

EXECUTIVE SUMMARY

Timor-Leste is in the process of building the pillars of its economic and social policy in which minimum wages (MW) is a key area of focus. The Labor Code established by the UNTAET is in the process of revision and three Boards, pursuant to the Labor Code, have been commissioned, of which one deals with minimum wages. The MW in Timor-Leste was informally set at USD 85 per month or about USD 4 per day by UNTAET. While this has not been legally binding, it has had an important impact on wage setting in the formal sector, including the civil service. Timor-Leste also has serious problems of unemployment, particularly among the youth and in urban areas. In that context, wage policy and bargaining mechanisms are important factors in determining labor market outcomes, though there are of course other key determinants related to the broader macroeconomic and business environments. The government realizes the importance of employment and thus, job creation, especially for youth and ex-combatants is one of the stability priorities.

The intent of the paper is to inform wage policy discussions in light of international and regional experience on wage policy and wage setting mechanisms, and analysis of labor market conditions and wages in Timor-Leste. Data and literature on Timor-Leste are extremely sparse and very little information is available on bargaining mechanisms, growth of trade unions and impact of key demographic variables on labor force participation. The major source for this paper is the 2002 Poverty Assessment (PA), which was based on the Timor Living Standards Survey (TLSS). In addition, it also uses comparative information from other countries, in order to inform the discussion for Timor-Leste. The paper is divided into three parts. Part I is a discussion of the role, prevalence and importance of MW, followed by a review of international experience on the effects of MW on employment. Part II attempts to understand labor market conditions and wages in Timor-Leste that have a bearing on MW setting. Part III puts forth some policy options with regard to MW for Timor-Leste in the context of unemployment.

Prevalence and Levels of MW: MW is considered to be an important social policy tool and its potential effects on the reduction of poverty and inequality are often cited as important reasons for the enactment of MW laws and their effective enforcement. Thus, most countries have, at least in principle, some laws relating to MW. Minimum wages in the 1990s ranged from USD 5.45 per month in the Kyrgyz Republic to USD 1661 per month in Denmark. Richer countries have a higher MW as is evidenced by the graph in Figure 1. However, MW structures are not uniform and variations are based on the applicability of the laws. These variations could stem from a number of factors including age, region, sector, industry and occupation. Often in developing countries, the agricultural sector and self-employed workers are excluded from MW. Since it is difficult to enforce MW in the informal sector, informal workers are also often excluded. In practice, even when MW laws apply to agricultural and informal workers, it is almost impossible to enforce them.

The ratio of average wages to MW is often used as a guide to the importance of MW. The higher the ratio the better is the relative position of minimum wage workers, but also the larger its potentially harmful employment effects or what is known as the “bite” of the minimum wage. In addition, other indicators such as ratio of average to median wages are also used to assess the impact of MW.

Effects of MW on employment and lessons from empirical evidence: The effects of MW on employment is a controversial subject, and empirical evidence is largely based on research from OECD countries, and even this is far from either unequivocally supporting, or clearly refuting, the received wisdom from economic theory. The most obvious potentially positive effect that MW can have, and the reason for its existence, is that it will raise incomes of the poorest workers and thus protect them from vulnerability. However, there are reasons to believe that MW may not always have this positive outcome and may actually hurt the very workers it seeks to protect. The most widely studied impact of MW is on overall employment, since economists fear that it may introduce rigidity in the labor market, causing employers to drop those workers whom they have lower demand for or whom they can afford to lay off. Labor market impacts of MW are most often judged in the context of a number of prevailing conditions, including unemployment rates, size of the formal sector, wage inequality prior to setting the MW, overall skill levels in the country, conditions of work, including workers' earnings, average number of hours worked per worker, extent of youth employment and poverty.

The empirical evidence shows that:

- A moderate MW does no harm either to employment or competitiveness and certainly improves the earnings of those workers who are at the bottom of the scale and for whom the demand exists, but if MW is raised beyond a moderate level, it has adverse employment effects, both in terms of driving workers into the informal sector, and laying off formal workers. These effects are particularly pronounced for workers in small firms in developing countries.
- Even when there are no disemployment effects of MW on the general workforce, there is a negative effect on youth employment, and a sub-minimum wage for youth to a large extent ameliorates these disemployment effects on younger workers.
- MW could positively impact poverty if some conditions are fulfilled such as
 - if higher MW result in higher uncovered sector wages;
 - the rise in uncovered sector wages is high enough to push some of the population out of poverty; and
 - the number of those come out of poverty exceeds those who fall into poverty due to the MW.

Setting a Prudent MW: There are several factors to consider while setting the MW in addition to the minimum wage/average wage ratio, overall labor market conditions and growth and competitive-ness of the economy discussed in the previous section. These include:

- a. Balancing social with economic objectives
- b. Sectoral coverage of the MW
- c. Enforceability and compliance
- d. Issues of growth and competitiveness
- e. Bargaining mechanisms

Relevance to Timor-Leste: As we have seen from the foregoing discussion, labor market conditions and other factors such as demographic trends, particularly unemployment rates, are key

to the impact of the MW. Following is a short overview of labor market characteristics and wages in Timor Leste which are most relevant to MW policy formulation.

- Very high youth unemployment in urban areas and an increasingly young workforce.
- Low skill levels as proxied by average years of schooling and having a bearing on labor productivity. Limited new evidence from the construction sector shows that firms may be bringing in foreign workers for higher-skilled jobs.
- Dominant agricultural sector and subsistence farming, with a very small proportion of the workforce employed in formal wage labor. The subsistence farmers would be unaffected by the MW if it were to be formalized, and since are the most vulnerable workers, the potential social benefits of such a formalization would be lost for them.
- Very high informal MW/average wage ratio and even higher MW/median wage ratio.
- High levels of wage inequality in urban areas. At least one-quarter of the poorest urban workers would suffer if the MW was formalized, while the top 10 or 20 percent would feel no effect at all, thus, risking increased unemployment, inequality and poverty in Timor-Leste.
- Existing informal MW is unlikely to be binding since one-fourth of urban workers earn below the MW. Thus, the market determined minimum is lower than the informal MW.
- More than half the unskilled workers earn below the informal MW and are most likely to be negatively affected by any formalization. In a scenario where manufacturing industry is very limited, unskilled workers' supply outweighs their demand and they would be at greatest risk of being laid off if a MW is enforced.
- Limited evidence available suggests that wages actually paid are falling in urban areas.
- Low institutional capacity to enforce MW may create problems of governance if a MW formalized and unable to be enforced, thus frustrating the poorest workers and youth.
- Some evidence of better wages for foreign workers in higher-end jobs in the construction industry, while unemployment rates are higher for educated Timorese.
- Trade union movement is in its formative phase and may in coming years exert some influence over wage setting and enforcement in formal enterprises.
- Data gaps in Timor-Leste are substantial and this analysis is based on 2001 data, which is already out of date. In the absence of recent data, no clear and definitive recommendations can be made.

Conclusions: The informal MW in Timor-Leste, set at USD 85 per month is unlikely to be enforced since the vast majority of the workforce is employed in subsistence agriculture and in the informal sector – sectors impossible for monitoring and enforcement. Thus, the positive effects of the MW in the form of raising incomes are likely to be restricted to skilled workers in formal enterprises – the smallest and most elite sections of the workforce. Second, since institutional capacity to ensure enforcement is low, the chances in that scenario are that the MW may be more of a deterrent to employers who want to expand businesses, than a protection for poor workers. A large proportion of all *wage workers* (not all workers) receive wages below the informal MW. This indicates that the informal MW is set higher than the prevailing wage for the existing skill level of the workers and for the existing demand in wage work. The discussion in previous sections of this paper has brought out the importance of a policy that generates employment, encourages private investment and protects the poorest (and not the best off) workers.

Recommendations: There are three policy routes that Timor-Leste can follow. The first is to formalize the existing informal MW of USD 85 per month. The second is to formalize the MW at a lower level and the third is to leave the MW flexible. Whichever policy route Timor-Leste proceeds along, its foremost requirement is a strong statistical base for the determination of appropriate wages and strong institutional capacity to enforce legislation and arbitrate disputes. In particular, strengthened the arbitration capacity of the MWB and the legal system on industrial relations would greatly facilitate informed choices which would in the long run, have positive effects on both workers and enterprises. Within existing data constraints, the results of this analysis present the following recommendations.

1. The preferred option for Timor-Leste in the short-term at least, would be to have a flexible MW.
2. If on the other hand, the political determination is that a MW needs to be set, it is critical that it be set on par with neighboring countries or countries with the comparable skill-income mix, in order to avoid seriously negative impacts on overall employment, and investment, and even more negative effects on youth and small firm employment.
3. In case MW has to be set, a sub-minimum wage for youth would be highly advisable.

THE LABOR MARKET IMPACT OF MINIMUM WAGE POLICY: THE CASE OF TIMOR LESTE IN COMPARATIVE PERSPECTIVE

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Rationale

Timor Leste is in the process of building the pillars of its economic and social policy by reforming several critical areas like civil service, vocational education and training and labor market institutions. Policy discussion on minimum wages (MW) is a key area in such a process. The Labor Code established by the UNTAET is in the process of revision and three Boards, pursuant to the Labor Code, have been commissioned, of which one deals with minimum wages. Timor-Leste also has serious problems of unemployment, particularly among the youth and in urban areas. Wage policy and bargaining mechanisms are important factors in determining labor market outcomes, though there are of course other key determinants related to the broader macroeconomic and business environments.

The intent of the paper is to inform wage policy discussions in light of international and regional experience on wage policy and wage setting mechanisms, and analysis of labor market conditions and wages in Timor-Leste. Data and literature on Timor-Leste are extremely sparse and very little information is available on bargaining mechanisms, growth of trade unions and impact of key demographic variables on labor force participation. The major source for this paper is the 2002 Poverty Assessment (PA), which was based on the Timor Living Standards Survey (TLSS). In addition, it also uses comparative information from other countries, in order to inform the discussion for Timor-Leste.

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