

## Potential Impact of the Minimum Wage Policy on the Malaysian Economy

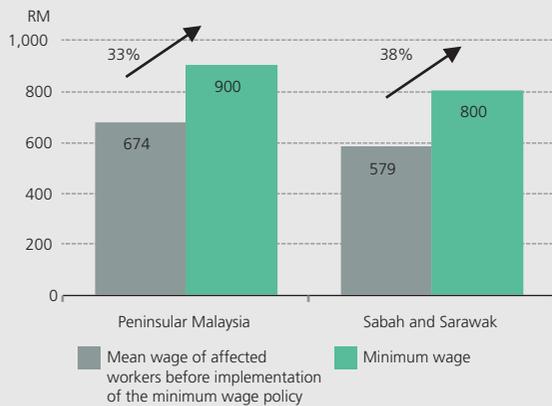
### Introduction

Malaysia implemented a minimum wage policy on 1 January 2013<sup>1</sup>, thereby joining more than 150 other countries that already have minimum wage laws in place. The policy sets a minimum wage of RM900 per month (RM4.33 per hour) for Peninsular Malaysia and RM800 per month (RM3.85 per hour) for Sabah, Sarawak and the Federal Territory of Labuan, covering both the local and foreign workforce, except for domestic workers such as domestic helpers and gardeners. The minimum wage policy is intended to ensure that the basic needs of workers and their families

are met, to reward and protect them from exploitation, and to incentivise firms to move up the value chain by investing in technology and boosting productivity<sup>2</sup>.

Chart 1

Wage Increases for Workers Affected by the Minimum Wage Policy



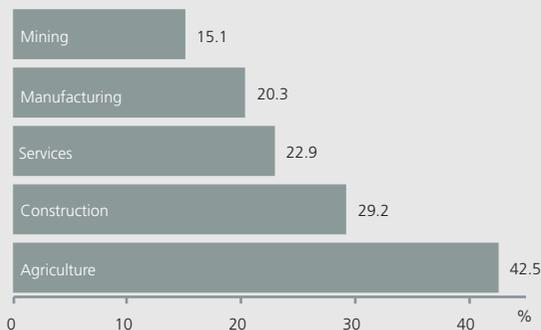
Source: Bank Negara Malaysia

### The minimum wage affects close to one-third of the workforce

The minimum wage policy is estimated to benefit about 27% of workers nationally<sup>3</sup>. On average, the affected workers in Peninsular Malaysia are expected to receive a 33% increase in wages, while those in East Malaysia would be given a 38% increment. By economic sector, the agriculture industry is expected to be the most affected, as 43% of workers in the sector received wages that were below the minimum wage prior to the implementation of the policy.

Chart 2

Share of Workers Earning Below the Minimum Wage by Sector (Peninsular Malaysia)



Source: Bank Negara Malaysia

### The minimum wage will improve worker welfare and facilitate transformation of the economy

The minimum wage policy is envisaged to have an important role in addressing inefficiencies in the labour market, and in improving the social welfare of low-paid workers. First, setting a minimum level for wages will alleviate labour market distortions and maximise the efficiency of labour usage in the economy. When wages are artificially suppressed below productivity levels, it would lead to low labour participation rates in the economy, as workers have less incentive to take part in the labour market. In some instances, wages have been suppressed at such low levels that local workers were displaced by low-waged foreign workers. In Malaysia, real wages have recorded a slower growth compared to real labour productivity

<sup>1</sup> Note: For microenterprises, the implementation date is 1 July 2013. A total of 635 firms and members of selected associations that were due to implement the minimum wage on 1 January 2013 have been granted extensions. The deadline for microenterprises to send in their applications for extension is 1 April 2013.

<sup>2</sup> Source: Ministry of Human Resources.

<sup>3</sup> Source: Bank Negara Malaysia.

growth, especially in the manufacturing sector, where wages increased by 2.4% per annum over the decade while labour productivity expanded by 5.0% per year over the same period<sup>4</sup>. The higher wage levels following the implementation of the minimum wage policy are expected to encourage greater participation in the labour market and improve the utilisation of labour in the economy.

Second, the increase in the incomes of low-wage workers, to levels that would fulfil their basic needs, would improve the economic welfare of workers by raising their standards of living. From a macroeconomic perspective, the increase in wages would also raise consumption and support domestic demand, as low-income groups tend to have a higher marginal propensity to consume (see box article on *Variations in Household Propensity to Consume across Income Segments*).

Third, consistent with the Government's objective of transforming Malaysia into a high-income and high-productivity economy, the minimum wage policy provides incentives to both firms and workers to undertake productivity-enhancing measures. As the relative cost between capital and labour narrows, firms may be encouraged to invest in automation and newer technologies that could enhance production capacity, rather than rely on low-cost foreign labour. Firms may also be incentivised to provide training to enhance the skills and productivity of their employees. With lower reliance on low-cost unskilled labour, firms may in turn be encouraged to move up the value chain to be more competitive. For workers, the greater availability of jobs with higher wages and the potential for the acquisition of higher skills would encourage increased participation in industries that were previously avoided. These changes would facilitate the transformation of Malaysia into a high value-added, high-income economy.

#### **Short-term adjustment costs to be contained**

In the short run, the minimum wage policy may subject firms to higher costs, especially those that have been highly dependent on low-wage workers. This could result in adjustments through several possible means, including by absorbing the increased cost through a reduction in margins, increasing productivity, reducing the overall costs through improved efficiency, and reducing the amount of labour used. Firms may also pass on some of the increase in costs to consumers, although this may not be a feasible option in an environment where firms face strong market competition. For the more labour-intensive and financially-constrained firms, immediate adjustment to the policy may result in cost-cutting or, where applicable, cost-passing measures.

Several studies on the impact of the minimum wage policy in other countries find a small negative effect on employment, particularly for young and low-skilled workers. The magnitude of this effect varies across countries due to differences in labour market characteristics and the prevailing economic environment. For Malaysia, while there may be some risk of lower employment, this effect is expected to be transitory and contained, given the country's strong economic fundamentals. Demand for labour is expected to continue to increase in the current environment of sustained growth and low unemployment. Any adjustment to employment as a result of the minimum wage policy will likely be temporary, as dislocated workers would be reabsorbed into the workforce given the relatively tight labour market. Indeed, job vacancies have been on an increasing trend since 2004<sup>5</sup>, while Malaysia's unemployment rate has remained consistently low, with a historical average of 3.3% over the recent two decades.

Malaysia's low and stable inflation, together with the healthy profit margins of firms, would further aid in mitigating the extent of the pass-through of costs to consumers. The magnitude of price increases would also be constrained by the extent of adjustments that are made by the larger firms, which are generally price leaders and tend to be less affected by the minimum wage policy.

<sup>4</sup> Source: The World Bank's Malaysia Economic Monitor, April 2012.

<sup>5</sup> Vacancies refer to the number of job postings on the JobsMalaysia portal, as reported by the Ministry of Human Resources.

Findings from a survey conducted by Bank Negara Malaysia<sup>6</sup> in May 2012 suggest that the impact of the minimum wage policy will be manageable. Over 90% of firms that would be affected indicated they would not retrench workers in response to the policy, while only 25% indicated a reduction in hiring. The survey also showed that about half of the firms that would be affected did not have plans to pass on the cost increase to consumers. More importantly, close to 50% of the firms that would be affected indicated they had plans to increase training to enhance labour efficiency, while 40% indicated they would expand automation as an option to offset the increase in the cost of labour. The results of the survey reaffirm the expectation that firms will be able to adapt to the minimum wage policy, at the aggregate level, through a number of adjustment mechanisms without experiencing any significant economic disruptions.

### **Conclusion**

Over the medium to long term, the minimum wage policy is expected to have a positive impact on the Malaysian economy. The short-term costs and risks of the minimum wage policy on inflation are expected to be well-contained. The impact on business cost will likely be small, as the increase in wages could be mitigated through improvements in productivity. Given that low-wage households tend to have a higher marginal propensity to consume, the increase in the incomes of the affected workers can be expected to result in higher consumer spending and economic activity.

The minimum wage policy is envisaged to be a positive step towards encouraging a fairer wage structure, and in contributing towards the promotion of higher value-added economic activities and higher-skilled jobs. To achieve its objectives, the policy is further complemented by other productivity-enhancing measures, such as the provision of training to up-skill workers, improvements in the quality of education, and the facilitation of investment in automation and advanced technology. With government and institutional support, as well as proper supervision and enforcement, the minimum wage policy is well-positioned to realise its goals.

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<sup>6</sup> Bank Negara Malaysia conducted a Minimum Wage survey in May 2012. A total of 232 firms responded.