

# Economic Strategy for Higher Wages and Expanded Labor Participation

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## ABSTRACT

We propose two alternative policy options for promoting increased earnings and employment of low-income households: expanding the Earned Income Tax Credit (EITC) among childless workers, and implementing a wage subsidy for low-income workers that would be administered through employers. The EITC is based on household income and administered as a tax credit, while the subsidy based on hourly wages would require no filing or administrative effort by workers. We compare and contrast the costs and benefits of these two approaches to raising wages. Our two policy options are meant as part of a response to the sluggish income growth at the bottom of the distribution over the past several decades. Over the long term, a broad set of policies is needed to boost productivity and ensure that the resulting incomes gains are widely shared—and we discuss the elements of such an agenda that should receive bipartisan support. Over the near-term, however, the policies we propose are well-targeted to improving the incomes and participation rate of workers at the bottom who have been left behind by the rising prosperity of the U.S. economy.

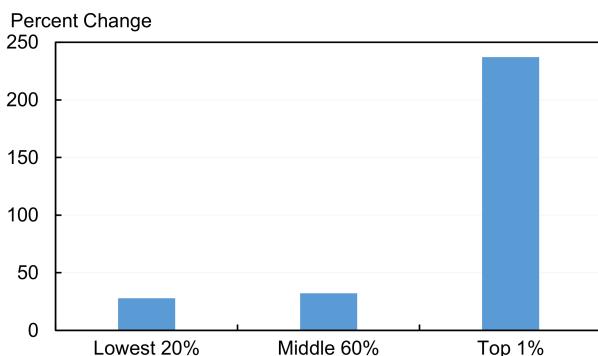
## Introduction

From 1979 to 2015, according to the Congressional Budget Office (CBO), real income before taxes and transfers increased by a total of 237 percent for the top 1 percent, but by only 28 percent for the lowest quintile and 32 percent for the middle three quintiles—in all cases for non-elderly households (Figure 1a). Taxes and transfers meant somewhat larger gains at the bottom of the distribution, but even so incomes after taxes and transfers rose over the same period by a total of 46 percent in the middle three quintiles and 70 percent for households in the lowest quintile (with half of this gain coming from Medicaid, assuming it is valued by households at cost). In contrast, income after taxes and transfers rose by 240 percent for the top 1 percent (Figure 1b). American households in the middle and at the bottom saw annual income gains of barely more than 1 percent on average over three-and-a-half decades.<sup>1</sup> This contrasts with the roughly 3 percent annual income gains enjoyed by the typical family from 1948 to 1974.<sup>2</sup>

1 The figures in this paragraph are for non-elderly-headed households defined as childless households up to age 64 plus households with children. They are calculated from Congressional Budget Office (2018b), "The Distribution of Household Income, 2015," November. <https://www.cbo.gov/publication/54646>

2 The more comprehensive CBO figures are not available for the earlier period so this is based on Census data which is not a completely apples-to-apples comparison.

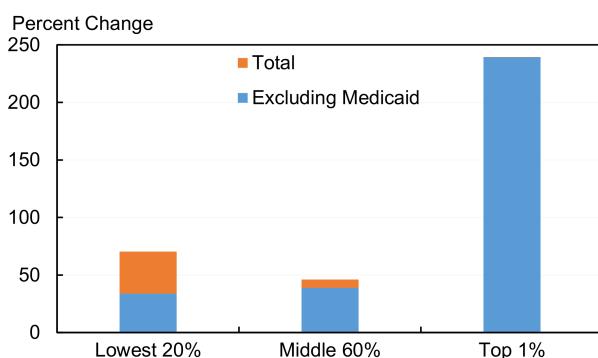
**Figure 1a. Change in Household Income Before Taxes and Transfers for Non-elderly-headed Households, 1979-2015**



**Source:** Congressional Budget Office (2018b); authors' calculations.

**Note:** Households ranked by income before taxes and transfers.

**Figure 1b. Change in Household Income After Taxes and Transfers for Non-elderly-headed Households, 1979-2015**



**Source:** Congressional Budget Office (2018b); authors' calculations.

**Note:** Households ranked by income before taxes and transfers.

We propose policies to do better.

The slowdown of income growth can be largely accounted for by three factors (Council of Economic Advisers, 2015). First, the largest reason is that overall economic growth has slowed. From 1948 to 1974, productivity growth (measured in units of consumer goods) was 1.7 percent annually but has slowed to 0.8 percent annually from 1974 to the present. This largely has been mirrored by the slowdown of the growth of mean compensation, although since around 2000 mean compensation has grown slightly more slowly than the overall economy as the share of income

going to labor has fallen. If productivity growth had not slowed after 1974, holding distribution constant, mean wages would have been 47 percent higher today.

The second and also substantial reason is that median wages have grown less than mean wages—the worker in the middle has not kept pace with average wages driven by large gains at the top. In 1974 median wages were 81 percent of mean wages but today they are only 72 percent of mean wages. Holding the slower growth constant, median wages would have been 13 percent higher today if they had simply kept up with mean wages.

Finally, up through 2000 the entry of women into the workforce provided a cushion for the slowdown in wage growth—helping ensure more families had two earners instead of one. Since 2000, however, women’s labor force participation has levelled off and started to decline, joining a trend that has been underway for men since the 1950s. If these trends continue, they will increasingly weigh on household incomes because households will be supported by fewer and fewer workers.

We want policies that result in strong gains in the middle and for the bottom half of the distribution. This could happen with stronger growth and the same or perhaps even greater inequality. In the late 1990s, for example, families throughout the income distribution saw strong gains even while inequality widened. Or it could happen with decreasing inequality. Either way, the test of economic policy should not be solely the growth rate, which reflects economy-wide averages and can obscure mounting inequality, but also how households in the middle and bottom of the distribution are doing.

The economic challenges of wage growth and participation in the workforce, both of which are rooted in and also can contribute to slower economic growth and widening inequality, have neither a single cause nor a single solution. Moreover, the solutions may not necessarily directly reflect the causes—for example, if technology widens inequality it is not necessarily the case that restraining technology is the best solution to inequality.

We took it as our charge to propose economic policies that can improve either wage or job growth, ideally both, in the near-term. For our purposes, this refers to policies acting immediately or over the span of a business cycle. Given this time horizon, this paper does not focus on the important policies aimed at improving human capital which tend to have longer-term payoffs, and which are complements to our proposals.

The first part of this paper outlines some of our goals. We recognize that our list of goals is not comprehensive. Our aim was to list major goals for which we think there will be broad support, not to set down every possible goal.

The second part of the paper provides a high-level synopsis of *some* of the most important elements of an overall economic approach that would help to achieve these objectives and thus manifest in faster wage growth for the typical worker. We do not attempt to flesh out the details of these; in many cases, the details that would be necessary for actual policymaking could prove substantially more contentious than these high-level summaries.

The third part of this paper outlines two specific options for subsidies to raise wages and increase hours worked or labor force participation for less skilled workers while taking the overall economic environment as given. In some economic circumstances, wage subsidies can boost *both* incomes and employment at the same time. One option expands on the existing Earned Income Tax Credit (EITC) while the second option would provide a wage subsidy for employers. Either of these options could be dialed up or down in light of other economic realities.

While these options would require actions to address the overall fiscal trajectory, we consider this issue outside of the scope of our paper—the particulars of the needed fiscal adjustment are not connected to the analysis we provide of the policy options themselves.

The EITC expansion or introduction of wage subsidies would advance prospects for lower-income workers but are far from a comprehensive solution to the issues facing these workers. This option is a complement to (and not a replacement for) policies that improve human capital or boost productivity and thus improve potential output. Moreover, given fiscal constraints, a system of wage subsidies will not be effective in boosting wages for median workers, let alone workers at the 85<sup>th</sup> percentile. In these cases, the best way to make progress is to get the major economic policies right.

Other members of the Aspen Economic Strategy Group are proposing policies that have the promise of making beneficial long-term impacts on private sector wage and job growth. Progress on the human capital agenda proposed by Austan Goolsbee and Glenn Hubbard would spur productivity growth over a long period, leading to higher incomes and wages over time, which would then translate into job growth. Moreover, progress on a human capital agenda that improves skills and educational levels for those with relatively few could spur income gains over time at the bottom of the distribution. Keith Hennessey and Bruce Reed propose measures intended to increase participation in the labor force. Together these are intended to help to address slower wage and jobs challenges, potentially complementing the ideas put forward in this paper.

## The Goals

A policy agenda that will boost private sector wage and job growth starts with getting the economic environment right in both the short term and (especially) the long term. This should entail focusing on five goals:

1. Ensure the economy is operating at full employment, using its full potential.
2. Increase long-term productivity growth and labor force growth leading to a better trajectory for potential output.
3. Make a more resilient economy in the face of shocks and inevitable cyclical downturns.
4. Ensure more sustainable economic growth over the longer term.
5. Contribute to more broadly-shared prosperity.

We believe that these general goals should have broad support from across the political spectrum. All policymakers should want a strong and stable economy with improved productivity growth, and an economy that is more resilient in the face of shocks. All policymakers should also want prosperity to be broadly shared. But there will be sharp differences on how to achieve these outcomes and how to balance the inevitable tradeoffs involved, such as between growth and distribution.

## Some Major Policy Elements for Achieving These Goals

Achieving these goals will require policies in numerous areas including fiscal, tax, regulation, immigration, trade, energy, infrastructure, health care, and retirement among many others. In this section we note some specific areas or policies that could form the basis of bipartisan policy efforts without attempting to necessarily provide a list that would be complete from either of our perspectives. This is not meant to be a comprehensive list of the policies that either of us favor—and omitting some policy does not necessarily indicate that one or both of us would oppose it.<sup>3</sup>

In addition to these affirmative proposals, it is important for policymakers to avoid mistakes, including trade wars, interfering with the Federal Reserve's independence, and so on. We also have in mind to eschew policies that seek to undo technology-driven changes such as by supporting declining industries or preventing the emergence of new ones or of new technologies.

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3 To give an example, we both support taking action to address the challenge of climate change, but do not set out policies or otherwise address the issue in this paper beyond this footnote.

There will be inevitable tradeoffs involved between the impact of change in driving growth and in giving rise to dislocation. We are not suggesting to ignore the costs of dislocation on people, communities, or industries, but rather to be cognizant of the tradeoffs involved, including across different time horizons.

## **1. ENSURE THE ECONOMY IS OPERATING AT FULL EMPLOYMENT, USING ITS FULL POTENTIAL**

In general economists support using **monetary policy** as the most effective way to help push the economy back toward full employment in response to both smaller shocks and larger ones, like recessions. Monetary policy has the advantage of being set by an expert group, can rapidly respond to changing circumstances, and does not incur long-run fiscal costs.

**Discretionary countercyclical fiscal policy** can also play an important role, potentially affecting the economy more quickly than monetary policy in the event of a sharp downturn and can be especially efficacious when interest rates are constrained by the effective lower bound. Moreover, a diversity of instruments may help when the impact of any one instrument is uncertain. All of these were motivations for the fiscal stimulus measures enacted from 2008 through 2012 (Furman, 2018).

We are not taking a position on the current stance of short-run monetary or fiscal policy as this paper is not a response to the immediate high-frequency economic situation; we simply endorse these two tools of monetary policy and discretionary fiscal policy for use whenever economic circumstances warrant.

## **2. INCREASE LONG-TERM PRODUCTIVITY GROWTH AND LABOR FORCE GROWTH LEADING TO A BETTER TRAJECTORY FOR POTENTIAL OUTPUT**

Short-run macroeconomic policy can be effective in moving the economy back to its potential but cannot substantially increase that potential, beyond some positive hysteresis effects. To improve the economy's potential requires stronger productivity growth and/or expanding the workforce. Doing this entails a wide range of policies, including tax and spending policy, regulatory policy, and so on. We note a few of them here:

First, invest more in **infrastructure and basic research** while ensuring that the dollars are allocated effectively and, where possible, the investments are financed through dedicated revenue in a manner that enhances their efficiency. This includes more cost-benefit analysis in the allocation of infrastructure funds or encouraging more such analysis by states that receive formula funds, and ending lower priority

investments. Second, policies to encourage more **participation in the workforce** (the topic of the paper by Hennessy and Reed). Finally, **expanding immigration** would advance both aspects of this goal by expanding the workforce and increasing innovation and entrepreneurial dynamism.

### **3. MAKE A MORE RESILIENT ECONOMY IN THE FACE OF SHOCKS AND INEVITABLE CYCLICAL DOWNTURNS**

The goal is to improve the response of the economy to shocks, reducing the volatility of the economy, and smoothing out the business cycle. This could involve both monetary policy and fiscal policy.

With respect to **monetary policy**, the equilibrium interest rate is likely lower now than it was in past decades and thus it is likely that future policymakers will more frequently find themselves at the effective lower bound. This will constrain conventional monetary policy, and policymakers may be concerned that unconventional monetary policy, like forward guidance and quantitative easing, may not be fully effective or could have negative side effects for financial stability.

This implies that monetary policymakers should continue to explore alternative policy tools, goals, and institutional arrangements. As examples, the questions to be explored include the most effective ways to undertake quantitative easing if again needed; the appropriate target for monetary policy; and alternative institutional arrangements that could facilitate a monetary policy response when needed.

With respect to **fiscal policy** this means improving the automatic stabilizers that automatically expand spending or reduce taxes when the economy weakens and then reverses these impacts as it improves. This already happens with tax revenues, unemployment insurance, the Supplemental Nutrition Assistance Program (SNAP), and other programs. An improvement of the automatic stabilizers could involve an addition on top of current spending levels or involve reducing a program in good times and expanding it in harder times so that it averages out to roughly the same size over the business cycle.

One of the top priorities for improved automatic stabilizers is **unemployment insurance** (UI). Unemployment insurance benefits are limited in duration and magnitude, generally lasting up to 26 weeks and replacing, on average, somewhat less than 50 percent of wages, although that varies substantially across states. In theory these limits balance the cost of discouraging work against the benefits of helping people smooth their consumption in the face of unforeseen shocks and also allowing jobseekers to take the time to match to better jobs. The optimal design of unemployment insurance is open to debate, but one feature that such a system would have is to increase benefits and/or extend the period for which people can

receive benefits when the unemployment rate is higher, and then reverse this as the labor market recovers. When the unemployment rate is higher there is less concern about moral hazard (because in a deep recession the problem is too few jobs not too few people willing to work) and a greater concern for helping people smooth consumption (Chetty 2008). (Separately, unemployment insurance has other issues—like falling coverage rates with many workers, including part-time ones, falling through the cracks in the system, a fact that also reduces its countercyclical effectiveness (West et al., 2016; McKay, Pollack, and Fitzpayne, 2018).)

Federal policymakers sometimes expand and more frequently extend unemployment insurance benefits during recessions, but this is often done in a haphazard manner, potentially starting too late as the economy turns down. The federal Extended Benefits program triggers additional assistance to states with high unemployment. However, these triggers are designed ineffectively and do not cover the full cost of expanded/extended benefits (West et al., 2016). Such triggers could be fixed to reflect state unemployment levels and increases in unemployment rates. Given the impact of downturns on states' financial conditions, it would also make sense to have 100 percent Federal funding to provide longer and possibly larger benefits in the next downturn.

There is likewise research evidence that Federal assistance to state and local governments was relatively effective in supporting the economy during the recession (see e.g. Chodorow-Reich et al., 2012; Dupor and McCrory, 2018, Dupor and Mehkari, 2016; Chodorow-Reich, forthcoming). A typical way to put this assistance in place is for Congress to adjust the formula by which the federal government matches **state-specific Medicaid spending**—this is known as adjusting FMAP (Federal Medical Assistance Percentage). A statutory approach that automatically adjusted the FMAP based on, say, state unemployment rates could provide for a more rapid fiscal response to cyclical downturns while still allowing legislative discretion to make changes. As with UI, it would be important for the rule to contemplate both recessionary and expansionary periods in designing such a countercyclical policy.

#### **4. ENSURE MORE SUSTAINABLE ECONOMIC GROWTH OVER THE LONGER TERM**

Ensuring that growth is strong and sustainable over time would involve steps to achieve a sustainable fiscal trajectory, more moderate growth of health spending, stability of the financial system, and more.

CBO (2018a) estimates that the **fiscal gap** is 2 percent of GDP over the next 30 years but would be about twice as large if policymakers choose to continue recent spending increases and temporary tax provisions. Moreover, some of the solutions to the wage and jobs challenges we face will entail provisions that, by themselves,

would raise spending or reduce revenue—and thus exacerbate this fiscal challenge. Thus it is necessary to find other ways to reduce lower-priority spending and/or increase revenue both to put the debt on a sustainable path and to make room for new higher-priority provisions, like the EITC or wage subsidies we discuss in the next section.

Ultimately the fiscal adjustment cannot merely consist of “paying for” new proposals absent a larger fiscal framework. For example, consider the case of reversing the December 2017 tax cut and using every penny for new spending programs. That may be a better or worse compositional policy but it is equal in its degree of fiscal responsibility to never having undertaken the tax cut and simply increasing spending.

Policy actions are needed to achieve a sustainable fiscal position over time, but there is considerable disagreement over the composition and timing of those actions—and indeed, disagreement over fundamental choices regarding the size, scope, and role of the government in society that ultimately will determine the nature of the fiscal adjustment and the shares of revenue and spending out of GDP.

One fiscal measure that we think would be efficient is changes to the tax treatment of health insurance. The so-called **“Cadillac Tax”** included in the Affordable Care Act (ACA) and subsequently delayed until 2022 requires employers to pay a 40 percent tax on coverage in excess of a relatively high limit. This creates an incentive for individuals, businesses and insurers to devise efficient ways to reduce the growth of health costs and thus to increase wages. The Cadillac Tax grows over time so further delays or repeal would significantly worsen the fiscal hole. Instead, it could be retained or possibly reformed.

One proposal would be to have the tax rate on health insurance above the “Cadillac” level vary with families’ tax rates rather than applying a 40 percent tax rate regardless of income. Another set of tweaks proposed by the Obama Administration would be to adopt State-specific high-cost thresholds and alter the indexation of plans (Furman and Fiedler, 2016). A more ambitious change would be to eliminate the exclusion, either for payroll taxes as proposed by Martin Feldstein (2017) or entirely, and replace it with a flat credit. All of these changes are politically challenging—the Cadillac Tax has never taken effect. Still, steps such as these would help to slow health spending and improve the fiscal trajectory, or prevent policy from making it worse.

## 5. CONTRIBUTE TO MORE BROADLY-SHARED PROSPERITY

Finally, we both believe that achieving full employment, expanding potential growth, and ensuring more resilience and sustainability would—even absent other steps—increase wages across the board. But we also believe that further steps to ensure more broadly-shared prosperity are necessary, either because they can increase

growth and equity at the same time or because they can achieve additional equity at an acceptable cost.

First, a rapidly growing body of well-identified causal research has found that the social safety net for children can increase long-run earnings, employment, educational and health outcomes, and reduce crime (e.g., Cohodes et al., 2016; Hoynes, Schanzenbach, and Almond, 2016; Wherry et al., 2018; Brown, Kowalski, and Lurie, 2015; Heckman et al., 2010). Specifically, one step we endorse is for the remaining states to take up the **Medicaid expansion** that was passed under the Affordable Care Act (ACA). The Children's Health Insurance Program (CHIP) provides health insurance for children in low-income families but the benefits identified in the research are connected to safety net programs that cover the adults in the household, namely Medicaid.

We realize Medicaid expansion is politically fraught since it is wrapped up in the debate over the ACA. Expansion is also seen as fiscally controversial, with some governors worried about the cost, even with the federal government picking up most of the cost of the expansion (and even while states declining the expansion are effectively foregoing considerable federal subsidies). We also worry about the fiscal constraints facing states. In light of the evidence on the positive impacts and given the reality that legislative efforts to repeal the ACA are at a standstill, we endorse take-up of the Medicaid expansion by the remaining states—and note that several additional states have chosen to expand Medicaid in the last year.

Second, there is considerable evidence that wages are not set in a simple competitive market but that employers have power over wage-setting and thereby the ability to hold down—what is sometimes called **"monopsony in labor markets** (Benmelech, Bergman, and Kim, 2018). This might be especially the case when a few firms constitute a large share of hiring in a local labor market; the idea is that greater concentration of economic activity would strengthen this monopsony power and contribute to the increased wedge between mean and median wages discussed in the beginning. Some analysts would see policy implications as suggesting to take steps to further the bargaining power of workers including through unions, better enforcement of anti-trust laws, and reducing non-compete agreements. While the two of us are not putting forward a policy proposal here (in part because we do not agree on the precise agenda), the broad idea is to take action to help promote more shared growth—and to the degree to which these steps reduce or countervail existing employer market power they would promote efficiency as well.

Third, increasing mobility between jobs and between places is another way to help more people share in the benefits of the economy while increasing efficiency. There has been a long-term decline in the fraction of people moving between places, jobs, occupations and industries (see e.g. Molloy et al., 2016; Molloy, Smith, and Wozniak,

2014; Davis and Haltiwanger, 2014). While there may be a number of perfectly good or efficient reasons for these shifts, there are also a number of policy distortions that have contributed to them. In particular, the growing gap between housing values and construction costs appears to be due in part to scarcity that is deliberately caused by **land use restrictions**. These restrictions drive up rents in more economically successful areas, reducing the ability of people to move to good jobs – the AESG proposal by Josh Gottlieb provides details.

At the same time, the share of jobs that require an occupational license has grown from less than 5 percent to 29 percent, with the requirements for many licenses varying across states (Kleiner, 2015 and Department of the Treasury Office of Economic Policy et al., 2015). Reforming **occupational licensing restrictions** would make it easier for people to move between jobs, potentially also increasing their leverage to bargain for higher wages.

## **Two Options to Subsidize Wages for Less Skilled Workers**

Our desired outcome is to increase wages and employment for people across the income spectrum. Within this outcome, an important policy priority and one that lends itself to specific, targeted policies is to raise the wages of workers with lower skills and levels of education.

There will be other potential benefits from policy success beyond higher wages and job creation, including lower rates of crime, improved marriage-ability of those who work and have higher incomes as a result, and more economically active communities, which have positive spillovers for other residents. Indeed, many others have pointed to the considerable personal and societal negatives of having a large part of the population not working or earning low wages.

We propose two distinct options that would achieve many of the same objectives. The first option expands on the existing EITC structure to nearly triple the amount that goes to workers without qualifying children (for whom the maximum credit is \$519 in 2018). The second option sets up a new structure to deliver wage subsidies through employers. There would be important administrative hurdles to overcome to put this second proposal into operation. But some states already carry out the necessary steps as part of their unemployment insurance systems, suggesting that it is feasible.

We first provide a broad overview of these two options and then discuss some pros and cons of the two approaches.

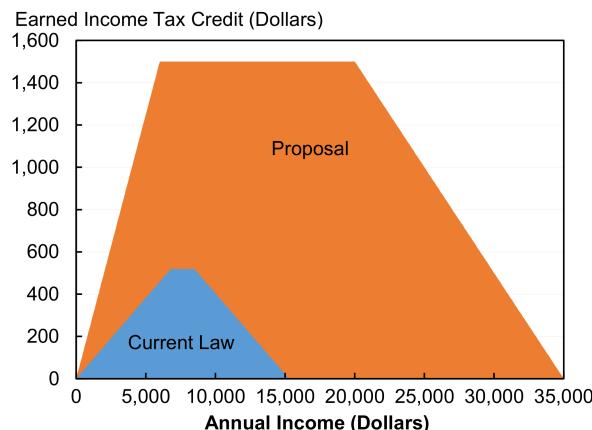
## **OPTION 1: EXPAND THE EARNED INCOME TAX CREDIT FOR WORKERS WITHOUT QUALIFYING CHILDREN**

The EITC has been expanded numerous times since its inception in the 1970s. In addition, the child tax credit was created in 1997 and has also been expanded and made more refundable since then. Both of these policies focus on households with children. As a result, parents who have qualifying children and whose incomes are below the poverty line generally get net tax credits back from the government—lifting about 4 percent of such households above the poverty line from the direct effect of the tax credit and potentially more when the additional work encouraged by the tax credit is factored in (Furman, 2014).

The EITC has a small benefit for workers without qualifying children, a group that includes both childless workers and also parents—generally fathers—who are not married and not living with their children. In 2018 this credit was \$519 for workers with adjusted gross incomes between \$6,780 and \$8,490. The credit starts to phase down after incomes reach \$8,490, a little bit more than a halftime worker at the minimum wage makes, and is fully phased out above \$15,270, which is just above the earnings of a full-time worker at the minimum wage. This small credit is generally outweighed by the taxes these workers pay, resulting in about 7.5 million low-income workers without qualifying children being taxed either into poverty or more deeply into poverty each year (Marr and DaSilva, 2016). For example, a worker making just over the poverty-line wage of \$12,140 will pay \$929 in taxes and receive \$241 in EITC, moving him below the poverty line. Moreover, this credit is too small to make much of an effect on decisions about working and, in fact, many qualified beneficiaries are not aware of it and either do not claim it or get it as a windfall. Finally, the credit is limited to workers between the age of 25 and 64.

A number of economists, including one of us (Furman, 2006; Scholz, 2007), and policymakers (President Obama, former Speaker Paul Ryan, Senator Sherrod Brown and Congressman Richard Neal) have all proposed to expand the childless EITC. Our option would increase the maximum EITC for workers without children to \$1,500 (phased in at a 25 percent rate on the first \$6,000 of earnings) and have the full credit available to workers who earn up to \$20,000. The credit would fully phase out for incomes above \$35,000. The change from the current schedule is shown in Figure 2. These parameters could be adjusted based on budgetary and other considerations. In addition, the option would lower the eligibility age from 25 to 21 while maintaining the prohibition on full-time students receiving the credit.

This option would cost \$14 billion if it were in effect in 2018 and would provide an average benefit of \$870 to 16 million workers (assuming 75 percent take-up). A worker making just above the poverty line would now get slightly more in EITC (\$1,500) than what the worker pays in other taxes, moving the worker further above

**Figure 2. Earned Income Tax Credit for Childless Adults**

**Source:** Internal Revenue Service; authors' calculations.

the poverty line. Overall, on net, the tax code would reduce the poverty rate for this group by 3 percentage points (assuming no changes in labor supply, an issue we return to below).

This paper does not address the important issues surrounding subsidies for families with children. Other proposals include increasing the EITC for one-child households to better reflect their comparative cost of living (Hoynes 2014) and also converting the child tax credit and EITC into a child allowance that is separated from work.

## OPTION 2: A WAGE SUBSIDY FOR LOWER-INCOME WORKERS

The second option is a wage subsidy for lower-income workers, an idea that goes back at least to Muth (1966), was championed by Nobel-prize winning economist Ned Phelps (1997), and more recently has been proposed by Karl Scholz (2007), Cass (2015), and Austin, Glaeser, and Summers (2018). This idea is both larger than the EITC and departs from the existing administrative infrastructure so it would need further testing and vetting before it was implemented. Unlike the EITC, this option would be delivered to employers of low-income workers—although this administrative difference should not affect the ultimate beneficiaries of the tax credit, which does not depend on whether it is paid to employers or workers. The bigger difference from the EITC is that it would be based on hourly wages rather than annual household income or other circumstances and the benefits to workers would be in the form of wage compensation which would require no filing or other administrative effort by workers.

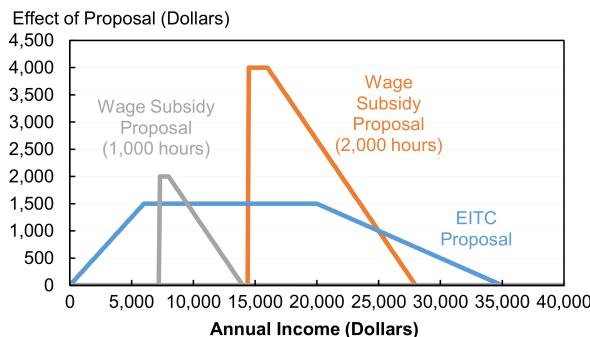
Our wage subsidy proposal would establish a tax credit for hourly wages paid to low-wage employees. To be eligible for the credit, employers would need to pay an hourly wage of at least \$10 an hour to all employees. The credit would start at \$2 an hour and phase down by \$0.50 for each \$1 increase in the hourly wage above \$10 per hour—fully phased out for wages of \$14 an hour. An employer now paying the federal minimum wage of \$7.25 an hour could pay \$10 an hour at an effective net cost of \$0.75 per hour, with the \$2.00 per hour subsidy covering 73 percent of the incremental cost. An employer paying \$12.50 an hour would receive a \$0.75 per hour wage subsidy, and so on.

The subsidy would be provided as a tax credit to employers in a similar manner to the current Research and Experimentation Tax Credit, so that for companies without income tax liability it could be carried forward to use against future earnings or applied against payroll taxes for smaller businesses (this latter provision especially would be important for new firms). There are no fully refundable business tax credits and we do not propose one. This is to maintain program integrity although it comes with some tradeoffs in terms of eligibility for employees at smaller and less profitable firms.

Our option would establish a single nationwide schedule for the subsidy, although it could also be limited to or made larger for specific places as proposed by Karl Scholz (2007) and Austin, Glaeser, and Summers (2018) in order to take advantage of the spillover effects of poverty in highly disadvantaged areas. As Austin, Glaeser, and Summers (2018) note, however, even if the proposal were not made contingent on location, the fixed dollar value of the subsidy would effectively make it more valuable in lower-cost areas, a form of *de facto* geographic adjustment.

Research finds limited impact from past wage subsidies to disadvantaged workers because employers screened out the targeted workers (Katz, 1998). Evidence from the Targeted Jobs Tax Credit, the Welfare-to-Work Credit, and the Work Opportunity Tax Credit is that take-up is low in part because of an apparent stigma in which employers see the cost of training low-wage workers as high. Our proposal would apply to all low-wage workers rather than disadvantaged workers or people leaving welfare, which would reduce the possible impact of this stigma.

The tax credit provided for a full-time worker under this proposal is compared to the expanded EITC proposal in Figure 3, with different subsidies depending on the total number of hours worked. Note that unlike the EITC option, this option would include workers with children, but it could be altered to sync up with the EITC in a variety of ways. Details would also have to be considered for workers with substantial earnings from tips. We do not propose or model the full set of changes in the child tax credit and EITC that might accompany this proposal; instead, we present cost estimates and benefit estimates for workers without dependent children—which makes them comparable to the proposal for EITC expansion. Specifically, this option would cost about \$60 billion annually, providing an average subsidy of \$2,060 annually per worker to 30 million workers (assuming 95 percent take-up).

**Figure 3. Expanded Earned Income Tax Credit for Childless Adults vs. Wage Subsidy**

**Source:** Authors' calculations.

**Note:** Wage subsidy proposal depicts scenario in which all benefits of the subsidy pass through to workers. Wage subsidy proposal assumes 1,000 or 2,000 hours worked per year.

The plan would be administered by states, along the lines of the current UI system. This would require states to track not only annual or quarterly pay but also hours, something Minnesota, Oregon, Rhode Island, and Washington already do through their employment systems. The policy would provide a one-time subsidy to firms and states to implement these administrative and payroll changes (one could imagine the small subsidy applied to payroll processing firms such as ADP for employers that use these services).

This is not a minimum wage in the sense that employers could pay below this level and simply forgo the wage subsidy. The requirement that firms pay all workers at least \$10 per hour helps skew the benefits of the credit to workers by avoiding a situation in which employers of workers who now make less than \$10 per hour simply pocket the subsidy without passing on the credit to workers through higher wages.

## ANALYSIS OF THE OPTIONS AND PROS AND CONS OF THE DIFFERENT APPROACHES

Much of the effect of the two proposals would be the same—additional income for low-income workers that likely also results in higher employment rates, increased marriage rates, more child support payments and reduced crime. The size of the two proposals as we have put them forward is different, but either of them could be dialed up or down to hit specific targets (although it is easier to do a smaller EITC proposal because it just alters existing tax parameters and applies to a more limited group whereas the fixed cost of establishing a new wage subsidy program would only make sense if it were at a sufficient scale). We discuss the impact of the

two options, including their similarities and differences, without focusing on the different costs, even though the cost of each proposal would be a central factor in any actual implementation.<sup>4</sup>

### **Employment and other associated effects**

A long literature has found that the EITC has substantial employment effects (Eissa and Liebman, 1996; Meyer and Rosenbaum, 2001), and has also been shown to increase marriage rates, reduce crime, and improve current and long-term health, educational, and other outcomes for children in the households that receive the credit (Hoynes, Miller, and Simon, 2015; Evans and Garthwaite, 2014; Bastian and Michelmore, 2018). In New York City and Atlanta, the evaluation firm MDRC is conducting a randomized control study to evaluate the impact of an EITC for workers without dependent children, similar to our proposal. Final results from three years in New York City found that employment increased by an average of 2.4 percent in the latter two years of the experiment, with the gains in both years statistically significant, and, in the evaluators' view, more representative of the ongoing impact of the program (Miller et al., 2018). Overall, the evaluation found that earnings increased an additional \$0.33 for each \$1 workers received directly from the program—the opposite of the proverbial leaky bucket.<sup>5</sup> (Employment gains were even higher for participants who were offered information about employment services.)

Wage subsidies like the ones we are proposing have not been evaluated so we do not have specific evidence about their impact. Labor supply, however, is elastic. To the degree to which our wage subsidy proposal raises after-tax wages, it would be expected to increase labor supply as well. For example, if the proposal raised after-tax wages for low-income workers by 10 percent, then using CBO's labor supply elasticity of 0.31 for primary earners in the lowest decile, it would be expected to increase labor supply by 3 percent (or slightly less after taking into account the income elasticity, which is that people making more money want to consume more leisure and thus work less) (CBO, 2012).

There is no firm basis for comparing the employment effects of the two proposals because they have not been evaluated in complementary ways. Cass (2015) argues that wage subsidies would have a larger employment effect because they result in a transparent, upfront increase in hourly wages whereas the EITC is only received in a lagged, lump sum manner that will have less of a behavioral impact.

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- 4 Dicker-Conlin and Holtz-Eakin (2002) compare employee-based and employer-based subsidies that have much in common with our two options but also have important differences. They "find a modest preference for employee-based approaches" like the EITC.
  - 5 A full evaluation would also need to reflect the welfare costs associated with additional work. Normally reduced leisure should be counted as a cost but for this population there is an argument that increased participation might be counted as a benefit.

Another issue is the incentive on different marginal tax rates. The EITC encourages participation, but for workers in the phase-out range, it increases marginal tax rates both for extra hours worked and for higher wages. Overall the evidence is that increased participation substantially outweighs any incentives for hours worked. The wage subsidy, in contrast, does not impose any marginal tax rate on increased hours worked but imposes a higher marginal tax rate on additional wages, which means that it would not discourage someone from working longer but could impose larger distortions on other choices. Overall, both proposals likely expand work incentives on net but also impose some distortions—an outcome that is inevitable with any income-related program.

### ***Incidence of the two proposals***

Both the EITC and the wage subsidy would have an incidence that is mostly on workers but also partly on firms. In the case of the EITC, the increased labor force participation would likely lead wages to fall somewhat, allowing employers to capture some of the benefit of the subsidy. In the case of the wage subsidy, wages likely would not rise by as much as the amount of the subsidy , thereby also allowing employers to capture some of the subsidy. Economic theory says that it generally does not matter which side of the market gets the check from the government, since the underlying economics dictates the incidence. In practice, there may be some “flypaper” effect that leads to a greater benefit to the side of the transaction that receives the check.

In competitive markets, as usual with tax policy, we would expect relatively larger increases in wages if labor supply is inelastic—as might be the case today with the unemployment rate quite low. Conversely, the wage subsidy might result in more of an increment to employment rather than wages when the economy is weaker and the supply of labor is relatively elastic (and of course it would be necessary to consider the elasticity of labor demand as well).

There is no direct evidence on the incidence of the EITC. Rothstein (2008) simulates what this incidence might be based on a variety of modeling assumptions, projecting that single mothers keep \$0.70 of every dollar of EITC, while employers capture \$0.30. Direct evidence is clearly needed, especially since the incidence of any given proposal to expand the EITC need not be the same as that for the EITC as a whole. In particular, a wage subsidy that applied to all workers would not have the feature that Rothstein found in the EITC of potentially lowering wages for ineligible workers.

To the degree that wages fall somewhat (for the EITC) or the credit is not fully passed through (for the employer subsidy) that would generally reflect an increase in labor supply. In other words, the subsidy would encourage employers to hire low-wage workers and also induce more of them to enter the labor market, which is an outcome that has its own benefits.

The analysis is more complicated in moving away from the competitive model of the labor market and considering monopsony power on the part of employers. In general, the more market power an employer has, the more it would be expected to capture the benefit of the wage subsidy and the less they would be expected to increase employment in response.

Both options also raise an important question about whether the minimum wage should be increased. A higher minimum wage would help to ensure that more of the benefit of the subsidy went to workers. Depending on the magnitude of the minimum wage increase and the time horizon, employment losses could reduce the intended positive effects. In the case of an EITC, a combination of increased EITC and a higher minimum wage might be optimal even in competitive models in which the minimum wage increase results in employment losses (Lee and Saez, 2012). The wage subsidy could be combined with a minimum wage increase for similar incidence reasons, effectively making our proposal a way for the cost of the increased minimum wage to be partly subsidized for employers (that is, for the cost of the minimum wage to be diffused more broadly in the economy in whatever manner of financing is preferred).

### ***Targeting***

The EITC can be better targeted to household circumstances because it is based on annual household income. For example, a teenager in a high-income household would not get the EITC but could benefit from the wage subsidy. The wage subsidy goes only to workers with low hourly wages, whereas in some cases (not overly frequent) the EITC could go to higher-wage workers who work fewer hours.

The EITC is also shaped to target other circumstances such as by providing a larger benefit to households with more children. One could also consider having subsidies for children separated from work support.

The wage subsidy may be better targeted at lower-skilled workers with fewer opportunities. This is because it is based on the hourly wage whereas the EITC goes to some households with higher hourly wages who only work part time and thus have lower annual incomes.

### ***Timing of Payments***

The EITC provides a refund to employees the year following their work and is paid in a lump sum. This can be a form of desirable forced savings but can also be a source of instability and even costly debt financing in the period leading up to the lump sum payment. The wage subsidy would lead to higher paychecks and thus a more regular income.

Moreover, this difference could lead to varied psychological effects for workers. It is possible that workers would prefer the idea of higher pay from their employer compared to a benefit delivered as a larger government refund (even if to the economist the economic incidence is what matters), although there is also evidence that many recipients have positive feelings towards the EITC (Sykes et al., 2015).

### ***Take-up Rates, Administration, and Compliance***

The EITC expansion would be straightforward for the Internal Revenue Service (IRS) as it only involves changing parameters already in the tax code. It would be relatively straightforward for workers as well, with a modicum of added complexity since additional workers would be eligible to file for the EITC (in practice, more than half of low-income workers use paid tax preparers). Currently about 85 percent of households with children take up the EITC; the final results for the credit for households without dependent children in New York City indicate a take-up rate of 59 percent (Miller et al., 2018). In addition, there is some EITC error rate in terms of improper claims, often around the issue of which adult has a child under the precise definition of the credit; this would not be an issue for our EITC option—that is, while it is desirable to address the EITC error rate it is not essential to do so before implementing this expansion proposal.

The wage subsidy option would rely on largely untested administrative mechanisms of administration through state UI systems, which would add burdens for states and for employers (though as noted above, several states do already track hours in their UI systems). Take-up rates for the wage subsidy could be higher relative to the EITC because businesses are more sophisticated about claiming tax benefits and no filing or effort by workers is needed.

The biggest concern with a wage subsidy would be fraud. In particular, both the employer and the employee would have an incentive to report higher work hours, which for any given total amount of pay would result in lower hourly pay and thus larger subsidies.<sup>6</sup> This could be an even bigger issue since hours, unlike dollars, are much harder for the government to observe and monitor. Programs that are contingent on hours in Europe have suffered from widespread fraud. For wage subsidies to have a chance of working without such fraud, significant enforcement efforts and penalties on employers for fraud may be required.

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6 In the current tax system the incentives help to produce truthful reports of how much workers are paid by their employers because of the offsetting incentives of the employer and worker. The employer has an incentive to report a higher number for wages and thus to get a larger deduction against business income while the employee prefers to report lower pay and thus pay less taxes. This is why there is nearly perfect compliance with taxes on wages, in contrast to other parts of the tax system, like small business income, that lack the same types of reporting and offsetting incentives.

## Conclusion

The U.S. economy has enormous strengths but it also has major challenges—with wage growth and participation in the workforce, especially for less-skilled workers, at the top of the list. Currently there are different visions for dealing with these issues. One is based on a smaller government with lower taxes and less regulation, another based on a more active government that directly aims to address these problems. The two authors of this paper have varying degrees of sympathy with these two approaches. But we also believe that substantial common ground can be found, especially in terms of the goals we should be trying to achieve and some of the high-level policies that would help to achieve them. Moreover, some specific policies—like expanding the EITC or establishing wage subsidies—could be a part of any overall approach. Many of the ideas underlying these policies are already known but additional work would help to clarify remaining concerns and to develop concrete policy proposals that will be ready when an opportunity to address these issues presents itself.

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