



Minnesota's Taxes: Who Pays and How Much

An Explanation of Tax Incidence

One goal of any tax system is fairness. Fairness can be defined in many different ways, but one common way is by looking at what portion of income taxpayers are contributing in taxes. Fortunately, Minnesotans have a tool for looking at this issue — the *Tax Incidence Study*. The *Tax Incidence Study* shows that Minnesota's state and local tax system has the following characteristics:

- Minnesota's tax system is slightly regressive, with high-income Minnesotans paying a smaller percentage of their incomes in state and local taxes than Minnesotans with less income.
- Each tax varies in its impact. Lower-income Minnesotans pay more of their total taxes as sales and excise taxes; upper-income people pay more of their total taxes as income taxes.
- Tax changes made in the surplus years have reduced taxes for all income levels.

Measuring Tax Levels: The Tax Incidence Study

To determine who pays Minnesota's taxes, the Minnesota Department of Revenue releases a comprehensive *Tax Incidence Study* every two years.¹ 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 property tax on it, a portion of the tax is shifted to renters in the form of higher rents. Likewise, taxes paid by businesses may be shifted on to workers as lower wages, on to consumers as higher prices, or on to owners as a smaller return on their investment.

The *Tax Incidence Study* divides the population by income into ten groups containing an equal number of households, called deciles.² For example, the bottom decile contains the 10% of Minnesotans with the lowest incomes.³ The study looks at actual taxes paid and calculates what percentage of income each decile spends on Minnesota's taxes, which is called its *effective tax rate*. The *2003 Tax Incidence Study* covers taxes paid in 2000 and estimates taxes to be paid in 2005. The study was released in March 2003, and does not include the impact of decisions made in the 2003 Legislative Session.

Minnesota's Tax System is Slightly Regressive

Tax systems are often described in terms of regressivity or progressivity. A tax is said to be *regressive* if households with lower incomes pay a higher percentage of income for that tax than those with higher incomes do. In contrast, if those with higher incomes pay a higher percentage of income for a tax than do those with lower incomes, that tax is said to be

¹ Minnesota Department of Revenue, *2003 Minnesota Tax Incidence Study: An Analysis of Minnesota's household and business taxes*, March 2003, www.taxes.state.mn.us/legal_policy/research_reports/content/incidence.shtml. Except where noted, all data in this fact sheet come from current or past editions of the *Tax Incidence Study*.

² 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* in the tax incidence study 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 24% more households than the Census, and the median household income is approximately 20% less than reported by the Census.

³ There are a number of data concerns regarding the bottom decile, which overstates the level of taxation for this group. For this reason, it is common to disregard the first decile in analysis. Although the results for the first decile are shown in this document, the results from the first decile are generally disregarded when making statements about the tax system as a whole.

progressive. Minnesota’s overall tax system is slightly regressive, and sometimes is described as **proportional**, meaning all Minnesotans pay about the same percentage of their incomes in total state and local taxes. However, the label “proportional” may no longer fit Minnesota’s tax system as well as it once did.

The degree to which a tax is regressive or progressive is measured by the Suits Index, which is 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. Minnesota’s total state and local tax system has a Suits Index of –0.03, indicating that it is slightly regressive.

As shown in Table 1, individual tax types have very different Suits Indexes, with Minnesota’s estate tax being the most progressive and cigarette and tobacco taxes being the most regressive.

In Minnesota, the progressive income tax balances the regressivity of the other taxes. Minnesota is unusual in the degree to which it relies on the income tax, but this is also what helps make Minnesota’s state and local tax system less regressive than is seen in other states.

Estate Tax	0.249
Individual Income Tax	0.184
Total Tax System	-0.030
Total Local Property Taxes after Property Tax Refund/Renter’s Credit	-0.096
Total Local Property Taxes	-0.137
Corporate Franchise Tax	-0.149
Motor Vehicle Registration Tax	-0.153
General Sales and Use Taxes	-0.176
Alcoholic Beverage Excise Tax	-0.183
Motor Vehicle Sales Tax	-0.207
Motor Fuels Excise Tax (Gas Tax)	-0.278
MinnesotaCare Taxes	-0.296
Gambling Taxes	-0.372
Cigarette and Tobacco Excise Taxes	-0.553

Another way of measuring tax distribution is by comparing how much each group pays in relation to its share of total income. For example, although the wealthiest 10% pays more than 10% of total taxes, their share of total taxes is *less than* their share of total income. The wealthiest 10% of Minnesotans pay 38.7% of state and local taxes, but they receive 41.9% of total income.⁴

Decile	Income	Share of all Income	Share of all Taxes Paid
1	\$8,945 and under	1.0%	1.6%
2	\$8,946 - \$14,734	2.1%	1.8%
3	\$14,735 - \$20,731	3.1%	2.9%
4	\$20,732 - \$27,424	4.2%	4.2%
5	\$27,425 - \$35,029	5.5%	5.6%
6	\$35,030 - \$44,822	7.0%	7.7%
7	\$44,823 - \$56,869	8.9%	9.6%
8	\$56,870 - \$72,622	11.3%	12.1%
9	\$72,623 - \$102,411	14.9%	15.8%
10	\$102,412 and over	41.9%	38.7%

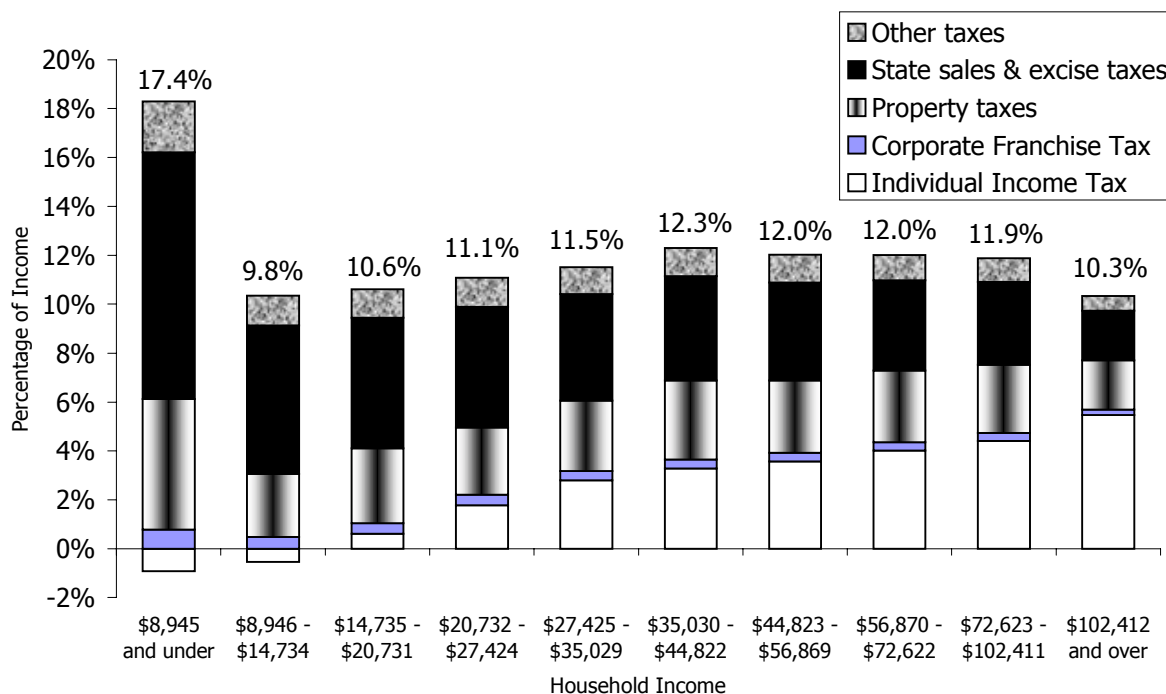
Minnesota’s Tax Distribution

In 2000, Minnesotans paid an average of 11.2% of their incomes in state and local taxes, with 8.4% of income being paid for state taxes and 2.8% for local property taxes. The way in which Minnesotans pay their taxes varies greatly with income, as shown in Graph 1 below. As income grows, sales and excise taxes become a smaller part of total taxes paid and income taxes become a larger part. This difference is important to keep in mind when evaluating proposals to change

⁴ An alternative way of looking at tax distribution is to compare state and local tax levels after accounting for the tax savings from federal taxable deductions. An analysis using this method describes Minnesota’s tax system as regressive. See Institution on Taxation and Economic Policy, *Who Pays?*, www.itepnet.org/whopays.htm.

a certain tax. The impact will not be evenly felt “across the board,” but will depend on how large of a share that tax contributes to the taxpayer’s total taxes paid.

Graph 1: Minnesota Effective Tax Rates (2000)



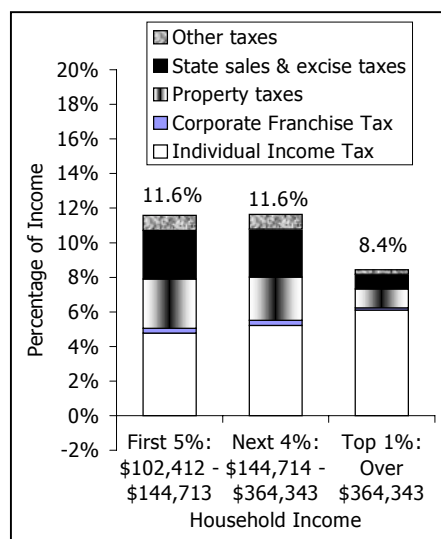
Graph 1 above puts households of the same income level together, but within each income group there will be households of different sizes, and the actual taxes paid by any particular household can vary from the average. Actual taxes paid will depend on factors such as family size, marital status, whether one is a homeowner or a renter, and eligibility for various tax deductions and credits.

The *Tax Incidence Study* allows for a closer look at the differences in taxes paid among those in the top decile. In addition to information about the wealthiest 10%, data is provided for the wealthiest 5% and the wealthiest 1%. Although as a group the wealthiest 10% of Minnesotans pay 10.3% of their incomes in total state and local taxes, breaking this decile into three groups shows a different picture. The wealthiest 1% pays 8.4% of their incomes in taxes, while the rest of the top 10% pays 11.6%, closer to the average amount paid by Minnesotans with low- and middle-incomes.

Changes Over Time

Since 1996, two significant and related changes have occurred in Minnesota’s tax system. One is that total tax levels were reduced for all income groups. Over the surplus years of 1997 to 2001, Minnesota’s taxes were cut significantly by the Legislature. One-time rebates totaling \$3.7 billion were enacted in each legislative session between 1997 and 2001. Permanent tax cuts were also made in each of the

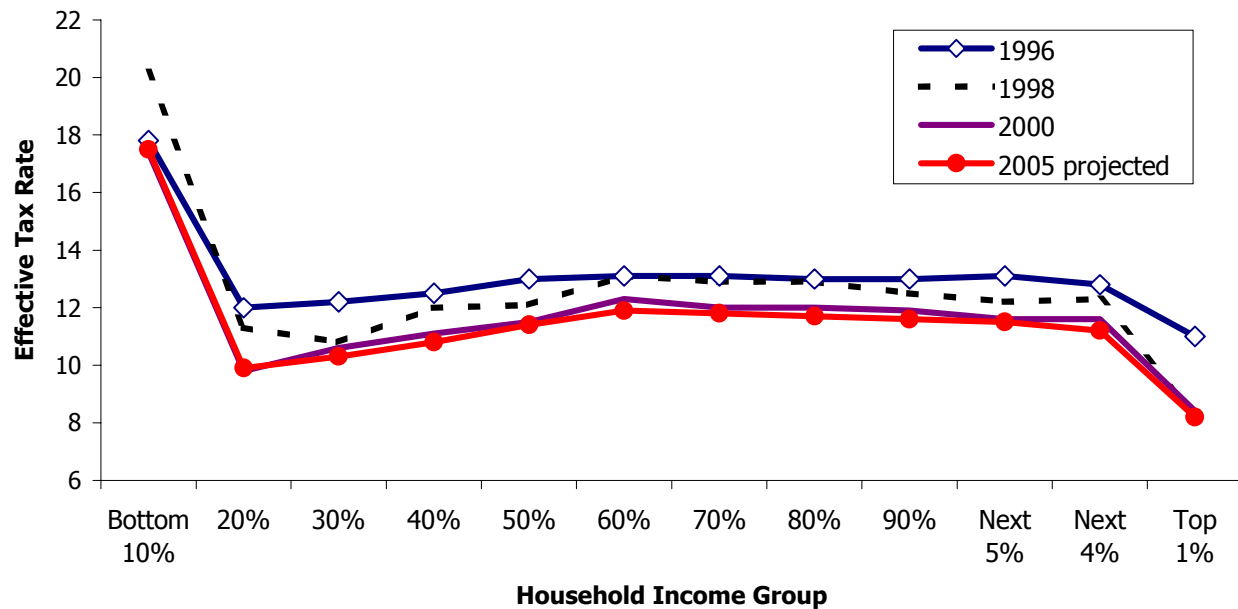
Graph 2: Minnesota Effective Tax Rates (2000), Top 10%



surplus years: property taxes were cut in 1997, 1998, 1999, and 2001, income taxes in 1999 and 2000, and motor vehicle registration taxes in 1999. The impact of these tax cuts is a \$2.8 billion reduction in total taxes in FY 2005.⁵

The *2003 Tax Incidence Study* provides estimated taxes for 2005, at which time all tax cuts enacted during the surplus years will be fully in effect. As mentioned above, in 2000 Minnesotans paid an average of 11.2% of their incomes in state and local taxes. In 2005, total state and local taxes are estimated to drop to 11.0% of income. This continues a steady decline in average taxes, which were 12.7% of income in 1996 and 11.8% of income in 1998.⁶

Graph 3: Minnesota Tax Levels Over Time, 1996 to 2005



The second change is that, although Minnesota’s state and local tax system is still not strongly progressive or regressive as measured by the Suits Index, when tax levels are graphed, it looks less like the “flat line” pattern associated with a proportional tax. Instead, a pattern is emerging in which Minnesota’s tax system is progressive from the lower to middle deciles, but regressive from the middle to upper deciles.

Policy Implications

Tax fairness is created through attention to how the tax system is structured. When evaluating tax proposals, Minnesotans should bear in mind the main findings of the *Tax Incidence Study*: Minnesota’s tax system is slightly regressive, individual tax types vary in their impact on Minnesotans of different income levels, and total taxes on all Minnesotans are significantly lower than they were in the past. Tax debates should always include understanding of the implications for the system’s level of fairness. Otherwise, unintended consequences may contribute to additional regressivity in the system.

⁵ House Fiscal Analysis, *Tax Cuts and Rebates: The Fiscal Impact of Five Years of Tax Cuts (1997–2001)*, www.house.mn/fiscal/files/02taxcuts.pdf.

⁶ The *2003 Tax Incidence Study* includes more of the total state and local tax system, and for the first time included the estate tax, waste taxes, local sales taxes, taconite taxes, and local gross receipts taxes. This added 1.9% to total measured taxes, which means that average tax levels for previous years is understated. Adjusting for this difference suggests average taxes of 13.0% in 1996 and 12.0% in 1998. The data in Graph 3 has *not* been adjusted to reflect this difference.