

Minimum wage – does it cut poverty?

Setting a minimum wage looks like a good way of raising living standards. But some critics argue that it actually creates more poverty. What is the truth of the matter?

Catherine Saget

Conditions of Work and
Employment Programme (TRAVAIL)
ILO

Can a minimum wage policy reduce poverty? At first sight, the answer is clearly “yes” – the protection of workers and their families represents the main objective of the minimum wage policy. As the Minimum Wage Fixing Recommendation (No. 135) puts it: “Minimum wage fixing should constitute one element in a policy designed to overcome poverty and to ensure the satisfaction of the needs of all workers and their families” (Article 1).

Yet the role of minimum wage fixing in reducing poverty in developing countries has been questioned. Sharp criticisms and warnings have emerged within the framework of the Poverty Reduction Strategy Papers (PRSP), which coordinate all development policy. It has been argued that government spending should be focused on poor people, including workers in the informal economy, and that in the context of developing countries, a minimum wage does not protect the poorest workers in the informal economy, but covers only the formal and better-off workers.

Some critics go so far as to say that the minimum wage could in certain cases *create poverty*. They argue that, because it increases the cost of production, the minimum wage forces employers in the formal economy who comply with the regulation to reduce the number of workers employed. As a result of the increase in the minimum wage, it is claimed, formal workers lose their jobs, and end up looking for an informal job with lower pay.

Are minimum wage levels below or above poverty line?

Before entering further into this debate, let us recall a few facts. First of all, a very striking feature of the minimum wage in developing countries is that figures close to the level of extreme poverty (US\$1 a day or US\$30 a month) are not uncommon. As a matter of fact, the minimum wage represents \$34 in Benin, \$34 in suburban areas in the Chinese province of Guangdong and \$28 in Ghana (Table 1).

These figures may be said to be based on the simple conversion of the minimum wage in local currency into dollars using the official exchange rate. Thus these dollar figures, although perhaps useful for external investors, tell us little if anything about the amount of goods and services minimum wage earners can afford. The World Bank provides what is known as the Purchasing Power Parity factor which transforms local currency into dollars of the same purchasing power (see Table 1). For example, the value of \$1 in Benin is comparable to \$2.76 dollars in the United States.

If the differences in the price of consumer goods are taken into account, the picture changes. For example, a worker paid the minimum wage in Benin (\$34 a month) lives as well (or as badly) as someone with \$94 in the United States. Nonetheless, this figure involves a very low level of consumption which seems unable, at

Table 1. Level and purchasing power of the minimum wage in selected countries

Country	Minimum wage(s) in \$ per month	Purchasing power ^a in \$ per month
Benin (2000)	34	94
China (Guangdong) (2003)	34-61.8 ^b	140-255
Ghana (2003)	28	204
Niger (2002)	40	145
Senegal (2002)	76	209
Togo (2002)	20-33 ^b	106-166
Bangladesh (1994) EPZ	12 ^c	?
Philippines (2002)	39-102 ^b	214-556
Cambodia (2003)	30-45 ^b	162-243

Notes: ^a To buy the same basket of goods and services, you would need the minimum wage in Benin (\$34 using the official exchange rate) and you would need \$94 in the United States. ^b China (Guangdong): suburban and urban rates. Togo: unskilled and professional workers. Philippines: AMRM region and capital region. Cambodia: apprentices and regular workers. ^c Bangladesh: workers in EPZs (export processing zones) are paid in dollars. As the rate of exchange between the Bangladeshi taka and the US dollar is not available, information on the living standards of workers paid in dollars is lacking.

Sources: ILO database on minimum wages (forthcoming), on minimum wage. World Bank on Purchasing Power Parity Conversion Factor.

first sight, to lift a family out of poverty, even if we use the conventional threshold of extreme poverty: \$30 a month.

Therefore, one conclusion that may be drawn is that in some cases, the minimum wage seems too low to protect workers from poverty. Furthermore, we would expect that people who are not employed (the disabled, the elderly, sick people, the unemployed) are more affected by extreme poverty, because they do not receive any income from work. On the other hand, we might expect that workers, in particular minimum wage earners with a full-time job, are less likely to be living in extreme poverty. Hence, the second conclusion may be that the minimum wage cannot have a direct impact on people outside waged employment, but only on workers and their families.

In some other cases, such as the Philippines, the earnings of minimum wage workers are estimated to range between \$214 and \$556, a wage that is clearly above the *extreme* poverty line.

There is evidence that the minimum wage can play an important role in reducing poverty

Implementing the PRSP: cases where the minimum wage policy is directly beneficial to the poor. Trade unionists in some countries have advocated a minimum wage policy and have managed to get it integrated into the PRSP process. In a few cases, it was argued that a minimum wage directly contributed to the reduction of poverty. In Cambodia, for example, where the textile sector is the only industry with a minimum wage, remittances sent by women workers to the countryside were shown to benefit the poor. More generally, wage levels and other aspects of working conditions might have a determining influence on the reduction of poverty. For instance, it is widely believed that economic development is promoted by better health and education, especially better access to health and education in remote areas. However, both nurses and teachers are reluctant to go to remote areas. This leads to a high turnover rate and a low quality of

service. Higher levels of pay could provide an incentive to move to remote areas and deliver basic services of high quality.

Cases where the minimum wage has an indirect effect on poverty. For some middle income countries in Latin America such as Argentina, Brazil, Mexico and Uruguay, the minimum wage was relatively low in the 1990s and represented between 20 and 25 per cent of the average wage. In these countries, almost all workers in the formal economy receive wages higher than the minimum wage, while many workers in the informal economy were receiving *exactly* the minimum wage and many had their wages increased each time the minimum wage was adjusted. That the minimum wage could have an impact on informal wages means that considerations of what is a “fair wage” are not absent from the determination of wages in the informal economy: the determination of informal wages goes beyond the traditional notions of supply and demand. It also means that increases in the minimum wage could have a positive impact on the extent and the level of poverty in the informal economy, provided it remains at a fairly low level.

Cross-country comparison. Other studies based on cross-country comparison indicate that a higher minimum wage is associated with a lower level of poverty. However, this result should be interpreted with caution: “This result *per se* does not imply that setting a higher minimum wage would reduce poverty; it is merely the sign of a correlation between the two variables. For instance, the correlation could indicate that countries with a high minimum wage are also more committed to the reduction of poverty and have developed social policies targeting the poor” (Saget, 2001). Therefore, a virtuous circle exists between the minimum wage and other tools used to combat poverty.

To fight poverty, the minimum wage should be used with caution

At least three conditions have to be met in order for the minimum wage to have a positive effect on the standards of living of workers and their families:

- Most workers are entitled to receive at least the minimum wage in exchange for their work. No workers or very few workers lose their jobs because of the minimum wage. Or in a case where job losses are entailed, workers can find another job: the economy is growing and some sectors are creating jobs.
- Employers comply with the minimum wage. Compliance with the regulations implies both that employers are organized and have been consulted during the minimum wage fixing process and that there is a well-functioning mechanism to enforce the regulation, such as a labour inspectorate.
- There is no increase in prices following the rise in the minimum wage.

The problem in setting the minimum wage is that it can reduce poverty only if it is high, and if it is high, it is unlikely that any of these three conditions will be met. To summarize: “On the one hand, a high level of minimum wage is an effective way of protecting low-paid workers from poverty but it might cover few such workers because of job losses, or non-compliance following the introduction of the high minimum wage. On the other hand, a low minimum wage might cover more workers but offer a weak protection against poverty” (Saget, 2002).

If the minimum wage is set at a level which is too high with respect to the capacity of firms to pay wages, then enterprises will fire workers or cease complying with the regulations. Workers who have lost their jobs become vulnerable to poverty in the absence of employment opportunities. It is thus all the more important to recall that some studies have concluded that the minimum wage has no strong negative impact on the level of employment, providing that a few principles are respected

(increases are in line with economic conditions, social partners are consulted). Other studies have shown that even if there is no loss of employment following the rise in the minimum wage, the employment of sub-groups of workers such as very low-skilled, low-productivity workers might be at risk. This is because the employment level of some groups of workers might *increase* following the rise in the minimum wage (in particular, the employment of previously inactive women) while the employment of other sub-groups might decrease. Finally, some firms might be at risk too: small firms might encounter great difficulties adjusting to the new rate, while big firms may not.

From the above discussion, we can conclude that there is probably very little relation, if any, between the minimum wage and extreme poverty: the minimum wage might have an impact on the poor, but not on the very poor.

Hence it is not enough to use the minimum wage policy as the main tool for poverty reduction in developing countries. There are reasons why wages and incomes from work in general are low in these countries. Wages are low because productivity, which is the value of goods produced by one worker in one hour, is low. Productivity is low because health and education are low. Wages are also low because markets cannot develop: shortcomings include poor infrastructure and capital, lack of access to markets and lack of credit and inputs. For these reasons, investing in health and education and developing infrastructure appear as the priorities set in most PRSPs, and this will hopefully lead to better standards of living.

A more efficient minimum wage policy so as to reduce poverty

The minimum wage policy is mainly characterized by six features: the objectives which are being pursued, the fixing method (who decides on the minimum wage policy and whether social partners and other bodies are consulted), the coverage of the minimum wage (who is entitled

to receive at least the minimum wage as pay), the criteria used to introduce/adjust the value of the minimum wage, the level of the minimum wage and the mechanisms in place to ensure compliance.

If the objective of minimum wage fixing is to reduce poverty, how should the policy be designed? It should minimize negative effects on prices and employment and benefit low-paid workers.

The fixing method should involve consultation of employers, trade unions and representatives from the informal economy. Involving the informal economy in the determination of the minimum wage might also address the non-income aspect of poverty, which is the lack of a say and of representation.

Coverage and level of the minimum wage

The influence of the minimum wage on informal wages in some cases, as discussed above, suggests it would be possible to imagine a kind of reference wage for the informal economy. This reference wage would be determined in accordance with the general level of informal wages, i.e. no worker should receive less than 50 per cent of the median informal wage (the median is the wage level higher than that of 50 per cent of workers and lower than that of the other 50 per cent).

Criteria

The level of wages in the informal economy should represent an important criterion, upon which increases in the minimum wage depend.

Compliance with the level of the minimum wage can only be weakly enforced in the informal economy, but it might be possible to design a campaign to promote a minimum wage level relevant to that part of the economy.

Some impact on poverty – but it varies

Three main conclusions may be drawn:

Firstly, the minimum wage might have an impact on informal wages in some middle-income developing countries with low levels of minimum wages. The minimum wage could thus have an impact on the living standards of poor people, to the extent that they are concentrated in the informal economy. In these countries, the minimum wage really acts as a floor for unskilled workers.

Yet unions are often reluctant to promote such a strategy and accept low levels of minimum wages which are almost irrelevant for the formal economy. In fact, many unions favour a situation where the minimum wage covers a sizeable percentage of formal workers: in this case, the minimum wage is too high to exert any influence on the earnings of the poorest workers. There is a simple explanation for the unions' position. In general, collective bargaining is weak in developing countries, so that formal wages are strongly determined by the minimum wage rather than by collective bargaining. In other words, the minimum wage fixing machinery is a substitute for collective bargaining and fails to achieve its objective of protecting the weakest workers. Unions fear that, in the absence of a minimum wage which is "high enough", formal wages would be left without protection. But if the min-

imum wage is "high enough", the impact on poverty might be minimal.

Hence, the strengthening of collective bargaining around wage issues is a prerequisite for the minimum wage to play a stronger role in the fight against poverty.

Secondly, on a small number of occasions, it appears that the minimum wage has contributed to poverty reduction in poorer countries too, depending on the type of workers who receive it.

Thirdly, there is hardly any evidence to show that the minimum wage can be a general and valuable tool in fighting extreme poverty, but it could have an impact on non-extreme poverty.

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