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I Z A
World of Labor
Evidence-based policy making

Introducing a statutory minimum wage in middle and low income countries

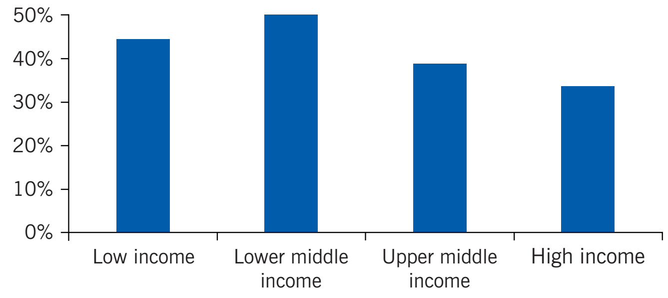
Successful implementation of a statutory minimum wage depends on context, capacity, and institutional design

Keywords: minimum wages, institutional design, developing countries, informality, enforcement

ELEVATOR PITCH

Motivations for introducing a statutory minimum wage in developing countries include reducing poverty, advancing social justice, and accelerating growth. Attaining these goals depends on the national context and policy choices. Institutional capacity tends to be limited, so institutional arrangements must be adapted. Nevertheless, a statutory minimum wage could help developing countries advance their development objectives, even where enforcement capacity is weak and informality is pervasive.

Share of countries without a statutory minimum wage



Source: [1], [2]

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KEY FINDINGS

Pros

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

Cons

- Other tools for poverty reduction can be more effective than a minimum wage.
- 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 levels that reduce total employment) relative to the productive structures of their economy.
- Enforcement, coverage, and complexity are major problems for institutional design in developing countries.

AUTHOR'S MAIN MESSAGE

When the conditions are right, developing countries could consider introducing a minimum wage as one tool for reducing poverty and worker exploitation and for potentially enhancing total (formal plus informal) employment and growth. The institutional mechanisms set up to implement the minimum wage, however, influence how effective it will be in attaining its objectives. Political economy issues require attention to ensure that the policy is implemented as effectively as possible.

MOTIVATION

More than 20% of countries do not have a statutory minimum wage [1], and this number rises to more than 40% for developing countries [2]. Many developing countries have introduced, or are considering, a statutory minimum wage, primarily as a tool for poverty reduction and social justice. The diversity of systems introduced globally, and their varying degrees of effectiveness, indicate a lack of understanding of its appropriate context, optimal design, and effects. Moreover, the weak institutional capacity and pervasive informality typical of low- and middle-income countries 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 to maximize its benefits.

This summary of what is known about introducing a statutory minimum wage in developing countries highlights the importance of accounting for major differences between developed and developing countries when designing minimum wage institutions and suggests ways to favor the employment- and revenue-enhancing effects of a minimum wage.

Statutory minimum wage

A statutory minimum wage is the lowest wage permitted by law.

DISCUSSION OF PROS AND CONS

Motivation for introducing a minimum wage

From an economics perspective, the minimum wage has four attributes that make it an attractive redistributive tool [3]:

- it has no immediate budgetary consequences;
- it increases the incentive to work;
- it is administratively simple and not too difficult to enforce; and
- it establishes the right social costs of labor in the market since low-wage firms and consumers of their products bear the full cost of that labor rather than all of society through taxes and subsidies.

Furthermore, economic theory suggests that frictions in labor markets can generate monopsony power for employers, and minimum wages can be a means of increasing income and employment. The sorts of frictions that can generate such monopsony power seem particularly prevalent in developing countries.

Countries that decide to implement a statutory minimum wage do not explicitly evoke these justifications. Rather, where the motivation for the law is written into its preamble, the main reasons often relate to poverty reduction (through increased income), social justice (through a fairer distribution of wealth), and economic growth (by putting more money into the hands of those who will spend it [2]). Although there has been little empirical work explicitly examining the effectiveness of the introduction of a minimum wage in attaining these goals (see [4] 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 economic growth are particularly prevalent in developing countries. Still, the lack of evidence on effectiveness has not deterred countries from proceeding. For example, Hong Kong and Malaysia both recently adopted statutory minimum wages in 2011 and 2012 respectively (see **An example of the motivation for a minimum wage**).

An example of the motivation for a minimum wage

"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."

Philippine Wage Rationalization Act of 1988, sec. 2.

Institutional considerations for introducing a minimum wage

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 of the minimum wage is set and adjusted.

Governance

Countries enact a minimum wage in a specific political context and must choose a governance structure that satisfies several criteria and is appropriate to the context. There is considerable variability in minimum wage setting institutions around the world [5].

Legitimacy: The perceived legitimacy of the system is partly determined by perceptions about its independence from political influence. When the minimum wage is imposed by the government without consultation with the main stakeholders (employers and workers), it is likely to be devalued by the 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. To improve buy-in from all social partners, minimum wage systems should constrain the government's ability to arbitrarily set minimum wages, especially in countries where governments attempt to maintain order in public discourse in other domains.

Competence: The institution responsible for setting the minimum wage must have the ability to absorb the information it receives and arrive at a well-reasoned decision on the level of the minimum wage and when to adjust it. While such expertise is typically available in academia or among independent experts, concerns for legitimacy can lead to the inclusion of employer and employee representatives and other representatives of civil society who may not be equally competent to understand the data. Worker representatives, in particular, can be outmatched by the much greater analytical resources available to their employer counterparts.

Efficiency: The choice of the governance structure also affects the efficiency of minimum wage setting and adjustment. The mechanism for setting the minimum wage will be delegated to a committee or remain within the government. When minimum wage setting rests with the government, the wage is often set by ministerial decree, although some countries (such as the US) require legislative action to adopt or change a minimum wage. Different wage setting mechanisms imply different lead times between 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 a minimum wage commission or by ministerial decree.

Coverage and complexity

According to the International Labour Organization's (ILO) Database of Conditions of Work and Employment Laws, many countries have a minimum wage system that is intended to cover the entire workforce [6]. In other cases, the minimum wage system excludes particular categories of workers from coverage, such as youth, domestic workers, agricultural workers, and people with disabilities. The absence of statutory coverage of certain categories of (mostly low-paid) workers can be intentional, as in Indonesia, Paraguay, the Philippines, and Thailand [7].

Beyond categorical statutory coverage exclusions, governments rarely bind themselves with the same constraints as they do the private sector, so the statutory minimum wage is not a legal wage floor for the public sector [4], [6], [7]. Moreover, self-employment is an important source of jobs in developing countries that escapes coverage of the minimum wage. And many employers in developing countries are not registered with the state; when they are registered, they often do not declare all their workers. The intensity of enforcement determines the share of these workers that are covered by the minimum wage, although research shows that the effects of a minimum wage can extend beyond the workers who are statutorily covered and declared by their employers [8].

In addition to deciding which workers to cover, governments must decide whether to adopt a single minimum wage or different minimum wages for different classes of workers, often determined by age, profession, sector of activity, or geographic region [6], [7]. According to the ILO, 61% of countries with a minimum wage have opted for a single minimum wage, 21% have sectoral or occupational minimum wages that are set by the government or a tripartite body (government, employers, and employees), 8% do not have an explicit statutory procedure but set sectoral or occupational minimum wages through collective bargaining, and 11% use a combination of these systems.

Although some variation in minimum wages can be justified by differences in productivity, there are risks in adopting a system that is too complex. 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 detail, frequency, and credibility needed. Complicated systems make enforcement and management of the minimum wage difficult. And 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. Accordingly, several countries that initially opted for complex systems of minimum wages have reduced the number of different minimum wages and simplified their systems.

Level and adjustment

Setting the initial level of the minimum wage and subsequently adjusting it require collecting and analyzing data at the micro level (on 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. 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 [8]. Although observed average minimum wage levels vary considerably, developing countries are more likely to adopt high minimum wages (measured relative to average wages or value added per worker) than developed countries [1]. Some analysts have suggested that this can arise in settings where collective bargaining institutions are weak and unions use minimum wages to advance their interests [7].

Variables for adjustment: The factors to be considered when setting and later adjusting the minimum wage need not be specified in the legal texts that introduce the minimum wage, although some countries have done so. The need for explicit lists of variables to assess in setting the minimum wage (these lists do not exclude consideration of unlisted variables) depends on the capacity of the parties involved to understand what information they need to make informed decisions. When that capacity is low, providing a list of variables can improve the likelihood that the policy achieves its goals.

Some laws enacting a minimum wage precisely specify and define variables, such as the consumer price index, national and individual income, labor productivity, wage levels, income distribution statistics, unemployment, and economic growth. Others provide more general guidance, 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 in advance how often the minimum wage should be reevaluated (even if the level is not changed). Although many countries allow government discretion, unions will typically push for more frequent revisions when no specific guidelines have been established, as in Hong Kong and the Philippines, which could lead to social unrest. Regularity in the schedule of potential revisions allows employers to plan and time investments accordingly. It is thus important to specify precise deadlines, with a default adjustment (possibly zero) serving as a credible threat to those who set the level.

How frequently the minimum wage is reevaluated will depend on several factors, although annual or biannual reassessments are the most common. It is important to allow time for technical analysis, including subcontracting research and reports as needed, and to solicit input from concerned parties. Nevertheless, as Chile's experience in 1998–2000 shows, the schedule should not be so rigid as to prevent adjustments in response to crises.

Capacity constraints need to be considered

Capacity of social partners to participate effectively in minimum wage determination

With 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 that slow 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 responsibility for coordinating the minimum wage setting process. The government must be able to produce credible, relevant data, in a timely manner, to inform discussions on level setting and adjustment. The government needs to be able to coordinate meetings, convene stakeholders to provide testimony, and act on wage setting decisions through appropriate legislative or executive channels. This capacity is limited in many low- and middle-income countries, as evidenced by the lack of regularly produced labor market data and inefficient administrative systems.

Workers: Worker representatives in developing countries, usually labor unions, tend to have weak analytical capacity. Their primary functions are organizing activity and shows of strength (strikes). They tend to invest little in developing skills for independent labor market analysis. They are thus usually outmatched by employers in the ability to credibly negotiate minimum wage levels, since their arguments are less likely to be founded in data and analysis. Accordingly, they may find themselves in the minority and view 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. In developing country environments, where workers are predisposed to see employers as exploitative and pervasive poverty is taken as proof of exploitation, employers often find it difficult to win over public support, including when they argue that minimum wages are destroying jobs. Moreover, the reporting requirements of a minimum wage impose additional costs on employers who comply with the law. Wages must be recorded (this does not happen in many establishments in developing countries), and in some cases informal workers must be formalized, potentially exposing employers to payroll tax assessment. Employers may thus lack the financial or managerial capacity to properly implement the minimum wage.

Informational hurdles

Part of the difficulty of implementing a minimum wage in developing countries is informational. Workers need to know four things:

- Are they covered by the minimum wage?
- What is the relevant minimum wage?
- How much of their wages are covered by the minimum wage? (Are housing or transportation allowances included? Are in-kind benefits covered and how should they be valued?)
- How can they ensure that the employer pays the right amount?

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

The administrative institution has to have the capacity to collect and analyze the data needed to set and adjust the minimum wage. The fact that many developing countries do not conduct regular household surveys means that the minimum wage could be set without reference to relevant economic variables and thus could be inappropriate for a given labor market.

Capacity of the administration to enforce the minimum wage

Enforcement of a minimum wage requires mechanisms for identifying violations (inspection, whistle-blowing) and for sanctioning violations (penalty imposition). Many developing countries lack the capacity to ensure that these mechanisms function properly [6], [8].

Countries often lack enough inspectors to identify violations. A study found that employer behavior is sensitive to credible enforcement, but ensuring that inspections are adequately resourced requires more than the limited number of labor inspectors that are typically employed.

Even with adequate inspection, poorly functioning legal systems can make the sanctions meaningless. A study of Mexico showed that labor courts can be particularly ineffective at awarding damages in cases of labor law violations, and even when damages are awarded, the judgments are enforced less than half of the time.

The high prevalence of corruption in developing countries can also reduce effective enforcement. According to the World Bank's enterprise surveys in developing countries, 25% of surveyed employers consider it necessary to give gifts "to get things done" – the rate is as high as 50% in the Middle East and North Africa.

Expected effects of introducing a statutory minimum wage

Most of the analysis of the ability of minimum wages to attain their objectives has focused on poverty reduction and employment. Almost none of the work has explicitly considered the introduction of a minimum wage (the policies examined have all been in place for years before the analysis is undertaken), so little is known about how economies adapt to the initial implementation of a minimum wage. Nevertheless, the characteristics of developing countries suggest several dimensions to consider:

- First, a large share of employment in developing countries is in the informal sector, where firms tend to be less productive than in the formal sector. Introducing a minimum wage is likely to impose labor costs that exceed labor productivity in many informal firms, reducing the likelihood of compliance. Countries that introduce a minimum wage without allowing time for firms to adjust production techniques should expect less compliance than in developed countries. Providing assistance to these low-productivity employers could improve productivity and growth, as well as increase compliance and effective coverage of the policy.
- Second, even with large gaps in coverage due to informality, minimum wages may still increase wages. Part of this effect occurs directly, as the minimum wage raises the wages of low-paid workers; part is due to spillovers higher up the wage distribution; and part is due to what has been called the "lighthouse effect," with wage increases in the formal sector inducing increases in the informal sector.
- Third, there is little consensus on the expected impact on employment. Formal sector employment may fall or be unaffected, but some formal workers may shift to the informal sector, while some people not previously in the workforce may decide to start working as a result of increased compensation. Net employment can thus increase, fall or remain unaffected.

Introducing a minimum wage generates winners and losers. Potential winners include low-paid workers, such as youth and the unskilled, who retain their jobs at higher levels of pay; people (especially women) who were not previously working because it was not attractive to do so and who now earn an income for their families; and firms that invest in productivity-enhancing technologies. A known and stable wage floor can also attract foreign investment, as multinationals desire information and stability before investing. Losers include workers who are laid off and firms that are driven out of business because they cannot raise their labor productivity sufficiently. Although it can be difficult to identify the losers beforehand, having compensation mechanisms in place for them, in particular transfer systems, may impose unanticipated budgetary costs on the government.

LIMITATIONS AND GAPS

There are many important gaps in our knowledge of how best to introduce a minimum wage and what its potential effects are, especially in developing countries. There are more studies for developed countries, but the importance of institutions to success of the policy makes extrapolation risky. Almost everything we know about minimum wages attaining their objectives of poverty reduction, social justice, and growth comes from developed countries. For developing countries, most of the evidence is from Latin America. In particular, there is very little evidence on the performance of a minimum wage policy in low-income countries.

There is also very little empirical work on optimal institutional design. The econometric hurdles to undertaking credible empirical analysis of institutional performance are numerous. Minimum wage policies tend to be implemented with a single institutional structure, making it difficult to attribute variations in performance to that structure.

The minimum wage is one of the most politically sensitive of economic policies. That means that important decisions may be made to satisfy political imperatives rather than to maximize the chances of the policy achieving its goals.

SUMMARY AND POLICY ADVICE

Countries typically introduce minimum wages to reduce poverty, advance social justice, and accelerate growth. Key determinants of success in reaching these goals are institutional design choices; country context, including the political environment; and the capacity of social partners to effectively manage the system.

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

Although minimum wages are not the best tool for fighting poverty (targeted transfers can do a better job, with fewer side effects), the development imperatives facing developing countries can justify introducing the policy. However, the institutional arrangements need to be designed carefully with each country's context guiding the design. A minimum wage has the potential to move a country at least part way toward its development goals, despite weak enforcement capacity, pervasive informality, and political influence that can distort the policy structure.

Acknowledgments

The author thanks an anonymous referee and the IZA World of Labor editors for many helpful suggestions on earlier drafts.

Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

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The full reference list for this article is available from the IZA World of Labor website (http://wol.iza.org/articles/introducing-a-statutory-minimum-wage-in-middle-and-low-income-countries).