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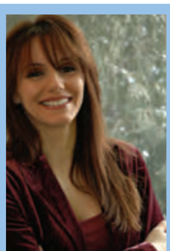
THE MINIMUM WAGE AND LABOUR MARKET FLEXIBILITY

The labour market is of fundamental importance in an economy, allocating human capital to its most productive uses. With the aim of protecting workers, however, governments have instituted various institutional constraints over the years, making this market less flexible. These rigidities have the effect of slowing job creation and pushing up unemployment. This is especially true of Quebec, with a labour market that is more highly regulated than elsewhere in North America – and with an unemployment rate that has consistently stood above the Canadian and American averages for the last 30 years (see Figure 1).



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How the labour market works

To appreciate the importance of flexibility in a labour market, it is crucial to understand first how it operates. On the one hand, workers come into the labour market to offer their services. This puts them in the role of sellers. Obviously, the higher the wage on offer for a given job, the more applicants there will be, and vice versa. Moreover, individuals will take only the jobs that look most advantageous, meaning those that pay best in relation to their attractions or difficulties.

In contrast, employers come to the labour market to find workers and thus play the role of buyers. Employers will hire workers only if they (with all attributes taken into account) will bring in more than they cost (with all expenses accounted for). Applying the same logic, employers will agree to salary hikes or added fringe benefits only if the workers' productivity is high enough to justify the extra costs.

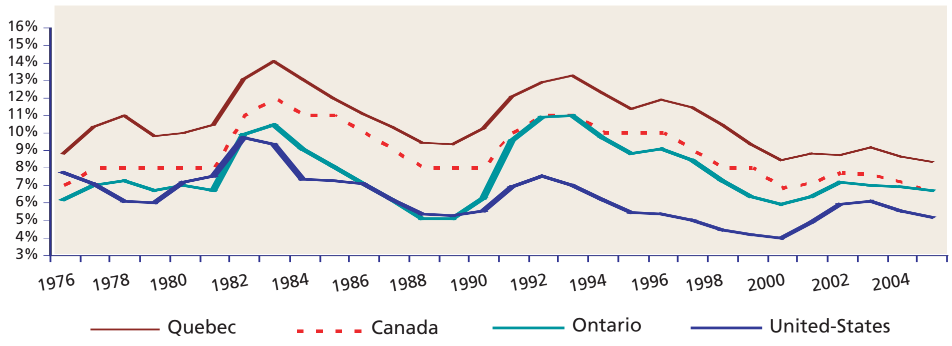
Labour market flexibility refers to the ease with which workers and employers can negotiate mutually advantageous labour contracts so that remuneration, working conditions and workforce size can fluctuate with the least possible interference.

In situations where qualified workers are in short supply, employers will find it worth their while to offer higher wages and better working conditions to attract the people they need. By way of contrast, in areas where job offers are limited, workers will have an interest in lowering their wage expectations and their demands. Where these exchanges can occur with relative ease, an optimal number of job offerers and seekers will achieve satisfaction, resulting in creation of a maximum number of positions.

For the labour market to be considered flexible, it has to operate freely, with an ability to adapt to any shocks that may arise and a capacity to adjust to a constantly changing economic environment. This flexibility is important, because it provides for the changes needed to deal either with surpluses or shortages of labour when some industries are in decline while others expand. For example, growth in information technologies during the 1990s, along with fear of the Y2K bug, created a shortage of computer specialists. But this shortage was soaked up quickly when many workers, drawn by high salaries, chose this profession.

FIGURE 1

Unemployment rates, 1976-2005



Source: Statistics Canada, "Labour force survey estimates," CANSIM, Table 282-0002; U.S. Bureau of Labor Statistics, "Employment status of the civilian noninstitutional population, 1940 to date," available at http://www.bls.gov/cps/cpsaat1.pdf.

Rising costs

Government intervention in the labour market generally aims to protect workers by ensuring them of higher income or of job security. However, one of the first lessons we learn from economics is never to judge a policy or law by its intentions but rather by the behaviour it encourages and the results it produces.

For example, though wages and working conditions are generally flexible when they are on the way up, there exist constraints that lead to rigidities when things are headed down and that prevent the labour market from adjusting spontaneously to the economic context. Other measures involving higher pay or fringe benefits block the negotiation of mutually advantageous agreements or limit an employer's freedom to lay off staff. All cause an increase in the costs assumed by the company.

When costs go up while worker productivity remains unchanged, some workers start to cost more than they bring in and no longer hold much interest for the employer. For example, a worker whose services generate $7 an hour in revenues for an employer will not be hired if he or she costs $8 an hour.

Unemployment is thus due in part to agreements that cannot occur even if both sides are willing to go along because of constraints that artificially raise the costs and risks of hiring. Laws may force an employer to pay more generous wages or to retain workers, but they cannot require a company to hire workers who may cause losses.

Minimum wage

The most direct way a government can ensure higher income for a group of workers is to impose a wage floor. This is what they do in instituting a minimum wage, for example. Taking account of differences in living standards in each region, Quebec has the highest minimum wage in North America.[1]

At first sight, this measure seems irreproachable and its aim praiseworthy: to raise the income of wage-earners who are at the lowest rung of the ladder and rescue them from poverty. But this fails to take account of the perverse effects it causes and the fact that the persons it covers are not necessarily those one might believe.

Minimum wage is the entryway to the labour market for the least qualified individuals. This explains why a high proportion of workers paid at minimum wage are young people working part-time, often still at school and living with their parents in households that are not poor.[2]

Labour market flexibility refers to the ease with which workers and employers can negotiate mutually advantageous labour contracts.

1. The annual income of a person working at minimum wage represents 50% of GDP per capita in Quebec, the highest proportion among the 60 states and provinces in North America. See Jason Clemens, Amela Karabegovic, Keith Godin and Niels Veldhuis, "Measuring Labour Markets in Canada and the United States: 2004 Edition," Fraser Institute, September 2004, p. 28, available at http://www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=690.
2. Nearly two-thirds of minimum wage workers are under 25 years old. A similar proportion live with their parents or other family members. See Deborah Sussman and Martin Tabi, "Minimum wage workers," Statistics Canada, *Perspectives on Labour and Income*, March 2004, pp. 7 and 11, available at http://www.statcan.ca/english/freepub/75-001-XIE/1030475-001-XIE.pdf.

Other minimum wage workers include persons who, for various reasons, have little education or work experience (dropouts, immigrants, elderly women returning to the labour market, etc.). By definition, these persons are unproductive, and their only way of eventually climbing the labour market ladder is to start at the bottom rung.

A higher minimum wage has the effect of raising this bottom rung to a height many of them cannot reach, leaving them unemployed. Employers will not find it worth hiring workers whose productivity fails to match the rising costs they generate. Moreover, when machines can replace human labour, companies may turn to production techniques that make greater use of machines if this costs less than hiring additional workers.

Most economists agree that a higher minimum wage fails to reduce poverty and creates at least some unemployment.

Most economists agree that a higher minimum wage fails to reduce poverty and creates at least some unemployment.[3] For example, Canadian researchers have shown that a 10% rise in the minimum wage reduces employment among teenagers by 2.5%.[4] If the aim is truly to help persons living on low incomes, tax-based measures such as a "work premium" (in other words, a refundable tax credit on employment income) have a much more direct effect on net income, without the perverse effects that a higher minimum wage has on the labour market and on employment.

Regulation of labour relations

Another way of seeking to protect workers is to regulate labour relations, either by making it harder to lay off workers or by favouring unionization. These measures also cause perverse effects, however.

Before hiring a new worker, employers will take account of every cost they will have to bear, including costs created by dismissal. When the law requires a long advance notice, heavy severance payments or very strict conditions for layoffs, this raises the costs of hiring new employees, making the labour market less flexible.

In a survey of empirical studies on this issue, the OECD concluded that the impact of job protection measures on total unemployment was not clear because these measures tended to hold back both firing and hiring. However, they did hurt certain groups, especially "first-time entrants (mainly young people), and re-entrants (mainly women who are more likely than men to move between employment and inactivity, in particular when seeking to balance the competing demands of work and family life)."[5]

Quebec, and Canada as a whole, are in an advantageous position in this regard. Based on an indicator developed by the OECD, Canada ranks third among countries where employment protection laws are least rigid, with all the top spots held by English-speaking countries. Southern European countries, on the other hand, have the strictest laws.[6] The debate that took place in France early in 2006 on the "first-job contract" aimed precisely to seek a solution to this problem of labour market rigidity.

Quebec emerges much less favourably when labour relations come under examination. Quebec labour laws are among the most favourable to unions, and Quebec is the place with the highest rate of unionization in North America. This situation has highly negative effects in terms of labour flexibility.[7]

A survey of research on this topic concludes that unions exert upward pressure on wages but hold back job growth.[8] As economic theory would predict, job growth is weaker in unionized sectors than in non-unionized sectors since companies will hire fewer workers if they cost more. Moreover, since the number of unionized jobs is limited, unemployed persons will opt for non-unionized markets, creating an abundance of workers and exerting downward pressure on wages in these other markets.

3. "The minimum wage. A blunt instrument," *The Economist*, October 28, 2006, p. 40.
4. Michael Baker, Dwayne Benjamin and Shuchita Stanger, "The Highs and Lows of Minimum Wage Effects: A Time-Series Cross-Section Study of the Canadian Law," *Journal of Labor Economics*, Vol. 17, No. 2, April 1999, pp. 318-350.
5. Organisation for Economic Cooperation and Development, "Employment Protection: The Costs and Benefits of Greater Job Security," *OECD Policy Brief*, September 2004, p. 3, available at http://www.oecd.org/dataoecd/6/32/33736760.pdf.
6. *Ibid*., p. 2.
7. See in particular the Economic Note by Norma Kozhaya, "The consequences of a strong union presence in Quebec," Montreal Economic Institute, September 2005, available at http://www.iedm.org/main/show_publications_en.php?publications_id=106.
8. Barry T. Hirsch, "Unionization and Economic Performance: Evidence on Productivity, Profits, Investment and Growth," Fraser Institute, 1997, available at http://www.fraserinstitute.ca/admin/books/files/PPS3-Unionization%20Econ%20Perform.pdf.

Labour law flexibility plays a crucial role in labour market performance. Researchers have shown that unemployment rises when the laws governing labour relations are too rigid.[9] The Fraser Institute has compared labour market performance in the continent's 60 states and provinces with a labour relations law flexibility index that takes account of several factors: accreditation and disaccreditation procedures, arbitration of disputes, the obligation to be a union member and pay union dues, treatment of technological change, successor rights, anti-strikebreaking measures, and third-party picketing. Quebec comes in last place with respect to the rigidity of its labour relations laws, and it ranks 49th in the performance of its labour market.[10]

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Conclusion

As a general rule, it has to be expected that firms will react to the constraints imposed on them. For example, under pressure from a high minimum wage and rigid labour laws, they can choose to hire a smaller staff, to replace workers with machines, to reduce performance premiums and other incentives, or to relocate their activities elsewhere in the world. In all cases, unemployment increases and the labour market is less dynamic. The big losers are young people, women, unemployed persons lacking experience, and everyone whose productivity is too low to justify their wages.

Some people benefit from these constraints, in particular workers who hold onto their jobs and who benefit from increased protection. Many employers have no choice but to pay higher wages and grant extra benefits, even when these are not justified by higher productivity. However, companies that see their production costs rise will have cause to boost their prices as a result. The losers then are consumers who have to pay more for their goods and services.

The most effective way to help workers is to keep labour laws flexible, thereby ensuring labour market dynamism. In a context of high job creation, workers will easily find jobs and wield greater negotiating power when the time comes to set their wages and working conditions, considering that they can easily go elsewhere. In case of layoffs, they can find other work quickly. Higher incomes and secure jobs are ensured not by strict regulations but by a scarcity of labour in relation to demand.

9. Edward Bierhanzl and James Gwartney, "Regulations, Unions and Labor Markets», *Regulation*, Vol. 21, No. 3, 1998, pp. 40-53, available at http://garnet.acns.fsu.edu/~jgwartne/regulation%20--%20gwartney.pdf.
10. See Jason Clemens *et al*., *op. cit*., pp. 30-31.

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