THE LABOR MARKET IMPACT OF MINIMUM WAGE POLICY:

THE CASE OF TIMOR-LESTE IN COMPARATIVE PERSPECTIVE

World Bank
Timor-Leste

THE LABOR MARKET IMPACT OF MINIMUM WAGE POLICY: THE CASE OF TIMOR-LESTE IN COMPARATIVE PERSPECTIVE [1]

BY

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WORLD BANK

JUNE 26, 2004

[1] I am grateful to Philip O'Keefe for overall guidance and detailed comments on earlier drafts, to Kathleen Beegle and Kaspar Richter for access to data on East Timor, Jan Rutkowski for comments, discussion and data and Victor Sulla for compilations of aggregate data on wages. Finally, Elisabeth Huybens' valuable technical comments and on-the-ground sense have also enriched this paper.

TABLE OF CONTENTS

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 ceratinly 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

Maitreyi Bordia Das

Draft June 26, 2004

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.

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.

PART I: IMPORTANCE OF MINIMUM WAGES AND REVIEW OF INTERNATIONAL EXPERIENCE

MW is one of the more politically charged subjects in labor policy. It is used by governments for both economic and social policy objectives. Supporters of MW argue that it raises the wages of poor low-income earners while opponents fear its effects on employment, since they argue that it sets an artificial wage floor unrelated to the real labor market conditions. The empirical evidence shows that MW in and of itself is neither the boon nor the blight that it is made out to be, and what really matters is the level it is set at, the development level and priorities of the economy, the level of unemployment etc. A moderate MW in effect does no harm, and can do some good, to workers and the economy. On the other hand, a high MW can have the opposite effect, of increasing unemployment and reducing the competitiveness of an economy. Part I of the paper has three sections. Section 1 deals with the prevalence and levels of MW as well as the indicators used to assess its impact on the economy. Section 2 gives guidelines and the factors to consider while the setting a prudent MW. The international evidence on the effects of MW is the subject of Section 3.

1. Minimum Wages: Prevalence and Levels

This sub-section is a review of MW "regimes across countries. It discusses

- **a.** Prevalence of MW – How common are they?
- **b.** Variations in the structure of MW
- **c.** Range of absolute levels of MW
- **d.** Judging the level of MW – high, medium and low – based on indicators.

a. How common are minimum wages?

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. OECD countries, with their historically strong labor movements have had MW laws that are strictly enforced. Similarly, countries with a Soviet legacy too have had stringent MW laws, but variation across states in enforcement and coverage recent years.

Most countries in East Asia too have a MW (except notably Malaysia, which has other worker protection laws and mechanisms including a provident fund system). Indonesia has an intricate system of MW which differ by sector and region, and MW there doubled in real terms between 1988-95, following criticism that Indonesian workers were being done out of the gains of economic development[2]. Most countries in South Asia and Africa also have MW legislation. How far and in which sectors MW are enforced depends on a number of factors and ultimately plays a large role in determining the real impact of the MW on various sectors of the economy.

[2] Edwards, 1996

b. Variations in MW structures

A key set of issues in MW policy relates to legal coverage of MW, and the extent to which there should be a single or multiple MWs for covered sectors or social groups. MW are sometimes national and applicable to all sectors, but more often, they vary by a number of factors. These are:

- *Age* – A number of developed and developing countries, including Portugal, New Zealand and India have sub-minimum wages for young workers.
- *Region* – Countries like Austria, Finland, Germany, Ireland and Indonesia have regional MW.
- *Industry and Occupation* – Countries like Austria, Denmark, Finland, Ireland, Italy, Norway, Portugal, Sweden, Switzerland and China have separate MW for different industries and Finland, Greece, Ireland, Sweden have occupational MW.

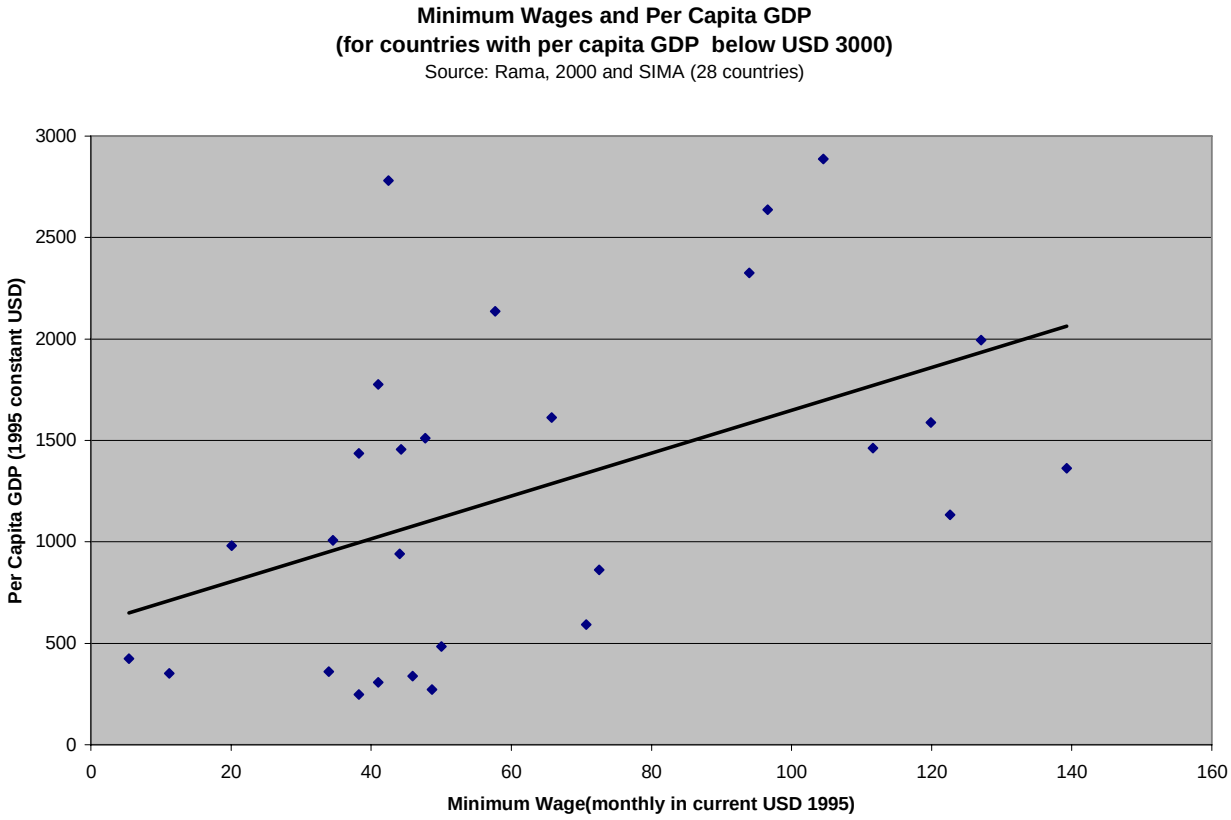
Often in developing countries, the agricultural sector and self-employed workers are excluded from MW. Since it is difficult to enforce MW in the informal sector, informal workers are also often excluded. In practice, even when MW laws apply to agricultural and informal workers, it is almost impossible to enforce them.

c. Absolute levels of minimum wages

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, which shows the positive relationship between MW and GDP per capita.

In the 1990s Pakistan had the per capita GDP of USD 484 – closest to the current level of Timor-Leste (USD 472) and had a MW of USD 50 (Appendix Table 4). All countries which had per capita GDP below USD 500 in the 1990s had also MW below USD 50. These included Bangladesh, Kenya, Vietnam and India. Countries that had a MW close to Timor-Leste's informal MW of USD 85 (ie: between USD 80 and 90) were much richer - Botswana and Uruguay - with per capita GDP of 3654 and 6581 respectively, showing exactly how high Timor-Leste's MW is informally set at, when compared to its level of development. While there are clearly problems in making comparisons of this nature, yet this gives an intuitive understanding of the level of MW of similarly placed countries.

Figure 1



d. Minimum Wages: Low, moderate or high? How do we know?

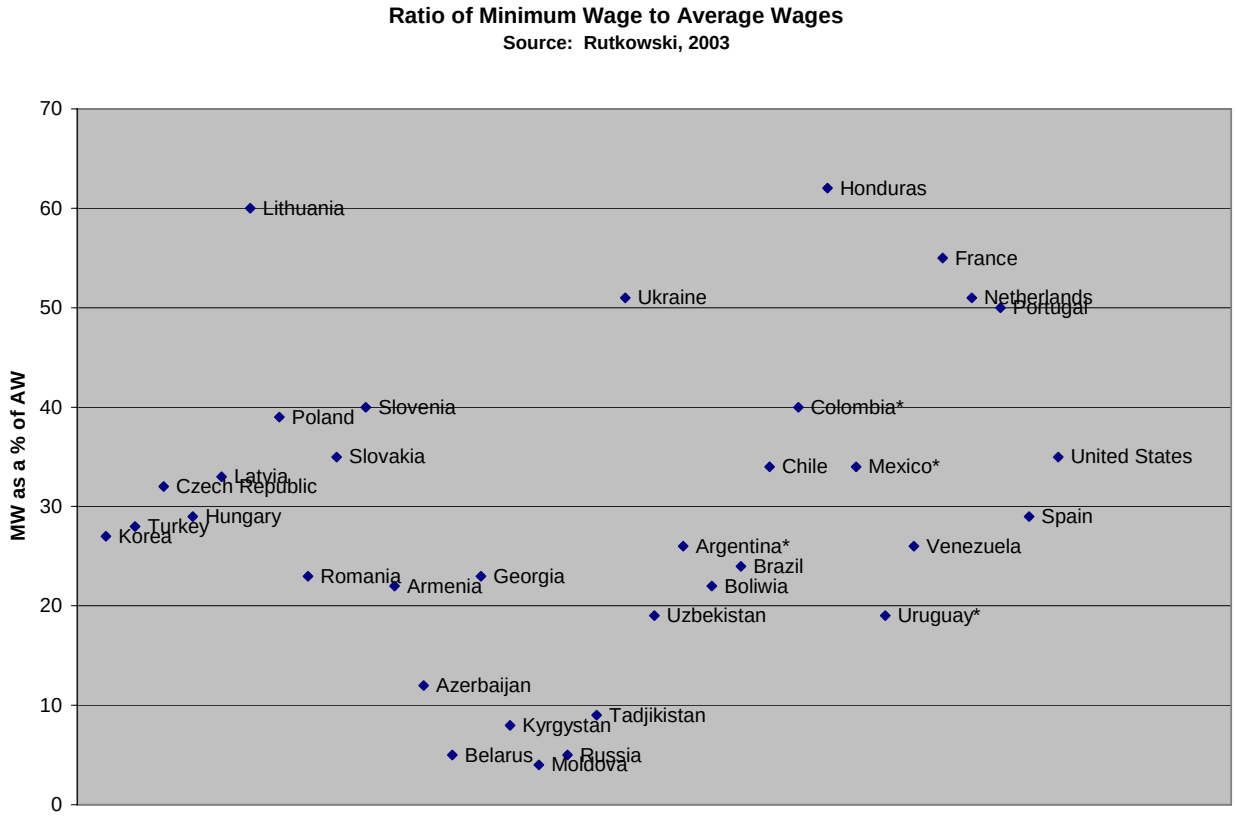
The ratio of average wages to MW is often used as a guide to the importance of MW. The higher the ratio the better is the relative position of minimum wage workers, but also the larger its potentially harmful employment effects or what is known as the "bite" of the minimum wage.

"The minimum wage/average wage ratio is used both to describe the minimum wage system and to guide policy decisions. A decline in this ratio, unless intentional and agreed among social partners, often spurs upward minimum wage adjustments so as to maintain the minimum wage at a fixed level relative to the mean wage. However the *mean* wage, although commonly used, is not the most appropriate reference point for the minimum wage. The reason is that the mean is strongly influenced by changes at the upper end of the wage distribution, for example by he growth of salaries of highly skilled professional workers. As such the mean wage does not reflect labor market conditions faced by low-productivity workers. The *median* wage (which is the wage such that one-half of all workers earn less than it and one-half earn more) is a more relevant benchmark to assess the "bite" of the minimum wage"[3].

[3] Rutkowski, 2003 (pg 4)

Although median wage may be a better indicator, however, for most developing countries, it is difficult to come by data on median wages[4]. Therefore, the ratio of MW to average wage is the more widely used indicator to assess the impact of MW. Later in Part II, we try to assess the importance of the informal MW in Timor Leste using calculations of the median wage.

Figure 2



Although Figure 2 contains mostly OECD countries, yet there are also countries whose per capita income is low. The figure indicates that the ratio of MW to AW ranges from over 62 percent in Honduras to below10 percent in Belarus, Tajikistan, Kyrgyz Republic, Moldova and Russia, with the majority of the countries for which data are available falling between in the 20-40 percent range. MW above this range are mostly advanced industrialized countries. Ratios of 50 percent or more are considered very high and under 20 percent considered low.

[4] Based on available data, the range of MW to median wage in OECD countries is between 20 percent for Mexico to over 60 percent for France.

Table 1: Categorization of minimum wage levels

Minimum wage level	MW as percentage of the average wage
Low	less than 20
Modest	20 – 29
Medium high	30 – 39
High	40 – 49
Very high	50 or more

Source: Rutkowski, 2003.

2. 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. In fact, 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 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. These include:

- Unemployment rates (and where these are not an accurate indicator of the labor market, ***underemployment*** rates). Where unemployment is high (or high in particular areas or sectors), a high MW can deal a blow to low-income, low skill workers.

- The size of the formal sector and the proportion of the workers employed in the non-agricultural sector also key to the effect that the MW can have. Usually MW are only applicable to the formal sector and the rest is "uncovered". If the major share of the population is in the uncovered sector, the relative importance of the MW declines as we have seen in the previous section. Relatedly, if the formal sector and manufacturing employment in the private sector are underdeveloped and the government has an express policy to encourage this sector, then setting the MW too high can jeopardize its development by increasing labor market rigidity. Thus, the existing employment in formal and informal sectors, and in private and public sectors are all important in understanding the impact of MW on overall employment.

- Wage inequality prior to setting the MW, in particular, where a worker actually falls on the wage distribution determines the impact of MW on him/her. Those workers who earn closest to the MW are the most affected by it[5]. Therefore, it is important to know ***what percent of the workers earn below the proposed MW before it comes into force.*** In

[5] Neumark et al, 2000; Maloney and Mendez, 2002.

developing countries, it is likely that agricultural laborers and workers in the informal sector will be earning wages below or at the MW. If a MW raises the wages of these workers through its enforcement or its influence, then it is likely that these low end (often low-skilled) workers may be laid off, thus risking higher unemployment rates. Research shows that even when wages of low-wage workers increase with increases in MW, their hours of work and employment can both decline, and the combined effect may be an overall decline in earned income.

- Overall skill levels of the workforce: This is particularly important for a developing country. If skill levels are low, and MW is set too high, employers will be forced to lay off workers, not hire low skilled workers, or resort to importing workers. Some countries have therefore set different MW for unskilled workers.

- Conditions of work: This includes workers' earnings and average number of hours worked per worker. Where workers' earnings are very low, a MW may seek to increase these earnings and improve conditions of work.

- Extent of youth employment: Research shows that even when the overall disemployment effects are low, the effects on youth unemployment could be potentially high.

- Extent of poverty and inequality: Both quantity and quality of employment in developing countries are key determinants of poverty levels. Here, effects by gender, especially in those countries where female employment is already low, are especially important.

The rest of this section draws lessons from the literature, mainly to enable an evaluation of the effects of MW on employment, so that recommendations can be made in later sections for wage determination in Timor Leste.

a. Overall Employment Effects

In OECD countries the evidence is mixed on the overall employment effects of MW. However, the structure of the economy, means of enforcement, coverage, age-structure of the population are all very important in assessing the employment effects of MW, as we have seen earlier. In developing economies, while the factors determining impact are much the same as in other economies, yet, the contexts are vastly different. ***What appears to emerge with greatest clarity is the fact that a moderate MW does no harm either to employment or competitiveness and ceratinly improves the earnings of thoese workers who are at the bottom of the sacle and for whom the demend exsits*** (see Table 1 for catgeorization of MW as high, moderate and low).

In developing (especially low-income) countries, informal sectors often employ the larger proportion of the workforce, and it is important to assess not only the overall impact of MW on employment, but also its impact in terms of push out of the formal and into the informal sector, and especially for vulnerable groups, such as low-skilled workers, youth, women. ***The empirical evidence on the overall employment effects of increased or high MW in developing countries show that 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. Thus, for instance, Ghana's increasing minimum wage during the 1970s and 1980s led to a reduction of formal sector jobs and an increase in informal sector jobs[6]. In Costa Rica MW increases led to lay-offs of part-time workers, and an increase in the hours worked for full-time workers[7]. In the case of Indonesia, workers in small firms were adversely affected by the MW increases in the 1990s[8].

b. Effects on youth employment

In many developing countries, increasing numbers of young workers are poised to enter the labor market. The effect of MW on youth unemployment thus occupies central place in any policy analysis of MW. The theoretical basis for the assertion that MW will have negative impact on youth employment is that when forced to pay higher wages, employers would be most likely not to hire or to lay off younger, unskilled and inexperienced workers. In many countries therefore, there is a sub-minimum wage for younger workers. Where it is in place, the sub-minimum wage typically ranges from 60 to 80 percent of the overall MW (See Table 3 and Appendix table 5).

Research from developed countries is more prolific on this topic and it confirms the view that ***even when there are no disemployment effects of MW on the general workforce, there is a negative effect on younger workers.*** Moreover, a sub-minimum wage to a large extent ameliorates these disemployment effects of MW on younger workers[9]. Employment effects of MW on younger workers are not easy to come by in the empirical literature on developing countries. However, the case of Indonesia has been relatively well-researched, and here, even when the results show no overall negative effects on employment of minimum wages, the effects on youth disemployment are more clear[10]. Table 3 describes the MW fixing machinery and the policy for young workers with regard to MW for a select group of developing countries. Comparable information for OECD and selected transition countries is provided in Appendix Table 5. It is clear that when there is high pre-existing youth unemployment – either nationwide or in urban areas – policymakers need to be very cautious in introducing a MW. The case for caution is even stronger when demographic patterns indicate a continued high inflow of youth to the labor market.

[6] Jones, 1997
[7] Gindling and Terrell, 2002
[8] Rama, 1996; Atalas and Cameron, 2003
[9] For instance, using data for the US from the 1970s to the 1980s, Neumark and Wascher (1992) found that a 10% increase in the minimum wage caused a decline of 1-2% in employment among teenagers and a decline of 1.5-2% in employment for young adults. They also found evidence that youth subminimum wage provisions enacted by state legislatures moderated the disemployment effects of minimum wages on teenagers.
[10] Rama, 1996; Suryahadi et al, 2000.

Table 2 Minimum wage fixing systems and youth MW rates in selected developing countries

Countries (1)	MW-fixing machinery (2)	Young worker statute (3)	Youth MW as % of adult MW (4)
Brazil	Statutory MW	Adult MW applies to young workers	
India	Fixed by central and state governments	Special rates for young workers	In New Delhi, 75% for young workers aged between 14 and 18 50% for children below 14
Cote d'Ivoire	Statutory MW	Special MW rate to young workers by age	60%: 14-15 old 70%: 15-16 old 80%: 16-17 old 90%: 17-18 old
Mauritius	MW rates are fixed by the Ministry of Labor on the basis of recommendation made by the tripartite national Remuneration Board (WRB)		

Source: Drawn from Ghellab, 1998 Table A1.1

c. Effects on poverty and inequality

The dominant view on the role of MW in poverty reduction in developing countries is that the MW has little effect on poverty due to four main reasons[11].

- Coverage of MW is limited to a small section of workers, typically in the formal sector.
- Poverty lines in developing countries - where the exist - are very low and MW benefits typically do not accrue to the poorest.
- Large fraction of the poor work in the uncovered or self-employed sector.
- High inflation rates make it difficult to set a MW.

However, conditions under which MW could positively impact poverty are if:

(a) Higher MW result in higher uncovered sector wages.
(b) Rise in uncovered sector wages is high enough to push some of the population out of poverty.
(c) Number of those come out of poverty exceeds those who fall into poverty due to the MW.

While evaluating effects on inequality, the effects on the gender wage-gap and differential employment effects on women and men have also to be considered. MW is often touted as an antidote to the gender wage gap, especially in OECD countries. Some studies show that women

[11] Lustig and McLeod, 1996

tend to benefit more from the MW than do men, but the evidence from developing countries is sparse on this subject. Such evidence as there is shows mixed results. In Trinidad for instance, males working in large firms tended to have their wage increased to at least the minimum level, while employers for both large and small firms in some cases responded to the minimum wage by laying off workers. As far as employment effects on women are concerned, an Indonesian study shows significant depression in female urban formal employment due to increases in the MW. [12] Thus, there is more reason to be concerned about introduction of a MW when female employment is already low.

3. Prudent Minimum Wages: What are the Factors to Consider?

In the context of the foregoing discussion, this section lays out some basic principles for prudent MW setting. MW are set through two basic mechanisms – statutory MW set by governments or MW set through collective bargaining agreements (See Appendix table 5 column 2). These mechanisms are not mutually exclusive and often MW are set statutorily in consultation with unions and employers associations. 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 and MW

a. Balancing social with economic objectives

ILO policy regarding minimum wages is presented in a number of ILO Conventions and Recommendations, the most recent one being the Minimum Wages Convention (No. 131) with special reference to developing countries, which was adopted in 1970. By then it was evident that collective bargaining and other non-statutory means of wage determination were not spreading as widely and rapidly as the ILO might have hoped for. Article 3 of the Convention requires that the minimum wage fixing authorities take into account the following elements:

(a) the needs of the workers and their families, taking into account the general level of wages in the country, cost of living, social security benefits, and relative living standards of other social groups;
(b) economic factors, including the requirements of economic development, levels of productivity and the desirability of attaining and maintaining a high level of employment.

According to the ILO[13], most of the criteria formulated internationally for fixing the relative level of minimum wages are variants of the following four concepts, which represent the sectoral interest of workers, employers and the macroeconomic concerns of the authorities:

[12] Suryahadi et al, 2003

[13] ILO, 2000

- the needs of workers;
- capacity to pay of employers;
- comparable wages and incomes; and
- requirements of economic development

In practice, minimum wage fixing authorities "*are usually expected to strike a balance between economic and social concerns*"[14]. In line with the ILO recommendations, countries usually set MW based on a conception the "basic needs" of the workers – needs that are determined by the cost of a standard basket of goods. How generously a policy defines "basic" can depend on its political leaning, its per capita income, GDP, and strength of its trade union movement, among other factors. For instance, in Indonesia, the basis for the MW changed from "minimum physical needs" (or the local acronym KFM) to "minimum subsistence needs" (and the local acronym KHM) in 1996. Both concepts include a basket of commodities including food, clothing, housing, transport, health, recreation, etc. The KHM includes an expanded conception of minimum needs and also adjusts for capacity and sustainability of companies, market wage rates, labor market conditions, and micro and macro economic growth rates. In addition, Indonesia switched from a province based MW to MW within provinces that were specific to sectors.[15]

b. Sectoral Coverage

The sectors that the MW pertains to are key to determining its employment effects on the economy. In developing countries, MW generally applies to the formal sector and to non-agricultural occupations. There are however some exceptions[16]. Even if MW does apply to agricultural workers and the informal sector (which they often do not), enforcing it is a huge administrative and legal undertaking. Of course, wages in the uncovered sector may rise as well, due to the legal and demonstration effect of the MW. Thus, in Latin America there are indications of a "lighthouse effect" that raises wages in the uncovered sector as well[17]. Anecdotal evidence from India[18] points to an increase in the bargaining power of workers in the informal sector when a MW exists, and when informal workers organize to demand higher wages (for instance in the construction sector). While this can be an important social policy outcome, it may also contribute to increased rigidity in the labor market.

In other cases, the MW may be set so high, that is not "binding", meaning by which that the market determined wage is much lower, and if the MW were really to be enforced, then firms would go out of business. In Colombia, for example, in the 1980s, MW increased and was binding in most cases, making their impact significant[19].

c. Enforceability and Compliance

[14] ILO, 2000
[15] Suryahadi et al, 2003
[16] For instance, India has minimum wages for agricultural workers as well, but these are seldom enforced.
[17] Maloney and Mendez , 2002
[18] Self Employed Women's Association (SEWA)
[19] Bell, 1995

Many developing countries have limited institutional capacity in enforcement of MW and legal recourse available to workers. For instance a study from Trinidad after a MW was first introduced demonstrated that the potential costs of full compliance were large. Given this and the fact that the probability of detection of noncompliance and the associated penalties were small, noncompliance was in reality high[20]. In Indonesia, it is estimated that about a quarter of the establishments pay wages below the Province MW and that about 14 percent workers in 2001 received wages below the Province MW. It is not clear if this includes workers in the formal establishments only.

Table 3 Indonesia: Minimum Wage Coverage – 2001

	First Quarter	Second Quarter	Third Quarter
National Standard of MW (Rp)	272,790	271,150	278,530
Average Wage of Workers Receiving Less Than Province MW (Rp)	220,040	228,690	230,760
% Establishments Giving Less than Province MW	26.1	22.6	22.1
% Workers Receiving Less than Province MW	15.7	13.6	13.2

Source: Statistics Indonesia, 2002

If a MW exists but is not enforced during periods of high unemployment and growing trade union activity, it could create potential governance problems as well, with workers getting frustrated with the disjoint between legally mandated and actual wages. This may in turn lead to potential labor unrest and political instability.

d. Issues of growth and competitiveness

One of the conventional arguments against the hypothesized rigidity introduced by increases in MW is that firms – both foreign and domestic - will be forced to either scale down or close operations if their labor costs increase due to a statutory MW. In the case of developing countries which rely on multinational firms for large scale employment this may mean either cutting back employment disproportionately, or moving operations out of the country or importing cheaper foreign labor. The research shows that the ***competitiveness of small firms which suffers*** with increases in MW. Domestic enterprises in developing countries are often small and medium sized operations, and if MW has a negative effect on the competitiveness on these firms, the chances are that both growth and employment will suffer, as pointed out earlier.

e. Bargaining Mechanisms and Minimum Wages

Bargaining coordination between workers and employers has been shown to have important outcomes for both workers and employers. Thus, the while setting the MW, the authorities have to give due consideration to unions and this can often affect the MW level itself. One of the important roles of unions is in wage-setting through the collective bargaining process.

A survey of existing research shows a mixed picture of the impact of unions on the economy and strengthens the argument for a contextual, country-specific approach rather than an aggregate or

[20] Strobl and Walsh, 2003

even a region specific one. However, one effect of collective bargaining emerges clearly - unions in both industrial and developing countries are successful in securing a wage markup for their members and other workers covered by collective agreements; and depending on the economic, institutional, and political environment in which unions and employers interact, collective bargaining as opposed to individual contracting can contribute negatively or positively to the economic performance of firms and to the well-being of workers. In terms of wage dispersion and earnings inequality, countries with coordinated collective bargaining tend to have less wage dispersion than other countries[21].

Conclusion: In order to set a prudent MW thus, a country needs to consider a number of factors including its level of development, issues of growth and competitiveness, the wage distribution, coverage and compliance, and which workers the MW would affect. None of these is possible without reliable data and measurement of the labor market. This is where labor market surveys and analyses come in useful – to ensure that the MW is set at levels that would not harm the economic or social well being of its population. Box 1 gives 9 elements of setting a prudent MW.

[21] Aidt and Tzannatos 2001 and 2002

Box 1: Nine principles of a prudent minimum wage policy

1. Set the minimum wage so as to provide a minimum acceptable standard of living for low-paid workers but simultaneously ensure that its "bite" is limited, that is it dos not cut too deeply into the wage distribution.
2. Allow for labor market conditions. Do not increase the minimum wage when unemployment is high or rising and is concentrated among low-skilled workers.
3. Implement a youth sub-minimum wage, especially if youth unemployment is high. Roughly, the youth sub-minimum should account for about 75 percent of the adult minimum wage. Further differentiation may be considered, e.g. a lower minimum wage for teenagers and higher for young adults.
4. Consider regional differentiation in the minimum wage if labor market conditions and productivity vary substantially across regions. In economically depressed regions with high unemployment the regional minimum wage should be lower than in regions with more buoyant labor markets.
5. Do not extend sectoral collective agreements regarding minimum wages to non-participating employers, and provide and "opt out" option for employers (especially small ones) for whom it is too costly to comply with sectoral agreements. Such employers should be bound only by the national minimum wage.
6. Carry out periodical minimum wage adjustments to allow for the price or wage growth. At the same time, take into account changes in labor market conditions (see point 2). To balance these two consideration, do not get locked into a rigid formula for regular adjustments of the minimum wage. For example, the balance can be struck by linking minimum wages to average wage increase, but subject to the inactivity rate remaining below a specified level (as it is the case in the Netherlands).
7. Collect data on the wage distribution either by means of an employer- or household-based survey.
8. Analyze the wage distribution before increasing the minimum wage, focusing on factors that will determine the impact. The two most important are:
    a. The ratio of the *new* minimum wage to the average (preferably median) wage for vulnerable worker groups (e.g. youth, low-skilled workers) and across regions.
    b. The proportion of workers to be affected by the increase, i.e. the proportion of workers whose wages are between the current and the new level of the minimum wage (by worker group and region);
9. Set the minimum wage at a lower level and enforce it effectively. This is a more efficient and equitable approach than setting the minimum wage at a higher level but with weak or selective enforcement.

Source: Rutkowski, 2003

PART II: RELEVANCE FOR TIMOR LESTE

What are the implications of the foregoing review of international experience on MW, employment and bargaining for Timor-Leste? A few aspects of the Timor-Leste economy in this context deserve initial mention. Timor-Leste is at a critical stage in the development of its labor market institutions and faces serious challenges in this area. Its historical context with respect to these institutions is rooted in its pre-independence experience. The East and SE Asian regional experience can be expected to have demonstration effects in terms of growth of trade unions and drawing upon the policy experience of its neighbors. Part II is based on an analysis of the data from the Timor Living Standards Survey 2001. Since 2001, there have been several developments that have potentially affected the labor market, but lack of fresh data has necessitated an analysis based on the TLSS. Nevertheless, the low inflation rate since 2001, combined with the negative impact on urban employment and wages from the scaling back of donor presence in Timor-Leste, suggest that the 2001 data remain useful for LM analysis.

Box 2: Employment Related Definitions

According to the standard approach to measuring labor force participation for the economically active population, the labor force includes all people who are considered employed and unemployed i.e. those having worked in the last week, having not worked in the last week but having a permanent job, or having not worked in the last week but having looked for work in the last week.

Unemployed persons, according to international definitions, are those individuals who, in the last 7 days, did not work but were looking for work. Both employed and unemployed persons are considered to be in the labor force and employment rates (as distinct from labor force participation rates) are based on the sample of people who are in the labor force. Those who are out of the labor force are usually individuals who were neither working nor looking for work, such as students, persons doing domestic work, and beggars, prostitutes, smugglers, remittance recipients, rentiers, pensioners, unable to wok due to disability, and children 0-14 years of age.

The standard definition of unemployment may not adequately capture those without work who want to be working, and who may not looked for a job in the last 7 days or those who are working in jobs far below their optimal capacity, or in other words, are underemployed. In developing countries, open unemployment rates are often low, since people cannot afford to remain unemployed and take any job available, after a period of looking for a suitable job, but underemployment is high but difficult to measure. A final important issue relates to so-called "discouraged workers", who have given up job search due to lack of success, but would be willing to take work if it were available. This group are not categorized as within the labor force in traditional analysis, but can clearly be seen as potential labor force members, and a symptom of lack of demand in the labor market

1. Labor Market factors in Timor-Leste and the Potential Importance of MW

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. For example, if unemployment is high to start with, the effects of a high MW will clearly be more deleterious than if unemployment was low to start with. Following is a short overview of labor market features in Timor Leste which are most relevant to MW policy formulation.

a. High urban unemployment: In Timor-Leste urban unemployment (ILO definition) is high with workers in Dili/Baucau facing the highest unemployment rates at 20 percent. Labor force participation rates are highest in rural areas but within rural areas there is considerable variation in labor force participation across the center, east and west areas. In terms of the importance of the MW, the urban areas are where the MW is most likely to have an effect and to be enforced.

b. Labor Force Participation by Gender and Education: In terms of gender differences, labor force participation rates are significantly higher for men (81 percent) than for women (40 percent). Unemployment is higher among the educated than the non-educated, a pattern seen in many developing countries. In a regime of scarce employment opportunities, those with no schooling are most likely to be in the labor force, probably because they can least afford to not be working (or looking for work) compared to those with more education. Finally, in terms of the gender gap, one fourth of the women compared to one in seven men are unemployed, so that concerns about female unemployment are an important factor in MW policy in Timor Leste.

c. Coverage and compliance: The discussion in Part I emphasized that the effect of MW is felt most strongly in countries where coverage and compliance are high. In Timor-Leste, over 80 percent of the labor force is engaged in agriculture and enforcing MW in agriculture is practically impossible. Moreover, wage employment is a very small part of the overall employment picture. Coverage of the MW, therefore, is more likely to be restricted to urban areas and formal wage employment, which is a very small proportion of the employed workforce. Moreover, since Timor-Leste is a new country, having limited institutional capacity in enforcement, it will be a challenge to effectively enforce the MW, deal with legal issues, and cope with workers' expectations even in the formal sector.

d. Large youth cohorts and high urban youth unemployment: Previous sections have underscored the importance of the MW in youth employment. Timor-Leste has a very young population and will be seeing increasing numbers of young workers entering the workforce. The population pyramids in Appendix figure 1show a substantially increased share of the population comprising the under 35-year olds in 2025. The ability of the labor market to absorb these large inflows of youth will be a key social and economic challenge. As of 2001, unemployment rates are highest among the youngest cohorts in urban areas and decline sharply with age, with the unemployment rate among the urban 15-24 year olds being 43 percent, and declining to 17 percent for the 25-34 years olds, and nine percent of the over-35 year olds. Given the risks of negative effects on youth employment from high MW, the starting point of high urban youth unemployment is a key factor in MW policy development in Timor-Leste.

e. Importance of small firms: The earlier discussion has shown that the disemployment effects of MW are felt most severely on small firms. In 2001, a little less than 4 percent of the employment in Timor-Leste was in the manufacturing sector. Moreover, self-employment was the dominant employment type. Thus, the large majority of firms were likely to be small, although no precise estimates are available. If private sector development in Timor-Leste is to be encouraged, then the interests of small firms would have to be promoted, and an inordinately high MW would definitely have a negative impact on small enterprise in Timor-Leste.

f. Skill Levels: Timor-Leste has a shortage of skilled workers, as proxied by average years of schooling, which in 2001 was 4.62 years. Only 4.25 percent of the TLSS sample had attended university. This has a bearing on both productivity and the potential of the country to attract foreign investment. The ensuing discussion will highlight the likely impact this has had on Timorese workers.

g. Labor laws and growth of collective bargaining: Unions and legal institutions in Timor-Leste are in a formative phase and rely on support from their Australian counterparts, the ILO and other global umbrella organizations. The unions get their legal standing from the Labor Code, which came into existence based on ILO standards. The law permits workers to form and join worker organizations without prior authorization. However, attempts to organize workers generally have been slowed by inexperience and a lack of organizational skills. The Labor Code also provides for a maximum workweek and overtime, minimum standards of worker health and safety, days off, and other standard benefits. As required by the Labor Code, the Government nominated members to the National Labor Board, the Labor Relations Board, and the Minimum Wage Board. These boards are expected to receive training and begin work in 2004. The law treats all workers, legal and illegal, the same in terms of wages and working conditions[22].

Despite low capacity and other problems, there are now well-publicized instances of strikes aimed at securing to workers the rights against unfair dismissal, for fair wage and some social protection. Collective bargaining is therefore likely to be a factor in the setting and enforcement of a MW, though perhaps not immediately the most important one.

2. Wages in Timor Leste and the "Bite" of the MW

The "bite" of a MW as we have seen, refers to its (usually negative) impact on the wage structure in particular and the economy, more generally. 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. In the context of the discussion of the factors determining the importance of the MW, let us begin with some observations regarding Timor-Leste.

[22] US State Dept. 2004

- With the informal MW, the MW/AW ratio for Timor-Leste is 0.53, or in other words, the MW accounts for 53% of average wages [23]. This puts Timor-Leste ratio in the "very high" range in international comparison (see Table 1), higher than the Netherlands and Ukraine and closer to countries such as France (Figure 2).

- In absolute terms, the informal MW for Timor-Leste is dramatically higher than the level of MW in countries of comparable income levels, including neighboring Indonesia and Vietnam (Appendix Table 4). A MW level of USD 85 places Timor-Leste close to Uruguay in the 1990s. However, the per capita income of Uruguay was USD 6581 and the average years of schooling for its over-15 population was 7.56 in the 1990s, compared to USD 472 and 4.62 respectively for Timor-Leste.

- The monthly MW of West Nusa Tenggara – the neighboring Indonesian province was set at around USD 24 in 2001 and at USD 40 at the end of 2003 (See Appendix Table 3). Clearly, in that comparison, the MW of USD 85 per month for Timor-Leste is almost twice as high. While cost of living may also be higher in parts of Timor-Leste such as Dili due to heavy donor presence, these differentials between West Nusa Tenggara and Timor-Leste may be narrowing over time.

- If average years of schooling is taken as a crude proxy of skill levels, Timor-Leste with average years of schooling of 4.62, is closer to the Dominican Republic, but the latter had a had a MW of USD 42 in the mid 1990s (Appendix Table 4). Thus, even in terms of skill levels, Timor-Leste has inordinately high MW levels.

- Finally, Appendix Table 4 also shows that in terms of per capita income, Timor-Leste is closer to Pakistan, which had a MW of USD 50 in the mid 1990s.[24]

a. Wage Inequalities

The ratio of MW/AW discussed above tells us that the informal MW in Timor-Leste is at the very high level (see Table 1). In order to get a more disaggregated picture of wages, we analyze wages in the urban areas where the MW is most likely to be enforced and the MW impact on unskilled workers nationally. Simple numerical measures of the minimum wage may offer deceptive indications of its impact. Alternative measures, such as graphs showing distribution of wages are more reliable as well as intuitive, and highlight influences at different points in the wage distribution, and therefore we use these to get an empirical as well as a tactile flavor of relative wages[25].

Urban Wages: The MW/AW ratio in urban areas is about 56 percent – higher than the national ratio of 53 percent. However, we also know that this ratio does not tell us very much about the degree of wage inequality. That being so, we find the urban ratio of MW to median wage in Timor-Leste is 70%, which is a higher ratio than in any OECD country (see Appendix Figure 3).

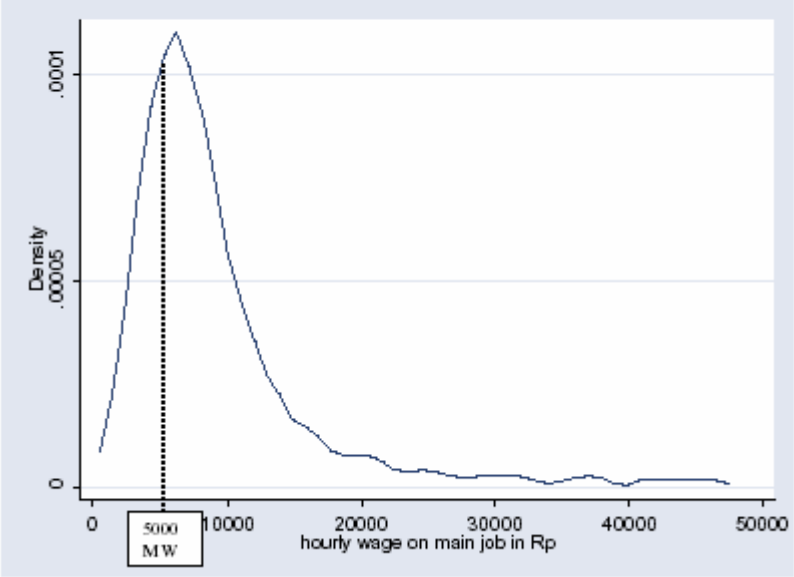
[23] Based on wages calculated from reported data on cash payments for primary employment in the last three months (in all sectors and occupations), divided by the number of hours spent in doing that work in the TLSS 2001.
[24] With a MW of USD 50, Timor-Leste would have an MW/AW ratio of 0.31, which is a moderate MW/AW ratio.
[25] See Maloney and Mendez, 2003

Therefore, the urban wage distribution in figure 3 demonstrates that the wages are compressed around the mean. In numerical terms the plot (and calculations) show that ***almost 25 percent of urban workers earned below the informal MW in 2001. Thus, the informal MW was not binding.***

Figure 3

Urban Wage Distribution in Timor Leste

(Source: TLSS, 2001)



The median worker in urban areas earned only USD 116 per month. A further exploration of inequalities shows that the bottom 10 percent earned only USD 59 and the bottom 20 percent earned USD 74. At the high end, the top 10 percent of the urban workers earn an average of USD 264 and the top 20 percent earn almost USD 200, hence the long "tail" on the right hand side of the wage distribution. Thus, on the one hand we have low-paid workers who earn below the MW, and at the other we have very high end workers who drive up average wages. What these figures reveal is that wage inequality in Timor-Leste is high (see Table 4).

Table 4: Percentile Distribution of Wages in Urban Timor Leste

Source: TLSS, 2001

Percentile	**Wages in USD Per Month for Urban Workers (n=344)**
10	59
20	74
50 (Median)	116
80	200
90	264

Unskilled Workers' Wages: Turning to unskilled workers[26] ***we find that the more than half of them earned below the informal MW in 2001*** (Figures 5)**.** There was also a high degree of inequality among unskilled workers, with the top one-tenth earning more than five times what the bottom one-tenth earned in 2001 (Table 5). This could very well have sectoral explanations. For instance, unskilled agricultural laborers may well earn a lower wage compared to those in manufacturing or construction. However, very small sample sizes of unskilled workers who earn a cash wage do not allow us to probe this issue. What is clear is that if the MW is formalized, the unskilled workers - more than half of whom earn below USD 85 per month - will be the most negatively affected.

Figure 4

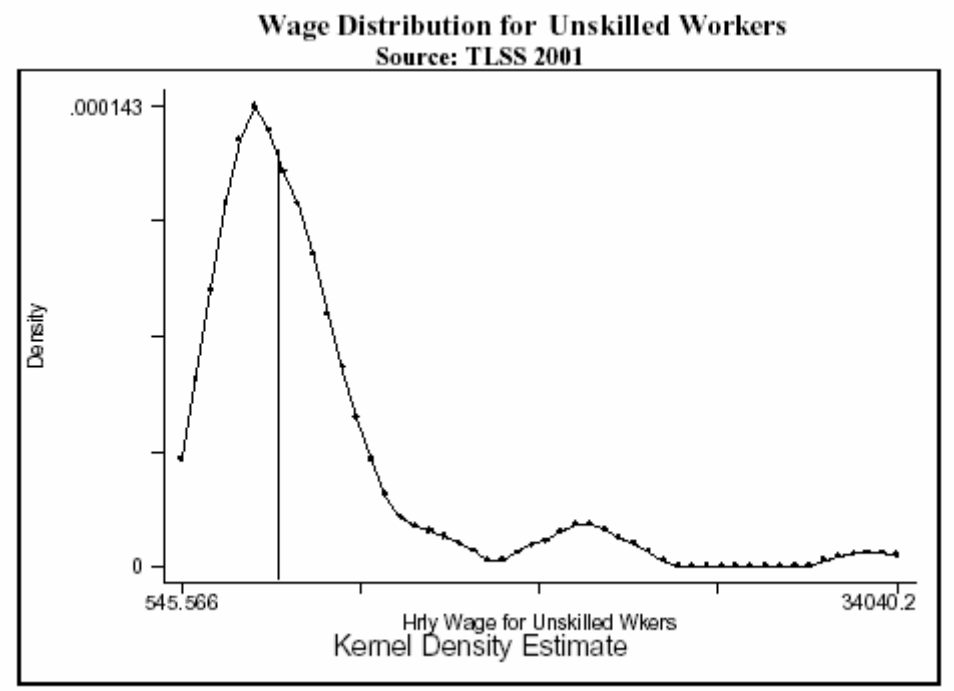


Table 5: Percentile Distribution of among Unskilled Workers in Timor Leste
Source: TLSS, 2001

Percentile	Wages in USD Per Month (Unskilled)[1] N=64
10	41
20	46
50 (Median)	82
80	129
90	205

[26] Unskilled workers are coded from the occupational category "unskilled including agricultural laborers" who reported cash wages in the survey.

Our earlier discussion showed that the "bite" of the MW – if it were to be formalized at the current informal level and enforced - would be felt by the workers who earn below the informal MW presently. ***We find that 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.*** Moreover, if the MW was to be formalized and applied across sectors, ***unskilled workers would be the worst affected since over half of them earn below the informal MW.***

b. Wage movements since 2001

The MW/AW ratio for Timor-Leste was 0.53, or the MW accounted for 53% of average wages in 2001, suggesting that the informal MW may already, by 2001, have inflated wages[27]. Estimates of average wages by occupation show that every occupational group received a wage in 2001 that was higher than USD 4 per day (Appendix Table 4). However, there may have been a fall in average wages in more recent years due to scaling back of donor and international NGO presence. There is some evidence of this provided by a 2003 survey of the construction sector (Table 7), which found average wages reported for unskilled construction workers being considerably lower than average wages for all unskilled workers in 2001 (USD 3.85 in the construction survey compared to USD5.12 in TLSS)[28]. This suggests that wages at the lower end of the labor market in particular, are falling in response to falling demand. While the comparison is a crude one (comparing wages in a particular industry with overall wages), it is consistent with anecdotal information that suggests that the wages of unskilled workers have taken a downward turn in the two years after the TLSS.

It is also likely when the informal MW, though not binding, not only raised the average wages, but also forced employers of some private enterprises to look outside Timor-Leste especially for skilled labor. In the construction industry, unskilled work is done mainly by Timorese, semi-skilled labor is mainly done by Indonesians and Timorese, while other nationals exclusively do skilled labor and supervisory work, and earn wages far higher then Timorese workers[29]. This also draws attention to the lack of skilled workers in Timor-Leste. Thus, wages of unskilled workers possibly declined by 2003, while for the skilled bracket, employers began to bring in foreign labor.

[27] There is also evidence of this from a draft report on civil service pay (2001) which indicates that local hotels/lodges in Dili pay about USD 5 per day or USD 120 per month for literate staff with limited secondary education – somewhat higher than Level 2 at ETTA. Inexperienced staff with a post-school diploma earn about USD 170 a month – a little higher than ETTA Level 4. Post-school diploma staff with 10 years experience earn USD 400 per month – a higher rate of pay than currently available in the civil service at any level. The reservation wage for unskilled workers in Dili in early 2000 was about USD 3 per day while the market wage was USD 4 (or USD 88 per month). This latter figure corresponds closely with the existing rate of USD 85 per month at Level 1 of the ETTA scales (Valentine, 2000).

[28] Though note that wages were much closer for skilled workers (USD 7.7 in the construction survey compared to USD 7.5 for production and other workers in TLSS).

[29] Wichmann, 2004 (draft)

Table 6: Average salary of construction workers in Timor Leste: 2003

Average salaries (USD per day)				
		Timorese	Indonesians	Other nationalities
Unskilled construction workers	Mean	3.85	2*	
	Median	3.4	2*	
Semi-skilled and skilled construction workers	Mean	7.67	7.3	19.88
	Median	7	6.75	22.5
Engineers/supervisors	Mean	15	20.5	27.35
	Median	12	15	26.5

*One case only
Source: Wichmann (2004, draft)

c. Civil Service Wages

Timor-Leste is also in the process of civil service reform and revision in the pay and benefits of civil servants. Civil service pay scales are highly compressed compared to other countries, implying that the difference between the highest and lowest pay scales is very narrow (Table 8). Thus, the rewards for high skilled personnel are disproportionately lower than those for low-skilled staff. In terms of attracting highly qualified personnel, this presents a barrier, since the salary structure does not allow differentiation for different skill levels and performance[30]. Civil servants are thus, perhaps not the drivers of the high end of the wage distribution in Timor-Leste. This is also evidenced by the wages of NGOs in Table 7. While the wages of ETTA and UNTAET are more compressed, those of NGOs are much more dispersed. It appears that in 2001 the NGOs in Timor-Leste agreed to the lowest level pay scales being below the informal MW, suggesting that this was an acceptable minimum level for organized establishments and the fact the informal MW may have been too high at the time.

Table 7: Monthly Salaries of Civil Service and Other Employees (USD)

	ETTA	**UNTAET[1]**	**NGO Agreement[2]**	**NGOs Actual**
Level 1	85	111 – 134	77 – 88	69 – 94
Level 2	100	144 –174	88 – 110	86 – 152
Level 3	123	191 – 231	--	125 – 240
Level 4	155	253 – 335	121 – 198	120 – 263
Level 5	201	335 – 445	176 – 242	172 – 285
Level 6	266	445 – 538	176 – 242	263 – 550
Level 7	361	589 – 713	--	--

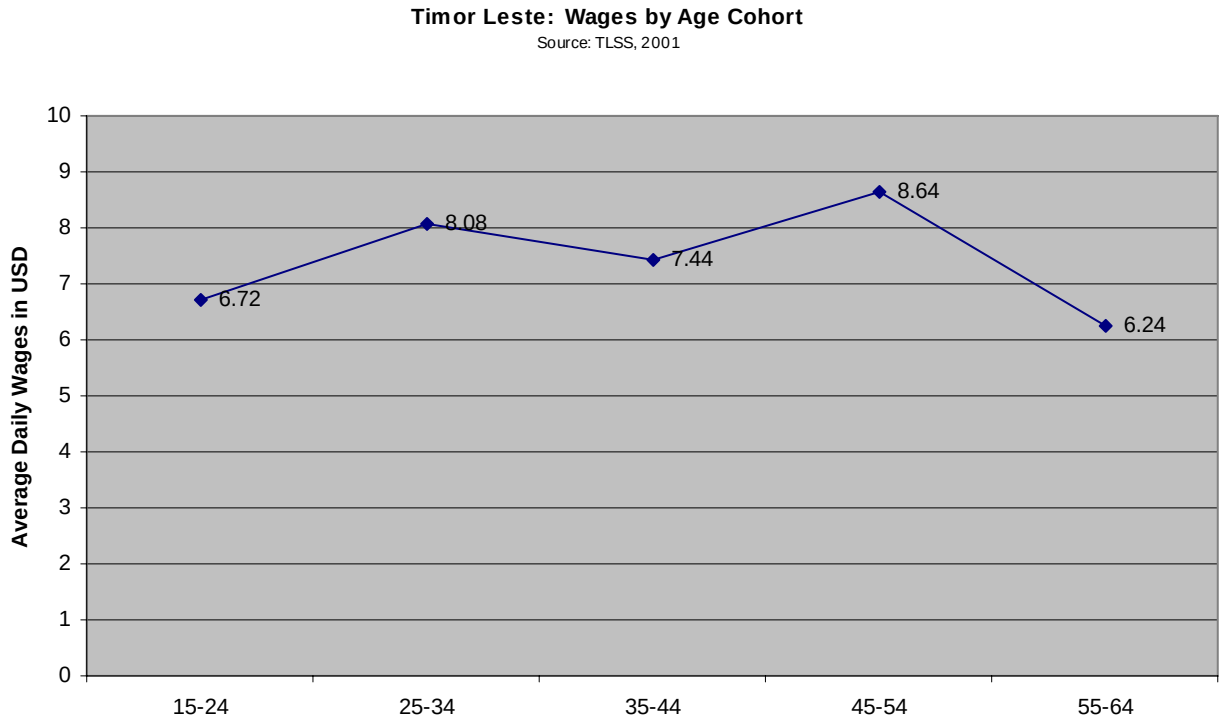
Source: Valentine, 2001, based on data supplied by ETTA, UNTAET and NGOs operating in Timor-Leste.

[30] Valentine, 2001

d. Wages of Younger Workers

One of the major issues in MW policy development for Timor-Leste is youth unemployment. While unemployment rates among the youth are higher than among the general population, yet, **if employed**, all age-cohorts appear to receive wages above the MW from their primary activity. Figure 4 shows the distribution of average wages by age cohort. The jagged M-shape of the average wages indicates that the youngest, oldest cohorts get the lowest wages, with the 45-54 year olds being the highest paid. Median wages are slightly lower for younger than older workers, but not significantly so. Therefore, it appears that when employers have to pay the MW, they would rather not hire younger workers. In the absence of time-series data, one could speculate that the MW may in part account for the very high unemployment rates (43%) of the youngest cohorts.

Figure 5



e. Summary of Wages and Labor Market Conditions in Timor-Leste Relevant to MW Policy

- Data gaps are substantial and 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.
- 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/AW 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 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.

Part III: Policy Implications and Recommendations for Timor Leste

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.

There appear to be the following options three for Timor-Leste.

Option A

Formalizing the current level of informal MW at USD 85 per month appears to be economically as well as socially the most deleterious option. As we have noted earlier, the prevailing informal minimum wage is very high for the country's level of development and its skill levels. This is true by whatever measure of appropriateness of MW is used: MW/AW ratio; absolute level of the informal MW relative to neighbors and countries at similar income levels; or the share of workers already receiving wages below the informal MW. Given that such a very high MW has a disproportionately negative impact on youth employment and employment in small firms – the two key features of employment in Timor-Leste – the negative consequences for the country of formalizing the informal MW of USD85 would be unusually high. In addition, the data from the survey of construction industry already points to the fact that private companies are seeking and getting high-end foreign workers whose wages are higher than those of Timorese. 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. Thus, In the face of high urban unemployment levels, and the economic downturn in the last year, again, this option would have serious ramifications for Timorese workers.

Option B

Based on the evidence from international comparisons, there seems a strong case that any formal MW in Timor-Leste would need to be considerably **lower than the current informal level** of USD 85 per month. While attempts to formulate the "right" level for the MW would not be fruitful in the absence of reliable data, it is clear from all points of comparison that a significantly lower level would be needed to avoid negative employment impacts on unskilled workers, youth, and those in small firms. It would moreover need to be based on the country's development level and in tandem with other countries with similar indicators.

As the foregoing discussion has shown, unemployment among urban youth is high, but when employed, their wages are not very different from those of older workers, indicating perhaps, that the need to pay them on par with more experienced workers may be driving some of the urban unemployment. The review of international evidence has also shown that even when the overall disemployment effects are negligible, the likelihood that youth employment would suffer is high. Thus, several countries adopt a lower MW for younger workers, or what is called a sub-minimum wage. This seems an option for strong consideration in Timor-Leste if it does take the route of formalizing a MW. However, if the MW is formalized, it would be important to decide on the intended coverage. In the interests of compliance and enforcement it would be best to exclude the agricultural and the informal sector.

Option C

Given that currently, data in Timor-Leste are weak and formalizing the MW may run the risk of imprecise levels being formalized, **the best option would be to keep the MW flexible**. Since donor activity, which was driving employment, is in the process of being scaled back, several sectors, would need time to adjust to the change. Therefore, in terms if timing, this is not the opportune moment to formalize a MW. If the needs of collective bargaining so emerge, wages could at a later date, be set through employer-employee negotiations, with the MW Board playing the role of arbitrator.

Concluding Recommendations

No MW can or should be set without adequate data to guide its formalization. In addition to data on labor markets, current wages and enterprises, Timor-Leste would also need:

- A minimum commodity basket of basic goods and services for specific urban areas.[31]
- Adjustments made for inflation, which in the last 3 years had been at 3 percent (year on year).

Thus, whichever policy route the country 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, it needs to strengthen the arbitration capacity of the MWB and the legal system on industrial relations. Only informed choices would in the long run have positive effects on both workers and enterprises.

That being so, the following are the conclusions of this paper.

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

[31] The IMF Staff Report on the Article IV consultations in 2003 brought to the fore that fact that the CPI is in the process of revision. Once a minimum basket of commodities is finalized it would form the basis for the subsistence minimum which can be taken into account in discussions with trade unions, and in fixing the MW.

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.

As the ILO notes,

> ….. But minimum wage fixing is not a once for all exercise. Fixing the initial levels and the successive adjustments should be seen as part of a process. The fact that one criterion becomes predominant at a particular stage, does not imply that the satisfaction of the others should not be envisaged for the future. In fact, seeing minimum wage fixing as a process opens new alternatives for negotiations among the parties in difficult times.
>
> ILO, 1998

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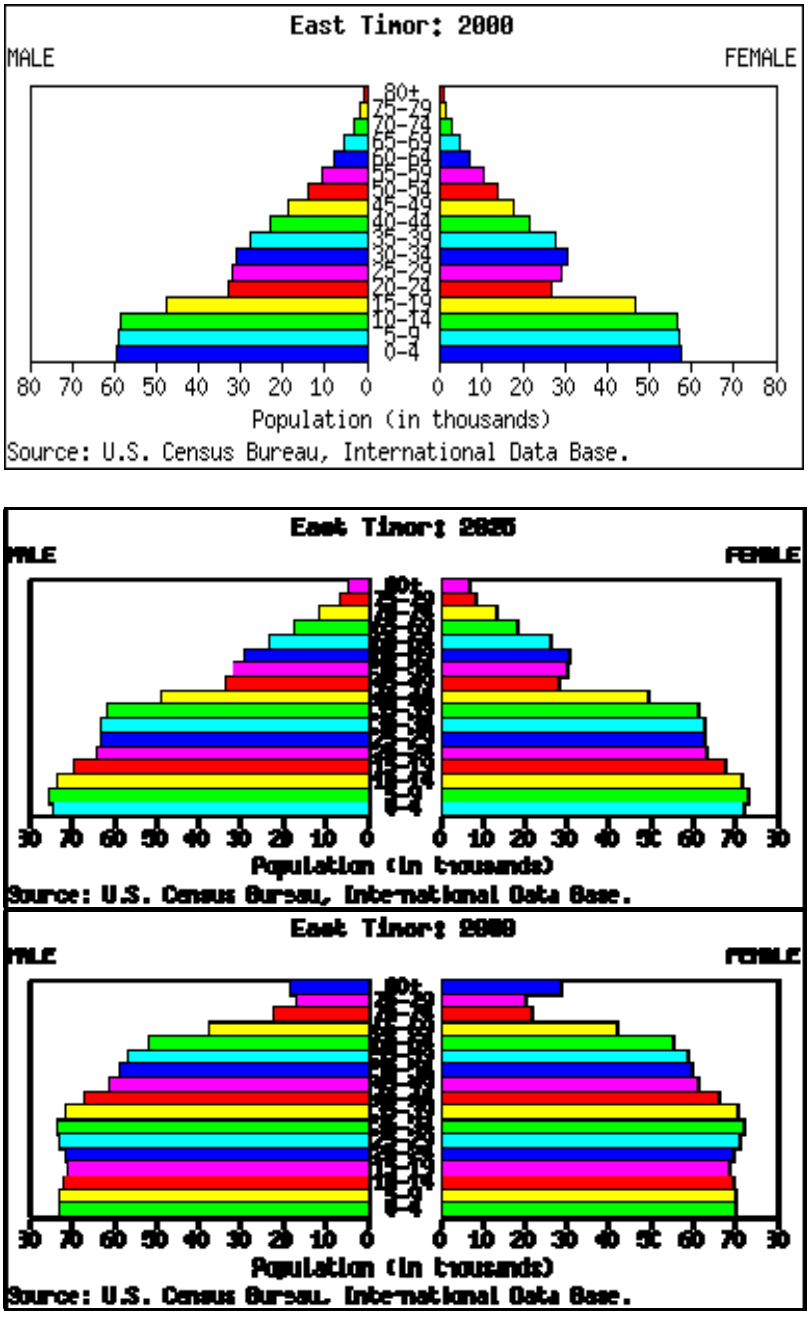
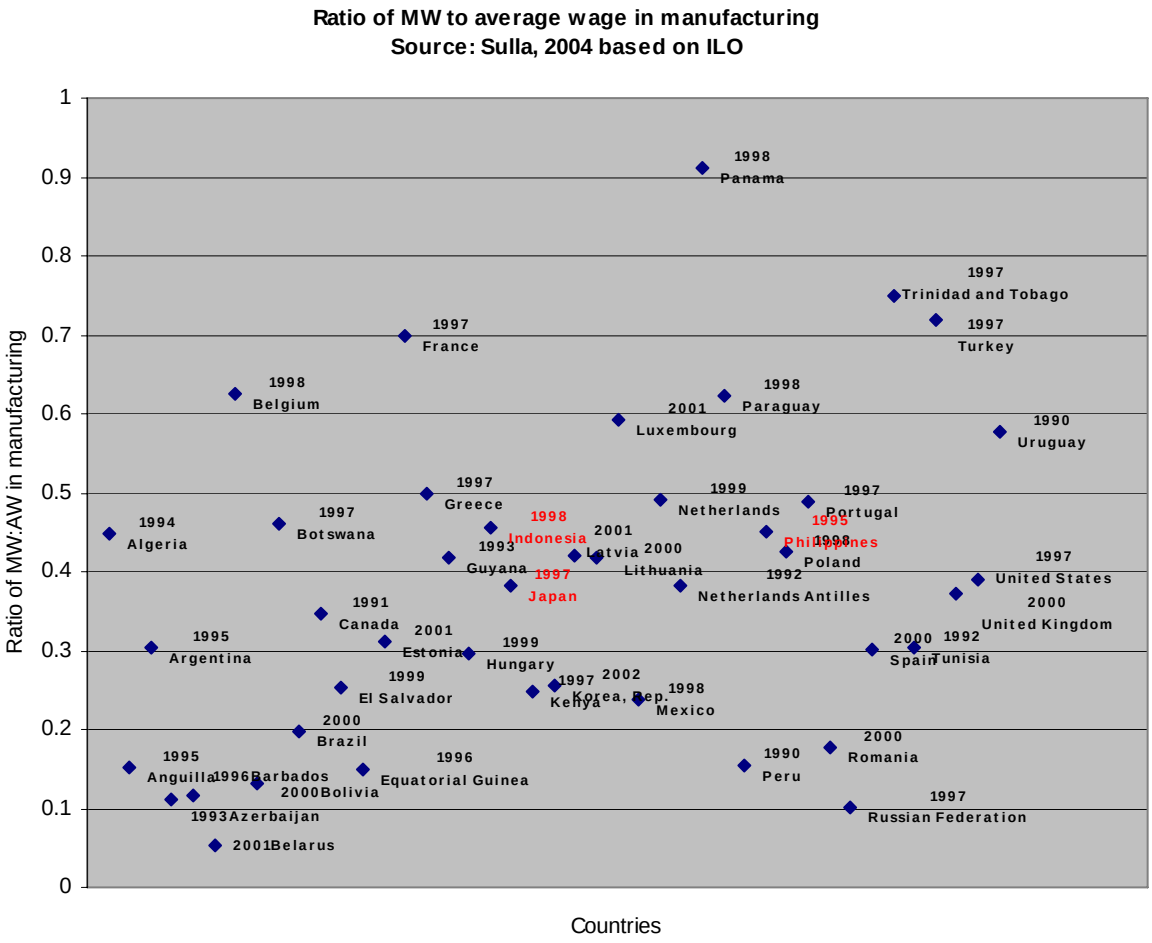
Appendix Figure 1
Timor-Leste: Projected Age Cohorts – 2000-2050



Appendix Figure 2



Appendix Table 1
Indonesia: Labor Strikes by Area: 2001-2003

Province	2001	2002	2003*
D.I. Aceh	0	0	0
North Sumatra	4	3	3
West Sumatra	0	1	1
Riau	0	3	0
Jambi	3	0	0
South Sumatra	4	4	0
Lampung	2	0	0
Batam	0	0	1
DKI Jakarta	57	71	40
West Java	53	96	48
Central Java	16	19	22
D.I. Yogyakarta	3	7	0
East Java	18	16	6
Bali	5	0	1
N T T	0	0	0
West Kalimantan	1	0	3
East Kalimantan	3	3	2
Central Kalimantan	2	2	0
South Sulawesi	1	1	0
Maluku	2	0	0
Irian Jaya	0	1	0
TOTAL	**174**	**220**	**146**

*January – November 2003
Source: ILO, 2004

Appendix Table 2: Indonesia: Labor Strikes by Sector: 2001-2003

Sector	2001	2002	2003*
Plantation	6	3	1
Mining	2	0	1
Industry	127	163	112
Construction	1	2	0
Electricity, Gas and Water	2	0	0
Trading and Banking	6	0	0
Transportation	2	0	0
Service	26	52	31
Others	0	0	0
TOTAL	**174**	**220**	**146**

*January – November 2003
Source: ILO, 2004.

Appendix Table 3: Comparison of Minimum Wages in Indonesian Provinces 2001-2004

Province	Minimum Wages (in Rp)			
	2001	**2002**	**2003**	**2004**
Nanggroe Aceh Darussalam	300,000	330,000	425,000	550,000
North Sumatra	340,000	464,000	505,000	537,000
West Sumatra	250,000	385,000	435,000	480,000
Riau	329,000	394,000	437,500	476,875
Jambi	245,000	304,000	390,000	425,000
South Sumatra	255,000	331,000	403,500	460,000
Bangka Belitung	.	345,000	379,500	447,923
Bengkulu	240,000	295,000	330,000	363,000
Lampung	240,000	310,000	350,000	377,500
Banten	.	360,000	475,000	660,000
DKI Jakarta	426,000	591,266	631,554	671,550
West Java	245,000	280,799	320,000	367,000
Central Java	245,000	314,500	340,400	440,000
Yogyakarta	255,000	321,750	360,000	365,000
East Java	220,000	245,000	281,750	310,000
Bali	309,750	341,000	341,000	425,000
East Nusa Tenggara	275,000	330,000	350,000	.
West Nusa Tenggara	**240,000**	**320,000**	**375,000**	**412,500**
West Kalimantan	304,500	380,000	400,000	420,000
Central Kalimantan	362,000	362,000	425,000	425,000
East Kalimantan	300,000	500,000	540,000	540,000
South Kalimantan	295,000	377,500	425,000	.
North Sulawesi	372,000	438,000	495,000	.
South Sulawesi	300,000	375,000	415,000	455,000
Central Sulawesi	245,000	350,000	410,000	.
South East Sulawesi	275,000	325,000	390,000	470,000
Gorontalo		375,000	410,000	430,000
Maluku	320,000	285,000	370,000	.
North Maluku	320,000	322,000	322,000	.
Papua	400,000	530,000	600,000	650,000

Source: ILO, 2004

Appendix Table 4: Timor Leste

Labor Force Participation Rates by Gender, Poverty and Region

	Total	Men	Women
National	60.0	80.8	39.6
Quintile			
Poorest Q1	58.1	80.8	37.6
Q2	58.9	81.2	35.6
Q3	60.1	81.7	39.3
Q4	60.9	83.3	39.2
Richest Q5	61.4	77.8	44.6
Poverty			
Non-poor	60.9	80.7	41.4
Poor	58.4	81.1	36.4
Area			
Dili/Baucau	48.2	65.4	29.3
Other urban	59.3	77.3	41.2
Rural	62.4	84.6	41.2
Highlands	63.6	84.8	42.5
Lowlands	61.6	84.4	40.3
Center	68.0	86.3	49.6
East	54.5	81.4	29.9
West	60.6	84.5	38.4

Note: Labor force participation is defined by standard ILO convention for the economically active population aged 15-64. Both employed and unemployed are considered in the labor force i.e. those having worked in the last week, having not worked in the last week but having a permanent job, or having not worked in the last week but having looked for work in the last week.
Source:2001 TLSS.

Appendix Table 5: Minimum Wages (in Current USD per Month) for Selected Countries- Latest Available Year (1990s - sorted by ascending MW)

	MW (current USD per month) 1990s	GDP per capita (1995 constant USD)	Average Years of Schooling (15 and above) 1990s
Kyrgyz Republic	5.45	425	..
Vietnam	11.17	351	3.84*
Indonesia	20.07	981	4.55
India	34.00	360	4.52
Egypt, Arab Rep.	34.54	1007	4.98
Mali	38.24	247	0.76
Guatemala	38.28	1437	3.25
Bangladesh	40.99	306	2.41
Ecuador	40.99	1776	6.14
Russian Federation	42.47	2782	9.77^
Bolivia	44.11	940	5.58
Romania	44.28	1456	9.42
Kenya	45.92	337	4.2
Bulgaria	47.73	1511	9.26
Burkina Faso	48.71	272	..
Pakistan	50.00	484	3.92
Jamaica	57.68	2136	5.02
Mexico	64.02	3620	7.23
El Salvador	65.79	1612	4.7
Senegal	70.70	591	2.55
Cote d'Ivoire	72.57	862	..
Czech Republic	78.50	5206	9.48
Botswana	80.09	3654	6.28
Uruguay	85.55	6581	7.56
Colombia	94.00	2326	4.96
Hungary	94.36	5136	9.12
Thailand	96.61	2638	6.08
Turkey	104.51	2887	5.29
Brazil	109.00	4486	4.88
Algeria	111.64	1463	4.83
Dominican Republic	119.88	1589	4.66
Venezuela	121.90	3482	6.69
Philippines	122.64	1133	8.21
Tunisia	127.07	1994	4.53
Poland	132.04	3536	9.84
Costa Rica	136.53	3356	5.77
Morocco	139.29	1362	..
Chile	148.45	5146	7.55
Argentina	200.00	8313	8.83
Trinidad and Tobago	247.87	4088	7.44
Korea, Rep.	325.23	12174	10.56

Portugal	337.14	12411	5.87
Spain	481.48	16836	7.28
Israel	488.39	15594	9.45
Taiwan, China	488.76	15023	8.76
Greece	504.74	12674	8.67
Canada	658.08	22174	11.62
United States	671.30	30965	12.05
Kuwait	687.00	15067	5.96
New Zealand	757.56	17553	11.74
France	1006.02	26493	7.42
Ireland	1007.23	25622	9.35
Japan	1022.07	43653	9.47
Australia	1059.33	20040	10.67
Netherlands	1264.17	30473	9.35
Belgium	1323.47	29857	9.34
Luxembourg	1385.51	54443	..
Denmark	1661.08	37619	9.66

*1990

^USSR

Source: Rama, 2000; Barro and Lee, 2000, SIMA, 2004.

Appendix Table 6

Employment by Gender, Sector, Poverty and Region

	Men			Women		
	Agriculture	Industry	Services	Agriculture	Industry	Services
National	82.3	4.3	13.4	80.8	3.2	16.0
Quintile						
Poorest Q1	95.7	1.2	3.2	85.9	4.4	9.7
Q2	88.9	4.3	6.9	86.0	3.8	10.3
Q3	86.6	3.2	10.2	83.2	3.4	13.4
Q4	85.7	4.0	10.3	85.2	2.1	12.8
Richest Q5	60.2	7.9	32.0	68.5	2.9	28.6
Poverty						
Non-poor	76.9	5.1	18.0	78.3	2.7	18.9
Poor	92.2	2.9	5.0	86.3	4.2	9.6
Area						
Dili/Baucau	23.3	13.7	63.1	17.9	2.8	79.4
Other urban	84.5	3.0	12.5	78.4	4.5	17.2
Rural	90.0	3.2	6.8	87.4	3.1	9.5
Highlands	90.3	3.8	5.9	90.9	1.6	7.5
Lowlands	89.8	2.8	7.5	84.7	4.2	11.1
Center	89.8	3.0	7.1	87.5	3.7	8.9
East	90.4	3.4	6.2	89.5	1.1	9.4
West	89.9	3.4	6.7	85.4	3.4	11.2

Note: Employment sector refers to the sector of employment for the person's main job in the last 3 months. Agriculture includes agriculture, livestock, forestry, fishing, and hunting. Industry includes mining and quarrying, manufacturing or processing, electricity, gas, water, and construction. Services include wholesale trade, retail restaurants and hotels, transport, storage, communications, financing, insurance, real estate, business services, public administration, military, health services, education services, and other community, social and personal service activities.

Source: 2001 TLSS.

Appendix Table 7: Minimum wage fixing systems and youth MW rates in selected OECD and transition countries

Countries (1)	MW-fixing machinery (2)	Young worker statute (3)	Youth MW as % of adult MW (4)
Selected OECD Countries			
Belgium	Negotiated by union and employers as part of national agreement	Special rates for young workers	Small reduction for young workers aged under 23
Canada	Federal MW fixed by labor code, while in some provinces, the MWs are fixed by government regulation	Special rate for young workers and apprentices in some provinces	
Korea	National MW fixed by a tripartite body	Special rates might be fixed for young workers under the age of 17 who have less than 6 months' work experience Apprentices are excluded from MW coverage	
France	Set by government on the basis of a formula foreseen in the law	Special rates for young workers who have less than 6 months' work experience in the same branch. Special rates for trainees and apprentices according to age and duration of training (trainees: 30% to 65 % apprentices: 25% to 78%)	80% aged under 17 90% 17 18 years old
Germany	Fixed by technical committee at the branch level and approved by the Federal Minister of Labor		Special rates are embodied in industry agreement
Greece	Set by a national collective agreement	A youth wage differential existed in 1989. Presently, no special rate for youth	
Japan	Regional rates are fixed by local wage councils	Adult MW applies to young workers	

	and industry rates are determined by ad hoc committees		
Netherlands	Statutory MW	Special rates apply to young workers according to age. Apprentices are excluded from MW coverage	22 years: 85% 15 years: 3%
New Zealand		Until 1994, teenagers 16-19 were excluded from MW coverage before being applied (as from 1994) special rate	60% for youth aged 16-19
Portugal	Statutory MW	Special rates apply to young workers and apprentices	75% under 18 years 80% under 25 years
Spain	Statutory MW	Special rate for youth	66% under 18 years
Sweden	Fixed at the industry level through collective agreement	Special rate for youth	85% under 24 years
United Kingdom	Before 1993: Set by wages councils in certain low-wage industries; now only in agriculture	Youth, under 22, were excluded	
United States	Passed by Congress and signed into law by the President at the national level. Also conducted legislatively at the state level.	Special rate for students	
Selected Transition Countries			
Czech Republic	Fixed through a tripartite national agreement and confirmed by government directive	Adult MW applies to young workers	
Poland	Set by the Ministry of Labor after negotiations with trade unions		

Appendix Table 8
Timor Leste: Average Daily Wages by Area of Residence (2001)

Area	N	Daily Wages (USD)
Dili/Baucau	304	7.2
Other urban	40	8.16
Rural Center	43	9.76
Rural east	29	11.12
Rural west	18	5.04

Note: Unweighted calculations based on (TLSS 2001) hourly earnings reported by workers (15-64) on their primary activity. Rp:USD exchange rate at 10,000 and average hours of work per day at 8.

Appendix Table 9: Timor Leste: Average Daily Wages by Occupational Groups (2001)

Occupational Categories	N	Daily Wages (USD)
Professional	124	9.52
Sales/Service	103	7.44
Agriculture/Animal Husbandry and related workers	14	6.72
Production & Transportation Workers	46	7.44
Unskilled (including agricultural laborers)	64	5.12
Other	83	7.6

Note: Unweighted calculations based on (TLSS 2001) hourly earnings reported by workers (15-64) on their primary activity. Rp:USD exchange rate at 10,000 and average hours of work per day at 8.

Appendix Note 1: Trade Unions in Timor Leste

While unions and workers' organizations are in their infancy in Timor-Leste, yet, they have grown substantially in the last 2 years. The US State Departments' annual report on human rights states that workers in Timor-Leste have little experience in negotiating contracts, promoting worker rights, or engaging in collective bargaining and negotiations. The law provides for the right to strike, but few workers have been able to exercise this right. In April 2003, taxi drivers staged a brief strike. In September 2003, some airport workers went on strike to protest the firing of two colleagues. This strike was allowed to continue peacefully even after a foreign labor leader was arrested for assaulting a police officer. On December 4, Chubb Security fired 32 employees contracted to the World Bank for striking. The striking employees were protesting a wage and prior to the strike, the workers conducted 8 days of nonviolent picketing.

Appendix Box 1: Growth of Trade Unions in Timor Leste

A prominent labor group is the Labor Advocacy Institute of East Timor (LAIFET). LAIFET has expanded its activities from labor advocacy to organizing workers. It also helped organize the first Labor Congress in East Timor in late February 2001 in order to launch an East Timor trade union centre which is called Timor Lorosa'e Trade Union Confederation (TLTUC). Other unions in East Timor were established on the basis of industry or occupation, for example, the union for nurses (first union formed in mid-2000), and followed by unions for teachers, journalists, agricultural workers, construction workers, hotel and restaurant workers, port workers, medical doctors, etc.

The Trade Union Confederation of Timor Lorosae (KSTL) claims to represent 4700 organized workers including teachers, nurses, journalists and those working in the construction, agricultural, maritime and transport sectors. Founded in February 2001, the KSTL prides itself on being an independent, politically unaligned body acting on behalf of workers. It receives support from the ILO, the International Confederation of Free Trade Unions and the Australian Council of Trade Unions, all of which have made a commitment to provide assistance for the next six months. The KSTL's two main stated objectives are to encourage workers to organize and to provide advocacy and conciliation services. Another workers' alliance, the National Syndicate Union (UNS), was launched in March 2003. Founded by the Socialist Workers' Union (SBST) and the Port Workers' Union (OTPTL), the UNS cites a membership of 1000 workers. The UNS functions with volunteer staff and has three objectives: to lobby the government over labor issues; to monitor working conditions; and to raise community and workplace awareness about labor matters and the importance of forming unions. While there are rivalries between the KSTL and the UNS, both alliances are vital in the present political climate.

Major business organizations in East Timor are the East Timor Chamber of Commerce, and the National Association of East Timor Entrepreneurs (ASSET).

Sources:
1. Waite, 2003 **http://www.etan.org/et2003/july/20-26/23labour.htm**
2. ILO, 2001 **http://www.ilo.org/public/english/region/asro/bangkok/arm/tmp.htm**