



The economics of minimum wages

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Garment workers shout slogans during a protest asking for wage increase in Dhaka on September 21. Thousands of workers took part in the protest to demand a minimum monthly wage Tk 8,000. Photo:AFP

The Rana Plaza tragedy, although devastating and sad as an event, has contributed to one positive result. This has raised sufficient international and national voice to support the need for better employment standards and practices in the organised private sector.

One aspect of this re-examination of what constitutes globally acceptable employment practices is the need for a realistic minimum wage. There is an ongoing heated political and social debate on this subject.

This is welcome but it needs to be tempered with good economics to make sure that the end result is a positive outcome for the labour market, the readymade garments (RMG) sector, and Bangladesh development as a whole.

The importance of looking at the economic aspects of this debate cannot be over-emphasised in a labour surplus economy like Bangladesh. For the economy as a whole there is a major employment challenge defined as the need to create good jobs that is characterised by higher productivity and higher incomes.

The most recent Labour Force Survey of 2010 showed that some 88 percent of Bangladesh's 54 million labour force was engaged in economic activities that are informal in nature. Some 45 percent of total employment was in agriculture, where real wages and average labour productivity tend to be the lowest in the economy.

A major development challenge, which also coincides with the most fundamental aspect of the employment challenge, is the need to shift labour from agriculture and other low-productivity, low-income informal activities to formal manufacturing activities.

The growth of the RMG sector has provided Bangladesh a great opportunity to reduce the employment share of agriculture and increase the employment share of formal manufacturing, very much on the basis of the economy's comparative advantage.

Abundant supply of low wage workers, primarily female workers, has been a major factor underlying the growth of the RMG sector. As rising wages (adjusted for productivity) increase the unit cost of RMG (adjusted for quality differential) in competitor countries, such as China, India and Sri Lanka, the international demand has been shifting to lower cost sources

including Bangladesh.

Indeed the labour cost advantage of Bangladesh is the most important reason for sustaining this competitive edge.

This labour cost advantage, however, does not necessarily support the contention of some RMG producers that current wages are appropriate or that the employment conditions cannot be improved because it will increase the cost of production excessively.

International experience shows that most countries have minimum employment standards as a part of the social protection policy that allows for insurance and other allowances to deal with accidents, illness, maternity, child care and employment termination.

Most countries (some 90 percent) also have minimum wage legislation to prevent perceived or actual instances of labour exploitation. These interventions are aimed at improving the welfare of workers thereby contributing to higher productivity through better motivation and commitment.

The issue of minimum employment standards is hardly contentious and the Rana Plaza tragedy and similar other events in the past are ample testimony to the need to fill this legislative and policy gap quickly.

What, however, are contentious amongst economists is the need for and the level of minimum wages. The main issue here is the adverse implication of minimum wages for employment.

Standard economic theory suggests that if wages are set too high in relation to market clearing wages, there will be a reduction in employment. Those who are employed will gain, but those who cannot get a job (or lose job) because of lower demand for labour owing to higher minimum wages will lose. Labour group as a whole may gain or lose depending upon the underlying demand and supply elasticity.

There is a huge body of empirical literature on the subject of minimum wages and employment based on international experience. On balance, the evidence is not conclusive.

Studies on both sides of the debate have found evidence in their favour: some studies say employment falls while some conclude that there is no adverse effect on employment.

Those studies that do not find evidence of falling employment explain the result by pointing out that employers have a range of options to adjust to higher minimum wages.

These include adjustment by improving labour productivity through better supervision, by lowering non-wage benefits and training costs, by reducing the number of hours or days of employment, by substituting lower-skilled workers with higher skills, by passing on costs to consumers through higher prices, and by absorbing the extra cost from profits.

As is obvious, not all ways of adjusting to minimum wages is conducive to the interest of the workers and as such a careful research on the level and the impact of minimum wages on the welfare of workers as a whole is important.

In the absence of conclusive evidence from international experience on the impact of minimum wages on employment, how might Bangladesh proceed?

There is no short-cut answer to this question. Considerable research and careful analysis is needed to inform this debate. A few fundamental points will need to be kept in mind in designing this research and making recommendations based on the findings of this research.

First, wages will have to be properly aligned with labour productivity to keep the Bangladesh competitive edge in RMG and other labour-intensive productions.

Second, minimum wages must not be set at a level that is substantially higher than market wages. This begs the question what is the market wage rate in Bangladesh? The answer to this question can be found from a good analysis of wages data from the latest Labour Force Survey. Research done by this author shows that labour markets in agriculture, non-agriculture informal sector and formal manufacturing work reasonably flexibly, and wages respond to productivity improvements.

Wages economy-wide are increasing in response to productivity improvements. This empirical result is of fundamental importance and can guide the process of minimum wage

setting. Real wages and average labour productivity are the lowest in agriculture and set a floor on real wages economy-wide in an opportunity cost sense.

Adjusting for differences in number of days worked, transaction costs of migration and productivity differential in manufacturing resulting from better education and training, it is possible to estimate minimum average real wages in manufacturing that will be consistent with the development challenge of inducing labour transfer from agriculture to manufacturing.

This exercise should be cross checked with more direct evidence from the production cost and profitability analysis of the RMG sector. The contribution of labour cost to per unit cost of RMG output and what level of wage rate is consistent with a reasonable rate of return on investment in RMG can provide conclusive evidence on whether present wages are too low and exploitative in nature.

In doing this exercise, other labour cost emerging from the need to ensure better social protection to workers through employment legislation must also be taken into account.

Finally, it is also important to keep in mind that Bangladesh RMG producers are essentially price takers – garment prices are determined internationally by global market forces. Raising minimum wage too high might be counter-productive if that results in loss of RMG markets, which in turn will hurt employment opportunities.

Nevertheless, as the author wrote in several previous articles, RMG producers must understand that it is in their own interest to have a happy and committed work force in a safe work environment.

Since RMG is targeted to the global market, it is good policy to ensure minimum employment standards consistent with good global practices.

The matter of minimum wage setting is more an empirical question than a political or philosophical one. Wage setting cannot be isolated from labour supply and demand as otherwise it will undermine a critical basis for international trade.

Bangladesh derives its comparative advantage in RMG and other labour-intensive manufacturing precisely because it is well-endowed with labour force and as a result wage costs are relatively low.

However, it is possible that owing to lack of information and organisation the RMG workers are being paid below the true market wages. The rationale for minimum wages should be to help establish a floor on wages that is consistent with the concept of a true market wage rate.