

## ***The Debate on Minimum Wage in Mexico***

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### ***Summary***

*In Mexico, a burgeoning debate on wage policy has taken place recently. In this article, I demonstrate that a minimum wage purchasing power can have beneficial effects for Mexican economy and society.*

*In order to do so, I shall reconstruct the disputes on minimum wage at the macro level. Then, I shall investigate specific social and economic determinants in Mexico.*

*Eventually, I shall cast lights upon the consequences of minimum wage policy, according to existing literature.*

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### **Policy Recommendations**

- Mexican government should implement a gradual plan to recover a system of minimum wage.
- Minimum wage should be increased in order to meet the minimum wellbeing line.
- There must be a monitoring system, which considers macroeconomic and local effects.
- A gender-compensation-mechanism should be part of a large minimum wage policy.



## I. Introduction

A national debate on wage policy has recently taken place in Mexico. It is related to a long-dated discussion concerning the worsening of income levels for those in the bottom of the distribution, and its effects on national poverty and income inequality.

Furthermore, this discussion underscores the modest effectiveness of social and economic policies applied during the last decades. The public expenditure on social programs, 7 percent of the GDP in 2013, and the relative macroeconomic stability, clearly contrast with the stagnation of the Mexican economy and the worsening of social conditions with over two additional millions of people falling into poverty from 2012 to 2014.

In this regard, this policy brief **advances an informed policy recommendation** on wage policy. For that purpose, it analyzes the minimum wage evolution in Mexico and the diverse stands on the debate related to increasing the minimum wage.

The article is organized as follows: the first section presents important economic trends leading the minimum wage debate and provides examples of wage policies carried out in the international and regional context. Secondly, it presents the political and social determinants of the minimum wage in Mexico, stressing the need to restore minimum wage's original welfare entitlement. Afterwards, the article describes the ongoing debate on the macroeconomic effects of an increase in the minimum wage. Finally, as closing remarks, it outlines a policy recommendation considering the elements discussed.

The analysis finds that the undeniable benefits of restoring the minimum wage purchasing power significantly exceed the arguments against its increase. Therefore, a primary recommendation for the Mexican Government is to implement a **gradual** plan for recovering the minimum wage. The first required step is to **increase the minimum wage** by an amount sufficient enough to allow a worker family to **afford the minimum wellbeing line**, that is, a basic food basket for each

one of its members. This recovery plan should also comprise a permanent **monitoring system** able to identify and prevent conflicting macroeconomic effects. It would also involve a **gender compensation mechanism**, in view of women's less favored conditions in both national distribution and labor market.

## II. Minimum Wage: the global debate

Broadly speaking, the new approach to wage policies is driven by two economic dynamics: on the one hand, a rise in inequality during the past decades for most of the Organization for Economic Co-operation and Development (OECD) economies, on the other, a systematic fall of the labor share, that is, the part of national income going to labor compensation.

According to recent studies by the International Labor Organization (ILO) and the OECD, these economic trends have important implications for the **effectiveness of social policy**. For instance, a **rise in inequality** reduces the positive effect on national income of an increase in public spending (ILO et al. 2015). As well, the **fall on labor share** implies that improvements in macroeconomic performance may not translate to equivalent gains for household income (ILO & OECD, 2015). The combination of both dynamics reinforces each other, therefore fueling a vicious cycle of limited effects of redistributive policies and increased inequality.

In this scenario, an updated discussion on minimum wage has taken place on the international field. This new debate intends to provide an alternative perspective to social policy design by incorporating labor market institutions.

For instance, on 2016 the United Kingdom established the National Living Wage aiming to offset the lowest paid workers, who have not recovered the pre-crisis living standard. The year before, Germany enacted a mandatory minimum wage for the first time in its history, as a response to workers' demands to stop the decline of labor income. Lastly, some cities in the United States of America (US) recently promoted a rise of their

minimum wage, and even the President of the US is leading a proposal for a national act on this matter.

With regards to Latin America, about a decade ago progressive governments incorporated wage policy as a key element of a broader social development strategy. Since 2006, Brazil implemented an active wage policy addressed to stimulate domestic markets by means of increasing the minimum wage. Uruguay, as well, opened the century endorsing a wide-ranging wage policy that allows the sustained growth of real minimum wage since 2005, with insignificant effects on unemployment and inflation ever since.

Mexico arrives late to the international debate on minimum wage, although the consequences of the delay are increasingly evident in its social landscape. The OECD has expressed concern as Mexico shows the lowest minimum wage relative to the average wage in the OECD and the lowest in Latin America (OECD, 2015). In addition, the Economic Commission for Latin America and the Caribbean (ECLAC) declared in 2014 that Mexico is the only country in Latin America where the minimum wage is below the poverty line.

### III. The debate in Mexico

In Mexico the debate on minimum wage is also the result of national concerns regarding the **rise of inequality** and the **worsening of labor compensation** for those in the bottom of the income distribution.

The National Institute of Statistics and Geography (INEGI) released new information suggesting a significant under estimation of **inequality** levels. This recent study estimates inequality by means of correcting income data through including sub-reporting in both extremes of the income distribution (Bustos, A., Leyva, G., 2016). As a result, INEGI's estimation of the Gini coefficient for 2012 is 0.63, compared to 0.44 resulting for the same year without allowing for the corrections.

Furthermore, ILO documented a positive and increasing gap between labor productivity and real wages in Mexico which reflects the existence of a

downward pressure on the **labor share**. As labor income represents an important proportion of a Mexican household's total revenue, particularly for middle and lower income groups, its relative decline deepens inequality and hinders the recovery of household income, becoming a main factor of social impoverishment in Mexico.

At this point, the Mexican debate on wage policy centers on the efforts to halt the decline of social welfare. This new approach implies changing the conceptual and practical use of the minimum wage, transiting from its conception as a mechanism to control the rise of price levels, to regain its original purpose: to ensure the welfare of Mexican workers, as defined by the Political Constitution of Mexico.

#### ***a) Determinants of the Minimum Wage***

By law, the minimum wage must be defined by the CONASAMI, combining the analysis of economic and social variables and negotiating with the business sector, in order to preserve the minimum wage purchasing power.

However, during the episode of high inflation of the 80s, the federal government implemented the Economic Solidarity Pacts, a set of comprehensive agreements aiming to fight inflation by systematically increasing wages at the expected inflation rate. These were negotiated between the government, union leaders and the business sector.

The logic of these arrangements prevails until the present day in the process of defining the minimum wage in Mexico. Consequently, and after two severe economic crises in the past three decades, this adjustment mechanism resulted in a loss of over three quarters of wage's purchasing power.

In 2016, the CONASAMI set the national minimum wage at 73.04 pesos for a full labor day of eight hours, approximately 3.84 US dollars.

That same year, INEGI reported 7.9 million people being paid this amount or less, which represents 16 per cent of Mexico's total working population. Half of this group is classified as belonging to the "subordinated" or "wage-earning" work force. The

other half belongs to “independent” or “self-employment”. Overall, when compared to the ratios of the total working population, these figures suggest a more informal labor scheme for the one-or-less minimum wage group.

Additionally, the one-or-less minimum wage group consists of a major proportion of women, 53 per cent, compared to the whole working population where only 38 per cent are female workers. Moreover, women are over represented at the bottom of the income distribution: 21 per cent of working women earns one-or-less minimum wage, while only 11 per cent of men is paid this amount. Likewise, 51 percent of working women declare to earn two-or-less minimum wages, compared to only 38 per cent of men. At the other end of the income distribution, only 5 per cent of female workers earn more than 5 minimum wages.

Furthermore, women almost double the “ratio of unemployment and underemployment” of men: 14 per cent versus 8 per cent. In particular, 7 out of 10 young people in Mexico who do not work or study in 2015 are women. This scenario widens the gender gap in the labor market, deepens the inequality and denotes a considerable more complex labor situation for women in the country.

On the other hand, the evident difference between the economic conditions of those earning one-or-less minimum wage (reinforced by the inter gender inequality) and the income needed to cover their living expenses, has **centered the minimum wage debate on the capability of labor remuneration to afford a basic food basket** (minimum wellbeing line).

For instance, while the minimum wage barely reaches two thousands pesos per month, the cost of a basic food basket in urban areas, as reported by the National Council for the Evaluation of Social Development Policy (CONEVAL) on June 2016, is 1,322.61 pesos per capita per month.

Allowing for a standard Mexican household of four members, with only one member earning the minimum wage, an increase of 2.4 times the minimum wage would be needed in order to bring

this household above the minimum wellbeing line. Likewise, for households comprised by two members, where only one of them receives one minimum wage, an increase of 21 per cent above the current minimum wage would be required just to subsist over the minimum wellbeing line, that is, 88.2 pesos per day.

In other words, under the official poverty measure methodology in Mexico, any household earning just one minimum wage is not able to bring its members over the minimum wellbeing line by means of its labor compensation. In 2014, more than 24 millions of people subsisted with an income below this threshold.

### **b) Contrasting stances on increasing of the Minimum Wage**

Despite the urgency to take further steps in order to improve the lowest income, Mexico is facing several institutional barriers for an effective wage policy: a market-oriented economic policy paired with an orthodox monetary policy implemented by a Central Bank whose main concern is to preserve the macroeconomic equilibrium through rigorous inflationary controls. These views started to antagonize with the idea of increasing the minimum wage, arguing possible adverse effects on the economy, particularly on price levels and employment.

The debate on the macroeconomic effects of an increase in the minimum wage was recently taken to the *Encounter of Minimum Wage Specialists*<sup>1</sup>, coordinated by the CONASAMI. This encounter proved a unique experience in the recent history of policy design in Mexico, as it gathered together national and international institutions and specialists to confront theoretical and empirical evidence in order to develop an informed wage policy.

**Regarding inflation and price levels**, the analyses focused on assessing the lighthouse effect: the impact on the average labor wage, either

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<sup>1</sup>

<http://www.conasami.gob.mx/comisionconsultiva.html>  
(Accessed: 28 July 2016).

formal or informal, of a change in the minimum wage.

The Mexican Central Bank estimated the lighthouse effect for the Mexican labor market, finding a ratio of 0.85 per cent to every one per cent of increase in the minimum wage. This lighthouse effect results in an increase of 0.15 percentage points to the inflation rate during the first year, and is insignificant after the second year of the minimum wage rise. Under this scenario, **if the minimum wage increases 21 per cent in order to attain the minimum wellbeing** line for a two-member household, the inflation rate would be around 6 per cent in the first year and virtually non-existent for the second year after the increase, with a permanent increase on the price level estimated in 3.7 per cent.

These estimations, however, contrast with empirical evidence suggesting that the rise of inflation could be less dramatic than expected. For instance, Kaplan and Perez-Arce (2006) found that changing the Mexican real wages has a positive effect on labor income for all groups on the wage distribution. However, this effect decreases in the highest income earning groups and shows a declining trend over time.

Moreover, Campos Vazquez (2015) conducted a study for the Mexican case, allowing the lighthouse effect to vary over the formal and informal sector in order to create different scenarios. In this case, **considering an increase of 51 per cent in the minimum wage**, the price level would only increase about 3 per cent. Furthermore, the study found that the poverty rate would decrease by 4 per cent, which illustrates the potential of wage policy to improve the conditions of the working population.

**For what concerns employment**, since the 90s there is an international debate trying to identify and measure the effect of the minimum wage on the labor market. However, according to the World Bank, despite numerous studies on the matter, a consensus has not been reached either in developed nor in emerging economies.

National evidence suggests that an increase of the minimum wage would not have a negative effect on employment. However, the plausibility of these results must be revised for major increases on the minimum wage. For instance, Campos, Esquivel and Santillan (2015) conducted a study on the effects of an increase of three per cent in the real minimum wage after the homogenization of two different wage zones in Mexico in 2012. The study found no significant effects on the employment rate due to the increase in the minimum wage. Moreover, the probability for a formal worker to pass to informality decreased after the minimum wage rise, and the probability to pass from unemployment to the formal sector increased.

Finally, international literature suggests that the distance between the initial minimum wage and the wage of equilibrium in the labor market is a key variable for estimating the macroeconomic effects of an increase of the former. In the case of Mexico, data indicates that the minimum wage is below the wage of equilibrium, although there is no conclusive confirmation on this front. Some elements supporting this argument are: the widening gap between labor productivity and real wage, as documented by ILO; the relatively lower cost for hiring a formal worker compared to the rest of Latin America; and strong evidence of monopsonic power in the labor market, which entails a downward distortion of wages in Mexico.

#### IV. Policy Recommendation

At this point, evidence for Mexico puts forward two conclusions. First, there might be a rise of inflation due to an increase of the minimum wage, but not as serious and harmful as expected. Secondly, the effects of raising the minimum wage on employment could be negligible, owing to the current historic-low value of the minimum wage and the structure of the Mexican labor market.

With regards to these conclusions, and since it is implausible to accurately estimate an efficient minimum wage, the most feasible option for the Mexican government is to develop and implement a **gradual plan for recovering the minimum wage**. A compulsory first step is to increase the

minimum wage at least to an amount enabling it to afford the minimum wellbeing line for a two-member household, that is, **an increase of 21 per cent**. A proposal in this fashion has already been devised by the Mexico City Government with the support of several academic and international institutions.

Furthermore, this wage policy must comprise a **permanent monitoring system** preventing the minimum wage rises to exceed a critical threshold, above which further increases could reverse the positive effects on the population perceiving the lowest income. For instance, this regularly monitoring system would signal the moment when an actual adverse effect on the inflation or unemployment rate starts to take place in order to re-estimate the subsequent minimum wage increase.

In addition, such policy must have an explicit **gender compensation mechanism**. Such mechanism would address the particularities of the participation of women in the labor market: their greater exposure to deprivation of labor income, either by a lack of opportunities or due to an unequal compensation of their work. This would also imply, for example, the estimation of a gender-differentiated minimum wage paired with fiscal incentives favoring women hiring.

At present, the economic and social conditions in Mexico result in a pressing need to take further steps towards recovering the minimum wage. Indefinitely continuing this debate implies delaying the implementation of policies addressed to improve the wellbeing of millions of families who survive today with one-or-less minimum wage.

It is important to acknowledge that increasing the minimum wage will not solve by itself the deep economic and social crisis that looms over Mexico. However, it does represent a progress on the way to the sustainable recovery of national income, starting from those in the most critical situation.

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