

THE ROLE OF INCOME-CONDITIONING IN THE AMERICAN SYSTEM OF TRANSFERS
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Between 1960 and 1973 social welfare expenditures under federal, state and local government programs increased from \$52 billion to \$215 billion. They were equal to 11.8 percent of gross national product (GNP) in 1960 and 17.6 percent in 1973. The three leading classifications of these expenditures are social insurance (\$86 billion), education (\$65 billion), and public aid (\$28 billion). Lesser amounts are listed under health and medical programs, veterans programs, "other social welfare," and housing. In addition to these public expenditures, there is a growing set of private transfers to persons in the form of such things as pensions, health insurance benefits, scholarships and charitable grants. This battery of public and private transfers, in cash and in-kind, is financed by taxes, which, in some cases, are designed to further certain transfer purposes, and by private contributions. The public and private components of this American system of transfers now take in and pay out an amount equal to almost one-fourth of GNP. And that share seems destined to grow.

The scope and scale of this system have grown particularly rapidly since 1964, starting with the introduction of medicare and medicaid and federal aid to elementary and secondary education, and continuing in more recent years with other innovations as well as with the expansion of existing programs. I will, in this paper, point to a few of the more remarkable changes of recent years. The changes selected for discussion were all designed to concentrate their benefits on families in relatively low-income status. They all have to do with the income-conditioning of benefits, a practice which is now surprisingly popular.

Three Recent Changes

Supplemental Security Income (SSI), which goes into effect January 1, 1974, is our first nation-wide negative income tax. Perhaps it is the second such plan in the world, following the British Family Income Supplement of 1971. It covers only the aged, blind, and disabled, but it does establish near-poverty-line guarantees (\$2500 for a couple) in all states and it sets uniform rules for determining eligibility and benefits. It will be administered by the Social Security Administration and financed out of general revenues. States must contribute enough to maintain present guarantees for current beneficiaries and are encouraged to add to SSI levels for new recipients. The guarantee is reduced dollar for dollar by all but the first \$20 per month of non-earned income (including social security benefits) and by 50 percent of earnings after the first \$65. In other words, after certain set-asides, the implicit tax rates are 100 percent on non-earned income and 50 percent on earnings. This will produce break-even points in the neighborhood of \$6000 for a year for those couples with earnings. There is no work test and

no relative responsibility test, but there is a resources test.

SSI will add about \$3 billion of cash income to low-income families and individuals in its target categories. This will fill a substantial part of the poverty-income gap which was about \$12 billion in 1972 and is probably less in 1973. However, this effect is somewhat muted by the withdrawal of eligibility for foodstamps on the part of most of those claiming SSI.

A second notable change is the liberalization of Aid to Families with Dependent Children (AFDC). The 1967 Amendments specified that the tax rate on earnings cannot exceed 67 percent. Researchers find that because of the set-aside of \$30 a month indicated by federal law, and because of practice in some states of ignoring earnings that bring total income up to stated standards, and because of deductibility of work expenses (a favorable ruling requires deduction after the 67 percent tax rate is applied to earnings), and because of variability of rent allowances, the tax rate is rarely as high as 67 percent. This means, of course, that break-even incomes are substantially higher than guarantees. AFDC has also been liberalized by court rulings outlawing rateable reductions in benefits to extend a fixed-sum appropriation through a benefit period, state residence requirements, and state rules on the issues of "a man in the house" and the non-adoptive step-father, as well as the earlier practice in some states of counting "expected" but not actually received contributions from relatives. All of these changes, plus a less harsh stance by administrators and, perhaps, a decline of stigma associated with receiving AFDC benefits, have contributed to a close to 100 percent take-up by eligibles, if we are to believe Census reports of numbers and incomes of broken families. This remains true in spite of the Talmadge Amendment of 1972 which mandated a work test for mothers whose youngest child is six years of age or older.

AFDC guarantee levels have varied widely from state to state, with the highest-paying states' guarantees running six times above those in the lowest. However, the advent of the foodstamp program has served to reduce this variation. AFDC cash plus foodstamp bonus values now yield guarantee levels for a family of four of \$2316 in Mississippi and \$5046 in Hawaii, i.e., a difference of only about two to one. Similarly, the availability of foodstamps for working poor families diminishes the gap between what a low-wage earner can provide for his family and what they would get if he deserted and let them go on AFDC.

The third remarkable change in our system of transfers is the evolution of foodstamps into a major program. The foodstamp schedule which goes into effect on January 1, 1974 has a guarantee of

\$1704 for a family of four, a set-aside of \$360 as well as deductibility of taxes paid and of certain working expenses, and a tax rate of 30 percent, leading to a notch where \$288 worth of benefits are lost, down to a break-even point of \$5676. This schedule is to be operational in all areas of the country by next July. This year, about 12.5 million people have benefited from the program, but the higher benefit schedule and the mandating of it nation-wide will make more than 30 million people eligible, in spite of the fact that most SSI recipients are not eligible. Hence it is a second nation-wide negative income tax, but, in this case, one with benefits in kind. It can be argued that some part of the \$5 billion to \$10 billion of foodstamp bonuses of the expanded program should be counted as reducing the poverty-income-gap.

All the bonus values going to those with money income below poverty lines would be relevant to this consideration if one could affirm that foodstamps are as good as money, which they are when people would spend at least as much on food as they can claim in foodstamps. This is roughly the case at poverty-line incomes (the poverty-line for a family of four is now \$4300) and above. The monthly foodstamp allotment for a family of four is \$142. If such a family has a money income of \$375, their foodstamp bonus is \$38, which yields a total income of \$413. At that level of income they are likely to spend \$142, or one-third of income, on food. On the other hand, at very low levels of cash income this is not likely to be the case. For example, at \$100 of cash income the full foodstamp allotment of \$142 would cost the family \$25. A family in that situation is unlikely to want to devote \$142 out of their full income of \$217 (\$100 in cash plus \$117 of foodstamp bonus), that is, two-thirds of their income, to food. Hence, they are likely to bootleg part of their stamps or food and to lose something in the process, or to buy something less than their full allotment of coupons. The fact that these calculations are based on monthly rather than annual income means that foodstamp benefits are worth more to a family with income that varies from month to month than to one with a stable income.

Even with those limitations, foodstamps will serve as a useful supplement to income for many working-poor families. The low guarantee (relative to the average AFDC guarantee) is partly justified on the ground that intact families (unlike single-parent families) have the option of taking income in the form of home-produced child care at the same time that they get income from the market. As we noted, foodstamps also serve well to narrow the interstate variation of AFDC benefits. However, they heighten the disincentive problem for those on AFDC. Since the foodstamp formula takes account of AFDC benefits, the 30 percent tax rate implicit in the foodstamp schedule does not simply add to the 67 percent rate in AFDC, but it does produce a combined rate of about 77 percent on earnings. Even though, as we noted above, the actual rates of tax in AFDC are below the nominal rates, it is unreasonable to expect that large numbers of welfare mothers

are going to work voluntarily in this situation, especially if they have any un-reimbursed work expenses. Even deductibility of child care cost will leave some part of that cost as a tax on earnings. Hence, a woman will have to earn a considerable amount before her "disposable income," net of payment for child care, is equal to the guarantee at zero earnings, in which situation she consumes her own home-produced child care.

There are intriguing questions of equity here. Some single-parent families with earnings below AFDC break-even levels (which range up to \$8000 and above in some states) are ineligible for AFDC help because their earnings are above the guarantee level. (The H.R. 1 Family Assistance Plan would have corrected this anomaly.) This produces understandable claims by those excluded from AFDC for help in meeting their child care costs, and Congress has responded by liberalizing income tax deductions for child care and by pushing for direct government provision of day care on a sliding scale of benefits, with partial subsidy extending above median family income levels. Currently, federal support of day care runs to about \$2 billion a year, with added amounts via welfare deductibility and tax deductibility of day care costs paid by families.

Cumulation of Tax Rates

However, to return to the incentive issue, the fact is that AFDC, foodstamps, and the unreimbursed portion of work expenses, leave many welfare mothers, who are now the majority of women heading families with children, living under a regime of 100 percent implicit tax rates. This is without taking account of medicaid, which varies considerably from state to state, but which has inequitable and disincentive features in it. The Nixon Administration, according to newspaper reports, is going to propose again what they did in 1971, namely, the nationalization of medicaid and a more orderly income-conditioning of its benefits without regard to welfare status. However, a family would lose eligibility if the head is regularly employed fulltime, in which case they would have the lesser protection of compulsory private insurance contracted for by the employer. Apparently, the medicaid guarantee for a family of five would be on the order of \$1000 in insurance terms. This would be accompanied by a zero tax rate on incomes up to a certain low level, with co-payments functioning as an implicit tax rate beyond that. So this solution to the "medicaid mess" would still leave medicaid with a share in the cumulative tax rate burden.

The Administration is also considering another variant of a negative income tax in the form of an income-conditioned housing allowance, in which the guarantee would vary by family size and also by locational difference in the cost of decent housing. Moreover, the Administration has pushed for, and the Congress has authorized but not yet funded, a negative income tax in the form of Basic Opportunity Grants (BOG) for college students. The guarantee is equal to one-half the cost, including living costs, of attending a

college, up to \$1400. Beyond certain set-asides, the tax rate is 20 percent if the student is a family-dependent for income tax purposes, and 75 percent if he is independent. The break-even income level for a family of four with a dependent student is above \$10,000; it is \$2300 if the student is independent.

Let us assume that the proposed revision of medicaid, the housing allowance, and the BOG program all come into being and take their place alongside income-conditioned child day care, foodstamps, AFDC, and SSI. Some beneficiaries of some of these benefits will at the same time be paying payroll and income taxes and will be bearing unreimbursed work expenses. As we indicated before, AFDC recipients will typically confront cumulative tax rates of 100 percent or so in certain ranges, even without reference to medicaid, housing allowance or BOG. But what about low-income people who are not on AFDC or SSI? They will face the 30 percent tax rate in foodstamps; a tax rate of, say 20 percent in the housing allowance; possibly, depending upon employment status, a 20 percent rate in medicaid; and, depending on circumstances, some combination of tax rates from among the following: child care benefits, BOG, unreimbursed work expenses, payroll taxes, and income taxes. Hence, it would appear that many working poor and near-poor family heads will face cumulative tax rates well above 50 percent in certain income ranges and at certain stages in the life cycle. Thus, we would seem to be on a collision course with the expectation that most people should have strong monetary incentive to work.

Let me re-state what the cumulative tax rate problem is. If the same earnings are taxed twice by, say, a payroll tax and an income tax, the two tax rates are added together to determine the combined tax rate. But here we are also talking about implicit tax rates, that is, the rates of reduction of a cash or in-kind guarantee. If there are two such guarantees, both subject to a 50 percent tax rate, and if the break-even points are the same, the combined implicit tax rate is 100 percent. As we have seen, the combining of positive tax rates and implicit tax rates, the latter associated with negative income taxes or income-conditioned benefits, has gone some distance. There are only two basic ways to back off from the prospect of high cumulative tax rates. One way is to reduce the combined guarantee and the other is to extend the break-even points of some or all of the benefits. Neither is likely to be happily received by everybody. The first means reducing benefits for poor people; the second means raising taxes.

Ways to Reduce Combined Tax Rates

Ways to limit the combined guarantee include the following. Legislation can require that the benefit from one program be subtracted from the guarantee of another. Thus, social security benefits must be subtracted from the guarantee of SSI. Another rather clever way to limit the combined guarantee is to consolidate two programs by folding the current budget of an as yet unde-

veloped program into the proposed budget of another and producing a new combined guarantee which is actually less than the formulas would dictate. This seems to be how foodstamps were "cashed out" for SSI recipients. A different way is to count the benefits of one program as "income" in computing the benefits of the next. Thus, AFDC benefits are "countable income" for foodstamps. Another technique is to design benefits to avoid simultaneous receipts. Legislation could specify, for example, that anyone claiming foodstamps is ineligible for a housing allowance, or, legislators could simply anticipate that few families will claim income-conditioned pre-school and college aid at the same time.

The other basic tactic for avoiding high cumulative tax rates is to extend break-even points of one or more of the benefits. Set-asides, disregards, and deductibles will accomplish this. Another way is to simply not income-condition the benefit at all and to let the break-even point be determined by the tax system. The model here is public education. Perhaps the next best candidate for this kind of treatment is medical care benefits. A way to at least confuse the break-evens is to use a different income accounting period for each benefit. Some may use a month, some a quarter, some a year. BOG would use the income of the prior year as the base for the current year's benefit. The British Family Income Supplement uses an estimate of future earnings as the base. Still a different way to extend a break-even is to allow considerable flexibility in the definition of the "family" whose income is to be counted. Congress tried to confine college students applying for foodstamps to the families who claimed them as income tax dependents, only to have the Supreme Court find such a restriction in violation of Constitutional due process. (See U.S. Department of Agriculture v. Murry, 41 LW 5099, U.S. Sup.Ct. No. 72-848, June 23, 1973). It would seem likely that this same reasoning would apply to the income tax dependency test in the BOG scheme. If it were, many college students from affluent families would go "independent" and claim the maximum grant. This would only be an extension of a profound trend in welfare law toward narrowing family responsibility. SSI cuts the few remaining legal ties between children and their aged parents. Note that in the cases cited, guarantees and nominal tax rates are unchanged, but people behave in such a way as to increase the number of beneficiaries and the cost to the treasury. High cumulative tax rates will encourage such behavior.

The set of in-kind income-conditioned benefits now in place and on the horizon seem to leave little room for a cash benefit for the non-categorical or working poor. Even a plan with an implicit tax rate of about one-third--like the McGovern plan or the proposed British tax credit scheme, which, incidentally has no guarantee for those earning less than one-fourth the average wage--would appear to be rivalrous with foodstamps, medicaid, a housing allowance, and other benefits and positive rates we have mentioned. Some have advocated an earnings subsidy as a way out of this problem. Thus, the Senate recently passed a bill

to refund to workers the social security tax (both that paid by the employer and the employee) on earnings up to \$4000 (at that point the refund would equal \$400) and to diminish the refund to zero at \$6000 of earnings. This would offset to a minimal degree the cumulated tax rates listed above with respect to earnings below \$4000, but would introduce a new implicit tax rate of 20 percent between \$4000 and \$6000 of earnings. Another "way out" is a wage rate subsidy, but that is not easy to confine to poor families, it sets up disincentives to taking jobs at higher wages, and it is difficult to administer. Both an earnings subsidy and a wage rate subsidy are antithetical to deductibility of child care expense. The alternatives of subsidizing private employers or public agencies to create jobs for the poor have at least as many problems as earnings and wage rate subsidies.

A Concluding Comment

The recent moves toward more income-conditioning of benefits mean, it seems to me, that advocates of a simple, straight-forward negative income tax with a moderate tax rate in it are caught between a rock and a hard place. They may wriggle out of the difficulty by designing a negative income tax with very low tax rates or by shifting over to an earnings subsidy (which means negative rates). Or, they may try to cancel out or consolidate guarantees or extend the break-evens of some of the non-cash income-conditioned benefits. Stating the alternatives this way is to indicate my belief that we are approaching the outer limits of income-conditioning.

The practice of confining benefits to low-income families is based upon what might be called the doctrine of minimum provision. As we have seen, it seems to have its own internal dynamic. If minimum provision is assured for education, why is it not also for health care, food, housing, pre-school child care, higher education, legal services, and yet other goods and services? The level of minimum provision is often set well above the level that families with median income will voluntarily consume, e.g., federal standards for child care. The only restraints on this dynamic appear to be unwillingness to tax the non-beneficiaries in order to fully fund the high standards for all eligibles, and concern for high cumulative tax rates on beneficiaries.

The next phase in the development of the American system of transfers may see a greater emphasis on two other doctrines that power the growth of the system. These are the doctrine of sharing income loss and the doctrine of sharing in extraordinary expenditures. The recent emphasis on income-conditioning may turn out to be only a chapter in a longer book.

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