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Minimum Wages and Poverty in a Developing Country: Simulations from Indonesia's Household Survey

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Summary. — This study focuses on minimum wages, income distribution, and poverty, taking Indonesia as a case study. A simulation approach assesses who benefits and who pays for minimum wage increases. Among the poor, a minimum wages increase boosts net incomes for 21% of the households, while it results in net losses to 79% of the households. The impact is slightly less severe when there are job losses. Although minimum wage increases are mildly progressive (the non-poor pay a higher share of the costs), they are unlikely to be an effective antipoverty instrument in developing countries like Indonesia.

Key words — Asia, Indonesia, minimum wages, poverty, income distribution

1. INTRODUCTION

In recent years, there has been a renewed interest in policies which seek to cushion workers from the harmful effects of globalization (Elliot & Freeman, 2003; Greenaway & Nelson, 2001). This has given new impetus to an old debate on minimum wage policy and its implications for employment and labor welfare in both developed and developing countries. On the one hand, it is argued that minimum wages may not threaten employment and can reduce poverty by boosting the incomes of low-wage workers (Card & Krueger, 1995). On the other hand, opponents of minimum wage legislation argue that minimum wage policy has had a limited impact on poverty, mainly because most poor families do not have minimum wage workers (Burkhauser, Couch, & Wittenburg, 2000).

The debate raises the broader question of whether minimum wage policy is an effective anti-poverty instrument, in an international policy environment where poverty reduction

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strategies are at the center of many government programs. To answer this question, we need to examine how the increased minimum wages impact on household incomes and cost of living of workers and their families, in addition to their direct effect on employment.

A second, related issue involves the distributional impact of minimum wages. In this case, the key question is the benefits from a minimum wage hike accruing to the poor relative to other income classes. A minimum wage policy is "pro-poor" (and hence a well-"targeted" policy) if poor households gain disproportionately compared with other income groups (Dollar & Kraay, 2000).

This paper addresses these issues. It seeks to examine the impact of a minimum wage hike on incomes and the cost of living of poor households, in the context of their broader distributional effects in a developing country. While this subject has been the focus of simulation experiments in the studies of developed economies, we are not aware of similar studies in developing countries like Indonesia. In developing countries, the attention of minimum wage studies has tended to be on urban labor markets in the context of high rates of urban–rural migration and urban unemployment. Our focus is more on the formal–informal sector divide. It can be expected that the results will differ significantly in developing compared with developed countries because a high proportion of workers in the former tend to be employed in the "uncovered" and informal sector. The households that depend on the informal sector may receive no direct benefits but experience the direct costs from labor regulations targeted at regular wage workers.

The focus of the study is Indonesia, where poverty reduction strategy programs (PRSP) have become an important element in most government programs since the economic crisis of 1998 (Bird & Manning, 2003). An active minimum wage policy has been adopted partly as a tool to reduce poverty, through a focus on the level of wages relative to the minimum needs of wage earning families (Manning, 2003). Like in other countries, attention has tended to be on the effects on employment rather than on the income distribution and poverty. [1]

The aims of the paper are threefold. First, it provides estimates of the impact of a moderate increase in minimum wages on the poor. Second, rather than focusing on the outcomes alone, it aims to demonstrate the channels through which minimum wage increases might affect real labor incomes and poverty. And finally it attempts to throw light on the distribution of net income effects, both among the poor and between the poor and better-off households. From a political economy standpoint, potential beneficiaries can be expected to be more organized wage earners, whereas the losers are likely to consist of a much larger group of more dispersed informal sector workers and consumers. Such a finding would provide a compelling explanation for adoption of a minimum wage policy even though it may hurt the poor.

Given the difficulties in modeling the longer term, general equilibrium effects, the paper concentrates on the shorter term impact on incomes. First it is assumed that employment remains unchanged, and the effects of minimum wages are principally passed on to consumers in the form of higher prices. Later, we relax the no-job-loss assumption in separate simulations to examine the distributional implications of employment losses.

Flagging some of the main results, we find that the increase in minimum wages helps some poor households escape out of poverty, whereas other previously non-poor households become poor. Since the majority of poor households do not have a minimum wage worker, they are penalized through higher prices, as a result of the increase in wage costs. In short, our findings suggest that an aggressive minimum wage policy like that adopted in Indonesia is likely to be a blunt instrument for poverty reduction.

The paper is organized as follows. Sections 2 and 3 briefly outline the framework for analysis and provide a background to the Indonesian labor market and minimum wage policy. Section 4 sketches out the empirical methodology while Section 5 presents the simulation results for the actual increases in minimum wages in Indonesia in 2003. The results are presented in three parts: the benefits, costs and net benefits to different income groups, and implications for poverty. Section 6 repeats the simulations taking into account the employment losses and productivity adjustments. Section 7 offers some conclusions and draws attention to some qualifications.

2. FRAMEWORK OF ANALYSIS

Some economists view minimum wage policy as mainly an income distributional issue whereby some persons gain and others lose from a