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Designing Inclusion: Introduction

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Access to a career and to a livelihood in society's mainstream economy is again a topic of discussion among economists and sociologists. Great value is placed on the opportunity of working-age people to obtain rewarding work in the formal economy and to earn enough in such jobs to be self-sufficient. These are the twin conditions for what is sometimes termed *social inclusion*, or, more aptly, for *economic inclusion*.

The central importance of jobs and self-support derives from several human needs. People need to engage their minds and, for most people, jobs are the main means by which they encounter new problems to solve, discover their talents and expand their capabilities. People gain satisfaction from achieving something and experience personal growth from working with others. A great many people also want involvement in their society and, for them, to work in a job in the economy's mainstream is to be a part of society's grand project. Last but not least, the pecuniary reward from working is of both material and symbolic value. People want the dignity brought by self-support and the autonomy brought by having a substantial income of their own to meet their special needs. Earning one's own way – making enough to support one's self at a decent level by society's standards and to be a part of community life – is hugely important for people's self-respect. For these reasons, the *availability* and the *quality* of a country's jobs as well as the wages employers can afford to pay, hence the *productivity* of work, are among life's "primary goods" in John Rawls's terminology. It is no wonder, then, that people want to be included. The recognition of inclusion, by the way, is not new to economics, which has long prized low unemployment, high job satisfaction and high productivity.

Until recent decades, the goal of inclusion was a rallying cry to break down the discriminatory barriers that were depriving women and many minorities from the ample access to the economy and the community that white males had long enjoyed. Commentators did not need to canvass moral philosophy to condemn these barriers. It was (and is) axiomatic that all persons having the same qualification – the same talent and preparation – ought to have the same career chances, regardless of race, religion or gender. And it was understood that the courts could pave the way, without benefit of economic theory and fiscal expertise. Those were simpler times.

INCLUSION OF THE LESS ADVANTAGED

The deficiency of inclusion that is the subject of this volume is the tendency of a great number of the less advantaged, or less qualified, to be marginalized from the society and possibly even from the labour force. Not all those whose labor in the market economy would be productive to some positive degree, however small, are found to be employed in the market, even those who would like to work and contribute if offered terms that society could afford.[1] Like the inclusion failure deriving from racial or ethnic or gender bias, this classic inclusion failure is quite old. It must have emerged or intensified if it was already a problem when impersonal private ownership of businesses began to pervade the market economy, so that a marginal worker in the family or in that of a neighbor would no longer be employed out of obligation or reciprocity.

The problem involves unequal treatment of persons of unequal marketability, which is philosophically different from unequal treatment of persons of equal ability and preparation. It is a great deal more difficult, since it is impossible to equalize rewards, such as wage rates, without deadening some of the incentives to prepare and to make an effort; more generally, it is impossible to pull up rewards to those at the bottom rung of the ladder without also pulling up rewards in the next rung and the rung after that, and so forth. So it cannot be usefully addressed by pretending that the problem is one of two homogeneous classes, proletarians and the rest; or even three such classes or several.

The marginalization of the less advantaged operates through both a paucity of jobs for them and through pay offers so remote from the earnings of those in the mainstream of the labor force that their morale is impaired or broken. Clearly the system called the market economy does not promptly deliver a viable job for everyone upon request – no matter how low a wage one is prepared to accept; there is involuntary unemployment. And while some number of unemployed persons may be justifiable to concentrate the minds of employees on their jobs, the

[1] Understandably, many would at once object to the idea that even people with just an epsilon of productivity should be brought into the market economy or else be deemed an inclusion failure. So many will advocate a positive threshhold level that people's productivity must exceed for us to count their non-employment as an inclusion failure. But moral philosophers have not suggested a solution to the problem of what an appropriate threshhold level might be if not zero. As a practical matter, however, minimum wage laws remove the problem. One would not want to design and evaluate machinery to pull up wages from so low a level that they would remain be below the statutory minimum wage.

invisible hand is not thought to have restricted unemployment to the optimum level from this point of view. Even if that efficiency maximum prevailed, some workers might be so unlucky from entry to retirement that they never get a career going and earn their own support, which would be inequitable. That is a failure of inclusion. It is not enough to say that they all had acceptable chances for a career and a decent living. And people cannot buy insurance against missing out on self-support and personal development – on having a life.

The way a market economy determines wage rates also affects inclusion. People are far from identical in their capabilities and their productivity in terms of market value ranges over a vast spectrum from barely positive productivity at all to dazzling ability. There were times when a deficiency in capabilities did not translate into a deficiency of inclusion. A family farm might involve all the family members, even those only marginally productive. In the modern corporation, managers do not have much left after the demands of shareowners with which to subsidise some workers' employment – especially with the increased competition brought by globalisation. As a result, the average pay check even a tenth of the way up the wage distribution is a small fraction of the average pay in the middle – about one-half in the United States and the so-called Anglo-Saxon countries generally. So workers in that neighborhood of the distribution, even when they are steadily employed, can hardly achieve the self-support and self-worth once thought to be attainable by all in the working class and have to live in poverty by the standards of the middle class. In turn, the meagre pay available to these low-wage workers weakens their job attachment and their productivity, thus forcing up the employer's costs. The effect is to reduce their wage rates further and also to reducing their employability, thus driving up their unemployment rate. So to the deprivations of a low pay rate is added the economic and emotional burdens of joblessness.

A serious decline in the inclusion of less qualified workers swept over the advanced Western economies in the late 1970s and 1980s. None entirely escaped it and, in general, it was not fully offset by the higher employment and elevation of wages brought by the investment booms brought in several Western economies from 1996 to 2000; in any case, those booms have now largely subsided.[2] Compared with the 1960s, the pay gap between the low end of the labour market and the middle remains far wider and, among less educated men, participation in the

[2] The U.S. is not an exception to the decline of inclusion in either of its two dimensions. In the last years of the boom, 1998 to 2000, both relative wages and relative unemployment rates were much improved their levels a decade earlier. But it is doubtful one could show that the bottom decile of wage earners could afford good housing, clothing, and community participation to the same extent the corresponding group in, say, the 1960s could, since the relative wage as measured by the 10/50 ratio declined so much over the preceding two and a half decades. Further, both high-school dropouts and (by a smaller margin) those workers with only a high-school diploma had a higher reported unemployment in 1998 than in 1970 or 1965, notwithstanding the strong boom.

labor force is still lower and unemployment rate still much higher. (In Europe over the past two decades, France and Germany actually compressed the pay gap and Italy resisted a widening, but they appear to have paid the price with a far greater rise of unemployment and fall of participation among less-educated men than elsewhere in Europe.)

One can summarize these observations by saying that the advanced economies have generally suffered an adverse shift of what may be called their *inclusion frontier*. That frontier relates the relative wage in the *lowest-paid* ranks to substantially these workers' absolute unemployment rate – or, more conveniently, their *employment* as a ratio to their number in the labor force.[3] The unemployment rate is a measure of the frequency with which workers join or are discharged into the unemployment pool multiplied by the waiting time that entrants into the low-wage job pool must expect before being called to a job. These two data, the relative wage of the low-paid and the proportion of the time they are employed, express their degree of inclusion.

CAUSES OF THE LOST GROUND

Today, after considerable investigation, there is some degree of consensus that the deterioration of inclusion is, approximately at any rate, the result of structural forces operating through essentially non-monetary channels – both macro-structural forces and micro-structural ones. From this perspective it appears that most of the decline of inclusion in the Western economies can be explained by the evolution of three macro-structural forces: the economy's productivity growth, personal wealth and the world real rate of interest. The extraordinarily low jobless rates in the so-called "glorious years" from the mid-1950s to the early 1970s are now seen as the product of exceptional circumstances in all three respects: For one thing, the austere level of private wealth in relation to productivity that was a legacy of the war kept wage pressure low enough to permit very high employment; and the sprint of productivity, especially on the Continent where businesses moved to catch up with best technical practice in the U.S., caused wealth to lag further behind productivity, which lowered wage pressure more. Second, real interest rates throughout the world were low, thanks to the desire to reaccumulate wealth; this and the prospect of continued productivity growth at a fast rate served to lower the expected net cost of capital (net of expected productivity growth), which boosted the wage that businesses could afford to pay and thus the hiring they were willing to do. The U.S. was similarly blessed though not to the same degree and so its unemployment rate never reached the record lows set

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[3] The two sets of workers are not identical since in some countries the young may be important among the low paid but less so among the unemployed and in some other countries the reverse. Whether youth unemployment and low pay among youth represents a deficiency of inclusion or instead the rough efficiency and "tough love" of the free market goes beyond these notes.

in Europe. Yet the post-war structural boom could not last. Legislatures expanded welfare entitlements in the 1960s, and this rise in *social* wealth appears to have played a role over ensuing years as wages showed upward pressure, unemployment rates moved generally higher and profit shares generally lower. As the technical catch-up neared completion in one country after another in the 1970s, expected future productivity growth slowed from its breakneck speed to a normal pace; the resulting rise in the cost of capital (net of expected productivity growth) dampened hiring and the resulting slowdown of paychecks relative to wealth generated upward wage pressure. Finally, a further rise of the cost of capital and still more wage pressure resulted following the sharp elevation of the world real rate of interest early in the 1980s. In the U.S., of course, such a catch-up did not apply but there was a substantial though lesser productivity slowdown from 1974 until 1994 and overseas interest rates became a regular object of American worry.[4]

This slump is distinctive not only in being largely structural nature in nature. It is distinctive also in the severity of its relative impact on the less advantaged – say, for statistical purposes, those in the least-educated group, the high-school drop-outs. With few exceptions in the OECD countries over the 1980s and neighbouring years, the *proportionate* increase in unemployment rate, not just the absolute increase, and the proportionate decrease in *wage rates* were both greatest in the lowest education category – and generally by a wide margin. Two of the macro-structural forces may have struck the earning power of the less educated with disproportionate force. The rise in the net cost of capital may have penalized the less educated if hiring them posed a greater investment cost relative to their wage than hiring more qualified workers did. And social wealth (social insurance and social assistance) rose steeply from the 1960s into the 1990s in most countries and the less advantaged got the lion's share of it. At the same time, poor families shared fully in the slowdown of productivity. As a result, particularly in low-productivity areas, work ceased to "pay" for as many as it did decades earlier. It is also plausible that the less advantaged suffered further reversals at the hands of some micro-structural forces: Globalization increased the reach of outsourcing by employers and the information technology put an added premium on educated labor.[5]

To address the deficiency of inclusion through governmental action on a large scale – large enough to make a large difference –

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[4] These views are developed and many of them tested in Phelps (1994), Hoon and Phelps (1997) and and Phelps and Zoega (1997, 1998). Some of the same views (and others) are also found in Pissarides (1990), Layard, Nickell and Jackman (1991) and Blanchard (1997, 1999). A new perspective is offered in Greenwood (1997).

[5] A less cursory discussion is in Phelps (1997a). See also Greenwood (1997).

requires a paradigm shift in political economy that some policy makers are not yet ready to accept. So we are obliged to take up the philosophy of such a step and only then proceed to the business of this volume, which is the engineering of concrete fiscal programs to boost inclusion.

POLITICAL ECONOMY

A basic question here is whether the deficiency of inclusion among the less advantaged is, to any degree, a problem for society to address through the state. In the view of some observers, low inclusion, however regrettable, is *not* a phenomenon appropriate for *social intervention* – not something to be corrected through collective action by the state.

The reply to that position, a reply dating back to the 18th century Enlightenment, is that a democratic country's formal economy is a project for citizens' mutual gain, so the accessibility of this project and the satisfactoriness of the terms it offers participants are a legitimate object of social policy. Some of the classical economists, with their notion of consumer surplus, suggested that in fact a mutual gain does result, an idea brought up in the Progressive era. A formulation is sometimes found in textbooks today: Just as the gains from foreign trade, which originate in the diversity of national resources, benefit everyone – or *could* be made to do so, if necessary with the help of redistributive taxes and subsidies, so likewise all workers interlinked in a large society's market economy enjoy wages rates superior to what they would earn if they worked alone or in homogeneous teams – at any rate, superior wage rates *could* be arranged through fiscal tools. So there is a "social surplus" that society can distribute in any one of a great many different ways to the diverse kinds of workers without leaving any group with no gain over what it could have if it broke away.[6]

The Progressive Era first raised the question of the size of the surplus and – a matter of basic principle in any case – the appropriate uses of it. Most took the surplus to be nearly all of what is produced, suggesting, as did Hobhouse (1922), that one who does not collaborate or barter with others would not have any productivity to speak of.[7]

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[6] In Phelps (1997b) the economic doctrine of the Scottish Enlightenment is seen as a liberation movement prizing people's release from domestic work within the family or hamlet into the relative freedom, diversity and stimulus of the market economy. On the social surplus, Paul Samuelson's textbook (4th edition, 1958, p. 445) cites Adam Smith's water-diamonds paradox and quotes Progressive-era theorist L. T. Hobhouse (1922), p.162-163.

[7] Possibly the surplus is a smallish proportion of what is produced, since there is more behind labor productivity in a country than workers' diversity and specialization Theoretical calculations by Gilles Saint-Paul and myself put the surplus at roughly one percent of the gross domestic product. (Phelps, 1997a, p. 141, also cites this result.) In judging the significance of that result three points must be borne in mind. First, the neoclassical model used is just one model of the many that could be built for

Whatever its size, the surplus could be used to add to the rewards of participants who would otherwise earn a very low wage, taking away from others some or all of what the surplus had been adding to their relatively high rewards. Or it could be used to boost the educational preparation of persons who would otherwise be unable to earn more than a very low wage. With the surplus evidently in mind, Theodore Roosevelt in his 1912 re-election campaign sounded the theme of "distributive justice."[8] Much later, in John Rawls's 1971 book, the surplus is viewed from its first pages as the rock on which any theory of economic justice must build. To his credit, the analysis takes fully into account that steadily boosting marginal tax rates to fund higher wages or education for the disadvantaged, in reducing the incentives of the others to work and save, would actually be lowering the surplus; and that, at some point, the marginal rates would be so high that no further boost in rates would succeed in moving more surplus to workers with the lowest wage. So it isn't as if the surplus were some honey pot against which to measure the adequacy of public expenditures and subsidies aimed at a more equitable distribution of pay.

In present times, attention is more apt to be given to the *negative* interactions among people that may arise if an underclass is allowed to develop: *All* suffer a loss of amenities – unsafe streets, drug use among youth, public health hazards, high tax rates for social assistance, and so forth – if large numbers of working-age people are marginalized from work and self-support.[9] A central part of my book *Rewarding Work* (1997a) argues that the benefits from reducing these negative externalities through low-wage employment subsidies that draw the marginalized into regular work and self-support would come close to covering the cost of the subsidies.[10]

To commentators unmindful of the classic lines of thought reviewed above, however, deficient inclusion is nothing more than an instance of income inequality and, for some, not the most serious inequality either (if bad at all). On the seriousness issue, it is true that in several countries pay rates are estimated, upon controlling for a range of factors such as education, to discriminate against both women and blacks. Of course it rankles that there should be a systematic pay difference between two

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studying the question. The specialization of a heterogeneous labor force may produce Smithian learning and externalities. Second, it may produce a diversity of new ideas for new goods and methods. In any case, one per cent of the GDP in the U.S. is close to 100 billion dollars, which far exceeds the net budgetary cost of the modest plan proposed in Phelps (1997a).

8 Roosevelt's views on the economy are presented in a recent biography (Dalton, 2002).

9 Although the occasional investigation fails to find an effect of unemployment rates on one or more social indicators, there are many successes. For example, Ernesto Felli and Giovanni Tria (1999) find that regional unemployment rates in Italy correlate pretty well with regional murder rates.

10 See Chapters 4 and 9 in Phelps (1997a).

apparently equally prepared subgroups and we must all be sensitive to the historical background of extreme racism and sexism. Yet the extant pay differentials of this kind are no longer garish and they appear to be still trending downwards.[11] By contrast the inequality between the tenth percentile wage and the median wage is huge in the U.S. and quite wide in a great many other Western economies.[12]

On the basic issue, the reductionism that takes inclusion failure to be essentially an income inequality, the point is that a deficiency of inclusion – too few employed in society's central economic institution, the market economy, or too few of the employed able to support themselves by working, even full-time – has social effects beyond income inequality, wage inequality and inequality in general.[13] Because having a job and earning in that job enough to be independent are crucial in their own right – no matter how much one's non-wage income, including the benefits offered by entitlements, may be available – failure to achieve these objectives undermines self-esteem and self-confidence.[14] The consequences in turn are that the unemployed and the dependent make poor parents and neighbours, and when a community is dominated by these problems the effects extend to drug trade and the loss of public safety. One might think that all this is

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[11] A paper by Sandra Black and Elizabeth Brainerd (1999) finds that the competition resulting from globalization has induced U. S. companies to reduce costly discrimination against women.

[12] Finis Welch, in his Ely Lecture at the American Economic Association meetings in 1999, held that most Americans would prefer today's vast inequality to the more homogeneous income distribution of the late 1940s when racism and sexism blocked occupational choice and pay. Perhaps so. But the question, if there is one, is whether marginalization of the disadvantaged now is less serious than racism and sexism *now*, not *then*. Take the US. The wage difference now between childless men and childless women ages 27 to 33 is put at less than 2 per cent by the Independent Women's Forum of Washington, D.C. (Wall Street Journal, April 13, 1999, p. 1). In contrast, the wage ratio between the 10^{th} and 50^{th} percentiles of full-time jobs is put at 44 per cent in 1986 by Gottschalk and Joyce (1992). In December 2001 the gap between the male unemployment rate and the female rate was equal to zero while the gaps between the average unemployment rate in the bottom education group and the rate in each of the other education groups were very large.

[13] Empirically, inclusion difficulties add to income inequality. Theoretically, though, they might not do so. In a "lifecycle" model of the economy in which successive cohorts of homogeneous workers are born in the unemployment pool and emerge with lifetime jobs, there may be *lifetime equality* as *all* the young suffer *equally* from the inclusion difficulty. (For such a model see Phelps (1998).)

[14] Another unfortunate effect of viewing deficient inclusion as an instance of income inequality is that it burdens the discussion of inclusion with the baggage of controversy and confusion about inequality. First of all, an increase in income inequality cannot be judged out of context to be either good or bad. Yes, it may be that some non-inclusion is theoretically needed (in the form of positive unemployment) to avoid serious inefficiency in employee conduct so there is a theoretical ambiguity there too; but there is a strong presumption that inclusion at present is far from reaching a level at which it threatens productivity. Second, many economists appear to think that existing taxation of high incomes is about right, believing that continuing moderation in marginal tax rates at the top is serving to pull up after-tax wage rates across the board– hence those of the least advantaged – by energizing effort and innovation. (Some other economists muster no interest in income equality whatsoever.) It is possible to stand in that camp, however, and still believe that a great deal more inclusion, suitably achieved, would yield a pretty general gain.

commonplace wisdom. "Yet," as Derek Bok said, "we continue to talk...as if income statistics captured the phenomenon in some meaningful way."[15]

By its nature, then, the inclusion problem cannot be solved by "throwing money" in the form of *transfer payments* to those not included. Receiving income support from the state does not make one a contributor to society's economy and a member of society who works for what he has. When the OECD governments expanded the system of entitlements offering transfer payments under various contingencies (illness, reaching a certain age, etc.), they were meeting a desire of the electorate for greater security – not for greater inclusion, which had been rising in the postwar decades and which was already pretty broad in several of these countries. Unfortunately, these programs have lessened inclusion. That must be so if recent studies are right in confirming that what lies behind the inclusion difficulty faced by many working-age people – their low pay rates in relation to their other resources, their low participation rates and their high unemployment rates as a result of their poor morale – is their low marginal productivity after taxes and any subsidies *relative* to the benefits from their private assets and their entitlements. To legislate still more government transfer payments would worsen the inclusion problem by making jobholding less competitive as a means of supporting one's self and thus lowering participation and increasing unemployment, especially among working-age people with relatively low earning power.

By the same logic, the spread of the underground economy does not solve the problem either. The underground economy, like the welfare state, shrinks and damages the formal economy by weakening performance incentives in formal jobs and weakening the incentive to participate in the formal economy. Working underground may be socially preferable to *welfare*, since at least something is produced, but it is a poor substitute for a job in the legitimate economy. Like the domestic economy of paid housework, the underground economy functions as an escape valve that drives unemployment in the legitimate economy above the level it would have if there were no such escape from unemployment.[16] If that is right, the underground, far from offering a welcome *cushion* of alternative work for

[15] Domestic Strategy Group (1998), p. 18.

[16] When payroll tax rates and income tax rates were increased in the 1970s and 1980s, the *initial* response was a fall of employment in the form of both higher unemployment and lower labor-force participation. In the theoretical perspective of incentive-wage theory, wages were cut insufficiently to accommodate the cost shock since employers knew that further wage cuts, which would be needed to restore employment, would reduce pay *relative to wealth* to such low levels as to have disincentive effects that would actually leave production costs increased on balance. (The collective bargaining perspective tells a parallel story.) Yet, if there existed no underground economy, the *long-term* response *would* have been a fully accommodating decline of wealth and pay in equal proportion, triggered by the reduction of saving in response to the decrease of employment and earnings; this would have proceeded to the point where employers could afford to offer the same number of jobs as before. In offering escape into subterranean jobs the underground blocks the completion of that adjustment of wealth and wages, thus blocking full recovery of employment in the *formal* economy.

people viewed as having irrevocably lost the possibility of employment in the formal sector, ultimately substitutes its inferior jobs – dead-end jobs, jobs with poor conditions that would once have been passed up, jobs that are viable only because of tax evasion and other criminal acts, all work activities that were once rejected – for the good jobs that would otherwise have been created in the formal economy. The personal and social effects of this development may be nearly as stultifying and pernicious as the effects of the entitlements of the welfare state. However, the toleration of both the explosion in welfare entitlements and the expansion of the underground economy are parts of the *problem*, not solutions.

I would add that the value of careers in the formal economy depends on the stimuli provided by its organisation along capitalist lines. Any country can achieve full employment and high relative wage rates at the low end by sacrificing private enterprise and foregoing decentralised wage setting. The Soviets did it through central wage setting and state-enterprise toleration of employee shirking, absenteeism and alcoholism. Yet that system could not offer the job satisfactions and personal growth obtainable from stimulating jobs and motivating pay. In capitalism, owing to its unplanned and entrepreneurial nature, careers have unforeseeable turns. Most people relish and learn from the novel challenges and changing opportunities presented, and they compare it favourably with the bureaucratic sector. The right objective, therefore, is wide inclusion in *private enterprise*, not more work and better pay anywhere at all. And worthwhile inclusion requires jobs offering real engagement in firms – preferably career-track jobs and in any case full-time jobs, so there is serious involvement with the firm and its workforce rather than just a peripheral and ephemeral presence.

It should be commented that policy measures unshackling private enterprise from *harmful* regulations and harnessing their productivity through *helpful* regulations, to the extent those measures speeded up productivity growth, would usefully boost inclusion as a side-effect. An acceleration of productivity in European business would bring a partial recovery of inclusion just as the deceleration of productivity in Europe decades ago contributed to its decline. Yet it would be unrealistic to suppose that governments could find a way to return to the record-breaking productivity growth rates of the “glorious years.” So such an attempt to restore inclusion to its level in the 1960s would not reach the goal of restoring inclusion to the level of the glorious years. That is why another policy tool must be deployed.

RECENT POLICY RESPONSES

The large setback in the inclusion of the less advantaged has posed the question of how governments might best respond. Until recently the discussion focused on the optimum position to assume on the two horns of the dilemma. One camp proposed dismantling union-set pay scales and statutory minimum wage rates propping up pay at the low end, saying that these “rigidities” destroyed jobs and thus operated to expand dependency or increase the underground economy. The other camp opposed moving to greater employment through increased ”flexibility,” saying that a fall of low-end pay rates or of social transfer payments would widen income inequality. Many in this camp boldly advocated that a statutory minimum wage be created if it did not already exist or be increased if already created as a means to help low-productivity workers as a group. The latter view accepts lower employment in return for higher pay at the low end while the former would trade off some pay for more jobs. Some at the low end will lose from the one, others from the other.

It is now dawning on policy makers and commentators, in Europe and to some extent in America, that countries can engineer a reduction of unemployment *without* a sacrifice of low-end pay and a rise in low-end pay rates *without* a sacrifice of employment (or some of both). This can be done by means of tax-subsidy measures producing a favourable *shift* of the inclusion locus. Already several countries have introduced, some many years ago, fiscal programs aimed to do just that. The Luxemberg Summit of 1999, with its agreement of governments to submit annual reports on progress made and new initiatives taken, has served to intensify governmental attention on the matter.

France, for example, has taken steps starting as far back as 1994 to decrease markedly the payroll tax on the low-paid. The size of that part of the social contribution paid by the employer (rather than the employee) now shows a cumulative reduction amounting to about 10 per cent of the employer’s total wage cost per employee at the lowest (minimum wage) level. The tax paid by low-wage earners for their health insurance, which was about 4 per cent of the employee’s wage, has also been lifted, with the tax burden shifted to the general social contribution faced by all income receivers. Finally, a flat subsidy of 4,000 francs per employee per year affecting relatively low-wage employees has recently been introduced in connection with the 35-hour workweek. In France as in other economies in recently years, many things have been going on at the same time, so any inference of cause and effect is risky. Nevertheless, there has been a large gain relative to trend in employment in just two years and this gain is heavily weighted toward the low end of the market.

Important initiatives in the same direction have also been taken in the Netherlands. The payroll tax on workers who were unemployed when hired has been reduced by 10 per cent for a period of 2 years and reduced by 13 per cent for employees who had been unemployed for more than 4 years. The traditional exemption in the personal income tax law has been abolished and replaced by a tax credit that tax payers may apply against the personal income-tax liability on their wage income. This “earned-income” tax credit is not politicised, so far at any rate: it applies to older workers as well as younger ones, couples as well as those who are single, the childless as well as parents, men as well as women. This credit amounts to some 9,000 guilder (from 3 to 4 thousand U.S. dollars).

On the other hand, efforts in this direction in some other countries have been far more limited. Typically, those efforts are targeted at one or more relatively narrow groups in the low-wage population. An extremely selective sort of program started up around 1980 in the U.S. – the Earned Income Tax Credit – and in the U.K. – the Family Credit. The original intent of such tax credits was to lift from low-wage people the burden of the proportional tax imposed to finance retirement and other old-age benefits (if only because the working poor had low survival rates). However, a combination of political forces could agree only on tax credits to parents of dependent children having low earned income, the selling point being that the recipients would claim even more money if left in the “welfare trap” than they would if induced to work.

THIS VOLUME’S STUDIES

This volume presents four studies of fiscal instruments – subsidies of one kind or another – that are or might be aimed at boosting employment and pay rates among the relatively low-paid. The first of these, by Hian Teck Hoon and myself, examines the effects in our incentive-wage model of a graduated employment subsidy – one offering a higher subsidy the smaller the wage rate, gross or net. Both the open economy and the closed economy, and both the short run and the long run, are considered. Hoon and I study the theoretical effects on pay rates and employment from bottom to top of the labour force. In every case, we find, the result is a lift to employment as well as to paychecks at the low end of the market. Special attention is paid to the effects on near-bottom wage earners. These effects of the employment subsidy are then contrasted with the effects of a hiring subsidy.

The next paper, by Dale Mortensen and Christopher Pissarides, uses their version of the search-and-matching model to study the theoretical effects of a range of fiscal tools that might be legislated in the name of employment creation. It is found, for example, that a hiring subsidy reduces the average duration of unemployment but has an ambiguous effect on the employment rate. The authors also explore the “optimum” mix of the fiscal tools, each one responding to one or more of the market’s imperfections.

For some, there is a side-effect of employment subsidies or wage subsidies that could be a serious, possibly fatal drawback. Their very success in making low-wage jobs more plentiful and beter paid might greatly slow the growth of their human capital and thus their future earnings growth. The paper by James Heckman, Lance Lochner and Richard Cossa conducts simulations based on microdata estimates to analyze the outcomes of one kind of subsidy, the Earned Income Tax Credit. Two models of skill formation are used and the outcomes for skill formation are quite sensitive to the model selected. In the standard Becker-Ben Porath model, where skill formation is gained by schooling, the subsidy to wage earnings increases schooling's opportunity cost (the present earnings foregone) without generally increasing the benefit (the gain in future earnings) as much. In a model of "learning by doing," which receives more empirical support, the subsidy actually increases skills among the lowest-wage workers whose earnings remain in the phase-in region of the credits schedule. So apparently there is no tradeoff between boosting wages and boosting skill formation after all.

The paper by Michael Orszag and Dennis Snower contrasts the effects of low-wage subsidies exhibited in their model with another fiscal instrument, the unemployment voucher – a voucher that unemployed workers can present to the firm hiring them in order to defray some of the hiring costs. As the authors show, both programs operate in their different ways to combat unemployment and to reduce the poverty of the working poor. Which one is better depends upon how much relative weight one puts on raising pay and how much on raising employment.

Those with an interest in ways to raise the inclusion of the least advantaged in the working-age population and hence an interest in how subsidies of one or another kind would work will discover a wealth of findings in the four, diverse papers of this volume.

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