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TWO ALTERNATIVES TO FAP'S TREATMENT OF THE WORKING POOR

This paper was stimulated by the difficulties which President Nixon's Family Assistance Plan (FAP) has encountered in the Congress. From the beginning of the Congressional debate on FAP through the early months of the Ninety-second Congress, several provisions of the bill have met with serious criticism.[1] While some of this criticism concerns the adequacy of the plan's level of income support, other criticism focuses on the incentive effects of the high "tax rate" on earned income, the coerciveness of the work test, and other more operational characteristics of the plan. Much of this controversy is centered upon the issue of how best to provide supplementary income to the "working poor."

The term "working poor" here refers to those poor families who are not eligible for any one of the existing categorical public assistance programs, i.e., Aid to Families with Dependent Children (AFDC), Aid to the Blind, Old Age Assistance, and Aid to the Permanently and Totally Disabled. In the context of the FAP discussion, this term applies only to those men in families with children. In this paper then, the term "working poor" means those families with children that are headed by able-bodied men under age 65.[2]

In 1966 there were about two million families classified as working poor. It is crucial to the discussion which follows to note that most of these families, although poor, had some earnings. Seventy-one percent had earnings at or above one-half the level of the poverty line. (One-half the poverty line for a family of four is now about $1750.) And only 13 percent of them had earnings under one-fourth the poverty line (see Table 1).

TABLE 1. DISTRIBUTION OF FAMILIES WITH CHILDREN HEADED BY NONDISABLED MEN UNDER AGE 65, BY PRETRANSFER WELFARE RATIO, 1966

	Pretransfer Welfare Ratio[a]				
	Under .25	.25 to .50	.50 to .75	.75 to 1.00	All under 1.00
Number of families (thousands)	248	304	558	853	1,980
Percent of families	13	16	28	43	100

Source: A special tabulation from the Survey of Economic Opportunity.

[a]A pretransfer welfare ratio of 1 means a family of any size has earnings equal to the poverty line for its family size.

As presently formulated, FAP is designed to do two things: (1) to introduce federal standards into the categorical public assistance programs for the aged, blind, disabled, and broken families, and (2) to introduce a new federal benefit for the working poor families with children.

Any plan with a constrained budget which seeks to accommodate both these objectives is confronted with the natural conflict between them. The maximum benefit level (or guarantee) for a family with no income which is suitable for purpose (1) is considered by many to be unsuitable for purpose (2). A program with a higher guarantee either significantly expands the number of those receiving benefits and the budgetary cost of the program or entails a high implicit tax rate on earned income. Hence the Administration's revised version of FAP has a guarantee of $2200 ($1600 plus $600 worth of food stamps) for a family of four and carries with it an implicit tax rate of over 60 percent.[3] Such a plan, it has been argued, appears to invite able-bodied men to reduce their participation in the work force. About 24 million persons are in families that would be affected by this high tax rate.

This conflict between objectives is clearly illustrated by the current indecision of both the Administration and Congress regarding the disposition of the categorical assistance program for families with dependent children and unemployed parents--AFDC-UP. Currently, twenty-three states participate in this federally supported program. However, because of the undesirable attributes of the program, a number of states are abandoning it. The primary defect of AFDC-UP is the 67 percent or higher tax rate on earned income to which recipients are subject, and the provision which reduces benefits to zero when more than a certain mumber of hours are worked. There are, therefore, strong incentives to get onto this program and strong disincentives to seek full-time work and get off. The House-passed FAP requires all states to adopt AFDC-UP. On the other hand, the FAP plan which the Administration recommended to the Senate Finance Committee abolishes AFDC-UP but provides a "grandfather clause" to keep any present beneficiary from losing benefits for a period of two years.

In this paper we attempt to illuminate the issues surrounding FAP's treatment of the 2 million working poor families, and to suggest some alternative ways of responding to the needs of these people. Both of the alternatives outlined here eliminate the need for some of the more objectionable provisions of FAP's treatment of the working poor. They accept the FAP provisions for changing the existing system of public assistance as the appropriate way to deal with the categorical poor.

The first alternative which we outline and argue pro and con incorporates a lower guarantee for the working poor than does FAP. It compensates for this lower guarantee by adopting a schedule with far lower tax rates on earned income than those implicit in FAP. Indeed, for increments to earned income up to $2000, the implicit tax rate is zero; beyond $2000 the marginal rate is 40 percent or less. In spite of its low guarantee, this plan channels nearly as much money to the total group of the working poor as does FAP, while avoiding some of the latter's disincentives to earning extra income.

The second alternative is more extensive than either FAP or the first alternative. It combines an income maintenance system with a public employment-training program. In so doing, it accepts the proposition that a number of those in the lowest income groups require tailor-made public employment and training programs. A key feature of this alternative is the strong incentive for private employment which it incorporates. As described, it provides a substantial program of income support to all working poor families.[4]

ALTERNATIVE I

If the conflict of objectives reviewed above severely reduces the probability that the FAP program of assistance to the working poor will be enacted, then a modification of FAP may be in order. One possible modification is to change the guarantee and benefit structure for the working poor only to the schedule shown in Table 2. It contrasts with the schedule of FAP without food stamps (the version which passed the House), which is also shown. The FAP schedule shows a zero marginal tax rate on the first $720 of earnings and a 50 percent marginal tax rate on earnings above $720 and up to $3920.[5] The schedule of Alternative I indicates that a working person with low income will be able to retain 100 percent of his earnings up to $2000. From $2000 to $4000 the implicit tax rate is 40 percent or less. The relatively low guarantee together with the low marginal tax rates means that no work test should be necessary to maintain the labor force participation of working poor people. Presumably, a work test would still be required for mothers on AFDC who have no children under age 6.

TABLE 2. NET ALLOWANCES FOR A FOUR PERSON "WORKING POOR" FAMILY: FAP AND ALTERNATIVE I

Family Income before Allowance	Net Allowance		Income after Allowance		Marginal Tax Rate	
	FAP	Alternative I	FAP	Alternative I	FAP	Alternative I
$ 0	$1600	$750	$1600	$ 750	0%	0%
500	1600	750	2100	1250	0	0
1000	1460	750	2460	1750	28	0
1500	1210	750	2710	2250	50	0
2000	960	750	2960	2750	50	0
2500	710	600	3210	3100	50	30
3000	460	400	3460	3400	50	40
3500	210	200	3710	3700	50	40
4000	0	0	4000	4000	50	40

As the table indicates, this schedule features a low allowance of $750 in the event of no earnings. Moreover, for earned income levels from zero to about $1500, this proposal pays out at least $500 fewer benefits per family than does FAP. However, and this provides a chief rational for this proposal, there are relatively few working-poor families who have less than $1500 of earned income (Table 1 suggests that about 500,000 families or 25 percent of the total have less than that amount of earnings). Thus for the overwhelming proportion of the working poor--those earning over $1500 annually or an average of $30 per week--this proposal provides nearly as much annual supplementation as does FAP. For this reason, this proposal will pay out nearly as much money to the total group of working poor as would FAP.[6]

Advantages of Alternative I Relative to FAP

1. Relative to FAP it provides less disincentive to work by reducing the maximum benefit proposed in FAP for a working poor family with no income, and by eliminating the 50 percent tax rate over the very low income range and reducing it from 50 percent to 40 percent or less over higher (although still poverty) income levels.
2. It would funnel approximately as much federal money to working poor people as would FAP. However, it assures that most of that money would go to the bulk of the working poor who presently have incomes above $1500. In effect, it says that the nation recognizes that these people are putting forth effort and using their abilities. It declares than when these efforts fail to generate above poverty-level income, the government will provide some income supplementation. Its philosophy is similar to that of two government plans recently proposed in other nations, namely the British Family Income Supplement and the Canadian income-conditioned family allowance.

3. This proposal enables the dropping of the work test provisions of FAP as they apply to male-headed families.
4. If combined with an extension of unemployment insurance benefits, this proposal would enable the phasing out of the AFDC-UP program, together with its inequities and adverse incentives. Such a combination could significantly reduce the disparity in benefit levels between this alternative and FAP for many of the working poor with incomes below $1500--namely those whose very low income is related to long-term unemployment.

Disadvantages of Alternative I Relative to FAP

1. This proposal provides for a lower maximum benefit for working poor families with no (or very low) earnings than does FAP. (Establishment of this income guarantee has been a focal point for many in the debate over income maintenance legislation. We have suggested that the argument for the high maximum benefit figure is largely misplaced, inasmuch as it relates to the working poor. This is so because of the small portion of the working poor at or close to zero earned income.)
2. It continues the categorization found in FAP (with state supplementation) of the poor into working and nonworking groups and treats each group differently. (Although this categorization is undesirable, it can be eliminated in all states only by a plan with a guarantee at the New York level of about $3700 per year for a family of four.) To the extent that FAP benefit levels exceed AFDC benefits in some low benefit states, FAP moves farther toward the elimination of this categorization than does this alternative.

3. Because of its lower income guarantee level, Alternative I is not as effective in reducing the incentive for family breakup as is FAP. It does improve on legislation now in effect, however.

ALTERNATIVE II

The second alternative to FAP's treatment of the working poor is substantially more extensive than the first. However, it too capitalizes on the observation that the bulk of the working poor have earnings in excess of $1500 per year for a family of four. This alternative is based on the presumption that the small group of very low-income working poor form an especially disadvantaged poverty group requiring tailor made programs of assistance. It offers two different options for such people. Option (a) incorporates large economic incentives for engaging in work by matching dollar for dollar every increment to earned income up to a specified limit. Option (b) provides a special program of public employment and job training.

For the poor who are able to find employment in the private sector, option (a) would provide a 100 percent subsidy--matching grant--for each additional dollar earned up to the $1300 level. After achieving earned income of $1300--which, when matched, would provide total income of $2600--the worker would fall onto a schedule similar to FAP. A tax rate of 50 percent would apply to income from $1300 to $3900 earned in private employment. Table 3 illustrates the schedule applicable for low-income workers who engage only in private sector employment.

Option (a) is not a wage-rate subsidy. It is better called an earnings subsidy, since it does not vary with wage rate but with wage rate multiplied by hours worked. It also pays the subsidy directly to the worker rather than to his employer, as some proposals for a wage rate subsidy would have it.

TABLE 3. NET ALLOWANCES FOR A FOUR PERSON FAMILY WITH PRIVATE SECTOR EMPLOYMENT: ALTERNATIVE II

Family Income before Allowance	Net Allowance	Income after Allowance	Marginal Tax Rate
$ 0	$ 0	$ 0	-
500	500	1000	-100%
1000	1000	2000	-100
1300	1300	2600	-100
1500	1200	2700	+ 50
2000	950	2950	+ 50
2500	700	3200	+ 50
3000	450	3450	+ 50
3500	200	3700	+ 50
3900	-	3900	+ 50

Option (b) would make public employment and/or job training available to the principal earners in all poor families. Participation in such employment or training would be remunerated at the prevailing regional hourly wage rate for unskilled labor. As opposed to employment in the private sector, public employment would not qualify for the 100 percent matching grant. However, it would guarantee work or training that would yield $2600 of annual income to any low-income family of four persons. This amount of income would require a varying number of hours depending on the wage rate in effect.

In addition to opting for either private sector or public sector employment, a low-income worker could combine the two. However, for a worker with some private sector earnings, the public program could be used to supplement private matched earnings up to a total of $2600 (for a family of four) without an erosion of marginal earnings through the implicit tax rate. Beyond $2600, incremental public earnings are subject to the 50 percent tax rate.[7] Similarly, an individual with some public sector earnings could use private sector (matched) earnings to supplement public earnings up to the $2600 level without an erosion of marginal earnings. In either case, then, if subsidized private sector earnings plus public sector earnings total more than $2600, earnings in excess of $2600 are subject to the implicit 50 percent tax rate.[8] Table 4 illustrates the total income pattern for low-income workers who engage in either public sector or private sector activities or who combine these alternatives in various proportions.

In the table, several patterns are of special interest. First, the very large incentive for increased private sector employment (provided by the matching grant on private earned income up to $1300) is seen in the first column. As private earned income increases from $500 to $1000 to $1300, total income increases from $1000 to $2000 to $2600. This incentive for incremental private sector employment is also seen by reading across the rows. For any level of earned income, the level of total income is inversely related to the proportion of it which is earned in the public program.

This pattern of incentives favoring private employment can perhaps be seen more clearly by focusing on the implicit hourly wage rate rather than total income associated with particular number of hours worked. If we assume that employment in both the private and public sectors is paid an hourly wage rate of $1.50, then an individual working 1000 hours per

TABLE 4. TOTAL INCOME BY EARNED INCOME LEVEL AND BY PUBLIC-PRIVATE DIVISION OF EARNED INCOME FOR A FAMILY OF FOUR PERSONS: ALTERNATIVE II

Earned Income	100 percent private	75 percent private 25 percent public	50 percent private 50 percent public	25 percent private 75 percent public	100 percent public
$500	$1000*	$875*	$750*	$625*	$500*
1000	2000*	1750*	1500*	1250*	1000*
1300	2600	2275*	1950*	1625*	1300*
1500	2700	2613**	2250*	1875*	1500*
	($2.70)+	($2.61)+	($2.25)+	($1.88)+	($1.50)+
2000	2950	2950**	2800**	2500*	2000*
2500	3200	3200**	3175**	2888**	2500*
3000	3450	3450**	3450**	3175**	NA
3500	3700	3700**	3700**	3488**	NA

*Any individual with total income below $2600 is eligible for additional public sector earnings equal to the difference between the total income figure shown and $2600 without an erosion of marginal earnings.

**If it is assumed that private earnings accrue prior to public employment-training, then at least part of the public earnings of individuals in these categories are subject to an implicit 50 percent tax rate. As we argue below, this characteristic would insure against excessive use of the public program.

+Figures in parentheses are implicit (after-tax) wage rates for a person working 1000 hours at a nominal wage rate of $1.50 per hour.

NANot applicable, in that public sector earnings cannot exceed $2600 per worker.

year is in the earned income category of $1500 in the table. As the numbers in parentheses in that row indicate, if all 1000 hours are spent in private sector employment, the implicit (after-tax) wage rate is $2.70 per hour. If the 1000 hours are split evenly between the two sectors, the implicit wage rate falls to $2.25 per hour. If all 1000 are spent in public employment or training, the implicit wage rate equals the actual rate--$1.50 per hour.

Second, the effect of the 50 percent tax rate on income over $2600 is seen by reading down any of the columns. This characteristic is necessary to assure that the break-even income level will not exceed approximately $4000. This tax rate has yet another impact which is observable in the table. While individuals who have some private income are eligible for a total of $2600 of public sector income, any public income earned after a total income level of $2600 has been attained is subject to the 50 percent tax rate. In effect, such earnings would entail employment at approximately 50 percent of the minimum hourly wage rate--or about 80¢ per hour. Few could be expected to make themselves available for the public program at this hourly rate. Consequently, this provision assures the excessive use of the public program will be minimal.

Finally, it should be emphasized that in all cases in the table showing total income of less than $2600 families could get additional tax-free income by working in the public employment-training program. (These cases are denoted by a single asterisk and are found above the line running diagonally through the table.) As shown in the table, then, these cases represent individuals who choose not to avail themselves of the $2600 public sector guarantee which is open to them.

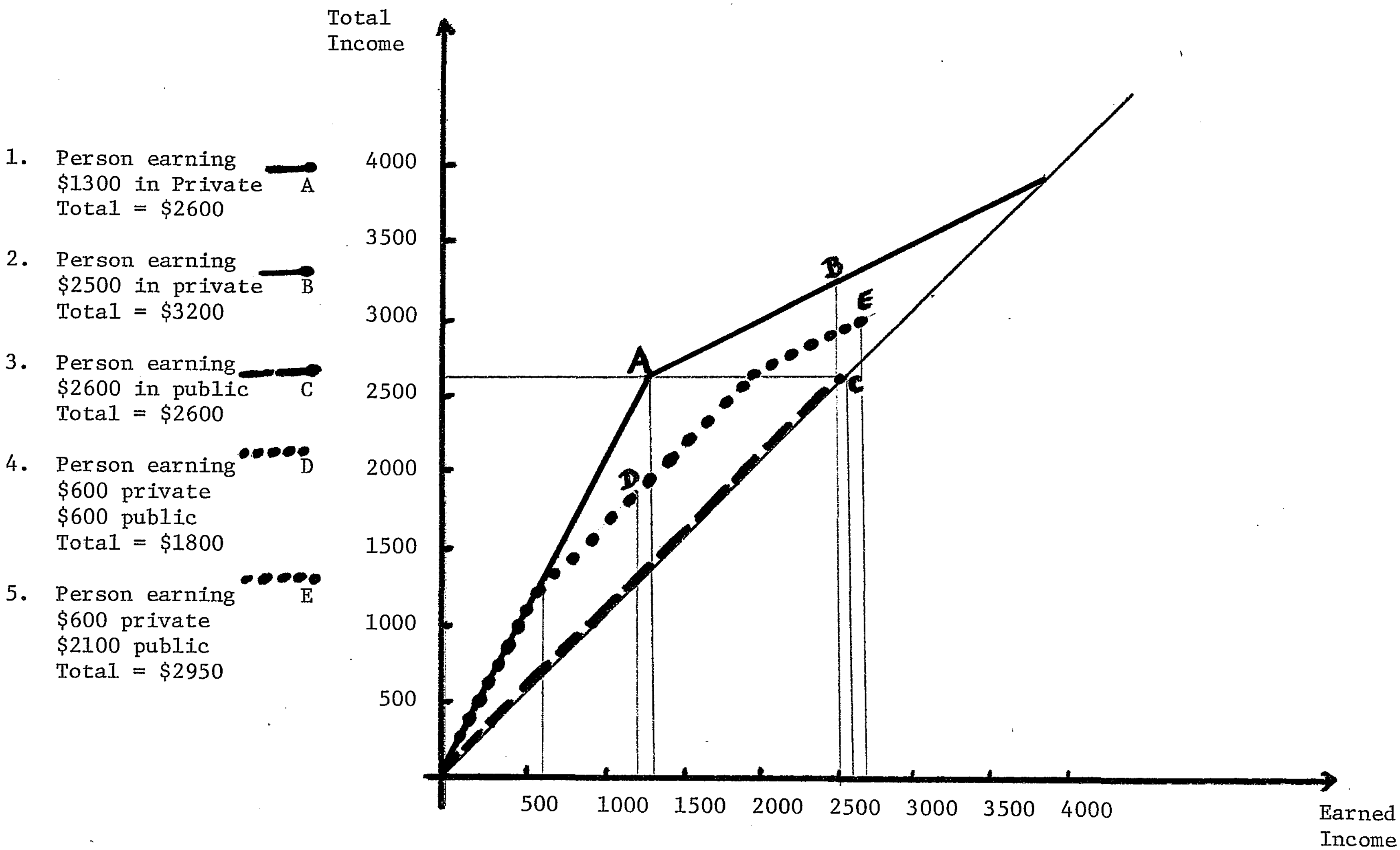
Several of the combinations explicit in Table 4 are shown in Figure 1.

Several additional characteristics of Alternative II are the following. First, this plan requires no explicit work test. (As is true of Alternative I, a question remains with regard to the work test for AFDC mothers with school-age children).

Second, this plan calls for the abolition of AFDC-UP. Any long-term unemployed worker along with all other workers, would have the opportunity for public employment and/or training. As noted above, the matching grant on earned private sector income provides the worker with substantial incentive to seek and accept such work if it is available. The implicit wage rate on such activity is approximately double that earned in the public program.

Third, we suggest that eligibility for public employment under this plan be limited to principal earners in families with children. Because of the family-related guarantee levels, either individuals with larger families will be permitted to work more hours in the public program than workers with smaller families or they will be paid at a higher hourly wage rate. We prefer the former alternative, with perhaps some wage-rate differential for principal earners with very large families, because of the effect on morale in the public program of differential wage rates for individuals performing the same work.

Fourth, like FAP, the benefits provided by this plan would be related to the size of family. Our calculations focused on a guarantee level of $2600 for a family of four. Larger family sizes would entail



Note: All principle earners guaranteed choice of number.

Figure 1

Benefits under Alternative II for a Family of Four Persons a higher maximum income figure applicable to both the public and private sector earnings.

Fifth, this plan could be administered on either an annual basis or on, say, a quarterly basis.[9] (This is the case with Alternative I and with FAP as well.) There are strong equity reasons for favoring the annual basis. However, if a quarterly basis were chosen, the guarantee level would be divided by four and applied during a quarterly accounting period. Thus, if earnings within a quarter exceeded \$650 (\$2600 ÷ 4), a family would receive no net benefits from the program. Earnings in a previous quarter in excess of \$975 would be recorded in a carry-over account to eliminate the payment of benefits to individuals with an annual income above the breakeven point which is bunched in one or two quarters. With such an accounting period arrangement, an individual could be entirely employed in the private sector during some periods of the year, entirely employed in the public sector during other periods of the year, and employed in both the public and private sectors during other periods of the year.

Advantages of Alternative II Relative to FAP

1. It eliminates the need for most of the work-test provisions of FAP.
2. It guarantees every noncategorical poor family a minimum in excess of the current FAP guarantee--e.g., \$2600 for a family of four.
3. It encourages private sector earnings, by providing families dollar-for-dollar matching grants for all private sector earnings up to a stated maximum--\$1300 for a family of four. Thus a family that earned \$1000 in private employment in a year would be provided with an additional \$1000.

4. It enables the principal earner from a low-income family to combine private and public earnings, but discourages public work beyond a reasonable point. Such an earner would receive the matching grant on private earnings. However, when his total income (including the matching grant) attained a stated level ($2600 for a family of four), increments to income would be subject to an implicit 50 percent tax rate. This is lower than either the combined FAP-food stamp tax rate of about 60 percent or the AFDC rate of at least 67 percent. However, it is high enough to eliminate the possibility of abuse--excessive use--of the public employment-training program. After the stated income level is attained, participation in the public employment program yields income at an hourly rate (after tax) of about one-half of the federal minimum wage rate.
5. It would eliminate the need for AFDC-UP.
6. Because of its higher guarantee level relative to FAP, this plan overrides the AFDC programs in a greater number of states. Consequently, it would reduce the incentives for family breakup relative to both FAP and the existing welfare system.
7. The budgetary cost of this plan is likely to be somewhat greater than FAP's provisions for the working poor, at least in the short run. However, because of the substantial incentives in the plan to increase private sector employment, it should generate long-run cost savings relative to FAP. We judge that there exists substantial potential for innovation to develop a wide range of employment activities which are both meaningful to low-income workers and productive

of valuable services to society. Few, we suspect, would deny that there is enormous need for an enlarged range of public services and for improved quality of those services. Consequently, it should be emphasized that the higher administrative costs of public employment relative to public assistance programs are likely to be more than offset by the real benefits of the public employment program in the form of both the real goods and services produced by the program and the value of the human investment in the form of a more highly trained labor force.[10]

Disadvantages of Alternative II Relative to FAP

1. Administrative skill would be required in handling special cases involving those persons who cannot or will not meet reasonable standards of effort and productivity in public employment or training.
2. The 100 percent matching grant provided to private earnings below $1300 could encourage workers and self-employed persons to overstate their private earnings. This would present an auditing problem quite different from FAP, which will tempt workers to understate earnings.
3. It would require the establishment of a program and office to (a) design creative means of making productive use of the low-income people participating in the public employment program and (b) design and administer job training programs to meet the needs of these people. The program of public employment-training envisioned by this alternative places a new and substantial responsibility on the public sector. Experience in devising innovative employment

opportunities for people with meager skills--programs which will be neither demeaning or coercive--is not in long supply in government at any level. Moreover, the history of work relief programs in this country does not indicate that success in operating such programs is inevitable.[11] Although assisting low-income people to become better able to compete for private sector jobs would seem preferable to only providing financial aid, the relatively high administrative and other complementary costs of public employment programs and their likely competition with regular public employment should not be ignored.

NOTES

[1]One controversy has to do with the "revenue sharing" aspects of FAP. Through FAP several state governments would be relieved of their present public assistance costs in varying degrees. In this paper we do not discuss that controversy since it largely deals with federal-state sharing of the cost of the categorical welfare programs, rather than the structure of assistance to the working poor, which is our primary concern.

[2]As noted below, one part of Aid to Families with Dependent Children, namely AFDC-UP (for unemployed parent), extends benefits to some families headed by men and hence overlaps alternatives here discussed.

[3]When the schedules of the state supplements and other public programs for which some low-income people qualify are included, the implicit tax rate of the combined programs rises well above 60 percent.

[4]We note that there is some support for other ways of providing support for the working poor. These include wage subsidies, extended unemployment compensation, and family allowances, none of which we discuss here.

[5]The FAP schedule shown here indicates a 50 percent marginal tax rate. This tax rate rose to about 65 percent in later versions of FAP, after the food stamp program was melded into FAP. Even in the earlier version of FAP shown in the table, working poor families faced implicit tax rates well above 50 percent. This was due to the earnings-conditioned benefit levels of programs such as food stamps, rent supplements, and Medicaid.

[6]One possibility for reducing the disparity between this plan and FAP in the level of benefits provided families below $1500 of annual earnings would be federal legislation mandating an extension of unemployment compensation coverage and benefits. Such extension would offset the short-fall in the benefits of this proposal relative to FAP for at least the group of very low-income families headed by persons experiencing considerable unemployment.

[7]An alternative arrangement would permit public earnings to be free from the marginal tax rate until total income reached the FAP schedule for only private earnings. For public sector earnings in excess of this intersection, the 50 percent tax rate of FAP would take effect.

[8]The discussion in the text assumes that a family has only one worker. In fact, over 20 percent of all poor families have two or more earners. Therefore, the question of the treatment of secondary workers in this plan becomes an important one.

We would suggest the following for multiple worker families. The family would declare which of its earners is to be regarded as the principal earner. That earner would be the only one eligible for public employment. Earnings of secondary workers would be combined with and handled as private earnings of the principal worker, as in Table 2.

There will be cases in which combined earnings exceed the breakeven level. For instance, the principal earner may earn \$2600 in public employment and the secondary worker \$2000 in private income, for total earnings of \$4600. Any earnings above the breakeven point of \$3900 would be taxed at regular federal income tax rates. In this rather extreme example, the public employment-training option has helped the family to rise above the poverty line.

It should be emphasized that the intent of this arrangement is to restrict the public employment option to primary earners in families with children.

[9]The question of the accounting period is extraordinarily important in the design of income maintenance plans. For one thing, the costs of the plan depends heavily upon whether benefits are calculated on the basis of one month's earnings or twelve months' earnings. The variation in cost follows from the fact that fluctuating levels of earnings confront the worker with different tax rates. Thus in Alternative II the worker in private employment may face either a <u>negative</u> 100 percent tax rate, a 50 percent rate, or (above \$3900) a 14 percent tax rate.

[10]For a review of the conditions under which a public employment program can be more economical than a straight income-support program, see Jerry Pohlman, "A Cost-Benefit Analysis of Transfer Payments: Job Creation vs. Welfare" (mimeo.).

[11]We have emphasized that the incentives inherent in this alternative are designed to minimize abuse or excessive use of the public employment program. These incentives also encourage high turnover in the public program and thus increase the difficulty of designing productive and meaningful jobs for people in the public program. To offset these high turnover incentives, participation in the public program could be made contingent on minimal periods of enrollment, say, one or two months. Thus, an individual opting for the public employment-training program would be required to, say, enroll in a particular training class or employment module lasting some specified period of time. This sort of provision would decrease turnover rates in the public program and give further incentive for private employment.