



# The Consequences of Legal Minimum Wages in Honduras



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## SUMMARY

Minimum wage policies are implemented in most developing countries, so understanding their consequences is critical to determine their effectiveness. This paper quantifies the labor market and poverty effects of Honduran minimum wages from 2005 to 2012. Using 13 household surveys as repeated cross-sections, I estimate the net effects of minimum wage hikes using variation from annual reforms to multiple minimum wages, a 60% increase, and changes in the number of minimum wage categories. Evidence shows that employers are partially complying with minimum wage laws, and respond to hikes by increasing their level of non-compliance. Higher minimum wages reduce covered (formal) employment and increase uncovered (informal) employment. Formal sector wages increase but greater labor supply in the informal sector leads to a negative net effect on wages. This last result is often empirically ambiguous, although consistent with the dual-sector minimum wage model. I find no evidence that minimum wages reduce extreme or moderate poverty.

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## 1. Introduction

There is an extensive literature in developed countries, particularly the United States, that studies the consequences of minimum wage hikes. Research in the US has found higher minimum wages can lead to job losses, no effect on jobs, or even job growth.<sup>1</sup> In developing countries, minimum wages tend to be set higher (Maloney & Mendez, 2004), are less likely to be rigorously enforced (Kanbur & Ronconi, 2016), and labor markets are often segmented into formal and informal sectors with minimum wage policy only covering formal workers (Fields, 1990). Given these differences and that minimum wage policies are widespread in developing countries, understanding how minimum wages affect labor markets and welfare is critical for economic growth, developing effective labor policy, and poverty alleviation.

This paper evaluates recent minimum wage policy in Honduras. Similar to other developing countries, Honduras sets high minimum wages that are weakly enforced in a segmented labor market. Assessments of minimum wage policy often rely on variation in the structure of minimum wages (Alaniz, Gindling, & Terrell, 2011; Comola & Mello, 2011; Gindling & Terrell, 2009; Khamis, 2013; Lemos, 2009), large increases (Castillo-Freeman & Freeman, 1992; Muravyev & Oshchepkov, 2016), or institutional reforms to wage floor systems (Gindling & Terrell, 2007). Here, I exploit

category-level variation from all three sources to quantify the consequences of minimum wages on compliance, labor market outcomes, and poverty. Estimates are drawn from 13 household surveys assembled into repeated cross-sections. These data cover eight wage floor hikes from 2005 to 2012 and provide information on almost 330,000 individuals in the Honduran labor force (approximately 41,000 per year).

Theoretically, the effectiveness of a country's minimum wage policy depends on whether it is able to redistribute earnings to low-paid workers without generating employment loss. Empirical work in developing countries often disagrees on which of these effects prevails.<sup>2</sup> Evaluating the consequences of higher minimum wages is thus an empirical question. To accurately estimate the impact of minimum wage hikes requires finding a source of exogenous variation in wage floors. Minimum wages are usually updated to account for inflation or aggregate economic conditions. Changing commodity prices cause shifts in labor supply and demand. Thus wage floors, wages, and employment are simultaneously determined, so regressing minimum wages on socioeconomic outcomes suffers from endogeneity bias.

Recent events in Honduras created natural experiments that generate plausibly exogenous minimum wage shocks. Honduras sets multiple minima that have differed across regional, industrial, and firm-size categories. This category-level structure is my main source of variation, which is akin to using state-level differences

<sup>1</sup> See Card (1992), Card and Krueger (1994), Neumark and Wascher (2008) and Dube, Lester, and Reich (2010).

<sup>2</sup> See Lemos (2007) and Neumark and Wascher (2008) for literature surveys.

in the US. From 2005 to 2012, this variation was affected by annual minimum wage reforms, a large increase, and changes in the number of minimum wages. The largest shocks are due to the latter two events. First, President Manuel Zelaya authorized a 60% average increase in real minimum wages aiming to equalize floors across categories in 2009. Second, the number of minimum wages changed from industry firm-size minimum wages (23 categories) to regional floors (2 categories) in 2009, to region and firm-size minima (6 categories) in 2010, and returned permanently to a modified version of industry firm-size minimum wages in 2011 (37 categories). On average, real minimum wages in Honduras increased 10.8% over this period. Differential changes across categories encompass declines of  $-11.1$  to hikes of 204.5% when adjusted for inflation.

While minimum wage increases are the most visible component of this policy, enforcement and compliance are also key elements. Increasing legal minimum wages that are imperfectly enforced often results in non-compliance (Ashenfelter & Smith, 1979; Bhorat, Kanbur, & Stanwix, 2015). About one of every three covered workers earns sub-minimum wages in Honduras (Gindling & Terrell, 2009), with some paid much less than their legally entitled wage (Ham, 2015). I approximate the effect of minimum wage hikes on non-compliance in the covered sector. The resulting evidence indicates that small employers comply much less than large firms, and large firms less than the public sector. Moreover, large covered employers increase their level of non-compliance in response to higher minimum wages by 36%.

Because the Honduran labor market is segmented, I test the predictions of the dual-sector minimum wage model (Boeri, Garibaldi, & Ribeiro, 2011; Harris & Todaro, 1970). In this framework, rising wage floors should lead to employment losses and higher average wages in the covered sector, and vice versa for the uncovered sector. Following the legislation, I define these sectors using occupational categories. Results provide strong and robust evidence in support of this model. A 10% increase in minimum wages lowers the likelihood of covered employment by about 8% and increases the probability of uncovered sector employment just over 5%. The data indicate that individuals substitute wage-earning jobs for self-employment as a direct consequence of minimum wage hikes. Consequently, covered sector wages increase but rising labor supply in the uncovered sector leads to a negative net effect on informal wages.

Therefore, minimum wage increases contribute to the growth of the informal sector, consistent with findings in Comola and Mello (2011) and Muravyev and Oshchepkov (2016). Unlike these and other studies, I find evidence of negative effects on wages in the uncovered sector. The large increases in Honduran minimum wages over this period lead to a greater influx of wage earners into self-employment, which is consistent with theory but tends to be inconclusive empirically. Such findings suggest that Hondurans would rather work in uncovered jobs than remain unemployed.

Since uncovered sector jobs in Honduras tend to be lower-paid part-time positions, average earnings in this sector often lie below covered sector incomes. Hence, there is a potentially adverse effect on individual well-being from a larger informal sector. I test whether minimum wages affect the likelihood of falling below national poverty lines, finding that increases in poverty for the uncovered labor force outweigh potential reductions for the covered labor force. This result indicates that higher wages for the covered workforce are unable to compensate for the resulting income losses in the uncovered sector that occur because of changes in labor force composition.

The remainder of this paper is organized as follows. Section 2 outlines the dual-sector minimum wage model and reviews the empirical evidence. Section 3 describes minimum wage policy in Honduras and my identification strategy. Section 4 presents the

data. Section 5 studies enforcement and compliance with minimum wages and Section 6 estimates the net effects of minimum wage increases on labor market outcomes and poverty. Section 7 concludes.

## 2. Minimum wages in developing countries

### (a) Theory

Minimum wages in developing countries are commonly studied using a competitive dual-sector model that classifies workers as covered (formal) or uncovered (informal) first proposed by Harris and Todaro (1970).<sup>3</sup> The former are entitled to wage floors, while the latter are not. Each sector  $s = \{c, u\}$  has its own labor demand and supply, so that equilibrium wages ( $w_s$ ) and employment ( $E_s$ ) are determined by the intersection of these curves. The key assumption is that wages in the uncovered sector,  $w_u$ , are more flexible than in the covered sector,  $w_c$ . This implies that mobility between sectors is possible, but limited. Individuals can migrate from covered to uncovered jobs freely, but moving from uncovered to covered employment is more difficult because wage rigidity causes segmentation between sectors (Mazumdar, 1989).

Figure 1 details the expected consequences of a binding minimum wage hike. Wages in the covered sector increase but some individuals lose their jobs. Displaced workers may either seek uncovered employment or choose to remain unemployed. If some decide to migrate, uncovered labor supply shifts from  $L_s$  to  $L'_s$ . Since wages in the uncovered sector are flexible, this market clears with higher employment but a lower equilibrium wage. In summary, the covered (uncovered) sector will have employment losses (gains) and higher (lower) average wages.

These are not the only potential consequences of minimum wage increases. Higher minima may also affect intensive margin employment by changing the amount of hours worked. A priori, effects could go either way. Differences in firm technology may lead to a rise or fall in hours (Strobl & Walsh, 2011). Effects on hours worked may also respond to different firing costs (Gindling & Terrell, 2007). If layoffs are costly, we may see a reduction in hours rather than employment, or a decline in both. But if termination costs are low, employers may downsize part-time staff while increasing hours worked by remaining employees.

Minimum wage increases may also have consequences that extend beyond the labor market. Since many workers rely on earnings as their main source of income, changing wage floors could indirectly affect poverty. If the predictions of the dual-sector model are borne out, the risk of income deprivation is expected to increase. This result is driven by covered employment loss and migration toward the lower paid uncovered sector. However, poverty responses will also depend on whether minimum wage workers are in low-income families, the level of wage floors relative to the poverty line, and intra-household factors.<sup>4</sup>

An unspoken assumption in this framework is that covered sector employers comply with minimum wage laws because governments effectively enforce them. However, regulation tends to be lax in most developing countries, which often leads to non-compliance (Ronconi, 2012). Enforcement affects firm-level compliance decisions, which play a key role in determining minimum wage impact. In fact, Basu, Chau, and Kanbur (2010) show that “a simple deviation from perfect to imperfect enforcement is sufficient for theoretical predictions to be overturned”.

<sup>3</sup> Alternative minimum wage models may be found in Card and Krueger (1995), Manning (2003), and Boeri and van Ours (2008).

<sup>4</sup> See Lustig and McLeod (1997), Saget (2001), Neumark and Wascher (2002), Fields and Kanbur (2007), and Gindling and Terrell (2010) for a more in-depth discussion of these factors.

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