



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #358

### **Earned Income Tax Credit (General Fund Taxes -- Income and Franchise Taxes)**

[LFB 2009-11 Budget Summary: Page 255, #4]

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#### **CURRENT LAW**

The earned income tax credit (EITC) is offered at both the federal and state levels as a means of providing assistance to lower-income workers. The state EITC is calculated as a percentage of the federal credit. The state, therefore, uses federal definitions and eligibility requirements for purposes of the EITC, except that the state does not provide a credit to individuals without children or advance payments of the credit. Both the federal and state credits are refundable -- if the credit exceeds the amount of tax due, a check is issued for the difference.

The credit is calculated based on family size, filing status, and the amount of earned income (although the credit can also be affected by adjusted gross income). Individuals without earned income are not eligible for the credit.

The income limits and maximum federal credit amounts are adjusted annually for changes in inflation. The maximum federal credit for tax year 2009 is \$3,043 for families with one child, \$5,028 for families with two children, and \$5,657 for families with three or more children. The state credit percentages are: 4% for families with one child; 14% for families with two children; and 43% for families with three or more children. Based on the 2009 federal credit parameters and the state credit percentages, the maximum state credits for 2009 are: \$122 for families with one child; \$704 for families with two children; and \$2,432 for families with three or more children. For filers with one child, the credit is phased out for income between \$16,420 and \$35,463 (between \$21,420 and \$40,463 for married couples filing jointly). For filers with two children, the income phase-out range is from \$16,420 to \$40,295 (\$21,420 to \$45,295 for married couples filing jointly). For filers with more than two children, the income phase-out range is from \$16,420 to \$43,279 (\$21,420 to \$48,279 for married couples filing jointly).

## **GOVERNOR**

Increase GPR funding for the EITC by \$22,617,200 in 2009-10 (\$4,917,200 to reflect changes in the number of recipients and federal indexing provisions and \$17,700,000 to reflect federal law changes) and by \$24,265,100 in 2010-11 (\$6,065,100 to reflect changes in number of recipients and federal indexing provisions and \$18,200,000 to reflect federal law changes).

Because the state EITC is calculated as a percentage of the federal EITC, changes to the federal credit affect expenditures for the state credit. For tax years 2009 and 2010, recent federal changes include creating a new third tier of the credit for families with three or more children and raising the income threshold at which the credit begins to phase out for married couples by \$1,880 (that is, the credit will start to phase-out at \$21,420 instead of \$19,540 for 2009). The credit percentage for the new tier will be set at 45%, as opposed to the previous rate of 40% that will be retained for claimants with only two children, and result in a maximum federal credit of \$5,657, which is \$629 higher than those claimants would have received previously. Because the state's credit is calculated as a percentage of the federal credit, the maximum state credit will increase by an estimated \$270 (from \$2,162 to \$2,432). By increasing the income threshold for married couples, claimants with incomes above the previous threshold (\$19,540 for tax year 2009) will receive higher credits. Also, the credit will phase out at a higher income level (\$45,295 versus \$43,415 for 2009), thereby extending credits to some married couples not previously eligible.

The state credit is funded with a combination of GPR and PR funding. The program revenue is federal temporary assistance for needy families (TANF) funding transferred from the Department of Children and Families (DCF). The GPR portion is provided through a sum-sufficient appropriation and covers the balance of the cost of the credit. Base funding for the EITC is \$98,700,000, consisting of \$6,664,200 PR and \$92,035,800 GPR. Under the bill, total funding for the EITC would be increased to \$121,317,200 in 2009-10 and \$122,965,100 in 2010-11. The PR funding would be unchanged from the base level amount of \$6,664,200, while the estimated GPR sum sufficient portion would be increased from the base level of \$92,035,800 to \$114,653,000 in 2009-10 and \$116,300,900 in 2010-11. The net increases reflect the administration's estimates of the total cost of funding the EITC in the 2009-11 biennium.

## **DISCUSSION POINTS**

1. The federal EITC was created in 1975 to offset payroll taxes paid by low-income workers with children. As the program's parameters have expanded, participation has also increased, and over 20 million families currently receive the federal credit. At the state level, 236,691 claimants received the federal and Wisconsin credits in 2007. The credit has been characterized as encouraging work because individuals must work to receive the credit. Also, the amount of the credit increases as earnings increase, until a maximum credit amount is reached.

2. The credit has also been characterized as lifting families out of poverty, but the credit may be less effective relative to this objective in the current economic conditions. As

unemployment rises (particularly among low wage earners) and wage income falls, credit payments for some claimants will decrease. Conversely, reductions in earnings and wages could make more families eligible for the credit. Because low wage earners spend a greater portion of their income than high income individuals, the credit can be viewed as stimulative.

3. As noted, the federal American Recovery and Reinvestment Act of 2009 made two changes to the federal EITC. First, the Act created a new third tier for the credit that will extend to families with three or more children. The credit percentage for the new tier will be set at 45%, as opposed to the previous rate of 40% that will be retained for claimants with only two children. The credit for families with more than two children will result in a maximum federal credit of \$5,657, which is \$629 higher than those claimants would have received previously. This change recognizes that families with more children incur higher costs for child care, food, and other necessities. Second, the Act raised the income threshold at which the credit begins to phase out for married couples by \$1,880. As a result, the 2009 credit will start to phase out at \$21,420 instead of \$19,540. By increasing the income threshold for married couples, claimants with incomes above the previous threshold (\$19,540 for tax year 2009) will receive higher credits. Also, the credit will phase out at a higher income level (\$45,295 versus \$43,415 for 2009), thereby extending credits to some married couples not previously eligible. This change addresses the "penalty" in the form of a lower credit that results from the use of couples' joint income in calculating the credit.

4. The state EITC is calculated as a percentage of the federal EITC, so changes to the federal credit affect expenditures for the state credit. The attached table displays how the maximum state credit and income limit has changed by type of claimant since 2004, including the amounts for 2009 and 2010 resulting from the federal law change. Two factors explain why credit expenditures will be higher in 2009 than in prior years. First, the inflation rate used under the federal program in the four previous years has averaged 2.9%, but a factor of 4.3% will be used for 2009. Both factors displayed in the table are indexed either directly or indirectly to the inflation factor. Second, the table displays how the ARRA has increased the number of married-joint filers eligible for the credit (by increasing the married-joint income limits) and increased the maximum credit amounts for families with three or more children.

5. The federal changes will extend the EITC to about 17,000 more married couples in Wisconsin and increase the credit for claimants with more than two children. In addition, parameters used to calculate the credit are adjusted each year based on the change in the consumer price index, and the number of Wisconsin claimants has increased between 1% and 4% each year over the last five years. After these adjustments, the cost of the program is estimated at \$123,700,000 in 2009-10 and \$125,700,000 in 2010-11. For the 2009-11 biennium, these amounts represent an increase of \$5,117,700 (\$2,382,800 in 2009-10 and \$2,734,900 in 2010-11) relative to the AB 75 estimates. The administration's estimates do not assume any change in the number of claimants in response to the ARRA changes, so the reestimates presented here are higher. These reestimates are reflected in Alternative 1.

6. Prior to the ARRA change to the federal credit, Wisconsin recognized that families with more than two children needed a higher reimbursement rate in recognition of the added costs

associated with more than two children. Relative to the federal credit, Wisconsin's reimbursement rate increases from 14% for families with two children to 43% for families with more than two children. Given the new reimbursement tier for the federal credit, Wisconsin could reduce the state credit's reimbursement rate for families with three or more children from 43% to 38.2% without impacting these families' state tax credit payments, relative to prior law provisions. Although their state tax credit amounts would be unchanged (except for the effects of indexing), these families would still receive larger federal credits due to the ARRA change. This option would result in estimated state EITC payments totaling \$115,300,000 in 2009-10 and \$117,200,000 in 2010-11. For the 2009-11 biennium, these amounts represent a decrease of \$11,782,300 (-\$6,017,200 in 2009-10 and -\$5,765,100 in 2010-11) relative to the AB 75 estimates. These amounts are reflected in Alternative 2.

7. Due to the size of the state's projected deficit, another option that would reduce the cost of the credit, but offer some protection to the neediest claimants, would be to adjust the state reimbursement percentages so that the maximum state credit amounts for each type of claimant in 2009 would be equal to the maximum state credit amounts in 2008. In 2008, the maximum state credit amounts equaled \$117 for claimants with one child, \$675 for claimants with two children, and \$2,074 for claimants with three or more children. In 2009, the maximum credit amounts will increase to \$122 for claimants with one child, \$704 for claimants with two children, and \$2,432 for claimants with three or more children. If the state reimbursement percentages were set at 3.83% for claimants with one child, 13.43% for claimants with two children, and 36.67% for claimants with three or more children, the maximum state credit amounts in 2009 would remain at \$117, \$675, and \$2,074, respectively. This option would result in estimated state EITC payments totaling \$110,600,000 in 2009-10 and \$112,400,000 in 2010-11. While these amounts represent a \$25.6 million increase over the base-year doubled funding level, they represent a decrease of \$21,282,300 (\$10,717,200 in 2009-10 and \$10,565,100 in 2010-11) relative to the AB 75 estimates. These amounts are reflected in Alternative 3.

8. Another option would be to acknowledge that Wisconsin's reimbursement rate for families with more than two children should be adjusted in light of the federal addition of a reimbursement tier for those same families, but to redistribute the additional credit payments among all families receiving the Wisconsin credit. If the current proportional relationship between the three reimbursement rates is maintained, the reimbursement percentages could be set at 4.30% for families with one child, 15.07% for families with two children, and 40.89% for families with more than two children. This option would result in estimated state EITC payments totaling \$123,700,000 in 2009-10 and \$125,700,000 in 2010-11. For the 2009-11 biennium, these amounts represent an increase of \$5,117,700 (\$2,382,800 in 2009-10 and \$2,734,900 in 2010-11) relative to the AB 75 estimates. These amounts are reflected in Alternative 4.

9. Finally, two EITC provisions are included under the entry entitled "Internal Revenue Code Update" and the administration inadvertently reported their fiscal effects as impacting revenues, rather than expenditures. First, the federal Emergency Economic Stabilization Act allows claimants whose principal residence was in the Midwestern disaster area to calculate their earned income tax credit for the tax year that includes the disaster date using their earned income from the

previous year. The administration estimates that adopting this federal provision would increase GPR expenditures by \$3,160,000 in 2009-10. Second, the federal Heroes Earnings Assistance and Relief Act permits claimants to permanently treat combat zone compensation as earned income for purposes of the EITC, even though it is otherwise excluded from gross income. This treatment was previously permitted for tax years 2004 through 2007. The administration estimates that adopting this federal provision would increase GPR expenditures by \$240,000 in 2009-10 and \$90,000 in 2010-11. Combined, the two provisions are estimated to increase EITC expenditures by \$3,490,000 in the 2009-11 biennium (\$3,160,000 in 2009-10 and \$330,000 in 2010-11). These amounts are included in each of the alternatives presented below.

**ALTERNATIVES**

1. Reestimate total funding for Wisconsin's earned income tax credit at \$127,100,000 in 2009-10 and \$125,790,000 in 2010-11. Increase the program's GPR sum sufficient appropriation by \$5,782,800 in 2009-10 and \$2,824,900 in 2010-11. These increases include \$2,382,800 in 2009-10 and \$2,734,900 in 2010-11 due to provisions in the federal American Recovery and Reinvestment Act, inflation adjustments, and increased levels of participation, and \$3,400,000 in 2009-10 and \$90,000 in 2010-11 due to the reclassification of revenues as expenditures in relation to provisions in the federal Emergency Economic Stabilization Act and Heroes Earnings and Tax Relief Act.

<b>ALT 1</b>	<b>Change to Bill Funding</b>
GPR	\$8,607,700

2. Reduce the credit rate for families with three or more children from 43% to 38.2%, effective for tax year 2009 and reestimate total funding for Wisconsin's earned income tax credit at \$118,700,000 in 2009-10 and \$117,290,000 in 2010-11. Decrease the program's GPR sum sufficient appropriation by \$2,617,200 in 2009-10 and \$5,675,100 in 2010-11. These amounts reflect decreases of \$6,017,200 in 2009-10 and \$5,765,100 in 2010-11 due to the lower credit rate for families with more than two children, provisions in the federal American Recovery and Reinvestment Act, inflation adjustments, and increased levels of participation, and increases of \$3,400,000 in 2009-10 and \$90,000 in 2010-11 due to the reclassification of revenues as expenditures in relation to provisions in the federal Emergency Economic Stabilization Act and Heroes Earnings and Tax Relief Act.

<b>ALT 2</b>	<b>Change to Bill Funding</b>
GPR	-\$8,292,300

3. Reduce the credit rates to 3.83% for families with one child, 13.43% for families with two children, and 36.67% for families with three or more children, effective for tax year 2009

and reestimate total funding for Wisconsin's earned income tax credit at \$114,000,000 in 2009-10 and \$112,490,000 in 2010-11. Decrease the program's GPR sum sufficient appropriation by \$7,317,200 in 2009-10 and \$10,475,100 in 2010-11. These amounts reflect decreases of \$10,717,200 in 2009-10 and \$10,565,100 in 2010-11 due to the lower credit rates, provisions in the federal American Recovery and Reinvestment Act, inflation adjustments, and increased levels of participation, and increases of \$3,400,000 in 2009-10 and \$90,000 in 2010-11 due to the reclassification of revenues as expenditures in relation to provisions in the federal Emergency Economic Stabilization Act and Heroes Earnings and Tax Relief Act.

<b>ALT 3</b>	<b>Change to Bill Funding</b>
GPR	- \$17,792,300

4. Modify the credit rates from 4% to 4.30% for families with one child, from 14% to 15.07% for families with two children and from 43% to 40.89% for families with more than two children. Reestimate total funding for Wisconsin's earned income tax credit at \$127,100,000 in 2009-10 and \$125,790,000 in 2010-11. Increase the program's GPR sum sufficient appropriation by \$5,782,800 in 2009-10 and \$2,824,900 in 2010-11. These increases include \$2,382,800 in 2009-10 and \$2,734,900 in 2010-11 due to changes in the credit rates, provisions in the federal American Recovery and Reinvestment Act, inflation adjustments, and increased levels of participation, and \$3,400,000 in 2009-10 and \$90,000 in 2010-11 due to the reclassification of revenues as expenditures in relation to provisions in the federal Emergency Economic Stabilization Act and Heroes Earnings and Tax Relief Act.

<b>ALT 4</b>	<b>Change to Bill Funding</b>
GPR	\$8,607,700

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Attachment

## ATTACHMENT

### Change in the Maximum State Earned Income Tax Credit and Income Limit by Type of Claimant , 2004-2010

#### Families With One Child

<u>Tax Year</u>	<u>Maximum Credit</u>	<u>Percent Change</u>	<u>Single</u>		<u>Married-Joint</u>	
			<u>Income Limit</u>	<u>Percent Change</u>	<u>Income Limit</u>	<u>Percent Change</u>
2004	\$104	2.0%	\$30,338	2.3%	\$31,338	2.2%
2005	106	1.9	31,030	2.3	32,030	2.2
2006	110	3.8	32,001	3.1	34,001	6.2
2007	114	3.6	33,241	3.9	35,241	3.6
2008	117	2.6	33,995	2.3	36,995	5.0
2009	122	4.3	35,463	4.3	40,463	9.4
2010	122	0.3	35,576	0.3	40,586	0.3

#### Families With Two Children

<u>Tax Year</u>	<u>Maximum Credit</u>	<u>Percent Change</u>	<u>Single</u>		<u>Married-Joint</u>	
			<u>Income Limit</u>	<u>Percent Change</u>	<u>Income Limit</u>	<u>Percent Change</u>
2004	\$602	2.2%	\$34,458	2.3%	\$35,458	2.2%
2005	616	2.3	35,263	2.3	36,263	2.3
2006	635	3.1	36,348	3.1	38,348	5.7
2007	660	3.9	37,783	3.9	39,783	3.7
2008	675	2.3	38,646	2.3	41,646	4.7
2009	704	4.3	40,295	4.3	45,295	8.8
2010	706	0.3	40,421	0.3	45,431	0.3

#### Families With Three or More Children

<u>Tax Year</u>	<u>Maximum Credit</u>	<u>Percent Change</u>	<u>Single</u>		<u>Married-Joint</u>	
			<u>Income Limit</u>	<u>Percent Change</u>	<u>Income Limit</u>	<u>Percent Change</u>
2004	\$1,849	2.3%	\$34,458	2.3%	\$35,458	2.2%
2005	1,892	2.3	35,263	2.3	36,263	2.3
2006	1,950	3.1	36,348	3.1	38,348	5.7
2007	2,028	4.0	37,783	3.9	39,783	3.7
2008	2,074	2.3	38,646	2.3	41,646	4.7
2009	2,432	17.3	43,279	12.0	48,279	15.9
2010	2,440	0.3	43,414	0.3	48,424	0.3