Welfare policy in the United States

Motivations - relative income inequality, income distribution: The evolution of income inequality over time in the US. From late 1960s to late 1970s, income inequality was falling. The share of income to the bottom quintile grew and the share to the top income quintile fell. Gini coefficient: another measure of income inequality. Define it. From 1980 to now income inequality has been rising. Share of income to bottom quintile fallen more than 20%, share of income to top quintile risen by 15%. Now more than half income goes to top 20%. Mostly due to increases in income at very top of income distribution. This relative income inequality is higher than in other developed nations.

Programs that redistribute income to low-income groups. Categorical and means-tested. Categorical welfare programs are aimed at people with some demographic characteristic, such as single mothers, disabled. Mean-tested welfare programs give benefits based on income level and asset level. For instance available only to those with income below poverty line. Most income redistribution programs are both means-tested and categorical.

Cash welfare programs provide cash benefits to recipients. In-kind welfare programs give goods such as medical care or public housing.

This chapter discusses Temporary Assistance for Needy Families (TANF) and Supplemental Security Income (SSI). There is a third income redistribution program, Earned Income Tax Credit (EITC), which will be discussed in Chapter 21.

TANF is funded jointly by federal gov and by states. Gives support to low-income families where one biological parent absent. Replaced Aid to Families with Dependent Children (AFDC) started in 1935 aimed at widows and orphans. To be eligible for TANF, must have sufficiently low income. States are allowed to use TANF funds for either single-parent families or two-parent families. Only 3.5% of recipient families have two parents present.

TANF is relatively small: 25.8 billion expenditures in 2004, compared to 529.9 billion benefit payments for SS.

A family becomes eligible for TANF due to sufficiently low income. Then they qualify for a benefit guarantee - cash payment from state. This benefit is not so high as to lift a family above the poverty line.

Benefit is means-tested. Payment is reduced as income from other sources grows.

Federal gov gives block grants to states to finance their TANF programs. Federal gov also puts requirements on who can get benefits: time limits and work requirements. Can’t receive TANF for more than 5 years in lifetime. Must work
after receiving at most 24 months of TANF benefits (states can have shorter
deadlines).

Half a state’s TANF recipients must be working at any time. 30% of recipients
can count education or job-skills training as work.

Supplemental Security Income (SSI)
Cash welfare to blind, elderly and disabled. Meant to fill gaps left in SS and
disability insurance (DI). To get disability insurance, must have worked in the
past. A young person who has never worked, disabled in car accident can’t
qualify for DI, but can for SSI. SSI has larger expenditures than TANF: $36
billion in 2004.

In-kind programs: Foods stamps - like debit card system. If household has
only TANF, SSI or state cash welfare recipients, it is eligible for food stamps.
Otherwise, households without elderly or disabled members must have income
below 130% of poverty line to get food stamps. Amount of benefit falls as
income rises.

If not disabled or elderly, must be willing to take any job offered, otherwise
benefits may be discontinued. Permanent residents must have been in US for 5
years to get food stamps.

Public housing - 2 programs. First is housing in public projects. Second is
"section 8 vouchers" - can be used to subsidize private rent from landlords who
participate in program. To be eligible, must usually have income below 50% of
median income in metropolitan area. Of spending, 2/3 on private vouchers, 1/3
on public housing projects.

Additional nutritional programs. Special Supplemental Nutrition Program for
Women, Infants and Children (WIC). Pregnant, recent mothers, children under
5 eligible if on welfare, Medicaid, or have incomes below 185% of poverty line.

School lunch and breakfast program - in families with income below 130% of
fed poverty line get free meals in school, between 130 and 185% get meals for
no more than 40c.

Having some kind of income redistribution from rich to poor is desirable from
a Rawlsian point of view. Rawls viewed justice as fairness. Here, fairness
means a fairness of systems of laws or conventions in the organization of society.
The organization should maximize the expected utility from behind a ”veil of
ignorance” - maximize the expected payoff when you don’t know beforehand
who you will be. Following this, risk-averse people would then choose a more
equal distribution of wealth than would be seen from pure competition. They
would want the worst possible position to be not too bad. He is not talking
about the optimal distribution though (if so, the optimal distribution from this
point of view would be for everyone to have equal wealth), but the optimal set
of rules that lead to a distribution.

But there are efficiency losses with this kind of redistribution. First, welfare
entails administrative costs that are 10% of total TANF spending - not very much. Also, there is efficiency loss due to the distortionary tax on higher-income individuals needed to pay for the transfer.

Third, there is a moral hazard problem for potential recipients of the transfer. Moral hazard arises when there is insurance against some event that can be affected by the insurance-holder’s behavior. It refers to the fact that insurance holders can change their behavior to make the event insured against occur. Welfare is a kind of insurance against low income. It thus raises incentives for people to be poor in order to qualify for welfare. Depending on an individual’s preferences over income and leisure, they could decrease hours worked, decrease income in order to qualify for welfare.

Consider a pure means-tested transfer system. This is a welfare system that redistributes money based on income. With this system, the government guarantees every individual an income transfer, which is reduced as earnings increase. The rate at which the benefit is reduced as earnings increase is called the benefit reduction rate or the implicit tax rate.

The benefit to an individual would equal

\[ B = G - \tau \times w \times h, \]

where \( G \) is the benefit guarantee level, the same for everyone, \( \tau \) is the benefit reduction rate, \( w \) is the wage rate of that individual, and \( h \) is hours worked by that individual. If the guarantee level is $10,000 and the benefit reduction rate is 1, an individual would get a benefit of $10,000 minus their labor income, until their income reaches $10,000, at which point the benefit is zero.

If nobody changed their behavior due to the implementation of such a program, it would be possible to cheaply end poverty in the US by a transfer system like this. The guaranteed benefit level \( G \) would be set equal to the poverty line, and the benefit reduction rate would be set equal to 1, so that benefits fall by $1 for every dollar of earnings. The government would pay every family below the poverty line the difference between their income and the poverty line. This is estimated to cost $104 billion dollars based on the March 2003 Supplement to the US Bureau of the Census Population Survey. That cost is only about 20% of the yearly government spending on Social Security.

However, in reality, people will respond to such a program by changing their amount of work supplied. This will cause the cost of the program to increase. Consider the graph below which depicts three different households’ choices of consumption and leisure with and without the transfer system.
Households X, Y and Z have the same income but different preferences over leisure (time spent not working) and the consumption of other goods. Household Z prefers working more and consuming more, household Y has greater preference for leisure than Z, and household X has the greatest preference for leisure relative to consumption of the three households. Initially there is no transfer program; the households’ budget line represents what they can afford to buy given their work hours.

Then the transfer program is implemented. The transfer program changes the budget line to make it horizontal at the benefit guarantee for amounts of leisure such that income is equal or below the benefit guarantee (see the graph). When the program is started, household X will definitely move to point D: They will get both more leisure and more consumption than at their original point. In other words, they will stop working entirely and live only from welfare benefits.

Household Y will also switch to point D given the preferences shown in the graph, but this depends on Y’s preferences. If we had drawn the indifference curve differently, it may not have switched.

Given the way we have drawn Z’s indifference curve, Z will stay where it is in response to the implementation of the transfer system. So Z prefers a higher level of consumption, even if it means working, to consuming less but not working.
Notice that given that a household participates in the welfare program there is no reason to work under the system drawn in the graph. The tax rate on additional income is 100%, as benefits are reduced by $1 for every $1 of additional income. So for anyone making less than the benefit guarantee in the first place, there is no reason to work once the program is in place.

This is why such an attempt to bring everyone in the US up to the poverty line will cost more than the sum of the differences between people’s incomes and the poverty line. A transfer program with a benefit reduction rate of one will lead everyone with income below the benefit guarantee to stop working, as well as some people (like household Y) whose income was initially above the benefit guarantee. This will cause the government to pay the entire benefit guarantee for many households, including some that were above the poverty line to begin with. The cost will therefore be much higher than the original calculation.

This is an example of moral hazard. Moral hazard occurs whenever people change their behavior in response to insurance, making the event insured against more likely. Welfare can be viewed as a kind of insurance against having low income. The existence of welfare can cause more people to choose to have low incomes. To reduce the moral hazard problem, one possibility would be to lower the benefit reduction rate. This would reduce the disincentive to work, as the tax on working when on welfare would be lower.

Consider a system with a benefit reduction rate of 0.5 instead of 1. The benefit guarantee remains the same as before ($9800). With a benefit guarantee of $9800 and a benefit reduction rate of 50%, once income reaches \(9800 \times 2 = 19600\), a household is no longer eligible for any benefits (because \(0 = 9800 - 0.5 \times 19600\) in the benefits equation).

The original budget line and the budget line under the system are shown in the graph below. Household Y moves from \(Y_1\) to \(Y_2\) under this system. Unlike under the system with a benefit reduction rate of 1, under this system household Y still chooses to work. In fact, Y’s choice of labor hours is only slightly lower under this system than without any transfer system. However, the effect of more labor hours chosen by Y is counteracted by Z’s choice of less labor. Contrary to the case of a 100% benefit reduction rate, with a 50% reduction rate Z chooses to be on welfare and to work less in order to qualify. This may offset to cost reduction caused by Y’s choice of more labor relative to the 100% benefit reduction case.
In conclusion, with a simple cash welfare program it is impossible to achieve the three goals of encouraging work, redistributing income and lowering costs simultaneously. To get around this problem, other methods need to be used.

Reducing the moral hazard of welfare

If the government could observe everyone’s earning capacity it could base welfare payments on earnings capacity rather than on observed earnings. Then there would be no moral hazard problem because people’s behavior could not change their earnings capacity. The government would give larger checks to those with least earnings capacity.

In reality the government observes only what people actually earn. This is related to earnings capacity, but to some extent can be changed by behavior (labor supply decisions). A person may be poor because they have low ability, or because they did not learn enough skills for whatever reason, or because they are high-ability but have a high preference for leisure. When the government gives welfare benefits based on observed earnings, they give the third type of individual an incentive to work less.

To overcome this problem, some programs (SSI) are targeted at people whose earnings capacity is reduced by disability, such as blindness. The best targeting mechanisms are unchangeable. If they are changeable, people will change their
behavior to qualify, and the desired effect (raising the incomes of the less able while keeping amount worked the same) will not be attained. Suppose, for example, that cash benefits were given to everyone whose income was below the poverty line last year. Then people couldn’t change their last year’s income to qualify. But such a program would have to be unexpected (otherwise people would lower their incomes in expectation of it) and could not go on for several years (otherwise it would not be unexpected).

Targeting by single motherhood. This was the traditional way the US targeted people for cash welfare. Single motherhood is positively associated with low incomes. The poverty rate for single female headed families is more than 35%. But it is not unchangeable. Women can never marry before they have children or divorce. Will a person do this just to get welfare? That is unclear. Evidence suggests that women do not become single mothers just to qualify for welfare. Time series of single motherhood and welfare benefits show that in the years after in 1960s, single motherhood rose, though welfare benefits fell dramatically. If women were becoming single mothers to qualify for welfare, the rate of single motherhood should have fallen with welfare benefits, as there would be less of a reason to qualify for welfare.

Another form of evidence compares single motherhood in states that raise their benefits to that in states where benefits are constant or falling. The effect of benefit rises on single motherhood is zero or very small.

Due to this evidence, it appears that single motherhood meets both criteria for being a targeting mechanism. Yet, it would be very costly and unnecessary to give welfare benefits to all single mother headed families, including very wealthy ones. So there has to be an income limit too. This income limit will probably lead to some women choosing to earn less than they would have if there were no welfare.

There was political opposition to targeting welfare to single mothers, in the belief (despite the evidence) that it prevented the formation of stable families. When TANF was set up in 1996 no distinction was made in theory between single-mother-headed families and others (though single female headed families have made up most of TANF recipients).

Ordeal mechanisms - giving welfare programs undesirable properties so that only those who really need them will choose to use them. If the goal is to redistribute money to the less able, the welfare program could be endowed with features that make it unattractive to the more able.

Suppose there are two types of individuals who want to be on welfare: those with less taste for leisure, but low ability, and those with much taste for leisure, but high ability. The government wants only to distribute money to those with low ability. They could use education levels or some measure of intelligence, but those are only partially correlated with ability. Another ordeal mechanism would be work or training requirements that TANF includes. People with high
taste for leisure would not choose welfare in this case because they don’t like to work - they were just choosing welfare to increase their leisure. The requirements are less costly for the low-ability individuals who like to work.

Other ordeal mechanisms - in-kind instead of cash benefits. And give in-kind benefits that not everybody wants. For example if the benefit is an apartment in a housing project, not everyone will want to live there unless they absolutely can’t get an apartment any other way. High-ability people may rather work and live in a nice house than not work and live in a housing project.

Another ordeal mechanism is making people wait in long lines at the welfare office.

Ordeal mechanisms may be used for paternalistic reasons - government’s concern that low-income groups might not spend the money in the best way for the family.

Paradox of ordeal mechanisms - apparently making the needy worse off through an ordeal mechanism might make them better off (depending on the ordeal mechanism). Because of the ordeal mechanism, the non-needy who would have otherwise pretended to be needy won’t be competing with the truly needy for funds. For instance, by hiring fewer people to work at a soup kitchen, depending on the tastes for time of those non-needy who would pretend to be needy, the truly needy could end up being better off by having longer waits, which would scare off the non-needy.

Increasing outside options

Training - Many women on welfare are high school dropouts with low qualifications. State welfare programs ran randomized trials to see how well this kind of training works. Evidence: Training leads to small decreases in welfare receipt and increases welfare recipients’ earnings. But will not lead to large reductions in number of welfare recipients.

Labor market subsidies - One type is EITC (Earned Income Tax Credit), which subsidizes each dollar of earnings for families with incomes below a certain level. In 2006 to be eligible a family with two or more children has to earn less than 32,001. The EITC gives more money when more income is earned up to a certain level. This has been shown to increase labor supply of low-income people. But it is more expensive than TANF - 35 billion a year rather than 25.8 billion.

A series of programs tried to target wage subsidies to people on welfare already (people not on welfare can qualify for EITC). Research found that work subsidy (giving some money for each hour worked) increases employment among welfare recipients. This program, because it is targeted at welfare recipients, is less expensive than EITC.

However, more people would have the incentive to join the welfare program if they can thus receive a work subsidy.

Child care - subsidizing child care shown to raise female labor supply (married
and unmarried). A 10% rise in child care subsidies increases female labor supply by ca. 2%. If the wage is too low, a mother may not be able to pay for child care or may not find it worthwhile. Debate over whether more child care and more work hours for mothers is better or worse. High-quality preschool programs found to lead to better outcomes than for children not in the programs (but could this be due to the parents who choose such high-quality programs. But on the whole, more child care seems to lead to aggressiveness and less motor and social skills.

Child support -only half of court-ordered child support payments made in US today. In every year from 1981 to 1999, a fed legislation was enacted to increase enforcement make absent parent (usually father) pay child support. The state can withhold their wages until they pay. But most such fathers are also poor. Money goes to state to offset welfare costs of women. State is then taxing poor to support welfare.

Chapter 21.3

Earned Income Tax Credit (EITC)

EITC is an income tax policy aimed at low earners. It was established to redistribute money to low-income groups while increasing these groups' labor supply. It expanded after the Tax Reform Act of 1986 (higher subsidies and slower phase out). Previously it was available only to families with children, now available to anyone with sufficiently low income.

The EITC gives a subsidy for earnings. Consider a single earner with two children. At zero earnings the credit is zero. For the first 11,340 of earned income, you receive a payment of 40c per dollar of earnings, up to a maximum payment of 4536. Then the EITC payment is flat at 4536 until 14810. Up till 36348, the payment per dollar of earnings decreases until it reaches zero.

Theoretical predictions of EITC’s effect on labor supply

For people not in labor force, the EITC should raise labor supply, since that is the only way to get credit is to be in the labor market. The EITC has no income effect on this group since they started with no income, but it has a substitution effect, because it raises returns to every dollar of income (hour worked).

People who earn less than 11,340 are in the phase-in portion of the EITC curve. They receive more EITC for each hour worked (40c for each dollar of earnings). There are both income effects and substitution effects.

People earning between 11,340 and 14,810 receive the same EITC no matter how much they work within this range. EITC does not raise hourly wage for more work hours, so there is no substitution effect. There can be just income effects due to EITC, which may lower hours worked.

People earning between 14810 and 36348 are on phaseout portion of EITC curve. They get less EITC by working more. Substitution effect should reduce labor supply, income effect also reduces labor supply. So labor supply falls for this
Evidence of EITC’s effect on labor supply - single mothers.

EITC has increased labor force participation among single mothers.

Eissa and Leibman (1996): Single mothers 1.4 to 3.7 percentage points more likely to work as a result of EITC’s 1986 expansion.

Effect of work hours - Eissa and Leibman found no effect of EITC expansion on hours worked by those already in labor force. Even though tax on marginal earnings of people in the phase-out range is very high at 51.3%.

Effect on married couples - EITC is computed based on total family earnings. For most low-wage couples with children, family is at maximum credit level with just father’s earnings, so wife will be on phase-out portion of EITC curve. Eissa and Hoynes (1998) found a small reduction in labor supply of married women due to EITC expansion 1986.