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:


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)

- 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
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

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?
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.

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.
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.
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

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.
Figure 2A. Net Income Compared to Earned Income in 2004, Baseline Example

Figure 2B. Net Income Compared to Earned Income in 2004, Baseline Example
## Figure 1. Net Income Compared to Earned Income in 2004, Baseline Example

<table>
<thead>
<tr>
<th>Earned Income ($1000s)</th>
<th>Net Income ($1000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>15</td>
<td>15</td>
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<tr>
<td>20</td>
<td>20</td>
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<td>30</td>
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<td>35</td>
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<td>40</td>
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</tr>
<tr>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>50</td>
<td>50</td>
</tr>
</tbody>
</table>

Numbers show gain per $100 of additional earnings.

## Figure 2C. Net Income Compared to Earned Income in 2004, Baseline Example

- **Red**: Net income before medical costs or child care
- **Blue**: Net income after medical costs (zero child care)
- **Green**: Net income after both medical costs and child care costs

### Earning Ranges
- **2*Poverty Level**
- **3*Poverty Level**

### Poverty Level

- **Region 4**
**Figure 3. Average Change in Net Income Per $100 of Added Earnings**

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

**Impact of recent law changes**

  - 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 4. Gain from Additional $100 of Earnings in 2004 Under Old Law

Figure 5A
Net Income after Medical & Child Care Expenses in 2004 Under Alternative Laws
Figure 5B
Net Income after Medical & Child Care Expenses in 2004 under alternative laws

Figure 5C
Net Income after Medical & Child Care Expenses in 2004 under alternative laws
Figure 6. Impact of Law Changes Between 1998 and 2004
Change in Gain from Increasing Earnings by $100

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

Issue 1: Minnesota’s 2-tier EITC
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”

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)
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.
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 of BSF child care)
Net Income Compared to Earned Income
MFIP, Tax Credits, Taxes, Basic Sliding Fee, Childcare, MnCare Premiums, & Health Insurance

Single Parent with
One Child (age 2)

Married Couple with Two
Children (ages 2 and 5).
Spouse earns $10,000
Figure 13. Single Parents with Earned Income
Number of Families by Income Range, Minnesota 2002

Figure 14. Single Parents with Earned Income
Number of Families, Minnesota 2002
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.