



# Standpunkt

## Deutschland

## Minimum wage at EUR 8.50: The wrong policy choice

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*David Folkerts-Landau, Group Chief Economist*

The current negotiations between CDU/CSU and SPD towards forming a government point to the implementation, for the first time, of a country-wide minimum wage of EUR 8.50 per hour. We estimate the subsequent employment losses at between 450,000 and 1 m. Quite paradoxically, given the proponents' intentions, aggregate wage income could actually decline, since the net destruction in jobs could more than offset the increase in wages per head.

Empirical evidence suggests that the effect of a minimum wage is particularly toxic when it is brought to a level that is close to the median wage. In the EU, only France would do worse than Germany.

The diffusion effects of such a minimum wage would be very high. This would mean higher wages for about 6 m workers (17% of all workers). The introduction of a minimum wage would not only have a one-off level effect. The possible annual hikes could serve as a benchmark for collective wage negotiations and thus could lead to additional wage increases further up the scale.

At first glance, the likely minimum wage would not jeopardise Germany as a production location, as it will have a limited impact on jobs in the larger German export-oriented companies. It will, however, have an indirect negative impact on their cost basis, via the suppliers of domestic services.

A minimum wage will certainly impair the employment chances of problem groups which already have distinctively higher unemployment rates. In structurally weak regions, e.g. in parts of east Germany, a floor of EUR 8.50 could severely hamper the creation of new jobs and lead almost certainly to the disappearance of existing jobs.

A minimum wage would essentially reverse one of the key achievements of the Hartz reforms, namely getting problem groups back into work by establishing a low-wage segment in the labour market. Companies will, where possible, substitute towards offshoring/outsourcing or the shadow economy.

If society or politicians do not want to accept the distributional effects of the market outcome, this should be dealt with via taxation and transfers and not by interfering with wage setting, which has so far been left to industry and union negotiations. This has been one key pillar of the successful German model. The minimum wage potentially opens the door for politicians to engage in more redistributive policies, where the bill will show up in the long run in higher structural unemployment.



## Minimum wage intended by all major parties

The minimum wage issue was a hot topic in the election campaign. At the time all major parties advocated a wage floor, but presented different proposals.

In line with its campaign's focus on "social justice" the SPD favoured a country-wide statutory minimum wage of EUR 8.50 per hour. This concept met broad public support.

In contrast, the CDU proposed to build on the present regulation, i.e. industry-specific and regionally differentiated minimum wages negotiated by unions and employers associations, and to extend it into a country-wide network of wage floors. German business supported this particular approach as it is embedded in the regionally structured system of wage bargaining on industry levels. In contrast, the unions which had once welcomed this approach as well changed sides, arguing that their bargaining power in economically weak regions especially in east Germany was too limited to successfully negotiate "satisfactory" minimum wages.

Given the high ranking of this issue in the political agenda, at least on the SPD side, a compromise on the introduction of a minimum wage is now a precondition for a CDU/CSU and SPD coalition. While differences initially seemed impossible to overcome, a compromise is now in the offing.

Therefore, it is likely that one of the first legislative acts of a future CDU/CSU/SPD coalition will be to enact a law on a country-wide minimum wage. Although details have still to be hammered out, the reference for this legislation is likely to be the SPD's proposition at EUR 8.50. A possible compromise here might be to have a certain phase-in period first. Then, on a permanent basis, a kind of "low pay commission" similar to the British model, with participants from the trade unions and the employers' associations and perhaps academics, would decide on future (annual) increases.

## Substantial job losses expected – especially in SMEs and the services sector

At 58% of the full-time median wage, a minimum wage at EUR 8.50 per hour would make the German minimum wage the second highest (together with Slovenia's) within Europe<sup>1</sup> – where 21 EU countries do have minimum wages – exceeded only by France (60.1%) and clearly above the EU average of 48.3%.

This would mean higher wages for about 6 m workers (17% of all German workers). But as it will probably trigger an upward drift for wages marginally above EUR 8.50, the institution of a minimum wage would directly and indirectly affect 1/4 of all German employees.

Furthermore, there is a risk that the introduction of a nation-wide statutory minimum wage would not only have a one-off level effect. The annual hikes that would probably be driven by distributional considerations would serve as a benchmark for collective wage negotiations and thus could lead to additional momentum in wage increases reinforcing the negative impact on employment.

Given these figures, such a wage floor will obviously markedly impact the German labour market and the economy.

Minimum wages in Europe

1

	EUR/hour Oct 2013	% of full-time median wage
LU	11.10	42.0
FR	9.43	60.1
BE	9.10	50.3
NL	9.07	47.4
IE	8.65	47.7
<b>DE</b>	<b>8.50</b>	<b>58.0</b>
GB	7.78	46.7
SI	4.53	58.2
ES	3.91	43.9
GR	3.35	51.1
PT	2.92	56.5
PL	2.21	44.5
CZ	2.01	34.5
HU	1.97	49.5
SK	1.94	45.6
EE	1.90	38.6
LT	1.76	47.9
LV	1.71	57.3
RO	1.06	47.7
unweighted	4.34	48.3
weighted*	5.49	47.5

\* weighted by population size

Sources: WSI, Groll/Kohts

<sup>1</sup> Among larger countries Argentina, Australia, Brazil, Canada, Japan, Korea, New Zealand, Turkey and the US have minimum wages.



## Minimum wage at EUR 8.50: The wrong policy choice

A minimum wage is often seen as an instrument to boost domestic demand via stronger private consumption. These arguments have even become more popular in the context of intra-EMU rebalancing. Low-income households with their marginal propensity to consume at 1 could generate a particularly strong demand effect. We strongly disagree with this view.

We estimate a likely range for job losses using the following approach. The introduction of a minimum wage of EUR 8.50 would lead to a wage increase of a good 35% for workers with wages below the minimum. With an elasticity of employment to wages of  $-0.5^2$  for low-qualified workers, employment in this category would fall by 18% or about 1 m, while the unemployment rate of these workers already stands at almost 20%. Even using the lower bound of the employment elasticity to wages ( $-0.2$ ), the low-qualified employment would still decline by around 450,000.<sup>3</sup>

The overall effect on labour income is likely to be negative, since job destruction would outweigh the increase in wages for those who would remain in employment. In the worst case, where all employees who enjoy a wage increase are being dismissed, aggregate wages would shrink by about 8%. In our “lower elasticity case”, which we consider to be overly optimistic, the net impact on gross income would be nil.

German companies by number of employees

2

Number of employees	Number of companies ('000)	%
0-9	3,322.1	91.0
10-49	258.6	7.1
50-249	56.2	1.5
>250	12.5	0.3
Total	3,649.4	100.0

Source: Federal Statistical Office

The likely negative impulse on private consumption would be even larger, as the net income of a large number of minimum-wage beneficiaries will hardly increase. This is especially true for two major groups of low-wage earners: (1) those who are married to spouses with a higher income and (2) persons who get additional financial support from the state. While the first group's increase in gross income will be reduced by higher taxes, given Germany's progressive income tax scale the latter group will be subject to cuts in their income-dependent transfers.

German companies by turnover

3

Turnover m	Number of companies ('000)	%
<1	3,293.1	90.2
1-2	153.2	4.2
2-10	151.4	4.1
10-50	39.6	1.1
>50	12.1	0.3
Total	3,649.4	100.0

Source: Federal Statistical Office

The impact would differ across industries and regions. While the larger export-oriented companies will be less affected, markedly higher wage costs would especially hit smaller enterprises with less latitude to adapt and they would hit jobs in many branches of the services sector. While for companies with more than 200 employees – with a low proportion of lower-paid employees – the aggregate wage level would increase by 1% only (assuming unchanged employment), companies with less than 5 employees would have to pay about 10% more on average (companies with 5 to 10 employees 7%). This is even more problematic as larger companies in general have more options, such as outsourcing and/or offshoring, to cope with wage shocks than SMEs. But even in larger companies someone has to pay. Assuming that they would not hike prices given the constraints of international competition, either profits would have to fall, or the wages of the better-qualified would have to grow more slowly. Not a good incentive for a country which depends on the input of highly skilled labour.

In general, the export sector should be able to cope with a minimum wage, as the labour cost share is relatively small. However, even larger companies are embedded in supply chains. Therefore, beyond its direct effect on wage costs a minimum wage has an indirect impact on the companies' cost basis (suppliers of domestic services). This should not be overlooked. Such indirect cost drivers

<sup>2</sup> This is the mean of prior estimates which are all negative ranging from  $-0.2$  to  $-0.9$  (see for more details Ragnitz, J., Thum, M. (2008). Beschäftigungswirkung von Mindestlöhnen – eine Erläuterung der Berechnungen des ifo Instituts. Ifo Schnelldienst 1/2008).

<sup>3</sup> Our rough estimates are more or less in line with the results of other studies. According to a literature review, employment losses range from 140,000 to 1.2 m given a minimum wage rate of EUR 7.50 which was discussed at that time (see for details Müller, K.U. (2009). Wie groß sind die Beschäftigungsverluste aufgrund eines allgemeinen Mindestlohns? DIW Wochenbericht 26/2009 and Ragnitz, J., Thum, M. (2008). Beschäftigungswirkung von Mindestlöhnen – eine Erläuterung der Berechnungen des ifo Instituts. Ifo Schnelldienst 1/2008).

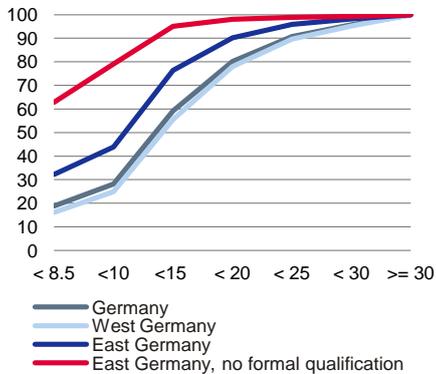


## Minimum wage at EUR 8.50: The wrong policy choice

### Bleak situation in east Germany

4

y-axis: cumulative share of employees  
x-axis: hourly gross wage groups



Sources: SOEP, Deutsche Bank Research

are also relevant for other industries where the direct impact is relatively small, like the financial services and the mining & utilities sectors.

In addition, the export sector is dominated by larger manufacturing companies. The four major industries, i.e. automotive engineering, chemicals, mechanical engineering and electrical engineering, have a common share of two-thirds in German merchandise exports. Wages in these industries are above average. Nevertheless, even in manufacturing about 14% of all employees earn wages below EUR 8.50 at present.

In contrast to these industries the wage bill would increase noticeably in agriculture (6% under the assumption of unchanged employment) and in parts of the services sector (about 4%) such as services for private households as well as certain services for companies like plant security. Although these services sectors produce non-tradable only, especially the latter supplies input for the whole economy. A minimum wage could hamper the structural change of the German economy towards a more domestically / services driven growth model, if the negative employment effects prevail.

### Most vulnerable groups in the labour market with a relatively high share of persons earning less than EUR 8.50

5

Share of employees earning less than EUR 8.50 in 2011



Sources: SOEP, Deutsche Bank Research

## Empirical studies: Negative effects in comparable countries

This negative view may be surprising given that a lot of often-quoted empirical studies, focusing on the US and UK experiences, fail to find strong relationships between employment and the minimum wage. However, we believe that these findings are hardly applicable to the German case.

Indeed, the minimum wages in those two countries are not comparable to the country-wide statutory minimum planned in Germany. In the US and the UK, minimum wages differ by region, sector and/or labour qualifications. Moreover, in the UK the minimum wage slightly exceeds 45% of that country's median full-time wage and in the US it comes to merely 38%, whereas the minimum wage planned in Germany would equal nearly 60% of the full-time median.

The same applies to initial analyses of the minimum wage arrangements which have already been agreed for individual sectors in Germany and do not find any serious negative consequences for employment. Indeed, the experience to date refers to specific sectors and the minimum wages negotiated for east Germany are lower than those for west Germany. In most cases the agreed floors are far below the nation-wide statutory minimum currently under discussion (security industry EUR 7.50, care sector EUR 8.00, industrial cleaning EUR 7.56 – 9.00 and staffing services EUR 7.50). A uniform wage, i.e. a statutory minimum for all sectors and all regions, would probably have much more negative consequences for the labour market than the current sector agreements.<sup>4</sup>

Our negative view is supported by analyses of the French market, where the minimum wage is slightly over 60% of the median wage and is thus much higher than in the US and the UK, making it comparable to the minimum wage proposed for Germany. Empirical studies document that employment in France was significantly affected by the successive minimum wage hikes.<sup>5</sup> To deal with the

<sup>4</sup> See Wissenschaftlicher Beirat beim BMWi (2012). Die Gefahren eines flächendeckenden Mindestlohns, Schlaglichter der Wirtschaftspolitik 9/2012 and Gemeinschaftsdiagnose (2013). Konjunktur zieht an – Haushaltsüberschüsse sinnvoll nutzen.

<sup>5</sup> See Börsch-Supan, A. (2008). Mindestlöhne vermeiden Armut nicht. Ifo Schnelldienst 6/2008 and Laroque, G., Salanié, B. (2002) Labour Market Institutions and Employment in France, Journal of Applied Econometrics, 17 and Abowd, J., F. Kramarz, P. Lengerman, S. Perez-Duarte (2004) Are Good Workers Employed by Good Firms? A Test of a simple assortative matching model for France and the United States, mimeo, and Abowd, j., F. Kramarz, D. Margolis, T. Philippon



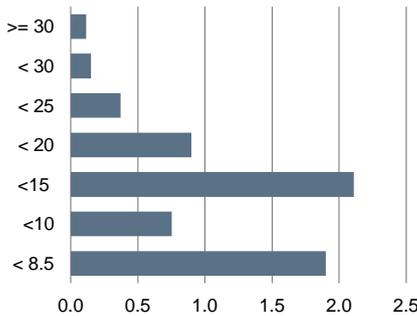
Minimum wage at EUR 8.50: The wrong policy choice

toxic effect of the minimum wage the French authorities were forced to create a series of “Ptolemaic circles”, e.g. reducing payroll tax for the workers paid between 1 and 1.6 times the minimum wage and therefore shifting the burden of funding the welfare state to skilled workers, hardly boosting potential GDP growth.

East Germany: Employees by hourly wage rates

7

y-axis: hourly gross wage in EUR  
x-axis: m persons



Sources: SOEP, DB Research

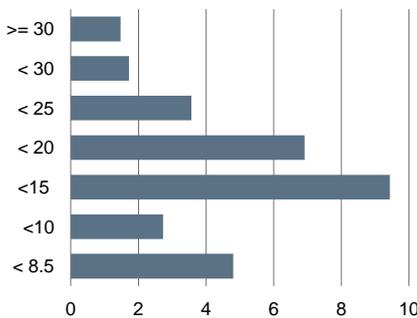
### Clouded employment prospects for problem groups

According to our calculation based on SOEP data the effect of the introduction of a minimum wage varies largely across different groups in the labour market. Particularly problem groups like low-skilled workers, migrants and single parents will find it harder to get a full-time job. While the share of employees earning less than EUR 8.50 amounts to about 1/5 for Germany, the share is about 1/3 in east Germany and over 60% for employees in east Germany with no formal qualification. Especially young migrant workers employed in the private sector with no formal qualification will be most affected. Thus, a minimum wage could miss one of its goals, namely to improve the situation of low-paid employees, as it might push many of them back into unemployment.

West Germany: Employees by hourly wage rates

6

y-axis: hourly gross wage in EUR  
x-axis: m persons



Sources: SOEP, DB Research

### A minimum wage could jeopardise the catch-up process of structurally weak regions

Germany’s wage gap between prosperous and weaker regions, in general between the south and the north and between west and east Germany, reflects different unemployment rates among other things. This gap would become manifest in the impact of a minimum wage, too. While in west Germany 15% of all workers earn wages below EUR 8.50, the respective ratio for east Germany is 27%. Furthermore, EUR 8.50 amounts to about 54% of the median wage in west Germany but to about 70% in east Germany. Therefore, frictions on labour markets in economically weak regions in east Germany and elsewhere are likely to increase. If a country-wide EUR 8.50 minimum wage is established the creation of new jobs in these regions could be markedly hampered and even existing labour-intensive sectors would be seriously impaired.

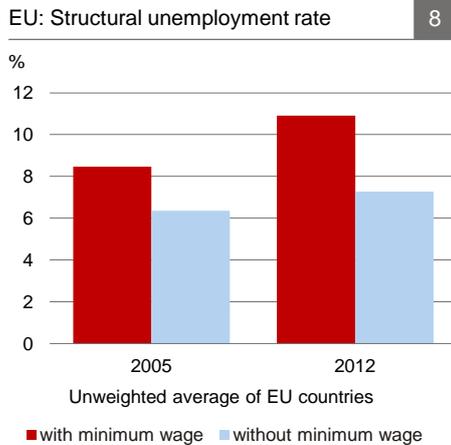
### Avoidance to become more difficult

Under present conditions a minimum wage would make the so-called mini-jobs, where workers can earn a maximum of EUR 450 per month, more attractive for employers as well as for employees. As these jobs are liable to favourable tax treatment and reduced social security contributions a substantial increase in the number of the mini-jobs (at present about 7.5 m) would hit public coffers, especially the social security schemes, and thus spur the debate on an abolishment of this kind of job. Another opportunity to circumvent a minimum wage could be service contracts (Werksverträge) where pay is linked to output. Not surprisingly, the SPD has been pushing for tighter regulations mostly in this area as well.

(2000). The Tail of Two Countries: Minimum Wages and Employment in France and the United States. IZA Discussion Paper Series No. 203.



## Wrong device to provide more “social justice”



Source: European Commission

Due to a decline in low-skilled employment the distribution of households' net disposable income would slightly widen as a result of a general minimum wage. Therefore, a wage floor is a questionable device to enhance “social justice”.

A minimum wage essentially reverses one of the key achievements of the Hartz reforms, namely getting lower-skilled and otherwise disadvantaged people back into work by establishing a low-wage segment in the labour market. If society or politicians do not want to accept the distribution effects, this should be dealt with via taxation and transfers and not via interference in the primary contribution.

So far the primary distribution, i.e. wage setting, has been left to industry and union negotiations, which has been a key pillar of the successful German model. The minimum wage potentially opens the door for politicians to engage in more redistributive policies, where the bill will show up only in the long run via an increase in structural unemployment. In an EU sample, the countries with a minimum wage labour under a structural unemployment rate that is around 3 percentage points higher than in those countries without a minimum wage. In addition, while the structural unemployment rate increased 2 ½ percentage points in those European countries with a minimum wage from 2005 to 2012, it rose by only 1 percentage point in countries without a minimum wage.<sup>6</sup>

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<sup>6</sup> This is the result on an unweighted basis. On a weighted basis which is dominated by a 3 pp drop of the German structural unemployment rate, the structural unemployment rate of those countries without a minimum wage even decreased by almost 1 pp from 2005 to 2012.



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