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NEGATIVE INCOME TAXATION: A CHALLENGE TO SOCIAL ENGINEERS

by

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The field of social welfare is currently in turmoil. There is discontent with some of the programs we have and uncertainty about where we should go from here. The negative income tax is one of several proposals for change which have received encouraging response from specialists in the field. However, there seems to be only limited understanding of what negative income taxation is, how it would work, and what purposes it might serve. In this note we offer summary answers to those questions and then conclude with advocacy of one particular negative income tax plan.

What Negative Income Taxation Is.

The term, "negative income taxation", is something of a misnomer, since the concern is not with "negative income" or business losses. Rather, the word "negative" is meant to modify "taxation", and to indicate that the income tax system would be reversed to pay out money to people with incomes below certain levels. At present, the federal individual income tax has a set of rates that diminish from 70 per cent on increments of income at the highest levels down to zero per cent. The range of income over which a zero rate applies is determined by the level of exemptions (now $600 per person) and the minimum standard deduction (now $300 per taxpayer and $100 per dependent). Hence, for a family of four, the marginal tax rate is zero at and below $3,000 of income.

The idea of negative income taxation, which is, incidentally, an old idea among tax experts, is to run the progressive rates schedule below zero so that families with incomes less than the total of their exemptions and deductions would receive some fraction of the dollar difference in the form of a negative tax or outpayment from the treasury. For example, a four-person family with an income of $2,000 would ha ve $1,000 less than its exemptions and deductions, and it might be entitled to 14, 50, or 75 per cent of that $1,000 in the form of a negative tax. This would make the individual income tax symmetrical from the lowest to the highest incomes and would extend to the low income reaches distinctions in tax liability among families of different sizes that have the same income.

The logic is that if the principles of the income tax are acceptable for middle and high income families, then they ought to be acceptable for low income families as well. If the income structure is valid for taking money away from people, then why isn't is equally valid for giving money away to people? The relevant principles are (1) that a

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person's tax liability should be a function of his income and family size, and (2) that tax rates should decline with income. This logic does not instruct us as to how the rates should run below zero nor as to how other significant features of the tax law should be designed. The existing income tax may be said to have no character aside from its particular rates schedule and its definitions of income, taxpaying unit, and income accounting period. By the same token, we haven't said much about negative income taxation until we specify the nature of the choices open under these headings. Tax rates below zero could form a proportional, a regressive, or a progressive pattern. "Tax rate" in this context is the fraction of the income-gap or difference between actual income and break-even income (exemptions plus minimum standard deduction) which is to be paid out by the treasury. For example, a 50 percent tax rate would mean that a family of four with a $2,000 income (and, hence, a $1,000 income-gap) would receive a $500 negative tax. The tax rate on additional income, or the marginal tax rate, could be set at, or higher or lower, than the average rate of, in this example, 50 per cent. That is to say, if the family with $2,000 of income in one year were to increase its income to $2,500 in the next year, the amount of the negative tax could stay the same at $500, (in which case the marginal tax rate is zero) or it could fall to zero dollars (in which case the marginal tax rate if 100 per cent). In the latter case the rise in income is completely offset by the reduction in the negative tax allowance. One important aspect of the decision on a rates schedule is: what is the negative allowance to be in the case of a family of a given size with no income? Should that decision be for an allowance equal to the total of exemptions and deductions, then we are forced either to a 100 per cent marginal tax rate or to raising the break-even level of income above the total of existing exemptions and deductions. The harsh nature of choices begins to appear.

The definition of income also presents some difficult issues. Should a family be permitted to exclude all types of income now excluded under existing income tax legislation, such as social insurance benefits, interest on state and local government bonds, and one half of long-term capital gains? What about home-grown food and do-it-yourself construction? What about a self-employed businessman slaiming accelerated depreciation or an investment tax credit? Is the distinction between a family's "total income" and its taxable net income feasible for positive but not for negative income taxation? Is it a case of what is sauce for the taxpaying goose not being sauce for the negative tax-receiving gander? While recognizing the inconsistency, most would agree that a different definition of income is required for negative taxation in order to assure that allowances go only to genuinely poor people. To achieve the latter purpose, some would even require an imputation of income to non-yielding assets, such as idle land.

Similar questions arise in defining the tax unit. Under the positive income tax, the person with taxable income is encouraged to add dependents without income to his tax return and to exclude dependents with income. Under negative taxation the reverse is the case. A person without income would be encouraged to file separately. Unless existing rules were altered, wives and children without income might gain more by filing for negative tax allowances than the head of the family would lose by claiming them as dependents on his positive tax return. Again, if the purpose is to confine eligibility for negative tax allowances to people who really need them, special measures are needed to prohibit people like dependent spouses and children from filing separately and to require a joint return reporting the incomes of all family members.

In the existing tax law the income accounting period, except for certain income averaging and loss-carry-forward provisions, is one year. If one were to extend income taxation to the negative range, would it be desirable to have a longer or shorter accounting period? The argument for a longer period is that a family with a $10,000 per year income in years 1 and 3 does not need a negative tax benefit if their income falls to $2,000 in year 2. The argument for a shorter period (say, a quarter) is that a family needs immediate help if its income has been running at a rate of $3,000 per year but suddenly drops to zero for any given month. We confront, then, the fact of variability of income, one of many that make income tax design so difficult.

What, then, is negative income taxation? It is an extension of positive income taxation. But, just as is true of positive income taxation, the genus has many species which differ from one another in terms of tax rates schedules, and definitions of income, tax unit, and income accounting period.

How Would Negative Income Taxation Work?

Suppose Congress were to pass a law that answered all the questions we have posed thus far. Suppose they settled on a flat 50 per cent tax rate, an inclusive definition of income, a restrictive definition of eligibility to file a negative tax return, and a one-year income accounting period. How, then, would such an arrangement be administered? Here, again, a range of choices would be open. One would be for families to file at the end of the year, claiming allowances based on the income and family size of the previous year. Alternatively, a family could be allowed to file each month on the basis of the preceding twelve months. A second method would be for a family to declare an estimated income at the beginning of the year (or each quarter) and, if their income is expected to be below break-even levels, receive monthly allowances with a year-end adjustment for over or under payment when estimates of income or family size turn out to be in error. A third method would pay a standard monthly allowance to all families of a given size and then subject their incomes up to the break-even level to a withholding tax rate of 50 per cent. For example, every family of four could automatically get an annual allowance of $1,500 ($125 per month). If, during the year, that family earned $3,000 or more, its withholding tax would equal $1,500 and the net allowance would be zero. If, on the other hand, its annual earnings turned out to be $2,000, the withholding tax would be $1,000, the net allowance would be $500, and the total income after allowance would be $2,500. For those who had income not subject to withholding or who had a change in number of dependents during the year, a year-end adjustment for over or under payment would be needed.

One unusual problem of administration arises with regard to other transfer payments which are designed to vary with income. The clearest example is public assistance. One idea is to exclude public assistance benefits from income for negative tax purposes and let public assistance administrators adjust their payments to the introduction of negative tax allowances. However, to the extent that negative tax allowances go to those eligible for public assistance benefits, we are merely relocating financial responsibility from state and local treasuries to the federal treasury. If negative tax allowances are lower than assistance standards for break-even income, then the conditions for granting assistance dominate the conditions in the negative tax legislation. To the extent that public assistance benefits are payable on a different income accounting period than negative tax allowances, the possibility exists that two families that have equal pre-allowance annual incomes could end up with different post-allowance and post-assistance incomes.

The adjustment by public assistance administrators is only one among many possible adjustments that various actors could presumably make to negative income taxation. We do not have a good picture of "how it would work" until we review adjustments by employers, landlords, and others, especially by the family units. One critical matter is the adjustment in work effort by potential recipients of negative taxex. The classical economic analysis of the income-leisure choice predicts, both on the basis of income and substitution effects, that low income persons will work less after negative taxation is introduced. (Incidentally, this same analysis predicts no clear change by high income individuals to higher positive tax rates). However, it is possible that offsetting influences to blur this affect could come about from higher incomes giving rise to (1) new preferences for income as opposed to leisure and to (2) higher productivity via better health and education and improved mobility of labor. It is also likely that the particular definitions of key terms in the law and the method of administration would ater the work response of negative tax beneficiaries. For example, if current benefit changes lag income changes by several months, the disincentive effect may be less marked than if the two are simultaneous.

What Purposes Could Negative Taxation Serve?

Thus far we have reviewed questions of what negative income taxation is and how it would work. At every turn, we have specified options and conditional predictions. To arrive at a judgment about the first two questions, we need to give consideration to a third, namely, what purposes might negative income taxation serve?

Obviously, the outcome of negative income taxation is to narrow income differences between the rich and the poor. In this regard, it is similar not only to progressive income taxation, but also to transfer payments. Hence, it may be thought of alternatively as an extension of income taxation or as an addition to the present system of income maintenance. The latter, which encompasses public assistance, social insurance, and veterans benefits, now pays out over $40 billion in benefits per year. Each one of the separate transfer payment programs has its own rationale and its own pattern of benefits. The resulting composite system of benefits is not necessarily the one we might design if we set about it *de novo*. Hence, one might say the purpose of negative income taxation is to "corrent the imbalance" of existing transfers. What are those imbalances? In the first place, most of the present transfers go to the non-poor. Of the more than $40 billion, only about $11 billion go to the post-transfer poor, using the Social Security Administration guidelines for identifying the poor. Secondly, present transfers to the poor are biased against intact families with children present.

This suggests, then, a special role for negative income taxation, namely, to correct the bias against the poor and more particularly that against the intact families among the poor which the present American system of transfers expresses. The way to do this is to tailor the rates schedule and the definitions of income, tax unit, and income accounting period to take account of the circumstances and behavioral characteristics of this particular part of the nation's population. Of the 30 million poor persons, over 20 million are in household units not receiving public assistance and having one or more persons in the labor force. Few of the latter group are without some earned income in each year. These 20 million are what may be classified as "the working poor". A negative income tax designed especially for this group might reasonably differ from one especially designed for another group, say, those receiving public assistance benefits for the categories of old-aged, blind, disabled, and fatherless families. For the working poor, the level of the allowance in the event of no earnings would not have to be high, since most of them have some earnings, which when supplemented by negative tax allowances, would equal or exceed maximum public assistance benefits in the several states. Since we expect these people to work, it is important to keep the marginal tax rate low, on the strong presumption that the lower the marginal rate, the less the disincentive to work and to srive for property income.

A Negative Income Tax for the Working Poor.

The key features of a negative income tax aimed at the working poor are reflected in this table of allowances for a family of four persons. Parallel tables would be established for each family size.

(1) Pre-allowance Income	(2) Allowance	(3) Post-allowance Income	(4) Income-gap ($3,000 less Col. 1)	(5) Average Tax Rate (Col. 2 - Col. 4) Percent	(6) Marginal Tax Rate (Increment to Col. 2 - increment to Col. 1) Percent
$3500	$ 70	$3430	$ 500	14	14
3000	0	3000	0	0	50
2500	250	2750	500	-50	50
2000	500	2500	1000	-50	50
1500	750	2250	1500	-50	50
1000	750	1750	2000	-37½	0
500	750	1250	2500	-33 1/3	0
0	750	750	3000	-25	-

As we move down the income scale in Column (1), the tax rate changes from positive to negative at the poverty line and the allowance increases to maximum at a pre-allowance income of one-half the poverty line income. Through a 1500 dollar income range the marginal tax rate is 50 per cent, but at all other low income levels it is zero or 14 per cent. The maximum size of the allowance is deliberately selected to be far below a subsistence level of income for a family of this size and, hence, not to offer an attractive alternative of subsistence income at no work. If a family is literally able to gain no income in the form of earnings, property, or social insurance, then it would, under this plan, just as is true under present laws, need to apply for public assistance. In other words, the lowest rows of the table are not meant to be operative except in a few unusual cases.

Most of the poor four-person families are not on assistance and most of them have incomes from work in the $1500-2999 range. Hence, this particular plan would supplement earnings of most poor families of this size by up to $750 per year. It would pay lesser amounts to smaller families and unrelated individuals and larger amounts to larger families. While it would not take any family out of poverty, it would fill one-half the poverty income gap for most of the 23 million poor persons not presently on public assistance. It would do this at a cost to the treasury of approximately $4 billion, which would need to be collected from non-poor income taxpayers.

It is, of course, possible to design negative plans to cost either less or more than $4 billion. Some are meant to take over the role of public assistance and, therefore, provide a high maximum allowance and carry a high marginal tax rate. Some have a break-even level of income far above the poverty line, with the result that much of the allowance money will go to non-poor families who will be converted from positive taxpayers to negative tax-allowance receivers. A plan to pay a maximum allowance equal to poverty-line incomes would cost in the neighborhood of $25 billion after deducting $6 billion which would be saved by the complete elimination of public assistance. There does not appear to be any way to raise all American incomes above poverty-line levels via transfers for anything less than that amount.

Negative income taxation needs to be compared with other methods that could be used in pursuit of similar goals. One method is to reform and extend public assistance to reach more of the 30 million poor. Only 8 million of the 30 million poor are presently on assistance. Several million could be reached by an expanded AFDC-UP program (Aid to Families with Dependent Children having an Unemployed Parent), which is being modified to have a 66 2/3 per cent marginal tax rate rather than the traditional 100 per cent rate.

A second alternative is a family allowance, not an income-conditioned one of the sort implicit in a negative income tax, but one paid out on a flat per-child basis. Since there are over 70 million children in the country, a yearly allowance of $60 per child would cost over $4 billion, about 10 per cent of which would be reclaimed if the allowance were made taxable. Less than $1 billion of this would accrue to poor families.

It seems to me that an expenditure of $4 billion through a negative income tax of the type described would accomplish more than $4 billion on either of the albernatives. It is better adapted to the special needs of the working poor than is the extension of public assistance with its high maximum allowances and high marginal tax rates. It is preferable to a non-income-conditioned family allowance because it is more efficient per dollar of cost.

Whether this negative income tax plan, or any varient of it, is to become a reality will depend heavily upon the ability of our "social engineers" to satisfactorily define income, tax unit, and income period, and to design a workable method of administration. Some work has been done on this, but much more remains to be done in order to provide a basis for the public and the Congress to decide whether the adoption of negative income taxation would "promote the general welfare".

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