
Buyer Beware

Low-Income Homeowners
Penalized Under the
Wisconsin Tax System



Policy implications of the
Wisconsin Tax Incidence Report

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I: Introduction

The currently hot political debate in Wisconsin is about *how much* we pay in taxes. But that's only half the picture. Equally important is how taxes are distributed among different groups of taxpayers, and how this corresponds to their differing abilities to pay. Questions about *how much we pay* have to do with whether or not tax revenues for Wisconsin state and local government are adequate for funding government services. Questions about *who pays* have to do with whether or not the responsibility for paying taxes is shared fairly and equitably by all.

The Wisconsin Department of Revenue recently released its long-awaited *Wisconsin Tax Incidence Study*, which answers questions about *who pays*. [The report is available at: <http://www.dor.state.wi.us/ra/txinci04.html>] The 126-page study is the first comprehensive look in a quarter-century at who pays state and local taxes in Wisconsin. It examines \$15.1 billion in state and local taxes for 2001, the most recent year for which complete data were available. Because of the amount of technical work involved, there is unlikely to be another such study for years. This study involved contributions from experts at three Wisconsin agencies (the Departments of Revenue, Workforce Development, and Health and Family Services), three University of Wisconsin campuses (Madison, Platteville and Whitewater) as well as the Federal Reserve Bank of Chicago and the Minnesota Department of Revenue.

Media coverage of the study was short and short-lived. This overview of the *Wisconsin Tax Incidence Study* will analyze the main findings of the report regarding who pays, and identify the changes needed in state and local tax policies to maximize tax fairness.

II: Summary of important results

The fundamental finding in any tax incidence research is how taxes are distributed across income groups. As the study says on its opening page, "Most economists and policy makers agree that taxes should, at least to some extent, be based on taxpayers' ability to pay, as measured by income."

In what is called a '*progressive*' tax structure, those with higher income are considered to have greater ability to pay taxes. So, for example, a household with \$20,000 annual income would pay a smaller share of that income in taxes than would a household with \$100,000 income. The \$20,000 household might pay 10% in taxes, while the \$100,000 household pays 15%. This is considered more fair, on the theory that the \$20,000 household has little left after buying necessities, while the \$100,000 household has more discretionary income and can better afford to spend on taxes.

By contrast, in a '*regressive*' tax structure, low-income households pay a larger share of their income to taxes than higher-income households. For example, if the \$20,000 household paid 15% in taxes while the \$100,000 household paid only 10%, this would be regressive. A regressive system is one that puts a greater tax burden on those who can least afford it.

A tax system that is neither progressive nor regressive is called '*proportional*.' A proportional system treats wealthy and poor exactly the same, taxing each at the same rate. While this proportional or flat tax appears to treat all taxpayers equally, it ignores the fact that a 10% tax rate for a low-income family has a much greater impact on money available for necessities than a 10% tax for a high-income household.

The *Wisconsin Tax Incidence Study* concludes that the overall tax system is neither progressive nor regressive, but proportional. Its most remarkable finding, however, is that for homeowners, the tax system is quite regressive across all income groups. Moreover, married homeowners with lower incomes are hit the hardest of all. *

The fact that the tax system is regressive for homeowners means that wealthy homeowners have the lowest tax burden, middle-income homeowners have a greater tax burden than the wealthy and lower-income households pay an even higher portion of their income for taxes than either wealthy or middle-income families. And married, low-income homeowners are systematically punished by Wisconsin's tax system with the highest rates of all, the study found. This defies conventional societal expectations, in which both marriage and homeownership are encouraged, especially for those struggling at the lower end of the income ladder.

Overall, the Wisconsin tax structure is proportional. Low-income households in Wisconsin are paying state and local taxes at roughly the same rate as high-income households. However, the impact on the families is far from the same. A family with \$20,000 in income paying 10% for taxes reduces household purchasing power by \$2,000. This can make a significant difference in the family's ability to afford basic necessities. A family with \$200,000 in income paying a 10% tax bill has \$180,000 remaining with a minimal impact on the household capacity for meeting basic needs.

While the study says in several places that Wisconsin's tax structure overall is "slightly progressive", when the impact of federal taxes is taken into account, tax rates are proportional. Wealthier households are much more likely to itemize deductions on their federal tax returns, thereby obtaining deductions for local income and property taxes and reducing their overall tax bill. The study notes: "Before adjustment for these federal tax policies, Wisconsin's tax structure was mildly progressive; when these policies are taken into account, Wisconsin's tax structure can best be described as proportional." (p. 62)

Another important finding is that of the three major state and local taxes – property tax, income tax and sales tax – only the state income tax is progressive. Both property taxes and sales taxes are regressive. When these three major taxes are combined, the progressive nature of the income tax is countered by the regressive natures of the property tax and sales tax to create an overall structure that is proportional.

Other noteworthy results include the following:

- The regressive nature of the property tax is tempered somewhat by the Homestead Credit, which helps lower-income homeowners and renters. **However, the study estimated that an alarmingly low percentage of eligible households (43%) actually received the Homestead Credit.** In fact, in the first concrete result of the study, the state's form for filing the Homestead Credit has been simplified to encourage greater participation.
- **Business taxes are a very small share of overall taxes and have little impact on the overall progressive or regressive nature of the system.** This is due not only to the many exemptions businesses have to paying various taxes, but also because of the ability of businesses to pass some of the taxes on to customers (higher prices) and/or workers (lower wages).
- **There were no significant differences between elderly households (where the head of household is at least 65) and non-elderly households.**

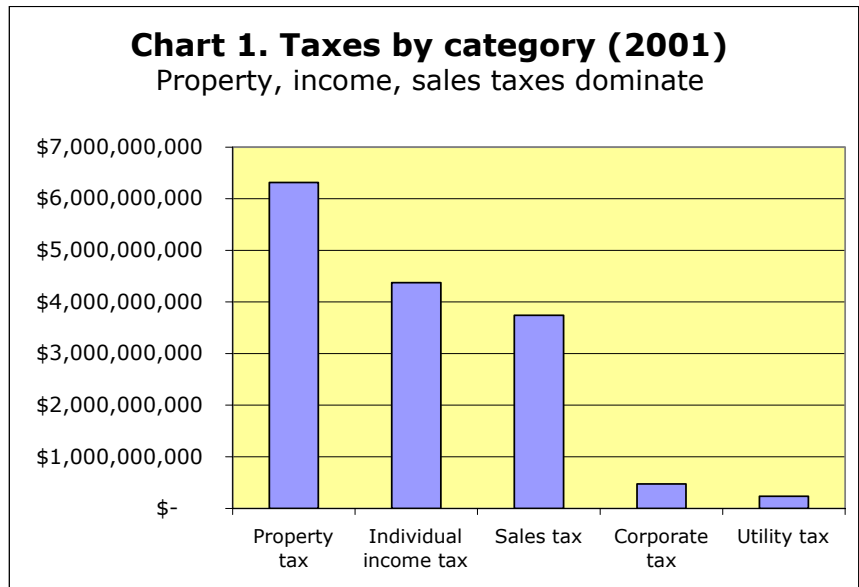
* The study was unable to determine how this compares with previous years, especially whether or not the system has been moving in a regressive or progressive direction. There was a previous Wisconsin tax incidence study, in 1979. But the differences in method between the two studies are so significant that their results cannot be compared.

III: A closer look at significant results

The 'big three' taxes

Three taxes accounted for almost all the taxes studied: property taxes, individual income taxes and sales taxes. Together, they accounted for over 95% of all taxes studied. The property tax was by far the largest tax of all. See Chart 1 for the total amounts of tax included in the study.

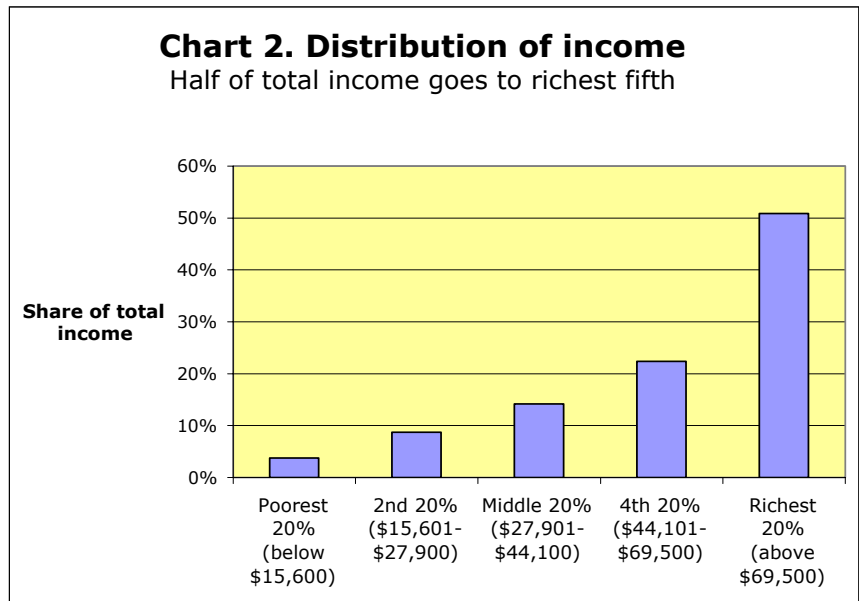
About 12% of total taxes were not studied. These include the motor fuels tax, estate tax, insurance premium tax, and excise taxes such as those on alcohol and cigarettes.



Distribution of income

Before calculating tax burdens – taxes paid as a percentage of income – it was necessary to determine the income of households (including untaxed income such as unemployment compensation and W-2 subsidies). The result yields Chart 2, a picture of the income distribution among Wisconsin households.

The chart shows clearly how income is concentrated among a relatively small number of households. Those in the poorest one-fifth of households, for example (annual incomes in 2001 below \$15,600), had only 4% of total state income. Indeed, the bottom 60% of households (income below \$44,100) combined for only 27% of total income. By contrast, the richest fifth of households (incomes above \$69,500) captured 51% of all state income. The imbalance means that Wisconsin's 'middle' class has



significantly less income, as a group, than do the wealthiest. The middle 60% of households (incomes between \$15,600 and \$69,500) had only 45% of total incomes, less than that of the richest fifth. Within that highest-income bracket, the distribution is skewed heavily in favor of the exceptionally wealthy. The top 1% of households had 12% of total income, and the top 10% of households had 35% of all state income.

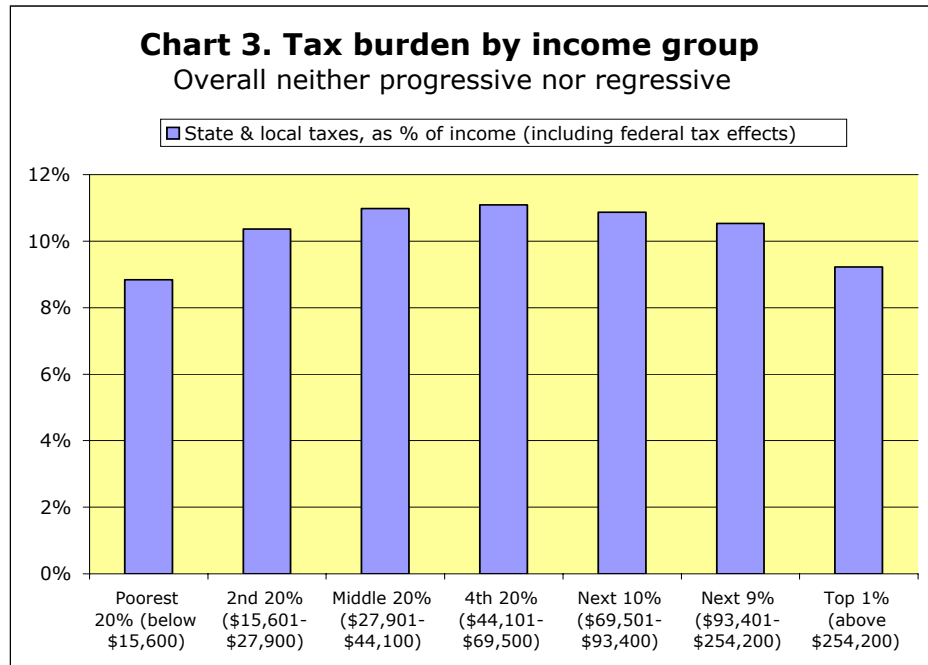
Tax burdens overall

The total incidence of state and local taxes – after taking into account all the effects of federal tax policy, including deductibility of some local taxes and the federal Earned Income Credit – is shown in Chart 3.

The poorest fifth of households pay a slighter lower percentage of income than higher-income households. The richest fifth also pay a lower percentage than middle-class households.

Determining whether a tax structure is progressive or regressive is best done not by eyeballing such charts, but by using carefully researched technical measures.

The technical measure used in the Wisconsin incidence study is known as the ‘Kakwani index.’ A Kakwani index of greater than zero signifies an overall progressive tax structure. A Kakwani index below zero signifies a regressive structure. Before taking into consideration the impact of federal taxes, the overall Kakwani index for Wisconsin was 0.013, which is above zero but barely so. On this basis, the study calls Wisconsin taxes “mildly progressive.” But when the impact of federal taxes is taken into account, the Kakwani index fell to -0.004, every so slightly regressive but basically zero. These results – with Kakwani indices so very close to the zero mark – are why the study concludes that taxes overall in Wisconsin are proportional rather than progressive or regressive.



Property taxes

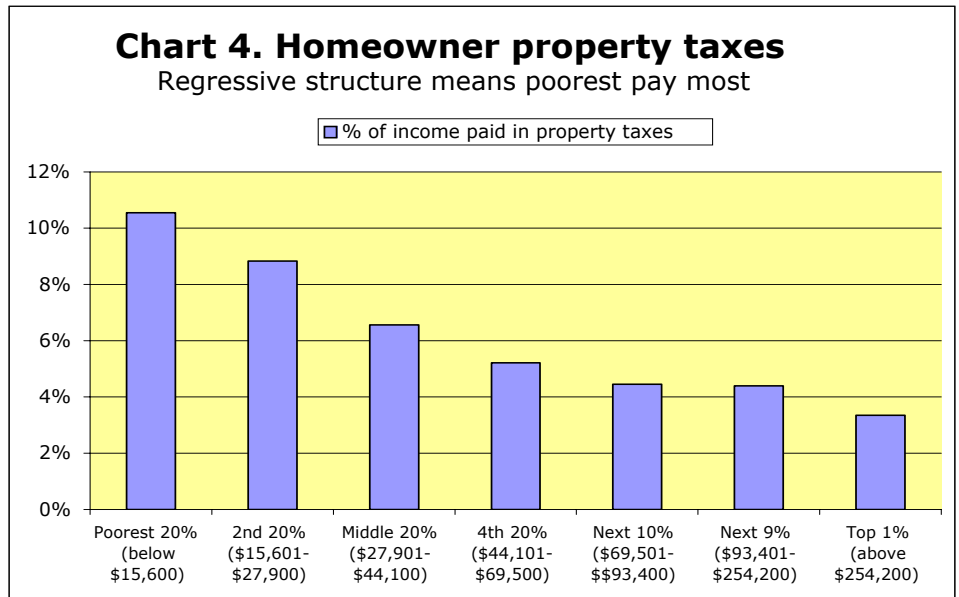
Property taxes are regressive across all income groups, the study found. Indeed, property taxes were so regressive for homeowners that it outweighed the progressive nature of the income tax, with the result that “total taxes were regressive across all income groups for homeowners.” (p.64)

While the Homestead Credit did reduce somewhat the regressive nature of the property tax, the study noted, it “did not completely eliminate the regressivity of the property tax.” The study estimates that only 43% of eligible households actually claimed the Homestead Credit. [Even for those who took advantage of the Homestead Credit, the value of that benefit has been slowly eroding due to inflation. For a fuller account of the declining value of the Homestead Credit, see *The Homestead Credit: An Effective Form of Property Tax Relief that Is Losing Its Punch*, a recent report from the Wisconsin Council on Children & Families (<http://www.wccf.org/>).]

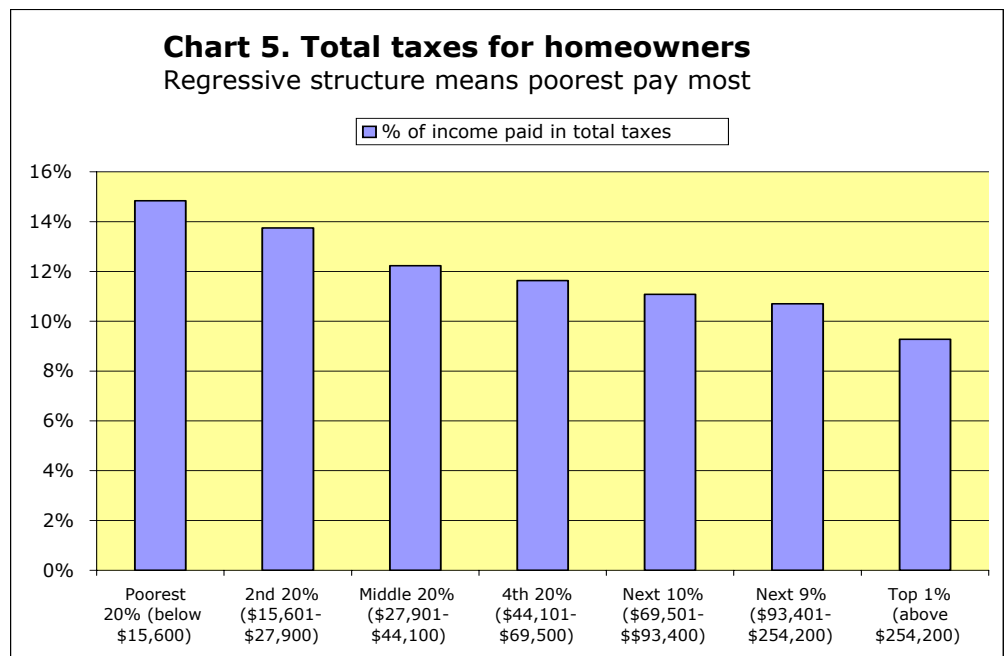
Homeowner tax rates

Among homeowners, even when the Homestead Credit was taken into account, property taxes were highly regressive. Chart 4 shows the burden of the residential property tax on homeowners.

The 40% of homeowners at the lowest end of the income scale pay property taxes at a percent of income that is more than twice as high as the 20% of households with the highest income.



The regressive nature of property taxes is strong enough to ensure that the total tax burden on homeowners is also regressive. In other words, the progressive nature of the state income tax was simply not enough to offset the severely regressive nature of property taxes for homeowners. This is seen in Chart 5, which shows the tax burdens on homeowners from all taxes, not just residential property taxes. For renters, the overall tax structure was “mildly progressive.”



The tax penalty for low-income married homeowners

One of the most startling results of the study is that this regressive situation is significantly worsened for those low-income homeowners who are married. Among the lowest 40% of households (those with incomes below \$27,900), married households paid a higher share of their income in taxes than single households, regardless of the presence of children. (p. 71)

The regressive nature of taxes on homeowners in general and married homeowners in particular means that Wisconsin's tax system systematically punishes those in the bottom half of the income brackets who do exactly what they are 'supposed to do' under conventional social norms: marry and buy a home. Those who do, the tax incidence study tells us, wind up paying taxes at the highest of all rates.

Business taxes are a small factor

Business taxes have little impact on tax incidence, the study concludes. For one thing, taxes imposed directly on business accounted for only 18% of all taxes. These taxes include the corporate income tax, sales taxes on business purchases and property taxes on business property. And a good deal of that 18% is passed on to customers (through higher prices) or to workers (through lower wages).

Income taxes

The state income tax is the only tax that is progressive throughout all income brackets. This is because of an initial standard deduction that exempts up to \$13,410 of income from the income tax. This deduction phases out as incomes grow, ensuring that it has a progressive impact. The Earned Income Tax Credit provides additional relief for many low-income households, further extending the progressive nature of the tax. And finally, income tax rates increase slightly as income grows. As a result, the effective income tax for the lower 40% of households is less than 2%, while the effective income tax for the top 40% of households is above 4%.

The study includes interesting data on the sources of income for various income groups. For example:

- Households with income in the top one-fifth accounted for 73% of all investment income (capital gains, interest and dividends). Reductions in taxes on investment income (such as those made in the federal tax system in recent years) therefore clearly benefit mainly the richest households in Wisconsin.
- The bottom 20% of households, by income, accounted for only 18% of all government transfer payments (such as unemployment compensation, welfare and child care subsidies). This shows that government benefits are concentrated more on those closer to middle-income.
- Among households in the bottom 40% of income, less than one household in six participated in a tax-deferred savings plan for the future, such as 401(k). For households in the upper 40%, by contrast, nearly three households in four participated.

Sales taxes

The sales tax is regressive across all income groups. This was not a surprise, since it is widely understood that lower-income households spend a greater proportion of their income on consumer goods subject to the sales tax than do higher-income households, which spend more of their income on investments, housing, and services exempt from the sales tax.

The study found that the poorest one-fifth of households paid nearly 4% of their income in sales taxes, compared with less than 2% for the top 1% of households.

IV: Lessons for tax reform

The *Wisconsin Tax Incidence Study* analysis of the distribution and impact of existing taxes on various groups provides groundwork for designing changes in the tax system that increase the level of tax fairness:

1. Because the system as a whole is proportional rather than progressive, any changes should move it in a progressive direction. In other words, changes should provide more relief for lower- and middle-income households and/or tap more the resources of wealthier households.
2. One way to increase the progressivity of the system is to increase its reliance on the income tax, which is progressive, and decrease its reliance on property and sales taxes, which are regressive.
3. Low-income, married homeowners bear the heaviest burden among all groups. Any tax reform should include specific measures to reduce the tax burden on this group.
4. Because property taxes are regressive, efforts at property tax relief *can* improve the fairness of the overall system. However, proposed changes in property taxes must be carefully examined to ensure they benefit lower-income households. Otherwise, property tax reform might actually increase the regressivity of the entire system.
5. Taxes can be made more progressive by increasing taxes on higher income groups, decreasing taxes on lower-income groups, or a combination of both.
 - a. The income tax could be made even more progressive by raising the rates on higher-income households; by increasing the standard deduction for lower-income households; or by increasing the value of the Earned Income Tax Credit.
 - b. The property tax could be made less regressive by increasing the value of the Homestead Credit and adjusting income limits so more households are eligible.
 - c. No conclusions can be drawn on the consequences of broadening the base of the sales tax (that is, increasing the number of goods and services subject to the tax). However, it is clear that simply increasing the sales tax rate, without corresponding adjustments elsewhere, would make the system as a whole more regressive.

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