The Work Opportunity and Welfare-to-Work Tax Credits

Sarah Hamersma

Over the past ten years, public assistance programs have encouraged labor force participation as a route to self-sufficiency. The 1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA, or “welfare reform”) and significant expansions in the Earned Income Tax Credit (EITC) created the largest and most studied changes in the work incentives of the poor. However, some smaller programs that may also affect employment among the poor have been largely ignored in the policy discussion. The Work Opportunity Tax Credit (WOTC), introduced in 1996, offers generous subsidies to firms that hire disadvantaged workers, including certain welfare recipients, food stamp recipients, people with disabilities, and others. The similar Welfare-to-Work (WtW) tax credit, implemented in 1998, offers firms potentially larger subsidies for hiring long-term welfare recipients. Although these programs are much smaller than cash assistance or the EITC, the tax credits totaled nearly $500 million in fiscal year 2003 according to the Office of Management and Budget (2005).

The policy goal of the WOTC and WtW is to improve job prospects for individuals who face barriers to employment or are in hard-to-employ groups. While workers may respond to direct subsidies like the EITC by seeking a job, there is concern that employers may still be unwilling to hire some of these workers due to their lack of experience or qualifications. The WOTC and WtW are designed to provide incentives for employers to hire such workers.

This brief provides some policy background on employer subsidies, discusses participation in the WOTC and WtW, surveys the current evidence on the effects of the tax credits on labor market outcomes, and discusses the costs and benefits of the programs. The evidence suggests that the programs are vastly underutilized and have not had a meaningful effect on employment rates among the disadvantaged. However, those relatively few workers whose employers participate do appear to experience a modest earnings increase as a result of the subsidies.

Policy History and Eligibility

Employer subsidies have been a feature of U.S. anti-poverty policy since the 1970s. The longest-running program was the Targeted Jobs Tax Credit (TJTC), which was in place from 1978 until 1994. This tax credit was available to firms that hired workers from any of several categories of poor or disadvantaged individuals. The research consensus on the program was that it had remarkably low participation among eligible firms, that the program had primarily subsidized employers for workers they would have hired anyway, and that most workers’ job outcomes were not substantially improved by the policy.

Based on this evidence, the Inspector General of the Department of Labor (1994) recommended against reauthorizing the TJTC legislation and the program was allowed to expire at the end of 1994.

In 1996, the nation’s welfare reform received substantial attention, and policymakers made new efforts to improve the work incentives associated with public assistance. The Work Opportunity Tax Credit was introduced in this policy environment as a new, improved TJTC. Some important flaws of the TJTC were removed, such as its provision allowing...
firms to claim subsidies for any eligible workers they currently employed rather than just new hires. The WOTC application form, in contrast, must be filled out on or before the date of hire; policymakers hoped this would cause the subsidy to affect hiring decisions more directly.\(^2\)

The WOTC is available to for-profit firms that hire workers from any of eight target groups, many of which are comparable to those under the TJTC:

1. Workers from families that have received Aid to Families with Dependent Children (AFDC) or Temporary Assistance for Needy Families (TANF) for at least 9 of the previous 18 months,
2. Workers age 18–24 who are members of families that are receiving or recently received food stamps (receipt for last six months, or three of the last five months if now ineligible),
3. Workers age 18–24 who reside in one of the 145 federally designated Empowerment Zones (EZs) or Enterprise Communities (ECs) (“high-risk youth”),
4. Veterans who are members of families that are receiving or recently received food stamps,
5. Disabled workers who have completed or are completing rehabilitative services from a state or the U.S. Department of Veterans Affairs,
6. Ex-felons who are members of low-income families,
7. Recipients of Supplemental Security Income (SSI) benefits, and
8. Workers age 16–17 residing in EZs or ECs and hired as Summer Youth Employees.

Employers that hire workers from any of the eight target groups can qualify for a generous subsidy, dependent upon the workers’ tenure at the firm. For workers who leave the firm before working at least 120 hours, the subsidy is not provided. If workers stay for 120 hours but leave the firm before reaching 400 hours, the subsidy rate is 25 percent of the workers’ earnings. For workers who remain for more than 400 hours, the employer is reimbursed for 40 percent of wages, up to a subsidy cap of $2,400 per worker ($6,000 in earnings).\(^3\) The subsidy applies to hours worked in one year after the date of hire. Administrative data from Wisconsin indicates that workers are evenly distributed across the three categories of 0, 25, and 40 percent subsidies.

The Welfare-to-Work tax credit was introduced in 1997 (and implemented in early 1998) as a complement to the WOTC with a focus on long-term welfare recipients.\(^4\) Eligibility requires 18 months of welfare receipt, so workers who qualify for the WtW are also qualified for the WOTC (although employers may claim only one credit). The subsidy requires 400 hours of work, and provides a 35 percent credit in the first year of work and a 50 percent credit in the second year. The maximum credits are larger than the WOTC because up to $10,000 in earnings can be subsidized. However, since few workers in this population stay more than a year at the same firm, and the WtW has a higher tenure requirement, firms often benefit from claiming the WOTC rather than the WtW even when a worker is eligible for the WtW.\(^5\)

Table 1 provides some characteristics of the WOTC/WtW-certified population in Wisconsin (the only state for which microdata are available to me). The largest target groups are welfare and food stamp recipients, as well as high-risk youth. These individuals typically have low education levels and are disproportionately working in the service and retail sectors.\(^6\) Unsurprisingly, starting wages are generally quite low for this population.

The WOTC and WtW are administered jointly by the Department of Labor (DOL) and the Internal Revenue Service (IRS). The DOL administers the subsidy certification process. State DOL offices process applications for the subsidies and audit some percentage of applications to verify eligibility of workers being claimed. The IRS administers the tax credits themselves, and is responsible for ensuring that enough hours have been worked for the subsidy rate claimed (although firms are not required to submit documentation with the tax form).

This joint administration creates some difficulties in identifying program effects, because there is no complete record of a worker’s connection with the WOTC or WtW. While state records can indicate whether a worker was approved by DOL, they have no information about how large a subsidy was ultimately claimed for that worker (if any). In this brief, I will reference some analysis that uses unique Wisconsin administrative data linking WOTC and WtW records to employment
Participation in the WOTC and WtW has been low, just as it was in previous programs.

Participation in the WOTC and WtW

If a firm chooses to participate in the WOTC or WtW, the application and certification process is quite straightforward. Potentially eligible workers are asked to fill out a short form (often as part of the application or hiring packet) that requires them to check a box if any target group describes them. Some firms require all new hires to fill out this form, even if they are unlikely to qualify. Workers who appear to be qualified based on this form are asked to provide a bit more detail in a second one-page form to establish eligibility (such as a welfare case number) and may need to submit documentation of their disadvantaged status. Each form requires minimal information from the employer (such as firm name, address, date of hire, and starting wage). These forms must be signed on or before the date of hire and must arrive at the State Employment Security Agency (SESA) within 21 days for confirmation of the worker’s eligibility and permission to claim the WOTC or WtW. Upon receiving a letter of certification from the SESA, an employer may claim the WOTC or WtW on its federal tax forms.

Participation in the WOTC and WtW has been low, just as it was in previous programs. While the number of certifications increased from 126,000 in 1997 to over 600,000 in 2001 (the most recent year for which the total is available), this total is still small relative to the number of eligible workers who are hired by firms but are unclaimed. National estimates of 1999 participation rates among eligible workers (i.e., the number of certifications divided by the number of eligible workers) are reported for two target groups in table 2. These estimated bounds on participation rates, from Hamersma (2003), suggest that only one-tenth to one-third of eligible welfare recipients are certified for the WOTC or WtW; participation is even lower for food stamp youth.

Why is participation so low among firms that already hire eligible workers? A number of reasons have been suggested. Many firms might be unaware of the program, which directly prevents participation. Firms might be concerned about the WOTC and WtW in order to contribute to this policy discussion.

---

### TABLE 1. Characteristics of Wisconsin WOTC/WtW Certifications, 1999–2002

<table>
<thead>
<tr>
<th>Target group (N = 20,323)</th>
<th>Percent in category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare (WOTC only)</td>
<td>10.1</td>
</tr>
<tr>
<td>WtW (or both WOTC and WtW)</td>
<td>24.8</td>
</tr>
<tr>
<td>Veteran</td>
<td>1.6</td>
</tr>
<tr>
<td>Ex-felon</td>
<td>9.1</td>
</tr>
<tr>
<td>High-risk youth</td>
<td>13.5</td>
</tr>
<tr>
<td>Vocational rehabilitation</td>
<td>9.2</td>
</tr>
<tr>
<td>Summer youth</td>
<td>1.4</td>
</tr>
<tr>
<td>SSI</td>
<td>9.0</td>
</tr>
<tr>
<td>Food stamp youth (18–24)</td>
<td>21.2</td>
</tr>
</tbody>
</table>

**Starting wage (N = 20,205)**

- < minimum wage: 2.4
- $5.15–$5.99: 23.6
- $6.00–$6.99: 35.8
- $7.00–$7.99: 17.1
- $8.00–$8.99: 12.4
- $9.00 and up: 8.7

**Occupational category (N = 20,235)**

- Service: 35.1
- Clerical and sales: 32.6
- Professional/Technical/Managerial: 9.4
- Machine trades: 1.3
- Processing: 0.7
- Structural: 0.7
- Farm/Forestry/Fishery: 0.6
- Other: 19.5

**Firm headquarters (N = 20,493)**

- Wisconsin: 51.4

**Source:** Author’s tabulation of data from Wisconsin’s WOTC/WtW database.

**Notes:** Sample sizes vary slightly because of missing data. See Hamersma (2005) for details about the data set.

---

records. Although these data still cannot identify subsidy claims by employers directly, they do allow for an estimate of the subsidy value for each worker based on his or her wages and tenure.

Both the WOTC and WtW have been reauthorized repeatedly (typically for two years each time) and are currently set to expire again at the end of 2005. The most recent WOTC/WtW-related congressional hearing occurred in 2000. According to the president’s FY 2006 budget, the administration would like to consolidate the funding for the WOTC and WtW with other job-related programs and provide funds to states directly. It is unclear whether this proposal will move forward through potential reauthorization. The remainder of this brief summarizes the current research on the WOTC and WtW in order to contribute to this policy discussion.
No meaningful increase in employment of the disadvantaged can be attributed to the programs.

Effects of the WOTC and WtW on Disadvantaged Workers

Any analysis of the effectiveness of the WOTC and WtW must first consider whether the programs have improved employment rates among the disadvantaged, since that is their primary goal.
fairly small in absolute terms (less than $10 per week) but more than 10 percent of the average earnings in this population ($1,150 per quarter).\footnote{12} However, the effect appears to apply only to the WOTC/WtW job in particular, as overall average earnings are basically unaffected. The lack of a tenure effect is consistent with the 2001 GAO report that concluded firms did not appear to fire eligible workers when their subsidies ran out in order to hire new eligible workers. The report concluded that very few workers reached the maximum subsidy, and that firms’ costs of hiring and training new workers would not make this “churning” cost-effective.

**Costs and Benefits**

An important feature of the WOTC and WtW is that costs are primarily determined by participation. While the programs would cost billions of dollars every year if participation were high, they are in fact much less expensive. During fiscal years 2000–03, tax expenditures on the WOTC and WtW stayed roughly between $400 million and $500 million annually. About $20 million is spent on administration of the programs each year. The WOTC and WtW are small relative to other aid programs, such as food stamps ($24 billion in 2004), TANF ($18 billion in 2004), and the EITC ($33 billion in 2004) (CBO 2005).

The low cost of the WOTC and WtW corresponds to the relatively few individuals served. In fiscal year 2001, just over 500,000 workers were certified; this amounts to an average tax credit of about $1,000 per certification (Hamersma 2003).

Certainly if each certification represented an additional job created by the credit, this would be a very small price tag. However, as noted earlier, there is no evidence of meaningful job creation as a result of these programs. The only measurable benefit appears to be in the form of an earnings premium for subsidized workers. Based on estimates from Wisconsin, the average worker receives perhaps 40 percent of the value of the credit as an earnings premium; the rest remains with the employer (Hamersma 2005).

Given the limited benefits of the WOTC and WtW, they appear much less effective than the EITC in improving workers’ labor market outcomes. While both the EITC and the WOTC and WtW appear to have a positive effect on workers’ income, the EITC has been demonstrated to improve employment rates while the WOTC and WtW, which were designed specifically for this purpose, have not succeeded.\footnote{13} It may not be surprising that a program costing over $33 billion a year has larger effects than two programs costing about $500 million; however, the low cost of the WOTC and WtW is not simply due to lower funding, but is a direct effect of a lack of participation. It is not clear how the costs and benefits would change if the programs operated at a higher level of participation.

**Conclusion**

Employer subsidies for hiring disadvantaged workers have existed in various forms for many years, but have yet to provide the significant improvements in employment for which they were in-

<table>
<thead>
<tr>
<th>TABLE 3. Estimated Effects of the WOTC and WtW</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings per quarter while at relevant job</strong></td>
</tr>
<tr>
<td><strong>Earnings</strong></td>
</tr>
<tr>
<td>Estimated earnings effect of WOTC/WtW certification</td>
</tr>
<tr>
<td><strong>Quarters employed at relevant job</strong></td>
</tr>
<tr>
<td><strong>Tenure</strong></td>
</tr>
<tr>
<td>Estimated tenure effect of WOTC/WtW certification</td>
</tr>
</tbody>
</table>

*Source: Author’s estimates using Wisconsin data, described in detail in Hamersma (2005). Note: Standard errors in parentheses. * Statistically significant at the 95 percent level.
The government may be able to improve participation rates by improving marketing or simplifying administration.

...
Act of 1996 (PL 104-188). Both programs were most recently reauthorized in the Working Families Tax Relief Act of 2004 (PL 108-311) and will expire in December 2005.

5. Unfortunately, data are not available on the number of “dual eligibles” who end up being claimed under WOTC versus under WtW. The IRS, which administers the subsidies, does not require firms to report individual workers’ data.

6. Educational information is available only for a subset of the sample and is not provided in table 1. See Hamersma (2005) for additional demographic variables for this subset.

7. For example, in Wisconsin a few large firms submit many WOTC or WtW applications that are not approved; these firms do not screen the forms for potential eligibility before sending them in.

8. Documentation requirements vary by state, as some states verify status via government administrative records instead of collecting documentation from workers.

9. All relevant forms can be downloaded at http://www.doleta.gov. As an alternative to the usual certification process, workers are also allowed to obtain documentation of their eligibility before the job interview. In this case, they can provide their voucher to their prospective employer; the employer would submit the voucher to the SESA instead of the separate form with eligibility information. In practice, this route to certification is seldom used.

10. This percentage of firms was established by first reweighting the data to make them representative of the 1,838 total firms in Texas and California that met the sample-inclusion criterion (see GAO 2001 for details).

11. See Hamersma (2005) for a theoretical model of these incentives.

12. In some more recent work, Hamersma and Heinrich (2005) find a larger premium for workers in the temporary help services industry than for those in direct-hire jobs.

13. See Hotz and Scholz (2002) for a summary of the estimated effects of the EITC.

14. A similar option already exists within the WOTC and WtW programs but is seldom used.

References


About the Author

Sarah Hamersma is an assistant professor of economics at the University of Florida.
The Tax Policy Center (TPC) aims to clarify and analyze the nation's tax policy choices by providing timely and accessible facts, analyses, and commentary to policymakers, journalists, citizens, and researchers. TPC's nationally recognized experts in tax, budget, and social policy carry out an integrated program of research and communication on four overarching issues: fair, simple, and efficient taxation; long-term implications of tax policy choices; social policy in the tax code; and state tax issues.

A joint venture of the Urban Institute and the Brookings Institution, the TPC receives support from a generous consortium of funders, including the Annie E. Casey Foundation, Charles Stewart Mott Foundation, Cummings Foundation, Ford Foundation, George Gund Foundation, and Lumina Foundation for Education.

The views expressed do not necessarily reflect those of the Urban Institute, the Brookings Institution, their boards of trustees, or their funders.

http://www.taxpolicycenter.org

Permission is granted for reproduction of this document, with attribution to the Urban Institute.

This paper is generously funded by the John D. and Catherine T. MacArthur Foundation. The authors would like to thank Jeffrey Rohaly for his valuable comments and Henry Chen and Mohammed Adeel Saleem for their excellent research assistance and programming.