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GOVERNING AGAINST THE WEAK: THE RISKS OF RAISING AND INDEXING THE MINIMUM WAGE

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"There are certain animals that are weak compared to others: for example, the porcupine is defenceless except for its quills, the deer is vulnerable except for its speed. In economics there are also people who are relatively weak. The disabled, the young, minorities, the untrained - are all weak economic actors. But like the weak animals in biology, they have a compensating advantage: the ability to work for lower wages. When the government takes this ability away from them by forcing up pay scales, it is as if the porcupine were shorn of its quills. The result is unemployment, which creates desperate loneliness, isolation and dependency."
Walter Block (Mises Institute)

"Opponents of minimum wages argue that they hurt jobs in Europe; supporters say that they combat exploitation and help the poor. (…) Contrary to popular wisdom, it is as easy to make a theoretical case against minimum wages as for them. Evidence, not theory, is what is needed now. (...) The (good or bad) effect of minimum wages has been exaggerated."
Dolado et al (1996)

The Minimum Wage Crisis

Little more than a month ago, negotiations between the Government and the social partners to raise the minimum wage (SMI) caused a new crisis in various spheres of public life. This discord was created by a clause that sought to index-link the SMI to past inflation by means of a similar mechanism to the one used for updating pensions.

Initially, it caused a crisis within the Government itself. The negotiation of this clause behind the back of the Ministry for Economic Affairs led Pedro Solbes, the Second Vice-President and Economy and Finance Minister, to veto it, branding it "foolishness". The Prime Minister then intervened at the last Cabinet meeting of the year, stripping his Vice President of the authority to veto the measure and recognizing the authority of the Minister for Employment and Social Affairs. Once again this demonstrated the absence of any authority on economic matters and the lack of a real economic policy deserving the name.

"Over and above the decision to raise the SMI, the idea of linking this and other wages to past inflation sets us back 26 years. It means returning to the situation that existed before the "Moncloa Pacts" of 1977, with wages being linked retroactively to prices, disregarding changes in productivity. This is a major economic policy error"

Just when things seemed to be getting back to "normal", the Spanish employers" association CEOE issued a statement in which it denied that it had reached an agreement with the Government and the trade unions CCOO and UGT on the SMI, and said that the SMI should be updated, thus contradicting the words of the Minister for Employment and Social Affairs.

In order to find a way out of the crisis, the Minister urged the various social partners involved to take part in a series of talks, in order to solve a problem that he had created himself. However, whilst the employers' association believed that an automatic review of the SMI based on past inflation was unacceptable, because it would place jobs in danger and decrease the competitiveness of the Spanish economy, as well as favouring an "inflationary spiral', the trade unions did not consider the concession they had secured to be negotiable and regarded all discussion on this point to be closed. Thus, a second crisis front was created. The Government proved itself incapable of coordinating social dialogue in the first significant negotiations of its term in office.

Over and above the consequences of this twofold crisis, it is essential to carry out a rigorous analysis of the possible effects on the Spanish economy of raising and indexing the SMI.

The Minimum Wage for the Year 2005

Following the last Cabinet meeting of 2004, the SMI was fixed for the present year at 14 payments of 513 euros. This amount comes to approximately 41% of average wage costs (1,461.46 euros a month during the third quarter of 2004), according to the Quarterly Survey of Labour Costs produced by the National Statistics Institute (INE). A comparison with the average wage (equivalent to 12 monthly payments of 1,263 euros at the end of 2003), which is more representative given current wage distribution, brings this figure up to 47%.

In one year, the Government raised the SMI by 52 euros (the wage established at the beginning of 2004 was 460.50 euros), so we are dealing with an increase of 11%. Two arguments were cited justifying such a large increase. First, it was a question of recovering the purchasing power that had allegedly been lost since 1996 (calculated by means of the difference between the accumulated increases in inflation during this period and increases in the SMI). Secondly, the Ministry of Employment and Social Affairs insisted on the need to bring the minimum wage closer to 60% of the average wage, as recommended by the European Social Charter.

Reactions to such a brusque increase in the SMI ranged from those who considered it to be a means of redistributing wealth among workers, without any adverse effects, to those who forecast grave consequences for the Spanish economy. In the following section we shall analyse five possible sources of risk that derive from increasing the SMI, apart from linking it to the consumer price index (CPI). Conceptually, we should distinguish between these two measures. The Government's commitment to raise the minimum wage to 600 euros by the end of its term conceals the problem of indexing it throughout this period, given that the increases required to make the promised figure possible will undoubtedly exceed the figure corresponding to the CPI. Once the desired figure has been achieved, then all the potentially perverse effects of indexing will become apparent.

"There is a great temptation for the Government to play around with income distribution using the SMI, since such a measure is very cheap. However, raising the minimum wage has serious consequences: both a "quantity effect" involving changes in the economy's employment level, and a "price effect', transferring the increase to wages and prices, and generating an inflationary spiral"

Before we begin our analysis, it is worth highlighting the surprising lack of transparency that characterizes this debate. The figures relating to the groups that are directly affected have not even been made public. The Government's "statistical blackout" is quite evident.

Five Manifestations of Risk

There is a great temptation for the Government to play around with income distribution using the SMI, since such a measure is very cheap. This is very much a short-term analysis, given that raising the minimum wage has an impact on various parts of the economy. There is a "quantity effect', i.e. changes in the economy's employment level, and a "price effect', which transfers this increase to wages and prices, thus generating an inflationary spiral, feared by most economic analysts and the subject of warnings from the Spanish employers' association, the CEOE.

- Effects on Employment

In a competitive labour market, the introduction of a minimum wage that is higher than the equilibrium wage creates excess labour supply and thus unemployment. The situation is especially dramatic in the "weakest" labour segments (young people or low-skilled workers, for example). These workers are the people most adversely affected by a measure that is in fact designed to protect them. This is basically the line of reasoning that Walter Block pursues in the quotation cited at the beginning of this article. It is also the most immediate objection that has always arisen in discussions about establishing a minimum wage or raising its level. However, it is neither the most convincing objection nor the most relevant in the case of Spain.

In fact, empirical studies that have analysed the effects of introducing a minimum wage on employment do not offer us any particularly conclusive results. This apparent empirical paradox (i.e., that raising the minimum wage does not entail the mass destruction of employment) is explained by the fact that the labour market is not always competitive. In certain situations, when there are frictions within the labour market, it may well be the case that employees are remunerated at levels below their marginal productivity. When this occurs, a certain margin exists in which raising the minimum wage does not have any negative effects on employment. A typical case would be that of a monopsony in which only one jobseeker exists.[1] However, this market structure cannot by any means be considered to be generally prevalent.

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The absence of a general tendency for employment to be destroyed does not mean that a negative "composition effect" cannot occur within the labour market, as described by Newmark and Wascher (1995)[2]. In this paper, which focuses on youth employment, we can see that raising the minimum wage increases the probability of young people giving up their studies. Some of these young people fail to find work, which suggests that it is necessary to stand in line in order to find jobs that pay the minimum wage. Other young people do find jobs, but this tends to be at the cost of workers with lower qualifications, who are displaced from the labour market and find that their probability of remaining unemployed or without work is increased.

In spite of the fact that the aggregate effects on employment do not necessarily have a significant impact on young people, we have focused on the changes that are produced with regard to the composition of the working population. Low-skilled young people are the ones most strongly affected by increases in the minimum wage, because it is considerably more probable that they will lose their jobs, in view of the fact that they can be replaced by more highly trained workers.

"In its last quarterly report on the Spanish economy, the Bank of Spain presented quite a critical view of the Government's SMI reform, concluding that we can expect adverse effects on youth employment and the employment of the lowest-skilled workers"

Thus there exist convincing economic grounds –both theoretical and empirical– for predicting adverse effects on youth employment and on the situation of the lowest-skilled works as a result of raising the minimum wage. In fact, this is the conclusion drawn by the Bank of Spain in its last quarterly report on the Spanish economy.[3] This publication presents quite a critical view of the Government's SMI reform. It states: "We cannot rule out the possibility that significant revaluations of the SMI could have a negative impact on the employment opportunities of these groups of workers (workers with the lowest productivity levels) and affect the capacity of the Spanish economy to maintain the current strong rate of job creation.'

The measure is especially questionable at a time when a process of mass regularization of immigrants is beginning. This involves a group of workers who to a certain extent present all the characteristic risks of being excluded from the labour market as a result of minimum wage increases. For some immigrants (who can be incorporated into Ricardian models of gross labour), their low qualifications mean that the risks of exclusion are especially high. One probable consequence of raising the minimum wage is that these workers will remain in illegal employment within the black economy. This is exactly the opposite of what the Government is trying to achieve.

"The Government has shown itself to be without any kind of clearly defined economic policy. The SMI reform is an example of a measure that has been adopted without much thought. It also coincides with a process of mass immigrant regularization, whose consequences have not been properly evaluated"

Furthermore, it is worth highlighting the fact that this measure goes completely against the Lisbon Agenda by clearly increasing the risks of exclusion from the labour market and social marginalization for people with the worst chance of gaining access to employment.

The Government has not considered any sensible alternatives which might help it to prevent these risks, such as establishing different minimum wages based on skills and productivity levels.

- Effects on Wage Distribution

There is ample literature documenting in empirical terms the theoretical prediction that raising the SMI leads to compressed wage distribution. Good examples are the studies by Machin, Manning and Rahman (2002)[4] and by Dickens, Machin and Manning (1999)[V]. In both cases, it was demonstrated that the introduction of the minimum wage in the United Kingdom in 1999 led to substantial compression at the lower end of the wage distribution table.

Compression of the wage structure, especially at the lower end of the table, has a number of negative effects, one of them being that it discourages the accumulation of human capital and means that there is no longer an incentive for the least qualified workers to pursue their training.

Once more, we can see how this measure contradicts another of the policies enshrined in the Lisbon Strategy, in this case to promote the training of the labour force (accumulation of knowledge and human capital) in order to create more jobs and enhance their quality.

- The "Displacement Effect" on Collective Bargaining

Raising the SMI causes upward pressures when it comes to reaching collective bargaining agreements, transferring the SMI increase to the entire wage scale. This is one of the most dangerous consequences of a considerable SMI increase and of linking it to the consumer price index, as pointed out by the Bank of Spain, the Spanish employers' association and numerous studies in the field.

Thus, raising the SMI will not only affect the group that is meant to feel the increase, but the entire labour market. The impact will vary depending on the sector, the job category and the corresponding position on the wage scale.

The SMI is the benchmark used as a point of reference in many collective bargaining agreements, given that basic wages are linked, both implicitly and explicitly, to the SMI. And we should not forget that the SMI represents over 70% of the average wage of unskilled workers employed in the service sector, which means that this point of reference is always important when it comes to negotiating wage demands in this segment of the labour market.

In fact, there is evidence to suggest that the displacement effect is already having an impact on collective bargaining. The trade unions are now negotiating basic wage rises based on the SMI increase awarded over the past year. Wage agreements in many sectors have been affected by the increased SMI in a large number of job categories.

"Raising the SMI causes upward pressures when it comes to reaching collective bargaining agreements, transferring the SMI increase to the entire wage scale. This is one of the most dangerous consequences"

- Effects on Other Minimum Social Welfare Payments

Up until the SMI reform of last June, the minimum wage had served as a reference point for numerous social welfare benefits, ranging from income support to access to subsidized housing. Under the reform, a new general income indicator called IPREM was created, designed not to be linked to the SMI, and to take over as the reference income for a large number of social welfare benefits. The IPREM was set at 469.80 euros a month for 2005. For the time being, it will be updated in accordance with the inflation objectives established by the Government in its national budget.

The main criticism we might level at this approach is based on a certain scepticism as to the feasibility of creating different social welfare indicators such as the SMI and the IPREM, using different amounts and updating mechanisms. It seems that a considerable gap is likely to emerge between the two figures in a very short period of time.

Society as a whole will find this asymmetry difficult to accept and voices will soon be heard calling for the gap between the two indicators to be closed. The final outcome will be that the IPREM does, in fact, rise in line with the SMI, even though the Government may have initially stated that this will not be the case.

Pressures aimed at evening out the amounts corresponding to these two indicators are no fiction. In fact, when the IPREM was originally designed, the collective bargaining negotiations raised the possibility of updating the IPREM in accordance with past inflation. It seems clear that sooner or later this kind of updating mechanism is likely to emerge. What is more, the larger the gap between the SMI and the IPREM, the more difficult it will be for the Government to stand firm in its negotiating position. We run an obvious risk of a contagion effect with regard to the indexing of all the various minimum social welfare benefits.

- Effects on Inflation and Competitiveness

The big SMI increase and its subsequent indexing, linking its growth to past inflation, will create inflationary pressures for various reasons, some of which we have already mentioned: the displacement effect on the lower levels of the wage scale, a contagion effect on the IPREM, and higher social security contributions payable by employers because of increased wage levels.

Furthermore, there is a very strong chance of increases in direct costs being passed on immediately to the consumer in the form of increased prices in those activities, especially in the service sector, which are strongly affected by the SMI increase.

"The current Government's economic policy has led to an increase in the inflation differential vis-à-vis the EMU of over 1%. New inflationary tensions will erode the competitiveness of our economy still further and make it even more difficult to correct our foreign sector, whose alarming imbalance is the second highest in the world, holding back GDP growth by two percentage points"

Indexing, as highlighted by the Bank of Spain, will represent an "additional restraint on the economy's flexibility' and will "strengthen the economy's inflationary inertia'. In the present context, in which the current Government's economic policy has led to an increase in the inflation differential vis-à-vis the Economic and Monetary Union (EMU) of over 1%, new inflationary tensions will erode the competitiveness of our economy still further and make it even more difficult to correct the burden on growth that our foreign sector has come to represent in the last few quarters. Its present alarming imbalance has the dubious honour of being the second highest in the world, holding back GDP growth by two percentage points.

Conclusions

The Government has again shown itself to be without any kind of clearly-defined economic policy. The SMI reform is an example of a measure that has been adopted without much consideration at all. It also coincides with a process of mass immigrant regularization, whose consequences have not been properly evaluated.

Over and above the decision to raise the SMI, the idea of linking this and other wages to past inflation sets us back 26 years. It means returning to the situation that existed before the Moncloa Pacts of 1977, with wages being linked retroactively to prices, disregarding changes in productivity. This is a major economic policy error.

"The reform has been carried out in such an unfortunate manner that it has broken the process of dialogue that existed between the various social partners involved. This has happened just at the time when the Government really needs to tackle a series of labour market reforms, measures that are much more urgent and essential if we are to improve our economic performance"

The effects of simultaneously introducing an increase in the SMI and the legalization of one million immigrants are unknown. This is particularly so considering that we have never witnessed any change in the economic cycle with as high a resident immigrant population rate in Spain as there is now.

The risks entailed by the decision to introduce a big SMI increase and to link its growth to the consumer price index are determined, above all, by the impact this will have on prices and wages in our economy and, therefore, on the economy's competitiveness. The transfer of these increases to collective bargaining agreements (the "displacement" effect) and future pressures to bring the IPREM into line with the SMI, are just two of the worrying consequences that we believe the Government has failed to take into account when implementing this reform.

The Government has not considered the option of different minimum wage levels either, which would involve establishing special minimum wages for groups that are at greatest risk of becoming unemployed.

Furthermore, the reform has been carried out in such an unfortunate manner that it has broken the process dialogue that existed between the various social partners involved. This has happened just at the time when the Government really needs to tackle a series of labour market reforms, measures that are much more urgent and essential if we are to improve our economic performance. Placing the emphasis on raising the minimum wage is to completely misread current needs with regard to labour market reform.

Reform of collective bargaining negotiations or redundancy costs, or the creation of a more efficient and rational unemployment benefit system, are examples of much more ambitious and difficult measures that must be taken. Such measures require a healthy dialogue among the various social partners involved, a dialogue that the Government has already exhausted.

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[1] The theoretical details are outlined in Dolado, J. J., Kramarz, F., Machin, S., Manning, A., Margolis, D. and Teulings, D. (1996), The Economic Impact of Minimum Wages in Europe. Economic Policy. October, pp. 318-372.

[2] Newmark, D. and Wascher, W. (1995), The effects of Minimum Wages on Teenage Employment and Enrollment: Evidence from Matched CPS Surveys. National Bureau of Economic Research. Working Paper no. 5092.

[3] Bank of Spain (2005), Informe trimestral de la economía española ("Quarterly Report on the Spanish Economy"). Boletín Económico. January

[4] Machin, S., Manning, A. and Rahman, L. (2002), Where the Minimum Wage Bites Hard: the Introduction of the UK National Minimum Wage to a Low Wage Sector". Centre for Economic Performance, London, Discussion paper, n° 544.

[5] Dickens, R., Machin, S. and Manning, A. (1999), The effects of Minimum Wages on Employment: Theory and Evidence from Britain. Journal of Labor Economics, Vol. 17, n° 1.

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