The Earned Income Tax Credit as a Tax Expenditure: An Alternative to Traditional Welfare Reform

Timothy J. Eifler

University of Richmond

Follow this and additional works at: http://scholarship.richmond.edu/lawreview

Part of the Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation
Available at: http://scholarship.richmond.edu/lawreview/vol28/iss3/5

This Comment is brought to you for free and open access by the Law School Journals at UR Scholarship Repository. It has been accepted for inclusion in University of Richmond Law Review by an authorized editor of UR Scholarship Repository. For more information, please contact scholarshiprepository@richmond.edu.
THE EARNED INCOME TAX CREDIT AS A TAX EXPENDITURE: AN ALTERNATIVE TO TRADITIONAL WELFARE REFORM

Welfare has become a common topic of concern recently as President Clinton and his political adversaries begin battle over the second major element of Clinton's agenda for reform. As a necessary corollary to, and a direct complement of the health care proposal, the welfare system presents the next area that requires reform for a truly effective agenda for change.

A key element of the Clinton Administration's welfare reform proposal has already been accepted. This past August, the Revenue Reconciliation Act of 1993 ("1993 Act") was signed into law.\(^1\) This action raised the income tax system from a minor participant in the welfare system to a new, effective tool for aiding needy families. The 1993 Act revitalized and expanded the earned income tax credit, metamorphosizing the credit from a weak method of mitigating a regressive tax rate structure into a medium for providing incentives and subsistence credits to the working needy.

This paper analyzes the effectiveness of welfare reform that incorporates the earned income tax credit as a major component. Through a study of the historical evolution of the credit from a remedial provision to its present aggressive status as a provision that redistributes income to the needy, a proper basis will be laid to compare the earned income credit to proposed

alternative methods of redistribution under the income tax system.

The question presented is whether the earned income tax credit should be moved from the realm of the "correct" tax base to that of the "special provisions" that comprise tax expenditures. The Clinton Administration has decided that issue by transforming what was basically a remedial provision in the Internal Revenue Code into a substantial expenditure provision that performs not revenue but welfare functions. This transformation deserves analysis.

I. HISTORICAL PERSPECTIVE OF WELFARE

Although the term "welfare" is used frequently, there are many misconceptions as to what exactly comprises the present welfare system. Many understand that a system of federal and state grants available to the needy exists, but they do not understand the requirements for eligibility and the severe limits on benefits.

Further, it is not commonly known that "welfare" comprises many varied programs interspersed throughout the U.S. Code that have accumulated over many decades of welfare-minded administrations. Before the role of the earned income credit can be analyzed, one must undertake an overview of the history of this accumulation and the present makeup of the U.S. welfare system in order to provide a framework for analysis.

The welfare system, a system of public assistance programs to the needy, has its origins in the New Deal. The original and still most significant piece of the welfare puzzle, Aid to Families with Dependent Children ("AFDC"), came into being in 1935.

2. See generally Boris I. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 927-29 (1967) for identification of the provisions that represent favorable treatment and have the intent to promote objectives that are more important than basic revenue and equity considerations. These "special" provisions erode the "correct" tax base and constitute tax expenditures.

As originally enacted, AFDC attempted to provide minimum subsistence to needy children by making cash grants available to needy children without fathers. At the time, the bulk of family income was derived from men, who made up the vast majority of the workforce. Congress and subsequent administrations revised the program as the composition of the home and the workforce as well as the definition of “needy” evolved.

At present, the AFDC program provides cash assistance for (1) needy children who have been deprived of parental support or care because a parent is a) continuously absent from the home, b) incapacitated, c) deceased, or d) unemployed, and (2) others if in the household of such a child and if eligible. Dubbed “cooperative federalism,” AFDC is a federal program that relies on the states to determine their own definition of poverty and their own level of benefits within broad parameters. Federal matching funds comprise 50% to 80% of the actual benefits, with the remainder consisting of smaller contributions by the individual states.

AFDC is presently one of the nation’s largest welfare programs. In 1991, the program provided a total of $20.3 billion in benefits of which the federal government provided $11.1 billion, almost 55%.

Congress significantly expanded the AFDC program in 1990. The Omnibus Budget Reconciliation Act of 1990 mandated that states participating in the AFDC program implement a job opportunities and basic skills (JOBS) program. Such programs are often given positive sounding names such as California’s GAIN (Greater Avenues for Independence) program, Arkansas’ Project Success, and Colorado’s New Directions program.

6. GREEN BOOK, supra note 4, at 603.
7. Id. at 654.
9. Such programs are often given positive sounding names such as California’s GAIN (Greater Avenues for Independence) program, Arkansas’ Project Success, and Colorado’s New Directions program. GREEN BOOK, supra note 4, at 616-19.
Although President Johnson's Great Society initiative which constituted his "war on poverty" is often considered the beginning of America as a "welfare state," this is a misconception. The programs implemented under President Johnson's administration in the 1960s merely added an additional layer of assistance to a welfare foundation laid thirty years prior.\footnote{14}

The Great Society did produce Medicare, Medicaid,\footnote{12} and the Food Stamp Program.\footnote{13} These programs remain remarkably intact and provide the support structure that enables AFDC to operate somewhat effectively.\footnote{14}

At present, one of the most important aspects of the AFDC program is that beneficiaries are automatically eligible for Medicaid coverage.\footnote{15} Medicaid is sponsored jointly by the federal and state governments to provide public medical assistance for low-income persons who are aged, blind or disabled, members of families with dependent children and certain other qualifying individuals whose incomes fall below a specified level.\footnote{16} With the rising costs of medical care and the problems with employer-sponsored health coverage, this component of the welfare package plays a particularly important role. Entering the welfare system does not entail a loss of medical coverage. However, one problem that is beyond the scope of this paper involves the automatic loss of government-provided health care for those who leave the welfare system.

The largest federally-subsidized welfare grant is the federal Food Stamps Program.\footnote{17} Those persons who qualify for AFDC

\footnotesize{\begin{itemize}
\item Cf. Edelman, \textit{supra} note 11, at 1712 n.79.
\item \textit{GREEN BOOK}, \textit{supra} note 4, at 604, 1641.
\item \textit{GREEN BOOK}, \textit{supra} note 4, at 1640.
benefits automatically qualify for food stamps.

The Food Stamp program assumes that individuals will contribute 30% of their monthly cash income to food purchases. Based on a minimum sustenance level set by the U.S. Department of Agriculture, the government, both state and federal, allocates the remaining amount necessary to achieve that level of sustenance in the form of food stamps. The Food Stamp Act provides for 100% federal funding of food stamp benefits. The states provide management of the program and distribute the actual benefits.

The scope of the Food Stamp program is much broader than AFDC. The particular category required to qualify for AFDC, single parent with a qualifying child, does not hinder Food Stamp eligibility. Instead, anyone with sufficiently low income and assets may qualify. This explains why Food Stamps, as a federal expenditure, has grown to one and a half times the size of the AFDC program.

These programs constitute a federal grant program to aid needy families and qualifying individuals based on differing income thresholds. It is surprising that although they revolve completely around an individual's income, these welfare pro-

---

18. GREEN BOOK, supra note 4, at 1616.
19. The statute itself states that the Food Stamp Program's purposes is "[t]o alleviate . . . hunger and malnutrition" by permitting "low-income households to obtain a more nutritious diet through normal channels of trade by increasing food purchasing power for all eligible households who apply for participation." 7 U.S.C.A. § 2011 (West 1988).
21. 42 U.S.C.A. §§ 602(a)(7), (8) (West 1993). Monthly cash income determines primary eligibility for Food Stamps. There are different levels for different family sizes, and actual family income is determined under a complex series of rules determining what can be deducted when making the income calculation. GREEN BOOK, supra note 4, at 1618-20.
22. As of 1990, the federal disbursement for Food Stamps in 1992 dollars was $14,184,000, and for AFDC benefits was $10,894,000. Compare SOCIAL SEC. ADMIN., U.S. DEPT OF HEALTH & HUMAN SERV., SOCIAL SECURITY BULLETIN: ANNUAL STATISTICAL SUPPLEMENT, 1993 AT 332 with STAFF OF HOUSE COMM. ON WAYS AND MEANS, 102D CONG., 2D SESS., OVERVIEW OF ENTITLEMENT PROGRAMS: 1993 GREEN BOOK 616 (Comm. Print 1993).
grams exist wholly separate from the income tax. The income tax, as will be shown, presents unique opportunities for welfare reform.

Any welfare proposal can be assessed based on its ability to accomplish seven general goals of welfare reform. Any welfare proposal involves deciding which of these goals deserve emphasis and which deserve de-emphasis. This give and take analysis means that a determination of which goals are to receive emphasis, determines which method of welfare assistance to implement.

One goal of welfare reform is to eliminate poverty. This can be accomplished by guaranteeing everyone a standard of living above their relevant poverty threshold.

Another goal is to maximize equity. This goal seeks to insure that those who are equally needy receive equal benefits and that those who are more needy receive greater benefits.

A proposal should also maximize work incentives, employment, and national output. This is the basic efficiency argument which is an integral part of any legislative analysis. Integral to the proposal's efficiency is the minimization of the inflationary impact of redistributing wealth.

A specific type of efficiency involves the targeting of the proposal. Any proposal that seeks to aid the needy should be targeted such that most of the benefits are paid to those whom the proposal seeks to aid. As will be shown, this goal hinders many of the traditional methods used to aid the needy.

23. See generally Robert I. Lerman, Welfare Reform Alternatives: Employment Subsidy Proposals Versus the Negative Income Tax 5-6 (1977). Lerman actually proposes ten goals but the seven goals discussed are the most important and the most significant for this analysis. Lerman identifies the ten goals as 1) eliminating poverty, 2) maximizing equity, 3) maximizing work incentives, employment, and output, 4) minimizing inflationary impact of redistribution, 5) maximizing target-efficiency, 6) minimizing the administrative burden, 7) minimizing undesirable social effects, 8) maximizing public support, 9) maximizing effective integration with other government programs, and 10) minimizing implementation problems.

24. Id. at 5.

This paper will further discuss how the implementation of many welfare proposals would involve a great deal of administrative complexity. This complexity siphons off a significant portion of budgeted amounts that could otherwise directly aid the target group. Thus, minimization of the administrative burden is an additional goal of welfare reform.

An oft-heard criticism of the present welfare system is the system's negative externalities. The system is said to promote illegitimacy, broken families, nonparticipation in the work force, and increased child-birth in poor families. Any welfare proposal should minimize these undesirable social effects as well.

A final consideration for welfare reform is not necessarily a goal but a budgetary necessity in today's climate of massive government deficits. Any welfare reform proposal must be financially feasible working within the general revenue constraints of the federal budget.

The income tax offers a plethora of opportunities for new incentive-based welfare provisions to aid needy families while at the same time making work attractive. In fact, some provisions that already exist need only be expanded to provide just such a result. One provision which has recently gained new attention for its incentive and income assistance qualities is the earned income tax credit. Under the basic framework of welfare reform goals, and as an alternative to other welfare reform proposals, the earned income tax credit provides a newly discovered method to reform the present welfare system.

II. THE EARNED INCOME TAX CREDIT

The earned income tax credit ("EIC") is a special provision in the internal revenue code that has quietly played an important

---

role for needy families since 1975. Before this role and the purpose of the credit can be analyzed, the basic working of the credit must be examined.

The credit is provided under section 32 of the Internal Revenue Code.\(^{30}\) As a credit provision, a taxpayer enjoys a dollar reduction in taxes for each dollar of the credit. Though simple in application once the level of credit is determined, the earned income credit has gained notoriety for the difficult calculations required to determine the amount of credit that is available to any given taxpayer.\(^{31}\)

Until the recent changes in the earned income tax credit, an individual or married couple was eligible for the credit only if they had a "qualifying child"\(^{32}\) in the United States and if they enjoyed earned income. A child would qualify if it (1) was a son or daughter, a descendant of either parent, a stepson or stepdaughter, or a foster or adopted child, (2) was below the age of 19,\(^{33}\) and (3) had the same principal place of abode as the taxpayer for more than one-half of the taxable year (the entire year in the case of a foster child).\(^{34}\)

The amount of the credit increases by a percentage of each additional dollar of earned income. Beginning at the first dollar of "earned income," the pre-1994 credit phases in at a percentage known as the phase-in rate (Pi).\(^{35}\) Thus, for the first dollar of earned income, and for each dollar thereafter, the increase in the earned income tax credit is the phase-in rate multiplied by one dollar.\(^{36}\)

This phase-in is limited over a "phase-in range." The credit provisions cap the amount of earned income at which the credit

---

33. There are exceptions to the age limitation if the qualified child is a student or is permanently and totally disabled. Id. § 32(c)(3)(C).
34. Id. § 32(c)(3).
35. The notation for the components of the EIC and the graphical framework, infra, are derived from a helpful economic work. HOFFMAN & SEIDMAN, supra note 25, at 7-23.
36. Pi multiplied by earned income. Id. at 22.
phases in. This, in effect, determines the maximum value of the credit because the phase-in multiplied by the cap provides the greatest credit possible. The cap is therefore the minimum amount of earned income at which the maximum credit is granted, or $Em$.

After the taxpayer's income reaches the phase-in cap, there may be a stationary range where the credit remains at its maximum value. The stationary range has undergone a great deal of change over the many years of the EIC's existence. In the first two years the EIC was available, there was no stationary range at all. The stationary range has become a routine component of the EIC, and has evolved to encompass a significant range of income. In 1993, the maximum credit was available over a range of greater than $\$10,000$.

The stationary range ends when the phase-out rate, $Po$, begins to take effect. The EIC provisions specify an earnings level, $Eb$, where the phase-out rate begins to operate, reducing the credit amount by the amount of earnings above that earnings level multiplied by the phase-out rate.

The basic structure of the EIC can be best be understood graphically. The following figure demonstrates the interplay of all the EIC's components and the flow of the credit value ($C$) over increasing earnings ($E$).

---

37. See Appendices, Table 1, years 1975 and 1976.
38. See Appendices, Table 1.
39. Reduce the credit amount by $(Earnings-Eb) \times Po$. 

The earned income tax credit was established in 1975. Congress expressly intended the credit to compensate low income wage earners and low income self-employed persons for the social security taxes or self-employment taxes they pay. Congress also recognized the potential of the credit to aid low and middle-income families.

A unique feature of the EIC is the refundability of an excess credit. If the earned income credit exceeds the family's tax liability, the IRS will refund the difference. A taxpayer may claim the credit by filling out a special schedule on the individual's income tax form.

Another EIC feature of particular importance is the advance payment election. An eligible employee can fill out a Form W-5, Earned Income Credit Advance Payment Certificate, and present it to his employer. The employer must then make additional payments in the employee's wages. The credit is distributed

42. Id. at 84.
43. Schedule EIC may not be claimed on Form 1040EZ.
over the entire taxable year, as opposed to a lump-sum payment that arrives with the taxpayer’s return.\footnote{26 U.S.C. §3507(a).}

The reason for the advance payment option is obvious. In order for the EIC to adequately offset even a portion of social security withholding, the credit must be spread out over the wage-earning period. Otherwise, the taxpayer feels the income squeeze during the year from the social security withholding and receives a windfall with his tax return. Surprisingly, few eligible taxpayers actually elect advance payment.\footnote{Forman, supra note 28.}

Until about midway through the 1992 filing season, the IRS calculated the EIC for individuals who it determined to be eligible, but who failed to claim the credit.\footnote{Id.} The IRS would automatically recalculate the taxpayer’s tax liability after the credit and make any necessary refunds. Although this was lauded as a useful measure to increase use of the EIC, it was later proven to be grossly inaccurate. During the 1992 filing system the IRS determined that 600,000 taxpayers were eligible for the credit but failed to claim it.\footnote{Id.} Later analysis proved that the IRS had incorrectly awarded 270,000 earned income credits.\footnote{Id.} It is estimated that the government lost more than $175 million from this miscalculation.\footnote{Id.} While the automatic calculation would help solve some of the problems resulting from the complexity of EIC calculation, it does not help the large number of eligible individuals that fail to file a tax return.

Under the tax code, an individual is not required to pay income tax unless his income exceeds the amount of the minimum standard deduction plus the sum of available personal exemptions. Social security taxes, however, are paid on all covered earnings by workers and employers, regardless of how

\footnote{George K. Yin, Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Tax Income Credit Program, 94 TAX NOTES TODAY 40-56 (1994), available in LEXIS, FEDTAX Library, TNT file (text near footnote 22).}

\footnote{Id. (text near footnote 87).}

\footnote{Id.}
small the amount of earnings. Further, a self-employed taxpayer faces a higher rate of tax than a wage-earning employee. In 1975, the year the EIC was first enacted, the social security tax rate on employees was 5.85% of the employee’s wages up to $14,100. Self-employed individuals paid tax at a 7.9% rate on net earnings from self-employment income up to $14,100 if that income exceeded $400.

These social security taxes amount to a regressive effective tax rate structure. The code imposes the tax on both employees and self-employed individuals at a flat rate up to a wage cap. As wages increase, the effective rate of tax decreases. This was regarded as placing a heavy and disproportionate burden on low to middle-income taxpayers. Such a regressive system was viewed as a tax disincentive to work.

Although the burden affected all such individuals, Congress found that to allow a credit to all of them would be a substantial drain on revenue. Therefore, the credit focuses on individuals that are deemed to be the most needy — wage earners of low income families.

When first enacted, the EIC phased-in at a rate greater than the social security payroll taxes. This relationship has been maintained over the life of the EIC, and the rate differential has widened over time. The role of the EIC as a redistribution mechanism and a welfare tool has long been recognized. Current proposals to use the EIC as such a tool are only expanding what is already a moderate welfare mechanism. However, now the EIC has been expanded into a more significant component of the American welfare package.

As of 1993, section 32 provides an income tax credit of 18.5% of earned income for eligible individuals with one qualifying child up to a maximum of $1,434.

50. See Table 2.
52. Id. at 84.
53. Compare Table 1 with Table 2.
The amount of the credit is reduced by the amount of adjusted gross income, or the amount of earned income, (whichever is greater) that exceeds $12,200 on the basis of $1.32 for each $10 of income in excess of $12,200. Graphically, in 1993 an eligible taxpayer with one qualifying child faces the credit scale graphed in figure 2. An eligible taxpayer with two qualifying children faces a similar EIC structure with a slightly quicker phase-in rate and a higher maximum credit.54

The effective tax rate structure an eligible taxpayer faces is quite different. The social security payroll taxes have a significant impact on the effective tax rates that low to middle-income families face.

When such families qualify for the EIC, the effective rate structure becomes even more complex as shown in the figures on the previous page, describing the 1993 effective rate structure applicable to married individuals with one child.55

54. See Table 1.
55. These diagrams are based on rates only. The effects of the standard deduction and personal exemptions are not taken into account.
The EIC does provide a strong incentive structure up to the stationary point. However, while the EIC is phasing out, there is a strong disincentive to earn additional “earned income.”

56. This point has been the subject of debate. Economists differentiate between two labor effects: the income effect and the substitution effect. Over the phase-in range of income levels, the effects operate in opposite ways on worker incentive. The income effect of the EIC involves workers seeing themselves as wealthier because of the additional credit income. As a result, they decide to work less while enjoying the same level of pre-credit income. The substitution effect of the EIC describes the situation where the worker sees that work, in relation to leisure, is now more profitable with the credit. Therefore, the worker will choose to work more. Most agree that the substitution effect is stronger over the phase-in range.

For the phase-out range, the effects operate similarly on worker incentives. The income effect is the same as under the phase-in range. More work makes the person wealthier. The substitution effect is different, however. Because the worker now experiences a decreasing credit as income increases, he has a disincentive to work more. The income and substitution effects are seen by economists to create a strong work disincentive in the phase-out range. Robert L. Moore, Recent Proposals to Redesign
In section IV, a newer, enhanced Clinton Administration EIC will be analyzed.

III. ALTERNATIVES TO EITC

The earned income tax credit provides an easy mechanism to aid low to middle-income families. However, since welfare reform has been an issue almost every year since welfare was instituted, a number of different proposals have been offered to

---

the EITC: An Economist's Response, TAX NOTES, July 5, 1993, 105 at 106. Some legal scholars argue that because an individual does not see the effects of working less directly in his or her paycheck, the substitution effect does not alter work decisions in either range. Francine J. Lipman & James E. Williamson, Recent Proposals to Redesign the EITC: A Reply to an Economist's Response, TAX NOTES, Feb. 28, 1994, 1175 at 1176. Therefore, the work disincentive in the phase-out range is not very strong.
aid needy families. Among the various formulations, the most popular are the negative income tax, the minimum wage, and wage subsidies.

A. Negative Income Tax

Proposals for a negative income tax ("NIT") recur whenever there is talk of welfare reform. Early in the 1960s, a working model for an NIT structure took shape. Today, the NIT offers both a strong alternative to the welfare system as a whole and a significant structure that could complement the present welfare system.

NIT advocates place high priority on the goals of simplicity, ease of administration, universality, and horizontal equity. The NIT can efficiently achieve these welfare reform goals.

1. Description

The negative income tax proposes to use the existing federal income tax system to distribute cash to needy individuals. Under the NIT, a minimum tolerable income is determined for different taxable units. If a taxable unit’s income falls below the minimum income level, the IRS makes up the difference by paying out some percentage of that difference as a refund. The negative income tax derives its name from the concept that under the positive tax system the IRS shares in all individuals’ income above a minimum threshold (standard deduction plus personal exemption) by requiring a percentage payment of the surplus. Under the NIT it also shares in all deficiencies in income below the minimum income amount by paying a percentage of the deficit.

57. LERMAN, supra note 23, at 20-21 (equity), 33 (simplicity and ease of administration); HOFFMAN & SEIDMAN, supra note 36, at 55 (universality) (discussing a broader NIT than that contemplated by Lerman); William A. Klein, Some Basic Problems of Negative Income Taxation 1966 Wis. L. Rev. 776, 797 (1966) (negative income tax has the advantage of avoiding the anomalies of the categorical approach).

58. The NIT could have just one minimum income level determined for all individuals.

The NIT can be most easily understood by an example. If it is determined that the minimum yearly taxable income for a married couple with no children is $2000 and such a couple actually realized only $800 of taxable income, then that couple would have $1,200 of negative income. Under the negative income tax, the couple would be entitled to a payment equal to some percentage of its negative income.

Such a system serves two main objectives. First, the NIT has a welfare objective in that it seeks to guarantee a minimum level of income. Second, the NIT has a work-incentive objective in that it seeks to increase employment by allowing payment of only a percentage of negative income. As will be discussed, these objectives compete with each other so that any NIT structure must be a compromise between the two. The final compromise is codified in the NIT's two components.

a. Maximum Payment

The first component of the NIT is the maximum payment for which a taxable unit may be eligible. This is the minimum taxable income that the NIT will guarantee. Such a level is relatively easy to set as the government yearly determines the poverty level for different family structures. However, the issue is more complex than that.

One source of complexity in the NIT involves categories of taxpayers. The NIT has actually been lauded for being a "noncategorical welfare program." Unlike traditional welfare programs, an individual's benefit level under many NIT proposals depends solely on his income and not whether he is in a particular category such as a single parent, disabled, blind, and so on. For the NIT to be truly effective, however, it must have some categories.

Most NIT proposals break down taxpayers into family units for purposes of determining minimum income levels. Thus, single taxpayers, married taxpayers, and families with different

---

60. See Klein, supra note 57, at 777-78.
61. Id. at 781.
numbers of children are each entitled to different minimum income levels. This still does not present an insurmountable challenge as poverty levels are set for all of these categories. However, when the financial costs of the NIT are weighed against the poverty levels, the ease of the NIT disappears.

An NIT is inherently costly. This cost is a direct function of the minimum income guarantees. Unlike AFDC, the NIT would be available to all taxpayers provided their incomes fall below the minimums. Because of the prohibitive cost, the requisite income cannot be guaranteed for all taxpayers that fall below the poverty lines as determined by the government. Thus, some level must be set that falls below the minimum poverty thresholds.\(^6\) The welfare objective must, therefore, give way to fiscal soundness as it has done in a myriad of other programs.

b. Rate of “Tax”

The second major component of the NIT is labeled by economists as the rate of “tax.” This is the percentage of the income deficit below the minimum income level that the government will pay to the individual or taxable unit.

Unlike the maximum payment which is hopefully determined with regard to welfare and humanitarian considerations, the rate of tax is a function of the NIT work-incentive objective. One of the major AFDC deficiencies is the program’s effective 100% tax. For every dollar an AFDC recipient earns, that individual’s benefits are decreased by a dollar.\(^6\) This is seen as a major flaw in AFDC because the program provides no incentive for recipients to seek employment.\(^6\)

---

63. See James A. Tobin et al., Is a Negative Income Tax Practical?, 77 YALE L.J. 1, 26-27 (1967) (discussing the large cost of any NIT program that would guarantee full poverty threshold amounts to taxpayers).

64. The implicit AFDC tax rate has been close to 100% since the program was started. Id. at 1; 42 U.S.C.A. §§ 602(a)(7)(B), (C) (West 1993). In 1967, Congress reduced the AFDC tax rate to 67% and then increased the rate to its previous 100% level in 1981. See Robert Moffitt, Welfare Reform: An Economist’s Perspective, 11 YALE L. & POL’Y REV. 126, 139 (1993); Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 357.

65. See Judith M. Gueron, Welfare and Poverty: The Elements of Reform, 11 YALE L. & POL’Y REV. 113, 114 (1993); Moffitt, supra note 64, at 126.
Unlike the welfare system with its caseworkers and direct contact with beneficiaries, the NIT is a "noncategorical welfare" system which would be operated on paper exclusively through the tax system. The NIT beneficiaries would not have to show they are trying to find work. This faceless aspect requires that an incentive system be a part of any negative taxation system implying a tax rate of less than 100%.

The NIT can offer as strong or as weak a work-incentive as its crafters wish. By varying the rate of tax, an extra dollar of earned income can provide one dollar of extra income or no extra income. However, there is a competing consideration here.

The tax rate, just like the minimum income level, is a determinant of cost. The higher the tax rate the lower the cost of the NIT. Further, for any given cost, a level of minimum income necessarily implies a certain tax rate and vice versa. The interplay of cost, minimum income level, and tax rate create complexity in the creation of any NIT. The final levels will reflect the crafter's determinations of whether the main objective of the NIT is humanitarian or the creation of work-incentives. Existing proposals call for between a 33.3% to a 50% tax rate.66

The final complexity, and one that has provoked a great deal of literature, is the proper tax base for which to apply the tax rate. Since the NIT is a welfare program based on need, it is necessary to measure the true economic plight of a potential NIT recipient. The maze of special deductions and exemptions found in the positive tax code do not provide the proper measurement in taxable income. Instead, the definition of income for NIT purposes must be comprehensive.

Some proponents have proposed a variant of the present positive income tax measurement of income. Under these proposals, many of the special exclusions would be included, such as tax-exempt interest and scholarships and fellowships above the tuition level.67 Further, income would be imputed for owner-occupied housing and for home-grown vegetables.68 Finally,

66. See Klein, supra note 60, at 778-80 (discussing Lampman-Friedman 50% proposal); Tobin, supra note 63, at 4 (discussing a 33.3% and 50% tax rate).
67. Tobin, supra note 63, at 11.
68. Tobin, supra note 63, at 12 (imputing income from owner-occupied housing
some measure of wealth could possibly be part of an individual’s income.\textsuperscript{69} The administrative difficulties presented by such a definition of income are obvious and have been noted and discussed in detail by other more realistic proponents of the NIT.\textsuperscript{70}

Once the NIT is completely phased-out at the NIT breakeven point, the taxpayer would revert to a normal tax rate. Proponents have offered an election system whereby the NIT recipients could elect to continue benefits until they reach a tax-breakeven point.\textsuperscript{71} The election would remove any strong tax rate disincentive at the breakeven point. Again, this would add to the complexity of the NIT structure.

The basic graphical structure of any NIT would be similar to figure 5. The labeling of the NIT elements is the same as that used for the EIC.

The NIT and the EIC appear to operate similarly. In fact, the NIT appears to be graphically identical to the EIC without a phase-in range. However, they are not identical, and it will be shown that they are not truly interchangeable alternatives.

2. Negative Income Tax and The Earned Income Credit

Although similar, there are significant operating differences between the negative income tax and the earned income credit. One significant difference is that the two systems apply to different tax bases. They also apply to different categories of taxpayers and operate at different levels of income.

---

\textsuperscript{69} Tobin, \textit{supra} note 63, at 13. Such an element of “income” would assume that individuals may have to liquidate some of their assets before the government would provide any financial assistance to achieve a minimum level of income.

\textsuperscript{70} See, \textit{e.g.}, Cohen, \textit{supra} note 59, at 680.

\textsuperscript{71} See Tobin, \textit{supra} note 63, at 6-7 (discussing possible methods for dealing with the “notch” problem).
As discussed above, the NIT would apply to a modified, comprehensive definition of income. Such income would be similar to that under the positive income system in that it would include interest, dividends, and gains from the sale of property.

The EIC phases in based upon a person's earnings for the year. Such earnings are defined to include "wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year."\(^7\) The EIC has a much stricter base of application than the NIT since it is limited to labor earnings.

The EIC also has a narrower category of eligible beneficiaries. The NIT applies to all individuals provided they meet the asset and income qualifications. As explained above, an individual is currently eligible for the EIC only if the individual has a child who satisfies a relationship test, a residency test, and an age test.\(^3\) The NIT clearly applies to a broader range of taxpayers and would generally provide a greater gross amount of benefits making it more costly than an EIC with similar benefit provisions.

\footnote{72. 26 U.S.C. § 32(c)(2)(A) (Supp. 1993).} 
\footnote{73. See supra notes 32-34 and accompanying text.}
Finally, there are striking differences in the operations of the EIC and the NIT. If a household does not have any earnings, then under the EIC it would receive no credit. Under the NIT, however, a household with no earnings[^4] would receive the maximum benefit. Thus, the NIT provides the largest benefit to households which work the least.

It is questionable whether the NIT's provision for work-incentives is as great as that of the EIC.[^6] The basic reason for the difference in incentives is the phase-in range under the EIC. The NIT lacks such a range and instead begins at zero income with either a stationary range or a phase-out range. Significantly, a negative income tax is the present earned income credit without a phase-in range. A comparison of the two provided graphs will illustrate this.

3. Negative Income Tax and AFDC

The negative income tax has never been proposed as an alternative to the earned income credit. Instead, proponents offer it as an alternative or complement to the present Aid to Families with Dependent Children program.[^6]

Many argue the current AFDC program has a certain negative social stigma.[^7] They argue that the stigma demeans AFDC recipients who retain some element of personal pride to help them fit in with the rest of society. The NIT lacks this stigma.

[^4]: Whether the household with no earnings would actually receive a benefit depends on the definition of income under the NIT.

[^5]: Note that the true work incentives of the EIC are uncertain. See discussion supra note 56.

[^6]: See Klein, supra note 57, at 781-99 (discussing benefits and drawbacks to substitution versus a complementary approach); Moffitt, supra note 64, at 138-40 (discussing problems with incentives for welfare recipients with a complementary NIT system); Tobin, supra note 63, at 14-16 (recommending maintenance of public assistance programs as supplements to a national NIT system).

[^7]: See Gary Burtless, Are Targeted Wage Subsidies Harmful? Evidence from a Wage Voucher Experiment, 39 INDUS. & LAB. REL. REV. 105, 113-14 (1985) (discussing the stigma of AFDC). This argument also applies to the Food Stamp program. There is empirical evidence that many who qualify for food stamps refuse them because of the stigma that attaches to the use of such stamps. See Robert Moffitt, An Economic Model of Welfare Stigma, 73 AM. ECON. REV. 1023 (1983) (discussing the stigma of both the Food Stamp and AFDC programs).
The NIT applies to all individuals. It is noncategorical in nature. Because there is no rigorous enforcement of categories, individuals will not have to endure humiliating procedures to prove that they qualify. The negative system provides cash benefits only, and unlike AFDC, neither imposes work requirements nor offers social work services. Further, there would be no need for the administrative bureaucracy that accompanies such procedures which reduces administrative costs and increases efficiency.

The noncategorical nature of the NIT would remove a major problem with the current AFDC eligibility structure. AFDC currently provides an incentive for women to become or remain a single parent in order to qualify for benefits. Critics see this as one of the causes of inner-city decay and the destruction of the family. Fathers of children born into low-income families are not needed once the child is born. In fact, their presence is discouraged because the mother can support herself financially with the help of AFDC benefits. The NIT would remove this incentive by providing benefits regardless of family structure provided income requirements are met.

A further drawback to AFDC is the effect of state implementation and oversight. Each state chooses the level of benefits to be provided to eligible participants. It is argued that differing levels of benefits lead to a migration of welfare recipients to high-benefit states. The benefit increase can be quite large. For instance, in 1992 a two-person family in Mississippi would be eligible for $96 per month while the same family would be eligible for $821 per month in Alaska. While it is unlikely any recipients would move from Mississippi to Alaska, the point is that there may be a real incentive to migrate under AFDC.

---

78. This is not a necessary element of an NIT. Proposals for differing NIT taxable units include different definitions of family units. Problems created by a family unit approach include developing a structure to assign individuals to units and determining the support allowances in relation to families differing in size and composition. Tobin, supra note 63, at 8-11.
79. Klein, supra note 57, at 782; Rosen, supra note 62, at 179.
80. The extent to which mothers actually act upon this incentive is disputed. Moffitt, supra note 64, at 136-37. Regardless of the actual percentage rate, with the present problems of family decay in America, removal of an incentive for further decay would be a step in the right direction. See generally Gueron, supra note 65.
81. Klein, supra note 57, at 788.
82. The empirical research on this issue has been inconclusive. It is argued that
The NIT would impose a national level of minimum income. This would remove any migratory incentive. If the NIT structure were implemented with the existing AFDC system in place, it could reduce the present migratory incentive.

As previously discussed, the AFDC system fails to provide a work-incentive under its present 100% tax rate. The NIT would remedy this situation as well with a less than 100% rate. If the NIT were to supplement the AFDC it would improve the current AFDC situation.

4. Conclusions

The negative income tax provides a real alternative proposal to the earned income credit and a possible complement to the present AFDC program. Proponents have developed workable systems that provide serious work-incentives to low-income individuals.

Implementation of the NIT would require some adjustment of the present tax code. The definition of income would have to be changed. This is not as difficult as it first might appear as there has been extensive literature on this topic since the income tax became a constitutional reality in 1913. The taxable unit would have to be altered to account for the present myriad of family structures and the accounting period would have to be lengthened to accommodate the fluctuations in many individuals’ earnings from year to year to prevent wide fluctuations in benefit levels.

the studies have a large error factor due to external societal factors not accounted for in these analyses. See Moffitt, supra note 65, at 137.

83. Curiously, there is no discussion of varying allowance amounts for regional variations in costs of living in the proposals reviewed. If there is a migratory effect caused by regional variations in real AFDC benefit amounts, there would also be such an effect in an NIT system that provided the same level of allowances regardless of the recipient’s cost of living.

84. Cohen, supra note 59, at 679.


86. See Klein, supra note 57, at 785-86; Michael R. Asimow & William A. Klein, The Negative Income Tax: Accounting Problems and a Proposed Solution, 8 HARV. J. ON LEGIS. 1, 6-10 (1970).
As a substitute to AFDC, the NIT would be exorbitantly expensive. Because of the increase in the number of eligible beneficiaries, the level of benefits must be lower than presently under AFDC. The effect on the truly needy in this situation is questionable.

As a supplement to existing programs, the negative income tax would lose many of the qualities that make it attractive. The objectivity, loss of stigma, and administrative efficiency arguments would no longer hold.

B. Minimum Wage Legislation

The level of wages in general and the minimum wage in particular has been the subject of intense discussion and extensive argument. Many call for an increase in the minimum wage to guarantee, at a minimum, an income level concomitant with the poverty threshold. Others argue for a dual minimum wage structure with a reduced minimum wage for "younger workers just getting started in the labor market." Those opposed to these proposals question the economic value of a minimum wage and instead propose its elimination.

The ideal method to increase the wages of the poor is to increase their marginal productivity. In this way the work product of the poor would command a greater wage in a free labor market. However, this method is problematic. An increase in worker productivity would require job training and basic skills programs. These are costly programs and their effects would not be immediate but rather reflected gradually over the long-term. In the short-term period before the effects of such a broad-based training program were felt, an increased minimum wage could potentially alleviate many of the present income problems associated with the working poor. Because the minimum wage is the subject of substantial controversy and has recently reemerged as a potential tool for the Clinton

88. Id.
89. Significantly, many such programs are presently in place at the state level for AFDC recipients under the federally-mandated JOBS initiative. See infra Section I.
Administration's welfare reform, the minimum wage deserves thorough analysis.

1. Historical Background

Congress first imposed the minimum wage by enacting the Fair Labor Standards Act of 1938 ("FLSA"), setting the first such minimum at $.25 per hour for "employees engaged in commerce or in the production of goods for commerce" where 'commerce' was strictly defined as that between the states. By enacting the wage floor, Congress sought "to correct and as rapidly as practicable to eliminate" from interstate commerce "labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers." Significantly, the minimum wage policy was to raise the general condition of low-wage laborers without "substantially curtailing employment or earning power."

Although the minimum wage is a broad-based federal edict, it is not comprehensive. Instead, the FLSA specifically exempts a number of categories from coverage. Workers who most likely would not be taken advantage of by harsh employment practices and also would not likely be paid at or near the minimum wage rate are exempted. Such workers include persons working in executive, administrative, or professional capacities.

More important for our purposes, the FLSA exempts many occupations which employ a significant percentage of the working poor. The wage floor does not apply to persons working in seasonal amusement establishments, persons doing outside sales work, babysitters hired on a casual basis, and persons

---

91. Id. § 206(a).
92. Id. § 203(b). This definition has been significantly broadened over time through liberal interpretation. See Smith & Vavrichek, supra note 87, at 24.
94. Id.
working in low volume retail trade and service firms.\textsuperscript{97} Self-employed individuals would, of course, not need any protection and are exempted as well.

Since its inception, the minimum wage has fought a continuing battle with inflation. Congress has periodically raised the minimum wage, but the wage level has never been pegged to any type of index. As a result, steady inflation has eroded the real purchasing power of the minimum wage in the years between such periodic adjustments.\textsuperscript{98}

From an original rate of $.25 per hour, Congress increased the minimum wage to $1 per hour in 1955,\textsuperscript{99} $2 per hour in 1974,\textsuperscript{100} $2.65 per hour in 1977,\textsuperscript{101} $3.35 per hour in 1977,\textsuperscript{102} and by the most recent amendment in 1989\textsuperscript{103} to the present $4.25 per hour level. Superficially, these increases seem adequate if not generous.

a. Prices and the Minimum Wage

When inflation enters the analysis, the true history of the minimum wage can be seen. In 1947, Congress mandated a $.40 per hour minimum on hourly employees. The per hour minimum reached $4.25 as of 1991. During the period 1947-1991, inflation increased prices 463%.\textsuperscript{104}

Table A shows the yearly progression of the minimum wage in current dollars and in 1991 constant dollars. Note that the

\textsuperscript{97} 29 U.S.C. § 213 (1988) (also exempt are persons employed in certain fishing and other seafood harvesting operations, certain agricultural workers, and employees of certain small newspaper operations).

\textsuperscript{98} Smith & Vavrichek, supra note 87, at 24.


real purchasing power of the minimum wage has undergone significant fluctuation over time due to inflation and upward adjustments of the wage floor. The nominal minimum wage has increased since its inception in 1947. Only since 1989 has the minimum wage consistently risen in real dollars. Most recently under the 1989 amendment to the FLSA, the level was raised to $4.25 per hour in 1991, but when the effects of inflation are considered, the minimum wage's true value is no higher than it was in 1985. Thus, the recent increase in 1991 has failed to correct the erosion in the minimum wage's purchasing power in real dollars.\(^5\)

---

105. See Table A.

106. Nominal minimum wage amounts based on several sources. GREEN BOOK, \textit{supra} note 4, at 601, Table 46; Shapiro, \textit{supra} note 96, at 656, Table A; Smith & Vavrich, \textit{supra} note 87, at 25, Table 1. Constant dollar amounts are based on the author's calculations using the Annual Average Consumer Price Index (CPI). \textit{See} MONEY INCOME 1991, \textit{supra} note 104, at B-2. The CPI numbers provide the basis for effective present dollar calculations of the minimum wage.
b. Poverty Thresholds and the Minimum Wage

The minimum wage has experienced a similar trend with respect to poverty levels. Full-time, year-round minimum earnings have decreased with respect to poverty thresholds as the thresholds change with inflation while the minimum wage re-
mains fixed. This result holds even after the most recent minimum wage increases.\footnote{107}

During the 1960s and 1970s, a full-time worker earning minimum wage and working the entire year was guaranteed income sufficient to meet the poverty threshold for a family of three.\footnote{108} In 1992, a worker earning minimum wage working full-time, year round would earn $8,840.\footnote{109} This is a little over the poverty level for a two person family and falls far short of the poverty threshold for a three person family.\footnote{110} A worker in a three person family earning minimum wage would have barely scraped by in the 1960s and 1970s and, as the world progressed into the 1990s, would have experienced a steady decline into poverty.\footnote{111}

Assuming Congress over the years has unofficially set the minimum wage at the poverty threshold for a family of three, the present minimum wage is grossly inadequate. To return to previous levels and thereby restore minimum wage purchasing power, an additional $1.18 per hour is required to bring the present minimum wage up to $5.43 per hour.\footnote{112}

The conclusion to be drawn from the history of minimum wage levels is that the wage floor in recent years has declined in real purchasing power. This means that hourly employees working the same hours are earning less and paying more for goods. The idealistic objectives espoused in the FLSA have not been achieved. Proponents of a minimum wage increase argue that while Congress has pronounced lofty principles it has actually guaranteed low-wage workers a gradual descent into poverty.\footnote{113}

\footnotesize

\footnote{107. Smith & Vavrichek, supra note 87, at 26-27.}
\footnote{108. Based on poverty thresholds and minimum wage levels. See Table A.}
\footnote{109. 40 hours per week x 52 weeks per year x $4.25 per hour.}
\footnote{110. $9,212 and $11,280 respectively. GREEN BOOK, supra note 4, at 1272.}
\footnote{111. This assumes the worker is the only wage earner in the family.}
\footnote{112. The 1992 projected poverty threshold for a family of 3 persons is $11,280. GREEN BOOK, supra note 4, at 1272. A person earning $5.43 per hour working full-time year-round would earn $5.43 per hour x 40 hours per week x 52 weeks per year = $11,294.}
\footnote{113. Smith & Vavrichek, supra note 87, at 24.}
2. Economic Analysis

The minimum wage is one area, perhaps the only area, where economists are in agreement as to economic effects of policy changes. Generally, increasing the minimum wage reduces employment and generates involuntary unemployment. What is surprising is that strong theoretical evidence points to the working poor as the main victims of the resulting job dislocation.

a. One Sector Model

The basic labor market can be defined by a labor supply curve and labor demand curve (see Figure 6). The labor demand curve slopes downward since more labor is demanded as its price, the wage rate, decreases. The labor supply curve demonstrates the inverse. This curve slopes upward because as the wage rate increases, more persons are willing to work.

The labor market is in equilibrium where the labor supply and labor demand curves intersect. The amount of labor offered for employment at this wage is equal to the amount of labor demanded. The wage is the equilibrium wage level, W₀, and the corresponding level of employment is the equilibrium employment level, E₀. A minimum wage set at or below the equilibrium level has no effect on the labor market because market forces maintain this wage level regardless of government mandate.

If the wage is increased above the equilibrium wage level it has significant effects on the labor market. Assume the government sets the minimum wage at W₁. At this level, firms demand less labor because the cost of labor has increased while there has been no corresponding increase in the amount of

---

114. Shapiro, supra note 96, at 668 (adopting economic analysis from M. SPENCER, CONTEMPORARY ECONOMICS 545 (4th ed. 1980)).
revenue a given worker hour can produce for a firm. At this higher minimum wage, work becomes more attractive\textsuperscript{115} and more people will enter the labor market. The actual amount of labor employed is determined by the labor demand curve. The difference between labor demanded, $E_{d1}$, and labor supplied, $E_{s1}$, is the level of involuntary unemployment, as people want to work but cannot get jobs. Most significantly for our purposes, the actual level of employment decreases when the minimum wage increases. In this example, the overall employment level has fallen from $E_0$ to $E_{d1}$.

If the minimum wage is increased further to $W_2$, these effects will be even more dramatic. The higher the minimum wage is above the equilibrium wage, the greater the reduction in overall employment. Further, the higher the minimum wage, the greater the number of workers seeking employment. This simple example provides a theoretical basis for analyzing minimum wage effects, but the actual interaction of the minimum wage and the labor market is more complicated. Because the FLSA is not comprehensive in coverage, a more realistic model

\textsuperscript{115} This is known as the "substitution effect." When the wage increases, work becomes more attractive relative to leisure. The actual rate at which work and leisure will be substituted is the income elasticity of leisure and is a function of individuals utility curves.
analyzes a labor market with both a covered and an uncovered sector.

b. Two Sector Model

As discussed, the FLSA provides extensive coverage of many wage occupations. A number of exemptions, however, remove a large segment of the labor market from minimum wage coverage. By expanding the general labor market examination to a two sector model, graphical analysis will capture these nuances.  

Assume that there are two sectors in the labor market. One sector, the exempted (uncovered) sector, comprises workers and jobs where the wage rate is determined independent of the federally-mandated minimum wage. The other sector, the covered sector, encompasses workers and jobs where the wage cannot drop below the FLSA wage floor. Further, assume workers are fully mobile between the two sectors.

The labor supply comprises both skilled and unskilled workers, and the wage commanded is generally a function of the skills the worker possesses. All things being equal, a skilled worker will command and receive a higher wage than an unskilled worker. The working poor predominantly fall into the unskilled labor force.

116. Daryl Shapiro has provided an in-depth analysis of this model. See Shapiro, supra note 96, at 668-71.
117. This assumption is not based on empirical data but is for analysis purposes only.
118. This statement is subject to economic conditions. If the unemployment rate is extremely high, even highly skilled workers will command a low wage. In this situation, however, a skilled worker would be hired before an unskilled worker.
If the government imposes a minimum wage in the covered sector, unskilled workers will want to work there. Unskilled workers in the exempted market would likely be paid at a wage below the minimum wage.

If the government increases an existing minimum wage in the covered sector from $W_0$ to $W_1$, demand for labor will de-

---

119. Shapiro, supra note 96, at 669.
cline (see Figure 7).\textsuperscript{120} The single market model proved that as the cost of labor increases, employers will hire less and even fire some of the existing labor. Because workers with the lowest skills produce work product valued lower than that of highly skilled workers, the lowest skilled will be let go. These unskilled workers would include much of the working poor.\textsuperscript{121} Overall employment in the covered sector will decrease as a result of the minimum wage increase from Ec0 to Ec1.

The only available employment will be in the uncovered sector. Many of the workers who lost jobs in the covered sector will seek occupations that are exempt from FLSA coverage, since those jobs are unaffected by the minimum wage increase. As the supply of labor in the covered sector increases, the equilibrium wage will fall from W0 to W1. Employers will be able to hire more workers for less. Accordingly, the overall employment in the uncovered sector will increase from Eu0 to Eu1.

The total effect of the minimum wage in this model is to produce both "winners and losers."\textsuperscript{122} The winners are those workers in the covered sector who retain their jobs at the higher wage.\textsuperscript{123} These would not be the working poor. The losers are composed of two groups.\textsuperscript{124} Those severed from covered-sector jobs lose whether they are rehired in the uncovered sector or not as they either receive a lower wage or remain unemployed.\textsuperscript{125} These would again include most of the working poor. Another group includes those workers who originally worked in the uncovered sector. They suffer a real wage reduction due to the increase in available uncovered sector labor.\textsuperscript{126}

The conclusion to draw from the two-sector model is that the working poor lose the most as a result of minimum wage in-

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{120}] Shapiro, supra note 96, at 670 (adopted from RONALD EHRENBERG & R. SMITH, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY (3d ed. 1989)).
\item[\textsuperscript{121}] See U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORTS, SERIES P60-185, POVERTY IN THE UNITED STATES: 1992, (1993) [hereinafter POVERTY 1992] (education level table shows a greater proportion of those under the poverty level as not completing high school than those with a college diploma or greater).
\item[\textsuperscript{122}] Shapiro, supra note 96, at 669 (citing R. EHRENBERG & SMITH, supra note 120, at 83).
\item[\textsuperscript{123}] Id.
\item[\textsuperscript{124}] Id.
\item[\textsuperscript{125}] Id.
\item[\textsuperscript{126}] Id.
\end{enumerate}
\end{footnotesize}
creases. While the overall employment effect in this model is unclear, employment will decline in the covered sector and increase in the uncovered sector.

There will also be a capital-substitution effect in the long-term due to any minimum wage increase. The increase in labor costs for the covered section financially enables capital substitution. The reduction in employment in the covered sector may be permanent because some industries may convert to automation, permanently replacing labor positions such that later wage decreases will not increase employment.

3. Demographics

Proponents of a minimum wage increase have failed to account for the demographic makeup of the wage guarantee population. The surprising statistical features of the average minimum wage worker offer a strong argument against using the minimum wage as a welfare mechanism.

In 1992, approximately 81.5 million persons worked full-time for 50 weeks or more. Roughly 2.2 million were below their relevant poverty thresholds. This statistic is important when considered in conjunction with the number of poor who are paid the minimum wage.

In 1984 there were 70.4 million workers in full-time jobs. 2.1 million of these workers were considered poor based on the 1984 poverty thresholds. Significantly 800,000, or 38% of the poor workers who worked full-time, toiled in occupations not covered by the FLSA and were unaffected by any changes

127. Id. at 673 (citing D. HAMMERMESH & ALBERT REES, THE ECONOMICS OF WORK AND PAY 112 (4th ed. 1988)).
128. Id. at 673 (citing EHRENBERG & SMITH, supra note 120, at 103).
129. A person is classified as having worked at full-time jobs if he or she worked 35 hours or more per week during a majority of the weeks in which work was performed. POVERTY 1992, supra note 121, at A-12.
130. Id. at tbl. 14.
131. Id.
132. Smith & Vavrichek, supra note 87, at 29 (citing BUREAU OF THE CENSUS, CONSUMER INDEX SERIES P-60, NO.149, CURRENT POPULATION REPORTS 27 (1985)) (assuming a full-time worker to be one who works at least 50 weeks per year for 35 hours or more per week).
133. Id.
in the minimum wage. This translates into 38% of the full-time working poor who would not feel any direct impact on their income levels from an increase in the minimum wage.

An additional 2.8 million full-time workers worked, including 200,000 poor, but only on part-time schedules. Of the remaining 59.6 million workers who worked year-round and predominantly full-time in occupations potentially covered by the FLSA, only 1.1 million had a cumulative family income below the poverty threshold. Thus only 1.8% of full-time, year-round workers in occupations covered by the minimum wage were poor. Although these are 1984 statistics, the conclusions to be drawn provide strong evidence as to the present composition of workers covered by the minimum wage.

The effect of these results on the arguments for increases in the minimum wage is fatal. Over 98% of workers who would benefit from such increases would not be poor. Analysis of which population segments compose this 98% does provide some normative implications for present minimum wage policy.

Approximately 70% of workers earning at or below the minimum wage in 1985 lived in families with another wage earner. A third of those earning at or below the wage floor were teenagers. These statistics imply that, while raising the minimum wage will not directly target the poor as beneficiaries, a graduated and categorized minimum wage could provide greater help to the poor.

4. Minimum Wage and the Earned Income Credit

How does the minimum wage fare against the earned income credit? As a mechanism for aiding the working poor, the wage floor has many flaws. The minimum wage is not well targeted toward the working poor. Most of the benefits of the mini-

---

134. Id.
135. Id.
136. Id.
137. Id.
138. Id. at 27-28.
140. See supra Section B.1.
The minimum wage accrues to teenagers and workers who only supplement the income of families' primary income earners. In addition, the minimum wage causes unemployment. Under the two-sector model, it causes a dislocation which affects the working poor the most.

The EIC lacks these flaws. It is well-targeted to aid the working poor; teenage dependents who work would not be eligible because the taxable unit for EIC qualification is the family unit, not individual workers. Further, the working poor with low wages would be the major beneficiaries. In 1988, 41% of the working heads of households or single parents claiming the credit had wages less than $5 per hour. Of the wives who claimed the credit 43.9% received less than $5 per hour. These percentages are much higher than those provided by the minimum wage demographics.

As an incentive, the EIC is considerably more effective than the minimum wage. While the EIC incentive system provides increasing enticements to the extremely poor for additional work over the phase-in range, the minimum wage remains constant.

From an employment perspective, the EIC is preferable as well. Unlike an increase in the wage floor, there would be no unemployment effect since the credit does not affect wages. Wages would be free to float with fluctuations in the labor market, allowing the labor supply to equal labor demand.

The minimum wage does enjoy a political advantage over the EIC. The earned income credit has obvious federal budgetary costs that make passage of any EIC increase difficult. However, employers in the covered sector bear the cost of a minimum wage increase. This cost is hidden through increased labor

141. The author was unable to determine the percentage of teenagers who held these minimum wage jobs to enable their families to achieve income levels above the poverty threshold.
142. The study from which these numbers were derived defines the husband as the head of a married household except in rare circumstances. Hoffman & Seidman, supra note 35, at 35 n.10 (citing the Panel Study of Income Dynamics conducted by the University of Michigan's Institute for Social Research).
143. Hoffman & Seidman, supra note 36, at 33.
144. Id.
145. Id. at 57.
costs and therefore the government does not have to justify any extra spending.

C. Wage Subsidy

A direct alternative to the minimum wage and a possible method of aiding the needy is the wage subsidy. Economists have long viewed the wage subsidy as an attractive structure to guarantee income levels for the working poor, but the wage subsidy has been largely overlooked by legal theorists.\(^{146}\)

The goals of wage subsidy advocates are somewhat different from those who advocate the NIT or the minimum wage. The wage subsidy is an effective method of achieving high incentives to work, high rewards for work, an increase in employment,\(^{147}\) and equity.\(^{148}\) This definition of equity differs from basic notions of horizontal or vertical equity in that it seeks equality of opportunity.\(^{149}\) Under a wage subsidy, the government increases the chances of the poor to earn income. If a needy person chooses not to pursue this opportunity, "he has no claim on government resources."\(^{150}\)

The wage subsidy concept is simple. It is a three-part mechanism to provide labor-supply side impetus to employment as well as improvement of income levels. It consists of a target wage rate, a subsidy rate, and categorical eligibility definitions.\(^{151}\)

\(^{146}\) Two recent proposals by legal scholars have actually suggested use of a wage subsidy. See Jonathan B. Forman, *Expanding the Earned Income Tax Credit: Clinton Style*, TAX NOTES, Jan. 11, 1993, at 231; James E. Williamson & Francine J. Lipman, *The New Earned Income Tax Credit: Too Complex for the Targeted Taxpayers?*, TAX NOTES, Nov. 9, 1992, at 789. Jonathan Forman has proposed converting the EIC into a wage subsidy credit arguing the change would "better target the benefits to the working poor and increase the work incentives associated with the earned income credit." Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. L. REV. 41, 81 (1988).


\(^{148}\) LERMAN, supra note 23, at 3.

\(^{149}\) Id.

\(^{150}\) Id.

The government first establishes a socially determined wage rate. Wages falling below this level are then eligible for subsidies. The process for this determination would be similar to that discussed under the NIT and EIC using categorical poverty thresholds.

The subsidy rate chosen would be the difference between the actual wage rate and the target wage rate. To be economically feasible, the wage subsidy would be some level less than 100%. Further, by setting the subsidy rate below 100%, the government can provide a strong incentive system. The closer the subsidy approaches 100%, however, the greater the incentive to work more hours.\footnote{152}

Finally, the system may or may not be universal. The wage subsidy could easily be guaranteed to all workers whose wage rate falls below the target rate. Due to budgetary and target concerns however, the system should incorporate certain categorical definitions that limit subsidy eligibility.\footnote{153}

In deference to budgetary and welfare considerations, the wage subsidy could be limited solely to the working poor.\footnote{154} Specifically, the subsidy could be available only to principal earners, generally the working parent or parents, living in a family with children.\footnote{155} The subsidy could then be varied by family size to allow families with greater need to earn more income.\footnote{156}

A basic example will clarify these three elements. The government could give a family's principal wage earner a subsidy equal to 50% of the difference between $6.60, the socially determined wage rate, and the worker's hourly minimum wage. This would guarantee income concomitant with the poverty threshold of a three person family in 1992. A minimum wage, full-time,
full-year worker would receive a wage subsidy of approximately $2,444. For incomes above the three person family poverty threshold, the wage subsidy declines by a fraction of a dollar for each dollar earned over the threshold until it falls to zero.

Like the earned income tax credit, and unlike the NIT, benefits from the wage subsidy are a function of whether a person works. The subsidy augments the recipient's hourly wage. The more hours worked, the more subsidy to which the person is entitled. If the persons fails to work any hours, he receives no subsidy.

Figure 8 demonstrates the basic nature of the wage subsidy. As in previous graphical depictions, the labor supply curve slopes upward as an increase in wage would entice more workers to enter the labor market. The labor demand curve slopes downward evidencing employers' decreasing demand for labor as wages increase.

157. Figure adapted from Robert I. Lerman, A Comparison of Employer and Worker Wage Subsidies, in JOBS FOR DISADVANTAGED WORKERS: THE ECONOMICS OF EMPLOYMENT SUBSIDIES, 159, 164, fig. 1 (Robert H. Haveman & John L. Palmer eds., 1982).
N represents the equilibrium level of employment at \( W_m \), the market determined equilibrium wage level. \( W_g \) represents the level of wage guaranteed by the wage subsidy. \( W_g \) is, therefore, the actual wage workers would face if Congress implemented a wage subsidy.\(^{158}\) Employers, however, would still face the market determined wage because the government subsidy would be paid directly to workers.\(^{159}\)

The effective wage of workers would increase, drawing more workers into the labor market just as would happen under a minimum wage regime. With a minimum wage however, this would amount to a decrease in employment from \( N \) to \( L_D \). One of the principal strengths of the wage subsidy is that it does not entail this labor dislocation. Employment remains at the same level, \( N \), because the effective wage that employers face has not changed.

---

\(^{158}\) This is a basic illustration. The functioning of the subsidy rate implies that individual workers face differing actual wages based on the amount by which their real wage falls below the target wage. For the purposes of this discussion, the assumption of a single wage subsidy level like a minimum wage level is an accurate simplification.

\(^{159}\) A wage subsidy does not have to take this form. A number of employer subsidies have been proposed. Such employer proposals differ significantly in their labor market effects. See Lerman, suprano note 157, at 161-63.
The wage subsidy would entail a large movement of workers into the labor force, as figure 9 depicts. This would cause the labor supply curve to shift out for all levels of wage over the relevant subsidy range to LS2. The increase in labor for wage rates below W1, the socially determined government wage level, would cause wages to further decline as employers must pay less to entice workers to accept employment. Thus, the employer's cost per worker declines for wages below W1, causing the labor demand curve to shift outward to LD2 over this wage range. The more complex wage subsidy graph shows the effect of these labor supply and labor demand increases. The market comes to a new equilibrium at a higher level of employment, with employers paying lower effective wages and employees receiving higher effective wages. The difference between the effective wage received by employees, W1, and the wage paid by employers, W2, is the subsidy per worker paid by the government. The detrimental labor effects of the minimum wage model are avoided by the wage subsidy, and, in fact, a wage subsidy would also result in a large increase in employment.

1. Wage Subsidy and the NIT

The wage subsidy is much more efficient in creating work incentives than a negative income tax. With the wage subsidy, additional earnings are supplemented instead of being taxed. The benefits for sub-target wage workers are limited only by their physical ability to work long hours. By not focusing on gross earnings, the wage subsidy provides a significant incentive to work as many hours as possible. However, as the benefit decreases for every extra hour worked, the NIT incorporates significant disincentives for greater work. As outlined in the NIT discussion, work incentive is the major criticism of the NIT structure.

Some characteristics of the wage subsidy imply easier implementation than the NIT. Unlike a categorical NIT, the wage

160. Id. at 163-65.
161. Lerman, supra note 157, at 164, fig. 1.
162. Id.
163. Betson & Bishop, supra note 151, at 190.
subsidy involves neither asset nor work tests, and the measurement of unearned income is unnecessary. Nevertheless, the wage subsidy is not wholly void of administrative complexity. To determine eligibility, the hours of work must be measured. If Congress chooses to implement the wage subsidy on a categorical basis, the status determination of primary earners or heads of households would entail additional complications. The effect is to render a determination of greater administrative feasibility between the wage subsidy and the NIT ambiguous.

The conclusion is that the labor supply decrease from implementation would be less under the wage subsidy than under the negative income tax. Thus, because the wage subsidy has little negative impact on labor supply, it is a more effective means of raising benefit recipients' income.

2. Wage Subsidy and the Minimum Wage

The wage subsidy and the minimum wage are closely related as both utilize the wage as the instrument for guaranteeing income. However, the secondary effects between these methods of wage manipulation are, however, significantly different.

A wage subsidy could be tailored to aid only those workers needing an increase in wages as opposed to all workers who earn the minimum wage, many of whom are not poor. Specifically, the wage subsidy could be available only to the heads of low-wage families. Alternatively, the wage subsidy could apply to all low-wage earners. There would not have to be exceptions such as those codified in the FLSA.

Both the minimum wage and wage subsidy provide effective incentive systems. Under both, work is required for eligibility. Only the wage subsidy, however, could be structured to allow for a phase-out for earnings above a threshold level. Most significantly, the wage subsidy lacks the negative labor market effects of the minimum wage. Wage subsidies increase

164. Id at 193.
165. Id.
166. Id.
employment by increasing the desire of the poor to work while not affecting the costs of hiring them. The minimum wage decreases overall employment. Clearly, based on labor market considerations alone, the wage subsidy is more advantageous than the minimum wage.

3. Wage Subsidy and AFDC

Based on the demographic data outlined with the minimum wage, the wage subsidy would not be an effective method to aid heads of single-parent families with young children. These people are often outside the labor force.

This implies that a wage subsidy should not be a substitute for AFDC. Instead, AFDC should remain in place with a wage subsidy as a supplement to provide benefits for those in need who currently do not receive aid, namely the working poor.

The earned income tax credit targets the same group of needy individuals. Thus, the wage subsidy would act as a substitute program to the EIC. But there are significant drawbacks to a wage subsidy that deserve mention.

4. Benefits and Drawbacks of the Wage Subsidy

A number of wage subsidy benefits have been enumerated, but there are significant drawbacks to the subsidy that temper the attractiveness of wage subsidy proposals. Unlike the NIT and EIC phase-out ranges, which positively tax increases in hours worked, the wage subsidy taxes incremental increases in wage rates. This provides a disincentive for workers to make the necessary investment to increase an individual's hourly wage rate.

There is also a major incentive to cheat. The wage subsidy can be maximized by underreporting wages earned and overreporting hours worked. This provides an incentive for collusion between employees and employers.167

167. BARTH, supra note 147, at 73.
Without a major categorical structure, such as limiting benefits to primary earners in families below the poverty line, the wage subsidy would have the same targeting problems as the minimum wage. Many low wage employees are members of families that are not poor.\textsuperscript{168} Greater targeting of the wage subsidy would eliminate this problem but would entail greater administrative complexity.\textsuperscript{169}

Administrative complexity is endemic with a wage subsidy regardless of categorical eligibility. Major issues that would have to be addressed include non-straight-line hourly earnings such as tips and fringe benefits.\textsuperscript{170} These items present a problem of what measures should be taken with regard to the reporting of hours and wages to prevent fraud. Benefits would have to be paid to the employee either directly or through the employer. If paid through the employer, problems associated with employer disincentives to hire employees receiving government aid arise.\textsuperscript{171}

The wage subsidy is not a comprehensive welfare program. It fails to recognize that a number of the poor are unable to find a job through no fault of their own.\textsuperscript{172} Further, a basic wage subsidy program neglects to provide for workers who are temporarily laid off, a situation occurring with increasing frequency.\textsuperscript{173} Presumably, these individuals need income assistance as much, if not more, than the working poor.

If the wage subsidy is provided in each paycheck, it would require changes to the tax code as well. New provisions would be necessary to recapture subsidies given to those whose situations improve over the year. For example, suppose the government implements a wage subsidy but limits benefits to primary earners in families below their respective poverty lines. If a subsidy is provided throughout the year to the primary earner

\begin{footnotesize}
\begin{itemize}
\item 168. Shapiro, \textit{ supra} note 96, at 661; Smith & Vavrichek, \textit{ supra} note 87, at 27.
\item 169. \textit{Id.} Barth, \textit{ supra} note 147, at 73.
\item 170. \textit{Id.}
\item 171. Shapiro, \textit{ supra} note 96, at 693 (Shapiro takes this conclusion from Ehrenberg \& Smith, \textit{ supra} note 120, at 117.
\item 172. \textit{See} Lerman, \textit{ supra} note 23, at 19 (discussing willingness and opportunities for work).
\item 173. Wage subsidy programs incorporating unemployment benefits and temporary layoff coverage can be constructed. \textit{See, e.g.,} Lerman, \textit{ supra} note 23, at 9-28.
\end{itemize}
\end{footnotesize}
based on projected earnings, but during the year another family member gains employment which places the family over the relevant poverty line, subsidies paid to the primary earner would have to be recaptured.

Clearly, the wage subsidy offers unique features as a welfare program. Wage subsidies have many drawbacks as well, therefore, some, but not all welfare reform goals, can be achieved. The major negative consideration for a wage subsidy proposal is the administrative complexity.

IV. WELFARE REFORM UNDER THE CLINTON ADMINISTRATION

The Clinton Administration's particular welfare proposal should be analyzed, with an understanding that there is wide popular support for welfare reform. President Clinton has set lofty goals for welfare reform, promising a significant alteration of the present system of public support. Although the specific elements of the coming welfare reform are unknown, the basic framework has been articulated by the Administration and has been the subject of wide comment and criticism.

President Clinton's goal, loudly touted during his election campaign, is to "end welfare as we know it." To that end, Clinton will send a welfare reform bill containing four or five of his campaign promises to Congress later this year. The general thrust of the Administration's welfare reform involves four key areas.

A. Improve Child Support

Presently, only a third of single parents receive the court-ordered child support payments. The administration will propose two methods to improve collection of child support.

---

177. Id.
First, the reform bill will require single mothers to establish paternity at the hospital when the child is born.178 The IRS will then be instructed to withhold wages from fathers who are delinquent in their child support payments or who refuse to pay.179

Second, the bill will propose child support assurance.180 Under this program, the government will guarantee a minimum payment to mothers if the fathers cannot be located.181 The guaranteed payment will be graduated providing, for example, $3,000 per year for the first child and $1,000 per year for the second child of a single mother.182

B. Expand Education and Training Programs

The bill will expand the Family Support Act of 1988, which required state AFDC programs to include education, training and job placement for virtually all able-bodied recipients with children over the age of three.183 These programs, known as Job Opportunity and Basic Skills Programs (JOBS), enrolled about 7% of adult welfare recipients in 1992.184 President Clinton wants to expand that number dramatically. While all states receiving federal AFDC funds must implement such programs, states have been slow to respond.185 The administration has expressed interest in increasing the budget allocations for the federal portion of these programs, and others are argu-

178. Id.
179. Id.
180. Id.
181. Id.
182. Id.
185. Under the current program structure, a state must require non-exempt AFDC recipients to participate in the JOBS program. Federal matching for JOBS program costs is available as a capped entitlement limited to $1.1 billion in fiscal year 1994. The Federal match is 90% for expenditures up to a capped amount and 60% for expenditures beyond that amount. Due to budget pressures at the state level, as of 1992 40% of the federal funds allocated to the program went unspent. See GREEN BOOK, supra note 4, at 621; Gueron, supra note 65, at 121.
ing for an expansion of the requirements for participants in order to broaden the program's enrollment.¹⁸⁶

C. **Time Limit for Receipt of Welfare**

One of the most controversial elements of the bill, which has already been the subject of widespread criticism by some liberal politicians, is the proposal to limit welfare mothers' checks to two years or thirty months.¹⁸⁷ There is no consensus on whether AFDC recipients, once forcibly removed from the program, will be able to reapply later for benefits.

More conservative commentators have called for different time limit structures. The GOP proposal includes a two year limit on benefits while requiring recipients to join a job training program during their AFDC eligibility and/or to work up to thirty-five hours per week.¹⁸⁸ In this way, recipients could work off their benefits. If they refuse to follow these guidelines, the GOP proposes expelling them from welfare. After the two-year cycle, recipients would be required to provide unpaid community service to earn additional benefits or take minimum wage public-sector work if they cannot find private-sector jobs.¹⁸⁹ Liberals have attacked this proposal arguing that it is not workfare but "slavefare."¹⁹⁰

D. **Making Work Pay**

The final key to Clinton's reform package directly involves the cash-transfer methods previously discussed. The administration proposes to "make work pay" through a three-part plan.¹⁹¹

---

¹⁸⁹. Id.
First, the government will guarantee universal health-care coverage. This element of the welfare reform proposal has already reached the stage of a formal proposal.192

Second, the administration wants to expand access to child care. This would provide individuals who would otherwise have to stay at home, the opportunity to find gainful employment.193 It is hoped that this would encourage significant numbers of people to leave the welfare rolls.

Finally, the government proposes to significantly expand the earned income tax credit. This component of the "making work pay" reform element is already in place.194 The government has targeted the working poor for expansive credits in the hope that this will result in families and individuals rising above the poverty line. In effect, the Clinton Administration has made an affirmative choice to use the EIC as its major cash-transfer incentive program instead of implementing an NIT structure, increasing the minimum wage, or providing a wage subsidy. The new EIC provision is a major broadening of the previous credit and brings the income tax into the foreground as a major piece of the welfare system.

1. 1994 Earned Income Credit

The Omnibus Budget Reconciliation Act of 1993195 significantly increased the benefit levels and the categories of eligible taxpayers under the earned income tax credit.196 Effective in 1994, this new EIC will provide benefits to an additional category of workers and will provide much higher maximum credits for the traditional categories of eligible participants.

One major change in structure is the expansion of eligibility to low income workers who do not have any qualifying children. Specifically, the credit is now available to individuals age twen-

---

192. Id.
193. Id.
194. The earned income credit was expanded as part of the Clinton plan in 1993. Pub. L. No. 103-66, § 13131(a)-(c), (d)(1) (applicable to taxable years beginning after Dec. 31, 1993).
195. See supra, note 1.
ty-five or older, but less than sixty-five years of age who are not dependents of others and who have a principal place of abode in the U.S. for more than one-half of the taxable year.

The credit available to individuals with no qualifying children is very limited as shown in figure 10. For the 1994 taxable year, the credit phases-in at a 7.65% rate up to a $4,000 earned income level. This amounts to a maximum credit of only $306. The credit then phases-out at the same rate, 7.65%, for earned income levels above $5,000, completely phasing-out at earnings of $9,000.

---

200. Id.
The credit amounts for workers with qualifying children are significantly higher than they were in 1993. The amount of the maximum credits available are a function of the phase-in rate and the earnings cap which determines the length of the phase-in range. For eligible individuals with one qualifying child, the credit phases-in at 26.3% of earned income up to a maximum earned income of $7,750 as shown in figure 11. This amounts to a maximum $2,038.25 credit. The phase-out of benefits occurs for earned income levels above $11,000 and at the more gradual rate of 15.98%. Eligible individuals with one qualifying child ("QC") do not receive any credit if they enjoy earned income greater than or equal to $23,755.

---

201. Prior to 1993, for workers with one qualifying child the credit phased-in at a 118.5% rate for a maximum credit of $1,434 at earnings above $7,749. Above $12,200 the credit then phased-out at 13.21% until completely phased-out at earnings of $23,050. Workers with two qualifying children enjoyed a credit that phases-in at 19.5% for a maximum credit of $1,511 at earnings above $7,749. Above $12,200 the credit then phased-out at 13.93% until completely phased-out at earnings of $23,050. In 1993, Pub. L. No. 103-66, § 13131(a)-(c), (d)(1) significantly broadened the credit.


203. Id. § 13131(b)(1)(B).

204. The credit phases-out at a 15.98% rate for earnings above $11,000. Thus, the maximum credit amount of $2,038.25 phases-out completely at $23,755. ($23,755 - $11,000) × .1598 = $2,038.25.
For eligible individuals with one QC, the benefits phase-in and phase-out more quickly than they did in 1993. Significantly, the stationary range has been shortened under the new scheme. The phase-out begins at an earnings level $1,200 less than the 1993 phase-out threshold.

![Graph of EIC 1994 2 Q.C.](image)

Figure 12

For eligible individuals with two or more QC, figure 12 shows that the results are similar; faster phase-in and phase-out of benefits with a shortened stationary period. The effect of these changes is to increase the benefits for eligible individuals with one QC more than 42%. The increase for eligible individuals with two or more QC is even more significant. The maximum benefit level is now more than 62% higher.

The amended statute provides for a three year transition period over which phase-in and phase-out rates will increase for individuals with qualifying children due to an adjustment in

---


206. Based on figures in amended I.R.C. § 32 (1993). See also Table 1.

207. See Table 1.

208. The maximum credit in 1993 for one QC was $1,434. In 1994, the maximum credit is $2,038.25.

209. The maximum credit in 1993 for two QC was $1,511. In 1994, the maximum credit is $2,527.50.
the maximum earnings amount. The maximum credit level will remain effectively the same for individuals with one qualifying child and will experience a moderate increase for individuals with two qualifying children over that period.\textsuperscript{210}

This amounts to a major change in the role of the EIC. It has moved from a support system limited to families with children to a broader credit for all wage earners. Redistribution is much greater, transforming the EIC from a band-aid provision to offset the harsh effects of payroll taxes into a significant measure for guaranteeing socially acceptable income levels for the working poor.

Under the 1992 poverty levels, the 1994 EIC at the end of the phase-in range provides sufficient income for eligible individuals with one QC to pass the poverty threshold.\textsuperscript{211} Eligible individuals with two QC or more would be just below the poverty threshold. The credit for individuals without qualifying children, however, would provide little more than half the relevant poverty threshold income.

\begin{center}
\textbf{FIGURE 12-A}
\end{center}

\begin{tabular}{l|l|l}
& 1994 & 1992 Poverty Max Credit \\
\hline
Status & Threshold \textsuperscript{212} & at Min. Income \\
1 QC & $9,212 & $9,788.25 \\
2 QC & 11,280\textsuperscript{213} & 10,952.50 \\
0 QC & 7,202 & 4,306 \\
\end{tabular}

\textsuperscript{210}. The maximum credit level for individuals with one QC is $2,038.25 in 1994 and $2,040 in both 1995 and 1996. The two QC maximum credit is $2,527.50 in 1994, $3,033 in 1995, and $3,370 in 1996. See Table 1.

\textsuperscript{211}. This observation is based on 1992 poverty thresholds. See POVERTY 1992, supra note 121, at vii, Table A.

\textsuperscript{212}. GREEN BOOK, supra note 4, at 1272.

\textsuperscript{213}. Family of three persons.
Clearly the administration has chosen to use the EIC to effect a significant increase in cash-transfers under the welfare umbrella. There is evidence that this will not be the only federally-guaranteed income change the Clinton Administration will implement.

Labor Secretary Robert Reich is calling for an increase in the minimum wage as a necessary complement to the earned income tax expansion.\textsuperscript{214} Reich argued that a fixed nominal minimum wage would decrease over time with inflation, requiring continual expansion of the EIC just to maintain minimum wage families at the same real income level.\textsuperscript{215} Without such an expansion, Reich argued, the fall in the real purchasing power of the minimum wage would move more families into poverty.\textsuperscript{216}

Secretary Reich proposes to raise the minimum wage $.25 to $4.50 per hour and to index that level to inflation.\textsuperscript{217} Thus, although the full welfare reform proposal has not taken final form, there is real evidence that a minimum wage increase will be part of President Clinton's proposal.

\section*{V. CONCLUSION}

Within the analytical framework of the seven goals of welfare reform, the earned income tax credit wins high marks as a viable method of redistribution to aid the working needy. Assuming the goal is to target aid to those persons who fall below their relevant poverty thresholds, yet are attempting to work their way out of poverty, the Clinton Administration's expansion of the EIC is a long stride toward a more effective welfare system.

The present AFDC and Food Stamp programs lack effective incentive systems to encourage recipients to enter the labor

\begin{footnotesize}
\begin{enumerate}
\item Reich outlined his request for a minimum wage increase to President Clinton in a recent memo. \textit{Reich Orders Review of Minimum Wage, Supports Indexing in Memo to Clinton}, 159 Daily Lab. Rep (BNA) No. 159, at AA-1 (Aug. 19, 1993). The memo was supposed to be confidential, but was obtained by the Bureau of National Affairs, Inc.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\end{enumerate}
\end{footnotesize}
force and to strive to work longer hours. Without the addition of such an incentive system, the welfare system will continue to grow not only in budgetary requirements, but also in scope as more people enter the welfare rolls and never leave.

The alternatives that have been proposed over the years focus on different goals as the proper way to reform the welfare system. By determining the true faults of AFDC and the Food Stamp program, one defines the additional structure needed to overhaul the present system into a viable system of temporary redistribution. This system will in the long-run revitalize recipients, allowing them to reenter society as valuable contributors to the economy as opposed to remaining a long-term expense for our government.

The negative income tax proposals fail to offer a viable method to achieve this revitalization. Not only are most NIT recommendations administratively difficult, complex, and costly, they also fail to provide the necessary incentive structure to encourage individuals to enter the workforce.

The basic NIT structure with universal eligibility achieves few welfare reform goals. In the form discussed, the NIT would do little to eliminate poverty. Because it is poorly targeted to help the working poor, the broad scope of possible benefit recipients would entail a much lower level of transfer payments. Even at such a low level, a basic NIT would be exorbitantly costly.

The only advantage of the basic NIT is that it is equitable. Its noncategorical nature implies parallel application to persons with parallel income levels. Further, a noncategorical structure implies that the present AFDC program's negative social effects would not exist under an NIT. Instead of offering the highest level of benefits only to families where a parent is missing, the NIT provides benefits to all families.218 However, this advantage could be helpful only if the NIT was implemented to replace AFDC. If AFDC remains, the problems would remain at the same magnitude.

---

218. This assumes a noncategorical NIT approach.
The NIT could be implemented using a categorical approach. By limiting eligibility, the NIT could be financially feasible but at the cost of administrative complexity. However, the incentive problems would remain, leading to the conclusion that the NIT is not a viable reform option at present.

An increase in the minimum wage also fails to offer a viable option. As with a basic NIT, the minimum wage is poorly targeted to help the working poor. In fact, the majority of beneficiaries would be teenagers who live in families with incomes above the poverty thresholds.219

The most significant flaw in the minimum wage is the negative labor effects that any wage floor entails. Significant labor dislocation and higher unemployment are the well-accepted result of any minimum wage increase.220 The present state of the economy can ill-afford such a further depressive influence to productivity. Also, the labor dislocations expected from enactment of the North American Free Trade Agreement221 alone will be substantial enough without additional labor disruptions caused by a rising minimum wage.222

From a work-incentive standpoint, the minimum wage ranks lowest. Far from offering encouragement to better oneself, the minimum wage encourages a grant of extra income that is not scaled or phased-in over any range. Significantly, it is American business that foots the bill for this grant.223

American business will quickly restructure to more capital-intensive operations to reduce the cost of labor.224 The effect is long-term job loss and dislocation. Although the minimum wage is easily the most cost-effective reform tool for the government, it appears to be the most costly to American society as a whole.

219. See discussion supra part III.B.3.
220. See Shapiro, supra note 96, at 676.
223. See Shapiro, supra note 96.
224. Id. at 673-76 (discussing the capital-labor substitution effect).
Acceptance of Labor Secretary Reich’s recommendations would clearly be a step in the wrong direction.

Finally, there is the wage subsidy. Often overlooked, this proposal merits further consideration. A wage subsidy would go far to eliminate poverty as it can be easily targeted to those who are the most needy. As a joint undertaking between business, which manages payroll and can identify classes of workers, and the government, which can budget the necessary benefit amounts, a wage subsidy offers low administrative complexity, low cost, and few negative social effects.

As with the NIT, the wage subsidy would have no effect on the negative social effects that result from the AFDC structure. However, the strong work incentive that results under the wage subsidy provides strong impetus for workers to work their way out of welfare and poverty-level incomes. Further, the wage subsidy is an equitable method for redistribution because ease of targeting allows more benefits to be channeled to the most needy.

Unlike a minimum wage, a wage subsidy does not produce disastrous labor market effects. If the Clinton Administration decides it must increase low-level wages, the method should be a categorical wage subsidy. In comparison, the minimum wage is a dangerous government intervention into the market that can only hurt American business in the increasingly competitive global economy.

The broadened EIC is clearly a step in the right direction for welfare reform. Unlike the alternatives, the EIC offers a equitable redistribution, a strong incentive system (until income levels reach those subject to positive taxation), and well-targeted benefit allocation. As measured against the goals of welfare reform, the EIC ranks highest among the four alternatives that have been analyzed.

The broadened scope and increased credit amounts of the 1994 EIC translate into a significant increase in cost to government revenue. Funding for the expanded EIC will have to

225. See discussion in III.C.4; see also Shapiro, supra note 96, at 692-93.
226. The out-of-pocket cost for the expanded EIC is projected by President Clinton’s budget proposal for Fiscal Year 1994 to be $26,787 million over the next 5
come from other programs. The basic problems underlying the AFDC and Food Stamp programs suggest that their restructuring could provide significant funds for earned income tax credits.

The government has realized that the present income tax structure overseen by the Internal Revenue Services offers an easy and cost-effective administrative mechanism for channeling welfare redistribution benefits to the working poor. The earned income credit has moved from a remedial provision to a major tax expenditure provision, serving a non-revenue raising purpose. Hopefully, as Congress awakens to the potential of the existing government revenue raising structure, further refinement of the American welfare system will result.

President Clinton, himself, expressed the potential of the present revenue raising structure to help the working poor. In his words, "the most important thing we can do in welfare reform [is] to make a simple statement that if you have kids and you work 40 hours a week, you will not be in poverty, we will reward your work. The tax system will keep you out of poverty."\(^{227}\)


\(^{227}\) See Rector, supra note 184, at n.31.
VI. APPENDICES

**TABLE 1**

Earned Income Tax Credit

<table>
<thead>
<tr>
<th>Year</th>
<th>( P_i )</th>
<th>( E_m )</th>
<th>( C_m )</th>
<th>( P_o )</th>
<th>( E_o )</th>
<th>( E_s )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>10%</td>
<td>$4,000</td>
<td>$400</td>
<td>10%</td>
<td>$4,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>1976</td>
<td>10%</td>
<td>$4,000</td>
<td>$400</td>
<td>10%</td>
<td>$4,000</td>
<td>8,000</td>
</tr>
<tr>
<td>1979</td>
<td>10%</td>
<td>$5,000</td>
<td>$500</td>
<td>12.5%</td>
<td>$6,000</td>
<td>10,000</td>
</tr>
<tr>
<td>1985</td>
<td>11%</td>
<td>$5,000</td>
<td>$550</td>
<td>12.2%</td>
<td>$6,500</td>
<td>11,000</td>
</tr>
<tr>
<td>1987</td>
<td>14%</td>
<td>$6,080</td>
<td>$851</td>
<td>10%</td>
<td>$6,920</td>
<td>15,432</td>
</tr>
<tr>
<td>1988</td>
<td>14%</td>
<td>$6,240</td>
<td>$874</td>
<td>10%</td>
<td>$9,840</td>
<td>18,576</td>
</tr>
<tr>
<td>1989</td>
<td>14%</td>
<td>$6,500</td>
<td>$910</td>
<td>10%</td>
<td>$10,240</td>
<td>19,340</td>
</tr>
<tr>
<td>1990</td>
<td>14%</td>
<td>$6,810</td>
<td>$953</td>
<td>10%</td>
<td>$10,730</td>
<td>20,264</td>
</tr>
</tbody>
</table>

1991:
1 QC 16.7%  $7,140  $1,192  11.93%  $11,250  21,250
2 QC 17.3%  $7,140  $1,235  12.36%  $11,250  21,250

1992:
1 QC 17.6%  $7,520  $1,324  12.57%  $11,840  22,370
2 QC 18.4%  $7,520  $1,384  13.14%  $11,840  22,370

1993:
1 QC 18.5%  $7,750  $1,434  13.21%  $12,200  23,050
2 QC 19.5%  $7,750  $1,511  13.93%  $12,200  23,050

1994:
1 QC 26.3%  $7,750  $2,038.25  15.98%  $11,000  23,755
2 QC 30%   $8,425  $2,527.50  17.68%  $11,000  25,296
0 QC 7.65%  $4,000  $306    7.65%   $5,000   9,000

1995:
1 QC 34%   $6,000  $2,040    15.98%  $11,000  23,766
2 QC 36%   $8,425  $3,033    20.22%  $11,000  26,000
0 QC 7.65%  $4,000  $306    7.65%   $5,000   9,000

1996:
1 QC 34%   $6,000  $2,040    15.98%  $11,000  23,766
2 QC 40%   $8,425  $3,370    21.06%  $11,000  27,002
0 QC 7.65%  $4,000  $306    7.65%   $5,000   9,000

228. Based on Green Book, supra note 4, at 1015.
### TABLE 2

Social Security Insurance Taxes

<table>
<thead>
<tr>
<th>Year</th>
<th>Employee Rate</th>
<th>Employee Maximum</th>
<th>Self-employed Rate</th>
<th>Self-employed Maximum</th>
<th>Wage Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>5.85%</td>
<td>$825</td>
<td>7.9%</td>
<td>$1,114</td>
<td>$14,100</td>
</tr>
<tr>
<td>1976</td>
<td>5.85%</td>
<td>$895</td>
<td>8.0%</td>
<td>$1,224</td>
<td>$15,300</td>
</tr>
<tr>
<td>1979</td>
<td>6.13%</td>
<td>$1,404</td>
<td>8.1%</td>
<td>$1,855</td>
<td>$22,900</td>
</tr>
<tr>
<td>1985</td>
<td>7.05%</td>
<td>$2,792</td>
<td>12.75%</td>
<td>$5,049</td>
<td>$39,600</td>
</tr>
<tr>
<td>1987</td>
<td>7.15%</td>
<td>$3,132</td>
<td>12.85%</td>
<td>$5,628</td>
<td>$43,800</td>
</tr>
<tr>
<td>1988</td>
<td>7.51%</td>
<td>$3,380</td>
<td>13.57%</td>
<td>$6,107</td>
<td>$45,000</td>
</tr>
<tr>
<td>1989</td>
<td>7.51%</td>
<td>$3,605</td>
<td>13.57%</td>
<td>$6,514</td>
<td>$48,000</td>
</tr>
<tr>
<td>1990</td>
<td>7.65%</td>
<td>$3,924</td>
<td>13.85%</td>
<td>$7,105</td>
<td>$51,300</td>
</tr>
<tr>
<td>1991</td>
<td>7.65%</td>
<td>$5,123</td>
<td>13.85%</td>
<td>$7,396</td>
<td>$53,400</td>
</tr>
<tr>
<td>1992</td>
<td>7.65%</td>
<td>$5,329</td>
<td>13.85%</td>
<td>$7,687</td>
<td>$55,500</td>
</tr>
<tr>
<td>1993</td>
<td>7.65%</td>
<td>$5,529</td>
<td>13.85%</td>
<td>$7,978</td>
<td>$57,600</td>
</tr>
<tr>
<td>1994</td>
<td>6.20%</td>
<td>*$3,720</td>
<td>13.85%</td>
<td>$8,310</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

**Timothy J. Eisler**

---


230. For the years prior to 1994, 1.45% of the employee rate consisted of the OASDI tax. The OASDI tax is not figured into the 1994 calculations because, unlike the remaining portion of the Social Security Insurance taxes, after 1993 the OASDI portion is no longer capped at a specific wage level.