

# **German Minimum Wage Promises Salvation or Nightmare?**

**Universiteit Maastricht**

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Maastricht, 10th October 2009

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Study: International Economic Studies

Course Code: 3075B / EBC2096

Group Number: 2

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## **1. Introduction**

The election campaign for the “Bundestagswahl 2009” in Germany has just been in all news. One of the central issues that were extensively discussed is the different promises for minimum wages made by the parties. The Christian Democratic Party (CDU), the party of chancellor Merkel, has a rather liberal point of view. It proposes to set up a commission which examines each industry by itself and then sets an appropriate minimum wage if beneficial. In contrast, the Social Democratic Party (SPD) led by chancellor candidate Steinmeier is in favor of a national minimum wage set by law. Their intended minimum hourly wage is EUR 7.50 for all industries. The CDU claims that a national minimum wage of EUR 7.50 would lead to a substantial increase in unemployment and worsen the already bad fiscal situation of the government. The SPD on the other hand points to the positive effect of the introduction of minimum wages in England in the last decade and argues that the same beneficial effects could be expected in Germany.

This paper sets out to explore the open question of the impact of minimum wages to be or not to be introduced in Germany. The debate on minimum wages is first put into perspective by describing the development of the German welfare state. It will be shown that the emergence of minimum wages as a viable option for the parties to campaign for marks a turning point in the political economy of Germany. The long-lasting corporatist model seems to be a relic of bygone times and a new hybrid model arises putting minimum wages high on the political agenda of the egalitarian minded German people.

In order to assess the likely effect of the introduction of minimum wages, the existing impact studies for Germany which predict by and large adverse employment effects are critically reviewed - and rejected. It will be argued that the highly controversial assumption of perfectly competitive markets, which is shared by all of the studies, is driving the results. Elaborating on the long-standing tradition of imperfectly competitive labor market models, the modern conception of monopsony power is used to firstly criticize the neoclassical approach towards minimum wages and secondly to argue that theory is a bad guide for labor market reforms in general. Instead, we make a strong case for relying on empirical studies to evaluate policy options.

Having said that, the results of the introduction of a nationwide minimum wage in the United Kingdom (UK) in 1999 are inspected and the final conclusion is drawn that the German people can without serious worries vote about minimum wages as they please, because no unambiguous theoretical prediction can be made and empirics do not show any significant drawbacks if minimum wages are going to be introduced in Germany.

## **2. The Political Economy of Germany**

### **2.1 Germany as Ideal Type of a Welfare State**

Esping-Andersen (1990) famously argued in his modern classic on welfare state typology that the welfare state cannot be regarded as the total sum of social policies, it is more than a numerical accumulation of discrete programs. Hence, he set forth the by now famous and further adjusted three types of welfare states, each representing a unique complex of legal and organizational features that are systematically interwoven. Understanding the logic of organization, social stratification and societal integration of the different regimes helps to predict what kind of social policies are favored and how big their impact might be. The first section sets out to clarify the characteristics of the German welfare state, which helps to put the introduction of minimum wages into perspective.

The body of work on welfare state typology soared after Esping-Andersen published his work on three worlds of welfare capitalism in 1990. Wil Arts and John Gelissen (2002) distinguish between seven different models in their survey on this body of work, including the original one of Esping-Andersen, which all have different typologies of welfare states. Therefore, it is necessary to follow two steps in order to conclusively evaluate the German welfare state: Firstly the relationship between the different models has to be examined and one of the models needs to be chosen; secondly it has to be checked whether Germany is classified in similar ways by all models or whether there are big differences.

The main line of critique over the last decade has been that there should be a fourth type of welfare state covering the southern European countries rather than considering them as immature continental ones. This is, however, not of importance for the classification of Germany. More importantly, different measurements have been put forward to distinguish between welfare

states. Fortunately, all models despite their different criteria have quite similar groupings which look like this: 1) Anglo-Saxon, 2) Bismarckian, 3) Scandinavian and 4) Southern. The key point is then whether Germany belongs to the same cluster in every model. Wil Arts and John Gelissen (2002) made an overview of the clustering of all seven models and come to the conclusion that “Germany approaches the Bismarckian/Continental/conservative ideal-type.” Of course, today every country presents a system mix, but this result suggests that there might be strong inclinations for certain kinds of social policies in Germany as it is the standard textbook example of a continental country.

Prior to examining whether the models which unambiguously put Germany into the continental welfare state group have implications for the viability of minimum wages, it is necessary to know what these authors find characteristic for the continental group. Esping-Andersen (1990) originally pointed out that in continental countries social benefits mainly depend on former contributions and status. This thesis has been supported by Castles and Mitchell (1993) who argue that high social expenditure, but little adoption of equalizing instruments in social policy, is typical for continental countries. Furthermore, Leibfried (1992) highlights the right to social security with the welfare state as compensator of the first resort and employer of the last resort. Korpi and Palme (1998) as well as Ferrera (1996) put emphasis on the corporatist structure of continental welfare states. They argue that insurance schemes as, for instance, unemployment benefits and employment protection legislation are mainly governed by unions and employer organizations.

Summarizing the characteristics of the German welfare state, one can say that the continental welfare state and thus Germany are characterized by strong social partners who have a say in the organization of insurance schemes and the labor market. Their key role stems from the corporatist tradition which formed the continental welfare state over the last two centuries. Contributions are mainly coming from payroll taxes emphasizing the important role of the social partners. Benefits are mostly related to earnings, which is in line with their function as status rather than poverty insurance. Overall, the state is guaranteeing social security, but issues regarding social security of workers are mainly covered by the social partners.

## 2.2 The Debate on Minimum Wages

Naturally, the following question comes to one's mind: What have minimum wages to do with continental countries like Germany which are dominated by collective bargaining? – And for a long time the obvious answer has been: Nothing! It is necessary to look at the development of collective bargaining in Germany over the last two to three decades in order to understand the new and fiercely fought debate on minimum wages. The decline in importance of collective bargaining is inextricably related to the emergence of the debate on minimum wages.

Germany might be considered as the ideal type of a continental country, but most of the articles surveyed before are from the 1990s, which was exactly the time when massive change started to take place in the German labor market. The 1990s stand for the emergence of a nonunionized low wage sector which led to a break in continuity of the traditional flat German wage structure (Schettkat, 2006). The traditionally compressed wage structure has been a feature of the strong influence of unions which were able to expand their collective bargaining agreements to almost all workers in each industry, no matter whether they were members or not. As this influence declined over the last two decades, wage disparities increased (Durstmann et al. (2007), Bosch and Weinkopf (2008)), especially for the low skilled, so that the German wage disparities are closer to the US than to other continental countries by now (Streeck, 2009).

**Table 1** Trade union membership, collective bargaining coverage and unemployment in Germany and Great Britain, 1998-2004

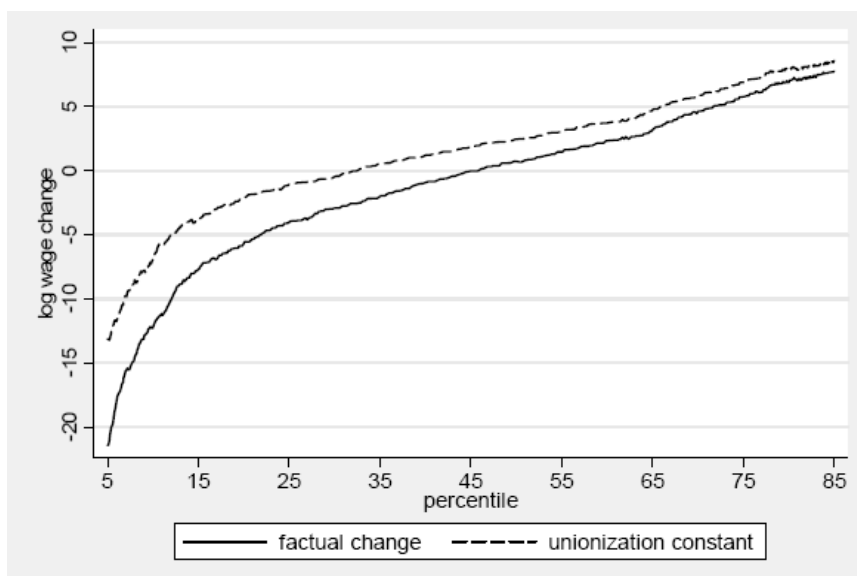
		<i>Germany West (East)</i>	<i>UK</i>
Trade union density	1998	29%	30%
	2004	25%	28%
Coverage of the employed workforce by collective agreements	1998	76 (63)%	38%
	2004	68 (53)%	35%
Coverage of establishments by industry-wide collective agreements	1998	53 (33)%	8%
	2004	41 (19)%	7%
Unemployment	1998	9.2 (17.8)%	6.3%
	2004	8.5 (18.4)%	4.8%
Low pay: per cent earning less than 50% gross median earnings	1998	11.4%	19.2%
	2004	15.0%	18.4%

Source: Brown and Skarpelis (2008)

The trade union density in Germany was just 25% in 2004 and the coverage of the employed workforce by collective agreements decreased from 76% to 68% in West Germany and 63% to 53% in East Germany respectively over the preceding eight years (see table 1). The share of people earning less than 50% of gross median earning increased from 11.4% to 15% over the same period of time. For comparison the same data is given for the UK as well. It suggests that trade unions had less power compared to Germany in general and have still lost more power from 1998 to 2004. However, the share of people earning less than the gross median earning decreased in contrast to Germany. This can be seen as a result of the successful introduction of nationwide minimum wages in the United Kingdom in 1999 (Brown and Skarpelis, 2008).

The impact of the absence of collective bargaining agreements on a substantial part of the workforce in Germany can be seen in graph 1. Dustmann et al. (2007) estimated the change in wages with and without decline in collective bargaining agreements. The factual wage change is plotted against the counterfactual wage change that would have prevailed if unionization rates had remained at their 1995 level, for the 1995 to 2004 period. The figure illustrates that workers throughout the wage distribution would have experienced a higher wage growth over this period if unionization rates had not declined. However, the impact of de-unionization is substantially stronger at the lower end of the wage distribution. For instance, wages in 2004 would have been 8% higher at the 5th percentile, but only 0.5% higher at the 85th percentile.

**Graph 1** The role of de-unionization, 1995-2004



Source: Dustmann et al. (2007)

The myriad causes of the declining influence of trade unions have been investigated by other authors before (see Streeck (2009) for Germany, for instance) and will be taken as given in this paper. The focus is rather on the implications of this trend and its repercussions for the German welfare state. At heart it is about nothing less than the future viability of the corporatist/continental model to provide adequate security and welfare to the German people.

Although trade unions clearly lost ground and were not able to bargain for most of the workers anymore, legal minimum wages have been an anathema to German trade unions for a long time. Unions argued that minimum wages are incompatible with free collective bargaining and that being in favor of them would admit their weakness (Streeck (2009); Brown and Skarpelis, 2008). However, the emergence of a two-tier wage system in which increasingly people are part of a nonunionized low wage sector, puts political pressure on trade unions and political parties. In 2006 Verdi, the union of the service sector, demanded a nationwide legal minimum wage of EUR 7.50 as the first union ever to demand a legal minimum wage in Germany.

From then on, minimum wages have been finally publicly debated in Germany. The development of the German minimum wage debate resembles the one that took place in the UK, which ended with the successful introduction of a legal nationwide minimum wage in 1999. At first British unions were against minimum wages. However, they changed their opinion at the beginning of the 1990s and participated in the establishment of the British minimum wage later on. Brown and Skarpelis (2008) argue that Germany and the UK have faced, and continue to do so, similar developments with regard to their labor markets and public support for minimum wages. Germany is just lacking behind according to their view and thus the introduction of minimum wages just seems to be a matter of time.

Consequently, the introduction of minimum wages seems to be a pragmatic response to the declining influence of trade unions. Germany as the ideal type of a continental country has been affected later than other countries by the downward pressure on wages and still toils with the debate on minimum wages, because of its strong corporatist legacy. The important question is then in which direction is the German welfare state developing?

Wolfgang Streeck (2009), one of the foremost researchers on the German welfare state, points out that sectional unionism among narrow groups of highly skilled workers and the use of

legislation to prevent low wages from falling below the poverty line, are not characteristic of corporatist, but of liberal and pluralist welfare states. Hence, there is profound evidence that Germany cannot be characterized as the ideal typical continental welfare state anymore. The decline in union influence, the rising wage inequality, which rather resembles the US wage dispersion than the one of France or Italy, and the parallels between the minimum wage debate in the UK and Germany, are all indicators for the change of the German welfare state towards a more liberal orientation.

Conclusively speaking, it should come as no real surprise that minimum wages are close to being established in Germany nowadays. As trade unions are not able anymore to provide wage floors for the complete workforce, minimum wages seem to be the next best instrument which can support nonunionized workers and therefore get support from an increasing share of voters. The German welfare state has undergone tremendous change and if the German people would like to enjoy the same benefits as in the past, new policy responses like the introduction of minimum wages seem to be inevitable. Overall, the preceding section on the German welfare state has shown that Boeri and van Ours (2008) have a point with their conclusion that within-model variance in the levels of different institutions is increasing relative to the dispersion across country groupings, so that the taxonomy of welfare states is becoming less and less powerful.

### **3. Economic Implications of the Minimum Wage**

The historical development of the German welfare state just reviewed has shown that minimum wages are a real option for German policy makers nowadays. The second part of the paper takes an economic stance on the minimum wage debate. It tries to quantify the likely consequences of the introduction of minimum wages in Germany in terms of unemployment, wage distribution and public expenditure. This attempt, however, is severely hampered by the lack of appropriate models of the labor market. Most of the previous studies used a neoclassical framework to evaluate the effects of minimum wages. As it is argued later, this approach fails to acknowledge important labor market characteristics as, for instance, monopsony power. Their inclusion might lead to different conclusions. But let's go step by step and first have a look at the main findings of the neoclassical research about the consequences of the implementation of

minimum wages in Germany. Afterwards we will show the major shortcomings of this approach and its consequences for policy advices.

### **3.1 The Neoclassical Delusion**

Most of the neoclassical studies estimate the employment effects by assuming a certain labor demand elasticity. The assumption about the elasticity is then used to make conclusions about the effects on unemployment, wage distribution and public expenditures. In this paper we focus on the estimated consequences of a minimum wage of EUR 7.50, since this is the most debated minimum wage in Germany.

Ragnitz and Thum (2007), who based their study on an elasticity of -0.75, estimate the employment loss to be around 1.1 million people. Similar results are found by Knabe and Schön (2008) who found an employment loss of about 0.85 million people. According to them, mini-jobs, pensioners and students are hit the most. Further they doubt that the net income relative to the median income can be increased substantially. They rather point out the risk of an increasing poverty rate due to more unemployment. Knabe and Schön tested other policy options based on social security subsidies to the employers. They constrain the subsidies to EUR 4 billion which is their estimated public expenditure increase due to the increase in unemployment caused by a minimum wage of EUR 7.50. They conclude that this subsidy, in contrast to a minimum wage, would lead to a positive employment and income effect.

Recently, the German Institute for the Study of Labor (Forschungsinstitut zur Zukunft der Arbeit) published a work done by Bauer et al. (2008), focusing on the fiscal effects of a minimum wage of EUR 7.50 in Germany. They concluded that the minimum wage would generate an additional fiscal burden of EUR 9.5 billion. Additionally, they found that an increasing unemployment rate due to the minimum wage would mostly be caused by job losses among marginal and part-time workers as well as low- and semi-skilled full time workers, whereas high skilled workers are less affected.

In short, the results of the neoclassical approach argue against the introduction of a minimum wage in Germany, but rather recommend the implementation of social security subsidies instead. Their main point of criticism is the substantial increase in unemployment as

well as the high fiscal burden. The presented impact studies are even more pessimistic about the consequences of the introduction of a binding minimum wage than the international survey on the effect of minimum wages by Neumark and Wascher (2007) would have suggested. Looking at empirical case studies, Neumark and Wascher show that two thirds of the studies suggest a slightly negative employment effect, but as they admit themselves, often with low statistical significance.

Obviously, the results presented above are not in line with the political economy argumentation before. The growing support for a minimum wage would imply that Germany would have to bear enormous costs if a minimum wage was introduced. However, there are good arguments why the results of the reviewed studies might be misleading. The neoclassical model utilized by the studies which were surveyed before, unambiguously predicts that a binding minimum wage leads to unemployment. This result crucially relies on the assumption of perfectly competitive markets which has been heavily criticized by many scholars.

The critique is especially true when it comes to labor markets. Marx (1894) famously argued that the profit of firms was nothing else than the extraction of surplus value from the exploited workers (or in his terms: proletariat). But not only radical figures like Marx, also famous pioneering economists like Richard A. Lester, thought of workers as being especially vulnerable in the market. Lester (1941, p. 43) explains in his textbook “Economics of Labor” that “some of our most imperfect markets are labor markets” and goes on that “Generally, it is easier for buyers to dominate the labor market and control the price of labor than it is for them to control the markets and prices of standard commodities”.

The intuition that firms have an advantageous bargaining position boils down to the economic concept of monopsony power. The modern conception of monopsony power means that firms are able to set wages below the marginal product of labor due to market imperfections. Metcalf (2007) mentions three sources of imperfections which cause workers to accept lower wages. Firstly, there is the absence of perfect information on alternative jobs. This means that workers have to deal with uncertainty if they quit a job to go somewhere else. Risk-averse people would therefore be willing to get a lower wage for more certainty. Secondly, there are costs involved when changing the employer, both material and social. Thirdly, he mentions different preferences by workers, such as distance to the job, hours working and the social

environment. All those factors give firms the opportunity to pay workers less than their actual contribution to the firm.

### **3.2 Monopsony Power**

As it was just shown, there are good reasons to believe that employers are able to pay lower wages than predicted by the perfectly competitive model. This ability boils down to the issue of market power which derives from the monopsonistic power of firms. The fundamental idea in monopsony is that the labor supply curve to individual employers is not perfectly elastic, i.e. individual firms are wage setters and not takers. The extent of employer monopsony power is therefore related to the wage elasticity in the labor supply curve facing an individual employer: the less elastic the supply curve, the more market power the employer possesses. Hence, the lower the elasticity, the lower will be wages for given demand and supply curves.

$$w = \frac{1}{1 + \varepsilon} * MPL$$

The equation above shows the relation in mathematical terms, where  $\varepsilon$  is the inverse of the wage elasticity of the labor supply curve to the individual employer. Employer with monopsonistic power will thus pay workers less than their marginal product and hire less than the optimal number of workers to gain most from the market power (see most standard labor economic textbooks).

In the following section, models of monopsonistic labor markets are surveyed to demonstrate that a binding minimum wage could theoretically decrease unemployment rates. The overall conclusion is, however, that theory is a bad guide for policy recommendations.

#### ***Theoretical Implications***

The simplest model of monopsonistic labor markets, which is a static partial equilibrium model and presented in most textbooks, concludes that there is always a minimum wage that raises employment (Boeri and Van Ours, 2008). Manning (2003) shows in his survey on more elaborated models that this does not always have to be the case. General equilibrium models of oligopsony do not allow such clear-cut policy prescriptions.

Two important distinctions between partial equilibrium models of monopsony and general equilibrium models of oligopsony are at work: 1) in a general equilibrium setting, the elasticity of labor supply for the whole market does not have to be the same as the one for individual employers and 2) there is huge heterogeneity among employers. The model used by Manning (2003) points to three different characteristics that determine whether a binding minimum wage raises or reduces unemployment in a general equilibrium setting: 1) standard deviation of wages, 2) degree of monopsony power and 3) degree of spillovers. Simulations show that depending on the parameters chosen, there are ambiguous effects on unemployment for all kinds of minimum wage levels.<sup>1</sup>

Manning concludes that there may be a relatively wide range of minimum wages over which the impact on employments is likely to be small, but that the potential downside from excessively high minimum wages exceeds the potential up-side for a well-chosen one. However, he goes on that a well-chosen minimum wage is not beyond the reach of good policy. Moreover, the effect on employment should be rather an empirical issue, because theory does not allow one to draw strong conclusions and is mainly driven by quite arbitrary assumptions. Hence, empirical studies should be used to inform policy.

### ***Measurement of Monopsony Power***

Theoretical results of monopsonistic models might be ambiguous, but more caution in drawing strong conclusions is already something most studies based on neoclassical models still have to discover. Evidence that firms actually have monopsonistic power would invalidate their findings and show how vulnerable their policy advices are to unrealistic assumptions.

The best measurement of monopsonistic power, as discussed already earlier, would be an estimate of the wage elasticity of labor supply facing an individual employer. However, those estimates are rare as most mainstream models do not consider the case of monopsonistic power. The majority of papers that estimate the elasticity found rather low values, but a few argue that the elasticity is around 5, which implies that wages could be roughly 17% below their marginal value and monopsony is the usual rather than the exotic case (Manning, 2003).

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<sup>1</sup> A graphical illustration can be found in the appendix

A rather simple, but nonetheless valuable indicator of the competitiveness of labor markets and thus monopsonistic power, is the amount of newly hired people who are coming from a different employer, i.e. who are enticed away. A high share implies that the frictions like search costs, which explain monopsonistic power, are not that pervasive and thus firms are not able to push down wages easily. In the US and UK, for instance, the share of poached workers amounts to roughly 45% to 50%, which indicates that employers have substantial market power in those countries (Manning, 2003).

## **2.3 Empirical Evidence**

### ***The British Minimum Wage Experience***

In Great Britain the effect on employment has been by no means as bad as it is predicted for Germany. Stewart (2004) has found that the minimum wage in Great Britain did not lead to any significant adverse employment effects. Further he found that the probability of a worker earning the minimum wage being employed is not lower than the probability of worker earning slightly more than the minimum wage being employed. This result is consistent with the findings of Metcalf (2007) who also could not find a negative employment effect, and Draca et al. (2008) who say that “it has proven difficult to identify evidence of negative employment effects associated with these wage gains”.

Other research has tried to capture the impact of wage inequality in response to the national minimum wage in Great Britain. They have come to quite positive results, too. Machin et al. (2003) chose to investigate the care home sector, because it is characterized by low wages and therefore very vulnerable to the here discussed policy. They found a wage increase for a considerable part of the workforce due to the minimum wage. The downside of this study is a small decrease in employment, but as we saw before, this employment loss is not representative for Great Britain as a whole. Additionally, Mason et al. (2006) claim that most of the research done on this subject suggests that this policy made low-paid workers better off.

These empirical results for Great Britain seem to be at odds with neoclassical labor market theory. Draca et al. (2008) mention two possibilities how a firm could avoid laying off workers in response to an increase in labor costs. One way would be to transfer the costs from the

producers to the consumers by means of higher prices, which would have a negative effect on real wages. The second way would be to pay the higher costs by a reduction in profit margins which would be possible in the presence of monopsony power as shown earlier in the theoretical part. They claim that there is little evidence that the higher labor costs have been absorbed through an increase in prices. Instead, Draca et al. find empirical evidence for a decrease in profitability of firms in Great Britain after the introduction of the minimum wage. Their result is a negative relationship between the minimum wage and firm productivity. This finding supports the second view, which means that the increased labor costs are encountered by reduced profits instead of layoffs.

The empirical results of the minimum wage effects in Great Britain show that this policy can be a good instrument to improve labor market outcomes. It seems that the main goal, a decrease in wage inequality through an increase of the wages at the lower end of the wage distribution, has been achieved. This has been reached without a significant employment loss, but rather resulted in a decrease of firm profitability in Great Britain. The empirical findings documented for the UK clearly are in contrast to the neoclassical predictions which falsely assume perfectly competitive markets. As it has been shown, monopsony power, for instance, seems to be an essential feature of the labor market and its ignorance would lead to ill-advised policy recommendations.

Interestingly, Dickens et al. (1999) have tried to incorporate monopsony power in their theoretical models. They estimated a positive employment effect in Great Britain due to a minimum wage. At this point, the following question comes to mind: Why did the word ‘monopsony’ not show up in any of the above surveyed neoclassical articles estimating the impact on Germany? At least, one could have wished to find an explanation of why monopsony power has been ignored. In the following section the paper proves the relevance of monopsony power for Germany.

### ***Monopsony Power in Germany***

Firstly, we would like to reemphasize that we live in a world where perfect markets do not exist. There is no doubt about the fact that each and every individual is not supplied with perfect information and that the mobility of workers is far from being perfect. Therefore, it is not important to discuss whether firms have monopsony power, but rather to examine the magnitude

of this power. As already stated above, there has not been that much attempt to measure monopsony power, but there are a few articles that put forward quantitative estimations of monopsony power for Germany.

Ridder and van den Berg (2003) have tried to quantify the monopsony power of firms caused by search frictions in a similar way as the simple measurement suggested by Manning (2003). They use the average number of job offers which an employee receives during his employment spell as an indication for monopsony power. The intuition behind this is that the relative bargaining power of employees increases as the number of job offers rises. The authors estimated the index for Germany to be very low. Compared to the UK it is twice as small and compared to the US just one third. This suggests that the search frictions in Germany are relatively high in comparison to the United Kingdom and the United States.

Hirsch et al. (2008) do not use a similar, but exactly the same measurement as proposed by Manning (2003). They estimate the amount of newly hired people who have been poached away from another employer. Hirsch et al. find that the share of hires which result from poaching is about 53% in Germany. This value is similar to the ones estimated by Manning for the United States and the United Kingdom. It emphasizes that monopsony power is far from being negligible.

Hirsch et al. also tried to find exact values for the wage elasticity distinguishing between male and female workers. Their estimated long run elasticities imply that female workers would earn between 38.7% to 53.6% more and the wage of male workers would increase by roughly 27.4% to 40.2 % if both groups were paid their marginal product. Gender differences go beyond the scope of this paper, but it is worth mentioning that monopsony power is probably one of the reasons for the gender wage gap. In addition, it is mentioned that monopsony power is dependent on the earned wages as well. Hirsch et al. show that monopsony power is bigger for firms dealing with low wage workers than for firms mostly hiring high paid workers. This finding suggests that low skilled people, who are naturally earning lower wages, are affected worst.

To say it in the words of Hirsch et al. the “estimated labor supply elasticities are far from the conventional textbook case of being totally elastic”. Quite the contrary, monopsony power seems to be of significant magnitude in the German labor market and even more so than in the UK and US. Furthermore, low skilled and female workers have to suffer most.

## 4. Conclusion

It should come as no surprise that minimum wages were fiercely debated in the German election campaign. The debate signifies the collapse of the corporatist welfare state model which has been subtly eroded through the bleeding of social partners in terms of members and influence in the last two decades. This development should be interpreted in the broader picture of the vanishing explanatory power of the taxonomy of welfare states as the within-model variance in the levels of different institutions is increasing. The German people are just searching for the next best instrument to make up for the incapability of trade unions to provide wage floors nowadays.

The desire for minimum wages has been sharply confronted by the majority and most influential part of the German economists who predicted disastrous effects on employment and public expenditure in many impact studies if a nationwide minimum wage of EUR 7.50 was introduced in Germany. However, it has been shown that this result is driven by a severe misconception of labor markets. Since very recently, the growing body of work on monopsony power, which is linked to a long-lasting tradition that recognizes the labor market as prime example of imperfect competition, provides the theoretical weaponry to prove the neoclassical impact studies as arbitrary.

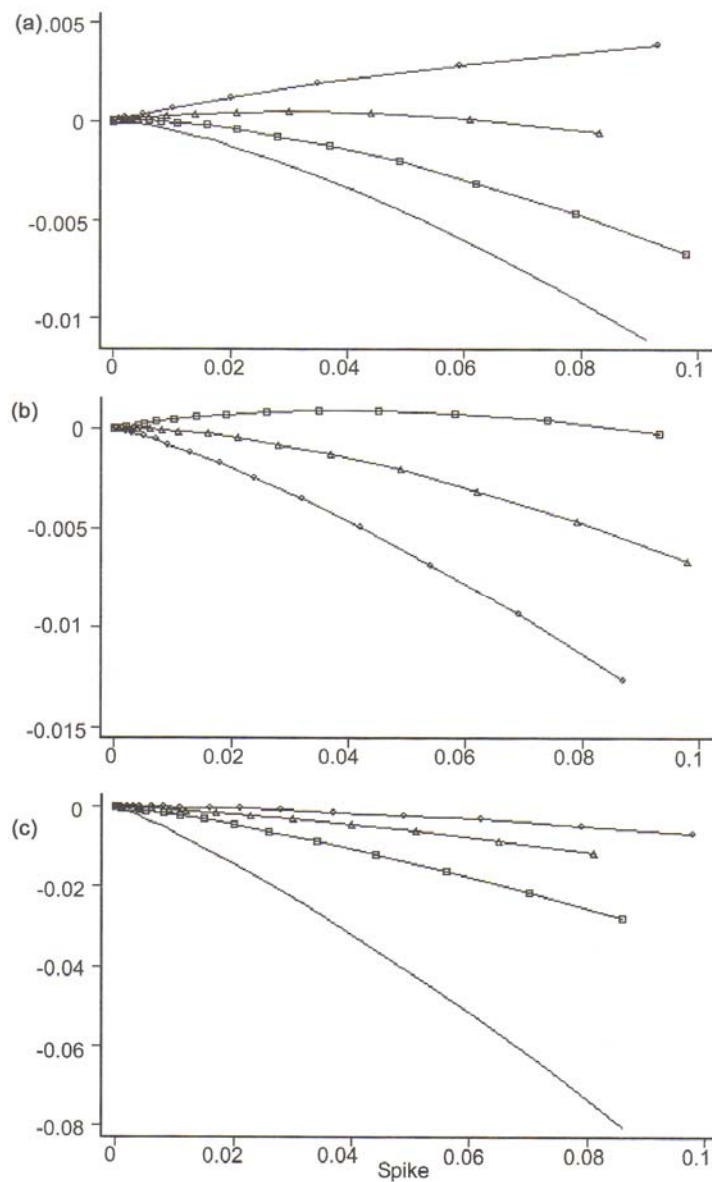
As monopsonistic models of the labor market come closer to reality, it is not possible to make straightforward theoretical predictions regarding the effect of minimum wages anymore. Instead, careful analysis of empirical studies should be used as a guide for policy reforms. In contrast to the horror scenarios told by most impact studies, empirics do not show any significant and consistent negative effects of minimum wages. The British experience even points towards positive effects as the binding minimum wage introduced in 1999, led to a decrease in monopsony power of firms rather than a decrease in employment.

Similar results seem to be most likely for Germany as well. As it has been shown, several indicators suggest that monopsony power is highly relevant in the German labor market, even more so than in the UK. Hence, the predictions of the neoclassical studies have nothing to do with the facts. There are no a-priori reasons against the introduction of a minimum wage in Germany. The success of such a policy is more likely than not and crucially depends on fine-tuning.

## Appendix

The graph shows the employment impact of the minimum wage as a function of the spike (Manning, 2003).

- The effect of varying the standard deviation of wages.  $\circ$ ,  $\sigma_w = 0.2$ ;  $\Delta$ ,  $\sigma_w = 0.3$ ;  $\square$ ,  $\sigma_w = 0.4$ ; solid line,  $\sigma_w = 0.5$ .
- The effect of varying the degree of monopsony power.  $\circ$ ,  $\varepsilon = 0.1$ ;  $\Delta$ ,  $\varepsilon = 0.2$ ;  $\square$ ,  $\varepsilon = 0.3$ .
- The effect of varying the degree of spillovers.  $\circ$ ,  $\theta = 0.25$ ;  $\Delta$ ,  $\theta = 0.5$ ;  $\square$ ,  $\theta = 0.75$ ; solid line,  $\theta = 1$ .



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