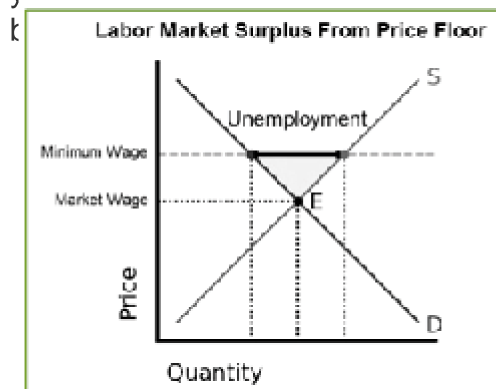
February 7, 2014

"In short, what the living wage is really about is not living standards, or even economics, but morality. Its advocates are basically opposed to the idea that wages are a market price--determined by supply and demand, the same as the price of apples or coal. And it is for that reason, rather than the practical details, that the broader political movement of which the demand for a living wage is the leading edge is ultimately doomed to failure: For the amorality of the market economy is part of its essence, and cannot be legislated away."
-Paul R. Krugman

"A general flat minimum-wage law for all industry is permissible, but I do not think that it is a particularly wise method of achieving the end. I know much better methods of providing a minimum for everybody. But once you turn from laying down a general minimum for all industry to decreeing particular and different minimum for different industries, then, of course, you make the price mechanism inoperative, because it is no longer the price mechanism which will guide people between industries and trades."
-F.A. Hayek

Recently, a small suburb of Seattle, Sea-Tac, raised the municipality's minimum wage to $15 per hour. That is double the current federal wage mandate of $7.25. Now, unless you happen to own a business or work in this area, the new legislation probably never entered your purview. That's all about to change. In last week's State of the Union address, President Obama made clear his intentions to tackle the rising income inequality in America. He has stated that one of his preferred methods for dealing with this divergence is through a higher federal minimum wage. To be specific, the president supports a federally mandated minimum wage of $10.10 per hour. If you're tempted to conclude the president's lame duck status as reason to dismiss this topic, consider this: In a nation divided along so many lines, recent polls show that both Democrat and Republican voters support a higher minimum wage. This means that the real question isn't whether a wage increase will come; instead, it's how large it will be.

To begin evaluating the potential consequences of such an increase, let's start with the traditional context in which most people talk about a minimum wage. In economic language, the graph below illustrates in a basic form the effect of higher wages on employment. Basically, if you set the price of wages (minimum wage) too high, there will be more workers than there are



This makes sense; the higher the wages, the more inclined people are to work. At the same time, businesses are less incentivized to hire workers, because doing so becomes more and

more costly. The reverse is also true; if you require your workers to accept less than they think is fair, you will have more employers willing to hire than available workers.

Economic theory and hypotheticals are the languages used by academics to explain financial forces at work. (Of course, politicians have never been known for their economic literacy!) However, I find this approach to be an incomplete, if not inadequate, way to think about such implications. Perhaps the most important takeaway for readers when it comes to the economic debate surrounding the minimum wage is the volume of conflicting results that studies have yielded. A good example of inconclusive findings is the Federal Reserve's report, *Why Minimum Wage May Not Reduce Employment*.

As the above report is rather in-depth, let me attempt to summarize what many economists have said regarding minimum wage increases. First, it's nearly impossible to find an economic environment in which the only variable that changes is the minimum wage itself. The countless variables that affect employment levels can blur the impact of wage changes. Also, it's difficult to understand the goal of a minimum wage. As you will see as you continue to read, the impacts of wage changes are mixed. Employees who keep their jobs benefit from additional income, but at what expense? So, if economists can't clearly determine the effects of the minimum wage, how can we decide how to implement policy around it? I contend that a more practical examination would be helpful. Instead of using economic models, let's use real-life examples. Let's think as business owners and employees to identify the implications of a higher minimum wage.

If wages do increase, the first question is whether businesses can afford to pay higher wages. For businesses, large or small, that are operating on the verge of profitability, an increase will likely be a fatal blow. This means fewer jobs. Other businesses that are profitable will simply be less profitable, a clear improvement if you are a minimum wage worker who remains employed. However, in this simplistic example, it's hard to assess whether this is a better situation for the economy as a whole.

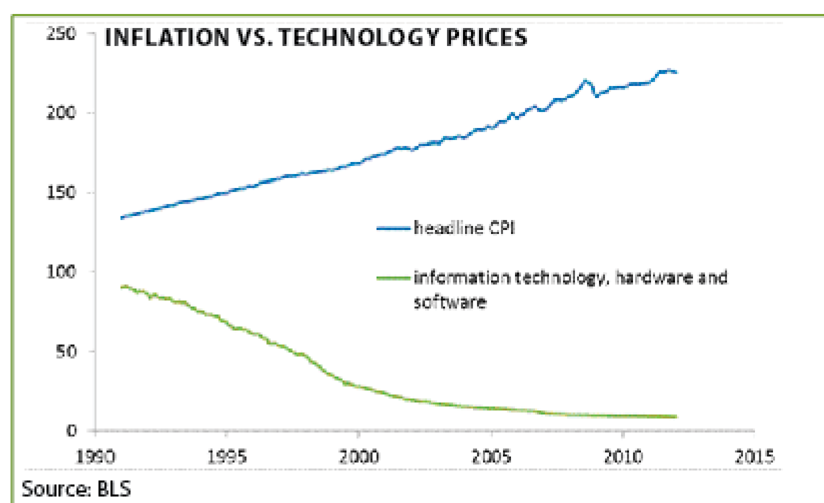
Maybe I've oversimplified. Those businesses that are operating on the verge of profitability have another way to offset the increased cost of labor. They can raise prices. The notion that big businesses with fat profit margins will bear the brunt of an increase in wages just isn't true. In many cases, the end users of the goods or services are footing the bill for these increases. There is no free lunch. As I said earlier, the money must come from somewhere.

Some proponents have made the argument that a positive compounding effect occurs when minimum wages are increased. The argument goes like this: Minimum wage workers get paid more, which causes them to consume more. As one CEO put it, "Our employees are our customers." Imagine an old pioneer town where the only business is a saloon. If the saloon pays its workers more, then it can charge more for food and whiskey. Like a carousel, this can go around and around. In the end, if all that changes is price, all you've really done is create inflation. Additionally, research studies (e.g., Neumark and Wascher 1997) have questioned the very foundation of this theory. They found that many employees don't in fact simply recycle the wage increase. Think about it more plainly, does it make sense that a McDonald's employee will just buy more Happy Meals or Big Macs if that employee is paid more? No, that employee will buy an iPhone or Xbox. Without greater production of these devices, their price will rise, essentially inflating away the minimum wage benefit for the overall consumer.

Let's zoom out and try to get a handle on the magnitude of what a federally mandated minimum wage would mean. While it's true that only 2.5% of all Americans earn the minimum wage, nearly 30% of Americans are within 150% of minimum wage. This means almost one-third of Americans earn a few dollars more an hour than minimum wage. If the lowest-wage workers see

an increase, wouldn't it seem reasonable for those who were previously making slightly more to expect to maintain their premium? Clearly, workers aren't going to stand idly by and watch their employers pay the least skilled workers more money while their own income remains unadjusted. If the bag boy (my first occupation) gets a $2/hour raise, it seems likely that the checkout clerk, who performs more complex functions, will not sit by and earn relatively less. This is known as "the ripple effect." It's hard to predict where it will stop. However, it's obvious that employers will be forced to raise the wages of workers far beyond the bottom 3% of earners. The potential economic effects of this could be sizable depending on the amount of wage increase.

The substitute for human labor is no longer just something from the *Jetsons*. Our partner at GaveKal, Louis Gave, recently published *Too Different for Comfort*, which takes a fascinating look at the "robo-lution" occurring in the manufacturing industry. As the price of labor increases, turbocharged by the increasing benefit obligations borne by employers, the idea of using a machine, or robot, has never been more attractive or more feasible.



Debate is rampant over the current rate of inflation. I've heard people cite orange juice, plane tickets, cars, or whatever to support their deflationary or inflationary outlook. One area where sane people don't debate the direction of prices is technology. Driven by the power of Moore's Law, technology continues to develop at a staggering rate. This means that automating more of the tasks we humans have performed is less of an *if* and more of a *when*. Be ready, though, as there will be those who warn that automation will lead to structural unemployment and that mechanization is anti-jobs or even un-American. Since the beginning of the Industrial Revolution some 150 years ago, technophobes have warned at every major technological advancement that permanent massive unemployment was just around the corner. In 1945, it was Eleanor Roosevelt who wrote, "We have reached a point today where labor-saving devices are good only when they do not throw the worker out of his job." Whether it is the cotton gin, the washing machine, or the PC, technological progress hasn't created structurally higher unemployment. In fact, it's quite the opposite. It's lowered prices on goods. It's allowed us to pay less for almost every type of good in terms of hours of labor required to buy it.

LABOR TIME COSTS OF COMMODITIES (1895-1997)			
Commodity	Time-to-Earn in 1895 (hours)	Time-to-Earn in 1977 (hours)	Productivity Multiple
Horatio Alger books (6 vols.)	21	0.6	35.0
One-speed bicycle	260	7.2	36.1
Cushioned office chair	24	2.0	12.0
100-piece dinner set	44	3.6	12.2
Hair brush	16	2.0	8.0
Cane rocking chair	8	1.6	5.0
Solid gold locket	28	6.0	4.7
Encyclopedia Britannica	140	4	35.0
Steomway piano	2400	1107.6	2.2
Sterling silver teaspoon	26	34.0	0.8
Oranges (dozen)	2	0.1	20
Ground beef (1 lb.)	0.8	0.2	4
Milk (gallon)	2	0.25	8
Television		15	
Plane ticket SFO-BOS		20	
Antibiotic strep throat cure		1	
Dental x-ray		2	
Laptop computer		70	

Source: 1895 Montgomery Ward Catalogue

Regardless of minimum wage levels, increasing adoption rates of automation seem inevitable. Certain industries will remain protected for the foreseeable future. It is the monotonous, repetitive jobs that are in the crosshairs. For example, do you really need someone to check you into your hotel room? It won't be long before your smartphone will serve as your room key and you can avoid the front reception desk of hotels altogether. Checking out at a grocery store is likely to be a thing of the past. Self-checkout is already emerging and it will be facilitated by developments in radio frequency identification (RFID). Other jobs will remain protected. Chefs at five-star restaurants, where creativity drives food preparation, are not likely to be threatened. Lawyers, CPAs, and architects who deal with dynamically evolving environments and uniquely different situations are safe.

While we've explored the possibility of a more rapid introduction of robotics/automation, it's not going to be an overnight transformation, even in industries where job functions are easily replicable. Assembly line workers won't be tossed to the streets overnight, even if the minimum wage shoots up dramatically. This begs an interesting question: Is there any clear case study that can help us anticipate what may happen to a capitalistic economy if wages jump overnight? As I stated earlier, the effects of the minimum wage have been debated with much fervor but little resolution. Economists like Paul Krugman believe that a higher minimum wage could spur economic growth. Others like Milton Friedman have argued the exact opposite. A simple Google search will yield enough information to make you an expert on either side of this issue. Let's leave academia behind again and look at a minimum wage increase that is unfolding in a virtual vacuum.

If you were to ask yourself where one might start a search to untangle the confusing economic effects of the minimum wage, it's unlikely you would think to start 2,500 miles southwest of Hawaii in American Somoa. A tiny island chain inhabited around 850 AD, likely from what is modern-day New Zealand, it remained untouched by Western civilization until it was occupied

by Germany and the United States. In 1899, with Germany controlling the western half and the United States controlling the eastern half, the two navies prepared to engage in a sea battle at Pago Pago harbor. Just prior to the conflict, a typhoon struck the island chain preventing the naval showdown. Not long after, an armistice was reached which gave the United States control of the eastern portion of the islands, known today as American Somoa.

Not exactly an economic juggernaut, Samoa's economy ranks 187th in the world, just ahead of Micronesia and Sao Tome, two countries it's unlikely anyone other than a cartographer would be able to pinpoint. In 2007, the US. Congress passed legislation to increase the federal minimum wage 40%, from $5.15 to $7.25. As a territory of the United States, American Somoa was also required to conform to this wage increase. Previously, the territory had set its wages independently to range from $2.68 to $4.09 per hour. Samoa's economy is divided into three main categories: the public sector, tuna canneries, and the rest of the private sector. The new legislation passed in D.C. required American Somoa to raise minimum wage rates $.50 each year until they were in line with those of the mainland US. This wage increase was severe for the territory. Think of it this way. On a per capita income basis, it would be like increasing the federal minimum wage here in the mainland to $20 an hour. The consequences were as follows (read the full report here):

- One tuna cannery, Chicken of the Sea, closed.
- The other cannery, operated by Starkist, dramatically cut its workforce.
- Real wages fell 11% as inflation increased.
- After only a $1.50 hike, a 14% decrease in employment occurred.
- The increase represented an 8% hike for those minimum wage workers who remained employed.
- The tuna canning industry planned more layoffs.

Exactly how large a role the minimum wage played in the collapse of Samoa's economy is debatable. In a detailed report, the tuna industry cites other competitive disadvantages from operating within American Somoa, but largely blames the wage increase. Here is a quotation from testimony before a congressional subcommittee: "I remain concerned that this GAO [General Accountability Office] report does not adequately, succinctly, or clearly convey the magnitude of the worsening economic disaster in American Samoa that has resulted primarily from the imposition of the 2007 US minimum wage mandate." (-Democratic Governor Togiola Tulafono of American Samoa September 2011)

In July 2012, the House voted 378-11 to freeze minimum wage hikes in the territory until 2015. While some may look at the consequences seen in American Somoa as some sort of vindication for arguing against minimum wage hikes, plenty of people would disagree. Critics argue that a 2007 tsunami, which killed 34 people, was the real crippler of the territory's economy. Others contend that changing competitive dynamics in the region made other nations better suited for tuna canneries. Still others argue that American Somoa has few similarities to the diverse American economy. This is all true, and the consequences of minimum wage increases probably will never be universally agreed upon, particularly in our politically fractured country that seems to grow more splintered with each passing day.

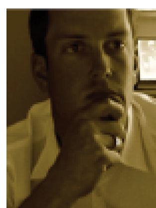
The purpose of this EVA isn't to take sides or to say who is right or wrong. The goal is to alert readers that the topic of wage levels and the income gap is likely to take front and center in the nation's political battlefield. From an investor's standpoint, increasing the minimum wage means changes to the investment landscape. To what extent largely depends on the magnitude and scope. In this type of environment, companies that are "price makers" are likely to remain insulated. Makers of branded household staples can pass their higher wages along to consumers because they have more pricing power. Companies that rely heavily on cheap labor

are likely to be pressured, yet I should remind readers that the effects of higher wages on lower paid employees will likely trigger reverberations in all employer-employee negotiations. This means thinking that only businesses that employ lower skilled workers will face an increase is likely a costly miscalculation. (I might add that while this is clearly inflationary, the deflationary environment created by the global currency wars is also likely to serve as a counterbalance to rising wages.) Businesses with strong balance sheets will be able to make the necessary capital investments to replace humans with machines when possible (the Fed's long campaign to suppress interest rates ironically facilitates the substitution of machines for labor). Companies with reliable profit margins can more easily absorb the cost increase represented by higher priced labor.

Do not despair that all is lost if certain jobs are automated. New industries will emerge. New companies will thrive by supplying machines. Salespeople will sell these machines. Programmers will write the software that makes the machines perform previously unimagined tasks. Maintenance workers will service the machines. Product prices will be driven down as productivity gains are made. This means consumers will have to spend less, leaving them with more money to spend elsewhere.

Do despair that our nation is facing a widening income gap with few solutions that get at the root of the problem. A shifting focus on equality of outcome seems to be favored over equality of opportunity. Waiting until people are in their 20s without a college degree or valuable trade skills is far too long.

Perhaps the most significant aspect of the minimum wage issue for high net worth investors is what it represents, not what it does. We can debate the merits of QE endlessly, but one cannot ignore the result. It's made a lot more money for those on Wall Street than Main Street. Policy makers know this, and there is little doubt in my mind that the prerequisite for future decisions is to find a way to reverse these unintended consequences. We've seen a tax increase on those in the top income bracket. Now, the momentum is gaining for an increase to the federal minimum wage. Where this will stop is anyone's guess but, if I had to bet, it will not slow until we begin to see a contraction of the nation's income gap. Given the visible weakness we've seen in emerging markets, as well as the complex set of issues domestically, we think investors are being given a chance to tactically reposition their portfolios. The notion that a static approach to investing in this volatile environment makes sense, gives us pause—though not when it comes to taking more chips off the table.



Tyler Hay | Chief Executive Officer

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