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Identification problems on the causal relationship between minimum wage and employment ❖

P. Kapopoulos*, P. Papadimitriou and F. Siokis*****

Corresponding author: Dr. Fotios M. Siokis, Economics Research Division, Alpha Bank, Panepistimiou 43, Athens, 105 64 – Greece.

The economics of minimum wage continues to be a pivotal area and recently has been the topic of renewed interest in economic literature. The opponents of a minimum wage policy setting argue that such an action would price the unskilled workers out of jobs. On the other hand, the theoretical consensus about the effect of minimum wages on the employment has been challenged by the influential empirical research work of Card and Krueger who documented that increases in minimum wage lead to increases in employment. We find that a reverse relationship exists. The causality runs from employment changes to minimum wage changes, and arguing that the results of Card and Krueger's research is the outcome of an identification problem, i.e. changes in employment may affect the relative bargaining power of the competing parties, employers, and employees, during the wage setting procedure. **JEL: E24, J31, J38.**

Introduction

The economics of minimum wage continues to be a pivotal area and has recently been the topic of renewed interest in economic literature. Mainly, the importance of the minimum wage in policy discussions is due to two factors. First, minimum wage may have significant impact on the unemployment rate, and consequently, on the economic activity and social welfare, and, secondly, the fact that at some time during their lives, most employees were paid the minimum wage. Lastly, because those who earn minimum wages tend to be from low-income families, the discussion about the minimum wage has affected the attention of social activists as well.

The policy and research discussion are centred around the abolition and on the impact of the minimum wage on European labour markets (OECD, Jobs Study, 1994; Dolado et al., 1996). The opponents of minimum wage policies argue that such an action would price the unskilled workers out of jobs. In other words, an increase in minimum wage is not translated into an increase in the incomes of the least skilled workers but as a restriction of their employment opportunities and thus, to an increase in unemployment. Further, even the simple supply-demand framework states that introducing minimum wage increases unemployment. The proportional reduction in employment is equal to the proportional wage increase times the elasticity of demand (Brown, Gilroy and Kohen, 1982). Lastly, minimum wage legislation is considered as an ineffective instrument to fight poverty, since many of the beneficiaries are not poor[1] while the employer's cost rises greatly.

On the other hand, the theoretical consensus about the effect of minimum wages on employment has been challenged by the influential empirical research work of Card and Krueger (1994a, 1994b and 1995). They present evidence (using data from some recent episodes in USA like the 1992 increase in New Jersey's minimum wage in fast food industry, the 1988 rise in California's minimum wage and the 1990-91 increases in the federal minimum wage), that increases in the minimum wage lead to increases in pay, without any loss in jobs (and in some cases increase in employment). The theoretical support of this evidence lies on the old idea of George Stigler (1946) stating that if monopsonistic employer's power is strong, firms are artificially reducing the wage below the marginal product of labour. The labour is hired until the curve of marginal cost intersects the demand curve. A minimum wage makes the employer a price taker and thus it simply reduces his monopsonistic mark-up while the labour demand remains unchanged. At the same time, labour supply increases so that the net employment effect is positive[2]. Manning (1995) provides another theoretical argument why minimum wage might raise employment in the framework of an efficiency-wage model, where the productivity of labour depends on the wage paid.

In our paper, we try to clarify the relationship between minimum wage and employment within the context of a dynamic vector autoregression analysis. Empirical findings reveal the existence of a positive causal relation from employment to minimum wage. The reverse causality seems not to be statistically significant as someone might expect. Then, how can the fact be explained that Granger causation runs from employment changes to minimum wage changes? In our opinion, it is a matter of further investigation whether this finding is restricted just in the Greek case with no greater applicability. The sense in which this statement is made concerns the positive employment effect, which has been documented in some of the papers mentioned above, was the outcome of an identification problem. More specifically, changes in employment may affect the relative bargaining power of the competing parties, employers, and employees, during the

[1]For a simple and detailed presentation of this argument, see Sutherland (1995).

[2]The criticism to the "monopsony model" concerns the partial equilibrium nature of the analytical framework (Saint-Paul, 1996) and the absence of evidence that this model is important in modern day low wage labour markets (West and McKee, 1980).

wage setting procedure. In equilibrium, minimum wage formation must be compatible with the market condition (labor demand and supply). In other words, there might be a sort of "error correction" mechanism in place, in the sense that when the minimum wage is high relative to the market conditions, then it tends to grow more slowly the following year. Therefore, the minimum wage converges to some target ratio relative to the average wage. This target ratio depends positively on the rate of change of employment[3] and it means that a reduced job creation growth will lead to downward pressure on the minimum wage, due to the reduced bargaining power of insiders in a standard insider-outsider model.

Is Greece an ideal laboratory?

Minimum wage policy has been one of the major concerns of all Greek governments in recent years. Especially, the 1980-1990 period could be characterised as one of real importance for the implementation of the minimum wage policy. Although, there was an automatic wage indexation mechanism in place-from 1982 to 1990- in several instances, the rate of increase on minimum wage exceeded the rate of inflation whereas in some others, for example during the stabilisation period from 1985 to 1987, the minimum wage growth was marginal. Particularly, noteworthy was the 1982 increase, where minimum wage rose by 42% (as a compensation of the continuous real wage loss that took place in the past and in line with pre-election commitments of the then new Socialistic government) at a time where inflation was at about 20%. This rise took place in a period of increasing openness to foreign competition and resulted in a hike in the unit labour cost by 26% (in 1982), as well as to an increase in employment as many firms were forced to go out of business (Christodoulakis, 1994).

The hike in minimum wages in 1982, and later in 1984, was not followed by subsequent increases in employment level but rather with decreases. These observations support the neo-classical argument that an increase in the minimum wage leads to a reduction in the employment level. However, as the stabilisation in 1985-86 and the overlapping convergence programs in 1990-93 began to emanate the two variables at hand appear to have moved together, exhibiting strong positive correlation as the migration trend start to emerge. This finding, again, does not in itself, provide reliable conclusions, as long as can be attributed to the impact of other factors and especially on the fiscal stabilisation program which included measures of fiscal consolidation and the impact of reduced public transfers. As far as the reduction in employment in the post 1990 period is concerned, this fall may be attributed to the impact of illegal immigration. Between 1990 and 1994, more than 500,000 migrants entered Greece, who up to an extent absorbed the supply of new labour-intensive job openings. The migration flow - partly related to social and economic developments in Albania and elsewhere in Eastern Europe - were not counted in the overall employment figure. After 1994, when most of the illegal workers received working permits (or the so-called green cards), labour force participation and consequently the employment figure exhibited an increase. In the area of

[3] Saint-Paul (1996b) analysed the basic macroeconomic and political determinants of the minimum wage using OECD data. He found that such a target ratio depends negatively on the unemployment rate and on the degree of conservatism of a right-wing government.

manufacturing industry, the number of employed workers had declined significantly by 20% in the period 1990-1994.

Setting the minimum wage

The system of minimum wage determination in Greece was introduced in 1955. Firstly, the minimum wage level for all employers and workers are set in a "national general agreement" as the product of negotiations between the trade unions and the employers' association. However, in the case that a sectoral or occupational agreement anticipates a higher wage, then this wage is regarded as the minimum one.

The role of government in the negotiation process is considered predominant. More specifically, in the period 1955-74, the government through the controlled representative body of the trade unions virtually determined all wage changes, having as a criterion the growth of economy-wide productivity. Through the period 1975-81 the government announced guidelines for setting the nominal wage level, and, consequently minimum wage increases, before the annual collective bargaining round. However, in the case where the negotiations between the trade unions and the employers association were not fruitful, the government was called in to act as a compulsory arbitrator. For the next period 1982-89, the above system was supplemented by legislative arrangements concerning partial indication of nominal wages and two wage freezes (in 1983, 1985). During 1975-90 period, compulsory arbitration was the main instrument of income policy implementation. Seven out of sixteen national general agreements were the product of compulsory arbitration. Overall, from a total of 5523 negotiations that have taken place in the same period, 50.4% were ended with collective labour agreements and 49.6% were resolved through compulsory arbitration (Sabethai 1997).

Although, compulsory arbitration was abolished in 1991 nevertheless, the role of the state remained still active in the process of collective bargaining agreements. Through the announcement of incomes policy, the government set the wage increases in the wider public sector which was used as the "guideline" for the following bargaining agreements in the private sector. But in 1993, 1994 and 1996, the private sector employers had accepted wage increases greater than their projected inflation rate either because they wanted to give productivity bonuses or to keep a peaceful working environment without strikes and temporary work stoppages. After 1990, the national general collective labour agreements were based on two-year contracts.

The last period, 1991-1996 a new form of acquiescent negotiations was instituted taking explicitly into account the governmental targeting economic policies. For example, the National Association of Greek Workers had accepted wage increases, which were lower than the official projected inflation rate. Consequently, the real wage exhibited a downward pattern for the period 1991-1994. Furthermore, in support of the above argument, while the percentage of compulsory agreements was 49.6% for the period 1975-1990, that percentage has declined significantly ever since to 23.2% in 1991 and 9.7% in 1993. Therefore, all of these outcomes make the Greek labour market an ideal laboratory for studying the impact of minimum wage on employment.

Lastly, the characteristics of the minimum wage in Greece and the level of minimum wage varies according to several factors including: (a) job tenure (the augmentation of the minimum wage reach their highest level up to the ninth year of employment), (b) the economic sector within which employment is taking place, and (c) the marital status of the worker, etc. Recent estimations show that the percentage of employees that are paid the minimum wage has gone up by up to 20%; a growth value which is much higher compared to other countries (Dolado et al 1996).

Received Evidence and Identification Problem

The major volume of the research has focused on the effects of minimum wage changes on the level of employment, with the causality to be positive or negative. Furthermore, these studies have estimated the effects of minimum wages on the employment - population and labour force - population ratios by using cross-section data (Van Saest 1989, Wellington, 1989) and time series data (Feliciano, 1998, Brown, Gilroy and Kohen, 1983), by employing single equation estimation techniques. In our case, we examine the alternative or the reverse causality i.e. running from employment to minimum wage by simply allowing the policy making to be endogenous.

Our Research Strategy

We focus on the effects of minimum wages on employment dynamics (and vice versa) for two reasons. First, the "net job creation" effects more accurately measure the extent of harm if the minimum wage does restrict job opportunities. Second, the changes in methods for measuring labour force status introduced to Population Surveys of Greece in 1981 affected the count of unemployed significantly more than that of the employed. By trying to clarify the relationship between minimum wages and employment we use a dynamic vector autoregression analysis with data from the Greek manufacturing sector[4]. The VAR methodology has the advantage of allowing the analysis of the dynamic responses of employment to changes in the minimum wage as well as the investigation of a possible causal relationship between the two variables. If there is a policy response equation, the minimum wage will be positively affected by employment. Empirical findings reveal the existence of a positive causal relation from employment to minimum wage. Further statistical analysis, by the means of variance decomposition confirms the exogeneity of the employment, whereas, the minimum wage appears to be endogenous. More specifically, we present some evidence by testing the links between minimum wages, average wages of white collar workers, employment and business cycle of industrial production. Quarterly seasonally adjusted data covering the period 1974:1 to 1997:1 were used to estimate the parameters of our model. The variables included in the system are: the log of employment level, the log of real minimum wage, the log of real white collar wages and the log of real manufacturing production.

Our findings can be summarised as follows: First, a positive shock to the minimum wage (which is translated to an increase in minimum wage) impacts employment negatively-although is it not statistically significant- before the

[4] For a detailed technical evaluation please refer to "Minimum Wage and Employment Dynamics in Greek Manufacturing" Discussion Papers in Economics 98-07, University of Crete.

occurrence of any subsequent increases. This pattern does not fit so easily into the neo-classical argument where an increase in minimum wages has a negative persistent effect on employment. Secondly, an employment innovation (therefore, employment increase) has positive impacts on minimum wage. The impulse induces persistent and statistically significant increases to the point estimates of the minimum wage. This surprising effect can probably be explained within the context of negotiation procedures among the interested parties. The state of the employment at any given time predetermines (or affects) the level of minimum wage. Furthermore, employment seems to Granger-causes minimum wages with a statistically significant level of 0.036. The shock to employment also has a positive effect on the other variables, i.e. white collar's wages and manufacturing production. The incorporation of the manufacturing variable in the VAR system is twofold: a) to examine the impact on the business cycle and on the real economy and b) to use as a metric of the accuracy of our model, in terms of economic theory, where an increase in the employment level signifies an expansion in production (and vice versa).

A similar conclusion can be reached from the estimators of the variance decomposition. The variables included in the system explain only a small portion of employment's forecast variance, indicating thus that employment is exogenous.

The causal unidirectional relationship which links employment and minimum wage can be viewed as a result of the rather greater weight of poverty alleviation than that of unemployment reduction, in the policy response function of the Greek government. The fact that until the end of the decade of 80s, unemployment in Greece was low, and despite its recent increases is still lower than the European Union average, allowed the government to deal more effectively with the improvement of the real standards of living of Greek employees. In applying such a policy, the role of the unions was crucial, since their enhanced negotiating power in periods of increased employment, obliged, to some extent, the government to follow an expansionary income policy.

Conclusions

Based on the continuing debate on the impact of minimum wage on employment, we try to determine the role of the minimum wage in the Greek manufacturing sector and offer some new evidence. Using various statistical techniques we show that changes in employment affect minimum wage developments. The finding that neoclassical argument does not hold for the case of Greece, at least in the period 1975-96, where minimum wage increases were followed by periods of accelerated economic activity- shows that an abolishment of the minimum wage system may not have any significant positive effect on employment. Measures that could reduce unemployment should probably be sought in other forms of labour market liberalization.

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* **Dr. Panayotis Kapopoulos** is a Senior Economist in Economic Research Division of Alpha Bank. Dr. Kapopoulos received his Ph.D. in Economics from the Athens University of Economics and Business and taught at the same University as an Assistant Professor during the period 1995-1997. Dr. Kapopoulos is widely published in the area of applied macroeconomics, with publications in the European Journal of Political Economy, the International Review of Economics and Business, the Cyprus Journal of Economics, the Journal of Peace Research, etc.

** **Dr. Pyrros Papademitriou** is a Lecturer of International Economics at University of Macedonia. Dr. Papademitriou received his Ph.D. from University of Kent at Canterbury.

*** **Dr. Fotios Siokis** is a Senior Economist in the Economic Research Division, ALPHA BANK. He holds a Ph.D. from the Graduate School University Center of the City University of New York. Previous positions held, in Market Analysis and Forecasting, AT&T and Bell Labs, New Jersey, USA and Visiting Professor in the Economics Department, University of Macedonia.

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Book Review:

Arvin, B. Mak (ed.) (2002). New Perspectives on Foreign Aid and Economic Development., Praeger Publishers: Westport, Connecticut. PP 297. ISBN 0-275-9754-9

The literature on foreign aid is vast and controversial. In particular, the evidence from empirical studies has been inconclusive. The main debate revolves around the motivation and effectiveness of foreign aid on economic development. The time has come not only to take stock, but also learn from it and put forward new lines for research. This is what the book by Arvin has to offer and we welcome it.

Two out of ten chapters are empirical studies and for presentation purposes, the book is divided into two parts. The first part is devoted to issues involving donors' behaviour and goes beyond the 'recipient need-donor interest' approach of earlier studies. The second part presents the debate on the effects of aid on growth, draws our attention to the relation between aid and democracy, and warns us about the possible effects of technology transfers on wage inequality.

Aid allocation to one country is not determined independently of aid to other countries so Feeney and McGillivray (chapter1) estimate a simultaneous equation model to examine Australian aid allocation to Papua New Guinea during 1968-1998. Their results suggest that 'recipient needs' motives are behind Australian aid disbursements. In contrast, McGillivray, Leavy and White (chapter 3) show the importance of commercial and political motives by deriving optimal aid allocations and comparing them to the actual allocations. They obtained donor performance indices for France, Japan, United Kingdom and United States for 1977 to 1997. France performed the best and not surprising because of its links with Egypt and Israel, United States was the worst. More interesting, focussing on the donor's commercial interest, Schönherr and Vogler-Ludwig (chapter 5) show that the effects of untied aid on Germany's exports outweigh the effects of tied aid implying that changing the balance from tied to untied aid is not as costly as donors think and would benefit all parties.

The remaining chapters in Part I discuss issues related to adequate participation and coordination. Johnson (chapter 4) and his field study of an NGO in Thailand shows how important it is for donors and recipients to pay attention to socio-cultural and political factors and makes us aware of the important role the poor play in the design, implementation and evaluation of projects to increase aid effectiveness.

Rowland and Ketchenson (chapter 2) test for complementary (higher degree of concentration for each donor in their top recipients and reduced repetition of disbursement to recipients) and supplementary co-ordination (increased correlation between allocation patterns of different donors) between Canada and nine other donors in Sub-Saharan Africa during the period 1981-1998. They found no clear patterns after applying correlation and regression analysis. The importance of co-ordination among donors is highlighted in the theoretical model developed by Lahiri and Raimondos-Møller (chapter 6). In a two donors and one recipient world, they compare the non-co-operative with the cooperative equilibrium assuming that donors are altruistic and self-interested (trade related). Key to the analysis is the existence of positive welfare externalities between donors. In a non-co-operative equilibrium, free riders explain the low levels of aid but if altruistic donors co-ordinate and agree to increase the transfers, then all countries would be better off. The effects of co-ordination are mitigated if donors are also self-interested and if any transfer shifts the terms of trade in their favour. But even so, aid co-ordination might improve welfare across all countries.

In Part II, the aid-growth relation is explored in chapters 7 and 9. Using an extended Solow-type growth model, Gounder finds that foreign aid contributed significantly in the growth process of the Solomon Islands during 1975-1997. Recently, the World Bank has linked aid efficiency with "good policy/high poverty". Beynon challenges this relation by addressing the fragility of the econometric studies underlying it. But more important, he points out the need for further research to understand the connections between growth, investment, aid and poverty.
Arvin, Barilla and Lew (chapter 8) examine the interdependence between aid and democracy in developing countries over 1975-1998. They conduct first, a trivariate Granger causality test and then, check for co-integration among the variables. They found that aid has a positive effect on democracy only in a few countries and that donors do not take into account democracy in recipient countries when allocating aid.

In the last chapter, Benarroch and Gaisford design a dynamic model to examine the effect of foreign aid on the wage gap between skilled and unskilled workers in both donor and recipient countries. Specifically, they concluded that when aid promotes learning and technology transfers, then both wage inequality and skill formation will increase (decrease) in the recipient (donor) country.

This appealing and helpful book will be of considerable interest to researchers and policymakers. The aim of the editor was to offer the reader a framework in which to understand the foreign aid controversy focussing on the issues of aid disbursement, equity and efficiency. The contributors have fulfilled the objectives intended by the editor in this respect.

Carmen A Li

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* The April 2003 issue of the Economic Journal has papers by, amongst others, M. Lundberg et. al., on *The Simultaneous Evolution of Growth and Inequality*; M.D. Evans on *Real risk, Inflation Risk and the Term Structure;* M. Obstfeld et. al., on *Sovereign Risk, Credibility and the Gold Standard: 1870-1913 versus 1925-31.*

* The March 2003 issue of the Journal of Economic Literature papers by Angus Deaton on *Health, Inequality and Economic Development*; Assar Lindbeck and Mats Persson on *The Gains from Pension Reform*.

* The Spring (May) 2003 issue of the Journal of Economic Perspectives contains a Symposium on Enron and Conflict of Interest with papers by Paul Healy and others.

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Schmidt-Hebbel, K. and L. Servén*, editors. The Economics of Saving and Growth: Theory, Evidence, and Implications for Policy. Published by Cambridge University Press for the World Bank 1999. Reviewed by* ***Mak Arvin****.*

UNCTAD – FDI Determinants and TNC Strategies: The Case of Brazil*. United Nations: New York and Geneva, 2000. Reviewed by* ***Yemi Babington-Ashaye.***

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