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Wage Subsidies in Developing Countries: Design and Implementation

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Presented at the IZA/World Bank/OECD Conference on Activation and
Employment Support Policies, Istanbul, Turkey, April 30, 2012



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



Some examples

- 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 Jefas* (Argentina)
 - Youth Wage Subsidy Pilot (South Africa)
 - Others in Turkey, Columbia, Mexico, ...
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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
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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
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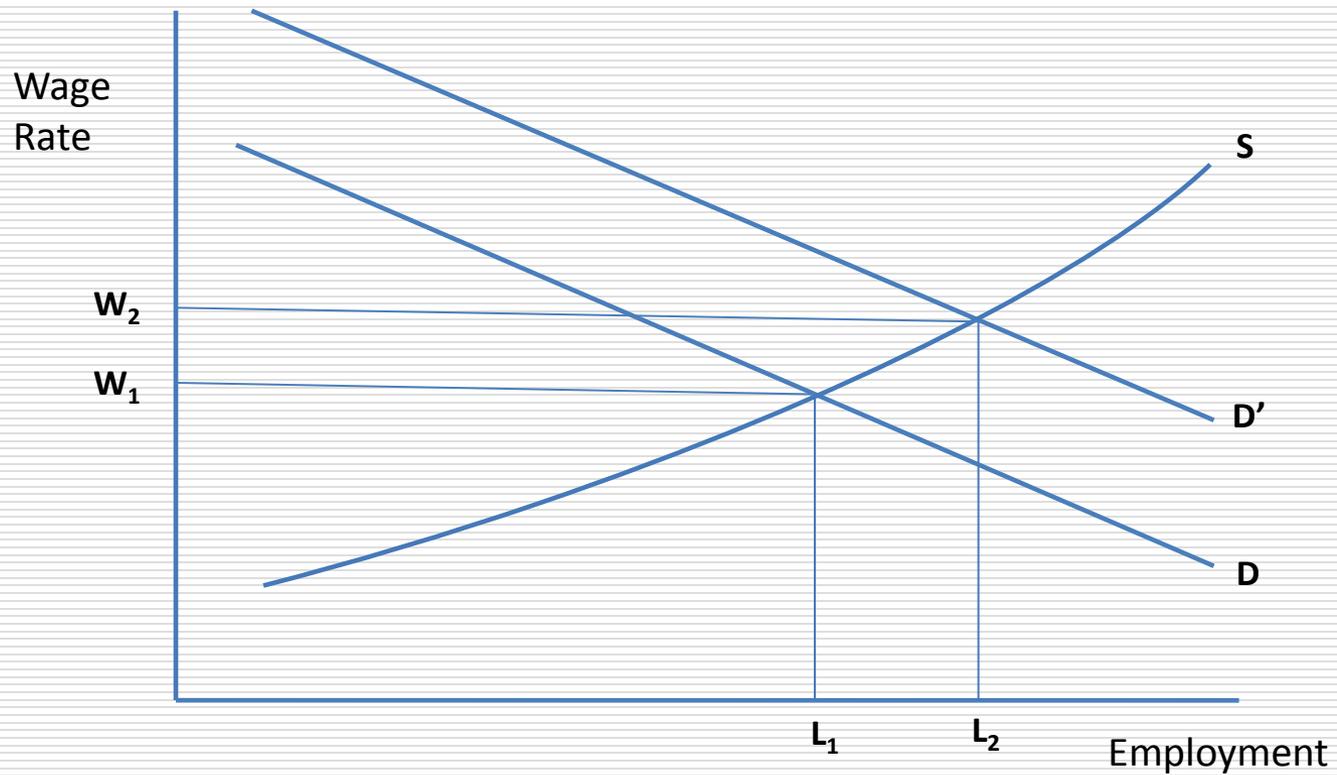


Effects of wage subsidies

- 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
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The Econ 101 of wage subsidies





Effects of wage subsidies on employment and wage rates

	Wage rates flexible downward	Wage rates inflexible downward
Labor supply perfectly elastic (e.g., large informal sector)	Firm or employee subsidy: <ul style="list-style-type: none"> • Increased employment • No change in wage rates 	Firm subsidy: <ul style="list-style-type: none"> • Increased employment • No change in wage rates Employee subsidy: <ul style="list-style-type: none"> • No change in employment • Increased total wage • Increased unemployment
Labor supply not perfectly elastic	Firm or employee subsidy: <ul style="list-style-type: none"> • Increased employment • Increased wage rates 	Firm subsidy: <ul style="list-style-type: none"> • Increased employment • Increased wage rates Employee subsidy: <ul style="list-style-type: none"> • No change in employment • Increased total wage • Increased unemployment



Wage subsidies in developing countries

- ❑ 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
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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
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Implementation issues

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

- 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
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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?
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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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