Low-Wage Employment Subsidies versus the Welfare State

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This paper is a brief for the introduction of a subsidy to any qualified firm for its use of low-wage employees as a means to reduce the unemployment and raise the pay of disadvantaged workers. There would be a case for such a wage subsidy in all the advanced market economies, and certainly the American one, regardless of recent trends. The case has grown stronger, however, with the worsening of the relative wages and especially the unemployment rates of low-age workers. The globalization of investment and the bias of technical progress are the causes most often suggested. I would add the growth of the welfare system—the public entitlements to hospitalization, to retirement and disability insurance, and to the benefits labeled "welfare" in the narrow sense. Since this factor tends to be overlooked, I devote Section I to it. Section II proceeds to the case for a low-wage employment subsidy. It will be clear that the beneficial effects of the subsidy on disadvantaged workers are the mirror opposite of the harmful side effects of the welfare system, side effects that the subsidy would counteract.

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I. Side Effects of the Welfare

The welfare system harms disadvantaged workers through its impacts on the availability of jobs, on the overall reward from work, and on the morale of disadvantaged communities. On the unemployment impacts, my multivariate study of the postwar OECD economies, with Gylfi Zoega, found that the payroll tax is a powerful determinant of the natural unemployment rate. Its rise, much of it to finance welfare spending, is a major source of the increase in the natural rate from the 1960's to recent years (Phelps, 1994). The steeper rise of this tax in Europe than in the United States helps to explain the far larger rise of the natural rate there.

Underpinning this study is the incentive-wage (efficiency-wage) theory of the natural rate. In that theory, if the economy finds itself with zero involuntary unemployment, firms' hiring having been buoyed by wages low enough to clear the market, employee quit rates and consequent training costs will be so high that every firm will see it as cost-effective to raise its pay, putting it above the industry standard, in the expectation of achieving lower labor turnover—to pay the optimal *incentive wage* corresponding to the unemployment rate. The consequent escalation of the pay standard means that merely paying the going wage would cost more than before, with the result that all firms cut back hiring. The downsizing must go on until the unemployment rate has risen to its natural level, where involuntary unemployment is just high enough to decrease the (cost-effective) incentive wage to the level of the *demand wage,* the wage firms can afford to pay if they are to maintain current employment rolls. In the proto-models, though, taxes were neutral for the natural rate (Phelps, 1968; Steven Salop, 1979).

My new work emphasizes that employees' average propensity to quit (and also to shirk, to be an absentee, etc.) is a function not only of the unemployment rate and their relative wage, as before, but also of the ratio of their wage (or of the standard wage) to their average *nonwage income,* income from wealth plus net transfers. Workers' nonwage income, or unearned income and that of family and friends bolsters their willingness to quit (also, to shirk, etc.), at the risk of losing their jobs. In this asset-enriched model, *a payroll* tax is not neutral: it has a negative impact on the demand wage (by adding to firms' costs), but less so on the required incentive wage (since it does not tax away any nonwage income). Both the wage and employment fall, unemployment rising to a new and higher natural level.

This enriched model, if extended to heterogeneous workers, would show unemployment to fall primarily on the disadvantaged, since the more skilled workers may land a lesser job when waiting for an opening in their normal work, while the unskilled have no such alternative.

There is another channel through which the welfare state has aggravated joblessness. Richard Layard and Stephen Nickell put the harm done by unemployment compensation into their model and estimated its effects (Layard et al., 1991). But like all pioneers, they did not go half far enough. As Zoega argued, the safety net (food stamps, medicaid, etc.) has a sort of wealth effect alongside the substitution effect from the payroll taxes to finance them: it increases the willingness of workers to take risks that might cost them their jobs. Quitting for a change of scene, shirking, and the like become more tempting. Hence, the required incentive wage is pushed up (and in some cases the demand wage is pulled down), with obvious consequences for the natural rate (Zoega, 1993; Phelps, 1994).

The overall reward to the disadvantaged from employment may also be hurt: their wages must drop to finance their participation in a welfare system that they would not have been willing to buy, being too poor. The wealth effect of the system, in elevating quit rates, also operates to reduce employees' net productivity (net of training costs) and thus to reduce the demand wage on this account as well. So the welfare state may reduce the wages of the disadvantaged by more than would just compensate for the imposed welfare entitlements.

There are also effects on self-esteem: with the safety net only inches below, many of the disadvantaged will see employment as far less rewarding in utility terms, and hence emotionally. When people do not need employment to have housing, food, and even to raise children, the meager pecuniary reward of the low-end jobs is devalued. The effect must be a decline in many people's morale. The reduced morale impairs their job performance, which in turn costs them some opportunities and reduces the profitability of investing in themselves to improve their future opportunities. The weak morale is contagious in a close-knit community.

All this damage done to disadvantaged workers might not matter much if disadvantaged workers were all fairly and handsomely rewarded in the workplace. In fact, though, the *very disadvantaged*—say, the bottom tenth—continue to do badly in the advanced economies, with unemployment rates that are extremely high, especially among the young, and with wage rates that are little above the meager wage minimum instituted by law or by trade unions. In the United States, the earnings of workers at the tenth percentile in the distribution of earned income in 1986 were only 35 percent of the earnings of median workers (Peter Gottschalk and Mary Joyce, 1992 table 2).

Has the relative wage and the relative unemployment rate of very disadvantaged workers deteriorated as my analysis suggests? The position of disadvantaged males has declined noticeably since the end of the 1960's, and this despite the increased numbers of complementary workers having more education. It remains to be learned how much of this deterioration is the effect of the welfare state and how much the effect of other factors (e.g., technological change and developments overseas). Though the welfare state may not be the main culprit, it may be making a worsening situation still worse.

II. The Argument for Low-Wage Employment Subsidies

My theme is not mainly the familiar call for reviving the "stick," axing social programs that draw the disadvantaged from job-seeking into rent-seeking. It is more a call for fortifying the "carrot": for creating institutions to enlist the self-help of the disadvantaged by raising the reward to their initiative and perseverance in gaining employment. I have proposed for some time that a system of *low-wage employment subsidies* be introduced, a subsidy to every qualifying firm based on the stock of low-wage workers on its rolls, in order to pull up the wage rates and employment rates of all very disadvantaged workers (Phelps, 1985, 1990).

My thesis here is that, in stimulating the demand for low-wage labor, low-wage employment subsidies would yield a social benefit exceeding the purely private benefit. Social "externalities" would flow through three channels, which I will briefly take up.

Equity.—Almost nowhere in the moral-philosophic literature is it deemed just that those with only a limited kind of labor input to offer should receive only its reward in classical competitive general equilibrium— its marginal product--no matter how low. (Imagine that unskilled labor were so abundant its marginal product was zero!) In many views about fairness in the rewards to workers from their cooperation in the economy, from a utilitarian view to the diverse views of the present, economic justice requires the more advantaged to provide a subsidy, financed by a tax on their own income, to the disadvantaged; its function is to allocate to the disadvantaged an increased portion of the gain resulting from the social cooperation—to give them a fairer shake. In some conceptions of justice, the more fortunate will not want to profit from economic cooperation if it would be at the expense of the less fortunate. Ayn Rand (1964) offers the image of the bus in which the less fortunate are given a free ride. The more fortunate pass up any share of the gain from cooperation, content with the same benefit net of cost obtainable without cooperation. In John Rawls's (1971) world of collaborative production, though, any effort by the more advantaged to rebate through the tax/subsidy mechanism the whole of their gain from the collaboration back to the less advantaged might be counterproductive: both groups might be better off lowering tax rates, accepting the resulting increase of inequality in return for the improved incentives to work more cost-effectively. In Rawls's theory of justice the more advantaged would tax themselves to make the gain to the disadvantaged as large as possible, no matter that there is a greater gain in it for themselves, since it is not at the expense of the disadvantaged.

A less uncompromising moral observer than Rawls would be satisfied to see a large step taken toward that reference point: *some* subsidy, but not one lifting the bottom wage rate as far as it can be made to go. Certainly a subsidy simply to avert burdening low-wage employment with the financing of various social-insurance programs financed by payroll taxes would seem minimal. If a person not in the labor force and with no visible means of supporting himself is deemed to have a right to social health insurance free of charge, then it would not seem right to require a person of little productivity to pay the whole cost of his or her insurance, especially when that insurance is mandatory and would not have been bought by poor workers.

Where is the externality here? Why are taxes and subsidies needed to achieve people's notions of what is less unjust (however incomplete they may be}? One might think that individual economic actors could implement these principles themselves in the way they draw up contracts for compensation among themselves. The answer is that when an individual—a "producer," we may call him—is contemplating the terms under which he collaborates with another less advantaged than himself, he knows that greater self-restraint on his own part does not translate into a similar restraint binding everyone else in his position, a side effect that would have appealed to his sense of justice. Because his unilateral action does not have that external benefit, he restrains himself less than he would if it did, and the same is true of the others. Hence, people are glad to be able to vote the tax/subsidies necessary to yield a *general* scale-back in the after-tax reward to the advantaged for the sake of a *general* pulling up of the after-subsidy reward of the disadvantaged (see Amartya Sen,1961).

Unemployment and Waste of Resources.—The failure of society to arrange better pay for those with the poorest skills and commercial background largely accounts for the extraordinary unemployment among disadvantaged workers. In the efficiency-wage theory of involuntary unemployment, summarized earlier, considerations of employee incentives drive wages above market-clearing levels and thus create an equilibrium volume (or path) of involuntary unemployment. As noted, the unemployment is widest among the most disadvantaged, in pyramid fashion. In a society rich enough to put up a safety net, the widespread availability of welfare entitlements and access to those of family and partners undermines the interest of the disadvantaged in careful and sustained performance at work, and this diminished attachment to jobholding ultimately increases the shortage of jobs.

This unemployment results in some resource waste. Up to a point, measures operating to raise the employment of the disadvantaged by raising the demand for their services could generate enough tax revenue and savings in welfare entitlements (at fixed tax and entitlement rates) to pay for the wage subsidies. Some subsidy could be justified purely on efficiency grounds. The catch is that those who would have to finance it are already facing high tax rates to finance the welfare state and various public expenditures such as national defense. Hence, there is a first-order efficiency loss from still higher tax rates to be weighed in the balance.

Community Effects.—In several ways the dismal wage rates of very disadvantaged workers and the acute shortage of jobs attack the vitality of the whole economy. The relatively very low wages and shortfall of jobs available to the more disadvantaged workers push the more susceptible of them into intermittent criminal opportunities, which are much more plentiful and vastly better paying. For example, the supply of illicit drugs is thus stimulated, which operates to turn on a demand. The result is harm to others—external diseconomies. A subsidy to increase the demand for disadvantaged labor in legitimate enterprises would be a valuable step in the opposite direction.

The plight of very disadvantaged workers also operates to undermine the performance and initiative of others. When parents and older relatives are frequently unemployed, and hence often dependent on welfare, a child is not provided with the role models from which to acquire the habits of initiative and responsibility needed for realizing his or her potential in legitimate business. A culture of passivity may thus develop. Also, some disadvantaged workers, lacking access to most business enterprises, must feel cut off from the economic mainstream, so a culture of alienation may also develop. Furthermore, as noted earlier, to be very disadvantaged in a society rich enough to put up a comfortable safety net means that there is rather little distance between the outcome one can hope for by knocking oneself out and the average expectation for other people in the same situation; so a sense of powerlessness—little power to do better—must overtake many of the disadvantaged. Drug use is intensified, and the addiction induces the user to turn into a supplier recruiting new addicts to support the addiction. This surrender to alternative life styles spawns inappropriate role models, making it more difficult for children, and even friends if exposed on all sides, to stay clear of these pursuits. Thus a culture of criminality may result as well. Then incidents of violence become common. As the bleak prospects of the disadvantaged reduces what they are willing to pay for their own lives, it also reduces the value they place on others' lives as well. It would be surprising if some of the disadvantaged, feeling they were being shown a lack of respect by society, did not seek "respect" through the use of guns.

If for no other reason than these external diseconomies, thus sheer self-preservation, we all have an interest in collective action to improve the opportunities for disadvantaged workers.

III. Concluding Remarks

There exist, in reality or on paper, several kinds of low-wage subsidy schemes (see Robert H. Haveman and John L. Palmer, 1982). The American scheme in place is the earned-income tax credit. Its drawback is that, in increasing labor supply, it lowers the wage paid by employers, which is costly to those not covered by the program (workers without children), many of them just as disadvantaged, and of symbolic importance even to those in the program.

Some other proposed schemes each offer a category of workers (recipients of an unemployment benefit or other welfare benefit) the right to exchange it at a firm in return for a job. These categorical schemes have the drawback that they privilege some persons (the unemployed or welfare recipients) in the competition for jobs at the expense of others with no less a moral claim.

A more equitable and no less feasible scheme is a graduated subsidy based on the wage paid to all employees, new and old alike, in all categories. It would entail a large budgetary outlay. But the savings in welfare outlays, unemployment benefits, crime-fighting, and the increased tax revenues flowing in might counterbalance the budget.

In the meantime, it would be a natural step to institute budgetization, or fiscalization, of all or most of the payroll taxes paid by employers on their low-wage workers, as the French are talking of doing. Such a step would at once increase the demand for such workers, lowering their unemployment rates and lifting their wage rates.

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