BACK TO BUSINESS IOWA PODCAST

A partnership of Iowa State University Extension and Outreach and America's SBDC Iowa

SEASON 2 | EPISODE 4: Minimum Wages & Their Effect on Firm Entry/Exit - An Economist's Take

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Description: *Iowa State University professor and economist Dr. Peter Orazem discusses his recent research into the minimum wage and its effects on firm entry and exit. He also discusses his research on firm entry and exit during the COVID-19 era and some predictions about the future state of business bankruptcies.*

[music]

Steve Adams, host 00:10
Hello, and welcome to the Back to Business Iowa podcast from Iowa State University Extension and Outreach. This podcast is a collaboration between Iowa State University Extension and Outreach and the programs including Community and Economic Development, Farm, Food and Enterprise Development, and the Iowa Small Business Development Centers. These podcasts cover relevant topics for businesses and individuals related to education, research and technical assistance during and post COVID-19.

Steve Adams, host 00:54
I'm Steve Adams, field specialists three at Iowa State University Extension and Outreach, part of the Community and Economic Development unit and your host for these podcasts. Today we'll be speaking about two very hot topics, both in the national dialogue but also for the Iowa economy. We'll be discussing the impact of minimum wage on business entry and exit from the economy, and more generally, business entry and exit in rural economies like Iowa's. Our guest today is Dr. Peter Orazem, who's a returning guest on our program. Dr. Orazem is a professor of economics at Iowa State University, who focuses his academic and research interests in part on labor and rural labor economics. He has some new research findings to share with us on the program, and we can't wait to hear about it. Professor Orazem, Peter, hey, thanks for joining us again today. We're glad to have you back on the program.

Peter Orazem 01:56
Thank you very much. It's an honor to be asked.

Steve Adams, host 02:00
Well, I don't know about an honor, but we'll glad to have you back. [laughter] So I'm sure you're aware of the national discussion around raising the minimum wage to $15 an hour countrywide, or across the United States.

Peter Orazem 02:14
Yeah, of course.

Steve Adams, host 02:16
Well, proponents argue that $15 an hour is a quote unquote, living wage, and that a person working at today's minimum wage of $7.25, even if they're doing that full time, cannot afford the basic necessities of life, like food, housing and clothing. On the other hand, opponents to the minimum wage increase

argue that by increasing the minimum wage to that level of $15 an hour will end up hurting small businesses who can't afford that sort of labor cost. I've summarized that correctly, I think, Peter—is there anything you'd like to add to that, maybe?

Peter Orazem 02:54
Well, no, that's exactly the point. And there's a lot of sort of talking past one another in terms of what the objective of the minimum wage is. The objective of the minimum wage was to prevent firms from exploiting labor, and not so much as a means of allowing someone to perhaps earn enough for a family of four. I mean, most of the people who earn the minimum wage are single, they're young, and they have relatively low skills. And so those aren't the target populations for poverty relief programs. You know, for example, if we have the earned income tax credit, it's much more effective in trying to reduce the poverty rates for the working poor.

Steve Adams, host 03:49
Well, and in regards to your research, do you have any idea of how many people in the United States currently work at that $7.25 an hour minimum wage?

Peter Orazem 04:00
It's, if you look at the $7.25 and less, since there's jobs that are exempt from the minimum wage, it's roughly 1% of workers in the US who are now in what we would call the minimum wage group, the federal minimum wage group. Remember that there are 29 states and the District of Columbia that have minimum wages that are higher than the federal level, and so they would be covered by state, not federal, $7.25 minimums. Remember that about half the workers in the US are paid salary, and so they're not covered by the minimum wage, and so only hourly workers are covered by the minimum wage. And so the target is relatively low-skill people who are paid hourly.

Steve Adams, host 04:54
And you said that was 1%. Is that correct?

Peter Orazem 04:57
Yes. It's for all intents and purposes not really relevant currently for wages that are paid in the United States.

Steve Adams, host 05:10
I think a lot of people, Peter, you know, would think that most minimum wage people are teenagers or college kids who are in their first job, just trying to pick up a little part-time income perhaps or more. Are they working parents? Is there some other demographic that maybe I'm missing or overlooking here?

Peter Orazem 05:30
The majority of the people who work the minimum wage are young, so 24 or less, they are single, not married. And they tend to have a high school education or less. So a small fraction of college graduates, perhaps 1% of college graduates, are paid the minimum wage versus say 4% of high school dropouts.

Steve Adams, host 06:01
Well, I guess too, I'm just curious, and I've done some of this research myself. Iowa is one of the top states in the country to where people are working, in a family of four are sometimes working two full-time jobs and then a part time job. I think the figure is 2.5% are working more than one full-time job. Is that is that still an accurate statement?

Peter Orazem 06:28
Well, it is true that if you're looking at the minimum wage population, they're more likely to be working part-time than full-time. And so you might have minimum wage workers who are are patching together multiple jobs in order to work full-time hours. But once again, I think the disproportionate share of minimum wage jobs are going to be aimed at people working under 35 hours a week.

Steve Adams, host 06:59
Okay. Well, now that we've kind of got a lay of the land here, please tell us about your research into this issue. First of all, how did you conduct it and who and what were you actually studying? And were there some fundamental questions you were trying to answer in this research?

Peter Orazem 07:16
Well, most of the research on the minimum wage has been on its impacts on employment. And the research tends to be somewhat mixed; you get different effects, depending on location and different effects depending on the kind of industry and you have additional complications. For example, for restaurant workers who are paid tips, we have a lower minimum wage that applies to restaurant workers. But often with the tips, they're paid well above the minimum level. So we thought it would be interesting to look at the effects of the minimum wage on firm entry and exit.

Peter Orazem 07:56
Unlike with employment, if you're raising the cost of labor, that puts pressure on firms. And so it should make it more expensive for firms to enter. And it should make it more likely that firms are not going to be able to meet their financial obligations and they would exit. And there was a particular concern that if we look at rural areas versus metro or urban areas, because prevailing wages in rural areas are lower than they are in in the urban or metro areas, it's going to affect rural firms more directly, so you're going to have a higher increase in the cost of labor for rural firms than then urban firms.

Peter Orazem 08:46
And so what we did was, we looked at information over about a 20-year span. And we compared firm entry and exit in urban markets versus rural markets. And we also focused on the sectors of the economy where the minimum wage is more likely to bite. And that's going to be in the entertainment sector, retail, hospitality and restaurants. And what we found was that in both urban and rural markets, increases in the minimum wage reduce the probability of firm entry. And so the firm entry rate went down both overall and in those particular sectors, and the firm exit rate rose overall and in those particular sectors. And there's a modestly greater effect in rural areas than urban areas, but it wasn't as large as we expected.

Peter Orazem 09:53
And one of the reasons is, if you focus on those minimum wage sectors, which are retail, restaurants, hospitality and entertainment, the wage differential between the urban and the rural markets is about half what it is in general. And so there isn't as much of a difference in the cost of labor in urban and rural markets in the sectors that are most directly affected by the minimum wage.

Steve Adams, host 10:22
So did you learn anything here that kind of surprised you at all? And were there some conclusions that you were able to draw, I guess?

Peter Orazem 10:31
Well, I think, number one, we were surprised at how common the minimum wage effect was. We did not expect that it would affect, for example, manufacturing. And yet, on the margin, it did affect

particularly small manufacturers. And we did not expect to see as much of an effect in in the urban and metropolitan areas as we did. We thought to some extent, you know, if you look at San Francisco, where median wages are about $23, $24 an hour, a $15 minimum wage shouldn't really matter that much. And yet, you still find that in in metro areas, the minimum wage does affect the likelihood that small firms survive.

Steve Adams, host 11:30
Where do you think further research needs to be done? What else needs, what else do we need to find out, Peter?

Peter Orazem 11:37
Well, if you go back to your initial question about living wage, clearly, cost of living differs between rural and urban and metropolitan markets, and in some cases, they differ substantially. So if you have a uniform minimum wage that's applied to all areas, it's going to bite hardest in rural areas, because the cost of living is lower there. And so you can get by with a lower wage and and still meet your obligations. And so when you have a uniform minimum wage that's imposed across all markets, it's going to have the effect of of raising the relative cost of business in rural areas versus urban areas.

Peter Orazem 12:33
And I and I think that to some extent, the right answer is to have a relatively low federal minimum wage, and then allow the states to adjust the minimum wage, you know, using their own their own relevant cost of living. And so to the extent that there is an objective of trying to make sure that workers get at least some level of pay that meets the cost of living in their own areas, you have to have a minimum wage that adjusts to those factors. And so to some extent, I think this might be better legislated at the state or even local level than at the federal level.

Steve Adams, host 13:24
I know I think it was in Washington state, Peter, though, there was some objection raised, I think it was in the Seattle area, for actually raising the minimum wage in that the state or local control should not be given consideration. But I think what I'm hearing you saying is you're more of an advocate for the state or the local governmental or public entities to set that. Is that correct?

Peter Orazem 13:50
Well, to the extent that what you're trying to do is to set a minimum based on on cost of living, then that's the case. I mean, Seattle, and the prevailing wages in Seattle are very different than the prevailing wages in relatively rural eastern Washington. And so a $15 minimum wage in Seattle might not affect firms as much as a $15 minimum wage in rural eastern Washington. And so remember that here in Iowa, wages in metropolitan areas in Iowa are roughly 20% higher than wages in rural areas of Iowa, reflecting differences in the cost of living. And of course, that's one of the reasons why people commute from rural to urban areas is to access that higher wage and they pay for that by the time it takes to get from their hometown to the place of business. So I do think that a uniform minimum wage is going to tend to disadvantage the parts of the country that have the lowest cost of living and Iowa is one of those.

Steve Adams, host 15:08
So again, another part of the rural-urban divide, I guess you could say, and I certainly understand you know, that the cost of living, I have a lot of friends in and around this part of Iowa that commute into Omaha as a perfect example. And others a little farther to the east that commute in every day into the Des Moines market to work. And I think it again has to do with the higher wages paid, but there certainly is a tradeoff, I think, with commute time and wear and tear on vehicles and that type of thing, isn't there?

Peter Orazem 15:40
Oh, sure. Absolutely. But I mean, there you mentioned Nebraska, I mean, Nebraska is an interesting state, Nebraska turns out to be more urban than Iowa. And you say how can that be, I've driven through Nebraska and a lot of Nebraska is empty. And that's exactly the point. So the job centers in Nebraska tend to be on the eastern side of the state. And the places that didn't have those commuting opportunities basically shrank. And here in Iowa, we have an advantage that a lot of the job centers are scattered about the state. So you can access an urban market relatively easily in almost all parts of the state.

Peter Orazem 16:31
And that's one of the reasons why the small towns in Iowa have been able to sustain themselves to a much greater degree than the small towns in in Nebraska. If you look at residents of small towns in Iowa, say 2,500 or less, three quarters of them do not work in that town. So the strength of small towns in Iowa is really tied to the ability to access an urban market. And I'm not sure that that's always appreciated as much as it should be. You know, perhaps we should invest more in roads and bridges and to make that cost of commuting lower, as opposed to assuming that each town is going to be able to provide enough jobs for all its residents.

Steve Adams, host 17:29
Yeah, I think any review of Iowa labor sheds would backup that point 100%. Now, you've also, I know, recently conducted some research regarding business for firm entry and exit from the marketplace. This is kind of separate and apart from the research on the minimum wage correct? And how so?

Peter Orazem 17:51
Well, it's sort of on the same thing. What we were interested in was, what is it about a community that attracts new firm entry? And we found a lot of things that you might not find surprising, right? So access to upstream input providers and downstream customers is important. And access to an educated labor market is important. And having a customer base, a population that has a high average per capita income is important in trying to sustain firms. And so we didn't find anything that surprising in that.

Peter Orazem 18:34
But what we found surprising was, then we looked at, okay, and what affects the probability that firms stay in business? And those very same factors also increase the probability that firms exit. And when you look at the data, it's sort of clear what's going on. If you have a market that has a local economic environment that invites a lot of firm entry, it also invites potential purchasers of the capital assets of firms that are in business. And so you have the potential that your firm is doing fine, but somebody is willing to pay you more than the value of your firm in order to take over that particular location. And if you're in a smaller market that doesn't have those advantages, then that's going to mean that you don't have a ready supply of potential replacement firms.

Peter Orazem 19:29
And so to some extent, you have to stay in business because that's the only option for the capital investment that you've made. And so what we found was that the strongest markets for firm entry were strong in part because you had a better outside option for your investment, right, the salvage value of your firm was high here, and so that lowers the risk of entry. If you're in a market where there's not going to be a potential purchaser of your assets if the venture isn't doing as well as you would like, then you're more hesitant to open in the first place. And so what we found was strong markets had both high rates of firm entry and high rates of firm exit. And the weaker markets had low rates of firm entry and low rates of firm exit.

Peter Orazem 20:23
And this sort of speaks to another puzzle that we had seen earlier on in some earlier research. And that is that in small markets, in rural markets, the probability that a firm survives is higher than it is in an urban market. And we have speculated at that point that that might be because people are more hesitant to open a business in a rural market. So they have to have a higher probability, or higher expectation that the venture is going to succeed in order to induce them to enter. And that appears to be what's going on.

Steve Adams, host 20:59
Well, my producer and I were just talking earlier that we are this week celebrating pretty much the anniversary date of when we were all told to shut our offices, go home, and really, the whole impact of the pandemic started to hit. But I think all of our listeners would be curious to learn what the impact in the last year has had on small business and business in general. And I know you touched on the entertainment, hospitality, restaurant, but can you tell us a little bit more about the study and your findings, generally, overall?

Peter Orazem 21:33
Yeah, so if you look at the pandemic, this has clearly been a major challenge for small businesses, especially businesses that were not considered important for maintaining during the early shutdowns. And so restaurants, bars, hotels, pretty much the entire service sector of the economy, including small retailers, lost sales, because they effectively were shut down. And if they didn't have another way of maintaining revenues, they were in serious trouble. On the other hand, we did have three large efforts on the part of the federal government to infuse funds into small businesses, including others. And so if you look at bankruptcy rates in the United States, they've actually gone down.

Peter Orazem 22:40
So if you look at Iowa, the bankruptcy rates didn't go down as much as they did for the US as a whole overall. In the US, if you look at the end by the end of 2020, versus 2019, bankruptcy rates were 30% lower, on average, and the commercial bankruptcy rates were down 17%. So individual households got a better infusion of funds, plus many households were excused by having, you know, from having to pay mortgages or rents. And so as a consequence, you had fewer bankruptcies than we had in the non-pandemic years. Here in Iowa, the bankruptcy rate has only gone down 23% versus 30% nationally, and so our share of overall bankruptcies has gone up.

Peter Orazem 23:41
That's both good news and bad news, right? So a lot of companies have been able to survive, but they're not necessarily in a healthy position. And so as we come out of the pandemic, and in particular, as the access to the federal support payments disappears, I'm really skeptical that we're going to see a huge increase in the number of people going to restaurants and retailers and so on. And so it's the, I think there's going to be a relatively slow recovery in those sectors. And so I think, to some extent, the relatively low rates of bankruptcy that we had in 2020 might be foreshadowing a surge in bankruptcies that might be occurring in the balance of this year and next year.

Steve Adams, host 24:43
Well, that bankruptcy rate thing kind of surprises me, I guess. And I think you're right, though, that the stimulus packages as provided by the federal government have at least kept the boat afloat. But I also kind of hear you saying that once that spigot gets turned off, you're thinking we'll see a real surge in those bankruptcy rates, right?

Peter Orazem 25:07

I think that, I do think that it's going to be a big challenge for firms, unless, I mean, maybe people will, you know, want to return to life as normal immediately. But I just don't think that's going to happen. I think you're going to have a lot of people, even if they've been vaccinated, and even if they think that, in general, the possibility of contracting the disease has been reduced, they're still going to be hesitant to get into crowded areas. And so the sorts of businesses that depend on large foot traffic and high concentrations of population, whether it's entertainment or restaurants and bars, or businesses that depend on tourism, I think it's going to be a relatively protracted recovery.

Peter Orazem 26:12
And not everyone's going to be able to make enough money during that recovery to stay in business. And I mean, if you look at the states that were the most adversely affected by the pandemic, the biggest reduction in employment was in Hawaii. And although Nevada as a state has recovered a little bit, Las Vegas itself is still having unemployment rates above 10%. You know, I don't think that you're going to see an immediate return to normalcy for those parts of the economy.

Steve Adams, host 26:56
Oh, and yet, Federal Reserve Board chair Jerome Powell just earlier this week said he expected the GDP growth to be really substantial after the middle of this year and going into 2022. Are you seeing that? And again, I understand what you're saying, those people are dependent on that foot traffic, especially in the hospitality and tourism industry. We might see a complete change in that revenue, and that foot traffic might never come back. But if the economy grows, I assume other sectors of the economy will also grow along with it.

Steve Adams, host 27:35
You know, for example, I know that in recent things that I've been looking at, things like outdoor recreational activities, there have been huge increases there, people are traveling more. And so home improvement took on a big leap, and almost all the major box lumber stores saw huge increases in the amount of sales. But I guess where I'm going with that is that some sectors are going to do better than others, right?

Peter Orazem 28:07
Yeah, absolutely. It's absolutely the case that Amazon made a lot of money on the pandemic, right? So on the other hand, bricks and mortar retailers, who were stressed before the pandemic, were really stressed during the pandemic. And we saw, we've seen a lot of major exits on the part of bricks and mortar retailers over the last year. And I don't think that has ended. You see a surge in Hy-Vee and other grocery chains, and Walmart, which also is a big box retailer, taking up business, a part of which would have gone to restaurants, right? So the number of meals being consumed away from home decreased as a result of the pandemic.

Peter Orazem 29:10
On the other hand, if you're a restaurant that could continue serving, particularly delivery-oriented restaurants got a surge. So the stock price for Domino's went up 30% in the first few months of the pandemic and Chipotle's that also delivers went up. So there's certainly been a shakeout related to the pandemic. But remember that if we have four and a half percent growth, it was off an artificially low base because of the decline in the economy during the pandemic. So at least a good share of the growth that Chairman Powell is referring to is simply going back to what we would have been in the absence of the pandemic and not growth above that. So, you know, I don't think we want to get too far ahead of ourselves to say that 2021 is is going to be a return to where we would have been had the pandemic not occurred.

Steve Adams, host 30:18

Sort of like a false positive on your COVID test, right, Peter? [laughter]

Peter Orazem 30:22
Well, I don't know. It's just, we want to be a little bit cautious and for the small businesses that have really, I think, faced a really tough year, I think it's going to be a continuing challenge going forward for at least two years before, I think people will feel comfortable enough that sort of herd immunity has been attained. And even the small variations in virus that we get all the time with the flu and the cold, that we've now built up enough near immunity that we would be able to fight those new variants as well.

Steve Adams, host 31:15
All this has been very enlightening, if not somewhat depressing, Peter, but I do appreciate your candor and your honesty here. So, again, thanks so much for being a returning guest once again on our podcast. We certainly appreciate your time and insights and it's all very informative. If someone had any additional questions for you regarding your research and opinions, is there a good way for them to contact you?

Peter Orazem 31:43
Well, certainly I mean, by email pfo@iastate.edu. My direct line is 515-294-8656. And I'm happy to talk to everybody. And I know economists are viewed as sort of the dismal scientists, and our job is to always sort of, what was it? Take the punchbowl away when the party is just getting started? I do think that there's a lot of grounds for optimism. I think if you look at where we were a year ago, I don't think anyone would have thought that there was a chance that we would have three apparently reliable vaccines that are currently being rolled out in the population and that we might have a good share of the population vaccinated by June I.

Peter Orazem 32:41
You know, I think that for the sectors of the economy that aren't as directly related to hospitality and transportation and entertainment, I think that it's going to be a relatively smooth move back toward normalcy. And I hope that it also is for the hospitality industry writ broad, as well. But I just know that there's going to be a lot of people who are a little bit shy about getting out in crowds again.

Steve Adams, host 33:22
Well, thanks for at least bringing some of the punchbowl back.

Peter Orazem 33:25
Yeah [laughter]. Well, thanks for having me.

Steve Adams, host 33:29
You bet. If you have any questions about this Back to Business Iowa podcast, please feel free to contact me, Steve Adams, at stadams@iastate.edu. And as always, thanks for listening. Well, if you've enjoyed listening to this podcast, please consider posting a review or becoming a subscriber on Stitcher, Spotify, Castbox, the Podcast app, Apple, Google or on whichever platform you find your podcasts. Reviews, ratings and comments are all helpful as well—that will help us build, of course, a better podcast. So whether it's a one-star or five-star review, we want your input and your opinion.

Steve Adams, host 34:09
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