Briefing

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The minimum wage: A motor for growth or a brake on the economy?

SUMMARY

Setting minimum wages are a direct way for governments to influence wage levels. Even though they are one of the most analysed and debated topics in economics, their impact on (un-)employment, growth and poverty remains ambiguous. For some experts, the rise of minimum wages will lead to job losses, as it increases the cost of labour. Others argue that minimum wages not only prevent the creation of a 'working poor' class, but create jobs by increasing employee purchasing power. The empirical evidence from OECD countries does not provide a clear answer.

Over recent years, the focus of the debate has switched from the macro-economic effects to the social dimension of minimum wages. A statutory minimum wage is increasingly considered a useful tool to ensure fair wages and social inclusion.

The international financial crisis widened the gap on minimum wage levels between many Member States. At the same time, it gave new momentum to the debate on 'just' minimum wages, low wage immigration and a harmonised minimum wage rate for all Member States. The idea of combining minimum wages with fiscal policy measures such as tax relief, earned income tax credits or additional income support provisions to increase low paid employees' incomes is a subject for further discussion.

The European Parliament (EP) has adopted several resolutions against 'in work poverty' and social exclusion over recent years. The minimum wage is increasingly considered to be a tool which ensures fair wages and social inclusion.

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Glossary

Equilibrium wage: determined by the interaction of labour demand and labour supply, and should, in theory, lead to full employment.

Median wage: an average wage, whereby 50% of the employees earn more and the other 50% less.

Employment elasticity: relies on the principle of price elasticity (of demand) which measures the relationship between price change, e.g. for goods or services, and demand change. Regarding employment, an increase in labour costs (e.g. higher wages) would result in a decrease of employer labour demand.

Background

In July 2015, the Organisation for Economic Co-operation and Development (OECD) released its Employment Outlook 2015 report. Currently, 26 of the 34 OECD countries have statutory minimum wages in place, with Germany being the most prominent country to recently introduce a statutory minimum wage (January 2015).

According to the OECD, the international financial crisis and increased social and income inequality have reignited the minimum wage debate. The United States and several EU Member States are currently debating the relevance of statutory minimum wages, as well as envisaging raising them.

In addition, some higher-income Member States are confronted with low wage immigration which is perceived by some experts as a threat to existing wage differentials. These developments add new momentum to the debate on a harmonised minimum wage rate in the EU.

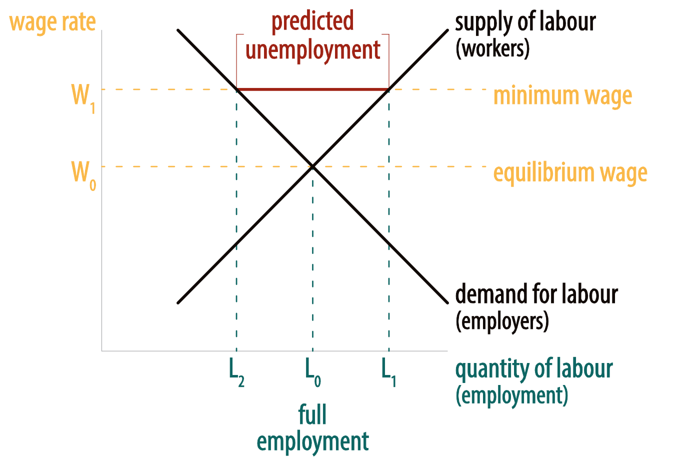
The neoclassical theory of minimum wage impact

A minimum wage is a direct policy means for a government to influence wage levels. There is no 'natural' level for a minimum wage, they are set by policy decision and/or based on an agreement between social partners.

Disagreement amongst economists on the macroeconomic effects of minimum wages has persisted for decades. According to neoclassical economics, (the usual theory used to explain market equilibrium), the labour market is, like any other market, a standard competitive market with a rising supply curve and a descending demand curve.

The equilibrium wage (W_0) would lead to full employment (L_0) as supply and demand of labour are in balance (see Figure 1). According to this theory, a binding or statutory minimum wage (W_1) higher than the equilibrium wage increases the price for labour by artificially introducing a wage floor. The supply of labour (L_1) would be larger than employer demand (L_2). This would result in unemployment, since fewer workers are needed or employed. However, the rise of labour prices may not necessarily manifest itself in higher unemployment; but

Figure 1 – Curve chart: relation between wages and employment



may also take the form of slower hiring and employment growth. On the other hand, a higher wage would not only increase the quantity of labour, but also employee willingness to work.[1]

As elegant as this neoclassical model may be, it has limitations. The model is simplified, makes general statements, and does not distinguish different industries, occupational groups or between richer and poorer regions. Over 85% of minimum wage jobs are in restaurants, retail, nursing homes and cleaning services. An increase in minimum wages may have a negative impact on the employment situation in cleaning services, but not in retail, for instance, as profit margins vary in different industries.

Furthermore, it is obvious that in major cities (e.g. London, New York) the minimum wage is higher than in other areas. In addition, the model does not take into account the varying qualifications and skills of employees. Employers do generally pay higher skilled workers a salary above the equilibrium wage in order to compete with companies for suitable employees.[2]

Sometimes, increases in minimum wages do not have a discernible effect on overall employment; whilst low skilled work opportunities may fall, highly qualified jobs might equally increase. In addition, employers often have other adjustment means, such as reducing training, other labour costs, or non-wage benefits, and employers may reduce working hours.[3]

Arguments for and against minimum wages

Proponents put forward demand-oriented and/or social arguments for a minimum wage, which may provide:[4]

- increased salaries for low-income employees;
- economic stimulus – low income employees are more likely to spend their (entire) salaries than higher paid groups (who tend to save any surplus) – which could boost the economy and create jobs;
- a key labour standard for ensuring fair pay, preventing exploitation and as an anchor for wage bargaining;
- attractive jobs for highly skilled workers and reduced turnover among employees, with positive effects on a company's productivity;
- reduced social and income inequality, by narrowing the gap between low and high income employees.

Opponents prefer cost-related and competition arguments against minimum wages, claiming:

- such government price controls destroy jobs, as labour costs are often the largest share of a company's budget: minimum wages force employers to cut jobs or to reduce working hours in order to maintain profits, thus contributing to unemployment or reduced income for low skilled workers;
- levels of 'informal work' increase;
- inflationary effects, as higher labour costs are passed on to consumers through increased prices;

- lower profits for employers, thus preventing companies from investment and business expansion and therefore from creating jobs;
- governments should use fiscal means to encourage savings for low-income families, as the best means to reduce poverty and social inequalities.

The minimum wage in practice: ambiguous empirical evidence from OECD countries

Prior to the mid-1990s, many economists believed that minimum wages would lead to job losses because they artificially introduce a wage floor and increase the price of labour.

Since the mid-1990s, however, the picture is revealed as more ambiguous. Several meta-studies have analysed dozens of empirical research papers and deduced some interesting implications. The findings show that, apart from slight negative effects on less skilled groups (young people and job market entrants in particular), the overall negative impact of minimum wage increases on employment tends to be insignificant.

The 2013 meta-analysis of minimum wage studies by the Centre for Economic Policy and Research (CEPR) concluded that higher minimum wages have no discernible effect on employment. An academic paper from 2009 reviewed 64 studies and concluded that the impact of increased minimum wages on employment was close to zero.[5] In addition, in its Employment Outlook 2015 paper, the OECD concludes that 'at reasonable levels, increases in the minimum wage are unlikely to cause substantial job loss'.[6]

There are, however, diverging views. According to a well-known study by Brown, Gilroy and Kohen (1982), increases in minimum wage do affect unemployment, especially for young and less skilled people. The employment elasticity for teenage employment, for instance, clustered between -0.1 and -0.3.[7] Studies and data collected through 1999 also confirmed the elasticity ranges overall, and the implications – that minimum wages do eliminate jobs normally available to vulnerable groups such as young and unskilled people.[8]

In their meta-analysis, the authors Neumark and Wascher conclude that 85%, or 28 out of the 33 most relevant studies (these included research, amongst others, on Canada, Mexico, Portugal, the UK, and the US), point to a negative (although not always statistically significant) effect of increased minimum wages on employment.[9]

Minimum wages are a contested topic in major OECD countries. In the US, most states have their own minimum wage rates. There is, however, a statutory federal minimum wage (currently US$7.25 an hour), last raised in July 2009.

In the European Union, 22 out of 28 Member States have a statutory minimum wage (the exceptions are Austria, Cyprus, Denmark, Finland, Italy, and Sweden). Minimum wage levels and setting mechanisms vary significantly across countries (see table 1).[10] Germany was the last major industrialised European country to introduce a statutory minimum wage, in January 2015.

Table 1 – Development 2000-15: Minimum wages per hour; on 1 January of each year

	Currency	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Belgium	EUR	7.33	7.48	7.63	7.94	8.41	8.41	8.58	8.75	9.10	9.10	9.10
Estonia	EUR	1.02	1.14	1.37	1.73	1.73	1.73	1.73	1.80	1.90	2.13	2.34
France	EUR	7.61	8.03	8.27	8.44	8.71	8.86	9.00	9.22	9.43	9.53	9.61
Germany	EUR	-	-	-	-	-	-	-	-	-	-	8.50
Greece	EUR	3.31	3.51	3.62	3.94	4.05	4.28	4.28	4.34	3.35	3.35	3.35
Ireland	EUR	7.00	7.65	8.30	8.65	8.65	8.65	8.65	8.65	8.65	8.65	8.65
Latvia	EUR	0.67	0.76	1.01	1.37	1.54	1.54	1.69	1.69	1.71	1.93	2.17
Lithuania	EUR	0.86	0.97	1.21	1.41	1.41	1.41	1.41	1.41	1.76	1.76	1.82
Luxembourg	EUR	8.48	8.69	9.08	9.08	9.49	9.73	10.16	10.41	10.83	11.10	11.12
Malta	EUR	3.25	3.38	3.48	3.57	3.67	3.81	3.84	3.96	4.06	4.15	4.16
Netherlands	EUR	7.76	7.81	7.98	8.19	8.47	8.64	8.74	8.88	9.01	9.11	9.21
Portugal	EUR	2.26	2.32	2.43	2.57	2.71	2.86	2.92	2.92	2.92	2.92	3.04
Slovakia	EUR	1.24	1.32	1.45	1.55	1.70	1.77	1.82	1.88	1.94	2.02	2.18
Slovenia	EUR	2.83	2.96	3.02	3.11	3.41	3.45	4.32	4.41	4.53	4.56	4.57
Spain	EUR	3.11	3.28	3.46	3.64	3.78	3.84	3.89	3.89	3.91	3.91	3.93
Bulgaria	BGN	0.89	0.95	1.07	1.30	1.42	1.42	1.42	1.61	1.85	2.03	2.08
Croatia	HRK	12.03	12.54	13.28	14.11	15.88	16.27	16.27	16.27	16.27	17.44	17.51
Czech Republic	CZK	42.50	44.70	48.10	48.10	48.10	48.10	48.10	48.10	48.10	50.60	55.00
Hungary	HUF	328.00	360.00	377.00	397.00	411.00	423.00	449.00	535.00	564.00	584.00	604.00
Poland	PLN	4.91	5.20	5.41	6.51	7.38	7.61	8.01	8.67	9.25	9.71	10.12
Romania	RON	1.84	1.96	2.31	2.96	3.56	3.56	3.97	4.15	4.15	5.04	5.78
United Kingdom	GBP	4.85	5.05	5.35	5.52	5.73	5.80	5.93	6.08	6.19	6.31	6.50
Turkey	YTL	2.51	2.72	2.88	3.12	3.42	3.74	4.08	4.55	5.02	5.49	6.16
Argentina	ARS	2.25	3.15	4.00	4.90	6.20	7.50	9.20	11.50	13.35	18.00	23.58
Australia	AUD	12.30	12.75	13.47	13.74	14.31	14.31	15.00	15.51	15.96	16.37	16.87
Brazil	BRL	1.18	1.36	1.59	1.73	1.89	2.32	2.45	2.83	3.08	3.29	3.59
Canada	CAD	7.11	7.43	7.64	7.96	8.49	9.02	9.50	9.85	10.07	10.18	10.57
Japan	JPY	665.00	668.00	673.00	687.00	703.00	713.00	730.00	737.00	749.00	764.00	780.00
Korea	KRW	2 840	3 100	3 480	3 770	4 000	4 110	4 320	4 580	4 860	5 210	5 580
New Zealand	NZD	9.00	9.50	10.25	11.25	12.00	12.50	12.75	13.00	13.50	13.75	14.25
USA	USD	5.15	5.15	5.15	5.85	6.55	7.25	7.25	7.25	7.25	7.25	7.25

Source: WSI Minimum Database International. The figures are indicated in national currency to provide better comparison beyond distortions caused by changes in currency exchange rates.

Minimum wage efficacy can sometimes be undermined by higher taxes and reduced social entitlements. On average across the OECD, the total burden from income taxes and social security system contributions amounts nearly to one third of the gross minimum wage, with approximately identical shares paid by employer and employee.[11]

The crisis and minimum wages: better incomes at the expense of fewer jobs?

The international financial crisis has widened the gap in wages and minimum wages in the EU Member States in absolute and relative terms. It provided new momentum to the debate on 'just' minimum wages, low wage immigration and a harmonised minimum wage rate for all Member States. In addition, the crisis moved the focus of the debate away from minimum wages creating or eliminating jobs, to the relevance of minimum wages for social inclusion and fair pay.

Across the OECD, minimum wages are set at around 50% of the median wage. Whether this is a 'just' level or not, is a subject for discussion. In previous decades, minimum wages often kept pace with the productivity rate; however, today they are often combined with the inflation rate, or determined by political decisions or bargaining between social partners. A 'reasonable' level for minimum wages, however, remains a country-specific issue, which must take account of minimum wage interactions with other issues, such as legislation, compliance, taxes, benefits or the economic situation, including the right timing for introduction/increase of minimum wages.[12]

The OECD states that during and after the recession, many countries relied on minimum wages, either to increase or sustain low paid workers' wages, or to lower minimum wages as a crisis-related measure.[13]

For some experts, however, there is a trade-off inherent to minimum wages, in the sense that they do contribute to social inclusion by setting a wage floor – at the expense of job losses.

In Germany, for instance, the newly introduced minimum wage is considered responsible for the loss of about 237 000 low paid part-time jobs, (so-called 'mini-jobs'), but simultaneously created around 50 000 (part-time) jobs liable for social insurance contributions.

Table 2 – Dataset: Minimum relative to average wages of full-time workers

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Australia	0.575	0.538	0.545	0.522	0.544	0.543	0.536	0.527	0.540
Belgium	0.509	0.498	0.503	0.508	0.516	0.507	0.509	0.509	0.500
Canada	0.400	0.405	0.404	0.414	0.426	0.436	0.445	0.451	0.441
Chile	..	0.650	..	..	0.707	0.710	0.674	0.671	0.678
Czech Republic	0.386	0.397	0.382	0.360	0.360	0.353	0.367	0.359	0.364
Estonia	0.401	0.370	0.358	0.378	0.398	0.404	0.381	0.376	0.388
France	0.670	0.634	0.633	0.630	0.628	0.621	0.620	0.631	0.628
Germany	-	-	-	-	-	-	-	-	0.51*
Greece	0.462	0.459	0.468	0.485	0.487	0.476	0.518	0.437	0.452
Hungary	0.481	0.490	0.483	0.477	0.478	0.474	0.495	0.539	0.539
Ireland	0.540	0.524	0.531	0.524	0.504	0.476	0.477	0.476	0.479
Israel	0.549	0.574	0.573	0.572	0.568	0.560	0.564	0.572	0.577
Japan	0.335	0.338	0.341	0.346	0.362	0.373	0.382	0.383	0.390
Korea	0.373	0.389	0.429	0.436	0.452	0.451	0.455	0.429	0.442
Luxembourg	0.414	0.409	0.411	0.405	0.412	0.408	0.414	0.414	0.414
Mexico	0.378	0.376	0.367	0.360	0.366	0.349	0.360	0.363	0.368
Netherlands	0.479	0.472	0.471	0.470	0.470	0.473	0.473	0.474	0.474
New Zealand	0.544	0.560	0.574	0.591	0.594	0.588	0.588	0.599	0.595
Poland	0.421	0.422	0.396	0.427	0.459	0.453	0.452	0.482	0.497
Portugal	0.525	0.511	0.514	0.524	0.537	0.566	0.565	0.577	0.558
Slovak Republic	0.432	0.445	0.443	0.428	0.454	0.457	0.456	0.451	0.455
Slovenia	0.512	0.513	0.500	0.485	0.486	0.566	0.582	0.595	0.612
Spain	0.430	0.442	0.439	0.419	0.417	0.411	0.410	0.411	0.413
Turkey	0.748	0.725	0.715	0.709	0.713	0.698	0.701	0.711	0.694
United Kingdom	0.450	0.454	0.466	0.461	0.461	0.461	0.467	0.472	0.469
United States	0.316	0.307	0.314	0.341	0.371	0.388	0.383	0.378	0.374
Latvia	0.410	0.367	0.363	0.405	0.475	0.490	0.524	0.504	0.482
Lithuania	0.469	0.427	0.407	0.402	0.457	0.463	0.450	0.445	0.516
Romania	0.441	0.419	0.375	0.409	0.453	0.439	0.471	0.472	0.496

Source: OECD

In the US, for instance, around three million (or 3.9%) of the 77.2 million workers are paid US$7.25 or less on an hourly basis (according to the Bureau of Labor Statistics). Due to inflation, the current minimum wage has lost more than 12% of its purchasing power since 2009, (and 30% since 1968 when it was introduced). President Barack Obama has announced his support for a Senate bill from the Democratic Party that would gradually increase the federal minimum wage from US$7.25 to US$10.10, indexed to inflation.[14]

In a report, the Congressional Budget Office (CBO) expects the rise in national minimum wages may cause job losses of up to 500 000 jobs, but at same time would increase the wages of 16.5 million Americans and raise 900 000 people out of poverty. A study by the Economic Policy Institute (EPI) forecasts that increased minimum wages would cost US$35 billion, but that GDP would also grow by US$22 billion, and a net 85 000 new jobs would be created.

The OECD states that minimum wages are a relatively blunt instrument for tackling poverty and social inequalities, as many poor families have no working member, and as minimum wages do not guarantee a sufficient number of hours of work to lift employees out of poverty.[15]

In order to increase take home pay, the OECD, along with some experts, supports the idea of combining minimum wages with fiscal policy measures such as tax relief, earned income tax credits or additional income support provisions for low paid workers.[16] This unburdening of private employers, however, may not only subsidise work for poverty level wages, at the expense of tax payers, but also encourage companies to decrease wages further, to below the poverty line.

Outlook: social partner positions and the European Parliament

The controversy about the impact of minimum wages on (un-)employment, growth and poverty will continue, since there is no final answer on whether minimum wages do create or eliminate jobs. In recent years, however, the scope of the debate has switched from the macro-economic effects towards the social dimension of minimum wages.

It is very likely that the future discussion will focus on scaling down the ratio of minimum and median wages, as well as on fiscal contributions. While across the OECD countries minimum wages are set at around 50% of the median wage, experts such as those from the European Trade Unions Institute (ETUI) request the implementation of a harmonised minimum wage rate (e.g. 55-60% of the median wage), binding for all EU Member States. In addition, a combination of minimum wages with fiscal policy measures such as tax benefit policies might be necessary in order to guarantee higher take home pay for low income employees. Some European employers' associations, however, argue that if minimum wages are set too high, they could be detrimental to the integration of the long term unemployed.[17]

The diametrical effects of a high minimum wage (increasing incomes and job losses for vulnerable groups such as young and less skilled people) makes it difficult for the European Commission to tackle youth unemployment. The European Parliament (EP) is aware of this difficult situation and has debated on low income and social exclusion over recent years. The minimum wage is increasingly considered to be a tool which ensures fair wages and social inclusion – in line with the European Social Charter of the Council of Europe. In a 2011 resolution, the EP 'encourages the Member States to develop minimum income schemes based on at least 60% of the median income in each Member State.' In addition, it calls for efforts to end 'in work poverty' and inequitable working conditions, 'through pay levels in general and minimum wage levels in particular, which – whether regulated by legislation or by collective bargaining – must ensure a decent standard of living.'

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6 OECD Employment Outlook 2015 report, p. 21.

7 Employment elasticity describes the ratio of the percentage change in employment to the percentage change in the MW. For example, an elasticity of −0.17 means that a 10% increase in the MW would reduce employment (of the affected group) by 1.7%.

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11 OECD 2015, op. cit., p. 38.

12 OECD 2015, op. cit., p. 34.

13 OECD 2015, op. cit., p. 21.

14 The so-called Fair Minimum Wage Act of 2013 was introduced by Senator Tom Harkin (D-IA), Chair of the Senate Labor Committee, and Representative George Miller (D-CA), Member of the House Workforce Committee. It foresees an increase of the MW in three steps (by 95 cents each year) from US$7.25 to US$10.10.

15 OECD 2015, op. cit., p. 49.

16 OECD 2015, op. cit., p. 50; T. Schulten, WSI-Mindestlohnbericht 2015 – Ende der Lohnzurückhaltung, WSI-Mitteilungen 2/2015, pp. 133-140.

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