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**Testimony before the Subcommittee on Human Resources of the Committee
on Ways and Means**

Work Disincentives and the Safety Net

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Introduction

Chairmen Davis and Tiberi and ranking members Rep. Doggett and Rep. Neal, I thank you for inviting me to testify on this important question of our safety net and tax benefit programs and their impact on work.

My first point, however, is that I believe it is essential to broaden the question at the heart of this hearing. For policy makers to gain a full understanding of the impacts of the policies under review, we must investigate not solely any work disincentives they may engender, but also work *incentives*. For example, the Earned Income Tax Credit, an important wage subsidy for low-income workers, has been found to have large work *incentive* effects.

The EITC also lifts millions of working families out of poverty (surely, this was why the EITC was Ronald Reagan's favorite anti-poverty program) and that raises another necessary dimension along which these programs must be evaluated: to what extent do they achieve their poverty reduction goals?

In other words, while it makes sense to examine the marginal tax rates and work disincentives associated with our anti-poverty programs, to stop there risks an incomplete understanding of the impact of the programs on work, poverty, and well-being.

A review of work disincentives, work incentives, and poverty reduction yields these central findings:

--While benefits of means-tested programs are, by definition, reduced as incomes rise beyond of certain point, their work disincentives differ, and a number of significant programs, including the EITC and SNAP, are found to have either positive or neutral impacts on labor supply.

--A recent, exhaustive review of the poverty reduction effectiveness of our safety net and social insurance programs found that "...the combination of the means-tested and social insurance transfers in the system have a major impact on poverty, reducing deep poverty, poverty, and near-poverty rates by about 14 percentage points in the U.S. population as a whole in 2004."

--Importantly, the study concluded that "...this impact is only negligibly affected by work incentives which, in the aggregate, have almost no effect on the pre-transfer rates of poverty in the population as a whole."

--Recent research also finds positive generational effects of safety net programs on later education and earnings outcomes of children from families that received such benefits. In the full accounting that I'm advocating, these benefits too must be assessed against any costs of work disincentives.

Finally, to the extent that work disincentives exist, policy makers should consider ways to reduce or eliminate them. In the final section of my testimony I offer three ways to do so:

- lower marginal tax rates by extending phase out ranges (though this increases costs);
- provide work supports, such as child care and transportation assistance;
- increase the number of jobs available to low-income workers through demand side policies.

Given the persistent weakness in the low-wage labor market in recent years, I want to be sure to stress the importance of this last point. Research over the last few decades has shown that the most effective work incentives for working-age members of low-income families are tight labor markets with rising pre-tax wages. In this regard, policies such as the job-creation measures in President Obama's American Jobs Act will prove far more effective in incentivizing work than lowering marginal tax rates on safety net benefits.

Conversely, it would be a significant policy mistake to require recipients of benefits to work without first ensuring adequate job availability. Even in a climate of strong work incentives, without adequate job availability, this is a policy recipe for rising poverty and the accompanying strain and families and children.

Evidence Regarding the Impact on Work

By construction, the benefits from means-tested safety net programs are reduced or eliminated once the income of beneficiaries rises beyond a certain level. That is, benefits face marginal tax rates—which could be 100%—once incomes surpass a particular program parameter. This has led policy makers to question the behavioral impacts—for example, regarding labor supply—on program recipients who face these “benefit cliffs” or high marginal rates.

In some cases, since higher earnings can reduce benefits, often quite steeply, the prediction is that beneficiaries of means-tested programs would reduce work to maximize benefit receipt. However, program parameters matter and can greatly influence the actual behavioral responses of beneficiaries.

Consider, for example, the EITC. For a worker from a low-income family with two children, every pretax dollar earned returns \$1.40 between income levels of \$1 and about \$17,000. At income above these levels, the wage subsidy begins to phase out at a rate of 21%, and it is fully exhausted at about \$42,000. In this regard, it is incorrect to conclude that workers exposed to the phase-out rate do not benefit from the program, though their incentive to work more is clearly diminished in the phase-out range.

It is thus an empirical question as to the net effective of these incentives on labor supply, and considerable research has been devoted to just this question. One authoritative review of this literature concluded that “...the overwhelming finding of the empirical literature is that EITC has been especially successful at encouraging the employment of single parents, especially mothers.”¹

¹ Nada Eissa and Hilary Hoynes, “Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply,” October 10, 2005, http://www.econ.ucdavis.edu/working_papers/05-29.pdf.

Research also investigated the role of the early 1990s EITC expansion in helping to incentivize single parents, mostly moms, to move from welfare to work. One study found that the refundable tax credit had a larger effect than the welfare law in generating the considerable employment gains that occurred in those years.²

Both the EITC and Child Tax Credit are only available to working parents. Thus, they have unambiguously strong work incentives at the “extensive” margin, meaning they significantly increase the incentive of non-workers to enter the labor market. Their impact on hours work--the “intensive” margin--is more ambiguous, depending on where a worker locates on the EITC schedule, and is thus an empirical question. In fact, various studies have found large, positive effects at the extensive margin and little impact on hours worked. Ben-Shalom et al (2011) summarize this point: “The evidence suggests that the [EITC] has had a positive impact on the employment rates of single mothers but no effect on their hours of work if working...”

Thus, even with its work disincentive effect in its phase-out range, on net, the EITC is widely recognized as encouraging work, and, as discussed next, reducing poverty. In announcing this hearing, Rep Davis pointed out that “Americans should believe with confidence that hard work pays off.” Surely, we would all agree, with no less the President Ronald Reagan, that the EITC meets this venerable criterion.

Of course, the American system of safety net programs goes well beyond the clearly pro-work, refundable credits discussed above. There are many more means-tested programs targeted at poverty reduction, nutrition, retirement security, and subsidized housing. Fortunately, a group of academic poverty analysts recently released an exhaustive review of the impact of the full set of anti-poverty programs, including means tested benefits and social insurance programs, such as Social Security, Social Security Disability Insurance, Unemployment Insurance, and others (the authors are Ben-Shalom, Moffitt, and Scholz, or BMS).

The research question of this work is the “holistic” one that I view as essential in evaluating these programs: do they, on net (factoring in both work incentives and disincentives) accomplish their goal of improving the economic conditions of their target populations? Their main finding is in this regard particularly germane to today’s hearing:

“First, the combination of the means-tested and social insurance transfers in the system have a major impact on poverty, reducing deep poverty, poverty, and near-poverty rates by about 14 percentage points in the U.S. population as a whole in 2004. Second, this impact is only negligibly affected by work incentives which, in the aggregate, have almost no effect on the pre-transfer rates of poverty in the population as a whole.”

Of course, since a relatively small share of the total population participates in anti-poverty programs, it is reasonable to look more closely at the participant population themselves. BMS provide a quantification of any disincentive effects in the following way. They first calculate the pre-transfer poverty rate (and deep poverty rate) for recipients of various programs. They then factor in estimates of behavioral effects--work disincentives--and recalculate these pre-transfer

² Jeffrey Grogger, “The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families,” *Review of Economics and Statistics*, May 2003.

poverty rates absent the disincentives. These simulated rates will be lower since work disincentives lower incomes and raise poverty. Finally, they calculate the post-transfer poverty rates.

This enables us to quantify what might be regarded as a core question of this hearing: accounting for work disincentives, do these programs still have substantial poverty reduction effects? Suppose, for example, that pre-transfer poverty rate for recipients of TANF were 50% and post-transfer rates were 20%. We might conclude that TANF lowered poverty rates by three-fifths. But suppose that in the absence of work disincentive, we estimate that poverty rates among this population would have been half as large—25% versus 50%. In this case, accounting for the impact of work disincentives, poverty reduction attributable to the program is only five percentage points, not 30. Not accounting for work disincentives, we'd argue the program quite impressively reduces poverty by three-fifths. But accounting for disincentives, we'd see it reduces poverty by only one-fifth.

Table 1 shows these results with the key variable in the last column: how important are the behavior responses for both poverty reduction and for deep poverty reduction (for families under half the poverty line)? For most programs, the differences between columns one and two are small relative to the base, less than 10% of the poverty reduction.

Still, the general impression from the table would probably surprise those expecting large disincentive impacts. In the popular imagination, for example, TANF is thought to generate large work disincentives among the poor. Yet, the poverty rate among TANF families after accounting for estimates of the actual behavioral effects on labor supply is just about the same as before such an accounting.

Moreover, the poverty reduction effects dominate. TANF benefits lift 17.5% of families out of deep poverty, and less than two of those percentage points can be attributed to behavioral effects. Unemployment compensation reduces poverty by 13 percentage points, while work disincentives account for less than one of those points. While work disincentives show up in this analysis, they are quantitatively small relative to poverty reduction.

SNAP, formerly food stamps, does not show up in BMS's table because their read of the literature suggests food assistance has no impact on labor supply.³ However, my CBPP colleague Stacy Dean points out that "Over the last two decades, the share of SNAP households that are *working* households has risen significantly. In 2010 more than three times as many SNAP households worked as relied entirely on welfare benefits for their income. Nearly half of all SNAP households with children have earned income."

Dean attributes this increase in part to the fact that the SNAP benefit formula incentivizes work, similarly to the EITC incentives described above. "For every additional dollar a SNAP recipient earns, her benefits decline by only 24 to 36 cents — much less than in most other programs. Families that receive SNAP thus have a strong incentive to work longer hours or to search for

³ BMS note a study that used the introduction of the Food Stamps program in the 1970s to gauge its impact of labor supply. The estimates on labor supply, they note, were negative but "small and almost always insignificant."

better-paying employment.” I return to this insight regarding such pro-work mild phase outs at the end of this testimony.

Generational Impacts

The central point of this testimony is that in order to fairly and fully evaluate our safety net, any net work disincentives must be considered against benefits like poverty reduction, as above. But recent research goes beyond the short-term impacts of higher family income and looks at the longer term impact on children in these families, both in terms of educational and employment outcomes. Some of these findings include:

--One recent study finds that raising a poor family’s income by \$3,000 a year (a fairly typical amount for a poor family to receive from the CTC and EITC) between a child’s prenatal year and fifth birthday is associated with a 17 percent increase in earnings, and an average of 135 hours of additional work per year, compared to similarly low-income children whose families do not receive the increase in income.⁴

--Researchers analyzed ten anti-poverty and welfare-to-work experiments and found a consistent pattern of better school results for children in programs that provided more income. Each \$1,000 increase (in 2005 dollars) in annual income (the equivalent of a full Child Tax Credit for one child) sustained over two to five years, led to modest but statistically significant increases in young children’s school performance on a number of measures, including test scores. While the study did not specifically analyze the EITC’s impact, the researchers noted that their results are most germane to “income-boosting policies that link increases in income to increases in employment” — an apt description of the EITC.⁵

--Researchers analyzed administrative data from a large urban school district and the corresponding U.S. tax records for all families in that school district. They found that even under conservative assumptions, additional income from the EITC and CTC leads to significant increases in younger student test scores.⁶ Another study using different data--nearly two decades worth of survey data on mothers and their children--concluded that additional income from the EITC raises the combined math and reading test scores of students by similarly large magnitudes.⁷

--Gordon Berlin, the president of one of the nation’s leading research organizations—MDRC, with a long history of rigorous evaluation of anti-poverty and welfare-to-work programs—summarizes these results, noting:

⁴ Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, “Early-Childhood Poverty and Adult Attainment, Behavior, and Health,” *Child Development* (January/February 2010), pp. 306-325

⁵ Duncan, Morris, and Rodrigues, 2010

⁶ Raj Chetty, John N. Friedman, and Jonah Rockoff, “New Evidence on the Long-Term Impacts of Tax Credits,” Statistics of Income Paper Series, November 2011, <http://www.irs.gov/pub/irs-soi/11rpchettyfriedmanrockoff.pdf>

⁷ The figures in the Dahl and Lochner study are expressed in 2000 dollars. Gordon Dahl and Lance Lochner, “The Impact Of Family Income On Child Achievement: Evidence From The Earned Income Tax Credit,” NBER Working Paper No. 14599, December 2008, <http://www.nber.org/papers/w14599>.

[There is] a remarkably strong body of research — much of it based on large-scale, well-implemented, experimental research designs — showing that supplementing the earnings of parents helps raise families out of poverty and improves the school performance of young children... We have reliable evidence involving thousands of families in multiple studies demonstrating that “making work pay” causes improvements in young children’s school performance.⁸

This research clearly suggests that reducing these benefits would, *net of any work disincentive effects*, lower income, raise poverty and harm future generations in terms of their educational and earnings outcomes.

Lowering Work Disincentives

A full assessment of the impact of the US safety net suggests we are getting a good “bang-for-our-bucks” in terms of poverty reduction and positive outcomes for children in beneficiary families. Yet, as Table 1 shows above, “net” work disincentives can be found in some of these programs (“net” meaning that unlike the EITC, the net of work incentives and disincentives is negative). How could policy makers reduce or eliminate them?

--End cliffs; lengthen phase out ranges: Means-tested programs, by definition, cease their benefit payout at some designated income level. Some programs, like SNAP and TANF, have steep cliffs—their benefits phase out quickly once family income reaches a certain threshold. Other programs, like the CTC or the EITC, phase out more slowly, and in the case of the CTC, starting from a relatively high income level (over \$100,000 for married couples).

In the context of today’s hearing, steep cliffs and high phase out rates cause high marginal tax rates and thus theoretically disincentivize work (as I’ve stressed, however, this is an empirical question). To get rid of them is technically simple: Congress would simply need to lower the rate at which benefits are reduced for each extra dollar a family earns.

Of course, this would make the programs more expensive, though the net cost would be reduced to the extent that the change incentivized more work by program recipients. How much more expensive is beyond the scope of this testimony, though if members are interested in learning more about such options, I would be happy to pursue such research.

The larger point is this: there is deep bipartisan agreement that our economy needs safety net programs to catch vulnerable families, particularly in periods of market failure, like the Great Recession from which we are still climbing out. Yet, partially for fiscal reasons, these programs are generally means-tested—their benefits are tied to income.

Once benefits are tied to income, marginal tax rates that can disincentivize work are created. That is an unavoidable outcome of the structure of these programs as I’ve just described. An

⁸ Gordon L. Berlin, remarks at National Summit on America’s Children, May 22, 2007, <http://www.mdrc.org/publications/456/presentation.html>.

important point stressed throughout is that the actual impact of such disincentives cannot be assumed. It is an empirical question, and in most cases, the research shows little negative impact.

--**Work supports:** As shown in Table 1, the research on the behavioral impacts of marginal tax rates on safety net programs shows that they have minimal impact on poverty reduction. Therefore, while reducing those rates could help mitigate what effects exist, a more promising margin to further incentivize work among safety net beneficiaries would be to increase work supports: policies to help low-income, often low-skilled workers, who are often parents of young children, get and keep jobs.

These include assistance with child care, transportation, job training, job placement, wage subsidies, housing, and even mobility, as such workers may be stuck in areas with less opportunity, yet unable to relocate to more promising areas.

--**More Job Opportunities:** Finally, the sole focus of the discussion so far has been on the “supply-side” of the equation—examining how individuals respond to incentives created by safety net programs. Yet, even with perfectly aligned incentives, the absence of enough jobs is a far more influential determinant of employment outcomes of workers from low-income (or any income) families.

The marginal tax rate arguments implicitly assume that jobs are available to program recipients, but that they don’t take them because the increase in the after-tax income (including benefit losses) doesn’t meet their reservation wage. But that assumption is far less relevant at high unemployment than at full unemployment. And the low-wage labor market has been characterized by high-unemployment for years.

For example, Figure 1 below shows unemployment rates by education level for persons 25 years and up for those with less than high-school, high-school, and all. The rates for less-educated workers are consistently above the average, and the least-educated, unemployment has been in double digits since the fall of 2008. Data from the Economic Policy Institute reveal that the hourly earnings of low-wage workers have been flat or falling for the past few years (a continuation of a longer-term trend).⁹ This combination of high unemployment and falling real earnings provide a clear sign of weak labor demand.

My own work has found that the benefits of a tight job market—one characterized by very low unemployment—are significantly greater for those at the low end of the wage scale. For example, for each percentage point lower unemployment, the increase in real hourly wages for low-wage workers is at least twice that of high wage workers.¹⁰

In this regard, if this committee wants to support the most effective work incentives for working-age members of low-income families, they should consider those demand-side policies that quickly raise the number of jobs and employ the most jobseekers. For example, President

⁹ EPI data show that real hourly wages at the 10th and 20th percentile are down 3-4% since 2007 (forthcoming, State of Working America, 2012).

¹⁰ See, for example, Bernstein and Baker, *The Benefits of Full Employment*, Economic Policy Institute, 2003, Figure 4E.

Obama has proposed temporary fiscal relief to states to attack the persistent flow of layoffs of public sector workers from states facing steep revenue shortfalls. Infrastructure programs, such as addressing the maintenance backlog at our public schools, could also help quickly create needed employment, as would the passage of a robust transportation bill. Particularly given today's weak demand climate, such policies will prove far more effective in incentivizing work than lowering marginal tax rates.

Conversely, it would be a significant policy mistake to require recipients of benefits to work without first ensuring adequate job availability. Even in a climate of strong work incentives, without the jobs, this is a policy recipe for rising poverty and the accompanying strain and families and children.

Conclusion

Work disincentives in the form of marginal tax rates on benefits are, by construction, a feature of means-tested, poverty reduction programs. The question is thus not whether they exist, but what is their impact on poverty reduction and the well-being of economically vulnerable families and their children? This is decidedly an empirical question.

The research reviewed here finds that in virtually every safety net program that has been empirically evaluated, poverty reduction effects swamp any work disincentives. That is, even accounting for any poverty-inducing impacts, the net increase in income and reduction in poverty rates of families that participate in the American safety net are substantial. As one comprehensive study summarized it:

“First, the combination of the means-tested and social insurance transfers in the system have a major impact on poverty, reducing deep poverty, poverty, and near-poverty rates by about 14 percentage points in the U.S. population as a whole in 2004. Second, this impact is only negligibly affected by work incentives which, in the aggregate, have almost no effect on the pre-transfer rates of poverty in the population as a whole.”

Recent research has added an important finding to this summary: the poverty reduction that occurs thanks to these programs has significant, positive effects on the future education, employment, and earnings outcomes of the children in recipient families. In this regard, measures that reduce benefits will be far more likely to lead to lower incomes, higher poverty, and worse child outcomes than to increased work effort.

However, to the extent that Congress wants to mitigate any work disincentives in means-tested programs, I recommend three areas of policy intervention. Extending phase-outs lowers any marginal tax rates on benefits, but it raises program costs. Work supports, such as child care assistance, have been shown to be extremely useful in helping low-income parents find and keep work. And most importantly in today's weak demand climate, demand side measures such as those put forth by President Obama in the American Jobs Act are essential. No matter how cleverly we align incentives, if there are not enough jobs for job seekers, those incentives will be ineffective and poverty will rise.

I thank my CBPP colleagues Arloc Sherman, Indi Dutta-Gupta, Will Fischer, and Stacy Dean for help in preparing this testimony, though any mistakes are my own.

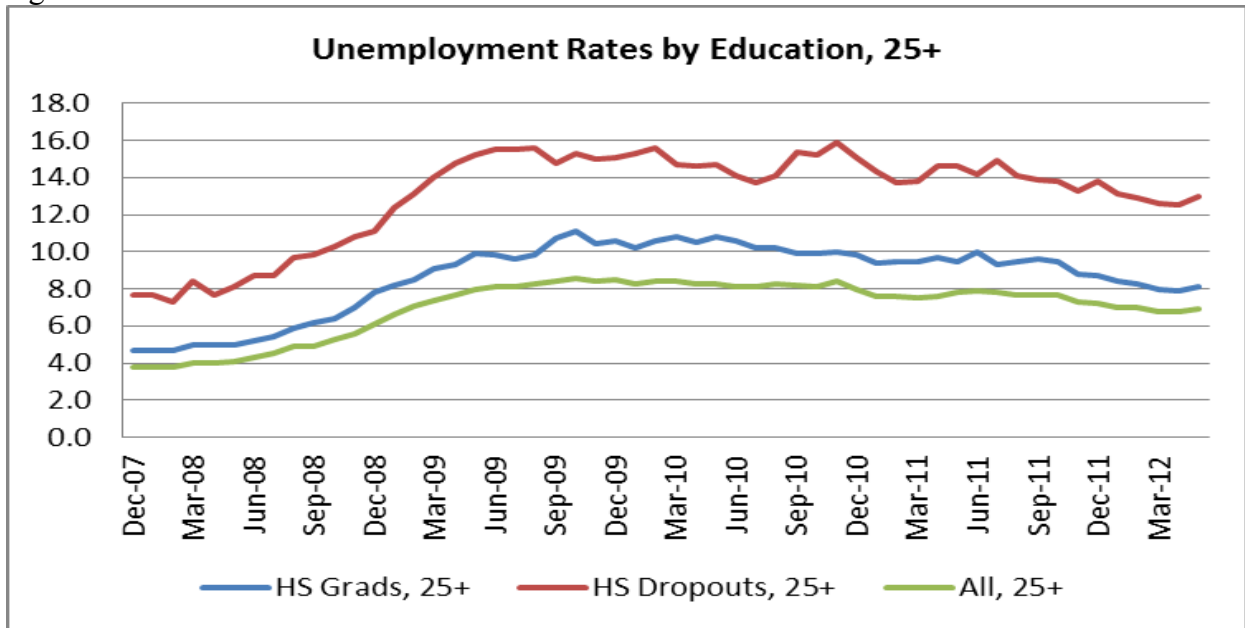
Table 1: Poverty Reduction Impact of Safety Net Programs, Accounting for Work Disincentives

<i>Safety Net Program</i>	Poverty Rates		
	Pre-transfer (accounting for		
	Pre-transfer	behavioral effects)	Post-transfer
SSI	80.2%	78.6%	72.2%
TANF	81.1%	80.6%	74.1%
Housing Asst	80.9%	74.7%	66.0%
Social Sec	49.2%	48.6%	12.5%
Disability Ins	70.5%	67.8%	40.7%
Medicare	54.2%	54.0%	14.0%
Unemployment Comp	53.1%	52.6%	40.1%
Workers Comp	53.9%	51.5%	4.6%

	Below 50% of Poverty		
	Pre-transfer (accounting for		
	Pre-transfer	behavioral effects)	Post-transfer
SSI	73.0%	70.5%	39.2%
TANF	66.4%	64.8%	48.9%
Housing Asst	67.7%	61.3%	25.5%
Social Sec	36.8%	36.4%	2.4%
Disability Ins	60.0%	56.9%	12.8%
Medicare	41.6%	41.5%	0.4%
Unemployment Comp	35.2%	33.8%	17.6%
Workers Comp	42.3%	40.1%	0.7%

Source: BSM, Table 9

Figure 1



Source: BLS