



10 September, 2014

New Zealand Taxpayers' Union Inc.
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Dear Jordan,

A Review of the Green Party Policy – “Fairer Reward for Fair Effort”

Introduction

The Green Party and others have proposed that the minimum hourly wage rate for employment in New Zealand should be increased from its current level of \$14.25 (applicable from 1 April 2014) to \$15 from 1 October 2014, to \$16 from 1 April 2015, to \$17 from 1 April 2016, and to \$18 from 1 April 2017.

The Greens also support the concept of paying a “living wage”, currently assessed at \$18.40 per hour, claiming that this is the minimum necessary to enable a wage earner to support a family. Assumedly, that claim takes into account the significant Government provided social support at that income level.

The Taxpayers' Union has asked us to outline the fiscal implications of this policy and provide a view as to whether the Green Party's policy costings are fair and reasonable.

How escalating the relative minimum wage affects wage-earners and the economy

The minimum wage is currently set at 66% of the (June 2013) median wage. We assume that the median wage will increase at the same rate as the average wage, which is estimated to have grown by 2.5% in the year to 31 March 2014, and is currently projected¹ to grow at 3.0% for the years to March 2015 and 2016, and at 3.4% in each of the following two years.

¹ PREFU 2014, Economic Indicators, page 130.

Increasing the minimum wage faster relative to the median wage would have several direct economic consequences:

- a. it would put upward pressure on the lower part of the wage structure, as people with wages not much above the new minimum would seek wage increases on the basis of relativity;
- b. it would create inflationary pressures, with increasing numbers of people year-by-year having their wages increased directly with the increased minimum wage, or through wage relativity adjustments;
- c. it would lead to a reduction in employment levels, as some employers would reduce staff numbers, or delay increasing staff numbers, if they could not recover the higher wage costs by increasing their output prices; and
- d. it would impose additional costs on the government's payroll and contract costs.

Numbers affected

With the most recent increase in the minimum wage, from \$13.75 to \$14.25 per hour, from 1 April 2014, the wages of around 110,000 people were directly affected. That is twice the number (55,000) of people who were earning the minimum wage prior to the increase. We estimate that increasing the minimum wage to \$16 on 1 April 2015 would directly affect the wages of around 220,000 people. Subsequent increases as proposed above would directly affect the wages of more people, as many as 360,000 by April 2017 with the proposed wage increases, and up to 500,000 if the "living wage" proposal is adopted within three years.

In addition, a third to a half more people could seek increased wages based upon relativity effects. If implemented today, the "living wage" would represent around 84% of the median wage. Many people with incomes between the new minimum wage and the current median wage would seek relativity adjustments, with some above that level also seeking increases, so the policy could affect about 50% of all wage earners, or around 800,000 people.

Inflationary impact and economy-wide wage adjustment effects

The Cabinet Committee paper submitted in support of the most recent Minimum Wage Order² drew upon analysis by MBIE and Treasury which concluded that the inflationary contribution of increasing the minimum wage to \$14.25 per hour would be negligible, at 0.03% of GDP. The inflationary impact of an increase at that time to the "living wage" was estimated at more than 1.0% of GDP. Annual minimum wage increases as suggested in the proposed policy would have an intermediate impact, likely around 0.3% of GDP at each annual increment. However, the wage inflation component would be somewhat greater.

Increasing the wages of a third to a half of the work-force by around 6-7% each year, as implied by the proposed policy, would lift the average wage gain above the baseline projection of 3.0 to 3.4% per year to somewhere in the range of 4.0 to 5.0% per year. The median wage would also grow faster than in the base-case, as some people with incomes below the median level would negotiate wage increases based upon relativities. To the extent that average and median wages are used as indexes for social policy transfers, including NZ Superannuation, there would be consequent impacts on the cost of welfare payments and other government expenditure.

² Annual Minimum Wage review 2013 and Minimum Wage Order 2014 – Submission by Minister of Labour Simon Bridges to the Cabinet Economic Growth and Infrastructure Committee

Impact on employment

The higher minimum wages and the higher level of wages near that threshold would impact on employment. While some employers may be able to absorb the increased wage costs by reducing their profits, and others will be able to recover at least some of the cost by increasing the prices of their goods and services, many will have no option but to reduce staff numbers or cut back on future hiring. It will be more economic for some to substitute automation for people. Expect to see more and higher capacity automated supermarket checkouts, to have to pack your purchases yourself, and still pay more for your groceries.

The Cabinet Committee paper estimated that the immediate adoption of the “living wage” would cost 24,000 jobs. We estimate that the progressive minimum wage increases under the proposed policy will reduce new employment by around 5,000 to 7,000 jobs each year³.

Impact on Government wage, salary and service contract costs

While few core Government employees are paid the minimum wage, with larger changes some will be affected directly, and relativity adjustments will affect many more. Further, many workers in firms providing contract services to the Government will be affected by the changes, and these firms will need to raise their charges accordingly. Many other people working for independent agencies funded directly or indirectly by the Government will also be affected. It is reasonable to assume that the Government will allow for the increased wage costs driven by its own policies in negotiating future service contracts.

In the Cabinet Committee paper, the direct cost to a limited number of core Government departments for an increase in the minimum wage to \$15 per hour was estimated at \$60 million per annum. For a move to the “living wage” the annual cost would exceed \$450 million. We believe that the indirect staff costs would be at least equal to the direct staff costs. As a result, we estimate the increased ongoing impact on government expenditure for each \$1 per hour increase in the minimum wage to be around \$160 million. Those costs will be compounded, year on year, as the minimum wage is increased. Over three plus years the combined costs to government will add up to around \$1.1 billion.

Fiscal impact of the minimum wage escalation policy

Green Party claims

We believe that the Green Party’s estimation of the fiscal impact of its minimum and living wage policies are fundamentally flawed.

On the final page of the Green Party’s “Fairer Reward for Fair Effort” policy document (under the heading “Costs”) the Green Party estimate that increasing the minimum wage will cost the Government \$1.1 billion over three years. This cost is in line with our estimates.

The Green Party also claim that this cost will be more than covered by increased wage derived tax payments, which the Party estimates at \$1.9 billion over the same period. That leads them to the surprising (and worrying) conclusion that increasing the minimum wage will generate net revenue for the Crown.

³ There are differing estimates of the significance of the employment effect. Evidence suggests that it is strong and negative when the minimum wage is closer to the median wage. Key references are provided in the Notes.

Our analysis of the fiscal impact

Based upon the progressive numbers of people affected with each successive increase in the minimum wage, we estimate the gross wage increase and additional tax on that as follows:

Year from 1 April	2014*	2015	2016	2017	Total
Minimum wage	\$15	\$16	\$17	\$18	
Number affected	160,000	220,000	280,000	360,000	
Marginal income increase at 2,000 hours / year \$m	120	120+440= 560	560+560= 1120	1120+720= 1840	3,640
Tax at 17.5% \$m					637

*From 1 October 2014

On this basis the Government will have increased expenditure of \$1.1 billion over 3 years, and receive just \$637 million in increased taxes on additional wage and salary income.

However, this ignores the impact of several factors, notably:

- the reduction in total numbers actually or potentially employed, which we have estimated at 6,000 each year, and taxes on all of their income; and
- the reduced profits and consequently reduced taxes paid by (non-Government) employers, to the extent that they are not able to pass on the extra costs.

The revenue lost from reduced employment is estimated as follows:

Year from 1 April	2014*	2015	2016	2017	Total
Minimum wage	\$15	\$16	\$17	\$18	
Jobs reduction	2,000	6,000	6,000	6,000	
Gross income loss at 2,000 hours / year \$m	60	60+192= 252	252+208= 460	460+216= 676	1,448
Tax at 10.5% (to \$14,000) 17.5% \$m	8.54	36.96	69.58	106.40	221.48

*From 1 October 2014

As a result, the potential tax revenue yield of \$627 million will be reduced by \$221.5 million, leaving just \$405.5 of net additional tax.

Finally, we assume that about half of the incremental non-Government wage bill will not be able to be passed on by employers, who will suffer reduced profits and pay less tax at 28% as a result. We calculate the fiscal impact of this effect as follows:

- the total wage increase over three years from the first table is \$3.8 billion, less the Government payroll and Government contractors' incremental wage bill of \$1.1 billion, leaving \$2.7 billion of wage increases for the residual private sector; and
- assuming that half of that incremental wage cost will be passed on to customers and half must be set off against profits, the \$1.35 billion loss of profits leads to a reduction in tax payable (at 28%) of \$378 million.

Taking the above into account, the net extra tax revenue yield is reduced to just \$27.5 million. If some Government contractors and / or more than half of the remaining private sector employers are unable pass on their costs, then the policy will have a negative impact on net tax revenue.

We conclude that there is no magical “pot of gold” to offset the direct costs to the Government of the increased wages.

We note further that adopting the “living wage” for Government employees and contractors would further increase the payroll and contract costs, without generating incremental tax revenue, through the same mechanisms. The relativity adjustments would also be more severe, leading to a spike in wage inflation generally.

Finally, we would expect the median and average wages to increase faster as a result of the minimum wage escalation policy, leading to increased payments of indexed social transfers, including New Zealand Superannuation. We have not estimated this cost, but note that a 1% increase in NZS will have a fiscal impact of between \$110 and \$120 million per year over the next three years.

Conclusion

We have shown the rapid escalation of the minimum wage relative to median and average wages would have adverse impacts in several areas:

- by the end of the three year escalation period, around 360,000 people will be on the new minimum wage, up from around 110,000 currently earning the minimum wage
- the wage relativity structure in the lower half of the wage income distribution would become severely compressed, leading to demands for compensatory wage increases
- the average wage growth would increase from around 3% to above 4.5%, and inflation rates would increase, leading to potential rounds of wage-price inflation.
- expected employment levels would reduce by around 6,000 people per full year, cumulatively
- Government expenditure on employee wages and contracts for services would increase costs to the Government, by around \$1.1 billion over 3 years
- not all employers would be able to pass on the wage costs, and their reduced profits would lead to reduced tax payments by companies and other business owners

We conclude that the primary fiscal balance would be reduced, by at least the direct costs already acknowledged by the Green Party, as the incremental tax revenue yield would be minimal (there may even be a net revenue loss), and social transfer payments linked to wage rates would be increased.



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Notes

Minimum wage setting process

The minimum hourly wage rates for adults and for starting-out workers and trainees in employment in New Zealand are set by a Minimum Wage Order under section 5 of the Minimum Wage Act 1983. The most recent Order increased the adult minimum wage from \$13.75 per hour to \$14.25 per hour, effective from 1 April 2014. The starting-out and training minimum wage rates were maintained at 80% of the adult minimum wage, and therefore increased from \$11.00 to \$11.40 per hour.

Note that the median wage used for Wage Order consideration is that prevailing at 30 June of the prior year. That allows time for policy analysis and Government decision-making prior to 1 April implementation.

Recent changes in the minimum wage compared to average wages and the median wage

Since April 2005, the adult minimum wage has increased by 50%, from \$9.50 to \$14.25 per hour. Over the same period, the average ordinary time hourly wage has increased by 37%.

The current minimum wage is 66% of the median wage of \$21.60 per hour as at 31 March 2014. The median wage is the wage above and below which 50 percent of wage-earners lie.

Relevance of the median wage as a reference point for the minimum wage

The median wage is commonly used a point of relativity for income adequacy and poverty analysis. Poverty is commonly judged to be linked to adjusted household incomes below either 60% or 50% of the adult median income. An individual working full-time for the current minimum wage would have an income significantly above such a poverty level. A couple each working 30 hours per week at the minimum wage would also have an effective income above the 60% poverty line (66% times 0.75 times 2 divided by 1.6 = 62%).

Relevance of the minimum wage for families with children

A family with children would receive significant amounts of social assistance if the parent or parents were earning the minimum wage, subject to their meeting the minimum weekly hours of work requirement. Hence the minimum wage is not intended to be a “living wage” that would enable a working parent or parents to support a family without social assistance.

Expected growth in the average and median wages from now to 1 April 2017

The Treasury’s projections in the PREFU (Economic indicators, page 130) for growth in the average wage in March years ending 2015 through 2018 are 3.0%, 3.0%, 3.4% and 3.4%. Compared to 1 April 2014, the cumulative growth figures for succeeding years are therefore 2015: 3.0%, 2016: 6.1%, 2017: 9.7% and 2018: 13.4%. Median incomes tend to grow more slowly than average incomes, but it is reasonable to assume a similar pattern of growth.

Expected growth in the median and minimum wage on current relativities and Green Policy

Based on the above wage growth projections, we might expect the median and minimum wages to increase year by year as follows:

Year from 1 April	2014	2015	2016	2017	2018
Median wage	\$21.60	\$22.25	\$22.92	\$23.69	\$24.50
Minimum wage	\$14.25	\$14.68	\$15.12	\$15.63	\$16.16

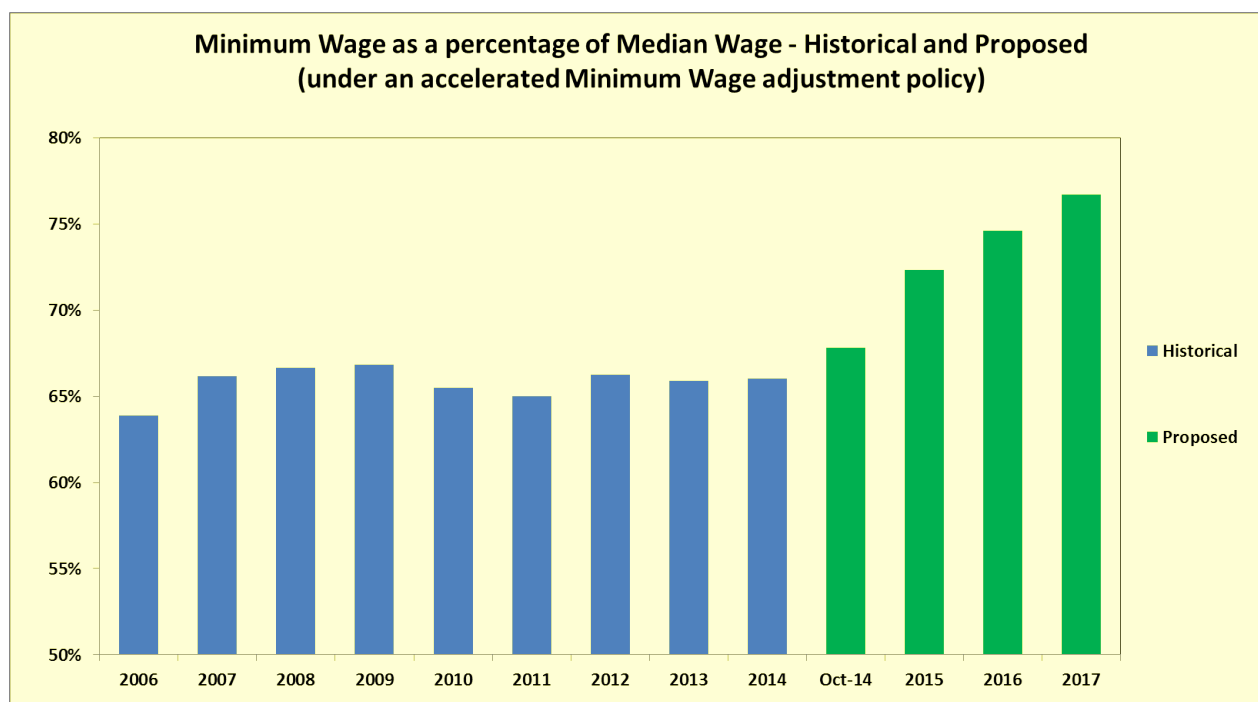
That assumes ongoing annual setting of the minimum wage at 66% of the median wage.

Applying the minimum wage progression policy advocated by the Green Party would lift the relativity towards 80% of the median wage, as follows:

Year from 1 April	2014*	2015	2016	2017	2014*
Median wage	\$21.92	\$22.25	\$22.92	\$23.69	\$21.92
Minimum wage	\$15	\$16	\$17	\$18	\$18.40
Percent of median wage	68.4	71.1	74.1	76.0	83.9

*Estimated as at 1 October 2014.

A minimum wage of \$18 per hour on 1 April 2017 would represent 76% of the median wage. We show this graphically below.



The impact of minimum wage changes on employment

Research into the impact of increasing minimum wages on employment has identified that the effects are negligible when the minimum wage is below 35% of the average wage (as in the US), but are more significant and negative (i.e. raising the relative minimum wage reduces future employment) when the minimum wage is above 45% of the average wage (as in France and several other European countries).

A key reference that explores this difference is: Abowd, Kramarz, Margolis and Phillipon: "Minimum Wages and Employment in France and the United States". NBER Working Paper No. 6996, March 1999.

A broad cross-country comparison of the effect of minimum wages is: Dolado, Felgueroso and Jimeno: "The Role of the Minimum Wage in the Welfare State: An Appraisal", IZA Discussion Paper No. 152, May 2000.

Another study with non-US data shows strong employment effects: Maloney and Mendez: "Measuring the Impact of Minimum Wages: Evidence from Latin America". NBER Working Paper No. 9800, June 2003.