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Policy Makers Must Remember That Incentives Matter

by Peter T. Leeson and Lawrence W. Reed

Summary

Human beings respond in powerful ways to both incentives and disincentives, and recognizing this fact is essential to crafting sound public policy. State and local officials therefore should avoid creating new welfare programs that provide disincentives to work and self-reliance and reform existing means-tested programs so that they reward, not punish, responsible behavior.

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"If you encourage something, you get more of it. If you discourage something, you get less of it." Whoever first said that deserves a medal for putting to words one of the most profoundly important elements of human nature. Human beings respond—and often powerfully—to both incentives and disincentives.

Understanding this fact is critical for sound public policy-making. When we ignore it, we raise taxes and then wonder why people don't work as hard or save as much. Or we give people welfare checks for not working and wonder why they're not polishing their resumes.

Indeed, welfare reform came about largely because Americans saw the tremendous toll that welfare had exacted on families and on virtues like work and self-reliance. We came to realize, for example, that one outcome of boosting handouts when the father left the home was that fathers often disappeared. We also discovered how counterproductive it was to cut a dollar of welfare benefits for each dollar of earned income—in effect, imposing a 100-percent marginal tax rate on welfare recipients who found jobs. Clearly, we had to stop *penalizing* work and *rewarding* non-work!

Unfortunately, a wide array of programs here in Michigan (and probably in all other states as well) may still be sending the wrong signals. Over the years, we've piled one means-tested program on top of another—the cumulative effect of which seems to be to say to Michigan families, "If you earn less than a certain amount, you're eligible for lots of things but if you start to earn much more than that, you can lose it all."

Every means-tested program government offers has the unintended effect of reducing incentives for most able people to become self-reliant. Get a job and surpass the program's income threshold and the aid disappears. Stay below this level and government pays you to stay unemployed or to remain in a low-paying job. Surely some hard-working people who earn slightly above the maximum allowed for certain benefits sometimes wonder if their efforts to take care of themselves are all worth it.

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In Michigan, families below certain income limits qualify for a laundry list of benefits. The other way to look at it is as a list of the freebies low-income workers can get if they just work less. For example:

- Unemployment benefits end when per-week earnings reach $450.

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- Subsidized housing eligibility for a family of four vanishes when annual income exceeds approximately $24,725 (actual limit depends on city and income grouping).

- State-subsidized low-interest mortgage loan availability goes away when annual income exceeds $43,575.

- A family of four whose income rises above about $573 per month loses Family Independence Agency (FIA) subsidies for living expenses (actual limit depends on recipient tier, shelter area, and employment deductions).

- A family of four earning more than $755 per month no longer qualifies for cash subsidies provided by the State Emergency Relief program to cover housing and utility costs.

- Households of four with monthly incomes exceeding $1,783 may no longer receive food stamps.

- A family of four grossing more than $2,876 per month ($34,512 per year) loses aid from the Low Income Energy Assistance Program to cover heating costs.

- A household of four gets subsidized child day care until its monthly income grows beyond $2,586 ($31,032 per year).

- A family of four loses state-provided employment and training services when its income exceeds about $573 per month (actual limit depends on FIA classification).

It may be more lucrative to accept a low-paying job than it is to accept a higher paying one because the value of government benefits more than offsets the loss of income.

Recently, a commission appointed by Gov. Engler proposed a "Postsecondary Access Student Scholarship" (PASS) program. If enacted, it would offer two years' free tuition for the pursuit of an associate's degree to students whose families earn $40,000 or less.

It's not precisely scientific, but it's fair to say that under the current panoply of aid programs, at somewhere around the $25,000 to $35,000 annual family income level, lots of benefits disappear. For some Michiganians, that means it may be more lucrative to accept a low-paying job than it is to accept a higher paying one because the value of government benefits more than offsets the loss of income from more gainful employment.

Careful, empirical surveys could illuminate the extent to which current programs are having unintended, negative effects. Suffice it to say for now that simply recognizing that incentives and disincentives matter would be progress in the public-policy debate, and it just might make Lansing think twice before adding more programs to the problem.

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