Paper discussion 1 – Taxes and welfare systems

In class, we discussed the effect of welfare programs on the labor supply of individuals. In this week’s practice session, you can see how two academic papers used the standard labor supply model to derive and test predictions about the effect of an alternative to welfare benefits, the so-called “in-work benefits”.


The following questions should guide your reading and will be discussed in class:

1. What are “in-work benefits” and how do they differ from traditional welfare benefits?

2. Imagine a single mother with two children in the US could get a monthly maximum of traditional benefits (depending on the state) of about 500$ (combining Aid for Families with Dependent Children “AFDC” with food stamps) in 1996. The combined benefit reduction rate was around 70% of each dollar earned, so that she would not receive any benefits any more at earnings of 8570$. Assuming the single mother faces a wage rate of 5$ (the federal minimum wage at the time was 4.75$) and that the normal workweek contains 40 hours, how did the annual budget constraint look like (on a consumption-leisure graph)?

3. Using the information in figure 2 in Meyer (2002), how did the annual budget constraint look like if the single mother just worked and received the EITC?

4. Which of the two programs is more likely to encourage labor force participation?

5. Using the standard labor supply model: What does theory predict as the most likely effects of an increase in EITC generosity on (a) labor force participation and (b) hours worked?

6. Now we want to measure the causal impact of an EITC expansion empirically. Do you think it is sufficient to compare the LFP of single mothers before and after the change?
7. An alternative way could be to measure the effect as the difference between the LFP of the target group and a different group which should not be affected (the control group) after the reform was enacted. This is called the “difference”-estimator. Do you think this method yields the right results?

8. Which identification strategy are the authors of the two papers using? What are the assumptions needed to identify the effect as causal?

9. Write down the specification of the main probit estimation in Eissa and Liebman.

10. What is the reason for choosing single mothers as main treatment group and single women without children as main control group?

11. Why do the authors look at all female heads of household and not only those in the income range affected by the changes in the EITC?

12. What other treatment and control groups are used in Eissa and Liebman and why?

13. What are the main results of the two papers with respect to the EITC expansions in 1986 and the 1990s? Do they confirm the theoretical predictions? What are the authors’ conclusions from that?