Chapter Summaries

Chapter 11: Practical Issues in Designing Transfers to the Poor

Chapter 11 begins by posing three important practical questions associated with giving transfers to the poor: 1. Should they be cash or in-kind? 2. Can they be decentralized? 3. Should they be broad-based or targeted? It then reviews how the mainstream and public choice theories answer these questions.

1. *Mainstream theory*: The transfers (and taxes) to satisfy the interpersonal equity condition for a social welfare maximum (equalize the social marginal utilities of income across all people) can either be cash or in-kind. They are targeted on the basis of social marginal utilities and, since they must also be lump-sum, they have to be centralized.
2. *Public choice theory*: Whether the transfers are cash or in-kind depends on what about the poor enters into the utility functions of the nonpoor. If specific goods, then the transfers are in-kind; if overall resources or utilities, then the transfers are cash. The transfers are necessarily targeted to the poor. If the aid is in-kind, it is decentralized; if cash, it must be centralized.
3. Other motives for transfers that economists have analyzed are charitable gifts to organizations made to confer status on the donor, and in-kind gifts of education rather than cash by parents to their children to avoid the Samaritan's dilemma.

The chapter then considers the relevant merits of broad-based versus targeted transfers.

4. A credit income tax is the simplest broad-based tax transfer program. It has the form $T = -S + tY$, where T is the tax liability, S is a refundable subsidy given to everyone, t is the tax rate, and Y is income. It is inexpensive to administer but requires a very high tax rate to achieve much of a net subsidy to the lowest income groups.

5. A targeted transfer to the poor, combined with an exemption for low income taxpayers under an income tax, which is the method used by the U.S., requires a much lower income tax rate than a credit income tax for a given subsidy to the poor, but it subjects the poor to a very high marginal tax rate on any income that they earn.
6. Milton Friedman's proposed negative income tax combines the low administrative costs of the credit income tax with targeting of the transfers to the poor. It also gives aid to the poor no matter what their personal characteristics are or where they live, in contrast to the state administered, categorical U.S. programs such as TANF and Medicaid. It violates the "local administration" principle of the English Poor Law, however, which may explain why it has not been adopted in the U.S.

The chapter concludes with a discussion of some of the practical problems associated with targeted transfers.

7. A targeted transfer program would be considered a success if it could meet three goals simultaneously: 1. Get (almost) everyone out of poverty; 2. Not be too expensive to the taxpayers; and 3. Maintain work incentives for the poor.
8. The standard formula for giving cash to the poor is to define a cut-off level of income, Y_{cutoff}, at which aid ceases and give a subsidy $S = X\%(Y_{cutoff} - Y_A)$, where Y_A is the actual level of income, and $Y_A < Y_{cutoff}$. The recipient's total income under this formula is $Y_{total} = Y_A + S$.
9. Achieving all three goals is impossible with this subsidy formula. The first two goals are in a trade-off relationship: the higher is Y_{cutoff} the larger the number of people who escape poverty, but the costs to the taxpayers increase.
10. The formula is also terrible for maintaining work incentives. The labor–leisure model demonstrates that there is both a substitution and income effect against work and in favor of leisure. The substitution effect against work arises because every dollar of additional income earned reduces the subsidy S by X% of the dollar. Therefore income is effectively taxed at X% on the margin. The income effect against work arises because the recipient is subsidized in total; higher income favors leisure over work because leisure is a normal good.
11. The Reagan administration destroyed all work incentives in the formula under Aid to Families with Dependent Children (AFDC), the precursor to TANF, by raising X to 100% after the first few dollars of earned income. To preserve the incentive to work, the administration instituted *workfare*, a requirement that recipients work or receive training as a condition for receiving benefits. Workfare initially failed because states were not subsidized for the work and training programs, but it became a central component of TANF, which replaced AFDC in 1996. In addition to workfare, states were given the option of removing people from the welfare rolls if they received assistance continuously for two consecutive years, or sporadically for five years.

12. The EITC is a wage subsidy for low income earners of the form S = s.Y, where s is the subsidy rate. s was 40% of the first $11,350 of wage income in 2006 for a family with two children. The formula provides much needed incentives to work for poor adults, but formulas of this kind suffer from a serious notch problem at the cut-off level of income – people who earn additional income above the cut-off end up with less income because they lose all of the subsidy. To avoid the notch problem, EITC offered the maximum subsidy of $4,536 (on an income of $11,350) for those earning between $11,350 to $14,850, and then reduced the subsidy by 21 cents per dollar until the subsidy became zero (at $38,348). Adding these two phases to avoid the notch problem generates negative work incentives for those earning above $11,350 and gives most of the aid under the EITC to non-poor families.