

Helping America's Low-Income Workers

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Outline of Remarks

- More on taxes and work activity
- Phelps proposal – economic issues
- Phelps proposal – political economy concerns
- An alternative proposal

Taxes and the Demand for Less Skilled and Secondary Workers

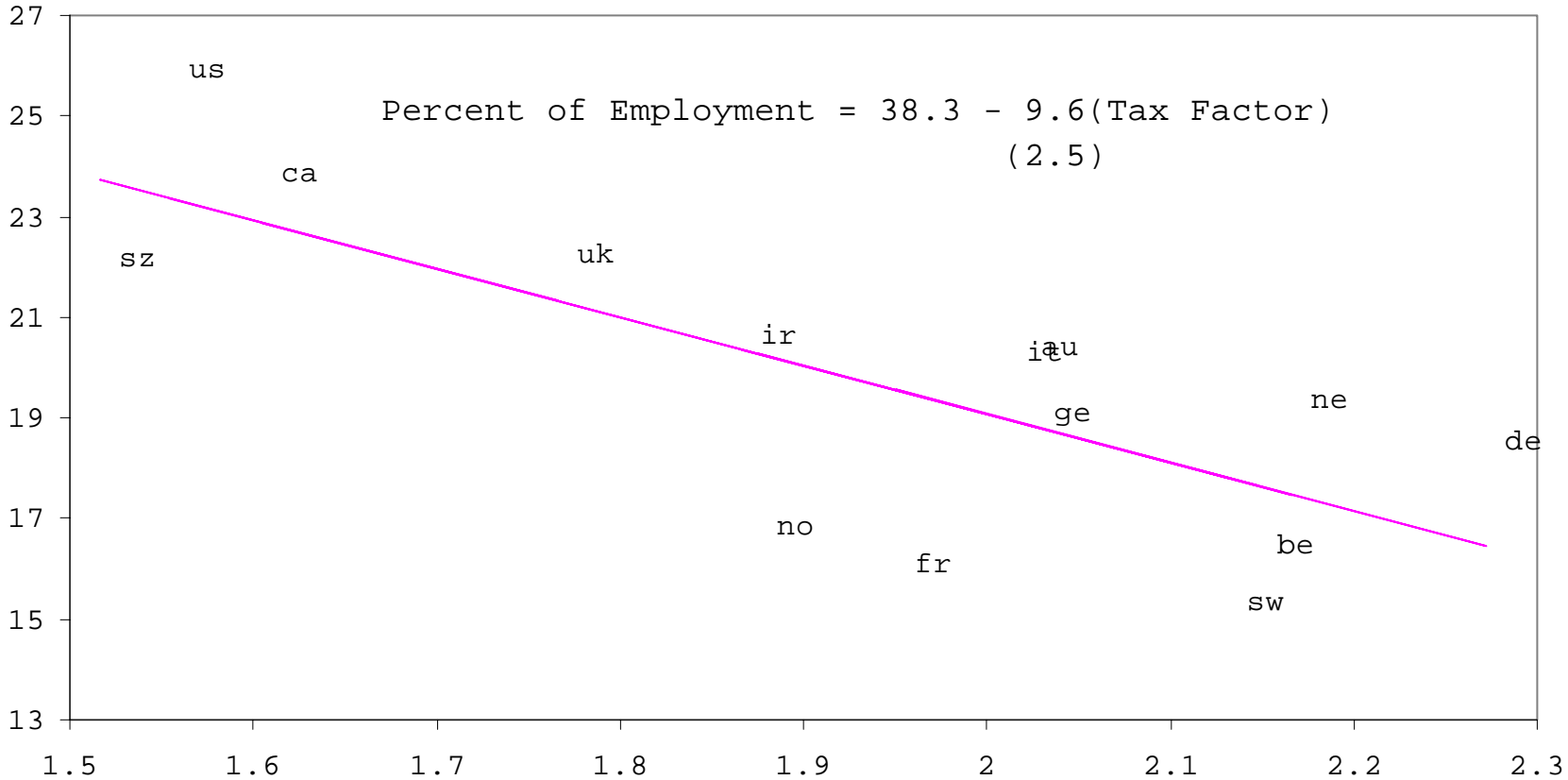
- Taxes on labor income and consumption expenditures encourage households to substitute from the market sector to home production and underground activity.
- Readily substitutable activities rely heavily on less skilled workers and secondary income earners.
 - Examples: restaurants, personal services, cleaning and laundry services, child care, consumer repair services, household maintenance and repair
- ➔ Uniform tax rates on consumption expenditures and labor income depress the relative demand for less skilled workers and secondary income earners.

A Bit of Evidence

The share of national employment and output in readily substitutable activities is lower in countries with higher tax rates on labor income and consumption expenditures (Davis and Henrekson, 2005).

Share of Employment in Trade, Eating, Drinking Lodging, Consumer Repairs, 1995, 14 Countries

Percent



Tax-Distorted Comparative Advantage Ratio

Amplification

- Less skilled workers and secondary income earners also tend to have more elastic labor supply according to most empirical studies.
- ➔ Hence, taxes twist the structure of labor demand away from less skilled and secondary workers, amplifying negative effects on work hours and employment

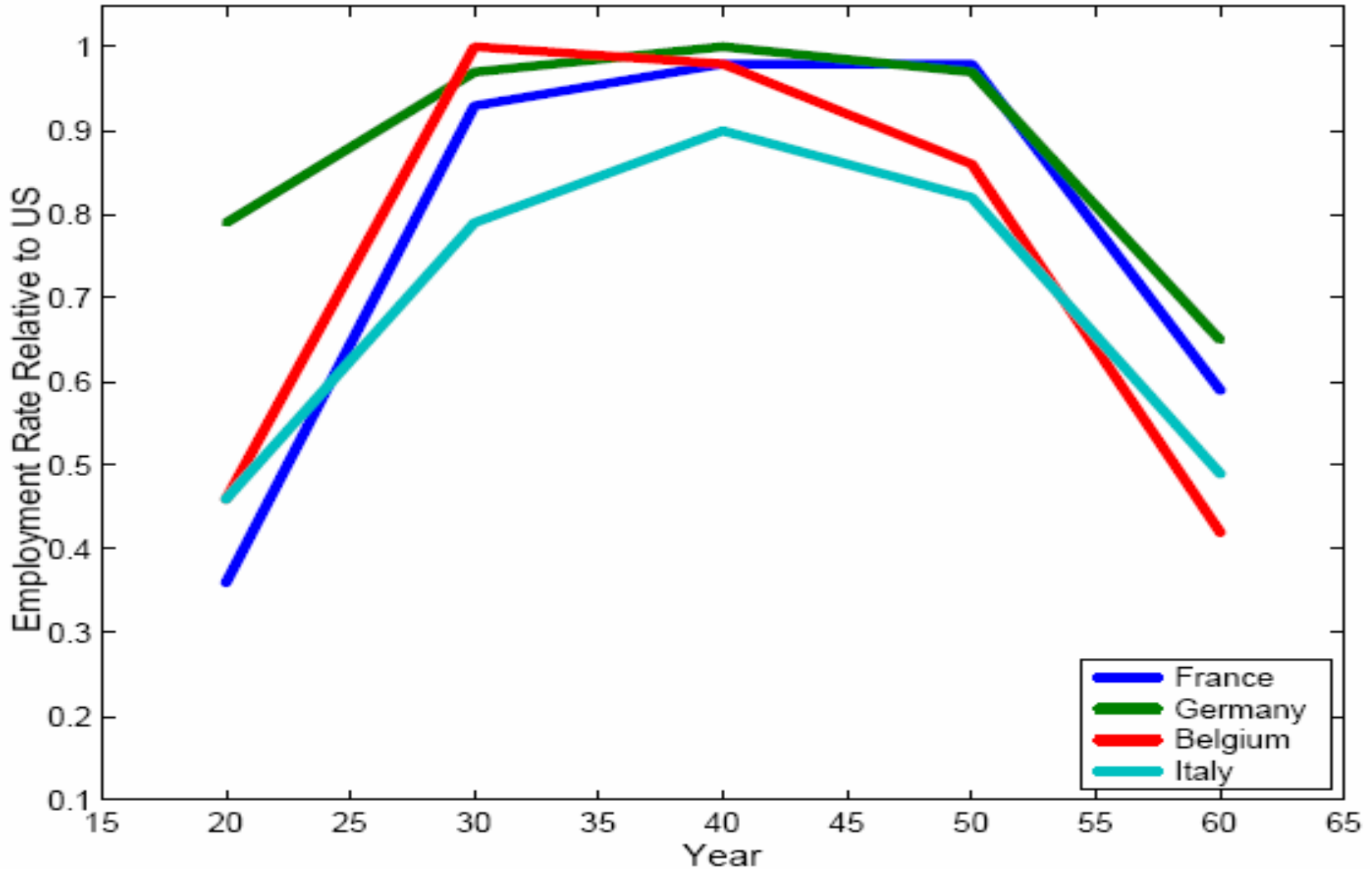
Market Work Activity Comparisons: Annual Hours Per Person, 15-64, 2004

	Hours	% of US
France	905	69.6
Italy	910	70.1
Germany	945	72.8
United Kingdom	1213	93.4
Japan	1229	94.6
United States	1299	100

Source: OECD Employment Outlook, 2005

Two Active Response Margins: Employment by Young and Old

Employment Rate by Age Relative to US 2000



Puerto Rican Example – Welfare State Run Amok

- Employment shortfall of stunning dimensions:
 - Employment rates roughly 25 percentage point below U.S. levels in last three decades
 - Employment gap of 7 percentage points in 1950s
- Many harmful policies, including
 - Access to most U.S.-level welfare programs
 - No EITC
 - Very high minimum wage relative to average wage
 - Misdirect tax subsidies (Section 936, etc.)
- See Davis and Rivera-Batiz (2005) and Enchautegui and Freeman (2005)

Subsidies to Workers, Jobs or Families?

Some Important Distinctions

- Workers from low-income households
- Workers with low earnings
- Workers who command a low wage rate
- Jobs with low earnings

Restricting the Subsidy to Private Enterprise

Economic Issues

- Blurry lines – some examples
 - Teaching assistants and tutors
 - Life guards
 - Hospital attendants
 - Cafeteria staff
- Public sector provision versus private enterprise (including “outsourcing”)

Restricting the Subsidy to Private Enterprise

Political Economy Issues

- A new fiscal tool for favoring some jobs, enterprises, and groups over others:
 - A dangerous precedent?
 - Why not bigger subsidies for “worthier” activities?
Seems like an irresistible political logic.
- Better to keep focus on encouraging employment rather than giving politicians a new tool for dispensing favors to particular business interests and consumer groups

An Alternative Proposal

- Introduce an annual personal exemption for social security taxes
 - A 12.4% subsidy, excluding Medicare HI
 - 15.3%, including Medicare HI
- Raise the OASDI cap by enough to achieve revenue neutrality
 - Current OASDI cap on annual taxable earnings is \$94,200
 - Requires economic analysis to determine revenue-neutral adjustment in OASDI cap

Remarks on Alternative

- Simple, easy to understand
- Easy to implement
 - Fits into current system for tax withholding
 - No need to separately verify wage rate and hours
- Less prone to political manipulation on behalf of special-interest groups
- A tax break for *persons* with low earnings rather *jobs* with low earnings
- Promotes employment, not “full-time” employment
- Comparison to expanded EITC

References

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