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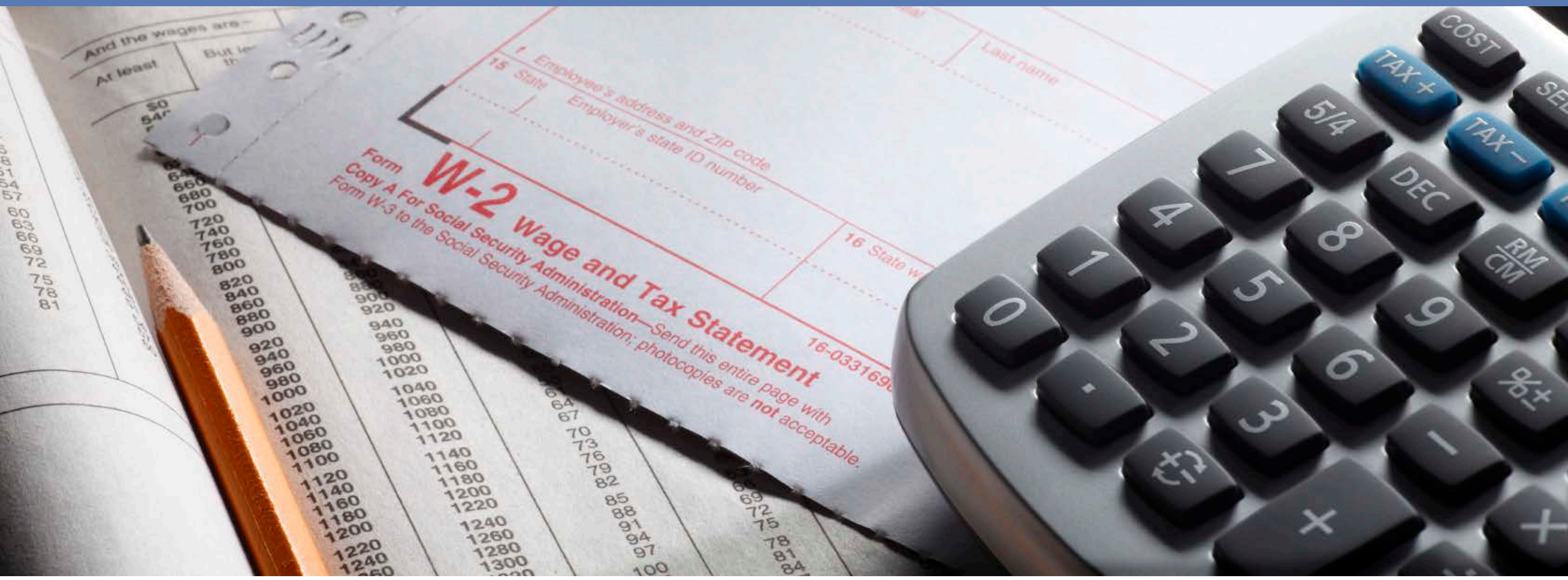

A No-Cost Proposal to Reduce Poverty & Inequality

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Summary

Proposals to increase the minimum wage at the federal, state and local levels are currently receiving a lot of attention. Workers from Seattle to Washington D.C. have been promised a raise.

Advocates for an increase point to the failure of the minimum wage to keep pace with inflation or with average wages in the economy as a whole. A single parent with two children earns less than $15,000 a year working full-time on a minimum wage job: hardly enough to support her family, especially after deducting payroll taxes and work-related expenses such as child care. Whatever her level of effort, she will end up poor and probably dependent on government benefits to survive.

While a higher minimum wage will help to boost earnings, critics worry about its effects on hiring, arguing that employers will create fewer jobs if they have to pay higher wages. Although past increases do not appear to have adversely affected employment, there is no denying the risk that much larger increases might pose to the least skilled workers. Raising the minimum from its current $7.25 to $15.00 per hour, as some have advocated, would more than double the cost to an employer and likely have some impact on hiring. In addition, a higher minimum isn't well targeted on just the poor. Many of the people who would benefit from a higher minimum are secondary workers from more advantaged families. About two-thirds live above 200 percent of the federal poverty line. Only about a fifth are poor.

If we are really worried about families at the bottom, a better way to improve their lot is to increase the Earned Income Tax Credit (EITC) since it is well-targeted to those who most need assistance and will not significantly affect employers.

That said, any increase in the generosity of the EITC could cost billions of dollars—unlikely to be approved in today's fiscally constrained environment. Moreover, as currently designed, although it clearly encourages work, it may discourage marriage, or encourage unwed childbearing. (Empirical evidence for the last two effects is lacking but they remain a concern.)

Our proposal

A better way to boost earnings is to combine the best elements of each policy, allowing them to work in tandem to reduce poverty and inequality. Specifically, we recommend the following hybrid policy:

- Raise the minimum wage to $10.10 and index it for inflation;
- Provide a more generous EITC to families with young children (and somewhat less to large families);
- Provide a significant benefit to childless individuals;
- Eliminate the marriage penalty for most households by basing credits on personal instead of family income;
- Impose a work requirement for childless workers (and a less stringent one for second earners) and restrict eligibility for these two groups to households below 200 percent of the federal poverty line.

Reductions in Poverty

This proposal reduces the poverty rate by an estimated 7 percent, lifting over 3.4 million people out of poverty. Its anti-poverty effectiveness would be enhanced over the longer run if the new plan encourages work and marriage or reduces unwed childbearing (current research suggests it will increase employment but any effects on marriage or childbearing are hypothetical at this

stage). The effects will also be larger to the extent that an increase in the minimum wage has a ripple effect on wages just above the new minimum.

Working single parents, in particular, would benefit greatly from these policy changes. Under our proposal, a single mother with one toddler who worked full-time (2,000 hours a year) at a minimum wage job ($7.25 an hour) would see her annual income from earnings and EITC benefits rise from about $18,000 to over $22,000, or by over 22 percent. More generally, poverty rates among single parent families would fall nearly 8 percent if our proposal was implemented.

Reductions in the Budget Deficit

Implemented together, these two policy changes would cost no more than current policy, and would represent an important first step towards improving the lives of America's working poor families.

Over the longer term, any solution to the plight of these families must involve improving the U.S. education and training system along with reversing the rise of single parent families, as we argued in an earlier paper, "Strategies for Assisting Low-Income Families." However, long before those goals are achieved, the policies that would most help such families are, first, a return to full employment, and second, boosting the earnings of those with jobs. Our earlier paper showed that the most effective policy for improving the incomes of the struggling working class would be to reduce the unemployment rate to 5.4 percent, a commonly used benchmark of a full employment economy. Now that the economy seems to be on the road to recovery, we need to also focus on making work pay.

Background

The Earned Income Tax Credit

Created in 1975 with the dual purposes of promoting work and offsetting payroll taxes, the EITC is a refundable tax credit that subsidizes the earnings of low-income households. EITC benefits vary according to the filing status of a taxpayer (single or married), the number of dependents claimed by the filer (childless, one child, two children, or three or more children), and total household earnings. Reflecting the program's goal of reducing child poverty, families with more dependents receive larger EITC benefits. The credit gap is particularly stark between workers with and without dependents. In 2013, for instance, the maximum credit available to single parents with one child was nearly seven times larger than that of childless single tax filers.

Smaller differences in credit amounts also exist by marital status and family size. Specifically, benefits are extended for married couples in order to help mitigate marriage disincentives embedded in the EITC. But, because tax credits are calculated based on household earnings, marriage will cause some workers to lose their EITC benefits. In a similar vein, since larger families are eligible for more benefits, the EITC could perversely encourage parents to have more children.

The EITC's biggest effects have been on employment and poverty, especially among single mothers. Meyers and Rosenbaum (2001), for instance, estimate that the expansion of the EITC during the early 1990s increased the employment of single mothers by 7 percentage points, and they attribute roughly 60% of the increase in the single mother employment rate from 1984 to 1996 to changes in the EITC. Research has also shown the EITC to be a very well-targeted anti-poverty program. For example, the tax credit lifted approximately 7 million individuals out of poverty (3 million of whom were children) in 2009, and reduced poverty and child poverty rates by roughly 10 and 16 percent, respectively, in 2007.

In contrast, the program has done little to change the economic circumstances (or employment) of workers without children. In 2007, for instance, less than 5 percent of all EITC benefits were received by individuals with no qualifying dependent. As a result, little is known about the effects of the EITC on the labor supply of low-income childless workers and noncustodial parents, many of whom are either ineligible for EITC benefits or receive far smaller credit amounts than workers with children. Recent research, however, suggests that the EITC—by stimulating labor supply and driving down wages—may actually hurt the earnings prospects of low-wage workers who do not qualify for (or enroll in) the EITC. More specifically, while the EITC benefits received by workers with dependents more than offset any wage reductions caused by an EITC-induced increase in labor supply, low-income individuals with no dependents only experience the negative labor-supply shock to their earnings. Even single tax filers who qualify for the EITC may experience a loss in earnings, since their low EITC-benefits may not be enough to compensate for the reductions in their wages.

The Federal Minimum Wage

The minimum wage is another important policy lever for supporting low-skilled workers and their families. After its most recent increase in 2009, it currently stands at $7.25 an hour. Despite its rise in nominal dollars, the minimum wage—which is not indexed to the price level—has fallen behind inflation. Between the late 1960s and today, the purchasing power of the minimum wage has declined by approximately 20 percent, while the wage differential between minimum-wage workers and the average American earner has grown substantially.

Many cities and states have responded by raising local minimum wages, and many more are contemplating doing so, leading to a patchwork of different wage levels for those doing similar work. At the federal level, some politicians have begun to push for another hike in the national pay floor. In his 2013 State of the Union Address, for example, President Obama called upon Congress to raise the pay floor to $9 an hour and index it to inflation. More ambitiously still, Senator Harkin and Representative Miller have put forward the Fair Minimum Wage Act, a bill that would lift the minimum wage to $10.10 an hour, index it to the price level, and increase the minimum cash wage for tipped workers to 70 percent of the regular minimum wage.

While a recent Gallup poll shows that 71 percent of Americans support a higher minimum wage, raising the minimum wage is a hotly contested policy proposal. The standard objection is that a higher minimum wage would kill jobs. But hundreds of research articles have been published on the effects of raising the minimum wage on the employment of teens and low-skilled laborers. While estimates can vary widely between individual studies, the literature as a whole favors the view that modest increases in the minimum wage have little effect on the employment of low-wage workers.

Second, many question whether minimum wage changes are sufficiently targeted to help low-income families. Analyses of the Harkin and Miller proposal, for instance, show that nearly a quarter of workers who would benefit from raising the minimum wage to $10.10 an hour have family incomes of less than $20,000, while 30 percent live in families with incomes above $60,000 (Cooper and Hall, 2013). Contrast this to the EITC: the Urban-Brookings Tax Policy Center estimates that, in 2015, 42 percent of all EITC benefits will go to tax filers with cash incomes of less than $20,000, and 91 percent will go to tax filers with less than $40,000 in cash income.

Proposal for EITC and Minimum Wage Reform

If implemented separately, raising the minimum wage and implementing EITC reforms would each generate significant benefits for struggling working families. Each policy change, however, also has its limitations. While a $10.10 minimum wage would provide critical financial support to many low- and moderate-income families, it lacks both the target efficiency and the full-time employment incentives of the EITC. Moreover, if raised too much, minimum wages are likely to adversely affect employment. In a similar vein, while our proposed EITC reform efficiently funnels resources towards reducing early childhood poverty, incentivizing work among childless workers, and removing marriage disincentives, some groups—namely older children and larger families—would lose benefits. Avoiding such trade-offs by simply expanding everyone's benefits could be very costly to the federal budget.

Fortunately, our analyses suggest that the shortcomings of each policy change can be mitigated if the two reforms are jointly implemented. In particular, we simulate the poverty effects of first raising the minimum wage to $10.10 an hour and then enacting our EITC changes. Our simulations are based on a sample of CPS households in 2011. We raise the minimum wage to $10.10 and assume no changes in employment as a result of the higher wage, in keeping with most research on this issue. We also make a series of changes to the EITC and again assume no changes in employment or other behavior as a result of the change even though most research suggests that the EITC increases employment. As a result, our estimates of the anti-poverty effectiveness of the proposal may be conservative. We focus on the effects of the combined proposal on the supplemental poverty measure (SPM), the most appropriate benchmark for looking at the effects of the EITC since, unlike the official poverty measure, it takes into account not only a family's cash income but also noncash benefits, taxes, tax credits, and work expenses.

The details of the EITC changes we suggest are shown in figure 1, and are as follows:

- <u>Create a worker credit and a family credit, both of which would be calculated using individual (as opposed to household) earnings</u>. Using personal earnings to calculate EITC benefits has been shown to reduce the severity and prevalence of marriage penalties. Our plan therefore calls for two separate credits: a "worker credit" that applies to workers aged 21 to 39 without dependents, and lower-earning spouses in families with children; and a larger "family credit" that applies to the primary (i.e., the largest) earner in a family with children. The new worker credits should encourage work and may encourage marriage.

- <u>Increase EITC generosity for workers without children</u>. We propose both raising the maximum benefit and expanding the eligibility range for childless workers. The maximum credit is equal to $1,625 (or 50% of the current maximum benefit for unmarried tax filers with one dependent). Benefits begin phasing out after $14,500, and are phased out completely once personal earnings reach 200% of the federal poverty line.

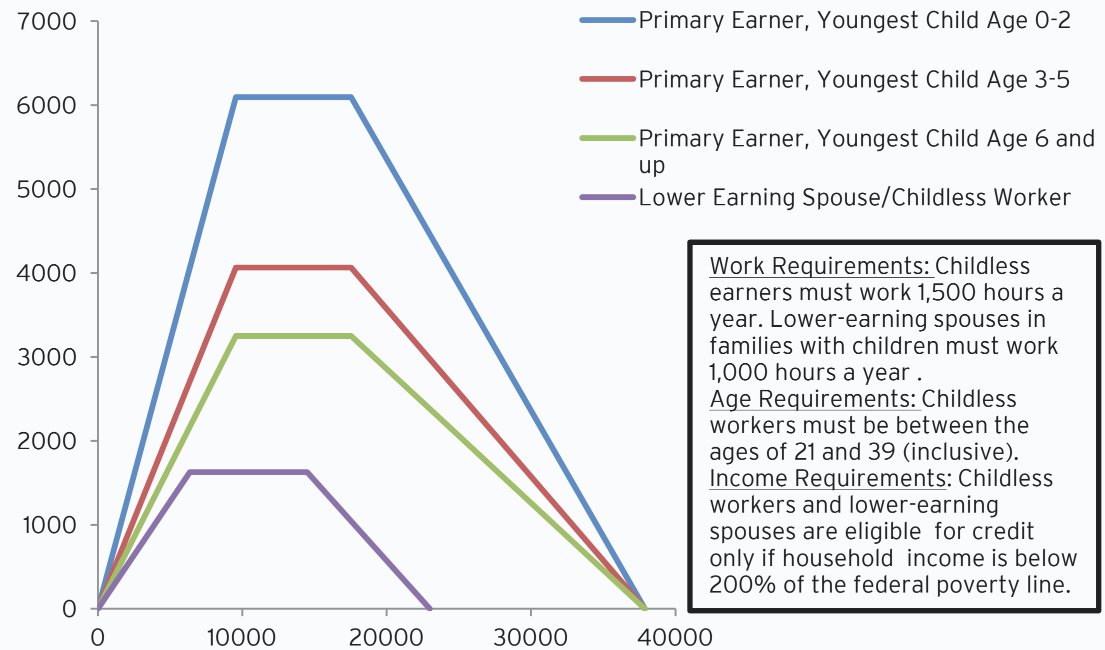
- <u>Create separate EITC tiers for primary earners of families with young children</u>. Instead of basing EITC generosity on family size, our family credit would seek to concentrate benefits among families with young children. This change is based on research showing that the effects of family income on later child outcomes are most pronounced in the early years. Thus, EITC benefits would be based on the age of the youngest child in a family. Those whose youngest child is age 6 or older would receive the same credit as under current law for single tax filers with one dependent. Those whose youngest child is 3-5 years old would receive more a more generous credit, while those whose youngest child is age 0 to 2 would receive the most generous credit (see Figure 4).

- <u>Strengthen the work requirements for EITC eligibility</u>. We propose conditioning EITC eligibility for childless workers and lower-earning spouses on hours worked in a year to ensure that the larger childless tax credits go to hard working individuals who are truly struggling to make ends meet. Recognizing the existence of important tradeoffs between work and parenting, we propose less stringent work requirements for lower-earning spouses in families with children, namely: 1,000 hours a year, which is equivalent to working roughly half-time. We do not impose any work requirements on single parents.

- <u>Restrict eligibility for worker credits to earners in households that are under 200% percent of the federal poverty line</u>. Basing EITC benefits on personal earnings tends to increase EITC eligibility up the income scale. To ensure that the EITC continues to target lower-income households, our plan restricts the worker credits to childless workers and lower-earning spouses living below 200 percent of the federal poverty line.

Ultimately, our plan prioritizes full-time work over part-time employment, young children over big families, and young single adults over older ones. While we recognize that not everyone would make the same tradeoffs, we believe that the above expansions and reallocations of funds represent budget-feasible improvements to the current EITC. However, many other trade-offs could be made, and our model and data are capable of assessing them, should policy makers show interest in such reforms.

Figure 4: Proposed EITC Schedule and Rules



Impact of the Proposal

The combined effects of raising the minimum wage and restructuring the EITC would be substantial, as shown in figures 2 and 3. If implemented, our proposal would lift roughly 3.4 million people out of poverty—800,000 of whom would be children. Overall poverty would decline by about 7 percent (1.1 percentage points) and childhood poverty would fall by about 5 percent (1.0 percentage point). We predict even larger declines in early childhood poverty and poverty among prime-age adults. Even among older adults, whose EITC benefits would decline under our proposed reforms, poverty is expected to fall due to a higher minimum wage.

Implementing both policies makes good fiscal sense, too. We estimate that enacting our proposed EITC reforms would, by itself, add approximately \$3 billion to the current EITC budget. But raising the minimum wage in addition to our proposed EITC plan would reduce current EITC budgetary costs by about \$1 billion a year.

Figure 2: The Effects of Reforming the EITC and Raising the Minimum Wage
(millions of people lifted out of SPM poverty)

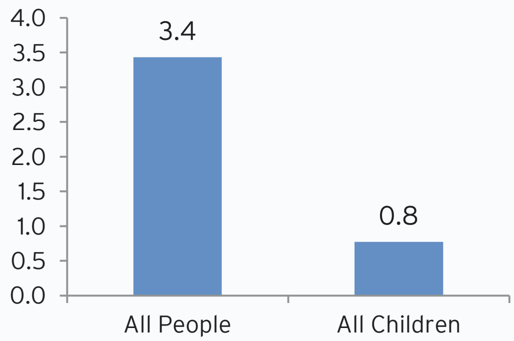


Figure 3: The Effects of Reforming the EITC and Raising the Minimum Wage
(percent reductions in SPM poverty rates)

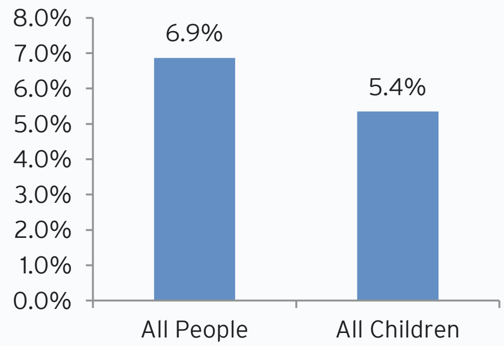
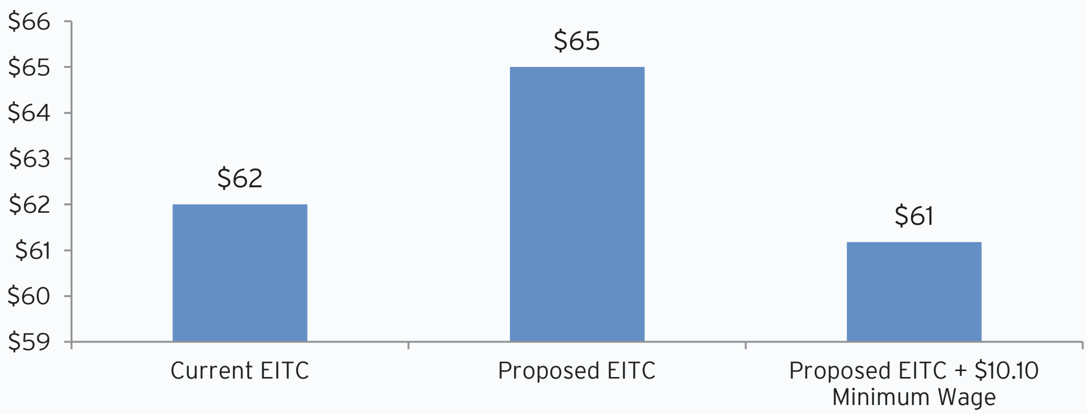


Figure 4: EITC Budget Estimates
(in billions of 2011 dollars)



A higher minimum wage in combination with an expanded and reformed EITC has much to recommend it. It would reduce poverty, and encourage work and marriage. It would do all of these good things without adding a dime to the federal budget and possibly even save money as more people became self-sufficient through work. Given currently high rates of poverty and inequality, such proposals deserve a hearing.

Authors

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