

## **Annex 1 –EUROFRAME-EFN Autumn 2007 Report**

### **Introduction of minimum wages in Germany: Coverage and consequences**

Microeconomic evidence based on the SOEP

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*Abstract: The introduction of minimum wages is on top of the political agenda in Germany. Minimum wages are often seen as a tool to ensure an acceptable standard of living. However, their introduction would have a number of disadvantages. In particular, minimum wages can worsen the employment perspectives of low income groups in the labour force, for example the low qualified, part time employees, pensioners, the unemployed as well as pupils and students. They would also have a negative impact on small firms. In a regional perspective, minimum wages can distort the performance of the East German labour market. Based on SOEP data from DIW Berlin, this contribution offers some microeconomic insights on the potential coverage and likely consequences of minimum wages.*

Currently, a discussion is underway in Germany whether minimum wages should be introduced. The proponents argue that payments for work should be large enough to secure the livelihood. In the low wage sector the bargaining power of the employees might be too weak, and a government intervention seems to be necessary to ensure an acceptable standard of living (Bosch, Kalina and Weinkopf, 2006). Minimum wages can also stimulate the purchasing power at the lower end of the income scale where

savings rates are below the average. Hence minimum wages could even support private consumption. Furthermore, a race-to-the-bottom in wage standards is feared due to the entrance of low paid workers from Eastern Europe in the German labour market. Minimum wages have been introduced in other countries, where labour market performances did not deteriorate. Nevertheless, the opponents of minimum wages expect higher unemployment among the low qualified.

Studies on the impact of minimum wages are available especially for the Anglo-Saxon countries, in particular for the US, where labour market regulation is less pronounced than in Germany. Studies have often detected consistent but not always statistically significant signs of negative effects on employment, see Neumark and Wascher (2007) for a recent overview. For Germany no empirical analysis on the implications of minimum wages exist. The reason might be that there are no economy-wide regulations in place. The exception is the construction sector. But the experience from this sector cannot be easily generalized for the whole economy, as the construction sector has been in crisis over a long period. This development was mainly caused by other factors, such as weak demand and excess supply created in the building boom in the first years after the German unification, not by the introduction of minimum wages.

In order to provide some input for the discussion, this study offers some empirical insights into the likely coverage and consequences of the introduction of minimum wages to the German economy. The microeconomic evidence is based on the socio economic panel (SOEP) which is conducted by DIW Berlin. The SOEP is a wide-ranging representative longitudinal study of private households. It provides information on all household members, living in the old and new German states, foreigners, and immigrants to Germany. In 2005, nearly 11000 households and more than 20000 persons were covered. Topics include, among others, household composition, occupational biographies, employment, earnings, health and satisfaction indicators.

### ***Frequency and structure of low wage employees***

Actual earnings of specific workers are below the levels discussed for minimum wages. Therefore, it has to be asked how many and which groups of employees would receive higher wages, given that the measures are enforced. Obviously this depends on the level

of the minimum wage. Different proposals are considered: they range between 4.5 euro (Bofinger, Dietz, Genders and Walwei, 2006) and 8 euro, as favoured by the left wing party (PDS). Other variants discussed in the political debate like 7 euro (Hickel, 2006) and 7.5 euro (SPD, trade unions) are also examined. The analysis focuses on employees, where specific groups like apprenticeships and internships, helping relatives, people in public employment services and handicapped are excluded.

According to the SOEP, a bound of 4.5 euro concerns 3% of employed persons, while a minimum wage of 8.00 euro would result in wage increases for every seventh employee (see tables 1 and 2). Low wages are particularly relevant for the marginally employed, for example people in mini and midi jobs, pensioners, the unemployed with additional income as well as pupils and students. In case of an increase in wage level, job opportunities especially for these groups would be reduced. In addition, low wages apply more frequently to women than to men. In contrast, there is no large differentiation between full and part time employment. However, a crucial distinction has to be made along the regional dimension, as low wages are more common in East Germany. Given that the concepts of the SPD and the trade unions are implemented, every fifth employee would have an increase in wage income. The PDS proposal would affect more than 25% of the employees. Full time employees receiving lower wages are more common in the Eastern part. If the PDS proposal is implemented more than 20% of the full time employees would have a wage increase, compared to 5% in the West.

Low wage employees work especially in small firms. With a minimum wage of 7.5 euro, the wage of one fourth of employees in small enterprises would have to be raised. In firms between 5 and 19 workers every fifth employee would experience a wage increase. According to the SOEP data, large scale enterprises would remain largely unaffected. In sum, an economy-wide introduction of minimum wages would imply wage increases particular in East Germany and for small enterprises.

Beyond direct effects second round impacts should be expected. Employees with wages above the minimum wage would try to maintain their relative income positions. For example, a baker-assistant in the East German industry, receives on average 7.65 euro per hour. He or she would certainly demand a wage increase, if a sales assistant receives a minimum wage of 7.5 euros.

### ***Contribution of low wages to the income of households***

As a central argument in favour of minimum wages, payments for work should be large enough to match the costs of living. Nevertheless, many low wage employees with earnings less than 7.5 euro live in households, where further subsistence is received or legal maintenance results from payments of a former marriage partner. Only for 4% of the employees the low wage the only source of household income. Singles receive less frequently low wages than persons in households with two or more adults. Low wages are particularly wide spread among single parents (tables 3 and 4).

Most of the low wage earners have their job since a long time. In the SOEP survey, 60% of the persons receiving a wage less than 6 euros said they did not change their job since the end of 2003. For those receiving less than 7.5 euro the share increased to 70%. The income of these low wage earners can be compared to the entire household income in 2004. On average the income of the small remunerated persons amounts to roughly a quarter to the entire income of the households. Of substantially greater importance is the income of other household members. Therefore, low wages do not necessarily result in income poverty, see also Burkhauser and Sabia (2005) on this argument. It can also be asked, whether the low income earners perceive their remuneration as unfair at all (Liebig and Schupp, 2005). The evidence is conflicting on this point: About half of the persons interpret the level of their wages as fair. A discontent is comparatively strong in Eastern Germany.

### ***Minimum wages implemented in other countries***

The argument in favour of minimum wages also refers to the fact that they exist in most other industrial countries, for example in most EU states and in the US. Germany, together with Switzerland is actual an exception. Nevertheless, the specific labour market conditions in other countries cannot be easily transferred to Germany. In the UK minimum wages have been introduced since a few years. However, with a high employment level they do not play a large role. For example, 1,4% of the employees worked for a minimum wage of 8 euro in 2004, while it was less important for young people. Because of a more favourable labour market situation, workers are usually paid

at rates above the minimum wage. The UK labour market is less regulated than the German one. Additional costs on minimum wages stemming from the social security system are clearly lower for employers than in continental Europe.

For France the situation is more comparable to Germany. With a similar lower wage bound as in the UK, about 15% of the employees received a minimum wage in 2004. The state subsidizes social insurance contributions for persons employed in the low income range. Thus public funds are used for a part of the costs due to the introduction of the minimum wage.

The introduction of minimum wages would have effects beyond the low wage range. Persons who receive a salary above the minimum wage would likely try to re-establish the previous wage gap to the low income earners. This would be particularly important in East Germany. Here, low wages are more common and many employees with wages in the range of 7.5 euro and 9 euro perceive their remuneration as unfair.

### ***Conclusions***

In order to avoid distortions on the labour market, minimum wages need to be differentiated. In principle this could be achieved through collective agreements. But a large part the low paid work in industries, where no collective bargaining exists. In countries with minimum wages, differentiation is often according to age; for example young people receive often lower wages than older workers. Such a gradation would make sense also for Germany, since unemployment is particularly relevant among the young people as well. According to information from the federal statistical office the unemployment rate of persons under 25 years was about 10,9% at the end of 2006, compared to 6.2% above this age.

In view of the large wage differentials between the Western and Eastern part of Germany, a regional differentiation is also required. This is not unusual, as the US shows. While there is a nationwide minimum wage, individual regulations exist for several states. For example, minimum wages exceed the national level in coastal regions. In contrast, the national minimum wage is applied in the weaker states of the middle west. Even existing collective agreements that determine minimum wages in Germany include regional differentiation.

The findings presented here further suggest a differentiation by firm size. However, such differentiations would inevitably bear the risk of creating a very complex and bureaucratic system. If one wants to have a simple instrument, one must set the minimum wages rather low, in order to avoid that certain sectors of the economy are hit by strong wage increases. But then one could do completely without minimum wages. If subsidized wages are introduced to a higher extent, lower bounds for the wage appear to be necessary. Otherwise wage reductions are expected, and the government would need to supplement the income of low wage earners to a high expense. The higher those minimum wages would be, the smaller would be the danger that the government becomes exploited.

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Table 1: Frequency of low wage employees

	Less than 4.5 euro	Less than 6 euro	Less than 7 euro	Less than 7.5 euro	Less than 8 euro
<b>Germany</b>					
Full time employees	1	3	5	6	7
Part time employees	2	3	6	7	11
Mini- Midijobs	9	21	39	44	48
Other less employed	12	15	25	25	27
Employed pensioners	11	21	28	34	41
Unemployed with additional income	22	33	47	48	50
Pupils and students	15	29	37	40	52
Men	2	4	6	7	9
Women	4	8	14	16	19
Total	3	6	10	11	14
<b>West Germany</b>					
Full time employees	1	2	3	4	5
Part time employees	1	3	4	5	9
Mini- Midijobs	7	20	39	42	46
Other less employed	4	6	17	17	19
Pensioners, pupils and students, unemployed with additional income	11	22	30	35	41
Men	1	3	5	5	7
Women	3	7	12	14	17
Total	2	5	8	9	11
<b>East Germany</b>					
Full time employees	1	6	12	16	22
Part time employees	4	7	13	15	20
Mini- Midijobs	25	27	32	58	58
Other less employed	55	69	69	69	73
Pensioners, pupils and students, unemployed with additional income	27	40	52	55	66
Men	4	9	14	17	24
Women	7	13	20	25	31
Total	5	11	17	21	28

Source: SOEP, DIW Berlin. Entries in % of all employees of the respective group.

Table 2: Structure of low wage employees

	Less than 4.5 euro	Less than 6 euro	less than 7 euro	Less than 7.5 euro	Less than 8 euro
<b>Germany</b>					
Full time employees	20	30	32	35	37
Part time employees	10	9	9	9	12
Mini- Midijobs	23	24	27	27	23
Other less employed	2	1	1	1	11
Employed pensioners	14	12	10	11	10
Unemployed with additional income	12	8	7	6	5
Pupils and students	18	15	12	11	12
Total	100	100	100	100	100
<b>West Germany</b>					
Full time employees	20	26	26	28	28
Part time employees	9	8	8	8	12
Mini- Midijobs	27	31	36	34	31
Other less employed	1	1	1	1	1
Pensioners, pupils and students, unemployed with additional income	42	35	29	29	28
Total	100	100	100	100	100
<b>East Germany</b>					
Full time employees	19	40	48	52	55
Part time employees	11	11	13	11	12
Mini- Midijobs	14	8	6	8	6
Other less employed	5	3	2	2	1
Pensioners, pupils and students, unemployed with additional income	51	38	31	27	25
Total	100	100	100	100	100

Source: SOEP, DIW Berlin. Entries in % of all low wage employees.

Table 3: Structure of households with low wage employees

	Less than 4.5 euro	Less than 6 euro	Less than 7 euro	Less than 7.5 euro	Less than 8 euro
<b>Germany</b>					
Singles	1	3	6	6	9
Single parents	2	6	10	13	15
2 adults without children	1	4	7	8	10
2 adults with children	2	5	8	10	12
3 adults without children	2	5	9	10	13
Remaining households	1	5	10	12	14
<b>West Germany</b>					
Singles	1	2	4	5	6
Single parents	2	6	8	11	13
2 adults without children	1	3	6	7	8
2 adults with children	2	4	7	8	9
3 adults without children	2	4	8	9	11
Remaining households	3	5	9	10	12
<b>East Germany</b>					
Singles	2	7	13	16	22
Single parents	5	11	20	22	25
2 adults without children	2	7	12	15	20
2 adults with children	6	9	14	21	31
3 adults without children	2	6	12	15	20
Remaining households	5	8	17	22	25

Source: SOEP, DIW Berlin. Entries in % of all employees of the respective group.

Table 4: Employees with low wages in households without further income

	Less than 4.5 euro	Less than 6 euro	Less than 7 euro	Less than 7.5 euro	Less than 8 euro
<b>Germany</b>					
Singles	1	3	5	6	8
Single parents	2	4	7	7	9
2 adults without children	0	2	3	4	5
2 adults with children	0	1	2	3	3
3 adults without children	1	1	2	2	3
Remaining households	0	0	1	1	1
All employees	1	2	3	4	5
<b>West Germany</b>					
Singles	1	3	4	4	6
Single parents	1	3	4	5	7
2 adults without children	0	2	3	3	4
2 adults with children	0	1	1	2	2
3 adults without children	1	1	2	2	2
Remaining households	0	0	0	0	0
All employees	0	1	2	3	4
<b>East Germany</b>					
Singles	2	7	13	16	22
Single parents	5	11	20	20	20
2 adults without children	0	3	5	6	8
2 adults with children	1	2	4	9	10
3 adults without children	1	1	3	3	4
Remaining households	1	1	3	3	3
All employees	1	3	6	6	10

Source: SOEP, DIW Berlin. Entries in % of all employees of the respective group.