

Effective Tax Rates Facing Low- and Moderate-Income Workers: Modeling the Impact of Policy Changes in Minnesota 1998-2004

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Full study available:

- Paul Wilson and Donald Hirasuna, "Effective Tax Rates Facing Minnesota's Low- and Moderate-Income Workers: The Impact of Budget Cuts on Incentives," Proceedings of the 2004 National Tax Association Annual Conference on Taxation: 325-35.
- Also in State Tax Notes (May 16, 2005): 507-515.

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Tax Reform

- TANF (work requirements & time limits)
- Reduce barriers to work:
 - Health insurance cliff -- Medicaid, MinnesotaCare
 - Child care costs – TANF child care, Basic Sliding Fee (BSF) child care, child care credits (federal and state)
 - Let worker keep more of each dollar earned:
 - EITCs (federal and state), federal child credit
 - Earnings disregard (TANF)

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- What is the net impact of the system?
- How has it changed through time?
- Identify and clarify policy tradeoffs
 - Revise MN's "two-tier" EITC?
 - Recent increases in MinnesotaCare and BSF copays
 - Reform of child support payments rules

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Goal

- Results useful to legislators
 - Use specific examples
 - Allow for regional differences in child care costs and medical insurance
- Flexible
 - Can easily modify assumptions
 - Can/will update the model annually
 - Standardize output to assist communication

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Questions

- Isn't this someone else's problem?
- What is the political agenda?
- Does it matter?
 - Doesn't TANF have work requirements?
 - Do lower-income workers respond to incentives that are so complicated and hidden?
- Isn't it dangerous to generalize from hypothetical examples?

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Baseline Example

- Single parent with two children (age 2 and 5) in Rochester, MN.
- Both children are in child care.
 - Child care costs equal average for full time care in a licensed center in Rochester.
 - Enrolled in BSF child care if meet income requirements.
 - Leave BSF child care if private care is less expensive or no longer eligible for BSF.

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Baseline example (contd)

- Medical costs equal national average (by age and gender). No employer-provided health insurance.
 - Switch to private health insurance if cheaper than MinnesotaCare (premiums plus out-of-pocket costs) or no longer eligible. Private insurance policy has maximum deductible of \$1000 per person.

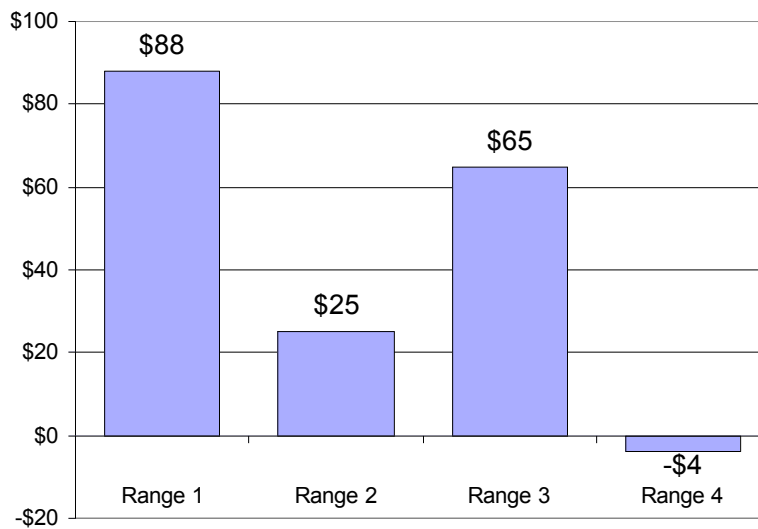
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Alternative Assumptions

- One child rather than two.
- Married rather than single parent.
- Higher or lower medical costs (or different maximum private insurance deductible).
- Higher child care costs (Minneapolis) or lower (rural counties). Or zero child care costs.
- Use of pretax child care accounts.

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Figure 1. Average Gain from Additional \$100 of Earnings (2004)
Single Parent with Two Children (Baseline Assumptions)



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Earnings Ranges

- Range 1: Increasing EITCs (\$1 to \$10,800)
- Range 2: Continued phaseout of TANF cash and food assistance (\$10,800 to \$17,600)
- Range 3: Off food stamps, but children still on Medicaid (\$17,600 to \$23,500)
- Range 4: Off Medicaid, but still eligible for BSF child care (\$23,500 to \$41,700)

*Single parent with two children

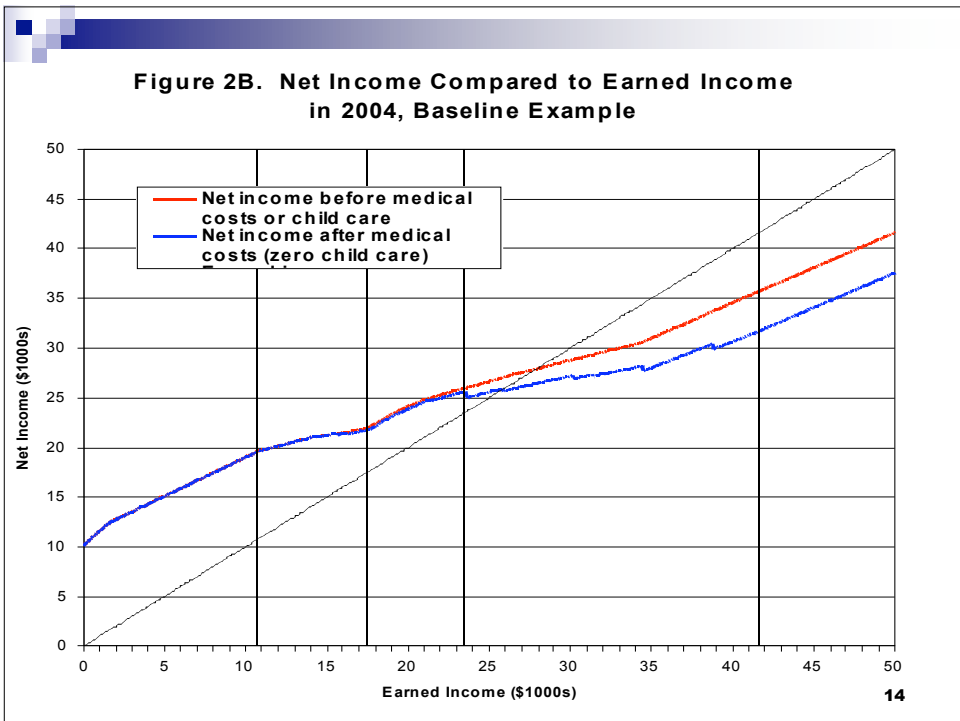
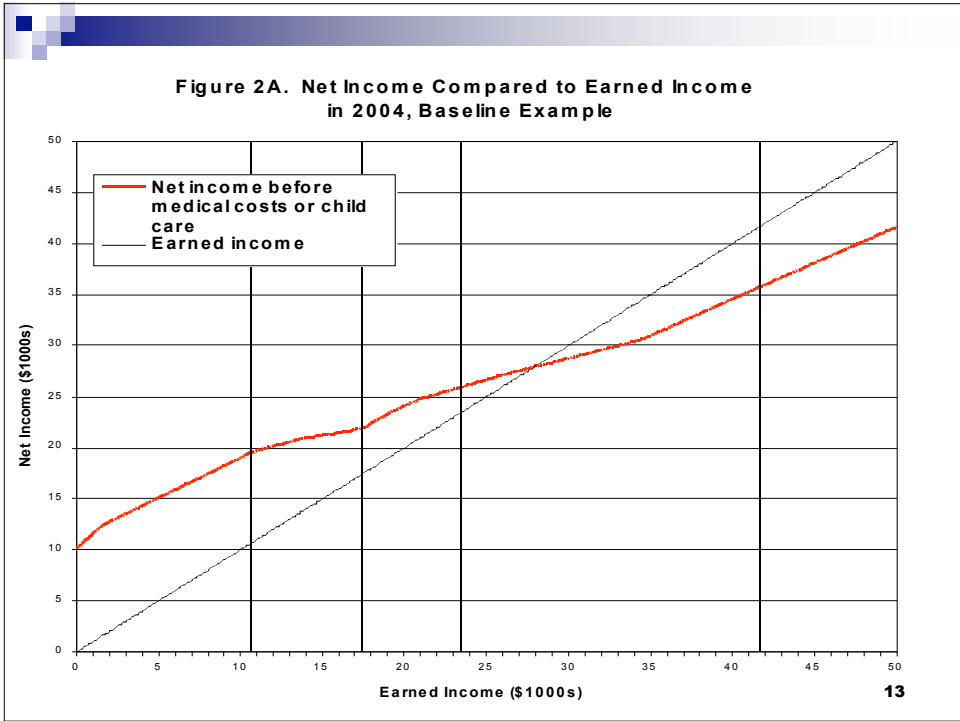
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Charts

- Net income
 - = Earnings
 - + TANF cash + Food stamps
 - SS tax – Income tax before credits
 - + Income tax credits
 - Medical care and health insurance costs
 - Child care costs

Note: This approach does not require putting a value on Medicaid and child care subsidies.

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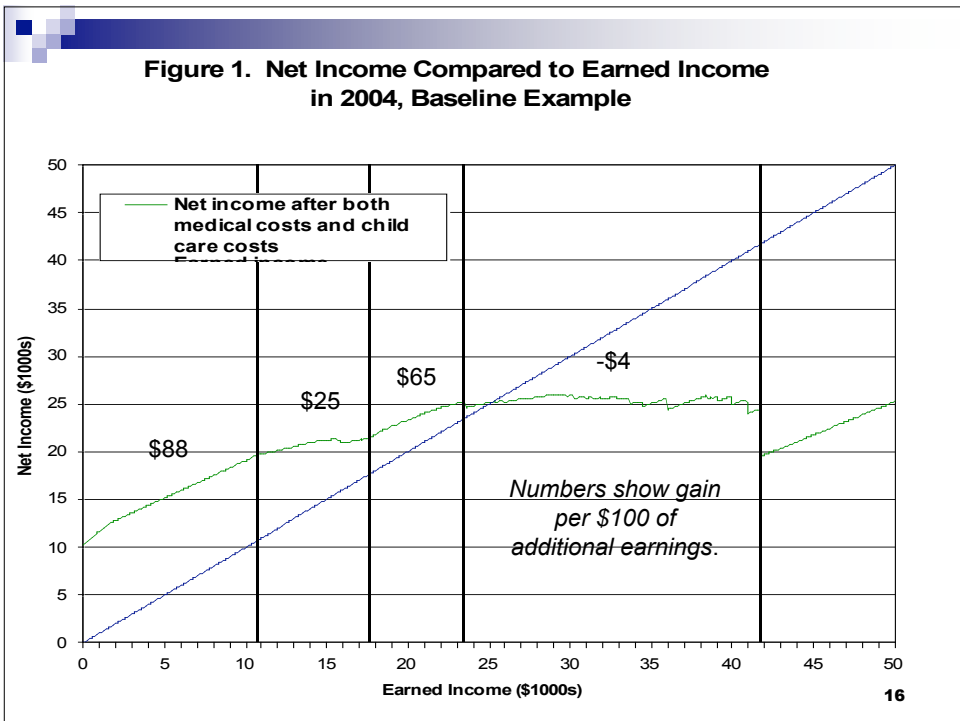
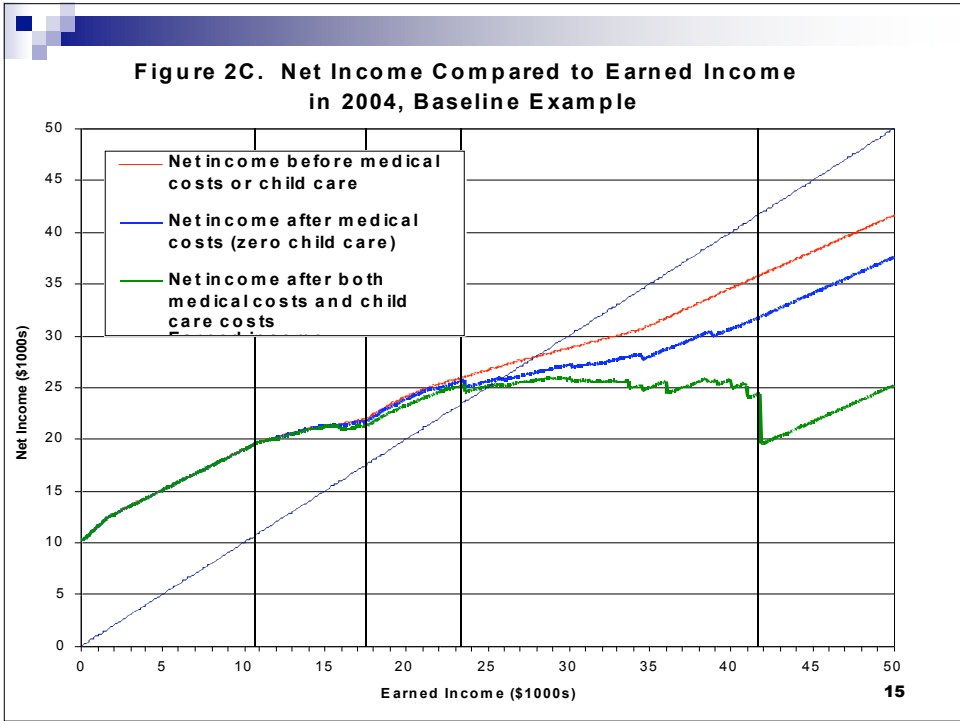
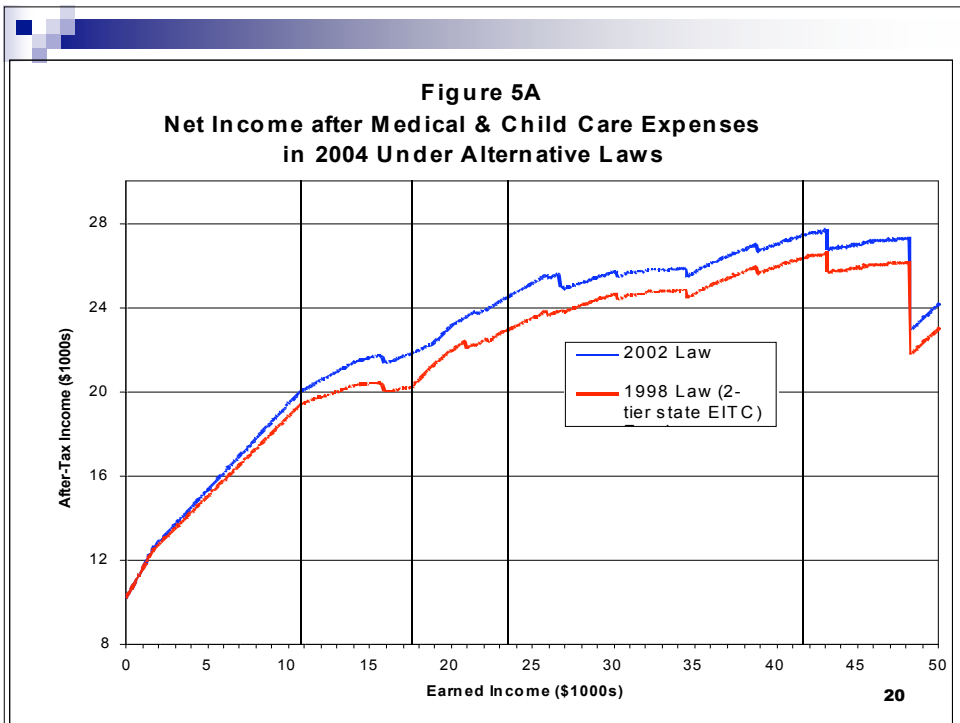
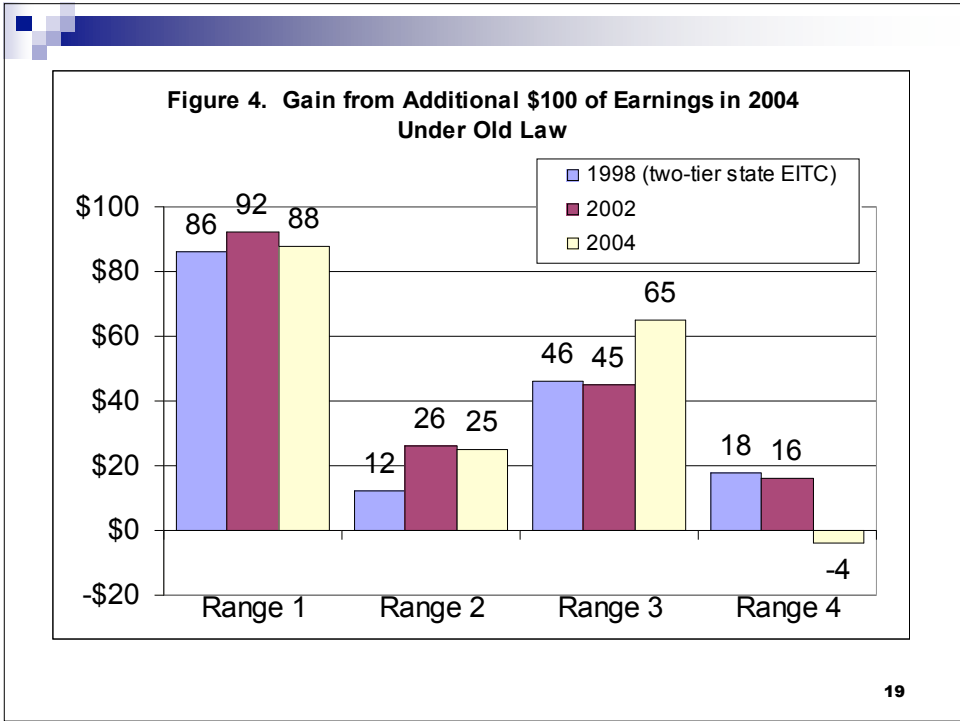


Figure 3. Average Change in Net Income Per \$100 of Added Earnings

Annual Earnings (\$1000s)	First \$10.8	\$10.8 to 17.6	\$17.6 to 23.5	\$23.5 to 41.7
Earned Income	\$100	\$100	\$100	\$100
TANF cash & food stamps	(\$55)	(\$64)	\$0	\$0
Taxes before credits				
Social Security	(\$8)	(\$8)	(\$8)	(\$8)
Federal income tax	\$0	(\$2)	(\$10)	(\$14)
Minnesota income tax	\$0	(\$1)	(\$5)	(\$5)
Tax Credits				
Federal child credit*	\$0	\$17	\$15	\$0
Federal EITC	\$40	(\$11)	(\$21)	(\$13)
Minnesota EITC	\$10	\$4	(\$3)	(\$6)
Medical costs	\$0	(\$3)	(\$2)	(\$20)
Child care costs				
TANF or BSF copays	\$0	(\$10)	(\$7)	(\$41)
Federal child care credit	\$0	\$0	\$6	\$5
Minnesota child care credit	\$0	\$3	\$2	(\$2)
Net Income	\$88	\$25	\$65	(\$4)

Impact of recent law changes

- Model old (pre-2004) law in 2004.
 - Adjust old law parameters if indexed for inflation or would have automatically changed for any reason.
 - NOT comparing actual effective tax rates in previous years.



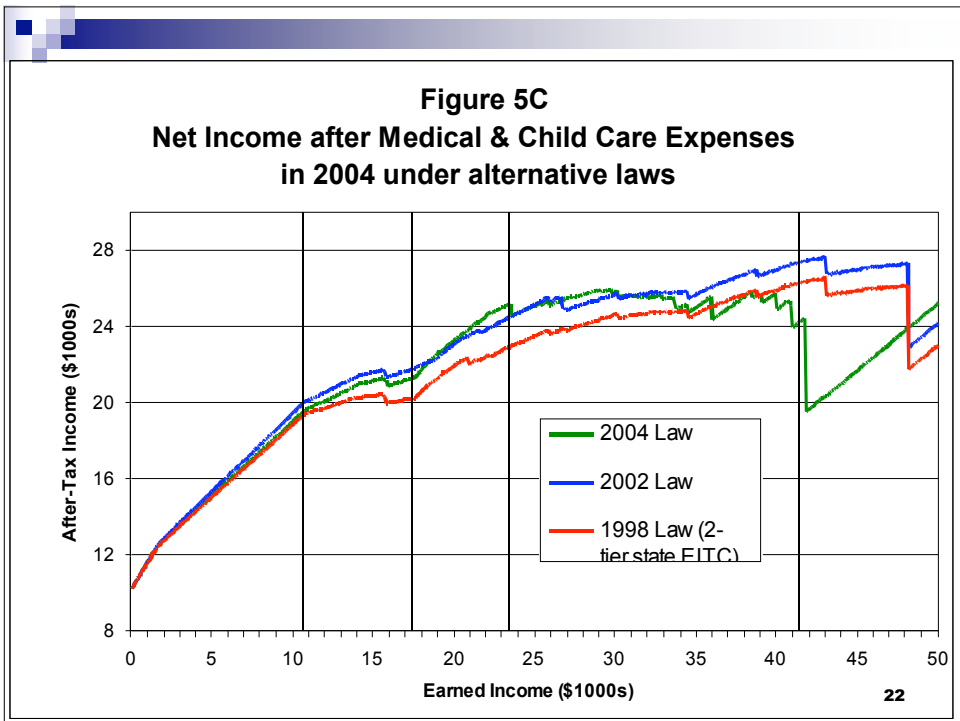
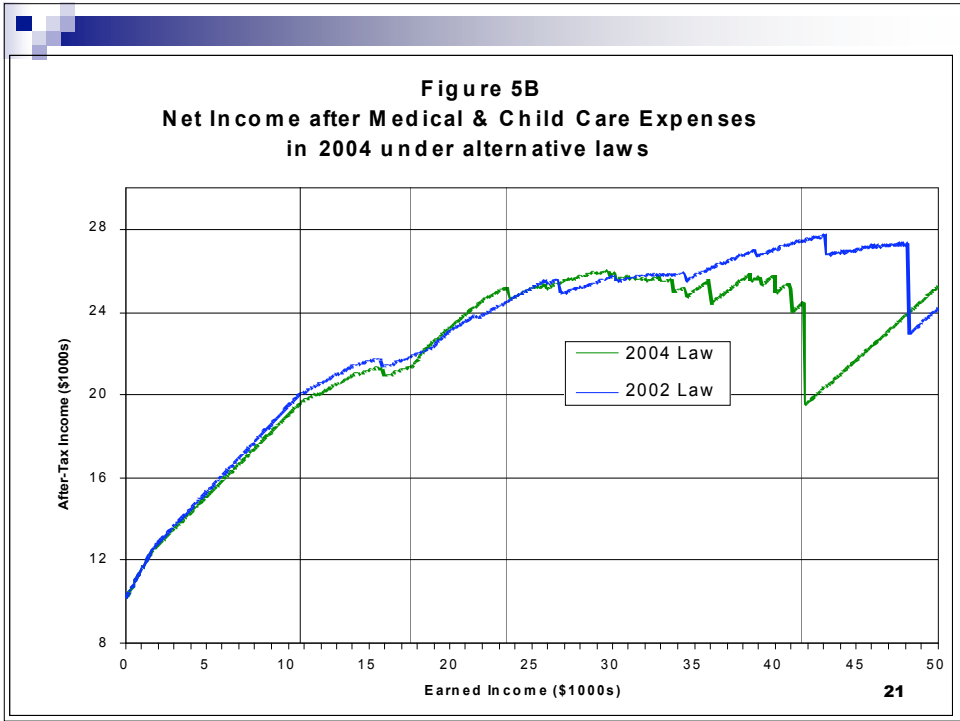


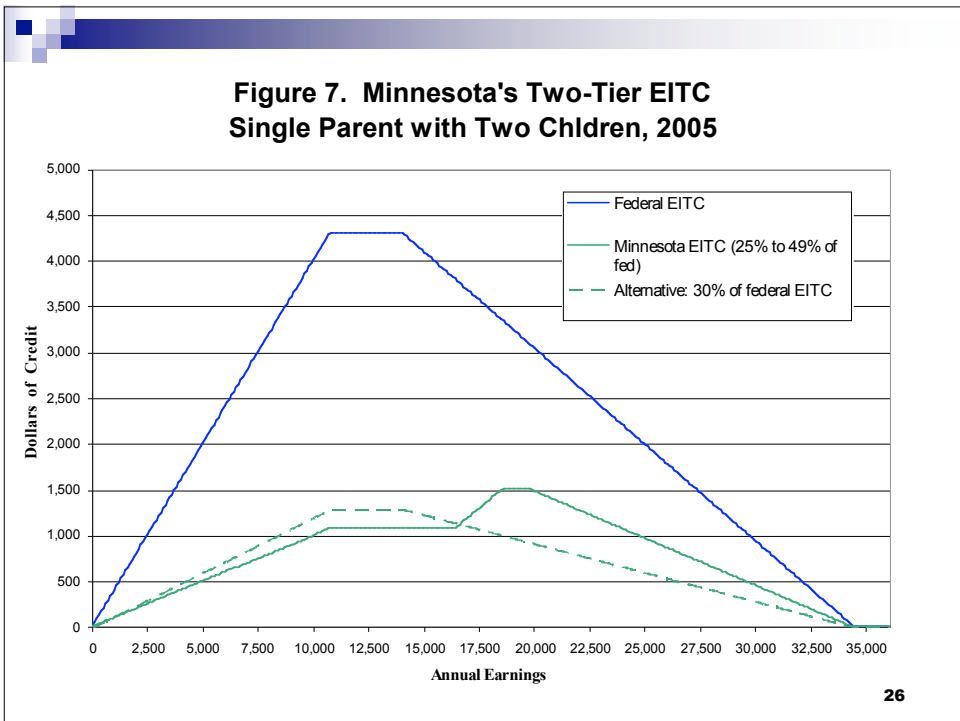
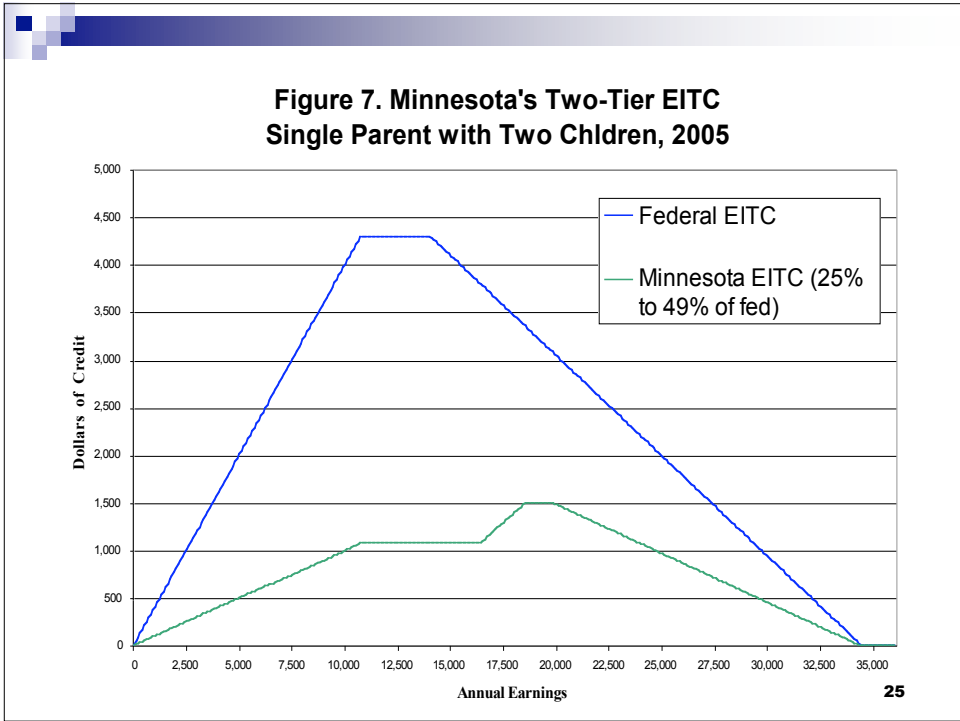
Figure 6. Impact of Law Changes Between 1998 and 2004
Change in Gain from Increasing Earnings by \$100

Law Change	Range 1	Range 2	Range 3	Range 4
Lowest federal tax rate cut from to 10%	-	0.9	5.0	0.8
Federal child credit increased from \$600 to \$1000 and made partially refundable	-	14.1	3.9	-
Minnesota income tax rate cut (6.5% to 5.35%)	-	0.1	0.7	0.7
Minnesota EITC rate increased	2.0	-	(1.0)	(0.9)
Medicaid exit point increased and MinnesotaCare copays raised	-	(0.4)	10.0	(5.0)
BSF copays increased (net of credits)	-	(1.8)	0.9	(18.4)
Total Impact 1998 to 2004	2.0	12.9	19.5	(22.4)

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Issue 1: Minnesota's 2-tier EITC

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Two-tiered credit

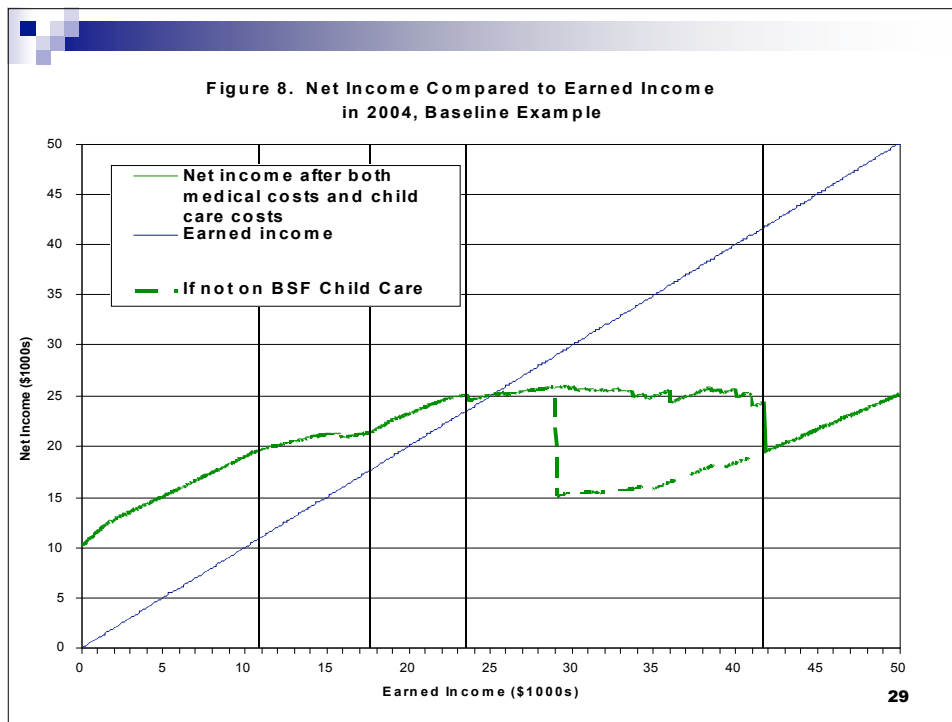
- In 1998, when adopted as a revenue-neutral change
 - Range 1: Down by \$2
 - Range 2: Up by \$6
 - Range 3: Down by \$3
- Increased complexity
- Undercut Minnesota's EITC rankings
 - "25% to 49% of federal credit if two children and 25% to 36% of federal credit if one child"

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Issue 2: Child care cuts in 2003

- Income limit for entry set below maximum income for those already on the program
- Willing to sacrifice horizontal equity to avoid more cuts to those already on BSF
- Also increased waiting lists (BSF is not an entitlement)

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Issue 3: Why are chart lines so choppy?

- Direct subsidies often have cliffs and high marginal tax rates.
 - Not obvious from the statutory language:

“If income is more than \$20,000 but less than \$24,000, copay equals 3% of income. If income is more than \$24,000 but less than \$28,000, copay equals 5% of income.” etc.
 - Creates a cliff of \$480 at \$24,000 and a marginal tax rate of 16% between the midpoints of each range.

■ MinnesotaCare

□ Beyond \$684 cliff where children lose eligibility

- Copays rise and average of \$16.50 per \$100 of added income

- Four more cliffs averaging \$440 each.

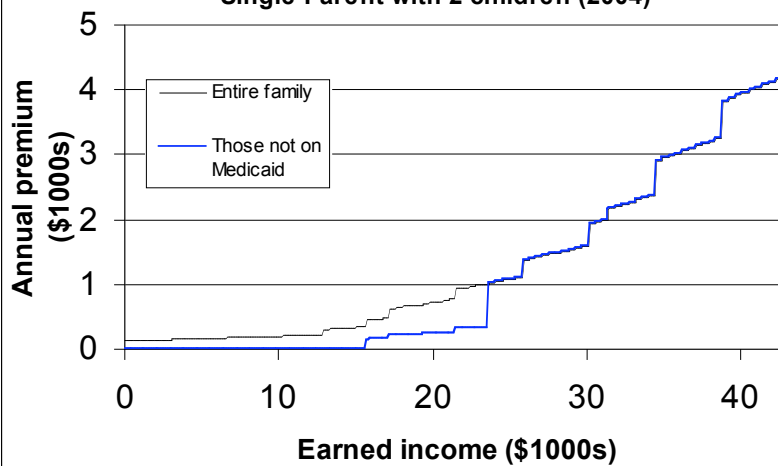
■ BSF Child Care

- Subsidy falls by \$8500 over a range of \$26,000 – an average of \$33 per \$100 of added income.

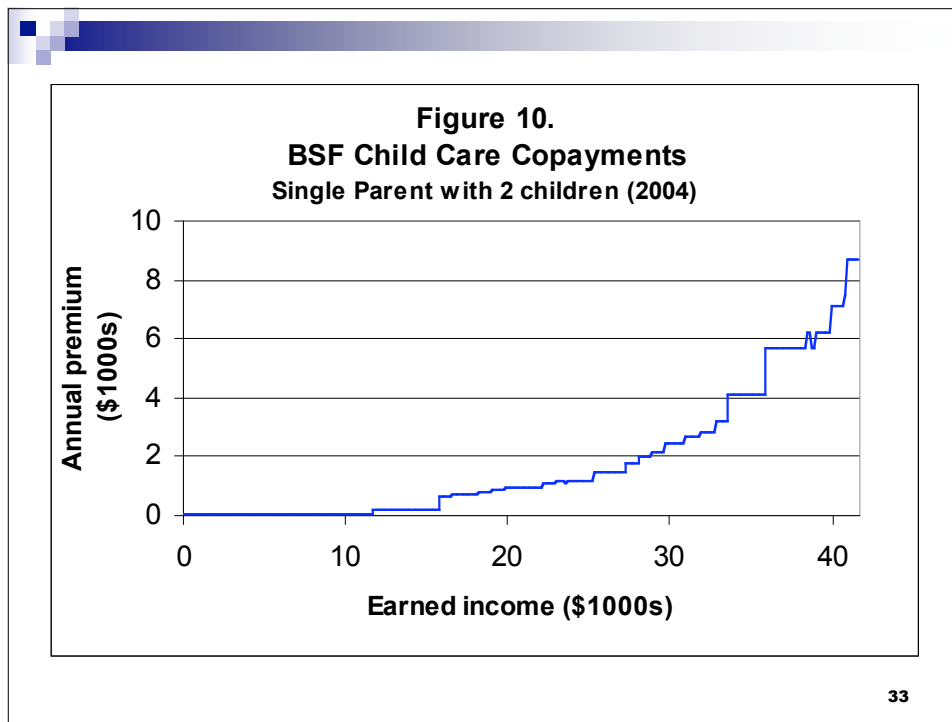
- Five cliffs exceeding \$500 each.

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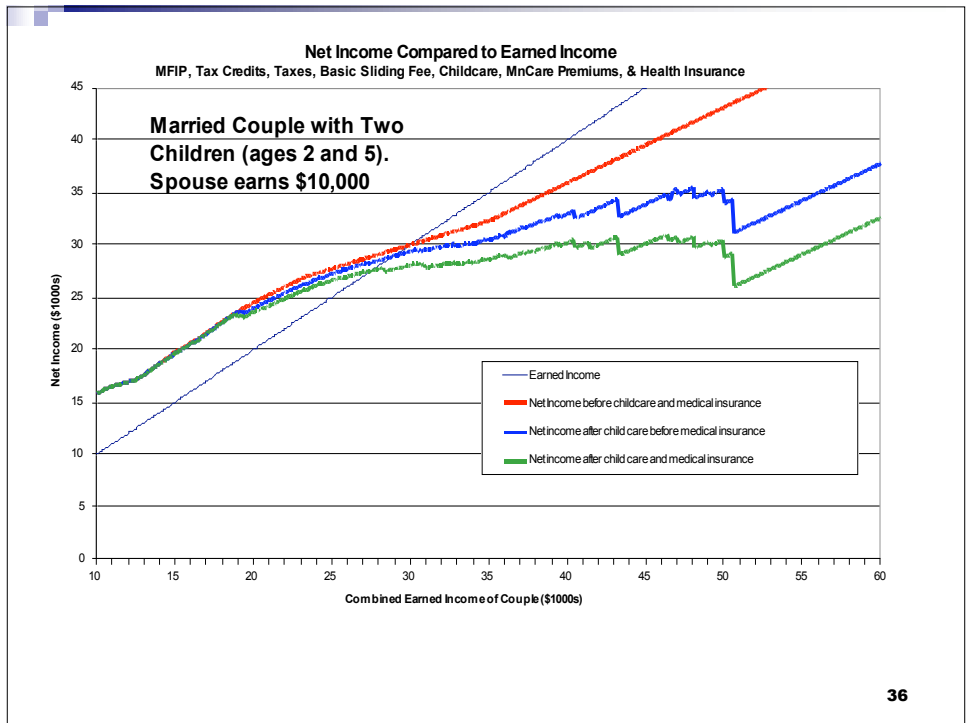
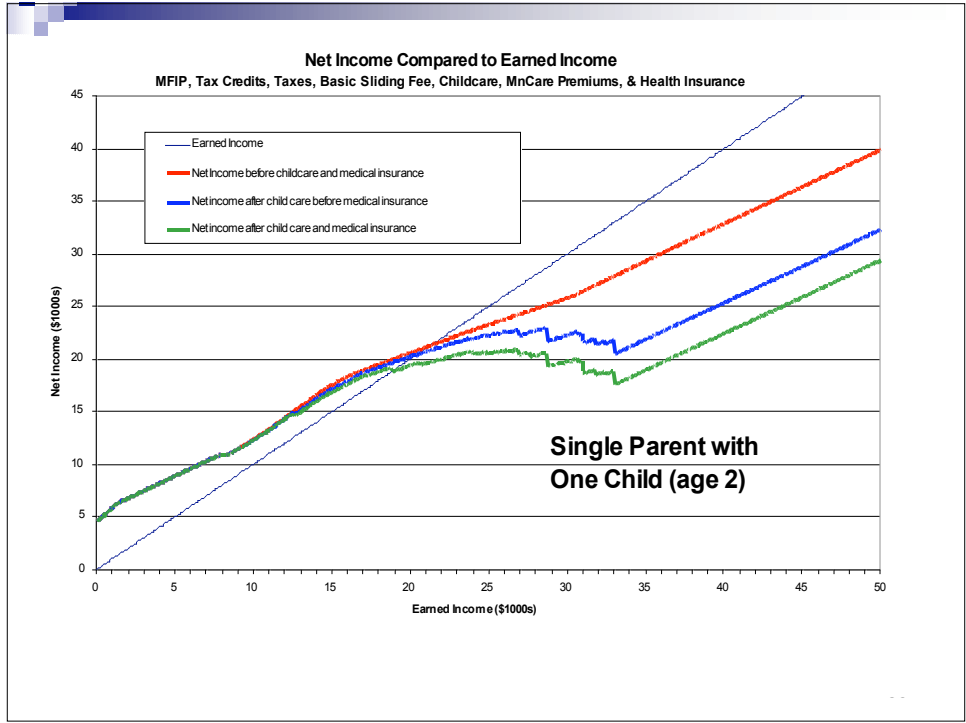
Figure 9.
MinnesotaCare Premiums
Single Parent with 2 children (2004)

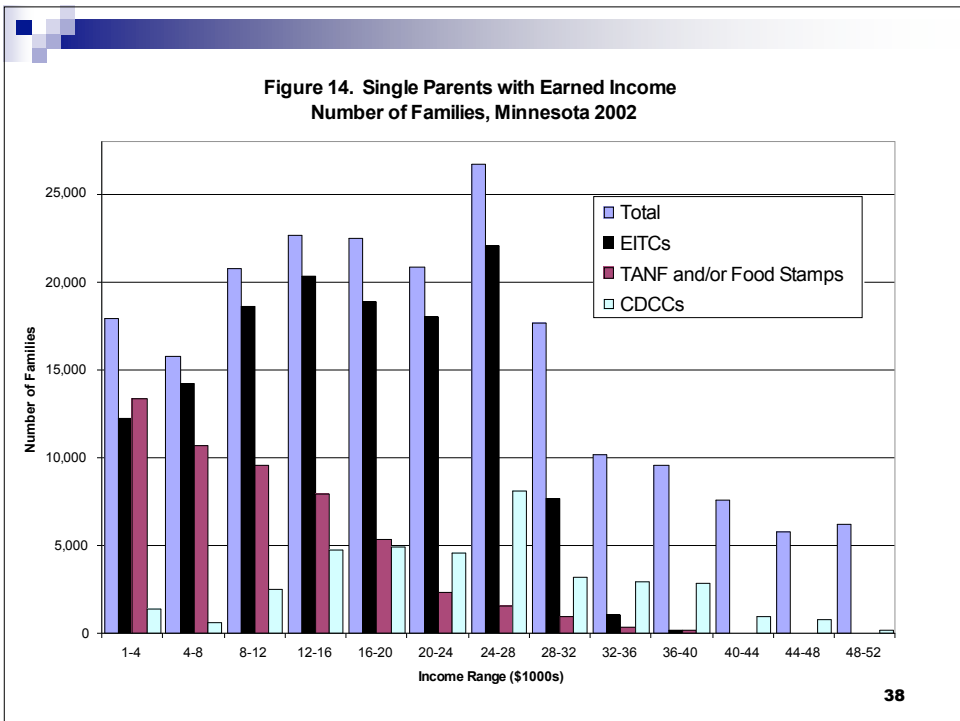
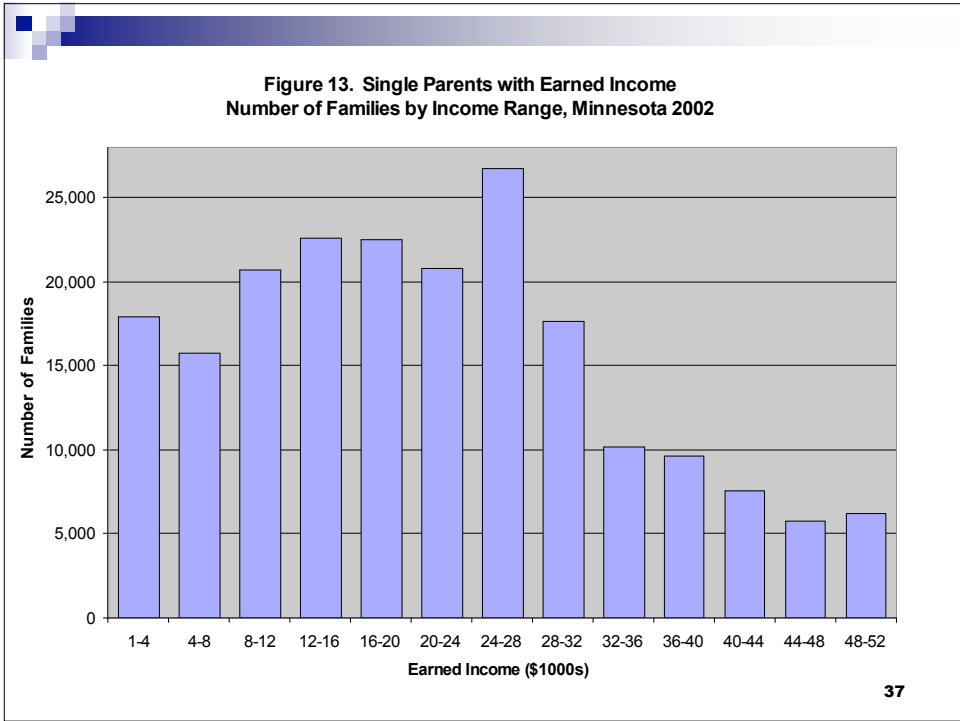


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- Is the baseline example a special case?
- Lower child care costs (rural MN) – no cliff when leaving BSF child care.
 - Single with one child – “range 2” does not exist.
 - Data on overlapping programs from Tax Incidence Study database – welfare and tax credits (but not MinnesotaCare or BSF child care)
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Conclusions

- If tax analysts don't do this analysis, no one else will.
- Tradeoffs familiar to economists, but not to most legislators and many other policy makers
- We have **not** been successful at regular model updating and standardizing output
- Would like to match tax and welfare records with health insurance and child care records.