

## Cash Transfers Exercise: (Dec 5: 9-10:30)

**This exercise is to be completed in small groups during the session on Friday, December 6 at 4:00. Please review the exercise prior to that session.**

Imagine that you are a senior social safety net advisor to the President of a low-middle income nation. Your country is experiencing an economic crisis because import costs have soared and export prices have plummeted. The President is very concerned about the alarming rise in poverty, despite a very well-funded cash-transfer-cum-social empowerment program.

Nearly twenty percent of the population are now classified as absolutely poor. Many of the poor are thought to be suffering very badly from the economic crisis. In theory, all households with incomes below the poverty line (set at R-\$ 625/capita) are supposed to be receiving a monthly cash assistance allowance, under the social empowerment program (SEMP program). But the results from a recent living standards measurement survey show that 40% of the poor don't receive any assistance at all while nearly half of the households in the country get a monthly SEMP program benefits allowance.

### Part 1: Family Allowance Versus a Minimum Income Guarantee

The President has just returned from an official visit to Europe. She's convinced that it would be better to substitute a family-allowance program for the income-tested SEMP program. She also wants to eliminate all of the other cash-transfer programs that the Government operates for specific groups (widows, disabled, orphans)--she feels that they are simply too much of an administrative burden. The President's proposal is to provide a monthly allowance to every family with a child under 14 years of age.

The national statistics service has just provided you with their latest summary statistics on household characteristics by income group (see attached Table 1). Use this information to answer the following three questions:

1. If a cash family benefit is provided for each child, what share of the cash transfers are liable to leak to non-poor households?
2. Are there other categorical indicators that could be used to better target family allowances to the poor? Are there certain categorical indicators that shouldn't be used?
3. Which categories of poor persons might be missed by a family allowance program?

### Part II: MERT Calculations and the Incentive Effects of a Flat-Rate Cash Transfer

The Minister of Finance is not fond of the idea of starting a new program. Instead, she proposes that the Government use categorical indicators and community screening to ensure that only those with an income below the poverty line are eligible for the monthly SEMP assistance grant. She suggests that the Government restrict the number of eligible beneficiaries under the fine-tuned SEMP program to the bottom twenty percent of the income earners. She proposes to accomplish this by restricting the number of program beneficiaries to 800,000 households, which is one-fifth of the total number of households in the country. Under her scheme, each poor household will be given a monthly grant of R-\$1,000 which, for a family of five, averages out to R-\$200 per person per month. She reckons that, on average, this should be sufficient to eliminate absolute poverty

since the difference between the poverty line and the average income of a poor family is also R-\$1000 per month.

The Welfare Minister thinks that better targeting is certainly a good idea, but has certain reservations about this proposal. He worries that the beneficiaries might be discouraged from working since the basic wage is just R-\$3,000./month. He also worries that the benefit might create a poverty trap since the marginal effective rate of tax for those just above the poverty line would be rather high.

The Finance Minister doesn't agree. She says that it doesn't matter if one is working for a minimum wage or not. As long as their income is below the poverty line, they'll get the cash grant. And furthermore, since the average tax rate on a poor family is just 10% (adding direct and indirect taxes), she doesn't see how there should be any tax issue to speak of.

Who is right? Please answer the following four questions:

Note: The Marginal Effective Rate of Tax (MERT) is equal to:

$$((\text{tax that must be paid} + \text{benefits lost}) / (\text{additional income earned})) * 100$$

- 1) Presuming that fine-tuned SEMP program is perfectly targeted, what would be the marginal effective rate of tax (MERT) for a family whose income would rise from just below the poverty line to R-\$500 above the poverty line? And the MERT for a family whose income would rise from just below the poverty line to R-\$1000 above the poverty line?
- 2) What incentive effects would such a program have on households whose income is modestly above the poverty-line level?
- 3) What might be the effects of such a program on the labor supply of the recipient population? What might happen to minimum wages? To wage-employment by the poor?
- 4) How could a minimum income guarantee type "cash grant" be designed so that it wouldn't discourage poor persons from seeking gainful employment (list two suggestions)?

### Part III. Better Targeting by Tightening the Exit Criteria

The Minister for Local Government and Provincial Affairs disagrees with both the Finance Minister and the Welfare Minister. She believes that the main problem is that the *exit-criteria* for the cash transfer program isn't operating. Once households become eligible for the cash grant, they don't want to give it up. Moreover, the local welfare officers don't want to withdrawal anyone's ineligibility for the cash grant since that might upset their relations within the villages. The Minister believes that targeting and transfer effectiveness can be improved if the SEMP program exit criteria is improved. She proposes three options for tightening the exit criteria. Which of these three options do you believe could help improve the effectiveness of the program?

#### *Exit Criteria Tightening Options:*

- a) Each few months, ask village leaders to draw up a list of those who don't need help anymore, and then drop those households from the eligibility rolls.

b) Require the head of household who is receiving the benefit to do 10 hours of community work per month and to attend classes on "managing your household finance". Those households who violate this requirement for three months in a row are struck from the beneficiary rolls.

c) Declare that the SEMP program has come to an end. Graduate everyone from the SEMP program. Start a new program for which there are new eligibility criteria. In re-certifying households, ensure that no more than one-fifth of all households are declared eligible and declare that no household may be eligible for more than two years.

#### Part IV. The Cash-Transfer Amount: funding a cash transfer program

The Finance Minister doesn't like to part with the Government's hard-earned cash and she is worried that the Government really can't afford to meet the needs of all of the poor people. She has calculated that the poverty gap (the triangle of income needed to catch-up to the poverty line) is equivalent to \$-Rs.1.5 billion. She only has an amount in the budget of \$-Rs. 850 million from Parliament for a new social assistance program. Is this budget adequate for the program? Has Parliament voted her too much or too few resources to fund such a program?

To answer this question, you should know that:

a) the Government already spends \$-Rp. 500 million to support the incomes of those in institutional care (i.e. prisons, charity wards, old age homes and orphanages).

b) families tend to provide cash transfers, in the form of remittances in cash and kind, equivalent to \$-Rp. 400 million per annum to the poor. Such remittances help to close the poverty gap, and are not recorded as "per capita income" in the figures listed below in Table 2; and

c). even with a well-targeted program, about 25% of the program recipients will be "non-poor" or unintended beneficiaries whose incomes are above the poverty line.

d) it is estimated that the cost of administering the program would add an additional 10% to the amount provided in cash-transfers.

[hint:  $\text{Transfer Budget} = (\text{Poverty Gap for the Target Group} - \text{Funds Already Provided} - \text{Private Transfers}) * (1 + \text{percent of unintended beneficiaries}) * (1 + \text{percent of administrative costs})$  ]

Per-capita Income Decile Groups (share of total household population)	Per-capita income R-\$	Average Household Size	Average Number of Children Under 14 years of age per household	Households Unemployed (%)	Households with Electricity Hook-ups (%)	Households with Cement Floor (%)	Landless households (rural areas only) (%)	Household Heads with a secondary or post-second education (%)	Households Receiving Social Empowerment Program Cash Transfers (%)
1 (10%)	0-459	6.2	3.3	1.0	14	7	79	4	61
2 (10%)	460-624	5.8	3.1	1.5	22	17	77	6	54
3 (10%)	625-762	4.2	1.7	3.3	68	52	31	49	58
4 (10%)	763-911	4.1	1.5	2.7	84	78	9	78	51
5 (10%)	912-1070	4.1	1.4	4.1	86	94	3	74	45
6 (10%)	1071-1279	4.0	1.4	6.2	88	97	4	89	38
7 (10%)	1280-1548	3.8	1.3	8.0	98	98	2	82	31
8 (10%)	1585-2041	3.7	1.3	7.4	99	98	2	88	22
9 (10%)	2042-3014	3.5	1.3	5.6	99	99	1	94	14
10 (10%)	3015 & above	3.4	1.2	4.2	99	99	1	92	5

Note: Each per capita income decile group contains exactly ten percent of the national population (20 million persons).

Source: National Statistical Service, *Household Consumption, Expenditure and Labor Force Survey*.