Ipswich Policy Note II

Minimum Wages and In-Work Poverty

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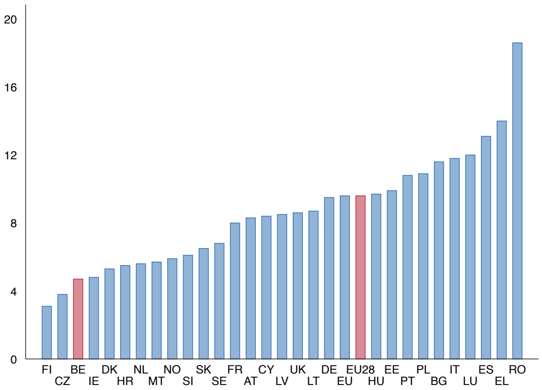
Summary

Labour market institutions are intended to guarantee certain minimal social standards, but often face criticism for paradoxically yielding the opposite outcome. An important question in this respect is to what extent minimum wages warrant fair pay and prevent in-work poverty. This policy note addresses the main lines of thought and summarizes our own findings. Our position is that minimum wages do not alleviate *existing* poverty, not by raising wages for those who are already in work, nor by creating jobs for those out of work when lowering the minimum wage. However, as moderate increases of the minimum wage do not have social costs, and may be economically beneficent when carefully set according to productivity growth and expectations, sectoral wage floors may prevent the *development* of in-work poverty.

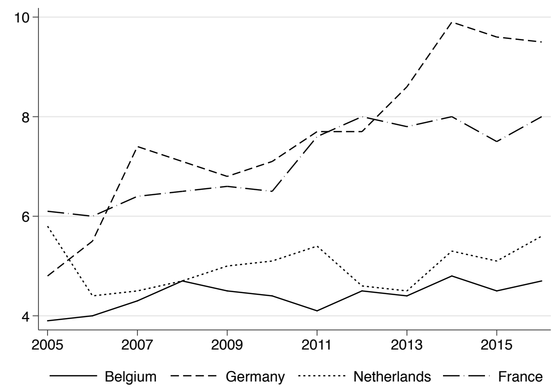
Context

In-work poverty is at a comparatively very low level in Belgium, at 4.7% in 2016 compared to the EU28 average of 9.6% (Figure 1). In Europe, the lowest levels are found in Finland (3.1%) and Czechia (3.8%), while the highest levels are found in Romania (18.6%) and Greece (14%). These figures reflect the EU-SILC definition of being 'at risk of poverty': this is earning an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers) (Orshansky, 1969). It is a relative threshold, which is raised when median incomes increase, but the underlying costs making up absolute poverty and the need for subsistence are also linked to economic growth (Foster, 1998). In the Netherlands, the level is at 5.6%, in France at 8%, and in Germany at 9.5%. The ten-year evolution in France (+33%) and in Germany (+73%) is also much more dramatic, even if this trend has been curbed in Germany in the most recent years.

Figure 1: In-work poverty in the EU in 2016 (left) and in Belgium and neighbouring countries from 2005 to 2016 (right).



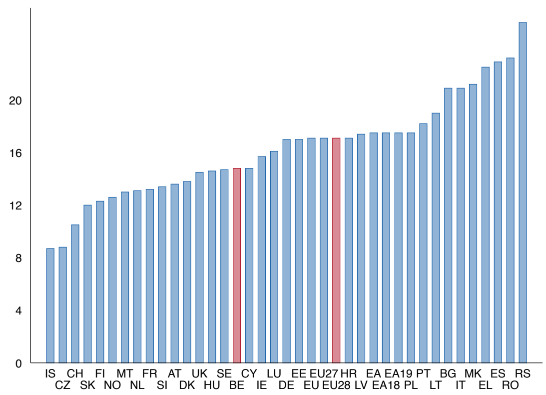
Source: EU-SILC



Source: EU-SILC

While these figures might be interpreted as a sign of the inclusiveness of the labour market in Belgium, the levels of in-work poverty are generally offset by the relatively low employment rate, and - because of joblessness – an overall risk of poverty of 15.5% in 2016 that is higher than some countries with lower levels of in-work poverty (Figure 2). Note that poverty in Wallonia is at a level that is twice as high as in the region of Flanders, and the poverty rate in Brussels is three times as high, even if the labour market institutions – aside from intermediation – are the same. However, at the country level the difference between Figure 1 and Figure 2 suggests a policy trade-off between in-work poverty and jobless poverty, which is the subject of much debate and dealt with in a separate paper and policy note by Diego Collado. Many accounts assert that, even if having a job provides protection against poverty, increasing the employment rate may not suffice to reduce poverty because, for instance, the first people to move out of unemployment into work would come from poor household (de Beer, 2007; Marx, Vandenbroucke, & Verbist, 2012).

Figure 2: Poverty in the EU in 2016 (left) and in Belgium and neighbouring countries from 2005 to 2016 (right).



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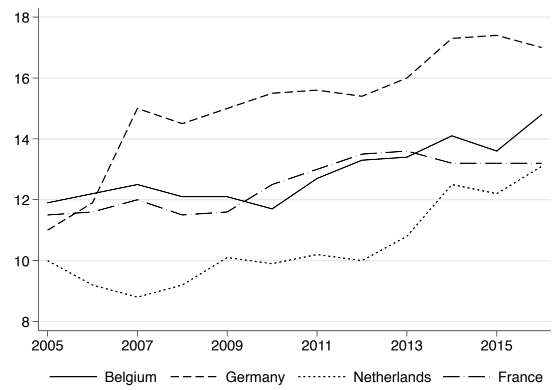
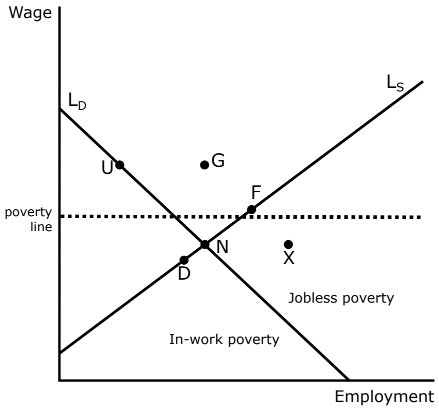


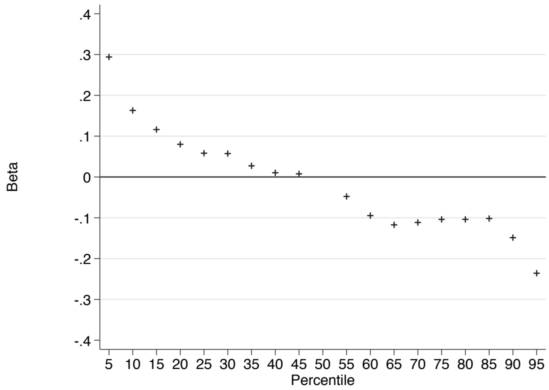
Source: EU-SILC

Literature and theory on minimum wages and poverty

To understand the dynamics on the labour market, Figure 3 sketches a standard supply and demand framework, showing a trilemma of policy choices (Iversen & Wren, 1998), in which one point needs to be given up: fiscal discipline when government increases social spending on poverty or public mployment (point G); employment when the statutory minimum wage is set too high or unions bargain for too high wages (point U); or earning inequality and poverty risks when the market equilibrium is below the poverty threshold (point N). The sacrifice to be made is a choice that depends on the welfare state regime. Typically, point G is linked to social-democratic regimes, point U to Christian-democratic regimes, and point N to liberal regimes. However, social and economic conditions may favour one choice over another, and these conditions may change. For instance, a minimum wage was introduced in 1999 in the UK and in 2015 in Germany, partly to counter trends of increasing wage inequality and precarisation (Freeman, 1996; Dickens Richard & Manning Alan, 2004; Machin, 1996; Amlinger, Bispinck, & Schulten, 2016). These differences in the national context also explain why the literature is somewhat mixed on the effects of minimum wages on employment and the distribution of wages and income. There are however two main points of consensus: one is that minimum wages do not alleviate overall poverty, the other is that minimum wages do not harm employment.

Figure 3: The policy trilemma (left) and wage compression effects of minimum wages in Belgium (right)





It may run against common intuition that minimum wages do not appear to have a direct effect on poverty. Indeed, as Figure 1 and Figure 2 suggest, it is possible to distribute income on the labour market, as in continental Europe, as well as to redistribute income through the state, as in Northern Europe. Empirical evidence indicates that, for given poverty thresholds (e.g. 60% of median income as used above), changes in the minimum wage do not generally have large enough effects to change overall poverty levels, increase earning of those already out of poverty and overlook household with low work intensity, or increase earnings of secondary incomes to the family (Gindling, 2014; Marx, Vanhille, & Verbist, 2012). It should be noted that poverty results from many factors other than wages, for instance career interruptions, family composition, health, education levels (Haughton & Khandker, 2009, Chapter 8).

The second 'consensus' is on the employment effects: moderate increases in the minimum wage do not consistently lead to employment losses (Neumark, 2017). There is counter-evidence for young workers, but this is also not a general finding (Wessels, 2001). Explanations for the neutral or beneficial effect of minimum wages in the short run refer to monopsony market, where wages are held below the competitive equilibrium by the sole employer (Manning, 2006), or to demand-side effects of the distribution of income on the long run (Betcherman, 2012). Also, it is possible that wage changes may be compensated through other channels, such as profits, top earnings, training, future wage raises (Hirsch, Kaufman, & Zelenska, 2011; Schmitt, 2013). In conclusion: it should be possible to increase low wages and limit wage inequality without distressing social costs. This has a direct effect on *in-work* poverty, as well as an indirect but subtle effect on the dependency trap, creating an incentive to work or a margin for increasing minimum benefits (Dolado, Felgueroso, & Jimeno, 2000).

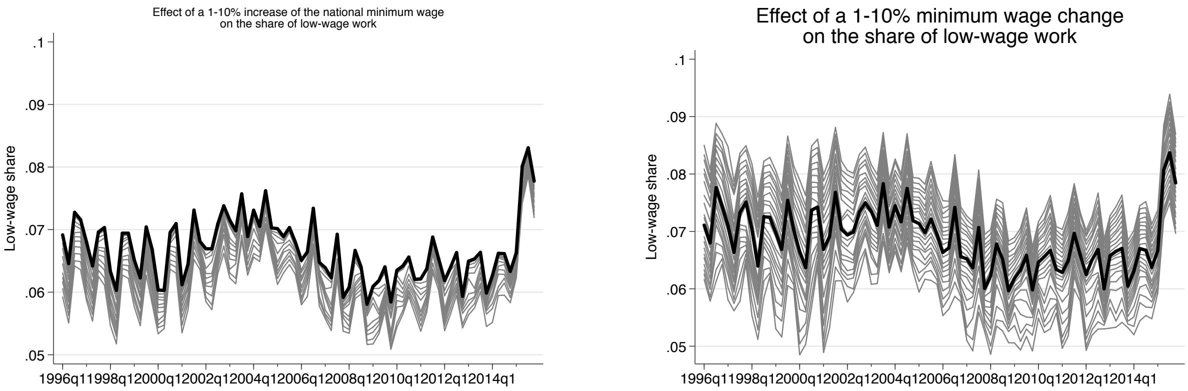
Employment and the wage distribution

We evaluated the effects of changes in the minimum wage on employment levels by sector, and on individual worker flows. When wages are pushed above equilibrium, employment losses should result. When the equilibrium moves, for instance because of simultaneous growth in demand, or when wages are below the competitive equilibrium, for instance because of monopsony markets, both wages and employment levels may increase.

At the sector level, we find that increases in the minimum wage increase employment levels for low-wage workers. The elasticity is very high, around factor 6. The effect on total employment is around factor 1.5. These high levels indicate endogeneity: minimum wages and employment increase together. At the individual level, we find positive correlations with both inflows and outflows of workers, within any category of background characteristics, but most strongly among 25-55 year olds and mainly among low-wage earners. The difference between inflow and outflow elasticities, however, is always positive, confirming positive relation at the sector level.

Looking into the distributional effects of minimum wages, we use the estimation results of the effects of minimum wages on the wage distribution at vigintiles (shares of 5% of employment), and apply these effect on the working population to simulates changes in the share of working poor when increasing or decreasing the minimum wages. Figure 4 shows that the largest effects are found when sectoral wage floors are adjusted: a 10% increase in the wage floors would decrease the share of low-wage work to 7%. However, relying solely on the national minimum wage does cover most of this effect, as the sectors with the highest share of low-wage work also have the lowest sectoral wage floors, often effectively referring to the national minimum wage.

Figure 4: Simulated effect of increases in the national minimum wage (left) or changes in the sectoral minimum wages (right) on the share of low-wage work in Belgium

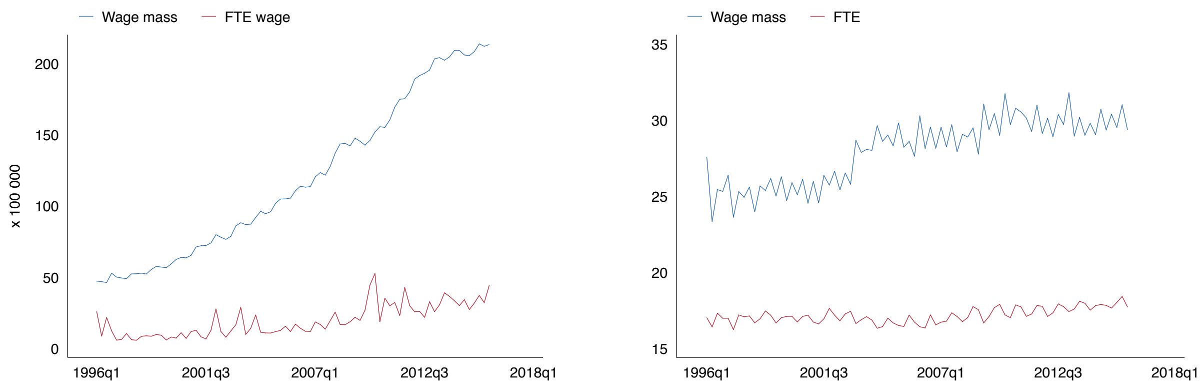


Job polarization and sectoral changes

Technological change influences the relative input of labour and capital, depending on the complementarity or substitution between the input factors. In the first and second industrial revolution, human physical force was replaced by machines, but the demand for operators and supporting functions ensured employment increased (Bessen, 2018). In the third and fourth industrial revolution (the 'second machine age', Brynjolfsson & McAfee, 2014), routine non-manual functions are taken over by computers, and creative and coordinating task by artificial intelligence (Frey & Osborne, 2013; Goos, Manning, & Salomons, 2010). In the short run, this trend is negatively affecting employment of workers in the middle class, but it also affects the bargaining power of workers in the lower segment of the labour segment, for instance when employed by platforms that behave like monopsonists (Azar, Marinescu, & Steinbaum, 2017), or facing competition due to very labour supply caused by increased migration flows. Examples in other developed economies show that in the absence of multi-employer collective bargaining and high bargaining coverage, this leads to the development of a low-pay segment in the labour market.

Looking into the data over a timespan of 20 years, we find that wage inequality did not increase for full-time full-year employment. Figure 5 in the left panel shows however that due to differences in the distribution of working hours, the differences in wag mass is steadily growing. In order to check polarization in the wage distribution, the right panel then compares the percentage difference between p60 and p40 in wage mass and FTE-wages. Besides a methodological break in the series in 2003, the difference is continuous. Yet there are some sectors that grow faster than others. If we linearly extend the trends of 1996-2015 to 2025 and 2035, we find that the share of low-wage work will increase by 0.5% per decade, and that most of this change is due to growing sectors with low sectoral wage floors (retail, sheltered work). The main low-wage sector that is decreasing in size is the clothing industry.

Figure 5: Evolution of the variance in wage mass and FTE-wages (left) and evolution of the p60-p40 percentage difference (right)



Source: National Office for Social Security

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Do social partners subscribe to inclusive growth?

Through a series of interviews, we evaluated to what extent social partners are concerned with the issue of poverty and social inclusion, and aware of future threats. The sectors involved, beside the national federations, were retail and steel industry. The respective positions of the social partners reflect the theoretical arguments outlined above: the employers emphasize the need for more flexibility and less automatic adjustments (wage indexation, seniority pay), in order to reduce unemployment and benefits expenditure, but do recognize the idea of fair pay and collective bargaining agreement, although some room is desired for adaptation to the firm's or employee's potential. The trade unions on the other hand put more emphasis on the fair distribution of productivity growth between labour and capital, as well as among workers. The aim is to maintain or increase purchasing power to the extent that it does not harm employment levels, whilst putting low-wage earners first. This is fully in line with the meaning of minimum wages we have identified: it is not an instrument designed to alleviate poverty, but to prevent in-work poverty. There is an awareness that low-pay activities have disappeared from the Belgian economy, such as mass production, and that digitalization and automation threaten employment in the retail sector, and this may have consequences to employment. Yet both sides by and large choose to keep wages out of the competition between firms, referring at the same time to the intersectoral wage norm that follows the pace of wage setting in the neighbouring countries, and to the market logic that defines wage levels and the bargaining position of firms and workers. The central regulatory force within a stricter legal framework, and the economic position of the firm or worker therefore appears both growing in importance, while the sector level remains the key actor governing the collective bargaining system, and providing a set of collective benefits (training funds and social unemployment funds) that runs parallel with the state's services but differs by sector.

Conclusion and recommendations

In so far the labour market is concerned with the distribution of income, the wage distribution in Belgium has been very stable over the last 20 years. Low-wage work is concentrated in ten sectors, including retail and sheltered work, most of which are growing, so that the share of low-wage work in Belgium will increase by 0.5% every ten years if policy is unchanged. Minimum wages may protect against in-work poverty, but cannot affect the broader issue of jobless poverty.

Recommendations

- Maintain multi-level collective bargaining, which guarantees minimum wages that do not harm employment in the short run, provides work incentives for the unemployed and allow increases of social minima. Wage floors protect against precariousness and in-work poverty and should therefore not only be enforced in the formal economy, but minimum wage jobs should also replace informal work and bogus self-employment.
- Collective bargaining sets wages by function, so that inequalities are less likely to arise based on individual bargaining power that is unrelated to productivity, such as gender or ethnicity. These dimensions also define target groups for poverty.
- Poverty in Belgium is mostly concentrated amongst those out of work, and minimum wages as well as labour market activation policies do not have a large effect for this group. The debate on poverty should therefore deflect from the labour market and focus on social policy. If the labour share is decreasing, the tax base for redistribution by taxes should shift towards capital income rather than rely on labour income only.
- Simple thresholds for either low-wage work or poverty hide larger distributional changes, such as job polarization, growing inequality, or extreme poverty. Policy makers should be aware that headcount poverty figures have such limitations.
- Discontinuous careers and less than full-time full-year employment are risk factors for poverty and currently a stronger trend than job polarization. Policy should ensure employment security and reduce working hours inequality.

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