

## How Taxes and Benefits Discourage People from Working

### *Higher Pay for the Poor Can Yield No Gain in Disposable Income*

Does it pay to work in Wisconsin?

We asked rhetorically whether it pays to work in Wisconsin as a means of evaluating tax-based incentives and their impact on the working poor. If the aim of Wisconsin's welfare reform is to induce people to seek work, then there should be incentives for making work more attractive than not working.

Wisconsin is one of the more generous states in providing support in the form of a refundable earned income tax credit (EITC), the homestead tax credit, child care and health care benefits. These incentives supplement those provided by the federal tax structure, which similarly offers a refundable EITC, as well as food stamps, child credits, and dependent care credits.

But does the combination of state and federal work-based incentives offered in Wisconsin function as well as it should? Are people scratching their way out of poverty rewarded with more dollars in their pocket when they earn more money?

To find out, we constructed three low-income tax and benefit models: A single person; a single adult with two children, and a two adult family with two children. We plotted what would happen to each model as each paid 1998 federal and state income taxes starting at an income of \$8,000 and rising in \$1,000 increments to above \$30,000. We assumed each would take full advantage of incentives offered by the state and federal governments and accounted for those in the calculations.

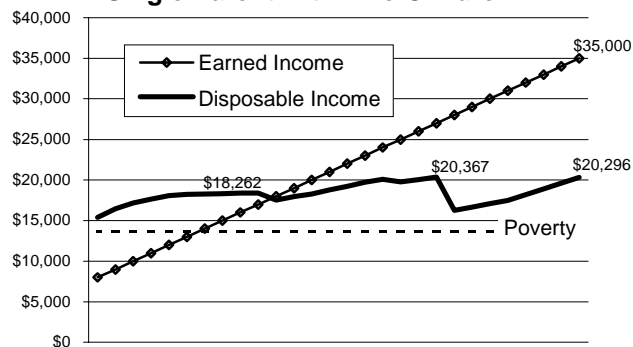
We then tested those results against seven other states to see how Wisconsin's working poor compared to their counterparts elsewhere. Those states are Minnesota, Iowa, Illinois, Indiana, California, Vermont and Florida. They states were selected because they varied in tax structures, benefits, size and geography.

### Introduction

*The research for this report was supported by:*

- The Milwaukee Foundation
- Serigraph, Inc.
- United Wisconsin Services
- Wisconsin Gas — a WICOR Company

**Disposable Income for a Wisconsin Single Parent with Two Children**



**Graph 1.** As a working person earns more, the combined effect of taxes and loss of benefits can mean no gain in disposable income.

### Key Findings

- Wisconsin provides strong incentives for the very poor to work. A single parent of two earning \$8,000 in wages – well below the federal poverty line of \$13,650 – can have an income of more than \$15,300.
- Wisconsin's working poor face "disincentives" at certain income levels due to the tax structure and the phase-out of federal and state benefits. A single parent of two moving from an income of \$17,000 to \$18,000 experiences a marginal tax rate of 190% due to loss of food stamps and reduced tax credits.
- As poor families earn more, they experience a flat growth in disposable income which leaves them hovering near the poverty line even as gross income rises into the mid-\$30,000 range.
- In comparison with the other selected states, Wisconsin is generous in its support of the poorest of the working poor. But Wisconsin compares less favorably to other states as families move up the income scale. A Wisconsin family of three or four that earns in the low \$30,000s has less disposable income than its counterpart in any of the other states we examined.
- Of the eight states studied, only Minnesota provides the poor a more even and steady growth line for disposable income as gross income increases.

With the passage of the federal Personal Responsibility and Work Opportunity Reconciliation Act of 1996 and the implementation of W-2 in September 1997, Wisconsin embarked on the road of radical welfare reform in which entitlement was replaced with the incentives of work. At the heart of both the federal and state efforts is “behavior modification,” getting people off the dole and into the workforce. That involves using both the carrot and the stick.

The purpose of this report is to focus narrowly on a set of incentives associated with the federal and state tax structures. If the aim is to induce people to seek work, then there should be logical incentives for making work more attractive and rewarding than not working. This axiom holds true also for the working poor. The reward ultimately should be more than subsistence survival.

Both the federal and state governments have attempted to provide a series of work based monetary incentives, including using the income tax structure, to entice those at the bottom rung of the economic ladder to climb toward the top. For instance, both federal and Wisconsin tax laws provide a refundable earned income tax credit (EITC) to assist the working poor. Research, as well as bipartisan political opinion, strongly suggests that the EITC is one of the best and fairest ways of augmenting the income of the poor.

We also know that barriers exist above and beyond the personal ones that many low-income persons and families bring with them. Financial penalties are exacted as EITC and other incentives, such as food stamps, childcare and health care benefits, are phased out as income climbs.

Wisconsin has been one of the more progressive states in attempting to provide adequate financial incentives to attract people from welfare into the workforce. The state consciously has bolstered the income of the poor through such incentives as a refundable earned income tax credit, the homestead tax credit, child care benefits, and now Badger Care health payments. Wisconsin is one of seven states that provide a refundable EITC.

Our tax analysis for the three examples is based on 1998 federal and state taxes as well as payment schedules for food stamps, child care and health benefits current through spring of 1999. Disposable income totals also account for the standard 7.65% withholding for social security. The poverty rates for the year of the analysis are \$8,050 for a single person, \$13,650 for a family of three and \$16,450 for a family of four. The analysis assumes an initial gross or earned income of \$8,000. At the federal minimum wage of \$5.15 per hour, that represents approximately 1,550 hours or three-fourths of a 40-hour week, 2,000-hour work-year.

## Findings

### *Tax Impact on a Single Parent with Two Children*

#### **Comparison of State Income Tax Thresholds and Incentives, 1998**

(Federal Poverty Line, single parent, family of three, \$13,001 est.)

| <u>State</u> | <u>Tax Threshold</u> | <u>Tax at Poverty Line</u> | <u>Earned Income Tax Credit</u> |
|--------------|----------------------|----------------------------|---------------------------------|
| Illinois     | \$3,900              | \$273                      | No                              |
| Indiana      | \$8,000              | \$306                      | No                              |
| Wisconsin    | \$15,400             | (\$258)                    | Yes, Refund                     |
| Iowa         | \$17,200             | 0                          | Yes, No Refund                  |
| Vermont      | \$23,600             | (\$900)                    | Yes, Refund                     |
| Minnesota    | \$23,700             | (\$751)                    | Yes, Refund                     |
| California   | \$34,400             | 0                          | No                              |
| Florida      | No Income Tax        |                            |                                 |

**Table 1.** States chosen for comparison were selected from a research report by the Washington (D.C.)-based Center on Budget and Policy Priorities to reflect a range of state income tax thresholds and earned income tax credits (EITCs). Included in the analysis are such incentives as the new federal child credit, food stamps, medical coverage, refundable and nonrefundable federal and state EITCs state childcare benefits and rent credits where they exist.

Graph 1 on Page 1 illustrates the substantial incentives offered a single parent with two children to join the workforce even in a less-than-full-time position. At \$8,000 gross income, the adult wage earner is receiving more than \$15,000 through a combination of federal and state refundable EITCs, homestead tax credit and food stamps.

As the family's earned income rises from \$8,000 to \$17,000, disposable income continues to rise – from \$15,383 to \$18,394. But the gap between gross and disposable income is closing relatively rapidly. Gross income grows by 113%. Disposable income increases 20%.

Between \$17,000 and \$20,000 gross income, disposable income actually falls, mainly because of the phasing out of food stamps. The same phenomenon occurs at \$28,000 but at a much steeper decline because of a sharp increase in childcare costs. This family earning \$29,000 is taking home less than it did at \$10,000 (assuming that the parent does not make new arrangements for childcare). In fact the family will have to increase its earnings to \$35,000 before it retains about what it did at \$27,000. In effect, between \$17,000 and \$35,000 in gross income, earnings increase 106% but disposable income climbs only 10%.

### ***Tax Impact on Two Parents with Two Children***

Again, Graph 2 below demonstrates the considerable support a two parent family of four receives from Wisconsin and federal tax policies at low-income levels. A low paying job (or jobs, if both adults are working) that earns the family \$8,000 in gross income produces a total of nearly \$17,000 in disposable income through combined state and federal income support. The 1998 federal poverty line for a family of four is \$16,450.

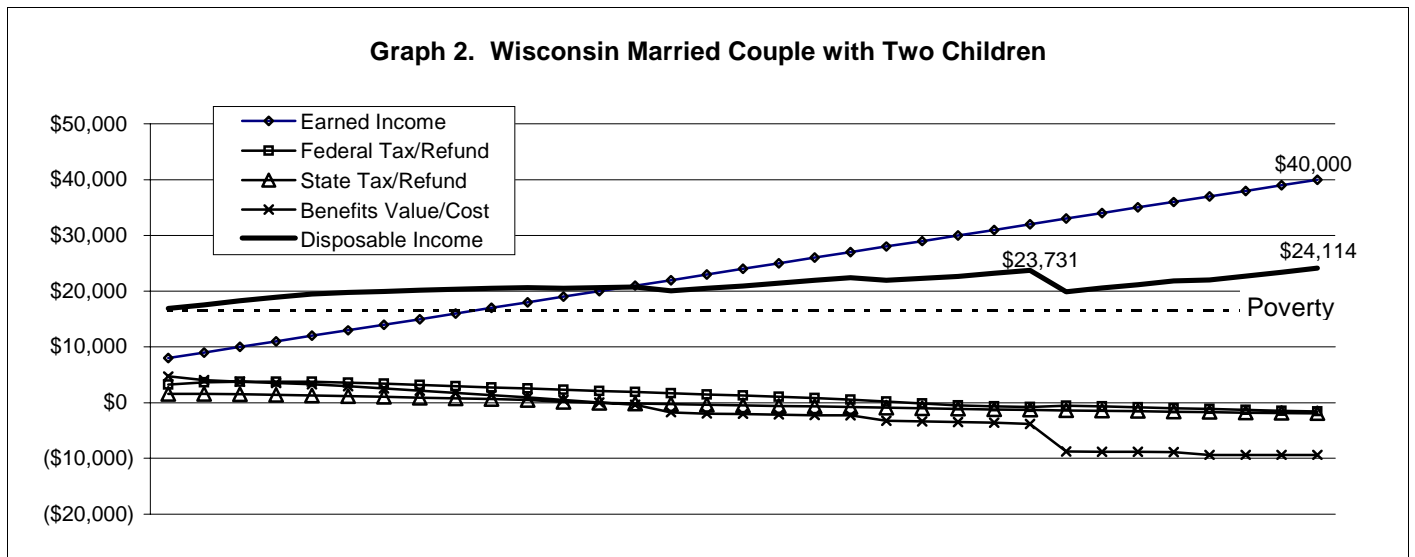
Disposable income continues to grow as earned income rises from \$8,000 to \$18,000 but at a considerably lower growth rate. Gross income increases by 125% while disposable income is up only 22%. However, at this point disposable income essentially becomes stagnant even while gross income climbs to \$23,000. Disposable income hovers between \$20,468 and \$20,799 as food stamp support disappears and state taxes are imposed. Gross income exceeds disposable income for the first time at the level of \$21,000 earned income.

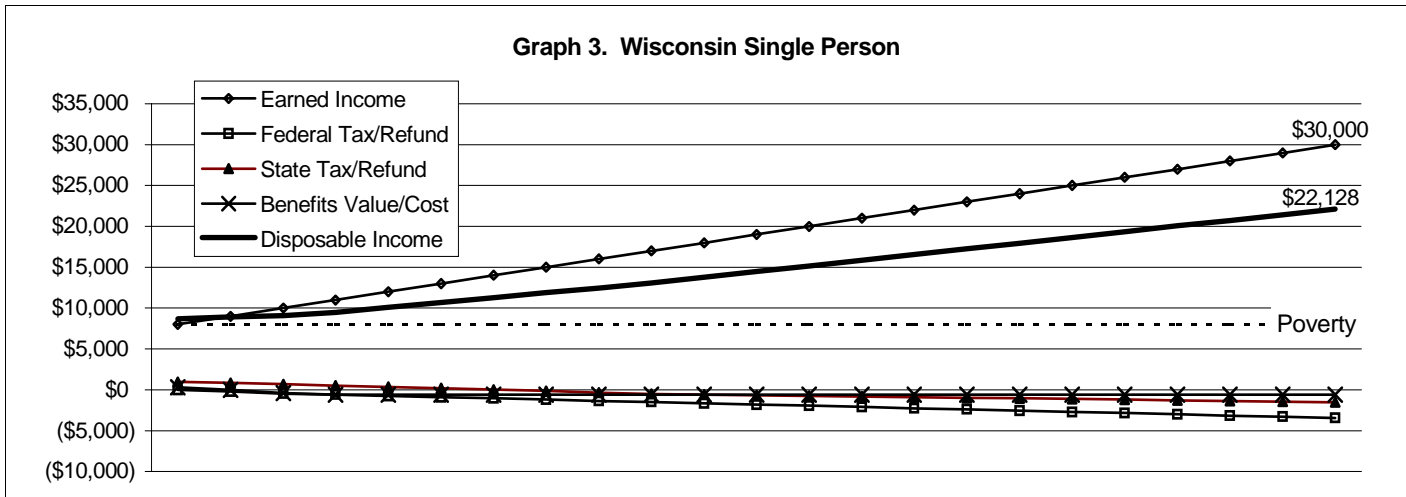
Between \$23,000 and \$32,000 in gross income, disposable income climbs modestly, from \$20,469 to \$23,731. Then a rather dramatic loss in disposable income occurs. Earned income of \$33,000 produces only \$19,881 in disposable income because of a steep increase in childcare costs. Disposable income is roughly the same amount the family was retaining at a gross income of \$14,000. This again assumes that the family will maintain its existing child care arrangements. The family will have to earn \$40,000 before its disposable income will rise above what it was making at \$32,000.

Overall, as the family's earned income grows from \$8,000 to \$40,000, a 400% increase, disposable income climbs from \$16,899 to \$24,114, up 43%.

### ***Comparison with Other States***

Tax and benefit policies differ significantly from state to state when it comes to health care and childcare subsidies as well as taxation. Our analysis found that the confluence of state tax policy, federal tax policy and state and federal benefits results in these characteristics among the states:

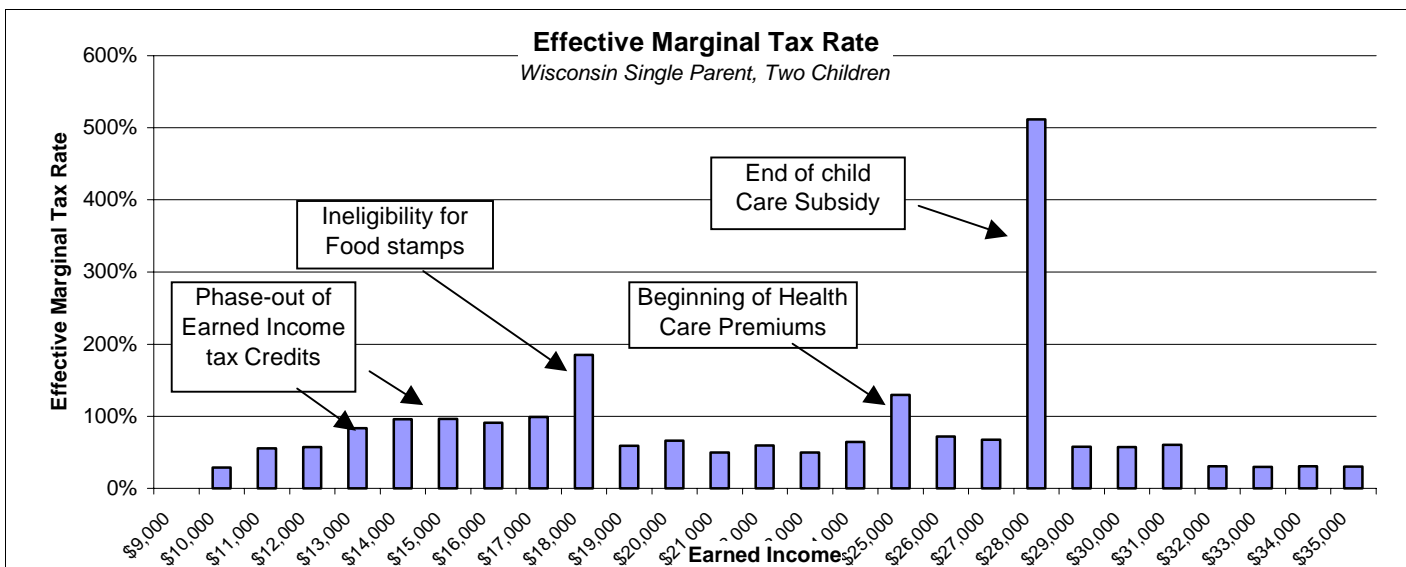




### *Tax Impact on a Single Person*

Both federal and state tax laws provide relatively small incentives to very low-income single persons. Wisconsin is slightly more generous than the federal government, mainly through the homestead tax credit. All federal and state income supplements, except the homestead credit, are gone when gross income rises to \$10,000. By that time a single worker's disposable income is less than his or her gross earnings.

What distinguishes a single person's climb up the income ladder from the other two examples is the fact that, as gross income rises, disposable income also always rises. The percentage growth in earned income from \$8,000 to \$30,000 is 275%; the equivalent growth in disposable income -- \$8,687 to \$22,128 -- is 155%. The single person earning \$30,000 has \$5,020 more disposable income than the single parent with two children and the same as the married couple with two children.



**Graph 4.** The effect of taxes and benefits on disposable income can be expressed in terms of marginal tax rates: the percentage of each extra \$1,000 that a family would lose in the form of taxes or benefits. The first bar, for example, shows that a single parent with two children who moves from \$9,000 to \$10,000 income pays an effective marginal tax rate of 29%; that is, the taxpayer does not see \$290 of that \$1,000 in extra earned income because of lost EITC and/or benefits. The effective marginal tax rate exceeds 100% at several junctures. For example, as the single parent's income increases from \$17,000 to \$18,000, the person, in effect, "pays" 190% of the extra \$1,000 in earnings in the form of lost food stamps and lost state and federal EITC. Similarly, a family of three may be better off earning \$24,000 than earning \$25,000 (because of loss of health care benefits) and may be better off earning \$27,000 than \$28,000 (because of loss of childcare benefits).

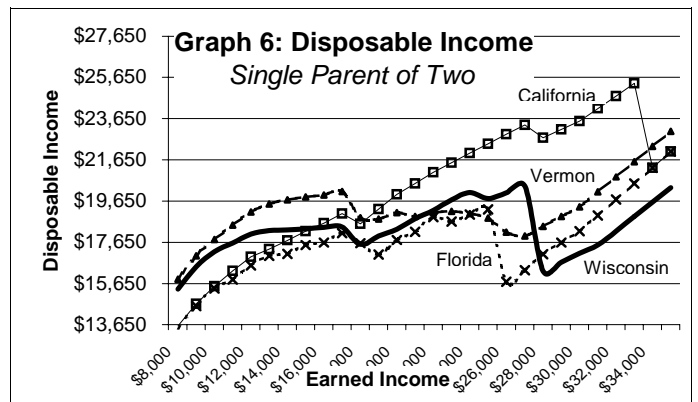
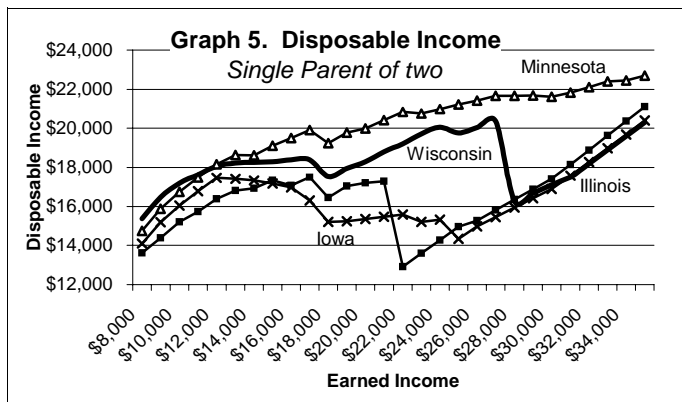
- **Florida** has no state income tax and a relatively modest benefit structure. A family of three with earned income of \$8,000 has disposable income of \$13,485, just above the poverty level. At \$35,000 in earned income, disposable income is \$22,049. (This does not take into account state and local taxes, such as sales and property taxes.)
- **Indiana** has a relatively flat income tax structure and modest benefits. A family of three earning \$8,000 has disposable income of \$14,024; At \$35,000 in earned income, disposable income is \$21,046.
- **Illinois** has a flat income tax structure and cuts off childcare subsidies at an earned income level of \$22,000 for a family of three, which reduces some families at that income level to disposable income to just above poverty level. At \$8,000 in earned income, the family has \$13,622 disposable income; at \$35,000, disposable income is \$21,116.
- **Iowa** has a non-refundable EITC that delays state taxes until a family of three earns \$15,000. A family of three rises above poverty somewhat faster than its counterpart in Illinois, Florida or Indiana. However, a modest benefit structure causes the family to hover just above poverty level at earned income levels into the high \$20,000s. A family of three earning \$8,000 has disposable income of \$14,109; at \$35,000, income is \$20,390.
- **California** has liberal childcare subsidies and credits that virtually eliminate the state tax for a family of three earning less than \$36,000. A family of three earning \$8,000 has disposable income of \$13,589; at \$35,000, the disposable income is \$22,049.
- **Vermont** has a refundable EITC as well as relatively generous child care subsidies. As a result, it is one of three states (Wisconsin and Minnesota are the others) that begins taxing working families well above the poverty level. At \$8,000 earned income, the family of three has disposable income of \$15,852; at \$35,000, disposable income is \$23,034.
- **Minnesota**, in addition to having a refundable EITC, offers the smoothest transition off of childcare subsidies of all the states studied. As a result, increased earned income at most levels translates into increased disposable income without any dramatic drops. A family of three earning \$8,000 has disposable income of \$14,753; at \$35,000, disposable income is \$22,703.

Graphs 5 and 6 below show that Wisconsin has the flattest disposable income progression among the eight states included in this analysis. That is because Wisconsin is generous at the low end of the earnings scale and has a relatively high tax rate.

Most states have economic cliffs in their benefits structures that literally cause certain families to lose money once they reach a certain threshold of earned income. That is because childcare and health care benefits cease. In all states, a family of three loses food stamps at an earned income level of \$18,000. Compared to Wisconsin, the loss-of-child-care-assistance cliff occurs at lower earned income levels for every state except California and Minnesota. Minnesota, families do not experience a cliff but rather a soft landing as childcare subsidies phase out more gradually.

### Options for Consideration

There should be steady, perceived rewards for individuals and families rising out of poverty if work is truly to “pay.” Thus, in fashioning any tax-incentive model at the federal or state level, efforts should be made to ensure that



those rewards exist as income grows. Those efforts should also recognize that tradeoffs may be necessary and one of those might be increased costs. Policy makers will have to weigh those costs against the proposed benefits and who should receive them in the name of overall equity.

There are at least six options for possible remedial action:

1. Finding ways to modify the federal formula for phasing out food stamps.
2. Increasing the income threshold at which families are eligible for state income taxation.
3. Modifying Wisconsin’s childcare support formula so that the negative income cliff for families is removed.
4. Adjusting the Wisconsin state income tax rates.
5. Some combination of all or part of the above.

### The Minnesota Example

Of all the states examined, only Minnesota provides a steadily rising and smooth slope to the disposable income line as the poor move up the economic ladder. Since Wisconsin and Minnesota are geographic neighbors, historically have had similar political roots, and have economic and social demographics generally alike, this report will use the “Minnesota model” as a way of testing a number of the aforementioned options on Wisconsin’s tax system. As a matter of expediency and efficiency, we will look only at one of the three models addressed – a single adult with two children.

At least two factors stand out in Minnesota’s approach to “making work pay.” One is Minnesota’s childcare program. The other is its tax threshold.

#### Minnesota Childcare

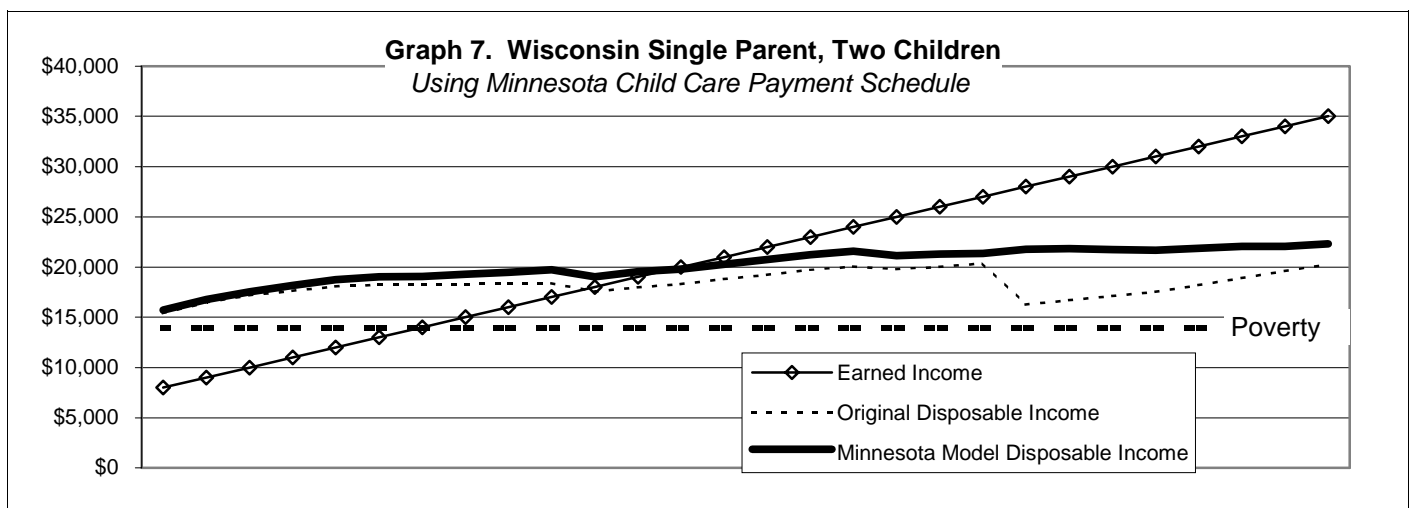
Minnesota’s payments for childcare are much more evenly graduated than Wisconsin’s as income climbs and they phase out at a higher income level. Minnesota’s childcare program, called Basic Sliding Fee (BSF), has been in existence for almost 20 years and makes use a combination of federal, state and county funds. The formula is geared to state median incomes for households of comparable sizes. Only families with incomes at or below 75% of the median for comparable households are eligible. Families at 75% to 100% of poverty have a monthly co-pay of \$5 per month or \$60 per year. Below that level there is no co-pay.

What would be the effect on Wisconsin’s disposable income growth line if Minnesota’s childcare program were substituted for the state’s current one? Graph 7 below shows that the negative notch or cliff so evident in Wisconsin’s disposable income line virtually disappears.

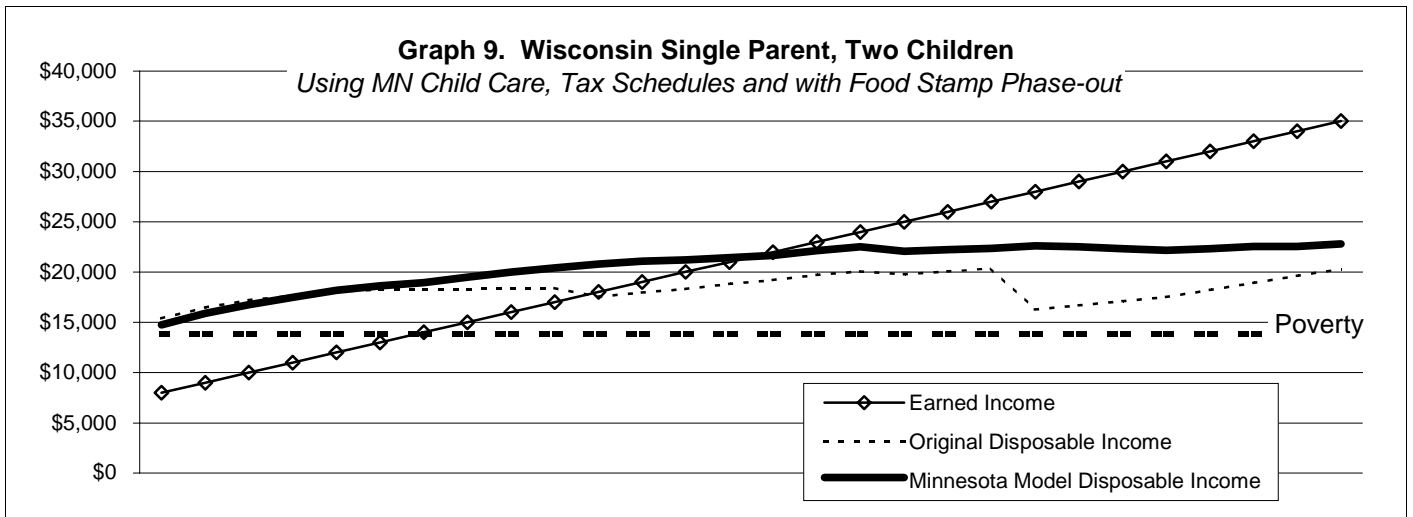
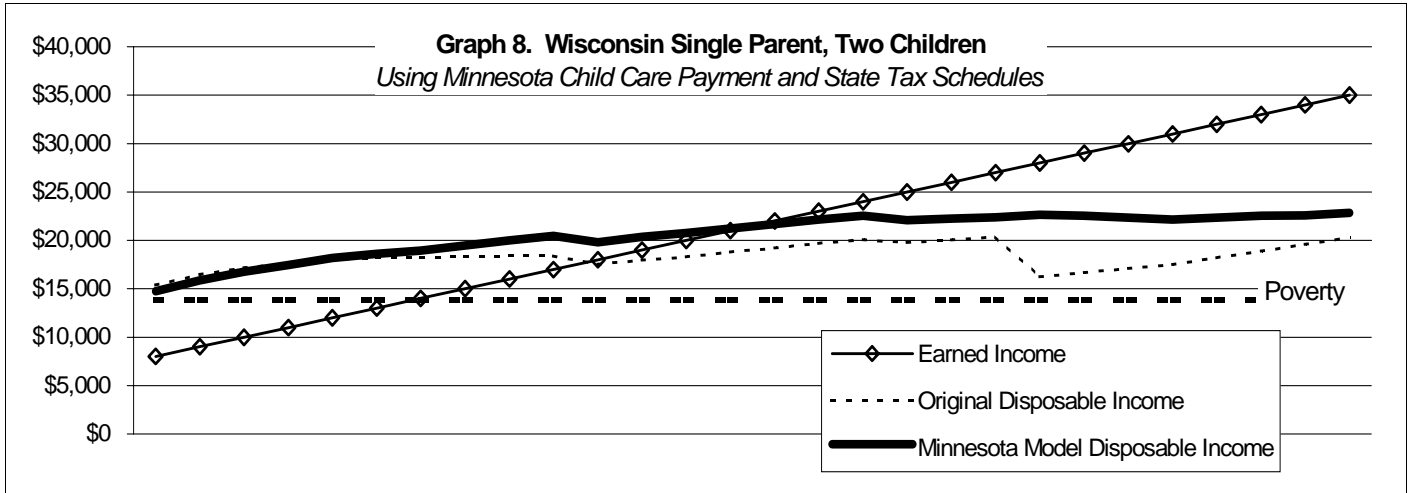
The Minnesota program, however, has some drawbacks — primarily inadequate funding. BSF funding has climbed steadily to \$63.3 million in 1999 but not enough to overcome growing waiting lists for childcare support.

#### Minnesota Income Tax Threshold

The threshold at which Minnesota begins to tax various household sizes is higher than Wisconsin’s. A single adult with two children begins paying Wisconsin income taxes when the family’s income reaches \$15,400. Minnesota’s threshold for the same family is \$23,700 (See Table 1).



Graph 8 demonstrates what happens to disposable income growth in Wisconsin if Minnesota's childcare and tax threshold are substituted for Wisconsin's tax schedules for a family of three. The disposable income line is raised. Disposable income at \$8,000 in earned income is slightly lower -- \$14,753 compared to \$15,719. But disposable income climbs to \$20,433 at \$17,000 and \$22,823 at \$35,000 compared to \$19,714 and \$22,309, respectively.



### Minnesota Model and Food Stamps

Food stamps at the federal level are responsible for a major negative cliff in disposable income as families make more money. Food stamp support now abruptly ends at \$10,000 in earned income for a single person, \$17,000 for a single parent with two children and \$21,000 for two parents with two children. For the latter two examples, earning \$1,000 more in income equates to a loss of \$1,200 in food stamp support.

In general terms, this occurs because families lose food stamp benefits when their earned income is greater than 130% of the poverty line. Under the peculiarities of the food stamp formula, net family income -- as defined by the formula -- also must be at or below 100% of poverty.

Modifying the equation can smooth that cliff out. However, Graph 9 indicates what disposable income in Wisconsin would look like with Minnesota's childcare benefits and tax threshold along with a more gradual phaseout of federal food stamps. By ending food stamp support at \$21,000 in earned income for a family of three instead of at \$17,000, such families are rewarded for earning more rather than being penalized for each additional dollar earned.

## Conclusions

Does it pay to work in Wisconsin, or are changes in order? Overall, the answer to both questions is a qualified “yes.” But the process is imperfect. Several observations can be made:

- The federal tax code is the primary driver. The basic federal tax rate, refundable EITC, dependent care, child credit, and food stamps set the pattern for overall work-based incentives. Wisconsin piggybacks on the federal model. Thus, if formulas were to be altered, changing the federal formula would have the most significant impact on boosting a low-income family’s earnings.
- Federal and state income support is front-end loaded. The combination of federal and Wisconsin tax provisions rapidly lift families up to and beyond the poverty level. That is demonstrated by the significant difference between disposable income and gross income when gross earnings are \$8,000.
- The financial incentives for families are more modest after the initial reward. Family disposable incomes hover relatively near poverty even as gross incomes climb into the mid-\$30,000 range. Steep increases in the growth of disposable income should not be expected after the initial rapid rise. But the current system leaves these families still within the shadow of the working poor.
- Families experience some discouraging dips and declines in net income due to quirks in benefit phase-outs and other factors. If behavior modification through incentives is the goal, then serious thought needs to be given to smoothing the disposable income growth lines as well as looking at ways to raise the slope of the lines so as to limit discouragement and frustration.
- Single persons have the greatest perceived connection between work and financial reward. A single person, while assisted least, can see more clearly the relationship between earned income growth and reward. There are no dips and drop-offs in disposable income as gross income rises. The growth of disposable income is steady, discernible and at a much higher slope than for families.
- Wisconsin differs in some ways from the peer states selected for this study comparison. Beginning Wisconsin wage earners enjoy a healthy financial start in comparison to their counterparts in Illinois, Minnesota, Iowa, Indiana, California and Florida. On the other hand, Wisconsin compares less favorably to other states as families move up the earnings scale. A Wisconsin family of three or four that earns in the low \$30,000s ends up with less disposable income than its counterpart in any of the other states we examined. That is primarily due to Wisconsin's relatively high income tax rate at that income level. Also, compared to Wisconsin, Minnesota has a much more steady growth line for disposable income as gross income increases.

## What Approach to Take?

If immediate steps are to be taken to remove from the current tax system the barriers that impede making work pay in Wisconsin, then legislators and other policy makers need to focus on what is law today and the basic income support mechanisms that are in effect. Federal tax laws and benefit programs remain the primary driving force in assisting the working poor to seek a better economic future. Wisconsin will have to work in concert with other states and interest groups to affect changes in the federal system.

But that should not be viewed as a barrier to modifying those provisions and programs under Wisconsin’s control – the panoply of incentive and support efforts aimed at welfare reform and the working poor. In that context, the “Minnesota model,” with all its imperfections, is worth exploring for what it might offer Wisconsin as we attempt to make work the most attractive incentive for our citizens to escape poverty.