

Reforming Wages and Welfare Policy

Six Advantages of a Negative Income Tax

John Humphreys

The replacement of all current welfare and wage provisions with a universal but minimal negative income tax would create jobs and reduce welfare dependency.

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Current welfare policy is clearly inadequate. The cost to government has blown out, yet poverty continues and special interest groups continue to seek more money.

The federal government will spend \$66.3 billion on Social Security and Welfare in the financial year 2000-01.¹ This amounts to 40.9% of all Commonwealth government expenditure and is a major driver behind our heavy tax burden. Using data for 1995, it can be shown that if we gave all Government spending on Social Security and Welfare directly to those people below the Henderson Poverty Index (HPI), each family could receive some \$55,520 per year (or \$1067.68 per week), exceeding the HPI by 264%.²

Despite this gross over-expenditure, poverty levels in Australia have risen from 4% in 1966 to 10.7% in 1981-82 (including the Whitlam 'anti-poverty' Government), and to 16.9% in 1989-90.³ A further irony is that welfare policies in Australia have entrenched some people in poverty cycles and perpetuated the marginalisation of certain sectors in society. For many low income families earning around \$25,000 per year, the Effective Marginal Tax Rate (EMTR) is about 85%; for some families this rate exceeds 100%.⁴

Clearly, current welfare policy in Australia has led to the expansion of complex, inefficient and ineffective government expenditure and higher taxes while failing to address—and to some extent worsening—the position of the disadvantaged. It has also left us with a legacy of dependency, an entrenched reliance on government and incentives for individual irresponsibility.

Wages policy

Australia's failed welfare system is supplemented by a failed wage system. Ever since the 1907 Harvester judgement, the concept of a minimum wage has been a cornerstone of government policy towards the working poor. But again, in an irony not yet understood by its socialist-minded supporters, the minimum wage has failed to help those most in need. It has also come at a considerable cost, and has relegated many Australians to unemployment and the failed processes of the welfare system.

A survey of recent studies shows the elasticity of labour demand in the range of -0.6 to -0.85 .⁵ This means that for every increase in wages by 10%, there will be a decrease in labour demand (i.e. employment) by between 6% and 8.5%. As this empirical evidence suggests, it is no coincidence that unskilled, young and rural workers, who rely most on the minimum wage, experience higher rates of unemployment.

The minimum wage acts as a price floor. This leads to an increased supply (of labour) and decreased demand (of labour), resulting in excess supply (unemployment). By removing the minimum wage and allowing people to work at a wage level representing their productivity, the supply of labour would equal the demand for labour, and unemployment would be significantly reduced.

John Humphreys attended The Centre for Independent Studies' advanced Liberty & Society seminar in March 2001. He is also the founder and President of the Australian Libertarian Society.



A return to private philanthropy is one possible way out of the current mess. In the pre-welfare era, voluntary philanthropy tended to be more effective and had fewer negative side effects than its public cousin. When the government nationalised welfare and introduced ‘forced’ philanthropy, however, voluntary efforts largely stagnated.

Unfortunately, policies are easier to introduce than they are to abandon. There is a degree of hysteresis due to the government’s actions—that is, the negative effects on private philanthropy cannot be undone overnight—and current expectations and government dependence take time to reverse.

The abolition of the worst types of poverty could be considered in a public context if private philanthropy did not entirely succeed. Such public provision, however, would have to be implemented in a way that not only avoids the pitfalls of the current system, but also is sufficiently unobtrusive to encourage the growth of private philanthropy to achieve most redistribution. A better welfare system would involve the replacement of all current welfare and wage provisions with a universal, but minimal, negative income tax.

The Negative Income Tax (NIT)

When we earn above the tax-free threshold (TFT), we must pay a portion of our income to the government in tax. The NIT simply extends this principle so that people who earn less than the TFT receive tax.

Table 1 below illustrates how this would work with a TFT of \$10,000 and a tax rate of 50%. The NIT provides an income guarantee for the unemployed (where gross income = \$0), and supplements the incomes of the low paid while providing incentives to

Table 1: After Tax Income Under a Negative Income Tax

Gross Income	Taxable Income (Income TFT)	Tax Paid	After Tax Income
\$0	-\$10,000	-\$5,000	\$5,000
\$5,000	-\$5,000	-\$2,500	\$7,500
\$10,000	\$0	\$0	\$10,000
\$15,000	\$5,000	\$2,500	\$12,500
\$20,000	\$10,000	\$5,000	\$15,000

Tax Rate: 50%
Tax Free Threshold (TFT): \$10,000

increase earnings through constant and low Effective Marginal Tax Rates.

A further rationale for the NIT is that it can accommodate fluctuating incomes.⁶ For example, if a person earns \$20,000 a year for two years, that person pays \$10,000 tax all up (using the above example). If, however, a person earns \$40,000 in one year and nothing the next, then that person will pay \$15,000 while having earned the same in

aggregate. This is because the first person takes advantage of the TFT twice, while the second person cannot. If there was a NIT then the second person would receive \$5,000 in the second year, and pay a total of \$10,000 over the two-year period, equal to the amount the first person paid.

The NIT thus completes the logic of having an income tax with a TFT. Further, as the NIT supplements the incomes of the working poor it also substitutes for the current wages policies that are aimed at assisting them; this means that the minimum wage can be abolished.

It should be noted that the above example is indicative only of the logic of the NIT, and not of the actual preferred level. The proposal under discussion here is for a limited negative income tax. Given that the goal of welfare should be the abolition of absolute poverty,⁷ it seems inappropriate for the level of assistance to exceed an absolute poverty line.

The Henderson Poverty Index (HPI) is not an adequate poverty line as it is indexed to Average Weekly Earnings (AWE) and is subsequently a relative measure of income inequality, not an absolute measure of poverty.

An alternative poverty measure is the Real Poverty Line.⁸ This measure takes the original finding of the Henderson report as a starting base, thus avoiding accusations of an overly conservative starting point, and then indexes this value for the Consumer Price Index to maintain the level in real terms.

The Real Poverty Line (RPL) is at 84% of the HPI, which would decrease the poverty line for a family of four from \$404.90 per week to \$339.07. To ensure benefits neutrality under the current system, \$574.45 would have to be paid to a family of four.⁹ This amount could be decreased by some 40%, and would still ensure the eradication of all absolute poverty in Australia.

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Consequences of the NIT

The consequences of moving towards the NIT can be categorised into six major issues. These are the effect on:

1. poverty and on the poor;
2. unemployment through the abolition of wage regulation;
3. the cost of welfare to government, and subsequently on our tax burden;
4. the administrative simplicity of welfare provision;
5. macroeconomic variables such as productivity and growth; and
6. social capital and individual responsibility.

Reduces poverty

A limited NIT, around 40% lower than the current level, ensures the eradication of absolute poverty in Australia, provided it is delivered universally and without restrictions. Further, the provision of the NIT to low income earners means the working poor are supported, although the greatest benefit to the poor from the NIT is a reduction in the size of the poverty trap.

The NIT also allows for a lower and more constant Effective Marginal Tax Rate (EMTR). As was previously mentioned, the current EMTR often approaches, and can sometimes exceed 100% (that is, for every \$1 you earn, you lose \$1 to the government). By reducing this rate, the NIT overcomes the current disincentive to work and earn, allowing people to escape the poverty cycle. In this way, it offers a real chance for individuals to improve their wellbeing by genuinely providing the opportunity for upward mobility.

Reduces unemployment

The NIT supplements the wages of low income earners, removing the need for wage regulations and the minimum wage. As already discussed, an elasticity of labour demand around -0.75 would provide an increase in employment of 7.5% for a decrease in wages of 10%. While it would be unlikely that the competitive pressures in the labour market would allow wages to drop by such a degree, there would be some adjustment, leading to some positive employment effect.

Taking advantage of this trade off has been proposed at various times in recent years. In 1997, Dawkins and Freebairn proposed a trade off between decreasing the

real minimum wage and providing equivalent tax credits, and advocated an eventual extension of this system into a more complete negative income tax.¹⁰ This was echoed by a group of five prominent economists in an open letter to the federal government a year later.¹¹ More recently, Des Moore, Director of the Institute of Private Enterprise, has suggested that the Government decrease the minimum wage rate (and introduce a tax credit scheme), with a possible outcome of creating 900,000 new jobs.¹²

Reduces Social Security and Welfare spending

While welfare rates could be cut by around 40%, these savings must be adjusted for two important offsetting factors. First, the NIT is not only paid to the unemployed, but also the working poor. To be viable, it would require an increase in the tax-free threshold.

This would increase the fiscal cost of the NIT vis-à-vis the current system.

Yet, as already discussed, the NIT would have positive effects on employment and upward mobility. It would be unlikely that many people would receive the complete payment, given the incentives to take on part-time work (that is, low EMTRs) and the fact that more work would be available. The cost of welfare policies is obviously

highly dependent on the level of unemployment. With lower unemployment under the NIT, the fiscal saving would likely be significant.

Further, with increased employment and upward mobility it is likely that national income (and subsequently income tax) would increase under the NIT, decreasing the cost of its introduction. While the cost of current policies tends to rise over time, the NIT will remain constant in real terms, and will therefore decline as a percentage of GDP. The NIT will therefore have a lower cost in the short term, and will continue to decrease in the long term. This could be used to fund considerable tax cuts to return wealth to those who create it, further decreasing the EMTR and encouraging higher national growth and productivity.

Simplifies administration

By combining the tax and welfare components of the public service, considerable efficiencies will be achieved. Providing assistance through the tax system provides informational economies of scale, and cuts back on

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government waste and inefficiency. In addition, by reducing welfare policy to only one element—the NIT—it would be much easier for the recipient to understand and access than the complexities of the current benefits system.

Boosts productivity

By increasing employment Australia will produce a bigger bundle of goods and services to be shared around. Lower EMTRs will reduce previously dominant perverse incentives, which should lead to greater marginal labour productivity and subsequently national growth.

National growth will also be stimulated by the tax cuts made possible by the decreased cost of welfare under an NIT system. National growth is obviously a worthy goal in itself, but it should not be forgotten that it is also positively correlated with life expectancy, infant survival, education and other quality of life indicators.

Builds social capital

Social capital is positively affected by the return of individual responsibility and the reduction of welfare dependency. While any welfare programme will continue to have negative effects in this area (as does the NIT), a limited NIT as discussed here acts to minimise such negative consequences. The increase in employment and upward mobility will lead to higher self-esteem, greater social participation, more opportunities and less hopelessness among people.

Conclusion

The current welfare system is failing us. The alternative proposed here is a limited NIT. While private philanthropy should be considered a primary and effective vehicle for assistance, replacing current welfare and wages policy with a limited NIT would provide real poverty alleviation while increasing employment and decreasing the other negative effects of welfare.

This policy will not work, however, if the current bloated levels of public forced redistribution are maintained. Milton Friedman has long advocated an NIT, but has opposed such a policy as an addition to current welfare instead of a replacement. Charles Murray also outlines how an overly generous NIT can led to

perverse outcomes, and simply reinforce the welfare state.¹³ Such warnings should not be dismissed lightly, and highlight the need to promote a *minimal* and *simple* NIT, against the pressures of the welfare lobby.

The benefits described above are dependent on a willingness to undertake fundamental reform of the welfare sector, challenging previously held beliefs in the welfare state and providing only a limited safety net to achieve real outcomes in a more efficient manner.

Endnotes

- ¹ Treasury Department, *Mid-Year Economic and Fiscal Outlook 2000-01* (Canberra: Department of the Federal Treasury, 2000).
- ² This is a conservative estimate as the HPI overestimates absolute poverty and Social Security and Welfare expenditure (which has continued to increase substantially since 1995) excludes many alternative programmes. See J. Humphreys, *Re-evaluating Australia's Welfare System: Poverty Alleviation, Welfare Reform and the Negative Income Tax in Australia* (1999), http://www.geocities.com/libertarian_aust/thesis.html, 46-7.
- ³ Lucy Sullivan, *Behavioural Poverty* (Sydney: The Centre for Independent Studies, 2000), 32.
- ⁴ G. Beer, 'The State of Play of Effective Marginal Tax Rates in Australia in 1997' *The Australian Economic Review* 31: 3 (1998), 263-70. See also J. Humphreys.
- ⁵ P. Dawkins and J. Freebairn, 'Towards Full Employment', *The Australian Economic Review* 30: 4 (1997), 405-417.
- ⁶ M. Friedman, and R. Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Brace & Company, 1980).
- ⁷ 'To prefer 'relative poverty' as a target of government action is to indicate that public policy should not be based on jealousy. Further, relative poverty is actually a measure of income inequality, not real poverty. Such a policy goal would mean more for taxation policy, as only a progressive tax system will be able to punish adequately the hard working and lucky. See Humphreys, *Re-evaluating Australia's Welfare System*.
- ⁸ See Humphreys, ch. 2.
- ⁹ Calculations by Dawkins and Freebairns, as discussed in Humphreys, ch. 4.
- ¹⁰ P. Dawkins and J. Freebairn, 405-417.
- ¹¹ P. Dawkins, J. Freebairn, R. Garnaut, M. Keating, and C. Richardson, 'Dear John: how to create more jobs', *The Australian* (26 October 1997).
- ¹² See www.ipe.net.au
- ¹³ C. Murray, *Losing Ground: American Social Policy 1950-1980* (New York: Basic Books, 1984), 147-153.