The antipoverty significance of the Tax Reform Act of 1986

According to Sheldon Danziger, the new tax bill marks a reversal in tax policy toward the poor.[1] For much of the last decade, poverty and inequality have been increasing, particularly for families with children (see Table 1). At the same time that their income share was decreasing, those at the bottom of the income distribution faced tax increases.

In 1975, the year of the most progressive federal tax treatment of the poor, the earned income tax credit (EITC) was introduced to subsidize the earnings of low-income families with children. In that year, for example, a family of four at the poverty line received a federal income tax credit of $250 (−4.55 percent of $5,497). Since that time, however, the three major pro-poor devices in the personal income tax—the EITC, the standard deduction, and the personal exemption—have been severely eroded by inflation. By 1985 such a family paid $370 in income taxes (3.37 percent of $10,988), an increase of $620. If one adds the increased burden of social security (payroll) taxes over this decade, then federal taxes paid by this family were about equal to the amount of food stamps it could have received in 1985. (But food stamps do not offset taxes, especially since many families are ineligible or fail to apply for this benefit.)

By increasing the standard deduction, the personal exemption, and the EITC and indexing them to inflation, the Tax Reform Act of 1986 will, by 1990, result in a negative federal personal income tax liability once again for a poverty-line family of four. The personal exemption is being raised from $1,080 to $2,000 by 1989; the standard deduction for joint filers is being raised from $3,670 to $5,000, and for single heads of households, from $2,480 to $4,400; and the EITC will increase to $840 by 1987 and $910 by 1989.[2]

Yet the new law does little to offset the increased poverty and inequality attributable to adverse market forces and reductions in income transfers that have characterized the period since 1973. As a result, Danziger suggests two additional income tax reforms that could aid the working poor without taking them through the welfare system:

1. A per capita refundable credit to replace the personal exemption. This credit would target more forgone revenue on those with lower incomes than would an increase in the personal exemption. A per capita refundable credit could be made high enough to replace both the personal exemption and the food stamp program.[3]

2. A refundable child-care tax credit. The current nonrefundable credit allows couples, when both spouses work, as well as working single parents, to subtract from their taxes a proportion of their work-related child-care costs. Very few poor families make use of this credit, however, because they do not have enough positive income tax liability to offset any refund to which they are entitled.

Danziger believes that the 1986 Tax Act means that antipoverty policy has reappeared on the national agenda. As such it can be extended in ways that will not threaten the efficiency effects of the recent tax reform and will have smaller disincentive effects on work and the family than programs to aid the poor through the welfare system. ■

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[1] This material is taken from Danziger's "Tax Reform, Poverty, and Inequality," IRP Discussion Paper no. 829-87, prepared for the Western Michigan University Department of Economics Lecture Series on Tax Reform in the U.S., supported by the Upjohn Institute for Employment Research.

[2] For a discussion of the changes in the EITC, see Eugene Steuerle and Paul Wilson, "The Earned Income Tax Credit," *Focus* 10:1, Spring 1987.

[3] See Irwin Garfinkel and Robert Haveman, "Income Transfer Policy in the United States," in Edward Seidman, ed., *Handbook of Social Intervention* (Beverly Hills, Calif.: Sage Publications, 1983). Available as IRP Reprint no. 473.

Table 1

Mean Before-Tax Money Income of Families with Children by Income Quintile in 1984 Dollars, 1967–1984, Selected Years

	Mean Before-Tax Money Income of Quintile					Mean of All Families	Percentage Poor[a]
	1	2	3	4	5		
All families with children							
1967	$9,347	$18,950	$25,602	$33,276	$54,665	$28,369	13.5%
1973	9,308	20,678	28,988	38,796	63,258	32,206	11.4
1979	8,057	19,179	28,855	38,203	61,256	31,138	12.7
1984	6,142	16,491	25,836	36,967	62,198	29,527	17.4
Percentage change							
1967–84	−34.3	−13.0	+0.9	+11.1	+13.8	+4.1	+28.9
1973–84	−34.0	−20.2	−10.9	−4.7	−1.7	−8.3	+52.6

Source: Computations from computer tapes of annual Current Population Survey.

[a] Percentage of all persons in these families with incomes below the official poverty line.