

Minimum Wages

There may be more intellectually discredited arguments than those for minimum wages. But it is not easy to find them. The only ones which come immediately to mind are the arguments for affirmative action. Most economists, in fact, dislike minimum wage laws, for excellent reasons. They agree with Paul Samuelson, Nobel Prize-winner and author of a famous textbook, that an unskilled black youth is but little helped by a law which says he must be paid \$10 per hour – if that requirement is what keeps him out of a job. This has for long been common cause amongst economists. Yet minimum wage laws are back on the agenda, not only of the British Labour Party and in the USA, but also in South Africa, where the idea is reasserting itself as a shared tenet amongst trade unions. Only last week the NUM's Martin Nicol called for the establishment of a National Wage Board to set a minimum wage of R650 for industries not covered by sectoral boards. The Agricultural, Plantation and Allied Workers Unions called for R850 for farm workers.

Minimum wages destroy jobs

What is more, minimum wages are no longer being supported primarily, as they have usually been, by non-economists who want to reduce poverty. For example, last month, COSATU's Sam Shilowa rejected the view that excessively high wages contribute to unemployment growth. But in addition, it is now being claimed by some economists that a minimum wage can actually improve the working of markets. So, did economists get it wrong before? Is the turnabout by some of them proof that they are capable of learning? Another Nobel Laureate, George Stigler, in 1946 provided a classic analysis of the adverse effects of minimum wage legislation. First, while wage rates in sectors covered by the law would rise, total wages in these sectors would fall and unemployment and poverty would increase. Second, unless the minimum wages were somehow targeted at the poor, there was no guarantee that they would not be paid to low-wage members of wealthier households (e.g. Houghton-based high school students waiting at table). Third, the sectors not covered by the law would face an increased supply of labour and wages there would fall, offsetting gains in the covered sector. Nor would a national minimum wage do any good, it would simply increase national unemployment.

Do minimum wages ever do any good?

Empirical studies since appeared to confirm Stigler's analysis. So much so that a third winner of the Nobel Prize, Milton Friedman, has argued for government aid to help the poor through income support in the form of subsidies and not through wage floors. Minimum wages, Friedman held, normally benefit the wrong people and only make the poor worse off. Why then the revival of interest by economists in minimum wages? The answer lies in the rediscovery of the so-called monopsony (monopoly buying) power of some employers, who can then hold down wages. At the same time the number of jobs offered is reduced and so of course is employment. The employers' object is to restrict output of their final product, which will then command a higher price and bring them higher profits.

Economists had of course long been aware of this possibility. However, they regarded it as only a theoretical oddity, logical certainly, but with no empirical support. After all, a single buyer of labour rarely exists except in the "company town" setting – or in those industries where firms get together to form a labour-buying cartel and act "as if" they were monopsonists. The whole argument hinges on the assumption of barriers to exit, i.e. that workers have such restricted choices of alternative employment that their bargaining power is negligible. But company towns are indeed rare. And the likelihood of labour-buying cartels acting "as if" they were monopsonists is surely unlikely. Individual cartel members usually have the incentive to cheat on their partners by undercutting on the final product price or overbidding on the wage rate. It is because this incentive is so difficult to resist that cartels have usually been unstable. To persist they need governments which enforce them and penalise chisellers with the force of the law.

Why then are some economists so interested in minimum wage laws all of a sudden? At least one reason is a continuing desire by them to appear to be motivated by egalitarianism whilst finding theoretical and empirical economic evidence for their politically correct presumptions. Superficially this answer recently appeared to receive support from a widely publicised interstate study in the USA of fast-food restaurants. New Jersey raised its minimum wage by 19% in 1992 but employment still seemingly went up (in line with the monopsony argument). This study was at once acclaimed by the minimum wage enthusiasts. In the face of overwhelming evidence to the contrary, up till then, from other times and places, and from both the developed and less developed world, it appeared as if the theoretical curiosity now at least had some support. Indeed it did. The results however appeared to be premature. The same data have been re-examined by later researchers, more systematically than before, and the conclusion was that fast-food restaurants were actually no exception. Minimum wages here too had the classic effect – increased unemployment.

Minimum wages featherbed employers and trade unions

But there is another more obviously materialistic rationale for minimum wages. Minimum wage legislation may be supported by a monopsonistic cartel of employers – which is paradoxical, of course. If the monopsony argument is correct, support for high and effective minimum wages will reduce profits. But Professor Sir Alan Walters resolved this paradox when examining UK Wages Councils before the Thatcher government abolished them. The explanation is that large employers (often partially or wholly unionised) had conceded wages exceeding those of many of their smaller competitors (often staffed with immigrants, non-whites and non-union labour). The small competitors were adamantly opposed to minimum wage laws, which either bankrupted them or inhibited their growth. In short, the monopsony argument did not hold. Minimum wages did harm both employment prospects and the interests of consumers in lower prices. Employers and unions, however, were quite happily engaged in cartel-maintaining behaviour, lobbying for the maintenance of industrial and wages councils for the benefit, not of the public, but of their own individual members.

In a recent paper on the subject, Professor Deepak Lal concluded that “despite the passion aroused, the textbook conclusion with which we began – that the minimum wage is an inefficient, well-intentioned but ‘inexpert interference’ with the mechanisms of supply and demand – still stands”. So what can we learn from experience elsewhere? If the fate of small business overseas is anything to go by, in the new democratic socialist South Africa we are heading for, the real menace is a predatory alliance between labour unions, government and big business. Should this happen we can sure alright that high minimum wages will be enforced with a vengeance. We can be sure that the fate of the unemployed will be even worse than it is now.

This Briefing Paper was written by Henry Kenney and Duncan Reekie and previously appeared in November 1995 in Business Day.