

PREVAILING WAGE LAWS, CONTRACTOR PROFITS, AND THE ECONOMIC PIE



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INTRODUCTION

What impact does a state prevailing wage law have on profit margins in the construction industry? The Associated Builders and Contractors, Inc. has claimed that prevailing wage legislation hurts small construction businesses, arguing that they are at a “disadvantage due to low net profit margins.” The ABC contends that prevailing wage increases labor costs, reduces profits, and limits the growth of the industry (ABC, 2015). The Laborers’ International Union of North America, in contrast, has asserted that employers oppose prevailing wage laws “because they want to cut workers’ paychecks and pocket the pay-cuts as profit.” Supporters of prevailing wage also claim that the legislation has no impact on total construction costs and raises worker productivity, which actually has positive impacts on the industry and the economy (LiUNA!, 2015).

Economic research has been relatively silent on the impact of prevailing wage laws on construction profits. The preponderance of evidence submits that state prevailing wage laws do not increase project costs for the public sector (Philips, 2014; Duncan, 2011; Mahalia, 2008; Wial, 1999; Prus, 1996) but do increase worker training and reduce workplace injury rates (Manzo et al., 2014; Philips et al., 1995). Prevailing wage laws have also been found to positively impact state economies by keeping good middle-class jobs in the local labor market (Dickson Quesada et al., 2013; Kelsay et al., 2011). If these findings are accurate, prevailing wage legislation should have no impact on the economic growth of the construction industry, because any increase in labor costs is offset by enhanced worker productivity and higher-quality infrastructure. These conclusions, however, do not suggest anything about *profits* for the private sector.

This ILEPI Economic Commentary explores the impact of state prevailing wage laws on profit margins in the construction industry. Since it is argued that increased profits lead to greater economic growth, the paper also presents data on construction industry growth and worker productivity. All data are extracted from the Bureau of Economic Analysis “Regional Data” and the County Business Patterns for 2012, the latest year for which all relevant information are available (BEA, 2012; USCB, 2012). For both datasets, information is collected, analyzed, and reported by the United States Department of Commerce using surveys of American firms. The Economic Commentary’s conclusions are based on a broad, summary level only, and do not incorporate advanced analytics to control for many factors that can be important in explaining differences in profit margins. The report does, however, provide a good overview and a first-step for researchers interested in understanding the relationship between prevailing wage laws and contractor profits.

WHAT IS A PREVAILING WAGE LAW?

Prevailing wage laws (or PWLs) are one of the oldest labor market policies in America. PWLs prevent government bodies from using their immense purchasing power in the construction market to undercut wages and benefits in a community. Instead, PWLs mandate that governments pay the wages and benefits in local labor markets that have already been agreed upon by contractors and workers for comparable work on similar projects. By setting

compensation at the prevailing rate but maintaining a lowest-bidder system, the downward pressure on wages is reduced and labor costs are effectively removed from the competitive bidding equation. Thus, in theory, a PWL forces contractors to compete based on quality, worker productivity, materials costs, technological advances, management practices and logistics, and profit margins (Figure 1). Paying a good middle-class wage, in addition, encourages skilled workers to enter the construction industry, provides an incentive for firms to train workers to boost productivity, and promotes stability in the labor market— added benefits of the policy which help to lower total project cost.

FIGURE 1: ILLUSTRATION OF THE EFFECT OF A PREVAILING WAGE LAW ON A CONTRACTOR’S BID

$$\text{Project Bid} = \text{Labor Costs} + \text{Quality} + \text{Productivity} + \text{Materials} + \text{Technology} + \text{Management Practices} + \text{Profit}$$

As previously noted, prevailing wage has in fact been found to enhance productivity, increase worker training, and reduce construction industry injury rates (Philips, 2014). After PWLs were repealed in nine states from 1979 to 1988, annual construction worker earnings declined by \$2,360 per worker on average and worker training fell by 40 percent (Philips et al., 1995). The quality of construction subsequently deteriorated because low wages discouraged high-skilled workers from seeking employment in construction. Finally, firms actually do alter crew mix and substitute capital for labor in response to higher labor costs. If prevailing wage laws increase labor costs, these factors must be accounted for (Duncan, 2011).

There is not, however, much data on whether contractors respond to prevailing wage laws by adjusting their business profits in some direction. One researcher has claimed that workers are paid more for work on prevailing wage projects, which increases costs for contractors who use low-skilled labor, making them less competitive. Firms that use low-cost labor, it was argued, are priced out of the market, reducing competition and allowing some contractors “to earn above normal profits” such that “profits from prevailing wage projects are no lower than profits on non-prevailing wage projects” (Clark, 2005). Given that labor only accounts for 25 to 30 percent of total construction costs (Duncan, 2011) and that prevailing wage has not been found to have any statistical impact on total costs, however, it is unclear whether this inductive reasoning is correct.

In a previous report coauthored with the School of Labor and Employment Relations at the University of Illinois, the Illinois Economic Policy Institute (ILEPI) found that prevailing wage laws increased construction worker incomes by 1 to 2 percent but had no effect on CEO incomes. Prevailing wage laws lift more workers into well-paying middle-class jobs but have no negative effect on those with the highest incomes, reducing income inequality in construction by upwards of 45 percent (Manzo & Bruno, 2014). If the average annual income of contractor CEOs is a proxy for contractor profit, then PWLs should be expected to have minimal impact on profits.

DATA DEFINITIONS

This ILEPI Economic Commentary utilizes two U.S. Department of Commerce terms which must be defined. The first is “*gross operating surplus*.” For a given business or industry, gross operating surplus includes owner income, corporate profits, consumption of fixed capital such as spending to upgrade machinery, and net “business current transfer payments” such as financial

holdings or insurance payments. In effect, gross operating surplus equals capital. Since the data include machinery upgrades and transfer payments, gross operating surplus is not exactly profit, but it serves as a good approximation of profit margins.

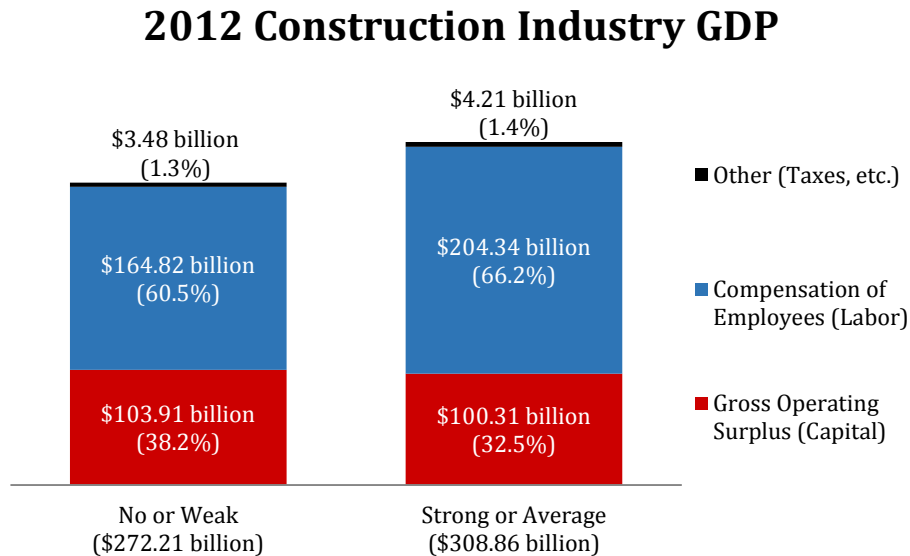
The second U.S. Department of Commerce term is “*compensation of employees*.” For a given business or industry, compensation of employees is the sum of all wage and salary accruals and of supplements to wages and salaries. The data include noncash benefits such as employer contributions to pension funds, to health insurance, and to social insurance programs. In effect, compensation of employees equals labor. Throughout this Economic Commentary, gross operating surplus is used interchangeably with capital and compensation of employees is used interchangeably with labor.

Finally, this report pairs states without a prevailing wage law with states that have a “weak” prevailing wage law, as defined by Belman and Philips’ (2014) update of Thieblot (1995). Across the 33 states with a PWL, there are considerable differences in the policy. PWLs vary by threshold contract amounts, the breadth of occupations and tasks covered, the formulas used to determine the prevailing wage, and the level of enforcement. In most cases, states with weak PWLs show little difference from those without PWLs because the former is ineffective at enforcing the fair rules of the road. If prevailing wage has any impact on profit margins and gross operating surplus, the effect will be greatest in states with “average” or “strong” PWLs.

REPEALING A PREVAILING WAGE LAW REDISTRIBUTES INCOME FROM WORKERS TO OWNERS

Data from the United States Department of Commerce reveal that there were 2.56 million construction workers in states without a prevailing wage law or with a weak prevailing wage law in 2012, or 9.0 workers per contractor (48.6 percent). In states with an average or strong prevailing wage law, there were 2.71 million construction workers (51.4 percent), or 7.3 workers per contractor.

FIGURE 2: DECOMPOSITION OF CONSTRUCTION INDUSTRY GDP, BY EFFECTIVENESS OF PWL, 2012



Source: Bureau of Economic Analysis, 2012.

Figure 2 presents data on the construction industry’s contribution to U.S. gross domestic product (or GDP), itemized by strength of state PWLs. The construction industry in states with no PWL

or with a weak PWL contributed \$272.2 billion towards the U.S. economy in 2012. Of this industry GDP, 60.5 percent was provided to labor in total compensation and 38.2 percent went to capital. For states with a strong or average PWL, on the other hand, the construction industry’s GDP was \$308.9 billion. Labor comprised 66.2 percent of construction GDP and capital made up 32.5 percent of construction GDP in these states. Thus, workers receive a larger share of the economic pie in states with an effective PWL (by 5.7 percentage points) and employers receive a larger share in states without an effective PWL (by 5.7 percentage points).

It is important to note, however, that other policies could factor into the finding that capital captures more of the industry GDP in states without a PWL or with a weak PWL. Many of these states also have right-to-work laws, for instance, which have been found to redistribute income from workers to owners (Stevens, 2009). It could be that other “pro-employer” policies or economic trends are the reason why contractors have higher gross operating surpluses in these states, not the absence of an effective PWL.

To account for these factors, a *difference-in-differences* technique is utilized in Figure 3. Difference-in-differences compare capital’s share of GDP and labor’s share of GDP in the construction industry with their equivalents in the entire economy for each type of state. Basically, the difference-in-differences approach nets out policies and phenomena that affect the whole economy so the effect of PWLs is singled out. For all industries, the economies of states without a PWL or with a weak PWL have higher shares of income going to capital, 41.1 percent to 39.5 percent (a 1.6 percentage point difference). Recall that, in construction, capital’s share of the pie is 5.7 percentage points greater in states without a PWL or with a weak PWL. After netting out the 1.6 percentage point structural bias in these states, the effect is a 4.1 percentage point increase in gross operating surplus from not having an effective PWL. Similarly, the penalty for working in a state without a PWL or with a weak PWL for workers is a 3.7 percentage point drop in compensation for construction workers. In summary, repealing a prevailing wage law would be expected to increase capital’s share of construction GDP by 4.1 percentage points and decrease labor’s share of construction GDP by 3.7 percentage points.

FIGURE 3: SHARES OF GDP, CONSTRUCTION VS. ALL INDUSTRIES, BY EFFECTIVENESS OF PWL, 2012

| 2012 | Share of Industry GDP: Capital | Share of Industry GDP: Labor |
|---------------------------------|-----------------------------------|---------------------------------|
| <u>Construction Industry</u> | | |
| No or Weak | 38.2% | 60.6% |
| Strong or Average | 32.5% | 66.2% |
| <u>All Industries</u> | | |
| No or Weak | 41.1% | 52.1% |
| Strong or Average | 39.5% | 54.0% |
| Difference-in-Difference | +4.1% | -3.7% |

Source: Bureau of Economic Analysis, 2012.

REPEALING A PREVAILING WAGE LAW WILL NOT GROW A STATE’S CONSTRUCTION INDUSTRY

The same *difference-in-differences* approach can be applied to economic growth (Figure 4). Opponents of prevailing wage laws claim that they increase construction costs and hinder economic growth. Over the decade from 2003 to 2012, construction GDP grew faster in states without a PWL or with a weak PWL than in states with effective PWLs. Economic growth for all industries, however, was faster in the former set of states due to an array of other factors. The national energy boom, for instance, has significantly increased the demand for construction. But

this demand is concentrated largely in states that do not have an effective PWL, such as North Dakota (no PWL) and Texas (weak PWL). Netting out all other factors and overall economic trends, construction GDP “grew” 0.1 percentage points faster in states without an effective PWL, an insignificant difference. The considerable underperformance of construction compared to the rest of the economy in both types of states— due to the Great Recession— reveals that the largest factors influencing industry growth are demand in the overall economy and healthy public budgets to invest in infrastructure, not the presence of an effective prevailing wage law.

FIGURE 4: GROWTH IN GDP, CONSTRUCTION VS. ALL INDUSTRIES, BY EFFECTIVENESS OF PWL, 2012

| 2003 to 2012 (Not adjusted for inflation) | Growth in Industry GDP |
|--|---------------------------|
| <u>Construction Industry</u> | |
| No or Weak | 16.3% |
| Strong or Average | 5.4% |
| <u>All Industries</u> | |
| No or Weak | 47.5% |
| Strong or Average | 36.8% |
| Difference-in-Difference | +0.1% |

Source: Bureau of Economic Analysis, 2003-2012.

REPEALING A PWL REDUCES PRODUCTIVITY AND TRANSFERS INCOME FROM LABOR TO CAPITAL

Prevailing wage laws promote a well-trained, highly-skilled workforce which ensures that roads, bridges, buildings, and other structures are built efficiently and to the standards of quality expected by the community. As a result of better health outcomes and increased training, construction workers in states with an effective PWL are more productive than their counterparts (Figure 5). Dividing industry GDP by the number of employees in each type of state, construction workers in states without a PWL or with a weak PWL each contributed \$106,505 toward the economy in 2012. Construction workers in states with a strong or average PWL, on the other hand, contributed \$114,178 per worker, or 6.7 percent more value added to the economy. As a reward for higher worker productivity, *compensation per employee* is 14.6 percent higher in states with an effective PWL (\$75,540 compared to \$64,487). However, despite increased worker productivity, *gross operating surplus per employee* is 9.6 percent lower in states with a strong or average PWL (\$37,082 compared to \$40,657). Once again, repeal of a prevailing wage law would be associated with a transfer of income from labor to capital.

FIGURE 5: GDP, GROSS OPERATING SURPLUS, AND COMPENSATION PER EMPLOYEE, BY EFFECTIVENESS OF PWL, 2012

| 2012 | GDP per Employee | Gross Operating Surplus per Employee | Compensation per Employee |
|------------------------------|---------------------|---|------------------------------|
| Strong or Average | \$114,178 | \$37,082 | \$75,540 |
| No or Weak | \$106,505 | \$40,657 | \$64,487 |
| Percentage Difference | +6.7% | -9.6% | +14.6% |

Source: Bureau of Economic Analysis, 2012; County Business Patterns, 2012.

CONCLUSIONS

Effective prevailing wage laws tend to reduce gross operating surplus for contractors and to increase the compensation of employees. It is reasonable to assume that the smaller shares of capital lead to lower construction industry profit margins in states with a strong or an average

prevailing wage law. Higher profits in states without a prevailing wage law or with a weak prevailing wage law, however, simply come at the expense of lower worker incomes. That is, the fact that prevailing wage laws have no impact both on total construction costs and on economic growth in the construction industry means that these higher profits are *not* because they create any new value for the economy. The economic pie remains the same and the lowest bid remains the same, but owners have more bargaining power to extract a larger piece. Repeal of a prevailing wage law, therefore, is just a transfer of the economic pie from labor to capital and a redistribution of income from the middle-class to the rich.

Across the country, middle-class wages are stagnant despite rising levels of productivity. Since 1973, hourly compensation (adjusted for inflation) has increased by only 9 percent while worker productivity has improved by 143 percent. These small gains in hourly compensation all went to the top of the income distribution, however. Real hourly wages are up just 6 percent for middle-class workers and down 5 percent for low-wage workers. Simultaneously, the top five percent of earners saw their incomes increase by 41 percent (Mishel et al., 2015). The disconnect between higher productivity and stagnant wages is the result of an array of factors, including declining rates of union membership, financial deregulation and laws which benefit the top 1 percent of earners, globalization policies, and various labor market policies and business practices (Mishel, 2015).

Any repeal of a state prevailing wage law across the country will further detach worker productivity from worker wages, contributing to the growing problem of income inequality in America. While the allure of slightly higher profit margins may lead some contractors and politicians to conclude that prevailing wage laws should be repealed or weakened, such measures would come at a significant cost: more middle-class erosion, declines in worker training and productivity, and increases in government assistance programs (such as food stamps) to construction workers. Instead, prevailing wage laws should be strengthened or enacted in states across America to protect the middle-class, increase construction worker skills, and support strong public sector budgets for the taxpayer.

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