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INTRODUCING A STATUTORY MINIMUM WAGE IN MIDDLE AND LOW INCOME COUNTRIES

Context, capacity and institutional design are key determinants for successful implementation of a statutory minimum wage in the developing world

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ELEVATOR PITCH

The motivation for introducing statutory minimum wages in many developing countries is often threefold: poverty-reduction, social justice and growth. How well the policy succeeds in attaining these goals will depend on the national context and the numerous choices made when designing the policy. Institutional capacity in developing countries tends to be limited, so institutional arrangements must be adapted. Nevertheless, a statutory minimum wage appears to have the potential to help low- and middle-income countries advance toward the aforementioned development objectives, even in the face of weak enforcement capacity and pervasive informality.

Advantages (pro)

- + There is often public demand for a statutory minimum wage, providing political cover for its implementation
- + Given the prevalence of market frictions and monopsony power, the conditions under which minimum wages can increase employment often hold in LICs and MICs
- + Minimum wages can protect workers with low bargaining power from exploitation
- + Minimum wages can increase household income when employment shifts to the informal sector are not large
- + Institutional mechanisms can be developed and adapted to the developing

Disadvantages (contra)

- Other tools for poverty reduction can be more effective than minimum wages
- Minimum wages can cost formal sector jobs and increase the size of the informal sector
- Political economy and analytical capacity concerns must be addressed in designing governance institutions
- Developing countries may be tempted to set initial minimum wages too high (at total employment-reducing levels) relative to the productive structures of their economies
- Enforcement, coverage and complexity are major problems for institutional design in LICs and MICs

AUTHOR'S CONCLUSION

When the conditions are right, developing countries could consider introducing minimum wages as a tool, among others, for reducing poverty and worker exploitation and potentially enhancing total (formal plus informal) employment and growth. The institutional mechanisms adopted to implement the minimum wage, however, play a determining role in how effective they will be, and attention must be paid to political economy issues to ensure that the policy is implemented as effectively as possible.

MOTIVATION

Over 20 percent of the world's countries do not have a statutory minimum wage ([http://doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Miscellaneous/](http://doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Miscellaneous/EWI-DB2013-data.xlsx)

Short definition of a statutory minimum wage:

The lowest wage permitted by law.

(http://www.ilo.org/dyn/natlex/natlex_browse.search?p_lang=en). Many countries in the developing world have recently introduced, or are considering the introduction of a statutory minimum wage, primarily as a tool for poverty reduction and “social justice”. Nevertheless, the diversity of systems that are seen in the world, and the varying effectiveness of the policy where it has been implemented, indicate a lack of understanding of its appropriateness, optimal

DISCUSSION OF KEY FINDINGS

Motivation for introducing a minimum wage

From the perspective of an economist (Freeman, 1996), “The minimum wage has, in principle, four attributes which make it an attractive redistributive tool:

- it has no immediate budgetary consequences,
- it increases the incentive to work,
- it is administratively simple and easy to enforce, and
- it establishes the ‘right’ social costs of labour in the markets since low-wage firms and consumers of their products bear the full cost of that labour rather than the whole society through taxes and subsidies”

Furthermore, economic theory suggests that the presence of frictions in labor markets can generate monopsony power for employers in labor markets, and minimum wages can be a means of increasing income and employment in such situations. The sort of frictions that can

design or effects. Moreover, the weak institutional capacity and pervasive informality typical of LICs and MICs reduce the usefulness of the (many) analyses undertaken in developed countries, implying the need to better understand how to design and implement a minimum wage system in a developing country so as to maximize its benefits.

This article summarizes what is known about the introduction of a statutory (i.e. established by law) minimum wage in developing countries. It highlights the importance of accounting for important differences between developed and developing countries when designing minimum wage institutions, and provides suggestions on how to favor the employment- and revenue-enhancing effects of minimum wage introduction.

An example of the motivation for minimum wages

“It is hereby declared the policy of the State to rationalize the fixing of minimum wages and to promote productivity-improvement and gain-sharing measures to ensure a decent standard of living for the workers and their families; to guarantee the rights of labor to its just share in the fruits of production; to enhance employment generation in the countryside through industry dispersal; and to allow business and industry reasonable returns on investment, expansion and growth.”

“Wage Rationalization Act” of 1988 (sec. 2) of the Philippines.

generate such monopsony power (Manning,

2003) seem particularly prevalent in developing countries.

Countries that decide to implement a minimum wage, on the other hand, do not explicitly evoke these justifications. Rather, in cases where the motivation for the law is written into its preamble (http://www.ilo.org/dyn/natlex/natlex_browse.home), the main reasons often relate to poverty reduction (through increased income), social justice (through a fairer distribution of wealth) or economic growth (by putting more money into the hands of those who will spend it). Although there has been very little empirical work explicitly examining the effectiveness of the introduction of a minimum wage with respect to attaining these goals (see Bhorat et. al., 2013, for the case of South Africa), there is some evidence that the sorts of labor market frictions that can make minimum wages an effective tool for poverty reduction, social justice and/or economic growth are particularly prevalent in developing countries (Azam, 1992 for Morocco; Devereux, 2005 for Namibia and Uganda). Nevertheless, this lack of evidence has not deterred countries from proceeding, as both Hong Kong and Malaysia have recently adopted statutory minimum wages.

Institutional considerations

The decision to introduce a minimum wage requires weighing the situation without a minimum wage against specific alternatives. Each alternative involves choices concerning institutional structure, such as the overall governance structure, the degree of coverage and the complexity of the system (one or many minimum wages), and how the level is set and adjusted.

Governance

Countries enact a minimum wage in a specific political context, yet must choose a governance structure that satisfies several criteria. The appropriate structure will be dependent on the context, and Boeri (2009) finds significant

variability in minimum wage setting institutions adopted around the world.

Legitimacy. The perceived legitimacy of the system will be partly determined by perceptions of its independence relative to political influences. Systems in which the minimum wage is established by the government absent consultation with the main stakeholders (employers and workers) are likely to be devalued in the eyes of the general public and subject to additional public scrutiny and media attention, in particular when unions are seen to represent the interests of workers as a whole. This perceived lack of legitimacy can provide a convenient excuse for stakeholders to reject the minimum wage when they wish to do so. Thus, in order to improve the likelihood of “buy in” from all social partners, it is important for governments to consider imposing constraints on their own ability to arbitrarily set minimum wages, especially in countries where governments attempt to maintain order in public discourse in other domains (Omeira et. al., 2008).

Competence. The institution responsible for setting the minimum wage must have the ability to digest the information that is presented to it and arrive at a decision regarding the level, and later the adjustment, of the minimum wage. Although such expertise is typically available within academia or by consulting “independent” experts, legitimacy considerations can lead to the inclusion of employer and employee representatives, as well as other representatives of civil society. Not all of these members are equally competent in understanding the available data; worker representatives, in particular, have been noted to be “outmatched” by their employer counterparts, whose resources for undertaking their own analysis are typically much greater.

Efficiency. The choice of the governance structure also has an impact on the efficiency of minimum wage fixing and adjustment. Depending on the governance structure adopted, the mechanism for setting the

minimum wage will either be delegated to a committee or remain within the government. When minimum wage setting rests with the government, it often takes place by ministerial decree, although some countries (such as the United States) require legislative action to adopt or change a minimum wage. The different wage setting mechanisms imply different lead times needed between minimum wage setting rounds. Structures that require parliamentary action typically take longer to revise minimum wages (once the appropriate level is determined) than those that allow wage setting directly by the minimum wage commission or by ministerial decree.

Coverage and complexity

According to the ILO's Database of Conditions of Work and Employment Laws, many countries have a minimum wage system that is initially intended to cover 100 percent of the workforce (<http://www.ilo.org/dyn/travail/travmain.home>). In other cases, particular categories of workers, such as youth, domestic workers, agricultural workers or the handicapped are excluded from coverage. Saget (2008) suggests that a lack of statutory coverage of certain categories of (mostly low-paid) workers can be intentional, as in the cases of Indonesia, Paraguay, the Philippines and Thailand.

Beyond categorical statutory coverage exclusions, governments rarely bind themselves with the same constraints as they do the private sector, meaning that the statutory minimum wage does not serve as the legal wage floor for the public sector (Kristensen and Cunningham, 2006; Saget, 2008; <http://www.ilo.org/dyn/travail/travmain.home>). Moreover, self-employment is an important source of jobs in the developing world (Gindling and Newhouse, 2012) that escapes coverage of the minimum wage, while many employers in developing countries are not registered with the state, and of those who are registered, many workers are not declared (Perry et. al., 2007). The intensity of

enforcement efforts determine the share of these workers that are covered by the minimum wage, although research has shown that a minimum wage can have effects that extend beyond the workers who are statutorily covered and declared by their employers (Gindling and Terrell, 2005; Kristensen and Cunningham, 2006; Dinkelmann and Ranchhod, 2011).

In addition to deciding which workers should be covered by a minimum wage, governments must also decide whether to adopt a single minimum wage for all workers or to propose different minimum wages for different classes of workers. Variation most frequently occurs by age, profession, sector of activity and geographic region (Saget, 2008; <http://www.ilo.org/dyn/travail/travmain.home>). According to the ILO, 61 percent of countries have opted for a single minimum wage for the whole country, 21 percent of countries have sectoral and/or occupational minimum wages that are set by the government or by a tripartite body, while 8 percent of countries with minimum wages do not have an explicitly statutory procedure, but rather set sectoral and/or occupational minimum wages through collective bargaining. A combination of two or three of these systems is used in 11 percent of countries.

Although some variation in minimum wages can be justified on the basis of differences in productivity, there are risks in adopting a minimum wage system that is overly complex. First, complex systems require accounting for more variables at increasingly fine levels of detail, and the statistical systems in developing countries are rarely capable of producing the necessary data with the level of detail, frequency and credibility needed to make such an undertaking feasible. Second, complicated systems make enforcement and management of the minimum wage increasingly difficult. Third, variations in minimum wages across regions or sectors can have unintended spillover effects into other sectors, as when a

lower minimum wage in one sector (intended to help low-productivity employers) leads workers to look for employment in other, higher paying sectors and forces the low-minimum wage employers to pay above-minimum wages simply to attract labor (Wicks-Lim, 2006). Accordingly, several countries that initially opted for complex systems of minimum wages have found a need to reduce the number of different minimum wages and simplify their complex systems (Gindling and Terrell, 2007; Edwards and Edwards, 2000).

Level and adjustment

Setting the initial level of the minimum wage and proceeding with subsequent adjustments requires the collection and analysis of data, at the micro level on both sides of the labor market (employers and workers) and at the macro level (growth rates, unemployment rates, inflation rates). Developing countries capacity to collect this data varies widely.

Mechanisms for setting and adjustment.

The choice of the initial level of the minimum wage is crucial, as it not only sets the starting point for future adjustments, but can also serve as the reference point for other tax-and-transfer system parameters, such as social assistance benefits or payroll taxes (Saget, 2008). Although observed average minimum wage levels vary significantly around the world, developing countries are more likely to adopt “high” minimum wages (measured relative to average wages or value added per worker) than developed countries (<http://doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Miscellaneous/EWI-DB2013-data.xlsx>). Some authors have suggested that this can be due to settings where collective bargaining institutions are weak and in which unions use minimum wages to advance their interests (Saget, 2008; Omeira et. al., 2008).

Variables for adjustment. The factors that should be considered when determining the

level, and the subsequent adjustments, of the minimum wage need not be specified in the legal texts that introduce the minimum wage, although some countries have opted to do so. The need for explicit lists of variables to assess when fixing the minimum wage, even though these lists do not exclude consideration of unlisted variables, is dependent on the capacity of the parties involved to know what information they need in order to make informed decisions. When that capacity is low, providing a list of variables to consider can be a means of improving the likelihood of the policy reaching its goals. Some texts enacting minimum wages specify precisely defined variables, such as the consumer price index, national and/or individual income, labor productivity, wage levels, income distribution statistics, unemployment rates and economic growth rates. Others provide more general guidance by specifying types of variables, such as “The state of the country’s economic development” (Taiwan); “General economic conditions, including the latest economic performance and forecasts”, “Labor market conditions, including labor demand and supply, wage levels and distribution, wage differentials, and employment characteristics”, and “Competitiveness, including productivity growth, labor costs, the operating characteristics of enterprises, entrepreneurship, business environment, business solvency, and economic freedom and competitiveness” (Hong Kong).

Frequency of adjustment. There are clear advantages to specifying the frequency of reevaluation of the minimum wage (even if the level is left unchanged) when introducing one. Although many countries allow government discretion, unions will typically push for more frequent revisions when no specific guidelines have been pre-established, as in the Philippines and Hong Kong, which can potentially lead to social unrest. On the other hand, regularity in the schedule of potential revisions allows employers to plan ahead and time other investments accordingly. It is thus important to

specify precise deadlines, with a default adjustment (possibly zero) serving as a credible threat to those who fix the level.

The frequency of reconsideration of the minimum wage will depend on several factors, although annual or biannual reassessments seem to be the most common. In determining the frequency, it is important to allow time for the preparation of technical analyses, including subcontracting research and reports as needed. It is also necessary to allow time to solicit input from concerned parties. Nevertheless, as the example of Chile in 1998-2000 shows (Infante et. al., 2003), the proposed schedule for reconsidering the minimum wage should not be so rigid as to prevent adjustments in response to major crises.

Issues of capacity

Capacity of social partners to be effective participants in minimum wage determination

In countries that adopt an institutional structure that relies on input from social partners (employers, workers and the government), differences in capacity can lead to outcomes that are perceived as unfair or can hinder employment and economic growth. Each social partner faces specific hurdles.

The Government. When introducing a statutory (as opposed to a collectively bargained) minimum wage, the government incurs the responsibility for coordinating the minimum wage setting process. This requires the government to be able to produce credible, relevant data, in a timely manner, to inform discussions on level-setting and adjustment. It also requires the government to be able to coordinate meetings, convene stakeholders to provide testimony as needed, and to act upon wage setting decisions through appropriate legislative or executive channels. This capacity is typically limited in many low and middle income country governments, as evidenced by the lack of regularly-produced labor market

data (Margolis et. al., 2010) and/or dysfunctional administrative systems.

Workers. Worker representatives, usually in the form of labor unions, tend to have relatively weak analytical capacity in developing countries. As their priorities are more often geared toward organizing activity and outward manifestations of strength (strikes), they tend to invest little in developing independent analyses of the labor market. As such, they are less likely to be able to partake credibly in negotiations over minimum wage levels than employers, since the arguments that they present are less likely to be founded in data and analysis. Accordingly, they may find their positions in the minority and perceive of the process as biased against them.

Employers. When a minimum wage is introduced with a social justice motivation, it is because employers are perceived as exploiting less powerful workers. Moreover, the arguments employers typically make about minimum wages destroying jobs notwithstanding, employers often find it difficult to amass public support in developing country environments where workers are predisposed to see employers as exploitative and where prevalent poverty is taken as proof of such exploitation. Moreover, the reporting requirements of a minimum wage imply additional costs to employers who respect the law, as wages paid must be recorded (this does not happen in many establishments in the developing world) and, in some cases, informal workers must be formalized, potentially exposing employers to payroll tax assessment. Employers may lack the capacity, be it financial or managerial, to implement the minimum wage as prescribed.

Informational hurdles

Part of the difficulty of implementing a minimum wage in developing countries is informational. To be effective, a covered individual needs to know four things:

- Is he/she is covered by the minimum wage?
- What the relevant minimum wage?
- How much of what he/she receives is covered by the minimum wage (e.g. are housing or transportation allowances included? What is the value of in-kind benefits received and are they covered?)
- How can he/she ensure that the employer pays the right amount?

Capacity of the administration to collect the data necessary for minimum wage setting and adjustment

The level and adjustment of the minimum wage being determined by available data, it is important that the administration has the capacity to collect this data. Unfortunately, many countries in the developing world lack regular household surveys (Margolis et. al. 2010), suggesting an increased risk that minimum wage levels might be set without reference to relevant economic variables, and thus inappropriately for a given labor market.

Capacity of the administration to enforce the minimum wage

Enforcement of a minimum wage requires the government to establish mechanisms for identifying violations (inspection, whistleblowing) and for sanctioning violations (penalty imposition). Unfortunately, many developing countries lack the capacity to ensure these mechanisms function successfully (Kristensen and Cunningham, 2006; Basu et. al., 2011; <http://www.ilo.org/dyn/travail/travmain.home>).

Part of the problem with identifying violations is simply due to not enough inspectors being present. Almeida and Carneiro (2011) show that employer behavior is indeed sensitive to credible enforcement, but ensuring the inspection part of the enforcement agenda is sufficiently resourced requires more than the limited number of labor inspectors that are typically employed.

Even with adequate inspection, poorly functioning legal systems can render ineffective the sanctions built into the minimum wage system. As Kaplan et. al. (2007) and Kaplan and Sadka (2011) point out in the case of Mexico, labor courts can be particularly ineffective at awarding damages in the case of labor law violations, and even when damages are awarded, the judgments are actually enforced less than half of the time.

The relatively high prevalence of corruption in developing countries is another factor that can reduce the likelihood of effective enforcement. According to the World Bank's enterprise surveys in developing countries, 24.8 percent of surveyed employers consider it necessary to give gifts "to get things done", with the figure being as high as 50 percent in the Middle East and North Africa.

Possible effects to be expected

Most of the work examining the ability of a minimum wage to attain its objectives has focused on poverty reduction and employment. Almost none of the work has considered the introduction of a minimum wage explicitly (the policies examined have all been in place for years before the analysis is undertaken), so little is known about the adaptation to a new minimum wage from a pre-existing situation without one. Nevertheless, the specificities of developing countries suggest several important dimensions to consider.

First, developing countries typically have a large share of employment in the informal sector, and these informal firms tend to be less productive than formal sector firms (Bloom et. al., 2010). Introduction of a minimum wage is likely to impose labor costs that exceed labor productivity in many of these firms, thereby reducing the likelihood of compliance. Countries that introduce a minimum wage without allowing a period of time for firms to adjust production techniques should expect a lower level of compliance than is seen in the developed world. Providing for assistance to

these low-productivity employers has the potential to not only improve productivity and growth, but to also increase compliance and effective coverage of the policy.

Second, even with large gaps in coverage due to informality, minimum wages may still increase wages of those working (Dinkelman and Rachhod, 2011; Gindling, T.H. and Terrell, 2005; Kristensen and Cunningham, 2006; Maloney et. al., 2001; Khamis, 2009). Part of this effect occurs directly through the increasing of wages of low-paid workers, part is due to spillovers higher up the wage distribution, and part is due to what has been called a “lighthouse effect” in the literature, whereby wage increases in the formal sector lead wages in the informal sector to rise too.

Third, there is little consensus on the expected impact on employment. Formal sector employment may fall or be unaffected, but some of these workers may shift into the informal sector and still find work, while other individuals may decide to start working as a result of increased compensation. As such, net employment can also increase or remain unaffected (Comola and de Mello, 2011; Gindling and Terrell, 2007; Lemos, 2009; Montenegro and Pages, 2003).

LIMITATIONS AND GAPS

As noted previously, there are many important gaps in our knowledge about the best way to introduce a minimum wage and its potential effects. The most important limit to our knowledge is that despite much research on minimum wage adjustments in the developed world, there has been less in developing world, and very little specifically on the question of introducing a minimum wage when there was not previously one present. Given the importance of institutions to success of the policy, extrapolation can be risky.

Insofar as concerns knowledge about the likelihood of a minimum wage attaining its

In sum, introduction of a minimum wage will generate both winners and losers. Low-paid individuals, such as youth and the unskilled, who retain their jobs at higher levels of pay, people (especially women) who weren't previously working because it was not attractive to do so but subsequently join the labor market and earn income for their families, and firms that invest in productivity-enhancing technologies can potentially benefit. Moreover, a known and stable wage floor can help attract foreign investment, as multinationals seek information and stability before deciding upon investments. On the other hand, some individuals will lose (typically better paid) formal sector jobs and shift to the informal sector, others will lose employment entirely, and some firms may be driven out of business if they cannot improve their labor productivity sufficiently and are unable to escape to the informal sector. Although it can be difficult to identify the losers beforehand, compensation mechanisms for these people, in particular transfer systems, may find themselves increasingly solicited and impose unanticipated budgetary costs on the government.

objectives of poverty reduction, social justice and growth, the vast majority of evidence comes from the developed world. Among developing countries, most of the evidence comes from Latin America. In particular, there is very little evidence on the performance of a minimum wage policy drawn from low income countries.

Another limitation is that, despite several theoretical contributions, very little empirical work has been done on optimal institutional design. The econometric hurdles to undertaking credible empirical analysis of institutional performance are numerous, not the

least of which being that minimum wage policies tend to be implemented with a single institutional structure in any given country context, making it very difficult to attribute variations in minimum wage performance to the institutional structure itself, as opposed to other characteristics that differentiate countries from other comparators with different institutional structures.

Lastly, despite any recommendations regarding optimal institutional structures, governance, complexity or enforcement, the minimum wage is one of the most politically sensitive economic policies that has been observed (Green and Harrison, 2009). As such, important decisions can be made to satisfy

SUMMARY AND POLICY ADVICE

Countries typically introduce minimum wages for any of three main reasons: poverty reduction, social justice and growth. The likelihood of a minimum wage policy attaining these objectives depends both on key design choices made regarding the institution itself and the country context in which it is implemented, not the least of which being the political environment and the capacity of the various social partners to effectively manage the system.

Developing countries face specific challenges (informality, political instability, capacity constraints on enforcement, statistical production and analysis) while simultaneously facing a stronger need for a tool to address poverty, social injustice and growth than most developed countries.

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political economy imperatives rather than to maximize the chances of the policy achieving its stated goals. Furthermore, the decision to implement a minimum wage can only be undertaken when the political environment is ripe, but the same factors that induce a change in the political environment conducive to implementation of a minimum wage are also likely to have effects elsewhere in the economy, further clouding the ability to empirically identify the effects of minimum wage implementation.

Although minimum wages are not the most appropriate tool for fighting poverty (transfers can do a better job with fewer side effects), the development imperatives middle and low income countries face can justify introducing the policy. However, careful attention needs to be paid to the design of the institutional arrangements and adapting them to each country's context. Nevertheless, and even in the face of political uncertainty that can drive the implement policy structure away from the optimal one, a minimum wage still has the potential to move a country at least partly toward its development goals, even in the face of weak enforcement capacity and pervasive informality.

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