

Does increasing the minimum wage reduce poverty in developing countries?

IZA World of Labor

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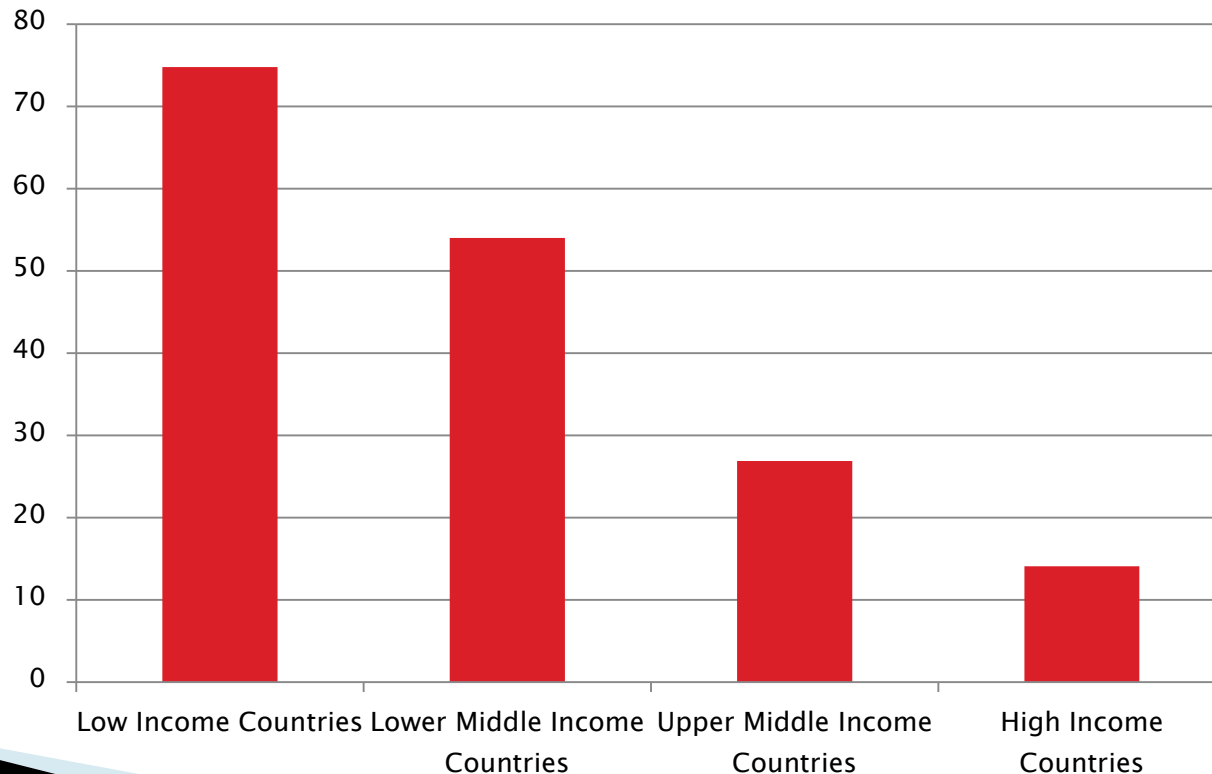
Does increasing the minimum wage reduce poverty in developing countries?

- ▶ It depends on the characteristics of the labor market and households
- ▶ Raising the minimum wage in developing countries could increase or decrease poverty, depending on
 - whether formal sector workers lose jobs
 - how widely minimum wages are enforced
 - how minimum wages affect informal workers
 - whether low-wage workers live in poor households
 - whether social safety nets are in place

Minimum wages may not raise the wages of the lowest paid workers

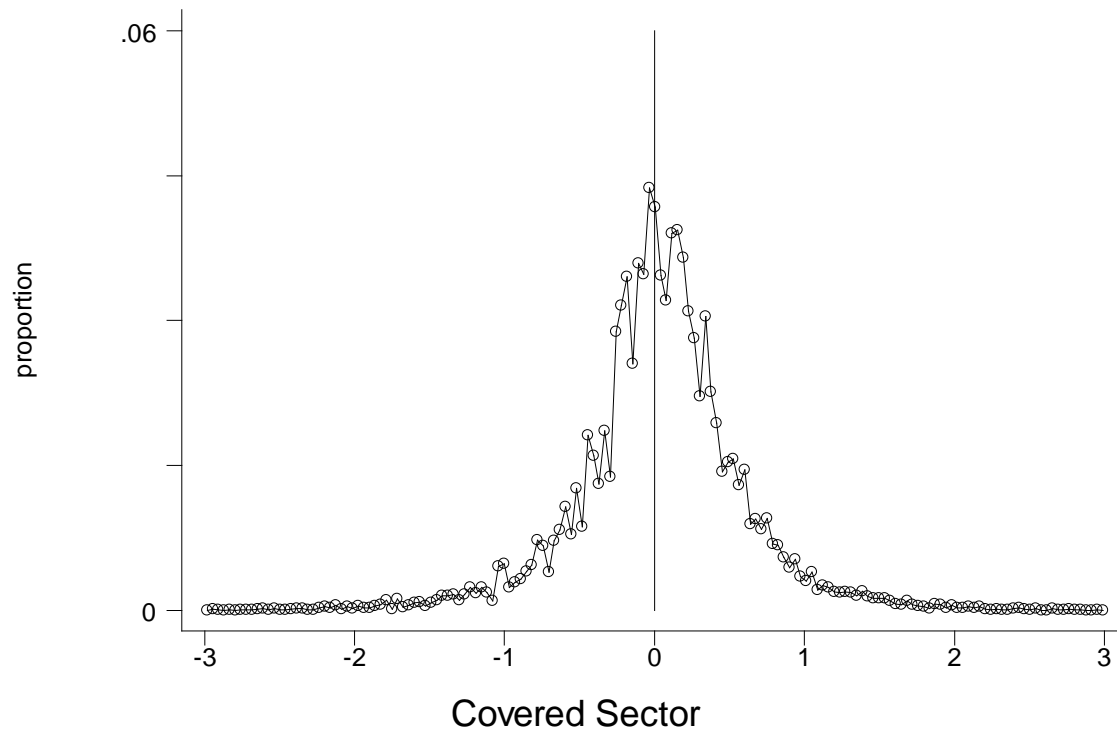
- ▶ More than half of workers in developing countries are not covered by minimum wage legislation

Percent of self-employed and unpaid employees



Even in the formal sector, many workers are paid less than the minimum

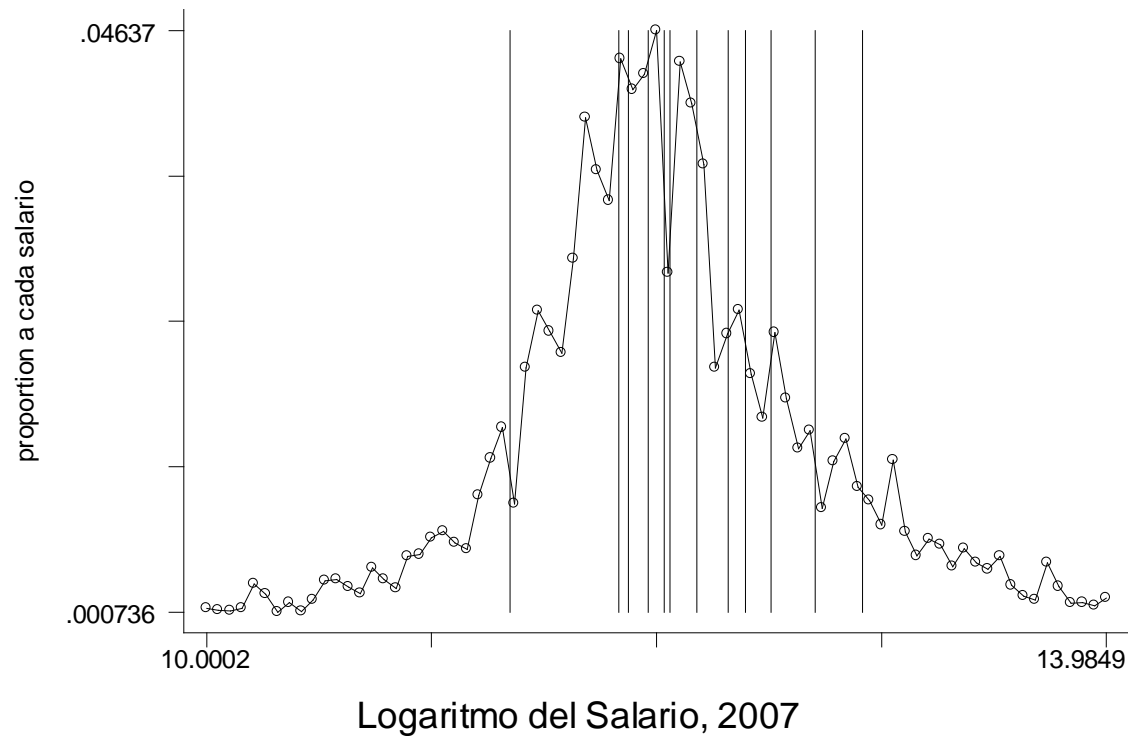
Distribution of $\log(\text{Salary}) - \log(\text{MW})$ in the formal sector,
Costa Rica 2007



Source: T. H. Gindling and J. D. Trejos, 2010, "Improving Compliance with Legal Minimum Wages in Costa Rica," ICE, University of Costa Rica

Minimum wage impacts can vary across the distribution of wages

Minimum Wages Across the Distribution of Salaries,
Costa Rica 2007



Source: T. H. Gindling and J. D. Trejos, 2010, "Improving Compliance with Legal Minimum Wages in Costa Rica," IICE, University of Costa Rica

Higher minimum wages can lead to job losses in the formal sector

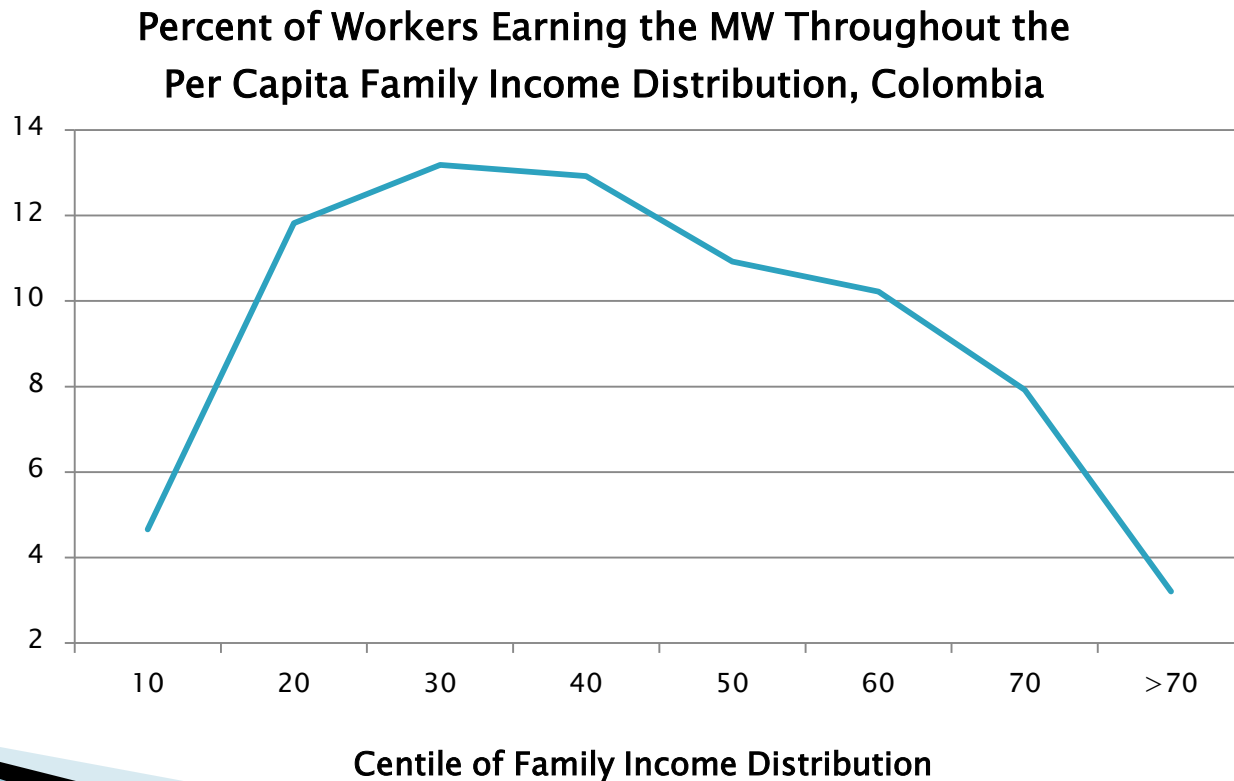
- ▶ Almost all studies find that a 1% increase in minimum wages reduces formal sector employment by less than 1%
 - As a group, workers affected by MW gain
 - But some workers lose and are pushed into unemployment or lower-paid informal employment
 - Workers who lose are more likely to be the least skilled
- ▶ Higher minimum wages likely decrease formal employment and increase informal employment
 - But may not lead to a fall in total employment in the economy

Impact of higher minimum wages in the informal sector matters

- ▶ Informal sector can cushion the impact on poverty of formal sector job losses by providing employment
 - Even low wages are better than no wages
- ▶ Informal wages may rise or fall with higher minimum wages
 - It is likely that formal sector employment increases the supply of labor to the informal sector
 - driving down informal sector wages
 - Some studies in Latin America have found a “lighthouse effect,” where higher minimum wages appear to lead to higher informal sector wages

Do workers affected by the minimum wage live in poor households?

- ▶ In Colombia, minimum wage workers live in middle income households
 - In Brazil and Mexico studies suggest the opposite



Impacts may differ between household members

- ▶ Household heads are most important
 - If wages for household heads rise without big decreases in formal employment, poverty will fall
 - Studies from Brazil, Colombia, Honduras and Nicaragua suggest that this was the case
 - This will be true even if there is a large negative employment effect among secondary family workers
 - If minimum wages only affect secondary family workers (and not household heads) then increases in minimum wages have little impact on poverty.

Higher minimum wages and social safety nets

- ▶ Social safety nets support the families of low-wage workers who lose because of higher minimum wages.
- ▶ Some social safety net program benefits are tied to the minimum wage
 - In Brazil, non-contributory pensions, which are a large portion of the income of many poor households, are tied to the minimum wage
 - The impact of increasing minimum wages on pensions in Brazil accounted for over 30% of the unprecedented fall in inequality from 1994 to 2004.

Does increasing the minimum wage reduce poverty in developing countries?

- ▶ Raising minimum wages may help to reduce poverty in developing countries, but the impact is limited because
 - A large share of workers is not covered by MW
 - Some low-income households lose with higher minimum wages
- ▶ Complementary (and maybe better) policies
 - Increase compliance with legal minimum wage
 - Likely to increase both wages and formality
 - Labor supply incentives such as earned income tax credit
 - Increasing long term productivity of workers in poor families
 - For example, Conditional Cash Transfers (CCT) have been shown to be effective
 - Social safety nets that protect those who lose when MW rise