

I. In-Kind Welfare

Targeting:

Nichols and Zeckhauser, in a 1982 AER article, present a rationale for in-kind welfare payments. In-kind transfers can be used to increase targeting efficiency. Targeting efficiency refers to the percent of welfare expenditures that reach the intended population. Individuals not in the targeted population may become 'impostors' in order to receive the welfare benefits. For example, the government may want to give welfare payment to those with low ability who are unable to earn a certain level of income. However, the welfare system may induce some high ability individuals to lower their income (and hence increase their leisure) in order to receive the welfare payments. The more impostors the welfare program creates, the less efficiently it is targeted.

Providing in-kind welfare in the form of an indicator good is a way to prevent impostors from receiving government welfare payments. Indicator goods are goods for which demand, holding income fixed, varies by ability level. For example, suppose that the low ability individuals have a higher demand for low quality processed cheese. The government could then provide means-tested welfare in the form of processed cheese. In order to qualify for the welfare, your income must be under a certain level. Given that level of income, the targeted group (the low ability) have a higher demand for processed cheese. The high ability are less likely to become impostors than if the welfare was given in the form of money.

"The key factor is that at any given income, intended recipients wish to consume more of an indicator good than impostors would." (See the graph on pg. 375 of Nichols and Zeckhauser)

A less frivolous example of an indicator good is health care. If the low ability are, on average, less healthy than high ability, health insurance may be an indicator good.

Ordeal Mechanism:

Another way to increase targeting efficiency is by attaching an ordeal mechanism to the receipt of welfare. An ordeal is an activity which is a pure deadweight loss. For instance, intentionally making the wait at a soup kitchen lengthy is an ordeal mechanism. Ordeal mechanisms are effective when the target population values the form of welfare being provided more than potential impostors. For example, rich individuals get 10 utiles from eating soup. They will eat at the soup kitchen if there is no cost. Poor individuals get 100 utiles from eating soup. If a wait is instituted that costs 11 utiles, then the rich individual will no longer eat at the soup kitchen and targeting efficiency has been increased. Another way to think about this is that the ordeal may confer different levels of disutility on the targeted and non-targeted populations. For example, waiting in line may cause relatively little disutility for those who are low-ability and have a low opportunity cost to waiting. Higher ability people, who have a higher opportunity cost, will suffer more disutility from waiting in line.

II. Welfare/Kinked Budget Constraints

Graph shows the budget constraints for a person who is deciding between leisure and consumption. The maximum number of hours is 2000. [You can also interpret the graph in terms of *labor supply* and consumption, if you think of leisure as 2000 minus labor supply.] This person earns \$10 per hour, if she works. The government guarantees at least \$5000 in income to every citizen.

Note the kink in her budget constraint at 500 hours of work/1500 hours of leisure.

With welfare, the person is unlikely to work in the vicinity of the kink. Why?

- ◆ If you choose >1500 hours of leisure, you might as well choose 2000 hours of leisure. By working an hour, you don't gain any income at all, but you lose an hour of leisure.
- ◆ If you choose 1499 hours of leisure, you can have \$5010 in consumption and 1499 hours of leisure. But if you were willing to sacrifice just \$10 in consumption, you could gain 501 hours of leisure. Unless you *really* prefer consumption to leisure, you'd probably choose to give up that \$10.
- ◆ If you choose 1498 hours of leisure, you have \$5020 in consumption and 1498 hour of leisure. If you sacrifice just \$20 in consumption, you could gain 502 hours in leisure. You'd probably choose to give up that \$20.
- ◆ Etc, etc, etc.

→ It seems quite unlikely that you will choose to consume at or near the kink!