

Setting the Initial Statutory Minimum Wage Rate

Submission by HKGCC

Introduction

With the release in March of the most comprehensive data to date on wages and operating characteristics of companies in different sectors, the discussion about setting a minimum wage for Hong Kong has entered a new phase. In this paper the Hong Kong General Chamber of Commerce (HKGCC) has made use of some of the government data in assessing the impact of a minimum wage at different levels. But before we go into the detailed analysis, we would like to reiterate some important basic premises that we think all parties should bear in mind in the discussion.

In our last submission to the Provisional Minimum Wage Commission (PMWC), we highlighted that any minimum wage rate worthy of the name must be set at some level above the market rate, which, according to time tested classical economic principles, means that companies are likely to hire fewer people or lay off those hired as the labour cost is artificially set at a level higher than the market price. In the submission we have identified the number of people at risk at different minimum wage levels. The bottom line is that setting the rate too high will force more of Hong Kong's under-educated, unskilled and less-experienced workers out of their jobs. We would like to emphasise again that our concern for this possible undesirable outcome remains the single most important consideration in our analysis based on the new government data.

All along we have been advocating that the PMWC should try its best to produce the best possible estimates of additional unemployment at different rates of the minimum wage, as we firmly believe only with such estimates can the Commission set the minimum wage at a rate that will increase unemployment by an acceptable amount. We would like to renew this call. The new government data helps the work to produce the estimate, but we believe this is only the beginning of a complicated and important task. Much work remains to be done.

Sources of Data

The PMWC is tasked to advise the Chief Executive on the initial statutory minimum wage (SMW) rate by adopting an "evidence-based approach". This paper is intended to provide input by analysing available data. Our major sources of data and information used for analysis include:

- The Annual Earnings and Hours Survey (AEHS) conducted by the Census and Statistics Department in the second quarter of 2009, which collected data on the level and distribution of wages, employment details and demographic profiles of employees in Hong Kong. A number of low-paying sectors can be identified from the survey.
- The supplementary statistical tables released by the PMWC, which tabulate information on the preliminarily identified low paying sectors, covering the estimated increase in wages of employees at different levels of SMW, and the operating characteristics of enterprises, including, among others, median profit ratios of different sectors. The supplementary information sheds light on the potential cost impact on enterprises and different sectors' ability to cope with the possible impact.

- As the UK experience in introducing a national minimum wage is widely seen as relevant to Hong Kong, we have drawn reference from the reports of the UK's Low Pay Commission, British government reports, and some related academic studies and papers.

The Range of Analysis

Our analysis will start by looking at the rates of \$33/hr and \$22/hr as the two ends of the range of analysis for the initial SMW rate. The \$33/hr rate is so far the highest rate proposed in public discussion, while \$22/hr is the lowest rate covered in the government's statistical data, though it might not necessarily be the lowest pay level in the market.

Profitability Analysis

Whether a particular rate would be affordable can be considered by estimating the cost increase by making use of two sets of government data:

- (A) the ratios of "compensation of employees to business receipts" in different sectors
- (B) the increase in wage bill at different levels of the SMW in percentage terms

The cost increase as a result of SMW is (A) x (B).

By comparing the cost increase figures at a particular minimum wage level with the corresponding median profit ratios in different sectors, one will be able to generate indications on whether companies were operating with profits or loss. The tabulation in the Annex shows a full comparison for \$22/hr - \$33/hr.

We are mindful that the government's data on wage bill increase did not reflect any potential knock-on effect triggered by a minimum wage on the higher percentiles¹, and that the median profit ratio data² did not factor in depreciation and capital cost. But we would still make use of those data with a view to generate some indications on how businesses might be affected. It is almost certain that any impact indicated in our calculations would be amplified considerably if knock-on effect, depreciation and capital cost are all considered.

\$33/hr

The tabulation in the Annex suggests that the rate of \$33/hr would be unsustainable for many businesses, especially for the labour intensive and low-paying sectors. Those operating with thin

¹ There is a lack of data and analysis on potential knock-on effect. The UK's Low Pay Commission had analysed the impact of the minimum wage on the income distribution, with the conclusion reached in 2009 that "...the minimum wage increases appear to have a knock-on effect up the earnings distribution to about the 30th percentile...the minimum wage, particularly the 2003 to 2006 upratings, had had an impact on relative pay levels in many low-paying sectors, either through narrowed differentials, or by precipitating changes to pay structures in response to the narrow differentials." (*National Minimum Wage, Low Pay Commission Report 2009*, Page 30) In other words, the only conclusion in the UK was that wage differentials in the low-paying sectors had been narrowed, but there was no indication on how much wages in the higher percentile changed, if any, directly as a result of the minimum wage.

² In the government's statistics, median profit ratios represent earnings / profit before deducting tax; depreciation; gain/loss on disposal of property, machinery and equipment; bad debts/write-off, amortization and provisions, to business receipts. This profit is similar to the notion of "Earnings Before Interest, Tax, Depreciation and Amortisation" (EBITDA) in business accounting.

margins are also likely to be affected. It can be seen in Annex's table that the ratio of "compensation of employees to business receipts" in the sectors of security services, cleaning services, elderly homes and estate management were on the high side: 82.7% in security services and 75.6% in cleaning services; and to a lesser extent, 55.5% in elderly homes and 46.4% in estate management, meaning that their cost of labour is a key factor of their cost.

With a \$33/hr SMW, the cost increase would exceed the median profit ratios for those sectors, implying that, at \$33/hr, half of the businesses in these sectors could be in deficit. This assumes, of course, that the increase in labour costs would not be passed wholly or partly to customers.³

The sectors of Chinese restaurants and Hong Kong style tea cafes have been operating with very thin profit margins. The median profit ratios in percentage terms were merely 1.7% (Chinese restaurants), and 3.7% (tea cafes). Thus, although the cost increase at \$33/hr in these two sectors did not exceed the median profit ratios, the differences were small enough (i.e. less than one percentage point difference) to cause worries. It should again be borne in mind that the business cost expressed in the notion of "median profit ratio" does not take into account factors such as depreciation and capital cost. When such factors are considered, many companies in these sectors are likely to go into red.

\$27/hr

The table also shows that at \$27/hr, the security and cleaning sectors would begin to experience difficulties. The cost increase for the security services sector at \$27/hr would exceed the median profit ratio, while the difference between the two ratios was within one percentage point for the cleaning services. It is important to highlight again that, if depreciation and capital cost factors were included, the cleaning services sector would likely to be in deeper trouble, while the other low-paying sectors might also face challenges. The potential knock-on effect on wage levels above \$27/hr, though difficult to quantify comprehensively, would make this minimum wage level even more unaffordable.

Following this line of analysis, the next logical step is to find a way to identify an optimal rate between \$26/hr and \$22/hr⁴.

Possible Rates between \$22/hr and \$26/hr

There are different ways to come up with a suggested rate between \$22/hr and \$26/hr by considering different benchmarking points:

Benchmarking Point 1: the UK "bite"

Many have suggested that Hong Kong should make reference to the UK's experience in introducing a minimum wage, which has successfully served to set a wage floor and avoid causing significant additional unemployment since its implementation in 1999. In 1999 the value of the UK's minimum

³ Some press reports suggest that some companies providing security, estate management and cleaning services would pass on part of the additional cost arising from a minimum wage to their customers, i.e. landlords and tenants. See report on Page A18, Sing Tao Daily, 28 April 2010. HKGCC's case studies conducted last year, which were discussed in the HKGCC's first submission to the PMWC, also had a similar finding.

⁴ The tabulation in the Annex's table shows that at \$26/hr and \$22/hr, the cost increases in percentage terms in the low-paying sectors were all within their corresponding median profit ratios. But at \$26/hr, companies could still face difficulties if factors such as depreciation, capital cost and knock-on effect were considered.

wage relative to the median wage of the earnings distribution (known as the “bite” of the minimum wage in the UK) was 45.7%.⁵

However, the UK experience has to be viewed in perspective of economic conditions. In the years before and after the UK's 1999 minimum wage law (i.e., 1998-2000), the UK economy grew an average of 3.7% p.a. That compares to just 2.3% p.a. in the previous decade. For Hong Kong, the government estimates that the GDP will grow just 1.3% p.a. in 2009-11, compared to 3.6% p.a. in the previous decade. In other words, Hong Kong is facing a considerable slower growth prospect when compared with the UK when the latter introduced a minimum wage. The PMWC should carefully consider the factor of economic cycle in selecting the bite for Hong Kong.

Taking these economic factors into consideration, and given the delicate state of the global economy and Hong Kong's exposure to direct competition, it would be prudent to look at a bite of something closer to 40%, which translates into **\$23/hr**.

Benchmarking Point 2: CSSA

In the 2008-09 Policy Address Speech, Chief Executive Donald Tsang has clearly articulated the relationship between minimum wage and family needs (or social assistance):

“As family needs vary, the minimum wage may not be sufficient to cover family expenses of all employees. Employees in need can obtain assistance under the current social security system. This can also encourage able-bodied recipients of the CSSA to rejoin the workforce and motivate them to move from welfare to self-reliance.”

It is clear from the Chief Executive's statement that the policy objective is not to set the minimum wage at such a level as to meet “family expenses” because family needs vary. It is government policy that employees in need of meeting family expenses should seek help from the social security system.

In other words, the government is not proposing that the entire responsibility to provide a basic living standard for all families should be shifted to employers through the introduction of a minimum wage. The objective of the minimum wage policy remains as preventing excessively low wages. In the future, the social assistance will effectively top up the minimum wage (which by definition will be higher than the market rate at the lower end) where necessary, in order to achieve a basic living standard for families. This is similar to how CSSA is supporting low wage workers under the existing system.⁶

Following this logic, one may argue that the minimum wage level should not exceed a “CSSA-equivalent” rate, as it has never been the government's objective to replace CSSA by a minimum wage. With this in mind, we are of the view that one may calculate a “CSSA-equivalent” rate as a ceiling for setting the minimum wage. But since CSSA is a family-based benefit, one must make

⁵ *National Minimum Wage, Low Pay Commission Report 2010*, page 34, Presented to Parliament by the Secretary of State for Business, Innovation & Skills by Command of Her Majesty, March 2010.

⁶ Provision of Disregarded Earnings under the Comprehensive Social Security Assistance Scheme”, Legislative Council Paper No.CB(2)1198/08-09(03)

certain assumptions in order to translate it into a workable figure. We take the case of a 4-member family with two able-bodied adults as the basis for calculation.⁷

Under the current Comprehensive Social Security Assistance (CSSA) scheme, a 4-member family with no income typically receives about \$9,980 a month. Assuming that two adults in a 4-member family are in full employment, they would be able to earn \$9,980 with each working a 200-hour month at about \$25/hr, or a 208-hour month at \$24/hr. We may then consider that the minimum wage could be set at **\$25/hr** as the highest rate not exceeding the CSSA equivalent.

Benchmarking Point 3: Potential Unemployment Impact

As reiterated in the introduction, one major consideration for setting the minimum wage is the potential impact on jobs. In table below, developed by collating the AEHS data, the unemployment rates in the different scenarios of layoffs are calculated as additional unemployed workers on top of the actual 199,867 out-of-work in the second quarter of 2009 (5.4% unemployment rate).

Hourly Wage	Additional No. Paid Less	Cumulative No. Workers	Resulting Unemployment Rate if Layoffs are:		
			60%	40%	20%
\$22.00	18,800	67,900	6.49	6.12	5.75
\$23.00	29,100	97,000	6.96	6.44	5.91
\$24.00	33,200	130,200	7.50	6.80	6.09
\$25.00	39,000	169,200	8.13	7.22	6.30
\$26.00	44,400	213,600	8.85	7.70	6.54
\$27.00	56,400	270,000	9.76	8.30	6.84
\$28.00	44,600	314,600	10.48	8.78	7.08
\$29.00	33,200	347,800	11.02	9.14	7.26
\$30.00	27,000	374,800	11.46	9.43	7.41
\$31.00	36,900	411,700	12.05	9.83	7.61
\$32.00	27,300	439,000	12.49	10.13	7.76
\$33.00	30,400	469,400	12.99	10.45	7.92

Note: The size of the labour force in Q2 2009 was 3,709,200

The first column is the hourly wage and the second is the number of workers earning less than that specific amount in April-June 2009. Column 3 is the cumulative number of workers earning less than the corresponding hourly rate and, in our analysis, it is the basis for understanding the total number of jobs at risk.

The last three columns are scenarios indicating what the unemployment rate would have been under different conditions, with assumptions of 60%, 40% and 20% layoffs, representing different scenarios of impact on jobs due to the SMW.

The following observations can be made under the different scenarios:

- In the case of 20% layoff, at \$23/hr, \$24/hr and \$25hr, the unemployment rates would be slightly higher (0.51, 0.69 and 0.9 percentage points respectively) than the 5.4% rate in the second quarter of 2009 (the period during which the AEHS survey was conducted by the government).

⁷ We do not use a 4-member family with only one person in employment or single parent families as basis for calculation because with CSSA at \$9,980 per month, a worker will have to earn \$48/hr for a 208 hour month to reach that wage level, or \$43/hr for 234 hours a month (typical hours for restaurant workers). These will be considered by many to be unrealistic figures given the prevailing market situation.

- However, for the scenario of 40% layoff, the resulting unemployment rate at \$23/hr, \$24/hr and \$25/hr would be 1.04, 1.4 and 1.82 percentage points higher respectively.
- In the case of 60% layoff, the unemployment rate could be further pushed up by as much as 2.73 percentage points.

Conclusion and Recommendation

The discussion of the parameters for setting the initial SMW rate has shown that \$33/hr would not be affordable for many businesses in the labour intensive and low paying sectors, especially for those already operating at a thin margin. The UK's experience shows that it would be best to start low and evaluate its effects rather than run the risk of setting it too high. Upward adjustment, if the initial minimum wage is deemed too low, is much easier than downward adjustment if it proves to be too high and people are already out of work and businesses closed.

The analysis presented in this submission has shown that after benchmarking externally (e.g. versus UK) and internally (e.g. versus CSSA-equivalent rate), it would be prudent to consider the initial SMW rate at a level between this range, which in our analysis would mean above \$23/hr and below \$26/hr. It would be a matter of judgement on what would be the acceptable unemployment spill offs by pegging the SMW at \$24 or \$25/hr.

Considering the potentially significant but so far unquantifiable knock-on effect on wage levels above the minimum wage level, the Commission would be well advised to stay more on the side of caution. Getting the estimation of the potential knock-on effect wrong by over-estimating it means starting at a lower SMW, with the prospect of upwards adjustments a year or two later. Getting it wrong by under-estimating the knock-on effect means driving people out of work and companies out of business and the damage done would be difficult to recover.

We trust that, with more researches (in particular on unemployment impact, and such impact when the knock-on effect is considered), and consultation with stakeholders, the PMWC will be able to arrive at an informed decision on a rate that would achieve the policy objectives as those set by Chief Executive Donald Tsang for Hong Kong: ensuring a sensible balance between forestalling excessively low wages and minimising the loss of low-paid jobs, while sustaining Hong Kong's economic growth and competitiveness.

Hong Kong General Chamber of Commerce
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* An annex is attached.

Impact on Total Cost at Different Levels of Minimum Wage

Sectors	Ratio of Compensation of Employees to Business Receipts (A)	HK\$22		HK\$23		HK\$24		HK\$25		HK\$26		HK\$27		HK\$30		HK\$33		Median Profit Ratio in %
		Est. % Increase in Wage Bill (B)	% Change in Total Cost (A*B)	Est. % Increase in Wage Bill (C)	% Change in Total Cost (A*C)	Est. % Increase in Wage Bill (D)	% Change in Total Cost (A*D)	Est. % Increase in Wage Bill (E)	% Change in Total Cost (A*E)	Est. % Increase in Wage Bill (F)	% Change in Total Cost (A*F)	Est. % Increase in Wage Bill (G)	% Change in Total Cost (A*G)	Est. % Increase in Wage Bill (H)	% Change in Total Cost (A*H)	Est. % Increase in Wage Bill (I)	% Change in Total Cost (A*I)	
(i) Preliminary Identified Low Paying Sectors	16.8	0.4	0.0672	0.7	0.1176	1	0.168	1.5	0.252	2	0.336	2.7	0.4536	5.2	0.8736	8.4	1.4112	5.5
1. Retail	9.1	0.1	0.0091	0.2	0.0182	0.3	0.0273	0.5	0.0455	0.7	0.0637	0.9	0.0819	2.2	0.2002	3.9	0.3549	4.5
1.1 Supermarkets and convenience stores	7.2	n/a	n/a	0.1	0.0072	0.3	0.0216	0.7	0.0504	1.3	0.0936	2	0.144	4.6	0.3312	8.5	0.612	24
1.2 Other retail stores	9.4	n/a	n/a	0.2	0.0188	0.3	0.0282	0.4	0.0376	0.6	0.0564	0.8	0.0752	1.9	0.1786	3.3	0.3102	4.5
2. Restaurants	28.4	0.3	0.0852	0.5	0.142	0.7	0.1988	1.1	0.3124	1.6	0.4544	2.2	0.6248	4.6	1.3064	7.9	2.2436	6.6
2.1 Chinese restaurants	32	0.1	0.032	0.2	0.064	0.3	0.096	0.5	0.16	0.8	0.256	1.1	0.352	2.5	0.8	4.8	1.536	1.7
2.2 Non-Chinese restaurants	26.3	0.1	0.0263	0.1	0.0263	0.3	0.0789	0.5	0.1315	0.7	0.1841	1.1	0.2893	2.8	0.7364	5.4	1.4202	7.1
2.3 Fast food cafes	22.9	1	0.229	1.6	0.3664	2.4	0.5496	3.6	0.8244	4.9	1.1221	6.4	1.4656	11.6	2.6564	17.8	4.0762	13
2.4 Hong Kong style tea cafes	30.3	0.3	0.0909	0.5	0.1515	0.8	0.2424	1.3	0.3939	2	0.606	2.8	0.8484	6.3	1.9089	10.7	3.2421	3.7
3. Estate management, security and cleaning services	46.4	1	0.464	1.5	0.696	2.2	1.0208	3	1.392	4	1.856	5.3	2.4592	10	4.64	15.2	7.0528	5.5
3.1 Real estate maintenance management	31.3	0.9	0.2817	1.4	0.4382	2	0.626	2.7	0.8451	3.5	1.0955	4.5	1.4085	8	2.504	12	3.756	3.4
3.2 Security services	82.7	1.6	1.3232	2.5	2.0675	3.5	2.8945	4.7	3.8869	6.1	5.0447	7.7	6.3679	13.4	11.0818	19.9	16.4573	6.3
3.3 Cleaning services	75.6	0.8	0.6048	1.3	0.9828	2	1.512	2.9	2.1924	4.4	3.3264	6.7	5.0652	15.6	11.7936	25.6	19.3536	6
4. Other low paying sectors	22.9	0.7	0.1603	0.9	0.2061	1.3	0.2977	1.8	0.4122	2.4	0.5496	3.1	0.7099	5.6	1.2824	8.8	2.0152	11
4.1 Elderly homes	55.5	0.2	0.111	0.4	0.222	0.9	0.4995	1.5	0.8325	2.3	1.2765	3.2	1.776	6.4	3.552	10.2	5.661	3.9
4.2 Laundry and dry cleaning services	33.3	n/a	n/a	n/a	n/a	0.8	0.2664	1.2	0.3996	1.8	0.5994	2.4	0.7992	4.7	1.5651	7.7	2.5641	12.4
4.3 Hairdressing and other personal services	39.3	1.3	0.5109	1.7	0.6681	2.2	0.8646	2.9	1.1397	3.6	1.4148	4.4	1.7292	7.4	2.9082	11.2	4.4016	19.3
4.4 Local courier services	36.7	n/a	n/a	n/a	n/a	0.7	0.2569	1	0.367	1.4	0.5138	1.9	0.6973	3.5	1.2845	6.4	2.3488	n/a
4.5 Food processing & production	16	0.1	0.016	0.3	0.048	0.4	0.064	0.6	0.096	0.9	0.144	1.3	0.208	2.6	0.416	4.5	0.72	1.5
(ii) Other Sectors	10.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0106	0.1	0.0106	0.2	0.0212	0.3	0.0318	4.8
5. Manufacturing	10.4	0.1	0.0104	0.1	0.0104	0.1	0.0104	0.2	0.0208	0.2	0.0208	0.3	0.0312	0.7	0.0728	1.2	0.1248	11.3
6. Construction	24.6	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0246	0.1	0.0246	0.1	0.0246	0.3	0.0738	0.6	0.1476	5.8
7. Wholesale and import/export trade	4.2	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0042	0.1	0.0042	0.2	0.0084	3.3
8. Hotels and catering	25.1	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.8	0.2008	11.6
9. Transport, storage and communications	12.5	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0125	0.1	0.0125	0.2	0.025	0.4	0.05	5.2
10. Financing, insurance, real estate and business services	22.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0223	0.1	0.0223	9
11. Education, medical, other community and personal services	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	n/a	0.1	n/a	0.1	n/a	0.2	n/a	0.4	n/a	n/a
12. Others	5.9	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0.1	0.0059	4.3
(iii) All sectors	11.1	0.1	0.0111	0.1	0.0111	0.2	0.0222	0.3	0.0333	0.4	0.0444	0.5	0.0555	0.9	0.0999	1.6	0.1776	5

Note:

- 1 The calculation methodology adopted in this exercise is to find out the percentage change of total cost due to increase in wage bills at different levels of min wage, with data provided by the Census and Statistics Department.
 - 2 Sectors of marginal cases (i.e. % change in total cost less than median profit ratio by no more than 1 percentage point) that are likely to suffer if costs like depreciation, gain/loss on disposal of property, machinery & equipment, etc. are considered because profit margin is close to median profit ratio.
 - 3 Sectors suffer at a specific level of min wage
- Since the definition of profit adopted by the government statistics is similar to EBITDA, which does not include many expenses and costs, that means the profit margins of some cases in reality are even less than what is implied by the government statistics.