Uses of the NIT framework

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The case for a negative income tax

The model or framework for a negative income tax is simple and elegant. A multifaceted problem is presented or summarized in a single measure of well-being, income, and then one instrument, cash transfers, is proposed to deal with the problem. One additional instrument enables some other trade-offs to be made: a rate schedule or benefit reduction schedule exchanges target efficiency—defined perhaps in terms of filling an income gap—for a variety of other considerations, including equity, the neatness of the rate schedule, and some labor supply considerations.

The framework reveals at once the trade-off among higher tax rates, minimum level of income, and breakeven. With a few simplifying assumptions, the system can be defined not just by two of these three parameters but by the two parameters that are discussed most in the policy arena: the maximum level of public support per recipient and budgetary costs.

The NIT framework beckons many to examine the combined impact of most transfer and tax programs, in particular their combined benefit level and combined tax rate effect. In addition, the NIT and kindred programs often offer simple ways of compensating for undesirable distributive effects of other government efforts, such as changes in energy taxes.

The negative income tax is also based upon the presumption that "choice" enhances efficiency: it is better to let individuals decide how to spend their money than to let a bureaucracy, sometimes an expensive one, deliver to them goods of much less value than cost. Once again, this foundation for the NIT has a number of useful applications, in particular, in demonstrating the relative inefficiency of many in-kind programs.

The case against the negative income tax

As I have noted, the elegance of the NIT is its simplicity. And its simplicity is also its principal defect. Perhaps the main difficulty with the NIT is that it uses income as the measure of need (or ability). In so doing, the NIT framework almost defines away a good deal of the problem it is designed to confront. In fact, we know that income is not measured well and that when used to measure need or welfare, it is a summary measure of effect, not cause.

My dissatisfaction with financial measures of income comes in part from Robert Lampman. Over the years I have had the opportunity to apply the estate tax multiplier technique he developed to files of estate tax returns merged with income tax returns. I discovered, not surprisingly, that economic returns to wealth were correlated poorly with reported measures of income. Of course, these files dealt mainly with the wealthy, but they made clearer than ever to me that our financial measures of income work best when applied to the returns from full-time, market-based, employment. The measures typically fall apart when individuals receive returns in noncash form, from home or nonmarket production, or in the form of leisure.

Understated or potential returns to human capital would be a more significant issue with an NIT than with the regular income tax. In the income tax, potential, but unrecognized, returns to human capital are given a favorable tax rate of zero—but not a negative tax rate. In theory, the income tax is meant to be a tax on "ability," with income an incomplete measure of that ability.[1] The same can be said about an income tax that is negative; that is, the transfer or negative tax ideally should apply to ability, not income. Administering a system that is considered both efficient and "fair" requires some distinction according to potential returns to human capital.

With an NIT, this distinction becomes even more important than with existing transfer programs. How, for example, would an NIT distinguish the perennial graduate student and the person who retires prior to social security eligibility? These individuals should be treated differently from persons with less ability to work, such as the disabled.

Understated returns to financial and real capital, including housing, is a problem for the NIT as well as for the regular income tax. These issues might be dealt with through a well-conceived wealth test, with some imputed return to the wealth, but at that point the NIT no longer would be so simple, and in fact could no longer be administered within an income tax structure that does not require wealth reporting.

Lampman on the Negative Income Tax

"Schemes for Transferring Income to the Poor," coauthored by Christopher Green, *Industrial Relations*, 6 (February 1967).

Negative income taxation would use the individual income tax system as a vehicle for closing a portion of the poverty-income gap, i.e., the difference between the actual income of poor families and the income they would need in order not to be poor. It would pay money from the federal treasury to families according to a schedule based on actual income received and family size. For example, a family of four persons with an income of $2,000 might be said to have a poverty-income gap of $1,000. That is, their income is $1,000 below a "poverty line" of $3,000. Similarly, it is $1,000 below their total of personal exemptions and minimum standard deductions under the income tax law. Hence, the $1,000 is that family's unused exemptions and deductions and it can be called their "negative taxable income." To this negative base one could apply a tax rate to compute a "negative tax" or allowance. Thus, a 50 percent tax rate would yield an allowance of $500 in the example given. The scheme described above is one variant of negative income taxation. . . . (p. 121).

Transfer-by-taxation differs from other modes of income maintenance in that income and family size are the leading factors which condition benefits. Most, if not all, the eligibility considerations which are used in public assistance or social insurance programs—assets, ability to work, relatives' responsibility, age, retirement status, employment record, previous taxes paid, and so forth—are left to one side. Hence, all families with incomes below some specified level—not just certain categories of families—would receive allowances. Moreover, every family would be assured a minimum (this may or may not be a "high minimum") level of income. (p. 123).

Even if income were measured well, it is one (and only one) measure of effect, not cause. The concern that drives society to make transfers is at least twofold: relieving a number of the effects of poverty on the poor; and removing some of the causes of poverty. In the latter case, the motivation may be both that removing causes has a higher long-term payoff to the poor and that there are certain additional benefits (externalities) to the nonpoor. However badly designed some of the requirements for work, child care, or training may be, at least they do represent attempts to get at the causes of poverty for portions of the poor population. Similarly, provision of community mental health centers, training centers, and other services cannot per se be determined to be worse than cash transfers.

Directions suggested by the NIT framework

If the case for an NIT is incomplete, it is nonetheless useful. By sorting through the advantages and disadvantages presented by the NIT framework, I believe that we can get a much better idea of the types of transfer policies that make sense. A broader-based reform of the transfer system is no less likely nor is it viewed any less skeptically now than was tax reform a few years ago. Here are a few of the policy and research steps that could be taken along the way.

Structured choices

As in a pure NIT, greater choice could be offered to transfer recipients. Even if cash benefits are considered unacceptable, recipients of existing transfers, for instance, ought to be able to propose alternative packages of benefits to the ones they currently receive. Perhaps even cafeteria plans of benefits could be developed.

Structured choices also offer a way to provide a more formal market for valuing benefit programs. If, for instance, public housing recipients would prefer housing vouchers at 75 percent of the cost of the public housing, we would know that the market price of the subsidized housing would at most be 75 percent of its cost. Structured choice would force at least some of the claims of advocates of different programs to be tested in the marketplace.

Integrated programs

Whether or not in-kind benefits should be preferred to income transfers, there is no reason that the programs themselves should not be considered as an integrated whole. Here I include tax programs (income taxes, social security taxes, the earned income tax credit [EITC], and child care credits) as well as the many transfer programs.

Certainly what I propose here is not new. Yet even the initial steps in the process have not been taken. In that regard, an integrated schedule of both explicit and implicit tax rates, or budget constraints, should be developed and presented on a regular basis as a source of information to decisionmakers. Efforts should then be made to eliminate extraordinarily high tax rates, say, in excess of 70 percent. When combined with other costs of working—transportation, clothing, child care—a tax rate of 70 percent may imply a marginal cost of working near to or in excess of 100 percent. There is a strong economic case for concentrating some effort on reducing those tax wedges that are greatest.

One particular policy change would greatly enhance our ability to structure programs in an integrated fashion. Most transfer payments could be made taxable, while their benefit structure could be changed so that there was no net reduction in total benefits paid to all recipients. Taxability per se would not achieve integration, but it would move us significantly in the direction of seeing just what type of system we have developed—in no small part because all of the data would finally be gathered in one place.

Integrated data on transfer programs should be used in the same way that distributional tables are now used in tax debates—as devices to try to constrain and guide the decisionmaking process.

Ranking priorities

Related to the issue of integrating programs is the issue of ranking priorities. Advocates of an NIT neatly solve this problem by replacing many programs with one that provides cash assistance. Just because we may stop short of an NIT does not relieve us from the requirement to rank priorities among existing, as well as alternative, programs. Moreover, these rankings must be made at alternative funding levels.

Recent data from the Social Security Administration indicate that public transfers for social welfare have averaged around 18.5 percent of GNP per year for a number of years. This implies that substantial real growth in transfer programs has remained in recent years and is likely to continue. Our choices often appear constrained because certain portions of these programs have built-in growth such that other options are foreclosed. Moreover, the endless debate over whether total transfers should be raised by another 1 percent of GNP simply translates to whether we reach a given level of real transfers three years earlier than we will under existing growth rates. To make the example more relevant to current budget choices, I wonder when we're going to decide that increasing real health and Medicare expenditures by over $20 billion per year is preventing us from making other, more worthwhile, transfers.

Reducing taxes or increasing assistance to low-income workers

Recent support for increases in the EITC and for child care credits imply that, while the negative income tax may not have a ground swell of support, a negative earnings tax (NET) may be much closer to the mark.

Designing a negative earnings tax is not without its own set of issues, however. In the EITC and proposed child care credits, both forms of NETs, there is a phase-in range and a phase-out range. Unlike the NIT, a phase-in schedule prevents the maximum payments from going to those who work little during the year.

Although reducing taxes or increasing transfers to low-income workers receives little public opposition relative to many other types of transfers, a strong indirect alliance exists against moving in this direction. First, there are those who recognize in a revenue-neutral world that such changes imply higher average marginal tax rates, sometimes on capital income. Second, some advocates for the poor want to increase welfare payments but have only minimal concerns with tax rates and with effects on the near poor. These two groups continue to compromise on the budget in a manner that generally raises both burdens and tax rates on low-income workers.

Summary

The NIT presents us a framework by which to test whether programs are adequately integrated. It confronts us with the requirement to address directly the issue of whether structured choice should be given to transfer beneficiaries, and, if not, why not. It forces us to rank priorities if cash itself is not always to be the ultimate priority. And it helps guide us in designing NETs, a direction in which we seem to be headed through increases in earned income credits and child credits.■

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[1] As Richard Musgrave points out, the ability-to-pay doctrine in its earlier versions was formulated in terms of faculty rather than income. Only later was it taken for granted that sacrifice was a function of income surrendered. See Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959), p. 94.