

# EPI BRIEFING PAPER

ECONOMIC POLICY INSTITUTE • FEBRUARY 27, 2007 • BRIEFING PAPER #183

## A FISH IS NOT A FOWL Tax Credits and the Minimum Wage

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Critics of the minimum wage sometimes suggest tax credits as an alternative means to increase the income of low-wage earners. While there is a case for tax credits (Batchelder, Goldberg, and Orszag 2006; Sawicky 2006a), they work much differently than a wage floor, and any change in tax credits must confront the problem of how the change would fit into the existing tax system and its array of credits, deductions, and exclusions. This paper pinpoints some problems entailed in substituting a tax credit for a minimum wage increase.

### **Taxes and low-income workers: a little background**

A number of features of the federal individual income tax benefit low-income families. The most important ones are the standard deduction, the personal and dependent exemptions, the child tax credit, the earned income tax credit (EITC), and the progressive rate structure. Nevertheless, economists have long been concerned with certain problems in the existing system with regard to how it affects low-income families.

The primary problem is that, to keep costs manageable, a tax credit that eliminates tax liability for the poor must be eventually withdrawn as income grows. The phase-out of a credit is considered to have the same impact on the taxpayer as a higher marginal tax rate. In other words, the taxpayer's share of an additional dollar of income is reduced by either a tax on that dollar or a reduction in a tax benefit caused by the increase in income. In this way, the combined effective marginal tax rates faced by the poor can be much higher than those faced by middle- or high-income persons, thus raising concerns not only about fairness but also about whether the tax system is creating disincentives to work (Hoffman and Seidman 2003; Carasso and Steuerle 2005; Sawicky 2003).

By contrast, the before-tax value of the minimum wage does not change with the work behavior of the worker, and the after-tax value is changed only by the impact of the income tax. This difference in tax implications between a minimum wage increase and an expansion of tax credits is a crucial consideration in any effort to match the benefits of a wage increase with some kind of augmentation of tax credits.

A second problem is the marriage penalty built into the current EITC. The EITC is now the second-largest source of means-tested aid to low-income families, yet its benefits fall significantly for single parents who marry (Ellwood and Liebman 2000).

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The third problem is that, for low-income families with children, obtaining tax benefits can entail a great deal of complexity and hardship (Holtzblatt and McCubbin 2003; Taxpayer Advocate Service 2005). Furthermore, the existing tax system's lack of transparency impedes workers' ability to anticipate the consequences of their decisions for after-tax incomes. Even with few tax benefits available, taxpayers can face complex eligibility rules, and, owing to mandates originating in the previous Republican-controlled Congress, failure to interpret the rules correctly can result in serious sanctions from the Internal Revenue Service (Taxpayer Advocate Service 2005; Sawicky 2002).

## **How a tax credit differs from a wage increase**

### ***Timing***

The taxpayer usually does not recoup benefits from a tax credit until he or she files an income tax return the following year. This delay induces a spending pattern that would probably differ if the benefits were received on a paycheck-to-paycheck basis (Smeeding, Phillips, and O'Connor 2001). The EITC can be received with take-home pay, but most beneficiaries elect to claim the benefit when they file their returns.

By contrast, a wage increase is received in real time, in each paycheck. One could make a case on policy grounds for either way of providing assistance, or for providing assistance in both ways. Biweekly aid helps families shoulder routine, recurring expenses, while an annual lump sum helps people who often lack bank accounts accumulate funds for important big-ticket purchases like appliances or cars.

### ***Labor force participation (LFP)***

Either a wage floor or a tax credit can induce greater labor force participation, and either one can make it easier for a secondary earner to work less and spend more time in the home. But the likelihood that tax benefits will be phased out at some point means that some families with members already in the labor force and income not far above the poverty line will face rising marginal tax rates.

A minimum wage increase can likewise push a worker into a higher marginal tax bracket, but this is due to graduated rates in the income tax, not the wage hike. The impact of such changes on the worker's behavior is an empirical question. Neumark and Wascher (1999) find a strong LFP effect from the EITC, while an increase in the minimum wage tends to influence those already working. Either result, or both, could be a goal of social policy.

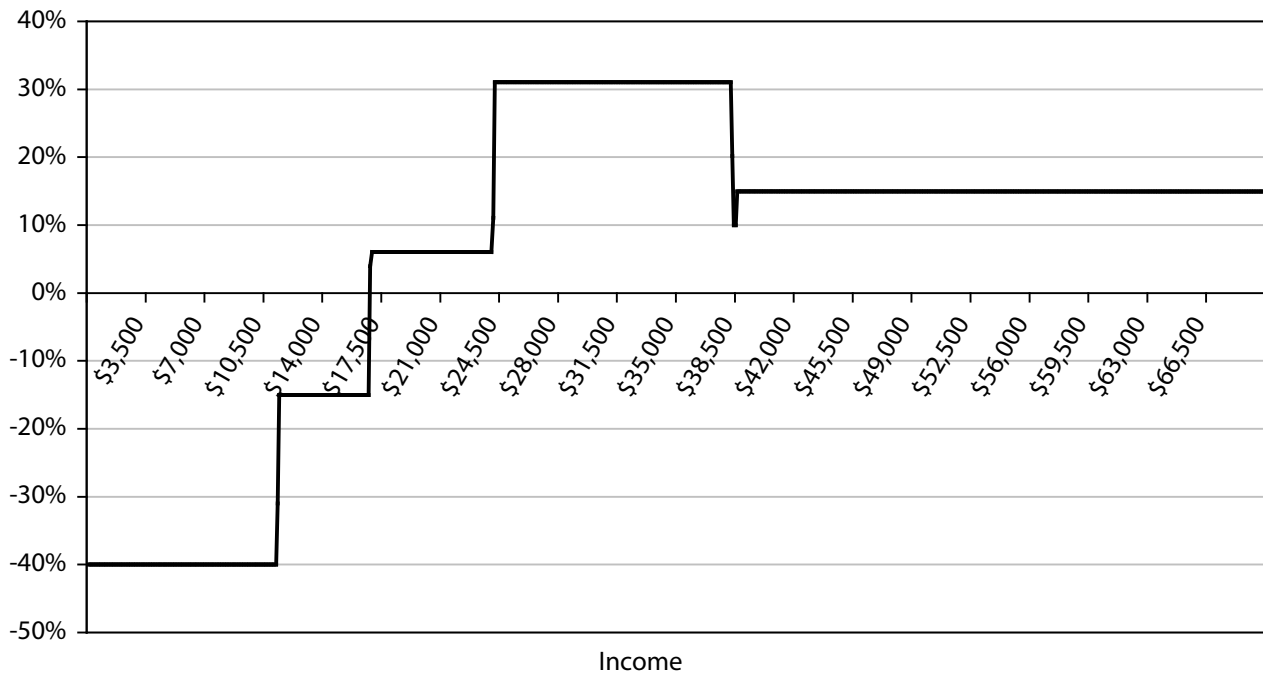
### ***Labor supply***

By labor supply in this discussion we mean a worker's decision to provide somewhat more or fewer hours, days, or weeks of labor. Obviously many workers lack the flexibility to adjust their schedules on their own, and public policy is typically more interested in whether people work or don't work, rather than with incremental adjustments in the number of hours they work. (In the case of workers with children, from a social welfare standpoint it might be preferred for parents not to work full time the year round.)

In economic analysis, it is the benefit of working that extra hour that is thought to inform the labor supply decision. Ordinarily a wage change increases the rewards to work on the margin, but the improvement in a family's total income could induce somewhat less labor supply overall. A tax credit with a phase-out will increase the rewards for additional labor supply at some income levels and reduce it at others.

### ***Marriage penalties***

Tax credits that are subject to phase-ins and phase-outs that depend on family income could entail marriage effects, since combining incomes under joint filing can change the benefits that would otherwise be available for the same two persons if they were unmarried and filing as single or head of household. (Sawicky (2006a) and Carasso and Steuerle (2006) discuss remedies in tax credit design.) By contrast, a wage hike in and of itself entails no marriage penalty, since

**FIGURE A****Effective marginal tax rates, married couple with two children**

SOURCE: Author's calculations.

the benefit stays with the worker regardless of marital status. In other words, a worker might lose a tax credit by getting married, but not a wage increase.

### **Complexity**

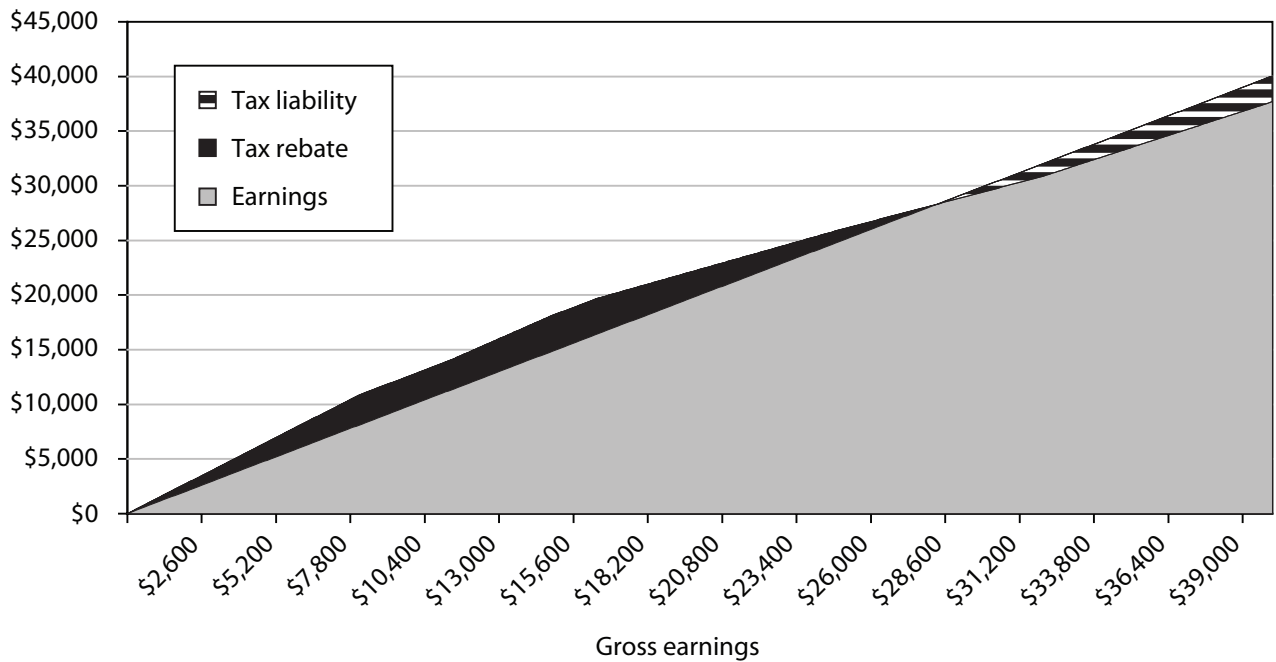
A wage floor has benefits that are transparent and clear for workers. As things stand, few workers could be aware of the landscape of marginal tax rates they face under the income tax system. **Figure A**, which shows marginal tax rates for a married couple with two children and income up to \$66,500, illustrates the sudden and major changes in tax rates that accompany incremental changes in income. (The figure encompasses the impact of just three benefits—the child tax credit, the EITC, and the dependent exemptions.) The complexity of tax credits evidently has an important impact on their use. While the EITC compares well with means-tested benefits available under spending programs, participation in the program is still around 80%, hence open to improvement. Here's where a minimum wage increase has an advantage: adherence to the mandate is the responsibility of the employer and relatively easy to check.

### **Inequality**

A tax credit can be targeted to income—though this is easier said than done in light of the trade-offs discussed above between generosity, cost, and marginal tax rate effects—while a minimum wage increase may be less targeted. While this effect may be a drawback from the standpoint of poverty reduction, it is less so from the standpoint of reducing overall income inequality, which extends throughout the wage scale. While some minimum wage workers come from middle-income families, few are found in the ranks of the wealthy. A minimum wage increase brings persons throughout much of the income spectrum closer to the top, where few minimum wage workers are found.

FIGURE B

After-tax income, current law



SOURCE: Author's calculations.

## Where and how the money goes

This section spells out some of the implications brought to light by Maag (2007) in comparing a minimum wage increase with a tax credit.

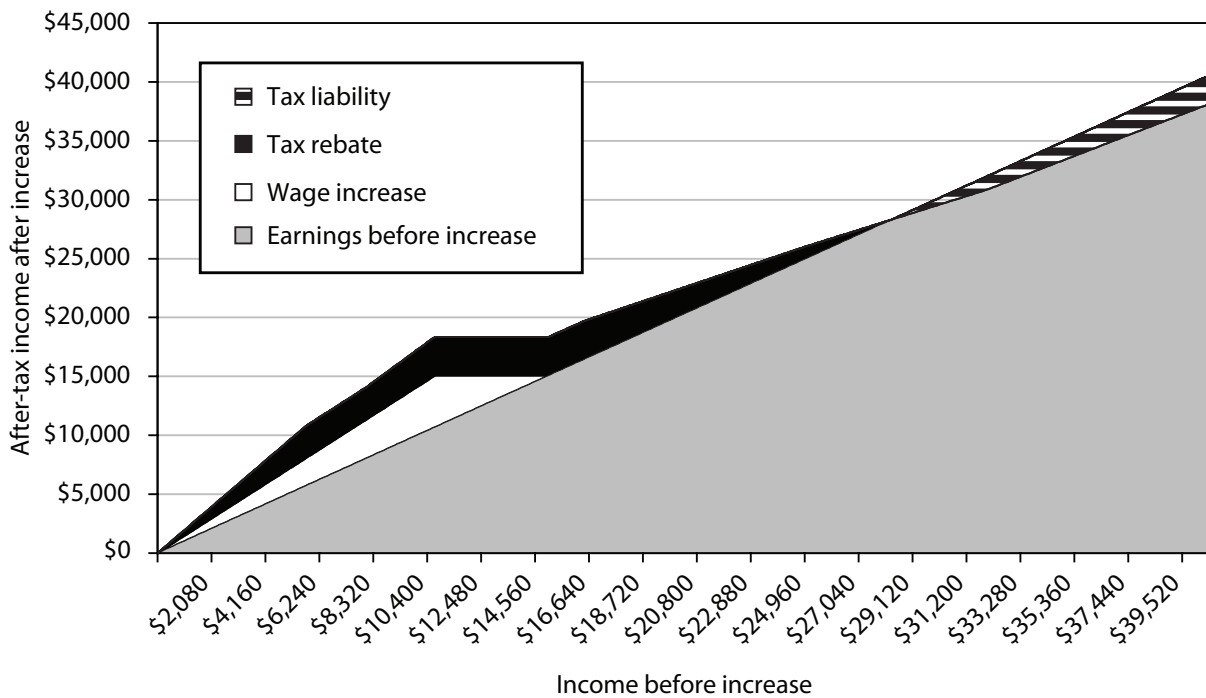
Figure B (which assumes a simple tax return with no credits or benefits other than the standard deduction, personal and dependent exemptions, and the refundable EITC and child tax credit) shows the after-tax income for a single parent with one child. Thanks to the EITC and the child credit, the taxpayer with earnings below \$28,350 receives a net tax rebate—a check from the IRS. Above that level, the credits are insufficient to totally offset ordinary income tax liability, and the taxpayer owes the IRS.

Figure C shows the consequences for after-tax income of an increase in the minimum wage to \$7.25. Annual wages for a full-time minimum wage worker are \$10,712 (\$5.15 an hour for a 40-hour week, 52 weeks a year). For purposes of illustration, we assume that, for income below that level, after the increase the worker receives \$7.25 for an equivalent number of hours he or she worked at the \$5.15 rate, and above that level income simply rises with the hourly wage. Thus, an increase to \$7.25 has a diminishing impact for workers as their wages rise from \$5.15 to \$7.25.

The figure illustrates the effect of the wage increase alone plus the “leverage” of the increased wage in terms of the added refunded credits it generates. Between the income levels of \$10,712 and \$15,080 (the latter the full-time wage at the higher rate), there is no change in after-tax income since, in this scenario, the wage is fixed at \$7.25 within that range. Above \$15,080 the rebates phase out and turn into positive tax liability. (For purposes of this illustration, we assume that workers with wages above \$7.25 are unaffected, though in reality there is evidence that the wage increase would have a ripple effect on wages above \$7.25.)

FIGURE C

After-tax income with minimum wage increase

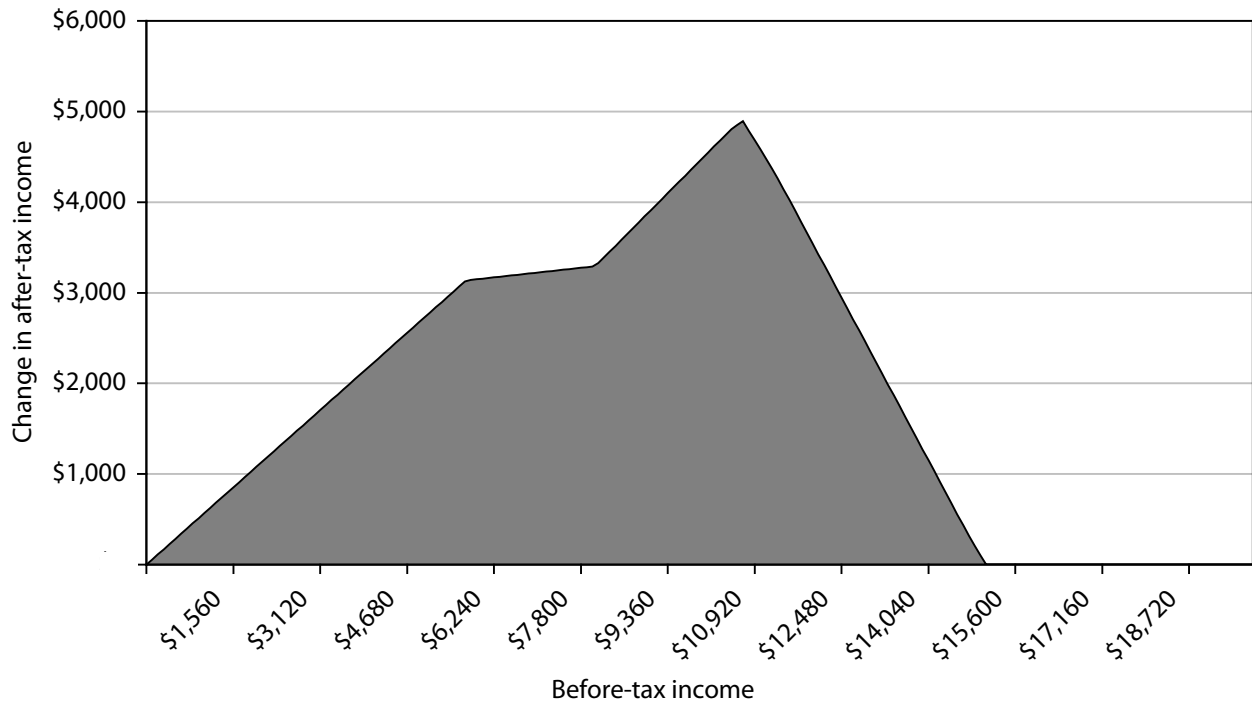


SOURCE: Author's calculations.

It should be noted that, in our example, the implication of a tax credit instead of a minimum wage increase is that the full-time worker gains nothing after-tax from a wage increase between \$5.15 and \$7.25. The effective marginal tax rate is 100%. For the same reason, a worker earning \$10,712 working less than full time at a somewhat higher wage gets no marginal benefit from putting in an additional hour of work. In the first case—a worker with a pre-tax hourly wage between \$5.15 and \$7.25—there is no incentive to exert additional effort for the sake of an hourly wage increase, and in the second no reason to increase one’s work hours. This has important implications for the tax credit versus minimum wage debate. Budget considerations are likely to cause the value of a tax credit to eventually decrease as income rises, reducing or eliminating the rewards to work on the margin. In terms of pre-tax income, by contrast, a higher wage rewards greater work effort or labor supply. The value of a minimum wage increase for affected workers is proportional to income.

Figure D shows the difference in after-tax income from the combined effects of the wage increase and refundable tax credits. As noted by Maag (2007), the total impact approaches \$5,000. In this example, addition to income grows initially at a rate of 55%, and on the downside the rate of decline is 115%. This would be an odd design for a new tax credit, and the irregularity of the shape stems from the peculiarities of the existing tax system. Introducing additional details of the tax code into this scenario would make it all the more uneven, illustrating again how complicated and mystifying the tax code can be for the ordinary person trying to make decisions about whether and how much to work.

Alleviating the steep decline of a hypothetical credit that duplicated the impact on after-tax income of a minimum wage increase would increase its cost and increase overall marginal tax rates. In this example, the peak effect occurs at an income of \$10,712. For a single parent with one child, there is also an EITC credit of \$2,747 at that income level. If one

**FIGURE D****Impact of a minimum wage increase**

SOURCE: Author's calculations.

phased out a combined benefit of \$7,747 (\$5,000 plus \$2,747) at the current EITC rate of 15.98%, the benefit would extend to incomes of \$59,000. As noted previously, there is a trade-off between the generosity of the credit, the total cost to the government in foregone revenue and cash benefits, and the severity of the phase-out of the benefit.

## An odd comparison

In response to a request from Senator Charles E. Grassley (R-Iowa), the Congressional Budget Office (2007) compared the effects of a minimum wage increase to an expansion of the EITC. The EITC expansion that was analyzed was an additional benefit for families with three or more children, and a higher benefit for workers without children eligible for the EITC.

The one common element in the two alternatives—the minimum wage increase versus the EITC expansion—is the cost in terms of families in poverty, roughly \$1.4-1.6 billion. But the focus on poverty and the comparison of these two means for boosting the incomes of low-income families are problematic for a number of reasons:

- Both the EITC and minimum wage affect many families of low or moderate income, not just those below the poverty line.
- Both measures are intended to “make work pay,” not merely to reduce poverty. Helping families distance themselves from the poverty line and achieve middle-class status requires aid not limited to families in poverty.
- The cost of the wage increase is to business owners, while the cost of the EITC expansion is to the federal budget and to taxpayers in general.
- The EITC expansion in question here affects a limited subgroup among families in poverty, unlike an increase in the minimum wage, which affects families to varying degrees throughout the income range.

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- The rationale for targeting families with three children, and those with none, makes sense as a remedy for shortcomings in the EITC (Sawicky 2003), but is entirely different from a decision to help all families in poverty whose workers receive low wages.
  - For those actually affected by the CBO options, the extent of assistance can vary significantly. A childless worker earning the current minimum wage could see an increase in after-tax income of about \$3,500 from the proposed increase. The EITC expansion simulated by the CBO provides no more than \$195 to any affected worker.

The good news in the CBO report is that some egregious gaps in the EITC can be remedied at relatively low cost—\$2.4 billion in 2004 terms. The improvement for workers with no children is limited, while the benefit for larger families is more substantial. But as for comparing and contrasting these benefits with an increase in the minimum wage, the exercise is a dubious one.

## Conclusion

There is a case for expanding refundable credits in the individual income tax, though proposals in this vein usually attempt to improve the existing tax system by reducing marginal tax rates and marriage penalties and consolidating credits for the sake of simplification. Tax credits are worthwhile in their own right, but they are not plausible substitutes for an increase in the minimum wage.

Boosting incomes with a higher minimum wage avoids the dangers of reduced work incentives and larger marriage penalties in the income tax, escapes the burden of offsetting the cost of an expanded credit under the pay-as-you-go rules, foregoes the complexity of redesigning the tax system, and provides a benefit in plain view of the worker.

Tax reform, especially consolidation, simplification, and expansion of tax credits, is a worthy endeavor, but it need not delay an increase in the minimum wage.

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