COLLABORATION ON TAXATION?

Assessing Two Tax Proposals and the Possibility of Compromise

The state's income tax would see massive changes under separate proposals made by Gov. Tony Evers and Senate Majority Leader Devin LeMahieu, with both proposals having their biggest impact on taxpayers with the largest incomes. Currently, Wisconsin's effective tax rates are more favorable than the national average for those with the lowest incomes and less favorable for those with the highest incomes.

The competing income tax plans between Gov. Tony Evers and Senate Majority Leader Devin LeMahieu represent one of the sharpest disagreements in the debate over the 2023-25 state budget. Yet they have one notable similarity: both plans exert their biggest impact on taxpayers at the very highest income levels.

In goals and approach, the two proposals diverge as far as almost any two major tax proposals in memory at the Wisconsin Capitol. The Evers plan in particular aims to increase tax credits for low and middle-income taxpayers to either lower their tax liability or increase credit payments for those who currently owe no income taxes. The governor's plan would also raise taxes on certain taxpayers, generally those with higher incomes, and would keep overall income tax collections essentially flat.

The Senate Majority Leader's plan would eliminate the state's current series of income tax rates that increase along with filers' income and replace them with a single flat rate for all income. That would lower income taxes for all filers with a current tax liability but deliver greater benefits to those with higher incomes, lowering overall state tax collections by $5 billion in fiscal year 2027.

The common thread of both tax plans is their most pronounced effects would be on those with more than $1 million in Wisconsin adjusted gross income (AGI – see box for definition). The average tax increase for that income group under the Evers plan would be more than 20 times as large as the change for any other income group. Under the LeMahieu proposal, the average tax cut for those with AGI of more than $1 million would be more than six times as great as for any other income group.

With the state enjoying its largest budget surplus on record, the upcoming 2023-25 state budget could see significant changes to Wisconsin's income tax, which was the first effective model in the nation. This brief will review the particulars of the two competing income tax proposals, as well as how Wisconsin's current income tax compares to those of neighboring states and the U.S. average. In doing so, we build on our report from last year that looked at trends in the state income tax since 2009.

State Adjusted Gross Income (AGI)

Wisconsin income taxes are computed using the state's definition of adjusted gross income. Wisconsin AGI starts with federal AGI and then makes certain changes such as excluding several sources of income, including Social Security benefits, unemployment insurance payments to low-income recipients, and 30% of most capital gains. Filers subtract the state standard deduction and their personal exemptions from AGI to arrive at their taxable income.

A LOOK AT THE TWO PLANS

Both the Evers and LeMahieu plans are unlikely to become law. Top GOP legislators have rejected the governor's proposal outright and the Republican leaders of the Joint Finance Committee have also said they do not think they can approve the flat tax plan as it has been proposed. Yet we analyze both plans here because they represent good examples of the goals and approach of the two sides in the budget debate and because, at least for now, no other complete plans have been made public.

Evers' plan would make a large number of changes to state income taxes and to so-called non-refundable tax credits – those which can only be used to reduce taxes owed. It would also increase refundable credits – those which can reduce taxes owed or result in a state payment to filers with no income tax liability. The proposal would make the following changes to individual and corporate income taxes:

- Create a non-refundable income tax credit of 10% of net tax liability or $100 – whichever is greater – for taxpayers up to certain thresholds. For married couples filing jointly, the Family and Individual Reinvestment Credit (FAIR) would fully apply to those with AGI of less than $150,000 and phase out for those making up to $175,000.
- Create a non-refundable income tax credit equal to 50% of the qualified expenses for a filer to care for a family member who is at least 18 and requires help with daily living activities.
- Double the state's non-refundable credit for child care or other expenses for the care of dependents from the current level of 50% of the corresponding federal credit to 100%.
- Expand the state's refundable Earned Income Tax Credit for filers with one or two qualifying children.
- Raise the maximum income for qualifying for the refundable Homestead Tax Credit, which offsets the property taxes of low-income Wisconsin residents. The bill would also tie to inflation the income threshold for filers and the maximum amount of property taxes eligible for the credit.
- Expand access to a property tax credit for disabled veterans and their surviving spouses.
- Increase taxes on owners of manufacturing firms by limiting the current credit on their profits to no more than $22,500 per company.
- Increase taxes owed by upper-income earners on capital gains from the appreciation and subsequent sale of assets such as stocks and real estate.

Some of these changes would have a major fiscal impact, including a projected loss of $839.8 million in revenues over the two-year budget from the creation of the FAIR credit and a projected gain of $655.1 million from limiting the credit for manufacturers, according to state estimates. The proposal would also align the state tax code with certain federal tax rules, increasing state collections by $387.2 million over the next two years.

Altogether, the proposed individual and corporate income tax changes would mean a net increase in state tax revenues of $257.3 million over the next two years compared to current law, according to state projections. Yet the budget would also increase expenditures on refundable income tax credit payments to individuals and businesses by more than $300 million, which would more than offset the higher taxes overall.

By increasing credits to low and middle income taxpayers and increasing taxes on the wealthy, the Evers plan would make the tax code more progressive, which means that the state would impose higher effective rates on taxpayers with greater incomes. That would reverse a trend over the past decade in which the state's income tax has become less progressive (though it remains more progressive than the average state income tax nationally).

The LeMahieu flat tax proposal would accelerate the state's recent trend. It would collapse the state's current series of four income tax brackets – each with a progressively larger marginal tax rate ranging from 3.54% to 7.65% -- and replace them with a single rate of 3.25% for all taxable income over a four-year period stretching from the current tax year (2023) to 2026 (see Table 1). The move would decrease individual income tax collections by a projected $2.11 billion in the state's 2024 fiscal year with the total reduction growing to $5.06 billion in 2027 and subsequent years.

While this plan would make Wisconsin's tax code much less progressive, the system would retain some progressive elements, including a standard deduction and certain tax credits that phase out as filers' income rises. Because the plan would keep all of the current

Table 1: Tax Rates Would Flatten Under Senate Plan

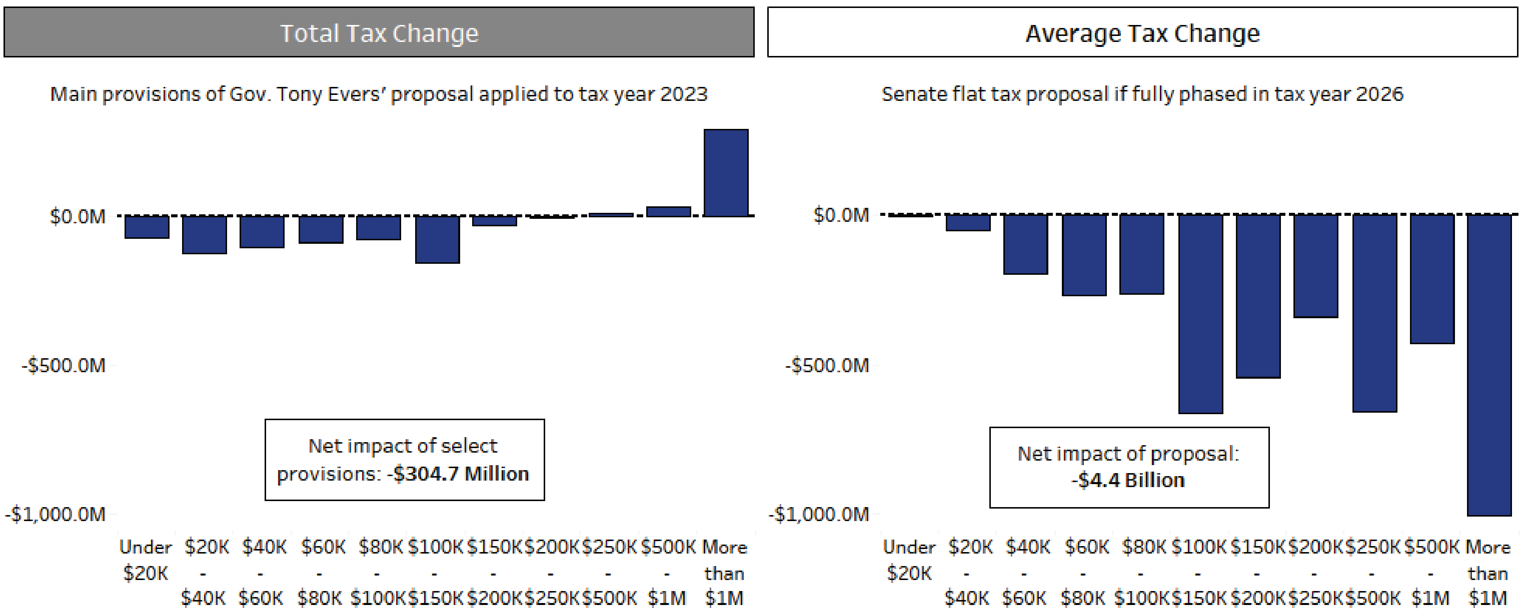
Actual and proposed marginal income tax rates by year (bracket amounts are for married couples filing jointly)

2022 Bracket Amounts	2022	2023	2024	2025	2026
$0 to $17,010	3.54%	3.47%	3.40%	3.32%	3.25%
$17,011 to $34,030	4.65%	4.30%	3.95%	3.60%	3.25%
$34,031 to $374,600	5.30%	4.79%	4.28%	3.76%	3.25%
$374,601 and greater	7.65%	6.55%	5.45%	4.35%	3.25%

Sources: Wisconsin Department of Revenue and Legislative Fiscal Bureau

Figure 1: Plans Would Impact Taxpayers Differently By Income Level

Amount of total income tax change compared to current law by income* class of tax filer



Sources: Wisconsin Department of Revenue and Legislative Fiscal Bureau. *Wisconsin Adjusted Gross Income - amounts are not adjusted for inflation.

exemptions, deductions, and credits, it is not expected to greatly reduce the amount of time it would take taxpayers to file their income tax returns.

COMPARING THE PLANS' IMPACT

Next, we look at how the tax plans would affect the taxes owed by filers according to their income class. It is worth noting that these groups are arranged according to state AGI, which can be lower than a taxpayer's actual income since some types of income are excluded. We draw here on projections from the state Department of Revenue (DOR) and LFB that seek to model the impact of the LeMahieu plan and the main elements of Evers' tax proposal. Readers should note that the figures in the charts are shown for the first year of full implementation and are not adjusted for inflation.

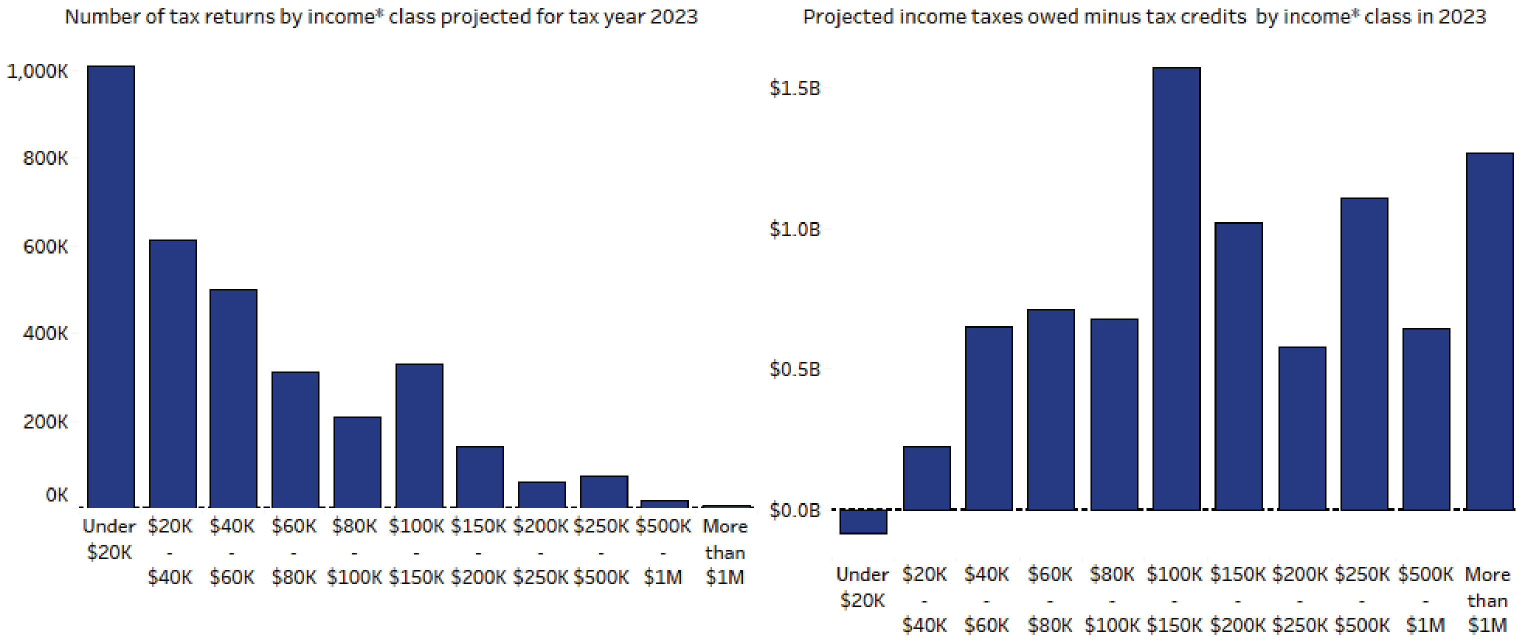
In tax year 2023, the Evers plan would lower taxes for taxpayers as a group in each income class up to $200,000 in annual AGI. Taxpayers with income up to $20,000 a year would receive an average tax reduction as a group of $70 and a total decrease of $70.7 million (see Figure 1). Taxpayers with AGI of $1 million or more would see their tax liability rise by $295.2 million collectively, with an average increase of $39,586 per taxpayer, the DOR data show.

The LeMahieu proposal would produce sharply different impacts. After being fully phased in by tax year 2026, the legislation would lower the taxes owed by those with AGI up to $20,000 by $7.4 million for an average tax cut of $8 per filer for all those in the group. Taxes owed by those with income of more than $1 million would decline by a projected $1 billion for 2026, with each filer receiving an average cut of $107,876.

Some context on how many tax filers there are in each group and what they pay under current law may help readers in evaluating the proposals. For example, filers with income up to $20,000 a year are projected to account for one million tax returns (see Figure 2 on page 4) in tax year 2023. Though some taxpayers in this class owe taxes, as a group they are currently projected to receive net payments from the state of $85.4 million in 2023 once refundable tax credits have been subtracted from their net tax liability. Taxpayers with AGI of $1 million or more file just under 7,500 returns and are projected to owe $1.27 billion as a group for the current tax year.

The larger tax cut for wealthy earners and the small one for low-income filers under the LeMahieu plan partly reflect the fact that upper-income earners have large tax liabilities and workers with very low incomes have little to no liability under current law. The larger cut for high income earners, however, is also due to the fact that the flat tax plan focuses only on filers who owe income taxes, not those who at present have no liability or receive payments from the state. Notably, these

Figure 2: There are More Taxpayers at Lower Income Levels but More Taxes Owed at Middle and Upper End



Source: Wisconsin Department of Revenue. *Wisconsin Adjusted Gross Income

workers may still pay other taxes such as payroll taxes that fund federal entitlements like Social Security.

Yet the single biggest reason for the larger tax cut for high earners under the LeMahieu plan is the cut in the top marginal rate from 7.65% to 3.25%, a decrease of 4.4 percentage points. In contrast, the drop in the state's lowest rate amounts to a decline of 0.29 percentage points from the current 3.54%.

For its part, the Evers plan targets nearly all of its tax relief to those who report an AGI of less than $175,000 a year (for married joint filers) and in some cases much less than that. The expansions of the Homestead and Earned Income Tax Credits, for example, would benefit many filers with no current income tax liability.

HOW THE CURRENT SYSTEM COMPARES

To evaluate these proposed changes, it's also helpful to consider how Wisconsin's current tax rates and system compare to other states. Conservative lawmakers, for example, say they would like to lower the state's top bracket and marginal tax rate of 7.65% as a means of enhancing Wisconsin's ability to compete with other states in the attraction of high earners and retention of those earners when they retire. This new bracket was created by Democratic lawmakers and Gov. Jim Doyle in 2009 to help close a state budget shortfall and since then the rate has been reduced only slightly. For the 2022 tax year, it applied to taxable income of greater than $374,600 for married couples filing jointly.

Though Hawaii, New York, and New Jersey all have top marginal rates at or just below 11% and California's rates max out at 13.3%, Wisconsin's top marginal rate still ranks as the eighth-highest of any state in the country. Figure 3 on page 5 shows that Wisconsin's top rate is second only to that of Minnesota among its neighbors.

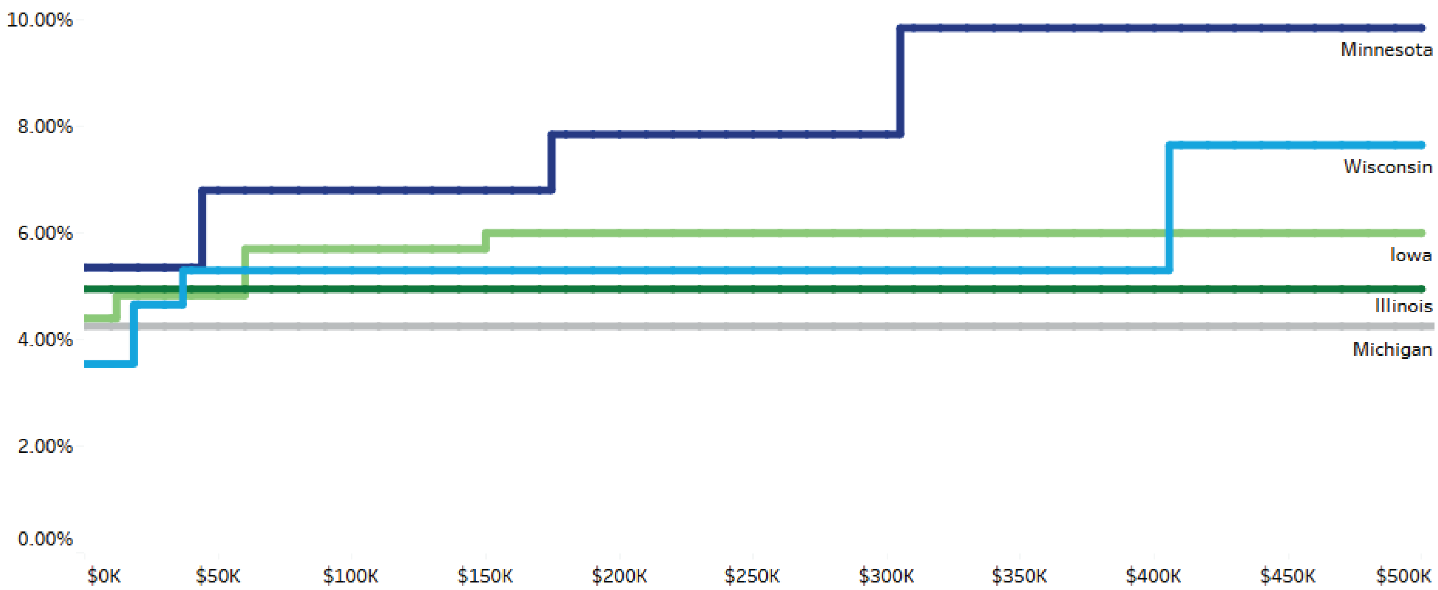
On the other end of the spectrum, Wisconsin's bottom marginal rate of 3.54% is higher than that of many states but the lowest of its neighbors. All filers with a tax liability – both low-income workers and the well-to-do – have this rate applied to their taxable income in the first bracket (which for 2022 extends to $17,010 for married couples filing jointly).

However, looking at marginal tax rates alone provides only a crude sense of how the income tax systems of different states affect taxpayers of varying income levels. That's because a number of other factors help determine tax liability. States differ in what income is taxed – Wisconsin, for example, does not tax Social Security benefits, unemployment insurance payments to low-income recipients, or 30% of most capital gains.

In addition, states have a broad range of standard deductions, personal exemptions, and tax credits. As

Figure 3: Wisconsin has Lowest Rate of Neighbors for Low Incomes, Second-Highest for Upper Earnings

Marginal state* income tax rate by taxable income for married couples filing jointly for tax year 2023



Source: Tax Foundation; *rates are based on current law and include recent changes by Iowa but could still change further for the 2023 tax year.

noted previously, Wisconsin phases out both its standard deduction and its earned income tax credit for higher earners. Those features make the state's tax code more progressive but also mean that low-income workers can see substantial growth in their effective tax rate if they receive a raise or take on a second job. Together with cutoffs for benefits such as food stamps and publicly subsidized child care, this contributes to a so-called "benefits cliff" that may serve as a disincentive for these workers to increase their incomes.

A full accounting of how different states treat taxpayers needs to include all potential sources of income – not just those subject to taxes in a given state – along with deductions, exemptions, credits, and marginal tax rates. A detailed 2021 study by the Minnesota Center for Fiscal Excellence sought to do just that. It can be used to show how much Wisconsin taxpayers such as a typical married couple would pay in taxes depending on their income, essentially providing an effective tax rate that can be compared fairly across states.

These data show that married couples filing jointly with income of $20,000 receive a larger state payment at $629 than the average for states nationally of $525, yielding a more favorable negative tax rate here. Wisconsin gave this hypothetical couple better treatment than any of its neighbors except Minnesota (see Figure 4 on page 6). The same was true for couples making $35,000 and $50,000 a year. Starting with couples making $75,000 a year, the situation reverses and Wisconsin rises above the national average in the study and remains above it for taxpayers up to and including those with annual income of $1 million.

The study, however, has a major limitation for analyzing Wisconsin's tax code: it draws on data from 2018. That means it does not include several income tax cuts approved in recent years in Wisconsin, mostly notably the cut that took effect in calendar year 2021 that lowered the rate for the state's third tax bracket from 6.27% to 5.30%. That change reduced state income tax revenues by roughly $1 billion per year and has likely closed much though not all of the gap with the national average for middle and upper-middle income taxpayers in Wisconsin.

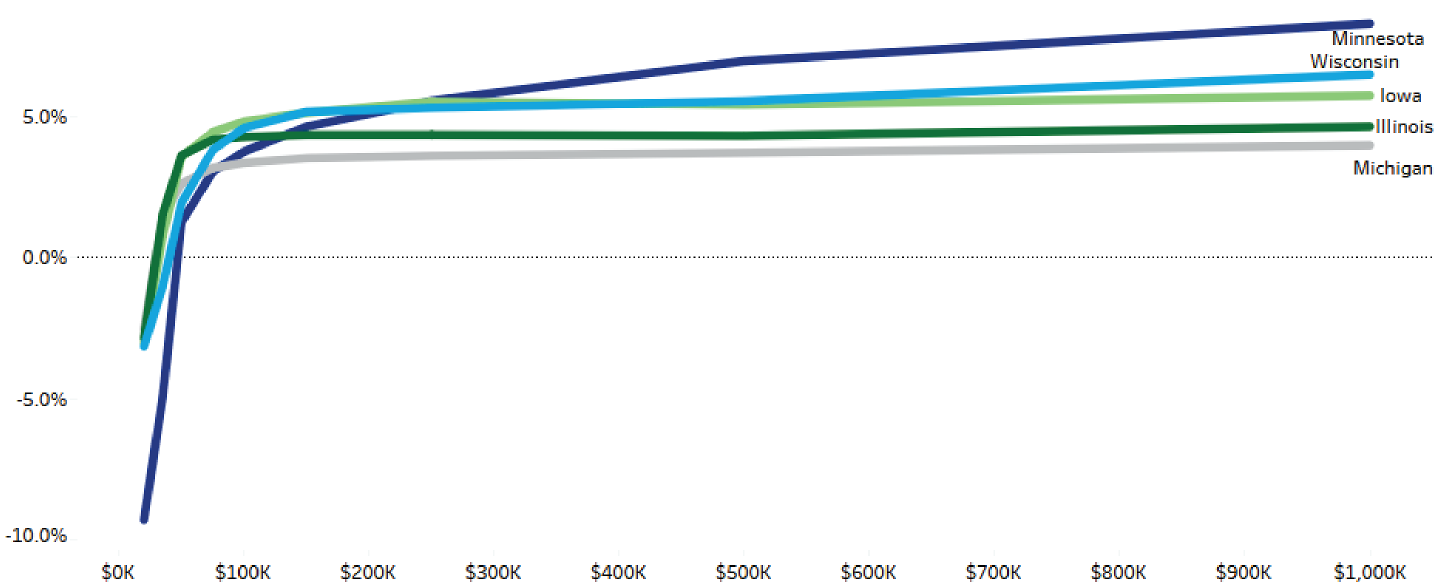
THE IMPACT OF CHANGE

The state's unprecedented budget surplus gives lawmakers and Evers a once-in-a-generation opportunity to overhaul state income taxes. However, such plans can also have a major impact on the state's ability to meet the needs of its citizens and invest in economic development moving forward.

Wisconsin relies heavily on income taxes to fund services and programs such as K-12 education, health care for low-income recipients, prisons, aid to local governments, and property tax relief. In sharp contrast,

Figure 4: Prior to Recent Tax Cut, Wisconsin Taxes High for Those With Upper-Middle Incomes

Effective state income tax rate by income for married couples filing jointly for tax year 2018*



Source: Minnesota Center for Fiscal Excellence; *these data have not yet been updated to capture the impact of Wisconsin's recent $1 billion tax cut.

seven states have no individual income tax at all and New Hampshire taxes only dividend and interest income while Washington taxes only capital gains income.

U.S. Census Bureau data show Wisconsin collected about $8.51 billion in individual income tax revenues in 2020. That amounted to 2.8% of personal income and $1,448 per capita, which rank 13th and 12th-highest in the country respectively. That could be seen as justifying cutting income taxes, but it also means major changes would have a greater impact on Wisconsin's budget than in states where income taxes account for smaller portions of the overall revenue pie.

As Figure 5 on page 7 shows, individual income taxes made up 27.4% of all state and local taxes in Wisconsin in 2020. That was greater than the 22.8% average across all 50 states and ranked 13th-highest nationally. In a state like Arizona, where individual income taxes made up 15.3% of state and local taxes, a substantial income tax cut would produce a smaller budget impact. For example, a $5.06 billion income tax cut – or one that is about the size of the Wisconsin flat tax proposal – would more than eliminate Arizona's income tax but only cut Wisconsin's roughly in half.

ANALYSIS AND CONCLUSION

The state's massive budget surplus means that leaders of both parties in the state Capitol are talking about big changes, though the nature of those changes and their impacts on taxpayers at different earnings levels vary.

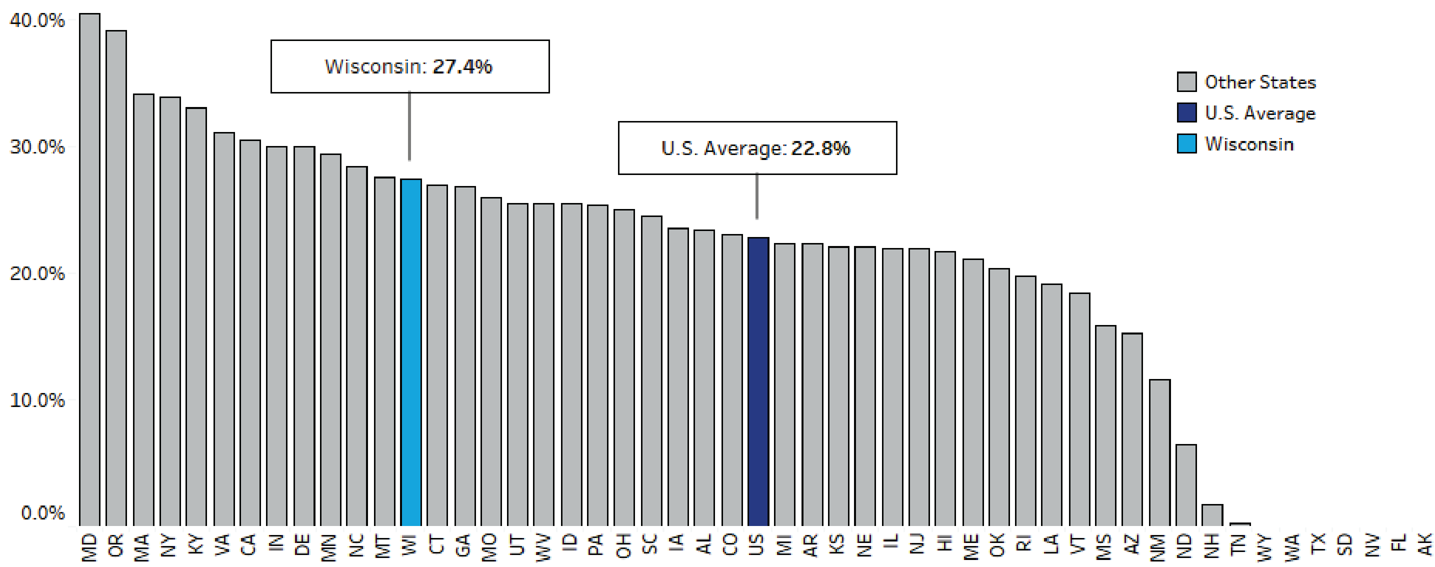
Most notably, Evers and Republican lawmakers both aim their most substantial changes at the taxes owed by the highest-income filers with AGI of $1 million or more. While Evers would increase income taxes by nearly $40,000 for the average filer in this group in 2023, the flat tax plan by 2026 would lower taxes for average filer in this group by nearly $108,000. At the other end of the ladder, taxpayers with income up to $20,000 a year would see an average tax cut per filer of $70 under the Evers plan and $8 under the flat tax plan

Much of the discussion around these sharply different approaches will center on perceptions of fairness, and both sides will find statistics they can cite to make their case. For example, Wisconsin's top marginal rate of 7.65% ranks as the eighth-highest of any state in the country and the second-highest of its neighbors.

In addition, a more sophisticated but somewhat dated analysis of Wisconsin's effective tax rate shows it is more favorable than the national average for married couples filing jointly with income up to $50,000 per year, but the state's effective tax rate is higher than the national average for couples making $75,000 a year or more. These factors may lead some to argue for reductions at the higher end of Wisconsin's tax code to

Figure 5: Wisconsin Draws on Income Taxes More than Many States

Percentage of total state and tax local tax revenues derived from an income tax by state for fiscal year 2020*



Source: U.S. Census Bureau; seven states do not have an individual income tax (Washington taxes only capital gains) and New Hampshire taxes only dividend and interest income.

help bring Wisconsin in line with other states and help attract and keep well-to-do taxpayers.

On the other hand, the $1 billion reduction in state tax collections and average cut of nearly $108,000 for those with AGI of $1 million or more per year under the LeMahieu flat tax plan may be deemed excessive by some, particularly when considering the long list of investment needs in state programs ranging from K-12 schools to aids to local governments to health care services for Wisconsin's most vulnerable individuals.

Last, some may see a greater need to help address the state's substantial labor challenges by incentivizing low-income and other residents to enter the workforce, increase their hours, or take on a second job. State officials could do so by revising the tax code to minimize disincentives to increase their earnings such as the loss of Earned Income Tax Credits.

At present, neither the Evers proposal nor the flat tax plan appear likely to emerge as the final income tax package within the state budget bill. Yet there is also good reason to expect that lawmakers will send Evers a bill with a significant cut to the state's current income tax as well as other potential tax cuts such as the repeal of the state's personal property tax.

As lawmakers deliberate, they may wish to consider the state's overall system of taxation, and not just the income tax. Groups such as the National Conference of State Legislatures have pointed to principles of reliability, balance, simplicity, and equity as the hallmarks of a sound tax framework. State officials may also wish to consider other goals such as boosting economic growth and minimizing inequality.

In the end, the state's massive surplus provides great potential for change, but also opens up the possibility of overreach. Given that most proposed income tax changes are permanent, policymakers run the risk of using this large pool of one-time state funds to cut taxes so deeply that in future years the state cannot sustain current levels of services. For that reason, the debate over income tax cuts cannot be separated from the larger discussion in the coming weeks on broader tax and spending targets at both the state and local level.