AIMS Commentary
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# Minimum Wages:
## Operating with a blunt instrument

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### Introduction

In Canada, minimum wages are under provincial jurisdiction, with those in the federal jurisdiction set as equal to the minimum wage of the province or territory in which the federal worker is employed. The federal government also voluntarily applies the federal minimum wage to its own workforce (Battle 2003, 3). As of July 2008, the minimum wage ranged from $7.75 per hour in New Brunswick and Prince Edward Island to $8.75 in Ontario (Geddie and Mason 2008, 6681). Obviously, these nominal levels reflect, in part, differences in the cost of living and average wage levels in different regions.

Minimum wages are part of employment standards legislation that exists in each jurisdiction. In addition to setting minimum wages, employment standards legislation also includes such factors as hours of work and overtime; vacations, holidays, and leaves; terminations and severance pay; and protection against harassment.

Minimum wages are one of a number of wage fixing initiatives. Pay equity legislation, for example, requires wages in female-dominated occupations to be the same as wages in male-dominated occupations when the jobs are of equal "value" as determined by a

*What's Inside:*

A minimum wage is a crude instrument for curbing poverty which is poorly targeted toward the poor because it also affects the wages of young people and multiple earners in non-poor families. Canadian evidence shows that a 10 percent increase in the minimum wages ***reduces*** the employment of teens by 3 to 6 percent and slightly less for young adults.

Who earns minimum wage:

- 47 percent of minimum wage workers are teens, 16 percent are youths (ages 20 to 24), of which 60 percent live with their parents
- 25 percent are couples (of which 75 percent have a spouse employed at a job above the minimum wage),
- 11 percent are unattached individuals, and four percent are single heads of families.

Proven alternatives to minimum wage legislation include earnings subsidies.

job evaluation scheme. Fair wage legislation generally requires the payment of some measure of "prevailing wages" on government contracts, mainly in construction projects. Such legislation exists only in the federal jurisdiction and in Saskatchewan and the Yukon, although they are also applied under orders-in-council in Ontario (O' Grady, Armstrong, and Chaykowski 2006). Wage extension legislation is another form of wage fixing whereby wages that are mutually agreed upon by a group of employers and unions in a sector are extended by juridical decree throughout the sector. Such legislation exists only in Quebec under the decree system, and the number of sectors where it has applied has been declining (Déom and Boivin 2005).

## The Purposes of Minimum Wage Legislation

Minimum wage legislation has a wide range of alleged rationales or purposes (see Gunderson 2005). These are often at cross-purposes, however, and the effects of such legislation are often inconsistent with achieving such objectives.

The most common rationale for minimum wage legislation tends to be to alleviate poverty among the working poor. At first glance, the argument appears compelling. A minimum wage enables recipients to "earn" their income, which both recipients and taxpayers generally regard as preferable to receiving a transfer payment. In that vein, a minimum wage can provide an attractive and more dignified alternative to social assistance or other income support programs. It effectively bolsters the labour market as a first line of defence against poverty.

The anti-poverty rationale also provides tempting guidelines for setting the minimum wage. An $8.00 minimum wage, when multiplied by a 40-hour week for 52 weeks, yields an annual income of $16,640, or about 75 percent of the poverty line amount of around $22,000 for an individual. A $10 minimum wage would yield an annual income of $20,800, or about 95 percent of the poverty line amount. While intuitively appealing as an anti-poverty device, the minimum wage is, at best, an exceedingly blunt instrument with which to curb poverty — at worst, it might be harmful (Benjamin 1996, 2001). As well, other policies can be more effective in achieving such objectives. As we shall see, a minimum wage essentially has no effect on reducing overall poverty and only a very small effect on reducing poverty among the working poor.

A minimum wage is a crude instrument for curbing poverty for various reasons. Many of the poor do not work or work only a few hours. A minimum wage is also poorly targeted toward the poor since it also affects the wages of youths and multiple earners in non-poor families. As Battle (2003), for example, indicates, of those aged 25 to 64 among whom working poverty is likely to be of greatest concern, only 3 percent work in a minimum wage job. Conversely, almost two-thirds of minimum wage workers are teens or youths (47 percent are teenagers ages 16 to 19 and 16 percent are youths ages 20 to 24), most of whom live with their parents. Specifically, 60 percent of minimum wage workers are teens or youths who live with their parents, 25 percent are couples (of which 75 percent have a spouse employed at a job above the minimum wage), 11 percent are unattached individuals, and four percent are single heads of families.

The teens and youths who dominate minimum wage jobs tend to hold them for only a short period as temporary stepping stones to higher-paying jobs — they are seldom stuck in minimum wage jobs, which would keep them in a state of long-run poverty. More than half of all minimum wage workers, for example, had been in their job for less than a year; only slightly more than one percent of those who had been in their job for more than five years were working at the minimum wage.

Minimum wage jobs are also poorly targeted at the poor since poverty is related to *family* income relative to family *need*, while a minimum wage is paid to individuals irrespective of their family situation or need. Furthermore, a minimum wage affects only small portions of the population and does little to increase earnings. When multiplied by a full-year, full-time work year of 2,000 hours, a typical minimum wage increase of 25 cents per hour would increase annual income by $500; the effect would be less for most since almost 60 percent of minimum wage workers work part time.

A minimum wage is not only a poorly targeted instrument for curbing poverty; it might also be harmful to the extent that it exacerbates poverty,

which can happen when, for example, individuals lose their job or are less likely to obtain a job or to be offered fewer hours of work because of the higher costs associated with a minimum wage. It is true that the adverse employment effects tend to fall on youths, most of whom are still living with their family and are only temporarily in minimum wage jobs. But this simply highlights the weak connection between poverty, which is related to *family* income relative to family *need*, and a minimum wage that is paid to individuals irrespective of their family situation or need.

The potential for a minimum wage to exacerbate poverty comes not only from the adverse employment effect but also because a minimum wage deters some individuals from accepting a low-wage job that could provide on-the-job training and experience that could foster subsequent wage growth that can facilitate a move out of poverty. As well, any adverse employment effect also reduces the accumulation of valuable training and experience. It is curious that we often encourage young people to volunteer or work at internships for free to get training and experience, but we prohibit them from working for low pay for such training or experience.

Using a minimum wage to curb poverty also places the onus on employers to deal with a social issue the costs of which should be shared by society in general. If society deems that a person should not have to work below a certain wage, should not the general taxpayers, who presumably support such a policy, pay for it by making up the difference between the individual's market wage and what is deemed a socially desirable wage — or would that make the cost a little too transparent?

Other related rationales have been offered for minimum wage legislation — as a tool of industrial policy, for example, by eliminating low-wage jobs and encouraging movement up the value-added chain, which, in turn, fosters the high-performance workforce that is necessary for high-wage economies like that of Canada to compete, especially against low-wage countries. This argument would be credible, however, only if the elimination of low-wage jobs did not impose costs on those who lose them or on employers that can effectively use low-productivity labour providing they can pay a commensurate wage — better to have a low-wage job than no job. The productivity of low-wage labour can be improved through more active means, such as training, so that higher wages will follow as the market responds to the higher productivity (and without any adverse employment effect). As well, competition from low-wage economies will eliminate many low-wage jobs through market forces — there is no need to do so by legislative fiat.

Minimum wages have sometimes been rationalized on the grounds that they increase the income and, hence, the consumption of recipients, which increases aggregate demand and has macroeconomic multiplier effects through the system, particularly if recipients have a higher propensity than average to consume out of their low income. This rationale, however, has problems for a range of reasons. First, individuals who become unemployed or are offered fewer hours because of the minimum wage would not see their income increased. Second, even if their income did increase, any increase in their consumption could be offset by a reduction in investment spending on the part of employers forced to pay for the minimum wage, or by a reduction in consumption spending on the part of customers if the cost of the minimum wage is passed on to them in terms of higher prices. The limited Canadian evidence in this area suggests that, in aggregate, the macroeconomic effects are negative.

Minimum wages have often been rationalized on the grounds that they "protect the unprotected" and those with little individual or collective bargaining power. When minimum wages were first instituted in Canada in the 1920s, they applied only to women and youths, allegedly for that reason (Whittingham 1970, 4–8) — "allegedly" because a more cynical interpretation was that they were meant to protect males from competition from women and youths who were willing to work in low-wage jobs. Employers that pay above the minimum wage might also support minimum wage legislation, not so much to appear progressive as to raise the labour costs of their competitors. Wal-Mart, the largest retailer in the world, supports minimum wage legislation (Chipman 2007), whether for the ostensible reason of giving its customers more purchasing power or because it already pays above the minimum and wants to reduce competition is an open question.

### *Alternatives to a Minimum Wage*

It is easier to criticize a policy than to suggest constructive alternatives, in the case of the minimum wage as much as elsewhere. Nevertheless, there are alternatives. One is earnings subsidies along the lines of the earned-income tax credit in the United States (and other countries), which have generally been regarded as effective and have increased in importance over time, irrespective of the "stripe" of the party in power (Burkhauser, Couch, and Glenn 1996).

Refundable tax credits also effectively increase the wages of the working poor, without having an adverse effect on employment or hours worked. Also, by working through the tax system, they can be better targeted to individuals or families, as well as towards dealing with child poverty. Canada has just taken a step in this direction in the 2007 federal budget with the federal Working Income Tax Benefit, which essentially provides the working poor a refundable tax credit of 20 percent of their earnings above $3000 and subject to a limit. By augmenting their labour market earnings, the benefit should encourage them to work more. Quebec's "work premium" is the same kind of fiscal incentive. Such programs merit more consideration since they "make work pay," in contrast to a minimum wage, which can make paid work disappear.

Full employment and sustained growth are also important since they disproportionately help the working poor. The working poor can also be assisted by active labour market programs such as training and apprenticeships, as well as through fostering labour market information, job search, mobility, and credential recognition. These strategies have the virtue of potentially increasing *both* wages and employment, and they can be targeted at the most vulnerable. Curbing dropouts is especially important, since the empirical evidence indicates that the wage and employment gains from education remain very high, particularly for those who remain in school versus those who drop out.

In essence, there are alternatives to what is, at best, a blunt policy instrument. A minimum wage might make good politics, but it does not make good economics — at least as a policy instrument to curb poverty.

## The Expected Effects of a Minimum Wage

Although the effects of a minimum wage tend to fall on employment, they can have other outcomes, including wage spillover effects on workers earning above the minimum wage, as well as on poverty and training and education decisions.

Basic principles of economics suggest that, as with any form of wage fixing, a minimum wage will reduce the employment opportunities of those affected by it — mostly teens and youths, as we have seen. This adverse employment effect occurs for two reasons. First, employers will substitute cheaper inputs for the now-higher-priced labour. This process need not be overt, such as replacing them with a machine. Especially in the longer run, the adjustment can occur in subtle forms: self-serve gas stations to replace those pumping gas; cafeterias and self-serve food distribution to replace wait staff; self-service checkout stations to replace cashiers; on-line ordering; offshore outsourcing to low-wage countries; shifts to the underground economy; big-box stores with do-it-yourself instructions rather than customized service; and the replacing of more expensive consumer durables that need occasional repair with inexpensive, imported, disposable "durables": the adage that it is cheaper to buy a new toaster than to repair an existing one applies to more than toasters.

The second employment adjustment occurs when the increased costs and, hence, prices compel employers to reduce their output and, hence, all inputs, including the now-higher-priced labour. Some firms even go out of business or close certain lines of business.

It is important to emphasize that the adverse employment effects occur not so much in the laying off of higher-priced labour by employers as in the slower employment growth available to such workers relative to what would otherwise have occurred. This, of course, also makes a minimum wage politically palatable, since the adverse effects are not so overt. And those who do not get a job because of the existence of a minimum wages do not form a vocal interest group even if they knew that was the reason for their unemployment.

A minimum wage can also have complicated spillover effects higher in the wage distribution. For example, it can lead to increased wages just above the minimum if there is pressure to restore the old relativities. As well, employers might substitute slightly higher wage personnel for minimum wage workers, thereby increasing the demand for and, hence, wages of such persons. Working in the other direction, some minimum wage workers who are displaced from their job might try to get the slightly higher paying jobs, with the additional competition from the supply spillover reducing the wages of those jobs. This effect might be mitigated, however, by the fact that, if such workers were qualified only for minimum wage jobs, they are unlikely to be qualified for jobs just above the minimum wage.

A minimum wage can also affect education and training decisions. A high minimum wage, for example, might induce youths to drop out of school to work, especially those who feel they are more qualified than youths who have already dropped out. A higher minimum wage can also inhibit some people from working in low-wage jobs in return for the training and experience that such jobs provide. Working in the other direction, however, it can also mean that such youths might return to school.
In summary, the expected effects of a minimum wage on poverty depend upon a range of factors, including the extent to which those in poverty are working; the extent to which they are affected by the minimum wage; the extent to which the minimum wage reduces their employment and/or hours of work; the extent to which increases in the minimum wage raise their earnings sufficiently to get them out of poverty; and the extent to which the minimum wage inhibits them from working for a low wage in return for training and labour market experience that could get them out of poverty in the long-run. Given these conditions, a minimum wage is unlikely to be a well-targeted and effective anti-poverty device, and might even be harmful.

The effects of a minimum wage can be mitigated, and perhaps even offset, by a number of factors. For example, the cost increases caused by a minimum wage might compel some employers to become more managerially efficient in ways that do not involve reducing the use of higher-priced minimum wage workers — although, it raises the question of why these employers did not follow such practices in the first place. As another example, the higher wages might encourage some employees to work harder and might also reduce turnover. In this case, however, employers would have an incentive voluntarily to pay such "efficiency" wage increases without being compelled to do so by legislation.

Firms that are dominant employers in the local labour market — *monopsonists* in the parlance of labour economists — might be reluctant to pay higher wages to attract new recruits if it meant also having to pay those higher wages to their existing workers in order to avoid internal inequities. In such circumstances, a higher legislated minimum wage might actually (and surprisingly) encourage such firms to hire more workers. The reason is that the higher minimum wage would allow them to hire additional workers without having to pay a higher wage to their current low-wage workers, who would now receive the minimum wage instead. It is difficult to know, however, if this monopsony argument is a practical reality or a theoretical curiosity.

Firms might also offset the cost increase of a minimum wage by altering the non-wage aspects of the job. For example, they might cease to provide uniforms or free or subsidized food; they might cut breaks or increase the pace of work or be less flexible in terms of working hours or time off; they might reduce informal on-the-job training or mentoring, arguing that they need the immediate output to justify the increased pay. These adjustments are generally negative, but very difficult to monitor and prevent.

## Evidence of the Effects of a Minimum Wage

Since the theoretically expected effects of a minimum wage often work in opposing directions, and since there are also potential offsetting factors, it is imperative to examine the empirical evidence to ascertain the actual effects of minimum wages. This evidence, in fact, is highly controversial, as there are several different methodologies for measuring such effects — although there is more consensus in the Canadian context (see Gunderson 2005).

The Canadian evidence is particularly appealing since it is based on data that are internationally highly regarded (Hamermesh 2002). The reason is that, in

Canada, minimum wages are under provincial jurisdiction, so there is considerable variation across provinces and over time in minimum wages that allow researchers to identify their effects. In countries, like the United States, where minimum wages are largely set federally, there is little variation with which one can determine their effects.

The recent Canadian evidence[1] tends consistently to find that a 10 percent increase in the minimum wage reduces the employment of teens by 3 to 6 percent and slightly less for young adults. This adverse effect occurs in the form of slower employment growth relative to what would have happened in the absence of the minimum wage increase; it does not necessarily indicate a decline in the actual employment of the groups. The effect in Canada is generally somewhat larger than in the United States, where a 10 percent increase in the minimum wage is thought to reduce teen employment by between zero and six percent. This difference could reflect any combination of better data in Canada or more workers being affected or longer-run effects being estimated in Canada.

The Canadian evidence is, however, consistent with that from most other industrialized countries when comparable methodologies are used — although, at first glance, it appears inconsistent with UK evidence (summarized in Metcalf 2004) that tends to find no adverse employment effects *economy wide* (Stewart 2004). UK evidence of effects in the *low-wage sector* (Machin and Wilson 2004), however, seems to confirm the Canadian experience, although the UK studies were based on small minimum wage increases that were consciously instituted at a time when the economy was expanding rapidly so their impact could more easily be absorbed.

The evidence on the effects of minimum wages on other dimensions besides employment is more limited, especially that based on Canadian data. Nevertheless, some conclusions emerge.

First, increases in the minimum wage are likely to lead to negative macroeconomic effects on unemployment, inflation, the inflation-unemployment tradeoff and gross domestic product, although the effects are not likely to be substantial if increases are moderate (Dungan and Gunderson 1989). Limited US evidence suggests that minimum wage increases reduce the stock market value of firms that tend to employ minimum wage workers by about 1 to 2 percent.

Second, minimum wage increases reduce the labour force participation rate, inducing some to leave the labour force, which means that not all the employment reductions get translated into unemployment rate increases. In addition, there is some evidence of small positive spillover effects, as an increase in the minimum wage raises the wages of those slightly above the minimum.

Third, minimum wages seem to have no substantial effect on schooling decisions in Canada, according to the one study that has looked at the issue (Campolieti, Fang, and Gunderson 2005b). In contrast, US studies tend to suggest a negative effect, whereby higher minimum wages encourage students to drop out of school and try to obtain the higher-wage minimum wage jobs.

Fourth, minimum wages seem to inhibit training very slightly, again according to the one Canadian study that has examined the issue (Baker 2005). The most likely negative effect in this area, however, is indirect, resulting from the more substantial adverse employment effect that precludes accumulating on-the-job training and experience. The US evidence tends to suggest that minimum wages reduce training opportunities, albeit the effects are small — sometimes statistically insignificant — and the evidence is not always in agreement.

Canadian and US researchers tend to agree, however, that minimum wages are a crude instrument that has little or no effect on reducing poverty and is not well targeted at the poor.[2]

## Policy Implications

Clearly, minimum wage legislation has considerable political appeal, given the alleged roles it can serve: alleviating poverty, eliminating low-wage jobs and

[1] See Baker, Benjamin, and Stanger (1999); Yuen (2003); Baker (2005); Campolieti, Fang, and Gunderson (2005a, 2005b); and Campolieti, Gunderson, and Riddell (2006).

[2] See, for example, Benjamin (1996, 2001) for Canada; and Burkhauser, Couch, and Glenn (1996) for the United States.

encouraging movement up the value-added chain, and "protecting the unprotected," who have little individual or collective bargaining power. If wages appear too low, then simply legislate them to be higher.

Basic principles of economics and the empirical evidence for Canada suggest, however, that minimum wage legislation is, at best, an exceedingly blunt instrument with which to achieve such objectives, and it might even be harmful. Minimum wages have unintended consequences: reduced employment and hours of work for younger persons; slightly increased wages up the wage distribution; possible reductions in schooling and training; slightly adverse macroeconomic effects; and the shifting of attention away from the underlying causes of low wages and towards the symptoms. Unfortunately, dealing with the symptoms has direct political appeal while dealing with the causes is more indirect and nebulous.

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Market mechanisms should be considered innocent until proven guilty — perhaps more so in labour markets than in other markets. All too often, however, the response to a negative labour market outcome is to try to “fix” the problem by imposing a law or regulation on the *symptom*: if wages are low, legislate a minimum; if older workers are required by company policy to retire, ban mandatory retirement; if striking workers are replaced by other workers, ban strike replacements. Although labour laws and regulations can be politically expedient in the short run by giving the appearance that action is being taken, in the long run they can be a recipe for disaster by shifting the focus to the symptom and away from the underlying *cause.* Worse, they can have unintended consequences, perhaps even harming the very people they were intended to help or protecting already-advantaged and well-organized interest groups.

Labour markets have characteristics that make them not only distinct from other markets, but also a target for regulation and institutional protection. There are grounds for this, but there are also dangers. Many of the differences between labour markets and other markets are ones of degree, not quantum differences in kind. Moreover, the regulations and institutions that are designed to mitigate market mechanisms also have their imperfections. Thus, when a negative labour market outcome presents itself, governments should take a certain sequence of decision-making steps (see Gunderson 2002):

- Determine if artificial barriers are inhibiting labour market forces themselves from dealing with the negative outcome; if that is the case, determine if the barriers are the unintended by-products of other government policies or regulations that can be altered to remove them.
- Determine if *well-defined* market failures are inhibiting market forces themselves from dealing with the negative outcome.
- Even if there are such failures, consider which is better: an imperfect market-based solution or an imperfect government-regulated solution, and bearing in mind that public intervention might well displace private activity in the area.
- If there is a role for public policy, determine how best to implement it, recognizing that public *financing* need not mean public *provision,* and that governments will face many of the same problems as market participants if markets fail.

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