

# **The Consumption Response to Minimum Wages: Evidence from Chinese Households**

**Ernest Dautovic**

University of Lausanne

**Harald Hau**

University of Geneva and Swiss Finance Institute

**Yi Huang**

Graduate Institute Geneva

November 2017

## **Summary**

In the first decade of the new century, China's President Hu Jintao pursued a "harmonious society" policy agenda promising more equity and income equality. But income inequality as measured by the Gini coefficient further increased from 0.45 in 2000 to 0.49 in 2008, placing China at the top quartile of the world's most unequal economies. Contemporaneous to this general increase in inequality, the rules regulating the minimum wages in the labor market have been reformed after 2003 and enforced throughout a labor market with more than 800 million workers. How effective were these minimum wage policies in improving income, consumption and welfare of low-income households? This research paper investigates this question using a representative panel of Chinese households over the period 2002-2009.

The paper shows that minimum wage policies – operating in conjunction with social transfers – had an economically significant impact on the welfare of China's low-income urban households. The empirical evidence indicates a positive reaction of income and consumption

of poorer household to an increase of the minimum wage. An increase of the minimum wage by RMB 1 increases household labor income by RMB 1.5 for those households that depend by more than 75% of their total income on minimum wages. At the same time, a RMB 1 increase in the minimum wage is accompanied by an equivalent increase in social transfers for the same group of households. The combined effect of the minimum wage increase on labor income and social transfers contributes thus in containing the income gap between poorer and richer households in China.

Following an increase in minimum wages we observe that the increased disposable income is entirely spent, and particularly so in households with children. We also show that roughly 40% of this additional minimum wage income is in fact "invested" in health care and educational spending with potential long-term benefits for household welfare. We also investigate whether the high consumption propensity can be attributed to credit constrained households, but we do not find that a higher minimum wage creates systematically different patterns of consumption across households deemed more or less financially constrained.

The benefits of higher consumption for the majority of low-income households could be challenged if workers faced higher unemployment risk as a consequence of the higher minimum wage. Yet, the household survey data used in this study provide no evidence for economically significant adverse employment effects among the general population, and even among the more vulnerable migrant population within urban centers. The absence of negative employment effects after minimum wage hikes could be explained by the low level of the minimum wage relative to the median wage in China and a high rate of job turnover, which seems to increase rather than decrease in the minimum wage level. Instead of pricing low-skilled workers out of the market, a higher minimum wage appears to have matched workers to other, perhaps more productive jobs. The extremely high rates of productivity growth in many firms could have contributed to these particular labor market conditions in China.