At what level should minimum wages be set?

Patrick Belser & Kristen Sobeck
Conditions of Work and Employment
International Labour office (ILO)
belser@ilo.org

The Importance of Good Policy Design

- The key question is: How best to set and operate a sound minimum wage policy? This question is of extraordinary importance given the large number of workers who are impacted around the world, and also because of the risks of mismanagement.

- While carefully designed minimum wage policies can promote social justice with little or no harm to the economy, past experience also shows that mismanagement can have considerable adverse economic and social consequences.

The Process of Minimum Wage Fixing

Perhaps the most important question is the level of minimum wages. A balanced approach is necessary because a minimum wage is a redistributive tool which has both benefits and costs (Freeman, 1996).

- If set high enough, minimum wages can increase the earnings of low-paid workers, reduce the number of “working poor”, reduce the gender pay gap in the lower part of the distribution, and reduce overall wage inequality (or limit its increase).

- If set too high, minimum wages can be counterproductive, setting off price inflation, hurt employment, and turn out to be unenforceable by small- and medium-sized enterprises.

At what level should minimum wages be set?

A balanced approach is reflected in ILO Convention No. 131 which calls on policy makers to take account of:

- a) the needs of workers and their families, taking into account the general level of wages in the country, the cost of living, social security benefits, and the relative living standards of other social groups; and
- b) economic factors, including requirements of economic development, levels of productivity, and the desirability of attaining and maintaining a high level of employment.

The Process of Minimum Wage Fixing

A sound approach implies that the determination of the minimum wage level should be based on statistical indicators:

- The objective of statistical indicators is not to substitute for social dialogue or bargaining. Minimum wage fixing is a sensitive issue which should be decided by Governments together with social partners. Rather, statistical indicators inform Governments and social partners about the range of values for which the benefits of a minimum wage are likely to exceed the costs.

- Statistical indicators should be used as a starting point or a reference point for these consultations. Ultimately, it is up to the national stakeholders to agree on one or more figures, depending on the weight that they attribute to different social and economic objectives.

At what level should minimum wages be set?

Some simple statistical indicators can be used:

- The needs of workers and their families can be assessed or calculated through the concept of a minimum living wage.
- Economic effects depend on the proportion of wage-earners affected by a certain minimum wage, and can be evaluated through indicators such as ratio of minimum wages / to median wages

There is no mathematical formula or ideal minimum wage level !

Minimum living wages

- According to the ILO, the “concept of a minimum wage level that cannot be abated implies the concept of a minimum living wage” (1992 ILO General Survey p.10). Also, the Preamble of the ILO Constitution called for “the provision of an adequate living wage”. The 2008 *ILO Declaration on Social Justice for a Fair Globalization* called for “a minimum living wage to all employed and in need of such protection”.

- While it is generally accepted that a minimum living wage should provide workers and families with a decent standard of living, the difficulty lies with the definition and measurement. Views diverge on the quantities of specified goods and services that are necessary to achieve this objective.

- One lower benchmark for living standards is provided by poverty lines. But national stakeholders may define higher minimum living wages in their national circumstances, to cover access to education and health service.

Minimum living wages

- One possible formula is (Anker, 2006):

$$Minimum\ living\ wage\ = \frac{(poverty\ line * household\ size)}{number\ of\ workers\ in\ the\ household}$$

Example:

National poverty line = 300 US$/month

Average household size = 2 adults + 2.5 children = 2.9 adult equivalents

Full-time equivalent workers = 1.5 workers

⇒ **Minimum living wage = (300 * 2.9)/1.5 = 580 US$ / month**

Note: Average household size is calculated using the standard “OECD scale” to take account of economies of scale and lower needs for children: the first adult counts as one adult, the second adult counts as 0.7 adults and children are given a weight of 0.5. An average household size of about 2 adults and 2.5 children corresponds to 2.9 “adult equivalents”, i.e. 1 + 0.7adults + 2.5*0.5children),

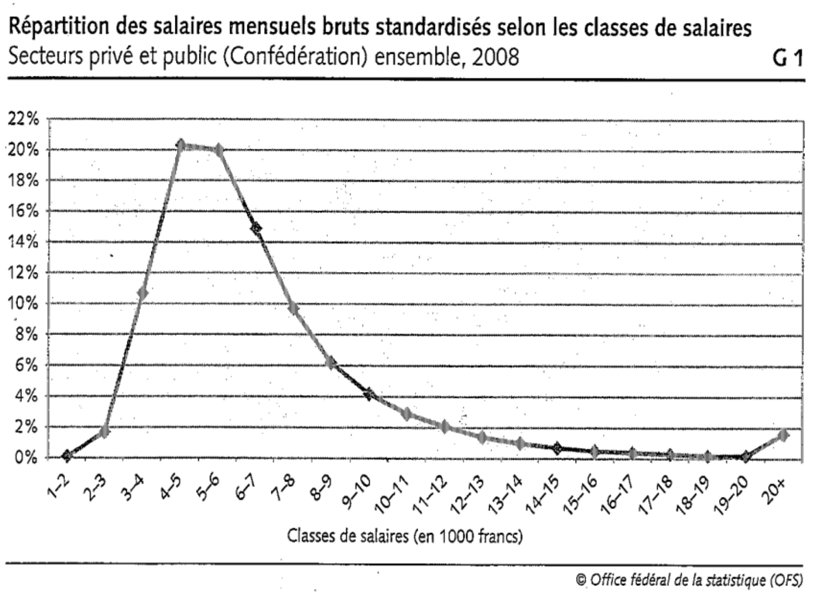
Minimum living wages

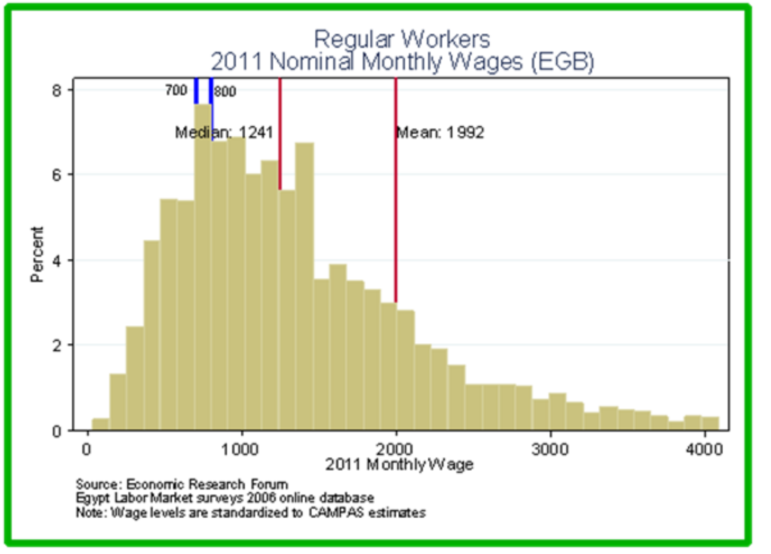
- Which poverty line? The lowest international poverty lines are set at $1.25 per day and $2.00 per day in PPP (purchasing power parity). But because different countries may have different perceptions of who is poor, it is more useful to base policy decisions on national than on international poverty lines.

- Regional differences in price levels can have a large effect on the costs of basic needs. Such regional differences will show up in regional poverty lines. For countries which have regional minimum wages, regional rather than national minimum living wages should be calculated.

Economic Factors

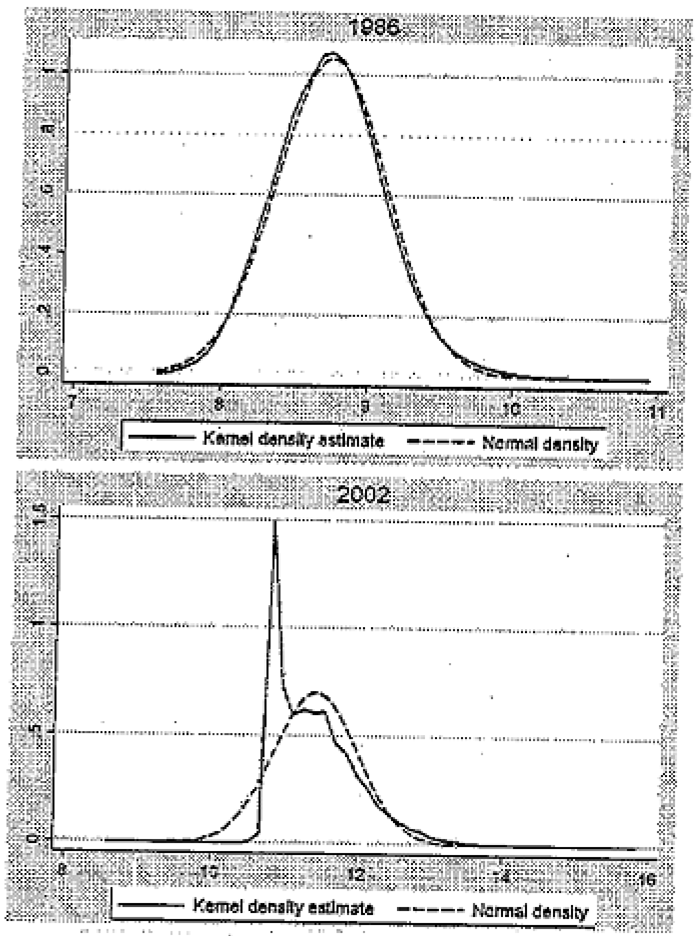
The need for statistics to understand the characteristics of the national distribution of wages (for men and women)





Switzerland (2008) **Egypt (2006)**

The effects of minimum wages on the distribution of wages



Before the minimum wage

After the minimum wage
(with perfect compliance)

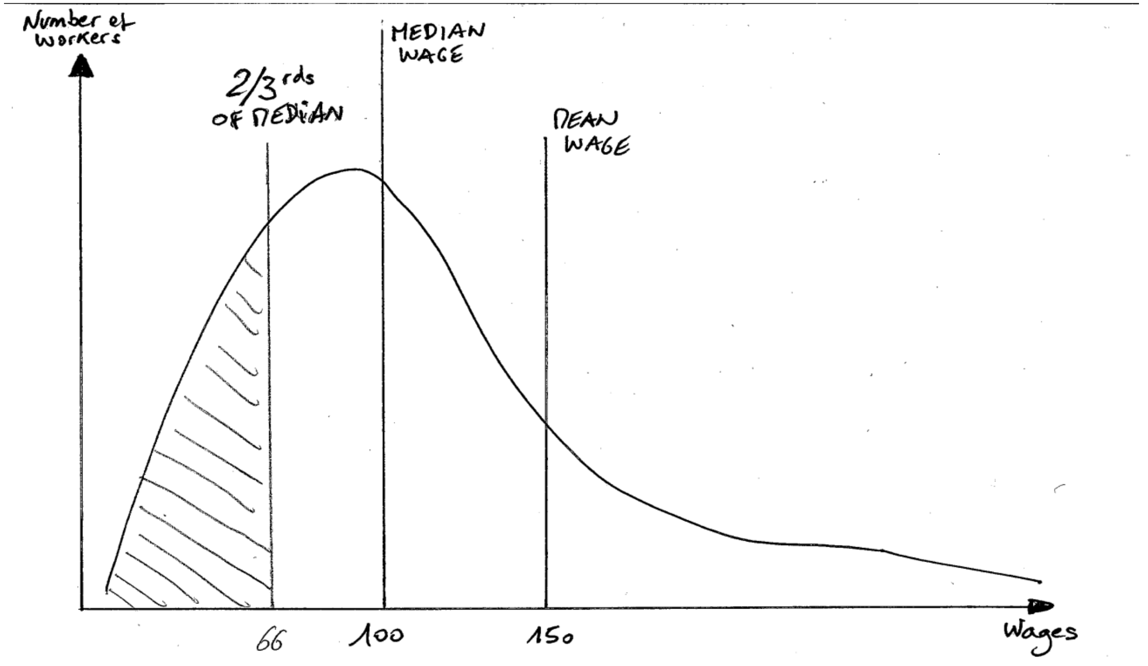
The economic effects depend on the share of wage-earners affected

Table 4: Proportion of regular employees earning less than various thresholds

Monthly earnings thresholds (Egyptian £ per month)	Proportion of regular employees paid less than threshold	Increase in average wages of regular employees if minimum wage set at threshold
600	15%	
650	16%	1.6%
700	19%	2.1%
750	23%	2.6%
800	25%	3.2%
850	28%	3.9%
900	31%	4.6%
950	34%	
1000	37%	
1050	39%	
1100	42%	
1150	45%	
1200	48%	

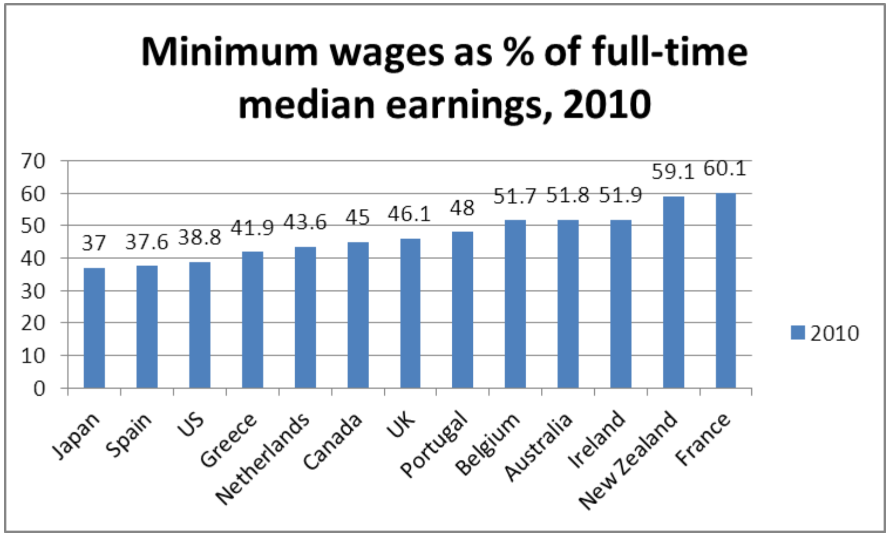
Source: ILO calculations based on Economic Research Forum, Egypt Labor Market surveys 2006 online database and CAPMAS Weekly Average Wage Data.

A similar (even more simple) indicator: Minimum wage / Median wage



A similar (even more simple) indicator: Minimum wage / Median wage

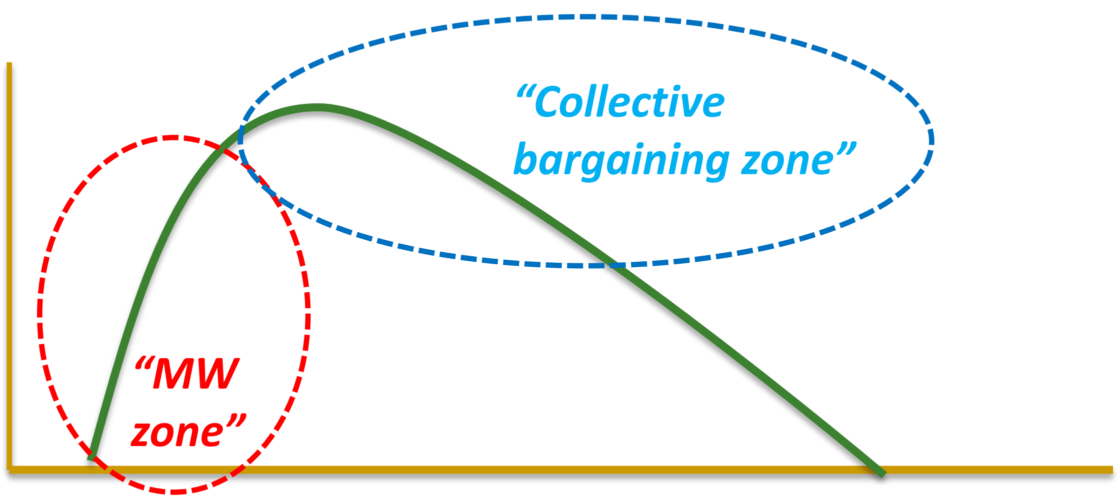
Figure 6: The Level of Minimum Wages in Developed Economies and European Union in 2010 (% of Full-time median wages)



Source: UK Low Pay Commission, 2012

In summary:

Minimum wages should be higher than the minimum living wage, but remain targeted at the lowest-paid employees



Annual Adjustment

- Maintain Minimum to Median wage ratio?

$$\textit{New MW} = \textit{old MW} + \Delta\ \textit{Median Wage}$$

- Compensate for higher cost of living + growth?

$$\text{New MW} = \text{old MW} + \alpha(\text{CPI}) + \beta\ (\text{GDP growth})$$

An example from the UK

The Rate adopted in 1999:

47 % of median wage

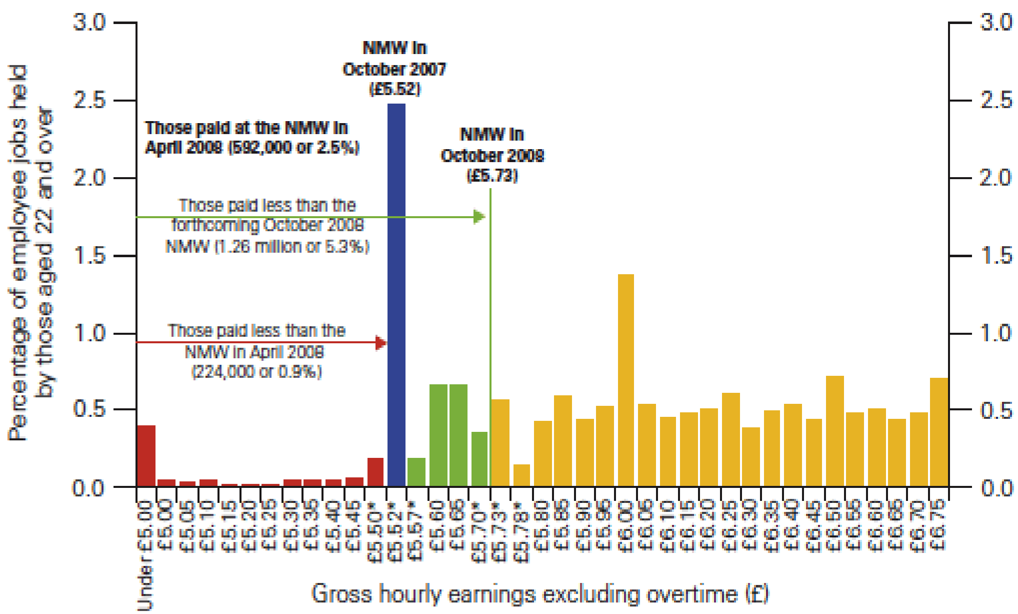
Affects lowest 13%

Benchmark	hourly earnings (1997)	% of workers below
	2.5	3
	2.6	4
	2.7	4
	2.8	4
	2.9	5
	3.0	5
	3.1	7
	3.2	8
	3.3	9
	3.4	10
	3.5	11
Actual rate proposed	3.6	13
	3.7	14
50% of median	3.8	15
	3.9	17
	4.0	18
	4.1	22
	4.2	26

Effects after 10 years (LPC 2009)

“Minimum wages exert a significant influence on wages at the bottom of the earnings distribution” (LPC report 2009)

Hourly Earnings Distribution for Employees Aged 22 and Over, UK, 2008

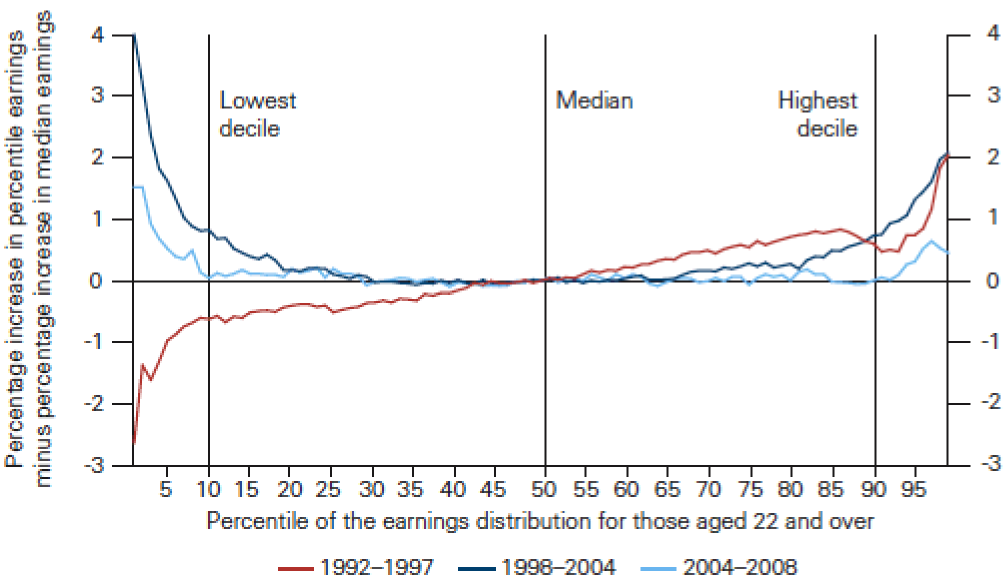


Source: LPC estimates based on ASHE 2007 methodology, low-pay weights, UK, April 2008.
Note: * Five pence bands except where stated otherwise (bands labelled by minimum pay amount).

Effects after 10 years (LPC 2009)

What impact on wage inequality?

Annual Increase in Hourly Earnings Minus the Increase in Median Earnings, by Percentile for Employees Aged 22 and Over, UK, 1992–2008ab



Effects after 10 years (LPC 2009)

What impact on labour costs?

- “The initial introduction of the minimum wage had the largest impact on the whole economy wage bill, an increase of 0.22 per cent, as the pay in a number of very low-paid jobs was raised to at least match the new minimum”.

- “The small upratings in 2000 and 2002 generally had a muted effect on the overall wage bill, while the larger upratings increased the wage bill by about 0.1 per cent a year, approximately half the impact of the initial introduction”.

Effects after 10 years (LPC 2009)

What impact on employment?

- “Firms appear to have adapted to these increases in wage costs by changing pay structures, removing wage premia, and reducing non-wage costs. The research found little evidence to suggest that the increases in the minimum wage had led to reductions in employment or hours worked”.

- “In all, we conclude that the minimum wage continues to exert a benign influence on the economy”

Importance of monitoring:

The experience of the U.K. also shows the case of an evidence-based minimum wage system. In such a system, monitoring is key, because depending on circumstances the minimum wage can be accompanied by:

- Non-compliance
- Ripple effects (wage increases above the minimum)
- Other problems …