Replace Minimum Wages with the Earned Income Tax Credit

Minimum wage laws have a superficial appeal, but are much less effective than the earned income tax credit.

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#minimumwage #economics #taxation

Within the current US policy system, there are two ways to increase the incomes of low-paid workers. The more popular method is to increase the legal minimum wage. The more effective method is to increase the EITC: the earned income tax credit.

The EITC is a reduction of taxes on low-wage incomes. It is also called a "negative income tax" because for very low wages, the worker not only owes no ordinary income tax, but receives money from the government. The amount of credit depends on income and number of children. Having started in 1975, the EITC transferred $63 billion worth of income to 28 million families in 2011. Some 25 US states have also enacted an EITC for their income taxes.

A legal minimum wage is in effect a tax on the employers of low-income workers. Suppose the minimum wage is raised from $10 to $15 per hour. This regulation is equivalent to paying a $10 wage, taxing the employer $5 per worker-hours, and transferring the $5 to the worker. The effect is that the minimum wage acts like a tax on the employers of low-paid workers.

By making labor more expensive, the implicit tax on low-paid employees reduces the quantity of labor hired. The minimum wage is only the beginning of labor costs. The employer has to pay half the social security tax, insurance for worker injuries, unemployment-compensation taxes, administrative costs, litigation insurance or risks, and, for larger businesses, medical insurance. The $15 money wage creates a cost of labor of $20 or more.

If an enterprise buys machines and other capital goods, it receives a tax reduction, often all in the first year. But if an enterprise hires an extra worker, it gets slapped with higher taxes. ***The tax burden of hiring low-skilled labor induces firms to, over the long run, replace labor with machines.*** A fast-food restaurant, for example, could replace workers who take orders and deliver food with a machine in which the customer makes a payment, selects his choice, and removes the food from a box. For manufacturing firms, the forced higher wage payments induce the company to move its operations to another country.

While trade and technology are blamed for the disappearance of jobs, we don't know how many jobs have disappeared due to the imposition of taxes on labor, both on employees and employers. Henry George in his book *Protection or Free Trade* recognized that much of the gains from trade and technological progress are captured by higher land rent, so while national income rises, wages might not receive the benefits, due to both the capture by rent and by taxes on labor.

The EITC is in effect a tax on the whole economy rather than being focused on employers. While the income tax that finances the EITC generates an excess burden, the burden is spread out, and so it does not reduce employment nearly to the same extent.

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The best long-run solution to the problem of both unemployment and low-wages is to completely eliminate taxes on wages. Tax-free labor would make American workers among the most productive in world, relative to wages. With the replacement of taxes on wages with taxes on rent, not only would labor be paid its economic contribution to output, but the income from land would become equalized, reducing economic inequality not by investment-hampering redistribution but by the equitable initial distribution of income.

None of the candidates from the political parties that are on ballots, including the challenger smaller parties, are advocating the replacement of minimum-wage laws with a greater EITC. That's because the public clamor is for higher minimum wages. Most people think only of the superficial appearance. Superficially, people think that if worker wages are too low, government can force them higher. The typical "progressive" and "liberal" activist sees the superficial solution, and may not even be aware of the more effective alternative.

I have said before that the main benefit we get from learning economics is to understand the implicit reality beneath superficial appearance. The implicit reality of higher minimum wages is the opportunity cost of not having instead a higher earned income tax credit, and the resulting loss of employment and investment. Before blaming trade and technology for low wages and less employment, blame taxes and artificial minimum wages.

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Mike Curtis

8 years ago

I was surprised to read the analysis of Prof. Foldvary. For many years I have believed that the Earned Income Tax Credit was a subsidy to the landowning employers. Since there is no longer a free-land opportunity, wages tend to an amount below which productivity would fall. That is to say: Wages tend to a level at which if they were lowered any more, the resulting fall in productivity would be greater than the reduction of wages. That would result in lower land rent. Under those circumstances the wages of the least productive workers tend to a bare subsistence.

It is for that reason I have always thought that the earned income tax credit distorted the market place, enabling things to be produced and employers to profit from goods and services that were only produced because other people were paying part of the wages. I have assumed that people would pick up their own pizzas, and Pizza delivery people would likely become pizza cooks if the cost of delivery was equal the full remuneration of those who delivered it.

My logic tells me that an increase in the Min. Wage increases all wages by the same amount. Therefore it increases the cost of production generally and does not create incentives to produce things that people are unwilling to pay the cost of production to consume.

Perhaps I can be enlightened.

Mike Curtis

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Steve Godenich

8 years ago

EITC is not NIT or a tapering minimum income. By itself, EITC is merely a business payroll subsidy that perpetuates and expands an army of low wage workers across generations, whether they are citizens or resident aliens. Alone, it provides no upward career path for citizens that lack the necessary skills to succeed.. Without provisions for the unemployed, it allows the welfare state to expand it's numbers.

A citizen's NIT is welfare for citizens whether they are employed or unemployed. When employed, it is a business/labor employment incentive. When unemployed, it can be used for going back to college or vocational school to learn skills that are in demand to obtain a decent paying job. It's an escape hatch to the middle class. It can shrink the welfare state.

Who will do all those menial jobs that nobody wants to do? Bring on the robots. Excepting medical goods and services, replace the welfare state with a poverty level NIT or tapering minimum income based on individual citizen incomes from any sources. For the roughly 45mn unemployed citizer K poverty level NIT or tapering minimum income is $540bn plus any income tapering. costs.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary’s commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary’s areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.