

**FIGURE 10**  
PERCENTAGE AND NUMBER OF USERS CITING REASONS FOR USING A DERIVATIVE PRODUCT

Derivative Product	To Reduce Cost of Raising Capital		To Increase Rate of Return		To Hedge		All Other	
	Number	%	Number	%	Number	%	Number	%
Interest Rate Swap	12	44	20	71	24	73	6	55
Foreign Exchange	4	8	33	55	62	94	10	67
Forward	6	50	7	50	9	69	1	50
Future	6	11	56	81	56	82	30	88
Option	6	14	46	81	39	72	8	73
Other	7	28	19	70	24	86	5	71

From Betsy Dotson, "Financial Derivatives: Governments as End Users," *Government Finance Review*, August 1994, p.13.

## THE AFDC DILEMMA: A PROBLEM OF INCENTIVES AND TRADEOFFS

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The issue of welfare has received much attention from economists and policy-makers since the seventeenth century when English poor laws made the state responsible for aiding the poor. Since then concern has been repeatedly voiced throughout the centuries over government aid programs for which the basic requirement to receive benefits is need. The basic objectives of these government programs which are to alleviate poverty and promote self-sufficiency have repeatedly been called into question. These goals have often been viewed as incompatible because the more benefits the government pays out the fewer incentives there are for people to work. The problem could be easily solved if the poor could be divided into those who are able to work and those who are not. However, since it is difficult for a government to discern who can and cannot work, economists and policy-makers have been left with trying to balance providing help for the poor with providing incentives for work and hence self-sufficiency. Hence, the obstacles faced by government assistance programs are providing proper incentives and balancing tradeoffs in policy goals.

Welfare in the United States at the Federal level has its origins in the Great Depression with the institution of the Social Security Act of 1935. This act was designed to provide aid to those people not able to work by instituting the programs of Social Security Income (SSI) and Aid to Dependent Children (ADC). The first program targeted elderly citizens while the second program focused on aiding children. Both target groups were perceived as worthy and needy of government assistance. ADC soon became Aid to Families with Dependent Children (AFDC) when benefits were extended to cover mothers. The program was designed to help a small group of poor widows to stay home and care for their children (Gueron 81).

Today welfare in the United States has grown to include six major government assistance programs and over a half dozen minor ones. Main cash transfer programs include AFDC, Supplementary Security Income (SSI), General Assistance, and Earned Income Tax Credits. Primary in-kind grants include food stamps, Medicaid, and housing and energy assistance. All aspects of government assistance have come under much public scrutiny but the one which has been the largest source of contention is AFDC.

AFDC is a means tested public assistance program in which eligibility and benefits depend on income and assets. This program is jointly administered by the federal and state governments to provide aid to families with needy children. In half of the states AFDC is restricted to single-parent homes. AFDC receives much attention because it is the largest single cash program for the poor (Burtless 62). It is true that real benefits from AFDC have fallen over the past twenty years but studies have shown that total transfers including food stamps and Medicaid payments have grown in real terms directly in line with income growth (State 123). Even though AFDC accounts for only one percent of the federal budget and most people only receive aid for short periods of time perceptions of high costs are widespread (Gueron 81). This is because a substantial minority of people remain poor and dependent on government aid for long periods of time. One-quarter of all those who receive AFDC remain recipients for ten or more years and account for 60% of total AFDC costs (Gueron 82).

The defects of AFDC have been evident to economists, policy-makers and the



public at large for many decades. There is a widespread consensus that the current system is flawed because it does not promote self-sufficiency. Instead AFDC is accused of providing aid to able-bodied poor, discouraging work, and promoting dependency on the government. Taxpayers do not want to help people who can help themselves and fear they are contributing to the creation of a permanent underclass. This fear is somewhat substantiated by a study appearing in the *American Economic Review* which found that daughters of eligible parents who received AFDC benefits were more likely to have an early birth and receive AFDC than daughters of eligible parents who did not participate in AFDC (Gottschalk 369).

AFDC has also been accused of encouraging illegitimacy and family dissolution. AFDC caseloads and costs grew in the 1960s and 1970s and the nature of the caseloads changed from the original target population of widows to 90% of the women receiving aid being divorced, separated, or never married. Voters have begun to believe that without AFDC more single mothers would work, be childless, or be with their husbands (Burtless 65). These beliefs have been supported somewhat by economists who have found that in certain instances it is possible for a family to earn more through welfare if a bread-winner leaves the home. If AFDC support levels are high and earnings in the family are low it makes sense for low income families to dissolve. They will then receive more assistance unless taxes on earnings are very low (Burtless 66). Also, welfare mothers currently receive increases in benefits if they have other children while on the government dole. In order to try to promote family unity Congress in 1988 extended AFDC benefits to two-parent families in which the principal earner is unemployed (AFDC-Unemployed Parent). AFDC-UP does provide aid to families besides those which contain only a single parent but it exacerbates the problem of work disincentives.

Another shortcoming is that AFDC benefits are too low to prevent destitution or promote self-sufficiency. Many people in support of AFDC point to the fact that poverty rates rose when AFDC benefits started declining (State 123). It is also noted that the poverty level has remained constant at 11.1% of the population since 1973 (Burtless 60). This would lead one to believe that the current AFDC program is doing little to rectify the problem of poverty.

A further problem is that the current system is often inequitable to people under similar circumstances. State agencies have the authority to set the amount of aid paid out under AFDC as well as the eligibility requirements to receive aid. This alone leads to inconsistency between states and theoretically could lead to migration of people eligible for aid to states which pay the highest benefits. The sheer size of the bureaucracy also means the costs of administering the program are high and it has been hypothesized that the program is more costly for taxpayers than it is worth to recipients (Burtless 59). In other words, a large amount of the taxpayers' money pays for administrative costs instead of aiding the needy.

Finally, AFDC has been described as ineffective in helping its ultimate target population - children. Children are viewed as innocent victims. Child poverty rates are higher in the U.S. than in other developed countries and today more children are in mother-only households dependent on welfare (Haveman 155). Today, 25% of all

children are born to unwed mothers and less than 75% live with two parents (Haveman 155). It has been shown that a mother's education and the amount of time a mother works in the paid labor force has a positive affect on children's attainment, measured by education and economic activity (Haveman 169). Conversely, changes in family structure have a negative effect (Haveman 169). It follows that some of the best ways to invest in children are to substitute earned income for welfare, encourage single mothers to work outside the home, and provide stricter child support payments which are nonwelfare payments that would help children (Haveman 171-172). The problem is figuring out how to reform the current welfare system to provide proper incentives in order to accomplish these goals.

### Conclusions and Proposals

As I stated at the very beginning of this paper the basic objectives of need-based government assistance programs have been questioned since they were instituted. The goals of alleviating poverty and promoting self-sufficiency are incompatible from an economic perspective because the more benefits the government pays out the fewer incentives there are for people to work. The dilemma could be solved if the needy could be divided into those who are able to work and those who are not, but a government assistance program based on need and run out of four cabinet departments and over one hundred state agencies is not capable of performing this differentiation. The current AFDC program does not provide enough benefits or proper incentives to lift recipients out of poverty or dependence. Instead of helping the target population of needy children the current system also provides economic incentives for illegitimate births and family dissolution.

After exploring how the AFDC dilemma has been addressed by different bodies of professional and nonprofessional literature I am almost more confused about how to reform the system than I was before I began my research. No one has suggested a definite way to provide proper incentives under AFDC so that there will be minimal tradeoffs between relieving poverty and increasing self-sufficiency. I will first outline the contributions, or lack thereof, from this literature to a solution to the problems with Aid to Families with Dependent Children and will then provide my own answers to the problem.

Economists have speculated on the effects of different reform measures and studied the effectiveness of incentive schemes that have been implemented in statewide welfare experiments. Judith Gueron has helped to make different reform proposals more comprehensible by classifying them as either "welfare" or "nonwelfare" reforms. She says "welfare" reform works within the current system to promote independence while "nonwelfare" reform operates outside the system to reduce poverty by making work more attractive. Many economists have speculated about the effectiveness of national work mandates as a method of reforming the welfare system but conclude that they would have modest and slow effects on poverty and dependence. The only conclusive insight economists have had is that all attempts at reforming AFDC will have mixed results. The main problem with providing proper incentives (besides the large AFDC bureaucracy) as seen by economists is that AFDC mothers cannot earn more from working than they can



by being on the government dole. The choice then becomes whether human capital should be increased to enable welfare recipients to obtain better jobs or welfare should be made less attractive.

Since Aid to Families with Dependent Children is a public assistance program instituted by the government it is fair to say that government is the origin of the welfare problem. During the Depression the national government took upon itself the tasks of eliminating poverty and redeeming people through self-sufficiency. It is ironic that these monumental tasks were undertaken in a program that was outlined in barely two pages under Title VI of the Social Security Act of 1935. Congressional hearings have focused on the bureaucratic mess that has resulted from adding to these original two pages. Recent Presidents have been in favor of fixing the mess and support doing it with work requirements, but they still want to provide adequate aid to the poor, and poor children especially. Fairness to everyone is the guiding light for Presidents and other politicians because they want to please the public. Policy-makers realize the need to restructure the incentives of AFDC but they are unwilling to make tradeoffs between self-sufficiency and poverty because it would not be politically wise.

Non-governmental research institutions are very effective at pointing out the problems with AFDC and the reasons for its ineffectiveness. They do much research and generate many reform proposals with one caveat. They say that time should not be wasted on researching reform measures which are not politically acceptable. NGROs point to a huge welfare bureaucracy that is impervious to reform and suggest the need to implement reform measures that would step outside of the current system. However, because this is not politically feasible "think-tanks" take the current system as given and resort to making suggestions about administration and requirements of the welfare system.

Psychology is a discipline which argues against objectifying welfare recipients. Psychologists are in general agreement that understanding recipients and their situations is the key to reforming AFDC and redeeming dependents. They do agree with the view that the current system prevents births from being legitimized because more money can be made if a father lives outside the home. However, they seem to stress the need to increase human capital through expensive educational programs in order to make better jobs more available.

The media is effective at relaying current proposals and debates on welfare to the public. However, the media is not a source to turn to in order to understand the problem of providing proper incentives to welfare recipients and the tradeoffs between poverty and dependence. Reform proposals found in the media are often instinctive reactions to the ineffectiveness of the current system.

Special interest groups definitely skew the welfare debate to support their specific agendas. They are very selective with the data they present and tend to focus on eliminating poverty or promoting independence to the exclusion of the other goal of AFDC. However, these groups are valuable for the ideas they represent and for pointing out different effects the welfare system is having on American society.

Popular culture quite possibly provides the most useful insight into the AFDC dilemma. Terms like "deserving" and "undeserving" poor, "oppression", as well as

political cartoons reflect society's attitudes and frustrations relating to AFDC. Even more relevant is the Bible which illustrates the deep-rooted commitment Americans have to help the poor and the firmly held belief that it is possible for able-bodied individuals to become self-sufficient and thus be redeemed from poverty. Popular culture is also relevant because it shows that economists and policy-makers are being asked to orchestrate "efficient charity"; something they are ill-equipped to do.

By exploring all of the previous commentary on Aid to Families with Dependent Children and especially the attitudes present in popular culture one is able to see why AFDC is viewed as a problem in this country. First of all, America is unique in its view of poverty. Not only do Americans seek to relieve the suffering inherent in true poverty, but there is an implicit belief that everyone is capable of being redeemed from poverty by becoming self-sufficient. Americans reject the idea present in other countries that there is a residuum that cannot be redeemed. This lowest class of people is sustained in other countries because they are accepted as being lazy and unable to be productive members of society. Thus other countries are not as hell-bent on reforming individuals but are perfectly content to just help them subsist.

If this view of a residuum is correct and there are people who cannot be redeemed then the American conviction to redeem the poor by making them become self-sufficient is inherently cruel. We are forcing people to become self-sufficient who are incapable of doing so. Thus one solution to the AFDC dilemma is that the system does not need reforming at all. Instead, what needs reforming is American ideology. If Americans could accept the idea of a residuum or a class of people that is beyond all hope then the current system would not need to be fixed. In fact, it would be perfect because it provides enough benefits to help the truly poor and the residuum do more than just subsist. However, most people, myself included, believe that rejecting the idea of a residuum enhances the value of all human life and promotes respect for all individuals. Therefore, given that the idea of a residuum is rejected the current AFDC program does need to be reformed.

Part of the problem in reforming AFDC lies in the differences in ideology of those who instituted the system and those who are now trying to reform it. Welfare was instituted in the 1930s by policy-makers and economists who subscribed to an institutionalist line of thought. They were dedicated to the betterment of society through rearrangement. In the case of Aid to Families with Dependent Children what was rearranged was income through the vehicle of cash transfer payments to the poor. Today, however, neoclassicists who are concerned primarily with efficiency are attempting to reform the system. They realize that the original target group of AFDC - children - are not benefitting sufficiently from the program because of a lack of proper incentives. These two lines of thought mark two very different ways of dealing with the "externality" of poverty. The institutionalists were seeking social improvement with little forethought as to how a system designed to help widows and their children might evolve into a system that condones out-of-wedlock births. The neoclassicalists on the other hand might favor the option of sustaining a residuum as the best way of promoting social improvement and efficiency.

There is no denying the fact that reforming AFDC means providing the right



incentives for people to accept aid who most need it but for those who do not to work. However, one can argue that government involvement in the "market" for charity makes it impossible to provide benefits and incentives that will relieve the effects of poverty and still promote self-sufficiency. Professor of Economics, Russell Roberts, of Washington University in St. Louis gave a speech at Duke on March 27, 1995 entitled "America's Future in the Global Economy - Will You Be Flipping Hamburgers for the Japanese?". He said that it is illusory to think that a government can invent a safety net that is attractive enough to help people but will not draw to many people into it. He also said that the biggest mistake of government is to think it can legislate humanity and that markets, free trade, and competition are the answers to society's woes. Even though in making these comments Professor Roberts was addressing the problem of trying to aid people in communities where major manufacturing plants had closed down his thoughts can be related directly to welfare and AFDC. Perhaps the best way to provide for the poor and to help people become self-sufficient is to let the "market" for charity operate without the interference of the government.

There is no denying the fact that government intervention in any market augments the market and changes equilibrium. In the case of charity when government entered the market it destroyed normal incentives. Before the government began providing public assistance, providers of aid to the poor could refuse aid to those whom they deemed unworthy or "undeserving". This promoted self-sufficiency because those who sought help knew that if they did not use their aid wisely or prove that they were indeed concerned about changing their poverty stricken state they would most likely not receive additional aid from the same source. Thus the "undeserving" poor were forced to become "deserving" unless they could travel to solicit help from different charities who had no contact with each other. In a sense government has destroyed competition in providing effective charity that possesses redeeming characteristics.

However, the government beginning during the Great Depression began distributing aid on the basis of need alone. If a person meets qualifications he or she can receive government charity regardless of his or her personal character. Thus, incentives to become self-sufficient are seriously reduced and people no longer weigh the consequences of their behavior as they once did. One example is that of illegitimate births. Government assistance, because it bases aid on need, makes it economically easier to have a child out-of-wedlock since a single mother with a child constitutes need. Whereas before foster homes or adoption agencies were employed to take care of illegitimate children the government now takes care of them while reducing the economic consequences of having premarital sex and out-of-wedlock births. This is just one example of how government intervention in the charity market has distorted incentives to become self-sufficient.

Hence, my first proposal to reform Aid to Families with Dependent Children is to eliminate it. If the American public wants to relieve the poverty of children and promote independence of single mothers the best way to achieve this is through private charities. This would assure that the poor who are unable to work would receive help while those who are able to work would be encouraged to do so. Societal pressures would be much more effective at redeeming individuals than government need-based

programs.

The main opposition to eliminating AFDC altogether stems from those who would accuse this proposal as being inhumane (ironically most of these same people would be involved in the current bureaucracy). They might say, "How can you possibly suggest taking away government funding from the needy? That is nothing short of heartless." In response I would argue that it is the most compassionate thing to do given the inability of the current system to provide benefits and incentives that redeem any section of the American poor. Further, there is a flaw in the logic that says government funding is necessary to redeem individuals. The people who decry the eradication of government aid act as if the government has a pocket-book of its own that it dips into to help the poor. In reality, government funding is only money from the American public that has been collected through taxes and redistributed as charity. Those who oppose eliminating AFDC actually support legislating humanity through the vehicle of the government. This line of thought originated during the Great Depression and was strengthened during the Great Society when people turned to the government to solve all of society's problems. "Government" is not an entity capable of accomplishing this enormous task. In fact, one can argue that government is an entity designed only to keep order in society not rid society of all disorders and render it perfect. Hence those who would oppose eliminating AFDC in reality support shifting the responsibility of caring for the poor from the American public to the government which they want to transform into the ultimate charitable organization. It might be feasible for government officials to reroute funds to private charities in order to redeem the American poor but a government program like AFDC whose only requirement to receive aid is "need" was bound to fail from the start. If redemption of the poor is what is truly sought then societal pressures and incentives are needed, pressures and incentives which government cannot provide and in many cases has distorted.

However, my more or less visceral proposal of eradicating AFDC is certainly not politically feasible. As much comment on AFDC has pointed out the current system is composed of a monstrous bureaucracy that is almost impervious to change. If the system were eliminated tens of thousands of people employed by it would lose their jobs and contribute to further unemployment. Although I believe that human capital is currently misallocated in the AFDC bureaucracy and that the training the civil servants in this bureaucracy have could be put to better use I cannot deny the fact that eliminating this welfare program would cause tremendous turmoil. Given then that AFDC has grown to a point that reform of the current system is the only politically viable option what is the solution?

This question embodies the true nature of the AFDC dilemma that everyone is trying to solve. "Workfare", child support, job training, child care, negative income taxes, negative earnings taxes, earned income tax credits, block grants, and a multitude of other proposals have been made which seek to enhance the effectiveness of the current program of Aid to Families with Dependent Children. However, all of these methods of reform have had mixed effects on incentives to recipients and on tradeoffs between eliminating poverty and promoting self-sufficiency.

Combining several of the proposals to solve the AFDC dilemma which are



most cost effective and administratively efficient might be the only way to reform the existing system. First of all, I support the suggestion of the Brookings Institution of reforming AFDC with a uniform national standard administered by a national administrative agency which would distribute funds according to uniform eligibility requirements. This would administer AFDC benefits much like those of social security and would equalize benefits across states as well as cut into the AFDC bureaucracy. The national standard would include a minimum federal contribution to all states plus the current amounts of support doled out by state agencies. This would be an improvement over the current administrative techniques in which states set benefits and the federal government meets a certain percentage of that amount. This new administrative structure would produce just as much if not more results in relieving poverty (depending on the size of the minimum federal payment) and might provide work incentives by treating all welfare recipients equally under federal monies regardless of number of children, marital status, or employment situation. Due to the increased federal role in funding welfare programs over the past several decades with few effects on poverty or dependence a national standard is justified.

A second measure which should be used to reform Aid to Families with Dependent Children is stricter enforcement of child support payments. Bergmann and Rogers of the Brookings Institution found that mothers who receive child support are more likely to be employed because the combination of wages and child support payments is more than could be received by holding the same job and receiving only AFDC benefits. This is because welfare benefits decline as income increases. Thus enforcing child support could help relieve poverty and provide economic incentives to work. Further, enforcing child support would force men to weigh the consequences of effecting out-of-wedlock births and as a result would decrease the number of individuals on the welfare dole.

The psychologists who say that enforcing child support could be harmful because it may strain the relationships between the "welfare couple" fail to recognize two things. First of all, if a child is receiving AFDC that means there is no "couple" supporting him or her. The parents are not married or at least are not living together to support the life which they both brought into the world. However, just because they chose to have an illegitimate child does not mean that they are free of any obligations to support this life. On the contrary, both parents have social and moral obligations to contribute to the well-being of the child they conceived. If they refuse to take this obligation seriously then society must provide incentives or pressures for them to do so. To say that child support should not be aggressively enforced because of possible harm to a "relationship" that was little more than carnal would logically mean society would end up supporting and even condoning all carnal unions no matter what their social or moral costs may be.

Second of all, a child is not a right. Many couples who are married and thus could have a legitimate child cannot do so because of biological problems. Hence the mere act of sexual intercourse does not mean that someone is guaranteed the right to a baby. However, even though a child is not something everyone is entitled to, every man and woman who brings about a life has responsibilities towards this life. If their

responsibilities cannot be fulfilled and they must turn to society for support, society has the right not only to aid the proper support of their child but to provide support directly if the parents cannot. This includes not only the right to aggressively enforce child support but to take custody of a child that is being neglected. Hence, requiring that parents support their children and strengthening methods of support is something which is justified and should be pursued. Some would argue that the costs of enforcement may be high, but there should be a way to tap into deadbeat parents' social security benefits in order to exact child support. However, even if the costs are high promoting parental responsibility is one of the best ways not only to force parents to become self-sufficient but to relieve the poverty of children.

A final method of reforming AFDC which should be employed along with a national standard and increased child support is a proposal made by researchers at the Institute for Research on Poverty. The Institute urged the creation and support of social service agencies outside the public assistance system to help solve bureaucratic problems and conditions of the poor. These agencies would provide options for welfare recipients which would relieve the effects of poverty as well as decrease welfare dependency. Examples of these social service agencies are neighborhood and community centers, offices staffed by professionals fully supported by the government, private organizations under government control, and private practitioners paid by government on a case-by-case basis. Even though the researchers at the Institute for Research on Poverty propose this method of reform as a way of stepping outside of current AFDC administration I think the two could be fused together. Gradually administrators of the current system could be reassigned to overseeing these more private ventures that do not involve government transfer payments to recipients. Instead, bureaucrats could oversee the use of funds funneled to new social service agencies and existing private organizations.

Thus I have laid out what I believe to be the ultimate solution of the AFDC dilemma (abolition) as well as a more politically practical system of reform. However, my suggestions or thousands of others can have no impact unless policy-makers decide to compromise over the inconsistent goals of relieving poverty and decreasing dependence. These individuals are going to have to realize that the only way to effectively reform Aid to Families with Dependent Children is to decrease the government's role at all levels in providing direct aid to welfare recipients. There is no question that reforming AFDC, if it is not done away with, should involve providing relief while providing correct incentives for redemption through independence. However, further government intervention in the form of providing direct assistance will only augment the "market" for charity and blur the distinction between the public and private sectors. The hardest thing to accept (at least from a political standpoint) in trying to reform Aid to Families with Dependent Children is that any reform is going to be difficult and cannot possibly please everyone involved. Perhaps a term limit placed upon legislators would provide incentives for them to solve the AFDC dilemma the proper way, by abolishing it, instead of trying to please all constituents. The current status of Aid to Families with Dependent Children is that there are no sure-fire cures, just bad-tasting placebos for an illness that should have been terminated long ago.



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