

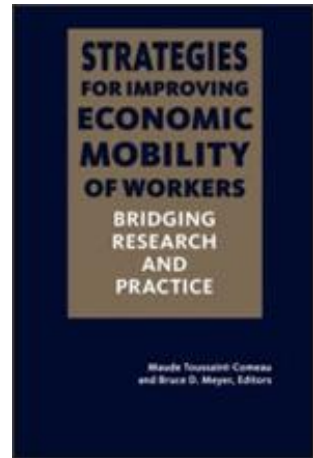
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Upjohn Institute Press

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

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Chapter 4 (pp. 61-73) in:

**Strategies for Improving Economic Mobility of Workers: Bridging  
Research and Practice**

Maude Toussaint-Comeau, Bruce D. Meyer, eds.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2009

DOI: 10.17848/9781441631992.ch4

# 4

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

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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 Temporary Assistance for Needy Families (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 long-standing 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 their employment. Indeed, employment rates of single mothers with children rose 11 percentage points over a 20-year period, from 73 percent in 1987 to 84 percent in 2006. Even more striking is the 16-percentage-point change (from 72 to 88 percent) that occurred between 1992 and 1999. During this span, gains were even larger for single mothers without a high school diploma; among this group, employment rates increased by 20 percentage points between 1992 and 1999. No other group of women (single women without children, married women with

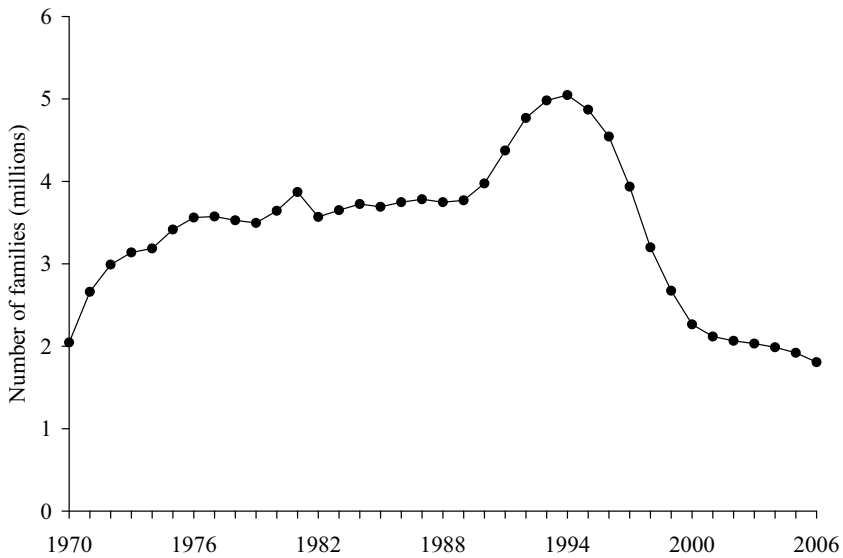
or without children) or men experienced such a dramatic increase in employment. In this chapter, I describe these important policies, as well as present trends in employment for single mothers, and I summarize what is known about how the changes in welfare and the EITC have affected employment.

## **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 were phased out at a very high rate: after a small disregard, benefits were reduced by one dollar for every additional dollar in earned income. This, by design, created a targeting of benefits to those with the lowest income levels, but it also inadvertently created a disincentive to enter the labor force because the increase in earnings was 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 had implemented some sort of welfare waiver. On the heels of this state experimentation, the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) was enacted in 1996, replacing AFDC with TANF. 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 4.1 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 con-

**Figure 4.1 AFDC/TANF Caseload, 1970–2006**

SOURCE: HHS (2008).

cern was that the NIT would discourage labor market activity as it was 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 one to have positive earned income and also requires one's adjusted gross income and earned income to be below a specified amount; in 2007, the maximum allowable income for a single taxpayer with one child was \$33,241 (\$37,783 with two or more children).<sup>1</sup>

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 phase-in region, the flat region, and the phase-out region. The credit for those in the phase-in region is equal to the subsidy rate times their earnings. The subsidy rate is quite high—

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 (in 2007 it was \$2,853 for one child and \$4,716 for more), whereas in the phase-out region the credit is discontinued at the phase-out rate (16 and 21 percent). As shown in Figure 4.2, the program expanded under the Tax Reform Act of 1986 (TRA86) and the Omnibus Reconciliation Acts of 1990 and 1993 (OBRA90 and OBRA93). Figure 4.2 illustrates these expansions in the program by plotting the (real) EITC payment schedule by (real) earnings for selected years between 1984 and 2006, separately for families with one child (Panel A) and for those with two or more children (Panel B).<sup>2</sup> The figure clearly shows that not only was the 1993 expansion the largest of the three but that it was much larger for families with two or more children. For example, between 1993 and 2006, single mothers with two children and earning between \$15,000 and \$25,000 (in 2006 dollars) experienced a more-than-doubling of their real transfer from the EITC. In contrast, single mothers with one child and 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.

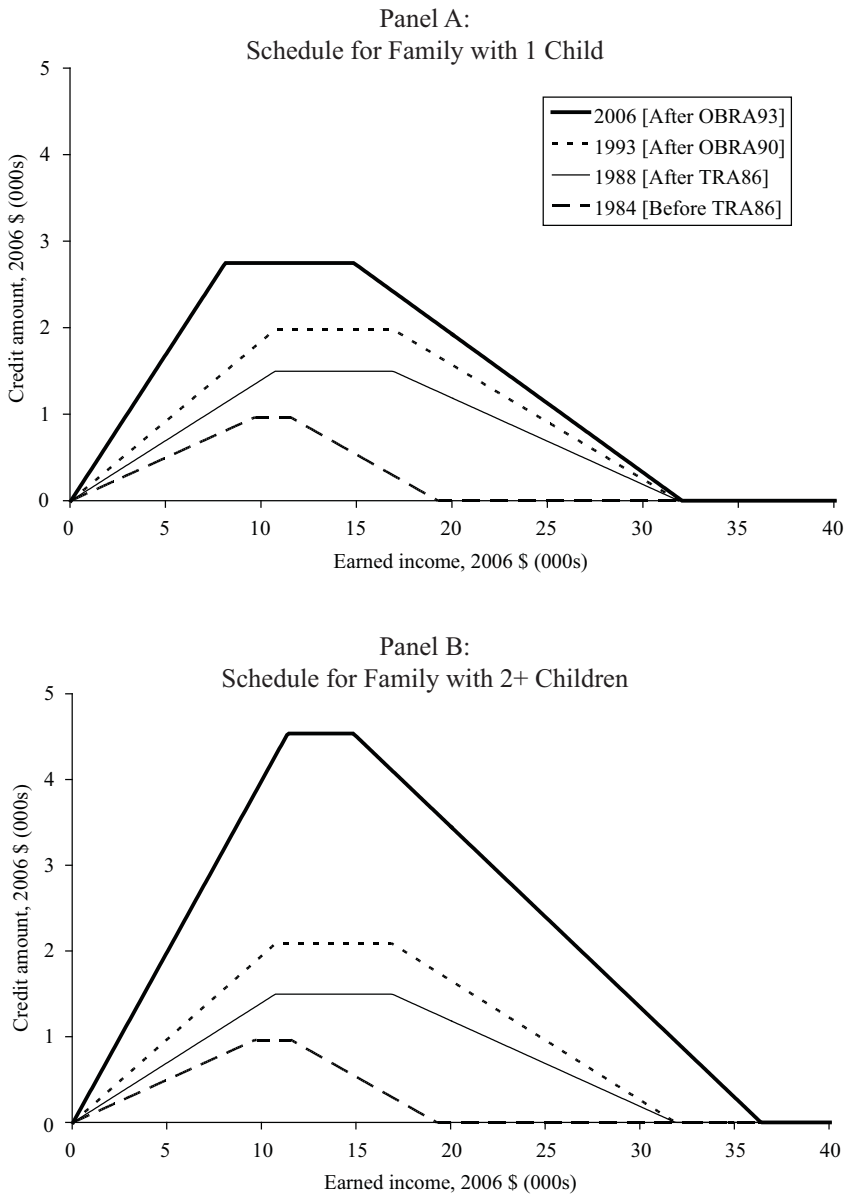
These expansions have led to a dramatic increase in the total cost of the EITC in recent years. Figure 4.3 plots the number of EITC recipients (taxpaying units or families) and the total tax cost of the EITC (in 2006 dollars) over the period from 1975 to 2005. The figure clearly shows the rising expenditures and number of recipients associated with the 1986, 1990, and 1993 tax acts. Importantly, between 1990 and 1996, real EITC costs increased more than threefold.<sup>3</sup>

Finally, Figure 4.4 contrasts the aggregate cost of the EITC with the cost of AFDC/TANF from 1975 to 2005. In a very short time, the EITC has overtaken AFDC/TANF and become the largest cash transfer program for low-income families.

## **POLICY CHANGES AND EXPECTED IMPACTS ON EMPLOYMENT**

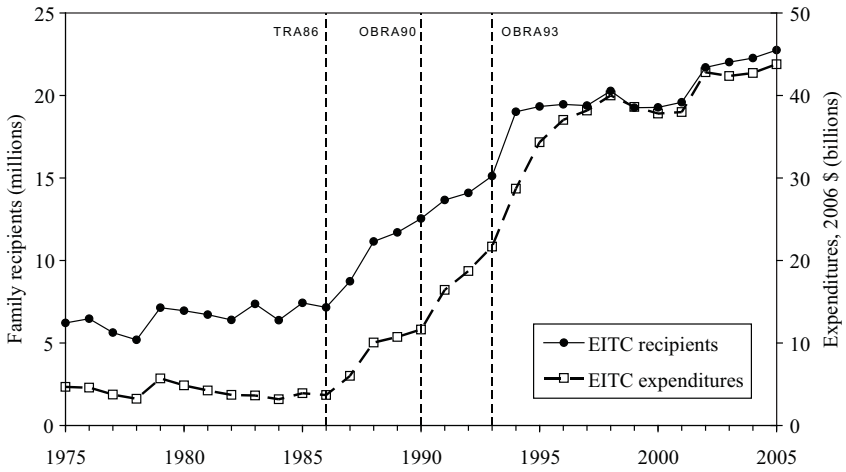
Labor supply theory suggests that welfare reform and EITC expansions should increase employment of low-income single mothers.<sup>4</sup> Vir-

**Figure 4.2 Real EITC Schedule for Single Mothers, by Real Earnings**



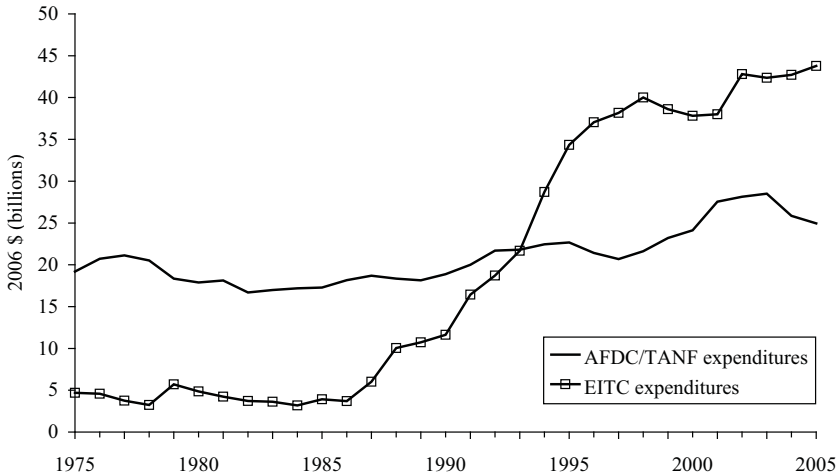
SOURCE: Author's tabulations.

**Figure 4.3 EITC Recipients and Expenditures, 1975–2005**



SOURCE: Tax Policy Center (2007).

**Figure 4.4 Comparing Cost of AFDC/TANF to EITC, 1975–2005**



SOURCE: AFDC/TANF expenditures from Office of Management and Budget (2007). EITC expenditures from Tax Policy Center (2007).

tually all of the provisions implemented in the state and federal welfare reform should lead to more 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 this effect is not the focus of this paper, the EITC is expected to reduce hours worked for those women already working whose earnings are in the flat and phase-out regions of the credit.<sup>5</sup>

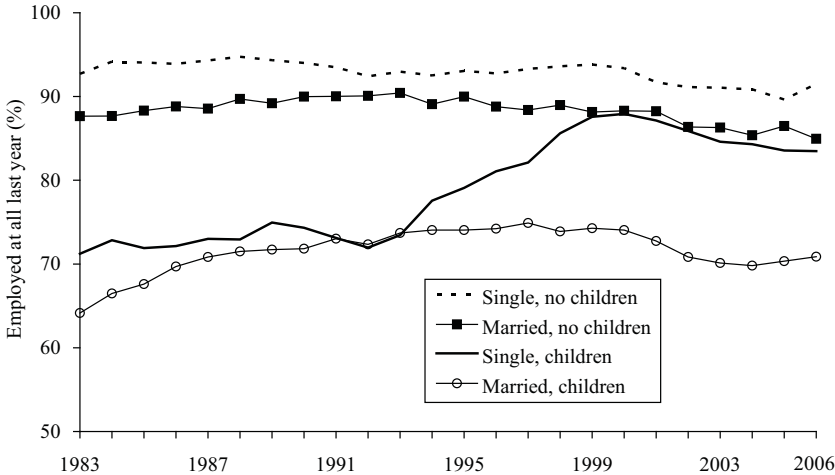
## TRENDS IN EMPLOYMENT OF SINGLE MOTHERS

Figure 4.5 presents annual employment rates for women aged 19–44 between 1983 and 2006.<sup>6</sup> We show the employment rates for four groups: 1) single women with children, 2) single women without children, 3) married women with children, and 4) 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 of single mothers increased by 13 percentage points—from 71 percent in 1983 to 84 percent in 2006. Most of this change occurred between 1992 and 1999, when employment rates increased by an amazing 16 percentage points (from 72 to 88 percent). This coincided with the largest expansion in the history of the EITC and the dramatic reform of the welfare system. Of course, not all the gains can be attributed to the EITC's growth and welfare reform; they also happened during the strong 1990s economic expansion—a time of rising wages and falling unemployment rates. However, it is clear from this simple figure that the gains in employment experienced by single mothers were not shared by all demographic groups.



**Figure 4.5 Annual Employment Rates for Women Aged 19–44, by Marital Status and Presence of Children**

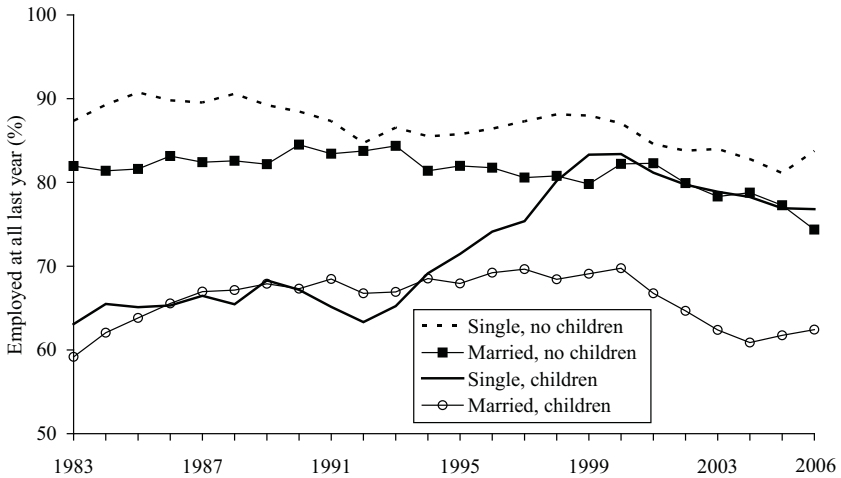


SOURCE: Author’s tabulation of the 1984–2007 March Current Population Surveys.

To refine the analysis, and recognizing that EITC recipients are more likely to have lower skill and education levels, Figure 4.6 presents the annual employment rates when limiting the sample to women with 12 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, as shown by a tremendous increase of 20 percentage points between 1992 and 1999.

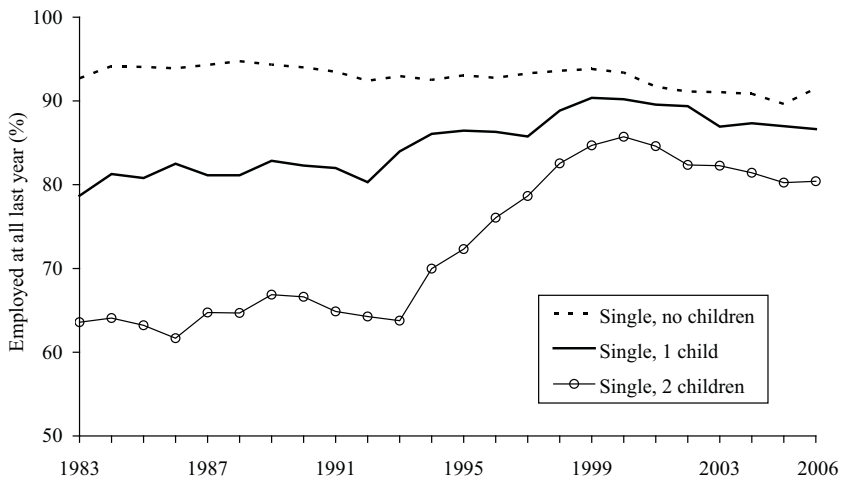
The last figure, Figure 4.7, shows the employment rates for single women by number of children (none, one, or two or more). Breaking down the data in this way reveals that the increases in employment were concentrated among single women with two or more children.

**Figure 4.6 Annual Employment Rates for Women Aged 19–44 with a High School Education or Less, by Marital Status and Presence of Children**



SOURCE: Author’s tabulation of the 1984–2007 March Current Population Surveys.

**Figure 4.7 Annual Employment Rates for Single Women Aged 19–44, by Number of Children**



SOURCE: Author’s tabulation of the 1984–2007 March Current Population Surveys.

## **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. The literature on the subject documents many approaches that have been taken 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. Yet another approach parameterizes the gains to work and utilizes variation in gains to work for women over time, across states, and in different skill groups. From all of these approaches, 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 large literature on the impact that the EITC and welfare reform have had on the labor supply of single mothers.<sup>7</sup>

Much of the work in this area concentrates on the impact of either 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. Furthermore, 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., single women and women with lower wages, lower education levels, and more children) 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 those of 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 that of the 12-percentage-point increase in employment rates of single mothers between 1984 and 1996, fully 60 percent of the increase was attribut-

able 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 from 1992 to 1996, however, Meyer and Rosenbaum find that the importance of welfare reform rose relative to that of the EITC—specifically, 35 percent of the increase in employment was linked to the EITC and other tax changes, and 20 percent was linked to welfare reform.

## CONCLUSION

The 1990s were a period of tremendous change in policies affecting single mothers with children. The expansion of the Earned Income Tax Credit and welfare reform both raised the financial rewards to welfare recipients for moving into the labor force. Furthermore, the gains in employment for single mothers during this period were sizable, and no such gains were experienced by other groups of workers. There is an extensive body of research that 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.

## Notes

This chapter was originally a paper prepared for the Federal Reserve Bank of Chicago Conference on “Strategies for Improving Economic Mobility of Workers,” November 15–16, 2007.

1. There is also a small credit for childless taxpayers. We ignore that here and focus on the main recipients, families with children.
2. Figure 4.2 plots the EITC schedule that applies to single taxpayers. Beginning in 2002, the flat and phaseout regions were expanded modestly (by \$1,000 from 2002 to 2004, by \$2,000 from 2005 to 2007, and by \$3,000 from 2008 onwards) for married filers.
3. In addition to the federal EITC, an increasing number of states offer state EITCs. As of 2004, a total of 18 states had introduced state EITCs that supplement the

federal credit. Almost all states structure their credits as a share of the federal credit, ranging 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).

4. The focus in this chapter 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 are more complicated and are likely to lead to reductions in employment for some married women (Eissa and Hoynes 2004, 2006a,b).
5. In the phase-in region, the EITC has an ambiguous impact on hours worked because of 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.
6. These 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 as any work done over the previous calendar year.
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).

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## **Bridging Research and Practice**

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Bruce D. Meyer  
*Editors*

2009

W.E. Upjohn Institute for Employment Research  
Kalamazoo, Michigan

**Library of Congress Cataloging-in-Publication Data**

Strategies for improving economic mobility of workers : bridging research and practice / Maude Toussaint-Comeau and Bruce D. Meyer, editors.

p. cm.

Includes bibliographical references and index.

ISBN-13: 978-0-88099-352-4 (pbk : alk. paper)

ISBN-10: 0-88099-352-9 (pbk : alk. paper)

ISBN-13: 978-0-88099-353-1 (hardcover : alk. paper)

ISBN-10: 0-88099-353-7 (hardcover : alk. paper)

1. Migration, Internal—United States. 2. Occupational retraining—United States. 3. Housing subsidies—United States. I. Toussaint-Comeau, Maude. II. Meyer, Bruce D.

HB1965.S76 2009

331.12'70973—dc22

2009022482

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Kalamazoo, Michigan 49007-4686

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Cover design by Alcorn Publication Design.

Index prepared by Diane Worden.

Printed in the United States of America.

Printed on recycled paper.