The NIT as income tax reform

by Christopher Green

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During the last decade the idea of a negative income tax (NIT) as the centerpiece program in antipoverty policy has faded politically to near extinction. Even if political support were favorable, I doubt that the NIT is currently a practical antipoverty proposal. Having made this admission, however, I hasten to say that I did not come to bury the negative income tax, but rather to suggest that the idea of negative taxes as part of the (positive) individual income tax system still lives. If this sounds contradictory, let me explain.

Early in 1965, the newly created Office of Economic Opportunity (OEO) asked Robert Lampman to investigate the means of opening a "second front" in the War on Poverty. OEO, which had been established in 1964, had opened its first "front" in the "war" with hands-on-type programs such as Job Corps and Head Start. However, as potentially productive as those programs were, they suffered from limited scope and the long-run nature of their beneficial effects. The "second front" was therefore to supplement the first one by introducing a program(s) with broad coverage of the poor and the capability of immediately getting cash into the hands of those with little or no income. The social insurance programs (OASDI and UI) had obvious limitations because they are status- rather than income-tested (i.e., one had to have a connection to the labor force to qualify). The major means-tested program, Aid to Families with Dependent Children, suffered from numerous deficiencies: insufficient funding; indefensibly large interstate variability; stigma; nonavailability to the "able-bodied" and working poor; and implicit 100 percent tax rates. Lampman suggested a new, universal, income-tested program: an NIT fit the bill.

There was much in favor of a negative income tax plan. An NIT has theoretically appealing features and had an evident ability to cut across ideological differences. Moreover, introduction of an NIT would force welfare reforms. Thus an NIT seemed like an economist's dream come true. It would reduce poverty, reduce income inequality, reduce the inefficiencies associated with public assistance, and make an end run around the Byzantine politics of welfare and poverty. It was hard to foresee in the ebullient mid-1960s that this was not the way it would work out. Perhaps if we had been students of public choice theory we might have realized that supporters of the existing welfare system would respond to the threat to their own programs by increased spending to combat poverty. Thus by the early 1970s, an NIT offered little as a weapon to further reduce poverty, yet, because of its initial association with the War on Poverty, the proposal lacked much of a constituency outside the domain of poverty researchers and welfare reformers. To all intents and purposes the NIT as an antipoverty program was dead. (Lest I be misunderstood I am *not* saying that issue of poverty reduction is "dead," or that the U.S. economy can outgrow poverty, which it certainly is not doing,[1] just as the United States has not and will not outgrow its budget deficits.)

What wasn't dead, although confined to a few ivory towers, was the idea of negative taxes as part of income tax reform. The mechanism is refundable tax credits; the goal of reform to replace personal exemptions in the income tax with tax credits and then to make the credits refundable if they exceed tax liability. To my knowledge, the first economist to propose that negative income taxation be implemented as refundable tax credits was Earl Rolph.[2] He convinced me, and I presume others, that refundable tax credits were the simplest and most elegant means of implementing an NIT. Unfortunately, the nature of the tax credit proposal would do more to supplement low incomes than it would do to reduce poverty, and could in no way provide a necessary minimum income guarantee for units without other income. It therefore would not become a full-fledged substitute for welfare; it would have to bypass the issue of welfare reform; and it would be more easily rationalized as tax reform than as an antipoverty weapon. Some of these assertions need explanation.

One of the favorite methods of implementing an NIT within the income tax system was the unused exemption and deduction method proposed by Friedman.[3] Since the domain of the NIT would not cover any part of the domain of the positive tax schedule (i.e., the former applied to levels of income exempt from positive taxation), one could propose (negative) tax schedules with 50 percent tax rates. If exemptions were set at something close to the poverty line, an NIT with a 50 percent offset rate could guarantee an income of 50 percent of the poverty line to each tax unit. The result would be that the positive income tax system would experience declining marginal rates over low-middle-income levels.

In contrast, substituting refundable tax credits for exemptions would mean that the existing positive income tax schedule would apply from the first dollar of income. Unless one were to radically alter the shape and level of the *positive* income tax schedule (moving from higher to lower marginal rates), refundable tax credits would have to be kept at modest levels. At a tax-back rate of, say, 15 or 20 percent, the credits could only be a small fraction of poverty line incomes, if the bulk of the population were to pay positive taxes net. Thus the refundable tax credit scheme, in its simplicity and elegance, was not really a workable antipoverty scheme. Like the unused exemption-deduction method of implementing an NIT, refundable tax credits have not been seriously considered as a central program in combating poverty. I suggest, however, that we reconsider the refundable tax credit in a program of tax reform, and I will refer to the Canadian experience to illustrate its potential viability.

Implementing refundable tax credits

The Canadian government has unintentionally, and without much notice, taken two steps toward the introduction of a negative income tax system. The first step took the form of adding, in the late 1970s, a refundable child tax credit to the individual income tax, the government's solution to reducing the relative importance of family allowances in its overall program of income support for families with children. The second step was to use the opportunity for tax reform to replace the personal exemptions in the income tax system with nonrefundable tax credits, setting the stage for their eventual conversion to refundability. That stage, however, is not likely to occur soon. Aside from Canada's large budget deficit, there are several problems in administering the income tax that need to be resolved. One is that most of the nonrefundable credit is attributable to the tax filer and his (or her) spouse. To make the credit refundable would represent a major transferral of income support away from families with children and would raise the specter of single individuals or childless couples living off the (refundable) tax credit. It would also raise the specter of spousal breakup, since eligibility for refund would require the tax filer to do what is now done for child tax credits: add in the income of one's spouse and other "supporting persons." Finally, conversion from nonrefundability to refundability would make it necessary to add social assistance payments to the calculation of net income, as is now done in the calculation of income for the purposes of determining the child tax credit. Ultimately, making all credits refundable would force a rethinking of the role of the social assistance program.

Conclusion

The tax-credit approach makes the most administrative and political sense if one wishes to implement negative taxes. The Canadian child tax credit and the recent conversion of exemptions to tax credits, which are now nonrefundable but which could become refundable, offer a sensible means of ultimately implanting an NIT in the income tax system. Among other things, the refundable-tax-credit approach is an implicit recognition that "administration matters." The tax-credit device potentially hides those dimensions of the system which some believe will produce harmful disincentive effects. The tax-credit approach, by focusing on tax reform, sidesteps the political deadend of a war on poverty. It also sidesteps the debate over whether social welfare programs create their own dependence or whether we have a "two-class" (rich and poor) economic system.[4] Finally, the tax-credit device is a particularly effective device for providing untainted income support if most poverty is relatively temporary, as Sawhill suggests is the case.[5] Thus the NIT, the idea which Robert Lampman did so much to launch and make academically credible, is not dead after all. In an age when tax reform is the watchword, refundable tax credits are the most obvious and effective means of bringing an NIT to fruition.■

[1] Peter Gottschalk and Sheldon Danziger, "A Framework for Evaluating the Effects of Economic Growth and Transfers on Poverty," *American Economic Review*, 75 (March 1985), 128–138.

[2] "The Case for a Negative Income Tax Device," *Industrial Relations*, 6 (1967), 155–165.

[3] Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

[4] M.W. Plant, "An Empirical Analysis of Welfare Dependence," *American Economic Review*, 74 (September 1984), 673–684.

[5] Isabel Sawhill, "Poverty in the U.S.: Why Is It So Persistent?" *Journal of Economic Literature*, 26 (September 1988), 1073–1119. Also available as IRP Reprint no. 599.