Subsidies that Save

by Edmund S. Phelps


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Was France's recent wave of protests against an amendment that would have increased employers' freedom to fire young workers a blessing in disguise? To defuse the protests, President Jacques Chirac was forced to withdraw the provision, and instead has proposed hiring subsidies as a way to reduce youth joblessness. A related proposal for targeted wage subsidies is being floated in Germany.

Advocates of greater labor-market flexibility insist that paying employers to hire young people is the wrong approach. Allow employers to fire workers more easily, they argue, and employers will hire them more readily. The limitation of this approach, however, is that a free market for labor will neither eradicate unemployment nor transform marginal, low-end workers into high-productivity, high-wage employees. If the proposed subsidies in France and Germany have a defect, it is not that they are unnecessary, but that they do not go far enough.

In the advanced economies of the West, many people in *all* age groups are effectively left out of formal employment. In the United States, the pay of less qualified workers is so meager that, if their situation is not dire, they find it emotionally difficult to keep a job for long, or they become too demoralized or distracted to be adequate employees, or minimum-wage laws make them unaffordable to law-abiding employers. In Europe, they are excluded from employment by labor agreements and in some cases by minimum-wage laws. In both cases, these workers lose the opportunity for engagement and personal development that most legitimate jobs provide.

This deprivation in turn generates high social costs, including crime, violence, and dependency. The latter pathologies then become a weapon in the populist attack on free enterprise, which Western countries require for economic dynamism – and thus prosperity. So those who *are* included and benefit by free enterprise, yet are burdened by the social costs of exclusion, should all be willing to pay something to remedy these conditions.

The best remedy is a subsidy for low-wage employment, paid to employers for every full-time low-wage worker they hire and calibrated to the employee's wage cost to the firm. The higher the wage cost, the lower the subsidy, until it has tapered off to zero. With such wage subsidies, competitive forces would cause employers to hire more workers, and the resulting fall in unemployment would cause most of the subsidy to be paid out as direct or indirect labor compensation. People could benefit from the subsidy only by engaging in productive work – that is, a job that employers deem worth paying something for.

Ideally, the subsidies will go for employing workers of all ages. However, it is understandable that plans under current discussion envision focusing first on the youngest and oldest workers.

Some people still think of wage subsidies as a welfare hand-out. But these subsidies are very different from social assistance and social insurance programs. Although such programs have been substantial in Europe and the US, the working poor remain as marginalized as ever. Indeed, social spending has worsened the problem, because it reduces work incentives and thus creates a culture of dependency and alienation from the commercial economy, undermining labor force participation, employability, and employee loyalty. What is needed is higher employment and pay through higher demand for the least productive workers.

Some would count on the free market to solve the problem with time. But market forces alone are unlikely to solve the unprecedented levels of labor-market exclusion that developed from the mid-1970's to the early 1990's. The prevailing belief in a reliable tendency to return to some *normal* degree of inclusion has little ground to stand on. True, most recessions are reversed, just as most booms end. Nevertheless, what is "normal" is itself shifting all the time.

Many argue that subsidies of any kind should never be countenanced, in part because they are extremely difficult, if not impossible, to abolish, even if they are no longer needed. According to this view, the total payment to a factor of production should not exceed its marginal productivity, so desirable outcomes should be promoted through tax incentives.

But, as early twentieth-century theorists pointed out, collaboration and exchange within a nation's diverse labor force increase everyone's productivity. There is a mutual gain from economic cooperation *in addition* to what each type of talent could produce independently – an insight later built on by the philosopher John Rawls.

A society can let the free market distribute this gain, or it can intervene to direct it to the least advantaged, so that some get more than their marginal product, others less. Since the least skilled workers face morale problems that lower their wages and erode their employability, it makes sense to deliver the mutual gain that is redistributed to them through subsidies that encourage greater self-support and employment. And, unlike tax incentives, wage subsidies target only employment of low-wage workers.

Both Europe and the US must do more to promote low-wage workers' inclusion. A good economy not only sustains growing output and national income; it also ensures its participants' capacity for self-sufficiency and ability to realize their potential. A substantial low-wage employment subsidy is a fair and efficient way to achieve this important goal.