

Ideas in the History of Chicago Economics *Milton Friedman & Negative Income Tax*

Thomas S. Coleman

Harris Public Policy

Nov 2021 (Draft November 17, 2021)

- ① Overview
- ② History of Ideas
- ③ Milton Friedman & Negative Income Tax

Many “Histories of Chicago Economics” discuss people, politics, ideology
But I want to change focus

- Discuss *Ideas* and *Concepts* that have sprung from Chicago

Two Central Themes:

- ① Taking economics seriously
- ② Applying and testing economics empirically

In discussions of economic science, Chicago stands for an approach that takes seriously the use of economic theory as a tool for analyzing a startling wide range of concrete problems, . . . that insists on the empirical testing of theoretical generalizations, and that rejects alike facts without theory and theory without facts. [1974 address to the University of Chicago Trustees. cf UofC Magazine Jan-Feb 2007, volume 99, issue 3]

Heckman's "Three Ground Rules for Chicago Economics"

Quoting from 2012 presentation at the Friedman Centennial Celebration

- ① Faculty know and understand the corpus of economic theory and economic empirical knowledge – not just their specialty within the field. *Students and faculty speak a common language – the language of basic price theory and the economics of incentives – and that we can communicate these ideas clearly.*

Heckman's "Three Ground Rules for Chicago Economics"

Quoting from 2012 presentation at the Friedman Centennial Celebration

- ① Faculty know and understand the corpus of economic theory and economic empirical knowledge – not just their specialty within the field. *Students and faculty speak a common language – the language of basic price theory and the economics of incentives – and that we can communicate these ideas clearly.*
- ② Chicago views economics as a serious subject, tackling serious problems.

Heckman's "Three Ground Rules for Chicago Economics"

Quoting from 2012 presentation at the Friedman Centennial Celebration

- ① Faculty know and understand the corpus of economic theory and economic empirical knowledge – not just their specialty within the field. *Students and faculty speak a common language – the language of basic price theory and the economics of incentives – and that we can communicate these ideas clearly.*
- ② Chicago views economics as a serious subject, tackling serious problems.
- ③ Chicago economics demands that scholars move beyond selective and self-serving appeals to “stylized facts” to “illustrate” theories and instead engages and promotes the serious scientific task of careful and creative analyses of data, linking theory and evidence. Chicago values the hard empirical work that produces convincing evidence and rigorous economic theorizing that produces lasting contributions to important problems.

① Overview

② History of Ideas

③ Milton Friedman & Negative Income Tax

A History of Ideas – The Big Names & Big Ideas

- Thorstein Veblen: *Conspicuous Consumption*
- Frank Knight: *Risk vs Uncertainty (Ambiguity)*
- Jacob Viner: *Price Theory*
- Ronald Coase: *Externalities*
- Robert Fogel: *Economic History*
- Friedman: *Cons fn & perm income; Methodology; Monetary History; Phillips curve and NAIRU*
- T.W. Schultz: *Ag Econ; Human Capital*
- George Stigler: *Regulatory Capture; Economics of Information*
- Robert Mundell: *Optimal Currency Areas*
- Robert Lucas: *Rational Expectations*
- Gary Becker: *Human Capital; Economics of the Family; Discrimination*
- James Heckman: *Econometrics; Labor; Early Childhood*
- Lars Hansen: *Econometrics; Ambiguity*

A History of Ideas – Lesser-Known Names

But also the ideas and some of the lesser-known names

- These are not the household names of Friedman, Becker, Lucas, Heckman. But it is because of these that Chicago is great
- Henry C. Simons: *Quantity Theory of Money*
- Paul Douglas: *Cobb-Douglas function*
- Wesley C. Mitchell
- Henry Schultz: *The Theory and Measurement of Demand*
- Law & Economics
 - Aaron Director: *Law & Economics*
 - Edward Levi
 - Richard Posner
- Trade and Open-Economy Macro
 - Harry Johnson, Larry Sjaasted, D. Gale Johnson (also Ag Econ)
- Labor & Applied Micro
 - H. Gregg Lewis: *Labor*
 - Jacob Mincer, Al Rees
 - Sherwin Rosen
- Econometrics
 - Henri Theil
 - Arnold Zellner
 - Zvi Griliches
- Regulation (Stigler)
 - Victor Zarnowitz
 - Lester Telser
 - Sam Petlzman
- Consumer & Home Economics
 - Margaret Reid , Mary-Jean Bowman

PRICE THEORY

- Seatbelt & Peltzman Effect
- Thinking about economic decisions

Jacob Viner, to Friedman, Becker,
Murphy

MICROECONOMICS

- Revealed Pref & Axioms
- Mathematics of economic decision-making

Practical guides to some of the ideas:

- Human Capital (Gary Becker)
- Natural Rate of Unemployment (Milton Friedman)
- Permanent Income (Milton Friedman)
- Vignettes available at www.hilerun.org/econ/chicagohistory (my site)

Heckman speaking at Harris 2017:

- Short clips:
https://www.youtube.com/watch?v=ivzCmrY_iAw&feature=youtu.be
- Full: <https://www.youtube.com/watch?v=9N8GSDwGYzI&feature=youtu.be>

① Overview

② History of Ideas

③ Milton Friedman & Negative Income Tax

“Case for the Negative Income Tax” – 1968

There is a far better way to guarantee a minimum annual income to all than our present grab bag of programs

Standard income tax: government takes income above standard deduction

Income above Standard Deduction (\$24,400 for married)

Pay to Government – 10% for income just above SD

NIT: Government *pays* when below standard deduction – fraction of difference

NIT: Government *pays* Below Standard Deduction

Receive from Government – fraction of difference $\tau \cdot (24,400 - E)$

Friedman proposes 50%

Earn	0	12,200	24,400	36,600
Gov Pay	12,200	6,100	0	-1,220
Total	12,200	18,300	24,400	32,940

Negative Income Tax = Universal Basic Income

Net effect: Universal Basic Income (“Universal Subsidy” or “Social Dividend”)

- Even if earn zero, get minimum \$12,200 ($\$24,400 / 2$)
- Guarantees Minimum Income to everyone
 - Adjust Standard Deduction to adjust Minimum Income
- Friedman argues using tax system to administer is effective & efficient

Friedman's Arguments in Favor

Friedman argues

- Simplifies current grab-bag of benefits
- Uses existing tax system
- Provides incentive to work (get to keep 50% of any earnings below \$24,400)

Arguments based largely on economic efficiency

- Government supports “poor” and transfers income
- This is more effective and efficient method
 - Uses cash rather than “in-kind” (e.g. Food Stamps (SNAP))
 - Strong argument to let *individuals* make their own rather than gov't saying “spend on food, ...”
 - Partly addressed since 1968
 - Uses existing income tax system
 - Reduces bureaucracy (cost)
 - Reduces temptation to use programs for other political ends

Contrast with EITC (Earned Income Tax Credit)

EITC enacted 1975, expanded since

One of the largest US anti-poverty programs

Sounds like a Negative Income Tax (and is in some respect)

- Negative tax rate on *wages* rather than income

Does *not* provide UBI – excludes those who don't work

- Positive: provides incentive to work (“deserving poor”)
 - Politically easier
- Negative: does not help those who do not work
 - Displaced workers, out of work due to “globalization”

Structure of EITC:

Structure of EITC (Earned Income Tax Credit)

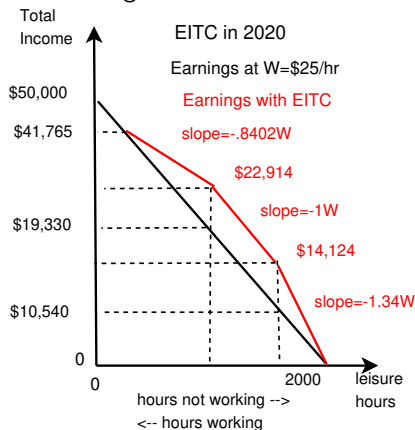
NIT: Pay even if no earnings

EITC: Pay extra when earn

Think about budget line, and EITC “pushes out” budget line

Structure of EITC (2020, one child)

- Low income: Extra \$0.34 for each dollar earned up to \$10,540 (extra \$3,584, total \$14,124)
- Moderate income: between \$10,540 and \$19,330, keep \$3,584
- Higher income: take away \$0.1598 per dollar between \$19,330 and \$41,765
- High income over \$41,765, gone



NIT: Guarantees Income, Discourages Work

NIT: Pay even if no earnings

EITC: Pay extra when earn

NIT: Gov't Pays when Below SD; EITC: Negative Tax Rate

NIT: Pay even if earn nothing: $\tau \cdot (24,400 - E)$; EITC: Negative rate for low earnings $-\tau^* \cdot E$

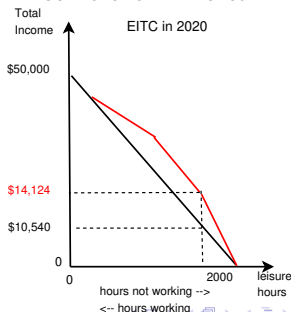
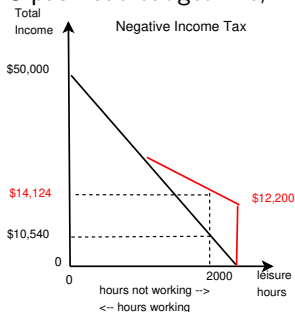
Friedman proposes 50%

Earn	0	10,540	19,330
Gov Pay	12,200	6,930	2,535
Total	12,200	17,470	21,865

Earn	0	10,540	19,330
Gov Pay	0	3,584	3,584
Total	0	14,124	22,914

Incentive to work – total increases with earnings (but effective 50% tax rate!)

NIT and EITC push out budget line; NIT – income even if no earnings



NIT: Guarantees Income, Discourages Work

NIT: Pay even if no earnings

EITC: Pay extra when earn

NIT: Gov't Pays when Below SD; EITC: Negative Tax Rate

NIT: Pay even if earn nothing: $\tau \cdot (24,400 - E)$; EITC: Negative rate for low earnings $-\tau^* \cdot E$

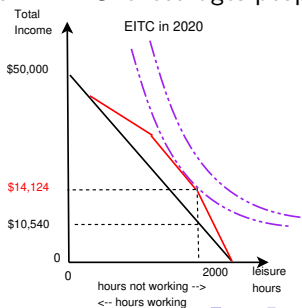
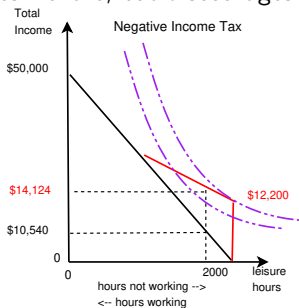
Friedman proposes 50%

Earn	0	10,540	19,330
Gov Pay	12,200	6,930	2,535
Total	12,200	17,470	21,865

Earn	0	10,540	19,330
Gov Pay	0	3,584	3,584
Total	0	14,124	22,914

Incentive to work – total increases with earnings (but effective 50% tax rate!)

NIT: increases welfare, but discourages work. EITC: encourages people to work



Question – Has EITC Affected Earnings?

It looks like tax policy over past 40-50 years has *decreased* inequality

- Decreased relative to what it would be without tax policy
- I think partly or largely due to EITC
- Seems taxes have become *more* progressive – Contrary to standard narrative

Data from taxes, income for bottom and top of income distribution

- How much has income grown, 1979-2014
- Before taxes & transfers: bottom half grew 26.9% (real)
- *After* taxes & transfers: grew 59.3%
- Seems taxes have supported bottom half. Probably due to EITC

National Income, 1979-2014	Average	0-50th	50-90th	90-99th	Top 1%
AS Pre-Transfer / Pre-Tax	70.9%	26.9%	63.3%	93.2%	157.1%
AS Pre-Tax (after transfer)	80.2%	58.5%	71.2%	95.7%	156.8%
AS After-tax	70.9%	59.3%	68.8%	83.2%	104.6%

Auten, Gerald, and David Splinter. 2019. "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends." <http://www.davidsplinter.com/>.