



Palestine Economic Policy Research Institute (MAS)

The Effects of a PNA Minimum Wage Policy

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The Palestine Economic Policy Research Institute (MAS)

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

Mission

MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

Strategic Objectives

- ♦ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ♦ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ♦ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ♦ Disseminating up-to-date socio-economic information and research results.
- ♦ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ♦ Strengthening economic and social policy research capabilities and resources in Palestine.

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Foreword

This study constitutes a detailed analysis of the positive and negative macro-economic effects which the introduction of minimum wage legislation can bring to the Palestinian economy. Moreover, MAS researchers do not limit their investigation to the economic aspects of minimum wage legislation only but also examine its potential social consequences. In order to evaluate the probable socio-economic results of minimum wages in the Palestinian Territories, the study considers the effects on employment, trade, government spending, investment, prices, consumption, and welfare.

In recent years, minimum wage legislation has attracted growing policy-oriented and academic interest from various stakeholders, such as trade unions, governments, employers, economists, and economic researchers. International experience shows that the adoption of minimum wages usually leads to considerable positive or negative outcomes, which provoke the above-mentioned attention. The primary objective of minimum wages comprises of assuring protection for low-wage workers and groups of workers with low bargaining power from employers' exploitation. Taking into consideration the dire state of the Palestinian labor market and the Palestinian economy in general, as a result of the Israeli occupational practices, the importance of investigating the potential positive effects of such legislation on the Palestinian economy are only self-evident.

This study utilizes primary and secondary data in order to develop a Computable General Equilibrium model, in addition to reviewing the experiences of developed and developing countries around the globe, to draw solid quantitative conclusions about what effects minimum wage legislation can bring to Palestine. The ultimate goal of this approach is to stimulate a nation-wide debate about the significance of minimum wages. Furthermore, with the publication of this paper, MAS hopes to provide policy-makers with the necessary theoretical and empirical knowledge to adopt the most appropriate legislation in this regard.

In the event of the release of this study, we would like to thank all those who contributed to the project. In addition to the main research team, we would like to express our gratitude to the participants in the workshops, whose input proved of crucial importance for the completion of the study.

Next, we would like to offer our gratefulness to the reviewers of this paper. Also, we would like to thank Dr. Numan Kanafani for his great assistance. Last but not least, our thankfulness goes to Friedrich-Ebert-Stiftung (FES), whose generosity made this project possible.

Dr. Samir Abdullah
Director General

Executive Summary

Minimum wage policies have attracted significant attention from trade unions, governments, and private-sector agents in numerous industrial countries, in addition to provoking the academic interest of economic theoreticians and institutions. This interest from various parties originates from the usually considerable positive or negative effects from the introduction of minimum wage legislation. Because of the high proportion of wage-workers, besides an increase in poverty in many countries, voices calling for the need to implement a minimum wage multiplied.

The main objective of this study is to analyze the potential macro-economic effects of adopting minimum wage legislation in the Palestinian Territories. In addition to examining international experiences, the study also seeks to investigate the socio-economic consequences of introducing a minimum wage on the level of overall economic activity, with special emphasis on determining the economic sectors which will be affected. The core of this paper focuses on the impact of minimum wage on exports and imports, welfare, consumption, and prices, as well as on the employment level (skilled and unskilled labor) and government spending and investment.

The methodologies used in this study consists of collecting data from primary and secondary sources, and reviewing the experiences of other – developing and developed – countries in implementing minimum wage policies. The study also employs secondary sources, such as data for the year 2008 and reports from PCBS, in order to develop a Computable General Equilibrium (GEM) model to estimate the effects of the adoption of minimum wage legislation on the macro-economic indicators in the Palestinian economy. In specific, the authors use the data to construct a 21x21 Social Accounting Matrix (SAM) for the economy.

The International Labour Organization (ILO) defines ‘minimum wage’ as “the minimum amount that must be paid to the majority of the workers of a country, generally on an hourly, daily or monthly basis and which is ideally fixed in such a way as to cover the minimum needs of the worker and his/her family, in light of the prevailing national economic and social conditions”. Minimum wage legislation primarily aims at providing protection for low-wage workers and groups of workers with low negotiating power in order to avoid their exploitation by employers. Such favorable development will, then, assist in the establishment and

enhancement of a fair wage structure in the labor market and will help in poverty alleviation by securing an acceptable minimum standard of living for low-wage workers and their families. Motives that justify the minimum wage legislation include the protection of vulnerable categories of workers and poverty reduction, ability to cover workers' basic needs, achievement of fair competition, and application of internationally accepted labor standards and conditions.

Minimum wage legislation covers the unskilled or low-skilled workers, workers in professions where labor supply exceeds labor demand, workers who are not organized in trade unions and who lack the power to influence the level of their wage through collective negotiations with employers, workers in the informal sector, and workers with unfairly low wages due to discrimination on the basis of sex, age, race, nationality, disabilities, or any other reason which prevents freedom of mobility and choice.

The application of minimum wage attracts both supporters and opponents. One needs to consider both the social and economic aspects of minimum wage legislation to obtain the full picture. With regard to the impact of minimum wages on employment, economic labor-market theories predict that the adoption of such legislation will lead to loss of jobs. On the contrary, some economists point out that the introduction of minimum wages will affect workers positively by canceling the comparative advantage of some employers, thus increasing competitiveness and encouraging employees to work harder and increase their productivity in order to preserve their jobs, which will boost overall workers' ethics. Others consider that the application of minimum wages will push employers to select their workers more carefully, creating a more efficient workforce, and to improve their management practices to receive a higher return on labor. Moreover, the implementation of minimum wages will accumulate additional income, which will raise private consumption and stimulate the economy.

The net effect of applying the minimum wage on poverty, income distribution, and social welfare will depend on the elasticity of demand for work, as well as on the social unit's structure and the social security system. Moreover, the adjustment of wages in the informal sector makes the impact of minimum wages on income distribution ambiguous. However, the total effect depends on the competition in the labor market, in addition to the difference between the minimum wage and the wage rate in the market.

The ILO proposes six criteria which a country should consider when setting its level of minimum wage: the needs of workers and their families, the general level of wages, living expenses and the changes that occur to them, social security payments, standard of living for other social groups corresponding to the weak employment, and economic factors, including the requirements for economic development. Moreover, the available literature suggests two more criteria for determining the level of minimum wages: the poverty line and the average wage in the local economy. Historically, countries' choice of main factors for calculating the minimum wage level varied widely, depending on the specific nature of the economy and the balance between the main objective of this legislation – assuring a basic standard of living – and other economic, social, and political aims.

The patterns used to apply minimum wages can vary too but fall into two main categories: through government legislation or through collective bargaining. Overall experience shows that the degree of participation of all parties to production in determining the minimum wage level plays a crucial role in providing balanced and predictable effects, which take into consideration the interests of all concerned groups. The possible methods of setting minimum wages divide into four categories: universal minimum wage for the entire economy or for a geographic region in a country determined by the government, minimum wages by economic sector and type of work determined by the government, universal minimum wage for the entire economy or for a geographic region in a country determined through collective bargaining among the parties to the production process, and minimum wages by economic sector and type of work determined by collective bargaining among the parties to the production process.

The most significant bodies in calculating the level of minimum wages include the legislative authority, the executive authority, councils with authority to issue effective recommendations, and councils with authority in the final decision-making. The participation of workers and employers in minimum wage legislation decision-making plays a crucial role because these parties have the necessary knowledge of the needs of laborers and the nature of and challenges ahead of each industry, respectively.

Recent Palestinian legislation has already tackled the issue of wages. Articles 86, 87, and 88 of Labor Law No. 7, ratified in 2000, provided for the establishment of the Wages Committee and the formulation of its objectives. However, ten years later, the Wages Committee has not been established yet, which leaves wages entirely to the effects of market mechanisms. Thus, in case of implementing minimum wage legislation to

the Palestinian Territories, the unskilled workers will constitute the main beneficiaries in terms of social protection.

The last ten years have been extremely tough for the Palestinian population and economy. Al-Aqsa Intifada, the electoral victory of Hamas, the split between the West Bank and the Gaza Strip, the Separation Wall between the West Bank and Israel, the Israeli government's closure policy on the Palestinian Territories and severe economic blockade on Gaza, and the general environment of political instability and human suffering produced a dire economic situation: decreasing wages and income per capita, a rapid rise in the poverty rates, and a dangerously high rate of deindustrialization. By increasing labor supply to the domestic economy, the closure policy imposed by the Israeli government could have even benefited the Palestinian economy (at least from a neoclassical perspective). Things, however, went differently.

In general, Palestinian agricultural workers receive about one-third, NIS 50-60, of the Israeli minimum daily wage for an eight-hour work day. In the industrial zones and in settlements, workers earn up to NIS 80-120, or nearly two-thirds of the Israeli minimum wage. One can easily conclude that setting Palestinian minimum wages to the Israeli equivalents does not constitute a reasonable decision due to the drastically different economic conditions in the two entities. Moreover, the model which this study uses divides the labor market by the level of skills, not by sector.

One has to recognize the two-fold nature of the potential effects produced by a minimum wage. On the one hand, from a neoclassical perspective, minimum wage policies may lower firms' labor demand as far as it gets fixed above the competitive equilibrium level. On the other, from a Keynesian perspective, it might stimulate aggregate demand (and thus output and employment) so long as two conditions are met. First, the minimum wage acts as a transfer from lower- to higher-propensity-to-consume agents and, second, the economy is wage- rather than profit-driven. To put this second condition differently: the imposition of a minimum wage may spur consumption but discourage investment and it remains unclear a priori what happens to aggregate demand (and thus output and employment). The co-existence of these different potential effects makes a purely neoclassical and a purely Keynesian model useless. Rather, one has to build a somewhat 'mixed' model in order to disentangle the possible neoclassical and Keynesian consequence of minimum wage legislation, which this study does.

The study comes to the following conclusion: however appealing, the simple imposition of a minimum wage paid to unskilled workers on Palestinian firms would not work. The neoclassical effect (higher wages reduce labor demand and output) clearly outweighs the Keynesian effect (higher wages boost aggregate demand and output).

The foregoing, however, does not imply that the introduction of a minimum wage constitutes a necessarily bad idea. Since imposing this burden to the domestic enterprises is unreasonable, the question becomes who has to pay for the minimum wage. This study offers a better alternative to subsidize those enterprises which will have to pay a minimum wage to their unskilled workers. In this way, domestic firms will not have to bear the obligation of financing this policy, and the above-mentioned Keynesian effect will dominate. Obviously, one cannot expect this policy to put the Palestinian economy on a sustainable growth path, which requires the free movement of people and merchandises in order to lower transaction costs and improve the investment climate. Nonetheless, this legislation may improve the currently tough situation of the unskilled workers without compromising firms' profitability.

Finally, the authors would like to stress that this simulation produces the desired results only if the minimum wage level is not too high. An increase in the current level of the average wages of more than 5 percent will be counterproductive as the neoclassical effect will once again overweigh the Keynesian one.