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TAX REFORM, POVERTY,
AND INEQUALITY

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Abstract

The Tax Reform Act of 1986 is the most significant antipoverty legislation of the last decade. The increased personal exemption, the increased standard deduction, and an increase in the amount of the earned income tax credit and the number of families who will be eligible for it will remove about six million poor and near-poor families from the tax rolls. These devices will be indexed for inflation.

Yet, because poverty and income inequality increased substantially in the 1970s, and because economic growth alone is not sufficient to aid many of the poor, some further tax reforms are proposed. These include replacing the personal exemption with a per capita refundable credit, and, more ambitious, raising the value of the per capita refundable credit to a level that will enable it to replace both the personal exemption and the Food Stamp program. A second proposed reform is to make the child care tax credit refundable so that it can be used by greater numbers of poor and near-poor families.

Tax Reform, Poverty, and Inequality

I. INTRODUCTION

The Tax Reform Act of 1986 is the most significant antipoverty legislation of the last decade. It is important not only for the $5 billion a year in tax relief it provides to the working poor but also because it reflects bipartisan support for using the tax system to increase the incomes of the working poor.[1] The consensus to aid the poor that emerged during debate over the 1986 Act is particularly important because the Reagan administration had previously disavowed using tax reform for distributional purposes. In his 1982 Economic Report, President Reagan stated:

> As a result of the passage of the historic Economic Recovery Tax Act of 1981, we have set in place a fundamental reorientation of our tax laws. Rather than using the tax system to redistribute existing income, we have significantly restructured it to encourage people to work, save and invest more (p. 6).

The Economic Recovery Tax Act (ERTA), unlike the 1986 Act, did not aid the working poor. Quite to the contrary, it actually increased their tax burdens. In addition to their adverse treatment by ERTA, the working poor have been adversely affected by two major economic and policy changes. First, the economic stagnation of the past fifteen years raised poverty and income inequality well above the levels achieved during the mid-1970s. And, although the current recovery has been long and robust, the poor have gained disproportionately little. Second, the Reagan budgetary retrenchment of the early 1980s reduced income transfers and social spending that was targeted on the poor and the near-poor. As a result, many low-income families who would have received benefits had social programs not been cut, receive no benefits today. And, despite the beneficial effects of the 1986 Act, the poor still have not regained their mid-1970s level of living.

Thus, since the early 1970s, changes in all three mechanisms by which income is generated and redistributed--the market, income transfer programs, the tax system--have tended to increase poverty. As I show below, the prospects for affecting the market-generated distribution of poverty or for reforming existing income transfer programs are not good. Thus, if poverty is to be reduced by 1990 to the level that existed in the early 1970s, even if the economy continues to grow without recession, we must move beyond the 1986 Tax Act. Although the Act eliminated the personal income tax burden for most of the poor, I conclude that further tax reforms offer the best way to aid the poor--particularly the working poor--in the late 1980s. Reforms such as those discussed below are feasible and are preferred by both taxpayers and the poor to reforms which would aid the working poor by taking them through the welfare system. But first we must ask whether the reduction of poverty is a legitimate goal to pursue.

II. WHY WORRY ABOUT EQUITY?

Why should an economist worry about the distribution of income in general and poverty in particular? Shouldn't s/he be interested in raising productivity and in achieving the most from society's scarce resources? Shouldn't the pursuit of efficiency be the primary goal? Isn't that why most of the papers in this volume emphasize the effects of taxes and tax reform on work, saving, capital accumulation, and economic growth?

My answer is "yes, but." If we were starting from an initial situation in which the endowments that individuals brought to the market had been attained in a market free of imperfections such as discrimination, then the answer would be much more emphatic for the "yes," and much more wavering for the "but." This is because given an initial distribution of income, the market, when all the assumptions of perfect competition are met, will produce the most efficient allocation of scarce resources. The goods to be produced and the resulting prices will determine an efficient post-market distribution of income. However, if we judge the initial distribution of endowments unfair, then we may want to change the distribution of income that results from the market, even if it has resulted from a perfectly competitive market process.

This highly simplified textbook example is relevant to the theme of this paper because the War on Poverty was premised on the belief that both the initial endowments being brought to the market by the poor and disadvantaged and how those endowments were compensated were adversely affected by market imperfections. If one accepts these underlying premises of the War on Poverty as still relevant 20 years later, then there remains a basis for public policies that provide more equality and less poverty than currently exist.

A call for expanded use of the income tax to aid the poor does not tell us how much more aid could promote equity without impairing efficiency. Indeed two recent articles, Joel Slemrod's (1983) "Do We Know How Progressive the Income Tax System Should Be?" and Anthony Atkinson's (1983) "How Progressive Should Income Tax Be?" each review the literature on the optimal income tax and reach no definitive conclusions. The answer depends, first, on how we value various degrees of inequality, that is, on our social welfare function; second, on how responsive taxpayers are to marginal tax rates; and third, on the distribution of endowments that generate the pretax (market) distribution of income. In general, Slemrod and Atkinson offer little more than the boundaries of the trade-offs--guidelines that argue against excessively high marginal tax rates without specifying the level at which efficiency losses become large.

Alan Blinder (1982) is much less technical, but much more eloquent. He concludes that:

> ...what this country needs now in the realm of income distribution policy is exactly what it needs, and has often been unable to get, in so many other problem areas: An economic policy with a hard head and a soft heart. A hard head to remind us of the wondrous efficiency of the marketplace, and how foolish it is to squander this efficiency without good reason. And a soft heart to remind us that championing the cause of society's underdogs has long been, and remains one of the noblest functions of government (p. 30).

My call for aiding the working poor through tax reform rather than welfare reform is based on a review of the efficiency effects of income transfer programs (see Danziger, Haveman, and Plotnick, 1981).[2] Because welfare programs involve much higher marginal tax rates than those put into place by the 1986 Tax Act, providing the same amount of aid to the poor through tax reform would have a lower efficiency cost than would providing it through welfare programs.

III. WHY NOT RELY ON ECONOMIC GROWTH?

Why argue that the income tax be reformed further to provide more aid for the poor? What about the importance of economic growth, which raises rather than redistributes income? Again, a careful review of the empirical literature suggests that economic growth is necessary, but not sufficient to aid many of the poor (see Gottschalk and Danziger, 1984; Danziger and Gottschalk, 1986).

This issue was clearly recognized at the early stages of the War on Poverty. In 1964, President Johnson stated:

> We cannot, and need not wait for the gradual growth of the economy to lift this forgotten fifth of our nation above the poverty line. We know what must be done and this nation of abundance can surely afford to do it (p. 15).

Growth was to be an important tool, but only one of many, in the fight against poverty.

The Johnson administration set in motion a vast series of policy changes that placed the question "What does it do for the poor?" at the top of the nation's domestic policy agenda. Robert Lampman (1974) has argued that all government programs and policies--those related to education and transportation, for example, as well as those related to tax and income maintenance programs--had to explicitly address their impacts on the poor. In my view, a major barrier to reducing poverty today is the fact that this question is now only rarely asked.

When President Reagan announced his program for economic recovery in 1981, he stated:

> The goal of this administration is to nurture the strength and vitality of the American people by reducing the burdensome, intrusive role of the federal government; by lowering tax rates and cutting spending; and by providing incentives for individuals to work, to save, and to invest. It is our basic belief that only by reducing the growth of government can we increase the growth of the economy (p. 1).

Thus, the question "What does it do for the poor?" was replaced by the question "What does it do for incentives to work and save?" Irving Kristol (1984), expanding on this view stated that:

> The administration's social policy cannot be understood apart from its economic policy--which is a policy of growth not redistribution.

I believe that this shift in domestic priorities helps explain why poverty declined rapidly as the economy grew in the late 1960s and why poverty has declined so slowly in the current economic recovery.

Ronald Reagan is not the only one who has chosen not to follow the path I am advocating and not to place antipoverty policy via tax reform high on the agenda. Henry Aaron (1985), in "How to Make the President's Good Tax Reform Plan Even Better," listed three serious problems with the federal income tax: (1) a narrow tax base; (2) unnecessarily high marginal tax rates that result from the narrowed tax base, with both of these problems leading to distortions in consumption, saving, investment, and production; and (3) the deficit, that is, too little tax revenue. Also, in Aaron and Galper (1985) one finds much concern with horizontal equity --the equal treatment of those with equal incomes--as a way to reduce the "tax-induced distortions of labor supply, saving, investments and risk taking," but little discussion of vertical equity or the need to increase the progressivity of the existing system.

The president wanted a bill that was both revenue neutral and distributionally neutral--that is tax reform that broadens the tax base and lowers marginal tax rates in such a way as to leave total revenue unchanged, that maintains the existing degree of progressivity, and achieves horizontal equity. So if Aaron only explicitly criticizes revenue neutrality, he must implicitly accept distributional neutrality.

It is evident, therefore, that public policy discussion has shifted away from a concern with poverty and inequality. Yet recent trends in the level and distribution of family incomes demonstrate a need for further reform of the personal income tax.

IV. RECENT TRENDS IN FAMILY INCOME

The period since the early 1970s has been not only one of economic stagnation but also one of increasing inequality. These macroeconomic changes contradicted two of the key assumptions of the War on Poverty-Great Society planners. First, they thought the business cycle could be controlled by the tools of Keynesian economics, so that poverty could be fought against a background of healthy economic growth. Second, they believed that in such an economy, with low unemployment rates and with antidiscrimination policies and education and training programs in place, everyone--rich, poor, and middle class--would gain. At a minimum, it was expected that economic growth would be proportional and that all incomes would rise at about the same rate. At best, income growth for the poor would exceed the average rate.

The facts demonstrating the failure of these assumptions are clear, but explanations for the failure are much more difficult. For most of the post-World War II period, family income, adjusted for inflation, grew at an annual rate exceeding 3 percent per year. Since 1973, however, growth has been minimal. There were three recessions--1974-75, 1979-80, 1981-82--and unemployment has remained at the 7 percent level through the mid-1980s despite the longer-than-average length of the current recovery. By historical standards, the current recovery is a very good one, but it is a recovery from the very depressed levels of 1981, not an economic high-water mark for the economy.

Table 1 compares the average annual growth in mean family income, adjusted for inflation, for the 1949-1969, 1967-1973, and 1973-1984 periods. The two postwar decades saw rapid growth in family income among both two-parent and female-headed families with children. Mean family

Table 1

Average Annual Rate of Growth of Real Family Income, 1949-1969, Compared to 1967-1973 and 1973-1984

	Annual Rate 1949-1969[a]	Annual Rate 1967-1973[b]	Annual Rate 1973-1984[c]
All Families with Children	5.75%	2.25%	-0.75%
White	5.00	2.34	-0.69
Black	8.34	2.73	-0.96
Hispanic	5.88	n.a.	-0.63
All Two-Parent Families with Children	6.17	2.96	-0.28
White	6.18	2.86	-0.33
Black	10.41	4.67	+0.35
Hispanic	6.39	n.a.	-0.23
All Female-Headed Families with Children	5.67	0.21	-0.71
White	5.68	0.02	-0.71
Black	9.92	1.23	-0.71
Hispanic	5.02	n.a.	-1.21

Source for 1949 and 1969 data: Computations by the authors from the computer tapes from the 1950 and 1970 decennial Censuses.

Note: While the Current Population Survey did not collect information on Hispanic origin in 1967, the decennial Censuses did collect those data.

[a]Defined as 100 x [(1969 real income - 1949 real income)/1949 real income] ÷ 20.

[b]Defined as 100 x [(1973 real income - 1967 real income)/1967 real income] ÷ 6.

[c]Defined as 100 x [(1984 real income - 1973 real income)/1973 real income] ÷ 11.

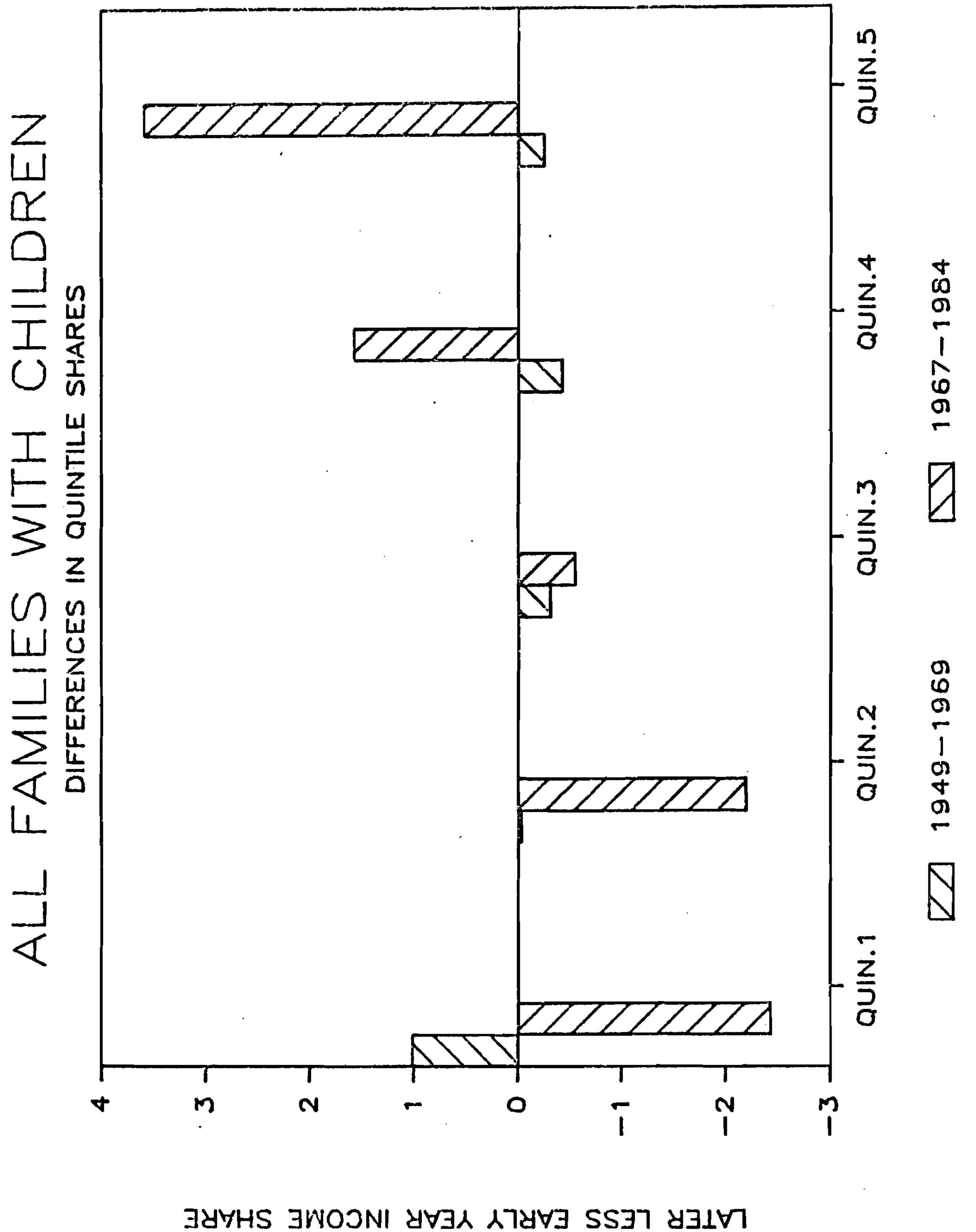
incomes grew by about 6 percent per year. Between 1967 and 1973, growth was about 3 percent per year for two-parent families and less than 1 percent for female-headed families. Growth per year was actually negative from 1973 to 1984 for 11 of the 12 rows in the table.

Changes in the mean indicate how the "typical" family fared, but they obscure the differing patterns of income changes that have occurred for families at different positions in the income distribution. To see how families of "low," "middle," and "high" income have fared, we classify families with children into one of five quintiles and compute the percentage of income received by each of these fifths of families. Changes in income shares provide a useful indicator of changes in income inequality.

Just as with mean family income, the trend in quintile shares since 1967 differs dramatically from the period covering 1949 to 1969. Chart 1 shows the change in the proportion of aggregate income received by each quintile during the 1949-1969 and 1967-1984 periods. During the earlier period, the income distribution shifted somewhat toward less inequality as the lowest quintile increased its share and the shares of the other four quintiles declined a small amount. The share of the lowest 20 percent of all families with children increased by 1.02 percentage points while the share of the highest 20 percent declined by 0.25 percentage points. Between 1967 and 1984, inequality increased--the income share of the bottom three income quintiles declined and the share of the top two increased. The share of the bottom quintile declined by 2.43 percentage points while the share of the top quintile increased by 3.59 percentage points.

Table 2 shows the mean income in constant 1984 dollars for each quintile of families with children. Also shown are the mean incomes of these

Chart 1



ALL FAMILIES WITH CHILDREN
DIFFERENCES IN QUINTILE SHARES
LATER LESS EARLY YEAR INCOME SHARE
4
3
2
1
0
−1
−2
−3
QUIN.1
QUIN.2
QUIN.3
QUIN.4
QUIN.5
1949−1969
1967−1984

Table 2

Mean Income of Families with Children by Income Quintile in Constant Dollars, 1967–1984
(1984 dollars)

	Mean Income of Quintile: 1	2	3	4	5	Mean of All Families	Percentage Poor[a]
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,							
1967–1984	−34.3	−13.0	+0.9	+11.1	+13.8	+4.1	+28.9
1973–1984	−34.0	−20.2	−10.9	−4.7	−1.7	−8.3	+52.6

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

families and the percentage of persons in them with income below the poverty line.[3] The mean income in a quintile changes when its income share changes and when the amount to be shared (aggregate income) changes. For example, between 1967 and 1984, mean income for all families increased by 4.1 percent, but the share of the lowest quintile declined sufficiently to result in a 34.3 percent decline, from $9347 to $6142. Over the same period, the mean income of the highest quintile increased from $54,665 to $62,198 because its share of the growing mean increased. A typical family in the second quintile lost 13 percent ($18,950 to $16,491) while one in the fourth quintile gained 11.1 percent ($33,276 to $36,967). Thus, there were shifts in income not only from the poorest to the richest families, but also from lower-middle-income to upper-middle-income families.

With mean incomes declining and inequality increasing, it comes as no surprise that poverty rates increased between 1973 and 1984. The last column of Table 2 shows the incidence of poverty using the federal government's official definition of poverty. Poverty for all persons living in families with children declined between 1967 and 1973, increased somewhat between 1973 and 1979, and then increased rapidly between 1979 and 1984.[4]

What was happened in the past 15 years is clear--income growth has been disappointing on average and poverty and inequality have increased. The reasons put forward for these disappointing economic developments can be catalogued as resulting from demographic changes, from economic changes, or from government policy changes. All have been advocated as the primary causal factor by one or more analysts. My own view is that each has probably been important, but that we do not have enough evidence to carefully apportion the blame.

Let me merely list some of these factors:

- Demographic changes. The baby-boom generation surged into the labor market, as did wives. The economy created many new jobs, but wage rates were often low. The ratio of female to male wages did not rise despite the occupational and experience gains by many women. Unemployment rates remained high. Divorce rates increased as did the percentage of children born out of wedlock.

- Oil price shocks. These price changes first caused rapid inflation and severe economic dislocations in oil-importing areas of the nation; then, deflation and dislocation in oil-producing areas.

- Changes in industrial structure. Manufacturing employment declined; employment in service industries increased. International competition and an aging domestic capital stock both contributed to these changes.

- Disincentives due to government programs. Because government benefits increased at the same time employment opportunities decreased, some workers who would have taken low-wage jobs dropped out of the labor force and drew on government benefits instead.[5]

V. THE REDISTRIBUTIVE EFFECTS OF THE PERSONAL INCOME TAX, 1964-1985

While the income distribution was moving slowly toward greater equality in the two post-World War II decades, so was the personal income tax. Minarik (1985) notes that the two most important devices promoting this trend were the introduction of the minimum standard deduction in 1964 and the earned income tax credit in 1975. Progressivity also increased for the unintended reason that inflation was pushing middle- and upper-middle-class taxpayers into higher and higher marginal tax brackets. Many analysts believe that these higher marginal tax rates produced great dissatisfaction with the personal income tax and contributed importantly to the popularity of President Reagan's goal of reduced taxation.

Okner's (1979) simulation analysis shows the total impact of the tax cuts of 1964, 1969, and 1975 to have been moderately progressive. The top 10 percent of tax filers received about 10 percent of the 1964 cuts, 1 percent of the 1969 cuts, and actually paid increased taxes after the 1975 tax cut. Congress rejected, however, a progressive 1978 Carter administration tax-cut proposal. In its place, the 1978 cut Congress enacted allocated only about 5 percent of the tax cut to the bottom 50 percent of taxpayers, and about half to the top 10 percent.

Okner and Bawden (1983) show that while the 1981 Economic Recovery Tax Act (ERTA) reduced total tax revenues by a much larger amount than the 1978 cut, the distribution of the cuts was similar. The 1981 cuts were mostly proportional with respect to taxes paid. Because a proportional tax cut does not aid low-income households that pay no taxes, the 1981 cuts were regressive with respect to household incomes.

While ERTA addressed the problem of high marginal tax rates by cutting the top tax rate to 50 percent on all forms of income and by proportionally cutting all other rates, it clearly reversed the pro-poor tilt of all the post-1964 tax changes. According to Minarik:

> ...the 1981 tax law can be judged unambiguously, at least by our post-1964 standards, to have been unfair to the poor; taxes of sub-median-income families have gone up since 1980, while the taxes of the better off went down (p. 41).

The anti-poor effects of the 1981 tax law, in marked contrast to the pro-poor effects of the 1986 Act, were not explicitly discussed in Congress.

The tilt toward the poor and near-poor up to 1975, and the tilt away from them between 1975 and 1985 are evident in Table 3, which is adapted from Steuerle and Wilson (1986). The first six columns show the average and marginal income tax rates for a four-person family with income at

Table 3

Average and Marginal Income Tax Rates for Four-Person Families[a]

	Income at One-half the Median			Income at Poverty Line			Social Security Tax Rate[b]
	Income (1)	Average Rate (2)	Marginal Rate (3)	Income (4)	Average Rate (5)	Marginal Rate (6)	(7)
1950	$1,838	0.00%	0.0%	$2,435	0.00%	0.0%	3.00%
1960	3,148	0.15	20.0	3,025	2.13	20.0	6.00
1970	5,583	4.65	15.0	3,966	1.94	14.0	9.60
1975	7,924	4.22	17.0	5,497	-4.55	10.0	11.70
1980	12,166	6.02	18.0	8,416	-0.66	26.5	12.16
1985	16,423	6.57	14.0	10,988	3.37	24.2	14.10
1990[c]	21,643	5.57	15.0	13,117	-5.35	10.0	15.30

Source: Adopted from Steuerle and Wilson (1986).

[a]A negative rate implies that the earned income tax credit exceeded the tax liability.

[b]Employer plus employee share.

[c]Steuerle and Wilson's projection.

one-half the median income and at the poverty line, for selected years between 1950 and 1985, and projections for 1990. Column 7 shows the total (employer plus employee) payroll tax rates that might be added to both the average and marginal rates if one were to examine the combined effects of federal taxes.

In the case of the federal personal income tax, 1975 marks the year of its most progressive treatment of the poor. This was the year in which the earned income tax credit (EITC), which subsidizes the earnings of low-income families with children, was introduced. In the next decade, all three major pro-poor devices in the personal income tax were severely eroded by inflation--the EITC, the minimum standard deduction (also known as the zero bracket amount), and the personal exemption. For example, in 1975, because of the EITC, a family of four at the poverty line received a federal income tax credit of $250 (-4.55 percent of $5497). By 1985, this family paid $370 in income taxes (3.37 percent of $10,988), for an increase of $620. If one adds the increased social security taxes over this decade, then the increased tax burden is about equal to the amount of food stamps the poverty-line family of four could have received in 1985. (But food stamps do not fully offset the taxes of all of the poor because some families at the poverty line are ineligible for food stamps because of asset limits or other administrative rules, and others fail to apply for them.)

As discussed in the next section, by 1990, the average tax rate will again be negative for this poverty-line family because all three pro-poor devices--the standard deduction, the personal exemption, and the EITC were increased and indexed to inflation by the 1986 Act. Also, the marginal tax rate in 1990 will drop back to the 1975 level.

Table 3 also shows that a family at one-half the median (a level in 1985 that was about 150 percent of the poverty line) was aided only slightly by the 1986 Act. Its average tax rate in 1990 will be midway between the 1975 and 1985 average rates. But the difference in rates between 1985 and 1990 is only 1 percent of family income for those at one-half the median, while it is almost 9 percent for the family at the poverty line. This result reinforces my view that further tax relief should be targeted on the low-income population.

The data presented thus far make it clear that the trend toward greater poverty and income inequality did not begin with the election of Ronald Reagan. In fact, much of the damage on both the income side and tax side occurred because of the high rates of inflation of the late 1970s. Inflation eroded the value of the pro-poor income transfers (which except for those to the aged were not indexed to prices) and the pro-poor components of the personal income tax. But the trends were unabated under Reagan, even though inflation slowed, because transfers were cut as part of the budgetary retrenchment and ERTA did nothing to correct the past or prevent further erosion of the pro-poor tax components.

That the recent tax changes have been quantitatively important can be seen in Table 4, which shows Census Bureau data that account for all taxes paid. Unlike the data presented thus far, these data allow us to decompose the increased inequality in the income share of households between 1980 and 1985 into two components. The first, shown in column 5, is due to changes in money income before taxes, which reflects changes (1) in cash income transfer programs, (2) resulting from recession, and

Table 4

Percentage Share of Aggregate Income Received by Each Fifth of Households, before and after Taxes, 1980 and 1985

	1980		1985		Difference Between 1980 and 1985 Shares Due to:		
Quintile	Before Taxes (1)	After Taxes (2)	Before Taxes (3)	After Taxes (4)	Before Tax Changes[a] (5)	Tax Changes[b] (6)	Total Changes[c] (7)
Lowest fifth	4.1%	4.9%	3.9%	4.6%	-0.2	-0.1	-0.3
Second fifth	10.2	11.6	9.7	11.0	-0.5	-0.1	-0.6
Third fifth	16.8	17.9	16.3	17.2	-0.5	-0.2	-0.7
Fourth fifth	24.8	25.1	24.4	24.7	-0.4	0.0	-0.4
Highest fifth	44.2	40.6	45.7	42.6	+1.5	+0.5	+2.0
All fifths[d]	100.0	100.0	100.0	100.0	0.0	0.0	0.0

Source: For 1980, U.S. Department of Commerce (1983), p. 11; for 1985, U.S. Department of Commerce (1987), p. 2.

[a]Defined as (column 3 - column 1).

[b]Defined as (column 4 - column 3) - (column 2 - column 1).

[c]Defined as (column 6 + column 5), which is equal to (column 4 - column 2).

[d]May not sum to 100.0 or 0.0 because of rounding.

(3) due to other economic factors. The second component, shown in column 6, reflects changes in state and local as well as federal income and payroll taxes.

The total difference between 1980 and 1985 in after-tax income shares, shown in column 7, reveals that each of the bottom four quintiles lost ground over this three-year period. Losses were due to before-tax income changes (column 5) for each of the four, and to tax changes (column 6) for the bottom three. The top quintile was the only one to increase its income share from either source of income change. Its increase, 2.0 percentage points, amounts to about $2000 per household. About one-quarter of this increase was due to the tax changes.

Unpublished tabulations from the Congressional Budget Office show a similar effect of federal tax changes on poverty. They show that in 1979, 0.675 million people were taken into poverty by federal taxes; by 1984, this number had increased to 2.426 million.

Thus, a significant portion of the trend toward greater poverty and inequality in the period since the mid-1970s can be attributed to either direct government tax and transfer policy changes or to the failure of government policy to respond to poor economic performance. Although precise data that fully account for changes in taxes paid and all types of noncash transfers and employer-provided fringe benefits received are unavailable, it is probably the case that the distribution of after-tax income is more unequal today than at any time in the past thirty years.

VI. THE TAX REFORM ACT OF 1986

The major goal of the 1986 Tax Reform Act was to lower tax rates and broaden the tax base. The law now has only two tax brackets--15 percent and 28 percent (although because the personal exemption is phased out at higher income levels, some taxpayers will face an effective rate of 33 percent). And many tax preferences were reduced or eliminated. The 1986 Act departed somewhat from distributional neutrality by raising corporate taxes. As a result, it provided disproportionate tax relief to the working poor while approximating revenue neutrality.

The major changes benefiting the poor are the increase in the personal exemption from $1080 to $2000 by 1989; an increase in the standard deduction for joint filers from $3670 to $5000 and for single heads of households from $2480 to $4400; and an increase in the maximum earned income tax credit from $550 to $800 by 1987. All of these devices are also indexed for inflation. As a result, about six million poor and near-poor taxpayers will be removed from the tax rolls.

Except for the poor, however, there will be little change in the overall progressivity of the income tax. This is because the expanded tax base increased progressivity to about the same extent as the reduced number of tax brackets lowered progressivity.[6] Table 5 shows recent estimates of the distributional effects of the 1986 Act (U.S. Congress, Joint Committee on Taxation, 1986). For each income class, column (1) shows the average tax change, column (2), the average 1986 tax liability, and column (3) the percentage change in tax liability. Since, the percentage reduction in tax liability generally falls as income rises, the overall effect is progressive.

Table 5

Distributional Effects of the Tax Reform Act of 1986

Income Class (thousands of 1986 dollars)	Estimated Mean Tax Change (1)	Estimated Mean 1986 Tax Liability (2)	Percentage Change in Tax Liability[a] (3)
Less than $10	$-39	$21	-65.1%
10-20	-200	695	-22.3
20-30	-220	2,018	-9.8
30-40	-273	3,254	-7.7
40-50	-486	4,849	-9.1
50-75	-150	8,388	-1.8
75-100	-176	14,293	-1.2
100-200	-612	27,353	-2.2
Above 200	-3,362	135,101	-2.4
All filers	$-194	$2,982	-6.1%

Source: U.S. Congress, Joint Committee on Taxation (1986).

[a]Defined as column 1, tax change, divided by 1986 tax liability that would have resulted if Tax Act had not been passed times 100.

There are, however, very large differences within income classes. Minarik (1986) refers to the Act as a "massive reshuffling," that is, as one primarily promoting horizontal equity. He points out that in the highest income brackets, the net change shown in Table 5 results from a situation in which about 45 percent of filers in the highest income bracket face tax increases of about $50,000, while the remaining 55 percent have tax reductions of about $53,000.[7] Taxpayers with similar incomes will now pay tax rates that are much more similar than before because of the expanded tax base and the reduced number of tax brackets.

Under the new law, many fewer people will be taxed into poverty by the federal income tax and many more families with children will receive credits from the expanded EITC. Yet these changes will do little to offset the large increase in poverty and inequality that characterizes the period since 1973. It is against this background of economic and policy changes that I advocate further tax reforms targeted on the poor and near-poor.

VII. SOME FURTHER TAX REFORMS

What else would I do to reform the income tax in such a way as to provide greater assistance to the working poor and near-poor without taking them through the welfare system? Ideally, I would replace the personal exemption with a per capita refundable credit. Lerman (1985) proposes an annual $600 refundable per capita credit, which would be made available only to those who do not itemize deductions. Such a credit would be administered in the same fashion as the Internal Revenue Service currently administers the EITC. With a marginal tax bracket of 15 percent, a $600 credit would be equal to an exemption of about $4000; for the 28 percent bracket it equals an exemption of $2143. Thus almost all of the additional costs associated with the credit would be targeted on taxpayers in the 15 percent bracket. Obviously, a refundable per capita credit better targets foregone revenue on those with lower incomes than would be the case if the same amount of revenue was foregone by raising the personal exemption.[8]

An even more ambitious proposal (Garfinkel and Haveman, 1983) would raise the value of the per capita refundable credit, and in return replace both the personal exemption and the Food Stamp program. The rationale is that such credits can effectively target funds upon the poor, lower their marginal tax rate, and avoid the stigmatization of recipients and the higher administrative costs of welfare programs. For example, a family of four with no other income is currently eligible for about $4000 per year in Food Stamps and faces a benefit reduction rate (marginal tax rate) in that program of 33 percent. With a refundable credit of $1000 per person, the family with no other income is equally well off, and the only marginal tax rate comes from the payroll tax, not the sum of the payroll tax and Food Stamp rates.[9] Of course, since the current personal exemption is not refundable, and many poor and near-poor families do not participate in the Food Stamp program, such a change would require additional revenues.

The lower marginal tax rates in the reformed income tax, however, provide a more efficient mechanism for raising revenue to aid low-income families than did the old rates. With the lower rates, the work disincentive effects of raising taxes decline. Assume, for example, that these refundable credits will be financed by broadening the tax base--say, by taxing the employers' contribution for health insurance. With only two brackets, a smaller percentage of the population will be shifted into a higher marginal tax bracket by this base-broadening than would have been so shifted under the pre-1986 rate structure. For most people then, any base broadening will have only an income effect (reduced income) promoting greater work effort; only a small number will have an altered substitution effect (since few change tax brackets) promoting lower work effort. For the beneficiaries of such expanded credits, the income effect will lead to less work but the substitution effect will lead to more work because the credits will take the place of a welfare program, which had higher marginal tax rates.

A second reform would make the child care tax credit refundable. The current nonrefundable credit allows couples, when both spouses work, and working single parents, to partially offset work-related child care costs. Only about 1 percent of poor two-parent families and 6 percent of poor single-parent families make use of the nonrefundable credit (Steuerle and Wilson, 1986). On the other hand, higher-income taxpayers receive credits up to $960 if they have more than one child and if they spend at least $4800 on care.

The credit begins at 30 percent for families with incomes below $10,000. Consider the case of a single mother of one child who works part time, earns $5.00 per hour for 1500 hours per year, and spends $1.50 per hour, or $2250, to keep her child in a day care center while she works. If this is her only income, she will not have a positive income tax liability (indeed, the expanded EITC will offset a portion of her social security taxes). Her potential child care credit--$675, or 30 percent of $2250--is thus of no value to her because it is not refundable. Refunding this credit would not only raise her net income, it would also make welfare recipiency less attractive.

VIII. CONCLUSION

In sum, I have argued that the 1986 Tax Act was an important addition to antipoverty policy. However, in the late 1980s, inequality of family income is continuing to increase, and poverty is only slowly declining, despite a robust economic recovery. The pro-poor extensions of tax reform that I have proposed would not threaten any of the efficiency accomplishments of the recent tax reform and will have much smaller work and family disincentive effects than would any alternative plan to aid the poor through the welfare system.

The Tax Reform Act has helped to refocus attention on the question "What does it do for the poor?" The further reforms suggested here reemphasize this question without rejecting the Reagan-era question "What does it do for incentives to work and save?"

Notes

[1]As an indication of the relative magnitude of the tax relief, note that the total cost of Food Stamp benefits is estimated at $10.9 billion in fiscal year 1987.

[2]This review suggests that total spending on all major income transfer programs reduced annual hours of work in the economy by about 4.8 percent in the late 1980s. One should not conclude from this that marginal changes in transfer programs would cause large efficiency losses.

[3]The federal government's official measure of poverty provides a set of income cutoffs adjusted for household size, the age of the head of the household, and the number of children under age 18. (Until 1981, sex of the head and farm/nonfarm residence were other distinctions.) The cutoffs provide an absolute measure of poverty that specifies in dollar terms minimally decent levels of consumption. To make them represent the same purchasing power each year, the official poverty thresholds are updated yearly by an amount corresponding to the change in the Consumer Price Index. In 1985, the poverty lines ranged from $7231 for a family of two to $22,083 for a family of 9 or more; the line for a family of four was $10,989.

[4]Care must be taken in interpreting the official poverty data. When the poverty thresholds were set in the mid-1960s, the poor received few in-kind transfers and paid little in taxes. Therefore, one could at that time legitimately compare cash income with the official poverty lines to obtain a fairly accurate picture of resources available to meet the families' needs. However, during the late 1960s and early 1970s noncash

transfer benefits increased rapidly. While these noncash benefits represented only 12 percent of outlays on income-tested programs in 1966, the figure had risen to about 70 percent by 1983. Clearly a better measure of a family's ability to meet its needs should include the value of in-kind programs.

Likewise, taxes detract from the availability of resources to meet needs. If taxes had not increased very much over this period they could be ignored, since the original poverty definition was based on income before taxes.

Unfortunately, we do not have a consistent time series for poverty which adjusts for both taxes and the value of in-kind transfers. Nonetheless, while the inclusion of in-kind transfers would reduce the extent of poverty in any single year, and the subtraction of taxes paid would increase it, they would not significantly alter the trends discussed here.

[5]My own view is that the disincentive effects of government programs have been exaggerated in the media and in such books as Charles Murray's Losing Ground (1984). For a review, see Danziger and Weinberg (1986).

[6]The issue of increasing the progressivity of the income tax is completely separate from the move from multiple tax brackets to only a few brackets. Hall and Rabushka (1985) show this explicitly in The Flat Tax, by presenting a table that shows various combinations of an adult exemption and a marginal tax rate that raise the same revenue. For example, while their basic plan contains an adult allowance of $5500 and a rate of 19 percent, one could choose an equal-cost more progressive plan with an allowance of $6600 and a rate of 23 percent.

[7]Minarik's estimate was made before the tax bill was finalized. These numbers are, thus, merely suggestive of the reshuffling created by the Act.

[8]For the poor, a refundable credit is clearly preferable to the exemption. Consider a family with no tax liability under current law--that is, all of its exemptions and deductions exactly offset its tax liability. Now assume that the family has another child. The additional exemption is worth nothing if family income is unchanged. However, the family would receive the full value of the refundable credit.

[9]Depending on the amount of earnings, however, the relevant comparison may be between the 33 percent rate under Food Stamps and a 22 percent rate: the sum of the employee share of the payroll tax and the first bracket rate of 15 percent. This is because, under the exemption, the marginal income tax is zero until a tax threshold is reached which equals the sum of the standard deduction and the exemptions, while under a per capita credit, the tax threshold falls to the standard deduction only.