Designing Wage Subsidies: when and how?

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Any transfer to reduce the cost of labor to employers or increase the earnings of employees...

... they come in many "flavors":

- Employer vs employee
- Transfers vs tax-credits
- Different formulas, levels, and durations
- For current or new workers
- With or without conditionalities
Topics

• Rationale
• Impact
• Design
Rationale
Three different objectives

- Protect or create jobs
- Increase participation rates
- Improve the employability of workers
Protect or create jobs

Percent of countries implementing wage subsidies during the crisis

High income: 80%
Middle income: 30%
Problems

• Sustainability
• Substitution effects
• Death-weight losses
But what about in times of crisis?

- It's costly to fire and hire workers...
- ... if the problem is a temporary lack of demand why not help employers keep workers?
But what about in times of crisis?

- It's costly to fire and hire workers...

- ... if it is a temporary lack of demand why not help employers keep workers?

- It might be difficult to pick the right employers

- If the problem is demand, why not sustain it through fiscal policy?

- ... or, keep credit going and let the employers find financing to keep their workers employed while things get better?
Increase participation

- To help people "graduate" from welfare
  - USA New Jobs Tax Credit
- To increase participation rates of target groups (women, youth):
  - India ENREGA
Can we justify these costs based on expected social gains?

• The subsidy reduces dependence from welfare -- better pay people who are working

• It is important to have more females participate in the labor market
Can we justify these costs based on expected social gains?

- The subsidy can reduce dependence from welfare -- better pay people who are working
- It is important to have more females participate in the labor market
- There is a question of whether welfare benefits are too high; subsidies cannot be implemented forever
- A negative income tax, though, can indeed help protect low income workers (but then the issue is not job creation)...
- Subsidizing work among inactive women can reduce employment among active women (unless public)
Improving employability

Productivity

Minimum cost of labor

t1

Time
Improving employability

Productivity

Minimum cost of labor

Time

$t_1$ to $t_N$
Improving employability

Productivity

Minimum cost of labor

COST

\( t_1 \)

\( t_N \)

Time
Improving employability

Productivity

Minimum cost of labor

COST

Time

t1

tN

Cost
But maybe subsidies then do less...

Changes in Shares if WSs are eliminated

- Self-employment
- Formal
- Informal
- Unemployment
- Unemployment of eligible

TUNISIA wage subsidy for youth
... than reducing the minimum wage?

<table>
<thead>
<tr>
<th>Category</th>
<th>Changes in Shares if MG is eliminated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employment</td>
<td>-0.06</td>
</tr>
<tr>
<td>Formal</td>
<td>-0.045</td>
</tr>
<tr>
<td>Informal</td>
<td>-0.03</td>
</tr>
<tr>
<td>Unemployment</td>
<td>-0.015</td>
</tr>
<tr>
<td>Unemployment of eligible</td>
<td>0</td>
</tr>
</tbody>
</table>

TUNISIA minimum wage for youth
What if minimum labor costs are not an issue?
Employers are unlikely to hire inexperienced workers

- Even if wages can be lower, there are risks involved (benefits might come or not in the future)

- There might also be additional costs of training (with the risk of poaching)

- The wage at which it can be a "good investment" to hire -- compensating from delayed, risky benefits, and additional costs -- can be too low
Impacts
The evidence

- The Tax-wedge
- Studies in OECD
- Studies in MICs
Tax-wedge
Tax-wedge

The difference between the total cost of labor and take-home pay

\[
\text{Tax Wedge} = \ W \cdot (1+\text{taxE}) - \ W \cdot (1-\text{taxW})
\]

\[\text{W: wage} \]
\[\text{taxE: taxes paid by employer (social security contributions)} \]
\[\text{taxW: taxes paid by workers} \]
Reducing the tax wedge increases formal employment.
<table>
<thead>
<tr>
<th>Program</th>
<th>Target group</th>
<th>Impact</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Targeted Jobs Tax Credit (TJTC) - USA</td>
<td>23-24</td>
<td>3.4pp increase in employment or 7.7%</td>
<td>Katz (1998)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DW: 40-52%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cost USD 1,500</td>
<td></td>
</tr>
<tr>
<td>TJTC</td>
<td>23-24</td>
<td>DW: 75%</td>
<td>Bishop (1999)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cost: USD 5,000-11,000</td>
<td></td>
</tr>
<tr>
<td>Earned Income Tax Credit (EITC) - USA</td>
<td>Welfare recipients</td>
<td>3.4% increase in earning &amp; 5.6% increase in employment</td>
<td>Hotz (2006)</td>
</tr>
<tr>
<td>Jobs Training Partnership Act - USA</td>
<td>Low income</td>
<td>No effect on youth or adult men</td>
<td>Orr et al. (1996)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>15% increase in earnings among women</td>
<td></td>
</tr>
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</tr>
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<tr>
<td>Working Tax Credit - UK</td>
<td>Low income</td>
<td>3.5-4% in labor supply among lone parents</td>
<td>Blundell (2006)</td>
</tr>
<tr>
<td>New Deal for Young People - UK</td>
<td>18-24</td>
<td>-20% in unemployment</td>
<td>Dorsett (2006)</td>
</tr>
<tr>
<td>Progressive payroll - France</td>
<td>Low income</td>
<td>No impact</td>
<td>Kramarz and Philippon (2001)</td>
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Rule of thumb

Labor supply elasticity = 0.75

Labor demand elasticity = -0.5

A 10% wage subsidy would increase employment by 3% and wages by 4%
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<tr>
<td>Wage Voucher for Women - Jordan</td>
<td>Women</td>
<td>40% increase in formal employment -- effect dissipates after 4 months</td>
<td>Groh (2012)</td>
</tr>
<tr>
<td>Wage Voucher for Youth - South Africa</td>
<td>Youth</td>
<td>7pp increase in wage employment -- persisted after 2 years</td>
<td>Levinsohn (2013)</td>
</tr>
</tbody>
</table>
Main observations

- In general, positive impacts on employment
- Much depends on the targeted group and design
- But most evaluations do not look at substitution effects and DW losses
- Subsidies cannot sustain employment creation...
- Might not be the best alternative to protect or create jobs during a crisis...
- ... but can be a policy instrument to improve employability (DW matter less)
Policy choices

- Target Population
- Payment to Employers or Employees
- Calculation of the Subsidy
- Conditionalities
Policy choices

TARGET POPULATION

Focus on the objective of improving employability

Target first time job seekers and the long-term unemployed

If there is a need for direct temporary job creation, use public works and services...
Policy choices

If the objective is to promote employability through OJT you need to reduce the cost of labor

This implies that the subsidy goes to the employer

But it should follow the work (use vouchers)
Policy choices

Which formula?
- Flat amount (e.g., internships)
- % of the min cost of labor
- % varies with individual characteristics
- Percentage of negotiated wages up to a maximum

What is the value?

What is the duration?
Formula depends on problem / target group

Productivity/wages

Minimum cost of labor

Skills
Formula depends on problem / target group

Productivity/wages

- Percentage of min cost of labor could work
- Percentage of negotiated wages
- Minimum cost of labor
Formula depends on problem / target group

Productivity/wages

- But no clear rule for the LEVEL
- For the DURATION, no learning if less than 9 months

Percentage of min cost of labor could work

Percentage of negotiated wages

Minimum cost of labor
Policy choices

It is important to have conditionalities on employers and employees

EMPLOYERS:
- So that job/internship matches expectations
- To control substitution effects
- Promote more learning and risk-taking (condition the duration)

EMPLOYEES:
- To participate in other ALMPs
Take aways...

• Programs can have a role to play in improving employability

• A difficulty is finding the right level and duration...

• ... and controlling substitution effects

• Because of the uncertainty on impacts it is important to pilot & evaluate between full scale implementation