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Minimum Wages, Unions, the Economy and Society

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Abstract

One of the characteristics of the WorkChoices *legislation introduced by the Howard government was the anti-union bias that permeated it. Some argue that this is appropriate because unions increase minimum wages, and economic theory shows that this will decrease employment and hence output. The Rudd government has signalled that it intends changing this anti-union bias, while at the same time restoring the role and coverage of minimum wages. This paper examines the arguments around these issues and concludes that neither side of the economic theory debate has delivered a knockout blow. The theoretical analysis is followed by a section looking at empirical evidence on the effects of deregulating labour markets. Again there is not complete consensus among the economics profession. However, both sides of the debate on the effects of labour market deregulation agree that strong minimum wage legislation does significantly reduce earnings inequality by increasing earnings at the bottom end of the distribution. The paper concludes that the increase in inequality consequent on labour market deregulation has adverse effects on the economy in the short run and disturbing longer run effects on society.*

Introduction

One of the most obvious characteristics of the *WorkChoices* legislation enacted by the Howard government, but an aspect underplayed in the media and in the 2007 election debate between political leaders, was its profoundly anti-union bias. A few of the more thoughtful journalists commented on it (for example, Ross Gittins, *Sydney Morning Herald*, 21 November 2005). The ALP and even the ACTU preferred to highlight the effects of *WorkChoices* on individuals, often through stories about actual individuals who had been treated particularly harshly by employers. After the election, the Rudd government signalled important changes to the *WorkChoices* legislation, under the label of *Forward with Fairness*.[1] The foreshadowed legislation includes provisions restoring the importance of collective bargaining, as well as restoring minimum protections in the form of National Employment Standards over a wider range of employment conditions than those covered by *WorkChoices*. Importantly, the proposed legislation will extend both the coverage of minimum wages, and also widen the

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range of factors which the new Minimum Wages Panel can consider in reaching wage decisions.

This paper maintains that while there may be some room for argument, though not much, about the effect of anti-union bias on the economy, which almost certainly will be adverse, there is no room at all for argument about the longer run effect on society which will be seriously detrimental due to the increasing inequality in income and wealth.

Another major change discussed by the Rudd government, as a departure from *WorkChoices*, is the role of collective bargaining. Under *WorkChoices* there was no requirement for employers to bargain collectively. Employers were free to bargain collectively with unions or other representatives of workers and many did. However, an employer was free to decline to bargain collectively with his or her employees. Such legal provisions 'effectively deny workers on AWAs the choice of participating in collective bargaining, thus undermining their fundamental right of freedom of association' (McCallum, Chin and Gooley 2007: 102). Perhaps the best insight into the Howard government's attitude towards unions was given by the disparate treatment accorded to small businesses and unions. The Coalition recognised that small business may have little or no bargaining power and little influence on prices and other conditions of supply of goods and services. It therefore legislated to allow small businesses to notify the Australian Competition and Consumer Commission (ACCC) that they wish to bargain collectively, and even hold a collective boycott if appropriate, and the ACCC was allowed to assess such notification (Australian Competition and Consumer Commission 2007). The Trade Practices Act does not deal with employer/employee collective bargaining as this is regulated under industrial and workplace relations legislation. However, employees have had no legal way of bargaining collectively if their employer has declined to do so. The Coalition accepted, for example, that experienced farmers should be able to bargain collectively with buyers of their produce, but denied a supermarket employee, even a teenager from a non-English speaking background, any similar right with respect to wages.[2]

The new workplace relations system which the Rudd government is hoping to implement restores the role of collective bargaining, particularly at the enterprise level. Employees will have a right to appoint a bargaining representative, which includes unions. In other words, employers will no longer have the right to refuse to bargain collectively with their employees.[3]

In order to evaluate the proposed changes to the workplace relations system, it is important to realise that *WorkChoices* has been defended with the argument that economic theory shows that if it is successful in keeping down wage rates at least at the lower end of the scale, then this will increase employment there and hence output. However, economic theory does no such thing. The following section of the paper examines this claim in detail and concludes that neither side of the economic theory debate has delivered a knockout blow on the role of minimum wage legislation, though many economists, including the present authors, award a victory on points to those who argue that the effects of the proposed Rudd government changes, on the total number of persons employed and on aggregate output, are less likely to be adverse than the effects of *WorkChoices*. The theoretical analysis is followed by a section looking at empirical evidence on the effects of deregulating labour markets, drawing on both Australian and overseas experience. Again there is not complete consensus among the profession, though many labour market analysts would agree that this is not surprising as the result of labour market deregulation depends on institutional and wider cultural factors. However, both sides of the debate over the effects of labour market deregulation agree that strong minimum wage legislation, of the kind the Rudd government wishes to implement, does significantly reduce earnings inequality by increasing earnings at the bottom end of the distribution. In our conclusion we argue that the increase in inequality consequent on labour market deregulation has adverse effects on the economy in the short run and disturbing longer run effects on society.

Theoretical Arguments

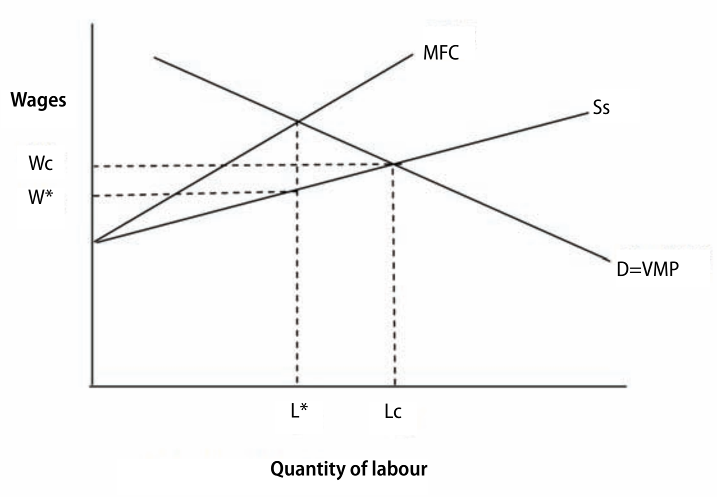
Typically, in the literature, unions are seen as keeping wages from falling while maintaining them at levels higher than they otherwise would be at, as well as being concerned with working conditions which may raise labour costs as well as productivity. In this section we evaluate the theoretical case for and against wage flexibility and lower wages as an effect of labour market deregulation.

The main rationale for the link between flexible wages and employment comes from the analysis of a firm in a perfectly competitive industry. Under these conditions, firms will produce a profit maximising output by equating marginal cost and marginal revenue. As perfectly competitive firms face an infinitely elastic labour supply curve, the marginal cost of hiring an extra worker is simply the wage, while the marginal revenue is the value of the worker's marginal product.

This assumes that firms can simply hire as much labour as they want without affecting the price of labour. However, firms which are large relative to the size of the labour market for the types of workers they hire may not be price takers with respect to labour. These firms have market power in the labour market. Under these conditions, they face an upward sloping supply curve for labour, and so must increase the wage offer in order to hire additional labour. Unless the firm discriminates, this higher wage must be paid to all workers, not just the last one employed. As a result, it follows that the marginal cost which these firms face for each extra unit of labour is greater than the wage rate. That cost, the marginal factor cost, is defined as the variation in the firm's total cost of labour of employing an extra unit. The marginal factor cost curve lies above the supply curve for labour because the cost of hiring an extra worker is the higher than the wage paid to the marginal worker, as it includes the increase in the wage bill due to the higher wage paid to all the previously employed workers.

The profit maximising output occurs when the firm equates marginal factor cost with marginal revenue product, ie, the cost of hiring an extra worker with the addition to total revenue which that worker brings to the firm. The demand curve for labour slopes downward due to the assumption that the marginal product of labour decreases with increased output. In Figure 1, this generates a level of employment 0L*. The wage rate corresponding to that level of employment is derived from the supply of labour curve, and is W*. This can be compared with the competitive level of employment, Lc and wage rate Wc obtained from the intersection of the supply and demand curve.

Figure 1: The Profit Maximising Wage and Employment Levels for a Firm with Market Power

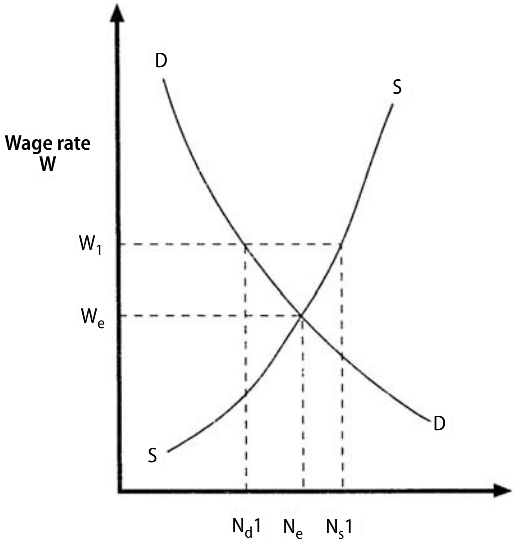


In this particular situation, a minimum wage set between the competitive wage (Wc) and the monopolistic wage (W*) will both increase wages AND increase employment.

In other words, what we have seen is that, even at the microeconomic level, neoclassical theory accepts that, once we are outside the world of perfect competition, minimum wages can increase employment. So, once we leave the world of perfect competition, the argument that a reduction in wages will always be employment creating needs to be modified.

At the macro level, according to the conventional wisdom, employment and wages are determined in the economy wide labour market, where the wage rate is seen as the price which equates the demand and supply for labour. Assuming that demand and supply schedules behave in the conventional ways, a market clearing wage will be established, so that there would be no involuntary unemployment at that wage.[4] Unemployment can only be the result of an impediment to the market mechanism, which prevented the wage rate from adjusting to the equilibrium level. This is represented in Figure 2.

Figure 2: Employment, Wages and the Labour Market



In Figure 2, W is the wage rate, and N the number of workers. SS, the supply of labour is represented as an increasing function of the wage rate, while DD, its demand, is a decreasing one. At the equilibrium wage rate of W_e, N_e is the quantity of labour both supplied and demanded, so that the labour market clears and there is no unemployment. If, for some reason such as minimum wage legislation or union activity, the wage rate is not allowed to adjust, so that it cannot fall below W_1, then the demand for labour will be N_d1 while its supply will be N_s1 The difference between these represents an excess supply of labour, or, in other words, unemployment. The labour market is seen as guaranteeing full employment, unless there are rigidities in the wage rate. Only in that event is there a role for government. For neoclassical economists, the role of government is limited to trying to eliminate the rigidity, although, especially after the work of Keynes there were alternate suggestions that the government may attempt to increase the demand for labour.

Keynes, in 1936, published *The General Theory of Employment, Interest and Money*, in which he was extremely critical of this explanation, and proposed an alternative account of the determinates of employment. Keynes' main criticism was in terms of the fallacy of composition. In other words, he argued that the neoclassical macro story incorrectly extended results to the economy as a whole which were only true for individual firms or industries. In particular, with respect to the labour market, Keynes argued that, while it was true that a reduction in the wage rate would increase an individual firm's demand for labour, this was not true of a general reduction in wage rates. The reason for this is that when we are considering an individual firm, it is reasonable to assume that it can reduce wages while the level of aggregate demand in the economy as a whole, and hence demand for their product, remains unchanged. However, if all wages fall, then the level of aggregate demand will also fall, and this will reduce employment or, at best, leave it unchanged. Keynes also argued that neoclassical theory is incorrect in portraying labour as bargaining for a real wage. Rather, the labour market bargain only determines the money wage. In other words, Keynes denied the quantity theory of money, maintaining that real wages are determined in the goods market where prices are determined.

It is not the wage rate, according to Keynes, which determines the level of employment, but rather the level of effective demand. Effective demand is determined by the sum of consumption demand, investment demand, net government demand and net international demand.

Keynes' central message was that there was no mechanism in a capitalist economy which could guarantee full employment. He explicitly rejected flexible wages as a solution, because he believed that the main cause of unemployment was insufficient effective demand, and a reduction in wages would not increase that demand.

Heterodox economists have developed Keynes' insights[5] and shown that wage flexibility is not an important factor in the determination of employment. They stress the dual role of wages as both a cost to the employer (and so increases are likely to reduce employment) and an income for the employee, and, therefore a source for their spending and demand (and so increases are likely to increase employment). As a result, there is no determinate relation between wage rates and the level of employment, as this will depend on a number of factors, including the state of the economy (Seccareccia 1991).

Empirical Evidence

Those wishing to restrict the influence of unions usually justify this stance by two claims: first that by raising wage costs unions reduce employment; and second that employment is also reduced by union support for security of employment.[6] Empirical evidence, both overseas and in Australia, provides little support for the proposition that unions by raising minimum wage rates above the market clearing level (where demand equals supply) increase unemployment and reduce output. There has been a long and acrimonious debate among labour economists about the effects of raising the minimum level of wages on employment. In the thirty years to 1980 a substantial number of studies were made of the effects of changes in wage rates, especially minimum wage rates, on the level of employment. A survey in the *Journal of Economic Literature* by Brown, Gilroy and Kohen (1982) concluded that:

> Time series studies typically find that a 10 per cent increase in the minimum wage reduces teenage employment by one to three per cent. … We believe that the lower half of that range is to be preferred; to the extent that differences in results can be attributed to differences in the specifications chosen, the better choices seem to produce estimates at the lower end of the range. … Cross-section studies of the effect on teenage employment produce a wider range of estimated impacts … but estimates of 0 to .76 percentage points are most plausible.

> The effect of the minimum wage on young adult (20–24 years) employment is negative and smaller than that for teenage employment. This conclusion rests on much less evidence than is available for those 16–19 years. The direction of the effect on adult employment is uncertain in the empirical work, as it is in the theory. (p. 524)

Various studies suggest that when minimum wages are increased, one effect is that adult employment increases at the expense of teenage employment.[7] To the extent that this is the case, the studies of teenager employment will overstate the elasticity of demand for labour as a whole.

In the 1980s there were fewer studies, but the pattern was for estimated effects of a rise in the minimum wage to be the same or smaller than those summarised by Brown, Gilroy and Kohen in the above quotation.[8]

The 1990s saw an increase in the number of studies published, most of which suggested that, if anything, the Brown, Gilroy and Kohen summary overestimated the effects on employment of a rise in the minimum wage. The most influential studies occurred in the context of a controversy between Neumark and Wascher, and Card and Kreuger. Neumark and Wascher (1992) used panel data on US state minimum wage laws and found that the effects of these laws on employment depend heavily on the exact specification of the estimating equation. In their preferred specification a 10 per cent increase in the minimum wage caused a decline of one to two per cent in employment of teenagers and young adults.

A whole series of United States studies by Card and Kreuger found that raising the minimum wage increased employment rather than reducing it, although in only two studies out of seven was the increase in employment statistically significant at the 5 per cent level.[9] However, to quote Card and Kreuger themselves,

> the results are uniformly positive and relatively precisely estimated. We find zero or positive employment effects for different groups of low-wage workers in different time periods, and in a variety of regions of the country. The weight of this evidence suggests that it is very unlikely that the minimum wage has a large negative employment effect. (1995: 390)

This provoked a counter study by Neumark and Wascher using data supplied by a quasi lobby group — the Employment Policies Institute. They found that employment had fallen in New Jersey fast food restaurants, although the fall was only weakly significant by the usual statistical criteria. However, Neumark and Wascher (1995) acknowledged that the Employment Policies Institute had 'a stake in the outcome of the debate' (p. 5). They undertook another study collecting additional data of their own. When they combined the two sets of data the rise in the minimum wage was followed by a fall in employment which was significant at the 5 per cent level. Their own data gave results which were not statistically significantly different from those of Card and Kreuger. Arguments for and against Card and Kreuger's position were not confined to the original participants and became very acrimonious, to say the least,[10] but those arguing that the elasticity was negative not positive never argued that it was large. The passion was over the sign of the elasticity.

A similar argument applies to reducing wages by abolishing loadings and penalty rates, as long as the discussion is confined to wages and employment of relatively low paid workers as occurred under *WorkChoices*. Loadings paid to those with medium to high levels of wages are another matter, and not much empirical work has been done on this.

The studies so far discussed were mostly undertaken at the firm or industry level. Another set of studies was prompted by the OECD (1994) study called Jobs Study. This study made ten recommendations about changes in institutions and policies in order to reduce unemployment. Six were easy for economists of a wide range of persuasions to accept. Three of the others — increased flexibility of working hours, reforming (i.e. reducing) employment security provisions and allowing more flexibility in wages and other labour costs (so that they could be reduced overall) — are things that unions would normally oppose. The final one related to unemployment benefits. Studies supporting or opposing these OECD recommendations look at the issue at a macro level and by and large used cross country comparisons. The evidence from some of the studies supports the view that the effects of raising wage costs on the level of unemployment are significant but other studies suggest the opposite. Freeman (2005) suggests two reasons for this inconclusive result:

> The first reason is that many adherents to the claim [that unions and other labour market institutions reduce employment] hold strong priors that labour markets operate nearly perfectly in the absence of institutions and let their priors dictate their modelling choices and interpretation of empirical results. The second reason is that the cross-country aggregate data at issue is weak — too weak to decisively reject strong prior views or to convince those with weaker priors. (p. 2)

Notice that Freeman judges that it is 'priors', or ideology, that underpin the conclusions supporting the OECD view, not the empirical evidence taken by itself.

Before leaving the effects of wage rates on employment it is perhaps appropriate to look at an Australian study made in response to the OECD *Jobs Study*. Debelle and Vickery (1998) provided the basis for the elasticity of demand used in a high profile policy proposal made by five economists to the former Prime Minister[11] made in 1998. This proposal used an elasticity of demand for labour of around -1. However, a careful reading of Debelle and Vickery shows that their empirical work does not lead to this conclusion. Debelle and Vickery argue that reducing real wage rates may increase employment, and reduce unemployment, in two ways. The first is through the substitution of labour for capital (with no change in output). The second they call the scale effect. It is a further possible effect which occurs if reducing real wages increases output. All the empirical research of Debelle and Vickery is into the first of these effects. They explicitly state that they do not know the size of the scale effect or even if it is positive. They make two assumptions. One is that there is no effect on output; an assumption they think is at the bottom end of the range. The second is one at the other end of the range, that output increases by so much that the final increase in employment is 2.4 times as large as that occurring just through the substitution of labour for capital with no change in output. It is results based on the second of these assumptions that the five economists use. They completely ignore results based on the first. Since Debelle and Vickery put in the too hard basket the task of estimating the effect of economy-wide wage changes on employment and output — a decision that may well have been wise — their study does not add to the empirical evidence on this issue despite the appeal to it by the five economists.

Freeman's conclusion that there is no robust evidence suggesting that high wage rates overall reduce employment remains, a fact admitted by the OECD (2004) who state that: 'The evidence is somewhat fragile overall and highlights the complexity of wage-setting institutions in OECD countries and their implications for economic performance' (p. 165).

As we saw above, the OECD *Jobs Study* also opposed Employment Protection Legislation (EPL) in general. However, after strong theoretical and empirical criticism, it has recently reversed its position. In 2004 the OECD *Employment Outlook* stated that:

> *The net impact of EPL on aggregate unemployment is therefore ambiguous* a priori*, and can only be resolved by empirical investigation.* However, the numerous empirical studies of this issue lead to conflicting results, and moreover their robustness has been questioned. (OECD 2004: 63, italics in original)

and:

> The impact of EPL on overall employment and unemployment rates is ambiguous . . . . Overall, theoretical analysis does not provide clear-cut answers as to the effect of employment protection on overall unemployment and employment. . . . no clear association can be detected between EPL and unemployment rates. (OECD 2004: 80)

Freeman (2000) summarises very succinctly the reasons for this retraction:

> The OECD Jobs Study came down strongly in favour of deregulation and active labour market policies, but succeeding analyses by the OECD have highlighted the weakness of that case. Countries with very different regulatory practices and policies have surprisingly similar outcomes. (p. 8)

There is now strong evidence suggesting that deregulation of labour markets and the related increased labour market flexibility is not associated to any significant extent with increased levels of employment or falling unemployment. The OECD (2004) itself has commented:

> *High union density and bargaining coverage, and the centralisation/co-ordination of wage bargaining tend to go hand-in-hand with lower overall wage inequality.* There is also some, albeit weaker, evidence that these facets of collective bargaining are positively associated with the relative wages of youths, older workers and women. On the other hand

> … [our study] does not find much evidence that employment of these groups is adversely affected. *No robust associations are evident between the indicators of wage bargaining developed in this chapter and either the growth rate of aggregate real wages or non-wage outcomes, including unemployment rates*. (p. 130, italics in original).

and:

> The chapter's analysis confirms one robust relationship between the organisation of collective bargaining and labour market outcomes, namely, that overall earnings dispersion tends to fall as union density and bargaining coverage and centralisation/co-ordination increase. It follows that equity effects need to be considered carefully when assessing policy guidelines related to wage-setting institutions. (p. 166).

The World Bank, traditionally a member of the Washington consensus, has gone much further not only confirming the effects of unions in reducing inequality but also affirming that they can improve macro economic outcomes. 'At the macroeconomic level, high unionisation rates lead to lower inequality of earnings and can improve economic performance (in the form of lower unemployment and inflation, higher productivity and speedier adjustment to shocks)' (World Bank 2003). The reduction in inequality itself plays a large part in bringing these and other benefits to the economy. It is reasonable to suppose, and the empirical evidence confirms, that workers 'care' about just conditions and equity, and they react adversely to perceived unfairness and inequality. In addition, there is evidence of a link between better employment rights and improving economic performance through improvements in labour productivity associated with better education and skill acquisition — and in increased FDI, among other factors.

Conclusion

The anti-union bias of *WorkChoices* was rationalised on the grounds that unionism is inimical to growth in employment and output. This paper has shown that, not only are there no rigorous theoretical justifications for the ideas underpinning that view but that the evidence supports the opposite position — that unions are associated with improvements in working conditions, which both are important in their own right, and also have a positive impact on productivity. There is no robust theoretical or empirical evidence to support the claims of supporters of the anti-union bias, suggesting that the support for this view is strongly ideological. We consider one of the main results of union activity to be higher minimum wages. There is considerable empirical evidence showing that higher minimum wage rates, in the range experienced in Western economies, only have a very small effect on employment. In any case, there is no consensus about the direction of any change in employment following a rise in minimum wage rates. What there is consensus about is that reducing minimum wages will increase inequity of earnings, which may have further undesirable social effects. This suggest that there will be positive effects on the economy from the Rudd government's proposed modifications to the industrial relations laws.

Concerns about the effect of inequality on individuals usually concentrate on those at the bottom end of the range. The same is often true with the effects of inequality on society more generally. Low income people may turn to crime if their income is inadequate to enable meaningful participation in society. Increases in income inequality may reduce productivity. This is particularly the case as empirical evidence suggests that workers care about social justice and that their incentive to work is influenced by their perception of how they are being treated. Also, casualisation is likely to reduce the commitment of workers to firms and hence reduce motivation and productivity. Very rapid increases in inequality, such as have occurred in Australia and the United States over the last decade or so, may reduce social capital more generally. In the extreme case financial inequality can greatly reduce democracy if that is defined as one person one vote and the concept of voting includes having significant power in choosing governments. Voting is not done in a vacuum. Voters are influenced by advertising but also by arguments. The richer one is, the more one can spend on advertising and on placing one's arguments before thoughtful voters who want more rigorous arguments than those incorporated into advertisements. But the problem goes even deeper than this. Those who are very rich can sometimes ensure that the generally accepted beliefs in the community are those which further their particular interests.

To sum up, above a certain level as inequality grows the inequality itself acts against economic efficiency and a healthy society. The size of the gap between the rich and the poor is important as well as the absolute level of the income of the poor. In the longer run and in the bigger picture the most important contribution of unions may well be moderating the size of this gap. As a result, the paper supports the view that the changes proposed by the Rudd government under the head of *Forward with Fairness* are likely to lead, at the very least to increased equality with no impact on employment and output, though it is likely that these will also improve.

Notes

1. Some of the key elements of the government's plans are documented at the *Forward with Fairness* website: http://www.workplace.gov.au/workplace/Publications/PolicyReviews/ForwardwithFairness/ .
2. This issue is discussed in Joe Isaac's paper in this symposium 'Collective bargaining under trade practices law'.
3. The importance of collective bargaining in any new industrial relations legislation is supported by Hancock (2008) and McCallum (2008).
4. This required that, for both schedules, if the income effect was of the opposite sign to the substitution effect, its absolute value was smaller.
5. These were simultaneously 'discovered' by Kalecki, who has also been an important influence in the heterodox tradition. See Kriesler (1997, 2002).
6. See for example Business Council of Australia (2007).
7. See for example Bureau of Labour Market Research (1983).
8. See for example Solon (1985), Swidinsky (1980) and Kaufman (1989).

9. Some of these studies were done separately and some together. Laurence Katz was co-author of two of the articles describing them. They are all set out in detail in Card and Krueger (1995).
10. See Blinder 1996 for a description and evaluation of the controversy between Card and Kreuger and Neumark and Wascher.
11. For details of the proposal see Dawkins (1999).

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