

One-pager on Globalization, Growth and Poverty *research*



Do minimum wages reduce poverty?

Evidence from Central America

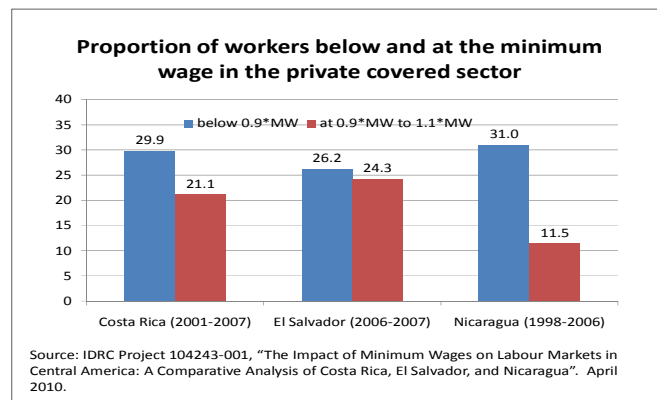
TOWARD INCLUSIVE GROWTH

Minimum wages are designed to reduce poverty and inequality. This key labour market policy intervention represents a common social protection policy in many Latin American countries. Raising minimum wages has traditionally been considered a way to protect poor workers and their families and boost their chances of climbing out of poverty. However, the effect of raising minimum wages remains an empirical question in the literature. Little country-specific evidence has been provided to show how effective these policies are. Heated debates arise when the time comes for setting a new minimum wage.

THE EVIDENCE

The IDRC-supported project *The Impact of Minimum Wages on Labour Markets in Central America*¹ examines the impact of minimum wage legislation on the welfare of workers and their families in three Central American countries. To do so, the project produced new multi-year panel data sets for households and individuals in Costa Rica, El Salvador and Nicaragua, and used state-of-the-art econometric methodologies to assess the impact of minimum wage changes on wages, employment, the movement of workers into and out of the formal and informal sectors and the labour force, and transitions into or out of poverty.

In Central America, legal minimum wages are set for multiple categories: 19 different skill levels and occupations in Costa Rica, 14 industries in Nicaragua, and 4 industries in El Salvador. In all three countries, these multiple minimum wages are negotiated among representatives of the central government, labour unions and the chambers of commerce. Minimum wage legislation applies to all private-sector employees, but in all three countries a large part of the work force is self-employed or works as unpaid family workers and is therefore not covered by the legal minimum. Self-employed and unpaid family workers account for 20% of workers in Costa Rica, 41.4% in El Salvador and more than 50% of workers in Nicaragua. Unsurprisingly, enforcement of legal minimum wages in Central America is limited because of the complex structure, limited capacity of enforcement institutions, and the existence of large sectors of workers not legally covered by minimum wage laws. However, even in the private formal sector a large percent of workers earn below the minimum wage (see graph).



The results show that increases in minimum wages have a positive effect on the wages of a subset of workers, mostly full-time workers in large firms. However, the results also show that increases in minimum wages are not likely to result in wage increases for workers in small firms or temporary workers in large firms, as well as jobs that are more typical of the informal sector and tend to pay low wages. That is, legal minimum wages in Costa Rica, El Salvador and Nicaragua are not likely to improve the wages of the lowest-paid workers.

The research also found that higher minimum wages have negative employment effects in the private formal sector. Changes in minimum wages deter firms in the private formal sector from hiring new workers and trigger layoffs from jobs that usually offer other benefits such as social security coverage. The estimates suggest that a 10% increase in the real minimum wage leads employment in the formal sector to fall by approximately 1% in Costa Rica, 3% in Nicaragua and 10% in El Salvador.

KEY CHOICES

Evidence suggests that minimum wages are not an efficient way to reduce poverty in Central American countries. Rather than creating and implementing complex minimum wage legislation, which may provide quick political gains, the discussion should turn to policies for enhancing compliance with minimum wages, improving incomes in the informal sector where minimum wages do not apply, and policies that aim at increasing long-term productivity of workers.

¹ Findings from IDRC Project #104243, "The Impact of Minimum Wages on Labour Markets in Central America: A Comparative Analysis of Costa Rica, El Salvador, and Nicaragua". See project profile at http://www.idrc.ca/en/ev-120227-201-1-DO_TOPIC.html.