State Income Tax Burdens on Low-Income Families in 1998:

Assessing the Burden and Opportunities for Relief

Nicholas Johnson
Christina Smith FitzPatrick
Elizabeth C. McNichol

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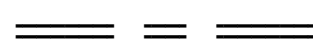

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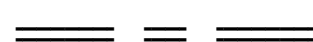

Robert Greenstein
Executive Director

Iris J. Lav
Deputy Director

Authors

Nicholas Johnson is a policy analyst with the Center on Budget and Policy Priorities' State Fiscal Project. He has authored several reports on state budget and tax issues.

Christina Smith FitzPatrick is a policy analyst with the Center on Budget and Policy Priorities' State Fiscal Project. She has co-authored the second edition of the Center's *Poverty Despite Work Handbook*.

Elizabeth C. McNichol is director of the Center on Budget and Policy Priorities' State Fiscal Project. She has worked for many years on state and local fiscal policy for research and advocacy organizations and for state government.

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Center on Budget and Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080

E-mail:center@cbpp.org
HandsNet: HN0026

Web: www.cbpp.org

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I. Summary

A growing number of states have chosen to exempt poor families from the income tax. As recently as 1996, the majority of states with income taxes levied income taxes on families of three or four with poverty-level incomes. Now the reverse is true: a majority of states *exempt* such families from their income taxes.

In 1998, 23 of the 42 states with income taxes exempted from taxation the income of a married couple with two children with income at or below the poverty line; the number of states exempting such poor families has risen from 18 to 23 in the last two years. The same 23 states exempted from taxation the income of a working single parent with two children with income at or below the poverty line.[1]

Nineteen states continued to levy income tax on poor families. Although some of these states in the last two years have substantially increased the income level at which income tax is first owed and thereby reduced taxes on the poor, the income taxes the poor must pay were still quite high in many of these states.

At a time when states are urging more families to make the transition from welfare to work, progress in relieving state income tax burdens can be an integral part of that policy agenda. Eliminating all or most state income taxes on working families

[1] The District of Columbia is treated as a state in this report. The two states that tax only interest and dividends (New Hampshire and Tennessee) are not included among the 42 states with income taxes for purposes of this report.

with below-poverty incomes results in a boost in take-home pay that helps offset higher child care and transportation costs that families incur as they strive to become economically self-sufficient. In other words, relieving state income tax burdens on families below the poverty line is making a meaningful contribution toward "making work pay."

Many welfare recipients that take jobs continue to have very low incomes, often below poverty. Recent evidence from several states shows that although most welfare recipients who find jobs are employed close to full-time, many of them earn wages at or only slightly above the minimum wage. Moreover, many do not qualify for paid vacation or sick leave, forcing them to take unpaid leave for reasons such as a child's illness. A number of studies show that welfare recipients who find jobs have average earnings of $2,000 to $2,700 per quarter, or $8,000 to $10,800 per year; many earn less.[2] Earnings in that income range are insufficient to lift a family of three or four above the poverty line.

Relieving income taxes is one of the simplest ways states can help working families with low earnings. And a growing number of states that do not tax the incomes of the poor are taking the further step of providing credits that poor families with no income tax liability may use to offset the cost of other taxes such as sales and excise taxes or property taxes.

States have made more progress toward relieving the income tax burden on poor families in the last two years than they made in the six previous years combined. From 1991 to 1996, the number of states that taxed the incomes of poor families did not change, and only six of the states that taxed the poor in 1991 increased their thresholds by amounts greater than the increase in the poverty line during that time. By 1998, however, the number of states taxing the poor had declined by five, and another eight states had brought their thresholds closer to the poverty line.

Still, progress by no means has been universal. Of the 24 states that taxed the income of some poor families in 1991, 19 continue to tax poor families' incomes today. These states have not taken the opportunity afforded by some eight years of economic recovery and strong fiscal conditions to ameliorate this situation. In fact, 11 of those 19 states have allowed their thresholds to decline relative to the poverty line during the 1990s. The poverty line is adjusted each year to reflect the increasing cost of supporting a family, but many states' income tax thresholds are not similarly adjusted.

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[2] These studies are summarized in *Welfare Recipients Who Find Jobs: What Do We Know About Their Employment and Earnings?*, Center on Budget and Policy Priorities, November, 1998.

The federal government has long recognized that taxing poor families is counterproductive and unfair. As part of federal tax reform in 1986, virtually all families below the poverty line were relieved of federal income tax liability. It has taken a dozen years for a majority of the states to implement this same policy.

Many of the states that have not yet removed state income taxes from poor families have not made it a priority to do so. Most state economies expanded through the 1990s and most states experienced robust fiscal conditions. As a result, 28 states enacted significant personal income tax cuts in the last five years. But 13 of the 15 states with the largest income tax cuts in recent years chose to cut top tax rates or cut all tax rates in ways that provide a disproportionate benefit to higher-income taxpayers. Six of the states — Delaware, Hawaii, Michigan, New Jersey, Ohio and Oregon — that have enacted the largest personal income tax cuts in recent years still have income tax thresholds below the poverty line.

Further tax reductions are under consideration or discussion in many states. Today's generally healthy fiscal conditions provide an opportunity for many more states to remove poor families from the income tax rolls, if they make such action a priority.

Tax Thresholds

This report assesses the impact of each state's income tax on poor families. It focuses on the income tax threshold in each state, which is the income level at which a family would begin to owe state income tax.

- In 23 of 42 states with income taxes, the income tax threshold for a family of four with two children was above the poverty line in 1998. For single-parent families of three, the state income tax threshold was above the poverty line in the same 23 states. In these states, families with below-poverty income were not required to pay income taxes. (The threshold for a single-parent family of three in a 24th state, Arkansas, nearly equaled the poverty line, meaning that a family began paying tax just when its income reached the poverty line.)

- In the states that did levy income taxes on some poor families, the average level at which a two-parent family of four began to owe tax was more than $6,200 below the 1998 poverty line of $16,655 for a family of four. For a single-parent family of three, the average tax threshold in these states was almost $4,200 below the poverty line of $13,001.

- Six states — Alabama, Hawaii, Illinois, Kentucky, New Jersey, and Virginia — imposed an income tax on very poor families of three or four, those with incomes below half the poverty line. Fourteen states imposed an income tax on poor families of three with a worker earning the minimum wage, an income level several thousand dollars below the poverty line.

- The state with the highest threshold was California, where the threshold was $34,400 for a family of three and $36,100 for a family of four — more than twice the poverty lines for families of those sizes and substantially higher than the threshold for any other state. Alabama's threshold of $4,600 was the lowest for a family of four; Illinois' threshold of $3,900 was the lowest for a family of three.[3]

Taxes on Poor Families

The impact of state income tax policy on poor families' budgets can be significant. Levying an income tax on the poor pushes families deeper into poverty, compounding the challenge of making ends meet.

- The average 1998 income tax bill for a family with income at the poverty line in the states with below-poverty thresholds was $162 for a two-parent family of four and $245 for a single parent with two children. The 1998 tax bill was as high as $550 on a family of four (in Kentucky) and $421 on a family of three (in Hawaii).

- By contrast, a number of states levied no income tax until a family's income was well above the poverty line. Ten states — Arizona, California, Connecticut, Maryland, Massachusetts, Minnesota, New York, Pennsylvania, Rhode Island, and Vermont — had tax thresholds of $21,000 or higher for two-parent families of four, thus eliminating taxes for families with income up to approximately 125 percent or more of the poverty line.

- Eight states with tax thresholds above the poverty line went even further. These states — Kansas, Maryland, Massachusetts, Minnesota, New Mexico, New York, Vermont, and Wisconsin — had state tax credits that provided

[3] Despite having the lowest thresholds, neither Illinois nor Alabama imposed the highest tax bills on families at the poverty line or with minimum wage income. Some states that had thresholds higher than Illinois and Alabama but that still taxed families with minimum-wage or below-poverty income levied taxes at higher tax rates than did Illinois and Alabama. Those higher rates resulted in higher tax bills.

refunds to low-income families with no tax liability.[4] The refundable credits acted as a wage supplement and/or as an offset to the other state and local taxes paid by low-income families. In seven of these states, the refundable credits were state Earned Income Tax Credits that piggy-backed on the federal Earned Income Tax Credit. The 1998 refunds provided to families with poverty-level income in these states were as high as $1,127 for a two-parent family of four and $900 for a single parent with two children.

Tax Relief Strategies

States used a variety of methods to relieve income tax burdens on the poor. States generally chose the strategies that fit best with their overall policies and philosophies of taxation.

- Most of the 23 states that did not tax the working poor in 1998 allowed relatively large deductions from income through personal and dependent exemptions and standard deductions. For example, the average combined value of these deductions in the seven states with the highest tax thresholds was higher than the poverty line for families of both three and four.

- Twenty-five states adopted measures that specifically targeted tax relief on low-income families. Due to the limited size of some of these measures, however, some of these states continued to tax poor families.

- Of particular note, nine states went beyond eliminating tax liability and offered credits that provided tax refunds to some or all families with income below the poverty line. The refunds from these credits were intended to boost the incomes of families with low-wage workers and to offset the burden of other state and local taxes paid by low-income families, primarily sales taxes and property taxes.

[4] Georgia's low-income credit was also refundable and led to a net refund to families with a minimum wage income. However, the maximum credit was not sufficient to fully offset tax liability at a poverty-level income, so that families with incomes at the poverty line paid Georgia income tax.

Recent Changes in Taxation of Poor Families

States have made noteworthy progress in relieving state income tax burdens on the poor during the last two years.

- In 1998, two states — Kansas and Mississippi — implemented legislation to raise income tax thresholds above the poverty line. Those two states and three others — Maine, Massachusetts, and Pennsylvania — raised their thresholds above the poverty line just in the last two years.

- A number of states with income tax thresholds that are still below the poverty line have nonetheless significantly increased the thresholds during the past two years. Arkansas in 1998 enacted a package of changes, including a new low-income credit, that raised its threshold for families of four by some $4,900. Georgia increased its threshold by about $2,000 in each of the last two years. Indiana more than doubled its income tax threshold between 1996 and 1997, and Oregon enacted a new, non-refundable earned income tax credit that raised its income tax threshold for families of four from $11,400 in 1996 to $14,200 in 1998.[5]

Changes in Thresholds 1991-1998

Between 1991 and 1998, the dollar amount of the income tax threshold increased in most states. Small changes in the nominal value of a threshold, however, will not necessarily protect a working poor family from taxation. The poverty line is adjusted upward each year as the cost of supporting a family rises. Changes in income tax thresholds must be judged by whether the change has been sufficient to relieve families living in poverty from taxation or to maintain such relief.

- Twenty of the 24 states with below-poverty thresholds for families of four in 1991 raised those thresholds between 1991 and 1998, but in only five states was the amount of increase large enough to bring the state's threshold above the poverty line. Kansas, Massachusetts, North Carolina, Pennsylvania, and Iowa were the only states that raised their thresholds enough since 1991 to eliminate income taxes on poor families of four. Eight states moved their

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[5] Two other states have enacted substantial threshold increases to take effect in future years. Illinois is phasing in an increase in its personal exemption that will raise the threshold for a family of four to $8,000, up from $4,000 in 1997. Hawaii in 1999 will introduce a new tax credit that, in combination with a tax rate reduction, will raise the threshold for a family of four to about $11,000, an increase of about $5,000.

thresholds closer to the poverty line than in 1991, but did not actually bring the threshold above the poverty line.

- States that had already removed poor families of four from their income tax rolls by 1991 were much more likely to target additional income tax relief to near-poor families. These states almost universally increased their thresholds between 1991 and 1998 by amounts greater than the increase in the poverty line over that period. These increases served to provide tax relief to near-poor as well as poor families in these states. The only two states that allowed their income tax thresholds to dip below the poverty line in the mid-1990s, Maine and Mississippi, each again exempted poor working families from the income tax by 1998.

II. State Income Taxes on Poor Families in 1998

The income tax is a major component of state tax systems. Forty-two states levy an income tax, and income tax revenue makes up 31 percent of total state tax revenue nationally. Thus, the design of a state's income tax affects greatly the overall fairness of a state's tax system.

Because the income tax is calculated as a percentage of a taxpayer's income, it is relatively easy both to determine its impact on taxpayers of different income levels and to modify that impact. In general, state income taxes are designed to be at least modestly progressive — that is, to take a smaller share of income from lower-income taxpayers than from higher-income taxpayers. This progressivity results from either a rate structure with higher marginal rates as income rises, deductions or credits that reduce tax liability proportionately more for low-income taxpayers, or a combination of these features.

While all state income tax systems are at least somewhat progressive, each system has a different design. One way that income tax systems differ substantially among states is their treatment of families at the lowest rung of the economic ladder. This report compares the treatment of poor taxpayers under each state's income tax structure and suggests ways that this treatment could be improved.

The relatively good fiscal condition that many states have enjoyed in the last several years has resulted in widespread consideration of tax cuts. This is an opportunity for states to make changes in their income tax provisions that will relieve tax burdens on poor families. Unfortunately, most states with below-poverty thresholds have, thus far, failed to take full advantage of this opportunity.

This analysis is particularly important in light of the policy debates that are occurring in many states this year. Policymakers at the state and federal level, both liberal and conservative, have professed their interest in helping welfare recipients to make the transition from welfare to work. With the enactment of federal welfare reform and declining welfare caseloads, states across the country have moved ahead. In light of this focus on work, the impact of state tax policy on low-wage working families has become an important part of welfare policy.

Low-income families often face high marginal tax rates; that is, as a family's income rises up to and beyond the poverty level, the combination of higher taxes and the loss of means-tested benefits (such as food stamps) consumes a significant share of these increased earnings.[6] In addition, the expenses of working, such as child care and transportation, often absorb a large proportion of the earnings of low-income workers. Thus, as part of a larger strategy to "make work pay" for low-wage workers, it is particularly important that state income taxes not be imposed on families whose earnings have not yet brought them above the poverty level.

More than a decade ago, the federal government recognized the inconsistency of encouraging poor families to work and then levying taxes that pushed them deeper into poverty. President Ronald Reagan spoke forcefully in the mid-1980's about the foolishness of taxing poor households deeper into poverty. In 1986, as part of an overall tax reform package, the federal government eliminated income tax liability for poor families. Since that time, many states have followed suit, but 19 still levy taxes on households with earnings below the poverty level.

The impact of state income tax systems on poor families has been increasing in importance in recent years because the number of working poor families has been growing across the United States. The increase in the number of families that have earnings from work but remain poor can be seen by comparing poverty rates in 1997 with those in 1979, two years when the economy was growing and unemployment rates were similar. The poverty rate for families with children in which the head-of-household worked climbed from 7.7 percent in 1979 to 10.9 percent in 1997, an increase

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[6] At some income levels, particularly those modestly above the poverty line, workers face marginal tax rates ranging from 67 percent to 79 percent from the combination of federal income and social security taxes, the phaseout of the federal earned income tax credit, and the loss of food stamps.

of 40 percent.[7] In 1997, roughly 8.7 million poor children — almost two out of every three poor children — lived in a family with a working parent.

It is critical that more states address the problem of taxation of poor families, both in the interest of fairness and in order to further the objective of allowing parents who work to support their families adequately. The first step is understanding the extent of the burden families bear and the features of the tax system that affect those burdens.

Income Tax Thresholds

The tax threshold is the entry point into the income tax system. It is the income level at which a family begins to owe state income tax.[8] A state's threshold level is affected by two broad factors.

Income taxes generally are not imposed on total income. States typically allow nearly every taxpayer some subtractions from income, most often through personal and dependent exemptions and/or a standard deduction, before tax liability is calculated. Some states provide this broad tax relief through a tax credit — a dollar amount subtracted from the tax bill — for each household member or for each dependent. The size of these exemptions, deductions, and credits affects the income level at which families begin to owe tax.

In addition, 25 states target special deductions, exemptions, or tax credits on low-income families.[9] These features affect the tax threshold for low-income families without altering the tax structure for families with higher incomes. (For an explanation of how exemptions, deductions, and credits work, see Chapter IV.)

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[7] Part of this increase reflects growth in the share of working families with children that are headed by a single female parent, since this group is much more likely to be poor than are two-parent families. Nevertheless, the poverty rate among families with a working parent has grown for both single-parent and two-parent families.

[8] A state's threshold tax level is not necessarily the same as the income level above which families are required to file an income tax return. For example, many states require families to file a state income tax return if they are also required to file a federal income tax return. (Federal filing requirements in 1998 for most taxpayers under age 65 were gross income of at least $8,950 for a head of household and at least $12,500 for a married couple filing jointly.) Most other states specify a minimum amount of income above which families are required to file that is lower than or equal to the tax threshold level.

[9] In one state, Pennsylvania, a low-income "tax forgiveness" credit is the only method used to reduce taxes for low-income residents. The state income tax does not include personal or dependent exemptions, nor a standard deduction.

This report calculates the tax burden on two types of low-income families: a married couple with two children and a single parent with two children. In each case, it is assumed the family has only one wage earner and that the family's income comes entirely from earnings. The tax thresholds are based on each state's personal and dependent exemptions, standard deductions, state earned income tax credits, and other deductions or credits that are available to all low-income taxpayers with children.[10]

The threshold calculations do not incorporate low-income credits that are based in part on factors other than income, such as the dependent care credit, because not all low-income families qualify for these credits and because the value of the credit for the typical family is difficult to identify. For example, a family with pre-school children may have child care expenses that make them eligible for a dependent care credit, while a similar family with older children may not incur such expenses and thus would not be eligible for the credit. In addition, low-income sales tax and property tax credits, which appear on income tax forms in some states, are excluded from the threshold calculations because they are not administered through the income tax in all states and, like a dependent care credit, are based on factors other than income. These credits are administered through the income tax primarily for ease of administration.

Tables 1A and 1B present the 1998 state income tax thresholds for single-parent families of three and two-parent families of four, respectively. The maps on pages 16 and 17 group the states according to their tax thresholds for each type of family in relation to the poverty line. The tables and maps show that:

- In 19 states, the tax threshold for a single parent with two children fell below the poverty line of $13,001 for a family of three. In those states, the average threshold was $4,180 below the poverty line.

- These 19 states also had thresholds below the poverty line of $16,655 for two-parent families of four. The average threshold in these states was $6,223 below the poverty line.

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[10] Michigan in 1998 offered a per-child tax deduction which equals $600 per child under the age of 7 and $300 per child between the ages of 7 and 12. The calculations in this report assume that each family claims a total deduction of $600, implying two children between the ages of 7 and 12 or one child under 7 and one over 13.

Table 1A
State Income Tax Thresholds for Single-Parent Families of Three, 1998

Poverty line (estimated): $13,001

Rank	State	Threshold
1	Illinois	$3,900
2	Alabama	4,600
3	Hawaii	4,800
4	Kentucky	5,000
5	Virginia	5,400
6	Montana	7,400
7	New Jersey	7,500
8	Indiana	8,000
9	Michigan	9,000
9	Oklahoma	9,000
11	West Virginia	10,000
12	Ohio	10,100
13	Delaware	10,600
14	Missouri	10,800
15	Louisiana	11,800
16	Georgia	12,100
17	Oregon	12,300
17	Utah	12,300
19	Arkansas	13,000
Average Threshold 1998		**$8,821**
Amount Below Poverty		**$4,180**

Rank	State	Threshold
20	North Carolina	$13,900
21	Colorado	14,400
21	District of Columbia	14,400
21	Idaho	14,400
21	Mississippi	14,400
21	South Carolina	14,400
26	North Dakota	14,800
27	Nebraska	14,900
28	Wisconsin	15,400
29	Maine	15,500
30	Iowa	17,200
31	New Mexico	18,000
32	Pennsylvania	19,000
33	Connecticut	19,100
34	Massachusetts	19,300
35	Kansas	19,800
36	Arizona	20,100
37	New York	21,500
38	Rhode Island	23,600
38	Vermont	23,600
40	Maryland	23,700
40	Minnesota	23,700
42	California	34,400
Average Threshold 1998		**$18,674**
Amount Above Poverty		**5,673**

Note: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The 1998 poverty line is a Census Bureau estimate based on the actual 1997 line adjusted for inflation. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

Source: Center on Budget and Policy Priorities

Table 1B
State Income Tax Thresholds for Two-Parent Families of Four, 1998

Poverty line (estimated): $16,655

Rank	State	Threshold
1	Alabama	$4,600
2	Kentucky	5,000
3	Illinois	5,200
4	Hawaii	6,100
5	New Jersey	7,500
6	Virginia	8,200
7	Indiana	8,500
8	Montana	9,000
9	West Virginia	10,000
10	Michigan	11,800
11	Missouri	12,000
12	Louisiana	12,300
13	Ohio	12,500
13	Oklahoma	12,500
15	Delaware	12,700
16	Oregon	14,200
17	Utah	15,200
18	Georgia	15,300
19	Arkansas	15,600
Average Threshold 1998		**$10,432**
Amount Below Poverty		**$6,223**

Rank	State	Threshold
20	North Carolina	$17,000
21	Iowa	17,200
21	Mississippi	17,200
23	Colorado	17,900
23	District of Columbia	17,900
23	Idaho	17,900
23	South Carolina	17,900
27	Nebraska	18,300
28	North Dakota	18,400
29	Wisconsin	18,700
29	Maine	18,700
31	New Mexico	20,300
32	Kansas	20,700
33	Massachusetts	21,100
34	New York	22,800
35	Arizona	23,600
36	Connecticut	24,100
37	Maryland	24,300
38	Pennsylvania	25,000
38	Rhode Island	25,000
38	Vermont	25,000
41	Minnesota	25,200
42	California	36,100
Average Threshold 1998		**$21,317**
Amount Above Poverty		**4,662**

Note: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The 1998 poverty line is a Census Bureau estimate based on the actual 1997 line adjusted for inflation. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

Source: Center on Budget and Policy Priorities

- In five states — Alabama, Hawaii, Illinois, Kentucky, and Virginia — families of three with incomes at just half the poverty line had some income tax liability. The same held true for families of four in each of these states plus New Jersey.

- By contrast, the income tax threshold was well above the poverty line in a number of states. For example, 12 states did not tax families until their incomes were at least $20,000 for families of four or $18,000 for families of three.

There were some common patterns among states that helped determine whether a state had a high threshold or a low threshold. Not surprisingly, the states with the lowest thresholds tended to have very low personal and dependent exemptions and standard deductions. For example, in the eight states with the lowest thresholds, the combined amount of the personal and dependent exemptions and standard deduction for a single-parent family of three averaged only $4,654, or 36 percent of the poverty line, compared with an average of $12,498, or 96 percent of the poverty line, for the other 34 states with an income tax.[11] A similar pattern held for the deductions and exemptions available to a two-parent family of four.

Similarly, most of the states with low income tax thresholds provided little or no targeted income tax relief for low-income residents. Of the seven states with the lowest thresholds for families of three, only Kentucky had an income tax credit for low-income families. New Jersey had a no-tax floor set at $7,500 — less than half the poverty level for a family of four. The pattern was similar for states that had the lowest thresholds for families of four.

In contrast, the states with the highest thresholds tended to use tax credits *and* more generous personal and dependent exemptions and standard deductions to raise

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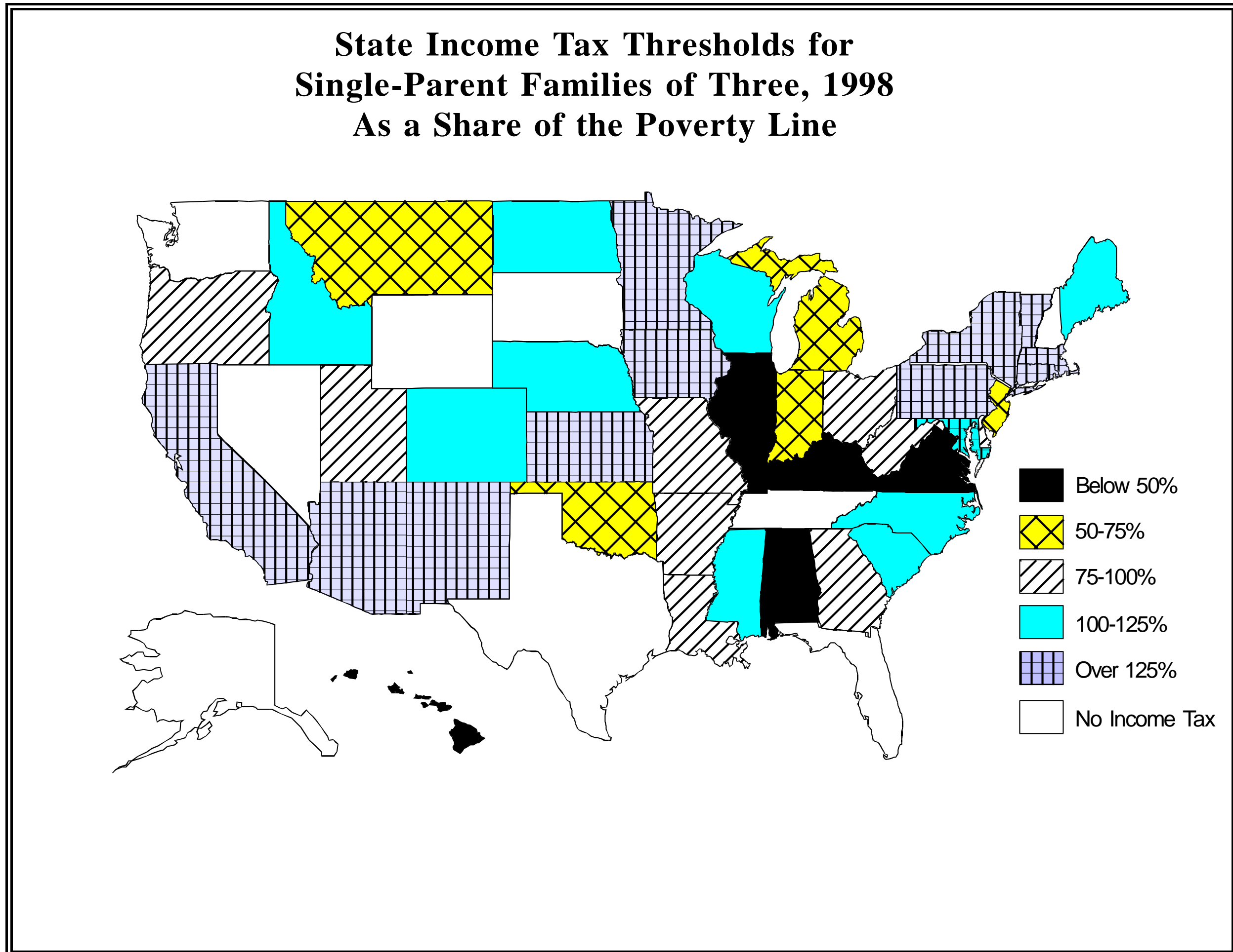
[11] These calculations reflect the combined personal and dependent exemptions and standard deductions at the income tax threshold in each state. They include the relevant amounts allowed on federal income taxes for those states that implicitly incorporate the federal personal and dependent exemptions and standard deduction by using federal taxable income or federal tax liability as the starting points in their state income tax systems.

In most states, personal and dependent exemptions were specified amounts that tax filers deduct from their adjusted gross income before computing their tax liability. A small number of states had personal and dependent exemption *credits*, under which tax filers subtracted a specified amount per exemption or dependent from their calculated tax liability. For states with personal or dependent exemption credits, the credit amount was converted to an equivalent income deduction amount based on the marginal tax rate for a low-income family for purposes of this comparison.

Figure 1



the threshold level.[12] The average combined value of the personal and dependent exemptions and standard deduction in the seven states with the highest tax thresholds was higher than the poverty line for both families of four and families of three.[13] In other words, these states generally set basic deductions at a level sufficient to exempt

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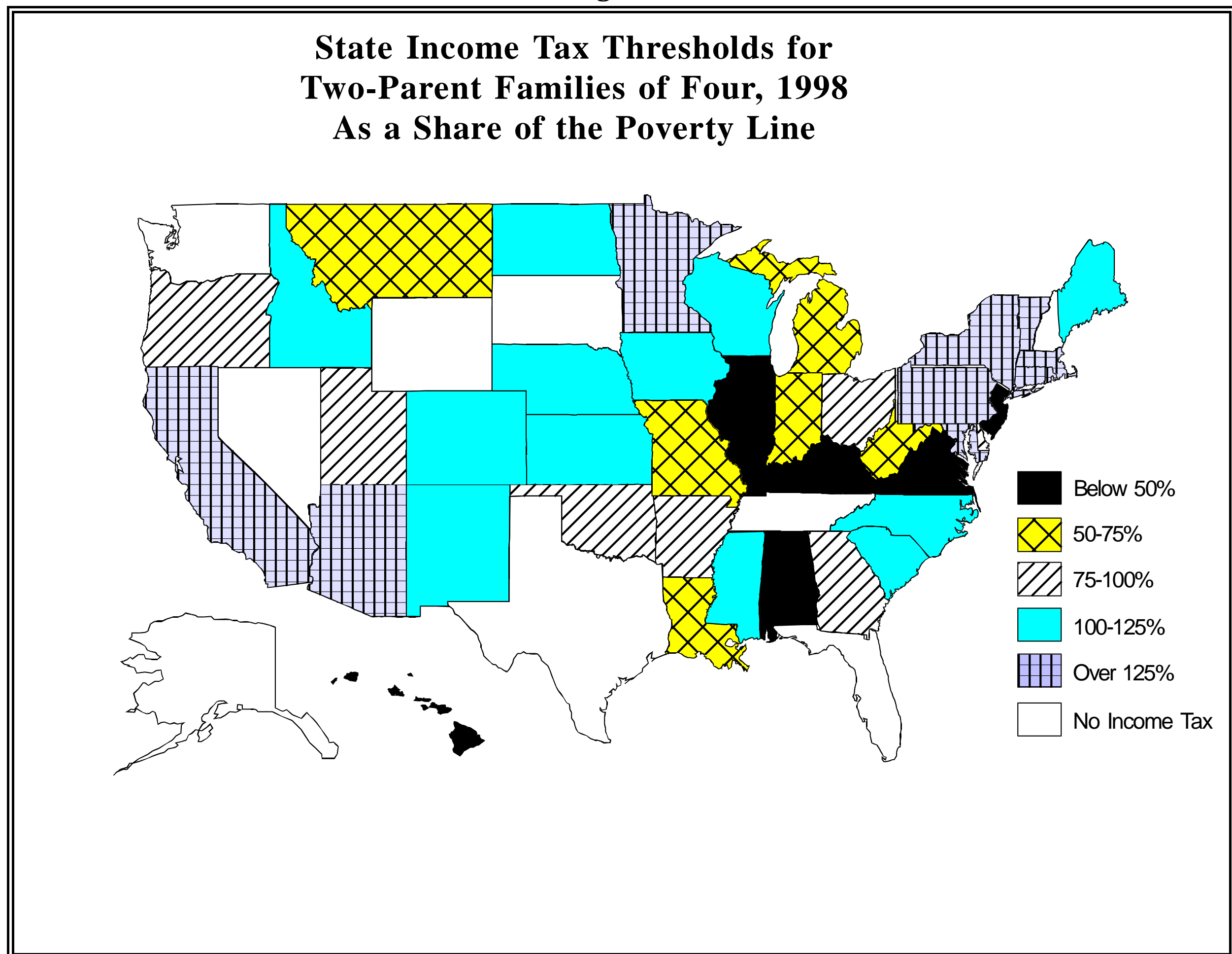
[12] The exception was Pennsylvania, which offered neither exemptions nor a standard deduction but still had a relatively high threshold. Pennsylvania relied entirely on a low-income tax credit to avoid levying the income tax on low-income families.

[13] The average value of these combined deductions for a family of three equaled 157 percent of the poverty line. The average value of these deductions available to families of four equaled 136 percent of the poverty line. Excluding California and Pennsylvania (the former because its deductions and credits were unusually high and the latter because it had no exemptions, deductions, or exemption credits), the average value for a family of three was 102 percent of the poverty line, and the average value for a family of four was 106 percent of the poverty line.

Figure 2



poor families from owing income tax. In addition to these basic deductions, all but one of these states — California — also offered substantial tax credits or deductions targeted specifically on low-income families that either raised the income tax threshold or lowered taxes for low-income families.

Taxes at the Poverty Line

Levying an income tax on the poor pushes families deeper into poverty, compounding the challenge of making ends meet. The amount of state income tax owed by families with incomes just equal to the poverty line can be quite substantial. In the states with below-poverty tax thresholds, the tax bill for poor families varied greatly in 1998, from as little as a few dollars to more than $500. By contrast, poor families who lived in states with tax thresholds above the poverty line did not owe any income tax, and in several of these states, such families actually qualified for a state tax refund.

Tables 2A and 2B show the state income tax burden on families of three and four with poverty-level income in 1998. The tables show that:

- For families of three living in states with below-poverty tax thresholds, the average income tax liability for a family with income equal to the poverty line was $162. Six states — Alabama, Hawaii, Illinois, Indiana, Kentucky and Virginia — levied a tax of $250 or more on such families.

- The average tax burden for poor two-parent families of four stood at $245 in the states with below-poverty tax thresholds. In eight states — Alabama, Arkansas, Hawaii, Illinois, Indiana, Kentucky, Virginia, and West Virginia — the income tax bill for such a family exceeded $250. In Kentucky, a family of four with poverty-level income owed $550 in state income taxes in 1998.

- At the other end of the spectrum, families with poverty-level incomes qualified for a state tax refund in eight states — Kansas, Maryland, Massachusetts, Minnesota, New Mexico, New York, Vermont, and Wisconsin. In the seven states other than New Mexico, the refund came as the result of a refundable state earned income tax credit tied to the federal earned income tax credit (EITC), a tax credit for low- and moderate-income workers.[14] The federal EITC is intended to supplement the earnings of working-poor families and complement efforts to help families make the transition from welfare to work. State EITCs build on the strengths of the federal credit by further helping working families escape poverty. State EITCs also serve to offset the sizable burden of state and local sales taxes and property taxes on the poor.

  The largest state EITC for families of four with two children, in Minnesota, provided a refund of $1,127. Vermont provided the highest EITC for a family of three with poverty-level income: $900.

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[14] Three other states — Iowa, Oregon, and Rhode Island — also had a state EITC in 1998, but these non-refundable credits could be used only to eliminate taxes on low-income families and not to provide refunds.

Table 2A
State Income Tax at Poverty Line for Single-Parent Families of Three, 1998

	State	Income	Tax
1	Hawaii	$13,001	$421
2	Kentucky	13,001	338
3	Alabama	13,001	333
4	Indiana	13,001	306
5	Illinois	13,001	273
6	Virginia	13,001	251
7	West Virginia	13,001	212
8	Michigan	13,001	176
9	Montana	13,001	167
10	Delaware	13,001	136
11	New Jersey	13,001	126
12	Oklahoma	13,001	107
13	Louisiana	13,001	60
14	Oregon	13,001	57
15	Missouri	13,001	44
16	Ohio	13,001	41
17	Georgia	13,001	19
18	Utah	13,001	16
19	Arkansas	13,001	4
20	Arizona	13,001	0
20	California	13,001	0
20	Colorado	13,001	0
20	Connecticut	13,001	0
20	District of Columbia	13,001	0
20	Idaho*	13,001	0
20	Iowa	13,001	0
20	Maine	13,001	0
20	Mississippi	13,001	0
20	Nebraska	13,001	0
20	North Carolina	13,001	0
20	North Dakota	13,001	0
20	Pennsylvania	13,001	0
20	Rhode Island	13,001	0
20	South Carolina	13,001	0
35	New Mexico	13,001	(85)
36	Maryland	13,001	(183)
37	Wisconsin	13,001	(258)
38	Massachusetts	13,001	(360)
38	Kansas	13,001	(360)
40	New York	13,001	(699)
41	Minnesota	13,001	(751)
42	Vermont	13,001	(900)

*The income tax threshold for a single-parent family of three in Idaho was $14,400 in 1998 but there was a $10 permanent building fund tax on each filing household.

Source: Center on Budget and Policy Priorities

Table 2B
State Income Tax at Poverty Line for Two-Parent Families of Four, 1998

	State	Income	Tax
1	Kentucky	$16,655	$550
2	Hawaii	16,655	519
3	Alabama	16,655	408
4	Indiana	16,655	396
5	Illinois	16,655	344
6	Virginia	16,655	293
7	Arkansas	16,655	273
8	West Virginia	16,655	260
9	Oregon	16,655	235
10	Delaware	16,655	230
11	Montana	16,655	221
12	Michigan	16,655	214
13	Oklahoma	16,655	194
14	New Jersey	16,655	163
15	Missouri	16,655	116
16	Ohio	16,655	93
17	Louisiana	16,655	88
18	Utah	16,655	33
19	Georgia	16,655	27
20	Arizona	16,655	0
20	California	16,655	0
20	Colorado	16,655	0
20	Connecticut	16,655	0
20	District of Columbia	16,655	0
20	Idaho*	16,655	0
20	Iowa	16,655	0
20	Maine	16,655	0
20	Mississippi	16,655	0
20	Nebraska	16,655	0
20	North Carolina	16,655	0
20	North Dakota	16,655	0
20	Pennsylvania	16,655	0
20	Rhode Island	16,655	0
20	South Carolina	16,655	0
35	Maryland	16,655	(14)
36	New Mexico	16,655	(80)
37	Kansas	16,655	(224)
38	Massachusetts	16,655	(283)
39	Wisconsin	16,655	(396)
40	New York	16,655	(499)
41	Vermont	16,655	(708)
42	Minnesota	16,655	(1,127)

*The income tax threshold for a two-parent family of four in Idaho was $17,900 in 1998 but there was a $10 permanent building fund tax on each filing household.

Source: Center on Budget and Policy Priorities

Taxes at Minimum Wage

A third measure of the burden of state income taxes on poor families is the tax owed by families with minimum wage earnings, an income level that is well below the poverty line. In most states, full-time minimum wage income in 1998 amounted to $10,712 per year, or 80 percent of poverty for a family of three and just 63 percent of poverty for a family of four.[15] Some seven states that levy income taxes set the minimum wage higher than the federal standard during 1998. Yet even in these states, minimum wage earnings fell significantly below the poverty line for families of three or four.

A popular stereotype holds that minimum wage workers are mostly teenagers or secondary earners in families that are not poor. Yet the reality is very different from this conception. In 1996, fewer than three in ten minimum-wage workers were teenagers. An analysis of the most recent increase in the federal minimum wage shows that 35 percent of the additional earnings resulting from the increase benefited the lowest-income 20 percent of families.[16] Given the reliance of many low-income families on a parent earning the minimum wage, relieving income taxes on families at this income level should be a priority.[17]

Despite the difficulty of supporting a family on minimum wage earnings, a number of states in 1998 levied an income tax on families in which a parent earns at this level. Tables 3A and 3B indicate the income tax liability for single-parent families of three and two-parent families of four with one full-time, year-round minimum wage worker. In the seven states with an income tax that also had a minimum wage higher than the federal requirement during 1998, the tax is calculated for the state-specific minimum wage.

- In 14 states — that is, in one-third of states with an income tax — single-parent families of three with minimum wage income owed some state income tax. The average income tax on single-parent families of three

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[15] The federal minimum wage was $5.15 an hour in 1998.

[16] Lawrence Mishel, Jared Bernstein and John Schmitt, *The State of Working America: 1998-99*, Economic Policy Institute, 1999.

[17] It should be noted that states typically do not allow teenagers who can be claimed as a dependent on their parents' income tax return to enjoy the full benefit of personal exemptions, standard deductions, and tax credits on their own income tax returns. Therefore, states can raise income tax thresholds for families with minimum wage income levels without unduly benefitting teenagers in high-income families.

Table 3A
State Income Tax at Minimum Wage for Single-Parent Families of Three, 1998

	State	Income*	Tax
1	Hawaii**	$10,920	$272
2	Kentucky	$10,712	235
3	Alabama	$10,712	218
4	Illinois	$10,712	204
5	Indiana	$10,712	184
6	West Virginia	$10,712	143
7	Virginia	$10,712	135
8	New Jersey	$10,712	94
9	Montana	$10,712	81
10	Michigan	$10,712	75
11	Oklahoma	$10,712	63
12	Oregon**	$12,480	16
13	Ohio	$10,712	10
14	Delaware	$10,712	8
15	Arizona	$10,712	0
15	Arkansas	$10,712	0
15	California**	$11,752	0
15	Colorado	$10,712	0
15	Connecticut**	$10,774	0
15	District of Columbia**	$12,792	0
15	Idaho***	$10,712	0
15	Iowa	$10,712	0
15	Louisiana	$10,712	0
15	Maine	$10,712	0
15	Mississippi	$10,712	0
15	Missouri	$10,712	0
15	Nebraska	$10,712	0
15	North Carolina	$10,712	0
15	North Dakota	$10,712	0
15	Pennsylvania	$10,712	0
15	Rhode Island	$10,712	0
15	South Carolina	$10,712	0
15	Utah	$10,712	0
34	Georgia	$10,712	(21)
35	New Mexico	$10,712	(100)
36	Maryland	$10,712	(307)
37	Kansas	$10,712	(376)
37	Massachusetts**	$10,920	(376)
39	Wisconsin	$10,712	(414)
40	Minnesota	$10,712	(751)
40	New York	$10,712	(751)
42	Vermont**	$10,920	(939)

* Income reflects full-time, year-round minimum wage earnings for one worker (52 weeks at 40 hours per week).
** Seven of these states had a minimum wage higher than the federal minimum wage in all or part of 1998.
*** The income tax threshold in Idaho was higher than minimum wage earnings in 1998, but each filing household paid a $10 permanent building fund tax.

Source: Center on Budget and Policy Priorities

Table 3B
State Income Tax at Minimum Wage for Two-Parent Families of Four, 1998

	State	Income*	Tax
1	Kentucky	$10,712	$220
2	Alabama	$10,712	178
3	Illinois	$10,712	165
4	Indiana	$10,712	150
5	Hawaii**	$10,920	135
6	West Virginia	$10,712	83
7	New Jersey	$10,712	80
8	Virginia	$10,712	50
9	Montana	$10,712	35
10	Connecticut**	$10,774	0
10	District of Columbia**	$12,792	0
10	Delaware	$10,712	0
10	Idaho***	$10,712	0
10	Iowa	$10,712	0
10	Colorado	$10,712	0
10	Arizona	$10,712	0
10	Louisiana	$10,712	0
10	Maine	$10,712	0
10	California**	$11,752	0
10	Arkansas	$10,712	0
10	Michigan	$10,712	0
10	Ohio	$10,712	0
10	Mississippi	$10,712	0
10	Missouri	$10,712	0
10	Oklahoma	$10,712	0
10	Nebraska	$10,712	0
10	Oregon**	$12,480	0
10	Pennsylvania	$10,712	0
10	North Dakota	$10,712	0
10	North Carolina	$10,712	0
10	Utah	$10,712	0
10	South Carolina	$10,712	0
10	Rhode Island	$10,712	0
34	Georgia	$10,712	(32)
35	New Mexico	$10,712	(130)
36	Maryland	$10,712	(361)
37	Massachusetts**	$10,920	(376)
37	Kansas	$10,712	(376)
39	Wisconsin	$10,712	(526)
40	Minnesota	$10,712	(751)
40	New York	$10,712	(751)
42	Vermont**	$10,920	(939)

* Income reflects full-time, year-round minimum wage earnings for one worker (52 weeks at 40 hours per week).

** Seven of these states had a minimum wage higher than the federal minimum wage in all or part of 1998.

***The income tax threshold in Idaho was higher than minimum wage earnings in 1997, but each filing household paid a $10 permanent building fund tax.

with minimum wage income in these states was $124. Seven states levied a tax of more than $100, and one state — Hawaii — imposed a tax of $272 on such a family.

- Two-parent families of four with minimum wage income owed income taxes in nine states. The average tax liability in these nine states was $122.

- By contrast, families with a minimum wage worker qualified for a tax refund in nine states. The seven states with refundable state earned income tax credits — Kansas, Maryland, Massachusetts, Minnesota, New York, Vermont, and Wisconsin — provided refunds ranging from $307 to $939 for families of three and from $361 to $939 for families of four with minimum wage income. In Wisconsin, the only state in which the EITC was designed to provide a larger benefit to poor families with three or more children than to other poor families, a two-parent family with three children and one minimum wage worker received a refund of $1,615. New Mexico's "low income comprehensive tax rebate" and Georgia's "low-income tax credit" resulted in smaller refunds. The New Mexico credit provided refunds of $130 for a family of four and $100 for a family of three with minimum wage earnings. The Georgia credit provided refunds of $32 for a family of four and $21 for a family of three with minimum wage earnings.

III. Recent Changes in State Income Tax Burdens on the Poor

More than a decade ago, the federal government recognized that taxing poor families was counterproductive and unfair. As part of federal tax reform in 1986, virtually all families below the poverty line were removed from federal income tax rolls. Before 1987, only a handful of states exempted poor families from their income taxes. In the wake of federal tax reform, many more states followed the federal government's lead. The eight states that based their income taxes on federal taxable income or federal tax liability incorporated the federal changes into their state tax systems automatically and as a result removed poor families from their state income tax. Other states moved to revise their tax systems in similar ways. As a result, by 1991, some 18 of the 42 states with income taxes exempted married-couple families of four with below-poverty income from state income tax.

From 1991 to 1996, little additional progress was made in removing poor families from state income tax rolls. Income tax thresholds increased more than the poverty line in fewer than half of the states between 1991 and 1996, and the number of states with below-poverty thresholds did not change. Not until 1997, after seven years of economic growth, did the number of states taxing poor families begin to decline appreciably, and the trend continued in 1998.

Largely as a result of changes in the last two years, a substantial number of states had lower tax burdens on poor families in 1998 than they did in 1991. Other states, however, have shown a disappointing lack of progress during the 1990s.

- Twenty of the 24 states with below-poverty thresholds for families of four in 1991 raised their thresholds since then. In five of those states, the amount of increase brought the states' thresholds above the poverty line; the five states were Iowa, Kansas, Massachusetts, North Carolina and Pennsylvania. Eight states moved their thresholds closer to the poverty

line, but did not actually bring the threshold above the poverty line. Seven other states increased their thresholds, but by amounts insufficient to keep pace with increases in the poverty line.

- In the remaining four states with below-poverty thresholds in 1991, the income level at which families enter the tax system either did not change (Alabama, Kentucky, Virginia) or declined (Hawaii). Because the poverty line increases each year as the cost of supporting a family rises, income tax thresholds in these states fell further and further below the poverty line.[18]

- In every state in which the threshold was already above the poverty line in 1991, the threshold remained above the poverty line in 1998. Moreover, thresholds in all but two of these states increased by an amount greater than the increase in the poverty line over that period. These increases extended income tax relief in these states to the near-poor as well as to the poor.

The 1990s Were a Time of Change for State Income Tax Systems and for State Welfare Policy

Given the number and magnitude of changes made to personal income tax systems between 1991 and 1998, it is surprising that even more progress has not been made in removing poor families from state income tax rolls. As states adapted their tax systems to changing times, many of them have not made ending taxation of the poor a priority.

The 1990s began with state budgets reeling from the effects of the national economic downturn. In 1991, states confronted their most serious fiscal crisis since the recessions of the early 1980s. The economic downturn both depressed revenue and increased demand for services, aggravating state budget problems. Rising health care,

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[18] Two of these states — Hawaii and Kentucky — have enacted tax changes scheduled to go into effect in 1999 or later that will raise the income tax thresholds (see box on page 32). Virginia in 1998 passed a tax credit for poor families with children that would have raised the threshold substantially, but the legislature made implementation of the credit subject to federal approval for counting the cost of the credit toward the state's "maintenance of effort" requirement under the federal Temporary Assistance for Needy Families program. The credit did not take effect because the federal government did not grant that approval. Instead, Virginia is likely to offer similar assistance through a new spending program that would provide "work incentive payments" to assist low-income working families with children in paying their Virginia income tax liability.

prison, and education costs added to state fiscal woes. According to a May 1991 survey by the National Conference of State Legislatures, prospective state deficits for fiscal year 1992 totaled more than $30 billion.

As a result of this fiscal crisis, many states increased taxes. Most states adopting significant tax increases in the early 1990s relied largely on regressive taxes — such as sales and excise taxes — to raise revenue. While states could have lessened the burden such taxes impose on the poor through enacting offsetting reductions in income taxes, only a few chose to do so. Of the 34 states that raised taxes in 1991, only six provided some offsetting low-income tax relief.

By the 1991 tax year, the largest tax increases that resulted from the fiscal pressures of the recession had been enacted. In 1991, the average state income tax threshold for families of four equaled $11,760 or 84.5 percent of the poverty line. Income tax thresholds were below the poverty line for families of four in 24 states.

The national recession ended in 1991 and the economy began to expand again. By the mid-1990s, most state economies had been growing for a number of years. With stronger economies came stronger revenue growth, and many states were ending their fiscal years with positive balances for the first time in several years. These balances were enhanced by continued conservative budgeting as states faced the uncertainties of federal actions and future economic trends; various government programs that had been cut or eroded during the recession were not restored to their pre-recession funding levels. As a result of the budget surpluses brought about by good times and constrained spending, many states began to consider tax cuts. The personal income tax was the major focus of tax-cutting activity in many states. Twenty-eight states enacted significant personal income tax cuts over the past four years; almost twenty states are contemplating further income tax cuts in 1999.

The economic expansion affected state welfare policy as well. With unemployment falling to a remarkably low rate, it became possible for some families that had been relying on public assistance to enter the labor force. At the same time, states were building on a set of policies enacted in the late 1980s at the federal level that stressed the importance of welfare recipients finding employment. A number of states began welfare reform experiments in the early 1990s.

In 1996, the federal government passed the Personal Responsibility and Work Opportunity Act, which among other changes created the Temporary Assistance for Needy Families (TANF) Block Grant. Resulting changes in state welfare laws, such as limits on how long families can receive cash assistance under TANF and requirements that recipients find jobs quickly, along with the healthy economy and other factors, resulted in many welfare recipients entering the labor force. In every state, reliance on welfare has declined dramatically. Nationally, the number of welfare cases has

dropped by two million from the peak level of five million at the height of recession in the early 1990s. Studies indicate that between half and three-quarters of former welfare recipients are employed shortly after they leave the rolls.

For many families, however, the move from reliance on public assistance to reliance on a paycheck has not meant an escape from poverty. The jobs that many welfare recipients take often pay low wages and provide few, if any, benefits. At the same time, the costs associated with going to work remain substantial. Those costs include transportation and child care — and, in many states, income taxes.

The tax-cutting activity of the mid- to late-1990s provided an opportunity for states to relieve tax burdens on low-wage workers, including those making the transition from welfare to work. Many states, however, failed to make low-income tax relief a priority.

Most States With Below-Poverty Thresholds in 1991 Continue to Tax the Poor — But Substantial Progress Is Being Made

In 1991, 24 states imposed income taxes on families of four with incomes below the poverty line. Table 4 shows the changes in thresholds for these states between 1991 and 1998. Of the 24 states, four did not increase their thresholds at all; in one of the four — Hawaii — the threshold actually fell (although Hawaii has passed legislation to raise its threshold in 1999). Another seven states increased their thresholds, but the increase was less than the amount by which the poverty line increased during the period. A final 13 states increased their thresholds by more than the amount by which the poverty line increased. In eight of these 13, the increases were not enough to bring the states' thresholds above the poverty line. But in five states, the tax thresholds were increased enough between 1991 and 1998 to remove poor families of four from the income tax rolls completely.

Each year, the federal poverty line is adjusted to take into account the impact of inflation on the costs of supporting a family. If a state's tax threshold remains the same or increases by less than the amount by which the poverty line rises, a higher proportion of the income of a poor family will be subject to tax. In states with below-poverty thresholds for families of four in 1991, the average increase in the tax threshold between 1991 and 1998 was over $3,700, compared with the increase of $2,700 in the poverty line. Thirteen of the 24 states raised the threshold by more than $2,700, thereby reducing the extent to which they taxed poor families of four. The other eleven states either failed to raise the threshold sufficiently to keep pace with the poverty line or failed to raise the threshold at all.

Table 4
State Income Tax Thresholds for Two-Parent Families of Four, 1991-1998
States with Below-Poverty Thresholds in 1991

State	1991	1994	1995	1996	1997	1998	Change 1991-96	Change 1996-98	Change 1991-98
Pennsylvania	$10,800	$15,300	$15,300	$15,300	$20,600	$25,000	$4,500	$9,700	$14,200
Massachusetts	12,000	12,000	14,000	15,500	17,400	21,100	3,500	5,600	9,100
Iowa	9,000	15,300	16,100	16,400	16,500	17,200	7,400	800	8,200
Kansas	13,000	13,000	13,000	13,000	13,000	20,700	0	7,700	7,700
Georgia	9,000	11,100	11,100	11,100	13,100	15,300	2,100	4,200	6,300
Arkansas	10,700	10,700	10,700	10,700	10,700	15,600	0	4,900	4,900
Indiana	4,000	4,000	4,000	4,000	8,500	8,500	0	4,500	4,500
Oregon	10,100	10,900	11,100	11,400	14,000	14,200	1,300	2,800	4,100
Delaware	8,600	8,600	8,600	12,500	12,700	12,700	3,900	200	4,100
North Carolina	13,000	13,000	16,000	17,000	17,000	17,000	4,000	0	4,000
Michigan	8,400	8,400	9,600	9,600	10,000	11,800	1,200	2,200	3,400
Missouri	8,900	9,700	9,900	10,000	10,200	12,000	1,100	2,000	3,100
Utah	12,200	13,600	14,100	14,400	14,900	15,200	2,200	800	3,000
New Jersey	5,000	7,500	7,500	7,500	7,500	7,500	2,500	0	2,500
Oklahoma	10,000	10,900	11,600	11,800	12,200	12,500	1,800	700	2,500
Montana	6,600	7,200	7,400	8,600	8,800	9,000	2,000	400	2,400
Ohio	10,500	10,500	10,500	11,500	12,000	12,500	1,000	1,000	2,000
West Virginia	8,000	8,000	8,000	10,000	10,000	10,000	2,000	0	2,000
Louisiana	11,000	11,000	11,000	12,300	12,300	12,300	1,300	0	1,300
Illinois	4,000	4,000	4,000	4,000	4,000	5,200	0	1,200	1,200
Kentucky	5,000	5,000	5,000	5,000	5,000	5,000	0	0	0
Virginia	8,200	8,200	8,200	8,200	8,200	8,200	0	0	0
Alabama	4,600	4,600	4,600	4,600	4,600	4,600	0	0	0
Hawaii	6,300	6,300	6,300	6,100	6,100	6,100	(200)	0	(200)
Average	8,704	9,533	9,900	10,438	11,221	12,467	1,733	2,029	3,763
Poverty Line	13,924	15,141	15,569	16,036	16,400	16,655	2,112	619	2,731

Income Tax Thresholds for Two-Parent Family of Four						
	1991	1994	1995	1996	1997	1998
Number Below Poverty	24	23	23	24	21	19
Poverty Line	$13,924	$15,141	$15,569	$16,036	$16,400	$16,655
Average	$11,760	$13,088	$13,645	$14,210	$14,919	$16,393

Of the 13 states that increased their thresholds by more than the amount by which the poverty line increased between 1991 and 1998, five — Iowa, Kansas, Massachusetts, Pennsylvania, and North Carolina — raised their thresholds enough to move from taxing the poor to not taxing the poor.

- Iowa's threshold for a family of four increased from $9,000 in 1991 — almost $4,000 below the poverty line — to $17,200 in 1998. This increase resulted mainly from an increase in the state's no-tax floor — a special feature of Iowa's income tax that established an income below which families owe no tax. In addition, Iowa's earned income tax credit increased as a result of expansions of the federal credit.

- Kansas in 1998 raised its threshold from $13,000 – the same level it had been throughout the 1990s – to $20,700. The change was mostly due to enactment of a refundable earned income tax credit equal to 10 percent of the federal EITC. Kansas also raised its personal exemption and standard deduction.

- Massachusetts raised its no-tax floor for a family of four from $12,000 in 1991 to $15,500 in 1996. This change left the threshold for a family of four slightly below the poverty line. In 1997, however, Massachusetts enacted a new, refundable earned income tax credit equal to 10 percent of the federal EITC. And in 1998, the personal exemption was raised substantially. These changes raised the income tax threshold for a family of four to $21,100, approximately $4,400 above the poverty line.[19]

- North Carolina's threshold of $13,000 for a family of four was below the poverty line in 1991. It remained unchanged until 1994 and so stood in that year more than $2,000 below poverty. In 1995, the state increased its

[19] A portion of the 1998 personal exemption increase was temporary based on surplus revenue allocated to the state's Tax Reduction Fund. The exemption and therefore the tax threshold are scheduled to decline in 1999. The threshold, however, will remain above the poverty line.

tax threshold through a combination of an increase in personal exemptions and the establishment of a credit of $60 per child for families with incomes below $100,000. By 1998, North Carolina's tax threshold equaled $17,000 — just $350 above the poverty line for a family of four.

- Pennsylvania increased its threshold substantially during this period by increasing its low-income "tax forgiveness" credit from $10,800 in 1991 to $15,300 in 1994. In 1996, the state's threshold for a family of four was approximately $700 below the poverty line. However, in each of the last two years the tax forgiveness credit again has been increased, raising the tax threshold to $25,000, $8,350 above the poverty line.

Eight other states with below-poverty thresholds in 1991 increased their thresholds by an amount equal to or greater than the increase in the poverty line between 1991 and 1998. However, the thresholds for families of four in these states were below the poverty line in 1991 and remained below the poverty line in 1998 even after these increases.

- The income tax threshold in Arkansas was $10,700 from 1991 to 1997. In 1998, Arkansas implemented a new income-tax table for low-income residents that, combined with a new credit for Social Security taxes paid and an increased standard deduction, increased the threshold for a family of four to $15,600, about $1,000 below the 1998 poverty line. Between 1991 and 1998, Arkansas' threshold increased from 65 percent of the poverty line to 94 percent.

- Delaware converted its personal exemption to a credit of $100 per family member starting in 1996. This, combined with a cut in tax rates in 1997, increased the tax threshold from $8,600 to $12,700 for a family of four. The threshold is now 76 percent of the poverty line.

- Georgia's threshold for a family of four increased by $2,100 between 1991 and 1994 as the result of increases in the state's dependent exemption. The threshold did not change between 1994 and 1996. In 1997 and 1998,

Future Increases in Income Tax Thresholds

This report shows income tax thresholds for 1998. As a part of legislation enacted early in 1999 and in previous years, some states have adopted changes to their income tax systems that will lead to increased thresholds in 1999 and beyond. So far none of those states will eliminate income taxes on the poor as a result of legislation that will take effect in 1999 or later years.

- Delaware in 1998 raised its standard deduction to $4,000 for a married couple and to $3,250 for a head of household, effective beginning with the 1999 tax year. The resulting increase in the threshold will be insufficient to exempt poor families from the income tax.

- In Georgia, the exemption for dependents is scheduled to increase from $2,700 to $3,000 in tax year 2003. The threshold will remain below the poverty line.

- Hawaii in 1998 enacted a new refundable low-income tax credit, along with reductions in tax rates, effective in tax year 1999. The state's income tax threshold for a family of four will increase to about $11,000, a substantial increase, but will remain well below the poverty line.

- Illinois in 1998 enacted legislation to increase its personal exemption from $1,000 to $2,000 over three years. Despite increasing substantially, the threshold will remain below half the poverty line.

- As part of tax changes made in 1996, Kentucky's standard deduction is being increased over several years from $650 to $1,700. After the increase is fully implemented, the standard deduction will be indexed for inflation. The increase in the standard deduction will result in a small increase in the state's tax threshold, but the threshold will remain less than half the poverty line.

- Beginning in 1999, Louisiana will no longer require taxpayers to pay state income tax if their income is below the federal filing threshold. This change will boost the threshold for a family of four in 1999 to $12,700 — still well below the poverty line.

- In 1998, Maine raised its personal exemption from $2,100 to $2,400 for tax year 1998 and to $2,750 for tax year 1999. The tax threshold will remain above the poverty line.

- Maryland in 1997 enacted a bill which is cutting tax rates and also increasing the state's personal exemption by $1,200 over five years, starting in tax year 1998. This legislation is raising the state's income tax threshold, already above the poverty line, by several thousand dollars. In addition, Maryland is expanding its refundable EITC over several years from 10 percent to 15 percent of the federal credit.

- Mississippi is phasing in increases in the personal exemption and standard deduction for married filers. The personal exemption will increase to $12,000 by tax year 2000 and the standard deduction will increase to $4,600 for tax year 1999. The tax thresholds, which are already above the poverty line, will be unchanged.

- Ohio enacted an increase in the state's personal exemption in 1996 from $750 to $1,050, phased in over four years. The final increase is scheduled to take effect in tax year 1999. These increases will not raise the state's threshold enough to bring it above the poverty line.

the combined effect of several changes to Georgia's tax system increased the tax threshold from $11,100 to $15,300, or 92 percent of the poverty line.[20]

- Indiana's income tax threshold for a family of four was $4,000 from 1991 through 1996. The threshold increased to $8,500 in 1997, due to adoption of a new earned income tax deduction and a new dependent exemption. The threshold is now 51 percent of the poverty line.

- Michigan increased its personal exemptions modestly from 1991 to 1997. In 1998, another personal exemption increase plus a new per-child deduction raised the threshold to $11,800, still well below the poverty line but by a lesser amount than in 1991.

- Missouri in 1998 increased its dependent exemption from $400 to $1,200. This change, along with inflation adjustments to the state's standard deduction, raised the threshold from $8,900 at the beginning of the decade to $12,000 in 1998, still about $4,650 below the poverty line.

- Oregon's tax threshold for a family of four increased from $10,100 in 1991 to $11,400 in 1996 due to the indexing for inflation of its personal exemption credit. In 1997 Oregon instituted a non-refundable earned income tax credit equal to 5 percent of the federal EITC. This increased the tax threshold to $14,000. Because the EITC is indexed for inflation, the threshold rose again in 1998 to $14,200, 85 percent of the poverty line.

- Utah's threshold rose automatically between 1991 and 1998 because its personal exemption and standard deductions are indexed to increase with inflation. In 1998, Utah's threshold for a family of four stood at $15,200, 91 percent of the poverty line.

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[20] As discussed on page 12, this report does not include in the calculation of tax thresholds any tax credits that are granted as offsets to other state and local taxes, such as sales taxes or property taxes. In previous versions of this report, the Georgia low income credit was not included in the calculation of the tax threshold, because the history of the credit suggested that it was intended as an offset to the sales tax on food. This apparent intention was reinforced by the denial of the credit to food stamp recipients; states are prohibited by federal law from imposing sales taxes on food purchased with food stamps. Last year, Georgia began phasing out its sales tax on food. Nonetheless, the low income credit was not reduced; moreover, in tax year 1997 the credit was not denied to food stamp recipients. Effectively, the Georgia low income credit has been converted to a general low income credit. It is treated as such in the calculation of the 1997 and 1998 thresholds.

At least one additional state, Hawaii, has already enacted changes that will go into effect in tax year 1999 that will increase the threshold sufficiently to offset the change in the poverty line during the 1990s. (See box on page 32.)

Most States With Above-Poverty Thresholds in 1991 Raised Their Thresholds

In contrast to the states that started the 1990s with below-poverty thresholds, all but two of the states with thresholds above poverty in 1991 increased them by amounts greater than the increase in the poverty line. As Table 5 shows, threshold increases in these states from 1991 to 1998 averaged $5,800, well above the increase of $2,700 in the poverty line during that period. Because these increases go beyond the increases that were necessary to maintain the threshold at or above the poverty level, they served to exclude from income tax the incomes of more near-poor families in these states.

Tax relief for the near-poor can be particularly important in a state with a high cost-of-living. In addition, many analysts believe that the poverty line underestimates the income level that a working family needs to afford basic items in a household budget, such as housing, food, transportation, health care and child care. For these and other reasons, tax relief for working near-poor families has become a priority for a number of states.

Seven of the eight states with the largest increases in their thresholds over this period all include tax credits targeted to low- and moderate-income residents as part of their tax systems.

- New York's income tax threshold for a family of four rose from $16,900 to $22,800 between 1994 and 1998. These increases resulted from legislation enacted in 1994 and 1995 that phased in through 1996, including provisions that scaled back one low-income credit, increased the standard deduction, created a state earned income tax credit, and reduced tax rates.

- The Arizona income tax threshold for a family of four rose from $15,800 in 1994 to $23,600 in 1998. This resulted from the creation and subsequent expansion of a tax credit per family member for families with income below $23,600, as well as an increase in the state's personal exemption.

- Substantial expansions of the federal earned income tax credit through 1996 led to large increases in the income tax thresholds in four of the states with a state earned income tax credit tied to the federal credit —

Table 5
State Income Tax Thresholds for Two-Parent Families of Four, 1991-98
States with Above-Poverty Thresholds in 1991

State	1991	1994	1995	1996	1997	1998	Change 1991-96	Change 1996-98	Change 1991-98
California	$20,900	$22,600	$23,000	$23,400	$23,800	$36,100	$2,500	$12,700	$15,200
Minnesota	15,500	19,000	20,000	20,900	21,600	25,200	5,400	4,300	9,700
New York	14,000	16,900	18,700	21,600	22,300	22,800	7,600	1,200	8,800
Arizona	15,000	15,800	20,000	20,000	20,000	23,600	5,000	3,600	8,600
Maryland	15,800	19,400	20,900	22,300	22,900	24,300	6,500	2,000	8,500
Rhode Island	17,400	21,100	22,400	23,700	24,400	25,000	6,300	1,300	7,600
Vermont	17,400	21,100	22,400	23,700	24,400	25,000	6,300	1,300	7,600
New Mexico	14,300	16,300	16,600	16,900	17,500	20,300	2,600	3,400	6,000
Maine	14,100	14,800	15,000	15,200	17,500	18,700	1,100	3,500	4,600
Wisconsin	14,400	16,400	16,400	16,700	17,000	18,700	2,300	2,000	4,300
Nebraska	14,300	16,200	16,600	16,900	17,900	18,300	2,600	1,400	4,000
North Dakota	14,700	16,500	17,100	17,400	18,000	18,400	2,700	1,000	3,700
Colorado	14,300	16,200	16,600	16,900	17,500	17,900	2,600	1,000	3,600
District of	14,300	16,200	16,600	16,900	17,500	17,900	2,600	1,000	3,600
Idaho	14,300	16,200	16,600	16,900	17,500	17,900	2,600	1,000	3,600
South Carolina	14,300	16,200	16,600	16,900	17,500	17,900	2,600	1,000	3,600
Mississippi	15,900	15,900	15,900	15,900	15,900	17,200	0	1,300	1,300
Connecticut	24,100	24,100	24,100	24,100	24,100	24,100	0	(0)	(0)
Average	15,833	17,828	18,639	19,239	19,850	21,628	3,406	2,389	5,794
Poverty Line	13,924	15,141	15,569	16,036	16,400	16,655	2,112	619	2,731

Maryland, Minnesota, Rhode Island, and Vermont.[21] In Rhode Island and Vermont, these increases have taken place without any major change in state tax policy. Minnesota and Maryland both supplemented the federal increases by expanding their own state EITCs in 1998.

- Unlike other states, California dramatically increased its threshold in 1998 without increasing tax relief for low-income families. The threshold rose from $23,800 in 1997 to $36,100, the largest increase in any state this decade. The increase was due to a significant expansion of the state's non-refundable dependent credit.[22] Because poor and near-poor families were already exempt from California's income tax, the great majority of the benefits from this expansion went to middle- and upper-income families.

- In Maine, enactment of a new low-income credit raised that state's tax threshold above the poverty line in 1997 and 1998. The income tax threshold in Maine had been above the poverty line in 1991 but was below the line in 1994 through 1996. A new low-income credit enacted in 1997 raised Maine's threshold to $17,500, over $1,000 above the poverty line; in 1998 the threshold again rose due to an increase in the personal exemption.

- New Mexico substantially expanded its refundable Low-Income Comprehensive Tax Rebate in 1998. This expansion, along with inflation adjustments to the state's personal exemption and standard deduction, increased the threshold from $17,500 in 1997 to $20,300 in 1998.

Thresholds in six other states — Colorado, the District of Columbia, Idaho, Nebraska, North Dakota, and South Carolina — increased about the same amount as the poverty line. These increases occurred largely because these states' personal

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[21] Wisconsin's earned income credit was not calculated as a percent of the federal credit for tax year 1994 but it has since recoupled with the federal credit. However, in 1996, the state reduced the percentage that the state EITC is of the federal EITC for families with two or more children. As a result, the EITC benefit for these families remained the same or fell slightly between 1995 and 1997. In 1998, Wisconsin's threshold for a family of four rose by $1,700 to $18,700 due to a new nonrefundable tax credit for low-income working families.

[22] A portion of the increase in the dependent credit is temporary. In 1999, the credit is scheduled to decline in value from $253 to $227, resulting in a decline of approximately $1,000 in the income tax threshold for a family with two children.

exemptions and standard deductions are indexed to increase automatically with inflation.[23]

Finally, Mississippi, the only state where the threshold for a family of four was above the poverty line in 1991 but below the poverty line in 1997, enacted changes to the personal exemption and standard deduction for married taxpayers that lifted Mississippi's threshold for families of four above the poverty line again in 1998.

Income Tax Relief for Poor Families Has Finally Arrived in Many States — But Remains Overdue in Others

Two years ago, despite strong fiscal conditions and large tax cuts in many states, state income taxes on poor families remained about as burdensome as they had been in the early 1990s. Now, as families file their tax returns for 1998, a number of states have changed course, providing tax relief to low- and moderate-income taxpayers as well as to wealthier taxpayers. Eight years into the economic recovery, states are at last making substantial progress in relieving income tax burdens on low-income families.

In 1998, the number of states taxing two-parent families of four with poverty-level income dropped by two from the previous year and by five from 1996. All of the states that had income tax thresholds above the poverty line for such families in 1991 have now regained that status. Two-thirds of states have taken advantage of generally healthy fiscal conditions and raised their tax thresholds during the current economic expansion more than the poverty line increased. In states in which the tax threshold remains below the poverty line, this rate of increase in the tax threshold means fewer poor families are subject to income taxes. In states in which the tax threshold was above the poverty line to begin with, tax relief is provided to near-poor families as well.

Still, many states have failed to take full advantage of the opportunity that the recent healthy fiscal climate offers to remove poor families from the income tax rolls. A number of states that still tax poor families have already cut their top income tax rates during the current recovery, which provides disproportionate benefits to the well-to-do. For example, New Jersey and Ohio cut income tax rates while allowing their income tax thresholds to fall relative to the poverty line. Some states have also chosen to cut income taxes while retaining higher sales and excise tax rates enacted during the 1990-

[23] In the District of Columbia's case, its no-tax floor is indexed by being tied to the level of federal exemptions and deductions.

91 recession, a pattern that is particularly unfair to low- and moderate-income families.[24] In sum, income tax relief for poor families remains overdue in many states.

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[24] See Nicholas Johnson and Iris J. Lav, *Are State Taxes Becoming More Regressive?*, Center on Budget and Policy Priorities, October 29, 1997. This report documents that many states tended to increase both personal income taxes and consumption taxes to maintain tax collections as the economy declined during the 1990-91 recession, but reduced only income taxes once the economy rebounded. Since consumption taxes are regressive, imposing a disproportionate burden on low-income households, this pattern of increases and decreases over the business cycle has made state tax systems more regressive overall.

IV. Strategies for Relieving State Tax Burdens on Poor Families

There are a host of ways that states can modify their tax systems to reduce the tax burden on the poor. This paper focuses on strategies related to the income tax for a number of reasons. It is relatively easy for states to alter their income tax provisions to relieve the burden of the income tax on the poor because information on the taxpayer's income is available at the time the tax is levied. The design of other major taxes makes such efforts much more cumbersome. For example, the sales tax is collected by merchants from consumers without regard to their income level and property taxes are passed through from property owners to renters as part of a rent payment. The income tax, on the other hand, is calculated as a percentage of a taxpayer's total income and thus offers a number of opportunities to reduce directly the burden of taxes on the poor.

There are three basic features of a standard income tax structure that states use to reduce or eliminate the income tax burden on low-income families: the personal and dependent exemptions, the standard deduction, and credits. The role of each of these in reducing the amount of taxes paid by a taxpayer can be seen by examining a typical income tax calculation.

The total amount of income tax owed by any taxpayer is determined in a number of steps. First, the taxpayer's total gross income is determined by adding all income sources subject to a particular state's income tax. Next, this amount (the adjusted gross income) is reduced by any exemptions and deductions allowed. This determines the total amount of income subject to taxation. Next, the state's tax rate is applied to that amount to determine the amount of tax owed. Finally, any credits allowed are applied to reduce the total amount of taxes owed.

In addition, some states have enacted provisions that eliminate any income tax liability for taxpayers with income below a set level, regardless of whether the calculations described above would yield a tax liability. These provisions are known as no-tax floors.

Each of these elements that provide tax relief for low-income taxpayers is described in more detail below. Some combination of these strategies is generally used to achieve the goal of reducing the burden of state income taxes on low-income families.[25]

Increasing Personal and Dependent Exemptions

Personal and dependent exemptions are subtractions from income. These exemptions reduce the amount of income that is subject to tax. They can be structured in a number of ways. In 1998, most states set a specific amount to be subtracted for each taxpayer and each dependent. Some states instead set one amount for the taxpayer and a different amount for dependents.[26] Furthermore, nine states used personal or dependent credits as an alternative to personal or dependent exemptions.[27] Unlike exemptions, which reduce taxable income, credits are subtracted from taxes that otherwise would be owed. This is an important distinction for the design of low-income tax relief and will be explained further below.

A personal exemption operates in a fairly straightforward way to reduce taxes. It reduces the amount of taxes owed by reducing the amount of income that is subject to taxation. For example, a family of four with total income of $12,000 in a state with a personal and dependent exemption equal to $1,000 would owe taxes on only $8,000 of that income ($12,000 minus four times $1,000) before any other tax provisions were

[25] Additional discussion may be found in Steven D. Gold and David S. Liebschutz, *State Tax Relief for the Poor*, 2nd ed., Center for the Study of the States, Albany, NY, 1996.

[26] New York allowed exemptions for dependents only. Connecticut allowed only a personal exemption, but its value depended on the family structure: the exemption for single taxpayers without children was $12,000, for single heads of household it was $19,000, and for married couples regardless of the number of children it was $24,000.

[27] The nine states were Arkansas, California, Delaware, Iowa, Kentucky, Nebraska, Ohio, Oregon and Wisconsin. Ohio had personal and dependent exemptions in addition to the personal and dependent credits. Two other states had credits for children that are similar to dependent credits. Louisiana had an "education" credit for all dependents in grades K-12. North Carolina had a child credit available to married couples with incomes below $100,000 and heads of households with incomes below $80,000.

taken into account. The higher the amount of the personal exemption, the more income that is sheltered from taxes. If a state wants to use the personal exemption to reduce taxes on low-income taxpayers, it can simply increase the amount of the exemption.

While increasing personal or dependent exemptions or credits may be a simple way to provide income tax relief to low-income families, it is also potentially quite expensive because the benefits are available to high-income taxpayers as well as low- and moderate-income families. The cost of increasing a personal or dependent exemption or credit — that is, the additional revenue foregone by the state — can be mitigated in a number of ways. Using a personal credit rather than an exemption is one way to target relief to low-income households and reduce costs. Another way to better target low-income tax relief is to reduce and phase out the value of the exemption or credit at higher income levels. These options are described in more detail below.

Differences Between Personal Exemptions and Personal Credits — Although both personal exemptions and personal credits ultimately reduce the amount of taxes owed, they work in somewhat different ways. Because an exemption reduces taxes indirectly by reducing the total amount of taxable income, the ultimate value to a taxpayer of a personal exemption is the amount of the exemption multiplied by the applicable tax rate. A credit, on the other hand, is subtracted directly from the amount of taxes owed. Therefore, the value of a credit generally is its face value. Consider the following two examples:

	A	B
Income	$12,000	$12,000
Minus: Personal Exemptions	4,000	6,000
Equals: Taxable Income	8,000	6,000
Multiplied by: Tax Rate	.04	.04
Equals: Tax	$ 320	$ 240

In example A, a family of four with income of $12,000 and a personal exemption of $1,000 per family member would have taxable income of $8,000. If the tax rate were four percent, the taxes owed would be $320. If, as in example B, the personal exemption were raised to $1,500 per family member, the $6,000 total exemption that the family is eligible for would reduce its taxable income to $6,000 and the tax liability would be lowered to $240. Thus, raising the personal exemption by $500 per person, or

a total of $2,000 for a family of four, resulted in tax savings of $80. This equals the amount of the increase in the exemption ($2,000) multiplied by the four percent tax rate.

	C	D
Taxable Income	$12,000	$12,000
Multiplied by: Tax Rate	.04	.04
Equals: Tax before Credits	480	480
Minus: Personal Credit	160	240
Equals: Tax	$ 320	$ 240

A tax credit works in a different way because a credit directly reduces the amount of tax owed. Therefore, when a personal or dependent credit is increased, the family tax liability is reduced by the full amount of the credit change. In example C, a family of four with taxable income of $12,000 subject to a four percent tax rate would face a tax of $480 before credits. If the personal credit equaled $40 per person, the family could claim a total personal credit of $160, and its tax liability after subtracting the credit would be $320. If, however, the personal credit were raised to $60 per person, as in example D, the family could claim a total personal credit of $240, and its taxes would be reduced to $240. Thus, an increase of $20 in a personal credit would lead to a tax savings of $80 for a family of four.[28]

There is a difference between exemptions and credits in terms of the impact on families of different income levels if a state has a graduated rate structure. For example, consider a state with two income tax brackets: a lower bracket which taxes income below $20,000 at a four percent rate and a higher bracket which taxes income of $20,000 or more at five percent. In this case, the value of increasing a personal exemption by $1,000 would be $40 for a taxpayer in the lower tax bracket. For a taxpayer in the higher bracket, however, the value would be $50 because of the higher tax rate. On the other hand, a credit equal to $40 for all taxpayers would reduce the taxes of both these taxpayers by that amount regardless of income level. For this reason, the benefit from a personal or dependent credit is likely to represent a greater

[28] Personal credits generally are limited to the amount of the before-credit tax liability. If the credit to which the taxpayer is entitled exceeds that amount, the taxpayer does not receive the difference as a tax refund.

share of income for lower-income households than for those at higher incomes and so may be a better targeted and less costly tool to use when the objective is low-income tax relief.

The fact that a credit is worth the same amount to all taxpayers, regardless of the tax rate they pay, while the tax savings from an exemption depends on the tax rate applied to that exemption, can have implications for the choice of methods used to reduce income tax burdens on the poor. In a state with a flat rate income tax — that is, a state in which all taxpayers are subject to the same tax rate regardless of level of income — the impact of increasing an exemption will be the same as that of increasing a credit if the credit is equal to the exemption times the applicable tax rate. In a state with a progressive rate structure, a credit would provide better targeting to low-income taxpayers at a lower cost.

Phasing Out Personal Exemptions or Credits — Both personal exemptions and credits may be phased out as income increases. This can provide the full benefit of the exemption or credit to low- and moderate-income households while lowering the total cost of the tax relief measure. For example, under the federal income tax, the personal exemption phases out for high-income taxpayers. The amount begins to decline at $186,800 of income for joint filers and at $124,500 for single filers. The box on the next page shows how the federal personal exemption phase-out works.

Ten states incorporated the federal personal exemption phase-out into their own tax systems in 1998 — Colorado, Idaho, Minnesota, New Mexico, North Carolina, North Dakota, Rhode Island, South Carolina, Utah, and Vermont. Four other states — California, Connecticut, Nebraska, and Wisconsin — use state-specific methods to phase out their personal exemptions, personal exemption credits, or standard deductions for families with income above a specific level.

Increasing the Standard Deduction

Most state income taxes include provisions that allow the deduction of certain taxpayer expenditures from income before taxes are computed. Taxpayers typically are given the choice of listing itemized deductions, which reflect specific taxpayer expenditures, or taking the standard deduction. The standard deduction is a subtraction from income of a fixed amount that is allowed any taxpayer, although the amount of the standard deduction allowed may vary with family structure, with size, or in a few states with income. In this typical structure, taxpayers using the standard deduction tend to be lower- and middle-income taxpayers who do not own homes. Homeowners are more likely to itemize their deductions because mortgage interest and property tax payments frequently lift their deductible expenses above the standard

The federal income tax establishes a personal exemption phase-out threshold at a specific amount of adjusted gross income (AGI) for each filing status. The phase-out levels are:

Single Filers	$124,500
Heads of Households	$155,650
Joint Filers	$186,800

Taxpayers with adjusted gross incomes above these thresholds gradually lose the value of their personal exemptions. The phase-out occurs over the next $122,500 of income, regardless of filing status. For each $2,500 of income over the phase-out threshold level, the personal exemption is reduced by two percent. Thus in 1998, when the personal exemption equaled $2,700, each personal exemption was reduced $54 for each $2,500 in income over the threshold level. Once income exceeds the phase-out levels by more than $122,500, the exemption is completely eliminated. The table below shows the effects of the personal exemption phase-out at different income levels for single taxpayers.

Single

AGI	Personal Exemption Per Person	Reduction in Exemption Amount	Reduced Exemption Amount
$120,000	$2,700	$ 0	$2,700
130,000	2,700	119	2,581
200,000	2,700	1,631	1,069
225,000	2,700	2,171	529
250,000	2,700	2,700	0

deduction amount. (States such as Illinois and Ohio that do not allow itemized deductions typically also do not allow standard deductions.)

As with increasing personal and dependent exemptions, raising the standard deduction increases the tax threshold, or income level at which families begin to pay taxes. It also reduces the amount of taxes owed by families with incomes above the threshold level. Relative to increasing personal and dependent exemptions, however, raising the standard deduction may be less costly because not every taxpayer would benefit from the increase; most of those who itemize their deductions would not be affected by the change. As a result, while the benefits of the standard deduction, like

the personal exemption, theoretically rise with income in states with a graduated rate structure, most taxpayers in tax brackets with higher marginal rates itemize and do not take the standard deduction. Thus, the benefits of a higher standard deduction would tend to be targeted on low- and moderate-income households.

No-Tax Floors

Another way to increase a state's income tax threshold is to set a "no-tax floor," or an income amount below which no taxes are owed. No-tax floor provisions supersede all other provisions of the income tax for taxpayers whose incomes fall below the specified level. Thus, with a no-tax floor in place, a family that would otherwise owe income taxes but whose income falls below the floor would face no income tax liability. For example, a family of four in Oklahoma with income of $12,500 in 1998 would have owed $73 under the state's regular income tax structure. But because the state had a no-tax floor of $12,500, families with income up to this level owed no state income taxes.

One area of concern in the design of no-tax floors is the impact on taxpayers with income just above the floor. If the normal structure of the income tax takes effect immediately above the tax floor, families benefiting from a no-tax floor can find themselves faced with an income tax "cliff" where a single additional dollar of income triggers a significant amount of tax, sometimes $100 or more. For this reason, most of the states that use a no-tax floor also phase in the underlying tax obligations over a relatively short range of income above the floor. For example, Iowa has an alternative tax under which families with income above the no-tax floor pay the lesser of the alternative tax or regular tax amounts. Nevertheless, families in states with no-tax floors with income just above the floor typically face high tax rates on each additional dollar they earn in the transition range.[29]

A no-tax floor keeps the cost of income tax relief down by targeting relief exclusively on families with income below a specified level. Of the seven states that used a no-tax floor, only Massachusetts and Nebraska set their levels high enough to eliminate income taxes on all poor families in 1998. Iowa, New Jersey, Oklahoma,

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[29] Tax cliffs are not unique to states with no-tax floors. Similar cliffs can exist when low-income credits of a fixed amount are used to offset tax liability. In 1998, for example, in the District of Columbia, a two-parent family of four with income of $17,900 received a low-income credit of $634 which fully offset the usual tax liability at that income level. If such a family earned $17,901, however, it was no longer eligible for the credit and faced a tax liability of $634.

Virginia, and West Virginia set their no-tax floors below the poverty level for both families of three and four.[30]

Low-Income Credits

Another strategy available to states for increasing income tax thresholds and reducing income taxes on low-income families is to provide income tax credits specifically for low-income taxpayers. A tax credit is a fixed amount subtracted directly from an individual's tax liability. Credits available only to low-income taxpayers are thus a targeted and efficient way of increasing the tax threshold and reducing the tax liability for low-income families. Credits that are refundable — that is, credits for which the taxpayer receives the entire value even if the credit amount exceeds the amount of taxes owed — can also serve to offset the burden of other state and local taxes and supplement wages for families at low income levels.

In 1998, some form of low-income credit was used in 18 states.[31] Ten states had an earned income tax credit (EITC) in 1998. States with low-income credits other than the EITC in 1998 included Arizona, Connecticut, the District of Columbia, Georgia, Kentucky, Maine, New Mexico, and Pennsylvania. Maryland, Massachusetts, and New York had both EITCs and other low-income credits. In some cases, these credits were simply a flat amount per dependent or household member. Arizona, for example, had a $40 credit per household member for families with incomes below $20,135. Other states had credits that equalled a percentage of the tax liability, with the percentage based on income. Three states had low-income credits that acted very much like no-tax floors. For example, Pennsylvania families of four with income below a set level — $25,000 for a family of four in 1998 — qualified for a "tax forgiveness" credit equal to 100 percent of their tax bill. The percentage of tax forgiven by the credit declined sharply as family income rose; a family of four with income over $27,250 received no credit.

Iowa, Kansas, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Wisconsin had state earned income tax credits (EITC) in 1998. State EITCs, which are modeled on the federal EITC, provide a credit to low- and moderate-income working families with children and to very low-income individuals and couples who are not caring for children in the home. The credit amount is

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[30] In Iowa, while the no-tax floor is below the poverty level, families of three or four with two children pay no tax at the poverty level due to other credits.

[31] Arkansas allowed low-income taxpayers to pay a reduced amount based on a "low-income tax table"; this reduction was similar in its effect to a credit.

determined by the family's earnings and number of children. Seven of the state EITCs available in 1998 were refundable.[32] Like the federal EITC, which is among the most effective government programs in lifting children out of poverty, these refundable credits served to supplement the earnings of these families, offset the burden of other taxes, and complement efforts to help families make the transition from welfare to work.[33]

In recent years, state EITCs have enjoyed growing popularity. Nine of the ten state EITCs have been adopted since passage of the federal Tax Reform Act of 1986, which eliminated federal income tax liabilities for poor families. State EITCs can easily be piggybacked on the federal EITC by adopting federal eligibility criteria and expressing the state EITC as a percentage of the federal EITC. Appendix I summarizes the structure of state EITCs in the ten states that use them.[34]

In addition, beginning in 1997 Indiana offered an "earned income deduction" that was unrelated to the EITC. The deduction was available to families with children with incomes below $12,000, and was calculated for each family by subtracting the family's income from $12,000. For instance, a family with income of $10,000 qualified for a $2,000 deduction.[35]

Other Design Issues

Personal exemptions, credits and standard deductions are often set at a fixed dollar amount which can only be increased through specific actions by state lawmakers. In some 14 states in 1998, however, personal exemptions or standard deductions were indexed for inflation.[36] For federal taxes, these amounts are adjusted automatically each year to account for the effects of inflation. In this way, the value of the exemption,

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[32] Maryland offers both a refundable and a non-refundable EITC.

[33] For further discussion of the effectiveness of the federal EITC, see *Strengths of the Safety Net*, Center on Budget and Policy Priorities, March 1998.

[34] For further information on state EITC programs, see *Rising Number of States Offer Earned Income Tax Credits,* Center on Budget and Policy Priorities, September 1998.

[35] The deduction was not available to families who received less than 80 percent of their income from wages, salary, tips and self-employment income.

[36] Two additional states, Michigan and Nebraska, will begin indexing their personal exemptions in the future; Kentucky and Wisconsin will begin indexing their standard deductions in the future.

credit, or deduction is maintained. In eight of these states, this indexing was the result of the state beginning their income calculation with federal taxable income.

The value of personal exemptions did not increase compared to last year in over half of the states with tax thresholds below the poverty level in 1998 for families of four. So, while the costs faced by poor families increased and were reflected in a higher poverty level, the income tax threshold did not also increase. One way to partially address this problem is to index personal exemptions or standard deductions to inflation so that they will automatically increase as the cost of living increases.[37]

Income Tax Rate Reductions Are Often of Small Benefit to Low-Income Taxpayers

Many of the states that have not yet removed state income taxes from poor families have not made it a priority to do so. Most state economies expanded through the 1990s and most states experienced robust fiscal conditions. As a result, 28 states enacted significant personal income tax cuts in the last five years. But 13 of the 15 states with the largest income tax cuts in recent years chose to cut top tax rates or cut all tax rates in ways that provide a disproportionate benefit to higher-income taxpayers. Six of the states — Delaware, Hawaii, Michigan, New Jersey, Ohio and Oregon — that have enacted the largest personal income tax cuts in recent years still have income tax thresholds below the poverty line.

Rate cuts would appear to benefit all taxpayers regardless of income. However, the benefit for low-income taxpayers of an income tax rate reduction is generally very small.

- A number of state income tax systems use graduated income tax rate structures with higher rates for high-income taxpayers. Some states have focused in recent years on reducing the top income tax rate; such actions disproportionately benefit high-income taxpayers.

- Even if a rate reduction is made across-the-board, reducing the rate for each tax bracket, it provides a larger dollar benefit for high-income taxpayers than for low-income taxpayers. For example, consider a state with an income tax with a flat rate of five percent and exemptions and

[37] North Carolina, for example, does not automatically adjust its income tax code for inflation. As a result, its threshold is not scheduled to rise above its current level of $17,000. Due to cost-of-living adjustments, the federal poverty line is likely to exceed $17,000 in 1999. As a result, without legislative action to increase its threshold, North Carolina is likely once again to tax the poor in 1999.

deductions that total $10,000 for a family of four. A rate reduction from five percent to 4.5 percent would reduce the taxes of a family earning $20,000 by only $50. The same rate cut would reduce the taxes of a family earning $100,000 by $450 — nine times more than the cut for the lower-income taxpayer. Moreover, the lower-income family's reduction amounts to 0.25 percent of its income, while the wealthier family's taxes are cut by 0.45 percent of income.

- In addition, as this report shows, many states exempt their lowest-income residents from the personal income tax. Residents that pay no income tax, of course, will receive no benefit from a rate reduction.

California is an example of a state where a reduction in tax rates provided no tax relief for low-income taxpayers. In 1995, California had eight graduated tax brackets. The top two brackets were tax rates of 10 percent and 11 percent, which applied to married filers with taxable income over $220,000. These top two brackets, which had been instituted in 1991 as a temporary rather than permanent feature of the tax code, were eliminated in 1996. As a result, the marginal tax rate for taxpayers with incomes above $220,000 dropped to 9.3 percent. While this provided a substantial tax cut for high-income taxpayers in the state and cost the state over $700 million in revenue, it provided no tax relief for poor taxpayers.[38]

Even a rate reduction targeted to lower-income taxpayers may not result in significant tax relief. New Jersey enacted a substantial rate cut that was phased in starting in 1994. New Jersey has a graduated income tax with five brackets. The rate reduction enacted was larger for the lowest income brackets than for the upper brackets. The rate for taxable income of less than $20,000 was lowered by 30 percent from 2.0 percent to 1.4 percent. A family of four earning $15,000 had their taxes reduced by $60 as a result of the rate cut, while the taxes of a family earning $150,000 were reduced by over $1,300. Despite the rate reductions, a family of four at the poverty line owed $163 in New Jersey income taxes in 1998.

Rate reductions are among the least efficient ways to relieve the tax burdens of the working poor. Changes in personal exemptions, standard deductions, tax credits or no-tax floors are far better choices for providing tax relief to those most in need of it at a modest cost.

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[38] California has subsequently cut income taxes in ways other than rate reductions, but those cuts have not benefitted low-income taxpayers either.

V. Conclusion

Many low-income working families face a heavy state and local tax burden. Eliminating state income taxes on the poor can help prevent taxing these families deeper into poverty. Relieving tax burdens on low-income working families can also improve their ability to remain self-sufficient. Although progress is being made in relieving the burden of income taxes on poor families, nearly half the states with income taxes still require two-parent families of four and single-parent families of three with income at the poverty level to pay income taxes. Even families with minimum-wage income that falls far below the poverty line are required to pay income taxes in a significant number of states.

It is not necessary for states to impose income taxes on poor families. A majority of states have already eliminated the tax burden on poor families. There are many ways to structure a state income tax to do so. Most of the 23 states that do not tax poor families of three or four allow relatively large deductions from income for all taxpayers through personal and dependent exemptions and the standard deduction. Some 25 states have adopted additional measures that target relief on low-income families.

The relatively good fiscal condition that many states have enjoyed in recent years has led to the adoption of income tax cuts in many states. Many states have used this opportunity to reduce taxes on working-poor families, thereby making it easier for low-wage workers to support their families — particularly important policy in the late 1990s as rising numbers of welfare recipients enter the workforce. In states that still tax the poor, the opportunity remains open for states to make changes in their income tax provisions that will relieve tax burdens on poor families — both in the interest of fairness and in order to further the objective of allowing parents who work to support their families adequately.

Appendix I
State Earned Income Tax Credits in 1998

In 1998, ten states had state earned income tax credits. State EITCs are tax credits for low-income working families that are based on the federal EITC. This table displays four major features of the EITC in each state:

- Whether the credit is refundable, that is, whether the full amount of the credit could be received even if it exceeded the amount of state income tax owed. The federal EITC is refundable.
- The percentage of the federal EITC at which the credit is set.
- Whether the credit is adjusted for family size beyond the adjustment in the federal EITC. The federal EITC benefit structure distinguishes only between families with one child and those with more than one child.
- Whether workers without qualifying children who qualify for the federal EITC are eligible to receive the state credit.

State Earned Income Tax Credits in Tax Year 1998

State	Percentage of Federal Credit	Workers Without Qualifying Children Eligible?
Refundable credits:		
Kansas	10%	Yes
Maryland[a]	10% in 1998	No
Massachusetts	10%	Yes
Minnesota	15% — no qualifying children About 25% — families with children[b]	Yes
New York	20%	Yes
Vermont	25%	Yes
Wisconsin	4% — one child 14% — two children 43% — three children	No
Non-refundable credits:		
Iowa	6.5%	Yes
Maryland[a]	50%	Yes
Oregon	5%	Yes
Rhode Island	27%[c]	Yes

Notes.
[a] A Maryland taxpayer may claim either the refundable credit or the larger non-refundable credit. The refundable credit is scheduled to increase to 15 percent of the federal credit over the next three years.
[b] Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit may range from 20 percent to 42 percent of the federal credit; the average state credit is about 25 percent of the federal credit.
[c] Rhode Island's credit is phasing down to 25 percent of the federal credit over five years as part of an overall reduction in the state income tax.