issue brief

The Wage Subsidy: A Better Way to Help the Poor

Oren Cass August 25, 2015
Urban PolicyWelfare
OtherPoverty
EconomicsTax

Executive Summary

As contentious debate proceeds about the extent and causes of wage stagnation on the lower rungs of America's economy, efforts have increased across the political spectrum to improve the economic fortunes of low-wage workers. In particular, policymakers have focused on making work more attractive. This approach, unlike most expansions of the welfare state, holds the promise of increasing the immediate well-being of the working poor, as well as the incentive of the nonworking poor to find jobs.

Two wage-support tools typically receive consideration: the minimum wage and the Earned Income Tax Credit (EITC). Both have the potential to significantly increase disposable income for at least some low-income workers. But their mechanisms—and impact—differ dramatically. The minimum wage, a price floor under wages, performs well vis-à-vis an individual worker but poorly in its labor-market and distributional effects. The EITC, a subsidy for income earned, has strengths and weaknesses roughly the opposite. The drawbacks of both tools prevent them from delivering fully on their antipoverty goals.

Any discussion of wage-support options should include a third policy tool with the potential to deliver the best of both worlds: a wage subsidy delivered directly to low-wage workers, via their paychecks, as additional dollars per hour for every hour worked. (The EITC, while commonly called a "wage subsidy," is not one. It is a tax credit paid after the fact on total income earned; a wage subsidy is paid in real time for each hour worked.)

Through its effect on wages paid, the wage subsidy would deliver to workers much the same benefit as a minimum wage. Through its effect on the economics of the low-wage employment relationship, it would influence the labor market in much the same way as the EITC. Its structure is thus preferable for the unemployed, for workers, for employers, and for society.

Variations of the wage subsidy have been proposed previously and have appeared prohibitively expensive. Nobel laureate Edmund Phelps's 1997 book, *Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise*, offers a detailed wage-subsidy proposal with an annual cost of $185 billion. In fact, the money needed for a large wage-subsidy program is available because the U.S. government already spends it—on a growing EITC and on various other safety-net programs that provide in-kind benefits to the working poor. A recent University of California at Berkeley study, for instance, found that federal and state governments spend more than $150 billion annually on benefits for low-wage workers, funds that could be rerouted to a more effective wage-subsidy program. Indeed, when Phelps redirected funds from existing programs to pay for his wage subsidy and accounted for the dynamic effects of the ensuing increased employment, his proposal had a net cost of zero.

This paper explains why a wage subsidy would help policymakers better achieve their antipoverty and economic-mobility goals than substantially increasing the minimum wage or expanding the EITC. Section I reviews the economic and social factors motivating the increased focus on wage supports. Section II outlines the components of the three aforementioned wage-support tools. Section III evaluates the merits of each tool.

READ FULL REPORT