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Minimum Wages, Globalization, and Poverty in Honduras

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Summary. — We test whether minimum wage legislation is an effective poverty reduction tool in a poor country trying to stay competitive in the global economy. In Honduras, increases in relatively high minimum wages lead to reductions in poverty, especially extreme poverty. However, the impact is felt only in households with workers in large firms and felt more strongly among those with low wage workers. Increases in the minimum do not affect poverty in sectors where minimum wages are not enforced or do not apply. Hence minimum wages can be a poverty reduction tool in the formal sector, which competes globally.

Key words — minimum wages, poverty, Central America, Honduras

1. INTRODUCTION

This paper examines the role of minimum wage legislation in reducing poverty in Honduras. The justification for minimum wage legislation is to protect low wage workers and, if effective, this policy tool could be especially important in developing countries during periods of rapid adjustment to the global economy. However, in an era when global competition is very strong, numerous economists and policymakers are arguing for reductions in (and even the abolition of) minimum wages and other labor market regulation in Latin America to allow for more labor market flexibility and increased competitiveness (see, e.g., Heckman & Pagés, 2003). The main argument of the proponents of this view is that rigidities in the labor market, such as wage rigidity caused by the minimum wage, can slow down job creation and in turn contribute to unemployment and poverty (see, e.g., Micco, Pagés, & Cowan, 2004).

An opposing view is that fierce competition in the globalized world is creating an environment that some have termed "the race to the bottom." The proponents of this view are concerned that wages and working conditions are being driven down by global competition and argue that there is a need to uphold the bottom with regulations such as the minimum wage and labor standards. Acemoglu's (2001) theoretical model, which shows that minimum wages can shift the composition of employment toward high wage jobs, supports this latter view. Hence, increases in minimum wages could contribute to the reduction of poverty by increasing the incomes of those affected by the legislation and perhaps even increasing the share of higher wage jobs in the economy. [1]

Our paper contributes to this academic debate on the value of minimum wages by providing evidence on the effects of minimum wage increases on poverty in a relatively poor country which was open to the global economy and negotiating a new trade agreement during the period of analysis (2001–04). [2] Our findings also shed light on the specific policy debate in Honduras that arose during the negotiations of the Central American Free Trade Agreement (CAFTA) at the beginning of the decade. Although the Hondurans agreed to increase enforcement of minimum wages and labor standards in CAFTA, they were concerned about the extent to which enforcing these policies would reduce Honduras' competitiveness. Our evidence on the impact of minimum wages on poverty before enforcement was strengthened provides a baseline from which the Honduran government and business sector can test for the impact of higher enforcement.

Tests for the impact of minimum wages on household income must take into account the fact that only part of the workforce is directly affected by minimum wage legislation. There is a large group of workers for whom minimum wages do not apply directly, but whose wages and employment can be affected indirectly either through the mobility of workers across sectors in response to changes in the minimum wage or through institutions, such as unions, that try to emulate the minimum wage increase in their sector's wages. We combine microdata from the household surveys with data on minimum wages to determine whether increases in the minimum wage affect the probability that a typical individual, as well

✠ Katherine Terrell died unexpectedly on December 29th, 2009. Her contributions to the understanding of economic development have been extensive and will be missed.

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as individuals from households with different types of workers in the covered and uncovered sectors, are more or less likely to be poor.

We find that minimum wage increases do reduce poverty: a 10% increase in the minimum wage will reduce the probability that an average individual in the population is in extreme poverty by 2.2 percentage points (i.e., from 47.7% to 45.5%) and in poverty by 0.9 percentage points. These results are driven entirely by the effect on workers in large private sector firms where a 10% increase in the minimum wage reduces extreme poverty and poverty by 2.5 and 1.1 percentage points, respectively. On the other hand, minimum wage legislation has no significant effect on the poverty of those who work in small private sector firms, the self-employed or wage earners in the public sector. We stress that these findings are net effects and do not account for the many channels through which this outcome is driven, which we discuss briefly in the next section.

2. THEORETICAL CONSIDERATIONS AND EMPIRICAL LITERATURE

The minimum wage as a poverty reducing tool is problematical for a number of reasons. To begin with, it is difficult to predict the direct effect of the minimum wage on the wages and employment of workers to whom the law applies (the covered sector). As Freeman (1996, p. 639) notes "The goal of the minimum wage is not, of course, to reduce employment, but to redistribute earnings to low paid workers." Yet, most of the literature using data from the United States and around the world has found negative employment effects. [3] There are a few studies using data from the Unites States (Card & Krueger, 1994, 1995) and the United Kingdom (Machin & Manning, 1994) that have found no or positive employment effects. If minimum wages raise wages and have no disemployment effects (as predicted by models based on imperfect information or monopsony), then minimum wage increases will certainly raise the earnings of low wage workers. However, if the labor market is competitive and the elasticity of demand for labor in the covered sector is high (greater than 1), minimum wages will reduce the share of total earnings to low paid workers by displacing a larger number from employment than the number whose wages are raised by the minimum wage. [4] Whether or not the displaced workers' earnings fall below the *per capita* poverty level is of course a function of a host of variables, including the existence and generosity of the social safety net, the flexibility of the labor market, the demand for the workers' skills, etc. In addition to disemployment and wage effects, there are of course other ways that workers covered by minimum wage legislation can gain or lose from increases in the minimum wage, including adjustments in hours worked and reduction in non-wage benefits which could also affect whether a worker moves into or out of poverty. [5] Finally, if there are spillover effects, such that workers above the minimum also gain from minimum wage increases, then there can be larger positive income effects on low wage workers. [6]

A second set of issues to consider is the indirect effect of minimum wage increases on workers in sectors not covered by minimum wage legislation or in sectors where there is no compliance with minimum wage legislation (the uncovered sector). Minimum wages can indirectly contribute to poverty creation in this sector if workers who lose their job in the covered sector greatly increase their labor supply to the uncovered sector, lowering wages below the *per capita* poverty line. In this two-sector competitive model of the labor market, the final effect on the uncovered sector will depend on the elasticities of labor demand and supply in both sectors. However, if there are institutions which try to garner the level and increases in minimum wage in the uncovered sector, then reductions in poverty of families of workers in the uncovered sectors might be an outcome.

In considering the potential for minimum wage policy to reduce poverty, we must recognize that poverty is a function of a worker's family income, which raises a third set of issues: it requires addressing whether low wage workers are in low income families. Hikes in the minimum wage that raise the incomes of low wage workers can only reduce poverty to the extent that those workers are in low income families. Gramlich (1976) was one of the first to note that minimum wage workers can live in relatively affluent families. More recently Burkhauser, Couch, and Wittenburg (1996) show that only one-third of the workers in the United States affected by the 1990 minimum wage increase were in poor or near poor families. (Another third of the workers were in families with incomes more than three times the poverty line.)

Assuming the minimum wage worker is in a low income household, a related issue is that minimum wages can have different effects on family income depending on who in the household is directly impacted (e.g., whether it is the primary or secondary earner) and what is the labor supply response of that person as well as the labor response of other household members. For example, one could envision scenarios where increases in the minimum wage could bring a family out of poverty if a secondary earner decides to join the labor force because the wage increase is above her reservation wage (Addison & Blackburn, 1999; Freeman, 1996). However, an increase in the minimum wage might also cause a family to fall into poverty if it is the head of the household who looses his or her job as a result of the increase, and other members are not able to increase their hours of work or find a job if not working. Which workers gain and which loose can influence whether the family's income is above or below the poverty line.

Finally, a fourth factor to consider is the relative level of the minimum wage to the *per capita* poverty line. [7] One might expect that raising the minimum wage could have a bigger effect reducing poverty if the minimum wage is set at or slightly above the *per capita* poverty line than if it is set at four times the *per capita* poverty line. However, the relative level of the minimum wage to the *per capita* poverty line also reflects the government/society's view as to whether the minimum wage is meant to cover the basic needs of one worker or that of a family, and the extent to which families are expected to rely on one *versus* two breadwinners. For example, if the society believes that the minimum wage should cover only the basic needs of a worker, a family of four with only one household member earning the minimum wage will be poor and raising the minimum wage in this scenario would have no impact on poverty reduction. On the other hand, if the minimum wage is meant to meet the basic needs of a family, then raising the minimum wage is more likely to reduce poverty.

Because of all these factors, it is difficult to predict what the consequences of a minimum wage increase are for poverty and the distribution of family incomes. We turn to the empirical literature on this question, which unfortunately is sparse in comparison to the literature on the wage and employment effects. We begin with the United States literature and then review the literature for developing countries, which, not surprisingly, is larger.

Card and Krueger (1995) provide one of the first estimates of the effect of minimum wages on poverty in the United States. They regress the change in a state's poverty rate from