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Rethinking the Wage Deduction

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This article suggests that reconceptualizing the tax deduction for salaries and wages could have substantial equity and efficiency benefits. In 2019, U.S. businesses paid $8.768 trillion in salaries and wages a substantial fraction of which was deducted for tax purposes.[1] This deduction provided hundreds of billions of dollars in tax benefits to businesses. Might it be possible to provide the same level of tax benefit to businesses but reallocate it to create better employment incentives?

As it stands, the tax code gives the same benefit to businesses for every dollar of employee compensation regardless of whether that dollar goes to an employee making millions or an employee making minimum wage. The federal income tax could be modified to provide tax benefits to employers for the number of employees they hire. This change in the tax code would encourage employees to hire more workers and increase the compensation paid to employees on the low-end of the wage distribution. Correctly implemented this reallocated tax benefit could increase the equity and the efficiency of the tax system.

I. THE LABOR MARKET'S FAILURE

A. The Plight of the Low-Wage Worker

Poverty is endemic in the United States.[2] 10.5% of the U.S. population (or 34 million people) live in some form poverty.[3] In its most extreme form, poverty entails severe material deprivation.[4] On any given night, 580,000 Americans face homelessness, including 172,000

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[1] See https://fred.stlouisfed.org/series/BA06RC1A027NBEA. Total claimed salaries and wages deductions for 2019 are not available but were $2.389 trillion in 2003 or 49.5% of aggregate salaries and wages paid—some wages and deductions are likely included in cost of goods sold.

[2] Poverty is often defined in terms of an income threshold. The percentage of the population in poverty has not dipped below 10% since the U.S. Census Bureau began measuring it in 1960 using the Current Population Survey. Page 12: https://www.census.gov/content/dam/Census/library/publications/2020/demo/p60-270.pdf. The long-run trend of the fraction of population in poverty has been nonuniformly downward, but the total number of people in poverty has not. There are approximately 10 million more people in poverty than there were in the 1970s. Id.

[3] These numbers are from before the COVID-19 pandemic. Id. Different government programs use different thresholds to determine Page 55-56: https://www.census.gov/content/dam/Census/library/publications/2020/demo/p60-270.pdf. Page 2 and page 5 (notes 2 and 7): https://www.urban.org/sites/default/files/publication/103656/2021-poverty-projections.pdf. Some definitions of poverty take a broader view, defining poverty as a lack of resources to meaningfully participate in the economic, social, and political ecosystems of the country. The United Nations, for example, states that "[p]overty entails more than the lack of income and productive resources … Its manifestations include hunger and malnutrition, limited access to education and other basic services, social discrimination and exclusion as well as the lack of participation in decision-making." https://www.un.org/development/desa/socialperspectiveondevelopment/issues/poverty-eradication.html.

[4] Poverty entails insufficient resources to meaningfully participate in the economic, social, and political systems. Thus poverty is a relative condition and intertemporal comparisons alone cannot demonstrate whether poverty as a systemic problem is improving or lessening. To make the case with an extreme example, nearly every living person today is high means compared to people six thousand years ago, and quite possibly every person living today will be low means compared to people six thousand years in the future. Neither of those comparisons has an obvious normative interpretation. One particular way in which intertemporal comparisons are challenging is that the relative cost of economically and socially important goods may change—for example, education and housing. Thus, even if real low-end wages have increased but the real costs of education and housing have increased far faster, then despite

people in families with children.[5] And millions of Americans, including millions of children, regularly suffer food insufficiency.[6]

But even short of severe material deprivation, poverty has consequences. Low income-earners tend to have negative savings rates—even those with median incomes save little on average.[7] The result is a skewed distribution of wealth, in which 34% of U.S. households have less than $30,000 in wealth.[8] Households with low wealth are unable to finance large expenditures, such as down payments on a house, and have little financial cushion to withstand adverse financial shocks, including unemployment and health issues.[9] Impoverished households are also at a severe disadvantage providing educational opportunities to their children.[10] And those with low-income parents are far more likely to be low-income themselves.[11]

Poverty is not a simple phenomenon—it is the result of an amalgamation of economic, social, political, and cultural forces. But without a doubt one important and proximate cause of poverty in the United States labor market and in particular the wages available to those at the low-end of the wage distribution.

A living wage yields sufficient income to pay for necessities, including food, childcare, healthcare, housing, transportation, clothing, and taxes.[12] Because the costs of these basic goods

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the wage increase, poverty may be more entrenched. See Phelps. Education grows way faster. https://nces.ed.gov/fastfacts/display.asp?id=76. Housing grew way faster. https://fred.stlouisfed.org/series/MSPUS#0/.

[5] Page 1: https://www.huduser.gov/portal/sites/default/files/pdf/2020-AHAR-Part-1.pdf.

[6] Table 1, 2a, and 2b: https://www.census.gov/data/tables/2020/demo/hhp/hhp21.html. Decreased life expectancy is another consequence of poverty. https://www.aafp.org/news/health-of-the-public/20181210lifeexpectdrop.html.

[7] The bottom two quintiles of income earners have negative savings and the middle quintile of income earners saves substantially less than $10,000 per year. https://www2.deloitte.com/us/en/insights/economy/spotlight/economics-insights-analysis-08-2019.html. Some but not all of this is explained by lifecycle spending patterns. The end result is strong correlation between wealth and income. https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/#range:2006.1,2021.1;quarter:126;series:Net%20worth;demographic:income;population:all;units:levels.

[8] These are 2016 numbers. https://apps.urban.org/features/wealth-inequality-charts/. Unsurprisingly, low-income earners also have much lower rates of homeownership. Page 10: https://www.census.gov/housing/hvs/files/currenthvspress.pdf.

[9] Page 10: https://www.census.gov/housing/hvs/files/currenthvspress.pdf. Something about shocks pushing people into poverty. Among developed countries this problem seems to be particularly stark in the U.S. OECD poverty rate comparison.

[10] Research has showed that randomly providing children higher quality education improves their outcomes when controlling for parent income.

[11] When an economic region is hit with a presumably random adverse shock, children growing up in this region have far worse outcomes when compared to children growing up in similar economic regions that were not hit with an adverse economic shock. The low income mobility in the United States has the added effect of entrenching the economic effect of historic and system racism. This problem is somewhat of a self-fulling prophecy. Poor employment opportunities for parents result in bad outcomes for children. Represented by the low income mobility. The quality of schools is tied to the income of parents and the quality of schools determines the income of the children. School Quality & Income Inequality: The Long-Term Effects of Early Childhood Education Raj Chetty and John N. Friedman. And other Chetty papers. The returns to high schools are relatively small and the returns to higher education are much higher. Autor, Goldin, and Katz study that says returns to high school staying relatively constant compared to returns to higher education. There is low income mobility in the United States. See Solon. Random income shocks during childhood result in substantially worse later earnings outcomes. Low income also creates challenges affording post-secondary education. See data on financial aid.

[12] These living wages assuming that the income earner works 40 hours per week, 52 weeks per year. Note that these numbers do not account for savings or leisure. A worker would require a larger income to save for retirement and large purchases (such as a house and college tuition) or to pay for vacations and restaurant meals. Id.

and services are a function of several factors, such as location and household composition, there is no universal living wage. An adult with a stay-at-home partner and two children in San Francisco would require $53.43 per hour ($111,143 annualized) to cover the above costs; whereas a single income earner with no dependents in Ouachita County, Arkansas would require $13.61 per hour ($28,308 annualized).[13]

Many, if not most, workers in the U.S. do not earn a living wage.[14] Workers in the 10th percentile of the wage distribution earn $11.26 per hour which corresponds to a full-time, annual income of $23,398.28.[15] The median wage is somewhat higher at $19.90 per hour, which corresponds to a full-time, annual income of $41,352.20.[16] The lack of opportunity in the labor markets, results in low household incomes for large swaths of the population. 21% of American households earn under $30,000 per year and 37% of households earn under $50,000 per year.[17]

The lack of reward at the low-end of the wage distribution not only impoverishes workers but also decreases the incentive to work.[18] Labor force participation in the United States is declining and lower than in both the OECD countries and the EU.[19] Alternatives to the labor market

[13] https://livingwage.mit.edu/counties/06075.

[14] Because of regional and household variation, it's difficult to know exactly what fraction of the population earns a living wage. Look for a good source here. In most of the United States, a living wage is substantially higher than the minimum wage. Id. See also https://www.brookings.edu/wp-content/uploads/2019/11/201911_Brookings-Metro_low-wage-workforce_Ross-Bateman.pdf. MEET the LOW-WAGE WORKFORCE. There is also the interesting question of at what wage workers qualify for benefits and what incentives this creates to work. https://www.cbpp.org/sites/default/files/atoms/files/11-18-08fa.pdf. A Quick Guide to SNAP Eligibility and Benefits.

[15] Civilian workers excluding farm, private household, and federal government workers. Wage data available at https://www.bls.gov/news.release/ecec.nr0.htm#. This does not include the $2.85 in non-wage benefits that are included in compensation. Hourly wages were annualized using Office of Personal Management convention, https://www.opm.gov/policy-data-oversight/pay-leave/pay-administration/fact-sheets/computing-hourly-rates-of-pay-using-the-2087-hour-divisor/#:~:text=A%20General%20Accounting%20Office%20study,work%20hours%20per%20calendar%20year. Some but not all of these low-wage workers are teenagers whose low-wage status is temporary. Over half of the hourly workers making at or below minimum wage are over the age of 25, table 1. https://www.bls.gov/opub/reports/minimum-wage/2020/home.htm.

[16] Id. Some wage earners are students or fall into some other group that is less worrisome.

[17] The percentage of workers in low-wage jobs is much higher in the United States than in other OECD countries. https://data.oecd.org/earnwage/wage-levels.htm. Low wage is defined as less than 2/3 the median. In the US hovers around 25% in the rest of the OECD hovers above 15%.

[18] There has been some low-end wage growth but is has been small relative to the other quantiles of the income distribution. https://fas.org/sgp/crs/misc/R44705.pdf . The result is increasing income inequality. https://www.pewresearch.org/fact-tank/2020/02/07/6-facts-about-economic-inequality-in-the-u-s/. https://www.epi.org/publication/swa-wages-2019/.

[19] Labor force participation is defined as the fraction of the working age population that is either working or seeking work. Decline in labor force participation since 2000. https://fred.stlouisfed.org/series/CIVPART. Most countries with developed economies have higher labor force participation rates. https://data.oecd.org/emp/labour-force-participation-rate.htm.

include welfare programs and crime, neither of which are generally preferably to voluntary, well-compensated work.[20][21]

There are two forces in particular that exert downward pressure on wages at the low end of the distribution.[22] First, low-skill work is continually automated—workers are replaced with machines.[23] As workers are replaced, demand for low-skill workers shifts down and the wage these workers command on the labor market decreases.[24] Since the pace of technological advancement is fast, and perhaps increasingly faster, a growing pool of workers find relatively little demand for their skills and little hope of increasing their market value. There are growing concerns that the labor market will not provide living wages to a larger and larger fraction of the population. Some pundits predict the eventual obsolesce of low-skill work.[25]

Second, the labor market in the United States is imperfect. In particular, employers in many regions have market power, which they use to push wages down. Much like monopolists supply goods at lower levels relative to competitive markets to drive the prices up, monopsonists demand at lower levels relative to competitive markets to drive prices down. There is evidence that employers do this for low-skill workers in many regions of the United States in which few employers dominate the demand for workers.[26]

B. Proposed Solutions

The state of the low-end labor market has drawn substantial interest from policymakers and pundits—and there are many policy proposals. Before enumerating and evaluating these proposals, it's helpful to have a sense of what an optimal policy response would look like—I identify three criteria. The optimal policy intervention designed to address poverty would (1) increase employment; (2) increase wages at the low-end of the distribution, and (3) not increase

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[20] Growing Number of people on disability. https://www.ssa.gov/policy/docs/statcomps/di_asr/2016/sect01.html. https://apps.npr.org/unfit-for-work/. But see https://www.huffpost.com/entry/npr-reporter-chana-joffew_b_2971443. Crime rates and unemployment rates are inversely correlated. Crime Rates and Local Labor Market Opportunities in the United States: 1979-1997 Author(s): Eric D. Gould, Bruce A. Weinberg and David B. Mustard Source: The Review of Economics and Statistics , Feb., 2002, Vol. 84, No. 1 (Feb., 2002), pp. 45-61.

[21] In sum, a growing share of workers unable to afford what constitutes a middle class life. See Phelps. Different pundits will focus on different aspects of the story but the overarching story is clear: a growing share of people in the United States are excluded from the preconditions to economic success. The lack of labor market opportunity also entrenches the historical and systemic disadvantages of Black workers by foreclosing an important path to full participation.

[22] Other factors include a general decline in government's role in distribution over the past few decades; globalization; and a failure to support parents and children, perhaps most acutely in the education system. To be fair: globalization has improved outcomes for workers globally, but not in the developed world. https://academic.oup.com/oxrep/article-abstract/22/3/349/418916. See also https://www.oecd-ilibrary.org/docserver/9789264246010-en.pdf?expires=1623771484&id=id&accname=guest&checksum=F1690752781E5FF206DD0EDA4E127E6C page 42. I suppose it's possible that even without any of these factors, many would not earn a living wage. We can delete this aside, I think.

[23] Automation is not inherently bad—on the contrary, it is generally beneficial to both consumers, investors, and in some cases even workers. But there are bad distributional outcomes to automation and, in some cases, the benefits may take time to manifest.

[24] This problem is most acute for low-skill workers, but machine learning threatens to automate many high-skill jobs, too.

[25] See Harari.

[26] Notably, high-skill workers are insulated from this advantage because of the considerably higher barriers to entry that prevent their labor markets from being inundated. https://www.nytimes.com/2021/02/25/opinion/inequality-medicine-law.html.

the federal deficit.[27] Employment is well known to have social, mental, and psychological benefits, so increasing the voluntary employment of those able to work is generally a good outcome.[28] Increasing wages at the low-end of distribution would lift workers out of poverty, benefitting both the effected workers and their children. And avoiding increasing the already large structural primary deficit is an important part of any sustainable policy change.

Two corollaries follow from these criteria. First, the optimal solution cannot increase the cost of hiring workers in the U.S. because U.S. businesses will respond by replacing U.S. workers with machines or foreign workers. Second, to avoid an increase in the deficit, the optimal solution must either not increase government expenditures or must be accompanied by a commensurate tax increase. The necessary tax increases would be on the order of hundreds of billions if not trillions of dollars annually, which is likely beyond what is politically feasible.

Some pundits argue that the free market without any government intervention will resolve the low-end labor market problem. There are three reasons why this is unlikely. First, as discussed above, labor markets are imperfect. There is evidence that in many regional labor markets employers use market power to depress wages, meaning that the preconditions for a good free market outcome do not exist. Second, the fast pace of technological change, which in many cases decreases the market value of low-end labor, makes it unlikely that the labor market will ever achieve equilibrium. Continuous adjustments and transitions are likely to have adverse effects on the pool of low-end workers. Third, even if the low-end labor market achieved a competitive equilibrium, the marginal product of the workers would still likely be below a living wage.

Others have suggested increasing the minimum wage.[29] There are good arguments in favor of raising the minimum wage.[30] However, a higher minimum wage has, at best, no effect on employment—it will not encourage employers to hire more workers.[31] Indeed, the increase to the minimum wage necessary to increase the number of workers earning a living wage would have to be very large—in some parts of the country it would require a minimum wage over $50 per hour.

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[27] This labor market policy intervention would not entirely eliminate poverty and it may certainly be complemented by other policies.

[28] Decreasing poverty without increasing employment would require transfers. This would be costly and would not generate additional economic value from labor.

[29] Increasing the minimum wage and expanding union coverage would increase the pay for some workers but would not increase the number of workers. Both policies make it more expensive for businesses to hire workers, so neither is likely to increase labor force participation. The minimum wage should increase the average wage of low skill workers but will not increase their employment (it may even fall) and thus has an ambiguous effect on the total earnings of low-skill workers. Labor laws attempt consolidate employees' interests so that their bargaining power better matches that of businesses. When labor laws give too much power to businesses, labor laws do not fully solve the issue they exist to solve. When labor laws give too much power to unions, labor laws can cripple businesses, which is especially problematic in an international context. Moreover, unions create other political economy problems because unions are entities whose own interests and whose management's interest may not align with employees. It's also worth noting that union and minimum wage laws don't benefit all workers. Both may reduce the quantity of labor demanded, leaving some workers without work.

[30] Evidence suggests that relatively small increases to the minimum wage increase incomes with only a minimum decrease in employment. However, there are concerns that increasing the minimum wage decreases the incentive for businesses to make capital investments which may have adverse long run labor market effects. Cite Sorkin. And some evidence suggests that to the extent that Black men may suffer disemployment effects after a minimum wage increase. See Bailey. But see Derenoncourt for evidence against this.

[31] The evidence mixed on whether minimum wages have negative disemployment effects or no disemployment effects.

At these wage levels, there would be a strong incentive for employers to find alternatives to U.S. workers.[32]

Others have suggested a robot tax levied on technologies that replace workers to discourage businesses from using those technologies and thus preventing some workers from losing their jobs. Robot taxes are likely not optimal policy for at least two reasons.[33] First, the effect of technology on workers is complicated and, in many cases, ambiguous. The Ford assembly line, for example, automated manufacturing processes (and thus replaced workers) but also created an enormous demand for additional workers.[34] Second, a non-global robot tax will not discourage businesses from using technologies in countries without robot taxes and will thus shift production into locations that do not have them, likely harming workers in the countries with robot taxes.[35]

Some pundits focus on the role of worker human capital. Increasing the skills and education of the population would increase wages and likely increase employment. However, this is a long-run solution. The most effective educational interventions occur at young ages, and all educational programs require an infrastructure that would take some time to create. These programs are also likely to be expensive and would thus add to the deficit.

Another policy that has attracted serious recent attention is universal basic income—a regular payment made to all citizens. UBI proposals vary substantially, but all of the ones that would make a dent in the poverty level would be very expensive. Moreover, a UBI program is unlikely to increase employment.

Lastly, some have suggested labor market subsidies—either employee-side subsidies (e.g., an expanded EITC) or employer-side subsidies.[36] Both of these would increase after-tax wages and might increase employment but would be expensive.[37] Some UBI proposals and labor market subsidy proposals include a tax increase, raising at least hundreds of billions of dollars if not trillions of dollars in annual revenue. With a substantial tax increase any of these proposals could be made revenue neutral, but with a great reduction in political feasibility.

I am not suggesting that these policy interventions are without merit. Nor am I arguing that they should not be pursued. I am merely stating that none of them increase low-end wages and employment without increasing the deficit or requiring an unlikely tax increase. It might be helpful to policymakers to have such an option.

II. A NEW HOPE

I suggest an alternative labor market approach to combat poverty: reconceptualizing the deduction for salaries and wages. A properly implemented modification would increase labor force

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[32] This includes hiring in other jurisdictions and automation. Increasing the power of unions would also encourage businesses to avoid hiring U.S. labor. Example: U.S. car manufacturers. Unions have also historically had some adverse political economy consequences. Many of these solutions could make some businesses nonviable, which of course the solution presented here could also do.

[33] A third reason: defining robot is really difficult. May if not most workers are far more likely to be replaced by an algorithm than a machine with a robotic arm. Would the tax apply to search engines? A broadly defined robot tax could have severe labor market ramifications.

[34] The cotton gin is another example of labor-saving technology that resulted in an increase in labor demand.

[35] If the goal is to help workers, then a subsidy on working would make sense. If the only alternative to domestic workers were domestic robots, a tax on robots might also make sense, but this is not the case. This is an application of the general principle that it's better to directly tax or subsidize. Non-targeted approaches have less of the desired effect and also have unintended consequences.

[36] Cite Phelps.

[37] There is new evidence that workers are not responsive to the EITC. Cite Kleven.

participation and increase wages paid at the low-end of the distribution, without increasing the deficit. There would of course be some downsides, which I discuss in Part III.

The deduction for salaries and wages is a tax benefit provided to employers equal to the wage expense multiplied by the employer's marginal tax rate. This tax benefit increases linearly with the size of the employer's wage expense and may be used to offset the employer's tax liability.[38] Assuming a 21% marginal tax rate, a $100,000 wage expense reduces tax liability by $21,000, and a $100,000,000 wage expense reduces tax liability by $21,000,000. This deduction is neither progressive nor regressive in the sense that it neither favors nor disfavors low-wage workers. The deduction is an employment incentive because it reduces the after-tax cost of hiring workers. This employment incentive is operationalized as an income tax deduction but is equivalent to a system that offers no wage deduction but did allow a subsidy equal to the wage expense multiplied by the marginal tax rate.[39]

My central claim is that policymakers should consider relocating this tax benefit in ways that increase labor force participation and low-end wages without increasing the federal deficit.[40] I suggest modifying the tax code to provide an employer subsidy for each employee.[41] For example, a business would receive $15,000 for each employee.[42] To prevent gaming, the subsidy would be prorated and only jobs that paid above a certain threshold would qualify. Thus, only jobs that paid more than, say, $40,000 per year would qualify and an employee working for only half a year would only qualify for half the subsidy. To make this tax law change revenue neutral, the federal government would decrease the deduction for wages and salaries by, say, 50%.[43]

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[38] The benefit does not increase linearly if changes in employment also change the marginal tax rate.

[39] Exceptions: Virtually equivalent because if, for example, the employer had a tax loss the benefit from the deduction would at best be an increased NOL and at worst would be nothing, whereas the subsidy would have a benefit in any event. Once viewed as an employer subsidy the deduction can reimagined in any number of ways. The current regime is effectively a proportional subsidy on wage expense. But there are alternative bases, including for example, the number of employees on payroll or the total number of hours worked. There are three obvious candidates for which object to subsidize: (1) the number of workers hire by a firm; (2) the number of hours hired by a firm; and (3) total wages paid—or some combination of those three. Payroll subsidies can also vary in other attributes. They may be permanent or temporary; they may be targeted or untargeted (e.g. available only for hiring people in a particular area or with a criminal record); they may be marginal or total (i.e. subsidize changes in payroll or subsidize the entire payroll); they may be a linear or nonlinear.

[40] There are infinitely many ways of reallocating the tax benefit in ways that would accomplish these goals.

[41] Another alternative would increase the value of the deduction for the first dollars paid to each employee and decrease the deduction at higher compensations. For example, the deduction would be 200% of all wages and salaries up to a certain amount and then 50%. This option will likely to less to decrease poverty, so I do not focus on it.

[42] There might be other qualification for this subsidy. For example, a series of benefits, such as healthcare, and vacation, maximum hours worked, etc. The subsidy could also be increased if the EITC, exclusion of employer provided healthcare, and forgone welfare and unemployment benefits were included. The government's current approach to regulating employment contracts involves a hodge-podge of interventions. Some examples include the government allowing but limiting unions and other forms of labor organization, the requirement that employers pay a threshold wage, and the right of employees to unpaid sick leave (FMLA). Atop these interventions, the government also incentivizes employers to provide health insurance to employees by making the premiums paid deductible to the employer and excluded from the employee's income. Similar tax provisions also incentivize other noncash benefits. Interestingly, some executive compensation is only deductible up to 1M dollars.

[43] I'm still wrapping my head around how to make a reasonable case for what I think the numbers should be. The precise amount of the subsidy and reduction of the deduction are an empirical matter beyond the scope of this paper. The larger the decrease in the deduction, the larger the available subsidy in a revenue neutral policy change.

This change would make hiring low-end workers much more attractive. Under the 100% deduction scheme, the after-tax cost of hiring a worker at $40,000 would be $31,600.[44] Under the 50% deduction with a $15,000 subsidy, the after-tax cost of a worker at $40,000 would be $20,800.[45] Because of the substantially lower after-tax cost, demand for low-end workers would increase, which would increase both the number of low-end workers with jobs and the amount they received in salaries and wages.

Not all workers would benefit from this scheme. The subsidy is only available for workers making over $40,000, so very low-end workers would become higher cost on an after-tax basis.[46] Higher demand for low-end workers will somewhat mitigate this effect on these very low-end workers. Those facing the largest downside would be high-end workers. because the deduction is limited to 50%, workers making above $143,000 would be more expensive on an after-tax basis. The policy switch would decrease demand for these high-end workers.

III. Potential Downsides

Replacing some of the deduction for wages and salaries with a per worker subsidy will increase workforce participation among low-end workers and increase the wages of those low-end workers without increasing the budget deficit. This policy change would lift many households out of poverty and would counteract the feared collapse of the labor market for low-skill workers.

The policy change would, however, come with some additional consequences. First, this would be a substantial deviation from the income tax base. The expenses of compensating employees decrease income and should thus reduce income on a dollar-for-dollar basis under an income tax regime.[47] But setting aside the neatness of a formalistic approach to raising revenue, there is no a priori justification for taxing income. The responsible legislature and executives should design a tax system to best meet certain objectives. Indeed, there are already many deviations from a pure income tax in the current system. It would be specious to deem this policy change bad solely because it doesn't comport with an income tax.

Second, reducing the deduction for wages and salaries would give some employee-employer pairs the incentive to attempt to reclassify the employee as an independent contractor. The proposed scheme would make some employees cheaper on an after-tax basis and others more expensive. If those made more expensive could be classified as independent contractors and the entire amount paid to them could then be fully deducted, employers could have the best of both worlds. However, there are already constraints in tax law concerning whether a worker is an employee or an independent contractor. And it seems likely that in the near future legislation and case law may expand the definition of employee. Although there may be some inefficient reclassification, it's unlikely to be substantial.

Third, reducing the deduction for employee compensation and adding a hiring subsidy may change the efficiency of the tax system. If all markets are perfect, then taxes will reduce efficiency.[48] But all markets are not perfect, and therefore there exists a possibility that government

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[44] $40,000 – 21%*$41,000.

[45] $40,000 – 21%*$41,000*50% - $15,000.

[46] Businesses are better off increasing the wages of all workers making above $26,000 to at least $40,000, at which compensation level the business is entitled to the subsidy. Workers making less than $26,000 will now be more expensive.

[47] The employment subsidy is also not consistent with an income tax regime.

[48] Externalities, market power, and suboptimal provision of public goods are some reasons why markets are imperfect.

intervention may increase efficiency.[49] There is growing evidence that employers use their market power to inefficiently push down wages for low-skill employees in the labor market. A non-regulatory remedy to demand-side market power is to tax expenses paid and subsidize the quantity of transactions. Relative to the status quo, decreasing the deduction for employee compensation is effectively a tax on employee compensation, so this transaction counteracts monopsony power and thus makes the low-end labor market more efficient.

The proposed scheme does increase the tax burden on employers that hire high-end workers. In some cases, suppliers of labor use market power to inefficiently increase compensation at the high-end of the labor market.[50] Wherever that is the case, this policy change may increase the efficiency of the market. There are, nonetheless, certainly labor market outcomes that will be less efficient under this new tax scheme, but it not at all obvious that aggregate result will be less efficient.

This final and biggest consequence of this proposed tax regime change is that some busines models will no longer be viable and some workers will be displaced. In particular, businesses that rely on very cheap, part-time employees or mostly on highly compensated employees would face a much higher tax burden under the proposed scheme. Some of the challenges may be mitigated by phasing in the change gradually or providing transition relief. If the nonviable business model were only viable under the previous regime because it was inefficient or exploitative, then we should be willing to suffer the frictions that will arise as these businesses are replaced with others.[51] But surely some productive businesses would be lost.

IV. CONCLUSION

In a sense, the proposed decreased deduction for employee compensation funds the proposed employer subsidy. There are of course other alternatives to fund an employer subsidy. One possibility is increasing the deficit. The deficit is already unsustainably large, so I’ve set aside that possibility. Another possibility is raising taxes—perhaps the most discussed option is adding a value added tax. From a pure policy perspective, there’s nothing inherently wrong with funding the employer subsidy with a tax increase. From a political perspective, there may be challenges involved in raising new taxes. Perhaps a selling point of my approach is that it simply rearranges an existing tax benefit.

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[49] Government intervention can correct externalities, counteract market power, and raise revenue to provide public goods at efficient levels.

[50] This is often accomplished by introducing barriers to entry to certain labor markets. Medicine and law are the best studied examples of this phenomenon.

[51] From a political optics standpoint, one might say that those businesses relying on cheap, parttime work were either unable to pay the an efficient or fair compensation to their employees.