

The Earned Income Tax Credit, Welfare Reform, and the
Employment of Low-Skilled Single Mothers

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Abstract

In the past 15 years there have been enormous changes in federal and state income assistance for low-income single families with children. Welfare reform has led to a dramatic reduction in the generosity of state cash assistance through the AFDC (Aid to Families with Dependent Children, now TANF, Temporary Assistance for Needy Families) program. At the same time, there has been tremendous expansion in cash assistance for low-income families through the tax system: currently, twenty-two million families receive a total of \$34 billion dollars in benefits from the EITC (Earned Income Tax Credit). In fact, the EITC is now the largest cash transfer program for lower-income families at the federal level. An unusual feature of the credit is its explicit goal to use the tax system to encourage and support those who choose to work. Consequently, low-income single mothers have faced a large increase in the financial gains to employment through welfare reform and the expansions in the EITC. In this paper, I describe these important policies, present trends in employment for single mothers, and summarize what is known about how the changes in welfare and the EITC have affected employment.

1. Introduction

Cash assistance for low-income families with children underwent tremendous change in the 1990s. Welfare reform led to a dramatic reduction in the generosity of state cash assistance and an elimination of the Aid to Families with Dependent Children (AFDC) program. At the same time, cash assistance through the tax system, in the form of the Earned Income Tax Credit (EITC), increased substantially. In fact, the EITC is now the largest federal cash transfer program for lower-income families, generating a total cost (in 2005) of \$34 billion compared with \$24 billion in TANF expenditures.

This shift in the structure of cash assistance for low-income families, away from welfare and toward tax-based assistance, is the outcome of a longstanding criticism that traditional welfare programs generate adverse incentives for work and family. Importantly, the policy changes to welfare and the EITC in the 1990s both provided incentives (financial and otherwise) for single mothers with children to increase employment. Indeed, employment rates of single mothers with children increased 11 percentage points over the past twenty years, from 0.73 in 1987 to 0.84 in 2006. Even more striking is the 16 percentage point change that occurred between 1992 and 1999 (from 0.72 to 0.88). These gains were even larger for single mothers without a high school diploma where employment rates increased by 20 percentage points between 1992 and 1999. No other group of women (single women without children, married women with or without children) or men experienced such a dramatic increase in employment. In this paper, I describe these important policies, present trends in employment for single mothers, and summarize what is known about how the changes in welfare and the EITC have affected employment.

2. Welfare Reform and the Earned Income Tax Credit

The AFDC program provided cash assistance to low-income single mothers with children from the 1930s to the 1990s. The program was designed to provide an income transfer for needy families in an era when women with children had minimal labor market attachment. Consequently, AFDC benefits are phased out at a very high rate: after a small disregard, benefits are reduced by one dollar for every additional dollar in earned income. This creates a targeting of benefits to those with the lowest income levels (by design) but also creates a disincentive to enter the labor force because the increase in earnings is offset by a reduction in the cash transfer.

Concerns about the labor supply disincentives in the AFDC program had an important impact on welfare reform at the state and federal level. Beginning in the early 1990s, many states were granted waivers to change their AFDC programs and by 1995 about half of the states implemented some sort of welfare waiver. On the heels of this state experimentation, PRWORA was enacted in 1996, replacing AFDC with Temporary Assistance for Needy Families. The key elements of reform in the state waivers and TANF legislation include: work requirements, lifetime time limits, financial sanctions, and enhanced earnings disregards. These changes were designed to increase work and reduce welfare participation. Figure 1 shows the dramatic decline in welfare caseloads that occurred during this period.

The EITC began in 1975 as a modest program aimed at offsetting Social Security payroll taxes for low-income families with children. It was the outcome of a vigorous policy debate surrounding the efficacy of a Negative Income Tax (NIT) as a means of reducing poverty. The concern was that the NIT would discourage labor market activity

as it is gradually phased out. Ultimately the EITC was born out of a desire to reward work. The EITC provides a cash transfer to low-income working families through the tax system. The EITC is refundable so that a taxpayer with no federal tax liability, for example, would receive a tax refund from the government for the full amount of the credit. Eligibility for the credit requires positive earned income and adjusted gross income and earned income below a specified amount; in 2007, the maximum allowable income for single taxpayer with one child is \$33,241 (\$37,783, with two or more children).¹

The amount of the credit to which a taxpayer is entitled depends on the taxpayer's earned income, adjusted gross income, and, since 1991, the number of EITC-eligible children in the household. There are three regions in the credit schedule. The credit for those in the phase-in region is equal to the subsidy rate times their earnings. The subsidy rate is quite high at 34 percent for taxpayers with one child and 40 percent for taxpayers with two or more children. In the flat region, the family receives the maximum credit (\$2,853 and \$4,716, respectively, in 2007); while in the phase-out region the credit is phased out at the phase-out rate (16 and 21 percent). The program expanded in the Tax Reform Act of 1986 (TRA86), and Omnibus Reconciliation Acts in 1990 and 1993 (OBRA90 and OBRA93). Figure 2 illustrates these expansions in the program by plotting the (real) EITC payment schedule by (real) earnings for selected years between 1984 and 2006 and separately for families with one and two or more children.² The figure clearly shows that the 1993 expansion was the largest and that the 1993 expansion was much

¹There is also a small credit for childless taxpayers. We ignore that here and focus on the main recipients, families with children.

²Figure 2 plots the EITC schedule that applies to single taxpayers. Beginning in 2002, the flat and phase-out regions were expanded modestly (\$1,000 in 2002, \$2,000 in 2007) for married filers.

larger for families with two or more children. For example, between 1993 and 2006, single mothers with two children earning between \$15,000 and \$25,000 (in 2006 dollars) experienced a more than doubling in their real transfer from the EITC. In contrast, single mothers with one child earning \$15,000 (in real 2006 dollars) experienced about a 40 percent increase in the real EITC, while those earning \$25,000 experienced about a 25 percent increase in the real EITC.

These expansions have led to a dramatic and recent increase in the total cost of the EITC. Figure 3 plots the number of EITC recipients (taxpaying units or families) and the total tax cost of the EITC (in 2006 dollars) over the period 1974-2005. The figure clearly shows the rising expenditures and recipients associated with the 1986, 1990, and 1993 tax acts. Importantly, between 1990 and 1996, real EITC costs increased more than threefold.³

Finally, Figure 4 contrasts the aggregate cost of the EITC with the cost of AFDC/TANF during 1974 to 2005. In a very short time, the EITC has overtaken AFDC/TANF and become the largest cash transfer program for low-income families.

3. Policy Changes and Expected Impacts on Employment

Labor supply theory suggests that welfare reform and EITC expansions are expected to increase employment of low-income single mothers.⁴ Virtually all of the provisions implemented in the state and federal welfare reform should lead to more

³In addition to the federal EITC, an increasing number of states offer state EITCs. As of 2004, a total of eighteen states have introduced state EITCs that supplement the federal credit. Almost all states structure their credits as a share of the federal credit, varying between 5 percent (Illinois) and more than 40 percent (Minnesota and Wisconsin), and almost all make the credit refundable like the federal credit (Llobrera and Zahradnik, 2004).

⁴The focus in this paper is on single mothers, who represent the vast majority of AFDC/TANF recipients and over 75 percent of EITC claims (Eissa and Hoynes 2006a). The labor supply impacts of the EITC expansion on married couples is more complicated and is likely to lead to reductions in employment for some married women (Eissa and Hoynes, 2004, 2006a, 2006b).

employment through removing the entitlement nature of welfare (time limits), increasing the costs of participation in welfare (work requirements, financial sanctions), and reducing the financial work disincentives (reducing the phase-out rate, increasing work disregards).

The expansions in the EITC also are expected to lead to more employment among single mothers. Because the EITC is available only to taxpayers with earned income, standard labor supply theory predicts that the EITC will encourage labor force participation. While not the focus of this paper, the EITC is expected to reduce hours worked for those women already working with earnings in the flat and phase-out regions of the credit.⁵

4. Trends in Employment of Single Mothers

Figure 5 presents annual employment rates for women aged 19-44 between 1983 and 2006.⁶ We show the employment rates for four groups: single women with children, single women without children, married women with children, and married women without children. These groups are chosen to illustrate the dramatic changes particular to single women with children—the group most affected by welfare reform and the EITC.

The figure shows the dramatic increase in employment rates for single women with children during this period. For example, between 1983 and 2006 employment rates

⁵In the phase-in region, the EITC leads to an ambiguous impact on hours worked due to the negative income effect and positive substitution effect. In the flat region, the EITC produces a negative income effect, leading to an unambiguous reduction in hours worked. In the phase-out region, the EITC produces a negative income and negative substitution effect, leading again to an unambiguous reduction in hours worked. Eissa and Hoynes (2006a) show that about three-quarters of single EITC recipients have earnings in the flat and phase-out regions of the credit—thus, the expectation is that the EITC will reduce the number of hours worked by most eligible single taxpayers already in the labor force.

⁶These tabulations are calculated using the 1984-2007 March Current Population Surveys. The sample includes all women aged 19-44 who are not in school or disabled. We also drop the relatively small number of women who report working positive hours but have zero earnings or report positive earnings but zero hours. For these calculations, employment is defined by any work over the (prior) calendar year.

of single mothers increased by 12 percentage points—from 0.71 in 1983 to 0.84 in 2006. Most of this change occurred between 1992 and 1999, when employment rates increased by an amazing 16 percentage points (from 0.72 to 0.88). This is during the period of the largest expansion in the EITC and the dramatic reform of the welfare system. Of course, not all the gains can be attributed to the EITC and or the welfare reform. It is also during a time of rising wages and falling unemployment rates during the strong 1990s economic expansion. However, it is clear from this simple figure that the gains in employment experienced by single mothers were not shared by all demographic groups.

To refine the analysis, and in recognition that EITC recipients are more likely to have lower skill and education levels, Figure 6 presents the annual employment rates limiting the sample to women with twelve or fewer years of education. While employment rates are lower among less-educated women, the same pattern is evident—large gains in employment for single mothers over the period with a tremendous increase of 20 percentage points between 1992 and 1999.

Finally, Figure 7 shows the employment rates for single women by number of children (none, one, two or more). This shows that the increases in employment were concentrated among single women with two or more children.

5. Did Welfare Reform and the EITC Contribute to the Increases in Employment?

Separately identifying the impact of welfare reform, the EITC, and the strong economy on single women is a challenge as the three factors were all at play in the mid-to late 1990s. Many approaches are taken in the literature in an attempt to disentangle the impacts. One approach is to take advantage of the variation across states in welfare reform, the business cycle, and the state EITCs. A second approach uses comparison

groups. Another approach parameterizes the gains to work and utilizes variation in gains to work across women over time, across states, and in different skill groups. Overall, there is strong evidence that welfare reform, the EITC, and the strong economy all played a role in the rising employment rates experienced by single mothers in the 1990s. This section provides a brief summary of the very large literature on the impact of the EITC and welfare reform on the labor supply of single mothers.⁷

Much of the work in this area concentrates on either the impact of welfare reform or the EITC. In the EITC literature, the studies suggest a strong positive relationship between the EITC and employment rates of single women with children. Further, the results are remarkably consistent across different policy expansions, different control groups, and different methodologies. Several studies (Ellwood, 2000; Rothstein, 2005; Meyer and Rosenbaum, 2000) find that groups with the most to gain from EITC expansions (e.g., women with lower wages, lower education levels, more children, and single women) experienced larger gains in employment rates. The welfare reform studies also find positive impacts on employment, with magnitudes somewhat smaller and less statistically significant than the EITC studies.

Few studies provide a direct comparison of welfare reform and the EITC. Meyer and Rosenbaum (2001) is an important exception. Their analysis examines the impact of taxes, welfare generosity, welfare reform, other policies (minimum wages, in-kind transfer programs), and demographics on the employment of single mothers. They find

⁷ Individual papers are cited where particularly relevant. The interested reader should consult the recent and comprehensive reviews of this literature by Blank (2002), Eissa and Hoynes (2006a), Grogger and Karoly (2005), and Hotz and Scholz (2003).

that of the 12 percentage point increase in employment rates of single mothers between 1984 and 1996, fully 60 percent of the increase was attributable to the EITC and other tax changes, and 15 percent was attributable to welfare reform. The results on the relative importance of EITC versus welfare reform are sensitive to the particular time period analyzed. For the period 1992 to 1996, however, they find that the importance of welfare reform rose relative to the EITC—in particular 35 percent of the increase in employment was linked to the EITC and other tax changes and 20 percent was linked to welfare reform.

6. Conclusion

The 1990s were a period of tremendous change in policies affecting single mothers with children. The expansion in the Earned Income Tax Credit and welfare reform both raised the financial rewards to moving into the labor force. Furthermore, the gains in employment for single mothers during this period were sizable; and no such gains were experienced for other groups of workers. There is an extensive body of research which looks at these facts and, using a wide variety of methodologies, concludes that these changes in taxes and transfers contributed in an important way to these increases in employment. The research suggests that the expansions in the EITC were the most important contributor to these changes.

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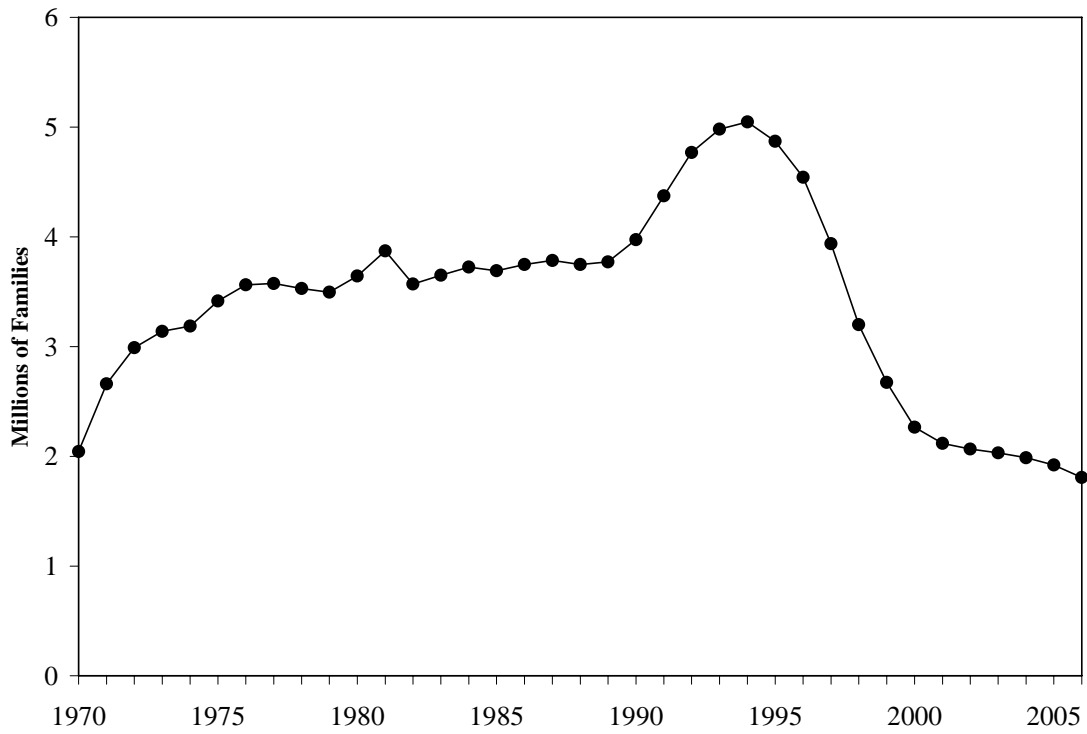
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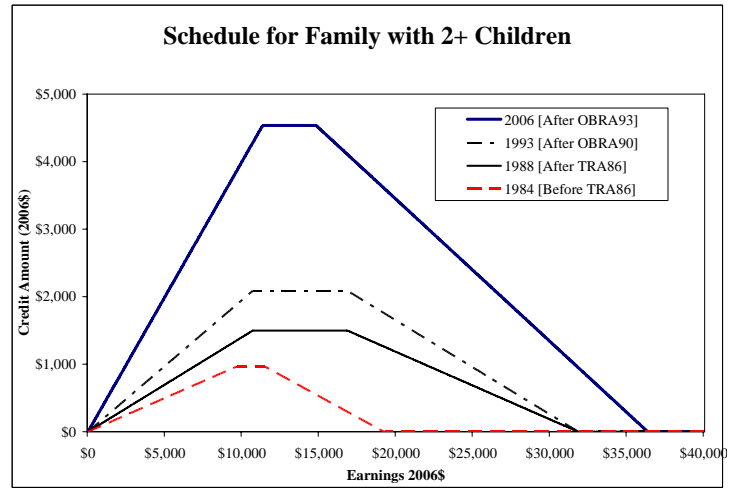
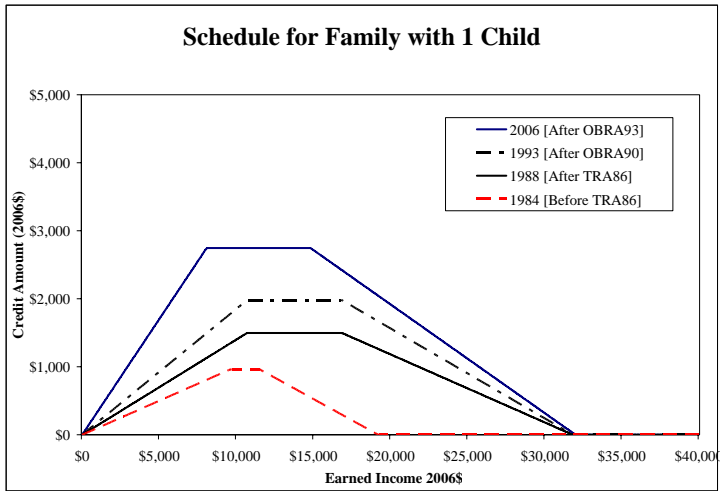
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Figure 1: AFDC/TANF Caseload 1970-2006 (Millions of families)



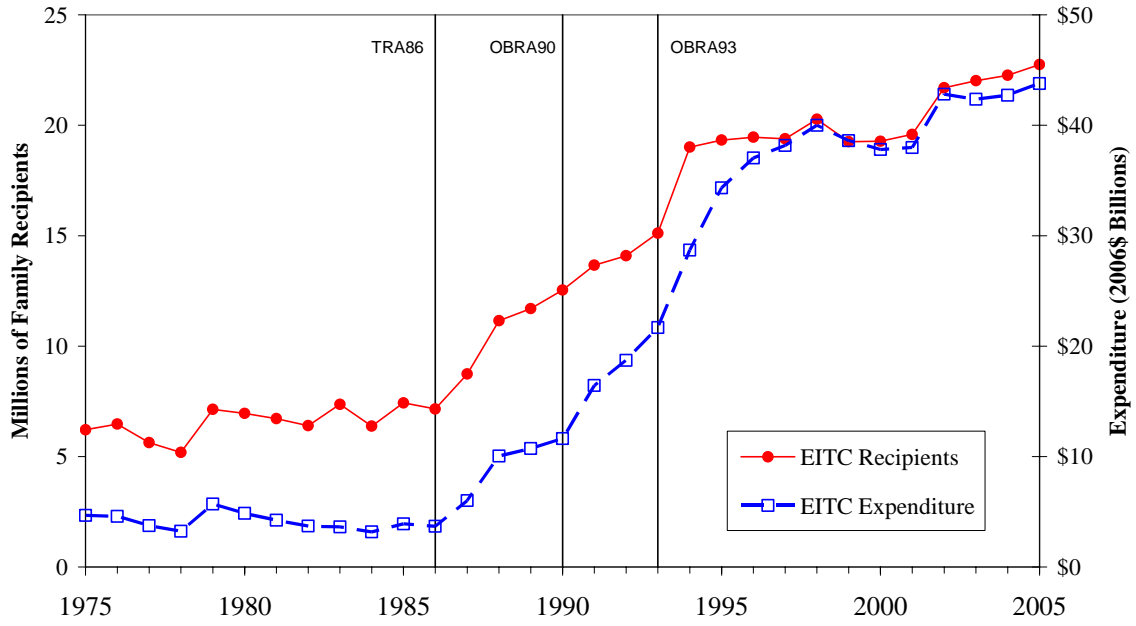
Source: (1) Health and Human Services, Office of Family Assistance, TANF/AFDC Caseload Data
<http://www.acf.dhhs.gov/programs/ofa/caseload/caseloadindex.htm>

Figure 2: Real EITC Schedule for Single Mothers by Real Earnings (2006 dollars)



Source: Author's tabulations

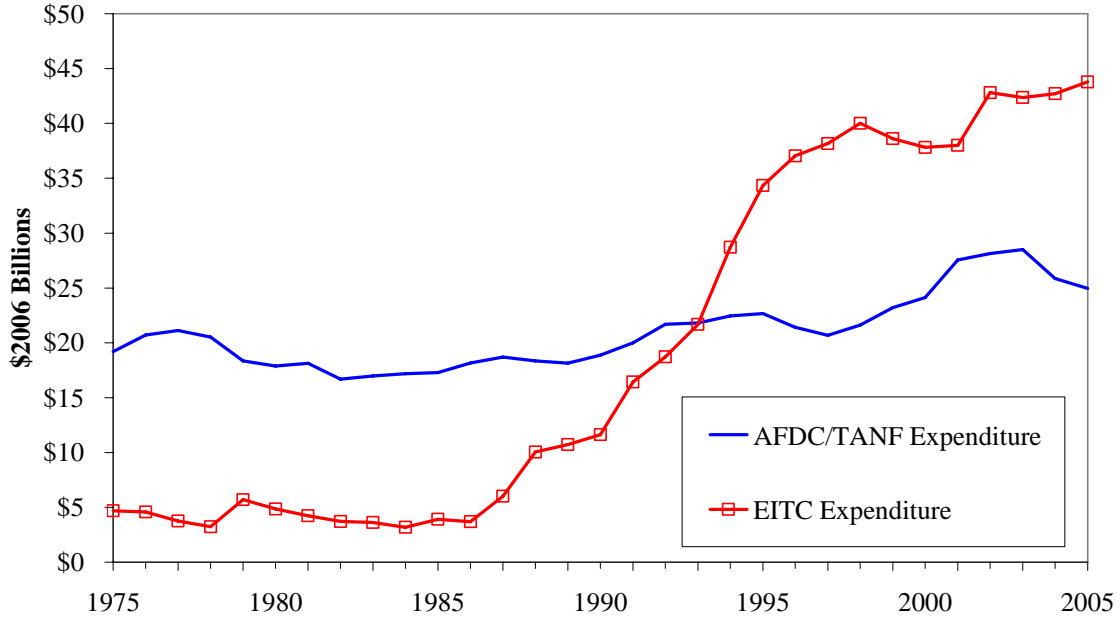
Figure 3: EITC Recipients and Expenditures 1975-2005



Source: Tax Policy Center, Tax Facts: "Historical EITC Recipients"

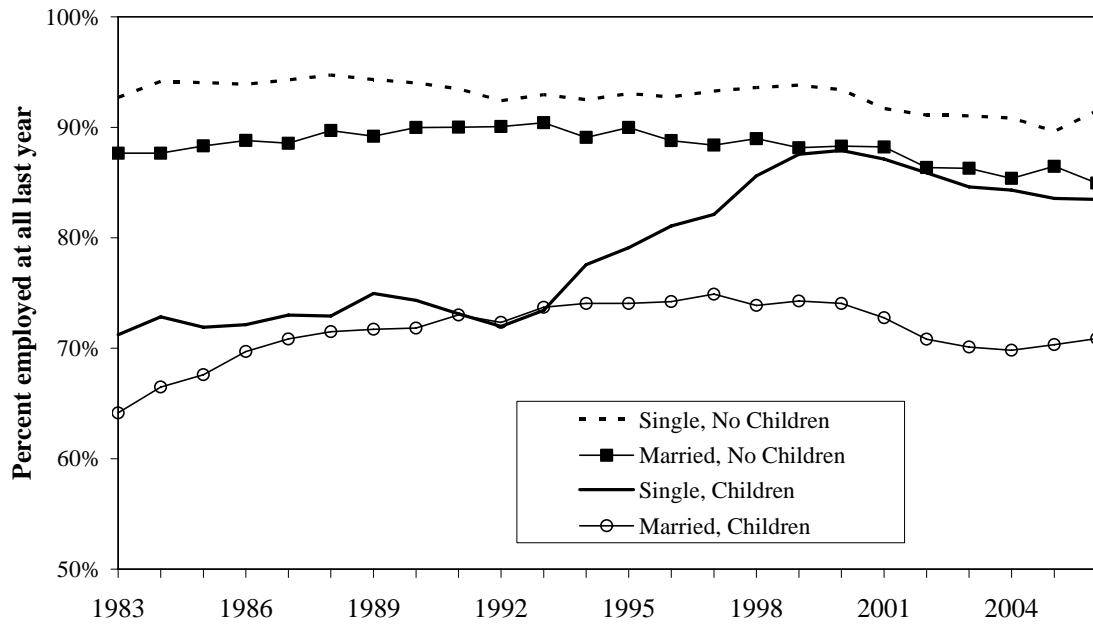
<http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=37&Topic2id=40&Topic3id=42>.

Figure 4: Comparing Cost of AFDC/TANF to EITC, 1975-2005



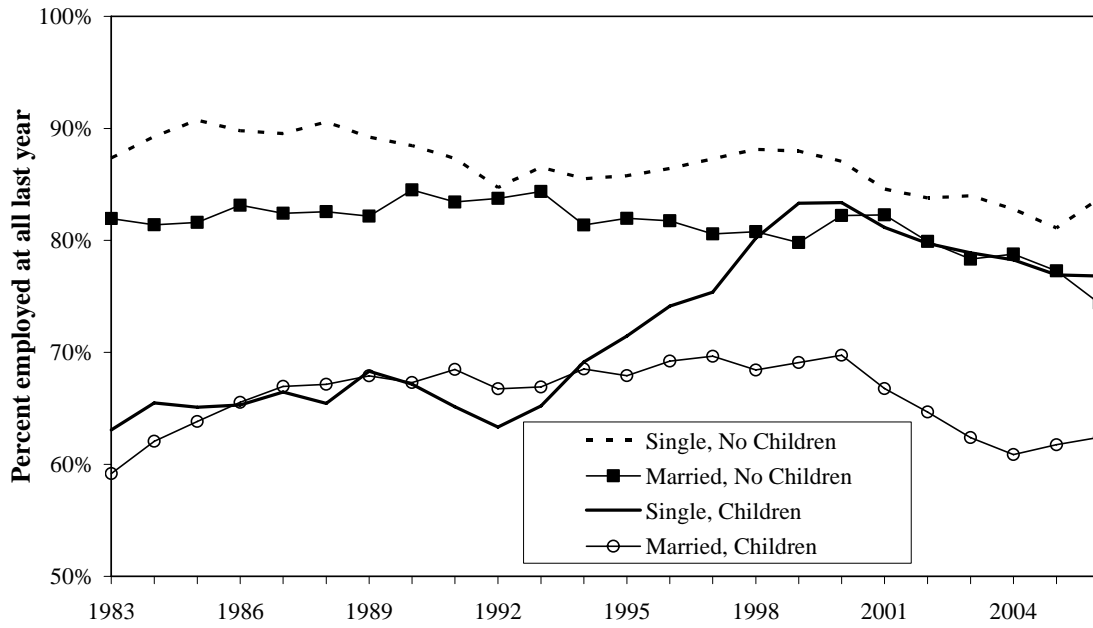
Source: AFDC/TANF figures from Budget of the US Government, Fiscal Year 2008: Historical Table 8.5 "Outlays for Mandatory and Related Programs," <http://www.gpoaccess.gov/usbudget/fy08/pdf/hist.pdf>. EITC expenditures from Tax Policy Center, Tax Facts: "Historical EITC Recipients" <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=37&Topic2id=40&Topic3id=42>.

Figure 5: Female Annual Employment Rates by Marital Status and Presence of Children



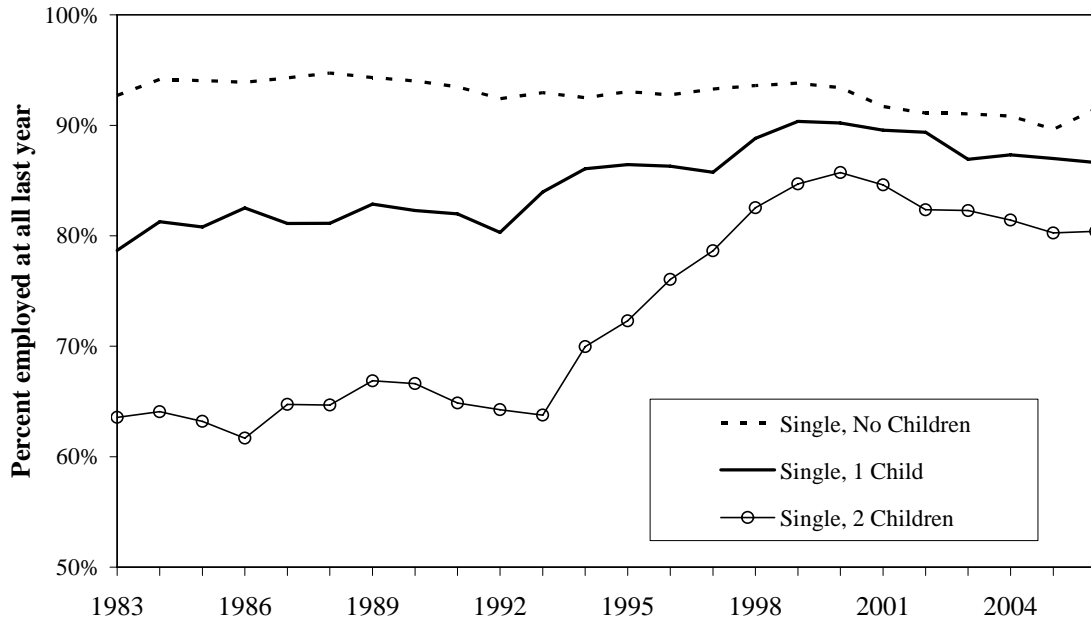
Source: Author's tabulation of the 1984-2007 March Current Population Survey

Figure 6: Annual Employment Rates by Marital Status and Presence of Children
 Women with a High School Education or Less



Source: Author's tabulation of the 1984-2007 March Current Population Survey

Figure 7: Annual Employment Rates for Single Women, by Number of Children



Source: Author's tabulation of the 1984-2007 March Current Population Survey