The determinants of minimum wage rates

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Abstract. This paper attempts to test the degree of responsiveness of Canadian provincial governments to different political groups in establishing their relative minimum wage policies over the 1975–1982 period. It discusses alternative explanations of minimum wage policies and focuses on the political market approach, where women, youth, small business and unions play a role. An econometric model is specified and estimated on pooled annual time series and cross-section data for nine provinces in Canada. The results tend to support most of the hypotheses.

1. Introduction

Minimum wage legislation is part and parcel of the Welfare State. At the beginning of the century, the American states and the Canadian provinces began to adopt minimum wage laws, at first applying only to women and children. The first laws were adopted in 1913 in the United States and in 1917 in Canada (Leman, 1980). The laws have been substantially modified over time (see, for instance, Gow, 1986). But the most striking fact is that they have remained in place everywhere.

The most important and enduring objective of minimum wage legislation has been to improve the living standards of low wage earners, and thereby contribute to a reduction in poverty (West and McKee, 1980). The major objection addressed to such legislation concerns its potential negative impact on employ-

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ment opportunities for low wage earners. This reduction in employment comes from two sources. First, firms faced with an increase in wages will reduce employment along the labor demand curve and substitute capital for labor. Secondly, the higher costs faced by firms using low wage labor will eventually result in higher prices to the consumers of the product and thus reduced sales and production, which typically implies a reduction in employment (Riddell, 1986). And, indeed, quite a number of econometric studies have confirmed the disemployment effects of increases in the minimum wage, especially for the teen-age workers.¹

If the minimum wage legislation has these perverse effects, why have governments adopted them and/or why haven't they abolished it? Three types of explanations can be offered. First, it could be argued that the benefits of the policy – in terms of poverty reduction – outweigh its costs in terms of unemployment. This line of reasoning, however, is not compelling. On the one hand, there are good reasons to believe that unemployment is deemed to be a very important problem, more important indeed than poverty (Blais, 1986; Johnston, 1986). On the other hand, different policy options – supplementing the income of the working poor and improving opportunities for training in order to raise productivity and earnings – seem to be more effective in raising living standards among low wage earners (Riddell, 1986).

A second explanation would be to the effect that the public largely ignores the disemployment effects of minimum wage legislation (West, 1974). We are unaware of survey evidence which could confirm or disconfirm this proposition. The hypothesis cannot be dismissed, however, as the public's extent of information about policies and their impact tends to be pretty small (Newman, 1986). Whatever the case, it is unlikely that legislators, at least in the 1980s, are ignorant of these effects, which have been documented in many studies, some of them being commissioned by governments. Legislators' lack of information could have been a factor only before the findings of the bulk of empirical studies became available.

A third explanation focuses on the political market. Whatever its overall benefits and costs, minimum wage legislation, like any public policy, creates winners and losers. The legislation could be adopted and maintained because the winners are more numerous and/or powerful (or, integrating the second explanation, less ignorant) than the losers (Steindl, 1973; Keech, 1977). Such a perspective leads to a consideration of the groups who are most likely to benefit and/or to be hurt by the minimum wage. Minimum wages increase the price of low wage labor (Cox and Oaxaca, 1982; Kau and Rubin, 1978); they are thus more likely to reduce the employment opportunities of women and of the youth (Cousineau, 1979). To the extent that a small business is more likely to hire low wage labor, it is also more likely to be affected by the minimum wage. On the other hand, union members, because they are typically high wage workers and

because low wage labor is a substitute for high wage labor, are likely to benefit from minimum wages, as indeed is big business (Cox and Oaxaca, 1982; Kau and Rubin, 1978). To the extent that big businesses and unions are more powerful than small businesses, women and the youth, the minimum wage could constitute a rational policy from the politician's perspective.

2. The model

We start with the assumption that the population is largely ignorant of the perverse effects of the minimum wage and tends to have positive views of such legislation, which is perceived to benefit the worthy hard-working poor. Indeed, public opinion polls indicate that a clear majority of the public has consistently been in favor of minimum wage laws (Simon, 1974). The level at which the minimum wage is set remains, however, to be explained.

If politicians are first and foremost responsive to pressure group demands, we will expect the minimum wage to be:

- a. positively related to the rate of unionization;
- b. negatively related to the importance of small businesses, women and the youth.

Moreover, to the extent that unions (and big businesses) are more powerful than small businesses, women and the youth, it could well be that only the first prediction will be carried out.

Pressure group demands, however, are unlikely to be the only factor at work. The literature on popularity functions also informs us that politicians have a stake in a good economic performance because such a performance affects the likelihood of being re-elected (Lewis Beck, 1986; Kiewiet, 1983). That being the case, politicians ought to be concerned with the perverse effect of the minimum wage on employment opportunities. As a consequence, we can predict that governments are more reluctant to increase the minimum wage when unemployment is high. They should also become the more reluctant as the evidence about the perverse effect of such legislation came to be strongly established. Likewise, inflation sensitizes voters and governments to the need for restrictive policies, and should therefore induce a slowdown of the minimum wage adjustments.

Politicians are then moved by their own ideology. There is now a vast literature documenting the impact of parties on public policies (Castles, 1982). Parties of the left tend to favor greater state intervention and parties of the right less intervention. We thus expect the minimum wage to be lower when the party in power is of the right.

Now, one ought to take into account the fact that decisions about the level of the minimum wage are taken in many jurisdictions, the various states in the U.S. and the various provinces in Canada and that the decisions are likely to be interdependent. In jurisdictions where the minimum wage is particularly low, there is going to be pressure for an increase to fill at least part of the gap. In jurisdictions where it is high, there will be pressure to reduce it or at least not to increase it. As a consequence, the minimum wages will tend to converge over time (Hofferbert, 1966; Hoberg, 1986).

Some of these hypotheses have been tested in previous studies. Kau and Rubin (1978) and Silberman and Durden (1976) have looked at the impact of unions, small businesses and parties on U.S. Congressmen voting on minimum wages. Cox and Oaxaca (1982) have examined the effect of organized labor and capital on U.S. state minimum wage rates. Yet these studies are somewhat unsatisfactory because they confine themselves to a few potential factors. The preceding discussion that arises from our review of the literature suggests that at least a more comprehensive empirical model is called for.

A complete list of our variables is presented in the appendix, along with their indicators, the data sources and the theoretical expectations. The data pertain to nine Canadian provinces² over a period of eight years (1975–1982). It may be appropriate to provide the rationale for the LEAD variable, which refers to the convergence effect which we anticipate. To the extent that the nominal rates tend to converge, the *relative* rates (that is, the minimum wage rates divided by the average wage rates) should tend to be highest in the low wage provinces which tend to adopt rates that are not too far apart from those prevailing in the richest provinces. We would thus expect the ‘leading’ richest provinces to have lower relative rates. We have also included a dummy 1980–1982 period variable which reflects the potential greater awareness of the perverse effects of minimum wage legislation after 1979. Indeed, the first empirical studies documenting the negative impact of the minimum wage on unemployment in Canada were published in 1979 (Maki, 1979; Cousineau, 1979). Of course, this dummy variable is at best only a proxy for what we really want to measure, i.e. legislators’ awareness of the consequences of the minimum wage and the results with respect to that variable can only be most tentative. For that reason we will present equations including and excluding the dummy variable.

3. The findings

Table 1 reports the empirical findings. Most of the hypotheses are confirmed. The relative minimum wage tends to be lower when and where there are more women and young people in the labor force, small businesses play a greater role in the economy, unemployment is high, the Conservative Party forms the

Table 1. The determinants of the relative minimum wage rate in the Canadian provinces

Variable	Equation 1	Equation 2
Union	-0.001 (1.0)	-0.001 (1.1)
Small business	-0.003 (3.4)	-0.002 (2.3)
Women	-0.010 (4.4)	-0.008 (3.3)
Youth	-0.010 (1.9)	-0.011 (2.2)
Unemployment	-0.004 (2.1)	-0.004 (1.9)
Party	-0.039 (4.1)	-0.040 (4.5)
LEAD	-0.310 (9.7)	-0.323 (10.9)
Inflation	-0.009 (4.1)	-0.004 (1.6)
1980-1982	-	-0.036 (3.6)
Constant	+1.521 (10.6)	+1.358 (9.7)
() = t-statistics	$\bar{R}^2 = 0.85$ N = 72	$\bar{R}^2 = 0.87$ N = 72

government as well as in those provinces where wages are above average. Only one variable is clearly insignificant; the rate of unionization. As for inflation, the results are statistically significant at 0.05 only when the dummy 1980-1982 variable is excluded; even in equation 2, however, the coefficient has the predicted sign and is significant at 0.10 (one-tailed test).

A number of conclusions can be drawn from these findings. The most important one may well pertain to the sole negative result, that is, the null effect of unions. It could be argued that while union members benefit from higher minimum wages, unions can be hurt in so far as a higher rate may be a disincentive to unionization among low wage employees. But such an argument is not compelling because we do know that unions consistently demand higher minimum wages. Our results rather suggest that unions simply do not have much political leverage. This is at variance with the conclusion drawn by Masters and Delaney (1987), that in the U.S., 'the effect of union PAC donations . . . appears more evident on such topics as the minimum wage' (p. 345). But as Masters and Delaney point out, most of those studies have not adequately controlled for a legislator's initial propensity to vote (see also Chappell, 1982 and Peltzman, 1984) and their findings may not be reliable.

Our results throw much doubt upon the pressure group model of public policy. To put it bluntly, two weakly organized groups, women and the youth, seem to have a greater impact on the level of the minimum wage than the strongly organized ones, unions and small businesses. In fact, most of the evidence on the pressure group model is quite devastating and the minimum wage simply constitutes one more case of negative findings. On tariffs, the most widely examined policy, the most thorough analysis concludes that 'these results constitute a fairly strong case against the likely importance of pressure

group influence in tariff setting' (Lavergne, 1983: 155; for a review of the literature, see Blais, 1986). Trade policy, in general, 'does not simply result from interest group pressures' (Lake, 1988: 57). Likewise, Blais and Vaillancourt, 1988, find no support for the pressure group theory in their study of the corporate income tax in the Canadian manufacturing industry. The same conclusions have been reached in studies of regulation (Hoberg, 1986) and deregulation (Quirk, 1988). It is not that politicians are not responsive to demands and pressures (as the results with respect to women, the youth and small businesses indicate). The evidence rather suggests that they are not principally responsive to *organized* interests.

The findings show that the political system is much more than responsive that it is usually depicted to be. On the one hand, organized pressure groups do not control policy outputs. On the other hand, politicians do respond to the demands and needs of constituents. Whenever women and young people form a greater part of the labor force, the relative minimum wage is decreased. Furthermore, politicians are concerned with economic performance; unemployment and inflation affect the level of the minimum wage. There is even some evidence that when the perverse effects of the minimum wage are widely known, governments behave the way they should, that is, they decrease the rate. Our findings suggest that the relative wage was reduced by four percentage points, a relative decline of 10%, after 1980. This latter result is, of course, tentative and a more in depth analysis is required before drawing any firm conclusion. Still, our results are consistent with the view that governments take into account perverse effects and attempt to correct them, and that the work of economists sometimes has substantial impact on public policies, as West (1974, 1977) has argued. Indeed, economists themselves may tend to downplay their actual impact on governments (Nelson, 1987). To the extent that economic performance is a crucial aspect of government popularity, politicians are induced to being particularly attentive to the judgment and suggestions of economists.

Our results also indicate that parties differ and matter. Everything else being equal, the relative minimum wage, which corresponds on average to 41% of the average manufacturing wage, is four percentage points lower when the government is a Conservative one; the relative difference is around 10% which is neither dramatic nor negligible. Such a difference constitutes another piece of evidence that parties matter. Our data support the party cleavage theory of electoral competition which predicts systematic differences between opposing parties rather than gradual convergence, as parties feel constrained from shifting positions in order to preserve their credibility (Page, 1978).

Finally, there is strong support for the existence of a convergence effect. The LEAD variable, which taps that effect, is by far the most significant of all the

variables in the model. Because there is a convergence of nominal rates, the relative rates tend to be higher in the poorest provinces which cannot afford wages that deviate too much from the Canadian average. Likewise, the richest provinces are able to postpone increases in nominal rates by pointing out that their rates are already higher than in the other provinces. Our results indicate that the minimum wage in the poorest province in 1982 is inflated by four percentage points because of this convergence effect. Without that effect, the nominal rate would have been 10% lower.

4. Conclusions

This paper has attempted to test the degree of responsiveness of Canadian provincial governments to different political groups in establishing their relative minimum wage policies over the 1975–1982 period. We have discussed alternative explanations of minimum wage policies, and focused on the political market approach where women, the youth, small businesses and unions play a major role. An econometric model was specified and estimated on pooled annual time series and cross-section data for nine provinces in Canada. The empirical evidence provided clearly shows that the relative minimum wage in the Canadian provinces is higher:

- when and where there are few women and young people in the labor force;
- when and where there are less small businesses;
- when unemployment and inflation are low;
- where the average wage in the province is below the average wage in Canada (convergence effect);
- before the perverse effects of the minimum wage became well documented.

Overall, our findings convey the image of a responsive and responsible government, attentive to the demands of its constituents, be they organized or not, concerned with efficiency, well aware of the policies enacted in other jurisdictions (the convergence effect) and consistent (Conservative governments are more conservative).

Notes

1. See, for example, the recent widely cited review article by Brown, Gilray and Kohen, 1982. There is, however, much less evidence on the impact of minimum wages on the overall unemployment rate. For an exposition of the reasons for a potentially small impact, see D.W. Lee and R.B. McKensie, 1987.
2. Prince Edward Island had to be excluded because of missing data.

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Appendix

Variable	Indicator	Source	Theoretical expectation
Relative minimum wage rate	minimum wage rate/average wage rate in the manufacturing sector	Department of Labour, <i>Labour Standards in Canada</i> Statistics Canada, <i>Employment, Earnings and Hours</i> , cat. 72-002	
Union	percentage of employed labor force unionized	Statistics Canada, <i>Corporation and Labour Unions Returns Act</i> , cat. 71-202 <i>Employment, Earnings and Hours</i> cat. 72-002	+
Small business	percentage of employment in firms with less than 20 employees	Statistics Canada, <i>Employment, Earnings and Hours: Seasonnally-Adjusted Series</i> , cat. 72-206; <i>Employment, Earnings and Hours</i> , cat. 72-002	
Women	percentage of labor force female	Statistics Canada, <i>Historical Labour Force Statistics</i> , cat. 71-201	-
Youth	percentage of labor force, 15-19 years old	Statistics Canada, <i>Historical Labour Force Statistics</i> , cat. 71-201	-
Unemployment	unemployment rate	Statistical Canada, <i>Labour Force Annual Averages</i> , cat. 71-529	-
Party	dummy variable which equals 1 when the party forming the government is the Progressive Conservative Party	<i>Canadian Parliamentary Guide</i>	-
LEAD	average manufacturing wage in the province/average manufacturing wage in Canada	Statistics Canada, <i>Employment Earnings and Hours</i> , cat. 12-003	-
Inflation	percent change in the Consumer Price Index	Statistics Canada, <i>The Consumer Price Index</i> , cat. 62-001	-
1980-1982	dichotomic variable = 1 from 1980 to 1982; 0 otherwise		-

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