BIG IDEAS
CHILDREN IN THE SOUTHWEST

Big Idea: Stop Taxing the Poor

by

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FIRST FOCUS
MAKING CHILDREN & FAMILIES THE PRIORITY

Advocates, policymakers and practitioners concerned with improving the lives of America's vulnerable families focus almost exclusively on efforts to increase spending. And for good reason: as the economic downturn continues to squeeze government budgets at the federal, state, and local levels, everything from education to nutrition programs is on the chopping block. In an effort to prevent deeper cuts many states have turned to an old source for new revenue: sales taxes. Despite the good intentions for how these new dollars will be spent, policymakers looking to use regressive tax vehicles to raise new revenue may be penny wise and pound foolish. Our research suggests that how we tax could be just as consequential for family and child well-being as how we spend and taxing the poor hurts everyone in the long run.

Our book, *Taxing the Poor*, considers the evolution of tax systems in the Southern states and how these regressive regimes are serving to make poverty worse today. In the course of our research we calculated recent trends in taxation for all states. In the process we noted that over the last 25 years the Southwestern states were beginning to follow the Southern model of increasing taxes on the poor, diverging sharply from the states of the Northeast and upper Midwest where impoverished families were being taxed less and often receiving a rebate through the tax code. As nearly one-third of all US children call the Southwest home, here we consider what increasing taxes on the poor in this region means for these children and their families.

How States Differ

Scholars and advocates interested in the connection between taxes and poverty typically focus on the merits of expanding the federal Earned Income Tax Credit (EITC). Indeed, the EITC raises more families out of poverty than any other government policy simply by putting more money in the hands of low-income earners.[i] At the same time, less attention has been paid to the tax bills levied on families by state and local governments. As we illustrate, there has been a tremendous divergence at the state level: whereas some states have followed federal lead and used tax policy as a way to fight poverty, others have moved in the opposite direction with tax policies that push poor families further behind.[ii]

Estimating the tax burden on the poor is a complicated endeavor (a process we discuss at length in *Taxing the Poor*). We began by attempting to understand income tax burden. For this we relied on NBER's "Taxsim" database, which draws on tax return and administrative data to provide accurate estimates of tax burden by income and family type.[iii] We used taxsim to estimate the income tax burden for a hypothetical family of three—one adult worker and two dependent children under 18—for every state. We then repeated this exercise using data for every year from 1982 to 2008. This provides us with a picture for the income taxes paid by the "Jones family" both across states and over time.

But income tax isn't the only instrument the Southwestern states are using to tax the poor. Given that sales taxes are particularly regressive—and popular—instruments for raising revenues, we wanted to measure the burden these taxes place on families at the poverty line, which is not a simple matter. How much do poor families like the Jones' have to pay in sales tax on food, medicine, clothing and other goods? To determine how much our hypothetical family would pay in sales tax, the uniform "consumption basket" – the goods our family purchases in a year – is multiplied by the sales tax rate they faced in each state, for every kind of purchase, for every year.

To illustrate how states have diverged over time, we graphed trends in the tax burden on the poor separately for the Southwestern states and the Northeastern states. These figures provide a sense for how the tax burden paid by the Jones family has changed over time in a region of the country with increasingly regressive policies (Southwest) versus a region with increasingly progressive policies (Northeast).

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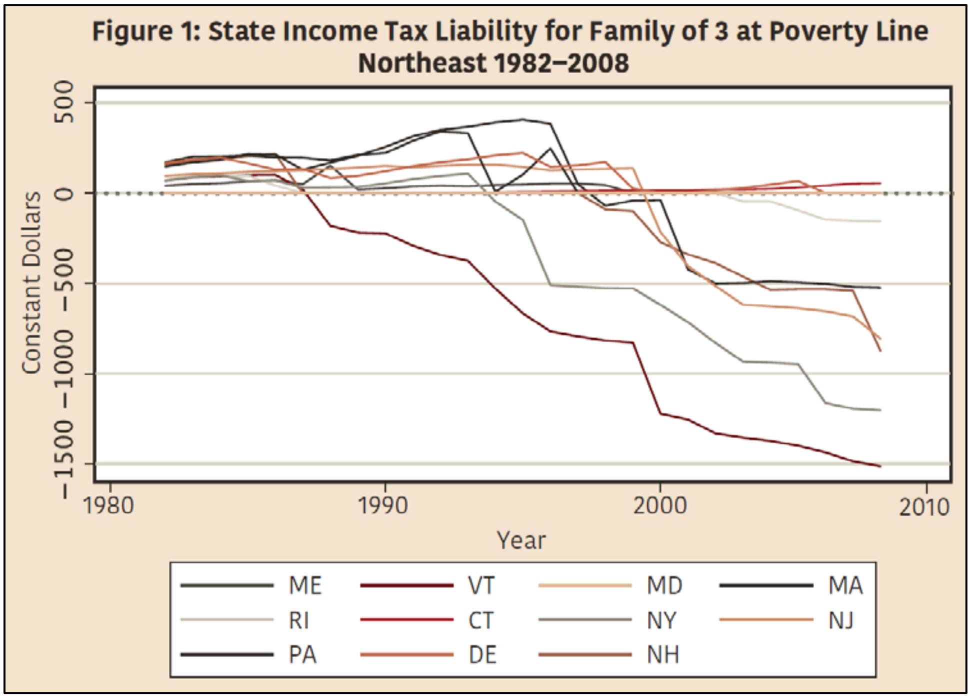
Figure 1 displays the average state income tax paid by our hypothetical family in each of the Northeastern states from 1982 to 2008. Over this 25 year period, Northeastern states introduced their own refundable tax credits. By the end of this period, no state in the Northeast required families at the poverty line to pay income tax and many had enacted refundable tax credits that actually put more money in the pockets of low-income families. The picture is much different, however, if we look at the trend in the Southwestern states. Here we see that over this time period state income tax liability remained relatively stable—and positive—for families at the poverty line. At the end of the period, only New Mexico used the tax code to put more money in the hands of these families through refundable credits. Notably, Colorado provided a remarkably generous refund to tax filers at the poverty line in 2000 but not in subsequent years. This is because the law in that state only permits refunds via tax credits in years where the state has experienced a budget surplus.



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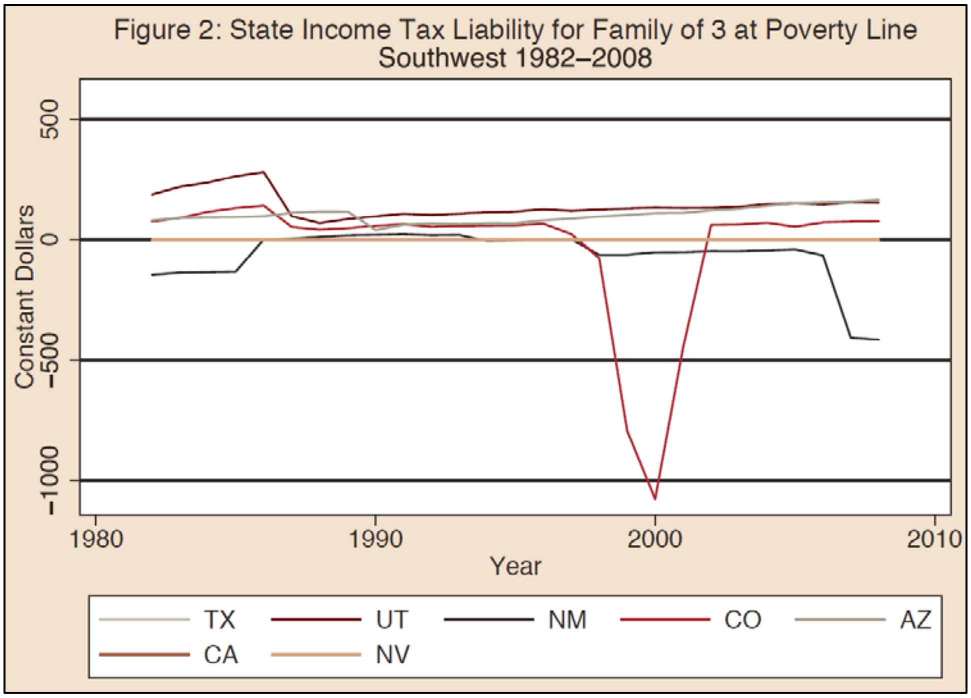
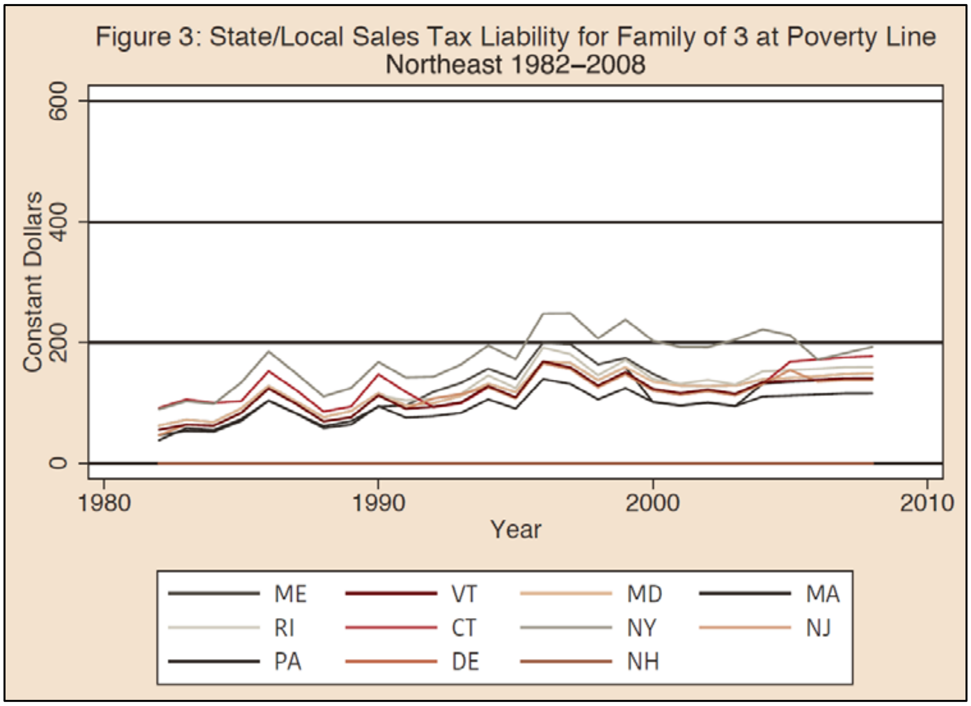
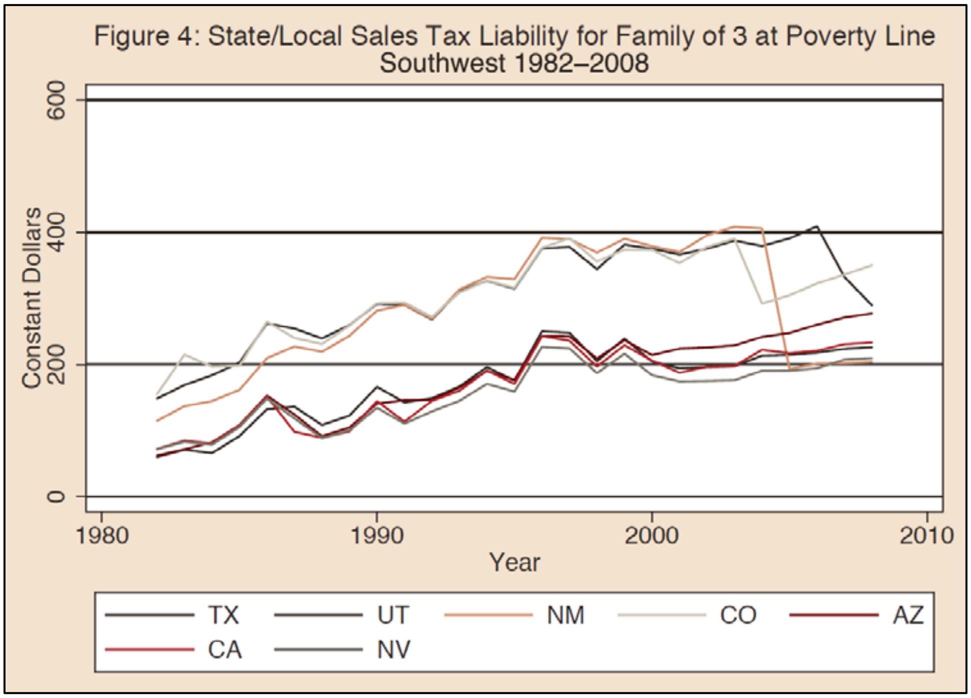


But what about the sales tax burden? Figure 3 shows the trend in the estimated state and local sales tax burden by state for 1982-2008 for the Northeast. The trend lines in every state are relatively flat—across the Northeast, poor families paid about the same amount of their income in sales taxes in 2008 has they did in the 1980s, adjusted for inflation. Compare this with the trend lines in the Southwestern states over the same time period as shown in Figure 4. The amount of money a family at the poverty line has to pay in state and local sales taxes has increased in real terms in every state in the Southwest between 1982 and the mid 2000s. Even after adjusting for inflation, state and local sales taxes have taken an increasing large bite out of the wallets of low-income families in the Southwest.





Taken together, there is a profound difference in the taxes paid by poor families in Southwest versus the Northeast. Whereas the Jones family faces a net tax burden of several hundred dollars in many Southwestern states, that same family would receive a tax refund of several hundred dollars in many Northeastern states, thanks to generous refundable tax credits. Moving from one state to another could save families up to $1,000 in direct taxes. For families making less than $20,000 per year, this difference in tax policy has meaningful implications for household income and, in turn, for family and child well-being.[iv]

Why Tax Policy Matters

But do differences in how states tax the poor translate into differences in measures of well-being? A growing body of research suggests it does. Statistical modeling using data from 1982-2006 finds that states that increased the tax burden on poor households did worse on a number of health and social outcomes than states that decreased the taxes paid by the poor. Specifically, increased taxes on the poor are found to be associated with higher relative mortality—a broad indicator of population health. The link between taxation and child health is particularly notable, with one study noting that states that enacted an Earned Income Tax Credit saw a reduction in babies born underweight, which has lasting implications for child health and development.[v] At the same time, our research finds that increasing taxes on the poor is negatively associated with high school completion; as the taxes on the poor go up, high school graduation rates go down. Moreover, increasing taxes on the poor also appears to be associated with increases in violent and property crime and even births to unmarried mothers. These associations were found net of a host of factors, including state social spending, political party control, unemployment, and poverty.

How does increasing taxes on the poor threaten child well-being? Quite simply: Money Matters. Every dollar taken out of the pocket of a low-income families can have consequences for material hardship—ability to pay for basic necessities like food, rent, and electricity. What's more, having to make ends meet with fewer dollars can lead to increased stress, which has consequences for the mental well-being of parents and, in turn, influences how they parent their children.

Taxing the poor has clear negative consequences for low-income children and families. But these negative consequences are not merely detrimental to vulnerable families; they're costly for the entire society. States that increase taxes on the poor to fill budget holes will find their efforts self-defeating. Weakening the pocketbooks of poor families only serves to worsen health, reduce educational attainment, and increase crime—which costs everybody. To put it simply: Taxing the poor makes everybody worse off.

What Is To Be Done?

There is much that can be done—in states and in Washington—to transform tax systems from instruments that weaken already vulnerable families into tools for fighting poverty

Individual states should proactively work to make their tax systems more progressive—doing so will pay dividends in the long run, in the form of reduced crime, better health and a more educated citizenry. In addition to lower the general sales tax rate, excluding whole categories of goods from taxation—such clothing—or offering a rebate to low-income families can also serve to lessen the hit to low-income families. At the same time, Southwestern and Southern states should follow the lead of their counterparts in the Northeast and Midwest by using the tax code as a tool for fighting poverty by introducing refundable Earned Income Tax Credits. Finally, states must eliminate supermajority rules and other constitutional limits on taxation. These rules—such as California's famous Proposition 13—put downward pressure on progressive tax instruments such as property taxes and increases reliance on regressive instruments such as sales taxes and user fees.

States in the Southwest—and across the country— can certainly do more to ensure their tax codes don't make matters worse by taking money out of the hands of vulnerable families. But we recognize that many states cannot afford to eliminate all taxes on the poor, particularly in this fiscal climate. Moreover, states with a high number of impoverished families have to deal with the double whammy of having greater need for social spending on schools, health and welfare trying to raise revenue from a poorer tax base. Much of this spending is in the form of federal matching grants, where states have to generate their own revenue to match federal dollars for high cost programs like Medicaid. We believe this needs to change. Truly reducing the squeeze on poor families requires reducing the squeeze on poor states by moving funding for key areas of social spending from state capitols to Washington, DC. Moving the financing of major programs to the Federal level will ensure that poorer states and localities don't have to shoulder more than wealthier communities while guaranteeing that vulnerable families have the social supports they need regardless of state residence.

In efforts to increase government resources for vulnerable children, it is important to consider how we raise revenue. Using regressive instruments such as the sales tax is certainly politically expedient, as many voters believe—wrongly—the sales tax is "fair". But taking the money out of the pockets of low-income parents will only serve to make matters worse for everyone, particularly their children.

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[i] See: Kneebone, Elizabeth. 2009. Economic Recovery and the EITC: Expanding the Earned Income Tax Credit to Benefit Families and Places. Washington DC: Brookings.

[ii] The focus of our original research, *Taxing the Poor*, is on the evolution of tax policy regimes in the US South, not the Southwest. However, in the course of that project we generated tax trend data for a family in poverty for all 50 states. Here we present data on the Southwestern states, the topic of this Focus on Children volume. For more information, see *Taxing the Poor*.

[iii] For more information, see http://www.nber.org/~taxsim/

[iv] Separate analyses demonstrate that this difference in household income is meaningful despite cost of living differences that may exist between states.

[v] See Strully, Kate W., David H. Rehkopf, and Ziming Xuan. 2010. Effects of Prenatal Poverty on Infant Health. American Sociological Review 75:4.

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