

# **GOOD NEWS FOR LOW INCOME FAMILIES: EXPANSIONS IN THE EARNED INCOME TAX CREDIT AND THE MINIMUM WAGE**

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A report by  
The Council of Economic Advisers

## EXECUTIVE SUMMARY

- The strongest labor market in a generation has resulted in particularly large gains among low-wage and disadvantaged workers. From 1979 to 1993, the real wages of low-wage workers fell sharply. Recently, however, low-wage workers have experienced large increases in real wages: For low-wage men, wages are up since 1996 by 5.7 percent after inflation. And for low-wage women, real wages have risen 6.1 percent.
- These strong wage gains have been accompanied by a steep decline in unemployment for low-skilled workers. In 1993, 11.1 percent of workers without a high school degree were unemployed; today that rate has fallen to 7.2 percent. Among high school graduates (with no college), the rate has fallen from 6.6 to 3.9 percent. Low-wage workers are thus gaining both by working more and by earning more for every hour that they work.
- The effects of a strong economy have been reinforced by successful policies designed to make work pay. Expansions in the Earned Income Tax Credit (EITC) since 1993 are supplementing the incomes of low-wage working parents. The EITC is one of our most successful programs for fighting poverty and encouraging work:

Lifts more than 4 million Americans out of poverty. The EITC lifted 4.3 million Americans out of poverty in 1997 -- more than double the number in 1993.

Dramatically reduces child poverty. In 1997, the EITC reduced the number of children living in poverty by 2.2 million. This report finds that over half of the decline in child poverty between 1993 and 1997 can be explained by changes in taxes, most importantly the EITC.

Encourages work among single women with children. In 1992, 73.7 percent of single women with children were in the labor force. In 1997, 84.2 percent of such women were in the labor force. The percentage of single women with children who received welfare and did not work has been cut by more than half -- from 19.3 percent in 1992 to 8.3 percent in 1997. Research studies suggest that the increase in labor force participation among single mothers is strongly linked to the expansion in the EITC.

- Increases in the minimum wage have been important in raising the earnings of low-wage workers. Empirical research suggests that recent minimum wage increases have had little or no adverse effect on employment.
- The combined effects of the minimum wage and the EITC have dramatically increased the returns to work for families with children. Between 1993 and 1997, families with one child and one earner who worked full-time at the minimum wage (i.e., \$4.72 in 1993 and \$5.15 in 1997, in 1997 dollars) experienced a 14 percent -- \$1,402 -- increase in their income, after inflation, just because of these two policies alone. Similar families with two children experienced a 27 percent -- \$2,761 -- increase in their income.

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## 1. The Labor Market Continues to Perform at a Record Pace

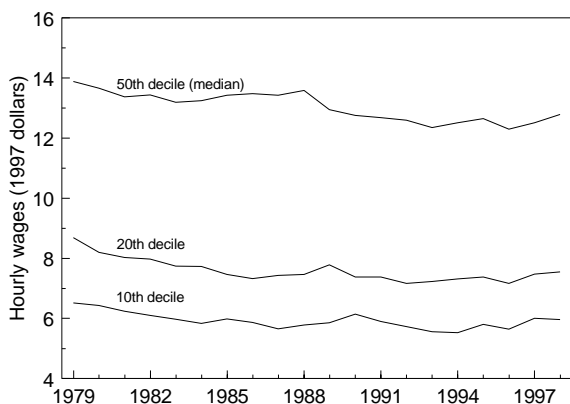
American workers are currently benefiting from the strongest labor market in a generation. Employment is at an all-time high, with 132 million Americans at work in November 1998, up from 119 million in January of 1993. Only 4.4 percent of the labor force is unemployed, having fallen by 2.9 percentage points since this Administration took office; the unemployment rate is now at its lowest level since 1969. Moreover, wages of workers are up sharply in the past several years, with a gain in median wages (after inflation) of 4.4 percent from 1996 through August of this year. As this report indicates, these gains are particularly strong among low-wage and disadvantaged workers, following more than a decade of labor market losses. Administration policies have been important in helping those at the bottom end of the labor market begin to catch up and share in the overall economic growth of the 1990s.

## 2. Low-Wage and Disadvantaged Workers are Making Particularly Large Gains

Low-wage and disadvantaged workers have experienced substantial gains in wages and employment. The real wages of low-wage male workers have shown large increases in the past few years, in contrast to the period from 1979 to 1993, when they declined by 14.7 percent. (We define low-wage as those workers at the bottom decile of the wage distribution.) Among low-wage women, the decline was 15.8 percent over this period. Charts 1 and 2 show recent significant improvements in real wages among all workers, but with particularly large gains among the lowest paid. Since 1996, men in the bottom decile have increased their earnings by 5.7 percent after inflation (Chart 1), while women have gained 6.1 percent (Chart 2).

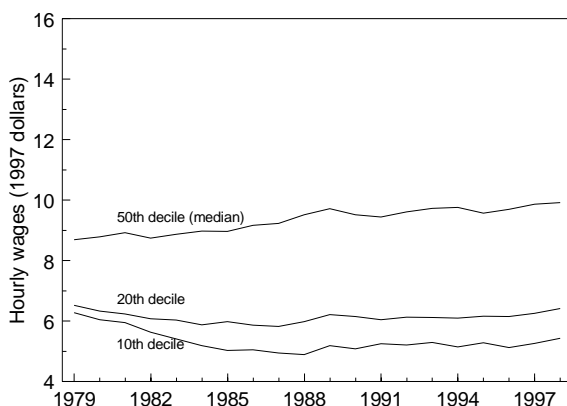
At the same time, unemployment rates among the least skilled have plummeted. When this Administration took office in 1993, 11.1 percent of workers without a high school degree were unemployed; today that rate has fallen to 7.2 percent. Among high school graduates (with no college), the rate has fallen from 6.6 to 3.9 percent. Hence, low-wage workers are working more and earning more for every hour that they work.

Chart 1: Hourly Wages of Men Aged 16 and Over



Note: 1998 figure is the January through August average.

Chart 2: Hourly Wages of Women Aged 16 and Over



Note: 1998 figure is the January through August average.

One group in particular -- single mothers -- has also experienced significant increases in labor force participation during this time period. Labor force participation rates among single mothers began to climb in 1993 after remaining essentially unchanged at 74 percent since 1984. By 1997, 84 percent of single mothers were in the labor force, a marked change for a group that has traditionally had extremely high rates of poverty and welfare usage.

### **3. Administration Policies Have Played a Key Role in These Gains**

The strong overall economy has been an important factor in increasing the wages and employment of less-skilled workers. Typically, employment among workers with less education is more sensitive to changes in the economy, with larger gains in recoveries and larger losses in downturns. This Administration has worked hard to maintain an environment in which economic growth can flourish and American businesses can compete fairly, both at home and abroad. However, the strong economy is not the only reason for these gains among less skilled workers. Administration policies to “make work pay” by expanding the Earned Income Tax Credit and raising the minimum wage have also been important.

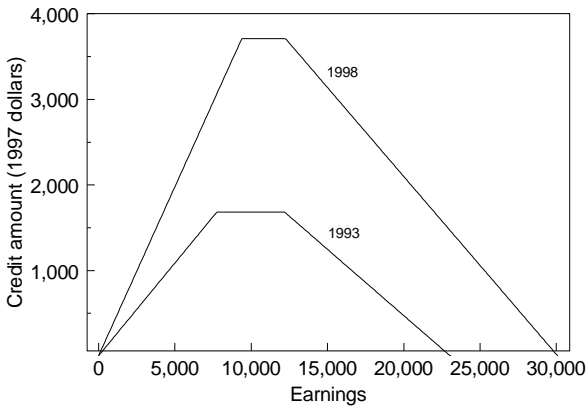
#### **3.1 Expanding the Earned Income Tax Credit**

##### *Description of the EITC*

The goals of the Earned Income Tax Credit (EITC) are to make work pay, to help ensure that working parents do not have to raise their children in poverty, and to offset the total tax burden of low and moderate income working families. As a result, the EITC eases the transition from welfare to work. To achieve these goals, the EITC consists of a refundable tax credit for working families with low incomes that offsets a family’s total tax burden. Because the credit is refundable, individuals can receive the full amount to which they are entitled even if the amount exceeds the individual income taxes they owe. About 80 percent of EITC payments offset individual income, social security, and other Federal taxes borne by families receiving the credit.

Only families that work are eligible for the tax credit, and the amount of the credit depends on a family’s labor market earnings. In 1998, for every dollar a low-income worker earns up to an established limit, as much as 40 cents is added to compensation in the form of a tax credit. In particular, the amount of the credit rises with earnings up to a maximum credit of \$2,271 for a family with one child and \$3,756 for a family with two or more children. The credit is flat for a range of earnings and then is phased out.

Chart 3: The Earned Income Tax Credit in 1993 and 1998



Note: Credit amount depicted is for a family with two or more children

The EITC was significantly expanded in the Omnibus Budget Reconciliation Acts (OBRA) of 1990 and 1993. As a consequence of these expansions, the EITC now provides a greater incentive for labor force participation than in 1993. In 1993, very low-income parents receive an additional 19 to 20 cents for each additional dollar earned. In 1998, a very low income parent with one child will receive 34 cents for additional earnings; if he or she has two children, the EITC will add 40 cents to their take-home pay (Chart 3).

OBRA 1993 significantly increased the credit for families with two or more children. The maximum credit was increased by over \$1,500 (1998 dollars), while eligibility for the credit was extended to families with incomes up to \$30,050 (or about \$3,600 above the prior law level). In addition, the 1993 expansion helped lower taxes for 15 million working families in 1996.

About 19.7 million workers are expected to claim the EITC in tax year 1998, receiving an average credit of \$1,547. About 16.5 million of these claims will be for workers living with children, who will receive an average credit of \$1,807.

The EITC is a non-bureaucratic way to reward work effort. There are no middlemen service providers, no long lines at government offices, and there is no need to take time off from work to apply for the credit. Working families apply directly to the Internal Revenue Service for the EITC and generally receive the credit as part of their tax refund.

### *Participation in the EITC*

While the EITC offers a substantial incentive to work and move out of poverty, the credit is effective if low-income families apply for it. A relatively high fraction of families eligible for the EITC -- 81 to 86 percent in 1990 -- have claimed the credit.<sup>1</sup> The participation rate has been substantially higher than those for other antipoverty programs, including AFDC (62 to 72 percent in 1986/87), and Food Stamps (54 to 66 percent in 1986/87).<sup>2</sup>

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<sup>1</sup>Scholz, J.K. (1994). "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness." *National Tax Journal*, 59-81.

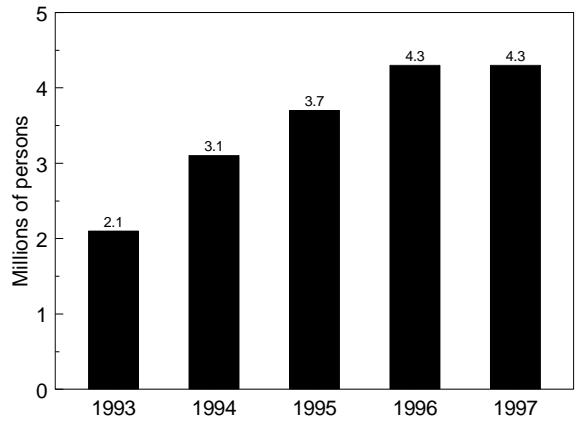
<sup>2</sup>Blank, R. and P. Ruggles (1996). "When Do Women Use AFDC and Food Stamps? The Dynamics of Eligibility vs. Participation." *Journal of Human Resources*, 57-89.

### *The EITC has reduced poverty*

The EITC is targeted to families living in poverty with the goal of lifting their income above the poverty line. As shown in Chart 4, the latest estimate from the Census Bureau shows that the EITC removed 4.3 million persons from poverty in 1997, which is more than double the number who were removed from poverty in 1993.

Over half of the people removed from poverty by the EITC (2.2 million) were children under the age of 18, and 1.8 million were living in families headed by unmarried women. Updating analyses reported in the 1998 Economic Report of the President, it is found that over half of the decline in child poverty between 1993 and 1997 can be explained by changes in taxes, most importantly the EITC (Table 1). In addition, the EITC removed about 1.1 million African-Americans and nearly 1.2 million persons of Hispanic origin from poverty in 1997. It is clear that the EITC has become a major weapon in our fight against poverty.

Chart 4: Number of People Removed from Poverty by the EITC



### *The EITC has increased the labor force participation of single mothers*

Between 1993 and 1997, the real value of the maximum EITC payment increased by 38 percent for single mothers with one child and by 116 percent for single mothers with two or more children.<sup>3</sup> These increases coincided with the period when the proportion of single mothers in the labor force increased dramatically, from 73.7 percent in 1992 to 84.2 percent in 1997.

In contrast, the labor force participation of single women without children -- who became eligible for a very small credit in 1994 if their earnings were very low -- did not change over this period (Chart 5). As Chart 6 indicates, the difference in the labor force participation rates of single women with and without children has closely tracked the growth in maximum EITC

Chart 5: Labor Force Participation Rates of Single Women With and Without Children

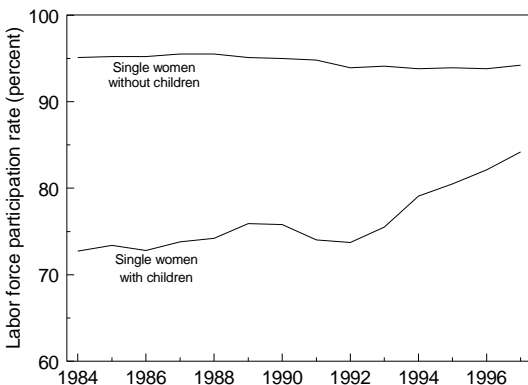
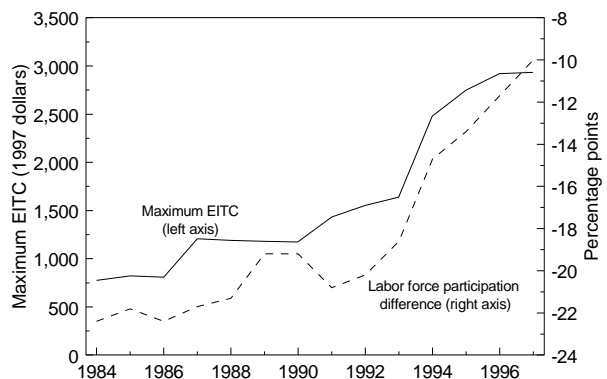


Chart 6: Maximum EITC and Difference in Labor Force Participation Between Single Women With and Without Children



Note: After 1990, the maximum EITC is the average of the maximum for taxpayers with one child and with more than one child.

<sup>3</sup>The same numbers apply to two-parent families.

benefits.<sup>4</sup>

One recent study concluded that as much as 60 percent of the increase in employment of single mothers since 1984 was attributable to expansions in the EITC.<sup>5</sup> For the period between 1992 and 1996, the EITC explains 33 percent of the increase in annual employment. A second study examined the 1986 EITC expansion, which was more modest than the 1993 expansion, and found that it significantly increased labor force participation among single mothers, especially for less educated women.<sup>6</sup> Yet another study found that the EITC could result in an increase in labor supply of 19.9 million hours in 1996 relative to 1993 law and induce 516,000 families to move from welfare into the workforce.<sup>7</sup>

EITC benefits for married couples are based on the combined earnings of both husband and wife. Hence, married couples are more likely than single parent families to fall in the range of earnings where the EITC is being phased out. This has caused some researchers to predict that the EITC might cause a decrease in hours of work among married couples. However, the limited available evidence suggests that the expansions in 1986, 1990, and 1993 had modest disincentive effects of 1.2 percentage points on labor force participation of wives, and they actually had a small positive effect on married men (of 0.2 percentage points).<sup>8</sup>

#### *How is the extra income from the EITC being used?*

Most families receive their EITC dollars at tax payment time, in the form of a larger refund. A recent study interviewed low-income workers who had gone to a volunteer tax preparation office in Chicago for assistance with their tax return. The study asked the workers what they planned to do with the EITC they were expecting to receive and found that 61 percent planned to use at least some of their refund for investment purposes, such as to pay for education (9 percent), repair, buy, or finance a car (10 percent), or to pay for a move (5 percent). Twenty-

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<sup>4</sup>Liebman, J.B. (1998). "The Impact of the Earned Income Tax Credit on Incentives and Income Distribution." *Tax Policy and the Economy*, 12, 83-119.

<sup>5</sup>Meyer, B., and D.T. Rosenbaum (1998). "Welfare, the Earned Income Tax Credit, and the Employment of Single Mothers." Department of Economics, Northwestern University.

<sup>6</sup>Eissa, N. and J.B. Liebman (1996). "Labor Supply Response to the Earned Income Tax Credit." *Quarterly Journal of Economics*, 111(2): 605-637.

<sup>7</sup>Dickert, S., S. Houser, and J.K. Scholz (1995). "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation." *Tax Policy and the Economy*, 9, 1-50.

<sup>8</sup>Eissa, N. and H.W. Hoynes (1998). "The Earned Income Tax Credit and the Labor Supply of Married Couples." Department of Economics, University of California, Berkeley.

eight percent said they were saving at least some of the EITC for future use.<sup>9</sup>

### 3.2 Increasing the Minimum Wage

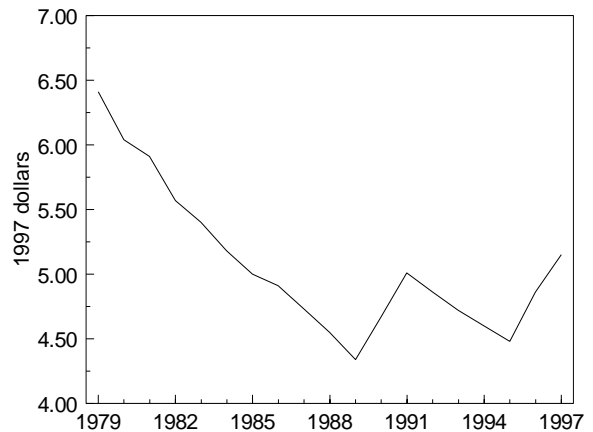
The Administration has fought for increases in the minimum wage, and on October 1, 1996 the rate was raised from \$4.25 to \$4.75. The rate was increased again to \$5.15 on September 1, 1997. Prior to these increases, it had been five years since the minimum wage was last raised, and its real value had decreased by 15 percent (Chart 7).

As shown in Charts 1 and 2, the wages of low-wage workers increased substantially since 1996, and the recent minimum wage increases are likely to explain much of this rise. It has been estimated that almost 10 million workers benefited from the recent minimum wage hikes.<sup>10</sup>

Most of the workers benefiting from the wage increases are adults from lower income families, and their wages are a major source of their family's earnings. Among workers who were earning between \$4.25 and \$5.15 just prior to the minimum wage increases, 71 percent were adults (20 or older), 58 percent were women, and one-third were black or Hispanic workers. Almost half of the affected workers (46 percent) worked full-time, and most of the low-wage workers were in low-income households. That is, over half of the benefits from the minimum wage increases were received by households in the bottom 40 percent of the income distribution. And in 1997, the earnings of the average minimum wage worker accounted for 54 percent of their family's total earnings.

One of the potential side effects of increasing the minimum wage is a reduction in employment. That is, with labor more expensive, some firms may hire fewer workers. Many empirical studies have examined this issue, and the weight of the evidence suggests that modest increases in the minimum wage have had very little or no effect on employment. In fact, a recent study of the 1996-97 wage increases used several different methods and found that the employment effects were statistically insignificant. Moreover, the unemployment rates of African-American teens and high school dropouts, who are two groups of workers most likely to

Chart 7: The Real Value of the Minimum Wage



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<sup>9</sup>Smeeding, T., K. Ross, M. O'Connor, and M. Simon (1998). "The Economic Impact of the Earned Income Tax Credit (EITC)." Center for Policy Research, Maxwell School of Public Policy, Syracuse University.

<sup>10</sup>This finding, and the subsequent two paragraphs are based on: Bernstein, J., and J. Schmitt (1998). *Making Work Pay: The Impact of the 1996-97 Minimum Wage Increase*. Economic Policy Institute, Washington, D.C.



be affected by the wage hike, are lower today than they were just prior to the increases.

#### **4. The Combined Effects of EITC and Minimum Wage Expansions**

Increases in the minimum wage and expansions in the EITC reinforce each other. Among low-wage workers, these changes have produced substantial increases in income. Table 2 demonstrates the combined effect of the two policies (after inflation), comparing 1993 and 1997 (as if the minimum wage was in effect the full year). During this period the minimum wage rose by 9 percent, while the maximum EITC credit rose by 38 percent for one-child families (116 percent for two-child families). For families with one earner working full-time at the minimum wage, their combined earnings-plus-tax refund would have risen 14 percent if they had one child (27 percent if they had two or more children). This is a significant gain in real purchasing power among these parents.

As the bottom of Table 2 demonstrates, full-time work at the minimum wage no longer leaves families below the poverty line. As a result of these policy changes, one and two-child families with a single full-time minimum wage worker now earn enough to escape poverty.

#### **5. Conclusion**

The past several years have been very good ones for less-skilled workers in the labor market. Wages are up and unemployment is down. Among single mothers, many more are participating in the labor market, while welfare caseloads have declined steeply. The research evidence indicates that these gains partially reflect the strong economy, but that the gains have been reinforced by Administration policies that have increased the financial rewards for low-wage and less skilled persons to work.

Providing the economic incentives to work are an important legacy of this Administration. These gains mesh well with other goals this Administration has pursued, such as adequate child care for the children of working mothers and available training for those workers who want to increase their skills and work opportunities. In the long run, a healthy strong economy must rely on a trained and hard-working labor force, with opportunities for both the more and less educated. There has been real progress toward this goal in recent years.

Table 1. Factors Accounting for Changes in Child Poverty

	1979-97	1979-89	1989-93	1993-97
Changes to official poverty rate attributable to changes in:				
Family structure	2.1%	1.2%	0.8%	0.3%
Earnings and other before-tax-and-after income	1.4%	1.1%	3.5%	-3.6%
Cash social insurance and welfare payments	0.3%	1.0%	-1.1%	0.5%
Total change in official poverty measure	3.8%	3.2%	3.1%	-2.8%
Change in extended poverty rate attributable to changes in:				
Means-tested food and housing transfers	0.4%	0.4%	-0.3%	0.4%
Taxes	-2.3%	0.3%	0.0%	-2.6%
Total change in extended poverty rate	1.9%	4.0%	2.9%	-5.0%

Table 2. The Effects of Changing Minimum Wage and EITC on Earnings of Single Parents  
(All numbers in \$1997)

	1993	1997	Percent Change
<u>Program Parameters</u>			
Minimum wage	\$4.72	\$5.15	9
Maximum EITC			
One-child family	\$1,602	\$2,210	38
Two-child family	\$1,689	\$3,656	116
<u>Earnings minus taxes*</u>			
One-child family	\$10,320	\$11,722	14
Two-child family	\$10,407	\$13,168	27
<u>Ratio of earnings minus taxes to poverty line</u>			
One-child family	0.93	1.06	
Two-child family	0.80	1.02	

\*Assumes one earner works full-time/full-year (2000 hours) at minimum wage. Taxes include income taxes (including the EITC) and employee share of social security taxes.