Technical Note on the Increase of Minimum Wages in Romania

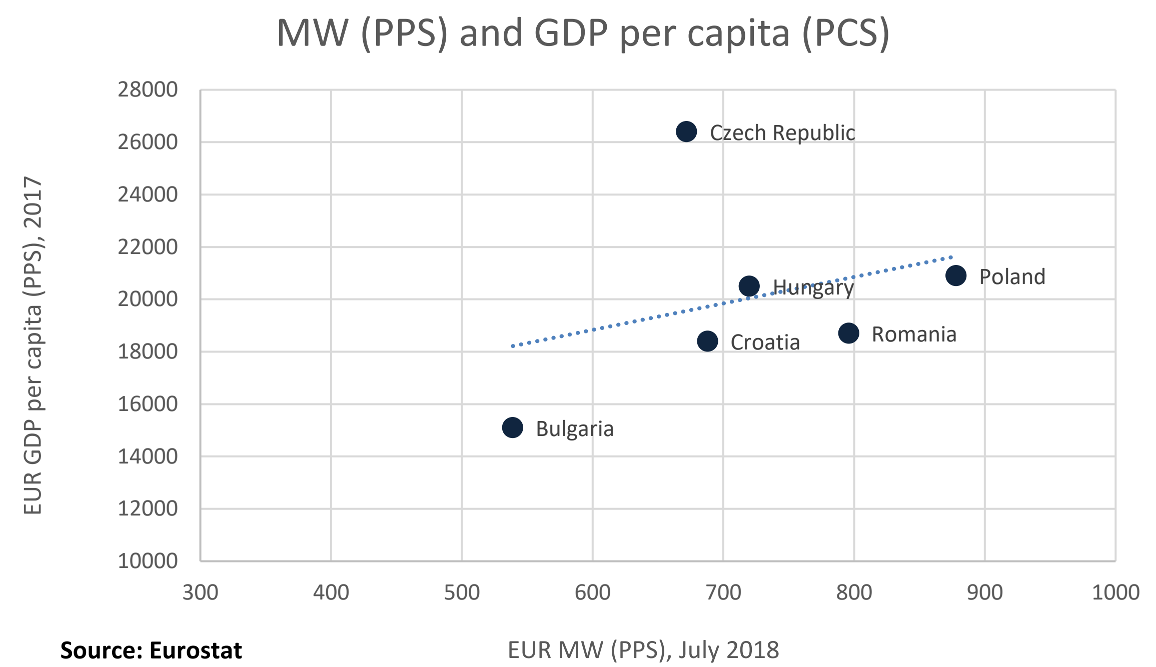
14 November 2018

Since 2012, an aggressive minimum wage (MW) policy has pushed up the level of MW from the equivalent of EUR 160 to EUR 410 in 2018. Current plans envisage further increases, to the equivalent of EUR 450 and EUR 500 respectively, for the holders of a university degree, starting December 2018. And MW could reach EUR 520 and EUR 580 for the holders of a university degree by October 2020. So far, MW rose at an annual rate of 21% over a 6-year time-span. At the moment, the economy enjoys record low unemployment and decent economic growth but any MW policy strategy should be geared in such a way as to hold across economic cycles. Looking forward, fixing the MW to 45% of the average wage, as proposed by the authorities from 2020 onwards, could have adverse implications for Romania's labour market and its future economic development. At this point, several considerations are worth mentioning:

- By looking at the recent wages-labour productivity relation, there appears to have been some scope for MW increases until around 2017. But, since 2017, total labour compensation growth has outpaced labour productivity. For economic policy a key issue is how far the MW can be further increased without starting to have adverse effects on employment and competitiveness. Research has shown that, in practice, identifying "ex-ante" the so-called ''tipping point'', has been rather challenging. However, upskilling a large part of the labour force at 21% per year for such a long period of time is bound to create imbalances across the domestic labour market, as Romania's value-added chains become more integrated with the EU and, thus facing an increased regional competition.

- Across the region, barring Bulgaria, MW levels are clustered around the EUR 470 level (i.e. Bulgaria: EUR 260, Czech Republic: EUR 470, Croatia: 470, Hungary: EUR 450 and Poland: EUR 480. Eurostat, July 2018). Starting with 2019 Romania will have the higher MW in the region for the employees which hold a university degree. But, purchasing power is different across countries so, a more suitable way of directly comparing MW levels across the region would be to express them in purchasing power standards (PPS). In July 2018 Romania had the second highest MW in the region expressed in PPS/month, EUR 800, after Poland (Bulgaria: EUR 540, Czech Republic: EUR 670, Croatia: EUR 690, Hungary: EUR 720 and Poland: EUR 880). The existing discrepancy between the ratio of MW in PPS to the

GDP/capita in PPS across the region suggests Romania's MW might be already too high, especially given the structure of both the economy and that of the labour market contracts



Source: Eurostat

(see next point).

- ➢ Long-run productivity increases depend on capital investment, which is itself, partly, an outcome of past wage growth episodes. The pass-through effects from the MW to the entire wage structure is important and the recent domestic trend clearly shows the limits of the MW increases. This indicates that the cost of labour might already be too high in Romania, especially given the existing level of infrastructure development, proximity to core EU markets, overall employers' costs, etc., when compared to other EU countries in the region.

- ➢ A too high MW would have an asymmetric impact across Romania's regions, disproportionately affecting low-wage industries. As a result, going beyond the ''tipping point'' with further MW rises, could actually decrease employment – as some labour intensive low value-added industries become uncompetitive – thus lowering economic growth. Or, it could increase the number of employees which pay ''envelope'' wages. The existing structure of the labour contracts distribution in Romania is extremely skewed towards the MW level contracts. According to ''Monitorul Social'', in early 2018 almost half of the labour contracts were set at the MW level (out of which, over 32% of total were full time contracts). This suggests that, if any form of wage indexing were to be applied to MW, it should be to the median and not to the average wage. Even when MW are indexed to average wages, like in the Netherlands, there are escape clauses that prevent the building up of disequilibria in the labour market. Developed countries that index to average wage tend to have less than 10% of labour contracts at the MW level.

- Indexing MW to median wage is a superior policy compared to indexing it to average wages. If the MW is indexed to the average wage, as with the current authorities' proposal, increases in MW would push up average wages, which, in turn, would lead to further increases in MW and so on. The result is that, in time, almost all labour contracts would be clustered around the MW level. This is what we already observe today. A continuation of this process would render Romania's economy uncompetitive in the near future by limiting the flexibility of wage adjustment in the labour market. In contrast, median wage moves independently of the minimum wage. Moreover, the median is much better suited for skewed distributions, which Romania currently has, compared to the average.
- Ideally, MW should be set in a collective bargaining processes, i.e. between employees and employers across industries. This would reflect much better the labour cost particularities of specific industries, while preserving their overall competitiveness.

To sum up, although in practice it is rather difficult to identify the level at which the MW starts to have adverse effects on the economy, an informative judgment tends to indicate that the current policy of MW might have outlived its usefulness. Labour productivity has been falling behind wage growth for almost a couple of years now. MW expressed in PPS is the second highest in the region. This will, sooner rather than later, impact companies' operational decisions with a direct repercussion on employment. There is an extremely high concentration of labour contracts around the MW level, which, on the assumption of a continuation of a current MW policy, could only grow larger. This trend will accelerate if MW were to be indexed to the average wage. All this would amplify the costs of labour market correction on the downward path of the economic cycle, when this would, inevitably, occur eventually.