



THE WORLD BANK  
Working for a World Free of Poverty

JOHNS HOPKINS  
Institute  
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Studies

# 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

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## Some examples

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- 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?

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- ❑ 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

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- 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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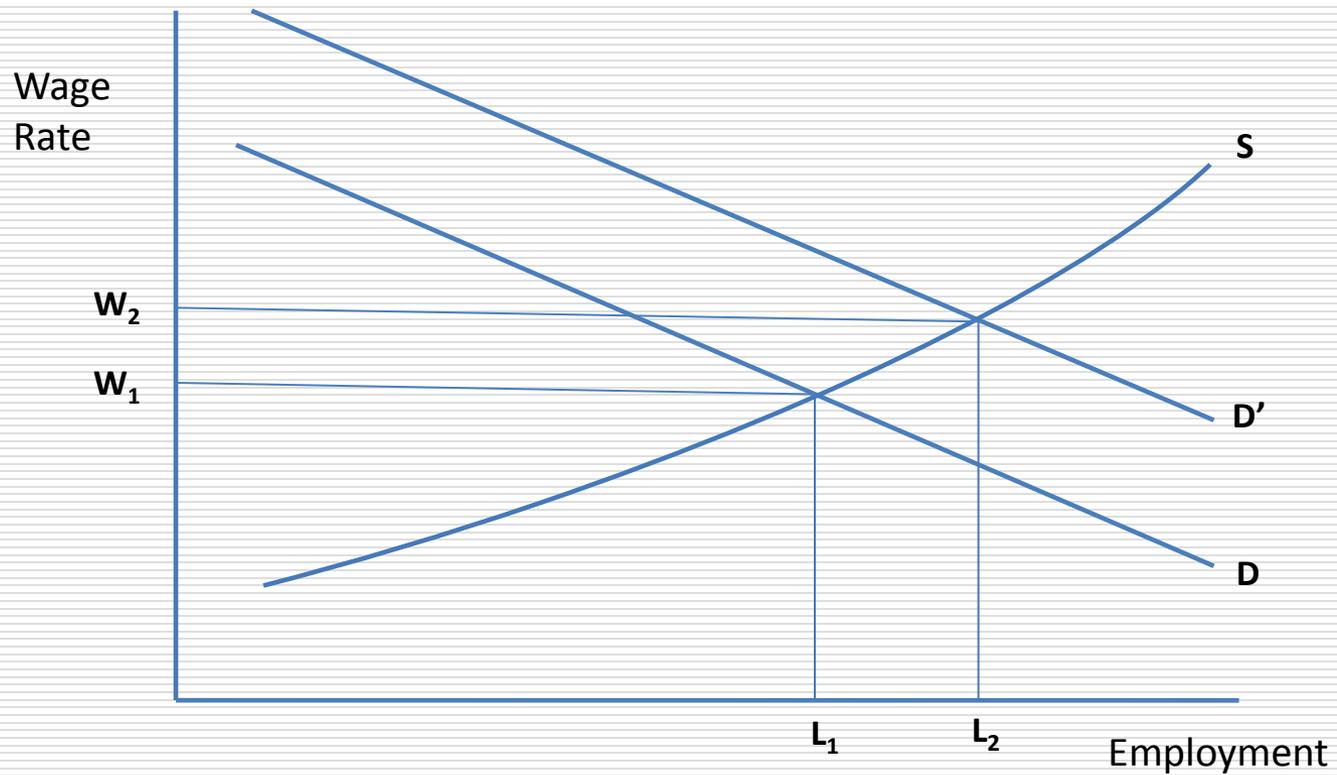
## Effects of wage subsidies

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- 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

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



## Wage subsidies in developing countries

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- ❑ 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

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- ❑ 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

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- 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

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- 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

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- 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

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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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