



# THE ECONOMIC CASE OF A MINIMUM WAGE

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The right-wing and neo-liberals are claiming that minimum wage is a counter-productive measure as it increases labour costs, and therefore unemployment. A quick look to the academic literature shows that it is not necessarily the case. In most cases, minimum wage has almost no effect on employment. In some cases, the effect on employment is even positive. Furthermore, a minimum wage tends to decrease wage dispersion and therefore is an efficient tool to tackle inequalities. As other labour market institutions, it can be argued that a minimum wage is part of a *predistribution* policy, aiming at tackling pre-tax inequalities. The case for a European-wide minimum wage is strong as it minimizes the adverse effects of social dumping induced by pro-competitiveness policies conducted simultaneously by most European countries.

**FEPS  
POLICY BRIEF**

MARCH 2016

FOUNDATION FOR EUROPEAN  
PROGRESSIVE STUDIES  
FONDATION EUROPÉENNE  
D'ÉTUDES PROGRESSISTES





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### **What are researchers saying about the economic effect of minimum wage?**

Lots of economists are sceptical concerning this policy tool due to the supposed negative effects on employment. However, the empirical results on the effects of minimum wage are much less straightforward. A study from OECD (1998) on nine countries over the period 1975-1996 shows that a 10 percentage points increase of minimum wage has no effect on the employment of people over 25 years old. It induces a fall of employment between 2 and 4% for workers who are younger than 20 years old and the effect is very closed to zero for 20-24 years old. Card and Krueger (1994, 1995) tried to measure the effect of the minimum wage rise in the State of New Jersey in 1992. They managed to isolate the effect on employment by comparing the evolution of employment in the neighbouring state of Pennsylvania where minimum wage did not change. Results of the experience were surprising. Employment in fast food restaurants (which use a large share of workers paid at the minimum wage) raised faster in New Jersey, despite the minimum wage increase. Of course, it is not possible to generalize this type of experiences. But this study shows that a rise of minimum wage does not induce a fall of employment systematically. Neuman and Washer (2007) do not share the opinion of Card and Krueger and underline that most of the studies found a negative link between minimum wage and employment. However, even when results are negative, the impact on employment is rather limited. In most studies, when employment raises by 1%, employment falls by around 0 to 0.5%. Effects are stronger however for workers who have more difficulties to find a job (young workers, women, migrants...). With an elasticity between minimum wage and employment below the level of 1, we can argue like Freeman (2010) that minimum wage can be an effective redistributive tool, even in developing countries characterized by a high level of informal economy.

Also, from a social-investment perspective, an increased level of minimum wage may have positive effects on productivity level. OECD (2007) shows that an increase of minimum to median wages ratio by 10 percentage points increases labour productivity by almost 2 percentage points. It may be explained by improved incentives for investing in training and a result of substitution of skilled labour for unskilled labour. These dynamic effects have possible positive effect on welfare.

This has been shown by Acemoglu (2001) and can explain why empirical studies on the economic consequences of minimum wage are inconclusive. He shows that both unemployment insurance and minimum wage leads to a higher level of higher productivity jobs, and that may increase welfare in the medium run. In a dual labour market based on a division between low-wage / low productivity and high wage / high productivity jobs, minimum wages increase the relative cost of bad jobs. For lots of these jobs, the wage becomes higher than their marginal utility. It makes this kind of jobs less profitable. This may increase the average level of productivity and thus increase welfare. Some argue that low wage jobs are a way to increase labour participation rate for low-skilled workers. It may be true in the short-term. But it also increases the incentives for firms to create less productive jobs. In a dynamic approach, this may be counter-productive in the long-run if it reduces incentives for firms to innovate and to increase their level of productivity.

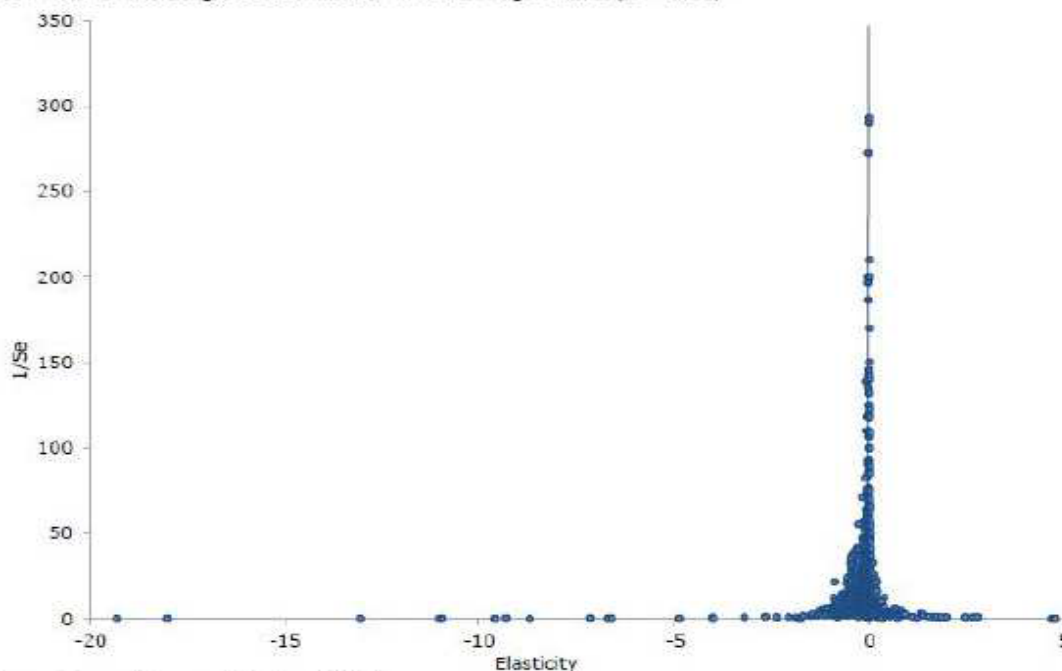


Minimum wage may also have a positive effect on investment in education outside the firms, and thus have long-term positive effects. Of course, increasing minimum wage may remain independent from the level of investments in skills. But it may encourage individuals to study longer, in order to get a level of productivity compatible with this higher level of minimum wage. Sutch (2010) suggests that an increase of minimum wage would increase the amount of schooling attained by a cohort that experiences the increases while in high school. According to his estimates, “the cumulative effect of the minimum wage increases beginning in 1950 was to add 0.7 years to the average high school experience of men born in 1986”. An “educational cascade” may follow an increase of minimum wage. This observation is very consistent with the hypothesis of social policies and labour market institutions as a long-term social investment.

Koeniger et al. (2007) show empirically that changes in labour market institutions can account for much of the change in wage inequality: «Over the 26-year period, institutional changes were associated with a 23% reduction in male wage inequality in France, where minimum wages increased and employment protection became stricter, but with an increase of up to 11% in the United States and United Kingdom, where unions became less powerful and (in the United States) minimum wages fell». Barany (2011) shows that a 30 percent *reduction* in the real value of the minimum wage, as in the early 1980s in the US, accounts for 15 percent of the subsequent rise in the skill premium, 18.5 percent of the increase in overall inequality, 45 percent of the increase in inequality in the bottom half, and 7 percent of the rise in inequality at the top half of the wage distribution.

Advocates of predistribution argue that it is necessary to tackle inequalities before redistribution from the States. Surprisingly, the role of such institutions is often underestimated. Maybe because of the fear that stronger labour market institutions have a cost in terms of efficiency, or increase the gap between insiders and outsiders. As we have argued, it is not necessarily the case. Figure 1 summarizes the result of academic studies studying the employment effects of minimum wage. As we can see, these are largely inconclusive.

**FIGURE 1**  
**Trimmed Funnel Graph of Estimated Minimum-Wage Effects (n = 1,492)**



Source: Doucouliagos and Stanley (2009).



## **The case for a European-wide minimum wage**

The obsession for competitiveness was prevailed in most European countries. But governments often forget that European countries are mainly competing one against each other and that the EU has indeed a trade surplus. Lack of competitiveness is not a European-wide problem. However, pro-competitiveness policies have adverse effects on other European countries as they increase the *relative* labour costs in countries that do not implement such policies. Most European countries have launched policies aiming at reducing unit labour costs. But the efficiency of such policies depends on the reaction of other countries. Such policies are a zero-sum game when all countries implement this policy simultaneously.

A European-wide minimum wage has strong advantages. It minimizes the risk that countries use wages as a tool to increase competitiveness, at the expense of other European partners. It avoids non-cooperative behaviours and social dumping. It therefore minimizes the potential social costs of minimum wage and reinforce the possible positive dynamic economic effects (on productivity).