



**MAKING WORK WORK: ADDRESSING WISCONSIN'S LABOR SHORTAGE THROUGH  
STATE POLICIES TOWARD LOW-WAGE WORKERS**

MARCH 1, 2001

---

---

**WHY WORK DOESN'T PAY**

**FOR MANY LOW-WAGE WORKING PARENTS**

**Summary of the Problem**

For many working families, getting a raise does not result in greater net income. Low-wage working parents face the highest marginal tax rates of any income category. For most of these workers, only 20 cents of each dollar of new earned income make it into the monthly budget. When these workers get a raise, they lose substantial amounts of support in tax credits and state and federal benefits. The combination of lost supports results in marginal tax rates of 80% or more. At critical points, working parents face even higher marginal tax rates, when very small raises put them over the threshold of eligibility for government programs. When a working parent makes enough money to become ineligible for food stamps, for example, the marginal tax rate exceeds 100%. At these key junctures in the move toward self-sufficiency, working parents are actually worse off despite an increase in their earned income.

Because of the unintended consequences of the way anti-poverty programs are structured, some working parents face difficulties moving up the ladder to self-sufficiency. State and federal governments have created programs to support working families. Earned income tax credits (EICs) supplement wages for poor workers. Food stamps provide support for family nutrition. Wisconsin's subsidized health insurance program BadgerCare, and Wisconsin Shares, which provides childcare subsidies for working parents, offer much-needed economic support for low-income workers. Tax credits and benefits like these help to create an incentive structure that makes it worthwhile for low-income parents to go to work. In the context of W-2, the state of Wisconsin invested in programs like BadgerCare and Wisconsin Shares that would make work pay. The problem today is that the structure of these programs does not make work *continue to pay*. State and federal tax credits and benefits phase-out abruptly, and working parents often lose these supports before their earned incomes compensate for the loss of support. For many of these workers, work ceases to pay when their hourly incomes fall within the \$6.50 to \$8.00 range.

For workers just coming off W-2 and moving into low-paying hourly wage jobs, tax credits and other benefits provide an incentive structure that makes work pay. The Public Policy Forum's 1999 study (summary enclosed) demonstrates that the problem with high marginal tax rates is most profound for working parents trying to move into higher-paying hourly wage jobs. For most families, high marginal tax rates affect the family budget when parents earn \$7 - \$12 an hour.

A single parent with two children has strong tax and benefits incentives to move off W-2 and into the workforce. At \$8,000 yearly gross earned income, this working



parent would be eligible for additional support worth more than \$7,000, bringing total family income to over \$15,000 a year. When a worker grosses between \$17,000 and \$20,000 disposable income actually **declines** because food stamp benefits phase-out at a higher rate than earned income increases.

High marginal tax rates, which result from the combined effects of state and federal tax and benefit programs, create two problems for low-wage working parents.

- **Stagnant Disposable Income.** Working parents tend to see only very small increases in their disposable income despite large increases in hourly wage (disposable income is the sum of earned income and all other benefits and subsidies).

The Institute for Wisconsin's Future's FIRST model illustrates the problem of stagnant disposable income for a single parent with two children in Milwaukee County.

With one pre-school and one school age child, this single parent's earned income, taxes and benefits working full-time at \$6.50 an hour totals \$1478 per month. Working full-time at \$10 an hour, the same family would have only \$1588 disposable income per month. Despite increasing earning power by \$3.50 an hour (\$560 additional earned income), this parent would have only \$110 additional in her monthly budget (for a marginal tax rate of 81%). In this case, getting a raise does not pay much more.

- **Cliff effects.** Working parents experience cliff effects where small raises result in a complete loss of substantial benefits.

Public Policy Forum calculations for 2000 show how a single parent with two children can actually lose money because of a raise. At \$8.65 an hour, this family's earned income totals \$18,000 a year, but benefits and tax credits raise disposable income to \$19,372. With a small raise (to \$9.13/hr), earned income increases to \$19,000 for the year, but because of lost benefits and credits, disposable income **declines** to \$18,288. The cliff is even more dramatic when families lose eligibility for childcare subsidies, when their income exceeds 200% of the federal poverty line. At that point, a raise of 50 cents an hour can result in thousands of dollars of lost subsidies. In this case, getting a raise costs workers and their families.

This burden on low-wage workers hurts employers, who are increasingly concerned about the adequacy of Wisconsin's labor force. Already, employers face challenges in recruiting and maintaining an adequate supply of labor. Shortages of skilled laborers are projected to increase as the baby boomer population ages and moves into retirement. A key factor in this current and projected shortage is that state policies designed to support low-wage workers instead unintentionally discourage many from moving into better paying jobs that pay more. While federal tax and benefit policies create the biggest impediment to workers getting ahead and employers finding the workers they need, state tax and benefit policies are also a critical factor. Resolving the contradictions these policies create for working families is a key to making



Wisconsin competitive in attracting and maintaining high quality workers, meeting the needs of state businesses, and sustaining the current economic expansion.

Casting this problem in terms of marginal tax rates can be very useful for policy discussions. But discussions of marginal tax rates do not illuminate all aspects of the problem. Reducing benefit levels for lower income earners, for example, would solve the marginal tax rate problem (because workers would have less to lose as they increase their wages), but would introduce new problems for the overall incentive structure supporting work. If benefits for workers at extremely low wages do not cover the high costs of health care and childcare, then the ladder to self-sufficiency will be inadequate at lower wage levels. As tax and benefits programs are currently structured in Wisconsin, support for minimum wage workers makes it worthwhile for them to stay in the labor force. Between \$8 and \$12 an hour, however, most working parents encounter one of the problems outlined above, if not both.

The current tax and benefits structure imposes exceedingly high marginal tax rates on some low-income families. This problem affects workers, employers and Wisconsin's broader economic development. Solutions to the high marginal tax rates problem will incur new costs and problems even while they may solve others. Can tax and benefits policies be structured to eliminate high marginal tax rates completely? Eliminating high marginal tax rates is difficult and, for most programs, likely to be expensive. At a minimum, proposed solutions should recognize that while some families may continue to confront high marginal tax rates, the effects of these rates are cushioned for other families. Ideally, policies would levy high marginal tax rates against the fewest number of families possible, and against those families best positioned to cope with them.



## BADGERCARE

### The Problem

Even for working parents with relatively high wages, the cost of health care is prohibitive. Anecdotal evidence points to the importance of health insurance coverage in establishing women's disincentive to work under the AFDC system. Recalling their time on AFDC, women report having left public assistance for work, returning to AFDC upon realizing they could not care for their children adequately without health insurance. The AFDC system incentive structure did not support women's own desire to work. State and federal programs now offer more opportunities for subsidized health insurance to low-wage workers. But there are still many uninsured people in Wisconsin. A DHFS Family Health Survey estimated 340,000 people in Wisconsin were uninsured in 1999, including 80,000 children. About 80% of non-elderly Wisconsin residents had health insurance through an employer in 1997, versus 6% who had publicly subsidized insurance.

In order to estimate monthly health insurance expenses for its FIRST model, IWF uses numbers from the Wisconsin-based Prime Care insurance plan. For a family of 3 (single mom with two kids), health care costs total \$662 a month (\$566 for insurance, \$96 for co-pays and over-the-counter expenses). For working parents that do not have access to an employer subsidized plan, these costs clearly establish a disincentive to work.

### Existing Program Solutions

Low-income families are covered by an array of subsidized health insurance programs. Each of these programs has a distinct mandate, specific population to cover, and its own package of state and/or federal funding. For consumers, the distinctions among these different programs may not be so clear. Parents and children in one family may be enrolled in different programs even though everyone in the family has the same benefits. Taken together, this package of state and federal health insurance programs is intended to provide a seamless web of support for low-income parents and children.

Eligibility rules for each program are as follows:

- **Medicaid.** Covers children ages 6 through 18 up to 100% of the federal poverty line (FPL). Parents are covered under the old AFDC income standard, about 60% of FPL. (No premiums charged)
- **Healthy Start.** Covers children under the age of 6 and pregnant women up to 185% of FPL. (No premiums charged)



- **BadgerCare.** BadgerCare was created to expand health insurance access for the working poor by maintaining access to health insurance for parents who are working, but do not have an employer-subsidized plan. Parents whose incomes do not exceed 185% FPL are eligible to enroll in BadgerCare; they can continue to receive benefits until their income exceeds 200% FPL. BadgerCare is not available to low-wage working parents who have access to insurance provided through their employer if the employer pays 80% or more of the monthly cost. BadgerCare recipients with incomes above 150% FPL pay a monthly fee of 2.5%-3% of family's income.

As of January 31, 2001, BadgerCare enrollment was approximately 75,000. Combined with Medicaid (130,500) and Healthy Start (105,200), total coverage of low-income Wisconsin families amounts to 314,400.

For FY 1999-2000, the state of Wisconsin budgeted \$63.5 million (of which \$22 million came out of state GPR). Higher than expected enrollments and a looming budget shortfall led the state legislature to pass a bill in January 2001 allocating an additional \$11.5 million to fund BadgerCare through the current fiscal year, bringing the budgeted funding for FY 2000-2001 to \$134 million (of which about \$45 million is state funding).

### **The Work Disincentive**

The creation of BadgerCare significantly improved the work incentive for low-income families, but problems remain. Requiring families with incomes above 150% FPL to share premium costs contributes about to the high marginal tax rates and stagnant disposable income of these workers.

For working parents who do not have access to an employer provided plan, or for whom monthly premiums would consume a substantial chunk of their monthly paycheck, the cutoff point of BadgerCare eligibility (at 200% FPL) creates a cliff effect.

### **Additional Issues**

BadgerCare was created using two sets of federal funds: Title 21 (Child Health Insurance Program) and Title 19 (Medicaid). Because of restrictions on the way these two kinds of federal funding can be used, Wisconsin required a federal waiver to cover both parents and their children in a non-entitlement program. A second waiver allows the state to receive the higher Title 21 reimbursement rate (71%) for coverage of parents over the poverty line, as long as the state meets certain conditions, such as maintaining at least the current income eligibility standards.



In evaluating how to construct a health care system, many other factors need to be considered, in addition to the potential impact on disposable income or “implicit marginal tax rates”. A few of the other considerations include:

- Discouraging “crowd-out” (the substitution of state subsidized care for employer sponsored insurance).
- Avoiding “adverse selection” (the enrollment of less healthy individuals, rather than a typical cross-section of the population).
- Designing cost-sharing policies that do not deter enrollment, diminish the use of preventive services, and drive up the use of inefficient care (such as emergency room treatment).
- Reducing or holding down the cost of uncompensated care.

### **Questions for Consideration**

- Should the income eligibility limit for BadgerCare be increased to 250% (for parents and children, or only for children)?
- Should the co-pay be lowered for families with incomes above 150% FPL?
- Should new tax deductions or credits for health care expenditures be created?
- Should greater use of employee reimbursement accounts that set aside pre-tax dollars to pay for health care expenses be promoted?



## FOOD STAMPS

### The Problem

The Food Stamps program is one of the few remaining “entitlements” and one of the most important benefits for people below the poverty level. However, Food Stamps benefits taper off sharply as income increases. In addition, the complex two-pronged eligibility test – which looks at both gross income and net income – can produce a sudden loss of benefits (a “cliff effect”) for some families.

### Existing Program Solutions

The Food Stamps program was created in 1964 to assist low-income individuals and families in purchasing food. The federal government pays virtually the entire cost of food stamp benefits – which totaled \$122.7 million in Wisconsin in FY 1999. Program administration costs, which are equally shared between the state and federal governments, amounted to an additional \$45 million that year.

Under federal law, Food Stamps are an entitlement available to those who meet the rather complex eligibility requirements. The value of the benefits provided to a family varies substantially -- depending on income, assets, and the number of individuals in the group. An audit of the Food Stamp program released last year by Wisconsin’s Legislative Audit Bureau contains the following information about participants in the program and the benefits they received in January 2000:

- 75,297 households, representing 198,549 individuals, were receiving food stamps.
- 56 percent of the recipients were children, and 8 percent were over 60.
- Among the 67,900 participant ages 18 through 60, almost 29% were disabled.
- More than two-thirds of the assistance groups had no earned income.
- Among food stamp participants with earnings, average annual earned income was approximately \$11,200.
- 28.6 percent of food assistance recipients received benefits of \$10 or less per month, while 3.9 percent received more than \$500 per month.
- Almost 50 percent received monthly benefits of less than \$100.

The Food Stamps program has a two-part income eligibility test:

- **Net** income – income minus deductions for childcare, medical expenses, and some shelter costs – must be below 100% FPL
- **Gross** income must be below 130% FPL (this does not apply to the elderly and disabled)

Because of the deductions, the first part of the test is usually easier to meet. The practical effect is that families are still receiving a significant amount of Food Stamps



when they go above the gross income ceiling. The result is a benefits cliff at 130% FPL.

*An Example.* For a family living in Milwaukee County in 2001:

Family size:	3	Family income:	\$18,000 (127% FPL)
# children in child care:	1	Rent & utilities/mo.:	\$600
Food Stamps benefits per month: \$94			

### **The Work Disincentive**

Food Stamps benefits decline steadily as income increases, starting with the first dollar of “net income.” A family of three, such as the example shown above (\$18,000 annual gross income), receives \$1,128 per year in Food Stamps benefits, compared to \$2,436 for a family that is earning \$3,000 less and has the same shelter costs and deductible expenses.

Although Food Stamps benefits decline at a fairly steep rate as income increases, the even greater work disincentive is the termination of eligibility, or “cliff effect,” when the family’s income reaches 130% of FPL. If the family noted above were to receive an additional \$400 in annual income (to \$18,400) they would exceed the 130% cap and lose more than \$1,100 in Food Stamps benefits. Even without factoring in variables such as FICA taxes, many families that get a \$1000 annual income boost that puts them over the 130% ceiling will experience an implicit marginal tax on that income of over 100 percent.

An even greater work disincentive is the cliff effect when the family’s income reaches 130% FPL. If the family noted above were to receive an additional \$400 in annual income (to \$18,400) they would exceed the 130% cap and lose more than \$1,100 in Food Stamps benefits. Even without factoring in variables such as FICA taxes, many families going above the maximum income limit experience an implicit marginal tax on that income of over 100%.

### **Additional Issues**

Participation in the Food Stamp program has declined significantly in Wisconsin since 1994. This decline cannot be explained by a drop in the number of eligible households, because the portion of the eligible population that is participating has decreased substantially. A January 2001 study prepared for the USDA by Mathematica Policy Research, Inc. found that the rate of participation of eligible families in Wisconsin’s Food Stamps program fell from 68% in 1994 to 49% in 1998. That moves Wisconsin to the 4<sup>th</sup> lowest participation rate in the country.



In light of this decline in participation, careful consideration of modifications in the program that will facilitate Food Stamp enrollment is needed. Recent changes at the federal level give states some flexibility to modify the assets tests and make some other adjustments that could remove barriers to enrollment

**Questions for Consideration**

- Should eligibility be increased and benefits phased out more slowly?
- Should the phase-out be kept the same, but the gross income standard removed or increased, to reduce the problem of a cliff effect when families reach 130 percent of the poverty level?
- Should the gross income test be kept the same, but the phase-out rate increased (by modifying the net income calculation), to reduce the problem of a cliff effect when families reach 130 percent of the poverty level?
- Given that the federal government pays for food stamp benefits and sets the eligibility standards, are there any realistic options for state-level action to mitigate the effect of food stamp policies in creating a work disincentive?



## CHILD CARE (WISCONSIN SHARES)

### The Problem

For many low-income families, the cost of childcare is prohibitive and can create serious barriers to full employment. The State of Wisconsin sets reimbursement rates for those receiving subsidies at the 75<sup>th</sup> percentile of market rates. A review of state reimbursement rates, therefore, provides a good benchmark for the prevailing costs of childcare.

- The current state reimbursement rates in Milwaukee County for licensed childcare are \$200 per week for centers serving children under age 2, \$180 per week for children ages 2-12 in centers, and \$165 weekly in licensed family care. (The average weekly rates for the whole state are \$134, \$117, and \$116, respectively.)
- In 1997, 48% of families in Wisconsin paid for childcare; the average weekly expense of \$279 comprised 9% of family income.
- For a Milwaukee County family with one child in licensed family care, yearly childcare costs would exceed \$8000.

### Existing Program Solutions

Wisconsin Shares is the State of Wisconsin's subsidized childcare program. While it is often linked with W-2, many participating families do not receive W-2 cash grant payments. Enrollment is not limited to current or former W-2 clients. Eligibility rules are as follows:

- Families whose work requires the use of childcare may enroll in Wisconsin Shares if their incomes are below 185% of the federal poverty level and they can remain in the program until their incomes exceed 200% FPL.
- Almost all families must pay co-pays, which increase with income and number of children requiring care. The median co-pay in December was just over 6% of income; 98.4% of participants pay less than 12% of income.
- Participating families make a weekly co-payment based on family income, family size, number of children in care, and type of care used. Co-payments currently range between \$2 and \$90 per week, according to an annual schedule established by the Department of Workforce Development. Collection of co-payments is the responsibility of the childcare provider.



During all of FY 1999-2000, approximately 33,000 families (with over 60,000 children in care) participated in Wisconsin Shares. Many of these families did not participate for the full year. In July 2000, there were 36,247 children whose care was subsidized through Wisconsin Shares.

The Legislature and Joint Finance Committee allocated \$201 million for the Wisconsin Shares program in FY 2001, but it now appears that at least \$240 million will be necessary to fund the program this year. Governor McCallum has proposed an appropriation of about \$242 million for each of the next two fiscal years.

*An Example.* For a family living in Milwaukee County in 2001:

Family size:	2	Family income:	\$18,000
# children in care:	1	Type of care:	licensed center
Age of child:	4		
Family co-payment:	\$40/wk	State subsidy:	\$132.50/wk

### **The Work Disincentive**

The cost of childcare is an obvious work disincentive for many parents. The Wisconsin Shares childcare subsidy is intended to alleviate this disincentive. Built into the Wisconsin Shares program, however, are unintended work disincentives:

- The steady rise in co-pays as income increases contributes to the substantial implicit marginal tax rates faced by low-income families. In general, the loss of benefits as income rises is 6% to 28%. Spread over a wide range of incomes, the average rate is 13% to 16%. In other words, disposable income falls by 13 to 16 cents for every dollar in increased earnings due to Wisconsin Shares.
- The most detrimental impact of Wisconsin Shares on families with rising incomes is the loss of benefits when a family's income exceeds 200% of the federal poverty level. This benefits "cliff" causes three- or four-digit marginal effective tax rates. As the family is forced to spend a much larger share of its income on childcare, disposable income drops precipitously despite the rise in earnings.

*An Example.* For the family profiled above, the impact of earning \$1 more than \$22,511 would be a loss of \$4,238 in annual child care subsidies (over a quarter of the family's earned income).



### **Additional Issues**

The current program design reflects efforts to balance a complex array of needs. To be effective, Wisconsin Shares must:

- Provide adequate reimbursement to childcare providers
- Support parents who cannot work without childcare
- Maintain affordable co-payments (enable access to very poor families)
- Stay within state budget limitations.

The core challenge of Wisconsin Shares is the high cost of childcare, especially in comparison to the incomes of participating families.<sup>1</sup> Under the current co-payment structure, families usually pay only 7% to 11% of the cost of care at 100% of the poverty level. At 150% of poverty, households with one or two children still pay only around a quarter of the childcare bill. For larger families, keeping co-payments to less than 12% of income means that they pay a mere 10% to 15% of their much larger bills, even at the highest eligibility levels.

But requiring families to pay more of the cost of childcare is difficult. At the lowest income levels, a household seldom has sufficient disposable income to take on even 5 to 10% more of the bill. Increasing the percentage of cost paid as income rises would sharply increase the loss of disposable income for each additional dollar earned. Some observers are also concerned that it would create a perverse incentive for families to seek low-cost care of questionable quality.

Attempts to reduce the benefits cliff require faster increases in co-payments as earnings rise. This increases the loss of disposable income experienced by all those participating in the program, not just those few with incomes near the maximum eligibility amount. Combined with the impact of other tax and benefits programs, this can push marginal effective tax rates to unacceptable levels.

Numerous other variables complicate the situation. Most positively, children age over time. The older the child, the less expensive the cost of care; eventually, the child does not require formal care. In general, this means that the number of families experiencing sharp net benefit losses will be fewer for purely demographic reasons. However, this is no consolation to the worker whose raise sends her over the cliff to zero benefits.

Other non-earnings variables having more negative impacts include workers who have a second or third child (causing a large spike in child care costs) and workers whose shift or job changes require use of more expensive off-hours care.

---

<sup>1</sup> It is worth noting that current reimbursement rates are relatively low compared to the cost of operating high-quality childcare programs. In the current market, most childcare workers earn low wages. This leads to worker shortages and high levels of turnover, both of which are extremely detrimental to children in care.



**Questions for Consideration**

- Should benefits be extended to those with incomes under **250%** of the federal poverty line?
- Should the co-pay structured be tied to actual cost of care?
- Should the state create a child and dependent care tax credit (this option would require update of the federal child and dependent care tax credit to be useful)?
- Should employees encourage use of reimbursement accounts that use pre-tax dollars to pay for childcare expenses?
- Should the state educational system be expanded to provide early childhood education for younger children?



## TAXES

### The Problem

Federal and state tax laws affect working families in two ways.

- 1) Taxes are levied against workers' incomes. These are taxes **owed** to state and federal governments. At the federal level, workers pay two different kinds of taxes. Social Security and Medicare are, for low- and middle-income workers, a straight percentage of earnings. At both the federal and state levels, income taxes support general governmental functions. The percentage of earnings paid as income taxes varies depending on overall income, household composition, and certain expenses.
- 2) Tax credits are monies given back to workers, which can be used to offset tax liability or, in the case of refundable credits, are directly refunded to workers to the extent they exceed taxes owed. The dollar amounts of tax credits usually vary in relation to income and other factors.

For many low-income families, a combination of lost tax credits and new tax liabilities contributes to the unusually high marginal tax rates they face. The problem is two-fold. Tax liability can become significant rapidly, and critical tax credits (especially the Earned Income Credit) phase out dramatically.

### *The Federal Tax Structure.*

#### \* Social Security & Medicare

Most workers pay 7.65% of each dollar earned to finance the Social Security and Medicare programs. There is no adjustment in the rate based on ability to pay.

#### \* Income Tax

The lowest tax rate currently assessed by the United States is 15% of taxable income. The income at which a household starts to actually owe this tax on every extra dollar earned is called the tax threshold. It is determined by subtracting the standard deduction and personal exemptions from income.

A single person with no children has the lowest tax threshold (\$7,200). This is the amount of the single standard deduction plus one personal exemption. These households start paying the 15% tax rate when they are at only 86% of the federal poverty level.



Heads of household and married couples get higher standard deductions and additional personal exemptions, so they don't start paying federal income tax until they earn more. Families with children can also take advantage of a non-refundable \$500 per child tax credit to increase their tax threshold. The following shows the earnings levels above which the 15% marginal rate is applicable (and where that is compared to the poverty level):

Single parent, 1 child	\$15, 385	137%
Single parent, 2 children	\$21, 520	152%
Single parent, 3 children	\$30, 985	182%
Married parents, 1 child	\$19, 085	135%
Married parents, 2 children	\$25, 215	148%
Married parents, 3 children	\$34, 685	174%

For those families with child care expenses, the non-refundable dependent care tax credit can increase the tax threshold by an additional \$3,200 to \$6,400.

**\* Earned Income Credit**

The Earned Income Credit (EIC) is now the largest federal anti-poverty program. It supplements earnings to help low-wage workers make ends meet. Although there is a small EIC for very low-income workers without children, the program is focused on workers with children, with higher benefits for families with two or more children.

The EIC for families with children increases as earnings increase from \$1 to \$9,720 (all figures in 2000 dollars). In other words, each additional dollar earned also increases the credit amount. The maximum benefit is \$2,353 for a worker with one child and \$3,888 for workers with two or more children. The maximum benefit is paid until earnings rise above \$12,690.

As earnings rise above \$12,690, the credit is phased out. This phase-out creates a large marginal effective tax rate. For families with one child, the loss is roughly 16 cents out of every additional dollar earned, or 16% marginal tax rate. For larger families, it is 21 cents, or a 21% marginal tax rate. This negative impact on disposable income continues until the reduced credit equals zero (at incomes of \$27,400 to \$31,150).



**The Work Disincentive**

The cumulative effect of the federal credits and taxes provides a significant disincentive for many low-income families to earn more. The marginal tax rate from the federal income tax system can be as high as 44%.

EXAMPLE: a single parent with two children

- Loses 29 cents out of every additional dollar earned between \$13,000 and \$28,000 (almost 8 cents for Social Security & Medicare taxes and 21 cents in reduced Earned Income Credit)
- Loses 44 cents for every \$1 earned between \$28,000 and \$31,000 (the same amounts for Social Security & Medicare taxes and lost EIC, plus 15 cents in federal income taxes)

***The Wisconsin Tax Structure.***

\* Income Tax

The state income tax affects working families at a lower income level than the federal income tax.

Wisconsin's income tax is complex. There is a standard deduction (varying by filing status) that phases out as income rises. There is a \$600 personal exemption for the filer(s) and each child. There is a non-refundable school property tax credit that reduces the taxes of both homeowners and renters. There is also a Working Family Tax Credit designed to reduce the income tax liability of very low-income persons to zero.<sup>2</sup>

For renters paying \$400 a month (no heat included), the lowest tax rate of 4.73% begins to be incurred once income rises above the following amounts (and percentages of the federal poverty level). The following tax "thresholds" are calculated without factoring in the EIC or Homestead Credit:

Single person, no children	\$11,175	134%
Single parent, 1 child	\$13,600	121%
Single parent, 2 children	\$14,110	100%
Single parent, 3 children	\$14,640	86%
Married parents, 1 child	\$18,695	132%
Married parents, 2 children	\$18,765	110%

---

<sup>2</sup> The Working Family Tax Credit is phased out for single taxpayers between \$9,000 and \$10,000 of earnings and for married taxpayers between \$18,000 and \$19,000. This rapid phase-out creates higher marginal tax rates (up to nearly 10% additional) on some households in these narrow income ranges.



Married parents, 3 children                      \$18,855                      94%

The next highest rate (6.33%) affects single, childless workers beginning around \$18,000, single parents around \$20,750, and married couples around \$27,000. The 6.55% rate kicks in at \$25,000, \$27,500, and \$35,500, respectively, for each household type.

\* Earned Income Credit

Wisconsin is one of a handful of states with its own EIC to supplement the federal credit. Wisconsin is the only state that adjusts its credit by family size. The state EIC is a percentage of the federal: 4% for families with one child, 14% for families with 2 children, and 43% for families with three or more children. These big differences in benefits are designed to help larger working families remain above the poverty line. There is no Wisconsin EIC for persons with no children.

Because the state EIC is piggybacked on the federal EIC, the same phase-in and phase-out structure applies. The maximum benefits payable (in addition to the federal EIC) are:

Families with one child	\$94
Families with two children	\$544
Families with three or more children	\$1,672

Piggybacking also increases the marginal effective tax rates experienced by families in the phase-out range. For families with three or more children, 9 cents of every additional dollar earned are lost because of the reduced EIC.

\* Homestead Credit

The Homestead Credit was originally designed as a “circuit breaker” to protect low-income elderly homeowners from rising property taxes. It was later expanded to provide property tax relief to all low-income Wisconsin residents.

The maximum Homestead Credit is equal to 80% of the first \$1,450 paid in property taxes. (Renters receive the credit based on the amount of rent paid.) The most any household may receive is thus \$1,160.

The Homestead Credit is reduced by 7.03% of income over \$8,000. This makes the maximum income for eligibility \$24,500. In other words, workers lose 7 cents of every additional dollar earned between \$8,000 and \$24,500 due to reduction in this credit.

In many respects, the Homestead Credit is a very carefully targeted form of property tax relief, since the “circuit-breaker” design is intended to provide relief once property taxes exceed a taxpayer’s ability to pay them. On the other hand, the credit is



not structured in a way that recognizes that property taxes will generally be a greater burden for larger families (compared to other households with comparable income). The chart below illustrates that point, as well as the marriage penalty in the credit, by showing the income range over which the credit phases out – both in absolute dollar terms and as a percentage of the 2001 federal poverty level.

Family Size	<u>Homestead Credit Phase Out Range</u>	<b>Phase Out Range Relative to the Poverty Level</b>
Single Individual	\$8,000 - \$24,500	93% - 285%
Married Couple	\$8,000 - \$24,500	69% - 211%
Single Parent & 3 Children	\$8,750 - \$25,250	50% - 143%
Married Couple & 3 Children	\$8,750 - \$25,250	42% - 122%

**The Work Disincentive**

Although the cumulative effect of the Wisconsin income tax system is less onerous on lower-income working families than the federal system, it does significantly exacerbate the problem. Marginal tax rates from the state tax structure can add as much as 17% to the already high marginal tax rates imposed by the federal system.

EXAMPLE: a single parent with two children

- Loses 15 ½ cents out of every additional dollar earned between \$14,500 and \$20,500 (5 ½ cents for state income taxes, 3 cents in state EIC, and 7 cents in Homestead)
- Loses 17 cents for every \$1 earned between \$20,500 and \$24,500 (the amount paid in state income taxes goes to over 7 cents)

**Combined Impact**

Using again the example of a single parent with two children, the combined effect of the federal and state tax systems on getting ahead can be seen at different income levels:

- 44 cents out of each dollar earned between \$14,500 and \$20,500
- 46 cents out of each dollar earned between \$20,500 and \$24,500
- 54 cents out of each dollar earned between \$28,000 and \$31,000



## **Questions for Consideration**

- Should the state offer a credit for federal Social Security & Medicare taxes to ease the tax bite on higher earnings?
- Should the Working Family Tax Credit be expanded and phased out more gradually?
- Should the phase-out of the standard deduction be changed to ease marginal income tax rates on low to middle-income working families?
- Should the state EIC be altered to reduce the phase-out burden, especially for larger families?
- Should the state EIC be totally redesigned to be separate from the federal EIC?
- Should the state adopt a general policy of decreasing or eliminating phaseout rates as the preferred method of providing tax cuts to the middle class in the future, in lieu of cutting state income tax rates or providing deductions or exemptions?

