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University of Wisconsin- Madison

Middle Income Tax Reform Options for Wisconsin: Evaluating A Proposal by the Joint Committee on Finance

Junjie Guo and Noah Williams
Center for Research on the Wisconsin Economy, UW-Madison
June 22, 2021

As an amendment to our initial report on June 17 titled "Middle Income Tax Reform Options for Wisconsin", we evaluate the potential impacts of cutting the third income tax rate from 6.27% to 5.3%, a proposal approved by the Joint Committee on Finance on the same day. We find the JCF proposal would cut annual tax revenue by about $927 million, which is roughly comparable with both the official estimate by the Legislative Fiscal Bureau and the cost of a proposal discussed in our initial report: simultaneously eliminating the phase-out of standard deductions and removing the second income tax bracket. Comparing the two proposals, we find both would cut the net tax and the marginal tax rate significantly for a large group of households. However, relative to the JCF proposal, simultaneously eliminating the phase-out of standard deductions and removing the second income tax bracket would lead to a larger benefit for middle income families, including a larger percentage increase in after-tax income and a larger reduction in the marginal tax rate which would provide them with more work incentive. The exercise illustrates the importance of considering different options to find the best approach to reforming the state's complicated tax code.

On Thursday June 17, 2021, we released a report titled "Middle Income Tax Reform Options for Wisconsin"[1]. The report evaluates the potential impacts of three middle income tax reform options: (1) eliminating the phase-out of standard deductions; (2) removing the second of the four income tax brackets by merging it into the first, which would effectively reduce the tax rate of the second bracket from its current value of 4.65% to 3.54%, the rate for the current first bracket; and (3) combining (1) and (2).

On the same day, the Joint Committee on Finance (JCF) of the Wisconsin Legislature approved a series of proposals to cut the state's income and property tax, one of which is to cut the tax rate of the third income tax bracket from its current value of 6.27% to 5.3%.

As an amendment to our initial report, we now evaluate the potential impacts of the JCF proposal of cutting the third tax rate, and compare it with the proposal of simultaneously eliminating the phase-out of standard deductions and removing the second tax bracket, the third reform option discussed in our initial report. We report the results directly. Details about our method can be found in the initial report.

Table 1 presents the revenue and distributional implications of cutting third income tax rate from 6.27% to 5.3%. We estimate that nearly half of all households would receive a tax cut. For those receiving a tax cut, the average amount is about $593. Overall, this proposal would reduce the annual tax revenue by about $927 million. In comparison, the Legislative Fiscal Bureau estimates that the proposal would reduce the tax revenue for 2021-22 and 2022-23 by $1,378 million and $994 million, respectively.[2] So our estimate is close to the LFB estimate for 2022-23 but smaller than its estimate for 2021-22. Part of this is likely because our estimate is based on income data from household surveys before 2020 which do not include the huge amount of transfers that Wisconsin households received from the federal government since the pandemic.

Table 1: Impact of Cutting the Third Income Tax Rate from 6.27% to 5.3%

	Taxpayers with a Tax Decrease					
WAGI class	Count	Amount of Decrease ($)	Average Decrease ($)	Count of All Returns	% of All Returns	% Change in After-tax Income
Less than $25,000	0	0	N/A	1,171,088	0.0	0.00
$25,000 - $40,000	139,568	-4,805,688	-34	528,812	26.4	0.03
$40,000 - $70,000	557,492	-98,460,584	-177	616,758	90.4	0.31
$70,000 - $100,000	324,720	-148,893,229	-459	324,720	100.0	0.57
Over $100,000	540,115	-674,716,438	-1249	540,115	100.0	0.75
Total	1,561,895	-926,875,941	-593	3,181,493	49.1	0.53

[1] https://crowe.wisc.edu/middle-income-tax-reform-options-for-wisconsin/

[2] https://docs.legis.wisconsin.gov/misc/lfb/jfcmotions/2021/2021_06_17/003_wedc_general_fund_taxes_and_budget_stabilization_fund/001_motion_120_omnibus_motion_lfb_papers_305_thru_318_320_thru_322_320_thru_334_655_thru_658_and_700

As having been reported,[3] higher income households would benefit more from this tax cut, because they have more income subject to the third tax rate. Households with income less than $25,000 would receive no tax cut because they have no income subject to the third tax rate. On the other hand, households with income above $100,000 would on average receive a tax cut of about $1,249, about 0.75% of their after-tax income, and in total they would receive about $675 million (73%) of the $927 million tax cut.

As a comparison, table 2 reports the revenue and distributional implications of simultaneously eliminating the phase-out of standard deductions and removing the second tax bracket (This is Table 4 in our initial report). The revenue cost of this combined reform is about $1.1 billion, slightly larger than our estimate for the JCF proposal. The combined reform would cover a larger fraction of Wisconsin households (about 70% relative to about 50% for the JCF proposal), although the average amount of tax cut for those receiving a cut is slightly smaller ($500 vs $593 for the JCF proposal).

Table 2: Impact of Simultaneously Eliminating the Phase-out of Stand Deductions and Removing Second Tax Bracket

	Taxpayers with a Tax Decrease					
WAGI class	Count	Amount of Decrease ($)	Average Decrease ($)	Count of All Returns	% of All Returns	% Change in After-tax Income
Less than $25,000	223,009	-5,232,652	-23	1,171,088	19.0	0.05
$25,000 - $40,000	507,017	-87,558,880	-173	528,812	95.9	0.53
$40,000 - $70,000	616,758	-277,272,500	-450	616,758	100.0	0.86
$70,000 - $100,000	324,720	-245,704,859	-757	324,720	100.0	0.95
Over $100,000	540,115	-489,652,253	-907	540,115	100.0	0.56
Total	2,211,620	-1,105,421,144	-500	3,181,493	69.5	0.64

Moreover, relative to the JCF proposal, a larger share of the tax cut from this combined reform would go to low- and middle-income households. About 19% of households with income below $25,000 would receive a tax cut, although the average amount is only about $23 for those receiving a tax cut. Households with income between $70,000 and $100,000 would see an increase in their after-tax income by about 0.95% on average, which is the highest among all households. In total, households with income above $100,000 would receive 44% of the ($1.1 billion) tax cut, compared to 73% under the JCF proposal.

To better understand the impacts of the two proposals, we use a hypothetical married couple filing jointly with two children as an example. We assign this household with different incomes and calculate the tax under three scenarios: the current tax code, the JCF proposal of cutting the

[3] https://madison.com/wsj/news/local/govt-and-politics/gop-led-budget-committee-approves-more-than-3-billion-in-tax-cuts/article_13415b36-6eea-5243-950e-977fb7896773.html

third rate, and the combined reform of simultaneously eliminating the phase-out of standard deductions and removing the second tax bracket.

Figure 1 reports how much the two proposals would cut the tax for the hypothetical household under different income levels. Under the JCF proposal, the household would receive no tax cut if its income is below $49,867, because none of the income would be subject to the third tax rate under the current tax code. As the household's income increases from $49,867 to $354,110, the amount of tax cut increases monotonically from $0 to about $3,098. The household would receive a flat benefit of $3,098 if its income is above $354,110.

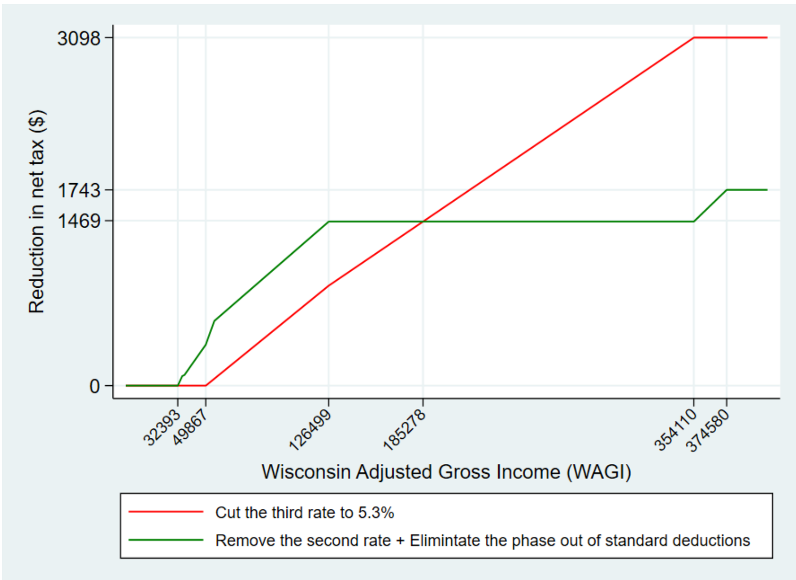

Figure 1: Reduction in net tax for a married couple filing jointly with two children: the JCF proposal cutting the third tax rate to 5.3% (red) and simultaneously removing the second income tax bracket and eliminating the phase-out of standard deductions (green)

In comparison, under the combined reform, the benefit would start from a lower income level of about $32,393, and it would be flat at around $1,469 for a large group of households with income between $126,499 and $354,110. The maximal benefit, received by households with income above $374,580, is about $1,743, significantly smaller than the value of $3,098 under the JCF proposal.

Figure 2 reports the percentage increase in after-tax income for the hypothetical household. Under the JCF proposal, the gain in after-tax income increases monotonically from 0% to a maximal of about 0.93% as the household's income increases from $49,867 to $354,110. After that, because the absolute amount of tax cut remains flat (figure 1), as a percentage of after-tax income, the gain declines with income.

In comparison, under the combined reform, the gain in after-tax income increases sharply from 0% to about 1% as the household's income increases from $32,393 to $50,000, it would continue to increase to a maximal of about 1.22% as the household's income reaches about $126,499.

After that it would decline continuously except for a small income range between $354,110 and $374,580 where the household faces the highest marginal rate of 7.65% under the current tax code, which is reduced to a lower rate of 6.27% by the combined reform because the larger standard deduction raises the income threshold for the highest marginal rate.

Figure 2. Percentage increase in after-tax income for a married couple filing jointly with two children: the JCF proposal cutting the third tax rate to 5.3% (red) and simultaneously removing the second income tax bracket and eliminating the phase-out of standard deductions (green)

In short, figures 1 and 2 show that, although both proposals lead to a significant tax cut for a large group of households, middle income households would benefit more from the combined reform of eliminating the phase-out of standard deductions and removing the second bracket than from the JCF proposal of cutting the third rate to 5.3%, both in absolute term and as a percentage of after-tax income.

Finally, figure 3 reports the effective marginal tax rate (MTR) faced by the hypothetical household under the three scenarios. As the tax rate incurred on an additional dollar of income, the effective MTR affects individual decisions on the margin such as whether to work (one more hour/job) and/or to invest (one more dollar), making it one of the most important parameters in evaluating a tax system/reform.

Although Wisconsin has only four statutory MTR, because the tax code has a number of credits and deductions which phase in and out, the effective MTR that taxpayers face may differ quite sharply from the statutory rates. In fact, as the black line shows, under current law the household of four would face the highest effective MTR of 9.83% if its income is around $50,000, which is more than two percentage points above the top statutory rate of 7.65% for the highest earners.

As the red line shows, the JCF proposal would cut this top effective MTR slightly to about 8.67%. More generally, it would cut the effective MTR by about 1 percentage point for a large group of households with income between about $49,867 and $354,110.

In comparison, as the green line shows, the combined reform would cut the top effective MTR of about 9.83% under the current law dramatically to about 6%. More generally, it would cut the effective MTR significantly for households with income between $32,393 and $126,499.

In short, although both proposals would cut the effective MTR for a large group of households, the combined reform has a much larger impact in reducing the high effective MTR faced by middle income families. Under this proposal the effective MTR would increase with income, apart from a very small “notch” for a very narrow income range which could be corrected by changing the phase-out of the EITC. As a result, the effective MTR would more closely match statutory tax rates, improving the simplicity and transparency of the tax code.

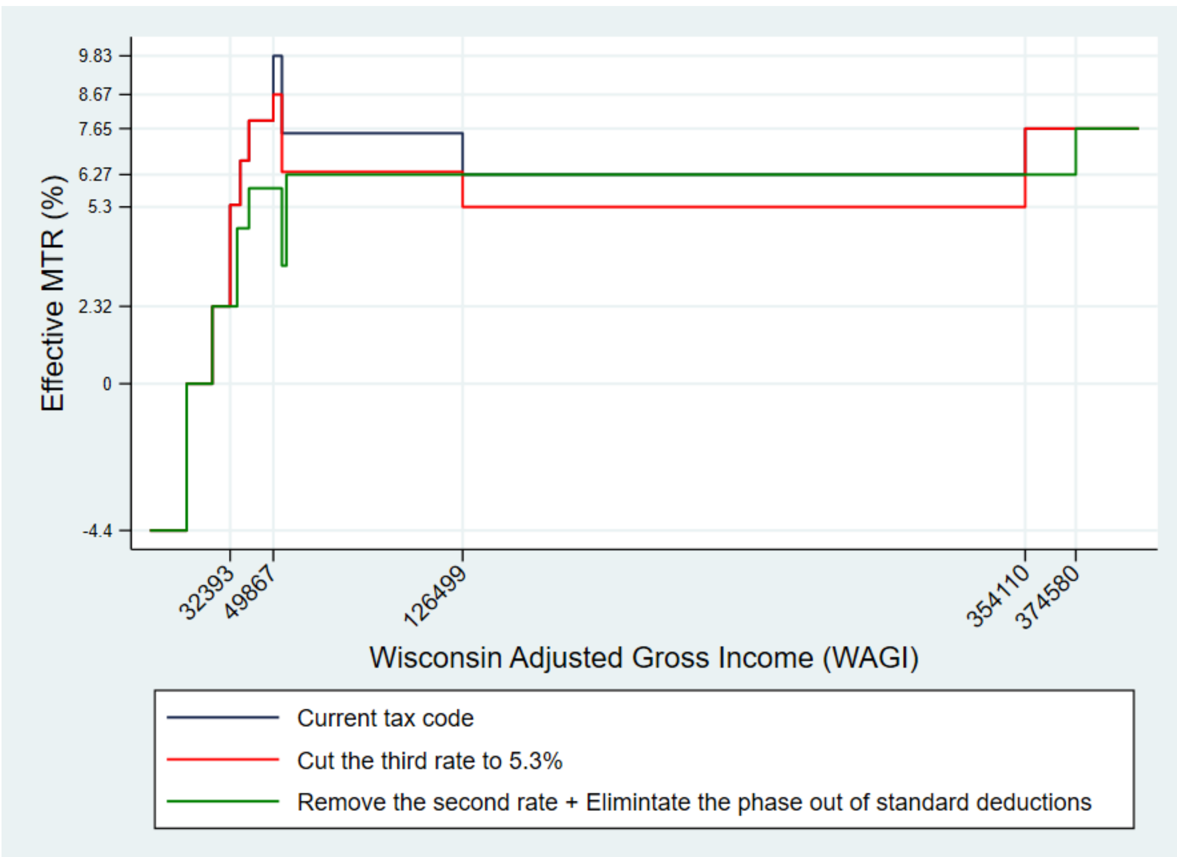

Figure 3: The effective marginal tax rate for a married couple with two children filing jointly under the current tax code (black), the JCF proposal cutting the third tax rate to 5.3% (red) and simultaneously removing the second income tax bracket and eliminating the phase-out of standard deductions (green)