

Wisconsin Budget Project

The Use of Earned Income Tax Credits in Wisconsin

The state and federal Earned Income Tax Credits (EITC) play a very important role in Wisconsin's welfare reform and anti-poverty strategies.

In the wake of the implementation of the W-2 program, state EITC claims were expected to grow over the last couple of years. However, the actual claims have declined in recent years. Recently released Department of Revenue data shows that the state Earned Income Tax Credits:

- cost \$11 million (15%) less than the budgeted amount in fiscal year (FY) 1999 and \$4 million (6%) less than anticipated in FY 2000;
- decreased by \$1.7 million since FY 1998; and
- were claimed by 5.4% fewer tax filers last year than in tax year 1996.

This paper looks at utilization of the state and federal EITC and analyzes some of the trends in the claims for this tax benefit.

Background

The state Earned Income Tax Credit (EITC) was crafted to help lift low-wage households with children out of poverty. Coupled with the federal EITC, this refundable state tax credit is designed to supplement earnings, offset the burden of Social Security payroll taxes and help families make the transition from welfare to work.

Wisconsin has had an EITC since 1989. For all but one year in that period, it has been set as a percentage of the federal credit. Since tax year 1995, the state EITC has been 4 percent of the federal credit for a family with one child, 14 percent for families with two children, and 43 percent for families with three or more children. The percentage increases with family size because it takes a bigger wage supplement to lift larger families above the poverty level.

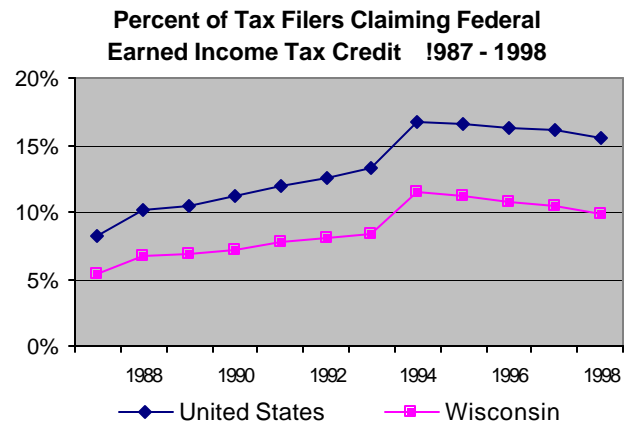
The maximum state credits are \$94 for families with one child, \$544 for two children, and \$1,671 for families with three or more children. Families with two or more children become eligible for the maximum credit when their income reaches \$9,700. The credit begins to phase down when a family's income reaches \$12,700 (regardless of family size). It drops to zero when income reaches \$27,414 for a

family with one child, or \$31,152 for families with at least two children.

Trends in Federal EITC Utilization

Because the state EITC is piggybacked on the federal credit, that credit is the logical starting point in looking at the trends in EITC utilization. The chart below shows the percentage of income tax filers nationally and the number in Wisconsin who claim the federal EITC.

The percentage of people claiming the federal credit peaked in 1994, when the credit was increased and eligibility was expanded. As the chart below illustrates, it has gradually decreased since that time – both in Wisconsin and nationally. Preliminary figures for tax year 1999 show that the percentage of filers claiming the credit is continuing to decrease.



The reasons for the decline in use of the federal credit are unclear. Because the EITC eligibility parameters are indexed for inflation, the effect of inflation on wages does not create a “bracket creep” effect that might help to explain the declining EITC utilization.

The graph illustrates that Wisconsin has historically had a smaller percentage of its population claiming the federal credit. That difference can largely be attributed to the relatively low percentage of people living in poverty in our state: 8.5 percent in 1997 and 1998 compared to 13 percent nationally. However, that difference narrowed a bit in 1999, as Wisconsin's poverty rate rose to 8.9 percent, versus 12 percent nationally.

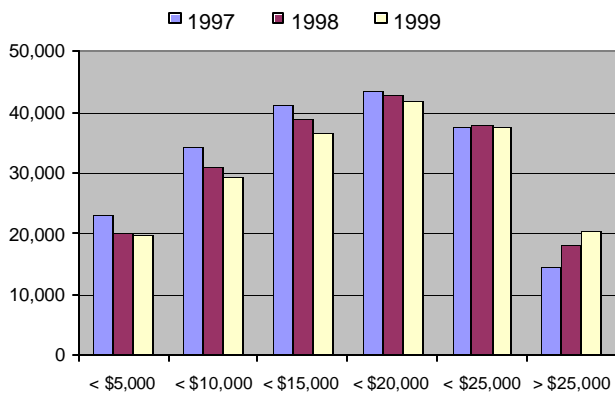
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Trends in State EITC Claims

State fiscal analysts expected the cost of EITC claims to grow to \$ 71.3 million in 1998-99 – an increase of about \$9 million over the level in the previous year. But instead of increasing, state EITC costs for fiscal year 1999 were \$1.6 million below the 1997-98 level and about \$11 million, or 15 percent, below the projected cost. The cost of EITC claims declined by another \$900,000 in FY 2000. For tax year 1999 the number of claimants slipped to its lowest level since tax year 1994 – 1.9 percent below the number in 1998 and 5.4 percent below the 1996 peak.

State EITC claims dropped in tax years 1998 and 1999 for claimants at lower income levels. The chart below shows the number of tax filers in different income categories who claimed the state EITC in the last three tax years. It reveals that the number of filers claiming the credit has dropped among those making less than \$20,000, has remained about the same among those making between \$20,000 and \$25,000, and has increased among tax filers making more than \$25,000.

EITC Claimants 1997-1999 by Income



At this point, the reasons for the decline in state claims are not altogether clear. A review of the available data suggests that some families who have received the credit in the past have made progress up the income scale and may have graduated out of eligibility for the EITC. The data also suggests that as additional people enter the workforce near the bottom of the income ladder, they are less likely to claim the credit.

Additional research will be necessary to understand more fully why EITC claims went down, even as more low-income families entered the workforce. However, the trends with respect to both the state and federal credits make a strong case for additional

outreach to let low-income families know that they are eligible for Earned Income Tax Credits.

Using Federal Welfare Funds for the EITC

In April 1999, the federal government issued new regulations relating to the use of federal funds under the national welfare reform program, known as “Temporary Assistance for Needy Families” (TANF). To encourage more states to adopt refundable Earned Income Tax Credits, the new rules allowed states for the first time to use TANF funds to pay for the refundable portion of an EITC.

The 1999 change in the rules allows a state like Wisconsin, which already has an EITC, to supplant most of the state funds that were being used to pay for the credit. This provision creates a very substantial loophole in the federal “maintenance of effort” standards that were intended to prevent states from using their flexibility with federal TANF funds to simply reduce the level of state support for programs designed to help low-income families.

The Legislature and Governor decided to take advantage of this loophole to free up roughly \$50 million per year for tax relief and other purposes.

Conclusion

The Earned Income Tax Credit is an important and politically popular part of the state and federal welfare reform and anti-poverty strategies. Former President Reagan called the EITC, “the best anti-poverty, the best pro-family, the best job-creation measure to come out of Congress.”

As Wisconsin was moving large number of former welfare recipients into the workforce, fiscal analysts projected that the cost of the state EITC would increase substantially. However, over the last two fiscal years the outlay for the EITC has fallen far short of projections, and the number of claimants has dropped to the lowest level since tax year 1995.

Ironically, expenditures for the Wisconsin EITC are declining at the very time that the federal government has given states the option of using federal welfare funds to create or expand EITC programs.

The reasons for the drop in claims for the state and federal credits are unclear. But the available data points to the need for more aggressive and comprehensive outreach to let low-income families know that they may be eligible for the EITC.