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Poor Laws (2)

The Minimum Wage and Unemployment

Kayoko Tsumori

EXECUTIVE SUMMARY

Many social policy researchers and practitioners in Australia believe that a high minimum wage helps alleviate poverty. But a high minimum wage provides no relief for the majority of poor households that are jobless and therefore receive no wage. A high minimum wage, furthermore, destroys employment opportunities for, and thereby increases unemployment among, low-skilled workers. Unemployment, in turn, exacerbates poverty.

- The number of jobless households has risen sharply in recent years. In 1997-98, 16.3% of all Australian households had no member in paid employment, a 3.6 percentage point increase from the corresponding figure from 1982. Joblessness is a major cause of poverty. Australia's social policy community, while sharply divided on the definition and measurement of poverty, nonetheless shares a view that the risk of being poor is far greater for those out of work. Poverty will be alleviated significantly by engaging the poor in gainful employment.
- For those households that do have a low-wage earner, the amount of relief that an increase in the minimum wage provides is very small due to the 'welfare trap'. Take, for example, a household with one adult receiving the federal award minimum wage, one adult not participating in the labour force and two dependent children. A higher minimum wage will push up their weekly before-tax earnings so that they lose part of their Parenting Payment. They will also have to pay more income tax. Perversely, much of the gain from an increase in the minimum wage is captured by households that are better off to begin with. The Federal government also profits from a decrease in social security spending and an increase in tax revenues.
- A high minimum wage destroys jobs. Many low-paid workers are low-skilled. A rise in the minimum wage increases the cost of low-skilled labour, to which employers may respond by cutting the number of low-skilled workers that they hire. A rise in the minimum wage also increases labour 'on-costs'—for example, leave entitlements, superannuation contributions, workers' compensation premiums—as many of these are proportional to wages. The cost of labour therefore rises by a lot more than just the increase in the minimum wage.
- The low-skilled are over-represented among the unemployed. A high minimum wage will merely add to low-skilled unemployment, and runs counter to the supposed objective of helping the most disadvantaged. Counterintuitive as it may sound, it is a decrease not an increase in the minimum wage that will help marginal labour market participants.

Dr Kayoko Tsumori is a Policy Analyst at The Centre for Independent Studies. The author wishes to thank John Freebairn, Helen Hughes, Peter Saunders and Susan Windybank for helpful comments and suggestions on earlier drafts. The usual disclaimers apply.

Background: the 9 May 2002 safety net decision

Awards have historically been the primary instrument for prescribing wages and working conditions in Australia. Their significance has diminished since the introduction of enterprise bargaining in the late 1980s. Awards now serve more as a safety net. Yet the award minimum wage—the minimum rate of pay that applies to workers covered by awards—remains important in Australia's industrial relations landscape.

Once a year, the Australian Industrial Relations Commission (AIRC) reviews the level of the federal award minimum wage. This 'Safety Net Review' is carried out in response to a 'living wage' claim lodged by the Australian Council of Trade Unions (ACTU). The living wage refers to a wage that would meet 'the needs of the low-paid', and in the ACTU's view, the award minimum wage must at least keep pace with the living wage. The underlying assumption is that, were it not for a minimum wage increase, the low-paid, with their needs unmet, would remain in poverty.

This year's safety net decision may appear to have boosted the living standards of the worse off. It most likely did not.

Early this year, the ACTU sought a $25 per week increase in all award rates. This was intended to deliver, in percentage terms, the biggest gain to the lowest paid and thereby to help keep them out of poverty.[1] The Federal Government, on the other hand, called for a more moderate increase of $10 per week, arguing that an excessive minimum wage would hurt the economy in general and employment in particular. Employer groups and some sections of the social policy community expressed similar concerns.[2] The ACTU nevertheless maintained that its proposal was modest and thus would have little or no effect on inflation or unemployment.[3]

On 9 May 2002, the AIRC decided in favour of an $18 per week increase, which brought the federal award minimum wage up to $431.40 per week.[4] This was, as reported in *The Australian* the next morning, 'the largest dollar increase ever granted in the national wage case and the biggest percentage jump in the minimum wage for more than 20 years'.[5] During the following months, the state industrial tribunals adjusted the award minimum wages in their respective jurisdictions by the same amount.

This year's safety net decision, on the face of it, may appear to have boosted the living standards of the worst off. It most likely did not. There are two primary reasons:

- Over a half of poor individuals are jobless, and will not be able to enjoy the benefits of a minimum wage increase;
- A minimum wage increase will aggravate unemployment and thus hardship among low-skilled workers. Employers will forego the employment of low-skilled labour, whose costs will rise as a result of a minimum wage increase.

Despite a near-decade of economic growth, excessive labour market regulation continues to undermine job creation in Australia. This is why unemployment—particularly long-term unemployment—remains pervasive. *Poor Laws (1)* explored how employment protection laws, such as unfair dismissal laws, exacerbate unemployment. This paper looks at how a high minimum wage raises labour costs, discourages firms from hiring, and thus contributes to unemployment.

The low-paid and the poor

Although the definition and measurement of poverty remain contentious, previous studies have made at least one thing clear: the risk of falling into poverty, however it may be defined and measured, is significantly higher for the unemployed than for the employed. A recent Smith Family/NATSEM poverty report found, for example, that few households below the 'poverty line' contained an adult working full-time. Even though this report defined its poverty line extremely generously,[6] only 4.6% of people in full-time employment were found to be 'poor' on this inflated definition, as compared with 57.5% of those who were out of work and earning no wage.[7] 'The low-paid' and 'the poor' are by no means synonymous.

Many low-paid individuals, in fact, live in households that enjoy relatively high standards of living. Sue Richardson and Ann Harding estimate that in 1994-95 approximately 40% of adults receiving the minimum wage or less were located in the top half of the family income distribution.[8] These adults included those who did not earn much themselves but had some other people in their families—typically their spouses—earning a fair amount of money.

Certainly, a high proportion of young low-wage earners was found in low-income families. Yet this should not be taken at face value. The Australian Bureau of Statistics' surveys, from which Richardson and Harding derive their data, record young low-wage earners as constituting a separate family even when they actually live with their parents. But young low-wage earners living with their parents most likely had no rent to pay, received some financial support, had access to their parents' cars, and so forth. The living standards of young low-wage earners were, therefore, not necessarily low.

The link between a low wage and a low income is weak. The primary cause of a low income is not a low wage but joblessness. Importantly, the number of jobless households has grown acutely in recent years. In 1997-98, 16.3% of all Australian households were jobless, with no member in paid employment. This represented a 3.6 percentage point increase from the corresponding figure for 1982.[9] The jobless, by definition, receive no wage, and so no amount of minimum wage increase improves their living standards.

The primary cause of a low income is not a low wage but joblessness.

The ACTU claims that safety net adjustments provide relief for some poor households that do contain low-wage earners.[10] The amount of such relief, however, is extremely small due to the 'welfare trap'. Consider a household with one adult receiving the federal award minimum wage, one adult not participating in the labour force and two dependent children.[11] They qualify for Parenting Payment. Their weekly before-tax earnings have now increased by $18. As a result, they have to pay more in income tax; moreover, their Parenting Payment is reduced by over $10 per week.[12] They are, in the end, only a little more than $3 per week better off. The experience of this household stands in clear contrast to another hypothetical household containing one adult earning $100,000 per annum and one adult receiving the federal award minimum wage: their after-tax income has increased by more than $11.

A minimum wage increase may thus widen rather than narrow income inequality. The annual safety net adjustment does nothing for the workless poor; it is also a drop in the bucket for the working poor. Much of the gain is captured by households that are better off to begin with. The Federal Government, too, profits from a reduction in social security spending and an increase in income tax revenue.[13] The minimum wage is clearly a blunt instrument for tackling poverty.

The low-paid and the unemployed

The low-paid are usually low-skilled as well, and so an upward adjustment of the minimum wage will raise the cost of low-skilled labour. Employers will respond by cutting the number of low-skilled workers in one way or another. They might, for instance, substitute machines for low-skilled workers. Standard labour economics theory thus predicts that a minimum wage increase will raise unemployment among the low-skilled.

Controversy erupted when two US labour economists, David Card and Alan Krueger, claimed in their 1995 book that a higher minimum wage would not decrease, and might even increase, employment.[14] Their findings, derived from observations within the United States, soon gained currency around the world. Yet a number of economists pointed—correctly—to a numerous flaws in the Card and Krueger study.[15] As far as Australia is concerned, it is simply inapplicable because the US minimum wage is, compared to that of Australia, very low to begin with. In 2000, the ratio of the minimum wage to the median wage was 0.364 for the United States and 0.577 for Australia. The US figure was the lowest among all the OECD countries for which data were available; in contrast, the only country that had a higher minimum to median wage ratio than Australia was France (0.608).[16] For this reason, the effect of a given minimum wage increase on labour market performance is thought to be much more significant for Australia than for the United States.[17] Card and Krueger themselves admitted in their book that, under a much higher minimum wage, employment losses might not be small.[18] Conclusions from cross-country studies generally remain ambiguous, but they too indicate that an excessively high minimum wage could significantly dampen employment among certain groups, such as teenagers.[19]

The ACTU, in this year's living wage claim, argued that given Australia's rosy economic outlook, a 'moderate' safety net increase would have no or little effect on labour market performance.[20] Certainly, a robust economy will generate jobs, thereby lowering unemployment. This appears to be what has occurred since the recession in 1993. A number of jobs, however, may have been lost in the meantime; it might merely be that job destruction resulting from a high award minimum wage has been offset by job creation resulting from economic growth. If the economy slows down, and/or if award minimum wage becomes exorbitant, more jobs may be destroyed than created. Continuous economic growth does not necessarily provide a sound basis for a continuous upward adjustment of the minimum wage.

Those supporting the continuation of the annual Safety Net Review also argue that, since the proportion of workers who are paid the minimum wage is in fact small, the effect of a minimum wage increase on employment is insignificant. In 1994-95, for example, only 6% of all workers were receiving the minimum wage.[21] Safety net adjustments, however, do not only extend to workers on the federal award minimum wage; they also flow through to other federal award workers, state award workers, and workers covered by federal and state enterprise agreements. As of 30 September 2001, there were, for example, about half a million employees who were covered by federal enterprise agreements and could be affected by safety net increases.[22] They included:

- 69,500 employees who would receive pay rises where consistent with safety net decisions;
- 92,500 for whom pay rises were conditional on the level of revised award rates;
- 14,500 who would automatically benefit from safety net increases; and
- 302,300 who were covered by agreements that neither specified nor ruled out safety net increases.

A rise in wage costs by some amount causes overall labour costs to rise by a lot more than that amount.

Taking into account such indirect as well as direct effects, this year's minimum wage rise—which was, contrary to the ACTU's claim, hardly 'moderate'—is estimated eventually to reduce the number of available jobs by 60,000 to 70,000.[23]

Safety net adjustments also have the effect of increasing 'labour on-costs'. Examples of on-costs in Australia include leave entitlements, superannuation contributions and workers' compensation premiums. Many of these are proportional to wages, and therefore, a rise in wage costs by some amount causes overall labour costs to rise by a lot more than that amount.

Labour on-costs in Australia, both in relation to total labour costs and in absolute terms, remain low by international standards. In 1995, the ratio of on-costs to total labour costs for Australia was 0.277. The figure was similar for countries with relatively deregulated labour markets, such as Canada (0.278), the United Kingdom (0.286), Ireland (0.286) and the United States (0.294). Among the 17 OECD countries compared, Australia was second only to Denmark (0.200). In terms of US dollars per hour, Australia had the third lowest on-costs (US$6.1), trailing Ireland (US$6.0) and the United Kingdom (US$5.9).[24]

Still, Australia's on-costs have increased more significantly than wages and salaries since the 1970s. This has to do with, among other things, the expansion of leave entitlements.[25] This year's safety net adjustment represented another jump in on-costs. Employers who have been affected are now required to pay, for each employee, an extra $18 per week plus a corresponding amount of on-costs. Consider an award employee on a weekly wage of $567.80.[26] He or she is estimated to be costing his or her employer an extra $23.40 per week after taking on-costs into account. Yet the employee's family, if consisting of him or herself, a jobless spouse and one child, is only gaining an extra $7.14 per week.

Thus, a small increase in the award minimum wage can trigger a large increase in the national wage bill, which in turn will add to the unemployment problem.

Counterintuitive as it may sound, it is a decrease not an increase in the minimum wage that will help marginal labour market participants. The reason is simple: a reduction in wages for low-skilled workers will not only prevent unemployment among, but also boost employment opportunities for, these workers. This is precisely what the 'Five Economists' envisioned when they proposed, in an open letter to Prime Minister John Howard in October 1998, a temporary wage freeze—or a real wage reduction—for low-skilled workers.[27]

A minimum wage increase runs counter to the supposed objective of helping the most disadvantaged.

Two of the Five Economists, Peter Dawkins and John Freebairn, simulated possible effects of a real wage reduction for low-skilled labour, using various assumptions. Their findings pointed to an increase in employment among low-skilled workers and a decrease in overall unemployment.[28] In the case where the real wage for low-skilled workers was cut by 10% and the substitution elasticity of low-skilled labour for high-skilled labour was 2.0 (that is, a 1% wage increase for high skilled labour induces a 2% increase in the demand for low-skilled labour), low-skilled employment grew by 770,000 persons and unemployment plummeted from 9.0% to 5.5%.

Some might claim that cutting wages for high-skilled workers should achieve the same purpose. But this is not quite the case. Jobs created by lowering the cost of high-skilled labour require, of course, high skills. The majority—approximately 60%[29]—of the unemployed are low-skilled and thus unqualified. Furthermore, wage reductions for high-skilled workers will generate far fewer employment opportunities than wage reductions for low-skilled workers, as Daniel Hamermesh concluded after an extensive review of studies on labour demand.[30]

Some might also suggest that more low-paid jobs for low-skilled workers may lead to a permanent 'underclass', but this is very unlikely. Low-wage earners do not necessarily become locked in low-paid positions; just over 50% of them eventually move into higher-paid positions after gaining on-the-job skills.[31] A minimum wage that is too high will, by destroying jobs, deprive the low-skilled of opportunities to climb up the wage ladder. Worse, unemployment will increase their risk of falling into poverty.

At the end of the day, low-wage jobs are better than no jobs at all. The annual safety net adjustment, though to a limited extent, benefits the 'insiders' (those already in jobs); but it denies the 'outsiders' (those without jobs and those in precarious jobs) opportunities to secure employment and improve their earning prospects. A minimum wage increase runs counter to the supposed objective of helping the most disadvantaged.

Policy implications

Many social policy researchers and practitioners in Australia believe that a high minimum wage helps alleviate poverty. Their faith is misplaced. Artificially high wages for low-skilled workers will reduce employment opportunities for, and thereby increase unemployment among, these workers. More people will find themselves in poverty because joblessness is a major cause of poverty. The majority of poor families have no member in paid employment, and so an increase in the minimum wage has no bearing on their wellbeing. Job creation is a far more efficient way of supporting the poor.

Next year, the ACTU will seek a $24.60 per week wage rise for award workers.[32] This is supposed to help low-wage earners who are struggling to support their families. It clearly will not. The living standards of households depending on single low wages should instead be protected through the tax-transfer system. It would be far more productive to have a serious debate about what sort of system might best suit Australia, rather than to continue fiddling with the level of the minimum wage.

Endnotes

1 Australian Council of Trade Unions (ACTU), *Living Wage Case: Written Submission* (Canberra: ACTU, 2002), 11.

2 See, for example, *The Australian* (15 April 2000).

3 ACTU, *Living Wage Case*, 2.

4 AIRC (Australian Industrial Relations Commission), PR002002, 9 May 2002.

5 Kristine Gough, 'Lowest Paid Win Extra $18 a Week', *The Australian* (10 May 2002).

6 See Kayoko Tsumori, Peter Saunders and Helen Hughes, *Poor Arguments: A Response to the Smith Family Report on Poverty in Australia*, CIS Issue Analysis No. 21 (16 January 2002); Peter Saunders and Kayoko Tsumori, *Poverty in Australia: Beyond the Rhetoric* (Sydney: CIS, 2002), especially chapters 1 and 2.

7 Ann Harding, Rachel Lloyd and Harry Greenwell, *Financial Disadvantage in Australia 1990 to 2000: The Persistence of Poverty in a Decade of Growth* (Camperdown: The Smith Family, 2001), 4, 12.

8 Sue Richardson and Ann Harding, *Low Wages and the Distribution of Family Income in Australia*, Discussion Paper No. 33 (Canberra: National Centre for Social and Economic Modelling, September 1998), 14-16.

9 Peter Dawkins, Paul Gregg and Rosanna Scutella, *Employment Polarisation in Australia*, Melbourne Institute Working Paper No. 9/02 (Melbourne: Melbourne Institute of Applied Economic and Social Research, June 2002), Table 1.

10 ACTU, *Living Wage Case*, 3.

11 The following examples are adopted from Peter Dawkins, 'Poor Sop for the Worst Off,' *The Australian* (14 May 2002).

12 The reduction of Parenting Payment occurs because this family's entitlement is reduced by 70 cents for each extra dollar that the employed adult brings home. See www.centrelink.gov.au/internet/internet.nsf/payments/parenting_iat.htm

13 See Heather Ridout, 'Pay Rise Short Changes Low-paid Workers', *The Australian Financial Review* (17 May 2002).

14 David Card and Alan B. Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton: Princeton University Press, 1995).

15 See, for example, Richard V. Burkhauser, Kenneth A. Couch and David C. Wittenburg, 'A Reassessment of the New Economics of the Minimum Wage Literature with Monthly Data from the Current Population Survey', *Journal of Labour Economics* 18:4 (2000), 653-80.

16 *OECD Labour Market Statistics*, CD-ROM (Paris: OECD, 2001).

17 Des Moore, *Minimum Wages: Employment and Welfare Effects, and Why Card and Krueger Were Wrong*, a paper presented at HR Nicholls Society XXIII Conference (Melbourne, 22-23 March 2002), 5.

18 Card and Krueger, *Myth and Measurement*, 393.

19 OECD, *Implementing the OECD Jobs Study: Member Countries' Experience* (Paris: OECD, 1997); OECD, 'Making the Most of the Minimum: Statutory Minimum Wages, Employment and Poverty', *OECD Employment Outlook*, 1998, 31-79.

20 ACTU, *Living Wage Case*, 3-5.

21 Sue Richardson and Ann Harding, 'Poor Workers? The Link between Low Wages, Low Family Income and the Tax and Transfer Systems', in *Reshaping the Labour Market: Regulation, Efficiency and Equality in Australia*, ed. Sue Richardson (Melbourne: Cambridge University Press, 1999), Table 4.2.

22 Commonwealth of Australia, *Safety Net Review—Wages 2001-2002: Commonwealth Submission* (1 March 2002), 68-69.

23 See Dawkins, 'Poor Sop'.

24 Derived from M. Walsh, 'Flexibility Key to Labour Gains', *The Sydney Morning Herald* (23 May 1996), 25, quoted in EPAC (Economic Planning and Advisory Commission), *Future Labour*

Market Issues for Australia, Commissioned Paper No. 12 (Canberra: Australian Government Publishing Service, 1996), Table 2.3.

[25] EPAC, *Future Labour Market Issues*, 19.

[26] The following example is adopted from Ridout, 'Pay Rise'.

[27] See Peter Dawkins, John Freebairn, Ross Garnaut, Michael Keating and Chris Richardson, 'Dear John: How to Create More Jobs', *The Australian* (26 October 1998).

[28] See Peter Dawkins and John Freebairn, 'Towards Full Employment', *The Australian Economic Review* 30:4 (December 1997), 410-11.

[29] An August 2001 estimate by Des Moore (*Minimum Wages*, 17).

[30] Daniel S. Hamermesh, *Labor Demand* (Princeton: Princeton University Press, 1993). In general, low-skilled labour is more likely to be a 'substitute' for capital (that is, greater use of low-skilled labour entails reduced use of capital) whereas high-skilled labour, a 'complement' with capital (that is, greater use of high-skilled labour entails greater use of capital). Take, for example, high-tech machines. They may be able to do a job comparable to that of low-skilled labour, but their operation calls for employment of high-skilled labour. Suppose that the cost of low-skilled labour falls for whatever reason and that, as a consequence, the price of high-tech machines becomes relatively more expensive. Firms then will choose low-skilled labour over high-tech machines. This, however, is not quite the case with high-skilled labour as far as employment of more high-skilled labour will involve purchase of more high-tech machines, thereby incurring extra costs to firms.

[31] Yvonne Dunlop, 'Low-paid Employment in the Australian Labour Market, 1995-97', in *Work Rich, Work Poor*, ed. Jeff Borland, Bob Gregory and Peter Sheehan (Melbourne: Centre for Strategic Economic Studies, Victoria University, 2001), Table 6.3.

[32] ACTU, 'ACTU Push for $24.60 Minimum Wage Rise', http://www.actu.asn.au.

Poor Laws (1)
The Unfair Dismissal Laws and Long-term Unemployment

Kayoko Tsumori

In the first of a new series on reforming Australia's welfare and labour market policies, Kayoko Tsumori examined Australia's poor record in job creation and relatively high unemployment rates despite a near-decade of economic growth. She found that excessive labour market regulation—in this case unfair dismissal laws—has reduced employment opportunities, particularly in the small business sector. *Poor Laws (1)* can be read and downloaded from the CIS website www.cis.org.au.

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