

## **Economic arguments in favour of the ETUC proposal for a Directive on Fair Minimum Wages and Collective Bargaining**

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### **An EU Directive on Fair Minimum Wages and Collective Bargaining is good economics.**

One of the arguments put forward against fair minimum wages and action by governments to ensure that the workers right to collective bargaining is recognised is that its bad for the economy or bad for jobs. The opposite is the case. In this briefing we set out how our proposals for the implementation of fair minimum wages and the right to collectively bargained wages across Europe would have a positive economic impact, increasing internal demand and saving jobs and therefore an essential tool to master the current COVID-induced crisis.

### **The double 60-50 threshold for fair minimum wages**

After years of political discussion, in autumn 2020 the European Commission will publish a proposal for a European regulation on fair minimum wages in Europe. Although in its two consultation papers the European Commission failed to clearly define what it means by “fair minimum wage”. The Commission simply states that the minimum wage should provide a decent standard of living. As a pragmatic approach, the so-called Kaitz index has become the accepted benchmark in the political debate for the definition of an adequate or fair minimum wage. The Kaitz index is a measure of the relative value of the minimum wage in relation to the national wage structure. Accordingly, a minimum wage is considered adequate when it is at least 60% of the national median wage. By analogy with poverty research, a minimum wage of 60% of the full-time median gross wage is the wage that enables a single full-time worker to avoid a life in poverty regardless of living and household circumstances, without relying on state transfers.

Since, particularly in the Central and Eastern European countries, it is customary to use not the median but the average wage as the reference for the relative value of the minimum wage, it is useful to measure the Kaitz Index additionally on the basis of the average wage. This is also shown by the fact that in many Central and Eastern European countries, trade union and political minimum wage initiatives currently refer to the Kaitz Index measured against the average wage. A European regulation which refers to the Kaitz Index measured against both the median and the average wage when determining the adequacy of minimum wages would therefore be much more in line with the political realities in the EU; furthermore, it would integrate the various national initiatives for a substantial minimum wage increase into an overall European strategy and contribute to the upward convergence of minimum wages across Europe.

This is why in its response to the Commission’s second stage consultation paper, the ETUC calls on the Commission to bring forward a directive that ensures member states cannot set

their statutory minimum wages below the double threshold of 60% of the median wage AND 50% of the national average wage.

In the long lasting discussion about a European minimum wage regulation and in particular after the COVID-induced economic crisis started to gather pace, two economic arguments were often raised by employers and many economists against a European regulation on fair minimum wages:

- (1) In particular in an economic crisis, companies cannot afford to pay a fair minimum wage at 60% of the national median wage and 50% of the national average wage; a European directive imposing such a minimum wage on companies would therefore make an economic recovery more difficult;
- (2) A minimum wage at 60% of the national median and 50% of the national average wage will destroy thousands of jobs

The objective of this briefing note is to show that there is little to none empirical evidence for the above claims and that the implementation of fair minimum wages across Europe would actually have a positive economic impact and therefore help to master the current COVID-induced crisis.

### **Neo-classic standard view of minimum wages**

The above arguments against the introduction of a fair minimum wage across Europe are based on a neo-classical view of minimum wages which exclusively focuses on the supply-side. According to this view, in a nutshell, the labour markets is considered a normal market following the rules of supply and demand. Wages should therefore be set as equilibrium wages so that the demand for work from business equals the supply of work from workers. Any minimum wage higher than the equilibrium wage causes involuntary unemployment because workers would be priced out of the market. According to the supporters of the orthodox approach, this pricing out of the market could lead to a loss of competitiveness and to “substitution effects” which means that firms may decide to replace some workers with more machines and a few skilled workers to operate these machines. In typical low-wage sectors such as the care sector, HORECA and other labour-intensive service sectors it is not that easy to substitute low-wage workers with machines. In these sectors the increased cost of labour may force the company out of business. This micro-level analysis of the behaviour of individual firms is then transferred to the macro level because if these effects happen on a large scale this will lead to a decrease of the aggregate level of employment.

Such an analysis is essentially based on the assumption that all labour market participants have full information and that labour markets are characterized by perfect competition. Based on the recognition that this is not the case in real life, more recent neo-classical analyses take a more nuanced approach. One example is the monopsony theory which is based on the hypothesis that many employers have enough market power which enables them as the major purchaser of labour to control the labour market to a certain degree. Thus, companies are in a position to employ a particular type of labour often in a narrowly defined geographical or functional niche labour market and can hold wages below their contribution to productivity. This implies that - when faced with higher labour costs - employers may have an incentive to maximize their profits by expanding production and employment so that on aggregate the minimum wage may even lead to positive employment effects.

However, most prospective studies based neo-classic models predicted a huge loss of jobs as a consequence of the introduction of a statutory minimum wage (or as a consequence of substantial minimum wage increases). A case in point is Germany where in view of the introduction of the statutory minimum wage in 2015 the predictions of the number of jobs lost due to the minimum wage ranged between 425.000 and 1,2 million (Knabe et al. 2014; Arni et al. 2014; Bachmann et al. 2008) - when in fact most recent studies show no negative employment effects (for an overview see Herzog-Stein et al. 2020).

### **No negative effects on employment**

By now there exists a comprehensive body of literature on the employment effect of minimum wages covering the experience of a wide range of countries and using a multitude of different research methods (for an overview see Dube 2019). Most studies exist for the US where the employment effect of the minimum wage has been frequently researched on the basis of comparisons of neighbouring states with different minimum wage levels. In particular since 2000 when several states adopted legislation introducing higher minimum wages or even living wages. In Europe, the introduction of a statutory national minimum wage in the UK in 1999 and in Germany in 2015 represented “natural experiments” to research the employment effect of minimum wages. So did other countries where the minimum wage was increased substantially at different points in time. One example is Hungary where from 2000 until 2002 the relative value of the minimum wage measured in relation to the median wage increased by 20 percentage points from 37% to 57%. Another example is Slovenia where the relative value of the minimum wage increased from 51% of the median wage in 2009 to 59% of the median wage in 2010. Research shows that in all cases neither the introduction of a statutory minimum wage nor the substantial increases led to significant negative employment effects (Dube 2019, Sturn 2017).

The fact that in practice the introduction of the minimum wage in the UK and in Germany and the significant minimum wage increases in other countries had no economically sizeable employment effect raises the question how companies dealt with the increased wage bill. There are various ways how companies coped. The first method is to pass on the increased costs to the consumer by increasing prices of the product or service. Various studies report that this practice was particularly prevalent in the retail and the hospitality sectors; i.e. domestic sectors less exposed to international competition than for instance the manufacturing sector. However, in the latter the general wage level tends to be higher in the first place and the proportion of low-wage workers is limited. Although some studies of the restaurant sector in the US have shown that price increases were limited (Allegretto and Reich 2018 Aaronson et al 2007), the experience of Germany illustrates that as a consequence of the introduction of the statutory minimum wage in 2015 prices in the taxi industry and the hairdressing sector, for instance, increased considerably. Since these particular sectors were characterized by particular low wages, the prices increases represent a necessary adjustment of previously undervalued work.

The second method of how companies coped with minimum wage increases was to compress the company-specific wage structure. This means that the increase of wages for low-wage earners at the bottom of the wage structure was (partly) absorbed by suspending or postponing wage increases and the payment of bonuses of workers higher up the pay scale (Hirsch et al., 2011). A third method used was to accept a reduction of the profit margin (Draca et al. 2011) and a fourth method was an increase in productivity which was mainly caused by a reduction in labour turnover and more investment in training to upgrade the skills level of the workforce.

A reduction in staff turnover helps companies to save costs for the recruitment, selection and induction of new workers and it also helps to simplify management processes (Dube et al. 2007, 2010).

This illustrates that the claim that the introduction of minimum wages or substantial increases of minimum wages would lead to a dramatic loss of jobs is not borne out by the empirical evidence.

Another major short-coming of the neo-classical view is its exclusive supply-side focus on the narrow confines of the labour market. This means that it entirely neglects the wider macro-economic consequences of minimum wages on the demand side. This broader perspective of the impact of the economic impact of minimum wages is taken into account by Keynesian-inspired approach to the analysis.

### **A Keynesian-inspired view of minimum wages**

In contrast to the micro-focus of neo-classic analysis a Keynesian-inspired approach focuses on the influence of the minimum wage on general wage developments and thus the development of aggregate demand (Herr et al. 2018; European Commission 2012). According to this view, higher minimum wages not only raise labour costs for employers, but they also increase consumption demand among the low-paid workers and their families. Such positive “consumption effects” can lead to increases in aggregate demand and employment. Thus, even if some low-productivity firms reduce employment or go out of business, this does not necessarily mean that aggregate employment will be reduced. Employment may expand in other firms and higher wages may attract more people into the labour market. This in a nutshell means that the potentially negative impact of increasing labour costs will be overcompensated by the positive effects of an overall increase in aggregate demand.

This effect is reinforced by the fact that the integrated European economy is “demand- and wage-led”; i.e. growth is driven by domestic demand to a much larger extent than by other factors such as profits and exports (Onaran and Obst 2016). And this even applies to Germany which takes a lot of pride in being “export world champion”. One of the main problems of the neo-classical view is that it fails to recognize that wages more generally are not just a cost for employers. They are also the main source of income for workers and their households. And spending that income provides business with the demand for their product and services. In this way, wages and wage increases function as an engine for economic activity, growth and jobs. In other words, my wage is my spending and that spending equals another workers’ job and wage. And of course, that workers’ wage and spending, in return, secures my job and my wage.

From the individual company’s point of view, wages are indeed nothing else but a cost factor. This prompts individual employers to think that cutting their wage bill will make their business more competitive and will make them sell more while at the same time also raising their profit margins. This behaviour is based on the assumption that the level of aggregate demand in the economy is a given and that, by offering cheaper products and services, the company will gain a larger share of this total demand.

In reality, however, especially in times of crisis, many other companies may react in the same way. If that happens, if wage depression becomes generalised across the economy, then the level and intensity of aggregate demand can no longer be taken for granted but will instead

decrease. Smaller wage bills for companies will not result in more jobs but in fewer jobs as total demand for goods and services has gone down. Nor can an individual company hope to gain a larger part of falling total demand as relative wage competitive positions between companies do not change much if the wage squeeze is general. The result is that aggregate demand is further weakened and that companies are finding that a larger part of their staff is now redundant. Thus, wage cuts end up in (more) job cuts.

In economic theory, this is known as ‘the fallacy of composition’ or the false idea that simply summing up the behaviour of individuals (“each single company cutting wages to save jobs”) equals the total outcome for the entire economy (“all jobs are saved”). Another way to understand this is to compare with the behaviour of an audience in a (football) stadium. If one member of the audience gets up, he or she has a better view. If all stand up, no one has a better view and nor does anyone have a seat anymore. A policy of lowering wages comes down to the same thing. Uncoordinated behaviour in the form of all of us cutting wages to secure our jobs does not help but makes things worse.

This logic works the other way round as well. Thus, if workers at one individual company manage to achieve higher wages, this will not have much effect on the level of total demand in the economy. However, if such wage increases are coordinated across the economy – for instance by a European directive ensuring fair minimum wages across Europe – then aggregate demand will increase and companies are likely to react by increasing production and jobs to service higher demand. Furthermore, such a coordinated approach via a Directive would not affect competitiveness as a relative concept because fair minimum wages would be implemented in every country at in relation to national wages at 60% of the median wage and 50 of the average wage. Thus, by strengthening purchasing power, wage increases are an engine for demand, growth and jobs.

### **Minimum wages and general wage development**

Fair minimum wages which are not set below the decency threshold of 60% of the national median and 50% of the national average wage would boost aggregate demand and thus contribute to economic growth by directly increasing the wage of low-wage earners whose propensity to consume is much greater – which means that they spend a much higher proportion of their (additional) income and save less than workers higher up the pay scale. However, since in many European countries the development of the minimum wage also forms an important benchmark for wage developments as a whole, the impact of minimum wages on internal demand goes far beyond their direct impact on wages in the lower wage segment.

In the literature, this more indirect influence is often referred to as “ripple effects” or “spillover-effects” of the minimum wage. According to Grimshaw and Rubery (2013: 102), ripple effects refer to wage increases above the level of the minimum wage that are indirectly caused by uprating the minimum wage. However, the extent of the ripple effects of minimum wages depends very much on broader characteristics of the national industrial relations system. In principle to kinds of ripple effects can be distinguished: long-reaching ripple effects and baseline ripple effects.

Long-reaching ripple effects occur in countries in which the whole wage grid is pegged to increases in the minimum wage and as a consequence the spillover effects of rising minimum wages on low and medium wages is in principle significant. The key strategy underlying long-reaching ripple effects is the objective of preserving pay differentials by linking the base rate of

the wage scale to the minimum wage so that percentage changes of the minimum wage are translated into an proportional increase in the wage groups further up the wage structure. The primary example for long-reaching ripple effects is France where changes in the minimum wage affect the whole wage structure up to the eighth wage decile (Aeberhardt et al. 2015; Arpaia und van Herck 2017). In France, the minimum wage serves as a platform for negotiations of the whole wage grid which ensures that the rise in the minimum wage is in principle diffused through the grid of wages – thereby supporting overall wage growth. This effect is supported by the comparatively high level of the minimum wage in France and a high bargaining coverage of more than 90% based on the extension of collective agreements.

Baseline ripple effects occur when the effect of the minimum wage increase is largely restricted to the bottom of the wage structure with little implications for wages further up the pay distribution. Baseline effects lead to a compression of the wage structure by lifting the relative position of the lowest paid vis-à-vis higher wage groups. Baseline ripple effects therefore reinforce the effectiveness of minimum wages in combating wage inequality. Since women are over-represented among low wage earners baseline ripple effects of minimum wages also help to reduce the gender pay gap with positive implications for aggregate demand and economic growth.

Another macro-economic consequence of fair minimum wages is their positive effect on state finances – in two respects: first, companies whose business model relies on paying unfair wages shift the responsibility of ensuring that a worker can make a living to the state which has to top up unfair minimum wages through tax credits or in-work benefits. Such companies externalize the costs of paying unfair minimum wages to the state and the society as whole and put a further strain on public budgets – in particular during an economic crisis. More than a hundred years ago, Sidney Webb, one of the founding fathers of industrial relations research, therefore concluded that one of the crucial functions of a minimum wage is ‘to secure the community against the evils of industrial parasitism’ (Webb 1912: 993). Second, by boosting domestic demand fair minimum wages furthermore help the state to generate more revenue through increased taxes and higher social security contributions. Thus, the state budget benefits not only by reducing expenditure but also by increasing revenue.

### **Summary of key arguments**

It is important not to repeat the mistakes of the management of the crisis in 2008-2009 when austerity, internal devaluation and the freezing or even cutting of minimum wages prolonged the crisis with sometimes dramatic social consequences. There is no convincing empirical evidence for the economic arguments against a European directive on fair minimum wages that in particular in the current economic crisis companies could not afford fair minimum wages of at least 60% of the national median and 50% of the national average wage and that such a minimum wage would cost many jobs. Research on the employment effects of minimum wage increases has shown no significant adverse effects because companies coped with the increases in labour costs in many different ways:

- increasing the price of the goods and services offered,
- compressing the wage structure by compensating wage increases of low-wage workers by postponing wage increases for workers higher up the wage scale,
- reducing the profit margin
- increasing productivity in particular by reducing staff turnover.

Neither would the implementation of fair minimum wages harm competitiveness and economic growth. The opposite is the case. Since a European directive would ensure the compulsory implementation of fair minimum wages in a coordinated manner across the whole of the EU it would create a level playing field and promote wage convergence in particular between countries from Central and Eastern Europe and Western Europe.

Since the EU economy is demand- and wage-led fair minimum wages would boost internal demand because of the low-wage workers' greater propensity to spend additional income. Minimum wages would boost internal demand and thus economic growth not only by directly increasing the wages of millions of low-wage workers. Through ripple effects minimum wages also influence the general wage development which reinforces their positive impact in internal demand and economic growth. Minimum wages are, however, only one factor contributing to increased internal demand. Another important factor is multi-employer collective bargaining because it raises the whole wage structure. For this reason, strengthening collective bargaining at sectoral level is also important to ensure that fair minimum wages at 60% of the median and 50% of the average wage really are fair minimum wages in the sense of ensuring workers a decent standard of living.

Moreover, the current crisis highlighted the importance of fair minimum wages for social stability in Europe. Due to the far-reaching social impact of the crisis, especially in the countries of Southern Europe most affected by the crisis, the feeling of being let down by the other EU Member States and the European institutions is increasing. Against this background it is essential to improve the social situation of many people in Europe with a European directive on fair minimum wages. Against this background, the timely implementation of a European directive on fair minimum wages in the EU from a social, political and also economic point of view would be an important component of a comprehensive strategy to overcome the current crisis.

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