



What is Behind Increasing Wage Inequality in Mexico?

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Summary. — We evaluate the impact of the educational expansion and changes in labor market institutions on wage inequality among Mexican workers using a simulation technique proposed by Knight and Sabot [*The American Economic Review* 73(5) (1983) 1132–1136]. We conclude that while increases in the relative rate of return of higher education would have induced an increase in wage inequality, changes in the composition of the educational distribution would have led to a stronger decline in wage inequality. Instead, increased wage inequality is largely explained by changes in Mexican labor market institutions; namely, unionization rate and minimum wages. © 2001 Elsevier Science Ltd. All rights reserved.

Key words — wage inequality, education, gender, labor market institutions, Latin America, Mexico

1. INTRODUCTION

There is overwhelming evidence that since the mid-1980s Mexico has faced increasing income inequality.¹ Among the different sources of income, wage inequality has contributed significantly to the increase in overall inequality. While the empirical evidence indicates that this is an international phenomenon,² the Mexican experience has been accompanied by a generalized decline in overall average wages.³

In the literature there are three competing explanations about increasing wage inequality: changes in relative demand of skilled labor—caused by either trade liberalization or technical progress—changes in relative supply, and changes in labor market institutions.⁴ The Mexican literature, however, has stressed changes in relative demand in its two versions: trade liberalization and increasing Foreign Direct Investment (FDI). To a large extent these latter two events coincided with the change in economic policy that the government began implementing during the mid-1980s. The trade argument can be summarized as follows: the opening of the economy induced the expansion of the export-oriented industries at the expense of the import-competing ones. Given that the export-oriented industries are intensive in skilled labor, this expansion induced higher demand for skilled labor relative to the demand for unskilled labor. Higher relative demand for skilled labor, in turn, induced positive changes in the relative return to higher education; thus, generating a widening

wage gap between high and low educational attainment.

The FDI explanation arises because of the inability of the trade argument to explain the fact that increasing wage inequality is largely due to changes not between industries (or sectors) as the theory would predict, but rather due to changes within industries.⁵ In effect, Aitken *et al.* (1995), Feenstra and Hanson (1995), Hanson and Harrison (1995) and Meza (1999) find that increasing wage inequality occurred in all industries alike. In an economy where the capital goods sector is underdeveloped, technical progress is achieved mainly through the increase in imported capital goods. In a sense then, the technical progress argument and the foreign direct investment one are the same. The FDI view argues that by bringing technology that is skill-biased, it contributed to the increasing wage gap between skilled and

* This study was conducted while I was a visiting researcher at the Center for Economic Studies, El Colegio de Mexico (CEE-COLMEX) during February–July 2000. Financial support from El Colegio de la Frontera Norte (COLEF) is gratefully acknowledged. I would like to thank Maritza Sandoval from El Banco de Mexico for her assistance in some of the statistical tests and support throughout this investigation, to participants at the CEE-COLMEX Seminar for their comments to an earlier version of this paper and to an anonymous referee for helpful suggestions. Remaining errors are mine alone. Final revision accepted: 19 May 2001.

unskilled labor. This argument is consistent with a number of characteristics of the Mexican manufacturing sector that explain wage inequality in the manufacturing sector. First, foreign-owned firms pay higher wages than domestic firms. Second, foreign firms exhibit higher labor productivity than domestic firms. Third, foreign-owned firms tend to assemble in capital-intensive industries and in regions with more advanced infrastructure. Fourth, there is no wage spillover from foreign investment to domestic firms (Aitken *et al.*, 1995).

While FDI explains increasing wage inequality in the manufacturing sector, it is unable to explain changes in wage inequality in the rest of the economic sectors. In fact, the flow of FDI is negatively correlated with wage inequality in agriculture, indicating that an increase in FDI would reduce inequality rather than increasing it.⁶ Further, a decomposition of overall wage inequality by economic sectors shows that it varies greatly across sectors, suggesting that there might be other factors behind increasing wage inequality that have not been considered so far.⁷

The core of the relative demand explanation rests upon the argument that the increase in overall wage inequality is in fact the result of the increase in the relative rates of return of higher education. Yet, the increase in the relative rates of return of higher education has occurred despite the substantial expansion of education that Mexico has enjoyed during the last decades. In effect, whereas the percentage of employed workers with less than secondary education declined from 60.2% in 1984 to 47.8% in 1996, the percentage of workers with at least some college education increased from 8.7% in 1984 to 12.2% in 1996.⁸ Moreover, the expansion of the relative demand for skilled labor seems to have occurred despite the lackluster performance of the Mexican economy since the mid-1980s. In effect, during 1984–96 Gross Domestic Product grew at an annual average rate of 1.9%.⁹

A further piece of evidence against the argument that changes in the relative rate of return of higher education are the leading factor behind the increasing wage inequality is the fact that wage inequality has increased within each educational category except among workers with no formal education. In fact, the highest growth rate of wage inequality occurred among workers with college education.¹⁰ In other words, for the relative demand argument to hold and assuming some degree of labor

mobility within each educational category, one would expect both an increase of the average wage rate and a reduction of wage dispersion within the skilled labor. The data indicate, however, that while the relative wage rate of a college-educated worker with respect to an uneducated worker has increased over time, their relative wage inequality has also increased over time. The increased wage inequality then cannot be explained exclusively in terms of shifts in relative demand.

There is a general consensus that education plays a central role in income determination; however, its relative importance in the growing inequality among wage earners is still unclear. In fact, while education has induced changes on wage inequality in other countries, it is still far from providing a full account of increased inequality among Mexican wage earners. Alarcón and McKinley (1997), for instance, study the effect of education on wage differential among different groups of workers but in a static framework. That is, they do not analyze changes either in educational attainment or in their rates of return over time. Bouillon *et al.* (1999), on the other hand, while allowing for changes in rates of return and in educational attainment, are unable to demonstrate directly the net impact of these changes on income (or wage) inequality. They reach their conclusion that education “substantially” contributed to increased inequality after comparing the educational gains of the lowest decile to the ones of the top decile with their respective monthly earnings.

Another characteristic is that these studies have overlooked the impact of changes in labor market institutions upon wage inequality, for parallel to changes in economic policy, or rather as a result of these changes, there have been changes in the Mexican labor market that have resulted in an increasing flexibility. These changes have not been properly analyzed in the context of wage inequality.

The purpose of this essay is therefore twofold. The first objective is to measure the impact of the educational expansion on wage inequality among Mexican workers. The second is to evaluate the impact of changes in labor market institutions; namely, labor unions and minimum wages. A number of studies have illustrated not only the extent by which women’s participation in the Mexican labor market has been increasing since the mid-1980s but also the extent by which they are discriminated against.¹¹ We, therefore, carry out the analysis for male and female workers, separately.

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