

## How to get the maximum out of the minimum wage

*Establishing a minimum wage may positively affect employment and industrial peace and is a means of fighting poverty. States have a major role to play in this and certain conditions have to be met. One of them is social dialogue.*

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Minimum wage regulation prohibits the payment of wages below a specified threshold. The main aim of such legislation is to sustain the living standards of low-paid workers. Empirical evidence (minimum wages have been in operation for years in most countries of the world) shows that other objectives are also invoked when setting up a minimum wage system. While supporting a minimum wage, governments, employers, workers and trade unions may indeed pursue different objectives.

For the workers, the minimum wage represents a basic requirement and a good way of improving or maintaining the standard of living of the low-paid and their families. The minimum wage is, furthermore, a way of protecting vulnerable workers who are not able to organize and thus prevents exploitation. It is also a means of redistributing income from capital to labour. Finally, negotiations around the minimum wage promote social dialogue.

At first sight, it might seem surprising to state that employers, for whom wages mainly represent a cost of production, have

any interest in the introduction of, or increase in, the minimum wage. However, from the employer's point of view, paying a minimum wage may increase productivity in three main ways: by minimizing shirking, reducing labour turnover and contributing to social peace. Firstly, the minimum wage is a way of raising productivity by motivating workers. Secondly, uniform wages, such as the minimum wage, contribute to reducing labour turnover, which can be very costly for firms. Thirdly, the minimum wage strengthens social cohesion and is a way for employers to ensure social peace by avoiding conflicts.

For governments, a major purpose of the minimum wage is certainly to contribute to alleviating poverty. The minimum wage can act as a social safety net in countries where social security is as yet little developed. Governments have also used the minimum wage to redistribute income in society, to promote productive employment and to enhance demand-driven growth.<sup>1</sup> In developing countries, the minimum wage is often at the core of social dialogue. Removing it may amount to seriously damaging the quality of social dialogue.

Furthermore, in countries where waged employment is developed, increasing the minimum wage might lower wage inequality and thus help to reduce income

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inequality.<sup>2</sup> In these countries, coordinated wage bargaining also acts as an important tool to achieve low inflation combined with a low level of unemployment when the growth of the economy leads to pressure on wages to increase (ILO, 2000).

In a period of high demand (high growth), firms tend to hire more people to meet the demand and unemployment tends to reduce. People have more wages, they spend more, enterprises also buy more input and inflationary pressure develops. In short, the higher the employment, the higher the inflation.<sup>3</sup> Higher employment is good, but higher inflation is not. To avoid this dilemma, as inflation is the continuous increase of prices (price of output and price of labour), one way to keep inflation low without reducing demand is to control wage increases. How? The best way to adjust wages seems to be to look at real wages (the increase in the purchasing power of wages) and the other sources of inflation such as budget deficits.

Another function of the minimum wage is to ensure a better match between workers' skills and job requirements. The minimum wage, by increasing the expected earnings from a future job, provides a feeling of security to workers, and gives them more time to find the job corresponding to their qualifications. Promoting a better match between workers' skills and job requirements is an important and underestimated role of the minimum wage. This is especially so in developing countries, where there is no unemployment benefit system to play such a role, but also in industrialized countries, where some groups of the population such as first-jobseekers are often not covered.<sup>4</sup>

Finally, the minimum wage is an incentive for employers to provide training for workers. This could contribute to increasing the quality of the labour force.

The objectives of social partners overlap, but not completely. Precise objectives are imperative in determining the minimum wage system. If the State's objective is to relieve poverty, the questions that have to be answered are: Where do the poor work? Are they in waged employ-

ment? What kind of work do they do? Do they need training or not? Depending on the answers, it might be that the minimum wage is not the appropriate tool for alleviating poverty, though it might still be able to achieve other objectives.

### Problems in determining the minimum wage system

In practice, problems arise as to the determination of the right level and coverage of the minimum wage system, if it is to fulfil the functions outlined in the previous section.<sup>5</sup>

There are several criteria to consider in the determination or the adjustment of the level of the minimum wage. The ILO's Minimum Wage Fixing Convention, 1970 (No. 131) identifies four of them: the needs of workers and their families, the capacity of firms to pay, the level of incomes and other wages in the economy, and the requirement of the economic development of the country. These criteria, though, might be contradictory and priorities therefore have to be established.

In some developing countries, it is unlikely that the minimum wage can cover basic needs. It might be useful to define what is meant by the "basic needs" of workers, and by the word "family", when setting mid-term or long-term objectives for a minimum wage policy in terms of basic needs. Once basic needs are defined, the automatic adjustment of the minimum wage to the increase in consumer price index, which seems logical, might not be such a good idea in countries where waged employment is developed, because of inflationary pressure. In such countries, minimum wage agreements now refer to changes in the purchasing power of the minimum wage in relation to the macro-economic situation, rather than just the consumer price index.

As to the second criterion, firms' capacity to pay might be estimated from the average growth in the economy, or in the sector, and from data on labour productivity when available. Other indicators such

as the size of enterprises and/or the structure of production costs in the sector (e.g. whether firms use a lot of capital or not) may be useful.

Defining the minimum wage in terms of other incomes and wages in the economy, which is the third criterion in the ILO Minimum Wage Fixing Convention, might raise another problem of data availability. It draws attention to income inequality in society, and to income generated from alternatives to minimum wage jobs such as subsistence agriculture, informal employment, unemployment benefit, etc.

The final criterion to determine the level of the minimum wage, “the necessity of economic development”, refers amongst other things to the constraint of remaining an attractive destination for foreign investment, which is an important channel of development.

The main dilemma in choosing the level of the minimum wage can be summarized as follows.

On the one hand, a high level of minimum wage is an effective way of protecting low-paid workers from poverty, but it might cover few such workers because of job losses, or non-compliance following the introduction of the high minimum wage. On the other hand, a low minimum wage might cover more workers but offer a weak protection against poverty.

To help us in judging what is a high or a low minimum wage, we might compare it with another wage. Comparing the minimum wage with the average wage has three advantages: the average is readily understandable and easily available, and it represents more or less the wage of skilled labour, while the minimum wage is often aligned on the wages of unskilled labour. There is a wide variation across countries with a very similar level of development. For example, the minimum wage represented more than 70 per cent of the average wage in El Salvador, Italy and Venezuela in the 1990s, while it was close to half the average wage in France, Poland, Sweden, Switzerland and Thailand in the second half of the 1990s. The proportion was relatively stable, at around 40 per cent,

in Botswana in the 1990s. Finally, it is now less than 35 per cent in Brazil, Chile and Spain and above 30 per cent in Bulgaria and Hungary.

These figures are taken at one point in time. The minimum wage, which in theory should preserve the standard of living of the lowest-paid workers, in practice often varies more than economic activity, and more than the average wage.

There is a big problem in comparing the minimum with the average wage: the average is extremely sensitive to very low and very high wage values.<sup>6</sup> It has therefore been suggested that the minimum wage should be compared with the median wage, defined as follows: 50 per cent of workers receive less than the median wage and, of course, 50 per cent receive more. In this case, a relatively low minimum wage would be something like 30 to 40 per cent of the median and a relatively high minimum wage would be more than 70 per cent of the median. Above a certain threshold, which is difficult to estimate because it depends on the structure of skills in the industry, the minimum wage no longer acts as a threshold for unskilled and inexperienced workers, but becomes the maximum wage that even experienced and semi-skilled labour can expect in their professional life. A maximum wage may lower the incentive to acquire skills and deter the employment of new entrants to the labour market, i.e. cause unemployment.

### **The impact of a minimum wage on the economy and on society**

The international evidence of the effect of the minimum wage on employment, industrial peace and poverty can be summarized as follows (Saget, 2001). Many recent studies have concluded that for a relatively low value of the minimum wage, small and regular increases in the minimum wage have no negative effect on the level of (formal) employment. This is because there are several ways an employer and the economy as a whole can react to an increase in labour costs, not all leading to redundan-

cies. A modest increase in the minimum wage can be compensated by a decrease in profits. This represents a redistribution of national income away from profits towards wages. There might also be an increase in the price of goods. In this case, the cost of the minimum wage to the employer is passed on to the consumer.

Another possibility for the employer, especially in the case of more substantial increases in the minimum wage, is to increase productivity, for example by making work more efficient and avoiding waste, by substituting capital for labour and by substituting skilled for unskilled labour.

In the case where increases in the minimum wage lead to the dismissal of some workers, at least some displaced workers may be able to find another job if external or internal demand is growing, or they may not be able to do so and become unemployed. The closure of some firms may follow a more substantial increase in the minimum wage.

This fact highlights, once again, the role of the State in setting a growth-friendly policy and providing the social partners with good forecasts on the state of the economy.

If increases in the minimum wage are offset by increases in labour productivity, demand will probably increase.<sup>7</sup> Finally, an increase in the minimum wage may *increase* the level of employment if the wage paid previously was also below the competitive wage.<sup>8</sup> In some rarer cases, even sizeable increases in the real minimum wage (15 to 20 per cent) did not result in higher unemployment. This depends on the initial value of the wage and the capacity of the economy to absorb any displaced workers.

A growing economy, which creates jobs, is able to absorb the small losses in employment which may possibly be caused by the adjustment of the minimum wage.

There are indications that the growth of the informal economy in the first half of the 1990s in Latin American countries was not mainly due to the level of the minimum wage, but rather was linked to the

decrease in gross domestic product (GDP) per capita (see Saget, 2001; van der Hoeven and Saget, 2002). The informal economy thus seems to result from a macroeconomic problem rather than from the rigidity of the labour market. However, in some countries, growth and informal-sector development coexist, so institutional factors cannot be completely ruled out.

In countries where the minimum wage was low, such as Mexico in the 1990s, virtually no workers in the formal sector received the minimum wage. Yet the minimum wage played an important role in the determination of wages in the informal economy, with a potential benefit for the poor.

A few studies also conclude that, amongst similar countries, those with a higher minimum wage have a lower rate of poverty (Lustig and McLeod, 1997; Saget, 2001). For at least two industrialized countries, there is evidence on the role of the minimum wage in explaining the level of wage inequality. The study by Lee (1999) concludes that most of the growth in inequality between the lower categories and the median of the US wage distribution was attributable to erosion of the real value of the minimum wage during the 1980s. The impact of the minimum wage on inequality was also confirmed by data on the Netherlands (see Teulings, Vogels and van Dielen, 1998).

Besides the traditional concerns about its effect on the level of employment, poverty, productivity and social dialogue, the minimum wage has many other social and economic effects which tend to be ignored. In some developing countries, particularly in Africa, a high proportion of employees in the public sector receive the minimum wage. A low minimum wage (and low wages in general) may, therefore, cause professionals and skilled workers to leave public employment, with negative effects on the quality of work performed and on service delivery.

While keeping the level of total employment constant, the minimum wage can have a different effect on the relative employment of various groups of work-

ers (men/women, youth/older workers). For example, a decrease in the minimum wage may cause a shift away from older workers towards younger workers, as appears to have happened in Mexico in the 1990s. A decline in the minimum wage in this country was also found to have a positive effect on the employment of women. The skill profile of minimum wage workers may also shift away from those with more formal education towards those with little education. Similarly, a differential impact of the minimum wage by sex and age was also found for the United States, together with an adverse effect on the employment of younger workers.

### Best practices

The previous arguments outlined the potentially beneficial role of the minimum wage in the economy and society as a whole, as well as the problems encountered in determining the level and coverage of the system. Certain conditions have to be met if a country is to enjoy the benefits of a minimum wage system while avoiding negative consequences such as unemployment, widening income disparities and inflation.

Social dialogue is a prerequisite. As mentioned, coordination of wage bargaining could be used to reduce inflation arising from expectations of wage inflation. The quality of social dialogue at the enterprise level is also crucial in ensuring that wage increases translate into productivity increases through changes in work organization. At the national level, more objective discussions on the distribution of national income and in particular on the share of wages in national income are needed. It is well-documented that the share of wages has been declining in most developed and developing countries for which data are available. What are the consequences of this trend on people's well-being, social cohesion and long-term economic development?

Changes in work organization which are the main factors responsible for the in-

crease in productivity in France after it legislated for a 35-hour week are a complex and costly process requiring the support of both workers and managers. According to Islam and Nazara (2000), consultations with unions and business organizations in Indonesia helped to ensure that minimum wage increases did not damage employment between 1990 and 1998. The authors compared the level of waged employment in several areas of that country when the ratio of the minimum to the average wage was low and when it was high, and growth was constant. They found no evidence that the increase in the ratio of minimum to average wages damaged waged employment. Finally, the participation of social partners in the setting up of the minimum wage system is a good way of ensuring compliance with wage regulations in developing countries where only limited resources can be spent on labour inspection. The necessity of reaching a compromise between the interests of workers, employers and the State may ensure that the minimum wage is the "right minimum wage".

Small and regular increases in the minimum wage are better than brutal adjustments following years of stability in nominal terms. In some cases though, even sizeable increases in the minimum wage were estimated to have no negative effect on the level of employment.

Linking wage increases, including the minimum wage, to productivity at a time of sustained growth is in principle a good idea. In practice, it raises numerous problems due to the difficulty of measuring labour productivity at the sectoral, national, workplace and individual level (see, for example, United Nations, 1995).

Minimum wages and more generally labour costs are not the main variables that investors compare. At least, they are not what investors should be comparing. Foreign investors should compare many factors before investing in a given country, including political stability, exchange rates and unit labour costs, which are the cost of labour per unit of output, rather than just labour costs. Trends in labour productiv-

ity and the transparency of the minimum wage system seem crucial, particularly at a time of renewed emphasis on sound managerial practices.

ILO Convention No. 131, which can accommodate very different systems of minimum wages, provides a good framework for best practices. Ratifying the Convention implies three obligations: the obligation of consulting the social partners, the four criteria to consider in fixing the minimum wage discussed above, and the binding nature of the minimum wage.

The Convention, although rather old (1970), contains all the elements for making minimum wage policy a successful tool of labour market policy. The Convention makes references to the participation of social partners, the state of the economy, the economic activity of the poor, etc. It also contains implicit references to all the elements that go to make up decent work. Social dialogue has already been mentioned. Social security is another determinant in the fixing of the minimum wage. As the Convention was born before the years of hyperinflation of the 1980s, it is much less explicit as to the potential role of wage bargaining in fighting wage inflation. The Convention was also formulated at a time when there was less stress on human resource development and changes in work organization as a way for employers to adapt to the minimum wage rise.

## Conclusion

The potential benefits of the minimum wage for the economy and society are undeniable, provided some conditions are met. The State has a major and triple-layered role to play in ensuring that bargaining on minimum wages is successful. First, it has to establish and maintain an institutional framework for minimum wage setting and collective bargaining. Second, it has to provide the social partners with good-quality, up-to-date information, so that both parties can decide on their position and bargain on the basis of accurate

information. In many cases, plenty of information is available, but not discussed. Third, the State should decide whether agreements reached by means of collective bargaining should be extended or not to other sectors or groups of workers.

Coming back to the first and second points, there is no magic formula for calculating the value of the minimum wage on the basis of economic and social data. The absence of sophisticated data, while always regrettable, is not the main obstacle to the success of the minimum wage system. Extensive discussions and debate within society on such a complex and potentially conflictual issue can produce a solution.

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## Notes

<sup>1</sup> This is because low-income families tend to consume more and save less, in proportion, than do higher-income families.

<sup>2</sup> Most economists would agree that inequality affects growth of the economy through a combination of inequality of access to credit markets, asset inequality and human capital inequality.

<sup>3</sup> This is a conventional explanation of inflation.

<sup>4</sup> One of the main arguments in favour of an unemployment benefits system is that it gives recipients time to find the appropriate job, which matches their qualifications, instead of taking any job just to survive. It therefore contributes to higher productivity. The minimum wage acts in a similar way: jobseekers know what to expect and do not have to accept just any job. They can afford to look for a suitable job.

<sup>5</sup> This paper ignores the problems that might arise in the determination of the right minimum wage fixing machinery; whether by statute, wages boards or councils, labour courts, etc.

<sup>6</sup> A country where a small proportion of the population receives very high wages shows a high average

wage. The value of this average wage, which is driven by a small group of the population, will mean very little to most workers.

<sup>7</sup> People benefiting from the rise in the minimum wage consume more and, providing they consume domestic goods, employment will increase if there is no constraint on the supply side of the economy.

<sup>8</sup> Imagine a situation where a major employer in a given area deals with workers who are not very mobile: wages will be very low, lower than if the workers could easily move. In this case, introducing the minimum wage will actually increase employment. The agriculture sector in Morocco in the 1980s is often given as an example of such a situation. In Morocco, there is a minimum wage specific to agriculture, which is substantially below the minimum wage payable in other sectors and seems to have been more or less enforced at that time. At a constant market price for wheat and other cereals, an increase in the real minimum wage in agriculture is found to increase wheat production and therefore the demand for labour. The minimum wage thus increases employment and, as the agricultural labourers are amongst the poorest workers, contributes to alleviating poverty.

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