



Reimagining the Deduction for Employee Compensation

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REIMAGINING THE DEDUCTION FOR EMPLOYEE COMPENSATION

Daniel Schaffa*

ABSTRACT

U.S. businesses pay trillions of dollars in employee compensation, a substantial fraction of which is deductible for tax purposes. This deduction reduces the taxable income of businesses, ultimately lowering business tax burdens by hundreds of billions of dollars. With a few exceptions, the tax code confers the same deduction to a business for every dollar of employee compensation, regardless of whether that compensation goes to an employee earning millions or an employee earning minimum wage. This is consistent with a pure Haig-Simons income tax, under which any business expense incurred ought to be deductible dollar-for-dollar. But many, if not most, tax policy objectives are inconsistent with a pure income tax, and the U.S. tax code is accordingly replete with substantial deviations from a pure income tax.

This Article considers what would happen if the deduction for employee compensation also deviated from a pure income tax. It finds that allowing employers larger deductions for compensation paid to low-wage workers would counteract persistent deficiencies in the U.S. labor market. A larger deduction for low-wage workers would incentivize businesses to both hire more low-wage workers and pay them more. This would decrease the number of workers earning paltry wages, reverse the decline in U.S. labor force participation, restrain the employer market power exerted in many local labor markets, and correct the negative externalities from low-wage work.

As part of its analysis, this Article considers how a larger deduction for low-wage compensation might be funded, focusing on funding sources that synergize with a larger compensation deduction for low-wage workers—including higher business tax rates and smaller deductions for high-wage workers—and it details the tradeoffs associated with these different policy options. This Article also explains why behavioral frictions may make an employer-side subsidy a more effective labor market intervention than an employee-side subsidy, such as the earned income tax credit (EITC).

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INTRODUCTION

Governments regularly overhaul the tax treatment of business asset costs, and there is a lively academic debate about the correct tax approach to these costs.¹ If a U.S. business had purchased and placed identical pieces of machinery into service in 1950, 1980, 2010, and 2020, the tax consequences for the four would have been entirely different.² Curiously, the same cannot be said about the tax treatment of employee compensation costs. Setting aside a few marginal changes, the tax treatment of employee compensation costs has remained substantially unchanged.³

The relative lack of interest in the tax treatment of employee compensation costs is perhaps even more surprising given the state of the U.S. labor market. While unemployment is currently low, other important labor market indicators are inauspicious.⁴ The wages available to many workers are meager.⁵ The fraction of the working-age population employed is relatively low and declining.⁶ In many localities, a few employers dominate the labor market, and there is evidence that these employers set inefficiently low wages to keep their costs down.⁷ And low-wage work is associated with negative externalities, bearing on the economic vibrancy of communities, drug addiction rates, crime rates, and government finances.⁸

This Article suggests a solution to these labor-market problems: increasing the deduction for compensation paid to low-wage workers. With a few exceptions, employers may deduct one dollar for tax purposes for each dollar they spend on employee compensation, regardless of

1. See Evsey D. Domar, *The Case for Accelerated Depreciation*, 67 Q.J. ECON. 493, 509 (1953); Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income*, 78 MICH. L. REV. 1 (1979); Walter J. Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income*, 78 MICH. L. REV. 1172 (1980); Alan J. Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C. L. REV. 1327 (1982); Karen Mathais, *Accelerated Depreciation - An Effective Tool in Encouraging Capital Investment*, 7 J.L. & COM. 517 (1987); Yoram Margalioth, *Not a Panacea for Economic Growth: The Case of Accelerated Depreciation*, 26 VA. TAX REV. 493 (2007); Philip Bazel & Jack Mintz, *Is Accelerated Depreciation Good or Misguided Tax Policy*, 67 CAN. TAX J. 41 (2019).

2. See *infra* Section II.A.3.

3. While Congress has introduced employee-side labor market interventions, such as the EITC, there are reasons to believe employer-side interventions may have a greater employment impact. See *infra* Section I.C.2.

4. The January 2024 unemployment rate was 3.7%. News Release, U.S. Dep't of Lab., Bureau of Lab. Stat., USDL-24-0148, *The Employment Situation—February 2024*, at 1 (2024), <https://www.bls.gov/news.release/pdf/empsit.pdf> [<https://perma.cc/X45L-ZCUD>].

5. See *infra* Section I.A.1.

6. See *infra* Section I.A.2.

7. See *infra* Section I.B.1.

8. See *infra* Section I.B.2.

whether that dollar is paid to a low-wage or high-wage worker. The particular innovation explored in this Article is a bonus deduction for jobs that (1) pay at or above some threshold and (2) offer benefits meeting or exceeding a set package. With the bonus deduction, employers providing jobs that meet these criteria would be entitled to a larger employee compensation deduction. With appropriately chosen policy parameters, the larger deduction would encourage employers to both hire more low-wage workers and pay them more.

A larger deduction for low-wage workers would decrease government revenues—the greater the deduction (and thus the labor market impact), the greater the revenue cost. Given this tradeoff, this Article explores synergistic adjustments to offset the cost of a larger deduction. More specifically, Congress could modify tax provisions to (1) change the cost of hiring low-wage workers relative to hiring high-wage workers; (2) more generally shift tax burdens from firms that provide many jobs exceeding a quality threshold to those that do not; and (3) reallocate relatively inefficient existing employee tax benefits to increase the size of the effective subsidy. Using these approaches, the government could substantially impact the low-end of the U.S. labor market and offset some of the bonus deduction's cost. These funding mechanisms could, however, give rise to burdens borne by non-low-wage workers and businesses.

Part I of the Article lays out a normative case for a labor market intervention. It documents the high prevalence of low-wage work in the U.S., links low-wage work to financial hardship, and explains how low wages implicate two market failures: employer market power and the negative externalities of low-wage work. Part I concludes by discussing the shortcomings of existing labor market interventions, including the minimum wage and the earned income tax credit (EITC), and listing some of the advantages of a tax-based labor market approach.

Part II explores how changing the deduction for employee compensation could remedy the labor market deficiencies described in Part I by incentivizing employers to hire more low-wage workers and pay them more. Part II also considers how this bonus deduction might be funded, focusing on provisions that have some political or economic synergy with the bonus deduction. Part II concludes with a simple simulation which suggests that low-wage work could be eliminated in the U.S. with a sufficiently large bonus deduction. The simulation also explores the tradeoffs—including larger deficits, lower business incomes and investment, and lower high-wage worker income and employment—that eliminating low-wage work might entail, depending on how this bonus deduction were financed.

Part III discusses some additional considerations, including evasion and avoidance responses to a modified deduction for employee compensation and how different businesses would be affected. It then addresses some of the technical details that legislation enacting a bonus deduction would need to flesh out. This includes the definition of key terms, whether any of the deduction would be refundable, and whether the deduction ought to be prorated and, if so, with what periodicity.

I. THE PROBLEM OF LOW-WAGE WORK

The U.S. labor market is remarkable in many ways. It arranges exchanges between millions of employees and millions of employers, it is a source of tremendous aggregate income, and it facilitates the production of a cornucopia of goods and services.⁹ But it is not without its flaws. In particular, the prevalence of low-wage work in the U.S. labor market results in financial hardship for many households, discourages work, and implicates harmful market failures. This Part discusses these flaws and explains why existing labor market interventions are likely insufficient, setting the stage for Part II, which explores a tax approach to mitigate the harm from these flaws.

A. *Low-wage Work in the U.S.*

The compensation available to many workers in the U.S. labor market is too low to ensure financial security and too low to induce many potential workers to enter the labor force. In other words, the prevalence of low-wage work means that many who work earn little and many choose not to work. This Section describes the links between low-wage work, the hardships of low-income households, and low labor force participation.

1. Low wages and financial hardship

For most U.S. households, labor is the primary source of income.¹⁰ Workers trade their time and effort to an employer in exchange for

9. There are 159 million employees in the U.S. *Table A-1: Employment Status of the Civilian Population by Sex and Age*, U.S. DEPT LAB. BUREAU LAB. STAT., <https://www.bls.gov/news.release/empstat.t01.htm> [<https://perma.cc/4VUR-XAKD>] (last modified Jan. 15, 2024).

10. CONG. BUDGET OFF., *THE DISTRIBUTION OF HOUSEHOLD INCOME 2018-5* (2021), <https://www.cbo.gov/publication/57404> [<https://perma.cc/L3NR-W33L>]. And, in aggregate, labor

compensation.¹¹ For many workers, the compensation is meager. According to one study, 43% of those who work in the U.S. earn low wages.¹² Among low-wage workers, median hourly earnings are \$10.22, and median annual earnings are \$17,953.¹³ The prevalence of low-wage work is approximately 45% higher in the U.S. than in the EU.¹⁴

Low-wage work substantially contributes to low household incomes both because low wages result in low earned income and, as explained below, low wages result in fewer jobs.¹⁵ Among households in the lowest

compensation comprises 59.7% of U.S. economic activity. *Share of Labour Compensation in GDP at Current National Prices for United States*, FED. RSRV. ECON. DATA (Jan. 21, 2021), <https://fred.stlouisfed.org/series/LABSHPUA156NRUG> [<https://perma.cc/8CQN-67W9>].

11. This compensation is predominantly cash but often includes important noncash benefits. For private industry employees, in aggregate, 29.6% of compensation is noncash benefits. News Release, U.S. Dep't of Lab., Bureau of Lab. Stat, USDL-22-1176, Employer Costs for Employee Compensation – March 2022, at 1 (2022), https://www.bls.gov/news.release/archives/ecec_06162022.pdf [<https://perma.cc/999S-HHRK>].

12. MARTHA ROSS & NICOLE BATEMAN, MEET THE LOW-WAGE WORKFORCE 6–7 (Brookings Inst. Metro. Pol'y Program 2019), https://www.brookings.edu/wp-content/uploads/2019/11/201911_Brookings-Metro_low-wage-workforce_Ross-Bateman.pdf [<https://perma.cc/M2UN-ZDSK>] (finding that 43.7% of U.S. workers earn low wages, defining low-wage as earning below two-thirds the median male wage). Most workers who are students and all workers who report self-employment income are excluded. *Id.* at 5–6. These figures do account for regional variation in the purchasing power of a dollar. *Id.* at 7. They do not, however, account for other important factors, including whether the worker has an income-earning spouse, the worker's tenure, and whether the worker is acquiring additional human capital. *Id.* at 12. Low-wage workers are disproportionately young, non-white, foreign-born, less-educated, disabled, unmarried, and without children. *Id.* at 10. Although there is no consensus on what constitutes a good job, low-wage work, or a living wage, there is substantial agreement that low-wage work is ubiquitous. *See, e.g., id.* at 5 (“There is no consensus definition of a low-wage worker.”). Important definitional issues include what income threshold to apply, how to account for part-time work, variation in household composition, and the regional cost of living. *See also* Vincent A. Fusaro & H. Luke Shaefer, *How Should We Define “Low-Wage” Work? An Analysis Using the Current Population Survey*, MONTHLY LAB. REV. (Oct. 2016), <https://www.bls.gov/opub/mlr/2016/article/how-should-we-define-low-wage-work.htm> [<https://perma.cc/V47Z-NZRP>] (finding that between 12% and 30% of U.S. workers earn low wages, depending on the definition applied).

13. ROSS & BATEMAN, *supra* note 12, at 9–10. Another study found that those earning low wages are more likely to become unemployed or leave the workforce entirely than to find a better job. Todd Gabe, Jaison R. Abel & Richard Florida, *Can Low-Wage Workers Find Better Jobs?*, 33 ECON. DEV. Q. 92, 92 (2019) (Within a 12-month period, “70% of workers in low-end occupations stayed in the same occupation, 11% exited the labor force, 7% became unemployed, . . . 6% switched to a different low-end occupation . . . [and] 5% of workers in low-end occupations moved into a higher-quality occupation.”).

14. ORG. FOR ECON. CO-OPERATION & DEV., WAGE LEVELS (2021), <https://data.oecd.org/earn-wage/wage-levels.htm> [<https://perma.cc/6UGQ-BWUS>]. Under the OECD's definition, in 2021, low-wage work accounted for 15.6% of work in the EU and 22.7% of work in the US.

15. A large fraction of those who do not participate in the labor force live under the poverty line. Michael Dotsey, Shigeru Fujita, & Leena Rudanko, *Where Is Everybody? The Shrinking Labor Force Participation Rate*, 2 ECON. INSIGHTS 17, 21 (2017).

income quintile, the average income is \$22,500.¹⁶ Low income-earners often have negative savings rates—and even those with median incomes save little on average.¹⁷ As a result, many households exist in an insecure financial state. 15% of adults spend more than they earn and thus have to spend down their savings, borrow, or rely on family and friends to make up the difference.¹⁸ According to survey responses, 32% of adults would not be able to afford an emergency \$400 expense, 24% of adults (and 50% of adults earning less than \$25,000) are unable to pay all their monthly expenses, and 17% of adults have fallen behind on their rent in the past twelve months.¹⁹

The lack of opportunity in the labor market contributes to endemic poverty in the U.S.²⁰ 10.5% of the U.S. population (or thirty-four million

16. CONG. BUDGET OFF., *THE DISTRIBUTION OF HOUSEHOLD INCOME*, 2018 6 (2021). These households do, however, receive more in means-tested benefits and pay less in federal taxes. *See id.* at 12–20. Notably, after transfers and taxes, the bottom quintile of household income has experienced much less real growth than the top quintile but more than the middle three quintiles. *Id.* at 32. Some of the most likely explanations for the slower rate of wage growth for the bottom quintile compared to the top quintile include technological innovation, policy changes, and globalization. ORG. FOR ECON. CO-OPERATIVE DEV., *DIVIDED WE STAND: WHY INEQUALITY KEEPS RISING* 26 (2011).

17. Akrur Barua, *Personal Savings: A Look at How Americans Are Saving*, DELOITTE (Aug. 27, 2019), <https://www2.deloitte.com/us/en/insights/economy/spotlight/economics-insights-analysis-08-2019.html> [<https://perma.cc/5RH7-SQ2T>] (noting that 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.). The end result is strong correlation between wealth and income and a skewed distribution of wealth, in which 34% of U.S. households had less than \$30,000 in wealth in 2016. *Distribution of Household Wealth in the U.S. Since 1989, Wealth by Income Percentile*, BD. OF GOVERNORS, FED. RSRV. SYS. (Sept. 22, 2023), <https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/> [<https://perma.cc/ZCC8-SMLY>]; *Nine Charts About Wealth Inequality in America*, URB. INST. (Oct. 5, 2017), <https://apps.urban.org/features/wealth-inequality-charts/> [<https://perma.cc/UCT2-HB3E>]; *see also* MITCHELL BARNES, WENDY EDELBERG, SARA ESTEP, & MORIAH MACKLIN, *BOLSTERED BALANCE SHEETS: ASSESSING HOUSEHOLD FINANCES SINCE 2019* 11 (Brookings Inst. Hamilton Project 2022), https://www.brookings.edu/wp-content/uploads/2022/03/ES_20220322_householdfinances_finalreport.pdf [<https://perma.cc/P4CL-GWXL>] (discussing further research on household savings).

18. *Codebook for 2021 Survey of Household Economics and Decision Making*, BD. OF GOVERNORS, FED. RSRV. SYS., at I20 (2021), https://www.federalreserve.gov/consumerscommunities/files/SHED_2021codebook.pdf [<https://perma.cc/MJR7-KP94>] [hereinafter *Codebook for 2021*]; BD. OF GOVERNORS, FED. RSRV. SYS., *ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2021* 19, 36 (2022), <https://www.federalreserve.gov/publications/files/2021-report-economic-well-being-us-households-202205> [<https://perma.cc/T6CR-CDTP>].

19. *See Codebook for 2021, supra* note 18, at 35–36.

20. Different sources use different definitions of poverty. JESSICA SEMEGA, MELISSA KOLLAR, EMILY A. SHRIDER & JOHN F. CREAMER, *INCOME AND POVERTY IN THE UNITED STATES: 2019* 55–56 (U.S. Dep't of Com., P60-270 ed., 2021), <https://www.census.gov/content/dam/Census/library/publications/2020/demo/p60-270.pdf> [<https://perma.cc/EWU8-P4GZ>]; LINDA GIANNARELLI, LAURA WHEATON & KATIE SHANTZ, *POVERTY PROJECTIONS* 5 nn.2, 7 (Urb. Inst. 2021), <https://www.urban.org/sites/default/files/publication/103656/2021-poverty-projections.pdf> [<https://perma.cc/9GBX-C39T>]. Some definitions of poverty take a broader view, defining poverty as a lack of resources to meaningfully participate in the country's economic, social, and political ecosystems. The United Nations, for example, states that “[p]overty entails more than the lack of income and productive resources Its manifestations

people) lives in some form of poverty.²¹ In its most extreme form, poverty entails severe material deprivation. On a typical night, 580,000 Americans face homelessness, including 172,000 people in families with children.²² And millions of Americans, including millions of children, regularly suffer from food insufficiency.²³ Poverty is not a simple phenomenon—it results from an amalgam of economic, social, political, and cultural forces. But one important and proximate cause of poverty in the U.S. is its labor market and, in particular, the wages available to those at the low end of the wage distribution.²⁴

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.” *Poverty Eradication*, UNITED NATIONS, <https://www.un.org/development/desa/socialperspectiveondevelopment/issues/poverty-eradication.html> [<https://perma.cc/Q36D-RKSF>].

21. Under the OECD definition, 18% of the U.S. population lives in poverty, which is far higher than the U.S.’s peer countries. ORG. FOR ECON. CO-OPERATION & DEV., *POVERTY RATE*, <https://data.oecd.org/inequality/poverty-rate.htm> [<https://perma.cc/2WNB-YZ9J>] (last visited Feb. 8, 2024). Under the U.S. Census Bureau’s definition, the percentage of the population in poverty has not dipped below 10% since the Bureau began measuring it in 1960 using the Current Population Survey. SEMEGA et. al., *supra* note 20, at 12. The long-run trend of the fraction of the 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.* 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. See EDMUND S. PHELPS, *REWARDING WORK: HOW TO RESTORE PARTICIPATION AND SELF-SUPPORT TO FREE ENTERPRISE* 17–18, 20–21 (1997).

22. U.S. DEPT OF HOUS. & URB. DEV., OFF. OF CMTY. PLAN. & DEV., *THE 2020 ANNUAL HOMELESS ASSESSMENT REPORT (AHAR) TO CONGRESS 1* (2021), <https://www.huduser.gov/portal/sites/default/files/pdf/2020-AHAR-Part-1.pdf> [<https://perma.cc/G24J-8YRS>].

23. *Week 21 Household Pulse Survey: December 9 – December 21*, U.S. CENSUS BUREAU, *FOOD SUFFICIENCY AND FOOD SECURITY TABLES*, tbls. 1, 2a & 2b (Jan. 6, 2021), <https://www.census.gov/data/tables/2020/demo/hhp/hhp21.html> [<https://perma.cc/KH4Q-PST4>]. Decreased life expectancy is another consequence of poverty. Michael Devitt, *CDC Data Show U.S. Life Expectancy Continues to Decline*, AM. ACAD. FAM. PHYSICIANS (Dec. 10, 2018, 4:02 PM), <https://www.aafp.org/news/health-of-the-public/20181210lifeexpectdrop.html> [<https://perma.cc/DY9C-8YFZ>].

24. Making normative claims about the labor market is challenging in part because there is no standard definition of labor market equity. Possible candidates include the prevalence of a living wage, the fraction of the workforce that are working poor, and the fraction of those working that earn low wages. See, e.g., U.S. DEPT OF LAB., BUREAU OF LAB. STAT., *REP. 1093, A PROFILE OF THE WORKING POOR, 2019* (2021), <https://www.bls.gov/opub/reports/working-poor/2019/pdf/home.pdf> [<https://perma.cc/WF7W-GMSR>]; Amy K. Glasmeier, *About the Living Wage Calculator*, MIT LIVING WAGE CALCULATOR (2022), <https://livingwage.mit.edu/pages/about> [<https://perma.cc/M5N2-N88W>]. There is suggestive evidence supporting the proposition that the labor market status quo is not equitable. For example, a large majority of Americans support a higher minimum wage. Amina Dunn, *Most Americans Support a \$15 Federal Minimum Wage*, PEW RSCH. CTR. (Apr. 22, 2021), <https://www.pewresearch.org/fact-tank/2021/04/22/most-americans-support-a-15-federal-minimum-wage/> [<https://perma.cc/A9GJ-LQWF>] (62% support a minimum wage of \$15 and an additional 27% support a minimum wage higher than the current minimum wage but lower than \$15).

2. Low wages and the incentive to work

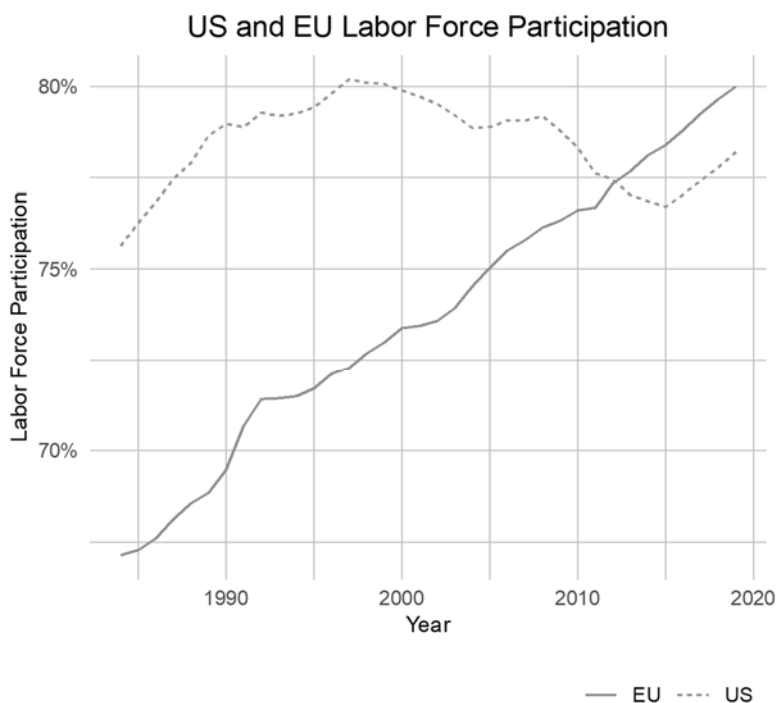
Low wages not only result in low incomes for those earning them, they also result in lower employment. The compensation paid to workers is the chief inducement to work. Few would work for free, and the higher wages are, the more attractive work becomes relative to its alternatives. Anyone familiar with recent economic headlines might be surprised to learn that low wages are inhibiting work in the U.S., given that the unemployment rate is near its all-time low.²⁵ Unemployment statistics, however, only reveal part of the story because they only include those looking for work. A more complete picture of the labor market requires an understanding of labor force participation.

The labor force participation rate is the fraction of the working age population currently working or looking for work.²⁶ According to the Organisation for Economic Co-operation and Development (OECD), the U.S. labor force participation rate is 77.3%, which is low compared to many of its peer countries.²⁷ The following graph plots the labor force participation rate in both the U.S. and the EU since 1996. It shows that the long-run trend of labor force participation is down for the U.S. and up for the EU, and that since 2012, EU labor force participation has exceeded U.S. labor force participation.

25. The July 2023 unemployment rate was 3.5%. U.S. DEP'T OF LAB., BUREAU OF LAB. STAT., USDL-23-0630, THE EMPLOYMENT SITUATION — AUGUST 2023 4 (2023), <https://www.bls.gov/news.release/pdf/empisit.pdf> [<https://perma.cc/RL2T-2CNY>].

26. Different institutions define working age population differently. *See, e.g.*, ORG. FOR ECON. CO-OPERATION & DEV., LABOUR FORCE PARTICIPATION RATE (2023), <https://data.oecd.org/emp/labour-force-participation-rate.htm#:~:text=Definition%20of,percentage%20of%20each%20age%20group> [<https://perma.cc/3G2R-NS5J>] (which includes people aged 15 to 64); U.S. DEP'T OF LAB., BUREAU OF LAB. STAT., LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY, AT CIVILIAN LABOR FORCE, OR LABOR FORCE (Jan. 11, 2023), <https://www.bls.gov/cps/definitions.htm#laborforce> [<https://perma.cc/LH74-4MUX>] (which includes people aged 16 and older). Other definitional issues include how to account for institutionalized people and members of the armed forces.

27. ORG. FOR ECON. CO-OPERATION & DEV., LABOUR FORCE PARTICIPATION RATE (2021), <https://data.oecd.org/emp/labour-force-participation-rate.htm#:~:text=Definition%20of,percentage%20of%20each%20age%20group> [<https://perma.cc/LD9S-JZ4B>] The BLS defines labor force participation differently. Under the BLS definition, the labor force participation rate is 62.3%. U.S. DEP'T OF LAB., BUREAU OF LAB. STAT., GRAPHICS FOR ECONOMIC NEWS RELEASES (2023), <https://www.bls.gov/charts/employment-situation/civilian-labor-force-participation-rate.htm> [<https://perma.cc/5MAA-R5ZK>].



This naturally raises the question: Why has labor force participation decreased in the U.S.? Some of the decrease is explained by changing demographics, including an older population.²⁸ But the largest share of the decline is attributable to the declining participation of men in their prime working years.²⁹ Among developed countries, only Italy has a lower labor force participation among men between ages twenty-five and fifty-four.³⁰ The downward trend in labor force participation among men is predominantly experienced by those with no more than a high school education.³¹ The preponderance of the evidence attributes this trend to lower labor demand because of changes in international trade and technology.³² In other words, changing economic conditions have

28. Those over 55 are less likely to work, so, if the share of the working age population shifts towards those above 55, one would expect a lower labor force participation rate. Dotsey et al., *supra* note 15, at 18.

29. *Id.* at 18–20.

30. *Id.* at 18.

31. *Id.* at 20. And for this segment of the population, eschewing the labor force is often not transitory. *Id.* at 21. These men spend more time engaged in recreation and rely on other household members and government assistance to finance their consumption. *Id.*

32. See Katharine G. Abraham & Melissa S. Kearney, *Explaining the Decline in the US Employment-to-Population Ratio: A Review of the Evidence*, 58 J. ECON. LITERATURE 585, 585–643 (2020)

lowered the wages U.S. employers are willing to pay workers with no more than a high school education. There is surely a wage at which U.S. employers would gladly hire low-wage workers, but this wage is too low to entice these workers.³³

B. Low-wage Work and Labor Market Failures

Beyond the financial hardships it is associated with, low-wage work implicates two market failures.³⁴ The first is the market power exerted by employers in many local labor markets to inefficiently depress wages, sacrificing hiring and output for higher profits. The second is the negative externalities of low-wage work and low labor force participation, which have adverse community-wide, fiscal, and intergenerational effects.

1. Employer market power and low-wage work

Nearly 60% of GDP is compensation paid in exchange for labor.³⁵ In the labor market, businesses are buyers of labor, employees are sellers of labor, and wages are the price employers pay to hire additional labor.³⁶ In an allocatively efficient labor market, employers will hire workers until the value of the additional product that an employee produces is eclipsed by the wage necessary to hire that employee.³⁷

(suggesting that labor demand factors were more likely responsible than labor supply factors (e.g. increases in welfare) and institutional factors and frictions (e.g. changes in the minimum wage)); Kerwin Kofi Charles, Erik Hurst, & Matthew J. Notowidigdo, *The Masking of the Decline in Manufacturing Employment by the Housing Bubble*, 30 J. ECON. PERSPECTIVES 179, 179–200 (2016) (arguing that long-run structural forces best explain the labor market outcomes for low-skill workers, but that the hot housing market before the Great Recession masked these structural forces).

33. And these wages may be below the minimum wage.

34. A market failure prevents the economy from achieving allocative efficiency. An economic outcome achieves allocative efficiency if (1) it is impossible to increase the amount of something valuable without decreasing the amount of some other valuable thing and (2) the relative quantity of valuable things corresponds to people's preferences. PAUL KRUGMAN & ROBIN WELLS, MICROECONOMICS 29 (3d ed. 2012).

35. *Share of Labor Compensation in GDP at Current National Prices for United States*, FED. RESRV. ECON. DATA (Jan. 21, 2021), <https://fred.stlouisfed.org/series/LABSHPUA156NRUG> [<https://perma.cc/DA7Z-MMY5>]; CONG. BUDGET OFF., THE DISTRIBUTION OF HOUSEHOLD INCOME, 2018 5 (2021), <https://www.cbo.gov/publication/57404> [<https://perma.cc/5APZ-RRQK>].

36. Market wages are adjusted for differences in the quality of a job or, in economist jargon, have compensating differentials. See PIERRE CAHUC, STÉPHANE CARCILLO, ANDRÉ ZYLBERBERG, WILLIAM MCCUAIG, STÉPHANE CARCILLO, & ANDRÉ ZYLBERBERG, LABOR ECONOMICS 170–74 (2d ed. 2014).

37. See *id.* at 153–56.

Assuming no other market failure, this is the outcome when there are many employers, none of which can individually influence the market wage. With many employers, if any individual employer attempted to pay less than the market wage for a particular job, it would not be able to hire or retain workers for that job.

Businesses employing a substantial fraction of a local labor market operate under different conditions. If such a business lowered its wage, it would still offer the best employment opportunities for many workers in that labor market. This employer would lose some, but not all, of its workers. In this setting, even if an additional worker would generate enough revenue to be worth a higher wage, an employer may not wish to raise wages to hire additional workers because the employer would then have to (eventually) raise the wages of the workers already in its employ. In other words, raising wages to attract new workers generally means paying current workers more too. These employers maximize their profit with lower wages, less hiring, and lower output, relative to the allocatively efficient outcome. The fewer employers there are, the more concentrated the labor market is and the lower the wage will be relative to its efficient level.³⁸

Several studies offer evidence supporting the theory that employer market power drives down wages and employment for low-wage workers and lowers output.³⁹ Economists have found that 60% of U.S. labor markets (which account for 16% of employment) are highly concentrated.⁴⁰ And, as theory predicts, higher concentration is associated with lower wages.⁴¹ One study found that, at an average manufacturing plant, labor market concentration resulted in a 35% markdown for the marginal worker's wages relative to the perfect competition outcome.⁴² A second study found that moving from the 25th percentile of labor market concentration to the 75th percentile of concentration was associated with

38. Efraim Benmelech, Nittai K. Bergman & Hyunseob Kim, *Strong Employers and Weak Employees: How Does Employer Concentration Affect Wages?*, 57(S) J. HUM. RES. S200, S200 (2022) (“consistent with labor market monopsony power, there is a negative relation between local-level employer concentration and wages that strengthens with time”).

39. See generally Alan Manning, *Monopsony in Labor Markets: A Review*, 74 ILR REV. 3 (2021). Employer labor market power may also explain inequality and labor share trends. *Id.* at 20.

40. José Azar, Ioana Marinescu, Marshall Steinbaum, & Bledi Taska, *Concentration in US Labor Markets: Evidence from Online Vacancy Data*, 66 LABOUR ECON. 1, 1 (Oct. 2020); see also David Berger, Kyle Herkenhoff & Simon Mongey, *Labor Market Power*, 112 AM. ECON. REV. 1147 (2022).

41. Azar et. al., *supra* note 40, at 1.

42. Chen Yeh, Claudia Macaluso, & Brad Hershbein, *Monopsony in the US Labor Market*, 112 AM. ECON. REV. 2099, 2099 (2022) (finding that workers earned only 65 cents on the marginal dollar generated and that this markdown decreased between the late 1970s and the early 2000s).

a 5% to 17% decline in posted wages.⁴³ There is also evidence suggesting that the economy-wide impact of labor market concentration is substantial. One study, using responses to state-level tax changes as a natural experiment, found that labor market concentration resulted in 20.9% less aggregate output and 7.6% lower aggregate wellbeing.⁴⁴

Workers with more education and greater geographic mobility are comparatively insulated from employer market power. Workers with higher levels of education compete with fewer other workers for jobs that impose an education requirement. And workers who are geographically mobile effectively have a larger pool of potential employers who compete for these workers with higher wages.⁴⁵ Given that high-wage workers tend have more education and be more mobile, labor market power likely has a disproportionate effect on low-wage workers.

2. The negative externalities of low-wage work

The role of labor extends far beyond its contribution to GDP. For most employees, working accounts for a plurality of their waking hours and is thus central to their experience of life.⁴⁶ Employment has the potential to provide social interaction, a sense of purpose and belonging, and invigorating mental stimulation.⁴⁷ Unemployment, on the other

43. José Azar, Ioana Marinescu, & Marshall Steinbaum, *Labor Market Concentration*, 57 J. HUM. RES. 167, 167–69 (2022).

44. David Berger, Kyle Herkenhoff, & Simon Mongey, *Labor Market Power*, 112 AM. ECON. REV. 1147, 1151 (2022).

45. Patrick J. Purcell, *Geographic Mobility and Annual Earnings in the United States*, 80 SOC. SEC. ADMIN., 1, 3 (2020); see also Mike Zabek, *Local Ties in Spatial Equilibrium*, (Fin. & Econ. Discussion Series, Paper No. 2019-080, 2019), <https://www.federalreserve.gov/econres/feds/files/2019080pap.pdf> [perma.cc/D2X9-L8XN].

46. See U.S. DEPT OF LAB., BUREAU OF LAB. STAT., AMERICAN TIME USE SURVEY — 2021 RESULTS, USDL-22-1261 tbl.2 (June 22, 2022), <https://www.bls.gov/news.release/pdf/atus.pdf>.

47. A study using a collapse in the Spanish construction industry as a natural experiment found “that an increase of the unemployment rate by 10 percentage points due to the breakdown in construction raised reported poor health and mental disorders in the affected population by 3 percentage points, respectively.” Lidia Farré, Francesco Fasani, & Hannes Mueller, *Feeling Useless: The Effect of Unemployment on Mental Health in the Great Recession*, 7 IZA J. LAB. ECON., 1, 1 (2018). Furthermore, when there was little hope of re-entering employment, “[it] led to long unemployment spells, stress, hopelessness, and feelings of uselessness.” *Id.* After being unemployed, workers experienced high rates of “symptoms of somatization, depression, and anxiety” compared to those who remained employed. Margaret W. Linn, Richard Sandifer, & Shayna Stein, *Effects of Unemployment on Mental and Physical Health*, 75 AM. J. PUB. HEALTH 502, 502 (1985). “Employment requires one to learn new skills, establish a routine, and engage socially, all of which can also provide purpose or meaning to one’s life and provide income. All of these can directly or indirectly bolster cognitive reserve, which may protect cognitive health, especially as one ages.” David E. Vance, Jennifer Bail, Comfort C. Enah, Jennifer J. Palmer, & Anna K. Hoenig, *The Impact of Employment on Cognition and Cognitive Reserve: Implications Across Diseases and Aging*, 6 NURSING: RSCH. & REVS. 61, 61 (2016). A study

hand, is associated with higher rates of substance abuse treatment admission.⁴⁸ And there is evidence that job loss is a substantial cause of opioid overdose mortality in the U.S.⁴⁹ Deficient labor markets also push workers towards alternatives to employment, including crime and government benefits.⁵⁰ Moreover, communities facing a locally

of older adults found “sustained engagement in cognitively demanding, novel activities enhances memory function in older adulthood.” Denise C. Park, Jennifer Lodi-Smith, Linda Drew, Sara Haber, Andrew Hebrank, Gérard N. Bischof, & Whitley Aamodt, *The Impact of Sustained Engagement on Cognitive Function in Older Adults: The Synapse Project*, 25 PSYCH. SCI. 103, 103 (2014). It is worth keeping in mind that there is a selection bias when measuring the effect of unemployment on various health outcomes. There may be an unobserved difference between those who are working and those who are not. See John Bound & Timothy Waidman, *Estimating the Health Effects of Retirement* (Mich. Retirement Rsch. Ctr., Working Paper No. 2007-168, 2007).

48. A percentage point increase in the unemployment rate is associated with an 9% increase in substance abuse treatment admissions. Sunday Azagba, Lingpeng Shan, Fares Qeadan, & Mark Wolfson, *Unemployment Rate, Opioids Misuse and Other Substance Abuse: Quasi-Experimental Evidence from Treatment Admissions Data*, 21 BMC PSYCHIATRY, 1, 1 (2021); Dieter Henkel, *Unemployment and Substance Use: A Review of the Literature (1990-2010)*, 4 CURRENT DRUG ABUSE REVS. 4, 4 (2011) (“Over one hundred-thirty relevant studies were identified investigating these issues. The main results are as follows: (1) Risky alcohol consumption (associated with hazardous, binge, and heavy drinking) is more prevalent among the unemployed. They are also more likely to be smokers, to use illicit and prescription drugs, and to have alcohol and drug disorders (abuse, dependence). (2) Problematic substance use increases the likelihood of unemployment and decreases the chance of finding and holding down a job. (3) Unemployment is a significant risk factor for substance use and the subsequent development of substance use disorders. However, the current research provides only limited information about which individuals are more likely to be affected. (4) Unemployment increases the risk of relapse after alcohol and drug addiction treatment. (5) The exact nature of the relationship between unemployment and the probability of smoking cessation remains unclear due to the mixed results observed in the literature review. (6) Drinking and smoking patterns appear to be procyclical.”).

49. Pinghui Wu & Michael Evangelist, *Unemployment Insurance and Opioid Overdose Mortality in the United States*, 59 DEMOGRAPHY 485, 485 (2022); see also *Overdose Death Rates*, NAT’L INST. ON DRUG ABUSE (Jan. 20, 2022), <https://nida.nih.gov/research-topics/trends-statistics/overdose-death-rates> [https://perma.cc/Y5PW-VEXP]; *Provisional Drug Overdose Death Counts*, CTRS. FOR DISEASE CONTROL & PREVENTION (Sept. 14, 2022), <https://www.cdc.gov/nchs/nvss/vsrr/drug-overdose-data.htm> [https://perma.cc/ZD86-G3C5].

50. Unemployment rates and crime rates are correlated. Eric D. Gould, Bruce A. Weinberg & David B. Mustard, *Crime Rates and Local Labor Market Opportunities in the United States: 1979-1995*, 84 REV. ECON. STAT. 45, 45 (2002); Steven Raphael & Rudolf Winter-Ebmer, *Identifying the Effect of Unemployment on Crime*, 44 J.L. & ECON. 259, 259 (2001) (“We find significantly positive effects of unemployment on property crime rates that are stable across model specifications. Our estimates suggest that a substantial portion of the decline in property crime rates during the 1990s is attributable to the decline in the unemployment rate. The evidence for violent crime is considerably weaker.”); EDMUND S. PHELPS, *REWARDING WORK: HOW TO RESTORE PARTICIPATION AND SELF-SUPPORT TO FREE ENTERPRISE* 32 (1997) (a decline in labor force participation for disadvantaged men correlates to increased convictions and incarcerations). In the US, limited labor market options may be driving workers to take up disability benefits, which may be preferable to low wages. Chana Joffe-Walt, *Unfit for Work: The Startling Rise of Disability in America*, NAT’L PUB. RADIO (2013), <https://apps.npr.org/unfit-for-work/> [https://perma.cc/V8JP-T5AK]. Furthermore, the disability benefits program incentivizes workers to avoid seeking employment. *Id.* See also *Beneficiaries in Current-Payment Status*, SOC. SEC. ADMIN., OFF. RET. & DISABILITY POLY, https://www.ssa.gov/policy/docs/statcomps/di_ast/2016/secto1.html [https://perma.cc/CSP6-ATZY] (last visited Sept. 15, 2023).

concentrated high unemployment rate over a prolonged period may become alienated from the economic mainstream.⁵¹ Workers from these communities face zip code discrimination when applying for jobs, have scant access to the information flows that are conducive to finding work, and generally have difficulty forming or connecting with the networks that result in gainful employment.⁵²

While the brunt of these burdens is borne by those residing in the affected communities, there are important costs that spill over more broadly. When labor markets do not provide adequate opportunities, those outside the directly affected areas are still subject to the impacts of higher crime rates and drug usage, smaller tax bases, and public expenditures directed toward programs that mitigate the harm of unemployment and low wages as opposed to alternatives.⁵³

Employment and wages also have intergenerational consequences.⁵⁴ Children with low-income parents are far more likely to be low-income themselves, at least in part because parents with higher incomes can invest more in the human capital of their children and because of the important role networks may play in children's earning potential.⁵⁵ For example, high-means parents may opt to move to a better-funded school

51. EDMUND S. PHELPS, REWARDING WORK: HOW TO RESTORE PARTICIPATION AND SELF-SUPPORT TO FREE ENTERPRISE 40–43 (1997); see generally WILLIAM JULIUS WILSON, WHEN WORK DISAPPEARS: THE WORLD OF THE NEW URBAN POOR (1996).

52. PHELPS, *supra* note 51, at 40–42.

53. *Id.* at 45–46.

54. *Id.* at 38–39 (describing cycles of poverty).

55. A parent's ranking in the income distribution is a strong predictor of a child's ranking in the income distribution. Espen Bratberg, Jonathan Davis, Bhashkar Mazumder, Martin Nybom, Daniel D. Schnitzlein, & Kjell Vaage, *A Comparison of Intergenerational Mobility Curves in Germany, Norway, Sweden, and the US*, 119 SCAND. J. ECON. 72, 75 (2017). Moreover, ranking persistence is higher in the U.S. than in other countries. *Id.* And there is evidence that income mobility is decreasing. Raj Chetty, David Grusky, Maximilian Hell, Nathaniel Hendren, Robert Manduca, & Jimmy Narang, *The Fading American Dream: Trends in Absolute Income Mobility Since 1940*, 356 SCI. 398 (2017). Increasing inequality has amplified the relative harm of being born to low-income parents. Raj Chetty, Nathaniel Hendren, Patrick Kline, Emmanuel Saez, & Nick Turner, *Is the United States Still a Land of Opportunity? Recent Trends in Intergenerational Mobility*, 104 AM. ECON. REV. PAPERS & PROC. 141, 141 (2014). Low income mobility entrenches racial disparities. Randall Akee, Maggie R. Jones, & Sonya R. Porter, *Race Matters: Income Shares, Income Inequality, and Income Mobility for All U.S. Races*, 56 DEMOGRAPHY 999, 999 (2019). Parents with higher incomes tend to invest more in the human capital of their children. Gary Solon, *A Model of Intergenerational Mobility Variation Over Time and Place*, in GENERATIONAL INCOME MOBILITY IN NORTH AMERICA AND EUROPE 41 (Miles Corak ed., 2004). "The share of high-SES friends among individuals with low SES—which we term economic connectedness—is among the strongest predictors of upward income mobility identified to date." Raj Chetty, Matthew O. Jackson, Theresa Kuchler, Johannes Stroebel, Nathaniel Hendren, Robert B. Fluegge, Sara Gong, Federico Gonzalez, Armelle Grondin, Matthew Jacob, Drew Johnston, Martin Koenen, Eduardo Laguna-Muggenburg, Florian Mudekerezza, Tom Rutter, Nicolaj Thor, Wilbur Townsend, Ruby Zhang, Mike Bailey, Pablo Barberá, Monica Bhole, & Nils Wernert, *Social Capital I: Measurement and Associations with Economic Mobility*, 608 NATURE 108 (2022).

district or send their children to private schools, affording them access to advantageous educational opportunities and wealthier classmates.⁵⁶ And children whose parents experience an unexpected and adverse change to their employment status have a lower likelihood of attending college and lower lifetime earnings.⁵⁷

Higher wages would draw more workers into jobs and increase the earnings of existing workers. However, employers have no incentive to increase wages to counteract the negative externalities of low wages and labor force participation. Wages do not generally include a social premium corresponding to the lower rates of drug usage, crime, and poverty, and the better intergenerational outcomes that would likely result if wages were higher. The labor market is thus allocatively inefficient, and low-end wages do not reflect the full social value of work.

C. Existing Policy Solutions

Governments in the U.S. already have policies in place aimed at improving the labor market, including minimum wage laws and the EITC. This Section explains why these policies, while likely beneficial, fall short of a complete policy solution. It also provides some general analysis about what an optimal labor market policy requires, setting the stage for Part II's exploration of a tax-based labor market intervention.

1. The minimum wage

Recall that the problem with the U.S. labor market is that the compensation available to many is too low to provide financial security and too low to incentivize work. An optimal policy intervention ought to increase both

56. When families are randomly moved to wealthier neighborhoods, the children experience higher future earnings. Eric Chyn, *Moved to Opportunity: The Long-Run Effects of Public Housing Demolition on Children*, 108 AM. ECON. REV. 3028, 3029 (2018); Raj Chetty, Nathaniel Hendren, & Lawrence F. Katz, *The Effects of Exposure to Better Neighborhoods on Children: New Evidence from the Moving to Opportunity Experiment*, 106 AM. ECON. REV. 855, 858 (2016). A study using random assignment also found that having higher achieving classmates increased future earnings. Raj Chetty, John N. Friedman, Nathaniel Hilger, Emmanuel Saez, Diane Whitmore Schanzenbach, & Danny Yagan, *How Does Your Kindergarten Classroom Affect Your Earnings? Evidence From Project Star*, 126 Q. J. ECON. 1593, 1622 (2011).

57. See generally Bryan A. Stuart, *The Long-Run Effects of Recessions on Education and Income*, 14 AM. ECON. J. APPLIED ECON. 42, 67 (2022); Milena Nikolova & Boris N. Nikolaev, *Family Matters: The Effects of Parental Unemployment in Early Childhood and Adolescence on Subjective Well-Being Later in Life*, 181 J. ECON. BEHAV. & ORG. 312, 315 (2021); Martti Kaila, Emily Nix, & Krista Riukula, *Disparate Impacts of Job Loss by Parental Income and Implications for Intergenerational Mobility* (Opportunity & Inclusive Growth Inst., Working Paper No. 53, 2021).

wages and hiring. Any solution that achieves only one of these outcomes (or, worse yet, one of these outcomes at the expense of the other) is incomplete.

This is the shortcoming of a higher minimum wage, which the federal government has set at \$7.25 per hour.⁵⁸ There is evidence suggesting that *small* increases to the minimum wage would have only negligible adverse effects on hiring—and perhaps none at all.⁵⁹ But a higher minimum wage is unlikely to increase hiring. And a substantially higher minimum wage—say \$15 per hour—would create strong incentives for employers to find alternatives to U.S. workers, thereby *lowering* hiring in the U.S., counter to the stated policy objective.⁶⁰ That is not to say that a higher minimum wage is bad policy—only that it is, at most, an incomplete solution to the U.S. labor market’s problem. More generally, optimal policy cannot increase the cost of hiring workers in the U.S. If the cost of hiring workers increases, U.S. businesses will respond by, at best, not hiring additional workers and, at worst, hiring fewer U.S. workers, counter to the stated policy objective.

2. The earned income tax credit

A promising path to improving labor market outcomes for low-wage workers is to decrease the cost of hiring U.S. workers either by subsidizing low-wage workers for working or by subsidizing employers for hiring low-wage workers.⁶¹ Under a simple, neoclassical economics

58. *Minimum Wage*, U.S. DEP’T LAB. (2023), <https://www.dol.gov/general/topic/wages/minimum-wage> [https://perma.cc/2K58-XF42]. Many states set higher minimum wages.

59. See David Card & Alan B. Krueger, *Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania*, 84 AM. ECON. REV. 772, 792 (1994). However, increasing the minimum wage may decrease the incentive for businesses to make capital investments which may have adverse long-run labor market effects. Isaac Sorkin, *Are There Long-Run Effects of the Minimum Wage?*, 18 REV. ECON. DYNAMICS 306, 322 (2015).

60. Economic studies suggest that large changes to minimum wages have substantial effects. See, e.g., Claus Thustrup Kreiner, Daniel Reck, & Peer Ebbesen Skov, *Do Lower Minimum Wages for Young Workers Raise Their Employment? Evidence from a Danish Discontinuity*, 102 REV. ECON. & STAT. 339 (2020). Alternatives to domestic hiring include hiring in other jurisdictions and automation. A similar line of reasoning applies to expanding union membership. Unions consolidate employees’ interests so that their bargaining power better matches that of their employers. Unions have increased compensation and working conditions for workers. See generally Richard B. Freeman & James L. Medoff, *What Do Unions Do?*, 38 INDUS. & LAB. RELS. REV. 244 (1985). However, the more successful unions are at raising wages, the more likely they are to decrease hiring.

61. If an employee subsidy were introduced, more workers would want to enter the labor market. As more workers competed for jobs, the wages employers paid would fall. Workers would generally be better off because the subsidy would be larger than the decrease in their pay. Because employers would pay less, they would hire more workers. Because workers would earn more after accounting for the subsidy, more workers would accept jobs. The final result: more work at

framework, these two approaches are equivalent—there is no reason to prefer an employer-side subsidy to an employee-side subsidy or vice versa.

In practice, the chief advantage of employee-side subsidies is that they are relatively better at realizing the ability-to-pay principle compared to employer-side subsidies. For example, a low-wage worker with a high-income spouse filing a joint tax return would not be eligible for the EITC but would benefit from a higher wage resulting from an employer-side subsidy. More broadly, an employer-side subsidy has no direct way to account for the financial circumstances of workers who benefit from the subsidy. Employee-side subsidies are, thus, more targeted.

On the other hand, behavioral frictions impede the effectiveness of low-wage employee subsidies, including the EITC. The EITC offers low-wage workers a subsidy which increases with their earned income and the number of qualifying children they have.⁶² The subsidy then phases out at higher levels of income. In theory, the EITC should encourage more people to work. If the tax system makes working more attractive for low-income workers, one would generally expect more low-income workers. However, the available empirical evidence on the impact of the EITC on employment is mixed. One study found that, apart from the 1993 tax reform, the EITC has had no measurable impact on labor supply.⁶³ And while the 1993 EITC expansion did coincide with an increase in labor supply, the interpretation of this correlation is confounded by the substantial and simultaneous reduction in welfare programs and the macroeconomic conditions at the time.⁶⁴

higher pay. If an employer subsidy were introduced, businesses would want to induce more workers to enter the labor market. To that end, businesses would increase employee compensation, effectively passing along some of the subsidy to their employees. Again, the final result: more work at higher pay.

62. I.R.C. § 32. The EITC pays workers a subsidy based on their earnings. I.R.C. § 32(a)(1); see also MARGOT L. CRANDALL-HOLLICK, CONOR F. BOYLE & GENE FALK, CONG. RSCH. SERV., R43805, THE EARNED INCOME TAX CREDIT (EITC): HOW IT WORKS AND WHO RECEIVES IT (2021). This subsidy varies based on the number of qualifying children the worker has. I.R.C. § 32(b)(1). A worker with no children receives a maximum subsidy of 7.65%, and a worker with three or more children receives a maximum subsidy of 45%. *Id.* Thus, if a worker with no children earned \$100, they could receive a subsidy of up to \$7.65; and if they had three children, they could receive up to \$45. There is a maximum credit dollar amount, which also varies by the number of children, and a phaseout, meaning that high-income earners are not eligible for the credit. I.R.C. § 32(b)(2).

63. Henrik Kleven, *The EITC and the Extensive Margin: A Reappraisal* 6 (Nat'l Bureau of Econ. Resch., Working Paper No. 26405, 2022). *But see* Diane Whitmore Schanzenbach & Michael R. Strain, *Employment Effects of the Earned Income Tax Credit: Taking the Long View*, 35 TAX POL'Y ECON. 87, 87 (2021).

64. Kleven, *supra* note 63, at 6. See also Lawrence M. Mead, *Overselling the Earned Income Tax Credit* 21 NAT'L AFF. 20, 29 (2014), <https://www.nationalaffairs.com/publications/detail/overselling-the-earned-income-tax-credit> [<https://perma.cc/742V-WLGR>] (describing 1995 research in which 60 welfare officials were asked about why welfare caseloads were plummeting. "They mentioned a

Behavioral economics offers three explanations for why the EITC may be less effective than neoclassical economic theory would predict.⁶⁵ First, there may be information frictions. For example, survey data suggest that only a small fraction of the relevant population is aware of the EITC, and one would expect a substantially smaller response (or even none at all) from oblivious taxpayers.⁶⁶ Second, fear of entanglements with the IRS may discourage taxpayers from claiming the EITC if they are uncertain of their eligibility.⁶⁷ Because the credit is a function of the number of dependent children, this is particularly true of taxpayers with unconventional household arrangements, where children have multiple caregivers spread over multiple homes. Third, potential workers may not be willing to lower their pre-tax wage demands even if the credit would raise their after-tax income. Say, for example, a taxpayer with three children were considering working. If their reservation wage were \$12 per hour, they would not accept a job paying \$10 per hour. If, however, they were eligible for the EITC, a \$10 per hour wage would yield an after-tax wage of \$14.50 per hour. If they mistakenly responded to the

wide range of factors, especially welfare reform, good economic conditions, and child-support enforcement. Not a single one cited the EITC or the state's own wage incentive.”).

65. This is an example of why the incidence of a tax might matter. See Zachary Liscow & William Woolston, *Who's In, Who's Out? Policy to Address Job Rationing During Recessions*, 70 TAX L. REV. 627, 628 (2017); see also James M. Poterba, Julio J. Rotemberg, & Lawrence H. Summers, *A Tax-Based Test for Nominal Rigidities*, 76 AM. ECON. REV. 659, 662–75 (1986); John J. Donohue, *Diverting the Coasean River: Incentive Schemes to Reduce Unemployment Spells*, 99 YALE L.J. 549, 596–99 (1989). A fourth reason, which is consistent with classical economics, is that the EITC phaseout creates a very high effective marginal tax rate, which might discourage work.

66. See, e.g., Saurabh Bhargava & Dayanand Manoli, *Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment*, 105 AM. ECON. REV. 3489, 3519 (2015); Katherin Ross Phillips, *Who Knows About the Earned Income Tax Credit?*, in THE URBAN INSTITUTE (NEW FEDERALISM: NAT'L SURV. OF AM.'S FAMILIES, SER. B, NO. B-27, 2001); Elaine Maag, *Paying the Price? Low-Income Parents and the Use of Paid Tax Preparers*, in THE URBAN INSTITUTE (NEW FEDERALISM: NAT'L SURV. OF AM.'S FAMILIES, SER. B, NO. B-64, 2005); Wojciech Kopczuk & Cristian Pop-Eleches, *Electronic Filing, Tax Preparers and Participation in the Earned Income Tax Credit*, 91 J. PUB. ECON. 1351, 1351 (2007); ALAN BERUBE, ANNE KIM, BENJAMIN FORMAN & MEGAN BURNS, *THE PRICE OF PAYING TAXES: HOW TAX PREPARATION AND REFUND LOANS ERODE THE BENEFITS OF THE EITC* (Brookings Inst. & the Progressive Pol'y Inst. 2002); Raj Chetty & Emmanuel Saez, *Teaching the Tax Code: Earnings Responses to an Experiment with EITC Recipients*, AM. ECON. J. APPLIED ECON. 1, 1 (2013).

67. Saurabh Bhargava & Dayanand Manoli, *Psychological frictions and the incomplete take-up of social benefits: Evidence from an IRS field experiment*, 105 AM. ECONOMIC REVIEW 3489, online app. tbl. A2 (2015) (finding that of eligible survey participants 44% would not claim because of perceived ineligibility, 24% would not claim because the forms are too confusing, 7% would not claim because the benefits were too small, 7% would not claim because they feared a penalty or an audit, and 2% would not claim because they did not need government help). Taxpayers may have difficulty determining their eligibility for the EITC, and mistakenly claiming the EITC may result in a substantial penalty. Moreover, favorable interactions with the IRS may require either tax counsel or tax literacy, which relatively few low-wage workers may have. The end result may be a chilling effect on EITC claims. See Michelle Lyon Drumbl, *Those Who Know, Those Who Don't, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns*, 11 PITT. TAX REV. 113 (2013).

\$10 incentive as opposed to the \$14.50 incentive, they would not take the job. In other words, a robust employment response to the EITC would require workers to respond to their after-tax income and adjust their pre-tax wage expectations, which many may not do.⁶⁸ If the EITC does not cause the pre-tax wage expectations of workers to fall, then businesses will have no incentive to hire more.⁶⁹

The behavioral frictions which limit the effectiveness of the EITC (and employee subsidies more generally) are likely smaller for employer subsidies.⁷⁰ While businesses are by no means unerring in their interactions with the tax system,⁷¹ they are generally better equipped to navigate the tax code than low-wage workers. Businesses are both more likely to know of advantageous tax code provisions and less likely to fear interactions with the IRS, meaning that businesses are more likely to respond to incentives in the tax code. For example, numerous studies have found that firms are highly responsive to tax incentives aimed at increasing research and development.⁷² This is especially true for large, sophisticated businesses, which account for a large and growing share of employment.⁷³ Moreover, because subsidizing businesses to hire

68. Fewer than 5% of EITC claimants understand how their level of earned income changes the amount of credit they are eligible for. Jennifer L. Romich & Thomas Weisner, *How Families View and Use the EITC: Advance Payment Versus Lump Sum Deliver*, 53 NAT'L TAX J. 1245, 1255–56 (2000); see also *How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?: Hearing Before the S. Comm. on Fin.*, 112th Cong. 2 (2011) (statement of Raj Chetty, Professor of Economics, Harvard University); Chetty & Saez, *supra* note 67, at 1.

69. See Liscow & Woolston, *supra* note 65, at 629 n.5.

70. These limitations of the EITC do not necessarily make it bad policy. Even if it does little to increase employment, the EITC increases household income for low-wage workers. About 25 million workers received approximately \$60 billion in EITCs. *Statistics for Tax Returns with the Earned Income Tax Credit (EITC)*, INTERNAL REVENUE SERV., <https://www.eitc.irs.gov/eitc-central/statistics-for-tax-returns-with-eitc/statistics-for-tax-returns-with-the-earned-income> [<https://perma.cc/2UM8-GQF6>] (last visited Mar. 10, 2022). Moreover, some of the behavioral frictions caused by the current construction of the EITC could be reduced by simplifying it.

71. Some firms seem to make suboptimal use of their losses for income tax purposes. Eric Zwick, *The Costs of Corporate Tax Complexity*, AM. ECON. J. ECON. POL'Y, 467, 467 (May 2021); see also Dean Sonderegger, *Top 10 Tax and Accounting Mistakes Cost Companies Billions*, CFO MAG. (Mar. 11, 2015), <https://www.cfo.com/news/top-10-tax-and-accounting-mistakes-cost-companies-billions/664323/> [<https://perma.cc/KM6C-VTX4>] (conducting a survey of 200 in-house tax and accounting professionals at firms with revenues greater than one billion dollars).

72. Nick Bloom et al., *Do R&D Tax Credits Work? Evidence From a Panel of Countries 1979–1997*, 85 J. PUB. ECON. 1, 1 (2002) (“We estimate that a 10% fall in the cost of R&D stimulates. . . just under a 10% rise in R&D in the long-run.”); see generally, Bettina Becker, *Public R&D Policies and Private R&D Investment: A Survey of the Empirical Evidence*, 29 J. ECON. SURVS. 917 (2015).

73. The share of large firms (those with at least 100 employees) grew from 41% in 1978 to 48% in 2019. Christopher Goetz & Martha Stinson, *Business Dynamics Statistics Trace Evolution of Job Growth, Employment at U.S. Firms Over Four Decades*, U.S. CENSUS BUREAU (Feb. 16, 2022), <https://www.census.gov/library/stories/2022/02/united-states-startups-create-jobs-at-higher-rates-older-large-firms-employ-most-workers.html#:~:text=Mirroring%20the%20growing%20share%20of,of%20the%20series%20in%202019> [<https://perma.cc/2S3J-HRWH>].

induces them to increase the contract wages they offer, workers need not account for the subsidy in their labor market decisions. Since the employer subsidy increases both worker pre-tax and after-tax wages, the incentive will work even if workers misplace their attention and respond to pre-tax wages.

Given the evidence that behavioral frictions substantially hinder employee-side subsidies, there is a sound case for subsidizing employers to hire more low-wage workers and pay those workers more.⁷⁴ Contributing to this literature, the following two parts of this Article explore how the tax code might be used to effectuate these subsidies.

D. Other Policy Proposals

The government could use non-tax means to intervene in the labor market. The tax system, however, offers four important advantages. The first is ease of implementation.⁷⁵ The tax system already requires substantial information reporting from both taxpayers and related parties. As long as the subsidy would not require new reporting (or only a modicum of additional information already available to taxpayers), running the subsidy through the tax system would necessitate little effort on the part of taxpayers. Second, as a political matter, taxpayers are generally more receptive to expenditure programs run through the tax system.⁷⁶ Third, there is a clear precedent for Congress's use of the tax system to incentivize businesses investment in productive assets. Using the tax code to incentivize businesses to increase wages and employment engenders a politically appealing symmetry. Fourth, as discussed below, Congress could modify the tax code to change business labor market incentives by reimagining already existing tax provisions such that little, if any, additional strain would be placed on the U.S. deficit. This could limit the politically fraught need for unrelated tax increases, spending cuts, or additional borrowing to finance the subsidies.

There are also non-labor market approaches that have been suggested as ways to help struggling people—for example, universal basic income and a robot tax. The chief advantage of universal basic

74. See EDMUND S. PHELPS, *REWARDING WORK: HOW TO RESTORE PARTICIPATION AND SELF-SUPPORT TO FREE ENTERPRISE* 32 (1997); see also Liscow & Woolston, *supra* note 65, at 627; J. Michael Orszag & Dennis J. Snower, *Designing Employment Subsidies*, 10 *LAB. ECON.* 557, 558 (2003).

75. In general, whichever government agency is best equipped to implement a program should do so. See generally, David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 *YALE L.J.* 995 (2004).

76. Conor Clarke & Edward Fox, Note, *Perceptions of Taxing and Spending: A Survey Experiment*, 124 *YALE L.J.* 1252, 1279 (2015).

income relative to a labor market intervention is that it would provide assistance to all needy persons, even those not working.⁷⁷ It would not, however, create an incentive to work. Indeed, it could well create a disincentive to work.⁷⁸ The extent to which this is a disadvantage depends, in part, on the psychological and social value of work, a full discussion of which is beyond the scope of this Article. Moreover, the government budget cost per dollar transferred to the needy of universal basic income would likely be much larger than a labor market approach.⁷⁹

A robot tax, levied on technologies that replace workers, would discourage businesses from using those technologies and thus prevent workers from losing their jobs to robots.⁸⁰ Robot taxes would not require additional government funding (they would in fact raise revenue) and would thus avoid the challenges involved in financing a new government program. Robot taxes do, however, come with two important downsides. First, the effect of technology on workers is complicated and there is strong evidence that, in manufacturing at least, labor and capital are complements. The Ford assembly line, for example, automated manufacturing processes (and thus replaced workers by requiring fewer workers to make the same number of cars) but also created an enormous demand for additional workers.⁸¹ Determining which technologies decrease demand for workers and which increase demand for workers would be a challenge—especially considering that effects may vary over time. A technology that initially displaces workers may increase demand for workers after some time. Second, a non-global robot tax would not discourage businesses from using technologies in countries without robot taxes and would thus shift production into locations that

77. Logan Ward, *The Pros and Cons of Universal Basic Income*, UNIV. N. CAROLINA CHAPEL HILL COLL. ARTS & SCIS. (Mar. 10, 2021), <https://college.unc.edu/2021/03/universal-basic-income/> [<https://perma.cc/CU95-CFSD>].

78. *Id.*

79. With a labor market approach, some of the income accruing to low-means people would come from the employer and reflect the worker's marginal product. With a universal basic income approach, the entire payment would be funded by the government. A more precise comparison would require specific program design details beyond the scope of this Article.

80. See Ryan Abbott & Bret Bogenschneider, *Should Robots Pay Taxes: Tax Policy in the Age of Automation*, 12 HARV. L. & POL'Y REV. 145, 152 (2018); Jay A. Soled & Kathleen DeLaney Thomas, *Automation and the Income Tax*, 10 COLUM. J. TAX L. 1, 36–45 (2018). *But see* Orly Mazur, *Taxing the Robots*, 46 PEPP. L. REV. 277, 328 (2019).

81. The assembly line required fewer workers to move parts around and fit them together. Nonetheless, this technological change increased the marginal product of workers, resulting in higher demand for workers. Daniel M.G. Raff & Lawrence H. Summers, *Did Henry Ford Pay Efficiency Wages?*, 5 J. LAB. ECON. S57, S63–S69 (1987). More generally, economic studies have found that when the cost of capital falls, employment increases. *See, e.g.*, E. Mark Curtis, Daniel G. Garrett, Eric Ohrn, Kevin A. Roberts, & Juan Carlos Suárez Serrato, *Capital Investment and Labor Demand: Evidence from 21st Century Tax Policy* (Nat'l Bureau of Econ. Rsch., Working Paper No. 29485, 2022).

do not levy robot taxes, likely harming workers in the countries that do levy robot taxes.⁸²

All that is to say, there are indeed many possible policy interventions, each with its advantages and disadvantages. The aim here is simply to put forward a previously unexplored policy intervention to add to the menu of options available to policymakers.

II. REIMAGINING THE DEDUCTION FOR EMPLOYEE COMPENSATION

The current U.S. income tax regime affects the labor market by allowing a deduction for employee compensation. This deduction, however, is not calibrated to achieve any social or economic objective. But it could be, as this Part demonstrates, by offering a bonus deduction to employers for each job meeting or exceeding an adequate compensation and quality threshold. Of course, increasing deductions would lower government revenues, so this Part also discusses ways to raise revenue that would have some synergy with this bonus deduction.

A. A Bonus Deduction Incentive

This Section provides some background on the deduction for employee compensation and explains how a bonus deduction for compensation above a threshold amount would create business incentives that would help low-wage workers. This Section then notes that varying the deduction for employee compensation would be inconsistent with a pure income tax, while also highlighting that the current U.S. tax code generally (and the rules for deducting the cost of business assets specifically) is a far cry from a pure income tax.

82. Orly Mazur, *Taxing the Robots*, 46 PEPP. L. REV. 277, 300 (2019) (“Moreover, taxing robots would negatively impact a country’s international competitive position, which would drive production abroad and further exacerbate the loss of jobs, growing inequality, and lost tax revenues.”) A third issue is that defining “robot” is challenging. Many 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 and unpredictable ramifications. Robert Seamans, *Tax Not the Robots*, BROOKINGS INST. (Aug. 25, 2021), <https://www.brookings.edu/articles/tax-not-the-robots/> [<https://perma.cc/39YX-4EKT>].

1. Varying the deduction for employee compensation

The U.S. federal income tax regime allows businesses to deduct their expenses—including employee compensation, whether in the form of cash, non-cash benefits, or property—for the purposes of determining their income tax liability.⁸³ Employee compensation costs are deductible in the year incurred unless the employee's efforts contribute to the production of property, in which case different rules apply, generally deferring at least some of the deduction.⁸⁴

If a bank paid \$5,000,000 in wages to a banker and \$25,000 in wages to a secretary, the bank could properly deduct both of those expenses for the purpose of determining its income liability. The compensation paid would reduce the bank's taxable income and thereby reduce the bank's tax liability. At an effective tax rate of 20%, the banker's compensation would reduce the bank's tax liability by \$1,000,000, and the secretary's compensation would reduce the bank's tax liability by \$5,000.⁸⁵ In either case, the compensation would reduce the bank's tax liability by 20% of the compensation paid.⁸⁶ Notably, the reduction in tax liability accruing from an additional dollar of compensation to the banker would be the same as the reduction in tax liability accruing from an additional dollar of compensation to the secretary.⁸⁷ The deduction

83. I.R.C. § 162(a). There are a few exceptions, including for example a limitation on deducting the compensation paid to principal executive officers of publicly traded corporates. I.R.C. § 162(m). During times of economic hardship, Congress has sometimes given employers incentives to retain employees. For example, the New Jobs Tax Credit in 1977 and the Employee Retention Credit and deferral of employment tax deposits under the CARES Act. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126; CARES Act, Pub. L. No. 116-136, 134 Stat. 281 (2020); Rev. Proc. 2021-33, 2021-34 I.R.B. 327; *Deferral of Employment Tax Deposits and Payments Through December 31, 2020*, INTERNAL REVENUE SERV. (Apr. 22, 2022), <https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020> [<https://perma.cc/24PA-HVBP>].

84. The costs of producing inventory and property are not immediately deductible. I.R.C. § 263A. This includes some labor costs. *See, e.g.*, 26 C.F.R. § 1.263A-1(e)(3), (f). The costs of goods sold (inventory costs) are deducted from a business's gross receipts to arrive at gross income. 26 C.F.R. § 1.61-3. The cost of business property is deducted as the property depreciates. I.R.C. §§ 167-68.

85. For simplicity, assume that the marginal and effective tax rates are equal. Without this assumption, the underlying analysis remains essentially the same, but the examples necessary to elucidate these concepts become more cumbersome. Marginal tax rates will change with income when, for example, there are different tax rate brackets or the business has a net operating loss that it has carried over.

86. The employee compensation deduction is effectively paying 20% of the cost of hiring the employee. This employment subsidy is operationalized as an income tax deduction, but it is equivalent to a system that permits no wage deduction and allows a subsidy equal to the wage expense multiplied by the effective tax rate.

87. The equivalent tax benefit of an additional dollar of compensation to either holds regardless of whether marginal tax rates are constant or not.

rules themselves generally provide no incentive to pay more or less to any employee.⁸⁸

Changing the deduction for employee compensation would change business incentives to hire. If businesses received a larger deduction for dollars paid to low-wage workers, they would hire more low-wage workers.⁸⁹ If the larger deduction were contingent on paying workers at least a threshold compensation, businesses would have an incentive to pay workers at least that threshold compensation.⁹⁰ And if the larger deduction were contingent on other job features—including employer-provided healthcare, a minimum number of vacation days, parental leave, maximum hours per week—businesses would have an incentive to incorporate those features into their employment contracts, too.⁹¹

The deduction for employee compensation holds intriguing and unharnessed potential to change business incentives. Modifying the deduction could improve the U.S. labor market by incentivizing businesses to hire more workers and pay them more. The deduction could also be changed to achieve other objectives, including to raise additional government revenue, as discussed below.

88. Cf. I.R.C. § 162(m) (a notable exception are the principal executive officers covered under this code).

89. Businesses will use more of an input if it becomes cheaper. Every unit of input that a business decides to employ—be it an additional hour of labor, an additional gigabyte of cloud storage, or an additional square foot of factory space—has a marginal cost and a marginal benefit. The cost is what the business forgoes to use that unit of input and the benefit is what the business gains from that unit of input. Businesses only use inputs when the benefit exceeds the cost, and, in general, the cost of successive units increases while the benefit of successive units decreases. When the cost of an input falls, the marginal benefit of additional input exceeds the marginal cost, meaning that businesses will use more of that input. The marginal benefit of additional inputs generally tends to decrease because of the decreasing marginal product of each input and the decreasing marginal utility of the good being produced. If a car manufacturer increased the number of welders, holding all other inputs constant, the additional cars produced by each welder would decline. Moreover, the additional revenue from each car would decline as lower prices would be required to induce more buyers to purchase.

90. Joel Slemrod, *Buenas Notches: Lines and Notches in Tax System Design*, 11 *EJOURNAL TAX RSCH.* 259, 259 (2013) (in economics parlance, this is called a notch). A credit available to employers hiring an employee for a job meeting certain criteria would have a similar effect. OFF. OF DISABILITY EMP., POL'Y U.S. DEP'T OF LAB., TAX INCENTIVES FOR EMPLOYERS, <https://www.dol.gov/agencies/odep/program-areas/employers/tax-incentives-for-employers> [<https://perma.cc/8MA2-E2GV>] (such a credit already exists for a narrow class of employees and jobs) (last visited Nov. 14, 2023).

91. As a general principle, only those benefits which provide some societal benefit or which do not organically achieve an efficient level through employee-employer negotiations should be made a prerequisite for a larger deduction. For example, healthcare market failures may make government intervention efficient and equitable. David M. Cutler & Richard J. Zeckhauser, *Adverse Selection in Health Insurance*, 1 *F. FOR HEALTH ECON. & POL'Y* 1 (1998). Thomas Buchmueller & John DiNardo, *Did Community Rating Induce an Adverse Selection Death Spiral? Evidence from New York, Pennsylvania, and Connecticut*, 92 *AM. ECON. REV.* 280 (2002); Peter Zweifel & Willard G. Manning, *Moral Hazard and Consumer Incentives in Health Care*, 1 *HANDBOOK HEALTH ECON.* 409 (Anthony J. Culyer & Joseph P. Newhouse eds., 2000).

An alternative to a bonus deduction would be a bonus credit. A carefully designed deduction could be made nearly (if not entirely) equivalent to a credit—and vice versa. A deduction could be made partially refundable, and a deduction could be made to vary with the taxpayer's marginal tax rate, making the tax benefit invariant with respect to the taxpayer's marginal tax rate.⁹²

2. A bonus deduction example

There are many ways Congress could engineer a larger deduction for low-wage employee compensation. This Section offers an example of a very simple approach. Its aim is merely to illustrate the general concept—not claim that the specific structure (and especially not the specific numbers) is the optimal approach.

Say that every year, each business received a bonus deduction of \$60,000 for each worker it paid at least \$30,000 annually. To understand the effect of this bonus deduction, consider three types of jobs. As in the table below, Job A pays \$20,000, Job B pays \$30,000, and Job C pays \$180,000. Without the bonus deduction, assuming a 20% tax rate, compensating a worker reduces a business's tax bill by 20% of the compensation paid. Thus, after taking into consideration the tax reduction, the cost of hiring a worker is 80% of the compensation paid to that worker.

A bonus deduction of \$60,000 would further reduce the business's tax liability by 20% of the bonus deduction, which in this case would be \$12,000. In other words, the bonus deduction would increase an employer's tax reduction for any worker paid at least \$30,000 by \$12,000. Thus, the employer's cost of hiring a worker for Jobs B or C would fall by \$12,000, as shown in the table below.

TABLE 1: BONUS DEDUCTION EXAMPLE

Job Type	No Bonus Deduction			Bonus Deduction		
	Wages Paid	Tax Reduction	Net Cost	Tax Reduction	Net Cost	% Cost Reduction
A	\$20,000	\$4,000	\$16,000	\$4,000	\$16,000	0%
B	\$30,000	\$6,000	\$24,000	\$18,000	\$12,000	-50%
C	\$180,000	\$36,000	\$144,000	\$48,000	\$132,000	-8%

92. This Article contemplates both increasing and decreasing the deduction, which seems somewhat more natural than administering a positive and a negative credit. Therefore, the focus of the analysis is on the deduction.

While at first it may appear that the economic landscape has only changed for workers in Jobs B and C, the bonus deduction has three effects which result in more general benefits for workers. First, note that with the bonus deduction the net cost of a worker in Job B would be lower than the net cost of a worker in Job A—it would be cheaper to pay a worker \$30,000 than to pay a worker \$20,000. The same applies to a range of workers. For any worker earning above \$15,000 and below \$30,000, employers would save by raising the worker's compensation to \$30,000. The bonus deduction would therefore create an immediate and substantial incentive for employers to increase compensation for many low-wage workers.

Second, the bonus deduction would make workers cheaper and thus incentivize businesses to hire more. This effect would likely be much larger for workers in Job B because the bonus deduction would make those workers relatively cheaper. As the table above shows, in percentage terms, the bonus deduction would reduce the cost of Job B by 50% but would only reduce the cost of Job C by 8%.⁹³ In other words, without the bonus deduction, the cost to a business of a Job C worker would be equivalent to the cost of six Job B workers. With the bonus deduction, the cost to a business of a Job C worker would be equivalent to the cost of eleven Job B workers. Despite the reduction in absolute cost for Job C workers, those workers would be relatively more expensive because businesses would only receive one bonus deduction for each worker, no matter how much that worker were paid. Hiring more workers at the threshold compensation would be relatively more attractive than hiring workers well above the threshold because employers would receive the marginal product of the employee and a relatively larger tax benefit.

Third, the bonus deduction would tighten the labor market, which would benefit all workers, including the unemployed.⁹⁴ If businesses aimed to hire more workers because the cost of hiring had fallen, they would have to hire either those working elsewhere or those unemployed. Drawing workers away from either source would tighten the labor market. The bonus deduction would increase the pay and demand for Job B workers, meaning that Job A workers would shift towards Job B. Job B might require additional training, more arduous work, a longer commute, a less flexible schedule, or something else that either prevented businesses from offering more Job B-type work or prevented

93. If the compensation for Job A were increased to \$30,000, then the employer's cost would fall by 25%.

94. This increases the tightness of the labor market, but the effect may depend on general labor market conditions. If, for example, the bonus deduction were introduced during a recession, the effect would be different than if the bonus deduction were introduced during an expansion.

Job A workers from taking Job B work. The bonus deduction would lower these business costs, which would create an incentive for businesses to pay to train more workers or to hire less skilled workers. It would also increase worker pay which would create an incentive for workers to develop their own human capital and take on work that were in some other way less desirable.

The result would be a far more robust labor market, particularly for low-wage workers. These workers would bring not only their skills and efforts to the table but also a substantial tax benefit. For many jobs, employers would lower their net cost by increasing worker pay. More generally, employers would want to hire more workers because the bonus deduction would lower the after-tax cost of hiring, and they would want to increase business activity to take full advantage of the lower cost of labor. This would raise demand for labor generally, increasing compensation generally. As desired, both employment and wages would increase. The effect would be largest for workers who were paid below the eligibility threshold before the introduction of the bonus deduction and whose employers would benefit by making the job eligible for the bonus deduction.

It is worth explaining how the amount of bonus deduction and the threshold for bonus deduction eligibility change incentives. The benefit of a higher bonus deduction would be a larger incentive to increase compensation, resulting in more employment at higher wages. Note that the bonus deduction should not be set so high as to drop the after-tax cost of employment below zero. For example, if the employer's tax rate were 20% and the bonus deduction were \$300,000, then the after-tax cost of hiring a bonus-deduction-eligible worker for \$50,000 would be *negative* \$20,000. The employer would have an incentive to hire as many workers as possible (assuming refundability) even if they did no work. In this case, the bonus deduction would be an enormous hit to the fisc with relatively little positive policy impact.

The benefit of a higher bonus deduction threshold would be higher compensation for those workers whose compensation were increased to the threshold. So, for example, if the bonus deduction threshold were \$50,000 instead of \$30,000, more workers would have their compensation pushed to at least \$50,000.⁹⁵ However, the additional cost to employers would dampen the employer incentive to raise compensation substantially for some low-means workers, so fewer total workers would receive raises to reach the bonus deduction threshold. For example, if a

95. A higher threshold would also reduce the fiscal cost of the bonus deduction by decreasing the number of employees who would have eligible compensation levels.

job paid \$20,000, a bonus deduction of \$60,000 would provide a strong incentive to raise the job's compensation to a threshold of \$30,000 but not to a threshold of \$50,000. And just as with the bonus deduction, the threshold should be set to prevent the cost of hiring workers from falling below zero.

The bonus deduction discussed in this example was simple, but more intricate policies are possible. As noted above, the bonus deduction could be contingent on job features beyond compensation, including for example, benefits and flexible scheduling. There could also be bonus deduction tiers. For example, a \$60,000 bonus deduction for workers paid at least \$30,000 and an \$85,000 bonus deduction for workers paid at least \$40,000. The key point is that a bonus deduction gives employers an incentive to pay workers at least a threshold amount, giving the policymaker a powerful tool to intervene in labor markets.

3. Optimal deviations from a pure income tax

Some readers will observe that a dollar-for-dollar deduction for business expenses is inherent in a Haig-Simons income tax because business expenses reduce dollar-for-dollar the amount that a business can pay out to its owners.⁹⁶ Any modification of this deduction (including the bonus deduction and partial deductibility discussed in this Article) would be a deviation from this pure income tax. But Congress's mandate should be to design a tax system that most equitably and efficiently achieves its policy objectives, not to implement the purest income tax. And U.S. tax law is already replete with deviations from a pure income tax.⁹⁷ Indeed, Congress perpetually tinkers with the business tax treatment of productive assets because there is a political and academic consensus that getting that policy right is important. The resulting trend has been toward a more favorable tax treatment of these asset purchases and further from a pure Haig-Simons income tax.⁹⁸

96. A Haig-Simons income tax levies a tax on any increase in the taxpayer's ability to consume either now or in the future. JOSEPH BANKMAN, DANIEL N. SHAVIRO, KIRK J. STARK, & ERIN ADELE SCHARFF, *FEDERAL INCOME TAXATION* 363 n.2 (19th ed. 2023).

97. For example, capital gains are untaxed if there is no realization event. They are eliminated if the taxpayer holds the assets until death. I.R.C. § 1014. Certain non-cash employee compensation is excluded from income. I.R.C. §§ 132, 79, 106. Some gain from the sale of a primary residence is excluded from income. I.R.C. § 121. Different types of income are taxed at different rates. I.R.C. § 1. In addition, the federal government collects revenue from several excise taxes, which are inconsistent with an income tax. I.R.C. §§ 4001–5000D.

98. Jason G. Cummins, Kevin A. Hassett, & R. Glenn Hubbard, *A Reconsideration of Investment Behavior Using Tax Reforms as Natural Experiments*, 1994 BROOKINGS PAPERS ECON. ACTIVITY 1 (1994).

Under an income tax, businesses should be allowed to deduct the cost of productive assets.⁹⁹ For long-lived assets, the question arises, when should businesses be entitled to these deductions? A pure income tax would allow deductions only as the value of these assets declined. In the early 1900s, this was U.S. tax law.¹⁰⁰ Since then, the tax treatment of these deductions has changed, and the trend has been to allow businesses to take deductions earlier. In 1954, Congress allowed businesses to take accelerated depreciation deductions.¹⁰¹ In 1981, Congress expanded accelerated depreciation.¹⁰² In 2002, Congress started allowing businesses to immediately deduct some of the cost as bonus depreciation.¹⁰³ And in 2017, bonus depreciation was increased to the full cost of the asset.¹⁰⁴

Allowing businesses to take deductions earlier is tantamount to lowering the business tax rate because time-value-of-money-adjusted business tax payments are lower, as are treasury receipts.¹⁰⁵ The higher the discount rate, the greater the length of the deferral, and the larger the deferred amount, the lower the effective tax rate. And there is substantial evidence that this preferential tax treatment changes business behavior, increasing investment.¹⁰⁶

99. Under a pure income tax, purchasing long-lived assets has no tax consequences. The firm has traded money for an asset of equal value—the firm is neither better nor worse off and thus has neither income nor loss. When the firm uses the asset to generate value, there is taxable income. Concomitantly, the use of the asset will generally decrease its value, reducing the firm's income.

100. See DAVID W. BRAZELL, LOWELL DWORIN, & MICHAEL WALSH, U.S. TREASURY DEP'T, OFF. OF TAX ANALYSIS, OTA PAPER 64, A HISTORY OF FEDERAL TAX DEPRECIATION POLICY 3–4 (1989).

101. See Internal Revenue Act of 1954, Pub. L. No. 83-591, 68A Stat. 3.

102. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 203.

103. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 22. The deduction was retroactive to 2001. 116 Stat. at 23.

104. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified at I.R.C. § 168(k)).

105. Allowing businesses to take deductions earlier lowers their effective tax rate by virtue of the time value of money. Consider a business that has \$100 in revenue both this year and next and is entitled to a \$100 deduction but may choose to take it either this year or next year. If the business takes the deduction this year, its taxable income this year would be \$0, and its taxable income next year would be \$100. If the business opts to take the deduction next year, then its taxable income this year would be \$100, and its taxable income next year would be \$0. At a 20% tax rate, the business will pay \$20 in taxes in either case—the only question is when. Generally, the business will prefer paying later because it may then invest the \$20 for a year and earn a return on that investment. On the other side of the transaction, the Treasury will receive payment later, meaning that it will have lost the return on the remittance that it would have earned had it received payment earlier. Equivalently, the Treasury may borrow to finance government purchases this year and repay the debt with next year's tax receipts. In this case, the interest on the debt will reduce the amount the government can purchase.

106. There is a large empirical literature that finds increased investment in assets in response to more generous depreciation deductions. See Robert E. Hall & Dale W. Jorgenson, *Tax Policy and Investment Behavior*, 57 AM. ECON. REV. 391, 392, 407, 408, 413 (1969); Christopher L. House &

Congress has made no analogous exertion with respect to the business tax treatment of employee compensation.¹⁰⁷ The general rule allowing deductions for employee compensation has remained virtually unchanged since the inception of the U.S. federal income tax in 1913.¹⁰⁸ The only meaningful change in the tax treatment of employee compensation was the required capitalization of some employee compensation costs.¹⁰⁹ This change was likely made with little, if any, contemplation of its labor market effects and effectively raised the cost of hiring by requiring businesses to defer deductions arising from some employee compensation.¹¹⁰ In sum, just as the deduction for business assets deviates from a pure income tax to change incentives, so too could the deduction for employee compensation to achieve important policy objectives.

B. Financing a Bonus Deduction

This Section considers the fiscal impact of a bonus deduction and then explores some policies which could offset the cost of a bonus deduction, and which would have some economic or political synergies with the bonus deduction. The general concept is to reimagine existing tax benefits in such a way as to improve labor market conditions while limiting

Matthew D. Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation*, 98 AM. ECON. REV. 737, 737, 738, 757–62 (2008); Eric Zwick & James Mahon, *Tax Policy and Heterogeneous Investment Behavior*, 107 AM. ECON. REV. 217, 217, 218, 242–46 (2017); Eric Ohrn, *The Effect of Corporate Taxation on Investment and Financial Policy: Evidence from the DPAD*, 10 AM. ECON. J. ECON. POL'Y 272, 272, 273, 286–89, 299 (2018); Giorgia Maffini, Jing Xing, & Michael Devereux, *The Impact of Investment Incentives: Evidence from UK Corporation Tax Returns*, 11 AM. ECON. J. ECON. POL'Y, 361, 361, 362, 383–85 (2019); Curtis et al., *supra* note 81, at 2.

107. Outside of the deduction for employee compensation, Congress has used credits and payroll tax holidays as a way to incentivize businesses to retain workers during times of economic upheaval and to hire disadvantaged workers. See, e.g., *Deferral of Employment Tax Deposits and Payments Through December 31, 2020*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020> [<https://perma.cc/LXM2-7A4W>] (last updated Mar. 1, 2023); *Work Opportunity Tax Credit*, INTERNAL REVENUE SERV., <https://www.irs.gov/businesses/small-businesses-self-employed/work-opportunity-tax-credit> [<https://perma.cc/C7X6-WBY7>] (last updated Aug. 31, 2023); *Tax Incentives for Employers*, U.S. DEPT LAB. OFF. DISABILITY EMP. POL'Y, <https://www.dol.gov/agencies/odep/program-areas/employers/tax-incentives-for-employers> [<https://perma.cc/9R9N-MTUH>] (last visited Nov. 14, 2023).

108. Congress has made some small changes, including the disallowance of deductions for some employees. I.R.C. § 162(m).

109. Tax Reform Act of 1986, Pub. L. No. 99-514, §803(a), 100 Stat. 2085, 2350–55 (1986) (codified at I.R.C. § 263A).

110. § 263A's capitalization requirement brought the treatment of assets produced by a business more in line with the tax treatment of assets purchased by a business. JOSEPH BANKMAN, DANIEL N. SHAVIRO, KIRK J. STARK, & ERIN ADELE SCHARFF, *FEDERAL INCOME TAXATION* 367–68 (19th ed. 2023).

the impact on the government budget. For example, a bonus deduction would reduce business income tax liabilities, so one might seek other ways to increase business income tax liabilities to offset the bonus deduction impact. It is, in theory, possible to leave the government deficit constant while entirely changing business labor market incentives.

1. The fiscal impact of a bonus deduction

A bonus deduction would have a fiscal impact: The government's tax revenue would fall if it provided this incentive to businesses. Lower government revenue would divert resources from alternative uses. The precise fiscal consequences of the bonus deduction would depend on how it were designed. Many parameters would affect the cost, but, essentially, the larger the bonus deduction, the bigger the effect on low-income workers and the larger the government budget cost of the program.

Keeping with the numbers from the previous Section's example, a bonus deduction of \$60,000 would decrease government revenues by \$60,000 times the recipient business's marginal tax rate. At 21% (the current corporate tax rate), the cost would be \$12,600 per bonus deduction. As noted above, the bonus deduction would give firms an incentive to hire more workers with at least \$30,000 of compensation and increase the compensation of many current workers to at least \$30,000. Thus, the cost would be far larger than \$12,600 times the current number of workers earning over \$30,000.

Partially offsetting this cost would be several smaller increases in government revenue. First, as businesses expanded hiring and output in response to the bonus deduction, their gross incomes would almost certainly grow, resulting in more business tax revenue. Second, as current employees were paid more and more workers were hired, individual income tax and FICA tax receipts would increase.¹¹¹ In some cases, the revenue increase would be material. In the previous Section, an employer might raise an employee's compensation by \$15,000 to make that employee's job eligible for a bonus deduction. But even at a high marginal tax rate, the additional tax revenue collected would be small relative to the revenue lost from the bonus deduction.¹¹² And for many workers, the additional tax revenue would be negligible. Workers, for

111. Higher incomes would, however, also increase future social security benefits owed.

112. Even at a 37% tax rate (the highest individual income tax rate), a \$15,000 compensation increase yields only an additional \$5,550 in revenue, which is much less than the revenue lost from an additional bonus deduction.

example, at or above the bonus deduction threshold might see small increases in compensation as the labor market tightened, but these workers would still entitle their employer to a bonus deduction.

Some government expenditures would also likely fall. If the labor market tightened, it would draw workers into jobs, meaning that fewer workers would collect unemployment. Additionally, workers might also forgo disability payments to enter the workforce—perhaps because the increase in jobs would create employment opportunities that would accommodate their specific disabilities or because the increase in pay would make work more attractive than collecting disability. Welfare take-up would similarly decline as workers' income increased beyond the welfare threshold. Fewer people would be eligible for coverage under Medicaid. More employment opportunities would likely decrease crime rates, which could also lower government expenditures.

Government is no monolith, and a bonus deduction would affect different layers of government differently. The federal government would bear the costs of the bonus deduction program, but many of the increases in revenue and lowered expenditures would benefit state and local governments. States with business or individual income taxes would collect more revenue.¹¹³ Most states would pay out less in benefits from various government programs.¹¹⁴ And states might reduce their

113. Most states have a corporate income tax. The exceptions are Nevada, Ohio, Texas, and Washington (which levy gross receipts taxes) and South Dakota and Wyoming (which impose neither a corporate income tax nor a gross receipts tax). Corporate tax rates range from 2.5% to 11.5%. Janelle Fritts, *State Corporate Income Tax Rates and Brackets for 2022*, TAX FOUND. (Jan. 18, 2022), <https://taxfoundation.org/publications/state-corporate-income-tax-rates-and-brackets/> [https://perma.cc/QS8Z-X4H5]. Most states have an individual income tax, which would tax non-corporate business income and employment income. New Hampshire's income tax, however, taxes only dividends and interest. Top marginal rates range from 2.5% to 13.3%. Timothy Vermeer & Katherine Loughead, *State Individual Tax Rates and Brackets from 2022*, TAX FOUND. (Feb. 15, 2022), <https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/> [https://perma.cc/2JPN-QZDR]. Several localities also tax income. Jared Walczak, *Local Income Taxes in 2019*, TAX FOUND. (July 30, 2019), <https://taxfoundation.org/local-income-taxes-2019/> [https://perma.cc/8FLA-HU7P]. States and localities that tax property might also expect higher revenues, as higher employment, more business activity, and less crime tend to increase property values. See Steve Gibbons, *The Costs of Urban Property Crime*, 114 ECON. J. 441 (2004); Devin G. Pope & Jaren C. Pope, *Crime and Property Values: Evidence from the 1990s Crime Drop*, 42 REG'L SCI. & URB. ECON. 177 (2012).

114. Unemployment is funded by the federal and state governments. I.R.C. §§ 3301–11; Manuel Alcalá Kovalski & Louise Sheiner, *How Does Unemployment Insurance Work? And How is it Changing During the Coronavirus Pandemic?*, BROOKINGS (July 20, 2020), <https://www.brookings.edu/blog/up-front/2020/07/20/how-does-unemployment-insurance-work-and-how-is-it-changing-during-the-coronavirus-pandemic/> [perma.cc/3QE3-5S3W]. Medicaid is funded by the federal and state governments. On average, the federal government funds between 57% and 60% of a state's Medicaid costs, but the federal government pays a higher percentage of costs in poorer states. *Policy Basics: Introduction to Medicaid*, CTR. ON BUDGET & POL'Y PRIORITIES (Apr. 14, 2020), <https://www.cbpp.org/research/health/introduction-to-medicaid> [perma.cc/3GPX-BTXF]. In 2020, Medicare spending was \$671 billion. *NHE Fact Sheet*, CTRS. MEDICARE & MEDICAID SERVS. (Dec. 14, 2022, 4:03 PM), <https://www.cms.gov/Research-Statistics-Data->

expenditures if crime rates fell.¹¹⁵ Thus, as the table below highlights, there would be a mismatch between the levels of government losing and gaining net revenue, in essence effecting a transfer from the federal government to state governments.

TABLE 2: BONUS DEDUCTION FISCAL EFFECTS

Change	Fiscal effect	Government level
Cost of bonus deduction	Lower revenue	Federal
Additional corporate income	Higher revenue	Federal + State
Additional individual income	Higher revenue	Federal + State + Local
Fewer unemployment claims	Lower expenditure	Federal + State
Fewer Medicaid claims	Lower expenditure	Federal + State
Fewer disability claims	Lower expenditure	Federal
Fewer other welfare claims	Lower expenditure	Federal + State
Less crime	Lower expenditure	Federal + State + Local

and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/NHE-Fact-Sheet [perma.cc/YDF3-43J2]. 8.2 million people receive disability benefits from Social Security Disability Insurance. Payments totaled \$145 billion in 2019. *Chart Book: Social Security Disability Insurance*, CTR. ON BUDGET & POL'Y PRIORITIES, <https://www.cbpp.org/research/social-security/social-security-disability-insurance-o> [https://perma.cc/45CJ-N52W] (updated Dec. 13, 2023). The federal government provides states with substantial welfare funding. In 2019, state and local governments spent \$744 billion on welfare. *State and Local Backgrounders*, URB. INST., <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/public-welfare-expenditures> [perma.cc/3UJL-4F2R]. See also *Policy Basics: Temporary Assistance for Needy Families*, CTR. ON BUDGET & POL'Y PRIORITIES (Mar. 1, 2022), <https://www.cbpp.org/research/family-income-support/temporary-assistance-for-needy-families> [perma.cc/F3UK-FWRA].

115. Crime expenditures may be partitioned into police costs, corrections costs, and court costs. Localities bear most of the policing cost, and states bear most of the corrections cost. *State and Local Backgrounders*, URB. INST. (2022), <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/public-welfare-expenditures> [perma.cc/6SET-P98Y]. If the prison population declined, corrections costs would fall. If prosecutions declined, court costs would fall. If crime rates fell, governments might choose to lower police expenditures.

The decrease in government revenue is an important policy consideration. With \$5 trillion per year, the federal government could surely make enormous equity and efficiency improvements to the labor market. But this sum would have to come from somewhere else and reallocating it would surely have counteracting consequences. The U.S. labor market merits serious attention from policymakers, but it is neither the only important matter before Congress nor the only objective worthy of more funding. The government could set aside funding to make vast improvements in the labor market by substantially raising taxes, cutting other government programs, or borrowing.¹¹⁶ But each of these options has its costs.

2. Possible synergistic sources of revenue

Policy proposals that require additional funding are, in some sense, more complete if they explore how that funding will be raised. This exploration makes possible cost-benefit analysis, without which it is impossible to say whether a particular policy proposal is net beneficial. The more specific the funding proposal, the better. There is a list of funding sources that are often suggested to finance policy changes—these include a wealth tax, a VAT, a carbon tax, social security reform, eliminating capital gains preferences, and higher taxes on high-means taxpayers. While any of these could be used to finance a bonus deduction, this Article focuses on policies that synergize, either economically or politically, with the bonus deduction.

¹¹⁶. As an institution subject to political forces, the U.S. government has little difficulty spending and great difficulty raising additional revenue. And economists generally agree that long-term U.S. government budget projections are worrisome. See, e.g., CONG. BUDGET OFF., *THE 2022 LONG-TERM BUDGET OUTLOOK 6–12* (2022), <https://www.cbo.gov/system/files/2022-07/57971-LTBO.pdf> [perma.cc/NVT9-F5G5]; Daniel Schaffa, *The Intergenerational Equity Case for a Wealth Tax*, 90 U. CIN. L. REV. 735, 750–54 (2022); ALAN J. AUERBACH, WILLIAM G. GALE, & AARON KRUPKIN, *IF NOT NOW, WHEN? NEW ESTIMATES OF THE FEDERAL BUDGET OUTLOOK 3* (Brookings 2019), <https://www.brookings.edu/research/if-not-now-when-new-estimates-of-the-federal-budget-outlook/> [perma.cc/J2UX-SREC]; Jason Furman & Lawrence Summers, *A Reconsideration of Fiscal Policy in the Era of Low Interest Rates* 1, 3 (Nov. 30, 2020) (discussion draft), <https://www.brookings.edu/wp-content/uploads/2020/11/furman-summers-fiscal-reconsideration-discussion-draft.pdf> [perma.cc/8AB7-EVLK] (discussion draft) (advocating for more borrowing while noting that “current projections do raise concerns over the fiscal situation beyond 2030”); William G. Gale, *Five Myths About Federal Debt*, BROOKINGS (May 2, 2019), <https://www.brookings.edu/opinions/five-myths-about-federal-debt/> [perma.cc/3VAT-HJ6K]. Note that CBO projections have historically overestimated revenues by 5.3% on average, suggesting that experienced deficits may exceed those projected. Leonard Burman, Benjamin Page & David Weiner, *The Implications of Uncertain Economic Paths for Revenue Projections*, 75 NAT’L TAX J. 681, 681–82 (2022).

a. Higher business tax rates

One approach to raising additional revenue would be to increase business tax rates.¹¹⁷ Because this increase in tax rates would be in conjunction with a bonus deduction which would substantially reduce business tax liability, the new result could still be favorable to businesses. Depending on the parameters chosen, aggregate business tax liability could increase or decrease.

There is additional synergy between the bonus deduction and higher business tax rates because deductions become more valuable at higher tax rates. Increasing the tax rate, would therefore increase the efficacy of the bonus deduction because the higher tax rate would further increase the incentive to hire workers eligible for a bonus deduction. With a bonus deduction and higher business tax rates, businesses incurring a substantial fraction of their costs compensating employees eligible for the bonus deduction (but not far exceeding the eligibility requirements) would be relatively better off with a bonus deduction and higher business tax rates. These businesses would claim more bonus deductions, which would offset the higher tax rate. Indeed, one way to conceive of higher business tax rates as a funding source for a bonus deduction would be as a policy shift towards favoring businesses that provide more and better paying jobs to low-wage workers.

b. Smaller deduction for high-wage workers

In line with a reimagined deduction for employee compensation, a second approach to increasing taxes on businesses would be to decrease the business deduction for high-wage workers. Congress could allow

117. There are many ways in which business tax rates could be increased. Perhaps the most obvious path would be eliminating the Qualified Business Income (QBI) deduction and increasing corporate tax rates. The case that 199A is good policy is difficult to make and many tax policy experts oppose it. See, e.g., Daniel Shaviro, *Evaluating the New US Pass-Through Rules*, 2018 BRIT. TAX REV. 48 (2018). Eliminating the QBI deduction would raise approximately \$50 billion in revenue. Samantha Jacoby, *Repealing Flawed "Pass-Through" Deduction Should Be Part of Recovery Legislation*, CTR. ON BUDGET & POL'Y PRIORITIES (June 1, 2021), <https://www.cbpp.org/research/federal-tax/repealing-flawed-pass-through-deduction-should-be-part-of-recovery-legislation> [https://perma.cc/5NXX-ZFLB]. See also I.R.C. § 199A; *Facts About the Qualified Business Income Deduction*, INTERNAL REVENUE SERV., (Sept. 29, 2022), <https://www.irs.gov/newsroom/facts-about-the-qualified-business-income-deduction#:~:text=QBI%20is%20the%20net%20amount,sole%20proprietorships%2C%20and%20certain%20trusts> [https://perma.cc/QNP6-XZM5]. There are efficiency implications to raising business tax rates, which depend on the market power that businesses are able to exert. KIMBERLY A. CLAUSING, *CAPITAL TAXATION AND MARKET POWER* (2023), <https://ssrn.com/abstract=4419599> [https://perma.cc/Y59R-LRXXD].

a deduction for only a fraction of employee compensation above a particular compensation level, as the tax code already does in some cases.¹¹⁸ For example, Congress could allow 100% of employee compensation to be deductible below the bonus deduction threshold and 50% of employee compensation to be deductible for compensation above the bonus deduction threshold.¹¹⁹

With a \$60,000 bonus deduction, a \$30,000 threshold, and 50% partial deductibility (above the threshold), paying an employee \$29,000 would yield a deduction of \$29,000; paying an employee \$30,000 would yield a deduction of \$90,000;¹²⁰ and paying an employee \$230,000 would yield a deduction of \$190,000.¹²¹ Under this scheme, there remains a substantial incentive for businesses to increase employee compensation to at least \$30,000, as there is a substantial decrease in cost to the employer.

Partial deductibility would, however, decrease the incentive for businesses to compensate high-wage workers. Lower compensation would discourage high-wage workers from working, which would have two downsides. First, different types of labor are often complements.¹²² Decreasing the incentive to compensate and hire high-wage workers could dampen the incentive to compensate and hire low-wage workers.¹²³ However, the incentive of the bonus deduction to hire more low-wage workers and pay them more will almost surely overwhelm the disincentives arising from complementarity.

Second, effectively increasing the tax on hiring high-wage workers could introduce inefficiencies into the labor market if, for example, varying the tax incentive to hire different types of workers distorted hiring decisions. There are, however, three reasons why the inefficiencies introduced by increasing the effective cost to businesses of hiring

118. The most extreme form of partial deductibility would allow 0% of the deduction, which is what the tax code already does for some employees with high levels of compensation. I.R.C. § 162(m)(1). A related alternative would be a phaseout of the bonus deduction above a compensation threshold.

119. Partial deductibility could begin at any income level, but partial deductibility below the bonus deduction threshold could make some low-income workers more costly relative to the status quo, depending on the parameters chosen.

120. A full deduction for the \$30,000 of compensation and a \$60,000 bonus deduction. $\$30,000 + \$60,000 = \$90,000$.

121. A full deduction for \$30,000 of compensation, a 50% deduction for the remaining \$200,000 of compensation, and a \$60,000 bonus deduction. $\$30,000 + 50\% * \$200,000 + \$60,000 = \$190,000$.

122. For example, if an automotive firm hires more plant floor managers, the marginal benefit of additional welders and forklift operators would likely increase.

123. If, holding all other things constant, plant managers became more expensive to hire, firms would likely hire fewer, which would depress the marginal benefit of hiring welders and forklift operators.

high-wage workers may still be worth raising revenue to benefit low-wage workers. First, some high-wage employees command those high wages by virtue of an inefficient licensing requirement or another market failure that restricts the supply of those workers.¹²⁴ Because the market failure holds the supply of these workers below its efficient level, a decreased demand for these workers could have a relatively small effect on the number of these workers in the labor market. In other words, an already existing inefficiency may mitigate the inefficiency of increasing the cost of these high-wage workers. Second, recall that part of the benefit of the bonus deduction would be correcting market failures in low-wage labor markets, including employer market power and the negative externalities of low-wage work. It is usually the case that two small economic distortions are better than one large economic distortion, although whether this holds in any particular situation depends on various economic parameters.¹²⁵ If the general rule applies in this case, it could be more efficient to suffer a new distortion in the high-wage labor market to decrease a larger distortion in the low-wage labor market. Third, even if the combined bonus deduction and decreased deductibility of highly-compensated employees were, in total, less efficient than the status quo, the efficiency loss may be worth the equity gain.¹²⁶

124. Morris M. Kleiner, *Reforming Occupational Licensing Policies* (Hamilton Project, Discussion Paper No. 2015-01, 2015). A growing fraction of the workforce is subject to occupational licensure requirements. *Id.* While in some cases occupational licensure has the theoretical potential to improve safety outcomes for consumers, many economic studies find little benefit for consumers. *Id.* at 6. Occupational licensure tends to reduce the number of workers in the regulated industries. *Id.* The main beneficiaries of occupational licensure tend to be those holding licenses, who tend to receive higher compensation. *Id.*; see also Morris M. Kleiner & Evan J. Soltas, *A Welfare Analysis of Occupational Licensing in US States* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26383, 2019); Morris M. Kleiner, *Occupational Licensing*, 14 J. ECON. PERSPS. 189, 189 (2000); Morris M. Kleiner & Alan B. Krueger, *Analyzing the Extent and Influence of Occupational Licensing on the Labor Market*, 31 J. LAB. ECON. S173, S173 (2013).

125. More technically, the efficiency cost of an economic distortion increases with the square of the size of the distortion at the margin. Thus, for example, a distortionary tax in one market of \$2 per unit will often have a higher efficiency cost than a distortionary tax of \$1 in two different markets because $2^2 > 2 \times 1^2$. However, there are market conditions under which this will not hold.

126. The extent to which policy should tradeoff between efficiency and equity is contentious, but most people would willingly forgo some economic efficiency to achieve more equitable outcomes. There is also some evidence suggesting that the labor market response to decreasing the deductibility of very high-wage worker compensation would be small. As part of the Tax Cuts and Jobs Act (TCJA), businesses were disallowed deductions for the compensation of some highly-paid employees. Tax Cut & Jobs Act of 2017, Pub. L. No. 115-97, § 13601, 131 Stat. 2054, 2155 (codified as amended at I.R.C. § 162(m)). An empirical analysis of this provision of the TCJA found evidence that the effect on compensation was small. See Gregg Polsky, Brian Galle, & Andrew Lund, *Does Tax Matter? Evidence on Executive Compensation After 162(m)'s Repeal*, 26 STAN. J. L. BUS. FIN. 1 (2021). Notably, a small labor market response from highly paid executives does not imply that the labor market response to a bonus deduction for low-wage workers would be small if, for example,

In essence, financing the bonus deduction with partial deductibility would increase employer incentives to compensate low-wage employees and sacrifice employer incentives to compensate high-wage workers. This transforms the deduction for employee compensation into a progressive-like element of the tax code.¹²⁷ If the partial deductibility revenue increase were sufficient to offset the cost of the bonus deduction, the policy change would simply rearrange the tax benefit of hiring employees to create different incentives without changing the overall tax reduction attributable to employee compensation.

c. Eliminating employee tax benefits

Another approach to financing the bonus deduction would be to eliminate tax benefits which become less valuable when there is a bonus deduction. One possibility would be to eliminate the EITC.¹²⁸ The EITC and the bonus deduction have similar policy objectives—both aim to help low-income workers. However, as discussed above, there is evidence suggesting that the EITC may have a limited effect on employment.¹²⁹ In addition, the EITC causes some economic inefficiency by having a high effective marginal tax rate over the phase-out region. There is no obvious reason to believe that the EITC and the bonus deduction would complement one another as policies. Rolling the EITC into a bonus deduction would allow the government to implement the bonus deduction at a larger scale at a lower total fiscal cost.¹³⁰

A second tax preference which might be eliminated and used to fund the bonus deduction is the exclusion of employer-provided health insurance. Current tax law allows employees to exclude the cost of employer-

employers exerted market power over low-wage employees but not high-wage employees. The design of the intervention could also make it incredibly attractive and salient for businesses to avail themselves of the tax benefit by hiring more and raising low-wage compensation.

127. Typically, progressivity is applied to the total income of a taxpayer not solely their wages from a single employer. There are important cases in which the suggested policy change does not align with progressivity in the usual sense. For example, a worker earning a low wage may have a spouse earning a high wage or more generally additional sources of household income. Nonetheless, there is substantial overlap between these two definitions of progressivity.

128. See PHELPS, *supra* note 21, at 132–34 (making a similar argument in favor of abolishing the EITC to support a larger wage subsidy).

129. Even if the EITC has a limited effect on employment, it still provides a credit to workers who successfully claim it.

130. The cost of the EITC to the federal government is approximately \$73.1 billion. Erica Williams, Samantha Waxman & Julian Legendre, *How Much Would a State Earned Income Tax Credit Cost in Fiscal Year 2021?*, CTR. ON BUDGET & POL'Y PRIORITIES, <https://www.cbpp.org/research/state-budget-and-tax/how-much-would-a-state-earned-income-tax-credit-cost-in-fiscal-year> [https://perma.cc/97UT-JUYM] (last updated Mar. 9, 2020).

provided health insurance from their incomes.¹³¹ The exclusion is beneficial because it incentivizes employer-provided health insurance, decreasing the number of uninsured people, who may receive inferior care and whose healthcare costs must be paid by another party.¹³²

The exclusion, however, comes with its own downside. A dollar of cash as compensation is taxed, but a dollar of health insurance as compensation is untaxed, meaning that employers may provide more total after-tax compensation by shifting the allocation of compensation towards health insurance.¹³³ The exclusion changes relative prices, potentially pushing more employees towards more expensive health insurance policies. The change in incentive is stronger for taxpayers with higher marginal tax rates—a high-income earner must forgo only \$0.63 of cash income to receive an additional \$1 of health insurance coverage, whereas a worker with sufficiently low income faces parity, having to forgo \$1 of cash income to receive an additional \$1 of health insurance coverage. The resulting over-insurance lowers government revenues by shifting compensation towards excluded benefits.

The bonus deduction could be designed to resolve this problem. If the bonus deduction were conditioned on a minimum level of health insurance coverage, there would be a strong incentive for businesses to provide their employees with coverage, reducing the social benefit of the exclusion. The exclusion could then be eliminated, resolving the over-insurance problem and freeing up approximately \$273 billion for a larger bonus deduction.¹³⁴

131. I.R.C. § 106(a). Crucially, employers may nonetheless deduct the costs of employer provided coverage under I.R.C. § 162.

132. The provision of healthcare to uninsured people is sometimes mandated. *See, e.g., Emergency Medical Treatment & Labor Act (EMTALA)*, CTRS. FOR MEDICARE & MEDICAID SERVS. (Dec. 5, 2022, 10:31 AM), <https://www.cms.gov/Regulations-and-Guidance/Legislation/EMTALA> [<https://perma.cc/RVM4-C5FU>].

133. Consider, for example, a cheaper health insurance policy (A) which covered weekly physical therapy for those in need and a personalized home exercise plan. Compare that to a more expensive health insurance policy (B) which covered daily physical therapy visits. Given the choice, some would prefer policy A and higher cash compensation, while others would prefer policy B and lower cash compensation.

134. Employer and most employee contributions to health insurance premiums are excluded from income taxes. The Joint Committee on Taxation estimates that the income tax expenditure on the exclusion for employer-sponsored health insurance was over \$153 billion in fiscal year 2019. Employer contributions for health insurance premiums are also excluded from employees' wages when calculating payroll taxes. Including its impact on both income and payroll taxes, the exclusion reduced government revenue by \$273 billion in 2019. *See* URBAN INST. & BROOKINGS INST., *Key Elements of the U.S. Tax System: Which Tax Provisions Subsidize the Cost of Health Care?*, in TAX POLICY CENTER'S BRIEFING BOOK (2020), <https://www.taxpolicycenter.org/briefing-book/which-tax-provisions-subsidize-cost-health-care> [<https://perma.cc/7RRT-44BY>].

d. Reducing intergovernmental grants

A final synergistic source of revenue would be reducing governmental grants from the federal government to state (and possibly local) governments. In 2021, the federal government provided states \$1.2 trillion in cash and in-kind grants, comprising 40.5% of state spending.¹³⁵ Because many states would have larger revenues (and lower expenses) if the federal tax code included a bonus deduction, they would not be worse off if federal grants were reduced by less than the increase in revenue. The fifty states are, however, quite different. It is unlikely that the additional net revenue each state would raise (if there were a bonus deduction) would perfectly correlate to the amount that state receives in grants from the federal government. Thus, reducing federal governmental grants could affect the distribution of funds among the states.

C. Simulating an Alternative Deduction Scheme

To provide some insight into what might be accomplished by changing the deduction for employee compensation (and at what cost), this Section reports the results from a simulation based on the U.S. economy. The simulation attempts to show how offering a bonus deduction, imposing partial deductibility, and raising business tax rates might affect low-wage workers, high-wage workers, businesses, and government finances. While the simulation aims to be realistic, it makes several simplifying assumptions and ought to be thought of only as an inexact illustration of a plausible policy change.

1. Simulation overview

In the simulation, the policymaker sets the business tax rate and the rules for deducting employee compensation. In particular, the policymaker offers bonus deductions to businesses for each job that meets specified requirements and sets a partial deductibility rate for compensation above a specified limit. The policymaker may also eliminate the exclusion of employer-provided health insurance. Businesses respond to the tax regime that the policymaker has defined. They decide how much to produce, how much to hire, what wages to pay, and how much investment to seek out. These decisions must be consistent. To produce more, businesses must hire more workers or procure additional

135. OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE US GOVERNMENT FISCAL YEAR 2023 205 (2022), https://www.whitehouse.gov/wp-content/uploads/2022/04/spec_fy2023.pdf [<https://perma.cc/Y5YD-RADE>].

assets. To hire more, businesses must pay workers more. To attract additional investment, businesses must offer a higher rate of return.

The simulation is calibrated to the U.S. labor market using limited publicly available data. Where possible, the simulation uses 2019 data under the assumption that the pandemic had anomalous labor market impacts.¹³⁶ Notably, there are several important labor market and tax features that the simulation does not incorporate, including the market failures discussed in Part I, intertemporal consumption decisions (e.g., social security and retirement accounts), part-time work, household composition, and the different tax treatment of different business types. It also assumes that a deduction has the same effect on all businesses, regardless of whether they have small or large taxable incomes. More detailed information on the simulation may be found in this Article's Simulation Appendix.

For simplicity, workers in the simulation are partitioned into two groups. Those earning no more than \$40,000 are considered low-wage workers, and those earnings more than \$40,000 are considered high-wage workers. Under these definitions, there are approximately 58.3 million low-wage workers with average annual wages of \$27,031 per year and 59.3 million high-wage workers with average annual wages of \$109,870 in the U.S.

The simulation highlights important features of the bonus deduction and partial deductibility. First, a larger bonus deduction makes workers cheaper and thus encourages more hiring. Each worker has a benefit and a cost, which together determine the employer's profit from hiring that worker. The bonus deduction changes the calculus of hiring by adding a tax benefit that increases the net benefit of hiring. As discussed above, the effect is largest for low-wage workers because hiring low-wage workers for qualifying jobs is a cheaper way to accumulate bonus deductions than hiring high-wage workers for qualifying jobs. Partial deductibility further increases the relative attractiveness of low-wage workers.

Second, the bonus deduction threshold plays an important role in determining how much workers are paid because employers have a strong incentive to pay at least the threshold amount. In particular, the bonus deduction has the largest impact on the lowest-wage workers when the employer is incentivized to pay all full-time workers at least the threshold compensation. Assuming a 20% business tax rate, a \$40,000 bonus deduction for jobs paying at least \$50,000 would make it cheaper to pay an employee \$50,000 than to pay an employee \$40,001. Many employers would thus raise compensation for jobs paying between \$40,000 and \$50,000 to at least \$50,000. There would be some benefit to

136. The numbers are not inflation adjusted.

workers earning below \$40,000 because of the tighter labor market, but the largest benefit would accrue to those earning above \$40,000. Alternatively, a \$40,000 bonus deduction for jobs paying at least \$25,000 would make it cheaper to pay an employee \$25,000 than to pay an employee \$15,001. Many employers would thus raise compensation for jobs paying between \$15,000 and \$25,000 to at least \$25,000. Because federal minimum wage laws mandate that most full-time workers be paid at least (approximately) \$15,000 annually, the \$25,000 bonus deduction threshold effectively raises minimum annual earnings. In short, the threshold compensation for the bonus deduction plays a large part in determining which workers receive the largest benefit.

Third, a higher business tax rate has two important, counteracting effects. Higher tax rates discourage business activity because they lower the returns to investing and hiring. But they also increase the value of the bonus deduction. Say, for example, an employee were paid \$30,000 in compensation and their employer also received a bonus deduction of \$30,000. At a 20% tax rate, the total deduction would offset \$12,000 of tax liability. At a 30% tax rate, the total deduction would offset \$18,000 of tax liability. The additional benefit of the bonus deduction at higher tax rates encourages more hiring and increasing the compensation for a larger range of jobs.

Fourth, the bonus deduction shrinks the business tax base, which decreases business tax revenues and increases the deficit. In the simulation, leaving all other tax laws unchanged, a bonus deduction of \$10,500 would completely eliminate the business tax base.¹³⁷ If one were only concerned with the deficit, an unrelated funding source (higher taxes elsewhere or spending cuts) would constitute an adequate countermeasure. If, however, one wished to preserve the business income tax base, something would have to be done to increase business taxable income. Partial deductibility of employee compensation above a certain limit is one possible path to recover the business tax base. With a bonus deduction and partial deductibility, the deduction for employee compensation could be both resized and reshaped, changing outcomes for both employees and employers. One possibility is leaving the total size of the deduction unchanged, but changing how it is distributed and what it incentivizes.

As a final thought, the mechanics of the simulation, which aim to mimic the U.S. labor market, make it unlikely that a policy change could make everyone substantially better off. In particular, to make low-wage workers materially better off, some combination of high-wage workers, business owners, and government finances, must be made worse off. In

137. More precisely, aggregate business tax liability would be \$0 assuming refundability. Some businesses would owe taxes, and some would be owed a refund equal to their tax loss times the business tax rate. Summed together, the net result would be no business tax revenue for the government.

the simulation, the magnitudes are large: aggregate wages paid to low-wage workers increase by hundreds of billions of dollars, but either the aggregate wages paid to high-wage workers and business profits fall by hundreds of billions of dollars or the government deficit increases by hundreds of billions of dollars. This Article does not take a position on how to tradeoff between these outcomes—it merely attempts to give some sense for what this tradeoff entails.

2. Simulation outcomes

The simulation projects outcomes based on the parameters set by the policymaker. The set of feasible policy parameters is quite large, and depending on the policy objective and constraints, different parameters will be optimal. This Section discusses simulation outcomes for two sets of plausible parameters to illustrate the effects of the bonus deduction and partial deductibility. The two scenarios are illustrative—neither is meant to be a definitive statement of optimal policy.

The policy goal in both simulations is to maximize the wages paid to a worker earning \$15,000 in the status quo. In addition, both simulations are constrained to (1) be internally consistent (e.g., more production requires more hiring; more hiring requires higher wages), (2) use only plausible parameter values (e.g., no negative tax rates), and (3) disallow decreases in business tax revenues of more than 75%. The simulations do differ in important ways. Simulation one disallows decreases in high-wage employee hiring of more than 1.3% and must be revenue neutral.¹³⁸ Simulation two disallows any decrease in high-wage employee hiring.

a. Simulation one

In simulation one, the policymaker increases compensation and employment for low-wage workers by offering a bonus deduction of \$37,500 to businesses for each job paying at least \$35,500. The policymaker also raises the business tax rate to 35%, allows only 39% of annual wages paid above \$35,500 to be deductible, and eliminates the exclusion of employer provided health insurance.¹³⁹ The results of the simulation are presented in the table below.

138. James R. Hines Jr., *Perils of Tax Reform*, 71 NAT'L TAX J. 357 (2018) (explaining that while there is nothing sacred about a revenue-neutral change—and indeed, most reforms trumpeted as revenue-neutral end up being revenue negative—taking into consideration the cost of a new program and bearing in mind possible funding sources disciplines the analysis of that new program).

139. Increasing the business tax rate to 35% would be approximately achieved by raising the corporate tax rate to 35% and eliminating the QBI deduction. QBI effectively decreases the tax rate

TABLE 3: SIMULATION ONE OUTCOMES

	Current	Proposed	Change	in %
Low-Wage Workers				
Average pre-tax wages	\$27,031	\$36,216	\$9,185	34.0%
Average effective tax rate	-6.6%	3.5%		
Average after-tax wages	\$28,424	\$34,407	\$5,983	21.0%
Number of jobs (<i>millions</i>)	58.3	60.2	1.8	3.2%
High-Wage Workers				
Average pre-tax wages	\$109,870	\$101,135	-\$8,735	-8.0%
Average effective tax rate	17.3%	17.7%		
Average after-tax wages	\$89,259	\$81,727	-\$7,532	-8.4%
Number of jobs (<i>millions</i>)	59.3	58.5	-0.8	-1.3%
Businesses (<i>billions</i>)				
Total revenue	\$43,991	\$42,269	-\$1,723	-3.9%
Total wages to low-wage	\$1,576	\$2,179	\$602	38.2%
Total wages to high-wage	\$6,511	\$5,918	-\$594	-9.1%
Total wages	\$8,088	\$8,097	\$9	0.1%
Pre-tax net income	\$3,629	\$3,390	-\$240	-6.6%
Bonus deduction	\$0	\$4,450		
Non-deductible wages	\$0	\$3,600		
Tax liability	\$315	\$180	-\$135	-43.0%
After-tax income	\$3,314	\$3,210	-\$104	-3.1%
Effective tax rate	8.7%	5.3%		
Government (<i>billions</i>)				
Business tax revenue	\$315	\$180	-\$135	-43.0%
Employee income tax revenue	\$1,023	\$1,127	\$104	10.2%
Medicare tax revenue	\$235	\$235	\$0	0.1%
Unemployment net outlays	\$137	\$127	-\$10	-7.4%
Disability outlays	\$145	\$140	-\$5	-3.8%
Medicaid outlays	\$1,195	\$1,180	-\$16	-1.3%
Total			\$0	

of some business income by 20%. JOSEPH BANKMAN, DANIEL N. SHAVIRO, KIRK J. STARK, & ERIN ADELE SCHARFF, *FEDERAL INCOME TAXATION* 411 (19th ed. 2023). Without QBI, the highest tax rate on non-corporate business income would be 37%. IRC 1(j)(2).

In simulation one, before the policy change, 41% of all full-time workers earn less than \$35,500. Under the new policy, all full-time workers earn at least \$35,500 because the bonus deduction and higher business tax rate create an enormous incentive to pay workers at least \$35,500. Indeed, it costs an employer less to pay a worker \$35,500 than it does to pay a worker \$15,400, which is just under \$8 per hour wage annualized. The poorest full-time workers would see their annual after-tax wages increase by \$15,530. For many low-wage workers, their wages more than double. On average, in the simulation, after-tax low-wage worker incomes increase by \$5,983, and the number of employed low-wage workers increases by 1.8 million.¹⁴⁰ All workers earning less than \$44,307 are better off. As their incomes increase and their employer-provided healthcare is no longer excluded, the average federal income tax rate paid by low-wage workers increases from -6.6% to 3.5%.¹⁴¹

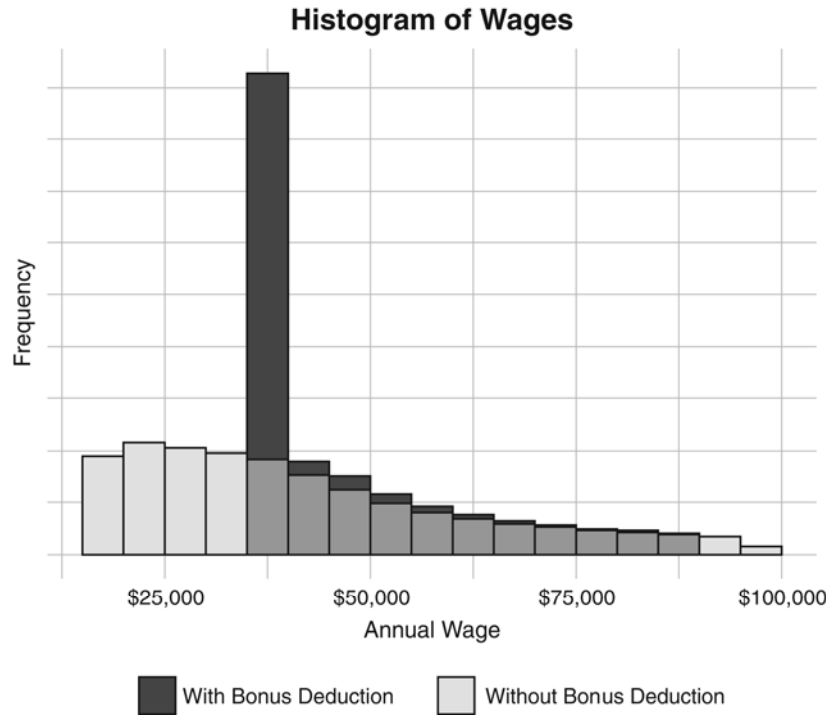
The benefits accruing to low-wage workers are traded off against higher burdens on high-wage workers and business owners. On average, in the simulation, after-tax high-wage worker incomes decrease by \$7,532, and the number of employed high-wage workers decreases by 0.8 million. The average federal income tax rate paid by high-wage workers remains roughly the same, increasing slightly from 17.3% to 17.7%, because the employer-provided healthcare is no longer excluded. The burden falls disproportionately on those with higher incomes. Those earning the highest wages in the simulation (\$465,000 or more) experience a 14% decline in after-tax wages. A worker earning \$60,058 would experience an after-tax wage decrease of \$2,178, and a worker earning \$101,511 would experience an after-tax wage decrease of \$7,376. Whether these wage decreases are worth the large wage increase that the poorest workers would experience depends on one's normative priors. Generally, it is not possible to effect a large subsidy for low-wage work and collect taxes from businesses without increasing the business tax base in some other way—partial deductibility is one method of increasing the business tax base.

The following two graphs provide some additional sense of what happens to the wages of workers earnings under \$100,000. The first is a histogram of pre-tax wages under the status quo (without bonus

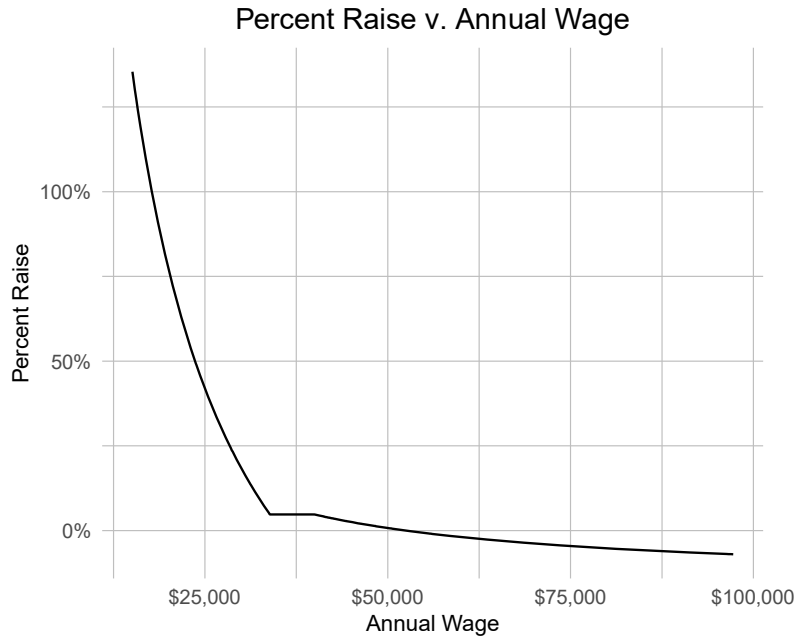
140. In the simulation, after-tax incomes are wages after federal income tax and Medicare taxes are subtracted. Social security taxes are not modeled to avoid the complication of including intertemporal decision-making.

141. While the policy change does not eliminate the EITC, the number of EITC-eligible households in the simulation plummets as low-wage worker compensation soars.

deduction) and under the proposed regime (with bonus deduction). The second plots worker pre-tax raises against worker pre-tax wages.



The histogram illustrates how the policy change compresses the annual wage distribution. It counts the number of workers in each \$5,000 bin between \$15,000 and \$100,000 in the status quo and with the proposed policy. Under the status quo, there are many workers earning under \$35,500. The proposed regime pushes those workers higher in the wage distribution. Under the status quo, however, there are relatively more workers earning over \$90,000. Partial deductibility pushes those workers lower in the wage distribution.



The second graph shows how workers at the low-end receive large raises so that their employers are eligible for a bonus deduction. The raises accruing to workers earning above the bonus deduction threshold are relatively small. And partial deductibility results in wage decreases for workers earnings above approximately \$54,000—and these wage decreases are larger at higher annual wage levels.

The large bonus deduction, partial deductibility, and higher tax rate incentivize businesses to shift economic activity towards low-wage workers and away from high-wage workers and productive assets. The aggregate wages businesses pay to low-wage workers increase by \$602 billion, and the aggregate wages businesses pay to high wage workers decrease by \$594 billion. Total business revenue falls by \$1,723 trillion, and pre-tax business net income falls by \$240 billion.¹⁴² Businesses accrue \$4,450 billion in aggregate bonus deductions by paying workers at least \$35,500, which is largely offset by partial deductibility resulting in \$3,600 billion in non-deductible employee compensation. Business tax liabilities decrease by \$180 billion, and business after-tax incomes fall by \$104 billion.¹⁴³

142. Note that pre-tax net income is not the same as taxable income. In particular, pre-tax net income does not account for bonus deductions.

143. There are many reasons why effective business tax rates are not equal to the statutory business tax rate. See generally U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-105384, CORPORATE

The simulation achieves revenue neutrality. Although business tax revenue falls by \$135 billion, employee income tax revenue increases by \$104 billion in large part because employer provided healthcare is no longer excluded. Medicare tax revenue also increases very slightly. Lower outlays from the unemployment, disability, and Medicaid programs—savings of \$10 billion, \$5 billion, and \$16 billion, respectively—also help recoup the bonus deduction’s cost.

a. Simulation two

In simulation two, the policymaker increases compensation and employment for low-wage workers by offering a bonus deduction of \$19,500 to businesses for each job paying at least \$21,000. The policymaker also raises the business tax rate to 23% and allows only 81% of annual wages paid above \$26,750 to be deductible. The results of the simulation are presented in the table below.

TABLE 4: SIMULATION TWO OUTCOMES

	Current	Proposed	Change	in %
Low-Wage Workers				
Average pre-tax wages	\$27,031	\$30,005	\$2,974	11.0%
Average effective tax rate	-6.6%	-4.3%		
Average after-tax wages	\$28,424	\$30,872	\$2,449	8.6%
Number of jobs (<i>millions</i>)	58.3	59.1	0.8	1.3%
High-Wage Workers				
Average pre-tax wages	\$109,870	\$109,391	-\$479	-0.4%
Average effective tax rate	17.3%	17.0%		
Average after-tax wages	\$89,259	\$89,262	\$3	0.0%
Number of jobs (<i>millions</i>)	59.3	59.3	0.0	0.0%
Businesses (<i>billions</i>)				
Total revenue	\$43,991	\$43,915	-\$76	-0.2%
Total wages to low-wage	\$1,576	\$1,773	\$196	12.4%
Total wages to high-wage	\$6,511	\$6,483	-\$28	-0.4%
Total wages	\$8,088	\$8,255	\$168	2.1%
Pre-tax net income	\$3,629	\$3,434	-\$195	-5.4%

	Current	Proposed	Change	in %
Bonus deduction	\$0	\$2,308		
Non-deductible wages	\$0	\$1,375		
Tax liability	\$315	\$87	-\$228	-72.4%
After-tax income	\$3,314	\$3,347	\$33	1.0%
Effective tax rate	8.7%	2.5%		
Government (billions)				
Business tax revenue	\$315	\$87	-\$228	-72.4%
Employee income tax revenue	\$1,023	\$1,022	-\$1	-0.1%
Medicare tax revenue	\$235	\$239	\$5	2.1%
Unemployment net outlays	\$137	\$133	-\$4	-3.0%
Disability outlays	\$145	\$143	-\$2	-1.5%
Medicaid outlays	\$1,195	\$1,189	-\$6	-0.5%
Total			-\$211	

In simulation two, before the policy change, 10% of workers earn under \$21,000. After the policy change, no workers do. On average, the policy change increases low-wage worker annual wages by \$2,974. The aggregate effect on high-wage workers and businesses is minimal. High-wage worker employment remains constant, and business revenues fall slightly. Businesses accrue \$2,308 billion in bonus deductions and \$1,375 billion in non-deductible employee compensation. As payrolls rise, businesses have lower pre-tax net income, but this is more than offset by the increased deduction. The result is a \$33 billion increase in after-tax business income. The deficit increases by \$211 billion, mostly because business tax revenues fall.

It is worth noting, again, that these simulations are merely attempts to forecast outcomes under a plausible set of assumptions. Further analysis with better data would be prerequisite to any legislative action. Moreover, the simulation posits an objective without any explicit discussion of what optimal policy should strive for. One might prefer a policy even more favorable to low-wage workers, or one which exacts a smaller toll on high-wage workers and businesses. One might be more comfortable with a revenue-increasing policy change or a larger deficit. In any event, the simulation endeavors to show that there is potential in the deduction for employment compensation to change business incentives and improve the labor market.

III. FURTHER DISCUSSION

As Part II suggested, the bonus deduction, and the accompanying changes limiting revenue loss, have potential to improve labor markets for low-wage workers. This Part explores the policy proposal at a more granular level to highlight some of the nuances that any legislation reimagining the deduction for employee compensation would have to contemplate. It begins by considering additional aspects of the policy, including its effects on tax evasion and avoidance. It then discusses a few technical details, including whether any of the deduction should be refundable, whether the deduction ought to be prorated, and if so, with what periodicity.

A. Additional Policy Considerations

This Section considers some additional effects of a bonus deduction and partial deductibility. It first explores which business are likely to benefit, which businesses are not likely to benefit, and the possibility of gradual implementation. It then discusses some behavioral responses to the policy change from taxpayers seeking to minimize their tax liability—some legal, others not.

1. Winners and losers

A bonus deduction would benefit low-wage workers and businesses with a high ratio of bonus deductions to income.¹⁴⁴ It could incidentally create incentives to expand strategically important industries in the U.S. Recently, for example, there has been substantial interest in developing robust semiconductor chip manufacturing in the U.S. because of the crucial economic and military role these chips play.¹⁴⁵ One challenge of encouraging this industry to develop in the U.S. (and part of the reason it has developed elsewhere) is the relatively high cost of domestic labor. It has historically been advantageous for businesses to manufacture goods in foreign markets and then ship them to the U.S. The bonus deduction vastly reduces the cost of hiring low-wage U.S. workers, making it more

144. Some low-wage workers are unlikely to earn compensation sufficiently high to make their employer eligible for a bonus deduction—part-time workers, for example.

145. See Erica York & Manish Bhatt, *States Enact Semiconductor Subsidies in the Wake of CHIPS*, TAX FOUND., Sept 11, 2023, <https://taxfoundation.org/blog/state-semiconductor-incentives/> [<https://perma.cc/W5UP-MKQR>].

competitive to manufacture many goods in the U.S., including, potentially, strategically important ones. Congress has used investment incentives for the semiconductor industry in particular, but the bonus deduction may provide an alternative or complementary approach.

Not all businesses, however, would benefit. If the bonus deduction were funded with a higher business tax rate and a lower business deduction for compensation paid to high-wage workers, businesses with few low-wage workers would face higher tax rates and receive no offsetting deduction. The burden would be even greater on firms with a large cohort of high-wage workers whose compensation would only be partially deductible. These firms would likely account for a lower fraction of economic activity if this reform were enacted. Some of the transitional challenges of the higher tax burden might be mitigated by phasing in the change gradually or providing transition relief.¹⁴⁶ Gradual implementation could allow the businesses detrimentally affected to adjust, potentially limiting the economic fallout.

The different tax treatment of different employers complicates the task of determining the effects of these policy changes. Limiting attention to domestic employers, some are tax exempt (such as nonprofits), some are double taxed (C corps), and some are taxed only once (S corps, LLCs, partnerships, and sole proprietorships).¹⁴⁷ Moreover, different businesses face different tax rates. Corporations generally have a tax rate of 21% at the entity level, but the tax rate on other business income depends on the tax bracket of the owner. Further complicating the picture, some business income is eligible for a Qualified Business Income deduction, reducing the effective tax rate by as much as 20%.¹⁴⁸ This all matters because the marginal tax rate of the business determines the value of the bonus deduction and the harm from partial deductibility. The more heavily taxed a business is, the more benefit it derives from the bonus deduction, and the more partial deductibility will cost it.

Nonprofits would not be directly affected by either the bonus deduction or partial deductibility but would probably have to pay higher wages to low-wage workers to compete with employers benefiting from the

146. There is a large literature on the equity and efficiency implications of transition relief. See, e.g., DANIEL SHAVIRO, WHEN RULES CHANGE: THE ECONOMICS OF RETROACTIVITY 216–26 (2000); Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 52–63 (1977); Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1138–52 (1996).

147. The analysis is further complicated because not all corporate income is doubled taxed. Leonard E. Burman, Kimberly A. Clausing, & Lydia Austin, *Is U.S. Corporate Income Double-taxed?*, 70 NAT. TAX J. 675 (2017).

148. I.R.C. § 199A.

bonus deduction. On the other hand, partial deductibility could decrease the wages that nonprofits would have to pay to high-wage workers.

2. Evasion responses

The bonus deduction scheme could change the level of tax evasion.¹⁴⁹ A business could fraudulently report that it is paying an employee \$40,000 in compensation and claim a bonus deduction for that employee. Of course, if the employee does not report \$40,000 in income, someone is lying. The plot thickens if the employee does report \$40,000 in income without receiving the full \$40,000. Why would the employee do this? Say the employer offered the employee \$10,000 with no work requirement. The employee would still have to pay taxes on \$40,000 of income, which at a 10% tax rate would be \$4,000. The employee would thus be \$6,000 better off. With a \$60,000 bonus deduction, the employer would pay \$10,000 in compensation but receive a total deduction of \$100,000, which would yield a tax benefit of \$21,000, assuming a 21% tax rate.¹⁵⁰ The employer would thus be \$11,000 better off. If an employee-employer pair were willing to commit tax fraud, they could avail themselves of this scheme.

A more sophisticated scheme would involve two sole-proprietorships.¹⁵¹ Each would hire the owner of the other as an employee for the same compensation package, which would meet the eligibility requirements for the bonus deduction. This would leave the income of both owners (as each receives and pays out the same sum) unchanged while making both eligible for a bonus deduction.

Legislation could limit the new incentives to evade caused by the bonus deduction in several ways. First, the law should make clear that schemes designed to generate bonus deductions without work constitute tax fraud. The legal consequences of engaging in these schemes would have some deterrence effect. Second, if an employee had multiple employers, the statute could make only the employer paying the largest compensation eligible for a bonus deduction.¹⁵² And, if an employer hired

149. Tax evasion is an illegal attempt to underpay taxes. I.R.C. § 7201; *see also* PHELPS, *supra* note 21, at 115 (discussing fraudulent attempts to take advantage of a wage subsidy and possible government responses).

150. The benefit to the employer is smaller if the compensation is only partially deductible as discussed in the previous part. *See supra* Section II.B.2.

151. Although a sole-proprietorship is the simplest case, a similar arrangement would be possible with other business types.

152. To avoid partial deductibility, an employer could attempt to pay an employee through different business entities.

the same person for multiple jobs, all compensation paid to that employee could be aggregated. This would limit some of the possible evasion schemes. Third, the law could mandate a work requirement, perhaps in the form of a minimum number of hours prerequisite, which would prevent bogus employees from entitling employers to a bonus deduction. Fourth, the bonus deduction could be made available only to corporate employers, in which case the double tax could blunt some of the incentive to evade.¹⁵³

Moreover, while the bonus deduction creates opportunities for those without scruples, it may also counteract the incentive to evade. As it stands now, employers and employees may have a joint incentive to underreport employee income because doing so decreases both the employer's payroll tax liability and the employees' federal tax liability. A bonus deduction makes it attractive to honestly declare at least the threshold compensation for any employee earning at least the threshold compensation when the benefit of the bonus deduction exceeds the benefit of underreporting.

In short, a bonus deduction creates new opportunities for evasion, but also diminishes the benefit of some existing evasion schemes. It is difficult to predict what the net effect would be, but in any event, the effect on evasion is something Congress and the IRS should keep in mind.

3. Avoidance responses

The bonus deduction and partial deductibility could create incentives for taxpayers to prefer one legal arrangement over another. The two most obvious sets of classifications would be independent contractor/employee and owner/employee. A business could attempt to classify a worker as either an employee or an independent contractor with the aim of reducing the joint tax burden.¹⁵⁴ Similarly, a business owner could attempt to classify their income as either employment income or business income with the aim of reducing their tax burden. In neither case is discretion unlimited. There are rules that determine whether a particular worker is an independent contractor or an employee, and there are rules that determine whether income is

153. Partial deductibility would then likely only be imposed on corporate employers.

154. In some settings, the joint tax burden will not be the object of interest. For example, when an employee looks only at their pre-tax income, their employer may be able to gull them into a worse after-tax position to the employer's sole benefit.

employee compensation or business income.¹⁵⁵ Nonetheless, there is some gray area, and more importantly, businesses might opt for alternative arrangements to reclassify transactions if the tax benefit were sufficiently large.

A bonus deduction combined with partial deductibility would make some employees more expensive and some cheaper on an after-tax basis. In particular, partial deductibility would make highly compensated employees more costly to businesses. Businesses might respond by reclassifying these employees as either independent contractors or owners, which would lower the tax burden. For example, say an LLC had \$1,000,000 in gross income, one employee whom it paid \$500,000, and no other tax-relevant considerations. With a bonus deduction of \$60,000 and a partial deductibility rate of 50% above \$100,000 in compensation, the taxable income of the LLC would be \$640,000,¹⁵⁶ and the taxable income of the employee would be \$500,000, resulting in a total taxable income of \$1,140,000. If the employee were instead an independent contractor, the LLC's taxable income would fall to \$500,000, and the taxable income of the independent contractor would be \$500,000, resulting in a total taxable income of \$1,000,000. If the employee were instead an owner, the LLC's taxable income would be \$1,000,000, to be apportioned amongst the various owners.

The employee route results in a higher total taxable income. That does not necessarily make it an inferior tax strategy—given specific tax rates and other considerations an employment contract may still yield the lowest tax liability. But in some cases, the worker and the business could collude and opt for a mutually beneficial arrangement. The alternative arrangements incentivized under the policy change might result in inefficient economic activity and decreased government revenue.¹⁵⁷

It is not clear how large a problem this would be. The scope of work for many employees makes it difficult to reclassify them as independent contractors. And shifting employment income to business income may not be a substantial problem for two reasons. First, this option is not practicable for corporations, which means a majority of economic

155. See *Independent Contractor (Self-Employed) or Employee?*, INTERNAL REVENUE SERV., <https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee> [<https://perma.cc/R2SP-RY92>] (last updated Apr. 5, 2023).

156. $\$1,000,000 - (\$100,000 + \$60,000 + 50\% * 400,000) = \$640,000$.

157. For example, to meet the requirements of an independent contractor relationship, the business might have to limit the extent to which it directs the former employee. Frank Messina, Bruce P. Ely, Lisa-Ann Polack, & Marena Messina, *Employee Versus Independent Contractor: The IRS and Department of Labor's Focus on Worker Classification*, 89 CPA J. 32, 36 (2019). The decreased government revenue is merely a transfer, but it may have inefficient consequences—for example, the need to raise additional revenue at an additional efficiency cost.

activity would be immune from reclassification. Second, there is already an incentive to reclassify employment income as business income in many cases. The existing incentive could limit the number of instances in which partial deductibility would result in a change. And, as mentioned above, limiting the bonus deduction (and partial deductibility) to corporate employers might also limit these behavioral responses.¹⁵⁸

On the other hand, the bonus deduction would also give businesses an incentive to hire low-pay independent contractors as employees to be eligible for the bonus deduction. To the extent that employment arrangements are preferred to independent contractor arrangements, this would be desirable.

B. *Technical Details*

The bonus deduction, as outlined above, might strike one as a relatively simple change to the tax code: Employers receive a deduction for each employee compensated above a certain level. So too with partial deductibility: Compensation paid to an employee earning above a threshold is only partially deductible. But as is always the case with tax law, there are nuances which must be fleshed out if Congress were to enact comprehensive and sound legislation. To start with: Who is an employer? Who is an employee? What is compensation? And what happens if a particular employer has a tax loss after taking all the bonus deductions it is eligible for? These issues, and a few more, are briefly explored in this Section.

1. Key definitions

The policy proposal requires clear definitions of several terms, including, crucially, employee, employer, and compensation. As a starting point, there is already a definition of employee for tax purposes, but this definition does not address all relevant issues.¹⁵⁹ For example, should only workers in the U.S. be eligible for the bonus deduction? What about

158. If the incentive to reclassify employees to independent contractors were very large, the government could change the tax treatment of amounts paid to independent contractors to discourage widespread reclassification.

159. See *Employee*, 26 C.F.R. § 31.3401(c)-1 (2023) (“Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.”); see also *Wages*, 26 C.F.R. § 31.3401(a)-1 (2023).

U.S. citizens working in other countries? A reasonable eligibility requirement is that the employee pay U.S. federal income taxes on the compensation that determines the employer's eligibility for the bonus deduction.¹⁶⁰ This allows for better verification of the compensation. The definition of an employer raises similar issues. Again, a reasonable (and possibly necessary) eligibility requirement is that the employer pay U.S. federal income taxes, which would be consistent with the notion of reimagining a tax benefit.¹⁶¹ The definition of compensation would also change the effect of the policy. Should all non-cash compensation be included in the eligibility test? Any compensation that is not included for determining eligibility for the bonus deduction would be disfavored by employers. One possible approach, as noted in the previous Part, would be to impose a minimum cash compensation requirement and a minimum non-monetary benefits (such as employer-provided healthcare) requirement.

2. Full expensing

As noted above, some employee compensation costs are capitalized and added to the value of an asset, including, notably, to inventory.¹⁶² Only when the asset is sold are those employee compensation costs deductible as part of the employer's cost of goods sold.¹⁶³

160. This would ensure that as the taxable income of employers decreases, the taxable income of employees increases.

161. Note that non-profits would not apply under this definition because non-profits do not pay tax. This is, in some sense, the right outcome because non-profits do not benefit from the deduction and would not be directly harmed by partial deductibility. See PHELPS, *supra* note 21, at 108–09 (discussing why non-profits should not be eligible for a wage subsidy). Alternatively, one might take the view that any employment with the requisite compensation should be eligible. One could imagine a credit alternative to the deduction, and this credit could be designed such that non-profits would be eligible. Note that including non-profits would increase the cost of the program.

162. I.R.C. § 263A.

163. Requiring capitalization for some employee compensation and allowing a deduction only when there is a sale is consistent with a pure income tax. JOSEPH BANKMAN, DANIEL N. SHAVIRO, KIRK J. STARK, & ERIN ADELE SCHARFF, *FEDERAL INCOME TAXATION* 366–67 (19th ed. 2023). Consider a business which buys \$5 worth of wood and hires a carpenter for \$10 to make a cabinet, which it later sells for \$20. The cost of the wood is not an economic loss. One asset, money, is exchanged for another, wood. The same is true of the compensation paid to the carpenter. Two assets, money and wood, are exchanged to create another, a cabinet. The business has paid out \$15, but it has gained an asset (likely worth more) in return. Under a pure income tax, the cost of creating this asset should not be deductible when incurred because there is no decrease in economic value. The deduction should be allowed to offset the gain from the cabinet. This is known as the matching principle. *Id.* at 163. It is not, however, obvious when the income should be recognized. Recognizing income when the asset is created may fit best with a pure income tax. When the asset is created, however, the sale price may not be known, meaning there is a substantial administrative benefit to recognition at sale.

The bonus deduction and partial deductibility provisions discussed above are, however, made more complicated if some employee compensation must be capitalized and some may be deducted immediately. Moreover, allowing immediate deductibility would generally preference hiring, which is the policy objective of interest in this Article. There is, thus, a case to be made that, in conjunction with the enactment of the bonus deduction and partial deductibility, all employee compensation costs should be immediately deductible. This would also bring employee compensation costs more in line with the current tax treatment of business asset costs, which are immediately deductible.

3. Excess deductions

Another important issue is whether any of the bonus deduction should be refundable or carried forwards or backwards.¹⁶⁴ The bonus deduction would yield a tax benefit to any firm with a positive marginal tax rate, but businesses with deductions exceeding gross incomes would have a tax loss and thus face a zero marginal tax rate. In particular, businesses eligible for many bonus deductions could experience tax losses, meaning the value of bonus deductions to these businesses would be lower since they would, at best, be able to use the tax loss in a future year. The value of an additional bonus deduction to a firm with a tax loss would be uncertain and, at the very least, would have to be time-value-of-money discounted based on when it would most likely be usable. This would limit the benefit of the bonus deduction and thus the incentive to hire and compete for workers by increasing compensation.

Congress could incentivize even businesses with tax losses to hire by making some fraction of the bonus deduction refundable, meaning that employers with bonus deductions sufficiently large to generate a tax loss would receive a check from the U.S. Treasury. In a sense, refundability subsidizes compensation to workers while, in some cases, subsidizing bad businesses. An additional benefit of refundability may emerge during recessions when many businesses suffer tax losses. If the bonus deduction provided no immediate benefit to many employers during a recession, they might cut their workforce precisely when it would be in the economy's best interest to maintain employment. A refundable

164. Refundability is a concept generally applied to credits, but there is no reason why it might not also apply to a deduction. *Id.* at 15–16. The amount refunded would be the amount of the deduction (up to the tax loss), potentially discounted, and then multiplied by the tax rate. If there were more than one tax bracket, the lowest tax bracket with a positive tax rate would be a reasonable candidate for setting the appropriate tax rate.

bonus deduction would essentially pay employers to retain workers, counteracting the recession. This would have obvious benefits for workers, reduce unemployment and welfare benefit claims, and avoid the transaction costs associated with cyclical layoffs and hires.¹⁶⁵

4. Proration

The bonus deduction could be prorated for employees who work for less than one year. Say, for example, that a business employed a worker for nearly an entire year who then decided to quit. If the bonus deduction threshold were \$40,000 and that worker were only paid \$39,500, the employer would not be eligible for a bonus deduction for that employee.¹⁶⁶ If employers were concerned with employees leaving before earning the bonus deduction threshold in compensation, the bonus deduction's incentive to hire would be dampened. Moreover, employers would have calendar-year hiring incentives, as employees hired on January 1 would only need to be paid \$40,000 annually for the employer to receive the bonus deduction, whereas employees hired on July 1 would need to be paid \$80,000 annually for the employer to receive the bonus deduction.¹⁶⁷ Employers would generally have a greater incentive to hire earlier in their year.¹⁶⁸

One possible solution to this issue would be to prorate the bonus deduction. The proration could be applied using any periodicity. Say that the bonus deduction were applied to an hourly wage so that an employer would receive a bonus deduction of \$30 each time an employee were paid at least \$20 for an hour of work.¹⁶⁹ The bonus deduction would not cause employers much concern because they would at most lose \$29.99 in effectively accrued bonus deduction.

There are, however, two material downsides to slicing the bonus deduction too finely. First, the amount of data required to implement the bonus deduction would increase. Verifying the number of hours an employee earned at least a certain hourly rate is more complex than

165. The transaction costs of cyclical employment include search costs and lost industry-specific human capital. See Richard Rogerson et al., *Search-Theoretic Models of the Labor Market: A Survey*, 43 J. ECON. LITERATURE 959, 959–60 (2005); Derek Neal, *Industry-Specific Human Capital: Evidence from Displaced Workers*, 13 J. LAB. ECON. 653, 653 (1995).

166. In theory, the employer would benefit by writing the employee a \$500 check. This would, however, violate a work requirement.

167. Assuming the employer's tax year is the calendar year.

168. Cleverly designed employment contracts may also mitigate this problem.

169. These numbers are approximately the hourly equivalent of \$60,000 and \$40,000 in full-time annual compensation, respectively.

verifying annual compensation. Second, \$20 per hour may be a good wage, but because there is no guaranteed number of hours, an employee earning that wage may still be impoverished by not having sufficient work. At 80 hours per year, the bonus deduction would only incentivize \$1,000 of compensation. In contrast, incentivizing a minimum annual compensation (e.g., \$40,000) would lift many employees out of poverty. A middle ground—for example, monthly proration—might be the best path, limiting administrative complexity and ensuring a minimum level of monthly pay, while not dampening the incentive to hire too much.

5. Cost of living variation

A person's cost of living is a function of the locality they inhabit. One could envision a bonus deduction that would be greater in labor markets with high costs of living and lower in labor markets with low costs of living. It could also vary along other dimensions, including the employee's household composition. Adjusting the bonus deduction to account for additional factors would have some benefits, but it would also substantially complicate the required legislation and administration necessary to institute a bonus deduction.

CONCLUSION

The U.S. labor market is an incredible source of wealth and opportunity, but it falls short of its potential. For low-wage workers, the U.S. labor market is inadequate. Market failures implicated by low-wage work have widespread social and economic consequences. These challenges are likely to worsen as technological change exerts additional pressure on the low-wage segments of the U.S. labor market.

Tax law offers an intriguing potential remedy that could provide opportunities for many of the least fortunate in the U.S. By increasing the deduction for employee compensation, Congress could incentivize more employment and higher incomes for low-wage workers. Tax law also offers a related path for offsetting some of the costs of larger deductions for low-wage workers—a lower deduction for high-wage workers. More generally, the case for a dollar-for-dollar deduction for all employee compensation, regardless to whom it is paid, should be scrutinized more carefully. With some reimagining, the employee compensation deduction could well become an incisive tool for policymakers to improve the U.S. labor market.

SIMULATION APPENDIX

This appendix offers additional details on the simulation presented in Part II. It describes the data sources, the central modeling decisions, and some of the simulation's shortcomings.¹⁷⁰

Annual wages were extrapolated from Bureau of Labor Statistics (BLS) data. The BLS data provided the first decile, first quartile, median, third quartile, and ninth decile of usual weekly earnings of full-time wage and salary workers.¹⁷¹ Using a fourth order polynomial, these quantiles were extrapolated to generate a full distribution. The distribution was adjusted to ensure that all full-time workers earned at least the minimum wage. Ad hoc adjustments were made to prevent odd outcomes at the high- and low-end of the distribution. Weekly wages were annualized assuming all workers worked the same number of weeks per year. The number of weeks per year was set so that aggregate annual wages from the distribution matched 2019 BLS data.¹⁷²

Aggregate BLS statistics were adjusted to include only full-time workers by removing annual wages earned by part-time workers. This adjustment was made using data on the number of full-time workers,¹⁷³ average part-time and full-time hourly wages,¹⁷⁴ and the hours worked per day of full- and part-time workers.¹⁷⁵ Assumptions, including how many days per week part-time workers work, were needed to make the adjustment.

Functions mapping income to EITC and average tax rate (not including EITC) were estimated using a flexible functional form.¹⁷⁶ Tax

170. Please contact the author with any questions.

171. News Release, Bureau of Lab. Stat., U.S. Dep't of Lab., USDL-22-2036, Usual Weekly Earnings of Wage and Salary Workers Third Quarter 2022 (Oct. 18, 2022, 10:00 AM), https://www.bls.gov/news.release/archives/wkyeng_10182022.pdf [<https://perma.cc/4DY6-MJLP>].

172. *Quarterly Census of Employment and Wages*, U.S. BUREAU OF LAB. STAT. https://data.bls.gov/cew/apps/table_maker/v4/table_maker.htm#type=0&year=2019&qtr=A&own=0&ind=10&supp=1 [<https://perma.cc/N848-A4ZC>] (last modified Sept. 7, 2022).

173. Roxanna Edwards & Sean M. Smith, *Job Market Remains Tight in 2019, as the Unemployment Rate Falls to its Lowest Level Since 1969*, U.S. BUREAU LAB. STAT.: MONTHLY LAB. REV. (Apr. 2020), <https://www.bls.gov/opub/mlr/2020/article/job-market-remains-tight-in-2019-as-the-unemployment-rate-falls-to-its-lowest-level-since-1969.htm#:~:text=The%20number%20of%20employed%20people,partly%20reflecting%20lower%20population%20growth> [<https://perma.cc/46VR-XVLQ>].

174. DAVID M. PONGRACE & ALAN P. ZILBERMAN, U.S. BUREAU OF LAB. STAT., A COMPARISON OF HOURLY WAGE RATES FOR FULL- AND PART-TIME WORKERS BY OCCUPATION, 2007 (July 23, 2009), <https://www.bls.gov/opub/mlr/cwc/a-comparison-of-hourly-wage-rates-for-fulland-part-time-workers-by-occupation-2007.pdf> [<https://perma.cc/4DK4-FDP2>].

175. See News Release, Bureau of Lab. Stat., U.S. Dep't of Lab., USDL-23-1364, American Time Use Survey – 2022 Results, (June 22, 2023, 10:00 AM), <https://www.bls.gov/news.release/pdf/atus.pdf> [<https://perma.cc/3WZR-89UJ>].

176. Using a continuous function (in lieu of a series of tax brackets) made the simulation easier to run.

liabilities were computed assuming a single-filer with one child and no non-wage income.

Employer-provided health insurance (EPHI) costs were modeled as a function of employee income. The function was constrained so that the revenue cost of the EPHI exclusion in the simulated distributed matched aggregate numbers.¹⁷⁷ Estimated costs varied from 15.6% of income for the lowest-income employees to 3.7% of income for the highest-income employees.

The simulation assumed that aggregate business tax revenue was a CES production function of three inputs: capital, low-wage work, and high wage work. Aggregate taxable income was computed by taking aggregate business tax revenue and subtracting the deduction for employee compensation and a deduction for all other costs, assumed to be a fraction of total business assets—this fraction was determined by using these aggregates. Aggregate wages were increased to account for deductible non-wage compensation. Aggregate after-tax income was computed by taking aggregate business tax revenue and subtracting the cost of employee compensation, all other costs, and business tax liability.

The aggregate values were determined using SOI and IRS data and combining corporate and non-corporate businesses.¹⁷⁸ Non-corporate businesses were assumed to face the same effective tax rate as corporate businesses.

Aggregate labor supply was partitioned into aggregate low-wage and aggregate high-wage labor supply. The model did not account for intensive margin labor supply decisions. Aggregate low-wage labor supply changed with the average after-tax wage of low-wage workers, assuming the elasticity of extensive margin labor supply with respect to after-tax wages was 0.15. Aggregate high-wage labor supply changed with the average after-tax wage of high-wage workers, assuming the elasticity of extensive margin labor supply with respect to after-tax wages was, again, 0.15.

In the simulation, the amount of capital, the number of low-wage workers, and the number of high wage workers were chosen to maximize aggregate after-tax income, assuming fixed wages and an opportunity cost of capital of 10%. The CES substitution parameter implied by the status quo was 0.12. The share parameter for capital was assumed to

177. See *supra* note 134.

178. RON DECARLO, TUBA OZER-GURBUZ, & NINA SHUMOFSKY, INTERNAL REVENUE SERV., PARTNERSHIP RETURNS, TAX YEAR 3 (2020), <https://www.irs.gov/pub/irs-soi/soi-a-copa-id2204.pdf> [<https://perma.cc/P79X-3NRY>]; INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY, CATALOGUE NO. 61538P, STATISTICS OF INCOME—2019 CORPORATE INCOME TAX RETURNS: COMPLETE REPORT 2 (2019), <https://www.irs.gov/pub/irs-pdf/p16.pdf> [<https://perma.cc/Q2Q9-E4DH>].

be 0.4; calibrating the model implied the share parameter of low-wage work was 0.12 and the share parameter of high-wage work was 0.48.

There were insufficient degrees of freedom to allow both the share parameter for capital and the level of capital to be exogenous. When the level of capital was fixed, the implied share parameter for capital was nonsensical.¹⁷⁹ To avoid this outcome, the share parameter for capital was fixed and the level of capital was determined internally by the model.

Changes in the deduction for employee compensation, changes to the business tax rate, and changes to the after-tax average wage caused by eliminating the EITC and the exclusion for EPHI resulted in different equilibrium levels of capital, low-wage workers, and high-wage workers and, consequently, different equilibrium levels of income tax revenue from employees and businesses.

Medicare tax revenues were assumed to be 2.9% of wages. Federal unemployment tax receipts were assumed to change by \$42 times the change in the number of employees.¹⁸⁰ Federal unemployment outlays were assumed to change by 20% of the change in the number of low-wage workers multiplied by the implied average annual benefit.¹⁸¹ Disability outlays were assumed to change by 20% of the change in the number of low-wage workers multiplied by the average disability benefit per recipient.¹⁸² Medicaid outlays were assumed to change by the change in the number of low-wage workers multiplied by the average Medicaid benefit per recipient.¹⁸³

179. Allowing the cost of capital to be determined internally by the model, instead of the level of capital, resulted in cost of capital below 3%.

180. The federal unemployment tax rate is 6%, applied to the first \$7,000 paid to each employee. However, businesses are entitled to a credit for state unemployment taxes. For many states, this results in an effective federal unemployment rate of .6% and a tax liability of \$42 per full-time employee. *Topic No. 759, Form 940—Employer's Annual Federal Unemployment (FUTA) Tax Return—Filing and Deposit Requirements*, INTERNAL REVENUE SERV., <https://www.irs.gov/taxtopics/tc759#:~:text=FUTA%20tax%20rate%3A%20The%20FUTA,federal%20or%20FUTA%20wage%20base> [<https://perma.cc/49ET-TTFN>] (last updated Oct. 18, 2023). See also Emp. & Training Admin., *Unemployment Insurance Tax Topic*, U.S. DEPT OF LAB., <https://oui.doleta.gov/unemploy/uitax-topic.asp> [<https://perma.cc/CQ9M-PEVS>] (last updated Sept. 5, 2023).

181. The implied average annual benefit was computed by dividing annual unemployment benefit outlays by the number of unemployed. *Federal Unemployment Compensation Program, Employment and Training Administration, Labor: Fiscal Year Summary*, USASPENDING.GOV, https://www.usaspending.gov/federal_account/016-1801 [<https://perma.cc/9MQL-KD2R>] (last visited Sept. 15, 2023).

182. *Chart Book: Social Security Disability Insurance*, CTR. ON BUDGET & POL'Y PRIORITIES, <https://www.cbpp.org/research/social-security/social-security-disability-insurance-0#:~:text=SSDI%20benefits%20are%20modest,for%20most%20of%20their%20income> [<https://perma.cc/N59D-5ZCL>] (last updated Feb. 12, 2021).

183. In 2019, the median expenditure per Medicaid program participant was \$8,436. See *Medicaid Per Capita Expenditures*, MEDICAID.GOV tbl. 1, <https://web.archive.org/web/20230511034403/https://www.medicaid.gov/state-overviews/scorecard/how-much-states-spend-per-medicaid-enrollee/index.html> [<https://perma.cc/2VGN-L456>] (webpage archive captured May 11, 2023).