The design of 'soft' welfare-to-work programs ☆

Nicola Pavoni [a,b,c], Ofer Setty [d], Giovanni L. Violante [e,b,c,f,∗]

[a] *Bocconi University, Italy*
[b] *CEPR, United Kingdom*
[c] *IFS, United Kingdom*
[d] *Tel Aviv University, Israel*
[e] *New York University, United States*
[f] *NBER, United States*

A R T I C L E   I N F O

A B S T R A C T

This paper models welfare-to-work programs as contracts offered by the principal/ government to unemployed agents in an environment with moral hazard. A welfare-to-work program comprises of several policy instruments (e.g., job-search, assisted search, mandated work) the principal can use, in combination with welfare benefits, in order to minimize the costs of delivering promised utility to the agent. The generosity of the program and the skill level of the unemployed agent determine the optimal policy instrument to be implemented. Restricting attention to 'soft programs' — contracts that make no use of punishments or sanctions — allows a fully analytical characterization of the optimal program and, in addition, it makes the solution robust to hidden saving.

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1. Introduction

Welfare-to-work programs are government programs aimed at the poor and the jobless. Their objective is providing income support and, at the same time, promoting economic self-sufficiency through work. Achieving this objective is challenging because the provision of assistance interferes with individual incentives to exert effort to find and retain a suitable job. In order to tackle successfully this insurance-incentive trade-off, governments use a wide range of policy instruments.

The backbone of most welfare programs around the world is a combination of Unemployment Insurance and Social Assistance. We use the term Social Assistance as an umbrella to capture all those policies of pure income support such as

Table 1

Use of policy instruments across some US states.

Source: Department of HHS. Year 2009.

State	Fraction of welfare (TANF) recipients			
	Inactive	Search	Work	Training
Illinois	0.43	0.03	**0.42**	0.12
Pennsylvania	0.59	0.08	0.10	**0.23**
Michigan	0.72	**0.18**	0.04	0.06
New York	**0.82**	0.04	0.09	0.05

the Supplemental Nutritional Assistance Program (SNAPS, formerly called Food Stamps), child-care and housing assistance, or Disability Insurance in the case of the United States.

A large class of policies goes under the heading of Job-Search Assistance. Here, we focus only on those interventions where the public employment agency actively helps the participant to find work by providing job contacts with suitable employers.[1] A variety of interventions are based on work requirements. At one end of the spectrum, the work requirement is purely intended as a social obligation for the receipt of the welfare check. At the opposite end, the work requirement is meant to function as a transition into self-sufficiency through private employment. For example, while the participant is mandated to work in a public or non-profit agency, the caseworker actively assists her search for private employment in a similar job. Or, the caseworker directly matches the individual to a private employer with the expectation that she might be retained by that same employer. To distinguish the first type of work (work in exchange for benefits) from the second (stepping stone to private employment), we label them Mandatory Work and Transitional Work.[2] Finally, many programs include financial incentives to employment such as re-employment bonuses and earnings subsidies, for example the US Earned Income Tax Credit.

The United States is an interesting case to study because the 1996 Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) deeply reformed the system of cash welfare assistance for poor households. In particular, it removed federal regulatory power over the structure of these programs, and gave states full flexibility in choosing policy instruments. As a result, a range of diverse programs was implemented across US states over time: some programs are more focused on assisting individual job search, others on education and training, others on moving the individual as soon as possible into some form of work.

Table 1 illustrates some key characteristics of welfare-to-work programs for four large US states: Illinois, Pennsylvania, Michigan, and New York. It reports the fraction of recipients of the Temporary Assistance for Needy Families (TANF) — the main form of welfare benefits — not employed in the private sector, by activities they are required to perform.[3] The first fact that emerges is the large dispersion in the fraction of inactive individuals, those exempted from any activity, among these four states. The second fact is that different states emphasize different activities. In Michigan, the most common required activity is job-search, in Pennsylvania training, and in Illinois mandated work. In conclusion, it appears that states take very heterogeneous approaches to the design of welfare-to-work programs. A first natural question is therefore: what explains this heterogeneity?

The 1996 welfare reform also allowed states to set their own TANF benefit level and, once again, this freedom of choice led to significant heterogeneity across states. Fig. 1 illustrates this point by grouping states by the maximum monthly amount of TANF benefits payable to a single parent with two children. Not surprisingly, there is a correlation between the 'color' of the administration (Democratic vs. Republican) — and hence the state residents' political preferences towards redistribution — and the degree of generosity of the state towards its welfare participants.[4] Then, a second natural question is: given how generous a state wants to be toward its welfare participants, what mix of policy instruments should its welfare program contain? For example, in Table 1 and Fig. 1, we saw that New York is one of the most generous states and, at the same time, one of the states that is most willing to tolerate inactivity from its welfare recipients. Instead, Illinois is much less generous and bases its program largely on work requirements. Are these states making the right choices in designing their welfare programs?

To address these questions, we need a normative framework to think about the optimal design of welfare programs.

Our starting point is the optimal unemployment insurance contract in the presence of a repeated moral hazard problem caused by the inability of the principal/government to observe the unemployed agent's job-search effort (Shavell and Weiss, 1979). The problem admits a recursive representation with two state variables: the expected discounted utility promised

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[1] To enforce active job search, some programs require the welfare recipient to show evidence of her job-search efforts (applications, contacts, interviews) to the caseworker. The optimal use of monitoring of search activities is analyzed extensively in Pavoni and Violante (2007), and Setty (2014). Other search-based interventions focus on the development of job-seeking and interviewing skills. Wunsch (2013) studies the optimal design of this type of intervention.

[2] Another important class of interventions based on training is aimed at augmenting the market value of skills of the participant. We abstract from these interventions in this paper, and return to this point in the Conclusions, where we discuss directions to extend our analysis.

[3] See Appendix B for details on the calculation of these fractions.

[4] In 2010, the average value of the maximum monthly TANF benefits was $510 in Democratic states and $390 in Republican states.