THE DEPARTMENT OF REVENUE PERSPECTIVE

MICHAEL L. MORGAN*

Thank you, Marquette University, for conceiving the idea to hold a tax colloquium, a forum where state and national leaders in tax policy are convened to discuss issues important to the State of Wisconsin. I am grateful to Marquette University for affording me an opportunity to participate in the colloquium.

What I am going to talk about this morning are the challenges that we see at the Department of Revenue as they relate to tax policy in the State of Wisconsin. As many of you know, since taking office, Governor Doyle and his cabinet have been grappling with a very difficult budget situation in a very difficult economy. In fact, the first order of business for the Governor, as Secretary Marc Marotta stated last night,[1] was to put together a biennial budget that solved a $3.2 billion deficit—an unprecedented budget deficit in the history of the State of Wisconsin—without raising taxes. In fact, we were able to put together what I believe was a sound budget. Secretary Marotta gave you some details on that budget, and why we believe it was a good one. Even so, the challenges that we saw a year ago will remain as we go into our next budget cycle. Our economy has not performed in the way that we would have liked. Although economists insist that we are in the midst of a recovery, it appears to be a jobless recovery, which is wreaking havoc on revenue sources that the State of Wisconsin depends on. So we have some continuing challenges.

The problems, as we reflect on the last budget, were exacerbated by a few things that I want to discuss today. I will just mention some of the problems that contributed to the budget deficit. Spending by the state throughout the 1990s simply exploded. For example, in areas like corrections, double-digit spending increases occurred in this period. The policy of two-thirds funding of schools by the state may have been a good idea but proved too expensive for the state to continue. The state also pursued a policy of lowering income taxes for individuals. This was accomplished by reducing tax rates,

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1. Marc J. Marotta, *Taxing Thoughts*, 88 MARQ. L. REV. 5 (2004).

increasing the standard deduction, and raising the married couple credit, among other things. For Fiscal Year 2001, the state experienced a 13.5% decrease in individual income tax collections, followed by a 3.4% decrease in Fiscal Year 2002. We also had a recession where we saw employment decline by 1.1% from 2001 to 2002. Critical decisions that were made by the prior administration—this is not to lay blame, but just to make an observation—also added to the deficit problem. The securitization of tobacco settlement funds provided one-time funding to plug into the prior biennial budget, but it left a hole when it came time to find dollars to fund, for example, shared revenue in the biennial budget we had just put together.

I have already talked about the jobless recovery. As we were beginning to take office, the U.S. economy and the Wisconsin economy were mired in a recession. In fact, since the year 2000 in the State of Wisconsin, we lost some 93,000 manufacturing jobs, which has had a tremendous impact on tax revenues. So, there were a number of factors that led to the budget deficit.

I am pleased to report that we were able to find ways to preserve those things that are important for the State of Wisconsin, without raising taxes. But it seems to me that is only the first part of the equation, and I know the Governor agrees with that. He understood that we really needed to get our arms around how we were going to fund the operations of government and encourage economic activity and job growth in the state, which necessarily meant that we had to take a look at tax policy.

One of the early things that he did, after we put the budget to bed, was to convene cabinet work groups. One cabinet work group was a tax policy work group, which I headed. The Tax Policy Work Group's charge was to solicit ideas on how to fit all State of Wisconsin tax policies into a plan that encourages economic development. We went out and talked to various groups, business leaders, professors, tax practitioners, and others around the state to inform them of our thinking concerning Wisconsin tax policy.

At the heart of my inquiry were several important questions: What are the principles of good tax policy? Do we currently have a balanced tax system? What are the features of the new economy that might give rise to challenges to our current tax structure? And, what are some of the tax policy challenges of the new economy?

I. TAX PRINCIPLES

The first principle of good tax policy is fairness. Tax fairness means taxes are applied and enforced uniformly. Tax systems need to anticipate and adjust to the changing nature of society and the economy so that they do not become obsolete and unfair. The second principle is equity. Equity requires that there be similar tax burdens for people similarly situated, and that lower income taxpayers should not have to pay a higher proportion of their income in taxes than higher income taxpayers. Efficiency, the third principle, is something we pursue aggressively in the Department, in terms of both administrative efficiency and economic efficiency. Administrative efficiency requires us to drive down costs associated with administering tax laws in the state and encouraging compliance with the law, while economic efficiency requires that a tax system should not create economic distortions. The fourth principle is that we need to ensure revenue reliability—a tax system that provides adequate revenues in a reliable manner. To do this, we need a balanced mix of revenue sources—concentration in a handful of taxes makes a revenue system vulnerable to the vagaries of the economy.

II. CURRENT TAX LANDSCAPE

Wisconsin collections are currently concentrated in a handful of taxes. Wisconsin state and local governments collected about $18.5 billion in taxes in Fiscal Year 2003. Individual income, property, and general sales and use taxes were the major sources, accounting for 86% of that total. From Fiscal Years 1985 to 2003, the share contributed by the three largest taxes—property, individual income, and sales—increased from 82% to 86%. The sales tax share rose from 19% to about 22%, and the property tax share rose from 35% to about 37%. The individual income tax share increased slightly from about 26.8% to 27%.

The contribution of the corporate income tax actually dropped over the last several years. Some reasons for the decline in the share of the corporate income tax are the lagging economy, special tax treatment of business (tax credits, etc.), and the changes in the organizational structure of businesses. Between 1990 and 2001, the number of C-Corporations in the state remained basically flat, while the number of S-Corporations and partnerships doubled. Some of the revenue that used to be collected as corporate income taxes is now being collected as individual income taxes. So it would be a mistake to assume that all the decline associated with corporate income tax can be attached to tax credits and tax exemptions; some of it has to do with the structure the companies are choosing to use.

Residential property taxes have become an increasingly large share of total property taxes in the state, while property taxes on manufacturing, commercial, and agricultural land, and other nonresidential properties, have declined in importance. This happened as a result of policy decisions as well as market-driven circumstances. Residential property accounted for 69% of property taxes in Fiscal Year 2003. That share was about 47% back in 1970, so residential properties have seen an increase in their share of the property tax burden. Residential properties include single-family, as well as multifamily housing (two to eight units).

One policy change that resulted in some of the shift in the property tax to residential property is "use value" assessment of farmland. A very simplified explanation of use value is that farmland is valued based on the net income that could be generated from the land's rental for agriculture use. Between 1970 and 2003, there was a substantial drop in agricultural property's share of property taxes—from 9.9% to less than 1%. Another policy change relates to manufacturing property. In the mid-1970s, the state created an exemption for machinery and equipment used in manufacturing, which resulted in a decline from 10.4% in 1970 to 3.6% in 2003 in the share of property taxes paid by manufacturers.

The rising share of property taxes on residential property is also due, to some extent, to the booming market for residential properties. The fact of the matter is, whether it is market-driven or policy-driven, there has been a shift of the burden from other property tax groups to residential owners. This has caused some problems around the state and has given rise to legislation like the tax freeze offered late last year.

As I indicated, you can see the definable shifts in the tax burden among groups in the State of Wisconsin. If we are striving for a fair, equitable, and efficient tax system, we need to collect more data on who is actually bearing the burden of paying taxes in the State of Wisconsin. One of the things we are going to do is to repeat a Tax Burden Study that was done by the Department of Revenue some 25 years ago to try to give us a better understanding of who pays taxes in the state and whether there is a disproportionate burden on a particular taxpayer group.

I want to talk a little bit about administrative efficiency. I am proud of these figures, and former Secretaries of Revenue like Mark Bugher, who is present here today, probably have as much to do with this as I have. We have used technology well in the Department of Revenue to increase our administrative efficiency and to lower processing costs. Over the last couple of years, we have moved taxpayers from paper returns to e-filing, and for every individual who files electronically, we save about 75 cents. This is characteristic of something broader in state government that the Governor is trying to foster, and that is the need to find ways to provide high levels of services to residents while driving down costs, which means we need to use technology and other new approaches to deliver services.

The other thing that we are proud of in the Department of Revenue is our outreach efforts. We plan to talk to people in all sectors of the community, in all tax groups, and help them comply with the law, and hopefully encourage voluntary compliance and lower compliance costs. We also plan to have an integrated tax system in place that will manage the collection of all types of taxes in an integrated way that will allow us to cross-reference tax data, instead of storing information in separate "silos." This will make it much more effective for the Department of Revenue to identify if there is a problem with a taxpayer or if there is a problem with the system.

I think all of us are aware of the difficulty the Governor had in balancing the biennial budget without any tax increases and without any substantial change in the mix of taxes in the state. The next budget is undoubtedly going to produce some challenges as we seek to fund shared revenue, which is important for property tax relief policy and to finance our schools. We need to revisit school finance. This means that we need to look at our mix of taxes in the state and how we use our taxes in the state. We must fund those missions that we believe are important.

One of the things that we want to get our arms around is the future of the new economy and how it impacts tax policy. Some of the characteristics of the new economy are going to give rise, I think, to important challenges to our tax policy. Wisconsin's state and local taxes were developed in an economy that was centered around the production and distribution of tangible goods. Such a tax structure is not easily applied to the knowledge-based and service-oriented new economy, in which things like intangible assets, human capital, and provision of services assume greater importance.

The new economy is characterized by a greater convergence between economic sectors. Telecommunications, computer technology and services, and information services are converging. As a result, telecommunications, cable television, and information services companies that once were separate businesses providing separate and distinct services are beginning to bundle those services into a single package. This presents a challenge. The State of Wisconsin has the ability to levy a tax on certain telephone services, but it becomes more difficult if those services are provided through online services. We know that cable companies and online service providers are looking at telephone services and beginning to sell them in the marketplace. The effect is that certain taxes that we rely on, particularly the sales tax, are increasingly becoming unstable. Even at a time when the sales tax is being looked at as a way to relieve some of the burden of the property tax and provide help in areas like school finance, we cannot look at the sales tax as it is currently applied. The new economy may require some adjustments, so that we will have a stable revenue source over time.

Globalization of the economy is also a challenge with regard to encouraging stable revenue sources. Computers and other technologies are rendering irrelevant boundaries created by political jurisdictions. Electronic commerce permits transactions between geographically separated buyers and sellers. Digitization permits electronic distribution of literature, music, computer software, and other products that were once available only in tangible form. Under our current laws, we are unable to apply those taxation principles that apply to goods and services bought on Main Street to goods and services sold over the Internet. As such, we are less able to collect sales tax on those goods and services that are sold over the Internet. We have a use tax, but that depends on the buyer's voluntarily reporting on his or her individual income tax return the purchases made over the Internet and the taxes to be remitted. Compliance with regard to the use tax on Internet purchases is very poor.

The old economy rules do not work for many of the transactions in the emerging economy. For example, transactions involving intangible property exchanged by geographically separated buyers and sellers—such as computer software—present difficult compliance issues that challenge our ability to keep a stable tax base. When an information service in one state sells access to electronic databases to a business whose employees access the information from locations in several other states, we have to ask ourselves, for purposes of taxation, where does that sale occur? Does it occur at the firm's headquarters? Does it occur wherever the firm's employees access the database? What are the implications for the State of Wisconsin if we decide that the sale does not occur here in the state?

Another real challenge is whether an economic player has sufficient presence in the jurisdiction so that it can be taxed. Again, the standards that were developed during an industrial economy are difficult to apply in the new economy. The traditional test related to the physical presence of the taxpayer becomes less relevant as companies are increasingly able to conduct business in the state without having to be physically present in the state. The problem for us is to define the nexus that provides us with the basis on which we can apply the tax on goods and services that are sold in the state. Tax structures in the old economy were based on real or tangible personal property. Production and sales occurred in a clearly defined physical location. That is not always true today.

If a sale or transaction of tangible property is made, and the retailer is located in the State of Wisconsin, a sales tax is attached. If that sale occurs over the Internet by a retailer that does not have a physical presence in the State of Wisconsin, no sales tax is attached, but there is a use tax. Individuals who buy tangible property over the Internet have a responsibility to report the use tax on their income tax returns. Very often that is not done. This is a problem for states throughout the country. The Streamlined Sales Tax Project is an effort to address the inequity that currently exists between the treatment of e-commerce or goods sold electronically and the treatment of goods sold on Main Street. In fact, we believe that as a result of this inequity we currently lose somewhere in the neighborhood of $150 million each year. This revenue loss from e-commerce undermines our ability to fund schools, shared revenue, and other important initiatives. The sales tax is imposed on the sale of tangible personal property rather than on intangible property or services, which, for the most part, are not taxable. This distinction between goods and services is also a part of that old economy. The service sector now accounts for about half of our economy. The transition from a manufacturing-based economy to an economy that is much more service-based has not involved a corresponding change in tax policy.

As we explore the relationship between tax policy and economic development, we begin to understand clearly the competitive nature of the environment in which we find ourselves. States are competing with each other for economic activity and jobs. The mobility of businesses is an important feature of the new economy. This has led to tax incentives that the state provides to businesses. We have asked ourselves some fundamental questions: Do the incentives work? Also, how well do we evaluate whether the tax incentives we provide have the desired outcome on economic activity and produce more jobs?

Businesses decide where to locate based on a number of factors, including an educated and skilled workforce, the availability of venture capital or risk capital, and the proximity of related businesses that stimulate intellectual exchanges and enrich the business climate. At the end of the day, we found that we were not in the position to determine how effective our tax incentives have been. For example, has the manufacturing equipment tax exemption had an impact on the manufacturing sector of our economy? And if so, has it had the desired impact? Was it intended to slow the rate of decline in the manufacturing sector or encourage growth? We need a much better understanding of whether tax incentives actually work or whether other factors control if businesses want to locate in the State of Wisconsin.

There are some things that we all agree on. We know the tax systems were designed long ago, and that they need to be reexamined in light of economic changes that have occurred. We need to take a hard look at our complement of taxes in the State of Wisconsin to determine whether tax policy adjustments are needed to insure that we provide an adequate revenue source to meet the needs of the public. We need vigilance on our part to insure tax compliance. Any number of tax avoidance strategies have been employed by various industries and, as a tax agency, we must remain vigilant and be aware of those schemes. We need to continue our outreach to the community to ensure that the tax policies that have been put in place to help, such as the Earned Income Tax Credit and the Homestead Credit, are in fact used by those populations whom they were designed to benefit. Tax incentives, as I indicated, need to be tied to performance measures. For example, recent legislation created a sales tax exemption for fuel and electricity used in the manufacturing process that would replace the income tax credit for sales tax paid for these items. Unused credits from prior years will be allowed to be carried forward, but only if certain performance measures are met, such as whether a certain number of jobs are created in the state and whether the companies invest at a certain level. If we are going to provide tax incentives, we need to know what the return is going to be in terms of economic activity for the State of Wisconsin

I certainly appreciate the opportunity to participate in the discussion today. We at the Department of Revenue believe that it is important for us to participate in discussions at the state and national level on matters that may affect tax policy in the State of Wisconsin. Thank you, Marquette University Law School, for your willingness to organize and host this important tax policy discussion.