

Does Work Pay?

A Summary of the Work Incentives under TANF

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The nation's income support system is making welfare recipients' work pay, giving them a realistic hope of moving out of poverty. Today, by working full time at the minimum wage and supplementing her earnings with tax credits, food stamps, and other public assistance, a mother with two children can bring her family's income to almost 120 percent of the poverty level. At the same time, the consequences of not working are potentially devastating, since families unwilling or unable to work may lose all their welfare payments.

This brief focuses on how current state welfare programs, food stamps, the Earned Income Tax Credit (EITC), and tax payments affect a low-income mother's financial incentives to work and how these incentives vary across 12 states.¹ The central finding is that low-income single mothers are significantly better off working, even at minimum wage, than relying solely on welfare, but they gain little from raising their wage rate from \$5.15 to \$9 per hour.

Background

For years, policymakers have struggled to make a paycheck more attractive than a welfare check while ensuring that poor children

do not suffer serious material deprivation. The most recent efforts to promote work have involved replacing Aid to Families with Dependent Children (AFDC) with the Temporary Assistance for Needy Families (TANF) block grant, substantially expanding the EITC, broadening eligibility for Medicaid and other health insurance, and increasing funding for child care programs.

Changes in the cash welfare system, passed as part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA), have altered fundamental features of the old AFDC program. The new law substantially broadens states' authority to set both work requirements and the relationship between earnings and benefits. It also specifies a maximum

five-year lifetime limit on families' receipt of cash assistance under TANF and stipulates that the proportion of state welfare recipients in a work activity must reach at least 50 percent by 2002. While states can respond to these mandates by exempting some recipients from work activities and providing some with assistance beyond the five-year limit, many states are implementing work rules and time limits more stringent than required under federal law. These tough welfare rules make work a more urgent priority, since recipients recognize that they can lose a

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large portion of their already meager income unless they find jobs.

The rewards for work have increased significantly in large part due to recent expansion of the EITC. In 1991, low-income families with two or more children received tax credits of 17 percent on earned income up to \$7,140. By 1997, the subsidy rate had jumped to 40 percent on earnings up to \$9,140. The maximum credit increased threefold, from \$1,235 to \$3,656. Meanwhile, food stamps continue to supplement the incomes of working families, providing about \$150 per month in 1997 to families with \$9,000 in annual cash income.

What do the new policies imply for welfare recipients' work incentives? This brief answers the question by calculating how the total net monthly income of a single mother with two children changes with the hours she works and the wage she earns. Since returns to work can vary significantly by state, the report documents the interactions between earnings, public benefits, and family income in 12 states.

How Does Work Raise a Family's Income?

Poor families receive income from several sources. We focus initially on those income sources that a family working its way off welfare is most likely to receive: earnings, TANF, and the cash equivalent of food stamps. We also take taxes into account since the family will be subject to payroll taxes and federal and state income taxes and may qualify for the EITC. We compare this family's income across states and under four different work scenarios: (1) no work; (2) a part-time job at minimum wage; (3) a full-time job at minimum wage; and (4) a full-time job at \$9 per hour.

As a family of three moves from no work to part-time work at minimum wage (20 hours per week at \$5.15 per hour), its total income grows dramatically, as illustrated in table 1. Across the 12 states, a family of three's income would increase by an average of 51 percent. There is considerable variation across states: In Washington, a family of three moving from welfare with no earnings to part-time minimum wage work would

see a 38 percent increase in income; in Mississippi, the family's income would rise by 108 percent.

Table 1 also shows the effective marginal tax rates² on earnings for the family of three as it moves from no work to part-time minimum wage work that yields a gross monthly salary of \$443. In Mississippi, low benefit levels and the federal EITC actually generate a negative tax rate. This means that for every dollar the family earns, its income increases by more than a dollar. The family would face the highest tax rate in Washington, which has a 30 percent marginal tax rate, meaning that a family keeps \$0.70 for every dollar it earns. The median marginal tax rate on earnings across the 12 states is 12 percent.

Several factors contribute to the substantial variation in work incentives across the 12 states. First, the disparity reflects differences in the level of TANF payments: The incentive to go to work in some states is very high because the basic grant level is so low. If the family lives in a low-benefit state like Mississippi, Alabama, or Texas, its income will rise sharply in percentage terms if the parent begins working. Conversely, if

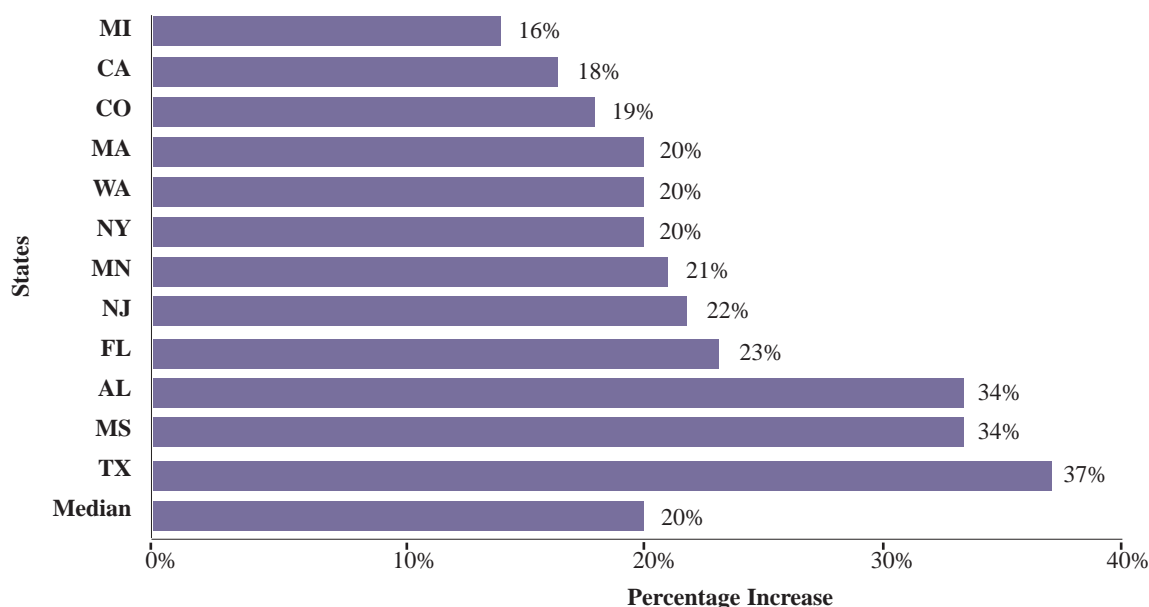
Table 1
Monthly Net Total Income and the Effective Marginal Tax Rates for a Family of Three Moving from No Work to a Part-Time Minimum Wage Job

State	No Work	Part-Time Minimum Wage Job	Percent Change in Net Income	Effective Marginal Tax Rate
Alabama	\$479	\$ 894	87%	6%
California	825	1,226	49	9
Colorado	674	1,041	54	17
Florida	618	1,036	68	6
Massachusetts	825	1,209	47	13
Michigan	743	1,082	46	23
Minnesota	763	1,168	53	8
Mississippi	435	905	108	-6
New Jersey	726	1,066	47	23
New York	833	1,205	45	16
Texas	503	901	79	10
Washington	812	1,120	38	30
Median	734	1,074	51	12

Notes: Net total income consists of earnings, TANF benefits, the cash value of food stamp allotment, the federal Earned Income Tax Credit, and state earned income and other tax credits, less the employee's share of payroll taxes and federal and state income tax liabilities.

The effective marginal tax rate is the percentage of a family's increase in earned income that is offset by lost benefits and increased tax liabilities.

Figure 1
Percentage Increase in Monthly Net Total Income for a Family of Three
Moving from a Part-Time Minimum Wage Job to a Full-Time Minimum Wage Job in 12 States



Notes: Net total income consists of earnings, TANF benefits, the cash value of food stamp allotment, the federal Earned Income Tax Credit, and state earned income and other tax credits, less the employee's share of payroll taxes and federal and state income tax liabilities.

Program rules are based on the Urban Institute's summary of state TANF plans, legislation, and regulations as of October 1997.

the family lives in a high-benefit state like New York or California, the family's earned income from a part-time minimum wage job will be relatively small compared to the size of the family's TANF grant. Even though the incentive to work is larger in low-benefit states, the family would still have more income in high-benefit states.

Second, state policies differ in how the TANF grant declines as a family's earned income rises. For example, in California a family can keep the first \$225 it earns a month and loses only \$0.50 of TANF benefit for every dollar thereafter; in contrast, a Washington family's TANF grant falls by \$0.50 on the dollar beginning with the first dollar earned. When a parent with two children begins working part time, earning minimum wage, her TANF grant falls by \$221 in Washington but by only \$109 in California. Because benefits phase out relatively quickly in Washington, the effective marginal tax rate on earnings is 30 percent in Washington, compared with 9 percent in California.

In general, when the parent in a family that had been relying solely on

public assistance begins working part time at minimum wage, the family faces low effective marginal tax rates, and the family's net income grows significantly.

Figure 1 illustrates that as a family moves from part-time work (20 hours per week) to full-time work (35 hours per week) at minimum wage—a 75 percent increase in work effort—its total income grows by 20 percent, on average. This is a far smaller increase than the one enjoyed by the family when it moved from no work to part-time work at minimum wage. The variation across states is also much smaller, with an increase ranging from a low of 16 percent in Michigan to a high of 37 percent in Texas. The effective marginal tax rate faced by a family of three as the parent moves from part-time to full-time minimum wage work ranges from 0 percent in Texas to 47 percent in Michigan. The median is 28 percent.

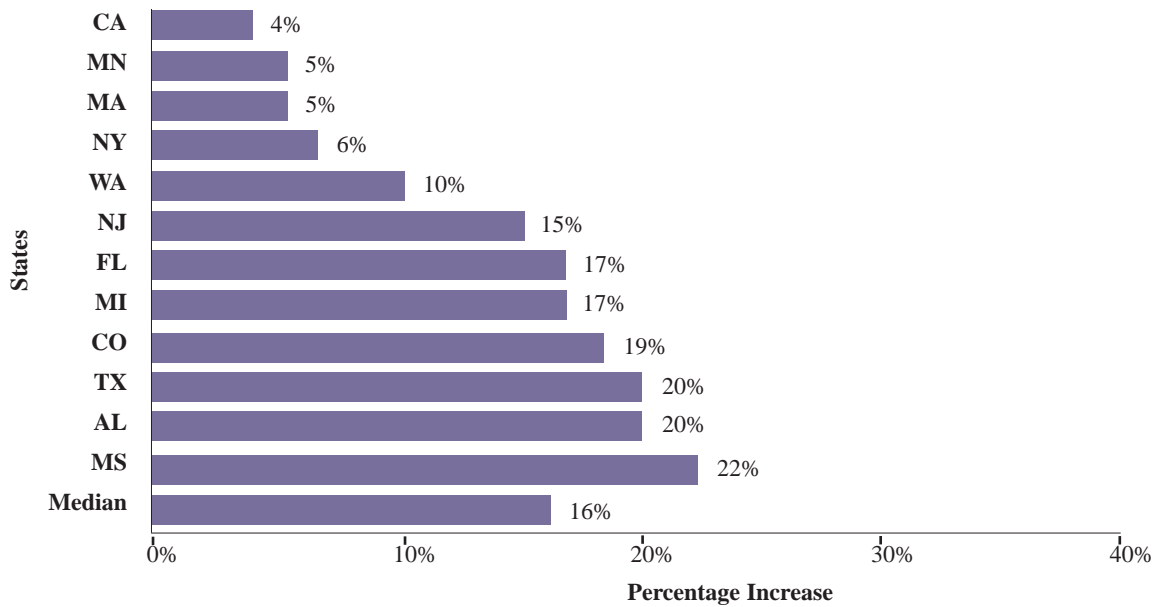
As a family moves from full-time work at minimum wage to full-time work at \$9 per hour—a 75 percent increase in earnings per hour—its total income grows by 16 percent, on

average. Figure 2 shows that the increase ranges from a low of 4 percent in California to a high of 22 percent in Mississippi. The median tax rate across the 12 states is 65 percent, ranging from 55 percent in Mississippi to 89 percent in California and Minnesota.

Table 2 shows that by the time a single mother with two children is working full time at \$9 per hour, her family's net income is well above the poverty level. In fact, even a full-time minimum wage job brings the family above the poverty level in all 12 states when supplementary benefits are added to earnings.

Figure 3 shows how the composition of a family's income changes as the parent works more hours for higher wages. We use Colorado as the example because it is close to the median of the 12 focal states in all work scenarios. When the parent works part time at a minimum wage job, earnings (less taxes) comprise about 40 percent of net monthly income, less than the TANF grant and food stamp benefit combined. The family loses all TANF benefits when

Figure 2
Percentage Increase in Monthly Net Total Income for a Family of Three
Moving from a Full-Time Minimum Wage Job to a Full-Time \$9/Hour Job in 12 States



Notes: Net total income consists of earnings, TANF benefits, the cash value of food stamp allotment, the federal Earned Income Tax Credit, and state earned income and other tax credits, less the employee's share of payroll taxes and federal and state income tax liabilities.

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it moves from part-time to full-time work, but its net monthly income grows from \$1,041 to \$1,243. The loss of TANF benefits is partially offset by the increase in the federal EITC, which comprises a quarter of the family's income. Once the parent's wage rate increases to \$9 per hour, the family's monthly income rises to \$1,478, with earnings accounting for 82 percent of income. The federal EITC is phasing out, comprising 15 percent of the family's income, and food stamp benefits are negligible.

Figure 3 also illustrates that working one's way off welfare is not just a matter of replacing one income source with another, but of increasing overall financial well-being as well. Indeed, work pays mainly because of the continued federal financial commitment to working families. As a family moves from part-time to full-time minimum wage work, the federal EITC program actually increases the family's benefit, adding approximately 10 percent to the family's income. Without the EITC, the family's net monthly income for part-time

minimum wage work would be \$864; moving to full-time work at minimum wage would increase the family's income by \$74. With the EITC, the family's monthly income increases by \$202, from \$1,041 to \$1,243. On average across all 12 states, the EITC is responsible for well over half the income gain enjoyed by families moving from part-time to full-time minimum wage work. While the EITC does phase out as income continues to grow, it still provides positive benefits at income levels at which the family is ineligible for, or receives very small benefits from, other programs in the social safety net.

What about Other Public Assistance Programs?

TANF, food stamps, and the EITC are not the only public assistance programs that aid needy families. Other forms of assistance include federal housing assistance, child care subsidies, and Medicaid.³ Although these programs are not

included in this analysis, they have the potential to greatly affect the well-being of a family shifting from welfare to work.

Housing

Some families on public assistance can live "rent free" by staying with relatives, but most have to pay rent. Historically, most families receiving cash assistance under AFDC did not receive public housing subsidies.⁴ Because housing assistance effectively increases a family's net income but phases out as earned income grows, the incentives to work would be lower for families receiving housing assistance. Still, a family of three receiving housing assistance would raise its net income by 29 percent if the parent took a part-time job at minimum wage. Without housing assistance, median income would rise by 51 percent.

Child Care

While some parents may be able to avoid paying for child care by relying on relatives or other informal sources of care, many others have to

Table 2
Monthly Net Total Income as Percentage of Poverty for a Family of Three
under Four Work Scenarios in 12 States

State	No Work	Part-Time Minimum Wage Job	Full-Time Minimum Wage Job	Full-Time \$9/Hour Job
Alabama	44%	83%	111%	134%
California	77	114	134	140
Colorado	63	97	115	137
Florida	57	96	118	138
Massachusetts	77	112	134	141
Michigan	69	100	117	136
Minnesota	71	108	131	137
Mississippi	40	84	113	137
New Jersey	67	99	121	138
New York	77	112	134	143
Texas	47	84	114	138
Washington	75	104	125	138
Median	68	100	119	138

Notes: Net total income consists of earnings, TANF benefits, the cash value of food stamp allotment, the federal Earned Income Tax Credit, and state earned income and other tax credits, less the employee's share of payroll taxes and federal and state income tax liabilities.

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pay for care themselves or rely on a child care subsidy provided by the state.⁵ Typically the state maximum payment is set equal to the market rate as determined by state surveys. Copayments for child care can vary based on family size, family income, and the number of children receiving care. Copayments for families with low earnings are low and subsidies are pegged closely to cost, so these subsidies should offset the child care costs associated with work, leaving work incentives unaffected. However, neither child care subsidies nor spots in child care centers are guaranteed.⁶ Thus, in practice, child care needs may remain a significant obstacle to work if subsidies are not available and/or a mother cannot find an acceptable child care provider.

Medicaid

The Medicaid program provides health care to low-income and medically needy families. Academic research confirms what policymakers have long feared: Potential loss of Medicaid benefits deters families from leaving welfare for work (Winkler 1991 and Yelowitz 1995). Indeed, historically, while families

receiving AFDC were categorically eligible for Medicaid, many low-wage workers had no health insurance (Uccello 1998). Since loss of Medicaid is a strong disincentive to leave welfare for work, the Family Support Act of 1988 requires states to provide Medicaid coverage for up to 12 months for families leaving AFDC for work. Under waivers, some states expanded coverage for up to 24 months.

PRWORA broke the direct link between eligibility for cash assistance and Medicaid. While states have a great deal of flexibility in setting cash benefit levels, earnings disregards, and benefit reduction rates for aid under TANF, they must use policies that are at least as liberal as those under their old AFDC rules when determining eligibility for Medicaid (Ellwood and Ku 1998). Further, families that leave TANF for work are still eligible to receive 12 months of Transitional Medicaid Assistance (TMA).⁷ Once transitional Medicaid benefits are exhausted, Medicaid expansions now provide coverage to all children under 6 years of age living in families with incomes below 133 percent of the federal poverty

level and to all children born after September 30, 1983, living in families with incomes below the poverty level (Ellwood and Ku 1998). Many states also cover children in near-poor families under Medicaid and the new Children's Health Insurance Program (CHIP).

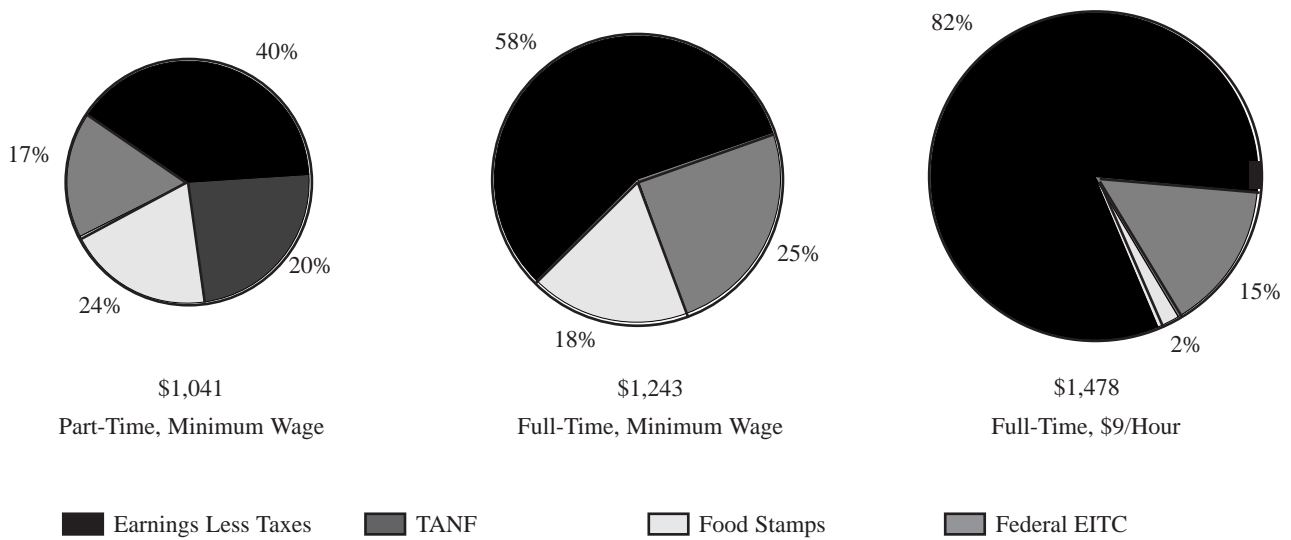
As long as TANF recipients understand Medicaid's eligibility rules, fear of losing Medicaid should not deter TANF recipients from leaving welfare, but TANF recipients may not realize that they can continue to receive Medicaid when they leave TANF.⁸ Given the lack of knowledge about transitional Medicaid benefits, the fear of losing Medicaid may still discourage some recipients from leaving welfare. In addition, adults who exhaust their transitional Medicaid may subsequently return to public assistance to obtain health insurance.

Nonfinancial Work Incentives

Time Limits

Restrictions on the number of years families can receive TANF benefits increase the incentive to leave

Figure 3
Income Composition of a Family of Three in Three Work Scenarios (Colorado)



welfare for work and to avoid welfare in the first place. The magnitude of the effect of time limits depends on TANF recipients' views of the future and their awareness of the time limits. Under a lifetime limit, receiving benefits this month means forfeiting a month of benefits that might be needed in the future. For families who worry about their future need for TANF benefits, time limits certainly add to the incentive to move from welfare to work. However, for families unconcerned about future TANF benefits, unaware of the time limits, or expecting an exemption from the time limits, the impact on work incentives may be minimal.

Work Requirements

Under TANF, states require able-bodied adult recipients to work or engage in work-related activities. Generally, the family has some time to "get its act together" before the work requirements take effect, and families with very young children may be exempt from the work requirements.⁹ If the parent fails to comply with work requirements, she will be sanctioned and her TANF benefits will be reduced. Work requirements are likely to strengthen the incentive to move from welfare to work since a TANF recipient can no

longer devote all her time to her children in lieu of work-related activities.

Conclusions

Federal and state income support policies offer big rewards for going to work at least part time, even at low wage rates. Some states encourage work by setting very low benefit levels, while others encourage work by allowing employed recipients to keep more of their TANF benefits as they begin working. To keep program costs manageable, these states must reduce grants rapidly, which means that recipients face high marginal tax rates as they work more hours and at higher wage rates.

The combined effects of rules under state TANF programs and the federal Food Stamp and Earned Income Tax Credit programs are twofold. First, work pays, even at low wages and even in a part-time job. Earnings at the minimum wage for 35 hours a week, together with government supplements, bring a family of three to an income about 20 percent above the federal poverty level. Not working and relying entirely on government benefits would leave such a family 32 percent below the poverty level. Second, the financial gain from increased wages

can be minimal. A family with a full-time working mother with two children will see only a 16 percent increase in income from a 75 percent raise from the minimum wage to \$9 per hour. Thus, current policies encourage recipients to work some hours, even at low-paying jobs, but yield only modest returns from additional work or increases in pay.

Mistaken impressions about these programs and how they interact with other public benefits may affect the work choices of recipients and families eligible for welfare. Work will look less attractive to TANF recipients who incorrectly believe that Medicaid coverage will end when they leave welfare or who are unaware of child care subsidies. Families may not recognize the work incentives built into the EITC, since nearly all receive their payments as a lump sum based on their work during the prior year. If families view the EITC as a windfall instead of a subsidy to earnings, their perceived financial gains from working may be far below the actual incentives. Policymakers may, therefore, wish to engage in outreach activities to ensure that TANF recipients know how much work really pays.

Notes

1. These states are Alabama, California, Colorado, Florida, Massachusetts, Michigan, Minnesota, Mississippi, New Jersey, New York, Texas, and Washington. These 12 states contain a large portion of the nation's population, including about half of the nation's Aid to Families with Dependent Children (AFDC) recipients. The 12 states represent a broad range with respect to geography, fiscal capacity, citizen needs, and traditions of providing government services. Focusing on these states presents us with a fairly general, albeit incomplete, picture of the work incentives facing TANF recipients.

2. Effective marginal tax rates are the percentage of a family's increase in earned income that is offset by lost benefits and increased tax liabilities. For example, if a family's earnings rise by \$100, but after welfare payments are reduced and tax liabilities are assessed, the family's net income rises by only \$25, the effective marginal tax rate faced by this family is 75 percent—out of the additional \$100 earned, 75 percent was "taxed" away, leaving the family only \$25 better off.

3. Families with very young children may be eligible for food vouchers through the Women, Infants, and Children (WIC) program. Some states also run General Assistance programs, but most such programs provide aid to families and individuals who are not eligible to receive federal cash assistance.

4. Estimates are that only 20 percent (Kingsley 1997) to 25 percent (*Green Book* 1998) of the AFDC caseload received public housing assistance.

5. Federal funds are provided to the states in a block grant, giving states the power to set the income limits for eligible families, the family copayment for child care subsidies, and the maximum amount that the state will pay to child care providers.

6. The entitlement for child care assistance that existed prior to PRWORA has been replaced by strong financial incentives for the states to make serving the welfare populations their first priority. See Long et al. (1998) for detailed information on child care subsidies before and after PRWORA.

7. The 12-month period of TMA is divided into two six-month periods. For the first six months, the family's benefit remains unchanged; for the second six months, states can require the family to enroll in a managed care program, reduce services, and require some copayment or contribution toward premiums.

8. A study by the Southern Institute of Families and Children found that three out of four welfare families interviewed in

North Carolina and Tennessee had misconceptions about Medicaid coverage. Further, community organizations working with welfare families in these two states were generally unaware of transitional Medicaid benefits (Ellwood and Ku 1998).

9. For a detailed description of work requirements, see Gallagher et al. (1998).

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