

Help the Working Poor, but Share the Burden

By N. Gregory Mankiw

In a speech last month, President Obama brought renewed attention to economic disparities in the United States. The gap between rich and poor is indeed substantial — much larger than in most developed nations and much larger than it was 40 years ago. So what is the best way to help those struggling at the bottom of the economic ladder?

If we could figure out a way to do it, the most effective solution would be to increase the skills of those low-wage workers. Many studies have shown that the financial return of education is now high by historical standards. Reforming the education system so that more students graduate from high school and college is thus crucial to a more egalitarian prosperity. But upgrading the skills of the labor force is a decades-long project, not a quick fix. And educational reform is easier said than done.

As a result, those who are worried about inequality look for more immediate ways to help workers with limited skills. Before turning to President Obama's proposal, let's consider two other possibilities. For lack of better terms, call them Plan A and Plan B:

PLAN A The government subsidizes the incomes of low-wage workers. These subsidies are financed by increasing taxes on middle- and upper-income Americans.

PLAN B The government again subsidizes the incomes of low-wage workers. But under this plan, the subsidies are financed by taxing those companies that hire low-wage workers.

Stop reading for a moment and consider: Which of these plans would you prefer, and why? If you have a pen or pencil handy, jot down your reasons.

O.K. — and now, here are my answers:

To me, Plan A is distinctly better than Plan B, which suffers from two problems — one involving fairness, and one involving efficacy.

First, fairness: If we decide as a nation that we want to augment the income of low-wage workers, it seems only right that we all share that responsibility. Plan A does that. By contrast, Plan B concentrates the cost of the wage subsidy on a small subset of businesses and their customers. There is no good reason this group has a special obligation to help those in need.

Indeed, one might argue that this group is already doing more than its share. After all, it is providing jobs to the unskilled. Asking it to do even more, while letting everyone else off the hook, seems particularly churlish.

But even putting fairness aside, there is reason to doubt the efficacy of Plan B. Taxing businesses that hire unskilled workers would alter their behavior in ways that would hurt those we are trying to help.

To avoid the tax, businesses would have an incentive to hire fewer of these workers. For example, they would have greater incentive to replace workers with labor-saving machines.

In addition, some of the tax would be passed on to customers in the form of higher prices. These customers, in turn, would have an incentive to spend more of their income elsewhere. Over time, these businesses would shrink, reducing the job opportunities for the unskilled.

All in all, the Plan B tax-and-subsidy plan sounds like a pretty bad idea. Why, you might wonder, did I bring it up? Because it is the one favored by President Obama. He calls it an increase in the minimum wage.

To be sure, the minimum wage isn't exactly a system of taxes and subsidies. But its effects are much the same as those of Plan B. Unskilled workers earn more, and the businesses that hire them pay more. The main difference between the minimum wage and Plan B is that, under a minimum wage, the extra compensation is paid directly from the business to the worker, rather than indirectly via the government.

When proposing to increase the minimum wage, President Obama said that "there's no solid evidence that a higher minimum wage costs jobs." In fact, many studies suggest that it does precisely that. Mr. Obama is like a physician who prescribes a medicine based on a few studies that find no side effects while ignoring others that report debilitating effects.

What is most disappointing about the president's proposal is that the federal government has the option of using the much better Plan A. It is called the earned-income tax credit. Originally passed into law in 1975 and expanded substantially in the 1990s, the credit is a subsidy to low-wage workers paid by the rest of us, not just by the businesses who hire those workers.

Advocates of a higher minimum wage like to note that the current minimum wage, adjusted for inflation, is low by historical standards. That is true but beside the point. Because the earned-income tax credit has grown over time, the minimum wage is increasingly less relevant. As a nation we have switched from Plan B to the better Plan A. And a good case can be made for eliminating Plan B entirely by repealing the minimum wage.

Because "tax" is a dirty word in Washington, politicians generally prefer regulations like the minimum wage to accomplish their goals. But many regulations work like hidden taxes. Sometimes, in the process of hiding taxes, lawmakers opt for more damaging alternatives.

If, as a nation, we decide we want to do more to supplement the incomes of low-wage workers, that's fine. But let's do it openly, without artifice, and with broad participation.