Minimum wage in Montenegro – a dangerous concept

What is the minimum wage and why do governments set a minimum wage level? This paper presents background information on this issue with special emphasis on Montenegro. The minimum wage regulations in Montenegro are somewhat different than those in the market economies; therefore, the first part of this paper will present a short overview of the minimum wage policy, its goals and effects, and the second part will focus on the specificity of the Montenegrin case.

What is the minimum wage?

A minimum wage is the lowest level of work compensation secured by law. The purpose of the minimum wage is to protect the employed from exploitation. This wage is usually applied to unskilled adults entering the labor market for the first time. The key objective of the minimum wage is social in nature, to prevent the exploitation of labor and to prevent poverty. The minimum wage should enable workers to have a basic standard of living by ensuring sufficient purchasing power through earned wages.

The first minimum wage regulation was introduced in New Zealand at the end of the 19th century, followed by Australia, and later by Great Britain, in the beginning of the 20th century. As the main objective of the minimum wage was to prevent underpaying workers, its application was initially restricted to a limited number of low-paying sectors or to selected categories of workers, such as women, children and indigenous workers that were considered to be particularly vulnerable.

Opponents of the minimum wage concept claim that it has failed to meet its objectives. One of the arguments against the regulation is that it did not help the poorest of the poor workers (those in the informal sector), as the regulation only covers the officially employed. Another view argues that if the minimum wage were set above the market clearing level, it would have negative employment effects. An additional opinion is that in the globalization process, nation states are forced to compete for foreign investment, and the minimum wage regulation is lowering the attractiveness of a country from this point of view.

Although the key objective of the minimum wage was to alleviate poverty among the lowest paid unskilled workers, it seems that this objective has not been met. The minimum wage regulation introduces heavy distortions to the labor market, does not improve the situation of the poor, and what's more, it actually reduces the number of available jobs. Firms are forced to increase their wage bill and thus they lay workers off. Also, as most regulations imposing a non-market clearing solution, it results in a redistribution of income. In this case it is the redistribution of income from the owner of the firm to workers, which influences firms' decisions on future operations and possible investments.

Minimum wage concept in Montenegro

The minimum wage policy in Montenegro goes beyond the standard provisions described above and has many more far-reaching consequences for the economy that are not commonly found in other countries. Thus, it deserves a closer investigation.

Why is the minimum wage policy different in Montenegro? As mentioned before, the minimum wage was introduced as a social policy measure aimed at protecting the most vulnerable portion of the labor force. Thus the reasoning behind the minimum wage regulation is to protect workers with low qualifications in certain industries in which the salaries are extremely low.

In Montenegro, the minimum wage regulation was introduced in 1990[1] in the framework of the Collective Agreement[2] and is used as a benchmark for setting salaries in the economy. In the Collective Agreement (CA), signed by the Government, Chamber of Commerce and the Trade Union Alliance, the minimum wage is defined as a monthly salary for the simplest, full time work (basically for unqualified workers). Besides this standard provision, the CA contains details on the so-called "coefficient system" that determines how wages are set in the economy. Coefficients are related to specific levels of education and determine the minimum wage for employees with these education levels in relation to the general minimum wage set by law. For example, for unqualified (elementary school only) workers the coefficient is 1 and means that their minimum wage is equal to the general minimum wage. Workers with a 6-month education above the elementary level have a coefficient of 1.2, which earns them at a minimum 20% more than the minimum wage. On the other end of the payment scale, a master's degree has a coefficient of 2.95 and the coefficient for a doctorate is 3.20.

Other provisions[3] of the CA establish additional links between the minimum wage and monthly fringe benefits provided to employees on a mandatory basis:

- Summer allowances are set at a level of 3 minimum wages and winter allowances at the level of 0-3 minimum wages.
- Retirement benefits are set at the level of 6 minimum wages.
- Meal allowances are set to 50% of the minimum wage.

However, not all salaries in the economy are linked directly to the official minimum wage. For example in some companies, such as Telecom, ProMonte, Monet, EPCG, etc. the minimum wage is set at a higher level[4], so that the official minimum wage increases are not binding for these companies. However, this only concerns a small portion of the employed.

Another channel through which the minimum wage influences the total wage bill in the economy has its origins in the unofficial wage accounting practices prevalent in Montenegrin enterprises. It is common practice for employers to pay the official minimum wage along with an unofficial supplement on which no wage-related taxes have to be paid; therefore, the actual earnings of employees are higher than the minimum wage, but they represent a lower cost to the employers since the official tax burden is

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[1] Until 1990, wages were calculated based on the so-called 'wage points'. The workers' assembly determined wage points in socially owned, self-governed companies. Namely, besides the management, the representatives of workers had their input in running the companies. By looking at the company's profits this assembly made the decision on the value of one wage point. Every working position was assigned a certain amount of points, and the salary was obtained as the product of the number of points and the value of the point.

[2] The Collective Agreement contains the detailed regulations with regard to rights and obligations of the employees, specifically with regard to salaries

[3] For details on these provisions, please see Monet 8.

[4] In some cases the minimum wage is 100% higher than the official one.

only levied on the legal, minimum-wage-based portion of the earnings. In this case, increasing the minimum wage results in a higher tax burden for the employers, as they are required to pay taxes on the higher, legally registered portion of the salary; so, even in companies that pay their employees higher than minimum wage, wage expenditures increase following an official increase in the minimum wage.

What are the consequences of the policy in Montenegro?

If we investigate the measures taken by the Government during the last couple of years, we can conclude that no consistent wage policy, especially minimum wage policy, exists. Namely, in the Collective Agreement, it is clearly stated that the minimum wage is to be increased if retail prices experience an increase of 5% and if this is accompanied by an increase in production. However, the law does not specify which production indicator is to be used (GDP, industrial output) or over which period such an increase is to be measured, which in view of the massive fluctuations described in chapter1 is a crucial question. Such a vague statement in the law renders itself to many interpretations. Even though it incorporates economic reasoning behind minimum wage increases (i.e. economic growth), it does so in a very imprecise way, which can easily be taken advantage of by political players.

While it is difficult to judge when the conditions for an increase in the minimum wage are satisfied, it is clear that each of the wage increases that took place in Montenegro were a direct result of immediate pressure from the labor unions and threats of strike, rather than a careful economic debate.

In the beginning of 2002, the Government passed a decision, effective July 2002, to increase the minimum wage by 8.7%, and also announced the intention to increase it further by 18% in 2003. In late February 2003, the Government agreed to increase the minimum wage for education employees by 8% (from 50 to 54€) and to increase the wage coefficients by 10%. Interestingly, the Budget Law for 2003 does not allow for such a large increase in the projected level of 'wages and salaries'; and so it would seem that in view of the marked discrepancies between projections and executions (see the chapter on budget), the budget plan is not very binding in Montenegro.

An increase in the minimum wage would certainly raise wage and salary expenditures in the budget. This, along with an increased consumption in the private sector, will certainly exert upward pressure on prices, resulting in higher inflation (especially for non-tradable), which in turn may trigger union demands to increase the minimum wage. In parallel, due to the described mechanism, the minimum wage increase will also raise the tax burden in the private sector (increase in the tax base) and consequently increase the cost of labor. According to professor Veselin Vukotic[5], "in the fixed exchange rate system (having adopted the euro Montenegro has no control of the level of its currency), without real increase in productivity and economic efficiency, the conflict between the exchange rate (euro) and wage-price cycles must occur, initiated with minimum wage."

The minimum wage system in Montenegro will have other far-reaching negative effects. A relatively high minimum wage as well as the additional regulations that link benefits to the minimum wage has a negative impact on the competitiveness of Montenegrin enterprises. Minimum wage policy also has a negative impact on foreign direct

[5] ISSP internal documents

investments due to the restricted flexibility of the labor market and increased cost of labor.

In summary, the concept of the minimum wage as it has been developed in Montenegro introduces considerable rigidities in the labor market and increases the labor cost thus impeding investment and hindering economic growth. Therefore, we believe that it should be modified to better serve the Montenegrin economy.

The most important policy recommendations regarding future wage policy include:

- Liberalization of wages (dismantling linkages between wages in the economy and the minimum wage) along with the deregulation of the labor market,
- Reduction of the tax burden (the average total labor cost to employer, including the employee's compensation and taxes is 2.3 times higher than the average wage, i.e. for every € 100 of salary, employers have to pay € 130 in contributions and taxes),
- Constraints on future minimum wage growth to correspond with productivity increases.

In the end, a quote by Mr. J. Cooper[6], professor at Boston University, Department for Economics concludes:

"On the surface, arguments in favor of a minimum wage seem quite reasonable. If people aren't paid enough, then simply have the government require firms to pay workers more. This way, workers can earn more and everyone is happier. Of course, if this argument is correct, the government could force firms to pay workers $1 million and everyone in our country would become millionaires. Clearly, there must be something incorrect with this logic: creating such high income out of simple government regulation is too good to be true. That is, once again, there is no such thing as a free lunch."

[6] http://www.bu.edu/econ/faculty/cooper/rcplays/minwage/MINWAGEwebez.htm