Economics and business of minimum wage in RMG

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It is paradoxical that the our readymade garment (RMG) industry

attained stupendous success on the back of what one local daily found it apt to describe as "ruthless exploitation" of workers. The truth might be a bit more sobering than that because of the complex phenomena created by a vast army of surplus labour desperately seeking work in a tight jobs market. The Rana Plaza episode has brought the issue of labour standards, worker rights, and workplace environment in the forefront of the discourse. These are issues not to be ignored anymore. Singular attention is now focused not just on a living wage but on what the minimum wage should be in the $20 billion garment industry. Raising the minimum wage will affect wage setting across the board in the RMG sector. It is as much a human and social challenge as it is an economic one.

Thus the debate on the subject of raising the minimum wage in the RMG sector is heating up. Not surprisingly, there are as many shades of opinion as there are speakers on the subject. In my view, two aspects of the debate need to be carefully examined: the part that deals with providing a minimum living wage to the garment worker, and the part that affects the long-term sustainability of the RMG industry that will continue to be the biggest source of formal sector job creation in the country for some time to come. One cannot be resolved without taking the other into account. Though the first aspect has wider social implications, we also need to examine the underlying economic rationale behind setting a minimum wage and the income and employment implications of such a measure. Then there are the business implications related to cost escalation and maintaining of competitiveness in global markets which ought to be kept in focus.

Employment in the RMG sector must first be looked at in the overall context of Bangladesh's employment challenge. According to the Labour Force Survey of 2010, about 88% of our labour force of 65 million are employed in informal low-productivity jobs of which agriculture makes up for the lion's share. The employment challenge is to move the workforce from informal, low-productivity jobs to formal sector jobs in manufacturing or services. The rapid expansion of the RMG sector provided the scope for directly absorbing some 4.0 million (40 lakh) workers — mostly women. In addition, significant numbers are also employed in RMG linkage industries such as fabrics, accessories, packaging and courier services. This transformation process needs to be sustained. That means the rights of workers and the incentives of entrepreneurs to manage and expand the business must both be nurtured. Otherwise, we will be killing the goose that lays the golden eggs.

A minimum wage in the garment industry is seen as a tool to provide a way for workers in low-earning (entry level) jobs to have a self-sustainable standard of living. What is that in the Bangladesh and RMG context? It would be difficult to put a Taka figure on this wage. At best, it could be a range. However, economic theory does provide some rationale for minimum wage setting, while empirical research throws some light on the employment and income effects of this measure. Typically, a minimum wage (which is a wage floor) would be set at a level that is higher than the market clearing wage — a wage that would have prevailed in response to the uninhibited demand and supply of labour. The proximate result of setting a minimum wage in the textbook sense is to create unemployment as employers will be led to hire fewer workers at the higher than market clearing wage. Some workers eagerly looking for a job will not be hired. Empirical evidence from developing countries is mixed. Some research findings suggest that an increase in minimum wage is likely to have a positive wage effect for workers in the industry covered (RMG) by the minimum wage and a small negative employment effect which is stronger among low-wage workers. Overall, the evidence is rather inconclusive on whether minimum wages leave low-paid workers better off.

Nevertheless, one can derive some clear indications from economic theory. If the labour market were perfectly competitive, the prediction is clear that an increase in the minimum wage would result in a reduction of employment. But the overall effect of the RMG minimum wage on the economy depends on multiple factors, including the degree of competition in the labour market, relative level of the minimum wage to the market clearing wage, structure of minimum wages, share of workforce covered by minimum wage, elasticities of demand in the RMG and non-RMG sectors.

However, theory and evidence reveal that departures from the perfectly competitive model can lead to dramatic changes in the predicted effect of the minimum wage. And labour markets in the real world are seldom perfectly competitive. In a monopsonistic labour market (which is the case with RMG producers wielding asymmetric market power in hiring decisions), a moderate increase in the minimum wage that is greater than the market clearing wage but less than the marginal revenue product of labour (MRP), results in an increase in employment and wages. That is, if RMG producers were to increase minimum wage which is still lower than the incremental sales revenue from an extra low-wage worker (which is what MRP is), then the effects are positive. But if minimum wage exceeds MRP, then employment and income effects are negative — a lose-lose scenario. So the first order of business is to find the marginal revenue productivity of entry level (low-wage) workers in RMG. While there might be scope for raising the minimum wage, it is critical to ensure that minimum wage is not set above the marginal revenue product of labour of low-wage workers. That is the clear economic policy message. In the circumstances, it is for RMG producers to share the information on this critical indicator (for an average RMG factory) that will help in determining the feasible increase in minimum wage in the RMG sector from its current level of Tk. 3000/-. If any proposed minimum wage is found to be higher than the marginal revenue product of low-wage workers, it will hurt this group of workers as well as the employers. If it is lower, then all is well and good. This marginal revenue product is not carved in stone. It is a function of the price that exporters can fetch in the world market. There lies the catch.

The other logical outcome of raising the minimum wage is that it could lead to the upward revision of all categories of RMG wages thus resulting in substantial one-time cost escalation. The cost escalation would be greater depending on the rise in the minimum wage. So one should expect greater resistance from employers to higher fixation of minimum wage.

Now if the minimum wage is raised, doing nothing will simply raise production cost per unit in RMG. What can producers do to stay competitive? A number of options are available to companies: employers may respond by becoming more efficient/productive; companies may settle for lower profits; employers may respond by cutting back on benefits or overtime; companies may actually improve output through less employee turnover; workers themselves might respond by voluntarily working harder. What would happen in reality is perhaps a mix of all these possibilities.

That brings us to the business implications of minimum wage. In the context of Bangladesh RMG, what might be most difficult to realise would be to raise output prices in response to higher cost escalation. Unlike sales in the domestic market where prices can be jacked up in response to cost escalation, RMG exporters have very little say on price determination in the international market. They are basically price takers. This needs a bit of explaining from an economist's point of view. International prices are determined by global demand and supply conditions on which our RMG exporters have little control since they are not owners of brand name clothing. They can export increasing volumes only at the prevailing prices. If they raise prices unilaterally, they will lose markets. Because cut-throat competition in the world market prevents them from asking and getting a higher price just because domestic costs went up. Consequently, their margins are going to be squeezed when costs escalate. The question is how much room do they have? This is a grey area on which there is minimal information; and it would be in the interest of the RMG producers to share data with researchers on revenue and profits.

A look at relative minimum wages across competing countries (Fig.1) might give some but not complete idea of margins in Bangladesh. To give one example, if both Bangladesh and Vietnam supply Calvin Klein trousers of the same design which is sold at the same price in New York Macy's, it is likely that either (a) margins are higher in Bangladesh, or (b) prices offered to buyers (e.g. GAP) are lower, or both.

It is often argued that our RMG entrepreneurs are a rich class making huge profits. That may be true but they have no Bangladesh brand to command market power. Moreover, there is fierce domestic competition to get buyers' contracts thus lowering prices to rock bottom. The market power to determine prices is described by economists as “monopoly power”. Brand name clothing chains — e.g. Tommy Hilfiger, Levis, Calvin Klein, Van Heusen — who source their product from Bangladesh are the ones exercising monopoly power in a market that may be loosely described as monopolistic competition. Each product is differentiated from the other — a differentiation that attracts loyal customers. This product differentiation commands extra price in the global marketplace, often loosely related to cost of production. This is why retail and distribution margins can be huge and a function of product differentiation, while cutting and making margins (received by most RMG producers in Bangladesh) are relatively small. Until such time that we have a Bangladesh brand that sells in Walmart or Target, or Macy’s, we can only be at the receiving-end of price making.

That is not to say that our producers cannot sit down with buyers and negotiate prices. International pressure that has been mounted is not all about raising wages and labour standards in Bangladesh RMG factories, it is also about global brand name buyers paying a decent price for products they buy from Bangladesh so that Bangladeshi producers in turn can pay higher wages and improve compliance. So higher minimum wages could help overall cost increases that buyers would be forced to pay as long as Bangladesh still remains competitive vis-à-vis other countries. It is not unknown that in the product value chain, retail and distribution margins are large and leaves room for absorbing some of the cost escalation in Bangladesh industry.

Nevertheless, at the end of the day, it is the asymmetrical market power in the global clothing market that determines who is a price-maker and who, a price-taker. Do Bangladeshi RMG exporters face an impervious price ceiling?