Employment Policies Institute

Helping Low-wage Americans

The Earned Income Tax Credit: An Effective Solution to an Age-old Problem

"It can be argued that the substitution of a higher minimum wage with a higher EITC [Earned Income Tax Credit] would be a positive accomplishment."

— Clinton Secretary of Labor Robert Reich[1]

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> "The idea of using a minimum wage to overcome poverty is old, honorable—and fundamentally flawed. It's time to put this hoary debate behind us, and find a better way to improve the lives of people who work very hard for very little."
>
> — *New York Times* editorial[2]

Earned Income Tax Credit: A Better Solution

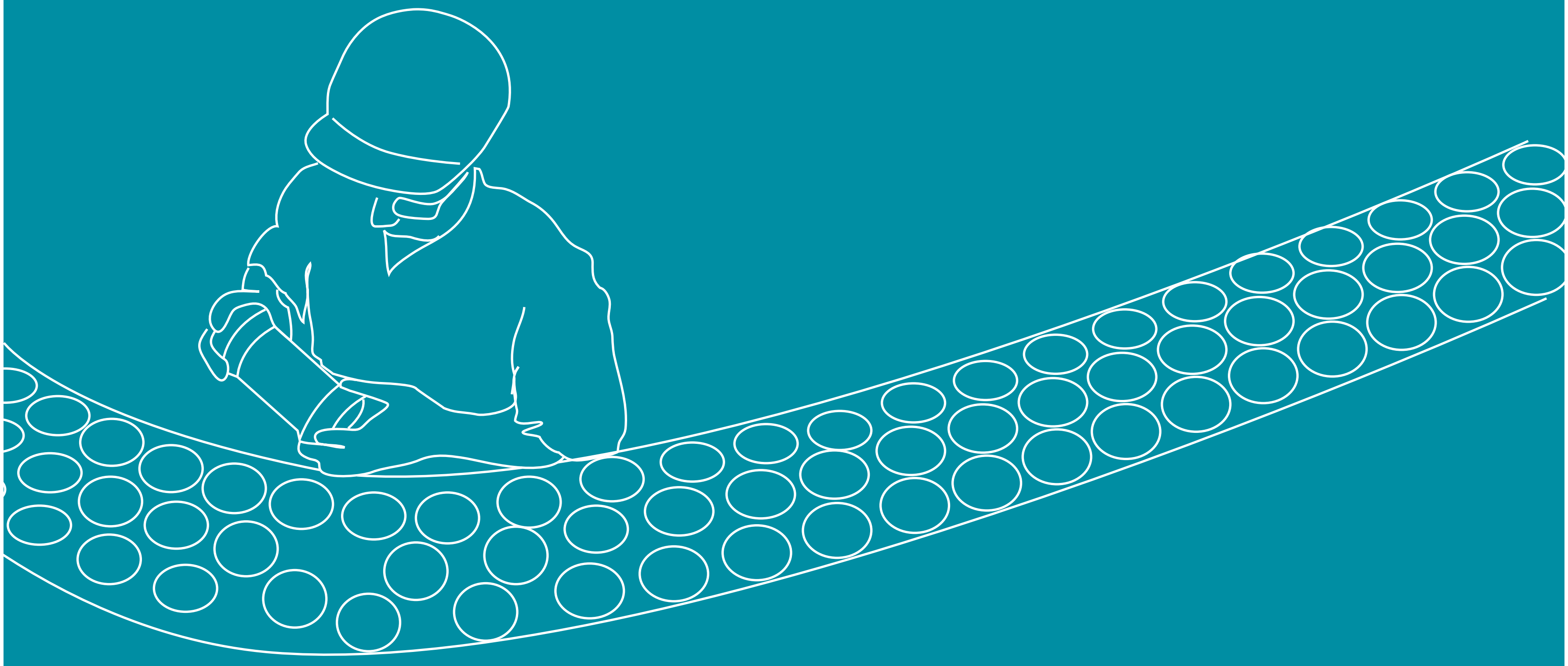
The unemployment rates for demographic groups such as teens and minorities are consistently in double digits. Millions of potential entry-level employees aren't even counted in these figures because they have given up hope and stopped looking for work. Yet newspapers all over the country advertise jobs paying $10 an hour or more. Many practically beg for applicants. One test of our employment and anti-poverty policies should be whether they are tailored to address this disconnect.

The near-universal conclusion of decades of economic research is that minimum wage increases diminish total employment and destroy opportunities for entry-level employees.[3] Moreover, most of the benefits associated with minimum wage hikes accrue to non-poor families. The Earned Income Tax Credit, in contrast, increases poor Americans' income without destroying job opportunities.

Despite these well-documented realities, a low national unemployment rate–coupled with the superficial appeal of minimum wage increases–will once again lure lawmakers into promoting one of our least effective anti-poverty programs. But there is a better way.

“We can increase the Earned Income Tax Credit by a couple of billion dollars a year and, far more efficiently than raising the minimum wage, lift the working poor out of poverty.”

— **President Bill Clinton**[4]



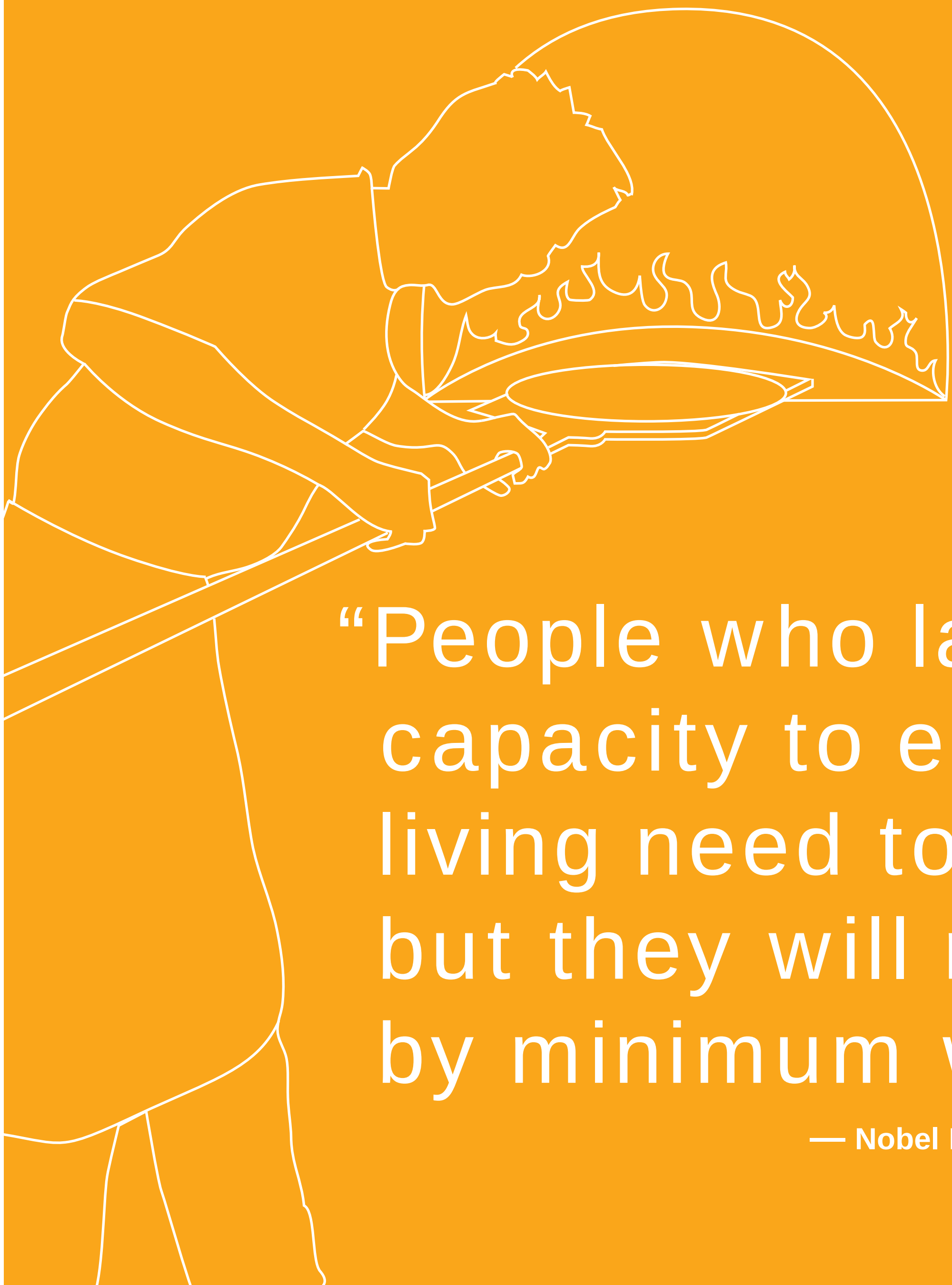
> “Legislators are right to search for ways to help the working poor, but wrong to think that raising the minimum wage is one of them.”
>
> — *New York Times* editorial[5]

Completing the Work of Welfare Reform

With the passage of welfare reform legislation in 1996, Americans signaled their desire to promote work, rather than dependence. But as with many laudable efforts, there were unintended consequences. Many former welfare recipients lacked the skills required to find and keep a job.

However much we might wish otherwise, there is an inevitable connection between low skill levels and low wages. Employers will pay artificially inflated wages to low-skilled adults only so long. The natural consequence of a minimum wage increase is that employers will replace low-skilled adults by hiring those with skills to match the wages they are forced to pay. And that leaves low-skilled adults without a job or the EITC income supplements that are tied to work. Few people dispute the need to address poverty and improve job opportunities for every American. The economic evidence, however, is clear: minimum wage increases are one of the most inefficient and often counterproductive means of achieving this goal. For many Americans, they represent an unbreakable wall separating them from employment.

The EITC accomplishes the same goal as the minimum wage–helping low-skilled individuals maintain a certain level of total income–without killing job opportunities in the process.



“People who lack the capacity to earn a decent living need to be helped, but they will not be helped by minimum wage laws.”

— Nobel Prize–winning economist James Tobin[6]

> "The chief effect of a higher minimum wage today would be to increase incomes, not for working poor people but for a group of workers who are predominantly part-time, second earners in middle-class families."
>
> — Progressive Policy Institute[7]

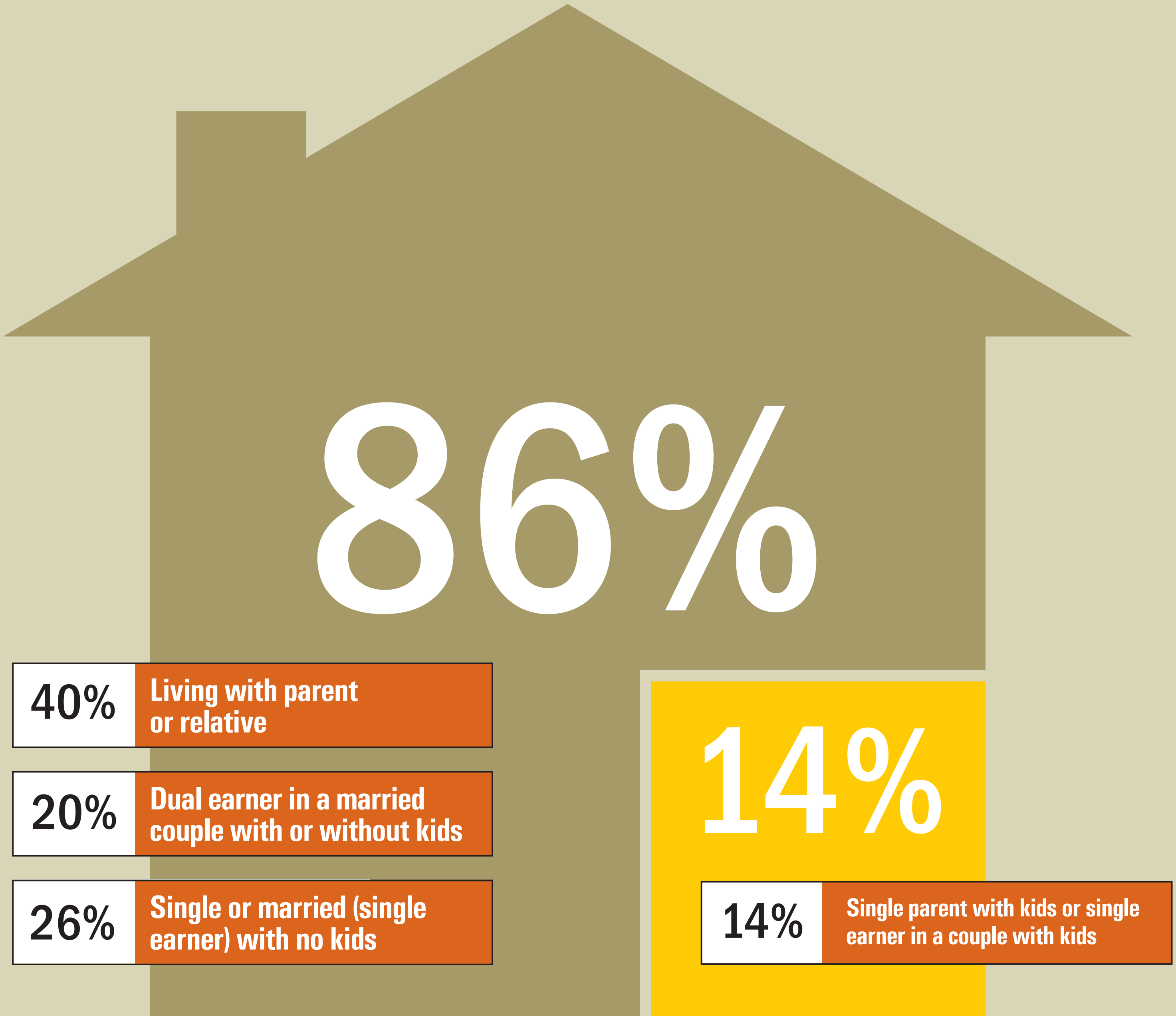
Targeting

Supporters of minimum wage increases often claim that the typical minimum wage employee is struggling to raise a family on a single income. While this paints a sympathetic portrait, it simply is not true. According to U.S. government data, in 2006 only 14% of minimum wage recipients were raising a family on the minimum wage. The remaining 86% were teenagers living with their working parents, adults living alone, or dual-earner married couples. Furthermore, the majority of minimum wage employees do not work full time, and nearly a quarter work fewer than 20 hours per week.[8]

Sensible anti-poverty programs should provide the bulk of their benefits to poor individuals and households with high work effort. But the minimum wage is unable to distinguish between a low-wage employee (who might live in a well-off household) and an employee in a low-income family. Data from the U.S. Census show that the average family income of a minimum wage recipient is over $46,000 a year.[9] Why? The majority of recipients are either teenagers or second earners in relatively high-income families. National polling shows that opposition to a minimum wage increase doubles when people realize this one fact.[10]

Because the minimum wage cannot target those who truly need help, the majority of its benefits go to non-poor families. Research from Syracuse University shows that 83% of the benefits from the last minimum wage hike went to families above the poverty line.[11] In contrast, the Internal Revenue Service (IRS) found that in 2004, over 93% of EITC benefits went to families with incomes of less than $25,000 a year.[12]

Who Actually Earns The Minimum Wage?



“After all, most minimum wage workers aren’t poor.”

— Clinton Secretary of Labor Robert Reich[13]

Poverty and the Minimum Wage

Advocates of a higher minimum wage often claim that the existing rate is a “poverty level” wage. This assertion, however, applies only to the micro-minority of single-earner minimum wage families with two or more children who don’t take advantage of the EITC benefits available to them. The vast majority of minimum wage employees do not fit this description.

Even for these single minimum wage employees with children, increasing the minimum wage may do them no favors. Employers may decide to replace such employees if their output cannot justify their higher mandated wage. This would cost individuals not only their wages but also over $4,000 in potential EITC benefits and the opportunity to increase their skill level and future wages.

The average family income of minimum wage employees is over $46,000 per year.[14] As a result, a minimum wage increase does a poor job of targeting poor families. Meanwhile, targeted programs such as the EITC avoid the negative consequences of the minimum wage and direct assistance to those most in need.

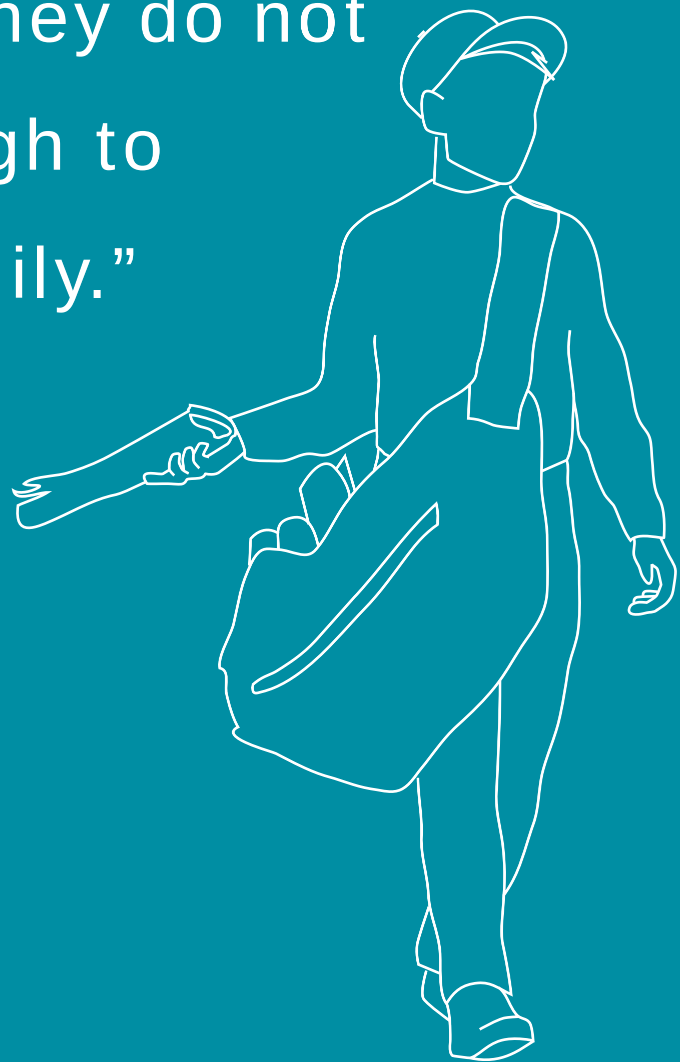
Not only is the minimum wage rate not a “poverty level” wage, but research shows that the poor targeting and other unintended consequences of the minimum wage make it terribly ineffective at reducing poverty—the intended purpose of the policy. Economists at Ohio University found that the federal minimum wage did not decrease poverty and may actually have increased poverty for certain subgroups.[15] That’s because the majority of benefits go to non-poor families. Research out of Stanford University found that only 24% of the benefits from a minimum wage hike go to the poorest 20% of families, while 35% of the benefits go to the richest 40% of families.[16]

“The vast majority of minimum wage workers are in families that don’t need public wage support because their incomes are well above the poverty level.”

— Democratic Leadership Council[17]

“Today’s labor market often has both spouses and even a teenage child or two working. Surely they do not all need to earn enough to support their own family.”

— Nobel Prize–winning economist Joseph Stiglitz[18]



> “[T]he vast majority of [minimum wage] workers move on to higher paying jobs as they accumulate experience.”
>
> — William Carrington and Bruce Fallick, Welch Consulting and Federal Reserve Board[19]

Minimum Wage Employees’ Income Growth

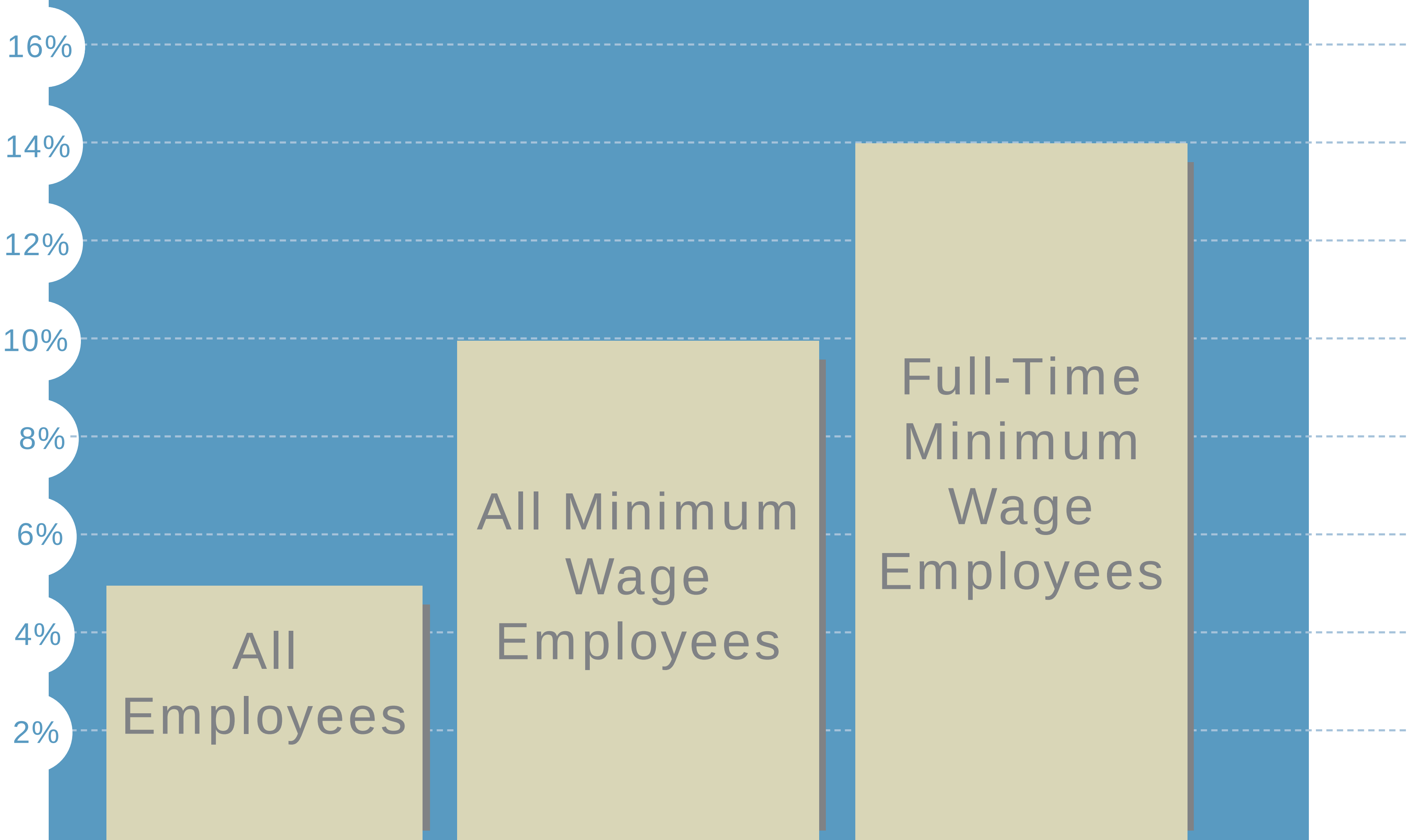
Advocates of minimum wage increases argue that the minimum wage must be regularly increased to ensure that low-skilled individuals receive better pay. Supporters habitually insist that millions of minimum wage employees have not received a raise since 1997. This is simply false and arguably classist. The vast majority of minimum wage recipients don’t need a handout to get a raise. Every year, nearly two-thirds of minimum wage employees receive an increase in pay.[20] These raises result from their increased skill level and experience, and their work effort.

Minimum wage earners receive wage hikes relatively frequently, largely because they tend to be new entrants or re-entrants to the workforce who can quickly acquire the skills necessary to achieve higher earnings. Research out of Miami University of Ohio and Florida State University found that minimum wage employees are approximately five times more likely to be entrants to the workforce from a spell of non-employment than those earning above the minimum. As these new employees increase their skill level, they experience significant wage growth.[21]

The median wage growth for all minimum wage employees is over 10% annually, and those working full time enjoy a median wage increase of nearly 14% each year. This is nearly three times the wage growth for all employees.[22]

Unfortunately, there will always be a small group of minimum wage employees who fail to increase their skill level and corresponding pay. Wage hike supporters point to these individuals as justification for a minimum wage increase. But the unintended consequences of such an increase are particularly harsh for these employees. Employees who are unable to increase their wages on their own are the ones most likely to lose their jobs in the event of a mandated wage hike.

Annual Median Wage Growth



> "Even a wizard would have a great deal of difficulty repealing the economic law that higher minimum wages reduce employment. Since politicians are not wizards, they should not try."
>
> — Nobel Prize–winning economist Gary Becker[23]

The Minimum Wage and Job Loss

Decades of economic research show that an increase in the minimum wage leads to overall job loss for affected employees, particularly for the least skilled. While opinions may vary among economists as to the severity of the impact, the overall message couldn't be clearer.

Below is a summary of academic research regarding job loss and the minimum wage:

- In 1978, Congress and the Carter administration created the Minimum Wage Study Commission to analyze the impact of the minimum wage on U.S. employment. The Commission determined that every 10% increase in the minimum wage results in a 1% to 3% employment loss for teenagers.[24]

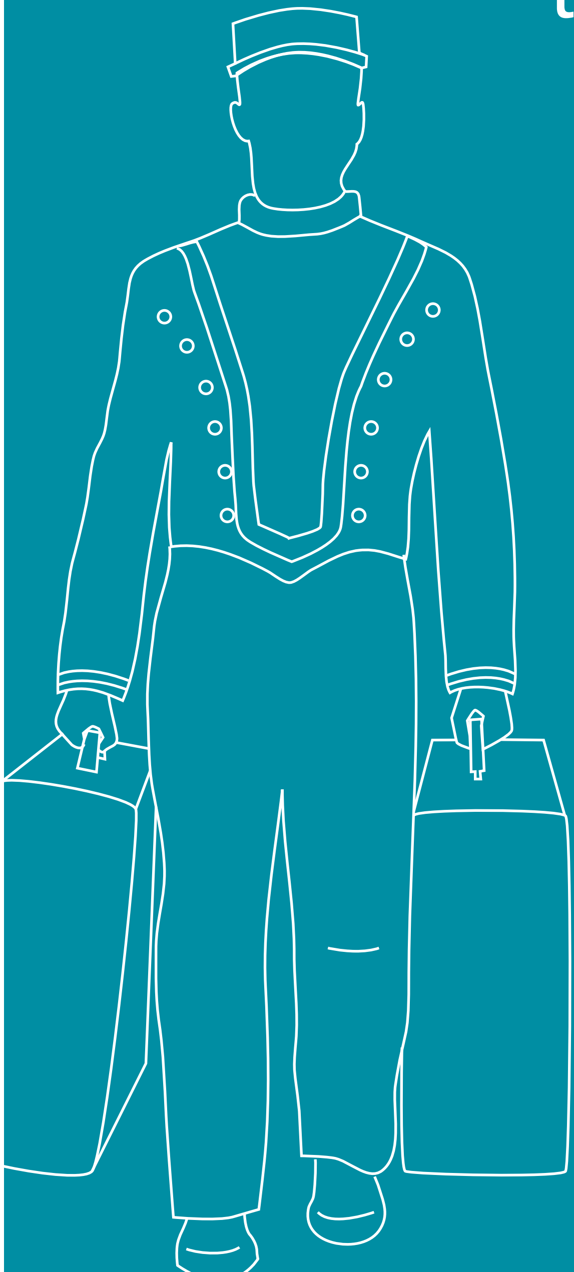
- A 2003 study by economists at the Federal Reserve found that a 2% to 3% decrease in employment is expected from a 10% increase in the minimum wage.[25]

- A 1993 study from Carnegie Mellon University examined the effect of California's minimum wage increase on its retail sector–the largest employer of minimum wage labor. Even though California's retail sales grew at almost twice the national rate, employment growth was below that of the rest of the nation.[26]

- A 1998 survey conducted by economists at Stanford, Princeton, and the Massachusetts Institute of Technology found that the average economist believed a 10% increase in the minimum wage resulted in a 2.1% decrease in teenage employment.[27]

“The reason I object to the minimum wage is I think it destroys jobs, and I think the evidence on that, in my judgment, is overwhelming.”

— **Federal Reserve Chairman Alan Greenspan**[28]



> "Just as no physicist would claim that 'water runs uphill,' no self-respecting economist would claim that increases in the minimum wage increase employment. Such a claim, if seriously advanced, becomes equivalent to a denial that there is even minimal scientific content in economics ... "
>
> — Nobel Prize–winning economist James Buchanan[29]

The Minimum Wage and Job Loss (continued)

- A 1995 report from economists at the University of Chicago and Texas A&M University revealed significant reductions in teenage employment nationwide after the federal minimum wage increase of 1990–91. Employment of teenage males fell 5% after the wage hike, while employment of teenage females fell 7%.[30]

- In 1983, the General Accounting Office found "virtually total agreement that employment is lower than it would have been if no minimum wage existed. This is the case even during periods of substantial economic growth."[31]

- A 2000 study by economists at Cornell University, the University of Connecticut, and the Urban Institute found that a 10% increase in the minimum wage would lead to a 2% to 6% decrease in teenage employment (a common indicator of the impact on entry-level employment).[32]

- A 2006 study from the University of Georgia found that a 10% increase in the minimum wage resulted in as much as a 1.1% decrease in retail employment and a 1.2% decrease in small business employment. Low-skilled teenage workers were particularly affected, with employment decreases of as much as 4.3% in retail and 9% in small business.

- A 2006 literature review by National Bureau of Economic Research economists found that the "overwhelming majority of research" done since the early 1990s found that minimum wage hikes result in increased unemployment.

Studies Showing No Job Loss

While the weight of economic evidence clearly shows that minimum wage hikes decrease employment, a small number of studies published in the mid-1990s purported to find no job loss from a minimum wage increase. The most widely cited study of this type, by Drs. David Card and Alan Krueger, actually found an increase in employment—something that cannot be explained with standard economic theory.

The Card/Krueger study examined employment in New Jersey following a minimum wage hike, relative to neighboring Pennsylvania. Their analysis suggested an improbable increase in New Jersey's employment numbers. But Card/Krueger was flawed. The source of their counterintuitive conclusion was revealed when actual employment numbers for individual businesses became public. It turns out that the telephone survey questions used in their study were very poorly constructed, making accurate collection of data impossible.

According to the Card/Krueger telephone survey, a Burger King outlet in New Jersey had six full-time workers in February 1992, but by November, it had added 23 additional full-time employees—an implausible increase of almost 400%. A Wendy's in New Jersey had zero full-time employees in February, but by November had hired 35 full-time employees without any change in the number of part-timers on staff.

Compare those implausible increases to purported layoffs in Pennsylvania which did not raise the state minimum wage. A Burger King there reportedly went from 50 full-time individuals in February to 15 in November, and from 35 part-time employees in February to just 18 in November. A Wendy's in Pennsylvania supposedly had 30 full-time people in February, but by November all full-time individuals had apparently quit or been terminated without replacement—zero were reported in the telephone survey.

Subsequent research into payroll records (and product price fluctuations) from restaurants examined in the Card/Krueger study verified traditional economic theory: the reported employment and pricing numbers were grossly inaccurate. When the real figures were used, they showed that employment declined in New Jersey following the mandated wage hike.[33]

"A higher minimum will further reduce the employment opportunities of workers with few skills."

— Nobel Prize–winning economist Gary Becker[34]

Who Gets Hurt by Minimum Wage Hikes?

Individuals with little education and experience must secure entry-level employment before they can apply for higher-paying jobs. But it is these low-skilled individuals who are disproportionately hurt by increases in the minimum wage. As wage mandates rise, lesser-skilled employees find themselves crowded out by better-equipped applicants attracted by the higher pay—such as teenagers from wealthy families. They are often deprived of the opportunity to increase their skills on the job and move into higher-paying employment. In this way, the employees the minimum wage is designed to help—the least skilled—are the ones it hurts the most.

National polling indicates that support for a minimum wage increase drops from 83% to 44% when respondents understand this effect. Strong support drops from 59% to 19%.[35]

The economic literature supporting the contention that minimum wage hikes hurt low-skilled employees is voluminous and consistent:

- A 2004 study by economists at Duke University found that minimum wage increases attracted teenagers from high-income families into the labor market, displacing previously employed low-skilled employees. Even in the unlikely case that the higher mandated wage did not affect *overall* employment levels, it still led to layoffs for current minimum wage employees.[36]

- In 2000, researchers at Cornell University, the University of Connecticut, and the Lewin Group found that vulnerable groups of young adults without a high school degree (20–24), young black adults and teenagers (16–24), and all teenagers (16–19) suffered

“The high rate of unemployment among teenagers, and especially black teenagers, is both a scandal and a serious source of social unrest. Yet it is largely a result of minimum wage laws.”

— Nobel Prize–winning economist Milton Friedman[37]

significantly more employment loss as a result of a minimum wage increase. For example, the authors found that a 10% increase in the minimum wage will result in an 8.5% decrease in employment for black young adults and teenagers. This is over four times the employment loss expected for non-black young adults and teenagers.[38]

- A 1995 Boston University study showed that low-skilled adults in states that raise their minimum wage are often crowded out of the job market by teens and students.[39]

- Research from the University of Wisconsin found that mothers in states that raise their minimum wage remain on public assistance an average of 44% longer than their peers in states where the minimum wage remains unchanged.[40]

- A 1995 Michigan State University study showed that high-skilled teens, or those who are perceived as more "desirable" employees, often displace low-skilled employees in minimum wage jobs after a mandated wage hike. A higher minimum wage was also found to increase the number of idle teens–those who neither work nor attend school–by as much as 20%.[41]

- Evidence of the displacement of low-skilled employees dates back to the original minimum wage. The administrator of the Wage and Hour Division of Franklin D. Roosevelt's Labor Department wrote: "In a number of instances there have been reports that workers who had been receiving less than [the new minimum wage] had been laid off, and replaced by more efficient workers."[42]

- A 2007 University of California at Irvine study found that the disemployment effects of minimum wage hikes are concentrated on young minority men and the less skilled. A 10% increase in the minimum wage results in decreased employment among:
  - Young minorities by 3.9%;
  - Young Hispanics by 4.9%;
  - Minority teens by 6.6%;
  - African American teens by 8.4%; and
  - High school dropouts by 8%.

- In 2006, National Bureau of Economic Research economists concluded that there is "overwhelming" evidence from recent minimum wage studies that the least skilled experience stronger disemployment effects as the result of a minimum wage increase.

Amount of every $10 in new wages adult employees could keep after taxes and benefit reductions **$1**

$9 **Amount of every $10 in new wages adult employees could lose to taxes and decreased benefits**

Loss of Benefits

One significant downside to minimum wage increases is that the low-income employees who get a pay raise often lose government benefits such as EITC payments, food stamps, and low-cost health insurance. Unlike the EITC—which is neither taxed nor counted as income by other programs—the "raise" an employee receives as a result of a minimum wage hike is largely eaten up by increased taxes and lost benefits.

Separate studies out of New York University Law School and the University of Kentucky found that many potential beneficiaries of a minimum wage increase face effective tax rates of 90% on increased wages.[43] In other words, many low-wage workers could receive only 10 cents of every new dollar resulting from a minimum wage increase. Support for a minimum wage hike drops 30% when Americans realize this fact.[44]

> "Eager to save money on labor costs, businesses are stepping up the pace of automation. Nearly 13,000 self-checkout systems will have been installed in American retail stores like Kroger and Home Depot by the end of this year, more than double the number in 2001."
>
> — *New York Times,* November 17, 2003[45]

Where Do the Jobs Go?

Decades of economic research prove that employers will cut employment in response to a minimum wage increase. In addition, employers will take the following steps, none of which is beneficial to low-skilled employees:

- **Hire skilled applicants with more experience,** rather than taking a chance on individuals with little education or experience. The displacement of these less-skilled employees is seen in the higher employment loss for vulnerable groups such as teens, minority teens, and adults without a high school diploma.

- **Automate services once performed by entry-level employees**. Self-service gas stations, automated phone systems, automatic teller machines, self-service soda fountains, and self-checkout lanes at grocery stores are all examples of the automation of jobs that were once held by low-skilled, entry-level individuals. In these positions, employees were able to gain the skills necessary to improve their future earnings. Without this vital gateway into the labor force, these individuals will be deprived of future economic success.

- **Cut back on customer service**. It has become quite common for customers at fast-food restaurants to bus their own tables. Baggers at many grocery stores have been eliminated. Forced to pay high mandated wages, employers are choosing to cut back on services rather than raise prices. This results in fewer opportunities for low-skilled Americans.

“Unfortunately, many entry-level jobs are being phased out as employment costs grow faster than productivity. In that situation, employers are pressured to replace marginal employees with self-service or automation or to eliminate the service altogether. When these jobs disappear, where will young people and those with minimal skills get a start in learning the ‘invisible curriculum’ we all learn on the job?”

— Former Senator and Democratic Presidential Candidate George McGovern[46]

“Rather than increase the minimum wage, we should look into expanding the breadth of the EITC program by giving earned income tax credits to older, disabled and other low-income workers without children. We also should look into increasing the generosity of the tax credits to better help poor workers with children to earn a living wage.”

— Cornell economist Dr. Richard Burkhauser[47]

Benefits of the Earned Income Tax Credit

Seven out of every eight Americans living in poverty either do not work or do not work full time.[48] That startling statistic makes it clear that employment is the best solution to poverty.

The federal earned income tax credit (EITC) was originally intended to reimburse low-income working families for their payroll tax (FICA) contribution. In 1993, this tax credit was dramatically expanded to serve as the nation’s largest assistance program.

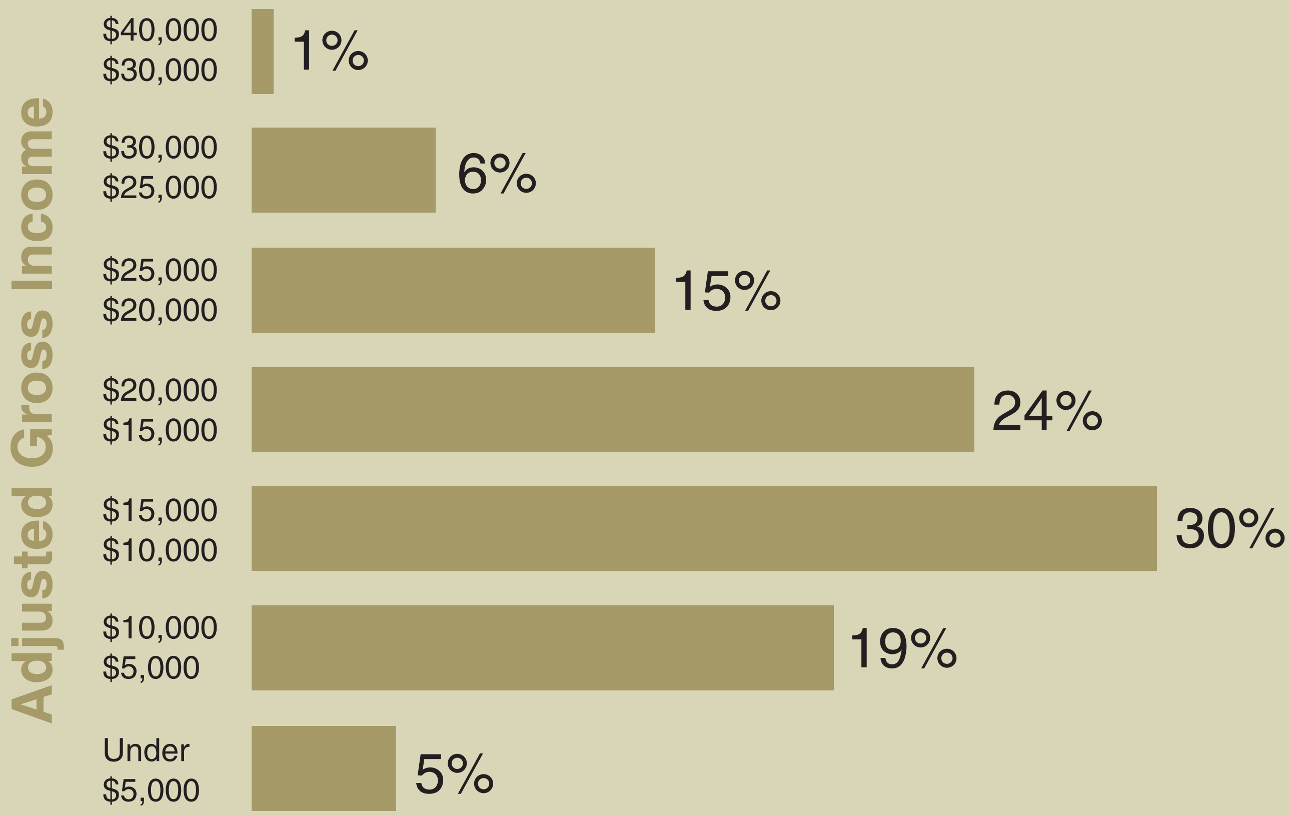
Since the EITC is not available to those without a job, it provides an unambiguous incentive to work. By increasing the income of America’s least-skilled individuals, the credit facilitates employment—which in turn allows employees to increase their skill levels while earning a living.

The EITC provides up to $4,400 in tax-free income to working families. While most participants choose to receive their benefit in a lump sum at the end of the year, they have the option of receiving the benefit in every paycheck. In this way, the EITC allows low-skilled employees with families to receive the income society deems necessary. With the EITC, a full-time minimum wage worker can experience an effective wage rate of up to $7.22 an hour.

With its emphasis on work, it is unsurprising that the EITC increases employment. But it does more than that. Research from economists at Michigan State University and the Federal Reserve found that recipients of the EITC increase their work effort and enjoy higher earnings, moving these employees closer to self-sufficiency.[49] The EITC is the only program that accomplishes this dual goal of improving the earned income of recipients while still providing cash assistance.

Where Do EITC Benefits Go?

In tax year 2004, about three-quarters of EITC benefits went to families with adjusted gross incomes between $5,000 and $20,000 a year.



Source: Internal Revenue Service, Statistics of Income 2004, http://www.irs.gov/pub/irs-soi/02in33ar.xls

State EITC Programs

Policymakers across the political spectrum have recognized the success of the federal EITC program. Begun in 1975 and expanded under presidents Reagan and Clinton, the program has won the support of leading members of both political parties. The reason is simple: no other government program has been as effective in lifting families out of poverty. Most important, because the benefits are focused exclusively on those with jobs, the EITC creates a clear incentive to work.

This success has led a number of states to enact their own EITC programs, which act as an important boost to the federal credit. Because state programs can piggyback on the federal program, they are also relatively easy to establish.

Most states with their own EITC programs use the same eligibility guidelines as the federal program. Their credits are usually set as a percentage of the federal credit. For example, a low-income family can qualify for just over $4,300 in federal EITC benefits. With a state program set at 20% of the federal benefit, a low-income family could receive more than $800 in additional benefits. It is even possible for recipients to adjust their payroll tax withholding to reflect the tax credit. This boosts the take-home pay of needy families and allows them to receive benefits throughout the year.

States, however, can establish their own guidelines to more precisely target the benefits. Some states limit the program to low-income households with children. It is also possible to structure the program so that the credit increases with the number of children in a household. This can help the state direct the benefits to those families most in need.

Federal welfare policy even provides some assistance to states to establish these programs. States are allowed to use their federal Temporary Assistance for Needy Families (TANF) grants to underwrite the costs of a state program. Alternatively, states can count spending on a state EITC program toward their *maintenance of effort* requirements under federal welfare programs.

Of course, financial incentives from the federal government alone don't justify a state EITC program. The ability of the program to target assistance to those most in need–without potentially pushing them out of the job market–is reason enough for states to act.

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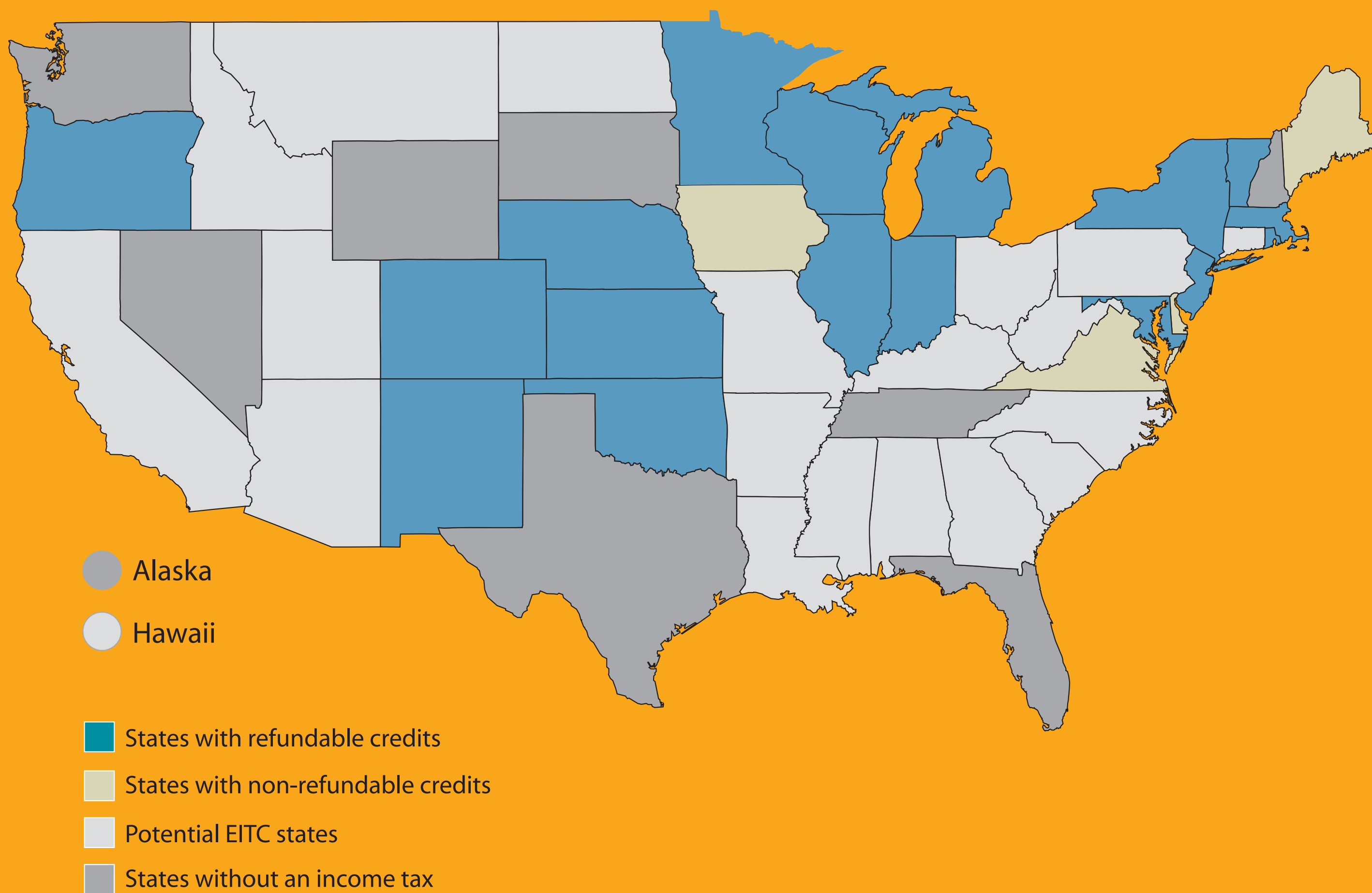
States with Supplemental Earned Income Tax Credit Programs



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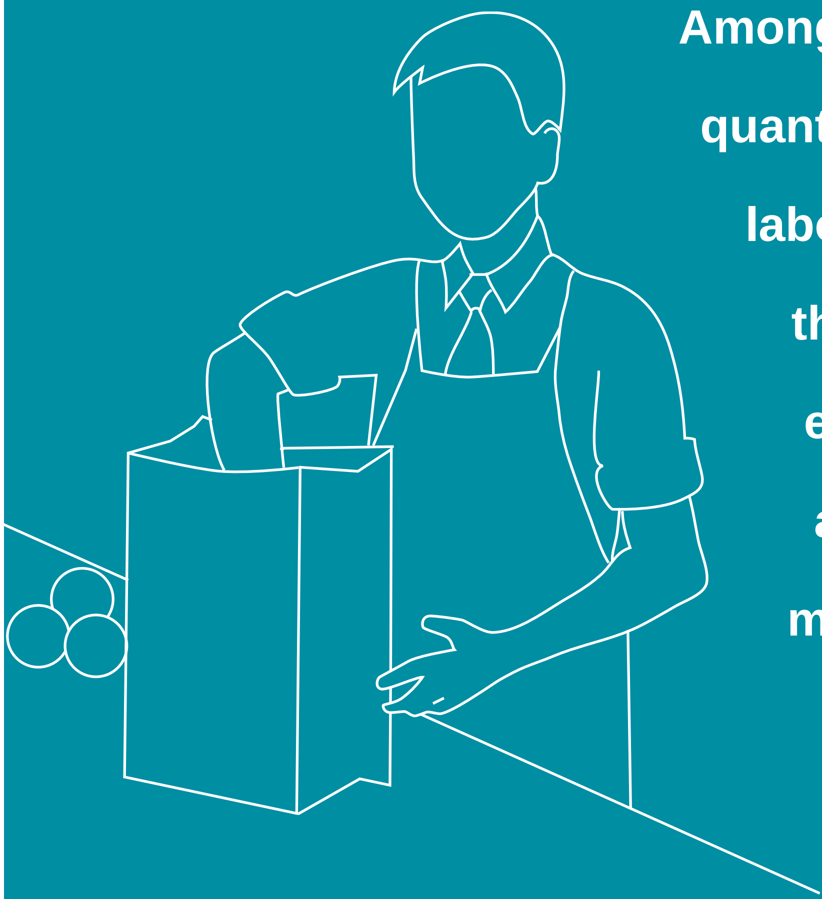

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The Case for an Earned Income Tax Credit

The Minimum Wage Destroys Jobs:

"Polls show that more than 90% of professional economists agree with the prediction that a higher minimum wage reduces employment."

— David Card and Alan Krueger, University of California-Berkeley and Princeton University[50]

The Minimum Wage Hurts Low-Skilled Employees:

"The primary consequence of the minimum wage law is not an increase in the incomes of the least-skilled workers but a restriction of their employment opportunities."

— William Baumol and Alan Blinder, New York University and Federal Reserve Board[51]

The Minimum Wage Is Poorly Targeted:

"The connection between hourly wages and the standard of living of a family is thus remote and fuzzy."

— Nobel Prize–winning economist George Stigler [52]

There Is a Better Way:

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