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Germany's Coming Labor-Market Catastrophe

A new minimum-wage law could put 600,000 people out of work.

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Germany's new governing coalition plans to introduce a national minimum wage of €8.50 per hour, beginning Jan. 1, 2015. Artificial labor price floors adversely affect employment rates, particularly for low-skilled employees. But since in Germany's case the decision is foregone, the question now is how to minimize and mitigate the new law's negative effects.

In Germany, the median hourly wage for full-time employees was €17.10 in 2012. This means that the proposed minimum wage amounts to 50% of the median income in the country, placing Germany considerably above the OECD average of 40%. This asymmetry will have several adverse consequences for the German labor market.

Studies by Germany's Institute for the Study of Labor show that some 600,000 people, or 1.38% of the country's labor force—among them part-time employees, women, low-skilled workers and East Germans—could lose their jobs as a result of the new minimum wage. The move could drive up the German unemployment rate to 8.7%, from the current rate of 7.3%, especially since part-time employment and the service sector were significant contributors to recent job growth.

Small businesses and those in East Germany will be especially hard-hit, and forced to make significant upward wage adjustments. This will also adversely affect the overall employment rate, creating incentives to circumvent minimum wages by, for example, working unpaid overtime or by shifting employment to work contracts based on formal self-employment.

The new law would also add an additional labor-market barrier for young workers, trainees, interns and the long-term unemployed. High minimum wages encourage adolescents to drop out of training programs. Why? A minimum wage makes even simple jobs more attractive. Instead of accumulating human capital, which is increasingly important in the global economy, young workers may accept unstable and low-skilled jobs, damaging their future labor-market prospects.

Moreover, due to large differences in minimum-wage levels across the European Union and given the free movement of labor within the EU, additional workers from countries with lower minimum wages may seek work in Germany. This would also have adverse effects on Germany's overall labor market.

Finally, it's unclear whether the new minimum wage would even fulfill the social-fairness considerations put forth as its main political rationale. Although a minimum wage has a positive impact on the wage distribution in a country, the interaction of minimum wages with the given country's tax and wealth-transfer systems means that there is little change in disposable income. That's because higher wage income raises tax liability and that, in turn, leads to reductions in supplemental income benefits these individuals receive.

Worse, most of those who currently qualify for the minimum wage don't live in low-income households. So it isn't surprising that the income distribution across households can hardly improve. Minimum wages are very inefficient tools for fighting inequality.

So what should be done? Since the political debate on the matter is over, a cautious approach to implementing the law is advisable. Starting off at a lower level than €8.50 would allow the German government to test the impact of a minimum wage on the market. Based on the results, the minimum wage could be raised on an incremental rather than wholesale basis.

Second, a lower minimum wage for adolescents without training, as well as for trainees and interns, is reasonable—provided that skills acquisition has priority, as it should. Moreover, an exception for the long-term unemployed helps to prevent the minimum wage from becoming a permanent hiring obstacle. Third, the government should continually analyze dynamic changes in the level of employment and wages, corporate workforces, labor demand and the quality of work.

Thus far, it appears the German government doesn't have plans to carefully examine the effects of the law using independent scientific research. And it seeks to impose the minimum wage strictly and generally, with practically no exemptions. But policy makers should tread carefully.

After all, the road to social-policy improvements is plastered with examples that ended up backfiring—not just preventing the intended positive effects from becoming a reality, but contravening them. Germany can't afford such mistakes.

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