

Position Paper on the European Commission's Proposal on

Possible Action Addressing the Challenges Related to Fair Minimum Wages

The European Commission (EC) has proposed options for possible EU action addressing the challenges related to fair minimum wages in the European Union.

According to the EC, the initiative has a general objective to ensure that all workers in the EU are protected by fair minimum wages, allowing for a decent living wherever they work. The initiative would leave Member States the freedom to keep their current minimum wage system. According to the EC, ensuring adequate wages for all workers in the EU is even more relevant in the preparation for recovery of COVID-19 crisis.

While securing favorable conditions for working individuals to improve their well-being is one of the goals of economic policy, statutory minimum wage may not be an adequate measure to contribute towards this goal. Some of the proposed policy options would harm not only low-wage earners but also small businesses and the economy at large.

The EC proposes such policy options as promoting collective bargaining, specifying clear and stable criteria for the way to set and update statutory minimum wage and ensuring involvement of social partners and independent experts. The EC also suggests setting non-binding reference values for the adequacy criteria to guide the assessment of the adequacy of minimum wage. According to the EC, all exemptions and variations in the minimum wage across the Member States should be eliminated.

Statutory minimum wage, in general, is harmful for the economy, the most economically vulnerable workers and SMEs and it should not be mandated. If, however, minimum wage is imposed by law, social partners and independent experts should be involved in policy formulation, updates should be guided by clear criteria, and differentiation by age groups and regions should be applied. It is advisable that minimum wage should be bound with an average or median wage at a rate not higher than 40 per cent.

The implications of minimum wage regulation are of particularly relevance for Central and Eastern European Members States due to existing disparities in income levels caused by a rapid growth in higher income segments which in turn increases the average wage. The rate at which the minimum wage is set should be allowed to vary across Member States in order not to harm the least-skilled and economically vulnerable groups of population.

This Position Paper is a response to the EC's second phase consultation with social partners and analytical document on possible options for an initiative at the EU level¹. It is presented by the Lithuanian Free Market Institute in co-operation with the Center for Economic and Market Analysis (Czech Republic), Civil Development Forum (Poland), the Institute for Market Economics (Bulgaria), and the Institute of Economic and Social Studies (Slovakia).

¹ It is the second phase consultation of social partners, which includes a summary of the results of the first phase consultation and provides an analysis of the main challenges to be addressed as well as the need, value and options of EU action. All documents can be found here:
<https://ec.europa.eu/social/main.jsp?catId=522&langId=en&moreDocuments=yes>

MINIMUM WAGE – A BAD TOOL TO ACHIEVE GOOD GOALS

The EC states that minimum wages can help protect low-wage earners and reduce wage inequality, strengthen incentives to work and reduce in-work poverty.

An increase in minimum wages would not provide a better protection for low-wage earners. Economic theory suggests that minimum wage hikes lead to a decline in the demand for minimum wage earners and a growth of the official rate of unemployment. They may also fuel price increases and make businesses fire the least skilled workers or even go bankrupt. Fixing wages above market-clearing levels on competitive labour markets has an inevitable consequence of damaging job creation and economic growth, and competitiveness suffers as a result. Employers search for cheaper alternatives and jobs get automated.

Those who maintain their jobs after a minimum wage increase might expect wage increases. However, a dilemma arises about what is more important – higher wages or higher employment. Unemployment is a likely outcome for the most vulnerable segments of society: youth, disabled people, low-skilled workers, and population in regions. Research from US scholars suggests that an increase in the minimum hourly wage in Seattle from \$9.47 to \$13 reduced the number of hours worked in low-wage jobs by 6 to 7%².

Relatively high minimum wages may equalize wages of skilled employees. This could not be the case if higher minimum wages raised the overall wage level. However, this scenario is quite unlikely, especially with the outbreak of COVID-19. Minimum wage increases would be harmful for those countries where average wages might fall due to COVID-19 or other reasons. This would bring disorder and misallocation of resources on the labour market and in the whole economy.

Minimum wage hikes might also boost the shadow economy instead of reducing in-work poverty. With higher mandatory minimum wages, some businesses may not afford to pay official wages and may be forced deeper into the illegal economy. They may formally employ workers under part-time contracts and additionally pay “envelope wages” so that the total labour costs (official and undeclared) for employing a worker are lower than the mandatory minimum wage and still equal to the competitive market wage. This effect would be particularly strong in countries with a high level of labour taxation.

It should be noted that minimum wage setting is also used as a political tool to garner support from low-wage earners. Political promises to raise minimum wages tend to intensify before elections. In many cases, it is unclear how the level of minimum wage is determined, and this ambiguity allow politicians to take advantage for the purpose of popularity gains.

The main goal of the governments should be to create appropriate conditions to increase the productivity of workers, not minimum wages. The cost of losing a job has to be taken into account for every employed person, not matter whether they get the average wage or the minimum wage. If workers create less value for their companies than their wages, they have to be either subsidized by their co-workers and/or employers or be dismissed.

2 Minimum Wage Increases, Wages, and Low-Wage Employment: Evidence from Seattle
Ekaterina Jardim, Mark C. Long, Robert Plotnick, Emma van Inwegen, Jacob Vigdor, Hilary Wething:
<https://www.nber.org/papers/w23532>

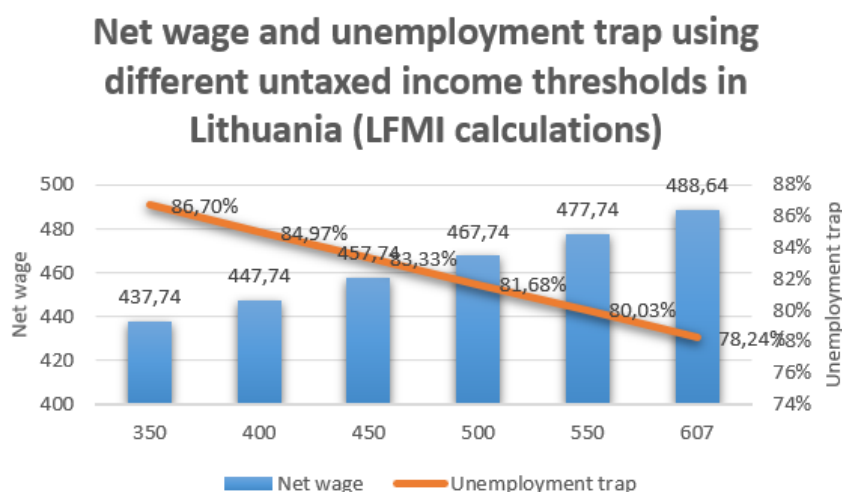
Reducing taxes on labour, particularly on low-wage earners, would achieve the goal of minimum wages at a lower cost. Such a measure would increase the net incomes of most vulnerable workers with no negative effects for their employment, and in fact would have positive employment effects. Zero-hour contracts and more flexible working conditions could also provide a better protection for workers than higher minimum wages. “Zero” or “empty” employment contracts mean that an employee commits to do a job when there is demand for it, and the employer commits to pay for it. Also, labour market policy should promote remote work, work from home or in clusters of cooperation. These conditions would be a better solution for workers than minimum wage hikes. They would allow them to adapt or to earn extra money.

THE EFFECTS ON WORKERS, BUSINESSES AND SOCIETY

According to the EC, when minimum wages are too low, they involve negative consequences for the economy, workers and businesses: they do not secure adequate income for workers and their families, cause wage inequality and in-work poverty, lower incentives to take up a job if work does not pay, and create uncertainty about future wages and entitlements.

It should be noted, however, that the main problem for minimum-wage earners is reduced incentives to work, and raising minimum wages is not the only or the best way to improve those incentives. The net minimum wage can be increased by reducing taxes on labour, especially for low-wage earners, and/or raising the level of tax-exempt income.

As an illustration, the figure below shows the unemployment trap³ and the net wage with different tax-exempt income thresholds in Lithuania. It evaluates the tax burden on minimum wage earners in Lithuania would increase by almost 7% if the amount of tax-exempt income equaled the amount of minimum wage.

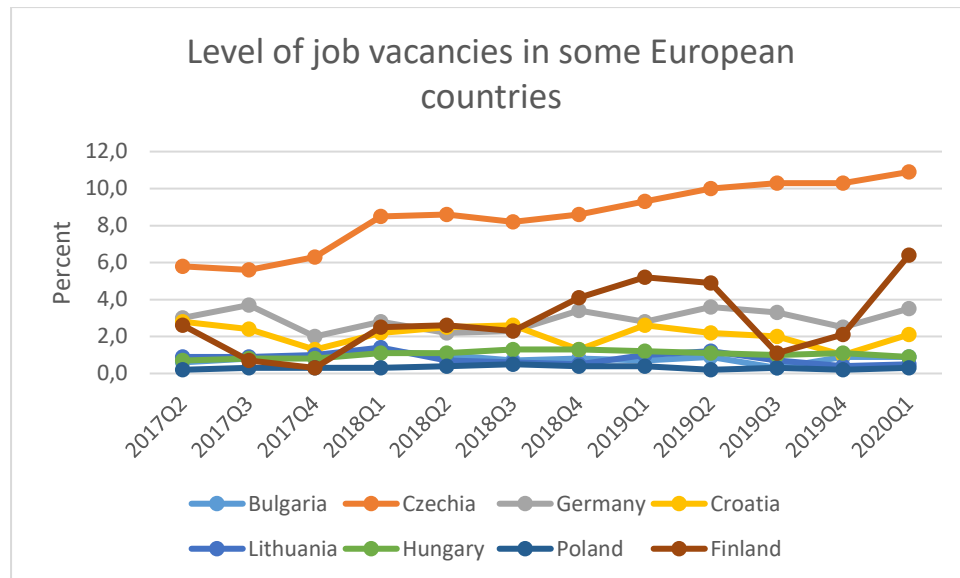


Source: Lithuanian Free Market Institute

³ The unemployment trap is a relative indicator that represents the level of social benefits received as a share of potential income an unemployed person would earn if they had employment.

According to the EC, low minimum wages also have adverse consequences for businesses, such as increased job turnover, weaker incentives for firms to invest in workers' skills, less engaged workforce, and a smaller pool of workers to recruit.

The figure below represents changes over time in the level of job vacancies across some Member States. It shows that the share of job vacancies is on the rise.



Source: Eurostat data <https://ec.europa.eu/eurostat/web/labour-market/job-vacancies>

Notably, businesses are already facing difficulty finding employees. Increasing minimum wages would aggravate these problems, especially for SMEs which would then afford less workforce or would even be forced to close down. As a result, employment would shift to bigger enterprises where workers would be offered more certainty about the future. This would indeed lead to less engaged workforce.

The EC also notes that low minimum wages have a negative impact on public budgets.

As minimum wage hikes make businesses hire less workforce, it results in lower budget revenues. Higher unemployment means higher expenditures for unemployment benefits and lower revenues from labour taxes. Minimum wage hikes are seen as an attractive policy tool because they do not require a significant increase in government spending. Increases in the minimum wage fuel inflation and distort the allocation of resources by businesses by forcing them to take prompt measures to adapt.

REDUCING NEGATIVE EFFECTS OF MINIMUM WAGES FOR THE ECONOMY

The following chapter provides specific comments on the possible actions delineated by the EC in the analytical document under analysis.

The EC suggests the following policy options regarding collective bargaining:

- “To take measures, in cooperation with social partners, to promote collective bargaining to support fair minimum wages.”

Indeed, involvement of social partners in setting measures for promoting collective bargaining is a much needed and welcome position. While social partners can contribute analytical insight on proposals under consideration, importantly, their involvement should help achieve fair minimum wages for all the parties - not only for the employees but also for the employers and the government.

- “Where wages are set exclusively through collective bargaining, to take action to ensure that all workers are covered. This can be achieved for example if all workers potentially can be covered by a collective agreement.”

Collective agreements and individual agreements between the employer and the employee are more appropriate than government-imposed regulations because they provide more flexibility to negotiate and better reflect specific needs of the employer and employee. It has also to be noted that social partnerships are not equally strong in all EU countries and they represent different proportions of workers.

- “Provide specific guidance to promote collective bargaining in all Member States.”

The European Commission should more clearly express its opinion on what specific guidance for promoting collective bargaining it has in mind. Individual agreements should not be considered as less valuable than collective agreements because they allow individual workers to negotiate the best possible conditions.

The EC lays down the following proposal on national frameworks for setting and updating statutory minimum wages:

- “To provide for updates of statutory minimum wages setting mechanisms to be guided by clear and stable criteria.”

It is essential that updates of statutory minimum wages (i.e. changes in the amount of minimum wage) are guided by clear criteria that can help protect minimum wages from being used as a political tool. It would protect voters from ill-founded and unjustified populist promises from politicians to provide high minimum wages after election.

- “To provide for updates of statutory minimum wages being conducted at reasonably frequent and regular intervals.”

Updates should be conducted at regular intervals to prevent minimum wages from being used as a political tool. This would also minimize interruption and uncertainty for companies and better inform their business plans. Employers would be better informed as to when and how much the minimum wage would be increased and this would give them more time to choose the best strategy to prepare for changes.

- “Specify the number of elements to be taken into account for statutory minimum wage setting and updating, such as the cost of living and the level of distribution of wages, together with other economic and social conditions.”

Every Member State should define clear criteria how wages are set or updated. Some examples of Member States show that wage determination is chaotic and decisions adopted, for example, by the tripartite councils are not always mandatory.

Examples of minimum wage determination systems in Member States

In Lithuania, minimum wage is set based on the average of the four EC Members States with the highest ratio of minimum wage to the average monthly wage. Also, there is a negotiated proportional interval of average wage into which minimum wage should fall, which sometimes becomes a political tool of manipulation. Lithuania has a two-tier minimum wage differentiation. The minimum wage can only be paid for unskilled labour, while qualified employees should receive higher wages than the minimum wage. This law inflicts an additional administrative burden as the employers have to evaluate and prove that certain job positions can be defined as skilled or unskilled.

In Poland, national labour law lays down rules for setting the minimum wage. Those rules are not binding though and are routinely changed in the tripartite commission or unilaterally by the government. However, national law requires evaluating economic factors in setting the minimum wage level. The government delivers various data to the tripartite commission, but neither the commission nor the government are obliged to follow them, other than the forecasted Consumer Price Index (CPI). The only mandatory factor in determining the minimum wage level is that the minimum wage has to go up by at least the inflation rate, in other words, by a forecasted change in CPI.

In addition to mandatory minimum wage the Slovak Republic has five other levels of minimum wage which distort the labour market even more than the standard minimum wage. By law, Slovakia differentiates its minimum wage by type of jobs based on the level of job difficulty. In total, there are six levels of the minimum wage, standing at 100%, 120%, 140%, 160%, 180% and 200%. It should be noted that those levels are not applicable for public sector jobs. The rate of 200% is applicable to the highest managerial positions.

Countries in the EU should clearly define what minimum wage represents a decent level of subsistence in their country and stipulate fixed and clear-cut criteria to calculate it.

Source: [Minimum Wage Regulation. It's complicated](#). Lithuanian Free Market Institute, 2018.

- “Define a set of indicators to guide the assessment of minimum wage adequacy, while considering economic conditions such as (i) the gross median wage, (ii) the gross average wage, (iii) the net median wage, (iv) the net average wage, or (v) a criterion to ensure decent living standards, in particular by defining a reference basket of goods.”

The EC does not provide insights or information on what could be regarded as an adequate minimum wage. Member States differ considerably from one another, so they all have to apply independent measures to define what a decent living standard is. The net average wage in theory should be the clearest indicator, nevertheless, the average wage indicator completely ignores the income structure and is highly influenced by outliers both on the high and low end of the income structure. The median wage is calculated only every four years, so it would be hard to compare. The gross wage does not reflect the situation best because tax regimes differ across countries. So the ratio of minimum wage to average or median wage should be applied as possible adequacy criteria.

- “Set non-binding reference values for the above adequacy criteria to guide the assessment of minimum wage adequacy. Approaches could be the following: (i) comparing the gross minimum wage to thresholds such as 60% (50%) of the median wage, or 50% (40%) of the average wage; (ii) comparing the net minimum wage to 60% (50%) of the net average wage or 70% (60%) of the net median wage.”

Most studies investigating the optimal level of minimum wage focus on the ratio of minimum wage to average wage. A joint report from ILO, OECD, IMF and the World Bank suggests that a minimum wage should correspond to around 30-40% of the median wage. It is important to note that due to the skewness of income distribution, the median wage tends to be lower than the average wage in most countries. Some earlier research by IMF that focused on individual countries suggested similar findings.

It is important to note that binding the minimum wage as a higher percentage of average or median wage increases the overall average or median wage in a given country. Thus, a problem arises that minimum wages would constantly increase more than they would otherwise before the binding. It would become a driving factor of inflation. Law-makers should keep that in mind before setting the exact percentage of average or median wage.

All Member States have different tax systems, so comparing net minimum wage to average or median wage is more likely to show an accurate situation of workers' welfare. What matters for employees is net salary, not gross salary. The European Commission should create this kind of comparison to properly evaluate the situation.

Examples in the box below show that some Member States have already reached the EC proposed thresholds for the gross minimum wage. Nevertheless, the difference in taxation is important because in some countries the net minimum threshold is below the proposed criteria while the gross minimum threshold falls within the interval.

EC proposed thresholds and existing ratios in Lithuania, Slovakia, Czech Republic, Bulgaria and Poland

Lithuania: Lithuania has already reached the interval which the European Commission names as adequate criteria for gross minimum wage. However, the net minimum wage is slightly below 50% of the net average wage. This signals that low-wage earners are taxed comparatively more than in other Member States on average.

The Lithuanian Statistics Department calculates the median wage only once every four years. The last calculation was made in 2018, so using the median wage-based approach would not be precise. Only calculations with average wage would be reliable. At present the gross minimum wage stands at about 44% of the average wage in Lithuania. Based on the EC's proposed approaches, 50% of the average gross wage would amount to 690.5 euros, and 40% of the average gross wage would make 552.4 euros. Lithuania's net minimum wage is currently about 49.7% of the average net wage. If calculated based on the EC's proposal, 60% of the average net wage would amount to 527.5 euros, while 50% of the average net wage would make 439.6 euros. (Source: Lithuanian Free Market Institute).

Slovak Republic: The Slovak Republic has exceeded all EC proposed thresholds. At the beginning of 2014 Slovak gross minimum wage was about 41% of average gross wage. In 2020 the share reached 52% and in 2021 it is expected to go up to 54.2%. The Slovak Republic aspires to be the leader in the share of minimum wage to average wage in 2021. These high numbers are a result of six years of populist politics. The Slovak government has been raising the minimum wage at twice the rate of raising average wage and at four times the rate of rising the productivity of labor. This trend is not being reversed even in the COVID-19 crisis.

*Czech Republic*⁴: Taking into account data for 1.H 2020, the gross minimum wage (14600 CZK = 557.25 EUR) is exactly 42.8% of the gross average wage (34077 CZK = 1300 EUR).

⁴ 1 EUR = 26,20 CZK

Considering net wages, minimum wage of 14600 CZK (557.25 EUR) on payroll means net income of 12124 CZK (462.75 EUR), when 34077 CZK (1300 EUR) makes 25557 CZK (975.45 EUR).

Bulgaria: In mid-2020 the minimum wage stood at 45% of the gross average wage at the national level. Overall, since 2015 the minimum wage has been growing by a steady 20 to 25 euro per year, lagging behind the growth in average wages in the period of economic growth at the peak of the economic cycle. The higher growth of the average wage, however, is a consequence primarily of a faster growth of wages and income at the top end of the income structure (as demonstrated by the growing income inequality indicators). Calculations done back in 2019, when the idea of introducing EU-wide minimum wage rules was first floated during the EU election period, show that in the case of Bulgaria fixing the minimum wage at 60% of the median would actually initially result in a reduction of the current minimum wage levels and a slower growth in the following years.

Poland: In 1.H 2020 the gross minimum wage (2600 PLN = 591EUR) reached the level of 50% of average wage in the national economy (5165 PLN =1174 EUR), up from 44% in the same period of 2015. Strikingly, the current ratio of net minimum wage to net average wage (51%) is nearly the same as for average wage, which points to almost completely flat taxation, without any preferences for low income workers.

Source: Eurostat data

https://ec.europa.eu/eurostat/statistics-explained/index.php/Minimum_wage_statistics

- “Using an indicator framework or the development of national definitions of adequacy, accounting for the interplay with tax-benefit systems and the broader wage-setting system.”

It is essential that benefit systems do not reduce incentives to take a minimum wage job. Businesses already have difficulties finding employees as the level of job vacancies is comparatively high. This signals distortions in the benefit systems.

The EC suggestion on involvement of independent experts in statutory minimum wage setting is as follows:

- “To associate independent experts with statutory minimum wage setting and updating.”

Involvement of independent experts is indeed significant and much needed. Their unbiased opinion could make the minimum wage setting less political and determined by mutual concession for each party in negotiations.

The EC indicates the following suggestion on exemptions and variations:

- “Provide elements so as to aim at the elimination of exemptions and/or variations in the countries where they exist.”

Exemptions and variations are a two-sided issue. On the one hand, they create inequality, some groups of individuals can face more difficulties to get employed or employers may give priority in hiring certain groups. Nevertheless, exemptions are better compared with the general fallacy of minimum wage itself. A uniform minimum wage can be harmful for regions, for businesses which create less value and for employees with less experience. Regional variations of minimum wage could pull some workers out of the shadow economy, while variations by age groups could make employment for young or unskilled people more

available. The ratio between the mandatory minimum wage and the average wage differs substantially within a country. For more see [Minimum Wage Regulation. It's complicated.](#) Lithuanian Free Market Institute, 2018.

Minimum wages as a ratio to the average wage in Lithuania, Slovakia and Bulgaria

In 2018 Slovakia's Bratislava region had this ratio at just below 50%, while in the Presov region the minimum wage accounted for more than 70% of the average wage. (Source: [Minimum Wage Regulation. It's complicated.](#) Lithuanian Free Market Institute, 2018.)

A uniform minimum wage in Lithuania means that the minimum wage comprises 44% of the average wage in Vilnius and even 68% of the average wage in Zarasai (Source: Statistics Lithuania). This brings distortions to the labour market.

The same is true for Bulgaria. For 2018, the minimum wage was just 32% of the average wage in the Sofia (capital) district, but 67% in the Montana district and 68% in the Blagoevgrad district, and overall the ratio was above 50% for most regions. This clearly demonstrates that the minimum wage is a significant barrier to entry in the less developed regions of the country.

CONCLUSION

1. In general, statutory minimum wage is harmful for the economy, the most economically vulnerable workers and SMEs. Minimum wages do not protect low-wage earners. Minimum wage hikes reduce demand for minimum wage earners and drive up unemployment. As a result, the price levels go up and businesses are forced to fire the least efficient workers or even go bankrupt.

In a situation when minimum wage is set by law, the following considerations are important:

2. Involvement of social partners and independent experts is key. Their opinion and position should be heard before the new minimum wage is set.
3. Updates should be guided by clear criteria and done at regular intervals. This would prevent minimum wages from being used as a political tool.
4. Variations of the minimum wage should be applied. Differentiation of minimum wages by age groups would help to protect youth and unskilled workers. Regional differentiation of minimum wages would pull some workers from the shadow economy and reduce the burden for businesses.
5. Minimum wage should be bound at a rate not higher than 40% of a country's average wage. The International Monetary Fund indicates that this proportion to average wage has the least negative consequences. The percentage at which the minimum wage should be bound could vary among Member States given that in countries with high income inequality wage growth of high-skill high-income workers is almost inevitably faster compared to low-income earners. This would help to avoid pricing of those with lower skills or little experience out of the labor market. Also, tax systems differ considerably across Member States, so the net wage indicates the situation better than the gross wage.