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**Welfare Reform  
in the United States:  
Lessons for a Future Social  
Federation of the EMU**  
Waltraud Schelkle

Robert Bosch Foundation Research Scholars Program  
in Comparative Public Policy and Institutions  
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## A. THE CASE FOR A SOCIAL FEDERATION OF EMU IN COMPARATIVE PERSPECTIVE

In 1999, the European Union formed a currency area of roughly the same size as that of the United States. Currency unification is meant to be the vehicle for “ever closer” political union. That would ultimately imply the formation of a continental polity with wide socio-economic disparities. In this respect, the Economic and Monetary Union (EMU)<sup>1</sup> of Europe would resemble the U.S. rather than any of its constituent nation-states.

One of the most divisive issues is how to proceed with respect to social policy matters. In the richer EMU countries, fears of a rush to the bottom are widespread. Poorer countries are afraid of a rapid upward convergence in social standards since they see this as a threat to their catching-up. Thus, a uniform level of social insurance would either mean a tangible loss of living standards in high-income regions or a development trap for low-income regions.

Are there ways to circumvent this well-known dilemma that potentially undermines political support for European integration, let alone for “political unity?” This is the basic question of the present study. It will be explored with respect to the U.S. for obvious reasons. First of all, this dilemma of social policy in a federation with wide income disparities has shaped the U.S. welfare state ever since its beginnings.<sup>2</sup> And dealing with this dilemma was at the heart of the more recent welfare overhaul that supposedly “ended welfare as we knew it.”

Two elements of this welfare reform prove to be of particular interest for the present study: first, the manifestations of a New Federalism it contained; and, secondly, the emphasis on earnings subsidies entailed in its “workfare” strategy. Both elements will be explored asking how they contribute to solving that dilemma, namely to hinder both an imminent rush to the bottom and the emergence of development traps.

The issues involved will be discussed from an economic angle. This is not because the political dimension seems to me of lesser importance. But, as already alluded to in the introductory paragraph, EMU was created as that curious vehicle that applies exclusively economic means to a political end.<sup>3</sup> Therefore, one has to get the economics right if EMU is to be the success story its ghostwriters had in mind. Moreover and closely related to this, I want to challenge the widely held view that a social federation may be good politics but is certainly bad economics.<sup>4</sup> This view is even held by some who are sympathetic to the idea of a social union, yet think of it in terms of a trade-off between economic efficiency and social cohesion. Such a trade-off may exist if a social federation is inappropriately designed. But this precisely means that the issue is one of design not one of principle.

The economic case for a social federation of EMU entails a twin hypothesis. First, there are valid economic reasons in favor of EMU-wide social insurance of income risks precisely

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<sup>1</sup> For American readers it may be helpful to point out that the European Union (EU) has fifteen member states at present. The European Economic and Monetary Union—the “Economic” is often skipped—started with eleven members only, i.e., all EU countries except Denmark, Greece, Sweden, and the UK.

<sup>2</sup> This has been described by many authors and will not be pursued here in any detail. But see Skocpol/Ikenberry (1983) or Peterson (1995) for complementary and exceedingly interesting records.

<sup>3</sup> E.g. Giscard d’Estaing: “Since the beginning, monetary union has been a political project” as quoted by Olshausen (1998, p. 67) in his pungent account of the rhetoric surrounding EMU advocacy.

<sup>4</sup> Elsewhere, I developed at greater length why EMU is not well advised to remain a monetarist project, i.e., stop at unification of monetary policy. It requires to be supported by novel ways of simulating the fiscal and social union of a nation-state (Schelkle 2000, ch.6). This study takes yet another tack on the issue of social union.

because these income risks arise in the same currency area. And secondly, the amount of social insurance provided has to allow for diversity in accordance with the disparities in income and development, i.e., a social federation rather than a social union is required. I will take up these two dimensions of the economic case for a social federation of EMU in subsequent sections.

In the final section, I will outline the kind of lessons I am looking for in the New Federalism and in the workfare approach. This requires to point out the methodological intricacies facing any research on U.S. welfare in a comparative perspective. They result from the fact that the U.S. and the European countries belong to different “worlds of welfare capitalism” as Esping-Andersen (1990) aptly demonstrated. These worlds do not even share a common understanding of what the term welfare comprises. Therefore, objections against my search for lessons are not to be taken lightly. But I will argue that EMU has created a novel situation and has come at a time which makes drawing lessons from the U.S. experience more pertinent even if it would be far-fetched for any single EMU member state.

The terms social policy, social insurance, and welfare will be used interchangeably in the first two sections. They comprise poverty relief, public health care, unemployment benefits, and social security for the elderly, sometimes with an emphasis on one of these elements. These terms will be looked at more closely in the third section to highlight the basic difference between U.S. and European social welfare states.

## **I. The Economic Case for a Strong Safety Net**

Social insurance is important for macroeconomic stability in a monetary union.<sup>5</sup> (1) It functions as an automatic stabilizer and becomes even more important when there is no more room for an interest rate policy specifically targeted at single member states. And (2) it erects a barrier against deflationary pressures when a common currency provides for a common price dynamic. These changes have been discussed in the more recent literature on EMU but with a narrower focus, namely their impact on financing government debt and on price stability. For the welfare-nexus, one has to go back to the older literature on functional fiscal federalism, on anti-cyclical macropolicies and automatic stabilizers.<sup>6</sup>

Characteristically, both changes point to a potential role of welfare spending that may stabilize or even stimulate income and employment. Strong safety nets helped to make protracted phases of deflation as well as sharp fluctuations of employment to be just well known and much feared phenomena of past economic history.<sup>7</sup> Notwithstanding the efficiency problems that have arisen over the years, public welfare systems thus seem to fulfill these functions reasonably well in mature economies since the 1950s. Perhaps too well. Certain features of the U.S. welfare reform, e.g. time limits, indicate that these rationales of welfare may have fallen into oblivion. This is why I elaborate on the nexus between the monetary regime and social policy in some detail, providing also evidence for its importance.

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<sup>5</sup> See Blank/Blinder (1986) for the general argument and some empirical evidence.

<sup>6</sup> These were all topics of the theory of public finance inspired by Keynesian macroeconomics. They were questioned not so much because of their basic economic rationale but because that literature paid less attention to the political economy or public choice issues involved which figure so prominently now. The classic works are Musgrave (1959) and Oates (1972). For a more recent discussion of these topics in the context of fiscal decentralization see Bird (1993) and the comments by Gramlich (1993) and Oates (1993).

<sup>7</sup> This may change presently. See the *Economist* (1999).

### (1) Interest Rates and a Compensatory Role for Social Policy

A currency area is characterized by a common, or at least converging, interest rate level among member states. The common European central bank quotes one rate for refinancing credits. Banks participate in a common payments and clearing system (called TARGET). And currency unification eliminates exchange and liquidity risks of financial claims due to different monies so that the respective risk premia will be competed away. But the interest rate convergence also implies that it is impossible to have specific interest rate policies for a member state that undergoes recession or boom in contrast to the average of fellow member states.

This is where social policy comes in. Regions or member states are differently affected by interest rate changes.<sup>8</sup> Or they experience asymmetric, i.e., region-specific exogenous shocks such as a fall in demand for an important regional product. Social policy cannot substitute for differential interest rate policies in member states because its primary impact is on goods and labor markets not on asset markets, and the time horizon is different from that of monetary policy. But the financing of as well as the expenditure on welfare can dampen or reinforce such deviant regional developments. Preferably, both should be designed so as to work anti-cyclically. That is, welfare taxes or contributions ought to go down and spending to go up in a downturn relative to other regions of the currency area. And vice versa in an economic upturn or in the case of a positive asymmetric shock. This is the well-established economic function of an automatic or built-in stabilizer, i.e., built into the working of the fiscal system, not triggered by discretion. Social policy can thus dampen the volatility of regional employment.

How important is this function of welfare spending and finance to act as a built-in stabilizer empirically? A number of estimates have been produced to assess the extent to which the U.S. fiscal federation substitutes for the lack of bilateral exchange rates between the states, some of them in comparison to other federations such as Germany.<sup>9</sup> They all answer the question how much of a negative region-, state- or Land-specific shock is compensated for by additional transfers from and a lowering of tax payments to the national government, respectively. In the U.S., a consensus seems to have arisen that between fifteen and thirty cents of each dollar variation in state income is thus compensated for by overall federal spending and finance (Atkeson/Bayoumi 1993, pp. 316-317). For Germany, the estimates are roughly twice as high, between more than 30 and more than 40 percent depending on whether transfers within the interstate *Finanzausgleich* are taken into account (Italianer/Pisani-Ferry 1994, pp.169-171).

In addition, one may look at the components that make up the total compensation. The results of two representative studies are as follows:<sup>10</sup>

- Within a monetary union, such as the U.S., capital flows across regions are much larger, portfolios geographically more diversified than across European nations. Interest payments on cross-regional asset holdings thus compensate regional income fluctuations to some extent. But even in the U.S., insurance of fluctuations in regional

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<sup>8</sup> For evidence with respect to the U.S., see Carlino/DeFina (1997). The most important factor for a differential impact of the Fed's interest rate policy they find is differential demand for long-term credit, e.g. between regions with a high share of manufacturing as compared to regions where service industries dominate.

<sup>9</sup> This research started with a seminal paper by Sachs/Sala-i-Martin (1991) and is explicitly undertaken to draw lessons for EMU.

<sup>10</sup> Not surprisingly, all these estimates involve econometric specification and data problems. The pros and cons of different approaches are reviewed in Italianer/Pisani-Ferry (1994).

labor income is carried out principally by government and not by private capital markets (Atkeson/Bayoumi 1993).

- Stabilization is largely provided as a side effect of fiscal redistribution.<sup>11</sup> In the U.S., it is mainly social security contributions and employers' contributions to pension funds that count for stabilization (roughly 50 percent of the total fiscal contribution). In Germany, it is mainly unemployment insurance and interregional grants via the *Finanzausgleich* on the expenditure side. On the revenue side, the corporate income tax plays the most important stabilizing role in both countries, closely followed by the personal income tax in the U.S. and taxes on goods and services in Germany (Italianer/Pisani-Ferry 1994, pp.170-171; see Table A-1).

Thus, social welfare in a broad sense plays a non-negligible role as an automatic stabilizer even in a fiscal federation such as the U.S. being considerably less developed than the German one.

**Table A-1: Built-in Stabilization in the U.S. and in the German Federation (1970s to mid-1980s)**

	United States	Germany (West)
Percentage of variation in regional income compensated	<b>15—30 %</b>	<b>30—40 %</b>
Main contributors		
revenue side	corporate income tax, personal income tax; social security;	corporate income tax, tax on goods and services
expenditure side	employers' contributions to pension funds	unemployment insurance; horizontal fiscal federalism ( <i>Länderfinanz-ausgleich</i> )

Source: Atkeson/Bayoumi 1993; Italianer/Pisani-Ferry 1994

The theory of fiscal federalism allows then one to argue that those redistributive functions that have considerable stabilizing properties should be provided centrally, i.e., at the EMU level.<sup>12</sup> This follows basically from the insurance principle. In this way, individual regions or states, populated by risk-averse inhabitants, can pool risks to their advantage if these risks are less than perfectly correlated.

## (2) The Dynamic of the Price Level and Welfare as an Anti-Deflationary Force

A currency area is characterized by a common dynamic of the price level, i.e., by a uniform process of inflation or deflation (which does not preclude differences in **levels** of average regional prices especially for housing). Inflation or deflation can only be sustained by an expansion or reduction of money and credit denominated in the common currency. Changes in

<sup>11</sup> The stabilization properties and the redistribution properties of transfers and taxes can be easily discerned in principle, if not in practice. Stabilizing transfers (and taxes) just aim at dampening fluctuations around a given trend of income growth or around a given level of income. Redistributive transfers and taxes try to change that trend or level of income, e.g. to make it converge with other regions (Italianer/Pisani-Ferry 1994, pp.156-158).

<sup>12</sup> For the general case see Peterson (1995, pp. 17-39) and for a summary of the economic discussion Spahn (1994, p.149).

nominal wages (or exchange rates) can incite as well as feed either process. More precisely, wages are a nominal anchor for the price level if the price level in the aggregate results from firms' mark-up on unit costs.<sup>13</sup> In a situation of unemployment, one would expect downward pressure on wages and thus on average prices. If banks then reduce credit because their borrowers have difficulty to service the existing debt, a deflationary spiral is in the offing.

Monetary policy is less effective to prevent deflation than inflation.<sup>14</sup> Providing cheap refinance and printing money does not necessarily stimulate commodity demand since households and firms rationally increase their money holdings and wait if they expect prices and wages to fall further. Nor does easy money necessarily induce banks and firms to finance investment if they expect to default for the very reason of weak demand and prices at the beginning of the production process being higher than at a later time of selling. After all, real wage costs may even rise for firms whose prices fall faster than nominal wages.

Income maintenance via social benefits may at least stem these deflationary pressures. The level of cash benefits for an unemployed person establishes a kind of implicit minimum wage. Many countries, among them the U.S., also have a statutory *explicit* minimum wage. While such statutory minimum wages contribute to anchoring the price level, it is evident that such a standard cannot be enforced if there are no social benefits as an alternative to jobs that are paid below the explicit minimum wage. An unemployed worker then has to accept such a substandard job or engage in semi- or illegal activities. In short, social benefits help to sustain a floor for the nominal wage level. Real wages that are the relevant macroeconomic determinant for employment can still be altered via changes of the price level and exchange rates.

How important is welfare as an anti-deflationary device in the case of the U.S., admittedly a lean welfare state from a European point of view? This question has, to my knowledge, not been directly addressed in the literature. But it seems possible to get at least an idea about the quantities involved by estimating the labor force potential of those who receive effective poverty relief from welfare and unemployment benefits.

In 1996, the year of welfare reform, the panoply of cash and non-cash transfer programs removed from poverty 26.7 million or 46.6 percent of the 57.3 million pretax and pre-transfer poor. Without these programs, the poverty rate would have stood at 21.5 percent in contrast to 11.5 percent. The Bureau of the Census uses an **absolute measure of poverty**. The threshold of income is based "on the cost of a minimum adequate diet multiplied by three (to allow for other expenses). The one-third ratio of food to total income was based on studies of consumer expenditure. To determine a family's poverty status, its cash income before taxes is compared with the appropriate threshold." (Haveman/Wolfe 1998, p.21)

The following table provides an overview on the most effective assistance categories.<sup>15</sup> In the view of what was said above, it makes sense to add the income support provided by

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<sup>13</sup> Recent macroeconomics overwhelmingly assumes this to be the case. The most prominent, if controversial expression of that is the NAIRU, i.e., the Non-Accelerating Inflation Rate of Unemployment, an acronym for a level of unemployment which keeps nominal wage costs and thus the price level stable.

<sup>14</sup> In the economic literature, this asymmetry is treated in the theory of liquidity traps. See for a recent contribution Krugman (1999). However, even his novel theory of the liquidity trap retains the traditional assumption of the money supply to be exogenous, i.e., autonomously determined by the central bank. In contrast, the following remarks in the text imply that money supply is endogenous, i.e., determined by the interaction of banks and firms with the central bank that determines the interest rate floor.

<sup>15</sup> These calculations ignore behavioral responses to the benefit programs (Haveman/Scholz 1994, p.431). Some critics of welfare such as Charles Murray (1984) maintain that a large share of the poor would not be in that pool to begin with were it not for getting benefits from and becoming eligible for these programs.

unemployment compensation (House of Representatives 1998, section 4). Since this is only partly and unintentionally a program that provides poverty relief, it is attached as a memo. Unemployment benefits were claimed by a total of 8.1 million unemployed workers in 1996 for an average duration of 14.9 weeks. This represented on average 2.3percent of all workers covered which was less than half the total civilian unemployment rate of 5.5percent in that year. Of these 8.1 million unemployed, 2.7 million exhausted the benefits which in all but two states is the case after a maximum of twenty-six weeks. I count these 2.7 million as being those removed from poverty as long as they receive unemployment benefits.

**Table A-2: Antipoverty Effectiveness of Transfers  
(including federal income and payroll taxes) for All Persons, 1996**

	Removed from poverty		Reduction of poverty rate <sup>a</sup>
	number of persons <sup>a</sup>	percentage of poor persons	
Social Security <sup>b</sup>	17.8 mil.	31.0%	6.7%
Means-tested cash	2.9 mil.	5.1%	1.1%
Food and housing benefits	4.3 mil.	7.5%	1.6%
Earned Income Tax Credit less federal taxes <sup>c</sup>	1.7 mil.	3.0%	0.6%
<b>Total removed/ total reduction</b>	<b>26.7 mil.</b>	<b>46.6%</b>	<b>10.0%</b>
<i>memo: Unemployment Compensation</i>	<i>2.7 mil.</i>	<i>4.5%</i> <sup>d</sup>	<i>1.2%</i> <sup>e</sup>

<sup>a</sup> Of 57.3 mil. or 21.5 percent, respectively, before taxes and transfers.

<sup>b</sup> Includes all benefits under the Old-Age, Survivors, and Disability (OASDI) Insurance Programs. The Green Book uses the term “social insurance” but OASDI does not include health care and unemployment compensation.

<sup>c</sup> This is thus a measure of net impact because the Earned Income Tax Credit was originally installed to offset the effects of payroll taxes on low wage earners.

<sup>d</sup> If the 2.7 million beneficiaries of unemployment compensation who exhausted the benefits were poor otherwise, i.e., this percentage represents 2.7 million of a total number of then (57.3+2.7=) 60 million poor individuals.

<sup>e</sup> Reduction of a poverty rate of then 26 percent if all 2.7 million “maximum beneficiaries” of unemployment compensation were poor otherwise.

*Source:* House of Representatives 1998, Tables H-23 and 4-1, and own calculations.

These figures which measure broadly the antipoverty effectiveness of income support programs in the U.S. give also a rough estimate of potential pressures on market wages if absent. By how much would labor supply rise if the programs listed in Table A-2 would be eliminated? A back-of-the-envelope calculation gives me a potential of 12-13 percent of the present civilian labor force: From the total of 57.3 million poor, one has to subtract the 17.8 million benefiting from social security because these are either old or disabled wage earners and the labor force potential of surviving family members (widows and children) is negligible. We have to divide

the resulting number roughly by three in order to get the adults capable of earning a living.<sup>16</sup> That leaves us with around 13 million beneficiaries who would be hard-pressed to find a job or to increase hours worked without assistance. In addition, we have 2.7 million recipients of maximum unemployment compensation.<sup>17</sup> The resulting conservative estimate of 16 million poor and/or unemployed individuals represent a share of roughly 12.5 percent of the civilian labor force of 129 million in 1996. The estimate is conservative since the base year is one of high employment and only the net impact of the Earned Income Tax Credit has been taken into account.

In other words, even in good times welfare and unemployment insurance allow up to 13 percent of the U.S. workforce to abstain from seeking a job at any rate (or from begging or engaging in illegal activity for that matter). Ending all kinds of income support for these beneficiaries would certainly exert a downward pressure on wages. In addition, a labor-intensive public service and thus a huge amount of welfare-based employment would be wiped out. What this admittedly extreme scenario indicates is that even if eliminating all social income support would stop short of inciting an outright deflationary spiral, I think it is safe to expect that it would make downward turns of the business cycle distinctly more pronounced.

## **II. The Case for Diversity in Safety Nets**

EMU faces specific and unprecedented challenges as regards the maintenance and creation of a safety net. It is a monetary union characterized by wide disparities in economic, social and institutional development among member states. And there is only a very weak fiscal authority at the center which commands a budget of little more than one percent of the wider community's GDP. Thus, diversity is here to stay as a matter of fact and for lack of fiscal means, let alone political mandate, to build up an EMU safety net on top of the national systems. The question for EMU policy then becomes one of safeguarding that diversity which is not the same as preserving the existing pattern. Safeguarding diversity in social insurance systems is the only conceivable way that allows each member state to develop according to its economic potential and in compliance with the democratic mandate of the respective electorate. This is why the case for diversity supports a federation rather than a union in social policy.

However, diversity seems to be less easy to maintain within EMU. The economic forces in favor of downward convergence stem basically from two changes brought about by currency unification, (1) in the economic policy regime, and (2) in market integration. These changes and their likely consequences for social policy have been more extensively dealt with in the recent literature which is why their outline can be kept somewhat more cursory.

### (1) The Economic Policy Regime and the Impact of Social Insurance on Unit Labor Costs

Currency unification implies a shift in the economic policy regime. Prices and wages between the member states are no longer linked by variable exchange rates. Producers and unions have to take this into account when they set prices and bargain over wages primarily, it is

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<sup>16</sup> This is roughly the factor (2.78) that the U.S. Department of Health and Human Services (DHHS) uses to calculate the number of individuals which benefited from assistance under Aid to Families with Dependent Children (AFDC), given that 4.6 million heads of households received AFDC transfers in 1996.

<sup>17</sup> The national average weekly benefit amount was only \$189, which is certainly not enough to sustain a family. Therefore, I do not multiply this by a factor to account for family members.

said, because devaluation is no longer possible.<sup>18</sup> A common monetary policy also undermines any strategy by which a lower inflation rate at stable exchange rates renders domestic producers more and more competitive. Both arguments imply that in EMU, unit labor costs play an unrivalled role in determining the competitiveness of production in member states and regions.

The financing of social benefits obviously has a bearing on unit labor costs. Throughout Europe and especially in Germany, high labor costs due to generous social benefits have been blamed for a poor employment performance relative to the U.S. Moreover, the financing of social benefits drive a wedge between product wages which determine labor cost and disposable wage income relevant for labor supply (cf. Table A-3).

**Table A-3: Disposable Income of Average Production Worker as Percent of Gross Pay 1995**

	<b>United States</b>	<b>Germany</b>	<b>EU Average<sup>a</sup></b>	<b>OECD Average<sup>a</sup></b>
<b>Single person</b>	74.2	59.5	69.6	73.8
<b>Married with two children</b>	81.4	75.0	81.7	85.1

<sup>a</sup> Unweighted

Source: OECD (1998a)

In all member states, there is thus a more intense pressure to lower labor costs by decreasing the level of social insurance. But what happened if a government succeeded in cutting benefits required to be financed by payroll taxes or contributions? It turns out that the effects of the same measure may vary quite substantially:<sup>19</sup>

- Most studies emphasize the effect on demand for labor which is expected to increase if labor costs, as firms perceive it, go down. The extent to which this is the case depends on the price elasticity of labor demand. It is typically too low to count for major employment gains.<sup>20</sup> E.g., the measured responsiveness is as low as -0.14 in the case of Germany so that even substantial lowering of wage costs by 10 percent would increase labor demand by only 1.4 percent. Higher demand elasticities are to be obtained in the long-run when non-labor inputs may adjust over time.

<sup>18</sup> I am rather skeptical as regards this argument which is popular among economists as a straightforward application of the Rational Expectations Hypothesis to economic policy. But what, if the exchange rate is not a reliable instrument to compensate wage levels that are too high? And why should unions accept a lowering of real wages via devaluation and price hikes if they strived for non-competitive nominal wages (given their price expectations) in the first place? At least, the latter behavior would violate the RE assumption. While monetary unification does imply a regime shift for the national and subnational wage bargains, the effects seem to me rather ambiguous and specific for different types of labor markets (Schelkle 1997).

<sup>19</sup> It is hard to imagine a more concise and perceptive discussion of the effects on microbehavior than that of Kosters (1998). As the director of the economics program at the American Enterprise Institute, he is hardly suspect to be a champion of generous welfare.

<sup>20</sup> See Solow (1998, pp.30-31) who thinks “it is fair to say that the measured responsiveness [of labor demand] is disappointingly small.” For an extensive account of labor demand studies, see Hamermesh (1993, ch.3). What he calls his best “guesstimate” amounts to -0.3 in an (absolute) interval of [0.15; 0.75]. That is, real wages have to fall by 10 percent for an expected 3 percent rise in demand for labor. This elasticity seems to be somewhat lower for skilled labor, higher for unskilled labor.

But even if employers would respond more strongly than they empirically seem to do: From an economic point of view, it is not even obvious why wage costs firms perceive should decline at all when payroll taxes or contributions levied on employers go down.

- If the wage bargain is fairly atomistic, employers would see themselves urged to step up other components of workers' compensation, such as fringe benefits or health insurance, to keep their labor force working as much as before. Evidence for the U.S. indicates this for the opposite case, namely that increases in labor costs mandated by government have led to lower disposable income for workers than would otherwise have been expected (see the literature cited by Kosters 1998, note 2). I.e., in a competitive labor market, total labor costs should not be affected by employers' contributions to social insurance.
- If the wage bargain is more centralized as is the case in most European countries, employers may not be forced to increase other components of the compensation package because employees' threat to leave the firm for better contracts is not credible. But competition in commodity markets may force them to pass lower payroll taxes or contributions on to lower prices. Employers who forego all or part of the windfall gain from lower labor costs can supply at more competitive prices, so that others have to do the same or they risk to lose market share. Lower prices would thus increase the purchasing power of wages that individual employers did not care to raise.
- Either way, it is—apart from short-term effects—only the purchasing power of disposable wage income that is affected by leaner welfare finance. The value of benefits to workers is then crucial for the response of labor supply to a decrease in benefits and an increase in disposable wage. If they place a value on the benefits that is at least as high as their costs, no change in labor supply would occur. If compulsory social insurance can provide better coverage than private insurance,<sup>21</sup> retrenchment may even lead to an adverse shift in labor supply.
- A favorable shift in labor supply is only to be expected if workers value the benefits they finance via the non-wage component of their compensation less than the wage foregone. Employers could then pay less for the same amount of labor input into their production. Employment effects may be expected if firms hire more labor for the same total wage outlay and wage-dependent households therefore reduce their non-market activities (subsumed under "leisure"). Households would simply have less aggregate time to do their own cooking or renovate their flats. This would increase the market for services and probably entail efficiency gains.

Obviously, it is a strong effect on labor demand and the latter prospect which the designers of EMU had in mind when they hoped for a radical regime shift through monetary union. The upshot of a more comprehensive view is though that no two governments who engage in a lowering of welfare standards should expect to see the same results, let alone clear-cut employment gains. The effects of cutting direct welfare benefits vary according to existing labor

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<sup>21</sup> Why this might be the case will be discussed below in (2) Integration of Markets.

market institutions, competition in commodity markets and the value of benefits to those who pay for it eventually.<sup>22</sup> What may be appropriate for one country, need not be so for another.

This is not to warn against reform or streamlining of benefits even if undertaken with the intention to attract employment at the cost of other member states. But from an EMU perspective, i.e., keeping in mind the case for a strong safety net, it makes sense to think about how the diversity of systems may be preserved. Otherwise, there may be just competitive retrenchment, the notorious rush to the bottom, which weakens the stability of the monetary system and thus worsens the conditions for real income growth.

## (2) Integration of Markets and Pressures for Downward Convergence in Welfare Provision

Currency unification means closer capital and labor market integration if for the only reason that one money increases price transparency.<sup>23</sup> The internal market program has removed a number of barriers to enhance competition in these and commodity markets which the European Commission is also actively promoting. This means at least a tendency for prices and wages to converge, brought about primarily by mobile production sites on the input side and trade on the output side. Moreover, labor and taxpayer mobility, even if low on average, may increase at the lower and upper end of the income distribution.<sup>24</sup>

These developments are not going to materialize quickly. But governments are likely to anticipate resulting pressures of systemic competition even if not forced to act by actual migration of welfare recipients, tax payers, and production sites respectively. Paradoxically, such anticipatory policies responding to public and publicized opinion may be worse than policies which react to an observed rise in mobility.<sup>25</sup> This is because a *real* increase in mobility could render some social insurance obsolete as Wildasin (1995, S.528) points out: “[...] while greater factor mobility may add constraints to the ability of governments to redistribute income, it can also itself provide a form of market insurance against income risk. Access to ‘external’ factor markets limits the extent of factor price variation through spatial arbitrage and may, to some degree, obviate the need for public sector insurance of such risks.” If higher mobility is just virtual, however, policy adjustments would merely mean less social insurance of income risks.

The governments most concerned are those that so far maintained high or progressive taxes and handed out comparatively generous social benefits. They tend to become “welfare magnets” as Peterson/Rom (1990, pp.79-82) have argued for the U.S. To become a welfare magnet means that over time marginally employed households move to places where benefits are high while poor residents are more likely to stay at these places even if their employment

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<sup>22</sup> As regards the latter, the signals are at least mixed: While complaints about high taxes and social insurance fees are quite common, elections in the run-up to EMU brought governments into office that promised to save welfare as we know it.

<sup>23</sup> The a priori case for closer goods market integration is ambiguous. If scale economies are important and market power becomes more concentrated, it may very well be that commodity prices become even more regionally differentiated. That would entail segmentation of labor markets as well if the wage bargain takes place at the plant level. I.e., insider-outsider types of labor markets would be reinforced rather than eroded.

<sup>24</sup> However, there seems to be only anecdotal evidence on this, such as the market for construction services in Germany or spectacular incidents of sports stars emigrating to Monaco.

<sup>25</sup> Peterson/Rom (1990, pp. 16, 63, 67; chapter 2) and Brueckner (1998, pp. 19-21) provide evidence that state governments in the U.S. usually reacted on the basis of expectations, rumors in the press etc., rather than on the basis of well-established facts that there is an influx of welfare immigrants attracted by generous benefits. The evidence on the latter is not conclusive but seems to me slightly in favor of the existence of welfare migration (Brueckner 1998, pp. 13-17).

prospects were slightly better somewhere else.<sup>26</sup> This has obvious implications for public expenditures: Peterson/Rom (1990, p.78) estimate that an increase of one standard deviation in the poverty rate would have raised welfare costs of the average U.S. state by \$44 million in 1985 dollars of which it would have offset only one third by reducing welfare benefits. On the revenue side, citizens' choice of settlement will tend to reduce their tax base and increase that of low or flat tax jurisdictions. Those governments that are able to attract high-income taxpayers and deter poor households would even achieve the goal of a more equitable income distribution which is a plausible rationale for redistributive policies in the first place. This is why even conceiving the developments of more intense systemic competition creates incentives to adopt reforms implying a downward convergence of social benefits.

Why would less diversity in the sense of a tendency for downward convergence be problematic? The modern "social insurance view of redistribution"<sup>27</sup> would argue that the welfare state may enhance the efficiency of economies because it makes them more "risk-productive." Risk productivity captures the economic phenomenon that, on average, markets select projects which exhibit a positive correlation between risk and return. If a society enables its individuals to bear more risks, then one would expect an increase in real income despite the fact that failures also become more likely. Social insurance of income risks allows individuals to bear more risk. These enabling features would show up in that individuals become more mobile, acquire more specialized skills, found their own companies, or spend more time in educating themselves instead of pursuing gainful employment.<sup>28</sup> A lot of observable behavior is then not easy to discern from behavior characterized by moral hazard as one is inclined to view e.g. rising numbers of students who indulge in long and rather exotic studies. But there is an efficiency criterion: A social welfare system which pools the risks of such behavior would nevertheless be "risk efficient" as long as the rise in aggregate income thus generated is larger than its cost in terms of social insurance. High or rising skill premia for labor in mature economies indicate that even long and exotic studies may enhance the capacity to create wealth.

Thus, from a purely economic point of view one may argue that downward convergence may leave all member states less risk efficient, given their diversity in development and income levels. Risk productivity may even gain in significance as economies become more mature. The upshot of it all is that redistribution may enhance the efficiency of an economy, i.e., there is not necessarily that awkward trade-off between efficiency and equity (Sandmo 1995, p.473).

In principle, an alternative to retrenchment exists. Governments could also opt for reforms that create a more immediate cost-benefit nexus of social services.<sup>29</sup> After all, high-income taxpayers may also value the higher level of public services made possible by higher taxes. Such reforms would surely be welcome regardless of EMU.

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<sup>26</sup> Peterson/Rom (1990, p.83) emphasize that low-income people respond to wage opportunities in other states roughly to the same extent as they are sensitive to inter-state differences in welfare policy.

<sup>27</sup> Wildasin (1995, p.528n) uses that expression. Its leading proponents make up a rather heterogeneous group of economists (Anthony Atkinson, James Buchanan, John Harsanyi, Hans-Werner Sinn and Hal Varian). For a formalization of the insurance view cf. Sinn (1995).

<sup>28</sup> All this has to be taken *ceteris paribus*, i.e., given all other institutional and behavioral factors that determine the attitude towards risk. The hypothetical scenario is one of comparing the same economy with more or less social insurance of income risks, not one of comparing different economies.

<sup>29</sup> Heilemann/von Loeffelholz (1999) call this quality competition of fiscal systems in contrast to price (alias tax rate) competition. While the authors rightly point to an important alternative, in general the economic notion of (and plea for) competition seems to be rather misplaced in this context as will be pointed out in the text presently.

Unfortunately, the potential for such popular reforms seem to be more limited in the realm of welfare than in say public infrastructure or education. For one, it is rarely obvious to voters how much welfare assistance contributes to the containment of crime and destitution, let alone to the containment of deflationary pressure or cyclical volatility. It is non-events that a fairly working social welfare system produces. In contrast, failure and abuse of social insurance are easy to identify just because they occur. Moreover, those who contribute most to financing the welfare system are rarely the greatest beneficiaries. This is inherent to insurance schemes. But since social insurance is of a compulsory nature, this is easily rated as unfair. And yet, it has to be compulsory in order to overcome the very problem of adverse selection responsible for the failure of some private insurance markets. Nevertheless, one hardly thinks about cost-benefit ratios in the provision of public services that one uses daily as long as their quality is enduring, while one is likely to find faults with public services of no obvious use to oneself.<sup>30</sup>

The competition of fiscal systems in general, welfare systems in particular, has thus a number of adverse effects absent in competition of private economic actors. This is due to their being substitutes as Sinn (1998, p.6) aptly points out: “[...] competition of states will not work even in the absence of cross border externalities and European public goods, since the states by their very nature are supposed to carry out exactly those tasks where private markets fail. Since market failure is at the very basis of the duties of the state, it makes little sense to reintroduce markets through the back door of systems competition.”

The mainstream theory of fiscal federalism therefore suggests that one necessary if not sufficient safeguard of diversity in welfare is to centralize the financing of redistribution (Peterson 1995, chapter 5). It will be explored later on whether the U.S. welfare reform provided such safeguards or whether it created incentives for a rush to the bottom (Section C). In any case, there is an external constraint for a social federation of EMU to follow the guidelines of the mainstream theory of fiscal federalism. For the time being, there will simply be no center to do any relevant financing of social insurance. So, one also has to look out for substitutes that contain systems competition and leave room for diversity. We will see that the U.S. welfare reform provides lessons in both respects.

To wrap up by relating these two sections to U.S. welfare reform. I have argued that social insurance of income risks is not necessarily a luxury that rich countries indulge in when managements and workers become self-satisfied or governments self-important. The welfare system is an inherent part of prosperous and comparatively stable market economies whose firms and labor force must explore market niches if they want to maintain high living standards.<sup>31</sup>

But for social policy to support and facilitate that, it has to be appropriately designed. What might be alright for a small, homogeneous country is not viable in a large federation. This is why earnings subsidies are of particular interest to this study. They provide a means to ensure an implicit minimum wage even among regions with large income differentials. And they would allow for more elastic wage responses of firms and labor in an economic down-turn.

It was also pointed out that federations face specific challenges as regards the maintenance of a diversity in safety nets, at least potentially in line with economic potentials and democratic mandates. This is where the New Federalism comes in. The term implies a

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<sup>30</sup> This is particularly true for a regime such as in the U.S. where those who finance welfare are unlikely ever to become beneficiaries. This will be further explored in the next section.

<sup>31</sup> Interestingly, the World Bank is now considering the stabilizing role of social insurance for the Asian ex-miracle countries where reform and recovery is difficult due to a lack of basic income support for wage-dependent households. See <http://www.worldbank.org/poverty/eacrisis/index.htm> and Rieger/Leibfried (1998) on that nexus.

reshuffling of federal responsibilities with an emphasis on devolution. It creates a complex set of incentives. State and local administrations ought to strive for best practices in welfare provision, contain the cost dynamic of welfare finance and yet keep up minimum social standards. The various provisions that set these incentives will be explored after they have been described in the next section.<sup>32</sup>

### **III. U.S. Welfare Reform in Comparative Perspective**

To any serious student of comparative social policy the present undertaking ought to be dubious. Welfare in the U.S. and social insurance in continental European countries do not comprise the same programs. They do not share a tradition or underlying norms. Public welfare spending is of quite different relevance for the respective socio-economic fabric. Not even the challenges of reform make them equals at long last just because they supposedly share that common fate called “globalization.” All this will be pointed out in the following, partly to document the methodological problems involved, partly to warn the reader who expects obvious lessons ready for transfer.

And yet, despite these objection, I do think that meaningful lessons can be drawn from the U.S. welfare overhaul of 1996 for a future social federation of EMU. For one, EMU has created a historically singular economy and polity for which little theory was at hand.<sup>33</sup> The closest we can get to an empirical precedent for EMU is the U.S. federation and currency union. It allows us to infer what EMU does imply (a common currency, interest rate floor, and price dynamic) and what is missing (no relevant fiscal center, no social and political union) compared to a federation that exists. In considering why this leaves important functions to be fulfilled, we may be able to identify problems ahead (rush to the bottom or development traps, deflationary pressure, more pronounced business cycles). All this has been topical in the preceding two sections.

The next step then is to ask if and how one may tackle these upcoming problems. While there is no substitute for a theoretical notion of equivalents which could fulfill these functions, comparative studies help to substantiate and enrich this notion. Options applied in other countries (e.g. wage subsidies combined with a mandatory minimum wage, selective migration incentives and barriers) have a tangible form and they already passed the “reality test.” The U.S. welfare overhaul is a (theoretically) fortunate case in point. It is unthinkable without decade-long research of its elements, such as different types of grants in fiscal federalism or negative income tax experimentation. But these elements now got a definite shape and were implemented in a fairly radical reform so that sizable effects are to be expected.

Finally, it seems to me that EMU is more comparable to the U.S. than any of the member nation-states. This is certainly true in a static sense: With the notable exception of Germany, all EMU countries are fairly centralized, while the U.S. is a decentralized polity with strong state governments. They are certainly even stronger in EMU or in the EU. But the ECB, and the European Commission for that matter, already stand for that role of the central government in a federation, namely setting up a common framework for a payments system, for some coordination of budget policies or for regulating competition. Whether this will be the case in

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<sup>32</sup> For the informed and curious reader: Of interest will be capped block grants, maintenance of effort requirements, the residency versus the home state principle in determining benefit levels, and time limits for receiving welfare.

<sup>33</sup> As I argue in Schelkle (2000), the older theory of optimum currency areas beginning with Mundell (1961) is not able to grasp the most important economic rationales of EMU, namely its containment of exchange rate instability and its being a trigger of structural change in the policy regime.

social policy matters in the conceivable future, is notoriously difficult to predict. At least welfare reform in the U.S. intended to weaken the role of central government in favor of the states. It ought to become the guardian (and financier) of diversity in the subsidiary governments' way to practice welfare to work. If an executive branch at the EMU level is ever to assume a role in social policy, this being a guardian with some financial leverage would be it. A full-fledged European welfare state is inconceivable for the foreseeable future. So evolution may make the respective social federations more alike, even if they had taken quite different routes before.

The lessons one may draw from this case study in comparative perspective are unlikely to be of the nature: "It is recommended to transfer this and that institution." It has become—for good reason, I think—a commonplace that institutions are embedded. Piecemeal transfer of single institutions may completely change their meaning or pervert the incentives they generate. In theory and practice, one is regularly on the safe side to draw more cautious lessons such as: "If this and that institution will be transferred, it may not work out as expected for this and that reason." Or: "To make this institution work the same way, this and that adjustment has to be undertaken." But these are useful lessons, nevertheless, since even if a transfer seems not advisable, an institution makes us aware of a problem for which another or modified solution may exist. I find reason to conclude just that with respect to certain features of the New Federalism and the workfare approach.

It seems now in order to highlight the fundamental differences in U.S. and continental European welfare systems alluded to in the opening paragraph.

- **Meaning of welfare.** In the U.S., "welfare" is defined as income-tested or need-based benefits. As such, welfare does not include social insurance programs financed by contributions such as pensions ("Social Security"), part of health care ("Medicare") or unemployment benefits.<sup>34</sup> There is then a dichotomy between pure redistribution or **welfare proper**, and **social insurance** based on the equivalence between contribution and expected payoff. Most taxpayers receive direct benefits just from the latter. In continental Europe, welfare comprises assistance as well as insurance. They both entail payments from the state or publicly endorsed organizations to those hit by adverse income risks, such as health problems and disability, unemployment, old age or even maternity. There is then no clear-cut distinction between redistribution and insurance, or rather: insurance is redistribution insofar it necessarily implies a redistribution from winners to losers.
- **Welfare traditions.** The U.S. welfare state was born out of specific schemes to provide pensions for single mothers, predominantly widows, and veterans at the beginning of this century.<sup>35</sup> The benefit levels were determined by state or even local governments. The country never had anything like a nation-wide unemployment

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<sup>34</sup> This definition of what constitutes welfare follows the Green Book (House of Representatives 1998, p.1413) which lists all the income-tested benefit programs in Appendix K. However, it is not necessarily shared by all experts. They may e.g. speak of "non-welfare" assistance with respect to the Earned Income Tax Credit (Lerman 1999, p.6). The notion here is welfare being assistance and service to *non-working* poor households. However, this notion is no longer applicable to "welfare to work" or "workfare." For most non-expert U.S. citizens, welfare is synonymous to cash assistance for families with dependent children (AFDC and now TANF, see Section B).

<sup>35</sup> See the contributions in Weir/Orloff/Skocpol (1988) for a rich historical, theoretically informed account and Peterson/Rom (1990, ch.4) for a concise history emphasizing the federal aspects. They both contain references to an immense literature.

insurance. In both instances, it were the poorer Southern states that successfully averted attempts at harmonization, i.e., the formation of a social union. Very soon, however, in the Great Depression, the national government had to step in to save the locally funded mothers' pensions. In Europe, despite some significant differences, welfare states were immediate descents of industrialization and the concomitant rise of the labor movement. Different regimes may be identified depending on whether they are based on distinct insurance programs for different class and status groups, or whether they provide an encompassing social insurance to promote equality of status.<sup>36</sup> In general, central government played a more decisive role in setting up the welfare state.

- **Norms.** As is obvious from the definition as well from the origins in mothers' and veterans' pensions, welfare in the U.S. is meant to assist the "deserving" poor. Whether the prospective beneficiaries deserve it or not has to be assessed specifically for the purpose. This has created a "categorical antipoverty system" of a "patchwork nature: programs are designed to serve particular categories of people, and each program has a different eligibility standard." (Haveman/Scholz 1994, p.424) In contrast to this **categorical assistance** principle, the European consensus on welfare may be summarized in a **universal insurance** principle. It comprises all as each may potentially contribute to the system. This has created a public insurance system that knows of no inherent limits to what might be acknowledged as a justly insurable risk or as an eligible category of people to be covered by social insurance.
- **Relevance of welfare spending.** The share of the U.S. public sector in domestic spending is relatively small and so is spending on welfare and social insurance compared to other OECD countries (OECD 1998b, Table 1). The share was less than a third of the economy with a declining trend throughout the nineties (32.8 in 1990 to 31.6 in 1997 as a percentage of nominal GDP). Roughly one fifth was devoted to "social security" according to OECD-classification (19.3 in 1990 to 22.2 in 1996 as percentage of total government outlays; OECD 1998b, Table 7). In contrast, EU governments (except Luxembourg) have a much larger share in their economies, ranging from more than 50 percent (in Belgium, Denmark, Finland, France, Italy, and Sweden) to 35 percent (Ireland) with the majority in the range of 42 to 48 percent of nominal GDP. Their outlays on what the OECD calls "social security" varied widely, from as little as 11 percent of total outlays in Ireland to more than 35 percent in Belgium, Italy and the Netherlands in 1996. The U.S. would definitely rank at the lower end of the European spectrum.
- **Challenges of reform** (cf. Table A-4).<sup>37</sup> In the U.S., rising income inequality made poverty an ever more pressing issue. For a rising share of workers having a job did not ensure to lift them out of poverty. This working poor phenomenon was all the more disquieting in the 1990s which saw sustained growth in employment and a fall of unemployment below rates that were once considered to be safe for monetary stability. This nurtured debates on how to "make work pay," e.g. by rising the national minimum wage or stepping up tax credits for low income households. In

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<sup>36</sup> See Esping-Andersen (1990, pp.23-29) for a seminal work on welfare regimes.

<sup>37</sup> The data are from the Luxembourg Income Study, one of the two major comparative datasets on welfare, as well as from the OECD (Smeeding 1997). See also Section B on "Sources of mounting frustration" for further evidence on U.S. welfare.

Europe, it is not so much poverty but social exclusion that has become the issue of foremost concern.<sup>38</sup> There was no uniform tendency towards more income inequality but unemployment was on average high and rising, an ever larger share being long-term. Thus labor market reform was prior on the agenda. Welfare was part of that debate insofar it was held responsible for a large or even rising wedge between product wages that employers pay and after-tax wages that employees receive as well as for high marginal tax rates. Both creates disincentives for labor supply on the one hand, incentives for tax evasion and informalization of jobs, on the other.

**Table A-4: Selected Comparative Statistics**

	<b>United States 1991</b>	<b>Germany 1989</b>	<b>EU-9 Average<sup>a</sup></b>
<b>Pre-tax/transfer relative poverty rate<sup>b</sup></b>	21.0	14.1	21.1
<b>Post-tax/transfer relative poverty rate<sup>b</sup></b>	11.7	2.4	3.9
<b>Income inequality<sup>c</sup></b>			
<b>low income (P10)</b>	36	54	54
<b>high income (P90)</b>	208	172	179
<b>P90/P10 decile ratio</b>	5.8	3.2	3.3
<b>Percent low wage workers<sup>d</sup></b>	25.0	13.3	11.3
<b>Unemployment rate<sup>e</sup></b>			
<b>1986</b>	6.9	7.6	10.4
<b>1996</b>	5.3	9.0	10.9
<b>Long-term unemployment rate as of total<sup>e</sup></b>			
<b>1986</b>	8.7	48.3	53.1
<b>1996</b>	9.5	47.8	49.3
<b>Total social transfers (as % of GDP)<sup>f</sup></b>	14.6	24.1	26.4
<b>Non-aged social transfers (as % of GDP)</b>	3.5	7.9	9.7

<sup>a</sup> Unweighted average around 1991 for Belgium, Finland, France, West-Germany, Ireland, Italy, Netherlands, Sweden, and United Kingdom.

<sup>b</sup> Percentage of individuals in households with incomes (adjusted for household size) below 40 percent of the median within each country.

<sup>c</sup> P10 is the ratio of the (net cash) income of a household at the lowest 10<sup>th</sup> percentile to median income, P90 is that ratio for a household at the highest 90<sup>th</sup> percentile of the income distribution. P90/P10 measures the gap between the richest and the poorest in each country, P10/P50 the gap between the poorest and middle income households.

<sup>d</sup> Share of full time workers earning less than two-thirds median national earnings.

<sup>e</sup> For years noted in the first column. 1986 figures for Germany are for West only, 1996 figures for unified Germany. Long-term unemployment is defined as 12 months or more. EU average is for EU-15.

<sup>f</sup> The Luxembourg Income Study uses another definition for “social transfers” than the OECD “social security” but they both show that the U.S. welfare state is lean compared to the European average.

*Source:* Luxembourg Income Study (1998), OECD (1998a) for unemployment data.

<sup>38</sup> Cf. European Commission (1997, p.9) and Silver (1998). This is not to deny that there is considerable poverty in some countries. But since it shows no alarming trend or size, poverty has not figured prominently in public debates of the need for reform. For comparative evidence see the low income measures of the Luxembourg Income Study (1998).

This sketch of fundamental differences between welfare in the U.S. and social insurance dominant in EMU countries underlines that this study must not look for obvious lessons ready for transfer. But it may view the provisions of the U.S. welfare overhaul as indicative of general problems facing social federations with heterogeneous member states and may evaluate (qualitatively) how well these provisions work in the U.S. context. Depending on the latter judgment, one can then think more specifically about obstacles for transfer, modifications required, and workable solutions.

The official approach to EU social policy so far seems to be quite sensible since it is cautious. It relied on “a framework of minimum standards” established first in the Social Charter signed in 1989 by then twelve member states except the UK (which joined under the Blair government) and followed up in a White Paper in 1994 (European Commission 1994). These minimum standards concern working time (e.g. eleven hours’ rest every day, an average maximum working week of forty-eight hours), workers’ rights (e.g. equal treatment of men and women, fair remuneration, social protection according to the arrangements applying in the individual member states) and provisions to safeguard the internal market (work permit in any member state, recognition of qualifications, transferability of social entitlements). These standards have to be routed through the national legislatures in order to make them domestic law. Contrary to what is often suggested by skeptics, the approach so far has not been one of harmonization of standards. It is rather to induce “the convergence of goals and policies over a period of time by fixing common objectives [...], since it will permit the coexistence of different national systems” (European Commission 1994, p.12).

What is missing, however, is to review this approach in light of the novel situation brought about by EMU. What may be appropriate for the creation of an internal market may prove inadequate with respect to a monetary union. E.g., easy transferability of social entitlements may have to be reviewed in light of EMU when the maintenance of strong safety nets becomes more important. Or the framework of minimum standards may be put in jeopardy if systemic competition intensifies. A bolder approach such as defining requirements for a minimum of fiscal effort of member states may be called for. But so far, the Commission seems not even to conceive that the monetary union of eleven member states may give rise to a set of issues different from or more pressing than those related to the single market program. At least, EMU is not addressed at all in a recent major statement on “modernising and improving social protection in the European Union” (European Commission 1997, ch.2) where the “key issues for modernisation” are: (1) to study social protection as a productive factor, (2) to develop more employment-friendly protection systems, (3) to adapt the systems to the demographic aging, (4) to make provisions for the new gender balance, and (5) to improve protection for migrating EU-citizens. These are all issues that are hardly EMU-specific.

We can now proceed and explore what has been done about it in the U.S., a social federation and currency union which has recently undertaken what to some is a radical overhaul, to others an innovative reform.

## **B. OUTCOME AND BACKGROUND OF WELFARE REFORM IN THE U.S.**

Welfare reform has been a hotly debated issue in the U.S. for quite some time but it was only since the mid-80s that proposals and enactment of welfare legislation accelerated. It culminated in the *Personal Responsibility and Work Opportunity Reconciliation Act* (PRWORA) in August 1996. The transformation of U.S. welfare is going on as several amendments in the

aftermath of that reform amply showed and President Clinton's State of the Union Address in January 1999 indicated. But the passing of this welfare law was fundamental and will be the point of departure for any further measures.

In this section, I first give an overview of what were the principal issues of the reform debate as well as the main features of the eventual overhaul supposedly "ending welfare as we know it."<sup>39</sup> In the second section, I will elaborate on the details of the welfare law. Both sections serve to disentangle the issues of broader concern from those that are specific to the U.S. context. Thus, those aspects of U.S welfare reform which seem to be most relevant for a future social union of EMU will be identified in the last section.

### **I. "Ending Welfare as We Know it"**

The concept "Welfare to Work" or "Workfare" will be used here as a general term to capture the thrust of welfare policy enacted in 1996.<sup>40</sup> That is, a recipient has to take up a job in order to obtain cash assistance on the one hand, and government will support her or him in doing so on the other. The core of this new welfare policy is the program "Temporary Assistance for Needy Families" (TANF) which replaced Aid to Families with Dependent Children (AFDC) and two other minor programs. Workfare in the U.S. has three essential features:

- (a) The law establishes a universal work obligation and explicitly eliminates the entitlement to financial support when destitute. That is, there is no longer a notion of families or individuals being categorically eligible to obtain cash assistance. Moreover, job placement is given priority to formal training. This priority was already obvious in the Clinton administration's massive expansion of earnings subsidies ("tax credit") for low-income households since the beginning of the nineties. It prepared the ground for a "work first" strategy that made employment to be the binding constraint on receiving transfers.
- (b) The status of being "on welfare" is meant to be strictly transitional. To this end, there is a maximum span of time that an adult or the head of a household may obtain federally funded cash benefits in lifetime. This time limit of five years applies with few exceptions. The respective applicant is obliged to accept a job offered within two years of receiving benefits (or less than two years as a state option). On the side of government, this conditionality of aid requires state administrations to provide work opportunities.
- (c) The fiscal responsibilities and regulatory functions among central, state and local units of the federation have been realigned.<sup>41</sup> There is a general tendency to decentralization and devolution, i.e., lower levels of government have assumed a more active role and got greater leeway in designing welfare programs of their own. Transfers from the national government to the states now come to a large extent in the

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<sup>39</sup> This was the slogan that Bill Clinton used in his 1992 election campaign to popularize the idea of welfare reform.

<sup>40</sup> Used as a technical term, "Welfare to Work" stands for a particular grant of \$3 billion that was authorized under the Balanced Budget Act of 1997. It provides additional federal funds for state administrations to improve the chances of the least-employable to move into jobs (Smith Nightingale/Brennan 1998). As such it is a specific component of "Welfare to Work" in the sense of a general approach or model for welfare policy.

<sup>41</sup> The terms "central" and "national" will be used as synonyms throughout this paper, meaning the government headed by the U.S. president in Washington, DC. Following Peterson (1995, p.14), I will save "federal" for references to relationships among the three-tier system of government.

form of block grants instead of matching grants. Additional spending on welfare has thus become more expensive for state governments.

These three elements contain the meaning of what the pompous title of the welfare overhaul tries to convey. *Personal responsibility* means that welfare recipients have to accept a job in return for cash benefits, which are of a temporary nature. The greater demands on personal responsibility are supposedly matched better chances to fulfill them, i.e., with a *work opportunity* being made available. Fiscal decentralization has provided a means to enforce this. The state governments have to provide job opportunities, directly or indirectly through subsidies for private employers. Otherwise, the national government curtails its payments to the respective state government.

It is not only TANF (Temporary Assistance for Needy Families) that is significant for the workfare model of a social welfare system. While this cash assistance program for poor families contains all the ingredients of the welfare overhaul in a nutshell, it is equally remarkable and significant that the Earned Income Tax Credit (EITC) was expanded even before the PRWORA was passed in 1996. Already in place since 1975, this earnings subsidy program experienced successive liberalizations and expansions, under Republican administrations in 1986 and 1990 and then even more so under the first Clinton presidency in 1993 (Weaver 1998, p. 398). This underlines not only the new emphasis on in-work benefits but also that a bipartisan consensus as regards this emphasis had built up over quite some time.

From hindsight, it appears that pressure on U.S. “welfare as we knew it” had to emerge as a result of two developments (Wiseman 1996, p.84; Lerman 1999, pp. 2-6). These were, on the one hand, a substantial step-up of government efforts to alleviate poverty and, on the other, a continuous worsening of welfare indicators. Naturally, the widening gap between effort and outcome had to produce frustration on the part of politicians and their electorate across party lines.

The mounting efforts, i.e., measurable increases in welfare provision, may be illustrated as follows (House of Representatives 1998, pp.1411-1416):

- Between 1968 and 1994, real expenditure on welfare programs almost quintupled, rising by 399 percent. In this period, the U.S. population rose by 32 percent. Growth in spending receded in 1995 and became negative in 1996. But still, in constant 1996 dollars per capita spending increased to \$1,386 from \$367 in 1968.<sup>42</sup>
- The numbers of beneficiaries have become considerable. Just to mention the biggest programs to be discussed in more detail below: In 1996, 41.3 million persons received Medicaid, 26.8 million Food Stamps, an estimated 14.6 million persons got Aid to Families with Dependent Children, and 53.7 million persons in 17.9 million families benefited from earnings subsidies under the Earned Income Tax Credit.<sup>43</sup>
- Total outlays on income-tested benefit programs reached a record-high in fiscal year 1995, namely 5.1 percent as a share of GDP. This share has dropped since to 4.8

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<sup>42</sup> As Peterson (1995, p.115) and Wiseman (1996) point out, this rise in fiscal effort went on irrespective of a liberal or conservative presidency.

<sup>43</sup> There are double counts in these figures, i.e., persons may receive Food Stamps as well as Medicaid. Unduplicated counts do not exist, however (House of Representatives 1998, p.1414). But from the State Rankings of the Census one can get a rough impression, namely that 7.7 per cent of the U.S. population received some kind of public aid in 1994 (Bureau of the Census 1998, p.14).

percent or \$367.7 billion in 1996. The national government provided 71 percent or \$261.3 billion of these funds, which accounted for 16.7 percent of the 1996 Federal budget.

And yet, welfare indicators such as the rate and persistence of poverty worsened steadily, particularly during the recession of 1990 to 1992. The studies I refer to in the following rely on data either from the Census or from the Green Book.

- Ever since 1979, poverty increased steadily, reaching a record high of 15.2 percent in 1983. Poverty rates had dropped significantly in the 1960s and 1970s with the lowest rate of 11.1 percent occurring in 1973. Particularly worrying has been the fact that in the recent period of rapid job growth, poverty rates have been declining only slowly, namely from 15.1 percent or 39.3 million persons in 1993 to 13.7 percent or 36.5 million persons in 1996 (Haveman/Wolfe 1998, pp.21-22).<sup>44</sup>
- The working poor phenomenon had become more severe, i.e., a larger portion of families had to get means-tested benefits despite there being at least one working parent. The poverty rate among all workers, including those without children, was nearly 20 percent higher in 1996 than in 1979. Some 15 million people (of which 8.8 million were children) lived in a working-poor family in 1996. The poor working parents had a combined average of 41 weeks of employment, i.e., welfare eligibility was not primarily due to long-term unemployment (Johnson/Lazere 1998, p.3).
- The trends in poverty and the working poor phenomenon are part of rising income inequality. According to Census data, average low income declined absolutely and relatively between 1979 and 1996. The lowest two quintiles (fifths of the income distribution) had lower average income in 1996 than in either 1979 or 1989, which are comparable years of the business cycle. Real average income of the poorest fifth of families was 10 percent lower in 1996 than in 1979. In contrast, the average income of the top fifth in the income distribution increased by 28 percent over the same period (Greenstein/Shapiro 1998, p.3).
- While the average length of time a family is on welfare varies widely, it was more than five years for about one half of all recipient families (47.8 percent) at any one point in time in 1994. The mean time on welfare was 6.5 years or 78 months (Nightingale 1996, p.4; House of Representatives 1998, pp.531-532). This implies that the time limit of five years introduced by the welfare overhaul might become binding for a significant share of welfare beneficiaries.
- The share of single parent households in all parent-child family groups rose from 13 percent in 1970 to 30 percent in 1993 (Bureau of the Census 1994). Over 90 percent of welfare parents are single mothers and having a baby within the last six months was the most common cause for first entering AFDC (74 percent of all, House of Representatives 1998, p.533). There are no other equally characteristic features of welfare recipients. E.g., welfare mothers are fairly even distributed among major

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<sup>44</sup> As mentioned in Section A, the Census Bureau measures poverty in absolute terms and is based on the cash income necessary to maintain a minimum standard of living. It is a widely criticized measure, predictably by conservatives for overstating the problem and by progressives for understating it. But to my knowledge, no alternative standard has been established so far.

ethnic groups (White, Black, Hispanic) although minorities are heavily over-represented.<sup>45</sup> The academic levels of welfare recipients in general cover the full range of educational attainment (42 percent had less than High School, 42 percent graduated from High School, 16 percent had some College). And a welfare family has on average less than two children just like the population in general (Nightingale 1996, pp.1-2).

There is not a single cause for these developments. It is not even possible to establish beyond doubt to which extent welfare helped to mitigate these trends or whether it actually contributed to them. Yet to most observers, it seemed all too obvious that the welfare system as it were provided the wrong incentives for recipients, possibly also for those whose business and profession it was to provide those services. Welfare was thus accused of discouraging work, of encouraging illegitimacy, of prolonging dependency, and of being inefficiently provided (Wiseman 1996, pp.85-88). And it is important to notice that the welfare system was not only unpopular with politicians and taxpayers but also with recipients (Lerman 1999, p.4).

It is outside the purview of this study to discuss these judgments. First of all, they have been made with respect to virtually all mature welfare systems. To explore them with respect to the U.S. would thus be a rather roundabout way to draw lessons for a social union of EMU. Moreover, some developments are specific to the U.S., for instance the particularly high ratio of single mothers among welfare recipients. Reform provisions that were directed at reducing out-of-wedlock births and teen pregnancy are thus of little relevance for most European welfare debates. Finally, the working poor phenomenon is also not as prominent in Europe as in the U.S. Therefore it will be discussed in Section D what role earnings subsidies can play if they are not primarily meant to lift working adults out of poverty as in the U.S.

## II. The Anatomy of U.S. Welfare Reform

The U.S. welfare system consists of almost 80 incomes-tested benefit programs that provide cash and non-cash assistance to persons with low income. Three categories of welfare spending—medical benefits, cash and food aid—were hotly debated. On the way, I introduce the “big five” of welfare programs within these categories (\$ amounts in parenthesis are millions in FY 1996 and represent total cost to national and state-local governments).<sup>46</sup>

1. *Medical benefits* is the category on which a bit less than half of all welfare outlays (48.3 percent) are spent in 1996. **Medicaid** (\$159,357) is the biggest program in this category providing health care for the poor as well as needy children.
2. *Cash aid* comprises a number of programs but three of them stand out. They are in order of decreasing magnitude in 1996: first, the **Supplemental Security Income** (SSI) which provides income to aged and disabled persons (\$30,367); secondly, the **Aid to Families with Dependent Children** (AFDC) which gave cash to low-income

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<sup>45</sup> In 1994, 37 percent of welfare mothers were White compared to about 80 percent in the average of the U.S. population; 36 percent are African-American compared to about 12 percent on average; 20 percent were Hispanic (who may be of various ethnic origins) compared to over 3 percent on average. Based on Nightingale (1996) and Bureau of the Census (1992) for population shares.

<sup>46</sup> All figures are from the latest Green Book (House of Representatives 1998, Appendix K). Unfortunately, there will be no Green Book in 1999 though the Congressional Research Service has provided a somewhat leaner update (CRS Report 1999).

- households with children (\$23,677) and, thirdly, the **Earned Income Tax Credit** (EITC) which is an earnings subsidy for low-income workers (\$21,566).
3. *Food aid* covers a bag of different, often overlapping programs, but is to a large extent outlay on **Food Stamps** (\$27,344), which are coupons that indigent families and children can use to buy food. The food stamp program is the only U.S. program available to all the poor, i.e., irrespective of disabilities, family or employment status etc.

The following charts compare the outlays on these categories with the remaining ones such as education benefits or housing assistance (see next page). National and state-local spending are shown separately for the obvious reason that this study is particularly concerned with those specifics of welfare reform that may be explained by the workings of the U.S. federation (see Section C).

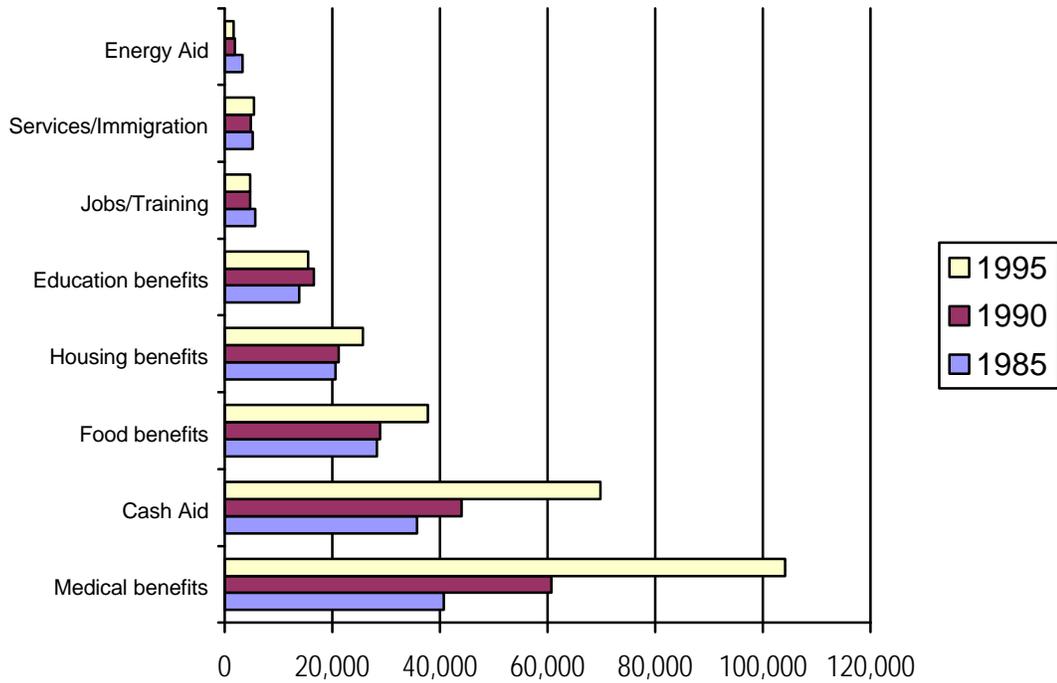
It immediately strikes the eye that outlays on medical services, basically Medicaid, exploded at both the national and the state level. In 1996, the respective programs consumed almost 40 percent of central outlays for welfare and almost 70 percent of all state-local welfare funds. Between 1980 and 1993, rising costs in this category accounted for almost all the increase (80 percent) in aggregate spending.

AFDC experienced a rapid increase in the caseload at the beginning of the 1990s. However, since the 1980s, real cash benefits received by each family declined, i.e., outlays for AFDC grew more slowly than the number of recipients. Roughly one third of this decline was offset by Food Stamps. And for the majority of poor families with a working parent, this decline was somewhat compensated by a substantial increase in the EITC (Haveman/Wolfe 1998, p.4).

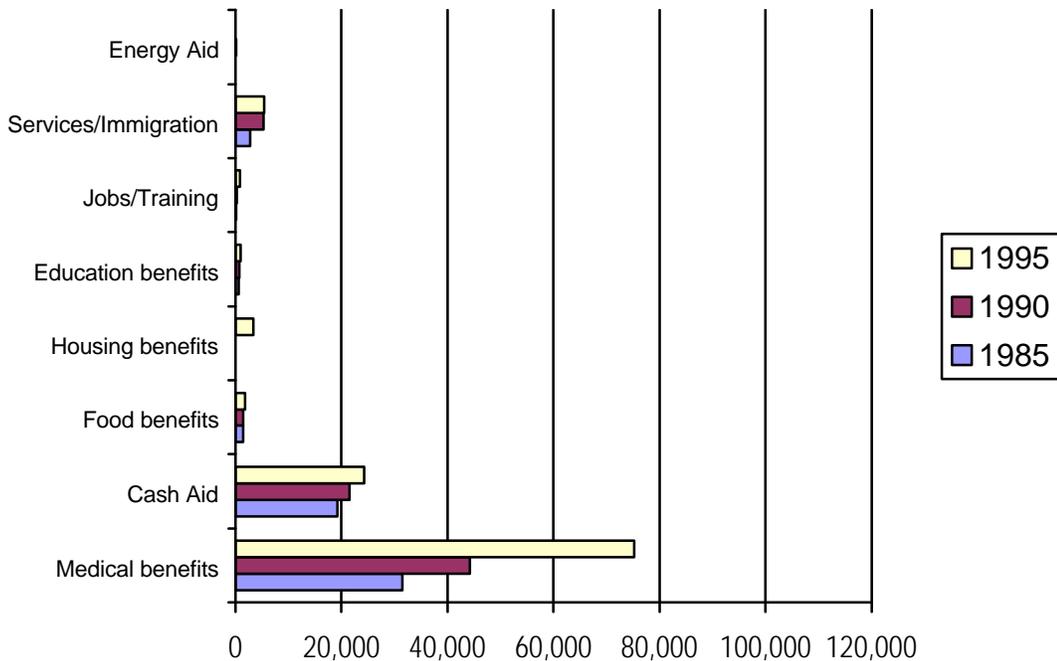
Medical benefits, cash aid, and service/immigration constitute the only welfare categories on which the state governments spent a significant amount of resources. They invested surprisingly little in “human capital” programs for the poor which provide education, jobs, and training. This is all the more notable since non-welfare expenditures for education constitute the single most important outlay in state budgets.

What then happened to these different spending categories in the welfare overhaul of 1996? The box following this paragraph describes the various changes in more detail for interested readers and as a reference in later sections. The bottom line is this: AFDC was heavily attacked and finally replaced by TANF. This was the single most important element of the welfare overhaul. In contrast, being hotly debated for some time, Medicaid was virtually left untouched by the welfare reform as enacted by the PRWORA 1996. The attempts died with the initiative for health care reform itself. Medicaid remains the largest single program in both national and state spending on welfare. The EITC was another component that escaped the operation “ending welfare as we know it” unscathed, at least in the first round, despite a massive expansion in outlays in the 1990s. Most of the savings in welfare spending, projected to amount to \$54.5 billion over six years, are expected to result from cuts in the Food Stamps and SSI programs.

**Chart B1a: Federal Spending on Welfare Categories**  
(Millions of constant 1996 dollars)



**Chart B1b: State-Local Spending on Welfare Categories**  
(Millions of constant 1996 dollars)



Source: U.S. House of Representatives (1998, Table K-2)

### **Box 1: Contents of the PRWORA of 1996<sup>47</sup>**

This summary is selective and intends just to highlight how the novel features of the welfare overhaul materialized in the new regulations.

**Universal work obligation:** Adults must participate in defined work activities after receiving assistance for a maximum of 24 months (i.e., state governments can shorten that grace period). Otherwise assistance is curtailed pro rata or even more at state option. Criteria for what satisfies the work engagement requirement is left to state governments to define. States have a specific and increasing fraction of their entire caseload involved in the work activities identified by the legislation (e.g. single parents have to work 5 hours a week in 1997 which increases to 10 hours a week by 2002; two-parent families have to work 15 hours a week and 18 hours by 1999, one adult in families with no children under six must work 35 hours a week by 2000).

**Time limit on maximum period of TANF assistance:** With few exceptions, federally funded assistance to families that have received aid for more than 5 years will be terminated. For families currently receiving assistance, the five-year clock starts with the respective state's implementation of the block grant. Under the "hardship-exemption", states are allowed to exempt 20 percent of their caseloads from this requirement (e.g. for family members who have been subject to extreme cruelty). A contingency matching fund of \$2 billion (for the period 1997-2001) was established for support of states that experience negative asymmetric shocks. A "contingency fund trigger" is either a rise of state unemployment by 10 percent above 6.5 percent, or a rise in food stamp recipients of 10 percent and more. State governments that receive contingency funds have to maintain the historic level of their welfare payments (so called 100 percent Maintenance of Effort or MOE).

**Maintenance of effort (MOE) requirement:** State governments are asked for a MOE of 80 percent, "effort" being the aggregate spending on the three programs replaced by TANF in FY 1994. Only a MOE of 75 percent is required if the work-participation rate requirement is met. If not, a state's block grant will be reduced one dollar for each dollar that a state's spending falls below the required MOE.

**Predominance of block grants:** AFDC, an open-ended matching grant, as well as two minor programs (Emergency Assistance or EA and the Job Opportunities and Basic Skills Training Program or JOBS) were replaced by TANF.<sup>48</sup> Each state receives a fixed ("capped") amount based on payments received for the three supplanted programs either in 1994, in 1995 or on average in 1992-94, whichever is larger (\$16.38 billion aggregate in each fiscal year of 1997 to 2002). Because of a declining caseload, TANF therefore implies a net increase in national funds. State governments have to submit plans specifying "objective criteria for delivery of benefits and determining eligibility" in order to get the national grant for TANF. State governments may carry over funds for the purpose of providing assistance in future years under the TANF block grant.

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<sup>47</sup> This account follows closely the description of the Department of Health and Human Services <<http://www.acf.dhhs.gov/programs/opa/facts/tanf.htm>> and the Green Book of 1998 (House of Representatives 1998, Section 7).

<sup>48</sup> Before TANF, the national government reimbursed states for about 55 percent and the states paid the other 45 percent of total welfare expenditures. Central funding for AFDC and EA was unlimited, entitlement for JOBS funding was capped.

**Subsidiarity in administration:** State governments get much more flexibility to determine eligibility standards and they continue to set benefit levels. In contrast, AFDC law defined eligible categories of needy families and required states to assist if family income was below state-set limits. Now they may deny assistance to additional children born while the parent is on welfare or to unmarried teen parents and their children. They may require school attendance by parents if they have not completed high school. They are allowed to make payments or hand out vouchers for employment placement programs. The law also allowed state governments to treat families who have moved from another state under the cash assistance rules operating in that state, including benefit levels, for 12 months. However, this stipulation has been ruled unconstitutional by the Supreme Court in May 1999.

**Sustained cut in welfare spending:** The PRWORA supposedly saves \$54.5 billion over six years of which 85 percent were projected to stem from almost equal reductions in Food Stamps and SSI expenditures. These savings are planned to result, first, from eliminating access to Food Stamps and SSI for legal immigrants (“aliens”) either until they have obtained citizenship or, if they have entered after enactment in August 1996, for five years after which TANF eligibility is just a state option.<sup>49</sup> The second major source of savings is tightening the standard of child disability to be eligible for SSI. On the other hand, the fastest growing programs, EITC and Medicaid, were basically untouched. A state option is to deny Medicaid along the lines of TANF eligibility, i.e., to legal immigrants and to adults who fail to participate in work activities.

**Additional funding:** National funding for childcare has been substantially increased. States are eligible for supplemental grants if they experience either exceptional population growth rates (more than 10 percent between 4/1990 and 6/1994) or have very low grant amounts per low-income person (less than 35 percent of national average in FY 1994). The national government also hands out rewards for performance relative to block grant goals (\$220 million per year for all “high-performing states”) and for reducing out-of-wedlock births (\$20 million to each of the five states most successful in reducing “illegitimacy” without increasing abortion). Finally, welfare-to-work grants of \$3 billion have been authorized in 1997 to move the least-employable TANF recipients into long-term employment. All additional grants are capped.

**Penalties for state governments:** The national government imposes penalties, mostly grant reductions, for failure to meet work participation requirement (exempt are states receiving contingency funds), for failure to submit required biannual reports (the PRWORA contains detailed information requirements), for misuse of funds, for failure to participate or poor performance in child-support collection systems. Penalties for any quarter must not exceed 25 percent of the basic grant. In case of all penalties, states must replace national grants with their own so that the benefit of recipients is not diminished by penalties.

It is obvious that the new division of financial and administrative responsibilities between jurisdictions was an essential part of the reform agenda (Haveman/Wolfe 1998, p.12; Seeleib-Kaiser/Gebhardt 1997, p.714). The state governments got greater autonomy as regards the details and levels of welfare provision. But the central level of government uses its financial leverage to make lower levels of government take care that both ends of the reform act meet.

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<sup>49</sup> While the law cut \$24 billion in benefits to legal immigrants and refugees, in 1997, nearly \$12 billion of SSI benefits were restored by permitting many immigrants to retain their old age and disability benefits. I am grateful to Phil Martin who made me aware of these post-1996 changes.

### III. Implications for Comparative Research

This section introduced the very subject under scrutiny, i.e., U.S. welfare after 1996. It just remains to summarize explicitly what this contributed to the research agenda, which eventually aims at drawing some lessons for a future social federation of EMU.

The welfare debate and attempts at reform were driven by mounting frustration over the discrepancy between increasing efforts and worsening results as regards poverty relief. Beforehand, this constitutes a close parallel to concerns expressed in many welfare debates in Europe. E.g., they express themselves in statements such as “less [effort] is more [effective social policy]” or “the welfare system is part of the problem”. But even if this rhetoric of retrenchment sounds so familiar to a transatlantic observer, one has to keep in mind that the very focus of the debate is different. While the European debate is largely related to the pressing unemployment problem, it is welfare in the sense of poverty relief in the U.S. That difference in focus is intimately related to the difference between the respective welfare regimes, as was pointed out in Section A.

This has some bearing on the present study. Namely, we can duly disregard certain provisions of the welfare overhaul, which played a prominent role in the U.S. debate. They are only loosely related to the problem of income maintenance of the unemployed or structural differences in regional development. One set of provisions being of less relevance to this study is dealing with the high incidence of welfare dependency among single mothers, the problem of teen pregnancy and childcare. These issues do not figure prominently in European welfare debates and they need not concern us with respect to EMU. Another provision of little interest to the present study is the whole issue of Medicaid. In the U.S., health care reform was essential for the reform strategy “to make work pay”. Since there are categorically different health care systems for welfare and non-welfare households, those who go off welfare lose Medicaid and either have to enter a relatively expensive private scheme or remain without protection. Such disincentives for leaving welfare are not equally present in comprehensive public health insurance systems that exist in most European countries.

Another and most important conclusion from a closer look into the background of the debate is that historically the long-term questions as regards the federal constitution of a social union are intimately related to the issue of welfare retrenchment. But it seems to me that one has to be diligent in separating the two. Apart from the fact that retrenchment is not of primary interest to the present study, mixing up both aspects of the U.S. reform is likely to lead to serious misinterpretations of cause and effect. As far as one can tell from recent studies of attempts at welfare retrenchment (Pierson 1994), their outcome may be quite paradox. E.g., any reform is usually costly even if implemented with the explicit goal to save costs.<sup>50</sup> If this aspect is not seen as separate from the reshuffle of federal responsibilities, one is easily led to conclude that devolution has gone too far with subsidiary governments out of control—or that devolution has not gone far enough leaving subsidiary governments with little incentives to spare money. Moreover, the same measures to create a leaner system may have fundamentally different effects in different welfare regimes or in different political and socio-economic settings. In a unified social insurance regime this could be of more far-reaching effect than in a dichotomized system such as the U.S. This is why both aspects—retrenchment and redesign of the intergovernmental

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<sup>50</sup> Cf. Wiseman (1996). Vocal critics of welfare as we knew it also emphasized that reform cannot primarily aim at welfare savings if recipients are to be made self-sufficient in the medium to long run (Murray 1994, p.229; Mead 1997, p.56).

division of labor—have to be separated conceptually despite their being closely related in the recent U.S. history of welfare reform.

But separating the issues conceptually does not imply to ignore one side or part. It is important to realize that the New Federalism has been instrumental to many of the reform provisions which in turn primarily aimed at cutting back welfare expenditure. But if that were its sole purpose, the New Federalism would hardly entail any lessons for Europe. One reason for that seems to me that broad public support for radical changes and curtailments is not conceivable in unified social insurance systems. In such systems, virtually all who contribute also receive benefits. It is the amount of redistribution involved that is contentious but not the very existence of the system. A slogan that begins with “Ending social insurance” is thus barely popular with European voters. The recent shift in EMU to governments led by social democrats may be taken as bearing witness to that impression.

The fact that reform was meant to decrease welfare spending by making it more efficient has basically two implications for my research. First, it is important to get an intuition about the extent to which the New Federalism creates incentives for the notorious rush to the bottom. If that were overwhelmingly the case, the New Federalism would have only limited relevance for a future social federation of EMU. It is particularly interesting that at least two elements have their obvious rationale in their likely contribution to contain systemic competition and retrenchment of state welfare: the maintenance of effort requirement as well as the controversial home state principle versus the residency principle in determining benefit levels.

Secondly, it is unlikely that workfare seen as a whole system has any chance to be transferred to Europe since this would require an even more radical regime switch than in the U.S. We have thus to watch out for elements even if such “disembedding” is problematic from a methodological point of view. One such element of particular interest is the design of grants that flow from the center to the regions or states, in particular how this affects the stabilization properties of a fiscal federation. Hard time limits are also part of that focus, namely to look at how welfare provisions contribute to stabilization. Finally, the emphasis on in-work benefits will be an element worth studying because they have the potential of establishing a wage floor and to respect diversity at the same time.

The bottom line of these concluding remarks is that readers who expect simple lessons to be drawn from the U.S. for EMU should beware. They will not find them.

### **C. THE NEW FEDERALISM**

The last section already alluded to that aspect of the U.S. welfare overhaul which is often overlooked by conventional accounts of the debate that emphasize incentive effects on individual behavior as the basic issue. This aspect being that the federal system has a particular bearing on U.S. welfare, on the process and the actual outcome of reform, respectively, as has been pointed out by students of federalism (e.g. Peterson 1995, ch.5) and experts on welfare reform (e.g. Wiseman 1996, fn.39; Weaver 1998, p.401). This is of immediate interest to a future social federation of EMU.

At the heart of the so-called New Federalism is devolution, which entails passing policy responsibilities from the national to the state and local governments (Watson/Gold 1998, p.1). Following suggestions from the theory of political and fiscal federalism one may ask how the various stipulations of the system, i.e., workfare, relate to the post-reform division of federal responsibilities. And following suggestions from in-depth studies of the reform process, one may

ask whether they favor particular evolutions of the U.S. welfare system, most notably a rush to the bottom.

In the first section, I will describe more specifically what it was that lent itself to broad political support for welfare reform in a federal set-up. This is obviously important to know if one contemplates the lessons to be drawn from the U.S. welfare reform for Western Europe, a federation and a political space that is ideologically at least as diverse as the U.S. polity. The various manifestations of the New Federalism will then be discussed in the second section. In the third section, it will be explored what this New Federalism presumably implies for welfare spending in the foreseeable future. All this can be just a preliminary and hypothetical assessment since the time that has elapsed since the implementation of welfare reform is just too short to find the structural changes well documented in the data yet.

### **I. State Support for Welfare Reform**

Ever since the first term of the Reagan administration, state governments were given greater latitude in administering the AFDC program. They were allowed, in particular, to introduce workfare programs that made benefits conditional on work in the public service.<sup>51</sup> Waivers were provided for state experiments and demonstrations in administering AFDC, Food Stamp and Medicaid programs. Two conditions were laid down for waiver-based demonstrations to be approved. First, they had to be cost neutral in the sense of implying no additional outlay for the national government. And secondly, they had to be rigorously evaluated which meant by random assignment. The cost effects were assessed by comparing costs between control and experimental groups with state budgets covering the difference between national pre-case costs for the control and for the experimental group (Wiseman 1996). In the beginning of welfare reform, it is thus quite obvious that retrenchment and devolution were twins. The latter, devolution, is the core of what later came to be known as the “New Federalism.”

Politically, these waivers for demonstration programs firmly established a sustained interest for welfare reform in the states. Since the late 1980s, they were instrumental in shifting the center of gravity of welfare reform away from the national government. Ironically for the Republican Party, this may eventually have helped presidential candidate Clinton, then governor of Arkansas, since welfare reform offered him a political platform to make himself a name at the national level. As president later on, he had a somewhat strained relationship with these state initiatives. On the one hand, his administration let it be known that state initiatives would be welcomed almost without any qualification, thus breaking imminent stalemates in the national maneuvering over welfare legislation (Weaver 1998, pp. 362, 393). However, this also aroused the impression that his administration had lost control over the reform agenda to the state legislatures which were pushing for waivers relentlessly, some as forerunners and others joining them when the bandwagon rolled.<sup>52</sup>

No government or party, neither at the state nor at the national level, could afford to ignore the public hostility against welfare as it were. Public opinion polls throughout that political haggling over welfare legislation showed that the electorate preferred almost any change

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<sup>51</sup> The Omnibus Budget Reconciliation Act of 1981 provided the legal basis for this shift toward devolution and self-support as an obligation.

<sup>52</sup> Cf. Weaver (1998, p. 401). A particular challenge for Clinton’s administration was the “Wisconsin Work not Welfare” Initiative of 1993 followed by the “Wisconsin Works” (W-2) proposal of 1995, forwarded by the Republican Senator Thompson (Kaplan 1998, pp. 10-13). Clinton, however, succeeded in using the approval of the Wisconsin project for his own political agenda (Wiseman 1996).

to no change (Weaver 1998, p.375). Most scholars ascribe this widespread hostility to a common sense notion that one has to distinguish between the deserving poor, such as the disabled and old aged, and the non-deserving poor, such as single mothers or long-term unemployed adults. The rising share of caseloads related to out-of-wedlock births was clearly taken as an indicator that welfare is more and more spent on the non-deserving poor. And the racial skewing of the AFDC caseload only contributed to that hostility (Weaver 1998, p.364; Faye Williams 1998).

In a comparative perspective, it is important to note that the extreme unpopularity of welfare in the U.S. is institutionally fostered by the social policy regime. As outlined in the first section, that regime dichotomizes welfare and social security cum unemployment compensation. Thus, for most U.S. Americans it is inconceivable that they will ever be in need of support from the welfare part of the system. For that majority of middle and upper class, mostly white Americans, welfare is a public expenditure for which they are taxed but from which they never benefit directly. It is a kind of contrived philanthropy. In contrast, each individual will at some point be a beneficiary of a uniform social insurance system which embraces welfare, health care irrespective of income levels, social security, unemployment benefits etc. In such a system, it is rather unlikely that a majority is hostile to the system as such. This is true notwithstanding the fact that a majority may feel uneasy about the cost-benefit-ratio of his or her contribution to the system.

It would lead us too far to describe the bitter combat over welfare reform between the Republican and the Democratic Party. At the peril of over-simplifying, it seems to me that the Republican handwriting is obvious in the “personal responsibility” part of the Act, while the Democrats insisted on the “reconciliation” with work opportunities to be taken care of by government. But those reform proposals which constituted a radical break with past welfare policy and were later adopted in the actual law made their first public appearance in congressional initiatives of the Republican Party.<sup>53</sup> This is not all that surprising if one recalls that the Welfare to Work model originated in the Reagan era and that the Republican Party is traditionally inimical to Big Government, i.e., favors on principle—if not always in practice—decentralization and a minimalist state. That Republican principles and practice do not easily match was most obvious in the party’s discussions over the amount of devolution it should lobby for. While the conservative party’s principle suggests that “getting Washington out of the welfare business” was key, others argued in view of liberal state practices “that it was irresponsible to give states money without mandating deterrence approaches—such as family caps, a ban on benefits to teenage mothers, and time limits” (Weaver 1998, p.385). The law gave these considerations of practice more weight than the conservative principles.

Above all, it was President Clinton’s centrist political line that helped the Republicans to push through their reform agenda. He seized the opportunity to achieve this major reform against the odds that he was no longer backed by a Democratic majority after the landmark congressional election in 1994. The Republicans took over the majority in both chambers for the first time in forty years. To seize the opportunity and get results thus required to compromise on the substance of his party’s stance on welfare, namely that welfare is an entitlement of any needy individual. And it implied to alienate important Democratic constituencies such as unions and

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<sup>53</sup> E.g., the idea of a five-year time limit for obtaining AFDC was introduced on February 2, 1993, by the House Ways and Means Committee Republicans. And a universal work obligation as an expression of “personal responsibility” was sponsored by House Republicans in H.R. 3500 on November 10 of the same year. The Democrats, in contrast, initiated several proposals to increase funding for training and job provision, such as the Work for Welfare Act of the Democratic Senator Moynihan on January 21, 1993 (APHSA 1998b).

public sector employees since advocacy of workfare was hardly popular with them, given the wage effects of that policy (see Section D-I.). Clinton's literal opportunism was most obvious with respect to a hard time limit for obtaining welfare, which he strictly opposed in the beginning but finally accepted to keep things going, to the dismay of his party and the delight of Republicans (Weaver 1998, pp. 381, 389). However, it was backed by a "New Paternalism" that endorsed mandatory work as part of a supervisory approach to poverty relief.<sup>54</sup> The total of reform provisions thus sanctioned by a Democratic president amounted to what is to most observers an unexpectedly radical reform law.<sup>55</sup>

The PRWORA was finally passed by a vote of 328 to 101 in the House of Representatives (Republicans 230—2, Democrats 98—98) and by a vote of 78 to 21 in the Senate (Republicans 53—0, Democrats 25—21). Thus, it was the Senators who were decisive for a slight majority of the Democratic Party to be in favor of the reform bill. This Senate vote may be interpreted as a further indication of the states' advocacy of welfare reform contributing more to its final passing than bipartisanship. Moreover, there was virtually no opposition on the Republican side to what was support of President Clinton's position after all.

The conclusion thus is that federal forces, in particular state governments and the national executive branch, seem to have been more decisively striving for welfare reform than the national legislature in a bipartisan attempt. This is reassuring for the present study since a predominance of federal forces renders the U.S. case more suitable for comparison. In the case of EMU, there is no comparable national level, i.e., neither an elected government nor a strong legislature such as Congress. The most forceful requests for reform as regards a social union will thus come from the state legislatures, perhaps rooted through the European commission, while the European parliament will play a secondary role for the time being.

## II. Manifestations of the New Federalism

The PRWORA, as originally enacted in 1996 and outlined in Box 1 of the last section, contained basically four manifestations of the New Federalism: (1) block grants, (2) a time limit, (3) maintenance of effort requirements, and (4) the home state principle.

(1) Technically, the core of the new welfare policy was to replace the AFDC and two other minor programs with the program "Temporary Assistance for Needy Families" (TANF). It is a **block grant** that is capped, i.e., it is a fixed sum of \$16.4 billion each year for a five-year period.

Since its beginnings in the Nixon presidency, the New Federalism favored block grants as the basis of intergovernmental fiscal relations. Block grants make it easier than matching grants to break the cost dynamic of welfare. They may even lead to less welfare spending because it becomes marginally more expensive for state governments. This is best understood if compared to a matching grant: A state government that wants to have an additional dollar spent on welfare would only have to pay its share if there is a matching grant. This share was on average 50 percent before 1996. The other fifty cents are paid by the national government. So the "marginal cost" of welfare is only 50 percent for that state government (for low income states such as

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<sup>54</sup> Cf. the contributions in Mead (1997), in particular those of the editor himself.

<sup>55</sup> That the law was passed at all is equally surprising. Ever since Nixon proposed a kind of negative income tax and was defeated in 1973, each subsequent president (except George Bush who never tried) shared his fate in that large-scale welfare reform was proposed and dismissed (Haveman/Scholz 1994, p.417).

Mississippi it was even less, namely 20-30 percent).<sup>56</sup> In contrast, a state government bears the full cost under a block grant, i.e., spending on welfare has a marginal cost of 100 percent. The analogue holds for welfare savings: a state government that wants to have one dollar less welfare spending gets just 50 percent of the savings in a matching grant system but the full return with block grants. That one-dollar saved can be put into a rainy day-fund, for instance. So there is clearly an incentive for cutting back on welfare in a block grant system.

(2) Hard **time limits** for being on welfare are a manifestation of the New Federalism insofar their implementation uses the fiscal leverage of the central government. The leverage is used to make state governments comply with the workfare strategy as envisioned by the federal law. While work is an individual obligation, state administrations face reductions in their block grant if they do not succeed in putting beneficiaries into defined work activities over time. For those beneficiaries who have reached the time limit, there will be no grant payment any more.

Time limits obviously have a bearing on the stabilizing role of the cash assistance provided under TANF. Imagine there being a deep recession in the U.S. Even if long-term unemployment is not the problem, marginally employed people will be on welfare time and again. Reaching their time limits should make them accept jobs even below the mandatory minimum wage.<sup>57</sup> So deflationary pressures may arise. At the same time, state governments are less likely to succeed in placing their welfare population into jobs, so the block grants will be reduced one for one. This may require them to raise taxes or cut other expenditures, just at a time when government policy should be expansionary in its effects. Thus, spending on TANF does no longer work as a built-in stabilizer but changes pro-cyclically. Welfare expenditure falls simultaneously with private demand.<sup>58</sup>

(3) The matching grant was replaced by a generous block grant to which a **maintenance of effort requirement** was attached. That is, state governments have to maintain 80 or 75 percent of the expenditure level they had with respect to the three programs replaced by TANF in 1994.<sup>59</sup>

On the one hand, the MOE requirement is a safeguard for diversity insofar it is defined as a percentage. It requires equality of effort only in a relative sense, which respects historical standards, and the corresponding pattern of diversity at present. While this does not ensure that the states' spending on welfare is efficient, it provides at least the opportunity to find out over time because it neither enforces convergence nor does the MOE requirement prevent change in either direction. It is possible to gradually reduce spending levels by sticking just to the MOE target of 75 or 80 percent, respectively, while it is not forbidden to show more than this level of effort. Notably, it is possible for state governments to design programs that count as MOE

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<sup>56</sup> Marginal is meant in contrast to total: For a state government to decide whether it should *expand* welfare, only the *additional* (i.e., marginal) cost of doing so is of relevance and not the total cost of welfare spending already incurred.

<sup>57</sup> As already mentioned, this time limit may become a tough stipulation: if one looked on any one day in 1994, admittedly a year of peak load, almost half of the welfare population has been on welfare for more than five years (Nightingale 1996, p.4).

<sup>58</sup> This said, one has to admit, that this role of TANF is not of primary importance in the U.S. Total outlays on income-tested benefit programs reached a record-high in fiscal year 1995, namely 5.1 percent as a share of GDP, which has dropped to 4.8 percent or \$367.7 billion in 1996 (House of Representatives 1998, p.1413). The outlay on TANF is, as mentioned, only \$16.4 billion a year.

<sup>59</sup> It turned out that only 75 percent had to be maintained since all states met welfare-to-work participation rates for all families in 1998 (press release by the DHSS on August 2, 1999, cf. <<http://www.acf.dhhs.gov/news/partpr.htm>>).

expenditures but which are not subject to TANF stipulations, such as the time limit or exclusion of legal immigrants from receiving benefits for five years. That is, the block grant may be used to finance a food program for immigrants ineligible for Food Stamps or a program of access to postsecondary education for low-income students (Greenberg 1999). This provides yet another opportunity to counter the homogenizing trend of TANF stipulations in line with the idea of devolution.

On the other hand, this MOE requirement implicitly admits that there is an incentive for state governments to reduce welfare spending now that block grants are fixed for a period of five years and provide for marginal savings of 100 percent. More precisely, it points to the fact that there may be asymmetric incentives to reduce spending compared to raising them (Figlio/Kolpin/Reid 1998).

(4) The New Federalism also showed up in the stipulation called **home state principle**. It allowed state governments to treat families who have moved from another state under the cash assistance rules operating in that state for twelve months. To put that into perspective: a family of three who is on welfare would have to live with an average cash benefit of \$164 in Alabama while that same welfare family resident in Alaska receives \$923. Or less extreme and more in a neighborhood: Maximum TANF benefits in Delaware are \$338 while they are \$636 in Connecticut, again for a family of 3 (House of Representatives 1998, Table 7-9).

The home state principle to determine benefit levels implicitly admits that there is a problem of welfare magnetism, if only as a latent “angst” in the public mind.<sup>60</sup> Notably, this principle has been put in the welfare law despite a Supreme Court ruling in 1969 that such stipulations violate a citizen’s right of free movement. Consequently, state governments who put it into effect after 1996, such as California, have been challenged in the Supreme Court, which decided against this stipulation in May 1999.

The home state principle is, in contrast to the residency principle, a barrier to migration. Such hindrance of migration may be justified on the grounds that the individual right to move freely comes at a cost, if state governments react sensitively to real or potential migration of low-income and marginally employed households. In case this engenders a “race to the bottom” of welfare expenditure to deter such migrants, individual mobility is a negative externality for resident low-income households that fall time and again back on welfare. They may suffer from a preemptive welfare restraint even though existing benefit levels would have been considered adequate without that imminent migration. The crucial question then is whether a race to the bottom, i.e., competitive slashing of state welfare, is a real threat.

### **III. Hypotheses and Evidence about Emerging Trends**

What will be the long-term effects of the reshuffle in the U.S. social federation? Two hypotheses about emerging trends are of particular interest to the present study. They have been already mentioned in the above sketch of how the New Federalism manifests itself.

- The new division of fiscal responsibilities may have a long-term effect on the level of benefits. The New Federalism has been intentionally designed to break the cost dynamic of welfare. Many expert observers think this has been overdone, actually

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<sup>60</sup> Therefore, it is still of some interest to the present study even though it has been ruled unconstitutional in the meantime. I come back to welfare magnetism in the last section of this section.

- providing incentives for states to reduce spending to an extent that leaves a relevant share of the population destitute.
- The New Federalism may affect the stabilizing properties of welfare expenditures. In particular, one might ask whether there is a tendency for post-reform finance of public assistance to become more or less pro-cyclical. This trend is of particular concern to EMU because it would exacerbate the problem that the monetary union is less stable due to the lack of both a fiscal union and a social federation.

The following table summarizes how the various manifestations of the New Federalism relate to these two trends in theory.

**Table C-1: The New Federalism and Possible Trends**

	<b>What favors a decrease in state spending levels?</b>	<b>What favors pro-cyclical expenditure dynamics?</b>
<b>Block grant</b>	marginal cost effects of state spending and marginal reward effects of welfare savings	fixing over a time span of more than a FY
<b>Time limit/work requirements</b>	ambiguous (decline in caseload versus higher costs per caseload)	recipients close to the time limit
<b>MOE requirement</b>	contrary to decrease in the short and medium run	no effect
<b>Home state principle</b>	would have countered competitive decrease	no effect

Will the post-reform system foster a decline in state welfare? State governments may decrease spending on welfare under the New Federalism for two reasons. First, additional spending becomes more expensive and savings become more rewarding. So there are *fiscal incentives* in the New Federalism working in favor of a decline in welfare spending. Secondly, a rush to the bottom may occur because state governments react to each other's welfare spending. It is then the *fiscal interdependencies* between subnational governments that work towards less social welfare.

What is the evidence about the first trigger of state responses, namely **fiscal incentives**? It has already been pointed out in the last section that under a block grant system, additional spending on welfare has to be fully borne by state budgets because there is no matching from the national government, and, for exactly the same reason, savings pay off 100 percent. These marginal incentives created by a switch from a matching grant to a block grant will be reinforced by the interaction of AFDC/TANF with the Food Stamp program (Chernick/Reschovsky 1996, pp.12-13). Cash benefits under the old and the new regime must be calculated by subtracting 30 percent of household income from the maximum food stamp benefit. An increase of benefits above the threshold for maximum benefits thus leads to a reduction of Food Stamp allocation by 30 percent. Because of this implicit taxation, one additional dollar of cash assistance requires to increase spending by more than one dollar, namely by \$1.43 (= 1:0.7). Under a block grant, a state government has to pay the full amount of \$1.43. Under a matching grant, it bears roughly half of this, so an additional dollar of AFDC benefits costs only \$0.71.

The incentives to decrease benefit levels and/or become more restrictive as regards eligibility has also been observed with respect to the SSI (Supplemental Security Income). In 1974, the SSI replaced Aid to the Aged, Blind, and Disabled which “had the effect of converting an open-ended matching program into the fiscal equivalent of a block grant.” (Chernick/Reschovsky 1996, p.20) What was happened was that most low-benefit states immediately ceased to contribute to this assistance program. High-benefit states generally maintained their existing supplements but most of them have not increased the nominal level of benefits, which means that state SSI spending has declined in real terms.

The econometric evidence about the effect of switching to block grants varies widely as regards the quantities involved, that is as regards the question how much state spending would decline. But the estimates agree that there will be a reduction. Chernick/Reschovsky (1996, pp.15-19, 24) conclude their review of the evidence with a best estimate “that over the course of several years, states will respond to the imposition of block grants for welfare by reducing benefits levels by from 17 percent to 25 percent.” Table C-2 shows that state spending on cash aid has indeed fallen in 1997 and 1998, the latest fiscal year (FY) for which data is available. This is all the more remarkable since spending for other major items such as Medicaid and Food Stamps as well as total spending has slightly increased in real terms. One also has to admit, however, that cash aid in both post-reform years is more than 75 percent of the 1996-level.

**Table C-2: Spending on Income-Tested Benefits, FY 1996-98 (billions of dollars)**

	Federal Spending			State Spending		
	1996	1997	1998	1996	1997	1998
<b>Cash aid</b>	72.8	73.0	73.9	23.3	21.6	20.7
<b>Medical benefits</b>	108.0	109.5	113.8	76.9	79.5	82.6
<b>Food benefits</b>	38.6	35.9	33.5	2.0	2.0	2.1
<b>Total</b>	273.9	274.0	277.3	111.4	111.9	114.4

Source: CRS Report (1999, Tables 4 and 5)

A last indicator for fiscal incentives fostering a decline in state spending on welfare is what happened to General Assistance (GA). GA programs are run in thirty-five states, financed and operated exclusively by states, counties, or localities.<sup>61</sup> After reform, the GA has become “the last strand in the safety net” for legal non-citizens and able-bodied childless adults without work (Gallagher 1999, p.1). Yet, GA programs have been severely cut back on benefits, especially by defining disabilities more restrictively. Moreover, the value of benefits has eroded in real terms because nominal levels stayed constant since 1989. The PRWORA has provided for additional opportunities to reduce state spending on GA: “[T]his policy change enabled states to shift some of these costs to the federal government. Nine states transferred responsibility for two-parent families and/or pregnant women to their TANF program.” (Gallagher 1999, pp.5-6) Thus, while this trend of considerable contraction had begun already in the 1980s, the New Federalism seems to have reinforced it.

<sup>61</sup> State-funded aid of the GA (non-medical care component) is estimated at almost \$1.3 billion in 1997, locally-funded aid at almost \$2.0 (CRS-Report 1998, p.218, note dd, based on Census data).

As regards the second trigger of state responses: What is the available evidence about **fiscal interdependencies** between states? Again, it is block grants in the presence of household mobility that potentially call forth responses, which may lead to a competitive slashing of benefits and entitlements. The case that a race to the bottom is looming rests basically on three considerations:

1. The fear of becoming a welfare magnet: If devolution would allow state governments to cut their benefits and restrict eligibility *ad libitum*, those that did not intend to do so may follow suit in order to avoid an influx of destitute migrants. Thus, the welfare magnetism argument for a rush to the bottom relies on virtual migration of low-income households since this may trigger a response from governments before migration actually occurs (Peterson/Rom 1990, Brueckner 1998).
2. Cost-benefit characteristics of welfare spending: State responses to what others do may be asymmetric, that is they may react to a lowering of benefits in neighboring states but not to increases. Figlio/Kolpin/Reid (1999, pp.6-7) argue that for responses to be asymmetric it suffices to assume that expected costs from a larger caseload rise at an increasing rate because the political liability grows more than proportionately, while expected benefits decrease at an increasing rate with additional caseloads because it raises the prospect of a larger tax burden with its crippling effects on the local economy.<sup>62</sup>
3. Systemic competition: Even free-market adherents admit, that in principle the failure of certain insurance markets justifies government intervention.<sup>63</sup> Social welfare systems are supposed to provide for the insurance of individual income risks that market solutions would deliver only at an inefficiently low level if at all. However, if devolution introduces competition between subnational welfare systems, this may precisely lead to the market solutions they were built to correct (Sinn 1998).

The evidence on such an imminent rush to the bottom is inconclusive and lends rather weak support to the hypothesis (Chernick/Reschovsky 1996, pp.21-24). However, this may be due to the empirical approaches chosen rather than the hypothesis itself. First, conventional tests of the welfare magnet hypothesis evaluate actual mobility of low-income households and find it too low to pose an imminent threat. Yet, Peterson/Rom (1990) substantiate their claim that there is a phenomenon of welfare magnetism with a case study of Wisconsin where virtual and not real migration posed the problem. Idiosyncratic and all but representative stories about inter-state migrants in the media can put enough pressure on elected politicians to make them inclined to cut back benefits. Secondly, responses are usually assumed to be symmetric, implying that governments would react equally to an increase as well as a decrease of benefits in neighboring states. This may distort the estimates, render them either insignificant or on average rather low.

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<sup>62</sup> In economic jargon: for there to be a race to the bottom, marginal indirect (political) costs have to be convex while marginal benefits from social welfare have to be concave.

<sup>63</sup> The failure arises from so-called quality uncertainty about potential insurance buyers, i.e., whether they are low risk or high risk ("lemons"). Average (pooled) insurance premiums will deter the clientele with low risks while attracting those with high ones. Adverse selection is the result. So, if insurers do not find a way to make potential customers signal their "true" risk category, no insurance will be provided even though everybody could be made better off by having one. Moreover, certain income risks, such as that from unemployment, cannot be insured in private markets because of the moral hazard involved.

At present, no retrenchment of social welfare has occurred. On the contrary, per capita spending on welfare has increased. This is because block grants and MOE requirements have fixed the aggregate funds available while the decline in welfare caseloads has been spectacular.<sup>64</sup> Therefore, spending, if not benefit, per recipient has increased dramatically. Moreover, time limits do not have enough time, so to speak, to take their toll yet since the clock started running with the passing of welfare law. However, considering the incentives in theory and available evidence on their effectiveness in practice leads me to expect a decline in welfare spending over the medium to long-term.

Will the post-reform system foster pro-cyclical welfare spending? As indicated in Table C-1, the spending on workfare is likely to become more pro-cyclical due to two elements of the New Federalism: block grants and time limits. A pro-cyclical impact of public finance is in general problematic because it generates larger fluctuations in income and employment. A pro-cyclical pattern amounts to less spending in a recession and more spending in a boom. This is contrary to what usually happens, for instance, in a recession: tax revenues decline due to lower economic activity while expenditures rise because of an increasing caseload of welfare recipients and more applicants for unemployment benefits. In other words, the budget automatically stabilizes the economy in that net public expenditure rises and thus compensates for the fall of private demand. And vice versa in a boom. One has thus to explain what causes block grants and time limits to work against that built-in counter-cyclical change in the budget.

The incentives created by a block grant system have just been discussed, namely generating a trend towards less spending. There are reasons to expect these incentives to vary with the business cycle. More specifically, marginal savings from welfare spending are likely to be valued differently in different phases of the business cycle. Savings become imperative in times of recession when budget constraints become more binding, especially in the U.S. where most states have self-imposed balanced budget rules.<sup>65</sup> And vice versa in a boom: Ever since the implementation of PRWORA, state administrations have been flush with money. But large balances held at the treasury will signal to Congress that TANF is over-funded at the national level (Lazere 1999, Greenberg 1999). Thus, state governments may want to spend more than they would if they had not to fear effects after the present legislative period ends. Moreover, there seems to be uncertainty about the conditions under which states will be able to retrieve unspent funds held at the treasury (Powers 1999, p.6). This again encourages to spend rather than to accumulate such funds. In good times, many states therefore spend more than they would do without such expectations of responses at the national level. This is why I think that block grants not only generate a downward bias on spending levels in the long run but also make public outlays on welfare more pro-cyclical. In the present boom, the latter trend may overcompensate the former downward bias.

Time limits lead to pro-cyclical spending the closer recipients are to hitting them. Especially in a recession, more and more beneficiaries will then be contrived off the welfare rolls so that spending is reduced. In a boom, more money can be spent to assist the transfer from dependence on TANF payments to independence from welfare.

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<sup>64</sup> Between August '96 and June '99 there was a drop of 44 percent overall, from more than 12 million recipients to less than 7 million. The latest figures as well as long-term data can be downloaded from a Web site maintained by the U.S. Department of Health and Human Services <<http://www.acf.dhhs.gov/news/>>.

<sup>65</sup> Balanced budget requirements, enacted since the mid-1970s, have made state and local government spending “a more symmetrical destabilizing force” as Penner (1998, p.6) aptly puts it.

The work requirements attached to time limits have a more ambiguous effect on the spending dynamics over the business cycle. They could work counter-cyclically, if in a recession the government acts as an employer of last resort. To the extent it assumes this role, recipients would also be less likely to hit the time limit. There is no evidence so far, since time limits had no chance of becoming a binding constraint so far. This is due, of course, to vigorous economic growth as well as for the technical reason that the five-year limit can be reached in 2001 the earliest.

But, as already mentioned, most U.S. state budgets have to comply with constitutional rules that force them to be balanced in each FY. Taking this restriction into account, TANF work requirements even magnify the impact of caseload changes and business cycles on state budgets, thus making it more likely that fiscal behavior becomes pro-cyclical (Mermin/Steuerle 1997, p.6). The welfare reform law determines work requirements with respect to the base year 1995. For instance, in 2001 half of the 1995 caseload has to participate in approved work activities. Mermin/Steuerle (ibid.) illustrate how these requirements interact with caseload changes: Assume two states A and B had 100,000 caseload in 1995, but A has only 90,000 in 2001 while the caseload does not change in B. In 2002, A would have to place 36,000 recipients in approved activities while it would be 50,000 in B.<sup>66</sup> In other words, a difference of 10,000 in caseload translates into an *addition* of 14,000 recipients for whom the state government has to find jobs if it wants to avoid cuts in block grant funding.

Not only does this multiplier effect put pressure on state governments to contrive welfare recipients off the rolls even before recession strikes. It also means that PRWORA made recessions create an additional need for tax increases and expenditure restraint to meet the challenge that local welfare offices have to find jobs just at a time when job offers become harder to find. The latter effect is even more striking if one changes the scenario slightly and assumes that B had experienced a decline in its caseload just like A but is particularly hard hit by a national recession. If by 2001, the former decline is wiped out, it has to find 14,000 jobs for the 10,000 that come back on the welfare rolls just because of the recession. It is not beyond imagination, that the government of B would react by reducing benefit levels and limiting eligibility so as to keep the caseload low.

The law has explicitly acknowledged the stability problem in that it provides for a contingency fund. Its volume of \$2 billion is more than sufficient at present, a growth period unprecedented in U.S. post-war history. But it stands to reason whether this is true in a recession.<sup>67</sup> During the last recession, between 1990 and 1992, federal AFDC expenditures rose \$6 billion above the amount expended in 1989 (Super et al. 1996). Even if the caseload is now 40 percent less and would rise proportionally, a contingency fund of a bit less than \$4 billion would be needed to support income. The problem with such funds is that in an emergency situation, Congress would have to be asked for additional funding. The time lag that such a parliamentary procedure creates is way too long for short- to medium-term stabilization.

Moreover, Powers (1999, pp.6-7) suggests that states may rely on spending cuts rather than on the federal Contingency fund. She enumerates several conditions why this may be the case.

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<sup>66</sup> The number 36,000 in A results from 50 percent requirement minus 10 percent caseload decline (i.e., 40 percent) times the actual caseload of 90,000.

<sup>67</sup> This has not gone unnoticed at the state level, of course: "state legislators are aware that the TANF block grant may not be sufficient to meet the needs of needy families during a recession." (National Conference of State Legislatures 1997, p.19)

- States may not meet the particular criteria for access to the Contingency fund such as the required rise in the Food Stamp rolls etc. even though they experience considerable distress.
- There is a 100 percent matching rate required to get grants from the Contingency fund, states would have to increase their own spending significantly to induce a funding from the national government.
- The DHSS is directed to make contingency funds available on a first-come, first-served basis, so that the fund may be depleted before a state in need becomes eligible to use it.

Moreover, allocation of block grant money to rainy day funds, i.e., state government funds for unexpected rises in welfare expenditure, does not count as MOE expenditure (Mermin/Steuerle 1997, fn.9). Again, instead of relying on contingency and rainy day funds, this creates incentives to lower benefit levels or to redesign eligibility rules in order to control costs when the caseload increases in bad times.

#### Concluding Remarks on Emerging Trends

There seem to be noticeable trends toward a long-term structural decrease in welfare spending as well as toward pro-cyclical changes in state welfare expenditure. The imminent decrease as well as the destabilizing pattern of welfare may be countered by a **centralization of welfare finance, which** may accompany the devolution of administrative responsibilities. What is more, this could be a paradoxical consequence of states' attempt to shift costs to the central government (Steuerle/Mermin 1997). What might cause this centralization of welfare finance in the U.S.? At least until 2001, the national budget has borne 100 percent of the AFDC/TANF cost by fixing its block grant at a level that reflected pre-reform spending levels while the MOE requirement for states was effectively 75 percent. Moreover, anti-poverty programs that are wholly financed by the national government, have gained and still gain in relative importance, in particular Food Stamps and the EITC (of which more will be said in the next section).

This leads to a somewhat puzzling conclusion: The incentives that devolution or the New Federalism creates seem to further more centralized welfare finance at the same time. And decentralized operation may even require centralized finance in order to stop the process of erosion and destabilization in states' spending. Such a requirement is likely to show up in the next recession.

This consideration is of obvious concern for a future social federation of EMU. If both emerging trends can only be hindered by a centralization of welfare finance, it would not bode well for the New Federalism in Europe. The central budget for such an additional responsibility is just not conceivable.

#### **D. THE EMPHASIS ON IN-WORK BENEFITS**

Proposals for in-work benefits are not affiliated with one extreme in the debate on how to reform, either retrench or sustain, mature welfare systems (Steuerle 1992, ch.6; Weir 1998, pp.20-21). Ever since the seventies, critics of U.S. welfare as we knew it have favored in-work benefits, in particular the negative income tax, as a way to get rid of a separate transfer system all together. But in the last decade, it was also proponents of comprehensive social insurance who

came forward to support in-work benefits as a way to reintegrate the long-term unemployed into the labor market. Thus, in-work benefits would be politically acceptable for a wide range of the party spectrum. This is the principal political consideration that counts for their potential to play a more prominent role in a social federation of EMU. The task then is to ponder the relevant economic considerations.

First, I will briefly describe the contexts in which in-work benefits figured prominently as part of welfare reform proposals in order to specify the aspect on which this study is focused. Secondly, I will analyze the three basic types of in-work benefits, such as a wage subsidy, a negative income tax, and an earned income tax credit. The workings of the latter in U.S. practice will be analyzed at greater length in the third section. The complementary role of a statutory minimum wage is the topic of the final fourth section.

## **I. In-Work Benefits and Reform**

The very purpose of the workfare model is to reallocate welfare payments so as to support low-paid employment rather than to make unemployment individually bearable. Therefore, post-reform cash assistance in the U.S. is made up almost exclusively of in-work benefits. The Earned Income Tax Credit (EITC) is by far the most important. It has been called “a rallying point in redirecting poverty policy” (Hoffman/Seidman 1990, p.1) and “the nation’s most effective antipoverty program for working families” (Johnson/Lazere 1998, p.2). As mentioned in Section B, the EITC survived the welfare overhaul virtually unscathed. Outlays on this tax credit were even stepped up in line with the main thrust of this reform, namely “personal responsibility”, which translates into a “work first” and “making work pay” strategy.

In-work benefits require households to have earnings as a precondition for receiving a specified benefit. As such, they serve a strategy to “make work pay” by increasing incomes in work relative to those out of work. In general, they do so by rising net incomes for a given level of gross job earnings. Other strategies to “make work pay” are (i) a minimum wage legislation, i.e., to prescribe an income floor for those working, (ii) active labor market policies, i.e., to increase potential earnings by improving skills, and (iii) the reduction of out-of-work incomes, i.e., to cut benefit levels (Whitehouse 1996, p.130). A statutory minimum wage is a major alternative *non-welfare* strategy to make work pay. And in contrast to the latter two strategies, it is a possibility to establish a nominal anchor for the price level, i.e., downwardly rigid nominal wages. This is why its role as an alternative to in-work benefits and as a stabilizer within the workfare model of social assistance will be considered in the final section.

In-work benefits have always been considered as an alternative or complement to more traditional means of income support, i.e., as a part of welfare reform. This holds in at least four respects:

1. In-work benefits first became an issue of public debate in attempts to deregulate the welfare state (Phelps 1994, Myles/Pierson 1997). It was in particular one variety, the negative income tax, that was meant to “reduce welfare dependency” of unemployed job-seekers. As a negative tax, i.e., an earnings subsidy<sup>68</sup>, it is designed to eliminate the disincentive of punitive marginal tax rates when taking up a job. The income transfer system would thus be absorbed by the tax infrastructure. Besides helping to reduce administrative costs, this would also overcome some of the stigmatizing

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<sup>68</sup> The term “earnings subsidy” is used whenever transfer payments to the working household are meant. In the U.S., wage subsidies implicitly stand for subsidies to the employers of targeted households.

- features of being “on welfare”. A negative income tax treats every beneficiary as a deserving worker who potentially contributes to the system. It thus brings welfare closer to the notion of universal social insurance prevalent in Europe.
2. In-work benefits have been discussed as a means to reintegrate the structurally unemployed. Proponents point to the fact that the incidence of unemployment is persistent and highly selective as regards skills, age, gender, and race. E.g., the human capital approach stresses that market forces put ever higher premia on skill formation and life-long learning. It is then just the reverse of an inevitable market dynamic that sets those at a disadvantage who are less capable to acquire skills continuously and over an extended life-span (Heckman et al. 1997). They are likely to become long-term unemployed if they are not subsidized into regular employment where they have at least the opportunity to get training-on-the-job.
  3. More recent is the perception of in-work benefits being a means for mature welfare states to stay competitive in the global economy. For some, it is the imminent “race to the bottom” that forces governments to adopt more targeted forms of social insurance if minimum standards for the least well-off are to be maintained. For others, globalization is a healthy disciplinary device pressing governments to abolish seemingly over-generous social benefits and to develop a more flexible and employment-prone welfare system (Rieger/Leibfried 1997, Rodrik 1997). A shift towards in-work benefits supposedly achieves either of these goals.
  4. Finally, in-work benefits may provide a minimum wage variety most appropriate for federal systems in which divergent interests can be powerful. It has been shown with respect to the U.S., that it is very difficult to establish a unified safety net in a politically decentralized and economically heterogeneous nation (Skocpol/Ikenberry 1983, Pierson 1995). The traditional low-wage regions of the South successfully contained whatever initiative came from the central government to build a unified welfare system. A wage subsidy, however, does not necessarily threaten employment and the competitiveness of lagging regions while providing a downward floor for nominal wages.

All these aspects of wage subsidies are of obvious relevance for the design of a social federation in Europe. The present research project, however, focuses on the fourth rationale for in-work benefits. It is this strand of the discussion that is most relevant to integration policy and where comparative research on the U.S. seems to be most rewarding.

## **II. Basic Types of In-Work Benefits**

In this section, it will be explored in general whether in-work benefits can serve as a basis for a social federation of a currency area with wide income disparities. I concentrate on three basic types of in-work benefits, namely an earnings subsidy, a negative income tax, and a tax credit on earned income such as the EITC. In this qualitative assessment, I try to answer the following questions:

- (a) Most of the economic literature on the EITC in particular, on in-work-benefits in general, focuses on their incentives for labor supply. Do they discourage or encourage additional work and entering into the labor market? How do the incentives vary with different subsidy rates?

- (b) In the context of the debate on welfare reform, characteristics that affect their usefulness as antipoverty policies have been analyzed as well. Specifically, are they well targeted to the poor?<sup>69</sup>

In what follows, these criteria for comparison will be briefly mentioned.<sup>70</sup> In addition, however, each instrument will be discussed with respect to criteria that are relevant for the cases in favor of strong and diverse safety nets in heterogeneous currency areas. This requires to answer the following questions:

- (c) Does a particular type of in-work benefit guarantee a minimum income independent of gross earnings, and thus establish an effective downward barrier against deflationary pressures?<sup>71</sup>
- (d) Do outlays on the in-work benefit under scrutiny increase in a downturn and decrease in an upturn of employment, so that this instrument acts as an automatic stabilizer of macroeconomic fluctuations?
- (e) Does the particular type of in-work benefit establish comparable downward wage floors between regions, which are compatible with a range of different levels of gross market earnings and with diversity in other social benefits?

This exploration will then be followed by a closer look at the EITC and how this program works in the U.S.

### Wage Rate Subsidies

The most simple and straightforward means of providing in-work benefits is a wage rate subsidy, a special variety of an earnings subsidy. It would pay the beneficiary or the employer a fraction of the gap between his or her wage rate and a fixed target wage rate. The subsidy is the higher, the lower is the wage earning per hour because this implies that the gap is larger. E.g., given a subsidy of 50 percent of the gap and the target wage rate being \$8 per hour, an individual worker who earns \$3 would receive \$2.50 subsidy (half of a \$5 gap), while another earning \$6 per hour just gets \$1 (half of a \$2 gap).

By definition, a wage subsidy is only paid if there is a wage earning to be subsidized but in principle it could be paid without there being employment, i.e., to step up wages that are just virtual.<sup>72</sup> But if it is to be a pure in-work benefit, there has to be a minimum wage rate of say \$1 per hour worked, for a worker to become eligible for the subsidy (of then \$3.50). This as well as a subsidy rate of roughly 50 percent has been assumed in Chart D-1. How does a wage rate subsidy fare with respect to the criteria mentioned above?

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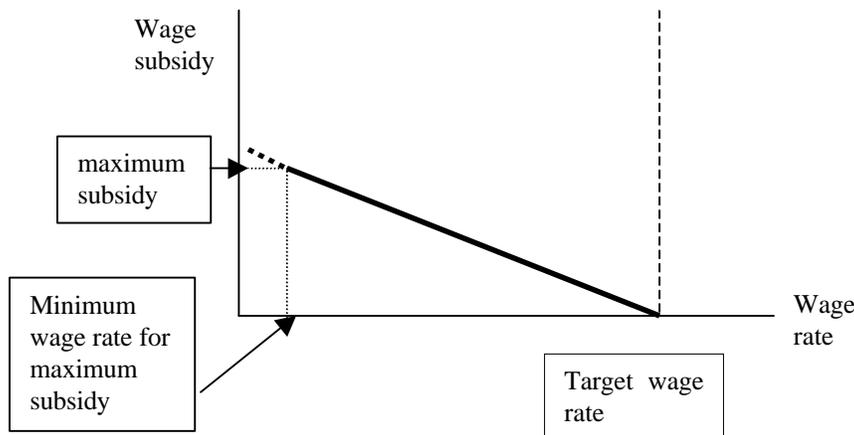
<sup>69</sup> Cf. Besley/Coate (1992a) for an economic discussion of incentive effects inherent in welfare.

<sup>70</sup> In doing so, I refer mainly to a very useful publication of the W.E. Upjohn Institute for Employment Research that motivated my comparison between these in-work-benefits in the first place (Hoffman/Seidman 1990, esp. chapter 4).

<sup>71</sup> In a welfare context, the function (c) of a nominal anchor against deflation has to be clearly distinguished from that of an antipoverty device in (b). The objective in (c) is at variance with the very objectives of social policy (Weaver 1988, ch.2). Social policy considerations suggest implicit or explicit indexation of social benefits or the minimum wage, to enforce a minimum standard of purchasing power that goes with each hour worked. But strict indexation, i.e., the guarantee of a *real* minimum wage, amounts to an erosion of the nominal anchor function.

<sup>72</sup> It would then resemble a Negative Income Tax with no stationary phase as will be seen below.

**Chart D-1: The Wage Rate Subsidy Schedule**



(a) What are the **incentives on labor supply** created by such a wage rate subsidy? Microeconomic theory assumes that an individual's decision to work more or less depends on three considerations, given a certain amount of time at his or her disposal (say eighteen hours net of daily sleep requirements): (i) preferences for consumption of goods versus consumption of leisure; (ii) the net wage rate which is the price for leisure time in terms of consumption goods; (iii) non-labor income, e.g., from assets. Choosing one's labor supply means that the individual worker gives up leisure time in order to work and earn the income that buys goods. It has to be underlined, especially for non-economists, that this refers to a decision at the margin, i.e., assuming an individual contemplating more or less work. It does not relate to the decision of participating in the labor force, i.e., the binary choice of taking up or refusing a job of a certain standard working time. In-work benefits create incentives for labor force participation by definition since they condition transfers on having a job.<sup>73</sup>

A wage rate subsidy affects only the net wage rate of an individual worker while his or her income is a result of this net wage rate and the amount of hours worked. The subsidy increases the net wage rate, the maximum being obtained at the lowest wage rate eligible for subsidy. Therefore, working more hours does not result in a lower subsidy while a better paid job does. A wage subsidy therefore does not discourage working time by the individual or by the household. But it discourages the search for a better paid job.<sup>74</sup> To illustrate the latter adverse effect on labor supply by the example given above, i.e., a 50 percent subsidy rate and \$8 target wage (Hoffman/Seidman 1990, p.59). If a worker earns a wage increase from \$4 to \$5 per hour, the subsidy will be cut from \$2 to \$1.50. The effective wage rate (subsidy plus market wage) thus rises only from \$6 to \$6.50, i.e., not by one dollar as the market wage itself. While this in-work benefit does not eliminate the incentives for better paid jobs completely, it does implicitly impose a tax rate of 50 percent on wage rate increases by cutting the subsidy by that percentage.

(b) From a **social policy** and a fiscal point of view, there is definite drawback of a wage rate subsidy affecting only the individual's wage rate. For that very reason, it is not well targeted.

<sup>73</sup> The NIT is an exception of sorts. Hoffman/Seidman (1990, pp.38-43) provide an overview of the textbook economics and apply it to the EITC.

<sup>74</sup> All this holds true in the economics textbook case where social and psychologically relevant aspects are disregarded such as the reputation and self-respect conveyed by a better paid job.

It is not only the working poor who gets it but also the spouse of a high-income earner or a teenager who earns pocket money for non-basic needs. Having the individual wage rate as the eligibility criterion, transfers are paid indiscriminately of whether the subsidy helps a family income to pass the poverty line or whether it props up the income of an already well-to-do household. Thus, a wage subsidy is a priori less effective as an antipoverty policy for given expenditures on a program or, what is the same, more expensive to achieve a certain amount of poverty relief.

Having briefly described the more conventionally discussed aspects of a wage subsidy, we can now proceed to look at the three criteria of specific relevance to the present study: How well-suited is a wage subsidy to provide a nominal anchor for the price level, to act as a built-in stabilizer, and to allow for diversity in regional labor costs and/or social benefits?

(c) For a wage rate subsidy to provide a **nominal anchor of the price level**, the target as well as the minimum wage rate has to be defined nominally. If they are indexed, the nominal values of these thresholds would rise and fall with the price level, could thus not stabilize it. However, this is only a necessary condition but not sufficient in times of high unemployment. Since this type of in-work benefit only reaches wage-dependent labor, massive layoffs and distress self-employment would trigger deflationary pressures. I.e., a sufficient condition for wage subsidies to act as an anti-deflationary device is wage employment at a positive price of remuneration to be available.<sup>75</sup> If both conditions are met, the effective floor for wage rates provided is the minimum rate plus the maximum benefit (in the example given above: \$1 + \$3.50 = \$4.50).

(d) A wage rate subsidy is not particularly apt to act as an **automatic stabilizer**. A downturn in the economy affects both wages and employment. In institutionally mature economies, it is likely that the latter effect on employment is more important because long-term collective wage contracts prevent nominal wages from falling. So firms adjust by cutting extra hours and laying off marginal workers. But the outlays on wage subsidies increase only if more wages fall below the stipulated target wage. Expenditure would even decrease if workers rapidly lose their jobs while wages of those employed stay fairly constant. Or, in positive terms, only if income falls due to wage rates, not due to hours worked, will a wage subsidy be effective as an automatic stabilizer. But this is empirically a rare exception, and for good theoretical reason if deflation is a real danger for the working of monetary economies. Wage rate subsidies perform not well under these circumstances because they stabilize just the price component of employment but not the quantitative component.

(e) Finally, wage rate subsidies are compatible with **regional diversity**. Within limits, they would allow for regionally different levels of labor costs, the difference being made up by the subsidy. Low-wage regions are likely to receive more transfers per capita, insofar they have a higher share of employment eligible for subsidization and not just higher unemployment. The limits are circumscribed by two conditions, one for low-wage regions and one for high-wage regions. First, low wages in low-income regions must not be less on average than the minimum rate eligible for subsidization (\$1 in the example above). They should even be somewhat higher than the maximum subsidy (here: \$3.50) in order not to have adverse effects on labor supply. And secondly, low wages in high-income regions must not be higher than the minimum wage

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<sup>75</sup> In an ongoing deflation, this is not necessarily the case because employers have to expect that they have to buy inputs, in particular labor services, today at higher prices than is justified by the price of the output to be sold later on. In a deflation, the representative firm rationally expects to lose. Moreover, since production is at least partly financed by credit, deflation amounts to a revaluation of firms' liabilities.

level thus established (\$1+\$3.50 in the example). Otherwise the wage rate subsidy does not provide for a wage floor. Only if both conditions are met, regions have an incentive to participate in such a scheme. Given that, even benefit parameters could be varied. E.g., the subsidy rate as well as the minimum income for maximum credit may be adjusted for regional purposes. But both would have to be varied in order to keep a uniform effective minimum wage rate, which results from the sum of these two components. That would make sure that a nominal wage floor is kept.

To sum up this qualitative assessment of wage rate subsidies (see also Table D-1 at the end of this section): They pass the test for the nominal anchor and for regional diversity given certain conditions. I.e., they can play a role as an anti-deflationary device if nominally defined and underemployment being not too pervasive. They are also compatible with different levels of regional labor costs and, for certain combinations, differences in benefit parameters. However, they barely pass or fail the test in three respects: From a purely microeconomic point of view, they have adverse effects on the upgrading of jobs even from the point of view of the supply side. They are not well targeted as antipoverty policies. And, finally, they are not very suitable as built-in stabilizers.

### Negative Income Tax

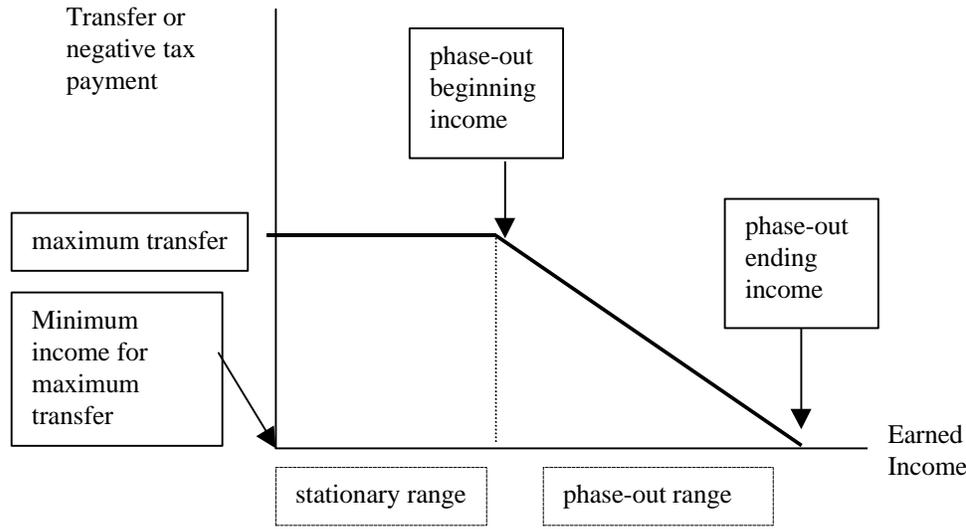
The Negative Income Tax (NIT) is an in-work benefit, but not exclusively so.<sup>76</sup> It aims at guaranteeing a minimum cash income for households and uses the tax system for providing that. A household with earnings below the threshold of this minimum cash income or with no earnings at all would receive a net transfer, i.e., a negative tax payment, from the tax authorities. In most NIT proposals, the amount of transfer would stay constant over a certain (stationary) phase even if earnings from work increase. After the household has reached a certain threshold of earned income, the negative tax payment (i.e., the tax credit) would be phased out, i.e., for each additional dollar earned the transfer would be reduced by a certain percentage till it reaches zero. E.g., assume that a maximum transfer of \$600 per month would be reduced by 25 percent if the household earnings reached a threshold of say \$700, which amounts to a combined income of \$1,300. It then takes additional wage earnings of \$2,400 to completely phase-out the negative income tax, say for a family of four.<sup>77</sup> These features are shown in Chart D-2.

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<sup>76</sup> See also Barr (1993, ch.11) for an excellent comparative discussion of the NIT as a general approach to income support and Jerger/Spermann (1997) for a recent proposal to implement a specific NIT-scheme in Germany.

<sup>77</sup> This does not mean that only then the household would be liable to pay (positive) taxes, just that the household is entitled to offset its tax liabilities against the NIT as long as the pre-tax family income is below the threshold marked by the phase-out ending income (equal to \$3,100 in this example). Cf. Hoffman/Seidman (1990, pp.12-13 and pp. 22-23) with respect to the analogous case of the EITC.

**Chart D-2: The Negative Income Tax Schedule**



(a) For the assessment of the **labor supply effect** it is important to note that the NIT affects income, namely the product of the wage per hour and working hours supplied plus unearned income. Like a wage subsidy, the NIT rises the net wage rate, i.e., the price of leisure in terms of commodities foregone if time is spent not working. An increase in this price or wage rate makes leisure more expensive so that one would expect the household to supply more working hours (economists call this the substitution or price effect). But it also affects income as such. If the NIT increases income, the household can afford more leisure, which discourages labor supply as long as leisure is a normal good (this is called the income effect).<sup>78</sup>

In the stationary range of the NIT, the household would receive unearned income while his or her net wage rate would not be changed. There is thus a pure income effect, which discourages additional labor supply (again, as long as leisure is a normal good, i.e., one wants more of it if one gets richer). In the phase-out range, this adverse effect is reinforced by the substitution effect. Any increase in the net wage rate is reduced by a cut-down of the tax credit, i.e., each additional dollar is implicitly taxed which makes it less worthwhile to add an hour of work. But the household still receives unearned income, even if lower than in the stationary range, which amounts to the adverse income effect. Thus, an NIT discourages labor supply even if it does not punish entry into employment as positive marginal taxation of low-wage earners does.

(b) Because the NIT is based on household income, it is better **targeted to low-income families** and individuals than a wage subsidy. Neither teenagers from well-to-do households nor spouses of high-wage earners would receive a transfer. Yet, the highest benefits go to non-working households, in absolute terms and relative to their (zero) earnings.

<sup>78</sup> I.e., the household is not supposed to be a workaholic, not even somebody who likes to do its work for another reason than getting the money to buy consumer goods. Moreover, the textbook model of household's labor supply assumes that leisure and consumption of commodities are substitutes, not complements. While policy debates typically rely on this rather simplistic textbook story, economists have worked on a refinement of the model. Alas, the corresponding modifications allow for all kinds of household responses, leaving the model virtually without explanatory or predictive power.

(c) The NIT can act as a **nominal anchor** to the price level provided the maximum transfer and phase-out beginning income are nominally defined. The effective floor for nominal wages is then the maximum transfer in the stationary range of income because there would be no incentive to accept a job that offers a wage rate at non-zero working hours, which pays less than the amount of transfer obtainable without work. What that means, though, is that it is effective as an anti-deflationary device insofar it is not confined to an in-work-benefit.

(d) The NIT is effective as a **built-in stabilizer**. If income falls—be it due to less hours of work or falling wages or both—negative tax expenditures go up because more people become eligible for transfer payments. And vice versa in the case of rising income. This is due to income, i.e., the result of wage rate and hours employed, being the criterion for eligibility.

(e) **Regional diversity** is compatible with the NIT. It would allow for regionally diverse labor costs, since the transfer payment would equalize the after-tax wage rate relevant for the labor supply decision of households. Again, there are limits to the range of diversity compatible with this scheme. They are circumscribed by the condition that low wages in low-wage regions must be sufficiently above the level of the maximum transfer to maintain incentives for labor force participation. And low wages in high-income regions should obviously not lie above the phase-out ending income for the region to receive any transfers. To some extent, the NIT would be compatible with some diversity in welfare stipulations, such as the phase-out rate or the phase-out beginning income. They could be varied without jeopardizing the provision of a wage floor as that is provided for by the amount of transfer in the stationary range. For that very reason, the amount of maximum transfer could only be varied to the extent that the regional levels of the cost of living, in particular for housing, do vary.

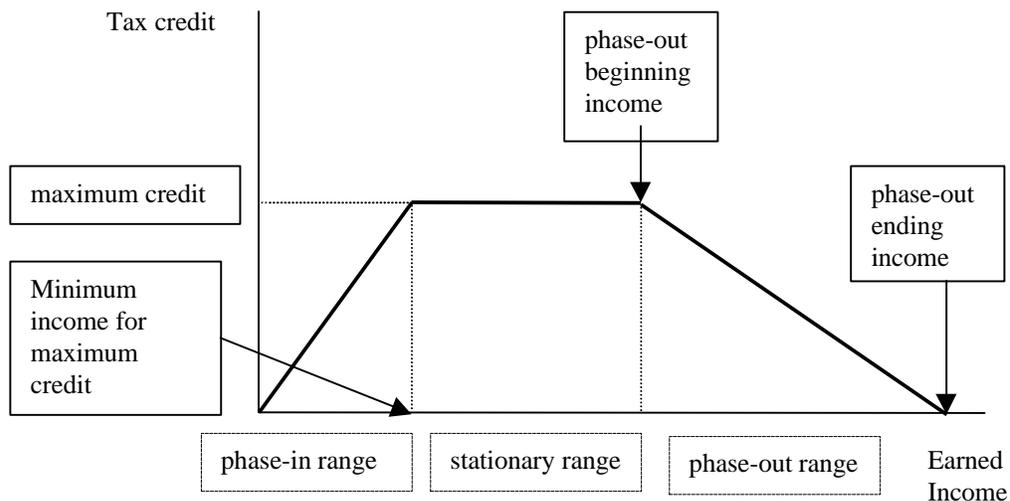
In sum, the NIT does quite well with respect to the three criteria most relevant in the present context, i.e., nominal anchor, built-in stabilizer, and compatibility with a certain amount of regional diversity. But that scheme does not equally recommend itself with respect to the effect on labor supply and as regards the targeting within a workfare model of social assistance.

### Tax Credit

A tax credit like the EITC works basically like a negative income tax, namely routing benefits to low-income households through the tax system. It is different in two respects: the EITC is restricted to working households, i.e., there is no guaranteed income independent of the employment status. And the EITC is a negative income tax that rises over a certain range as the household's income rises, i.e., there is a phase-in range. Chart D-3 depicts the similarities and the differences.

(a) For households with an income in the stationary and in the phase-out range, **labor supply effects** are obviously the same as under an NIC scheme: additional labor supply is unambiguously discouraged because of higher income and marginal taxation of that income. But in the phase-in range of household income, the substitution effect works in favor of more labor supply. The net wage rate increases due to the phase-in credit, i.e., instead of marginal taxation there is marginal subsidization of earnings. The income effect again discourages labor supply. But a high phase-in rate can make the substitution effect stronger than this adverse income effect so that the overall effect would be an encouragement to work more. The graph above has been depicted so as to show a scheme conducive to additional labor supply: the phase-in rate should be high (steep) while the phase-out rate should be low (flat): this amounts to substantial subsidization of additional labor at low earnings and moderate marginal taxation at the higher end of eligible income.

**Chart D-3: The Earned Income Tax Credit Schedule**



(b) Like the NIT, the EITC is based on household income, not on an individual's wage rate. So as regards **targeting**, it is superior to a wage subsidy. Within a workfare model of social assistance, it is even superior to the NIT in that the credit goes exclusively to working households.

(c) Again, it is a necessary condition for the EITC to act as an **anti-deflationary device** that the threshold incomes are defined nominally. But this is not sufficient. This is because of the phase-in range for eligible income. As soon as household income falls within that range, the EITC does no longer provide a barrier to bid down market wages since the household is always better off to accept a job even if the nominal wage rate approaches zero. The household would then at least get a (tiny) tax credit to step up the family income. Thus, the EITC does not provide an effective floor for market wages.

(d) The EITC can act as an **automatic stabilizer** in principle. But in contrast to the NIT, this depends on whether employment or wages vary more in the business cycle. Expenditures go up if income declines in a recession if this income decline is due more to a decline in average wages than to rising unemployment.<sup>79</sup> But the outlays on an EITC may be pro-cyclical if employment is more elastic than wages as is empirically the case in most European labor market systems. In a recession, where mass layoffs by workers occur, EITC payments would decline, in a boom with rapid increase in working hours at current wages, EITC payments may rise. The role of an automatic stabilizer is thus impaired by this program being a pure in-work benefit. In the case of German unification, for instance, an EITC would not have been a very strong automatic stabilizer since East-German jobs were lost for good on a massive scale.

(e) Like any of the other in-work benefits, the EITC would be compatible with **regional diversity** in the sense of regionally diverse labor costs. What is even more, this holds irrespective of the limits circumscribed by low wage levels in low wage regions mentioned with respect to wage subsidies and the NIT. Since there is a phase-in range, there is no guaranteed

<sup>79</sup> A decline in average wages may be due to a cut in extra payments (for overtime, bonuses etc.) or to a scaling down in the wage hierarchy.

subsidy at very low income levels. So even more diversity of labor costs would be allowed. This is just the reverse of its weakness as an anti-deflationary device, of course. But the condition at the upper end still holds, namely that low wages in high-income regions must not be higher than the phase-out ending income.

Yet, if the earnings from a low wage job in one region fall in the phase-in range, but in the stationary range or even the phase-out range in another region, different effects on regional labor supply may arise. This could be mitigated by differences in phasing-in and phasing-out rates with corresponding adjustments of the stationary range. Moreover, regional diversity in the sense of huge differences in regional unemployment rates and low mobility would also be problematic because an EITC then provides for vastly different levels of transfer payments, not covering the worst-off regions where unemployment is high and mobility low.

To sum up: The EITC does theoretically better on the conventional criteria than the NIT, i.e., non-discouragement of labor supply and targeting within the workfare logic. This is because it has a phasing-in range of eligible income and because it is a pure in-work benefit. It can play a role as an automatic stabilizer as long as a downturn is not triggered by a massive layoff of workers. Moreover, it is compatible with some regional diversity. The EITC is not effective as a nominal anchor, which is due to the very feature that makes it so attractive on conventional grounds, namely its phase-in range. The following table summarizes this qualitative discussion.

**Table D-1: In-work Benefits in Comparison**

	<b>Wage Rate subsidy</b>	<b>Negative Income Tax</b>	<b>Earned Income Tax Credit</b>
<b>Labor supply</b>	marginally discouraging	marginally discouraging	encouraging in the phasing-in range, otherwise like the NIT
<b>Targeting</b>	working individuals, not necessarily needy	needy families and individuals, not necessarily working	needy families and individuals, if working
<b>Nominal anchor</b>	very limited	effective	limited
<b>Automatic stabilization</b>	very limited	effective	limited, possibly pro-cyclical
<b>Regional diversity</b>	compatible within limits	compatible within limits	compatible

From this qualitative assessment, I conclude that it is the NIT that scores best beforehand. It is most effective with respect to the last three functions (c)-(e) that are particularly relevant in the present context. Moreover, the NIT does in principle fulfill each function reasonably well. However, this assessment is less clear if the EITC is accompanied by an effective unemployment insurance that would substitute for its poor performance as an anti-deflationary device. Since that

would be the case in most EMU countries, an EITC would perform comparatively better, especially if seen as an element of the workfare model.<sup>80</sup>

It may be surprising and paradoxical that all these in-work benefits have marginally discouraging effects on labor supply, i.e., discouraging additional labor or an upgrading of jobs. But such adverse labor supply effects are an inevitable result of means-testing, which by its very purpose has to have a phasing-out of benefits attached to it (Hoffman/Seidman 1990, p.47). What this implies is that workfare is hardly “ending welfare” in the sense of making social assistance redundant. An in-work benefit does encourage labor force participation but in itself does not encourage earning an income that would make the household independent of transfer payments all together. There is a workfare trap just as there is a welfare trap for poor households.

### III. The Earned Income Tax Credit in U.S. Practice<sup>81</sup>

The EITC was introduced in 1975. As its name indicates, income-tested cash assistance is available only to *working* families with children, which has been extended to working taxpayers without children in 1994. The EITC was designed to eliminate the disincentive of punitive marginal tax rates when taking up a job. Today, this income supplement is seen by its proponents as a genuine expression of the “work first” and “making work pay”-strategy implied in the welfare overhaul of 1996 (Lerman 1999, pp.11-14).

Technically, the EITC is a *refundable tax credit* (House of Representatives 1998, pp.866-870). Refundable means that if the amount of credit exceeds the worker’s federal income tax liability, the excess amount is paid to the taxpayer as a transfer payment. The credit equals a certain percentage of wages up to a maximum amount that applies over a certain income range and then diminishes to zero over a specified phase-out range (see Chart D-3 above and Table D-2).

**Table D-2: Earned Income Credit Parameters, 1998**

	No children	One child	More than one child
<b>Credit rate (percent)</b>	7.65	34.00	40.00
<b>Minimum income for maximum credit</b>	4,340	6,500	9,140
<b>Maximum credit</b>	341	2,271	3,756
<b>Phase-out rate (%)</b>	7.65	15.98	21.06
<b>Phase-out range</b>			
<b>Beginning income</b>	5,570	12,260	12,260
<b>Ending income</b>	10,030	26,473	30,095

Source: Internal Revenue Service Web site <[http://www.irs.gov/prod/forms\\_pubs/pubs/p596toc.htm](http://www.irs.gov/prod/forms_pubs/pubs/p596toc.htm)>

Table D-2 shows that three different schedules apply according to the number of children. Larger families, i.e., of three or more children, do not get more generous refunds than families with two children. In assessing the income eligible for an EITC refund, most states disregard

<sup>80</sup> In the last section, I discuss possible improvements of the EITC for the purpose of a social federation of EMU. See also Walker/Wiseman (1997) for a detailed discussion of the British case.

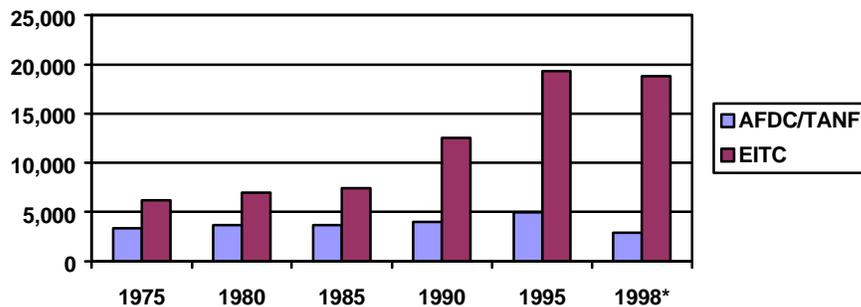
<sup>81</sup> Cf. Scholz (1996) for an overview.

cash assistance under TANF the family may possibly receive. Nor is EITC counted toward Food Stamp eligibility (Smeeding et al. 1998, p.4).

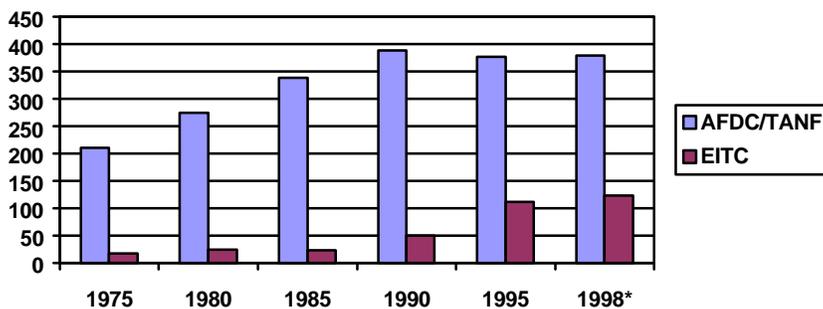
Even before 1996, it has become the single largest cash assistance program in the US (Haveman/Wolfe 1998, Table 1). And it has been rapidly stepped up in three successive legislative changes since 1986 (House of Representatives 1998, App. K).

The EITC always benefited a much larger number of people than AFDC or TANF but by a correspondingly smaller per capita amount. However, there is a widespread perception that the EITC is an expensive program (e.g., Walker/Wiseman 1997, pp.410, 418). We will see that this assessment depends on the interpretation of the underlying goal. In a workfare interpretation of the program it is true: its work incentives come at a comparatively high cost (see footnote 13). But it is untenable if seen as an antipoverty program. Per capita outlay is small even according to U.S. standards and it is effective as regards lifting households out of poverty, i.e., the EITC has a net impact beyond mere compensation of positive taxation (Table A-2 above; see also below).

**Chart D-4a: Number of Recipient Families Under AFDC/TANF and EITC, FY 1975-1998 (in thousands)**



**Chart D-4b: Average Monthly Benefit per Family Under AFDC/TANF and EITC, FY 1975-1998 (current \$)**



Source: House of Representatives (1998, Tables 7-6, 7-47, 13-14) and DHHS

\* provisional figures for 1998; average monthly benefit under TANF is maximum benefit for a family of three in the median state

After having described the main empirical features of the EITC in U.S. practice, I will go into more detail as regards its being an element of the workfare model of social assistance. In doing so, I will stick broadly to the five criteria discussed in the last section: (a) work incentives, (b) social policy characteristics, (c) nominal anchor, (d) automatic stabilizer, and (e) compatibility with regional diversity.

(a) Like all other in-work benefits, the EITC in the U.S. rewards **labor force participation** by definition. Studies explicitly focusing on this effect like that of Eissa/Liebman (1995) and Dickert/Houser/Scholz (1995) estimate that new entrants expand labor supply by 1.4 to 3.3 percent.<sup>82</sup>

But it creates **labor supply incentives at the margin** only in the phasing-in range while it discourages a gradual increase in work hours and job progression later on. The study of Hoffman/Seidman (1990) simulates a situation with EITC and compares it to one without EITC, using supply elasticities that have been measured in Negative Income Tax experiments. They find an overall decline of working hours by 2.2 percent. Studies that measure the effects of changes in the EITC parameters and find again negative overall effects that are in the range of just below zero to 4 percent.<sup>83</sup> Walker/Wiseman (1997, p.419) succinctly summarize these results: “The effects on labour supply may be perverse.” In a certain sense, this is inevitable because the EITC is a means-tested benefit that has to be phased out eventually.

Besides, anecdotal evidence suggests that unemployed welfare recipients learn about the availability of EITC only after they have applied for a job. They are hardly aware of it because they do not file income tax.<sup>84</sup> Somewhat ironically, lack of knowledge about the EITC could explain why the *disincentives* do not lead to more reduction of labor supply. This is particularly true with respect to the advance payment option, which only few EITC filers realize. The overwhelming majority who has already learned about it receives this tax refund as an end-of-year reward rather than as an incentive to work more in order to make ends meet on a day-to-day basis. Since 1979, this transfer may be received in the paycheck. However, 95 percent of households claim the refund on their tax return filed by April of the following year (Walker/Wiseman 1997, p.411). This could explain why some studies find only little hours response on the expansion of the EITC (Eissa/Liebman 1995, p.34). But this would not bode well for the future of the EITC as a workfare program. When people get to understand its incentive structure over time, more and more would feel inclined to stay on the workfare rolls.<sup>85</sup>

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<sup>82</sup> Eissa/Liebman (1995, p.32) note that if all of their observed 1.4 percent increase were regarded to be due to the EITC expansion of 1986, this would amount to 124,600 new entrants at a cost of \$23,000 in constant 1992-dollars per entrant.

<sup>83</sup> For an overview of studies before 1995, see Dickert/Houser/Scholz (1995, p.11) for which Holtzblatt/McCubbin/Gillette (1994) is representative. Eissa/Hoynes (1998) measured the effects on a specific group, namely married women, who tend to be secondary earners. The effects here are negative, as is to be expected on theoretical grounds. Trabert (1999) provides an excellent overview on the EITC as a *Kombilohnkonzept* in German.

<sup>84</sup> At the “Welfare Reform: Promising Practices Conference” in Baltimore (March 31-April 2, 1999), Fred Kramer of Marriott International reported in the workshop on “Employer Outreach” that Marriott’s training under a Welfare-to-Work grant contains teaching former welfare recipients about their entitlement to EITC. Asked whether they do not know beforehand and have the prospect of EITC as one incentive to apply for the job, he answered definitely in the negative. According to him, the clients of these training courses were in general unaware of the EITC since they were unemployed before or did not report their meager earnings.

<sup>85</sup> There is already some evidence for such change in behavior (Blank/Card/Robins 1999, pp.17-18). I want to stress that the presence of such windfall beneficiaries is only devastating for a workfare rationale of the EITC. It is not an issue of concern if the objective is one of poverty relief. I come back to that in the last section.

In practice, the EITC is thus an income supplement collected considerable time after the work qualifying for it was undertaken. Why this may be the case is a matter of debate. In order to get up to 60 percent of the maximum allowable amount of EITC in their monthly or weekly paycheck, employees have to fill out a W-5 withholding form, which the employer has to submit to the Internal Revenue Service. Based on this, Smeeding et al. (1998, p.6) provide two possible explanations: first, employers may be unwilling to cooperate or, secondly, employees do not want to take this route through the employer because they fear stigma or lower pre-tax wages. Both considerations are important since they potentially question the role of the EITC, as it stands, to be a forceful labor *demand* incentive.

The authors find a third explanation more convincing, namely that beneficiaries like the contrived savings aspect of an end-of-year EITC refund which allows to acquire valuable assets over time. Their study substantiates this hypothesis by finding “that most of those people have at least one asset building social mobility related use for the EITC.” (Smeeding et al. 1998, p.20)<sup>86</sup> What this suggests is that low-income households may prefer a larger share of EITC entitlements over a larger share of wage payments, at least if they have reached a threshold of current income that covers roughly their day-to-day expenses. Again, this is in contrast to the proposition that EITC makes economic sense as a labor supply policy.

Thus, for the majority of EITC filers,<sup>87</sup> there are disincentives to work hours that would make them independent from this income supplement. This assessment is at odds with all the studies that find EITC to “making work pay.” These studies typically focus on changes in total income and if they find net income of beneficiaries in work to be unambiguously higher than net income without work, they conclude that labor supply incentives are positive.<sup>88</sup> But this conclusion is at least premature. It would only be correct if the alternative to consumption, namely enjoying leisure, has close to no value for welfare recipients. Since leisure becomes more affordable when income rises, such a rise brought about by the EITC creates *disincentives*. Proponents of workfare have to discount these heavily in arguing their case. Yet this is a strong assumption if one keeps in mind that leisure includes the time available for parental, i.e., unpaid, child care.

Finally, even if one considers low valuation of leisure by welfare recipients to be a legitimate assumption so that the income effect works in favor of more labor supply,<sup>89</sup> the question arises why work incentives of welfare should be a problematic issue at all. A small reward for work would then suffice to make recipients apply for jobs. More generally, one cannot share the preoccupation of those who argue for a workfare model and claim at the same

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<sup>86</sup> An “asset building social mobility related use” is e.g., purchasing a car, paying tuition for training or for moving in a safer neighborhood. Such uses are contrasted to uses that make ends meet like paying routine bills or purchasing food. However, the authors include some dubious items into the category of “social mobility related uses” such as repaying loans or medical bills (Appendix Table A-2). This certainly drives their result that such a high share of EITC recipients has this type of use and thus “prefers” it as a lump sum at the end of a fiscal year.

<sup>87</sup> About 60 percent of households have income in the phase-out range (Eissa/Liebman 1995, p.7).

<sup>88</sup> See, for instance, Acs et al. (1998, p.15 and passim; fn. 4 and 14) in an otherwise excellent and comprehensive study of post-reform workfare.

<sup>89</sup> E.g., not because they value it so little but because the time limit makes leisure an extremely expensive activity for welfare recipients (Acs et al. 1998, pp.31-34). But even that is not unambiguous with respect to the labor supply incentives as the authors note in their most informative analysis of the impact of a time limit (idea, pp.33-34): “To the extent that [families] do not believe that the time limit will be enforced, value the present over the future, or believe that benefit levels will fall in the future”, the labor supply incentives of a time limit are less effective or even perverse.

time that its inherent reliance on means-tested benefits has no adverse effects on labor supply at the margin. I call this *the workfare paradox*.

(b) If the EITC constitutes a **welfare program** (House of Representatives 1998, App. K), one may ask how these parameters relate to the official poverty line for different types of families. As noted in the introduction to this section, the EITC has been called the nation's most effective antipoverty program for the working poor. According to the Census Bureau, the EITC removed 4.3 million persons of all ages from poverty in 1997.<sup>90</sup> Among them were more than 2 million children which amounts to 30 percent of children who would otherwise be poor (Smeeding et al. 1998, p.5). In addition and related to the discussion of the last section, one may ask how the after-tax income compares with an income at the minimum wage, were there no EITC. Table D-3 gives some illustrative examples. They are just meant to show the antipoverty effectiveness of the EITC.<sup>91</sup>

**Table D-3: Income after Payroll Tax and EITC Compared to Income with Minimum Wage and at Poverty Level (\$ in 1998)**

	After-tax income <sup>a</sup>	Census poverty standard	Full-time minimum wage <sup>b</sup>
Single parent, one child, full-time, <sup>b</sup> year-round employed at minimum wage	11,783	11,235	9,512
Single parent, two children, employed 48 weeks per year at 37 hours a week at minimum wage	12,202	13,133	9,512
Two parents, two children, one full-time, year-round earner employed at \$6.75 per hour	15,468	16,530	9,512

Source: Internal Revenue Service, U.S. Bureau of the Census, own calculations

<sup>a</sup> Annual income after counting for the federal income tax on taxable income, payroll taxes of 7.65 percent and offsetting EITC refunds.

<sup>b</sup> Full-time is 50 weeks at 40 hours of employment, the mandatory minimum wage is \$5.15. A full-time minimum wage thus amounts to \$10,300 less \$788 of payroll taxes (no federal income tax).

The last two cases of a family of three or four clearly show that the federal EITC is not enough to lift families with two or more children out of poverty. But it brings working families of this size near to the poverty threshold. As an aside one may note that the examples clearly demonstrate the present level of the minimum wage is not even enough to lift a single parent with one child out of poverty. This is relevant for 11.8 million or 10 percent of the workforce in the U.S. for whom the minimum wage sets the floor of hourly earnings in 1998 (Bernstein 1999, Table 1).

<sup>90</sup> This is the *gross* effect, i.e., not just the offsetting effect to federal income and payroll tax (cf. Table A-2).

<sup>91</sup> More comprehensive assessments, including TANF cash assistance, the cash equivalent of Food Stamps, state EITCs, housing subsidies etc., can be found in Walker/Wiseman (1997, pp. 412-416) and Acs et al. (1998, pp.13-16).

There is then a role for other benefits, most notably Food Stamps.<sup>92</sup> Or for State EITCs. At present, there are seven states with refundable credits while three more states have non-refundable credits. With the exception of Minnesota, they all piggy-back on the federal EITC, i.e., they express the state credit as a specified percentage of the federal credit. And they all use federal eligibility rules (Johnson/Lazere 1998, p.2). Only Wisconsin treats families with three children more generously. But other benefits suffice to lift a family of three out of poverty even in the poorest and least generous U.S. states, given that a single parent has full-time work at the minimum wage of \$5.15 (Acs et al. 1998, Table 3).

The antipoverty effectiveness of the EITC is to a large extent due to a relatively high participation rate. Estimates from the beginning of the 1990s suggest that up to 85 percent of all eligible persons receive EITC, well above all other means-tested programs (Smeeding et al. 1998, p.3). This is because the EITC is given as an entitlement. If a household files for his income tax, the IRS has to assess whether the household is eligible for a tax refund even if not requested. However, this points to profound differences that make transfer difficult (Walker/Wiseman 1997, pp.410-411). One is that the U.S. income tax system relies heavily on the filing of end-of-year tax returns so that virtually all households with non-transfer income are required to file. In the U.K. or in Germany, only a fraction of taxpayers files annual returns because the systems are pay-as-you-earn.

Moreover, high participation may be simply due to the fact that the program is subject to “excessive fraud” (Walker/Wiseman 1997, p.419). A study of the tax authority in early 1997 suggested that taxpayers claimed \$4.4 billion more in EITC refunds for 1994 than they were eligible to receive. The IRS states on its Web site that the latest and best available indicator of the EITC overpayment rate suggests a 32.08 percent to 34.28 percent overpayment rate.<sup>93</sup> This raises a fundamental question about any negative tax strategy of welfare that tries to absorb the transfer system in the tax system. The question being whether assessing the eligibility via tax declarations is inherently more fraud-prone than the old-fashioned way of assessment by caseworkers.

(c) Since 1987, all income thresholds of the EITC are indexed for annual inflation (House of Representatives 1998, pp. 866, 868). This makes sense considering the political will that brought about the EITC in the first place, namely to correct the workings of the income tax so as to prevent low-income households to stay or become poor just because of taxation. It is then only natural to correct for the “inflation tax”. But this also implies that the EITC does not even meet a necessary condition for being an anti-deflationary device. Yet, as noted in the last section, this **nominal anchor function** is in any case severely limited due to its widely acclaimed phasing-in.

In U.S. practice, it is the minimum wage that fulfills this function of stabilizing the price level by stabilizing wages at the lower end. The minimum wage is not indexed and thus can act as a nominal anchor. In a deflation, the purchasing power of a constant minimum wage would rise while the income thresholds of the EITC would be adjusted downwards. Thus, less and less households would receive EITC, either because their earnings from employment at the minimum wage would no longer qualify for a refund, or because less and less workers would find jobs that

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<sup>92</sup> Considering that for most recipients the EITC is a windfall, i.e., a reward for work in the past year, Walker/Wiseman (1997, p.412) note: “In the US, Food Stamps are the most important source of immediate income supplementation.”

<sup>93</sup> <<http://www.irs.ustreas.gov/prod/news/efoia/doc10932.html>>, cf. “Minimizing Tax Filing Fraud”.

pay the minimum wage.<sup>94</sup> Contrary in an inflation. There it becomes ever more profitable to employ workers at the minimum wage and rising EITC payments become ever more significant for low wage workers to sustain their living standards. EITC payments would rise on average because more and more recipients would fall into the phase-in or stationary range of the credit. The government would pay a rising share of low-wage incomes. Therefore EITC finance would be pro-cyclical, at least for non-trivial rates of changes in the price level. This pro-cyclical feature results from an indexed EITC interacting with a nominally fixed minimum wage.

(d) For moderate business cycles, the EITC may work as an **automatic stabilizer**. This would be reinforced by the work requirement and the time limit on welfare in a lifetime, which forces low-wage households to keep a job at any rate. However, a counter-cyclical pattern of disbursements and number of recipient families did not emerge so far. Both indicators went constantly up (Charts D-4 above). This is due to a constant revision of income ranges and credit rates since the mid-eighties, which expanded outlays and beneficiaries continuously (House of Representatives 1998, Table 13-12). This is about to come to an end as the projections in the Green Book reveal. The recent increase in EITC expenditures during the longest post-war boom of the U.S. economy might be interpreted as a result of the Clinton administration's attempt at establishing the EITC as a built-in stabilizer.

Do the volumes involved justify such an interpretation? After all, an effective automatic stabilizer should not only vary inversely and timely with the ups and downs of the business cycle, but it should also have enough weight in aggregate demand to make its impact felt. The total amount of EITC is projected to lie in the range of \$27 to \$30 billion in the years 1997-2000 (House of Representatives 1998, Table 13-14). This is considerably less than expenditures on some means-tested benefits for the poor, notably Medicaid, or on some social insurance schemes for the middle classes. But among these government expenditure programs, it is only social security that has a considerable counter-cyclical influence (cf. Table A-1). E.g., variations in health care expenditures, be it Medicaid or Medicare, are not strongly related to regional or national business cycles.

To assess the qualities of the EITC as a built-in stabilizer, it has to be noted that the program is targeted on the working poor. This enhances its effectiveness as an automatic stabilizer. It redistributes income to households that have a high propensity to spend. In a recession, income support for such households has a marginally larger impact on increasing aggregate demand. Vice versa in a boom, namely dampening demand when income support is withdrawn. In more technical terms: the multiplier of a given amount of government expenditure is increased if spending is routed through the EITC because the recipient households have a lower than average propensity to save (or rather capability, given preferences).

Seen as an effective stabilizer, it made good macroeconomic sense that the EITC was vigorously expanded in the recession of the early 1990s. Interestingly, Eissa/Liebman (1995, p.25) note that for the first time in this recession the maximum EITC moved in the same direction as the unemployment rate. Since this was a discretionary measure, however, it was not *automatic* stabilization that was at work but a deliberate demand side policy in disguise.

(e) The EITC is the only cash assistance program that is completely financed by the national government. Given that there is a positive correlation between a low level of state income and a high share of low-wage employment eligible for EITC (Bernstein 1999, p.2 and

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<sup>94</sup> This also underlines that a minimum wage is not sufficient to provide an anchor against a downward spiral of wages and prices, it has to be complemented by income support for laid-off workers.

Table 2), the residents of poorer states get proportionally more refunds. The EITC is thus a federal program that is effective not only in interpersonal, but also in **interstate redistribution**.

As already mentioned, some states piggy-back their own State EITCs on the federal program.<sup>95</sup> The reasons for doing so are obviously varied (Johnson/Lazere 1998, pp.9-10). First of all, the EITC is a bipartisan program and, being an in-work benefit, is unlikely to become a suspect of promoting welfare magnetism. Some state administrations have a progressive tradition and want to lift more people out of poverty. Some state governments want to provide relief from state and local taxes for the working poor just as the federal program provides relief from payroll taxes. State EITCs are also a way to correct the regressive direction of tax legislation in the 1990s, which brought higher sales and excise taxes while lowering income tax rates. Such flexibility as regards the goals pursued lends itself to transfer to other political environments.

**Variation in State EITCs** exists but is limited. With two exceptions, credit rates vary between 10 and 25 percent of the federal credit (Johnson/Lazere 1998, pp.12-13).<sup>96</sup> E.g., in the case of one child and full-time minimum wage employment for one parent, this would add another \$568 (25 percent) or \$341 (15 percent) to the federal EITC of \$2,271.<sup>97</sup> As the examples in Table D-3 reveal, even small amounts added by State EITCs, may be sufficient to lift households above the poverty line. That is, the EITC is compatible with some regional diversity so as to be still effective in fulfilling its assigned function, namely to correct the tax system for its poverty-generating effects.

In summing up, I highlight just the more important issues that will prove important for the discussion in the last section. Basically in agreement with Walker/Wiseman (1997), there is reason for a more sober assessment of the EITC.

- In practice, the EITC does not make economic sense as a policy to create labor supply incentives. Even the labor demand incentives are doubtful since the stigma of a means-tested benefit seems not completely absent. I have alluded to what seems to me the economic rationale of the EITC above, namely as regards its qualities in macroeconomic stabilization and its compatibility with regional diversity.
- The EITC, as it stands, cannot act as a nominal anchor for the overall price level because the income thresholds are indexed. This may have been less important for the U.S. economy because of a nominally fixed minimum wage and its key currency position which allowed the U.S. to have a constantly higher inflation rate than its main trading partners without risking a balance-of-payments crisis. But this should be kept in mind in a comparative study.
- Finally, fraud seems to be a problem. This is more serious from a purely economic point of view, if one sees the EITC primarily as a labor market policy. I consider this to be more serious in its effect on sustained political support for redistribution via this

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<sup>95</sup> As of September 1998, refundable State EITCs existed in Kansas, Maryland, Massachusetts, Minnesota, New York, Wisconsin, and Vermont; non-refundable (i.e., just tax-offsetting) credits existed in Iowa, Oregon, and Rhode Island (Johnson/Lazere 1998, p.2).

<sup>96</sup> The two exceptions are the Wisconsin EITC (4 percent of the federal credit for families with one child, 14 percent for two, and 43 percent for three children), and the Minnesota EITC, which is independent of the federal credit, but effectively amounts to 20 to 42 percent of the federal credit (Johnson/Lazere 1998, p.13).

<sup>97</sup> Except for Wisconsin, they do not vary the parameters for larger families. And most State EITCs apply the same percentage of the federal credit for all family sizes so that the family-size differential of the federal credit is preserved. This differential is not enough to compensate fully for the higher poverty line of larger families. Cost considerations do not explain this deficiency because large families are only a modest share of all EITC-eligible families (Johnson/Lazere 1998, p.14).

instrument. For EMU, this would certainly be a non-negligible consideration given the fragile political acceptance of any policy originating at the European level.

#### **IV. The Workfare Rationale of a Minimum Wage**

It is a notable fact that earlier in the year in which the welfare act was passed, the minimum wage was raised in two steps from \$4.25 to \$5.15. Up to 1996, its purchasing power had severely eroded since Congress refused to raise it in the 1980s for nine years. Even with the increases since then, the minimum wage is still 19 percent lower in real terms than in 1979 (Bernstein 1999, p.1).

Finally, it is informative to contrast this more detailed assessment of in-work benefits briefly with the non-welfare alternative of a minimum wage. After all, “ending welfare as we know it” could potentially mean to abolish means-tested benefits for working poor all together and rely exclusively on minimum wages to make “work pay”. This would have the political advantage of coming at no obvious fiscal cost. I will argue, however, that the minimum wage is not a non-welfare substitute for in-work benefits but rather a complement. Which is why it cannot be abolished even though the EITC is in place.

(a) In the case of a minimum wage, there can be no disincentive effects of workfare on **labor supply** because there is no -fare to it. An effective minimum wage means that the majority of those at the lower end of the wage scale get a higher reward for their work than without this stipulation. This is true for every additional hour worked.

(b) There is no **targeting** involved. Whoever gets and accepts a job at the minimum wage, receives the benefit. While a full-time minimum wage job does not lift a person out of poverty (see Table D-3 above), it cannot be excluded either that secondary earners who do not live in a poor household work at the minimum wage rate.

(c) In general, it is the very rationale of minimum wages to enforce an **income floor** for hours worked. In countries, where established institutions for collective wage bargaining are absent, hidden or open underemployment is considerable and/or tax capacity to finance safety nets limited, such legislation is basically the only way government can put some halt on downward pressures on nominal wages. Again, the minimum wage fulfills this role of an anchor for the price level best if there is no indexation. It has to be adjusted not in line with inflation but in line with the secular increase in labor productivity, i.e., the average living standard. This would meet the requirements of lifting working individuals out of poverty according to a relative standard.

(d) A minimum wage, being a non-welfare strategy to make work pay, cannot possibly have a role as a built-in **stabilizer**. Employment at the minimum wage would vary with private (investment and consumer) demand and thus evolve pro-cyclically. There is even reason to believe that workers employed at the minimum wage would on average be more than proportionally affected by rising unemployment, insofar they represent marginal employment (Blank/Blinder 1986).

(e) In principle, it is conceivable that different statutory levels were defined so as to ensure equivalent **living standards in regions** with different consumer price levels. However, that would obviously create incentives for firms to move to these regions. This is likely to incite even more controversy in a federation than the perception of welfare magnetism since it affects a region’s economy, not just its government’s budget. A majority of voters in high-income regions are likely to resent this so that the respective governments may then rather vote for no minimum wage legislation at all. The latter may also be the preferred option of low-wage regions because

this leaves them their absolute advantage of low labor costs.<sup>98</sup> So if a minimum wage legislation becomes effective at all, it is likely to serve a homogenization of the regional wage structure, at least at the lower end. The limits are circumscribed by analogous condition mentioned with respect to wage rate subsidies. The common minimum wage must not be higher than low wages in low-income regions, nor must low wages in high-income regions be significantly above that statutory level. Minimum wage legislation is then able to contain diversity so as not to encourage competition for capital investment.

In sum, a statutory minimum wage has obvious drawbacks compared to all three types of in-work-benefits. Apart from being no instrument of providing welfare, it is also unfit to act as an automatic stabilizer. Its obvious strength is that of a nominal anchor although preferably for a currency area with little diversity in regional incomes.

One may then ask whether a statutory minimum wage has any role to play in workfare. How does it interact with in-work benefits such as the EITC? As mentioned in the beginning, in-work benefits make low-wage employment bearable. But this also means, they do not encourage or they even discourage a rise in low wages. Employees have less reason to push hard for marginal wage increases while it is in the employer's self-interest to keep costs low. Over time, given that average nominal wages have a tendency to rise along with productivity gains, this implies that an ever larger share of low-wage payments has to be borne by government or taxpayers, respectively. Government can correct this process of financing an increasing share of low-wage employment by rising the minimum wage level roughly in line with the general rise in living standards. From a fiscal point of view, the reliance on in-work benefits and the stipulation of a minimum wage are thus strictly complementary.

Thus, a minimum wage legislation is not redundant, given the emphasis on in-work benefits in the workfare model of social assistance. On the contrary, it seems to be a necessary complement for the long-term fiscal viability of workfare and for a more equitable distribution of the secular rise in general living standards.

## **E. LESSONS FOR THE EUROPEAN MONETARY UNION**

The point of departure for this study is that there is no such thing as a social charter for the EMU specifically. This is unfortunate because EMU seems to create a new pattern of income risks that are insurable only at the EMU level, as was pointed out in the first section. That being the case, I will now look at specific lessons from the U.S. welfare overhaul, first as regards the element of the New Federalism in this reform and, second, as regards the workfare component. All these conclusions are tentative meant to guide further research.

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<sup>98</sup> Levin-Waldman (1998, esp. pp.12-13) provides some U.S. evidence for this. States as represented in Congress voted overwhelmingly against minimum wage increases if they had a (anti-unionist) "right-to-work" legislation, which corresponded to lower than average wage levels. They voted in favor if they had a high union density that corresponded a positive wage differential to the average. Voting behavior of representatives and senators exhibited a significant impact of state affiliation, which in the case of Democrats even overrode their party affiliation. I.e., Democrats from the Sunbelt states largely opposed minimum wage increases despite their party's tendency to support them. See also Bernstein (1999) for a more recent discussion.

## I. Mixed Lessons of the New Federalism

This preliminary assessment of the lessons from the New Federalism relates links between monetary union and social policy outlined in the first section to the manifestations of the New Federalism described in Section C. The resulting policy conclusions are the following.

**Block grants** seem to be problematic because they foster pro-cyclical expenditure on welfare. I suppose that this is not so much the case because of their marginal effects on welfare spending and saving. While the theoretical literature leads one to put this at center stage, the historical evidence is mixed and more recent empirical trends do not point in this direction (see Section C.III). What seems to be of more relevance is that this new fiscal federalism based on block grants is combined with existing stipulations in a large number of state constitutions that require state budgets to be strictly balanced. These stipulations put pressure on governments to spend surpluses in good times and cut rigorously back in bad times.

In EMU, analogous provisions have been implemented with the Maastricht fiscal criteria and the Stability Pact. The resulting pro-cyclical effect on welfare spending would be felt even more in EMU countries because social transfers have a much larger share in GDP.<sup>99</sup> So if there will ever be a flow of welfare funds from an EMU-budget to member states, it should be based on matching grants. They may be capped to put a break on the cost dynamic and have some trigger mechanism for fiscal support to it in case a member state fares exceptionally bad.

**Hard time** limits create deflationary pressures because they force those whose time limit has expired to accept a job at any rate. And they cut off transfers to the states just when they are most likely to need it. This is bad macroeconomics. That harsh statement seems to me in order despite the fact that there is no problem of long-term unemployment in the U.S. The contingency fund is endowed with too little means to be an inappropriate instrument for short- to medium-term stabilization.

This is important to note since the present EU approach is to create a new fund subject to national parliamentary approval whenever a new issue arises. In principle, such funds are fiscally appropriate to tackle structural policy issues. But with respect to stabilizing the emerging income risks in a monetary union, such funds are too inflexible. Thus, one has to think about alternatives for a social federation of EMU.

**Relative measures of MOE**, such as the 75 or 80 percent stipulation of the U.S. welfare law, do make sense. They make sense because they respect the historical spending levels of high-insurance and low-insurance regions. So each is asked to keep that level of social insurance that has been politically legitimized and therefore may reflect the risk preferences of the median voter in a particular state. Thus, there is an *a priori* that the historic state spending on social policy is also the best proxy one can get for the risk-efficient level of social insurance.<sup>100</sup> This is particularly important for states with more fully developed systems. A relative MOE makes governments feel the full impact of welfare retrenchment but does not hinder reforms to make the welfare system work better.

But it is by no means just a technical problem to assess the fulfillment of this requirement. This holds in the U.S. as anecdotal evidence suggests, yet would be even more relevant for EMU. Most EMU governments want to engage in major reforms of their welfare systems. If they succeed in their reform efforts, it would be hard to decide which of the

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<sup>99</sup> Cf. the last two rows in table A-4.

<sup>100</sup> Just to remind the non-economic reader of what (maximum) economic efficiency means: It describes the satisfaction one can possibly get from applying limited means (“resources”) to competing ends, given preferences as regards the ends and their feasible combinations.

reductions in spending levels are due to efficiency gains (ideally providing the same amount of insurance with less means or even more insurance with existing means) and which are due to retrenchment (i.e., free riding in the union of member states).<sup>101</sup>

It seems to me imperative to maintain more or less the given levels of social insurance in EMU for the time being. This is not only because the revealed preferences of a majority of voters point to this and because there are sound macroeconomic reasons for it, given that new income risks arise with the advent of EMU. There is also a case political economy in favor of maintenance. Major structural changes are still in the making, e.g., as regards wage bargaining institutions, the orientation of monetary policy, or regional employment dynamics. In such a state of flux, voters' capacity for change may be easily overstretched if the security that social welfare and insurance provides would be jeopardized at the same time.

The home state or—in the case of EMU—the **nationality principle** to determine benefit levels creates an effective barrier for a downward convergence of welfare provision. This is not so much because there is overwhelming evidence that “welfare tourism” abounds but because it prevents public and publicized opinion to become inimical to a federation that allows for freedom of movement. While the reasoning of the Supreme Court decision makes a lot of sense for the U.S., it is equally sensible to draw an opposite conclusion. In order to preserve the federation in the long term, it might be necessary to *temporarily* restrict its full operation for the individual belonging to that federation. Such an opposite conclusion seems to me all the more pertinent for the case of EMU, as yet a fragile political community. But the home state principle should be generalized so that workers who migrate within EMU not only receive the benefits they would get in their home country. They should then also pay just those contributions they would have to pay back there. This would imply, for instance, that a Spanish worker in Germany had a higher disposable real income than his or her German colleague since the German pays more for social insurance.<sup>102</sup> But it seems to be a matter of fairness that migrants who receive the lower benefits of their home countries also have to contribute less so that they can buy additional insurance in private markets if they so wish. This would help to mitigate the admittedly problematic issue of a citizen's right to move freely.

The present EU approach favors the residency principle. This makes sense if the overriding goal is to preserve the internal market in a formal sense, namely of granting the four freedoms (i.e., the freedom of trade in goods and services, of capital movements, and of migration). But, as said in the beginning, the home state principle may help to further the goal of an ever-closer political union if (and only if) it helps to reconcile a potentially divisive issue. Whether this is the case is—as far as one can tell from case studies of the U.S.—above all a question of perceived welfare magnetism. The generalization of this principle to the revenue side, however, would break new ground and it is difficult to say how controversial this would prove to be.

Thus, the lessons of the New Federalism as originally envisaged in the U.S. are mixed if one contemplates their transfer to a social federation in Europe. But it is an important lesson

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<sup>101</sup> Cf. Atkinson (1999) for an excellent discussion of the sometimes perverse economic consequences of retrenchment.

<sup>102</sup> How, in the present example, German voters would react to such a provision is an indicator of the perceived need for reform. If the German social insurance system is reasonably efficient, the (positive) wage differential of the Spanish worker would not be able to buy as much insurance in private markets as the German worker's differential contribution.-- See Sinn (1998) for a discussion of a generalized home state principle.

nevertheless to infer that, for instance, block grants are not such a good idea as a basis for a fiscal federation in social policy matters.

## II. A Different Role for In-Work Benefits

I would like to stress from the outset that the following discussion about the role of in-work benefits in U.S. workfare as compared to their virtual role in an EMU-setting is not about making the latter as market-oriented as the former. This would misrepresent what workfare is all about: namely an activating government policy that tightly links social policy and labor market policy. In-work benefits make low-wage employment bearable and sustainable. They subsidize labor inputs to produce goods for which there is too little willingness to pay in order to justify higher wages. In this sense, the workfare model is certainly not a free market alternative to welfare as we know it. Introducing workfare elements into the social welfare systems in Europe is thus about partly substituting for one government involvement by another. The question then is what is the rationale for doing so if systems and their resulting problems differ.

It has been pointed out in the first section that there is plenty of reason to be cautious as regards lessons in the case of workfare. This model of social assistance is intrinsically linked to specific views about the legitimate role of government, to shared notions of what constitutes need and how extensive there is an individual entitlement to public assistance. And even from a purely economic point of view, one has to take the institutional embeddedness of workfare into account, namely corresponding to labor market institutions that provide virtually no barrier to wage differentiation and labor turnover.

With these warnings in mind, one can nevertheless try to assess what a transfer of U.S. workfare elements would mean in continental Europe. Two obvious, if complex questions come to mind:

- a) What are the problems to which workfare is supposed to be a solution in the U.S. and in the EMU, respectively?
- b) What solutions can workfare provide?

To start with the first question: Table A-4 contained in a nutshell the different set of problems relevant for either of the two currency areas and their respective social policy regimes. The comparative data largely confirm the stereotypes of public debates. The U.S. has an economy with a high incidence of pre- and post-interventionist poverty, even among those who work, but with low unemployment. The EU, in contrast, is characterized by a welfare system that is highly effective in combating poverty but suffers from high unemployment, especially long-term. Closely related to this is that personal income inequality is considerably higher in the U.S. than on average in the EU.<sup>103</sup>

What is less well known is the fact that there is little difference in **regional income inequality** (Table E-1). The U.S. exhibits a larger degree of positive deviation from the average while the EU (or EMU, for that matter) exhibits more negative deviation due to distinctly lower income levels in the Southern enlargement countries. But contrary to the U.S., the EU so far has no effective institutions of fiscal federalism, namely revenue-sharing and budgetary transfers,

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<sup>103</sup> This may change, however. Income inequality is rising in the EU due to persistently high unemployment and a cutback in benefit levels, while the increase in income inequality seems to have reached a plateau due to high employment in the U.S. (Smeeding/Gottschalk 1998, p.18). – Cantillon (1997) provides a comparative discussion of policies to alleviate poverty and exclusion respectively.

with an explicit redistributive mandate to narrow gaps between state incomes. The various structural funds are capped at too modest a level for having much of an impact.

Tables A-4 and E-1 allude to the fact that there are different emphases in political debates about welfare. In the U.S., the majority of voters and opinion leaders got politically ready for workfare because there was mounting frustration with “welfare as we know it”. Measurable increases in welfare provision coincided with worsening welfare indicators such as the rate and persistence of poverty. In contrast, voters in Europe have recently brought parties into power that traditionally stand for policies to maintain a high level of social protection. At least for now, the majority of voters is thus not in favor of radical change but supports mending what is widely held to be a regrettable symptom of strong safety nets, namely complex social exclusion that comes with long-term unemployment.<sup>104</sup>

This outline of problems leads to the second question: Is workfare a solution to both sets of problems that overlap only in that both are characterized by a fair amount of regional income inequality? In order to emphasize the different functions that workfare has or would have to fulfill in the two worlds of welfare capitalism, I take three pairs of problems at a time and discuss the solutions workfare can provide: poverty versus (long-term) unemployment, personal income inequality versus regional income inequality without fiscal federalism, mounting frustration ready for radical change versus discontent with certain symptoms such as social exclusion.

**Table E-1: Regional Inequality**

<b>Regional income inequality<sup>a</sup></b>		
the five poorest states	Mississippi 72	Greece 66
	West Virginia 75	Portugal 68
	New Mexico 77	Spain 76
	Arkansas 78	UK 97
	Montana 79	Finland 98
the five richest states	Delaware 114	Netherlands 108
	New York 120	Germany 110
	Massachusetts 122	Austria 111
	New Jersey 128	Belgium 112
	Connecticut 140	Denmark 116

<sup>a</sup> Index is 100 for the U.S. and the EU-15 in 1996, respectively. Real personal income per capita in case of the U.S., GDP per capita in purchasing power standards in case of the EU. Luxembourg with the highest index of 169 was left out since it is a rather small city-state.

Sources: Eurostat (1998), Bureau of the Census (1998), and own calculations.

*How is workfare supposed to alleviate poverty in the U.S. and persistent unemployment in the EU?* In the U.S, workfare is meant to deal with both syndromes of poverty, namely the existence of an underclass and the persistence of the working poor. The “underclass”, i.e., long-term recipients of welfare, who become more and more detached from mainstream norms concerning work and self-support are contrived to join the mainstream by a work obligation and

<sup>104</sup> Social exclusion relates to the many facets of what has classically been called poverty, but is not necessarily a lack of money income given strong safety nets. Besides material want, it comprises the loss of (self-)respect, social disengagement and lack of political participation which characterizes the state of the long-term unemployed in rich welfare states (Silver 1998).

the lifetime limit for TANF.<sup>105</sup> Moreover, workfare “makes work pay” by subsidizing earnings of the working poor or, seen from the employers’ perspective, by subsidizing specific, namely largely unskilled labor inputs.

In Europe, one rationale for earnings subsidies is to lower fixed employment costs that are due to high income taxes and social insurance contributions. Moreover, it is hoped that workfare allows for more pre-tax wage differentiation because work requirements and earnings subsidies are supposed to make those on welfare or unemployment insurance to accept lower wages paid by employers. That is, it leaves the reservation wage of households intact while it provides sanctions and incentives to accept jobs at wages below that reservation wage. That could make certain services relatively cheaper and thus enlarge markets for them, therefore create jobs.

However, I have pointed out in the last section that there is a **workfare paradox**. Its *inherent* reliance on means-tested benefits creates disincentives for labor supply, or more precisely: “[...] the enhanced incentive to start work is offset by aspects that may discourage workers from increasing earnings through job progression and increasing hours.” (Walker/Wiseman 1997, p.408) And even if these were negligible, there is still the macroeconomic drawback of in-work benefits, namely that they are prone to add to deflationary pressures if there is a rise in unemployment due to less labor demand. In the U.S., this is likely to be taken up by creating community jobs, i.e., state and local governments acting as employers of last resort.<sup>106</sup> In Europe, this tendency for deflationary pressures could also be mitigated by nation-wide systems of unemployment insurance. In contrast, only one-third of all unemployed in the U.S. actually receives benefits because state administrations are rather restrictive in handing them out.<sup>107</sup> However, these unemployment insurances in place beg the question of compatibility with workfare. While this is not a question of principle, it may require some national systems to become more active in assisting unemployed job-seekers to find work. This could be a welcome pressure on administrations to become more result-oriented.

*How is workfare supposed to lower personal and regional income inequality in the U.S. and regional income inequality in the absence of effective other means of fiscal federalism in the EMU?* In the U.S., it is first and foremost the poverty relief component of workfare, namely the EITC, that has a bearing on the inequality of personal income. The EITC is a means to make the tax system more progressive, not by changing the whole tax structure but by changing selectively the effective tax rates that low-income households face.

The EITC also deals with regional income inequality although this has, to my knowledge, not been its purpose. As a national program, it effectively redistributes income from high-income regions to low-income regions. This is because a higher share of households will receive an earnings subsidy in these low-income areas in which it is also more likely that labor-intensive industries will be concentrated. Moreover, there is a federal minimum wage in the U.S. of \$5.15

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<sup>105</sup> See Symposium (1999) for a more recent discussion whether the welfare overhaul has been a success story in this respect, namely to reintegrate those supposed to make up the underclass.

<sup>106</sup> PRWORA allows states to subsidize private sector and/or public sector employment for recipients to comply with participation requirements. 37 state governments have opted to provide for some form of subsidized employment in their state TANF plans, 17 governments did not (National Governors’ Association 1998). There is already evidence of public employment being essential for state administrations to fulfill participation requirements of their clients under PRWORA (Wiseman 1999, Conclusions).

<sup>107</sup> Between 1990 and 1996, the recipient rate averaged 34 percent of all unemployed individuals in the U.S. In the southern and Rocky Mountain states, the ratio of active claimants for unemployment insurance to total unemployment is as low as 20 percent (Vroman 1998, p.2 and table 1).

since October 1997, which homogenizes the regional wage structure at the lower end. Therefore, regions diverge in the share of workers that are employed at the minimum wage but they do not diverge with respect to the wage floor (Table E-2).

In the EMU, regional income inequality is of particular relevance because of the price and wage dynamics it may create in a common currency area. Workfare could potentially help to reduce after-tax inequality. Since there is a phase-in range of earnings that is subsidized, the first Euro of earnings would be subsidized but there is no guaranteed subsidy independent of employment status. So, a large amount of diversity of labor costs would be allowed, with more subsidies flowing to low-income regions. A limit to an EITC being viable is marked by the condition that low wages in high-income regions must be lower than the phase-out ending income. Moreover, regional diversity in the sense of huge differences in regional unemployment rates and low mobility would also be problematic because an EITC then provides for vastly different levels of welfare, not covering the worst-off regions where unemployment is high and mobility low.

**Table E-2: Share of Minimum Wage Employment in U.S. Regions and States<sup>a</sup> (those with highest and lowest share of region), 1998**

<i>Region</i>	<i>Share (%)</i>	<i>Number</i>
Northeast	8.4	1,859,298
Maine	10.9	56,908
Connecticut	5.9	88,802
Midwest	9.7	2,741,742
North Dakota	15.1	42,307
Minnesota	7.6	170,040
South <sup>b</sup>	12.0	4,868,723
West Virginia	17.5	115,517
Maryland	6.6	155,043
West	9.2	2,307,006
Montana	16.5	57,310
Alaska	2.9	7,219
U.S.	10.1	11,776,770

<sup>a</sup> Some states have minimum wage levels above the federal level so that figures show share of employment at wages in the range from \$5.15-\$6.15.

<sup>b</sup> The District of Columbia has the lowest share (5.7 percent), but has been excluded because it is basically a city.

Source: Bernstein (1999) based on Current Population Survey data.

However, the wage differentials in EMU member countries are at present too large to allow for such a common floor (see Table E-3): The level of non-work social assistance deemed necessary for poverty relief in Germany is considerably higher than low wages in some other member countries. Moreover, the absence of an infrastructure of fiscal federalism would mean that it would have to be implemented at the national level. In striking contrast to the U.S., this would impoverish low-income regions because their governments would have to pay proportionally more earnings subsidies. Equally counterproductive as regards convergence of regional incomes are in-work benefits if there is considerable regional diversity in unemployment rates as is the case in both the EU and the EMU. Those regions with high

unemployment rates and thus with the greatest need would receive very little stabilizing transfers if benefits are basically conditioned on having a job.<sup>108</sup> Thus, workfare as a means to deal with regional income inequality requires a certain amount of wage convergence and a central budget that has effectively the means for federal redistribution.

**Table E-3: Minimum and Average Wages in Select EU Countries (DM)**

	Monthly minimum wage <sup>a</sup>	Average gross wage in manufacturing (DM)
Germany <sup>b</sup>		4,343 <sup>c</sup>
Single, no children	2,436 / 1,154	
Married, two children	3,507 / 2,872	
Belgium	2,100	3,506
France	2,040	2,970
United Kingdom	1,825	./.
Greece	792	1,541
Spain	785	1,934
Portugal	553	862

<sup>a</sup> All mandatory except for Germany, own calculations of monthly wages given the mandatory hourly wage rates, assuming 173.3 working hours per month.

<sup>b</sup> Disposable household income of an unskilled worker in manufacturing, West Germany, as of January 1, 1998, and social assistance (*Hilfe zum Lebensunterhalt*) respectively.

<sup>c</sup> Gross average wage in manufacturing per month, own calculation as 4.3 times the gross wage per week.

Sources: OECD 1998b, Pohl 1998, *Statistisches Bundesamt* (Web site)

*How is workfare supposed to deal with quite different political attitudes toward welfare reform in the U.S and in the EU?* The U.S. welfare overhaul and the subsequent switch to a workfare model of social assistance has been popular. Again, extraordinary income and employment growth may have helped to make the majority of voters more supportive for social assistance to the poor, despite the fact that expenditure per beneficiary has risen.<sup>109</sup> But apart from the macroeconomic situation, workfare is likely to be popular in a country where it is common to distinguish between the deserving and the undeserving poor. And deserving is largely synonymous to “working” if somebody is non-elderly and non-disabled. In other words, workfare targets those who are considered to be deserving in that it stipulates labor force participation and gives cash assistance only to those with a job.<sup>110</sup> And it is supposed to deter behavior such as out-of-wedlock births that makes long-term dependence on non-work assistance likelier. Finally, a minimum wage that is increased with the general rise in living standards allows to adjust the cost of earnings subsidization.

<sup>108</sup> However, proponents of workfare could argue that such a system of public assistance may increase much-needed labor mobility in Europe. The issue here is the well-known debate whether it is the availability of jobs that is the root of the unemployment and low mobility problem or whether it is high reservation wages on the part of the workforce, supported by generous non-work benefit levels.

<sup>109</sup> Economists describe this behavior as one of decreasing marginal utility of income and assume that this is typically the case. Households characterized by such preferences wouldn't mind to give away relatively more of their income for purposes such as social assistance as they become richer because additional income conveys less and less additional utility (although it continues to convey some positive utility).

<sup>110</sup> See the seminal article by Moffitt (1983) on welfare stigma and, more recently, the model by Besley/Coate (1992b) on how workfare may or may not reduce the stigma of aid.

In the EU, the political attractions of workfare seems to apply as well, namely to rely on a uniform and widely accepted eligibility criterion for transfers. It requires a minimum of taxpayers' solidarity. The political legitimacy of central redistributive activities may thus be enhanced if they are based on workfare. The legitimacy (and the capacity) for redistribution at the EU level is low at present, to put it mildly. Yet, this has been the case for the national government in the U.S. ever since there was a nation-state. So it seems to me that a transition to a social federation of EMU could proceed on the basis that the administration in Brussels embarks on workfare programs only while the national systems of the member states continue to provide the bulk of social insurance.<sup>111</sup> An immediate candidate for such a program would be a common framework for an earnings subsidy for the long-term unemployed. The long-term unemployment problem in the EU is so manifest and depressing that controlled experiments with new approaches seem more than justified. However, for the time being the national systems will have to bear the bulk of social insurance. In contrast to the U.S., it is neither likely nor warranted to go "from welfare to workfare". In a social federation of EMU member countries, it seems rather likely that we go back and forth "between (national) welfare and (European) workfare."

### III. Final Remarks

To underline the general thrust of these conclusions: In debates on European social policy it is often said that there is a trade-off between economic efficiency and social cohesion. I have argued that such a trade-off does not exist in principle. A social federation may enhance both economic efficiency and social cohesion of EMU—if appropriately designed. It is thus high time to engage in a discussion of that design. The New Federalism is a starting point for that discussion but there are elements in it that seem to be economically dysfunctional if politically rational.<sup>112</sup>

Workfare is not the end of traditional welfare as some proponents suggested. Non-work benefits or categorical welfare programs, such as Medicaid and Food Stamps, continue to play an important role (Wiseman 1999). Its effectiveness as a poverty relief for working families relies on continuing support via earnings subsidies and on a variety of categorical assistance programs. This seems to me inevitable. The functioning of the model, namely establishing eligibility for transfers via labor force participation, requires so much downward wage differentiation that the resulting wages do not move the representative family out of poverty.

What this also means is that the U.S. social welfare system post-PRWORA has not overcome the notorious dilemma of the welfare state, namely to create poverty traps by the very activity of assisting the poor. One may also express this as the workfare paradox: If, as the adherents of this model claim, work incentives and sanctions are necessary to get beneficiaries and state administrations going, then workfare is self-defeating because it inherently relies on means-testing. If, in contrast, one considers the discouraging effects on labor supply to be rather negligible, the supply side rationale for workfare breaks down. The majority of beneficiaries then does not need incentives but adequate jobs to get them off the welfare rolls. In view of the theoretical as well as the empirical evidence, the latter position makes more sense to me. That is why I think workfare has to be seen as a genuine social policy the most important criterion for

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<sup>111</sup> This is also required for reasons of macroeconomic stability since in-work benefits are by definition unable to stabilize when recessions produce a sizable increase in unemployment.

<sup>112</sup> The time limit is such a case which gives the national government some leverage over state administrations after devolution has eroded that leverage to a large extent. But if time limits become effective, they have very problematic macroeconomic and social policy effects.

which is its effectiveness in combating poverty. On this account, the result is mixed. Benefit levels are arguably too low. Yet this is a matter of more generous endowment, not one of principle.

This leads to a last and perhaps the surprising finding of this study. It seems to me, that the U.S. workfare model of public assistance implies a convergence towards universalism in social insurance like there is in continental Europe. Post-reform social assistance replaced a *de iure* entitlement to welfare by a *de facto* entitlement to earnings subsidies. This universalistic touch depends heavily on the existence of Anglo-Saxon labor markets, however, which are highly—I suppose even to an inefficient degree—absorptive as regards low-wage labor. The paradigm for this universalism of sorts is the EITC: it is a means-tested benefit, yet treats every beneficiary as a virtual taxpayer or contributor to the system. Therefore, it straddles the gap or dichotomy between welfare and social insurance in the U.S.

In this sense, I do think that welfare reform of 1996 deserves its name, namely it has been a systemic *reform* of the American social welfare state. However, whether this is a more effective and not just a less stigmatizing way of providing poverty relief remains yet to be seen. The outcome will depend largely on how generous or stingy state welfare spending will be in the future. Some of the incentives built into the New Federalism give reason for skepticism in this regard, that is, a downward bias is likely to prevail in the long term. There may be more appropriate means to control the cost dynamic of welfare spending than block grants and time limits for living on public assistance. This has to be carefully watched by European observers.

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