

**ISSUES FOR TAXPAYERS
AND TAX ADMINISTRATORS IN THE NEW ECONOMY**

By

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SUMMARY STATEMENT

Wisconsin's state and local tax structure, like those in other states, was developed in an economy centered on the manufacture and distribution of tangible goods. This tax structure is not easily applied to a New Economy in which intangible assets, human capital and the provision of services are increasingly important. A new tax system more in tune with this economy needs to evolve—one that distributes tax fairly among all players so that economic behavior is not distorted and that is simple for taxpayers and tax administrators.

The New Economy is challenging the tax system by making it difficult to define taxable activities and identify where they take place. These challenges are likely to put downward pressure on taxes generally, in particular on property and income taxes on productive property. However, they also offer opportunities for increased cooperation in solving tax problems between business and government, and among governments at various levels.

ISSUES FOR TAXPAYERS AND TAX ADMINISTRATORS IN THE NEW ECONOMY

A NEW ECONOMY....

Throughout most of the 20th century, the economy of the United States was primarily industrial, centered on the production of tangible goods. Production of capital goods used in further production and of final consumer goods continues to expand, yet tangible goods are declining as a percentage of the American economy.

Assuming greater importance are intangible property rights, human knowledge and the provision of services. Such productive assets as software designs that power productive hardware, and inventory management practices that substantially reduce costs are increasingly valuable. Information once printed on paper can now be accessed electronically—and digital databases can be updated more frequently and searched more easily. The New Economy is increasingly knowledge-based and service-oriented.

Convergence, or greater interconnectivity, also marks the New Economy; distinctions that used to be important are blurring. An aspect of this is the globalization of the economy. During the industrial age, new transportation and communication technologies eliminated oceans and mountains as barriers to trade; computer and other information technologies are rendering irrelevant the 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 once available only in tangible form.

Economic distinctions are also blurring. Such sectors as telecommunications, computer technologies and services, and information services are converging due to both technological and economic factors. Fiber optic cable, compared to the copper wire it is replacing, has immense transmission capacity; thus the amount of information that can be sent over the telecommunications network is greatly increasing.

Further, different kinds of messages—text, sound, images and video—are being converted into a common format that can be transmitted electronically. As a result, the telecommunications, cable television and information services companies that once focused on their particular specialty are now bundling previously disparate services into a single package. Each of these types of companies may sell, at a single price, a package that includes local, long-distance and mobile telephone service, paging, messaging, cable TV and other entertainment services, and access to the Internet and to news, financial and other databases. In other words, these companies are increasing their vertical integration and at the same time are in greater competition with one another in a deregulated marketplace.

These technological and economic trends nourish each other. Innovation that increases connectivity and permits technological convergence leads to wider possibilities of exchange and more competition. That encourages greater innovation and makes regulation unnecessary, and these, in turn, promote further competition.

....AND AN OLD ECONOMY TAX SYSTEM

State and local tax structures, in Wisconsin and elsewhere, evolved during the industrial era. They are designed to tax real and tangible property, to tax income generated from the production of goods, to tax the sale of goods transferred between buyer and seller—and for all

these taxes, the property, the production and the sales transaction are generally at a clearly defined physical location.

In the New Economy, property may be intangible; income may be derived from the production of knowledge at multiple locations; and the sale may be of digital information delivered electronically between a buyer and seller who are geographically separated. The existing taxing regime is applied uneasily, if at all, to the New Economy.

The tax system cannot help but evolve with the New Economy—though the transition will not be easy, since it is inevitably political, formed by society's competing values and interests. However, if taxes do not adjust in a relatively timely manner, they will not provide government with sufficient revenues to provide the services demanded of it and they will act as a drag on the economy by distorting behavior and creating nonproductive compliance burdens.

Put another way, the central issue in the debate over taxation of the New Economy is not the level of taxation—though that too is important: taxes must neither be so high as to dampen the functioning of the economy and other dimensions of society, nor so low as to preclude government's role in providing necessary services. Rather it is a question about the mix of taxes that will be used to raise the desired level of governmental resources. The two major issues in this discussion are neutrality and simplicity.

A neutral tax is one that does not alter economic behavior by creating larger tax burdens for one set of companies than for their competitors. For example, Wisconsin has traditionally taxed the transmission of information but not information content. Voice telephone calls, data transmissions via the telecommunications network and Internet access are taxable, while the sale of news and other information accessed electronically are not. With the bundling of content and transmission into a single service, tax administrators and taxpayers are confronted with the thorny problem deciding what is taxable and what is not. Tax neutrality is violated if these services are taxed when provided by companies traditionally subject to tax, like telephone or cable TV companies, but not when provided by emerging companies.

Neutral taxes are called neutral because they are fairly and equally distributed, thus minimizing the distortionary effect taxes have on economic decision making—distortions that tend to make the economy less productive. Taxes that are not neutral interfere with the market place in unintended ways; distortionary taxation essentially substitutes government decision making for that of the market.

For example, current law treats intangible productive assets more favorably than tangible assets. Income tax rules generally permit immediate deduction of the costs of creating intangible assets, but require expenditures for tangible property to be depreciated over several years. The property tax typically does not fall on intangibles, but tangible personal property used in production is often taxed. Such favored tax treatment may encourage over-investment in intangibles and under-investment in tangible assets. The choice is not purely market-driven; government also has an influence, so lower productivity may result.

Simplicity is important because taxes, even if they are neutral, can interfere heavily with the economy if they are too complicated. A complicated tax diverts resources for tax compliance in the case of taxpayers and for tax administration in the case of the revenue agency. These resources could be put to better use in other economic activity. Thus, simplicity is another guiding principle in establishing the tax policy congruent with the New Economy.

In the following sections, I present some specific tax issues emerging with the New Economy.

TAX ISSUES IN THE NEW ECONOMY

1. Where Is the Economic Activity?

Situs, or sourcing, refers to the location at which an economic activity takes place. It is an essential concept in taxation.

Situs rules for the sales tax, traditionally imposed on sales of tangible personal property, focus on the transfer of the property from the buyer to the seller. They do not work well for many of the transactions found in the emerging economy—for example, transactions involving intangible property exchanged by geographically separated buyers and sellers. When an information service in one state sells access to electronic databases to a business whose employees access the information at locations in several other states, where does the sale occur?

Sourcing issues also surface in the taxation of business income, notably in the apportionment to a particular state of the taxable income of a multistate corporation. Wisconsin currently uses a three-factor apportionment formula, based on the corporation's share of its total payroll, property and sales attributable to Wisconsin. The sales factor is the most important of the three factors, double-weighted in the current formula—and the Governor and Legislature are likely to consider making sales the only factor in next year's legislative session. In the New Economy, buyers and sellers are increasingly located in different states. A financial institution in one state may provide loans, credit cards and other services to customers in another state. Does the sale occur in the state where the seller performs the service, or in the state where the buyer utilizes the service?

States' approaches to sourcing rules are likely to be in directions that do not discourage the location of productive activity within their boundaries. The main reason for this is that the assets that are becoming more important in the New Economy—human capital and intangibles—are much more mobile than physical assets. This mobility allows human capital and intangible assets to be more responsive to differences in tax levels, and state tax structures will reflect that responsiveness. The push in several states to increase the importance of the sales factor in the apportionment of corporate income reflects this attitude. It is a way that a state can lower the tax liability of companies that have heavily invested, in terms of property and payroll, within its borders.

2. Where Is the Taxpayer?

Nexus, whether an economic actor has sufficient presence in a jurisdiction so that it can be taxed, is another area where standards developed for an industrial economy are difficult to apply to the New Economy. The traditional tests have been related to physical presence, but companies are increasingly able to conduct business in a state without being physically present there.

One concern among states relates to sales by energy brokers in competitive markets. If consumers are able to purchase energy from an out-of-state broker, state-imposed sales taxes may not apply and use taxes may be difficult to collect. Some states have responded by requiring energy brokers to have physical presence before they are allowed to do business in the state.

Another concern for states is sales taxation of electronic commerce, and this issue is grounded in nexus. In general, sales of tangible personal property by retailers located in Wisconsin to persons in the state are subject to the state sales tax, whether or not the seller and buyer meet in a single physical location to complete the transaction. In such instances, the retailer is required to collect the tax on their sales to Wisconsin consumers. Thus, a mail order sale by a Wisconsin retailer to a Wisconsin customer is subject to tax. The same rule applies to sales over the Internet: a sale by a Wisconsin retailer to a Wisconsin customer via the Internet is subject to the state sales tax.

However, existing nexus standards permit the state to impose the tax on the seller only when it has a physical presence here, and many Internet sellers do not; Wisconsin cannot require them to collect the tax on their sales to Wisconsin consumers. These customers still have a use tax liability on their purchases, but the use tax, especially on household consumers, is largely unenforceable. The loss in state sales tax revenue due to e-commerce is not yet significant, believed to be around \$25 million this year. However, the Department of Revenue estimates that it could climb to \$140 million to \$220 million by 2004. In that same year, the Department expects to forego another \$120 million in tax on sales by mail-order companies and other traditional remote sellers

3. What Is the Tax Base?

The emerging economy may also shrink the tax bases of the property and sales taxes. The property tax in most states is imposed on real estate, and roughly half the states also tax tangible personal property. The intangible assets that are of growing importance are generally not taxed. Tax neutrality argues that productive assets, whether tangible or intangible, should be treated the same. Interstate tax competition will likely preclude increased taxation of intangibles; the more likely scenario is that the property tax burden on tangible productive assets will be reduced. This has already occurred in Wisconsin, with the exemption for computers enacted in 1998.

The sales tax is imposed on the sale of tangible personal property rather than intangibles or services. Many of the services that are taxed are related to property or tied to a specific location, like the rental of a hotel room, the repair of personal property, or the sale of an admission. In the New Economy, products formerly produced in tangible form, such as computer software and games, music, movies, newspapers, magazines, books, and educational materials, are increasingly distributed electronically. In most instances, the tangible products are taxable but when information is digitized and no longer sold in tangible form, but instead accessed electronically by purchasers, taxability becomes questionable.

ONE MORE ISSUE: WE ARE GETTING OLDER

The American population is aging as the baby boom generation approaches the end of its working years and begins to retire. This trend is unrelated to the New Economy, but it too will have a significant impact on government tax and spending policy.

The Department of Revenue's long-term forecast, published in May 2000, anticipates that the growth of the working age population, currently at about 1% per year, will drop to about 0.5% during the first decade of the new millenium. Growth will continue to slow thereafter, and between 2015 and 2024, the working age population is actually expected to decline. At the

same time, the growth rate in the number of persons age 65 or older, currently less than 1% per year, will climb, reaching 3% per year after 2015.

The composition of the tax base will change as a result of these trends. Wages and salaries, currently about 80% of the tax base, will fall to about 70% of the tax base in 25 years. Retirement income, (e.g., pensions, annuities, IRA distributions and social security benefits), and property income, (e.g., interest, dividends and rent), will see their share of tax base rise by the 10 percentage points wages are giving up.

On the expenditure side of the government ledger, services directed at the elderly, such as health care and nursing home care, will consume a growing share of the budget.

IMPLICATIONS FOR TAX POLICY

The New Economy's impact on tax policy cannot be predicted with any degree of certainty—it depends on the direction in which this emerging economy is evolving, and that is not clearly known. Nonetheless, there appear to be some general trends taking place:

1. Taxes in general

It is impossible to say whether the New Economy will push for higher or lower taxes. The downward pressure on business income and property taxes, and challenges facing the sales tax suggest that overall taxes will decline. On the other hand, the New Economy thrives on human capital; this may lead to pressure for increased government spending on education—especially since the working force population and thus the labor supply will grow very slowly, if at all, over the next 25 years. Government spending may also receive a boost from the aging population.

The tax mix will continue a trend in Wisconsin state and local tax collections already evident in the latter part of the 20th century, as the table below shows.

Tax	Percent Distribution of Wisconsin State and Local Taxes, Fiscal Years 1980 and 2000	
	FY 1980	FY 2000
Taxes falling primarily on households		
Individual income tax	29.4%	33.3%
Class A residential property tax	21.1%	21.5%
Sales and use tax	17.5%	20.7%
Subtotal	68.0%	75.5%
Taxes falling primarily on business		
Other property taxes	13.2%	10.4%
Corporate income and franchise tax	6.4%	3.6%
Subtotal	19.6%	14.0%
Other State and Local Taxes	12.4%	10.4%

Taxes falling primarily on households have risen from 68% to 76% of the total state and local tax burden. The share attributable to individual income taxes rose about four percentage points, to 33%. Part of this is the result of a one-time effect from repeal of the school property tax credit for tax year 1999 to partially fund the sales tax rebate. This had

the effect of raising income taxes in FY 2000. The property tax credit has been restored, and together with restoration of indexing, rate cuts, and standard deduction and personal exemption increases, are likely to reduce individual income tax shares in the future. The sales and use tax rose three percentage points, to 21% of the total, due to an increase in the state sales tax rate to 5% in 1982 and imposition of a local 0.5% tax by about three-quarters of the state's counties.

Relative to total taxes, the residential property tax burden has stayed relatively constant. However, residential property taxes are an increasing portion of the property tax because taxes on manufacturing, commercial and other nonresidential property have declined in importance. In 1980, the taxes on nonresidential property were 13% of total state and local taxes; in 2000, they were 10%. Corporate income taxes have also dropped 3 percentage points. Thus, taxes paid by businesses have declined from 20% to 14% of the total—a substantial drop of nearly 30% in its share. The reduction in business taxes is the state's response to increasing interstate competition and the desire to avoid being distinctly different from other states in ways that are viewed as negative by the business community.

Other state and local taxes, such as motor fuel, excise and utility taxes, declined from 12% to 10% of the total.

2. Property taxation

The current exemption for intangible assets is likely to continue, and this will apply pressure toward lower property taxation of other productive assets, notably personal property.

3. Income taxation

The mobility of human capital and intangible assets will put downward pressure on taxes imposed on these productive factors, and the principle of tax neutrality will encourage reduction in taxes on capital income generally. Further, taxing jurisdictions will try to structure their taxes to encourage location of all types of productive assets within their boundaries. Increasing emphasis on the sales factor in apportioning the income of multistate corporations is an example of this trend.

4. Sales taxation

States will try to ensure tax base equity by including more services and digitized products. They will also continue efforts to impose collection responsibilities uniformly—on traditional brick and mortar retailers, and on Internet, mail-order and other remote sellers alike.

5. Tax Simplification and Other Cooperative Efforts

The global economy will increase the pressure on taxing jurisdictions to harmonize their tax systems. These jurisdictions will want to collect sufficient revenue to finance the contribution they are expected to make to society, but they will also not want to place themselves at a competitive disadvantage relative to other jurisdictions. The Streamlined Sales Tax Project is an example of cooperation among taxing jurisdictions that will become more prevalent.

Wisconsin and thirty-nine other states are members of the Streamlined Sales Tax Project. The Project seeks to reduce the costs and burden of sales tax compliance for participating sellers to as close to \$0 as possible. The Project would simplify laws and administrative

practices and incorporate the use of technology in the administration and collection of the tax. The goal of the project is to design and implement a simplified sales tax system that can be used by traditional brick and mortar vendors as well as vendors involved in e-commerce.

There will be other opportunities for partnership as well: between government and business, and between federal and state governments. A number of efforts between government and business are already underway—several relating to the taxation of electronic commerce and another regarding the income and sales taxation of telecommunications. And, since the challenges facing the states in terms of appropriate tax treatment of the New Economy are national and international in scope, this will require a joint solution between the states and the federal government.

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