

CHAPTER 5

The Importance of Labour Market Mobility to Productivity Growth

By Robert P. Murphy

Introduction

Virtually all Canadians support higher living standards for workers. Unfortunately, many “pro-labour” government policies actually *reduce* employment and wage rates. By loosening or eliminating certain regulations affecting labour markets, policymakers could promote flexibility in labour contracts, leading to improved productivity growth, higher wages, and faster job creation. In this essay, I discuss the productivity-improvement rationale for more flexible labour markets.

Theoretical framework

The only way to raise living standards for workers over time is to raise their productivity; the value of output that the average worker produces in a certain period of time must increase. Worker productivity is influenced by obvious factors such as innate skills and education, as well as background conditions such as the region’s endowment of natural resources, and the quality of tools and equipment. It is also influenced by labour laws and regulations that limit the flexibility of market forces to determine labour compensation and employment levels.

This essay summarizes some of the empirical literature showing the connection between flexible labour markets, productivity performance, and government policies. Before proceeding, I should explain the relevance of two particular empirical observations. First, if inflation-adjusted wages increase, that is evidence that worker productivity has increased

since profit-maximizing employers won't pay more to workers unless they believe those workers will produce more for the firm.

Second and less obvious, lower unemployment rates are also evidence of higher worker productivity, other things equal. For an individual worker, the less frequent and/or the shorter the duration of spells of unemployment during his or her career, the more time is spent "on the job," acquiring human capital and hence boosting productivity. For society as a whole, the lower the unemployment rate, the greater the fraction of the labour force that is actually going to work and producing output. That means, of course, that the average productivity of workers—when measured as total economic output divided by the total workforce—goes up, since the average person in the labour force is actually working and producing more rather than being "between jobs."

For these reasons, empirical studies showing that specific government policies promote faster wage and employment growth or lead to lower unemployment rates are also indirectly showing that those policies are promoting labour productivity growth.

High minimum wage policies hurt low-income workers

Minimum wage legislation is perhaps the most obvious example of an ostensibly "pro-labour" government policy that in reality hurts many of its intended beneficiaries. As discussed by Murphy, Lammam, and MacIntyre (2016), the minimum wage is a blunt instrument that doesn't effectively target low-income workers. As of 2012, 87.5 percent of Canadians earning the minimum wage lived in households *above* the Low Income Cut-Off (LICO) threshold, while 83.4 percent of workers from households *below* the LICO threshold earned more than the minimum wage.

Even if minimum wage legislation increased the compensation of some low-income individuals while not reducing employment, it would still arguably be a net loss for all low-income workers. Since most workers in relatively poor households already earn above the minimum wage, the latter will not be helped by the policy and might actually be hurt to the extent that minimum wage policies make food and other consumer goods more expensive for them to buy.

As a separate problem, forcing employers to pay a minimum wage could reduce employment for those (mostly young) workers affected. Specifically, by artificially raising the initial hourly wages that must be paid to inexperienced workers, minimum wage policies make it riskier for an employer to take a chance on such applicants, thereby making it harder for

young workers to get entry-level positions and acquire the human capital that improves their workplace skills. Up through the 1980s, virtually all empirical studies confirmed the harmful effects of minimum wage policies on the employment of low-skilled workers. This consensus was challenged in the 1990s by some US researchers relying on new statistical techniques. Notwithstanding, dozens of US studies since then have endorsed the original findings.

Canadian studies—which are considered more reliable than their US counterparts, in part because there is wider variation in provincial minimum wages than among US states—confirm the original consensus. The Canadian literature generally estimates that a 10 percent increase in the minimum wage reduces employment among young workers (ages 15 to 24) by 3 to 6 percent (Murphy, Lammam, and MacIntyre, 2016). To reiterate, higher unemployment rates tend to reduce labour productivity over time, because workers can only gain experience that enhances their productivity when actually *on the job*—not when between jobs.

To avoid undesirable impacts, at the very least policymakers should *refrain* from additional hikes in minimum wage levels; it would be even better to eliminate them. A more effective policy to help the working poor would be some version of a refundable tax credit (which was originally implemented in Canada as the Working Income Tax Benefit, or WITB, but now an expanded version is called the Canada Workers Benefit or CWB). Although the details are important, economists generally agree that a tax credit aimed at low-wage workers is a way to boost their incomes without reducing an employer’s incentive to hire, and is thus a better instrument for helping them than minimum wage laws.

“Right to Work” policies promote employment and wage growth

In the United States, individual states are either “right-to-work” or not.¹⁵ In a right-to-work (RTW) state, unions cannot compel non-union members to pay union dues if they work at a company with a union contract.

Although economists disagree on the theoretical impact that RTW status has on wage rates, it is generally accepted that RTW states have more flexible labour markets, which, in turn, should promote employment and hence productivity growth. Table 1 provides some empirical measures of economic performance of RTW and non-RTW states from 2001 to 2013.

¹⁵ The discussion in this section reproduces material from Murphy, Emes, and Eisen (2016).

Table 1. Key economic indicators, RTW vs. non-RTW (USA), 2001-2013

Indicator	Non-RTW	USA	RTW
Private non-farm employment growth	8.2%	11.7%	17.4%
Growth in real private sector output	20.3%	23.8%	30.3%
Growth in real manufacturing output	19.5%	25.2%	35.4%
Change in number of firms (2001-2012)	-0.8%	1.6%	5.6%
Growth in real personal income	15.3%	19.6%	27.7%

NOTE: "RTW" are states that had RTW legislation enacted in or before 2001.

Source: Eisenach (2015) relying on BEA and Census Bureau data.

Table 1 demonstrates a strong *correlation* between a state's RTW status and various measures of economic performance, although it doesn't prove *causation*.¹⁶ Reed (2003) finds very strong positive wage impacts from RTW, arguing that most previous studies either focused only on *union* wage rates and/or didn't adequately control for the possibility that states with low initial wages might be more likely to adopt RTW. These findings suggest that RTW status allows more flexible labour markets and, in the long run, allows employers and workers to match up more efficiently, thereby boosting productivity and average wages. While there is mixed evidence on whether RTW status increases average worker pay, there is more of a consensus that RTW increases employment, particularly in manufacturing (e.g., Holmes, 1998).

Relaxing occupational licensing boosts labour productivity

Occupational licensing requirements are another clear example of regulations that interfere with labour markets and reduce productivity, particularly when "unqualified" workers would in the worst case merely be annoyances—such as dog groomers or hair stylists. Although licensing requirements supposedly protect the public from shoddy providers, in practice they restrict legitimate competition. As a consequence, excluded workers are forced into occupations where their productivity is lower, hence reducing overall economic output (Friedman and Kuznets, 1945).

¹⁶ Indeed, some studies conclude that the superior performance of RTW states is due to other factors; see Moore (1998) for a review.

Policymakers could therefore boost productivity by reducing or eliminating occupational licensure requirements, particularly in areas where there is little potential harm except unsatisfied customers. As a simple first step, the various Canadian provinces could enact reciprocity agreements, so that (say) an electrician who is certified to work in one province doesn't need to complete redundant certification requirements to take a job in a different province.

Increased immigration, with a focus on STEM applicants, boosts labour productivity

Immigration barriers obviously impede the flow of workers to where their productivity is highest; there are millions of potential workers around the world who would earn higher incomes in Canada than in their native countries. A relaxation of immigration barriers would allow some of these workers to relocate to Canada, where—coupled with better infrastructure, other skilled workers, and more capital—successful immigrants would see a tremendous boost to their productivity and hence earnings.

Yet the more interesting question is whether a relaxation of immigration barriers would enhance the productivity of *existing Canadian workers*. In theory, more immigration leads to two competing effects on Canadian wage rates. On the one hand, if there is no reorganization of production, an increase in the supply of labour should reduce wage rates as more workers enter the market.

On the other hand, more immigration could lead to an enhanced “division of labour,” whereby a larger population allows workers to specialize in those areas where they are most productive. In particular, if highly skilled or entrepreneurial immigrants start new businesses in Canada, this would boost the productivity of Canadians whom they hire, raising living standards not just for the immigrants, but for the native-borne as well.

Globerman (2019) reviews both theory and evidence regarding high-skilled immigration to Canada. He finds that while highly educated immigrants may have a modest negative impact on the incomes of their native-born, highly educated peers, they raise the wages of other Canadians (for whom the immigrants' skilled labour is a complement, not a substitute). Furthermore, there is evidence that highly educated immigrants increase the rate of return on domestic capital investment, and boost job creation by being innovative and entrepreneurial.

To be sure, immigration barriers are not merely an economic policy, but reflect other considerations that are beyond the scope of this essay. Even so, if policymakers wish to boost labour productivity generally, they

should consider relaxing immigration restrictions, particular on highly educated workers in the STEM fields.

The economic benefits of labour market flexibility

The previous sections in this chapter focused on specific examples of government policies interfering with labour markets. This section concentrates on the general concept of labour market flexibility. The Fraser Institute publishes an annual index of the Economic Freedom of North America (Stansel et al., 2019), and one of its components measures Labour Market Freedom. This measure is constructed from three statistics for each jurisdiction: (1) full-time minimum wage income as a percentage of per capita personal income, (2) the share of government employment to total employment, and (3) union employment as a share of total employment. The *lower* a given jurisdiction scores on these metrics compared to its peers, the *higher* its rating for Labour Market Freedom.

According to Dean Stansel, “Annual changes in EFNA [Economic Freedom of North America] labor market freedom scores (from 2000 to 2015) are positively correlated with subsequent annual changes in employment,” and likewise are positively correlated with “wages and salaries... in the following year (from 2001 to 2016).” Furthermore, “those annual changes in freedom are negatively correlated with unemployment rates... the following year” (Stansel, 2018: 21).

Stansel (2018) reviews other studies and finds that the *total* economic freedom score on the EFNA index is correlated with desirable economic performance. While some studies find that labour market freedom is not as important as the other two major components of the index (namely, government spending and taxation), Garrett and Rhine (2011) conclude that a good score on labour market freedom “was more strongly associated with employment growth” than were good scores on government spending or taxation (Stansel, 2018: 18). This general pattern seems to hold up at a global level (Feldman 2005; 2009).

To sum up, both theory and a wealth of empirical evidence suggest that more flexible labour markets make it easier for employers and good job candidates to find each other, thereby boosting employment and average pay in the long run. Furthermore, eliminating arbitrary restrictions on who is allowed to work in specific occupations means that workers can best exploit their specific skills. The result is higher labour productivity and higher wage rates.

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Acknowledgments

The author thanks Bob Lawson, Dean Stansel, and Ben Powell for literature recommendations.

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