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The Impact of the 1981 Welfare Reforms on
Female-Headed Households: Dissertation
Summary

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OVERVIEW

As the nation's largest cash welfare program, Aid to Families with Dependent Children (AFDC), is replaced by state welfare programs funded by federal block grants, the effects of reforms on the welfare-participation and labor-supply choices of low-income individuals remain a topic of considerable interest. This dissertation uses two different approaches to analyze the effects of changes in welfare-program benefit formulas and eligibility rules on the economic well-being of and the choices made by low-income individuals.

Empirical evidence of the effects of such changes is available from the 1981 AFDC reforms, which sought to reduce caseloads by restricting limits on earnings and assets. The 1981 Omnibus Budget Reconciliation Act (OBRA81), designed to reign in the explosive growth in caseloads that had occurred over the previous decade, dramatically altered the treatment of earnings and assets in the AFDC program. The 1981 Act eliminated the disregard of one-third of earnings after four months of work, capped the disregards given by caseworkers for work expenses and child-care expenses, and imposed new eligibility restrictions. OBRA81 denied eligibility to families whose pre-disregard income was over 150 percent of the state need standard and imposed a new asset limit of \$1,000 per family. The overall result of these changes was that drastically fewer recipients could maintain eligibility while working, and hence the work disincentive for AFDC recipients was significantly increased.

Current state temporary assistance for needy families (TANF) proposals to expand earnings disregards and asset limits would directly reverse several of the federal regulations implemented under the 1981 Act. This dissertation presents an analysis of the effects of the 1981 welfare reforms on female-headed households with children.

CHAPTER 1

Chapter 1 investigates differences in demographics, income and poverty, labor supply, and multiple welfare-program participation among all female-headed households, AFDC participants, nonparticipants, new AFDC entrants, and recent AFDC exiters, from 1975 to 1987. The results confirm that the population of female-headed households with children is economically quite disadvantaged, with an average real total annual income of \$21,000 (in constant 1994 dollars), average earnings of only \$11,000, and an in-or-near poverty rate of 50 percent. Moreover, AFDC participants are far more likely to be seriously economically disadvantaged than nonparticipants. Among AFDC participants, average total income is only \$11,000, average earnings are only \$2,600 and the in-or-near poverty rate is 88 percent, while among nonparticipants the average total income is \$25,000, average earnings are only \$14,000, and the in-or-near poverty rate is 36 percent.

After 1981, the average annual AFDC benefit fell 28 percent from \$5,600 to \$4,000, the average total income of AFDC participants fell by 19 percent from \$12,000 to \$9,700, and the percentage of households in poverty rose from 66 to 80 percent. In contrast, the real incomes of nonparticipants stayed roughly constant over the 1975-1987 period. In addition, new AFDC entrants after 1981 were more disadvantaged than entrants before 1981. Their AFDC grants were an average of 34 percent lower, earnings were 10 percent lower, total income was 12 percent lower, and their poverty rate was substantially higher. In contrast, the population of AFDC exiters after 1981 was at a level of economic well-being that was roughly equal to the analogous population before 1981, with the exception that exiters after 1981 had earnings that were 26 percent higher than those exiting before 1981.

Paul A. Smith received his Ph.D. from the University of Wisconsin-Madison. His dissertation advisor was Robert Haveman.

CHAPTER 2

The results from Chapter 1 suggest a change in the composition of the caseload of AFDC participants, with participants after 1981 likely to be even more disadvantaged than AFDC participants before 1981. Chapter 2 uses a simple nonparametric approach to estimate the effects of the 1981 welfare reforms on AFDC participation, entry and exit rates, spell lengths, eligibility rates, and participation rates among eligibles. The results showed striking differences between white and nonwhite households. Among white households, the probability of AFDC participation *increased* from 20 to 22 percent after 1981, while among nonwhite households it *decreased* from 42 to 35 percent. The probability of AFDC entry decreased for both groups, but the drop was much larger among nonwhite families (from 12 to 7 percent of previous-year nonparticipants, compared to a drop from 6 to 5 percent for white households). Similarly, the one-year exit rate from AFDC *increased* for white households, from 28 to 30 percent of participants, while it *decreased* for nonwhite households, from 27 to 23 percent. These patterns of strong negative effects on the participation of nonwhite households and weaker positive effects among white households continue even after conditioning separately on age, education, and family size.

The results suggest that, at least among nonwhite households, AFDC participation became increasingly concentrated in the lower tail of the potential-earnings distribution. Although not statistically significant, some evidence was also found that AFDC spell lengths increased somewhat after 1981, consistent with a change in the composition of the AFDC caseload toward less-skilled, lower earning households.

AFDC eligibility rates among female-headed households declined significantly after 1981, even after conditioning separately on age, education, race, and family size. Because eligibility is based on earnings and assets and is hence essentially endogenous, this result shows little evidence of households dramatically reducing labor supply or divesting assets in order to retain eligibility. This is also consistent with an increasing concentration of participants in the lower tail of the potential-earnings distribution.

Finally, AFDC participation rates *conditional* on eligibility increased significantly after 1981, suggesting that rather than discouraging participation among eligibles, the lower benefits and tighter eligibility standards imposed in 1981 refocused participation onto the households most likely to find that the benefits of AFDC participation outweighed the costs.

CHAPTER 3

Chapter 3 develops a formal structural discrete-choice model to estimate utility parameters underlying individual work and welfare choices. Estimates are derived from a discrete-choice model in which female heads choose among six welfare/work combinations: on versus off welfare, together with zero, half-time, or full-time work. The estimation is complicated by kinks in the budget constraint that arise from the loss of welfare benefits at higher income levels, the interaction of the AFDC and Food Stamps programs, and the progressivity of the federal tax system.

Since the joint work/welfare choice affects the shape of the budget constraint, two budget constraints must be evaluated for each household, one with AFDC benefits and one without. The discrete-choice approach to modeling labor supply simplifies this problem considerably, since it reduces the number of points at which each budget constraint must be evaluated. This approach avoids the need to calculate the location of each kink point for the two budget constraints faced by each household. Furthermore, discretizing the labor-supply decision allows the problem to be cast as a standard discrete-choice problem with different work/welfare combinations as alternatives. A cost of this discrete-choice approach is the inability to capture marginal changes in labor supply that may occur as a result of welfare.

A problem faced by recent structural studies of work and welfare is the lack of a tractable analytic solution to the welfare/work choice problem characterized by heterogeneity in preferences. Revealed-preference inequalities in the model specified here are solved analytically, and the model is estimated with standard maximum-likelihood techniques.

The model is estimated on a sample of 2,462 PSID female heads-of-household over the years 1978 to 1984. The changes imposed by the 1981 OBRA are accounted for explicitly in the budget set, as are changes in the federal tax system and the interaction of AFDC and Food Stamps. Also accounted for is a concurrent erosion in real benefit levels that occurred as states failed to increase benefits at the rate of inflation. Once estimated, parameters are substituted into the utility function to predict the response of each individual in the sample to a new policy environment. This technique is used to disentangle the multiple effects of the 1981 reforms and to predict responses to new policy changes.

The findings show that the higher benefit-reduction rate imposed by OBRA81 had a large negative effect on

labor-force participation among AFDC recipients. Restricted eligibility rules had little effect on participants but a positive effect on the labor supply of women newly ineligible for AFDC. Eroding real benefit standards had a large negative effect on AFDC participation, resulting in a large positive effect on the labor supply of women leaving AFDC.

Estimated utility parameters were also used to simulate the effects of hypothetical policy changes. AFDC participation and labor-supply choices were predicted to be unresponsive to changes in needs standards. However, both choices were responsive to changes in payment standards. Higher wages decreased AFDC participation, resulting in a large effect on the labor supply of AFDC exiters. But the effect of higher wages on the labor supply of recipients was predicted to be small, at least in the absence of

higher disregards to match the higher earnings. The net effect of higher wages was to increase the labor supply among female heads.

Perhaps most relevant for states considering new reforms is the prediction that manipulation of the benefit-reduction rate induces significant, offsetting changes in both AFDC participation and work effort by recipients. Lower benefit-reduction rates encourage work effort among recipients, but much of this work effort comes from new women drawn onto the rolls who would have worked even more off of AFDC. Accounting for this effect on labor supply, the net response of aggregate labor supply of female heads to the benefit-reduction rate is small. Finally, lower benefit-reduction rates also significantly increase expenditures on benefits, as more women move onto AFDC.