Wage Subsidies

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Abstract

The Committee on Employment Opportunities viewed temporary wage subsidies as a means through which the current long-term unemployed could be brought back into the effective labour supply. Experience with wage subsidies suggests that they will lead to minimal job creation and a churning of the pool of unemployment.

The Committee on Employment Opportunities has placed considerable faith in the ability of wage subsidies to deliver worthwhile jobs to the long-term unemployed within its Job Compact. It viewed the current JOBSTART programme as a key component of its preferred policy option. JOBSTART is a graduated wage subsidy package where the subsidy payments vary according to the duration of unemployment of the job seeker.

This comment on the proposal of the Committee on Employment Opportunities is organised around four inter-related issues. First, we provide brief background information on job subsidies in the context of the Report of the Committee on Employment Opportunities. Second, we provide information on the conventional wisdom concerning the way wage subsidies work. Third, the success or otherwise of wage subsidies in the past is evaluated. Fourth, the issue of whether it is reasonable to expect wage subsidies to be effective under the Job Compact is addressed.

1. The Job Compact

Around one million Australians are unemployed. The Committee on Employment Opportunities identified changes in wage costs relative to productivity as one cause of this problem. Specifically, real wages are too high and cannot be adjusted downward in the market. Redressing this cause of the

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unemployment problem essentially means attempting to wind back labour costs while maintaining productivity. The most effective way, in theory, to deal with this problem is to eliminate the rigid award structures that appear to be the major impediment to the wage movements: otherwise the problem will occur time and time again [see Freebairn, Porter and Walsh (1987)]. An alternative is to rely upon a social contract, such as the Prices and Incomes Accord, to deliver lower real wages. The Prices and Incomes Accord is generally described as a consensual incomes policy where the interest of the unemployed is taken into account when determining the wage outcome. Recent experience suggests that the social contract alternative may be viable.

However, while recognising that employment is sensitive to wage costs, the Committee did not see a general real wage reduction as a practical alternative (p. 54). It argued that the employment elasticity with respect to the real wage is about 0.75, implying that a real wage cut in the order of 8 per cent would be required to increase employment by 6 per cent. It suggested that nominal wage cuts would lead to price reductions that offset, in part or in whole, the nominal wage reduction. The Committee also argued that large real wage cuts would not be socially acceptable (but the Accord delivered real wage cuts!), and that they would not deliver jobs to the long-term unemployed: instead the extra jobs created would mostly be taken up by individuals currently outside of the labour market. The Committee is possibly correct on the last count.

A second approach to correcting the unemployment problem, which is a longer-term proposition, is to provide the foundations for a more productive workforce that would be competitive at the going wage rate. Given that the problem is that wage costs are too high relative to productivity, this alternative simply amounts to a focus other than the cutting of real wages. It has been favoured by a number of writers. For example, Smith (1981), in the context of the youth unemployment problem, states: 'the main goal should be the preparation of disadvantaged youth for long-term success in the labour market, rather than the reduction of youth unemployment per se'. This is suggesting that the long-term unemployed are in that state mainly because of some easily identifiable characteristics (e.g., low levels of education, low ability, absence of work-related skills). If this is indeed the case, remedial programs (e.g., TAFE courses), would seem to be superior. In Chapter 3 of its report the Committee on Employment Opportunities gives ample consideration to the training requirements of the Australian labour force.

Because the Committee did not wish to entertain the idea of real wage cuts, and due to the longer-term nature of any package that attempts to increase productivity, either in general through workplace bargaining or microeconomic reform, or through more focused policies directed at the quality of labour, it has been forced to rely upon a bandaid solution to provide an immediate fix to the problem of the long-term unemployed. Wage subsidies are a core element of this solution.

2. Wage Subsidies: The Conventional Wisdom

Wage subsidy packages may be constructed in a number of different ways. Flat-rate and percentage subsidies typically provide the framework for analysis, though within each type modifications can be made to accommodate particular government policy. A brief review of basic wage subsidy schemes is provided here, together with comment on some of the ways the basic schemes can be altered.

a. **Flat Rate Subsidy:** The government, for distributional reasons (i.e., equity considerations) might guarantee that all workers will receive the current award, W^A. This guaranteed amount will be paid in part by the government in the form of a subsidy of W^S, and in part by the firm employing the worker. In this instance the firm's cost (W^M) would be $W^M = W^A - W^S$. Hence:

$$W^A = W^M + W^S$$

For example, if the current award rate of pay was \$300 per week, the government might pay a flat rate of \$100 per worker to firms employing any worker eligible for a subsidy, and the firm would be required to make up the difference. This then constitutes a direct substitution of funding from public sources (the tax payer) for funding from the firm's revenue. The amount of the subsidy could be permitted as a tax rebate, or it could be paid periodically to the firm, or it could be paid as an up-front lump sum if the government wished to make the scheme more attractive. Wage subsidies would typically be of limited duration, say six months to a year. The duration of the subsidy will be determined as a trade off: the longer the subsidy period the greater the benefit to the worker in terms of developing marketable skills, but the greater is the cost to the public purse. This trade-off is one that the Committee was acutely aware of.

b. **Percentage Subsidies:** The subsidy could also be paid as a percentage amount [see Bruce (1990), p. 441]. In this situation the government would guarantee an income that is lower than the current award (denoted by W^G). Then it would claw back this guaranteed income

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by a fraction β of every dollar the worker earned. Hence, the subsidy paid to any worker would be:

$W^S = W^G - \beta W^M$ provided that $\beta W^M < W^G$,
so that earnings would be

$W^M + W^S = W^M + W^G - \beta W^M = W^G + (1-\beta)W^M$ if $\beta W^M < W^G$
and W^M if $\beta W^M \geq W^G$.

For example, if the guaranteed rate of pay was \$200 and β was 0.6, a worker whose rate of pay from the firm was \$260 would receive a subsidy of \$44 = [(\$200 – 0.6(260)] and hence have total earnings of \$304.

Simpler forms of subsidy would involve the government reimbursing firms (say) one-half of the cost of employing an eligible worker, subject to an annual limit per worker. Where there is little variation in award rates for the group eligible for the subsidy, the flat rate and percentage amount forms of subsidy would be similar.

As noted, modifications to these general schemes are possible. For example, the subsidy could be paid only to certain members of the group, such as the long-term unemployed. Such a subsidy is termed a **selected** or **targeted** subsidy (c.f. a general subsidy). Elaborate versions of the targeted subsidy are possible. For example, the value of the subsidy could vary according to the identifiable characteristics of the group (e.g., length of unemployment, level of education). Note that, at the extreme, general subsidies might be paid in relation to workers already employed, a situation that would offer little prospect of substantial job generation. For this reason, further refinements are generally considered. Thus, the subsidy might only be paid when a firm hires new workers rather than on the employment of any worker who satisfied the eligibility requirements. This type of subsidy creates an incentive for firms to increase labour turnover and thus gives rise to a phenomenon termed 'churning'. Alternatively, the subsidy could be paid only when those employed represent net additions to a firm's work-force. This type of subsidy is termed a **marginal** employment subsidy, and it can be used to minimise churning. Views on the practicality of marginal employment subsidies differ greatly. Smith (1981, p. 7.16) states that they represent an unattainable scheme, while Pankhurst (1981, p. 8.13) suggests that '... there has been some success with controls to ensure that subsidies are only paid to an employer when there is a net increment in total employment'. For cost reasons, many wage subsidy schemes have been developed along the lines of marginal, targeted schemes.

3. Have Wage Subsidies Worked in the Past?

Evaluations of wage subsidy packages have typically considered a number of major issues. These are noted below. Specific comments in relation to the Job Compact are provided in Section four.

1. Wage subsidy schemes must be administered, and this will necessitate additional record keeping by firms and some bureaucratic apparatus. The magnitude of these costs is generally unknown, but their presence provides a reason why wage subsidy schemes should be as simple as possible. Accordingly, flat rate schemes have obvious merit in this context.

2. Wage subsidies will involve considerable costs to the government, with the major cost comprising the payments to firms. Public expenditure on subsidies will be offset by reduced public expenditure on welfare. There may also be higher direct and indirect tax revenue. The net impact on the government's budget does not appear to have been determined in overseas studies. In Australia, however, many labour market programs have been costed in recent years. Data presented in Chapter 4 of the Committee's Report indicate that for every dollar spent on JOBSTART wage subsidies, the government gets back 64 cents in reduced social security payments and higher tax receipts. This is a very encouraging ratio of saving to expenditure. Unfortunately, the formula from which the figure was derived was not listed, so the extent to which displacement effects are taken into account cannot be determined. (On this issue, see point 6 below).

3. To the extent that a wage subsidy scheme represents a net addition to government expenditure, there is a further cost that needs to be considered. Government funds must be raised and if this is done through income taxation (either through general income tax or a jobs levy) it will have a deadweight loss that is not experienced with wage cuts. Findlay and Jones (1982) estimate that the cost of raising an extra dollar through personal income taxation in Australia is between \$1.23 and \$1.65. In other words, if additional taxation revenue has to be raised to finance the wage subsidy programme, the cost is **not** simply the revenue raised. Consideration must also be given to efficiency costs of 23 per cent to 65 per cent of revenue raised.

4. If the choice is between a wage cut and a subsidy, then there are two effects on labour supply. First, compared to the wage cut, the wage subsidy scheme will be associated with a greater number of people participating in the labour force. Second, compared to the wage cut, the wage subsidy may be associated with a greater or smaller number

of hours worked among those who secure employment. The direction of impact here will depend on the shape of the hours of work schedule among the employed.

5. Pankhurst (1981, p. 8.13) has noted that the take-up rate in overseas wage subsidy programs has been unevenly distributed across the economy, with the incidence being greater in sectors in economic trouble. Consequently, it might be suggested that wage subsidies may hinder structural adjustment by reducing the re-allocation of labour. Freebairn, Porter and Walsh (1987) note that subsidies will tend to be more prevalent in labour-intensive industries characterised by product demand that is relatively responsive to price changes. In earlier wage subsidy schemes in Australia there was an over-representation in the manufacturing and retail industries. Similarly, in the JOBSTART scheme the subsidies have mainly been taken up in the manufacturing, retail and hospitality industries. This scheme excludes State and Commonwealth governments

6. Wage subsidies reduce the cost of employing a member of the target group. There can be expected to be two main types of effects. First, the employment level of the target group should rise. Second, to the extent that there are other groups competing for the available jobs who are substitutes for the target group, the employment levels of some other groups may decline. The magnitude of these effects may be determined through empirical study. The available evidence suggests:

   a. Demand for some groups, such as teenagers, is highly elastic, so wage reductions might be expected to lead to considerable increases in employment.

   b. There is limited knowledge of the demand elasticities for disadvantaged groups, and also of the inter-relationships between the demand for substitute groups like the long-term unemployed and the low-skilled employed. Knowledge of these interrelationships is important because of the possibility of displacement effects whereby a worker not eligible for a wage subsidy is displaced by a worker eligible for a wage subsidy. This displacement effect may be considerable. For example, it has been reported that up to 80 per cent of the subsidised positions under the Special Youth Employment Training Scheme that was initiated in 1976 were displacement-type positions [see Hoy (1983)]. Marginal employment subsidies can minimise the adverse consequences of the labour market package.

7. Stigmatising effects have been alluded to in the literature. As only members of the target group receive a subsidy, employers know that the eligible persons are 'disadvantaged' and thus may be less willing to hire them [see Burtless (1985)]. Smith (1981, p. 7.16), reflecting upon the poor response to the Target Jobs Tax Credit in the US, states that this 'may indicate that the requirement that the worker be economically disadvantaged offsets the potential saving ...'.
8. Wage subsidies may have adverse implications on skill formation. Essentially, wage subsidies are provided only on a temporary basis, whereas a wage reduction might be viewed as having a more permanent basis. Where training takes longer than the subsidy period, the incentive for skill formation might be reduced. This will be exacerbated where the skills are firm specific and the expected tenure of the job does not exceed the period of subsidy. A remedy for this would be to couple a wage subsidy with an incentive scheme for firms to offer training to the groups eligible for the subsidy.
9. The general impression is that, from the perspective of economic efficiency, wage subsidies should not be preferred over wage cuts. However, equity considerations give rise to a preference for targeted wage subsidies. That is, given that the longer-term unemployed have been identified by the government as a group that requires special assistance, the objective should be to find cost effective ways of helping them in a timely manner. Marginal, targeted wage subsidies may be useful in this regard. But this solution does not remove the need to increase the flexibility in the labour market through workplace reform.

4. Wage Subsidies in the Job Compact

The Committee on Employment Opportunities stated that 'the equity arguments for assisting long-term unemployed into jobs are well-known and compelling'. Temporary wage subsidies were seen as a means through which the current long-term unemployed could be brought back into the effective labour supply. To this end, the JOBSTART program was viewed as an essential component of the Job Compact.

However, some possible modifications to JOBSTART were flagged. Under the Job Compact, the number of JOBSTART places would be expanded by over 80,000. To achieve this growth, the Committee suggested that the public sector could be made eligible to participate in JOBSTART, and the level of subsidy could be increased. As stated on page 111 of the

Committee's Report, '... recent experience with JOBSTART has suggested that more employers will hire subsidised workers even in a downturn if the value of the subsidy is increased'.

How does the Committee's appraisal of wage subsidies compare with the check list provided in the previous section?

First, the costs of administration/compliance were not given prominence in the report. Some estimates of the administration costs of job subsidies would have been useful. To be fair, though, any scheme that attempts to improve the position of the long-term unemployed will have costs of administration, and the Job Compact does not appear to be overly complex.

Second, the Committee is to be commended for the way that it has set out to establish the net cost of job places under JOBSTART (pages 102-103). It has established the net cost of assistance and the net cost for each positive outcome. Moreover, it has attempted to document the reductions in social security payments and the increase in tax revenue associated with the JOBSTART program. Without a listing of the formula used in the calculations, however, it is impossible to know how complete they have been in their work. Do the calculations take account of displacement effects, for example?

Third, the Committee has ignored completely the efficiency costs of its financing proposals for its preferred package. To the extent that the earlier work by Findlay and Jones (1982) is correct, this aspect has the potential to raise the cost to the community of the Job Compact by up to 65 per cent.

Fourth, the Committee gave due consideration to the important role supply-side factors play in determining unemployment rates. Beyond this initial consideration, however, the Committee does not concern itself overly with the impact that its Job Compact will have on the number of people in the labour force. To some extent this is understandable, as the Job Compact has a focus on the long-term unemployed, which will tend to limit any net additions to the labour force.

Fifth, the Committee noted the concentration of job subsidy places in the manufacturing, retail and hospitality industries, and argued that a more widespread distribution of JOBSTART places might be needed if the program is to be expanded. Beyond the simple expedient of widening the scope of the JOBSTART program to include the government sector and tinkering with the level of subsidy, it did not tell us a great deal about how this could be done.

Sixth, the Committee was mindful that the Job Compact might lead to a churning of the pool of unemployed. The level of job creation is estimated at 15 to 20 per cent of subsidised places (p. 107). It also noted that 'During 1992-93 only 30 per cent remained with the subsidised employer 3 months after the subsidy ended'. One interpretation of this is that the temporary wage subsidy did not lead to a change in productivity that eliminated the root cause of the unemployment, namely that wage costs are too high relative to productivity.

Seventh, there is no real discussion of stigmatising effects. In an earlier study by Miller and Volker (1987) the scar effect of a history of joblessness was shown to be an important determinant of the incidence of unemployment. Moreover, in one of the earliest attempts to predict the risk of long-term unemployment, Miller and Volker show that the scar effect is important. Whether this sort of scar effect carries over to program participation is of interest.

Eighth, the importance of skill formation is recognised throughout the Committee's report. However, it states that 'imposing a training requirement as part of JOBSTART will probably reduce employer interest in the scheme'. It seems that the JOBSTART program could be interacted with the requirements of the Training Guarantee. For example, training provided to participants in labour market programs could be given a 'double plus allowance' towards the firm's obligations under the Training Guarantee. This proposal would increase skill formation among the long-term unemployed and possibly encourage firms to retain program participants after their subsidy ends.

In summary, the Committee's Report is based largely on finding a cost-effective way of implementing an objective that arises out of equity considerations. The arguments in favour of subsidies are incomplete in a number of respects, as indicated above. But, as a document aimed at stimulating public discussion rather than academic debate, the Report of the Committee on Employment Opportunities has much to recommend it.

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