

The Strained Case for the Work Opportunity Tax Credit Antidote

to the Problems of the Hard to Employ

Tiffany Davidson

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Professor Beckley

Washington and Lee University

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I. Context for the Work Opportunity Tax Credit

On the right, there were many years of anecdotes about “welfare queens” driving Cadillacs and teaching their children that welfare made working unnecessary. On the left, there was an assumption that welfare was a necessary aid to the poor, but also a growing concern about welfare dependence being a way of life handed down from generation to generation. Years of debating about welfare reform culminated in comprehensive legislation in mid-nineties that focused on promoting work, responsibility and self-sufficiency and embodied a recognition that getting a job did not solely depend on wanting one.

The welfare reform bill, the Personal Responsibility and Work Opportunity Reconciliation Act of 1996¹ (PRWORA), contained strong work requirements, strict child support enforcement, supports for families moving from welfare-to-work—including increased funding for child care and transitional medical coverage,—pressure for states to reduce welfare caseloads, and a performance bonus to reward states for reducing their welfare caseloads. Temporary Assistance for Needy Families (TANF), a block grant program established by Title I of PRWORA, devolved to the states primary responsibility for designing programs to assist needy families in becoming self-sufficient members of the work force. TANF also imposed a five year limitation on the provision of assistance funded by the federal block grant to adults.² Combined with the then newly increased minimum wage and the Earned Income Tax Credit (EITC)—which provided a refundable federal income tax credit to low-income workers—

¹ Pub. L. No. 104-193, 110 Stat. 2105.

² There is a 20% exemption of the average monthly number of families to which assistance is provided under the State program funded under TANF can be exempt from the time limit for hardship or if the family includes an individual who has been battered or subjected to extreme cruelty. I.R.C. § 51(2003).

PRWORA was to make work pay for more Americans. Additionally, the fervor for employment subsidies was reborn.

Any welfare-to-work initiative has to consider the constraints of the labor market. Now that the provision of federal welfare assistance would be limited to five years, Congress had to address the problems that the limitation might present to those with barriers to employment—the low skilled, unskilled, and poorly educated. To this end, Congress implemented the Work Opportunity Tax Credit.

Created in 1996 by the Small Business Job Protection Act, the Work Opportunity Tax Credit (WOTC) became one of two tax credit programs aimed at stimulating the demand for employees from targeted groups by providing employers with a tax credit for hiring them. The Taxpayer Relief Act of 1997 created the Welfare-to-Work Tax Credit, a more generous credit for hiring long-term public assistance recipients³. Although the substantive requirements are different, these two tax credits are coordinated and the certification process is the same so that an employer cannot claim both credits for the same individual. This employment strategy seems to be a carefully planned compromise: It channels resources to aiding those living in poverty while meeting popular demand to put individuals who are dependant on public assistance to work. But even if members of the targeted groups move from welfare into employment will these individuals be better off in terms of acquiring skills that would allow for position advancement,

³ The other tax credit program, the Welfare-to-Work Tax Credit, was enacted a year after the WOTC. It added long-term welfare recipients to the list of target groups. The qualified individuals are those who are (1) members of a family that has received family assistance (i.e., AFDC/TANF or a successor program) for at least 18 consecutive months ending on the hiring date; (2) has received family assistance for a total of at least 18 months (whether or not the 18 months are consecutive) beginning after the day of enactment (August 5, 1997), and has a hiring date that is not more than two years after the end of the earliest 18-month period; or (3) whose AFDC/TANF eligibility expired under a Federal or State law after the day of enactment (August 5, 1997), for applicants hired within two years after their eligibility expired. The Welfare-to -Work Tax Credit is coordinated with the WOTC so that in any one taxable year an employer cannot claim both credits with respect to the same individual. The Welfare-to-Work Tax Credit for new hires employed 400 or more hours or 180 days is 35% of qualified wages for the first year of employment and 50% for the second year. Qualified wages are capped at \$10,000 per year.

unsubsidized work, earning enough to live above the poverty level, or long-term employment? If not, the likely result is that the welfare rolls will shrink—but only by increasing the ranks of the working poor. If that is a “success,” it should not be. Since its enactment, WOTC has been reauthorized five times and again expired on December 31, 2003.⁴ Pending legislation seeks to extend WOTC for one more year (retroactively through December 31, 2004),⁵ yet with approximately twenty million dollars⁶ a year being allotted by the federal government to the states for the administration of the WOTC to support a four hundred and thirty million dollar tax expenditure,⁷ surprisingly little has been done to determine the extent to which the tax credit has aided the hard to employ.

This paper focuses on the WOTC and argues that a harder look should be taken to assess the value of continued reauthorization of the WOTC. Legislators should not look at only the tax credit’s ability to get individuals a job, but also at the WOTC’s affect on the promotion, long-term employment, acquisition of skills and in lifting the targeted individuals out of poverty. This paper examines the WOTC’s “success” and outlines the type of additional studies needed before meaningful review of the program can be achieved. It does so by exploring the context in which the WOTC arose, the reasons for its implementation, and the history of like credits. This paper also questions why we would think that the WOTC would fare any differently from employer-

⁴ Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (authorized WOTC through to September 1997); Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (reauthorized WOTC through to June 30, 1998 and retroactively to its last date of expiration); Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277 (reauthorized WOTC through to June 30, 1999 and retroactively to its last expiration); Tax Relief Extension Act of 1999, Pub. L. No. 106-170 (reauthorized WOTC through to December 31, 2001 and retroactively to its last date of expiration); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147 (reauthorized WOTC through to December 31, 2003 and retroactively to its last date of expiration).

⁵ H.R. 3521, 108th Cong. (2003).

⁶ U.S. Dep’t of Labor, Employment and Training Administration, Work Opportunity Tax Credit State Allotments: FY 2003 vs. FY 2002, *available at* http://wdr.doleta.gov/directives/attach/TEGL23-02_AttachVII.pdf.

⁷ Budget of the United States Government, 2005 Analytical Perspectives, estimate of total income tax expenditures, 2003 estimate, *available at* <http://frwebgate.access.gpo.gov/cgi-bin/multidb.cgi>

based tax credits in general, or its failed predecessor in particular. Answering these questions may suggest that the case for the WOTC has been met with unwarranted enthusiasm.

II. Employer-based Compared to Employee-based Subsidies

The Congressional Budget Act of 1974 defined tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”⁸ Tax expenditures are designed to encourage desired behavior by granting special tax relief to those who act in accordance with the desired behavior. One such expenditure is an employment subsidy in the form of a tax credit. An employment subsidy is a payment by the government that can be either employer-based—made to an employer to assuage the cost of employment—or employee-based—made to an employee to supplement income. Tax credits, which provide a dollar for dollar reduction in one’s tax liability by reducing the amount of taxes owed to the government, are considered to be revenue owed to the government foregone in order to encourage certain behavior. Thus, tax credits are considered to be a payment made by the government.

Employer-based tax credits have advantages: they influence employer behavior, they can be better exploited because employers are better equipped to deal with IRS practices and procedures than are the employees such subsidies tend to target, and targeting is likely to be more accurate. Employer-based wage subsidies can be used to influence behavioral changes in employers in a way that employee-based tax credits cannot. The benefits of adhering to the policy behind an employer-based tax credit accrue to the employer. In administering employee-

⁸ Joint Economic Committee, 106th Cong., Tax Expenditure: A Review and Analysis 99 (Comm. Print 1999), Lexis 99 CIS J. Print 84219.

based subsidies in the form of tax credits, the IRS's practices and procedures have not reflected the lack of adequate information about filling out tax forms and the lack of ability to pay a tax preparer that attend taxpayers entitled to such subsidies. Complicated IRS procedures may frustrate the goal of supplying employees with a tax credit. Employers tend to be better situated, than low-wage employees, to ensure such a tax credit actually influences the desired behavior and is used. Additionally, the provision of an employer-based wage subsidy has tended not to rest solely on a worker being classified a low-wage worker. Past employee-based subsidies have relied on income to determine whether or not an individual qualified for the tax credit. A flaw in using income as the sole criteria for provision of the credit is that not all low-wage workers are part of low income families.⁹ Such employee-based subsidies are also unable ensure that individuals who have large savings or investments, or are increasing their human capital while being supported by someone else do not benefit. So an employer-based tax credit is better able to target low income families. The administrative requirements of targeting an employee-based tax credit to low income families in a way similar to that of past employer-based subsidies would likely be too much of a strain on a low income family in terms of paperwork and the need for continued verification of eligibility.

Although employer-based subsidies have some advantages over employee-based subsidies, employer-based subsidies have been characterized by low participation rates.

⁹ The largest existing employee-based subsidy is the earned income tax credit. An individual who is 25 or older, single, and living at home with his or her parents can qualify if the individual worked, was not a student and earned less than \$11,230. The individual's parents cannot claim him or her as a dependent. The individual will qualify for the credit regardless of the wealth of his or her parents..

Employee-based wage subsidies appear comparatively more successful¹⁰ in “inducing additional labor market participation and raising incomes.”¹¹

Studies have offered three explanations for the low participation rates of employer-based subsidies relative to employee-based subsidies. First, the impact of an employer-based subsidy may differ across firms and across industries. Firms and industries that are understaffed because of the cost of employment or that can easily increase output at low cost will respond to an employment subsidy with greater desired behavioral change (i.e. hiring more workers) than firms with less job availability or ability to expand.¹² Anne L. Alstott in *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, articulated an inherent limitation, and possible perverse result, associated with employer-based wage subsidies:

The effects of an employment subsidy depend heavily on market conditions, including the responsiveness (or elasticity) of the supply and demand for labor to changes in the wage rate.

....

... If labor supply is very inelastic, the program can raise wages but not employment. In that case, low-wage workers who take jobs will be better off, but the subsidy will not expose larger numbers of workers to the "discipline of work" that proponents seek. An employment subsidy can raise employment if labor supply is highly elastic, but workers will earn something very close to the prevailing wage, frustrating the goal of raising living standards for the working poor.

....

The tradeoff is that targeting opens the way for displacement, which occurs when subsidized jobs are not new jobs but instead are shifted from the nontargeted group to the targeted group. A targeted subsidy potentially encourages the substitution of (now-cheaper) targeted workers for nontargeted workers.

....

¹⁰ Internal Revenue Service, *Tax Stats at a Glance*, at <http://www.irs.gov/taxstats/article/0,,id=102886,00.html> (Earned Income Tax Credits claimed for the Tax Year 2001 equaled \$33.4 billion; WOTCs issued equaled 438,604 in 2001).

¹¹ Stacy Dickert-Conlin & Douglas Holtz-Eakin, *Employee-Based Versus Employer-Based Subsidies to Low-Wage Workers: A Public Finance Perspective*, in *Finding Jobs: Work and Welfare Reform* 262, 263 (David E. Card and Rebecca M. Blank eds., 2000).

¹² Anne L. Alstott, *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, 108 *Yale L.J.* 967, 1020 (1999) (arguing that employment subsidies have some benefit but are too heavily centered on questionable claims about the “intrinsic or instrumental value of paid work” that motivated the 1996 welfare legislation).

... If the goal of the policy is simply to increase employment of Type A workers, and the government really does not care about employment levels of other workers, then it should be very happy with a targeted employment subsidy that increases the employment of Type A workers by 100 and reduces the employment of Type B workers by 100. But if the employment prospects of Type B workers also matter, then a problem arises.¹³

Employer-based wage subsidies may provide an incentive for employers to hire the targeted individuals at the expense of individuals who are not a part of that group. If the labor market cannot create new jobs, the possible result of a strong incentive to hire certain individuals is that those employees who are not able to supply the employer with the benefit will either be fired if already employed or not hired when seeking a position. Because employers do not accrue any tax benefit from hiring targeted individuals when the tax credit is employee-based, employee-based credits avoid displacement—the replacement of unsubsidized workers with subsidized workers—incentives. Similarly, when the employment subsidy is employee-based there is no incentive for churning—employers’ manipulation of turnover rates to maximize their tax credit by hiring several subsidized workers for short periods of time and replacing them with other subsidized workers.

Second, targeting employer-based wage subsidies to specific individuals can add to an employer’s administrative costs.¹⁴ Past employer-based subsidies have required an exchange of information between workers, the state employment agency in charge of certifying employees as eligible for the credit, and employers. Many employers employ management assistance companies to handle the paperwork associated with the tax credit; however, the use of these firms may not be financially feasible for smaller businesses.¹⁵ Employee-based wage subsidies,

¹³ *Id.* at 1021-29.

¹⁴ Janet Holtzblatt, *The Earned Income Tax Credit: Interview with Janet Holtzblatt, Deputy Director of the Individual Taxation Division in the Department of the Treasury's Office of Tax Analysis*, 8 *Geo. Pub. Pol’y Rev.* 54, 62-63 (Fall, 2002/Winter, 2003), available at Lexis 8 *Geo. Pub. Pol’y Rev.* 54.

¹⁵ Dickert-Conlin & Holtz-Eakin, *supra* note 9, at 290.

on the other hand, are typically administered through the employee's tax return and have no participation costs to the employer.

Third, there is a stigma associated with having to identify ones' self as belonging to a targeted group. For targeting to be effective in the context of an employer-based subsidy, an employer must identify the targeted workers. Employer-based subsidies thereby provide employers with personal information about the employees—the characteristics that make them eligible for the tax credit.¹⁶ If the employee perceives the information to be stigmatizing or personal, the employee may not disclose it. The stigma may not affect only employees' desire to participate in the program, but also employers' desire to participate.¹⁷ Conditional certifications (acquired by a prospective employee, to be presented at job interviews, as documentation that the prospective employee has been tentatively determined eligible as a member of a WOTC target group, and therefore hiring this person may lead to an employer certification under the WOTC program) have been used in the past as one way in which a worker can be certified as eligible to supply the employer with a tax credit. Providing a prospective employer with information about the employee's status as a member of one of the targeted groups may generate employer discrimination as a result of the possibly preconceived belief of the low quality or skill of the targeted group members.¹⁸ Even if the employee did not present conditional certification prior to being hired, the subsequent inquiry into the employee's belonging to a targeted group can have the same discriminatory effect with regard to retention. In contrast, an employee-based subsidy can be targeted—although less narrowly—without any intrusion into worker privacy or fear of

¹⁶ Holtzblatt, *supra* note 12; Dickert-Conlin & Holtz-Eakin, *supra* note 9, at 290.

¹⁷ Gary Burtless, *Are Targeted Wage Subsidies Harmful?: Evidence from a Wage Voucher Experiment*, 39 *Indus. & Lab. Rel. Rev.*, 105, 112 (Oct. 1985).

¹⁸ Dickert-Conlin & Holtz-Eakin, *supra* note 9, at 290.

stigma. The eligibility for the credit is strictly between the worker and the Internal Revenue Service.

There are advantages and disadvantages associated with both employee-based and employer-based tax credit, but both kinds of credits can effectively function in tandem. Each kind of credit aims at influencing behavior by different groups who have conflicting interests regarding wages—employees want to earn as much income as they can and employers want to keep their cost of employment low. The EITC, implemented in 1975 and greatly expanded in 1993, is an employee-based wage subsidy which directly supplements the wages of low income individuals by providing refundable tax credits, in part, to provide an incentive to work.¹⁹ EITC reduces an individual's federal tax liability, should it exist, and when the EITC exceeds the amount of taxes owed it results in a tax refund.²⁰ So the EITC, in effect, raises the income of eligible individuals without any additional cost to the employer. The WOTC was an employer-based subsidy that reduced an employer's federal tax liability when the employer hired individuals from certain targeted groups. In effect, the credit lowered the employer's cost of employing that individual. An employer-based tax credit can influence an employer to hire certain otherwise unattractive job applicants by lowering the cost of employing them—an incentive that could not be created by an employee-based subsidy. EITC is a benefit to only those who work, but it does not help to get individuals employed. WOTC aimed at getting people employed. Seemingly, prudent policy making would incorporate both; however, employer-based subsidies have had difficulty in influencing employer hiring practices.

¹⁹ Internal Revenue Service, *EITC Overview*, at <http://www.irs.ustreas.gov/individuals/article/0,,id=96406,00.html>. (It was significantly expanded in the Tax Reform Act (TRA) of 1986 and the Omnibus Budget Reconciliation Acts (OBRA) of 1990 and 1993.)

²⁰ *Id.*

III. The Predecessor Program—Targeted Jobs Tax Credit

The program that preceded the WOTC, the Targeted Jobs Tax Credit (TJTC), evinced some of the problems with employer-based tax credits. The TJTC was enacted in 1978 to help increase job opportunities for designated groups.²¹ The program permitted a business to claim a tax credit if it hired members from the targeted groups. Since its inception, TJTC was repeatedly amended in attempts to correct the program's deficiencies. At the TJTC's last reauthorization, employers could claim 40 percent of the first \$6,000 of wages paid during the first year of employment (for a maximum credit of \$2,400 per worker)²² provided the worker was employed for at least 90 days, or 120 hours.²³ The targeted groups included persons with disabilities referred from state vocational rehabilitation or the Department of Veteran Affairs; economically disadvantaged youth, summer youth, Vietnam-era veterans, and former convicts; and recipients of Supplemental Security Income (SSI), General Assistance,²⁴ or Aid to Families with Dependent Children (AFDC).²⁵

A study conducted by the United States Department of Labor's Office of Inspector General found that the TJTC (1) did not cause employers to hire individuals that they would not otherwise have hired; (2) the amount of the tax credits and the administrative cost greatly outweighed the program's economic benefits; and (3) the majority of jobs provided were "entry level, low paying, low-skilled, part-time positions which [did] not offer benefits."²⁶ Because the program was not an effective and efficient means of helping the members of the targeted groups

²¹ Office of Inspector General, U.S. Dep't of Labor, Rep. No. 04-94-021-03-320, *Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?* (1994).

²² For economically disadvantaged summer youth employees, the credit was equal to 40 percent of up to \$ 3,000 of qualified first-year wages, for a maximum credit of \$ 1,200.

²³ *Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?*, *supra* note 19, at 6.

²⁴ The General Assistance program was a cash assistance program to help needy individuals and families who are not eligible for assistance under any other Federal or state program.

²⁵ *Targeted Jobs Tax Credit Program: Employment Inducement or Employer Windfall?*, *supra* note 19, at 7.

²⁶ *Id.*

obtain jobs, the inspector recommended discontinuance after it expired. The tax credit expired on December 31, 1994, and was not reauthorized.²⁷

In a report of its review of the reinstatement of a tax credit similar to that of the failed TJTC, Congress's Committee on Finance stated the following:

While the prior-law targeted jobs tax credit was the subject of some criticism, the Committee [on Finance] believes that a tax credit mechanism can provide an important incentive for employers to undertake the expense of providing jobs and training to economically disadvantaged individuals, many of whom are underskilled and/or undereducated. The bill creates a new program whose design will focus on individuals with poor workplace attachments, streamline administrative burdens, promote longer-term employment, and thereby reduce costs relative to the prior-law program. The Committee intends that this short-term program will provide the Congress and the Treasury and Labor Departments an opportunity to assess fully the operation and effectiveness of the new credit as a hiring incentive.²⁸

The Administration was hopeful that a properly drafted tax credit would provide an effective means of helping members of the targeted groups find employment.

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IV. Work Opportunity Tax Credit

The WOTC carries an unpromising pedigree. It comes only two years after the discontinuance of TJTC—the last attempt to encourage employers to hire individuals from targeted groups. Despite an unsuccessful past and almost no solid information about the law's effectiveness. Congress enacted the WOTC.

The WOTC was first authorized in the Small Business Job Protection Act of 1996 to improve upon and replace the TJTC. When first authorized, the WOTC was 35 percent of the first \$6,000 of wages—compared to 40 percent under TJTC—(for a maximum credit of \$2,100 per worker). To decrease incentives for churning, the minimum retention period was extended to

²⁷ <http://www.house.gov/jec/fiscal/tx-grwth/wel-work/wel-work.htm>

²⁸ S. Rep. No. 104-281, (1996), Lexis 104 S. Rpt. 281.

180 days, or 400 hours.²⁹ In order to reduce windfalls to employers and to have a larger effect on hiring decisions, employers could claim WOTC only if the employer confirmed that an applicant was eligible before hiring the applicant (which was not the case under the targeted jobs tax credit). Congress simplified the WOTC application process. To focus more narrowly on those that truly needed the credit, the groups targeted under WOTC differed slightly from those under the TJTC. Recipients of SSI benefits or General Assistance were excluded. Certain recipients of food stamps were added. The minimum period of required AFDC/TANF enrollment was extended from at least 90 continuous days under TJTC to nine months under WOTC. Eligibility was extended to some family members of welfare recipients. Finally, qualified youth had to reside in empowerment zones or enterprise communities instead of qualifying under Lower Living Standard Income Level guidelines determined by the Department of Labor.³⁰ The WOTC had since, its inception been, amended a number of times.

The Small Business Job Protection Act of 1996 was entitled an act “[t]o provide tax relief for small businesses, to protect jobs, to create opportunities, to increase the take home pay of workers, to amend the Portal-to-Portal Act of 1947 relating to the payment of wages to employees who use employer owned vehicles, and to amend the Fair Labor Standards Act of 1938 to increase the minimum wage rate and to prevent job loss by providing flexibility to employers in complying with minimum wage and overtime requirements under that Act.”³¹ The legislators who supported the legislation thought the WOTC and other tax relief measures in the Small Business Job Protection Act were necessary to buffer the effects of a minimum wage

²⁹ *Id.* at 6.

³⁰ <http://www.house.gov/jec/fiscal/tx-grwth/wel-work/wel-work.htm>

³¹ Pub. L. No. 104-188, 110 Stat. 1755.

increase on employers.³² The tax credit, however, had as an express policy the desire to aid individuals from certain groups in seeking employment and the credit was targeted so as to be beneficial to only employers who hired individuals from those targeted groups.

The legislators who supported the WOTC made a number of statements regarding what they hoped to achieve by adopting it and how it fit in with other contemporaneous reform.. In proposing that the WOTC be part of the bill to increase the minimum wage, Congressman Amo Houghton, who was responsible for drafting the WOTC provision, stated that “[p]eople come off welfare, they need jobs, [the WOTC] is a way to create incentives for those people who are willing to offer them jobs. It is a wonderful program. It hires those people who have not had jobs and also it helps retain them.”³³ In addition to being concerned about the fate of people who would be leaving the welfare rolls, the Congressman was also concerned with helping small businesses adapt to the increase in the minimum wage, and the common belief that an increase in the minimum wage would lead to job loss in order for some employers to be able to comply.³⁴ Congressman Houghton stated:

For the businesses, what it does is help those businesses that are going to be having an increase in the minimum wage to absorb the cost. As a matter of fact, if you hire an individual, the arithmetic works out that you, in terms of the total 2-year period which you will be hiring this individual and having him work in your

³² 142 Cong. Rec. H5504 (daily ed. May 23, 1996) (statement of Rep. Rahall), Lexis 142 Cong Rec H5504p*5530-31. (“But the Republicans who oppose this increase [in the minimum wage] also did something else besides threaten to commit suicide or to resist with every fiber of their being. They went to their ways and means pharmacy and they concocted an antidote to the democrats poison pill of a bill to increase the minimum wage. They met in the dark of night under a full moon, no doubt, and using potent herbs and verbs, and using the eye of Newt, and hair and nail clippings from known Democrats who use the House barber shop-they developed their antidote and they called it the Small Business Job Protection Act, and cried out that if it was not enacted and administered immediately after enactment of a minimum wage hike, then small business would die. Well, guess what? Democrats are all for helping small businesses the backbone of our nation, and its number one source of job creation. We had no problem with the Small Business Job Protection antidote. So we nearly all voted for it – it passed by a vote of 414 to 10 on May 22.)

³³ 141 Cong. Rec. H10872 (daily ed. Oct. 26, 1995) (statement of Rep. Houghton), Lexis 141 Cong Rec H10872p*10909

³⁴ *Id.* (“what [WOTC] does is take those needy people, who are working off welfare or getting off of food stamps or getting off a whole variety of things, to come into the work force”).

establishment, that the cost will be less than the minimum wage is now because of the incentive which the Government gives.³⁵

Congressman English stated that the “WOTC [was] a critical initiative to bring more people out of the welfare system and into the work force.”³⁶ Congressman Shays stated that “[Congress was] giving a tax credit to individuals that hire what [he] would call the least employable, the people who are on welfare, the people who simply have not had work experience.”³⁷ Many believed the Small Business Job Protection Act increased the minimum wage in a responsible way that would actually help businesses increase jobs, rather than lead to job loss.

The WOTC, at its last reauthorization, equaled 40 percent of the first \$6,000 of wages.³⁸ A credit equal to 25 percent of the first \$6000 of wages was available to employers if the employee remained on the job for 120-399 hours and no credit was available for an employee employed for less than 120 hours.³⁹

In order to qualify for the WOTC, a new employee had to belong to one of nine target groups:⁴⁰

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1) a recipient or member of a family that is receiving or recently received TANF or AFDC; 2) an 18-24 year old member of a family that is receiving or recently received Food Stamps; 3) an 18-24 year old resident of one of the Federally designated Empowerment Zones (EZs), Enterprise Communities (ECs), or Renewal Communities (RCs); 4) a 16-17 year old EZ/EC or RC resident hired between May 1 and September 15 as a Summer Youth Employee; 5) a veteran who is a member of a family that is receiving or recently received Food Stamps; 6) a disabled person who completed or is completing rehabilitative services from a State or the U.S. Department of Veterans Affairs, 7) an ex-felon who is a

³⁵ 142 Cong. Rec. H5445 (daily ed. May 22, 1996) (statement of Rep. Houghton), Lexis 142 Cong Rec H5445p*5469.

³⁶ 142 Cong. Rec. H5445 (daily ed. May 22, 1996) (statement of Rep. English), Lexis 142 Cong Rec H5445p*5469.

³⁷ 142 Cong. Rec. H5445 (daily ed. May 22, 1996) (statement of Rep. Shays), Lexis 142 Cong Rec H5445p*5471.

³⁸ The employer's cost of education and training assistance, health care and dependent care are treated as qualified wages.

³⁹ I.R.C. § 51(2003).

⁴⁰ The Welfare-to-Work Tax Credit (WtW), implemented in 1997, provides a tax credit to employers who hire an individual that is a long-term welfare recipient. For new hires employed 400 or more hours or 180 days, the credit is 35% of qualified wages for the first year of employment and 50% for the second year. An employer cannot claim both the WOTC and WtW for the same employee and thus has to choose one tax credit or the other.

member of a low income family; 8) recipient of SSI benefits; or 9) a New York Liberty Zone Business.⁴¹

The WOTC was only available on an elective basis. To claim the WOTC, employers had to either (a) actually receive certification that the employee was eligible to qualify its employer for the tax credit from the State Employment Security Agency (SESA), the state's office charged with administering the WOTC, before the employee starts work, or (b) complete a "pre-screening notice" on or before the hiring date and submit the notice within twenty-one days of the start date to the state employment agency in charge of issuing certifications.⁴² A prospective employee could also independently be conditionally certified, have eligibility predetermined by the SESA, in most states.

Although WOTC reduced only federal tax liability and was not money given to employers directly, WOTC, in effect, saved an employer employing an individual at minimum wage, \$5.15 an hour, for 1166 hours, \$2,400 off the \$6004.90 cost of employment. So the incentive to hire WOTC eligible low wage workers was high—a subsidized employee hired for \$5.15 an hour would actually cost the employer approximately \$3.09 an hour—but because of the cap on the credit the savings became less pronounced as wages increased. The number of new hires who could qualify employers for the tax credit was unlimited.⁴³ But employers had to reduce their tax deduction for wages and salaries by the amount of the credit.⁴⁴ Additionally, because the WOTC fell under what the IRS calls the general business credit the total amount of

⁴¹ *Work Opportunity Tax Credit*, *supra* note 28.

⁴² *Id.* at n39.

⁴³ U.S. Dep't of Labor, *Hiring Welfare Recipients Can Reduce Employer Taxes by \$8,500 Per New Hire: The New Welfare-to-Work and Work Opportunity Tax Credits*, available at <http://wtw.doleta.gov/resources/fact-taxcredits.pdf>

⁴⁴ U.S. General Accounting Office, Rep. No. GAO-01-329, *Work Opportunity Tax Credit: Employers do not Appear to Dismiss Employees to Increase Tax Credits* (2001).

WOTC credits claimed was subject to a yearly cap.⁴⁵ The yearly cap makes the tax credit less beneficial for businesses with very large tax liabilities.

The Department of Labor prescribed for the SESAs internal controls for verifying an applicant's eligibility and for reporting the results of an applicant's activities: (1) a quality review by a second SESA staff person conducted within 48 hours after eligibility was determined by a member of the SESA's staff; (2) establishment and maintenance of appropriate forms review, record keeping, and reporting capability; and (3) periodic random sample audits of individuals certified, and prompt action taken in accordance with the results of the audits.⁴⁶ The SESAs were also to coordinate efforts with other employment agencies to promote the WOTC to employers and job seekers and for the purpose of issuing conditional certifications. Because state agencies were granted broad authority in shaping the management of the WOTC, the Department of Labor's prescriptions provided only planning guidance. So the management of the WOTC program differed from state to state.

Although past studies on employer-based wage subsidies have cast doubt on the effectiveness of such programs, there has been very little attention paid to whether results improved under the WOTC.

V. Assessment

⁴⁵ U.S. Chamber of Commerce, Online Small Business Center, *The General Business Tax Credit*, available at http://www.uschamber.com/sb/business/P07/P07_3222.asp. ("In order to provide some uniform rules about dollar limitations, carrybacks and carryforwards, and other technical details, many of the federal income tax credits available to businesses are lumped together and treated as components of the 'general business credit.'" "[The] total general business credit for the year can't exceed ... net income tax, minus the greater of (1) ... tentative minimum tax, or (2) 25 percent of...net regular tax liability that is more than \$25,000 (\$12,500 for marrieds filing separately). [The] net income tax is [the] net regular tax liability plus [the] alternative minimum tax.") Any amount in excess of the general business credit's yearly limitation can be carried over to the next year.

⁴⁶ U.S. Department of Labor, Employment and Training Administration Advisory System, Training and Employment Guidance Letter No. 1.03, July 3, 2003, available at http://workforcesecurity.doleta.gov/dmstrec/tegl/tegl2k3/tegl_01-03.htm

The basic approach of the 1996 welfare legislation, known as the “work first” strategy, argues: “(1) there are plenty of jobs for those who want to work; (2) by taking any job, even an entry-level job, and sticking with that job, a person will move up the employment ladder; (3) the problem with [individuals reliant on public assistance] is that they do not have the motivation or the incentives to leave welfare and enter the paid labor markets; and (4) the state programs have shown that recipients can be moved from welfare-to-work.”⁴⁷ The administration did, however, recognize that certain members of the poverty stricken population were not particularly appealing candidates for employment. Businesses that hire individuals from certain groups face the potential risk—either real or assumed—that those individuals may be less productive or less skilled than other employees. Wage subsidies are intended encourage employers to assume this risk and to compensate employers for doing so, while providing disadvantaged individuals with income and the opportunity to develop the skills and experience necessary to secure long-term, unsubsidized jobs. But there is little known about whether the WOTC had any affect on employers or whether the credit aided the employment outcomes of the targeted individuals.

A. Where the WOTC has been a Success

The WOTC has experienced all the benefits to be gained from the use of an employer-based subsidy: benefits of the use of the credit accrue to the employer so as to stimulate employer behavior; employers, better equipped to deal with the IRS practices and procedures than are employees who such subsidies tend to target, handle the paperwork; and it has the ability to weed out those that are temporarily in poverty such as unemployed graduate students or adults from wealthy families. In order to rectify the shortcomings of TJTC, the WOTC

⁴⁷ Joel F. Handler, American Regulatory Policy: Have We Found The "Third Way"?: Symposium Paper: The "Third Way" or the Old Way?, 48 Kan. L. Rev. 765, 788 (2000).

reformulated the descriptions of the target groups with the intention of better targeting, simplified the application process and increased the minimum retention period for receiving a higher rate of credit.

The WOTC does theoretically have a role to play in the war on poverty. The EITC and the WOTC can complement each other. EITC only addresses part of the problem—raising wages. EITC is only beneficial to individuals who work and WOTC aimed at encouraging employers to hire the hard to employ. Unless the majority of unemployed individuals are unemployed primarily because public assistance is more lucrative than work—which would mean that the EITC or some other wage increase alone would fix the problem because it raises wages,—without some mechanism for getting the hard to employ employed, the EITC is of limited use. With PRWORA work supports—such as child care subsidies,—the expanded EITC, and the increase in the minimum wage, the WOTC may exist in an overall better climate than did the TJTC.

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The amount of tax credits issued from 1997, the year of the program’s inception, to 2001, the last year for which statistics are available, shows that the yearly percentage change in the amount of tax credits being claimed has been increasing (1999 to 2000 being the anomaly).

Tax Credits Issued:

Fiscal Year	No. of WOTC Certifications	% change
2001	438,604	18.27%
2000	370,835	10.46%
1999	335,707	17.66%
1998	285,322	126.24%
1997	126,113	0

Source: U.S. Department of Labor, Employment and Training Administration, *Employment Tax Updates*, at <http://www.uses.doleta.gov/updates.asp>

Welfare recipients have, in most years, comprised more than half of all WOTC certifications.⁴⁸

Food stamp recipients were the second largest target population certified.⁴⁹

B. Why the Case is Strained

Reauthorization of the WOTC is not wholly unsupportable. Unfortunately, conjecture, rather than substantive analysis, has been the guidepost for the reauthorization debate since the inception of the WOTC. The WOTC in the context of the “work-first” initiative currently seems to rely on questionable suppositions about the social advantages of work. While there are benefits to be gained from work, welfare-to-work policy resting on the belief that any work is better than no work is fundamentally flawed and partially responsible for individuals cycling on and off of welfare. Although there was some concern for helping the hard to employ acquire job skills, the WOTC program had no mechanism to further a certain level of quality of work, wages paid, or skills acquired. No studies have been done to evaluate how effective or efficient the WOTC has been in aiding the targeted group members either find jobs or improve their employment outcomes. But there is support for its reauthorization. Such a tax credit to aid the poor needs to have as its real focus improvement in the employment outcomes of the poor—meaning position advancement, acquisition of transferable and marketable skills to allow for unsubsidized work, earning enough to live above the poverty level, and long-term employment. Policymakers, in this context, have substituted welfare policy for poverty policy, focusing on getting people off welfare rather than striving for better employment outcomes for the working and nonworking poor. So who is the WOTC really helping?. Although policymakers have, in

⁴⁸ U.S. Dep’t of Labor, Final Report, *Employers Use and Assessment of the WOTC and Welfare-to-Work Tax Credits Program*, at 2 (Mar. 2001).

⁴⁹ *Id.*

molding poverty policy, tended to accept that some structural barriers to self-sufficiency do exist, programmatic emphasis has been on motivating the individual to work without more.

1. Wages; Above the Poverty line; Promotion

The current focus on welfare caseload reductions renders certain policies a success by obscuring evaluative criteria that would otherwise complicate or even reverse assessment. Even if one ignores other criteria, the belief that caseload decline, or employment of former welfare recipients, demonstrates the success of welfare reform depends on a particular framing of the evidence. Such framing has misleadingly established support for WOTC.

High usage indicates one aspect of effectiveness of the WOTC. If the amount of tax credits claimed show an increase over time, by definition workers in the targeted groups are being employed. But because the tax credit only applies to newly hired employees usage does not address how WOTC employees fare after the credit has been claimed. Usage is also of questionable value as an indicator of effectiveness because it does not address the problem of employers hiring individuals that they would have hired even in the absence of the credit.

Research has shown that a substantial majority of individuals on public assistance have significant barriers (relatively high incidence of physical and mental health problems, disabled children, alcohol and drug abuse, low education levels and cognitive abilities, transportation problems, and limited work experience) that limit their ability to work.⁵⁰ Those barriers are not limited to employment discrimination—which is what the WOTC in effect addresses. No incentive is likely to be great enough to entice an employer to hire an individual who did not have the skills necessary to perform a job or that could not be taught to perform a job at little or

⁵⁰ Sheila R. Zedlewski & Pamela Loprest, *Will TANF Work for the Most Disadvantaged Families?*, in *The New World of Welfare* 311 (Rebecca M. Blank and Ron Haskins eds., 2001).

no expense to the employer. Even for relatively low-skilled jobs, employers tend to seek basic skills such as job readiness, social skills, and basic cognitive abilities, in addition to any job-specific skills.⁵¹ So not only does there remain a segment of the population that the WOTC could not induce employers to employ, but because of the characteristics of many on welfare there are a limited number of jobs that they can assume. .

Historically, subsidized jobs have been part-time, low-paying, low-skilled, short-term positions which did not substantially improve the employee's standard of living or long-term job prospects. Typically the employers that find a wage subsidy for hiring disadvantaged workers enticing are those that are able to offer low-skilled positions. Sharon Parrott of the Center on Budget and Policy Priorities reported findings regarding the employment and earnings patterns for TANF leavers, in general, who find jobs:⁵²

1. Employed former recipients and recipients combining work and welfare typically are paid less than \$8 per hour and a substantial portion earn less than \$6 per hour.
2. Those who find jobs tend to work a substantial number of hours—typically more than 30 hours per week during weeks in which they are employed.
3. Despite this relatively high number of weekly work hours, recipients who find jobs typically earn between \$2,000 and \$2,700 per quarter (or between \$8,000 and \$10,800 annually), a total well below the poverty line for a family of three. The low quarterly earnings figures suggest that many recipients who find jobs have periods of unemployment or very low earnings during a three-month period.
4. Not surprisingly, recipients with better skills have higher earnings when they find jobs than do recipients with very low skills. A three-city study found that recipients who have a high school diploma or GED (General Equivalency Degree) have quarterly earnings that are between 19 and 29 percent higher than those who lack diplomas.
5. In addition to low wages, most recipients who find jobs do not receive paid vacation or sick leave from their employer or employer-sponsored health

⁵¹ Harry J. Holzer, *Mismatch in the Low-Wage Labor Market: Job Hiring Perspective*, in *The Low-Wage Labor Market: Challenges and Opportunities for Economic Self-Sufficiency*, 127 (Kelleen Kaye & Demetra Smith Nightingale eds., 2000).

⁵² Sharon Parrott, *Welfare Recipients Who Find Jobs: What Do We Know About Their Employment and Earnings?*, Nov. 16, 1998, available at <http://www.cbpp.org/11-16-98wel.htm#References>.

insurance. Many such parents also will not be covered by the federal Family and Medical Leave Act (FMLA) which requires employers to provide up to 12 weeks of unpaid leave for employees who need time off for certain reasons such as to care for a child with a serious health condition or to attend to their own serious health condition. Only employees who have worked for their current employer for at least one year and who worked at least 1,250 hours — approximately 25 hours per week — in the last year are covered under the FMLA. Thus, many recipients who find jobs may not have access to paid or unpaid leave even when a family member is seriously ill.⁵³

The study demonstrated that, generally, individuals who leave welfare and find jobs typically work a substantial number of hours per week but are paid low wages and do not usually receive paid sick days, vacation leave, or health benefits.⁵⁴ Their incomes are likely inadequate to meet basic needs. With the rapid turnover typically associated with most low-wage jobs, employees usually did not have time to acquire the skills and experience they needed to obtain unsubsidized jobs. Alternatively, requiring employers to retain workers for longer periods of time may discourage them from hiring high-risk employees. Because these jobs are low skilled there is not much likelihood that they present opportunities for the upward mobility of the individuals that the tax credit targets. There is no reason to assume that the new generation of TANF leavers will fare any better.

2. Usage and Stigmatization

The WOTC aimed at addressing the shortcomings in the failed TJTC. One important aspect of the TJTC that the WOTC did not address, and which could pose a significant barrier to its ability to aid the poor, is stigma. If you measure the success of the WOTC in terms of the ratio of people who use it to the total of those that are eligible for it, it may not seem like such a success.

⁵³ *Id.*

⁵⁴ *Id.*

The WOTC did not cure the problems associated stigma. The WOTC required that the employer receive certification that the employee was eligible to qualify its employer for the tax credit. A prospective employee could also independently be conditionally certified in most states. By either means, the employer would become privy to the information that qualified the employee for the credit.

Measuring the effects of stigma on an individual's (either an employee or an employer) decision not to participate in the program is difficult, but it is the most oft cited reason for low participation from both employers and employees.

3. How WOTC Fits in With PRWORA

In the context of TANF's time-limited assistance and the sometimes forced entry of disadvantaged individuals into the labor market, the need for the labor market to deal with the swelling amounts of the disadvantaged poor is even more pronounced.

The WOTC does not have a provision in place to safe guard against the displacement in hiring of workers that are ineligible for the credit with workers that are eligible for the credit. TANF time limits are likely to flood the labor market with low-skilled, poorly educated individuals, and many leaving the welfare rolls will have trouble finding employment. The low-wage labor market is likely to be able absorb the new entrants associated with welfare reform as long as the economy is healthy.⁵⁵ In a weak economy, as we are currently experiencing, the large inflow of new entrants into the low-wage labor market could leave many people unemployed. Because of windfalls and substitution, a targeted tax credit may not create new

⁵⁵ *Work Opportunity Tax Credit: Employers Do Not Appear to Dismiss Employees to Increase Tax Credits*, supra note 45, at 13. (Although the study concluded that both displacement and churning are limited, "displacement [was] less likely to occur when employers are increasing their workforce—as has been the case since the introduction of the credit—because they have less need to dismiss non-WOTC workers in order to hire WOTC workers." So the study adds credence to the WOTC's dependence on the labor market.)

jobs; instead, there may be a redistribution of the same number of jobs among different groups of people.⁵⁶ Under the WOTC, members of the targeted groups may find jobs at the expense of other needy individuals who are not members of the eligible population. In effect, members of targeted groups will have an advantage over others who are competing for entry level positions—many of whom may be prior recipients of public assistance who do not qualify for the program. Such competition creates perverse incentive effects. Individuals may resort to becoming members of the targeted groups in order to qualify for the program. Even if the low-wage labor market is able to absorb new entrants in a slow economy, the large influx (likely to occur as a result of TANF time-limits) may cause a reduction in wage levels.

C. Recommendations for a Study

A model for measuring the success of the program should not only look at whether employers are using the credit, but should also address (1) the extent to which the WOTC actually mitigated the pitfalls attendant to employer-based subsidies; (2) whether the tax credit actually stimulates the desired behavior; (3) the extent to which employers have changed their hiring and retention practices as a result of the WOTC; (4) whether employees who allow their employer to realize the credit are retained past the threshold point; (5) the existence of training, counseling, and mentoring programs available to teach these employees both soft and hard skills; (6) the employment prospects of individuals who do leave a WOTC employer's employ; (7) whether the kinds of jobs that the WOTC eligible get pay wages that allow them to be self-sufficient; and (8) whether the WOTC certification procedure induced stigmatism.

⁵⁶ *Id.* at 14n.7 (The GAO study also showed that “for an estimated 70 percent of participating employers in the two states [used in the study], the tax credit’s insufficiency to offset recruitment, hiring, and training costs has little or no deterrent effect on employer willingness to fill vacancies with credit-eligible individuals”).

Although WOTC has been reauthorized five times, studies concerning the effectiveness of the credit have either evaded those questions or been non-determinative.⁵⁷ What is known about the credit raises questions about the benefits gained from its continued authorization and to whom those benefits accrue.

D. Study—Employer’s Use and Assessment of the WOTC

In 2000, the U.S. Department of Labor’s Employment and Training Administration had a contractor conduct a study to examine employers’ use and evaluation of the WOTC.⁵⁸ The study stated that the employers interviewed in the study were not a representative sample in the statistical sense and cautioned that the study was not determinative.⁵⁹ Even though the study is thereby of limited value, certain themes emerged: (1) employers were unanimously positive in their assessment of the program; (2) special recruitment efforts for candidates within the targeted groups were mixed; (3) individuals hired from the targeted groups would have been hired even in the absence of the credit; (4) employers believed that the tax credit was, nonetheless, justified because individuals from the targeted groups typically needed additional help being integrated into the workforce—longer training time and mentoring—which increase employment costs; (5) WOTC employees were given the same pay and the same promotional opportunities as other workers in similar positions; (6) because of the high turnover associated with low-skilled, low-

⁵⁷ Three studies are available concerning the WOTC: U.S. General Accounting Office, GAO-01-329, *Work Opportunity Tax Credit: Employers do not Appear to Dismiss Employees to Increase Tax Credits*, 7 (Mar. 2001) (stating it “did not evaluate how effective or efficient the WOTC has been in increasing the employment and earnings of target group members”); U.S. General Accounting Office, GAO-03-39, *Business Tax Incentives: Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact* (Dec. 2002) (entitled “Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact”); Employment and Training Administration Office of Policy and Research, U.S. Dep’t of Labor, Final Report, *Employers Use and Assessment of the WOTC and Welfare-to-Work Tax Credits Program* (Mar. 2001) (stating that the sample of businesses interviewed was not “a representative sample in a statistical sense” and therefore not determinative).

⁵⁸ U.S. Dep’t of Labor, Final Report, *Employers Use and Assessment of the WOTC and Welfare-to-Work Tax Credits Program*. at 2 (Mar. 2001).

⁵⁹ *Id.* at iv.

wage jobs, employers received the full credit for only a small portion of the individuals hired from the targeted groups; (7) it was difficult to calculate what percentage of hires were considered to be WOTC eligible because some employees left before the outcome of their certification request was known; (8) the use of conditional certifications was very low and (9) there were generally not many problems with processing applications.⁶⁰

The results of the study suggest that just as its predecessor—the TJTC—the WOTC may not induce employers to hire members of target groups who would not have otherwise been hired. Most of the jobs obtained by the targeted group members were low-skilled, low-paying, high turnover entry level positions. One positive was the suggestion that additional training and mentoring was being provided to WOTC eligible hires. But the conductors of the study cautioned against imputing any of these results to all WOTC participants.

VI. Conclusion

The policy reasons for and continued reauthorization of the WOTC, without studies concerning the efficacy of the program assumes too much about which we can currently only conjecture. Studies have not addressed the ability of the WOTC to increase employment, to lift the hard to employ out of poverty, to provide the targeted group members jobs that allow for the acquisition of hard and soft employment skills, or to increase the targeted individuals' prospects for unsubsidized employment. These should be the goals of the WOTC. Moving individuals into work, any work, does not really benefit the poor. It serves the goal of reducing welfare caseloads, while increasing the population of the working poor. Even if the WOTC has a role to play in aiding the hard to employ it has inherent limitations and could not take the place of programs like EITC, programs that teach job skills, or drug and alcohol rehabilitation programs.

⁶⁰ *Id.* at 4-12.

The challenge for WOTC advocates is to strengthen the case for the WOTC by acknowledging its limitations and then explaining why the WOTC is still worthwhile. Before WOTC is reauthorized, its effectiveness should be better understood.

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