

# **Individual Income and Sales Tax Reform**

## **Options and Background**

# Income and sales tax collections in Wisconsin

- Individual income tax collections:  
    \$7.041 billion (FY12)
- Sales tax collections:  
    \$4.288 billion (FY12)
- Fiscal effect of sales tax exemptions:  
    \$4.750 billion (FY12)
- Under the Wisconsin statutes:
  - Sales of goods are taxable unless specifically exempted from tax
  - Sales of services are not taxed, unless specifically listed as subject to tax

# Option 1

- Eliminate individual income tax
- Keep current sales tax base
- Set sales tax rate at 13.2% on current base

# Option 2

- Eliminate individual income tax
- Eliminate all sales tax exemptions
- Set sales tax rate at 6.3% on broader base

# Option 3

- Eliminate individual income tax
- Eliminate sales tax exemptions, except for the following exemptions:
  - Personal necessities (prescription drugs, medical services, food, residential heat and power)
  - Purchases by governments and nonprofits
- Set sales tax rate at 8.0% on broader base

# Option 4

- Eliminate individual income tax
- Eliminate sales tax exemptions, except for the following exemptions:
  - Personal necessities (prescription drugs, medical services, food, residential heat and power)
  - Purchases by governments and nonprofits
  - Purchases by businesses (including farm businesses) of currently exempt goods (manufacturing equipment, supplies used in farming, etc.)
  - Purchases by businesses of currently exempt services (computer, legal, engineering, consulting, advertising, accounting, R&D, etc.)
- Set sales tax rate at 9.8% on broader base

# Notes re Options 1 – 4

- All four options are revenue-neutral
- Under all four options, the following major sales tax exemptions would be eliminated:
  - Labor input into construction (\$499 million annual effect)
  - Motor fuel (currently subject to the gas tax in Wisconsin; subject to the sales tax as well as the gas tax in 9 states) (\$596 million)
  - Personal and recreational services (barbers, beauty salons, funeral services, health clubs, etc.) (\$108 million)
  - Services related to real property (commissions to real estate brokers, repair of real property, cleaning services, etc.) (\$114 million)

# Sales tax exemptions in Wisconsin – Overview

- Most of the biggest current exemptions are for:
  - Necessities (food, prescription drugs, medical services, residential heat and power) (\$1,413 million annual effect)
  - Sales of goods to non-profits (governments, charities, etc.) (\$519 million)
  - Sales of goods to nonfarm businesses (\$340 million)
  - Sales of goods to farm businesses (\$297 million)
  - Sales of services primarily used by businesses (\$673 million)
- Most of the exemptions Wisconsin has are also provided in the majority of other states

# Sales tax exemptions in Wisconsin – Details

- Major exemptions (goods):
  - Food (\$555 million annual effect in FY12) (exempt in 28 states)
  - Motor fuel (\$596) (exempt from general sales tax in 36 states)
  - Sales to governments and schools (\$369)
  - Manufacturing machinery and equipment (\$176)
  - Prescription drugs/medicines (\$150) (exempt in 44 states)
  - Sales to charitable/religious groups (\$150)
  - Fuel/electricity for residential use (\$118) (exempt in 32 states)
  - Vehicle trade-ins (\$97)

# Sales tax exemptions in Wisconsin – Details

- Major exemptions (services):
  - Labor input into construction (\$499 million annual effect)
  - Physician and dentist services (\$590) (exempt in 43 states)
  - Computer services (programming, data proc.) (\$176)
  - Legal services (\$120)
  - Architectural and engineering services (\$84)
  - Consulting services (\$80)
  - Advertising services (\$77)
  - Accounting services (\$51)
  - Scientific research and development services (\$47)

# Key points – Sales tax

- Most states (45) have a general sales tax
  - Exceptions: Alaska, Delaware, Montana, New Hampshire, Oregon
- The vast majority of states tax some but not most services (personal services, business services, professional services, computer services, etc.)
  - Most services are taxed in 5 states (Hawaii, New Mexico, South Dakota, and in addition Delaware and Washington through a low-rate business gross receipts tax)
  - Many services are taxed in 15 states, including Wisconsin
  - Few services are taxed in 26 states
- Wisconsin taxed 76 services as of 2007 (11th in the U.S.), compared with a U.S. average of 55

# Key points – Sales tax

- General state sales taxes are imposed by 45 states
  - 38 states allow local sales taxes
- Wisconsin's state sales tax rate is 5.0%
  - 24 states are higher, 13 are lower, 7 are the same
- Wisconsin's maximum state/local sales tax rate is 5.6%
  - 40 states are higher and 5 are lower
- Wisconsin's optional county sales tax rate is 0.5%
  - Maximum local option tax rates range from 0.6% in Wisconsin up to 7.0%
  - 30 states have county sales taxes
  - 28 states have municipal sales taxes
  - 5 states have K-12 school district sales taxes

# Sales taxes on business inputs – Good or bad policy?

- Ideally the sales tax should not be levied on any business inputs (State Tax Policy by David Brunori)
  - The tax was designed as a tax on personal consumption
  - Hence, goods and services should not be taxed at the intermediate stages before final consumption occurs
- "Pyramiding" problem:
  - When business inputs are taxed, the ultimate product price will contain the tax on inputs, creating a tax on a tax for consumers
- Competitive job creation problem:
  - A state that taxes most business inputs will be at a significant competitive disadvantage compared with states that do not
  - Only 5 states tax most business inputs