

## From Welfare to Wage Subsidy

*Edmund S. Phelps, Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise, Harvard University Press, Cambridge, Mass., 1997*

*Reviewed by Tim Maloney*

**W**AGE inequality among US workers has increased substantially over recent decades. Edmund Phelps's remedy for this predicament is to use employment subsidies to lift the wages of the poorest workers. He argues that the problem can no longer be ignored, and that employment subsidies are preferable to other government policies that could be adopted to deal with it.

*Rewarding Work* is aimed at a general, non-academic audience. The author, an economics professor at Columbia University, refers only in passing to economic theories that could either support or refute his conclusions. Detailed empirical evidence is almost non-existent. Phelps offers no new historical evidence on the increasing wage inequality in the US. However, this is not a criticism of the work; rising wage inequality has been well documented by others. Phelps takes its existence as given, and seems to believe that we don't need to worry about the specific factors that are responsible for it (such as technological change or free trade).

Phelps argues convincingly that rising inequality should be of great concern. Since the early 1970s, wages for the low-skilled and poorly educated have fallen substantially in real terms, while increasing markedly for the high-skilled and well educated. Market work and the receipt of a 'living wage' are necessary for normal, healthy life. Falling wages lead to lower household income and standards of living. It also hurts the self-esteem of the low-paid, reduces their participation in the community, and undermines social cohesion. Low wages and poor employment prospects create a sense of exclusion, powerlessness and despair. The deterioration in the position of America's second-class workers thus creates negative externalities for society, such as increasing crime, drug and alcohol addiction, welfare dependence and parental failure.

Who or what is to blame for rising wage inequality? Typically for an economist, Phelps refuses to attribute it to attitudinal changes or shifting cultural factors. Although I think he is correct, he doesn't provide any direct evidence that would lead the non-economist to the same conclusion. The best that can be said is that two other factors are more apparent. The first is structural change in the US economy over recent decades, such as a growing reliance on information technology, reductions in trade barriers and economic globalisation. The second is the rise of the welfare state. Welfare 'devalues' work and reduces 'job attachments', which reduces morale, undermines the work ethic, and results in criminality and drug use. Phelps argues that his proposed employment subsidies would, in contrast, promote independence, self-reliance and social cohesion.

This analysis has two problems. First, although real wages for the disadvantaged have declined since the early 1970s, they haven't declined relative to the wages

received by similar workers in the 1950s. As Phelps admits, the decline in living standards attributed to lower wages over this longer period should be viewed as relative rather than absolute. But this weakens Phelps's claim that lower wages lead to increased criminality, drug and alcohol use, and welfare dependence.

Second, Phelps's claim that welfare programs are among the key factors behind the declining relative position of the poor is unsubstantiated by evidence. To claim that welfare programs *worsen* the position of the poor implies that the positive redistributive effects of welfare programs are more than offset by negative behavioural consequences that reduce households' current and future earning capacities. One advantage of welfare programs is that they directly target household income, whereas raising *individual* wages through employment subsidies does not necessarily raise the living standards of the poorest households. Although the incentive effects of welfare are clearly problematic (and current US welfare reforms seem to address at least some of them), welfare is relatively more 'target efficient' than wage subsidies.

Phelps's proposed direct wage subsidies (for example, an employer who pays a worker US\$4 an hour might receive a subsidy of \$3 an hour) would taper off as the wage increased, disappearing almost entirely by the time it reached \$12 an hour. Its estimated cost of US\$125 billion would be offset by reductions in expenditures on welfare, Medicaid, police, judicial and correctional services; by increasing tax revenues; and by making possible the elimination of the Earned Income Tax Credit. It could even increase the productivity of the entire workforce. Wage subsidies would be preferable to increasing the minimum wage (which discourages employment), providing public-sector jobs (which creates a two-tier wage system for the disadvantaged, discouraging job attachment in the private sector), promoting training and education (which helps only in the long run and is ineffective among the disadvantaged), expanding welfare programs (which discourages positive behaviour) or pushing for faster economic growth (which may worsen, rather than improve, the lot of the poor).

Employment subsidies for low-paid workers are not a novel idea. For example, in the 1970s the Work Incentive Tax Credit gave US employers a 20 per cent tax credit for hiring welfare recipients. It is unclear why Phelps does not acknowledge the existence of these earlier employment subsidies, or survey the literature on their possible effects in the labour market (for example, Palmer, 1978; Haveman & Palmer, 1982).

I have three problems with Phelps's discussion of his proposed low-wage employment subsidy. First, the details of the program are sketchy in places, and not very well thought out in others. An example of the latter is the proposed limitation of the subsidy to full-time low-paid jobs. What is wrong with subsidising part-time work, especially of women with children at home? Do we want employers to reduce the availability of such jobs? Phelps also argues that firms should not have to report hours of work, but simply declare that a job is full-time (say, 35 or more hours a week) to receive a fixed subsidy. This would provide clear incentives for firms to create jobs with the minimum number of hours necessary to qualify for the

'full-time' subsidy. Do we want artificially to restrict workers' choice in hours of work per week?

Second, there is an underlying tension in the book between employment subsidies and human capital investments in training and education. Phelps dismisses public subsidies for training and education as an alternative policy for raising the earnings of low-wage workers. Such policies, he claims, provide little immediate relief; forecasts of the type of training or education that will be needed in the future are difficult to make; and, most damning of all, the payoffs from such investments among the disadvantaged are exceedingly low. Yet human capital investments overcome one of the key drawbacks of employment subsidies. It is possible to raise the earnings of the poor without increasing their productivity; but training and education raise can raise their earnings *by* increasing their productivity. Worst of all, employment subsidies might discourage the accumulation of human capital, since narrowing the wage distribution reduces the incentives of individuals to pay for training and education. Because employment subsidies decline with higher wages, firms also have fewer incentives to train their workforces. For modern economies that will rely heavily on increasing their stock of human capital, this is potentially a serious disadvantage of employment subsidies.

Third, Phelps claims that employment subsidies would enhance participation in the community and increase social cohesion. Yet Burtless (1985) and others have concluded that eligibility for employment subsidies can have a stigmatising effect on low-wage workers.

Phelps concludes by addressing the likely criticisms of his proposals. He considers 'perversity objections', or the possibility that any policy may have a variety of unintended, negative consequences. The possibility, mentioned above, that employment subsidies might discourage human capital accumulation is one such objection. Employment subsidies raise the earnings and well-being of the poorest segments of society; yet they encourage employment in the least productive sectors of the economy. It is unclear whether the overall gains to society from a low-wage employment subsidy would outweigh the negative side-effects.

I hope that Phelps's book promotes more discussion of, and research into, low-wage employment subsidies. Although I am not convinced that such policies would be preferable to those that would promote training and education, growing wage inequality in the US is a problem and all policy options should be explored.

## References

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