

## Economic Analysis

## BBVA Research discussion points on the minimum wage

- **It would not be advisable to raise the minimum wage until better mechanisms for combating informal employment are in place**
- **Before any debate about the convenience of increasing the minimum wage, its use as a benchmark for a significant number of prices and tariffs would have to be eliminated**

There has been an intense discussion in Mexico in the last few days about the proposal to increase the minimum wage. We would like to contribute our thoughts to this debate.

The effects of an increase in the minimum wage are one of the most studied subjects in the economic literature. There is a theoretical framework around this issue, as well as a large number of empirical studies, particularly in the case of the United States.

Above and beyond this discussion, we should point out that the only way of increasing workers' wages in a sustained manner is by improving productivity. This ought to be underlying this debate in Mexico. In recent decades productivity has not increased in Mexico; in fact, in some years it has even deteriorated. The structural reforms approved by Congress during the current administration should help. The government's expressed goal of reducing informal employment would also contribute to achieving this. Perhaps the most important factor is to raise the level of human capital by improving the educational system.

In conditions of perfect competition as described in text books, i.e. when neither corporations nor workers have market power, setting the minimum wage above the market equilibrium means jobs are lost. That is, a number of workers will get a higher wage at the expense of others losing their jobs. This happens because at the level at which the minimum wage is set, there is an excess of labor supply.

Nevertheless, as market failures appear, in which corporations have some bargaining power over workers, it is possible to raise the minimum wage and the employment level at the same time. In economic terms there is a transfer from companies to workers who earn the least. But if the increase is quite large, jobs will eventually be lost. For this reason many countries set a minimum wage in their labor legislation in order to provide a minimum standard of living for the poorest workers. Internationally, there is a great deal of evidence that moderate increases in the minimum wage do not translate into lower levels of employment.

In Mexico, there is a constitutionally recognized body, the National Minimum Wage Commission, which is where discussions of this nature should take place and where all the economic agents are represented.

If the minimum wage is increased by more than the annual rate that has been applied every year up to now, this would undeniably have a direct impact on the inflation rate. For this reason, in the event of this measure being considered, it would be a good idea to increase the minimum wage in a one-off move, so that the impact on inflation would only be temporary and price trends would not be perturbed.

In the case of Mexico, there is an additional problem: a large number of prices and tariffs are indexed to the minimum wage. Among these prices and tariffs, some of the most significant are the fines imposed by various levels of government and the monthly installments on a large number of mortgage loans, in particular those

taken out with INFONAVIT. Raising the minimum wage involves an increase in mortgage installments which millions of workers have to make. **Before opening any debate about whether to raise the minimum wage, its use as a benchmark for the above-mentioned prices and tariffs would need to be abandoned.**

Prices and tariffs should not be linked to the minimum wage, in our view, since it is a variable which reflects decisions that are fundamentally political, rather than changes in economic equilibriums. It would be much better if an effort were to be made to change all the existing references to the minimum wage and, instead, use investment units (UDIs, for its acronym in Spanish), for example, which reflect changes in inflation.

In Mexico the minimum wage has fallen steadily in real terms over the last few decades; its value today is 26.2% less than it was two decades ago, once corrected for inflation. More importantly, it has fallen more than productivity. However, it is true that the number of formal workers who only take home the minimum wage has diminished in recent years. For example, in 2000 there were 2.1 million workers who earned the minimum wage, whereas in June 2014 this figure had dropped to 571,000 workers; even so, this is a significant number, although 67% of the new jobs affiliated with the IMSS corresponds to workers earning between one and three times the minimum wage.

But we also need to bear in mind that a possible negative effect of increasing the minimum wage is that it might encourage informal employment. To this end, measures introduced by the government to force companies and workers to take part in the formal economy must continue. **It would not be advisable to increase the minimum wage until there are better mechanisms in place to fight informal employment.**

To sum up, before seriously considering the proposal to increase the minimum wage in Mexico, the reference linking this variable to a large number of prices and tariffs needs to be changed, indexing them instead to the value of investment units. Once this has been done, such proposal could be debated with the aim of trying to correct part of the deterioration in the minimum wage in recent years. Moreover, it is advisable that the increase be done in a one-off fashion in order to avoid affecting the inflation path.

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