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Will Welfare Reform Cause Displacement?

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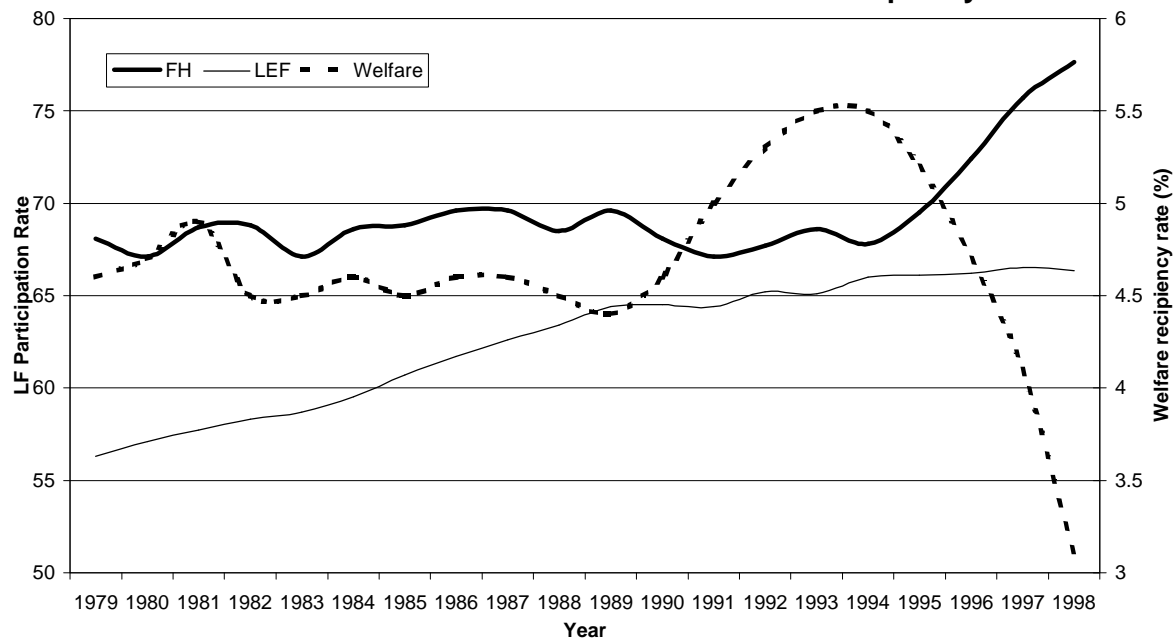
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Will Welfare Reform Cause Displacement?

Welfare reform is pushing large numbers of welfare recipients into the labor market. Will this added labor supply lead to higher unemployment or lower wages? If it does, who will be most affected?

Clearly, federal and state welfare reform efforts are dramatically lowering the welfare rolls and adding to the labor supply. Figure 1 shows the welfare rolls and the labor force participation rates of single mothers and other women with similar education levels. The recent decline in welfare rolls is unusually large, even for an economic recovery, and the decline has been accompanied by an upsurge in labor force participation of single mothers. Although some of this labor supply increase is due to the 1993 expansion of the Earned Income Tax Credit, a careful study suggests that at least a third of this labor supply increase is due to welfare reform (Meyer and Rosenbaum 1998).

Figure 1. Labor Force Participation Rates of Female Heads and Other Less-Educated Females and the Welfare Reciprocity Rate



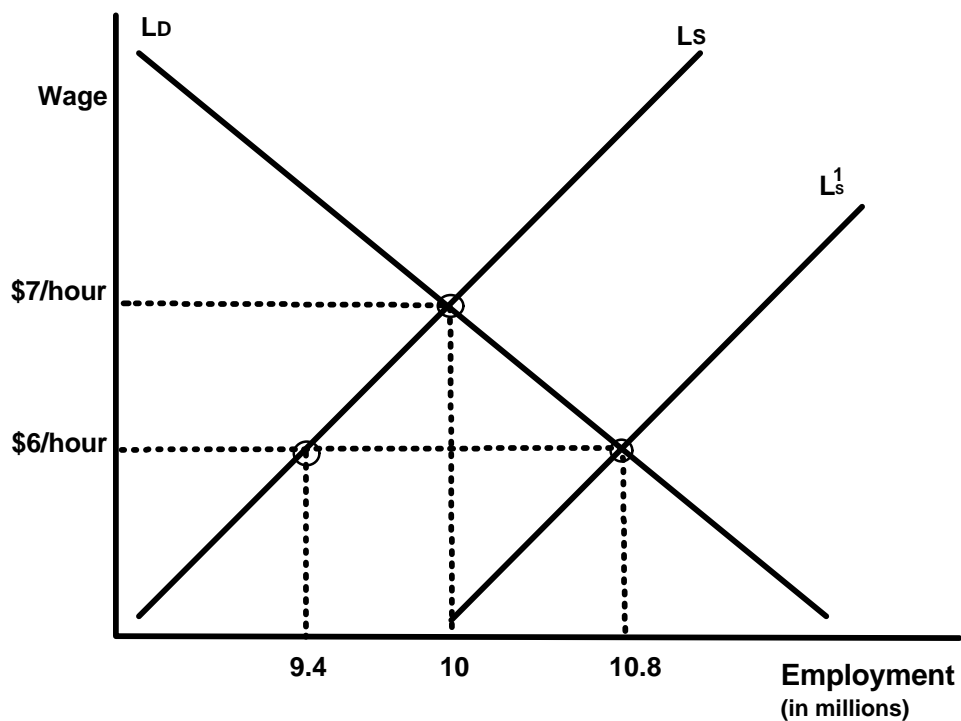
Source: Derived from Bartik (1999).

Notes: "Female heads" (FH) are female heads of household, with other relatives present in the household, who are also ages 16-44 and have less than 16 years of education. "Less-educated females" (LEF) is all females, ages 16-64, with less than 16 years of education, except for female heads. The welfare reciprocity rate is the number of welfare recipients for that fiscal year as a percent of the U.S. population for that calendar year.

In a recent study (Bartik 1998), I reviewed previous research and presented new findings on the effects of welfare reform on labor supply. I concluded that welfare reform over the 1993–2005 period is likely to raise the total labor force by between one million and two million persons.

How this labor supply increase affects wages and employment depends upon how labor demand and labor supply respond. Figure 2 shows how a labor market is affected by a labor supply increase; the labor market in question could be the overall labor market or some segment of that market, such as the market for less-educated women. As the figure shows, the increase in labor supply lowers wages. Although employment increases, the increase is not as much as the added labor supply, implying that some workers lose their jobs (that is, they are displaced) because of the labor supply increase.

Figure 2. Wage and Displacement Effects of a Labor Supply Shock



Notes: L_D , labor demand curve; L_S , labor supply curve before shock; and L_{S1} , labor supply curve after shock. Wage and employment numbers given in figure are arbitrary numbers, chosen for illustrative purposes. Based on these arbitrary numbers, the labor supply shock lowers wages in this labor market from \$7/hr. to \$6/hr. Employment increases from 10 million to 10.8 million. However, this employment increase of 0.8 million is less than the labor supply increase of 1.4 million (= 10.8 million minus 9.4 million). Of the 10 million workers originally employed, 0.6 million lose their jobs due to the labor supply increase (0.6 million = 10 million - 9.4 million), that are displaced. The "displacement rate" or "displacement effect" is the loss in employment of the original workers, divided by the number of new workers who find jobs, or 0.6 million/1.4 million = 0.43 in this arbitrary example.

Displacement and wage declines depend on how sensitive labor demand and supply are to wages, which in Figure 2 is shown by the slopes of the lines. If the labor demand curve is closer to vertical, then labor demand does not respond much to wages and a labor supply increase causes larger displacement and wage effects. If the labor supply curve is closer to horizontal, then labor supply is more responsive to wages and the increase in labor supply will have smaller negative effects on wages, but larger displacement effects.

Our knowledge of the overall labor market suggests that the effects of welfare reform on average wages for the entire United States and on overall displacement are likely to be small. First, the labor supply increase from welfare reform is small as a percentage of the total U.S. labor force, probably less than 1.5%. Second, empirical evidence suggests that the total demand for all labor in the United States is quite responsive to an increase in supply. As supply is added, labor demand is stimulated not only by lower wages, but also by “multiplier effects” of the added labor supply on overall U.S. output.

However, the effects of welfare reform on some labor “sub-markets” are likely to be large. First, the labor supply increase from welfare reform is quite large as a percentage of groups such as single mothers with less than a college degree (12%) or female high school dropouts (9%) (Bartik 1999). Second—although there is some dispute over this issue within economics—the best evidence suggests that labor demand for lower skill groups is not very responsive to wages. For example, although there is dispute within labor economics over the effects of the minimum wage, the dispute is over whether the effects of the minimum wage on labor demand are zero or small.

In the short-run, the labor market effects of welfare reform on less-educated women will mainly occur through displacement. In the short run, wages are sluggish to adjust and unemployment varies a great deal, which is the same as saying the short-run labor supply curve is flat. Over the long run, more of the labor market effects on less-educated women will occur through wage declines because of the greater long-run flexibility of wages.

Table 1 presents some possible scenarios for the effects of welfare reform on less-educated women. As the table suggests, welfare reform is likely to have considerable displacement effects on this group, especially in the short run. For every two ex-welfare recipients who get a job, one other woman of similar education level is likely to lose a job. Over the long-run, wages for some groups of less-educated women may decline by close to 10%.

Table 1. Two Possible Scenarios for the Displacement and Wage Effects of Welfare Reform

Type of model	Group considered	Displacement effect ^a	Wage effect
Model with unemployment (Short-run model)	Single mothers	0.6	– 1%
Market-clearing model (long-run model)	Female high school dropouts	0.4	– 9%

SOURCE: Derived from Bartik (1999)
^a “Displacement effect” is loss in employment of those originally working in the group considered, divided by the gain in employment of added labor supply in that group.

The displacement and wage effects presented here are all predictions based on simulations. Can we see any of these effects yet in the data? As reviewed in Bartik (1999), there have been recent declines in relative wages and increases in relative unemployment rates among less-educated women. However, these changes could be occurring because welfare recipients tend to have below-average wages and above-average unemployment rates; for example, in March 1998, the average unemployment rate of women who received welfare during 1997 was 33%. “Spillover” effects of the increased supply of welfare recipient labor on other women are not yet evident.

In sum, our current knowledge of labor markets suggests that welfare reform is unlikely to have large effects on the employment and wages of most Americans. However, welfare reform is predicted to cause significant losses in earnings for some women workers with less education, who will face more competition for jobs from the influx of ex-welfare recipients into the labor market. This will worsen economic prospects for many women who already have low earnings.

How could policymakers respond to this problem? There are three possible alternatives, not necessarily mutually exclusive. The first is to slow down the rapid influx of welfare recipients into the labor market. A second is to expand policies that provide lower income workers with earnings supplements, such as the Earned Income Tax Credit. A third would be to implement policies to add to the employment of less-educated workers with expanded labor demand, such as public service jobs, community service jobs, or subsidies to private employers for hiring.

Suggestions for further reading

Bartik, Timothy J. 1998. “The Labor Supply Effects of Welfare Reform,” Kalamazoo: W.E. Upjohn Institute Working Paper 98-53 (July).

Bartik, Timothy J. 1999. “Displacement and Wage Effects of Welfare Reform.” Prepared for November 1998 conference on Labor Markets for Less-Skilled Workers, Joint Center for Poverty Research. Available at the Upjohn Institute Web site.

Meyer, Bruce D., and Dan T. Rosenbaum. 1998. “Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers.” Working paper, Northwestern University, October.

Timothy J. Bartik is a senior economist at the Upjohn Institute. This article is based on research supported by the Institute, the Joint Center for Poverty Research, the Russell Sage Foundation, and the Rockefeller Foundation. The findings and opinions stated here are those of the author and do not necessarily reflect the views of any of the sponsors of this research.