Article

Work vs. Freedom: A Liberal Challenge to Employment Subsidies

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I. INTRODUCTION

Work has taken center stage in welfare reform. Federal legislation adopted in 1996 replaced the Aid to Families with Dependent Children (AFDC) program with Temporary Assistance for Needy Families (TANF).[1] The new law imposes a five-year time limit on benefits and requires states to put recipients to work more quickly than ever before.[2] The states are free to adopt shorter time limits and tougher work rules, and many have done so.[3] Politicians, including the President, argue that putting welfare recipients to work will end welfare "dependency" and usher in a new era of personal responsibility.[4]

To date, the transition to the new regime has been relatively smooth. States are experimenting with workfare, childcare assistance, and other initiatives.[5] A booming economy has given the states an extra cushion of federal funding,[6] and a tight labor market has helped to ease the implementation of the new work rules.[7] The welfare rolls in most states have dropped dramatically, although the decline began well before the 1996 legislation took effect and is attributable in large part to the economic recovery.[8]

Despite the early glow of success, the new approach to welfare reform is fundamentally flawed because it ignores the woeful condition of the low-wage labor market. The vast majority of welfare recipients will enter a labor market characterized by sub-poverty wages and little job security. Wages for low-skilled men fell twenty-two percent between 1979 and 1993,

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1. *See* Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105 (1996) (to be codified in pertinent part at 42 U.S.C. §§ 601-1788).

2. *See* 42 U.S.C.A. §§ 607, 608(a)(7) (West 1998); *cf.* COMMITTEE ON WAYS & MEANS, U.S. HOUSE OF REPRESENTATIVES, 1998 GREEN BOOK 472-88 (1998) (describing the work rules under AFDC) [hereinafter 1998 GREEN BOOK].

3. *See* 1998 GREEN BOOK, *supra* note 2, at 515-18.

4. For example, President Clinton predicted: "From now on our nation's answer to this great social challenge will no longer be a never-ending cycle of welfare: it will be the dignity, the power, and the ethic of work." William Jefferson Clinton, *Remarks at the Welfare Reform Bill Signing*, Aug. 22, 1996 (visited Feb. 20, 1999) (transcript available at <http://www.acf.dhhs.gov/news/welfare/wr/ 822potus.htm>).

5. *See* L. Jerome Gallagher et al., Urban Institute, *One Year After Federal Welfare Reform: A Description of State Temporary Assistance for Needy Families (TANF) Decisions as of October 1997* (visited Oct. 1, 1998) <http://newfederalism.urban.org/html/occas6.htm>.

6. *See* 1998 GREEN BOOK, *supra* note 2, at 505 (noting that TANF grants exceed AFDC funding by 10%).

7. *See* Bureau of Labor Statistics, *Economy at a Glance* (visited Nov. 5, 1998) <http://stats.bls.gov/eag.table.html> (showing that in June 1998, the national unemployment rate was 4.5%).

8. *See* Council of Econ. Advisers, *Technical Report: Explaining the Decline in Welfare Receipt, 1993-1996* (visited Oct. 1, 1998) <http://www.whitehouse.gov/WH/EOP/CEA/Welfare/Technical_Report.html> (finding that economic growth accounted for 44% of the AFDC caseload decline from 1993 to 1996, while state welfare reforms before TANF accounted for 31%).

and unemployment rates for this group remain high, even in good times.[9] Low-skilled women have seen a smaller drop in their wage rate, but their wages remain significantly below those of their male counterparts.[10] Although economists predict that the market can eventually generate enough jobs for all welfare recipients, they also expect that wage levels will remain too low for many welfare recipients to become self-sufficient.[11] In 1993, for example, only twenty-two percent of less-skilled single mothers earned enough to support their families at the poverty level.[12] Even the 1990s economic boom has only mitigated, rather than reversed, these long-term trends.[13]

The result is that TANF-style welfare reform will shrink the welfare rolls—but only by swelling the ranks of the working poor. Surprisingly, the response from critics has been muted. For the most part, they reject only the means of welfare reform, not its ends. Even left-leaning economists and policy analysts have largely accepted the right's agenda of putting welfare recipients to work.[14] But instead of leaving welfare recipients to the tender mercies of the market, they advocate an "employment strategy"[15] that uses the power of government to reduce unemployment and raise wages at the bottom.

Employment subsidies are one key component of this employment strategy. An employment subsidy is simply a payment by the government to firms that hire low-wage or otherwise disadvantaged workers. In 1997, the Clinton administration won passage of the new "welfare to work tax credit" (WWTC), which pays firms a one-time bonus of several thousand dollars for every former welfare recipient they hire.[16] Edmund Phelps, a

9. *See* REBECCA M. BLANK, IT TAKES A NATION 58-62 (1997) (describing wage trends for full-time, full-year workers).

10. Between 1979 and 1993, wages for female high-school dropouts who work full time, year-round, fell 6.3%. *See id.* at 63. In 1994, the average wage for female high-school dropouts working full time was $287, compared to $400 for male dropouts working full time. *See id.* at 61.

11. *See* Gary T. Burtless, *Welfare Recipients' Job Skills and Employment Prospects*, 7 FUTURE OF CHILDREN 39, 50 (1997) (concluding that a majority of welfare recipients will not find work that suffices to support a family above the poverty line after child care and transportation expenses are deducted).

12. *See* BLANK, *supra* note 9, at 80-81.

13. *See* Peter Passell, *Benefits Dwindle Along with Wages for the Unskilled*, N.Y. TIMES, June 14, 1998, at A6 (showing a six percent decline in real wages for workers with only a high school diploma between 1980 and 1996, and only modest wage increases in recent months).

14. *See, e.g.*, BLANK, *supra* note 9, at 260-63, 274-79 (recommending policies including job placement, training, and earnings supplementation); JOEL HANDLER & YEHESKEL HASENFELD, WE THE POOR PEOPLE 213-15 (1997) (recommending a set of programs to "attack poverty, and in the process reform welfare, by reforming the low-wage labor market").

15. The term is Rebecca Blank's. *See* Rebecca M. Blank, *The Employment Strategy: Public Policies To Increase Work and Earnings*, *in* CONFRONTING POVERTY 168 (Sheldon H. Danziger et al. eds., 1994).

16. I.R.C. § 51A (West 1998) (providing for up to $3500 in the first year of employment, and $5000 in the second year). For a more detailed discussion of the properties of the WWTC and other employment subsidies, see *infra* Sections III.B-D.

prominent economist, has a more ambitious proposal. Phelps advocates a permanent employment subsidy for *all* low-wage workers—not just former welfare recipients. At a cost of $125 billion each year, the program would pay private firms as much as $6000 per full-time employee.[17] Rather than a one-time payment, the subsidy would last as long as the worker remains employed. Phelps predicts that companies would respond by expanding employment and raising wages. Other prominent policy experts have also embraced employment subsidies.[18]

This Article argues that employment subsidies take a step in the right direction but concede too much to the work-centered agenda that motivated the 1996 welfare legislation. The case for employment subsidies rests on mistaken or morally dubious claims about the intrinsic or instrumental value of paid work. Advocates of the employment strategy typically invoke either "community values" or the social benefits of work to defend work requirements. But a closer look shows that the values (and the community) being invoked are too ill-defined, and the social advantages of work are too unproven, to construct a solid moral foundation for making assistance conditional on work. Employment subsidies would enhance the resources available to some of the poor, but they would exclude too many inner-city residents and women. Employment subsidies also confront a host of practical problems. Not least, they would require ongoing government manipulation of labor market processes that economists do not fully understand. By distorting market allocations, they could—ironically—lure even more people into a lifetime of dead-end jobs. Employment subsidies are also extremely difficult to design and administer. Past programs have been notable failures, largely because of administrative dilemmas that are virtually insoluble in programs of this kind.[19]

But there is a better way. A program of unconditional cash grants would enhance the freedom and economic security of the least advantaged. This cash strategy has three distinctive advantages. First, unlike employment subsidies (or conventional welfare programs), a modest, but truly unconditional source of income would allow the poor greater freedom to structure their working lives to meet personal and family needs, to seek more education, or even to choose where to live. Although no real-world program can promise boundless freedom for all, cash grants would go much

17. *See* EDMUND S. PHELPS, REWARDING WORK 112-16 (1997).

18. These analysts recommend employment subsidies as part of a larger package of job-related assistance. For two thoughtful efforts supporting employment subsidies and expansion of the EITC, see BLANK, *supra* note 9, at 116-17, 261-62; and HANDLER & HASENFELD, *supra* note 14, at 106-11.

19. *See infra* Part III.

further than either current, miserly programs or employment subsidies in expanding the real freedom of the least free members of society.[20]

Second, unconditional grants also would help open the way for labor market reforms that can expand employment opportunities. If the poor were guaranteed a modest income, the government could more readily reduce or eliminate the minimum wage and other market regulations adopted in the name of fairness. The cash program alone would go a long way toward eliminating welfare rules that burden work, and additional programs might expand economic opportunity for inner-city residents. Employment subsidies distort the labor markets and make the promise of income conditional on finding and keeping a full-time, low-wage job. In contrast, the cash strategy provides a secure income floor and then lets markets set wages at realistic levels. Freeing up the labor market could not only expand work opportunities but also make the real rewards and opportunity costs of low-wage work more transparent.

Third, the cash alternative has practicality, as well as principle, on its side. Unconditional cash grants are relatively simple to administer. Employment subsidies open up a host of new opportunities for abuse, inviting employers to understate wages, overstate hours, and even create phantom workers. Targeted employment subsidies, which call for detailed information on workers' income or personal history, only deepen the administrative quagmire. While cash programs are not entirely uncomplicated, they pose few new administrative challenges compared to the complex interventions that employment subsidies require.

These shortcomings suggest that even the political case for employment subsidies has been oversold. At first glance, the employment strategy seems to be a canny compromise: It channels resources to the poor while meeting popular demands to put welfare recipients to work. But political support for employment subsidies may falter when the complexity, uncertainty, and high cost of the programs becomes apparent.[21] To be sure, unconditional cash grants are not likely to be enacted in the immediate future. In the longer term, however, a better understanding of the cash strategy's merits

20. Unconditional cash grants are not a liberal panacea. They can raise incomes, and labor-market reforms can help make jobs available to those who want them. But neither unconditional grants nor employment subsidies attempt to address the underlying economic and educational inequalities that help cause poverty. Instead, the programs relieve poverty and mitigate the consequences of disadvantage. A truly comprehensive anti-poverty strategy would have to make thoroughgoing reforms in education and take other steps to equalize opportunity at the earliest stages of life. For one thoughtful program, see DANIEL P. MCMURRER & ISABEL V. SAWHILL, GETTING AHEAD: ECONOMIC AND SOCIAL MOBILITY IN AMERICA 85-89 (1998).

21. *See infra* Part III. Of course, political predictions are tricky. In the recent past, small employment subsidies have retained political viability despite their ineffectiveness, thanks to a coalition of low-wage employers and political leaders eager to appear to be "doing something" to find jobs for the unemployed. But those programs were small and relatively cheap. A significant employment subsidy should attract greater scrutiny.

could help make the difference. For instance, in Europe and Latin America the liberal case for the basic income has been more widely understood, and it is treated as a serious proposal in both intellectual and political conversations.[22]

This liberal argument for the cash strategy marks a departure from the conventional terms of debate in American tax- and welfare-policy circles. In philosophy and constitutional law, liberalism occupies center stage. In those fields, the great debates ponder the meaning of freedom and equality and the scope of individuals' rights against the collective. But when it comes to taxes and transfers, liberal principles of distributive justice give way to utilitarian talk of costs and benefits, incentives and disincentives.[23] To be sure, much of the utilitarian work in tax and transfer policy is admirably rigorous in identifying first principles and examining their policy implications.[24] And positive economics is enormously useful in analyzing the effects of tax policies. But on the normative side, utilitarian talk necessarily omits core liberal values of individualism, freedom, and equality.[25]

This Article begins to show how liberalism can contribute to a richer debate. To illustrate the practical potential of the cash strategy, I offer two unconditional cash grants—the basic income and the negative income tax. Although the two programs differ in some respects,[26] nothing in the argument requires a choice between them, although that issue could usefully be pursued on another occasion.[27] There are even more novel

22. *See, e.g.*, PHILIPPE VAN PARIJS, REAL FREEDOM FOR ALL (1995); Claus Offe, *Towards a New Equilibrium of Citizens' Rights and Economic Resources?*, *in* SOCIETAL COHESION AND THE GLOBALISING ECONOMY: WHAT DOES THE FUTURE HOLD? 81, 98-101 (Organisation for Econ. Co-op. & Dev. ed., 1997); Philippe Van Parijs, *Competing Justifications of Basic Income*, *in* ARGUING FOR BASIC INCOME 3 (Philippe Van Parijs ed., 1992); *see also Newsletter of the Basic European Income Network*, 28 BASIC INCOME (Basic European Income Network, Louvain-la-Neuve, Belgium), Christmas 1997, *available at* <http:// www.econ.ucl.ac.be/etes/bien/BI28.doc> (visited Feb. 20, 1999) (discussing basic income initiatives in various countries).

23. For two exceptions, see Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259 (1983), which makes a liberal case for the estate tax; and Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994), which argues that liberal principles undermine the case for the estate tax. But see Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996); and Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419 (1996), for critiques suggesting that McCaffery's argument is inconsistent with liberalism.

24. *See, e.g.*, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987) (using the principles of optimal taxation to explore the utilitarian case for progressivity); Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405 (1997) (considering utilitarian arguments for and against the minimum wage).

25. This Article is part of a larger project that seeks to demonstrate how liberalism can generate practical policies that look well beyond both the status quo and standard utilitarian prescriptions. *See, e.g.*, BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY (forthcoming 1999); Alstott, *supra* note 23.

26. *See infra* text accompanying notes 39-45.

27. *See, e.g.*, VAN PARIJS, *supra* note 22, at 35-38.

institutional alternatives for a liberal program. In *The Stakeholder Society*, Bruce Ackerman and I pursue a somewhat different, though complementary, approach.[28] In this Article, I advocate a basic income or negative income tax in order to frame the policy alternatives in the most familiar terms. In future work, we or others may pursue the finer questions of how best to combine basic income, negative income tax, stakeholding, and other programs.[29] For now, when the liberal perspective on tax and transfer policy remains so new, at least in the United States, the crucial task is to challenge the prevailing mania for work and to demonstrate the philosophical and practical advantages of the liberal alternative.

Even in utilitarian terms, however, it is not so clear that employment subsidies should carry the day. Twenty or thirty years ago, economists ranging from Milton Friedman on the right to Robert Lampman on the left embraced unconditional cash grants, including the negative income tax and the basic income, sometimes called a demogrant.[30] Their utilitarian arguments urged relieving poverty by simply giving resources to the poor. In contrast, today's policy debate most often marshals utilitarian arguments to support behavioral control of the poor through work requirements. I will argue that the new view ignores key strengths of the older tradition. As we will see, the liberal case for unconditional cash grants is strong and distinctive. By comparison, any utilitarian policy recommendation is contingent. But, as I will show, both economic theory and empirical evidence suggest that the cash strategy has considerable utilitarian advantages over employment subsidies.[31]

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28. ACKERMAN & ALSTOTT, *supra* note 25. Our basic stakeholding program is a one-time, cash grant of $80,000 for every 21-year-old U.S. citizen. *See id.* at 4-5. Citizens may also be entitled to a basic income in two circumstances. First, those who do not graduate from high school may not claim a stake but are entitled to the interest on their stake, which is in effect a basic income. *See id.* at 38. Second, Americans aged 67 or older may claim a "citizen's pension," or unconditional flat pension payment, which is also, in effect, a basic income. *See id.* at 129-54.

29. This Article goes beyond the scope of *The Stakeholder Society*, taking a close look at the economic and employment prospects of the most disadvantaged 20% (or so) of the population. For a brief comparison of stakeholding and a basic income, see *id.* at 210-16.

30. *See, e.g.*, MILTON FRIEDMAN, CAPITALISM AND FREEDOM 190-94 (1962); Robert J. Lampman, *Approaches to the Reduction of Poverty*, 55 AM. ECON. REV. 521, 526-27 (1965). *See generally* DANIEL P. MOYNIHAN, THE POLITICS OF A GUARANTEED INCOME (1973) (describing the political context of President Nixon's proposed Family Assistance Plan, which resembled a negative income tax in some respects).

31. The demogrant and negative income tax have not disappeared entirely from the tax- and welfare-policy literature. For recent utilitarian arguments, see Bankman & Griffith, *supra* note 24, at 1945-58, which advocates a demogrant as part of an "optimal" tax structure; and Shaviro, *supra* note 24, at 469-73, which argues for a negative income tax. Although these are excellent articles, they are not directly on point here, since they do not compare the utilitarian merits of a truly unconditional grant with those of a wage-rate subsidy. Bankman and Griffith are interested in average rate progressivity, *see* Bankman & Griffith, *supra* note 24, at 1945, and Shaviro's emphasis is on smoothly increasing marginal tax rates—both of which are compatible with making the cash payment conditional on work, *see* Shaviro, *supra* note 24, at 471-73.

For one efficiency analysis that explicitly prefers the wage subsidy to an unconditional grant, see Robert K. Triest, *The Efficiency Cost of Increased Progressivity*, *in* TAX PROGRESSIVITY AND

The Article proceeds in two stages. Part II contains the normative argument. The typical advocate of employment subsidies compares the policy to the status quo, contending that the program would increase both income and employment. This argument is misleading, however, since a basic income or negative income tax would be just as effective (if not more so) in raising incomes. Comparing employment subsidies to a basic income or negative income tax allows us to focus more rigorously on the central philosophical issue—the value of employment itself. Some proponents invoke communitarian rhetoric, suggesting that claimants for public support must work in order to live virtuous lives according to community standards. Others take a utilitarian tack, emphasizing the welfare-enhancing benefits of work for individuals, families, and communities. But both lines of argument romanticize low-wage work and exaggerate what employment subsidies can realistically contribute to either community solidarity or aggregate utility. More fundamentally, both philosophies are too ready to sacrifice the individual liberty of the least free members of society to some notion of the collective good.

Parts III and IV take up the practical side of the argument. Advocates of employment subsidies gloss over serious institutional questions. Employment subsidies require ongoing intervention in complex markets. They inevitably create design problems that sharply constrain their effectiveness. To date, our long-term experience with employment subsidies has been little short of disastrous. Although the Phelps program is more ambitious and somewhat better designed than existing policies, both economic theory and administrative experience suggest caution. Of course, we should not reflexively reject new ideas simply because they require institutional adaptation. But the trouble with employment subsidies goes to their core. Even if the policies work in textbook fashion, they cannot address the disparate problems of the inner-city minority poor, who face discrimination and transportation problems, and of low-income mothers of young children, who face distinctive barriers to sustained employment.

This Article offers a skeptical account of both employment subsidies and the broader employment strategy. We should not let our ideals be driven entirely by short-term political strategizing. We should keep alive a better aspiration: to maximize freedom, even for people who earn the fewest rewards in the market. A fuller development of the implications of liberalism suggests its radical potential for challenging conventional pieties about welfare and work.

INCOME INEQUALITY 137, 148-68 (Joel Slemrod ed., 1994), which estimates that the efficiency cost of an increase in the EITC is smaller than that of unconditional transfers. Triest's analysis, however, is incomplete, even in utilitarian terms: He measures only the efficiency losses of alternative programs and does not consider potential welfare gains from the broader redistribution that unconditional transfers accomplish.

II. IF EMPLOYMENT SUBSIDIES ARE THE ANSWER, WHAT IS THE QUESTION?

Arguments for employment subsidies typically take the status quo as their baseline. Phelps, for example, argues that employment subsidies should replace large portions of the current welfare state.[32] Welfare policy experts Joel Handler and Yeheskel Hasenfeld argue that employment subsidies and other programs are needed to temper the harshness of current welfare-to-work policies.[33] This Section asks a different question: Are employment subsidies superior to a program of cash assistance not conditioned on work?

This is a better question, for two reasons. First, it asks us to look beyond the politics and institutions of the moment. Parts III and IV return to practicalities. But to begin, we should measure the case for employment subsidies against an alternative ideal rather than the flawed status quo. Changing the baseline forces us to confront the very different ways in which redistribution can be accomplished and the fundamental values at stake in each case. Second, framing the question this way highlights the common but problematic assumption that promoting work should be a core value in American welfare policy.[34] That moral proposition merits a closer look.

This Part compares two sets of policies—a generic employment subsidy, on the one hand, and two types of unconditional cash grants, on the other. To highlight the main questions of principle, this Part abstracts quite a bit from institutional detail. The employment subsidy is modeled loosely on Phelps's plan—a wage-rate subsidy for full-time workers.[35] The maximum annual subsidy of $6000 is paid to the lowest-wage workers. The subsidy rate falls as the wage rate rises, so that firms receive the maximum subsidy for workers earning low wages and no subsidy at all for workers earning, say, twelve dollars per hour.[36] For simplicity, I assume that the employment subsidy is financed by an across-the-board increase in the

32. *See* PHELPS, *supra* note 17, at 129-34 (arguing that employment subsidies could reduce outlays for welfare, unemployment compensation, and the EITC).

33. *See* HANDLER & HASENFELD, *supra* note 14 at 217 (characterizing their proposals as a pragmatic and morally and socially responsible response to current welfare policy).

34. For examples of scholarship that makes this assumption, see MARY JO BANE & DAVID T. ELLWOOD, WELFARE REALITIES (1994); and IRWIN GARFINKEL, ASSURING CHILD SUPPORT: AN EXTENSION OF SOCIAL SECURITY (1992).

35. The Phelps plan is described in more detail *infra* Section III.C.

36. That is, the employment subsidy contains an implicit tax: As workers move to higher wage rates, their subsidy rate falls. For example, a worker earning $4 per hour receives a subsidy of $3, while a worker who moves up to $5 per hour would receive only $2.29. *See* PHELPS, *supra* note 17, at 113.

income tax.[37] I also assume that the employment subsidy both raises low wages and increases employment levels, as Phelps predicts.[38] (Part III uses economic theory and empirical evidence to question these rosy predictions, but for now let us grant employment subsidies the best-case scenario.)

The first type of cash grant is a *basic income* of $6000—a cash payment of $6000 made each year to every adult between the ages of eighteen and sixty-five.[39] This program is also assumed to be financed by an increase in the income tax. The distinctive feature of a basic income is that benefits are not formally reduced (or "phased out") as recipients' incomes rise. But the structure of the progressive income tax creates, in effect, an income test: Low-income households receive a net benefit (benefits exceed the new taxes imposed) while higher-income households make a net payment (new taxes exceed the benefit received). A basic income typically would pay net benefits at slightly higher income levels than would an employment subsidy (or a negative income tax).[40] Thus, a

37. Phelps proposes to increase income taxes or payroll taxes. *See id.* at 116-17. To simplify the analysis, I assume income-tax financing. By an "across the board" increase, I mean that each income class would pay the same proportion of the new taxes as it paid of the prior tax burden.

38. *See id.* at 115-16.

39. The age restriction is strictly for comparability; a true basic income might be payable per capita, regardless of age, or might pay smaller amounts to children and larger amounts to the elderly. *See* VAN PARIJS, *supra* note 22, at 39.

40. The crossover point, where net benefits turn into net taxes, depends on the program's structure, particularly the pattern of tax rates. The table below compares hypothetical programs:

TAXPAYER'S INCOME	NET BENEFIT		
	NEGATIVE INCOME TAX	BASIC INCOME (A)	BASIC INCOME (B)
$10,000	$6000	$6000 (no tax)	$6000 (no tax)
$20,000	$4500	$4500 ($6000 benefit minus $1500 tax)	$5000 ($6000 benefit minus $1000 tax)
$30,000	$3000	$3000 ($6000 benefit minus $3000 tax)	$4000 ($6000 benefit minus $2000 tax)
$40,000	$1500	$1500 ($6000 benefit minus $4500 tax)	$3000 ($6000 benefit minus $3000 tax)
$50,000	0	0 ($6000 benefit minus $6000 tax)	$2000 ($6000 benefit minus $4000 tax)
$60,000	-$1500	-$1500 ($6000 benefit minus $7500 tax)	-$800 ($6000 benefit minus $6800 tax)
$70,000	-$3000	-$3000 ($6000 benefit minus $9000 tax)	-$3600 ($6000 benefit minus $9600 tax)
$80,000	-$4500	-$4500 ($6000 benefit minus $10,500 tax)	-$6400 ($6000 benefit minus $12,400 tax)
$90,000	-$6000	-$6000 ($6000 benefit minus $12,000 tax)	-$9200 ($6000 benefit minus $15,200 tax)
TOTAL	0	0	0

basic income usually redistributes more income but also requires higher tax rates (particularly on middle-class and higher-income taxpayers) than a comparable negative income tax or an employment subsidy.[41]

The second cash program is a *negative income tax*, which provides an explicitly income-tested cash grant of up to $6000.[42] The income test reduces the cash benefit as income rises, as in conventional welfare programs (and some employment subsidies).[43] The income test reduces the revenue cost of the negative income tax compared to a basic income with the same benefit level. But the revenue savings requires, in effect, higher marginal tax rates on lower-income recipients.[44] To facilitate comparison, the negative income tax is assumed to require the same income-tax increase as the employment subsidy.[45]

The table assumes, for simplicity of illustration, that there are nine people in society, evenly distributed across nine income classes. Thus, the first person has income of $10,000, the second has income of $20,000, and so on up to $90,000. The negative income tax provides a benefit of $6000, which phases down at a rate of 15% as income rises over $10,000, so that the net benefit drops to zero at income of $50,000. The tax cost of the program is financed with an income tax of 15% of the amount of income over $50,000. There are two variants of the basic income.

Basic Income (A) demonstrates that one can, in principle, replicate the effects of a negative income tax. Basic Income (A) provides a universal cash grant of $6000, but imposes an income tax of 15% on income over $10,000. Basic Income (B) demonstrates a more typical pattern, with more progressive income tax rates: a $6000 universal benefit, financed by an income tax of 10% on income that exceeds $10,000 but is less than or equal to $50,000, and 28% on income in excess of $50,000. Basic Income (B) provides net benefits higher up the income scale than the negative income tax, but higher-income taxpayers face a marginal tax rate of 28% rather than 15%.

41. *See supra* note 40. The basic income is also more costly for a second reason: The eligible population is larger than for an employment subsidy. In 1996, for example, there were 90 million full-time workers (defined as those who work 35 or more hours per week) but 164 million adults between the ages of 18 and 65. *See* ECONOMIC & STATISTICAL ADMIN., U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 16 tbl.16, 406 tbl.635 (1997) [hereinafter STATISTICAL ABSTRACT OF THE UNITED STATES].

42. Because a negative income tax is income tested, those with the lowest incomes would receive the full $6000, while those with higher incomes would receive less. For an explanation of the basic mechanics, see FRIEDMAN, *supra* note 30, at 191-94.

43. *See infra* Sections III.C-D (discussing wage testing in the Phelps plan and income testing in the EITC).

44. The phaseout of benefits amounts to a "tax" on incremental earnings. Compared to a basic income, the negative income tax imposes a temporarily higher marginal tax rate at relatively low income levels in order to phase out benefits more quickly. *See supra* note 40; *see also, e.g.*, David Betson et al., *A Simulation Analysis of the Economic Efficiency and Distributional Effects of Alternative Program Structures: The Negative Income Tax Versus the Credit Income Tax*, *in* INCOME-TESTED TRANSFER PROGRAMS: THE CASE FOR AND AGAINST 175, 184 (Irwin Garfinkel ed., 1982).

45. A recent study suggests that a negative income tax comparable to the one I discuss in the text could be enacted for an amount close to the cost of the Phelps plan. *See* Fred Block & Jeff Manza, *Could We End Poverty in a Postindustrial Society? The Case for a Progressive Negative Income Tax*, 25 POL. & SOC. 473, 488-90 (1997). Block and Manza propose a negative income tax that has more generous benefits, but a higher phaseout rate, than the one I discuss in the text. Their plan would pay maximum benefits ranging from $6000 for single individuals to $16,500 for two-parent families with children. Benefits would phase out at a rate of 50%. *See id.* at 487 tbl.1.

According to Block and Manza's calculations, their negative income tax would have had a gross cost of $208 billion in 1990 (the year of their demographic data). *See id.* at 489. After taking into account offsetting savings in other programs, they find that the net cost would have been $55

I offer two alternative cash programs because each is comparable, in at least one important respect, to the employment subsidy. The basic income provides the same $6000 per-person transfer but would require higher income tax revenues. The negative income tax provides the same maximum benefit of $6000 and requires no higher tax revenues than the employment subsidy, but imposes a steep "phaseout" rate as incomes rise. Neither program is equivalent to the employment subsidy, because, as I shall explain, the targeted groups and the terms of the program necessarily differ. Yet each alternative captures at least one important economic resemblance.

My argument in this Part does not require a choice between the two cash alternatives, and I will generally treat them as interchangeable. On occasion, where a distinction between the cash programs is relevant to some nuance of the normative argument, I will highlight the variation. And I will return to the differences between the programs again in the discussions of administration in Parts III and IV.

Two final institutional details are important for the analysis. First, the $6000 cash grants are not intended to provide a subsistence-level income.[46] Not only are the grants low, but they also are invariant to family size, just as the employment subsidy is. For purposes of comparison, in 1997, the federal poverty threshold for a single person was $8183 and for a family of four was $16,276.[47] For present purposes, however, the $6000 grant simply renders the cash benefit and the employment subsidy comparable in magnitude. The resulting cash grant may seem small, but it is far from trivial. In 1997, a $6000 cash grant would have been larger than the maximum annual welfare benefit (for a family of four) in thirty-five states.[48]

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billion in 1990 dollars. *See id.* at 490. In contrast, Phelps calculates that his program would have a gross cost of $125 billion and a net cost of $5 billion. *See* PHELPS, *supra* note 17, at 116, 126-34. However, Phelps is more aggressive in calculating budget savings than Block and Manza. For example, Phelps anticipates reducing law-enforcement costs by $25 billion and cutting Medicaid spending by $15 billion. *See id.* at 129. Block and Manza do not anticipate any cuts in law enforcement or Medicaid. Eliminating those revenue offsets would raise the net cost of the Phelps program to $45 billion. Without knowing the details of both authors' calculations, it is impossible to make a rigorous comparison. Nevertheless, the Block and Manza proposal suggests that my rough comparison is at least in the ballpark.

46. I am setting aside the question whether the basic income *should* be set at a subsistence level. I also ignore the interesting question of coordination with benefits for the elderly and people with disabilities and simply assume that the grant is for adults of working age (21-65) who are able to work.

47. *See U.S. Bureau of the Census, Poverty Thresholds: 1997*, (visited Oct. 1, 1998) <http://www.census.gov/hhes/poverty/poverty97/pv97thrs.html>. The threshold for a family of four assumes two adults and two minor children in the household.

48. *See* 1998 GREEN BOOK, *supra* note 2, at 524-25 tbl.7-47 (showing maximum TANF benefits and a median benefit of $379 per month); *id.* at 454 tbl.7-24 (showing that in fiscal year 1995, the average number of people constituting an AFDC unit was 2.8). I assume that either an employment subsidy or a basic income would replace current cash welfare programs for working-aged adults—i.e., TANF and general assistance.

Second, as Phelps recommends, the employment subsidy applies only to full-time workers.[49] While an employment subsidy might be offered for part-time work, I am choosing to begin with the most extreme rule. In Part IV, I note that one of the attractions of the EITC is that it relaxes the full-time requirement. But this compromise requires significant philosophical and practical concessions by advocates of employment subsidies.

In the remainder of this Part, I articulate the basic liberal argument for the cash programs and then consider the two strongest arguments for employment subsidies. These are respectable views, and I cannot "refute" them in any dispositive way. Rather, my purpose is to demonstrate that the best arguments for employment subsidies rely on questionable empirical assumptions and sacrifice the individual freedom of the poor to a questionable vision of the greater social good.

A. *Setting the Baseline: The Liberal Case for Basic Income (or a Negative Income Tax)*

In contrast to utilitarians, whose goal is to maximize aggregate utility,[50] liberals seek to ensure that every individual has the greatest possible freedom to shape her own life. Liberals generally agree on state neutrality toward competing visions of the good life in order to give primacy to individuals' decisions about their own lives. In its egalitarian incarnation, liberalism rejects the libertarian idea that the invisible hand of the market distributes resources fairly. "Formal freedom"—the individual's power to do what she will, given the circumstances in which she was born—is not enough. Instead, each individual is equally entitled to resources that will give her *real* freedom to shape her life.[51] Basic background institutions—including taxes and transfers—should create fair starting points and enable the greatest possible liberty for all. Liberals of this stripe include Bruce Ackerman, Ronald Dworkin, John Rawls, and Philippe Van Parijs.[52] Taken together, these liberals defend the core values of equality of resources, neutrality toward visions of the good life, and individual freedom.[53]

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49. *See* PHELPS, *supra* note 17, at 108.

50. By "utilitarians," I mean those who accord equal weight to each individual's utility. This method employs, in effect, a pure "utilitarian" social welfare function, rather than a maximin or some other weighting rule.

51. *See* VAN PARIJS, *supra* note 22, at 21-29.

52. *See* BRUCE ACKERMAN, SOCIAL JUSTICE IN THE LIBERAL STATE (1980); JOHN RAWLS, A THEORY OF JUSTICE (1971); Ronald Dworkin, *What Is Equality? Part I: Equality of Welfare*, 10 PHIL. & PUB. AFF. 185 (1981); Ronald Dworkin, *What Is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283 (1981) [hereinafter Dworkin, *Part 2*]; VAN PARIJS, *supra* note 22; *see also* ACKERMAN & ALSTOTT, *supra* note 25 (applying principles developed in ACKERMAN, *supra*, to specific issues of tax and transfer policy).

53. Of course, this thumbnail sketch blurs many important differences within this group. Not all of these writers have offered concrete policy prescriptions for dealing with the problem of low-

A basic income serves these liberal goals. Van Parijs, for example, justifies it as a way of maximizing the freedom of the least free individuals. He proposes a basic income set at the highest sustainable level (taking into account incentive effects), arguing that it would maximize the worst-off individuals' freedom to arrange their lives as they wish.[54] They may work as much or as little as they choose, provided they can otherwise survive on their basic income. Van Parijs's example is the surfer—who chooses to live on very little cash but gets a lot of satisfaction from spending his time at the beach. Conventional morality might condemn the surfer as a "do-nothing"—but in a truly liberal regime even the slackers have an equal right to their fair share of resources to fulfill their own vision of the good life.

A related line of liberal argument might justify the negative income tax. As discussed above, the key difference between the negative income tax and the basic income is that a negative income tax imposes a higher marginal "tax" rate at lower income levels.[55] Liberals may advocate one program or the other,[56] but both provide unconditional cash assistance and a benefit (net of taxes) that depends on income.

Ronald Dworkin offers a distinctive liberal justification for cash grants to low-earners, financed by a progressive income tax.[57] In Dworkin's ideal theory, all participants enter the market with equal resources, but thereafter the free market sets the price for every commodity including labor. Under these conditions, market prices are fair, because prices for any particular resource—a piece of land, say—reflect the opportunity cost of the land to everyone else. The problem, though, is that the market price for some kinds of labor may leave some people unable to earn a living. (For example, a liberal society in which many people valued literature, but no one liked basketball, would leave Toni Morrison a very wealthy person, but Michael

earners. For example, Rawls's influential book is short on specifics, although he does suggest that unskilled workers might be the least advantaged. *See* RAWLS, *supra* note 52, at 98. Those who have specifically considered the situation of low-earners endorse analogous policies for rather different reasons. For example, Dworkin's social insurance scheme relies on talent-pooling, *see* Dworkin, *Part 2*, *supra* note 52, at 314-23, which Van Parijs rejects, *see* VAN PARIJS, *supra* note 22, at 68-77; *see also infra* note 73. And some would prefer another program over a basic income or negative income tax. *See* ACKERMAN & ALSTOTT, *supra* note 25, at 1-17, 210-16. Nevertheless, this simplified approach should suffice to contrast liberalism with the utilitarian and communitarian approaches I will invoke shortly.

54. *See* VAN PARIJS, *supra* note 22, at 30-40.

55. *See supra* text accompanying notes 40-41.

56. Van Parijs favors a basic income, not because of the marginal tax rate structure, but because of its advance payment feature. A negative income tax—or conventional welfare program—typically contains a lag between the time income drops and the time eligibility is determined. A basic income, in contrast, is immediately available in full. *See* VAN PARIJS, *supra* note 22, at 36.

57. *See* Dworkin, *Part 2*, *supra* note 52, at 314-23.

Jordan not so fortunate.)[58] Although people with low market wages are not disabled in any obvious way,[59] the outcomes of free-market bargaining can leave them with few resources at their command.

Dworkin argues that this prospect would lead citizens to agree in advance to a system of social insurance that would put a floor on the income any individual will receive.[60] No matter what the value of my talents in the marketplace, I will be assured a minimum income of $X. Putting a value on $X requires further argument,[61] but for present purposes, suppose that it is the poverty level for a family of four, or about $16,000. If my market wage turns out to be only $10,000 a year, the social insurance fund will pay me $6000 a year to make up the difference. The fund raises the money to make these payments from a progressive income tax, which was also agreed upon as the fairest way for citizens to pay "premiums." The net redistribution runs from people who use their talents to earn high market incomes to those who do not have highly-valued market talents.[62]

Dworkin's ideal scheme is not precisely equivalent to either the basic income or the negative income tax. Dworkin's payments, for example, would be contingent on ability, and not income level. If I have the capability to be a Wall Street lawyer, I could not collect social insurance payments because I chose to work at a low-paid job instead. And the payment level would vary with my ability—$6000 if my maximum earnings were $10,000, but only $2000 if my maximum earnings were $14,000. Still, both the basic income and negative income tax are reasonable, if imperfect, real-world translations of the Dworkinian ideal. After all, it is impossible to observe ability reliably. Even if this could be done, in the real world, people's opportunities are limited not only by their innate talents but also by social and educational inequalities.[63] An inner-city child may possess talents that would be valued highly in the market but have no chance to develop them, if she lives in a dangerous neighborhood and goes to substandard schools. Although the first-best response would be

58. *Cf.* Graetz, *supra* note 23, at 275 (noting that demand for goods and services, and therefore particular skills, varies with public tastes).

59. The argument here does not address what is owed to people with conventionally-recognized physical and mental disabilities. For a variety of approaches, see ACKERMAN, *supra* note 52, at 107-38; VAN PARIJS, *supra* note 22, at 58-84; and Dworkin, *Part 2*, *supra* note 52, at 292-304.

60. In Dworkin's version of the "original position," citizens know in advance what their talents are, but they do not know how the market will value them. *See* Dworkin, *Part 2*, *supra* note 52, at 316.

61. Dworkin discusses a variety of arguments about why social insurance provisions will guarantee a decent but not lavish income. *See id.* at 319-23.

62. Dworkin assumes away the epistemic difficulty of ascertaining what people's abilities are. In his insurance scheme, a talented person who could earn more but chooses not to is excused from paying (much) income tax, but may not collect a benefit. *See id.*

63. *See* ACKERMAN & ALSTOTT, *supra* note 25, at 26-27, 160-62.

to correct these inequalities of opportunity, some form of cash benefits tied to actual earnings may be a reasonable second-best accommodation.

Although Dworkin does not consider employment subsidies explicitly, his argument has some clearly negative implications. In Dworkin's theory, low earnings capacity is a kind of disability. If my talents are sufficiently low-valued by the market, I am effectively "disabled" from performing a basic task that others can do—earning a living by selling my labor. The important point is that the remedy for this employment-related disability should be a cash payment rather than an employment subsidy, which would raise my market wage.

The liberal perspective invokes, once again, the value of freedom. Compared to an employment subsidy, a cash payment enhances the opportunities of the person with low earnings capacity. Recall the person whose ability allows her to earn a maximum of $10,000 and who now receives an unconditional cash grant of $6000. The cash payment gives her a range of choices that the employment subsidy does not. She may choose to work as hard as she can (full time) and take home a total of $16,000. Or perhaps she will work half-time, earning only $5000, and manage to live on a total of $11,000. If she is extraordinarily frugal and ascetic—or has generous friends—she might choose not to work at all, and get by on $6000. The employment subsidy, by contrast, restricts her choice: She gets the $6000 supplement only if she works full time.

But, the critic may respond, is the cash program really fair to the taxpayers who are funding the $6000 payment? Is their freedom not reduced? After all, they are not only working for themselves, many full time, but now must pay higher taxes. The low-earner now appears to have more freedom than they do. This is, of course, a real-world complaint that expresses some of the frustration of the working and middle classes toward the welfare poor: *I* have to go to work; *I* can't stay at home with my kids even if I want to; *why should she*?[64]

64. The situation of today's welfare recipients (and the working poor) is not so different from Dworkin's hypothetical case, since many have low earnings capacity. This is not to say that poor people necessarily have low "ability"—*The Bell Curve*'s questionable argument has justly been challenged. *Compare* RICHARD J. HERRNSTEIN & CHARLES MURRAY, THE BELL CURVE: INTELLIGENCE AND CLASS STRUCTURE IN AMERICAN LIFE 105-13, 127-42, 155-66 (1994) (arguing that low intelligence is the best predictor of poverty and unemployment and that intelligence is primarily inherited), *with* THE BELL CURVE WARS (Steven Fraser ed., 1995) (arguing against Herrnstein's and Murray's conclusions), CLAUDE S. FISCHER ET AL., INEQUALITY BY DESIGN: CRACKING THE BELL CURVE MYTH (1996) (same), Howard Gardner, *Cracking Open the IQ Box*, AM. PROSPECT, Winter 1995, at 71 (same), Steven J. Gould, *Curveball*, NEW YORKER, Nov. 28, 1994, at 139, *passim* (same). A combination of disadvantage (poor schools, racial discrimination, and so on) and shifts in market demand for low-skilled labor have left a significant group of people without the ability to earn a living. Although in the future, we should try to improve the background conditions that limit their choices, it is irresponsible to ignore the fact that today many people have socially-imposed, rather than natural, disabilities that limit their earnings capacity.

The answer to the challenge is that, despite their complaints, the high-earning taxpayers still have more freedom than the low-earner who collects a net cash benefit. The low-earner's choices are limited to the three options above, and none of them, realistically, is particularly attractive. The $6000 payment cannot transform the low-earner's life chances in a dramatic way; it simply expands her options a little. In contrast, a high-earner has more life options, since she has all the opportunities that the low-capacity earner has, and then some. Table 1 presents a highly simplified picture of the range of life choices open to each person under either a basic income or an employment subsidy. Relative to a cash grant, an employment subsidy contracts the range of choices open to the low-earner, without expanding the freedom of the high-earner.

The table illustrates two key points. First, the cash benefit improves the low-earner's range of life choices, compared to the employment subsidy. In every case she has at least as much free time, and in two of three cases she has more cash too. Her opportunity set is enhanced. Second, in every case the high-earner has a better range of life options than the low-earner does. Even if the government guaranteed an unconditional cash grant to all those who can (or choose to) earn very little, in all three situations, the high-earner has the same amount of leisure and as much or more cash than the low-earner.[65]

Thus, the high-earner should hesitate before complaining about the nonworker who chooses to live on her basic income or negative income tax. In the end, the high-earner has a greater range of meaningful life choices. If she chooses to work part- or full-time for a high salary, she is pursuing a life plan that is simply beyond what is open to the low-earner. To be sure, the high-earner may feel beleaguered at times, as if she has "no choice." Perhaps she is working long hours to pay the mortgage, buy good clothes for the children, and save for their college education. The higher taxes needed to fund unconditional cash grants will make it harder to achieve her goals. But the important point is that even these conventional aspirations are far beyond the low-earner's capabilities—her $16,000 maximum will not suffice to buy a middle-class lifestyle, nor will her $6000 grant if she does not work. If she does not work in the market at all, she will have to live under very frugal conditions indeed.[66] Those of us with better prospects should not begrudge her the little bit of extra freedom and dignity that the unconditional cash grant confers.[67]

65. For purposes of illustration, the table assumes that a cash grant of $6000 is available only to those who can (or choose to) earn less than $20,000 per year. Those with higher earnings receive nothing.

66. *See* KATHRYN EDIN & LAURA LEIN, MAKING ENDS MEET 20-59 (1997).

67. Indeed, it may be appropriate to set the cash grant higher, if economically feasible. But for the reasons I describe in the introduction to Part II, I will not pursue here the question of how large the optimal basic income or negative income tax ought to be.

TABLE 1. HOW CASH GRANTS AND EMPLOYMENT SUBSIDIES AFFECT FREEDOM

LIFE CHOICE	CASH BENEFIT		FULL-TIME EMPLOYMENT SUBSIDY	
	LOW-EARNER	HIGH-EARNER	LOW-EARNER	HIGH-EARNER
FULL-TIME WORK	$16,000[68] + Minimal Leisure	$100,000 + Minimal Leisure	$16,000 + Minimal Leisure	$100,000 + Minimal Leisure
HALF-TIME WORK	$11,000[69] + Medium Leisure	$50,000 + Medium Leisure	$5000 + Medium Leisure	$50,000 + Medium Leisure
NO WORK	$6000 + Maximum Leisure	$6000 + Maximum Leisure	$0 + Maximum Leisure	$0 + Maximum Leisure

The results are much the same even if we complicate the analysis. One objection might be that tax rates will rise too much. Under my introductory assumptions,[70] a basic income (though not a negative income tax) would cost more and therefore require higher tax rates across the board than an employment subsidy. Table 1 implicitly assumes that the tax rates on the high-earner are the same under either a cash grant or an employment subsidy. The result would be the same, however, even if the cash grant requires much higher tax rates. As long as the high-earner keeps at least as much after-tax cash as the low-earner in each work scenario, the high-earner enjoys greater freedom. This answer, however, raises another objection: Does the liberal position imply that we should tax away *all* of the high-earner's extra earnings to fund a high basic income?

Not necessarily. For one thing, at some point higher tax rates may produce disincentives that reduce revenue available for a basic income. We need not be utilitarians to take economic incentives into account. But the liberal approach offers a distinctive standard for evaluating when taxes are too high. The utilitarian calculus in effect treats welfare gains to the poor and welfare losses to the rich (including losses due to disincentives) as morally equivalent. One simply chooses the combination of taxes and transfers—whatever it may be—that maximizes aggregate welfare. In contrast, Van Parijs suggests the criterion of sustainability: The right policy is the highest sustainable basic income, taking into account the disincentive

68. Cash grant of $6000 plus full-time wages of $10,000 ($5 per hour for 2000 hours).
69. Cash grant of $6000 plus half-time wages of $5000 ($5 per hour for 1000 hours).
70. *See supra* text accompanying notes 35-45.

effects of taxes.[71] The sustainability standard may approve tax rates that are higher than the utilitarian criterion would allow.[72] But in all likelihood, the sustainable tax rate will allow the high-earner to keep a significant fraction of her earnings.[73]

Another objection is that Table 1 unrealistically divides the world into high- and low-earners, ignoring the large middle group that is especially likely to feel burdened by the taxes necessary to finance a basic income. But it is easy to add a "middle-earner" to Table 1. There are two principled constraints on the tax burden for the middle-earner: First, the middle-earner should keep at least as much cash in each work scenario as the low-earner;[74] second, the tax should be low enough to make the chosen level of basic income sustainable. Now suppose that those criteria are met, and the middle-earner pays more in taxes than she does today, while the low-earner collects a basic income. In that case, the middle-earner may feel that she is being treated harshly, because her wages are funding benefits for the low-earners.

Once again, what this objection misses is that the middle-earners' set of opportunities *includes* the lower-earners'. The middle-earner can work fewer hours or take a low-level job and collect the basic income or negative

71. *See* VAN PARIJS, *supra* note 22, at 38-41; *cf.* RAWLS, *supra* note 52, at 78 (noting that the difference principle may encourage entrepreneurship that works to the long-term advantage of the worst-off class).

72. That is, there may be a net utility loss, because the rich lose more utility than the poor gain. This is a highly uncertain proposition, for two reasons. First, it makes an implicit assumption about the economic effects of taxation and the declining marginal utility of money. If the behavior of the rich is inelastic enough, or their tastes jaded enough, we might enact very large and very *efficient* taxes and transfers. Second, the efficiency claim requires that we make interpersonal utility comparisons—a dubious proposition indeed. For a brief introduction to that debate, see Bankman & Griffith, *supra* note 24, at 1917-18.

Even granting that the liberal tax burden may in some cases be inefficiently high, it is still the case that the utilitarian calculus ignores the claims of individuals. Even if the price of fairness to individuals is a smaller economy, the price is worth paying. The situation would be different if, for example, it turned out that the higher taxes reduced economic activity in a way that particularly harmed the opportunities of the least advantaged. In that case, policymakers should revisit the level of taxes and their structure. Forced to consider not only the reduction in the size of the pie, but the distribution of the economic losses, the liberal would have to weigh incommensurables: the value of unconditional resources provided by a basic income against, say, a smaller range of job opportunities at the bottom, or lower wages.

73. This issue also raises the question of "talent-pooling," which I have so far avoided. In some schools of thought, the high-earner has little or no moral claim to her success; after all, genetic endowments and psychological attributes such as persistence and ambition are randomly distributed in the population and are not earned by the individuals who possess them. And economic success often includes a substantial component of sheer luck and requires the contribution and cooperation of many people, not all of whom are so well compensated. *See* RAWLS, *supra* note 52, at 101-02; Dworkin, *Part 2*, *supra* note 52, at 292-304. Other liberals reject this view, however; both Van Parijs in *Real Freedom for All* and Ackerman in *Social Justice in the Liberal State* admit more room for individuals to claim the fruits of their own talents. *See supra* notes 22, 52. One's views on this question will affect the degree and type of taxation that can be justified, but it is beyond the scope of this Article to explore these nuances.

74. Real-world welfare programs with steep phaseout rates may violate this condition, leaving some of the working poor worse off than welfare recipients.

income tax. Some people might make that choice. Yet one suspects that relatively few middle-class people would dramatically cut back their work hours or voluntarily take bad jobs in order to qualify for a government payment. I want to defer the empirical question of whether that is an accurate prediction.[75] For present purposes, the point is normative: Like the high-earner, the middle-earner has all the choices that the low-earner has, and then some.

We might usefully complicate the analysis even further by adding a fourth segment of society. The working class (i.e., those relatively low earners who fall just above the lowest earning class) may actually receive a net *benefit* from a basic income or negative income tax of the type described above. In contrast, conventional welfare payments aid only the very poor; traditionally they have excluded most two-parent families as well as most families headed by a steady worker.[76] A gradual phaseout of the negative income tax or a progressive marginal rate in the income tax used to fund the basic income would ensure that the working class retains some net benefit—albeit a smaller one than the lowest earners receive.[77] Of course, an employment subsidy could also be structured to provide some support to this group.[78] But the unconditional cash grants provide a safety-net for the working class that the employment subsidy cannot match. Working-class individuals and couples are often just one job loss—or one divorce—away from real poverty. Cash grants would provide a ready income supplement to make temporary unemployment or divorce a less devastating event. In contrast, an employment subsidy tends to reward success: Only full-time workers need apply.[79]

The freedom that cash grants confer could be especially valuable to low-earning single mothers, who face high poverty rates and few chances for advancement. In 1996, thirty-three percent had incomes below the

75. It is. *See infra* text accompanying note 143.

76. AFDC, for example, included categorical eligibility rules that excluded most poor, two-parent families with a steadily-employed worker. *See* 1998 GREEN BOOK, *supra* note 2, at 399-401. AFDC benefits also typically excluded families earning more than a modest amount per month. *See id.* at 416-18 tbl.7-8 (showing AFDC income cutoffs for a family of three in January 1997). Most TANF programs are less categorical than AFDC, but they often cut off benefits at modest income levels. *See, e.g.*, Karen Fox Folk, *Welfare Reform Under Construction: Wisconsin Works (W-2)*, FOCUS, Special Issue 1996, at 55, 55 (describing the Wisconsin program, which assists parents with incomes at or below 115% of the poverty line).

77. *See supra* notes 40-41 and accompanying text.

78. Phelps's plan, for example, anticipates paying a sizeable hourly supplement of one dollar or more to those earning market wages of up to $7 per hour (roughly $14,000 per year). The subsidy then declines to just pennies at $12 per hour (roughly $24,000 per year). *See* PHELPS, *supra* note 17, at 113. At $7 per hour, the subsidy is $1.12; at $12 per hour, the subsidy is $0.06.

79. To be sure, the Phelps plan arguably increases the chances of successfully finding and keeping a job. I take up the normative arguments in favor of increasing employment opportunities in Section II.C, and I consider whether employment subsidies are likely to increase employment in Part III.

poverty line,[80] and their median income was $19,911 per year—compared to a median income for all American families of $42,300.[81] Current rules limit cash welfare to just five years in an individual's lifetime. Once off welfare, their earnings prospects are bleak. A study of a group of former AFDC recipients is particularly revealing. Among those who worked, the median starting wage was just $6.07—rising to only $6.72 an hour after eleven years.[82] Employment subsidies could raise wages, at least for those who hold full-time jobs. But a basic income or negative income tax would also support part-time or part-year work. Mothers might choose to live frugally in order to spend time at home while the children are very young, shifting to more market work and a higher total income once the children are in school. This is, in fact, a familiar pattern among middle-class women.[83] The employment subsidy denies low-earning mothers this choice. No matter how long or how persistent a worker she is, the subsidy ends the moment she leaves the work force. A basic income or negative income tax offers a small measure of independence, while employment subsidies make holding and keeping a full-time job a matter of some urgency.

The cash strategy also can enhance the freedom of childless workers. Since the 1970s, wages for low-skilled working men, for example, have fallen more dramatically than those of any other group and may fall further as globalization and other trends reduce demand for low-skilled labor in the United States.[84] Current welfare programs offer this group little or no assistance.[85] Employment subsidies would improve the situation by increasing the economic payoff of a low-wage job. But once again, a basic income or negative income tax would work equally well to supplement

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80. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, POVERTY IN THE UNITED STATES: 1996, at vii tbl.A (1997).

81. *See* U.S. Bureau of the Census, *Historical Income Tables: Families (Table F-7)* (visited Oct. 1, 1998) < http://www.census.gov/hhes/income/histinc/f07.html>.

82. *See* Burtless, *supra* note 11, at 43-45. A recent study of welfare mothers reported their experience that persistence in low-wage work rarely paid off in the form of significant advancement or higher wages. *See* EDIN & LEIN, *supra* note 66, at 69-73, 128-31 (reporting that the median real wage of female high-school dropouts rose only one percent per year between ages 21 and 29).

83. *See* Howard V. Hayghe & Suzanne M. Bianchi, *Married Mothers' Work Patterns: The Job-Family Compromise*, 117 MONTHLY LAB. REV., June 1994, at 24-35; *see also* Rebecca M. Blank, *Labor Market Dynamics and Part-Time Work*, *in* 17 RESEARCH IN LAB. ECON. 57, 58, 64-68, 89-90 (1998) (finding that women are far more likely than men to cycle in and out of the labor force and between part-time and full-time jobs and that women with preschool children are especially likely to reduce their work hours).

84. *See* BLANK, *supra* note 9, at 61-64.

85. TANF is available only to families with (or expecting) children. *See* 42 U.S.C.A. § 602(a)(1)(A)(i) (West 1998). General assistance programs, typically the only source of cash welfare for the childless, provide very low benefits and have been eliminated in several states during recent years. *See* HOWARD JACOB KARGER & DAVID STOESZ, AMERICAN SOCIAL WELFARE POLICY 258-59 (1994). The Food Stamp program extends benefits to childless individuals but imposes a strict work requirement on those who are able-bodied and of working age. *See* 7 U.S.C.A. § 2015(o) (West 1998).

wages, while offering greater opportunities for upward mobility. Workers who want to go back to school can rely on a modest but guaranteed stream of income. An employment subsidy, by contrast, disappears the day one quits work.[86] Inner-city residents could also use a cash grant to help fund a move out of the neighborhood, even if the move requires a job change or other disruption to their working lives.

At this point, more objections may spring to mind. Don't community values demand that everyone who is able work for her subsistence? Wouldn't poor families and communities be better off if more people worked? Can we really trust the life choices made by welfare mothers, who are cut off from mainstream values and in need of moral guidance? Is it responsible to offer unemployed residents of the inner cities cash grants rather than employment subsidies when their most common complaint is that "there are no jobs"? Why isn't the cash strategy just welfare all over again?

I will address all of these objections, and a few more, as I turn to the affirmative case for employment subsidies.

B. *Community Values*

One of the most common arguments for employment subsidies is a moral claim. The basic idea is that hard work is morally required, and people who display this kind of virtue should be guaranteed a job at a decent wage.[87] Put another way, full-time work is both necessary and sufficient as a condition for a decent level of subsistence. This argument seems to make a clear case for employment subsidies and to call into question the wisdom of unconditional cash grants. Once one accepts this moral premise, work is an appropriate precondition for assistance.

This argument is probably best understood as a kind of communitarian claim, in a quasi-Walzerian vein.[88] The communitarian would argue that

86. Of course, an employment subsidy raises the wage for low-skilled work, enhancing recipients' ability to save funds that will allow them to go back to school, or change jobs. Relative to the status quo, the employment subsidy is freedom-enhancing. But relative to an unconditional cash grant, it is freedom-restricting.

87. *See* Clinton, *supra* note 4 (characterizing the welfare-reform law as "restor[ing] America's basic bargain of providing opportunity and demanding in return responsibility").

88. For one example of this claim, in a similar context, see OREN M. LEVIN-WALDMAN, MINIMUM WAGE AND JUSTICE? (Jerome Levy Econ. Inst. Working Paper No. 197, 1997), which argues that the minimum wage implements a communitarian principle of reciprocity, because those who are willing to work can command a livable wage. I am using "Walzerian" here to denote a style of argument and not Walzer's own views; as I shall demonstrate shortly, Walzer probably would not endorse employment subsidies and instead has a more radical proposal for the reorganization of work. *See* MICHAEL WALZER, SPHERES OF JUSTICE 116-19 (1983) (proposing a system of small communes with worker ownership). This argument might be, instead, some more universalistic claim about the virtue inherent in market work. But most arguments of this kind have a communitarian flavor, and I will pursue that strand here.

work is the defining criterion for social membership in America today (at least for those who have no independent source of support). On this view, poor nonworkers are appropriately stigmatized as outsiders, but poor workers are full members, entitled to claim assistance from the community.[89] Once poor workers meet their obligation to the community by standing ready to go to work, the community has a reciprocal obligation to guarantee a job and a minimal living standard.[90] Here, I want to distinguish between the claim that hard work is good because it meets community standards and the claim that it is good *because it has good consequences* for the worker, her family, her community, etc. The two arguments are often made together, but they are analytically separable. Although the community-values claim for employment subsidies may seem appealing at first, a closer look reveals several serious shortcomings. I will take up the question of consequences in Section C.

1. *Community Values vs. Moral Guidance*

The first problem with the communitarian defense of employment subsidies is that community values are a dubious source of moral guidance. We should beware easy invocations of "community" that simply ratify the second-class status of its poorest members. Employment subsidies lionize one way of life—full-time market work—over other choices that individuals might legitimately make.

The community values claim discounts the freedom of any low-earner whose vision of the good life does not revolve around market work. Parents wanting to rear their own children, churchgoers with missionary aspirations, and even Van Parijs's surfers, all face a particularly bleak choice under a regime of employment subsidies—at least if they have low earning power. Either they must work full time and trade their preferred way of life for a decent living standard, or they must rely entirely on their own limited resources. Employment subsidies make having a job the ultimate test of community membership. Those who hold a full-time market job will be minimally secure, while those who do not become economic pariahs regardless of their other contributions to society.

Of course, the cash alternative will not entirely supplant the need to work, at least for most people. Six thousand dollars a year is below the poverty level for a single individual. Not surprisingly, then, empirical

89. *Cf.* WALZER, *supra* note 88, at 64-94 (explaining the close connection between membership and need and asserting that these can only be understood in cultural context).

90. *See* HANDLER & HASENFELD, *supra* note 14, at 216 (acknowledging the appeal of a basic income or a negative income tax but arguing that they "run[] counter to the strongly held beliefs about the value of work for both economic and social reasons, for both families and community"). For general principles of communitarian reciprocity, see WALZER, *supra* note 88, at 64-94.

evidence suggests that most of the poor would continue to work (as many welfare recipients now do) to supplement their cash grant.[91] But cash grants would still confer a modest, but real, increase in freedom. With a basic income, the loss of a job is not an economic catastrophe. People willing to live on very little in order to pursue their own religious or personal goals have that option. The community-values position trivializes the loss of freedom that employment subsidies impose—as if nonworkers and part-time workers are shirking their obligations to the rest of us. But on a liberal view, the loss of freedom is profound.

The tension between market work and freedom takes on a special resonance for women, who remain disproportionately responsible for nonmarket work—caring for children, the frail elderly, and so on.[92] Here, one cannot be quite sure what "community values" demand, because the gendered division of labor is today simultaneously obeyed and contested. There is still no cultural consensus on the proper role of paid work for middle-class mothers,[93] although welfare policy is much clearer in its expectation that poor mothers should work.[94]

But whatever "community values" may be, in terms of justice, employment subsidies ignore the distinctive situation of women. Some advocates of employment subsidies simply miss the issue. Phelps, for example, focuses almost exclusively on the employment prospects of young men. In Phelps's view, employment subsidies will help women by restoring men to their traditional status as breadwinning heads of families.[95] This rosy prediction seems a poor foundation for policymaking, however, in light of the long-term growth in single-mother families.[96] Unless employment

91. *See* EDIN & LEIN, *supra* note 66, at 43-45 (finding that 46% of welfare mothers in their sample worked, while only five percent reported doing so); *see also infra* notes 143-144 and accompanying text (summarizing empirical evidence suggesting that cash grants would not dramatically reduce work effort).

92. *See* VICTOR R. FUCHS, WOMEN'S QUEST FOR ECONOMIC EQUALITY 60-61 (1988); FRANCES K. GOLDSCHEIDER & LINDA J. WAITE, NEW FAMILIES, NO FAMILIES? 110-11 (1991); David H. Demo & Alan C. Acock, *Family Diversity and the Division of Domestic Labor: How Much Have Things Really Changed?*, 42 FAM. RELATIONS 323, 325-26 (1993).

93. For example, recent articles in the *New York Times Magazine* explored women's and men's conflicting feelings about pursuing careers or staying at home to care for children. *See* Madeleine H. Blais, *Who's Got Time To Stay at Home?*, N.Y. TIMES, Apr. 5, 1998, § 6 (Magazine), at 48 (describing a busy and accomplished stay-at-home mother who finds it difficult to convey to others the importance of her work); Susan Chira, *Beyond Fear*, N.Y. TIMES, Apr. 5, 1998, § 6 (Magazine), at 65 (conveying the author's conflicting feelings about her decision to return to her job during a child's serious illness); Peggy Orenstein, *Almost Equal*, N.Y. TIMES, Apr. 5, 1998, § 6 (Magazine), at 42 (recounting the experiences of a professional couple in which the wife became the primary earner).

94. The federal TANF statute requires single welfare mothers to work 30 hours a week by 2000. State programs may require more hours of work. *See* 42 U.S.C.A. § 607 (West 1998).

95. *See* PHELPS, *supra* note 17, at 129-30.

96. *See* STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 41, at 63 tbl.75 (showing that the percentage of single-mother families increased from 19% to 27% between 1980

subsidies can magically reverse decades of social change, we should ask instead how single mothers will fare under an employment subsidy and whether the cash alternative can do better.

2. *The Example of Single Mothers*

A closer look at the case of single mothers demonstrates the kind of burden on the least advantaged that the communitarian argument seemingly endorses. According to the stereotype, poor single mothers are not pursuing a meaningful life plan. They live on welfare and stay at home to take care of their kids (or watch television). They are cut off from the mainstream community. This is particularly outrageous, says the community-values advocate, in an era when more and more middle-class (married) mothers must leave their children in day care while both parents work to help the family make ends meet.

But the reality is different. To begin with, this story exaggerates the "work problem" with poor single mothers. As a group, single mothers are extremely poor,[97] but they work more than married women,[98] and their labor force participation has historically been remarkably constant despite the substantial disincentives built into traditional welfare programs.[99] The stereotype also exaggerates the labor-force participation rates of married mothers. In 1992, for example, sixty-seven percent of married mothers of children under eighteen were in the labor force, but only thirty-seven percent of married mothers worked full time, year-round. The remainder worked part time or part year.[100] Among married mothers of children under three, only twenty-eight percent worked full time, year-round.[101]

If we narrow our focus to welfare mothers, we do find significantly lower rates of work. In 1993, for example, only thirteen percent of AFDC mothers reported working.[102] But a recent study suggests that the key word

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and 1996, and also showing an increase in the proportion of single-mother families in every racial and ethnic group).

97. *See supra* notes 81-82 and accompanying text.

98. *See* Robert Moffitt, *Incentive Effects of the U.S. Welfare System*, 30 J. ECON. LITERATURE 1, 12 (1992).

99. *See id.* at 13 ("[T]he most surprising feature [of the data] is the extreme inelasticity of the labor supply of female heads . . . .").

100. *See* Hayghe & Bianchi, *supra* note 83, at 24-35; *see also* Blank, *supra* note 83, at 57-58, 64-68, 89-90 (finding that women are far more likely than men to cycle in and out of the labor force and between part-time and full-time jobs).

101. *See id.* at 25; *see also* Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey, Table 6: Employment Status of Mothers with Own Children Under Three Years Old, 1996-97 Annual Averages* (visited Nov. 5, 1998) <http://stats.bls.gov/news.release/famee.+06.htm> (showing that, in 1997, 56.8% of married mothers with very young children were employed; and that, of these, 67% worked full time; so that, for the group as a whole, 38% work part time).

102. *See* STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 41, at 387 tbl.606.

here is "reported." Edin and Lein found that up to forty-six percent of welfare mothers work, at least intermittently, and mostly at lawful jobs—but the large majority do not report their earnings.[103] In effect, the old AFDC system (on which all the relevant studies are based) made a tacit compact with recipients. It paid benefits that were well below the poverty line and it penalized recipients who took a (reported) job by cutting their benefits sharply.[104] At the same time, the system turned a blind eye to unreported work so long as it was neither too lucrative nor too blatant. The facts suggest, then, that welfare mothers do work; and that they use welfare to make ends meet. Econometric evidence confirms that, although welfare leads some single mothers to reduce their work hours somewhat, the average loss in earnings is small. On average, welfare mothers would be desperately poor in the absence of the program.[105]

Here we reach a normative crossroads. A basic income or negative income tax would improve single mothers' fortunes compared to welfare. At just $6000 per year, the benefit level would be higher than welfare benefits in most states,[106] and mothers could work as much or as little as is compatible with their child-rearing responsibilities and their own life plans. What, then, is left of the communitarian case for requiring full-time work in exchange for an employment subsidy?

One familiar argument is that these welfare mothers are so isolated from the larger community that their values have become warped. Their seemingly "free" choices just reflect their estrangement from the community of work. This claim, however, runs contrary to the facts. The best empirical evidence suggests that most welfare mothers have held at least one job within the past two years.[107] Many of these women know quite a bit about their job options, and interview data suggest that they have made informed tradeoffs between the monetary and intangible rewards of work, on the one hand, and its costs, on the other.[108] The hard fact is that, even with an employment subsidy, the rewards of work for this group are limited. Low-skilled women will continue to earn only low wages, and, on

103. *See* EDIN & LEIN, *supra* note 66, at 43-45, 167-78. Because Edin and Lein's sample was not representative, their figures cannot be generalized to the welfare population as a whole. Still, their results suggest that a substantial proportion of welfare mothers are working, but are not reporting their earnings. In their sample, 46% reported working to some degree, but only eight percent were involved in underground (criminal) work. *See id.* at 43-45.

104. *See* 1998 GREEN BOOK, *supra* note 2, at 404-05, 416-18 (describing AFDC benefit-reduction rules and state benefit levels).

105. *See* Moffitt, *supra* note 98, at 17. Of course, to the extent that these studies rely on reported earnings, they may understate recipients' non-welfare income. The discrepancy is unlikely to be huge, however. While Edin and Lein find that *rates* of reported work are too low, they also find that mothers' earnings are modest. *See* EDIN & LEIN, *supra* note 66, at 43-45 (finding that earnings from legal and illegal work contributed an average of $128 per month).

106. *See supra* note 48.

107. *See* EDIN & LEIN, *supra* note 66, at 63.

108. *See id.* at 60-87.

average, their earnings are not likely to grow much as they gain experience.[109] While better-educated women have gained enormously in earning power since the 1970s, low-skilled women have been left behind.[110] Paid child care is expensive, especially on a low salary, and poor women—unlike their middle-class peers—often have to worry about leaving children unsupervised in dangerous urban neighborhoods.[111]

Contrary to stereotype, welfare mothers generally endorse mainstream values of work and family, and they dislike being on welfare.[112] Edin and Lein's study suggests that most welfare mothers set moral priorities: Given their low earnings prospects and the strictures of traditional welfare, they find it untenable to leave welfare for a reported job. Instead they remain on the rolls and put family needs above honesty in reporting their earnings.[113]

Edin and Lein's findings are striking because they render morally comprehensible the choice to remain on welfare. In light of the bleak alternatives that welfare mothers confront, it is difficult to assert with confidence that they would be better off as members of the community of work. An appealing community would not demand that the poorest mothers work the hardest. Without some richer justification, it seems hypocritical, even from a communitarian perspective, to hold poor mothers to a standard of full-time work that their middle-class peers often do not meet. Here, the communitarian must walk a fine line: Although community values define social obligations, a community must also generate shared understandings of its practices that are acceptable to *all* its members—rich and poor, single and married.[114] At a minimum, the communitarian should explicitly justify the differential in expectations: If the poor single mother and her middle-class counterpart are both full members of the community, why is the former expected not only to live on less, but also to work harder to earn it? Why do low earnings and the absence of a husband make the decisive difference? If the communitarian aspires to more than thinly-veiled libertarianism, these are serious questions.

In contrast, a basic income or negative income tax would offer poor single mothers a guaranteed minimum, without the sharp divide between "welfare" and "work" that is characteristic of traditional welfare. A single

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109. *See supra* note 82.

110. *See* BLANK, *supra* note 9, at 70 ("[T]he overall expansion in women's work opportunities has not affected all women equally . . . . [Low-skilled] women continue to face a limited set of jobs with low wages and few nonwage benefits, as they always have.").

111. *See* EDIN & LEIN, *supra* note 66, at 65, 75-76, 133-36.

112. *See id.* at 76-83.

113. *See id.* at 76-83, 167-75.

114. Compare Walzer's discussion of the caste system in India. Walzer acknowledges the hierarchical structure of the caste system but suggests that it would be a defensible community if all its members, including the lower castes, shared the understandings that governed the distribution of opportunities—for example, the idea of equal opportunity "across the lives of the soul." *See* WALZER, *supra* note 88, at 27, 313-15.

mother with low earnings would still end up with fewer resources than her married or middle-class counterpart. The cash alternative need not equalize incomes to ensure that poor single mothers receive a minimum, fair share of resources. In communitarian terms, the cash strategy recognizes poor single mothers as full members of the community.[115]

3. *Do American Values Support Employment Subsidies?*

Even if one does not share the liberal devotion to freedom, the communitarian argument for employment subsidies remains uneasy. The pretty picture of community values painted by proponents of the employment strategy does not necessarily portray American attitudes and practices. Of course, people commonly disagree about questions of distributive justice. But actual disagreement has a strong capacity to undermine a communitarian argument, because there is no foundational moral claim other than community agreement.[116] The case for employment subsidies is particularly vulnerable, because it disregards some equally plausible descriptions of community norms.

For example, many Americans probably agree that hard work is good but would strongly deny any collective obligation to create jobs for the poor. On this view, low-earners ought to work, but for whatever jobs the market creates. Individuals may provide voluntary charity, but that is all. One may or may not like this libertarian notion, but surely many Americans believe it. Indeed, our current practices tend to follow the libertarian model. The childless, working-age poor receive few, if any, welfare benefits.[117] Poor single mothers now face time limits on welfare benefits—after which they must live primarily on their own earnings.[118] The minimum wage and

115. Although this discussion has taken for granted the likely persistence of the gendered division of labor, the argument does not endorse it. The question is whether employment subsidies are likely to overcome gendered patterns of socialization, workplace and educational structures, and wage differentials that combine to reinforce traditional modes of child-rearing. Perhaps a truly feminist case for employment subsidies could be made, but to my knowledge it has not. One challenge would be to show how employment subsidies would transform the workplace, rather than simply replicate existing differentials in wages, participation, and status. Another challenge would be to explain why it is appropriate to constrain women's freedom in order to bring about change in the division of labor. Might we use less intrusive mechanisms—education, for example—to achieve the same goals? Part of the enduring appeal of cash grants is that they act on the promise of equality today by granting women's choices the same respect as men's—and, no less importantly, giving women real resources that make their equality more than merely formal.

116. *See generally* MICHAEL WALZER, INTERPRETATION AND SOCIAL CRITICISM (1987) (offering an account of the possibilities for communitarian social criticism, which is based on interpretations of shared values and practices).

117. *See* 7 U.S.C. § 2015(d) (1994) (imposing work requirements for able-bodied adults under 60 who seek to receive food stamps); KARGER & STOESZ, *supra* note 85, at 258-59 (describing the limited relief provided by state general assistance programs).

118. *See supra* text accompanying notes 2-4. The EITC is the principal current-law wage supplement for this group. *See infra* Part IV.

the EITC provide a modicum of financial assistance to poor workers, but primarily those with children.[119] A left-leaning communitarian might argue that the EITC represents our better practices, but it is not readily apparent that the EITC is a more accurate reflection of the American community than TANF.

In the end, the case for employment subsidies remains highly contingent, as the right-communitarians square off against the left-communitarians in an effort to define our ostensibly shared values. This search for agreement is doubly doomed, because community values are not fixed; they are at least potentially malleable. Our current practices help shape our values, so it is tautological to defend those practices by invoking those values. As the next Subsection shows, a richer account of the communitarian ideal might mandate more fundamental social reforms, which would help shape a more inclusive community, rather than simply ratify the status quo.

4. *A Thin Ideal of Community*

Finally, the communitarian case for employment subsidies reflects a failure of moral and institutional imagination. A more persuasive account of community would look beyond employment subsidies to alternative social and economic reforms that could more thoroughly redefine the connection between work and community.

To see the point, consider some institutional alternatives. Even assuming that community values require paid work in exchange for subsistence, it is not clear that employment subsidies are the right answer to the communitarian problem. Consider what an ideal employment subsidy does: It increases wages and employment for low-wage workers. The program does not guarantee anyone a job; it simply increases the odds that low-skilled workers can find employment.[120] The result is that some vulnerable community members could be severely let down, if employment subsidies stop short of full employment.[121] It is difficult to square this arbitrariness with the account of membership and need that Walzer offers,[122] and that seems implicit in the community-values argument: *Everyone* willing to work should be able to do so.

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119. *See* Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995); *see also* Shaviro, *supra* note 24, at 418-59 (considering whether the minimum wage benefits low-income workers).

120. For example, people whose economic productivity is zero would receive no subsidy under Phelps's proposal. *See* PHELPS, *supra* note 17, at 157.

121. *See infra* Section II.C.

122. *See* WALZER, *supra* note 88, at 75 (arguing that once the community has defined a need, the community has an obligation to ensure that the need is met for each community member).

But even if we imagine a souped-up employment subsidy that could guarantee everyone a job, there is a deeper problem. The communitarian argument for employment subsidies rests on an implicit account of community that is pitifully thin. Jobs would continue to be distributed by the invisible hand, with no guarantee that jobs would be created where workers are located.[123] Market forces would—within the constraints of the labor laws—continue to set the conditions and hours of work. On this view, "community values" require workers to accommodate themselves to whatever terms the market offers—just sweetened a bit by the employment subsidy.

This is perhaps plausible as an account of American values: highly market-oriented, with a truncated sense of duty to the lowest-earning citizens. But Walzer and other serious communitarians have offered more radical proposals. A principled communitarian need not accept current market institutions as given. After all, on the communitarian view, neither efficiency nor individual freedom trumps the demands of community life. Walzer proposes reorganizing the working world into a system of small communes, or petty-bourgeois-scale enterprises, with worker ownership.[124] And Mickey Kaus, the journalist whose proposals echo the Walzerian concern for community, recommends a program of guaranteed public jobs. The jobs would guarantee full employment to all willing workers, symbolize the public commitment to all citizens, provide a workforce for community-oriented service and infrastructure projects, and provide a new space where Americans from diverse backgrounds could work side by side.[125] Whatever the practical merits of these ideas, they suggest the broad sweep of a vision of justice that seeks to promote real community, rather than to ratify the status quo.

None of this implies that the liberal vision should be unconcerned with employment opportunities. It would be wrong simply to hand out cash and conclude that we have provided all the resources that free men and women need. Poor women and men face multiple barriers to work, including, in some cases, labor markets that simply fail to function. The next Section argues that the liberal remedy is to help make the labor markets work, provide unconditional cash grants, and then let people—even poor people—choose for themselves how much and on what terms to work.

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123. *See infra* text accompanying notes 148-150 (discussing spatial mismatch).
124. *See* WALZER, *supra* note 88, at 116-19.
125. *See* MICKEY KAUS, THE END OF EQUALITY 125-35 (1992).

C. *Positive Consequences*

The second argument for employment subsidies rests on the asserted good consequences of raising wages and employment levels for low-wage workers. Phelps, for example, argues that putting the poor to work could enhance the welfare of poor individuals, their families, their communities, and society at large.[126] He notes, with alarm, the decreasing attachment of young men to the workforce and the high rate of unemployment among young black men.[127] Phelps contends that better-paying jobs can raise individual self-esteem and channel workers' talents back into the legitimate market and away from criminal activity. Greater employment would expose even more poor people to the discipline of market work. And these benefits would spill over to families and communities, as young men get married and share their new prosperity with their wives and as communities change their role models and prosper as residents' dollars circulate.[128]

Phelps's concern for the urban poor echoes the work of William Julius Wilson, who describes the destruction wrought by long-term high unemployment in inner-city black neighborhoods.[129] Wilson argues that government policies and labor-market conditions have combined to make work disappear from inner-city African-American neighborhoods.[130] Residents confront a dismal labor market, characterized by a declining number of manufacturing jobs, falling wages, and racial discrimination. To compound the problem, many low-wage jobs have shifted from central cities and into suburbs, leaving inner-city residents geographically isolated. For important reasons (to which I will return later), Wilson calls for public jobs, rather than employment subsidies, to increase employment opportunities.[131]

Phelps and Wilson offer a powerful critique of the status quo. The labor market, in combination with current social welfare policy, leaves large numbers of disadvantaged people with bleak prospects—unemployment, low-wage work, and a meager, time-limited welfare system. The hard question is what to do about the situation.

Once again, the comparison of employment subsidies to cash grants is highly revealing. Phelps's argument implicitly predicts two positive

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126. *See* PHELPS, *supra* note 17, at 126-34.

127. *See id.* at 30-33, 40-43.

128. For a similar line of argument, see Shaviro, *supra* note 24, at 428, which describes the utilitarian benefits of increased labor-force participation, including "increased economic production, reduced crime rates and levels of injury from violence, reduced drug and alcohol abuse, better morale, and reduced strife between socioeconomic groups."

129. *See* WILLIAM JULIUS WILSON, WHEN WORK DISAPPEARS: THE WORLD OF THE NEW URBAN POOR 3-86 (1996).

130. *See id.* at 25-50.

131. *See id.* at 224-35.

consequences of employment subsidies. First, employment subsidies will redistribute income to low-wage workers, their families, and their communities. Second, employment subsidies will increase labor-force participation, which itself will produce positive consequences for the newly-employed, their families and communities. Although advocates of employment subsidies typically invoke both arguments at once, changing the policy baseline shows that they are analytically distinct.

In the following Subsections, I examine each claim from both liberal and utilitarian perspectives. The liberal insights developed to this point challenge the normative importance of putting people to work. The utilitarian approach provides a rigorous way of understanding the consequentialist argument for employment subsidies and its internal weaknesses. This analysis yields three strong conclusions:

First, cash grants are a superior method of raising income and producing the attendant good consequences *whether one adopts a liberal or utilitarian perspective*. On this point, at least, the two schools are in agreement: Freedom and welfare go together.

Second, the liberal and utilitarian perspectives diverge on the importance and consequences of increasing employment. A liberal approach suggests that it is employment opportunities, not employment levels, that matter. A liberal program that includes appropriate measures to combat current labor-market failures would go a long way toward securing the consequentialist benefits of work that are often ascribed to employment subsidies.

Third, the heart of the utilitarian case for employment subsidies is that raising employment levels may produce additional positive externalities that outweigh the costs of the labor-market distortions the subsidies inevitably create. But a closer look at the facts suggests that the positive-externalities argument has been exaggerated. Even in utilitarian terms, employment subsidies may well be inferior to the alternative of cash grants plus labor-market reforms.

1. *Liberal and Utilitarian Perspectives*

A large part of the claimed advantages of employment subsidies fall away when the baseline policy is a basic income or a negative income tax rather than the status quo. It is certainly true that higher wages and levels of employment would improve the lives of poor workers, their families, and their communities. But this argument exaggerates the positive effects of employment subsidies, because it *conflates resources with employment.* Today, this is a reasonable confusion: If poor people want more money, they have to earn higher wages or work more hours. But a basic income or negative income tax would redistribute resources without requiring work. In

fact, the cash alternative is clearly preferable if our goal is simply to increase the well-being of the disadvantaged. A basic income or negative income tax would redistribute resources more broadly and target the resources more rationally to need. Low-wage employment subsidies redistribute to many people who are not needy,[132] and they exclude needy people who do not or cannot work full time. As the previous Section pointed out, married and particularly single mothers may fall into the latter camp. To be sure, an employment subsidy could help mothers go to work by providing a higher wage to fund the cost of child care. But an equivalent cash payment also would fund child care for mothers who chose to work while still providing something to those who work less than full time.

The employment subsidy may appear to leave one group unambiguously better off: current nonworkers who are motivated by the employment subsidy to go to work. After all, this group will gain both the employment subsidy and the entire wage as well. For example, a new worker's income would rise from zero (or whatever welfare benefit she may have been getting) to $16,000—her $10,000 wage plus the $6000 employment subsidy.

But this line of argument is misleading. Framed either in liberal terms of freedom or utilitarian terms of welfare, cash is better than a conditional grant because cash maximizes choice.[133] People who want to work can use the cash to supplement their modest wages; or they can choose to maximize their well-being in other ways. The nonworker in our example would only be better off if we converted her $6000 employment subsidy into a $6000 unconditional grant. She could then choose to work full time and collect the cash (for a total of $16,000)—or to work less and make better use of her free time. Here, the utilitarian agrees with the liberal: Freedom makes people better off. The only exception would be if employment creates positive externalities, a possibility I will discuss in a moment.

From this important point of agreement, the utilitarian and liberal perspectives on employment subsidies begin to diverge. At this point, it is important to understand how the utilitarian method differs from its liberal counterpart. The goal of maximizing utility requires a detailed calculus. Welfare-enhancing features of each policy must be weighed against welfare-reducing features. The winner is the program that adds the most to aggregate welfare. We will see that some factors weigh in favor of cash grants, while others cut in favor of employment subsidies. The final determination is an empirical question.

A utilitarian comparison of employment subsidies and a basic income or negative income tax must take into account four potential welfare effects.

132. *See infra* notes 217, 281, 282 and accompanying text.
133. *See* Shaviro, *supra* note 24, at 471.

First, progressive redistribution may increase social welfare because it involves transferring money from (low-marginal-utility) rich people to (high-marginal-utility) poor ones.[134] Second, if there is to be a transfer, in general it should be made in cash rather than in kind and with the fewest possible restrictions because, as we just saw, freedom enhances the utility of the recipient. Taken together, these two factors tend to favor cash grants, which redistribute income to a broader group (nonworkers as well as workers) and attach no strings to the transfer.

But the remaining factors tend to favor employment subsidies. Cash grants create greater potential work disincentives than employment subsidies. These work disincentives are a matter of concern because they distort people's ordinary welfare-maximizing behavior. The utilitarian believes that people (usually) make optimal choices about work in the absence of taxes and transfers.[135] Any tax or transfer policy that distorts the labor-leisure choice will presumptively reduce utility. (I will take up, in a moment, the utilitarian argument in favor of "distorting" work effort in the positive direction.)

In considering potential work-disincentive effects, it is useful to distinguish between the income and substitution effects.[136] Any transfer program typically has a negative income effect: Recipients feel richer than before and may work less, since they can live just as well as before the transfer but with less work. Both cash grants and employment subsidies potentially discourage work in this way, although the full-time work requirement in the employment subsidy will mitigate this effect.[137]

In contrast, cash grants have a negative substitution effect, while employment subsidies have a positive effect. The substitution effect arises when a transfer program (or a tax) alters the relative benefits of an extra hour of work compared to an extra hour of leisure. The employment subsidy described above[138] has a positive substitution effect: Because

134. This is a utility-enhancing move only if one assumes that the marginal utility of income declines. One might attack that proposition by arguing that interpersonal utilities are not comparable. *See supra* note 72. Another objection would be that, as an empirical matter, marginal utilities either do not decline at all or do not decline in a pattern that supports a basic income or negative income tax. For analogous arguments regarding progressive income taxation, see WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 57-63 (1953).

135. *See* HARVEY S. ROSEN, PUBLIC FINANCE 305-14 (3d ed. 1992) (describing the theory of excess burden and efficiency in taxation).

136. The following discussion concentrates primarily on the income and substitution effects of the programs themselves and not on the taxes that finance them. Recall that the negative income tax and the employment subsidy are assumed to require the same tax increase. *See supra* text accompanying note 45. The basic income requires a larger tax increase, and I note its effects where relevant.

137. The income taxes raised to finance each program have a positive income effect: Taxpayers may work harder to make up for the income lost to higher taxes.

138. *See supra* text accompanying notes 35-38.

workers earn, for example, seven dollars rather than four dollars per hour, they are likely to find work more attractive than before. In contrast, a negative income tax has a negative substitution effect. Because the program reduces benefits as income rises, each extra dollar of earnings is subject, in effect, to a "tax"[139] that reduces take-home pay and makes work less attractive than before. Although a basic income has no explicit phaseout of this kind, it does require higher income taxes than either of the alternative programs, and these taxes produce negative substitution effects.

Although the income effect will become significant at a later point in my argument,[140] the substitution effect is considered the proper measure of the economic distortion.[141] To summarize, the employment subsidy creates work incentives for recipients, and these help offset, in whole or in part, the extra work disincentives faced by the taxpayers who pay the higher taxes needed to fund the program. In contrast, a negative income tax creates work disincentives for recipients as well as taxpayers, while a basic income simply creates larger disincentives for taxpayers. These differences arise because the employment subsidy is linked to work effort.[142]

Is this third factor a decisive objection to the cash alternative? Not necessarily, even in purely utilitarian terms. The magnitude of the work disincentives is uncertain, but probably is not large, given the inelasticity of even poor workers' labor supply.[143] Furthermore, employment subsidies create economic distortions of their own. In particular, they create a marginal disincentive for low-wage workers to seek education and training

139. *See supra* notes 42-45 and accompanying text.

140. *See infra* Subsection II.C.3.

141. *See* ROSEN, *supra* note 135, at 314.

142. To be more precise, an employment subsidy has a negative income effect for workers already at work who receive a higher wage. The full-time work requirement helps minimize this income effect. For present purposes, the utilitarian concern is with the substitution effect alone. (The income effect becomes relevant for purposes of the externalities analysis. *See infra* Subsection II.C.3.). An employment subsidy has a positive substitution effect for current workers and nonworkers alike: Work becomes more attractive, relative to leisure or other pursuits, than it was before. This positive substitution effect offsets the negative substitution effect of the income taxes used to finance the program.

143. For an analysis of the work-disincentive effects of a negative income tax, see Robert A. Moffitt, *The Effect of a Negative Income Tax on Work Effort*, *in* WELFARE REFORM IN AMERICA 209, 213 (Paul M. Sommers ed., 1982). Moffitt discusses the "disconcertingly wide" range of estimates of labor-supply effects of a negative income tax, but he concludes that a representative negative income tax would reduce work hours by participants, on average, by 1 hour per week for husbands, 2.4 hours per week for wives, and 2.1 hours for female heads of households. *See id.* at 213, 223. As a percentage of initial hours worked, the reductions look larger for the women: The percentages are 4% for husbands, 27% for wives, and 16% for female heads. *See id.* at 223.

For disincentive effects of income taxes, see generally ROSEN, *supra* note 135, at 417-21, which discusses empirical studies of the effects of income taxation on labor supply. *See also* Anne L. Alstott, *Tax Policy and Feminism: Competing Goals and Institutional Choices*, 96 COLUM. L. REV. 2001, 2017-22 (1996) (discussing uncertainty in empirical work on the effects of taxation on women's labor supply).

or to look for higher-wage jobs.[144] Although difficult to quantify, these distortions should also be weighed in the utilitarian case for employment subsidies—on the negative side of the ledger.[145]

For the utilitarian, this is all a matter for empirical inquiry: Do utility gains outweigh utility losses? In contrast, liberalism suggests a more decisive view. Individuals are more than simply utility-generating members of a collective. Each individual is entitled to just treatment, even if some other arrangement would improve aggregate welfare. A basic income or negative income tax is part of the background institutions necessary to a just society. Work disincentives become a matter for liberal concern only when they begin to harm the least advantaged—that is, when the aggregate reduction in work is so severe that the basic income or negative income tax is economically unsustainable.[146] Minor work disincentives—of the kind a modest basic income or negative income tax would create—simply are not a telling objection.

2. *Expanding Employment—Or Employment Opportunities?*

The fourth and final factor brings into focus the key utilitarian argument for employment subsidies: Work incentives create paternalistic benefits and positive externalities that exceed the welfare lost by interfering with individuals' free choices. The paternalist claim is that holding a job improves workers' lives in ways that the workers themselves cannot fully appreciate. The positive externalities claim is that families and communities will reap benefits that exceed the purely private value that workers would place on being employed.

For example, Wilson writes:

> [W]ork is not simply a way to make a living and support one's family. It also constitutes a framework for daily behavior and

144. The potential disincentive to education and training occurs because low-skilled workers can earn more at their present jobs. The disincentive to earn higher wage rates occurs because the amount of the subsidy is phased out as the wage rate rises. Although a worker would still earn more if she gets a one dollar (pre-subsidy) wage increase, her after-subsidy wage-increase is less than one dollar.

145. Some have suggested that this effect is unlikely to be large, given the limited gains produced by conventional worker-training programs. *See* James J. Heckman et al., *The Effects of Government Policy on Human Capital Investment and Wage Inequality*, CHI. POL'Y REV., Spring 1997, at 1, 17. This evidence is not dispositive, however: The authors' own evidence suggests that government training programs are notably ineffective, but that private-sector training, chosen by workers and firms, may be more promising. *See id.* at 6-13. Phelps also spots this issue, but argues that employment subsidies would help orient workers to the business world and that the link between wage differentials and aggregate educational trends is unproven. *See* PHELPS, *supra* note 17, at 162-63. Without better data, however, Phelps's defense is itself unproven.

146. *See* RAWLS, *supra* note 52, at 285 (arguing that the social minimum should be set in accordance with the difference principle); VAN PARIJS, *supra* note 22, at 38-41 (describing the requirement that the basic income be sustainable).

> patterns of interaction because it imposes disciplines and regularities. Thus, in the absence of regular employment, a person lacks not only a place in which to work and the receipt of regular income but also a coherent organization of the present—that is, a system of concrete expectations and goals. . . . In the absence of regular employment, life, including family life, becomes less coherent. Persistent unemployment and irregular employment hinder rational planning in daily life, the necessary condition of adaptation to an industrial economy.[147]

Although this is a powerful indictment of involuntary unemployment, I will argue that it does not make the case for employment subsidies. My argument is ultimately a liberal one, but I will also show that even in utilitarian terms, the predicted benefits of work are overstated.

To begin with, consider the strong element of truth in Wilson's statement: The opportunity to work is a key part of life for many people. Paid work can be a unique way of developing talents, personal discipline, and sociability. Even a skeptic of work-centered policies must see that there is something wrong when—as Wilson and others describe—poor, inner-city residents find themselves unable to find any job, even at the lowest wage.

Wilson documents several barriers to employment for this group. First, inner-city dwellers face the problem of "spatial mismatch."[148] Over time, the combination of an economy-wide shift in the composition of jobs, migration patterns, and a host of well-intentioned but ultimately misguided government policies have left the inner cities economically devastated. The result is a pool of low-skilled inner-city workers that exceeds the supply of local jobs.[149] And for many, transportation and other barriers place suburban jobs out of reach.[150] A second problem is employment discrimination. Wilson documents employers' negative attitudes about poor black men, which lead even some minority employers to prefer other employees.[151] Third, Wilson points out that welfare policies have exacerbated unemployment by making welfare incompatible with work.[152] Finally, to this list one might add other regulatory barriers to employment, like the minimum wage, which keeps wages artificially high for low-skilled workers and may thereby reduce employment opportunities.[153]

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147. WILSON, *supra* note 129, at 73.

148. *See id.* at 34-46.

149. *See* Katherine S. Newman, *What Inner-City Jobs for Welfare Moms?*, N.Y. TIMES, May 20, 1995, at A23 (describing results of a two-year jobs study in Harlem, which found that 73% of those applying for fast-food jobs found no work of any kind after one year of serious job search; the study also found that employers preferred to hire commuters from outside the neighborhood).

150. *See* BLANK, *supra* note 9, at 74-75; WILSON, *supra* note 129, at 39-42.

151. *See* WILSON, *supra* note 129, at 111-46.

152. *See id.* at 50.

153. *See* Shaviro, *supra* note 24, at 433-59.

These barriers to employment prevent the labor market from functioning well for some low-skilled workers. Spatial mismatch, employment discrimination, and employment regulations artificially reduce employers' demand for inner-city, low-skilled workers. Welfare programs with punitively high phaseout rates may dampen the supply side if workers decide that a low-paying job is simply not worth taking. Given these barriers, cash grants alone cannot guarantee real freedom. A basic income (or negative income tax) cannot meaningfully enhance opportunity unless the labor market functions reasonably well so that every individual can sell her labor for the prevailing wage if she chooses.

But this is a far cry from agreeing that "everyone ought to have a job." Creating the *opportunity* to work is different from creating the *obligation* to do so in exchange for a fair share of social resources. The liberal emphasis on opportunity yields two strong conclusions. First, we should act decisively to correct the policy failures that collectively prevent labor markets from working. A liberal approach cannot turn a blind eye to the barriers to employment that inner-city residents face. Liberalism is not the naive view that only money matters.

Second, the opportunity to work means the ability to sell one's labor for a price determined in a fair market. No one has the right to sell her labor for more than her free counterparts will pay. If market wages for some work are so low that some cannot earn a living wage, then the proper remedy is a basic income or negative income tax with no strings attached rather than an employment subsidy. This is the lesson of Dworkin's social insurance proposal.[154] Of course, Dworkin's perfect liberal marketplace would be impossible to achieve without fundamental changes in economic and social structure—since people do not currently enter the bidding with equal monetary resources or social or educational backgrounds. In the absence of such thoroughgoing change, it is impossible to know what "fair" wages would be. Nevertheless, the ideal is clear enough to give us some practical direction. We should take steps to ensure both fair starting points and access to the market. Ideally, we should provide a basic income or negative income tax *plus* measures to combat race and sex discrimination; to remedy spatial mismatch; to eliminate welfare disincentives; and to reduce regulation of the labor market.[155] We should not artificially raise wages for low-skilled jobs, nor require full-time work in exchange for a fair share of resources. The liberal version of fairness mandates an equitable distribution of resources and opportunities, not the manipulation of market prices.

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154. *See supra* Section II.A.

155. Of course, correcting market failures may not be easy or quick. For some ideas, see *supra* text accompanying notes 159-166. But I have assumed, for the moment, that employment subsidies will work, so I will grant the same temporary grace to market-correcting efforts.

In this liberal view, voluntary unemployment in a well-functioning market is not a matter for concern. Suppose that the market wage for low-skilled work is five dollars per hour and that the market clears at that price—that is, there are just enough jobs so that everyone willing to work at five dollars can find a job. Some individuals will be unemployed and probably unhappy about it. Although their labor is worth only five dollars—and they could take a job at that wage—they will not work for that. They prefer instead to rely on a partner or friends, or to make do on their basic income or negative income tax. It would take eight dollars an hour to get them to take a market job. The liberal approach is to do nothing here, once the basic income or negative income tax is in place. The five-dollar worker is not entitled to eight dollars, although she *is* entitled to an unconditional cash grant.[156] Real freedom does not demand that everyone be given unlimited choices or that everyone be happy—that would be impossible. Every individual is free to decide whether to work for the wage she commands, or to use her time elsewhere if the wage seems too low.[157]

The employment subsidy, in contrast, seeks to lure the holdout into taking a job by artificially raising her wage.[158] Over the long term, this market distortion can create serious costs. At the margin, some people will forgo education and training because unskilled work would now pay better than before. Although the magnitude of the effect is an empirical question, the prospect is grim: The employment subsidy could artificially expand and maintain a pool of low-skilled workers, who otherwise might have been able to move up. In contrast, a cash grant expands access to education and lets the human capital markets work. People could rely on their cash grant to help pay living expenses while they go to school. While the employment

156. The liberal standard described here is related, but not identical, to efficiency. In public finance, "efficiency" means, very generally, letting free markets work to set wages and employment levels. *See generally* ROSEN, *supra* note 135, at 305-27 (explaining the concept of excess burden). The liberal criterion is subtly but importantly different, because it insists not only on free markets but also on just background institutions, including, for example, a basic income or negative income tax. A free market may be efficient, but it is not just unless proper provision is made to ensure real freedom for the least advantaged. In a utilitarian analysis, all institutions are contingent: A system of cash grants might be part of a utility-maximizing set of institutions, or it might not, depending on the declining marginal utility of income, the excess burden created by taxes and transfers, and so on. If not, then no individual can claim, in the name of freedom or equality, a larger share of resources.

157. This neoclassical account of the labor market may be too simple. Another source of unemployment that Phelps emphasizes is the presence of "incentive wages," which arise when employers set wages above the market price in order to deter shirking. The result—as in the minimum-wage case—is that not everyone can find a job at the prevailing wage. *See* PHELPS, *supra* note 17, at 52-53, 79-80. For a discussion, see *infra* text accompanying notes 167-170.

158. Phelps argues that the increase in the wage appropriately reflects the "social benefit" (including positive externalities) of employment. *See* PHELPS, *supra* note 17, at 124-26. But this is a curious argument that privileges the social benefit of employment over the value of individual freedom and the productivity of other pursuits. For the reasons given in the text, I reject this view and prefer instead a fair marketplace with just background institutions including a basic income or a negative income tax.

subsidy pays only as long as the worker stays on the job, the cash grant allows people to reach for something better.

One virtue of the basic income or negative income tax is that it can readily be combined with market-correcting policies. Recall the four labor-market obstacles that Wilson identifies: spatial mismatch, discrimination, welfare disincentives, and labor-market regulation. Although not all low-skilled workers face these obstacles, Wilson's list is a useful starting point for considering the kinds of public policies that would be needed to attack the most entrenched barriers to the operation of a free labor market.

First, a system of cash grants might usefully be combined with policies to combat spatial mismatch. Properly understood, spatial mismatch is a market failure. The problem is barriers to opportunity, not uneven economic development. In a functioning market, some neighborhoods will boom while others decline. Liberal solutions to spatial mismatch, then, should focus on two tasks: First, the removal of artificial barriers to economic development; and second, the enhancement of individuals' mobility. Even standing alone, unconditional cash grants can help. With a guaranteed minimum income, inner-city residents might more confidently move to new areas, risking a period of transitional unemployment. Recent research suggests that mobility policies, which help the inner-city unemployed move to suburban jobs, may be promising.[159] Although conventional enterprise zones have largely failed to move jobs into the cities,[160] there may be better ways to combat the collective action problem of rebuilding viable market institutions in inner cities.[161]

An employment subsidy could also help combat spatial mismatch, but it is not a panacea. As I explain at greater length in Part III, an employment subsidy provides an economic "push" in the right direction. Employers may respond by moving into the inner cities or by finding ways to transport inner-city residents to suburban jobs. But generic employment subsidies are not well-designed to address spatial mismatch. Although this is ultimately an empirical question, a plausible scenario is that employment subsidies will work best at tightening suburban markets for low-wage labor without dramatically improving access to jobs for inner-city workers.[162] Employment subsidies, then, should also be combined with more targeted assistance.

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159. *See* BLANK, *supra* note 9, at 131-32 (reviewing mobility policies); Jeffrey S. Lehman, *Updating Urban Policy*, *in* CONFRONTING POVERTY 226, 228 (Sheldon H. Danziger et al. eds., 1994) (same).

160. *See* Helen F. Ladd, *Spatially Targeted Economic Development Strategies: Do They Work?*, 1 CITYSCAPE 193, 200-02 (1994).

161. *See* BLANK, *supra* note 9, at 127-32 (discussing programs to improve physical structures in neighborhoods, economic development efforts, and mobility strategies); Lehman, *supra* note 159, at 247-52 (recommending "access-to-enterprise zones").

162. *See infra* text accompanying notes 288-291.

For similar reasons, both unconditional cash grants and employment subsidies require supplementary policies to combat the second obstacle—employment discrimination. By itself, a cash grant will not address discrimination, but it is compatible with governmental enforcement of the civil rights laws, and targeted policies to help integrate inner-city black workers into the work force. An employment subsidy might give employers an extra incentive to overcome their prejudice toward (or the perceived economic costs of hiring) low-skilled black workers. But it would be naive to rely solely on an employment subsidy. For one thing, workers of all ethnic groups will qualify for the subsidy because the economic reward is for expanding the low-skilled labor force, not for hiring minorities. For another, it is not at all clear that even enhanced market incentives alone can erase discrimination.[163]

As to the third problem, both unconditional cash grants and employment subsidies can eliminate or offset welfare-program disincentives. The basic income eliminates the income test altogether, while the negative income tax substitutes a more gradual phaseout.[164] A cash grant also provides extra income to help pay for transportation, child care, and other costs of working. An employment subsidy counters a work disincentive with an affirmative work incentive. The employment subsidy makes work more attractive, and more feasible, by raising the wage for low-skilled work. But, once again, the employment subsidy works by indirection. Rather than eliminating the income test, it introduces a new market distortion.

Finally, unconditional cash grants by themselves will not eliminate labor-market regulation, but they do ease the way for freer markets. When the lowest earners are assured a basic income or negative income tax, we need not artificially prop up wages with the minimum wage or indirect protections such as import restrictions. As long as we are willing to set the cash grant to take into account the decline in low wages when labor-market deregulation takes effect, we can make these changes more easily. Although deregulation may raise the explicit cost of cash grants, it will also remove the hidden costs of labor-market mandates like the minimum wage, which reduces low-wage employment.[165] The liberal approach both improves employment opportunities and makes transparent the real wages for low-skilled labor. An employment subsidy might also help clear the way for

163. *See* John J. Donohue III, *Discrimination in Employment*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 615, 616-17 (Peter Newman ed., 1998) (describing critiques of Gary Becker's idea that market competition is sufficient to eradicate discrimination); *see also* Shelly J. Lundberg, *Equality and Efficiency: Antidiscrimination Policies in the Labor Market*, CONTEMP. POL'Y ISSUES, Jan. 1989, at 75, 79-84 (describing how discrimination can persist in competitive markets with limited information).

164. *See supra* text accompanying notes 39-45.

165. *See infra* note 208 and accompanying text.

repealing minimum-wage and other regulation that artificially raises wages at the low end. Allowing low wages to be set initially in the market would, of course, raise the cost of the employment subsidy because more workers would fall into the lowest-wage, and therefore highest-subsidy group. Ultimately, the employment subsidy substitutes one form of regulation for another.

This analysis suggests that a basic income or negative income tax, in combination with labor-market reforms and other policies, could help increase employment. By itself, the cash grant removes only one of Wilson's four obstacles to employment opportunity—welfare-program disincentives. But unconditional cash grants ease the way for labor-market deregulation and may help individuals take measures to combat spatial mismatch. In addition, the cash strategy is compatible with additional measures to combat discrimination and to enhance the mobility of labor or capital. We should not underestimate the difficulty of some of these tasks: Experience has shown that solving problems of spatial mismatch and employment discrimination is not simple.[166] Yet employment subsidies alone are also insufficient to address Wilson's four concerns; the same challenges confront both the cash strategy and the employment strategy.

One final issue deserves a brief mention. To this point, I have relied on the neoclassical model of the labor market, in which unregulated markets clear and each worker finds a job at a wage reflecting her marginal contribution. Not all economists subscribe to this view, however. One alternative holds that employers pay above-market "efficiency" (or "incentive") wages in order to deter shirking, distinguish among types of workers, or create a stronger bond between workers and employers.[167] On this view, conventional market reforms cannot eliminate involuntary unemployment. Because efficiency wages exceed the market-clearing wage, some qualified workers will be unable to find a job. Furthermore, unconditional cash grants can exacerbate labor-market failure. When workers command a source of income that does not depend on work,

166. *Compare* John J. Donohue III & James Heckman, *Continuous Versus Episodic Change: The Impact of Civil Rights Policy on the Economic Status of Blacks*, 29 J. ECON. LITERATURE 1603, 1615-41 (1991) (arguing that federal civil rights law helped narrow differentials in whites' and blacks' earnings, wages, and occupational status in the 1960s to mid-1970s), *with* John J. Donohue III & James J. Heckman, *Re-Evaluating Federal Civil Rights Policy*, 79 GEO. L.J. 1713, 1729-35 (1991) (questioning the ability of antidiscrimination law to effect continuing improvement in blacks' economic status).

167. For an account of the shirking, signalling, and "gift-exchange" models, see Gillian Lester, *Careers and Contingency*, 51 STAN. L. REV. 73, 131-36 (1998). For a general description of efficiency wage models, see RONALD G. EHRENBERG & ROBERT S. SMITH, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY 572-73 (5th ed. 1994).

employers will respond by raising incentive wages still further, leaving even more people involuntarily unemployed.[168]

Although this is an interesting theoretical problem, it does not pose a decisive challenge to the liberal case for cash grants. First, the efficiency-wage theory is at least as controversial among economists as is the neoclassical theory.[169] Second, the cash alternative worsens labor-market conditions only if one adopts a particular version of the efficiency-wage theory. On the shirking theory, cash grants may increase involuntary unemployment. But on the signaling theory, cash grants either have no impact or improve the situation.[170] Third, even if the shirking theory is right, the response is to be quite clear about liberal priorities. If the shirking theorists are correct, there will be tension between two dimensions of freedom: the opportunity to find employment (at a low-wage job) and the ability to command resources to shape one's life. Employment subsidies lionize the first freedom and ignore the second. That is unacceptable. Liberalism cannot endorse any absolute priority of one freedom over the other, because free individuals might choose either. While one can imagine a range of reasonable liberal responses to this possible dilemma, cash grants combined with market reforms represent one way of according respect to both types of freedom.

3. *The Consequentialist Case for Expanding Employment*

What, then, remains of the consequentialist case for employment subsidies? I have just shown that a basic income or negative income tax, in tandem with appropriate policies, could increase employment relative to the status quo, at least for some groups. Of course, an offsetting effect, discussed above, is that the cash grant could reduce employment through negative income and substitution effects. The net effect of the combined liberal program could be an increase or a reduction in employment levels compared to the status quo. That outcome reflects the liberal goal: Some will use their freedom to work more, others to work less.

In contrast, the employment subsidy creates a positive substitution effect, and the potentially negative income effect is minimized by the full-

168. *See* PHELPS, *supra* note 17, at 52-53, 92-94 (arguing that welfare programs reduce attachment to the work force, raise labor costs, and increase involuntary unemployment among low-wage workers).

169. For a discussion of theoretical objections and empirical evidence relating to each theory, see EHRENBERG & SMITH, *supra* note 167, at 384-85; and Lester, *supra* note 167, at 99-105, 136-37, 138-40.

170. Lester's discussion of unemployment insurance (UI) illustrates this point nicely. *See* Lester, *supra* note 167, at 142 (pointing out that liberalizing UI would reduce or increase unemployment, depending on the model of incentive wages one adopts).

time work requirement.[171] In theory then, the employment subsidy should have a larger impact on total employment. Although the magnitude of the additional employment is an empirical question, which I will take up in Part III, assume for the moment that employment subsidies would increase employment by an additional increment—call it *X*. The workers who make up group *X* are precisely the labor-market "holdouts" I described earlier. Their labor is worth only, let us say, five dollars in a free market, but the employment subsidy guarantees them eight dollars for full-time work, and the extra wage is enough to draw them into the labor force.

The utilitarian question is whether incremental employment *X* produces welfare gains large enough to offset the welfare lost through the market distortions that employment subsidies create. The rationales come in two varieties: paternalism and positive externalities. The paternalist rationale is that the extra *X* group of workers will experience new self-esteem, opportunities for social contact, and personal growth that they did not anticipate. The state, in effect, directs them to better choices than they would make on their own. The positive externalities point looks outward: Perhaps youngsters will benefit from the additional (*X*) role models they see, or maybe communities will flourish more if an additional *X* number of residents join the work force.

No one can know the magnitude of these effects, but there are reasons to be skeptical even if one accepts a utilitarian calculus. For one thing, abstract predictions about the benefits of employment often seem divorced from the realities of low-wage work. In the romantic vision, workers discover their hidden potential and set heroic examples for others. But in reality, low-wage work is often physically exhausting, socially demeaning, dangerous, or dirty. These jobs often offer minimal prospects of advancement.[172] The daily experience of janitors, maids, low-level service workers, construction laborers, and others at the bottom of the social scale is often far from uplifting. In psychological terms, these repetitive, subordinate jobs may create stress rather than opportunities for autonomy and creativity.[173]

Of course, resources are scarce. We cannot all have interesting jobs with prestige and a clear path to advancement. Even with a basic income or negative income tax, many current low-wage workers would take their current jobs (or comparable ones). We should respect the dignity of those

171. *See supra* text accompanying notes 136-137.

172. *Cf. supra* text accompanying note 82.

173. *See* Judith R. Smith et al., *Parental Employment and Children*, *in* INDICATORS OF CHILDREN'S WELL-BEING 279, 286 (Robert M. Hauser et al. eds., 1997) (describing relevant psychological studies and arguing that "[t]he lack of opportunity for less educated women to acquire jobs that encourage autonomy and self-direction has ramifications for the mother's role satisfaction, as well as for the quality of the home learning environment she provides for her children").

who choose this work. Still, there is reason to question the wisdom of spending large sums to bring in the extra (*X*) group. The key difference is that the liberal strategy does not lionize these jobs. Instead, it seeks to make workers' choices more transparent. When combined with labor market reforms, cash grants leave the final choice—whether to work, and if so, how much—to each individual.

This extra freedom can produce positive social effects of its own by promoting job mobility and education as well as an extra measure of economic security. A basic income or negative income tax would give the poor resources to help weather a period of unemployment pending a job change, a geographic move, or a change in family circumstances (e.g., a marriage, a divorce, the birth of a child). The employment subsidy, in contrast, pays only while the job lasts, and then only for the lowest-skill jobs.

The romanticization of market work also overlooks the potentially harmful consequences of sending low-income mothers into the full-time work force. As discussed above, the employment subsidy will simply exclude some mothers who are not willing or able to work full time.[174] But others will take up the challenge and work full time, even though their market productivity is lower than their wage. Whether this is a good effect, in social terms, depends at least in part on the fate of their children. The evidence here is not encouraging. Children are not necessarily better off if their parents work full time rather than part time or not at all, particularly when the alternative is cheap day care.[175] And adding a full-time job to the real work of parenthood exacts a psychological toll as well. While mothers who really want to work may adapt well to the task of balancing work and family, there may be more role strain for those who are initially on the fence but who respond to the employment subsidy.[176]

4. *How Strong Is the Consequentialist Case for Employment Subsidies for Young Men?*

A closer look at the situation of young men, who are the primary target of Phelps's program, reveals additional flaws in the consequentialist case.

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174. *See supra* text accompanying notes 83-84.

175. *See generally* Sylvia Beyer, *Maternal Employment and Children's Academic Achievement: Parenting Styles as Mediating Variable*, 15 DEV. REV. 212, 242 (1995) (finding that while maternal employment per se is not harmful, the quality of child care and maternal role strain make a difference); Sandra Scarr & Marlene Eisenberg, *Child Care Research: Issues, Perspectives, and Results*, 44 ANN. REV. PSYCHOL. 613, 626-36 (1993) (finding that child-care quality affects child development).

176. For a discussion of role strain and its effects on children, see Smith et al., *supra* note 173, at 284-86, which describes studies of single, employed mothers that found that "mothers who preferred their current employment status . . . were lower in role strain than their employed counterparts who preferred to stay home."

Phelps's concern is the low and falling labor-force attachment of low-income young men, particularly African-Americans. In 1996, the employment rate for all men ages sixteen to nineteen was 81.9%, and for men ages twenty to twenty-four it was 90.5%.[177] The comparable rates for African-American men were 63.1% and 80.8%.[178] Notably, employment rates among the lowest-skilled men as a group fell ten percentage points from 1973 to 1989.[179] These unemployed men are not, by and large, engaged in caregiving work. Instead, they are idle, or may be working off the books or sporadically. In some cases, they are engaged in antisocial activities: drugs and crime. It is no coincidence that Phelps focuses his energies here: Doesn't this group pose the strongest consequentialist case for creating a bias *in favor* of market work?

My answer is still "no," although I will add one caveat shortly. To begin with, Phelps's argument tends to exaggerate the problems of this group. Although his data emphasize the downward trend in employment among the lowest-skilled workers, nearly two-thirds in every group is working, including very young African-American men, despite the discrimination and other obstacles they face.[180] This is not to say that the trend should be a matter of indifference, but the liberal program of market reforms and cash assistance could improve employment prospects and promote—rather than discourage—efforts to get more education or training.

Phelps's analysis also jumps too quickly from unemployment to crime—asserting that "[a] significant number of the disadvantaged men have left poorly paying jobs or left the unemployment pool for illegal activities."[181] It is true that a nontrivial number of young, unskilled men are involved in crime, and that criminals can inflict disproportionate suffering on their neighbors.[182] But there is no simple causal relationship that suggests that employment subsidies will reduce crime or that unconditional cash grants will increase it. Although empirical studies reveal some correlation between crime and unemployment,[183] that fact does not prove

177. *See* STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 41, at 405 tbl.633.

178. *See id.*

179. *See* PHELPS, *supra* note 17, at 32 (describing how labor force participation among men with less than a high school education fell from 87% in 1973 to 77% in 1989).

180. *See* WILSON, *supra* note 129, at 111-46 (describing employment barriers, including employers' racial stereotyping, that constrain job opportunities for inner-city, African-American men).

181. PHELPS, *supra* note 16, at 32. It is inexcusable to equate lower-class and minority unemployment with crime. Despite "underclass" stereotypes, the vast majority of poor people, including urban poor minorities, are neither criminals nor drug addicts. *See* ACKERMAN & ALSTOTT, *supra* note 25, at 40; BLANK, *supra* note 9, at 47-51.

182. *See* RICHARD B. FREEMAN, WHY DO SO MANY YOUNG AMERICAN MEN COMMIT CRIMES AND WHAT MIGHT WE DO ABOUT IT? 3 (National Bureau of Econ. Research Working Paper No. 5451, 1996) (noting that 12% of high-school dropouts aged 25 to 34 were incarcerated during 1993).

183. *See id.* at 13.

that employment subsidies are superior to the cash alternative. If there is a causal relationship between unemployment and crime, it is not clear what the mechanism is. Do the jobless commit crimes because they are idle, or because they need money? In the latter case, unconditional cash grants might help reduce crime too.[184]

To put the point more strongly, people may initially object to cash grants because they believe that young men involved in crime will take the money and still commit crimes, possibly using the money as a capital stake for even bigger criminal ventures. This is possible, of course, but it is also plausible that other young men will use their newfound resources to replace their criminal income, and spend their time and money in more responsible, and safer ways. Even if a large number of people fall into the first category, we cannot be sanguine about the effects of an employment subsidy. The data suggest that criminals often combine paid work with crime, either simultaneously or by cycling between sectors.[185] Higher wages in legitimate work may lure some in this group out of crime altogether, but others will gladly take their higher wages and retain their criminal income too.[186]

The key point, then, is that the interactions among crime, wage and employment levels, and other sources of income are complex. There is no reason to assume either that employment subsidies will successfully fight crime or that cash grants will generate a new crime wave. On this evidence, it is not apparent why we should deny the freedom that cash grants could confer on the great majority of law-abiding young men, simply on the off-chance that we might indirectly reduce crime.[187] Low-income young men, including African-Americans in the inner city, ought to be entitled to no less respect than better-off citizens. Instead of presuming the homogeneity of any income or racial group, we should take pains to distinguish among individuals and reward or punish each appropriately.

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184. International comparisons provide one piece of speculative evidence on this latter point: Richard Freeman notes that the United States' high incarceration rate is unmatched internationally, but that Western Europe's population of long-term, unemployed welfare recipients is roughly comparable to the U.S. prison population. *See id.* at 4.

185. *See id.* at 15-16.

186. A simple economic model suggests that crime can be reduced by improving the economic returns to legal activities. One way to do that is through an employment subsidy. But unconditional cash grants and labor market reforms *also* improve the relative rewards of legitimate ways of life and raise the opportunity cost of going to jail.

Employment subsidies and cash grants might also indirectly affect levels of crime by increasing neighborhood wealth. For example, the demand for criminal products (drugs or stolen goods) might rise. Alternatively, neighborhood residents might turn away from crime and its products and invest their new wealth in legitimate activities.

187. A better approach might be to use cash grants, and perhaps other programs, as a series of "carrots" and "sticks" to deter entry into crime and recidivism. *See* ACKERMAN & ALSTOTT, *supra* note 25, at 49-51 (discussing the denial and reinstatement of the stake as adjuncts to more traditional criminal-law enforcement tools).

A seemingly more forceful objection is that unconditional cash grants are just welfare all over again. Haven't we tried that approach and witnessed its failure? In the grimmest scenario, hasn't welfare left people worse off than before? Wilson describes inner-city communities that have high proportions of welfare recipients as well as high rates of violence, school dropout, and unemployment.[188] Although these conditions are deplorable, the welfare analogy is a weak argument against cash assistance. As Wilson points out, inner-city conditions are not simply the product of cash welfare. A combination of misguided housing and development policies and conscious and unconscious racism have left the inner cities and their residents socially and economically isolated.[189] These effects have compounded as multiple generations have been brought up in conditions of severe disadvantage.[190]

Furthermore, although welfare may have contributed to unemployment and anomie, traditional welfare is not a fair test case for liberal cash programs. Welfare programs have traditionally paid miserly benefits and have imposed a variety of distorting conditions ranging from rules that leave welfare recipients worse off when they go to work to more stringent eligibility conditions for two-parent than one-parent families, and so on.[191] This country lacks any sustained experience with a true basic income or a long-term negative income tax. It has not tried combining cash grants with energetic policies to combat spatial mismatch, minimize employment discrimination, and reduce labor-market regulation.[192]

But perhaps there remains a nagging sense that cash assistance and market reforms are just not enough. At least in the poorest communities that Wilson describes, a generation or more of unemployment and limited opportunity has damaged the fabric of society and denied young men and women the chance to consider a range of opportunities that include a good job. Under these conditions, individuals may not be ready to make informed decisions. One may question whether young people can make reasonable choices without exposure to the discipline and the opportunity of work. Furthermore, there may be serious collective action problems. When communities and social networks have deteriorated so dramatically, it may

188. *See* WILSON, *supra* note 129, at 3-15, 18-24, 52-86.

189. *See id.* at 34-50.

190. *See id.* at 46-50. For benefit levels, see *supra* note 48 and accompanying text.

191. *See* EDIN & LEIN, *supra* note 66, at 61-67. Although state TANF programs depart in some respects from AFDC, it is too early to evaluate the effect of the new law.

192. In the 1960s and 1970s, negative income tax experiments tested a variety of negative income tax plans in several geographic locations. Although the experiments were short-term, they suggested that the participants as a group would reduce work effort by modest amounts, in response to a higher benefit level and lower marginal tax rate. Interestingly, the studies suggested that men would reduce work effort by less than women, and that, among the men, the reduction in work effort came about because just a few individuals chose not to work at all (rather than many men reducing their hours). *See* Moffitt, *supra* note 143, at 213-16.

be unreasonable to suppose that individuals acting on their own can rebuild the networks of friends, businesses, churches, and other institutions that allow individuals to thrive in a community.

These are serious concerns for liberals. Liberalism requires just background institutions that ensure everyone a decent education and exposure to different possible ways of life. The appalling fact is that these preconditions for autonomy may simply be unavailable to Wilson's poor, inner-city neighborhoods, where schools are bad and opportunities limited. We may legitimately be concerned that people's choices have been and will be made based on unduly constrained option sets.

But a recognition of the problem does not imply that employment subsidies are the right answer. Stepping back for a moment, consider two very different approaches. One would be the "pure liberal" approach: give resources to people, help the markets work, then let individuals decide whether to rebuild their communities or to move out. Communities, after all, have no special moral status. Once we have removed artificial sources of market failure, if individuals can build better lives elsewhere, we should not bind them to a particular place. A second, more interventionist approach requires governmental decisions about how best to allocate resources among different activities. Employment subsidies might be part of such a plan, reflecting a judgment that formal work is an important route to regaining social control.[193] It is not clear, a priori, that the interventionist route is the more appropriate. While Wilson's work shows how joblessness, poverty, and market failures combined to erode social organization in the inner city, re-creating it, once lost, is an unprecedented task, requiring not merely funding but policy innovations that do not yet exist.[194]

Even if policymakers are inclined toward the interventionist mode, however, the cash strategy should not be ruled out. Imposing limited conditions on the receipt of cash grants could ensure that young people experience the world of paid work—while still preserving a greater degree of individual freedom. The government might, for example, require young people to hold a private or public job for a couple of years before claiming their basic income or negative income tax. This experience would ensure that they can make an informed choice about how to use their freedom. If, after reasonable exposure to the world of work, they decide to pursue another path, the government should respect their freedom to make choices and live with the consequences. Reasonable people may differ on what a meaningful period would be, but no one could argue that one should have to work an entire lifetime to demonstrate the maturity to make informed

193. Wilson argues that widespread joblessness contributes to a loss of social organization and social control. *See* WILSON, *supra* note 129, at 20-21, 59-66.

194. *See supra* text accompanying notes 160-161 (describing the failure of enterprise zones and hopes for alternative approaches).

choices. It might make sense to target the work requirement to disadvantaged youths, perhaps high-school dropouts.[195] Alternatively, a program might impose the same conditions on everyone who claims the basic income or negative income tax, regardless of her class background.

In any event, we should hesitate before taking this road. We should be careful not to condescend or to offer paternalistic solutions too readily. Employment subsidies treat all low-wage workers as if they need a lifetime of re-education. Moreover, these programs evince a blind faith in the power of work to magically create social structure and personal discipline. The employment subsidy would put a few more people to work, but it is not at all clear how daily hours of commuting to work in monotonous, low-paid service jobs will mystically create a sense of community. More income and expanded employment opportunities will help, but I have already shown that the liberal program can produce both.

One of the beauties of the liberal program is that it allows us to take a gradual approach. We should try market-correction first and see what happens when people have both a meaningful opportunity to work and a basic income. If we decide that more interventionist measures are necessary, they ought to be temporary and not merely an excuse for permanent work requirements for the poor.

The liberal alternative acknowledges that paid work is not the only source of personal satisfaction or the only opportunity for disciplined coordination with others. The policy community's mania for work blinds it to the alternative discipline of other modes of life, when they are freely chosen, and not the product of desperation. Predictions are difficult because this route simply has not been tried. But try to imagine a world in which every working-age adult has a guaranteed minimum income that is not quickly taken away when she begins to work. Some will use their cash to supplement their full-time wages: That group will act as Phelps would like, and with similar consequences—more role models and higher total incomes. But other poor people will make different choices. Some mothers may work less and supervise their children more. They will provide another kind of role model for their children. Other people will devote themselves to charity or to community affairs. Still others may do nothing obviously productive—they will watch television, read, or spend time with friends. The puritans among us may grumble that they are "wasting" their time. But that is a harsh condemnation, particularly coming from people with a much larger set of attractive opportunities. Faced with the realities of hard, low-wage work, some of us might "drop out" too. The liberal approach alone ensures that even they can count on a legitimate means of support.

195. *Cf.* ACKERMAN & ALSTOTT, *supra* note 25, at 38 (requiring high-school graduation as a condition of stakeholding).

Looking further ahead, what new social and cultural institutions might arise once people realize that the basic income or negative income tax is theirs to count on, job or no job? What effects would this kind of stability have on families and on communities? Our difficulty in imagining this kind of liberal community suggests how far we are from it.[196] But it is difficult to view this ideal as a worse one than the employment-maximizing society of frenetic full-time workers and commuter communities empty during the day. Money cannot buy everything, but neither can work.

D. *Conclusions*

The cash alternative provides a useful baseline for evaluating employment subsidies. The policy comparison raises hard questions of fact and harder choices about values. If one believes that market work should be the foundation of community membership, then employment subsidies are the better program. But we should pause to consider whether that belief follows from an appealing and coherent vision of community or whether it simply ratifies arrangements that perpetuate the privilege of the advantaged.

Similarly, employment subsidies are the better program if we believe that maximizing social welfare is the right goal, and that an incremental increase in employment will produce immensely positive consequences. But the liberal perspective challenges the easy consequentialist case. At a minimum, we should be careful neither to conflate resources with employment nor to romanticize low-wage work.

III. DO EMPLOYMENT SUBSIDIES WORK?

Suppose that one is still interested in employment subsidies—for reasons of political pragmatism or principle. The next logical question is whether they actually work. Advocates claim that employment subsidies can raise wages and employment levels, integrate poor workers into the community of work, and improve the welfare of the poorest workers, their families, and their communities.

Before taking a closer look at these claims, it is useful to refine our understanding of the diverse programs that can be termed employment subsidies. Very generally, an employment subsidy is a payment made by the government to employers, where the payment is based on employment levels, wage rates, or earnings. The subsidy may be calculated by reference to the current employment level (a "general" subsidy) or only to employment in excess of a threshold (an "incremental" subsidy). The

196. For another vision, see *id.* at 181-96, which describes how stakeholding and related programs can help strengthen a liberal community in the United States.

employment subsidy may be available for the employment of any worker or only for workers with certain income or other characteristics (a "targeted" subsidy). The subsidy payment may be calculated based on the number of workers, on workers' wages (a "wage subsidy"), or on workers' earnings (an "earnings subsidy").

In this Part, I use the term "employment subsidy" to refer only to payments to employers. But in Part IV, I will show that these conventional employment subsidies are closely related to programs that pay benefits directly to workers. The EITC is the primary example in current law.

Despite the diversity of employment subsidies, some general conclusions can be drawn. This Part and Part IV invoke both economic theory and empirical evidence to argue that advocates have overstated the case for a new employment subsidy program. Even at the level of theory, employment subsidies are risky; they require sustained intervention in labor-market processes that are little understood. At the level of practice, we know more, and what we know is not promising. With the exception of the EITC, most employment-subsidy programs to date have been notable failures. They are difficult to design and are subject to easy interest-group capture and taxpayer manipulation. Meanwhile, their benefits for workers have been, by most accounts, slim to none. While Phelps's proposed program and the EITC are the best of the bunch, as we shall see they have significantly different strengths.

A. *The Uncertain Economics of Employment Subsidies*

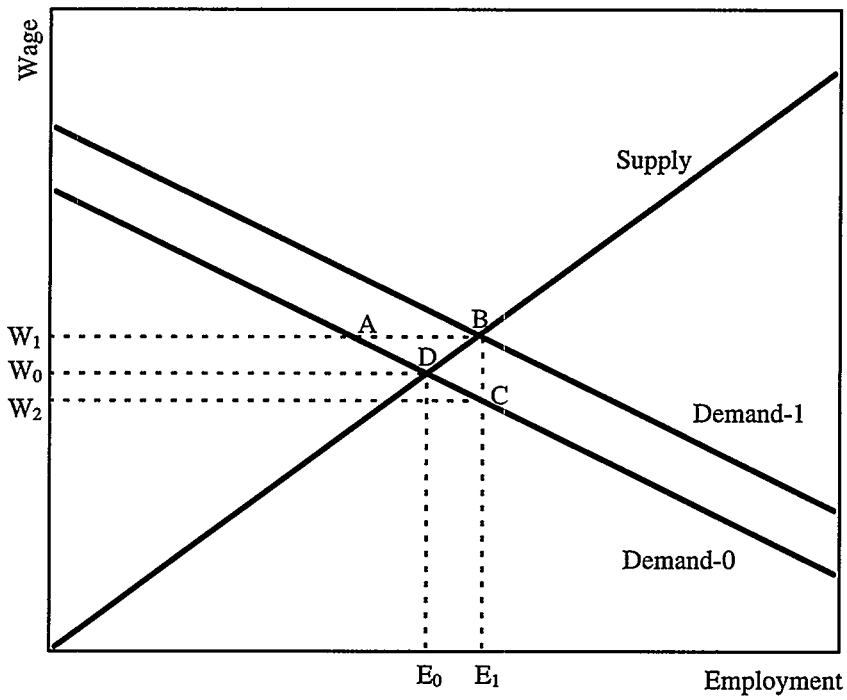
To understand the theory of employment subsidies, it is useful to start small, with a stripped-down program and partial equilibrium analysis in a perfectly functioning neoclassical labor market. We can add sophistication as the basics become clear.

A simple employment subsidy can increase employment, raise wages, or do both. The employment subsidy lowers the after-subsidy cost of labor to employers, in effect shifting the demand curve for labor to the right. Figure 1 depicts a very simple model of the labor market, with a wage subsidy equal to a fixed sum per hour of work. The demand curve shifts to the right because, for every quantity of labor, the employer is willing to pay up to the old wage (W_0) plus the subsidy amount (S). At the old employment level (E_0), there is now excess demand, because employers will pay ($W_0 + S$) while employees require less than that. In the new equilibrium at B, employers increase hiring to E_1, and the market wage level rises to W_1.

The employment subsidy increases hiring through both a substitution effect and a scale, or output, effect. The substitution effect occurs because a reduction in the relative price of labor leads employers to use more labor and less capital. The scale or output effect occurs because a transfer of

income to the employer leads the employer to increase production, thus using more labor and more capital and increasing the scale of her business.[197] It follows that the impact of the subsidy may differ across firms and across industries. Firms and industries that can easily substitute labor for capital or expand output cheaply will respond to an employment subsidy of a given magnitude with a greater behavioral change than firms with fewer opportunities for substitution or expansion.

FIGURE 1. A SIMPLE WAGE SUBSIDY



Depending on the shape of the supply and demand curves, the distributional benefit of the employment subsidy may go to workers, to employers, or to both. That is, workers' wages may increase by the full amount of the subsidy paid to the employer, by zero, or by some

197. *See* U.S. DEP'TS OF LABOR & TREASURY, THE USE OF TAX SUBSIDIES FOR EMPLOYMENT 10 (1986) [hereinafter 1986 TREASURY REPORT]; Daniel S. Hamermesh, *Subsidies for Jobs in the Private Sector*, *in* CREATING JOBS: PUBLIC EMPLOYMENT PROGRAMS AND WAGE SUBSIDIES 87, 97 (John L. Palmer ed., 1978). The two effects should increase employment by firms receiving the subsidy. A general equilibrium analysis is needed, however, to consider whether there are offsetting effects on employment in firms not receiving the subsidy. Some firms might decrease employment as a reaction to the higher taxes used to finance the subsidy or because consumers or producers change the mix of products they buy. *See* 1986 TREASURY REPORT, *supra*, at 10.

intermediate amount. In Figure 1, because of the way the curves are drawn, the benefit of the subsidy is divided between employers and employees.[198]

This simple story is elegant, but also a bit misleading. The effects of an employment subsidy depend heavily on market conditions, including the responsiveness (or elasticity) of the supply and demand for labor to changes in the wage rate. For example, if the supply of labor were perfectly elastic, an employment subsidy would increase employment but not wages, because by definition there would be an unlimited supply of workers willing to work at the current wage. If the supply of labor were perfectly *in*elastic, an employment subsidy would increase the wage but not employment levels, because by definition there would be a fixed supply of workers.[199]

Although these extreme cases are unlikely to describe the labor market as a whole, they do suggest the importance of market conditions for the performance of an employment subsidy. Supply or demand might be quite inelastic or elastic over certain ranges, in very short or long time periods, or in particular segments of a market. For example, various theories of unemployment suggest that market conditions may prevent the labor market from clearing. In that situation, there are workers who are willing to work at the prevailing wage but who cannot find a job. There is, in effect, a perfectly elastic labor supply curve for employment levels close to the current one.[200]

The elasticities point is striking, because it suggests the inherent limitations of employment subsidies. If labor supply is very inelastic, the program can raise wages but not employment. In that case, low-wage workers who take jobs will be better off, but the subsidy will not expose larger numbers of workers to the "discipline of work" that proponents seek. An employment subsidy can raise employment if labor supply is highly elastic, but workers will earn something very close to the prevailing wage, frustrating the goal of raising living standards for the working poor.

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198. To see why, note that the cost of the subsidy to the government is ($S \times E_1$), or the rectangle W_1W_2CB. Because employers' after-subsidy wage drops from W_0 to W_2, employers gain additional consumer surplus equal to polygon W_0W_2CD. Workers gain additional producer surplus equal to polygon W_0W_1BD, because the market wage rose from W_0 to W_1. The "missing" revenue is the deadweight loss measured by the triangle *BDC*. A subsidy creates a deadweight loss because it distorts the allocation of resources: Starting out with the subsidy, we could make a Pareto improvement by repealing the subsidy and giving both workers and employers an amount of cash equal to the lost consumer or producer surplus, plus half of triangle *BDC*.

199. To take two more extreme cases, completely inelastic demand for labor would result in no increase in either wages or employment, while perfectly elastic demand would increase both wages and employment. For an illustration of the complex interactions among supply and demand elasticities, see Jeffrey M. Perloff, *Micro- and Macroeconomic Effects*, *in* JOBS FOR DISADVANTAGED WORKERS: THE ECONOMICS OF EMPLOYMENT SUBSIDIES 95, 108 tbl.1 (Robert H. Haveman & John L. Palmer eds., 1982).

200. *See* Lawrence F. Katz, *Wage Subsidies for the Disadvantaged*, *in* GENERATING JOBS 21, 28 (Richard B. Freeman & Peter Gottschalk eds., 1998) (finding that groups facing substantial structural unemployment may have high labor supply elasticities).

In fact, there is significant uncertainty about the elasticity of low-wage labor supply. In a recent paper, Lawrence Katz offers a "best guess" estimate that a ten percent general wage subsidy for low-wage workers would increase employment by two percent and wages by five to six percent.[201] I will describe empirical studies of particular programs below, but the basic point is clear enough: We cannot take for granted that one dollar of employment subsidy translates into one dollar of increased wages.[202]

Before we turn to specific programs, however, it is important to understand the limitations of the simple economic model that we have used to this point. The analysis thus far has taken a static, partial equilibrium view, which is useful but incomplete for two reasons. First, in the long run, an employment subsidy may have dynamic effects that intensify or counteract its static effects. For example, raising the wages of low-wage workers may shift the supply curve to the right, if more workers forgo training or nonworkers are attracted into the market.[203] In that case, the wage will tend to fall back toward its original level, although aggregate employment will be higher in the end. Changes in the labor markets may also affect other markets, including the capital and products markets. An employment subsidy might, for example, alter the mix of labor-and-capital-intensive industries in the economy. Although the partial-equilibrium approach may be acceptable for small or targeted employment subsidies, it may be less so for larger or more universal subsidies.

Second, the simple analysis ignores involuntary unemployment.[204] In the neoclassical model, every worker whose productivity is at least equal to the prevailing wage can find a job. But this situation hardly squares with

201. *See id.* at 28.

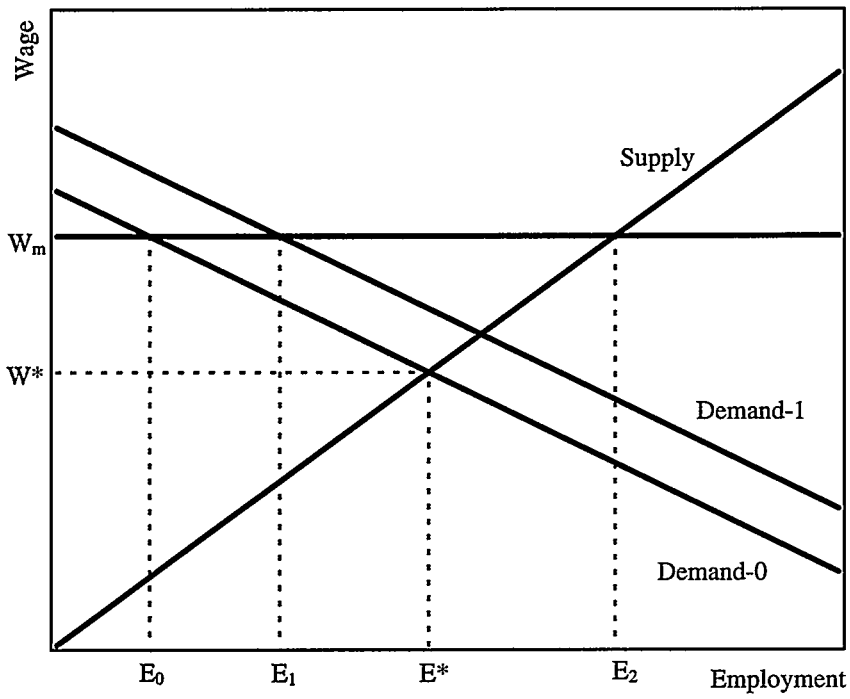
202. An employment subsidy like the one depicted in the graphs is essentially a kind of negative payroll tax on employers. Thus, we might expect the distributional and efficiency effects of an employment subsidy to parallel those of the payroll tax, at least if the employment subsidy were paid for all workers. Here, it is curious to note that the usual assumption is that payroll taxes are shifted entirely to workers, implicitly assuming that the supply of labor is perfectly inelastic, at least in the short run. *See* ROSEN, *supra* note 135, at 286-87 (discussing incidence of payroll taxes and noting that the assumption of perfectly inelastic supply probably holds in the short run). This is curious because a frequent shorthand assumption in studies of employment subsidies is that labor supply is perfectly elastic. The answer to the puzzle may be that employment subsidies are usually directed, de facto or de jure, at low-wage labor rather than at all labor. Thus, the payroll tax analogy is a limited one: The right analogue would be a payroll tax on low-wage workers. For that group, the assumption of perfect labor-supply inelasticity is almost certainly incorrect, as Katz asserts. *See* Katz, *supra* note 200, at 28.

203. *See* Hamermesh, *supra* note 197, at 90.

204. A third complication is that the taxes used to finance the subsidy can also affect the operation of the program. For example, higher taxes may reduce employment or wages, offsetting part or all of the impact of the employment subsidy. It would make little sense, for example, to finance a wage subsidy for low-wage workers with an equivalent payroll tax on the same workers. *See* Shaviro, *supra* note 24, at 407, 414-19. Ideally, the employment subsidy and its financing should be considered together, but for now I will implicitly assume financing that would not reverse the program's distributional and incentive impact.

our experience. Economists offer multiple and, in some respects, competing theories of unemployment. Unemployment may be frictional or the result of search by firms and workers.[205] It may be produced if firms pay incentive wages, above the market clearing price, in order to control shirking and discipline workers with the threat of unemployment.[206] Legal rules, like the minimum wage, may also produce unemployment by introducing artificial wage rigidities.[207]

FIGURE 2. THE MINIMUM WAGE



Although an extended discussion of the various theories would take us far afield, consider the minimum wage example, which illustrates how an employment subsidy can reduce involuntary unemployment, but only by introducing a second distortion that helps to counteract the first. Figure 2 depicts an employment subsidy in a market with a minimum wage. Initially, the minimum wage (W_m) creates involuntary unemployment, because the supply of workers (E_2) exceeds the demand for workers (E_0). An employment subsidy can partially or completely offset the effects of the minimum wage on employment. In the Figure, the employment subsidy

205. *See* EHRENBERG & SMITH, *supra* note 167, at 566-67.
206. *See id.* at 572-73.
207. *See id.* at 567-71.

shifts the demand curve outward, raising employment to E_1 and leaving the wage at W_m. Unemployment falls, from $E_2 - E_0$ to $E_2 - E_1$.[208]

Incentive wages, search costs, and other theories of unemployment cannot be so easily depicted. Nevertheless, economic models incorporating these theories predict that, in principle, an employment subsidy similar to the Phelps plan should raise employment levels and wages.[209] These models produce only simulated results, but they confirm that an employment subsidy should operate in the expected direction, even taking these complexities into account.

To this point, the discussion suggests that labor-market conditions constrain the operation of employment subsidies. Another constraint is at least as important: The design of the subsidies also matters, and potentially quite a lot. In designing employment subsidies, one important criterion is cost effectiveness, or *the maximization of the desired behavioral change per dollar of subsidy*. If the objective is to maximize employment, for example, then all other things being equal policymakers would prefer an employment subsidy that creates 100 jobs for $100 over one that creates the same 100 jobs for $500. Whether the program's goal is to reinforce community values through work, or to maximize the positive consequences of higher wages and employment, it is better to get more bang for the buck.

The difficulty, of course, is that "all other things" are rarely ever equal. Some employment subsidies are highly cost effective but can create only a limited number of jobs. Other employment subsidies are cost effective in theory but have high administrative costs. Still other designs are narrowly cost effective but undermine other program goals by displacing some workers.

Cost effectiveness is not the same thing as "efficiency" in the usual public-finance sense of minimizing the deadweight loss of a tax or transfer. Employment subsidies inevitably create deadweight loss because they create a behavioral distortion: employment of labor whose private value is less than the wage prevailing in the absence of the subsidy. This mismatch between private values of supply and demand is precisely what employment

208. This example assumes that the widely-accepted neoclassical model of the operation of the minimum wage is valid. For a challenge to that model and some alternative accounts of how the labor market operates, see DAVID CARD & ALAN B. KRUEGER, MYTH AND MEASUREMENT: THE NEW ECONOMICS OF THE MINIMUM WAGE 355-86 (1995). For an excellent summary of the standard theory and a careful critique of Card and Krueger's theory and evidence, see Shaviro, *supra* note 24, at 436-59.

209. *See* Hian Teck Hoon & Edmund S. Phelps, Low-Wage Employment Subsidies in a Labor-Turnover Model of the "Natural Rate" (Dec. 8, 1997) (unpublished manuscript, on file with *The Yale Law Journal*) (developing a model of the labor market that demonstrates that a graduated wage subsidy would raise take-home pay and employment for low-wage workers); Dale T. Mortensen & Christopher A. Pissarides, Taxes, Subsidies and Equilibrium Labor Market Outcomes (Dec. 8, 1997) (unpublished manuscript, on file with *The Yale Law Journal*) (using a labor-market model to simulate the effects of wage and employment subsidies and concluding that both would raise wages and employment levels for low-skill workers).

subsidies intend. Employment subsidies *aim* to create inefficiency, in this sense.[210] And, as noted in Part II, the artificial wage increase creates additional distortions in human capital markets.[211] The employment subsidy may also create distortions across industries by favoring labor-intensive over capital-intensive goods, and firms with large (pre-credit) tax liabilities over those with little taxable income.

Any employment subsidy faces two potentially serious design problems: windfall and displacement. For now, I will introduce these issues at the theoretical level. The next Section will illustrate how these dilemmas limit the performance of a range of real-world programs.

The windfall problem arises when firms receive a subsidy for workers they would have hired or wages they would have paid even in the absence of the subsidy. Windfalls reduce cost-effectiveness, because the behavioral change per dollar of subsidy is zero.[212]

Although windfalls are usually defined as subsidies paid to firms that do not change behavior, we can state the problem more generally and more precisely as any distributional benefit of a subsidy that is received by a market actor whom the subsidy does not intend to benefit. The usual goals of an employment subsidy, for example, are to raise wages or increase employment, and not to enrich employers.[213] Windfalls do not necessarily defeat the purpose of employment subsidies in any fundamental way. They simply raise the cost of achieving the desired change in the labor market. As a practical matter, we will see that some windfall to employers is often a necessary by-product of the program. But an ideal design would minimize the subsidy not only to firms that do not change their behavior at all, but also to those that could be induced to act more cheaply.

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210. *See* PHELPS, *supra* note 17, at 123-26 (arguing that an employment subsidy raises wages and employment to reflect the social value of work). As a technical matter, excess burden is a function of compensated elasticity (the substitution effect), while the overall behavioral effect depends on uncompensated elasticity. *See* ROSEN, *supra* note 135, at 319-22. Thus, the absence of a behavioral change does not signal the absence of a distortion. But the employment subsidy seeks a behavioral change, so the basic relationship still holds: The larger the distortionary substitution effect, the larger the desired behavioral change.

211. By artificially raising the wages of low-skilled workers, employment subsidies may discourage people from seeking additional training, expanding the supply of low-wage workers over the longer run. In theory, we might combat this effect with a second-best policy such as incentives for training, but the design of such programs is, if anything, more problematic than that of employment subsidies. For a review of experience in the United States and abroad with training incentives, see generally BURT S. BARNOW ET AL., FINANCIAL INCENTIVES FOR EMPLOYER-PROVIDED WORKER TRAINING: A REVIEW OF RELEVANT EXPERIENCE IN THE U.S. AND ABROAD (1990).

212. Windfalls (also known as "buying the base") arise not only in employment subsidies but also in other kinds of subsidies directed at changing behavior. *See, e.g.*, Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 222 (1993) (discussing windfalls in the research and development tax credit).

213. One complicating feature of the windfall problem is the uncertain incidence of the "employer" windfall. The windfall might accrue to the owners of the firms or it might be shifted to consumers of the firm's products through lower prices.

Suppose that there is only a single employer, and in the absence of the employment subsidy, the firm would have employed ninety workers. Now, an employment subsidy is introduced that pays the firm one dollar for every worker employed, and the employer raises employment to 100 workers, receiving $100 from the government. The usual windfall definition focuses on the fact that the employer received ninety dollars for workers it would have employed anyway. There is, however, a second potential source of windfall here: If the employer could have been induced to hire the additional ten workers for only fifty cents per worker, then it has been paid too much for the ten extra workers.

Figure 3 illustrates the two components of the windfall problem. The total cost of the subsidy is rectangle W_0W_1DB.[214] But part of the subsidy (rectangle W_0W_1CA) is paid for employment and wages that would have occurred even in the absence of the subsidy. This employer surplus[215] is the first kind of windfall—payment for employment that would have occurred in any event. The rest of the employer surplus (triangle ADC) represents the second kind of windfall—subsidies paid to employers in excess of the amounts needed to induce the employers to change their behavior.

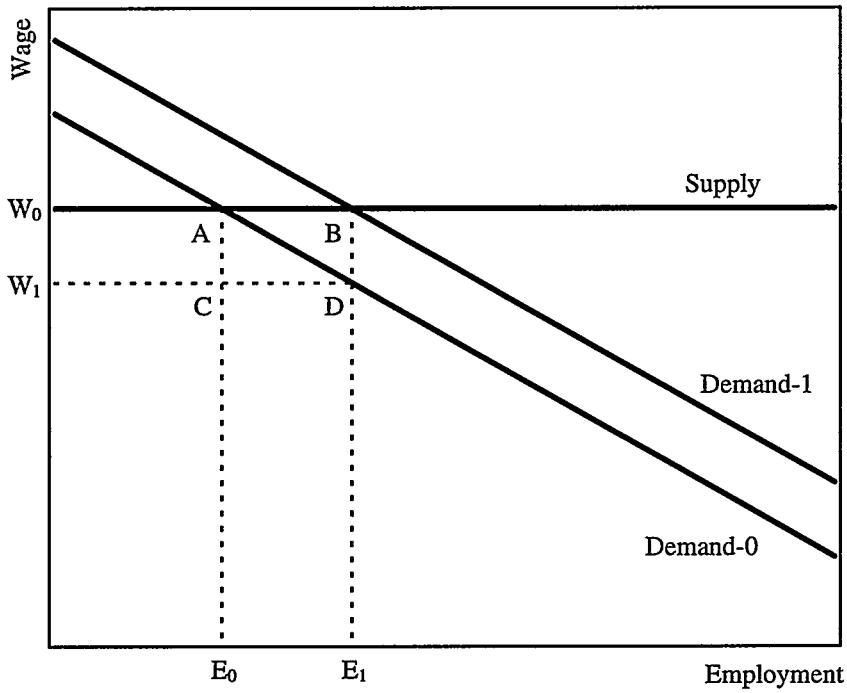
In the employment subsidy context, the magnitude of windfalls depends on the extent to which the market wage rises. If the market wage increases by the full amount of the subsidy, there is no distributional benefit to the employer, but if it rises by less, the employer gains. Thus, if policymakers could ensure that the market wage would rise by the full amount of the subsidy, they would not need to worry about employer windfalls.

Subsidy design can mitigate, but generally not eliminate, windfalls. Under many market scenarios, increasing employer surplus is simply necessary in order for the subsidy to operate. The whole point of the subsidy is to induce employers to increase employment and/or raise wages by making it profitable for them to do so. In equilibrium, at the margin, there is no more employer surplus, but the adjustment path necessarily creates windfalls in order to move employers along that path. The only way to eliminate windfall from employment subsidies completely is not generally feasible. In theory, we could design a subsidy that price discriminates perfectly, paying market participants only enough to induce the desired behavioral change. Simple employment subsidies generally cannot price discriminate, however, and thus it is impossible to eliminate all distributional benefit to employers.

214. The vertical distance between the two demand curves is the subsidy (S), and the distance from the origin to the new equilibrium employment rate is the total employment on which the subsidy is paid.

215. I am using the term "employer surplus" rather than the familiar "consumer surplus" to emphasize that the "consumers" here are employers.

FIGURE 3. EMPLOYER WINDFALLS



The second design problem, displacement, is closely related to the first. One way to improve the cost-effectiveness of an employment subsidy is to target the program more narrowly. For example, suppose that the primary goal of an employment subsidy is to increase employment among low-wage workers. A subsidy available for all workers would probably increase the employment of the low-wage group, but only by subsidizing the hiring of many high-wage employees as well. A program targeted directly to low-wage workers would be more cost-effective, raising the number of low-wage employees hired per dollar of subsidy paid.

Targeting can take a variety of forms. Phelps's subsidy, for example, is payable only to employers of workers who earn low hourly wages.[216] But even that approach may be overbroad for an anti-poverty policy, since many low-wage workers are not poor.[217] Another approach pays employers

216. *See* PHELPS, *supra* note 17, at 113.

217. *See* RICHARD V. BURKHAUSER ET AL., PUBLIC POLICIES FOR THE WORKING POOR: THE EARNED INCOME TAX CREDIT VERSUS MINIMUM WAGE LEGISLATION 16 (Institute for Research on Poverty Discussion Paper No. 1074-95, 1995) (finding that, in 1989, only 22% of those earning less than half of the average private-sector hourly wage were poor, and an additional 17% were near-poor); CARD & KRUEGER, *supra* note 208, at 282-83 (finding that, in 1990, 19.7% of minimum-wage workers were poor, and another 13.4% were near-poor); ORGANISATION FOR ECON. CO-OP. & DEV., EMPLOYMENT OUTLOOK: JUNE 1998, at 51 tbl.2.8 (1998) (indicating that

only when they hire a member of a disadvantaged group. This has been the Clinton Administration's preferred strategy. The Work Opportunity Credit (WOC), for example, targets seven categories of workers, including welfare and food stamp recipients, veterans, ex-felons, and youths from low-income families.[218] The Welfare to Work Tax Credit (WWTC) targets long-term welfare recipients.[219]

The tradeoff is that targeting opens the way for displacement, which occurs when subsidized jobs are not new jobs but instead are shifted from the nontargeted group to the targeted group. A targeted subsidy potentially encourages the substitution of (now-cheaper) targeted workers for nontargeted workers.[220] As we shall see, the magnitude of displacement is an empirical question, and the importance of displacement is a normative one. But, in general, the potential for displacement increases if the targeted group is a small percentage of the relevant labor supply and the targeted workers are fungible with the nontargeted workers.[221]

Thus, a targeted employment subsidy tends to increase employment and wages of target-group members and to reduce employment and wages of untargeted workers.[222] The subsidy could also reduce the employment of targeted workers who do not participate in the program. This is a significant real-world issue, since rates of participation in targeted programs are usually rather low.[223] A targeted subsidy and the taxes that finance it may

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in 1993, 22.1% of low-wage workers were poor; another 16.3% were low income; but 62% were from moderate- or high-income families).

218. *See* I.R.C. § 51(d)(1)-(3) (West 1998). Some of the categories overlap, and the rules are complex. For example, any welfare recipient is eligible if the family has received benefits for at least nine months, with the welfare spell ending within nine months of the hiring date. Veterans are eligible, but only if they are also welfare recipients (meeting a shorter durational requirement) or food stamp recipients (for three months, ending within a year of hiring).

219. In general, the WWTC applies to members of families who have received TANF or AFDC for a period of at least 18 months ending on the hiring date, or whose benefits were terminated because of a federal or state time limit. *See* I.R.C. § 51A(c) (West 1998).

220. *See* 1986 TREASURY REPORT, *supra* note 197, at 14; Hamermesh, *supra* note 197, at 99-100.

221. *See* 1986 TREASURY REPORT, *supra* note 197, at 14 (arguing that net new jobs creation is more likely if the subsidy is targeted to individuals with elastic labor supply and if the financing burdens factors that are relatively inelastic); George E. Johnson, *Allocative and Distributional Effects*, *in* JOBS FOR DISADVANTAGED WORKERS, *supra* note 199, at 57, 70-75 (noting that, under one theory of unemployment, displacement rises with supply elasticity and falls as the percentage of the labor force covered by the subsidy rises); Robert I. Lerman, *A Comparison of Employer and Worker Wage Subsidies*, *in* JOBS FOR DISADVANTAGED WORKERS, *supra* note 199, at 159, 167-68 (concluding that if targeted workers are a small percentage of the relevant labor force, displacement is more likely, and that a net increase in employment will occur only if the targeted group is larger than the nontargeted group).

222. *See* Lerman, *supra* note 221, at 171-72 (considering the equivalent effects of a subsidy paid to workers).

223. *See* 1986 TREASURY REPORT, *supra* note 197, at 104. Lawrence Katz reports that the number of TJTC-certified workers reached a peak of 622,000 in 1985 and declined to 364,000 in 1992 because of program changes. *See* Katz, *supra* note 200, at 32. He estimates that from the mid- to late 1980s, only nine percent of economically disadvantaged youth who were eligible and employed were TJTC hires. *See id.* at 33.

also indirectly reduce employment of untargeted workers. For example, a targeted subsidy might induce shifts in output from subsidized firms to unsubsidized ones—think of a shift in total production from, say, IBM to McDonald's.[224]

But is displacement a *problem*? The answer depends on policymakers' confidence in the normative crispness of the categories used to classify program participants. If the goal of the policy is simply to increase employment of Type *A* workers, and the government really does not care about employment levels of other workers, then it should be very happy with a targeted employment subsidy that increases the employment of Type *A* workers by 100 and reduces the employment of Type *B* workers by 100. But if the employment prospects of Type *B* workers also matter, then a problem arises. If Type *A* were, say, low-income household heads, and Type *B* were affluent suburban teenagers, displacement might be a matter of little concern. Unfortunately, as we shall see,[225] in conventional programs the normative tradeoffs are much harder. Displacement is closely related to the larger dilemma of welfare reform: The problem is not simply how to find jobs for welfare recipients, but how to improve conditions for the working poor as well.

B. *Pitfalls in Policy Design*

It is time to move from theory to real-world practice. We have a wealth of experience with the actual performance of employment subsidies, although the data are sometimes difficult to interpret. The federal government experimented briefly with a large-scale program in the late 1970s, and since then it has tried a variety of smaller efforts. Each of the major programs teaches some cautionary lessons, and together they set the stage for considering Phelps's more dramatic plan.

1. *Incremental Subsidies: The NJTC Example*

The New Jobs Tax Credit (NJTC) had a brief career between 1977 and 1978. Adopted as a countercyclical measure to stimulate employment, the NJTC paid firms that increased their level of employment compared to the previous year. More precisely, a firm could claim a nonrefundable tax credit equal to fifty percent of the increase in the firm's unemployment tax (FUTA) wage base over 102% of the previous year's FUTA wage base.

Although the NJTC was paid for incremental employment of any worker, regardless of her wage, the program's design tilted the subsidy

224. *See* 1986 TREASURY REPORT, *supra* note 197, at 14.
225. *See infra* Subsection III.B.3.

toward low-wage workers. At the time, the FUTA wage base included only the first $4200 of wages paid to each worker. The cap on the wage base per worker meant that employers could earn more tax credits by hiring low-wage workers. For example, an employer who hired ten additional workers, each earning $10,000, would have the same additional FUTA base as an employer with ten extra workers, each earning $25,000.[226]

The NJTC was a good-sized program, costing about ten billion dollars over two years, or about twenty-four billion in 1996 dollars.[227] Its efficacy remains contested, largely because of the econometric difficulty of determining what would have happened in the absence of the program. The evidence is very cautiously optimistic.[228] Although several studies found that the credit increased employment, their methodologies have rightly been questioned. The studies may have detected only the fact that savvy managers are more likely both to know about the credit and to run growing firms.[229] Even if the studies' results could be accepted at face value, they document an increase in employment only in some industries that may have been offset by a decline in employment elsewhere (e.g., in capital-intensive industries).[230] A study of a similar, incremental program in Canada found that only one-third of subsidized jobs were newly created.[231]

The NJTC illustrates nicely the many dilemmas of designing an incremental employment subsidy. The difficulty is that the current employment level is not necessarily a good proxy for what we really would

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226. This tilt toward low-wage workers was effective only for low-wage workers earning at least the FUTA amount of $4200.

227. *See* 1986 TREASURY REPORT, *supra* note 197, at 5. In 1978, the CPI-U index stood at 65.2; in 1996, it stood at 156.9, representing an increase in the general price level of 141%. *See* STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 41, at 487 tbl.752.

228. *See* Katz, *supra* note 200, at 31 (noting the shortcomings of the empirical studies but concluding that "the evidence suggests that a temporary, noncategorical, incremental employment subsidy has some potential for stimulating employment growth").

229. *See* John Bishop, *Employment in Construction and Distribution Industries: The Impact of the New Jobs Tax Credit*, *in* STUDIES IN LABOR MARKETS 209, 217 (Sherwin Rosen ed., 1981); Jeffrey M. Perloff & Michael L. Wachter, *The New Jobs Tax Credit: An Evaluation of the 1977-78 Wage Subsidy Program*, 69 AM. ECON. REV. 173, 175 (1979). These studies found a correlation between firms' knowledge of the NJTC and employment growth, but critics have pointed out that this may be a spurious correlation, if both knowledge of the NJTC and growth of the firm were products of some other variable (e.g., skilled entrepreneurship) or if knowledge of the new program just happened to increase as employment growth did. *See* 1986 TREASURY REPORT, *supra* note 197, at 58.

230. For this reason, a 1986 Treasury Department study concludes that "[t]he available evidence is not sufficient to measure the NJTC's impact on the growth of aggregate employment and output." 1986 TREASURY REPORT, *supra* note 197, at 5. The Treasury analysis is significantly less positive than the initial research studies and some other commentary, which describes the NJTC evidence as showing that the program had a "major impact." John H. Bishop & Charles A. Wilson, *Effects on Firm Behavior*, *in* JOBS FOR DISADVANTAGED WORKERS, *supra* note 199, at 219, 220. Note that Bishop is the author of one of the original studies. *See* Bishop, *supra* note 229.

231. *See* Surendra Gera, *An Evaluation of the Canadian Employment Tax Credit Program*, 13 CAN. PUB. POL'Y 196, 202 (1987) (analyzing a Canadian jobs tax credit program in effect from 1978 to 1981).

like to observe, which is the employment level in the absence of the subsidy. To see the problem, consider a growing or shrinking firm or labor market. Suppose that in the absence of the subsidy, the employment level would have been 100 units of labor in year one and 120 units in year two. To work perfectly, an incremental subsidy must take into account the growth in the baseline, paying only for employment above 100 in year one and above 120 in year two. If the baseline remains 100 in year two, the incremental subsidy will pay a windfall to employers, who are paid for twenty units of employment they would have hired anyway. The mirror-image problem occurs in a declining market: If employment would have been eighty units in year two, then leaving the baseline at 100 will make the subsidy ineffective (unless the subsidy amount paid just over 100 units is so large that it can induce firms to make the twenty unit marginal investment).

The designer's task, then, is to define the baseline employment level, balancing economic accuracy against observability. The NJTC used each firm's prior employment level plus two percent, in effect assuming a two percent "natural" growth rate. This approach ranks high for observability but low for accuracy. And because the basic formula was so simple, the credit had to add complex rules to combat predictable abuses. For example, firms could claim tax credits by replacing full-time workers with part-time ones, assuming that the latter were paid at least $4200 per year.[232] To fight that strategy, the NJTC layered on a second test, which limited the credit to the increase in the employer's total wage base over 105% of the previous year's total wages.

The credit also needed special rules to combat tax-motivated business startups and mergers. The problem arises because an incremental employment subsidy creates a valuable new tax attribute: a low prior year's wage base. Taxpayers will predictably attempt to "traffic" in it or to create it out of thin air if possible.[233] The NJTC responded with a weak compromise, capping the credit at twenty-five percent of the firm's FUTA

232. For example, suppose that an employer originally employs 100 full-time workers at wages of $10,000 each. In an extreme case, the employer could double her FUTA wage base by firing all the full-time workers and hiring 200 half-time workers, paying each one $5000. There would be no net increase in employment in the firm in terms of full-time equivalent jobs. The FUTA base also would count two half-year workers in the same job as two workers. *See* 1986 TREASURY REPORT, *supra* note 197, at 31.

233. If Firm *A* merges with Firm *B* to create new Firm *C*, what is the prior year's wage base? Is it *A*'s prior wage base, *B*'s prior wage base, or zero, because Firm *C* did not exist a year ago? This simple case is not actually too difficult: logically, the base is Firm *A*'s base plus Firm *B*'s base. *See* Treas. Reg. § 1.52-2(a) (1998) (providing that purchasers inherit the predecessor's wage base). But it is more difficult to deal with complex business combinations and asset sales. Intercompany worker transfers are also possible: Clever taxpayers can manufacture credits by shifting workers among related firms without changing their duties. *Cf.* Treas. Reg. § 1.52-1(a) (1998) (requiring apportionment among firms that are under common control). In addition, there is always the danger that firms will reincorporate under new names and claim to be startup operations with a zero prior wage base.

wage base. This rule limited the profit potential of fraud, but also capped the incentive for legitimate startup businesses. For rapidly growing businesses, the ceiling converted the incremental credit into a pure windfall with no marginal incentive.[234]

The NJTC's use of the prior year's employment base also opened the playing field for tax avoidance games such as "hopscotch," in which a firm deferred new hiring to every other year. This created an artificially low FUTA base in year one and an artificially high base in year two.[235] It simultaneously created an incentive, counter to the usual pressures, to treat independent contractors as employees.[236]

An incremental subsidy also faces the problem of uncertainty in business planning. Employers do not always know, when a hiring decision is made, whether the firm will qualify for an employment subsidy that year. This problem is likely to be most severe early in the year and when total hiring is uncertain or close to the subsidy's threshold. There is no design solution to this issue. It is simply one artifact of the attempt to curtail windfalls.

Finally, a number of institutional issues are common to incremental and non-incremental subsidies alike. Against which taxes should a subsidy be allowed as a credit: income, payroll, or both? If the firm's subsidy exceeds its tax liability, should the excess be refundable? The advantage of refundability is that the incentive (or windfall) operates even in loss years and for startup firms. The disadvantage is that refundability may invite fraud.

This litany of design issues highlights a fundamental tradeoff in employment subsidy design. Incremental subsidies can cut back on windfall and reduce the dollars spent per job created. But at the same time, they also reduce the total number of jobs created.

The problem arises because the larger the subsidy, the more firms will participate, and the more firms will respond by increasing employment. At the same time the government is paying windfalls to some employers, it is also paying other employers who would not create jobs at a smaller or truly incremental subsidy level. For example, suppose that the program pays a

234. *See* 1986 TREASURY REPORT, *supra* note 197, at 51. The NJTC also limited the total credit to $100,000 in an attempt to direct proportionally larger benefits to smaller employers. *See id.*

235. *See id.* at 13 n.3.

236. There are, of course, other design options with different mixes of observability and accuracy. An incremental employment subsidy might, for example, adopt a year-one employment base with a fixed formula increase each year tied, say, to the rate of employment growth in the economy as a whole. This structure would prevent firms from manipulating the wage base but could be severely inaccurate for individual firms. The prescribed rate of growth in the base might be tailored a bit for industry or local economic conditions, but any aggregate adjustment is likely to be rough. *See generally* Bishop & Wilson, *supra* note 230, at 222-27 (simulating employer responses to several different thresholds).

subsidy for every new job created over 110% of the prior year's employment level. Now suppose policymakers lower the threshold to every new job created over 100% of the prior year's employment level. The change will, predictably, both increase windfall and expand employment. The government will now pay windfall credits to firms that would have expanded employment above the 100% mark (but not above the 110% mark) anyway. The lower threshold reduces cost effectiveness, but also induces participation by some new firms, who could not be induced to reach the 110% level.[237] The magnitude of both effects is, of course, an empirical question, and the right balance to strike is a normative one. But in general, we can expect that programs that cut back very tightly on windfall will be both more cost effective (in the narrow sense defined above) and less likely to boost employment levels.[238]

The NJTC experience teaches some preliminary lessons. For one thing, we do not have adequate tools to know whether the program had any effect at all. The empirical evidence offers a whisper of hope, but no more. For another, the effort at incrementalism led to remarkable complexity of design. There is some evidence that the complexity of the NJTC may have hindered its effectiveness.[239] Although the program was too short-lived to allow employers to become familiar with its terms, one might predict that greater familiarity would have both improved and hindered the functioning of the credit, as employers learned both how to comply and how to game the system.

2. *Another Kind of Incrementalism: Hiring Subsidies and the TJTC*

A more familiar kind of incremental strategy is the hiring subsidy, which rewards employers for hiring new workers. A hiring subsidy is incremental because it applies only to new employees. A hiring subsidy is

237. A similar effect occurs when setting the size of the subsidy as well as the baseline for incremental growth. For example, suppose that a subsidy of $1000 per job created could induce employers to create 100 new jobs. If policymakers increase the size of the subsidy to $1500 per job created, two results will follow. First, the government will pay a windfall of $500 per job for the 100 new jobs it could have "purchased" for only $1000. But the extra $500 per job may induce additional job creation by employers for whom the cost of job creation is higher. Even a perfectly incremental credit would create this second type of windfall as the price of luring higher-cost job-creators to change their behavior. There may also be another important dynamic at work: Even pure windfall credits might lead a firm to expand output and employment by reducing average, though not marginal, cost. *See* Perloff, *supra* note 199, at 97.

238. *Cf.* Laurie J. Bassi, *Stimulating Employment and Increasing Opportunity for the Current Work Force*, *in* THE WORK ALTERNATIVE: WELFARE REFORM AND THE REALITIES OF THE JOB MARKET 137, 143-44 (Demetra Smith Nightingale & Robert H. Haveman eds., 1995). The Hamermesh simulation shows that as baseline employment thresholds rise from 85% to 100%, the cost per job and the employer windfall decline, but so does the total number of jobs created. Hamermesh, *supra* note 197, at 104.

239. *See* 1986 TREASURY REPORT, *supra* note 197, at 61.

imperfectly incremental, however, because it applies to all new hires, even if they would have been made in the absence of the subsidy. The old Targeted Jobs Tax Credit (TJTC) and its recent successor, the WOC, are both hiring subsidies. Both pay employers a percentage of the first-year wages (up to a cap) of newly-hired employees who are members of certain disadvantaged groups.[240]

The saga of the discredited TJTC program, and its surprisingly quick reincarnation as the WOC, offers a striking example of common design pitfalls and the political costs of creating an ineffective employment subsidy that gains a powerful business constituency. The TJTC was widely criticized because its design permitted and even encouraged employers to claim windfall credits. With some significant exceptions described below, the WOC is designed in a very similar way. Because the WOC is too new to have generated any empirical evidence, I will discuss the windfall problem first in the context of the TJTC and then introduce the relevant design differences between the two programs.

The TJTC permitted a practice called retrospective certification.[241] The TJTC paid firms for hiring disadvantaged workers in nine specific categories (including welfare recipients, low-income youth, and certain food stamp recipients). To claim the TJTC, employers had to obtain a certification from the state employment service, a division of the state labor department, stating that the worker hired was a member of a TJTC-eligible disadvantaged group. Determining the TJTC eligibility of job applicants and filing certification requests required burdensome paperwork, and many employers found it impractical, unappealing, or even illegal[242] to screen job applicants ahead of time.[243] Instead, many firms went on with their routine hiring practices and then referred already-hired workers to the personnel department or a "management assistance company" that determined TJTC eligibility and filed the certification request—all *ex post*.[244] Indeed, a whole

240. The WOC is 40% of the first $6000 of wages in the year of hiring. *See* I.R.C. § 51(a)-(b) (West 1998). It has eight categories of eligible recipients, instead of nine. *See id.* § 51(d)(1). Recent budget legislation extended both the WOC and WWTC to June 30, 1999. *See Clinton Signs Omnibus Package*, 98 TNT 204-1 (Oct. 22, 1998).

241. For a description, see John H. Bishop & Suk Kang, *Applying for Entitlements: Employers and the Targeted Jobs Tax Credit*, 10 J. POL'Y ANALYSIS & MGMT. 24, 37-38 (1991).

242. Some employers were concerned that asking applicants about their disadvantaged status could constitute employment discrimination. *See* 1986 TREASURY REPORT, *supra* note 197, at 102.

243. There is also evidence that, at least initially, the state employment services found it efficient to engage in retrospective certification to meet internal administrative quotas. *See id.* at 68. The Treasury Department also reported that states provided limited funding for TJTC administration. *See id.*

244. See former I.R.C. § 51(d)(12) (1994), which required only that the certification request be submitted before the employee began work.

service industry of management assistance companies sprang up to obtain TJTC certifications for employers.[245]

Retrospective certification was at odds with the initial conception of the TJTC. The original idea was that workers would obtain TJTC vouchers ahead of time and bring them into employment interviews. But for a variety of reasons, few employees obtained advance certification.[246] This left employer certification as the main method of implementing the TJTC. By allowing retrospective certification, the TJTC clearly paid windfall credits to employers that did not change hiring practices.

To be sure, retrospective certification does not, by itself, prove that credits claimed were windfalls. If employers either inquired about TJTC eligibility before hiring or took measures to increase the number of TJTC-eligible workers in the hiring pool, the credit might be effective, even if employers delayed formal certification until after hiring. But on-the-ground observation suggests that most employers did not change their hiring practices. Instead, TJTC screening took place after the fact, and often through a management assistance company.[247]

Some interesting (if limited) empirical evidence confirms that a large portion of TJTC expenditures were paid for hiring that would have occurred anyway. Applying econometric techniques to survey data on employment patterns and use of the TJTC, Bishop and Montgomery find that at least seventy percent, and potentially more, of TJTC credits were claimed for workers who would have been hired in the absence of the subsidy.[248] In a

245. *See* EDWARD C. LORENZ, THE TARGETED JOBS TAX CREDIT IN MARYLAND AND MISSOURI: 1982-1987, at 72-75 (National Comm'n for Employment Policy Research Report No. 88-18, 1988).

246. The Treasury Department reports that, for the first three quarters of 1981, 63% of all TJTC certifications were retroactive. *See* 1986 TREASURY REPORT, *supra* note 197, at 102. A Labor Department survey found that in subsequent years 86% of employers determined TJTC eligibility after a job offer was made, and that 77% of employers routinely completed TJTC eligibility determinations for all newly hired employees. *See* OFFICE OF THE INSPECTOR GEN., U.S. DEP'T OF LABOR, REPORT NO. 04-94-021-03-320, TARGETED JOBS TAX CREDIT PROGRAM: EMPLOYMENT INDUCEMENT OR EMPLOYER WINDFALL? 17 (1994).

247. *See* Bishop & Kang, *supra* note 241, at 37 (describing survey evidence of retrospective certification and the use of MACs); *see also* LORENZ, *supra* note 245, at 74-75 (describing the origin of MACs). Bishop and Kang report, for example, that in many states MACs requested more than half of all TJTC certifications, and surveys of MACs indicate that most of their clients engaged in retrospective TJTC screening. *See* Bishop & Kang, *supra* note 241, at 37. Although the most optimistic picture comes from employer surveys, even the self-reported efforts are not impressive. *See* U.S. GEN. ACCOUNTING OFFICE, GAO/HRD-91-33, TARGETED JOBS TAX CREDIT: EMPLOYER ACTIONS TO RECRUIT, HIRE, AND RETAIN ELIGIBLE WORKERS VARY 3 (1991) (summarizing interviews with employers, in which 45% reported taking some action to recruit, hire, or retain TJTC-eligible workers).

248. *See* John H. Bishop & Mark Montgomery, *Does the Targeted Jobs Tax Credit Create Jobs at Subsidized Firms?*, 32 INDUS. REL. 289 (1993). As the authors note, this estimate is probably optimistic. The study found a correlation between employment growth and use of the TJTC, but like the earlier NJTC studies, this study cannot rule out the possibility that the TJTC did not *cause* the employment growth. Instead, growing firms may have been more likely to know

1991-92 audit, the federal Labor Department's Inspector General found that ninety-two percent of TJTC credits were for workers who would have been hired in any event.[249] The same audit found that employers determined TJTC eligibility for eighty-six percent of employees after hiring.[250]

A new study by Katz is somewhat more optimistic. Katz's work takes advantage of a natural experiment created by 1989 changes in the TJTC, when twenty-three- and twenty-four-year-old disadvantaged youths were made ineligible, while those aged eighteen to twenty-two retained eligibility. He concludes that forty to fifty-two percent of TJTC jobs were net employment additions for the targeted group, with a rather modest cost of $1500 per job. Katz suggests using caution in interpreting the results but nevertheless concludes that the TJTC had "modest positive employment effects on economically disadvantaged young adults."[251]

The retrospective certification problem shows the practical *and* political constraints on good subsidy design. Reformers had argued for years that retrospective certification should be disallowed, but for a long time no effective steps were taken. The political constituency against reform was powerful, because large employers of low-wage labor inevitably hire TJTC eligibles and so benefit significantly from being able to claim credits without changing their hiring behavior.[252] Another reason for retrospective certification is that state employment services were unable to process paperwork quickly enough to make prospective certification feasible.

During 1996, policymakers added a new chapter to the retrospective certification story. By then the TJTC had expired, with the approval of the Clinton Administration, whose Labor Department condemned the program as wasteful.[253] But the enactment of welfare reform made it desirable to promote jobs for the disadvantaged, and so the TJTC was revived and renamed the WOC. Although the WOC is similar to the TJTC, it does contain new provisions intended to prevent retrospective certification. To claim the WOC, employers must either (a) actually receive certification before the employee starts work, or (b) complete a "pre-screening notice"

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about and claim the TJTC and use it for hiring they would have done anyway. *See id.* at 296-97 (discussing methods for assessing the resulting statistical bias).

249. *See* OFFICE OF THE INSPECTOR GEN., *supra* note 246, at 16-18. The OIG methodology was very rough. The auditors simply asked employers whether they would have hired the TJTC employees anyway, a counterfactual question vulnerable to employers' memories, among other things.

250. *See id.* at 17.

251. Katz, *supra* note 200, at 40.

252. For example, the following firms testified before the House in support of the TJTC in 1994: the American Health Care Association (which employs nursing-home workers), Pizza Hut and the National Restaurant Association, Waffle House, Inc., and the National Council of Chain Restaurants. *See Targeted Jobs Tax Credit: Hearing Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 103d Cong. 191, 195, 225 (1994) [hereinafter *1994 Hearings*].

253. *See id.* at 76-77 (statement of Robert B. Reich, Secretary, U.S. Dep't of Labor).

on or before the hiring date and submit the notice within twenty-one days of the work start date.[254] The pre-screening notice is the key: It requires employers to identify some basis, early on, for thinking that the employee may be WOC-eligible.

Although the new rules take a fair stab at ending retrospective certification, they do point out the impossibility of eliminating the practice. Even now, large employers could meet the requirement by simply having all new hires routinely complete, on the hiring date, a boilerplate questionnaire to identify any possible basis for WOC eligibility. The new rules prevent the most egregious retrospective certifications, even if they still allow many employers to participate passively, by creating generic forms or accepting WOC vouchers from applicants they would hire anyway. It is too early to know how employers have reacted to the new rules.

Another asserted source of windfall in the TJTC was its small size, and the WOC is vulnerable to the same charge. Critics argued that the TJTC's subsidy was too meager to induce employers to change their behavior, given the high cost of active measures to screen workers for TJTC eligibility.[255] Over time, the value of the TJTC declined, with inflation and legislative change. In 1978 the credit was worth about $9000 (in 1990 dollars), but by 1990, the credit was worth only $2400 (in 1990 dollars).[256] The WOC is even smaller. Today, the maximum is $2400, or about twenty-three percent of the wages of a full-time, full-year minimum wage worker.[257] There is, of course, a (by now) familiar catch-22 here. A credit that is too small to induce behavioral change will confer only windfalls. A larger credit can induce greater behavioral change, but will also pay even bigger windfalls to firms that would have made the targeted hires in any event.

The TJTC also illustrates design issues unique to hiring subsidies. Critics of hiring subsidies argue that they promote "churning," as employers fire and rehire (or at least take fewer steps to prevent turnover) in order to maximize their subsidy payment. The potential increase in

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254. *See* I.R.C. § 51(d)(12) (West 1998).

255. *See, e.g.*, Edward C. Lorenz, *TJTC and the Promise and Reality of Redistributive Vouchering and Tax Credit Policy*, 14 J. POL'Y ANALYSIS & MGMT. 270, 282-84 (1995) (arguing that "the credit was allowed to become so small and of such short duration that it was only popular with high turnover, low pay employers"). Lorenz discusses, but discounts, a study that found that TJTC workers' productivity was seven percent lower than the average for low-wage workers. *See id.* at 282.

256. *See id.* at 283.

257. The WOC is 40% of the first $6000 of wages, or $2400. *See* I.R.C. § 51(a) (West 1998). The credit is effectively reduced, however, by the loss of the employer's deduction for the amount of the credit. *See* I.R.C. § 280C(a) (West 1998). At a 35% marginal tax rate, the loss of a deduction of $2400 costs the employer $840. The net value of the credit, then, is $1560, or 15.15% of the $10,300 cost of employing a full-time worker for 50 weeks at the $5.15 minimum wage.

turnover is objectionable, assuming that the goal of the subsidy is to increase employment of at least normal duration. Low-wage employment—the kind that most TJTC-eligibles secure—is already characterized by very high turnover, and the hiring subsidy may exacerbate the situation.[258] One way to combat churning is to impose a durational requirement on employment.[259] But the tradeoff, of course, is that a long period may reduce the effectiveness of the subsidy.

The TJTC's design flaws render it a useful cautionary tale, but hardly a blueprint for constructive action. Unfortunately, the new welfare to work tax credit (WWTC)—another Clinton Administration proposal—basically expands the WOC for welfare recipients who have received welfare for at least eighteen months.[260] The main difference is that the WWTC subsidy is larger and applies to two years' wages, not just one.[261]

In the end, it seems wise not to exaggerate the design problems of incremental subsidies. No policy is perfect, and we should not demand an impossible degree of precision. Nevertheless, these recurrent dilemmas teach us something about the practical difficulties of managing the labor market.

3. *Targeted Subsidies: Displacement, Stigma, and Administrative Cost*

Current employment subsidies also illustrate three key costs of targeting. Recall that displacement arises when an employment subsidy raises employment for the targeted group by reducing employment for other workers. Prior experience also suggests that targeting may also stigmatize the very workers it is intended to help and create administrative barriers that undermine the efficacy of the program.

The TJTC, WOC, and WWTC provide good examples of the first problem—displacement. The problem arises because many "officially" disadvantaged workers are competing with poor but untargeted workers who possess similar employment characteristics. The low-wage labor market typically includes welfare recipients looking for work, non-welfare working poor family heads and single individuals, and a large group of middle-class teens and secondary workers.[262] Although employers tend to

258. *See* Hamermesh, *supra* note 197, at 90. The counterargument is that the credit may offset the training and other costs of hiring new workers that lead some employers to "under-hire," increasing current workers' hours rather than hiring new ones.

259. The WOC, for example, requires 400 hours—considerably longer than the TJTC's 120-hour rule. *Compare* I.R.C. § 51(i)(3) (West 1998), *with* I.R.C. § 51(i)(3) (1994).

260. *See* I.R.C. § 51A(c) (West 1998).

261. The WWTC is 35% of the first $10,000 of wages in the first year, and 50% of the first $10,000 of wages in the second year. *See* I.R.C. § 51A(a) (West 1998). The certification rules are the same as for the WOC. *See* I.R.C. § 51A(d)(1) (West 1998).

262. In 1989, only 39% of low-wage workers were poor or near-poor. *See supra* note 217.

have negative attitudes about welfare recipients, ex-felons, and other targeted workers, they often cannot readily distinguish these workers from others in the low-wage labor pool. (Targeted credits may actually harm workers by making identification easy. This is an important point to which I will return later.)

Suppose that in the absence of an employment subsidy, an employer (say, a fast-food restaurant or a retail store) would hire a mix of workers from all categories. The targeted employment subsidy encourages the employer to employ targeted workers and fire (or not hire) workers who are not targeted. The net result is that identified WOC and WWTC eligibles probably are employed more, but unidentified eligibles, working poor family heads not eligible for the credit, and other low-wage workers will have a harder time finding a job.

Here, then, is the normative problem. Neither the community-values position nor the positive consequences argument supports reducing employment opportunities for the working poor. It makes little sense to displace, say, poor worker *A* with welfare recipient *B*, because worker *A* will then be quite badly off and may end up on welfare herself. In communitarian terms, the community has just defaulted on its obligation to worker *A*. In utilitarian terms, there is no net increase in employment to revitalize families or communities. On either view, there is no point in a zero-sum game in which jobs are simply traded among the poor.

But perhaps this is too simple a story. Instead of displacing other poor workers, the WOC and WWTC may displace wealthier low-wage workers, including teens and secondary workers from middle-class families. Although the teens and secondary workers may be worse off, perhaps it serves community values or aggregate welfare to give their jobs to the disadvantaged.[263] The question of who is displacing whom is an empirical one, and we have limited evidence. If not all workers are equally productive, then displacement will not occur randomly; if the subsidy is large enough to induce hiring of targeted workers, they will tend to displace the least productive of the remaining group. But we do not have reliable data on relative productivity or on the mixture of different groups in labor markets. If markets are geographically isolated and mobility is limited, teenagers and secondary workers may compete for low-wage jobs in suburban market *A* while welfare recipients and working poor family heads compete in inner-city market *B*. In that case, displacement will tend to operate within the latter two groups.[264]

263. Admittedly, there may be other reasons to dislike putting these people out of work: Teenagers' and secondary workers' incomes may give them a measure of independence that the official family income statistics do not capture.

264. The evidence on displacement is rather limited, because of problems of data and methodology. *See* Bishop & Montgomery, *supra* note 248, at 290. Bishop and Montgomery found

The only remaining defense stretches either the community values rationale or the utilitarian principle to the breaking point. Even if there is no short-term increase in employment, perhaps there is a net gain if the displaced working poor can bounce back and find another job, while the credits help hard-to-employ welfare recipients and others make a long-term transition to work. This claim requires a troubling empirical leap, however, and at least three reasons suggest caution. First, there is no direct evidence that this is what happens. Second, what we do know is that the working poor and the welfare poor are not discrete groups. The boundary is porous, and there is much crossover.[265] Some unemployed low-wage workers find jobs, but others cycle back onto welfare. Third, we also know that the TJTC was not particularly successful in improving workers' employment prospects. One study found that TJTC workers had higher incomes in the first year after hiring (compared to a control group of TJTC-eligible workers who were not hired), but their earnings advantage over the control group faded quite quickly.[266] The same study found a correlation between the size of the credit claimed and long-term earnings increases, indicating that workers who stay employed longer (or earn higher initial wages) are likely to have higher earnings in the longer term.[267] But it is not clear whether the credit causes this outcome—by increasing attachment to the workforce, for example—or whether stronger employees with better long-term prospects also are more likely to earn higher wages or have longer spells of employment to begin with. Another study found that while the TJTC may have reduced job turnover slightly, the program did not raise wages, compared to recipients' previous and subsequent jobs.[268]

Our experience with this alphabet soup of employment subsidies highlights an important tradeoff between minimizing the cost per job created and maximizing the total number of jobs created. International comparisons confirm this design dilemma. It is never simple to compare policies across nations, because context and program terms differ. Nevertheless, a recent OECD report, summarizing empirical studies of four programs from three countries, reached a conclusion that tends to confirm

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some evidence of displacement effects in the TJTC, but their conclusions are weak, because their data did not allow them to identify TJTC-eligible employees directly. Instead, they looked at youth hiring generally. They found little evidence that TJTC youth hires were displacing adults but could not determine whether young TJTC eligibles were displacing young non-eligibles. *See id.* at 300-02.

265. *See* EDIN & LEIN, *supra* note 66, at 60-87 (describing welfare mothers' experience cycling between welfare and work); Alan M. Hershey & LaDonna A. Pavetti, *Turning Job Finders into Job Keepers*, 7 FUTURE OF CHILDREN 74, 76-80 (describing high job turnover and rapid cycling between welfare and work).

266. *See* Lorenz, *supra* note 245, at 25-39.

267. *See id.* at 27-39.

268. *See* OFFICE OF THE INSPECTOR GEN., *supra* note 246, at 21-22, 30. Turnover remained high in the TJTC group. After five quarters, only 24% of TJTC hires remained with the same employer. *See id.* at 22, 30.

the American experience: General employment subsidies tend to have significant windfalls, while targeted subsidies tend to displace.[269]

These are dispiriting findings, but are they inevitable? Is it possible to improve the targeting of the Clinton plan to minimize displacement while also increasing the likelihood of net new job creation? For example, instead of targeting welfare recipients, could the government design a subsidy program that would target low-income workers? That sort of targeting would still displace, but according to a more rational pattern; it would shift jobs toward poorer workers from their richer counterparts at the same wage level.

The short answer is "not likely," at least with an employment subsidy paid to firms rather than to workers. Part IV describes why it is so difficult to target an employer-paid subsidy to low-income workers. Employers have information only about a slice of employee income: the wages earned at that job. They have no independent information about wages from other jobs, a spouse's earnings, or a family's deductions. For all these reasons, targeting based on low wages has become an increasingly flawed proxy for low income. In 1990, for example, less than thirty-five percent of minimum-wage workers were living in poor or near-poor families.[270]

Nor is displacement the only drawback of targeting. A second problem is stigma. Some troubling evidence from the TJTC era suggests that tagging workers as "disadvantaged" can harm their employment prospects, presumably because employers have negative attitudes about members of the targeted groups.[271] In a controlled experiment, a random sample of disadvantaged job applicants was divided into three groups. The first two groups received different types of employment vouchers, which identified the applicants as disadvantaged and offered employers a subsidy for hiring them. The third group was the control group, which received no vouchers. The surprising result (the study was designed to test the different vouchers) was that the control group landed *more* jobs than either of the two vouchered groups. The stigma problem clearly has the potential to sabotage well-intentioned programs. The possibility of stigmatization may also deter participation: If targeted workers fear that being tagged as disadvantaged will hurt their prospects, they may rationally decline to come forward.[272]

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269. *See* ORGANISATION FOR ECON. CO-OP. & DEV., EMPLOYMENT OUTLOOK 63-64 (1993). *But see* Katz, *supra* note 200, at 46 (arguing that none of these studies provides "particularly compelling" evidence).

270. *See supra* note 217.

271. *See* Gary Burtless, *Are Targeted Wage Subsidies Harmful? Evidence from a Wage Voucher Experiment*, 39 INDUS. & LAB. REL. REV. 105, 113-14 (1985).

272. *See, e.g.*, Katz, *supra* note 200, at 32 tbl.1.1 (showing low participation rate among disadvantaged youth in a comparison of TJTC certifications for that group with employed members of that group).

Finally, targeting increases administrative costs, particularly the costs of transmitting information to employers and the IRS. High administrative costs borne by the government increase the revenue cost of the program and reduce cost effectiveness. High administrative costs borne by private participants reduce participation in the program. Once again, the TJTC experience is on point. In theory, TJTC eligibility criteria should be relatively easy to administer, since virtually all of the categories are tied to participation in a transfer program. Nevertheless, it proved difficult to make the TJTC process work. The relevant bureaucracies were unwilling or unable to coordinate information exchange among employers, workers, and the state employment services.[273] The TJTC's complex rules may have discouraged active recruiting by employers, leaving the credit most attractive for large employers of low-skilled labor, who passively participated by hiring management assistance companies to claim windfall credits.[274] And the TJTC paperwork burden on the state employment services amounted to an expensive but unfunded mandate that, as described above, contorted the program into a system of retrospective certification.[275]

One can certainly imagine better implementation strategies. Ideally, employers might be able to gain instant access (with their employees' permission) to a national computer database on WOC and WWTC eligibility. But no such database now exists, and constructing one would be a massive achievement of federalism (since the states administer both welfare and food stamps). The IRS computers are the subject of enough critical reporting to avoid making them the linchpin. Is a better system impossible? No. Would it be easy? No.

C. *The Phelps Plan*

In contrast to our past and present programs, the Phelps plan is elegantly simple. Phelps proposes a general (non-incremental) wage subsidy for low-wage workers. Employers would receive a subsidy equal to a fraction of the hourly wage rate for every full-time worker employed at any time during the year. For example, employers would receive $3 per hour for workers earning $4, $2.30 for workers earning $5, and so on, with subsidies ending at hourly wages of $12.[276] The program cost is large, at least initially. Phelps estimates a gross annual cost of $125 billion but predicts offsetting savings elsewhere in the budget.[277] Phelps would finance

273. *See supra* text accompanying notes 241-244.
274. *See* Bishop & Kang, *supra* note 241, at 41.
275. *See supra* text accompanying notes 241-244.
276. *See* PHELPS, *supra* note 17, at 113.
277. *See id.* at 116, 129-34.

the net cost of the plan with an across-the-board increase in the payroll tax.[278]

Phelps's plan is frankly ambitious in scope and cost. At $125 billion annually, it is more than 400 times the size of the WOC and WWTC combined.[279] The program provides a maximum yearly subsidy per worker that is nearly twice as large as the WWTC (the larger of the two existing programs);[280] and the subsidy is payable for a worker's entire career, not just for two years of employment with the same firm. This boldness is an advantage. Instead of opting for the cheap, cosmetic fix, Phelps is digging deeper. Unfortunately, five problems undermine the initial appeal of the program.

First, Phelps's plan distributes resources in a relatively scattershot way. Targeting based on wage rates is inevitably overinclusive. The plan would tend to increase earnings and employment not only for poor low-wage workers, but for middle-class teens[281] and secondary workers as well.[282] This is not a fatal criticism; it simply means that the program redistributes toward some workers who do not, in fact, need help. The result is a program that occupies an uneasy middle ground. It is not universal, like Social Security or a basic income, and so it cannot claim the symbolic and political advantages of universalism. It therefore carries the political baggage of a poverty program, but it is not well-targeted to need. It provides less to the disadvantaged than a better-targeted program of similar size—say, a negative income tax.

Second, Phelps's plan avoids some administrative snafus but may create new ones. Targeting based on wage rates allows the employer to determine readily whether a worker is eligible for a subsidy. This easy rule avoids the costly information exchange necessary under the TJTC and its progeny. The Phelps program also avoids the mind-bending task of designing a baseline for an incremental program like the NJTC. But the employer's ready control of the information flow also opens the way for easy fraud. Firms have an obvious incentive to maximize the subsidy by understating wages and overstating hours. Today, employers do not have to report wage rates to the government (they report total earnings to the IRS).[283] For example, a firm could gain as much as $6000 per year by

278. *See id.* at 116-17.

279. *See* OFFICE OF MANAGEMENT & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1999, at 92 tbl. 5-1 (1998) (showing that the FY 1998 tax expenditure on the WOC was $275 million and on the WWTC was $10 million).

280. $6000 versus $3500.

281. The full-time work requirement will cut down on this problem, at least for after-school jobs. Even so, teens will still qualify when they take full-time summer jobs.

282. *See supra* note 217.

283. *See* I.R.C. §§ 3101, 3402 (West 1998) (imposing Social Security payroll taxes and requiring income tax withholding on total wages).

treating an $8000-per-year worker as working full time (2000 hours) at $4 per hour instead of half-time (1000 hours) at $8 per hour.[284] And it is difficult to imagine a system that could accurately monitor employees' working hours. Another profitable employer strategy would be to substitute (unreported) fringe benefits, such as health insurance or a free day care center, for cash wages in order to expand the apparently "low-wage" workforce. Admittedly, the tax code contains many provisions that are susceptible to fraud, but the potential economic payoff of up to seventy-five percent of wages[285] creates a large incentive for employers to arrange their affairs to their best advantage.[286]

Third, employers can also make money quite legally by displacing higher-wage workers with lower-wage ones, a prospect that Phelps ought to take more seriously. The feasibility and profitability of that strategy depend, of course, on elasticities of substitution. And perhaps we do not care if one $14-per-hour worker is displaced by two $7-dollar-per-hour workers. The low-wage group gets two new jobs, and the higher-wage group has lower unemployment rates and may be better able to weather spells of unemployment. But we should feel differently if the $7 workers are displaced by $4 workers. In defense of Phelps's plan, the potential displacement is at least not as arbitrary as under current programs, which divide the working poor from the welfare poor.

Fourth, the graduation of the wage subsidy adds an extra distortion to workers' decisions. The program is not income-tested in the traditional sense; workers can work unlimited hours at the same wage rate without losing a dollar of subsidy. But the subsidy does create an implicit "tax" on moving to a higher wage *rate*. Workers still earn more in absolute terms by getting a raise, but the marginal gain is smaller than in the absence of the subsidy.[287] Advocates may view this as a small price to pay for greater justice in the low-wage sector, but once again, employment subsidies distort, rather than correct, the market.

Fifth, a serious shortcoming of both the Phelps plan and other generic employment subsidies is the geographic and demographic distribution of the jobs they create. Employment subsidies, by their nature, encourage job

284. The subsidy at $4 per hour is $3. *See supra* note 276. The firm would receive no subsidy for a part-time worker.

285. A $3 subsidy for a $4 wage.

286. Although Phelps acknowledges these problems briefly, *see* PHELPS, *supra* note 17, at 114-15, he proposes only that violators be subject to penalties for fraud and that the wage subsidy be structured as a credit against payroll taxes, *see id.* Although these are reasonable measures, they seem likely to leave considerable room for employers to commit easy and virtually undetectable fraud.

287. For example, under Phelps's plan a pre-subsidy wage increase from $4 to $5 results in an after-subsidy wage increase of only $0.29—from $7 to $7.29. An increase from $9 to $10 in the pre-subsidy wage results in an increase in the post-subsidy wage of $0.81, from $9.43 to $10.24.

creation by employers who can create jobs most cheaply. Only employers that can create a new job for an amount less than or equal to the subsidy will do so.[288] The implication is that employment subsidies, particularly small ones, will not work well where there are very high cost barriers to job creation.

Thus, employment subsidies may do a better job of increasing employment and wages in the suburbs rather than the inner cities, which contain multiple cost barriers to business investment and job creation.[289] If employment subsidies are least useful in the most economically disadvantaged areas, then increasing employment for residents of those areas may require larger subsidies, public jobs programs, or mobility policies to help them take jobs in other communities.[290] Wilson, for example, recommends public jobs "of last resort," although he does not consider the employment subsidy alternative.[291]

Could policymakers solve the problem by targeting additional employment subsidies to the inner cities? This is the intuitive appeal of enterprise zones, added to the tax code in 1993 under the name "empowerment zones."[292] Federal empowerment zones offer employment subsidies and other assistance to firms that locate in disadvantaged areas. The problem is that this concept so far has not worked. While the federal program is too new to permit sustained empirical study, decades of experience with state-level programs suggest skepticism. One careful review of the empirical studies concluded that displacement plagued enterprise zones, which were not notably successful in creating new jobs.[293] Given the multiple market failures and misguided government policies that have blighted the inner cities, it is sad—but not surprising—to realize that it will take more than modest employment subsidies to reverse the problem.

D. *Administering a Basic Income or Negative Income Tax*

These are damaging facts. Design problems plague all varieties of employment subsidies, and experience is, if anything, even more depressing

288. "Job creation" here need not be *new* job creation. A targeted subsidy would also induce behavioral change among employers who can most cheaply *substitute* targeted for nontargeted workers.

289. *See* WILSON, *supra* note 129, at 34-50 (discussing reasons for joblessness in urban ghettoes).

290. *See supra* notes 159-60 (discussing policies for inner-city development); *see also* Edward M. Gramlich & Colleen M. Heflin, *The Spatial Dimension: Should Worker Assistance Be Given to Poor People or Poor Places?*, *in* GENERATING JOBS, *supra* note 200, at 54, 67-68 (recommending both people- and place-based assistance, but expressing skepticism about enterprise zones).

291. *See* WILSON, *supra* note 129, at 225-35.

292. *See* I.R.C. §§ 1391-1397E (1994).

293. *See* Ladd, *supra* note 160, at 202-08.

than theory. But isn't the liberal alternative equally flawed? Isn't just as difficult to design and administer a basic income or negative income tax?

In fact, the answer is no. Begin with the basic income, which is one of the simplest programs to implement. A flat, per-person payment to every adult between eighteen and sixty-five could be based on just one piece of information: proof of age.[294] A basic income would be far simpler than even Social Security, which is currently one of the most administratively efficient transfer programs.[295]

As we add conditions, of course, administration becomes more difficult. A negative income tax, for example, would require periodic income information for all claimants. While this information could be collected through the federal income tax, certain complications arise because tax rules are not always readily adaptable to making transfer payments.[296] The income-testing required by the EITC is a good example of the tension between ordinary tax rules and the demands of a low-income transfer program.[297] But the fact that the EITC is an employment subsidy compounds the problem.[298]

None of this makes administration of a negative income tax impossible, or even terribly difficult, in the larger scheme of things. If Congress were content to apply the same rules to low-income as to high-income taxpayers, the problem would mostly disappear.[299] Another solution would be to take the task of income-testing out of the hands of the IRS and place it with an agency better adapted to gathering information from low-income people.[300] The problems of income-testing, though not negligible, are entirely

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294. The government might also require proof of American citizenship or residency, depending on the terms of the program.

295. In 1996, administrative expenses were less than one percent of Social Security benefits. *See* 1998 GREEN BOOK, *supra* note 2, at 62-63 tbl.1-38 (showing benefits of $343.3 billion and administrative costs totaling $2.8 billion).

296. *See generally* Michael R. Asimow & William A. Klein, *The Negative Income Tax: Accounting Problems and a Proposed Solution*, 8 HARV. J. ON LEGIS. 1 (1970) (noting the need for distinct negative income tax reporting rules); William A. Klein, *The Definition of "Income" Under a Negative Income Tax*, 2 FLA. ST. U. L. REV. 449 (1974) (acknowledging the need for elaborate rules in a negative income tax context); William D. Popkin, *Administration of a Negative Income Tax*, 78 YALE L.J. 388 (1969) (recognizing the administrative difficulties of a negative income tax); James Tobin et al., *Is a Negative Income Tax Practical?*, 77 YALE L.J. 1 (1967) (describing the technical difficulties with implementing a negative income tax).

297. *See* Alstott, *supra* note 119, at 564-89.

298. *See id.* at 579-89 (arguing that the regressive marginal tax rate structure, attributable to the employment-subsidy component of the EITC, compounds problems of periodic payment and administration); *see also infra* Subsection IV.A.2 (comparing administration of the EITC and other employment subsidies).

299. *See* Alstott, *supra* note 119, at 566-70.

300. Some states are conducting just this experiment with the EITC, running the program through state welfare offices. *See* John Karl Scholz, *Tax Policy and the Working Poor: The Earned Income Tax Credit*, FOCUS, Winter 1993-1994, at 1, 7-8; Paul Wilson & Robert Cline, *State Welfare Reform: Integrating Tax Credits and Income Transfers*, 47 NAT'L TAX J. 655, 670-75 (1994).

familiar. Current welfare programs devote considerable resources to income-testing, although sometimes with inefficiencies, since rules differ from program to program.[301] Consolidating all (or most) of this apparatus into just one program would go a long way toward streamlining the task.

The major administrative difference between a negative income tax and an employment subsidy is that the employment subsidy requires new information of a kind that neither the traditional tax system nor the welfare authorities are skilled in collecting. The Phelps plan, which is the simplest, requires information on wage rates and hours worked that is not easily observable by authorities. The alphabet-soup programs—TJTC, WOC, and WWTC—require coordinated information about personal history, program participation, *and* income.[302]

Finally, although opportunities for fraud certainly exist in a negative income tax, employment subsidies are particularly vulnerable on that front. Under a negative income tax, the primary avoidance games would be to understate income or to create nonexistent claimants. Auditing and verifying income is, of course, a classic task of the income tax, and tax authorities have an impressive array of institutions dedicated to the task, including, most importantly, information reporting of wages, interest, and dividends.[303] They also have mechanisms to prevent the manufacture of false identities for the purpose of claiming income tax benefits, although these might need to be refined.[304] Employment subsidies may avoid these challenges if they reject income-testing. But they create new fraud opportunities, including the manipulation of hours and wage rates through outright misreporting, the use of under-the-table payments, and the substitution of in-kind benefits for cash wages.[305]

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301. For examples of recent efforts to consolidate the administration of different welfare programs, see Alstott, *supra* note 119, at 564 n.122.

302. In some cases, WOC eligibility requires an income determination. *See* I.R.C. § 51(d)(4) (West 1998) (setting income requirements for families of qualified "ex-felons"). In other cases, the income determination is part of the eligibility rules for participation in other programs, which becomes the basis for WOC eligibility. *See, e.g.*, I.R.C. § 51(d)(2)-(3) (West 1998) (defining "qualified IV-A recipient" and "qualified veteran").

303. Monitoring self-employment income is much more difficult, but again the qualitative challenge is precisely the same in the regular income tax as in the negative income tax. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 150 & tbl.5.1 (1996) (reporting estimates that only 41.4% of self-employment income is reported for regular tax purposes). *But cf.* Alstott, *supra* note 119, at 586 (noting that the structure of the EITC encourages some workers to *overstate* their incomes).

304. In 1986, the tax code was amended to require, for the first time, that taxpayers include a social security number for each dependent for whom an exemption was claimed. *See* I.R.C. § 151(e) (1994). Between 1986 and 1987, seven million dependents previously claimed miraculously disappeared. *See* SLEMROD & BAKIJA, *supra* note 303, at 146.

305. *See supra* text accompanying notes 283-286.

IV. THE EITC ALTERNATIVE

To this point, I have considered only employment subsidies paid to employers. But what if the subsidies were paid to workers instead? Would that make any difference in the impact on employment and wages? Would payment to workers otherwise improve program design? These are not merely theoretical questions, since the government's major current employment subsidy is paid directly to workers.

The EITC pays a cash benefit of up to $3756 each year to low-income workers with children and smaller benefits to childless workers.[306] The EITC is a "refundable" tax credit that uses the rules of the tax code to pay what is in effect a transfer payment to EITC recipients.[307] Throughout its nearly twenty-five-year history, the EITC has been portrayed in various ways: as a work incentive for welfare recipients, as a payroll-tax reduction for workers, and even as a child care plan.[308] But an equally apt description is that the EITC is an employment subsidy. More precisely, it is an earnings subsidy paid to workers. The subsidy depends on total annual earnings, rather than the hourly wage, as in Phelps's plan; the benefit is explicitly income-tested, so that benefits drop to zero at approximately $30,000 of annual earnings.[309]

Although some employment subsidy advocates—notably Phelps—oppose the EITC, I will argue that it offers some unique advantages over its employer-paid counterparts. But before discussing the EITC, I shall begin with a basic question: Does it *matter* whether an employment subsidy is paid to workers rather than to employers?

A. *The Incidence Puzzle*

Simple economic theory suggests that the answer is no. In the classic model, an employment subsidy paid to workers has exactly the same effect on wages and on employment as one paid to employers. Figure 4 compares the employer-paid wage subsidy of Figure 1 with an equivalent wage subsidy paid to workers. The wage subsidy paid to workers shifts the supply curve to the right. The vertical distance between the old demand curve and the new one is the amount of the subsidy (S). The increase in the supply of labor results in a new equilibrium, with higher employment (E_1

306. In 1998, the maximum benefit for a worker with two children is $3756; for a worker with one child it is $2271; and for a childless worker it is $341. *See* Rev. Proc. 97-57, 1997-52 I.R.B. 22.

307. For an explanation, see Alstott, *supra* note 119, at 540-44.

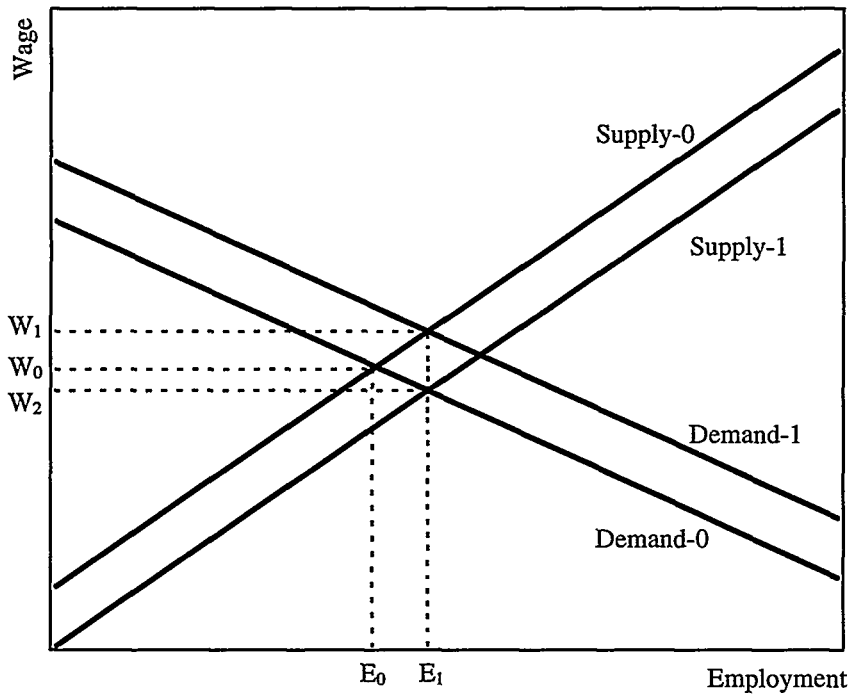
308. *See id.* at 540.

309. The phaseout amount for a worker with two children is $30,095; for a worker with one child is $26,473; and for a childless worker is $10,030. *See* Rev. Proc. 97-57, 1997-52 I.R.B. 22.

instead of E_0). A key difference is that the market wage actually drops here, from W_0 to W_2, and the reduction in the market wage induces employers to increase employment. But the after-subsidy wage received by workers actually rises—to W_1 (which is $W_2 + S$).

In this case, the worker-paid subsidy produces the same economic outcomes as the employer-paid subsidy. This is not a trick in the way the graphs are drawn. It is, instead, a basic prediction of incidence theory: Whether the initial subsidy is paid to workers or employers, market participants will ultimately bargain to the same solution. This same theory explains why analysts routinely assume that the incidence of the Social Security payroll tax does not depend on whether it is imposed on the employer or the worker.[310]

FIGURE 4. A SIMPLE WAGE SUBSIDY PAID TO EMPLOYEES



The simple incidence story, however, poses an interesting puzzle for employment subsidies. Although some analysts acknowledge the theoretical equivalence, most policy discussions treat the two kinds of subsidies as very different. Most of the debate over subsidies paid to firms (the WOC, WWTC, TJTC, and NJTC) centers on whether or not they create jobs,

310. *See* Rosen, *supra* note 135, at 286-87.

while most proponents of the EITC and of wage subsidies paid to employees focus on raising workers' earnings.[311]

The question, then, is whether the simple equivalence can withstand real-world economic and institutional complexity. If the two kinds of subsidies are identical, then the two bodies of literature should be more closely linked, and the choice of one policy rather than the other should be made based on administrative ease rather than economic effect. If, however, real-world programs do not conform to theoretical predictions, we ought to take account of that fact in designing each type of program. In fact, there are at least two reasons why the equivalence may not hold—wage rigidities and institutional differences.

1. *Wage Rigidity*

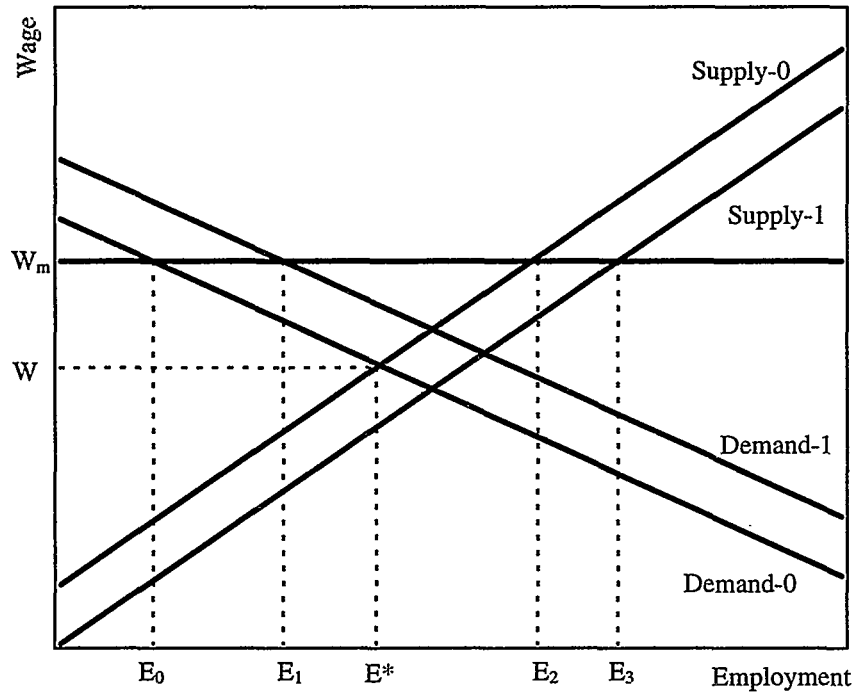
The basic model in Figure 4 assumes, inter alia, that wages are free to adjust upward or downward. That assumption is crucial to the equivalence between employer-paid and worker-paid subsidies, because the former operates by raising market wages and the latter operates by reducing market wages. If wages cannot adjust in one direction or the other, then the two kinds of subsidies are no longer equivalent.

The minimum wage provides a good example. The minimum wage does not affect the operation of an employer-paid subsidy, because firms remain free to bid up the market wage, if necessary, in order to expand employment. As discussed above, in the presence of the minimum wage, an employer-paid subsidy may not actually increase the wage (since there is in effect a perfectly elastic labor supply over the immediate range) but can increase employment, thus offsetting the unemployment effect of the minimum wage itself. Consider Figure 5, which shows that the enactment of the employer-paid subsidy does not increase the wage above the minimum (W_m) but does expand employment from E_0 to E_1. In contrast, in the presence of a constraining minimum wage, a worker-paid subsidy cannot increase employment. The worker-paid subsidy increases the after-subsidy wage ($W_m + S$) and supply of labor, but because the market wage cannot fall, employment does not increase. Instead, the worker-paid subsidy increases involuntary unemployment (from $E_2 - E_0$ to $E_3 - E_0$), because even more workers would be willing to work at the prevailing minimum wage.[312]

311. *See* Lerman, *supra* note 221, at 159-60. An interesting exception is a recent proposal to convert the EITC into an employer-paid wage subsidy. The authors posit that the employer-paid subsidy would supplement wages just as effectively as the EITC but would shift administrative burdens from workers to employers. *See* George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals To Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 286-94 (1994).

312. *See* Bassi, *supra* note 238, at 139-41; Lerman, *supra* note 221, at 165-66. These results depend, of course, on the level of the minimum wage relative to the market wage (W^*) and S. For

FIGURE 5. THE MINIMUM WAGE, REVISITED



Thus, the asserted equivalence between employer- and employee-paid subsidies turns on an empirical matter: the level of the minimum wage relative to the market wage. If the minimum wage is constraining, an employer-paid subsidy will increase employment but not wages, while a worker-paid subsidy will increase (after-subsidy) wages but not employment.[313]

2. *Institutional Differences: Privacy, Stigma, and Transactions Costs*

The equivalence prediction also assumes that both kinds of employment subsidies can elicit information and provoke behavioral reactions from the relevant actors. But, in fact, there are asymmetries in the two programs. For

example, if the minimum wage were below W^*, there would be less constraint on the employment effect of the worker-paid subsidy, and if it were below W^* by an amount at least equal to S, then there would be no constraint.

313. The equivalence also fails if wages are not flexible upward. Some economists theorize that employers might be reluctant to raise wages in response to an (employer-paid) employment subsidy, because they cannot raise wages only for the marginal workers but instead must raise wages for all existing employees as well. In that case, assuming that the labor supply curve is upward sloping, the employment subsidy simply confers a windfall on employers and is ineffective in either raising wages or employment. *See* Lerman, *supra* note 221, at 171. In contrast, because a worker-paid subsidy operates by reducing *market* wages, this kind of wage rigidity does not affect its operation.

employer-paid credits to work, employers must learn about and apply for the credit and respond by increasing employment and wages. For worker-paid credits to operate, workers have to learn about and apply for the credit and react by taking jobs with lower market wages. These differences seem obvious enough, but they can produce dramatic differences in administrability. Consider two illustrations.

First, information asymmetries can be severe, especially for targeted employer-paid subsidies. A simple wage subsidy requires only wage-rate information, which is equally available to workers and employers. In contrast, an employment subsidy linked to workers' unobservable characteristics expands dramatically the information demands of the subsidy.

The WOC, for example, requires employers to discover whether the worker is a member of a targeted group. If the worker perceives the information to be stigmatizing or simply private, she may balk at disclosing it. Workers may be reluctant to apply for vouchers and equally hesitant to disclose their situation to employers who inquire. In contrast, a worker-paid subsidy could be targeted using the same criteria without any intrusion into worker privacy or fear of stigma. The credit is strictly between the worker and the Internal Revenue Service.

Even if information is not stigmatizing or inherently private, there are transactions costs involved in any system that requires employers to obtain information from employees. The TJTC, for example, required a three-way information exchange among workers, the state employment service, and employers. Another explanation for the prevalence of retrospective certification in the TJTC is that employers find it too costly to process the information in advance and one-by-one for all applicants, but they find it profitable to do so, in arrears and in a bulk process, for workers actually hired.

Second, there may be asymmetries in the ability of employers and workers to comply with the terms of a complex subsidy. Here, the comparative advantage of employers is not as clear as some analysts predict. The EITC is a good example. The EITC is income-tested based on a worker's total earnings and total income. Workers with children receive the largest credits, and childless workers under twenty-five or over sixty-five cannot claim the EITC. The rules governing eligibility are complex.[314] Critics have pointed out that complexity may decrease participation, increase error rates, and even reduce workers' take-home credits, if they

314. Recent reforms have simplified the child-related conditions, but the income-related conditions have grown increasingly complicated in recent years, as Congress has sought to make the income test more and more precise. *Compare* I.R.C. § 32(c)(3) (West 1998) (defining a "qualifying child"), *with* I.R.C. § 32(c)(5) (West 1998) (making modifications to the definition of adjusted gross income and denying the credit to claimants with excessive investment income).

must pay high fees to commercial preparers.[315] There is evidence of significant taxpayer error in the EITC and numerous anecdotal instances of fraud.[316]

To see the asymmetry, consider whether it would be feasible to reform EITC administration by converting it into an equivalent employer-paid subsidy. The idea has immediate appeal, because it could shift EITC eligibility determinations to firms, which may be better able to handle complex legal rules.[317] In theory, at least, employers could elicit the relevant information from employees more accurately and at less cost than the current system, which relies on a combination of self-reporting by workers and assistance by paid preparers. The IRS might also find it easier to audit employers and to hold them accountable. The current system for employer withholding of income and payroll taxes would seem to provide a good precedent for a system of employer administration.

A closer look suggests, however, that problems of information transmittal could offset and even outweigh the comparative administrative advantage of employers. Imagine an employer-paid subsidy that is identical to the EITC. Employers would have to find out initially, and then adjust periodically, detailed information about their workers' sources of income and their family status. Workers may be reluctant to transmit private income and family information to their employers. And even if workers were willing to disclose, employers may ask the wrong questions (or questions that are easily misunderstood), or may transcribe the answers incorrectly, or may fail to update information. All of these are problems with the current system, because EITC claimants and paid preparers may misunderstand or misapply the law. The question is whether there are reasons to expect employers to do much better.

Experience with employers' participation in the EITC suggests extreme caution in assuming that employers can capably administer a complicated program. The EITC "advance payment" rules require employers to offer to pay the EITC in installments to eligible workers, as part of their regular paychecks. The available evidence is sparse, because participation in the advance payment option has been quite low.[318] But the evidence, such as it

315. *See* Alstott, *supra* note 119, at 584-89. For criticism of complexity in the EITC, see Yin et al., *supra* note 311, at 254-56.

316. *See* Yin et al., *supra* note 311, at 247-60. For more recent developments, see *GAO Reports on EIC Noncompliance Controls*, 72 TAX NOTES 1653, 1653-54 (1996).

317. For similar arguments, see Yin et al., *supra* note 311, at 286-88, although they suggest that privacy considerations would preclude an employer credit that required information about employees' total incomes. *See id.* at 288-89.

318. *See* U.S. GEN. ACCOUNTING OFFICE, EARNED INCOME TAX CREDIT: ADVANCE PAYMENT OPTION IS NOT WIDELY KNOWN OR UNDERSTOOD BY THE PUBLIC GAO/GGD-92-26, at 3 (1992). For a discussion of why advance payment is inherently difficult, particularly in an earnings subsidy like the EITC, see Alstott, *supra* note 119, at 579-84.

is, is quite negative: Employers have made many errors.[319] Perhaps employers would be more careful in an employer-paid program, when the credits would be "their own" rather than something to be passed on to workers. But advance payment of the EITC actually requires *less* information than the EITC itself, and employers still made a hash of things.[320]

Without better evidence, we are left to *a priori* speculation. Some employers will do better than others; one might expect that large companies with sophisticated management or even medium-sized firms with a large low-income workforce would find it profitable to create rigorous and efficient information-gathering procedures. Other firms may fail to set up good practices, and even sound procedures can be spoiled by ineffective local implementation. It is difficult to compare, for example, the current performance of EITC return-preparers at H&R Block with the potential efforts of low-level personnel employees or local franchisees of, say, McDonald's. Both employer- and worker-paid subsidies create incentives to claim credits when doubt exists about whether such credits are due; workers can earn more income, preparers can earn higher fees or repeat business, and employers can gain larger subsidies.

Both employer and worker-paid subsidies create fraud opportunities, although the former may be slightly easier to monitor and sanction. The sums of money at stake for each worker are larger, as a percentage of income, for individual workers than for firms. Nevertheless, individuals can usually claim only one credit each, unless they are clever enough to create a "shadow" business that employs fictitious workers. Businesses may be in a better position to create fictitious workers, and they can also more easily commit fraud by over-claiming subsidies (by a small amount in each case) for a large number of workers. One advantage of employer-paid credits is that employers (at least real ones) tend to have more assets, so that the IRS can recover overpayments more easily from them than from individuals. In addition, an employer-paid credit can plausibly be made nonrefundable, limited to income and payroll-tax liability. Nonrefundability would prevent some smaller or poorer firms from taking full advantage of the subsidy but would help prevent some of the more egregious fraud schemes involving fictitious employees and wages. No one will pay $100 in unnecessary payroll taxes in order to claim a $100 refund.

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319. U.S. GEN. ACCOUNTING OFFICE, *supra* note 318, at 3.

320. To make advance payments, employers need to know the wages being paid and must take a statement from the employee about her other income and family situation. *See* I.R.C. § 3507(b) (West 1998). The employer can rely entirely on the very general information provided by the employee and need not ask more detailed questions about total income such as other family members' earnings, or living arrangements.

These economic and institutional asymmetries explain why the simple equivalence story may be compelling for the Social Security payroll tax but is much less applicable to complex employment subsidies. The payroll tax is based on earnings from the current job, information that is readily available to employers, employees, and the government. It does not depend on total income, and both the employer and worker portions of the payroll tax are collected through the same administrative apparatus, employer withholding.

The larger point is that the EITC demonstrates how administrative difficulties persist in either type of employment subsidy. Neither payment to workers nor payment to employers is a panacea for the likely administrative failings of employment subsidies.

B. *Comparing the EITC and the Phelps Plan*

The EITC is also interesting because it begins to point the way to a compromise between the Phelps plan and the liberal alternative. In effect, the EITC combines elements of a negative income tax and an earnings subsidy. EITC benefits are explicitly conditioned on work. But the program does not require full-time work, and benefits are based on earnings and income levels, not wage rates.

Consider how the EITC affects the choices of three groups of workers. For simplicity, assume that all workers have at least one child and can earn only the minimum wage.[321] For nonworkers, the EITC acts as a pure employment subsidy: This group receives nothing unless they go to work. For part-time workers, however, the EITC is a hybrid. Just as with a negative income tax, workers receive a payment even if they work less than full time. Just as with an employment subsidy, they receive a larger payment if they work more. Finally, for full-time workers, the EITC is very much like a negative income tax. At full-time wages of $10,300 per year, there is no incremental subsidy for working more hours, and at $12,260[322] the cash grant begins to phase out.[323]

The EITC demonstrates that relaxing the full-time work requirement moves in the direction of compromise. Nonworkers still have an incentive to take a job, but mothers and others with valuable nonmarket time can take

321. With heterogeneous wage rates and family size, the analysis becomes slightly more complicated. For example, a half-time worker at $10 per hour will face the same benefits schedule as a full-time worker at five dollars. In addition, childless workers receive much lower benefits, which phase out at lower income levels.

322. *See* Rev. Proc. 97-57, 1997-52 I.R.B. 20.

323. This is a brief sketch of the similarities between the EITC and alternatives. For a more extensive discussion, see Philippe Van Parijs & Claudio Salinas, Basic Income and Its Cognates: Puzzling Equivalence and Unheeded Differences Between Alternative Ways of Addressing the "New Social Question" (1998) (unpublished manuscript, on file with *The Yale Law Journal*).

part-time jobs and still gain from the program. This is a small step in policy design; the Phelps plan, for example, could implement a wage-rate subsidy without the full-time rule. Abandoning the full-time work rule requires a bigger philosophical shift. The EITC, for example, allows part-time work and is income-tested. Yet these features are antithetical to Phelps's ideal of full-time work.[324] The full-time rule serves a practical function in the Phelps plan as well: Without it, lots of middle-class teenagers would qualify for a hefty employment subsidy for their after-school jobs. Restricting the subsidy to full-time workers helps compensate for the lack of an income test.

From a liberal point of view, the EITC is preferable to the Phelps plan, precisely because it offers more scope for individual choice. But, as Part V concludes, we can do even better.

V. CONCLUSION

An examination of employment subsidies and the cash alternative yields four lessons about American welfare policy. First, TANF is an unconscionable welfare policy. Although state-level programs vary considerably, benefit levels remain low, and the federal law mandates both significant work requirements and a five-year time limit on benefits.[325] Instead of offering low-wage earners an unconditional cash grant, the government provides a small, time-limited grant conditioned on work—and that much only to families with children. The childless are left to state general assistance programs, if any. Time limits alone do nothing to broaden opportunities for low-wage work or to ensure that every needy claimant can find a job.

Second, a serious, large-scale program of long-term employment subsidies would be an improvement over current policy. Experience confirms that small, targeted programs like the WOC and the WWTC probably do little to expand employment or raise wages. Although these programs deliver a rhetorical punch at low cost, they are not a serious policy initiative. Phelps's program, in contrast, is more than window dressing. For the considerable but manageable sum of $125 billion each year, the government could improve low-wage workers' job opportunities and wages. And the assistance would be lifelong, not just five years' worth.

324. *See* PHELPS, *supra* note 17, at 108.

325. More precisely, the federal legislation imposes a five-year limit on *federally funded* benefits. States remain free, in principle, to distribute unlimited benefits with their own funds. *See* 42 U.S.C.A. § 608(a)(7)(F) (West 1998). In practice, the vast majority of States have adopted the five-year time limit (or in some cases a shorter limit) for state-funded benefits. *See* 1998 GREEN BOOK, *supra* note 2, at 515-18.

Third, although Phelps's ambitious proposal is a real contribution, it still does not go far enough. It would pour resources into an untested initiative that requires continuing manipulation of a labor market we do not fully understand. The program invites easy fraud by employers, unless the government can create new institutions to monitor wage rates and employment levels. It tends to discourage low-wage workers from seeking to move up through promotion or education.[326] The program would confer windfall benefits on suburban teens and secondary workers, but would exclude, through the requirement of full-time work, the poor single mothers who will be most affected by new time limits in welfare programs.

In contrast, a basic income or negative income tax represents a better ideal and one that is eminently practical. Unconditional cash grants could provide new freedom to poor single mothers, poor couples, and poor childless men and women. Combined with labor-market reforms, the cash strategy could raise incomes and improve opportunities to work. And both elements of the program are administratively and fiscally manageable. The labor-market reforms are by far the hardest piece of the program to implement. Our knowledge about how to combat spatial mismatch and employment discrimination, for example, is still evolving, and we do not have any sure-fire policies. Nevertheless, these challenges would remain much the same, even with a program of employment subsidies. Employment subsidies might increase levels of employment, but only by tackling the relatively easy cases.

An expanded EITC may be an attractive compromise for some. Many of the real attractions of the EITC—the eligibility of part-time workers, the targeting to low-income workers—are directly attributable to its movement away from a strict Phelpsian employment subsidy and toward a negative income tax. But even the EITC limits individual freedom, relative to the cash alternative. The maximum payment today is less than $4000, and part-time workers receive partial benefits instead of the full payment they would receive under a basic income or negative income tax.

Finally, even the political prospects for unconditional cash grants may not be as bleak as they first appear. No one expects to see President Clinton or congressional leaders propose them this year or next. Over the longer term, say ten years, as society begins to experience the failures of the employment strategy, a coalition of utilitarians and liberals might carry the day. The cash strategy, especially in combination with labor-market

326. This is true relative to the status quo and relative to an unconditional grant. The employment subsidy raises the wage for low-skilled work, making it more attractive than before, relative to other alternatives like going back to school. Additionally, a basic income or negative income tax would provide a source of income that would continue during periods of job transition or education. The employment subsidy offers low-wage workers more income, which they might save and use for a period of unemployment or education; but the transfer itself is conditional on work.

reforms, can relieve poverty more broadly, preserve recipients' free choices, and produce many of the positive externalities claimed by the employment strategy. A properly structured program can enhance the incomes of the poor, expand their work options, and cushion the transition period while market reforms take effect.

We can and should take the case for unconditional cash grants seriously, for the sake of the individuals whose freedom is at stake. Welfare recipients and the working poor are not merely the objects of the latest experiment in improving the collective welfare. They are free and equal individuals, entitled to claim, as a matter of right, their fair share of social resources. These arguments may not immediately persuade those who share the moral assumption that the poor ought to work in exchange for the "assistance" that the government gives them. But careful argument can help render that assumption problematic. A basic income or negative income tax is not charity. It is, instead, a way of making practical the liberal commitment to real freedom for each of us.