MINNESOTA CENTER for Fiscal Excellence

ISSUE BRIEF

Sound tax policy. Efficient spending. Accountable government.

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How Progressive Can We Be? Minnesota's Individual Income Tax Rankings and Potential Policy Implications

Executive Summary

MCFE's *Comparison of Individual Income Tax Burdens by State, 2015 Edition* calculates, compares, and ranks income tax burdens for similar households with similar incomes across the country. This edition is the first to capture the effects of the fourth income tax tier Minnesota lawmakers enacted in 2013. This *Issue Brief* reports on the study's Minnesota findings.

Findings on Minnesota Income Tax Burdens

- Across all non-senior filer types, tax burden rankings rise as income rises – often exceptionally, from national lows to national highs – reflecting the significantly greater progressivity of Minnesota's individual income tax system relative to other states.
- The establishment of a 4th tier in the Minnesota individual income tax has had a major influence on the tax burdens – and the associated rankings – of high-income filers relative to other states. For the $500,000 married filer, the state income tax burden has increased from 18.7% to 40.9% above the national average. For the $1 million filer the burden has increased from 20.4% to 50.0% above the national average.
- Taxation of senior income in Minnesota remains very high relative to other states. Excluding groups of senior taxpayers where the vast majority of states impose no burden, Minnesota is first in the nation in eight of the remaining eleven examples.
- Of the 38 taxpayer profiles studied, Minnesota treats married filers at $35,000 of income most favorably relative to other states. The state's earned income tax credit (Working Family Credit, or WFC) creates a "negative" income tax burden for that household of $944, which is $1,297 below the national average tax burden for similar households.

Findings on the Structural Progressivity of the Minnesota Income Tax

- The progressivity of Minnesota's income tax system, as measured by the differences in effective tax rates between the same filers at different income levels, ranks among the highest in the nation – primarily due to the Working Family Credit.
- For married filers with $20,000 of income the WFC is the 5th most generous state earned income credit in the nation (and 3rd when adjusted for purchasing power). For married filers at $35,000 of income the credit ranks 1st in the nation because it is more accessible and generous than similar credits offered by other states.
- The Working Family Credit is a powerful and under-recognized contributor to state income tax progressivity. The credit accounts for nearly 45% of the total effective tax rate differential between married filers at $1 million of income and those at $20,000 of income.
- Minnesota's new fourth tier raised considerable amounts of money but did comparatively little to make the income tax more structurally progressive. For tax year 2013 the total effective income tax rate differential between a $20,000 married filer and a $1 million married filer is 15.1%. The new fourth tier created a 1.4% differential. In contrast, a 6.7% differential is attributable to the Working Family Credit.

Findings on Combined State and Federal Tax Burdens and Progressivity

- Federal income taxation has a far greater influence on income tax progressivity than the state's income tax does. When including federal income tax burdens the effective tax rate differential between the married filer at $1 million of income and at $20,000 of income is 79.5% – over five times higher than for state taxes alone.

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- For the $35,000 married filer, including federal taxes lowers the effective income tax rate from -2.7% to -14.8% – the result of refundable credits including the federal Earned Income Tax Credit. For the $500,000 married filer, including federal taxes increases the effective income tax rate more than fourfold from 7.2% to 29.9%.

Implications For Issues of Ongoing Policy Interest in Minnesota

Status of Minnesota's Working Family Credit

While the Working Family Credit has long been recognized as an efficient and effective means of combating poverty and improving the lives of low-income households, its contributions to the progressivity of the Minnesota income tax system are no less noteworthy. The WFC is a preferable way to improve "tax fairness." It offers far more progressivity for the dollar than raising rates of high-income earners while avoiding the potential economic dangers and harmful effects created by higher income tax rates.

Policymakers need to understand how proposals designed to improve the economic well being of low-income Minnesotans would interact with the WFC. For example, for married filers who each work 30 hours a week at the minimum wage, the additional income from a $2.50/hour increase in the minimum wage would be taxed at 61.5% because of higher payroll taxes and reduced credit eligibility. If households also lose access to other income support programs, the effective tax rate would be even higher.

Taxing Senior Income

Unlike many other states, Minnesota does not offer additional tax relief for Social Security income or private pension income beyond what the federal government provides. However, the ability of other states to keep these preferential senior treatments intact is a major question given the fiscal implications this growing demographic has for the future. Moreover, from a tax policy perspective, there is no theory of taxation that provides an argument under which age alone should exempt a person from income taxation. Given all this, additional careful study is warranted before pursuing a push for "senior income tax parity".

Tax Competitiveness

Considerable research has been done on the relationship between state tax policy and mobility, the location of new plants or firms, and economic and employment growth generally, but findings are often conflicting and contradictory. Nevertheless, two recent studies published by the National Bureau of Economic Research find that individual income taxes affect both high-level scientific talent and pass through employment levels. Such findings suggest Minnesota's income tax policy has legitimate competitiveness implications worthy of careful consideration.

With Minnesota's increased outlier status with respect to high income taxation, it is critical that the benefits and value proposition be very clear and tangible to the pass through business entities and highly paid talent paying the higher tax burden. Business activity will be attracted to other locations if equivalent levels and quality of public goods, human capital, and physical infrastructure can be "purchased" at lower tax prices elsewhere.

Addressing Income Inequality Concerns

Rising income inequality has generated considerable attention nationally as well as calls for action here in Minnesota. However, the evidence suggests Minnesota has reached a practical limit in advancing further income equality objectives by raising revenue through the income tax system. For both practical and political reasons, any substantial new spending intended to reduce income inequality will almost certainly need to be supported by new revenue streams from other, more regressive forms of taxation.

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