

## Talking point

### Minimum wage: First negative effects become visible

April 20, 2014

**Roughly 100 days have passed since the introduction of the minimum wage, and the Minister of Labour Andrea Nahles is already calling it a success story. However, we would urge caution given the considerable time lags with the effects of the minimum wage of EUR 8.50 per hour. In the medium term, we continue to expect clearly negative effects\* on employment and a missing of the targets of a more just income distribution and fiscal relief. In the medium term, we still expect a negative employment effect of 800,000 persons in line with our ex-ante study "Minimum wage of EUR 8.50 per hour: Grand Coalition on the wrong track".\*\***

Some temporary factors are proving a favourable environment which is concealing the negative effects. For example, the German economy has brightened noticeably following the stagnation in the wake of the weak summer of 2014. This is mainly due to the oil price plunge and the decline of the euro as a result of the more expansionary ECB policy. This, together with the widespread take-up of retirement at 63, for which over 250,000 persons have applied so far, leaves a considerable staffing gap in the affected companies and is creating strong demand for labour. At roughly 540,000, total registered vacancies have reached a multi-year high. Employment is breaking from one record high to the next, and at 6.4%, the rate of unemployment is at its lowest level since German reunification.

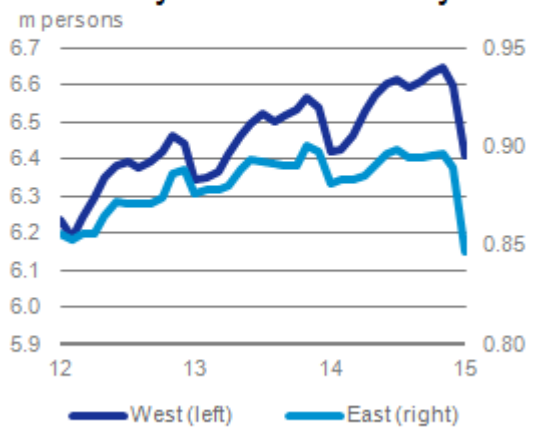
In addition, the short-term growth effect of the minimum wage is likely to be positive all in all, as around 4 million employed benefited from a marked increase in hourly wages and are largely consuming the additional income. However, for companies the minimum wage causes a considerable cost pressure, which is even increased by additional bureaucratic costs above all for small companies. Margin pressure is most pronounced in the structurally weak regions of east Germany and above all in agriculture, trade and the services sector. With regard to the export-oriented manufacturing companies, direct cost pressure probably plays a minor role thanks to the relatively high wage level and the capital-intensive production. Rather, these companies are worried by the implications of the turnaround on energy policy, the retirement at 63 option and the planned tighter regulations concerning temporary work.

Companies will probably try to pass on the cost increase – if the competitive situation permits – to prices, curtail extra benefits and payments that exceed collectively agreed levels, move parts of the production chain with a relatively high input of low-skilled labour abroad or strengthen automation at home or replace intermediate products/services, which have become expensive in Germany, with foreign ones. Furthermore, unpaid overtime, a transition to the shadow economy and (pseudo) self-employment are likely around the corner, which are difficult for customs to monitor and hard to prove.

The companies that claimed to be affected by the minimum wage stated in an ifo company survey at the end of last year that they plan the following measures to dampen cost pressure: price increases (east: 39%; west: 21%), cut in extra benefits (east: 30%; west: 21%), staff cuts (east: 27%; west: 20%), lower capital spending (east: 23%; west: 14%), reduction of working hours (east: 22%; west: 16%).\*\*\*

Thus, the initial increased incomes for many employees are likely to be only temporary and employees will probably be "in free fall" if they lose their jobs as a consequence of the required adjustment steps. Initially, companies are likely to lay off the least productive employees, and for them, re-entry into the labour market is

#### Number of marginally employed persons markedly down in January



Source: Federal Employment Agency



probably most difficult. Furthermore, problem groups in the labour market, for whom unemployment rates are stuck at a relatively high level anyway, will likely find it difficult to find a job. In many cases, the entry into the labour market will be permanently closed.

It is too early even for a preliminary assessment of effects of the minimum wage, but the first evidence reveals that prices were already increased in individual sectors and the employment effect should indeed be negative. There have been particularly strong price increases for taxi services (+11% yoy), newspapers and magazines (+6% yoy) and hairdressing (+3% yoy). The intensity of the impact of the minimum wage is especially strong for marginally employed persons. Therefore, the first negative employment adjustments are expected to be seen for this group (share of persons earning hourly gross wage below EUR 8.50 before the introduction of the minimum wage: west Germany: 55%; east Germany: 75%). The month-on-month decrease in the number of marginally employed persons accelerated to 230,000 persons in January 2015 – after the decline of roughly 55,000 persons in December. Subdivided by region, the number of marginally employed persons was down by 190,000 persons or 3% in west Germany and by 42,000 or 5% in east Germany in January. The simultaneously staged significant decline of the number of marginally employed persons and the introduction of the minimum wage suggested that the decline was probably caused to a large extent by the minimum wage and only a small part moved into another form of employment given the favorable labour market situation. Additionally, the introduction restricted the allowed number of hours worked for Minijobs to 53 per month given their upper earnings limit of EUR 450 per month. This posed a challenge for the personnel planning for the companies. Total employment growth would probably have been stronger in the counterfactual situation – the hypothetical development on the labour market if the minimum wage had not been introduced – so far.

In the medium term, the effect of the minimum wage will depend strongly on the adjustments to be determined by the minimum wage commission. The first amendment of the minimum wage will be made on January 1, 2017. This amendment will have to be determined by the commission by mid-2016. Afterwards, the amendments will take place every two years. When setting the minimum wage, the commission is to retrospectively use the development in collective pay as a guide, according to the minimum wage law. We oppose this as it rigidly ties the lowest pay grades to wage trends in more productive sectors, resulting in relatively strong wage increases for this group; wages will increase strongly especially at the beginning of a downswing compounding the spike in unit labour costs for the “weakest” employment group, likely causing the companies to make faster and deeper staffing cuts. Additionally, there is reason to fear that the government will support the introduction of an employment subsidy to dampen the negative employment effect of the minimum wage. This would be the wrong track, in our opinion, as we expect that it would result in enormous fiscal costs as can be seen by the unfavourable developments in France.

By introducing the minimum wage at a high level, the grand coalition clearly chose a trade-off to the detriment of the problem groups in the labour market and has made their (re)entry into the labour market much more difficult. In the medium term, the negative employment effect should prevail and the structural unemployment rate will likely increase with a pronounced negative fiscal effect. After the labour market reforms implemented in the mid-2000s, which increased the integration opportunities of problem groups via the deliberate creation of a low-wage sector, the clock is now being turned back. The minimum wage will make entry into the labour market more difficult – if possible at all – for persons who are already in a disadvantaged position in the market and are expected to come under additional pressure from further globalization and ongoing technological change. Compression of the gross pay distribution will reduce the inequality of primary incomes, but the income inequality of the whole population will probably increase.

\* There are certain exceptions – trainees, apprentices, employed minors and long-time unemployed – and up to end of 2016 for sectoral minimum wages only few. For one-third of the 18 sectors, the minimum wage is below EUR 8.50 (meat industry, hairdressing sector,

## The minimum wage at work

German consumer prices, % yoy



agriculture and forestry, horticulture, contracting and part-time work (east Germany), textile and clothing industry (east Germany), laundry services for commercial clients (east Germany). They are 15-6% below the generally applicable minimum wage, with plans for phased increases already having been decided.

\*\* See Focus Germany. June 4, 2014.

\*\*\* See Lehmann, R.; Ragnitz, J.; Weber, M. (2015) Mindestlohn in Ostdeutschland: Firmen planen Preiserhöhungen und Personalabbau, ifo Dresden berichtet 1/2015.

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