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On the Effects of the Minimum Wage on Employment, Formality, and the Wage Distribution

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We use a bargaining model to characterize the effects of the minimum wage on the joint distribution of sector (formal versus informal), wage, and employment. We show that the economy's response to the policy is related to the type of jobs low-wage workers hold and thus workers can be divided into distinct sets depending on how they respond to policies that increase the costs of operating in the formal sector. As a result, the aggregate effect of the minimum wage will typically involve increasing wages in the formal sector, a decrease in overall employment levels, and a decrease in the absolute and relative size of the formal sector, where the relative strength of these distinct responses is dictated by the types of jobs low-wage workers hold.

We show that the bargaining model nests both compensating differentials mechanisms in the sense of Rosen (1986) and self-selection mechanisms in the sense of Roy (1951). We also show that the bargaining model collapses to the standard Roy (1951) model under the limiting case in which the worker's bargaining power goes to one. We estimate the effects of the minimum wage for the Brazilian economy using the "PNAD" dataset for the years 2001-2005. Our results suggest that the minimum wage substantially increases the size of the informal sector, an effect that is due to both adverse employment effects on the formal sector and movements of workers to the informal sector that are induced by the policy.