

## **The Effect of Transfer Income on Labor Force Participation and Enrollment in Federal Benefits Programs: Evidence from the Veterans Disability Compensation Program**

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This is the second phase of a project on the interactions between disability policy and labor supply, focusing in particular on the Veteran's Disability Compensation (VDC) program and its relationship to the Social Security Disability Insurance (SSDI) program and other Social Security benefits. In the first phase of the project, some theoretical background work was completed to better understand how disability benefits may influence labor supply. In particular, the study differentiated more clearly between the income and substitution effects associated with disability policy. Substitution effects may be important, if eligibility for benefits is contingent on not working, thereby imposing an implicit tax on work. Because SSDI benefits may be foregone by returning to work, for example, there is a financial incentive for SSDI recipients to remain non-working in order to retain their benefits. Income effects may be important on the other hand, if they make early retirement attractive, even if one could retain their benefits and work at the same time. A key aspect of VDC policy is that the benefits are largely non-contingent; they are received whether or not an eligible veteran continues working. Thus analyses of VDC policy enable us to isolate the income effect of disability benefits on work behavior in a way that is more difficult to differentiate for SSDI beneficiaries.

Our analysis focuses on the effects on behavior of a unique policy change in the VDC program. The VDC program currently provides income and health benefits to about three million veterans of military service. In July of 2001, the program was expanded to cover a broader set of conditions for veterans who had served in Vietnam with "boots on the ground." This policy change allows us to use other veterans as a comparison group when estimating the effect of this program. The empirical work in phase one was largely exploratory and relied on Current Population Survey data. The results were suggestive that the 2001 increase in VDC program eligibility substantially lowered labor supply among Vietnam era veterans. These findings therefore highlighted the possibility that income effects on labor supply could be sizable for near-elderly adults in moderate to poor health in the SSDI program as well. In other words, the observation that very few SSDI recipients ever return to work could be as much a result of the income effects of the program as the substitution effects.

This second phase of the project extends the analysis in two ways. First, it compiles much more comprehensive data on VDC beneficiaries. The core dataset for the second phase of the project was obtained from the U.S. Army's Office of Economic and Manpower Analysis (OEMA) and contains detailed demographic and service information for a sample of more than 4.1 million veterans, virtually all of whom left the Army between the years of 1969 and 1985. These core data were then linked using veterans' social security numbers to (1) the NCHS Master Death File, (2) Veteran's Administration data on enrollment and benefits in VA programs including disability compensation, and (3) SSA data on earnings, SSDI benefits, SSI benefits and OASI benefits. Second, because of the richness of the dataset,

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we have been able to explore the effects of veterans' disability benefits not only on labor supply, but also on the receipt of SSDI, SSI and OASI benefits.

Our findings confirm that the increase in VDC enrollment caused by the 2001 policy change led to a significant reduction in the labor supply of affected veterans. Our estimates suggest that on average, approximately 30 percent of individuals newly awarded benefits dropped out of the labor force, even though they could have continued working at the same time as receiving the benefits. This suggests that a large part of the effect of SSDI and other SSA-administered programs on labor supply may reflect the effect of additional income rather than the effect that the programs have on individuals' incentives to work.

The 2001 policy change also had an effect on enrollment in the benefit programs administered by the Social Security Administration. Most notably, it raised SSDI enrollment among veterans who became newly eligible for VDC benefits by a full percentage point. The most plausible mechanism for such an effect is straightforward – by causing some individuals to leave the labor force, the expansion in the VDC program reduced the costs of applying to the SSDI program for certain individuals. This likely led a large fraction of individuals to apply for SSDI. Our findings for the SSI program are less clear cut, though they suggest that if anything the increase in VDC enrollment may have reduced the number of people on SSI. This is not surprising when one considers that SSI is means-tested and thus the increase in VDC benefits may have caused some veterans to become ineligible for SSI. And finally, our results for OASI suggest that the program may have reduced the fraction of veterans claiming age-based retirement benefits early. This may be partly driven by the increase in SSDI enrollment described above and also by allowing some veterans to hold off on claiming and enjoy the benefits of the actuarial adjustment that increases OASI benefits.

The full working paper is available on our website, [www.nber.org/programs/ag/rrc/books&papers.html](http://www.nber.org/programs/ag/rrc/books&papers.html) as paper NB08-07.

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