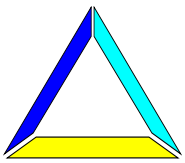
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T38

"Administrative increases of the minimum wage – facing the poverty-unemployment trade-off"

Executive summary

The Government of Ukraine currently plans an administrative increase of the minimum wage. While such a measure could yield higher incomes for some of the working poor, the government has to respect the trade-off between poverty alleviation and employment creation. Wage increases outpacing real growth in labour productivity will trigger the shedding of low skilled labour on the firm level. Furthermore, resulting rising labour costs will contribute to inflation. Both rising unemployment and inflation will hurt the poor more than other social groups. At the same time, the very scope of the plans will affect most wage contracts in Ukraine while heavily diminishing the role of the labour market.

The minimum wage plays currently a very significant role for Ukraine's labour market improving the bargaining power of the lower end of the wage distribution. In order to minimize the negative effects of increasing minimum wages, while at the same time ensuring that the working poor participate in the increasing welfare of a growing economy, we recommend binding the minimum wage to the development of the average wages in the economy. The government of Ukraine needs to disentangle labour market and social policies and stop misusing the minimum wage issue as a substitute for targeted social policies. In the long run the government will have to consider whether a minimum wage will remain necessary to support the bargaining power of low-skilled workers or whether free wage formation might be more appropriate.

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1 Introduction

Economic growth is the basis for growing wages and income of the population. The Government of Ukraine announced to increase the minimum wage by administrative means in its attempt to fight poverty in Ukraine.[1] The plan revealed intends to raise the minimum wage to the level of the administratively fixed subsistence minimum in the year 2007. This means nominally roughly more than doubling the minimum wage from its present level. The increases of the past 4 years have already translated into a 63% raise of the minimum wage in real terms.

With perfect labour markets, wage setting by administrative act or by duopolistic negotiation is second best. First best would be to let the market find wages according to relative scarcities of different skill groups of wage earners. The outcome would be that the wage of any particular skill group corresponds to the marginal productivity of its labourers.

However, labour markets in Ukraine are imperfect and the bargaining power of negotiators is unequal[2]. Thus, strengthening the weaker position of low-skilled workers at the lower end of the wage spectrum does currently have some justification. The policy-tool currently used in Ukraine for strengthening the bargaining power of low skilled workers is the minimum wage. The limits to using this tool are defined by the scarcities of respective labourers. If wages rise too fast, scarcity will turn in abundance and lead to labour shedding.

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1 For a more detailed analysis of poverty in Ukraine see: IER policy paper T25 “Poverty in Ukraine”. February 2004.

2 In many regions of Ukraine labour markets are monopsonic, i.e. one large employer is dominating employment in the village or town.

This paper discusses the main implications of the planned administrative minimum wage increases and the poverty-employment trade-off of such a policy.

2 The role of the minimum wage in a market economy

In a market economy the minimum wage is a potential instrument for levelling the unequal market bargaining power between employers and employees at the lower end of the wage distribution. The minimum wage shall ensure that low skilled workers do get wages according to their marginal productivity but not less.

In the spirit of the bargaining power argument, the International Labour Organisation (ILO) "Minimum Wage Fixing Convention" (ILO-Convention C131, 1970) characterizes the minimum wage as an instrument providing 'protection for wage earners against unduly low wages'.[3]

The ILO-Convention states that groups of wage earners covered by the established minimum wage have to be specified. While determining and adjusting the level of minimum wage, according to the ILO-convention the following criteria should be taken into consideration:

1. The needs of workers and their families;
2. The general level of wages in the country;
3. The cost of living;
4. Social security benefits;
5. The relative living standards of other social groups.

However, the ILO-Convention also stresses the limits to using minimum wages as given by economic constraints such as economic development, the level of productivity, and the desirability of a high level of employment, thus making clear that a minimum wage is not a means of social policy to alleviate poverty.

[3] Nearly all OECD countries have some form of minimum wage-setting arrangements in place. In many OECD countries a single national minimum wage is in place, even though some countries provide 'sub-minimum' rates for some employees, usually young people.

3 Minimum wage in Ukraine

In its legislation Ukraine tries to follow the ILO-convention. According to Ukrainian legislation the minimum wage is obligatory for all employers.[4] The Law On Remuneration of Labour specifies that the minimum wage is set for simple unskilled labour for a full working week (currently equal to 40 working hours per week). The minimum wage does not include remuneration for overtime work or benefits for working in harmful conditions.

However, the implementation of the Law remains weak and Ukrainian employers do have the possibility of paying up to 50% of the minimum wage in kind, while at the same time the prices used for the in kind payment are determined by them. Other ways of circumventing the legislation are working times of less than 40 working hours a week, with disproportionately to the working time lower wages. Thus the goal of protecting the lower end of the wage distribution is achieved only partially in Ukraine.

3.1 The present role of the subsistence minimum for the minimum wage setting

Following some ILO criteria, the Ukrainian legislation defines that the minimum wage rate should take into account the levels of the subsistence minimum, average wage, productivity, and the employment rate in the economy. However, in the past the government of Ukraine calculated the level of the minimum wage mostly taking into account considerations of employment levels and living costs.

Until 1999 the government used for establishing the minimum wage level the legally defined benchmark “not sufficient income” to approximate the cost of living. In 2000 the benchmark was substituted with a new measure, the so called “subsistence minimum”. The subsistence minimum is basically the price tag of a basic consumer basket containing predefined food items and a minimum set of non-food products and services. The nominal amount of the subsistence minimum shall be estimated annually for the upcoming period based on current prices. The calculation method of the subsistence minimum does not seem to be connected to real performance of the economy and the development of market prices.[5]

While the subsistence minimum is in our view an inappropriate measure of poverty, Ukrainian legislation states that it shall be used for calculating the minimum wage. In

[4] This provision is stated in the Law “On Remuneration of Labour”, various collective agreements (general, sector specific, and regional), and other legislative acts envisaging that employers are barred to pay less to employees than legislatively established minimum wage.

2000 due to the change in methodology for calculating the living costs a wide gap between the minimum wage and the subsistence minimum occurred.

The flaws of the subsistence minimum make it highly susceptible to politicisation in parliament. Consequently the Verkhovna Rada failed repeatedly to establish the level of the subsistence minimum for the year 2004, and, thus, to determine a wide range of social policy payments linked to the subsistence minimum.[6]

However, as stated above, the minimum wage should **not** substitute a targeted social policy. Therefore, there is no economic reason to attach the level of the minimum wage to the level of subsistence minimum.

3.2 The procedure of the minimum wage setting in Ukraine

Since 2004 the level of the minimum wage is set in the State Budget Law.[7] During the budget year the level of the minimum wage can be revised depending on the CPI increase and with the agreement of social partners.

Currently the level of the minimum wage seems to be more dependent on tax revenues and government priorities on budget spending, sidelining the social partners and the role of the labour market in wage determination. Last but not least, the outcomes of the annual political bargaining process on the minimum wage and the subsistence minimum can be hardly predicted, what increases uncertainty and thus costs on the firm level.

3.3 Minimum wage tendencies in Ukraine

Since 1998 the administrative increases of the minimum wage are outpacing the growth of real GDP, real wages, and labour productivity in Ukraine (see Figure 1). This indicates that the government is misusing the minimum wage as a tool of social policy, instead of confining it to the protection of the wage earners at the lower end of the wage distribution. It means at the same time that the unit labour costs have been increasing and wages are under administrative pressure from the lower end of the wage distribution.

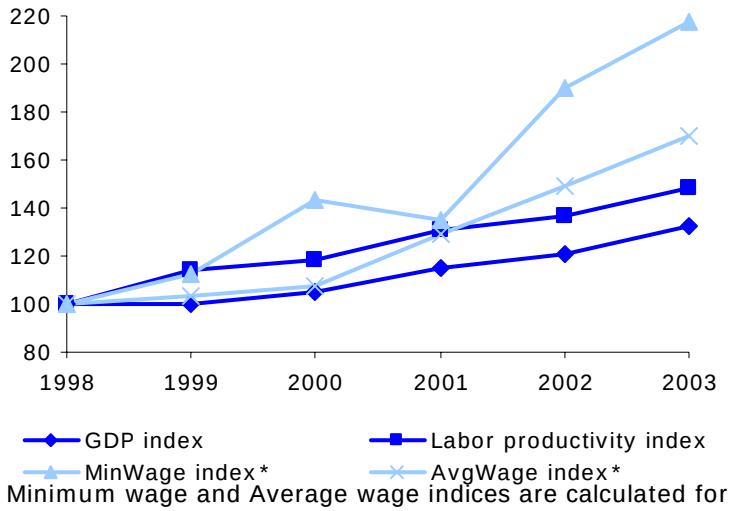
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5 The standards and consumption prices used for calculating the subsistence minimum need a critical assessment.

6 In 2004 the Verkhovna Rada approved a new subsistence minimum level only in May. The decision faced criticism from many deputies, as the 6% increase of the subsistence minimum was below the inflation rate of 8.2% in 2003.

7 From 1999 the minimum wage level was established by the respective Law adopted by the Verkhovna Rada taking into account results of negotiations with social partners. Before that it was established by resolutions of the Verkhovna Rada and the Cabinet of ministers and Decrees of the President.

Figure 1
Developments of wages, GDP and productivity (in real terms, 1998=100%)



* Minimum wage and Average wage indices are calculated for December of each year.

Source: Derzhkomstat, own calculations

However, the ratio of the minimum wage to the median wage has remained rather stable during recent years (see Table 1), amounting to roughly 55% - a rather high level. This indicates the binding character of the minimum wage.

Table 1
Wage tendencies

	Ratio of the Minimum wage to the Average wage (%)	Ratio of the Minimum wage to the Subsistence minimum (%)	Ratio of the Minimum wage to the Median wage (%)
1998	32.58	67.84*	n.a.
1999	41.63	70.81*	56.92
2000	43.45	37.02	57.14
2001	37.93	37.91	52.44
2002	40.52	44.59	55.45
2003	40.40	54.58	54.11

* Here it is non-sufficient level of income. Subsistence minimum was calculated starting 2000.

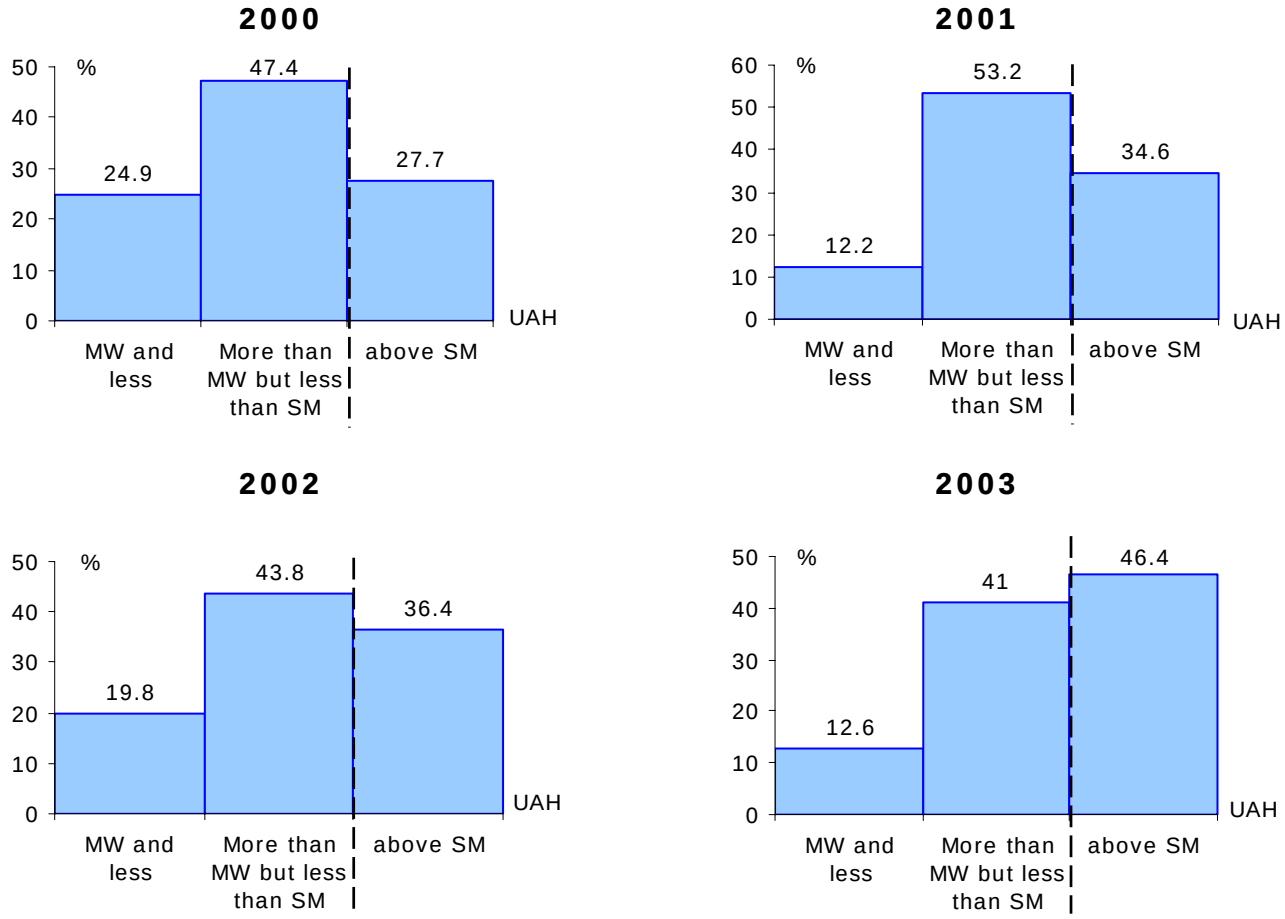
The distribution of wages paid during the years 2000-2003 shows that because of the highly politicized and economically inappropriate process of setting both subsistence minimum and minimum wage the share of people receiving the minimum wage varies extremely from year to year (Figure 2). However, these high variations in the numbers do not reflect real changes in the economy.

Under the 2003 wage distribution, the policy of raising the minimum wage to the existing subsistence level by 2007 (as announced by the Government) would effectively mean that more than half of all wages paid in the economy would be minimum wages – i.e., be regulated by a governmental decree. Furthermore taking into account that the minimum wage provides a floor for other wages paid - especially

in the public sector - the overwhelming number of working contracts (probably somewhere around 75%) would be administratively regulated by the government in the annual Budget Law. Even in the spirit of the bargaining power argument, such an administrative regulation of wages is certainly not consistent with the principles of a market economy.

Figure 2
Wage distribution of 2000 – 2003*

MW Minimum wage, SM Subsistence minimum



* The data cover employees working 50% or more of the weekly working time norm, i.e. 20h or more. Small enterprises and self-employed people are not included.

Source: Derzhkomstat

4 The impact of administrative minimum wage increases on employment

The administrative wage setting bears the risk of setting the minimum wage above the marginal labour productivity of the low skilled workers. At the firm level this would create significant pressure on the unit labour costs. Firms will react either by increasing prices, shifting of economic activities to the shadow economy, or by reducing production or labour shedding. Any of such firm level reactions will be to the disadvantage of the working poor.

The labour shedding by the firms will mainly depend on the competitiveness of the product markets or the flexibility of prices and tariffs.[8] The more competitive the market, the more likely the response of the firms will be through shedding labour.

The impact of administrative minimum wage increases on employment can be divided into two parts: direct effects and spill over effects.

4.1 Direct effects

Workers receiving wages lower than new minimum wage level are directly affected by the minimum wage increase. However, firms may respond to this increase not only by raising wages for these low-wage workers, but also by laying off some workers. Therefore, while some low-wage workers will be better off receiving higher wages, others will loose their jobs. The more people are directly affected by the minimum wage increase, the higher the expected losses in employment. The direct effect tends to be higher when the wage distribution is already skewed to lower wages, as it is in Ukraine. Besides, under the current regulation employers can respond to the minimum wage increase by de-linking from minimum wage requirements via decreasing working time of employees without increasing their wages.

4.2 Spill over effects

The spill over effects concern employees earning more than new level of the minimum wage, since they will receive higher wages as a result of the minimum wage increase, especially if employers use a tariff scale.[9] They also might be hurt by the firm reduction of employment due to higher labour costs. Empirical evidence suggests that low-wage workers are disproportionately more laid off as a result of wage increases.

The described effects indicate that the government faces a clear trade-off as regards minimum wage increases and employment. On the one hand, the minimum wage increase causes improvement for some of the working poor. But on the other hand, it will have a negative impact on employment for the group of low-wage unskilled workers.

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[8] Anecdotal evidence suggests that for example public utilities companies such as the Vodokanals are especially hurt by the increasing wage costs. The tariffs charged by Vodokanals are regulated by government and are currently not cost covering. Such companies respond to the wage increases by cutting production (scheduled water supply), non-payment for electricity, non payment of taxes, and significant shedding of labour.

[9] In Ukraine tariff scale is obligatory by Law; however, not all enterprises use it in their wage determination scheme.

Even worse, in its consequence the higher minimum wage raises the barriers for re-entry into the job market for both, long-term unemployed and low skilled young people. In order to facilitate the entry into the job market of these groups, the government should allow temporarily exemptions below the minimum wage.[10]

4.3 The Hungarian experience

Among the transition countries Hungary provides a recent example of the trade-off governments are facing with respect to minimum wage increases. The Hungarian government nearly doubled the minimum wage in two steps in January 2001 and in January 2002. The effect was a significant reduction in employment. Especially strong was the labour shedding reaction in the small business sector. Further it adversely reduced the job retention and job finding probabilities of low-wage workers.[11] Depressed regions in Hungary and the low-wage segments of the market were more severely affected by these minimum wage increases.

5 Impact on inflation

Firms could translate the higher labour costs associated with the minimum wage increase also into higher product prices.[12] Higher inflation will again hurt disproportionately more the poor.

In contrast to other transition economies inflation is in Ukraine more sensitive to wage growth than to money supply growth, which urges that government policy as regards wages should be conducted very careful.[13]

According to our estimates,[14] an impulse increase in the average wage, which will be inevitable after quick minimum wage raise, induces an immediate positive impact on

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10 This practise used in many OECD countries, e.g. the UK and Canada.

11 Gabor Kertei, Janos Kollo, *Fighning "Low Equilibria" by Doubling the Minimum wage? Hungary's Experiment*, William Davidson WP #644, Jan. 2004

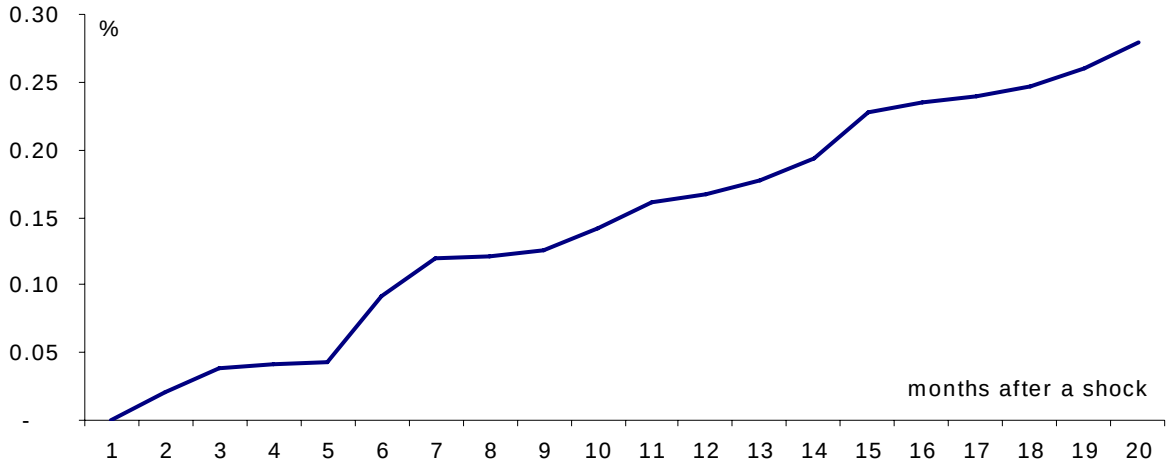
12 For the survey on inflationary impact of the minimum wage increase, see Sara Lemos *The Effect of the Minimum Wage on Prices*, IZA DP No. 1072, March 2004.

13 Research results on this topic are available upon request: Boriss Siliverstovs and Olena Bilan, Determinants of inflation in Ukraine, Unpublished Manuscript, IER, 2004

14 We estimate the effect of minimum wage increases on inflation only indirectly (using the average wage) because of the specificity of data. Using regression analysis, we assess the short-run dynamic interrelationship between four variables: consumer price inflation, growth of money supply, average wage growth and variable that approximates exchange rate expectations. It should be noted that since wages are basically prices for labour, wages along with goods prices are affected by the same long-term factors such as money supply growth. However, in a transition economy such as Ukraine various forms of administrative regulation affect wage setting. Thus, the development of wages is likely to have an autonomous influence on prices in the short-run. This indicates that wage growth affects inflation independently from money supply growth.

growth of consumer prices. More importantly this impact remains positive and accumulates over time (see Figure 3). We find, that a 1.0% increase in the average wage, everything else remaining equal, forces the price level to grow by 0.10% after 6 months, and by 0.17% over a 12 months horizon.

Figure 3
Accumulated response of price index to 1% increase in average wage



Source: Boriss Siliverstovs and Olena Bilan, Determinants of inflation in Ukraine, Unpublished Manuscript, IER, 2004

While the quantitative influence of average wage on inflation is not large, it is likely to grow if the development of wages in the economy is pushed from below by quickly administratively raised minimum wages. The time period on which the effect of average wage on inflation was tested is characterized by one important factor: increase in average wages was not considerably pushed up by minimum wage increase. If, however, in the future the minimum wage increases at much faster pace than before, it is likely to create upward pressure on average wage. Thus, effect of average wage rise on inflation is likely to be even greater.

6. Conclusion: The poverty-unemployment trade-off

Summarising the impact of administrative minimum wage increases above marginal productivity levels of low-skilled workers on employment, inflation, and poverty - the government clearly faces a trade-off. Pursuing the proposed government policy of rapid minimum wage increases will hurt mostly the people the government wants to protect with the minimum wage – the low skilled working poor – through higher unemployment of this group of people and higher inflation that hurts more the low income groups.

Instead of misusing the minimum wage as a substitute of targeted social policy the government needs to disentangle labour market and social policies. Wage settings should be connected to increases in marginal labour productivity and hence be determined in a market. In turn directly targeted transfers payments to the social needy are by far the more efficient social policy. Instead of continued market interventions and distortions of prices for labour the government of Ukraine should start now developing such targeted social policies to fight poverty in Ukraine.

7 Recommendations

Wage increases should be based on marginal productivity growth, which results from competition among companies, a favourable business environment and sound economic policies of the government. Only such a strategy would lift over time the great majority of Ukrainian citizens to income levels significantly above the subsistence minimum.

As regards the present situation with an existing minimum wage our immediate recommendations to the Government of Ukraine are the following:

1. Do **not** implement the administrative increases of the minimum wage in the proposed way.

2. Do **not** tie the minimum wage to the arbitrarily and not the reality reflecting poverty measure - subsistence minimum. This would avoid the highly politicised and uncoordinated annual procedure of the administrative setting the subsistence minimum and the minimum wage.

3. Wages must be paid from production. For calculating the minimum wage we recommend to use for the time being the only existing and publicly available aggregated proxy of productivity, i.e. the average wage as calculated by Derzhkomstat. Binding the minimum wage level to the average wage at a certain percentage rate can minimize the potential negative effects of increasing minimum wages, while ensuring that the working poor benefit from the economic growth and increasing welfare of the country.

4. In order to avoid unnecessary disturbances in the labour market we recommend to adjust the minimum wage to a level of around 40-45% of the average wage of a certain period in the past.[15]

[15] This is the ratio of the minimum to the average wage as it existed in the recent past (see Table 1). I.e., we assume this ratio to have been a good proxy for the equilibrium ratio.

5. Attempting to lower the entry barriers into the job marked for unskilled and young workers the government should allow temporary exemptions of payments below the minimum wage.

However, in the medium term it will not be sufficient to let the minimum wage rise with average productivity. As marginal productivities of different skill groups change differently, wages must also rise differently. Otherwise labour markets will not be cleared. Rigid wage structures will cause rising structural unemployment. Hence, the government will have to consider whether a minimum wage will remain necessary to support the bargaining power of low-skilled workers or whether free wage formation might be more appropriate after some time.

Finally, the government of Ukraine should **never** – neither in the short nor in the long run – misuse the minimum wage policy as a means of social policy. Wages for each skill group, including low skilled workers, must be tied to productivity.

L.Ha., S.B., O.B. Lector: R.F.

June 2004