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A Contingent Wage Subsidy for V-Shaped Recovery

Robertas Zubrickas

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In parallel to the pandemic, most countries are also going through an unparalleled economic experiment and the daunting prospect of economic recession. To contain the spread of the Covid-19 virus, governments have basically switched off their economies until the situation around the pandemic improves. The unsettling question is whether hopes of V-shaped recovery will materialize, and the economy will swiftly rebound to its pre-pandemic level when it is switched back on.

The hopes of V-shaped recovery are based more on faith than on any evidence because of the current crisis's unprecedented nature. If we unwittingly draw on the 2007-08 financial crisis for prediction, then we can even speculate that it may take years for the economy to recover. While the comparison to the financial crisis is dubious, the financial crisis and its aftermath may yet be revealing of potential obstacles lying ahead of us at the present time. After more than five years since the end of the financial crisis, the Organisation for Economic Co-operation and Development still found the world economy caught in "a self-fulfilling low-growth trap" with many countries struggling with double-digit unemployment levels and real earnings for most populations below the 2007 levels.[1]

Coordination problems and the "big push"

The "self-fulfilling low-growth trap" is a reference to the economic coordination problem and its dismal outcome. It is well understood that a key driver of economic expansion is business expectations. When optimistic about economic prospects, firms expand and, consequently, further fuel overall optimism prompting other firms to expand. From a practical perspective, new hiring by one firm is a reason for new hiring by other firms because of employment spillovers related to additional aggregate demand, new trading opportunities, or production synergies. However, without coordinated action, the virtuous hiring cycle may not start, stranding the economy in the state of pessimistic expectations with low employment and low spending as in the aftermath of the financial crisis.

Policymakers are well aware of the economic coordination problem and the importance of spurring optimistic expectations. The traditional approach to this problem emphasizes a "big push" when the government spends enough to convince the private sector to start spending. It is also the approach that many governments are now planning to take to revive their economies out of the pandemic lockdown.

Consider the United Kingdom's recovery plan. During the lockdown, over 9 million employees or a third of the UK's workforce have been furloughed with their wages paid by the government. As part of the recovery plan, employers will receive a one-off bonus of £1,000 ($1,250) for each furloughed employee they retain after the furlough scheme ends. In support of youth employment, businesses will be given £2,000 ($2,500) for each new apprentice they hire under the age of 25. Further stimulus measures include substantial tax breaks for different sectors of the economy.[2]

Economic experts are, nevertheless, underwhelmed by this plan because it is not clear if job subsidies and tax breaks will be sufficient to convince firms to retain furloughed employees. In fact, this plan could be seen as a sign that the UK government may be running out of steam for a big push. Indeed the £30 billion ($38 billion) allocated for the recovery plan is dwarfed by the £350 billion ($440 billion) package used during the lockdown.[3] Apparently, the UK government's ability to dish out free cash is not limitless, nor is that of any other government.

Having your cake and eating it too

In normal times, businesses need no subsidies to start running, retain workers, or hire new ones. In London, for instance, restaurants and cafes will bring their staff back without any stimulus from the government as soon as office workers are back to their offices. And so will firms in transportation, hospitality, and professional services. In times of low economic activity and unemployment, the role of subsidies is to induce businesses to hire new staff in order to kickstart the virtuous hiring cycle. But once the cycle starts, the monetary incentives behind the inducement are not of primary importance for firms and, in fact, they may even be harmful because of non-market distortions. The question then arises if it is possible to design a subsidy scheme such that it induces firms to hire but without disbursing subsidies?

Zubrickas (2020) proposes exactly such a subsidy scheme, called a contingent wage subsidy.[4] To illustrate it abstractly, suppose that the economy is in a state of low employment. Now consider a policy that offers firms wage subsidies for new hires payable only if the total number of new hires made in the economy *does* *not* exceed a pre-specified threshold. An example would be a promise to cover all new labor costs contingent on that less than, say, 100,000 new jobs are created in total. From a firm's perspective, two outcomes can occur from this policy. One outcome is when the number of new jobs is less than the threshold, in which case the firm has its additional labor costs covered while keeping all the additional revenue. The second outcome is when the threshold is met, and no subsidies are paid. The firm then benefits from employment spillovers generated by a substantial increase in total employment, which makes hiring profitable even without any subsidies. With hiring profitable in both scenarios and, thus, all firms hiring, the threshold for new hires is reached, bringing the economy to the state of high employment without any subsidies paid.

To illustrate this policy in application to economic recovery from the pandemic lockdown, consider the case of the United Kingdom again. The economic problem that the UK government has to address with its recovery plan is how to make employers retain the 9 million furloughed employees. Without any stimulus, employers are facing a coordination problem: if an employer holds expectations that other employers are not retaining their staff, then it shouldn't either, and vice versa. Now suppose that instead of offering the meagre bonus of £1,000, the UK government offers firms a more generous bonus of £10,000 for each furloughed employee retained. However, the payment of the subsidy is contingent on that less than, say, 5 million furloughed employees were retained. Following the same argument, employers will choose to retain their furloughed staff because either they will receive the subsidy or return to normal times when their staff will be needed. With all employers retaining their staff, the condition for not paying subsidies will be met, and, hence, the government will have its cake and eat it too.

One can think of different variants of the proposed policy. For instance, the contingent wage subsidy is equivalent to a loan scheme where the government offers loans to cash-strapped firms for retaining their staff, but loans need to be honored only if the total number of retained staff is larger than a pre-specified threshold. The contingent wage subsidy also has advantages other than not being disbursed in expectation. Under this policy, a firm's decision to hire or retain staff has to pass the market test, or otherwise, the firm will make a loss. Under the traditional policy, however, the subsidy itself can be the reason for hiring staff, resulting in a wasteful use of resources.

Robertas Zubrickas *is a Senior Lecturer/Associate Professor at the University of Bath.*

Endnotes

1. Organisation for Economic Co-operation and Development, 2016. OECD Economic Outlook, Volume 2016 Issue 1, OECD Publishing, Paris.

2. For details of the UK's recovery plan, its costs, and the overall impact of the pandemic on the UK's public finances and employment, see "UK public borrowing to exceed £350bn with Sunak stimulus plan" by C. Giles, G. Parker, J. Pickard and D. Thomas, *Financial Times*, 8 July 2020.

3. For the UK's initial financial response to the pandemic, see "Coronavirus: Chancellor unveils £350bn lifeline for economy", *BBC*, 17 March 2020, https://www.bbc.co.uk/news/business-51935467

4. Zubrickas, R., 2020. Contingent wage subsidy, *Journal of Public Economic Theory*, forthcoming.