Transfer Payments: Welfare and Social Security Part I

The tyranny of a prince in an oligarchy is not so dangerous to the public welfare as the apathy of a citizen in a democracy.
Charles de Montesquieu

Major Transfer Programs

- Roughly 50 cents out of every dollar is devoted to transfer payments.
  - Transfer payments – payments to individuals for which no current goods or services are exchanged, such as Social Security benefits

Cash vs. In-Kind Benefits

- Income transfer doesn't always entail cash payments.
  - In-kind transfers are direct transfers of goods and services rather than cash.
  - Cash transfers are income transfers that entail direct cash payments to recipients.

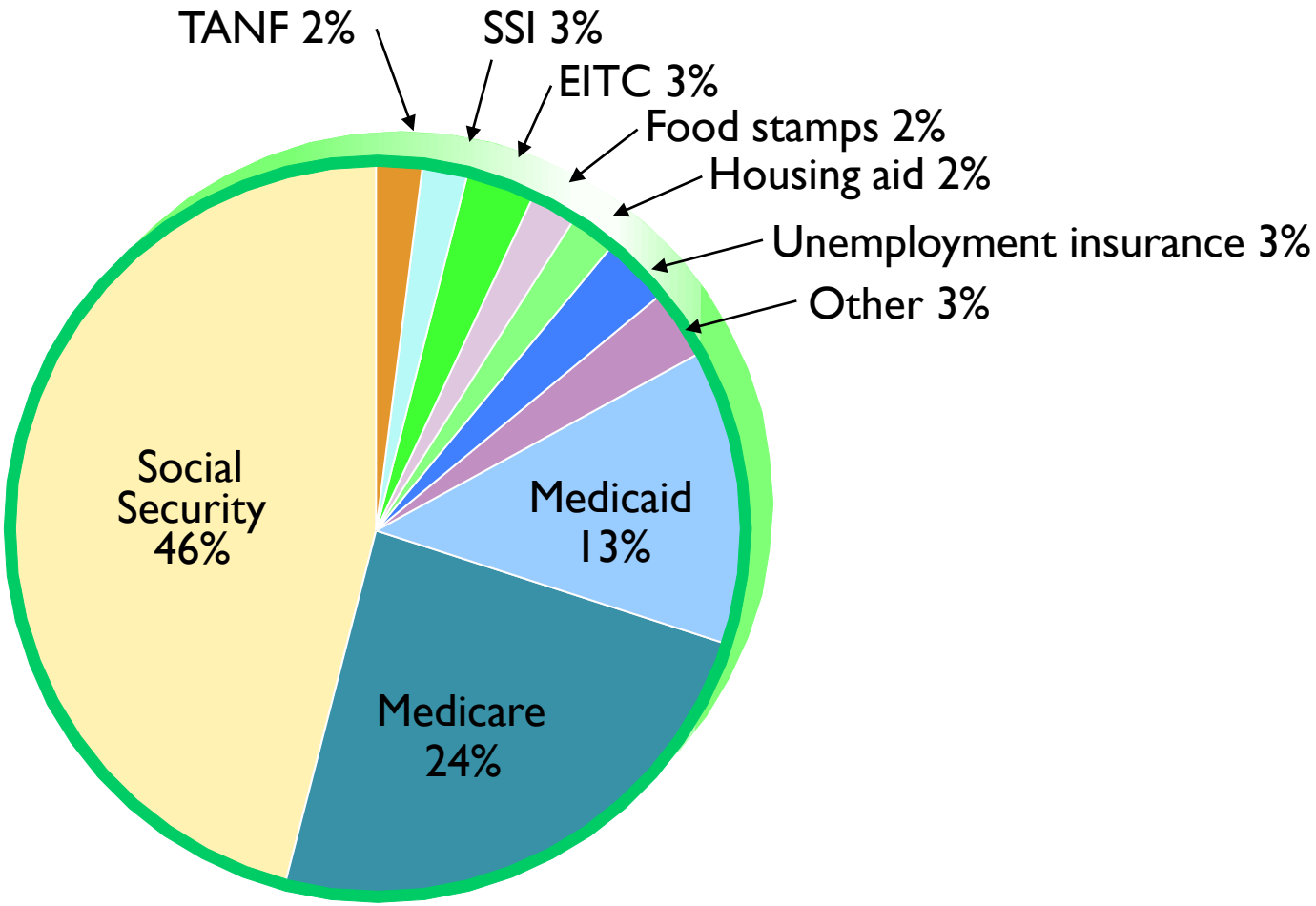
Cash vs. In-Kind Benefits

- Examples of in-kind transfers include food stamps, Medicaid benefits and housing subsidies.
- Examples of cash transfers include Social Security, welfare and unemployment benefits.

Cash vs. In-Kind Benefits

- Target efficiency is the percentage of income transfers that go to the intended recipients and purposes.
- The target efficiency of a transfer program tells us how well the transfers attain their intended purpose.

Chart: Income Transfer Programs



Social Insurance vs. Welfare

- Not all income transfers go to the poor.
  - A lot of student loans go to middle-class college students.
  - Disaster relief helps rebuild both mansions and trailer parks.

Social Insurance vs. Welfare

- Medicaid is an in-kind welfare program.
- Welfare programs – means-tested income transfer programs, examples include welfare and food stamps

Social Insurance vs. Welfare

- Social Security and Medicare social insurance programs are not welfare programs because recipients don't have to be poor.
- To get Social Security or Medicare benefits, you just have to be old enough and have paid into the program while you worked.

Social Insurance vs. Welfare

- Social insurance programs are event-conditioned income transfers intended to reduce the costs of specific problems.
- Most income transfers are for social insurance programs, not welfare.

Social Insurance vs. Welfare

WELFARE
- Food Stamps
- TANF
- SSI
- Housing Aid
- Child Nutrition
- Medicaid

SOCIAL INSURANCE
- Social Security
- Medicare
- Unemployment Insurance

Transfer Goals

- The basic goal of income transfer programs is to reduce income inequalities.
- The need for government transfers implies that there has been a failure of the market to distribute income equitably.
  - Market failure – an imperfection in the market mechanism that prevents optimal outcomes

FOR WHOM

- Transfer programs significantly change the distribution of income.
- US inequality has been reduced by at least 20%.

WHAT to Produce

- Transfer payments also change the mix of output.
  - Food stamps increase food consumption.
  - Housing subsidies increase the demand for housing.
  - Student loans increase college enrollments.

Unintended Consequences

Income transfer programs may change market behavior in unintended ways.

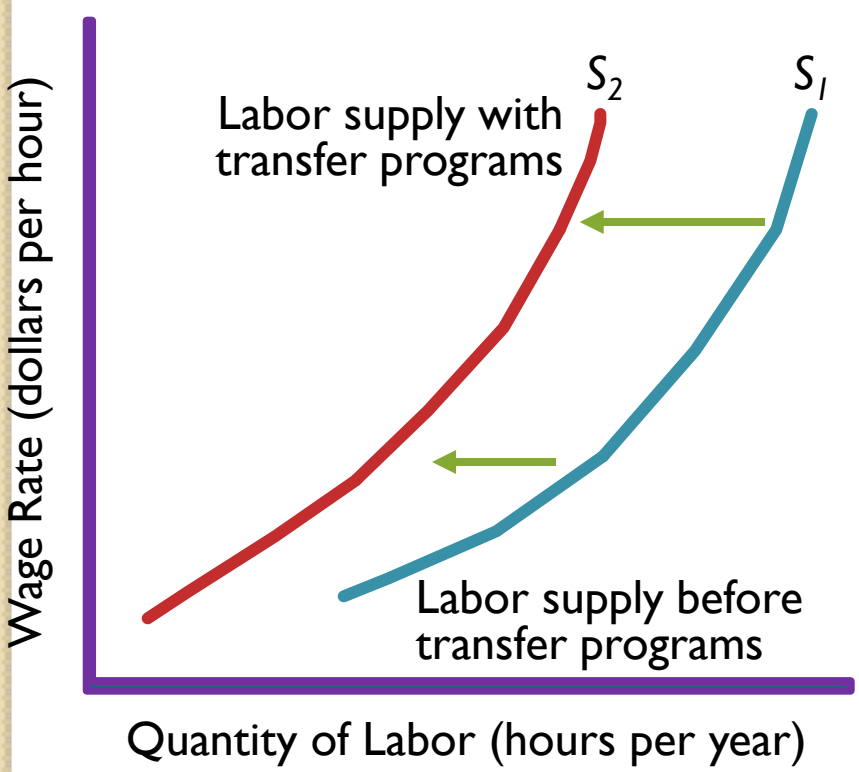
Reduced Output

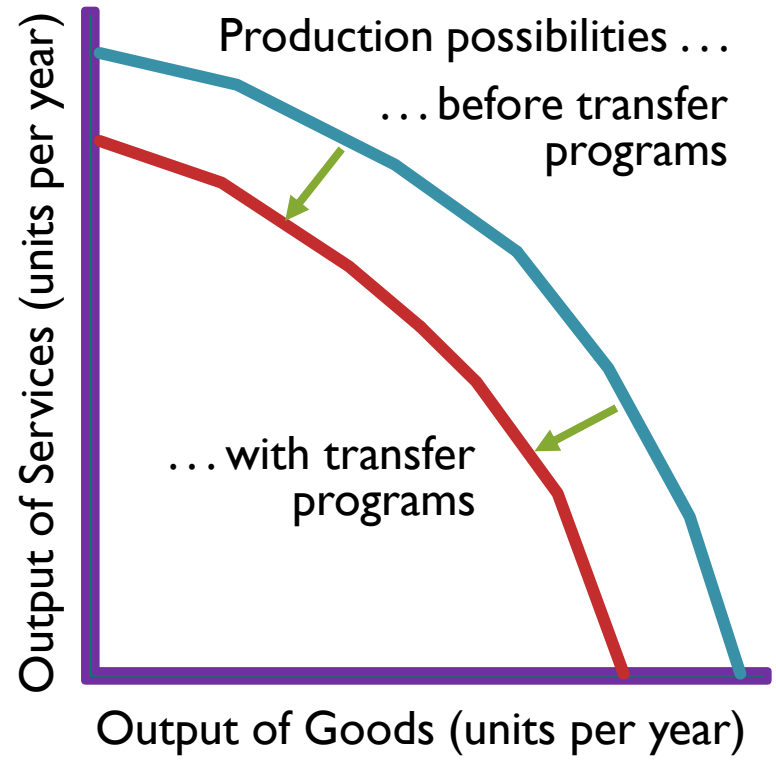
- Transfer payments may dull work incentives, reducing labor supply and total output.
  - Labor supply – the willingness and ability to work specific amounts of time at alternative wage rates in a given time period, *ceteris paribus*

Reduced Output

Attempts to redistribute income may reduce total income – the economic pie shrinks when we try to reslice it.

Charts: Reduced Labor Supply and Output





Undesirable Behavior

- People may also change their nonwork behavior.
  - Welfare benefits encourage recipients to have more children.
  - Medicare encourages recipients to overuse health care services.
  - Unemployment benefits encourage recipients to stay unemployed longer.

Welfare Programs

- The largest federal cash welfare program is called Temporary Aid to Needy Families (TANF).
- The TANF program was created by congressional welfare reforms in 1996 and replaced an earlier program (AFDC)

Benefit Determination

- The first task of the TANF program is to identify potential recipients.
- A four-person family with less than $18,900 of income in 2004 would have been considered poor.

Benefit Determination

- A family with $16,000 income in 2004, would have a poverty gap of $2,900.
- The poverty gap is the shortfall between actual income and the poverty threshold.

The Work Incentive Problem

- We could just give people a check for the amount of their poverty gap.
- No one would be poor.
- This might encourage people who are not poor to become poor.

The Work Incentive Problem

- Families that are already poor have reduced incentive to work to get out of poverty with transfer programs in place.
- This occurs because the programs are generally set up to reduce benefits as earned income increases.

Marginal Tax Rates

- When welfare benefits are set equal to the poverty gap, every additional dollar of wages reduces welfare benefits by the same amount.
- This amounts to a 100% marginal tax rate.

Marginal Tax Rates

- Guaranteeing a poverty-level income destroys the economic incentive of low-income workers to support themselves.
- This creates a moral hazard for welfare recipients.
  - Moral hazard – an incentive to engage in undesirable behavior

Less Compassion

- To reduce this moral hazard, Congress and the states set a much lower ceiling on welfare benefits.
- Rather than closing the poverty gap, states set a maximum benefit far below the poverty line.

Less Compassion

- The formula below for welfare benefits was the result.
- Using this formula, a family totally dependent on welfare is unquestionably poor.

$$\text{Welfare benefit} = \text{Maximum benefit} - \text{wages}$$

More Incentives

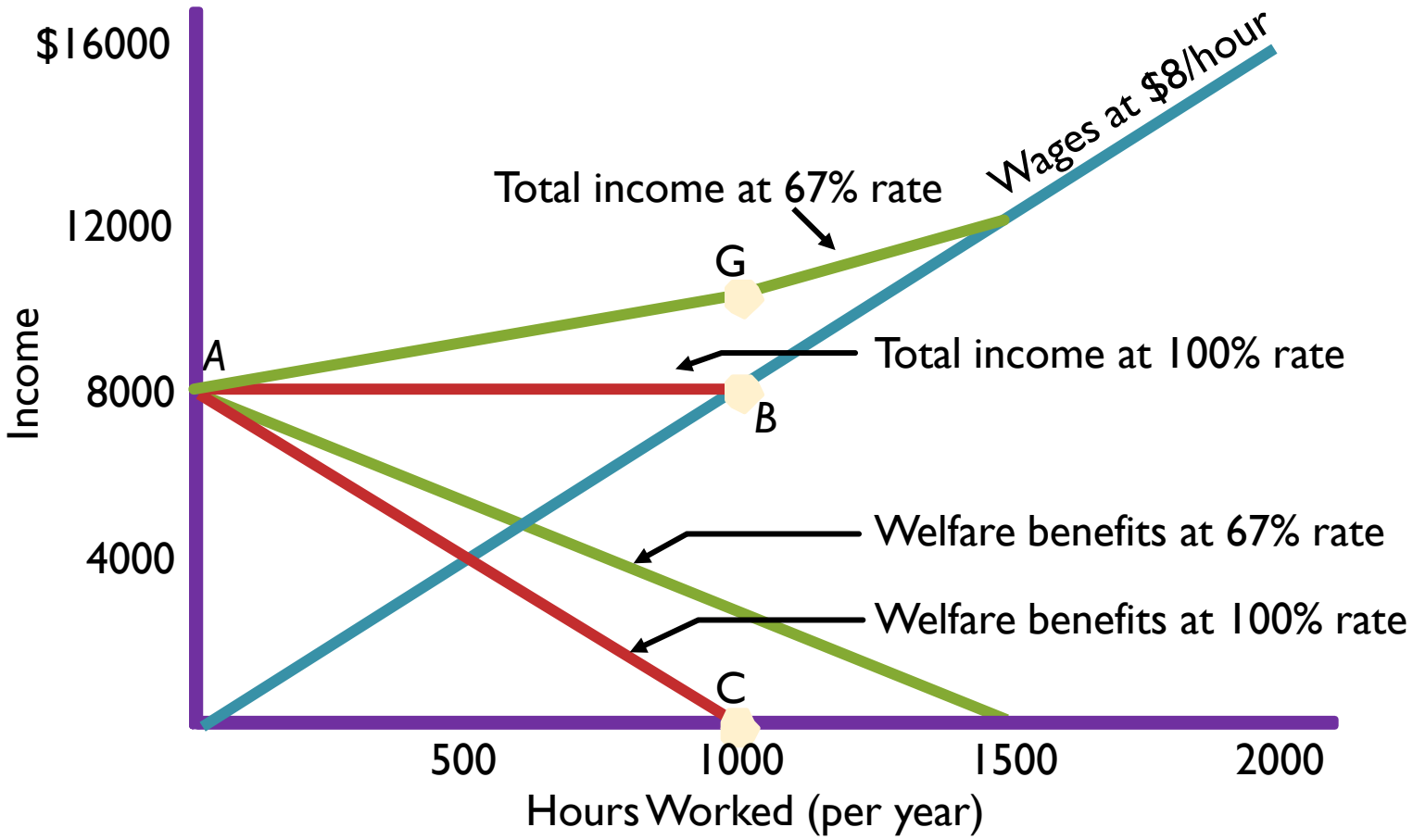
Another change has been made in the benefit formula to encourage welfare recipients to lift their own incomes above the poverty line.

More Incentives

- The implicit marginal tax rate was cut from 100% to 67%.
- So we now have a new benefit formula.

$$\text{Welfare benefit} = \text{Maximum benefit} - \tfrac{2}{3}(\text{wages})$$

Chart: Work (Dis) Incentives



CONTINUED IN TRANSFER PAYMENTS: WELFARE AND SOCIAL SECURITY PART II