

8. ECONOMIC EFFECTS OF MINIMUM WAGES

8.1 - EMPLOYMENT EFFECTS

8.1.1 - AFPC Conclusion

8.1 ACCI welcomes the conclusion of the AFPC that:

On the basis of the evidence available, the Commission considers that there is a negative relationship between the level of minimum wage increases and employment in Australia. The basis for any disagreement seems to involve the magnitude of the relationship rather than its existence.¹

8.2 ACCI also notes the following:

- a. The AFPC appeared to place more weight on the Econtech and CoPs surveys that showed substantial and significant disemployment effects from minimum wage increases.²
- b. The AFPC also appeared to place some weight on the OECD's most recent survey of Australia which argued for caution in adjusting our minimum wage.³
- c. The research by the Centre for Labour Market Research for the AFPC strongly supports ACCI's arguments that minimum wages cause significant disemployment, particularly amongst the low skilled and most disadvantaged.

8.1.2 - ACCI Response

8.3 It was disappointing that the AFPC did not incorporate these findings into its reasoning for its decision. Given that unemployment is a very significant social problem, why did the AFPC not estimate or comment on the disemployment effect of its decision?

1 AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, p.73

2 AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, pp.73-74

3 AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, pp.72-73

- 8.4 If the AFPC agrees with ACCI that minimum wages can cause unemployment, then it should demonstrate greater caution and moderation in its decision making and better explain the nexus between its conclusions on key issues such as unemployment effects, and the overall quantum increase awarded.
- 8.5 We are also concerned that the AFPC may only be finding that there is a relationship between employment and the magnitude of an increase in minimum wages. However, it is not just the size of an increase that matters, the impact also depends upon the existing level of minimum wages.
- 8.6 As ACCI notes, Australia effectively has the highest minimum wage in the developed world, confirmed by the most recent OECD Economic Survey of Australia and the latest data from the UK Low Pay Commission.

8.1.3 - Substitution

- 8.7 The AFPC correctly notes that the employment effects of minimum wages can be obscured by substitution – where a minimum wage encourages employers to substitute higher paid (and higher productivity) workers for lower paid workers.⁴ This is supported by the CLMR research commissioned by the AFPC.⁵
- 8.8 However, the AFPC only noted that this obscures the employment effects of minimum wages. It did not note that this substitution is a bad thing, in and of itself. As ACCI noted in our 2006 submission:
- a. The low skilled are in the greatest need of employment. Higher skilled individuals have more opportunities for work than the low skilled.

⁴ AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, p.71

⁵ [Work decisions and the tax transfer system - Colmar Brunton](#), p.6

- b. In addition, the low skilled are more likely to be in poverty than the high skilled (to the extent there is correlation between working and poverty, a phenomena dominated by those out of work).
- c. The substitution will increase income inequality (although this is not a relevant consideration for the AFPC).
- d. Given that workers are likely to have partners of similar skills this change will mean an increase in low skilled households with no employment in return for an increase in high skilled households with two jobs, which hardly seems a worthwhile change.
- e. Replacing one worker with another imposes costs on all parties and should not be imposed unnecessarily.
- f. Labour market regulations should not be designed to rearrange employment.

8.9 A different substitution effect is the effect that minimum wages have on hours. As shown in our 2006 submission (Section 8.2.9), employers may respond to the minimum wage increase by reducing hours rather than dismissing employees. If this is the case, this will reduce the observed disemployment effect and will reduce the financial benefit from the increase in the minimum wage. The AFPC acknowledges this effect only in passing⁶.

8.1.4 - Neumark & Washer (2006)

8.10 In the short time since our 2006 submission, there have been only been a few additional studies of relevance to the AFPC's processes.

8.11 One study of some relevance is a detailed and comprehensive survey of the literature on minimum wages by David Neumark and William Wascher⁷. While the paper does not perform new empirical research on

6 AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, p.80

7. Neumark & Washer (2006) "Minimum Wage and Employment: A review of evidence from the new minimum wage research" NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>

the effects of minimum wages, it provides a useful comparison, critique and synthesis of existing research.

- 8.12 While Neumark and Washer find that there is no consensus on the effect of minimum wages, they find that the overwhelming majority of the studies surveyed give a relatively consistent indication of negative employment effects of minimum wages. This is particularly true for the studies Neumark and Washer consider to be providing the most credible evidence.
- 8.13 They conclude that *“when researchers focus on the least-skilled groups most likely to be adversely affected by minimum wages, we regard the evidence as relatively overwhelming that there are stronger disemployment effects for these groups.”*⁸
- 8.14 The paper includes a table that summarises more than 90 studies from many countries (including Australia) on the effect of minimum wages.
- 8.15 Other insights provided by this paper include:
- a. In some cases, minimum wages have a negligible or positive effect in the short run, but a negative effect in the longer run. One reason for this is that businesses adjust non-labour inputs slowly, which tends to make adjustment of labour inputs slower as well. Various studies show the long run effect is likely to be more negative and more statistically significant than the short run effect.
 - i) As a consequence, Neumark and Washer argue that claims of an absence of a minimum wage effect on employment should be discounted unless the evidence shows no effect across both the short and the long run.
 - b. Studies incorporating school enrolment are consistent with the argument that minimum wages encourage employers to *“substitute away from lower-skilled teenagers (who are less likely to be in school)”*

8. Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, Abstract

*toward higher-skilled teenagers (who are more likely to be in school)*⁹. In other words, the disemployment effects are felt by the most vulnerable teenagers.

- i) This is also consistent with the argument that minimum wages can encourage the labour force participation by the least vulnerable at the expense of the most vulnerable (see Section 8.2 - below).
 - ii) In a different context, the AFPC correctly noted this substitution effect: “an increase in minimum wages encourages employers to substitute more productive workers on higher pay for less productive minimum wage workers”¹⁰
 - iii) Neumark and Washer find that there is “substantial evidence” of labour substitution within low skill groups.¹¹
- c. Some experts argue that studies that find negligible employment effects of minimum wages are incorrectly specified because they include year dummy variables.¹²
 - d. There are key data reliability problems with many of the studies showing negligible employment effects, because they relied on surveys.¹³
 - e. A pre-specified research study, designed to remove author bias, showed that increases in US state minimum wages had disemployment effects for young, less skilled workers.¹⁴

9 . Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, p.24

10 Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, p.24

11 Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, p.116

12 Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, (page 26ff)

13 Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, p.31

14 Neumark & Washer (2006) “Minimum Wage and Employment: A review of evidence from the new minimum wage research” NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, pp.41-42

- f. The monopsony model of the labour market, where minimum wages actually increase employment, implies that prices will not rise with an increase in the minimum wage. However, extensive data shows that prices do rise when minimum wages increase.¹⁵ ACCI discussed this in our first submission at Section 8.5.3. Neumark & Washer conclude that evidence from prices indirectly indicate that minimum wages do cause disemployment.

8.1.5 - Relevance of studies of aggregate wages

8.16 As argued in our 2006 submission (section 8.1.1.6), studies of the relationship between aggregate wages and aggregate employment are relevant to the examination of the effect of minimum wages on employment.

8.17 Our 2006 submission argued that the studies of the aggregate wage elasticity will underestimate the effect of minimum wages – the employment of low-skilled workers is more elastic than the employment of higher skilled workers – particularly because it is easier to substitute a computer for low-skilled worker.

- a. The Federal Government has also discussed this at length, see Federal Government (1998) Submission to Safety Net Review, page 150.

8.18 It would be helpful if the AFPC expressed a clearer finding on this issue.

8.1.6 - HILDA

8.19 ACCI also draws the AFPC's attention to the research performed by the Federal Government in its 2006 submission, showing that over 30 percent of the unemployed would be willing to work for wages that are below the minimum wage (page 129-130 and Appendix B7).

¹⁵ Neumark & Washer (2006) "Minimum Wage and Employment: A review of evidence from the new minimum wage research" NBER Working Paper 12663 - <http://www.nber.org/papers/W12663>, (pp.67-68)

- a. Presumably the proportion would be higher if the unemployed were wanting to work in an industry with a minimum pay point that is above the minimum wage.

8.20 This indicates that the level of the minimum wage is likely to be acting as a barrier to employment for a substantial portion of the unemployed (particularly the less skilled). In addition, a higher minimum wage will do nothing to encourage this group of unemployed people to enter the workforce. Those uprating minimum wages need to better take this into account in the timing and quantum of any increases.

8.1.7 - ACCI research – unemployment rates by industry

8.21 People who have been unemployed for less than two years are much more likely to have come from an industry that is award dependent. There is a strong positive relationship between award dependence in an industry and the unemployment rates of people who used to work in that industry, as shown in the table below:

Industry	Award dependence ¹⁶	Unemployment rate (avg for year to Feb 2007) ¹⁷
Agriculture, Forestry and Fishing	na	4.0%
Mining	2.4%	1.6%
Manufacturing	10.6%	3.5%
Electricity, Gas and Water Supply	0.9%	1.7%
Construction	12.0%	3.1%
Wholesale Trade	12.8%	3.1%
Retail Trade	28.7%	4.0%
Accommodation, Cafes and Restaurants	57.2%	5.0%
Transport and Storage	12.4%	2.2%
Communication Services	0.9%	3.0%
Finance and Insurance	5.1%	1.8%
Property and Business Services	23.2%	2.4%
Government Administration and Defence	0.6%	1.6%
Education	11.9%	1.6%
Health and Community Services	25.4%	1.9%
Cultural and Recreational Services	19.2%	2.6%
Personal and Other Services	23.4%	2.5%
Average	19.0%	2.9%

16. Source: ABS Cat No 6306, Table 15

17. The unemployment rate is the number of unemployed people who worked in that industry in the past two years (from ABS 6291.0.55.003 Data Cube UQ2), divided by the sum of the number of people employed in that industry (from ABS Cat No 6291.0.55.003 Table 04) and the number of unemployed who worked in that industry in the past two years.

- 8.22 The correlation between award dependence and unemployment rate is positive and strong, with an R squared of 50.4 percent¹⁸.
- 8.23 Clearly, employees from award dependent industries are more likely to become unemployed than employees in other industries. Comparatively higher rates of unemployment could well be caused by minimum wages being too high. Again, this suggests that more caution is required in increasing minimum wages.
- 8.24 In addition, the high rates of unemployment in award dependent industries suggests that competition for available jobs in these industries is intense and large award increases could significantly reduce the employment opportunities for many low-skilled workers.

8.2 - PARTICIPATION

- 8.25 The AFPC discusses the effect of minimum wages on participation, finding that the size of the gap in disposable income between working and not working will “by and large” offer adequate incentive for most to participate actively in the labour market (page 80).
- 8.26 Research by Colmar Bruton shows that those surveyed had a “strong desire” for paid work in preference to reliance on government benefits (page 4).
- 8.27 However, other AFPC comments appears to take a different view:

Ian Harper: ...What the Commission had to do was to think about demand as well as supply. So what you say is correct of course, that if you put minimum wages up too high, beyond some point there's a negative impact. But the other side is also important. In our country we have a social safety net in the form of unemployment benefits and disability pensions and other forms of benefit of this type. Now most of those increase at the CPI

Ian Harper:So in thinking about minimum wages what the Commission had to do was to balance the potential impact of putting wages up too high and thereby discouraging employment on the

18. Agriculture is excluded from the regression. The slope coefficient is 10.5.

employers side if you like against not putting minimum wages up high enough and then on the supply side as economists would say, encouraging people who are low paid, or who are without a job, to give it away.

Peter Mares: So you would have people who might choose to stay on benefits rather than ...

Ian Harper: Absolutely. So the Commission is focused on not increasing unemployment and that requires looking at both sides.¹⁹

8.28 We consider that the AFPC's emphasis on participation is largely misplaced.

8.29 This is because it is unlikely that high minimum wages have beneficial effects relating to participation:

- a. To the (limited) extent they encourage participation, high minimum wages encourage higher skilled workers to enter the workforce, making it harder for low skilled workers to find employment. Low skilled workers are clearly more vulnerable and need greater protection, not high skilled workers.
 - i) In fact, the AFPC has correctly noted this effect: "an increase in minimum wages encourages employers to substitute more productive workers on higher pay for less productive minimum wage workers".²⁰
 - ii) This is also supported in the CLMR paper commissioned for the AFPC.²¹
- b. High minimum wages reduce the number of available jobs, as acknowledged by the AFPC (page 73). Therefore, encouraging more people to look for work when there are fewer jobs available hardly seems like a worthwhile goal.

¹⁹ ABC Radio National – The National Interest, Interview with Professor Ian Harper, 17 December 2006.

²⁰ AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, p.71

²¹ AFPC (2006) *Wage Setting Decision and Reasons for Decision - October 2006*, pp.17-18 and elsewhere.

- c. If minimum wages increase labour supply and reduce labour demand, a higher minimum wage will just increase unemployment.
- d. If minimum wages increase participation, this may be causing some teenagers to leave school, which is unlikely to be good. Neumark and Wascher (1994)²² find data to support this conclusion.
- e. Neumark and Wascher (1995)²³ find that a higher minimum wage induces employers to substitute higher skilled teenagers for lower skilled teenagers, increasing the demand for higher quality workers. The displaced lower quality workers then exit the labour market completely (neither employed nor enrolled in school). They update and confirm these results in Neumark and Wascher (2003)²⁴.
- f. If minimum wages increase participation, this will largely mean that the less well off are displaced from jobs by the better off. Freeman (1996)²⁵ notes that if employers prefer workers from middle income households over those from low income households then the increased labour supply from a higher minimum wage will result in workers from middle income families displacing workers from lower income families. This will perversely increase poverty and inequality.
- g. If higher labour force participation is a goal, there are much better ways of encouraging this, in particular through lower effective tax rates on people entering the workforce.

22. D Neumark and W Wascher (1994) "Minimum wage effects on employment and school enrolment", NBER Work Paper 4679.

23. D Neumark & W Wascher (1995) "Minimum Wage Effects on Employment and School Enrollment" *Journal of Business & Economic Statistics* vol. 13(2), pages 199-206, April.

24. Neumark & Wascher (2003) "Minimum wages and skill acquisition - another look at schooling effects" *Economics of Education Review*, Vol 22, Issue 1, February 2003, pages 1-10

25. R Freeman (1996) "The Minimum Wage as a Redistributive Tool" *Economic Journal* Vol 106, No 436, May, page 639-49.

8.2.1 - Evidence

8.30 In any case, it is unlikely that minimum wages increase participation:

- a. More and more welfare recipients are required to look for work, and accept work if it is offered to them. They cannot choose to reject a job because the job's pay is too low. In other words, labour force participation for many welfare recipients is not optional and they cannot choose whether to participate based upon wages.
- b. Some people actually reduce their labour supply if they are offered higher wages. Evidence for this was presented in our 2006 submission in Section 8.2.9.
- c. Wellington (1991)²⁶ finds that minimum wages cause a reduction in participation for teenagers. The disemployment effect is roughly the same size, thus meaning that (measured) unemployment is approximately unchanged.
- d. The survey by Brown, Gilroy & Kohen (1982)²⁷ shows that the disemployment effects of minimum wages are larger than the unemployment effects, consistent with minimum wages reducing both employment and participation.
- e. Studies of the aggregate effect of wages on labour supply suggest that higher wages reduce male labour supply but increase female labour supply – see Borjas (2005 at p46)²⁸. The overall effect of higher wages on participation is therefore unclear.
- f. In addition, Borjas (2005) shows that there are various concerns over these figures. This does little to support the argument that higher minimum wages increase labour supply.

26. Wellington (1991) "Effects of the minimum wage on the employment status of youths: an update" *Journal of Human Resources*, Vol 26, No 1, pages 27-45.

27. Brown, Gilroy & Kohen (1982) "The effect of the Minimum Wage on Employment and Unemployment" *Journal of Economic Literature* Vol 20 pages 487-528.

28. Borjas (2005) *Labor Economics*, McGraw-Hill

- g. The research by Colmar Bruton for the AFPC showed that inadequate financial compensation for employment was a less important reason why people chose not to work (page 12).

8.3 - INTERNATIONAL COMMENTARY

8.3.1 - The OECD survey of Australia

8.31 Subsequent to our 2006 submission, the OECD released its 2006 Economic Survey for Australia. This survey provided support for *WorkChoices: “the industrial relations reforms are a step in the right direction with benefits likely to surface gradually over the coming years”*.²⁹

8.32 The OECD argues:

The minimum wage is high in international comparison and the number of low skilled who are long-term unemployed or disabled is also high, thus raising concerns about the adverse effects of the minimum wage on labour demand for the low skilled. At the same time, the minimum wage is a blunt tool to enhance fairness, as more than half of the low paid live in families with income above the median. (page 18).

The increasing scope for direct negotiations between employers and employees has probably also helped to raise productivity, as enterprise bargaining allows firms to adopt productivity enhancing practices and promotes a more co-operative work environment where performance and reward are more closely linked. (page 121)

more than half of the low paid live in families with income above the median, which means that pushing up wages is a blunt tool to enhance fairness. (page 123)

Distributional concerns should not be addressed by centralised wage setting, but by social policy instruments as is already happening to quite some extent. (page 131)

8.33 The OECD also finds that:

- a. Australia has the highest or second highest minimum wage in the OECD, when measured as a proportion of appropriately broad measures of wages (page 121).

²⁹ p.131

- b. All relevant studies of the employment effect of minimum wages have a negative sign (page 121).
- c. In a sample of OECD countries, Australia has the lowest proportion of disabled in employment (page 121).
- d. Australia's incidence of low pay is among the lowest in the OECD (page 122)
- e. Real income of the bottom deciles have increased (page 127)

8.3.2 - OECD Economic Policy Reforms: Going for Growth

8.34 The OECD's publication *Economic Policy Reforms: Going for Growth 2007* also has some relevant commentary:

a minimum wage set at a too high level is likely to deteriorate the job prospects of youth. (page 129)

a high legal minimum wage amplifies the unemployment effects of labour taxes (page 133)

a minimum wage set at a high, binding level is likely to price the least productive workers out of employment, and possibly out of the labour force if, as in the case of youth or low-skilled women, their attachment to the labour market is weaker. (page 133)

8.3.3 - World Trade Organisation

8.35 In January 2007, the World Trade Organisation (WTO)³⁰ released a review of Australia's trade policy, which also made significant comments about other policy reforms, including workplace relations. The WTO found that "Unemployment has reached its lowest level in 30 years, in great part due to reforms that have rendered the labour market more flexible." (page 1)

³⁰ WTO (2007) Trade Policy Review: Australia: www.wto.org/english/tratop_e/tp_r_e/tp279_e.htm

