-wage workers in Santa Monica either leave their jobs or are dismissed. Our point in raising this was to recognize that, because most low-wage jobs do not entail long tenure, an overall reduction in jobs by a relatively small amount would not be felt by workers as severely as would be the case if workers were anticipating a long-term job tenure. But Prof. Neumark states that this consideration is irrelevant, since it is missing the point that “there will be fewer low-skill jobs available to these workers (p. 5 of 8/31 letter).”

This then brings Prof. Neumark to his major point, which is that our pessimistic estimates show that there will be fewer low-wage jobs available in Santa Monica due to a living wage ordinance. In fact, our own analysis of this situation does not conclude that there will necessarily be fewer overall jobs available. We had rather concluded that “changes in employment practices subsequent to implementation of a living wage ordinance will depend on how firms respond through the other options available to them, i.e. raising prices, improving productivity or making changes in the firm’s distribution of income, (p. 97 of PERI study).” If firms do continue to operate in Santa Monica and unless they experience substantial productivity increases, they are most likely to avoid reducing overall employment, since that would also entail reducing their scale of operations.

Nevertheless, we did attempt to estimate potential employment losses, based in part on firms’ responses to our surveys and in part on Prof. Neumark’s own findings as to how increases in minimum wages would cause job losses in the fast-food industry. In doing so, we made highly pessimistic assumptions about the size of these losses to establish an outer bound, worst-case scenario, as we state clearly in our text. This worst-case scenario range of job losses was 72 – 186 jobs, or 2.9 – 7.5 percent of the total low-wage jobs among covered firms in the Santa Monica Coastal Zone. To provide perspective on the size of these losses, we then pointed out that even our most pessimistic figure of 186 job losses amounted to 1/100 of one percent of the 1.3 million low-wage jobs in Los Angeles. We also noted that between 1995-99, 40,000 new low-wage jobs have been created per year in this market, a rate that is 215 times greater than our pessimistic high-end estimate of job losses.

Prof. Neumark believes that such comparative statistics on the overall Los Angeles low-wage labor market are also irrelevant, since, as he says, “all that is relevant
is what the net effect of the policy is on the affected workers, which is those who work or might work in the Coastal Zone (p. 5 of 8/31 letter). But, as far as I can tell, Prof. Neumark’s comment only affirms our purpose in providing such comparative statistics, since, in fact, the workers “who work or might work in the Coastal Zone” includes the entire pool of low-wage workers in the Los Angeles area. This is most evident from the data we presented elsewhere in the report showing that the average commute time for low-wage workers in Santa Monica is 87 minutes round-trip. Clearly, these workers do not live in Santa Monica. They are part of the larger low-wage labor market in Los Angeles.

Let us consider this difference between Prof. Neumark and myself from a slightly different angle. From my perspective, it is very important to try to establish what the fallback position is for workers who might experience job losses, i.e. what their alternative employment possibilities would likely be after they were to lose their Coastal Zone jobs. In considering these fallback positions, I strongly believe that a huge distinction exists between a case where, say, four percent of low-wage workers in covered Coastal Zone firms experience job losses—i.e. 100 workers—and the case where four percent of all low-wage workers in the Los Angeles area lose their jobs—i.e 52,000 job losses. From my perspective, it is important to keep in mind that the 100 workers who might experience job losses would have a far easier time finding another job in the Los Angeles area than if 52,000 workers experienced job losses in this same greater Los Angeles job market.

In his public testimony, Prof. Neumark went so far as to offer an analogy between the case of 4.5 percent of low-wage Coastal Zone workers experiencing job losses and a 4.5 percent increase in the national unemployment rate. An increase in the national unemployment rate by 4.5 percent would entail 6.2 million job losses. Again, I think there is a huge qualitative difference between 6.2 million workers losing their jobs nationally and 100 workers losing their jobs in the Santa Monica Coastal Zone. The difference, moreover, is not a matter of magnitudes, nor does it reflect disregard as to the difficulties that even 100 workers—or, for that matter, even one worker—would experience through becoming unemployed. The point, rather is this: that the difference in magnitudes establishes a far different fallback position for those suffering job losses. If 100 workers in the Coastal Zone were to lose their jobs, their fallback position is to reenter the 1.3 million person low-wage labor market in Los Angeles, constituting less than 1/100th of one percent of this market. If 6.2 million people nationally were to lose their jobs, their fallback position is basically to scramble and make do until the national job recession ends.

This perspective on differences in fallback positions does itself suggest a possible counterargument to my position. It is that Santa Monica could be accused of relying upon the greater Los Angeles labor market to bail them out of a policy initiative that could cause worker layoffs. I think this is an accurate assessment. In my view, Santa

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1 The transcript of his testimony reads as follows: “Let me suggest that if we were talking about a policy that was going to raise the unemployment rate by 4 ½ percentage points we’d be pretty alarmed. Presidents have been thrown out of office very quickly for much smaller increases in the unemployment rate.”
Monica does have more freedom to experiment with a path breaking living wage policy precisely because the buoyant 1.3 million Los Angeles low-wage labor market gives affected workers a much stronger fallback position than would be the case if the Los Angeles itself, or the State of California, or the United States as a whole, were to attempt to implement an equivalent living wage policy.

Finally, as a contrast to Prof. Neumark’s view that we have “trivialized” the employment loss problems associated with the ordinance, Prof. Freeman offers a quite different assessment. Freeman writes on this issue as follows:

“I endorse their…mode of analysis of applying an estimated elasticity to the increase in wages, to assess the potential loss of jobs. Since estimated elasticities tend to be small, their leaning in the direction of picking a larger estimate…makes good sense to me. The worst case scenario shows only modest job losses, so I think their overall conclusion is correct: in the band of wages considered for the Coastal Zone firms, this should not be a major problem is correct.”

2. Capacity of Santa Monica Hotels to Raise Prices

Prof. Neumark argues that we have made technical errors in our econometric model that attempts to measure how much demand for hotel rooms in Santa Monica tends to change in response to an increase in hotel room prices—what economists call a “price elasticity of demand”. Referring to our discussion on pp. 72-73 of the text and Appendix 5 on pp. 206-07, Prof. Neumark concludes that “this component of the research is simply wrong and would not survive professional scrutiny (p. 6 of 8/31 letter).”

But Prof. Neumark does not recognize that, in our own assessment of the elasticity estimate, we had ourselves concluded that “unfortunately, we were unable to produce highly reliable estimates of any sort,” (p. 72); and “overall then, we are unable to reach any firm conclusion from our statistical model as to the relationship between hotel room prices and occupancy rates,” (p. 73). By contrast, Prof. Freeman did notice the circumspection with which we presented these findings from our econometric model, writing that “this data is limited and they are right to be dubious of the value of this exercise.”

Prof. Neumark also does not acknowledge that our formal econometric model was only one relatively small consideration among many types of evidence that we presented to understand the market for Santa Monica Coastal Zone hotels. Indeed, we presented 12 pages of text and eight graphs and figures between pp. 64-76 on this issue. This broader discussion included information showing the relationship between average hotel prices and occupancy rates in Santa Monica; the same figures for high-end Coastal Zone hotels only; the relationship between high-end and mid-rate Santa Monica hotels; the limits on the supply hotel rooms in Santa Monica; the average prices of hotel rooms in nearby coastal locations; and a discussion of the professional literature on hotel room pricing.
Based on an overall assessment of all of these pieces of evidence, we then reached three broad conclusions, presented on p.76 of our study:

1. Demand for the high-end Coastal Zone hotels is very strong. Specifically, within a wide band, demand appears to be largely insensitive to price increases.

2. The high-end Coastal Zone hotels do not compete with the mid-rate and economy hotels in the basic sense that an increase in high-end prices does not lead to visitors shifting to mid-rate lodgings.

3. Rising prices at Coastal Zone hotels will not induce significant increases in the supply of rooms. This is primarily the result of policy decisions of the City and its voters to limit hotel development.

These conclusions obviously did not rely on our econometric exercise, since, as Prof. Freeman notes, we were “dubious about the value of this exercise.” We rather reached these conclusions based on our overall assessment of a wide variety of data. Prof. Neumark explicitly challenged only our econometric technique, not this overall assessment. Of course, it would not be fair to assume that Prof. Neumark found this overall assessment to be convincing. But neither does he offer any arguments at all that it is wrong. From this, we can at least conclude that Prof. Neumark’s primary objection in this section is with the econometric model—something with which we ourselves had accorded virtually no weight in reaching our overall assessment on the issues relating to hotel prices, occupancy rates, and the policy-induced limits on the supply of rooms.

3. Evidence on Low-wage families

Prof. Neumark’s criticism here seems to be not primarily about our report as such, but rather about the efficiency of a living wage measure at benefiting low-wage families. This is an important subject, but before addressing it, I will briefly address his one detailed criticism of our how we have presented figures for family incomes, in particular Table 8.13. He believes he has found an error in our calculations in this table, and that this error “highlights” a broader problem with the “results on the share of family income earned by low-wage workers,” (p. 6 of 8/31 letter).

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2 I should note also that the empirical approach that we have taken in this section of the study, and in the research more broadly, is very much in the spirit of the brilliant 1991 paper by Lawrence Summers (the current Treasury Secretary and former Harvard economist), “The Scientific Illusion in Empirical Macroeconomics,” (Scandinavian Journal of Economics, 1991, pp 129-48). Among other things, Summers writes, “Successful research has been characterized by attempts to gauge the strength of associations rather than to estimate structural parameters, verbal characterizations of how causal relationships might operate rather than explicit mathematical models, and the skillful use of carefully chosen natural experiments rather than sophisticated statistical techniques to achieve identification,” (p. 130). Prof. Neumark’s specific criticism of our econometric exercise was precisely that we had made errors in attempting what Summers called “sophisticated statistical techniques to achieve identification”. But, in accord with the methodology advanced by Summers, we rather based our three overall conclusions on an attempt to gauge the strength of associations and on our verbal characterization of how causal relationships might operate.
He writes that Table 8.13 “shows that there are an average of 1.9 wage earners per family in the sampled population, but that the low-wage workers contribute well over one half of family income, on average. This seems to me virtually impossible, since the other earners in the family must on average be higher-wage workers (assuming no workers below the minimum wage),” (pp. 6-7 of 8/31 letter). I believe this issue can be easily resolved. Let us consider an example directly from Table 8.13. For the $5.75 - $7.10 wage category the table reports that the average family includes 2.2 wage earners. The median family income is $19,000 and the median “percentage of total family income contributed by worker in survey” is 66.2 percent. This means that the worker in the survey earns $12,578 (66.2 percent of $19,000). It therefore also means that the other 1.2 workers in the family earn a maximum of $6,422 ($19,000 - $12,578). The other family members could earn less than $6,422 in total, if part of the family’s total income came from “unearned” sources, such as an Earned Income Tax credit or Food Stamps. For simplicity, let us assume that the other 1.2 workers do earn the maximum of $6,422. This is what Prof. Neumark claims is “virtually impossible.”

However, Prof. Neumark seems to be assuming that all the other earners in the family necessarily work at full-time jobs. But we make absolutely no assumption along these lines, nor do we present evidence suggesting this is the case. Indeed, from the figures, it is clear that the additional employed workers in the family are working less than full-time. If we assume that they are working at minimum wage, the additional $6,422 in income would imply 1,116 hours of paid labor in a year, or about 54 percent of a full 2080 hours, for a full-year/40 hour a week job. This other adult family member would also likely be primarily responsible for child care. I don’t understand why it should be “virtually impossible” to allow that among the low-wage workers in Santa Monica earning between $5.75 - $7.40, a median case would be roughly one where one person worked nearly fulltime\(^3\), while the other family member in the labor market worked roughly half-time. That is precisely the case described by these statistics from Table 8.13.

Now beyond this detailed point, again, is Prof. Neumark’s concern that “there are many beneficiaries that are not in poor families,” (p. 7 of 8/31 letter). But Prof. Neumark offers no criticism of the basic conclusion of this section of the study:

“First, that most of these workers are on their long-term employment trajectory. They are commuting considerable distances to their Coastal Zone jobs, and this drive is absorbing a significant portion of their earnings. For the most part, they are not teenagers or second-income earners living in middle-class circumstances. Rather, these workers are living with families, and they are supporting, on average, one additional person with the income they receive from their jobs. Finally, these workers are mostly poor or near poor. Virtually none of them live in families whose overall income level would support a basic needs living standard in the Los Angeles area. This conclusion is strongly supported

\(^3\) We did report in Table 8.12 that the average work week for our sampled Santa Monica workers was 36.6 hours, not 40 hours.
by our overall results, even after we make allowances for the possibility
that workers might have underreported sources of unearned income,” (p.
157 of PERI study).

If we accept then that this is a basically accurate description of the living
conditions for most low-wage workers in Santa Monica, it then becomes an issue for
policymakers to decide whether this group of people and their families are appropriate
beneficiaries of a living wage ordinance. Our study of course recognizes that not all low-

wage workers in Santa Monica fit our overall description. Indeed, our estimates make
clear that roughly 20 percent of low-wage workers in the area live in families whose
overall income exceeds the basic needs thresholds established by the California Budget
Project (see Table 8.8 and p. 156 of PERI study). Thus, here again, part of the debate
among policymakers should therefore consider the efficacy of a living wage policy once
it is recognized that roughly 20 percent of the beneficiaries are living above a basic needs
threshold.

**Detailed Comments on Prof. Freeman**

In contrast to Prof. Neumark, Prof. Freeman does not revisit our discussions
concerning the confidential preliminary draft of the report. Instead, he writes, “in the
first draft of this report, I found several places where the evidence was less than
convincing, and so I told the authors. They have been very responsive on the bulk of
these points, so my critical comments will be limited,” (p. 1 of Freeman review).

Prof. Freeman then offers a broad consideration of our study. The Council would
benefit through considering all of his comments in detail. As I stated in my public
remarks on September 12, the City was most fortunate—as was I—to have had an
economist of Richard Freeman’s stature participate in this project. I will comment only
on one of Prof. Freeman’s points, where his analysis contrasts most sharply with the
discussion in our study. This concerns the issue of thresholds.

Prof. Freeman agrees with our judgment that a sales threshold would be more
workable than an employment threshold. But he then goes on to consider the fact that, as
he says, “thresholds are discontinuous.” By this he means that all firms under the
threshold—i.e. all firms with less than $3 million in gross receipts—would be completely
 unaffected by the proposed ordinance, while all firms over the threshold—i.e. those with
more than $3 million in sales—would face a significant “discontinuous” jump in their
labor costs.

Our report recognizes this problem, and indeed Prof. Freeman concludes that “the
discussion of how to deal with the problem of variability in sales and possible incentives
for firms to operate so that they can fall below the threshold shows considerable
sensitivity to the way such limits may affect behavior or accounting,” (p. 2 of Freeman
review). At the same time, Prof. Freeman suggests that we might consider doing more to
develop a threshold that more closely mimics how markets operate, for example, “relate
living wages to the size of firm through a continuous transformation—for instance applying a lower graduated living wage for smaller firms.”

In our study, we acknowledged that “in principle, it might be preferable to design an ordinance that would include living wage levels that rose incrementally as firms’ sales increased beyond an initial basic level.” But we then also concluded that “administering an ordinance of this type would create excessive complications, administrative burdens, and corresponding opportunities for avoidance,” (p. 43 of PERI study). Prof. Freeman also recognizes the possibility that such problems should occur, but still concludes that “perhaps it is worth considering given new computer technologies,” (p. 2 of Freeman review).

I think Prof. Freeman has raised an important point that the Council should explore further. Indeed, Prof. Freeman’s point has broader ramifications than he himself discusses in his review. In all situations where conditions for an average business firm, or a majority of firms, are considered, there will still also be “outlier” firms—those whose conditions do not conform to either the average or majority of cases. These firms would be affected differently than the majority of cases. Applying Prof. Freeman’s concept of a graduated, or continuous threshold—equivalent, as he puts it, to the structure of the progressive income tax—may well be an effective means for addressing the special situations for outlier firms, as well as the firms whose sales levels happen to be close to the threshold.

I would require more time and careful thought—perhaps in conjunction with Prof. Freeman as well as other serious analysts and policymakers—to become clear on how to design a graduated threshold in an efficient and equitable manner. Indeed, I am still not convinced that it can be done in a way that is more fair and equitable than the discontinuous $3 million sales threshold that we have proposed. In our study, we do show that in fact, relatively few firms in the Coastal Zone actually operate at sales levels close to the proposed $3 million threshold. Moreover, we also propose that firms’ coverage status should change only after they had crossed the threshold—from either below or above—and remained at the new sales level for two consecutive years (pp. 42-43 and Figure 3.2 of PERI study). Such simple measures may turn out to be the most effective means of addressing the problems resulting from discontinuous thresholds.

In conclusion though, I still think that Prof. Freeman’s proposal for a continuous threshold deserves very careful study. It should be considered first because of the way it might mitigate problems of firms’ crossing the threshold. But perhaps even more significantly, it might offer an effective way of systematically addressing the special cases of outlier firms.

Response to Business-Financed Critiques

Prof. Richard Sander of the UCLA Law School, as well as two junior colleagues wrote a report on the Coastal Zone proposal financed by “Santa Monicans for a Living Wage,” an organization financed primarily by the large hotels in the Coastal Zone. This
Mr. Tom Larmore has written two sets of two memoranda (one short/one long) to the Council, one short/long set written on September 11, and the second set written on September 19. I will assume the more recent set supercedes that of September 11, and thus will respond primarily to the September 19 memo.

**Issue of Bias in Business-Financed Critiques**

Aside from any possible overall strengths or weaknesses of a living wage proposal, it is clear that many businesses will oppose such a measure—just as they would oppose an increase in their taxes—for the obvious reason that it will cause their costs to rise. This is no more controversial a statement than to acknowledge that many low-wage workers would favor such a measure, regardless of its overall strengths or weaknesses, because it would provide them with higher wages.

Given this obvious initial predisposition of most businesses against a living wage ordinance, it should also not be surprising that the authors whose work is financed by the businesses should express a similar negative predisposition toward living wage proposals. But my view here is that this is a consideration that should be initially acknowledged, then quickly put aside. In my view, business-financed studies on living wage initiatives are fully capable of producing highly valuable perspectives that deserve the most serious consideration, regardless of their initial predisposition. Indeed, the arguments raised by businesses about the “unintended consequences” of living wage ordinances—that they would hurt the very people they are attempting to help by producing layoffs, business relocations, and heavy tax burdens for cities that adopt them—are fundamental matters of concern that no honest living wage supporter should neglect. Given my perspective, my approach in evaluating the critiques of Prof. Sander and Mr. Larmore is not to dwell on the predisposition of those who sponsored their work, but rather to evaluate the merits of the arguments they offer.

Since Mr. Larmore’s September 19 memorandum refers frequently and at length to Prof. Sander’s work, it will be efficient to first consider the Sander evaluation.

**Response to Sander Critique**

Unfortunately Prof. Sander has made it impossible to benefit from the efforts he and his colleagues have devoted to their critique in his chapter titled “The Pollin Report.” This is because his intention was clearly not to offer an honest, scholarly evaluation of our study in the first place. Prof. Sander simply chose not to rely upon the presentation of legitimate arguments and evidence, i.e. the standard apparatus of any serious analytic work. Instead, he offers hyperbole, sarcasm, vague appeals to authority, and outright—and frequently blatant—misrepresentation. In what follows, I document in detail the
methods that Prof. Sander has chosen to employ. But I do also extract one relatively
substantive consideration that he raises in his discussion, and respond to that substantive
point.

1. Santa Monica Hotel Prices Again.

Prof. Sander repeats points raised by Prof. Neumark concerning my discussion of
Santa Monica hotel prices (see pp. 6-7 above). But characteristically, Prof. Sander offers
these points in a hyperbolic, sarcastic style, apparently believing that this is more
persuasive than serious reasoning. For example, Sander writes, “Professor Pollin is
arguing that, in the case of hotels, the law of demand is repealed….No college freshman
can pass an introductory economics course without a conceptual understanding of why
the law of demand is so robust empirically,” (p. 58 of Sander critique).

Of course, we offered no such claim about the repeal of the law of demand.
Rather, as discussed above (p. 6, lines 41-45), we provided 12 pages of text and eight
graphs and figures which consider a wide range of evidence on hotel prices, occupancy
rates and limits on room supply. Similar to Prof. Neumark, Sander focuses only on our
econometric exercise and ignores the point that was clear to Prof. Freeman. It is worth
quoting again from our study, when we said, “unfortunately, we were unable to produce
highly reliable estimates of any sort,” (p. 72 of PERI study); and “overall then, we are
unable to reach any firm conclusion from our statistical model as to the relationship
between hotel room prices and occupancy rates,” (p. 73 of PERI study). These points are
again what was clear to Prof. Freeman when he wrote that “this data is limited and they
are right to be dubious of the value of this exercise.” But Prof. Sander is not satisfied to
simply ignore what we say here. He further claims that I did exactly the opposite of what
we wrote on pp. 72-73. That is, without offering any evidence whatsoever, he claims that
I “relied heavily upon” this exercise (p. 58 of Sander critique). In fact, again, I had
unequivocally acknowledged that we were “unable to produce highly reliable estimates
of any sort” through this exercise.

As for our overall discussion on pp. 64-76, Sander makes no effort whatsoever to
evaluate this, nor does he attempt to critique the three overall findings of this section of
the study, which I have listed above (on p. 7, lines 4-14). Given Sander’s association
with the Coastal Zone hotels, perhaps the most curious feature of his omission is his
complete neglect of our discussion of the professional literature by hotel management
specialists on pricing strategies in that industry (pp. 69-70 of PERI study). Had Prof.
Sander examined this point even in passing, he would have seen that that our price and
occupancy rate evidence for the Coastal Zone hotels was quite consistent with the overall
findings in this professional literature. It is unfortunate that he instead chose to rely on
nonsensical claims as to my putative efforts to repeal the law of demand.

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4 It is more generally notable that the Lewis and Shoemaker article we cite from the professional literature
(Cornell Hotel and Restaurant Administration Quarterly, 1997) builds creatively upon the early seminal
research on the relationship between price setting and perceptions of quality by Prof. Clive Granger of UC
San Diego, unquestionably one of the most eminent econometricians in the world over the past 30 years.
2. Potential for Productivity Improvements

Labor productivity is the measure of the total labor costs of producing goods and services by a given number of workers. Thus, anything that enables a firm to reduce the amount of its labor costs for a given amount of goods and services it produces will increase the firm’s productivity. For example, if a firm has a relatively low rate of worker turnover, and therefore spends relatively little money in hiring, training, replacing and supervising workers, that reduces the firm’s overall labor costs per worker, and thus raises productivity.

This section of Prof. Sander’s critique is brazen in its disregard for even minimum standards of reasonable professional discussion. It will be most efficient to document his misrepresentations one-by-one.

1. Prof. Sander writes “Professor Pollin contends on page 87 of his report that the hotels would realize ’20-25%’ gains in productivity as a result of the higher wages mandated by the Coastal Zone proposal.”

This is simply not what the very passage that he quotes from actually states. The sentence rather reads, “it seems reasonable to suggest that productivity benefits of the higher living wage for some firms could be as high as 20-25 percent of their total living wage costs,” (p. 87 of PERI study; emphasis added). What is the difference between the actual passage in our study and Sander’s representation of it? First, our passage makes no reference whatsoever to hotels in particular, as Sander claims. Second, our passage makes no definitive judgments such as Sander claims that any firms at all would necessarily achieve a given gain in productivity. Rather, we offer a nuanced judgement that “some firms could” achieve productivity gains “as high as” 20-25 percent. Thus, even in misquoting and misrepresenting a single phrase in our study, Prof. Sander has substantially altered the meaning of how we evaluated an important issue.

2. Prof. Sander writes, “How does Prof. Pollin come to such different conclusions [than ourselves]? As far as we can tell, he simply made his numbers up. He does not describe how he measured productivity changes in the Coastal Zone, or give any case studies of productivity improvements,” (p. 58 of Sander critique).

Contrary to Prof. Sander’s false claim, we offer substantial detailed evidence on turnover costs to firms, and discuss at some length how such costs, along with associated costs of absenteeism, training, and supervision can contribute to firm productivity.

A) We first discuss the professional literature on this subject (pp. 82-84 of PERI report, including footnote 19, which cites seven basic references from the professional literature on this subject).

We then turn to a detailed examination of turnover costs, derived both from our survey of 150 Santa Monica firms (pp. 84-85 of PERI study) and industry studies for both the hotel and restaurant industries (pp. 85-86 of PERI study).

We state clearly how we obtained information directly from Santa Monica firms about their turnover costs in our survey. Indeed, in footnote 20, we first state exactly the question (E7) from our survey in which our initial estimates of turnover rates come. We then proceed to describe in detail how we generated alternative estimates of turnover rates within our same set of survey questions, providing the exact arithmetic specification of how we calculated turnover costs from an alternative set of survey questions.

Our midpoint estimates of turnover costs for Santa Monica firms are reported in Table 5.6. In addition, for purposes of comparison, this same table reports turnover figures from our informal survey of La Jolla firms.

We report that, for the hotel and restaurant industries, studies sponsored by industry groups themselves find turnover rates—and associated costs—substantially higher than our own midpoint estimates (i.e. a 1998 American Hotel Foundation study found average turnover rates to be 92 percent. A 1998 National Restaurant Association study places average turnover costs at $5,000 per employee).

Considering all of these pieces of evidence, we then conclude “if we work from the midpoint turnover estimates derived from our own survey, the cost savings from lowered turnover would be in the range of perhaps 2 – 10 percent of the covered firms’ increase living wage costs,” (p. 86 of PERI study).

We then also conclude cautiously that “adding the potential savings in supervisory costs, lowered absenteeism and greater worker effort to the estimates we have derived on turnover costs, it seems reasonable to suggest that productivity benefits of the living wage for some firms could be as high as 20-25 percent of their total living wage costs,” (p. 87 of PERI study). We then document how we came to this cautious and explicitly rough and high-end figures:

a. We write “this rough estimate would be based on first allowing for higher turnover rates than our reported midpoint estimates—for example, figures closer to our high-end averages from our own survey…or those reported in industry studies.”

b. We continue, “We would then allow for additional cost savings through lowered absenteeism as well as reduced training and supervisory costs.”

c. We then qualify our high-end estimate as follows: “However, for other firms, these gains are likely to be negligible,” (p. 87 of PERI study).
Prof. Freeman’s review of this section of our work stands in stark contrast with Prof. Sander’s claim that we have done nothing less than invent evidence here. Writing simply, directly, and carefully, Prof. Freeman concludes, “This study also provides some evidence that lower turnover induced by higher wages will save the firms plausible amounts,” (p. 1 of Freeman review).

3. Prof. Sander writes, “indeed, we could find no evidence that Professor Pollin studied the internal operations of any actual business operating in the Zone.”

This is a remarkable claim indeed, given that we conducted a detailed survey of 150 business firms in Santa Monica. The evidence from this survey is presented throughout our study. Moreover, Appendix 2 of our study (pp. 188 – 200 of PERI study) describes our survey methods in detail, including the proportion of firms in our survey that are both inside and outside of the Coastal Zone (see especially Table A2.1 on p. 189 of PERI study). This appendix also includes a copy of our questionnaire. As any reader of that appendix can see, the questionnaire is fully seven pages long and asks specific and detailed questions about the “internal operations” of Santa Monica firms.

4. Prof. Sander concludes this section by asking: “Let us suppose that Professor Pollin is right—hotel and restaurant workers will become 20-25 percent more efficient as a result of higher wages. Would this not imply that hotels would be able to get by with 20 – 25 percent fewer workers? This unpleasant side effect apparently never occurred to Professor Pollin,” (p. 59 of Sander critique).

Characteristically deploying a sarcastic throw-away line as a substitute for serious reasoning, this statement by Prof. Sander conveys a complete misunderstanding of how productivity gains through lower turnover and absenteeism, and the associated reductions in training and supervisory costs, will influence firm productivity. The logic is actually quite simple. If, for example, a firm’s turnover costs fall, then the firm spends less money on replacing and training the workers who would have previously been leaving their jobs, either through quitting or being laid off. These cost savings are the source of the firm’s productivity gain in this instance. Such cost savings would by no means entail that the firm would actually reduce its total number of employees by 20 – 25 percent. Rather, the scenario we describe is fully consistent with the firm continuing to employ the same number of employees, but would spend less on hiring, training, supervising, and replacing them.

3. Reliance on Unscientific Survey Techniques

In referring to our survey of Santa Monica workers, Prof. Sander asserts that “The problem with Professor Pollin’s survey is that it is completely unscientific. Without random sampling, there is no assurance that his survey results are at all representative of the target population. Apparently research assistants simply approached people who

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5 This, of course, is not what we concluded, as I document on p. 13, lines 22-32 above. But for the moment we allow this misrepresentation to stand, to consider Prof. Sander’s broader claim in this passage.
struck them as likely workers…and asked them about their household income,” (pp. 59-60 of Sander critique).

In this discussion, Prof. Sander ignores all the documentation, evidence, and literature review that we provide on the methodology we employed in surveying Santa Monica Coastal Zone workers. These materials are presented most fully in Appendix 10 of our study (pp. 234 – 49 of PERI study). Of course, we fully acknowledge that our survey of Santa Monica workers is not derived from a random sample, writing, for example, “because of the conditions under which our Santa Monica survey were undertaken, it would not have been possible for us to create a random sample of workers for our interview pool,” (p. 145 of PERI study). But we also document in Appendix 10 how we constructed the survey utilizing three standard non-probability surveying techniques (p. 234 of PERI study). We then also cite standard professional references on the viability of using these non-probability techniques. For example we quote from a standard reference in the field, Royce Singleton and Bruce Straights Approaches to Social Research (Oxford University Press, 1999) as follows:

“It would be a mistake to rule out non-probability sampling. In many instances this form of sampling either is more appropriate and practical than probability sampling or is the only viable means of case selection,” (p. 234 of PERI study).

Of course, Prof. Sander is free to disagree with authorities such as Singleton and Straights as to the scientific status of non-probability sampling. But still again, he offers no argument whatsoever as to why such sampling techniques should be dismissed out of hand, relying still again on sarcastic throw-away lines about the nature of our sampling methods as a substitute for a reasoned argument.

But this gap in Prof. Sander’s discussion here is actually a relatively minor failing in comparison with the outright dishonesty with which he presents our overall approach to describing the potentially affected low-wage workforce in the greater Los Angeles area. In concluding that the results of our Santa Monica survey are “simply not credible,” (p. 60 of Sander critique), he offers the opinion that using data from the Current Population Survey is a far more reliable method of generating evidence on affected workers. *But nowhere does Prof. Sander even mention that our study draws heavily upon, and provides detailed evidence from, Current Population Survey.* The material that Prof. Sander is ignoring here includes pp. 145 – 154 from our study, and the accompanying eight tables and figures. It includes all of Appendix 9, which runs from pp. 226-233. It also includes multiple summary statements of the approach we have taken in this section of our work, which is to utilize data from both the Current Population Survey and our own Santa Monica survey, and derive overall results from both sources. For example, on p. 144, we write, “We will rely on two basic data series—the Current Population Survey…and our own survey of workers employed in the Santa Monica Coastal Zone….These two data sources compliment each other.” In short, it is simply impossible for Prof. Sander to have overlooked all the materials we have presented from the Current Population Survey.
Given the gross misrepresentation of our work in this section, it is not surprising that Prof. Sander makes no effort to evaluate our overall conclusions from examining the data from both the Current Population Survey and our own worker survey. Those conclusions have already been reviewed above (p. 8, lines 353-4553, and p. 9, lines 1-3 above) in our discussion of Prof. Neumark’s peer review. These overall findings remain unchallenged.

4. Validity of “Basic Needs” Threshold

Our study attempts to provide reasonable lower- and upper bounds of what we might define as a “living wage” income for families in Los Angeles. We fully document the procedures through which we generated these lower- and upper-bound thresholds (pp. 136 – 144 of PERI study and Tables 8.1 – 8.3). Prof. Sander claims that our presentation of upper-bound “basic needs” income levels “tends to render the debate meaningless,” since the highest amount for the upper bound threshold—representing a basic needs budget for a family of four with two working parents—is, according to Prof. Sander “well above the median household income for Los Angeles,” (p. 60 of Sander critique).

As we describe in our text, we derived these upper bound “basic needs” threshold levels directly from the study by the California Budget Project, Making Ends Meet: How Much Does it Cost to Raise a Family in California? This study is detailed and specific as to how it derived its basic needs budget, and we report the gist of their findings. For example, we write “for a single parent family with two children, the study finds that the yearly budget would include (in 1999 dollars) $7,116 for housing and utilities, $11,564 for childcare, $2,933 for transportation, $4,592 for food, $2,320 for health care, $3,790 for miscellaneous items, and $4,580 for taxes, for a total of $37,237,” (p. 142 of PERI study). Prof. Sander makes no effort at all to challenge whether these figures are inflated relative to the basic needs of this particular family type. Rather, again, he relies on a sarcastic one-line statement about a ‘meaningless debate’—without having attempted to constructively contribute to a more meaningful debate.

To be scrupulous here, Prof. Sander does briefly offer two points that are worth considering, even though he himself provides no discussion beyond simply mentioning them. The first is that for the for a four-person family with two working parents, the threshold of $45,683 is higher than the median family income in Los Angeles. A relevant question here is whether this figure is too high to represent a basic needs budget simply because it is above the median household income in Los Angeles. The first answer to that question is that this figure is the threshold for only one family type—i.e. the four person, two worker, two child family, not all families in the Los Angeles area. If one wishes to measure the validity of this threshold figure against median household incomes in Los Angeles, the relevant median figure to consider would be that for the same family type, not all families in Los Angeles, regardless of size.
But in addition, does it necessarily follow that the basic needs level of income must always be lower than a median income level? The California Budget Project in fact addresses this issue directly, writing as follows:

“This report illustrates the difficulties that families face in meeting basic living expenses. The basic family budgets presented in this report all require incomes much higher than those provided by the minimum wage and, in some parts of the state, more than the median income. The discrepancy between the wages available from work and the cost of raising a family provides an important foundation for policy deliberations,” (p. 9).

Thus, according to the California Budget Project, the fact that what they determine as a basic needs income level can in some situations be above the median family income level is “an important foundation for policy deliberations.” It does not, as Prof. Sander asserts, “render the debate meaningless.”

The second, related, point that Prof. Sander raises here is his contention that the worth of a living wage proposal such as that for the Coastal Zone should be judged accordingly to how well it “raises incomes of those most in need,” (p. 60 of Sander critique; emphasis in original). I do not dispute that this standard may be one measure of the value of a living wage ordinance. But it is also obviously true that, by this standard, there is clearly no point in proposing such measures. Those “most in need” in the Los Angeles area, and elsewhere, do not hold jobs at all and would therefore not benefit from living wage measures. Living wage measures are clearly targeted at a different population—i.e. working families that are struggling to get by, even though the families have at least one and often more employed members, with often at least one member holding a full-time job. This sort of family situation is the condition that we sought to capture in establishing our lower- and upper-bound thresholds for “living wage” incomes.

5. Estimates of Employment Losses

I have already dealt at some length with Prof. Neumark’s concerns regarding our estimates and assessment of the potential problems of employment losses through implementing the proposed Coastal Zone proposal (all of pp. 4-5 and p. 6, lines 1-5 above). I made clear there my sharp disagreements with Prof. Neumark on this matters.

But while Prof. Neumark disputes our evaluation of the costs to Coastal Zone workers who might lose their jobs, Prof. Sander’s critique is of an entirely different order. Sander claims that we have blundered in even attempting to estimate these employment losses. He writes that the technique that we adopted for this purpose “shows that Professor Pollin does not understand what labor elasticity means….To take these firms out of the base by which elasticities are multiplied is a fundamental—and to most economists—obvious error,” (Sander critique, p. 60). Prof. Sander then proceeds, in footnote 34 on this same page, with yet another sarcastic characterization as a short-cut attempt at dismissing our estimation method.
Typically, Prof. Sander ignores our reasoning in developing the technique we utilized in this section (pp. 98 – 100). In particular, he ignores that, in considering the method he would prefer that we had utilized, we concluded that “we cannot apply this finding directly to the covered businesses in the Santa Monica Coastal Zone,” (p. 98 of PERI study). We then proceed to develop in substantial detail a method that we regard as appropriate to the situation at hand. Here, according to Prof. Sander, is where we have blundered into what “most economists” would recognize as a “fundamental…and obvious error.”

Given that Prof. Sander has relied on this vague appeal to the authority of “most economists” in establishing the validity of his claim, it is useful here to take note of the views on this matter of the peer reviewers, i.e. two senior research economists who have actually reviewed the technique we developed here. First, as noted, Prof. Neumark offers no criticism of this technique, even while he is quite critical of the broader implications that we draw from our results. Prof. Neumark’s lack of criticism on this point is particularly notable, since, as we make quite explicit, the method we use adapts some of his own research results.

As for Prof. Freeman, I have quoted earlier from his comment on this section of our study (p. 6, lines 9 – 17 above), but it is worth restating his conclusion in full:

“I endorse their alternative mode of analysis of applying an estimated elasticity to the increase in wages, to assess the potential loss of jobs. Since estimated elasticities tend to be small, their leaning in the direction of picking a larger estimate from Neumark and Wacher makes good sense to me. The worst case scenario shows only modest job losses, so I think their overall conclusion is correct: in the band of wages considered for the Coastal Zone firms, this should not be a major problem is correct. It fits with the entire literature on the minimum wage, that employment losses are modest (given that the wage increases are invariably set to avoid an employment disaster),” (p. 3 of Freeman review).

In short, Prof. Freeman’s endorsement of our technique is clear. So here we have Prof. Sander claiming that “most economists” would recognize that we have made a “fundamental…and obvious error;” so obvious, indeed that it makes clear that I do not understand “what labor elasticity means.” On the other hand we have Prof. Richard Freeman, unquestionably one of the most eminent labor economists in the world, endorsing our approach, which is to say, also failing to recognize the “fundamental” error that Prof. Sander claims would be “obvious” to “most economists.”

Vague appeals to authority can be an effective debating ploy in some circumstances, even though they are never a substitute for honest, independent thinking. However, in this instance, Prof. Sander’s tactic has backfired. One can draw only one of two possible conclusions here. One is that Prof. Freeman is not capable of recognizing
an obvious fundamental error in his field of specialization. The other is that Prof Sander has either egregiously misunderstood or deliberately misrepresented our work. In my view, Prof. Sander’s failure here—regardless of whether it is a failure to reason adequately or to represent the views of others honestly—is unfortunately characteristic of his entire critique. Overall, I regard his critique as simply unworthy of the community of Santa Monica, in its sincere efforts to carefully evaluate the living wage proposals before them.

Response to Larmore Critique

In his September 19 memorandum to the City Council, Mr. Tom Larmore provides a far more measured critique of our study than that offered by Prof. Sander. Moreover, Mr. Larmore does usually (though not always) attempt to present both a reasonable representation of our study and his own disagreements with it. Broadly speaking then, Mr. Larmore’s September 19 cover letter and memorandum offer one basis for a reasoned discussion on the living wage proposal before the City Council. Indeed, as I will detail further below, Mr. Larmore’s discussion only becomes less constructive when he relies more directly on Prof. Sander’s report. In what follows, I address each of the five major points Mr. Larmore identifies in his 9/19 cover letter to the Council, which he then considers further in his longer memorandum.

1. PERI underestimates the potential health care costs.

Provision for full family care.

Mr. Larmore is correct that we budgeted into our estimates a relatively modest health care provision of $1.25 per hour to be provided for uncovered workers earning up to $12.00 per hour. It is reasonable to allow that the health care coverage should be more generous, so that some provision is made not only for the uncovered worker, but for his or her family as well. Borrowing from Prof. Sander’s study, Mr. Larmore suggests that a more reasonable hourly figure to provide a more generous health care package would be $1.60 per hour.

These are certainly valid considerations. At the same time, Mr. Larmore’s reasoning appears incongruous. He is, first of all, suggesting that we have been insufficiently generous in budgeting for the health care feature of the ordinance. But once one allows for a more generous health care provision, Mr. Larmore would then propose that the whole measure is now too costly for businesses and should be defeated. If Mr. Larmore were genuinely concerned that workers receive a more generous health care package than the $1.25 per hour that our studied has budgeted, one alternative way to incorporate that provision would be to consider reducing some other features of the measure—for example, reducing the wage increase by the amount that the added health care costs would generate if the health provision rose from $1.25 to $1.60, or reducing the number of paid days off below the 15 that we have budgeted.
As it is, even if we hold everything else about the $10.75 Coastal Zone proposal constant, raising the mandated health care provision from $1.25 to $1.60 would generate virtually no change in our overall findings. We can see this through some simple manipulations of the results we present in Tables 4.10 and 4.11 of our study, between pp. 56 and 57.

In Table 4.10, we see that, with a $1.25 health care provision, the total costs for health benefits for all covered firms amounts to $3.8 million, or 15.8 percent of the total costs of the ordinance. If we raised the health care provision to $1.60 for the same uncovered workers, that would increase the total costs of health care to $4.9 million and total costs of the measure would now rise from $24.0 to $25.1 million.

Turning now to Table 4.11, we can calculate how much this increase in total costs would represent relative to the fixed level of $604.9 million in total gross receipts for all covered firms. That ratio is 4.1 percent ($25.1/$604.9). This represents an increase of 0.2 percentage points over our previous overall ratio of 3.9 percent. An increase of this magnitude would not change any of the assessments we provide in Chapter 5 as to how firms might respond to an ordinance in terms of price or productivity increases, reductions in profit margins, or the prospects for employment losses or firm relocations.

Again turning to Table 4.10, we do observe that the health care component of total costs is higher than average for both restaurants and retail firms. This suggests that these sectors would incur relatively greater cost increases through raising the health care provision to $1.60 per hour. However, even allowing for this, it still would not be the case that any of our assessments in Chapter 5 would change through increasing the health care provision by 35 cents per hour.

One important reason for this is that, by design, our cost figures are already estimated on the high side, precisely so that, if we were to err, we would err by overestimating rather than underestimating total costs. We are not suggesting that our results are broadly inaccurate. But it does imply that allowing for an increase in total costs relative to gross receipts on the order of one percentage point or less will not entail any significant revision of the assessments presented in Chapter 5.

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6 As one example of how we conservatively estimated costs, and as we explain in detail in Appendix 3, where we did not have direct survey results, we used the Current Population Survey to apportion workers into different wage categories. Since it is likely that large Coastal Zone firms in Santa Monica pay somewhat higher wages than the average for Los Angeles as a whole, this implies that we would have estimated total wages and therefore labor costs as being lower than they actually are for the large Coastal Zone firms. This in turn implies that we will have overestimated the effects of increasing the mandated minimum wage to $10.75. As another example of our bias in favor of overestimating costs, we do not provide tipped worker exemptions for servers, bartenders and half of bussers at the covered hotels. See p. 201, footnote 61 for an explanation of this.
It has been correctly pointed out to us, by Mr. Larmore and others, that we overlooked allowing that tipped workers who would be exempt from the wage increase should still be eligible for the health care benefits.

We proceed as follows to calculate the additional costs associated with extending these workers health benefits. First, according to our estimates the six covered restaurants employ approximately 175 exempt servers, bartenders and bussers (details of our estimates can be derived from p. 202 of PERI study). On average, they are employed 33.8 hours per week for a full 52 weeks. If they are to be paid an additional $1.25 for health care, this would mean an increase in mandated costs for all six restaurants of $384,475, or an average of $64,000 per restaurant. This cost increase would raise the restaurants’ total costs as a percentage of gross receipts from 9.6 to 11.3 percent. The increase would be to 11.8 percent if, following Mr. Larmore’s suggestion, we also allowed the health provision to be $1.60 rather than $1.25.

In our discussions in Chapter 5, we had proceeded in our evaluation of how restaurants would respond in terms our five possible adjustment paths—i.e. price, productivity, redistribution, employment and locational adjustments—on the basis of assuming the cost increases would be roughly 10 percent of gross receipts. Even allowing for this new cost increase, it is still the case that the cost increase is roughly 10 percent of gross receipts, though now we are obviously rounding downward rather than upward. Still, given that, as mentioned above, we have attempted to err on the side of higher rather than lower cost estimates, the basic assessment we offer in Chapter 5 on the assumption of a roughly 10 percent increase in costs relative to gross receipts for restaurants is still valid.

2. Estimate of Potential Ripple Effect Wage Increases

More than half of Mr. Larmore’s 9/19 memo is concerned with our calculations of so-called “ripple effects” (this discussion runs about 4 ½ pages of the memo’s total length of about 8 ½ pages). Drawing upon the report by Prof. Sander, Mr. Larmore believes that “PERI grossly underestimates” these effects (9/19 cover letter to Council).

These ripple effects refer to increases in wages and paid days off that business owners give to workers who are not formally covered by the ordinance. It is reasonable to assume that many of these uncovered workers will still receive increases in pay and/or paid days off—even though such increases are not mandated by law—in order to preserve the rough hierarchy in compensation scales within a firm.

Allowing that some ripple effects are likely to occur, it is nevertheless difficult to estimate the size of these effects, since they are, after all, completely non-mandated. Thus, in trying to obtain an accurate assessment of how large these effects are likely to be for the Santa Monica Coastal Zone, one can only seek out analogous experiences for the insights they might offer. However, finding illuminating analogous situations is especially difficult for the Santa Monica case precisely because the living wage proposal is new and unique.
In our study, we took considerable care in estimating the potential ripple effects on wages. Our discussion covers pp. 49-55 and Appendix 4 (pp. 204-05). It also includes Tables 4.5 – 4.7 and A4.1. Considering the ripple effect for paid days off, we deliberately provided a maximum ripple effect—i.e. that all employees of all covered firms would receive the increase to 15 paid days off.

In our estimate of the wage ripple effect, we provided three types of evidence. We concentrated most of our efforts at studying the experience with ripple wage effects in the State of California between 1996-97 when, between increases in both the national and statewide minimum wage, the overall increase in the minimum wage for California workers rose by a substantial 35 percent—from $4.25 - $5.75 per hour. As important supplements to this original research, we first also examined the relevant professional literature on the subject. We then reported the results from our business survey when we directly asked business managers about how likely they would be, in response to an increase in the mandated minimum wage to $10.75, to also provide raises to their uncovered employees.

Evaluating the 1996-97 experience from California as well as the other two types of evidence, we concluded that the wage ripple effect is likely to be relatively weak. The exercise that we conducted to estimate the wage ripple effect based on the California experience yielded a wage ripple effect for the $10.75 Coastal Zone measure that amounted to 1.6 percent of the total cost increases for all firms (see Table 4.10, across from p. 56).

Prof. Freeman endorsed the general thrust of our findings, writing:

“I accept the argument that minimum wages compress differentials so that spillovers within firms are unlikely to be that great,” (p. 3 of Freeman review).

Nevertheless, in contrast with Prof. Freeman, Mr. Larmore finds that our results have “grossly underestimated” this effect. As mentioned above, his discussion is lengthy and quite detailed. But we need not review the details of his discussion to establish some basic points:

1. Despite the length of Mr. Larmore’s discussion on this matter, his discussion contains a glaring omission. It is that he makes no reference whatsoever to Table 4.6 (across from p. 54) of our study, in which we present the survey response by businesses on giving raises to workers above a mandated $10.75 increase.

As Prof. Neumark’s peer review correctly emphasizes, throughout our study we place limited weight on the results of the business attitude questions in our survey (see p. 63 of PERI study for our explanation as to why). However, this has not been the case for Mr. Larmore. Indeed, in the very first substantive paragraph of Mr. Larmore’s 9/19 cover letter to the Council, he chastises me for neglecting to sufficiently emphasize the results
of another set of business attitude questions (those in Table 5.12 on business relocation). Why then has Mr. Larmore completely ignored the results of Table 4.6 in which businesses present their own views on ripple effects, even while Mr. Larmore has devoted more than half of his total 9/19 memo to the issue of ripple effects?

Obviously, only Mr. Larmore can provide an answer to this question. However, the results presented in this table, as mentioned above, are fully consistent with our conclusion that ripple effects are likely to be weak. Thus, of all the firms we survey, 64.2 percent say they are “very unlikely” to give any raises at all above the mandated $10.75 increase. Only 22.8 respond that they are either “very likely” or “somewhat likely” to give raises above the mandated increase. For the hotels, in which over one-half of the covered workers would be employed, 85.7 percent of the firms responded that they were “very unlikely” to provide wage increases above the $10.75 mandate. None of the hotels that responded said they were “very likely” to provide non-mandated increases, and only 14.3 percent said they were “somewhat likely” to do so.

In his 9/19 memo, Mr. Larmore claims to know “the opinions of business owners” on this matter (p. 2 of Larmore memo). But he ignores the systematic evidence we have provided as to what those opinions are among Santa Monica business owners, even while elsewhere, he draws heavily upon this same survey evidence. At the same time, Mr. Larmore offers no evidence as to how he possesses systematic knowledge of the “the opinions of business owners” on this matter.

2. Mr. Larmore’s alternative calculations of the wage ripple effect are based on the report by Prof. Sander. But the reasoning and evidence supporting Prof. Sander’s methodology consists of exactly one sentence of text and one sentence in a footnote (see p. 13 and footnote 11 of Sander report). Moreover, the sentence in footnote 13 provides the only empirical support at all for his approach, and this sentence reads in its entirely: “We used the same assumption in our 1997 Los Angeles report, and our research since has suggested that this is a good estimator.” Thus, Prof. Sander provides no description at all as to what his corroborating research might actually consist of, nor does he offer the reader any citation as to how one might obtain access to this research.

3. Despite a complete lack of evidence, Prof. Sander asserted in his public testimony on September 12 that I had underestimated the ripple effect “by more than a factor of 10.” Mr. Larmore goes further, concluding that we have underestimated the wage ripple effect by a factor of 16 (estimating an increase of $6.2 million as against our $379,000 figure; p. 6 of 9/19 Larmore memo). But rather than dwell further on the details of this difference, let us instead allow, for the sake of argument, that Mr. Larmore’s wage ripple effect is actually accurate. Once the effects of this ripple effect 16 times greater than that which we have estimated are built into our overall cost structure, how much difference would it exert on our overall assessment of the impact of the living wage ordinance?

We can turn again to Tables 4.10 and 4.11 to help provide guidance on this question. For all covered firms, an increase in the wage ripple effect from $379,000 to
$6.2 million would be felt both through an increase in the wage ripple category by $5.8 million and through an increase of $725,000 in payroll taxes (12.5 percent of $5.8 million). Thus, the overall increase in costs is $6.5 million, bringing the new figure for total costs to $30.5 million. Turning now to Table 4.11, this increase in total costs would amount to 5.0 percent of total gross receipts of $604.9 million, an increase of 1.1 percentage points over the 3.9 percent figure in Table 4.11.

Would an increase in costs equal to 5.0 percent of gross receipts, as against 3.9 percent, significantly change the manner in which the average firm responds to a living wage ordinance? This is a possibility, but, in considering the options available to firms in terms of price, productivity or distributional adjustments, it cannot be regarded as a certainty. Nevertheless, allowing that this 1.1 percentage point additional increase in costs did represent a kind of tipping point through which the negative employment or relocation patterns of the ordinance began to predominate, this could also itself set off countermeasures.

For example, if ripple effect wage increases were indeed reaching the extremely high levels asserted by Mr. Larmore, the City Council might consider suspending the paid days off feature of the measure. According to our estimates, this would then save $3.2 million (including payroll tax reductions). Everything else equal, the average cost increase for firms would then fall back to 4.5 percent of gross receipts, i.e. now only 0.6 percentage points higher than our initial estimate.

The more likely scenario, however, would be that once firms experienced perhaps one round of ripple effect increases along the lines assumed by Mr. Larmore, they would then stop granting further wage increases that would be, after all, non-mandated. Such a response would obviously be more in keeping with the evidence we have presented on the limited size of non-mandated increases, including the attitudes of the business managers themselves. In other words, the market itself would likely generate its own countermeasures if we assume that wage ripple increases were to initially push the overall cost increases associated with a living wage measure to the extent suggested by Mr. Larmore. Thus, even in following through on the logic of the situation implied by Mr. Larmore’s assumption of a 16-fold increase in the ripple effect relative to our estimates, we return to a conclusion supported by all three types of evidence we provide on ripple effects: that the magnitude of the effect will most likely be modest.

3. Measuring Cost Impacts Relative To Gross Receipts vs. Profit Margins

It is hardly controversial to recognize that gross receipts and profit margins are two separate measures of the size and performance of business firms. Each has its advantages and disadvantages as indicators. This is why taxes on business operations are themselves based both on total gross receipts (or sales) and on profits.

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7In the interests of space, I focus here only on the case of the average firm. Below we consider again the situation for high-cost “outlier” firms.
Mr. Larmore claims that utilizing gross receipts as a standard against which to measure the cost increases associated with a living wage is “fundamentally flawed because it fails to consider the profit margins of these businesses,” (Larmore 9/19 cover letter). But by such reasoning, all forms of sales taxation are also “fundamentally flawed” because they also fail to make allowances for differential rates of profit between firms.

For the purposes of establishing a coverage threshold for a living wage measure or assessing the impact on firms of such a measure, there are two important advantages of measuring firms’ performance in terms of gross receipts rather than profits. The first is that a gross receipts standard is more objective. The measurement of a firm’s profits will change according to the accounting methodology it employs, while gross receipts is invariant between accounting methodologies. Perhaps more to the point, firms can, for example, appear to earn low profits simply by paying inflated salaries to its top managers, who also happen to be its owners. But again, with a gross receipts standard, the basic measure is not sensitive to how ownership/top management may structure its compensation system. In addition, allowing profits to serve as a coverage threshold would discriminate in favor of less profitable firms and firms which were better able to hide profits.

These considerations aside, Mr. Larmore does still have a point in suggesting that the City Council pay attention to the fact that different firms will experience the impact of a living wage measure to widely varying degrees. We tried to keep this basic point in mind throughout our study, as Prof. Freeman recognizes when he writes, “the analysis shows sensitivity to the fact that the living wage will affect different firms differently and different workers differently,” (p. 1 of Freeman review).

Indeed, Mr. Larmore expresses this concern more clearly in his 9/11 letter when he states, “Even if the percentage of gross revenue were a correct method to determine the impact on a firm, including all 42 of these firms together provides a very misleading picture of the impact on many of them—Pacific Park being a prime example,” (p. 1 of 9/11 letter). I largely agree with this statement. Moreover, I think the spirit of this statement leads us back to the point raised by Prof. Freeman, which is to explore the possibilities of something akin to a graduated coverage threshold. And as I had suggested earlier in this regard, even if such a graduated threshold were to prove infeasible, it still is of course necessary that the City Council pay careful attention to the situation for high cost “outlier” firms within the Coastal Zone. In addition to the Pacific Park, the situation for McDonalds is another prime example of a firm requiring special attention.

4. Would firm’s share of gross revenues adjust downward on a one-time basis?

The difference here between my position and that of Mr. Larmore is simply one of semantics and can be easily resolved. In Table 5.4 (across from p. 79), we show that, due to the living wage increase, the share of gross receipts going to low-wage workers at a hypothetical hotel rises once due to the establishment of a living wage law. If the
hotel’s gross revenues then grow in the subsequent year, and wages do not rise again, that
then necessarily means that the share of “remaining gross revenue”—i.e. those shares
going to claimants other than low-wage workers—will begin rising in this subsequent
year while the share to workers falls. This is the precise sense in which I referred to a
one-time downward adjustment in profit margins due to a living wage increase. The
arithmetic here is beyond dispute. What is more important is whether the assumptions
that I have incorporated into this exercise are realistic, which would then determine
whether the situation described by the exercise is also realistic. As we describe on p. 79,
we worked with quite realistic assumptions as they apply to the Coastal Zone hotels. Mr.
Larmore does not attempt to challenge any of these assumptions.

5. Productivity estimates again.

Mr. Larmore simply repeats here the criticisms of our discussions on productivity
presented by Prof. Sander. I have already taken extremely strong exception to Prof.
Sander’s critique on this issue, and have discussed the issue at length (see pp. 13-15
above).

Overall Conclusions

This memorandum has followed a long and sometimes labyrinthine path through
four sets of responses to our living wage study. In working through these four sets of
responses, I conclude that all of the major findings of our study remain firmly supported
by economic reasoning and the wide range of evidence that we present. At the same
time, I think that the process of review, critique and response generated by our study has
been, for the most part, constructive and illuminating. Most importantly, I think this
process has brought issues to the forefront that I hope are beneficial to the City Council
and the greater Santa Monica community.

From my perspective, two interrelated issues stand out as the most important
matters on which to focus further attention. They are:

1. How to establish a coverage threshold that is as fair and efficient as possible;
   and

2. In thinking further about designing such a fair and efficient threshold system,
   the situation of high cost “outlier” firms such as the Pacific Park and McDonalds requires
   additional attention.