WR - Tax credits

PROPOSED RENEWAL OF THE WORK OPPORTUNITY TAX CREDIT (WOTC)

Federal tax credits to encourage private-sector employers to hire unskilled workers have been available periodically since the 1970's and have become a key element in the goal of moving millions of welfare recipients into jobs. In 1996, after a 15 month hiatus with no federal job tax credit program, a bi-partisan group in Congress completed a major overhaul of the original Targeted Jobs Tax Credit (TJTC) in response to perceived shortcomings of that program. The new WOTC program will complete a one year "trial period" on September 30, 1997, and needs to be extended and improved.

WOTC provides employers a tax credit equal to 35% of the first $6,000 in wages paid to certain unskilled persons who work a minimum of 400 hours. Qualifying individuals include persons on AFDC for 9 consecutive months out of the previous 18 months; 18-24 year olds who live in an empowerment zone (EZ) or enterprise community (EC); 18 - 24 year olds who are members of families on food stamps for the last six months; veterans on food stamps; vocational rehabilitation referrals; low-income felons; and 16-17 years olds in EZs and ECs (eligible for summer employment only).

Employers participating in the new program recognize that concerns with the old program have been addressed and support the administrative improvements made. However, after six months of experience, they have identified some problems which need to be addressed to improve the program's effectiveness.

- **The combined 400 hour work requirement and 35% credit fail to compensate employers for the higher costs of recruiting, screening, training, and supervising high risk employees.** Since most workers leave before reaching the 400 hour threshold, many to take a better job, employers are forced to commit significant financial and managerial resources to participate in the program with little prospect of recouping that investment. As a result, employer participation in WOTC has fallen far short of expectations.

- **The short-term life of the program also discourages employers from participating.** To earn the WOTC, an employer must change its hiring strategy, procedures, and paperwork in order to hire persons less qualified than it prefers. Many employers require a multi-year program to justify the investment needed to make such significant changes.

Congressmen Amo Houghton (R-NY) and Charles Rangel (D-NY) will introduce a bill to fix these problems. It is likely that the proposed changes will be affordable under the existing cost estimates for WOTC. The Houghton-Rangel bill will:

1. **Increase the value of the credit to 40% for persons working at least 400 hours.**

2. **Grant a partial credit of 25% for persons working at least 120 hours but less than 400.**

3. **Extend the program for three years through September 30, 2000.**

4. **Clarify the welfare category by including persons receiving AFDC benefits for any 9 of the previous 18 months (the current interpretation requires 9 consecutive months).**

If you would like to become a co-sponsor, please contact either David Pearce (225-3161) in Mr. Houghton's office, or Jim Griffin (224-4365) in Mr. Rangel's office.

JOB DISPLACEMENT OR "CHURNING": DOES WOTC CAUSE EMPLOYERS TO REPLACE PRODUCTIVE EMPLOYEES?

In considering the merits of federal tax credit programs encouraging the hiring of unskilled workers, the question has arisen of whether such credits might encourage employers to replace existing workers with new employees who qualify for the credit. The clear answer is NO. The only way that job displacement, or "churning," would even begin to make financial sense to an employer is if the value of the tax credit for the new employee exceeded the costs associated with hiring and training the new person. This is definitely not the case with the WOTC.

Job Displacement and "Churning" Do Not Exist for the Following Reasons:

- **Employers do not discard productive employees, even low-wage entry level workers, and replace them with unskilled persons who have limited work experience.**

  A major challenge for employers hiring entry-level employees is to find persons willing to stay with the job. High-turnover brings constant turmoil and disruption to the work place. Employers asked about "churning" forcefully reject the idea that they would discard a useful employee in exchange for the possibility of receiving a modest tax credit for hiring an individual who will require extensive training and supervision. No evidence exists that even suggests employers "churn" or displace existing workers in order to receive a WOTC.

- **It costs more to hire a new person than an employer can expect to receive in WOTC tax credits for a newly hired person.**

  Human resource professionals calculate that it costs $500 - 1,500 (average: $900) to recruit, screen, and train an entry-level employee. Early WOTC data show that about 75% of entry-level hires thought to be WOTC-eligible are certified as such by state agencies. Of these, only half reach the 400 hour minimum work requirement. For them, the average net credit is just under $1,100. Therefore, for every new hire thought to be eligible for WOTC, an employer can expect to receive a net tax credit of approximately $413 [.75 x .50 x $1,100 = $413]. No employer would invest $900 to hire a person in exchange for a $413 tax credit.

Does WOTC tend to discriminate against those who are ineligible for the credit?

The primary purpose of WOTC is to reduce employer resistance to hiring persons on public assistance. The problem is particularly acute because welfare reform is forcing hundreds of thousands of people lacking basic job skills and work experience into the workforce in a very short period of time. Rather than creating a preference, the WOTC is a public-private partnership which helps "level the playing field" by offsetting some of the higher costs associated with hiring and training these people. Unfortunately, the value to the employer of the WOTC is proving to be inadequate in making public assistance recipients competitive in the job marketplace. Preliminary program results show that the WOTC is not meeting expectations, demonstrating the urgent need for some modifications to the program.

WHY EMPLOYERS DON'T HIRE WELFARE RECIPIENTS

For welfare reform to succeed, private sector employers must be persuaded to undertake actions which they generally believe are contrary to their business interests:

- Recruiting and hiring persons with no job skills or work experience;
- Training them in job skills, people skills, and workplace behavior;
- Supervising them closely but with extra patience; and
- Helping them cope with crises in child care, transportation, health, housing, etc.

Most employers won't take on such disruptive and costly burdens. Although WOTC helps compensate for some of the extra costs of bringing persons on public assistance into the workforce, the program is not yet achieving the desired results. Too few employers are participating because WOTC fails to offset a sufficient portion of the employer's higher costs.

The WOTC is equal to 35% of the first $6,000 of wages, so the maximum credit would appear to be $2,100 [.35 x $6,000]. However, since the amount of the credit must be added to income, its net value to the employer is considerably less. If an employer has a 35% tax rate, the tax bill on a $2,100 WOTC credit would be $735. Therefore, a $2,100 credit would have a net value to the employer of $2,100 - $735, or $1,365.

Most WOTC-eligible employees don't earn the maximum credit, of course. In fact, it is expected that the average net credit for WOTC-eligibles who work at least 400 hours will be about $1,100. Furthermore, since only 75% of those thought to be WOTC-eligible turn out be eligible, and since less than 50% of those eligible will complete 400 hours of work, only 37.5% (50% of 75%) of those thought to be eligible will actually earn a tax credit. Therefore, the tax credit an employer can expect for each employee thought to be WOTC eligible is only 37.5% of $1,100, or <u>$413</u>. Human resources experts calculate that it costs $500 - 1,500 per person (national average: $900) to hire and train new employees, so the employer of WOTC eligible persons will not, on average, even come close to recovering the higher costs associated with employing those persons.

<u>How To Improve Employer Willingness To Hire Those On Public Assistance</u>

The best way to move more people from welfare to work is to increase employer participation in WOTC. That can be done by enhancing the credit and creating a stronger public-private partnership. WOTC should be modified by:

(1) Increasing the value of the credit to 40% for those working at least 400 hours; and
(2) Granting a partial credit of 25% of wages for those working at least 120 hours but less than 400 hours.

This would increase to about <u>$518</u> the net tax credit an employer could expect to receive for hiring a likely WOTC eligible person. This change in expected return will bring more employers into the program, and will result in more public assistance recipients moving successfully from welfare to work.

Calculation for change in expected net credit:

For WOTC-eligible persons working more than 120 hours but less than 400 hours:

1. Assume 250 work hours @ $6/hr = $1,500 total compensation
2. Credit of 25% [.25 x $1,500] = $375.00
3. Less 35% corporate tax rate [.65 x $375.00] = $243.75
4. Assume 25% of WOTC eligibles qualify [.25 x $243.75] =61
5. Adjust for fact that only 75% of those applied for are WOTC eligible [.75 x $61] = <u>$46</u>

Adjust current expected net credit for 40%:

40% is one seventh more than 35%, therefore, increase $413 by one seventh

[$413 x 8/7 (1.143)] = <u>$472</u>

Therefore, an employer hiring a person thought to be eligible for WOTC could expect to receive a tax credit equal to:

<u>$472 + $46 = $518</u>

HOW DOES WOTC DIFFER FROM THE FORMER TJTC PROGRAM?

The new Work Opportunity Tax Credit (WOTC) program was enacted in 1996 as a fundamental transformation of the expired Targeted Jobs Tax Credit (TJTC) program. TJTC was first created in 1978 and was modified and extended periodically until the end of 1994.

The Department of Labor Inspector General and others criticized the structure of the TJTC program because of its potential for abuse. There were two major criticisms of TJTC: (1) employers were not required to try to determine an individual's eligibility for the credit prior to hiring the person, thus creating the potential for a "windfall" for employers; and (2) the "high risk youth" category of eligibility was so broad as to include some young people from middle class backgrounds without genuine need. These two items were changed substantially in WOTC.

WOTC includes the following major changes from the TJTC program:

1. <u>Pre-screening Requirement</u>. WOTC requires an employer to determine whether or not a new employee is likely to be eligible for a tax credit on or before the day a job offer is made. TJTC permitted an employer to gather this information after the person had already started work.

2. <u>Tighter Eligibility Requirements</u>. WOTC specifically targets persons on public assistance or at clear risk of becoming publicly dependent. The main changes from TJTC are (1) requiring that AFDC recipients receive benefits for 9 out of the previous 18 months [TJTC only required that a person be on AFDC for 3 months]; and (2) limiting the youth category to 18-24 year olds either in families on food stamps for 6 months, or living in an enterprise community (EC) or empowerment zone (EZ) [TJTC's "economically disadvantaged youth" category was 18-22 year olds in households with incomes below 70% of the BLS lower living standard]. Both programs have similar eligibility rules for veterans, vocational rehabilitation referrals, and ex-felons.

3. <u>Longer Work Requirement</u>. WOTC requires an eligible employee to work at least <u>400</u> hours before any credit is earned. TJTC had a minimum work requirement of <u>120</u> hours.

4. <u>Lower Tax Credit</u>. WOTC grants a maximum credit of <u>35%</u> of the first $6,000 in earnings. TJTC had a maximum credit of <u>40%</u> of the first $6,000 in earnings.

Preliminary results for the new program have fallen well short of expectations. Many employers are not participating because of the high cost of screening, hiring, training, and supervising persons with poor job skills and minimal work experience. Participation could be increased, and more persons hired, if (a) a partial tax credit of 25% were offered for persons who work at least 120 hours, but don't reach 400 hours; and (b) the credit for those working at least 400 hours were increased to 40%.

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WR - Tax Credits

February 4, 1997

Mr. Bruce Reed
Assistant to the President for Domestic Policy Development
The White House
1600 Pennsylvania Avenue, NW
2nd Floor West Wing
Washington, D.C. 20502

Dear Mr. Reed:

As you know, the New York Times printed an article and editorial regarding hiring tax incentives. At my request, Congressmen Rangel and Houghton sent on Friday the following response to the Times. I thought you would be interested in seeing it.

Sincerely,

William A. Signer
Vice President

CLINTON WILL SEEK TAX BREAK TO EASE PATH OFF WELFARE

Plan Calls for Federal Subsidy to Aid Businesses That Hire Long-Term Unemployed

By ROBERT PEAR

WASHINGTON, Jan. 27 — President Clinton, in keeping with a campaign promise, will soon ask Congress to provide tax credits to businesses that hire long-term welfare recipients, Administration officials said today.

But even before the proposal is formally made, critics have begun to express doubts about whether such credits will achieve their goal. Economists inside the Government and at several universities said that similar credits in the past had provided a windfall to employers without significantly increasing the number of poor people hired.

In the Presidential campaign, Mr. Clinton said that he wanted to create one million jobs for welfare recipients by the year 2000. The new welfare law, signed by Mr. Clinton on Aug. 22, will send hundreds of thousands of people into the job market because it requires most adults on welfare to work within two years of receiving aid.

Under Mr. Clinton's new proposal, to be included in his budget next week, employers could take a credit equal to 50 percent of the first $10,000 in wages paid to long-term welfare recipients — a somewhat bigger subsidy than has been available in the past. Such tax credits have been allowed, in one form or another, for 25 years. The tax credit proposed by Mr. Clinton would be available for hiring people who had been on welfare for at least 18 months. By contrast, the current tax credit, equal to 35 percent of the first $6,000 in wages, is available for hiring people who have been on welfare for 9 of the last 18 months.

Charles C. Masten, inspector general of the Labor Department, said he had studied a tax subsidy known as the targeted jobs tax credit, which provided credits to employers who hired welfare recipients and members of several other low-income groups. That credit was created in 1978 and expired on Jan. 1, 1995.

Mr. Masten reported in 1994 that the tax credit had "virtually no impact on employers' decisions to hire members" of these groups. Indeed, he said, 92 percent of the workers hired under the program would have been hired without the tax credit.

After conducting several audits, Mr. Masten said, "I can only conclude that the tax credit is a windfall for employers since the program is inconsequential in encouraging the employment" of welfare recipients and the other groups it was intended to help.

Moreover, he wrote, "The costs of the targeted jobs tax credit program far exceed its benefits." Auditors estimated that the program had cost $374 million a year and had produced benefits of $140 million a year in wages for people who would not otherwise have been hired. Mr. Masten concluded, "Only about 37 cents of economic benefits were returned for each dollar in tax credits and administrative costs."

But Rahm I. Emanuel, a senior adviser to the President, said tonight that Administration officials believed that the proposed new tax credit would be more effective than earlier versions. He said it was "just one piece of an overall strategy to make work more attractive than welfare." The other elements, he said, include child care, an increase in the minimum wage, health insurance for people leaving welfare and transportation to help people get to their jobs.

Gene B. Sperling, director of the National Economic Council, said, "We specifically designed the proposal for a new tax credit with criticism of the old one in mind."

Critics said that 70 to 90 percent of the people hired under previous programs would have been hired without tax credits. But Mr. Sperling said that employers on their own were unlikely to hire the intended beneficiaries of the proposed new tax credit: people on welfare for 18 months.

Indeed, some employers say that they will be reluctant to hire long-term welfare recipients even with the tax credit. A person on welfare for 18 months or more is unlikely to have the skills, experience or work ethic that employers seek, they say.

Linda Levine, an economist at the Congressional Research Service, said there had been two problems with earlier versions of the tax credit for hiring welfare recipients. In many cases, she said, employers did not know whether job applicants were on welfare because they did not ask, in part because employers feared that they would be sued if they asked. Thus, she said, "the tax credit was usually irrelevant to the hiring decision" and did not alter employers' behavior.

On the other hand, she said, job applicants who advertised the fact that they were on welfare were often stigmatized, and companies were less likely to hire them because the employers believed that they would be less productive than other employees.

Gary Burtless, an economist at the Brookings Institution who has studied the use of the tax credit, said in an interview: "People got fewer job offers if they mentioned to employers that they were covered by this tax subsidy. The result was exactly the reverse of what we anticipated."

Robert B. Reich, who stepped down on Jan. 12 as Secretary of Labor, said that Congress last year passed legislation "to reform the worst abuses in the targeted jobs tax credit program." But he said that such credits would not be a panacea.

In an interview last week, he said: "What worries me about tax credits to induce employers to hire people off welfare is that they may become a sort of stigma. It's like a scarlet letter — a sign to employers that this person could not otherwise get a job."

William A. Signer, a lobbyist for companies that use the tax credit, said the stigma had declined in recent years, as large companies made greater use of the credit.

Mr. Signer said the tax credit had helped hotels, restaurants, supermarkets and other retail stores that hire inexperienced workers with minimal skills and little education. In view of the changes made last year, he said, employers who participate in the program now have a clear incentive to hire more welfare recipients and others who are chronically unemployed.

Republicans in Congress have praised President Clinton for trying to enlist business executives in the effort to hire welfare recipients. But they have also urged him to proceed with caution. In a recent letter to Mr. Clinton, Representative Bill Archer, the Texas Republican who is chairman of the Ways and Means Committee, said, "Welfare recipients should not be given jobs at the expense of the working poor who may not qualify for a corporate tax credit but who nonetheless still need jobs."

Earlier versions of the tax credit spawned a whole industry of personnel consultants who did the paper work necessary to get the tax credit for employers. These companies became potent lobbyists for the tax credit.

"A number of studies found that employers did not significantly change their recruitment policies, but instead relied upon consulting firms to determine which of their newly hired workers coincidentally were members of the eligible population," said Ms. Levine of the Congressional Research Service. "Perhaps somewhere between 70 percent and 90 percent of the credits claimed under the targeted jobs tax credit program were for hiring that would have occurred without benefit of the credit."

NY Times A-1
1/28/97

NY Times
A.20
1/30/97

Tax Credits for Welfare Hires

President Clinton's proposal to give tax credits to companies that hire long-term welfare recipients can modestly boost employment and income of this hard-to-hire group. The positive impact is unlikely to be large, but tax credits are probably the most that Congress is willing to do to protect those who are in harm's way of the new welfare law, which imposes time limits on Federal cash assistance.

Tax credits for employers to hire disadvantaged workers have been used on and off since the 1960's without much success. Indeed, in some cases such programs have hurt the intended beneficiaries — by stigmatizing the subsidized applicant as a problem hire that employers would be better off avoiding. The Administration is well aware of the mixed record of tax credits and has designed its proposal to avoid the major pitfalls.

The plan would give employers a tax cut of 50 percent of the first $10,000 in wages paid to welfare recipients who have been on the rolls for at least 18 months. The credit is larger than that provided by previous programs, giving Mr. Clinton's plan a better chance of enticing employers to participate. He would avoid stigmatizing most former welfare recipients in the marketplace because his plan subsidizes only long-term recipients of welfare. At worst the Clinton proposal will fail to create many new hires, in which case it will not cost Washington much money.

There is, however, a chance the plan will do some good. Prof. Lawrence Katz of Harvard has shown that some tax-subsidy programs during the 1970's and 80's boosted employment of disadvantaged young adults by several percentage points, and raised earnings of adult women by 15 percent and of adult men by 10 percent. Tax subsidies worked better when combined with direct spending on job creation in areas of high unemployment. Mr. Clinton takes heed of this cautiously optimistic reading of the past by proposing to turn over about $3 billion to localities where there is high unemployment and welfare dependency to create private and public work slots. The President is also lobbying churches and nonprofit organizations to create jobs for welfare recipients.

But the plan will be hard pressed to register even the modest gains of the best-run programs from the past. Focusing on job applicants with the poorest skills and employment records will make it hard to score many victories.

The truth is that Mr. Clinton, who signed the bill that will deny cash assistance to long-term welfare recipients, has few other options to soften the blow. A Republican-led Congress is not about to spend enough money on public-sector jobs or any other direct relief to accommodate the number of people who will exhaust cash assistance before they find private-sector work. Mr. Clinton hopes to sell the G.O.P. on a tax cut for employers. For now, that is about all he can do.

Washington, DC 20515

January 31, 1997

The New York Times
229 W. 43rd Street
New York, NY 20036

via facsimile

To the Editor:

We appreciate the recent attention the Times has paid to the issue of granting tax credits to employers who hire welfare recipients (article of January 28 and editorial of January 30). Unfortunately, by linking outdated criticisms of an expired tax credit program to an expected initiative from President Clinton, you have almost totally ignored a year and a half of bi-partisan effort in the Congress (working closely with the Administration and private employers) to create a brand new public-private tax credit program called the Work Opportunities Tax Credit (WOTC) which is just getting underway nationwide. It will be an integral part of the President's efforts to find jobs for millions of welfare recipients.

Although millions of people were helped by the old Targeted Jobs Tax Credit (TJTC) program, its critics charged that many employers were rewarded despite the fact that eligibility for TJTC was not taken into consideration when the hiring decision was made. The new WOTC program addresses that criticism in two ways: it requires employers to screen for eligibility during the job application process, and it tightens the eligibility criteria to assure that the credit is available only for those who have demonstrated a significant history of dependence on public assistance programs.

As your editorial makes clear, welfare recipients and other unskilled persons bring major challenges to the workplace. They require special attention, training, patience, — and extra costs. Most employers refuse to commit the necessary resources for dealing with these "special" cases. Fortunately, some employers are willing to try to integrate those on welfare into their workforce. These employers have found that if they devote the needed resources and time, they can transform public assistance recipients into productive workers. These employers have become comfortable with hiring credits because it provides them with the resources they need to engage in on-the-job training. This new hiring tax credit helps to offset at least a portion of the higher costs associated with employing the hard-core unemployed.

The problem is that not enough employers even know that there is a new program, much less participate in it. What we need to do now is to encourage even more employers, especially small and medium sized businesses, to participate in the national goal of moving people from welfare to work. We urge the President to continue using his bully pulpit to encourage private sector businesses to make greater use of the WOTC program. It is our hope that WOTC will be renewed and expanded in 1997 and that more employers will become aware of and participate in the program.

Amo Houghton

Charles B. Rangel