"Leveraging Wage Subsidies to Facilitate Fair Wages and Increase Social Welfare"

(Joint with Tomer Blumkin & Haim Pinhas)

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Abstract

Wage subsidies can be provided directly to the worker, as in the federal Earned Income Tax Credit (EITC) program. They can also be provided indirectly by subsidizing the employer; by reducing the cost of labor, employers are induced to offer higher wages. The standard literature stipulates the irrelevance of statutory incidence: the identity of the entity that is statutorily entitled for the subsidy bears no implications for the economic incidence. We propose and test a mechanism by which indirect subsidies can lead to higher social welfare. A substantial empirical literature establishes that workers reciprocate gifts in the form of higher wages with the gift of exerting higher effort. Thus, if a wage subsidy is implemented by indirectly subsidizing employers, employers face a lower cost of labor and increase their wages, leading workers to reciprocate with higher effort and productivity than achieved by providing the equivalent direct subsidy. A controlled laboratory experiment supports our behavioral hypotheses and confirms the behavioral and welfare implications. Participants played the gift-exchange game in three treatments: no subsidy, direct subsidy, and indirect subsidy. We find that workers reciprocate the gross wages, leading to higher effort at the same level of employer wage costs in the indirect subsidy treatment. Employers only partially shift subsidies to employees, leading to lower net wages in the indirect subsidy treatment, but at a lower subsidy costs. It follows that switching from direct to corresponding indirect subsidy increases social welfare.

The lecture will be held in English