Published Weekly by
AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. XLVI No. 4 January 22, 1979

Welfare Reform

Given the cash grants and "in kind" transfers now available from welfare programs, virtually everyone can obtain a real income in excess of the "poverty line." Yet dissatisfaction with welfare programs is nearly universal, and reform of them seems necessary. Although some reduction of government outlays may be effected by "tinkering" with existing programs, radical reform, such as the provision of a guaranteed income, seems improbable. It is thus because of conflict among the goals of reforms: maintaining or increasing the level of aid to the genuinely needy, containing or reducing government spending, and maintaining or increasing the incentives for productive effort. The only sound way to reduce poverty effectively seems to be to promote economic growth by removing barriers to individual incentive and to the freedom to exchange.

About 15 years ago, the United States Government increased its participation in two "wars": one in Southeast Asia, and the other against "poverty" in the United States. Obviously, the U.S. failed to achieve its goals in Vietnam. Many also believe that the other war has been lost as well. The "hawks" in both instances probably would attribute the failures to a lack of willingness to "fight to win." In the shooting war, the U.S. never committed its full military capability to the fight, and the efforts to eliminate poverty have not to date included a minimum guaranteed cash income for every American family. "Doves" may argue that the objectives – attempting to do things for persons that only they can do themselves – were futile and made victory impossible.

As with any analogy, that between the two wars may be carried too far. In particular, the "defeat" in the "war on poverty" is by no means as clear as that in Southeast Asia. There are many who would argue that poverty (of the degree which the war was designed to eliminate) is no longer a problem in the United States. They might add that the failure to rejoice at this "victory" simply reflects dissatisfaction with the costs of welfare programs, the level of benefits received by those in genuine need, and the prospects for enabling welfare recipients to lead useful and productive lives. Nearly every politician, including each of our last three Presidents, has said that reform of the welfare system is a high national priority. Yet there have been no major changes in welfare programs during recent years, and none seems on the horizon. This inertia would seem to be the major source of the national sense of defeat in the war on poverty.

A useful description of the issues involved and the difficulties in obtaining a consensus that could facilitate desirable changes in our conduct of the war on poverty is contained in *Welfare: The Political Economy of Welfare Reform in the United States*, by Dr. Martin Anderson (Hoover Institution Press, Stanford, California, 1978, $10.00). Dr. Anderson was an advisor and consultant on welfare reform to Presidents Nixon and Ford and to Ronald Reagan in the 1976 presidential campaign. His book was the major source of the material in this article.

The Uncertain Victory

In many discussions, poverty is defined arbitrarily. The only available national poverty data are those of the U.S. Bureau of the Census. They determine the poverty level from the amount needed to obtain a "nutritionally adequate" diet, the estimated ratio of food outlays to total household purchases, and the level of the Consumer Price Index. For a nonfarm family of four, this estimated "poverty threshold" amount of annual income has increased from about $3,000 in 1960 to about $6,500 at present. (For a single person the level is now about $3,500 per year.) Some readers may think these levels low because they may know persons with, say, double the "poverty line" incomes, that they consider to be poor. Others may consider these thresholds overly large. The point is that poverty seems to be largely relative. After all, the income levels just described exceed by far those of most humans now living and even those of most Americans of past eras.

Although the poor by the official definition are poor only in relation to other Americans of today (see "For the Poor You Have Always With You," *Research Reports*, November 29, 1976), the Bureau of the Census data provide the basis for nearly all discussions of poverty, and this Bureau is the source of the discouraging news from the war on poverty that the proportion of the population below the poverty line, about 12 percent, has changed little during the past decade.

This seems incredible, given a nearly five-fold increase in government spending to prevent or reduce poverty between 1967 and 1977, about 2.5 times the increase in the price level during that period. Government outlays for anti-poverty-type "transfer payments" were about $95 billion during 1977 and $21 billion during 1967.* The 1977 amount equaled about $3,600 for every man, woman, and child officially counted as poor. Clearly something is amiss with the government programs to alleviate poverty, the measurements of poverty, or both.

Dr. Anderson and many others, including analysts at the Congressional Budget Office, claim that the Bureau of the Census' data greatly overestimate the extent of poverty in the United States because respondents to the surveys upon which the estimates are based may conceal

* Taken from the National Income and Product Accounts estimate of total transfer payments less payments for railroad retirement, Federal civilian retirement, military retirement, veterans pension and disability, and state and local government pensions, and three-quarters of old-age, survivors, and disability payments.

or simply not know their actual incomes; such persons' low-income status may be of very short duration; or they may be living off remittances from relatives, from sales of assets, or from other receipts that are not labeled "income." However, the most questionable aspect of the poverty data is that the official statistics reflect only cash incomes, not "in kind" receipts of goods or services.

Transfers in Kind

The variety of ways that governments and private charities disperse in kind benefits to the poor would enable one who is well-organized and takes advantage of available programs to have a cash income below the poverty line and yet claim resources (via food stamps, Medicaid, housing subsidies, day-care, educational and training programs, etc.) that otherwise would take a taxable income in excess of the national median! Such cases are probably rare, because few persons have the knowledge or the endurance to claim every government benefit to which they are "entitled."

In any event, a reasonable case can be made that the war on poverty, as poverty is officially defined, has been won. Many still in poverty may be unaware of what is available, and others may choose not to receive handouts. But the programs are there for those who are eligible, and a great many evidently are. According to the Congressional Budget Office, 44 million Americans received some form of welfare assistance during 1977.

The Poverty Wall

The explosion of government spending on welfare has increased the proportion of resources transferred from more productive citizens to less productive citizens. Although it is widely perceived that, with reference to the economy as a whole, this involves a flow of resources from the "rich" to the "poor," it is less well-known that the system places its greatest burden on those who are attempting to escape poverty, not on the very wealthy. Less than one-half of one percent of all taxpayers have any income taxed at the top Federal rate of 70 percent, and most private income is taxed at rates substantially smaller than that. The exception is the wage earner who is in the range of about $4,000 to $8,000 per year, for whom the combination of becoming a taxpayer and a loser of welfare benefits can result in a very small net gain out of every additional dollar earned.

Because of wide variations in state income taxes, eligibility requirements, and benefit levels among states, generalizations about the effective marginal tax rates on the earnings of those on welfare are not feasible. Dr. Anderson estimates that it can range as high as 80 percent. Moreover, sharp discontinuities in the effective marginal tax rates occur when earnings above a specific level disqualify one for specific benefits, say Medicaid. Dr. Anderson calls this effect the poverty wall.

Newly employed welfare recipients encounter expenses associated with working, such as commuting, child care, and clothing. They forfeit a lot of leisure time. And the initial jobs available to them often offer little prospect for advancement or "psychological satisfaction." There is plenty here to discourage one from taking a job when the alternative is the level of welfare benefits now available. "In effect," says Dr. Anderson, "we have created a new caste of Americans – perhaps as much as one-tenth of this nation – a caste of people free from basic wants, but almost totally dependent on the State, with little hope or prospect of breaking free." Perhaps this is why there has been little change in the percentage of the population still in poverty.

Guaranteed Income

Of all the proposals to change the welfare system radically, none has received more attention than a guaranteed income. Supporters of this notion have included both so-called conservatives and liberals. Some conservatives favor the substitution of a single cash grant for a bewildering variety of government programs (Dr. Anderson lists no less than 91 Federal programs in an appendix to his book) because it would involve less bureaucracy and enable the poor to buy what they really want rather than what legislators see fit to provide "for free." Liberals presumably view such plans as means of reducing disparities of income. This would seem to be the basis of a powerful alliance against the obvious opponents, the bureaucrats in charge of administering present programs.

However, a guaranteed income (or negative income tax) now seems to be a dead issue because it is a demonstrated disincentive to work. It is impossible to design a guaranteed income plan that can be integrated with the present income tax rates on moderate income wage-earners without raising the poverty wall and compressing it into a fairly small income range. For example, to guarantee an income of $6,500 to a family of four and to maintain the existing $1,100 of taxes and marginal rate of 25 percent (including Federal and state income taxes and Social Security taxes) on an earned income of $10,000 for the same family, marginal tax rates would have to *average* not less than 76 percent in the range of $0 to $10,000. Perforce the rates must greatly exceed 76 percent at some point, if a smooth transition to the existing marginal rate is to be made at $10,000 of earned income. Drastic alternatives, such as making all income subject to a single tax rate reduced by a large credit payable in cash, are also unacceptable. The single rate would have to be well over 50 percent if the cash credit were to be large enough to be a substitute for existing available welfare benefits. Such high marginal tax rates foster the growth of "subterranean" or "off-the-books" transactions, i.e., tax evasion. Moreover, as Dr. Anderson describes, experiments with guaranteed incomes (and the high marginal tax rates they involve) confirm they are a significant disincentive to work. Dr. Anderson conjectures that, if cash grants were universally available and permanent, this disincentive would be far more harmful than indicated by the limited experiments conducted to date.

The provision of in-kind transfers to the poor instead of guaranteed cash incomes probably is supported by busybodies appalled at the thought that the poor may spend the cash on flashy cars and clothes, lottery tickets, and divorce lawyers instead of better nutrition, medical care, housing or education. But some lawmakers may also prefer non-cash relief programs because they hide the poverty wall and flatten it somewhat. Since roughly 20 percent of Americans receive some form of relief but only 12 percent are classified as poor, it is clear that in-kind transfers are withdrawn only gradually as incomes increase. Thus, the poverty wall is extended over a fairly broad range of incomes and the peak effective marginal rate is lowered. Because some outlays for welfare "benefits" are claimed by "non-poor" persons, total outlays are larger than the amount needed to support indigents.

Prospects for Reform

Although reform of our welfare systems is accorded high priority by nearly every politician, Dr. Anderson tells

why there is little reason to expect major changes soon:

"The three basic elements involved in any radical welfare reform plan – the level of benefits, the marginal rate of taxation, and the overall cost to the taxpayers – are *inextricably linked to one another.* If the level of benefits is increased, and the tax rate is held constant, the overall cost must increase; if the overall cost is held constant, the tax rate must increase. If the tax rate is decreased, and the overall cost is held constant, the level of benefits must decrease; if the level of benefits is held constant, the overall cost must increase. If the overall cost is decreased, and the level of benefits is held constant, the tax rate must increase; if the tax rate is held constant, the level of benefits must decrease."

In short, the present state of affairs reflects a compromise, not a consensus, concerning welfare, and the terms of this compromise seem set for some time. Reportedly, only about 6 percent of Americans believe that governments should not support indigents. Those who would favor measures that will foster income equality at the cost of greater disincentives to work and smaller total incomes are also a small minority, presumably.

The only hope that Dr. Anderson offers the majority, whose principal interest seems to be the containment of welfare outlays, is to effect some relatively small savings by "tinkering" with programs as they now exist. Some programs might be consolidated or eliminated, such as unemployment benefits to strikers or to those who accept seasonal or temporary jobs. However, he mainly advocates concentrated efforts at better administration, particularly to reduce payments to ineligibles and to stop fraud.

Dr. Anderson seems to have overlooked a simple means of reducing the net payments to the less needy: declaring all welfare benefits to be taxable income. Then, if W-2 or equivalent forms were issued, welfare recipients whose needs were temporary or who received "non-means tested" benefits, such as Social Security payments, would have to return a portion to the government in the form of taxes. The proportion would be related to the total amount of income they received during a given year.

Dr. Anderson also may be faulted for totally neglecting the most useful remedy for poverty within the nation, which is real economic growth and increasing incomes. Economic growth has done more for the poor than re-distributionist schemes can ever hope to do. It would seem that genuine welfare reform will require increased understanding of the simple fact that output must first be produced before incomes can be distributed. Substantial evidence suggests that the way to foster increased output is to break down the barriers, including special privilege and confiscatory taxation, to an individual's opportunities. The creation of a new privilege, "welfare rights," almost surely will defeat its own purpose.

CONSUMER PRICES

For many years the major question about consumer prices has not been "will they increase," but "how rapidly will they increase." Current evidence suggests that the Consumer Price Index (CPI) will continue to increase rapidly during the next few months, but food prices probably will hold down the rate of increase somewhat.

Note: Data other than the percent changes from a year earlier are seasonally adjusted unless indicated otherwise.

According to the Bureau of Labor Statistics, the CPI for all urban consumers increased 2.1 percent, or at a compound annual rate of 8.8 percent, before seasonal adjustment during the 3 months ended during November. The unadjusted level of the index for November was 202.0 (1967=100), which was 9.0 percent more than that a year earlier. Adjusted for seasonal variation, the compound annual rate of increase during the 3 months ended in November was 8.6 percent.

The accompanying table shows the compound annual rates of change of the CPI and of various subcomponent indexes during the 3 months ended in February, May, August and November 1978. As the table indicates, the rate of increase in the total CPI accelerated to double-digit rates during the 3 months ended in May but then abated to slightly above 8 percent during the 3-month periods ended in August and November. Both the acceleration and the subsequent abatement in the rate of increase of the total CPI during those periods were attributable primarily to changes in the rates of increases in food and beverages prices and in housing costs then.

Although expenditures for food and beverages account for less than 20 percent of the total CPI, such costs historically have fluctuated markedly and have accounted for much of the fluctuations in the total index. Thus, the outlook for food and beverages prices is a major factor in assessing the probable near-future trend in the rate of increase in the CPI.

Two food-supply developments suggest a probable moderating of increases in food prices during the next few months. First, total crop production in the United States during 1978 was large, only about 0.8 percent less than the record amount produced during 1977. Second, farmers are sending their less than full grown cattle and pigs to slaughter to take advantage of the recent high prices for those animals. As a result, the supply of meat reaching the market over the short term may be adequate to reduce upward pressure on meat prices.

However, after these younger animals are slaughtered, the supply of meat reaching the markets will be unusually small. This will put upward pressure on meat prices. Further upward pressure may develop because beef cattle and pig suppliers have begun holding more of their mature animals off the markets for breeding. But because of the increased breeding stocks, cattle supplies should be markedly higher in another year or so.

ANNUAL RATES OF CHANGE
IN CONSUMER PRICE INDEXES*

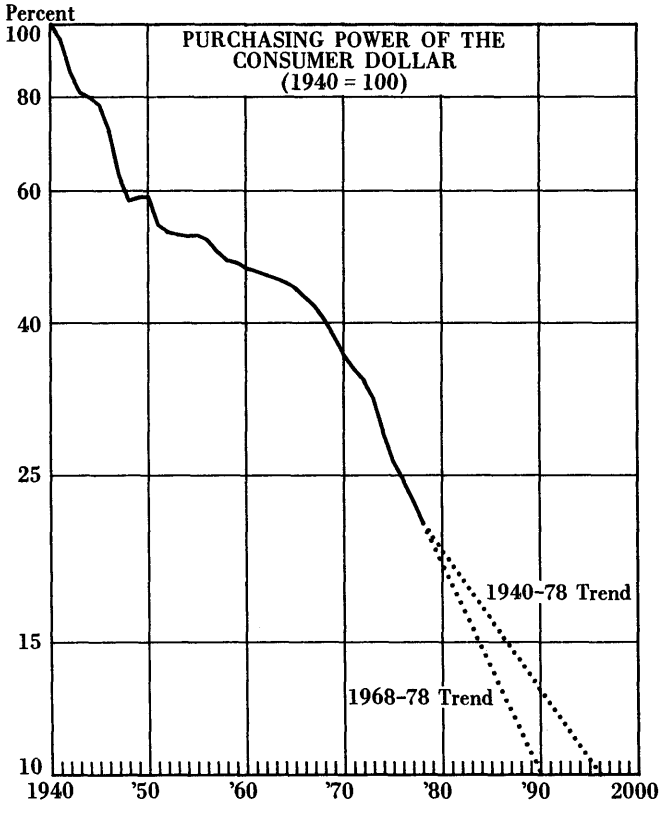
		Over Span of 3 Months Ended in:			
Relative Importance	*Index*	*Feb. 1978*	*May 1978*	*Aug. 1978*	*Nov. 1978*
100.0	All items	+7.5	+11.3	+8.3	+8.6
	Expenditure Group				
18.8	Food & beverages	+11.8	+19.8	+6.2	+6.7
43.9	Housing	+7.8	+12.0	+11.0	+9.7
5.8	Apparel & upkeep	–1.8	+10.7	+1.0	+4.6
18.0	Transportation	+7.1	+4.0	+7.6	+9.5
5.0	Medical care	+9.1	+7.7	+7.8	+11.7
4.1	Entertainment	+6.0	+6.1	+3.5	+5.8
4.4	Other goods & services	+3.7	+5.0	+9.4	+7.8
	Commodity & Service Group				
59.3	All commodities	+7.6	+11.0	+6.9	+8.8
18.8	Food & beverages	+11.8	+19.8	+6.2	+6.7
40.5	Other commodities	+5.6	+7.0	+7.1	+9.8
40.7	Services	+7.2	+11.7	+10.6	+8.3
	Memo:				
	Wholesale Price Index†	+9.2	+10.6	+4.4	+10.4

* Consumer Price Index for all urban consumers.
† Producer Finished Goods Index.
Note: All rates are compounded and based on seasonally adjusted data.

The result of all of these changes is that consumer food prices (especially meat prices) probably will increase relatively little for several months, then increase more rapidly until early in 1980, but subsequently moderate again for some months. Of course, prices paid to farmers for animals are not the only factors affecting prices paid by consumers for meat; furthermore, meat is only a small part of the food category within the CPI. Increases in the costs of processing and distributing food products, including meats, could offset somewhat the price influences mentioned above.

With food prices accounting for less than 20 percent of the total CPI, rapid increases in other-than-food prices might produce continuing high rates of increase in the CPI. Such prices, which do not fluctuate as markedly from month to month as food prices, already are increasing at near double-digit rates. Housing and transportation are the largest categories of non-food items. Within the housing category, large increases in mortgage rates, in the costs of new homes, and in the prices of home fuels seem probable in the coming months. Announced price increases for new cars and the expected increase in gasoline prices attributable to the crude oil price hike announced by OPEC may well keep transportation costs rising near or above double-digit rates.

Some analysts have suggested that President Carter's voluntary wage-price guidelines will help restrict future consumer price increases. That expectation is not warranted by historical evidence. During the early 1970's, consumer prices increased rapidly even though President Nixon had imposed mandatory controls. From August 1970 through July 1971 (the year preceding the imposition of controls), the CPI increased 4.4 percent; but during the next 32 months of various *mandatory* controls, the CPI increased at a compound annual rate of 6.5 percent. We should think that voluntary guidelines have less of a chance of restricting price increases than President Nixon's mandatory controls.



The estimated average purchasing power of the consumer dollar (as measured by the CPI) was 21.5 cents during 1978 compared to $1.00 during 1940. (The estimate was made from the CPI data for the first 11 months of 1978.) During the 38 years since 1940, the annual rate of erosion of the consumer dollar has been 4.3 percent per year. At that rate, the dollar loses half of its purchasing power every 16 years and 6 months. During the most recent 10 years, the purchasing power of the consumer dollar has eroded at an average annual rate of 6.7 percent, a rate that would halve it again in 10 years and 8 months, or by 1989. These possibilities are indicated by the dotted lines on the accompanying chart. If the rate at which consumer prices rose during the past year (about 9 percent) were to continue, the consumer dollar would buy half of what it does now in just 8 years. That may seem unbelievable to some, but seems well within the realm of possibilities to us.

A PRACTICAL REASON WHY CENTRAL BANKERS WILL NOT PHASE OUT GOLD

Officials of West Germany's central bank recently revealed that their bank had a loss of $5.72 billion during 1978 on its foreign-exchange holdings (mostly dollars) totaling about $41 billion in November. A Swiss central banker estimated in October that his bank's loss from such during 1978 would be between $3.26 billion and $3.91 billion. That bank's foreign-exchange holdings were about $14 billion in November.

These losses present the central banks with a practical problem: How do the banks absorb the losses? Like private banks, central banks must maintain a balance between assets and liabilities. It would be most embarrassing and politically unacceptable for these bankers to seek an infusion of capital from their respective treasuries and taxpayers to cover these losses.

What can they do? The Swiss official suggested his bank might increase the price at which the bank valued its gold holdings for bookkeeping purposes, which then was about $95 per ounce. To cover a $3.5 billion loss, the bank's book-price of gold would have to be raised to the Swiss franc equivalent of about $135 to $140 per ounce, according to our estimate. Presumably West German central bankers also will take this way out of their problem, inasmuch as their bank carries gold on the books at the mark equivalent of about $65 per ounce.

Each time the central bankers use their gold stock this way, the monetary role of gold is strengthened. Central bankers are not going to phase out gold for their monetary reserves when it is the primary asset they have for covering their foreign-exchange losses, all the anti-gold rhetoric from Washington notwithstanding.

PRICE OF GOLD

	1978	*1979*	
	Jan 19	*Jan. 11*	*Jan. 18*
Final fixing in London	$173.45	$220.65	$231.75

Research Reports (ISSN 0034-5407) (USPS 311-190) is published weekly at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Second class postage paid at Great Barrington, Massachusetts 01230. Sustaining membership: $9 per quarter or $35 per year.