Temporary Wage Subsidies

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Providing fiscal or tax subsidies to try to promote additional work and saving is a relatively modern notion. These subsidies may stimulate demand by putting more money in the economy, but they are designed primarily to affect behavior through incentives. Modern industrial economies like the U.S. over time have enacted fiscal subsidy programs within three general categories: permanent capital subsidies, temporary capital subsidies, and permanent labor subsidies. Left off the table consistently has been a fourth option that logically completes the list: temporary labor subsidies. Yet during a downturn this fourth type of option might uniquely be able to provide the best combination of economic incentives for an expanding economy and a fair distribution of the stimulus benefits.

Permanent capital subsidies have been proposed and adopted many times by the U.S. and other nations. Often they take the form of investment credits or permanent accelerations of depreciation allowances. Tax reform in the United States in 1986 moved against the permanent use of subsidies attempting to favor one type of capital or another and proposed instead simply to lower tax rates at both the corporate and individual level. Still, proposals are common to reinstate permanent subsidies in the form of accelerated depreciation, expensing of equipment purchases, or permanent enactment of credits for research. The argument behind these subsidies is that they will permanently increase the capital stock of the nation, thereby leading to a higher level of income.

Permanent wage subsidies have also played a major role in tax policy in recent decades and are symbolized best by the earned income tax credit (EITC). This credit, first enacted in 1975 and expanded significantly since then, provides a stimulus by supplementing earnings for those with modest or no wages. The design of the refundable child credit also provides some stimulus to work at lower wage levels since it effectively phases in for earnings above $10,000 offsetting disincentives to work from the EITC phaseout. Many economists would argue that these provisions provide a net work subsidy when compared to welfare programs that heavily penalize any work by taxing away the benefits almost as soon as one starts earning income. The case is not perfect: Opponents stress the extent to which the credit eventually is phased out, and in those higher earnings ranges, acts like a tax and discourages work. My purpose here, however, is simply to note that a prime rationale for these types of subsidies is to provide permanent work incentives.

During a recession or economic downturn, the debate often turns from permanent to temporary subsidies. In the debate over an economic stimulus package to deal with the 2001 recession, both Republicans and Democrats have suggested that accelerated depreciation allowances be granted temporarily for purchases of physical capital in the near term. These subsidies would later be eliminated, thereby encouraging a speedup of investment from the future into the current period.

If temporary capital subsidies make sense on occasion, however, why not temporary wage subsidies? Seldom, if ever, have they been proposed. Yet they would respond to the most commonly recognized feature of a recession — unemployment. In many ways they represent a market-based and partial alternative to government as employer of last resort. The disadvantage of this tried but generally rejected alternative is that the jobs created arbitrarily by government are seldom the ones needed by the economy, thus delaying the adjustment process and often creating little value for the money. Wage subsidies, on the other hand, are designed to let the marketplace determine where work is likely to be most productive.

Government does provide subsidies for unemployed labor — but only if people stay unemployed. Unemployment insurance is often expanded in a recession in recognition of the greater difficulty in finding jobs and in compassionate recognition of the needs of the unemployed. And, like any other fiscal policy simply to increase demand, it does put money in the economy. However, when considered from the subsidy or incentive side, it actually tends to prolong a recession since it subsidizes remaining unemployed. Thus, there

are limits in how high these subsidies can be made.

So far we have been examining capital and labor subsidies from the standpoint of whether they are temporary or permanent. One can also divide up capital and labor subsidies by whether they (1) subsidize unemployed capital; (2) subsidize the employment of capital; (3) subsidize unemployed labor; or (4) subsidize the employment of labor. In the stimulus bills that were debated in Congress to deal with the recent recession, much attention has been paid to the first three. In particular, one can argue that provisions to reduce the corporate AMT, expense a portion of capital purchases, and provide higher unemployment compensation are respectively devoted to the first three efforts.

Last year, however, there was a proposal directed to the employment of labor, although given only modest attention. Senator Pete Domenici, R-N.M., suggested that there be the equivalent of a temporary reduction in the social security tax as applied to wages. Legitimate debate followed on the overall effectiveness of this particular proposal and on how social security trust funds could remain unaffected. Irrespective, the suggestion was bold and novel and moved beyond the traditional methods of providing subsidies in a recession.

Consider, in particular, one major advantage of a temporary wage subsidy relative to other alternatives that might spend the same amount of money. Only it combines in one proposal three elements. First, it is temporary, thus creating little long-term threat to the budget. Second, it would stimulate the employment of labor, as opposed to its unemployment. Third, its immediate benefits would be distributed among the working class rather than among individuals with greater amounts of wealth.

One argument against a temporary wage subsidy at the end of 2001 or later is that there is already enough stimulus and we are already coming out of the recession. If so, its time — as well as the time of other stimulus proposals — may already have passed. In thinking about the future, however, there is no reason that temporary wage subsidies could not be designed to kick in once unemployment rates rise above a given level. An automatic mechanism would avoid the traditional criticism of discretionary fiscal policy — that by the time Congress gets around to enactment and taxpayers are able to implement the change, the recovery is already well underway. Thus, an automatic subsidy would fade out as the unemployment rate declined and be strongest when most needed.

Temporary subsidies for the employment of labor are not perfect by any means. But if we are going to be spending money during economic downturns, it's time to give them as much of a hearing as other forms of capital and labor subsidies. After all, the defining problem of a downturn is the temporary underemployment of labor.

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