Tax Reform Analysis

Department of Revenue

Eliminate Income Tax – Replace With Sales Tax

Option	Sales Tax Base	Sales Tax Rate Required to Eliminate Income Tax
1	Current law (maintain existing sales tax base)	13.2%
2	Eliminate all exemptions (tax all goods and services)	6.2%
3	Exempt necessities (prescriptions, food, residential heat/power, medical services) and govt/non-profit	8.0%
4	Exempt necessities (prescriptions, food, residential heat/power, medical services), govt/non-profit and business inputs Business inputs exempted would be: • Business services (R&D, computer, advertising, etc) • Professional services primarily provided to businesses (Legal, architecture/engineering, accounting, etc.) • Exemptions for sales of goods related to general businesses and farm businesses	9.8%

Eliminate Income Tax – Replace With Sales Tax

- Under options 2, 3, and 4, 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 Taxes on Business Inputs – Good or Bad Policy?

- Ideally the sales tax should not be levied on any business inputs
  - 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

Eliminate Income Tax - Considerations

- Strong initial appeal
- Details of sales tax base changes will raise concerns
- In theory, eliminating a tax on earnings is good for job creation
- In practice, sales tax base changes create problems for businesses
- Creates winners and losers
  - Difficult to explain at personal level

Eliminate Income Tax - Considerations

- Similar plans in other states have foundered quickly
- Sales taxes are not deductible on federal returns; income taxes are deductible
- People without income tax liability who receive refundable credits lose the benefit of those credits
- If individual income tax is eliminated, there is a strong policy argument that the corporate income tax should be eliminated too

Enact a Flat Tax

- To be revenue neutral, with our existing tax structure, the flat tax rate would need to be 6.10%.
- If major deductions, credits, and exemptions were eliminated (standard deduction, personal exemption, school property tax credit, itemized deduction credit, married couple credit, and capital gains exclusion) the rate would be 4.65%.

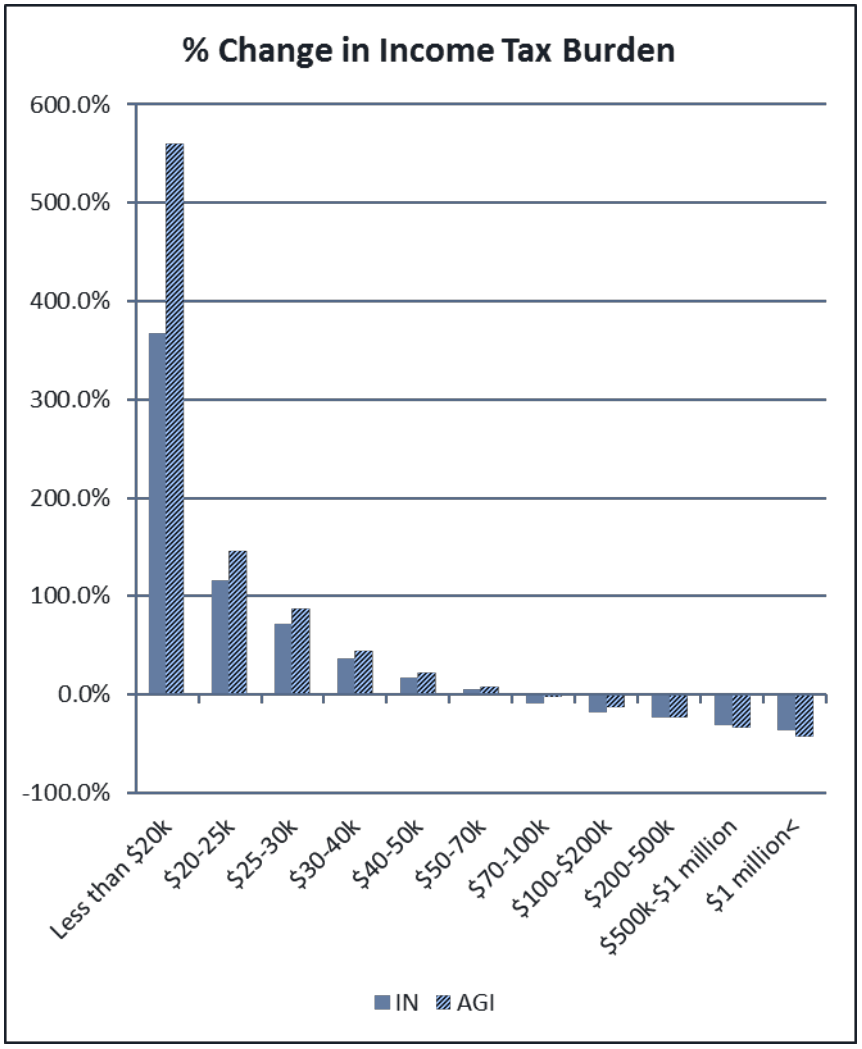
Enact a Flat Tax

Possible Constructs for Wisconsin

- Pennsylvania Model (Flat AGI Tax)
  - Essentially a flat tax on Wisconsin AGI
  - Drop all existing credits except taxes paid to other states credit
  - Leave current income subtractions for Social Security, retirement income and capital gains
  - Revenue neutral rate if applied to Wisconsin roughly = 4.5% to 4.6%

- Indiana Model (Marginal Flat Tax)
  - Adopt enhanced personal exemptions ($1,000 for each individual, extra $1,500 for dependent children, extra amounts for elderly)
  - Maintain taxes paid to other states credit and itemized deduction credit.
  - Adopt deduction for property taxes and rent.
  - Leave current treatment of Social Security, retirement and cap gains.
  - Remove all other credits and deductions.
  - Revenue neutral rate if applied to Wisconsin roughly = 5.3% to 5.5%

Enact a Flat Tax



Enact a Flat Tax - Considerations

- Proponents argue it is simpler to file and administer, due to single rate and elimination of deductions, exemptions and credits
- Multiple brackets with different rates are arguably among the least complex parts of the state tax code
- Simplicity effect is arguably overstated for most taxpayers
- In purest form (with elimination of exemptions and deductions), does not provide allowance for basic living expenses
- Would be criticized as regressive; removes the most progressive element of the state and local tax system

Enact a Flat Tax - Considerations

- Eliminates the arguably distortive effects of a tax code with preferences
- Creates winners and losers
  - Difficult to explain at personal level

Duplicate 2013 Reform

Broad-Based Rate Reduction

- Significant tax rate reductions were included in 2013 budget bill
  - Taxes were reduced by $650 million
  - Rates were reduced for all brackets
  - Largest reductions were for middle class taxpayers
  - Provided broad-based tax relief

2013 Reform

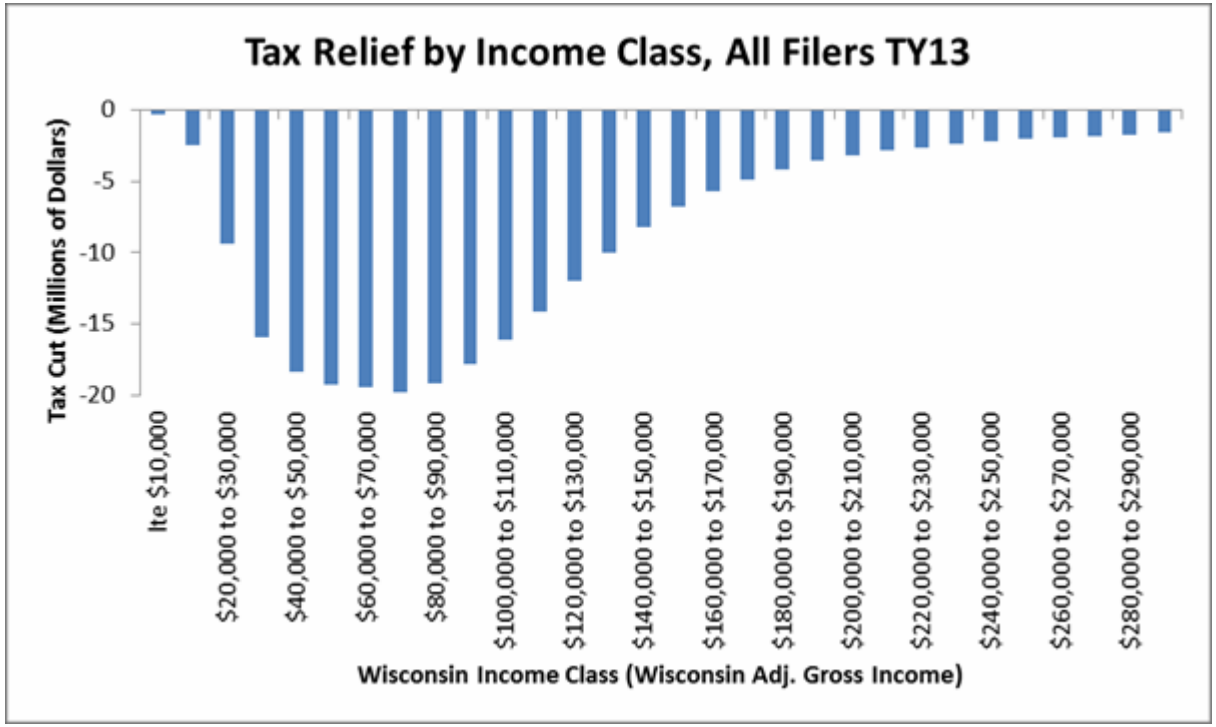
Tax Rate Reduction					
Rate	Bottom Rate	2nd Rate	3rd Rate	4th Rate	Top Rate
Before	4.60%	6.15%	6.50%	6.75%	7.75%
After	**4.40%**	**5.84%**	**6.27%**		**7.65%**

Overall Income Tax Reduction From Rate Cuts: $650 million

(Amount of reduction in budget bill for Tax Years 2013 and 2014)

2013 Reform

Middle Class Taxpayers See the Greatest Relief



2013 Reform

Increased Deductions

- State tax deduction for Health Savings Accounts
- Health insurance premium payments for employees become 100% deductible
- Increased child care deduction
- K-12 private school tuition deduction
  - Tuition payments are deductible, up to $4,000 per child through grade 8 and $10,000 per child for grades 9-12

Duplicate 2013 Reform - Considerations

- Provides tax cuts for all taxpayers
- Can be targeted where need for relief is greatest
- Could be viewed as incremental
- Provides steady, sustained, practical relief, which becomes significant over time
- Could be combined with additional simplification
- Legislative reaction is likely to be generally positive, with some enhancements and modifications
- Explanation at personal level is clear and straightforward

Property Taxes – Existing Levies

PROPERTY TAX LEVIES FOR 2011/12 BY TYPE OF UNIT

Type of Unit	Number of Units	Number of Units with a Tax Levy	Amount Levied	% of Total Levy
School districts	424	424	$ 4,646,695,395	44.75%
Technical college districts	16	16	771,464,190	7.43%
Counties	72	72	1,972,231,785	18.99%
Municipalities – regular	1,850	1,825	2,461,688,769	23.70%
Municipalities – TIF increments	384	384	350,607,230	3.38%
Special districts	542	238	99,508,142	0.96%
State (forestation tax)	1	1	82,623,849	0.80%
Total	3,289	2,960	10,384,819,360	100.00%

Significantly Reduce the Property Tax
Broad Options & Costs of Targets

Options include:

- Increasing aid to local governments while reducing their levies
- Removing items from the levy such as the forestry tax and tech college levy
- Increased property tax credits such as the First Dollar Credit
- Cut local aids and give local governments other revenue options such as local option taxes. Indiana did this to provide property tax relief

Pricetag of targets for typical home:

- To reduce the median valued home property tax by:
  - 10% you would need ~$920 million
  - 25% you would need ~$2.30 billion
  - 50% you would need ~$4.60 billion

Significantly Reduce the Property Tax

Options: Sales Tax Increase for Property Tax Relief

Option	Levy reduction (2012-13) levy	Percentage reduction	Sales tax increase needed
Remove technical colleges from the property tax	$787 million	7.5% for all property tax payers	0.9 cent
Eliminate personal property tax	$275 million	10.2% for business property tax payers; 0% for non-business property tax payers	0.3 cent
Eliminate forestry tax	$83 million	0.8% for all property tax payers	0.1 cent

Notes:

1. Each 1% reduction for all property tax payers would result in a $29 property tax reduction for the median value home.
2. The median value home is valued at $151,148 and the property taxes on that home are $2,943.
3. **Each 1 cent increase on the sales tax provides $960 million if started in FY16.**

Property Tax Relief
Typical Home Impact Scenarios & Cost

- Eliminating the Forestry Tax saves typical homeowners $25.
- Eliminating tech college levy saves typical homeowner $260 in 2014/15.
- Possible Tax Credit Options and Impacts:

Amount Necessary Under Different Relief Approaches		
Targeted Reduction in MVH in $	Levy Reduction/SLTC ($ millions)	First Dollar Credit ($ millions)
$1,000	$3,026.0	$2,226.4
$750	$2,269.5	$1,669.8
$500	$1,513.0	$1,113.2
$250	$756.5	$556.6
$100	$302.6	$222.6
	Even % relief across all categories	Note: Favors residences over business; could raise uniformity clause concerns

Property Tax Cuts - Considerations

- Property taxes are 25% above the national average and should be reduced, not just controlled
- Our current spending and levy limits will provide steady, sustained relief, which will become significant over time relative to other states
- There are policy arguments for a property tax cut/sales tax rate increase package
  - Wisconsin's sales tax burden is 15% below the national average
  - Taxpayers prefer sales taxes to income or property taxes
  - Taxing consumption is preferable to taxing earnings and savings
- Sales tax increases can be controversial
  - Taxpayers doubt that increases in one tax will actually result in decreases in another tax
  - Rate increases are more justifiable on policy and competitive grounds than base changes, and are less controversial, but would still be unpopular
- Sales taxes are not deductible on federal returns; property taxes are deductible