

Box 2. Setting of the minimum wage

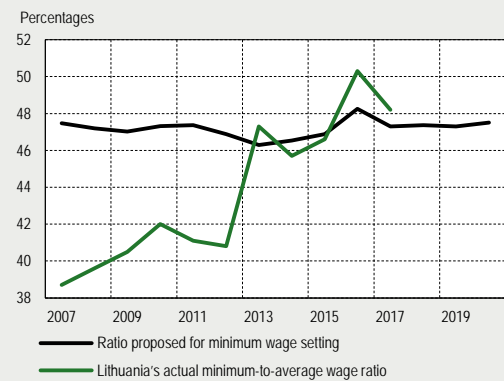
The minimum wage can help¹ tackle income inequality, poverty and the shadow economy, but it has to be set at an appropriate level. This means striking a balance between the need to address the above-mentioned problems and the employer's capacity to pay a given minimum wage. Raising the minimum wage too high may lead to a decline or weaker growth in employment, a faster rise in prices for goods and services, a decrease in international competitiveness, a scale up in the shadow economy, etc. The likelihood of negative repercussions increases when this measure attempts to achieve goals other than addressing economic and social challenges. Often in such cases, the proposed or promised level of the minimum wage is not based on economic analysis, resulting in inefficient solution of the said problems.

In order to improve the minimum wage setting process, it would make sense to depoliticise it, linking the minimum wage level to the average wage at a certain fixed ratio. Then an increase in the average wage would automatically translate into a rise in the minimum wage (at a similar rate as the average wage).

Since Lithuania is characterised by one of the highest levels of income inequality in the EU, low income, high emigration, large shadow economy and the like, it may be wise to choose a minimum-to-average wage ratio above the EU average, which stood at 43.4% in 2014-2016. It could be equal to the mean value of the ratios of one-fourth of EU countries² with the highest ratios of minimum to average wages during the last three years. Between 2014 and 2016, these countries were Slovenia (50.9%), France (47.3%), Luxembourg (47%), Latvia (45.8%) and Poland (45.6%); the mean value of their ratios stood at 47.3%³. The evolution of this ratio and Lithuania's actual minimum-to-average wage ratio is presented in Chart A.

Having decided to link the Lithuanian minimum-to-average wage ratio to the relevant indicator of other EU countries, the minimum wage should be set taking into account the Eurostat formula. Eurostat subtracts from the average wage irregular bonuses, premiums, allowances and lump-sum benefits (it should be noted that these payments are not included in the minimum wage as well). The average wage calculated in such a way differs from the average wage usually published in Lithuania, where bonuses, premiums and other allowances are taken into account. Consequently, the minimum wage in 2019 should be equal to 47.3% of the projected average wage for 2019 exclusive of bonuses, premiums, etc. (the Bank of Lithuania estimates that it should amount to roughly €896).

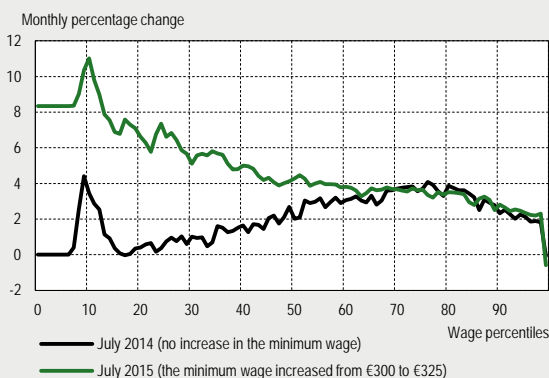
Chart A. Evolution of the minimum-to-average wage ratio



Sources: Eurostat and Bank of Lithuania calculations.

Note: For example, the minimum wage for 2019 is set according to the mean value of the minimum-to-average wage ratios of certain EU countries in 2014-2016.

Chart B. Monthly change in wages by level of wage



Sources: atvira.sodra.lt and Bank of Lithuania calculations.

It should be noted that minimum wage increases push up remuneration of both minimum wage earners and other higher-paid workers. For example, the effect of the minimum wage raise (from €300 to €325) in July 2015 can be seen by comparing wage developments which took place during that month with developments in July 2014. In both these months the situation in the labour market was fairly similar, and July-specific seasonal factors were identical. Thus differences in wage developments were mostly due to the increase in the minimum wage. As can be seen from Chart B, it affected wages of slightly more than half of workers.

Should the minimum wage be set at 47.3% of the average wage usually published in Lithuania (that includes bonuses, premiums and other allowances), the Lithuanian minimum-to-average wage ratio in 2019 published by Eurostat would reach about 50%. It would then depart from the mean value of the ratios of one-fourth of EU countries with the highest ratios of minimum to average wages and be exceptionally high. The ratio calculated on the basis of the average wage usually published in Lithuania for 2008-2017 was 1.6-3.1 percentage points lower than the ratio calculated on the basis of the Eurostat average wage. Accordingly, when setting the minimum wage on the basis of the usually published average wage, a ratio that is approximately 1.6-3.1 percentage points lower than the one calculated using Eurostat data should be applied.

¹ OECD Recent labour market developments with a focus on minimum wages (https://www.oecd-ilibrary.org/employment/oecd-employment-outlook-2015_empl_outlook-2015-en).

² Ratios of minimum to average wages are usually published by approximately 20 EU countries. Lithuania should not be included among the one-fourth of the countries.

³ According to the IMF, a minimum-to-average wage ratio amounting to 45-50% is high for Lithuania.