TAXING TEXANS:

A SIX PART SERIES EXAMINING TAXES IN THE LONE STAR STATE

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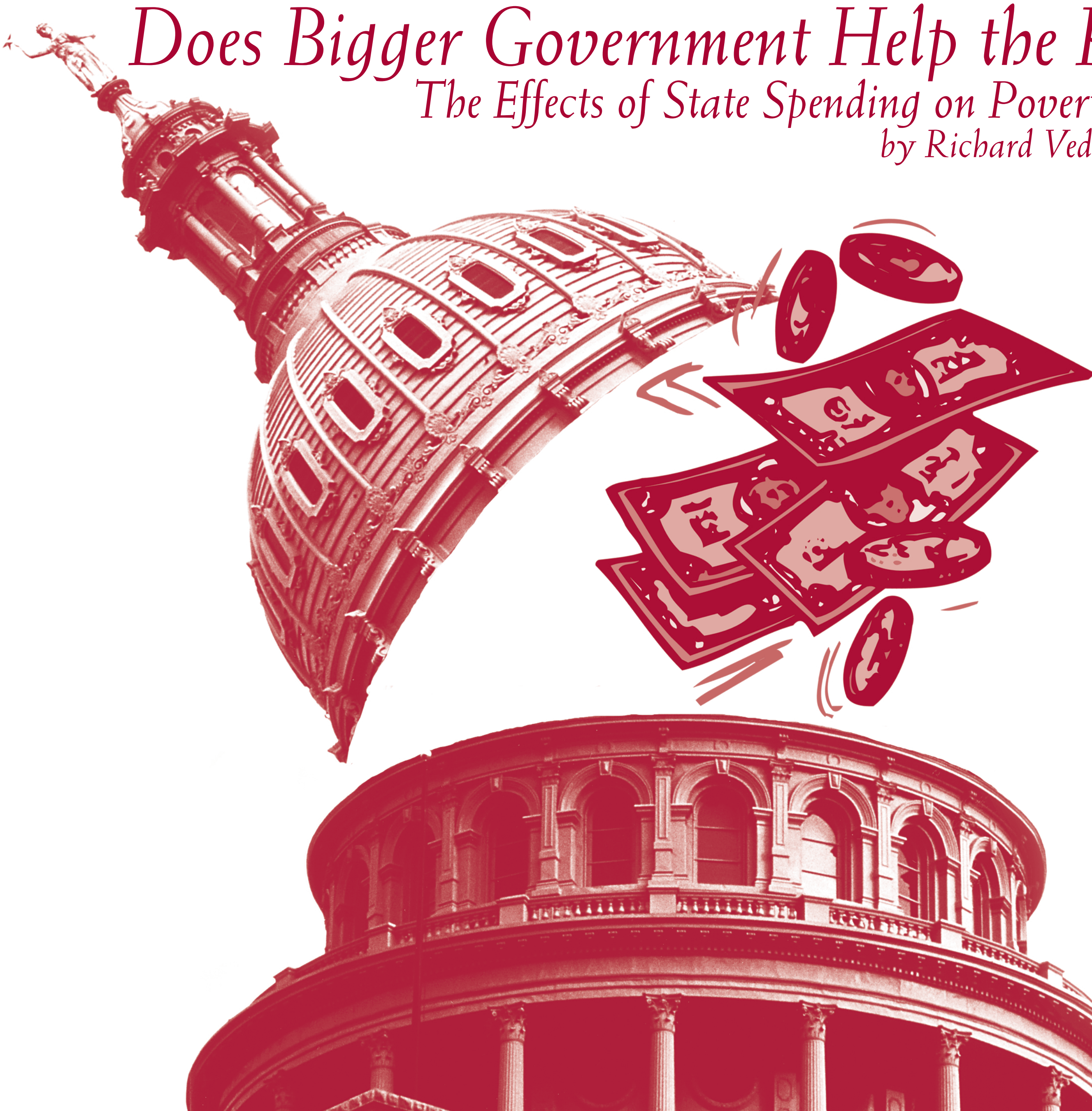
PART SIX:

Does Bigger Government Help the Poor?

The Effects of State Spending on Poverty Rates

by Richard Vedder, Ph. D.



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Part 6

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Executive Summary

...higher tax burdens are actually associated with greater poverty, as they reduce the ability of the poor to invest and save.

Does Texas hurt the poor with a system of low taxation and smaller government? Critics of current sales-and-property-tax system level two main charges. The first is that the current tax structure is excessively regressive: the sales tax does not tax the rich proportionally as much as the poor. The addition of a progressive income tax would shift more of the tax burden onto those individuals who best can afford it. Second, critics say that the additional revenues raised by new taxes would allow Texas to expand programs to help the poor, such as more generous welfare payments.

Using regression analysis and taking into consideration a variety of factors such as personal income per capita, labor union membership, unemployment, immigration status, and wage growth, it becomes clear that higher tax burdens are actually associated with **greater** poverty, as they reduce the ability of the poor to invest and save.

This finding makes sense to economists who investigate state fiscal policy; **the trend of recent research clearly shows that high taxation has a negative effect on the growth of personal income, especially at the margins where the poor reside.** There are also a number of studies showing that **high taxes reduce job opportunities and sometimes lead to higher unemployment.**

Does Bigger Government Help the Poor?

The Effects of State Spending on Poverty Rates

In the debate over whether to change the current tax structure in Texas from a sales and property tax model to an income tax model, no charge packs more emotional punch than the notion that the poor suffer under the state's "inequitable" tax system.

Critics of current sales-and-property-tax system level two main charges:

- The current tax structure is excessively regressive: the sales tax does not tax the rich proportionally as much as the poor. The addition of a progressive income tax would shift more of the tax burden onto those individuals who best can afford it.
- The additional revenues raised by new taxes would allow Texas to expand programs to help the poor, such as more generous welfare payments.

Testing the Tax System

To test the truth of these charges, I devised an econometric model to explore variations in poverty rates between the states. I took the average annual poverty rate for the period 1996-98 as estimated by the U.S. Bureau of the Census. Then, using ordinary least-squares regression analysis, I regressed the poverty rate against eight different explanatory variables, including the aggregate tax burden (state and local taxes as a percent of personal income), which I call TAXES, and the percent of tax revenues arising from income taxation (INCOME TAX).

Other factors need to be introduced into the analysis that might also impact on poverty. I introduced six such variables: personal income per capita (INCOME), the percentage of workers belonging to labor unions (UNIONS), the unemployment rate in the mid-period year, 1997 (UNEMPLOYMENT), the average pay of full-time workers (WAGES), the percent of the population over age 16 holding jobs (JOBPOP), and the percent of population in the 2000 Census that was foreign born (IMMIGRANT).

Table 6-1

The Tax-Poverty Relationship, 1996-98: Regression Results

Variable or Statistic	Coefficient or Value	T-Statistic*
Constant Term	37.6070	4.980*
TAXES	0.5461	2.181*
INCOME TAX	-0.0138	0.512
INCOME	-0.0006	2.359*
UNIONS	-0.2234	3.672*
UNEMPLOYMENT	0.4269	1.075
WAGES	0.0003	1.730
JOBPOP	-0.3949	3.728*
IMMIGRANT	0.1094	1.419
R^2	0.7533	
F-Statistic	16.0275*	

Statistically significant at the five percent level.

The results are reported in Table 6-1. The findings are strong and startling. The overall model explains about three-fourths of the considerable variation in poverty rates. The observed relationship between TAXES and poverty is positive and statistically significant (at the five percent level). In other words, **higher tax burdens are associated with greater poverty. Big government that is tax-financed is more likely to add, rather than subtract, from poverty rolls.**

Moreover, there is no statistically significant relationship between the proportion of taxes derived from income taxation and the rate of poverty. Moving away from existing tax sources to partial reliance on income taxes will not significantly reduce poverty, if the U.S. experience of the late 1990s is representative.

The reader might expect the results from Texas to be skewed because of the relatively high number of immigrants in the Lone Star State. Actually, the relationship between immigration and poverty is not even statistically significant, although it is positive. Interestingly, the actual annual average poverty rate in Texas was 16.1 percent, while the model, based on the values for the various variables used, predicted a poverty rate of over 15.5 percent. This means the "forecast error" for Texas was less than 0.6 percent. The model does a pretty good job of predicting the Texas poverty rate – and suggests that low taxes, if anything, have lowered that rate.

Reading the Research

This finding makes sense to anyone who knows the trend of the research on this issue. In fact, several decades of studies by economists confirm the proposition that **the higher the level of taxation, the lower the rate of economic growth**, holding non-tax factors constant. A low rate of economic growth will always disproportionally impact the poor, who are at the margins of employment and job security.

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This finding reversed earlier conventional wisdom that the effect of taxation on economic growth was negligible. Distinguished University of Illinois public finance expert John F. Due, for example, speaking about industrial location of firms, opined in 1961 that studies "suggest very strongly that the tax effects cannot be of major importance." By the later 1970s, however, research was drawing different conclusions – in part because the negative effects of taxes grew as the tax burden itself grew larger.

More recently, Martin Feldstein of the National Bureau of Economic Research (NBER) – the most prominent economic research organization in the field – concluded in a 1997 report that "the deadweight burden caused by incremental taxation ... may exceed one dollar per dollar of revenue raised, making the cost of incremental government spending more than two dollars for each dollar of government spending." A recent NBER study by Robert Carroll and others concluded that Feldstein's finding "is consistent with the view that raising income tax rates discourages the growth of small businesses."

Finally, there is mounting evidence that high taxes reduce job opportunities and sometimes lead to higher unemployment. Wasylenko and McGuire (1985) noted a negative correlation between taxes and metropolitan-area employment growth between 1973 and 1980. Even stronger findings were observed by Plaut and Pluta (1983). Goss, Preston, and Phillips contended in 1994 that previous studies understated the adverse employment effects of taxes by failing to control for other factors fully.

Lowell Gallaway and I have observed that high taxes are often positively associated with unemployment, both in the U.S. and internationally (Vedder and Gallaway, 1996 and 1999b). Other research using state and local data reaches similar conclusions (Dalenberg and Partridge 1995; Mark, McGuire, and Papke, 2000).

The research and the models clearly point to one conclusion: high taxes hurt economic growth, and especially hurt the poor.

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About the Author

Richard Vedder is Distinguished Professor of Economics at Ohio University. Educated at Northwestern University and the University of Illinois, Dr. Vedder has served as an economist with the Joint Economic Committee of Congress and has taught at several other universities, most recently as John M. Olin Visiting Professor of Labor Economics and Public Policy at the Center for the Study of American Business at Washington University in St. Louis.

The author of more than 200 scholarly papers and articles and six books or monographs, Professor Vedder writes and speaks frequently on tax and other public policy issues. His commentary has appeared in such leading newspapers as the *Wall Street Journal*, *Christian Science Monitor, Washington Post, Investor's Business Daily, USA Today*, the *Chicago Tribune*, and the *Dallas Morning News*. He has also advised political leaders in more than 20 states and several nations on fiscal policy issues. His most recent books include: *Can Teachers Own Their Own Schools* (Oakland, CA: Independent Institute, 2000), and, with Lowell Gallaway, *Out of Work: Unemployment and Government in Twentieth Century America* (New York: New York University Press, 1997).

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