The regional effects of marginal wage subsidies

Abstract The main research of this paper is the regional effects of marginal wage subsidies. Some regional economic issues are discussed such as production scales, operating profits, industry distribution, and expenditure distribution across the rich and poor regions. It is proven that, marginal wage subsidies improve the employment and raise the industrial share of the poor region, but meanwhile the expenditure share in the rich region increases for marginal wage subsidies. It is also showed that, the relationship between the effectiveness of marginal wage subsidies and the level of openness to trade is ambiguous when the wage level is very high, however, if the wage level is low enough thus marginal wage subsidies can cause relatively large employment increase, marginal wage subsidies cooperating with freer trade policy would be more effective.

Keywords employment increase, marginal wage subsidies (MWS), regional inequality

JEL Classification B22, D73
1 Introduction

How to cure regional inequality is an important theoretical and practical question, and many countries and international organizations have taken great efforts for its solution. In China, some large-scale economic movements have been launched after 2000 such as Western Development and Northeastern Revitalization, and just for the former, the central government spent more than 1,600 billion yuan from 2000 to 2005, which means about $42 billion per year for a single regional development program. In the US, according to the evaluation of Drabenstott (2006), from 2000 to 2004, the federal government spent annually $9.1 billion on regional and community development. Although Bartik (2002) estimates only $6 billion from federal government spent on local economic development program, the total spending is much larger if the additional $20–30 billion from state and local government is considered. There is not any other country or international organization attaching more importance to regional economic problem than the EU. It is a remarkable feature of EU’s regional policy that making sure that most available resources are directed to poorer regions, mainly in the form of Structural Fund. García-Pérez and Rowland (2004) pointed out that in 2001, 30% of total EU spending, or about 0.4% of EU GDP, was invested on Structural Fund, and in period 2000–2006, 70% of Structural Fund was allocated to promote the development and structural adjustment of the regions lagging behind. Dupont and Martin (2006) estimated that €213 billion went to EU regional policies for the 2000–2006 period, costing one third of the EU budget and just after the Common Agricultural Policy as the second budget item.

With the large monetary support, regional policies are expected to improve employment, stimulate investment, and therefore promote economic growth in the regions lagging behind. One widely used regional policy instrument is subsidizing the employment, or wage subsidies, which is discussed in the pioneering work of Kaldor (1936), and some recent researches about North American and European cases by Robertson (1994), Katz (1996), Bell, Blundell, and Van Reenen (1999), Orszag and Snower (2003), Kangasharju (2005), García-Pérez and Rebollo (2007), and Jaenichen and Stephan (2007).

Theoretically, no matter wage subsidies are received by the firms or the individual employees, the results are equivalent in improving the employment.\(^1\)

\(^1\) Undeniably, subsidizing the investment, or capital subsidy is important too, and the current employment-versus-capital dispute is also enlightening, such as the researches of Sinn (1995), Fuest and Huber (2000), and Petrucci and Phelps (2005). However, this paper focuses only on the employment side.

\(^2\) Borjas (1996) provides a theoretical proof of this result, but it does not always hold in practice, as the illustration of Dickert-Conlin and Holtz-Eakin (1999).