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Is a Negative Income Tax Practical?

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The war on poverty has brought emphatically to public attention the inadequacies of the nation's welfare system. The assistance given to the impoverished is pitifully inadequate in most states, and the rules under which it is given severely impair both the incentives and the potential of the recipients to help themselves. Most poor people are ineligible for public assistance, so restrictive are the eligibility requirements for the various categories of federal, state and local welfare programs. Many eligible poor people do not accept assistance from local welfare agencies because recipients are subject to numerous indignities by the procedures employed to enforce the means test and other conditions which determine who is entitled to help and to how much. The means test is in effect a 100 per cent tax on the welfare recipient's own earnings; for every dollar he earns, his assistance is reduced by a dollar. Administration of public assistance is now largely a matter of policing the behavior of the poor to prevent them from "cheating" the taxpayers, rather than a program for helping them improve their economic status through their own efforts. As a result poverty and dependence on welfare are perpetuated from one generation to the next, and the wall dividing the poor from the rest of society grows higher even as the nation becomes more affluent.

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Four ideas for reform of our present system of public assistance, none of them novel, have lately received serious attention from economists, social welfare experts, and public officials. One is that assistance should be available to everyone in need. Present welfare laws require not only a showing of need but also an acceptable reason for the need. Old age, physical disability, having children to feed but no husband to feed them—these are acceptable reasons. The inability or failure of the father of a normal, intact family to find a job that pays enough to support the family is not an acceptable reason. Such families cannot now receive welfare assistance in most localities. The second proposed reform is that need and entitlement to public assistance should be objectively and uniformly measured throughout the nation in terms of the size and composition of the family unit, its income, and its other economic resources. There would not be different calculations of need and entitlement from one state to another, one welfare administration to another, one case-worker to another. The third is that the public assistance to which people are entitled should be paid in cash for free disposition by the recipients, not earmarked for particular uses or distributed in kind as food, housing, or medical care. The fourth reform would modify the means test to reduce the "tax" on earnings below 100 per cent, in order to give the recipients of assistance some incentive to improve their living standards by their own efforts.

Some or all of these objectives are embodied in specific proposals that have entered public discussion under a confusing variety of names: "guaranteed income," "family allowance," "children's allowance," "negative income tax." These proposals can be described and compared in terms of two identifying features: the *basic allowance* which an eligible individual or family may claim from the government, and the *offsetting tax* which every recipient of the basic allowance must pay on his other income. The *net benefit* to the recipient is the basic allowance less the offsetting tax. The net benefit can be considered a "negative" income tax because it makes the income tax symmetrical. The regular or positive income tax allows the government to share in a family's earnings when those earnings exceed a minimum that depends on the number of exemptions and the size of allowable deductions. Under a negative income tax plan, the government would by providing benefits also share in any shortfalls of family income below a minimum similarly but not necessarily identically calculated.

The basic allowance can be regarded as the income guarantee. It is

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the net benefit received by a person whose other income for a year is zero and who has no offsetting tax to pay. It is therefore the minimum total disposable income—income from all sources including basic allowance less offsetting tax and other income taxes—the recipient can receive.

The basic allowance depends on the size and composition of the recipient unit. Plans differ in the schedule of basic allowances they propose, both in the adequacy of the amounts and in the variations for family size and composition. Some plans contemplate a fixed per capita allowance. Some would allow more for adults than for children. Some would add diminishing amounts to the basic allowance of a unit for successive children and perhaps impose a ceiling on the amount a family unit can receive regardless of size. Some would give no allowance for adults and would perhaps count young children more heavily than older children.

With respect to the offsetting tax, the main issue is the rate at which other income should be taxed. As already noted, current public assistance procedures generally impose, in effect, a 100 per cent tax. Some proposals for a universal "income guarantee" retain this same tax, disguised as a federal commitment to make up any gap between a family's income and an established living standard. Other "family allowance" plans contemplate no special offsetting tax at all; other income would simply be subject to the regular federal income tax. Some variants of this proposal would count the basic allowance as taxable income. In either case everyone in the country eligible for a basic allowance would be a net beneficiary.

So-called "negative income tax" proposals typically subject allowance recipients to a special offsetting tax with a rate less than 100 per cent but greater than the low-bracket rates of the regular income tax. At sufficiently high incomes the offsetting tax produces a negative net benefit to the family unit as large as or larger than its liability under the regular income tax. Taxpayers in this position would exercise the option to decline the basic allowance and thereby avoid the offsetting tax.

The authors strongly support some sort of negative income tax (NIT) plan, and indeed we have, as will appear below, some specific proposals regarding basic allowance schedules and offsetting tax rates. But the purpose of this article is not to expound the merits of the negative income tax approach in general or of our proposal in particular. The primary purpose is the more limited one of examining some of the sticky technical problems that must be solved if any such

plan is to be implemented. The larger issues of social policy are doubtless more important for the ultimate national decision, but the technical problems are neither trivial nor peripheral—nor can they be wholly divorced from the policy issues. The technical problems are in our opinion solvable. An analysis of at least one plan, with specific feasible solutions suggested for most of the problems, should advance understanding of the approach and meet some lines of criticism. A secondary purpose is to provide rough estimates of the cost of several alternative NIT plans; these are presented at the end of the article.

There are three major sets of problems in designing a workable plan: (1) How to define the family unit and relate basic allowances to its size and composition; (2) How to define the base for the offsetting tax and to relate NIT to the regular income tax and to existing governmental income assistance and maintenance programs; (3) How to determine eligible claimants, make timely payments to them, and collect offsetting taxes from them.

These questions are best discussed in the context of a specific proposal such as that described in section I. The three sets of problems are then considered in sections II, III and IV. The advantages and costs of the several variants of our proposal are described and evaluated in section V.

I. The Proposals

Under our NIT plan every family unit would be entitled to receive a basic allowance scaled to the number of persons in the family, provided it paid an offsetting tax on its other income. Two specific schedules of basic allowances are presented here; a High (H) Schedule which would guarantee allowances that approach the officially-defined "poverty lines" but would be relatively costly to the federal budget; and a Low (L) Schedule which would be relatively inexpensive but would guarantee only a fraction of poverty-line incomes. The schedules were chosen with some care. However, different numbers could be substituted for budgetary or other reasons.

The H Schedule would provide basic allowances ranging from \$800 a year for a one-person family to \$3,800 for an eight-person family. Under the L Schedule the allowances would range from \$400 to \$2,700. Two rates of offsetting tax are considered: 50 per cent and $33\frac{1}{3}$ per cent. Table 1 describes two plans: H-50 and L- $33\frac{1}{3}$. Two other possible plans are the H Schedule with a tax rate of $33\frac{1}{3}$ per cent and the L Schedule with a 50 per cent tax rate.

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To illustrate how the plan would operate, a four-person family under the H-50 Schedule would receive a basic allowance of \$2,600, and its other income would be taxed at a 50 per cent rate. However, no family would be left with a smaller net disposable income than it would enjoy under the current federal income tax without a basic allowance. For every family size there is an income at which the net tax, *i.e.*, offsetting tax less basic allowance, under this new rule is the same as the tax under present rates. On higher incomes, the regular tax schedule would apply.

The proposal thus would not increase anyone's tax liability under

TABLE 1
BASIC ALLOWANCES, BREAK-EVEN POINTS, AND LEVEL AT WHICH PRESENT INCOME TAX
SCHEDULE APPLIES UNDER THE PROPOSED NEGATIVE INCOME TAX^a

Family size (number of persons) ^b	Basic allowance (received by units with no income)	Break-even point (point at which no allowance is received and no taxes paid)	Level at which present tax rates begin to apply ^b	Present marginal tax rate at income in (4)
(1)	(2)	(3)	(4)	(5)
<i>H Schedule (with a tax rate of 50%)</i>				
1 adult	\$ 800	\$1,600	\$1,876	15%
2 adults	1,600	3,200	3,868	16
3	2,100	4,200	4,996	17
4 } including	2,600	5,200	6,144	17
5 } at	3,000	6,000	7,003	17
6 } least	3,400	6,800	7,857	17
7 } 2	3,600	7,200	8,100	17
8 } adults ^c	3,800	7,600	8,359	16
<i>L Schedule (with a tax rate of 33$\frac{1}{3}$%)</i>				
1 person	\$ 400	\$1,200	\$1,420	15%
2 } persons	800	2,400	3,007	15
3 } persons	1,200	3,600	4,633	16
4 } persons	1,600	4,800	6,279	17
5 } persons	2,000	6,000	7,963	19
6 } including	2,400	7,200	9,728	19
7 } at least	2,550	7,650	9,951	19
8 } 2 adults ^d	2,700	8,100	10,196	19

^a The tax rates are 50 per cent for the H Schedule and 33 $\frac{1}{3}$ per cent for the L Schedule.

^b Assumes one-person family is a single unattached individual with no dependents and that families of two or more persons are husband and wife families and file joint returns. Assumes also that the families are entitled to the number of exemptions shown in column 1 (and no additional exemptions for blindness or old age) and use the standard deduction. Rates are those applicable to 1965 and 1966 incomes under the Revenue Act of 1964.

^c A family of three or more receives basic allowances \$300 less if only one of the members is adult.

^d A family of six or more receives basic allowance \$150 less if only one of the members is adult.

the regular federal income tax (unless, of course, taxes were increased generally to finance the plan). Under the NIT proposal the government would pay net benefits to many families who now pay no taxes. Some families who now pay taxes would be relieved of these and would qualify for net benefits. Some families who now pay taxes would pay less taxes. Other families, with relatively high incomes, would be unaffected.

Table 1 summarizes the proposal for families varying in size from one to eight members. Column 2 gives the basic allowance, the amount to which the family unit is entitled if it has no other income. Column 3, which is simply Column 2 multiplied by two for the H-50 Schedule and by three for the L-33 $\frac{1}{3}$ Schedule, shows the "break-even income"; below it the family receives a net benefit equal to $\frac{1}{2}$ or $\frac{1}{3}$ of the shortfall from break-even income; above it the net benefit is negative, *i.e.*, the family pays a net tax. The net tax is $\frac{1}{2}$ or $\frac{1}{3}$ of the excess of the family's income over the break-even point so long as the tax so computed does not exceed the present federal tax liability. The income at which the two calculations are equal for typical taxpayers is given in Column 4, and the marginal tax rate applicable at that income under the regular tax schedule is shown in Column 5.

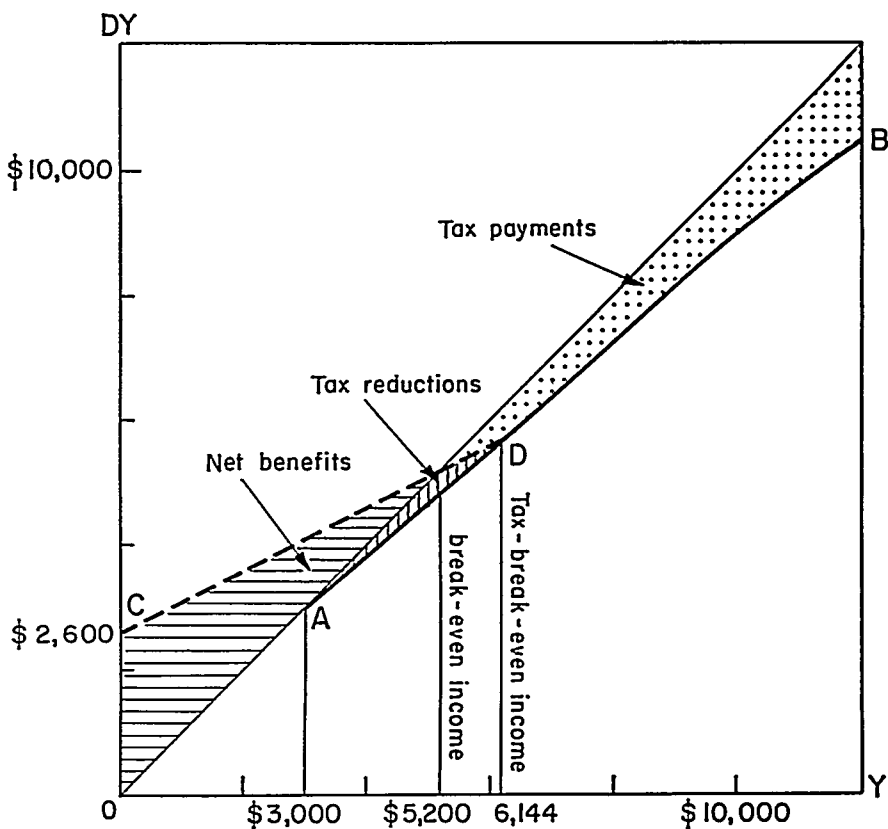
The best way to understand the proposal is to consider the disposable income (DY) after tax and allowance which corresponds to every income (Y) before tax or allowance. Aside from modifications which will be mentioned below, Y is the total income of the family before exemptions and deductions. In Figure 1 the solid line OAB shows the relationship between DY and Y under the present tax law for a married couple with two children filing joint returns. After starting from the origin with a slope of 1, since four-person families with incomes below \$3,000 pay no tax, OAB then takes on successively lower slopes as income increases and progressively high tax rates apply. The total tax is the vertical distance between OAB and the 45° line.

The proposal under the H-50 Schedule is to substitute the relationship CDB for OAB. Below \$6,144 (Column 4, Table 1) families will have larger disposable incomes than they do now; the dashed line CD is higher than the corresponding segment of OAB. Those with no income will get an allowance of \$2,600. Those with incomes below the break-even level of \$5,200 will get some net benefits—and this group includes some families, those between \$3,000 and \$5,200, who now pay tax. Families with incomes between \$5,200 and \$6,144 will pay a smaller tax than they do now; and those above \$6,144 will not be affected.

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The plan must include units with incomes somewhat higher than the break-even level of \$5,200 in order to avoid confiscatory marginal tax rates at that point. The H Schedule would wipe out all tax payments on incomes below \$5,200. If the regular tax schedules were applied to all income above \$5,200 a four-person family with an income of \$5,201 would pay a tax of \$32, leaving it with a disposable income of \$5,169. In other words, the additional dollar of earned income would cost the family \$32. The plan avoids this problem by giving the family the option to remain under the negative income tax system until its disposable income is exactly the same under the positive and negative income tax. For a family of four persons, this point is reached under the H Schedule at a "tax-break-even" income of \$6,144.

Figure 1 Illustration of Proposed Income Allowance Plan
for 4-person family under the H-50 Schedule



II. The Family Unit and the Allowance Schedule

A workable and equitable definition of the family unit is crucial to the success of a negative income tax plan. The two major problems are the relative amounts to be provided as basic allowances for families of different size, and the rules governing the assignment of individuals to units.

A. *Basic Allowances in Relation to Family Size and Composition*

One consideration in setting the schedule of basic allowances is the relative cost of supporting units of different sizes at the same standard of living. By this criterion a family of five should be given just enough more than a family of four so that neither is "better off" than the other. In principle a schedule of basic allowances so computed would be neutral as among families of different sizes. The basic allowance should rise with family size but not proportionately, since there are economies of scale in family consumption. Beyond this qualitative indication, the criterion is not an easy tool to apply; it tends to break apart in the hands of the user. Consumption patterns vary with income, and the economies of scale will be different for different consumption mixes. Whose consumption level should be maintained as family size increases? Parents presumably get some utility, or disutility, from having children; at any rate parents' consumption patterns are not the same as if they were childless.

Another major consideration is the possible impact of the basic allowance schedule on the stability and cohesion of the family as a unit. If there are large per capita differentials between small and large families—more than are justified by economies of scale—there will be an incentive to split up large units. For example, if a family unit of two gets a basic allowance of \$2,000 and a family unit of four a basic allowance of \$3,000, a group of four people could gain \$1,000 by splitting into two two-person units.

In the vast majority of cases the factors governing family-unit formation or splits are largely non-pecuniary in nature. Nevertheless, it would be unwise to ignore the possibility that a financial incentive might cause families to break up, or to pretend to break up. Accordingly, the objective of scaling assistance to poor families of different sizes in proportion to their needs must be balanced against the possible incentive such a standard might provide for family disintegration. The basic allowance schedules shown in Table 1 were designed to strike such a balance. In both schedules the per capita allowance for the first

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two members of the family unit is the same—\$800 in the H Schedule and \$400 in the L Schedule. Thus there is no incentive for a couple to define themselves as two single individuals. In the H Schedule the two \$800 allowances are available only to adults; otherwise there would be an opportunity for financial gain by setting up one-adult units in which a child is listed as the second \$800 member.

The allowance for children declines as the number of children increases. In the H Schedule, the allowances are \$500 for each of the first two children, \$400 for the third and fourth, and \$200 for the fifth and sixth. In the L Schedule the allowances are \$400 for each of the first four children, and \$150 for the fifth and sixth. No additional allowance is provided for children after the sixth in order to give some incentive to limit family size. A corollary, in all justice, is that the government should make birth control information and supplies easily accessible.

Although the schedules provide larger per capita allowances for small than for large families, the incentive to split will normally not be great. For example, under the H Schedule a family of two adults and six children would receive \$4,600 if it split into four-person families, as compared with \$3,800 if the group remained together as one unit—a difference of only \$800. Amounts of this size do not seem to be large in comparison with the other considerations that are ordinarily significant in the decision to maintain or split a family unit. For the rare cases of families with very large numbers of children, a significant financial advantage for splitting is unavoidable. For example, the H Schedule would give a family of 12 \$6,200 if it split in two but only \$3,800 if it remained together.

B. *Membership Rules*

Definition of family units for NIT purposes may be the single most difficult legal and administrative problem. The intention is clear. A single adult is a unit. A married couple and their children are a unit. A widowed or divorced mother and her children are a unit. But rules must also cover other situations—children who live with grandmothers or aunts rather than their own parents, fathers who support children but do not reside with them, married teenagers, college students, self-supporting 19-year-olds, etc. The rules should provide for genuinely split families—some children living with father, others living elsewhere with mother—without giving too much financial incentive for apparent or real splitting of intact families. The following rules have been devised with some of these complexities in mind.

A family unit consists of an adult nucleus, plus any other persons claimed as members by the adult nucleus. Government checks are payable to the individual, or jointly to the individuals, who form the adult nucleus; and this nucleus is also responsible for payment of the offsetting tax. The following can be the adult nucleus of a family unit for the purpose of qualifying for NIT allowances:

- (1) Any person 21 years of age or older.
- (2) Any person 19 or 20 years of age who maintains a domicile separate from his parents or guardian and does not receive more than half his support from his parent or guardian, and is not studying full time for his first college degree. We would conclusively presume that any unmarried non-student below 19 years of age was not in fact maintaining a separate domicile.
- (3) Any married couple, whatever their ages.

Individuals who are not eligible to be the adult nucleus of a unit are "children." The adult nucleus of a unit may claim children as other members of the unit as follows:

- (1) Any child of whom he is (they are) the legal parent(s) or guardian(s) provided the child is living with him (them) in the same dwelling unit, or, if not, is receiving more than half support from him (them) or is studying full time for his first college degree.
- (2) Any other children residing with him (them) in the same dwelling unit and receiving more than half support from him (them). An adult claiming someone else's child without the written consent of the child's parent or guardian would have to substantiate the claim.

However, no adult can claim a child without also including in the same unit any parent or guardian of the child residing in the same dwelling unit as the child. And, no adult nucleus can claim another adult without his consent.

No person can be a member of more than one unit. No person who is taken as an exemption on any regular income tax return can be claimed as a member of a family unit claiming NIT allowances. Likewise, if either husband or wife is a member of such a unit, they may not file a joint return under the regular income tax. The income of all members of a unit must be aggregated for the purposes of the offsetting tax.

In recognition of the additional expenses of college education, the

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adult basic allowance might be allowed for a person engaged in full time study for his first college degree, and added to the basic allowance to which the unit would be entitled if the college student were not counted as a member. Suppose, for example, that one of the three children of a married couple goes to college. Under the H Schedule the basic allowance of the family unit would rise from \$3,000 to \$3,400 (\$800 for the student plus the schedule allowance for a unit of four, \$2,600).

These rules leave open at least two possibilities that might be regarded as loopholes, but there are good reasons for retaining both. The first is that any adult could qualify as a separate unit and receive an allowance while remaining residentially, economically, and socially a part of a unit with adequate income. If this is deemed a loophole, it would be possible to plug it. But it seems consistent with good social policy and certainly with horizontal equity to assist adults who are incapacitated for independent living and employment by physical or psychological difficulties, even if they are attached to families of high income. The other possible "loophole" is that married minors would be permitted to claim allowances even though they are living with a parent. Again, this is a possibility which could be eliminated. But the advantages of giving married couples of whatever age some financial independence, even if their parents are well off, seem worth the small cost involved.

III. Definition of Income

Since the basic purpose of the negative income tax is to alleviate economic need, the definition of income should not coincide with the definition used for positive income tax purposes. The latter excludes many items of income that contribute as much to the ability of the family unit to support itself at an adequate consumption level as do taxable items. To avoid paying benefits to those who are not needy, the definition of income should be comprehensive.

A. *Receipts To Be Included in Income*

Income for NIT purposes should include many items that are specifically excluded in whole or in part from the positive income tax base. Thus, tax-exempt interest, realized capital gains, and scholarships and fellowships in excess of tuition would be included in full; income from oil and other minerals would be computed after allowance for cost depletion only; and exclusions for dividends and sick pay would not be

allowed. In addition to these obvious changes from the positive income tax base, a number of other modifications seem to be necessary:

(1) The simplest procedure is not to allow any exemptions for dependents or deductions (standard or itemized) in computing income subject to the offsetting tax. The basic allowance schedule already reflects the size of unit and the standard costs of living for units of different sizes. Therefore, further refinement of the income concept seems unnecessary. The only exception might be to allow deductions for certain unusual but unavoidable expenditures, *e.g.*, medical expenses greater than some function of the unit's basic allowance.

(2) Exclusion of the value of the services of owner-occupied homes from the offsetting tax would create the same inequities as it does under the positive income tax. Mr. A does not own his home but pays rent with the \$1,000 of taxable income he receives from \$25,000 worth of securities; Mr. B, having sold his securities and bought a home with the proceeds, has no taxable income to report. To put these individuals on a par, the net value of the services provided by B's home should be imputed as taxable income to him. For this reason we would favor inclusion of the value of the services of owner-occupied homes under the positive as well as the negative income tax. But general reform of income taxation is not our present purpose, and it is not necessary to make the definition of taxable income the same for both the positive and negative income taxes. The reason for taxing this type of income under the negative income tax is to gear net benefits more accurately and equitably to the true economic need of the family.

The problem of calculating the imputed net rental value of owner-occupied homes is admittedly difficult. However, most persons should be able to estimate the market value of their homes by correcting their property tax assessments for the generally known rate of underassessment in their locality. The rate of return on this market value must be imputed on an arbitrary basis. At recent interest and dividend levels, a 5 per cent rate would seem fair. As under the ordinary income tax, actual interest paid on a home mortgage would be deductible from income. Alternatively, at the taxpayer's option, the canonical 5 per cent rate of return could be applied to his equity in the home—that is, its market value less the outstanding principal of the mortgage.

(3) The value of food grown and consumed on the farm should also be imputed as income. The federal income tax law and most state tax laws omit this imputation, but it would be undesirable to extend this omission to a negative income tax. It should be possible to settle on a flat per capita amount for each state (if not for each region) to be added

to the money income of farmers for this purpose. Farm families could declare a smaller amount, but the burden of proof would be on them. In addition, the value of meals and lodging provided by employers should be included in employees' incomes, at least up to the amount that the individual would normally spend for the same purposes.

(4) Whether government transfer payments should be regarded as income subject to offsetting tax will depend in large measure on how the plan is integrated with other public welfare and social insurance programs. This problem is discussed in Section III *infra*. In general we recommend that if a transfer is intended not as a payment based on need but as deferred compensation for previous work it should be counted as income. Unemployment compensation and veterans' pensions, for example, would thus be included in the NIT base. If on the other hand a payment is based on need and is designed to supplement the benefits of the NIT program, it should not be counted as income. Public assistance, the benefits of the food stamp program, and rent subsidies would accordingly be excluded from income if these programs are continued unchanged after the negative income tax took effect.

Pensions and annuities from pension plans other than social security should be included in income to the same extent that they are included in the positive income tax base. Social security benefits are not included in the positive income tax base. But if social security beneficiaries are eligible for NIT, their benefits under Federal Old Age Survivors and Disability Insurance—but not their Medicare benefits—should be subject to the offsetting tax, at least in part. They might well be included in full, since the proportion of benefits paid for by the recipients is currently relatively low, particularly among those with very small benefits. Alternatively, a standard fraction of these social security benefits might be excluded as a return of contributions previously made from taxed income.

(5) Transfer payments from relatives, friends, and private charities are as helpful in maintaining consumption as are government transfers. These gifts should not be discouraged, but neither should the government assist individuals with easy access to private sources of aid as generously as it assists others. If gifts from relatives were to be wholly excluded from the negative income tax base, adult children of very wealthy families might be eligible for negative income tax allowances. Also, inequities might arise if some individuals were more fortunate than others in the amounts of assistance they receive from private charities. We propose as a compromise that transfer income from individuals and private charities be excluded from the tax base up to an

amount equal to half the basic allowance shown in Column 2, Table 1. Amounts in excess of half the basic allowance would be included in the tax base.

B. Integration with Public Assistance Programs

Current disparities among states in public assistance standards greatly exceed differences in cost-of-living; they reflect other political and economic differences among the states. They are inequitable and lead to uneconomic migrations. Although migration from agriculture and low income rural areas should be encouraged, it might well be desirable on both economic and social grounds to reverse the present tide of migration into a limited number of large northern urban areas. One of the purposes of establishing a national NIT program is to guarantee a decent minimum standard of life to Americans wherever they reside.

Nevertheless, it is probably desirable to encourage states to maintain public assistance programs as supplements to the national NIT system. This is particularly true if basic allowances are on the scale of the L Schedule, since these amounts would be inadequate substitutes for existing public assistance in most states (though of course much more comprehensive in coverage). Even the H Schedule falls short of welfare payments now made in some jurisdictions. State and even local supplementation is an attractive economical way to adjust for cost-of-living differentials. States with a greater than average sense of obligation to their less fortunate residents should not be discouraged from implementing it.

However, if the states continue to administer public assistance with a 100 per cent tax on other income, the value of the NIT as a device to maintain work incentives will be diluted. Suppose, for example, that the H Schedule is in effect nationally and a state wishes to add \$400 to the \$2,600 basic allowance for a family of four. If the state reduces its aid dollar-for-dollar for other income earned up to \$400, the incentive effect of the 50 per cent NIT rate would be negated unless the family could earn more than \$400. To be sure, the family certainly has more incentive than under present welfare laws; with a \$3,000 basic allowance and 100 per cent tax the family must find a way of jumping from zero earnings to more than \$3,000 before there is any financial reward for self-help. But it is undesirable for even small amounts of income to be subject to 100 per cent marginal tax rates.

States should therefore be encouraged to modify their rules to avoid

inconsistencies with the national plan. One possibility is to condition a federal subsidy for supplementary state allowances on adoption by the states of the federal negative income tax rules. That is, to be entitled to a federal grant-in-aid equal to, say, 50 per cent of the cost of a supplementary program, the states would be required to use the same rate of offsetting tax as used in the federal negative income tax.

At present the federal government pays an average of 59 per cent of the cost of federally aided categorical public assistance. The basic nationwide NIT program would be entirely federal; thus sizable state funds would be freed for the supplements or other purposes. The attraction of the optional state supplement plan is that it allows adequate guarantees to be offered in high cost-of-living states without entailing the expense of providing the same scale of allowances throughout the country. Also, individual states may find it desirable to allow for variations in the supplement plan within the state if there are substantial cost-of-living differences between rural and urban areas.

Ideally, the federal NIT program should be so generous that state supplements would be unnecessary. Although political and budgetary considerations probably make this impossible in the beginning, we believe that once an NIT program was adopted the federal minima would eventually become adequate. The welfare-minded states would have strong financial incentives to make the federal government solely responsible for income maintenance.

Since we view the negative income tax as a superior alternative to such welfare programs as Old Age Assistance and Aid to Dependent Children, we expect these and other categorical income-maintenance programs to be scaled down or eliminated if the negative income tax is adopted.

Whether assistance in kind should be abolished once cash assistance is increased in amount and in coverage is more doubtful. In general, we suggest that if public housing, the food stamp program and medical programs for the poor are to be continued, they should be justified, and modified, by considerations other than income maintenance. For example, under an adequate negative income tax the means test presently used in the determination of eligibility for public housing could be eliminated, and rent subsidies eventually could be eliminated. Eligibility for housing built under government programs would not depend on income levels. Public funds might still be made available by the government at rates below the market rate of interest, but these loans would be related to urban renewal programs and to the elimination of discrimination in the housing market—and not to con-

siderations of income maintenance. On the other hand, society will not allow anyone to be without essential medical care, even if his inability to pay for it reflects improvidence rather than poverty. Therefore, it is unlikely that direct assistance in kind in the health field can be eliminated until a comprehensive, compulsory health insurance plan is adopted.

C. *Integration with Social Security*

The negative income tax might be integrated with social security in two ways. One approach would be to cover people by both social security and NIT allowances. In this case, as explained above, social security benefits would be counted partially or fully as income subject to offsetting tax.

Alternatively, if minimum social security benefits were set at levels adequate for all groups, it would be unnecessary to include the aged and the disabled covered by OASDI in the negative income tax plan. Those who are not now eligible under the social security system could be blanketed in, and the cost of their benefits reimbursed to the social security trust fund from the general treasury. This cost would be relatively small since the vast majority of retired people are already covered by social security.

Nevertheless, to raise the benefits of social security to levels high enough to make the negative income tax unnecessary for retired people would probably be too expensive to be feasible. The present minimum social security benefits of \$792 a year for a retired worker and his wife would have to be raised substantially, and it is unlikely that this could be done without increasing OASDI benefits across the board. This would be an expensive and inefficient way to meet the objectives of income assistance, because large amounts of additional social security benefits would be paid to people whose incomes are adequate.

In general, it seems advisable to separate income assistance from the other objectives of the social security system and to meet the minimal needs of retired people by NIT allowances rather than by blanketing them under social security. The two systems are based on quite different principles; they can and should be operated independently.

D. *Application of the Offsetting Tax to Wealth*

There are a number of arguments for and against taking wealth into account in computing the offsetting tax. The major argument

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against "taxing" wealth is that *income* is the basic measure of ability to pay in the positive tax system. Reducing NIT benefits on the basis of wealth as well as income seems to impose a discriminatory capital levy on those with very low incomes. Moreover, the use of a comprehensive income tax base would prevent most "tax avoidance" on the part of recipients of NIT allowances.

On the other hand, it may be argued that the analogy between positive and negative income taxation is not appropriate. Isn't a government providing financial assistance to a family on a need basis entitled to ask the family to use at least part of its wealth in its own support? Some would argue that the family should be required to exhaust its capital before becoming eligible for NIT allowances. This is an unappealing view, and not only because it is inhumane. A 100 per cent capital levy is surely a disincentive to rainy-day saving, an invitation to improvidence for anyone who thinks it likely he will be needing government help.

In practice, the use of any except the harshest capital test would have little effect on the vast majority of poor persons. It has been estimated that only 39 per cent of all family units with incomes below \$3,000 have a net worth of more than \$5,000. The average net worth of all families in these income classes was \$7,609, of which owner-occupied homes accounted for \$3,204.¹

Nevertheless, it seems desirable to take some account of wealth, if only to avoid the charge that the program would subsidize wealthy persons who prefer to hold their capital in forms that yield little or no current income. Currently, an individual owning \$100,000 worth of IBM stock receives cash dividends of less than \$1,000 per year. While it is highly unlikely that such an individual would not have enough other income to disqualify him for NIT benefits, the mere possibility that the public might be obliged to such a capitalist could discredit the program.

One possibility is to deny eligibility to any individual or family unit with a net worth of more than, say, \$25,000. This solution has the merit of simplicity. However, a fixed limit would deny benefits to families with wealth just above the limit, while others just below it would be eligible. Such a "notch" would be inequitable and would create incentives to conceal or even give away wealth in order to preserve eligibility for negative income tax.

1. D. PROJECTOR & G. WEISS, SURVEY OF FINANCIAL CHARACTERISTICS OF CONSUMERS, table A-1, at 96, table A-8, at 110 (1966).

A much more equitable approach would be to impose an offsetting tax on capital as well as on income, though not at the same rate. The offsetting tax on capital would in effect require the family to use a portion of its wealth to maintain its consumption. The capital tax would be a flat percentage, say 10 per cent, of the family's net worth above an exemption, most simply stated as some multiple of the basic allowance. Thus, for example, if the minimum allowance for a family of four is \$3,000, an exemption of eight times the allowance would be \$24,000. A family with a net worth of \$50,000 would have to pay 10 per cent of \$26,000 or \$2,600 as offset against the NIT allowance to which it would otherwise be entitled.

There is room for difference of opinion on how large the exemption should be. The arguments are qualitatively the same as those for and against imposing any capital tax at all. Our own balance of these considerations leads us to suggest an exemption between four and eight times the basic allowance.

Net worth should be comprehensively calculated, with the family's debts deducted from its total assets. Valuations should be made on a current market basis; where market valuations are not available, they should be approximated by expert appraisers. As observed above, the value of owner-occupied homes may be estimated in most parts of the country by reference to the average ratio of market values to assessed values in the community.

Including the value of the equity in owner-occupied homes in net worth may be regarded as too strict. This rule might force some poor people to sell or mortgage their homes. But it would be highly inequitable to require a capital offset on the part of families with other types of assets and to exclude homes altogether. Since in any case the proposal would exempt a substantial amount of wealth for each family unit, any hardship that might be imposed on poor homeowners would be minimal. If further protection against the danger of forced sales is desired, the value of the home might be reckoned, not as market value, but as the maximum first mortgage for which it would stand as collateral.

An alternative method of dealing with wealth is to disregard property income in defining taxable income and to impose an appropriately larger offsetting tax on capital. For example, a total of 15 per cent might be imputed to the family's net worth and taxed as income. The 15 per cent equals the sum of a 5 per cent rate of return plus the 10 per cent capital offset discussed above. This procedure has the advantage of correcting for differential yields on assets; it would even

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impute a rate of return to cash holdings. To provide for the exemption proposed earlier, the imputation might be set at the rate of 5 per cent on net worth up to eight times the minimum allowance and 15 per cent above this point. This method has the additional virtue that the form filed by the family would require only two items of information—total family earnings and net worth—whereas the other method would require the family to report property income as well. On balance, there is little to choose between the two.

E. *Fluctuating Incomes*

It is well known that a progressive income tax based on a one-year accounting period imposes a heavier tax burden on persons with fluctuating annual incomes than on those with stable incomes. For example, under present law, the federal income taxes on a single person with an income of \$25,000 in each of two successive years total \$17,060; if the individual receives \$50,000 in one year and has no income in the second year, his two-year tax would be \$22,500, or almost a third higher. To reduce this inequity, sections 1301-04 of the *Internal Revenue Code of 1954* allow a measure of "income averaging" in federal taxation. Under these provisions, taxpayers are generally permitted to average their income for individual income tax purposes if "averageable income" (current year income minus $133\frac{1}{3}$ per cent of the average of the four prior years' income) exceeds \$3,000.²

Similar inequities could arise under negative income taxation. But here the rate structure benefits rather than penalizes recipients of fluctuating incomes. Fluctuations in and out of the NIT income range are advantageous. Consider an individual at the tax-break-even income level, with a regular marginal tax rate of 20 per cent and an NIT rate of 50 per cent. If his income exceeds that level by \$1,000 he is taxed \$200. If his income falls short by \$1,000, he gains \$500. Over a two-year cycle he is \$300 better off than if he had received the same total in equal installments.

Under plan H-50 a family of four which earns a *total* of \$10,000 spread evenly over a three year period will receive \$2,800 in NIT benefits. The same family, if it earned \$10,000 in one year and nothing in the two following years, would pay \$1,114 in positive tax and

2. INT. REV. CODE OF 1954, § 1301, provides:

. . . the tax imposed by Section 1 for the computation year which is attributable to averageable income shall be 5 times the increase in tax under such section which would result from adding 20 per cent of such income to . . . $133\frac{1}{3}$ % of [the average income of the previous four years].

receive \$5,200 in net NIT benefits during the two years of zero income: its net receipts from government over the three-year period would thus be \$4,086.

Moreover, there will doubtless be some instances in which the use of an annual accounting period for negative income tax purposes will provide benefits to persons who are not "poor" by most standards. Consider, for example, an individual who spends all his income when he earns it, with violently fluctuating annual income. Most people would not regard it as proper to provide negative income tax payments in one year to an individual who earned \$25,000 in the year before.

In spite of these inequities and anomalies, it does not seem desirable to try to enforce income-averaging by NIT allowance recipients. Most eligible people, the real poor, gear their outlays closely to their incomes. They would suffer real hardships if their current NIT benefits were cut back because of their past income, or if in their more prosperous years they had to repay NIT benefits received in the past. The rich man who by design or misfortune turns up with no income in one particular year will usually be disqualified by the offsetting capital levy already discussed. If not, the best protection is simply to deny him the privilege of averaging for regular income tax purposes if he has received negative income tax benefits in any of the four preceding years. A rule of this sort would require any individual with wide income fluctuations to weigh the advantage of receiving negative income tax against the disadvantage of losing the benefits of income averaging. It has the obvious attraction that it is entirely self-administering and does not complicate the negative or positive income taxes.³

IV. Methods of Payment

Although the calendar year should be the basic accounting period, there is every reason to adopt a short payment period. Benefits should be paid weekly or twice monthly to prevent real distress among those who have little capital or credit. Such an arrangement would be analogous to the positive income tax, which is withheld weekly or twice monthly for most wage earners and is then subject to a final reconciliation for the entire year when the final tax return is filed.

Government welfare and other agencies have substantial experience

3. A statement of the rule might be included with the averaging form. It is doubtful that this refinement needs to be mentioned on the form filed by the negative income tax recipient.

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in the payment of transfers to individuals and families, so that the mere preparation and mailing of NIT allowance checks poses no great administrative difficulties. The problem is to devise a method of payment prompt enough to prevent distress among those eligible and in great need for assistance while avoiding the paternalistic rules now imposed by the nation's welfare programs. Among the methods we have considered, two meet the requirements: (1) automatic payments of full basic allowances to all families,⁴ except those who waive payment in order to avoid withholding of the offsetting tax on other earnings; (2) payment of *net* benefits upon execution of a declaration of estimated income, patterned along the lines now used for quarterly payments of federal income tax by persons not subject to withholding.

A. *Automatic Payments of the Full Basic Allowance*

Under this system, the full basic allowance would be mailed out at the beginning of each period—week, or half-month—to all families. The checks would be received by families who may ultimately have incomes in excess of the break-even point, as well as those who will be eligible for net benefits. Likewise, all families would be subject to withholding at the rate of the offsetting tax on the first X dollars of their earnings, and would be required to pay the offsetting tax on other income by quarterly declaration. Final adjustment would be made by the tax return for the year filed the next April 15th.

This method may be illustrated for a family of two which, on the basis of the H-50 Schedule, has a basic allowance of \$1,600, a break-even point of \$3,200 and an offsetting tax rate of 50 per cent, and a tax-break-even point of \$3,868. The basic allowance would be mailed to all families in 24 installments of \$66.67. However, withholding tables would be adjusted so that 50 per cent of earnings up to \$322.33 per month (\$3,868 a year) would be withheld. Taxpayers not subject to withholding would be expected to pay the offsetting tax quarterly.

4. This is the procedure used for "demogrants" or family allowances in other countries. The essential characteristic of demogrants is that the payment is made to all families in the potential eligible group, regardless of income. In some cases, the allowances are subject to positive income tax, but this is not a necessary condition. Family allowances are used in many countries, including Canada, Belgium, France, West Germany, Italy, Luxembourg, Netherlands, Sweden and the United Kingdom. For data on the European countries, see JOINT ECONOMIC COMMITTEE, EUROPEAN ECONOMIC SYSTEMS, ECONOMIC POLICIES AND PRACTICES, PAPER No. 7, 89th Cong., 1st Sess. (1965). It should be noted that universal payment of basic allowances under an NIT program does not mean everyone is benefited by the program. Most people would pay an offsetting tax large enough to repay the allowance checks. Therefore the NIT program differs in essential respects from programs under which everyone benefits, no matter how wealthy. There is only an apparent procedural similarity.

There is no reason, of course, to burden the government and the population with unnecessary exchanges of payments. Any family which does not expect to be eligible for significant net NIT benefits can always elect to withdraw. The family will not then receive the periodic basic allowance payment from the government, and its working members will not be subject to withholding (or quarterly payments) of the offsetting tax. This election could be made in writing either to the Internal Revenue Service or to the employer. In the former case, the IRS would inform the employer not to withhold the offsetting tax. In the latter, the employer would inform the government through the IRS to stop the payments.

B. Declarations by Benefit Claimants

The declaration method would operate as follows: At any time families who believe they are or will be eligible for net NIT benefits could prepare a declaration of expected income for the current year. The declaration might be a simple post-card form requiring information only on family composition, expected income for the year, income in the prior quarter, and (if the proposed offsetting tax on wealth were adopted) net worth. The federal government—whether the IRS or some other agency—would compute the estimated *net* benefit, basic allowance less offsetting tax, for the year. Taking account of payments already made to the family during the year and taxes already collected from the family, the agency could estimate the remaining net benefit due and pay it in weekly or twice-monthly installments. Families whose incomes increased above expectation would be required to file a new declaration to stop or reduce the benefit payments. Families whose income fell short of expectation could make a new declaration at any time. Even if circumstances do not change, a renewed declaration would be required at the beginning of each year.

The withholding system would not need to be changed to collect the offsetting tax, because it would be deducted in determining net benefits to be paid.

The declaration method would not, of course, avoid the necessity of a final accounting and settlement between the family and the government for the year as a whole. This would be accomplished, as now, by the final income tax return on April 15, which would cover obligations under both the NIT and the regular income tax. At this time the family would either claim any net benefits not previously received or pay any net amount due the government.

The major drawback of the declaration method is that it would

invite many families to underestimate their income in order to obtain current payments. Claims for benefit payments would have to be compared with income information already available from prior years, from prior declarations, and employers' withholding. The computer makes prompt cross-checking of this kind feasible. Nevertheless, some families will use the NIT facility as an easy source of credit. This is not wholly undesirable, because many poor people lack credit facilities. But it would be reasonable to charge an interest penalty for underpayment of taxes or over-claiming of benefits. There will also be cases of outright fraud and these will have to be handled as severely as is fraud in the positive income tax. However, it should be remembered that the amounts potentially involved in "negative" fraud are small fractions of the sums often at stake in "positive" fraud.

It is difficult to choose between the two methods of payment. Both are workable. The declaration method would limit payments to families who expect to be eligible for net benefits and would not require any changes in the present withholding system. The automatic payment method, on the other hand, would be less likely to be abused by persons who are willing to take the chance of defrauding the government. The declaration method imposes the burden of initiative on those who need payments; the automatic payment method places the burden on those who do not want them. It may be argued that the latter are more likely to have the needed financial literacy and paperwork sophistication.

V. Budgetary Cost of the Plans

We have made a tentative and preliminary attempt to estimate the cost of the plans to the federal government. These estimates should be regarded as merely indicative and very rough. The costs are defined as the net reduction in income tax revenues which would result from superimposing the plans on the 1965 income tax code; this sum is the equivalent of the total increase in family incomes after taxes and allowances resulting from the plan. Although the tax law and rates applicable in 1965 are the reference point, the cost estimates are based on the 1962 population and the 1962 distribution of families by size and income. The reason is that 1962 was the last year for which *Statistics of Income: Individual Income Tax Returns* was published when work on these estimates commenced.

We made four sets of cost estimates covering each of the two allowance schedules in turn at the rates of 50 per cent and 33 $\frac{1}{3}$ per cent.

The costs are broken down into three parts: (A) the net benefits to family units which did not pay taxes in 1962; (B) net NIT benefits, plus reduction in income tax payments, for units which paid taxes in 1962 and which would receive net benefits under the negative income tax plan (*i.e.*, families whose incomes are below the break-even points); (C) the reduction in taxes for units which paid income taxes in 1962 whose net benefits would be negative under NIT but smaller than their regular income tax liability. The cost estimates for each of the four plans are given in Table 2.

TABLE 2
ESTIMATES OF ALTERNATIVE NEGATIVE INCOME TAX PLANS
(billions of dollars)⁵

The status under present law	H Schedule		L Schedule	
	33 $\frac{1}{3}$ % tax rate	50% tax rate	33 $\frac{1}{3}$ % tax rate	50% tax rate
A. Nontaxable	22.3	18.2	10.0	6.7
B. Taxable, income below break-even point	23.2	6.7	3.3	2
C. Taxable, income above break-even point	3.8	1.1	1.0	.1
Total cost	49.3	26.0	14.3	7.0

The estimates are based on data found in Table 18 of the *Statistics of Income*;⁶ this is the basis for an estimate of the distribution of tax-paying families by size and income. In deriving these distributions we assumed that families who claim children as exemptions do not have other dependents and families who have other dependents do not have children. Secondly, it was necessary to account for the 14.1 million people who do not appear on tax returns. It was assumed that they have the same family size and income characteristics as the non-tax-paying units who filed returns in 1962. This last assumption probably leads to a downward bias in the cost estimates, as families who do not file tax returns can be expected to have very low income.

On the other hand, the costs are over-estimated to the extent that the "adjusted gross income" concept on which they are based is nar-

5. These estimates are based upon a distribution of taxpaying families by size and income estimated from U.S. TREASURY DEP'T, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1962: INDIVIDUAL TAX RETURNS table 18 (1965).

6. *Id.*

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rower than the income concept proposed for NIT. Also, against the cost of the NIT program must be set the saving on other governmental income assistance programs which it will, at least in time, substantially replace. The federal government spends \$3.2 billion for categorical public assistance, and the states and localities dispense another \$2.4 billion.

On the assumption that people receiving social security also qualify for negative income tax, the single largest downward adjustment in the cost estimate would result from the inclusion of social security and veterans' pensions in the tax base. On the basis of information from the Social Security Administration,⁷ it is estimated that about \$4 billion of OASDI benefits and veterans' pensions are paid to married couples whose total income (including social security) is less than \$3,000 and to single men and women whose income is less than \$1,500. Since this type of income accounts for between 50 and 60 per cent of the total income of these groups, its inclusion in the tax base under plan H-50 would increase the base by at least \$4 billion and decrease the cost of the plan by at least \$2 billion.

In 1962 the gross rental value of owner-occupied dwellings was estimated to be \$37 billion. From the 1960 Census of Housing⁸ we estimated that about 12.8 per cent of the total value of owner-occupied homes was owned by people whose income was less than \$3,000. We estimate that imputing a 5 per cent return on owner-occupied residences would increase the negative income tax base by about \$2 billion and decrease the cost of plan H-50 by about \$1 billion. Other items, part of which would be included in the broader negative income tax base include: \$500 million of capital gains accruing to tax-paying units whose adjusted gross income was less than \$3,000, \$1 billion of unemployment compensation and \$2.2 billion of food consumed on farms.

Although our analysis is very imprecise, we estimate that the broadened tax base would save between \$3 and \$5 billion for plan H-50. It is not obvious whether the saving for plan H-33 would be higher or lower. For this plan the break-even levels of income are higher; therefore larger amounts of income that is not now taxed

7. See Merriam, *Social Welfare Expenditures, 1963-64*, in SOCIAL SECURITY ADMINISTRATION BULLETIN, table 3, at 3, 9 (October, 1964); Palmovc, *Differences in Sources and Size of Income: Findings of the 1963 Survey of the Aged*, in SOCIAL SECURITY ADMINISTRATION BULLETIN, table 1, at 3 (May, 1965).

8. 2 U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, CENSUS OF HOUSING pt. 1, table A-3, at 1-5 (1963).

would be included in the negative income tax base. On the other hand, the tax rate is lower.

Taking into account the fact that a substantial proportion of the \$5.6 billion of categorical assistance would be replaced by NIT, the net cost of H-50 would be about \$20 billion, while plan H-33 would cost at least twice that amount. The net cost of plan L-33 would be around \$10 billion, while the cost for L-50 would be less than \$5 billion.

Clearly these rough estimates do not even begin to take account of:

(1) The growth of population and income since 1962: There are more people, but the incidence of poverty has declined. How the costs of various NIT programs have been affected is hard to say.

(2) Induced responses to the program itself: Some people may work and earn more when their marginal tax rate is reduced from 100 per cent to 50 per cent or 33 per cent, while others work and earn less when the government makes them better off and raises their marginal tax rate from zero or 14-20 per cent to 33 or 50 per cent. These responses will change the tax base, but in the absence of experience or experiment it is not possible to estimate in which direction or how much.

(3) Savings in government expenditures other than income assistance: To an unknown degree NIT benefits may reduce the need for assistance in kind such as medical care, housing and food. We believe that a generous NIT program would also in time diminish expenditures now devoted to controlling and suppressing the symptoms of poverty—crime, social disorder, unsanitary environments—rather than to eliminating poverty. But budgetary savings are the smallest consideration in this anticipated consequence of the program, and they neither can be nor need to be estimated.

Although the authors believe that it is well within the fiscal capacity of this country to adopt a generous negative tax plan, there may be in the first instance a conflict between cost, the adequacy of the basic allowances, and the objective of keeping the offsetting tax rate as low as possible. The allowance levels for plan L are inadequate for many parts of the country and this plan would have to be supplemented in some way. On the other hand, if plan H were adopted for the country as a whole, the offsetting tax rate would probably have to be considerably higher than 33 per cent because of cost considerations. High tax rates unfortunately weaken one of the basic objectives of NIT, namely to improve upon the disincentive aspects of existing welfare programs.

The course of action which we think best balances these considera-

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tions is federal enactment of plan L with a tax rate of 40 per cent. The basic allowances of this plan would then, we hope, be supplemented by individual high cost-of-living states along the lines outlined above. As the federal budgetary situation eases, the national basic allowance schedule could be gradually improved to approach plan H.