ANNUAL REVIEW OF THE MINIMUM WAGE

MATERIAL PREPARED BY

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Background

Under Section 5 of the *Minimum Wage Act*, the Minister of Labour is required to review the minimum wage rate(s) prescribed under the Act each year. By way of background, in January of this year, the New Zealand government, in keeping with the Coalition Agreement made between the National Party and New Zealand First, agreed to lift the adult minimum wage from $6.375 per hour to $7.00 per hour – a 10 percent increase – and the youth minimum wage from $3.825 to $4.20 – also a 10 percent increase. Both increases became effective as of 18 March 1997. The Coalition Agreement provides for further (unspecified) rises in the adult and youth minimum wages, to apply from April 1998.

The Key Questions

This submission poses a number of questions. They are as follows:

- what is the evidence on the employment effects of minimum wages?
- what is the evidence on other economic effects of minimum wages?
- do minimum wages reduce the incidence of poverty? and
- will the state of the New Zealand labour market in early 1998 accommodate an increase in minimum wages?

A series of recommendations completes the submission.

Question 1: The Effect of Minimum Wages on Employment

Higher minimum wages reduce employment, with estimates of minimum wage elasticities varying from as low as negative 0.1 to well above negative one.[1] For a one percent increase in the minimum wage, employment could be expected to fall, with the estimated magnitude of this fall varying from 0.1 percent to considerably more than one percent. A recent study of minimum wage effects in France and the United States has found that for young men earning the minimum wage, a one percent rise in the minimum wage led to a 2 to 2.5 percent fall in their employment (Abowd, Kramarz, Lemieux and Margolis 1997). Australian evidence also points to relatively high own wage elasticities for young workers, with the study of the Bureau of Labour Market Research (BLMR 1983) indicating an own wage elasticity for young males (under 21 years of age) of minus 1.80 and for young females (under 21 years of age) of minus 4.58. In plain terms, a one percent increase in the wages paid to young males was found to be associated with a 1.8 percent decline in employment of young males, whereas a one percent increase in the wages paid to young females was found to be associated with a 4.58 percent decline in employment of young females.

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[1] The Card/Krueger result of a positive own wage elasticity must now be regarded as rogue. See below for further discussion.

Using New Zealand data from 1986 to 1996, Maloney (1995, 1997) is able to demonstrate that the adult minimum wage had a negative and significant impact on adult employment in New Zealand. An increase of 10 percent in the adult minimum wage produced a decline of 3.8 percent in the employment of young adults. Moreover, Maloney is able to establish a decline in adult employment *relative* to teenage employment for the period during which there were no youth minimum wages. Evidence presented to the government last year by the Department of Labour indicated that minimum wage hikes of 10 percent would lead to an increase in the rate of unemployment among young adults (20 to 24 years of age) from 8.8 percent to 12.3 percent and among teenagers from 15.2 percent to 18.7 percent.

Even in the face of evidence that suggests a substantial disemployment effect associated with higher minimum wages, some commentators have argued that the effect of minimum wages on employment has been over-rated, not least because a relatively small fraction of [US] workers are employed at the minimum wage (see Brown, Gilroy and Kohen 1982; Brown 1988).

In this context, it is interesting to review the historical research of Seltzer (1997) on the implementation of industry minimum wages in the seamless hosiery and lumber industries in the United States. In both cases, the stipulated minimum wage rates were highly binding in the sense that they were greater than prevailing wage rates, certainly in these industries in the south of the United States. Seltzer (1997) found that, in the case of the seamless hosiery industry in 1940, nearly one-third of workers earned the stipulated minimum wage and that in low wage factories in the south, employment had fallen by 17 percent in the two years following the introduction of the minimum wage. While evasion of the minimum wage was rife in the lumber industry, employment in the southern lumber industry grew at only 60 percent of employment in the northern lumber industry.

Clearly the extent to which minimum wages are binding, with a relatively high fraction of workers employed at and just above the minimum wage, is a significant consideration in any estimation of the employment impact of higher minimum wages. In the case of the United States, from which most of the empirical research is sourced, the minimum wage has over the past decades been maintained at low levels relative to average wages and at much lower relative levels than in other countries. Arguably, minimum wages have only been adjusted in the United States in lagged response to higher market wages for the lowest paid, in which case it is not surprising that much of the observed impact on employment is muted.

The path of minimum wages relative to average earnings between 1970 and 1995 is depicted in OECD (1997) for a number of developed economies, including New Zealand. The chart demonstrates that minimum wages relative to average earnings have been relatively low in the United States

throughout the period – ranging between 35 percent and 47 percent of average earnings. In the case of New Zealand, there have been considerable fluctuations in the ratio of minimum wage to average wages, with a lower ratio than the United States between 1980 and 1985, but at other times a ratio above the US figure. In more recent years, the adult minimum wage has varied between 45 and 55 percent of average earnings. Countries with relatively high minimum wages include the Netherlands (although the ratio to average earnings has fallen since the late 1970s), Greece, Belgium, Portugal and France (the latter with a rising ratio over the period).

An important development in research on the minimum wage is associated with the names of Card and Krueger (1995). The research of these authors, in particular their study of the impact of minimum wage increases in the fast food industry in two US states, appeared to turn accepted findings on their head: higher minimum wages, perhaps only modest ones, could increase employment. Should the Card and Krueger findings be part of serious public policy analysis? It is not necessary to review in any detail the criticism to which the Card and Krueger analyses have been subjected. In brief, there are serious methodological problems in relation to the surveys undertaken, particularly the enumeration of full-time and part-time employment numbers; the choice of large fast food chains as the case study; the failure of the *ceteris paribus* assumption to hold; and, perhaps most seriously, the lack of any theoretical basis for the results (see Ehrenberg *et al*. 1995, Sloan 1996, Maloney 1997, Dawkins 1997).
In sum:

- **higher minimum wages reduce employment;**

- **those most adversely affected by higher minimum wages are the young and unskilled; and**

- **the higher the minimum wage in relation to average earnings, the greater the expected disemployment effect.**

Question 2: What is the evidence of other economic effects of minimum wages?

Higher minimum wages may have an (observed) muted impact on employment because of the scope for substitution between wages and other non-wage benefits, including training. Fleisher (1981), for instance, concludes that higher minimum wages in the US retail industry led to reductions in fringe benefits and a deterioration in working conditions. Hashimoto (1982) has demonstrated that higher minimum wages have been associated with lower investment in on-the-job training. Neumark (1995) has also demonstrated that in the United States higher minimum wages for youth induce employers to substitute more skilled youth workers for less skilled ones, thereby offsetting the observed impact on employment. Section 3 of the

1994 New Zealand Business Roundtable study *What Future for New Zealand's Minimum Wage Law?* discusses these effects at greater length.

Clearly, the higher the minimum wage relative to average earnings (or the greater the hike in the minimum wage), the lower is the scope for substitution within the compensation package. Higher minimum wages may also be reflected in lower hours on offer and/or more intense work effort.

The key finding is:

- **higher minimum wages may reduce non-wage benefits, including training.**

Question 3: Do minimum wages reduce the incidence of poverty?

The research on the minimum wage as a anti-poverty device is largely derived from the United States and US data. The main proposition has been summarised by Parsons (1991) in the following way: "the impact of the [minimum wage] legislation on family income distribution may be perverse unless the fewer but better jobs are allocated to members of needy families rather than to low wage workers, most obviously teenagers, from wealthier families". Key studies are Gramlich (1976), Parsons (1980), Mincy (1990) and Wilson (1995). All these studies conclude that minimum wages have a very limited impact on poverty because most people earning minimum wages do not live in poor households. On Mincy's (1990) figures for the United States, a 27 percent increase in the minimum wage would reduce the poverty gap per family by 3.5 percent assuming no reduction in employment (a zero employment elasticity) and by 1.8 percent using published elasticities. This result assumes unchanged coverage and compliance. The poverty gap is measured here as the difference between family income and the official poverty line. The number of poor families would fall only 2.2 percent if employment elasticities are 'high' i.e. -0.3. The minimum wage has such little impact because many minimum wage workers are teenagers, mainly still in education, or low skilled females. Moreover, most workers earning minimum wages work part-time. Any increase in the hourly minimum wage, even assuming no effect on the number of hours offered to workers, has a relatively small impact on weekly household income.

According to Wilson (1995), of the 3.7 million workers in the United States working at or below the minimum wage, half are young (aged 21 years or less). Two-thirds of these young workers live in families with income levels two or more times the official poverty level. Some 12 percent live in poor families. Among the other half of workers working at or below the minimum wage, nearly 40 percent live in families with incomes two or more times the poverty level, although more than one quarter live in families with below poverty incomes. Wilson (1995) further notes that less than one quarter of

minimum wage workers were the sole breadwinner in the previous year and a very low fraction (some 16 percent) are full-time, full-year workers.

Most democratic governments regard as central the maintenance of minimum living standards of their citizens, by providing the resources to purchase adequate food, shelter, heating, etc, for those individuals who cannot afford, in whole or part, to do so themselves. This needs to be done in such a way that the incentives for self-provision are not undermined. However, ensuring a minimum living standard for all citizens through a social safety net provides no support for statutory minimum wages. Indeed, if a welfare function is foist on to the labour market, the end result will, in all likelihood, be greater reliance on the social safety net rather than less. In this context, it is interesting to note that the evidence compiled by the Department of Labour last year and submitted to the government indicated that tax and transfers arrangements had in combination lifted the incomes of low income families with children by between 5 and 7.5 percent, and those without children had received some tax relief.

The key findings are:

- **the impact of minimum wages on the incidence of poverty is relatively small;**

- **because many minimum wage workers are part-time, any hike in the minimum wage has a relatively small impact on family income; and**

- **the tax and transfer system is the appropriate mechanism to deal with inadequate family incomes.**

Question 4: Can the New Zealand labour market accommodate an increase in minimum wages?

The decision by the government to raise adult and youth minimum wages by 10 percent, effective as of 18 March 1997, was made at a time when the New Zealand labour market could be reasonably described as buoyant on the figures available at that time. The same cannot be said of the New Zealand labour market now. Using data from the Household Labour Force Survey for June 1997, unemployment had increased to 6.7 percent, from 6.0 percent in the June quarter of the previous year. The numbers unemployed rose by over 4 percent in the June quarter relative to the March quarter. Unemployment for those aged 15 to 19 years of age stood at 16 percent in the June quarter of 1997 and at 10.5 percent for those aged 20 to 24 years of age. Both figures are unacceptably high. The rate of unemployment among New Zealand Maoris stood at 16.6 percent in the June quarter of 1997 and at 15.1 percent among the Pacific Island group. Again, these rates are unacceptably high.

Changes in employment have been sluggish over the year, with a 0.4 percent increase recorded for the June quarter of 1997 over the previous year. The annual growth of full-time employment has been low, increasing by 0.4 percent over the year, while the annual growth of part-time employment was recorded at 3.2 percent over the year. It should be noted that growth of part-time employment, particularly relative to full-time employment, is often indicative of a weakening labour market, with part-time jobs replacing full-time ones.

While the June quarter 1997 employment/unemployment figures are too early to provide a clear indication of the future state of the New Zealand labour market, the general impression is of a weakening market, most particularly in terms of very slow employment growth. In retrospect, the increases in the adult and youth minimum wages effective as of April 1997 were extremely ill-timed, occurring at a time of a softening labour market. This point can be made even more strongly in respect of any further adjustment of minimum wages in 1998, as such increases would be additional to the large increase implemented in 1997.

The main findings are:

- **given what we know about the state of the New Zealand labour market in 1997, the increases in the adult and youth minimum wage were ill-timed;**

- **the rates of youth unemployment, both of teenagers and young adults, and of Maoris and the Pacific Island group are unacceptably high (all above 10 percent). These are the groups whose employment opportunities are most adversely affected by increases in minimum wages; and**

- **the outlook for the New Zealand labour market in 1998 underscores the inappropriate timing of any further increases in minimum wages.**

Findings and Recommendations

- **The case for any form of minimum wage regulation is invalid. Historical evidence points to the very substantial negative impact of minimum wages on employment (and hence forgone industry development).**

- **Incremental increases in minimum wages reduce employment, particularly of the young and unskilled.**

- **The higher the minimum wage relative to average wages, the greater is the impact of any increase in the minimum wage. New Zealand's adult minimum wage relative to average earnings is higher than the equivalent ratio in a number of developed economies, including the United States.**
- **Increases in minimum wages, even discounting the disemployment effects, do little to reduce the incidence of poverty because many minimum wage workers do not live in poor families. In addition, many minimum wage workers are part-time and any addition to family income is small.**

- **Poverty should be addressed through the tax and transfer system; foisting a welfare function on to the labour market will almost certainly result in higher unemployment.**

- **In retrospect, the 10 percent increases – a very large increase by international standards – in the adult and youth minimum wages effective as of April 1997 were extremely mis-timed given the significant weakening of the New Zealand labour market which is now apparent.**

- **Given the immediate outlook for the New Zealand labour market (and economy), there is no case whatsoever for any further increase in the adult and youth minimum wage rates in 1998.**

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