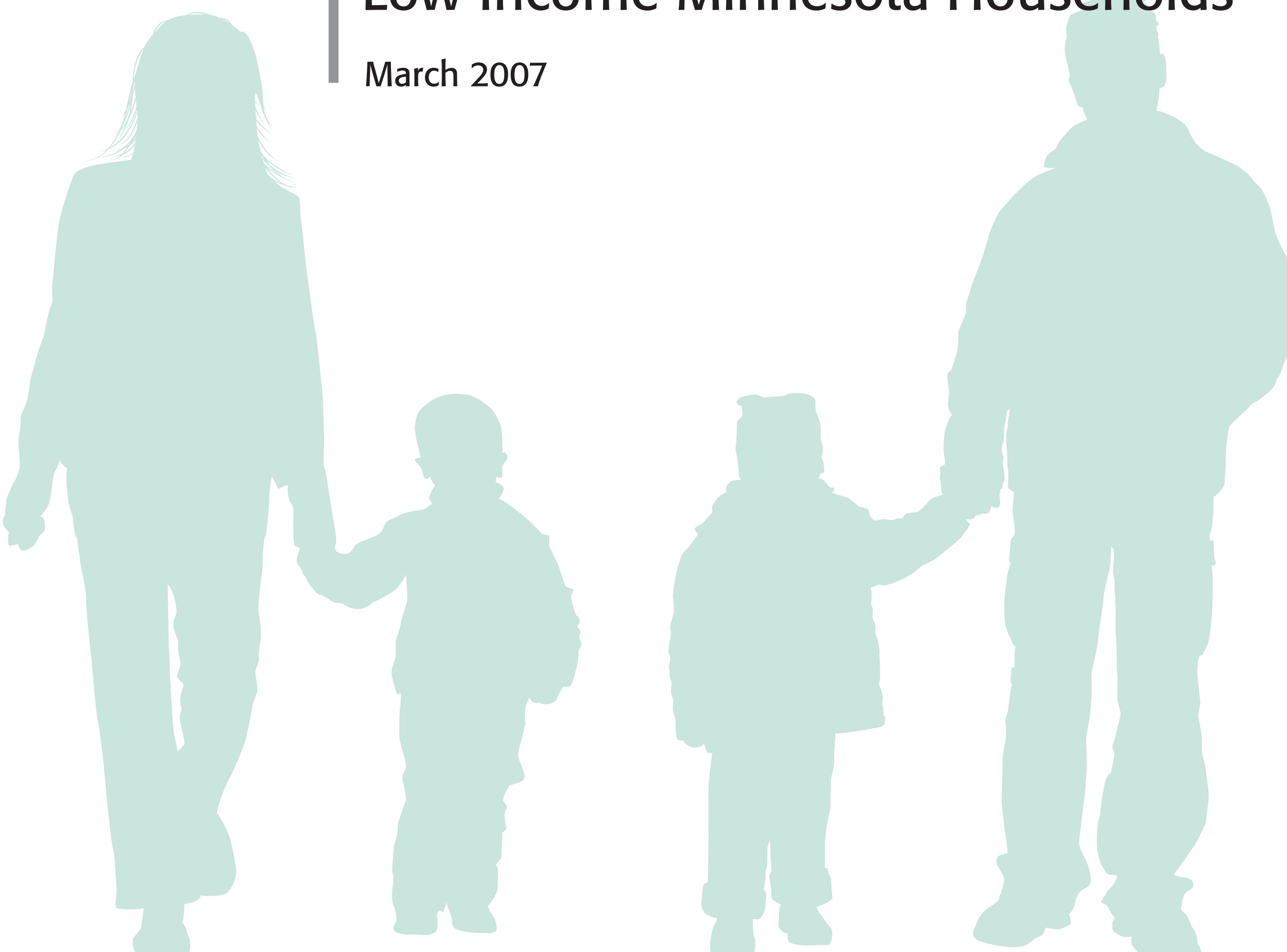
Disincentives to Earn

An Analysis of Effective Tax Rates on Low Income Minnesota Households

March 2007



Center for Public Finance Research

CPFR

RESEARCH IN GOVERNMENT

a 501 c(3) research and education organization
supporting the educational mission of the
Minnesota Taxpayers Association

Federal Child Tax Credit

Description
Provides a federal tax credit for children.

Funding Sources and Administration
Federal, administered by the Internal Revenue Service.

Population Served and Eligibility
Target population: families with children.

Administrative requirements: U.S. citizen, qualifying child who is a child. Children qualify by passing five tests: relationship (child, step-child, foster child, sibling, step-sibling, half-sibling or descendants of any of the previous); age (must be under 17); residency (must live with claimant for more than one-half of the tax year); support (cannot have provided over half of his or her own support during the tax year); and citizenship/residency (must be a U.S. citizen, a U.S. national or a resident of the United States).

Eligibility—Income Limits
The credit phases out above the following income levels: $110,000 modified adjusted gross income (modified AGI) for married-joint filers, $55,000 for married-separate filers and $75,000 for single taxpayers.

Eligibility—Asset Limits
None.

Calculation of Benefits
The maximum benefit is $1,000 per child. The credit is reduced by $50 for each $1,000 or fraction thereof above the threshold amount.

Fiscal and Usage Data

Federal Child Tax Credit Recipients and Costs: 1996 - 2005

Tax Year	Recipients	Cost	Cost per Recipient
1996	N.A.	N.A.	N.A.
1997	N.A.	N.A.	N.A.
1998	465,251	$309,942,000	$666
1999	482,071	395,957,000	821
2000	484,713	396,486,000	818
2001	486,036	456,920,000	940
2002	475,042	437,706,000	921
2003	470,747	457,918,000	973
2004	Data not available	Data not available	Data not available
2005	Data not available	Data not available	Data not available

Source: *Internal Revenue Service. Calculations by MCPFR/MTA.*

Federal Dependent Care Tax Credit

Description
Nonrefundable credit for a portion of qualifying child or dependent care expenses paid so that the taxpayer can be gainfully employed.

Funding Sources and Administration
Federal, administered by the Internal Revenue Service.

Population Served and Eligibility
Target population: families with children.

Administrative requirements: U.S. citizen, or non-citizen lawfully resident in the United States; the taxpayer must incur employment-related expenses in providing care for: a dependent who is under the age of 13 or a dependent or spouse who is physically or mentally incapable of caring for herself or himself, and who lives with the taxpayer for more than one-half of the year. Recipients may not file married-separate.

Eligibility—Income Limits
None.

Eligibility—Asset Limits
None.

Calculation of Benefits
The maximum amount of employment-related expenses to which the credit can be applied is $3,000 for one qualifying child and $6,000 for two or more qualifying children. Actual child care expenditures (to these caps) are multiplied by a percentage, which is determined by the taxpayer's adjusted gross income as follows:

Child and Dependent Care Tax Credit Percentages, Effective Tax Year 2005

Adjusted Gross Income		
Over	Not over	Decimal Amount
$0	$15,000	.35
15,000	17,000	.34
17,000	19,000	.33
19,000	21,000	.32
21,000	23,000	.31
23,000	25,000	.30
25,000	27,000	.29
27,000	29,000	.28
29,000	31,000	.27
31,000	33,000	.26
33,000	35,000	.25
35,000	37,000	.24
37,000	39,000	.23
39,000	41,000	.22
41,000	43,000	.21
43,000	No limit	.20

Source: Internal Revenue Service

The maximum credit is $1,050 for one child and $2,100 for two or more children.

Fiscal and Usage Data

Federal Child and Dependent Care Tax Credit Recipients and Costs: 1996 - 2005

Fiscal Year	Recipients	Cost	Cost per Recipient
1996	127,095	$47,906,000	$375
1997	128,349	48,923,000	381
1998	132,910	50,711,000	382
1999	134,860	51,645,000	383
2000	135,862	52,473,000	386
2001	131,299	50,862,000	387
2002	129,882	49,984,000	385
2003	143,548	61,743,000	430
2004	Data not available	Data not available	Data not available
2005	Data not available	Data not available	Data not available

Source: *Internal Revenue Service, calculations by MCPFR/MTA.*

Minnesota Dependent Care Tax Credit

Description
Nonrefundable credit for a portion of qualifying child or dependent care expenses paid so that the taxpayer can be gainfully employed.

Funding Sources and Administration
State, administered by the Minnesota Department of Revenue.

Population Served and Eligibility
Target population: low and middle income families with children.

Administrative requirements: Same as the federal credit above. Licensed daycare providers who provide care for their own children under the age of 6 qualify for the Minnesota credit. Filers who add a child to their family through birth or adoption during a tax year may claim the Minnesota credit for that year even if only one spouse has earned income.

Eligibility—Income Limits
Household income must be $34,070 or less.

Eligibility—Asset Limits
None.

Calculation of Benefits
The maximum amount of employment-related expenses to which the credit can be applied is $3,000 for one qualifying child and $6,000 for two or more qualifying children. The table below outlines total Minnesota Child and Dependent Care Credit amounts at various income points.

Minnesota Child and Dependent Care Tax Credit Amounts, By Income and Number of Dependents, Tax Year 2005

Earned Income*	1 Child	2+ Children
$2,500	$720	$1,440
5,000	720	1,440
7,500	720	1,440
10,000	720	1,440
12,500	720	1,440
15,000	720	1,440
17,500	720	1,440
20,000	720	1,440
22,500	612	1,224
25,000	468	936
27,500	342	684
30,000	216	432
32,500	90	180

** All wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment (determined with regard to the deduction for one-half of self-employment taxes).*
Source: Minnesota Department of Revenue

Fiscal and Usage Data

Minnesota Child and Dependent Care Tax Credit Recipients and Costs: 1999 – 2005

Fiscal Year	Recipients	Cost	Cost per Recipient
1999	35,020	11,982,640	342
2000	35,741	10,887,630	304
2001	Data not available	Data not available	Data not available
2002	37,180	11,659,307	314
2003	36,184	13,270,369	367
2004	36,135	12,855,588	356
2005	37,008	15,242,936	412

Source: *Minnesota Department of Revenue, calculations by MCPFR/MTA.*

Minnesota Property Tax Refund for Renters

Description
Provides a property tax refund for renters.

Funding Sources and Administration
State, administered by the Minnesota Department of Revenue.

Population Served and Eligibility
Target population: low to moderate income Minnesotans.

Administrative requirements: Minnesota resident; either U.S. citizen, or non-citizen lawfully resident in the United States; renter.

Eligibility—Income Limits
Income limits for the renter's property tax credit vary according to the number of dependents in the household as follows:

Minnesota Renters' Property Tax Refund Income Limits, Tax Year 2005

Number of Dependents in Household	Income Limit
0	$47,350
1	51,830
2	55,990
3	59,830
4	63,350
5 or more	66,550

Source: Minnesota Department of Revenue

Eligibility—Asset Limits
None.

Calculation of Benefits
Filers receive 19 percent of the rent paid during the tax year.

Fiscal and Usage Data
Renters' Property Tax Refund Recipients and Costs: 1996 - 2005

Fiscal Year	Filers	Total Annual Cost
1996	N.A.	$85,562,000
1997	N.A.	100,722,000
1998	N.A.	108,137,000
1999	N.A.	101,526,000
2000	N.A.	108,777,000
2001	N.A.	115,389,000
2002	N.A.	118,961,000
2003	N.A.	130,849,000
2004	N.A.	143,381,000
2005	N.A.	145,931,000

Source: *Fiscal Facts for Minnesotans,* Minnesota Taxpayers Association from various DOR publications.

Minnesota Property Tax Refund for Homeowners

Description
Two programs, the regular property tax refund and the special ("targeted") property tax refund, provide property tax refunds to qualifying homeowners.

Funding Sources and Administration
State, administered by the Minnesota Department of Revenue.

Population Served and Eligibility
Target population: low to moderate income Minnesotans (regular refund), Minnesotans with quickly escalating homestead taxes (special refund).

Administrative requirements: Minnesota resident; either U.S. citizen, or non-citizen lawfully resident in the United States; homeowner who owns and resides in the home on January 2 in consecutive years. For the special property tax refund only, the annual net property tax on the homestead must increase by more than 12 percent **and** that increase must be at least $100.

Eligibility—Income Limits
There are no income limits for the targeted property tax refund. Income limits for the regular homeowner's property tax refund vary according to the number of dependents in the household as follows:

Minnesota Regular Homeowners' Property Tax Refund Income Limits, Tax Year 2005

Number of Dependents in Household	Income Limit
0	$87,780
1	92,260
2	96,420
3	100,260
4	103,780
5 or more	106,980

Source: Minnesota Department of Revenue

Eligibility—Asset Limits
None.

Calculation of Benefits
Regular refund: the size of the refund depends on: the amount of property tax paid, household income and number of dependents in the household. The maximum refund is $1,640.
Special refund: the refund is 60% of the property tax increase in excess of the greater of 12 percent or $100, with a credit cap of $1,000.

Fiscal and Usage Data

Homeowners' Regular and Targeted Property Tax Refund Recipients and Costs: 1996 - 2005

Fiscal Year	Filers	Regular Refund	Targeted Refund
1996	N.A.	$84,350,000	$3,811,000
1997	N.A.	81,411,000	1,424,000
1998	N.A.	78,821,000	1,292,000
1999	N.A.	78,783,000	1,560,000
2000	N.A.	72,792,000	1,601,000
2001	N.A.	68,189,000	1,163,000
2002	N.A.	72,851,000	3,293,000
2003	N.A.	86,883,000	690,000
2004	N.A.	129,799,000	14,558,000
2005	N.A.	147,080,000	7,309,000

Source: *Fiscal Facts for Minnesotans,* Minnesota Taxpayers Association from various DOR publications.

This Page Intentionally Blank

Appendix B: Assumptions Used in the Development of the Family Assistance Model

Earned Incomes and Wages

Minnesota's minimum wage increased during calendar year 2005, from $5.15 per hour to $6.15 per hour on August 1, 2005. For instances when MCPFR staff calculated a minimum wage standard, a weighted average of $5.5692 per hour was used.

Earnings are assumed to be split between earners on a 60/40 basis except for total household earnings under $23,168 (the amount at which two persons work full-time at minimum wage). Under this amount, we assume that one parent works full-time, while the second parent works gradually less until he or she no longer works. Based on conversations with Department of Human Services staff, it is more likely that one parent will work full-time and one parent will work part-time than it is that both parents will work part-time.

Benefits programs:

Benefits programs in the model reflect eligibility requirements and benefit levels in effect during Federal Fiscal Year (FFY) 2005 (for federally-administered programs) and State Fiscal Year (SFY) 2006 (for state-administered programs). We used FFY 2005 since it covers the bulk of calendar year 2005. Each state fiscal year covers six months of calendar year 2005; therefore, we used SFY 2006 (which covers the second half of calendar year 2005) instead of SFY 2005 because it is much easier to find the necessary data.

Tax credits

We used tax year 2005, which corresponds to calendar year 2005 for virtually all individual income tax filers. We assumed that the model families had no interest or capital gains income, and that all families claimed the standard deduction. Minnesota Department of Revenue staff indicated that our assumption regarding the standard deduction is appropriate.

MFIP:

As per Minnesota Statutes 256J.37 subd. 3a, monthly Section 8 housing benefits to a maximum of $50 were subtracted from the total MFIP grant. We assumed that the model families do not receive income from Social Security. Based on a conversation with Minnesota Department of Human Services staff, we assume that MFIP recipients who do not meet the hourly work requirements through paid employment supplement that time with job search activities, and therefore do not have MFIP benefits reduced through sanctioning.

Medical Assistance and MinnesotaCare:

The benefit provided by these programs is a government subsidized health care plan. We assume that the benefit is equal to the cost that someone would pay to replace the plan, if it were not available. Given that the benefit provides a range of services rather than a fixed-dollar benefit, estimating the dollar value of the benefit poses certain problems.

We have borrowed from the work of the JOBS NOW coalition in addressing this problem. JOBS NOW regularly issues information regarding the cost of living in Minnesota. These cost of living budgets are based on a "no-frills" standard of living that falls short of a middle-class existence.[24] Given that claim, it is unlikely that JOBS NOW's figures would overstate the cost of health care, which in turn would overstate the value of benefit.

JOBS NOW's assumptions are as follows:

> Health care costs include both out-of-pocket expenses and the family share of insurance premiums. Out-of-pocket expenses are based upon data from the 2002 Medical Expenditure Study, which includes age-specific data. Adjustments for inflation are based upon the health care rate reported by the U.S. Consumer Price Index-Urban for Medical Care (CPI-U).
>
> Insurance premium costs are divided between the employee share of employer-sponsored insurance and the costs of non-group or private insurance policies. According to the 2004 Current Population Survey, 66.7% of the Minnesota population under 65 is covered by employer-sponsored insurance, and 24.4% is either covered by no insurance or by privately purchased insurance. In this study, since health care insurance coverage is considered a basic need, we assume that this 24.4% would have to purchase private non-group insurance. The remaining 8.9% of the population is covered by Medicare/Medicaid at no cost to the insured.
>
> Monthly healthcare costs are arrived at by computing a weighted average of the costs of employee contributions under employer-sponsored insurance plans, under Medicare/Medicaid, and under private non-group coverage. Out-of-pocket costs are then added to this weighted average. Costs for employee contributions varied, depending on whether the employee purchased single coverage, employee-plus-one, or family coverage. JOBS NOW applied the appropriate costs based on family size.
>
> Costs for non-group, private insurance premiums are based upon the cost of coverage for a policy from Health Partners for the family types we have defined. We assume both single and married parents to be twenty-five years old and non-smokers. We also assume an only child to be two years of age and two children in a family to be two and six years of age. The policy has a $500 deductible and 20% coinsurance with no additional copay. Data were obtained from www.ehealthinsurance.com.[25]

The benefit is calculated based on the number of family members qualifying for either Medical Assistance or MinnesotaCare. The benefit provided by MinnesotaCare and Medical Assistance is deemed to be equal, but MinnesotaCare benefits are reduced by the appropriate copayment.

The model does not capture the costs that MinnesotaCare and Medical Assistance recipients pay for eyeglasses ($3 for Medical Assistance, $25 for MinnesotaCare) and for prescription drugs ($3 per brand name prescription and $1 per generic prescription for Medical Assistance; $3 per prescription for MinnesotaCare). To the extent that the model family purchases eyeglasses or prescription drugs, the model overstates the medical benefits provided by the state. However, even assuming 24 prescriptions and 2 pairs of eyeglasses per year, the benefit is only overstated by $122 annually for MinnesotaCare and from between $18 and $42 per year for Medical Assistance.

---

[24] *The Cost of Living in Minnesota, 2004*, JOBS NOW Coalition, http://www.jobsnowcoalition.org, p. 1 (accessed August 9, 2006).
[25] Op cit., p. 39.

Child Care:

The model assumes that child care benefits are only provided to one-parent when that parent works 20 hours per week at minimum wage, and are only provided to two-parent families when both parents work a total of 60 hours per week. Minnesota Department of Human Services staff indicated that our assumption regarding these cutoffs regarding the provision of child care benefits is appropriate.

The model assumes that families pay an hourly rate for child care up to the point where the hourly rate exceeds the weekly rate. At that point, we assume that families pay the weekly child care rate.

The model assumes that, provided work requirements are met, MFIP-qualifying households are automatically provided with child care assistance. Families that do not qualify for MFIP may qualify for Basic Sliding Fee childcare, provided they meet the income guidelines.

The model assumes that non-school age children (under age 5) consume "full-time" child care and that school-age children (age 5 and older) consume "full-time" child care for 14 weeks per year (summer vacation), and consume 2.5 hours of child care weekly for the remainder of the year. This assumption was also used by the Office of the Legislative Auditor in its January 2002 program evaluation report *Economic Status of Welfare Recipients*.

Since the benefit payments are set at the 75th percentile of the median rate for each county, it is assumed that the family consumes the maximum benefit. We assume that families pay the county median rate for childcare, and that the family contributes the difference between the child care rate and the state-provided benefit. Similarly to the Legislative Auditor's study, the model assumes that the children are placed in an in-home day care facility (as opposed to a day care "center"). Applicable co-pays are automatically subtracted from the benefit.

Women, Infants and Children (WIC):

WIC provides vouchers for the purchase of certain foods. The value of the benefit will vary somewhat from family to family for two reasons. First, prices for the same products fluctuate from store to store. Secondly, each family will have different tastes and preferences. The following prices were recorded at Cub Foods in Saint Paul during August of 2006, and were incorporated into the model:

Type of food	Food assumed purchased per month	Size(s) of Purchase	Cost
Infant Formula	Enfamil EnfaCare Lipil 22 Calorie Milk Power	12.9 oz	12.99
Juice	Minute Maid Orange Juice Concentrate - Frozen	16 oz	2.59
Infant Cereal	Gerber Mixed Cereal	16 oz and 8 oz	5.18
Cereal	Cheerios	0 oz X2 and 15 oz	8.87
Milk	Kemp's 1%	1 gal	3.69
Milk	Kemp's 1%	1/2 gal	2.29
Milk	Kemp's 2%	1 quart	1.69
Eggs	Eggs	12 ct.	1.79
Peanut Butter	Flavorite	18 oz	1.99

Section 8 Housing:

The model assumes that families of 1 or 2 persons occupy a one-bedroom apartment, and that a family of 3 to 6 persons occupies a 2 bedroom apartment. We assume that model families occupy apartments renting at the county median. To determine this, we first apply the median rent for the appropriate county and apartment size (either one or two bedrooms) as determined by the Department of Housing and Urban Development. However, we realize that tastes and preferences in housing will vary considerably with income. Therefore, we gathered data on Wisconsin's Renters Tax Credit, which provides information on credits per capita by income strata. We used this information to adjust rent paid based on income as follows:

Gross Income	Adjustment from Median Rent
Less than $5,000	72.46%
Above $5,001	76.09%
Above $10,001	84.06%
Above $15,001	90.58%
Above $20,001	97.10%
Above $25,001	102.90%
Above $30,001	111.59%
Above $40,001	121.01%
Above $50,001	129.71%

Note that the Wisconsin data is presented in terms of Wisconsin Adjusted Gross Income (WAGI). We assume that the households modeled in this report do not have the additions (including: state and municipal interest; capital gain/loss addition; or farm losses) or the subtractions (including: state income tax refunds; interest or mutual fund dividends from U.S. bonds; or social security adjustments) that would make WAGI differ from Federal Adjusted Gross Income (FAGI). Since FAGI is virtually identical to gross income for the households under consideration in this report, we substituted gross income for WAGI when adjusting rents paid based on the data in the Workers Tax Credit.

Food Support (Food Stamps):

The model incorporates the rent and child care assumptions already discussed. Utility consumption is determined by combining expenditure-by-household income data (provided by the federal Energy Information Administration) with the $35 telephone allowance.

Energy Assistance:

The "Alliance for Energy and Economic Growth" indicates that 79% of Minnesota households rely on natural gas for heat, so the model home was assumed to be heated with natural gas. The model does not utilize the "cost-based" matrix (which requires information about the previous heating season's heating costs), but instead utilizes the "back-up assistance" matrix.

National School Lunch/Breakfast Programs:

Assumes meals are consumed for 180 days of the calendar year.

Federal Child Care Credit:

Assumes that income is split between earners as described above. Assumptions regarding total child care payments are identical to those described above under *Child Care*.

Minnesota Marriage Credit:

Assumes that income is split between earners as described above.

Minnesota Property Tax Refund:

The model incorporates rent assumptions discussed above. The state disallows Section 8 benefits from being considered in the property tax refund; therefore, the benefit was calculated based on rent paid out-of-pocket only.

This Page Intentionally Blank

Center for Public Finance Research

CPFR

RESEARCH IN GOVERNMENT

Research Arm of the Minnesota Taxpayers Association

85 East 7th Place
Suite 250
Saint Paul, Minnesota 55101