Center for Equitable Growth Continuing Fellowship Proposal

Project Title: The effect of a large increase in the minimum wage on employment, wages, firms' profitability and investment: Evidence from Hungary

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Between 2000 and 2002, nominal minimum wage was doubled in Hungary. Before 2000 the country was considered to have a low minimum wage. In 2002, however, its level relative to the median wage suddenly became one of the highest among OECD countries. To understand how such a large intervention at the bottom of the wage distribution affects equitable growth, I analyze how workers and firms responded to this policy change. To be more specific, first I show that even though the minimum wage increase was large and permanent, there is no evidence for substantial job loss even three years after the reform. In the second part of the project, I explore how firms' profit, investment rate and productivity were affected by the minimum wage increase. Understanding how firms absorb a huge increase in minimum wage without substantial employment loss broadens the perspective on the effect of the minimum wage on the economy and on welfare.

Policy Relevance:

While top incomes surged in the last 30 years, the bottom quintile experienced very limited real wage growth in the U.S. This stagnation happened even though many government policies supporting low-income households, such as EITC, were radically expanded as well in the early 90s. Therefore policies having more direct effects on wages at the bottom, such as the minimum wage, might be needed to achieve a more equitable growth. My preliminary results suggest that increasing the minimum wage in fact can be a very effective tool to increase wages at the bottom without having negative consequences on employment. In addition to that, I have the opportunity to look at the impact of minimum wage on firms' investment so as to understand how minimum wage policies affect growth.

Methodological contributions to the literature on the minimum wage:

1. Firms and workers might react differently to small changes in the minimum wage than to a large one. However, evidence on a large and permanent increase in minimum wage is scant.
2. The short term and long-term effects of increasing the minimum wage can be very different. Using a grouping estimator proposed by Blundell at. al.

(1998)[1] I estimate the effect of the minimum wage on employment on 3-5 years horizon.

3. My datasets have several advantages compared to the ones used previously in the literature. First, I am using an annual wage survey of employees in which I have a large sample of workers with precise information on hourly wages. Second, data on firms' balance sheets can be merged to the dataset. This allows me to look at the effect of the minimum wage on firms' profitability, sales, investment rate and productivity as well. Taking into consideration all of these margins is unique in the literature and will allow me to look at the welfare effects on owners and workers separately.

[1] Richard Blundell, AlanDuncan, and Costas Meghir, “Labor Supply Responses Using Tax Reforms.” *Econometrica*, Vol. 66, No. 4. (Jul., 1998)