

Overview of Minnesota's State and Local Tax System

The Minnesota Department of Revenue's *Tax Incidence Study* provides information about Minnesota's state and local taxes in 2004, the most recent year for which comprehensive data is available, as well as projections for 2009.

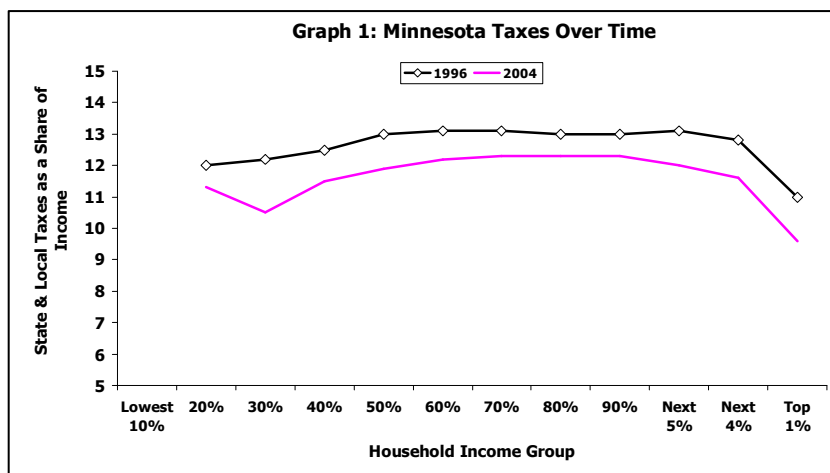
- From 1996 to 2000, the average amount of state and local taxes paid by Minnesotans, measured as a share of income, dropped by 13%.¹ But since 2002, taxes as a share of income have been rising and are projected to rise further in 2009.
- Minnesotans paid an average of 11.6% of their incomes in combined state and local taxes in 2004.
- Minnesota's state and local tax system is regressive — that means that Minnesota's low- and middle-income taxpayers pay a larger share of their incomes in taxes than the highest-income Minnesotans do. Minnesota's tax system is becoming more regressive — that is, less fair — over time.
- A greater reliance on local taxes — especially the property tax — has contributed both to the rise in taxes since 2002 and the erosion of tax fairness. Rising income inequality has also contributed to greater regressivity in Minnesota's tax system.
- How Minnesotans pay their taxes varies with income. Lower-income Minnesotans pay a larger share of their incomes in sales and property taxes, while higher-income people pay more of their incomes in income taxes.

Trends in Taxation

Over time, Minnesota is seeing changes in both the level of taxation and the degree of tax fairness. Taxes are becoming less fair. In addition, for most Minnesotans, taxes are increasing and are expected to increase further by 2009, after dropping significantly between 1996 and 2000. Both of these trends are described in more detail below.

Trend 1: Tax Fairness is Declining

Minnesota's tax system is becoming less fair over time. As shown in Graph 1, in 1996 Minnesota's tax system looked more like the "flat line" pattern associated with a proportional tax system in which all income levels pay about the same share of their incomes in taxes.² But in recent years, tax fairness has declined and a more uneven pattern is emerging in which Minnesota's tax system is



¹ The data in this fact sheet come from the Minnesota Department of Revenue, *Tax Incidence Study*, www.taxes.state.mn.us/legal_policy/research_reports/content/incidence.shtml. The opinions expressed are those of the authors. The *Tax Incidence Study* divides the population into ten groups containing an equal number of households, called deciles. For example, the first decile contains the 10% of Minnesotans with the lowest incomes. The tables and graphs in this analysis show the results for the 2nd through 9th deciles, and then the 10th decile is divided into the first 5%, next 4%, and top 1%. There are a number of data concerns regarding the 10% of Minnesotans with the lowest incomes, which results in the *Tax Incidence Study* overstating the level of taxation for this group. For this reason, the results from that income group are generally disregarded when making statements about the tax system as a whole, and we follow that practice in this analysis.

² Over time, the *Tax Incidence Study* has been expanded to include more of the total state and local tax system. This means that data for 1996 shown in Graph 1 understate the actual tax levels in that year.

roughly progressive from the lower to middle incomes, but regressive from the middle to upper incomes.³

The erosion of fairness is also demonstrated by the Suits Index, which measures the degree to which a tax is regressive or progressive. The Suits Index assigns a number between -1.0 and 1.0. A proportional tax has a Suits Index of 0. A progressive tax has a positive Suits Index and a regressive tax has a negative Suits Index. The *Tax Incidence Study* calculated a Suits Index of -0.018 for Minnesota's total state and local tax system in 2002. The system got more regressive in 2004, with a Suits Index of -0.024, and is expected to reach -0.032 in 2009. And the situation could be even worse — using an alternative method, the *Tax Incidence Study* measures a Suits Index of -0.030 in 2004 and -0.035 in 2009.⁴

Another way to illustrate the increasing regressivity of the tax system is to look at the widening gap between what the wealthiest Minnesotans pay and what average Minnesotans pay in taxes. In 2004, the wealthiest 1% of Minnesotans (those with household incomes over \$354,758) paid 9.6% of their incomes in total state and local taxes, compared to the average of 11.6%. In 2009, the share of income paid in taxes is expected to increase for most Minnesotans, while for the wealthiest 1% it will fall to 9.3%.

Both income trends and policy choices have contributed to the erosion of tax fairness. The Department of Revenue notes that much of the increase in regressivity can be traced to increased inequity in the distribution of wealth in the 1990s, in which the benefits of economic growth went disproportionately to those with the highest incomes.⁵ But policy choices are also part of the picture, including a shift away from state taxes, which are more based on the taxpayer's ability to pay, to regressive local taxes, especially property taxes. In 2002, local taxes made up 24.6% of total taxes, and this share rose to 25.8% in 2004 and is projected to rise further to 28.5% in 2009. At the same time that local taxes are becoming a larger share of total taxes, local taxes are also becoming more regressive.

Trend 2: Taxes Are Rising for Most Minnesotans

Between 1997 and 2001, Minnesota policymakers made decisions about how to allocate projected budget surpluses, and Minnesota's taxes were cut significantly. One-time rebates totaling \$3.7 billion were enacted in each legislative session between 1997 and 2001. Permanent tax cuts were made in each of the surplus years: property taxes were cut in the 1997, 1998, 1999, and 2001 legislative sessions, income taxes in 1999 and 2000, and motor vehicle registration taxes in 1999.

These tax reductions, coupled with income growth, means that Minnesotans paid an average of 12.9% of their incomes in taxes in 1996, but this figure fell to 11.2% in 2000 — a drop of 13%.

In 2002, average taxes stayed about the same at 11.3%. However, since then the average share of income that Minnesotans pay in taxes increased to 11.6% in 2004, and is projected to increase to 11.7% in 2009. Even with these increases, total taxes as a share of income will still be lower than in the 1990s.

Again, both income trends and policy

Health Impact Fee Worsens Both Trends

In 2005, the Governor and Legislature agreed to an increase in taxes on cigarettes and other tobacco products that, while structured identically to the state's cigarette and tobacco taxes, was called a Health Impact Fee. The Health Impact Fee is not included in the overall analysis in the *Tax Incidence Study*.

However, the Department of Revenue reports that incorporating the Health Impact Fee into the analysis results in taxes that are higher (total taxes are 11.9% of income, instead of 11.7%) and more regressive (a Suits Index of -0.038 instead of -0.032) in 2009.

³ A tax is regressive if low-income taxpayers pay a higher proportion of their income for that tax than those with higher incomes. In contrast, if those with higher incomes pay a higher percentage of their income for a tax, that tax is progressive.

⁴ This alternative methodology uses the entire sample of 93,000 data points to calculate the Suits Index, in contrast to the traditional approach of using 10 data points. The *Tax Incidence Study* notes that the "full sample" method is theoretically preferable, but they use the traditional method so that results can be compared to past studies.

⁵ For more information on income inequality, see Minnesota Budget Project, *Income Inequality in Minnesota 2006*, www.mncn.org/bp/bbjano06.pdf.

choices contribute to this outcome. Greater reliance on residential property taxes to fund services in Minnesota is part of the picture, and a contributor to the expected increases in 2009. In fact, the share of income spent on *state* taxes is expected to fall between 2004 and 2009, but this is more than offset by expected increases in *local* taxes.

Current Taxes in More Detail

In 2004, Minnesotans paid an average of 11.6% of their incomes in total state and local taxes, although the actual amount varies with income, as shown in Graph 2.⁶ The way in which a household pays its taxes

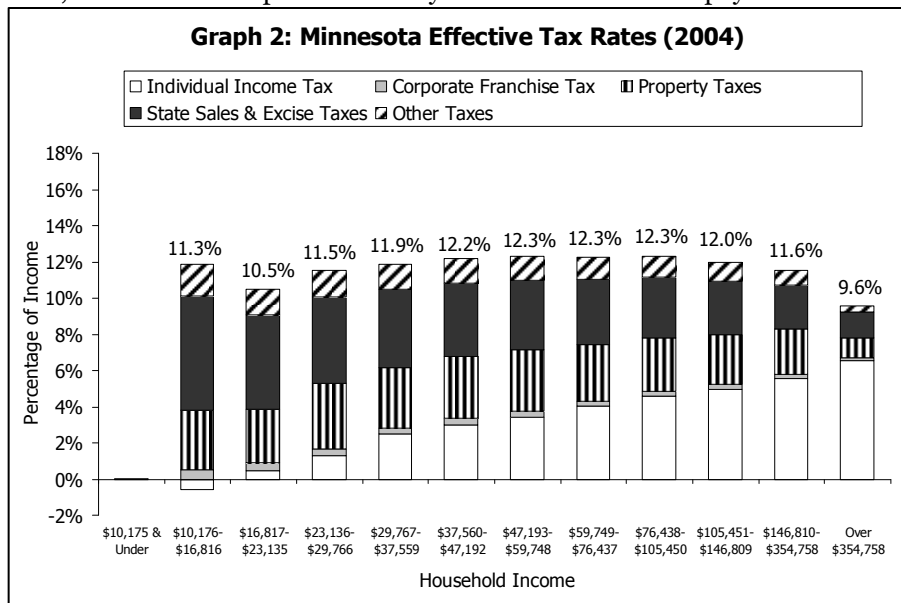
also varies with income.

Lower-income

Minnesotans pay a larger share of their incomes in regressive sales and property taxes, while higher-income

Minnesotans pay a larger share through the progressive income tax.

The difference in how various income groups pay their taxes is important to keep in mind when evaluating proposals to change a certain tax. The impact will not be evenly felt “across the board,” but will depend on how much that tax contributes to the taxpayer’s total tax bill.



Another way of measuring tax distribution is by comparing how much each group pays in relation to its share of total income in the state. As shown in Table 1, most income groups in Minnesota pay roughly in proportion to their share of total income.

Table 1: Share of Total Income and Share of Total Taxes Paid (2004)

Income	Share of Total Income	Share of Total Taxes Paid
\$10,176 - \$16,816	2.3%	2.2%
\$16,817 - \$23,135	3.4%	3.1%
\$23,136 - \$29,766	4.5%	4.4%
\$29,767 - \$37,559	5.7%	5.8%
\$37,560 - \$47,192	7.2%	7.5%
\$47,193 - \$59,748	9.1%	9.6%
\$59,749 - \$76,437	11.5%	12.1%
\$76,438 - \$105,450	15.2%	16.0%
\$105,451 - \$146,809	10.4%	10.7%
\$146,810 - \$354,758	14.2%	14.1%
Over \$354,758	15.6%	12.8%

The income group with the largest difference between its share of total state income and its share of total taxes paid is those with household incomes over \$354,758 (the wealthiest 1%). This group of Minnesotans had 15.6% of all income in the state, but paid 12.8% of total taxes.

Each Tax Varies in its Impact

As mentioned above, the degree to which a tax is regressive or progressive is measured by the Suits Index. Individual tax types have different Suits Indexes, as shown in Table 2. Minnesota’s estate tax and individual income taxes are the state’s only progressive taxes. All other taxes are regressive, with gambling taxes and cigarette and tobacco taxes being the most regressive.

⁶ Graph 2 puts households of the same income level together, but the actual taxes paid by any particular household will depend on factors such as family size, marital status, whether the family owns or rents their home, and eligibility for various tax deductions and credits.

Table 2: 2004 Suits Index by Tax	
Estate Tax	0.270
Individual Income Tax	0.219
State Taxes Only	0.026
Total State and Local Taxes	-0.024
Alcoholic Beverage Excise Tax	-0.083
Residential Property Taxes including Impact of Property Tax Refunds	-0.103
Mortgage and Deed Taxes	-0.130
Statewide Property Tax	-0.131
Motor Vehicle Sales Tax	-0.142
Corporate Franchise Tax	-0.145
Motor Vehicle Registration Tax	-0.147
General Sales and Use Taxes	-0.175
General Property Taxes	-0.178
Local Taxes Only	-0.178
Residential Property Taxes without Impact of Property Tax Refunds	-0.180
Motor Fuels Excise Tax (Gas Tax)	-0.253
MinnesotaCare Taxes	-0.271
Gambling Taxes	-0.477
Cigarette and Tobacco Excise Taxes	-0.486

In Minnesota, the progressive income tax partially offsets the regressivity of other state and local taxes.

Policy Implications

While levels of taxation and degrees of fairness are impacted by income trends, policy choices matter. An understanding of how the tax system is structured can inform policy choices that ensure that our tax system is both fair and that it raises adequate revenues to fund the state's priorities.

When evaluating tax proposals, Minnesotans should bear in mind the main features of our tax system: Minnesota's tax system has followed a trend of greater regressivity since 1996, and although average taxes are lower than they were in the 1990s, they have been on the rise since 2002.

Tax Incidence Study Methodology

To determine who pays Minnesota's taxes, the Minnesota Department of Revenue releases a comprehensive *Tax Incidence Study* every two years. Determining **tax incidence** means

identifying where taxes ultimately fall, regardless of who is legally required to pay the tax. For example, although the owner of an apartment building is required to pay the building property tax, a portion of the tax is shifted to renters in the form of higher rents. Likewise, taxes paid by businesses may be shifted onto workers as lower wages, onto consumers as higher prices, or onto owners as a smaller return on their investment.

The *Tax Incidence Study* includes 99.9% of all taxes paid in Minnesota in 2004, a total of \$19.3 billion. However, the distributional analysis of the study only includes the \$16.2 billion paid by Minnesota residents (83.7% of the total). It excludes the remainder, which is paid by nonresidents. The study also does not include the impact of fees.

The *Tax Incidence Study* provides estimated taxes for 2009 based on existing laws — these projections do not assume any policy action to change tax laws by the 2007 Legislature.

In the *Tax Incidence Study*, **income** includes taxable income as well as nontaxable income such as public assistance, tax-exempt interest, and nontaxable social security and pension income. A **household** is defined as "an actual or potential income tax filer and all dependents, even if not all living under the same roof." This varies from the Census, which defines a household as all persons who live together in a housing unit. For this reason, the *Tax Incidence Study* includes more households than the Census, and the median household income is less than reported by the Census.