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Minimum Wage and Low Incomes:
How Can Social Justice Be Reconciled with Economic Effectiveness?

Report by Pierre Cahuc, Gilbert Cette and André Zylberberg

Minimum wage, such as it is in France, is not an effective way to reduce poverty and inequality. Poverty can be primarily attributed to lack of employment, low number of hours worked and family situation.

The writers of this report have based their assessment on a thorough review of the situations prevailing in other countries where the minimum wage is less restrictive, if not inexistent. The French income redistribution system is based on a relatively high minimum wage, combined with a variety of social services whose complexity and characteristics (according to level of income from employment) result in a complete lack of visibility and very poor incentives for less skilled workers to seek new employment. This system also puts young people at a distinct disadvantage.

The writers suggest that an effective policy aimed at raising low incomes and reducing poverty would be based on tax measures and targeted social services, rather than on a high, uniformly applied minimum wage.

On 23 July 2008, this report was presented was presented to Messrs. Eris Besson, Secretary of State for Strategic Studies, Public Policy Evaluation and Digital Economy Development, Laurent Wauquiez, Secretary of State for Employment, and Martin Hirsch, High Commissioner for Active Solidarity, at a plenary session of the Conseil d'Analyse Economique (French Council for Economic Analysis). This newsletter, released by the Council's permanent staff, presents the main conclusions of the report.

The unique role of minimum wage in France

Minimum wage is applied in an exceptionally uniform way in France. In most countries which have a legal minimum wage, there are built-in exceptions based on age starting at the age of 18, sometimes based on region and sometimes even based on the economic situation. Moreover, there are some rather large industrialised countries which simply have no legal minimum wage at all. A floor-level wage of this type exists in seventeen OECD countries and in twenty of the twenty-seven EU member states. The seven member states currently without a legal minimum wage are Austria, Cyprus, Denmark, Finland, Germany, Italy and Sweden. These countries favour the use of social services and taxes to reduce inequalities.

The purchasing power of the gross hourly minimum wage, viewed in terms of its rise relative to the price index used as an automatic adjustment mechanism, has topped 150% since 1970. This is linked to a) the indexing of the minimum wage on half of the purchasing power of blue-collar workers' basic hourly pay and b) the impact of government increase decisions. From 1970 (the year the minimum wage was initiated) to 2002 (the year minimum wages began to converge), such decisions accounted for 60% of the gains in minimum wage purchasing power.

For almost four decades, the increase in minimum wage purchasing power has significantly exceeded median wage purchasing power. A considerable percentage of salaries are paid on the basis of minimum wage: over 15% in 2006 and almost 13% in 2007. Furthermore, given the distribution of minimum wage hikes across the entire range of low salaries, some 35% of salaries are either directly or indirectly impacted by minimum wage increases.

To compare the French minimum wage system to valid models in other countries, the writers use a composite indicator designed in a 2007 study performed by Aghion, Algan and Cahuc. The purpose of this study was to measure the type of restrictions that the explicit or implicit existence of minimum wages imposes on the labour market. The indicator covered two areas: 1) legislation, whereby it quantified the existence of different minimum wages, exceptions, and extension clauses pertaining to minimum wages by professional branch, as well as the degree of dispersion in minimum wages by age group, skill set, region, sector and profession; and 2) the level of minimum wage versus median salary. France is at the highest level of the composite index, both in terms of average figures over the 1990-2000 period and for 2000 alone.

France is an extreme case among OECD countries, set apart by the very centralised mechanism for setting the minimum wage: the mechanism applies to everyone without distinction, be it in terms of age, place, field of activity or profession. This situation, in which the government steps in for management and trade unions to control how the labour market operates, automatically reduces the scope for employer-employee communication. It therefore has a harmful effect on relations between employers and their employees.

Minimum wage and inequality

Poverty is measured on the basis of all levels of income, including minimum guaranteed incomes. The poverty rate is determined by taking the percentage of individuals with an income below 50% (historic threshold applied by INSEE) or 60% (new European standard) of the median income.

According to calculations by the CERC (*Conseil de l'emploi, des revenus et de la cohésion sociale*, French council for employment, income and social cohesion) in 2006, the income of a household in which at least one individual earns full-time minimum wage over the entire year exceeds the poverty threshold (at 50% of median income), irrespective of the number of children and factoring in various social security transfers and welfare allocations. At 60% of median income, a household would have to earn at least 1.5 times the minimum wage to cross the poverty threshold.

In France, the employment situation goes a long way towards explaining poverty. The situation of 'poor workers' can be primarily attributed to the short length of employment. These are individuals who work either independently or as salaried employees, but whose income is too low to lift their households above the poverty threshold. For the most part, they are individuals who alternate between periods of employment and unemployment or poorly paid part-time work. Only 1% of individuals working full time year-round are poor. It is the length of time worked over the year, rather than the level of hourly pay, that goes the farthest in explaining inequality and poverty. The poverty rate is highest for young people and single-parent homes.

Working poverty has been on an uptrend for the past thirty years, whereas poverty itself has decreased significantly: the overall poverty rate fell by half from 1970 to 2002 (down from 12% to 6%), while the poverty rate of salaried workers or unemployed persons having worked at least one month during the year rose from 3.4% to 5.7% over the same period. Clearly, the sharp increase in the minimum wage over this period (both in terms of purchasing power and relative to median salary) failed to prevent working poverty from climbing.

Comparisons with other countries confirm that the reduction of inequality is not linked to the existence of a minimum wage. Of those European countries demonstrating the fewest inequalities, four (Finland, Denmark, Sweden and Italy) do not have a minimum wage. Furthermore, existing studies do not show that a high, restrictive minimum wage reduces poverty and inequality.

Economic analysis reveals that minimum wage increases can have a positive impact on employment for low minimum wage levels; however, the impact becomes negative past a certain threshold. On the whole, empirical studies confirm this conclusion. In this respect, a comparison between France and the United States is enlightening. Since the early 1960s, minimum wage in France has done nothing but climb relative to average or median salary, while in the United States its real value in 2007 was lower than in 1960! These trends are so vastly different that a minimum wage increase could potentially cause employment to rise in the United States and fall in France.

To reduce the impact of minimum wage increases on employment in France, policies aimed at lowering social security contributions have been implemented. These measures have given rise to a government subsidy for the employment of least-skilled workers and is supposed to 'protect' at least 800,000 jobs depending on the subsidy. However, such measures could end up creating 'low wage' traps.

By increasing low salaries, minimum wage can reduce poverty and unequal pay. Other impacts, however, could tip the scales in the opposite direction. Firstly, minimum wage robs the least productive workers of their jobs, thus reducing the income they are able to earn. Comparative studies carried out in the US, where minimum wage varies by state, made it possible to measure the impacts of variations in minimum wage on poverty. The conclusions can be summed up by the following theory: an increase in income for the casually employed who keep their jobs and a decrease in income for those who lose their jobs.

Fighting more effectively against inequality

The results of economic analysis, confirmed by a number of empirical studies, have shown minimum wage to be a woefully inadequate mechanism for income redistribution.

The writers offer two proposals: key the use of tax instruments, such as income tax and social services, with minimum wage as much as possible, and change the terms for setting minimum wage by leaving more room for collective bargaining.

The writers review the characteristics of various types of social services in terms of field of activity, redistribution and budget cost. They also refer to the lessons learned from the optimal taxation theory, which attempts to define the most appropriate social services and taxes when the government, faced with a decision between effectiveness and inequality, nonetheless seeks to reduce the distribution of primary incomes for the purpose of 'social justice'. One of the key conclusions from this type of analysis is that a redistribution policy based on social services and tax measures is always better than a policy based on a restrictive minimum wage.

French strategy has widely diverged from the teachings of this theory. The French approach is to redistribute income by applying a restrictive minimum wage and multiplying the number of social services based on different, if not contradictory, arguments. There are two sticking points to this strategy: it places young people at a major disadvantage and creates a convoluted system with highly variable marginal tax rates that can be quite significant.

France has landed itself in a position where it has one of the lowest employment rates of 20-24 year olds in the OECD without offering the benefit of a minimum income to this same group. In Europe, only Luxembourg, Spain and France have established 25 as the minimum age to qualify for a guaranteed minimum income. Neither the Scandinavian countries (Denmark, Finland and Sweden) nor Austria, Germany or Italy impose an age limit, whereas guaranteed minimum income starts at 18 in Belgium, Ireland, the Netherlands and Portugal. The UK has set the age limit at 16. In the writers' view, if the government's goal is to redistribute income to the most disadvantaged persons, then young people should not be excluded.

The writers perform a critical analysis of currently available social services. They focus in particular on the PPE (tax credit awarded to low income earners), which covers a very broad, ill-defined group of people and, as a result, offers meagre incentive at best. What's more, there is a considerable time gap between the period of employment on which the PPE is based and its actual payment to the beneficiaries. Consequently, the effectiveness of the PPE as an incentive is debatable.

At the lower end of the income scale, the marginal tax rate often varies by several dozens of points upward or downward over very limited ranges of income from employment. These variations are particularly significant at the beginning and end of rights to services based on resources (Christmas bonus, back-to-school allocation), at the end of rights to differential services (here, the RMI, or minimum basic income) or regressive services (e.g. housing allocations), or at the start and end of rights to PPE-type services (which is first progressive, then neutral, then regressive relative to income from employment). As a result, these mechanisms are fraught with complexity, with confusing incentive signals and contradictory incentives on the supply of work according level of income from employment. For example, the gain in net monthly income (change in income from employment plus change in net social security transfers) following the transition from unem-ployment to minimum-wage employment appears to be very slight, particularly for a transition to half-time employment. For example, for an unmarried person or a couple in which only one person works, the increase never exceeds EUR 120 per month!

The writers argue for simplifying the offering of social services, so as to enhance their incentive power on the supply of work for least-skilled workers without reducing their impact in terms of combating poverty and while costing the government as little as possible. The RSA ('active solidarity income') programme is a step in the right direction.

In the writers' opinion, the RSA should replace the PPE, the RMI, the single-parent allocation and, where applicable, other minimum guaranteed incomes, as well as the associated temporary mechanisms aimed at encouraging the unemployed to return to employment, with a single and permanent system. Generally speaking, the RSA results in a transfer of additional resources to households with very low incomes, which have to be financed one way or another. In any event, the financing solution ends up reducing the net income of the households paying for it. Extending the RSA to under-25s creates an additional cost. The writers propose some reasonable figures for the replacement of existing financial aid options with the RSA, with 60% being the portion of income added to the RSA. According to these assumptions, the writers argue that the RSA could be financed at no additional cost.

Recommendations

Initiatives must be taken in a number of areas in order to combat inequality and poverty. It goes without saying that education and training policies should take high priority, as should urban and housing development policies. Having said that, minimum wage and support mechanisms for low income households in general must not be considered as less important issues just because they tend to be the subject of more disagreement. In France, myriad individuals are persistently trapped in situations of poverty or in unrewarding careers, owing to inadequate policies addressing low incomes. The purpose of the recommendations provided in the conclusion to the report is to propose a more coherent structure for these policies.

Establishment of a coherent policy to combat poverty

In the future, it would be better to select rules guaranteeing that changes in minimum wage will be consistent with medium-to-long-term concerns and with tax policy as a whole. Accordingly, the writers suggest the joint establishment of minimum wage and other minimum guaranteed incomes within the framework of finance law. Parliamentary debates on the adjustment of minimum guaranteed incomes and minimum wage would benefit from the input of management and trade unions via the *Commission nationale de la négociation collective* (CNNC, French commission for collective bargaining). A committee of duly mandated, independent experts should be created for the purpose of informing the opinions of the CNNC as well as Parliament. The members would be appointed in accordance with conditions guaranteeing their independence, and for a long enough period to place their work in a medium-to-long-term perspective. The committee should not be limited to reviewing the consequences of minimum wage; rather, it should provide a broader opinion on the consequences and effectiveness of all policies aimed at supporting low-income households. The current rules for the annual adjustment of the minimum wage would be replaced by decisions taken within the framework of finance law. It would be necessary, however, to maintain the automatic rules for adjusting the minimum wage during the year in response to inflation trends. Making the adjustment on January 1st instead of July 1st, as recommended by the *Conseil d'orientation de l'emploi* (French employment orientation council), would facilitate professional branch negotiations.

Reforming guaranteed minimum incomes

The reason for unifying guaranteed minimum incomes and employment-related services is linked to the argument for the RSA as a replacement for the PPE, the RMI, the single-parent allocation and, where applicable, other social security transfers (e.g. the *complement de libre choix d'activité*, 'free choice of employment' supplement), as well as the associated temporary mechanisms aimed at encouraging the unemployed to return to employment, with a single and permanent system.

The process of unifying guaranteed minimum incomes and employment-related services will be a gradual one. There are two main types of problems: firstly, there are many sources of national social security transfers, some of which are employment-related and others not, and a large number of related rights, some of which are national and some local, in addition to time lags between income from employment and disposable income. The writers refer to the recommendations published in the report by Quinet, Cazenave and Guidée (2007), whereby the RSA would be a service provided on the basis of a system of monthly or quarterly deposits, updated in relation to the beneficiaries' situation in order to avoid making too many undue payments at the end of the year, and that the RSA provided to unemployed beneficiaries would be financed by general councils while the RSA provided to employed beneficiaries would be financed by the government. The writers veer away from the above-mentioned report, which recommends that the management of this system be handled by the CAFs (*Caisses d'allocations familiales*, Family welfare centres), by favouring management by a single organisation created from the merger of the ANPE (*Association nationale pour l'emploi*, National association for employment) and the

ASSEDICs (*Association pour l'emploi dans l'industrie et le commerce*, Association for employment in commerce and industry) so as to orient the RSA towards a goal of integration. Unifying minimum guaranteed incomes and employment-related services should apply to all adults, without excluding under-25s who do not have dependents. In exchange, provision of this service should prohibit parents of beneficiaries from claiming their children as dependents. In this context, where 18-25s would receive the same rights as their elders, certain services which are currently specifically dedicated to this age group should be eliminated.

Encouraging employer-employee dialogue

The writers do not favour the oft-cited proposal of basing the reduction of social security contributions on the holding, or even the successful conclusion, of professional branch or company salary negotiations. Should this condition be applied, one possible guideline, recommended for example by the opinion of the COE (2008), would be to base the rate scales for social security contributions (including reductions) on minimum guaranteed incomes for professional branches where they are lower than minimum wage. Such a measure would certainly encourage collective bargaining in professional branches and help reduce the compression of wage hierarchies at the minimum wage level.

Comments

Daniel Cohen welcomes the report's conclusions. While he agrees with the premises and conclusions therein, he is nevertheless more reserved with respect to the figures used to support the conclusions. He specifically questions the relatively high percentage of minimum wage earners in France versus the percentages in neighbouring countries whose minimum wages are close to France's minimum wage. In addition to the difficulties in measuring salaried incomes (bonuses, tips, etc.), he questions the impact of various reductions in social security contributions at the minimum wage level, which tends to encourage employers to block salaries at this level.

Jean-Philippe Cotis supports the assessments and recommendations presented in the report. He also observes that rational economic choices may be subject to the influence of considerations relating to the 'political economy', with the theory of the dictatorship of the average voter. This may explain why minimum wage favours the current situation of salaried workers more than the development of employment, why reducing social security contributions on low wages now serves more to offset the effects of the decrease in working hours, and why the poorly targeted PPE appears to be more of a substitute for an income tax cut for taxpayers not subject to income tax. Similarly, he questions the influence of philosophical approaches such as the Aristotelian ethic of virtues which favours the distribution of resources based on merit and which can oppose the more utilitarian ideas that underlie universal welfare and undermine the redistribution structure recommended in the report. Rather, he argues for less ambitious but more socially accepted solutions.

Philippe Mongin opposes the report's proposal to extend the minimum wage to 18-25s. According to Mongin, such a measure would have negative impacts on the employment of this age group, given their higher preference for leisure than their elders, a risk of moral hazard for those who receive family welfare benefits and the impact of their behaviour as demonstrated in studies. He argues in favour of special financial aid depending on their individual status.

A point of view on the RSA

In a special contribution, ***Philippe Mongin*** gives his opinion on what might be an effective mechanism for the RSA. He argues for the broadest possible integration of financial aid benefits granted to the most disadvantaged. In addition to the various allocations which could be absorbed by the RSA, he argues for the monetisation of financial aid benefits and universal health coverage supplementing the different payment exemptions offered to the most disadvantaged. Noting that the PPE is not in keeping with either the initial incentive objectives or the goal of combating poverty due to the fact that it is relatively widely distributed, he would like to see it replaced with the RSA, which would recover the budget for the PPE. The ideal scale for the RSA would be concave, so as to encourage the unemployed to seek employment, even through small quantities of work. It should not be legally defined in relation to minimum wage and its adjustments should not be pre-defined either. This would help provide leeway to recalibrate the RSA, where applicable, by better including it in the future of associated rights. It would also make it possible to react in the event the mechanism were to expand too quickly. Finally, Mongin warns against the use of the poverty indicator based on the rule of 60% of the median income (European standard) to assess the government's goal of reducing poverty. Instead, he suggests measuring the gain in the standard of living of the first decile of income distribution.

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