CENTRO DE ECONOMÍA APLICADA

Abstract

We study the effect of a binding minimum wage on labor market outcomes, the accumulation of capital and welfare. We consider a large firm that invests in physical capital and hires several types of workers. Labor markets are characterized by search and matching frictions, while incomplete wage contracts allow workers to expropriate part of the return on each factor. Absent a minimum wage, the model generates levels of capital and employment that are inefficiently too low or too high. We show that the introduction of a binding minimum wage has ambiguous effects on employment, capital and welfare, and depends on the ability of the minimum wage to deter rent appropriation by workers.

Our model is able to generate situations where i) a minimum wage increases the level of employment through an increase in labor demand, or has a small impact on employment, at the same time as ii) it increases the aggregate stock of capital. The first outcome is in line with the empirical literature and holds even in partial equilibrium. The second result offers an explanation for the higher capital-to-output ratios observed in Continental Europe as compared to the US.