



## *Essays on Market and State Part2*

*Nonoy Oplas*  
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### *Introduction*

The three papers below discuss issues on wages and productivity, labor laws and entrepreneurship, and the limits of government regulation compared to pure, uncontrolled competition in a contestable market situation.

I have other short philosophical and economic essays written in the past. They will crop up one by one in future papers of the “Market and State” series, here in the MG website.

I am also thankful to some friends who are professors or lecturers of Economics or Political Science subjects in some big Universities in the country, who are using the MG website as among the reference materials for their students.

## ***I. What determines wage?***

The main determinants of labor supply and demand are the following: for labor supply, population size and growth, including labor migration; ie, as population growth and/or migration increases, labor supply increases. When economic opportunities in countries A and B improve and there are plenty of high-paying jobs available, some laborers in country C, especially the more skilled ones, will move out and go to the more dynamic economies. Consequently, country C will experience shortage, temporarily or permanently, of some skilled workers.

For labor demand, economic size and growth; ie, more economic growth, more business activities, more jobs created. Also, the level of skills, educational training, of the workforce, and the level of technological development of an economy. Industrialized countries are more knowledge- and capital-intensive, and less labor intensive. Households for instance, will have little or no need for domestic helper inside the house when there are plenty of machines: laundry machines, dish washing machines, and so on. Hence, demand for low-skilled workers is low.

Now, there are two types of wages: ***One***, market-determined or equilibrium wage: the level of wage where supply meets demand in a given skills level; and ***two***, government-mandated minimum wage; very often, this is above the market-determined wage for the unskilled workers.

There are three schools of thought why there is a difference between the two. ***First***, the common view that wage is a function of the cost of living of a family, or “family subsistence wage”. A family of five would need xxx Pesos per day or yyy \$ per hour to live decently; hence, this should be the minimum wage. The minimum wage is the level that even the most unskilled worker must receive.

***Second***, the view that wage is a function of increases in the price of commodities (inflation rate). The consumer price index (CPI) has moved up from xx to yy points over the last nn years; hence, wages must increase by a proportionate rate. This proposal is also called “wage indexation to inflation” and the purpose is to allow the unskilled workers to keep pace with commodity price increases.

***Third***, the view that wage is a function of productivity. Whether the worker is single or has 10 children, or inflation rate has increased by 1% or 20% per year, if productivity or average output per worker has not increased, wages cannot increase. Otherwise, the company will close shop and workers will be laid off. At the extreme, a No wage increase, even a wage cut, is better than joblessness.

The philosophy and logic of government setting minimum wage (either by legislation or administrative order), is to protect workers from underpayment and exploitation by their employers. The goal of worker protection is good and laudable, except that the means, minimum wage-setting by government, depresses the dynamism of the labor market.

Setting a government-mandated minimum wage way above the expected productivity of unskilled people, if strictly and rigidly implemented, will result in those unskilled people being hired by no one except the charity-oriented organizations and individuals. If the number of the unskilled people are much plentier than what charity people and organizations can absorb and employ, then the rest of those unskilled people will go hungry. In short, minimum wage and related laws protect only those who already have jobs, but discriminate the unskilled who are not employed yet.

That minimum wage should be xxx Pesos (or any other currencies) per day because that is what a family of five members (couple + 3 children) will need to live “decently”, regardless of the skills of the worker, will again work against the unskilled. There will be temptation and incentives for employers to hire only unmarried people, or married but have no kids yet (or have only 1 or 2 kids) so that the “needs of family of five” argument will not apply to the workers in negotiating for wage adjustments. And those unskilled workers who have plenty of children will be condemned to perennial joblessness, perpetuating further that family’s poverty.

Indexing wages to inflation rate is also inadvisable. Inflation rate can climb fast for a hundred reasons, like high interest rates due to government over-borrowing to finance the budget deficit; damage to crops or roads due to natural disasters (strong typhoons, hurricanes, floods, earthquake, volcanic eruption) or plain sabotage; increase in transportation cost due to world oil price increases, and so on.

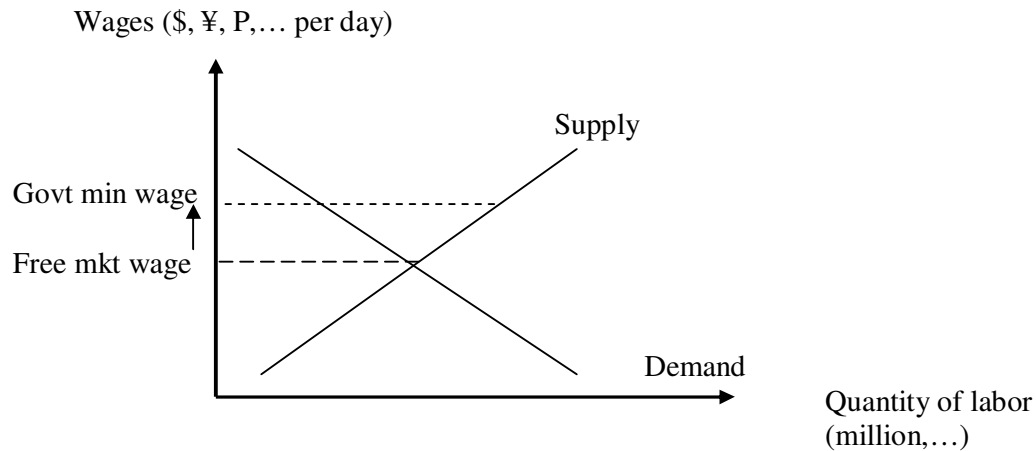
By forcing wages artificially high through government-mandated minimum wage, or by sabotaging certain infrastructures or markets so that inflation rate will rise, and if productivity does not rise by corresponding amount, then certain companies and businesses may be forced to stop additional hiring, or lay off some workers, or just close shop, even temporarily.

Wage is a function of, and is determined by, a worker’s skills and productivity. It is not a function of the number of children that a worker has, nor is it a function of the change in consumer prices (or inflation rate). Because if this were so, then workers can have 5, 10 or more children, and pressure the state to pressure the businessmen and employers to increase their pay because their needs to live decently have increased. In a situation of many poor economies like the Philippines where labor supply always exceeds labor demand every year because of fast population growth, the army of the unemployed will keep increasing and poverty incidence will keep expanding.

To further see these points, the following graphs will help. Supply of labor (or tomatoes or hamburgers or other goods and services) is upward-sloping; meaning as wage or price goes higher, more will be supplied. Demand for labor (or staplers or haircut or other goods and services) is downward-sloping; meaning as wage or price goes up, less will be demanded; and as wage or price goes down, more will be demanded.

We start with the market for unskilled labor. Skilled laborers always have wages higher than government-mandated minimum wage because those people can easily walk away if the offered salary is lower than what they think they deserve.

*Chart 1. Determining the wage for unskilled labor*

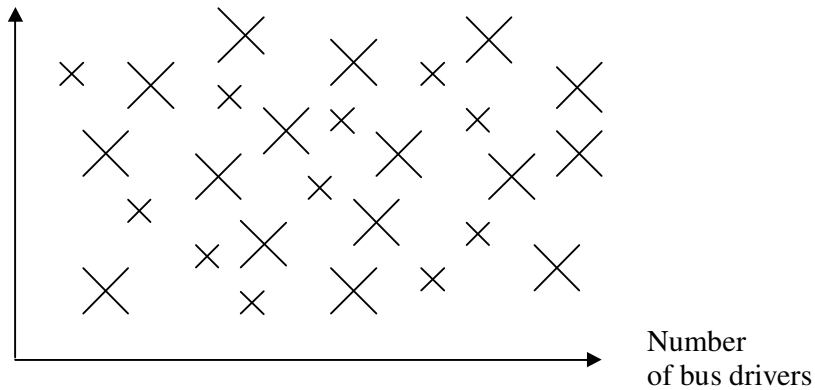


It is possible, and it is happening, that an economy can have numerous and endless equilibrium wages for numerous types of labor supplied and demanded: for domestic helpers (rich, middle class, poor households), construction workers, agricultural or aquaculture workers, hotel and restaurant workers, public transportation workers (airlines, shipping lines, bus lines, etc.), scientists, engineers, chemists, lawyers, economists, etc.

Even in a single occupation or type of work, say bus drivers, at any given time, there are dozens, if not hundreds, of market-determined (or equilibrium) wages for bus drivers among many bus lines in a particular country. And within the same bus company, there are varying rates or wages among drivers: the most experienced, most courteous, and most careful drivers, get higher pay than the less experienced, less careful ones. This situation for bus drivers for different bus companies can be depicted below:

*Chart 2: Different combinations of supply-demand for each driver category*

Wages for bus drivers (\$, P,... per day or per trip)  
at any given month or year



One opportunity that should be made more achievable for many workers and ordinary employees, is to become start-up entrepreneurs, to become employers themselves someday. Many workers do not aspire to become “employee forever”. Unless their company or organization keeps expanding so that they are assured of continued career mobility until they retire, workers should dream of becoming “their own boss” someday. This will put them on the same situation as their former employers, and this will temper them from making unreasonable demands that are beyond the capacity of employers to be granted. Conversely, if employers know that their current hard-working employees will leave them soon to put up their own start-up enterprises, they will be forced to give good pay and benefits to encourage said self-driven employees to stay in their companies.

## ***II. Rigid labor laws and "employee forever"***

Rigid labor laws, or laws that overly protect workers against possible "capitalist exploitation" is rooted in socialist thinking and philosophy. Since workers own no means of production but only their labor and talent, then they should be protected by the State.

Among the known rigid labor laws applied in many countries, in highly welfarist western European countries especially, are (a) high minimum wage for unskilled workers; (b) security of tenure, protection from dismissal and lay-off (even if the employee is displaying laziness and declining productivity, or even if the company is losing money); (c) long mandatory leaves with pay (vacation leave, maternity leave, generous sick leave, etc.); (d) expensive separation pay and retirement benefits; (e) short working hours (like France's 35 hours work week); and (f) very high taxes, both personal and corporate income taxes, partly to pay for generous unemployment allowances for the jobless. In short, a policy of "expensive to hire, difficult to fire".

One clear and explicit result of rigid labor laws of a country is high unemployment and high underemployment. Many people, the socialist-leaning groups especially, do not consider this as result of rigid labor laws, but as additional reason to make the laws more rigid and more "pro-labor". That is, since unemployment is already high, the more that the government should protect workers from being laid off.

But one big reason why unemployment is high is because many employers would rather (a) put up their plants and offices in other countries where labor laws are more liberal; or (b) hire temporary and contractual workers or job trainees than hire regular, full-time employees considering the high wages, high separation pay, and difficulty of firing or laying workers off.

Another impact of "expensive to hire, difficult to fire" policy is that many employees are lulled to become "employee forever" and entrepreneurial spirit is discouraged among them. If the laws are stacked against being a businessman and entrepreneur and in favor of employees, why aspire to become an employer? Why not stay as employee forever, preferably in government agencies or enterprises, and enjoy the benefits of rigid "pro-labor" laws?

The various labor and student unrest in a number of European countries like France in recent years is one proof of the inherent problem and contradictions of rigid labor laws and encouraging "employee forever" mentality. With double-digit unemployment and/or underemployment rate for the past few decades, and unemployment rate among younger people at twice the average unemployment rate, many European businessmen and entrepreneurs are getting bolder in asking for more liberal labor laws, a move that the employed and protected workers, and the young people aspiring to enter the protected labor market someday, oppose. The entrepreneurs want leeway and power to fire less-experienced and less-skilled workers without justifying themselves to the government courts for doing so; the students and labor unions oppose this scheme and

want full protection and security of tenure for young workers (again, even if the employees are displaying laziness and flat or declining productivity, or even if the company is not earning enough).

When faced with situations like this, at least two policy environments for labor can be chosen, like which is better: (a) a high-paying, fully-protected job but is hardly available, or a "low-paying", unprotected job but is easily available?  
(b) hard to be fired but difficult to be hired, or easy to be fired but also easy to be hired? And  
(c) government-protected and over-taxed employee forever, or self-protected and low-taxed entrepreneur someday?

The labor laws that workers demand to protect themselves from "capitalist exploitation" will be the same laws that will prevent them and their children from being easily hired someday, or to become self-reliant entrepreneurs and businessmen and women someday.

### ***III. Competition vs. Regulation***

May 26, 2008

There's a strong and noisy move on the part of the government – from the Office of the President to Department of Transportation and Communications (DOTC), National Telecommunications Commission (NTC), the House of Representatives and the Senate -- to force the three local telecomm companies to make SMS or texting free, they will charge the public only on voice calls. In addition, there are also proposals to bring back the "cap" on earnings these telecomm firms are allowed to make.

This looks cute, especially for us consumers. We can expect that the 200+ million texts/day will rise to 500 million or more texts per day. One can send again dozens of jokes or quotes or anything everyday, they're free anyway.

The telecomm companies' cell sites will be swarmed with millions of texts everyday. They need to put up more cell sites to back-up existing ones, but with little revenue as people will reduce their voice calls and send free texts, these companies will have less money to build new cell sites. So the old problem of messages either delivered several minutes or an hour delayed, or not delivered at all, can come back. When the public will complain why their messages are delivered late or none at all, do they have the right or moral ascendancy to complain? If someone asks me to deliver X kilos of rice or fish to his relative a few kilometers away and he pays me nothing and he's not even my friend or relative, can he complain if I don't do his "request"?

There are only 3 telecomm firms in this country of about 40 million cell phone subscribers. Singapore with only 4 million people has about 5 competing telecomm companies. I do not know the figures in other countries. The point is that there is little competition here among telecomm firms. If Sun Cellular did not come as a 3rd player, what would be the rates of the 2 incumbent players Smart and Globe, perhaps 10 percent or 40 percent higher?

So people should be thankful of the 3<sup>rd</sup> player? Maybe yes, but maybe not. Because when this firm came in, there was no more 4th or 5th player anymore. So competition is again limited.

Who limits competition? Who says one can or not do telecoms business here? It's the government; in particular, the NTC and DOTC. So now, the people and agencies who limit competition are the ones who are attempting to force those they have allowed to do business to provide certain free services.

Regulation allows the regulators to behave as if they own the firms that they are regulating, even if they are not the owners of those firms. Ownership and control are two different things. One need not own something but if he has control of that thing, he can do whatever he wants. Like a family driver. He does not own the car, but if he

decides to drive on his own and visit his friends without the knowledge or permission of his employer, he can do it. If he gets caught though, that's another story.

So the State does not own the three telecomm companies. But the State is the regulator. It's the one that gave franchise to the current players, the one that denied franchise and entry to other players that wanted to come in, the one that stipulated the provisions contained in the franchise, etc. Hence, the State can control the behavior of the firms they are regulating. And there are stiff penalties, political or otherwise, if those regulated will not follow the wishes of the regulators.

If we have a contestable market situation in telecomm industry (and all other sectors and sub-sectors), "right-pricing" of any service will not be a problem. Existing players cannot be complacent and charge high rates and make big profit for long because there will be new players who will come in to take advantage of the high profitability of that industry, by offering consumers even better services for the same price, or offer the same quality of services at a lower price. If the industry profitability declines to a minimum due to a big number of players and competitors, some incumbent players will close shop and other players will be discouraged from coming in. In short, it is competition, not government regulation, that will discipline all players in a sector.

But government bureaucrats and politicians do not see it this way. For them, only them -- not the profit hungry companies -- can protect the public. But politicians and bureaucrats produce nothing, not even a single kilo of nails or rice or fish. They produce tons of paper work and regulations. It's those private enterprises that produce all the things and services that we need, from ballpens to cell phones, from shoes to hamburgers to cars to computers, to laundry to hair cut, etc.

If we have more producers competing with each other, society will be more well-off, there will be more food, more cell phones, more telecomm companies, more spas, etc. And if we have less regulators and politicians, we will have less monopolies, oligopolies, less taxes, less regulations/accreditations/inspections, etc.

We need more competition. We need less regulation.

## **Comments and Reply**

I circulated that paper to some of some friends and got 3 comments. Here they are, along with my additional points.

(1) From Eunica:

"Thing is, in regulation, regulatory bodies normally lose sight of what they are created for- which is to promote competition and regulate where it is necessary. in fact this is the battlecry of regulation when privatisation in the UK started with just one wave of

Margaret Thatcher's magic wand in 1979. but it seems to me that most regulatory agencies have veered away from this and now functions mainly to regulate. It would be important to note though that proponents (1983) envisaged a short-term form of regulation only since they thought that after 5 years or so, the regulatory regime would have (and inevitably) brought about competition already (which did not materialise entirely in UK and elsewhere).

"Critiques would still say that regulation is too costly for businesses and for the government. and it is so true...

"Showing the costly and rigorous processes of regulating firms, however, might not be enough to disprove the merits of regulation especially of natural monopolies. And maybe it is true that competition is still the solution. But in a contestable market, we can only "mimic" the results of a perfectly competitive market through second-best pricing. Ramsey pricing also ensures that integrated firms do not exercise their gained market power by setting the price between the Incremental cost and the Stand-alone cost (proving the absence of cross-subsidisation ).

"As to why we can only mimic competitive results and this is not the world's biggest secret, is mainly because there is no such thing as perfect competition. It is only an assumption."

Eunica put a number of good points, but I would like to comment only on a few things.

First, on "no such thing as perfect competition; it is only an assumption". I say there is perfect competition, at least in a particular locality. The case of retail petroleum products is one example.

In some areas where gas stations are quite close to each other, one will observe price similarity for diesel and gasoline products from amongst Shell, Caltex, Total, Petron, other players. Should there be differences, it's only a few centavos. Why so? All the four components of perfect competition are present:

- a. homogenous product -- whether sold by total or petron or shell, a diesel is the same for all gas stations.
- b. many buyers, many sellers -- thousands of motorists-buyers, many gas stations.
- c. perfect information -- a motorist knows that the price of diesel or gasoline is about the same among neighboring gas stations; and gas stations know that motorists are "canvassing" the price of their competitors.
- d. price taker -- the many buyers and many sellers think they're all "small enough" to influence the price of the petrol product.

Bulk buyers like operators of big bus lines operate outside the gas stations - ordinary motorists market. The former go directly to petrol wholesale dealers, not the retailers. So those bulk buyers dealing with wholesalers are on another level of competitive markets.

## 2. How "less regulation" should it be?

I believe that for many industries, there should be zero, nada, government regulation. Firms operate on brand or trademarks, and firms protect the name and reputation of that brand, and consumers hold on to that brand for product quality and price stability. Take the fastfood chains. Whether it's Jollibee Davao or Jollibee Cubao or Jollibee Tuguegarao, the food quality and price are the same. There are perhaps 1,000+ shops or branches of Jollibee (and McDonald's, Burger King, Starbucks, etc.) nationwide, and we don't hear a single case of food poisoning.

Hence, there is zero need for "health and sanitation permit" from municipal and city governments for those shops because those fast food chains are themselves scared of any news of dirty food or food poisoning in any of their branches and shops.

What government should over-regulate are those killers, rapists, land-grabbers, kidnapers, hold-uppers, bombers, drug pushers, extortionists, etc.

Entrepreneurship and job creation is not a criminal activity that needs lots of regulations, from barangay clearance to mayor's business permit to BIR, SEC, DTI permits, etc,

(2) From Joey G.:

"I agree with Nonoy on his last paragraph. In order to comply with these government units, entrepreneurs have to spend a lot of money for professional services, office supplies and manpower on top of the fees they charge based on some existing local ordinance or agency circular. (We are not considering here the exorbitant penalties these Government units charge that would make any loan shark hide in shame for not conceiving it). How can any organization be competitive if companies utilize their most valuable resources to comply with the laborious requirements of these regulators?"

I thank Joey for his comments.

In microeconomics, one important concept is "contestable market". Here, entry and exit of firms (ie, opening and closing a business) should be as free as much as possible. Government regulations, especially complicated, costly and time-consuming ones, say 2 months or more to finish all business permits, already kill the attainment of a contestable market.

The beauty of a "contestable market" is that it is a regular, daily, reminder to incumbent firms that they cannot be complacent anytime anywhere. Once profitability is big, say during a city fiesta, new players can come in anytime to snatch up any surplus profit in the industry or locality. But incumbents have the advantage of being a "mainstay" player and if they have a good reputation, say a clean hotel with honest

and courteous staff, people will stick with it despite the presence of new players (say homestays that charge low nightly rates).

Back to "no such thing as competition", one important criteria to have a perfectly competitive market, is a homogeneous product as reference point for both buyers and sellers. Any change in product characteristics or quality, say small-medium- large criteria for tomatoes or fruits, that already constitutes "product differentiation" and you have 3 or more heterogeneous products already. For gasoline stations for instance that offer same price of diesel and gasoline along with their competitors, the "product or service differentiation" consists of having cleaner restrooms, more polite and friendly gasoline boys, bigger and cooler convenience store, etc.

(3) From Ted:

"An oligopolistic environment breeds an inelastic demand for a product. While SMS is definitely an "elastic" service, I still see a "threshold of elasticity" where even with a cost involved, people still send sms messages, albeit not as much as in a free environment. But again, "there is no such thing as a free lunch". What telecom companies will lose in sms revenue by making it free, they will find other means to preserve their bottom line and ROIs in the long run.

"I also believe the telecom industry is not as oligopolistic as perceived. Competition is the name of the game, even if there are only 3 players. I would see it more as monopolistic competition, where there are differentiation of products. Why, if it were really oligopolistic, these telecom companies wouldn't have to spend so many millions advertising their services and getting actors and actresses to endorse them on TV, right?

"And yes, I agree that there should be less regulation and more competition. But telecommunications is an area where historically, governments - be it a socialist, totalitarian, capitalistic or pure democracies (as the U.S. touts itself to be) need to have some level of control and regulation, supposedly for the common good of the population and the nation as a whole."

I thanked Ted for his comments. I also agree with him that the local telecomm industry is on a monopolistic competition, not oligopoly, market structure, because of the reason he gave -- high ads costs by the 3 competing firms to attract subscribers. But I am still wondering why they can not bring down the cost of local or national voice calls, when they can offer international voice calls for only three-fourth that of local calls.

My hypothesis is that either certain government telecomm regulations keep local calls and SMS expensive, or the monopolistic competition market structure of the industry allows the three players to keep local calls expensive.