

A Revenue-Raising Plan for Wisconsin

by Andrew Reschovsky

Preface

by Max B. Sawicky

In recent years, the federal government has relegated increasing responsibility to state governments. It has accomplished this goal in some important areas, most notably the welfare reform legislation passed in 1996. States have already been required to increase expenditures on a number of fronts, with the greatest pressures resulting from growing Medicaid costs. Rising school enrollment has further strained state budgets, as has increased demand for lengthier criminal incarcerations, resulting in rapid growth in spending on corrections. Although spending demands have increased, so has state revenue. In contrast to the projected decline in federal tax revenues, combined state and local revenues increased from 9.8% to 10.8% of gross domestic product between 1979 and 1996.

Aside from maintaining current services in such areas as health care and law enforcement, there is also the question of funding for public investment—spending on infrastructure, education, and training. Although federal funds have often been available, most public investment spending is performed by state and local governments. If there is to be more public investment, states will certainly play a central role.

Important evidence attests to the value of public investment in general economic growth, but unfortunately such investment has been declining in the United States for the past 25 years. Under the latest budget agreement passed by Congress, projections indicate

a continued decline in public investment for the foreseeable future. If the size of the **workforce** also declines relative to that of the population as a whole (as many expect), productivity growth spurred by public investment will be even more necessary to ensure growing standards of living.

The recent gains in the national economy are doing much to obscure these basic trends. Employment has risen and state budgets are in their best shape in years. In fact, budget surpluses have become common and have led to proposals for state tax cuts. New York has already cut its taxes, and proposals are expected in Wisconsin and elsewhere.

Unfortunately, two basic facts about these tax-cutting proposals commonly go unappreciated. One is that budgetary surpluses have been made possible by a peak in the business cycle that cannot last indefinitely. A second is that, in the long run, trends in health care and demographics will eventually place renewed pressures on state revenue systems. Tax increases inevitably will be considered and made all the more necessary if states choose to cut taxes now.

Beyond the current economic boom, therefore, lurks the question of how to best reform state revenue systems. Although state tax systems typically endure the closest scrutiny when they fail to produce sufficient revenue, they should not be spared analysis and evaluation during less dire times. In light of the budget deficits anticipated by experts in the field of state and local finance, the Economic Policy Institute commissioned five papers to address the question of how states can best revise their revenue systems. The authors of these papers do not necessarily advocate such increases. They do, however, try to describe the best way of increasing state revenues while simultaneously improving the design of state tax systems. As such, these papers provide insight on tax reform irrespective of revenue goals and could be used for guidance in either revenue-neutral reforms or to replace local tax systems.

The scale of the problem addressed in these papers is large compared to the usual preoccupations of state legislatures. This choice was deliberate. These papers mean to shed light on basic deficiencies in state tax systems, not merely suggest ways of modestly boosting revenue. The latter would be a simple exercise requiring little analysis. For the specific states examined, however, these papers provide guidance in preparing for imminent structural deficits.

It is hoped that this series, focusing on state revenue programs in Illinois, Maine, New Hampshire, New York, and Wisconsin, will help launch a constructive debate on state-level tax reform. Although some of these states are more hard-pressed to examine these issues than others, it is safe to say that, sooner or later, every state will have to grapple with these tough decisions.

Introduction

Although Wisconsin's booming economy has generated a state government budget surplus this year, if current spending trends and existing tax laws remain unchanged, the state government will experience a structural gap between revenue and expenditures. This paper explores economically feasible ways for Wisconsin to raise the additional tax revenues needed to address the shortfall that the state will eventually face. Of course, tax increases are not the only way to close these gaps—spending cuts or improvements in government efficiency would also help address this problem. This author does not advocate tax increases as a solution to the structural budget gap but rather addresses the question of how such tax increases might best be designed if they become necessary.

Wisconsin is presently blessed with a strong economy. Last year, the unemployment rate averaged 2.8%, two full percentage points below the national average. The state economy has generated a healthy flow of revenue into state government coffers and has reduced service demands, perhaps most notably by contributing to a more than 50% reduction in welfare caseloads since fiscal year 1992. Despite the currently strong economy, though, the long-run fiscal outlook in Wisconsin is not so encouraging. In an attempt to provide property tax relief and to “get tough on crime,” the state government has made commitments that will require it to devote a steadily increasing share of its budget to spending on public education and corrections. At the same time, current projections suggest that growth rates and tax revenues will slow over the next few years.¹ So unless the state is willing to reduce the current level of public services and relax its commitments to property tax relief and a tough corrections policy, a structural gap will arise between available revenues and expenditure needs. To close this gap, state taxes will need to be increased.

In response to growing public pressure for property tax relief, the legislature agreed to pay two-thirds of the cost of primary and secondary education, beginning with the 1996-97 school year.* In order to guarantee that the new aid would not be used to finance increases in school district spending, the legislature enacted permanent **revenue caps** to limit the annual amount by which school districts can increase revenues, and hence expenditures. Not only did this “two-thirds initiative” require a large increase in state school aid, it mandated that K-12 education would get first consideration for state revenues in the future.

The state's efforts to intensify law enforcement will also have a significant impact on Wisconsin's future fiscal health. Since the late 1980s, the Wisconsin legislature has stiffened penalties, instituted longer sentences, and restricted the use of parole.³ As might be expected, the collective impact of these policy changes has been a rapid increase in the state's prison population.⁷ Current projections by the Department of Corrections indicate that the adult prison population will increase at an annual rate of 9.390 over the next few years.⁵ In light of this rapid growth in the state's prison population, it is not surprising that corrections has been the most rapidly increasing portion of the state budget and, according to current projections, will consume an increasing portion of the state budget in future years.

In order to assess the budgetary consequences of the state's joint commitments to property tax relief and the increased incarceration of criminals, Reschovsky (1996b) calculated the amount-of money

the state would need annually between now and 2005 to meet these commitments while simultaneously maintaining other **state** government services at their current levels. Reschovsky's report then compared these spending projections to estimates of the revenue the state will have available each year if it makes no changes in current tax rates. The results of these calculations indicate that in each year from now through 2005 the amount the state will need to spend to meet its policy commitments and maintain the current level of state services exceeds available revenues. (These gaps between spending and revenues are referred to as *structural deficits*.)

According to these calculations, by the year 2002 the size of Wisconsin's structural deficit will be about 10% of general fund revenues.⁶ These estimates assume that the federal government will maintain current levels of aid to state and local governments. To the extent that state aid is reduced in future federal budgets, Wisconsin's structural deficit may grow even larger.

States have three basic options in dealing with structural deficits. First, they can search for ways to make government operate more efficiently. To the extent that states can find inefficiencies, they will be able to cut spending while maintaining current levels of public services. But if efficiency gains are not possible, states can choose to cut public services by reducing expenditures below the level required to maintain the current mix and level of services. If this approach is unacceptable, then states have the option of maintaining services by raising additional revenues. As noted above, this paper addresses the question of increasing revenues for the purpose of closing the state's structural deficit. As the long-term structural deficit has been estimated to be equal to about 10% of general fund revenues, the policy recommendations presented in this paper will be based on the assumption that a political decision has been made to enact revenue increases of this magnitude. Under current law, fiscal year 1999 general fund tax revenues are projected to be about \$9.6 billion. Thus, the goal in this paper is to raise \$960 million in additional general fund revenues in fiscal year 1999.

Evaluative Criteria

Crafting tax policy requires that one strike a balance among a set of goals that often conflict with each other. In suggesting specific ways in which to raise additional state revenue, this report considers each proposal in terms of the following criteria:

Economic efficiency - Taxes create inefficiencies to the extent that they distort behavior by encouraging individuals or businesses to take certain actions just to avoid taxation. For example, taxes on wages may lead people to work fewer hours, while a sales tax on a product may lead some individuals to reduce their consumption of that good.

All taxes used by governments have impacts on behavior. The goal in tax policy, then, is to choose a set of taxes that, given other goals, minimize the amount of distortions. One way to achieve this end is to utilize as broad a tax base as possible. Thus, in the case of an individual income tax, income from as many sources as possible should be subject to taxation. In the case of a sales tax, the ideal tax base includes the purchase of all goods and services used in final consumption.

Simplicity — All taxes generate compliance costs and administrative costs. Everything else being equal, taxes that are simple to understand and collect are preferable to taxes that are complex from the standpoint of the typical taxpayer and difficult to collect.

Vertical equity -Vertical equity refers to the degree of *progressivity* in the tax system. A progressive tax is one in which higher-income families face higher tax burdens (taxes relative to income) than lower-income families. Conversely, a regressive *tax* is one in which the highest burdens fall on those with the lowest incomes. The most recent comprehensive study of the distribution of tax burdens in Wisconsin, which was released by the Wisconsin Department of Revenue and based on 1974 data, concluded that the state tax system was mildly regressive (Wisconsin Department of Revenue 1979).⁷ A recent study of the distribution of tax burdens on nonelderly married couples in Wisconsin concluded that in 1995 the combined burden of the individual and corporate income taxes and sales and excise taxes was slightly progressive over the bottom half of the income distribution and regressive over the top half (Etthnger et al. 1996).

In evaluating the proposed tax increases, it is important to ask how the entire package influences the distribution of tax burdens, rather than focusing on any single tax's distributional impact.

Horizontal equity- While vertical equity calculations involve comparisons of tax burdens of individuals with different levels of income, horizontal equity focuses on comparing the burdens faced by individuals with similar levels of income. Thus, an income tax system that taxed income from different sources at different rates might be considered horizontally inequitable.

Revenue-Raising Proposals

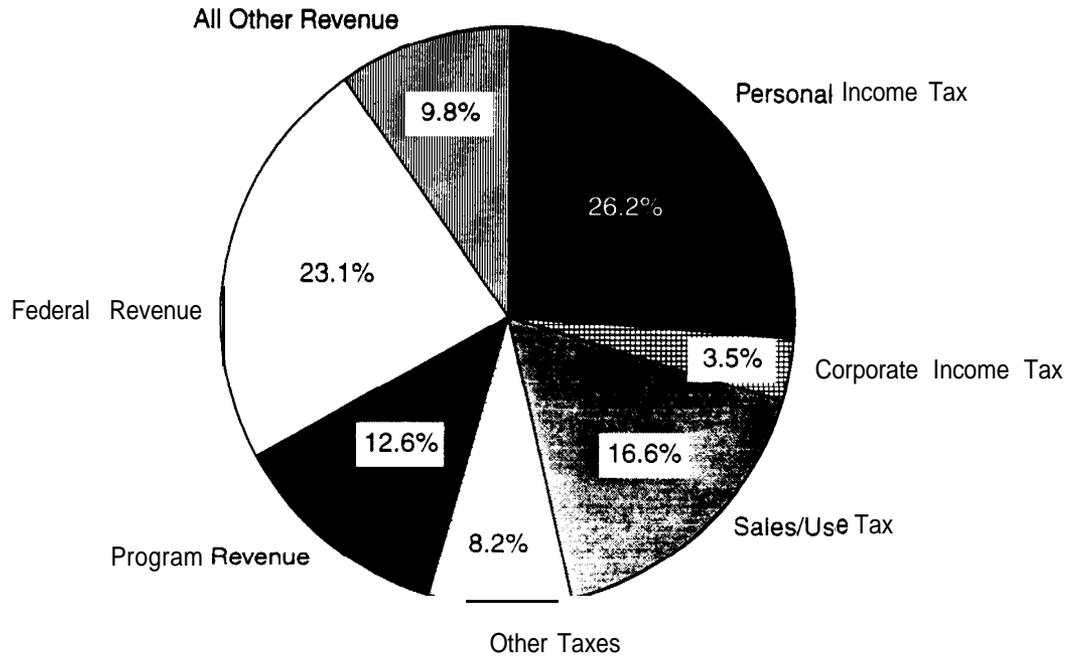
Existing Sources of Revenue

Before turning to specific proposals for raising revenue, it is important to review how state government is financed in Wisconsin. During the 1997-99 biennium, state government revenue from all sources is expected to total \$37.4 billion. **Figure 1** shows that taxes account for slightly over half of all revenue, federal grants for nearly another quarter, and the rest from charges and fees (called program revenues), as well as from miscellaneous sources. The data in Figure 1 include general fund revenues used to finance most state spending, plus revenues in "segregated" funds used for special purposes. The largest segregated fund is the transportation fund, which is used to finance highway construction and maintenance. Smaller segregated funds include the conservation fund, the petroleum inspection fund, the recycling fund, the clean water fund, various state employee pension funds, the veterans mortgage loan fund, the patients compensation fund, and the lottery fund.⁸ Expenditures from these funds are tightly restricted, and, with the exception of pension and loan funds, fund balances at the end of fiscal year 1997 were quite small. Thus, tapping these funds as a source of general-purpose revenues appears highly unlikely.

With the exception of revenue from the gasoline excise tax, all tax revenue goes into the general fund. **Table 1**, which lists the estimated revenue under current law for each of these taxes for fiscal year 1999, indicates that slightly over half of general fund tax revenue comes from the individual income tax

FIGURE 1

Wisconsin Revenue Sources, 1997-99 Biennial Budget



Source: Wisconsin Legislative Fiscal Bureau (1997d).

and a third comes from the general sales and use tax. The fact that these two taxes account for nearly 85% of total general fund tax revenue implies that any significant increase in tax revenues must, for all practical purposes, come in large part from these two taxes.

Summary of Proposals

Table 2 provides a summary of this report's proposals for raising \$960 million dollars in additional revenue in fiscal year 1999. Nearly half of the additional revenue comes from broadening the individual income tax base and adding three additional tax brackets and rates. Almost another third comes from broadening the sales tax base to include a number of personal and professional services purchased by individuals as well as from a one-quarter percentage point increase in the sales tax rate. About 6% of new revenue comes from an increase in the corporate income tax rate, and another 8% would be generated from increases in excise taxes on motor vehicle fuels, tobacco products, beer, liquor, and wine. Finally, nearly 8% of the new revenue is derived from increases in various fees and charges.

The rest of this section describes each proposed revenue change in detail and indicates why each proposal has been included as part of the overall revenue-raising package. Although each proposed

TABLE 1
Estimated General Purpose Tax Revenues,* Fiscal Year 1999

Tax	Amount (\$ millions)	Percentage of Total Taxes
Individual income	\$4,976.8	51.6%
General sales and use	\$3,194.3	33.1%
Corporate income	\$666.9	6.9%
Excise		
Cigarette	\$254.5	2.6%
Liquor and wine	\$30.5	0.3%
Beer	\$9.0	0.1%
Tobacco products	\$9.0	0.1%
Adult entertainment	\$1.5	0.0%
Other taxes		
Public utility	\$269.9	2.8%
Insurance	\$93.5	1.0%
Estate and gift	\$45.0	0.5%
Pari-mutuel	\$2.7	0.0%
Miscellaneous**	\$85.6	0.9%
Total GPR taxes	\$9,639.0	100.0%

*In addition to GPR taxes, the state expects to collect \$766 million in motor fuel excise taxes in fiscal year 1999.

**Includes \$40 million in expected revenue from a tax amnesty program.

Source: Wisconsin Division of Executive Budget and Finance (1997b), Table 8 adjusted for changes attributable to Senate Bill 361.

TABLE 2
Summary of Proposals to Raise \$960 Million in New Revenue in Fiscal Year 1999

Proposal	Estimated Revenue (\$ millions)	Percentage of Total
Broaden income tax base	\$150.1	15.6%
Change income tax rates and brackets	\$296.6	30.9%
Increase the corporate income tax rate	\$52.5	5.5%
Expand sales tax base	\$146.3	15.2%
Goods (\$18.6)		
Personal services (\$77.2)		
Professional services for individuals (\$50.5)		
Increase in sales tax rate	\$158.9	16.6%
Increase excise tax rates	\$80.7	8.4%
Increase user fees	\$75.0	7.8%
Total Proposed Tax and Fee Increase	\$960.1	100.0%

change will be considered separately, they should be evaluated as a complete package designed to address concerns about both tax equity and economic efficiency.

Broadening the Income Tax Base

This author's proposal includes broadening the income tax base by eliminating the existing 60% capital gains exclusion (\$125 million); adopting 1994 changes in the federal income tax that raised the proportion of Social Security benefits subject to taxation for certain moderate- and high-income taxpayers (\$21 million); and following federal government practice of subjecting 100% of unemployment compensation to taxation (\$4 million).⁹ These changes would produce \$150 million in additional revenue for the state.

Eliminate the 60% capital gains exclusion. As part of the Tax Reform Act of 1986 (TRA86), Congress eliminated the capital gains exclusion and began taxing 100% of realized capital gains. By excluding a portion of capital gains from taxation, capital gains were effectively taxed at a lower rate than other sources of income. There were two important reasons for the elimination of the capital gains exclusion. First, lower rates on capital gains introduced substantial economic inefficiencies by motivating taxpayers to pursue unproductive activities solely because these activities enabled them to convert ordinary income into capital gains. Second, the partial exclusion of capital gains also resulted in a substantial reduction in the income tax's progressivity, as a large share of all capital gains were realized by taxpayers with quite high incomes.

Most states followed the federal lead and subjected all realized capital gains to taxation. In fact, of the 43 states with an individual income tax, only five states, including Wisconsin, allow for a partial exclusion of realized capital gains (Wisconsin Department of Revenue 1996b). No state has a more generous tax treatment of capital gains than Wisconsin, which allows taxpayers to exclude from income 60% of capital gains on assets held for longer than a year.

The principal argument made in support of the exclusion is that, by lowering the effective tax rate on capital gains, Wisconsin will encourage individuals to invest in Wisconsin businesses, thereby spurring state economic growth. By providing a favorable tax environment, it is hoped that Wisconsin will be particularly attractive to entrepreneurs, whose returns on investments tend to come primarily in the form of capital gains.

The argument that a large capital gains exclusion spurs economic growth is often accepted as a matter of faith. There are, however, several reasons why such faith should be questioned. First, a capital gains exclusion is an extremely inefficient mechanism for encouraging economic growth in Wisconsin. Only a very **small** portion of realized capital gains are related in any way to new or recent investments in Wisconsin. For example, realizing a gain on the sale of 100 shares of IBM stock or from the sale of an antique necklace has no direct impact on new investment activity in Wisconsin.¹⁰ It is also important to note that a substantial portion of direct investments in Wisconsin businesses come from banks, pension funds, and other businesses that are not subject to the individual income tax and hence receive no benefit from the capital gains exclusion. Second, there is recent evidence that, in the long run, the rate of capital gains realizations are not very sensitive to tax rate differences (Burman and Randolph 1994). Further-

more, in an economy such as Wisconsin's, where growth is constrained by slow growth in the labor force, little is to be gained by subsidizing capital investments.

The capital gains exclusion also has the effect of reducing the progressivity of the individual income tax. Data indicates that a small group of upper-income taxpayers—the 5.4% of 1993 income tax returns with adjusted gross incomes of over \$75,000—received over half of the tax benefits from the 60% exclusion of net capital gains (Wisconsin Department of Revenue 1996b).¹¹ Eliminating this exclusion will serve to make the individual income tax more progressive.

Capital gains exclusions are often touted as a way to reduce the tax burden resulting from the sale of one's house. It should be pointed out, however, that the Taxpayer Relief Act of 1997 ended the federal taxation of capital gains from the sale of a principal residence for nearly all taxpayers.¹² With Wisconsin's recent adoption of these provisions of the federal legislation, the taxation of gains from owner-occupied housing in Wisconsin will be effectively eliminated.

A final advantage of eliminating the capital gains exclusion is that it will simplify the Wisconsin individual income tax.¹³ Under current law, any taxpayer with capital gains or losses must adjust his or her federal adjusted gross income to reflect the impact of the exclusion. This adds considerable complexity to the calculation of tax liabilities, and requires the completion of two additional tax schedules (Schedules 1 or 2 and Schedule WD).

Adopt 1993 federal changes in the taxation of Social Security benefits. In 1984, Congress enacted legislation mandating the partial taxation of Social Security benefits. Starting in 1985, the federal government started taxing 50% of Social Security benefits for middle- and high-income taxpayers with incomes above a certain level, a tax policy that Wisconsin subsequently adopted. In 1994, Congress passed further legislation that subjected 85% of Social Security benefits to taxation for a relatively small number of elderly taxpayers whose income was above new higher income thresholds (\$34,000 for those filing single returns and \$44,000 for those filing joint returns). To date, Wisconsin has not adopted these recent federal changes.

There are two reasons why Wisconsin should follow the federal lead. First, taxing Social Security benefits in the same way as the federal government will simplify the filing of income taxes for elderly taxpayers. Second, only a small number of relatively high-income elderly taxpayers would pay higher taxes. Calculations have shown that for the current generation of elderly, Social Security payroll taxes account for only about 15% of benefits received (Leimer 1994). The taxation of 85% of Social Security benefits for the high-income elderly would simply treat income from Social Security benefits similarly to income from private pensions. To relieve any undue hardship, Wisconsin could phase in the adoption of this policy.

End partial exclusion of unemployment compensation benefits. Prior to 1986, both the federal government and Wisconsin excluded a portion of unemployment compensation from federal and state income taxation, respectively. Upon passage of the Tax Reform Act of 1986, the federal government began taxing 100% of unemployment compensation. Wisconsin, however, has retained the partial exclusion.

There are several reasons why Wisconsin should eliminate this exclusion. First, the closer Wisconsin's definition of adjusted gross income is to that of the federal government, the easier it will be for Wisconsin taxpayers to calculate their state income taxes. Second, the partial exclusion of unemployment compensation is unfair to some taxpayers because it can result in situations where two individuals with identical earnings will face different net wage replacement rates. Any dollar amount of tax-free unemployment compensation will result in a higher net replacement rate if the initial wage earnings are subject to state income taxation. **Earnings—even** those from low-wage jobs are more likely to be subject to taxation if a taxpayer has other sources of income, such as the earnings of a spouse. Thus, the partial exclusion of unemployment compensation is likely to provide the smallest benefits to taxpayers with no other sources of income. Eliminating the tax-exempt status of unemployment benefits should not impact families with low incomes since they are the ones protected from paying income taxes by the standard deduction and, effective in calendar year 1998, the newly enacted Working Families Tax Credit.¹⁴

Changing Income Tax Rates and Brackets.

Wisconsin's individual income is based on a tax rate structure that uses only three rates. (The current tax rates and brackets are listed in **Table 3.**) The rates are applied to *taxable income*, which is determined by subtracting a standard deduction (that declines as income rises) from total income subject to taxation (referred to as Wisconsin adjusted gross income).

Between 1987 and 1997, the rate structure remained unchanged, and neither the brackets nor the rates were indexed for inflation. As part of the 1997-99 biennial budget, the legislature reduced the income tax rates by 1% beginning with the 1998 tax year, lowering the previous top rate of 6.93% to 6.87%. Starting in tax year 1999, the standard deduction and the income tax brackets are to be adjusted annually to reflect inflation as measured by changes in the consumer price index.

According to the Wisconsin Department of Revenue (1996a), the share of taxable income subject to the top rate has risen from 45.2% in 1987 to 60.0% in 1995. As a larger proportion of income is subject to a single rate, the progressivity of the income tax declines. In a recent study, Reschovsky and Reuter (1997) compare the distribution of income tax burdens among nonelderly married couples in 1975 with the distribution of burdens in 1995. The study concluded that the progressivity of Wisconsin's individual income tax has been reduced over the past two decades, mostly in the top half of the income distribution.

As a means of both raising revenue and increasing the progressivity of the individual income tax, this author proposes repealing the recently enacted 1% rate reduction and adding three additional rates to the income tax. An across-the-board percentage reduction in income tax rates reduces the progressivity of Wisconsin's income tax system. As incomes rise, taxes claim an increasing share of income. As a result, an equal percentage reduction in tax rates translates into larger percentage reductions in taxes relative to income for rich taxpayers than for poor taxpayers. In fact, for those with low enough incomes to have zero positive income tax liabilities, a rate reduction results in no tax savings. In addition to restoring tax progressivity, repealing the 1% rate reduction will raise revenues by \$50 million in 1998 and by increasing amounts in future years."

TABLE 3
Wisconsin Individual Income Tax
Tax Rates and Brackets for 1998

Taxable Income Brackets		Marginal Tax Rates
Single	Married-Joint ¹	
\$0 - \$7,500	\$0 - \$10,000	4.85 %
\$7,500 - \$15,000	\$10,000 - \$20,000	6.48 %
Over \$15,000	Over \$20,000	6.87 %

¹Married-separate tax brackets are one-half the width of married-joint brackets.
Source: Wisconsin Department of Revenue, Wisconsin *Tax* Bulletin, November 1997.

The additional income tax rates and brackets are shown in **Table 4**. **The** top rate would be increased by one-and-a-half percentage points to 8.43%, with that rate applying to taxable incomes over \$75,000 for individuals filing single returns and to incomes over \$100,000 for married couples filing joint returns.”

One objection to raising the top rates of the income tax is that it will hurt the state’s economy by making it harder to attract new business and more difficult to retain high-skilled (and highly paid) workers. This issue—the relationship between economic growth and the level of taxation—is not only of great concern to policy makers but has been the subject of a large number of empirical studies by economists.” After reviewing this literature, Michael Wasylenko (1997) concludes that the evidence suggests that, on the whole, taxes do not have a large effect on employment growth and firm location among states. There is strong evidence that neither individuals nor business firms look at taxes in isolation. Rather, taxes are considered in light of the mix and quality of the public services they finance. As long as Wisconsin continues to provide high-quality public services and finances them with a mix of taxes not strikingly out of line with that in other states, it is unlikely that a modest increase in marginal income tax rates in Wisconsin will have a negative impact on economic activity within the state.

In the **mid-1970s**, the top marginal income tax rate in Wisconsin was 11.4%. Over the following decade, it was reduced to its current level. As a consequence, the majority of states with individual income taxes now impose a higher top marginal rate. Even if Wisconsin raises its top marginal rate to 8.43%, it is important to point out that this rate will be below the top rates in two neighboring states: Iowa (9.98%) and Minnesota (8.5%).¹⁸

The impact of higher marginal tax rates (and the full taxation of realized capital gains) will be offset to some degree by the fact that Wisconsin taxpayers who itemize deductions on their federal income tax returns can deduct state income tax payments. Internal Revenue Service (1994) data for 1993

TABLE 4
Wisconsin Individual Income Tax
Proposed Tax Rates and Brackets

Taxable Income Brackets		Marginal Tax Rates
Single	Married-Joint	
\$0 - \$7,500	\$0 - \$10,000	4.90 %
\$7,500 - \$15,000	\$10,000 - \$20,000	6.55 %
\$15,000 - \$30,000	\$20,000 - \$40,000	6.93 %
\$30,000 - \$45,000	\$40,000 - \$60,000	7.43 %
\$45,000 - \$75,000	\$60,000 - \$100,000	7.93 %
Over \$75,000	Over \$100,000	6.43 %

*Married-separate tax brackets are one-half the width of married-joint brackets.

indicate that, while only 32.1% of all returns included itemized deductions, nearly 89% of returns with federal adjusted gross income over \$50,000 were filed by itemizers. These data suggest that a large majority of those taxpayers facing the proposed higher marginal rates would be able to reduce their extra state tax liabilities through itemizing. Although precise data are not available, it is likely that the average taxpayer facing higher rates would be able to reduce the net cost of the new rates by about 30%, while the highest-income taxpayers would be able to reduce the net burden of their extra state income tax liabilities by nearly 40%.

Increasing the Corporate Income Tax Rate

In Wisconsin, net corporate income is subject to a 7.9% corporate income tax rate. This author proposes a six-tenth of one percentage point increase in the rate to 8.5%.¹⁹ Given what is known about how businesses respond to interstate tax rate differences, it is unlikely that a modest increase in the corporate tax rate will discourage much business activity within Wisconsin.

Expanding the Sales Tax Base

In a search for additional revenue, the sales tax is an obvious place to look. The state government in Wisconsin relies on the sales tax for a smaller portion of its tax revenue than the average state or any of its four immediate neighbors, Illinois, Iowa, Michigan, and Minnesota (U.S. Bureau of Census 1997). In addition, the sales tax base in Wisconsin is quite narrow, as the state exempts a large number of goods and services from taxation.

The exemption of many services from the sales tax has serious long-run revenue implications for the state. In 1969, when the general sales tax was first adopted in Wisconsin, services played a much

smaller role in the state's economy than they do today. Although no comprehensive data exist on the value of the sales of goods and services in the state, an indication of the growing role of services in the state's economy is provided by data on the share of employment and of earnings used in services production. In 1969, 21% of total employment in Wisconsin was involved in the production of services. By 1996, a third of all employment is in service-producing industries, a share forecast to rise to 35% by the year 2020.²⁰ A similar pattern is observed when tracing the share of earnings originating in service-producing industries. *The fiscal consequences of a growing service sector cannot be ignored—over time, sales tax revenues will fail to keep up with the growth of the economy.*

Not only do exemptions reduce tax revenues and require a higher tax rate to achieve any given revenue goal, they can also distort economic behavior by both businesses and individuals. As an example, the fact that tax preparation computer programs are subject to taxation although the use of tax preparation services are exempt may induce some individuals to use tax preparers rather than purchase tax preparation software.

In designing a retail sales tax, economists nearly always recommend that its base be restricted to goods and services purchased for final consumption. The taxation of intermediate goods and services (i.e., those that will be used directly or indirectly in the production of other goods and services) should be avoided whenever possible. The taxation of intermediate goods and services leads to “pyramiding.” The result of sales taxes being levied on intermediate goods or services is that some goods, those that require multiple stages of production, will be taxed at much higher rates than other goods.

Despite economists' criticism of sales taxes levied on intermediate goods or services, most states, including Wisconsin, do in fact tax a substantial number of business purchases. Aside from the political popularity of taxing purchases made by businesses, it is often administratively difficult to distinguish between household and business purchases of taxable goods and services. In the case of small businesses, it is especially difficult to prevent taxpayers from fraudulently declaring household purchases as business expenditures.

Table 5 provides a proposed list of sales tax base expansions. The first two items, caskets and burial vaults and **newspapers and periodicals**, are goods currently exempt from taxation. Although both these exemptions are undoubtedly politically popular, they are difficult to justify on either efficiency or equity grounds.*

Table 5 also includes a list of personal services that would be subject to the sales tax. The taxation of these personal services would result in an additional \$77 million of tax revenue if adopted in fiscal year 1999.²² In terms of revenue raised, the three most important base expansions are for **bunk account service charges, beauticians and barbers**, and **health and reducing clubs**.²³ Although no precise data are available, none of these base expansions are likely to place substantial hardships on low-income families. It is also likely that, over a broad range of incomes, expenditures on beauticians, barbers, and health and reducing clubs increase as income rises.

This author proposes expanding the sales tax base to cover several types of professional services, but restricting taxation of these services to purchases for personal use. Thus, legal services involved in

TABLE 5
Proposed Sales Tax Base Expansions, Revenue Estimates for Fiscal Year 1999

	\$ Amounts (in millions) ¹
Goods	
Caskets and burial vaults	\$4.4
Newspapers and periodicals	\$14.2
Subtotal	\$18.6
Personal Services	
Automobile and travel clubs	\$1.3
Bank account service charges	\$25.5
Beautician and barber	\$17.9
Coin-operated laundry & dry cleaning services	\$2.3
Cloth diapers and diaper services	\$0.2
Dance and gymnastic studios	\$0.7
Dues to fraternal organizations	\$5.4
Funeral parlor services	\$5.6
Health and reducing clubs	\$7.9
Live bands and orchestras	\$0.2
Pet training and breeding	\$0.7
Veterinary services for pets	\$9.0
Other personal services, NEC	\$0.5
Subtotal	\$77.2
Professional Services for Individuals	
Accounting and tax preparation services	\$2.4
Architectural and surveying services	\$8.7
Computer services	\$6.5
Legal services	\$33.0
Subtotal	\$50.5
Total Sales Tax Base Expansions	\$146.3

Source: Revenue estimates from Wisconsin Department of Revenue (1997) updated for fiscal year 1999 by the author.

drawing up a will or purchasing a house or the use of an accountant to help prepare one's income taxes would be subject to the sales tax. However, legal and accounting services purchased by businesses are considered intermediate services and hence would remain exempt from taxation. Because of the difficulties in differentiating between business and personal use of some services, implementing a sales tax on the personal use of business services may prove to be quite difficult. Policy makers will need to decide whether the possibility of increased fraud is worth the revenue gain from this tax base expansion.?'

Expanding the sales tax base to cover these services will almost certainly increase the progressivity of the sales tax, as these services are primarily consumed by relatively high-income families. As shown in

Table 5, the taxation of four categories of professional services purchased by individuals would raise revenues by \$50.5 million in fiscal year 1999. In order to arrive at these revenue estimates it was necessary to determine what portion of expenditures on each service is accounted for by sales to other business firms and what proportion reflects final demand by households within Wisconsin. To accomplish this task, data were used from a regional input-output model developed by Deller, Sumathi, and Marcouiller (1993).

Increasing the Sales Tax Rate

Tax revenue could be increased by \$159 million in fiscal year 1999 by raising the state sales tax rate from 5.0% to 5.25%.²⁵ Currently, 17 of the 45 states that use the sales tax have state tax rates in excess of 5.25% (Federation of Tax Administrators 1998). Of the four states that share a border with Wisconsin, Iowa has a 5.0% rate, Minnesota a 6.5% rate, Illinois a 6.25% rate, and Michigan a 6.0% rate.²⁶ It is thus unlikely that raising the sales tax rate in Wisconsin will have a noticeable impact on sales by Wisconsin businesses.

Increasing Excise Tax Rates

Wisconsin will raise \$305 million in fiscal year 1999 from excise taxes on beer, wine, liquor, cigarettes, other tobacco products, and adult entertainment as well as an additional \$786 million from the excise tax on motor fuels. **Table 6** lists the current tax rates on these products and this author's proposed increases.

The conventional wisdom is that excise taxes on cigarette and alcohol consumption are highly regressive. Recent evidence, however, indicates that when the incidence of these taxes is calculated using data from more than a single year, the degree of regressivity is reduced (U.S. Congressional Budget Office 1990; Lyon and Schwab 1995; Rogers 1995). Although low-income individuals may still face the heaviest relative tax burdens, there is considerable evidence that by raising the price of consuming alcohol and tobacco products, taxes can discourage use, especially among the young. Cook and Moore (1994) find that for each one cent per can increase in the beer tax, beer consumption falls by 3.4%. In addition, they find that increases in beer taxes also reduce the probability of drinking.

In late 1997, the excise tax on cigarettes was increased by 1.5 cents to 59 cents per pack. Because Wisconsin's rate is now higher than the rates in all but six other states, it is inadvisable to raise the rate further at this time. This author proposes, however, increasing the excise tax on other tobacco products from 20% to 25% of the manufacturer's list price to distributors.

Currently, Wisconsin has an extremely low excise tax on the consumption of beer. At the current rate of 6.5 cents per gallon (equivalent to \$2 per 31-gallon barrel), the tax is lower than the beer tax in all but two states. The median rate is 18 cents per gallon and the highest rate (in South Carolina) is 76.8 cents per gallon (Wisconsin Legislative Fiscal Bureau 1997a). This author proposes doubling the current excise tax on beer. With a new rate of 13 cents per gallon, Wisconsin's rate would still remain considerably lower than the median rate for all 50 states and the District of Columbia.

All revenue from the motor fuel excise tax goes into the transportation fund, which primarily funds the construction and maintenance of highways. The tax rate is currently 24.8 cents per gallon, with the rate set annually to reflect changes in the inflation rate and in gasoline consumption. This author proposes

TABLE 6
Current and Proposed Excise Tax Rates

Product	Current Rates	Proposed Rates
Cigarettes	59 cents per pack	unchanged
Tobacco products	20% of manuf. list price	25% of manuf. list price
Beer	6.5 cents per gallon	13 cents per gallon
Wine	< 14% alcohol, tax=\$0.25/gal. > 14% alcohol, tax=\$0.30/gal.	< 14% alcohol, tax=\$0.45/gal. > 14% alcohol, tax=\$0.54/gal.
Liquor	\$3.25 per gallon	\$3.90 per gallon
Adult entertainment	5% gross receipts tax on sales	unchanged
Motor vehicle fuel	24.8 cents per gallon (indexed)	27.28 cents per gallon (indexed)

Source: Current rates are from Wisconsin Legislative Fiscal Bureau (1997a), modified by changes enacted as part of the 1997-99 biennial budget.

that Wisconsin retain the existing indexing rules but enact a one-time 10% increase in the rate (raising it another 2.48 cents per gallon), with the additional revenue earmarked for the general fund.

The motor fuel tax can be considered a *benefits tax*, as tax payments are related to the benefits one receives from government spending on highways. To the extent that higher gasoline taxes discourage driving, they also play a role in reducing automobile congestion and air pollution. Although gasoline taxes have a number of efficiency-enhancing characteristics, they have been shown to be somewhat regressive, even when tax incidence is calculated on the basis of 11 years of data on gasoline consumption and income (Chemick and Reschovsky 1997). Nevertheless, for a typical low-income driver in Wisconsin, the impact of the proposed excise tax increase will be quite small, increasing total spending by less than \$15 per year.

Increasing User Fees and Charges

The Wisconsin state government will raise approximately \$2.7 billion from fees and charges in fiscal year 1999. These fees pay for a wide range of services provided by the state. Examples of user fees include tuition payments at the University of Wisconsin, charges for health care at state-owned medical facilities, and fees for the use of state parks and other state recreational facilities. In addition, individuals and businesses in Wisconsin pay license fees in order to carry out a wide range of activities, from driving a car to operating as a private detective.

The state increased fees by nearly \$75 million during fiscal year 1997 and by \$43 million during fiscal year 1998. The state budget calls for \$87 million in net fee increases for fiscal year 1999.²⁷ This

author proposes that fees and charges be increased by an additional \$75 million in fiscal year 1999.

This package of fee increases would include a 20% increase in tuition charges by the University of Wisconsin system. To prevent undue hardship on students with limited economic resources, a tuition increase could be coupled with a large increase in student financial aid. Tuition at the University of Wisconsin is quite low relative to that at most of the other "Big 10" universities. For Wisconsin residents, 1997-98 undergraduate tuition and fees at UW-Madison are \$3,240. Among the Big 10 universities, only Iowa charges a lower tuition. Wisconsin's tuition is 23% below the average tuition charged by the other Big 10 universities. A 20% increase in charges would raise resident undergraduate tuition at the University of Wisconsin to \$3,888, a level that is more than \$250 below the *median* Big 10 tuition. Of the \$78 million in revenue generated by the 20% tuition increase, this author proposes allocating \$28 million for additional student aid. The result **would** be a net fee increase of \$50 million. If targeted appropriately, this additional scholarship money could make a university education more affordable for low- and modest-income families.

Conclusion

The purpose of this report has been to develop a package of tax and fee increases that would raise Wisconsin state revenues by approximately 10%. This author has proposed a balanced package that includes increases in all of the major taxes currently used by the state. Despite the fact that the largest dollar increases in the proposal come from the individual income tax, the entire package will result in a small (0.3 percentage point) increase in the share of the income tax in total taxes and a somewhat larger (0.4 percentage points) increase in the share of the sales tax in total taxes.?"

Although data are not available to allow a precise calculation of the distributional impacts of the proposal, an assessment of its individual elements suggests that this package of tax and fee increases will provide a modest increase in the progressivity of the state tax system. Eliminating the exclusion of realized capital gains, the expansion of income tax brackets, raising the top marginal income tax rates, and expanding the sales tax to cover selected professional services will all result in increases in tax burdens faced by taxpayers at the top of the income distribution. On the other hand, increases in sales and excise tax rates and in some user fees will lead to higher burdens on lower-income taxpayers. In the end, the net impact of the entire package of changes will be to shift a greater portion of the overall state tax burden away from low-income taxpayers and toward those with greater ability to pay.

The expansion of the sales tax base to cover some personal and professional services and the expansion of the income tax base to cover all realized capital gains will increase economic efficiency by reducing the incentive of taxpayers to change their consumption or investment choices solely to reduce tax liabilities. On the whole, the proposed tax package should do little to discourage business activity within the state. The tax rate increases have been structured so that Wisconsin retains its strong competitive position relative to neighboring states. By raising sufficient revenues to provide quality public services, Wisconsin should be able to maintain a fiscal environment that will remain favorable to strong economic growth.

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Endnotes

1. The fact that the state's economy is operating at full capacity with unemployment rates near an all-time low means that future growth will have to come primarily through growth in the state's labor force. Projections of relatively slow labor force growth imply that the growth of the state's economy will fall below the national average growth rate in the next few years. See Nichols (1997) for a recent discussion of the state's economic prospects.
2. Wisconsin is indeed a high property tax state. In fiscal year 1993 (the latest year for which these data are available), the ratio of property taxes collected to personal income was 32% above the national average.
3. For example, the maximum penalty for selling less than 10 grams of cocaine was doubled from five to 10 years. The minimum penalty for selling slightly larger quantities of cocaine (10 to 30 grams) was increased from six months to five years. The maximum penalty for certain felonies was doubled from 20 to 40 years, and life sentences without the possibility of parole were mandated for certain repeat offenders.
4. In 1987, 5,968 adults were in Wisconsin prisons; at the beginning of March 1997, the adult prison population had grown to 13,125.
5. In May 1997, the Wisconsin House passed legislation that severely curtails the use of parole in felony cases. Estimates suggest that if this legislation is enacted, the cost of corrections might increase by at least one-third above current projections.
6. Structural deficits of this size are not unique to Wisconsin. See Reschovsky (1996a) for discussion of structural deficits in several other states.
7. The Tax Burden Study concluded that under reasonable incidence assumptions, the state and local tax system was regressive. Excluding the regressive property tax, it appears that distribution of state taxes are regressive, although less regressive than the overall tax system.
8. The lottery fund used income from the state-run lottery to finance a lottery credit that provided property tax relief to homeowners. In late 1996, a circuit court declared the procedure for distributing lottery credits unconstitutional. The state has appealed the court's ruling. If the state loses the appeal, it is likely that the legislature will rewrite the lottery credit distribution procedures so that it can continue distributing lottery credits.
9. The revenue estimates from these income tax base expansions are fiscal year 1996 estimates of "fiscal effects" from Wisconsin Department of Revenue (1997). Because the Department of Revenues estimates of fiscal effects ignore possible behavioral responses by taxpayers to any changes in tax policy, it is likely that the fiscal effects provide an overestimate of the potential revenue gain from tax base expansions. Rather than inflating the 1996 fiscal effects from 1996 to 1999 and then reducing the estimates to reflect reduced revenues because of behavioral responses, I have chosen to use the FY 1996 fiscal effects as estimates of 1999 revenue gains from various tax base expansions.
10. The revenue cost of a capital gain exclusion restricted to gains directly associated with new investment in Wisconsin businesses would be a small fraction of the cost of the current capital gains exclusion.
11. In fact, capital gains are concentrated among taxpayers with very high incomes. The Department of Revenue data indicate that while about one-half of one percent of returns were filed by taxpayers with incomes over \$200,000, this small group of Wisconsin taxpayers received over 27% of the benefit from the capital gains exclusion.

12. See Auten and Reschovsky (1998) for a detailed description of the tax treatment of **capital** gains from the sale of a principal residence.
13. To make the state's treatment of capital gains as simple as possible, the state would need to adopt the federal treatment of capital losses. Under current law, Wisconsin taxpayers can use net capital losses to offset ordinary income up to a **limit** of \$500 per year. Unused capital losses can be carried forward for use in future years. Under federal law, the capital loss limit is set at **\$3,000**. According to the Wisconsin Department of Revenue (1996b), raising the loss limit from \$500 to \$3,000 would reduce revenues by about \$8 million.
14. Some might object to the inclusion of Social Security and unemployment benefits in taxable income on equity grounds. In the context of the package proposed here, such concerns ought to be alleviated to some extent. One must **also** think in terms of a viable strategy for tax reform, namely one that serves an important principle. The principle served here is the traditional one of taxing **all** types of income as uniformly as possible, while seeking to differentiate according to levels of income for the sake of progressivity. Allowing one exception to this principle encourages other exceptions, resulting in a Swiss-cheese tax base requiring higher rates.
15. The Legislative Fiscal Bureau estimates that the 1% rate change will generate over \$200 million in tax revenue by fiscal year 2003.
16. There are good reasons to argue that the new rates should be instituted along with the indexing of tax brackets, the standard deduction, and various credits. Without indexing, taxpayers may be pushed into higher income tax brackets even though their income has not increased once account has been taken for rising prices. Also, as income rises over time, an increasingly large share of all taxpayers becomes subject to the top marginal tax rate. From a political point of view, the major disadvantage of indexing is that it reduces tax revenues by a substantial amount. The Wisconsin Department of Revenue (1996a) estimated that the cost of indexing the tax brackets and the standard deduction would be about \$25 million in 1997. The cost will rise over time. The Department of Revenue estimated that if indexing were implemented this year, the loss of revenue would climb to \$49 million in 1998 and \$74 million in 1999, continuing to grow thereafter.
17. Michael Wasylenko (1997) points out in his recent survey of the economic literature on taxation and economic development that there have been at least 7.5 studies of economic development and firm location that have included an analysis of the role played by taxation.
18. For a comprehensive summary of individual income tax provisions in other states, see Wisconsin Legislative Fiscal Bureau (1997b).
19. As of the beginning of 1996, Iowa's top corporate tax rate was 12%, while Minnesota and Illinois have flat corporate rates of 9.8% and 7.3%, respectively (Council of State Governments 1996).
20. The employment and earnings forecasts are from Woods and Poole Economics (1996).
21. Of the 45 states that utilize a general sales tax, newspapers are taxable in 14 (Legislative Fiscal Bureau 1997c).
22. The revenue estimates come from updating for fiscal year 1999 a set of revenue estimates made by the Wisconsin Legislative Fiscal Bureau (1995).
23. In his 1997-99 biennial budget, Governor Tommy Thompson proposed expanding the sales tax base to include coin-operated laundry and dry cleaning services. The legislature, however, deleted this provision from the budget.
24. For a good discussion of the advantages and disadvantages of the expansion of sales tax bases to services, see Fox (1995).
25. In addition to the state sales tax rate, 48 of the state's 72 counties levy a 0.5% county sale tax. Thus, if the state sales tax rate is raised by 0.255, purchases in the majority of the counties would be taxed at 5.75%.
26. Adding local sales tax rates to these state rates makes the overall rates in neighboring states even higher.
27. **These** fee increases are listed in two memos to the members of the Wisconsin Legislature from Bob Lang, the Director of the Legislative Fiscal Bureau. The number for fiscal year 1997 is included in a memo on tax and fee modifications in the budget, dated August 10, 1995, while the 1998 and 1999 numbers come from a similar memo dated January 28, 1998.
28. For the purposes of these calculations, **total taxes** is the sum of all general fund taxes (see Table 1) and the motor fuels excise tax.

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