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The welfare implications of increasing disability insurance benefit generosity

John Bound^{a,b}, Julie Berry Cullen^{a,b,*},
Austin Nichols^a, Lucie Schmidt^c

^aDepartment of Economics, University of Michigan, Ann Arbor, MI 48109-1220, USA

^bNational Bureau of Economic Research, Cambridge, MA, USA

^cDepartment of Economics, Williams College, Williamstown, MA 01267, USA

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Abstract

In order to evaluate whether workers are over- or under-insured through the Disability Insurance (DI) program, we develop a framework that allows us to simulate the benefits as well as the costs associated with marginal changes in payment generosity from a representative cross-sectional sample of the population. Under the assumption that individuals are reasonably risk averse, we find that the typical worker would value increased benefits somewhat above the average costs of providing them. However, whether the benefit increases tend to lower or raise utility when we average across all individuals in our sample is sensitive to assumptions that affect the relative marginal utility of income to disabled individuals.

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1. Introduction

Disability status is increasingly used as a means for targeting resources in the United States. In 1999, 5.6 million disabled individuals and 1.6 million spouses and dependent children received a total of \$42 billion in Disability Insurance (DI) benefits, represent-

* Corresponding author. Department of Economics, University of Michigan, Ann Arbor, MI 48109-1220, USA. Tel.: +1-734-764-2367; fax: +1-734-764-2769.

E-mail address: jbcullen@umich.edu (J.B. Cullen).

ing over one-eighth of the Social Security budget for benefit payments. Given its importance and continuing growth, an evaluation of whether the DI program provides adequate insurance against the income losses associated with the onset of severe limitations is overdue.

The empirical literature on DI has primarily focused on the impact of program parameters on the costs of the program, either in terms of caseload growth or reduced labor force attachment. This focus on the efficiency costs of DI provides an incomplete view of the social desirability of the program and of the adequacy of payment levels. The effectiveness of the program depends on how the costs relate to the social gains from redistributing toward individuals and states of the world with higher marginal utilities of income.¹ What is striking is that there has not been any explicit valuation of the benefits associated with providing DI.² In order to provide a more comprehensive view, our analysis accounts for both the benefits and costs associated with a marginal change in benefit generosity. Our goal is to determine whether, given the degree of moral hazard and screening stringency under the existing DI system,³ individuals are over- or under-insured, and which factors are important to drawing a conclusion.

How an individual worker fares under this marginal reform depends on the expected change in lifetime utility. This expectation in turn depends on the impact on the path of family income and work effort both in the case where the worker becomes disabled and either successfully or unsuccessfully applies for DI and in the case where the worker never applies, and on the likelihood of each of these outcomes. Our approach is based on the intuition that if the population is in steady state, a representative cross-sectional sample of the population can be thought of as capturing the distribution of potential life-cycle paths for a representative individual or cohort. We can therefore use observed income and labor supply patterns to simulate the impact of increasing DI benefits for current recipients, potential new applicants, and workers in the sample. Combining data from the 1991 March Current Population Survey (CPS) with plausible assumptions about behavioral responses, we calculate the expected financial benefits accruing to and financial costs borne by each individual in the sample as a result of a 1% increase in DI payments.

The ratio of the total costs associated with the reform to the increase in transfers to current recipients yields an estimate of the average implicit price of providing an additional dollar of income to recipients in the presence of moral hazard. This price exceeds one only to the extent that there are behavioral responses to the benefit increase that generate additional tax and transfer costs. We first use this average price to explore whether representative workers should find purchasing additional insurance through reduced take-home pay financially attractive.⁴ We then account for the underlying

¹ See [Diamond and Sheshinski \(1995\)](#) for an example of a theoretical framework designed to balance redistribution goals and labor supply disincentives in determining the optimal level of disability payments.

² There is a literature documenting the economic disadvantage of the disabled, but this literature has not posed the question in terms of insurance adequacy (e.g., [Haveman and Wolfe, 1990](#); [Burkhauser et al., 1993](#)).

³ The baseline for our analysis is the program as it was in 1990, though we also evaluate the results for a reciprocity base closer to the current size.

⁴ [Bird \(1996\)](#) carries out an analogous analysis for the EITC program, finding that the benefits from reducing income risk compare favorably to the tax costs for many middle income individuals.

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