# Defrauding the American Taxpayer - The Earned Income Tax Credit

# EITC and Low Wage Jobs

**Part 5 of 7**
**By Edwin S. Rubenstein**
**For *The Social Contract***
**April, 2011**

At $60 billion a year, EITC spending dwarfs that of TANF (cash welfare.) Twenty-five million taxpayers filed for the credit in tax year 2008. They received an average $2,044.

Good news for the working poor, you say? That's what liberal activists would have us believe. So would George W. Bush, the Heritage Foundation, the *Wall Street Journal* editorial page, and the disciples of economist Milton Friedman. No doubt many of the program's conservative supporters are motivated by genuine admiration for its virtues; but activists for the poor, finding themselves in such strange company, would do well to ask themselves: is there a catch?

Maybe there is. Even more ominous than conservative support for EITC is the sorry record of the program's closest historical parallel: the "Speenhamland system." an obscure law in force in England between 1795 and 1834. Like EITC, Speenhamland linked welfare to work. Upper class eighteenth century Englishmen were no more eager to subsidize idleness than their 21st century American equivalents.

And also like the EITC, Speenhamland was an attempt to raise earnings without placing a burden on employers. If wages fell below a certain level, government made up the difference; as wages rose, the government benefit fell.

Employers soon discovered they could "game" the system by cutting wages below what workers were really worth to them. Before Speenhamland they would have gotten what they paid for: mediocre, malnourished, resentful workers. Or none at all. But with the country taking up the slack, they had nothing to fear.

The Poor Law Commissioners' Report of 1834, summarizing the failed program, called Speenhamland a "universal system of pauperism".

"In the long run the result was ghastly," wrote economic historian Karl Polanyi in his 1944 classic "The Great Transformation." "Wages which were subsidized from public funds were bound eventually to be bottomless." The result was that, as Notre Dame University Teresa Ghilorducci puts it, "The government subsidized wages so much they went broke." [J.W. Mason, "Is the Earned Income Tax Credit as good as it looks?," *City Limits*, June 2002.
http://www.citylimits.org/content/articles/viewarticle.cfm?article_id=2768 ]

EITC, like Speenhamland, rewards employers who pay workers sub-standard wages. To see this perversity at work, imagine that the economy consists of two companies producing widgets. Employer #1 hires moderately skilled workers at $10/hr., but he produces 10 widgets per worker per hour.

Employer #2 hires only the least skilled workers. In the absence of the EITC subsidy, assume that no worker would take the job for less than $7.50/hr. But workers on his less sophisticated assembly line produce only 5 widgets per worker per hour – half the productivity of employees of employer #1.

The result will be employer #1 will have to pay $1 in wages for every widget produced ($10/hr. for 10 widgets per hour), while employer #2 will have to pay $1.50 for every widget produced ($7.50/hr./5 widgets per hour.)

In this labor market, low-wage employer #2 will be unable to compete with his more productive, higher-wage competitor. Curtains for employer #2.

Now introduce an EITC program that adds, say, 50 cents to every dollar of wages.

Theoretically, employer #2 could offer his workers only $5/hr., since they would receive an added $2.50 from the government. So workers at #2 will stay on the job, and he will produce widgets at $1 per widget – the same cost as employer #1.

Increase the EITC subsidy rate even more, and employer #2 will be able to drive his more technologically advanced, higher wage competitor out of business.

Bottom line: low wage subsidies like EITC destroy high-wage jobs.

This is somewhat of a simplification: in the real world, employers do not cut wages a dollar for each dollar of wage subsidy. But employers have learned how to exploit a system that is ripe for exploitation - a system in which government subsidizes low-wage jobs while taxing moderate wages.

Walmart, for example, launched an aggressive campaign to "educate" its workers about the EITC program a few years ago. "The momentum behind it is education - ways our employees can save money and live better," a company spokesperson said at the time.
https://www.just-food.com/article.aspx?id=102932

Yet the nation's largest employer pays its non-supervisory employees about $18,000/ year, far less than half what GM workers were paid thirty-five years ago, adjusted for inflation.
http://www.rollingstone.com/politics/story/12699486/paul_krugman_on_the_great_wealth_transfer

And Walmart is notorious both for how few of its workers receive health benefits and for the stinginess of those benefits.

GM, by contrast, does not "educate" its employees on the virtues of EITC – for this reason: it pays them too well to qualify.

Gary Gereffi, Professor of Sociology at Duke University, deconstructs the vastly different business philosophies of the two companies in a Frontline interview:
http://www.pbs.org/wgbh/pages/frontline/shows/walmart/interviews/gereffi.html

Gereffi: "Wal-Mart is the biggest, most respected company in the United States, but it's very interesting to compare Wal-Mart with General Motors, which was the best known, largest, most respected company 50 years ago. I think these two models are radically different models. The Wal-Mart model is premised on global efficiency. The General Motors model was premised on having workers that could afford to buy the products that they made."

Frontline: "Are you suggesting here that Wal-Mart is pushing prices so low and pushing wages so low that it may, in fact, eventually bankrupt its own customers because they won't be making enough money to go shopping?"

Gereffi: "Wal-Mart is pushing wages down to a level where the people that work in Wal-Mart stores are going to be forced to buy in Wal-Mart stores, because they can't make enough money to buy goods elsewhere in the economy.

"The traditional model of American capitalism from the mid-20th century was that American corporations were respected because they were globally efficient, but they also paid their workers a good wage so that workers could become consumers and part of the middle class of American society. I think we've lost that model today…."

Our take: The EITC enables Walmart, McDonalds, and other low-wage employers to continue their policies of employee exploitation; it does nothing for high-wage, high productivity companies like GM. As the EITC subsidy increases, so will the fraction of U.S. businesses built on low-wages rather than high-productivity.

**EITC from the employee's perspective**

Consider a household with three children in 2011. For each dollar earned up to $12,780, the government kicks in an extra 45 cents. Between $12,780 and $16,690 the benefit is the same, $5,751, neither increasing nor increasing with additional earnings. So if this hypothetical two-child household earned the minimum wage in 2008, they would receive an extra $5,751 after filing their income taxes.

But once the family's income exceeds $16,690 – hardly enough to support four persons – their EITC payment starts to "phase-out." For this unfortunate family, this means they lose 21.06 cents of EITC for every additional dollar of income. Add in Social Security and income taxes, and in some states more than 50 percent of any pay hike is lost to higher taxes and lower credits – a higher marginal tax rate than the wealthy pay.

Why earn more if the government takes over half of the increase?

Why invest time, effort, and money to improve your work skills?

If poor families are rational, they will respond to the work disincentives of EITC by working less. Data backs this up. Around 77 percent of EITC recipients have incomes that fall in the flat or phase-out range of the credit. Economists generally agree that most of these folks will work fewer hours, and devote less time and effort to improving their work skills and education, because of the negative EITC incentives.
http://www.ssc.wisc.edu/~scholz/Research/EITC_Survey.pdf

In the short run, the EITC is effective in moving people out of poverty. But over the long haul, the program enables employers to offer less to workers, who because of the program's perverse incentives, may be satisfied with less. As a result, the program originally envisioned as a transfer to low-wage workers has become a transfer to their employers.

**EITC v. the minimum wage**

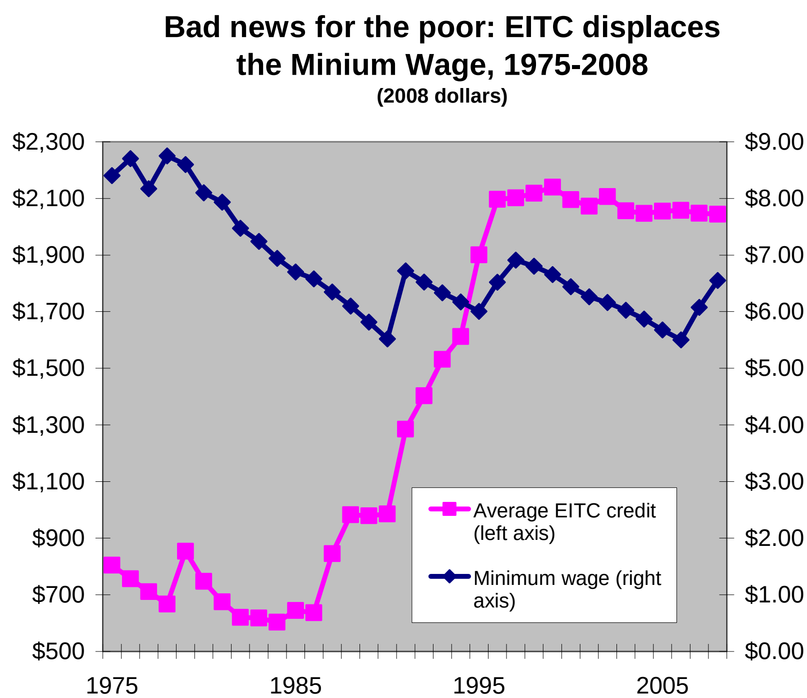
"**The minimum wage law is most properly described as a law saying that employers must discriminate against people with low skills.**" **–** Milton Friedman

Here the great conservative economist give voice to what has become the conventional wisdom among free market libertarians: Minimum wage laws hurt the poor. Their argument runs like this: In a free market, wage levels will always reflect a worker's value to the firm – their "marginal productivity. Employers who try to pay workers less than their true worth will only lose them to competitors. They either match the competitive wage, or go out of business. Their former employees will find work. But minimum wage laws interfere with this process. Many unskilled, uneducated workers simply do not contribute enough to a firm's bottom line to justify receiving the minimum wage. They are its victims rather than its beneficiaries.

Or, as Friedman cheekily observed: “It has always been a mystery to me why a youngster is better off unemployed at $4.75 an hour than employed at $4.25."

In fact, the conservative critique does not hold up in practice. A number of studies, notably by economists Alan Krueger and David Card in their book *Myth and Measurement*, have found that raising the minimum wage leads to increased employment for the poor because it encourages higher productivity and creates more spending in the poor communities themselves.
http://books.google.com/books?id=VDNI0Uy86J8C&pg=PP11&lpg=PP1&dq=%22Alan+Krueger%22+%22Myth+and+Measurement%22&ie=ISO-8859-1&output=html

More recently, a study of state minimum wage laws finds that “wages are higher and employment is no lower” in states with a higher minimum wage than those without. The median minimum wage was $1.40 (more than 25 percent) higher than the federal minimum in states that had raised their minimum wage. [Paul Wolfson, *State Minimum Wages: A Policy That Works*, Employment Policy Institute, 2006. http://blog.aflcio.org/2006/11/29/minimum-wage-increase-does-not-cost-jobs/]
Conservative objections to minimum wage laws, and their love for the EITC, has influenced public policy. As evidence, the following:




Since 1975 the average EITC benefit, adjusted for inflation, has increased by 154 percent, while the minimum wage has declined by 22 percent. Even with its sharp expansion, however, the EITC fell notably short of offsetting the drop in the minimum wage. Minimum wage families with children saw their real disposable income decline

during the nearly thirty-five year period in which EITC has been in existance.
http://www.upjohninstitute.org/publications/newsletter/H-S_103.pdf

Raise the EITC even more, you say? That would merely increase the government subsidy to low-wage employers. It is unconscionable, in this economy, for the federal government to underwrite businesses that exploit poor workers.

The obvious answer is to increase the minimum wage to a level where the EITC subsidy is no longer necessary

But what about the conservative rejoinder – that in a laissez faire economy where there is no minimum wage, wages will always reflect a worker's productivity?

The marginal product theory holds true in a labor market comprised of many small employers, each competing for the same pool of labor, each too small to influence the market wage. This model may have obtained when Adam Smith first articulated it. It was still revelant in the 19th and early 20th century U.S. But today, with the market for low-wage labor dominated by the likes of Walmart and McDonalds, it breaks down.. Gereffi again:

"Wal-Mart is also having a negative impact on employment in the retail sector. Wal-Mart is the largest employer in the United States after the federal government. But Wal-Mart is also very well known for being a non-union company and pushing non-union conditions on its workforce. ... It pays its workers at a minimum pay scale with very few fringe benefits. Because Wal-Mart's the largest private employer in the United States, whatever Wal-Mart does in terms of the labor market, all other businesses have to follow. So Wal-Mart is really determining the direction in which the U.S. labor market is moving."
http://www.pbs.org/wgbh/pages/frontline/shows/walmart/interviews/gereffi.html

**Walmart, and its enabler, the EITC**

**EITC and Immigration**

The same business groups that tout the virtues of EITC also support mass immigration. That should come as no surprise: the influx of unskilled, un-educated foreign workers depresses wages for all American workers – foreign and native-born alike. Lower wages mean higher profits, higher share prices, and a net transfer of hundreds of billions of dollars from the pockets of workers to employers.

EITC and immigration share joint responsibility for one of the most pernicious economic trends of our time: the obscene income gap between rich and poor in the U.S. George Borjas, an economist at Harvard's Kennedy School of Government, estimates that "almost half the decline in the relative wage of high school dropouts may be attributed to immigration." Black Americans in particular are big losers, with immigration reducing the income of the average native black person about $300 per year. [Peter Skerry, "How Immigration Re-Slices the American Pie," *The Washington Post*, October 28, 1999]

The EITC reinforces the negative impact of immigration by subsidizing low-wage employers and eroding the work incentives of their employees. One must also consider the direct impact EITC has on the number of immigrants entering annually. As the most accessible, generous, and immigrant–friendly of all federal benefits, it undoubtedly ranks high among factors considered by potential entrants.

Mass immigration in the modern (post World War II) era dates from the Immigration Reform Act of 1965. Prior to that law only about 250,000 immigrants a year entered the country; By the 1990s the country was admitting more than 800,000 legal immigrants a year, with an additional 300,000 to 500,000 aliens entering and staying in the country illegally.

During the decade of the 1990s, 47 percent of U.S. civilian labor force growth was due to immigration. This represented the largest influx of foreign workers *ever* to enter the U.S. in a given decade—substantially exceeding the number who came here during the Great Wave of 1890 to 1910. [Andrew Sum, et al., *Foreign Immigration and the Labor Force of the U.S.*, [PDF] Center for Labor Market Studies, Northeastern University, July 2004.]

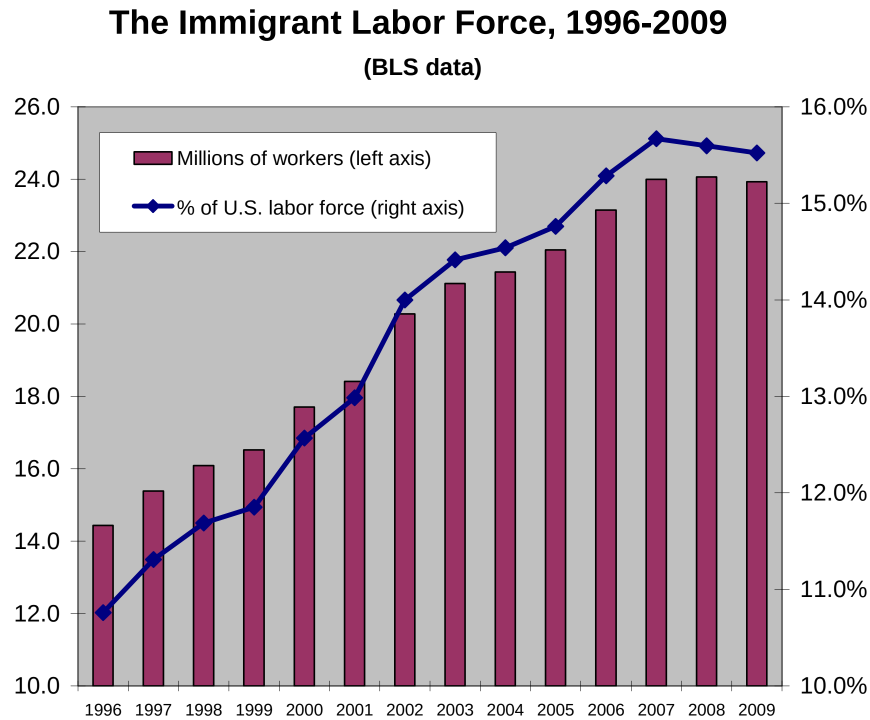
But records are made to be broken, and nowhere more so than in immigration. During the first decade of the 21st Century (2000 to 2009) foreign-born individuals accounted for:

33 percent of U.S. working-age population growth
47 percent of U.S. labor force growth
99 percent of U.S. employment growth. (In other words, immigrants displaced Americans).

The last percentage may seem implausible. It is not. BLS data show the Great Recession took a horrific toll on native-born workers. After peaking at 123.1 million in 2007, native-born employment fell to 118.3 million in 2009. That decline offset the entire growth in native employment over the 2000 to 2007 period. While foreign-born employment also declined during the recession, the reduction was a fraction of job gains recorded in the first seven years of the 21st Century.

Bottom line: all the net new jobs created during the first decade of this century were for immigrants.

The 1996 to 2009 period saw substantial increases in both the number and share of immigrants in the U.S. labor force:




The immigrant labor force (foreign-born individuals working or looking for work) numbered 14.4 million in 1996; by 2009 it had grown by more than one-half, to 23.9 million.

The foreign-born share of the labor force also increased – from 10.8 percent in 1996 to 15.7 percent in 2007. During the Great Recession, as immigrants lost jobs and returned home, the foreign born share of the labor force declined slightly - to 15.5 percent in 2009.

Even more important than quantity: the decreased *quality* of recent immigrants. In 1960 the average immigrant man living in the U.S. earned about 4 percent more than the average native man. By 1998, the average immigrant earned about 23 percent less.

The worsening economic performance of immigrants is due mainly to a decline in relative skills of the more recent cohorts. The newest immigrants arriving in the country in 1960 were better educated than the average native; by 1998 the newest arrivals had nearly two fewer years of schooling. As a result of this growing native/immigrant education gap, the relative wage of successive immigrant waves also fell. Immigrants entering around 1960 earned 13 percent less than natives; by 1998, the newest immigrants earned 34 percent less. http://www.cis.org/articles/1999/back1199.htm

The diminished quality of post-1965 entrants reflects fundamental changes in criteria for admission. The 1965 law repealed the national origins system, which granted visa mainly to persons living in the U.K., Germany, and other Western European countries. In its place, the law made family ties to persons already living in the key factor in determining whether a visa applicant is admitted to the country.

One notable consequence: the increased Mexicanization of U.S. immigration. This phenomenon's downside is neatly captured by Professor Borjas:

"…In 1940, 0.5 percent of all male high school dropouts were Mexican immigrants. Even as recently as 1980, only 4.1 percent of male high school dropouts were Mexican immigrants. By 2000, however, 26.2 percent of all male high school dropouts were Mexican born."

How much does immigration reduce the income of native-born Americans?

Professor Borjas finds that every 10 percent increase in the U.S. labor force due to immigration reduces native wages by about 3.5 percent.[George Borjas, *"The Labor Demand Curve is Downward Sloping: Reexamining the Impact of Immigration in the Labor Market,"* NBER, June 2003.]

In 2009 foreign-born workers accounted for about 15.5 percent of the U.S. labor force. Thus if Borjas is right, immigration has reduced average earnings of native workers by about 5.4 percent (15.5/10.0 X 3.5 percent).

Among native high-school dropouts – roughly the lowest tenth of the labor force – the estimated impact is even larger, reducing their wages by an estimated 7.4 percent.

Immigration, plus the negative incentives of EITC, poses insurmountable economic obstacles to many uneducated natives.