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World of Labor
Evidence-based policy making

OPINION PIECE: An increase of the minimum wage needs to be accompanied by complementary policies to be an effective tool for poverty reduction

A number of developing countries, among them Malaysia, Zambia and Cambodia, have recently raised or announced a revised minimum wage rate. A new opinion piece now published on IZA World of Labor in time for the UN International Day for the Eradication of Poverty on October 17 argues that increasing the minimum wage alone will only have a modest impact on poverty. In order to be an effective tool in reducing poverty raising the minimum wage needs to be part of a comprehensive poverty reduction package.

Does increasing the minimum wage reduce poverty in developing countries?

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Increasing the minimum wage can be part of a comprehensive poverty-reduction package in developing countries but should not be the only, or even the main, tool to reduce poverty. Minimum wages have a modest impact on poverty in developing countries for several reasons. First, in most developing countries the minimum wage effectively applies to only a minority of poor workers. It does not cover self-employed workers nor employees in the large informal sector where most of the poor work, and where it is common for workers to earn below the legal minimum wage. More than 75% of workers are self-employed in countries classified by the World Bank as low-income. Even in the formal sector compliance and enforcement of minimum wages is imperfect. For example, more than 20% of formal sector employees in Costa Rica, Nicaragua, and El Salvador earn less than the legal minimum wage.

Because legal minimum wages are enforced only in the relatively high-wage formal sector, the benefits of higher minimum wages often do not reach poor households. In Colombia, for example, workers earning the minimum wage were most likely to be in households in the middle of the income distribution, and few of the poorest households benefit from higher minimum wages.

Further, when legal minimum wages are enforced, raising the minimum wage creates losers as well as winners among poor households, pulling some out of poverty while pushing others in. An increase in the minimum wage may cause some formal sector employers to lay off current workers or not hire new workers. If enough of these workers live in low-income households, poverty may even increase, at least in the short term.

Given the limited proportion of poor workers affected by legal minimum wages in most developing economies and the potential for negative impacts on the employment status and incomes of some of the poorest families, raising minimum wages by itself is an insufficient and inefficient tool for reducing poverty. Complementary policies that have been shown to be effective include those designed to enhance compliance with minimum wage laws, improve incomes in the informal sector where minimum wages do not apply, and increase the long-term productivity of workers from low-income families.

Labor supply incentives, particularly the earned income tax credit, have been shown to be effective in increasing the employment and earnings of low-income workers in the US. Conditional cash transfers have been shown to be effective at both reducing short-term poverty and improving education and health, and therefore the long-term productivity, of children and workers from low-income families. For example, Brazil's conditional cash transfer program, Bolsa Familia, was more effective than higher minimum wages at reducing poverty and income inequality using the same amount of government funds. Conditional cash transfers to low-income households have the additional benefit of providing a short-term social safety net for households when workers lose their jobs because of higher minimum wages.

Read T. H. Gindling's article Does increasing the minimum wage reduce poverty in developing countries? You can find more research on economic inequality on our key topic site.

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Notes for editors:

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