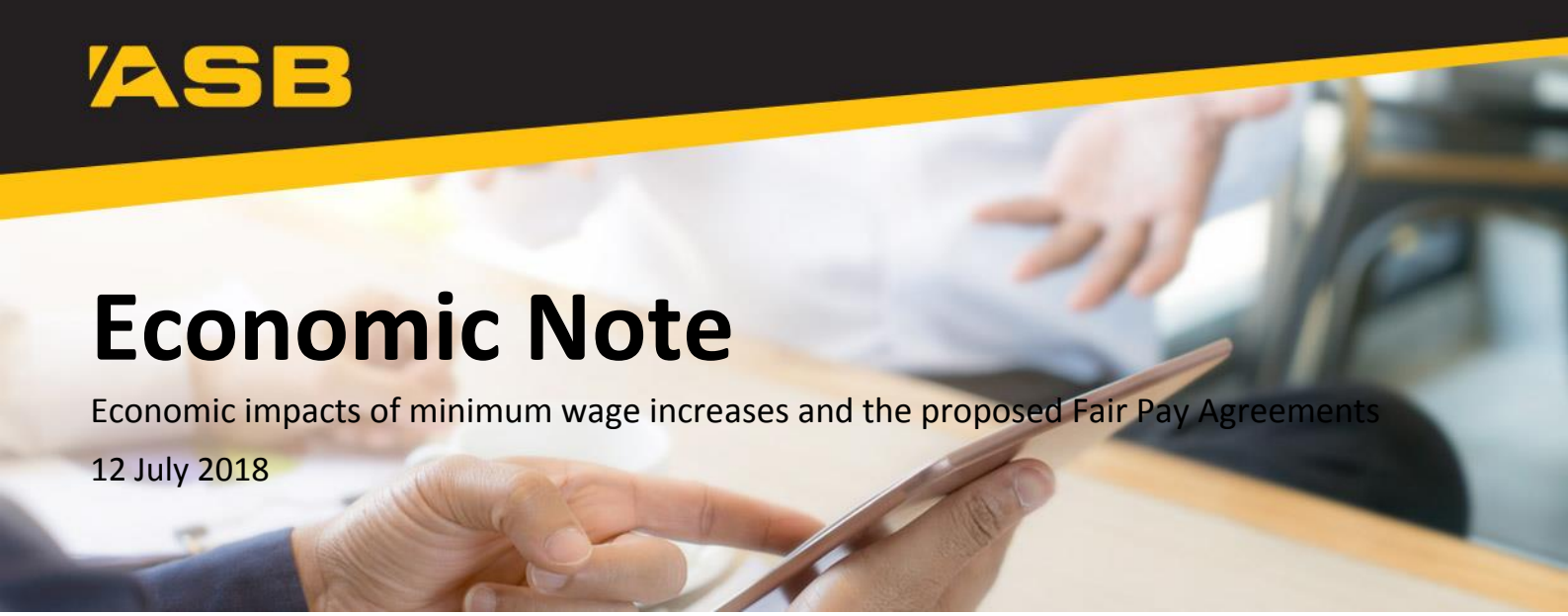

Economic Note

Economic impacts of minimum wage increases and the proposed Fair Pay Agreements

12 July 2018

Primed for an increase

- Increases in the NZ minimum wage to $20 per hour by 2021 could be the catalyst for a turnaround in wage inflation in New Zealand. The proposed imposition of Industry-Wide Fair Pay Agreements by the Government and move towards collective bargaining is likely to add to wage and consumer price inflation at the margin.
- Our estimates are tentative but suggest that the minimum wage increases and the fair pay agreements could add up to 0.5 to 1.0 percentage points per annum to wage inflation and between 0.3 to 0.7 percentage points to annual consumer price inflation through to mid-2022.
- We caution that employees will need to be realistic with their wage demands, or the consequence could be higher interest rates.

Summary & implications

Measures of labour utilisation currently depict a generally tight labour market backdrop. However, wage inflation has remained muted, both here, and abroad.

Increases in the NZ minimum wage to $20 per hour by 2021 could be the catalyst for a turnaround in wage inflation in New Zealand. Here, we use distributional wage data to estimate what the impact on wage inflation could be. Proposed Industry-Wide Fair Pay Agreements signal a move towards collective bargaining and are expected to add to wage pressure at the margin. Our estimates are approximate but suggest that the minimum wage increase could add between 0.5 to 0.7 percentage points to annual wage inflation through to mid-2022. Adding in the impact of Fair Pay Agreements could push the increase in wage inflation closer to 1% per annum.

Combined with a moderate outlook for underlying wage inflation, this would be sufficient to push annual inflation on the labour cost index towards 3%, the highest in a decade. Wages are a key input into consumer prices, with our estimates suggesting the minimum wage increases will boost annual consumer price inflation by approximately 0.3 to 0.7 percentage points per annum. This will be one of the catalysts helping to push (still - low) annual CPI inflation towards the 1-3% inflation target midpoint. We caution that employees will need to be realistic with their wage demands, or the consequence could be higher interest rates if real wage growth exceeds productivity gains.

All else equal, higher wages would lower the demand for labour, but the international evidence of the magnitude is inconclusive. We believe the economy-wide impact on employment is likely to be modest, particularly in the context of sizeable employment increases of late. Nevertheless, a higher wage bill poses challenges for some firms.

Wage inflation has remained low

The labour market looks stretched according to capacity metrics. However, wage inflation has remained low for this stage of the cycle. There has been limited flow-through to the wider labour market from July 2017 increases in the minimum wage and the April 2017 pay equity settlements for care and support workers. Annual LCI wage inflation for

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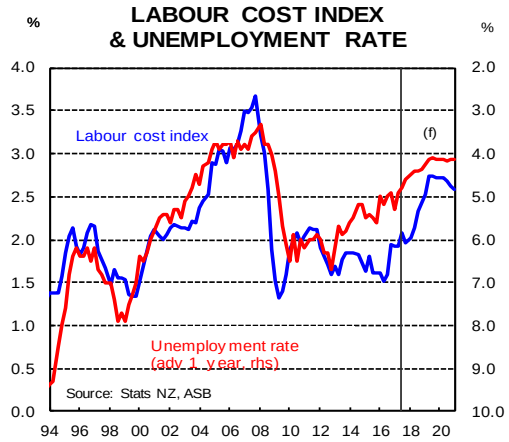
all sectors excluding the impact of the health care worker settlements was a mild 1.6% in the March 2018 year. Median increases (2.4-2.5% for the quarter and year) remained relatively mild. March 2018 data confirmed that only 34% of salary and wage rates had achieved a wage increase above 2% over the last 12 months, with 18% achieving more than 3%. Around 49% of salary and wages showed no annual increases, with the remaining 17% showing annual increases of 2% or less.



Persistently weak inflationary pressure has raised the issue of whether the Phillips curve – the relationship between labour market slack and inflation – has fundamentally changed following the Global Financial Crisis (GFC). This is analogous to the apparent puzzle of why consumer price inflation has stayed so low, both here and abroad, despite strong growth in the global economy.

While weak labour earnings growth is unusual in light of low unemployment rates, there are a number of factors that help to explain this wage moderation, including:

- A slowdown in labour productivity growth. Labour productivity will largely influence how much revenue businesses generate, and therefore how much they can pay employees over the long run.
- There could be more labour market slack than headline measures suggest. In some countries, underemployment rates (people who are employed but would prefer to work more hours) have not fallen by as much as the unemployment rate. The NZ underemployment rate has fallen of late, but is still around historical averages.
- A more digital and integrated global economy has changed the nature of employment. This may mean that labour market slack spills over between economies. In addition, technology, through greater automation, is adding to the range of competitive forces that may be weighing on overall wage growth.
- Low consumer price inflation. Some wages are indexed to CPI movements.

As noted previously, **New Zealand is not alone in this regard.** In its October 2017, Economic Outlook, which empirically analyses recent wage dynamics in advanced economies, the International Monetary Fund (IMF) finds that labour market slack, low productivity, and low inflation have exerted downward pressure on wages. Furthermore, the study also finds that a common global factor has exerted downward pressure on wages.

Minimum wage impacts

Over the last decade the minimum wage has increased by an average of just over 3% per annum, slightly above that of the average increase in private sector average hourly earnings.

Statistics New Zealand estimates for the 2017 year, based on the income module from the Household Labour Force Survey (HLFS), suggest that around 3% of employees, just 3% of paid hours and slightly less than 2% of total hourly earnings were on (or below) the minimum wage. Assuming this proportion was representative of the previous decade, the direct contribution to aggregate wage inflation from minimum wage increases averaged roughly 0.1 percent per annum.

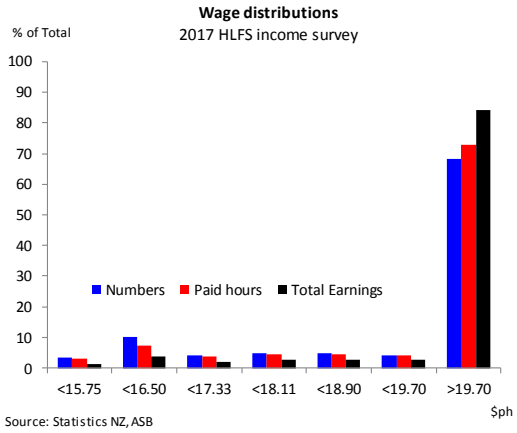
After increasing to $16.50 per hour in April 2018, the minimum wage is set to progressively rise to $20 per hour by April 2021, a cumulative increase of more than 25% since 2017 levels[1], at an average of just over 6% per annum. As well as the minimum wage increases, the April 2017 $2bn pay equity

[1] There are some exceptions. There is no minimum wage for employees under 16 but other minimum standards and employment rights and obligations apply. There is also the starting out minimum wage (currently $13.20 per hour) that covers 16- to 19-year-old employees who haven't done six months of continuous employment, who have been paid a benefit for 6 months or more or are currently in industry training.

settlements for 55,000 care and support workers (see here for details) and the $104m settlement for midwives announced in the 2108 Budget - many of whom were on the minimum wage – suggest that the growing cost of living is creating frictions.

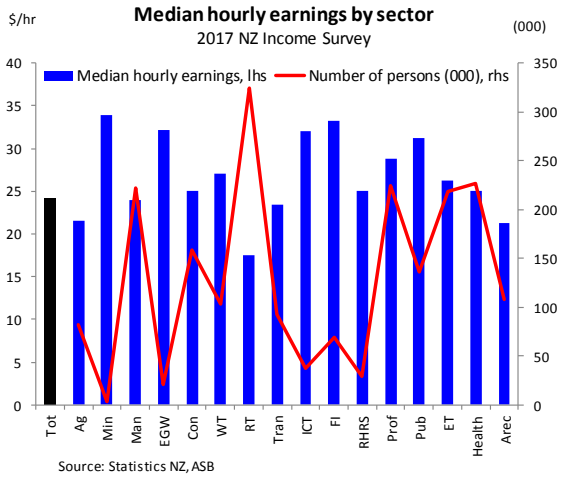
Numbers on the minimum wage

As was noted above, Statistics New Zealand figures for 2017 suggested that around 3% of employees and slightly less than 3% of paid hours were on (or below) the minimum wage at the time, accounting for less than 2% of total hourly earnings according to Statistics NZ estimates. **There are also a considerable number of employees earning just over the minimum wage.** Statistics NZ figures confirmed that a further 10% of employees (just over 200,000 persons) earn less than 5% more than the minimum wage. As many of these employees are part-timers, who are working while studying, the average hours worked in this cohort tends to be lower than average, with this wage band accounting for just 7% of hours worked. Close to a further 10% of workers earn from 5% to 15% more than the minimum wage.

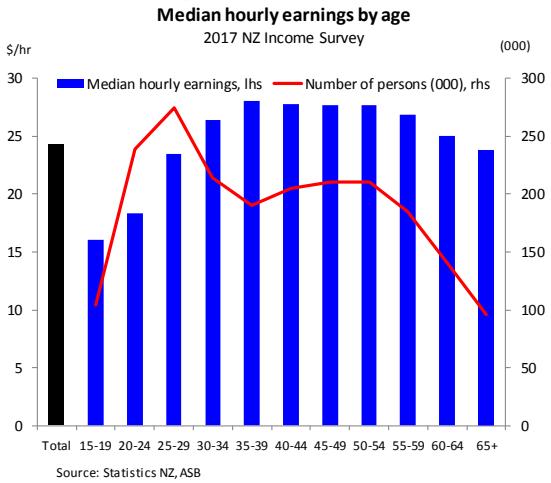


Source: Statistics NZ, ASB

Lower paid jobs tended to be more concentrated in the younger working age population (median hourly earnings for workers aged 15-19 were just 2% above the minimum wage according to Statistics NZ figures). Median hourly earnings tend to be highest for workers in the 35-55 age brackets. **There are also sector differences.** Median wages tend to be lower in the retail and arts/recreation sector, where a larger portion of younger workers are on the minimum wage. Higher-paid jobs tended to be in the (smaller) financial and insurance, utilities and mining sectors.



Source: Statistics NZ, ASB



Source: Statistics NZ, ASB

Quantifying the impacts on wages

What then, will prospective increases in the minimum wage do to aggregate wage inflation?

The wage impacts will depend on three things:

- The increase in the minimum wage.
- The number of people on the minimum wage.
- The ripple impact of higher wages for the lower paid to the broader economy.

Direct Impacts

The minimum wage is set to increase an average of 6% per annum through to 2021. **Assuming that the proportion of workers on the minimum wage stays at 3% over the next few years, the direct contribution of the increase in the minimum wage would be to add 0.2 percentage points to annual wage inflation through to 2022, around double that of the previous decade.**

However, it seems likely that the percentage increases in the minimum wage will outpace general wages inflation, with a growing portion of workers likely to find themselves earning the minimum wage. **This will increase the impact of the higher rising minimum wage on overall wage inflation.**

Exactly how much will depend on two things: the wage distribution for cohorts slightly above the minimum wage as well as the extent of prospective wage increases. We do not know these in advance, but by making some informed assumptions on prospective wage growth, it is possible to derive some ballpark estimates.

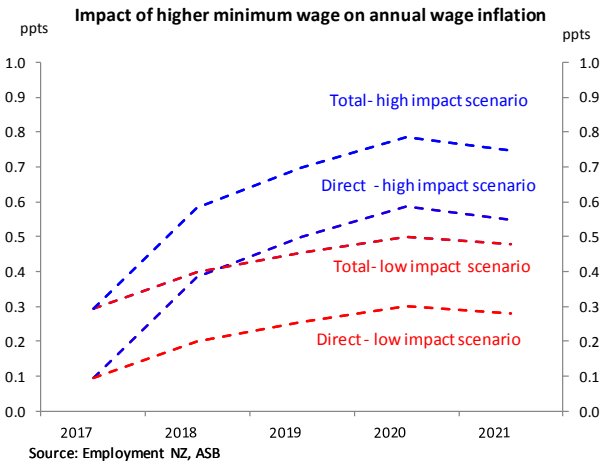
We use a high and low scenario to derive illustrative impacts:

- Low impact scenario - assumes wage inflation for low-wage cohorts averages 5% per annum over the next few years with a more sizeable proportion of the wage distribution towards the *upper* parts of the range. Increases in minimum wage will capture a *smaller* proportion of the labour pool.
- High impact scenario – assumes wage inflation for low-wage cohorts averages 3% per annum over the next few years with a more sizeable proportion of the wage distribution towards the *lower* parts of the range. Increases in minimum wage will capture a *larger* proportion of the labour pool.

These scenarios suggest that around 4% to 8% of hours worked will be at the minimum wage by 2021, with 5% to 11% of employees expected to be on the minimum wage by 2021**. All up, increases in the minimum wage would directly add 0.3 to 0.5 percentage points per annum to overall wage inflation over the next few years.**

Indirect impacts

With employees earning just below the minimum wage seeking to preserve wage relativities, increases in the minimum wage would likely have an impact on other wages. We expect this impact would be stronger wages just above the minimum wage, with the impact becoming progressively weaker the higher the wage. Estimates from the 2017 HLFS income survey suggests that around 18% of employees and 17% of hours worked were on wages 5-25% above the minimum wage at that time. As such, we assume staggered wage increases of between 3½% - 5% per annum over these wage brackets. This delivers an additional 0.2 percentage points to aggregate wage inflation. **Adding together the direct and indirect impact yields a total impact of between 0.5% to 0.7% percentage points per annum to annual wage inflation, or a total of 1.4% to 2.2% through to mid-2021.** Labour earnings would be boosted by a similar amount over this period as a result of the higher minimum wage. All up, we expect overall annual wage inflation from the labour cost index to peak at just below 3% by the end of the decade, equivalent to 4% increase in weekly hourly earnings.



Industry-Wide Fair Pay Agreements

The Government has recently announced that it intends to introduce legislation to allow employers and employees to create Fair Pay Agreements (FPA). The FPA would likely set minimum standards and conditions for employment for all employees in an industry or sector without the need for individual agreements. Arguably, this is a step towards the Modern Award system in place in Australia. The Government has established a working group to make recommendations of the design of the system by the end of 2018, with legislation likely to be introduced next year. **Unlike existing collective bargaining, industrial action, including strikes and lockouts, would not be permitted in negotiations for a Fair Pay Agreement.** Once laws enabling the FPA are in place, it will be up to unions and employers to create a FPA in their industry or occupation.

Impact of Fair Pay Agreements – Initial views

Initial views on the FPA are mixed. On the plus side, Fair Pay Agreements will help lift wages and conditions and ensure good employers are not disadvantaged by paying reasonable, industry-standard wages. Last year's $2 billion care and support workers settlement was similar to a Fair Pay Agreement and it had huge public support. However, there is the concern the move away from individual agreements would restrict flexibility for employers and workers, possibly resulting in some jobs losses, further aggravating labour market capacity pressures and potentially weighing on labour productivity.

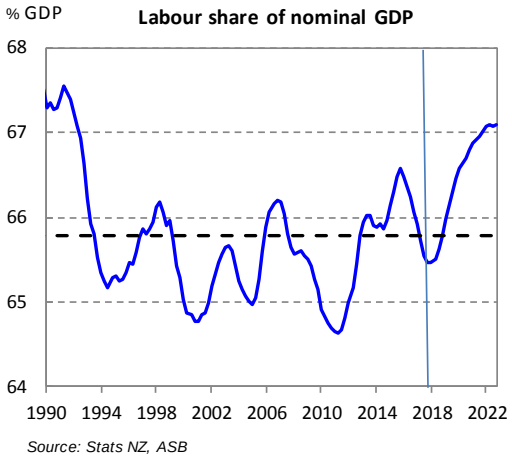
Evidence on the impact of FPA's on wages is mixed. Compared to individual bargaining or unilateral pay determination, collective bargaining (of which the FPA is in a similar ballpark) is associated with higher earnings, more security for employees and more earnings equality**. It seems more likely that the FPA will result in higher wage**

increases in lower-paid sectors, some of which has been already incorporated by the signalled increase in the minimum wage. According to a 2017 OECD study (see here), job protection legislation and fair pay agreements tend to protect wages of low-skilled workers with little bargaining power to a larger extent than those of high-skilled workers and that, as a result, reducing job protection tends to widen wage inequality.

We also assume that the FPA is likely to be staggered across industries and sectors from late-2019 to mid-2022 to mitigate the economy wide impact. **Our rough estimates suggest that the FPA could add up to a further 0.3 percentage points to annual wage inflation. All up, our estimates suggests aggregate wage inflation could be up to 1 percentage points higher per annum through to 2023.** Details remain scant and these estimates remain illustrative. We will be closely developments in this area - recommendations from the Working Group on Fair Pay Agreements are due by the end of the year. We will be refining our estimates as more details emerge.

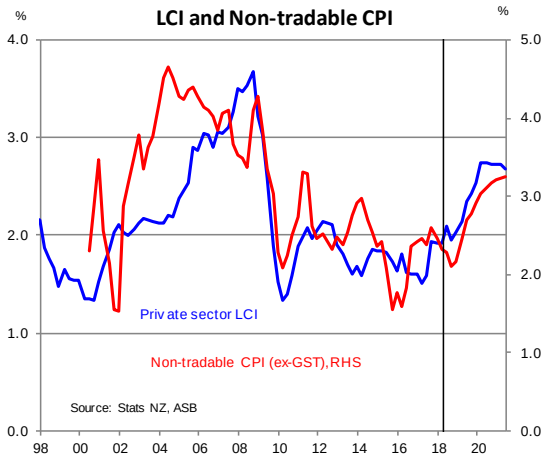
Impacts on employment and consumer prices

Wages are a key input into the pricing decisions of firms. The labour share of incomes – as proxied by gross labour earnings from the Quarterly Employment Survey (QES) relative to nominal GDP – is currently around two thirds. **Unless the increase in the wage bill is offset by increasing labour productivity, the changes would likely see the labour share of income increase.**



Source: Stats NZ, ASB

A 0.5% to 1% increase in wages, all else equal, would likely push up consumer prices by 0.3% to 0.7% per annum. Our projections (see here) assume that firming wage inflation is one of the major catalysts pushing annual CPI inflation (currently 1.1%) towards the 1-3% RBNZ target midpoint.



Whether or not this inflation increase occurs will depend on the decisions of firms, who may have scope to absorb some of the cost increases in their margins, extract greater productivity improvements from existing workers or choose to cut back on their demand for labour. **We suspect that the impact on consumer price inflation is likely to be along the lower part of this range.** It is possible that some of the inflation impact of higher wages will be blunted by increasing labour productivity. There is some evidence that employee perceptions of procedural fairness can influence their satisfaction with pay, their level of trust in management, and their overall commitment to the organisation (see here). The OECD (2017) does acknowledge that "companies may have fewer incentives to invest in innovation when unions are weak as they can increase profits by simply reducing wages". **However, we reiterate that employees need to be realistic with their wage demands. Sizeable wage increases not matched by a corresponding improvement in productivity could likely place the viability of some firms under jeopardy.**

While it is generally acknowledged that higher minimum wages will result in a lower demand for labour, recent research (see here) on the effect of minimum wages on employment is not conclusive. Overseas estimates generally report employment elasticities in a -0.1 to -0.2 range for lower wage cohorts, with elasticities closer to zero for the whole labour force. In its 2017 Half Year Economic and Fiscal Update (HYEFU) The Treasury assumed an elasticity of -0.3. With the Treasury estimating that increases in the minimum wage will boost average hourly earnings by 1.6% through till mid-2021, this would lower total hours worked within the economy by 0.4 percentage points (see here). The Treasury noted there is considerably uncertainty over the sensitivity of the demand for labour to wages, with the HYEFU estimates conditional on a range of assumptions. Similarly, evidence on the impact of FPA's on wages and employment is non-conclusive. We also assume that Fair Pay Agreements will not have a significant impact on employment. The proposed changes merely shift the New Zealand labour market back to OECD norms. New Zealand's

employment legislation is currently deemed by the OECD to be one of the most deregulated in the developed world (see here). New Zealand's labour productivity performance has been poor despite a high degree of labour market flexibility and it does not follow that productivity would suffer if additional regulation was put in place.

By taking the Treasury and overseas estimates as a guide, **our estimates suggest that hours worked within the economy could be up to 1% lower by mid-2021 as a result of the higher minimum wage and Fair Pay Agreements.** Our gut feeling is that the actual impact on employment is likely to be at the modest end of the scale, and is unlikely to jeopardise the RBNZ's employment objectives. Indeed, in the context of the 23% increase observed in HLFS hours worked since 2010 this looks minor. However, we do acknowledge that lifts in minimum wages will present challenges for some firms highly reliant on low-paid labour. For them, as well as the wider economy grappling with **capacity constraints, boosting labour productivity remains the goal to boosting living standards in the New Zealand economy** (see our note here).

The focus for financial markets will be what these policy changes mean for interest rates and the NZD. The recent change in the Policy Targets Agreement requires the RBNZ to take into account the labour market (see our note here on the new RBNZ Policy Targets Agreement). A low inflation starting point provides more leeway to accommodate the lift in consumer prices. However, the RBNZ will likely remain vigilant and alert to signs of productivity-adjusted labour costs (as proxied by the labour cost index) moving significantly above the midpoint of the 1-3% inflation target**. Sizeable wage increases not matched by a corresponding increase in productivity or a narrowing in firms' margins could threaten the 1-3% medium-term inflation outlook.** The consequence may be higher interest rates and a lower demand for labour.

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