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### **Creating a High-Wage Economy**

Finance minister Michael Cullen has been urging employers to lift wages to close the wage gap with Australia and stem the exodus of workers across the Tasman.

Why don't employers simply raise wages and stop the stampede?

In thinking about what lifts wages we should consider inflation-adjusted or 'real' wages, because it's what wages can buy that matters for living standards.

Wages are a price – the price of the labour services employees provide to firms. Like any other price in a market economy, they are determined by supply and demand in the marketplace – in this case the labour market.

In reality there are many labour markets, covering a whole range of skills and locations. Moreover, labour markets are becoming increasingly international, and not just for people like managers and rugby players.

Wherever there is a shortage of labour, wages tend to rise. The reason is not the generosity of employers. Firms have little choice – they have to pay the going rate or workers will be competed away by other firms.

In a healthy, growing economy, some may not be able to do so. Labour and other resources will then move to higher-valued activities. Firms unable to compete have to restructure, contract, or go out of business.

This is not a problem for business at large. Of course employers as buyers of labour don't want to pay more than they need to, just as buyers of houses want to get their preferred house at the lowest possible price. Equally, workers as sellers of labour want to get the best price for their services. Markets determine where the price is struck.

A surplus of labour (or a surplus of houses or anything else) puts downward pressure on prices.

New Zealand had a surplus of labour in the early 1990s – the unemployment rate rose during the 1980s and peaked at 11% of the labour force in 1991.

Increased unemployment was driven by excessive wage increases in the mid-1980s, disinflation, and the shedding of jobs in inefficient protected manufacturing industries and state enterprises. The problem was made worse by the rigid labour market of the time.

With the freeing up of the labour market in the early 1990s, average real wages fell marginally but began to rise as the economy grew strongly in the mid-1990s.

In addition, unemployment fell sharply, to 6% of the labour force by 1996. By 1999, over 270,000 new jobs had been created.

After the short recession of the late 1990s, the fall in unemployment resumed and real wages have increased by 15% since 1999, according to Dr Cullen.

Contrary to some claims, it's of no interest to business at large to have "a reserve army of unemployed" (to use the Marxist phrase). If it were, businesses rather than unions would push for high minimum wages that price people out of jobs. To the contrary, a buoyant, full-employment economy is good for everyone. Businesses need customers and the unemployed don't make good shoppers.

Rather, what matters for firms is simply whether employing workers is profitable. This is where productivity enters the picture. Given flexible wages, supply and demand can balance – full employment can be achieved – at any level of productivity. In Bangladesh the level is low, and so are wages; in the United States both are high.

It is widely understood that firms can't pay workers more than their labour productivity warrants, otherwise they would lose money by hiring them.

What's not so well known is that in competitive markets firms can't pay workers less than their productivity warrants – otherwise they will be bid away by competing firms.

Wages don't always track labour productivity simultaneously, but over time they do. Indeed real wage growth since 1999, at an average of 1.6% a year on Dr Cullen's numbers, has outstripped labour productivity, which has been growing at only 1.1% a year in the measured sector of the economy. (The wage increases would have been higher were it not for increases in other labour costs, like leave entitlements and ACC levy increases, which are ultimately paid for by workers.)

Productivity is not mainly about workplace arrangements, although they are a part of the story (major efficiency gains were achieved with the freer labour market). Education and training are also only part of the story.

More important is the overall business environment. A Mexican migrant to the United States is about five times more productive than one who stays at home. The reason is that the United States has a better legal system and other social institutions, better infrastructure, and better physical and cultural capital.

New Zealand's labour productivity growth improved markedly (to around 2.5-3% a year in the 1990s) following the adoption of better institutions and policies, but it has slumped as policy reversals and a failure to continue with pro-growth policies have made the economy less free and competitive.

Business and workers alike have a common interest in a high-employment, high-productivity, high-wage economy. Closing the 30% wage gap with Australia calls for renewed efforts to achieve that goal.

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