

TAX REFORM AND INCOME REDISTRIBUTION: ISSUES AND ALTERNATIVES

Redistribution through the Income Tax

1. The 1972 presidential campaigns evoked great popular interest in proposals for income redistribution through the federal income tax, though more confusion than understanding and more opposition than support. Of course, the income tax has always been an instrument of redistribution, in two senses: First, it embodies, though quite imperfectly, the principle that the burdens of federal expenditure should be borne in accordance with "ability to pay." Second, income tax revenues finance transfer payments and other programs with identifiable individual benefits; the resulting net redistributions are large and, on the whole, egalitarian.¹ The common novelty of various controversial schemes of recent years is the proposal that the income tax system itself should result not only in tax payments *from* most citizens but also in cash payments *to* others, that is, in negative taxes as well as positive taxes.

This proposal would make explicit the redistributive nature of income taxation. The same set of rules and criteria that determines whether citizens pay more or less taxes would also determine whether they pay taxes or receive transfers of smaller or larger amount. Some existing transfers, now administered separately from the income tax and by different criteria, would be replaced by negative taxes. Although the idea is not at the moment a very live option in American politics, thanks in no small part to the 1972 debacle, Britain is about to implement it.² Strangely enough, what is regarded here as a radical proposal is viewed there as conservative.

2. In this paper we consider some of the problems and issues in reforming the US federal income tax in the same direction. Our approach is quite pragmatic. We do not pretend that we are building from scratch a wholly new integrated system of taxes and transfers. We begin with the existing systems and we take some account, for reasons of both

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equity and political acceptability, of the interests of the current beneficiaries of tax concessions and special transfers.

We set forth below a number of specific plans and calculate their redistributive impact as of 1970. The reference plan is the actual federal personal income tax of 1970, together with the cash public assistance program of 1970. Each proposal is required to produce the same aggregate net revenue as the reference plan.

Families (including single individuals) are classified by several characteristics: size, income, age of head, home ownership. The redistributive impact of any proposal on an average family of any type is the difference, positive or negative, between its tax liabilities under the proposal and under the reference plan. We shall present summary statistics of the redistributions for several plans.

These gains and losses are the first-round effects of each proposal. They are calculated on the assumption that the original distribution of income, before taxes and transfers, is not changed by the reform. Revisions of the tax code will in general induce changes in behavior and earnings that will modify the first-round redistribution. We make no attempt to estimate these second-round effects. We are encouraged to believe that the omission is not serious by the experimental findings in New Jersey, where income guarantees and high marginal tax rates appear to have had little effect on earnings.³

The Credit Income Tax and the Negative Income Tax

3. All reform proposals of the genus described in section 1 provide an income guarantee, the amount of negative taxes a family receives when it has zero income. The guarantee can be regarded as a universal cashable *tax credit*—available to discharge gross income tax liabilities and receivable in cash to the extent the credit exceeds gross taxes.

Gross taxes must be large enough in aggregate to cover all the tax credits of the population and to provide the net revenues needed for the federal budget. A useful identity to bear in mind is the following:

$$\frac{\text{average gross tax}}{\text{average income}} = \frac{\text{average net tax}}{\text{average income}} + \frac{\text{average tax credit}}{\text{average income}}$$

Thus, if the federal budget needs 10% of personal income and the tax credit or income guarantee is set at 25% of average personal income, gross taxes will have to be 35% of personal income.

There are many tax codes that could produce the required net revenues, differing from each other in guarantee schedules, tax rate sched-

ules, definition of taxable income, and other provisions. We make one basic distinction, between a unitary code and a dual code. A unitary code, also called a *credit income tax*, specifies a uniform method of calculating tax liabilities; another distinguishing feature is that the marginal tax rate is either constant or nondecreasing with income. A dual code, generally called a *negative income tax*, offers the citizen a choice between two codes, of which one will generally be advantageous for poorer families, the other for richer. The second code is just the current positive income tax, with rates scaled up as necessary to pay the negative taxes. The first code offers tax credits in place of deductions and exemptions and offsets them by taxing an inclusive definition of income at a high marginal tax rate, 50% for example. When a taxpayer reaches the income at which the regular income tax code is cheaper, he shifts abruptly to a lower marginal tax rate.

Dual plans, negative income tax plans, have been extensively discussed and calculated.⁴ For that reason, our emphasis is on unitary plans. But we have included, for comparative purposes, one model negative income tax proposal.

Vertical Equity

4. Every concrete proposal for tax reform is a compromise among conflicting objectives. The important criteria that must be balanced are vertical equity, horizontal equity, historical equity, simplicity, and minimization of incentives for inefficient tax-avoiding behavior. We shall discuss these objectives in turn and point out the important ways in which they conflict. We shall also indicate the general nature of the compromises reflected in our specific proposals; the details are given below.

Vertical equity is of course a principal motivation for proposals of this type. Existing transfer programs miss many poor and near-poor families, particularly large families headed by men of working age.⁵ Income guarantees, tax credits, are designed to shift income to the low-income brackets. As for the upper brackets, the loopholes, privileges, exclusions, and deductions that neutralize the theoretical progressivity of the income tax are well known.⁶ It is natural, therefore, to seek at least part of the revenue for negative taxes by tightening the definition of taxable income.

The pure credit income tax, originally propounded by Earl Rolph,⁷ involves tax credits c , a single gross tax rate t , and a tight comprehensive concept of taxable income y . The tax liability of a family is $ty - c$, and may of course be either positive or negative. The system is progressive