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## **MINIMUM WAGE SETTING AND THE AUSTRALIAN FAIR PAY COMMISSION**

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In his speech to federal parliament on 26 May 2005, the Prime Minister announced that the government, as part of its new package of industrial relations reforms, intended to transfer responsibility for setting and varying minimum wages and other rates of pay in awards from the Australian Industrial Relations Commission (AIRC) to a newly created Australian Fair Pay Commission (AFPC). While the explicit rationale for this change is not clearly enunciated in the speech, the implied presumption is that such a change will help foster increased employment, continued productivity growth or both.

Details of how this new body is to operate were not available at the time of writing but the expectation is that it will be modeled on the Low Pay Commission established by the Blair Labor Government in the UK, and thus will comprise a relatively small number of economic experts and industry representatives appointed by the government. Unlike the UK Low Pay Commission, however, the Prime Minister's speech suggests that the AFPC will be more than an advisory body and will, like the current AIRC, have the power to directly set and vary wages in awards.

But what difference will simply transferring powers from one statutory body to another make? Answering this question is the central objective of this short article.

## The Case for Change

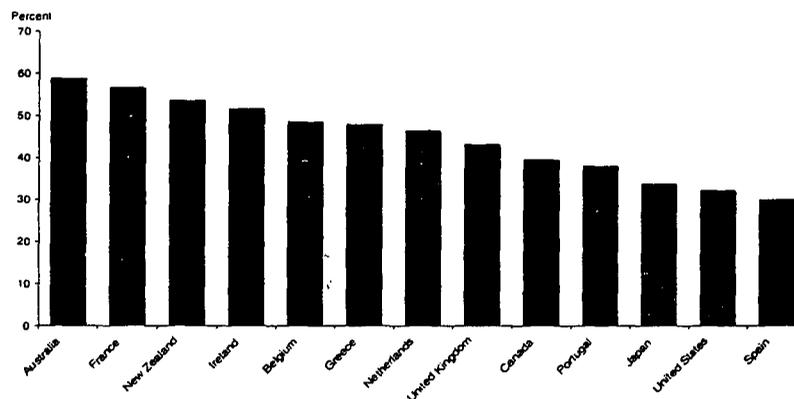
The case for removing responsibility for setting award wages from the AIRC can be made on at least four grounds. First, Australia's minimum wage is relatively high compared with most other developed countries, which in turn is acting as a barrier to further employment growth, particularly for those with relatively few labour market skills. The recent report of the UK Low Pay Commission (2005, pp. 233-241), for example, reported on data for 13 OECD countries for 2004 which showed that relative to full-time median earnings, the adult minimum wage in Australia was higher than for any other country in their list. These figures are reproduced in Figure 1. At a minimum such figures call into question claims that Australia has failed to meet its obligations under international law (e.g., Brosnan 2005). Under ILO conventions member states are required to guarantee 'adequate wages'. This of course leaves open the question of how to determine what is "adequate". Nevertheless, Figure 1 clearly demonstrates that minimum wages in Australia (at least within the federal jurisdiction) provide a much higher level of relative income than in any other OECD country, with the possible exception of France.

Many economists, including myself, however, would argue that minimum wages need to balance the interests of workers against those of the unemployed, and ratios between minimum wage and median earnings of close to 60 per cent are indicative of a system that prices many of the unemployed out of the labour market. The actions of the AIRC, however, in persistently raising the federal minimum wage over time thus suggests that either it does not care about the jobless or that it believes there is no relation between the price of labour and the volume of employment.

A second argument is that the AIRC does not have the expertise that would enable it to make sound decisions which take account of the economic effects of minimum wage increases. Many would contest this. Briggs and Buchanan (2005, p. 188), for example, have argued that the application of 'exacting standards of evidentiary proof' ensure that the AIRC's decisions are economically sound and as a result their decisions have been 'broadly in line with other international institutions'. Similarly, Peetz (2005, p. 98) points to the amount of time that is devoted

to the employment effects of minimum wages in national wage case hearings as evidence of how seriously the AIRC has taken this issue. In contrast, it could just as easily be argued that the fact that so much time is spent on this issue may actually be the result of the AIRC's inability to come to grips with the economic concepts involved, and this really should come as no surprise given the amount of disagreement between economists on the subject. Of particular concern is how so many of us confuse elasticities of demand for minimum wage workers with elasticities calculated with respect to larger populations (see James *et al.* 2001).

**Figure 1: Adult Minimum Wages Relative to Full-time Median Earnings, Mid-2004: OECD Countries**



Note: The Australian figure reported here uses earnings data from the Labour Force Survey. If data from the Survey of Employee Earnings and Hours are used instead, the ratio declines to 55 per cent.

Source: UK Low Pay Commission (2005, Table A4.2, p. 237).

What nearly all economists do agree on, however, is that beyond some point, further increases in the cost of labour must reduce the demand for that labour. This point was made very clearly by Card and Kruger (1995,

p. 393), who ignited the global debate about minimum wages and jobs in the 1990s, when they stressed that their finding that minimum wage increases do not harm employment only applied to the levels of minimum wages that existed in the USA during the 1980s and 1990s. Beyond some point, minimum wage increases must harm demand for employment and, as Figure 1 reveals, the relative level of the minimum wage in the USA remains a long way below that in Australia.

Third, the AIRC is a legally based tribunal, meaning that it operates like a court of law. Indeed, it is a requirement that the President of the AIRC have been admitted to legal practice for at least five years and many of the Commissioners have legal training. A highly adversarial judicial system, however, is exactly the wrong type of environment for making deliberations about wages policy. The parties to the proceedings have strong incentives to adopt extreme positions and then to present their evidence in as favourable a light as possible, while doing their best to undermine the evidence presented by the opposition. Further, in this environment it is even more critical that the Commissioners have the skills and expertise to make sense of the evidence presented before them and to be able to determine what is irrelevant or misleading, since it is often good legal strategy to present evidence that is designed to confuse and mislead.

Fourth, the setting of minimum wages by the AIRC continues to be heavily influenced by the notion of the 'living wage' even though minimum wages are no longer an effective tool for assisting low-income households. As discussed by Freebairn (2005), the belief that industrial tribunals play an important role in assisting low-income households in Australia is usually traced back to the *Harvester* decision of 1907 when Justice Higgins expounded the notion of a 'fair and reasonable wage'. This concept has survived over the years and continues to be reflected in the objects of the *Workplace Relations Act 1996*. Specifically, the Act effectively directs the Commission when making its deliberations to maintain an 'effective award safety net of fair and enforceable minimum

wages and conditions'.<sup>1</sup> Determining what is meant by "fair" is obviously highly subjective, but the decisions of the AIRC have made it very clear that they believe that protecting the needs of the low paid means, at a minimum, ensuring the real value of the minimum wage is not eroded over time.

But while minimum wages may have been an effective device for dealing with the income needs of Australian households 100 years ago when most households had just one income source, the male wage, it should be obvious that this is no longer the case. For a start, minimum wages cannot help improve the living standards of persons in households without jobs, which now account for anywhere between 15 and 17 per cent of households depending on the definition and data source used (Dawkins *et al.* 2002, Scutella and Wooden 2004). Further, income data have consistently shown that minimum wage workers are not concentrated in low-income households and can be found dispersed throughout the income distribution (Harding and Richardson 1999, Tsumori 2004). Finally, the nature of our tax-transfer system, and especially the means-testing of eligibility for payments, mean that many low-income families face relatively high effective marginal tax rates and, as a result, receive very little from any additional increase in the minimum wage. In fact, in the most extreme case, a full-time minimum-wage worker with a non-working spouse and two young children would actually earn less income after a wage increase, not more. Income taxation (at the marginal rate of 30%) together with the withdrawal of both Parenting Payment (at 70%) and the Low Income Tax Offset (4%) more than counteract the increase in gross wage income. Not surprisingly, relatively few parents in single-earner couple households are on the minimum wage – if they cannot secure jobs paying much higher wages either the non-working partner moves into the workforce or they gravitate towards a life of welfare dependence. Increases in minimum wages are thus very ineffective in redistributing income from the rich to the poor (see also Freebairn 2005). Indeed, rather than

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<sup>1</sup> In his speech on 26 May the Prime Minister reaffirmed the government's commitment to this principle. To quote him: 'The Government remains committed to protecting workers with a fair and sustainable safety net of wages and conditions'.

contributing towards the reduction of poverty they may well only exacerbate the problem by excluding many from accessing employment.

### **The Ineffectiveness of Minimum Wage Regulation**

There are thus very good reasons to believe that the AIRC is no longer the most appropriate body for setting minimum wages. Nevertheless, it is also not obvious that handing this power to another statutory body would lead to substantially different, let alone better, outcomes. The key reason for this, as should already be evident from the foregoing, is that effective incomes policy requires decisions about minimum wages be made in conjunction with income support and tax policies, and there is only one body in Australia that can do this – the federal government.

Assume for the moment that the new AFPC decided that it would be economically responsible to reduce the real level of the minimum wage in order to stimulate demand for low-wage workers (i.e., persons without skills that are in strong demand in the jobs market). This, for example, might mean reducing the real minimum wage to levels more in line with the levels in most other OECD countries, say something around 45 to 48 per cent of median earnings. Since the Prime Minister has told us that the AFPC will not be able to reduce any nominal wage rates below their current level, this would effectively mean holding the minimum weekly wage at its current level and letting inflation erode the real value. The employment outcome, however, depends on both supply-side and demand-side responses, and the AFPC is likely to discover that the income replacement rates for some people out of work are such that it would not be long before the benefits from not working, which are indexed to either prices or average earnings, will exceed the benefits from working.

Some crude evidence for this is shown in Table 1. This table reports figures constructed using the Melbourne Institute Tax and Transfer Simulator on in-work and out-of-work incomes for four types of households in July 2005. In all cases it has been assumed that the potential earned income is the national minimum wage – at the time,

\$484.40 per week before tax – and that there is 100 per cent uptake of all benefit entitlements.<sup>2</sup>

**Table 1: Income Replacement for Minimum Wage Workers, July 2005**

Household type	Weekly out-of-work after-tax income (\$)	Weekly in-work after-tax income (\$)	Income replacement rate* (%)
Single adult	202.55	478.30	42.3
Couple with 2 children – one earner	566.40	692.10	81.8
Couple with 2 children – one and a half earners	566.40	806.40	70.0
Sole parent with 2 children	485.90	721.20	67.4

*Source:* Figures provided by Guyonne Kalb and derived using the Melbourne Institute Tax and Transfer Simulator.

*Note:* The income replacement rate is the out-of-work after-tax income as a percentage of the in-work income, ie. Column 1 divided by Column 2 x 100.

If we focus on the first row we can see that a single person in receipt of unemployment benefits (Newstart Allowance) would be receiving just \$202 per week. If that person were able to secure a minimum wage job, their after-tax income would more than double to \$478. For this group, and indeed all persons without children, there is a sizeable economic return from employment in a minimum wage job. For people with children, however, the story is quite different. If we take a couple with two children, out-of-work disposable income per week is calculated to be \$566 per week. If one adult in the household were then to obtain a full-time minimum wage job their income would rise by just 22 per cent to \$692.12. Once we factor in the costs of working (such as transport costs), the loss of in-kind benefits associated with any loss of concession card

<sup>2</sup> It has also been assumed that none of our households are receiving rent assistance.

entitlements,<sup>3</sup> and the possible psychic disutility from working, the incentive to work, at least in a short-run static sense, may already be quite low. Holding the real wage constant while allowing benefits to increase in line with the Consumer Price Index (CPI) will obviously only further reduce the incentive to work.

In short, given the current structure of the tax transfer system, the AFPC may well find that unless it desires to reduce the incentive to work among low-wage workers with children, it will at some time in the near future be forced to effectively index the minimum wage to benefit levels (or in other words, to the CPI).

### Conclusion

A central feature of the government's proposed new industrial relations reforms is the creation of a new Australian Fair Pay Commission to set minimum wages. Presumably this new body will be established with a clear charter to ensure minimum wages are not inconsistent with the creation of new jobs for the unemployed. Changes in the real value of wages, however, affect not only the demand for labour but also the supply of that labour. That is, lower real wages, while increasing employment opportunities, reduce the incentive to work. The central thesis of this article is that for certain types of individuals, and especially those with children, any significant erosion in the real value of the wage may cause them to prefer life on welfare to life in work. The scope for using reductions in the real minimum wage to generate employment growth is thus limited, especially given our current tax and transfer system.

Ultimately, using lower real wages as a route to more jobs can only be done in conjunction with changes in our tax and transfer system that increase the incentives to work. Achieving this while at the same time

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3 Concession card entitlements are complicated, but most low income earners who are also parents (and thus receiving Parenting Payment) maintain their concession card entitlements after securing a minimum wage job. This is generally not true of people without children.

not seriously reducing levels of income support will require the adoption of entirely different income and tax arrangements than have existed previously. Essentially dealing with the twin issues of reducing the cost of low skilled labour while maintaining the incentive to work requires abandoning the minimum wage in favour of the use of negative income taxes whereby people with low pre-tax incomes get tax credits that bring their total income up to some guaranteed social minimum. This was previously advocated in Australia by the "five economists" (see Dawkins 1999, 2002). While such schemes are not without problems – Apps (2002), for example, is especially critical of the possible negative effects on the labour supply of secondary income earners – it is interesting that they continue to gain currency elsewhere in the world, and especially Europe. The use of negative income taxes to stimulate work incentives was recently touted by Olivier Blanchard, one of the world's most respected and influential economists (Blanchard 2005), as one of the institutional changes necessary to address the problem of unemployment in Europe, and indeed such incentives now operate in a number of European countries. For example, in 2001 France introduced the Employment Bonus, a tax credit paid to households where earned income is low (see Guieze and Lucas 2005), and more recently the Camdessus (2004) report on the French economy has recommended both that the level of the incentive be increased and that the scheme become more targeted. Similarly, financial work incentives are now one of the ingredients of the latest round of 'Hartz' reforms introduced in Germany (see Wunsch 2005).

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The Evatt Foundation's annual assessment of the performance of Australia's state governments *The State of the States 2005*, released in late November 2005, also includes five invited essays on the Howard governments Industrial Relations (IR) changes.

- Jeff Shaw and Monika Ciolek argue that the new IR scheme will remain less than national, uncertain and litigation prone.
- John Burgess and Peter Waring find that the Howard government's rhetoric on 'productivity' and 'flexibility' are masks for sustaining low wages, privileging managerial prerogative, shrinking employee rights, lowering minimum standards and intensifying work.
- Chris Briggs, Rae Cooper and Bradon Ellem argue that employers will be further empowered to force their employees onto individual contracts undermining wages, working conditions and human rights.
- Meg Smith and Peter Ewer observe that the Howard power grab threatens to reverse advances toward equality for women in the workplace.
- The concluding chapter by the NSW Commission for Children and Young People argues that young people will face difficulties in individually negotiating reasonable contracts.

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