Welfare Reform, Work and Wages: A Summary of the US Experience

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Background

Welfare programs confront policy makers with tradeoffs among conflicting objectives. Programs that alleviate need among the poor can lead to dependency. Desires to promote work in order to reduce dependency must confront the fact that benefits must fall as earnings rise unless the program is to be universal. This creates a work disincentive.

Starting in the 1960s, US policymakers struggled to fashion a program of cash assistance that would alleviate need among the poor while promoting work and limiting dependency. By the early 1990s, a series of reforms focused squarely on promoting work and limiting aid. Here we describe briefly the policy reforms that were geared toward promoting work and the empirical evidence of the effects those reforms had on employment. Much of this material is drawn from our forthcoming book, which goes into more detail and covers a much broader range of outcomes (Grogger and Karoly in press). One topic not discussed there, however, is how welfare reform affected wages. Here we discuss the limited evidence on wage effects and the importance of wages for determining the terms of the tradeoff among different policy objectives.

Prior to the passage of the Personal Responsibility and Work Opportunity Restoration Act of 1996 (PRWORA), the primary US welfare program was called Aid to Families with Dependent Children (AFDC). Like welfare programs everywhere, AFDC was available only to the poor. Unlike such programs in many countries, AFDC was intended primarily for single parents with co-resident children, with 93 percent of all aid going to families headed by single mothers. AFDC was an entitlement program, meaning that aid had to be provided to all eligible families who sought it. Funding was shared between the federal government and the states. The states set benefit levels, which varied widely. Despite differences in benefit levels, recipients in all states faced the same implicit tax rate when they went to work. The statutory tax rate was 100 percent after four months of work, which provided a clear disincentive for recipients to work.

In response to rising caseloads and concerns about employment disincentives and the effect of AFDC on family structure, several states sought and received permission to change their welfare programs beginning in the early 1990s. Momentum for nationwide reform gained steadily until the passage of PRWORA in August 1996. PWRORA ended the entitlement status of the welfare program and replaced AFDC with Temporary Assistance for Needy Families (TANF). It gave states leeway to change their programs in ways not possible under AFDC. Many of the changes undertaken by the states were designed to promote work.

Major policy changes during the 1990s

During the 1990s, the states changed their welfare programs in ways that are literally too numerous to mention. Of all the policy changes, financial incentives, work requirements and time limits probably had the greatest effect on work behavior. We discuss each in turn.

Financial incentives

Whereas AFDC imposed high tax rates on recipients' earnings uniformly across the country, states now differ a great deal in the rate at which they reduce recipients' benefits as their earnings grow. A few have maintained the old AFDC tax structure, but most have adopted lower tax rates. Connecticut

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has the most generous financial incentive in the country, allowing recipients to keep their full benefits until their earnings exceed the federal poverty line, which amounts to $1,268 per month for a single parent with two children as of 2004.

Financial incentives provide an incentive for non-working welfare recipients to begin working. However, because they involve conflicting income and substitution effects, their effects on hours of work are more complicated.

Work requirements

Work requirements mandate that recipients work – or engage in "work related activities" – as a condition for receiving aid. Not surprisingly, theory predicts that such requirements should increase employment among welfare recipients. The extent to which they increase work may depend on the nature of the welfare-to-work program, according to which non-working recipients satisfy their work requirement. During the 1990s, states largely replaced their skills-focused programs, which stressed education and training, with placement-focused programs, which stressed search and rapid employment. Placement-focused programs may have greater effects in the short-run, while skills-focused programs occupy their students with classroom activities. If those classroom activities impart valuable skills, however, skills-focused programs could boost wages and result in larger long-run effects.

Time limits

Time limits represent the most radical departure from past welfare policy. Whereas AFDC allowed families to receive aid as long as they remained eligible, federal TANF funds cannot be used to provide benefits for more than 60 months over the recipient's lifetime. Many states have adopted even stricter time limits. Time limits could have both behavioral and mechanical effects. Behaviorally, time limits provide consumers with an incentive to bank their benefits for later use, even before the time limit becomes binding (Grogger and Michalopoulos 2003). This behavioral response may also increase employment. Once the consumer exhausts her benefits, she may be removed from the welfare rolls. This should mechanically reduce welfare receipt, but its effect on employment is indeterminate.

Data

Theory predicts that all of the major reforms described above should increase employment. To test these predictions, we assembled data from 35 studies of the effects of specific welfare reform policies or welfare reform as a whole on employment. Among these studies, 29 are experimental and 6 are observational.

The experiments involved random assignment of welfare recipients to treatment and control regimes, where the control regime was AFDC and the treatment regime involved one or more of the reforms described above. We classify the experiments according to their major reform or combination of reforms. The observational studies typically involved analyses of data on welfare-prone populations, such as single mothers, from nationwide samples such as the Current Population Survey. The effects of welfare reform are identified in these studies largely from differences in the timing and nature of the states' reform policies, either specific reforms – namely financial incentives and time limits – or reform as a bundle. All of the studies whose results we tally included state dummies in an attempt to capture unobservable differences between the states that may influence both welfare policy and employment. Likewise, all included a state-level measure of economic performance in an attempt to distinguish the effects of the economy from the effects of welfare reform. Finally, these studies included controls for year effects in order to capture nationwide trends in factors that may have influenced employment among at-risk groups, such as negative media portrayals of welfare.

Results

The Table presents a tally of the qualitative results from experimental and observational studies of the effect of specific reforms or reform as a bundle on employment.[1] We think of these as reflecting the short-run effects of welfare reform, because the experimental results are based on roughly two years

[1] These are the same studies whose quantitative results are discussed in Chapter 6 and whose qualitative results are tallied in Chapter 10 of Grogger and Karoly (in press). Note that some studies contribute more than one count to the results in the Table. Some experimental studies examined employment impacts for two populations: longer-term welfare recipients and recent welfare applicants. A few observational studies estimated effects of more than one specific reform policy or both a specific reform policy and reform as a bundle. Two experimental studies contribute experimental results for reform as a bundle, as well as observational results for the mechanical effect of time limits.

Qualitative impacts of welfare reform policies on employment: Results from experimental and observational studies

Policy reform	Source	Negative impact		Zero	Positive impact	
		Signif.	Insig.		Insig.	Signif.
Financial incentives	E	–	–	1	1	1
	O	–	–	–	–	1
Work requirements	E	–	1	–	3	9
Financial incentives combined with work requirements	E	–	–	–	3	9
Time limits (behavioral)	O	–	–	–	–	3
Time limits (mechanical)	O	–	2	–	–	1
Reform as a bundle	E	–	–	–	2	4
	O	–	–	–	–	3

Note: E = Experimental studies; O = Observational studies. Statistically significant results are those with p<0.10 or better.

of follow-up data and the observational studies rarely include more than two or three years of post-reform data. The theory discussed above predicted that all of the major reforms should increase employment, and by and large, the theory is borne out by the data. Of the 44 estimates reflected in the Table, 40 are positive. Of the four that are not positive, two pertain to the mechanical effects of time limits, about which theory has the least to say. Among the 40 positive estimates, 31 are statistically significant at the 10 percent level or better. This is many more than one would expect by chance.

Not reflected in the table are some important qualifications. First, the quantitative effects of these reforms are generally modest in magnitude. The studies typically show that reform raises employment by roughly 5 to 10 percent. This is not a trivial amount, but neither can it be said to represent a fundamental change in behavior. Second, there is some evidence that these effects fade out over time. Eleven of the experiments that focused on work requirements provide five-year follow-up data. In the first two years of these experiments, work requirements increased employment by an average of 4.8 percentage points. By the last two years, the average effect had fallen to 2.0 percentage points.

Policy tradeoffs and the importance of wages

One way to summarize the results in the Table is that almost any reform undertaken led to increases in employment, albeit modest increases that may not have lasted too long. This provides some policy guidance. It shows that, since modest employment gains can be achieved from any of a number of policies, the real tradeoff policy makers face is between alleviating need and limiting dependence. In Grogger and Karoly (in press), we show that financial incentives raise incomes, but that they also raise welfare use, since they give consumers an incentive to combine work and welfare rather than leave welfare altogether. We also show that time limits and work requirements reduce welfare receipt, but have little if any effect on the mean incomes of recipients. Thus the policy tradeoffs involve financial incentives, which raise employment and incomes at the expense of higher welfare receipt, versus time limits or work requirements, which raise employment and reduce welfare receipt but have little salutary effect on income.

Two further questions follow from these results. The first is, what would be needed to make the short-term employment gains seen above last longer? The second is, what would be needed to lessen the terms of the tradeoff between the conflicting goals of alleviating need, limiting dependency and promoting work? The answer to both involves wages.

If welfare reform were to raise recipients' wages, then short-term employment gains should persist into the future, since higher wages make employment more attractive. Furthermore, positive wage effects can ease some of the short-term policy tradeoffs between alleviating need, limiting dependency and promoting work. If the wages of recipients rise with work experience, then policies that promote work may have favorable effects on earnings over the long-term, even if they have no such effect in the short term. Thus work requirements and time limits could eventually raise earnings and income, in addition to reducing welfare receipt and raising employment immediately. Similarly, the short-term increase in welfare receipt that stems from financial incentives may eventually dissipate, if wage growth eventually leads recipients to leave the welfare rolls altogether.

The key question is whether reform raises wages. Conceivably, it could do so either directly or indirectly. If welfare-to-work programs raised recipients' productivity, for example, by providing additional education or training, the result could be higher wages. However, most states implemented place-

ment-oriented welfare-to-work programs during the 1990s, so direct productivity effects seem unlikely.

Welfare reform also could raise wages indirectly by increasing employment, if welfare recipients enjoy positive returns to work experience. This question is surprisingly controversial. Although human capital theory predicts that wages should rise with experience, there is mixed evidence on whether low-skill workers such as welfare recipients enjoy the same returns to work experience as their higher-skill counterparts.

Among studies that focus on the low-skill population generally, results vary depending on how one measures experience. Studies that employ a traditional potential experience measure, typically defined as age minus education, generally report little if any return to experience (Burtless 1995; Moffitt and Rangarajan 1989; Pavetti and Acs 1997). Studies that employ a measure of actual experience, that is, the number of months or years of work experience since the worker finished school, report returns more comparable to those observed among more general samples of workers (Gladden and Taber 1999; Loeb and Corcoran 2001).

However, four recent studies that analyze the actual experience of welfare participants report conflicting estimates of the return to experience. Grogger (2005) analyzes data from the four-year follow-up of the Florida Family Transition (FTP) program. He estimates that former welfare recipients enjoy returns to experience of roughly 5.6 percent per year. Zabel, Schwartz and Donald (2004) analyze data from the 18-, 36-, and 54-month follow-up surveys of the Self-Sufficiency Project (SSP). They estimate returns to experience between 7.3 and 9.6 percent. In contrast, Card, Michalopoulos and Robins (2001), who analyze data from the 36-month follow-up of SSP, estimate returns between 2 and 3 percent. Finally, Card and Hyslop (2004, 15) report that "work experience attributable to SSP appears to have had no detectable effect on wage opportunities" based on an analysis of data from the 54-month follow-up.

Why these estimates differ so widely is not clear. Three of the studies are based on data from the same demonstration project, which one might expect to increase the similarity of their results. At the same time, they employ different approaches to deal with self-selection into employment and different methods to handle the potential endogeneity of work experience. Given the importance of the question they address, further research into the differences between these studies would be useful.

Even if welfare recipients enjoy returns to experience similar to those observed among higher-skilled workers, there remains the question of whether the experience gains that result from welfare reform are enough to spur meaningful wage growth. FTP increased experience by about three months over a four-year period (Grogger 2005). SSP raised experience by about four months over five-and-a-half years (Card and Hyslop 2004). Even if the return to experience is 7 percent, employment gains along these lines (which are fairly large by the standards of the experimental literature) would translate into small wage gains. Put differently, in order for wage growth to ameliorate the trade-offs among the conflicting goals of welfare reform, reform would have to result in much larger employment gains than we have generally observed.

Conclusions

Raising employment is a key objective of many welfare policy makers around the world. Economic theory predicts that it should be possible to raise work effort either using "sticks", such as work requirements and time limits, or "carrots", such as financial incentives. Results from dozens of welfare reform studies largely bear this prediction out.

At the same time, those studies reveal that the magnitude of those effects tends to be modest. This finding has important implications, particularly for the long term. Policy reformers often speak of work as first step toward a "virtuous cycle" by which recipients eventually leave the welfare rolls. The idea is that increased employment leads to higher wages, which in turn result in greater work effort and eventually higher incomes. In order for the virtue to start cycling, however, today's work must generate tomorrow's wage gains. This, in turn, requires that wages grow with experience and that experience grows enough to generate meaningful wage gains.

Recent work has provided mixed results regarding the return to experience facing low-skill workers such as welfare recipients. Perhaps more importantly, the experience gains generated by welfare reform experiments seem unlikely to lead to substantial wage gains, even if the return to experience is high.

Relying on increased experience alone is likely to result in only limited wage gains. Thus, with the prospects for substantial wage growth in doubt, the policy tradeoffs between alleviating need, limiting dependency and promoting work can be expected to dominate future welfare reform debates.

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