ECO 450G Notes
Fall 2006 Semester
University of Kentucky

Chapter 12 – Welfare Programs

I. Welfare versus Social Insurance
II. Welfare: The Cash Assistance Programs
III. Welfare Reforms, 1982-2002
IV. Welfare: The In-Kind Programs

I. Welfare versus Social Insurance

The key difference between *welfare programs* and *social insurance programs* is in their requirements. Welfare programs are means-tested, meaning that a family has low income, assets, or both. Social insurance programs are not means tested, and often have an enabling event – like turning age 65 or becoming unemployed.

Figure 12.1 shows that on the federal level, social insurance programs are relatively more expensive, mainly due to Social Security and Medicare. At the state level, however, welfare programs are far more expensive.

Some key welfare programs include TANF, SSI, the EITC, Medicaid, food stamps and public housing. Some – like TANF – are *cash* assistance and others – like Medicaid – are *in-kind* assistance (meaning the recipients gets "goods" rather than direct cash payments).

Figure 12.2 shows the ever-growing importance of Medicaid – it consumes 50% of spending on welfare benefits, mainly due to the rapid increase in medical costs and growing eligibility.

II. Welfare: The Cash Assistance Programs

Programs like SSI (for the aged, blind & disabled), TANF (for families with children), the EITC (for low-income workers) provide direct cash. In total, they amount to more than $80 billion in expenditure.

- TANF stands for Temporary *Assistance* to Needy Families (not *Aid* as in presented on page 210 and 211).

Each of these programs has *categorical* eligibility, meaning that only certain groups can qualify for those benefits. For example, a healthy 25-year old male without kids generally wouldn't qualify for any cash benefits. These categories explicitly target individuals that may have a low capacity to work and are perhaps "more deserving."

- Whether these are "inequities" or not depends on the ability of different groups to work. Schiller discusses different payments across programs, family types and states. The differences across states is partially, but not fully, explained by cost of living differences. For example, some of the most generous states in terms of TANF payments (Table 12.2) have the highest cost of living.

The evidence on whether welfare affects living arrangements – for example, by encouraging single motherhood – is quite mixed. In part, there isn't that much variation across states over time to identify such effects.

Work Disincentives

Schiller does a bad job of examining work disincentives from the welfare system, and we will examine this extensively in class. Basically, the issues boil down to:

- Static labor supply model – an individual faces a utility maximization problem, where the goods in question are "leisure" and "consumption goods."
- Rather than having a budget constraint with income, we give the individual a time endowment (T). For example, you allocate 24 hours each day to activities like work, leisure, studying, sleep, etc. You can "sell" your leisure in the labor market at wage rate *w*, which is why your implicit wage rate is the opportunity cost of your time.
- Selling your leisure and working allows you to buy other consumption goods. You have preferences over 2 goods, leisure and consumption. All else equal, you prefer more of each.
- Where your indifference curves are tangent to the budget constraint determines your optimal amount of consumption and leisure. Hours of work simply subtracts leisure from your time endowment.
- This budget constraints rotates when we change the wage rate and shifts if we give non-labor income.

Introducing the welfare system changes the budget constraint in particular ways.

- The welfare system will involve a guarantee (G), benefit reduction rate or tax rate (t) and a deduction (D).
- The relationship between actual welfare benefits receive and earnings (=wH) is:

Benefits = G	if earnings<D
Benefits = G - t(earnings - D)	if earnings>D & earnings<(G/t)+D
Benefits = 0	If earnings>(G/t)+D

- The (G/t)+D is the *breakeven* level where cash welfare eligibility is lost. We compute it by setting benefits equal to zero and solving for the earnings level.
- Example: $500 guarantee, 20% tax rate, $100 deduction.
    - With $100 of earnings, your total income is $600 - $100 from earnings & $500 from welfare.
    - With $200 of earnings, your total income is $680 - $200 from earnings & $480 from welfare. The first $100 of earnings is disregarded, and the final $100 of earnings reduces your welfare payment by $20 due to the tax rate. So you get $480 in total from welfare, which, when added to the

$200 of earnings, gives $680.

- With $600 of earnings, your total income is $980 – $600 from earnings, and $380 from welfare.
- When your income reaches $2600, you receive no welfare benefits. The breakeven formula is $2600 = ($500/0.2) + $100.

The new budget constraint interacts with preferences, and therefore affects work behavior. In general, there are income and substitution effects, as well as "kinks" in the budget constraint.

The breakeven level shows an implicit tradeoff between welfare guarantee, tax rates, and program costs. Raising the guarantee or lower the tax rates increases eligibility and brings more people into the welfare system.

- Schiller's statement (p. 219) that raising tax rates is a "great disincentive to working, especially for welfare recipients who were not likely to advance up the wage scale quickly" ignores individuals who become "mechanically" eligible with a lower tax rate. Depending on how many individuals are already working versus already on welfare, total work effort could go up or down.

III. Welfare Reforms, 1982-2002

The U.S. had some state experiments during the 1980s, an ineffective welfare reform in 1988 (called the Family Support Act), state waivers/experiments in the early 1990s, and welfare reform known as PRWORA in 1996.

PRWORA did the following:

- Ended Aid to Families with Dependent Children (AFDC) and replaced it with Temporary Assistance to Needy Families (TANF). Welfare was no longer an open-ended entitlement.
- Gave block grants to states that capped the cost to the federal government.
- Gave states more flexibility in designing programs.
- Implemented 5-year lifetime time limits and imposed work requirements after 2 years.
- Had provisions for non-marital births and non-citizens.

Welfare reform led to:

- Large caseload declines, though there is a key question on how much was due to welfare reform versus the growing economy. The logic that caseloads shouldn't decline until the 5-year time limit is reached isn't correct because recipients could "bank" their benefits.
- Many critics had dire predictions for welfare reform (people starving in the streets), but that didn't come true.

IV. Welfare: The In-Kind Programs

Three major in-kind programs are food stamps, Medicaid and public housing. They are all expensive, but Medicaid dominates the cost – \$270 billion in 2002.

These programs can create cumulate tax rates above 100%, and in the case of Medicaid, a “notch” in the budget constraint because it is lost entirely when cash welfare eligibility ends.

- Changes in the 1980s and 1990s loosened the link between Medicaid and AFDC/TANF for children. Yelowitz (1995) explores the consequences of these “natural experiments.”