How a Negative Income Tax Would Work

HOW A NEGATIVE INCOME TAX WOULD WORK*

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It seems clear to all that the present welfare program cannot be allowed to continue for long without substantial modification. It is inadequate, ineffcient, demeaning, and discourages welfare recipients from working. I believe the best way to improve the system is to replace it by a negative income tax, and I should like to explain how this alternative might be implemented.[1]

The term "negative income tax" describes a general approach to income maintenance, and there can be legitimate differences of opinion with regard to numerous details. Opponents of negative income taxation frequently exaggerate the nature of these differences, thus misleading the public about the true meaning of negative income taxation.

Perhaps the best way to put the matter in perspective is to recall that the sixteenth amendment to the Constitution, which gave the federal government the power to levy an income tax, would never have been enacted had it been delayed until there was general agreement over such matters as the general level of exemptions, the degree of progression, the definition of the family unit, the definition of income, and methods of payment. In fact, with a bit of research, we could probably find that for every criticism of the negative income tax there was a corresponding criticism made at that time against the positive income tax.

ESSENTIAL FEATURES OF THE NEGATIVE INCOME TAX

The negative income tax is a device to reduce or close the poverty gap by making payments to those in the lowest income classes in inverse relation to their incomes (that is, the lower their incomes the higher the payments). It is called a negative income *tax* because the payments can be regarded as an extension of the principle of progression, which now applies under the positive income tax, to those who are at the bottom of the income scale. But this does *not* mean that all the features of the positive income tax need be carried over into the negative income tax. As we shall see, it would probably be desirable to modify most of the definitions in the positive income tax structure in order to make the negative income tax workable and fair.

There are three essential features to the negative income tax:

(1) the amount of the negative tax payment would be determined on the basis of income, and size and composition of the family unit;

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1. For a detailed discussion of the problems, see Tobin, Pechman & Mieszkowski, *Is a Negative Income Tax Practical?*, 77 YALE L.J. 1 (1967).

(2) the only test to be applied in determining eligibility would be the comparison between the family's income and the "breakeven" level for that type of family. In other words, payments would be made to all the poor and not to certain categories of the poor;

(3) the income of the family would be subject to tax, but this tax would be substantially less than 100 per cent.

There is a fixed relationship among three variables in any negative income tax — the basic allowance (A), the breakeven level (B), and the tax rate (t) on the family's income — and it is impossible to vary one variable without affecting at least one of the other two. The relationship is that the basic allowance is the product of the tax rate and the breakeven level (or $A = tB$). Thus, if the breakeven level is $3,000 and the tax rate is 50 per cent, the basic allowance is $1,500. Conversely, if you wish to have a basic allowance of $2,000 and keep the breakeven level at $3,000, the tax rate must be 66 2/3 per cent. Examples of consistent A's, B's, and t's are shown in Table 1; there are, of course, many other possibilities.

Table 1

Illustrative Basic Allowances, Tax Rates, and Breakeven Levels

Basic Allowance (A)	Tax Rate (t)	Breakeven Level (B)
$ 1,500	50%	$ 3,000
2,000	66 2/3	3,000
2,000	50	4,000
3,000	75	4,000
1,000	33 1/3	3,000
3,000	100	3,000

Because of these relationships, the negative income tax can be thought of in two ways. It can be regarded as providing a basic allowance to all persons, together with a special tax rate on the incomes of those who accept the allowance. Or, it can be regarded as a payment that reduces the gap between income and the breakeven level by the same tax rate. The equivalence between these two approaches may be illustrated with the first combination of A, t, and B in Table 1. According to the first method, a family with an income of $1,000 would receive a basic allowance of $1,500 and would pay a tax of $500 on its income, which would leave it with a disposable income of $2,000. According to the second method, the family would receive a payment of $1,000 — 50 per cent of the difference between the $3,000 breakeven level and its income of $1,000 — leaving it with the same disposable income of $2,000.

The last entry in the table shows a basic allowance equal to the breakdown level. This occurs whenever the income recipient must give up one dollar of his allowance for every dollar of income he may receive: in other words, when the tax rate is 100 per cent. The United States welfare system had this feature until the Social Security Amendments of 1967 required the states to permit recipients to keep some part of whatever they might earn. (This provision will become fully operative in mid-1969.)

It might also be noted that there is essentially no difference between a negative income tax and a guaranteed minimum income plan. Under the negative income tax, individuals would receive the basic allowance if they had no other income, and in this sense the basic allowance is a guaranteed minimum. Some guaranteed minimum income plans implicitly impose a tax rate of 100 per cent on any income the family might receive, but this is not an essential feature of such plans.

THE DEFINITION OF INCOME

One obvious difference between the negative and the positive income taxes should be the definition of income. I believe that the nation would be better off if we were able to tax all incomes under the positive income tax, and I hope that we will be able to approach this ideal in the not-too-distant future. The inequity of having a definition of income that is less than comprehensive is all too clear when we consider the negative income tax. For example, I doubt that anybody would agree that a recipient of $10,000 of tax exempt interest annually should be eligible for a negative income tax payment.

Although it will be important to use a comprehensive definition of income to avoid such obvious anachronisms, most of the poor will not be affected by the degree of comprehensiveness since they ordinarily have little or no other income and do not benefit from the well-known "tax loopholes." The one exception — and this is a major policy issue — is the treatment of imputed rent from owner-occupied homes. Suppose *A* does not own his home but pays rent with $1,000 of taxable income he receives from $25,000 worth of securities, while *B* sold his securities and purchased a home, which does not provide any cash income. If they received no other income, and the rental value of owner-occupied homes were not taken into account, *B* would receive a larger negative income tax payment than *A*, even though they were in economically identical circumstances. Similarly, two families with identical cash incomes would receive the same negative income tax payments even if one owned his own home while the other paid rent out of his income. In both cases, the homeowner would be much better off.

The same inequity arises under the positive income tax, and it may be that it can be tolerated under the negative income tax. My view is that we should impute income to the homeowner for negative income tax purposes because it would provide fairer treatment between homeowners and renters and also lower the cost of the income maintenance program. However, this is a close question and will need to be given serious consideration by Congress. If imputed rent is to be included in income, a relative simple method is to apply a flat rate of return, say, four or five per cent, to the net equity in the home, that is, its market value less the outstanding principal of the mortgage.

Capital in other forms occasionally yields low cash returns and this might also lead to anomalous situations. For example, an individual owning

$100,000 worth of IBM stock receives cash dividends of less than $1,000 annually. Such an individual is likely to have enough other income to disqualify him for negative income tax payments, but the mere possibility that this could happen might discredit the program. The remedy is to require an individual to offset against the negative income tax a modest percentage, say, ten per cent of the value of any capital he may own above an allowance, say, $25,000. Thus, an individual with a net worth of $50,000 would offset ten per cent of $25,000, or $2,500, against the negative income tax payment to which he would otherwise be entitled. It would be appropriate to set the exemption at something like $25,000 in order to relieve the poor from reporting furniture, automobiles, and other personal property and to avoid imposing hardships on those who own modest homes.

Definition of the Family Unit

Another feature of the positive income tax that cannot be carried over to the negative income tax is the definition of the family unit. The unit under the positive tax is the individual; the appropriate unit for the negative income tax is the family, since the family provides the basic economic support for its members. The easy cases are married couples with children and adults living alone. Difficulties arise in other situations – broken families, married teenagers, college students, self-supporting minors, et cetera.

I believe that the family unit should consist of the adult nucleus, plus any nonmarried children in the same household. The adult nucleus might be defined as (a) any married couple; (b) any unmarried person 21 years of age or older; and (c) 19- and 20-year olds who do not live with their parents and do not receive more than half their support from them. Children and other minors living in the same household should be included in the family unit if they receive more than half the support from the adult nucleus; those who are studying fulltime for their first college degrees should be included, regardless of age.

Two difficult cases would arise under these rules. First, adults qualifying as a separate unit would be eligible for negative income tax payments even if they reside with another family unit. Such adults could be considered part of the unit with which they reside, but it would probably be better social policy to consider them separate units since most of them are incapacitated for independent living for reasons of health, age, or psychological difficulties. Second, married minors would be entitled to claim allowances while they are living with parents who are well off. This possibility can be eliminated, but there might be some advantage to giving married couples of whatever age some financial independence even if they live with their parents.

Size of Basic Allowances

The principle that should be followed in setting the basic allowances is that they should reflect the relative cost of supporting units of different size. This means that the allowances should increase with family size, but not proportionately because there are economies of scale in family consumption. According to the latest poverty threshold estimate by Mollie Orshanksy, a single person needs a little more than three-quarters of the income of a married couple to maintain the same living standard, and children add less than twenty-five percent each to the household budget with the percentage declining as size of family increases. These relationships could be incorporated in any schedule of basic allowances, and there is a good deal to be said for this approach.

The problem is that large per capita differentials between small and large families will provide some with an incentive to split up. For example, if a family of two receives a basic allowance of $2,000 and a family of four receives $3,000, the latter could gain $1,000 by splitting into two two-person units. In the vast majority of cases, the nonpecuniary factors governing family relationships are much more important than the pecuniary. But it would be unwise to provide too large a financial incentive to break up, even if the number of families affected might be relatively small. Accordingly, the basic allowance might be set on a per capita basis for adults and at lower amounts that decline with size of family for children. Two schedules conforming with these specifications are shown in Table 2.

Under the H-Schedule, a family of two adults and six children would receive $4,600 if it split into two four-person families, as compared with $3,800 if the family remained together — a difference of $800. I doubt that this advantage would bulk very large in comparison with other considerations that are ordinarily significant in the decision to maintain or split a family unit.

Table 2

Illustrative Schedule of Basic Allowances

Size of Family	Basic Allowance	
	L Schedule	H Schedule
1	$ 600	$ 800
2	1,200	1,600
3	1,600	2,100
4	2,000	2,600
5	2,300	3,000
6	2,600	3,400
7	2,800	3,600
8	3,000	3,800

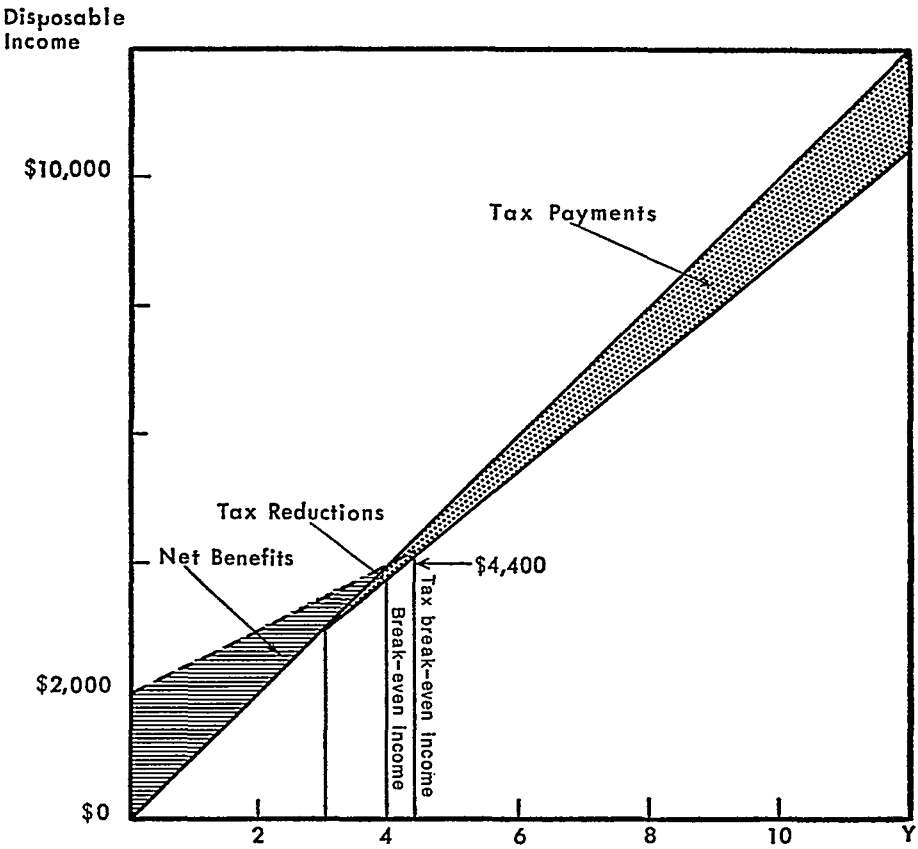
Relation to the Positive Income Tax

So long as the breakeven levels are no higher than the levels at which the positive income tax begins to apply, the negative income tax can be operated quite independently. However, if the negative income tax is to provide more than a pittance as a basic allowance, the breakeven levels will be higher than the levels at which the positive tax takes hold. For example, with a basic allowance of $2,000 and tax rate of fifty per cent, the breakeven level is $4,000 (see Table 1). The personal exemption and the minimum standard deduction for a family of four amounts to only $3,000. Thus, the two systems would overlap in the range between $3,000 and $4,000.

The answer to this problem is to give the family the option to choose the system under which its disposable income is higher. In the above example, it is obvious that all families with incomes of $4,000 or less would choose the negative income tax. It turns out that some families with incomes above $4,000 would also choose the negative income tax because the switch from the negative to the positive income tax precisely at $4,000 would raise the tax rate on an additional dollar of income above 100 per cent. At $4,001, the positive tax for a family of four (according to the simplified tax table) would be $144, leaving it with a disposable income of $3,857 instead of $4,000 it would have had without the additional dollar of income. Paradoxically, the option to pay the higher negative income tax rate would yield a family of four a higher disposable income until its income exceeded $4,400 in this example (see Figure 1). The exact location of this "tax breakeven point" need not concern the individual taxpayer because the final tax return would provide a reconciliation between the positive and negative income tax.

FIGURE 1

Illustration of a Negative Income Tax Plan for a Four-person Family with a $2,000 Basic Allowance and a Fifty Per Cent Tax Rate



METHODS OF PAYMENTS

Since the negative income tax is designed to help poor families provide their basic needs, it will be important to make the payments rather frequently — certainly once or twice a month. The payments can be calculated in one of two ways, corresponding to the two different conceptions of the negative income tax explained following Table 1. First, the basic allowances could be paid to all families, except those who waive payment in order to avoid the offsetting tax on other income. Second, the *net* benefits could be paid on the basis of a declaration of estimated income, patterned along the lines of the quarterly payments now made under the positive income tax by persons who are not subject to withholding.

The election to waive the basic allowance under the first method could be made in writing either to the Government or to the employer. In the former case, the Government would inform the employer not to withhold the offsetting tax; in the latter case, the employer would inform the Government to stop payments of the basic allowance. Tables would be provided, of course, to help individual workers make up their minds, but the decision would not be irrevocable. In the event the employee elected the wrong option, he would be reimbursed for any difference after he filed his final tax return.

If the declaration system is preferred, individuals and families would declare their incomes annually. The Government would compute the estimated net benefit for the year and make payments weekly or twice a month on a prorata basis. Families with a change in income status, either up or down, could amend their declarations at any time. Even if the circumstances did not change, a renewed declaration would be required at the beginning of each year.

The declaration method would not require any changes in the present withholding system and would thus not add to the costs of employers. On the other hand, the automatic payment method would be less likely to be abused by persons who are willing to take the chance to defraud the Government. In addition, the automatic payment method would place the burden of compliance on those who do not want negative income tax payments and these are the people who are likely to have the sophistication needed to make the decision.

It should be added that, under either system, there will be a final reconciliation at the end of the year at which time the taxpayer will pay any balance of positive income tax due or excessive negative income tax received and will receive a payment for any excessive prepayments of positive income tax or underpayments of negative income tax. Many billions of dollars are received from, or paid to, the Government at the end of each year under the present tax system and there is no reason why the additional — much smaller — amounts that would be involved in a negative income tax cannot be handled in approximately the same way and with as little fuss.

Since there would be an intimate connection between the positive and negative income tax, it would be appropriate for the Internal Revenue Service to receive the final tax returns and handle the refunds and payments due, as well as to make the necessary office and field audits. But the claims for the weekly or semimonthly payments could be made through another agency specially organized to guide the poor in preparing their applications for payments. One of the strong arguments in favor of the negative income tax is that it would relieve welfare agencies of the administrative tasks of investigating the validity of welfare claims and permit them to devote their personnel to guidance, counselling, and other social services that the poor badly need.

Integration with Public Assistance and Other Transfer Programs

The federal and state governments make a wide variety of transfer payments to individuals, and these must be integrated with the negative tax to avoid confusion and duplication. In general, the rule should be that transfers intended as deferred compensation for previous work should be counted as income. Unemployment compensation and veteran's pensions would thus be included in the negative income tax base. On the other hand, payments based on need — for example, public assistance, Medicaid, rent supplements, and the value of food received under food stamp programs — should not be counted as income. The aged should be permitted to elect negative income tax payments if they exceed the social security benefits to which they would be entitled.

The public assistance program as we know it today could be eliminated entirely if the basic allowances under the negative income tax were equal to or higher than the highest state payments. It is hardly likely, however, that the first negative income tax to be enacted in the United States will be so generous. It would be desirable, therefore, to encourage the states to keep their own public assistance programs as supplements to the negative income tax. This would permit the states to improve on the levels of assistance in the national program and also to make adjustments for cost-of-living differentials.

If the states were permitted to continue to administer their own public assistance programs, the value of the negative income tax as a device to maintain work incentives would be impaired unless their tax rates were consistent with that of the federal government. To encourage the states to conform in this respect, the federal government might offer to pay, say, half the cost of supplementary state public assistance programs provided the states agree to use the offsetting tax rate used in the federal negative income tax.

Can We Afford a Negative Income Tax?

While an effective negative income tax would cost a great deal of money, I do not believe that it is meaningful to ask whether we can afford such a program in this country. A nation that is allocating $25 to $30 billion a year to an unpopular war can surely afford to allocate at least as much to help its own poor after the war is ended. The question is one of priorities and social attitudes. Those who believe that the poor have only themselves to blame for their poverty will prefer tax reduction to an improved social welfare program. Those who believe, as I do, that the condition of the poor is traceable to oppression and discrimination will prefer the improved social welfare program.

It is becoming fashionable to argue that defense expenditures will not decline much after the war has ended because depleted stockpiles need to be rebuilt and long-range military programs have been deferred. But I doubt that our national security will be significantly improved if we spend $85 billion a year for defense instead of $60 billion. On the contrary, unless we make an early decision to take care of our poor, the national security will be endangered far more by uncontrollable forces within our midst than any enemies we may have abroad.