

Tax Incidence Analysis

Prepared by the Tax Research Division, Minnesota Department of Revenue

REVISED May 11, 2013

GOVERNOR'S Supplemental Budget Tax Proposals

HF 677 (Lenczewski) and SF 552 (Skoe)

As Amended by A13-0294

The Governor's Supplemental Budget (March 2013) proposes the following tax law changes:

- **Income Tax:**
 - o Create new 4th income tax bracket – **9.85%** tax rate on Minnesota taxable income over \$250,000 joint, \$150,000 single, and \$200,000 head of household starting in 2013. The new tax bracket is indexed for inflation.
 - o Conform to federal law change that would increase the Working Family Credit for some married taxpayers.
- **Corporate Tax:** Increase income subject to corporate tax, primarily by (1) repealing the foreign operating corporation (FOC) provisions, (2) repealing the foreign royalty subtraction, (3) including Minnesota sales made by *all* members of a unitary group in the Minnesota sales factor, and (4) indexing minimum fees for inflation.
- **Cigarette & Tobacco Taxes:** Increase the cigarette tax by **94 cents** per pack and raise the tax on other tobacco products.
- **Sales Tax**
 - o Raise the transit sales tax by 0.5 percentage points in the seven metro counties.
 - o Enact two sales tax provisions (affiliate nexus and an increase in the rental vehicle tax rate).
- **Property Taxes:** Increase local government aid by **\$80 million** per year and county aid by **\$40 million** per year, which will reduce local property taxes.
- **Property Tax Refunds:** Increase property tax refunds for renters by **\$19 million**.

These tax law changes would modify the burden of state and local taxes compared to what it would be under current law. The bill's impact can be estimated using the database and underlying models developed for the *Minnesota Tax Incidence Study*. **Because that study projects income and taxes to calendar year 2015, this analysis generally estimates the impact of law changes in that year.** Note that dollar estimates are for calendar year (or tax year in the case of income tax and property tax refunds) rather than fiscal year. The analysis is also limited to **permanent** changes in tax law.

A change in state and local taxes will in some cases have a direct impact on federal taxes – either by changing federal itemized deductions or by changing state and local taxes deducted on federal returns filed by businesses. ***As has been true for all incidence analyses completed for proposed law changes in past years, this analysis takes those direct changes in federal taxes into account.***

Impact of Law Changes on Minnesota State & Local Tax Burdens

- **Income Tax Changes:** The impact of the new 4th tier rate is modeled using the House Income Tax Simulation Model for tax year 2015. Minnesota residents would pay **\$492 million** (91%) of the \$543 million of tax raised through the new 4th rate.
 - In addition, the Working Family Credit change will reduce tax liability by an estimated **\$17 million**.
- **Corporate Tax Changes:** The burden of the estimated \$135 million increase in corporate tax is modeled using the corporate tax incidence model. Some of the burden would be borne in higher prices, some in lower wages, and some in lower returns to business owners. Tax burdens for Minnesota residents would rise by an estimated **\$84 million** (about 63% of added revenue). The remainder would be borne by nonresidents or the federal government (in lower federal corporate tax revenue). These estimates apply to the long-term burden, after businesses have fully adjusted to the change in tax burdens.
- **Cigarette and Tobacco Tax Changes:** Minnesota residents would pay **\$171 million** (95%) of the estimated \$181 million increase.
- **State Sales Tax:** The tax burden on Minnesota consumers is estimated to rise by **\$13 million** (91%) of the \$14 million increase.
- **Transit Sales Tax:** The tax burden on Minnesota residents is estimated to rise by **\$210 million** (91%) of the \$230 million increase in the sales tax in the 7 metro counties.
- **Property Taxes:** Local property taxes are expected to fall by \$65 million, including \$32 million for owner-occupied homes. The tax burden on Minnesota residents is estimated to fall by **\$53 million** (81%) of the \$65 million reduction, including all of the reduction for owner-occupied homes.
- **Property Tax Refunds:** Minnesota residents will benefit from **\$19 million** in renter refunds. Though rates for homeowner refunds would not change, homeowner refunds would fall by **\$3 million** due to reduced property taxes on homes.

Law Changes Not Included in the Analysis

- Except for the change in the Working Family Credit, **federal conformity provisions** are not included in the analysis. The other federal law changes to which the proposal would conform generally would affect only the timing of tax payments (such as changes in depreciation rules).
- **Provisions that affect only nonresidents**, such as the tax on part-year residents with an abode in Minnesota, are excluded because the *Tax incidence Study* analysis is limited to full-year Minnesota residents.

Results by Population Decile: Change in Minnesota State and Local Tax Burdens

- The Minnesota state and local tax burden on Minnesota taxpayers would rise by **\$884 million**. Of that increase, **65%** would fall on the top 10% (with 42% of total income), **62%** on the top 5% (with 31% of total income), and **52%** on the top 1% (with 16% of total income).
- Minnesota state and local tax burdens would rise by an average of **0.41%** of income. The increased tax burden as a percent of income is below that average for all but the bottom three deciles and the top decile. The increase is quite a bit higher in the 10th decile (at **0.63%** of income). For the top 1% of taxpayers the increased burden would equal **1.30%** of income.

Table 1.

Change in Minnesota State and Local Tax Burden as Percent of Income by Population Decile

2015 Population Decile	Income Range	Percent of All Households	Minnesota State and Local Tax Burden as Percent of Income		
			Current Law	Proposed Law	Change
1	10,937 & under	10%	29.9%	31.5%	1.53%
2	10,938 to 19,316	10%	12.6%	13.2%	0.64%
3	19,317 to 26,397	10%	11.4%	11.8%	0.43%
4	26,398 to 35,600	10%	11.0%	11.3%	0.29%
5	35,601 to 46,507	10%	11.7%	11.9%	0.22%
6	46,508 to 59,998	10%	11.9%	12.1%	0.24%
7	59,999 to 77,704	10%	12.0%	12.2%	0.22%
8	77,705 to 101,616	10%	11.8%	12.0%	0.19%
9	101,617 to 146,400	10%	11.6%	11.8%	0.16%
10	146,401 & over	10%	10.3%	10.9%	0.63%
All Households		100%	11.3%	11.7%	0.41%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	10.9%	11.0%	0.14%
Next 4%	202,408 to 510,005	4%	10.6%	10.9%	0.27%
Top 1%	510,006 & over	1%	9.6%	10.9%	1.30%
Full Decile	146,401 & over	10%	10.3%	10.9%	0.63%

As discussed on page 17 of the 2013 Minnesota Tax Incidence Study, results for the first decile are overstated for several reasons.

- The corporate tax, sales tax, and cigarette tax changes are regressive, but their impact is outweighed by the income tax and property tax changes. Under current law, the top 1% of taxpayers has the lowest effective tax rate (at 9.6% of income) and the drop in the effective tax rate between the 9th decile (11.6%) and the top 1% (9.6%) is significant. **Under the proposal, the effective tax rates for the 10th decile, the top 5%, and the top 1% would each rise to 10.9%.** This would still be below the effective tax rate of any other decile, but the sharp drop in the effective tax rate between the 9th decile and the top 1% – at 2.0% of income under current law – would be cut to 0.9%.

- The Suits index for the net tax change is **+0.318** which is very progressive. It is significantly more progressive than the current income tax (+0.200). Only the estate tax is more progressive.
 - The Suits index for the income tax changes alone is **+0.901**, compared to **+0.377** for the property tax reductions (including PTR increases), **-0.250** for state sales tax, **-0.237** for the transit tax, **-0.179** for the corporate tax, and **-0.610** for the cigarette and tobacco tax increases.
 - In the absence of the proposed increases in cigarette and tobacco taxes, the Suits index would be **+0.542**.
- With the proposed tax changes, the Suits index for all Minnesota state and local taxes would become less negative, rising from **-0.049** to **-0.036**. Though still regressive, this would be less regressive than in recent years (since 2006) and not much different from estimates for 1998 and 2000.
- As shown in **Table 2**, total Minnesota state and local tax burdens would rise by **3.6%**. The increases would be **6.1%** for the top decile and **13.5%** for the top 1%. Increases would be below the 3.6% average for all deciles other than the first three deciles and the 10th decile. Increases are 2% or less for those in the 5th through 9th deciles and in the lower half of the 10th decile.

Table 2.
Dollars of Minnesota State and Local Tax Burden
Impact of Tax Proposals in Governor's Supplemental Budget

Estimated Calendar Year 2015 Impact

2015 Population Decile	Income Range	Percent of All Households	Percent of All Income	Minnesota State and Local Tax Burden				
				Current Law Tax (\$1000s)	Tax with Proposed Law (\$1000s)	Change in Tax (\$1000s)	Decile's Share of Total Change in Tax	Percent Increase in Tax Over Current Law Tax
1	10,937 & under	10%	0.8%	537,928	565,395	27,467	3.1%	5.1%
2	10,938 to 19,316	10%	1.9%	514,797	540,853	26,056	2.9%	5.1%
3	19,317 to 26,397	10%	2.9%	707,921	734,916	26,995	3.1%	3.8%
4	26,398 to 35,600	10%	4.0%	945,145	969,942	24,797	2.8%	2.6%
5	35,601 to 46,507	10%	5.3%	1,334,108	1,359,146	25,038	2.8%	1.9%
6	46,508 to 59,998	10%	6.9%	1,756,088	1,791,337	35,249	4.0%	2.0%
7	59,999 to 77,704	10%	8.9%	2,277,516	2,319,566	42,050	4.8%	1.8%
8	77,705 to 101,616	10%	11.5%	2,916,622	2,963,943	47,321	5.4%	1.6%
9	101,617 to 146,400	10%	15.6%	3,902,773	3,957,342	54,569	6.2%	1.4%
10	146,401 & over	10%	42.2%	9,346,791	9,920,980	574,189	65.0%	6.1%
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	24,239,689	25,123,420	883,731	100.0%	3.6%

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	11.0%	2,578,683	2,611,011	32,328	3.7%	1.3%
Next 4%	202,408 to 510,005	4%	15.0%	3,413,204	3,501,431	88,227	10.0%	2.6%
Top 1%	510,006 & over	1%	16.3%	3,354,904	3,808,539	453,635	51.3%	13.5%
Full Decile	146,401 & over	10%	42.2%	9,346,791	9,920,980	574,189	65.0%	6.1%

- **Table 3** shows dollar tax changes by tax type. The reduction in property tax burden (down **\$69 million**) offsets **7%** of the increased burden due to other taxes. The net added burden from other taxes totals **\$952 million**. Income taxes account for **50%** of that amount, sales taxes (including the transit tax) for **23%**, cigarette and tobacco taxes for **18%**, and corporate tax for **9%**.

Table 3.
Change in Minnesota State and Local Tax Burden by Tax Type
Impact of Tax Proposals in Governor's Supplemental Budget

Estimated Calendar Year 2015 Impact, by Tax Type

Dollars in \$1000s

2015 Population Decile	Income Range	Percent of All Households	Percent of All Income	Change in Tax Burden					
				Income Tax*	Corporate Tax	Sales Tax (state and local)**	Cigarette & Tobacco Taxes	Property Taxes Net of PTR	Total
1	10,937 & under	10%	0.8%	(89)	2,245	7,998	20,698	(3,383)	27,467
2	10,938 to 19,316	10%	1.9%	(145)	2,906	10,095	18,797	(5,597)	26,056
3	19,317 to 26,397	10%	2.9%	(749)	3,705	12,013	18,454	(6,428)	26,995
4	26,398 to 35,600	10%	4.0%	(5,204)	4,605	14,087	18,199	(6,890)	24,797
5	35,601 to 46,507	10%	5.3%	(8,711)	5,715	16,347	18,007	(6,320)	25,038
6	46,508 to 59,998	10%	6.9%	(2,286)	6,746	18,815	17,608	(5,635)	35,249
7	59,999 to 77,704	10%	8.9%	(172)	8,369	22,546	16,752	(5,445)	42,050
8	77,705 to 101,616	10%	11.5%	(112)	10,465	27,165	16,187	(6,385)	47,321
9	101,617 to 146,400	10%	15.6%	9	13,822	33,521	15,323	(8,106)	54,569
10	146,401 & over	10%	42.2%	492,183	25,651	59,674	11,241	(14,561)	574,189
ALL MINNESOTA HOUSEHOLDS		100%	100.0%	474,723	84,230	222,263	171,265	(68,751)	883,731

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	11.0%	1,050	9,036	20,760	6,458	(4,976)	32,328
Next 4%	202,408 to 510,005	4%	15.0%	56,631	10,489	23,036	4,120	(6,049)	88,227
Top 1%	510,006 & over	1%	16.3%	434,502	6,126	15,879	663	(3,535)	453,635
Full Decile	146,401 & over	10%	42.2%	492,183	25,651	59,674	11,241	(14,561)	574,189

*Impact of the 4th tier is limited to the top two deciles. Impact in deciles 1-8 is due to change in the Working Family Credit.

**Primarily due to the additional 0.5% transit sales tax increase in each of the 7 metro counties.

Results by Population Decile: Change in Both Minnesota and Federal Tax Burdens

Because homeowner property taxes and state income taxes can be claimed as itemized deductions on federal income tax returns, a change in these taxes will change federal tax liability. The change in federal tax will offset part of the change in Minnesota income taxes and homeowner property taxes. There is no federal offset for those who do not itemize deductions, nor is there any offset for a taxpayer who is subject to the federal alternative minimum tax (because property and state income taxes are not deductible). For those who itemize (and are not subject to the federal AMT), the portion of the change in Minnesota tax that is offset by the change in federal liability is generally equal to the federal tax rate on the last dollar of the taxpayer's income. The offset is 15% for a taxpayer in the 15% tax bracket and 36.9% for a taxpayer in the 36.9% tax bracket.

- The change in federal tax liability would offset **20%** (\$97 million) of the \$475 million increase in Minnesota income taxes paid by Minnesota residents. However, higher federal income taxes would offset **13%** (\$4 million) of the benefit from reduced home property taxes net of PTR (\$29 million). As a result, the changes in itemized deductions would reduce federal taxes by **\$93 million**.
- Although the overall federal tax change is relatively small, it is concentrated in the top 1% of households. Federal taxes would fall by **\$95 million** for those in the top decile and by **\$95 million** for the top 1%.

Table 4.
Dollar Change in Minnesota State and Local and Federal Tax Burden
Impact of Tax Proposals in Governor's Supplemental Budget

(Dollars in \$1000s)

2015 Population Decile	Income Range	Number of Households	Net Change in Minnesota Tax Burden	Net Change in Federal Taxes		Net Change in Minnesota and Federal Tax Burden (\$1000s)
				Change in Federal itemized Deductions for State Income Taxes*	Change in Federal Itemized Deductions for Home Property Taxes	
1	10,937 & under	10%	27,467	-	1	27,468
2	10,938 to 19,316	10%	26,056	-	3	26,059
3	19,317 to 26,397	10%	26,995	-	10	27,005
4	26,398 to 35,600	10%	24,797	29	30	24,856
5	35,601 to 46,507	10%	25,038	100	81	25,219
6	46,508 to 59,998	10%	35,249	54	187	35,489
7	59,999 to 77,704	10%	42,050	1	372	42,423
8	77,705 to 101,616	10%	47,321	6	570	47,897
9	101,617 to 146,400	10%	54,569	-	1,008	55,576
10	146,401 & over	10%	574,189	(96,962)	1,400	478,627
ALL MINNESOTA HOUSEHOLDS		100%	883,731	(96,773)	3,661	790,618

Detail for the 10th Decile

Lower Half	146,401 to 202,407	5%	32,328	(193)	795	32,930
Next 4%	202,408 to 510,005	4%	88,227	(1,375)	420	87,271
Top 1%	510,006 & over	1%	453,635	(95,394)	185	358,426

*Positive values in this column are due to increased Working Family Credit received by itemizers.

- Although the proposal would increase the burden of *Minnesota* state and local taxes by \$884million, it would increase the total burden of *federal plus Minnesota* state and local tax burdens by **\$791 million**.
- When both federal and state taxes are considered, tax burdens would increase by an average of **0.37%** of income (rather than 0.41%). The tax burden would rise by **0.53%** of income (rather than 0.63%) in the 10th decile and by **1.02%** of income (rather than 1.30%) for the top 1% of taxpayers.
- Because the net reduction in federal taxes is concentrated at high incomes, adjusting for the change in federal taxes reduces progressivity. The Suits Index for the proposed change in taxes after adjusting for the change in federal taxes falls from +0.318 to **+0.246**, which is still quite progressive.

Table 5
Change in Minnesota State and Local and Federal Tax Burden as Percent of Income
Impact of Tax Proposals in Governor's Supplemental Budget

2015 Population Decile	Income Range	Percent of All Households	Net Change in Minnesota Tax Burden as Percent of Income	Net Change in Federal Taxes as Percent of Income		Net Change in Minnesota and Federal Tax Burden as Percent of
				Higher Itemized Deductions for Minnesota Income Tax	Lower Itemized Deductions for Home Property Taxes	
1	10,937 & under	10%	1.37%	0.000%	0.000%	1.37%
2	10,938 to 19,316	10%	0.57%	0.000%	0.000%	0.57%
3	19,317 to 26,397	10%	0.39%	0.000%	0.000%	0.39%
4	26,398 to 35,600	10%	0.26%	0.000%	0.000%	0.26%
5	35,601 to 46,507	10%	0.20%	0.001%	0.001%	0.20%
6	46,508 to 59,998	10%	0.22%	0.000%	0.001%	0.22%
7	59,999 to 77,704	10%	0.21%	0.000%	0.002%	0.21%
8	77,705 to 101,616	10%	0.18%	0.000%	0.002%	0.18%
9	101,617 to 146,400	10%	0.16%	0.000%	0.003%	0.16%
10	146,401 & over	10%	0.63%	-0.107%	0.002%	0.53%
ALL MINNESOTA HOUSEHOLDS		100%	0.40%	-0.045%	0.002%	0.36%

Detail on the 10th Decile

Lower Half	146,401 to 202,407	5%	0.13%	-0.001%	0.003%	0.14%
Next 4%	202,408 to 510,005	4%	0.27%	-0.004%	0.001%	0.27%
Top 1%	510,006 & over	1%	1.29%	-0.272%	0.001%	1.02%
Full Decile	146,401 & over	10%	0.63%	-0.107%	0.002%	0.53%

Technical Addendum

A. Assumptions about Changes in Local Property Taxes

- When general purpose aids to local governments are reduced, a portion of those aid cuts will result in property tax increases.
- For 2014 and future years we assume that non-school local governments will reduce taxes by 50% of any aid increases.

B. Estimating the Incidence of CHANGES in Business Taxes (“Incremental Incidence”)

- As explained on pages 60-61 of the 2013 Tax Incidence Study, the incidence of a change in the level of business taxes (“incremental incidence”) will differ from the average incidence of existing business taxes (“average incidence”). Average incidence divides an existing business tax into three parts – the national average tax on all capital, the sector differential, and the Minnesota differential. In contrast, a change in the level of a business tax is all treated as a change in the Minnesota differential.
- If the level of Minnesota business taxes changes, this will generally change the amount of *federal tax* paid by the business – either the federal corporate income tax or the federal individual income tax (for flow-through businesses). For a corporation paying federal tax at the 35% rate, each additional \$1000 in Minnesota tax will reduce the federal tax burden by \$350. So \$350 of the \$1000 of Minnesota tax burden is borne by the federal government in foregone tax revenue. The burden of the remaining \$650 in tax may be shifted to consumers in higher prices or to workers in lower compensation – or it may reduce the after-tax income of the business owner. This analysis assumes an average federal tax rate for business owners of 30% for corporate tax and 20% for individual income tax.
- The extent to which the tax burden will be shifted to consumers or workers will depend on the nature of the market. Minnesota tax changes are most likely to result in price changes if the market is local and close competitors see the same change in tax. Businesses selling in national or international markets are much less likely to shift the added cost to consumers by raising prices (or reduce their price in response to a tax cut). *As in the incidence study, the incidence results assume the market has time to fully adjust to any tax changes.*
- The incidence of the business tax changes in the bill (as modeled here) is as follows:
 - o Corporate tax increases: 35% shifted to Minnesota consumers, 27% shifted to Minnesota workers, 0.4% borne by Minnesota owners, and 37% borne by nonresidents and the federal government.
 - o Business property tax reductions: for nonresidential property, 26% of the benefits to Minnesota consumers, 11% to Minnesota workers, 16% borne by Minnesota owners, and 38% to nonresidents and the federal government. For rental property, 53% of the benefits to renters, 24% to Minnesota owners, and 23% to nonresidents and the federal government.
 - o Business sales tax (transit tax): 69% borne by Minnesota consumers, 23% by Minnesota workers, less than 1% by Minnesota owners, and 8% by nonresidents.