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## Pros and cons of a negative income tax

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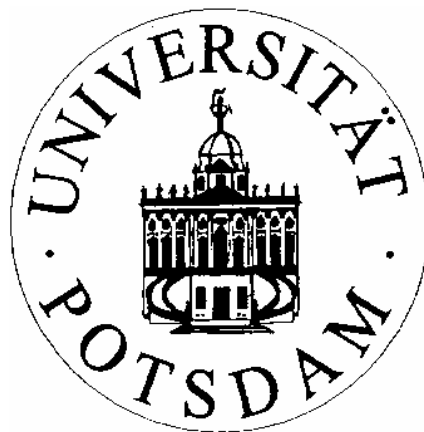
# UNIVERSITÄT POTSDAM

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**FINANZWISSENSCHAFTLICHE DISKUSSIONSBEITRÄGE**

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**Pros and Cons of a Negative Income Tax**



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*See if you can make sense of this.*  
*Major premise: capitalism is a success.*  
*Minor premise: socialism is a failure.*  
*Conclusion: therefore, we need more socialism.*  
*(Milton Friedman, 1994)*

## **I. Conceptual Framework**

This, on the first view, paradoxical statement of *Milton Friedman* precisely describes the current development within economic and social policy not only in the United States but also in Germany. In spite of the 1989 victory of individualism over collectivism, as consequence of a long tradition socialistic ideas are so deeply pushed into the minds of a majority of voters and politicians that the absurd consequences of such a political behavior do not become aware. The erosion of social norms and value systems has obviously gone so far that today even Western societies are confronted with chaotic normative situations. Consequently, almost every political action can be justified by improvements of „social justice“ - a term which is very frequently used by politicians because of its empty phrase characteristics.<sup>1</sup> Not only politicians and voters are infected, but also a substantial part of the economic profession. Therefore, the discussions on minimum income strategies and the negative income tax (NIT) are often puzzling, and surprising coalitions in between opponents or proponents of different ideological positions can be observed.

To avoid further confusion some very short remarks on the own normative position have to be made. All existing tax-transfer-systems are the result of numerous political decisions made during the past centuries. Conflicting group interests led to tax concessions and transfers (including transfers in kind) which favor not only the poor but almost everybody in our societies.

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<sup>1</sup>In his preface to „The Mirage of Social Justice“ *Hayek* concluded: „that the Emperor had no clothes on, that is, that the term ‘social justice’ was entirely empty and meaningless“; and „that the people who habitually employ the phrase simply do not know themselves what they mean by it and use it as an assertion that a claim is justified without giving a reason for it“ (HAYEK 1976, p. XI).

The popular *Murray's Law of Unintended Rewards* gives an impressive example: „Any social transfer increases the net value of being in the condition that prompted the transfer“ (MURRAY 1984, p. 212). And he goes on to observe, if „A deficiency is observed - too little money, too little food, too little academic achievement - and a social transfer program tries to fill the gap with a welfare payment then the program, however unintentionally, must be constructed in such a way that it increases the net value of being in the condition that it seeks to change - either by increasing the reward or by reducing the penalties“ (MURRAY 1984, pp. 212-213).

As consequence of the eroding income tax base and the ever increasing social expenditures, the tax rates of direct and indirect taxes as well as the contributions to the social security system were strongly raised. A substantial part of the redistributive measures is directed from one pocket to the other of the same individual or household,<sup>1</sup> accompanied by a socialization of individual responsibilities, thus increasing the influence of public bureaucracies. A diminishing market sector was substituted by public activities, giving political interventionists the opportunities for further influence to support newly defined group interests with the aim of maximizing their votes. As a result, moral hazard, rent-seeking, and free-rider behavior became dominant, not to mention all the complains on tax morality, avoidance, and evasion as well as transfer fraud.

All this has strongly impaired the incentive schemes for market sector activities and improved the conditions within the underground economy which is high on the agenda for at least two decades. Therefore, it is time to rethink the role of „social justice“ which today is in a serious trade-off with „economic efficiency“. Taking *Aristotle's* definitions of „justitia commutativa“ (or - in modern terms - justice of ability = Leistungsgerechtigkeit) and „justitia distributiva“ (or justice of need = Bedarfsgerechtigkeit) the former is in accordance with *Pareto efficient* solutions; as long as perfectly competitive markets do exist, there is no justification for governmental interventions. Partial market failures are to be cured by market improving regulations (Ordnungspolitik), not by permanent and arbitrary interventions. Only in the case of total market failure (existence of pure public goods), a public supply (not production) might be justified,<sup>1</sup> and in the case of poverty the justice of need requires a social aid system. Whereas the supply of pure public goods is in accordance with *Pareto efficiency* if the *Samuelson con-*

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<sup>1</sup>Following *Gordon Tullock*, most of the time the redistribution is roughly towards the middle income groups; for a detailed description of such effects in the German example see PETERSEN (1984).

*dition* is met, the realization of justice of need leads to welfare losses if social welfare functions are chosen which express more „social sympathy“ (or egalitarian preferences) than the *Benthamian solution*. Even if dependent individual utility functions (or partial altruistical behavior) are assumed, increasing redistribution from the rich to the poor is connected with raising welfare losses which are maximized in the egalitarian solution, where both, the rich and the poor, have less utility than under different social welfare functions.<sup>2</sup>

Obviously, welfare economics do not represent reality, but general trends for the distortive effects of an egalitarian policy have been impressively confirmed by historical events of the past years. Even if hard empirical facts are still missing, the soft evidence of qualitative values give warnings to be very careful with redistributive measures. Under the headline of „justice of need“ not only the poor - defined in absolute or relative income terms<sup>3</sup> - but in one way or another all members of the society are favored; the necessary amount for redistributive purposes is so large that serious disincentives via progressive taxes and high social security contributions are unavoidable. Therefore, it is a very poor strategy for experts in tax and transfer systems to look only at the existing social aid systems, and to neglect all other redistributive measures partially hidden in the tax system and in numerous transfers in kind.<sup>4</sup> What is badly needed is an inventory of all redistributive measures, especially those which favor groups who do not belong to the poor. The abolishment of those concessions connected with the concentration of redistribution to the „real poor“ would heavily decrease the redistributive activities, thus giving room to lower tax and contribution burden. Such a strategy would increase the disposable income of private households, giving them back the freedom to choose and the base for self-reliant action according to their personal preferences which might include voluntary payments to the poor due to charity. In such a framework, not in the existing German tax and transfer system which literally is more chaos than system, a rationally planned negative income tax could have pride of place, thus reducing the trade-off in between efficiency and justice. The following explanations will give more elucidation.

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<sup>1</sup>Here the research on the private supply of public goods has to be mentioned; see, e.g., GLAZER/KONRAD (1993), MÜLLER (1995) and the case study for Chile by LARROULET (1993).

<sup>2</sup>For more details see PETERSEN (1993, pp. 148).

<sup>3</sup>This important difference is discussed below.

<sup>4</sup>For such an analysis see, e.g., SIEBERT (1994).

## II. Theory and Impacts of NIT

The NIT-concept was already mentioned by *Cournot* as „impôt négatif“<sup>1</sup> and elaborated in detail by *Lady Rhys-Williams* in the form of the „social-dividend-type“,<sup>2</sup> whereas two decades later *Milton Friedman* proposed a „poverty-gap-type“.<sup>3</sup> Assuming linear tax and transfer schedules, principally no differences between both types do exist - one can easily be transformed into the other.<sup>4</sup> But both proposals are connected with another important feature: whereas the sd-type is a nontested transfer program with universal payments, the pg-type is an income-tested one. Although *Kesselman and Garfinkel* have shown under very specific assumptions within an labor/leisure model that the former might be economically more efficient than the latter,<sup>5</sup> this pretended advantage should not be taken as a general one. It is obvious that income testing is a labor-intensive procedure for the fiscal and/or social administration and connected with high administrative costs. But as long as direct (income or expenditure) taxes are levied by complicated assessment procedures, including a detailed declaration on personal income, wealth and (at least some) expenditures, income testing for the poor is not only a question of social symmetry. In countries in which a right (or liability) to alimony (German: *Unterhaltsverpflichtung*) does exist for spouses and relatives of the first degree (parents, children),<sup>6</sup> the introduction of a nontested transfer program would destroy this important instrument of self-responsibility.<sup>7</sup> Like in other fields, the role of the family would be further impaired.

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<sup>1</sup>See POHMER (1977, p. 252).

<sup>2</sup>See RHYS-WILLIAMS (1953, pp. 128).

<sup>3</sup>See FRIEDMAN (1962).

<sup>4</sup>This is true for proportional or indirect progressive tax and transfer schedules, where marginal rates are kept constant (as in the case of a flat rate tax). For more details see PFÄHLER (1972/73).

<sup>5</sup>See KESSELMAN/GARFINKEL (1978); the problem is also discussed in MEADE (1972).

<sup>6</sup>The German civil right (BGB = Bürgerliches Gesetzbuch) determines the liability (or right) to alimony; for details see HINTERBERGER (1991, pp. 174).

<sup>7</sup>Because of the pretended high costs of a nontested NIT *Jerger and Spermann* recently proposed a targeted NIT „for adequately defined persons“ (see JERGER/SPERMANN 1995). Even such definitions of certain groups are due to dangerous political influence. Therefore, the best target is an income test which includes the liability of alimony. Even the low minimum wage in the US is not precisely directed to the poor, just to mention the teenagers of wealthy families who work at McDonalds during their holiday.

Therefore, the liability to alimony connected with income testing even for close relatives is a fundamental limitation for transfer programs in using this important function of the family. Because of the reciprocity which rules in sound families voluntary private transfer payments will take place which are not (or less) connected with disincentives for the payer (or the recipient). In the case of nontested transfer programs private transfers are very frequently substituted by public transfers which normally lead to serious disincentives by the recipients as well as by the tax payers who have to finance such programs. Hence, individual or family problems are socialized, and the reduced self-responsibility opens the door for an unethical behavior which has already be mentioned above.<sup>1</sup> In one form or another the tax payer might feel exploited, and often such feeling is confirmed by reality. If people in our welfare states are only dependent on social aid payments, life might be really hard and scanty. Combined with black market income or side-payments from relatives the welfare state delivers a convenient hammock which suffocates the last work incentives. The erosion of social norms and value systems is accompanied by a reduced social shame so that exploitation of transfer programs becomes more likely, thus being one reason for the explosion of social expenditure in the public budgets of our redistributive society - what Jasay aptly called the „churning society“.<sup>2</sup>

Beside the problem of income testing the status of a NIT within the tax and transfer system is of specific importance; the NIT-concept is not useful for the further extension of the welfare state. The introduction of a NIT is only efficient as a part of an „integrated tax and transfer system“; the NIT has with an „ordinary tax“ in common the fact that there is no direct and immediate equivalent (no „quid pro quo“). The „negative term“ requires that the same norms have to be applied as in the case of „positive tax“ or a rational or even optimal tax system. Only direct taxes (personal income or expenditure tax) are seen as an integrated component. Transfers out of a NIT are only payments with the purpose of interpersonal redistribution in the case of neediness in accordance with the social aid principle (Fürsorgeprinzip). Private or social instruments which are exclusively based on the insurance (or benefit) principle - just

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<sup>1</sup>Here, the discussions in the United States have to be mentioned in which social aid payments might have impaired the self-responsible behavior of husbands and fathers especially in the slum regions of large cities; for more details see HERF (1992, p. 146) and SCHLESINGER (1992).

<sup>2</sup>See JASAY (1985, pp. 232).



leading to an intertemporal equalization of life-time income - have to be excluded.<sup>1</sup> Then the NIT is the only instrument of interpersonal redistribution which would cover the current social aid systems, the subject oriented subsidies for housing, the transfers out of the family equalization systems (partly due to income tax exemptions or family benefits) including education grants and transfers in kind connected with tuition free education on high school and university level, and - last but not least - the minimum income which is overwhelmingly granted within social insurance systems (especially in the pension, health and unemployment system).

The minimum or basic income which is the maximum transfer has to be fixed in absolute or relative income (or welfare) terms. Here we are confronted with the time-honored question of absolute and relative poverty<sup>2</sup> - „what does woman/man really need?“ Following a definition of *Rowntree* (1899), a family lives in absolute poverty whose „total earnings are insufficient to obtain the minimum necessities for the maintenance of merely physical efficiency“.<sup>3</sup> Hence, absolute poverty can be defined as „a certain food basket ... just sufficient to stay alive“, and in addition „a certain amount ... to account for other items like clothes and housing“ (HAGENAARS/VAN PRAAG 1985, p. 14). Fighting absolute poverty was obviously an unsatisfactory task for social politicians so that the permanent criticism has led to the observation of Sen, that „a consensus seems to have emerged in favor of taking a ‘relative’ view of poverty in the rich countries“ (SEN 1983, p. 153).<sup>4</sup>

Whether this development has taken place in the course of „ever increasing social sympathy“ or - perhaps in a cynical but likely more realistical interpretation - „in the course of ever increasing social envy“ is a question which has been discussed more recently. Relative poverty (or the „poverty line“) is overwhelmingly understood as a certain percentage of the median or average income.<sup>5</sup> Especially if incomes above the average income are increasing - e.g., the income distribution becomes more unequal - the poverty line is rising too, thus producing a larger number of poor in the society. Even at increasing total welfare poverty is growing - it

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<sup>1</sup>It should be mentioned that in existing social insurance systems the erosion of the benefit principle can be observed since decades, accompanied by increasing interpersonal redistribution; see, e.g., ROSA (1982).

<sup>2</sup>Other terms are: physical or socio-cultural minimum of subsistence.

<sup>3</sup>The quotation is to be found in TOWNSEND (1979, p. 33).

<sup>4</sup>A larger number of poor people does not only mean larger social budgets, but in addition more jobs for social politicians within the welfare institutions.

<sup>5</sup>For more details see HINTERBERGER (1991, p. pp. 71).

becomes an endemic disease which calls for more therapy.<sup>1</sup> A rising inequality is then interpreted as injustice, even if this is the result of the justice of ability within a functioning market economy. The ideological base for such an interpretation has clearly been identified by *Radnitzky*: „The contemporary rhetoric prefers ‘Social Security’, ‘Social Justice’, ‘Solidarity’. The pet formula of the social-democratic propaganda is ‘Justice’ - the ‘Justice Gap’. Unequal purchasing power of citizen is ‘unjust’“ (RADNITZKY 1994, p. 5). Under such a system the growth of government is a built-in phenomenon. „Prognosis is risky, but it appears a fairly safe prediction that *the general trend towards more of creeping socialism or social democracy will continue* - the ‘Road Back to Serfdom’“ (RADNITZKY 1994, p. 3).<sup>2</sup>

For this argumentation a certain evidence can be found in the real development patterns. However, the attempt to close the pretended „Justice Gap“ for „the“ poor - for Gods sake - opens a „Justice Gap“ for „the“ rich who are not defenseless. With powerful behavioral adaptations like tax evasion and avoidance as well as international mobility of capital and persons clear limitations against the „*Leviathan*“ are set - just to mention the *Laffer-curve* argumentation. High amounts of transfers are in the long run inevitably connected with high tax rates - which only temporarily can be mitigated by public debt. Serious disincentives on both sides - the favored and the burdened<sup>3</sup> - force scientists, voters, and politicians to rethink the poverty concept. Already more than a decade ago, *Sen* has moved back a step to the absolute concept: „There is, I would argue, an irreducible absolute core in the idea of poverty“ (SEN 1983, p. 159). But besides starvation, hunger, malnutrition additionally certain consumption habits (e.g., dress habits) do belong to the „necessaries“. Without appropriate clothes it is nearly impossible to find a job to overcome poverty by self-responsible action. Because of the necessary limitation of social expenditures to maintain the functioning of the incentive schemes within the market economy for both, the transfer receiver and the tax payer, the concept of absolute poverty should be reinforced for people in the employment age which are obviously

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<sup>1</sup>See for more details RADNITZKY (1991).

<sup>2</sup>Social democracy is not an phenomenon of a single party; it is found in almost all democratical parties. As it is well known, *Hayek* dedicated his „The Road to Serfdom“ (1944, First Edition) „To the socialists of all parties“.

<sup>3</sup>Under egalitarian conditions only burdened do exist, the disincentives are maximized; „egalitarianism is basically an emotional factor, most often fueled by envy (which often is partly subconscious)“ (RADNITZKY 1994, p. 6).

not willing to supply labor in the official markets,<sup>1</sup> whereas for others in addition specific transfers should be paid to improve their reintegration into the official labor markets.

Obviously such a poverty concept is an ambitious one; already *Sen* has been sharply criticized by TOWNSEND (1985, p. 664): „He does not say anything about the criteria by which we identify, or prioritize, human needs.“ This opinion is a typical one of social experts who have strong believe in the scientific proof of „just“ tax and transfer schedules. But even if we would accept interpersonal comparisons of utility - what a real liberal fundamentalist would never do<sup>2</sup> - it is well known since *Cohen Stuart* and *Ragnar Frisch* that a scientific proof for „just“ tax schedules is impossible.<sup>3</sup> If a tax schedule is progressive, proportional, or even regressive depends on the form of the individual utility function and the implemented sacrifice rule.<sup>4</sup> Therefore, in the case of tax and transfer schedules always political decisions have to be made which do not solely protect the interests of the poor, but also those of the rich. Without a broad consensus on personal redistribution the long-termed existence of the whole society is endangered - as very current events have demonstrated.

Besides the fixation of the basic income and the tax and transfer schedule an integrated system is also characterized by an unique tax and transfer base (income definition). The decision on the basic income - a linear transfer scheduled assumed - determines the marginal transfer reduction rate and the critical income where the tax schedule starts (see figure 2, below). The basic income has not to be defined identical for all citizens, but has to depend on the specific life circumstances of different individuals or households. Consequently, the tax and transfer schedule is a function without concrete parameters which are determined by the individually defined basic income.<sup>5</sup>

Without doubt for the formulation of an integrated tax and transfer system, a normative-theoretical foundation is inevitable which has to fulfill the criteria of consistency and reveals the intensity of income redistribution - which is in our contemporary social security systems

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<sup>1</sup>A move into the direction of an absolute poverty concept in Germany has recently be proposed by OBERENDER/FRICKE (1994, pp. 59).

<sup>2</sup>See, e.g., RADNITZKY (1994).

<sup>3</sup>See FRISCH (1932, pp. 114).

<sup>4</sup>The analytical proof is given in HINTERBERGER/MÜLLER/PETERSEN (1987) and PETERSEN (1993a).

<sup>5</sup>All necessary details are described in HÜTHER (1990); an overview is given in PETERSEN/HÜTHER/MÜLLER (1992).

hidden in hundreds or even thousands of specific regulations. The intensity of income redistribution principally determines the impact of a tax and transfer system on the supply of effort. Concentrating on the impacts on the labor supply which are normally analyzed within the neoclassical labor/leisure framework as mentioned above, some important factors (like the participation decision, intensity and quality of work) are neglected, whereas stress is put on the hours of work decision.<sup>1</sup> If all shortcomings of such an approach are taken into consideration, at least important trends can be isolated which partly have been verified by numerous empirical analyses.<sup>2</sup> The relevant wage per hour and the possible hours of work (eventually additional wealth income) determine the budget line (constraint) as spot of alternative labor supply decisions. The utility-maximizing labor supply is given by the slope of the indifference curve scheme derived from the individual utility function. The budget line and the labor supply decision is modified if taxes and transfers are introduced or marginal tax and transfer rates are changed, perhaps depending on some other family (or household) parameters (e.g., number of family members). The tax and transfer schedule has an impact on the slope of the budget line, whereas in case of a lump sum tax and transfer it stays unchanged.

Obviously, lump sum taxes and transfers are only connected with income effects, inducing - if only transfers are taken into consideration - a reduction of the hours of work and an increase of leisure; every income dependency changes the slope of the budget line, thus leading to additional substitution effects which again raise the leisure time. Therefore, the NIT is always connected with a certain deadweight loss (or excess burden). In other words: if the aim of justice of needs is striven for (and a certain amount of personal income redistribution) by a NIT system, a trade-off with economic efficiency is unavoidable. But this comparison with a lump sum system or a situation in which no social security system does exist is a rather unfair one. The only correct comparison has to be made in between the NIT and the existing social security system. It will be demonstrated below that the budget lines within our existing systems could hardly be determined or - more frankly spoken - are chaotic. Taking only the budget line of the social aid system, this line is parallel to the leisure axis because of a marginal transfer reduction rate of 100 percent. In such a case the incentives are always set to maximize leisure. A NIT system is connected with a marginal transfer reduction rate of less than

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<sup>1</sup> For more details see the fundamental study of KILLINGWORTH (1983).

<sup>2</sup> For the labor supply in general and the impacts of the NIT see the extensive literature cited in HÜTHER (1990, pp. 241-252).

100 percent - a realistical percentage is in between 50 and 60 percent. As is well known from the optimal taxation literature, the marginal tax rate principally determines the substitution effect, whereas the average tax rate determines the income effect, the same is true with regard to the transfer rates. Therefore, a NIT is connected with the above mentioned trade-off, but compared to most of the existing social aid systems this trade-off is reduced substantially- especially if the numerous distortions out of other components of the social security system are taken into consideration.

### III. German Social Security - System or Jungle?

The roots of the German welfare state date back more than 110 years; most of its basic principles were formulated with regard to the former social situations and conditions. Obviously, poverty today is quite different from poverty, however, in the last decades of the 19th century, but the basical principles have never been changed substantially. In contrast, the system has been extended to an ever increasing part of the society. Whereas *Bismarck* concentrated the social security system to the „working classes“, his successors extended this system with their last 1995 „innovation“ - the compulsory „social old-age nursing insurance“ - to every individual in the society. Following an interpretation of *Arthur Seldon*, *Bismarck* introduced the German social insurance system because of „cynical political reasons“,<sup>1</sup> or taking a modern expression of the public choice theory: he demonstrated a vote maximizing behavior or gave pre-election presents to a clientèle who otherwise would have given their votes to the socialists. This decision was the first one which has brought the socialistic bacillus into conservative as well as (in the European sense) liberal parties. „Before the war the German (Bismarckian) model of the welfare state even infected societies that had been the paragon examples of a free society - England (Lloyd George), the US (Roosevelt's 'New Deal'). After the war, it inspired the 'Swedish model' (Gunnar and Alva Myrdal) and infected even Switzerland ...“ (RADNITZKY, 1994, p.3). However, when the „Swedish model“ became a „Swedish disease“ some drastical reforms have been implemented.

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<sup>1</sup>See SELDON (1984).

The outcome of the still lasting social interventionism in the German example is an impressive verification of *Murray's Law* mentioned above. Neglecting the complicated direct tax system which has led to an ever increasing number of tax consultants<sup>1</sup>, there are over 40 institutions with more than 90 general regulations and laws involved by the German social policy<sup>2</sup> - not to mention thousands of guidelines for the administrative execution. There is not enough space and time to describe the tax and transfer jungle in detail,<sup>3</sup> so that only some short highlights are presented here.

The uncoordinated and arbitrary development of the marginal tax and transfer rate for a two-children-household (one spouse employed) is shown in figure 1.<sup>4</sup> Absurd hikes in the marginal rates can be observed due to the uncoordinated tax and transfer basis and schedules of the existing system, especially because of uncoordinated income brackets and the sudden abolishment of transfers. If additional transfers to households with another social status are taken into consideration, one can observe marginal rates which are considerably higher than 100 percent. It is quite clear that the labor/leisure model does not in all cases deliver a dominance of the substitution effect, but in view of this results an enormous indolence should be necessary to ignore the likely disincentives.<sup>5</sup>

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<sup>1</sup>The number of tax consultants is an ideal proxy measure for the inefficiency of our contemporary tax systems.

<sup>2</sup>See, e.g., KRESS (1994, p. 248).

<sup>3</sup>This is done in detail in PETERSEN (1989).

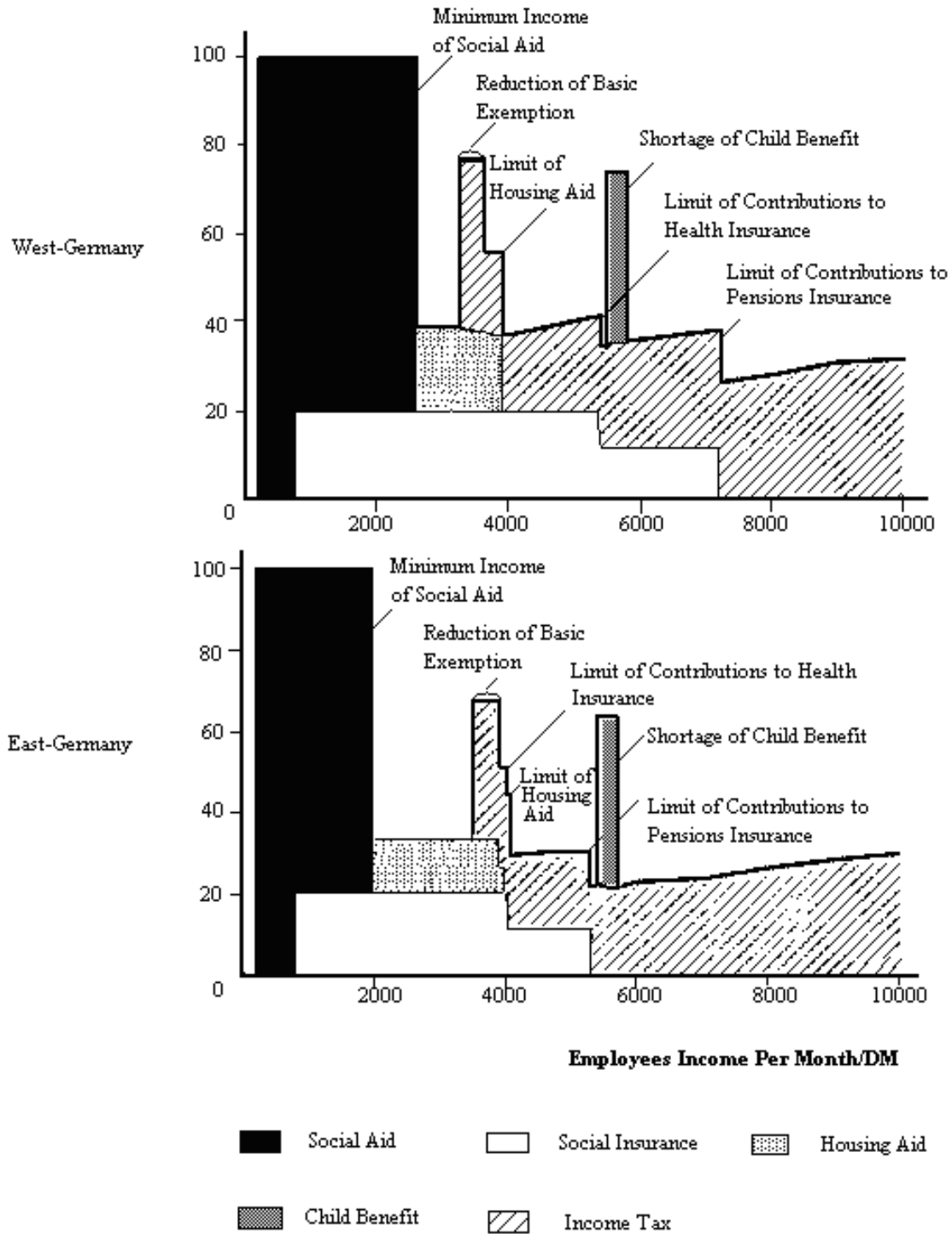
<sup>4</sup>See FRITZSCHE/VON LOFFELHOLZ (1994, pp. 235).

<sup>5</sup>Under the current income and wage tax regime especially the most productive households of (tax-honest) self-employed, employees, and workers are burdened, while the households of farmers, government officials and non-employed (pensioners etc.) are privileged. Under an expenditure tax base this situation would be reversed; see PETERSEN/HÜTHER/MÜLLER (1992, p. 188).

**Figure 1**

Marginal Tax and Transfer Rates

(Two-Children-Family, One Spouse Employed)



Source: FRITZSCHE/VON LOEFFELHOLZ (1994, p. 244).

Not only the marginal reduction rate of 100 percent of the social aid system is seriously connected with disincentive problems; another important problem is involved in the fact that wage income (and income from other sources) is taxed even if the gross wage is below the minimum income guaranteed by the social aid system. In some ridiculous examples households are receiving social aid payments and paying income tax. This has led to a verdict of the *German Constitutional Court* (BVerfG) that the current taxation of low income groups is not in accordance with the German Grundgesetz.<sup>1</sup> This verdict ignores the fact that low wage groups are not only burdened by income tax, but also pay social security contributions (taxes) to the social insurance system so that their residual income is further reduced, whereas the social aid recipients get most of the payments or transfers in kind out of the social insurance system without any personal contribution. It is likely that this fact will lead to a new verdict in the near future.

The wage and social security tax burden on low income groups is one important reason that the gap between the net income of employees with low wages and the net income of social aid recipients declined. Two or three decades ago, when the majority of the employees were wage tax free because of high basic exemptions and paid only moderate social security contributions, this net income gap was high enough in favor of the employees. In the following decades income tax schedules, income brackets as well as tax exemptions, were not adequately adjusted to inflation and the social security contributions rose sharply. Therefore, for almost all types of today's households this gap is so small that again serious disincentives are created. Own estimations for 1991 have shown that especially in the case of unskilled workers<sup>2</sup> the net income is often less than 15 percent higher than the net income of social aid recipients.<sup>3</sup> This very rough average number strongly depends on the specific situation of the single household; especially in down town areas of large cities rents are very high and social aid recipients are total reimbursed for all housing costs, which is not the case for low income employees so that the gap is often much smaller. Taking the situation in East Germany into consideration where the wages are much lower than in the West, then the gap is reversed in favor of a large num-

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<sup>1</sup>See BUNDESVERFASSUNGSGERICHT (1992). For 1993 to 1995 a temporary solution within the income tax schedule was introduced; to January 1, 1996 a final solution has to be found.

<sup>2</sup>In German: Hilfsarbeiter, Leistungsgruppe 3, Industrie.

<sup>3</sup>In the case of a single household social aid payments in 1991 were about 45 percent of the net income of an comparable unskilled worker; the figure for a single household with one child is 61 percent, for a two-person household (married) 63, for a two-person household with two (three) children 83 (84) percent, respectively. For the methods to estimate such figures see KLEIN (1986).



ber of the social aid recipients (married, two or more children) whose net income is about 120 or more percent of a comparable employees household.<sup>1</sup> Another illustrative example is given by the comparison of the net pension payment which results in the case of an unskilled worker who has worked all his life with an old-age social aid recipient. The single unskilled worker gets during his retirement period - again dependent on the actual housing costs - nearly the same amount as he could have got out of the social aid system with the only difference that his active life income was substantially reduced by contributions to the social pension system.

Today, the difference principle of the German social law which demands a considerable gap in between wages and social aid payments (about 15 percent in favor of the employees) is at least partially impaired. As we have already mentioned above, the combination of social aid payments and income from illicit work is often much more promising than income from a job in the official labor markets. Serious disincentives are set combined with transfer fraud; it is even impossible to give precise numbers because of the impossibility to observe such illegal developments. But the disincentives are only one side of the coin. With regard to the current labor market problems and unemployment, as important as the disincentives is the fact that the increase of wage and social security taxes (which have the character of payroll taxes) have risen the wage extra costs so seriously that especially for unskilled workers their productivity is often less than their total wage costs - one important reason why especially unskilled workers are the dominating group within the long-term unemployed. One or two decades ago, the firms could afford to hire a certain number of unskilled, today such a (partially philanthropical) behavior would endanger the existence of the firm and the other jobs. The attempt to improve the situation of the poor under the headline of „social justice“ has just created the opposite result:<sup>2</sup> Unskilled workers are driven out of their jobs into the welfare state network and - if they are unable to find employment in the underground economy - are suffering from deprivation - another impressive verification of *Murray's Law*.

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<sup>1</sup>In 1991 the wages in East Germany were roughly 65 percent of the Western wages, but the social aid payments were in the average about 96 percent; the figures for the households mentioned in the preceding footnote are: 66, 90, 92, 122, and 123 percent.

<sup>2</sup>Especially the policy of the trade unions has increased the wages for unskilled work in demanding higher wage increases for the lower income groups; later on - as typical for closed shops - they have preferred the dues paying insiders, giving the unemployed outsiders the „kind“ advice to wait for jobs which are in accordance with their „real“ qualifications.

For this reasons, the practical economic and social policy finds neither a diagnosis nor a therapy; the attempts of the German politicians to realize the demands of the verdict of the Constitutional Court reminds of blind activism. Under the dictate of exhausted public budgets even the last - if any should have survived - rational rules of the German income tax system are sacrificed. In tax policy it becomes more and more obvious that future oriented perspectives are badly missing; the struggle for „social justice“ has led to the fact that alibi solutions are dominating which meet neither the justice of need nor of ability. What remains is the *welfare state with empty pockets* - unable to fulfill the pretended entitlements promised by politicians, thus leaving behind annoyance and feelings of defraud which strengthen the resistance to the tax and welfare state on the side of the citizens. The unethical behavior (free-rider, moral hazard, tax evasion, transfer fraud, etc.) which is the consequence of excessive state interventions is then taken over even by highly reputed politicians<sup>1</sup> as sign of ever increasing egoism and materialism. The citizens and the market economy are made responsible for the erosion of individual and collective norms which originally has been created by false actions of the politicians themselves because they are overwhelmingly unable to mention - that because of the recourse on other people's property - „social justice erodes individual responsibility“ (FLEW 1994).

#### **IV. The NIT as Last Resort - Pros and Cons**

The discussions about the advantages and disadvantages of the introduction of a NIT are heavily dependent on the tasks which a NIT has to fulfill within a social security system; overwhelmingly the NIT is proposed to complete or to substitute an existing social aid system. Then the main role is to close still existing security or poverty gaps. With regard to the employment situation especially Scharpf has proposed to use a NIT system with the by-product to subsidize unskilled jobs in decreasing the effective wages for the employers via a

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<sup>1</sup>Only one out of a lot examples is the speech of the former President *Richard von Weizsäcker* at the biannual meeting of the Protestant Church in Hamburg, June 1995. With such a - hopefully unconscious - strategy politicians draw new moral authority from their own failure.

decline of the wage extra costs.<sup>1</sup> This proposal is connected with the perception that there is no general shortage of labor, but a shortage of „payable labor“. Thousands of low skilled jobs are vacant in the service sector as well as in private households.<sup>2</sup>

This partial reform of the existing social security system is mainly criticized because of two reasons. Especially authors who are closely connected with trade unions fear that the creation of new unskilled jobs could have a general impact even on the wages of skilled workers. In addition they complain about the pressure on the unemployed to accept a job below their personal skills.<sup>3</sup> The first argument is determined by the fear to lose influence and power within the collective wage agreements, the second is simply cynical: the message for the unemployed is to remain in the welfare network until they are totally unqualified.

The second counter-argument is not only shared by trade unionists but also by *Horst Siebert*: Whereas in the existing social aid system in 1992 about 1.25 mill. social aid recipients were in the employment age,<sup>4</sup> under a NIT system this number would have been increased to 10 mill. persons, thus creating a lot of new disincentives „for a NIT accustomed generation“.<sup>5</sup> For a partial reform of the social security system by an introduction of the NIT as a substitute for a social aid system *Siebert* is doubtlessly correct. But no serious proponent of NIT systems has ever proposed such a partial reform.

Regarding our contemporary social security system, not only 10 mill. individuals but every single household is within the welfare network and simultaneously burdened and favored by personal redistribution where the net result is usually unknown. However, the majority of experts is still of the opinion that a basic reform of the total tax and transfer system is politically not feasible.<sup>6</sup> Because of the ridiculous pocket to pocket redistribution, such a view is

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<sup>1</sup>These discussions were led under the headline „creation of a second labor market“, see SCHARPF (1993). In the meantime, he has changed his opinion because of the pretended costs of a NIT (Bürgergeld) concept and proposed just a subsidization of low income groups; see SCHARPF (1994, p. 113). See also JERGER/SPERMANN (1995).

<sup>2</sup>See SCHARPF (1994 a).

<sup>3</sup>See BÄCKER/STEFFEN (1994, pp. 5).

<sup>4</sup>This number increased in 1994 to more than 2 mill. as has been recently published by the Statistisches Bundesamt.

<sup>5</sup>See SIEBERT (1994, p. 11).

<sup>6</sup>See, e.g., BÄCKER/STEFFEN (1994); the excuse might be that trade unionists are no intellectuals?

simply undignified for intellectuals. A total reconstruction of direct taxation and transfers is inevitable. Such proposals have been made for Germany by *Mitschke*<sup>1</sup> and the *Kronberger Kreis*<sup>2</sup> and are supported by an increasing number of experts and even some politicians.<sup>3</sup> The „Bürgergeld“ and the „Bürgersteuer“ (in the form of a NIT) are substituting the existing income, corporation, wealth and inheritance tax, perhaps connected with a change from an income to an expenditure tax base<sup>4</sup>. The comprehensive tax base makes it possible to introduce a tax schedule with low marginal rate, even to come to a simple flat rate system, thus to abolish direct progression. Simultaneously, exemptions and tax concessions have to be abolished and the social security contributions of the employers have to be added to the individual wage income. All transfers with the task of personal redistribution (as mentioned above) have to be integrated into the „Bürgergeld“. The social insurance system could be liberated from its current tasks of personal redistribution and be changed into a pure insurance system which in future could be put into competition with the private insurance system.<sup>5</sup> Only if all these demands are met, there is pride of place for a NIT system which substantially would improve the incentive schemes which are essential for competitive market systems.

As we have demonstrated for different NIT schedules with highly developed simulation models only the analysis of the „first order effects“<sup>6</sup> has proved that the *Mitschke proposal* and some others are much less expensive than the contemporary system<sup>7</sup> - not to mention the possible „second order“ effects of the behavioral adaptations back from the underground economy, tax evasion and avoidance to market activity. Even the *Deutsches Institut für Wirtschaftsforschung* (DIW) has estimated the costs of a different NIT system between 65 and 173 bill. DM.<sup>8</sup> Especially the higher amount seems to be impressive; but as the Oberender study, besides others, has demonstrated, roughly 50 percent of the German social budget are in ques-

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<sup>1</sup>See MITSCHKE (1985) and (1994).

<sup>2</sup>See KRONBERGER KREIS (1986).

<sup>3</sup>An overview on the positions (of at least parts) of the political parties is given in KRESS (1994, p. 252).

<sup>4</sup>For an expenditure based reform see ROSE (1994).

<sup>5</sup>In this direction the most successful countries of the former Eastern Bloc are moving; see GOLINOWSKA/OCHOCKI (1995) and MÜLLER/PETERSEN (1995).

<sup>6</sup>See NAKAMURA/NAKAMURA (1990).

<sup>7</sup>For more details see HÜTHER (1990) and PETERSEN/HÜTHER/MÜLLER (1992).

<sup>8</sup>See DEUTSCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG (1994). Although here the opinion is expressed that some targets of the NIT might also be fulfilled within the existing system.

tion with a current amount of almost 500 bill. DM. Even at the highest costs of a NIT system a substantial reduction of that burden is possible.

This result is not very surprising if one does not have in mind the marginal rates out of the income tax schedule but concentrates on the effective tax rates which include all tax base reducing tax concessions and those parts of the individual incomes which have not been reported to the fiscal administration. For such a broad tax base we have estimated some preliminary effective rates for 1994: the effective average income tax rate (gross income of employment and wealth) is less than 11 percent for an average household, whereas the effective marginal rate is about 23 percent. The current income tax rates are 19.5 and 53 percent<sup>1</sup>, respectively. These figures clearly demonstrate that the scheduled tax rates cannot become effective because of thousands of different concessions and last but not least the adaptations of the tax payers. The very common illusion of taxing the „rich“ for the purpose of more egalitarianism is less than an idle wish - it is just an illusion. For Gods sake - the „rich“ who at least finance housing and jobs for the majority of the society are strong and keen enough to avoid the burden or to vote by feet via migration.

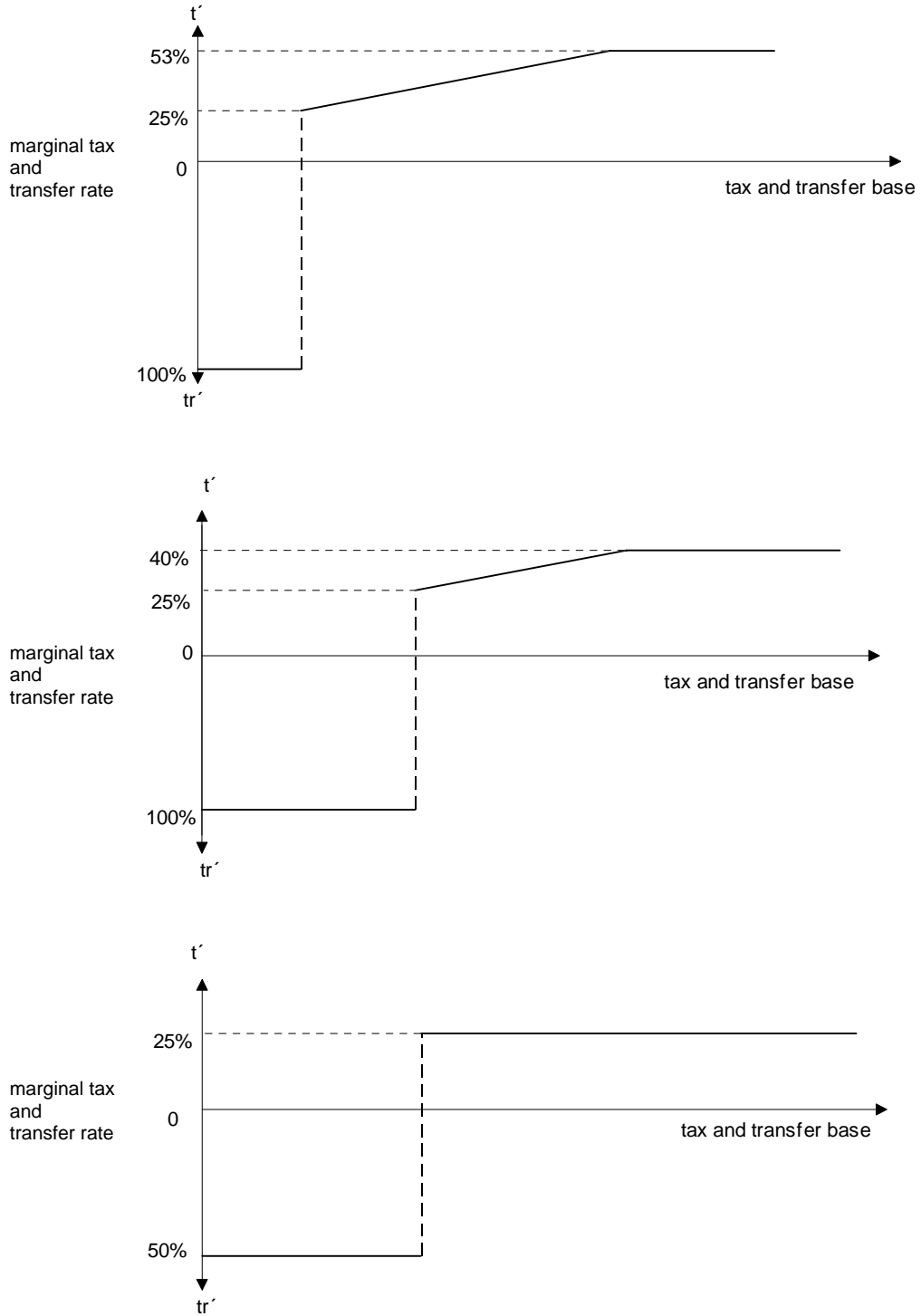
Under a broader and unique tax and transfer base the figure 2 demonstrates in stylized form the direction in which the further development could work; above, the 1996 picture of marginal tax and transfer rates are given. By a successive broadening of the current tax base and the integration of all transfers which are necessary to avoid abrupt changes, especially for the social aid recipients, and to give all citizens some time for self-responsible behavioral adaptations, a clear decrease in the marginal transfer reduction rate as well as in the maximum marginal tax rate is possible. In the long run even the introduction of a flat rate in the tax area seems possible, thus avoiding all the disadvantages and disincentives which today are connected with direct progression without having any clear impact on the net income distribution.

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<sup>1</sup>Not to mention the high marginal rates in the lowest bracket of the income tax schedule due to the adaptations in accordance with the verdict of the Constitutional Court (see figure 1).

**Figure 2**

Current and Possible Marginal Rate Development



Source: Own Estimations.

The progressive marginal income tax schedule mainly serves as feeding of social envy complex which is misused because of election tactics; the redistributive power of this instrument is neglectible as many empirical studies have shown.<sup>1</sup> Because of many concessions and loopholes not the „rich“ but the lower and middle income classes are hit by progression. The erosion of the tax base has impaired what is often mentioned „the truth of the tax schedule“. Therefore, to rely upon a progressive marginal rate structure - the progression falsehood and deceit - has become a main element of political dishonesty.

Are the pictures of figure 2 real world options or simply utopian ones? The question is hard to answer. But if the view is directed from Germany (and some other European states) towards the East or Far-East, new, flexible, and dynamic societies have entered and will enter the world stage which are not burdened by the elements of the „churning society“ - namely egalitarianism and constructivism. With these countries Old Europe will not only compete on the World market, but also as an optional home for the capital and the „rich“ themselves. If illusions and desinformation will further work in the old way that a welfare state can be financed by taxing the „rich“, the future would have a gloomy perspective. The competition out of the low-wage countries presses the old welfare states to a reducing cure. Via the abolishment of the redistribution from one into the other pocket enough reserves exist for a substantial reduction of the wage extra costs. If all citizens become aware that transfers have to be financed and do not fall from heaven like manna, the current entitlement behavior could be overcome. If one promotes the basic targets of the justice of need and the necessity of a certain personal redistribution, it is a question of honesty not only to close the poverty gap but also to keep the burden on the tax payers in mind which also determines the international competitiveness. From this point of view and in a mid-term perspective the NIT concept is one of the last resort.

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<sup>1</sup>For more details see PETERSEN (1988).

## V. Acceptance and Feasibility - Some Public Choice Remarks

The argumentation has put more stress on the political than on the technical aspects of NIT systems because the latter are obviously more favorable than those of any other redistributive scheme. But this view is not shared by many representatives of the political parties, the social administration, interest groups, and last but not least science. And even this differentiation is incorrect because one and the same person might be a member of more than one if not of all of this groups.<sup>1</sup> Assuming the politicians as the most important group then the today's success of a politician is dependent on the prevailing picture which the society has developed. The popularity mainly depends whether a politician maximizes his interventions into public or - even worse - private sector activities. Even if the politicians would be fully aware about the shortcomings of his personal resort - an assumption which is in view of the current personalities slightly too optimistic - no rational incentives do exist to abolish the failures of the system by a fundamental reform; in the contrary, such a behavior would be a serious mistake. On the one hand the politician has to intervene into the personal interests of the involved persons, thus impairing his popularity. On the other hand a fundamental reform would lead to the fact that the politicians have destroyed the base for their own jobs - the necessity of permanent interventions. From the politicians point of view it is rational not to cure the causes but the symptoms and this strategy is in accordance with the moral hazard theory.<sup>2</sup> Their pretended preference for market solutions is a pure lip-service.

Instead of a fundamentally market oriented reform temporarily effective measures to decrease the costs of the social security system are much more promising which will only work until all involved persons and groups have adapted their behavior to the new regulations. If these reforms are coordinated with the re-election cycle, the short-term effects are realized appropriately to increase the personal popularity. The following cost explosion several month later does not terrify an experienced politician, it is possible for him in hearings, interviews, TV talk shows, etc. to demonstrate again his importance which newly strengthens his popularity. If such political behavior cannot be led back to lack in information, ignorance, indolence or

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<sup>1</sup>Just to mention the personal experience within a hearing of the Federal Parliament, where among the scientist some „Honorarprofessoren“ were invited who in their main occupation are heads of interest groups.

<sup>2</sup>See PETERSEN (1995).



simply stupidity - all not very attractive attributes for a politician - it must follow a certain system. And that could be seen in the fact that the politician is able to exploit the systemic failures for his own interests. Every fundamental reform would block his possibility for the political self-representation. Therefore, efficient and frictionless tax and transfer systems are politically counter-productive because of the political self-interests.<sup>1</sup> To sum it up: we are surrounded by moral hazard.

The NIT approach is in accordance with a revival of the „Ordnungspolitik“ - namely by a reformulation of the institutional settings to obtain a reduction of the discretionary interventions via a strategy of de-politicization. An improvement of the institutional framework also includes strengthening the ethical behavior of responsible persons. Institutional ethics have a higher degree of universal acceptance than individual ethics; therefore politicians and bureaucrats, acting in social institutions, should have a higher societal obligation than private persons. Corruption and scandals are pointing to the fact that many are overstressed by this claim. The consequence of this moral hazard cases can only be: immediate reprivatization.

Is it time for such de-politicization strategies? This is the general question of feasibility. Politicians are gradually facing the fact that during the last decades they took over too many duties formerly solved by self-responsible actions within families or on markets into the political responsibility. Because of spreading information and a growing discontent and annoyance of the citizen they are increasingly unable to solve the complex societal problems. The arrogance of knowledge (*Hayek*) what is good for the people or what is pretendedly unnecessary, the merit and demerit argumentation, is recognized by well educated citizens who mention the limited abilities of political planning procedures. The last euphoria should have been destroyed by the fundamental political change of the last years, but still the interventionists within the political class are dominating.<sup>2</sup> But some politicians have become aware that they would like to get rid of the ghosts they have called. The international discussion on privatization and an

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<sup>1</sup>Here one has just to mention the discussions on the formula flexibility instead of discretionary interventionism in connection with the business cycle policy some decades ago which ended in favor of the latter.

<sup>2</sup>This was demonstrated in a public discussion between the state secretary of the German Ministry of Finance *Falthauser* (CSU) and *Uldall* (CDU). Whereas the influential politician opposed the comprehensive tax base because of the impossibility for further planned interventions, ULDALL (1994) stressed the neutrality of such a system. With regard to the NIT Falthauser mentioned Orwells 1984 in view of the „super-fisc“ necessary for the control. But currently Germany has both: a „super-fisc“ and a „super-welfare-administration“ doing partially the same work under totally different regulatory sets.

improved efficiency of a reduced public sector is only one proof. The standard role of a successful politician should be changed from interventionism to causal therapy of the imperfect contemporary institutions and instruments. Permanent and overwhelmingly blind activism is no character or political proof of the quality of democratical leaders.

In Germany, the erosion of the political influence especially on the tax and transfer system has become obvious for more than one decade; almost all substantial interventions into the social network can be led back to verdicts of the Constitutional Court - another proof for the lack of perspectives or courage on the side of tax and social politicians. The lack in courage is obviously connected with fears that the bureaucrats and interest groups which are engaged in the numerous welfare institution might strike back by desinformation, thus leading to diminishing popularity and loss of votes. But even scientific advice is not easy to obtain because usually politicians do not have enough expertise to choose experts. They have a preference for experts who confirm the own presuppositions or opinions. And if at all political action seems to be unavoidable, then an expert group or a leading economic institute is appointed to analyze the problem which lasts for several month or better years, giving the politicians the alibi for no actions. And within the group of scientist there are many wolves in sheep's clothing. Like in the case of the behavior of the politicians mentioned above, more inefficient institutions and inefficient instruments mean more demand for experts and their important reports - not to mention their prevailing presupposition that on old (tax) system is a good one.

This presupposition might have been correct under conditions in the past where the total public budget was less than 30 percent of GNP; the built-in flexibility of our contemporary systems results in an ever increasing state influence which can only be overcome by substantial reform processes. And here the next problem is hidden: Conservatives are not in favor of reformism; but if also conservatives and liberals are infiltrated by socialistic ideas, the result of their reforms again leads to more socialism. Hence, the introductory quotation of *Friedman* is verified.

Nevertheless, even under a NIT regime the risks of representative democracy still exist; to limit the political interventionism *Niskanen* demands a „new fiscal constitution“. <sup>1</sup> In the parliaments the annual debt limit, the introduction of new taxes or tax rate hikes have to be decided with two-third-majorities. Today's relative or absolute majority would not longer be sufficient, therefore, the danger to exploit wealthy minorities might be reduced. In addition, also politicians of the opposition would be included into the decision process, thus enhancing the common responsibility of government and opposition for the future. The limitation against an ever growing public sector would even be stronger if a NIT system would be included and decisions on its marginal and average rates have to be made not within the parliaments but by plebiscite. Then the influence of politicians, bureaucrats, and interest groups would be substantially reduced. <sup>2</sup>

All this is no scientific news but well known by the happy few who still follow some liberal norms. What is badly missing is the transfer of knowledge into the public via education and mass media. This transfer is delayed because of the aging society in which the elderly do not have this knowledge and the young not the power. Even politically mismanaged societies have been able for spontaneous order. In view of the fundamental upheavals of the very recent past one can be optimistic: For the young generations open societies which rely upon self-responsibility have always been attractive; the NIT system with reduced personal redistribution which is controllable by the public is a roll-call for the young not to drop-out but to be engaged in all the other serious problems we have to face in the coming century.

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<sup>1</sup>See NISKANEN (1992).

<sup>2</sup>For more details see VAUBEL (1991).

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