Income tax repeal would damage Minnesota's quality of life, increase inequality

MINNESOTA BUDGET PROJECT
An initiative of the Minnesota Council of Nonprofits

All Minnesotans deserve to lead healthy and secure lives. But the path to a stronger, more equitable future for our families and communities is threatened by a drastic proposal to eliminate the state's income tax. This would erode our quality of life here in Minnesota, damage our economy, and make inequality by income, race, and geography worse.

Eliminating the state's income tax would give massive tax cuts to higher-income Minnesotans while drastically slashing resources for public services that everyday Minnesotans count on, like schools, health care, child care, and housing.

It would shift more of the responsibility for funding public services to lower- and middle-income Minnesotans and lead to increases in less fair revenue sources. The experiences of other states show that these tax cuts won't deliver the economic growth that proponents claim.

Eliminating the state income tax would cut in half major state funding source for schools, health care, public safety, local services

The income tax is the state's largest general fund revenue source; it's expected to raise more than $30 billion in the current two-year budget cycle (FY 2022-23).[1] That's more than half of the revenue that goes to the state's general fund, a primary source of state funding to schools, health care, services for seniors and people with disabilities, property tax refunds for homeowners and renters, higher education, public safety, and other critical building blocks of strong communities and a robust economy.

Income tax funds essential public services

Amount raised by state income tax compared to state general fund spending FY 2022-23

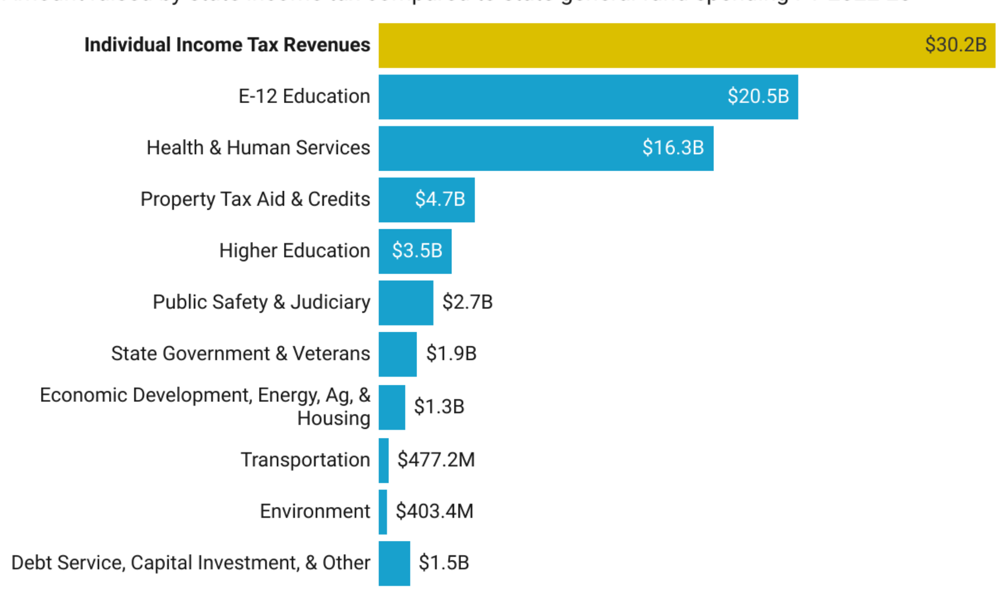

Chart: Minnesota Budget Project • Source: MN Management and Budget • Created with Datawrapper

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A Minnesota without an income tax would require cuts in public services that would make our state unrecognizable compared to what it is today. It's unrealistic to expect currently projected state budget surpluses to meaningfully make up for the lost revenue. A substantial part of the budget surplus is driven by short-term factors, including the positive effects federal COVID-response and stimulus legislation have had on the economy, household incomes, and state budgets. But these are largely coming to an end.

Eliminating the state's income tax would give massive tax cuts to high-income households

All Minnesotans pay taxes to support schools, health care, public safety, and a range of other services provided at the state and local levels. The income tax is the only major tax based on the ability to pay. In tax jargon, the income tax is called a progressive tax, which means that higher-income households pay a larger percentage of their income than middle- or lower-income households. High-income households have a big share of the total income that Minnesotans receive, and as a result they pay a substantial portion of the income tax.

Looking at our state's current income tax can give us an estimate of what would happen if it was repealed.[2] Eliminating the income tax primarily benefits high-income households. The highest-income 1 percent of Minnesotans would receive more than one quarter of the tax cuts going to Minnesota households, and the highest-income 5 percent would receive nearly half of the tax cuts.

In contrast, only about a quarter of the tax cuts would go to the 80 percent of Minnesotans who have annual incomes below $114,000.

Most tax cuts from eliminating Minnesota's income tax would go to high-income households

Share of tax cuts by household income

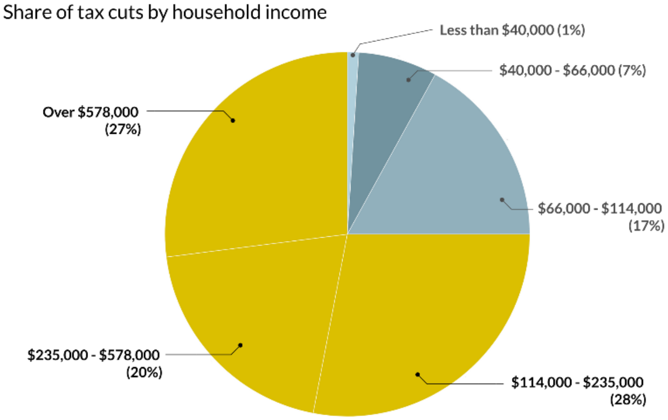

Chart: Minnesota Budget Project • Source: MN Department of Revenue, Tax Year 2018 • Created with Datawrapper

High-income households would get dramatically larger tax cuts than other Minnesotans. Households with incomes $235,000 and higher would get tax cuts about 25 times larger than what middle-income households (earning about $40,000 to $66,000) would receive, and the highest-income 1 percent would get tax cuts 73 times larger than what middle-income households would receive.

Household Income	Average change in tax from eliminating the income tax
Less than $21,000 (Lowest 20%)	+82
$21,000 - $40,000 (Second 20%)	-$291
$40,000 - $66,000 (Middle 20%)	-$1,508
$66,000 - $114,000 (Fourth 20%)	-$3,429
$114,000 - $235,000 (Next 15%)	-$7,536
$235,000 - $578,000 (Next 4%)	-$20,455
Over $578,000 (Highest 1%)	-$110,591
Minnesota Budget Project analysis of Minnesota Department of Revenue Tax Incidence Study data, net Minnesota income taxes paid by Minnesota residents in Tax Year 2018.	

Some lower-income Minnesotans and their families would actually see an increase in the total amount of state and local taxes they pay, assuming that eliminating the state's income tax system would also eliminate income tax credits. The Working Family Credit and other income tax credits help families afford the costs of child care and school expenses, and offset some of what they pay in other taxes, such as the sales tax.[3]

In addition to Minnesota residents, non-residents would also receive tax cuts from the elimination of the income tax. In fact, they would receive about 6 percent of the total tax cuts.

Eliminating the individual income tax would also mean that many businesses would pay no state income taxes on their profits, including some very large businesses.[4]

While proponents offer few details about how they would balance the state budget without the state's largest source of revenue, there's no doubt that it would drastically cut resources for public services and almost certainly lead to increases in other less fair revenue sources. Both of these consequences would make challenges far worse for everyday Minnesotans and low-income communities.

Eliminating the state income tax would worsen income, racial, and geographic inequality

It's hard to imagine that Minnesotans would be willing to see valued public services be cut so drastically. In the past when the state pulled back from its funding commitments, we saw a range of responses to try to soften the blow. The overall impact would increase income, racial, and geographic disparities.

This proposal would turn the state's tax system upside down, replacing it with one in which lower- and middle-income people pay a higher percentage of their incomes in state and local taxes instead of the wealthiest. There would be increases in other, less fair ways of raising state revenues. These include sales and property taxes, the other two major taxes that fund state and local services in Minnesota; these are regressive taxes for which lower- and middle-income people generally pay a larger percentage of their incomes than high-income people do. We can also expect rising tuition at our public colleges and universities, and higher costs for licenses, fees, and fines. Minnesotans would likely pay more for things like health care, child care, transportation, and housing if the state no longer has the resources to continue investments that make these things more affordable. These will all hit working-class and middle-income people the hardest.

Eliminating the income tax and its consequences would also worsen racial disparities, as Black and Brown households are disproportionately likely to have lower incomes and therefore see less benefit from tax cuts. Low-income and Black, Indigenous, People of Color (BIPOC) households will likely feel the greatest impact from cuts in public services and suffer disproportionately if schools, universities, transit, health care, and other crucial services are underfunded.

A big reduction in state resources would push more of the responsibility for meeting Minnesotans' needs to schools, cities, and counties. At the same time, it would reduce resources for funding that the state currently sends to schools and local governments to ensure that all Minnesotans can access quality public services, even if they live in communities with fewer resources. Rural areas would particularly be hard hit by a substantial change to our current system of providing aids to local communities funded by state income taxes.[5] State aids to local governments and state-paid property tax refunds to homeowners and renters collectively are called "property tax aids and credits" and are the third largest area of general fund spending – they surely would see a funding cut if the income tax disappeared, pushing up property taxes.

Tax cuts do a poor job of spurring economic growth

Research and lessons learned from other states consistently show that cutting income taxes has little, if any, effect on state economic growth. And it's generally been a failed experiment in the states that have tried it.

For example, the states of Kansas, Maine, Wisconsin, North Carolina, and Ohio all enacted large income tax cuts in recent years and all five saw slower economic growth than the nation as a whole, and four of the five states had lower private-sector job growth.[6]

Kansas creates a cautionary tale for those touting tax cuts as an economic growth strategy. Kansas enacted big income tax cuts that were predicted to be "a shot of adrenaline into the heart of the Kansas economy." The state cut their top income tax rate by nearly 30 percent and eliminated income taxes on some business profits. But the economic boom did not come. Instead, Kansas underperformed the nation and most of its neighboring states on several measures of economic success. Schools and other public services were cut, and the state's bond rating was downgraded. This supply-side tax-cutting experiment was repealed in June 2017.[7]

Having no state income tax is also not a magic bullet for economic success. The Institute of Taxation and Economic Policy (ITEP) looked at the economic performance of the nine states with the highest top income tax rates compared to the nine states with no broad-based state income tax.[8] They found that, contrary to tax-cut proponents' claims, states with the *highest* top income tax rates actually saw slightly faster economic growth over the past decade (2009-2019) compared to those without income taxes. The states with robust income taxes also saw faster income growth and lower unemployment rates on average.

The baseline is large cuts to the income tax have not yielded the benefits that their supporters claim they would. Rather than interstate differences in the income tax, factors such as economic trends, a state's natural resources and industry mix, and the education of its workforce play a larger role in determining economic growth.[9]

There is a better path to broad-based prosperity

Policymakers should focus on ensuring Minnesota has a fair tax system that sustainably funds the public services that Minnesotans count on and that build shared prosperity, rather than giving large tax cuts to the wealthiest residents. They should prioritize effective strategies to address the real problems that everyday Minnesotans are facing, including wanting the best education for their children, taking care of elderly parents or family members with disabilities, and making ends meet. As a state, we can invest in public services to ensure everyone has the care and support they need to thrive, and bring down the costs of child care, college tuition, and health care.

Targeted tax policy changes can also play a role in reducing the economic pressures on Minnesotans and their families. Expanding tax credits for working- and middle-class families would help them better afford the costs of child care, education, and keeping a roof over their heads. A targeted approach would begin to shrink the disparities by race, income, and geography that plague our state.

Only through this comprehensive approach – a fair tax system that raises the revenue we need, along with targeted tax policies and budget choices that prioritize everyday folks – can we pave the broadest path to prosperity for us all.

By Nan Madden and Joo Ning Lim

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[1] Minnesota Budget Project analysis of Minnesota Management and Budget, General Fund Balance Analysis: End of 2022 Legislative Session, July 2022.

[2] This analysis uses detailed information about taxes paid by Minnesotans in 2018, the most current year for which detailed data is available. Minnesota Budget Project analysis of Minnesota Department of Revenue, 2021 Minnesota Tax Incidence Study, March 2021.

[3] Other such tax credits include the K-12 Education Credit and Child and Dependent Care Tax Credit.

[4] These businesses are often incorrectly described as "small businesses". In fact, it is how its owners have chosen to structure the business that determines whether its profits are taxed through the corporate franchise tax or the individual income tax. Businesses that pay taxes on their profits through the individual income tax include partnerships, sole proprietorships, and subchapter-S Corporations (S-Corps). Profits from these businesses "pass through" or "flow through" to their owners and/or shareholders, who report the profits on their federal and state income tax returns.

[5] Joel Michael, Fantasy Policy, SALT Speak blog, July 14, 2022.

[6] Center on Budget and Policy Priorities, Big Cuts in State Income Taxes Not Yielding Promised Benefits, February 2018.

[7] Center on Budget and Policy Priorities, Kansas Provides Compelling Evidence of Failure of "Supply-Side" Tax Cuts, January 2018.

[8] Institute on Taxation and Economic Policy, Another Reason to Tax the Rich? States with High Top Rates Doing as Well, if Not Better, than States Without Income Taxes, September 2020.

[9] Center on Budget and Policy Priorities, State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth, May 2015.