



# Labour Market Matters

## Special points of interest:

- While minimum wage policy is found to alleviate wage inequality in a developing country context, it is also associated with movement of workers from formal to informal sectors.
- Increased union density unlikely to be effective in combatting labour market inequality.

***“The study finds that the imposition of a minimum wage strongly affects average wages – promoting an increase of around 20%, as well as alleviating wage inequality. However, labor tax revenues were found to fall by approximately 10% and the share of the formal sector in the Brazilian economy was found to be reduced by around 10%”***



Minimum wage policy found to shift workers from the formal to informal sector, increasing the informal sector by about 46% compared to a scenario without a minimum wage policy. Image: foto76/Freedigitalphotos.net

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## Minimum wage policy found to yield dubious social welfare impacts in a developing country context

While proponents argue that minimum wage laws are essential in improving social welfare and economic well-being, implementation of minimum wage laws can also be associated with increased unemployment and the movement of workers into the informal sector where worker protection and workplace standards are less likely to be observed compared to the formal sector. A paper entitled **“Estimating the Effects of Minimum Wage in a Developing Country: a Density Discontinuity Design Approach”** (CLSRN Working Paper no.142) by CLSRN affiliate Hugo Jales (University of British Columbia), proposes a novel framework to empirically assess the effect of the minimum wage on unemployment, average wages, sector mobility, wage inequality, the size of the informal sector, and on labour tax revenues. The study finds that while minimum wage policy can increase average wages and reduce wage inequality, the policy has the unintended effect of causing labor tax revenues to fall as a result of workers shifting from the formal to informal sectors.

An important factor that motivates Jales' empirical analysis is that microeconomic theory has ambiguous predictions for the effects of the minimum wage. This means that the policy can have substantially different effects depending on the market structure. For example, the standard model of competitive markets predicts that a minimum wage will generate

unemployment when the minimum wage exceeds the market clearing wage. However, if an employer has market power, a minimum wage can lead to a general increase in wages and employment. Also, in an economy with a large informal sector – such as that of Brazil – the implementation of a minimum wage might not generate typically measurable unemployment effects if workers are able to migrate freely between the formal and informal sectors.

Jales' paper documents novel empirical facts about the relationship between formal and informal wage densities, namely the similarities between them when conditioning on values above the minimum wage. The study extensively discusses the conditions under which the policy effects can be identified. It estimates a labour mobility parameter – which approximates the probability that a worker moves from the formal to the informal sector as a response to the implementation of a minimum wage. The study also estimates the impact of a minimum wage on labour tax revenues. Using a recent cross-sectional Brazilian dataset, Jales shows that the size of the informal sector increased by about 46% when compared to a scenario with the absence of a minimum wage. Jales argues that this result is driven by both unemployment effects on the formal sector, and the movement of workers from the formal to the informal sector as an unintended consequence of the implementation



Hugo Jales  
(University of British Columbia)

of a minimum wage policy. The study finds that the imposition of a minimum wage strongly affects average wages – promoting an increase of around 20%, as well as alleviating wage inequality. However, labor tax revenues were found to fall by approximately 10% and the share of the formal sector in the Brazilian economy was found to be reduced by around 10%, again when compared to the scenario in the absence of the policy.

These results shed light on the trade-off faced by policy makers when deciding the minimum wage level. In one hand the policy can alleviate wage inequality and boosts average wages. In the other hand, it comes with a cost of reducing the size of the formal sector and consequently the state's ability to support the social welfare system through the decrease in labor tax revenues.

## Increased union density in Canada unlikely to improve social welfare and inequality

In the past 30 years, union membership has declined in nearly all OECD countries, including Canada. In the United States, the percentage of workers represented by unions has fallen by one half. While proponents of unionization assert that unions have beneficial social welfare impacts, such as providing workers with improved wage rates, fringe benefits and working conditions, other evidence points to the negative effects of unions on corporate profits, investment, and employment growth. More recently, research has examined the potential for spillover effects of unions on the wage outcomes of non-unionized workers. Indeed, examination of spillover effects of union wage outcomes in the United States has been found to account for up to one-third of the growth in American wage inequality in recent decades.

In a paper entitled **“The Effect of Labour Relations Laws on Union Density Rates: Evidence from Canadian Provinces”** (CLSRN Working Paper no. 141), CLSRN affiliates Scott Legree (University of Waterloo), Tammy Schirle (Wilfrid Laurier University) and Mikal Skuterud (University of Waterloo) examine the impact of changes in labour relation laws on union density rates in Canada. They find that while changes to labour relations laws have the potential to greatly increase union density rates, increased unionization through labour relations reform tends to benefit workers who would enjoy relatively high wages even in the absence of unions.

Consequently, the authors argue that reforms in labour relations laws are unlikely to result in significant reductions in wage inequality



Tammy Schirle  
(Wilfrid Laurier University)

To estimate the impact of labour relations laws on union density rates, the researchers patched together survey data drawn between 1981 and 2012, from a variety of sources including the Survey of Labour and Income Dynamics (SLID) and the Labour Force Survey (LFS), and find that changes in labour relations legislation can have substantial impacts on union density rates. The researchers estimate that making legislation fully supportive of unions could raise Canada’s current national union density rate of 30% by up to 7 percentage points in the long run. The estimates suggest that legislative changes banning permanent replacement workers, providing automatic certification based on union card checks, and providing guarantees of interest arbitration to ensure first

contracts are reached are most effective.

The study also found that the benefits of shifting to a more union-friendly legal environment appears to be concentrated among highly-educated professional women employed in public services. At a finer levels of analysis however, the researchers also uncovered evidence of significant unionization gains among relatively uneducated women in private service-producing industries. In contrast, the gains among men are less than half of that for women. Given that public services tend to employ workers with higher average skill levels than private services, and that there is a high concentration of female employment in public services, it is not surprising that the unionization benefit estimates for women exceed that for men.

**“The social welfare implications of these findings are mixed. Evidence of large relative gains among women who already enjoy relatively high wages and benefits and better job security, suggests that labour relations laws are not an effective policy instrument addressing labour market inequality concerns.”**

The researchers suggest that legal reforms, within the scope of the Canadian legal system, are

unlikely affect unionization for many unskilled workers employed in the private services, where the risks inherent in organizing unions, such as the risk of dismissal, are too great. In contrast, in public services where profit incentives tend to be weaker, it is more likely that small changes in the costs of union organizing brought about by legal reforms are sufficient to alter organizing decisions.



Mikal Skuterud  
(University of Waterloo)

The social welfare implications of these findings are mixed. Evidence of large relative gains among women who already enjoy relatively high wages and benefits and better job security, suggests that labour relations laws are not an effective policy instrument addressing labour market inequality concerns. The authors note, however, that the spillover effects of union outcomes on non-union workers may be more important in labour markets where union density rates are lower, particularly in sectors such as unskilled services.

### Endnotes

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