Chapter Summaries

Chapter 10: U.S. Transfer Payments – The Public Choice Perspective

Chapter 10 begins with a historical account of the main U.S. antipoverty programs, from the English Poor Law of 1601 that set down three key principles of public assistance that resonate to this day, to the Social Security Act of 1935 that marked the entry of the Federal government into the provision of income support, to the current social insurance and public assistance programs.

1. The three principles of public assistance set down in the English Poor Law of 1601 are:
   1. Able-bodied people should work rather than receive public assistance, the only exception being those who are currently involuntarily unemployed;
   2. People who are poor and cannot be expected to help themselves are deserving of public assistance; and
   3. Aid to the poor should be administered at the local level because local officials best know who is truly deserving of aid.
2. The Social Security Act of 1935 established a two-pronged attack against poverty that remains the fundamental strategy to this day, consisting of social insurance to prevent people from falling into poverty and public assistance to support those who have become poor.
3. The main social insurance programs today are: Social Security pensions, disability payments, and Medicare; civil service and military pensions; unemployment insurance; veterans' benefits; and agricultural price supports. These programs are not means tested and constitute about 70 percent of total income support.
4. The main public assistance programs today are: Medicaid, Supplemental Security Income (SSI); Temporary Assistance to Needy Families (TANF); Housing Assistance; Food Stamps; and the Earned Income Tax Credit (EITC). These programs are means tested and constitute about 30 percent of total income support.

The chapter then presents the public choice perspective on public assistance.

5. Public choice economists see public assistance as an extension of private charity, which is motivated by altruistic feelings by the nonpoor towards the poor.
6. Because something about the poor bothers the nonpoor (i.e., enters the nonpoor's utility function), charity is just another example of a consumer externality. Since externalities are an efficiency problem, charitable donations motivated by altruism are called Pareto-optimal redistributions. They are not a matter of equity in the usual sense because they are win–win propositions: both the donors and the donees gain from the redistribution.
7. The first example involved two classes of people, the rich (R) and poor (P), with the rich deciding that the poor do not have enough food to eat. Therefore, R's utility function is $U^R = U^R(Y_R, F_R, F_P)$, where Y is a composite commodity whose price and marginal cost equal one and F is food. The Pareto-optimal condition for P's consumption of Y and F is $MRS^P_{Y_P,F_P} + \sum_R MRS^R_{Y_R,F_P} = MRT_{Y,P}$.
8. Public provision of charity becomes necessary because each rich person has an incentive to free ride on the altruism of the other rich people, which leads to an underprovision of private charity.
9. The way to achieve the Pareto-optimal condition is to subsidize the poor's purchase of food, with the per-unit subsidy, s = $\sum_R MRS^R_{Y_R,F_P}$. This is the standard Pigovian subsidy, equal to the sum of the marginal benefits to the rich of the poor's purchases of food. The poor can buy as much food as they want at the subsidized rate. If the rich view the poor as being in different income classes, such as near poor, poor, and very poor, with different (marginal) effects on their utility, then a different subsidy rate for each income class of the poor is required.
10. If the charitable impulse of the rich to the poor takes the form that the poor simply do not have enough total resources, such that $U^R = U^R(Y_R, F_R, U^P(Y_P,F_P))$, then the transfer to the poor should be in cash. Cash transfers have the advantage that they are preferred by the poor to subsidies of specific goods such as food. They give the poor higher utility for equal amounts of aid received.
11. The U.S. is ambivalent about whether public assistance should be cash or in kind, and uses a mixture of both types of aid. Cash programs include: SST, TANF, and the EITC. In-kind programs include: Medicaid, Housing Assistance, and Food Stamps. The majority of aid is in kind, primarily because Medicaid is larger than all the other public assistance programs combined.

12. Governments often put limits on the amount of in-kind aid that a recipient can receive because they want to know in advance the maximum amount of aid they are committed to. They also want to prevent resales of the aided item. But if the recipient spends more than the limit on the aided item, as is almost universally true with Food Stamps, then the in-kind aid is equivalent to a cash transfer.

The chapter concludes with a discussion of why mainstream economists think that Pareto-optimal redistributions are insufficient by themselves to resolve the question of end-results equity or distributive justice.

13. Pareto-optimal redistributions change the shape of and restrict the utility possibilities frontier, but they do not indicate where on the frontier society should be. A social welfare function is necessary to make that final decision, in essence a decision about the appropriate initial distribution of resources. Absent a social welfare function, the poor are disenfranchised and very little redistribution may occur if the nonpoor are not very altruistic towards the poor.
14. If the redistribution called for by the social welfare function substantially reduces inequality, then there may be no need for Pareto-optimal redistributions; those with higher incomes may no longer feel altruistic towards those with lower incomes if even the lowest incomes provide a decent standard of living.