The economic effects of the minimum wage

In France, concerns about household purchasing power have revitalised the debate on how high the minimum wage (known as the SMIC) should be set. After an initial increase of 2.3% on 1 May, the minimum wage is to be raised again on 1 July by 0.9%.

Although raising the SMIC may look like a way of increasing the purchasing power of the lowest-paid workers, the very existence of a minimum wage is highly damaging to them. With its effects on unemployment levels and pay rates for wage earners, it is actually a dubious concept.

WHAT IS THE COST OF SOMEONE EARNING MINIMUM WAGE?

Minimum wage refers to the lowest pay rate, set by law, that employers must provide to employees for their work. Accordingly, it amounts to a prohibition against employees receiving a pay rate below this legal threshold even if they may have some interest in doing so, for instance to avoid unemployment. The existence of a minimum wage thus prevents the signing of labour contracts that might have been agreed to in its absence. (If not, there would be no interest in instituting it.) In this sense, it is a creator of unemployment.

Although minimum wages have been instituted in many European countries, some countries have shunned them. This is true of Germany, which has long lacked any minimum wage. An initial step was taken in December 2007, however, with the adoption of a minimum wage in the postal sector.

Minimum pay rates are calculated on an hourly, daily, weekly or even monthly basis, depending on the country. In France, the minimum wage, called the SMIC (Salaires Minimum Interprofessionnel de Croissance, or minimum inter-professional growth wage) is based on an hourly rate. With the increase on 1 May, the gross monthly SMIC was 1308.88 euros. As of 1 July 2008, the gross hourly SMIC will be 8.71 euros, for a gross monthly wage of 1321.02 euros based on a 35-hour workweek. The net amount comes to 1037.53 euros.

But the cost to employers of workers paid at the SMIC rate is much higher than just the gross SMIC. All employer contributions must first be included. These vary according to many parameters such as a company’s size, its economic sector, the exemptions it is entitled to, the geographic area where it is based (in a rural revitalisation zone, for instance), or the extent of workplace accident contributions. Employing someone covered by the SMIC costs the company hiring that person about 1500 euros (exemptions included).

To employer contributions must be added other expenses that make hiring more expensive. These include the costs of absences, work facilities (plant, office, heating, etc.), administrative formalities, the costs related to collective representation of staff, and the costs of staff management.

3. Payroll taxes (CSG and CRDS) have been deducted.
and disputes. Such costs must be put in perspective, since they exist regardless of how much wage earners are paid. It is fundamental, however, to keep them in mind, to the extent that they raise even further the barrier to labour force entry constituted by the minimum wage.

For employers, the cost of a minimum wage worker is thus much higher than the amount of the gross wage paid to the worker. To be hired, an individual must produce goods and services each month with a value far greater than 1037.53 euros, the amount received at the end of the month. Those lacking the skills or experience needed to produce this value each month are thus effectively excluded from the labour market. This exclusion is all the more painful in that the first to be affected are young graduates without experience and people with little or no training.

THE MINIMUM WAGE: A CAUSE OF STRUCTURAL UNEMPLOYMENT

Simply through its existence, the minimum wage creates unemployment. This has to do with the very nature of labour contracts. A labour contract provides for an association between two persons who each find an advantage in it. An employer can hire people only if the product of their work, in the employer’s eyes, is worth more than what these people must be paid. By imposing a minimum wage, lawmakers close off access to employment for any workers if what they produce is worth less than the value of the minimum wage, payroll taxes included. This exclusion works to the detriment of the least productive workers.

Although it may be difficult to quantify the negative impact of the permanent existence of a minimum wage in terms of jobs, with many other parameters that must be taken into account (other labour market legislation, the economic situation, etc.), it is possible to get an idea of this by examining the economic effects associated with its establishment. Examples demonstrating this negative effect abound.

One example that best illustrates this impact is the case of Puerto Rico, a territory under U.S. sovereignty. Soon after the Second World War, the U.S. Fair Labour Standards Act, which sets a minimum wage, was extended to Puerto Rico, which at the time had low wages. As noted by Lloyd G. Reynolds and Peter Gregory in a study on this island’s economy, 8,000 workers lost their jobs between 1949 and 1954, with the number of industrial jobs at 58,000 in 1950. Thus nearly 14% of the people who had jobs found themselves unemployed. Similarly, but with an even greater impact, job losses were estimated at 29,000 between 1954 and 1958, with the number of industrial jobs at 66,000 in 1955. During this period, 44% of industrial jobs were thus destroyed.

More recently, the German parliament adopted legislation in December 2007 instituting a minimum wage in the postal sector (essentially to shield Deutsche Post from potential competitors). Until then there was no minimum wage in Germany. The effects on employment were immediate. Pin Group, one of Deutsche Post’s competitors, had to eliminate 5,760 jobs, more than half its staff; it was no longer legal to pay them at the previous wage and unprofitable to pay them more.

In France, the idea that the SMIC may have negative effects on employment comes up periodically in public debate. A note published in 2000 by two researchers with the National Institute for Statistics and Economic Studies concluded that “a 10% rise in the SMIC would destroy about 290,000 jobs on a long-term basis.”

The negative effects of the minimum wage on jobs are all the greater when the wage’s level is high. It means there are many people whose value of

production falls below this wage. In France, raising the SMIC to 1500 euros, as proposed by some Socialist Party politicians, would risk pushing unemployment up or keeping it at a relatively high level. Moreover, the two consecutive rises in the SMIC, on 1 May and 1 July 2008, make it more difficult to hire those who are currently unemployed. Good intentions do not always produce the desired results.

Some foreign examples help illustrate this phenomenon. The case of Singapore is one of the most striking. In 1979, Prime Minister Lee Kuan Yew decided to raise wages by nearly 20% a year over three years. His intent was to make Singapore one of the most highly developed countries. Although this rise covered all wages, the results logically were similar to increasing the minimum wage alone. It amounted to a rise in the cost of labour with no corresponding improvement in productivity. As noted by Robert Findlay and Stanislaw Wellisz, the results were the opposite of what was expected, namely “a substantial increase in unit labour costs, which reduces Singapore’s international competitiveness in relation to that of other Asian NIE’s [Newly Industrialised Economies] and contributed to the 1985 recession and to the accompanying decline in manufactured exports and employment.”

Some studies have pointed to similar effects in France. In a study published in 1998, Francis Kramarz and Thomas Philippon show that the years when the cost of labour goes up, essentially the years when the SMIC gets a “boost,” the probability of minimum wage earners losing their jobs also goes up. In contrast, the opposite result occurs when this cost goes down.

Quite similarly, an identical minimum wage will have far more serious effects in a country or region with low productivity than in a relatively rich one. The existence of a minimum wage can thus put a brake on the development of poorer regions or hold back a return to growth in regions hit by cyclical economic shocks. To the handicaps of a difficult initial situation are added the negative employment effects of a high minimum wage. Among these rigidities, the existence of a minimum wage that is the same in metropolitan France as in the overseas departments and territories may explain in part the especially high unemployment rates faced by the latter (generally more than triple the unemployment rate on the French mainland).

In the last few years, the net SMIC has risen more quickly than the average net wage. The latter accounts for part of the rise in labour productivity. Changes in one can thus tell us something about changes in the other. Since the net SMIC has risen more quickly than the average net wage, it would seem that it has risen at a faster pace than labour productivity, thus excluding a growing number of workers from the job market.

In France, lawmakers seem at least implicitly aware of the negative effects of the minimum wage on employment. This is why companies have received exemptions from some tax burdens. The so-called “Fillon reduction,” instituted in 2003, helps lower employer contributions to some extent.

THE SMIC: A SOURCE OF EXCLUSION

The barrier to labour market entry constituted by the minimum wage can nonetheless be avoided. If they are looking for something other than social transfers (minimum subsistence income or various allowances or assistance), the persons penalised by the minimum wage must stay on the fringes of this market.

9. Source: National Institute for Statistics and Economic Studies, *Évolution du salaire moyen et du salaire minimum*. Since 1995, it has been observed that the curve representing the minimum wage is growing more quickly than the curve representing the average wage. Graph available at: http://www.insee.fr/fr/fcc/figure/NATTEF04114.GIF. Statistical data available at: http://www.insee.fr/fr/fcc/figure/NATTEF04114.XLS.
Although it may protect workers who already have jobs, this protection occurs to the detriment of the least well trained and least productive job seekers. The law excludes them from jobs they could be filling because the value of what they produce falls below the total cost that employers must pay to hire them.

Finally, employers may see it as an incentive to replace more employees with machines. The minimum wage and payroll taxes increase the cost of labour to employers, which then becomes less attractive. Substitution is often much easier in industry than in services. As a result, it is mostly industrial jobs that suffer from this effect.

The existence of the minimum wage, as well as the payroll taxes that are added to it, thus form a barrier to labour market entry by the least productive and least well trained persons. Far from protecting the weakest, which is part of its initial purpose, the minimum wage excludes them from the labour market, relegating them to unemployment or to "parallel" forms of employment.

I CONCLUSION

The minimum wage is a significant factor (among several) in labour market rigidity. The good intentions that have often led to its institution contrast sharply with its real economic effects.

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