The Economic Impact of the Wisconsin State Legislature's Plan to Cut Income Tax Rates*

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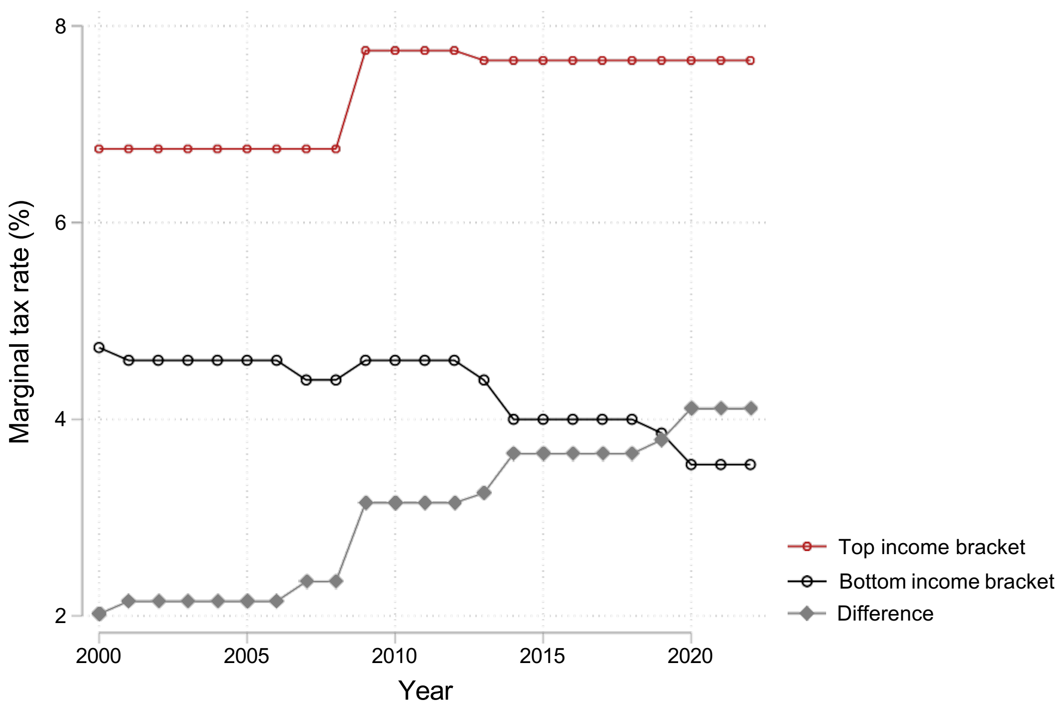
Wisconsin's individual income tax rates are higher than the rates in most other states. As of January 2023, the state's statutory rate for the bottom-income bracket is the 14th highest among all states and the District of Columbia, and its statutory rate for the top-income bracket is the 10th highest (Vermeer, 2023). Since then, there has been a slight drop in the state's statutory rates for the bottom-two income brackets, as shown in table 1, while the state's statutory rates for the top-two income brackets remain unchanged at their high levels.

Table 1: Individual Income Tax Rates in Wisconsin (%)

Income bracket	January 2023	Since July 2023
First (bottom)	3.54	3.50
Second	4.65	4.40
Third	5.30	5.30
Fourth (top)	7.65	7.65

Figure 1: Statutory Marginal Tax Rates in Wisconsin



The state's income tax structure has become more progressive as well. Figure 1 shows that the statutory rate for the bottom-income bracket dropped from 4.77% in 2000 to 3.54% in 2022. During the same period of time, the statutory rate for the top-income bracket increased from 6.77% to 7.65%. As a result, the difference in the statutory rates for the two income brackets, a measure of the progressivity of the income tax structure, has more than doubled from 2% in 2000 to 4.11% in 2022. This is the fifth largest increase among all states and the District of Columbia. With the drop in the state's statutory rates for the bottom-two income brackets shown in table 1, Wisconsin's income tax structure became even more progressive in 2023.

Related to high income tax rates, Wisconsin has a low rate of entrepreneurship, and has been losing population to other states. In 2021, Wisconsin's rate of new entrepreneurs was the fifth lowest among all states and the District of Columbia (Kauffman Foundation, 2022). Due to interstate migration, Wisconsin's population dropped by 72,006 between 2010 and 2019, and it dropped again by 11,383 between 2020 and 2022. Partly because of this, Wisconsin's civilian labor force has declined by over 80,000 from its peak in July 2017, compared to an increase of over 6 million for the U.S. during the same period.

Research shows that both high income tax rates and the progressive income tax structure have a negative impact on the economy. For example, Mertens and Ravn (2013) find that a one percentage point cut in the average personal income tax rate raises real GDP per capita by 1.4% on impact and by up to 1.8% after three quarters. Erosa and Koreshkova (2007) find the progressive income tax system in the U.S. reduces the incentive for workers to accumulate human capital, and switching to a proportional tax system increases output by 12.6%, capital by 21.8%, and consumption by 13.2% in the steady state.

The impact of the tax rate for households at the top of the income distribution is particularly large. In addition to the negative effect on human capital accumulation, the top tax rate has two other effects. First, it has a negative impact on business formation and investment, because income from pass-through businesses is highly concentrated among households at the top of the income distribution. For example, in 2019, over 55% of the pass-through income in Wisconsin was reported by households whose income was $500,000 or more. These households face the top tax rate of 7.65% at the state level. Second, a high top tax rate causes out-migration of top earners, who are more mobile and more likely to move across states in response to spatial differences in the income tax rates (Rauh, 2022). The out-migration of top earners from a state reduces the state's tax revenue and productivity. Rauh (2022) finds that total taxable income of people who moved out of California in 2020 surpassed that of those who moved into California in the same year by $10.7 billion, which leads to a potentially permanent annual net loss of about $1.17 billion in tax liability. One group of top earners are star scientists. The presence of star scientists in a state is typically associated with the fostering of new industries, from biotech to software to nano-tech. Moretti and Wilson (2017) find that, by cutting its statutory personal income tax rate on the top 1% of earners from 7.5% to 6.85% in 2006, the state of New York increased the net inflow of star scientists to the state by 2.6% over a ten-year period.

On January 24, 2024, **Assembly Speaker Robin Vos and Senate Majority Leader Devin LeMahieu unveiled the state legislature's latest proposal to cut income taxes**. According to Richmond (2024), "One bill would expand the state's second income tax bracket to cover higher earners. Right now, single filers who make between $14,320 and $28,640 and married joint filers who make between $19,090 to $38,190 fall in the second bracket. That means they face a 4.4% tax rate. Singles who make between $28,640 and $315,000 and married couples who make between $38,190 and $420,420 are in the 5.3% third bracket. The legislation would expand the second bracket to include single filers who make between $14,320 and $112,500 and married joint filers who make between $19,090 and $150,000. The change would result in income tax savings of nearly $795 million in fiscal year 2024-2025 and about $750 million annually thereafter, according to the Legislative Fiscal Bureau."

These estimates represent the static impact in the absence of behavioral responses. As households increase their labor supply and firms increase their investment in response to the lower tax rates, the dynamic impact of the tax cuts on the state's economy could be very different. One approach to the dynamic impact is to use multipliers and elasticities derived from other studies. The problem, however, is that the multipliers and elasticities are not Wisconsin specific and thus not able to produce reliable estimates for the Wisconsin economy.

We present a comprehensive model of the Wisconsin economy and its tax system to account for the behavioral responses from households and firms (Guo et al., 2023). In our model, income from pass-through businesses is subject to the top tax rate. A lower value of the top tax rate raises the incentive for firms to invest. Lower tax rates also raise households' incentives to work and accumulative more skills. The increased economic activity leads to a larger tax base and partially offsets the loss of revenue from lower tax rates.

We now use our framework to evaluate the economic impact of the bill mentioned above, which we model as a cut in the statutory rate for the representative (i.e., median-income) household from 5.3% to 4.4%. Table 2 reports the impact of the bill relative to the current law. Measured in percentage differences by comparing the steady state of the economy under the bill with the steady state under the current law, the estimates represent the long-run effects accounting for behavioral responses.

The Legislature's plan to expand the second income-tax bracket would increase the state's capital, labor and output by 0.69%. With Wisconsin's GDP valued at $396.21 billion in 2022, the impact would be about $2.73 billion. The increased economic activity leads to more revenue for the state government from corporate taxes (0.69%) and sales taxes (0.64%). The increased earnings from the extra labor also partially offset the loss of revenue from individual income taxes. Together, total tax revenue would decrease by

Table 2: Economic Impact of Expanding the Second Income-Tax Bracket (%)

	State aggregate
Capital	0.69
Labor	0.69
Output	0.69
Wage rate	0.00
Corporate tax revenue	0.69
Sales tax revenue	0.64
Total tax revenue	-3.76
	Median-income household
Income tax paid	-10.30
After-tax income	0.90
Consumption	0.64

3.76% in the steady state. Without behavioral responses, the model implies total revenue would decrease by 4.5% in the short run. This suggests that 16.5% of the lost revenue could be recovered through increased economic activities.

For the median-income household, the bill would cut income tax by 10.3%, raise after- tax income by 0.9%, and raise consumption by 0.64%.

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