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SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO

THE WORKPLACE RELATIONS FRAMEWORK

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About the Mannkal Economic Education Foundation

The Mannkal Economic Education Foundation ("Mannkal") is a policy institute founded in Western Australia to encourage the free market system, both in Western Australia and Australia more broadly. Mannkal promotes the values of voluntary co-operation, choice, personal rights, limited government and responsible resourcefulness of individuals.

Introduction

Given the breadth of issues considered in this inquiry, wishes to focus on minimum wages, specifically the divergence between the theory of minimum wages and their application. Mannkal wishes to highlight that minimum wages are an indirect and inefficient means of achieving a purpose, namely ensuring social welfare, and thus not only incur unnecessary costs but also fail to achieve their objective in full and in many cases create perverse outcomes.

Minimum Wages – definition and purpose

A minimum wage is an employee's base rate of pay for ordinary hours worked and is generally dependent on the industrial instrument that applies to their employment (for example, a modern award, enterprise agreement, transitional pay scale, or national minimum wage order). Minimum wages in Australia date back to the 1890s, when "Minimum Wage Boards" were introduced by the Victorian Government.

The minimum wages received by employees in the national workplace relations system are determined annually by a specialist Minimum Wage Panel of the Fair Work Commission, with any determinations made to vary minimum wages in modern awards or a national minimum wage order applying from the first full pay period on or after 1 July each year.

The national minimum wage is currently \$16.87 per hour or \$640.90 per 38 hour week (before tax) while casual employees covered by the national minimum wage also receive at least a 25 per cent casual loading.

The purpose of the minimum wage is to provide a "living wage", a wage deemed to be sufficient for a person (and their family) to live comfortably on in the Australian community. It is therefore clearly a welfare measure. The source of the minimum wage is altruism; a sentiment among the community that none of its members should be consigned to penury. This sentiment is undeniably admirable, however it is vital that the outcome envisaged in that sentiment be achieved in reality without excessive transaction costs or unintended consequences. However, Mannkal believes that the operation of minimum wages has clearly failed this test and is in fact an indirect and unsuitable mechanism for achieving a welfare objective.

Operation of Minimum Wages

Minimum wages are by definition an economic and labour market instrument and represent a clear and deliberate intervention in the labour market. The labour market exists as a means of supplying and purchasing labour without any expressed goal about how its outcomes will satisfy the base welfare needs of either side (other than, presumably, a hope from the suppliers that these needs will be fulfilled). The graph on the following page is a standard graphical representation of the supply-demand balance in the labour market:

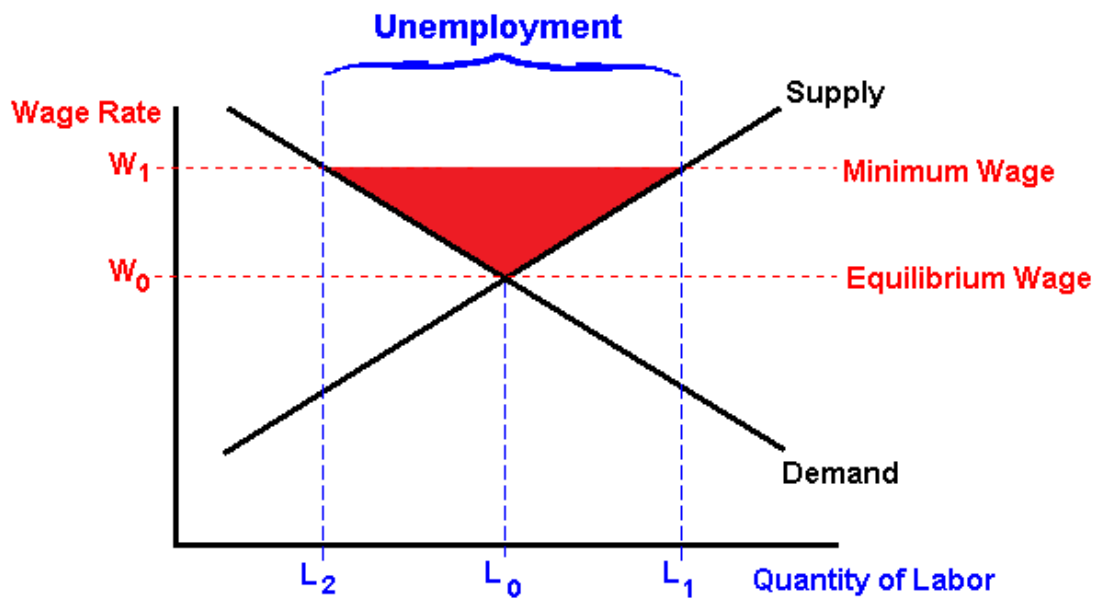


Figure 1: Unskilled Labour Market

As seen from Figure 1 above, a labour market allowed to clear at a price that represents the unadulterated supply-demand balance will reach a level of employment at L_0 and wages at W_0 , the “equilibrium wage”. The existence of minimum wages intrinsically assumes that the market-clearing equilibrium wage – in at least some sectors – would be below that deemed necessary to provide for a person’s welfare. In the case where this assumption were untrue – for example, in the market for unskilled labourers to work on mining sites during Western Australia’s recent mining boom – the minimum wage would be irrelevant and ignored by both sides of the labour market, representing only a pointless cost involved in maintaining it (fees for Fair Work Commissioners, costs of wage monitoring, et cetera).

The significant economic problem with minimum wages occurs when minimum wages are set above the market-clearing equilibrium wage, as shown in Figure 1. The mandated higher wage at W_1 results in both an increase in the supply of labour and a reduction in its demand, with the difference between L_1 and L_2 (the shaded red area) representing those who will not be employed, and the difference between L_0 and L_2 representing those who will lose their employment upon the imposition of a minimum wage – or, post its imposition, those who could have been employed, but never were. At L_2 , employment is reserved for the most highly skilled, experienced and connected workers.

Unintended consequences

Several problems arise from this intervention in the labour market on the basis of welfare objectives, problems that harm the welfare of some workers, unnecessarily enhance the welfare of others, and damage the economy as a whole.

The rationing of work implied in Figure 1 above by the lower level of employment at L_2 was first identified by Nobel Laureate, George Stigler, in 1946¹. Stigler found that while the wage rate would rise from W_0 to W_1 , the total level of wages (i.e. the product of W_1 and L_2) would be lower than it would be if the market were allowed to clear at the equilibrium wage. It is a perverse outcome that a measure intended to enhance welfare results not only in lower total wages but also in a fall in employment. The discrete nature of employment or unemployment means that wage rises that eliminate jobs do not create a linear trade-off in welfare; the 100% decrease in welfare for a worker who loses their job is not offset by a 100% rise in the welfare of a worker whose wages rise by some increment². Moreover, the higher hourly wages may lead to those who remain employed receiving fewer working hours and an increased casualization of the workforce.

Second, the effective rationing of jobs leads to a reasonable expectation that those employed will be those with the most skills, experience or personal connections to call upon. This effect tends to shut out the young and poorly skilled from the labour force – those who may be considered more likely to require some welfare support than the elder, more experienced and skilled workers. A minimum wage prevents those with surplus time (often, young workers) from pricing their labour at a lower value more reflective of its surplus nature, and prohibits those with no or few skills from offering their skills at a price that may make them more attractive to employers. By shutting out such workers, the minimum wage creates barriers to labour market entry and human capital growth³. One of the important features in any successful industry is the passing of knowledge and skills through generations of workers, with the new entrants progressively graduating to roles of greater skill and seniority. Where the young are precluded from participating, this crucial transfer, necessary to maintain and enhance the industry's productivity, is hindered.

¹ Stigler, G.J. 1946 "The Economics of Minimum Wage Legislation", *The American Economic Review*, Vol. 36, No. 3 (Jun., 1946), pp. 358-365

² Friedman M, 1966 "Minimum-Wage Rates" *Newsweek*, 26 September

³ Neumark, D & Wascher, W 2010, *Minimum Wages*, MIT Press, USA

Third, the minimum wage applies to all workers regardless of their level of wealth. A welfare measure should be discriminate – that is, it should be deliberately targeted to remedy instances of hardship. The imposition of a minimum wage will affect all workers employed, irrespective of whether each individual actually needs the minimum wage to survive. It is likely that some older and wealthier workers will remain in the workforce under a minimum wage, whereas if workers with lower skills were able to price their labour accordingly and in so doing push down the market-clearing price of labour, some workers who consider the market-clearing price insufficient compensation for their labour may choose to exit the workforce, thus freeing up opportunities for those prepared to work for lower wages. The minimum wage is thus a perverse cross-subsidy paid in some instances to workers who are more financially secure at the expense of those who are less financially secure.

A similar effect is clearly seen in the imposition of penalty rates, which are an increased rate of pay – an augmented minimum wage - for overtime or for work performed under abnormal conditions, often seen in sectors such as hospitality in which the prime operating hours are outside standard business hours. The hospitality sector tends to attract young people, such as university students, to work during evenings, weekends and public holidays. The imposition of penalty rates for working outside traditional business hours of Monday to Friday, 9am to 5pm, assumes that these workers experience hardship in offering their labour during these times.

However in the cases of many this assumption is wrong. For many young students whose university or apprenticeship schedules require them to study during regular business hours, the only time they are available to work is during evenings, weekends and public holidays. Rewarding them with penalty rates is unnecessary and irrelevant to their decision to work, rather than a compensation for hardship or additional effort. Further, many choose temporary low-wage employment in hospitality as a lifestyle and a direct trade-off to higher wages later in life upon the completion of their courses or apprenticeships. Finally, the most tragic outcome is when businesses simply choose not to open during nights, weekends and public holidays because the higher wage costs due to penalty rates would render operating unprofitable. In this case, all parties lose: the business loses custom, profit and potentially its branding or reputation, the workers lose any opportunity to earn, the Government forgoes potential tax revenue and potential customers neglected.

The world has changed vastly since the introduction of minimum wages in the 19th Century. Advances in communications technology have resulted in significant outsourcing of work that previously was domiciled in Australia to overseas providers, particularly low-value-added, data-intensive work that does not require client interaction. In light of this development, minimum wages discriminate against Australian employees by in some cases pricing them out of the market against foreign competitors. Wages of (for example) IT workers based in the Philippines and India are very low and unlikely to be matched by Australian workers, but by prohibiting Australian providers from narrowing the gap, minimum wage legislation removes any ability for domestic providers to attempt to compete.

Minimum wages no doubt enhance the welfare of some workers. It is clear, however, that some of these workers do not need this assistance – and indeed, many workers in the direst need miss out. A measure designed to enhance welfare in reality:

- reduces overall welfare and economic activity;
- rewards some who do not need any welfare support;
- induces hardship that did not previously exist (for those who lose employment);
- fails to address the welfare needs of many unskilled and young workers and in fact makes their situation more dire by erecting a price barrier to their participation in the labour market;
- shifts the responsibility for providing a welfare solution from the government's welfare budget to the labour market; and
- Discriminates against Australian workers in a rapidly globalising labour market.

This failure of minimum wages is explained by the indirect nature of their application: minimum wages are an economic measure, more precisely a labour-market instrument, mistakenly used to achieve a welfare goal. In addition to being indirect, minimum wages are also indiscriminate by failing to target individual circumstances – neither the identity of people with welfare requirements, nor the amount of support each might require.

Recommendation

On the basis that minimum wages are an expensive, inefficient, grossly sub-optimal and even counter-productive measure of providing welfare, Mannkal recommends the abolition of minimum wages and their replacement with direct welfare measures of income support. Replacing minimum wages with direct and targeted income support payments will:

- unshackle the labour market and allow it to operate purely as a labour market rather than a self-contradicting hybrid labour market/welfare mechanism;
- allow the labour market to generate more activity and higher tax revenues that will provide the necessary funds for income support measures;
- lower the overall welfare bill by only providing welfare to those in need and for the amounts required;
- remove barriers to labour market entry, thus increasing the welfare of many in the greatest need;
- eliminate artificial wage and price inflation created by minimum wages;
- allow wages to more accurately reflect supply and demand and thus better inform the decisions of labour market participants; and most importantly
- increase overall welfare.

Conclusion

The story of minimum wages is possibly the starkest example of the unintended consequences of good intentions. The laudable altruism driving the underlying concerns belies a failure of policy: by seeking to resolve welfare issues via the indirect mechanism of labour market intervention rather than direct income support payments, the system rewards some who are in no need, ignores some of those in the greatest need, hinders the ability and desire of others to produce and is extremely expensive (in terms of both direct and opportunity costs). The tragedy of this manifest failure is that despite over 100 years of minimum wages visibly failing those they are intended to help, precious little has been done to remedy the situation.