A FRESH LOOK AT LABOUR MARKETS

Minimum wage decisions should take into account all costs to the employer and all benefits to the employee, argues **John Humphreys**

Economic liberals are sometimes accused of 'treating labour just like any other commodity.'[1] This is a curious accusation. Of course, every market is different in some way, but all markets are same in one important way—they all follow the laws of economics.

Economists study how the economy works. Similar to physical scientists exploring scientific 'laws,' economists observe economic 'laws' and use this information to understand the workings of markets and government.

Another similarity to scientific laws is that economic laws exist irrespective of whether we like them or not. You can't argue with a chemical reaction. It is pointless saying that gravity is unfair because it acts equally on rich and poor. And all the good intentions in the world will not turn lead into gold.

The same is true with economics. The simple reality is that when something has a higher price, there will be relatively less quantity demanded.[2] This 'law of demand' exists despite the hopes, dreams or intentions of any economist. Neither a passionate plea for justice, nor political activism, nor tears of concern can change this law.

In saying that the law of demand applies to the labour market, an economist is not making a moral statement. This is not to say that the law of demand should exist. That would be like arguing about whether gravity should exist. Noting that the law of demand applies to the labour market 'just like any other commodity' is simply an objective observation of reality.

Despite the emotional appeal of saying 'the labour market is special,' most people intuitively know that the law of demand still applies. If the minimum wage were set at $100 per hour, then few people would be employed. If the minimum wage were set at $1 per hour, then more people would be employed.

How much unemployment?

Minimum wage has benefits and costs. The benefit is that some people (often from wealthy families[3]) get a higher income. The cost is that by imposing a price floor, some people who want to work cannot get a job. But how many of these people are there?

Economists have been exploring the links between wage levels and employment for decades, and there are literally thousands of studies investigating the relationship. These studies generally try to determine the wage elasticity of labour demand. If the elasticity is zero (perfectly inelastic), then there is no relationship between wages and employment. If the elasticity is -1, then a 10% increase in wages will lead to a 10% decrease in employment.

Most studies suggest that the elasticity is somewhere in between these two positions, though the exact level is open to debate. For example, in their Australian study, Philip Lewis and Garry MacDonald suggest a wage elasticity of

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labour demand is -0.8.[4] That is, if average wages were increased by 10%, then employment would decrease by 8%.

However, wage elasticity of demand does not directly address the issue of the minimum wage. If the minimum wage increased by 10%, it does not mean that all wages would increase by 10%. To determine the impact of minimum wages, we need to instead look at the 'minimum wage elasticity of labour demand.'

An influential 1982 paper by Charles Brown, Curtis Gilroy, and Andrew Kohen (BGK) surveyed the available literature for America and concluded that the minimum wage elasticity for low-skilled workers was between -0.1 and -0.3, and that range has become the conventional wisdom.[5] So, if the minimum wage were increased by 10%, low-skilled employment would decrease by somewhere between 1 and 3%.

In 2007, David Neumark and William Wascher reviewed more than 100 elasticity estimates—mostly American—and concluded that most of the credible new minimum wage research continues to support a small negative elasticity.[6]

In a famous exception, David Card and Alan Krueger found that there was no employment effect in a natural experiment of minimum wage changes.[7] However, their seminal study included a range of problems. In addition to some concerns about data and methodology, they used a short time period and considered only one industry. As Richard Burkhauser and Joseph Sabia note in their review of the literature, the results from the Card and Krueger study 'appear to be outliers.'[8] Neumark and Wascher note that the studies that fail to find a negative elasticity often had too short of a time frame.[9]

Studies from all over the world show a large range of results, depending on the size of the minimum wage and other factors. A Swedish study covering hotels and restaurants found a minimum wage elasticity of between -0.6 and -0.8; British studies found a range from -0.1 to -0.4; Canadian studies found -0.1 to -0.5 for youths; a New Zealand study found -0.2 to -0.3 for youths; a New York study estimated between -0.6 and -1.4 for youths; and a French study found an elasticity above -1 for some groups.[10]

Countries with a relatively high minimum wage could expect a bigger elasticity. Excluding non-wage regulations, Australia has one of the highest minimum wages in the world by any measure[11] (see Figure 1 over), and about 20% of the Australian workforce has an income on or near the minimum wage.[12] Consequently, you could expect Australia's minimum wage elasticity to be relatively high.

Australia has one of the highest minimum wages in the world.

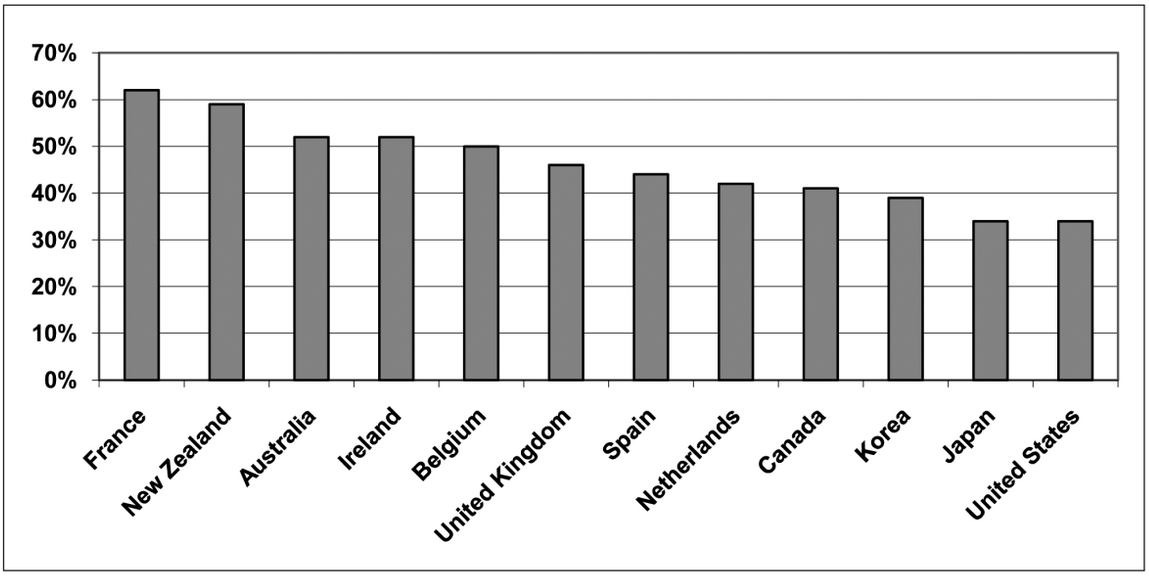
In Australia, perhaps the best available estimate comes from the work of Andrew Leigh, who looked at a natural experiment when the Western Australian minimum wage was increased six times between 1994 and 2001. He found an implied elasticity of between -0.2 and -0.4, with an average of -0.3.[13] This effect was particularly acute for young people and less relevant for people aged above 35. While a minimum wage elasticity of -0.3 is relatively high by international standards, it is consistent with the relatively high minimum wage in Australia.

A similar result was found by Don Harding and Glenys Harding using a survey of employer attitudes. Based on answers to questions about previous business decisions and hypothetical future decisions, they estimated an implied minimum wage elasticity of between -0.2 and -0.4.[14] The Harding and Harding paper lends support to the robustness of the conclusions in Leigh.

Even once we have an estimate for the minimum wage elasticity, it is difficult to determine the total impact on employment because the minimum wage elasticity will be relevant only for marginal changes in the minimum wage.

A reduction in the minimum wage would lead to more employment. However, as the minimum wage is lowered, the minimum wage elasticity would also decrease. While a 10% reduction in the minimum wage may lead to 300,000 extra jobs, it does not follow that an additional 10% reduction in the minimum wage would lead to an additional 300,000 extra jobs.[15] The benefit from reducing the minimum wage will steadily decrease until the minimum wage becomes effectively irrelevant.

Figure 1: Minimum wage (as % of median full-time wage) in 2008



Source: OECD Employment and Labour Market Statistics

If we assume that the minimum wage elasticity halves for every 10% reduction in the minimum wage, then abolishing the minimum wage would create about 600,000 new jobs.

Recent changes in Australia

Last year, there were two big decisions that affected the cost of employment. In July 2009, the Australian Fair Pay Commission (the commission) decided to leave the minimum wage unchanged, allowing the real minimum wage to decrease due to inflation. At the same time, the government introduced its new labour market regulations, strengthening unfair dismissal laws and increasing union privilege.

These two decisions will have offsetting effects. A freeze on the minimum wage will reduce the cost of employment (and increase employment), while additional non-wage benefits will increase the cost of employment (and reduce employment).

The decision to not increase the minimum wage saved jobs. If the commission had increased the minimum wage by 4.1% (as they did in 2008), then using the minimum wage elasticity provided by Leigh, employment would have declined by about 1%, which equates to more than 100,000 jobs. The commissioners deserve some of the credit for Australia's relatively low levels of unemployment during a year of declining GDP per person.

In contrast, the new government regulations are likely to cost jobs.

Although minimum wage laws impose a visible cost on employers by driving up wage rates, all labour market regulations impose costs on employers. From an employer's perspective, what matters is the total cost of employing a worker—including the minimum wage, other minimum benefits, unfair dismissal laws, and union privilege.

For workers earning well above the minimum wage, changes to non-wage benefits should not change their employment prospects. An increase in non-wage benefits (such as union privilege and job security) will lead to relatively lower wage benefits so that the cost of employment remains unchanged.[16] But for workers on or near the minimum wage, an increase in non-wage benefits will mean an increase in the cost of employment and, consequently, fewer jobs. To estimate the consequences of new labour market regulations, it is necessary to estimate a 'wage equivalent' impact of the non-wage elements.

For unfair dismissal laws, the costs include potential legal action, the efficiency cost of maintaining unproductive workers, and the

efficiency costs of choosing workers based on trust instead of competence. The best estimate is based on a 2002 survey of small and medium businesses done by Don Harding, which estimated that unfair dismissal laws increased average cost per employee by at least $296 (in 2002 dollars).[17] Adjusted for inflation, this is about 1.2% of the minimum wage. Following the Leigh minimum wage elasticity, unfair dismissal laws decrease employment by 0.35% (or 38,000 jobs).[18]

The 2006 reforms to relax unfair dismissal laws would have significantly reduced this cost, while the recent reforms to strengthen unfair dismissal laws will bring some of the costs back.

There are no equivalent studies regarding the costs to business of union privilege. If union privilege makes no difference to employment contracts, then it will not produce any cost to the employer. However, the fact that union employees continue to pay for union services suggests that unions do provide a benefit.

One method for estimating the costs of union privilege is to assume that union fees roughly represent the benefits provided by the union, and that those benefits come at the cost of the employer. This measure may overestimate the costs of union privilege by counting the cost of the non-privilege benefits of unions (social, informational, coordination), and it may underestimate the costs by not factoring in the uncertainty to the employer, spillovers to non-union labour, or the fact that the relative impact of unions is greatest for people on low incomes. While this is an imperfect measure, it at least provides some basis for calculating the costs of union privilege.

Full-time union membership is available for about $500 per year,[19] and approximately 20% of workers are unionised,[20] meaning that union privilege adds about $100 per year to the cost of employment. If we factor in a consumer surplus of 50% for union members,[21] then this estimate rises to about $150 per year, or about 0.5% of the minimum wage. Following the Leigh minimum wage elasticity, union privilege will decrease employment by 0.15% (or 16,000 jobs).

Under the new labour market regulations the benefits to unions have increased, including the right to enter a business with no union representatives and the right to force a business into 'good faith' negotiations. This may increase the cost of union privilege. The consequences of these changes depend on how effective they will be at providing a benefit to employees (and a consequent cost to employers). At the moment, this is impossible to accurately assess whether these reforms will have much of an impact, but if the government succeeds in doubling the union benefits for minimum wage workers, the consequence would be 16,000 fewer jobs.

The difficulty for the government is that it must either admit that its reforms make no difference or take the blame for thousands of people losing their jobs if it wants to take the credit for the benefits of its labour market reforms.

To estimate the consequences of new labour market regulations, it is necessary to estimate a 'wage equivalent' impact of the non-wage elements.

The future of labour market reform

Labour market reform has been a slow and ongoing process in Australia, with the last three decades seeing incremental changes towards a more flexible system. There have been occasional calls for more drastic reform to reduce regulation and increase employment, but the sensitivity of the topic lends itself to small changes. Below are three moderate suggestions for shifting labour market policy towards a system that encourages more employment.

Reporting the minimum cost of employment

It is not clear whether the labour market changes that occurred over the last year have increased or decreased the total cost of employment. This lack of information is an impediment to good decision-making.

To increase policy transparency, the government should provide annual information clearly outlining the benefits (to the employees) and cost (to employers) of labour market regulations, including union privilege and unfair dismissal laws.

If the government changes labour market regulations, the 'wage equivalent' impact of those changes should be estimated, and that information should be factored into decision-making about the level of the minimum wage.

Targeting after-tax income

Each year, a national wage body determines the federal minimum wage for Australia, generally providing a modest increase. Most of that increase is then eaten up in income tax, consumption tax, and inflation so that low-income earners receive little net benefit.

An alternative approach is to target 'after-tax' income instead of 'pre-tax' income.

By targeting the pre-tax income, the government is committed to pursuing a wage-based policy to assist low-income earners. Switching to an after-tax income target, the government opens up the possibility of using either a wages policy (increasing the minimum wage) or the tax-transfer system to achieve its goal.

Both sides of politics agree on the concept of a two-tier labour market, where people on lower incomes are offered relatively greater protections.

This would involve only a moderate reform to the current income setting arrangement. The current approach to wage setting could be maintained, but then the government would have the option to 'buy out' the minimum wage increase by offering low-income earners the equivalent benefit in tax cuts and/or transfer payments. This would mean no change in the minimum wage, but low-income earners would still get the same after-tax benefit as determined by the commission.

A similar scheme was suggested in 1998 by Peter Dawkins, John Freebairn, Michael Keating, Ross Garnaut, and Chris Richardson.[22] The so-called 'five economists plan' suggested a temporary freeze on the minimum wage, matched with tax cuts and transfer payments for low-income earners. The 'Reform 30/30' proposal also took advantage of a potential trade between minimum wages and the tax/transfer system.[23]

The benefits of such a trade are significant. If the government chose to 'buy-out' the minimum wage increases for three years, 300,000 new jobs could be created.[24] A 'buy out' of $10 per week tax cut for low-income earners would provide more than $1,500 annual benefit to low-income earners to ensure they were better off. The budgetary cost would be about $1 billion per year, while the budgetary savings (from less welfare and more tax) might be up to $2 billion per year.[25]

Two-tiered labour market

Both sides of politics agree on the concept of a two-tier labour market, where people on lower incomes are offered relatively greater protections. Under current labour market regulations, people earning more than $108,300 a year can make individual agreements without concern for award conditions. In effect, they can 'trade-off' some of their benefits.

A two-tiered labour market makes sense because of the different impacts of non-wage benefits. For people earning well above the minimum award wage, non-wage benefits are a substitute for wages. For these people, allowing trade-offs between wage and non-wage benefits should make them better off, as they can arrange their rewards to match their preferences.

The argument that employers will take the opportunity to lower total benefits for people earning more than the minimum award wage is not sustainable because employers are not obliged to pay a premium on the award: they would have already reduced total benefits if they had really wanted to. For people earning well above the minimum award wage, the impact of labour market inflexibility is purely negative. Having a 'no disadvantage test' is unlikely to make any difference but could be maintained for peace of mind.

However, for people earning on or near the minimum wage, allowing trade-offs between wage and non-wage benefits may lead to lower total benefits. Under the current system, employers do not have the right to reduce effective total (cash and non-cash) benefits: If given the chance, they may use non-wage flexibility as an excuse to lower total benefits.

The current cut-off in the two-tiered labour market was set arbitrarily and without reference for the underlying reason for the system. The cut-off should occur slightly above the rate of the minimum total benefits, including wage and non-wage elements. There is no reason to restrict flexibility for workers on higher incomes.

Factoring in the benefits of leave, minimum wages, unfair dismissal laws, and union privilege, the cut-off point should be closer to $40,000 per year for a full-time worker. The exact level could be determined each year by the government after it has determined the minimum total cost of employment.

Second-tier flexibility should also be expanded to cover all elements of labour regulations, including union privilege and unfair dismissal laws. Professionals earning $90,000 or so per year and wanting to 'cash in' their unfair dismissal protection should be allowed to do so. The government would maintain the assumption of unfair dismissal laws, union privilege, and other non-wage benefits, but for people well above the minimum wage, there should be avenues for employees to adjust their employment contract in their own interests, so long as nobody is worse off.

Conclusion

Labour market regulation was one of the original pillars of the so-called 'Australian settlement.' The other pillars were protectionism and the White Australia Policy. While we were able to move relatively quickly against protectionism and racist immigration policy, labour market reform has been achieved more slowly.

The evidence for a wage-employment link is overwhelming; with the best Australian estimate suggesting that a 10% reduction in the minimum wage would lead to a 3% increase in employment (about 300,000 jobs). It is impossible to know the exact number of unemployed due to the minimum wage, but it may be in the order of 600,000 people out of work.

A focus on the minimum wage is too narrow. When employers consider the costs of employment, they factor in both the minimum wage and also non-wage benefits, including the impacts of unfair dismissal laws and union privilege.

The last year saw two contradictory moves in labour markets, with the Fair Pay Commission freezing minimum wages (lower employment costs and saving jobs) while the government increased non-wage benefits (increasing employment costs and losing jobs).

Several moderate reforms can be considered to improve labour market performance. First, the government should increase transparency by calculating a 'total minimum cost of employment,' including the impact of all labour market regulations such as unfair dismissal laws and union privilege. Second, the government should consider the option of 'buying-out' the annual minimum wage adjustment by instead offering tax cuts and/or transfer payments. Finally, the government should maintain the current two-tiered labour market, but with increased flexibility for people on the upper tier and with a cut-off point set according to economic principles.

Endnotes

1 By 'liberal' I mean a preference for individual freedom and limited government. Other terms may be 'free-market,' 'classical liberal,' or (generally used as a pejorative) 'neo-liberal.' The quotation is from Kevin Rudd, 'The Global Financial Crisis,' *The Monthly* (February 2009).

2 There are two rare exceptions to this rule. With a 'Giffen good,' a higher price leads to a higher quantity demanded. The classic example is an inferior staple food, such as bread or rice. Price increases will decrease disposable income, potentially leading consumers to give up luxury foods and increase consumption of the inferior staple food. The other exception is when employers have monopsony power in the market (i.e. they are the only possible buyer).

3 Minimum wages are actually very poorly targeted towards poor households. Dawkins cites evidence that only 10% of minimum wage earners are from families in the bottom 10% of disposable incomes, while 25% of minimum wage earners come from families in the top 30% of disposable incomes. Peter Dawkins, *The 'Five Economists' Plan: Original Idea and Further Developments*, Discussion Paper 450 (Centre for Economic Policy Research, Australian National University, November 2002).

4 Philip Lewis and Garry MacDonald, 'The Elasticity of Demand for Labour in Australia,' *The Economic Record* 78:1 (March 2002), 18–30.

5 Charles Brown, Curtis Gilroy and Andrew Kohen, 'The Effect of the Minimum Wage on Employment and Unemployment,' *Journal of Economic Literature* 20 (June, 1982), 487–529.
6 David Neumark and William Wascher, 'Minimum Wages and Employment (Foundations and Trends in Microeconomics) (Now Publishers Inc, 2007), 1–182.
7 David Card and Alan Krueger, 'Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania,' *American Economic Review* 84 (1994), 772–93. For a discussion of problems in the Card and Drueger study, see Alex Robson, 'A Labour Market Fable,' *Policy* (Summer, 2004–05).
8 Richard Burkhauser and Joseph Sabia, 'Do minimum wage increases reduce poverty? An American perspective,' *2008 Minimum Wage Research Forum Proceedings, Volume 2*, October 2008, Research Report No. 4a/08 (Australian Fair Pay Commission), 169.
9 David Neumark and William Wascher, as above, 164.
10 All studies taken from David Neumark and William Washer, as above, 97–104.
11 Australian Fair Pay Commission, *Wage-Setting Decision and Reasons for Decision*, Appendix D: International Comparisons, 2009. Compared using PPP, at time of publication (July 2009), Australia had the highest minimum wage in the world. Compared using exchange rates we had the sixth highest minimum wage in the world. Also see, OECD, *Employment Outlook: Boosting Jobs and Incomes*, 2006, Table 3.10, which shows Australia having the highest minimum wage as a percentage of median wages among OECD countries in 2004.
12 Andrew Leigh, *Does Raising the Minimum Wage Help the Poor?* Discussion Paper No. 501 (Centre for Economic Policy Research, Australian National University, November 2005).
13 Andrew Leigh, *Employment Effects of Minimum Wages: Evidence from a Quasi-Experiment—Erratum, The Australian Economic Review* 37:1 (2004), 102–105. The average elasticity by Leigh was 0.29. Elasticity estimates have been rounded to the nearest 0.1% (so the Leigh average is 0.3), but the correct number has been used for all working.
14 Don Harding and Glenys Harding, *Minimum Wages in Australia: an Analysis of the Impact on Small and Medium Sized Businesses*, MPRA, Paper No. 25 (March 2004).
15 Using the Leigh elasticity, a 10% reduction in the minimum wage would lead to a 2.9% increase in employment. According to the ABS, total employment in October 2009 was 10,770,200. (ABS, Labour Force Australia, Cat. No. 6202.0 (October 2009), 7.
16 There is also the possibility of trading off non-regulated non-wage benefits. For example, employers may reduce the costs of employment by spending less money on workplace amenities such as work environment, work-social engagements, or other benefits such as a work kitchen or car park.
17 Don Harding, 'The Effect of Unfair Dismissal Laws on Small and Medium Sized Businesses,' Melbourne Institute Report No. 2 (Melbourne Institute of Applied Economic and Social Research, University of Melbourne, 29 October 2002).
18 In his paper, Harding assumes that unfair dismissal drives up the cost of employment for everybody and concludes that they will decrease employment by 0.46% (50,000 jobs). The estimate in this paper is lower because I have looked specifically at the impact on minimum wage earners.
19 This is based on union membership of $9 per week, as advertised by Union Australia.
20 As claimed by the Australian Council of Trade Unions (ACTU).
21 In economics, the consumer surplus is the benefit you get from a purchase in excess from the cost of the purchase. For example, if you put $20 of value on a movie ticket but pay only $15 for that ticket, then your consumer surplus is $5. With union membership, if you get $600 benefit but pay $500 for membership, then your consumer surplus is $100.
22 Peter Dawkins, as above.
23 John Humphreys, *Reform 30/30: Rebuilding Australia's Tax and Welfare Systems*, CIS Policy Monograph No. 70 (Sydney, The Centre for Independent Studies), 2005.
24 Inflation over three years would be about 10%, leading to a 2.9% increase in labour demand, which is slightly over 300,000 new jobs.
25 Budget cost is from $520 tax cut for approximately 2 million workers ($1 billion). Budget savings comes from 100,000 people receiving less welfare and more tax. The exact savings will depend on a number of factors but would be expected to be at least $15,000 per person ($1.5 billion).