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THE REAGAN ECONOMIC PROGRAM: // SELECTED BUDGET CUTS //

INTRODUCTION

Many of today's income security programs that provide financial assistance to groups such as the poor and elderly are being confronted with increasingly greater demands for their services and costs exceeding earlier expectations. These difficulties stem primarily from the programs' rapid growth, largely a result of increased coverage and liberalized benefit payments. Unfortunately, this expansion has often created excessive and unintended benefits. The proportion of the federal budget going to entitlement and income security payments has grown from 26 percent in 1960 to 50.3 percent in 1981.¹ The Reagan Administration has proposed reforms that would enhance the long-run stability of these programs by eliminating many of the misdirected benefits that have emerged during this period. The proposals are aimed at restoring these programs to their intended purpose of providing a "social safety net."

The proposed budget cuts to be discussed in this paper include many of the income security programs such as social security, unemployment compensation, and welfare as well as public service employment. The public jobs program is included because it offers benefits to workers who might otherwise be unemployed and may be thought of as a form of unemployment compensation.

¹ All numerical data, unless otherwise noted, are from one of two Administration reports: America's New Beginning: A Program for Economic Recovery (February 18, 1981) or Fiscal Year 1982 Budget Revisions (March 10, 1981). In addition, the years cited from these reports are fiscal years.

SOCIAL SECURITY

The original purpose of Social Security was to replace part of the earnings lost as a result of a worker's retirement. It was never intended to be the sole means of support for the elderly. Over the years, however, this objective has been expanded by the addition of programs paying large unearned benefits for purposes other than the provision of partial retirement income.² Many of these benefits are completely unrelated to a worker's contributions and are largely responsible for the emasculated condition of the Social Security trust fund. The Social Security system, however, is inappropriate for achieving these putative welfare objectives because it is financed by a regressive payroll tax. Such a tax may be suitable for the insurance goal of Social Security, but it is not justifiable to provide welfare benefits by a tax that places its heaviest burden on the very group it is designed to help. Thus, the increasing instability of the Social Security system can be attributed to two conflicting goals: "individual equity" and "social adequacy." The Administration's proposed changes are a move towards restoring the Social Security program to its original purpose of being a basic old-age and survivors insurance program. This would be accomplished by eliminating or modifying several of the current unearned and non-basic benefits.

Minimum Benefit

The minimum benefit, established by Congress in 1939 at \$10 a month has grown more rapidly than any of the other Social Security benefits and currently is \$122 a month. The minimum benefit is commonly regarded as a welfare component of the Social Security system because it is paid regardless of the beneficiary's past earnings history. The original purpose of the minimum benefit was to increase the income of those retirees with low earnings histories and to assist those who had worked in covered employment for only a short period of time as a result of incomplete coverage in the early years of the program. The amount of \$10 was decided upon both for administrative purposes and to avoid paying benefits of minimal value. Several changes over the years no longer justify such welfare payments, e.g., a larger number of income security programs are available for the poor and elderly and expanded coverage under Social Security. The Administration's proposal to eliminate the minimum benefit would result in an estimated savings of \$1.3 billion in 1982.

Today, the Supplemental Security Income (SSI) program provides a guaranteed level of income for the aged, blind and disabled that exceeds the minimum benefit provided under Social Security. In fact, the minimum benefit offsets SSI payments on a dollar for

² An unearned benefit here is defined as a benefit that is not directly related to and exceeds the tax contributions of its recipients.

dollar basis; therefore, these recipients would experience no reductions in their incomes. In addition, these people are also eligible to receive benefits such as food stamps, Medicaid, and housing subsidies.

Coverage under the Social Security system has grown from 58 percent of all workers in paid employment in 1940 to more than 89 percent in 1977. Moreover, the percentage of workers covered has been greater than 89 percent since 1965, and greater than 85 percent since 1955.³ The only major group not covered by Social Security are federal government employees, who are covered by their own retirement systems. Therefore, arguments favoring minimum benefit payments as a result of the incomplete coverage of the Social Security system are no longer valid.

Furthermore, as a welfare component of Social Security, the minimum benefit has been a very inefficient way of redistributing income, often paying the non-poor benefits that were designed for the needy. Many minimum benefit recipients have had short work periods in covered employment or low earnings histories because they spent much of their time employed in the federal government, where they have also qualified for generous civil service pensions. These workers, often referred to as double dippers, can beat the system in several ways. They may work in secondary part-time jobs for the minimum number of years necessary to become eligible for Social Security benefits, while being primarily employed in the federal government. Or, they may become eligible by working in the private sector before or after working for the federal government just long enough to receive a civil service pension. This type of abuse of the Social Security system does not appear to be uncommon: as many as 40 percent of those receiving a civil service pension may also be getting benefits under Social Security.⁴ In addition, a GAO study estimated that at least 12 percent of the minimum benefit recipients were homemakers with sporadic employment patterns.⁵ Despite the fact that they depended primarily on their spouse for support, they received substantial unearned benefits. Still others taking advantage of these welfare provisions include individuals with large savings or retirement incomes, but relatively low earnings histories. These people, despite being relatively well-off, receive benefits far in excess of their contributions.

Because of the myriad of income security programs available to the elderly and the poor, elimination of the minimum monthly

³ Peter J. Ferrara, Social Security: The Inherent Contradiction (San Francisco, California: Cato Institute, 1980), p. 421.

⁴ Alicia H. Munnell, The Future of Social Security (Washington, D.C.: Brookings Institution, 1977), p. 15.

⁵ U.S. General Accounting Office Report, "Minimum Social Security Benefit: A Windfall That Should Be Eliminated" (HRD-80-29, December 10, 1979), p. 17.

benefit will not hurt the needy. Rather, it will reduce unearned payments to those who cannot demonstrate a need for them.

Student Benefits

As of 1965, Social Security benefits have been payable to unmarried students between the ages of 18 and 21 (in 1972 the upper limit was extended to 22) whose parents are Social Security recipients. The benefits were designed to assist students in finishing high school and/or obtaining postsecondary education. These benefits were added at a time when the Social Security trust fund had adequate reserves. Student benefits have increased rapidly since the inception of the program: from \$165 million in 1965 to over \$2 billion in 1980. The Administration proposes to eliminate the student benefit by refusing any new participants and by reducing current student payments by 25 percent a year. Savings of \$1 billion could be realized by 1982 and as much as \$7 billion by 1986.

Social Security payments to adult students are neither fair nor necessary. Benefits from this program are not based on a student's ability to pay his educational costs, but on the earnings histories of his parents. The higher their past earnings, the greater the benefit he is entitled to. This perversion of the system results in inversely relating benefits to need. Moreover, benefits from this program may have the adverse effect of inducing a number of older workers to retire earlier, allowing their children to become eligible for these benefits.

In addition, when the program was first introduced in 1965, federal assistance to students was negligible. This is no longer the case today. There are currently several federal programs that provide assistance for students. In particular, the Basic Educational Opportunity (Pell) Grant is designed to target benefits based on educational costs and need, while the Guaranteed Student Loan program provides aid to all students, regardless of their financial status.⁶ Elimination of the student benefit would reduce some of the problems associated with benefit overpayment that results from ignoring educational cost and duplicating payments from other federal programs.

Lump Sum Death Benefit

The lump sum death benefit provides a payment of \$255 to the deceased's survivors upon the death of an insured worker. Originally, there was no provision in Social Security for survivors' benefits, and the lump sum death benefit was designed to provide a return on the worker's investment in Social Security. In 1939,

⁶ The Administration is proposing changes in both these programs. These reforms, however, would be geared primarily toward higher income groups that cannot demonstrate a need for student assistance.

Social Security was expanded to include benefits for the survivors and dependents of deceased wage earners. The lump sum death benefit, however, was payable only if there was no one eligible to receive survivors' benefits. In 1950 Congress decided that the death benefit would be payable regardless of whether or not there was anyone eligible to collect survivors' benefits. The intent of the benefit was changed from providing a return on the wage earner's investment in Social Security to providing assistance in meeting expenses incurred as a result of the worker's final illness or death. About half of the current lump sum death benefit payments are made even when there is no surviving family, with payments often going to funeral home operators. The Administration proposes to eliminate this benefit when there are no survivors, which will result in savings of about \$0.2 billion in 1982.

The Administration's proposal is a step in the right direction, but it does not go far enough. The lump sum death benefit should be eliminated entirely. A study by the GAO found that most of the beneficiaries of lump sum death benefits had already received benefits that were much greater than their contributions. The GAO report revealed that in a 1978 sample of lump sum death benefit claimants, 86 percent of the recipients had received average benefits that exceeded average employee contributions, and in over 75 percent of the cases, benefits received were about 15 times greater than contributions.⁷

Furthermore, the purpose of Social Security itself is to provide income for a covered worker and his dependents when his earnings are reduced from retirement, disability, or death. Its objective is not to defray the costs of final illness or burial. Because the death benefit is not means related, it would be more appropriate to set up a provision under the Supplemental Security Income program to provide a death benefit based on need, as was suggested by HHS in 1979.

Disability Insurance

Disability insurance (DI) was added to the Social Security system in 1965. The purpose of DI benefits is to provide an adequate standard of living for disabled workers and their families by replacing part of the earnings lost as a result of a disability. To qualify for benefits, a worker has to prove his inability to engage in gainful employment due to a medically determinable physical or mental impairment that is expected to last for at least 12 continuous months or to result in death. Payments of DI benefits have grown dramatically since 1970, with costs rising by 500 percent and the number of cases by 80 percent.

⁷ U.S. General Accounting Office Report, "The Lump Sum Death Benefit -- Should It Be Changed?" (HRD-80-87, August 8, 1980), p. i.

A major drawback of DI is that it may create work disincentives by replacing a large portion of a disabled worker's prior net earnings. Moreover, indexation adjusts these benefits fully for inflation. The problems associated with overly generous benefits are especially acute among low wage earners because of the redistributive aspect of the benefit formula favoring them. The incentive to return to work may further be reduced when the value of Medicare and benefits from other sources, such as workmen's compensation, are considered. A study by L. Scott Muller reported that in 1972, 44 percent of DI beneficiaries also received benefits from other sources as a result of their disability.⁸ Furthermore, the GAO reports that over 500,000 current beneficiaries may be receiving benefits despite no longer being disabled.

The Administration's proposals are aimed at minimizing these problems and reducing the drain on the DI trust fund by "tightening administration and ending misdirected benefits." Specifically, under the Administration's direction, the Social Security Administration would examine DI beneficiaries more closely to determine whether or not the worker's disability warrants assistance. In addition, eligibility requirements would be strengthened by requiring a claimant to have worked at least six of the last thirteen quarters. Finally, a "megacap" would be created that would limit the sum of benefits from public sources to a level not exceeding the worker's prior after-tax earnings, adjusted for inflation. The reduction in outlays is estimated at \$0.1 billion in 1981 and \$0.4 billion in 1982.

Medical evidence is often insufficient; therefore, the role of consultative examinations should be expanded to ensure the authenticity of disability. According to GAO: "It makes little sense to save \$107 in consultative examination funds if the savings result in incorrectly paying \$29,000 in benefits."⁹ Once such "authenticity" is determined, however, the minimum qualifying period should be waived to allow workers with legitimate disabilities to receive benefits. The thirteen-month restriction should be retained to ensure that only workers with fairly recent work experience receive benefits. This would allow an individual a reasonable period before his insurance "policy" expires.

The disabled worker should not be limited by the amount of benefits he receives from other sources. If a worker is receiving extra benefits, it is presumably because he has given up part of his income in the past to insure himself against possible disability. A "megacap" may be denying the worker benefits rightfully

⁸ L. Scott Muller, "Receipt of Multiple Benefits by Disabled-Worker Beneficiaries," Social Security Bulletin, 43 (November 1980), p. 4.

⁹ U.S. General Accounting Office Report, "Controls Over Medical Examinations Necessary For the Social Security Administration to Better Determine Disability" (HRD-79-119, October 9, 1979), p. 13.

due him. The DI benefit formula, however, does contain a redistributive element, which should be replaced by a proportional benefit structure, thereby ensuring an equitable return on all contributions. If this were applied to all public programs providing compensation for disability, a "megacap" would not be necessary.

Indexing

The Administration should also re-evaluate other policies used in determining Social Security payments. One commonly discussed proposal that would also improve efficiency and equity within the Social Security system is the modification of benefit indexation.

Benefits are currently adjusted for inflation by indexing them to the Consumer Price Index (CPI). Use of the CPI, however, may improperly lead to excessive Social Security benefits because it is commonly regarded by economists to overstate the true rate of inflation. One of the major flaws in the CPI is its treatment of homeownership. The CPI overstates housing costs by ignoring the investment value of the home. Other criticisms of the CPI include outdated buying patterns (determined in 1972-73), failure to account for consumer substitution when faced with higher prices, and limited applicability to certain subgroups, such as the elderly. In this connection, it should be noted that only a very small proportion of the elderly are in the housing market, a category heavily weighted in calculating the CPI. Choosing an index that more accurately reflects the buying patterns of social security recipients could result in sizeable savings.

BLACK LUNG BENEFITS

The black lung disability trust fund (BLDTF) was established April 1, 1978, by the Black Lung Benefits Revenue Act. Coal miners who are disabled from pneumoconiosis, or black lung disease, are eligible to receive benefits from the trust fund for themselves and/or eligible survivors if their disease cannot be linked to a single employer or where the company no longer exists. If an existing company is found liable, then it must pay the benefits directly. The trust fund is financed by a tax on coal production, which is 50 cents per ton for underground coal production and 25 cents per ton for surface-mined coal. The claims against BLDTF, however, have produced a three-year deficit of \$956 million at the end of fiscal year 1980. These claims are currently financed by loans from the Treasury. The Office of Management and Budget estimates that under existing law this deficit could grow to \$9.2 billion by 1995.

The Administration proposes to "restrict benefits to those who are truly medically disabled by black lung and to ensure that the program is financed entirely by a reasonable levy on the coal industry." The ultimate goal is to eliminate claimants with questionable disabilities and to reduce trust fund outlays to a

level that would allow payments to be financed solely by a coal tax. These changes are anticipated to result in savings of nearly \$400 million in 1982.

The trust fund's insolvency is largely due to liberalized eligibility standards that allow coal miners to receive benefits even if X-rays show no signs of black lung disease. A study by GAO reported that in one sample 88 percent of the claimants were either not disabled or could not prove that they had the disease. Equity and efficiency considerations mandate restricting the financing of the trust fund to a tax on coal production to ensure that all taxpayers are not forced to subsidize black lung benefits. Consumers and producers of coal should be forced to internalize the tax in order to ensure that the optimum quantity of coal is produced.

UNEMPLOYMENT COMPENSATION

Unemployment compensation has been designed to replace approximately 50 percent of a worker's former average weekly wage. The Federal-State Extended Unemployment Act of 1970, enacted to give additional assistance to unemployed workers during periods of high state or national unemployment, authorizes the extension of benefits at the regular weekly amount for an additional thirteen weeks whenever the unemployment rate among insured workers (IUR) rises above some state or national "triggering" level. The state trigger takes effect when the state's IUR equals or exceeds, for a thirteen-week period, 120 percent of the average rate for the corresponding period in each of the previous two years and when such a rate is also at least 4 percent. A state also has the option to extend benefits if the state's overall unemployment rate is at least 5 percent for thirteen weeks. When the national IUR reaches 4.5 percent, the national trigger is "on," and all states, even those with relatively low unemployment rates, become eligible for the extended benefits.

Unemployment compensation often has the adverse effect of making layoffs desirable for both employees and employers. Generous benefits and added leisure time often create significant work disincentives. An employer may be induced into laying off more workers during an economic downturn than he otherwise would because the tax used to finance unemployment compensation is not always directly related to the unemployment experience of the firm. The extended benefits program adds to these distortions and generates even greater inefficiency.

The Reagan Administration has proposed restructuring the extended benefits program so that it would provide relief only to those areas plagued by high unemployment. The changes suggested are meant to achieve results analogous to tax cuts -- to restore work incentives by making employment relatively more attractive than unemployment. Specifically, the Administration's proposal would: 1) eliminate the national trigger; 2) change the way the

state triggers are calculated; 3) raise the state trigger level from 4 to 5 percent of the IUR and, at state option, to 6 percent without regard to prior years; 4) require that extended benefits recipients have worked twenty weeks in the one-year base period; and 5) strictly enforce the new rule requiring claimants to accept any reasonable job offer. Employment will be considered acceptable if it pays at least the minimum wage and can replace the individual's current unemployment insurance benefits.¹⁰ The first two changes will become effective July 1, 1981, while the third change would take effect only on October 1, 1982, thereby allowing necessary changes in state law. The 1980 Reconciliation Act already requires that the work test be applied to all extended benefits recipients after April 1, 1981. These modifications would save \$523 million in 1981 and \$1.2 billion in 1982.

Abolishing the national trigger would reduce costly unemployment insurance benefits in states that would otherwise not qualify for extended benefits. In addition, efficiency in the labor market would be enhanced by eliminating one of the sources creating work disincentives. When the national trigger is "on," benefits are extended in all states, even those with relatively low unemployment rates. Despite the considerably better job opportunities in such states, unemployment may rise as a result of increased work disincentives associated with the availability of more benefits.

The proposal would also exclude extended benefits recipients from the calculation of the IUR. The problem with using the IUR as a measure of unemployment for triggering purposes is that it creates an extended benefits program which becomes self-perpetuating. When the trigger is "on," all persons filing claims for benefits are included in the IUR. This results in exhaustees that normally would no longer be considered part of the labor force to be included in the IUR for an additional 13 weeks. On the other hand, when the trigger is "off," those same workers are excluded. Making this fundamental change would save substantial benefit payments in states that have already reached their triggering level. An even better approach, however, would be to use the overall unemployment rate in calculating the trigger because it would more accurately reflect job availability in the economy.

Raising the state trigger level is desirable because it would ensure that only those in genuine need receive assistance. This, in part, is necessary to compensate for the changing composition of the labor force, which over the years has raised the natural rate of unemployment. Restricting eligibility to extended

¹⁰ The Administration is also proposing to apply this work test to individuals who have been unemployed for at least three months. The purpose is to hasten worker readjustment to a changing labor market by shifting employment from relatively unstable sectors in the economy. The proposed reform would become effective October 1, 1982.

benefits claimants who have worked at least twenty weeks in the one-year base period would limit participation to workers with a genuine attachment to the labor force. Finally, strengthening the work test can eliminate much of the waste and fraud in the program.

Although the changes proposed are all desirable from an efficiency and equity standpoint, they do not go far enough. The extended benefits program should be eliminated entirely. The original purpose of unemployment compensation was to provide temporary relief. The program is not suited to correct long-term structural problems.

TRADE ADJUSTMENT ASSISTANCE

Trade Adjustment Assistance (TAA) was introduced in 1962 to assist workers suffering from increased imports, which were a direct result of government policies aimed at the liberalization of international trade. Today, however, the Secretary of Labor can declare workers eligible if imports have contributed significantly to unemployment and to a decline in the sales and/or production of the firm(s) in question. In other words, workers no longer have to prove that they are hurt by freer trade or that imports are the major cause of their injury. The primary purpose of the TAA program is to help workers adjust to changed economic conditions by easing the transition period between jobs. Assistance available to workers consists of: 1) trade readjustment allowances; 2) employment services; and/or 3) job search and relocation allowances. TAA benefits supplement unemployment insurance benefits by providing 70 percent of a worker's former average weekly wage, up to a maximum of the national average weekly manufacturing wage. Because unemployment insurance replaces only about 50 percent of gross earnings, TAA can be significant to the unemployed worker. In addition, these benefits are available for up to a year. In 1980, outlays on the program had grown to 1.7 billion dollars, which was more than six times as much as in the preceding year.

The major problem with TAA is that it compounds all the problems associated with unemployment compensation. The more generous benefits and the lengthier entitlement period exacerbate work disincentives. Greater benefits also discourage workers from seeking employment in more stable industries. Since employers pay no supplemental tax for laying off workers who would receive TAA benefits, an employer may find it profitable to lay off workers during a period of slack demand, assuming that relatively generous TAA benefits will induce a worker to wait to be rehired rather than actively search for a new job. Finally, TAA creates inequities by discriminating in favor of a select group of unemployed workers, those affected by imports.

The Administration proposes to extend TAA benefits only to those workers who have exhausted their regular unemployment

compensation and to limit the size of these benefits to levels no higher than those under unemployment insurance. An unemployed worker will be allowed to receive benefits from TAA and unemployment insurance for up to a year. These changes will become effective October 1, 1981, and could reduce spending by \$1.2 billion in 1982 alone.

The limitations proposed on the availability of TAA benefits would improve efficiency within the program markedly. The results of several studies seem to indicate that reducing the availability of benefits would dramatically mitigate pernicious practices of employees and employers alike. One such study found that TAA recipients were much more likely to have experienced temporary unemployment than their counterparts receiving only unemployment insurance. Moreover, they were much less likely to have changed their industry or occupation. It can be said that "one of the surest ways to bring about adjustment is to provide no assistance, and assistance that compensated for every burden would leave no incentive to adjust."¹¹ The generous assistance payments seem to act as a deterrent to workers from seeking employment in new areas, thereby artificially generating too strong an attachment to a vulnerable industry. The proposed changes are needed to restore work incentives and to discourage misuse of the program.

Although the proposed changes in TAA would result in great savings and lead to a more efficient allocation of resources, the program would still have some shortcomings. Even greater savings could be realized if the eligibility requirements were made more stringent by requiring workers not only to show that they were displaced as a direct result of U.S. international trade liberalization but that it had been the single most important cause of their injury. To further this goal, the role of determining eligibility should be returned to the International Trade Commission. The Department of Labor has all too often demonstrated a bias in favor of organized labor, many of whose members are TAA recipients. This is important because there often is only a very tenuous link between layoffs and increased unemployment from imports. Is greater compensation then justifiable for workers who are laid off because their firms failed to modernize or because workers have demanded excessive compensation and, consequently, have effectively priced themselves out of the market? Automobile workers, for example, currently receive a large amount of supplemental benefits despite the ruling by the ITC that imports were not a substantial cause or threat of serious injury to the U.S. auto industry. Instead, the Commission found that the recession, rising costs of credit, high gasoline prices, and the resulting shift in demand for small cars harmed the industry more than imports. Moreover, since workers produce goods and

¹¹ J. D. Richardson, "Trade Adjustment Assistance Under the U.S. Trade Act of 1974: An Analytical Examination and Worker Survey," National Bureau of Economic Research, Working Paper 556, September 1980.

services for local, regional, national, and international markets, and all of these workers may be affected by unfavorable conditions, why should import-affected workers receive preferential treatment solely because they happen to produce for an international market? This would be especially true if increased imports were a result of greater competition rather than trade concessions granted by the government. Import-affected workers, however, are sometimes considered more deserving because their layoff is the result of promoting a socially desirable policy, i.e., one meant to achieve the greater benefits associated with free trade. Although this may be true, workers in other industries often are displaced for equally deserving causes. For example, stricter environmental controls, more stringent safety standards, and deregulation are just a few. Yet workers who become unemployed as a result of these policies receive no supplements beyond unemployment compensation.

Finally, the availability of TAA after 26 weeks of unemployment compensation renders it more like an extended benefits program. These payments should be reduced drastically, while expanding the availability of the adjustment services.

AFDC

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to needy families on behalf of dependent children when one parent is deceased, incapacitated, or -- in some states -- unemployed. The program is financed by federal funds to states on a matching basis depending on the per capita income of the state. The Administration is proposing some basic reforms in the AFDC program that would improve the targeting of welfare benefits, reduce fraud, simplify administration, and lower costs. The proposed changes, some of which are discussed in more detail below, are expected to yield savings of \$0.7 billion in 1982.

The Administration proposes to reform the AFDC program so that it would more accurately reflect a family's financial need by including other sources of income available to the household in determining eligibility and benefit levels. First, eligibility and benefits would be based on actual prior income, rather than the projected future income that states currently are allowed to employ. Prospective budgeting frequently results in considerable overpayments due to the uncertainty involved in estimating future income. Second, the earnings of stepparents and others living in the household with AFDC recipients would be included in determining the need. Third, states would also be allowed to consider food stamp benefits and housing subsidies in the definition of income. These changes would limit benefits to the truly needy.

The Administration also intends to examine the characteristics of AFDC recipients more closely to decide whether or not they belong in the program. Certain classes of participants

would be precluded or restricted from receiving benefits. First, benefits would no longer be paid to strikers. Second, parents attending college would be required to meet all work requirements under the AFDC program. Welfare payments to strikers and students are unwarranted because they subsidize non-work activities of potentially self-supporting individuals. Third, the definition of a dependent child would be amended to deny benefits to children over 18. Currently, a state may choose to pay benefits to students from 18 to 21 years of age. Such assistance is more appropriate under educational programs designed for the needy. Fourth, benefits and eligibility would be limited to unemployed parents of two-parent families in which the principal earner is unemployed. Fifth, states would be required to establish community work experience programs that would require individuals deemed employable to work in exchange for their benefits. Exceptions would be granted to the disabled, persons under 18 or over 65, those working full-time, or mothers with young children. The hours of work would be determined by taking the AFDC benefit and dividing by the minimum wage. These proposals would target AFDC benefits to those most in need.

Several administrative changes would also be made to lower costs or enhance efficiency. These include eliminating benefits of less than \$10 a month and creating a National Recipient Information System that would be used to collect information on individuals receiving assistance.

The most controversial reforms, however, are in the formula used to compute benefits. The earned income tax credit (EITC) provides a low-income parent a 10 percent credit on earnings of up to \$5,000 and is reduced at a rate of 12.5 percent on earnings beyond \$6,000 until it is completely phased out at \$10,000. Workers currently receiving the EITC may get it either as an advance monthly payment or as a lump sum at the end of the year. The AFDC monthly benefit is determined by disregarding a recipient's first \$30 earned in a month plus one-third of his remaining income. In addition, child care and work-related expenses are also deductible. Excessive costs often allow extraordinarily large deductions, permitting families with relatively high earnings to remain on AFDC.

The Administration proposes to count the EITC on a current basis, regardless of whether or not it is received as an advance payment. The objective is to reflect current need and reduce erroneous overpayments from counting them as a lump sum at the end of the year. In addition, the AFDC work expense disregard and the child care disregard would be capped, and the order in which the disregards are deducted from earned income would be changed. More specifically, the disregards from earned income would be applied in the following manner: 1) flat \$30; 2) standard allowance for work expenses would be limited to \$75; 3) \$50 allowance per child for child care expenses; and 4) one-third of the remaining earned income. The \$30 and one-third disregards referred to above would apply only to those workers who begin

work while already receiving AFDC benefits and then only for a four-month period. Finally, a gross income ceiling of 150 percent of the state's standard of need would be established for eligibility in the AFDC program.

These changes would create greater incentives to reduce expenses, improve administration, and reduce fraud and waste. Several studies report, however, that these reforms may substantially reduce the already weak financial incentives to work for AFDC recipients, especially after four months when the \$30 and one-third disregards expire. These studies, however, ignore the fact that those recipients considered employable would often not have a choice. If they could not get work in the private sector, they would have to work for their benefits under the workfare program or lose their eligibility for AFDC. This reform would reduce dependency on welfare, while encouraging attachment to the labor force for these people.

FOOD STAMPS

The food stamp program was originally created to provide for the nutritional needs of America's needy families. Spending on the program has risen sharply from \$34 million in 1965 to nearly \$11 billion in fiscal year 1981. Moreover, the food stamp program has been suffering financial problems which have required Congress to take emergency action for the past several years to provide funds beyond the original appropriation. The Administration has advanced several proposals to reduce payments by tightening eligibility standards so as to focus on the truly needy. The proposed reforms, to be discussed below, are expected to reduce the federal food stamp outlays by \$2.3 billion in 1982.

The Administration's proposals would restrict eligibility to a gross income limit at 130 percent of the poverty level, which is about \$11,000 a year for a family of four. Setting eligibility standards on the basis of gross, rather than net income, would remove families that have earnings well above the poverty level. The earned income deduction of 20 percent would be retained. This enhances work incentives by partially offsetting both increased taxes as well as the higher implicit marginal tax rates imposed by the loss of welfare benefits associated with increased income. The net result may be a reduced dependence on public assistance.

The Administration proposes to eliminate the overlap between the food stamp and free lunch programs. Currently, food stamp allotments are provided to pay for three meals a day. The Congressional Budget Office estimates that about 6.8 million students whose families already receive food stamps on their behalf are also benefitting from free school lunches.¹² As a result, these

¹² See Congressional Record, February 5, 1981, p. E405.

children are being subsidized for four, rather than three, meals each school day. Food stamp allotments would be adjusted for households with students in primary and secondary schools to avoid overcompensation in this manner.

Furthermore, the Administration proposes to determine eligibility by household income in the prior period, rather than leaving states with the option to base eligibility on either the household's anticipated future income or the prior month's income. The proposal would reduce excessive costs resulting from fraud and miscalculations associated with the former choice.

When a recipient is awarded food stamps for the first time, the allotment would also reflect the portion of the month for which assistance is actually needed by pro-rating his benefits rather than providing them for the full month. This would further reduce problems with overcompensation.

The Administration also proposes to repeal provisions that would allow the Secretary of Agriculture to estimate future price changes in calculating food stamp allotments and income deductions. Basing benefit payments on actual costs should be retained because the uncertainty involved in projecting food prices may lead to an overpayment of benefits. Moreover, the time lag is not uncommon in other indexed programs, including those for the poor. In addition, specialized deductions for 1982, added in recent amendments, would be repealed to ease administration and constrain misdirected benefits.

The Administration, however, would continue to exclude the value of in-kind payments from the definition of income. The exemption of such benefits is unnecessary and very costly because it overstates the true financial needs of many households. In effect, it allows more households to become eligible for greater benefits than otherwise necessary.

The Administration's proposals improve the cost-effectiveness of the food stamp program by targeting benefits more carefully. There are, however, still other reforms that could be enacted.

First, the purchase requirement, which was eliminated by Congress in 1977, should be restored. Under the purchase requirement, food stamp recipients would have to contribute some of their own money for food stamps representing a larger value. Currently, the food stamp program has become a generalized income transfer program, which allows recipient households to substitute their limited incomes for other nonfood purchases, some of which may be unnecessary in meeting basic needs. Requiring all but the very poorest food stamp beneficiaries to pay a portion of the costs would instill incentives to allocate their limited funds in a more efficient manner. In short, it would discourage the marginally needy from participating in the program.

Second, stricter eligibility restrictions should be placed on strikers and workers who have voluntarily quit their jobs without good cause. These people should not be subsidized at the expense of the taxpayer because they have voluntarily decided to pursue interests other than work.

Third, able-bodied recipients should be required to work for their benefits. Such a system as "workfare" would also discourage the marginally needy from applying for aid.

MEDICAID

Medicaid is an open-ended entitlement program that was enacted in 1965 under Title XIX of the Social Security Act to provide medical care for the needy. It is financed as a federal-state matching program, with states administering the program subject to federal guidelines. Benefits are available to low-income persons who are aged, blind, and disabled, and members of families with dependent children when one parent is absent, incapacitated, or unemployed, i.e., those eligible for assistance under SSI and AFDC. Some states also extend Medicaid benefits to the "medically indigent." This class includes people who have incomes large enough to cover basic living expenses apart from medical care. The federal government's contribution rate to medical expenses is determined by a formula that is inversely related to the per capita income of a state. Federal contribution rates range from 50 to 78 percent. There is, however, considerable variation among states with respect to eligibility requirements and benefit levels.

Health care costs have risen alarmingly over the past fifteen years, thereby increasing the burden of maintaining programs such as Medicaid, the services of which themselves have been growing at a rate of more than 15 percent annually for the last five years. The cost to taxpayers now averages more than \$1,300 per Medicaid recipient. One of the principal causes of escalating health care costs has been the increasing tendency for third parties to pay medical expenses. Currently, about 90 percent of hospital bills, and 60 percent of medical expenses in general, are paid by someone other than the patient.¹³ Third-party payments artificially inflate the demand for health care because covered patients perceive such services as being free. This not only drives up the price of medical care, but also results in vast inefficiencies by encouraging people to use health care services beyond a level commensurate with costs. Moreover, providers of health care have every incentive to provide excessive care, because they know that it often is costless to the consumer and they will be rewarded with greater revenues. As a result,

¹³ M. Stanton Evans, "The Medical Nightmare," National Review, March 20, 1981, p. 294.

excessive costs will be imposed upon taxpayers and consumers of insurance. Furthermore, high federal matching rates for Medicaid give states incentives to raise benefit levels and ease eligibility requirements beyond levels necessary for adequate care. Eligibility errors alone account for an estimated \$1.2 billion in overpayments annually.

To slow the rate of growth of Medicaid costs, the Administration proposes to cap open-ended federal expenditures as an interim measure until a long-range plan of comprehensive health reform can be developed to reduce accelerating cost inflation and improve Medicaid. These changes would be effected some time between 1983 and 1986. The level of federal expenditures would be reduced \$100 million below the current base estimate for 1981, then allowed to increase by 5 percent in 1982, and would subsequently be increased by the rate of inflation as measured by the GNP deflator. Each state would retain its present relative share of total federal Medicaid spending. In addition, states would be given greater latitude in operating their own programs. This would allow them to modify their eligibility and benefit requirements to provide medical care in an improved and more cost-effective manner. These changes would save approximately \$1 billion in 1982.

The proposed limiting of federal expenditures on Medicaid would encourage state administrators to reduce fraud, waste, and mismanagement. This goal would be enhanced by greater flexibility awarded the state to restructure their programs to meet the needs of their population in a more cost-effective manner.

The cap may not reduce inefficiency, but instead result in arbitrary cuts in coverage and services provided. In addition, inequities among states could be exacerbated because funding decisions would be based on past, rather than present, economic conditions. It is therefore important to note that the Administration views the proposed cap as only an interim measure until comprehensive reforms are developed.

PUBLIC SERVICE EMPLOYMENT

The public service employment (PSE) program is run by state and local governments under the Comprehensive Employment and Training Act (CETA). The program is financed by federal funds to help participants adjust to labor market conditions by providing them with temporary jobs (not to exceed 18 months). PSE was originally intended to provide low-income, structurally unemployed workers with training to prepare them for unsubsidized jobs in the private sector. During the 1974-75 recession, Congress expanded the role of the public jobs program by making it a counter-cyclical as well as counter-structural tool.

Because the program has been viewed as ineffective in achieving either goal, the Administration proposes to eliminate PSE by

phasing out the two CETA programs that provide it with funds: Title II-D, which deals with structural unemployment, and Title VI, which addresses cyclical employment problems. This would be done by the end of 1981. Under the Administration's proposals, the Secretary of Labor would be directed to phase out both PSE programs by placing a freeze on hiring, and permitting those currently enrolled (about 300,000) to "continue in their jobs and be absorbed into the regular State and local government payroll, be placed in an unsubsidized job in the private sector, or have to seek employment elsewhere." Unemployment compensation, however, would be available to those who would lose their jobs. These actions would reduce outlays by \$0.6 billion in 1981 and \$3.6 billion in 1982.

Recent evidence suggests that PSE has been a poor counter-cyclical device. Title VI of CETA was originally enacted to use PSE employment as a measure to combat the high unemployment rates experienced during the 1974-75 recession. High levels of PSE employment, however, were only attained in 1977-78, when the unemployment rate had already fallen appreciably. In fact, shifts in the business cycle may be exacerbated if government policy cannot accurately coordinate PSE employment levels to meet the constantly changing economic conditions. In other words, it may not be possible to continuously create or destroy such jobs at will. Moreover, if PSE employment generates an artificial demand for the services they provide, it may make it increasingly difficult to reduce the number of these jobs in the future. If such a trend were to continue, it could result in an inefficient allocation of labor between the public and private sectors. This would be especially true if the PSE jobs were not aimed at providing for worker entry into subsequent unsubsidized employment.

Further, the job creation abilities of the PSE program are highly suspect. State and local governments may be using PSE funds to replace their own revenues to hire employees that would have been hired anyway. This phenomenon is called "fiscal substitution," and it further discredits PSE as an effective counter-cyclical instrument.

As a counter-structural tool, PSE jobs have an equally dismal record. Current training programs have been far more effective than PSE jobs in improving the employability of their participants. Only about one-third of the participants in PSE employment find jobs after leaving the program. Furthermore, the average cost of finding employment for a person from the PSE program is two to three times as great as under the training programs. This apparent failure can primarily be attributed to the "make-work" jobs the program creates. PSE jobs prepare participants for positions that often have no counterpart in unsubsidized employment. If such positions did exist, the market would have already created them. Furthermore, the easy availability of PSE employment may actually delay worker assimilation into long-term unsubsidized employment.

Proponents of PSE argue that the make-work and fiscal substitution concepts are "mutually contradictory." If PSE jobs are make-work and serve no useful purpose, then state and local governments would not have hired these individuals in the absence of federal funding. On the other hand, so the argument goes, if PSE workers are substituted for regular public employees, then they must be worthwhile. These beliefs, however, are not mutually contradictory at all: a proportion of all PSE employees may satisfy the make-work criteria, while another set may qualify for the fiscal substitution group. The sum of these two separate factions may make up most of the PSE enrollment.

Another argument advanced in support of public jobs is that elimination of the program would result in a curtailment of valuable community services. However, if these services are really important, then the public's demand for them would be revealed through the political process. Otherwise, the tax dollars spent on these projects would be considered to outweigh the benefits.

George Gilder asserts that each CETA job may actually destroy more than one private sector job for the poor.¹⁴ To support this claim, he cites a GAO report that estimates the cost of creating a CETA job at over \$20,000, including overhead expenses. This amount, it is noted, may be nearly double the cost of employment in small businesses, which tend to be labor intensive and would be the most likely source of hiring in the absence of a public jobs program. Moreover, eliminating PSE would reduce the tax burden on all businesses and restore greater competition in the labor market by paying wages commensurate with the value of work performed. Both effects would stimulate the economy in the direction of more real jobs creation in the private sector.

CONCLUSION

The Administration's proposed budget cuts are necessary and an important step in reducing uncontrolled growth of government spending. A recent nationwide poll conducted by Sindlinger and Company, Inc. for The Heritage Foundation revealed strong support for the Reagan economic program, particularly in the area of spending cuts. In fact, a substantial number of those polled believed that the Administration's proposed reduction in government spending was too low. Several programs now considered "untouchable" by the Administration often award large unearned benefits to recipients regardless of need. Social Security retirement benefits and Medicare, for example, were largely exempted from budget cuts because they provide assistance for the elderly. As a result, many of the beneficiaries of these programs

¹⁴ George Gilder, Wealth and Poverty (New York: Basic Books, Inc., 1981), p. 161.