

NEW YORK CITY COUNCIL FINANCE DIVISION

Some Simple Economics of Paid Sick Leave

Economic Analysis of Proposed Intro. No. 97-A

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Introduction

If enacted, Proposed Intro. No. 97-A would mandate paid sick leave for a large number of workers in New York City who do not yet have this benefit. Clearly a paid sick leave benefit is of economic value to these workers, but what may be less clear is the cost of this provision. As Lawrence Summers notes, “(t)here is no sense in which a benefit becomes ‘free’ just because government mandates employers to offer them to workers.”¹ In the long run, a large portion of this cost will be borne by the workers themselves in the form of reduced wages or fewer employment opportunities. It is critical for policy makers to minimize this cost to the extent possible. In this respect, the timing of the imposition of a mandate is important, since choosing when to introduce it can avoid unnecessary costs.

Additionally, the costs are not the same for all firms, which is one of the reasons the market does not provide paid sick leave to everyone. Introducing paid sick leave in a 300 square mile city may be different from introducing it into a continental national economy. This section will demonstrate that the choices about how, when and where this benefit is instituted can be instrumental in minimizing the costs of this benefit to workers.

There is relatively little economic literature on paid sick leave, but there is a rich theoretical and empirical literature on other mandated benefits that can be applied to sick leave that we draw on here.

Why Mandate Sick Leave?

Proposed Intro. No. 97-A treats paid sick leave as a mandated benefit, though this is not the only way to provide this benefit. In many European countries paid sick leave is a part of the social insurance system, provided by the government and paid for by taxes. Currently, the market already provides paid sick leave to 74 percent of workers in New York City, especially to those who are better paid or work for larger firms. Therefore, adopting a European model would mean raising taxes to provide a subsidy to all firms – including those that would provide the benefit without the subsidy. In this and in other ways we will see below, mandated benefits can be the most efficient way to provide a benefit.

The response to the key question, does it make economic sense to provide the benefit if the market is unable to do so, will be postponed till the final section, after we have examined more of the economics of paid sick leave.

A Simple Model of Mandated Benefits

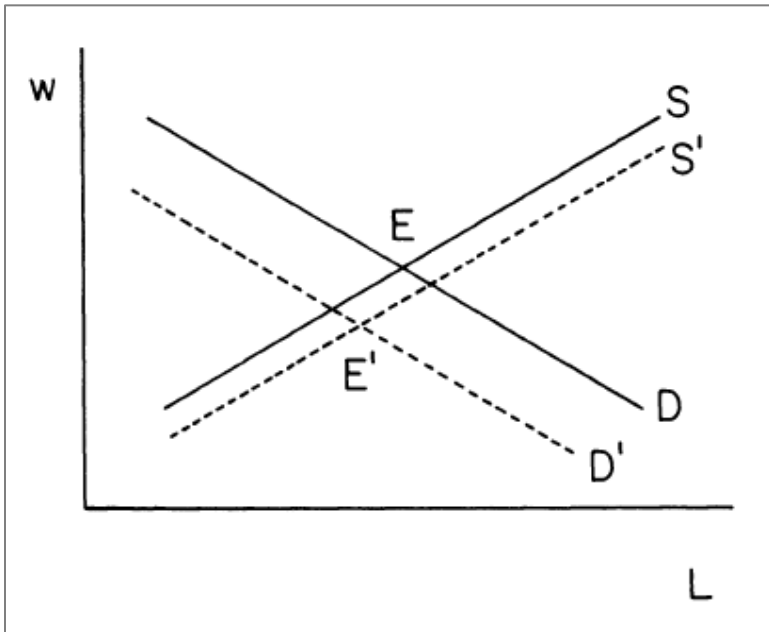
Lawrence Summers’ aforementioned paper provides a simple model that can illustrate the impact of paid sick leave. As with many concepts in economics, one can think about it in terms of supply and demand: in this case, the supply of labor by workers, and the demand for labor – i.e., hiring – by businesses. The number of workers willing to work in a sector – the supply of labor – will depend on the wage paid (once accounting for other factors such as worker’ preferences, the kind of work available, non-wage benefits and

¹ Summers, L.H. 1989. Some Simple Economics of Mandated Benefits, American Economic Review, Vol. 79(2): 177-183.

other opportunities, etc.). In other words, as the wage goes up, more people are willing to work. This is demonstrated by the labor supply curve S in Figure 1.

For firms, the willingness to hire – the demand for labor – will depend upon technology, their equipment, the price they are getting for their output and the cost of their inputs. This means the higher the wage, the fewer workers they are willing to hire, as shown by the labor demand curve D in Figure 1. The intersection of the two lines at point E gives us the initial equilibrium number of workers hired and the wage they are paid.

Figure 1



Source: Summers 1989

In a basic sense, the provision of a benefit such as paid sick leave has a value to workers and a cost to employers. Based upon paid sick leave benefits currently being provided in the New York City region, the New York City Council’s Finance Division estimates paid sick leave benefits will cost the typical employer between 1.1% and 1.8% of total compensation costs.² The extra cost impacts an industry in the same way as a payroll tax; it increases the cost of hiring a worker.³ This in turn reduces the willingness of the firm to hire workers at a given wage. This new demand for workers is shown by line D' .

For workers, paid sick leave has a value. This will make more workers willing to work at a given wage. This is shown by S' .

Putting the two together, wages and employment will move from where D crosses S at E , to where D' crosses S' at E' . There is something that is clear about the result and something that is ambiguous. It is clear

² Data source: U.S. Bureau of Labor Statistics, National Compensation Survey, March 2011. The data is for the NYC area which comprises a wide region around the City, including parts of Connecticut and Pennsylvania.

³ The model is much simplified assuming that all firms in the industry do not offer paid sick leave.

that as long as paid sick leave has a cost and is valued by workers, it will lower wages. On the other hand, the impact on employment is ambiguous as it depends upon what the benefit costs compared to how much workers value it. If the value to the workers is less than the cost to employers, employment falls. If the value to employees matches the cost it can have no effect. But if the value is high relative to the cost, it can increase employment.⁴ In this last case, however, it is likely that the market would be providing the benefit already, making government action unnecessary.⁵

This is an attractive feature of mandated benefits, if you choose benefits whose value matches costs, you can have little or no effect on employment. That is not to say there is no down side. As Summers explains: “workers pay directly for the benefits they receive.”⁶ When fully adjusted in this model, paid sick leave is not redistribution from owners to workers. Rather, paid sick leave changes the composition of total compensation, not its amount.

A New Mandate in a Weak Economy

In the real world things are not so simple. We do not generally expect nominal wages to fall among currently employed workers.⁷ In economists terms they are “sticky downward.” Summers notes that if, “wages cannot fall to offset employers’ cost of providing a mandated benefit ... it is likely to create unemployment.” This can be a problem while a new mandate is first being put into place.

Benjamin Sommers developed a model of this situation where nominal wages are sticky.⁸ This is represented by a kinked supply curve where workers will not accept wages below the current level (see Figure 2).⁹

The initial equilibrium is where the supply and demand curves meet at E. As in Lawrence Summers’ model, introducing a benefit like sick leave causes an inward shift of the demand curve D’ – employers hire fewer workers in aggregate -- and an outward shift in the supply curve S’ – more workers are willing to work. But because workers will not accept a lower wage, the outward shift in the supply curve has no impact on wages or employment. However, the inward shift of the demand curve will have a negative impact on employment. In this situation introducing sick leave hurts both employment and the profitability of the firm.

⁴ It is a bit more complicated than this: the supply and demand elasticity’s of labor also matter. For a more formal model see Jonathan Gruber & Alan Krueger. 1991. The Incidence of Mandated Employer Provided Insurance: Lessons from Worker’s Compensation Insurance, Tax Policy and the Economy, Vol. 5: 111-143.

⁵ There are cases where market failures necessitate mandates for the benefit to occur (Summers, 1989. p. 179).

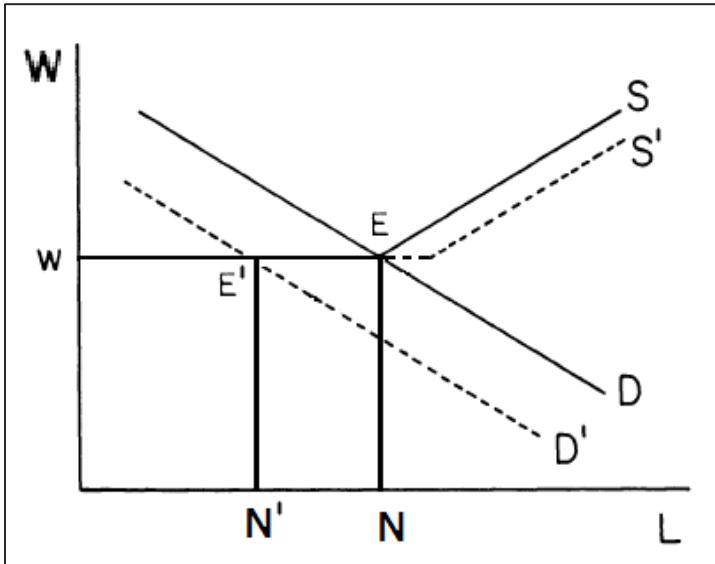
⁶ Summers, 1989. p. 182

⁷ Colla, C., Dow, W. & A. Dube. 2011. The Labor Market Impact of the Employer Health Benefit Mandates: Evidence from San Francisco’s Health Care Security Ordinance, NBER Working Paper No. 17198, July 2011, p. 3.

⁸ Sommers, B. 2005. Who Really Pays for Health Insurance? The Incidence of Employer-Provided Health Insurance with Sticky Nominal Wages, International Journal of Health Care Finance and Economics, Vol. 5: 89–118.

⁹ Sommers’ formal model assumes a cost to lowering wages rather than a fixed wage rate.

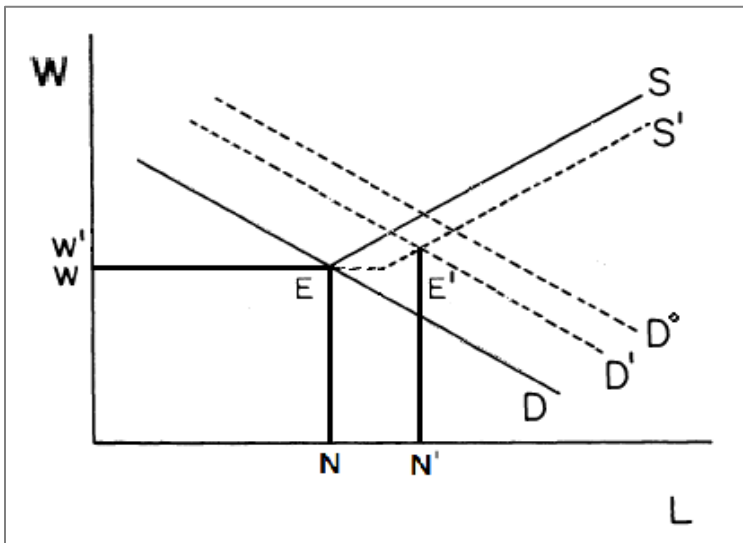
Figure 2



Source: Finance Division, adapted from Sommers 2005

Consider a somewhat different situation (Figure 3). Suppose we are in a world where labor demand is increasing. This could be because of an improving economy, or it could be because inflation is eating into wages causing the real value of the current nominal wage to fall. This is represented by an outward shift in the demand curve to D^* . Paid sick leave, by introducing a new cost pulls the demand curve back to the left in this case to D' . As before, because sick leave is valued by workers, it increases their willingness to work for a given wage. This increases the demand for labor, shifting the supply curve to S' . When all is said and done, wages remain around where they were before, but employment has actually grown. Note, however, that without the new mandate, wages would have gone up to where S and D^* cross. The new mandate has not caused wages to fall, but it has caused them to grow more slowly than they would have grown without the mandate.

Figure 3



Source: Finance Division.

Also note that for a mandate like paid sick leave, this slowdown happens once, during the initial adoption of the mandate. It does not continually slow the growth of wages.¹⁰

Weak labor markets slow nominal wage growth. We don't have direct evidence of the growth of wages for workers without paid sick leave. However, about three-quarters of workers without paid sick leave make less than \$15 an hour. This corresponds to skill levels 1-3 in the Bureau of Labor Statistics National Compensation survey. Between 2008 and 2010 (the most recent years available) the average wage growth rate of hourly mean wages for skill levels 1-3 was 0 percent. New York City's unemployment rate, which was 4.9 percent in 2007, was 9.9 percent in 2009 and averaged 9.2 in 2012. Though improving, New York City's labor market has been weak since the start of the recent recession, particularly for low-skilled workers.

San Francisco's effort in legislating paid sick leave is often held up as a model for others, such as New York City, to follow and there may be a lesson to learn here. San Francisco took advantage of a strong labor market when it implemented paid sick leave, which, as demonstrated above, makes it much easier for employers and workers to absorb the cost. San Francisco's living wage ordinance was implemented when its economy and labor market was benefiting from large housing and financial sector growth as well as from the strength of Silicon Valley's technology firms. We don't have National Compensation Survey data for 2006-2007 when San Francisco's paid sick leave ordinance was enacted. However, the unemployment rate in those years ranged from 4.4 percent in 2007 and 5.7 percent in 2008. The growth of average hourly mean wages for levels 1-3 workers in the San Francisco area workers in the first year we have data, 2008, was 5.8%.¹¹ In short, San Francisco was in a much more advantageous position in terms of adjusting to the imposition of a new mandated benefit on its employers.

Who Pays for Mandated Benefits?

For some firms and industries, another way of adjusting to paid sick leave may be by raising the price they charge their customers. Most workers without paid sick leave work for small and medium size firms. We do not generally think firms of these sizes as having a lot of control over the prices they charge. But many sectors without paid sick leave provide purely local services, and there is only so far that people will travel for such services. This effectively segments the market, which allows some possibility for price movements.¹² In effect, part of the cost of paid sick leave would be passed on to customers.¹³

¹⁰ In Sommers (2005) a benefit like health insurance, whose cost grows from year to year at a faster rate than inflation or money wages, causes a repeated slowdown in wage growth and may induce part of the cost of premiums to be deducted by employers from worker's wages.

¹¹ San Francisco's wage growth numbers are influenced by its minimum wage law, which indexed the minimum wage to inflation. Since these rates of growth exceed that of inflation, it suggests that the strength of the labor market was such that the law was not the source of this growth.

¹² Colla, Dow & Dube 2011, p. 3, Sommers 2005, argues that it is reasonable to treat small service sector firms that use low skilled labor as monopolistic competitive in the product market and perfectly competitive in the goods market. P 91, n3. This is what is assumed in figures 2 & 3.

¹³ Of course, one cannot assume such a change has no employment effect, as such prices are chosen to maximize profit, not employment.

Price impact becomes a larger issue in sectors exposed to regional, national, or international competition. Most of the sectors where the city competes nationally and globally, such as financial services, professional services, information, and education, generally already have paid sick leave. But some sectors with relatively low rates of paid sick leave, such as warehousing, distribution and wholesaling are exposed to competition from the rest of the region. The City is having a problem holding on to employment in these industries, despite significant effort made by the Economic Development Corporation. In these sectors, attempts to pass new costs on to consumers are likely to accelerate their decline.

How important are these various kinds of adjustments to paid sick leave?¹⁴ There is no direct evidence on paid sick leave itself but there is a large literature on other mandated benefits. The most influential study of mandated benefits, by Jonathan Gruber on maternity benefit mandates, found that the full cost of the mandate was passed on to the wages of men and women in the 20 to 40 age bracket. Empirical studies of worker's compensation insurance mandates find a pass-through to wages of 83 to 100 percent, with pass-through to small firms sometimes exceeding 100 percent.¹⁵ If the pass through to wages and prices is so complete, there is no reason to expect a large employment effect from mandated benefits

Carrie H. Colla, William H. Dow and Arindrajit Dube's 2011 study of the first 27 months of San Francisco's Health Care Security Ordinance provides a different view. It found about a 38 percent pass-through of costs to worker's wages. They were unable to look at prices for most sectors, with the exception of the restaurant sector where they found 51 percent of the additional costs were passed on to consumers. Employment effects were small and they could rule out impacts of more than one percent in most sectors. The exception was accommodation and food services where one version of their work indicated an employment effect of 2.4 percent.

Why Do Only Some Workers Currently Have Paid Sick Leave?

Sick leave is not just an expense to firms, it can have an upside. It is no accident that 74 percent of workers in the city have access to paid sick leave. The question is, why doesn't everyone have paid sick leave?

Certain illnesses reduce the productivity of workers and if the illness is infectious this effect can spread within the firm. How valuable this is will depend in part on where these infections come from. Where infections come largely from outside the firm, say a firm where employees have extensive contact with the public, sick leave will be less valuable than for a firm where infections largely come from in house.¹⁶

There are other areas where sick leave is of value to the firm. Abay Asfaw and her colleagues find that paid sick leave policies in a workplace help businesses reduce the incidence of nonfatal occupational injuries.¹⁷ This is good for workers and saves employers various costs including those related to workman's

¹⁴ This section follows empirical literature survey found in Colla, Dow & Dube 2011, p. 5-7.

¹⁵ Gruber and Krueger 1991, Viscusi and Moore (1987) cited in Colla, Dow & Dube 2011.

¹⁶ Skatun, J.D. 2003. Take some days off, why don't you? Endogenous sick leave and pay. *Journal of Health Economics*, Vol. 22: 379-402

¹⁷ Asfaw, A., Pana-Cryan, R. and R.Rosa. 2012. Paid Sick Leave and Nonfatal occupational Injuries. *American Journal of Public Health*, Vol. 102(9): e59-e64.

compensation claims. Clearly, the incidence of injury varies with occupation, with high-risk occupations benefiting the most from a paid sick leave provision.

Access to paid sick leave varies systematically by the size of firms. Small firms are less likely to offer it than larger firms. This is true of all of the benefits in the National Compensation Survey, except end-of-year bonuses.¹⁸ Retirement plans, health insurance, and life insurance are among the benefits that vary in this way.

Table 1

Firm Size	Access to PSL
1 to 49 workers	62%
50 to 99 workers	71%
100 to 499 workers	81%
500 workers or more	88%

Source: National Compensation Survey, Bureau of Labor Statistics, U.S. Department of Labor, March 2011, New York-Newark-Bridgeport, NY-NJ-CT-PA metropolitan area, private industry workers.

A simple hypothesis found in the literature is that there are economies of scale in providing benefits. Roughly speaking, the bigger a company is, the cheaper it is to provide benefits. For many benefits, discussions of scale economies focus on administrative costs.¹⁹ In small firms this requires valuable time from owners or key managers. In larger firms, specialists can do this without involving management time. Litigation and actions necessary to protect against litigation are also a cost. This may be a greater concern for small firms without in house lawyers and who don't have a law firm on retainer.

But there is a different kind of cost that may matter as well. When workers are absent, firms have to manage the flow of the services they are producing either without the full work team being available or by finding substitutes for absent workers. This may be harder for small firms. For the same average rate of absences per employee, a small firm is going to have more days with high absences and with no absences than a large firm. This means absences cause higher rates of volatility in workforce levels for smaller firm, impacting their ability to perform in the market place.

The New York City Council Finance Division has done a simple statistical simulation. It should be treated as illustrative rather than realistic. It suggests that businesses with fewer employees are more likely to experience a disruptive absence of employees. Here, a "disruptive absence" occurs if a business experiences the absence of more than 5 percent of its labor force over a five day period. Disruptive absences for reasons other than employees using this benefit are not considered.

As proposed in the bill, each employee is entitled to use up to five paid sick days in the event of an unpredictable emergency. It is assumed that an employee will use all five days randomly throughout the year- here assumed to be 240 work days. It is also assumed that sick days are used independently from

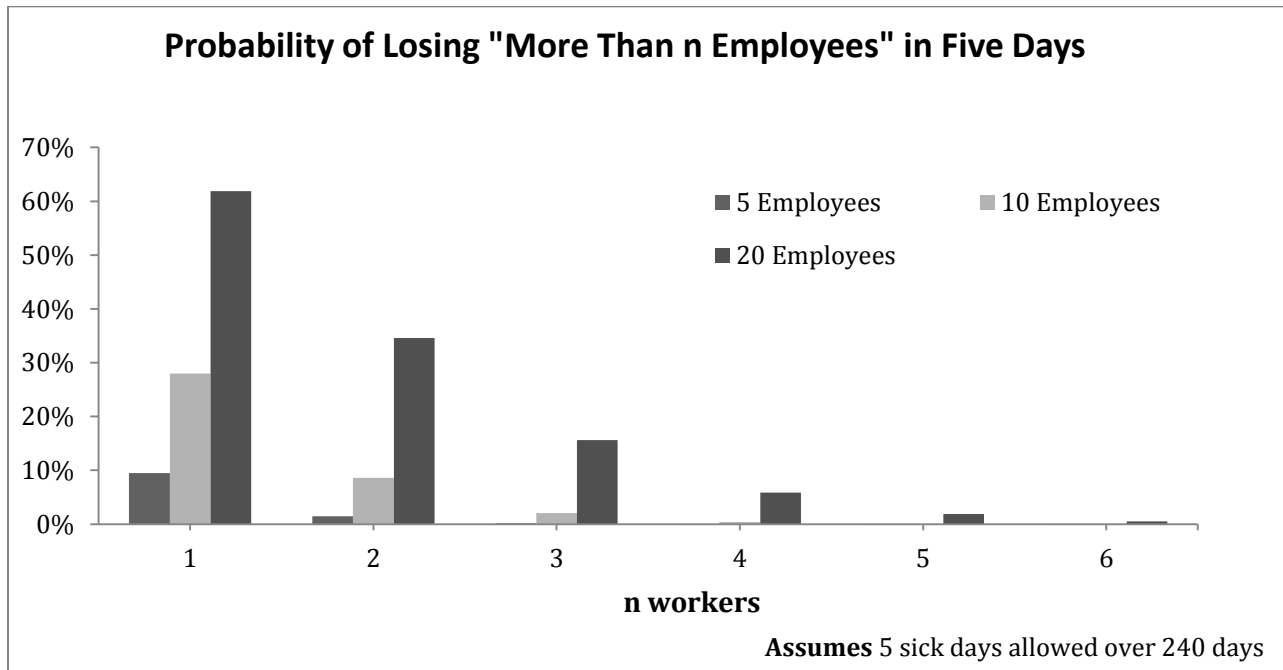
¹⁸ Abraham, J.M., DeLeire, T., and A. B. Royalty. 2009. Access to Health Insurance at Small Establishments: What Can We Learn from Other Fringe Benefits? *Inquiry* Vol. 46: 253-273.

¹⁹ Ibid., p. 253.

other employees and are not accumulated.²⁰ Using probability theory²¹, an employer can then calculate the probability of having a disruptive absence.

Below is a graph of the probability that three businesses with five, ten and twenty employees respectively lose “more than n employees” in a five day period. For example, if n is taken to be 1, the probability a business of twenty employees loses more than one employee is roughly 60 percent. The same event is only 10 percent likely for a business of five employees. As can be seen, the probability that any of the three businesses loses more than six employees is negligible.

Figure 4



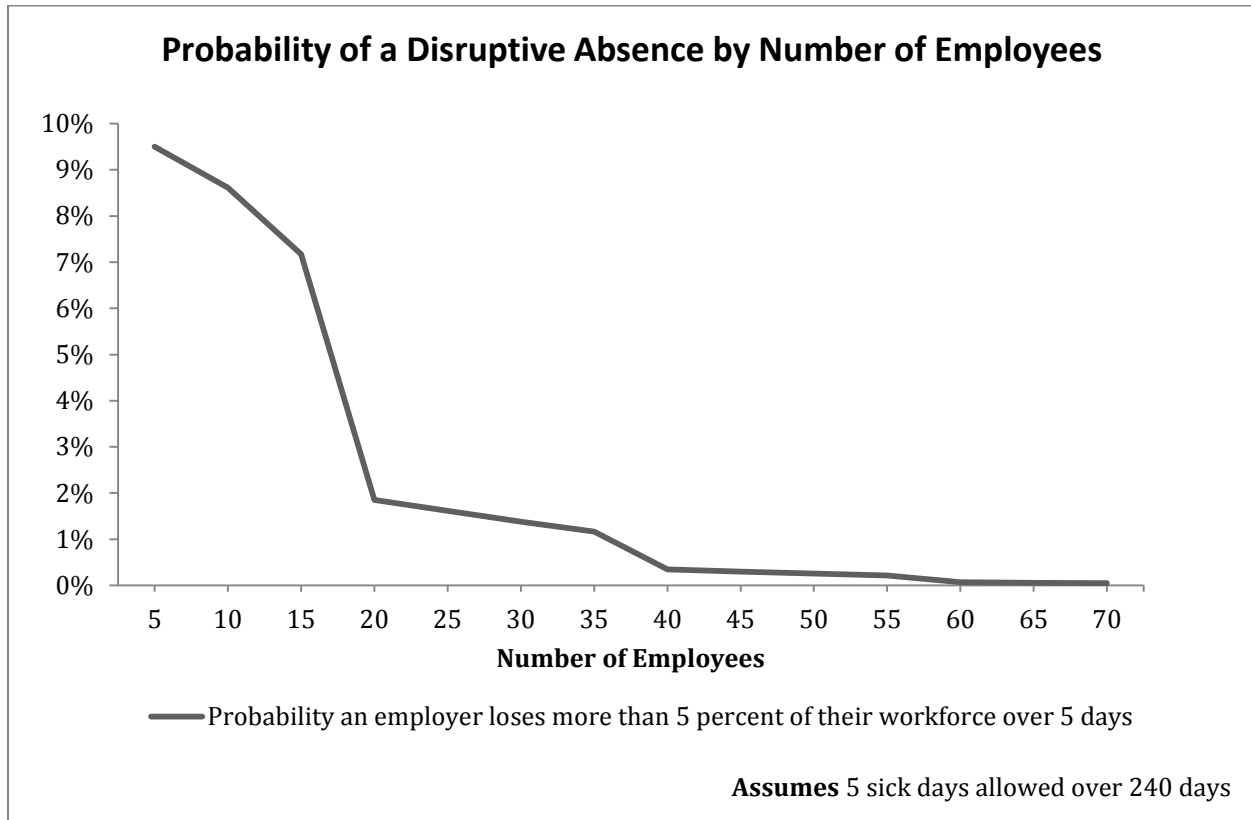
Thus, the larger business is far more likely to lose more than one employee over a five day period, as expected. However, the smaller business is more likely to lose a larger percentage of its workforce. To see this, note that if the business of five employees loses more than one employee then more than five percent of its workforce is absent. Looking at the graph above, this happens roughly 10 percent of the time. The business of 20 employees must have six or more employees not show up over a five day period to lose more than five percent of its workforce. This happens roughly 2 percent of the time. As a result, it is five times more likely a five employee business will have a disruptive absence due to paid sick leave than a twenty employee business. Equivalently, the five employee business will have a disruptive absence five times as often.

²⁰ Actual sick leave tends to be less than this, and by assumption we are ruling out infectious disease.

²¹ That is, according to the cumulative binomial distribution function.

The following graph shows the probability of a disruptive absence by the number of employees. To ensure that such an absence happens less than 5 percent of the time (one twentieth of the year), a business would need to have twenty or more employees.

Figure 5



In this case, life is a lot easier for the big firm.

Small firms tend to pay lower wages, and this may be a part of the explanation for the reduced access to sick leave in small firms, since access to paid sick leave, like many fringe benefits is more common among high wage workers than among low wage workers.²²

The literature suggests at least two reasons why this might be the case. The first is the idea that paid sick leave may be a ‘normal good’. Normal goods are those that we demand more of as income goes up, assuming price remains constant. While having the protection that paid sick leave offers may be valuable to low-income workers, meeting basic necessities may make getting more cash a larger priority. Since both economic theory and empirical evidence suggests that mandated benefits are paid for in whole or in part by workers, this is a real consideration.

²² Abraham, J.M., DeLeire, T., and A. B. Royalty. 2009. Access to Health Insurance at Small Establishments: What Can We Learn from Other Fringe Benefits? *Inquiry* Vol. 46: 253-273. Cited in Elizabeth Hansen and William Gentry, “Taxes and Fringe Benefits Offered by Employers” Williams College working paper 2011.

Table 2

Average Wage Quartiles	Access to PSL
Lowest 25 percent	40%
Second 25 percent	73%
Third 25 percent	87%
Highest 25 percent	86%

Source: National Compensation Survey, Bureau of Labor Statistics, U.S. Department of Labor, March 2011, New York-Newark-Bridgeport, NY-NJ-CT-PA metropolitan area, private industry workers.

The second reason involves taxes. Paid sick leave can be thought of as a kind of insurance. If paid sick leave lowers wages it also lowers the tax liabilities of workers. Consider a city resident at the top Federal, State and City tax brackets. For each extra dollar they earn, 48 cents goes to personal income tax. For someone in the lowest tax brackets, 16.9 cents of each extra dollar goes to taxes. Therefore, losing a dollar in wages to gain a desirable benefit is a lot easier for a high income worker because a big part of the dollar was going to taxes anyway.

If Workers and Customers Pay the Costs, Why are Small Businesses Concerned about Paid Sick Leave?

As we saw in the section on mandated benefits in a weak economy, the adjustment to paid sick leave is not instantaneous and there are reasons to believe it will be slower, with greater impact on employment, in a weak economy than in a strong economy. During the adjustment process paid sick leave is largely paid for by firms.

If the cost of managing paid sick leave is different among firms and if our analysis of the cost disadvantages of small firms is correct, there is another concern. The effects of the variations among mandated benefit costs among firms are explored theoretically and empirically by Patricia Anderson and Bruce Meyer.²³ If a firm's costs differ from the overall market it will not be able to pass those costs on to workers or customers. While overall employment effects will be small there could be "substantial employment reallocation across firms." Basically there is a risk that a mandated benefit like paid sick leave could have an impact on the structure of an industry, favoring larger firms that are better capable of handling it, over smaller ones.

Small firms are fragile; more than 30 percent of small businesses fail within four years.

The small business economy is improving but is still not doing as well as large firms. A recent analysis by the investment bank ING compared the National Federation of Independent Businesses' small business optimism index and the Institute of Supply Managers index which they use to track the performance of the larger corporate sector.²⁴ Normally small and large businesses perform more or less the same. But since the start of the recession they have been out of sync. The small business recovery has been significantly weaker than the large business recovery. Other data back this up. Between 2007 and 2010 the national

²³ Anderson, P. and B. Meyer. 1995. The Incidence of a Firm-Varying Payroll Tax: The Case of Unemployment Insurance. *NBER working paper* No. 5201 1995.

²⁴ ING Global Economic Daily March 13, 2013.

economy lost 288,000 small businesses with less than 50 employees. Over the same period it gained 175,000 businesses with more than 50 employees.²⁵

Infectious Disease, External Costs and Paid Sick Leave

Mandates like Proposed Intro. No. 97-A face a basic challenge: workers and firms have reached agreement on wages and conditions based on the specific situation that they are in. While everyone may prefer a better deal, workers and firms find this is the best they can do at the moment. When agreements are uncoerced, and not products of guile or deception, and no one is worse off from undertaking them, they improve economic welfare. In technical language they are referred to as Pareto-improving transactions. Economists generally recommend that we trust the individuals who make these deals to know more about their own lives and situations than we do and therefore that we should leave these deals alone.

However, there are important exceptions. Summers in his article on mandated benefits discusses several of these exceptions and one, externalities, applies to paid sick leave.²⁶ Externalities are when there is a cost or a benefit to a transaction that is not captured by either party to the transaction. Going to work with a cold or flu may spread the disease to others. This is a cost to third parties, not involved with the transaction. This is not unique to labor transactions, going to the theater with a cold, or buying a loaf of bread with the flu also have this effect. There is evidence in the public health literature that paid sick leave can be a tool in reducing these costs.²⁷

Several recent studies, mainly in health economics and public health fields, have investigated the empirical evidence behind sick leave provisions across different countries and in the U.S.

The key finding is that a provision of paid sick leave type of mandated benefit, in addition to obvious benefits to the receiving employee, significantly helps reducing a risk of mass infection and spread of wide scale contagion. In particular, applying to the 2009 H1N1 pandemic in the U.S., Kumar et al (2012) notes that in the U.S. “[t]he absence of certain workplace policies, such as paid sick leave, confers a population-attributable risk of 5 million additional cases of influenza-like illness in the general population...” Strictly speaking, the results of Kumar et al are not about sick leave as such. Their key variable is an index of work related features that allow for social distancing, which include paid sick leave, unpaid sick leave, and the ability to work from home and other arrangements that allow one to be out of work for seven to ten days. Although there are other ways of doing it, sick leave, by allowing people to stay away from other people, can reduce costs from epidemic disease.

²⁵ Council Finance calculations based on BLS Business Dynamic Statistics – net establishment entry

²⁶ The other two are evidence that parties are acting irrationally, or where there are market failures.

²⁷ In addition to the already mentioned publications, see for example the following: Asfaw, A., Pana-Cryan, R. and R.Rosa. 2012. Paid Sick Leave and Nonfatal occupational Injuries. *American Journal of Public Health*, Vol. 102(9): e59-e64. Kumar, S., Quinn Crouse, S., Kim, K.H., Daniel, L.H., and V. S. Freimuth. 2012. The Impact of Workplace Policies and Other Social Factors on Self-Reported Influenza-Like Illness Incidence During the 2009 H1N1 Pandemic. *American Journal of Public Health*, Vol. 102(1): 134-140; Heymann, S.J. and M. Gerecke. 2010. Paid Health and Family Leave: The Canadian Experience in the Global Context. *Canadian Journal of Public Health*, Vol. 101(1):S9-S15.

Summary: Costs of Paid Sick Leave

Most workers in New York City have access to paid sick leave. This reflects the fact that for most firms and workers paid sick leave pays. However, it doesn't pay for everyone and that is not accidental. As with most benefits it doesn't pay for many small firms and low income workers.

Like other mandated benefits both economic theory and evidence suggest that sick leave will be paid for primarily by workers and consumers. This process isn't instantaneous and is not always smooth. When it is not smooth the mandated benefit can be a burden on firms and can have negative employment effects. However, once fully adjusted there is no reason for paid sick leave to have a large employment effect.

But even if the aggregate employment effects are small, if small firms have a more difficult time providing sick leave they may not fully benefit from the adjustment process. They could face persistently lower profits, reduced employment. This could change the structure of employment in favor of larger firms.

The one clear upside to paid sick leave is that it may reduce the spread of infectious disease and in doing so offset some or all of the above costs.