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Welfare Reform & Beyond

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Welfare and the Economy

Executive Summary

Throughout the 1990s, the combination of economic expansion and major policy changes to the nation's public assistance programs resulted in rapidly declining welfare caseloads and rapidly increasing labor force participation. Program eligibility changed, with more applicants subject to sanctions, time limits, or diversion activities, and the robust economy fueled a strong labor market. It is difficult to forecast what will happen to caseloads and employment in a future recession. The 1996 welfare reform legislation contained three provisions to help states weather a recession: the ability to carry over block grant funds, a loan fund, and a contingency fund. These and other public assistance programs, however, need reworking to be entirely effective during a recession. Future policy options include making the welfare block grant funding cyclical, revising the trigger for contingency fund payments, authorizing state "rainy day" funds for welfare programs, increasing state flexibility on time limits, encouraging public employment programs, and reforming the current unemployment insurance system.

The 1990s produced a host of unexpected economic good news. Contrary to all economic predictions, unemployment fell to 4 percent by the end of the decade and inflation remained low and stable. Black and Hispanic Americans experienced record low unemployment rates, and women experienced unemployment rates nearly as low as in the 1960s, a time when far fewer women were in the labor force. At the same time, real wages for less-skilled workers began to rise steadily starting around 1995, following almost 20 years of decline or stagnation. Between 1994 and 1999, real wages rose 5 percent among male high school dropouts and 3.5 percent among female high school dropouts.

Even in the absence of any other changes, these exceptional labor market improvements should have increased employment and reduced welfare use among low-income families. But these economic changes coincided with a period of extensive policy change. The mid-1990s saw significant expansions in the Earned Income Tax Credit (EITC) and the minimum wage. The 1996 welfare reform legislation created the Temporary Assistance for Needy Families (TANF) block grant, replacing the old Aid to Families with Dependent Children (AFDC) cash welfare program. TANF gave states much greater discretion over the structure and operation of their public assistance programs, and states promptly began to implement programs designed to increase work and reduce cash assistance. These new work-oriented welfare programs were designed to move recipients (primarily single mothers) into employment as quickly as possible, and were surely helped by the strong labor market available to those newly seeking work.

The coincidence of a major economic expansion and a major shift in policy resulted

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in significant behavioral changes, with rapid declines in public assistance caseloads and rapid increases in labor force participation among single mothers. This policy brief investigates those changes, and explores what might happen in a future recession and how well prepared national and state public assistance programs are to deal with an economic slowdown.

What Happens in the Next Recession?

Since nobody knows what will happen in the next recession, the best way to predict the impact is to look at how past economic slowdowns have affected work behavior and public assistance caseloads. Notably, recent changes in programs and behavior have been so great and so fundamental that historical evidence may be quite unreliable.

Caseloads Public assistance caseloads have declined by more than half since the mid-1990s. Even the strongest proponents of welfare reform in 1996 would not have predicted such dramatic reductions in welfare usage. The key question is how much of the reduction is due to economic expansion versus policy change, and how much of it would be reversed in a recession. A growing body of research has tried to separate the impacts of policy and economy on welfare, with mixed success. The two are almost surely interacting with and reinforcing each other, so that a strong labor market has allowed states to put more energy into case management or move faster in placing recipients into welfare-to-work programs, without working as hard to help clients in these programs locate jobs. These interactions make it difficult to identify the separate effects of the economy and policy.

With this in mind, the existing research generally finds that a 1 percent increase in unemployment has historically increased welfare rolls by around 3 to 5 percent, although this effect occurs only over time and with a lag. These estimates are largely based on historical estimates from the AFDC program, when a smaller share of single mothers or welfare recipients were in the labor market and welfare had no time limit. Cyclical movements between the labor market and welfare were likely to be less common in this period than in the new world of TANF.

An alternative approach is to look at the historical response to changes in unemployment rates within the AFDC-Unemployed Parent (AFDC-UP) program. This program served married couples and was much more cyclical than the AFDC program for single mothers—more recipients left the program in good economic times and returned to seek assistance in times of high unemployment. Historically, a 1 percent increase in unemployment resulted in a 9 to 17 percent increase in the AFDC-UP rolls. This suggests that a serious recession that raises the unemployment rate from 4 percent to 7 percent could result in as much as a 30 to 50 percent increase in TANF caseloads.

This effect will be reduced if a share of these women is ineligible to return to welfare. For instance, sanction policies, time limits, or state diversion policies may keep some applicants off welfare, even when faced with serious economic need. Research based on recessionary effects within the AFDC program cannot take these TANF program changes into account.

Labor Force Participation As welfare usage declined, employment increased, particularly among single mothers with younger children. The rate of labor force participation among single mothers (age 20-65) with children under age 18 rose from 69 percent to 78 percent between 1990 and 2000. An important component of this change was a significant increase in the number of women who were both receiving welfare and working.

However, single mothers tend to have low levels of education, and jobs among less-skilled workers tend to be the least stable and most cyclical. Hence, a recession leading to a 1 percent increase in the aggregate unemployment rate would likely produce greater than 1 percent increases in unemployment among less-skilled workers.

How these newly employed single mothers respond to losing their jobs is important. Will they continue to search for work (thus remaining in the labor force and being counted among the unemployed), or will they leave the labor market entirely, either returning to public assistance (if they can, given sanctions and time limits) or relying on the income of boyfriends or other family members? One might assume that a loss of less-skilled jobs would reduce employment more than it will reduce labor force participation, if actively looking for work is a required component for receiving ongoing public assistance.

Poverty and Income Poverty fell in the 1990s, as one would have expected given the economic growth during this period. Poverty among female-headed households with children is now at an historical low (although it remains above 35 percent). However, as others have pointed out, many fewer people have left poverty than have moved off cash assistance. The result is an increase in the number of "working poor," that is, those in poverty who are also actively involved in the labor market. The share of working poor has typically increased in periods of economic expansion, as more low-wage jobs become available. Hence, a recession is likely to increase the overall number of poor people, as well as decrease the share of the poor who work.

There has long been a strong relationship between poverty and the overall economy.

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Estimates from the 1960s and 1970s suggested that a 1 percent decrease in unemployment rates decreased poverty by about 1 percent. However, despite a strong labor market and declining unemployment in the 1980s, poverty fell less over this period than historical data would have suggested. This effect appears to be related to the wage inequality of that decade, with wage declines among less-skilled workers offsetting the effects of the strong labor market. A stronger relationship between movements in unemployment rates and movements in poverty reemerged during the 1990s, although the declines in poverty in the 1990s are quite small relative to the dramatic declines in the 1960s.

Overall, the strong economy has clearly helped reduce caseloads and increase work opportunities. It has also helped reduce poverty and raise income (primarily through increases in earnings) in poor families. The economic expansion of the 1990s was surely not the only reason for declining welfare rolls and rising labor force participation, but it was an important component of those changes.

Behavioral changes would likely be much smaller and less dramatic had we implemented welfare reform in a period of slower economic growth.

How Well Prepared are TANF Programs to Deal with a Recession?

Since TANF changed the funding for public assistance from a matching grant system to a fixed block grant, states now bear the residual financial risk of any changes in economic need. A key problem with fixed funding is that public assistance demand is countercyclical, that is, it rises in periods of economic need. Thus, states generally will need to put more money into public assistance programs during a recession. Of course, this creates serious problems for many states, most of which operate under a balanced budget requirement in their constitution and typically cut their spending in recessions.

TANF contains three provisions that are designed to help states prepare for or weather recessions that disrupt their ability to provide welfare benefits to all poor families. First, states are allowed to carry over TANF funds. The TANF block grant provides states with a fixed amount of federal funds, the level of which is based on spending in the old AFDC program in the early part of the 1990s. To receive these funds without penalty, states must meet a maintenance of effort (MOE) requirement which compels them to continue to provide state funding at 80 percent of the level provided to a core group of public assistance programs in the mid-1990s (75 percent if state work participation requirements are met). TANF explicitly authorized states to carry over any block grant money not spent in a given year into future years. A primary reason for this provision was to allow states to build up "rainy day" funds that they could tap if faced with rising economic need.

Many states have used this carryover provision. As of September 2000, states reported $9 billion in unspent TANF funds, which amounted to 14.5 percent of all TANF funds awarded since 1996. Some of these dollars have been obligated to state programs, but are still unspent, while others are unobligated. Determining exactly how many of these dollars might be available to meet extra spending needs in times of economic decline is difficult.

Unfortunately for states, the future of carryover funds is somewhat uncertain. Congress could pass legislation that would reallocate unspent state TANF funds to other budget uses. Some states have explicitly avoided carryovers because of the risk of losing this money. Logically, this risk makes it unlikely that states will fully utilize the carryover provisions to build up sufficient rainy day funds.

In addition, the carryover funds must be spent on cash welfare. This means that carryover dollars could not pay for increased costs in state work programs during a recession (such as increases in child care or wage subsidies), thereby further limiting the usefulness of TANF carryover funds as a recession-financing mechanism.

The second provision for dealing with recessions is a $1.7 billion Federal Loan Fund, authorizing states to borrow up to 10 percent of the value of their TANF block grant. A loan must be repaid within three years and states must pay interest at the market rate. To date, this provision has not been used by the states and is likely limited in its usefulness, as state borrowing for social welfare programs in recessions may not receive strong popular support.

The third and most important anti-recession provision within TANF is the contingency fund. This fund provides additional money to states in times of economic need, and thereby supplements the fixed TANF block grants. A $1.96 billion contingency fund was authorized, but the authority expires at the end of 2001 (and there is no request for reauthorization in current budget proposals). In order to draw down these funds, states must meet two criteria. First, state unemployment rates have to be above 6.5 percent and must have increased more than 10 percent over the past year; or their food stamp caseload must be 10 percent higher than in 1994 or 1995. Second, state TANF expenditures must be 100 percent or more of their 1994 expenditures on a group of core public assistance programs.

While perhaps reasonable in 1996, these criteria have become quite outdated. So far, the contingency fund has been used only once, and it is unlikely that many states will be able to draw upon the contingency fund in the near future. With unemployment rates well below 5 percent, the unemployment trigger in the first criterion will not be met until states have experienced large increases in unemployment. Since food stamp caseloads have fallen by 40 percent (along with welfare caseloads), the food stamp criterion will also be difficult to meet. Finally, since state MOE requirements are currently at 75 to 80 percent of their previous expenditures and few states are at 100 percent, state spending on TANF programs in a recession would have to be increased substantially before states would be eligible to draw down federal contingency dollars.

Even if the contingency fund did not have access problems, many claim that it would not provide an adequate backup to TANF funds for states in a serious recession. For instance, if the eight states with the largest block grants were to all qualify in one year for contingency fund dollars, it would exhaust the fund.

Finally, it is worth noting that TANF provides for special supplemental grants for poor states or states with rapidly growing populations. Although not an explicit anti-recession measure, these supplemental funds could be very helpful to states that receive them during a recession. This provision is due to expire at the end of 2001, and 17 states will lose funds if this occurs.

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Policy Options

Given the serious limitations of the existing TANF provisions for recessions, many observers have suggested that a variety of changes are needed to "recession-proof" state TANF programs. These proposals include ways to solve the countercyclical financing problems faced by states in recession, as well as proposals to improve the states' ability to run effective work-oriented public assistance programs that can continue to operate in a more sluggish labor market.

The Contingency Fund In order to make this contingency fund usable to states, a new set of accessibility criteria is necessary. Keying access to the fund to large percent changes in unemployment or food stamp caseloads (without attention to the starting level) would enable states to obtain these funds in an economic downturn. Making access contingent only on the 75 percent or 80 percent MOE requirement (rather than the much more stringent 100 percent requirement in current law) is also necessary. If the current contingency fund is not renewed in 2001, it may be easier to create a new and more effective contingency fund, perhaps as part of the TANF reauthorization debate in 2002.

Strengthening TANF Given the current limitations of the contingency fund, an alternative would be to create cyclicality in the block grant funding amounts so that states with increased economic need would receive more federal dollars in their block grant. One idea for determining the formula by which this cyclicality occurs is to tie the additional money to changes in unemployment rates or other indicators of need. By itself, this approach would limit state access to increased dollars to a formula-based allocation of the block grant, which may not recognize specific high-need situations in states. Hence, it might make sense to also provide at least a small ongoing contingency fund program (accessed at state request under particular circumstances) even if block grant dollars are allowed to fluctuate.

State Rainy Day Funds for TANF Programs To address concerns about losing carryover funds, it may be important to explicitly give states authority to establish rainy day funds that allow a limited share of their TANF block grant allocations (maybe 10 percent) to be held without consequence should Congress decide to reallocate "excess" TANF funds. This policy would allow states some carryover ability, without encouraging them to build up large carryover balances. It might be useful to require that states justify their rainy day fund amounts through some sort of formal calculation of expected future need.

State Flexibility and Federal Time Limits In a recession, it will be harder for welfare recipients to find jobs and to earn enough to leave welfare. In this situation, welfare spells will lengthen and the five-year federal time limit may begin to bind on a larger share of families. Particularly in a time of limited job availability, removing people from public assistance due to rigid time limits is not an ideal option. States may need greater flexibility to issue more exemptions from time limits during recessions, or flexibility to extend eligibility for persons who meet certain criteria—such as actively participating in welfare-to-work activities—but are unable to find a job or earn enough to lose their welfare eligibility.

Encourage States to Create Public Employment Programs In a serious recession, it is unlikely that states can continue to run welfare-to-work programs that rely entirely on private sector job availability. If a state wants to enforce strong work requirements and assure that women on welfare who make every effort to meet the work requirements continue to receive assistance, then short-term paid public employment programs may be an attractive option. For instance, a woman might receive a six-month placement in a job provided in the public sector, after which she must spend a period of time seeking private sector work. Unfortunately, the expense and management challenges associated with public employment programs rise with the number of placements and the degree of state monitoring. However, a recent review of past U.S. employment programs by David Ellwood, a professor at Harvard University, offers lessons to help states design more effective programs. Federal funds to help design, initiate, and evaluate small-scale demonstration programs could help states begin to explore new options for building more effective employment programs.

Unemployment and Low-Wage Workers Very few low-wage workers currently collect unemployment insurance when they leave or lose their jobs. This unfortunate result is caused by a combination of factors.

First, persons fired for cause—such as a mother whose child care arrangements have fallen through—are often not eligible for unemployment. Second, persons who voluntarily leave a job—such as a mother who cannot arrange transportation between a job and child care obligations—are often not eligible for unemployment. Third, many states will not pay unemployment to workers seeking part-time jobs. Finally, states have requirements about how long and how continuously an individual must work to qualify for unemployment insurance, which many low-wage workers do not meet. Changes that make unemployment more available to low-wage workers, such as shorter qualifying periods for benefits or payments to part-time job seekers, could help provide an alternative source of short-term support for low-wage workers who either do not want to or cannot return to the welfare rolls.

Conclusion

The strong economy has been very important to the success of welfare reform so far. A recession, particularly a deep recession which raises unemployment rates by 3 points or more, might substantially reduce the success states have achieved in reducing caseloads and increasing work among less-skilled workers. A variety of legislative changes might be useful to both provide financial support to states in times of rising economic need, and to assure that state welfare-to-work programs continue to function when private sector jobs are not as readily available.

The views expressed in this Welfare Reform & Beyond Policy Brief are those of the author and are not necessarily those of the trustees, officers, or other staff members of the Brookings Institution.

Additional Reading

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