

# **MINIMUM WAGE AND BUSINESS ENVIRONMENT IN ROMANIA: AN INSTITUTIONAL PERSPECTIVE**

---

---

**Marius-Cristian Pana\***

## **Abstract**

*The institutional economics perspective is less present in the field of minimum wage law's implications, despite the fact that labor market is one of the most regulated markets in every economy. At its beginnings, the minimum wage legislation has been subject of intense controversies between the institutionalist and neoclassical economists, but the mainstream point of view has gained ground. Still, in the last decade the institutional economics perspective has made some progress in this area, its contributions being limited to justifying the necessity of the minimum wage legislation based on some arguments borrowed from the old institutionalists, especially from John Commons. This paper is focused on the minimum wage law's implications on the business environment in Romania. The institutional hypothesis that guides the entire reasoning in this paper is: any entrepreneurial endeavor means, basically, that the entrepreneurs act in an existing institutional frame. The formal regulations, such as minimum wage legislation, affect entrepreneurial behavior by creating and altering transaction costs. The aim of this paper is to offer an explanation to the evasive entrepreneurship in Romania using the concept of transaction costs related to the institutional rigidities created by the minimum wage legislation.*

**Keywords:** minimum wage law, transaction costs, institutional economics, evasive entrepreneurship

**JEL Classification:** B25, J58, L26

---

\*Affiliation , E-mail: Associate professor, Bucharest University of Economic Studies, mariuscristianpana@gmail.com

## **I. Institutional economics vs neoclassical economics concerning the minimum wage**

The minimum wage regulation represents one of the most controversial landmarks that labor economics has to deal with. The debates involve several aspects, starting with the arguments in favor of imposing minimum wage, continuing with the implications of these laws on unemployment, on the redistribution of incomes or combating poverty among the low-qualified workers. Since the introduction of the minimum wage laws, the controversies refer to the differences between institutional school (influenced by the German historical tradition) and the neoclassical school of economics. While the first ones were in favor of these particular stipulations, the last ones criticized them. Surprisingly, both visions won: the minimum wage laws were adopted in more and more countries for the past century, but, with regard to the scientific debate, the neoclassical vision is the one that dominates.

The institutional economics approach is less present in the field of minimum wage law's implications, despite the fact that labor market is one of the most regulated. Although, at its beginnings, the minimum wage legislation was subject of some controversies between the institutionalist and neoclassical economists, the mainstream point has gained ground. Still, in the last decade the institutional economics perspective has made some progress in this area, its contributions being limited to justifying the necessity of the minimum wage legislation based on some arguments borrowed from the old institutionalists, especially from John Commons.

The recent initiatives of institutionalists have focused especially on "deciphering" the messages "encrypted" in the minimum wage legislation (Kaufman, 2009, 2010). Therefore, the stake of these laws is the elimination of the negative effects on workers that more competition would cause through generalizing some low labor standards. The main benefit of the minimum wage, says Kaufman (2010, p.433) would be shaping the negotiating power from the employers, being in a dominant position, towards the employees. So, the latter would be protected and the social benefits would be balanced. In a completely inappropriate way, these arguments are usually associated to the institutional economics. They do not represent at all the recent evolutions which show that the increase of the regulations level contributes to imbalances and inefficient allocation of scarce resources. Actually, the above mentioned studies are completely lacking a straightforward analysis in this direction. Moreover, the argumentative approach is limited, despite some attempts of favorably associating the minimum wage with transaction costs.

Even so, the contributions in this area have a positive dimension. It highlights the limits of the neoclassical approach based on the competitive markets assumptions derived from some hypotheses that are completely out of the individual's reality. Following neoclassical perspective, minimum wage legislation fails to accomplish the most elementary objectives it basically assumes. To say it otherwise, although it is desired the counterbalancing of control in the process of wage negotiation from the employer towards the employee, most probably the employee ends up working in unregulated conditions with no control at all over his income. Although it is desired the protection of low qualified or unqualified workers, in the sense of offering them a

proper income able of offering them a decent living, they end up, most probably, being unemployed. These conclusions were stated in an influent article of Stigler (1946).

Kaufman (2008, p. 280-295) dismantles the hypothesis of competitive labor market, by indicating the impossibility of demand-supply diagram analysis, starting from the logic of transaction costs. The existence of transaction costs justifies the development of every firm. If the labor market would have been perfectly competitive, then the transaction costs would be zero, which would make impossible the existence of firms. Consequently, the labor market, seen as an expression of transactions (contracts) between employers and employees, would disappear; as long as the logic of the existence of these contracts is functioning only in the hypothesis of positive transaction costs.

Although it is correct, Kaufmann limits its critique related to neoclassical economists, blinded by their simplified hypotheses, because they haven't understood the beneficial role of the minimum wage. Actually, the instruments used, specific for the neo-institutional economics, have a limited application. What Kaufman ignores is the fact that the same neo-institutional theories support the harmful effect of the increase in regulations level of labor contracts precisely because they increase the transaction costs between parties. Also, there is completely missing the analysis regarding interest groups and their influence on the decision makings that regulate labor market. The most important element of the institutional analysis, the transaction cost, is not used for explaining the implications of the increase in the minimum wage on firms, and also the incentives that such regulations create regarding the evasive entrepreneurial behaviors.

Consequently, it is required the completion of the analysis of minimum wage implications from the perspective of the new institutional economics, by considering a larger spectrum of factors. By following the chronological stages of the analysis, a first objective could be represented by the identification of the reasons behind imposing such regulations from the perspective of the political processes. The modern economic theory in general and the institutional one in particular cannot neglect the influence of political processes in regulating the economy, especially those related to public policies. Therefore, the influence of interest groups cannot be neglected, because it can represent a pertinent explanatory factor of regulations of this kind. Sobel (1999, p.781-782) shows that the interest groups have played an important role in adopting the minimum wage legislation in the US (1938). According to his conclusions, the period 1936-1938 before the adoption of the minimum wage law was marked by the significant increase of the unions' influence, as pressure groups compared with the share of the business environment in this regard. The same conclusions were drawn about their influence on the minimum wage level as well.

## **II. Minimum wage, transaction costs and business environment in Romania**

An analysis of the implications of minimum wage legislation on the business environment in Romania could represent an important contribution to the

understanding of entrepreneurial behaviors from the transaction costs' perspective. And this approach is not meaningless. On the one hand, from the new institutional economics' perspective, the existence of some regulations concerning minimum wage represent a source of institutional inflexibility which increases the transaction costs of firms, therefore altering the entrepreneurial behaviors. On the other hand, for the assumed objective in this research endeavor the analysis of the minimum wage implications is extremely useful because it acts as an interface in the relationship between the educational system and the business environment. Recent graduates or young people who have given up the formal education are the most susceptible of being remunerated at the minimum wage level. Therefore, the institutional analysis of implications derived from the existence of the minimum wage can facilitate the understanding of employers' behaviors and of employees on the labor market as well as its rigidities.

Therefore, our aim is not necessarily to test the neoclassical hypotheses regarding the effects of the minimum wage legislation on unemployment, but to offer an explanatory frame of the consequences that an increase in the minimum wage has on employment. From this perspective, no matter the consequences of the increase of the minimum wage, its implications cannot be positive. Even in the conditions where the increase of the minimum wage does not significantly affect the employment level or the unemployment, the implications cannot be seen as positive. If this doesn't happen, then the high transaction costs involved are discounted through evasive entrepreneurial behaviors or they will reach high enough levels so that they will determine institutional changes on the labor market.

The existing studies regarding the relation between the change of the minimum wage and the evolution of the unemployment rate in Romania highlight conclusions that tend to place themselves in the mainstream literature trend. Andreica et al. (2010) noticed that the minimum wage changes have a small impact on wages, on the employment rate and on the price level. By trying to highlight the bidirectional relations between the average wage level, unemployment benefits and the minimum wage level, Enache (2012, p. 94) reaches the following conclusions: the long term elasticity of the value of unemployment benefits and of the minimum wage to the change of the average income is positive but less than 1. To put it other way, if the average income increases, then there will be a permanent increase of the minimum wage and of the unemployment benefits in real terms, but at a lower rate. The explanation for these evolutions integrates the government's vision in the analysis of the arguments and effects of imposing the minimum wage. Therefore, the increase of minimum wage and benefits could be the consequence of government's agency decision to maintain the level of the distribution of wealth in society taking into account the medium wage dynamics. A possible explanation of this behavior could be represented by the stimulation of some behaviors of interest groups (unions) whose scope is to increase the minimum wage (Enache, 2012, p.94)

A more elaborated analysis made by Bonca (2012) seeks to illustrate the phenomenon of the minimum wage from the perspectives of the political ideologies which are at the basis of the public policy in the case of transition countries. In Romania, the political orientation of governments represented an important factor in

influencing the unemployment rates, without existing a linear relationship between the minimum wage level and the unemployment rate<sup>1</sup> (Bonca, 2012, p.76)

A brief illustration of the evolution of the minimum wage in Romania starting with 2000 shows a more intense increase in the period of 2005-2008 before the economic crisis, compared to the period of 2009-2015 as it can be noticed from Table no. 1. The data from the table refer to the level of the before tax minimum wage and represent the weighted average of the minimum monthly wages during these years.

**Table 1**

**Minimum wage in Romania, 2000-2015**

	<b>Monthly before tax minimum wage (RON)</b>	<b>Minimum wage index (%)</b>	<b>Index of public budget revenues from payroll taxes (%)</b>
<b>2000</b>	70	100	100
<b>2001</b>	133	190	190
<b>2002</b>	169	127,1	127
<b>2003</b>	250	147,9	149
<b>2004</b>	280	112,0	104
<b>2005</b>	310	110,7	108
<b>2006</b>	330	106,5	103
<b>2007</b>	390	118,2	119
<b>2008</b>	510	130,8	130
<b>2009</b>	600	117,6	122
<b>2010</b>	600	100,0	100
<b>2011</b>	670	111,7	113,2
<b>2012</b>	700	104,5	105
<b>2013</b>	770	110,0	111,1
<b>2014</b>	875	113,6	112,3

<sup>1</sup> *The conclusions of the mentioned study, although extremely useful and necessary for the completion of the preoccupations specific for the new institutional economics, must be viewed warily, due to the period taken into consideration: 1994-2007. As it will be shown, the evolution of the minimum wage will intensify both as frequency and as level after 2007. This could affect the conclusions of the mentioned study, if we relate them to the changes made at the political decisions level and at the level of the labor market after this period.*

<b>2015</b>	1012	115,7	108,7
-------------	------	-------	-------

*Source: Own calculations based on data provided by the Ministry of Labor, Family, Social Protection and Elder Persons [http://www.mmuncii.ro/j33/images/Date\\_lunare/s1-15.pdf](http://www.mmuncii.ro/j33/images/Date_lunare/s1-15.pdf)*

Correlating the change of minimum wage with the weight of minimum wage in average wage results is a useful instrument for understanding the aftermaths of raising minimum wage from at least two interrelated perspectives: the labor market perspective and the micro perspective of the firm. In the first perspective the implied consequences means distorting the very basic grounds of setting wages. While wages, excepting the minimum one, are influenced by the specific type of labor, level of productivity, changes in the market structure and other elements concerning the economy and firms' performances, minimum wage's level results as a consequence of government's authorities decisions based on completely different grounds. This is the reason why the frequent raising of the minimum wage level for a long period of time negatively affects the ratio between minimum and average wage. Thus the implications on firms' activity are emerged. These can occur either as firing unskilled workers or as illegal payments.

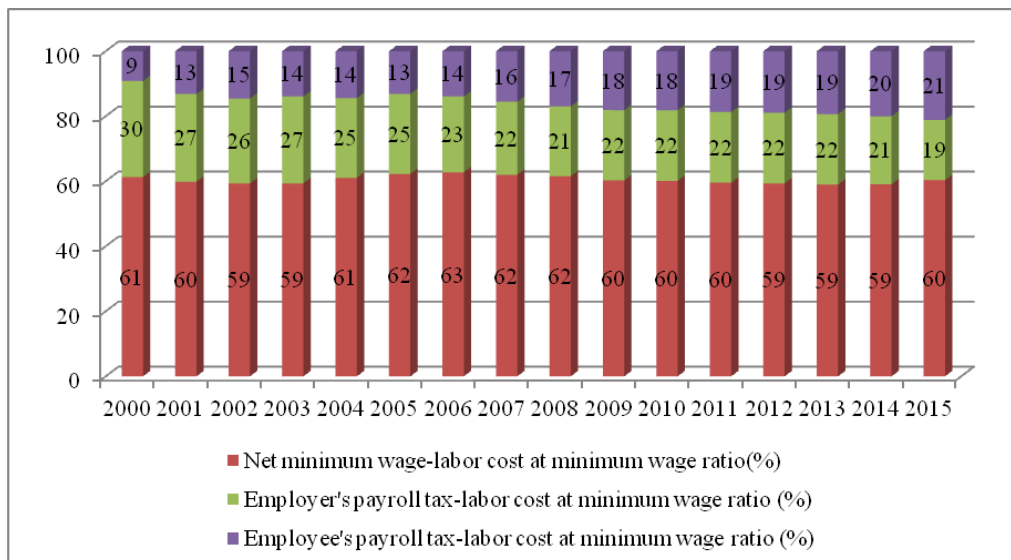
In this case, employment tax fraud can occur in various forms. The accelerated rising of minimum wage's weight in average wage can generate incentives for employers and employees to search for evasive methods in order to correct the uneconomical evolution of the minimum wage-average wage ratio. The alternative can arise as quasi evasive deals between employers and employees who agree to set the wage to the minimum level. The difference between the actual wage and the minimum one would be paid in an unregulated manner. Such a tendency is very plausible in the case of those employees whose wages are close to the rising levels of the minimum wage. Therefore, the wage stops being the main criteria for encouraging productivity of the unskilled or low skilled employees. For the former, wages are established by the authorities and for the latter by the formal regulation frame and the firm's transaction costs.

Whatever the consequences are, minimum wage regulation is an institutional rigidity that generates transaction costs. These tend to become a heavy burden to entrepreneurs which consequently develop evasive entrepreneurial behaviors. This is the reason why analyzing the consequences of minimum wage regulations on firms is extremely important.

The evolution of labor cost and tax weight corresponding to minimum wage during 2000-2015 emphasizes a negative situation for the employees. While minimum wage weight in labor cost remained virtually unchanged, the payroll tax burden increased from 9% in 2000 to 21% in 2014 (Figure 1). For the year 2015 the distribution of payroll tax burden between employer and employee should change and workers would pay more than their employers. As the labor tax increases, the labor force could be tempted to accept unregulated payments. Moreover, they could be in disadvantage because they accept salaries legally paid lower than real ones. Also they benefit from the experience accumulated and it is more likely that the employers would prefer such agreements with experienced workers, already employed, than using unskilled labor force.

**Figure 1**

**Distribution of payroll tax burden between employer and employee in Romania, 2000-2015**



Source: Own calculation based on data provided by the Ministry of Labor, Family, Social Protection and Elder Persons

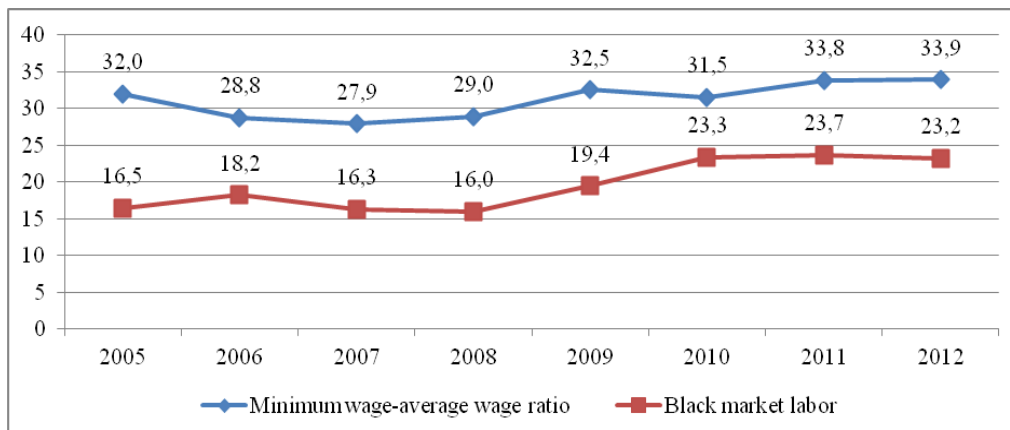
<http://www.mmuncii.ro/j33/index.php/ro/transparenta/statistici/date-statistic>;

<http://www.mmuncii.ro/pub/imagemanager/images/file/Statistica/Statistici%20lunare/Evolutia%20valorii%20cotelor%20de%20CAS%202011.pdf>.

Hiring unskilled labor force at the minimum wage is costlier and workers receive less as net salaries. Increasing transaction costs creates incentives for the unskilled labor to remain unregulated. Therefore, one can expect that black market labor to impact on unskilled workers. When the minimum wage-average wage ratio is lower, black market labor tend to diminish. If the average wage increases more rapidly than the minimum wage is less likely that employees would agree to receive unregulated payments. On the contrary, when minimum wage increases rapidly compared to the average wage, employment tax fraud is more likely to arise. As can be seen in Figure 2, black market labor increased during 2009-2012 as the minimum wage-average wage ratio was also increasing.

**Figure 2**

**The weight of minimum wage in average wage and black market labor in Romania, 2005-2012**



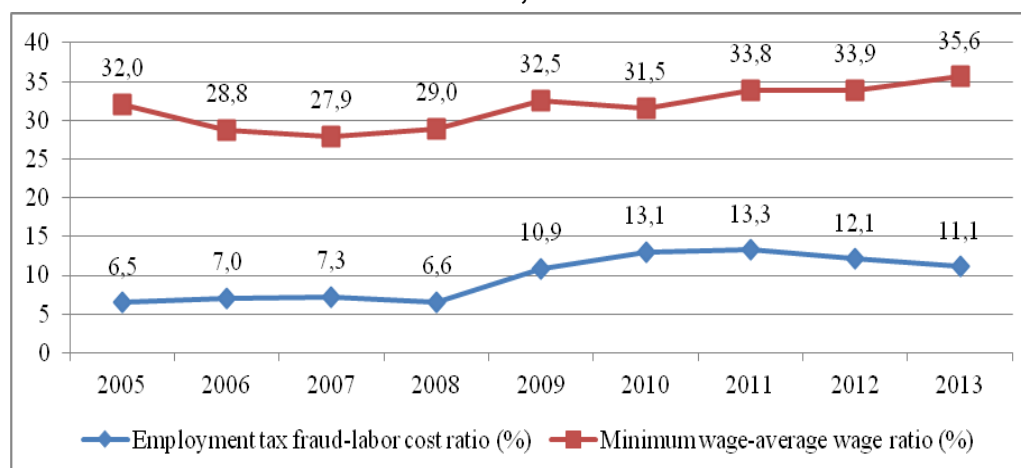
Source: Own calculation based on data provided by the Fiscal Council, Yearly Report 2012 <http://www.consiliulfiscal.ro/RA2012final.pdf> and the Ministry of Labor, Family, Social Protection and Elder Persons <http://www.mmuncii.ro/j33/index.php/ro/transparenta/statistici/date-statistic>, [http://www.mmuncii.ro/j33/images/Date\\_lunare/s0101-15.pdf](http://www.mmuncii.ro/j33/images/Date_lunare/s0101-15.pdf).

A lower minimum wage-average wage ratio caused by a fast rising of the average wage left nearly unchanged the weight of payroll tax in the total cost of labor. This means, at most, a growing employment tax fraud with a rate similar to that of the average labor cost. Such an observation is validated by the diminishing black market labor during this period of time. After 2009 one can be seen an abrupt rise of the employment tax fraud in the labor cost, probably caused by an extending black market labor relations and/or an extending number of dismissals. Another reason for this particular evolution could be the extension of employment tax fraud, even by using quasi evasive labor agreements between employers and employees.



**Figure 3**

**The weight of minimum wage in average wage and employment tax fraud in Romania, 2000-2013**



Source: Own calculation based on data provided by the Fiscal Council, Yearly Report 2013 <http://www.consiliulfiscal.ro/RA2012final.pdf> and the Ministry of Labor, Family, Social Protection and Elder Persons <http://www.mmuncii.ro/j33/index.php/ro/transparenta/statistici/date-statistice>, [http://www.mmuncii.ro/j33/images/Date\\_lunare/s0101-15.pdf](http://www.mmuncii.ro/j33/images/Date_lunare/s0101-15.pdf), <http://www.mmuncii.ro/pub/imagemanager/images/file/Statistica/Statistici%20lunare/Evolutia%20valorii%20cotelor%20de%20CAS%202011.pdf>

### III. Conclusion

Leaving aside the controversies concerning the minimum wage legislation, one conclusion is certain: minimum wage law creates labor market rigidities which generate growing transaction costs for parties involved. As a consequence of such institutional changes, entrepreneurs would be tempted to diminish transaction costs and adopt evasive behaviors but the actual aftermaths are more intense. Becoming a noneconomic substitute for wages formation, minimum wage law is distorting the relationship between labor market and educational system. Secondary and upper secondary education graduates could be most harmfully affected. As long as the minimum wage rises (completely unrelated with the business and educational environments), young graduates would be tempted to drop out of school in order to get a job. On the other side, unskilled or low skilled workers are not being encouraged to improve their abilities and to become more productive due to the high level of minimum wage.

On the other side, the educational system is not stimulated to become more effective and better adapted to labor market requirements. As long as inexperienced potential workers receive rapidly growing regulated wages, this can be wrongly perceived as a

result of a more efficient educational system. But it doesn't necessarily mean that the level of abilities created by the educational system is indeed correlated with the minimum wage. Therefore, the educational system becomes increasingly rigid in its institutional framework and tends to be unable to improve graduates' skills.

What can be more frequently seen as a particular case for Romanian economy is the use of minimum wage regulation as a specific tool against employment tax fraud. In fact, increasing minimum wage has become a way to increase public budget revenues collected from payroll taxes. This is the area with positive results from raising minimum wage, but with significant costs. Evasive entrepreneurship will persist, even if the unregulated payments are insignificantly decreasing. The main goal of the labor market institutional framework should be to reduce employment tax fraud. From an institutional economics approach, such goals could be attained due to institutional arrangements that increase the degree of economic freedom concerning contractual relations in the labor market. Thus, institutional rigidities and transaction costs can be diminished and evasive entrepreneurship could become less present.

#### **Acknowledgements**

**This work was financially supported through the project "Routes of academic excellence in doctoral and post-doctoral research - READ" co-financed through the European Social Fund, by Sectoral Operational Programme Human Resources Development 2007-2013, contract no POSDRU/159/1.5/S/137926.**

#### **References**

- Dolado, J.J. and Lütkepohl, H., 1996. Making Wald Test Work for Cointegrated VAR Systems. *Econometric Reviews*, 15, pp.369-386.
- INNSE, 2009. Monthly Statical Bulletin. [online] Available at: [http://www.insse.ro/cms/files/arhiva\\_buletine2009/bsl\\_4.pdf](http://www.insse.ro/cms/files/arhiva_buletine2009/bsl_4.pdf). [Accessed in April 2009].
- Lütkepohl, H. and Kratzig, M., 2004. *Applied Time Series Econometrics (Themes in Modern Econometrics)*. Cambridge University Press.
- Andreica, M. E., Aparaschivei, L., Cristescu, A., Cataniciu, N. "Models of the Minimum Wage Impact upon Employment, Wages and Prices: The Romanian Case." In *Recent Advances in Mathematics and Computers in Business, Economics, Biology & Chemistry* Proceedings of the 11th WSEAS International Conference on Mathematics and Computers in Business and Economics (MCBE '10) (WSEAS Press, 2010).
- Baumol, W. J. "Entrepreneurship: Productive, Unproductive, and Destructive," *The Journal of Political Economy*, Vol. 98, No. 5, Part 1 (1990): 893-921.
- Bonca, B. "Impact of Minimum Wage and Government Ideology on Unemployment Rates: The Case of Post-Communist Romania," *International Journal of Humanities and Social Science*, Vol 2, No. 1 (2012): 71-80.

- Coase, R. H. "The Nature of the Firm," *Economica*, New Series, Vol. 4, No. 16. (1937): 386-405.
- Enache, C. "Unemployment Benefit, Minimum Wage and Average Salary Earnings in Romania," *Review of Economic and Business Studies*, Vol. 5, Issue 2, (2012): 85-96.
- Kaufman, B. E. "Institutional Economics and the Minimum Wage: Broadening the Theoretical and Policy Debate," *Industrial and Labor Relations Review*, Vol. 63, No. 3 (2010): 427-453.
- Kaufman, B. E. "Promoting Labour Market Efficiency and Fairness through a Legal Minimum Wage: The Webbs and the Social Cost of Labour," *British Journal of Industrial Relations* 47:2 June 2009 0007–1080 (2009): 306–326. Accessed March 21, 2015, doi: 10.1111/j.1467-8543.2009.00725.x.
- Kaufman, B. E. "The Non-Existence of the Labor Demand/Supply Diagram, and other Theorems of Institutional Economics," *Journal of Labor Resources*, (2008): 285-299. Accessed March 21, 2015, DOI 10.1007/s12122-007-9037-7.
- Marinescu, C. *Costurile de tranzacție și performanța economică. Implicații privind România în procesul de integrare europeană*, Editura Expert, București, 2013.
- North, Douglass. *Instituții, schimbare instituțională și performanță economică*, Î.E.P. Știința, Chișinău, 2003.
- Sobel, R. S. "Theory and Evidence on the Political Economy of the Minimum Wage," *The Journal of Political Economy* Vol. 107, No. 4 (1999): 761-785.
- Stigler, G. J. "The Economics of Minimum Wage Legislation," *The American Economic Review*, Vol. 36, No. 3 (1946): 358-365.