

Employment-Based Tax Credits for Low-Skilled Workers



FAMILIES IN LOW-INCOME COMMUNITIES FACE three interrelated problems: unemployment rates are high, incarceration rates of low-skilled men are high, and a large fraction of children in low-income communities are being raised in single-parent households. Over the past fifteen years major reforms to the welfare system have decreased poverty among married couples, single mothers, and children, largely

by increasing the return to work. Sadly, low-skilled unmarried workers, especially black men, have been left behind. Poverty among low-skilled black men has actually increased over the last decade. Inadequate work incentives for these individuals have contributed to rising rates of unemployment, incarceration, and single-parent households.

In a discussion paper released by The Hamilton Project, John Karl Scholz of the University of Wisconsin and the Brookings Institution proposes a two-part strategy to address the problems of low-skilled workers by increasing their incentives to enter and remain in the labor force. First, he argues that the earned income tax credit (EITC) should be expanded through higher credits for childless workers, fewer age restrictions, and bonuses to encourage work among young people. Second, he recommends that the government offer residents of certain economically depressed areas a wage subsidy that would cover half of the difference between the worker's actual wage and a target wage of \$11.30 an hour. No single policy can fully tackle all three problems, but by increasing the return to work, Scholz estimates, these reforms would attract 855,000 people into the formal labor market, decrease crime by over one million incidents a year, and increase marriage rates.

THE CHALLENGE

Employment among low-skilled men is disproportionately low. In 2003, one-quarter of men without a high school diploma were out of work, as were 15 percent of those with a high school diploma. The situation is particularly bad among low-skilled black men. Among non-college-educated men, employment rates of black males are 30 percentage points below those of white and Latino males. Half of all black men without a high school diploma are not working (Table 1).

The employment situation of low-skilled men has been worsening even as the situation of the rest of the population has been improving. Since 1990, employment rates of women without a high school diploma have risen slightly, while those of men have slightly declined. This disparity is most evident for the black population. Among black women without a high school diploma, employment rates increased by 10 percentage points over that period. Among black men, employment rates declined by almost 10 percentage points.

Compounding the problems of unemployment are the high levels of incarceration among low-skilled men. The share of adult males who have spent time in prison has more than doubled in the last quarter century. Here again, the problem is most acute in the black population, whose incarceration rates are

more than three times higher than the national average. Almost one-third of black men 30 to 35 years old without a college education have spent time in prison, and almost two-thirds of those without a high school diploma have been in prison.

At the same time that unemployment and incarceration among low-skilled men have increased, their marriage rates have plummeted. Today only two-thirds of children live with two married parents, compared with 85 percent in 1970. Children in single-parent households are substantially more likely to drop out of high school, have a child before the age of twenty, face unemployment, and commit crimes. There are many reasons why this is the case, but clearly the lack of a second parent, most often a father, is one of the major causes.

Unfortunately, there is no silver bullet for the problems of unemployment, incarceration, and low marriage rates. But one thing is clear: increasing the return to work for low-skilled men could begin to address each problem. Evidence consistently shows that people respond to stronger incentives to work by joining the labor force. Higher wages also decrease incentives for seeking informal and illegal opportunities to make money. And studies find that marriage rates rise and divorce rates fall when men's earnings and employment increase.

Part of the evidence relating better wages to higher employment lies in the improvements women experienced in the 1990s. The expansions in the EITC, together with welfare reform and the strong economy, changed the culture of work among single mothers. Both the EITC expansions and welfare reform specifically targeted couples and single parents living with children. These groups also benefit disproportionately from core safety net programs such as Temporary Assistance for Needy Families (TANF) and the Food Stamp Program. The challenge before society is to create programs that will offer similar incentives and support to disadvantaged low-skilled workers not living with children. Policies that target

TABLE 1
Employment Rates among
Low-Skilled Black Workers, 1990 and 2003

Education	Employment rate	
	1990	2003
No high school diploma		
Males	60%	51%
Females	35%	45%
High school diploma		
Males	79%	70%
Females	65%	68%

Source: Survey of Income and Program Participation (SIPP), 1990 and 2003.

this group, especially men, could increase employment, lower crime rates, and reduce the number of children growing up with only one parent.

A NEW APPROACH

To address the problems of unemployment, incarceration, and single-parent households, Scholz puts forth a two-part plan designed to increase the return to work for low-income individuals. The first part is an expanded EITC for low-income taxpayers who are childless, defined as those without a child living with them for at least six months of the year. The second part is a wage subsidy specifically targeted at workers in certain economically depressed areas.

Expanding the EITC

The EITC is a federal program that rewards low-income individuals for working by giving them a tax credit on income they earn from work. The credit is fully refundable, so that even if individuals earn a credit that exceeds their income tax liability, the U.S. Treasury sends them a check for the difference.

The EITC works in three phases as a recipient's income rises. In the subsidy phase, the credit rises in proportion to the worker's earnings. This continues up to a certain level of income, at which point the worker enters the flat phase, where the credit remains the same even as earnings continue to increase. Finally, above a certain income level the credit phases out.

The EITC has been extremely successful at increasing employment among couples and single parents living with children, but it has had little to no effect on childless workers because of its small value. The current maximum annual credit for childless workers is a mere \$428, far below the \$2,853 maximum for a parent with one child or the \$4,716 maximum for a parent with two or more children. In fact, the credit for childless workers is so small that many who are eligible do not bother to claim it.

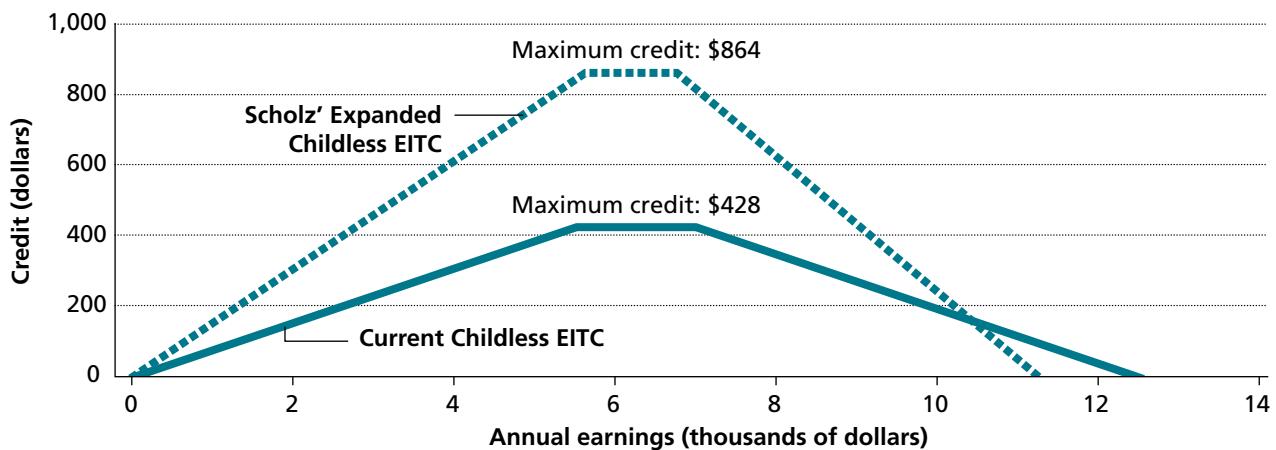
An expanded EITC and a new wage subsidy will increase the return to work for low-skilled individuals, bring them into the labor force, reduce crime, and improve marriage prospects.

Scholz proposes to reform the EITC for childless workers in three ways at a cost of \$7.3 billion if everyone eligible participated.

First, the EITC for childless workers should double to fully offset payroll taxes. The phase-in rate of the credit would increase to 15.3 percent of income up to an annual income of \$5,650. Figure 1 demonstrates how much more quickly a childless worker's credit would rise and how much higher the maximum credit would be under Scholz's proposal. The maximum credit of \$864 would exactly offset the employer and employee shares of taxes for Social Security and Medicare. The credit would start phasing out at \$6,780 and disappear completely for workers earning \$11,300 or more. All thresholds would be doubled for married childless taxpayers filing jointly.

Second, the age restriction on the childless EITC should be lifted to include workers between the ages of 18 and 24. In theory the current restriction ensures that the credit does not go to some young people who are expected to have high lifetime incomes, such as college students taking a year off. But because a substantial amount of career development—and criminal behavior—occurs before the age of 25, it is critical to give young people assistance. Full-time students would still be ineligible for the EITC.

FIGURE 1

Comparison of Proposed and Existing EITC for Single Childless Workers Over Thirty*

* For childless workers under thirty who are not full-time students, the credit rate under the proposal would be 25 percent rather than 15.3 percent, to a maximum credit of \$1,388. The proposal doubles for childless married couples, for whom the maximum EITC is \$1,728.

Third, an early career employment incentive for those under thirty years of age should be incorporated into the EITC. Giving an extra boost to workers during their initial working years would encourage valuable career development. Scholz proposes increasing the credit rate from 15.3 percent to 25 percent for workers under thirty, to a maximum credit of \$1,413.

Targeting a wage subsidy to disadvantaged workers

In addition to the expanded EITC, Scholz proposes a wage subsidy paid directly to workers. The subsidy would pay half the difference between the worker's actual wage and a target wage of \$11.30 an hour. Thus, for example, a worker with a wage of \$8 an hour would receive an additional \$1.65 an hour.

Wage subsidies are an attractive idea, even if instituted in addition to an expanded EITC. First, wage subsidies allow the government to target aid to specific individuals and communities. This is especially important given the significant spatial dimensions of poverty. Second, wage subsidies provide less of a disincentive than the EITC to work additional hours. Under the current EITC, every dollar earned above

\$15,390 by a worker with two children reduces that worker's credit by \$0.26. In effect, the EITC acts as a tax of 26 cents on the dollar in that phase-out range. With a wage subsidy, however, the return is the same for each additional hour worked.

Given the appeal of wage subsidies, it is not surprising that they have been tried before, in a variety of forms. Subsidies in the past, however, were always given through employers, and studies show that employers are less likely to hire employees eligible for these subsidies, perhaps because of the stigma attached to them. It is also not clear that the benefits of the subsidies accrued to employees. Scholz would solve these problems by giving the subsidy directly to the workers.

Since there is little evidence on the effectiveness of this innovative strategy, and because of the significant spatial dimensions of the problems of poverty, Scholz proposes to start the program small by targeting certain economically depressed communities. Specifically, he proposes instituting wage subsidies for individuals living in federally designated Renewal Communities, Empowerment Zones, and Enterprise Community areas (RC/EZ/EC communities). The nation's 100 RC/EZ/EC communities consist

of many of the poorest areas in the nation's largest cities, distributed among forty states and the District of Columbia. Scholz argues that the RC/EZ/EC communities are a good population in which to attempt a wage subsidy because the subsidy could significantly impact many of the major social and economic problems that such communities face. If concentrated in these communities, the wage subsidy would cost \$3.1 billion.

Effect on Poverty and Employment

Together Scholz's two proposals would make millions of individuals living in poverty better off than they are today. The expanded EITC would lift over half a million people out of poverty. It would triple the average credit for childless taxpayers. Scholz calculates that it would increase the return to work for those currently out of the labor market by about 10 percent. Based on estimates of the effect of increased earnings on employment, Scholz calculates that the expanded EITC would bring 708,000 more workers into the formal labor market. Especially important is that one-fifth of those impacted would be black, and almost 40 percent would be unmarried males.

The wage subsidy would have a smaller total impact because it targets fewer people: whereas 10 million people would be eligible for the expanded EITC (with no employment response), only 1.1 million workers in RC/EZ/EC communities would be eligible for the subsidy. But the subsidy would have a larger impact than the EITC on each person eligible. The average annual subsidy per worker would be \$2,696. It would increase the return to work by 37 percent, bringing an estimated 147,000 new workers into the labor market. It is also well targeted to black males: around 50 percent of the recipients of the subsidies would be black.

Effect on Crime

Both proposals would also have beneficial impacts on crime. By increasing the reward for working,

they would reduce the incentives to commit crimes. Based on studies analyzing the effect of higher wages on crime, Scholz expects that the expanded EITC could reduce crime rates by about 3.5 percent, or 918,000 crimes. This reduction in crime would bring not only social but also economic benefits. The cost of crime depends heavily on the type of crime and on whether one counts only the cost to the government, to the victims, or to society as a whole. Scholz prefers to use a conservative average cost of \$787 per crime. That means that the projected reduction in crime would save at least \$722 million, roughly 10 percent of the total cost of the expanded EITC.

Proposal Highlights

Two-Part Proposal

- **Expanding the Childless EITC:** The proposal increases the maximum credit from \$428 to \$854 for single childless taxpayers, and to \$1,728 for married childless taxpayers, ends the exclusion of eighteen- to twenty-four-year-olds, and provides an extra credit for childless adults under thirty.
- **Creating Wage Subsidies:** The plan would increase the wages of 1.1 million workers in poor urban areas. The subsidy would be half of the difference between the actual wage and a target wage of \$11.30 an hour.

Expected Benefits

- **Employment:** The wage supplements provided by the subsidy and the expanded EITC would attract about 855,000 more individuals into the labor market.
- **Crime:** The proposal would decrease crime by over one million incidents, saving at least \$850 million.
- **Marriage:** Studies show that higher earnings and employment improve marriage rates and decrease the likelihood of divorce.

Expanding the EITC would bring over half a million Americans out of poverty.

Scholz estimates that the 37 percent increase in wages due to the wage subsidy would lead to a reduction of at least 160,000 crimes. The cost savings, calculated as above, would be about \$126 million, 4 percent of the total cost of the proposal.

Other studies have come up with much higher values for the economic cost of crimes. One popular study puts it at almost \$17,000 per crime, over twenty times higher than the figure Scholz prefers. Using this number, the two proposals combined would save almost \$20 billion, twice their total cost.

Effect on Marriage

Scholz argues that his proposed policies would have a positive impact on marriage. There is evidence that increasing the employment and earnings of men increases marriage rates while also decreasing divorce rates. The studies that report these findings do not provide enough evidence, however, to allow one to predict precisely how much marriage should increase as a result of Scholz's proposals.

Several existing policies whose benefits depend on a person's marital status have been criticized for imposing a "marriage penalty," meaning that a married couple's after-tax income is lower than it would be if the same two people were not married. Some argue that such policies both reduce the incentive to marry and lead some married couples to divorce. Scholz points out, however, that studies have found little evidence to support the idea that the EITC negatively affects marriage. Furthermore, in Scholz's proposal for an expanded EITC, childless workers are more likely to have marriage bonuses. Bonuses would be larger than marriage penalties on average.

Questions and Concerns

Aside from low wages, could there be other explanations for low employment rates that earnings supplements won't solve?

The proposals offered by Scholz should not be taken as the sole solution to the problems of low employment. Unemployment can increase crime and decrease marriage rates, but it is also true that crime is itself a problem and that the causality works both ways. The drug culture and the presence of gangs lead to low employment, especially among ex-offenders. Poor education may also limit the employment opportunities available to low-skilled workers. Earnings supplements can increase the return to work but are only one component of a broader strategy.

Would the wage subsidies have substantial administrative difficulties?

State unemployment offices already receive information on wages paid, on a quarterly basis, so it would be relatively simple to confirm the earnings of workers applying for the subsidy. The problem is that most employer reports do not include hours of work. Those in Washington, Oregon, and Minnesota are exceptions. Their system of reporting would have to be extended to other states. Even with reported hours, it would still be possible for an employer to cheat the system: a worker working forty hours a week at \$11.30 an hour might be reported as working sixty hours a week at \$7.53 an hour, thereby qualifying the worker for a \$1.88 wage subsidy at no cost to the employer. Although this possibility does pose a challenge for any wage subsidy program, Scholz suggests that administrators could reduce such noncompliance through random audits of employer payroll records and sanctioning employers that misstate hours in their payroll reports.

Why is the wage subsidy denied to low-income workers outside the RC/EZ/EC communities?

Many scholars have long described the theoretical benefits of wage subsidies for increasing employ-

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *Employment-Based Tax Credits for Low-Skilled Workers*, which was authored by:

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Scholz is a professor of economics and served as Deputy Assistant Secretary at the Treasury Department. Scholz's writing focuses on wealth accumulation, the earned income tax credit and low-wage labor markets, and intergenerational transfers. He is currently a visiting scholar at Brookings.

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ment. But in practice such policies have not worked, primarily because the benefits had to pass through employers. A wage subsidy program that pays money directly to workers should circumvent this problem, but it has never been tried before. Thus it is critical to start such a program small and gather data on its effectiveness before expanding it to include other low-income workers. In addition, offering the subsidies only to workers in RC/EZ/EC communities takes advantage of the ability to target some especially disadvantaged communities. Scholz shows that these communities are twice as poor as the nation as a whole. Helping many workers concentrated in one area could have significant impacts, and the program could later be expanded to other regions and workers.

CONCLUSION

The two EITC expansions in the 1990s and many changes to the social safety net are intended to benefit families with children. But the well-being of these families is intertwined with the well-being of childless adults. "Childless" adults are in fact the fathers of many children in single-mother households—fathers who, if left out of the formal labor market, are unlikely to pay their child support or help contribute the economic resources necessary to sustain a healthy marriage. Ample social science evidence also links crime to the problem of poor labor market prospects.

Given growing and reliable evidence from programs that have proved successful for women with children, the same basic principles can be used to begin addressing the interrelated problems of unemployment, incarceration, and low marriage rates among men. If these policies work as the evidence indicates they should, they could later be expanded to have an even bigger impact. Scholz's proposal is one of many that can begin to broaden the range of the nation's poverty policy, reaching more individuals and helping more families.

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