The New Federalism and State Tax Policies toward the Working Poor

Elaine Maag and
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Occasional Paper Number 38

Assessing the New Federalism
An Urban Institute Program to Assess Changing Social Policies

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The Urban Institute
2100 M Street, N.W.
Washington, DC 20037
Phone: 202.833.7200
Fax: 202.429.0687
E-Mail: paffairs@ui.urban.org
http://www.urban.org

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About the Series

Assessing the New Federalism is a multiyear Urban Institute project designed to analyze the devolution of responsibility for social programs from the federal government to the states, focusing primarily on health care, income security, employment and training programs, and social services. Researchers monitor program changes and fiscal developments. In collaboration with Child Trends, the project studies changes in family well-being. The project aims to provide timely, nonpartisan information to inform public debate and to help state and local decisionmakers carry out their new responsibilities more effectively.

Key components of the project include a household survey, studies of policies in 13 states, and a database with information on all states and the District of Columbia, available at the Urban Institute's Web site. This paper is one in a series of occasional papers analyzing information from these and other sources.

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Introduction

In evaluating how government programs affect the poor, researchers have traditionally interpreted the redistributive role of government in two separate categories—revenue-side taxes that higher-income households pay and expenditure-side transfers that lower-income households receive. As transfer policy begins to be accomplished increasingly through the tax system, these lines become blurred. Yet little research has been done on the general effects of taxes on low-income families, and particularly little on the role of state-level taxes.[1]

State taxes *do* affect low-income families—in ways that have changed in recent years and will continue to change, especially in light of the "new federalism" approach to the redistributive function of government. While some state tax systems only affect the poor through sales and excise taxes, others have income tax thresholds low enough such that the poor pay personal income taxes. Meanwhile, certain states have begun to use the tax system as a means of transferring resources to low-income families through refundable tax credits—that is, credits that people can receive even if they do not owe taxes.

The tax system provides an important vehicle for studying a growing group of people—the working poor. In the wake of welfare reform, some states have emphasized expenditure-side transfer policies that provide assistance—such as child care subsidies and job training programs—for families on or recently leaving welfare. Subsidies made through the tax system are different from welfare in that a family's prior experience with welfare does not determine if they qualify for benefits. Rather, these tax policies are based solely on income or certain expenditures, thus providing support to a broader base of people. In addition, assistance provided via the tax system may provide a more permanent source of support. While this assistance may be subject to a state's current economic conditions, it is not subject to the same time limits as welfare benefits.

This paper discusses some of the ways in which state tax systems affect low-income families. Since the income tax system primarily affects people with earned income, our focus here is the working poor.[2, 3] We first explain why state tax policy matters for these families, describing some general trends in state tax structure among all 50 states. We then focus our attention to details on personal income and sales taxes in a subset of 13 states that the Urban Institute has been studying in a major, multiyear project titled *Assessing the New Federalism (ANF)*.[4] These states represent a wide variety of income distributions and tax structures. We discuss the implications of these tax policies for different types of families in terms of their after-tax income levels and work incentives. Finally, we examine the various policy options states have to increase tax relief for low-income families and the issues states must consider in evaluating those alternatives.

Why State Tax Policy Matters for the Working Poor

This paper focuses on tax liabilities of families with incomes around the federal poverty level (FPL) and provides some analysis on families at various points across the distribution of all incomes. In 1998, 12.7 percent of the U.S. population fell below the poverty thresholds for their family size and type.[5] The three-year average rate over 1996–1998 was 13.2 percent, indicating a recent decline in national poverty rates. However, the variance in experiences across states is large. Table 1 shows that among the 13 *ANF* states, the percentage of the population in poverty in 1996–1998 varied from a low of 8.6 percent in Wisconsin to a high of 18.3 percent in Mississippi. The shares of people in poverty do not necessarily correlate (inversely) with the states' overall levels of income; for example, Wisconsin's per capita personal income level is below the national average, while New York (a relatively "rich" state in terms of per capita income) has a poverty rate exceeding the national average.

Table 1 *Income in the 13* Assessing the New Federalism (ANF) *States*

State	Per Capita Personal Income			Population in Poverty, 1996–1998 Average
	1998 ($)	Change from 1997 (%)	1998 Rank in U.S.	(%)
Alabama	21,442	+3.7	40	14.7
California	27,503	+4.5	12	16.3
Colorado	28,657	+6.1	9	9.3
Florida	25,852	+4.2	19	13.9
Massachusetts	32,797	+5.0	3	10.3
Michigan	25,857	+3.6	18	10.8
Minnesota	27,510	+4.8	11	9.9
Mississippi	18,958	+4.8	50	18.3
New Jersey	33,937	+4.9	2	9.0
New York	31,734	+4.9	4	16.6
Texas	24,957	+5.3	25	16.1
Washington	27,961	+5.7	10	10.0
Wisconsin	25,079	+4.3	22	8.6
All of U.S.	26,412	+4.4	—	13.2

Sources: Personal income data from the Bureau of Economic Analysis, "1998 State Per Capita Personal Income," April 1999; poverty numbers from Bureau of the Census, "Poverty in the United States: 1998," September 1999.

Recent strong growth in personal income has translated into large increases in tax revenue, particularly for states where tax rates increase with income. As a result, several states have enacted various tax cuts, many of them geared toward increasing relief for low-income taxpayers. Given the uncertainty associated with the longevity of this growth, however, some states have opted for temporary or conditional, rather than permanent, tax reductions.[6]

Tax policy affects low-income families differently from other families—and not just because by definition they have less income to tax. First, given recent increases in employment, these families are more likely to be moving onto the personal income tax rolls for the first time. Thus, tax thresholds, or income levels above which families become liable for income tax, are important in determining the income tax burdens they face. Second, many of the working poor, and particularly welfare leavers, are single-parent families, so that the ways in which personal income taxes treat married versus single people, singles with and without children (head of household status), different numbers of children, and the expenses related to raising children matter. Third, when working poor families, especially young families, have taxable income, it consists mostly of labor (earned) income rather than capital income, and many income tax systems distinguish between these forms of income in the definition of their tax base and/or statutory tax rates. Finally, poor families face higher consumption tax burdens relative to their income than higher-income families because expenditures as a share of income tend to decline as income increases.

Generally, state taxes are more "regressive" or less "progressive" than federal taxes—that is, average state tax burdens do not rise as sharply with income as do average federal tax burdens—for two reasons. First, states tend to rely heavily on regressive consumption-based taxes (table 2) as a revenue source, and second, their personal income tax systems tend to be less progressive than the federal system. The

Table 2 *Overall Tax Composition and Burdens, with Focus on the 13* ANF *States, FY 1998*

	Percentage of Total Tax Collection From							
State	Personal Income (%)	General Sales (%)	Selective Sales (%)	Corporate Income (%)	Property (%)	Other (%)	Taxes Per Capita ($)	Taxes as a Percentage of Personal Income
Alabama	31.3	27.4	24.8	4.3	2.4	9.8	1,318	6.4
California	41.0	31.5	7.7	8.3	5.7	5.9	2,073	7.9
Colorado	48.9	26.0	13.4	4.6	0.1	7.1	1,485	5.5
Florida	0.0	57.4	17.8	5.7	4.4	14.8	1,509	6.1
Massachusetts	55.4	20.5	9.7	9.4	0.0	5.0	2,357	7.5
Michigan	31.3	34.9	8.9	10.9	7.2	6.8	2,210	8.9
Minnesota	41.3	28.2	14.7	6.6	0.1	9.2	2,434	9.3
Mississippi	19.5	46.9	19.5	5.6	0.5	8.0	1,578	8.7
New Jersey	35.8	30.5	18.5	7.6	0.0	7.6	1,923	5.9
New York	50.6	21.1	13.3	8.7	0.0	6.4	1,989	6.6
Texas	0.0	50.7	30.1	0.0	0.0	19.3	1,246	5.3
Washington	0.0	58.5	15.0	0.0	17.3	9.1	2,075	7.9
Wisconsin	45.3	27.3	13.8	6.1	0.7	6.8	2,135	8.9
All of U.S.	34.0	32.9	15.0	6.6	2.2	9.4	1,761	7.0
Federal	48.1	0.0	3.4	11.0	0.0	37.6	6,382	25.2

Sources: State tax collections from Census data; federal tax data from U.S. Treasury calculations in the *1999 Economic Report of the President* (Office of Management and Budget) B-78, p. 399.
Note: Federal social insurance taxes included in "other" category.

latter difference between state and federal tax systems will be highlighted later in this paper. With regard to the first difference, states in general (see "All of U.S." row) raise just 34 percent of their total tax collections from personal income taxes, while the federal share is over 48 percent. Among the *ANF* states, reliance on personal income taxes varies widely, from the three states with no personal income tax (Florida, Texas, and Washington) to New York and Massachusetts, with over half of their revenues coming from the personal income tax. Each of the states with no personal income tax collects over half of its tax revenues from general sales taxes.

On the other hand, state taxes are generally smaller than federal taxes in absolute magnitude. For fiscal year (FY) 1998, total tax burdens at the state level average 7 percent of personal income, in contrast to a much higher average federal burden of 25 percent. Among the *ANF* states, this tax share is lowest in Texas (5.3 percent) and highest in Minnesota (9.3 percent). These two states also represent the extremes in absolute tax burdens among the *ANF* states, with per capita taxes of $1,246 and $2,434, respectively. Given the larger overall tax burdens imposed by the federal compared with state tax systems, it must be true that the federal system imposes greater absolute burdens on at least some types of individual families. The federal burdens for some low-income families can be absolutely higher than their state-level burdens because the federal government relies heavily on payroll (social insurance) taxes as a source of revenue. Those taxes are generally less progressive than are income taxes, because they have no exemption level, are levied at a constant marginal tax rate (15.3 percent combined employer-plus-employee share), and apply only up to a maximum taxable earnings level ($72,600 in 1999). Although such payroll taxes are less regressive than consumption-based taxes in terms of how tax burdens relative to income *change* with income level, they still can impose higher absolute burdens on some low-income working families. The federal earned income tax credit (EITC), which we will discuss in detail later, typically more than offsets federal payroll taxes for poverty-level families with children, the focus of this paper. But for the working poor without children, federal payroll taxes typically cause overall federal tax burdens to exceed overall state-level tax burdens in absolute terms.

State taxation is becoming an even bigger issue for the working poor, given welfare reform's "new federalism," block grant approach to the federal funding of programs—Temporary Assistance for Needy Families (TANF) as legislated through the Personal Responsibility and Work Opportunity Reconciliation Act of 1996—and the state-initiated reforms that are taking place. Several states are creating their own versions of tax credits for low-income families as part of their welfare reform efforts. In 1996, only four states had their own versions of refundable EITCs, but by 1999 this had doubled.[7] The size of state EITCs is substantial relative to total welfare spending; for example, Wisconsin spent about $61 million for tax year 1997 on EITCs (all portions) and about $170 million on state maintenance of effort (FY 1998).[8] Because the TANF regulations that became effective on October 1, 1999, encourage the use of targeted tax credits, we suspect that many more states will adopt refundable EITCs and other refundable, targeted tax credits in the near future.

State Tax Policies toward Low-Income Families: What's Going On?

In this section we examine the current variety of state tax policies toward low-income families, focusing on the personal income and sales tax systems in the 13 *Assessing the New Federalism (ANF)* states as of tax year 1999.

Our interest in policies affecting the working poor leads us to study two typical families—examples of welfare-leaving families who have gone to work. The first family is a single parent with two children, with earnings around the three-person poverty level. Because the tax system differentiates between single-parent "head of household" filers and "married filing jointly" filers, and because poverty thresholds vary by family size, for comparison our second family is a married couple with two children and earnings around the four-person poverty level. Our focus on these representative families allows us to analyze how both federal taxes and the various state tax systems treat the working poor, adding an element to the broader picture of how government tax-and-transfer policies affect this population.[9]

Our quantitative analysis of state tax systems is limited to an accounting of personal income tax and sales tax burdens. We do not account for other state and local taxes that might potentially burden low-income families, such as property taxes, corporate income taxes, and excise taxes (taxes on specific goods). The assumptions we use to assign personal income and sales tax burdens to families—that they are borne fully by households and consumers, respectively—are less controversial than the assumptions needed in order to distribute property and corporate taxes. Moreover, much of the recent economics literature on the incidence of property and corporate taxes suggests that the burden of these taxes falls mostly on owners of capital, who are mostly higher-income households, so that accounting for these other taxes would not add significant burden to a low-income family with only labor income. Excise taxes are a different story, however: Their burden falls on consumers of such goods as alcoholic beverages, tobacco products, and gasoline. Some of these types of goods are consumed disproportionately by lower-income families, so that accounting for excise tax burdens would increase state-level tax burdens on our typical families. This could affect our conclusions for how relative tax burdens compare across states, because burdens will likely be understated more for states with greater reliance on excise taxes. Thus, we will qualify some of our later comparisons of tax burdens across states.

Personal Income Taxes

When taxing personal income, states face several important decisions with implications for the working poor. Broadly, these include determining the base of income that will be taxed and the rate or rates at which that income will be taxed. In order to yield the same amount of revenue, states may choose to tax a very broad base of income at low rates or a smaller base of income at higher rates. The implications of these choices are discussed below via examples of income tax systems from each of the *ANF* states with personal income tax systems. Later, the implications of the var-

ious choices are discussed more broadly. We do not account for any local-level income taxes, but because these taxes are typically small, we do not believe this biases our across-state comparisons. Overall, local-level income taxes collect only about 10 percent of the revenues that state-level income taxes do.

States typically adopt a definition of taxable income that is consistent with that of the federal government—earned income as well as many types of unearned income, such as interest, dividends, pensions, alimony payments, unemployment compensation, and some Social Security benefits. Generally, states exempt income earned in another state, as it will be taxed in the state in which it was earned, and they have the option to exempt or include additional types of income. Among the *ANF* states, the exemptions most likely to benefit the working poor are unemployment income (California and New Jersey) and $900 of income for those who report over half of their adjusted gross income (AGI) coming from unemployment compensation (Michigan). There are additional exemptions, such as those related to pension income, that primarily affect higher-income people.

As shown in table 3, each of the 10 *ANF* states with personal income taxes offers some type of standard deduction or personal exemption of income based on the type of filer and family size, although this is not true of all state personal income tax systems. Among the *ANF* states, overall levels and the relative treatment of different types of families differ tremendously. The last two columns of table 3 show compu-

Table 3 *Standard Deductions and Personal Exemptions, 1999*

	Standard Deduction		Personal Exemptions			Total Exemption	
State	Head of Household ($)	Married, Filing Joint ($)	Head of Household ($)	Joint Return ($)	Children ($)	Single Parent—Poverty-Level Income ($)	Married Parent—Poverty-Level Income ($)
Alabama	2,000[a]	4,000[a]	3,000	3,000	300	5,600	6,979
California	5,422	5,422	72[b]	144[b]	227[b]	31,722	35,322
Colorado	6,350	7,200	2,750[c]	5,500[c]	2,750[c]	14,600	18,200
Massachusetts	6,800	8,860			1,000	8,800	10,800
Michigan			2,800	5,600	2,800–3,400[d]	9,300[e]	12,100[e]
Minnesota	6,350	7,200	2,750[c]	5,500[c]	2,750[c]	14,600	18,200
Mississippi	3,400	4,600	9,500	11,000	1,500[f]	14,400	18,600
New Jersey			1,000	2,000	1,500	4,000	5,000
New York	10,500	13,000			1,000	12,500	15,000
Wisconsin	7,040[g]	8,900[h]			50[b]	7,802	9,106
Federal	6,350	7,200	2,750[c]	5,500[c]	2,750[c]	14,600	18,200

Sources: Commerce Clearing House (1999) and author's calculations.
Notes:
a. Cannot exceed 20 percent of AGI.
b. Credit, not exemption. Value is calculated as credit divided by marginal tax rate at the given income.
c. If AGI less standard deduction is equal to or less than $124,500.
d. $2,800, plus $300 for each child age 7–12 or $600 for each child age 6 years or younger.
e. Calculation assumes one child age 0–6 and one child age 7–12.
f. Head of Household dependent exemption is equal to dependents minus 1.
g. Represents maximum deduction, phased out for incomes greater than $7,500. For a head of household with income of $13,423, the deduction is $5,772.
h. Represents maximum deduction, phased out for incomes greater than $10,000.

tations of the total personal and standard exemptions provided to our two family types. For our single-parent family with income at the poverty level, this amount ranges from $4,000 in New Jersey to almost $32,000 in California, with most states falling below the federal standard of $14,600. For a married-parent family, the total ranges from $5,000 in New Jersey to over $35,000 in California.

When setting rates, most states again follow the federal lead by adopting a graduated rate structure, although both the rates and the sizes of the tax brackets vary greatly. Some states have adopted flat rate structures where, absent any credits that are phased in or out, everyone faces the same marginal tax rate, or tax rate on the next dollar of income. In other cases, the graduated structures reach the highest marginal rate at very low income levels, undercutting the fact that they are gradual at all. For example, in Alabama, a head of household will face the maximum marginal rate once her taxable income exceeds $3,000 and a married couple will face the maximum marginal tax rate once their taxable income exceeds $6,000. In contrast, a single parent in New Jersey will face the lowest marginal rate of 1.4 percent with taxable income under $20,000 and the highest marginal rate of 6.4 percent only on income that exceeds $150,000. Several states provide an annual indexing of tax rates that reflects changes in the Consumer Price Index (Commerce Clearing House 1999).

How Tax Credits Can Encourage Work among the Poor

The plight of many low-income families is one of poverty despite work. Tax credits aimed at the working poor can serve as an additional form of assistance while also promoting incentives consistent with welfare reform goals. These credits are especially beneficial to the poor if they are refundable. Among targeted tax credits, the earned income tax credit (EITC) is the most significant example.

Hailed as the nation's most effective antipoverty program for working families, the EITC may provide the most obvious link between welfare reform goals and the tax system (Johnson 2000). First established in 1975, the federal EITC sought to offset payroll taxes on working poor families and strengthen work incentives. The federal EITC has been expanded several times since its inception, and further expansions have been proposed. State-level EITCs, a mainly post-1990 phenomenon, are currently growing in both size and number. This growth in state EITCs reflects several trends: the recent strong increase in personal tax revenues that has allowed states to cut taxes, the general evolution of state income taxes as stronger promoters of social policies, the philosophy of welfare-to-work created by welfare reform, and the budgetary incentives created by the new TANF block grant program.

The effects of the EITC on work have been debated for various family types with varying incomes. For the single parent with dependents, the EITC provides an unambiguous incentive to enter the labor force in order to receive some of the credit (Ellwood 1999; Meyer and Rosenbaum 1999). Like any transfer program, the EITC increases resources to recipients, making it possible for such families to work fewer hours for the same amount of income, potentially leading to a reduction in labor supply (the "income effect"). However, the EITC also operates with an offsetting "substitution effect" during the phase-in income range of the credit, which encourages people to work more in order to claim a larger credit. In the plateau range, there is

no additional incentive to work; in the phase-out range, there is a disincentive to work as people face increasingly higher marginal tax rates. This latter effect, however, is an inevitable feature of any means-tested transfer program, because targeted transfers require either a gradual phase-out or elimination as income increases, hence increasing marginal tax rates in that income range. Regardless of the work incentive or disincentive, it is clear that this type of policy helps to augment the incomes of the working poor.

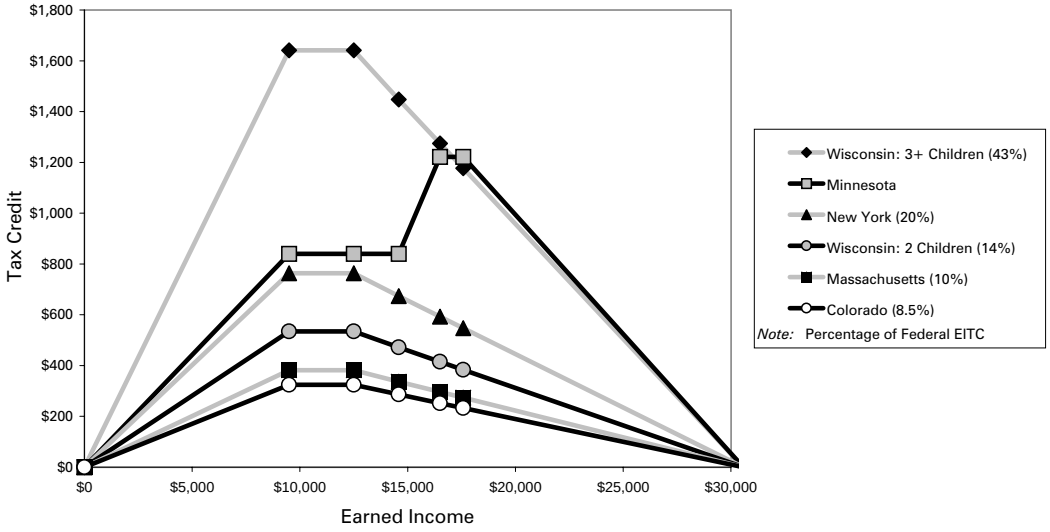
Although the federal EITC is available for all very low income working people, its focus is families with children. In 1999, the maximum credit available to a person with no children and an earned income between $4,500 and $5,700 is $347, while the maximum credit for a family with two children and an income between $9,500 and $12,500 is $3,816. The credit is completely phased out for no-child families once earned income reaches $10,200, but not phased out until income reaches $26,930 and $30,580 for families with one child and two or more children, respectively. Marital status does not determine the amount of credit for which a family is eligible, leading to potential "marriage penalties" or "bonuses" (discussed later).

Five of the *ANF* states had adopted their own EITCs as of 1999; and most are defined as a simple percentage of the federal EITC. That percentage ranges from 8.5 percent of the federal credit for families in Colorado with two or more dependents to 43 percent of the credit for Wisconsin families with three or more children (figure 1). Wisconsin is unique in that it treats families with more than two children differently from families with two children. Like the federal EITC, all the EITCs in the *ANF* states are refundable, although some other states have nonrefundable versions.

Of the *ANF* states, only Minnesota's EITC has an income-related structure different from the federal government. Here the credit plateaus at two income levels. For families with one child, the Minnesota EITC first plateaus when earned income is between $6,680 and $11,850, in which case a $506 credit (or about 22 percent of the federal EITC at those particular income levels) is available. The credit is increased again until the family's earned income reaches $13,200, at which point a credit of $621 (or 28 percent of the federal) is available. This amount is available until a family's income reaches $14,800, after which point the credit is gradually reduced until it is completely phased out at an income level of $26,900. For families with two or more children (figure 1), a Minnesota EITC of $840 (22 to 23 percent of the federal) is available for families with earned income between $9,500 and $14,600, above which the credit increases to $1,222 (or 41 percent of the federal) at an income of $16,500. That credit amount is available until income reaches $17,600, after which the credit declines and is completely phased out once this family's earned income reaches $30,600. As the benefit schedule of the EITC is adjusted, the pattern of effective marginal tax rates and work incentives is also affected, as will be shown later.

Besides the EITC, the federal government and the states have other tax credits based on family composition and targeted to low-income families. As recently as 1998, the federal government implemented both a nonrefundable Child Tax Credit and a refundable Additional Child Tax Credit. The total of these credits cannot be more than $400 for each child and is available to people with incomes higher than those qualifying for the EITC. The Additional Child Tax Credit is available for peo-

Figure 1 *State Earned Income Tax Credit for Families with Two or More Children, 1999*



ple with at least three children, representing increased generosity for families at the same income with more children.

The *ANF* states offer a wide variety of such credits with a correspondingly wide variety of purposes, although all of these other credits are either explicitly or effectively nonrefundable for the poverty-level families on which we focus (as are the federal versions). We will describe them here, but they do not enter our calculations of tax liabilities.

Colorado allows a credit equal to the maximum of $200 for each child or 50 percent of the federal dependent care credit. This credit is effectively nonrefundable for a poverty-level family. In Massachusetts, a head of household with two children can be eligible for the Limited Income Credit, which offsets taxes for people with incomes of less than $28,700. This same credit works to offset taxes for a married couple whose income is less than $32,200. Persons with a greater number of dependents can have a higher income and still be eligible for the credit. New York provides a nonrefundable Household Credit ranging from $30 to $120 for heads of household with two dependents who have incomes below $32,000. The larger credit is available for households with lower incomes. Wisconsin's nonrefundable Working Families Credit, available for the first time in 1998, is for single filers with incomes below $10,000 and joint filers with incomes below $19,000. For a head of household with income of $9,000 or less, tax liability is completely offset. Minnesota offers an additional credit that provides some relief from marriage penalties. It is available to married families in which husband and wife each have at least $14,000 in earned income and for whom joint taxable income exceeds $25,000.

Tax credits based on certain types of expenses also can assist working poor households. Since costs associated with child care can represent a disincentive and barrier to going to work, several states, as well as the federal government, offer some type of child care expense credit. In fact, as of 1999, nearly half of the states and the Dis-

trict of Columbia offered some sort of dependent care credit. States tend to model their dependent care credits on the nonrefundable federal credit, providing a state credit equal to between 10 percent and 50 percent of the federal credit. The nonrefundable versions are generally less targeted to the low-income population and tend to benefit high-income taxpayers nearly as much, or more, in dollar terms. But a few states have refundable versions, and among the *ANF* states, Minnesota and New York offer refundable child care tax credits that are much more targeted and confer the greatest benefits to lower-income families.

All modeling of expenditure-based credits was done at the federal poverty level. Using patterns suggested by the Consumer Expenditure Survey, we assume for illustrative purposes that a single-parent family at this income level spends $2,500 in out-of-pocket child care costs, that is, after any expenditure-side child care subsidies. Preliminary figures from the National Survey of America's Families also support this example: This expenditure level is about the average for single-parent welfare leavers with positive out-of-pocket costs, and most single-parent, low-income families do face these costs.[10] However, it is unclear how much these credits would apply to a married- parent family at such low levels of income. Presumably there is a higher probability that work schedules could be adjusted or that only one parent would be working outside the home. With the need for formal child care outside the home decreased, the probability of benefiting from a child care credit also decreases.

Given $2,500 of child care expenditures per year, table 4 shows that the state child care credits available to our single-parent family are $700 in both Minnesota and New York. In order to highlight the difference in structures for the child care credits, figure 2 shows the values of the federal credit and the three *ANF* state-level credits, as well as the value of the Massachusetts deduction, assuming a single-parent family has the maximum allowable amount of child care expenses. Unlike the federal credit, New York and Minnesota both offer refundable credits, making them much

Figure 2 *Maximum Child Care Credits, 1999*

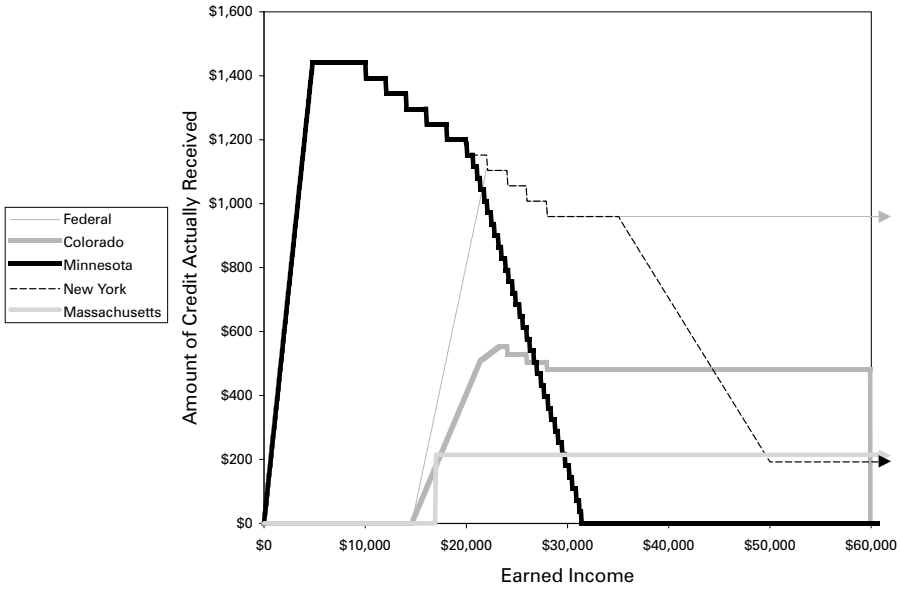


Table 4 *Tax Liability and Credits for a Head of Household with Two Dependents and Earnings at the Federal Poverty Level ($13,423), 1999*

State	Tax Liability before Any Credits ($)	Tax Liability after EITCs ($)	Tax Liability after Additional Credits for Child Care ($)	Other Credits Based on Family Size and Income (Not EITCs)	Child Care Credits
Alabama	351	351	351		
California	0	0	0		
Colorado	0	*–307*	–307	*Child Tax Credit*[b]	*Child Care Credit*[b]
Massachusetts	0	*–361*	–361	Limited Income Credit	Dependent Care Deduction
Michigan	181	181	181		
Minnesota	0	*–840*	–1,540[a]		*Dependent Care Credit ($700)* *Education Credit ($2,000)*
Mississippi	0	0	0		
New Jersey	132	132	132		
New York	37	*–686*	–1,386	Household Credit ($37)	*Dependent Care Credit ($700)*
Wisconsin	272	*–234*	–234	Working Families Credit	
Federal	0	*–3,613*	–3,613	Child Tax Credit	Dependent Care Credit

Notes: Italics indicate credit is refundable.

a. Does not include Education Credit, worth up to $2,000 per year for this family.

b. Receive greater of Child Tax Credit or Dependent Care Credit, but refundable only to the extent that federal income tax liability is offset. Because this family pays no federal income taxes, the credit is worth nothing to them.

more valuable to low-income earners. Because there is no tax liability to offset in the other states, the credit or deduction is worth zero to our typical single-parent family.

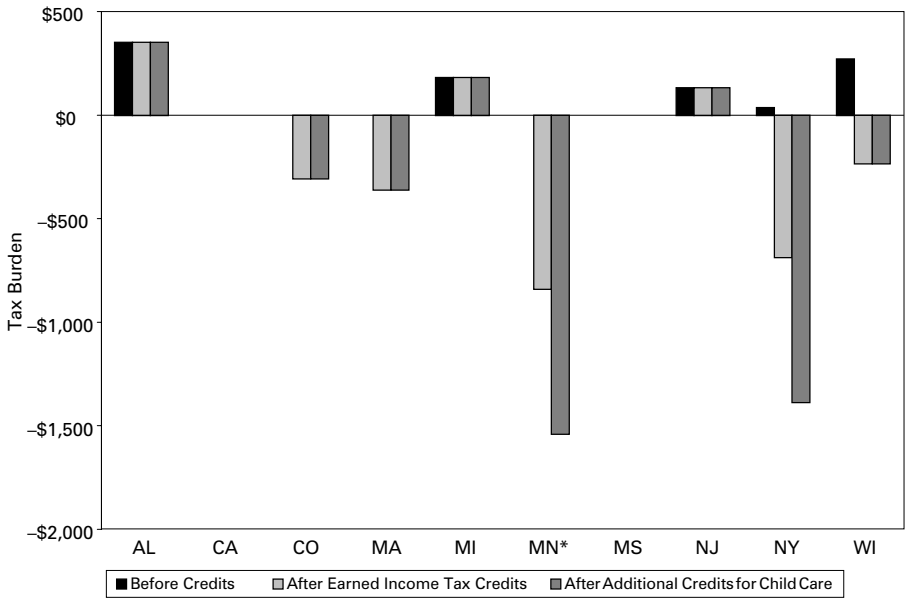
Minnesota offers an additional credit to assist families with school-age children, a refundable credit worth up to $1,000 per child (for up to two children) to offset education-related expenses. These expenses can range from school supplies to private music lessons taught by a qualified teacher.

Contributions of various elements of the 1999 personal income tax systems toward total tax liability are also illustrated in table 4. Absent the calculation of credits, the single-parent family faces a positive tax liability in five of the *ANF* states. However, including earned income and child care credits results in a negative income tax liability in five states.

Since our typical married-parent family would be eligible for earned income tax credits, the same basic patterns hold true for them, but are not shown. What may be different is that married families are less likely to benefit from the child care credits in Minnesota and New York, simply because they are less likely to have child care expenses (at poverty-level incomes).

Figure 3 illustrates state income tax burdens facing our typical single-parent, poverty-level family in the 10 *ANF* states that have income tax systems. The different bars indicate the "layers" of the tax structures that affect these burdens: taxes before any credits (but after exemptions and standard deductions), taxes after cred-

Figure 3 *Income Tax Burdens on Poverty-Level Families in* ANF *States (Head of Household with Two Dependents), 1999*



Notes: Values for child care credits assume $2,500 in annual expenses. Does not include housing-related credits.
* Excludes education credit (worth up to $2,000 per family).

its based on family size and income (this is solely the EITC for this family), and taxes after accounting for additional credits related to child care expenses.

The difference in tax liabilities across states is quite substantial—from a high of $351 in Alabama to a low of –$1,540 in Minnesota for single-parent families, especially considering the total earned income for the single-parent family is $13,423! (The across-state pattern for our married-parent family is very similar; burdens range from a high of $416 in Alabama to a low of –$1,222 in Minnesota.) The effect of tax credits is most dramatic in the federal tax system, where instead of having no tax liability, the single-parent family actually receives a refund of $3,613 and the married-parent family receives a refund of $2,882 due to the refundable EITC. Note that the difference in credit sizes between our single and married families is entirely a function of earnings, not filing status. This comparison underscores the need to include multiple facets of the tax system when studying low-income families.

Credits Related to Other Types of Taxes Administered through the Personal Income Tax System

It is quite common for the states to administer tax credits that are intended to offset other types of taxes. For individuals, the most common are credits aimed at offsetting property and sales taxes.

For property tax credits, we assume our typical families are renters, not homeowners. Because we do not assign them property tax burdens, we show the dollar value of property tax credits in this section but do not integrate these figures into the

Table 5 *State Tax Credits That Offset Taxes Other Than Income Taxes through the Income Tax System, 1999*

State	Name of Credit	Available Credit ($): Single Parent—Poverty-Level Income ($13,423)	Available Credit ($): Married Parent—Poverty-Level Income ($16,895)
California	Renter's	120	120
Colorado	Sales Tax Rebate	*159*	*318*
Michigan	Property Tax	*121*	*152*
Minnesota	Property Tax	*171*	*171*
New York	Property Tax	*50*	*43*
Wisconsin	Homestead	*439*	*114*

Note: Italics indicate credit is refundable.

calculation of overall state tax burdens shown later in the paper. Given that renter credits are designed to offset a renter's share of property tax burdens, the net bias in our absolute tax burdens should be close to zero in states with these credits. However, to the extent that property taxes burden renters—which many economists assume is close to zero—our characterization of relative burdens across states tends to understate the burdens in states without renter credits.

Of the *ANF* states, five offer property tax rebates and one offers a sales tax rebate through the personal income tax system, shown in table 5. Generally, property tax credits are available to both homeowners and renters, based on the assumption that at least part of the property tax is shifted forward to tenants in the form of higher rent. In California, the credit is available only to renters.

In order to compute the dollar value of the housing-related credits, we assume that our typical families spend $4,500 per year in rent, again based on expenditure patterns found on the Consumer Expenditure Survey. Sales tax rebates, in contrast, do not depend on actual expenditures (even though sales taxes themselves obviously do), because these rebates are typically based on filing status, family size, and / or income level. (In Colorado, the rebate depends on filing status and income only.)

Property tax credits for the poverty-level, single-parent family in the *ANF* states range in generosity from California's $120 credit, which is nonrefundable and hence does not benefit our poverty-level family, to a $439 refundable credit in Wisconsin. For the married-parent family, California's nonrefundable credit is still worth zero, and the most generous is Minnesota's $171 refundable credit. Colorado's sales tax rebate will be discussed further in the sales tax section, later in this paper.

Changing Income Tax Liability As Income Increases

As income increases, tax liabilities increase. However, changes in liability relative to a given change in income, or the effective marginal tax rate, depend on the starting income levels and reflect a combination of statutory marginal tax rates and the phase-ins or phase-outs of certain tax features. Tables 6 and 7 illustrate the variety of effective marginal tax rates affecting low-income families, showing the change in state and federal tax liabilities as income increases over ranges related to the poverty

Table 6 *Changes in Personal Income Tax Liability with Income Movement (Accounting for Credits Based on Family Size and Income) for a Single-Parent, Two-Child Family, 1999*

	Earned Income					
	50% to 100% of FPL		100% to 150% of FPL		150% to 200% of FPL	
	($6,712–$13,423)		($13,423–$20,135)		($20,135–$26,846)	
States	Tax Increase ($)	Marginal Tax Rate (%)	Tax Increase ($)	Marginal Tax Rate (%)	Tax Increase ($)	Marginal Tax Rate (%)
Alabama	290	4.3	294	4.4	285	4.2
California	0	0	0	0	0	0
Colorado	–79	–1.2	183	2.7	439	6.5
Florida			*No Personal Income Tax*			
Massachusetts	–92	–1.4	141	2.1	141	2.1
Michigan	181	2.7	296	4.4	295	4.4
Minnesota	–249	–3.7	163	2.4	999	14.9
Mississippi	0	0	179	2.7	293	4.4
New Jersey	132	2.0	94	1.4	104	1.5
New York	–149	–2.2	551	8.2	569	8.5
Texas			*No Personal Income Tax*			
Washington			*No Personal Income Tax*			
Wisconsin	142	2.1	725	10.8	741	11.0
Federal	–928	–13.8	1,413	21.1	2,251	33.5

level. Knowledge of how tax liability changes as income increases aids our understanding of how tax systems reward or penalize work—ultimately supporting or potentially undermining the current goals of welfare reform.

In computing effective marginal tax rates, we account for exemption levels, statutory rate structures, and credits based on family size and / or income (EITCs). We do not account for child care credits; to do so would require making assumptions about how child care expenses change as income changes, or holding them constant.

Table 6 shows that as a single parent with two children moves from 50 to 100 percent of the FPL, income tax liability decreases in four states and the federal government, increases in four states, and remains unchanged at zero in two states. The change in state income tax liability varies greatly, from a decrease of $249 (–3.7 percent of the $6,711 income change) in Minnesota to an increase of $290 (+4.3 percent) in Alabama. Federal liabilities fall by $928, or a –13.8 percent change in taxes relative to the change in income. All of the negative effective marginal tax rates in this income range are the result of EITC phase-ins; the value of the credit is increased in this interval (figure 1), and in all of the EITC states except for Wisconsin, the increase in the dollar value of the credit outweighs any increase in tax liabilities before credits.

Table 7 *Changes in Personal Income Tax Liability with Income Movement (Accounting for Credits Based on Family Size and Income) for a Married-Parent, Two-Child Family, 1999*

	Earned Income					
	50% to 100% of FPL		100% to 150% of FPL		150% to 200% of FPL	
	($8,430–$16,895)		($16,895–$25,343)		($25,343–$33,790)	
States	Tax Increase ($)	Marginal Tax Rate (%)	Tax Increase ($)	Marginal Tax Rate (%)	Tax Increase ($)	Marginal Tax Rate (%)
Alabama	308	3.7	338	4.0	359	4.3
California	0	0	0	0	0	0
Colorado	44	0.5	290	3.5	496	5.9
Florida	*No Personal Income Tax*					
Massachusetts	52	0.6	178	2.1	1,407	16.7
Michigan	211	2.5	372	4.4	371	4.4
Minnesota	–475	–5.7	1,222	14.5	857	10.2
Mississippi	0	0	260	3.1	400	4.8
New Jersey	167	2.0	119	1.4	148	1.8
New York	179	2.1	693	8.2	573	6.8
Texas	*No Personal Income Tax*					
Washington	*No Personal Income Tax*					
Wisconsin	73	0.9	1,229	14.6	838	10.0
Federal	515	6.1	1,850	22.0	2,371	28.2

Once a family moves from 100 to 150 percent of the FPL, tax liabilities increase in all cases except for California, where liability remains at zero. The state tax increases range from $94 (+1.4 percent) in New Jersey to $725 (+10.8 percent) in Wisconsin. Federal taxes increase the greatest amount, $1,413, representing a marginal increase of over 21 percent. Over this income interval, EITCs are reduced in all cases except for Minnesota, which explains why the effective marginal tax rate in this range jumps to over 8 percent in New York and over 10 percent in Wisconsin (where EITCs are rather generous but imply steeper phase-outs), but remains around 2 percent in Minnesota. Of course, the federal EITC is still more generous than any of the state EITCs, resulting in the highest marginal tax rate over this income interval (21 percent). Unlike the previous interval (50 to 100 percent of poverty), however, now nearly all of the marginal tax rates reflect the move from the exempt ranges of income into the taxable ranges. (California is the only case where the family is still exempt at 150 percent of poverty.)

The final column in table 6 shows the movement from 150 to 200 percent of the FPL. Again, all tax changes are positive except for California, with increases ranging from $104 in New Jersey (+1.5 percent) to $999 in Minnesota (+14.9 percent). The federal change is $2,251, or +33.5 percent. Note that the relatively high tax changes and associated marginal rates over this income interval largely reflect continuing EITC phase-outs; the highest are those of the federal government and three of the

ANF states with EITCs. Minnesota's effective marginal tax rate is much larger over this interval (at nearly 15 percent), both relative to other intervals and relative to the other EITC states, because this is the first interval over which Minnesota's EITC starts to fall, and from a steeper (and second) plateau (figure 1).

Table 7 shows the changes in personal income tax liability for a married-parent family with two children; these differ from the pattern observed for single-parent families approaching their (lower) poverty level of income. Because the EITCs represented by the federal government and the *ANF* states rely only on income and not on marriage status, a family of four moving from 50 to 100 percent of the FPL loses some EITC benefits. This family therefore pays more in taxes and has positive marginal tax rates in all cases except Minnesota, where the EITC increases in value as it reaches its second plateau. All other increases in income result in higher tax liabilities in every state. Again, as the EITCs phase out, a family faces quite high marginal tax rates. The other significant difference for married-parent families in Massachusetts is the high increase in taxes moving from 150 to 200 percent of the FPL, caused by the phase-out of the Limited Income Credit.

These effective marginal tax rate calculations consider the state- and federal-level changes separately. But we must recognize that for an actual family in a particular state, the relevant marginal tax rates they face are (at least) the sum of their state effective rate plus the federal effective rate. Thus, for example, for the single-parent family moving from 100 to 150 percent of the poverty level (table 6), the combined effective marginal tax rate for a Minnesota family is 2.4 plus 21.1 percent, or 23.5 percent. In other words, as this family's gross earned income increases over this range, its net (after-tax) income increases by only about 76 percent of that, because nearly 24 percent of the higher gross earnings goes toward higher tax liability. An equivalent family in Wisconsin faces a much higher combined marginal rate of 10.8 plus 21.1 percent, or 31.9 percent. The Minnesota family, however, faces a still higher combined effective marginal tax rate at the next income interval (48.4 versus 44.5 percent for the Wisconsin family), by which time the second plateau of the Minnesota EITC phases out and nearly half the increase in gross earnings is lost in additional taxes.

It is clear that while more generous EITCs provide greater assistance to low-income working families, allowing net subsidies from the tax system at low income levels, they also significantly increase effective marginal tax rates at higher income levels where they must eventually be phased out. That is an unavoidable trade-off: a more generous credit means more has to be taken away. The common "piggybacking" of state EITCs onto the federal EITC makes it easy for states to pitch in an extra share of the federally structured assistance but also implies that the state EITCs typically exacerbate the high marginal tax rates already generated by the federal EITC alone. Moreover, these marginal tax rate calculations do not include the effects of refundable child care tax credits, many of which have phase-out ranges similar to the EITCs. Along with many expenditure-side subsidy programs that may phase out over similar income intervals, these numbers suggest that families trying to "move out" of poverty may move through lots of forms of assistance, but also extremely high effective tax rates, on those journeys.

Relative Income Analysis

The previous calculations fix our typical families' income at the federal poverty level (or multiples of that level) and apply the tax laws of different states to that income. Because poverty rates and the distributions of income, and hence the share of the population to which these examples apply, vary widely across the states, we provide an alternative comparison that computes tax liability for these families at a given percentile of (taxable) incomes in each state.

Among single-parent families, we focus on median family taxable incomes (50th percentile),[11] because the nationwide median is close to the FPL. Table 8 shows these 1996 median incomes as reported by the National Survey of America's Families (NSAF) (based on distributions that include households with no earned income), along with the state and federal tax liabilities and average tax rates such families would face.[12] When inflated to 1999 dollars, median income ranges from a low of $6,700 in Mississippi to a high of $16,500 in Colorado. State income tax liabilities and effective tax rates vary significantly (from credits of over $900 to liabilities of $160), but these differences are muted tremendously by the generosity of the federal EITC once federal taxes are added. State tax liability ranges from –8 percent in New York to 1.6 percent in Alabama, but when federal taxes are included, the overall income tax rate is always negative and varies from a low of –48 percent in New York (where state refundable credits are generous and median income is very low) to a high of –16 percent in Colorado (where the state EITC is fairly small and median income is very high).

Table 8 *Median Taxable Income[a] among Single-Parent Families and Taxes at Median Income, Accounting for Credits Based on Family Size and Income*

State	Median Taxable Income (1999)[b] ($)	Federal Tax Liability ($)	State Income Tax Liability ($)	Effective State Income Tax Rate (%)	Effective Total (State + Federal) Income Tax Rate (%)
Alabama	9,260	–3,704	150	1.6	–38.4
California	9,260	–3,704	0	0.0	–40.0
Colorado	16,460	–2,871	–236	–1.4	–16.0
Massachusetts	11,310	–3,756	–376	–3.3	–36.5
Michigan	12,030	–3,756	120	1.0	–30.2
Minnesota	14,610	–3,261	–958[c]	–6.6	–28.9
Mississippi	6,690	–2,676	0	0.0	–40.0
New Jersey	15,430	–3,088	160	1.0	–19.0
New York	8,230	–3,292	–658	–8.0	–48.0
Wisconsin	11,310	–3,756	–381	–3.4	–36.6

a. 50 percent of persons live in households at or below this income.
b. Based on data from the National Survey of America's Families, November 1997.
c. Does not include Education Credit.

For married-parent families, we compare tax treatment of families at the 15th percentile of taxable income in each *ANF* state, again because this point in the nationwide distribution is close to the FPL for this family type. Table 9 shows that the tax treatment of married-parent families near the 15th percentile of income in each of the states varies quite widely. While the federal EITC is available to families with earnings at this level in all of the states studied, married-parent families in Min-

Table 9 *Tax Treatment of Married-Parent Families at the 15th Percentile of Taxable Income,[a] Accounting for Credits Based on Family Size and Income*

State	15th Percentile Taxable Income (1999)[b] ($)	Federal Tax Liability ($)	State Income Tax Liability ($)	Effective State Income Tax Rate (%)	Effective Total (State + Federal) Income Tax Rate (%)
Alabama	13,540	–3,589	282	2.1	–24.4
California	11,490	–3,816	0	0.0	–33.2
Colorado	19,990	–2,230	–305	–1.5	–12.7
Massachusetts	23,960	–1,394	–139	–0.6	–6.4
Michigan	23,330	–1,527	494	2.1	–4.4
Minnesota	26,250	–704	35[c]	0.1	–2.5
Mississippi	11,090	–3,816	0	0.0	–34.4
New Jersey	21,870	–1,834	236	1.1	–7.3
New York	12,500	–3,808	–762	–6.1	–36.6
Wisconsin	26,040	–780	901	3.5	0.5

a. 15 percent of persons live in married-parent households at or below this income.
b. Based on data from the National Survey of America's Families, November 1997.
c. Does not include Education Credit.

nesota and Wisconsin are well into the phase-out portion of the credit. This situation, along with the highest statutory marginal tax rate and the absence of other credits, means that families in Wisconsin at the 15th percentile are actually paying over $900 in state income taxes and on net over $100 when federal personal income taxes are added. In all of the other states studied, the refund from the federal EITC overwhelms any state tax liability, so families receive, on net, an income tax refund.

State Sales and Excise Taxes

For most states, and for all *ANF* states, the general retail sales tax is the largest consumption-based tax since there is no federal retail sales tax. These sales taxes apply broadly to tangible retail goods purchases, although many states exempt particular goods that are considered "necessities"—goods that make up larger percentages of lower-income household budgets—in attempts to reduce the regressivity of the tax. Food is the good most often exempted, but some states exempt clothing or other goods (such as medicines) as well.

Sales tax rates and exemptions for food and clothing for the 13 *ANF* states are shown in table 10. We estimate state-level sales taxes by applying each state's sales tax rate to a "tangible goods" definition of its taxable sales base, and we impute local-level sales taxes based on the aggregate of local-level sales tax revenues relative to state-level sales tax revenues.[13] In contrast to local-level income taxes, which are generally modest and vary little across states, the state-local mix of sales taxes varies widely, making it more important to account for them.

State-level sales tax rates among *ANF* states range from 3 percent in Colorado to 7 percent in Mississippi. Among these states, all except Alabama and Mississippi exempt food, while only Massachusetts, Minnesota, and New Jersey exempt clothing (as of 1999). These rates and exemptions are then applied to a single-parent, two-child family at the poverty level, based on some assumptions about typical expenditure levels from Consumer Expenditure Survey data. We assume this family does not

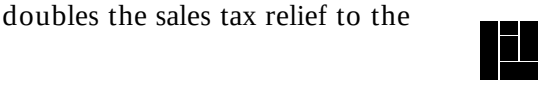
Table 10 *Sales and Income Tax Burdens in the 13* ANF *States, for a Single Parent with Two Children and Earnings at the Federal Poverty Level ($13,423), 1999*

State	Tax Rate (%)	Food Exempt?	Clothing Exempt?	State Sales Taxes* ($)	State and Local Sales Taxes ($)	Total Sales and Income Tax Liability ($)
Alabama	4.0	no	no	470	784	1,135
California	6.0	yes	no	515	632	632
Colorado	3.0	yes	no	258	509	43
Florida	6.0	yes	no	515	531	531
Massachusetts	5.0	yes	yes*	358	358	–3
Michigan	6.0	yes	no	515	515	696
Minnesota	6.5	yes	yes*	465	469	–1,071
Mississippi	7.0	no	no	823	823	823
New Jersey	6.0	yes	yes*	429	429	561
New York	4.0	yes	no*	343	648	–738
Texas	6.25	yes	no	537	653	653
Washington	6.5	yes	no	558	654	654
Wisconsin	5.0	yes	no	429	452	218

**Notes:* Example assumes total tangible goods purchases of $11,500, food-at-home purchases of $3,100, and clothing purchases of $1,400, based on Consumer Expenditure Survey data for three-person households in the $10,000 to $15,000 before-tax income range. Special rules for clothing exemptions: Massachusetts exempts clothing up to $175 sale price; Minnesota doesn't exempt athletic clothing, furs, or jewelry; New Jersey doesn't exempt furs; and New York instituted a partial clothing exemption effective March 1, 2000 (not shown here). The Colorado state sales tax does not include the $159 rebate (after the rebate the taxes are $99 and $350 for state and state plus local, respectively), but the rebate *is* counted in the sales and income tax column.

use food stamps, so that their food purchases are fully taxable in states without a food exemption.[14] Table 10 also shows estimated sales tax liabilities. Looking at state-level sales taxes only, Colorado and New York have relatively low sales taxes ($258 before rebate and $343, respectively), but after accounting for local-level taxes, their sales tax burdens look much higher ($509 and $648). After the Colorado sales tax rebate of $159, however, the state-plus-local burden falls to $350.[15] Overall, state-plus-local sales tax burdens, before rebates, range from $358 in Massachusetts to $823 in Mississippi. States with relatively low sales tax burdens tend to exempt food and have little reliance on local-level sales taxes. Caution about cross-state comparisons is necessary, however, since we are assuming the same levels of expenditures (as well as income) across states where the costs of taxable goods can be quite different.[16]

Sales tax burdens for a poverty-level, married-parent family are very similar to those shown for the single-parent family because sales tax liabilities depend on expenditures and only indirectly—not statutorily—on family size or marital status. Because taxable expenditures for the four-person married-parent household would be about 10 to 15 percent higher than those for the three-person single-parent household (based on our examination of patterns in the Consumer Expenditure Survey), sales tax burdens would generally be about 10 to 15 percent higher as well. One exception to this simple scaling up of burdens is in Colorado, where the sales tax rebate is doubled for joint filers. Because the rebate for married filers is $318 in 1999, or double the $159 rebate available to single or head-of-household filers, the net-of-rebate, state-plus-local sales tax burden for our Colorado married-parent family is only $245, which is actually lower in absolute dollars than the ($350) burden for our single-parent family. In other words, the Colorado rebate doubles the sales tax relief to the



married family, even though their taxable expenditures, and hence actual sales taxes paid, are far less than double those of the single-parent family.

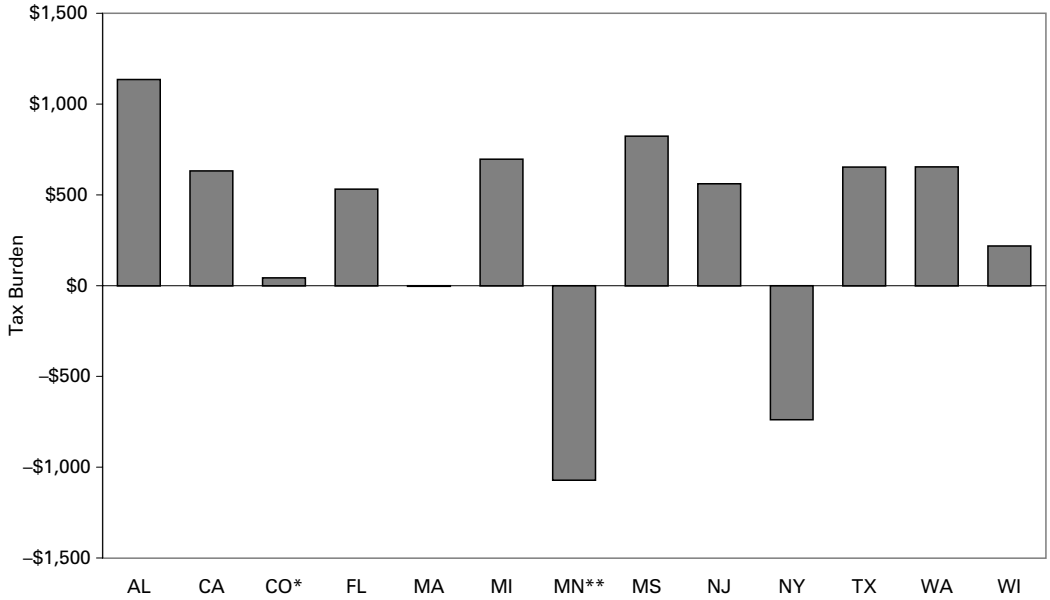
Some states have chosen to exempt particular goods, or provide tax "holidays" on the sales of certain goods, in order to lessen the regressivity of sales taxes. This strategy has limitations, as exemptions help families with higher incomes as well.[17] The strategy is further disadvantaged if states make up for a narrower base by raising the overall sales tax rate; a more progressive revenue-neutral policy would raise income tax rates instead. Some states try to tailor exemptions to avoid giving breaks for luxury purchases (for example, furs are still taxable in Minnesota and New Jersey, and only clothing items below $175 are exempt in Massachusetts) but without tying the relief to actual income, targeting low-income people is unavoidably difficult. Sales tax rebates are an ex post facto form of relief that cannot be literally tied to retail sales transactions. They are often administered through the personal income tax form—as in Colorado—and thus tend to resemble nontargeted, refundable income tax credits. Of the *ANF* states, Colorado is the only state with a sales tax rebate for 1999 sales taxes, although Minnesota rebated part of 1997 sales taxes in the summer of 1999 and Wisconsin rebated part of 1998 sales taxes in 1999–2000.

In addition to general sales taxes, states impose excise taxes on specific goods as well, which we do not include in our burden calculations. These taxes tend to be "per unit" taxes (instead of ad valorem, or percentage of value) and primarily apply to alcohol, tobacco, and motor fuel.[18] These taxes are often socially motivated—the consumption of such goods can generate negative externalities—but the downside is that they are highly regressive, both because expenditures on these goods are a larger share of income for low-income families and because these taxes are per-unit taxes, costing higher-income households that tend to purchase more expensive versions of these goods proportionately less. Generally, states without income taxes tend to rely more on excise taxes than do other states. Among the *ANF* states, however, Mississippi and Alabama obtain relatively large shares of their tax revenue from excise taxes (around 20 to 25 percent, compared with a nationwide share of about 15 percent) despite levying income taxes. Texas gets a large share of tax revenue from excise taxes (about 30 percent) and, compared with other states, its mix of excise taxes includes more of the "other" selective sales taxes, such as taxes on vehicle sales and rentals, rather than the more common excise taxes (on alcohol, tobacco, and motor fuel). Thus, our across-state comparison of state income-plus-sales-tax burdens will tend to understate the overall tax burdens for these states with greater reliance on excise taxes.

Overall State Sales and Income Tax Burdens

The last column of table 10 shows the total sales and income tax liability of the typical single-parent welfare leaver family, where the income tax calculations include the effects of the EITCs and refundable child care credits. Figure 4 illustrates that, ultimately, if we include our estimates of sales taxes and the various credits discussed previously, our typical welfare leaver would face the highest tax burdens in Alabama ($1,135) and Mississippi ($823) and the lowest in Minnesota and New York, with net subsidies of $1,071 and $738, respectively. Typically we observe state income-plus-sales-tax burdens of between $500 and $700 for this family where positive tax

Figure 4 *Total Sales and Income Tax Burdens on Poverty-Level Families in* ANF *States (Head of Household with Two Dependents), 1999*



*Includes effect of sales tax rebate.
**Excludes Education Credit (worth up to $2,000 per family).

burdens exist. This family would have a negative tax liability in three of the *ANF* states.

Although we do not present these figures, overall sales-plus-income-tax liabilities for the married-parent, poverty-level family follow a similar pattern. Alabama and Mississippi impose the highest burdens ($1,283 and $647, respectively), while Minnesota continues to provide the most generous tax credits (with a net subsidy of $697). But without counting child care credits in the taxes of our married-parent family, New York is no longer the second most generous; Colorado, Wisconsin, and Massachusetts show lower overall burdens, mainly because New York has higher sales taxes.[19] In the married-parent case, Minnesota is the only state with a negative net burden from sales and income taxes combined. Among the rest of the states, the positive net burdens tend to cluster at $600 to $800 (similar to the $500 to $700 range for singles).

Computing the influence of credits and sales taxes provides a very different picture of the tax systems in the *ANF* states than does an analysis that does not account for these features. Of course, additional layers of the tax system could be added to provide an even more complete view of taxes for low-income families, such as any personal property taxes, excise taxes, and various business taxes that might ultimately burden these families. For example, an accounting for property taxes, if at least part of the burden is assumed to fall on renters, would make New York look relatively more burdensome and Alabama and Mississippi relatively less burdensome. But accounting for excise taxes would tend to make Alabama and Mississippi, as well as the states without income taxes (Florida, Texas, and Washington), look relatively more burdensome.

Those neglected elements aside, the qualitative, major structural features of the various state income and sales tax systems can explain a lot of the differences in overall tax burdens on low-income families in the *ANF* states. The highest burdens are in states with food taxes, coupled with income taxes that lack refundable credits. States that do not tax income (Florida, Texas, and Washington) are not necessarily imposing the highest sales-plus-income-tax burdens on low-income families, because they exempt food from their sales taxes. Without income taxes, however, and with food already exempt, additional assistance to low-income families in these states is difficult because they lack the income tax mechanism for refundable credits. Additionally, accounting for excise tax burdens would likely make these no-income-tax states look significantly more burdensome. The lowest tax burdens are found in states that provide not only refundable EITCs but also refundable child care credits (Minnesota and New York).

Policy Implications: What Are States' Options for Further Low-Income Tax Relief, and What Are the Trade-Offs?

States vary considerably in how their tax systems treat low-income families. Most states with income taxes exempt the poorest families from their income tax rolls, so that only the other state tax components, most prominently sales taxes, affect these families. In some states, however, the presence of refundable income tax credits brings low-income families into the income tax system as they file to claim these subsidies, and such tax subsidies are substantial relative to the size of other government transfers they might receive, as well as relative to their earned incomes. In the wake of welfare reform, some states have chosen to modify the way their tax systems affect the well-being of lower-income people. These choices seem to depend on their starting points, that is, the existing tax systems, as well as on their policy goal(s) in terms of how they wish tax policy to supplement or substitute for the expenditure-side policy changes related to welfare reform.

Why the Starting Point Matters

How states can modify their tax policies to increase assistance to low-income families depends considerably on their existing tax structure. We showed earlier (table 2) that the mix of taxes varies greatly across states. Some states rely heavily on income taxes, while others have no income tax at all. In addition, state income taxes vary in progressivity and complexity. Some states have very flat rate structures and very broad measures of taxable income, while others have more graduated rate structures and greater tailoring of tax burdens through certain types of itemized deductions and special credits or exemptions.

States without income taxes (such as Florida, Texas, and Washington, among the *ANF* states) are severely limited in how much they can help low-income families via the tax system; they are "doomed" to have regressive taxes. Sales taxes are a form of

consumption-based taxation, and consumption uses up a larger share of income for lower-income families than for higher-income families. Thus, a tax on consumption imposes burdens that are relatively larger (as a percentage of income) for lower-income families. While this regressivity of sales taxes can be offset somewhat by exempting necessity goods, such as food and clothing, the effectiveness of that strategy is severely limited given that it exempts those purchases for all, including very rich, families. (Exempting necessity consumption is not as targeted as exempting low income.) Moreover, without an existing income tax, states likely face much higher administrative costs in setting up sales tax rebates related to family circumstances (such as marital status, family size, and income). States with income tax have the option of adding the rebate as a line on the personal income tax form, or even as a smaller form modeled on the existing form.

States with very simple income tax structures (that rely little on the complex federal personal income tax structure) may be more averse to targeted credits and special exemptions and deductions that further complicate the tax system and may encourage even more special provisions, a so-called "slippery slope."[20] While these complexities in the personal tax system are often intended to better "personalize" tax burdens to individuals' abilities to pay, they can also encourage certain activities over others, causing the tax system to become more distortionary and hence inefficient.[21] Therefore, states preferring to avoid complex systems of exemptions, deductions, and credits are more likely to consider additional "tax relief" (further exempting low-income families from taxes) rather than new "tax subsidies" (that would on net give funds to low-income families). Holding constant the desired degree of income redistribution, these states might also prefer to subsidize low-income families through more traditional, expenditure-side programs, rather than through the tax system. However, some evidence suggests that these states are generally less likely to undertake redistributive policy, whether done on the expenditure *or* tax side of the budget (Rogers and Weil 2000).

At the opposite extreme are states that already include targeted, refundable tax credits in their personal income tax systems (such as Colorado, Massachusetts, Minnesota, New York, and Wisconsin, among the *ANF* states). For these states, it is fairly easy—both politically and administratively—to simply increase the generosity of those credits. States that piggyback on the federal definition of the EITC, for example, can increase generosity by simply changing the percentage, as seen recently in New York. (The potential downside for low-income families is that it also may be relatively easy for these states to decrease the credits when budgets get tighter—an advantage for state budget administrators—instead of cutting expenditure-side programs.)

The new TANF rules allow states to count refundable tax credits like other forms of spending on low-income families. Through the recent combination of a strong economy and welfare reform, most states have experienced rapidly declining caseloads and subsequent surpluses of TANF funds. Thus, many states are looking for ways to spend TANF dollars, and targeted tax credits provide a relatively easy and attractive way to accomplish this.[22] Yet, while these rules give states greater incentives to create new refundable tax credits where none exist, they also may create some perverse incentives.

For one thing, the new rules count only spending on the *refundable* portions of *refundable* tax credits toward maintenance of effort (MOE) or as a qualified use of TANF funds. Thus, for states to take advantage of using welfare funds to pay for refundable portions of EITCs, their income tax structures must put low-income families in the zero tax category. This means that, ironically, states already taxing low-income families may have less incentive to institute an EITC than states where such families are currently exempt.

Secondly, the TANF regulations do not require that tax credits be "new" spending in order to qualify for the federal grant money. Thus, states funding preexisting EITCs with general revenues may face a new incentive to pay for EITCs with TANF money and free up general revenues for other tax decreases (including taxes on higher-income families or businesses). Among the *ANF* states, there are complaints of such "supplantation" in EITC funding in New York and Wisconsin (National Campaign for Jobs and Income 2000).

Possible Goals and Trade-Offs

In designing the optimal tax treatment of low-income families, states need to consider their own policy goals, the trade-offs involved in pursuing one type of goal over another, and the potential interactions of their proposed tax policies with both expenditure-side programs and federal-level tax policies already in place. In their 1996 book, *State Tax Relief for the Poor,* Steven Gold and David Liebschutz discuss many of these issues.

For example, if the policy goal is to relieve tax burdens on low-income families, increases in exemption levels are effective, more so than overall rate reductions that confer the greatest benefit to upper-bracket, higher-income taxpayers. States without income taxes can consider sales tax exemptions for necessity goods wherever they do not already exist, although a smaller tax base will require a higher overall tax rate for revenue neutrality. Sales tax rebates are another option, although for states without personal income taxes these may be more costly to administer.

If the goal is to go beyond tax relief for low-income families and to provide net subsidies to these families via the tax system, states need to grant refundable credits. What activities these refundable credits should be tied to depends on what the states desire in terms of incentive effects and the distribution of assistance.

If the goal is to encourage work among the low-income population, states can provide an EITC or other credits conditioned on work-related activities. But as discussed earlier, the incentive effect unambiguously encourages work only for people who are not currently working yet could move into the phase-in area of the credit. Once a person is already working, the increase in real income due to the EITC can reduce the desire to work by allowing fewer work hours for the same income. Moreover, in the phase-*out* range of the credit, the substitution effect discourages work as well, because additional earnings reduce the EITC benefit. Thus, the EITC potentially discourages work more than higher exemption levels (which have an income effect that decreases work, but not the substitution effect). On the other hand, little is known about how many low-income people face decisions in the phase-out range of the EITC, or how responsive they might be to the high effective marginal tax rates

found there (and demonstrated earlier), particularly when EITCs are typically received annually, not monthly.[23] It also might be true that the EITC encourages work in ways that economists do not consider. For example, the EITC may serve as some signal of "social norms," encouraging work by conveying what society views as "worthiness."

One way of decreasing the disincentives associated with EITC phase-outs is to lengthen the phase-out range, reducing the effective marginal tax rate over that range. But a slower phase-out extends EITC benefits to a larger group of people, and states have to evaluate whether reducing adverse incentives in the phase-out range justifies the necessary reduction in per-beneficiary benefit levels. As always, there is an unavoidable connection between increased generosity of means-tested benefits and greater work disincentive effects, and the state tax credits just "pile on" to the trade-off already faced in the federal EITC. If a state extends its EITC phase-out range beyond that of the federal, it also faces the more practical administrative problem of having to offer the state credit to people who are ineligible for the federal credit. Another strategy is to stagger phase-outs over different ranges of income, which is what Minnesota tried to do by offsetting the early portion of the federal phase-out with an extra plateau of its own EITC. As shown earlier, that approach only postpones an inevitably higher marginal tax rate (toward the higher end of the federal phase-out), although it may help smooth out the effective marginal tax rate schedule so that bad "spikes" do not occur at certain income levels. Ex post facto EITCs, such as Colorado's initially "intermittent" EITC, remove all disincentive effects but also remove all incentive effects! (When EITCs are based on decisions *already* made, and when the policy is *unanticipated*, they cannot affect those decisions.)

If the goal is to target benefits to the most vulnerable of the low-income population, then states should consider that work-related credits like the EITC do not help the nonworking poor. For those who have not been fortunate to find work upon leaving welfare, child credits (dependent only on family size and not income or spending for child care) are preferable to credits requiring work. Again, however, there are trade-offs with incentive effects: If a person can get a generous refundable credit without working, will that discourage work?

State policymakers concerned about family structure should consider the potential effects of the EITC on marriage and child care arrangements. Because the EITC is based only on earned income and number of children, it can disqualify a couple who separately have a qualifying level of income but together earn too much. On the other hand, the EITC provides a "marriage bonus" to a currently unemployed single parent if that parent marries a person with earned income and thus becomes newly eligible. State versions of the EITC could be tailored to relieve some of these marriage biases, if desired. Additionally, the EITC may encourage mothers with young children to go back to work sooner (perhaps too soon?), because their potential income is raised by the EITC. In fact, a boost in family income due to the EITC does not automatically increase overall family well-being. This is not a problem unique to the EITC and requires states to more generally reevaluate policies encouraging work, in light of individuals' different family circumstances.

Finally, in evaluating tax policy's potential role in achieving various goals, states need to carefully consider whether each particular goal is better served on the tax side of the budget or the expenditure side (Rogers and Weil 2000). The ability to "piggyback" on federal tax features and the more impersonal/anonymous nature of tax systems in general suggest that state tax policies involve lower administrative costs and greater participation than state expenditure-side policies. However, subsidies are then given based on a rather simplistic definition of need (income range by filing status), and some of the subsidies may be going to those who need them less than others who do not qualify for them. Assistance through the tax side also makes low-income people more vulnerable to whatever forces affect tax policy formulation. For example, do tax and spending programs differ in their sustainability during economic downturns? Colorado's initial EITC was conditioned on surpluses and created the undesirable effect that families may lose support when they need it the most. Is there a difference between subsidizing low-income families on the spending side versus the tax side in terms of the possibility and extent of undesirably procyclical policy? These are issues and trade-offs that states should consider in assessing the desirability of low-income tax policies.

Conclusion

State tax policy should not be neglected when it comes to evaluating how government policies affect the low-income population. With welfare reform encouraging work, and with the advent of tax policies designed to be part of that effort, state taxes will continue to become a more significant factor in the well-being of these families.

We have provided here an overview of the personal income and sales tax structures in several states, finding great diversity in how these states tax low-income families. Some states impose substantial burdens through income taxes with low thresholds and/or sales taxes that do not exempt necessities, while others provide generous subsidies through EITCs similar to the federal-level version. A few states go beyond the federal model and provide refundable child care credits as well. Further work is needed to more comprehensively account for the combination of state and local taxes and to evaluate what effects these tax policies actually have on household resources and decisions. Whether and how state tax policies *ought to* affect low-income families are issues that the states themselves will continue to grapple with as the lines between welfare policy and tax policy continue to blur.

Notes

1. Some studies that have focused on this issue, however, are Gold and Liebschutz (1996) and Johnson, Fitzpatrick, and McNichol (1999). Other than being a more current look at the rapidly changing state tax policies, our paper differs from those other studies in focusing more clearly on the explicit, effective tax rate structures facing low-income families; the contributions of particular features of the tax systems to those effective rates; and changes in the tax burdens facing these families as they increase participation in the labor market. We also define low-income families in terms of their relative positions in the income distributions of the various states, in addition to the absolute standard of the federal poverty levels. Earlier analyses typically made comparisons across states based on absolute measures of income only.

2. All of our calculations assume a family has earned income. We focus on two family types—a single-parent family and a married-parent family, both with two children. We choose our single-parent family to be representative of a welfare "leaver"—a family with two children and earnings at the poverty level, as described by Loprest (1999). We also look at a single-parent family at median earnings by state. Married-parent families are studied with respect to earnings at the federal poverty level as well as earnings at the 15th percentile by state.

3. This paper focuses only on state-level sales and income taxes and the differences across states in those taxes. Because states vary in their state and local tax mixes, our calculations and comparisons cannot be interpreted as evaluations of how the overall tax burdens facing these families vary by state. Also, we do not look at the structure of other types of state-level taxes, such as corporate income and property taxes. Corporate income and property taxes are not likely to be a significant burden on low-income, young families, however, because the incidence of these taxes falls primarily on capital income.

4. These 13 states are Alabama, California, Colorado, Florida, Massachusetts, Michigan, Minnesota, Mississippi, New Jersey, New York, Texas, Washington, and Wisconsin.

5. From Table A in U.S. Census Bureau, *Poverty in the United States, 1998*, September 1999. The poverty thresholds depend on family size and type; for example, the 1998 threshold for a three-person family with one adult and two children was $13,423.

6. For example, several states have enacted tax rebates that are one-time only, or "trigger tax reductions" that are permanent (can recur indefinitely into the future), yet conditional, depending on a legislatively defined level of excess revenues. Colorado is a prime example of a state that has enjoyed above-average growth in income tax revenues and has already given out sales tax rebates that were triggered by past revenue growth. For 1999, a new, refundable earned income tax credit was enacted—the "intermittent EITC." Other tax reductions were to take place for excess revenues beyond $170 million.

7. Johnson (2000) cataloged nine refundable and five nonrefundable state EITCs as of June 2000, counting Washington, D.C.'s recently approved 10 percent refundable version. The most recent to arrive among the *ANF* states is Colorado's "intermittent" refundable EITC, which was conditional on excess revenues and took effect for the first time on tax year 1999 forms. Other states have recently expanded existing EITCs; for example, Maryland has moved from a nonrefundable to a refundable version, and New York will gradually increase its percentage of the federal credit from 21 percent in 1999 to 27.5 percent in 2002. Local governments are getting into this type of policy as well. Very recently, Montgomery County, Maryland, became the first local government to adopt its own (refundable) EITC, effective starting in the 1999 tax year at 10 percent of the federal EITC (*The Washington Post*, October 20, 1999, p. B-01).

8. "Tax year 1997" corresponds to returns filed for the January 1, 1997, through December 31, 1997, period. "Fiscal year 1998" corresponds to the period July 1, 1997, through June 30, 1998.

9. All calculations assume a full-year resident where income is earned solely in the state shown. Although this is a slight simplification of taxes for some people, it is probably a good representation of the low degree of mobility of many low-income workers.

10. The National Survey of America's Families (NSAF) is a national survey fielded under the Urban Institute's *Assessing the New Federalism* project. The survey was fielded in 1997 and again in 1999. Information is available at http://newfederalism.urban.org/nsaf/.

11. Families are defined as likely tax units. For simplicity, we assume EITCs and child care credits will go to the parent living with the child. The same family income is assigned to each person in the family, and the median is the person at the 50th percentile.

12. Calculations of income are based on the definition of taxable income within each state. Families with no taxable income are included.

13. Local and state sales tax revenue data are available by state from 1995–1996 Census data; this is the most recent state-by-state breakdown of such data. Our imputation strategy implicitly assumes that any local-level sales tax base is identical to its state-level base, which is an appropriate assumption in most states where local-level sales taxes are significant. One exception is in Colorado, where many local governments tax food even though the state exempts food.

14. The federal government mandates exemption from sales taxes of all purchases made with food stamps. But Zedlewski and Brauner (1999) estimate that less than half of eligible former welfare recipients and other working poor participate in the Food Stamp program.

15. On the other hand, we assume the Colorado state-level exemption of food holds for all local-level taxes as well, which in fact is not always the case, so our state-plus-local sales tax burden in Colorado might be understated.

16. In addition, our sales tax burdens in all the states may be overstated, to the extent that income is underreported (and hence consumption relative to income overstated) for low-income families in the survey data.

17. See Johnson and Lav (1998) for issues and options concerning the exemption of food from state sales taxes.

18. Among the *ANF* states, for example, taxes on beer range from a low of 4 cents per gallon in Wisconsin to a high of $1.05 in Alabama, cigarettes from a low of 17 cents per pack in Alabama to a high of 87 cents in California, and gasoline from a low of 8 cents per gallon in New York to a high of 26 cents in Wisconsin.

19. Also, in the case of Wisconsin, our typical married-parent family qualifies for the "Working Families Credit" because their income is less than $19,000, while our single-parent family does not (because their income exceeds the $10,000 threshold for singles).

20. Pennsylvania is probably the best example, but it is not an *ANF* state. All of the *ANF* states have personal exemptions or standard deductions, but among them, Alabama and Michigan have the simplest structures.

21. An "inefficient" tax is one that reduces well-being by more than the dollar value of revenue collected and hence generates what is known as "excess burden." Distortionary taxes impose excess burden

because there is a decrease in well-being associated with people's substituting away from taxed activities into untaxed activities, even in the case where no revenue is collected.

22. In April of 1999, the Department of Health and Human Services issued the final regulations for the TANF block grant program, effective October 1, 1999. Those regulations allow states to count the refundable portions of low-income tax credits as part of their "maintenance of effort" (MOE) required spending and to fund such credits using state MOE or federally provided TANF funds. Moreover, the regulations exempt these qualifying tax credits from requirements placed on the more traditional forms of transfer programs, such as time limits and work participation rates.

23. See Rogers and Weil (2000) for more on this issue and other ways in which targeted tax credits differ from spending-side programs.

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About the Authors

Elaine Maag is a research associate with the Urban Institute's Income and Benefits Policy Center, where she currently focuses on issues related to the distribution of resources. Her research interests include state tax policy and earned income tax credit as well as the needs of people with disabilities.

Diane Lim Rogers is a senior research associate in the Income and Benefits Policy Center at the Urban Institute. She was principal analyst in the Tax Analysis Division of the Congressional Budget Office (1994–1999) and assistant professor of economics at the Pennsylvania State University (1989–1994). Her research and publications have focused on the distributional and incentive effects of broad-based taxes, welfare economics, state and local public finance, environmental taxation, and models of economic behavior and the macroeconomy. With Don Fullerton, she developed a life cycle model of the effects of taxation and wrote *Who Bears the Lifetime Tax Burden?* (Brookings Institution, 1993). She continues to teach public economics on a part-time basis and serves on the board of directors of the National Tax Association.

The Urban Institute

2100 M Street, N.W.
Washington, D.C. 20037

Phone: 202.833.7200
Fax: 202.429.0687
E-Mail: paffairs@ui.urban.org
http://www.urban.org

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