NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE 1998 REVIEW OF THE STATUTORY MINIMUM WAGE

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THE 1998 REVIEW OF THE STATUTORY MINIMUM WAGE

In broad terms the argument for raising the adult and youth statutory minimum wage rates is that it would increase the incomes of low-wage employees and produce a fairer distribution of income. People higher up the wage scale may also enjoy smaller wage gains as a consequence of increased demand for substitutes for low-productivity labour. However, if minimum wages inflict losses on others in society, for instance by denying a job to low-productivity workers, then raising minimum wages may not be consistent with the objective of greater equity and improvement in overall welfare in society. A further consideration in assessing the merits of raising minimum wages is whether there are other policy instruments better suited to improving the welfare of low-wage employees.

The first part of this submission explains why a minimum wage will inflict losses on some groups, notably less able people in the workforce. The second part outlines issues to be considered in assessing whether the gains to the beneficiaries are sufficiently great to justify the losses inflicted on the losers. Part III summarises the case for opposing any increases in minimum wages.

I LOSSES ASSOCIATED WITH THE MINIMUM WAGE

1.0 Labour market participants

1.1 Introduction

As is well known, conventional economic theory predicts that raising a statutory minimum wage above the market-determined minimum wage will reduce numbers employed and aggregate hours of employment. If so, although the incomes of low-wage earners who retain their jobs can be expected to increase, the market earnings of those who lose their jobs fall dramatically – to zero. The main claims of those who oppose raising minimum wages (and, indeed, favour their abolition) is that the losses imposed on the latter outweigh the benefits accruing to the former and that overall economic efficiency and national income are reduced through disemployment and other effects. The validity of this claim depends on whether minimum wages do cause a loss of low-wage jobs and, if so, on:

- the numbers precluded from employment;
- the nature and severity of the losses; and
- other effects of minimum wages.

These issues are examined in this section.

1.2 Do minimum wages preclude people from jobs?

The conventional view that setting a higher effective minimum wage will preclude at least some people from jobs has been challenged in recent years by proponents of the "new economics of the minimum wage" (hereafter 'the new view') who claim, primarily on the basis of recent statistical studies, that the effects on employment may be close to zero or even positive (see, for example, Card and Krueger, 1995; Chapple, 1997). The following theoretical points are relevant to assessing the merits of the two views.

The conventional view is underpinned by two main propositions:

- Raising the minimum wage tends to increase the costs of producing goods and services which require relatively intense use of unskilled labour in production. In the case of non-traded goods and services which are unskilled-labour intensive (eg fast food products) this tends to raise their prices relative to prices of other goods, thereby reducing quantities consumed and the quantity of unskilled labour hired to produce such goods. Production of unskilled-labour intensive traded goods and services also tends to decline because the profitability of producing them declines.

- Producers of both traded and non-traded goods tend to substitute other inputs for unskilled labour in production processes.

The new view is underpinned by two main theoretical constructs. The first derives from conventional theory that, within a certain range, setting a minimum wage will induce a monopsonist to increase the quantity hired of a given type of labour.[1] The validity of this theory is generally accepted. However, because the conditions for the existence of a genuine monopsony are extremely rare, the conventional view is that it is not a sound basis for expecting an increase in a statutory minimum wage to result in anything like a measurable *increase* in total employment of low-skilled labour. In essence, what is at issue is whether a firm such as McDonald's might be sufficiently dominant in the market for youth labour in an area to behave *as if* it were a monopsonist. While careful consideration of the conditions required for the existence of monopsony power suggests that this is unlikely be the case, for a variety of reasons it is difficult to find the kinds of evidence required to resolve the issue beyond dispute.

A second theoretical construct used in support of the new view is that the 'shock' of an increase in a minimum wage can induce employers to find ways of improving labour productivity to an extent which enables them to profit by increasing the quantities of labour hired. This is essentially an *ad hoc* explanation which is, at best, barely plausible

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1 A monopsonist is defined as the sole hirer of a given type of labour in a given market. An example might be a country hospital which hires nurses married to people living in the surrounding area.

because it is tantamount to assuming that previously employers persistently failed to perceive and exploit opportunities to increase profits.

We conclude that, in contrast to the commonsense propositions underlying the conventional view, the theoretical underpinnings of the new view are both contrived and unconvincing. Similar conclusions are to be found in the recent economic literature (see, for example, Hamermesh 1995, pp 837-838; Lewis 1997, pp 6-7). In summary, there are convincing theoretical reasons for expecting that minimum wages set above the market wage that would otherwise apply will exclude low-wage people from jobs.

1.3 How many people might lose jobs?

The conventional view, based on empirical studies stretching back over many decades (predominantly from the United States, but also from other industrialised countries), is that a 10 percent increase in the minimum wage can be expected to reduce employment of low-wage workers by something of the order of 1 to 3 percent (ie the elasticity of demand for low-wage labour seems likely to be in the range - 0.1 to - 0.3 percent). On this basis a 'ball-park' estimate of the effect of raising the adult and youth minimum wages in New Zealand by, say, 5 percent would be to reduce employment of youths and young adults (the 15–19 and 20–24 age groups) by perhaps 1,000 to 5,000 depending on the numbers in these age groups with jobs at the bottom of the wage spectrum. Additional job losses could be expected in other adult age groups. In contrast, the new view is that the effect of raising minimum wages (up to some unspecified limit) would be close to zero and possibly positive. Which of these two views is most plausible?

The evidence from New Zealand is limited and ambiguous. Consistent with the conventional view, Maloney (1995) finds that a 10 percent increase in the adult minimum wage only (ie holding the youth minimum wage constant), can be expected to reduce employment of young adults by 3.5 percent, and to increase employment of teenagers (because they become relatively less costly to employ). Chapple (1997) finds some evidence which is consistent with Maloney's estimates. However, his overall assessment of the evidence is "… a tentative working hypothesis … that increases in the real minimum wage have a minimal negative impact on employment rates … ." This accords with the new view.

In assessing where the balance of evidence lies, the following points should be considered.[2]

- In 1996, by which time the great majority of labour economists (if not all) would have been well aware of 'new view' evidence and arguments, 87 percent of a random sample of 193 US labour economists agreed with the conventional view that "a minimum wage increases unemployment among young and unskilled workers". The median response was that a 10 percent increase in the teenage minimum wage

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2 Given that there are sound reasons for expecting producer response to changes in wage rates to be similar across industrialised countries, it is appropriate to consider evidence from overseas. The bulk of this evidence comes from the United States.

would reduce teenage employment by 2 percent (Whaples, 1996). The median response from another 1996 survey of 65 US labour economists from 40 leading US university economics departments was that a 10 percent increase in the minimum wage would reduce teenage employment by 1 percent (Fuchs *et al*, 1998). Clearly, a great majority of US labour economists hold the conventional view that minimum wages reduce employment. In fairness, these same surveys showed opinions about evenly divided on the desirability of increasing minimum wages, a finding which Fuchs *et al* (p 1393) regard as surprising given these economists' views on likely job losses.

- A study conducted by Deere, Murphy and Welch in response to the new view provides statistically robust evidence that raising the US federal minimum wage from US$3.35 per hour in 1990 to US$4.25 per hour in 1991 resulted in falls in teenage employment of 7.3 percent, 11.4 percent and 10.0 percent for men, women and blacks respectively (relative to *projected* employment at a wage rate of $3.35) and in employment of adult high school dropouts of 3.1 percent, 5.2 percent and 6.7 percent for men, women and blacks. They conclude:

  > The regressions have no surprises. When the cost of employing low-wage laborers is increased, fewer low-wage laborers are employed (Deere, *et al* 1995, p 237).[3]

  Note that the study showed that disadvantaged groups bore disproportionately large shares of these job losses.

- In his recent survey of the international evidence on the effects of a minimum wage on employment, Murdoch University (Western Australia) economist Andrew Seltzer states: "The jury is still out, although the pendulum seems to be swinging back in favour of those who believe that the minimum wage does reduce employment at the margin. … The limited evidence from the United States suggests that the employment effects can be quite large for industries where the minimum wage really binds" (Seltzer, 1997).

- Leading advocates of measures to improve the earnings of low-wage employees clearly recognise that increasing a minimum wage may reduce employment. For example, in reviewing the minimum wage as an instrument for increasing earnings, Columbia University economist Edmund Phelps states:

  > No economist I know of has suggested that wage rates of $4 an hour might be pushed up to $7 by means of a hike in the minimum wage without causing a major decline in employment among low-wage workers.

  He goes on to state:

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3 These authors have now largely dropped out of the debate, almost certainly because they believe it to have been substantially resolved in their favour.

> … even if employers, in the face of a mandated wage increase, maintain their employment of their current low-wage employees, in whom they have invested something, they will look for ways to get along with fewer of them as these employees eventually move on. The long-run effects …[on employment]… might be much larger than those detected early on (Phelps, 1997, p 146).

Similarly, Harvard economist Richard Freeman, a leading advocate of the minimum wage as a measure for improving the distribution of income, states:

> Absence of noticeable employment losses in these [recent] studies does not, of course, imply that minimum wages much higher than those observed may not risk large job losses nor that minimum wages may not cause employment disasters in particular sectors, such as apparel, or in particular firms (Freeman 1996, p 642).

Both Phelps and Freeman make the point that whereas the Card/Krueger estimates focus on short-term effects of higher minimum wages, there are well recognised reasons for expecting the longer term effects to be larger – it takes time for responses, including changes in production technologies, to be implemented and ramify through an economy.

- Higher minimum wages increase the incentive for people such as students and married women to enter or re-enter the workforce (ie to become active participants in the labour market). Many such people may be relatively highly productive employees and may, in effect, displace less productive workers. Thus while the net effect of increasing a minimum wage on total employment may be small, the likelihood that it nevertheless precludes from employment substantial numbers who would otherwise have jobs should not be overlooked.[4] This is not in any way inconsistent with conventional theory. The important implication is that failure to detect a statistically negative relationship between a minimum wage and numbers employed cannot be assumed to be evidence that the minimum wage is not precluding people from finding jobs. As Neumark and Wascher state in relation to teenage employment:

> … although minimum wages may lead to small net disemployment effects for teenagers as a whole, there are significant enrolment and employment shifts associated with minimum wage changes that

4 Because the implications for policy-making are very different, it is important to distinguish between claims that increasing a statutory minimum wage may *increase* employment (eg Card and Krueger, 1995, pp 79, 236) and claims along the lines that it is unlikely that a statutory minimum wage has a *large* negative employment effect (eg Card and Krueger, 1995, p 390). Whereas neither the theory nor the evidence provides convincing support for claims of the former kind (see, for example, Hammermesh, 1995, Lewis, 1996, Seltzer, 1996), claims of the latter kind are consistent with accepted theory and there is at least some plausible supporting evidence.

> should be of concern to policy makers (Neumark and Wascher 1995, p 248).

> This is a possible explanation for the small estimates of aggregate job losses in Chapple (1997).

For a variety of reasons it is very difficult to devise statistical procedures which can be guaranteed to yield reliable estimates of the employment effects of minimum wages. This is reflected in the strong criticisms of econometric procedures launched from both sides of this controversy (see, for example, Welch 1995; Card and Krueger, 1995). However, the difficulty of devising statistical tests to 'prove' theories is not peculiar to the economics of the minimum wage. For example, it is doubtful whether anybody has produced an unambiguous econometric test of the proposition that, other things equal and except in certain unusual cases, reducing the tariff on an imported good will increase a country's real GDP. The reason this proposition is so widely accepted by economists is not that it has been confirmed conclusively by econometric tests but rather that the underlying theory is compelling and there is a lot of evidence, both statistical and direct, which is consistent with the theory. In our view the status of conventional minimum wage theory is comparable.

Finally, there is a common tendency to *underestimate* the effects of prices on quantities of goods and services demanded and supplied. This led the late Nobel Laureate George Stigler, a master of irony, to propound the following 'law':

> … most people believe that all supply curves are completely inelastic and all demand curves are completely inelastic too!

In other words, the common belief is that people respond little to price changes. A relatively recent striking manifestation of Stigler's law was the extent to which experts (including many economists) underestimated the effect of the substantial increases in oil prices in the 1970s on oil consumption. Thus organisations, including the US Department of Energy, Exxon, the CIA and the US Congressional Research Service, made predictions in the late 1970s of world oil consumption in 1985 that turned out to be between *50 and 80 percent too high.* The reason was essentially that these forecasters grossly *underestimated* the extensive opportunities to economise in the use of oil in response to a price increase (van Vector and Tussing, 1987). Other manifestations of the prevalence of Stigler's law are the numerous examples from many countries of widely unanticipated surpluses of stocks of agricultural products such as meat, dairy products and wool resulting from artificially supported prices for such products.

In summary, although still controversial in some circles, our conclusion is that both widely accepted theory and the balance of statistical evidence support the proposition that the most likely outcome of increasing a binding minimum wage rate is that employment will fall. Even if the negative effect is small it cannot be assumed that the number of people precluded from jobs is small because new, more productive entrants may displace people who would otherwise have jobs. In our opinion it would therefore be unwise to raise minimum wages in the belief that negative effects on employment will be minor or even positive, especially in the longer term. The fact that the predictions of the effects of changes in product and input prices have in the past often turned out to be too low is an added reason why it would be prudent to base decisions on minimum wage rates on the premise that higher minimum wages will preclude substantial numbers of people from obtaining jobs.

1.4 Losses imposed on people precluded from jobs

The main kinds of losses suffered by people who are precluded from employment or who lose their jobs are:

- loss of earnings and consequent reduced access to goods and services;
- loss of opportunity to acquire on-the-job training;
- loss of opportunity to maintain or establish a reputation as a good employee; and
- psychological stresses including loss of self-esteem attributable to being without a job which may encourage dependency on welfare support.

The effect of earnings losses on access to goods and services can be expected to vary with circumstances including entitlement to the community wage, access to private financial assistance, age, composition of the household in which the displaced worker resides, regional differences in costs of living and differences in work-related costs (eg travel, clothing). For example, preclusion from a job by a minimum wage can be expected to constrain consumption for an adult with few assets and no access to private assistance more severely than a similar loss of income for a young university student living with his or her parents.

The cost of loss of opportunity to acquire on-the-job training is measured conceptually by the present value of the associated loss of future earnings over a person's working life. Although these losses are easily overlooked, in purely financial terms they may be high, to the extent of overshadowing the immediate income losses attributable to preclusion from employment, especially for a young person attempting to get a foothold in the labour market.

Loss of opportunity to maintain or establish a reputation as a good employee can be damaging because employers rationally tend to use a person's unemployment record as an indicator of labour quality. For example, where an employer cannot be sure of the reason that a job applicant was dismissed from a previous job, it is rational for her to assign a positive probability to unsatisfactory performance as the cause, even if a job has in fact been made unprofitable by a minimum wage.

Loss of self-esteem can be expected to reduce the prospect of finding a job, especially for people who remain unemployed for long periods. They become dependent on welfare and add to its costs. In December 1997 just over 57,600 people or 3 percent of the labour force were registered as being unemployed for at least one year. Raising minimum wages can be expected to further reduce the likelihood that these people will find jobs.

The last three kinds of losses are interrelated. Loss of reputation and loss of self-esteem combine to make finding a job difficult, which in turn precludes on-the-job training. Putative earnings losses from the combined effects of loss of reputation, loss of self-esteem and loss of training are likely to be especially high for young people who, by being priced out jobs by minimum wages, become discouraged job seekers. Moreover, they tend to be more severe for the least productive people – those who are at the bottom of the wage distribution because they lack education and training or because of innate characteristics which limit their productivity.

In summary, although it is natural to focus in the first instance on the welfare consequences of income losses, the interrelated effects of loss of self-esteem, loss of reputation and loss of training opportunities have additional debilitating effects on the lives of people precluded from employment by minimum wages.

2.0 Producers and consumers

The effects of an increase in minimum wages on producers and consumers can be expected to vary across industries depending principally on:

- the share of unskilled labour costs in total production costs; and
- whether the product is a traded or non-traded good or service (the main determinant of the extent to which cost increases can be passed on to consumers).

While no cost increase is likely to be viewed favourably by producers, because the wages of most workers will remain unchanged (or change by relatively small amounts) the effects of an increase in minimum wages on profits are unlikely to be large in most cases. This will be less true for traded-goods industries where producers cannot pass on cost increases to consumers because prices for their products are determined in international markets.

However, this does not preclude the possibility of significant effects on the profits of particular firms. For example, in parts of the agricultural sector, where unskilled labour costs may constitute relatively large proportions of total costs (such as fruit growing), some producers may experience substantial reductions in profits, especially if their ability to pass on costs to consumers is limited by competitive pressures from imported products. Importantly, since some of these producers may already have low incomes it is far from clear either that increasing minimum wages will 'improve' the distribution of income or be consistent with generally held notions of fairness.

Similarly, although the effects of an increase in minimum wages on the prices of most products can be expected to be small, prices for some non-traded, unskilled labour-intensive goods, such as fast foods, may rise substantially. Effects of this sort were noted by some economists following the 10 percent increase in the minimum wage in 1997. Since some consumers of these products have low incomes it is again unclear that the impact of higher minimum wages will be consistent with either 'improving' the distribution of income or fairness.

II COMPARING BENEFITS AND COSTS

Besides considering the effect on economic efficiency and national income of altering market-determined wage rates, assessing the desirability of raising minimum wages also entails weighing the expected gains to the beneficiaries against the losses inflicted on the losers.

3.1 Assessing the worth of benefits

For a variety of reasons, people on minimum wages are not necessarily in a position of financial hardship, and the benefits of minimum wage increases as a poverty alleviation device may therefore be limited.

- Although low incomes are a cause of hardship for some people, not all low-wage employees can be considered to be financially disadvantaged – some in the early years of their working lives can expect to have adequate incomes in the future (eg many students, apprentices) and some are members of households which are not financially stressed (those with spouses in paid work, young people). A Treasury analysis found that low-waged youth are spread relatively evenly across all household income bands. Those on the adult minimum wage were also found to be spread widely but with a tendency to be concentrated on the central quintile.

- Low paid jobs are for most people a stepping stone to higher paid jobs. For example, a recent UK study found that 55 percent of a random sample of workers in the bottom quintile of the earnings distribution had moved to higher quintiles two years later (Sloane and Theodossiou, 1996). In an analysis of income mobility in New Zealand, Barker (1996), reported that at least 25 percent of taxpayers in the lowest income quintile had joined higher income groups one year later. Similarly, although at any given time about 5 percent of the US workforce is employed at a minimum wage, about 60 percent of the workforce has been paid a statutory minimum wage at some time in their working lives (Card and Krueger, 1995).

- Low pay and financial stress may not be closely correlated. A UK study showed that less than 30 percent of people who were in the bottom quintile of the earning distribution in 1991 and still there two years later were from low income households (household income in the bottom quintile). This suggests that income transfers effected by minimum wages may not be closely targeted on people from financially stressed households (Sloane and Theodossiou, 1996).

- Overseas research shows that hours of work rather than pay rates are a key factor affecting poverty. Lawrence Mead emphasised at the 1997 'Beyond Dependency' conference that 'non-work' rather than low pay was the main cause of poverty for the long-term poor in the United States. Research in the United States has shown that in 1954 two thirds of the heads of poor families were employed and almost a third were employed on a full-year and full-time basis. By 1995, only 52 percent of heads of poor families were employed and only 19 percent worked full year and full time.

3.2 Assessing the consequences of job preclusion

Loss of earnings can be expected to cause practical problems and stress for many of those deprived of jobs. The severity of the problems can be expected to depend on their circumstances, notably duration of unemployment, access to unemployment benefits, and access to private financial and other kinds of assistance.

- Based on a survey of 1479 unemployed people in the United Kingdom in 1973, Daniel found that "… financial considerations were paramount in determining the degree of concern about being out of work among the unemployed", with 72 percent of the 924 people who felt concerned about being unemployed regarding lack of money as the worst consequence (Daniel 1974, p 44).

The nature and severity of the personal and mental stresses attributable to being involuntarily unemployed presumably varies according to the circumstances and personalities of the people concerned. However, some notion of the severity of the stress of unemployment can be gleaned from the following observations, mostly from psychologists.

- Kelvin and Jarrett (1985, p 6) write of "… consistent evidence that human beings need a sense of purpose and structure to their lives; that the vast majority derive this purpose and structure very largely from their work; and that to be unemployed is therefore for most people deeply disturbing, distressing and debilitating."

- "In the eyes of the people who had experienced it, unemployment was seen almost invariably as unpleasant and sometimes highly distressing. Over half of those who had been unemployed at any time after redundancy described it as the worst thing they had ever experienced" (Westergaard *et al*, 1989, p 95).

- "The unemployed often become uneasily aware that as time goes on they develop a kind of inertia that is psychologically debilitating. They feel insufficiently stimulated and under-valued. The terms they use to describe their condition include 'depression', 'boredom' and 'laziness'. They feel increasingly that they are becoming not only occupationally, but psychologically deskilled" (Hill 1978, p 118).

- "Discussions of human consequences of unemployment are full of references to how it lowers self-esteem, saps self-confidence, undermines self-reliance, induces self-disgust, heightens self-consciousness, and so on – all of which cumulatively implies a profound change in the individual's self-concept" (Kelvin and Jarrett 1985, p 44).

- "It seems wholly likely that family life is shaken by unemployment – often to the point of disintegration – and we have evidence that points towards possible increases in divorce, domestic violence, abortions and unwanted pregnancies, parental and infant mortality, and morbidity in wives and children, as well as evidence of failure of growth in children" (Smith 1987, p 137).

- "In day-to-day practice, social workers observe that behaviour problems associated with stress and stress-induced disorders accelerate with unemployment. Recent research on social indicators bears out this observation. For example, child abuse, suicide, sclerosis of the liver (indicative of alcohol abuse), and cardiovascular and urinary diseases (indicative of too much stress) have been demonstrated to increase with increases in unemployment" (Keefe 1984, p 264).

- In a study of suicide and unemployment in Australia, Morrell *et al* (1993, p 755) conclude that statistical evidence "... supports the hypothesis that unemployment is significant as a predisposing factor for increasing the risk of suicide, especially for males." As Maley observes in commenting on this study, given that this is especially true for males in the 20–24 age group," ... we have strong grounds for criticising public policies which are, predictably but avoidably, exposing thousands of young men to the kinds of anguish, idleness and despair that arise from unemployment and which, for too many of them, may have suicide as one of its consummations" (Howard *et al*, 1995).

3.3 Other considerations

Both the beneficiaries and the nature of the benefits resulting from an increase in a minimum wage are readily identified. Importantly, these beneficiaries *can readily identify themselves* and are therefore likely to be strong supporters of minimum wage legislation. In contrast, those who suffer losses as a result of an increase in a minimum wage *cannot be readily identified*. In particular, few, if any, losers can know with certainty that they are the victims of minimum wage legislation. A loser knows only that she does not have a job – the minimum wage legislation which may have caused this misfortune is only one of many imaginable reasons why she cannot find one. For these reasons popular support for minimum wages tends to be strong, while the plight of losers can be easily overlooked.

Apart from the risk of inflicting severe losses on people who are already disadvantaged, there are at least two other substantial reasons for opposing an increase in minimum wages. First, if only because the people precluded from employment cannot be reliably identified, the effects of raising minimum wages on the distribution of income and wealth cannot be reliably predicted. However, there can be no presumption that income transferred from owners of businesses and consumers to beneficiaries of higher minimum wages will be systematically correlated with ability to pay. Indeed, perverse effects on generally accepted notions of equity seem inevitable. For example, minimum wages can be expected to transfer income from people with low incomes who buy take-away foods to some young people employed in the industry who currently have adequate incomes and who may well expect to have relatively high incomes in later life (eg students, apprentices). Similarly, since many business enterprises fail, often with disastrous financial consequences for their owners, there will inevitably be cases where minimum wages transfer income from low-income employers to employees who are not financially stressed.

The second (and in our view more important) reason is that appropriately designed tax-financed income transfers are better instruments for achieving the objectives of a minimum wage. Moreover, whereas minimum wages achieve their objective by impeding the functioning of labour markets, appropriately designed tax-financed income transfers leave people free to use markets to search for and negotiate welfare-improving employment contracts with employers. In view of the nature and severity of the consequences of unemployment as sketched above, the significance of this cannot be overestimated. To deprive a person of the freedom to decide whether he or she would be better off with a job at a negotiated wage below a statutory minimum (possibly offering prospects of higher future wages) or without a job and dependent on the community wage is, in our view, a substantial injustice.

For these reasons we consider that efforts to improve the welfare of people at the lower end of the productivity spectrum should be shifted away from minimum wages toward income support measures financed by government revenue. The role of the community wage in determining the reservation wage and thereby ensuring a minimum level of welfare for *people with jobs* should be clearly recognised. Provided people are aware that the community wage is available, and absent deception and fraud, they will typically not accept a market wage and other conditions of employment which leave them worse off than being without a job and on the community wage. Thus, a safety net based on the community wage tends to equalise the welfare of low productivity workers with and without jobs.[5] Such a safety net is clearly more equitable than a minimum wage, which confers relatively small advantages on the majority of low-productivity workers fortunate enough to hold on to their jobs but damages the minority who are precluded from jobs, possibly severely in some cases. Moreover, the establishment of a minimum wage at a level in excess of the community wage would deny some people the opportunity to earn an income that is higher than they would obtain without a job.

If the earnings of the minority of low-productivity workers whose wages remain persistently low are judged to be inadequate, other forms of income support, such as the guaranteed minimum family income or low-income earner tax rebates, should be re-examined. The advantages of these measures, relative to minimum wages, are that they can be targeted on those whose earnings can be expected to be persistently low and that they do not unduly preclude access to the labour market.

There are two common but unconvincing objections to shifting the emphasis from minimum wages to transfer payments. The first is that in the absence of minimum wages, employers are claimed to be able to 'exploit' low-productivity workers. However, as pointed out above, no employee will knowingly accept an employment contract which makes him (her) worse off than on the community wage. The worker

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5 This does not imply that incomes will be equalised, the (presumed) higher incomes of those with jobs reflecting the disutility of working and loss of leisure time.

with alternative job opportunities is a very difficult worker to exploit. As Alchian and Allen (1983) observed in relation to collective bargaining:

> … employers compete against other employers, and employees against other employees – not employees against employers, as folklore says. It is the availability of higher-valued alternatives … that increases bargaining power.

The best form of 'worker protection' is a well-functioning competitive labour market with high levels of employment. Minimum wages are an obstacle to full employment. Moreover, the presumption that 'exploitation' allows higher profits rests on limits to competition for workers. If workers are mobile, competition at the margin is not limited. The possible damage to employees from 'exploitation' in the absence of a minimum wage should be compared with the damage to those precluded from employment by a minimum wage.

A second objection is that the effect of income support is to deliver a subsidy to employers. Income support payments can be expected to shift the labour supply curve of low-productivity labour to the right, thereby tending to lower wage rates for low-productivity labour. The benefits of this shift will be shared between employees and consumers depending partly on elasticities of demand and supply. They cannot go to employers who (in competitive labour and product markets) will only be able to earn a normal rate of return. It is worth noting in this context that some economists regard employment subsidies as an important instrument for ameliorating unemployment (see, for example, Phelps, 1997; OECD, 1997). This view is contingent on the absence of superior instruments (eg the removal of labour market rigidities) for promoting employment. The use of income support measures as proposed does not depend on a 'second-best' justification of this kind and, given that it will expand output and hence employment and does not add to employers' returns, it is hard to see valid objections to it.

Income support programmes such as the guaranteed minimum family income and the former training allowance have not attracted criticism on the grounds that they constitute an employment subsidy. Schemes such as the guaranteed minimum family income are targeted to low income families with dependents and the family status of a worker is not normally a factor for an employer in determining wage rates.

In summary, a statutory minimum wage cannot be targeted closely on people who are likely to face continuing financial hardship and the burden of these transfers is not shared equitably over the population. For these reasons, we consider that it is not an appropriate instrument for underwriting income levels in accordance with the objectives of producing a more desirable distribution of income and wealth and a fairer society. Income support measures are likely to be superior instruments for raising the earnings of low-wage employees because they can be targeted on genuinely disadvantaged employees, the cost is shared more equitably across households, and the labour market is left to do its prime job of matching the supply of and demand for labour.

III CONCLUSIONS AND RECOMMENDATIONS

We oppose increasing minimum wages mainly because there are convincing reasons for expecting that at least some people, conceivably numbering in the thousands, will be precluded from jobs. Because they tend to be the least profitable to employ, people whose productivity is low (either because they lack education and training or have low innate abilities) are those most likely to be precluded from employment. The combined effects of loss of income, loss of training opportunities, loss of reputation, and loss of self-esteem may have serious consequences for already disadvantaged people over their entire working lives. These effects may extend to other members of their households.

Undoubtedly a number of people would gain from higher minimum wages. However, in our opinion, the social benefits of these higher wages would be outweighed by the adverse consequences for those precluded from jobs. Factors which have been taken into account in making this judgment are that the benefits of minimum wages are poorly targeted on financially stressed households; the resultant redistribution of income may in some cases not be consistent with generally accepted notions of fairness; and that there are superior policy instruments for improving the welfare of low-wage employees.

If the incomes of low-wage employees are judged to be inadequate, the appropriate remedy is to provide some form of income transfer, which does not create an undue obstacle to welfare-enhancing employment contracts through the labour market.

The negative effects of higher minimum wages on employment would almost certainly be more severe if demand for labour is weakened by the effect of the current global instability on aggregate demand in New Zealand. Consequently this is an especially inauspicious time to raise minimum wages

Finally, whether or not minimum wages are raised, in our view provision should be made to allow people to opt out of the provisions of the legislation in certain circumstances. Those would include people in jobs which contain a training component, new entrants to the labour market, and people unemployed continuously for more than 6 months.

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