

QUESTIONING THE WORK ETHIC: BASIC INCOME AS A MEANS OF PROMOTING A MORE EFFICIENT LABOR SUPPLY

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ABSTRACT

Economist Edmund Phelps argues that second-class workers should be helped through wage subsidies to employers. This is because the lack of work among such workers has social costs that could be significantly curtailed by these subsidies. I argue that Phelps' analysis is questionable because of his misapplication of the tools of welfare economics. I also suggest that a basic income might be a more efficient means of addressing poverty than wage subsidies would be.

In recent years social policy has intensified efforts to provide able-bodied recipients of benefits with an incentive to sell their labor. This is most evident in the welfare reform proposal signed into law by President Clinton in 1996. This reform stipulates that states cannot use federal funds to provide benefits for more than five years over one's lifetime or more than two years per "spell" on welfare. Also, states must require recipients to work or engage in some type of work preparation activity in return for their benefits. This requirement was also a provision of the welfare reform law of 1988, the Family Support Act, but the required hours of work or work preparation were lower than is the case under the more recent reform. **(REFERENCES)**.

A number of analysts are apparently dissatisfied with the reform of 1996 but not with the attempt to provide help providing people with an incentive to sell their labor. However, instead of focusing on the supply side of the labor market they focus on the demand side. That is, they are concerned with how to stimulate demand for labor and have proposed public employment as the way to do so (Wilson, 1997). In these schemes, the government would create jobs so those unable to find work in the private sector would have the opportunity to do so in the public sector. Such programs have the

potential to make unemployment a thing of the past except for that due to people voluntarily quitting to search for better jobs. The public jobs approach is one way to address inadequate demand for labor in the private sector. Another way, that relies more on the private sector, though with help from government, has been proposed by the well known economist Edmund S. Phelps. This proposal will be the focus of this paper.

In a book entitled *Rewarding Work* (1997), Phelps makes the case for wage subsidies as a method of addressing poverty among able-bodied men and women. His case is based on a theoretical application of some of the tools of welfare economics. Phelps argues that wage subsidies would result in benefits for those who obtain higher wages and jobs as a result of them as well as for the rest of society and that these benefits would outweigh the budgetary costs of attaining them. Thus, he concludes that the subsidies would promote efficiency. This paper raises questions about Phelps' argument.

I argue that Phelps misapplies the tools of welfare economics and that a theoretically appropriate application of them shows that Phelps' justification of wage subsidies might be unwarranted. Specifically, after a more careful consideration of the potential costs and benefits of the wage subsidy approach, I argue that it isn't clear that it would result in a net social gain. I conclude with the suggestion that the basic income guarantee (BIG) might be a more efficient means of addressing poverty than wage subsidies are.

I said above that others have proposed public employment as a way to address inadequate demand for labor in the private sector. Although most do not draw as heavily upon the tools of welfare economics as Phelps does, they often make similar arguments

(see Wilson, 1997). Thus, to the extent that analysts make points similar to Phelps' my criticism of him applies to them as well.

Phelps' Justification of Wage Subsidies

Phelps spends much ink in his book documenting the plight of "second-class workers." These are individuals who make lower wages and suffer higher rates of unemployment than more advantaged workers do. According to Phelps, there has been a broad decline in the wages and employment rates of second-class workers and these declines have resulted in significant social costs.

First, there are the costs to the second-class workers themselves. Second-class workers don't possess the means to purchase a middle-class lifestyle, which includes, "rudimentary health care, the responsibilities of marriage, raising one or two children and sending them to college, participation in community affairs, hobbies, travel, and insurance to retire at the accustomed level when old or disabled" (Phelps, 1997, pp.17-18). Second-class workers who happen to be experiencing a bout of unemployment don't get to enjoy the mental stimulation, the feeling that they have a place in society, and the possible health benefits that result from working. Regarding evidence for the latter, Phelps discusses a Paris physician he read about who reported that many of his patients died within a year or two of their retirement. The physician's explanation was that their mental and physical health depended on a degree of routine and order in their lives, something they had lost as a result of ceasing work.

Equally serious are the external costs of the low wages and lack of employment among many second-class workers. One such cost is the fact that low wages and unemployment among second-class workers render them incapable of serving as good role models for their children. Phelps states that:

when parents are poor earners, possibly jobless at times, and hence frequently or always dependent on welfare, one of the more serious consequences is that they are not in a position to be good role models for their children. Children are unlikely to be able to acquire from such parents the habits of initiative and responsibility they will need to succeed in the labor force (Phelps, 1997, p. 38).

The low wages and joblessness of second-class workers also have negative affects on others in their neighborhoods. Phelps states that second-class workers have become concentrated in large urban areas. Due to the difficult circumstances these workers face they become tenuously attached to the labor market and, therefore, unreliable employees. A high concentration of such workers in certain neighborhoods can give these neighborhoods bad reputations as sources of reliable employees. Thus, reliable workers from these neighborhoods may face difficulty in obtaining work because employers may be disinclined to hire persons “who come from there.”

Phelps also states that high concentrations of second-class workers affect young persons other than their own children. When neighborhoods are filled with disadvantaged workers there are few channels through which young people may gain information about newly opened jobs. Also, in a community where success is rare, young people are likely

to develop low expectations of what can be gained by hard work in the legitimate economy. This attitude accounts for the high rates of drug use and violent crime in these neighborhoods.

Phelps also discusses what he calls societal costs of low-wages and joblessness among second-class workers. He states that, “the aggregate income of high-skilled labor and land is significantly increased by the collaboration of low-skilled labor in the economy’s production” (Phelps, 1997, p. 44). What Phelps seems to be getting at is the view that second-class workers bring skills to the labor market that complement those of more skilled workers as well as other factors of production and this mix of complementary factors results in higher income for more advantaged workers and factor owners. High joblessness among second-class workers results in high-skilled workers and factor owners having to forgo this benefit.

Joblessness among second-class workers means they don’t pay as much in taxes as they would if they were working and, consequently, other taxpayers shoulder a larger share of the fiscal burden than they otherwise would. Other societal costs are the costs of law enforcement and welfare programs that help second-class workers.

To address these costs Phelps proposes a policy of wage subsidies to employers. More specifically, employers would be provided a subsidy the amount of which would depend on a worker’s unsubsidized wage. That is, the higher a worker’s unsubsidized wage, the lower the subsidy; at an unsubsidized wage exceeding \$12.00/hour the subsidy would phase out. This would result in decreased joblessness among second-class workers, since the subsidies would give employers an incentive to hire them, which would generate a number of social benefits.

These newly hired workers would be closer to being able to purchase (and, perhaps, able to purchase at least part of) that middle-class lifestyle discussed above. They would be able to enjoy the mental stimulation, sense of belonging, and possible health benefits that stem from working. They would serve as role models for their children and sources of information about available jobs to young people in their neighborhoods. The neighborhoods in which these newly hired employees resided would, over time, no longer have bad reputations as sources of unreliable workers. Thus, reliable persons from these neighborhoods seeking jobs would no longer suffer the cost of this bad reputation.

Young persons in these neighborhoods who see the success of the newly hired would come to believe that hard work in the legitimate economy pays off. This, in turn, would result in a decrease in drug use and violent crime in these neighborhoods. High-skilled workers would enjoy the benefits, discussed above, from collaborating with the newly hired lower-skilled workers. These newly hired workers would have higher incomes and, therefore, pay higher taxes than before. Thus, other taxpayers would benefit from having to shoulder less of the tax burden.

The fact that second-class workers would be working more would also increase output and sales and, therefore, corporate profit tax revenue. This increase in work would also result in their receiving less in welfare payments, benefiting taxpayers who finance these payments. Last, but certainly not least, law enforcement costs would decrease as a result of increased employment among second-class workers.

Phelps doesn't just consider the benefits of a wage subsidy but the costs as well, focusing on the budgetary costs. He believes that the tax revenue (discussed above) that would result from the program would be enough to foot the bill for it.

The Perspective of Welfare Economics

Welfare economics is the branch of the discipline that addresses normative issues. That is, it addresses questions about what ought to be done, more specifically what government ought to do. A prominent view in welfare economics is that government ought to promote efficiency, from the perspective of society as a whole, with efficiency being defined according to the *Kaldor-Hicks criterion*. This criterion, states that a public policy promotes efficiency if those who gain from it could compensate those who lose and still enjoy a net gain. Cost-benefit analysis (CBA), which is essentially applied welfare economics, relies heavily on the Kaldor-Hicks criterion. According to CBA, a policy promotes efficiency if the total benefits that result from it outweigh the total costs because, in such a situation, those who benefit could compensate those who lose and still enjoy a net gain (Fuguitt and Wilcox, 1999).

Phelps appears to be applying the logic of cost-benefit analysis to his wage subsidy plan and seems to think it would generate a net gain. From a welfare economic point of view, however, Phelps' analysis is problematic.

The Problems in Phelps' Analysis

Phelps' analysis suffers from four major problems that render his conclusion that the wage subsidy would generate a net gain questionable. First, he doesn't fully consider the potential costs of the program. Second, he seems to make what might be incorrect assumptions (more below) about the life circumstances of second-class workers, which might be resulting in his overstating the net benefits of the wage subsidy. Third, he fails to adopt the societal point of view for his analysis. Fourth, and related to the third, he counts as costs and benefits what are, in fact, merely income transfers.

Consider Phelps' view that one of the benefits of the wage subsidy would be that newly hired workers would be role models for their children. Welfare economists, like most mainstream economists, typically regard individuals as the best judges of what benefits them (Acocella, 1994). If one adopts this point of view, the question arises would the children of newly hired parents regard their working as beneficial to them? In more technical language, would children of the newly hired experience an increase in utility from the fact that their parents are working? Now this question might seem strange if one considers it in reference to an infant but less so if one considers the preferences of children about two years old or older. Such children appear quite capable of expressing whether they want their parents around or not. It is possible that some children of the newly hired would prefer their parents remain home with them. If such were the case, from a standard welfare economic point of view, the increase in work among these children's parents would be a cost to them not a benefit. Thus, Phelps' "role model benefit" view might be way off the mark.

A slightly more formal presentation may make this clearer. Let U_c be a child's utility level, t be the amount of time the child's parent (s) spends with him, and \mathbf{v} a vector of other variables that affect the child's utility. Then

$$1) \quad U_c = U_c(t, \mathbf{v})$$

where $\partial U_c / \partial t > 0$. Assuming that equation 1 accurately reflects the form of some children's utility functions the positive first derivative means that a wage subsidy that decreased the amount of time parents spend with their children would decrease their children's utility. From a welfare economic point of view, this decrease in utility ought to be counted as a cost against any benefits that might result from the subsidy. Phelps fails to consider this possibility.

He could respond that consideration of children's preferences for their parents' presence is ridiculous because adults know what is best for children. This may or may not be true, but there is nothing in welfare economics that grounds this view. Thus, one wonders whether it belongs in what purports to be a cost-benefit analysis of the wage subsidy. If the role model consideration is admitted then it's only reasonable to ask whether parents not working for wages can be role models for their children? Suppose some non-wage working parents, due to their having more non-wage timeⁱ, spend more time helping their children with their school work, involving themselves in parent-teacher organizations, or taking part in other activities that improve the lives of members of their community (for example, community organizing efforts to obtain needed services in their community). Couldn't parents' involvement in such activities allow them to serve as role

models for their children? If so, then if these parents were to work for wages as a result of the wage subsidy, the extent to which they serve as role models for their children might not change. Thus, their children could not be regarded as benefiting (in net) from the wage subsidy because it allowed their parents to be role models for them. In short, under such circumstances, Phelps would be overstating the net benefits of the wage subsidy.

During his discussion of the benefits of the wage subsidy plan to those who'd obtain wage work as a result of it, Phelps states that these individuals would obtain the means to purchase a middle-class lifestyle (see above). At no point during his discussion does Phelps consider the pecuniary costs often associated with wage work. People who work typically incur increased transportation costs and, in many cases, increased costs of child-care. They may even have to spend more on clothing and other accessories. In order to assess whether a work induced increase in income is a net gain one would have to subtract any pecuniary costs of wage work. Not to do so is to overstate the net pecuniary benefits of working.

Phelps states that another benefit of the wage subsidy would be the possible health benefits that the newly hired would enjoy. It is also possible that adverse health consequences would result from more wage work among this group. Work often involves commuting, which could result in higher stress levels. Work itself is often stressful, perhaps quite so in the kinds of low-tier jobs some who work as a result of the subsidy might obtain. Stress, of course, is related to various health conditions such as hypertension and cardiac problems. It may or may not be true that the health gains for the newly hired would outweigh any health costs they'd suffer. But by not considering these possible costs Phelps may be overstating the net gains of the wage subsidy.

As Phelps sees it, other benefits of the wage subsidy are that the newly hired would enjoy the stimulation and sense of belonging that comes from working. But people can derive stimulation and a sense of belonging from non-wage work activities. Suppose, as discussed above, some non-working persons involve themselves in parent-teacher associations and/or other community activities that improve the lives of those in their communities. Or suppose non-wage working persons simply spend lots of time adequately caring for their children or other relatives and friends. Such activities can stimulate people and give them a sense of belonging. Thus, if as a result of the wage subsidy, some move from non-wage work activities that stimulate them and give them a sense of belonging to a job that does so to the same extent, there would be no net gain in stimulation and a sense of belonging for such persons. Phelps' inattention to this possibility, once again, may be leading him to overstate the net benefits of the subsidy.

The possibility that "would be" beneficiaries of wage subsidies that are currently not working outside the home are taking care of relatives and friends suggest another cost of the subsidies that Phelps may be overlooking. Imagine a woman whose income comes from public assistance. She has a sick elderly mother who she takes care of, care that prevents her from having to go into a nursing home. Suppose further that her mother prefers being cared for in her own home to going into a nursing home. A wage subsidy may result in her daughter going to work, which may be beneficial in some of the ways Phelps proposes, but if it leads to her having to go into a nursing home, this would be costly to the mother. It's difficult to know how widespread a problem this would be if a wage subsidy were enacted so it's difficult to know the extent of the cost of such a policy to those currently receiving care. By not considering the possibility of such a cost at all,

Phelps seems to be assuming that it would be zero. If this cost were any number greater than zero, Phelps would be overstating the net benefits of the wage subsidy.

Phelps also states that the increase in work among second-class workers induced by the wage subsidy would benefit reliable unemployed workers and young persons in second-class workers' neighborhoods. Since these neighborhoods would no longer have reputations as areas of unreliable workers, reliable unemployed persons in them would find it easier to obtain a job. Also, young people would be able to obtain information about job openings from newly hired second-class workers.

The problem with this line of argument is that the increase in wage work that would result from the subsidy might result in external costs. As stated above, work often involves commuting. Commuting often generates congestion, which is costly as anyone who has sat in a traffic jam or rode on a crowded subway knows. Second-class workers, formerly unemployed but reliable workers, and young persons who, as a result of the wage-subsidy, sell more labor and, therefore, join the ranks of commuters on trains and highways, may not consider that their choices may add to congestion. Sitting in traffic jams and riding on crowded trains may increase stress, which, as stated above, can have negative health consequences. In order to determine if a wage-subsidy induced increase in work would generate a net gain one would have to subtract the costs of congestion and negative health consequences from whatever benefits might result from the increase in work. Phelps doesn't consider these costs at all.

Phelps also suggest that the increase in work and incomes induced by the wage subsidy would lead to second-class workers needing less public assistance and, therefore, other workers paying less in taxes to finance such assistance. The problem here is that

Phelps is counting as a benefit what is really a change in income transfers. From the societal point of view, the proper one for cost-benefit analysis, if the wage subsidy leads to our transferring less income from the better off to the worse off, this would not be a net social gain because the better off would have gained what the worse off has lost. It is true that a decline in income transfers would lead to lower costs of administering them, which could legitimately be regarded as a benefit of the wage subsidy. But counting the reduction in transfer payments as a benefit of the program amounts to overstating program benefits.

Phelps' discussion of the benefit of an increase in corporate tax revenue that would result from more work among second-class workers suffers from a similar problem. Such an increase would be a transfer from corporations to the government not a net social benefit. To count it as such is to overstate the social gains of the wage subsidy.

Another problem with Phelps' analysis is that he fails to consider the inefficiency that could result from the wage subsidy itself. Phelps states that one of the main reasons second-class workers are currently unemployed or making low wages is because they aren't very productive. Providing employers with a subsidy would give them an incentive to hire these less productive workers because government would pay part of their wages. This is exactly why the subsidy might result in inefficiency.

Imagine a less productive worker has a reservation wage of \$7 per hour, meaning she or he places a value of \$7 on the next hour of leisure.ⁱⁱ If this worker's marginal revenue product was \$4/hourⁱⁱⁱ, the labor market was perfectly competitive, and there was no wage subsidy, firms would only be willing to pay her or him a maximum of \$4 per hour. In these circumstances, from a societal point of view, this individual should spend

the next hour on leisure because the societal value or benefit of this hour of labor (\$4) is less than the societal cost (\$7) of it. But if government, through a wage subsidy, were willing to make up the difference between \$7 and \$4, firms might be willing to hire this person and she or he might be willing to accept the offer. That is, firms might be willing to purchase this person's labor even though the societal value of it would still be less than the societal cost of it. If Phelps' wage subsidy ended up causing employers to hire workers whose labor they value less than the societal cost of supplying it, and I can think of no reason why it wouldn't, this would result in an inefficient allocation of labor or a deadweight loss. From the perspective of cost-benefit analysis, this loss should be counted as a cost of the wage subsidy, one Phelps appears to completely ignore.

Phelps would probably respond that I'm only considering the private value of this worker's labor and that to fully assess its societal value I would have to add to the private the external value of it. The external value of work comes from, "one's ability to support oneself and to exercise responsibility as a citizen, community member, parent, and spouse" (Phelps, 1997, p. 107.). Presumably, Phelps is referring here to the benefits of the wage subsidy discussed above. But given how he might be overstating the net benefits of the wage subsidy, it isn't clear that, on a more accurate assessment, they'd be large enough to cancel whatever deadweight losses might result from it.

The Basic Income as an Alternative to the Wage Subsidy

In recent years, a number of social analysts have proposed an approach to addressing poverty that isn't wage work conditioned: the so-called "basic income"

(Widerquist, 1999; Lewis, 1998; Chancer, 1998; Aronowitz and DiFazio, 1994, and Van Parijs, 1995). This policy would assure that no one's income fell below some minimum level whether or not they worked. Phelps would no doubt oppose such a plan. In his discussion of a version of it called the negative income tax he states that the policy would result in young people lacking, "the vision and the will to resist yet another year of avoiding life's challenges and risks" (Phelps, 1997, p. 111). Presumably, Phelps would also oppose the plan because it would not result in the benefits associated with the wage subsidy discussed above. But given the problems in Phelps' analysis, it's questionable whether the wage subsidy would result in the optimal amount of labor supplied. Perhaps, through its effects on the demand for leisure, the basic income would result in this optimal quantity. Only careful analysis of the costs and benefits of this approach in comparison to those of the wage subsidy would allow us to tell. I know of no one who has provided such an analysis of the basic income, and, in spite of Phelps' important effort, the wage subsidy either. It may even be the case that such an analysis of these two programs, given the technical difficulties involved, isn't feasible. Hence, the "jury is still out" on which would be the more efficient policy.

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ⁱ *Non-wage time* refers to time spent not working for a wage. Thus, time spent in household production, like cooking and childcare, and playing tennis for fun is non-wage time. Also, I will use the terms *work* and *wage-work* interchangeably to refer to time spent working for a wage. This is in no way meant to deny the value of household production activities such as childcare, cooking, mowing the lawn, repairing the windows, etc.

ⁱⁱ A person's *reservation wage* is the minimum wage she or he would be willing to accept in order to give up one hour of leisure when she or he is supplying zero hours of labor. See Hamermesh and Rees. *The Economics of Work and Pay*. New York: Harper Collins College Publishers, 1993.

ⁱⁱⁱ A measure of how much hiring a given worker benefits the firm that hires her or him, that depends on how productive the worker is. See Hamermesh and Rees. *The Economics of Work and Pay*. New York: Harper Collins College Publishers, 1993.