Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

May 27, 2009 Joint Committee on Finance Paper #370

Indexing of Individual Income Tax Provisions
(General Fund Taxes -- Income and Franchise Taxes)

CURRENT LAW

Under current law, the sliding scale standard deduction and the tax brackets under the individual income tax are indexed annually to reflect changes in inflation, as measured by the U.S. consumer price index for all urban consumers, U.S. city average (CPI-U). The statutes specify that the indexing adjustment for each tax year is determined on a cumulative basis by comparing the change in the CPI-U as of August of the previous year from August, 1997. Effectively, this results in the incremental adjustment for a specific tax year being based on the change in the CPI-U in August of the prior year over the preceding August. For example, the indexing adjustment for tax year 2009 will be based on the change in the CPI-U from August, 2007, to August, 2008.

GOVERNOR

No change to current law.

DISCUSSION POINTS

1. The current indexing provisions are intended to protect taxpayers from paying additional taxes simply due to inflationary gains in income ("bracket creep"). In most years, the inflation adjustment is a positive percentage that results in a larger sliding scale standard deduction and wider tax brackets.

2. However, it is currently projected by IHS Global Insight, Inc. (the national economic forecasting service used by the state) and other economic forecasters that the CPI-U will decline during 2009. Based on projected deflation in 2009, the Department of Revenue estimates that the

parameters for calculating the sliding scale standard deduction and the income tax brackets will be decreased by 3.9% in tax year 2010. The negative indexing adjustment has been incorporated into our estimates of income tax revenues under current law and under AB 75. A positive indexing adjustment of 2.7% is estimated for tax year 2011 over 2010, but the tax brackets and standard deduction parameters will still be lower than the 2009 amounts due to the 3.9% decrease in 2010. These indexing adjustments will result in tax increases for most taxpayers in 2010 and 2011, compared to the 2009 income tax provisions.

3. In order to prevent these tax increases from occurring, the income tax indexing provisions could be modified to specify that the annual indexing adjustment could not be a negative number. This would ensure that individual income taxes are not increased during times of deflation, which are more likely during economic contractions. This option would reduce revenues by an estimated $92.4 million over the next three fiscal years ($30.7 million in 2009-10, $48.4 million in 2010-11, and $13.3 million in 2011-12), assuming the other income tax modifications recommended by the Governor are enacted. The estimates would have to be adjusted if the Committee chooses to not adopt some or all of the Governor's income tax proposals.

4. Given the significant reduction in income tax collections for the period 2009-10 through 2011-12, the Committee may not want to prohibit a negative adjustment at this time, but may want to establish that policy in the future. If so, the provision could be modified to prohibit a negative adjustment effective beginning with the 2012 tax year.

5. Finally, it should be noted that deflationary periods are very rare. According to data from the U.S. Bureau of Labor Statistics, there has not been an annual decrease in the CPI-U since 1955.

ALTERNATIVES

1. Modify the indexing provisions for the sliding scale standard deduction and income tax brackets to specify that the annual indexing adjustment could not be a negative number, beginning with the 2010 tax year. [In addition to the 2009-11 fiscal effect shown below, tax collections would be reduced by an estimated $13.3 million in 2011-12 under this alternative.]

ALT 1	**Change to Bill** Revenue
GPR	**-** $79,100,000

2. Modify the indexing provisions for the sliding scale standard deduction and income tax brackets to specify that the annual indexing adjustment could not be a negative number, beginning with the 2012 tax year.

3. Maintain current law.

Prepared by: Rob Reinhardt