MN HOUSE RESEARCH

Memorandum

May 8, 2023

To Representative Aisha Gomez

From Sean Williams, Legislative Analyst

Subject Effective marginal tax rates under different child credit proposals

You requested more information about the effective marginal tax rates faced by low- and moderate-income Minnesotans under the House and Senate's proposed child tax credits. This memo provides additional detail on the state and federal marginal tax rates resulting from credit phaseouts and tax brackets.

Executive summary

Under current law, low- and moderate-income taxpayers face high effective marginal rates. This is especially true of taxpayers who are in the phaseout ranges for the federal earned income credit and Minnesota working family credit, which are subject to phaseouts as high as 21.06% and 10.5%, respectively.

- The Senate's proposed child credit adds an additional 6.2% phaseout on top of existing state and federal phaseouts, resulting in marginal tax rates as high as 55.11%, depending on the taxpayer's filing status and number of children.
- The House proposal jointly phases out the working family and child credits, which avoids imposing additional marginal taxes upon individuals in the credit phaseout range.
- While precise estimates are difficult, taxpayers may also be subject to phaseouts of means-tested transfer programs over the same income range, which can cause effective marginal rates to approach or exceed 100%.
- Neither the Senate nor the House child credit proposal can fully address these issues, which are partially the result of federal policy. For most taxpayers, the House bill does not increase marginal rates relative to current law.

Tax credit phaseouts are mathematically equivalent to taxes

For a refundable tax credit, the rate at which the credit phases out is mathematically equal to an income tax rate. For example, a credit with a phaseout rate of 10% causes a credit to decrease by $10 for every $100 of income above the phaseout. Because tax credits reduce tax liability dollar for dollar, this results in the same financial change for the taxpayer as a 10% tax rate (which requires the taxpayer to pay $10 for every $100 of income).

Economic research suggests high marginal rates can be harmful to low-income individuals

High marginal tax rates make it difficult for low-income individuals to improve their standard of living and accumulate wealth as they move up the income distribution. Individuals may choose to work longer hours or pursue education to advance in their careers, but see little change in their material well-being, which can both frustrate workers trying to advance economically and reduce the incentive to earn more.

For example, research from economists at the Federal Reserve Bank of Atlanta[1] found that a Certified Nursing Assistant (CNA) may see less total income in the short run as a result of pursuing a job as a licensed practical nurse (LPN) or registered nurse (RN), even if the long-run earnings are higher in more skilled nursing professions. This can make it difficult for CNAs to transition into higher-skilled, higher paying jobs.

High marginal rates currently apply to low- and moderate-income taxpayers

Under current law, many state and federal refundable credits—particularly credits targeted at families with children—are phased out over the same income range. For example, for married couples filing jointly with two children, the following phaseouts apply in tax year 2023:

- **Working family credit:** Phased out at 10% from $37,230 to $60,489.
- **Dependent care credit:** Phased out at 5% from $59,210 to $83,210.
- **Federal earned income credit:** Phased out at 21.06% from $28,120 to $59,478.

In addition, the federal and state brackets begin to apply in similar income ranges, as the taxpayer's income begins to exceed the standard deduction and dependent exemption. For a married joint filer with 2 children, the first tier of the state and federal income tax begin to apply in the same income range.

- **State first tier income tax:** 5.35% rate begins to apply at $37,250 of total income (after the standard deduction and 2 dependent exemptions).
- **Federal first tier of the income tax:** 10% rate begins to apply at $27,700 of total income (after the standard deduction) and 12% rate begins to apply at $49,700 of total income.

While this memo discusses the marginal tax rates resulting from the policies listed above, there are other credit phaseouts in the same income range that may affect the effective marginal rates faced by taxpayers. The Minnesota education credit phases out at a very high rate (effectively 75%), from $33,500 to $37,500 of household income, and the while the student

[1] David Altig, Elias, Ilin, Alexander Ruder, and Ellyn Terry. "Benefit Cliffs and Financial Incentives for Career Advancement: A Case Study of The Health Care Career Pathway." Federal Reserve Bank of Atlanta Community and Economic Development Department. January 2020. https://www.atlantafed.org/community-development/publications/discussion-papers/2020/01/31/01-benefits-cliffs-and-the-financial-incentives-for-career-advancement.aspx

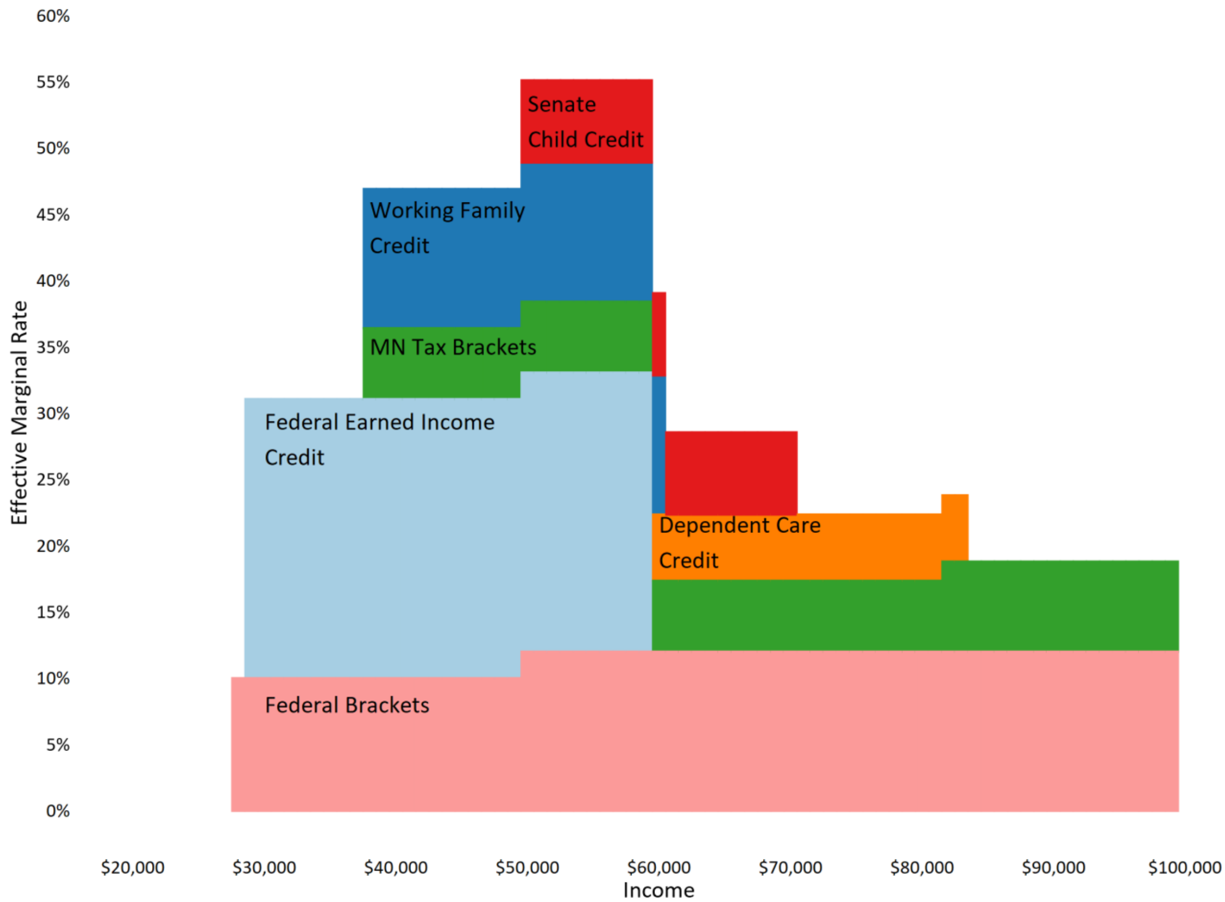
loan credit's phaseout depends on the amount of payments the taxpayer made, it can begin to phase out as low as $10,000 of AGI.

Comparison of effective tax rates under the House and Senate's proposals

The Senate proposed a new child credit which would be allowed in addition to existing credits. The credit would be phased out by $62 for every $1,000 of income (equal to a 6.2% rate), beginning at $50,000 of AGI for married taxpayers filing joint returns. This phaseout increases the effective marginal tax rate paid by taxpayers in the phaseout range. This results in effective marginal tax rates as high as 55.11% for married taxpayers filing joint returns with 2 children. In tax year 2023, from $50,000 to $59,478 of income, a married couple with 2 kids is subject to the 12% federal rate, the 21.06% federal EITC phaseout, the 5.35% state rate, the 10.5% state working family credit phaseout, and the 6.2% phaseout of the Senate's child credit.

Figure 1 below shows the way that these phaseouts stack upon one another in the Senate's proposal.

Figure 1: Effective State and Federal Marginal Tax Rates by Income, Senate's Child Credit
Married Taxpayer, 2 Children, Tax Year 2023

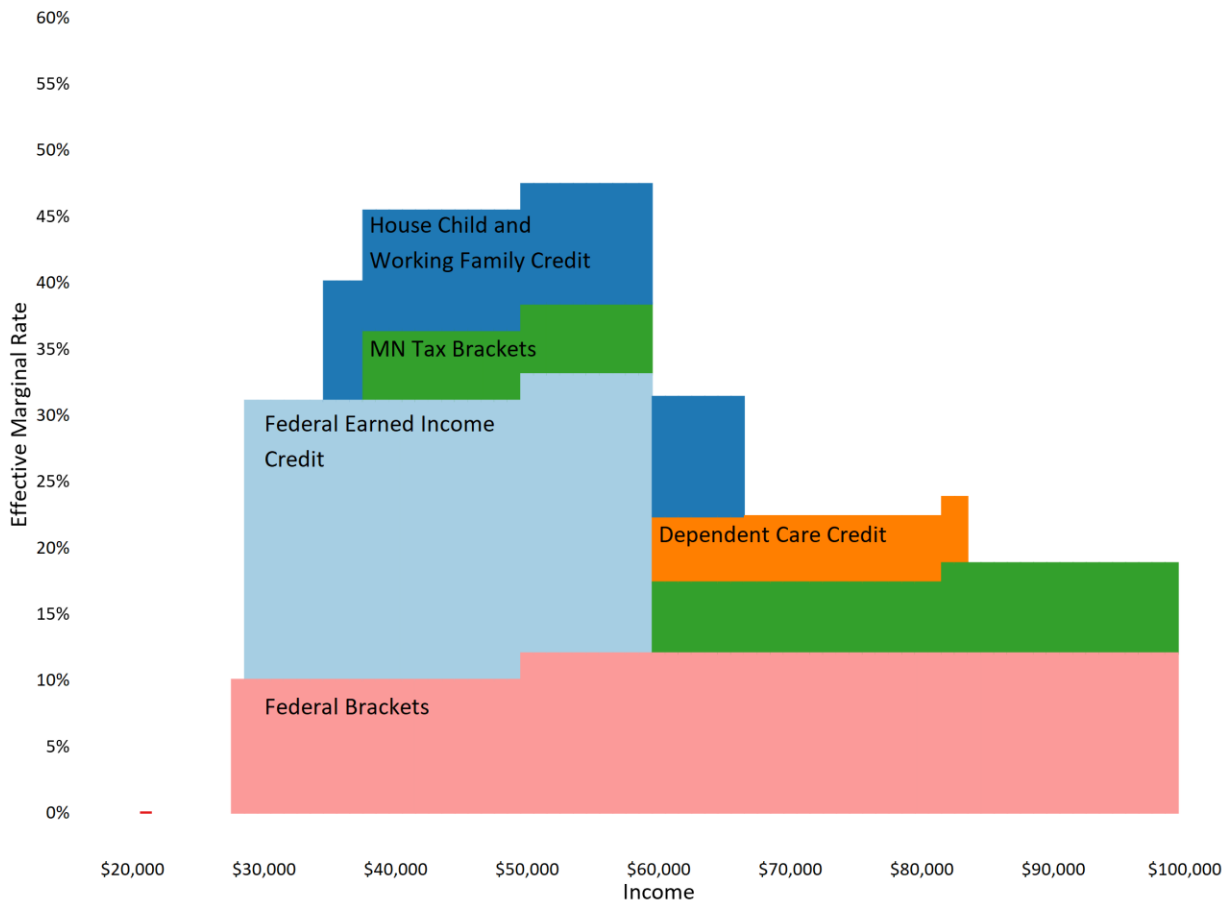


Graphic by House Research.

The House proposal phases out the working family credit in tandem with the child credit, and actually lowers the phaseout rate relative to the existing working family credit (for married taxpayers with 2 children). This results in a maximum effective marginal rate of 47.4%, a rate that is still high, but is more than 10 percentage points lower than the Senate, and slightly lower than existing law. Figure 2 below shows the combined effective marginal rates under the House omnibus bill proposal.

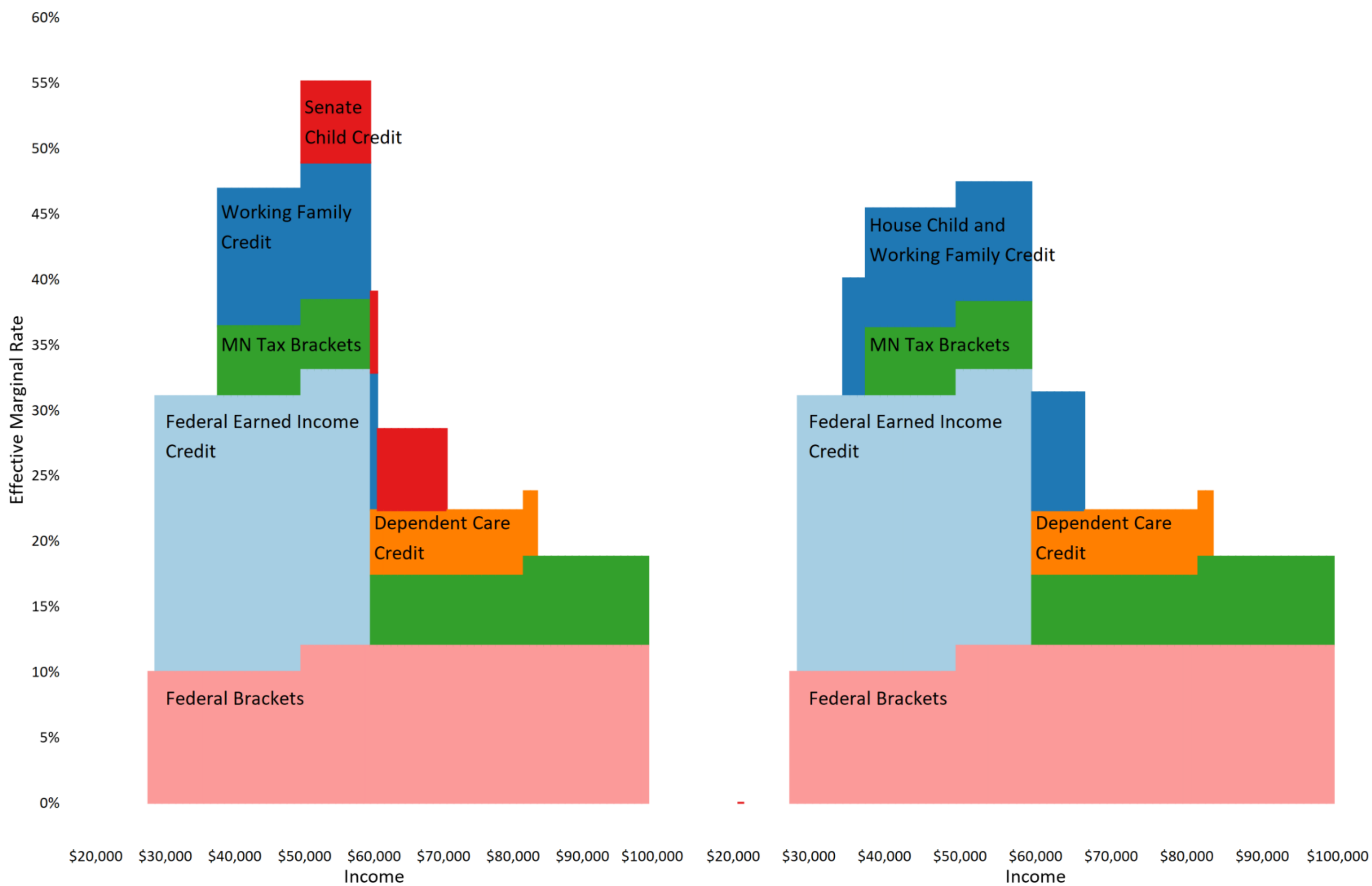
Figure 2: Effective State and Federal Marginal Tax Rates by Income, House Child Credit

Married Taxpayer, 2 Children, Tax Year 2023



Graphic by House Research.

Figures 1 and 2, Combined: Effective State and Federal Marginal Tax Rates by Income, House and Senate
Married Taxpayer, 2 Children, Tax Year 2023



Graphic by House Research.

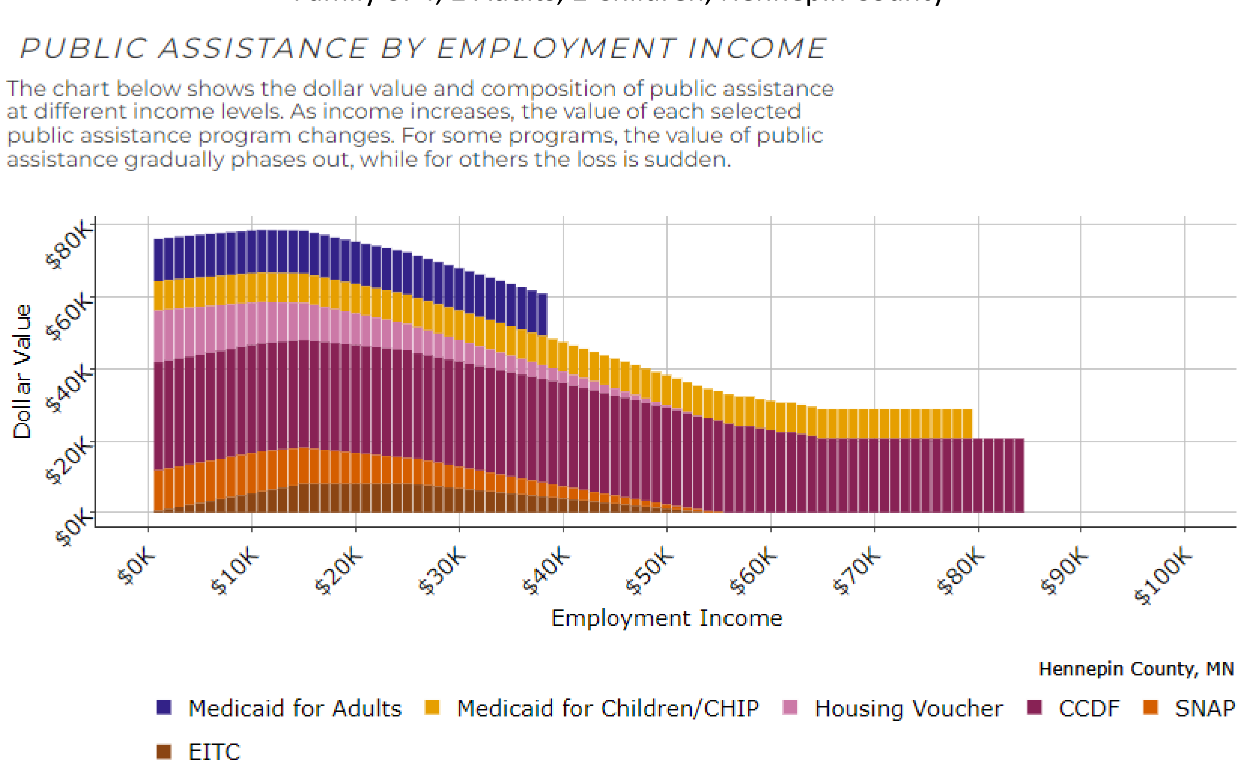
Transfer programs impose additional taxes over very similar income ranges

Figures 1 and 2 above only account for the phaseouts of state and federal credits and tax brackets. However, many public transfer programs are also phased out over similar income ranges.

The Federal Reserve Bank of Atlanta developed a tool to show how public benefits phase out in different geographic regions under current law. Figure 3 below shows how public benefits phase out in Hennepin County as income increases—the graph covers Medicaid, housing vouchers, child care subsidies (CCDF), Supplemental Nutritional Assistance (SNAP), and the federal the Earned Income Credit (EIC). The graph displayed shows the situation for a family of 4 with 2 children ages 18 and younger.

Figure 3: Public Assistance by Employment Income

Family of 4, 2 Adults, 2 Children, Hennepin County



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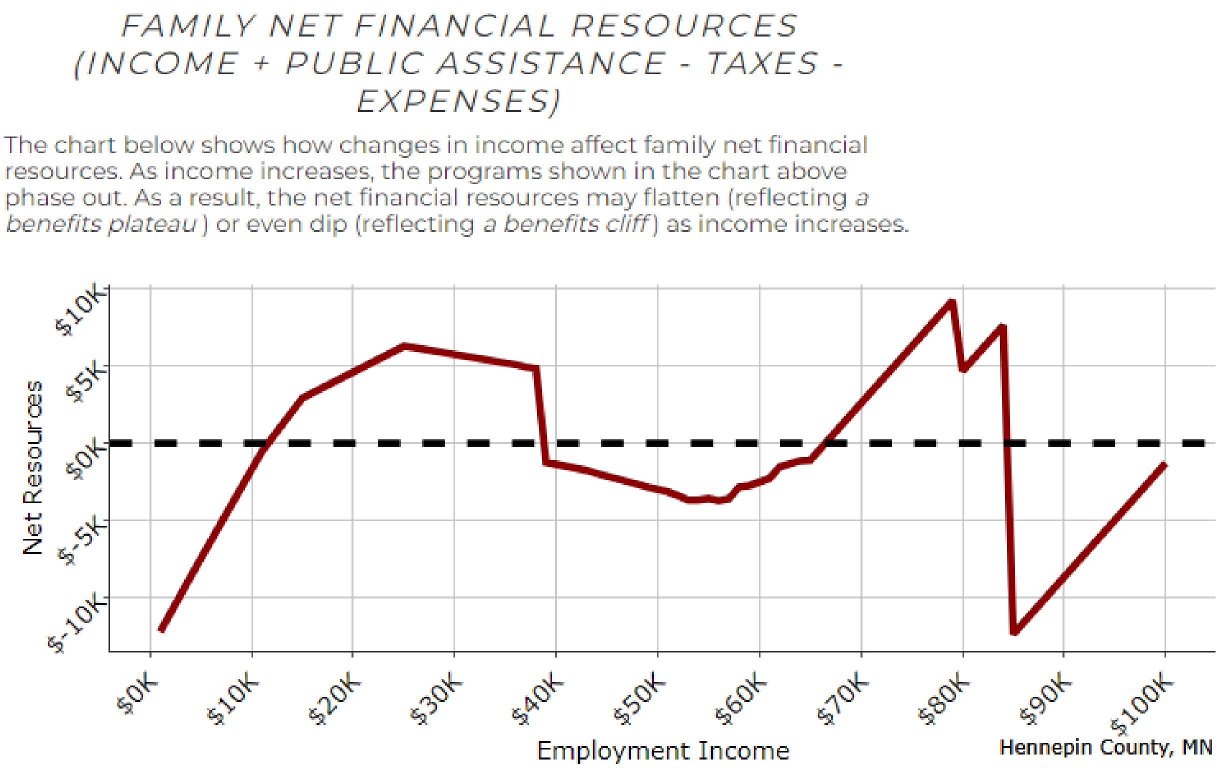
Source: Federal Reserve Bank of Atlanta. "Benefit Cliffs Across the U.S." Accessed April 18, 2023.

Figure 4 below shows how marginal changes in income affect the net financial resources available to a family. Essentially, the graph measures how much a family's total income (including public benefits) would increase or decrease as a result of a $1,000 gain in employment income. This graph does not account for existing state credit phaseouts or taxes, meaning the tool actually underrates the extent to which income gains are offset by credit phaseouts and taxes.

As the chart shows, there are significant income ranges over which an extra $1,000 of earnings does not significantly affect—or actually reduces—the amount of net resources available to Minnesota families. Notably, this particularly applies to incomes between $40,000 and $65,000, which is a portion of the income range over which the House and Senate's child credits are phased out.

Figure 4: Family Net Financial Resources by Employment Income

Family of 4, 2 Adults, 2 Children, Hennepin County

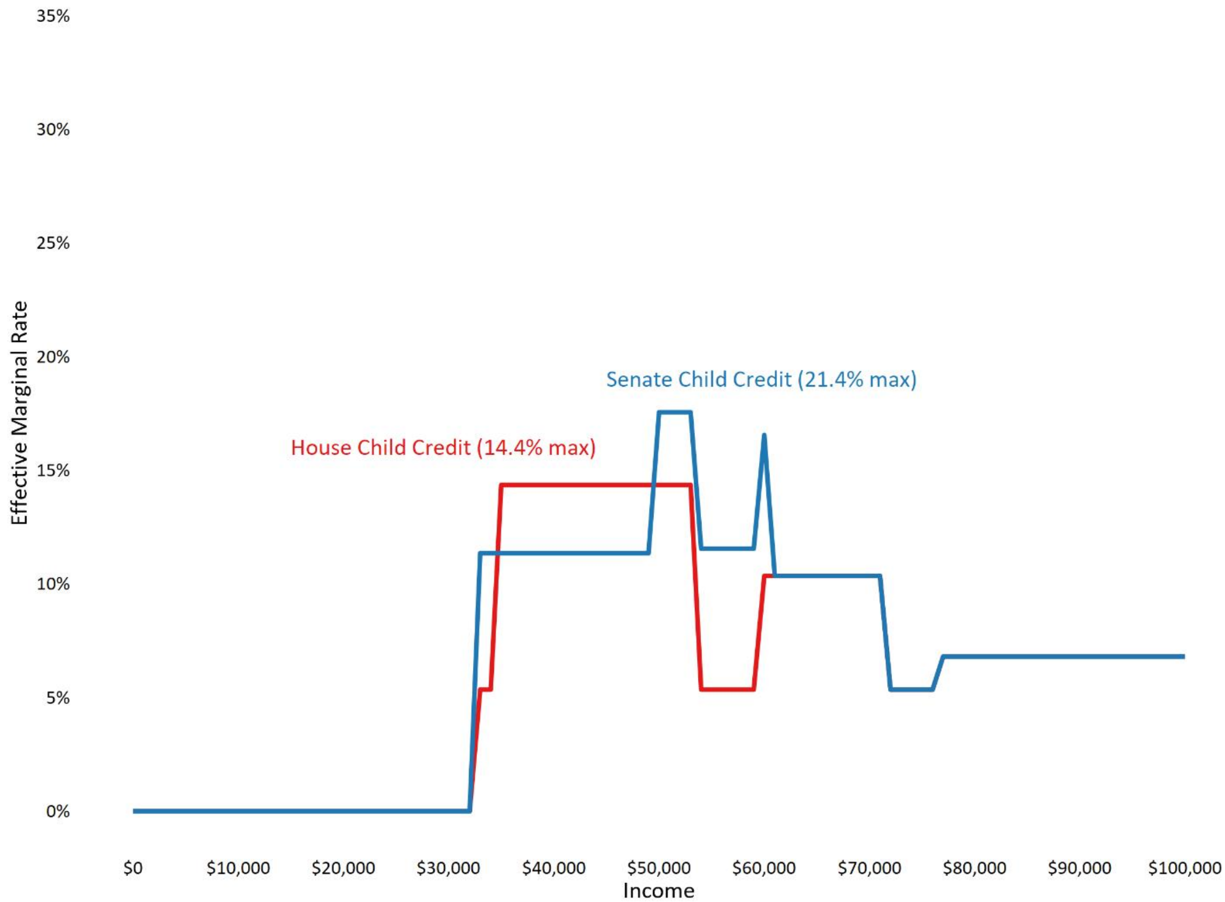


Source: Federal Reserve Bank of Atlanta. "Benefit Cliffs Across the U.S." Accessed April 18, 2023.

Appendix 1: Effective State Marginal Rates for Various Filers, House and Senate's proposed child credits

This appendix contains graphs comparing the effective state marginal rates under the House and Senate bill for taxpayers with 1, 2, or 3 children. It includes separate figures for both single and married taxpayers with varying numbers of children.

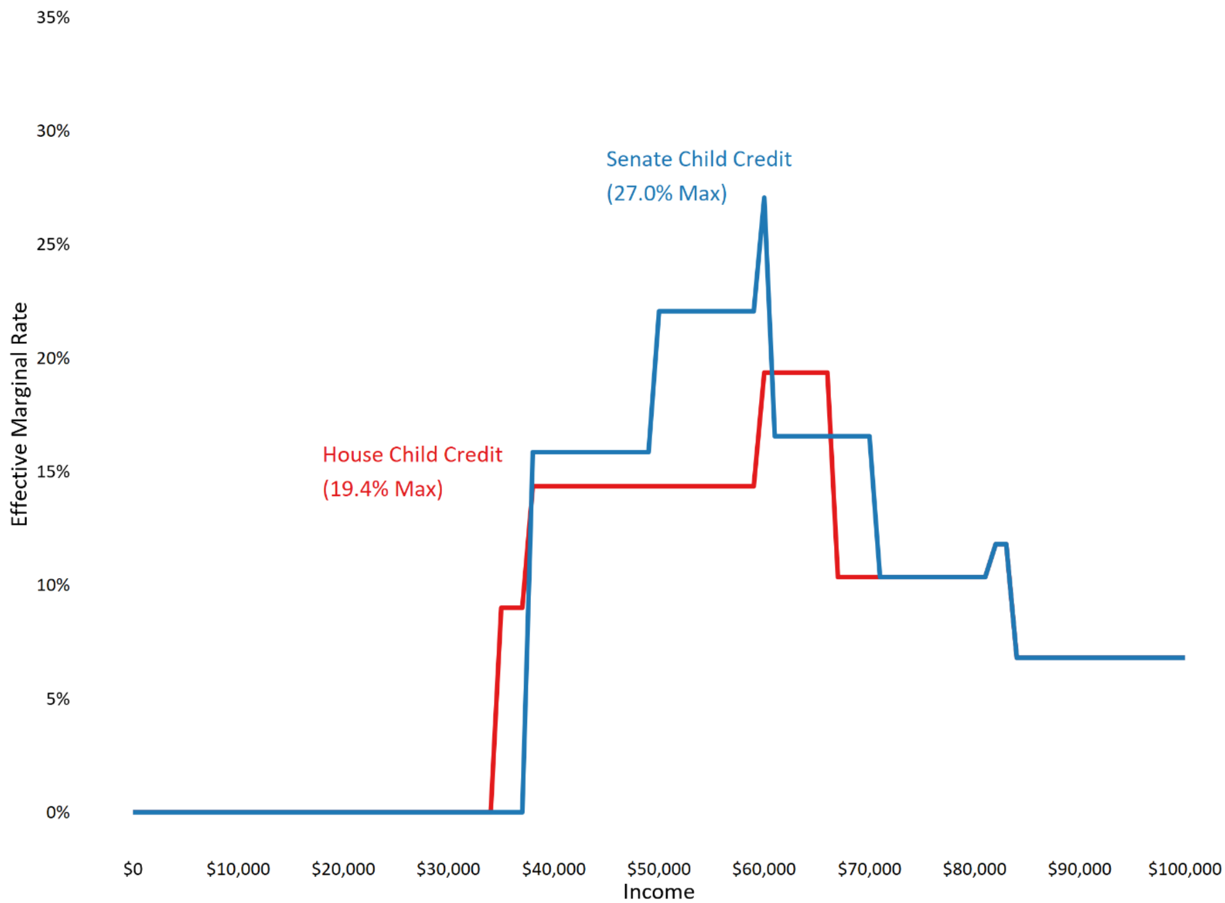
Figure 5: Effective State Marginal Tax Rates
Married Taxpayer, 1 Child, Tax Year 2023



Graphic by House Research.

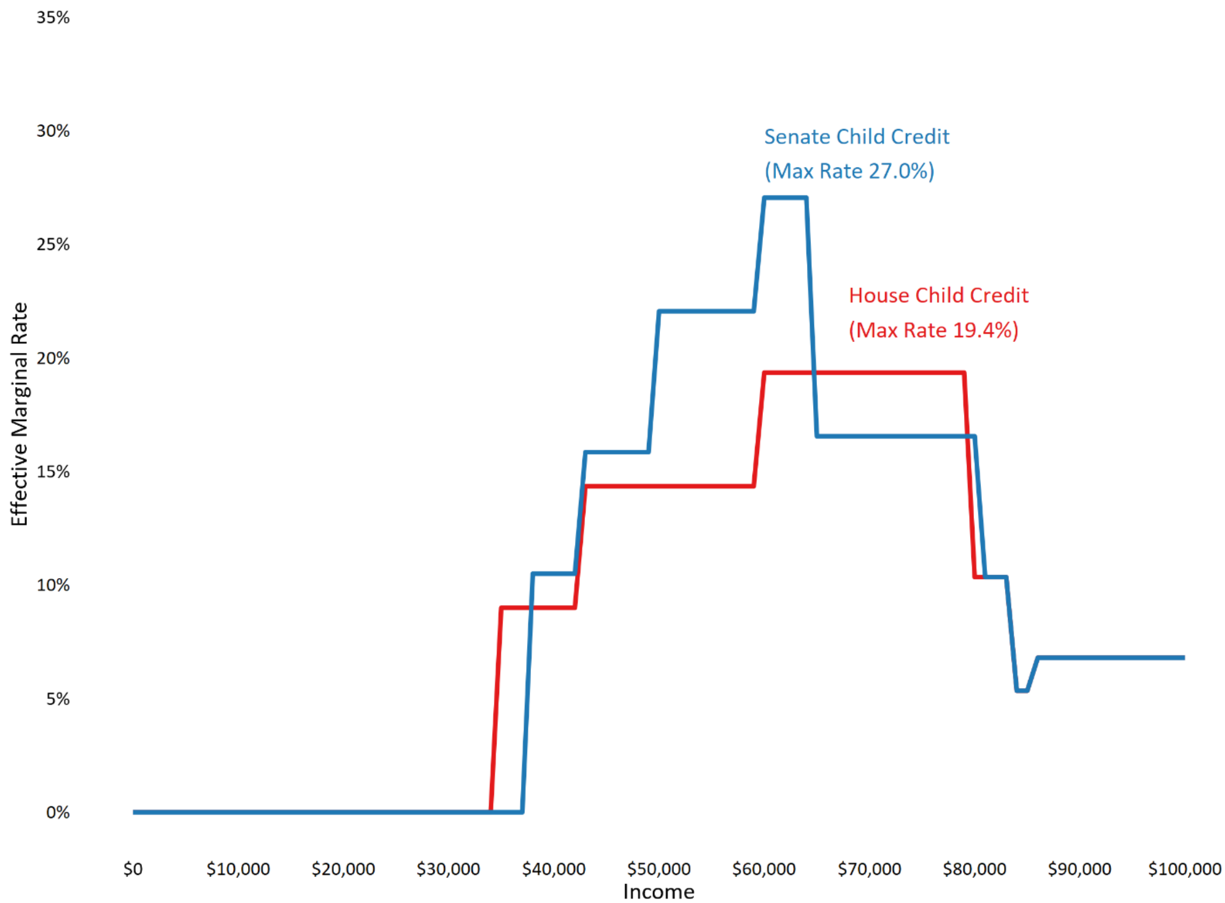
Figure 6: Effective State Marginal Tax Rates

Married Taxpayer, 2 Children, Tax Year 2023



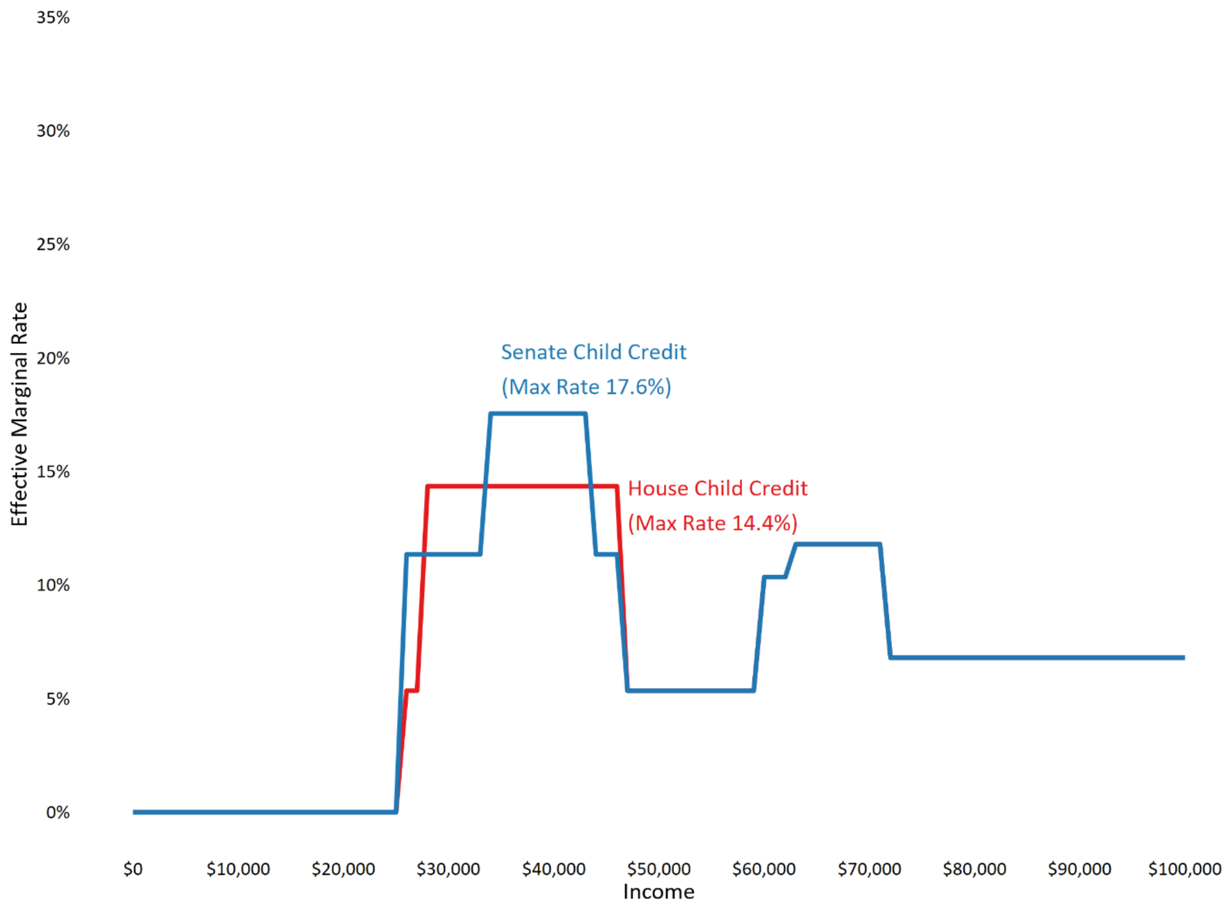
Graphic by House Research.

Figure 7: Effective State Marginal Tax Rates
Married Taxpayer, 3 Children, Tax Year 2023



Graphic by House Research.

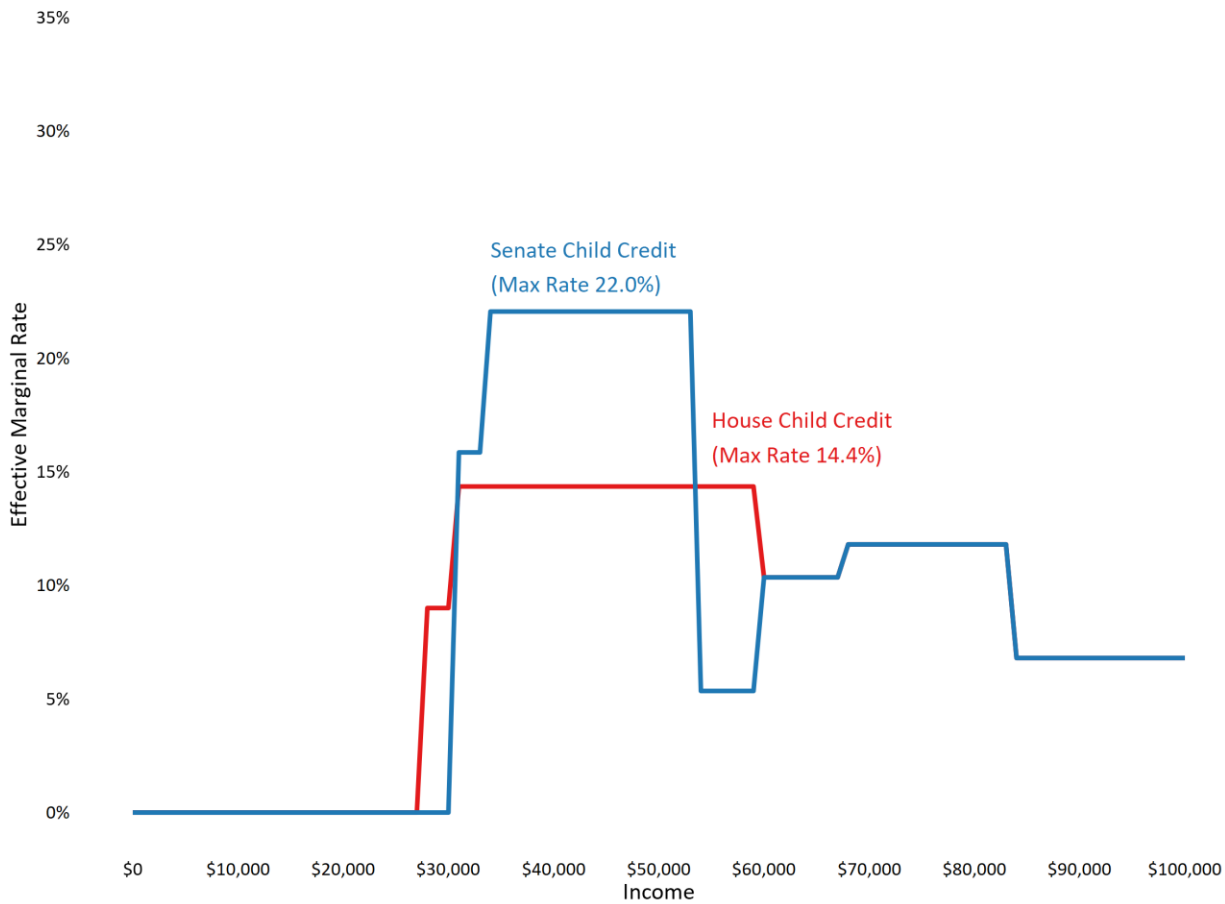
Figure 8: Effective State Marginal Tax Rates
Single Taxpayer, 1 Child, Tax Year 2023



Graphic by House Research.

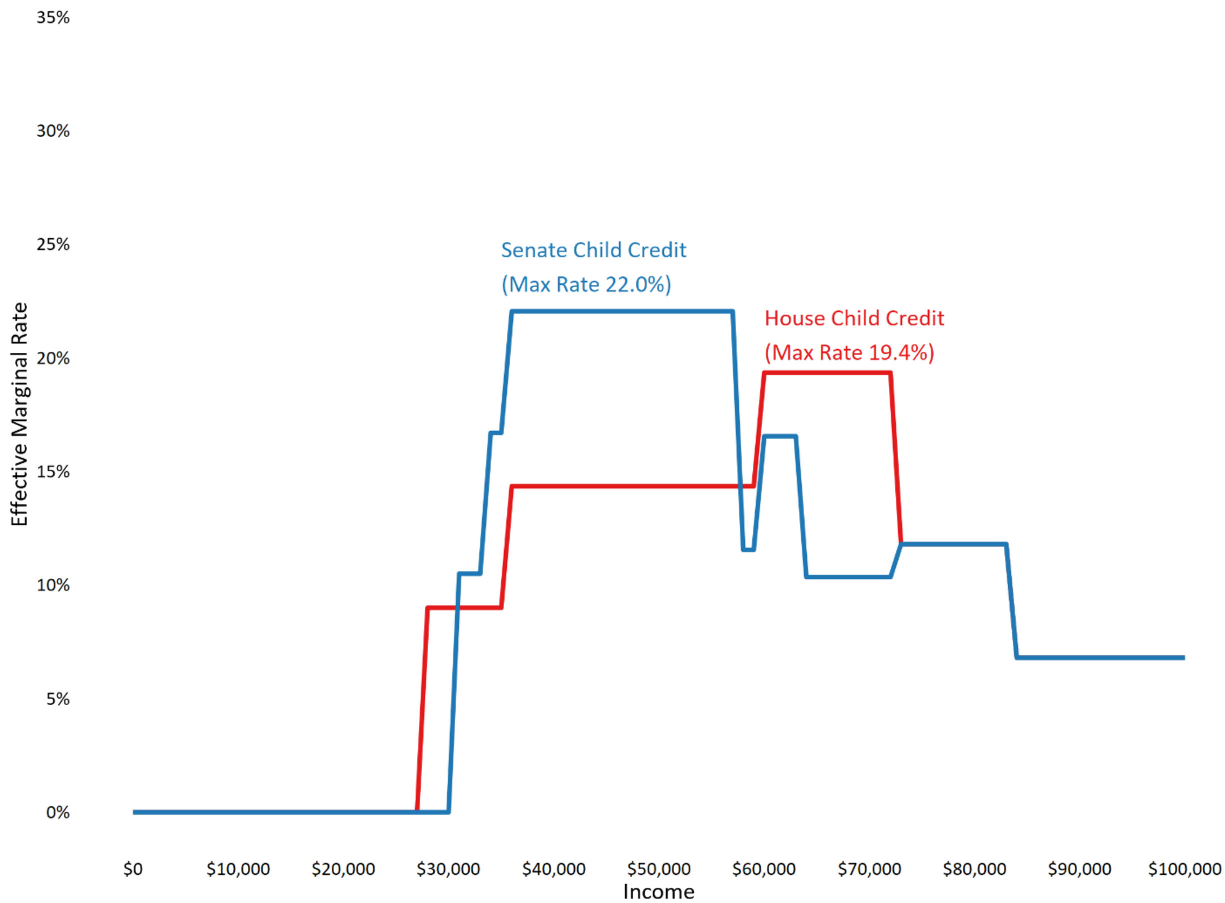
Figure 9: Effective State Marginal Tax Rates

Single Taxpayer, 2 Children, Tax Year 2023



Graphic by House Research.

Figure 10: Effective State Marginal Tax Rates
Single Taxpayer, 3 Children, Tax Year 2023



Graphic by House Research.

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