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

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

[LFB 2011-13 Budget Summary: Page 184, #4]

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. 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 2011 is $3,094 for families with one child, $5,112 for families with two children, and $5,751 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 2011 federal credit parameters and the state credit percentages, the maximum state credits for 2011 are: $124 for families with one child; $716 for families with two children; and $2,473 for families with three or more children. For filers with one child, the credit is phased out for income between $16,690 and $36,052 (between $21,770 and $41,132 for married couples filing jointly). For filers with two children, the income phase-out range is from $16,690 to $40,964 ($21,770 to $46,044 for married couples filing jointly). For filers with more than two children, the income phase-out range is from $16,690 to $43,998 ($21,770 to $49,078 for married couples filing jointly).

The state EITC 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. The GPR portion is provided through a sum sufficient appropriation and covers the balance of the cost of the credit.

GOVERNOR

Increase TANF funding for the earned income tax credit by $37,000,000 annually and decrease GPR funding by $50,900,000 in 2011-12 and $50,700,000 in 2012-13 to reflect current law reestimates ($6,400,000 GPR in 2011-12 and $7,300,000 GPR in 2012-13), proposed changes in the percentages used to calculate the credit (-$20,300,000 GPR in 2011-12 and -$21,000,000 GPR in 2012-13), and the proposed increase in TANF funding (-$37,000,000 GPR annually). Modify the percentages used to calculate the EITC by increasing the percentage from 4% to 5% for claimants with one child, decreasing the percentage from 14% to 8% for claimants with two children, and decreasing the percentage from 43% to 40% for claimants with three or more children, beginning in tax year 2011.

Under the bill, total funding for the EITC would decrease to $116,600,000 in 2011-12 and $116,800,000 in 2012-13, compared to base funding of $130,500,000. The TANF funding would increase from a base level of $6,664,200 to $43,664,200 annually. The estimated GPR sum sufficient portion would be decreased from the base level of $123,835,800 to $72,935,800 in 2011-12 and $73,135,800 in 2012-13.

With the proposed changes in the percentages used to calculate the credit, it is estimated that the maximum state credit for families with one child would increase from $124 to $155 in tax year 2011. The maximum credit for families with two children would fall from $716 to $409, and the maximum credit for families with three or more children would fall from $2,473 to $2,300.

DISCUSSION POINTS

1. This paper addresses the total funding level of the state EITC and the formula used to calculate the credit. The use of temporary assistance for needy families revenues as a funding source is discussed in a separate paper.

2. 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 25 million families currently receive the federal credit. At the state level, 273,939 claimants received the federal and Wisconsin credits in 2009. The credit has been characterized as encouraging work because individuals must work to receive the credit, and the amount of the credit increases as earnings increase, until a maximum credit amount is reached. Also, the credit can be viewed as stimulative, since low wage earners spend a greater portion of their income than high income individuals. The state credit was first offered in 1984.

3. The federal American Recovery and Reinvestment Act (ARRA) of 2009 made two

changes to the federal EITC that have been extended through tax year 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. First, a new third tier for the credit extends to families with three or more children. The credit percentage for the new tier is set at 45%, as opposed to the previous rate of 40% that continues to apply to claimants with only two children. The 2011 credit for families with more than two children results in a maximum federal credit of $5,751, which is $639 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.

4. The second change relates to the income threshold at which the credit begins to phase out for married couples, as opposed to single or head-of-household claimants. Prior to 2002, filing status was not a factor in the EITC computation, so married couples experienced a "penalty" in the form of a lower credit resulting from the use of the couple's joint income in calculating the credit. To address the marriage penalty, the Economic Growth and Tax Relief Reconciliation Act of 2001 created a higher income threshold for married couples beginning in 2002. For 2008, the Act set the adjustment at $3,000, and the Act provided an indexing adjustment for future years. However, ARRA increased the adjustment to $5,000 for tax year 2009 and provided an indexing adjustment for 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act extended the $5,000 adjustment and related indexing provision to tax years 2011 and 2012. As a result, the 2011 credit for married couples will start to phase out at $21,770, which is an estimated $1,910 higher than the adjustment would have been under the EGTRRA provision. By increasing the income threshold for married couples, claimants with incomes above the previous threshold will receive higher credits. Also, the credit will phase out at income levels that are $1,910 higher, thereby extending credits to some married couples not previously eligible.

5. By reauthorizing the ARRA provisions, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act will extend the EITC to about 17,000 more married couples in Wisconsin and increase the credit for claimants with three or more children. The Act was signed by the President on December 17, 2010. At that time, the Department of Administration (DOA) had already begun work on the 2011-13 biennial budget bill. Due to the way the Wisconsin EITC is calculated, federal law changes are automatically incorporated into calculations of the state credit. DOA adjusted the initial estimates for the Wisconsin EITC to reflect the interaction between the two credits for claimants with three or more children. However, no adjustment was made to reflect the larger number of claimants due to the higher income phase-out level for married couples. Adjusting for more married couple claimants would increase the estimated cost of the program by $3.7 million in 2011-12 and $10.6 million in 2012-13, relative to DOA's current law estimates. If the changes to the percentages for credit calculations that are proposed in SB 27/AB 40 are adopted, the DOA estimates of the program's cost would need to be increased by $2.9 million in 2011-12 and $9.2 million in 2012-13 (Alternative 1).

6. Under the SB 27/AB 40 proposal to change the percentages used to calculate the state credit, DOA estimates the all-funds cost of the program at $116.6 million in 2011-12 and $116.8 million in 2012-13. Under the re-estimates explained above, the cost of the program would be $119.5 million in 2011-12 and $126.0 million in 2012-13. The bills would increase the credit percentage for claimants with one child from 4% to 5%, while decreasing the credit percentages from 14% to 8% for claimants with two children and from 43% to 40% for claimants with three or

more children. The combined effect of the proposed changes would be to decrease total program expenditures 15% annually, compared to this office's current law estimates, or by $21.1 million in 2011-12 and $22.4 million in 2012-13.

7. After the ARRA changes to the EITC were extended, DOA examined several options for modifying the state credit percentages with the goal of expending the same amount of funding as was estimated before the extension of the ARRA provisions. Although each of these options increased the poverty gap among EITC recipients, the analysis indicated that the Governor's proposal would result in the smallest increase in the "poverty gap," among the options examined. In DOA's analysis, after considering the impact of federal and state earned income tax credits, the poverty gap represents the aggregate number of dollars that the income of credit recipients falls below the poverty threshold. The DOA analysis was based on 2009 EITC data, when the federal poverty level equaled $10,830 for one individual plus $3,740 for each additional individual in the family. Using the 2009 data, and this measure of poverty, approximately 1,000 additional families with 2,400 children would fall below the poverty line due to the changes in the bills.

8. By increasing the credit percentage from 4% to 5% for claimants with one child, total program expenditures would increase by an estimated $2.7 million in 2011-12 and $2.8 million 2012-13. The maximum 2011 state credit for these claimants would increase by $31 (25%), from $124 to $155. Decreasing the credit percentage from 14% to 8% for claimants with two children would decrease total program expenditures by an estimated $17.7 million in 2011-12 and $18.7 million in 2012-13 and would reduce the maximum 2011 state credit by $307 (-43%), from $716 to $409. Finally, the proposed decrease in the credit rate for claimants with more than two children from 43% to 40% would cause total estimated program expenditures to decline by $6.2 million in 2011-12 and $6.5 million in 2012-13. The maximum state credit for these claimants would fall from $2,473 to $2,300, or by $173 (-7%). Attachment 1 displays how the maximum state credit and income limit has changed by type of claimant since 2004, including the amounts for 2011 and 2012 under the SB 27/AB 40 proposal.

9. Table 1 reports the estimated 2011 distribution of claimants, total credits, and average credits by adjusted gross income (AGI) and by number of children, under current law and under the Governor's proposal. For each income class, the percent change in total credits and average credits equals the percentage change in the credit rate for each claimant type: +25% for one child claimants, -43% for two child claimants, and -7% for claimants with more than two children. Estimated credit increases average $20 for families with one child, and average credit decreases of $185 for claimants with two children and $106 for claimants with more than two children are estimated. Within each of the three claimant groupings, the table illustrates how the change in average credits will increase until AGI equals the maximum credit income level and the change in average credits will decrease after AGI exceeds the phase-out income threshold. Thus, for two children families, the 13,296 claimants with incomes between $10,000 and $15,000 would experience a larger credit reduction (-$295) than the 9,856 claimants with incomes between $5,000 and $10,000 (-$194) or the 38,182 claimants with incomes over $25,000 (-$113). An estimated 135,800 families with one child would receive a larger credit under the bills, and 152,600 families with two or more children would receive a smaller credit.

TABLE 1

Estimated Distribution of Claimants, Credits, and Average Credits by AGI and by Number of Children, Under Current Law and Under Governor's Proposal, Tax Year 2011

		Total Credits (in millions)			Average Credit		
	Claimant Count	Current Law	Governor's Proposal	Change	Current Law	Governor's Proposal	Change
Claimants with One Child							
Under $5,000	13,835	$0.6	$0.7	$0.1	$40	$50	$10
$5,000 to $10,000	20,600	2.2	2.8	0.6	108	135	27
$10,000 to $15,000	20,728	2.5	3.1	0.6	123	153	31
$15,000 to $20,000	20,203	2.3	2.9	0.6	115	144	29
$20,000 to $25,000	20,510	1.8	2.3	0.5	89	111	22
$25,000 to $41,132	39,920	1.2	1.5	0.3	29	37	7
Total	135,796	$10.6	$13.3	$2.7	$78	$98	$20
Claimants with Two Children							
Under $5,000	7,455	$1.1	$0.7	-$0.4	$153	$87	-$66
$5,000 to $10,000	9,856	4.5	2.5	-2.0	452	258	-194
$10,000 to $15,000	13,296	9.1	5.2	-3.9	685	390	-295
$15,000 to $20,000	13,156	9.0	5.1	-3.9	680	388	-292
$20,000 to $25,000	12,789	7.2	4.1	-3.1	563	321	-242
$25,000 to $46,044	38,182	10.0	5.7	-4.3	263	150	-113
Total	94,735	$40.9	$23.3	-$17.6	$431	$246	-$185
Claimants with More Than Two Children							
Under $5,000	4,239	$2.1	$1.9	-$0.2	$484	$450	-$34
$5,000 to $10,000	5,249	8.2	7.6	-0.6	1,558	1,449	-109
$10,000 to $15,000	7,280	17.2	16.0	-1.2	2,366	2,201	-166
$15,000 to $20,000	7,174	17.0	15.9	-1.1	2,375	2,209	-166
$20,000 to $25,000	7,274	14.8	13.8	-1.0	2,034	1,892	-142
$25,000 to $49,078	26,622	28.4	26.4	-2.0	1,068	993	-75
Total	57,838	$87.7	$81.6	-$6.1	$1,517	$1,410	-$106
State Totals	288,369	$139.2	$118.2	-$21.0	$483	$410	-$73

10. Currently, 23 states and the District of Columbia have enacted laws creating state earned income tax credits. In a report on state earned income tax credits released on April 18, 2011, the Center on Budget and Policy Priorities reports that Wisconsin and three other states (Kansas, Michigan, and North Carolina) are considering proposals reducing their state credits, and one state (New Jersey) has already enacted a reduction to its credit. Also, implementation of Washington's credit has been postponed until 2012. Wisconsin is unique in that it offers more than one reimbursement percentage, based on number of children. Relative to the credit percentages

proposed by the Governor, 17 other states offer credits above 5%, 15 other states offer credits above 8%, and no other state offers a credit of more than 40%, although the District of Columbia credit is set equal to 40% (see Table 2). Unlike other states, Minnesota's credit is not expressly structured as a percentage of the federal credit.

TABLE 2

State Earned Income Tax Credit Percentages, Percent of Federal Credit

Louisiana	3.5%	Nebraska	10.0%	New Jersey	20.0%
Illinois	5.0	New Mexico	10.0	Virginia	20.0
Maine	5.0	Washington	10.0	Maryland	25.0
North Carolina	5.0	Massachusetts	15.0	Rhode Island	25.0
Oklahoma	5.0	Kansas	18.0	New York	30.0
Oregon	6.0	Delaware	20.0	Vermont	32.0
Iowa	7.0	Michigan	20.0	District of Col.	40.0
Indiana	9.0				

Source: Center on Budget and Policy Priorities, Minnesota and Wisconsin not included.

11. If the Committee's objective is to achieve expenditure reductions so that the credit's total cost is similar to that of the Governor's original proposal, each of the credit rates authorized under current law could be reduced by approximately 20%. This would result in credit rates of 3% for one child, 11% for two children, and 35% for three or more children. These rates are presented as Alternative 2. Since Wisconsin's credit rate for claimants with one child is below the credit rate in 20 other states and the District of Columbia, another option would be to leave the credit rate for claimants with one child unchanged at 4%, but lower the credit rates to 11% for claimants with two children and 34% for claimants with three or more children. These rates are presented as Alternative 3, and they would produce total credit expenditures similar to those in the Governor's original proposal. Table 3 offers a comparison of the maximum credit amounts under the three alternatives and under current law.

TABLE 3

Estimated Maximum Credits for 2011 Under Current Law and Three Alternatives

	One Child		Two Children		Three or More Children	
	%	Maximum	%	Maximum	%	Maximum
Current Law	4%	$124	14%	$716	43%	$2,473
Alternative 1 (Gov.)	5%	$155	8%	$409	40%	$2,300
Chg. to Current Law		31		-307		-173
Alternative 2	3%	$93	11%	$562	35%	$2,013
Chg. to Current Law		-31		-154		-460
Alternative 3	4%	$124	11%	$562	34%	$1,955
Chg. to Current Law		0		-154		-518

12. As stated above, the EITC serves a broader purpose than simply a tax relief measure. Although it is designed to reduce taxes by offsetting state and federal income taxes, Social Security taxes, Medicare taxes, and other taxes paid by lower income families, it also supplements the wages of low and moderate income wage earners. In this regard, it helps lift families out of poverty and also assists individuals with incomes above the poverty level who have trouble paying for the necessities of daily living. By performing these functions, the credit provides incentive for low and moderate income people to work.

13. Earlier this session, 2011 Wisconsin Act 9 was enacted requiring any bill "that increases any of the rates of the income or franchise tax" to be approved by a two-thirds vote of the Legislature. One interpretation of the Act's reference to "rates" is that it is limited to the tax rates specified in s. 71.06 of the state statutes, which range from 4.60% to 7.75%. However, the Act's reference to "any of the rates" could imply a broader meaning, such as any action that increases the effective rate of taxation. A taxpayer's "effective rate" is based on the taxpayer's final tax liability after taking account of all provisions in the tax code.

14. This office consulted with attorneys at the Legislative Reference Bureau and the Legislative Council on this question. While the majority thought the Act 9 language does not encompass the proposed EITC changes, others suggested that an argument could be made that the proposed changes could trigger the Act 9 requirement because the change is economically equivalent to an increase in the effective rate of taxation. Because there is no case law on the new act, it is not possible to determine how the courts will interpret the provision.

15. The federal EITC changes enacted under ARRA and extended under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act apply only through tax year 2012. In an April 15, 2011, memorandum entitled "2011-13 and 2013-15 General Fund Budget," this office indicated that the sunset of these provisions would reduce general fund commitments in 2013-15 by $27 million annually. In recognition of this reduction, any EITC rate reduction included in SB 27/AB 40 could be enacted on a temporary basis. If the current law rates were reauthorized

effective in tax year 2013, the reduction in 2013-15 general fund commitments would be reduced to $5 million, or by $22 million, but there would still be a positive effect on the state's out-year commitments. Sunsetting the proposed EITC percentage changes after tax year 2012 is presented as Alternative 5.

16. Retaining the current law percentages for credit calculations and adopting the Governor's proposal to increase TANF funding would require total credit funding estimated at $140.6 million in 2011-12 and $148.4 million in 2012-13. The GPR-funded component is estimated at $97.0 million in 2011-12 and $104.7 million in 2012-13. For the two years, these amounts represent increases of $24.0 million and $31.6 million, respectively, compared to the Governor's proposal. This is presented below as Alternative 6.

ALTERNATIVES

1. Approve the Governor's recommendation to modify the percentages used to calculate the EITC by increasing the percentage from 4% to 5% for claimants with one child, decreasing the percentage from 14% to 8% for claimants with two children, and decreasing the percentage from 43% to 40% for claimants with three or more children, beginning in tax year 2011. Reestimate total funding for Wisconsin's earned income tax credit at $119,500,000 in 2011-12 and $126,000,000 in 2012-13. Approve the Governor's recommendation to increase TANF funding for the credit by $37,000,000 annually, but increase the program's GPR sum sufficient appropriation by $2,900,000 in 2011-12 and $9,200,000 in 2012-13 to reflect the reestimate of the program's total cost.

ALT 1	**Change to Bill** Funding
GPR	$12,100,000

2. Modify the percentages used to calculate the EITC by decreasing the credit percentages from 4% to 3% for claimants with one child, from 14% to 11% for claimants with two children, and from 43% to 35% for claimants with three or more children, beginning in tax year 2011. Reestimate total funding for Wisconsin's earned income tax credit at $112,600,000 in 2011-12 and $118,800,000 in 2012-13. Approve the Governor's recommendation to increase TANF funding for the credit by $37,000,000 annually, but decrease the program's GPR sum sufficient appropriation by $4,000,000 in 2011-12 and increase the appropriation by $2,000,000 in 2012-13 to reflect the reestimate of the program's total cost.

ALT 2	**Change to Bill** Funding
GPR	- $2,000,000

3. Modify the percentages used to calculate the EITC by decreasing the credit percentages from 14% to 11% for claimants with two children and from 43% to 34% for claimants

with three or more children, beginning in tax year 2011. Reestimate total funding for Wisconsin's earned income tax credit at $113,300,000 in 2011-12 and $119,500,000 in 2012-13. Approve the Governor's recommendation to increase TANF funding for the credit by $37,000,000 annually, but decrease the program's GPR sum sufficient appropriation by $3,300,000 in 2011-12 and increase the appropriation by $2,700,000 in 2012-13 to reflect the reestimate of the program's total cost.

ALT 3	**Change to Bill** Funding
GPR	- $600,000

4. Sunset the changes to the percentages used to calculate the EITC in Alternatives 1, 2, or 3 after tax year 2012, so that the percentages authorized under current law apply in tax years 2013 and thereafter.

5. Approve the Governor's recommendation to increase TANF funding for the credit by $37,000,000 annually, but retain the current law percentages used to calculate the credit. Reestimate total funding for Wisconsin's earned income tax credit at $140,600,000 in 2011-12 and $148,400,000 in 2012-13. Increase the program's GPR sum sufficient appropriation by $24,000,000 in 2011-12 and increase the appropriation by $31,600,000 in 2012-13 to reflect the reestimate of the program's total cost.

ALT 5	**Change to Bill** Funding
GPR	$55,600,000

Prepared by: Rick Olin
Attachment

ATTACHMENT 1

Change in the Maximum State Earned Income Tax Credit and Income Limit by Type of Claimant , 2004-2012

			Single		Married-Joint	
Tax Year	Maximum Credit	Percent Change	Income Limit	Percent Change	Income Limit	Percent Change
Families With One Child						
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	0.0	35,535	0.2	40,545	0.2
2011	155 *	27.0	36,052	1.5	41,132	1.4
2012	157 *	1.3	36,558	1.4	41,708	1.4
Families With Two Children						
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	705	0.1	40,363	0.2	45,373	0.2
2011	409 *	-42.0	40,964	1.5	46,044	1.5
2012	415 *	1.5	41,535	1.4	46,685	1.4
Families With Three or More Children						
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	2,436	0.2	43,352	0.2	48,362	0.2
2011	2,300 *	-5.6	43,998	1.5	49,078	1.5
2012	2,333 *	1.4	44,612	1.4	49,762	1.4

* Under Governor's proposal.