Wage Subsidies in Developing Countries: Design and Implementation

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Wage subsidy = payment to worker or firm based on wages earned or paid

Sometimes described as an earnings subsidy, subsidized employment, hiring subsidy, or tax credit
Developed countries:
- Work Opportunities Tax Credit (U.S.)
- Contrat Initiative Emploi (France)
- SPAK (Netherlands)
- Others in Canada, U.K., Belgium, Finland, Austria, Denmark, ...

Developing countries:
- Youth Employment Subsidy (Chile)
- *Plan Jefes y Jefes* (Argentina)
- Youth Wage Subsidy Pilot (South Africa)
- Others in Turkey, Columbia, Mexico, ...
Why adopt a wage subsidy?

- Increase employment and/or reduce unemployment of low-wage labor, especially among vulnerable groups
- Promote skill development by increasing the work experience of low-wage workers
- Increase the return to low-skill labor, thereby reducing the dependence on public transfers
- Provide a stimulus to aggregate employment and demand, as well as combatting unemployment, during economic crises and downturns
Policy parameters of wage subsidy programs

- Payee – firm or worker
- Targeting – typically on long-term unemployed or vulnerable groups like the disabled, youth, older workers
- Duration – new hires vs all workers
- Payment vehicle – direct payment, reduction in payroll or social security taxes, refundable tax credit
- Basis for computing subsidy – earnings vs hourly wage rates
- Reporting requirements and program monitoring – ensuring prompt, accurate payments and detecting/deterring fraud
Effects of wage subsidies

- Wage subsidies lower the cost of (subsidized) labor and/or increase the incentive to work. This can lead to increased employment and/or wage rates.

- Wage subsidies may also:
  - Cause substitution of subsidized workers for unsubsidized.
  - Displace employment in other firms or sectors.
  - Shift workers from the informal to the formal sector.
  - Yield windfalls (to firm or worker) for workers who would have been employed anyway (“deadweight loss”).
  - Lead to fraud and abuse.
The Econ 101 of wage subsidies
## Effects of wage subsidies on employment and wage rates

<table>
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<th>Labor supply</th>
<th>Wage rates flexible downward</th>
<th>Wage rates inflexible downward</th>
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| perfectly elastic (e.g., large informal sector) | Firm or employee subsidy:  
- Increased employment  
- No change in wage rates | Firm subsidy:  
- Increased employment  
- No change in wage rates  
Employee subsidy:  
- No change in employment  
- Increased total wage  
- Increased unemployment |
| Labor supply not perfectly elastic | Firm or employee subsidy:  
- Increased employment  
- Increased wage rates | Firm subsidy:  
- Increased employment  
- Increased wage rates  
Employee subsidy:  
- No change in employment  
- Increased total wage  
- Increased unemployment |
Frequently introduced in response to economic crisis or spike in unemployment

Typically paid to employer

Typical target groups: long-term unemployed; youth; women; disabled; low-wage workers

Usually paid either as an income tax credit or a reduction in employer’s contribution to social security

Usually limited-duration – first 6 months to 3 years of employment
Evidence on the effectiveness of wage subsidies

- There have been a number of evaluations of wage subsidies in the U.S. and Europe, only a few in developing countries
- Most find moderate impacts on employment
- Many found substantial deadweight loss
- Few looked at effects on wage rates or substitution

Caveats:
- Methodology not always strong
- Program and effects vary from country to country
- Enough findings of no effect to give one pause
Implementation issues

- Outreach to publicize the subsidy
- Verifying eligibility
- Verifying employment, wages, and hours
- Making payments
- Management information system
- Evaluation and monitoring program outcomes
Costs will depend on:

- Size of the target group
- Whether subsidy applies to all workers or only new workers
- Take-up rate among eligible firms and/or workers
- Amount of the subsidy
- Nature ("elasticity") of the supply and demand for labor of the type subsidized

Before adopting a wage subsidy, it is prudent to do careful cost estimate based on simulation of labor market
Looking ahead – policy issues

- What is the intended policy objective – increased employment, skill development, or income support?
- Should the subsidy go to the employer or to the worker?
- What group or groups of workers should be subsidized?
- Should the subsidy be permanent or time-limited?
- What should be the amount of the subsidy?
- Should the subsidy be accompanied by other labor market services, such as training?
- How should the subsidy be administered?
Looking ahead – knowledge gaps

We need to:

- Evaluate existing wage subsidies
  - Effects on employment and wage rates
  - Substitution effects and deadweight loss
  - Shifts from informal to formal sector

- Test any new wage subsidies in randomized trials before national implementation

- Better estimates of elasticities of labor supply and demand

Wage subsidies hold substantial promise, but not enough is known about their effects and effectiveness
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