Minimum Wage Submission, 2008

This is a short submission on the basis of my research on labour markets in general, and youth labour markets in particular. I submit that in the light of the Australian Fair Pay Commission’s “overarching objective of promoting the economic prosperity of the people of Australia” that an increase in minimum wages of about 4% in 2008 would help the poorer working families who are struggling against the increasing costs of living, especially with the increases in interest rates, food and fuel prices, etc. This modest increase of 4% in nominal minimum wages would be equivalent to about 0.6% in real wages using the RBA forecast for the year of about 3.4% in core inflation.

In this context it is important to note that there is a very small percentage of the workforce that is paid minimum wages. In fact, as was pointed out in Junankar and Waite (2000) many young workers are paid above the minimum wages, presumably because employers believe they get greater efficiency (productivity) by paying above minimum wages. The main sectors that have a significant number of workers on minimum wages are in retail and accommodation, cafes and restaurants.

Over the past decade or so the Australian economy has been growing very rapidly and hence is able to afford an increase in minimum wages for the low paid workers. Although growth has been approximately 3.5% per annum over the past decade or so, real wages have only increased by about 0.5% per annum for many groups. At the same time, CEOs have had large increases in their incomes. Further, the share of wages in GDP has been falling over the past decade while the share of profits has been increasing. In non-competitive markets, wages are determined by a bargain between workers and employers, see Blanchard and Sheen (2007). As is well known, most of the workers on minimum wages are low skilled, casual, and to a great extent women. An increase in minimum wages would then decrease wage inequalities, as well as improve gender equity (as women are over-represented in the group of workers on minimum wages).

One of the objectives of the new government has been to increase labour force participation: an increase in minimum wages would lead to an improvement in the earnings to welfare benefits ratio (or worsen the replacement rate).

There is little evidence that an increase in minimum wages leads to a statistically significant fall in employment, see Junankar and Waite (2000). The OECD is also circumspect about the impact of minimum wages on employment:

Firstly, the results suggest that a rise in the minimum wage have a negative effect on teenage employment. Secondly, negative employment effects for young adults are generally close to or insignificantly different from zero. Thirdly, for prime-age adults, the most plausible specifications suggest that minimum wages have no impact on their employment outcomes. (OECD Employment Outlook 1998, pp. 47-48).
However, they are cautious in their conclusion and emphasise the “fragility of the results in Table 2.5”, (OECD 1998, p. 47). They add:

At the same time, it is important to note that these estimated effects are relatively insignificant in terms of explaining the large decline that has occurred in the teenage employment-population ratio in some countries. (OECD Employment Outlook 1998, p. 48)

In recent years experimental economics has had a significant impact labour economics. In particular it has emphasised the role of reciprocity in the relations within the workplace. This work emphasises that the best way to have a productive relation between employers and workers is to have trust and fairness. A longer term relationship is beneficial to both parties: hence when workers feel they are being treated fairly they will provide increased efficiency (productivity). An increase in minimum wages for the low paid workers would engender a feeling of trust and fairness. An appendix discusses some of these issues.

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Appendix: Experimental Economics and Labour Markets

Much of the recent work on experimental economics suggests that the usual microeconomic theories of unemployment that are based on simple optimisation models with selfish agents are inadequate explanations of behaviour. These experimental economics results suggest that labour market behaviour is affected by issues of altruism and reciprocity. If a worker is treated well by his/her boss, s/he would provide more effort. This was discussed in a seminal paper by Akerlof (1982), also see Rabin (1993). Some recent work by Fehr and Gachter (2000), Fehr and Falk (1999), and Brown, Falk and Fehr (2004) show that the labour market is an important social institution that is affected by several factors other than monetary payments. More importantly they show that firms do not lower wages in the face of excess supply and that there are endogenous wage rigidities.

One of the fundamental problems in labour markets is that there are incomplete contracts: if a firm hires a worker and pays a wage per unit of time there is no control over the effort provided by the worker. It is difficult or very expensive to monitor each worker’s effort. In these cases it is important to provide the worker with incentives to work as best as possible without any form of control. Piece rate payment may be possible in some kinds of work but even there some kind of quality control is necessary. In an important paper Fehr and Falk (1999) use experimental methods (double auctions) to show that in the case of incomplete contracts with excess supply of labour firms are not willing to cut wages and workers are willing to under bid significantly to find employment but employers do not accept these low wage offers. This is rationalised in terms of efficiency wages or reciprocal behaviour: if a worker is paid well s/he puts in more effort and the employer
makes a higher profit. The experiment is carried out with a control group where effort is exogenously determined and compared with an experimental group where effort is endogenous. In the control group the contract wage is almost always below the wage offers of the workers while in the treatment group the contract wage is almost always above the majority of the wage offers by workers. These experimental results also showed that the profits of employers were higher when they paid higher wages.

This work supports the survey work done by Bewley (1999) who found that even in a recession employers were unwilling to cut wages because of issues of fairness and reciprocity.

Together the survey evidence and the experimental evidence show that in a labour market with excess supply employers do not voluntarily cut wages and hence the usual story that rigid wages are due to the uncompetitive nature of trade unions is not valid. As in the efficiency wage literature firm do not wish to cut wages in a recession because the effort of workers would fall and they would make lower profits. Wages are rigid because of the issues of fairness and reciprocity in a labour market: the labour market is a social institution.

In another paper, Brown, Falk and Fehr (2004) show that in the face of incomplete contracts there are serious incentive problems and the absence of third party enforcement of contracts causes fundamental changes in the nature of market interactions. The paper shows that there are benefits of long term relationships between an employer and employee. These long term relationships lead to both parties being better off. Efficiency wages and the threat of firing workers leads to the sharing of rents in this economy and long term relationships are more profitable than short term ones. The paper also shows that involuntary unemployment exists in this experimental model: unemployed workers would be willing to work for substantially lower wages. Given that a relationship of trust has developed between a worker and employer, a demand or supply shock does not lead to a break down of the relationship.

References


