

Chapter 4: Minimum wages and their effect on employment

Introduction

- 4.1 Section 23(a) of the WR Act requires the Commission, when performing its wage setting function, to have regard to:

“the capacity of the unemployed and low paid to obtain and remain in employment”.

- 4.2 This chapter outlines new international research that assesses the impact of minimum wages on employment.

Economic analysis

Effects of minimum wages

- 4.3 In its 2006 Minimum Wage Review decision, the Commission noted that “on the basis of the evidence available, the Commission considers that there is a negative relationship between the level of minimum wage increases and employment in Australia. The basis for any disagreement seems to involve the magnitude of the relationship rather than its existence”.⁷
- 4.4 In its submission to the Commission’s 2006 Minimum Wage Review, the Government presented a summary of results from international and Australian studies which investigated the relationship between minimum wage increases and employment. The overwhelming majority of these studies found that excessive minimum wage increases had a negative impact on employment.⁸
- 4.5 Since the Commission’s 2006 Minimum Wage Review decision, Neumark and Wascher have published a comprehensive international literature review in relation to the effects of minimum wages on

⁷ Australian Fair Pay Commission, *Wage Setting Decision and Reasons for Decision*, 2006, page 73.

⁸ Australian Government Submission to the Australian Fair Pay Commission 2006, pages 52-57.

employment.⁹ Neumark and Wascher found that of the 86 international studies surveyed, the vast majority of these studies indicated that minimum wage increases had a negative effect on employment. The Government presents a more in-depth summary of this literature review later in this chapter.

The minimum wage ‘bite’

- 4.6 An important consideration in setting minimum wages is the relative value (or the bite) of Australia’s FMW. The bite is commonly measured as a proportion of the minimum wage to full-time median earnings.
- 4.7 In comparison with other countries, Australia has the second highest minimum wage bite in the OECD (57.1 per cent) behind France (58.0 per cent) (see Table 4.1 below).¹⁰

⁹ D Neumark and W Wascher, ‘Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research’, National Bureau of Economic Research, Working Paper 12663, November 2006.

¹⁰ These data are the most recent data available but do not include the Commission’s 2006 increase to the FMW.

Table 4.1: Adult minimum wages relative to full-time median earnings, mid-2005.^A

Country	Percentage	
France	58.0	
Australia ^B		
- LFS	57.1	
- ES	53.6	
New Zealand	56.1	
Ireland	54.5	
Greece	48.8	
Belgium	48.0	
Netherlands ^C	46.0	[49.7]
United Kingdom ^D	44.9	
Canada	39.9	
Portugal ^E	37.6	[43.9]
Japan	33.2	
Spain ^E	32.8	[38.3]
United States	32.0	

Source: Minimum wages and median earnings for full-time workers: OECD estimates and OECD Earnings Structure Database, as cited in the UK Low Pay Commission Report 2007 - National Minimum Wage, March 2007, Table A4.2, page 322.

Notes:

^A In all cases, the minimum wage refers to the basic rate for adults. Except for the UK and US, the median earnings data for full-time workers for mid-2005 are estimates based on extrapolating data for earlier years, in line with other indicators of average earnings growth. All earnings data are gross of employee social security contributions.

^B Two estimates of median earnings are available based on the Labour Force Survey (LFS) and an Enterprise Survey (ES). In each case, the data refer to weekly earnings. The minimum wage refers to the Federal Minimum Wage.

^C The ratio including 8 per cent supplement for holiday pay is given in parentheses.

^D Differs from the Low Pay Commission estimate in Chapter 2 (Table 2.2), as the OECD estimate is for full-time, rather than all, employees.

^E The ratio including annual supplementary pay of two additional months of salary is given in parentheses.

Neumark and Wascher

4.8 In November 2006, Neumark and Wascher published a comprehensive literature review titled 'Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research'.¹¹ The authors analysed the effects of minimum wages on employment in the United States and other countries, including Australia.

¹¹ D Neumark and W Wascher, 'Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research', National Bureau of Economic Research, Working Paper 12663, November 2006.

- 4.9 Consistent with the Commission's finding that minimum wages have a negative effect on employment in Australia, Neumark and Wascher discovered that the vast majority of the 86 international studies they investigated found that minimum wages had a negative effect on employment.
- 4.10 In general, Neumark and Wascher described the results from their literature review as follows:
- "...about two-thirds give a relatively consistent (although by no means always statistically significant) indication of negative employment effects of minimum wages – where we sometimes focus on results for the low skilled – and fewer than 10 give a relatively consistent indication of positive employment effects".*¹²
- 4.11 As noted earlier, in its 2006 Minimum Wage Review decision, the Commission stated that the basis for any disagreement about the employment effects of the minimum wage involved the magnitude of the relationship rather than its existence.¹³ Neumark and Wascher found that the wide range of estimates in the United States studies "undoubtedly reflects both the new sources of variation used to identify minimum wage effects – notably increased state-level variation in minimum wages – and the new approaches and methods used to perform the relevant hypothesis test."¹⁴ Neumark and Wascher also found that the range of estimates would be considerably wider if they included estimates for narrower subsets of workers and industries or estimates from other countries.¹⁵
- 4.12 Importantly, Neumark and Wascher found few (if any) cases where a study provided convincing evidence of positive employment effects of minimum wages, especially from studies which focused on broader groups rather than a particular industry. Neumark and Wascher also noted that studies which focussed on low skilled groups found that these groups were adversely affected by minimum wages.¹⁶

¹² Ibid, page 115.

¹³ Australian Fair Pay Commission, *Wage Setting Decision and Reasons for Decision*, 2006, page 73.

¹⁴ D Neumark and W Wascher, 'Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research', National Bureau of Economic Research, Working Paper 12663, November 2006, page 114.

¹⁵ Ibid, page 114.

¹⁶ Ibid, page 115.

4.13 Neumark and Wascher recommended a number of areas where researchers could undertake additional work to better inform the minimum wage debate.¹⁷ The Commission may wish to consider these suggestions for its research programme.

- Firstly, Neumark and Wascher proposed additional research to address the issue of potential endogeneity of minimum wage policy to economic conditions. Most studies to date have largely ignored this issue, thereby biasing reported estimates.
- Secondly, Neumark and Wascher noted the need for more direct evidence regarding which model better characterises the low-wage labour market – the monopsony model or the competitive model. They argued that existing empirical evidence appears to be inconclusive.
- Thirdly, Neumark and Wascher argued that most studies to date focus on the employment effects of the minimum wage rather than overall labour input. They stated that while a few studies have looked into this issue, more research is required.
- Finally, Neumark and Wascher argued that given the variations of modelling estimates across studies, a systematic assessment of the sources of differences in the estimates across studies needs to be conducted. This, they argued, would provide complementary evidence to improve understanding of the existing literature.

Conclusion

4.14 In its 2006 Minimum Wage Review decision, the Commission concluded that based on the available evidence there was a negative relationship between minimum wage increases and employment in Australia.

4.15 A recent literature review by Neumark and Wascher noted that the overwhelming majority of 86 international studies found that minimum

¹⁷ Ibid, pages 117-118.

wages had a negative effect on employment. The paper contains some useful suggestions for future research into this issue.