

# WISCONSIN

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## TAX OPTIONS

A GUIDE TO FAIR, SIMPLE, PRO-GROWTH REFORM

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A dark, teal-toned photograph of a river flowing through a forest. The river is in the center, winding slightly to the right. The banks are covered with dense trees and foliage. The sky is visible in the background, appearing overcast. The overall mood is serene and natural.

# **INTRODUCTION**

## Executive Summary

Wisconsin has struggled with its tax system for decades. The state has always been marked by high property tax burdens, but in its effort to “fix” them has leaned on corporate and individual income taxes to a sizable degree as well.

Wisconsinites are often flummoxed by why taxes are so high here—government services have a good reputation, but it isn’t always clear they are worth the price tag. Still other taxpayers feel they should be grateful as at least fiscal matters aren’t in as dire of straits as in Illinois. In recent legislative sessions, the legislature and administration have made strides to improve the roughest edges of the state’s tax system, but comprehensive tax reform has not been at the top of the agenda. We believe it ought to be.

Over the last year, our team of economists and tax experts at the Tax Foundation joined with Wisconsin’s own Badger Institute to investigate what can be done about the state’s tax system. Over the course of 12 months, our team met with over 100 stakeholders from all walks of Wisconsin life, including small business owners, local government officials, trade associations, industry representatives, state legislators, accountants and tax attorneys, and everyday taxpayers. We also reviewed the history of the fiscal system, previous tax reform studies, and historical revenue and economic trends.

The result is this book, which is meant to help Wisconsin achieve the goal of true tax reform—reform that benefits all taxpayers and sets the state on a competitive path in the region and in the nation. It’s meant to start the conversation about what Wisconsin does well, but also what it could do better—by recognizing strengths, diagnosing challenges, and prescribing real, workable solutions.

During our meetings across Wisconsin, several themes emerged:

- Individual income tax rates are high. At 7.65 percent, Wisconsin’s top individual income tax rate is among the highest nationally and regionally, and taxpayers are aware. This issue is especially acute in Milwaukee, where firms must compete for top professional talent with other states, and taxes can influence relocation decisions.
- Corporate tax rates are high but are significantly abated by the Manufacturing and Agriculture Credit (MAC). This credit shields manufacturing and agriculture firms from much of the burden of the state’s high tax rates, but many industries do not have access to it, and this unequal treatment discourages diversified investment in the Badger State.
- For many Wisconsin taxpayers, property tax burdens are a persistent political concern, but attempts at fixes have been costly. While property taxes are a local revenue stream, the state government has tried all sorts of levers to ameliorate the property tax burden, including reimbursing local governments for property tax credits, providing property tax credits on state income tax returns, and offering direct subsidies to local governments in the form of a “shared revenue” program.



- Wisconsin is a member of the Streamlined Sales Tax Project and adheres to the U.S. Supreme Court’s standards for online sales tax collection. The state began remote sales tax collection in 2018 and now has the opportunity to apply this new revenue stream toward comprehensive tax reform.

Our conversations with Wisconsinites from all walks of life were instrumental in our development of four comprehensive tax reform options tailored to the Badger State’s unique strengths and challenges. Informing every page of this book are the insights and perspectives we gained from those who interact with Wisconsin’s tax system on a daily basis.

With these valuable perspectives at the forefront of our minds, we undertook this project as an independent national organization familiar with tax developments in many states, with the view that tax systems should adhere to sound economic principles, including simplicity, transparency, neutrality, and stability. Positioning Wisconsin for the future means creating a tax code that can grow with the state, not hold it back. A tax code better aligned with growth, opportunity, and job creation is in the interest of all Wisconsinites.

While economic efficiency is only one lens through which to analyze a tax code, it is an important one. After all, there are many ways to generate a dollar of tax revenue, but some taxes are more harmful to the economy than others and should be mitigated wherever possible.

Major tax studies consistently find that taxes have a negative impact on economic growth, and that this impact varies across tax types and structures. Among major tax types, corporate income taxes tend to be the most harmful to economic growth, since they penalize capital investment, followed by individual income taxes, which impact individuals’ labor and savings decisions.<sup>3</sup> Property and consumption taxes are less harmful because ultimately, it is production, innovation, and entrepreneurial risk-taking that drive economic growth.<sup>4</sup> Within each of these taxes, moreover, the decisions states make—to carve out tax bases, incentivize or penalize certain economic decisions, or create or reduce complexity—have an effect as well. For example, Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth.<sup>5</sup>

Each of the four comprehensive tax reform options presented in the pages ahead tackles Wisconsin’s tax dilemmas through a slightly different angle, but all four options present bold reforms and prioritize progress in key areas in which the state’s economic wellbeing is most at stake.

3 Jens Arnold, Bert Brys, Christopher Heady, Åsa Johannsson, Cyrille Schwellnus, and Laura Vartia, “Tax Policy for Economic Recovery and Growth,” *The Economic Journal* 121, no. 550 (February 2011).

4 See William McBride, “What is the Evidence on Taxes and Growth?” Tax Foundation, Dec. 18, 2012, <https://taxfoundation.org/what-evidence-taxes-and-growth>.

5 John K. Mullen and Martin Williams, “Marginal Tax Rates and State Economic Growth,” *Regional Science and Urban Economics* 24, no. 6 (December 1994).

We hope that this book and its recommendations will provide useful information and observations for policymakers, journalists, and citizens in the Badger State as they evaluate the state's fiscal system. We are thankful to the Wisconsinites who spent time with us talking about Wisconsin's taxes. Without their input, this publication would have been far less rich and meaningful. We are also grateful to the Wisconsin Department of Revenue for providing data to assist in estimating the fiscal impact of our proposed reforms.

## Our Objective

We hope these solutions guide the tax reform conversation in Wisconsin by providing a framework upon which legislators and citizens can make further decisions. Each "option" in the menu of choices we present is designed to ensure the state builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead.



## Menu of Tax Reform Options

Our menu of comprehensive tax reform options is designed to allow legislators and taxpayers to reimagine their tax system to build an economy for the long term. Each of these plans streamlines the tax system, removes or consolidates duplicative provisions, and positions Wisconsin for long-term growth. They are designed with economic growth in mind, consistent with the literature on the economic effects of different tax types and structures.<sup>6</sup> These plans are roughly revenue neutral, but if policymakers desire a net tax reduction or increase, rates can be dialed up or down accordingly.

**Option A would transform Wisconsin's income tax into a streamlined, simplified flat tax, balanced by modernizing and increasing the sales tax.** These changes would align the state's tax rates with competitor states, resembling changes enacted in the past decade in Indiana. It includes:

- A flat income tax rate of 4.82 percent
- A standard deduction that conforms with the new federal standard deduction created by the Tax Cuts and Jobs Act (TCJA), including elimination of Wisconsin's sliding scale so that the standard deduction becomes available to all taxpayers regardless of income
- A repeal of the personal exemption
- A moderately broadened sales tax base with a statewide rate of 5.75 percent, slightly higher than it is today
- A slightly lower corporate income tax of 7 percent
- Improvement in Wisconsin's ranking on our *State Business Tax Climate Index* from 32<sup>nd</sup> to 12<sup>th</sup>

**Option B would recraft Wisconsin's tax system in a similar fashion to state-level tax reforms in other states,** simplifying and reducing income and business taxes while broadening the sales tax to match today's economy. It includes:

- A consolidated income tax structure with rates of 4, 5, and 6.8 percent at thresholds of \$0, \$10,000, and \$40,000
- Conformity with the generous new federal standard deduction
- A repeal of the personal exemption
- Moderate sales tax base broadening at the current sales tax rate of 5 percent
- A reduction in the corporate income tax rate to 4.6 percent
- Improvement in Wisconsin's ranking on our *State Business Tax Climate Index* from 32<sup>nd</sup> to 14<sup>th</sup>

<sup>6</sup> Karel Mertens and Morten Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review* 103:4 (June 2013).

**Option C would set Wisconsin apart as the only state in the region with no corporate income tax**, making the state stand out as one of the few with no taxes on investment and job creation. Income tax rates are consolidated and reduced while the sales tax is broadened at the current rate. It includes:

- A full repeal of the corporate income tax, one of the biggest impediments to growth in the Badger State
- Large sales tax base broadening paired with a slightly higher sales tax rate of 5.2 percent
- A consolidated income tax structure with rates of 4, 5, and 6.8 percent at thresholds of \$0, \$10,000, and \$40,000
- Conformity with the generous new federal standard deduction
- A repeal of the personal exemption
- Substantial improvement in Wisconsin's ranking on our *State Business Tax Climate Index* from 32<sup>nd</sup> to 6<sup>th</sup>

**Option D simplifies and stabilizes Wisconsin's existing tax system**, broadening bases and adopting growth-friendly reforms while retaining progressivity, reducing business taxes, and keeping the current sales tax rate. It includes:

- A graduated individual income tax with rates of 4, 5, and 7.5 percent at thresholds of \$0, \$20,000, and \$150,000
- Elimination of the marriage penalty in the standard deduction but retention of the sliding scale as it exists under current law
- Retention of the current law personal exemption
- Moderate sales tax base broadening while maintaining the current 5 percent sales tax rate
- A reduction in the corporate income tax rate to 4 percent
- Improvement in Wisconsin's ranking on our *State Business Tax Climate Index* from 32<sup>nd</sup> to 14<sup>th</sup>

## Improvements Included in All Options

In addition to the specific changes listed above, Options A, B, C, and D each include the following structural improvements to Wisconsin's tax code, designed to move to more neutral treatment of business and individual activities while improving the state's competitiveness in the region and nation:

### Individual Income Tax

- Repeal the state's marriage penalty by doubling bracket widths for married couples and repealing the married couple credit
- Repeal the itemized deductions credit, as a more generous standard deduction available to all taxpayers (in Options A, B, and C) will reduce dependency on this credit

### Corporate Income Tax

- Conform to the TCJA's new full expensing allowances under Internal Revenue Code (IRC) Sec. 168(k)
- Repeal the 3 percent surcharge levied on top of the corporate income tax and instead fund the Wisconsin Economic Development Corporation (WEDC) through the General Fund
- Conform with new federal standards for treatment of net operating losses (NOLs) under the TCJA
- Eliminate the throwback rule in the corporate income tax

### Sales Tax

- Pursue sales tax base expansion (as detailed above and in Chapter 5)
- Share revenues from local flow-down of state base expansion between counties and municipalities
- Use revenue from the new online sales tax Supreme Court ruling to help pay for comprehensive reforms

Each of our reform solutions would improve Wisconsin's performance on our *State Business Tax Climate Index* overall and in the corporate tax, individual income tax, and sales tax components.

### Wisconsin's Rankings on the *State Business Tax Climate Index*, Current (2019) and Proposed

	Overall Rank	Corporate Taxes	Individual Taxes	Sales Taxes
Current Law	32	35	39	8
Option A	12	10	15	9
Option B	14	4	30	7
Option C	6	1	30	7
Option D	14	3	33	7

## Other Important Considerations

- Continue toward repeal of taxes on tangible personal property
- Allow property tax limits to continue working
- Consider tolling of Wisconsin's highways
- Repeal minimum markup law, which drives up gas prices
- Reform the state's unemployment insurance tax system

## Key Elements of Wisconsin Tax Reform Options

	Current Wisconsin Tax System	Option A	Option B	Option C	Option D
<b>Income Tax</b>					
Income Tax Rate	Four Rates: 4% 5.84% 6.27% 7.65%	Single rate of 4.82%	Three rates: 4% 5% 6.80%	Three rates: 4% 5% 6.80%	Three rates: 4% 5% 7.50%
Tax-Free Income for Couples or Families (tax year 2018)	\$19,580 plus \$700 per exemption; phases down after \$22,000 in income	\$24,000	\$24,000	\$24,000	\$21,160 plus \$700 per exemption; phases down after \$22,000 in income
Tax-Free Income for a Single Filer with No Children (tax year 2018)	\$10,580; phases down after \$15,500 in income	\$12,000	\$12,000	\$12,000	\$10,580; phases down after \$15,500 in income
Itemized Deductions Credit	Yes	No	No	No	No
Marriage Penalty	Yes	No	No	No	No
<b>Sales Tax (state portion)</b>					
State Sales Tax Rate on Sales of Retail Goods to Consumers	5%, with many exemptions	5.75%; prescription drugs and medical devices exempt	5%; prescription drugs and medical devices exempt	5.2% on all items	5%; prescription drugs and medical devices exempt
State Sales Tax Rate on Sales of Retail Services to Consumers	Mostly Exempt	5.75%	5%	5.20%	5%
<b>Corporate Income Tax</b>					
Corporate Tax Rate	7.9% plus 3% surcharge	7%	4.60%	Repealed	4%
Connection to Federal Full Expensing and Net Operating Loss Rules	Does not conform	Conforms	Conforms	Conforms	Conforms
Throwback Rule Partly Taxing Out-of-State Income	Yes	No	No	No	No
<b>Overall Estimates</b>					
Revenue Estimate (2021)	\$16.5b	\$16.4b	\$16.4b	\$16.6b	\$16.4b
Distributional Effect	Slightly Progressive	More Regressive	Slightly Progressive	Slightly Progressive	Slightly Progressive
Rank on State Business Tax Climate Index	32nd	12th	14th	6th	14th