STATEMENT

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On

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Mr. Chairman and members of the Commission, I am pleased to have this opportunity to appear before you to discuss an aspect of taxation on which I have thought long and hard.

My theme is the beneficial effects that would accrue from introducing a system of subsidies (in the form of tax credits) to firms in the private sector for their utilization of low-wage employees - a device usually termed "wage subsidies" - and, as a corollary, the destructive effects of existing payroll taxes.

I well understand that the Commission is charged with recommending how best to reduce the myriad preferences, disincentives and complexities in the present tax code, and how best to design the tax-rate reductions that would then become feasible.

I want you to know, therefore, that I have long championed market capitalism - private ownership and free enterprise. So I am entirely sympathetic with the desire to set tax rates so as to preserve incentives for private saving and investment to the greatest extent possible, thus to achieve the maximum possible economic growth. Of course, such a formulation of the "optimal tax" problem takes as given some specified government budget (and the planned budgetary deficit) with its various planned subsidies, expenditures and transfers.

In practice, though, the separation between subsidies and taxes is often breached. It is sometimes more convenient or prudent for the government to subsidize certain private activities implicitly through *tax credits* or through *reduced tax rates* or both. So while it might seem that my argument for wage subsidies paid to private
firms for their employ of low-wage workers should not be brought before the Tax Reform Commission (it should await some future Commission on Subsidies and Expenditures), the intense discussion of radical tax reform

now going on is an opportune occasion for me to make the case for low-wage subsidies/tax credits.

The Number One social problem in the country is the conditions among the disadvantaged part of the labor force - not just the poverty and the high unemployment (which magnifies the poverty) but also their outlook on life: the feeling of exclusion that the deprivation and idleness tend to create, especially among the young, and the feeling of powerlessness that results from dependency on family, charity and the welfare system. This dispiriting culture of poverty is apt to lead in turn to poor employee morale - low job attachment and problematic job performance, to drug abuse, to drug trade, and to a criminal element, all of which make the underlying conditions still worse. This is a problem for the rest of society as well as for the disadvantaged themselves.

In my opinion, this problem is a direct outgrowth of the meager wage rates available to disadvantaged workers. (The decline of values, such as self-reliance and respectability are a result, not a cause.) Low wages do not in themselves generate social pathologies, it is true. But damage results when the wages of disadvantaged workers are very low *relative* to their *nonwage* resources - their *private wealth* (to the extent they own assets) and, very important, their *social wealth* in the form of benefits under the welfare system (under this or that circumstance). Such relatively low wages undermine the worker's incentive to get a job or stay in the job or get a better one. What the person can do to improve his or her situation, short of Herculean efforts and a lot of luck, will make only a small difference (though some will do those things anyway, of course).

If, therefore, we are to establish economic self-support and integration of disadvantaged workers, and thus restore a culture of self-reliance and achievement, we will need a radical improvement in the rewards to their employment.

The nation's tax laws, unfortunately, have reduced further the wage to the working poor in choosing to finance a broad range of entitlement programs through payroll taxes that are structured to hit low-wage workers very hard. Repeatedly the economics profession has found evidence that the so-called incidence of such taxes fall preponderantly - indeed, virtually entirely - on the wage net of tax received by the employee. My own recent work, reported in my 1994 monograph *Structural Slumps* (Harvard University Press), finds also a negative effect on employment - in particular, an increased unemployment rate.

Recognition in the 1980s of the burdensomeness of payroll taxes on low-wage workers led to the enactment of the Earned Income Tax Credit, though originally it was seen as justified only if the earner was a parent with one or more dependent children. The scheme has at least three defects: (1) Insofar as people eligible for EITC supply more labor to earn a larger tax credit, they drive down the market wage (the wage on their paycheck), which is costly to workers earning that wage who are not covered by the program and of symbolic importance even to those covered by the problem, who want to feel their work is worth something; so the net stimulus to total employment may be small. (2) The decision of two eligible persons, both with low hourly wage rates, to work three months or work an extra three months would bring in a smaller tax credit to the person whose weekly wage is the lower of the two; so over the range of very low wage rates, the EITC tends to help least those whose wage is lowest. (3) To limit the cost, the size of the tax credit is designed to taper off with increased annual earnings beyond some threshold; so in that higher-wage range, a decision to work more would reduce the tax credit received - an implicit tax rate on top of the existing payroll tax rates.

The other fiscal approach to the problem of disadvantaged workers, which must go back as far as the income tax itself, is the exemption of all personal income below some threshold level. (Advocates of the flat tax propose a major hike of this cut-off to ensure that middle-income people are not net losers from the elimination or capping of many deductions.) The defects of this exemption as a solution to the problem are obvious: (2) In exempting the $5 an hour worker from the flat tax rate - say, 15 % to take a convenient figure - it rescues him from a cut of his wage after income tax to $4.25 (currently the statutory minimum wage) but does nothing to *pull up* wage rates (after tax); so it does not do what needs to be done - to *raise* wage rates of low-wage workers in order to make it possible for them to end their poverty by working in the market economy and thus contributing to society. (2) It awards the same tax relief to a median wage earner - a $10 an hour worker - who decides to work half the year on average as it awards to a $5 an hour worker willing to work in a full-time job the year around - and, for that matter, as it awards to a hippie choosing to live on interest, gifts, charity and welfare amounting to the same income per year; so, viewed as a means to preserve incentives to work among low-wage workers, it is far from cost-effective: for every dollar it awards disadvantaged workers it spreads many more dollars among median-wage, highwage, and non-wage persons.

Thus the two existing approaches, the EITC and the exemption, are ill-suited to the crucial task of engineering a radical improvement in the rewards from work available to low-wage workers.

The best solution that I see is the introduction of wage subsidies that would induce employers to raise the employment and ultimately the wage rates of low-wage workers. The illustrative scheme I have analyzed at some length would raise to $7 an hour the wage in jobs, or tasks, now paying $4 an hour (because the productivity of those activities is $4 an hour); it would raise to $7.50 an hour the wage in jobs previously paying $5 an hour; jobs paying $6 would go to $8, and so forth. This is engineered through a declining schedule of matching grant to the employer (in the form of a tax credit): for every employee the firm pays $7 an hour the government would grant the firm $3 an hour, reducing the firm's cost to $4 an hour; for employees paid $8 an hour the firm would be granted only $2 an hour, reducing the firm's cost to $6 an hour, and so forth. In effect the government is adding (on a sliding scale) a bonus to the firm on top of the productivity these workers have for the firm. As a practical matter, the scheme might best be restricted to full-time jobs in the private sector, and its administration integrated with the collection of payroll taxes (if they are left in place).

The usual apprehension about this approach is that it would give disadvantaged workers an unfair advantage over the less disadvantaged. Why employ two productive workers when it becomes cheaper to use five unproductive workers to eke out the same output? But this way of thinking appears to be based on thinking in terms of a single firm for which the tax credits are uniquely available. In the economy as a whole, the wages of the less disadvantaged will sink only if their physical productivity sinks as a result of the influx of the more disadvantaged. And the entire workforce of disadvantaged workers is too puny in productive power to be able to depress perceptibly the productivity of the less disadvantaged.

Of course, under this scheme firms would be motivated to represent as many of their employees as bottom-wage workers as is credible (to maximize the total tax credit) - just as firms paying payroll taxes would like to represent their wage bill as a payment to a few very high-wage employees (to minimize payment of the payroll tax). As with tax collection in general, an enforcement mechanism is necessary to guard against fraud.

The all-government budgetary cost of this tax credit system would be on the order of $100 billion per year *minus* the social-welfare and law-enforcement expenditures made unnecessary by the major increase in earnings among low-wage workers and *minus* the tax revenues generated by the extra output produced by the increase of employment that is generated.

I hope the Commission will consider seriously the arguments I have tried to make here.