PERSPECTIVES ON LOW-INCOME WORKING FAMILIES

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Analyzing Recent State Tax Policy Choices Affecting Low-Income Working Families: The Recession and Beyond

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This policy brief offers a framework for analyzing state tax changes affecting low-income working families from 2002 to 2006. This timeframe encompasses the difficult choices states faced in the latest recession and the years just beyond as state revenues recovered. Lessons learned about how state tax policy choices affected low-income families during and immediately after the recession can help states refine their choices in the future.

States often raise taxes during recessions, and depending on the design, those tax increases can fall hard on lower-income families. Policymakers may be particularly concerned with tax increases affecting low-income working families during times of fiscal stress because budgets for programs that assist these families are often cut at the same time (Rivlin 2002).

One reason that recessions can have such a substantial effect on state taxes and spending is that every state except Vermont has some sort of balanced budget requirement. So, unlike the federal government, states must balance expenditures and revenues in any given budget cycle (typically one year). States can have rainy-day funds that allow money to be carried over from good years to lean years. Before the recession that began in 2001, 47 states had such funds (Gonzalez and Levinson 2003). Faced with falling revenues, states can spend down rainy-day funds, increase borrowing, increase taxes, or reduce spending. All these factors played a role in state budget adjustments during the last recession.

State tax policies affect low-income working families in distinct ways. Though the level of state taxes may vary by state, most low-income working families can expect to pay broad-based income and sales taxes.[1] And as a share of income, low-income families can expect to pay more state income and sales taxes than high-income families in the same state (McIntyre et al. 2003). On the other hand, states also use the personal income tax to supplement the incomes of low-income working families with credits such as the earned income tax credit (EITC), which can also be used as a powerful tool to offset tax increases elsewhere.

Many states start taxing families at lower incomes than the federal income tax, so even a family exempt from federal personal income taxes will often owe these state taxes. For example, a single parent with two children could earn $34,600 before owing federal income taxes in 2005 (author's calculations). This same family would owe tax in every state that has a broad personal income tax except California (Levitis and Johnson 2006).[2] State sales taxes can also be significant for low-income working families. On average, low-income families spend a greater portion of their earnings on items subject to sales taxes than higher-income families (Burman, Gravelle, and Rohaly forthcoming). Policies that rely on increasing sales taxes can fall particularly hard on low-income families. Some states alleviate this burden by exempting purchases of food, medicine, and clothing from the sales tax.

When making tax policy choices, state policymakers can use several policy levers, including altering the amount of income subject to various tax rates, altering the tax rates applied to various amounts of income, changing the amount of income exempted from tax based on marital status or family size, and providing tax credits to subsidize certain activities such as working or raising children. These choices dictate how heavily tax burdens fall on low-income working families.

During the latest recession, states began by exhausting rainy day funds and later increased taxes. In many cases, states limited taxes for low-income working families rather than increasing them. Notably, between state fiscal years 2002 and 2006,[3] 14 states used EITCs to provide tax relief to low-income families. Five states implemented a new EITC and nine states (including the District of Columbia)[4] increased an existing EITC. In contrast, Colorado eliminated its EITC due to insufficient revenues, and Maine temporarily implemented a small EITC reduction from 2002 to 2005. Five other states left their EITCs unchanged. When states did increase taxes, tobacco taxes were the most likely to be targeted.[5]

How State Tax Changes Affect Low-Income Families

States can use several tax policy levers to tilt higher tax burdens toward lower- or higher-income families. For the personal income tax, key policy choices include the tax rates paid by different income groups, personal exemptions, and standard deductions. In addition, states can use the EITC to target tax relief to low-income working families. For sales taxes, states can enact increases that tend to exempt or include low-income families, though this can be tricky. States strategically used all their tools during the recession.

Increasing tax rates can be an expedient way to increase state revenues. For the income tax, states can increase total revenues while leaving the liability of low-income families unchanged—or less affected than other income groups—if legislators increase only the rates that apply to higher income brackets, or increase these rates more than the rates affecting lower brackets. Realistically, this cannot happen in most states because even the highest tax brackets cover relatively small amounts of income. At the extreme, once taxable income reaches $6,000 for married filers in Alabama, the highest rate of 5 percent applies, though Alabama has two additional rates that cover taxable income lower than $6,000.[6]

In states with more progressive income tax systems, however, it is possible to design rate increases that fall mostly on middle- and upper-income residents. The amount of personal income tax a family is required to pay depends not only on the tax rates applied to income, but also on the definition of taxable income. To arrive at the amount of income on which an individual must pay tax, most states allow families to subtract a set amount from their total income based on whether the family head is an individual or a married couple (the standard deduction).[7] This practice parallels that of the federal personal income tax system. Also consistent with the federal personal income tax, states often exempt a specified amount of income from tax (personal exemption) based on family size. These provisions attempt to take into account a family's ability to pay taxes, based on its composition, when determining how much tax should be paid.

Increases to either the personal exemption or the standard deduction increase the point at which a family begins to pay taxes—and can be used to ensure that families with earnings below a certain threshold (e.g., the poverty threshold) are not subject to income tax. Increasing exemptions and deductions helps families facing higher tax rates more than those facing lower tax rates.[8] Conversely, decreases to the personal exemption or the standard deduction mean that a family will start owing tax at lower income levels. In states with progressive income tax rates, decreasing these provisions means that more income will be taxed at the higher rates.

State tax credits provide a substantial policy lever that can assist low-income working families, and state EITCs continue to grow in popularity. Benefits from EITCs flow mostly to low-income families with children, though some state credits and the federal credit provide small benefits to low-income families without children. The federal EITC—the typical blueprint for state EITCs—provides a wage subsidy of up to 40 cents for each dollar a family with two or more children earns, until its earnings reach $11,340 (in 2006). A single parent with two or more children continues to receive the maximum subsidy of $4,546 until she earns $14,810.[9] After that, the subsidy decreases by about 21 cents for each additional dollar earned until no more credit is available. Single parents exhaust the credit once their earnings reach $36,348. A smaller subsidy is available to families with one child, up to $2,747.[10] States adopting the structure of the federal EITC provide families with a credit that equals 4 to 43 percent of the federal credit (Nagle and Johnson 2006). In 2001, 16 states had an EITC largely based on the federal EITC.

The federal credit and most state EITCs are refundable, so even a family that does not owe income taxes can still receive the full credit. As of 2006, 4 of the 19 state EITCs were nonrefundable (Delaware, Iowa, Maine, and Virginia). In the case of a nonrefundable tax credit, if a family's tax liability is less than the EITC it qualifies for, the family forfeits the amount in excess of its tax liability. Although nonrefundable federal credits offer little assistance to low-income working families, these credits can be valuable to low-income families since states often levy income taxes on very low income families.

States can use some of their Temporary Assistance for Needy Families (TANF) block grant funds to pay for the refundable portion of a state EITC—leading some experts to speculate in the late 1990s that these EITCs would be abolished if the economy turned downward and TANF caseloads expanded.

Some felt even those EITCs not funded by TANF funds might be at risk in the case of an economic downturn. For the most part, this concern turned out to be unfounded.

States also assist low-income families in other ways using the personal income tax system. The more prominent choices include credits that offset the cost of groceries, property taxes, or caring for children, as well as no-tax floors (provisions that specify an income below which no tax is due).

Turning to the sales tax, it is harder to design sales tax hikes that leave the tax liability of low-income families unchanged—or less affected than other income groups—than it is to design income tax hikes with this effect. But sales tax rate increases can be moderated for low-income families by exempting such items as food, which consume a large share of low-income families' budgets, or by providing offsetting credits.

State Tax Policy before the Recession

Most states appeared more prepared for the fiscal crisis that started in 2001 than for previous recessions. Many states had built up substantial rainy-day funds that were larger than in years past (Gonzalez and Levinson 2003), facilitated by the explosive capital gains growth in the late 1990s.

At the same time, the unusually large growth in capital gains and state revenues also allowed states to cut taxes in the years leading up to the recession. Between fiscal years 1995 and 2001, 36 states cut personal income taxes and 11 states increased personal income taxes (NGA and NASBO 1997–2005). As shown in figure 1, the largest legislated tax cuts were made in the personal income tax, and net cuts existed through FY 2002. Legislated net sales tax cuts also existed between FY 1998 and FY 2001. Despite these tax cuts, revenues continued to rise owing to the very strong economy. But the cuts meant that once the economy weakened, states were left trying to raise money with slimmed-down tax systems that ultimately proved insufficient for the task.

Many states also changed their approaches to tax policy decisionmaking during this period, hampering their ability to react during the 2001 recession. Three states enacted provisions that required voter approval for tax increases, and 10 states enacted provisions that required a legislative supermajority to increase taxes.[11] Supermajority laws require approval of three-fifths to three-quarters of each legislative chamber to enact a tax increase. Colorado voters suspended both these policies in November 2005 after recognizing how they handcuffed the state's ability to maintain services.

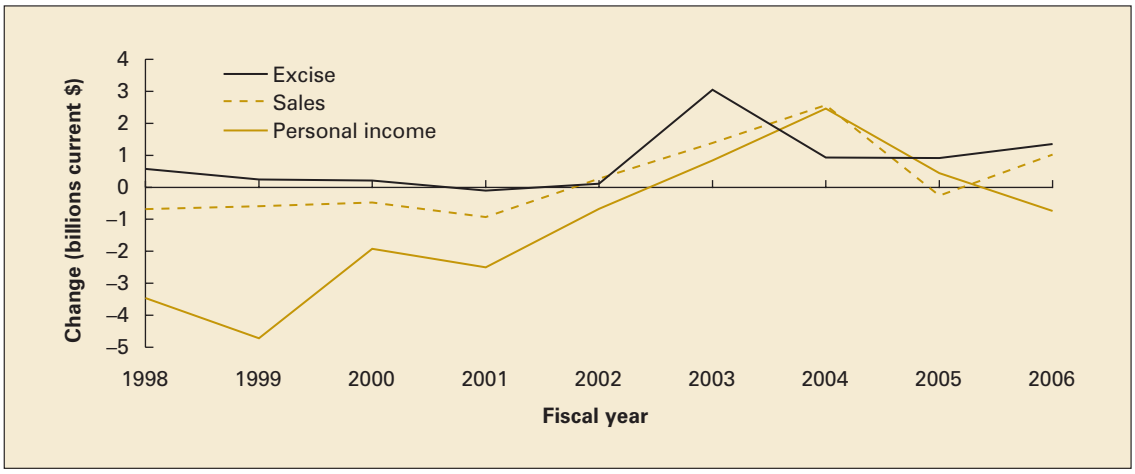
States had also increased spending during this period, making it more difficult for them to balance their budget during the recent recession. Most significant, perhaps, was the increase in Medicaid spending due to rising health care costs and program expansions (Smith et al. 2003).

State Tax Policy during the Recession

Because of flush rainy-day funds, most states were able to postpone making hard budget choices during that first year of the 2001 recession. Most states used program cuts as the primary strategy to balance budgets (Finegold, Schardin, and Steinbach 2003). Every state focused on reducing Medicaid spending to contain growth in program costs. Medicaid is a countercyclical program; costs increase when the economy weakens because more people qualify for benefits. States focused heavily on reducing provider payments and controlling spending on prescription drugs. But states also reduced benefits and eligibility and increased co-payments, which left Medicaid covering a smaller swath of low-income, uninsured adults than were previously eligible—though the total number of Medicaid enrollees grew (Coughlin and Zuckerman 2005; Smith et al. 2003).

The first major tax increases happened in FY 2003. During this year, states

FIGURE 1. Net Legislated Policy Changes: State Sales, Income, and Excise Taxes, FY 1998–2006



Sources: NASBO 1997–2005.

enacted over $3 billion in excise tax increases—almost exclusively on tobacco taxes (see figure 1). Excise taxes tend to fall disproportionately on low-income families (Gruber and Koszegi 2002). States also boosted revenues by securitizing their tobacco settlements (the sale of bonds backed by future revenues from the settlement of the multistate tobacco lawsuit). States enacted more modest increases in excise taxes in subsequent years, as well as increases to both personal income and sales taxes (Maag and Merriman 2003).

During FY 2002, most states left tax policy largely unchanged. Of those making changes, more enacted net cuts to all types of taxes except excise taxes, where four states enacted net increases and no state enacted a net cut (figure 2).

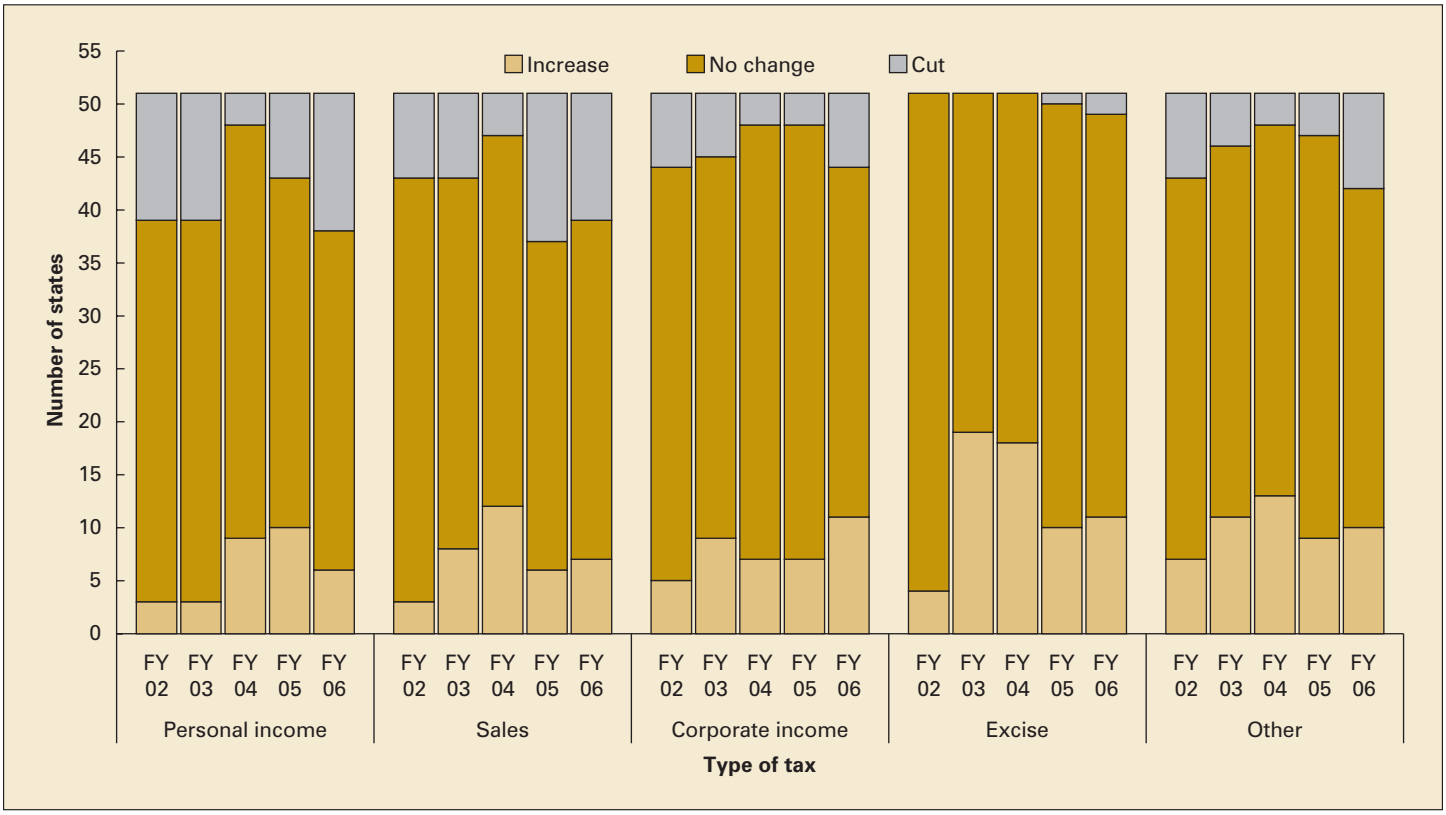
In FY 2003, although net tax cuts to personal income taxes remained in a majority of states enacting changes to the personal income tax, the tide shifted in other cases. An equal number of states enacted net sales tax increases as enacted sales tax cuts in FY 2003, and a majority of states that made tax policy changes enacted net increases to their corporate income, excise, and other taxes. In FY 2004, more states enacted net tax increases to all types of taxes than enacted net cuts. Changes to broad-based sales and income taxes and how these changes affected low-income families are detailed below.

Between 2002 and 2004, six states increased their personal income tax rate (table 1). North Carolina was the first state to take such an action (2002), followed the next year by New York, Arkansas, and Oklahoma. Among these states, New York protected low-income families by enacting this increase only for residents with taxable income exceeding $150,000. Connecticut and Michigan increased personal income tax rates in 2004.

Nine states increased sales tax rates over this period, and no states enacted broad rate cuts to the sales tax. Tennessee tempered the effect of the increase for low-income families by exempting food sales. Other states used income tax increases to offset some effects of a sales tax increase, described below. Five states cut personal income tax rates during this period, with Oklahoma cutting rates in both 2002 and 2004.

Five states (Arizona, Connecticut, Georgia, Massachusetts, and New York) raised the point at which families would begin to owe income tax by increasing either the personal exemption or standard deduction between 2002 and 2004. Connecticut had planned to increase the personal exemption for eight consecutive years, starting in 2000. In 2002, the planned increase was delayed until 2004, leaving the 2001 personal exemption in effect in 2002 and 2003. In 2004, the per-

FIGURE 2. Net State Tax Changes FY 2002–2006



Source: NASBO 2001–2005.
Note: Excise includes taxes on alcoholic beverages, motor fuel, and tobacco.

TABLE 1. Selected Tax Policy Changes 2002–2006

	2002	2003	2004	2005	2006
Selected Tax Increases					
Personal income tax rate increase					
High-income tax brackets only		NY[a]		CA[b]	
All tax brackets	NC	AR,[c] OK	CT, MI		
Sales tax rate increase	IN, KS, NE, TN[d]	NY, OH, VT, ID	VA		
Standard deduction/personal exemption decrease		NC			
EITC cuts	CO[e]	ME			
Other tax increases		CT,[f] AR[g]			
Selected Tax Cuts					
Personal income tax rate decrease	DC,[h] MA, OK, RI	NM	OK	OH, MT, AR[c]	OK, NY[a]
Sales tax rate decrease				ID, OH	NY, WV[i]
Standard deduction/personal exemption increase	AZ	GA, NY	CT, MA	AZ, VA	
EITC increases					
New EITC	OK	IN			DE, VA, NE
Increase existing EITC	KS, NJ, NY	IL, NJ, NY, MD, RI	MD	DC, RI	ME, OR, NY
Other tax cuts	UT, KS, MA			KY	

Sources: NASBO 2001–2005 and state personal income tax forms.
Notes: Year listed is calendar year when the change first went into effect. Change was not necessarily in effect for the entire year.
a. Applies to families with income > $150,000. Two additional brackets were added in 2003; these were decreased in 2004 and 2005 and expire in 2006.
b. Created new bracket for income over $1 million.
c. 3 percent income tax surcharge 2003–04.
d. Increase does not apply to food purchases.
e. EITC suspended 2002–06.
f. Reduced property tax credit.
g. Repealed working taxpayer credit.
h. Temporary tax rate decrease 2002–06.
i. Applies to food only.

sonal exemption increased, but additional increases were once again delayed. At present, the previously scheduled increases have been delayed until 2007.

In contrast, North Carolina increased taxes by reducing the standard deduction in 2003. Many higher-income residents itemize their deductions rather than take the standard deduction, so changes to the standard deduction do not affect them. This means that tax increases such as North Carolina's fall disproportionately on lower-income residents.

Expanding state EITCs was the single most popular form of tax cut between 2002 and 2004, implemented by 12 states (see table 1). Delaware, Indiana, Oklahoma, and Virginia enacted new EITCs, while Illinois, Kansas, Maryland, New Jersey, New York, Oregon, Rhode Island, and Washington, D.C., increased existing EITCs. In Indiana, Kansas, and New York, the changes offset sales tax increases.

Only Colorado and Maine reduced their EITCs during this period. Colorado's EITC was suspended in 2002, but this was a result of how the EITC was designed, rather than an explicit action taken by the legislature.[12] Maine's EITC had a very small temporary decline from 5.0 percent of the federal credit to 4.92 percent of the federal credit from 2003 to 2005. Other actions taken by states to reduce taxes during the recession were a food sales tax rebate in Kansas, an increased child deduction in Massachusetts, and the establishment of a no-tax floor in Utah.

Studies by the Center on Budget and Policy Priorities show that personal income taxes increased for families with poverty-level incomes in 16 states between 2001 and 2004. Personal income taxes decreased in 13 states and remained the same in the remaining 13 states with broad personal income taxes. In one state, the personal income tax increase was substantial. A family of three with poverty-level income in Colorado paid $403 more in personal income taxes, after adjusting for inflation, in 2004 than it did in 2001 owing to the loss of the state EITC. Taxes increased by an average of $24 in the remaining 15 states with increases, due largely to state tax systems not adjusting for inflation.

State Tax Policy after the Recession

With the recession in the rearview mirror and state revenues largely recovered, 2005 and 2006 provided an opportunity for states to reverse some of the broad changes enacted in the preceding years. Notably, only California enacted a broad rate increase, and this increase did not affect

low-income working families. Only families with income in excess of $1 million were subject to the new tax rate.

Starting in 2005, families in Arkansas were no longer subject to a 3 percent surcharge that had gone into effect in 2003, and the higher rates on families with incomes in excess of $150,000 in New York expired in 2006. Oklahoma enacted personal income tax rate cuts in 2006—reversing 2003 action. Ohio and Montana also lowered personal income tax rates. Ohio lowered its sales tax rate in 2005 after having increased it just two years before. Idaho, New York, and West Virginia took similar actions. This tax relief effort in West Virginia applied only to food, which allowed relief to be targeted toward lower-income families. Arizona and Virginia took steps to increase the amount of income exempt from tax, while Kentucky enacted a significant low-income credit that substantially increased the filing threshold for low-income families.

EITCs continued to be popular after the recession had ended. In 2005, D.C. and Rhode Island increased existing EITCs, followed by Oregon in 2006. Three new EITCs went into effect in 2006 (Delaware, Nebraska, and Virginia), and Maine restored the EITC it had cut in 2003. New York expanded its EITC to allow noncustodial working parents making child support payments to claim a credit.

Implications

State sales and personal income taxes together provide approximately two-thirds of state revenues.[13] How these taxes are levied can have a substantial impact on low-income families. Low-income families typically pay a greater share of their income in sales taxes than higher-income families, though exemptions of specific goods such as food or clothing can lessen this impact. Personal income tax systems can more easily be structured to place higher burdens on higher-income families than other types of taxes. States, like the federal government, can provide cash assistance to low-income families through the tax system—and they often do, with credits such as the EITC. Even during the recession, state governments seemed interested in helping low-income working families by enacting new EITCs and expanding existing EITCs. Between 2002 and 2006, five states enacted new EITCs and nine states increased existing EITCs.

Starting in 2001, states faced revenue shortfalls that ultimately lasted two years—substantially longer than the national recession. During this time, 15 states tried to solve at least part of their budget problem with increases to either the sales or personal income tax. In some cases, these taxes fell on low-income families. For example, Arkansas's 3 percent surcharge on personal income taxes during the recession affected all taxpayers, though those who owed higher taxes obviously paid a greater amount than those who owed low taxes. This is also true of the nine states that passed sales tax increases, though Tennessee exempted food from this increase (minimizing its impact on low-income families) and Indiana, Kansas, and New York offset the sales tax increase by enhancing state EITCs. Other states passed reforms that provided overall tax increases but had a limited effect on low-income families.

At the conclusion of the recession, some states moved to undo the changes they put in place in the preceding few years. In 2005, Arkansas's temporary 3 percent surcharge on personal income taxes that had been in effect since 2003 ended. In July 2005, Idaho ended its temporary sales tax increase that had been enacted in May 2002. Other states passed additional broad-based tax cuts. While these new tax cuts were often targeted at low-income families, they were not balanced with broad increases elsewhere. This action leaves states with revenue systems less able to generate revenue than in prior years.

When states increase taxes during a recession to plug what is expected to be a temporary budget shortfall, it may make sense to repeal these measures once revenues stabilize. If, however, these taxes helped modernize the state's economy, enabling it to deal better with future shortfalls, reversing the increases may leave the state vulnerable to future recessions, leaving states in the same position as they approach the inevitable next recession.

Taken together, states used a variety of tools to weather the latest recession. Individual states tended to focus narrowly, however, rather than exploit the broad range of tools available to them. At the start of the recession, states relied heavily on increases to the tobacco tax, which may fall particularly hard on low-income families. In future recessions, states may wish to carefully evaluate the impact of particular tax increases on low-income working families, and follow the lead of some states in the previous recession by enacting or increasing existing tax credits for low-income families so these families do not face the double burden of program cuts and tax increases.

Kee and Shannon (1992) argue that fiscal crises provide an opportunity for states to update their tax systems. It appears that states let this opportunity pass them by in the most recent recession. On the revenue side, most states closed budget gaps with one-time revenue sources or targeted tax increases. While these measures may provide a convenient way to delay more radical actions, they do not prepare the state for coming fiscal downturns.

Notes

1. Several states are notable exceptions. Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming have no, or only a very limited, income tax. Delaware, Montana, and Oregon have no sales tax. Alaska and New Hampshire have neither a broad-based income tax nor a sales tax.

2. These thresholds take into account only income tax provisions that are broadly available to low-income families and are not intended to offset other taxes.

3. For almost all states, the fiscal year lasts from July 1 to June 30. Exceptions to this standard are Alabama and Michigan (October 1–September 30), New York (April 1–May 31), and Texas (September 1–August 31). Fiscal years are named for the year in which they end; for example, FY 2002 for most states begins on July 1, 2001, and ends on June 30, 2002.

4. For the purposes of this discussion, the District of Columbia is considered a state.

5. While the burden of tobacco taxes generally falls disproportionately on low-income individuals, those same individuals receive a health benefit if the taxes work to discourage smoking.

6. In 2007, the point at which Alabama taxpayers start having taxable income rises, though it is still quite low. A family of four can earn $12,600 before having taxable income. Before the legislation, this family could earn only $4,600 before having taxable income (David White, "Income Tax Cut Bill Passes," *The Birmingham [Alabama] News*, 7 April 2006).

7. As in the federal income tax system, in some state income tax systems families may choose to itemize their deductions rather than taking the standard deduction. In 2003, 34 percent of federal income tax filers chose to itemize their deductions rather than take the standard deduction. Most low-income families take the standard deduction.

8. For a family facing a highest tax rate of 10 percent, the value of a $1,000 exemption would be $100 (0.10 x $1,000). If the deduction or exemption the family were eligible for increased by $1,000, the family would owe tax on $1,000 less of its income. If it instead faced a highest tax rate of 5 percent, the value of the same exemption would be $50.

9. The maximum credit and point at which the credit fully phases out are $2,000 higher for married couples.

10. In 2006, the maximum federal EITC for families with no children is $412, and the credit is no longer available to families once their income reaches $12,120.

11. National Conference of State Legislators, "State Tax and Expenditure Limits – 2005," http://204.131.235.67/programs/fiscal/tels2005.htm#back2.

12. Colorado's EITC was enacted as one part of a constitutional amendment specifying how revenues in excess of a defined formula would be returned to Colorado residents. In 2002, revenues in Colorado were not sufficiently high to trigger the EITC or other refunds.

13. See U.S. Bureau of the Census, "Table 1: State and Local Government Finances by Level of Government and State: 2005," http://ftp2.census.gov/govs/estimate/0400ussl_1.txt.

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