



The Global Voice of Business

GUIDANCE PAPER OF THE
**INTERNATIONAL
ORGANISATION
OF EMPLOYERS**



THE MINIMUM WAGE

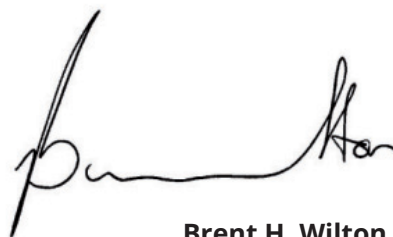
DEAR MEMBERS

In recent years, IOE members have expressed a renewed interest in discussing the minimum wage issue, which also emerged as an area requiring guidance for employers' organisations at the first meeting of the IOE Industrial Relation Policy Working Group (June 2013), where the participants exchanged views on different wage policies in various regions of the world.

This note aims to clarify the concept of the minimum wage, to present its objectives, intended benefits and potential drawbacks, and to guide companies and employers' organisations in approaching the discussion on minimum wage setting and adjustment at national level.

We hope you will find it useful.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Brent H. Wilton', with a stylized flourish at the end.

Brent H. Wilton
Secretary-General



Executive Summary

THE ISSUE OF THE MINIMUM WAGE IS OFTEN CONTROVERSIAL.

Minimum wages are essentially labour market interventions used by governments either as instruments of political macroeconomics or as social tools. Opponents argue that the minimum wage is too blunt an instrument to be useful, can have detrimental effects on employment, growth, and incentives to work, and can negatively impact opportunities for lower-skilled workers and youth. Supporters of the minimum wage conversely argue that it is an effective instrument in protecting the lower paid and in combatting poverty.

MINIMUM WAGES REPRESENT THE LOWEST LEVELS OF PAY, ESTABLISHED THROUGH A MINIMUM WAGE FIXING SYSTEM, TO BE PAID TO WORKERS BY VIRTUE OF A CONTRACT OF EMPLOYMENT.

Minimum wages have three aspects: a) the remuneration for work performed by the worker, b) the workers' basic income (and source of purchasing power), c) a production cost. Minimum wages can

be set by statute, collective bargaining agreements, decisions of national boards, or arbitration awards. They can be differentiated by region, by sector, or according to country-specific criteria. Other sectors/regions may remain uncovered by minimum wage legislation.

The concept of the **living wage** has been developed from the concept of the minimum wage, and refers to the level of wages that allows workers to meet their and their dependents' basic needs¹.

The minimum wage is not to be confused with the concept of "**minimum income**" which is a social welfare policy guaranteeing a minimum standard of living for individuals and their dependents when they have no other means of financial support. It is important to emphasise that wages are not the same as incomes. Incomes to the lower paid are a mix of wages from the employer, the government's approach to taxation, social transfers and government services.

¹ A guidance paper on the living wage was published by the IOE in February 2014.

What is the general objective of minimum wage policies?

TO UNDERSTAND MINIMUM WAGE SETTING POLICIES, A WIDER ANALYSIS OF THE GENERAL OBJECTIVES FOR SETTING MINIMUM WAGES COULD BE USEFUL.

Governments introducing minimum wage policies basically aim to protect low-income workers through the introduction of minimum wages based on country-specific factors such as the cost of living, welfare policies, labour market conditions, the inflation rate and other economic factors and trends.

The rationale driving decisions to introduce or increase minimum wages is related to:

i. Fairness/ reducing inequalities

Minimum wages aim at decreasing wage inequalities between the bottom and the middle of earnings distribution. The same idea of fairness is often incorporated into social welfare, which governments seek to maximize, also as a political strategy.

ii. Poverty alleviation

Minimum wages are often associated with poverty reduction, but in reality have been

acknowledged as ineffective in alleviating poverty as they are not well targeted to the poor.

iii. Imbalance of power in the employment relationship

Minimum wages are said to mitigate the potential effects that could arise from the power imbalance between enterprises and workers, which might lead to workers accepting lower wages to obtain employment.

iv. Incentives to work

Minimum wages could be justified within the framework of incentives, by motivating unemployed individuals to enter the workforce if the minimum wage is greater than benefits received through social support. Furthermore, minimum wages can increase the effort made by workers, as the rewards increase and the opportunity costs of losing the job become higher.

Specific difficulties to achieving the general objectives of minimum wage policies

PROTECTION OF LOW-INCOME WORKERS IS NOT ALWAYS ENSURED THROUGH MINIMUM WAGE FIXING POLICIES. THE MAIN DIFFICULTIES RELATE TO:

- The concrete definition of fairness and its measurement: how to properly estimate the trade-off between wage inequality and other factors in any welfare function?
- The inefficacy of minimum wage policies in a context of poverty alleviation. Poverty and low pay are indeed only weakly related. Research shows that in most countries only around 10% of low-paid workers are in poor households². Indeed statistical evidence demonstrates that the poorest households are those where no one is working, and therefore minimum wage policies could not directly contribute to their poverty reduction.
- The competition among employers that leads businesses to compete against each other to find the best candidates able to respond to their needs.
- The motivating effect of having attractive minimum wages, which may cause side effects on the employment market, such as unemployment increase whenever employers are forced to suspend their business due to their incapacity to pay the minimum wage.

² OECD, 1998

Benefits and Drawbacks

MINIMUM WAGE SYSTEMS, DESPITE SIGNIFICANT DIFFERENCES, ARE IN FORCE IN MORE THAN 90% COUNTRIES³

Some countries with high living standards, such as Austria, Germany, and the Scandinavian countries do not have statutory minimum wages, but collectively agreed wages cover directly or indirectly almost all workers in the country (between 50% and 100%).

There are differences of opinion over the benefits and drawbacks of minimum wages.

According to the World Bank publication, "Labour Regulations in Developing Countries: A Review of the Evidence and Direction for Future Research" (World Bank, 2008) many countries try to improve the welfare of low-wage earners, through the mandating of paid minimum wages but: "Whether such a policy actually achieves the intended outcome has been a subject of great controversy for decades. Theoretical predictions of the effects of minimum wages vary, and the empirical evidence has so far yielded contradictory results, depending on the country, the source of minimum wage variation, the methods of analysis, and the assumptions required for each particular econometric framework."

Demonstrated **benefits** of minimum wages include improved worker efficiency and higher productivity. Broadly speaking, higher minimum wages could have positive impacts on workers' purchasing power, thus increasing their consumption expenditure, and in turn stimulating aggregate demand and economic growth. Also, firms may increase their investment in plant and machinery to improve productivity to counter rising labour costs (for instance labour costs directly related to the increase in minimum wages).

Drawbacks are diverse. Minimum wages are widely seen as having a distortionary impact on the labour market.

- They have resulted in higher unemployment rates; higher labour costs for business; in some countries, and increased employment in the informal economy.

Some of the **reasons for these negative** impacts are the following:

- a. Minimum wages that are set too high can lead to unemployment among low-skilled workers. Indeed, workers with higher skills/

higher productivity who are not directly affected by minimum wage policies are preferred by employers, given the cost versus value added for labour, in comparison with lower-skilled workers/workers with low productivity. Furthermore, as firms increase their productivity due to wage increases, workers may be replaced in the medium-long term through automation. As a result unemployment may increase.

- b. General application of minimum wages, covering all sectors and categories of workers, in all regions of the country do not necessarily correspond to the employers' capacity to pay, nor take into account disparities between regional costs of living and the sectoral fluctuation of profits. This has led to some sectors being obliged to suspend their investment in certain regions.
 - c. Failure to find employment due to minimum wages being higher than the market-clearing level pushes workers to seek employment in sectors not covered by minimum wage legislation or in the informal economy where wages are even lower.
 - d. Although minimum wage legislation should be applied to all workers, it is difficult to enforce in the informal economy. The situation is more severe in developing economies with large informal sectors. The role of minimum wages in many developing countries as a means of establishing a social floor is therefore much more questionable.
- Minimum wages may drive workers into "uncovered" jobs, thus lowering wages in those sectors; reduce employment in low-wage industries, such as retailing; hurt small businesses generally; cause employers to cut back on fringe benefits and job training; encourage employers to install labour-saving devices; impact adversely on low-wage regions; increase the number of people on welfare; increase inflationary pressures⁴.

³ ILO, Global Wage Report 2008/2009

⁴ "50 Years of Research on the Minimum Wage" (Joint Economic Committee – Congress of the United States" (1995) - www.house.gov/jec/cost-gov/regs/minimum/50years.htm)

- Minimum wages may have direct negative effects on teenagers⁵; ethnic groups; the unskilled (they may also reduce motivation to pursue higher levels of education); workers with low productivity (those workers who could have been employed if no minimum wage system had been in place are excluded from employment).

Furthermore, it is essential to take into consideration wage relativity. Minimum wages do not only affect

those with low wages as other groups of workers will also demand higher wages to justify their higher productivity and skills, thus pushing up the overall costs that businesses face with “flow-on effects/ relativities effects”

In 2006 the IOE conducted a survey among its members, which resulted in the same practical considerations from an employers’ perspective at a national level.

Minimum wages in international regulation

THE PRINCIPLE OF THE “PROVISION OF AN ADEQUATE LIVING WAGE” IS PART OF THE PREAMBLE TO THE ILO CONSTITUTION.

When the ILO was established in 1919, member states considered that one of the key elements of workers’ protection would be “a wage that secured workers a reasonable standard of life as it is understood in their time and country”.

Subsequently, the ILO adopted the following **Conventions and Recommendations**:

- The Minimum Wage-Fixing Machinery Convention (No. 26) and Recommendation (No. 30), 1928;
- The Minimum Wage-Fixing Machinery (Agriculture) Convention (No. 99) and Recommendation (No. 89), 1951;
- The Minimum Wage Fixing Convention (No. 131) and Recommendation (No. 135), 1970.

The **Universal Declaration of Human Rights**, 1948, provides in Article 23, paragraph 3 that: *“Everyone who works has the right to just and favourable remuneration*

ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection”.

The **International Covenant on Economic, Social and Cultural Rights**, 1966, recognizes in Article 7 the right to *“Remuneration which provides all workers, as a minimum, with: ... (ii) A decent living for themselves and their families in accordance with the provisions of the present Covenant”.*

Other relevant instruments are: the **ILO Tripartite Declaration of Principles concerning Multinational Enterprises** as amended in 2006 which makes reference to “Wages not less favourable to the workers than those offered by comparable employers in the country concerned; but at least adequate to satisfy basic needs of the workers and their families”. (Paragraphs 33 to 35 of the Declaration).

The OECD Guidelines for Multinational Enterprises make use of the same definition.

The concept of the living wage

THE CONCEPT OF THE LIVING WAGE IS BEING INCREASINGLY REFERENCED.

However, the concept is problematic, especially for employers, as:

- Basic needs of workers and their families are diverse and potentially difficult to define and measure;
- The living wage can be set at an unrealistically high level and create dilemmas for employers in

setting priorities: job creation vs competitiveness and enterprise survival.

- It could lead to discrimination among workers.
- It is not the responsibility of employers to meet the basic needs of workers. This is the role of governmental social protection policies, to which employers already directly contribute.

⁵ 10% increase in the level of minimum wage would reduce teenage employment by range of 1-4%, OECD, 1998

ILO Convention No. 131 and Recommendation No. 135

OVER TIME, THE ILO HAS PROMOTED MINIMUM WAGE LEGISLATION AS A SINGLE RESPONSE TO ADDRESSING INEQUALITIES AND ALLEVIATING POVERTY.

Minimum wages still dominate the ILO agenda, both in terms of employment strategy and of the promotion of wage-related international labour standards.

ILO Convention No. 131 and Recommendation No. 135 are the subject of the June 2014 ILO Committee of Experts on the Application of Conventions and Recommendations (CEACR) General Survey, 22 years after the previous CEACR General Survey on the same topic. The Convention has been ratified by 52 countries. IOE members were invited to respond to the questionnaire, which serves as the basis for the Survey. The IOE forwarded to the ILO replies from members in 19 countries.

From this information, two elements appear to be critical for employers and employers' organisations in implementing and adjusting their minimum wage policies:

i. Consultation

Article 1(2) and 4(2) of Convention 131 calls for full consultations with the representative organisations of employers and workers concerned in order to determine the groups of wage earners to be covered by the Convention and to establish, operationalise and modify minimum wage fixing machinery.

The IOE was concerned that many responses revealed that representative organisations of employers were not fully consulted at all stages of the minimum wage fixing process, including the determination of the groups of workers to be covered, the selection of the criteria for fixing the wage levels, the rate of minimum wages and the period of their duration. This is the case in Armenia, Bolivia, Brazil, Indonesia, Kenya, Oman, Venezuela, and Zambia.

ii. Criteria to be used to determine minimum wages

Article 3 of Convention 131 lists the elements that have to be taken into consideration in determining the level of minimum wages. These have to include:

- 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;
- b. **Economic factors**, including the requirement of economic development, levels of productivity and the desirability of attaining and maintaining a high level of employment.

Here again, lack of consultation of employers' representatives, together with difficulties in measurement of productivity and economic trends, especially in developing countries with high levels of informality, it is difficult to fully use the "economic factors" element as provided for in the Convention. Examples can be found in Bolivia, Brazil, Cambodia, Kenya, Sri Lanka, Uruguay and Venezuela.

A good example of the proper consideration of workers' needs together with economic factors comes from the Philippines, whereby a "two-tier wages system" applies. The first tier consists of a compulsory floor wage to protect vulnerable workers, fixed by an administrative order at the regional level. The second tier consists of incentives, based on the productivity of workers and the performance of the enterprise and the sector, and is based on agreement between management and workers. A tax incentive related to productivity increases also applies⁶. Also, in South Africa, proposals for sectoral wage determinations are evaluated on the basis of their impact on the current and future employment level⁷.

⁶ Committee of Experts on the Application of Conventions and Recommendations, General Survey 2014, para 262

⁷ Committee of Experts on the Application of Conventions and Recommendations, General Survey 2014, para 263

Best approach for employers' organisations and companies

THE DEBATE ON THE MINIMUM WAGE IS BECOMING INCREASINGLY SIGNIFICANT AT NATIONAL LEVEL.

With heated discussions taking place among political parties, trade unions and employers' organisations, it is important for employers' organisations and companies to understand the potential challenges related to the implementation of minimum wages and unintended consequences.

Although the issue of the minimum wage is controversial, with benefits and drawbacks as detailed above, employers cannot disregard minimum wage systems that, despite differences, are widespread in more than 90% countries of the world. Thus, they need to face the discussion constructively so as to better meet their objectives, while not forgetting the general rationale for setting minimum wages. The main challenge for business is to have proper consideration of competitiveness, investment, growth and employment when fixing a minimum wage, especially since the debate about minimum wages is often highly political. Political influences render the challenge even greater and strong employers' organisations are needed to properly advocate on behalf of their members. The public perception of employers' organisations could be also at risk.

On this basis, employers' representatives have to be able to fully participate in minimum wage fixing and adjustment mechanisms. In addition, employers' representatives, in consultations with their members, are recommended to:

1. **Focus on the introduction of relevant economic factors into the minimum wage fixing machinery**, including the reference to

productivity levels at enterprise level, overall employment rate, employment of vulnerable groups such as youth, and other economic parameters which are fundamental for maintaining competitiveness and sustaining investment. The rate of inflation is also to be taken into account, as it directly affects businesses⁸. Tax increases and the level of social contributions have also to be considered as they are part of labour costs for business.

2. **Advocate for differentiation and decentralization of minimum wage fixing (for instance through collective bargaining procedures)**, as local authorities and local social partners are more aware of the capacity of companies to pay, as well as to workers' productivity level and the local costs of living. Therefore minimum wage fixing at regional or sectoral level, or per category of workers, could be a good approach.
3. **Consider and advocate for minimum wages that are not set too high**, so preventing companies, or even entire sectors, from suspending their investments in the country. **Minimum wages that are set too high may also induce companies to move from the formal to the informal sector.** The debate at national level should instead focus on how to fix a level of minimum wage that could favour companies moving from the informal to the formal sector.

⁸ The Minimum Wage, IOE Survey, 2006.

Annex I : Examples of minimum wages policies

Cambodia

The national labour market is composed of the “Foreign Direct Investment” market and the local market. Only the first has wage policies, while the second is in part coinciding with or influencing the informal sector. Only the garment sector has negotiated minimum wages through the Labour Advisory Committee, with low minimum wages plus different types of allowances permitting more flexibility to the employers. However, very rare use is made of the productivity rate in the country. As a consequence, productivity appears to be very low compared to other countries in the region. For national employers, productivity together with affordability and the cost of business (quite high in the region) are taken into account when determining wages. More information can be found via the following link. (IOE Member login required to access.)

Colombia

The social partners in the tripartite National Commission on Labour and Wage Policies agree every year on the minimum wage. The Government furnishes data and statistics, and directly intervenes if the Committee does not reach a consensus by unilaterally defining the minimum wage. The Colombian parameters for setting minimum wages include the inflation rate, productivity levels, the contribution of wages to national income, the increase in GDP and the Consumer Price Index. Colombia's minimum wage is one of the highest in the region, thus contributing to the departure of some labour-intensive sectors. Consequently, in 2013, fiscal reform was initiated with the objective of reducing non-wage labour costs by 13.5%, enhancing employment creation while reducing activity in the informal economy.

Germany

There is no minimum wage fixed by statute and wages are freely negotiated by collective agreement (CA). The German system of collective bargaining is based on the principle that the CA covers only the worker and employer, respectively members of the trade union and the employers' organisation that have concluded the agreement. However, for practicality, the employers voluntarily apply the CA to all workers, including CA rules on wages. Inflation, economic development and productivity are taken into account in determining the minimum wage. The system has recently been modernised thanks to the introduction of “opening clauses” allowing employers to agree wage standards with the workers that are lower than the collective agreement, if needed. This relieves companies of the engagement in negotiations and allows for greater flexibility at company level. Since the year 2000, wage increases have been moderate (between 2.5% and 3%).

Indonesia

The national minimum wage system in Indonesia is based on well-designed measurement criteria, such as the Safety Net, in which Decent Standard of Living (DSL) components are taken into consideration through surveys conducted by the Wage Council (a tripartite body composed of representatives of employers, governments, and workers at a 1:2:1 ratio). Minimum wage fixing involves, inter alia, factors such as productivity, economic growth, and the rate of inflation. However, in recent years, minimum wage setting has been used for political purposes instead of being an economics/measurement exercise. Last year, there were minimum wage increases of up to 70% in some regions, which are having a high impact on employers, especially SMEs.

These problems could be solved by improving social dialogue and respecting a system which is able to fix appropriate minimum wage levels on the basis of proper measurement criteria.

Kenya

The process of development of a national policy on minimum wages in Kenya is based also on three economic elements, such as the ability of companies to pay, productivity and the inflation rate. Two of the three elements established by the “national wages guidelines” – the ability of companies to pay and productivity – were not taken into account when determining the most recent minimum wage increase; only the third element, the inflation rate, was considered. Today, the minimum wage per month amounts to around \$100, which is relatively costly for Kenya and results in a tense IR climate; more difficult collective bargaining; and increased informal sector activity, especially by companies unable to afford such high minimum wages. The recent increase in the public sector minimum wage directly affected the private sector in Kenya by favouring workers' requests for equivalent increases in the private sector.

USA

The minimum wage system is established in the US at the Federal level, and is \$7.25/ hour. Single states or city administrations in practice determine minimum wage increases, which apply to only 1% of the population. Overall, trade unions in the US are not able to influence wage setting, except in strong sectors (building, transport, hotel), which results in individual agreements between one employer and one union, where the negotiation of wages is part of an “economic package” including health care and pension allowances.

For further information or advice, or to submit practical experiences of the minimum wage in your country, please contact Ms Alessandra Assenza, at assenza@ioe-emp.org

The IOE is the largest network of the private sector in the world.
With 150 business and employer organisation members in 143
countries, it is the global voice of business.



The Global Voice of Business

© IOE 2014
71 Av. Louis-Casali
1216 Cointrin/ Geneva
T: +41 22 929 00 00
ioe@ioe-emp.org
www.ioe-emp.org