Racine County, Wisconsin

County Tax Structure: Sales Tax Policy Report

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Introduction

State and local governments rely on tax revenue to provide government services to residents and businesses. While there are many types of taxes, there are three primary taxing methods:

- Tax **income**, which is mostly individual or corporate income taxes.
- Tax **consumption**, which are both general sales and use taxes as well as specific excise taxes (such as those on motor fuel, alcohol, and tobacco products).
- Tax **wealth**, which includes estate and inheritance taxes, taxes on luxury or high value items, and real property taxes.

For decades, local government (including county) tax structures have been dominated by the real property tax. There are a variety of reasons for this, including:

- Broad base of taxable real property.
- Generally stable tax collections, as real property tends to appreciate in value throughout most business cycles.
- Difficult to evade, as the property is immobile, evident, and can be seized for non-payment of taxes.

While the advantages of the real property tax are notable, there are concerns as well:

- While classified as a form of wealth tax, the rise of middle-class home ownership over the last 100 years has made the wealth connection less concrete.
- The general (and recently rapid) appreciation in home values means that homeowners on a fixed income may not be able to afford ever increasing property tax bills.
- Taxpayers have no control over the amount of the tax. Unlike sales taxes and income taxes, which are determined by taxpayer actions, the property tax is based on property value, and taxpayers have little opportunity to change that – other than to move.

As a result, property taxpayers tend to view the tax unfavorably. A recent report by the National Conference of State Legislature notes that "For years, opinion surveys have identified property taxes as the ones Americans hate the most."[1]

This unpopularity is not lost on state and local policymakers. Many local government elected officials will resist increases in real property tax rates, and many state government elected officials will enact various forms of property tax limitations, including caps on increases in rates, levies, revenues, or changes in assessments. Nearly every state has one or more real property tax limitation in place, including the state of Wisconsin.[2]

Racine County contracted with PFM Group Consulting, LLC (PFM) to conduct an analysis of the County's revenue structure, with a specific focus on the potential implementation of a local option sales tax. PFM's analysis relied on Racine County's financial reports and budget documents, additional data and information provided by the County, and nationwide data and information related to county revenue structures and best practices.

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[1] "The Most-Hated Tax—and What States Are Doing About It," National Conference of State Legislatures, July 24, 2023, accessed electronically at https://www.ncsl.org/fiscal/the-most-hated-taxand-what-states-are-doing-about-it
[2] The Lincoln Institute of Land Policy maintains a database of state property tax limits. https://www.lincolninst.edu/data/significant-features-property-tax/access-property-tax-database/tax-limits-truth-taxation/

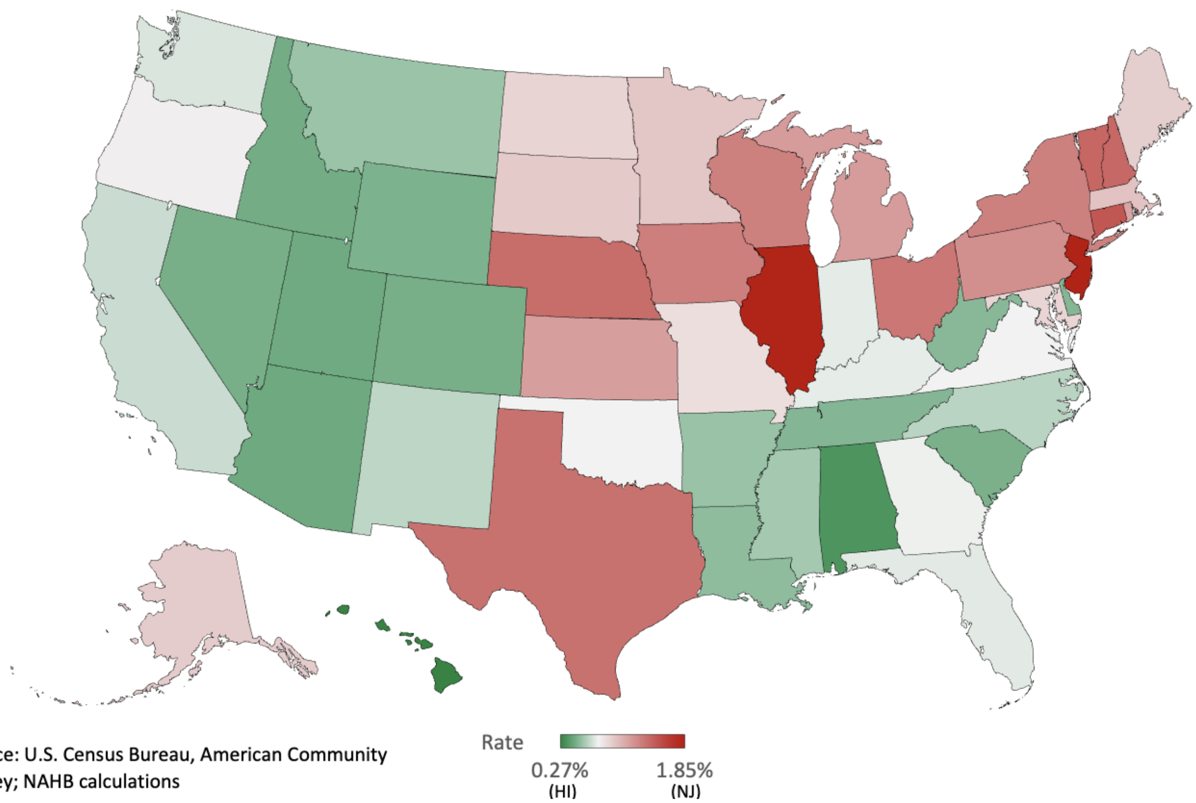
Racine Background

Racine County Background

Racine County, located in southeastern Wisconsin along the western border of Lake Michigan, is home to a population of roughly 198,000, making it the fifth most populous county in the state. Not unlike other counties throughout the United States, Racine derives most of its revenues from intergovernmental grants and contributions (30 percent) and property taxes (27 percent), with own-source revenues driven primarily by property taxes. Despite this reliance, property tax revenue as a percentage of own-source revenues has dropped significantly over the past decade, from 77.8 percent in 2014 to 60.7 percent in 2023. In addition, charges for services have been declining. In 2018, charges for services made up 10.0 percent of total revenue, compared to 6.5 percent by 2023. Parallel to this change, own-source revenue as a portion of total revenues has been declining, from a peak of 64.8 percent in 2018 to 56.1 percent in 2023.

Overall, these shifts in revenue structure highlight Racine County's increased reliance on other-source revenues over the past five years, partially driven by COVID-related ARPA funding which is set to expire in 2026.

Figure 1: Average Effective Real Property Tax Rates, 2022



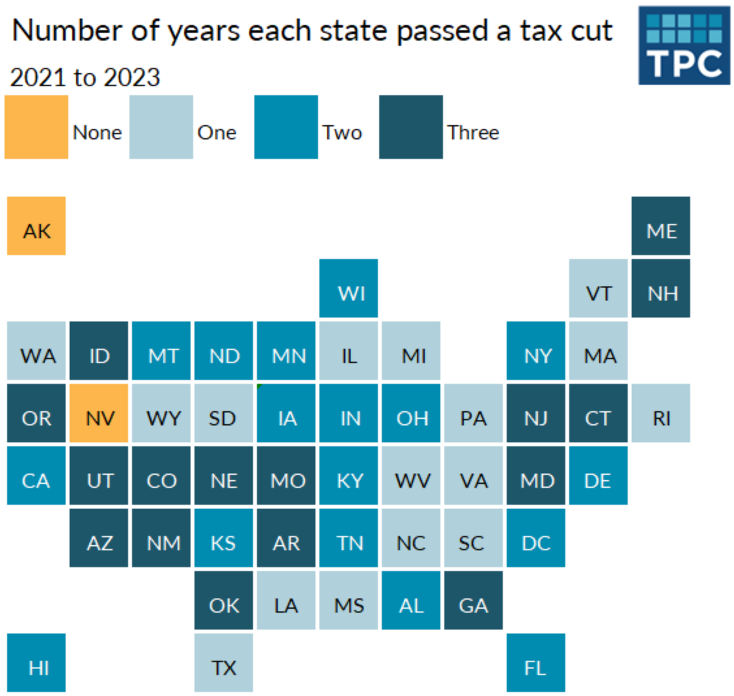
Source: U.S. Census Bureau, American Community Survey; NAHB calculations

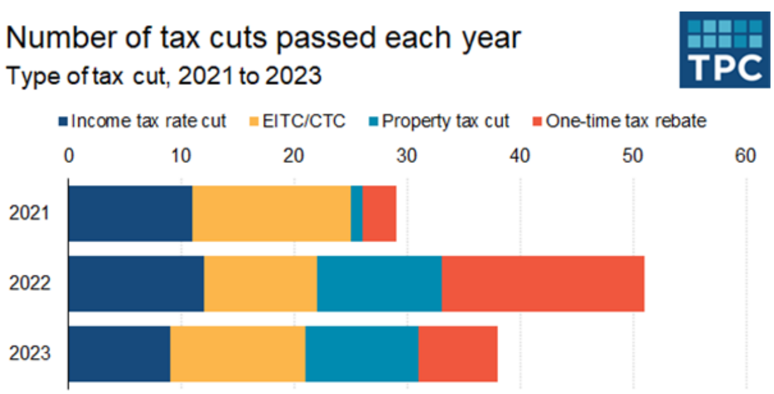
Within Racine County, residential effective property tax rates are 1.89 mills, compared to the actual 2024 county average property tax rate of 2.725 mills.[3] This effective rate suggests that a gap exists between assessed and market values.

[3] "Racine County 2024 Budget," accessed electronically at https://www.racinecounty.com/home/showpublisheddocument/46848/638428279760830000.

Tax Cuts are Reducing State Revenue Growth

Fueled by federal COVID-related funding and a revenue surge related to post-COVID consumer spending, the majority of states have cut taxes in recent years. According to an analysis by the Tax Policy Center, between 2021 and 2023, 32 states and the District of Columbia passed major tax cuts in two of the three years, and 16 enacted tax cuts in all three years.[4]





In the case of Wisconsin, this included a $1 billion income tax cut that was passed in 2021. Based primarily on enacted tax cuts, the state made a $439 million reduction in its biennial revenue forecast in January 2024.[5] Across the states, enacted tax cuts are having an impact on revenue collections. The Urban Institute, which tracks state tax collections on a quarterly basis, noted in September 2024 that preliminary data for the second

[4] Richard C. Auxier, "Reviewing Three Years of State Tax Cuts," Tax Policy Center, July 20, 2023 (https://www.taxpolicycenter.org/taxvox/three-years-state-tax-cuts)
[5] Wisconsin Legislative Fiscal Bureau, January 24, 2024 (https://docs.legis.wisconsin.gov/misc/lfb/revenue_estimates/188_january_24_2024.pdf)

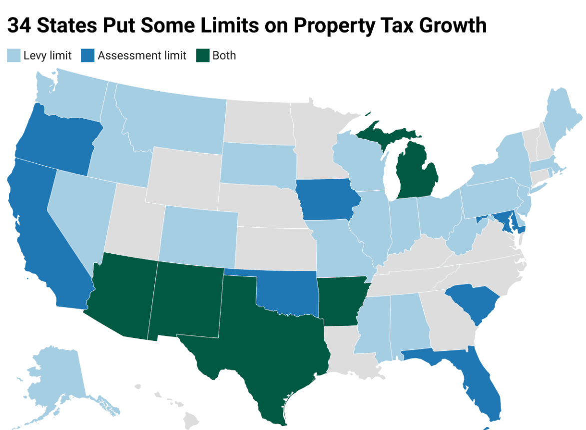
quarter of 2024 indicate continued sluggishness in overall state tax revenue collections for the median state, with modest growth of just 1.0 percent. The report concludes that "The long-term fiscal outlook for states remains uncertain due to several challenges, including volatility in financial and oil markets, higher interest rates, changing consumption patterns, declining labor force participation, and weakening in commercial and residential property markets."[6] This creates uncertainty, given the significant portion of county revenue that comes from the state. States often make reductions to local assistance during difficult budget years, as this does not disrupt state programs.

Besides concerns about state financial support, county governments also have to be mindful of current or future limits on real property taxes. States generally limit real property taxes in one of three ways:

- **Assessment Lim**its: These restrict how much the assessed value of a property can increase annually, regardless of its market value. For example, a state might limit assessment increases to 3% per year.
- **Rate Limits:** These set a maximum property tax rate. With rate limits, even if property values rise, the tax rate cannot exceed a certain percentage.
- **Levy Limits**: These limit the total amount of property tax revenue that a county can collect. In some instances, the levy limit is a percentage increase, which may be increased based on certain conditions (such as new construction).

Wisconsin limits county real property taxes primarily through levy limits. These limits restrict the amount that real property tax levies can increase each year. Specifically, the levy limit is the greater of zero percent or the percentage increase in the county's equalized value due to net new construction in the prior year. Additionally, Wisconsin has provisions for levy limit adjustments. These adjustments can account for specific circumstances such as increased costs for joint fire departments, emergency medical services, or intergovernmental cooperation agreements.

Most states have some form of limit on local government real property tax collections.



Source: realtor.com

Given these circumstances, it is understandable that the County has sought to diversify its revenue structure. The advantages of a diversified structure include:

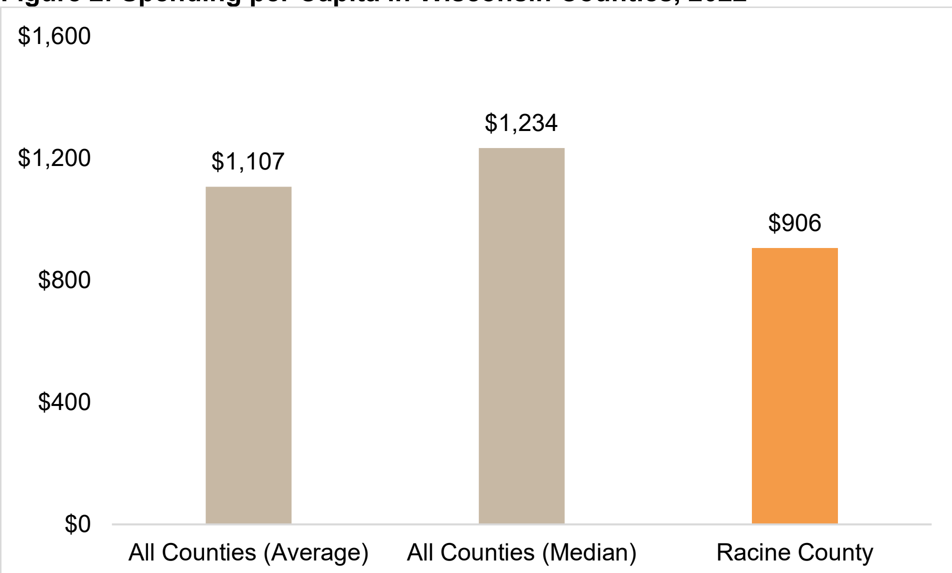
- It limits the negative economic impacts of any single tax. Because taxes will have varied impacts on the type of taxpayer, a diversified structure helps ameliorate negative impacts.
- It manages risk if any single revenue source underperforms.

[6]Lucy Dadayan, "State Revenues Show Sluggish Growth Through the First Six Months of 2024" Urban Institute, September 2024 (https://www.urban.org/sites/default/files/2024-09/STER_2024Q1.pdf).

- It allows the city or state to create multiple economic or community development strategies that could increase tax revenue.

Tightened revenues restrict operating expenditures, with Racine County spending less per capita than other counties, as shown in Figure 2. On average, Wisconsin counties spend $1,107 per capita, compared to just $906 in Racine County.

Figure 2: Spending per Capita in Wisconsin Counties, 2022



Source: Wisconsin County Fact Book 2024; PFM

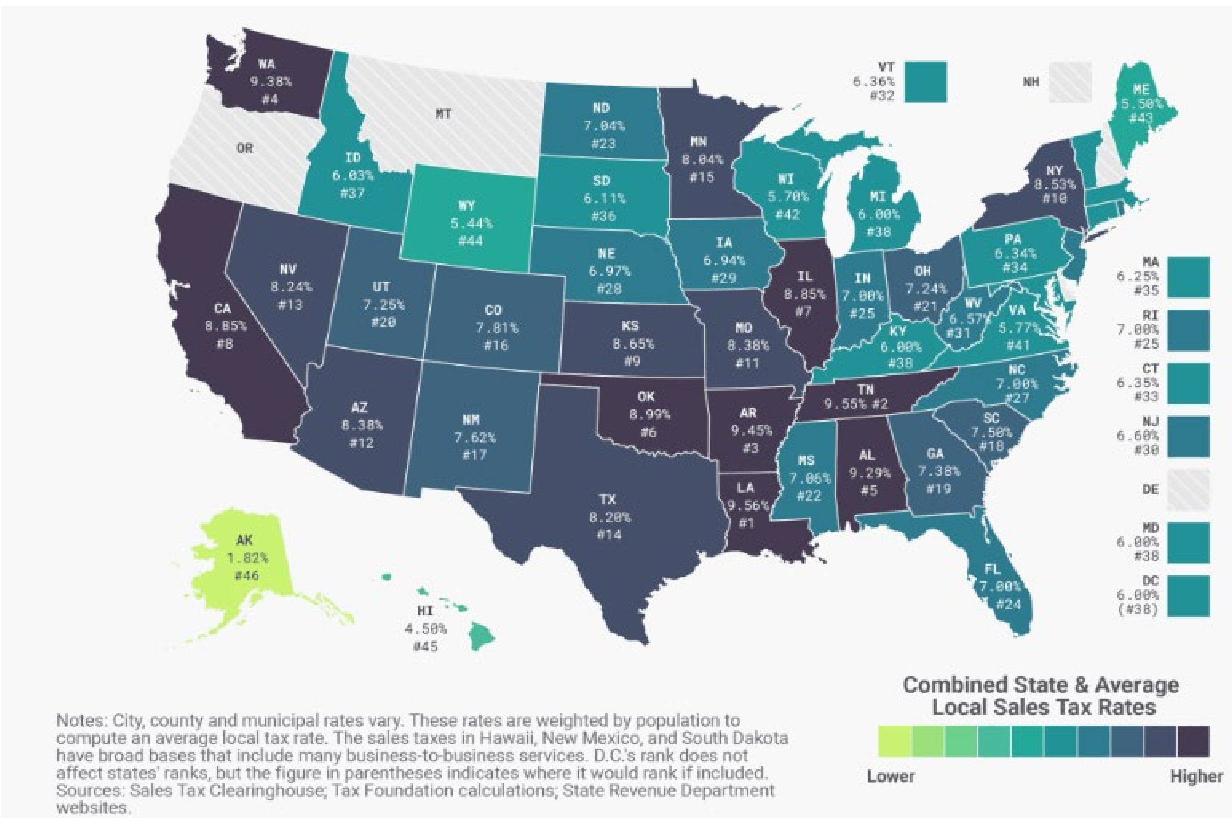
Wisconsin Revenue Structure

Wisconsin Sales and Use Tax

Sales tax is the second largest revenue source for the state of Wisconsin, behind only individual income taxes, and it comprises over one third of State's revenue. Despite this, Wisconsin's sales and use tax rate of 5.00 percent is the 18th lowest among states. Wisconsin grants its counties "administrative home rule power", that is, statutory power to act for the good of the county on organizational and administrative issues. The State has, by statute, granted all counties the right to enact an additional sales tax of 0.5 percent, and 69 of 72 counties have enacted the tax (including Manitowoc County, which approved their local option sales tax in July 2024 and will begin collections in January 2025). The first counties to enact a county sales tax were Barron and Dunn counties in 1986, paving the way for near complete adoption. In 2023, the State granted Milwaukee the right to enact a 2.0 percent sales tax, bringing the average local rate in Wisconsin to 0.70 percent, and the combined state and average local rate 5.70 percent, among the lowest of states with a sales tax. On average, Wisconsin counties that do levy a local option sales tax collect $121 per capita annually.[7]

As shown in Figure 3, Wisconsin's combined sales tax rate is lower than its surrounding states.

Figure 3: Combined State and Average Local Sales Tax Rates, 2024



Source: Tax Foundation

Wisconsin's relatively low combined state and local tax rate is a useful feature and aligns with a common tax axiom to establish the broadest possible tax base and impose the lowest possible tax rate. There is also general consensus around tax policy experts that there is something of a psychological barrier to combined sales and use tax rates going above 10 percent. In fact, there are locations in higher sales tax rate states where that is the case, but they are comparably rare. Wisconsin's existing combined rates gives it both flexibility for the future and reduces some of the economic effects of the tax.

[7] "The Green Book 2024: A book of county facts," Forward Analytics, accessed electronically at https://www.forward-analytics.net/wp-content/uploads/2024/09/2024-County-Fact-Book.pdf.

Revenue Structure Best Practices

Introduction to High Quality Tax and Revenue Systems

There are a variety of authoritative sources that articulate the principles of a well functioning revenue system. While it was primarily meant as guidance for states, the National Conference of State Legislature's Principles of a High-Quality Revenue System' is also useful for local governments. Key elements are highlighted in the following:[8]

- A high-quality revenue system comprises **elements that are complementary**, including the finances of both state and local governments.
- A high-quality revenue system produces revenue in a **reliable** manner. Reliability involves **stability, certainty, and sufficiency**.
- A high-quality revenue system relies on a **balanced variety** of revenue sources.
- A high-quality revenue system **treats individuals equitably**. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
- A high-quality revenue system **facilitates taxpayer compliance**. It is easy to understand and minimizes compliance costs.
- A high-quality revenue system **promotes fair, efficient and effective administration**. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
- A high-quality revenue system is **responsive to interstate and international economic competition.**
- A high-quality revenue system **minimizes its involvement in spending decisions** and makes any such involvement explicit.
- A high-quality revenue system is **accountable to taxpayers**.

The Government Finance Officers Association (GFOA) provides additional insights for the design of a high-quality local revenue system, including adapting to a changing environment, as digitization, globalization, and political and demographic change continue to impact tax bases.[9] Through a series of studies, GFOA identified ways in which local governments do and do not align their revenue structures with modern economic realities, including the rise of non-tangible property, consumer preferences for the purchase of goods versus services, and equity considerations surrounding fine and fee structuring. According to the GFOA, by aligning tax system design to the economic base and assets available, local governments can efficiently and fairly capture maximal revenues.

When considering tax design, there are three primary considerations: the tax base, the tax rate, and the collection rate. Not surprisingly, these weigh heavily on opportunities to revise a tax structure. When identifying tax options to analyze, there are generally four approaches:

1. Create a new tax on income, consumption, or wealth.
2. Increase an existing tax rate.
3. Expand an existing tax base.
4. Improve an existing tax collection rate.

These each will interact in different ways with the previously identified principles of a high-quality revenue system. For example, a new tax may provide for additional variety of revenue sources. At the same time, an axiom of taxation is that 'an old tax is a good tax.' This is because it comes with a greater degree of certainty

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[8] "Principles of a High-Quality State Revenue System," National Conference of State Legislatures, accessed electronically at https://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx

[9] "Rethinking Revenue," Government Finance Officers Association, accessed electronically at Rethinking Revenue (gfoa.org).

– taxpayers are familiar with it, administrative and collection systems are in place, and its economic impacts have already generally been built into business decision making. While this would suggest that raising an existing tax rate would be more beneficial, higher rates may be more likely to influence market decisions.

Improving collection rates on an existing tax should generally align with a high-quality system, as collecting taxes owed is fair, efficient, and effective administration. It often can be accomplished by ensuring that taxes are simple and easy to understand, which facilitates taxpayer compliance. Of course, if improving the collection rate requires a revenue investment that is greater than the additional revenue, it may not be worth the investment.

Expanding the base of an existing tax aligns with the previously mentioned tax axiom that it is beneficial to combine the broadest possible tax base with the lowest possible tax rate. This should improve overall stability, enhance sufficiency, and prevent higher rates that impact on business and consumer decisions. Of course, it will depend on how the base is broadened and whether it impacts on equity considerations.

Tax Policy Principles

The following are generally accepted guiding tax principles:

- **Equity:** Taxes are generally preferable when they fairly distribute the tax burden across taxpayers. Equity is often referred to as taxes 'being fair' according to the relationship between the amount of taxes paid by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government services. Equity is often analyzed based on the relationship to other taxpayers in two ways:
    - <u>Vertical Equity</u>: This occurs when the amount of tax paid by taxpayers with different income levels reflects their respective abilities to pay the tax. This is sometimes analyzed by looking at taxes paid as a percentage of income. Some would argue that this principle is satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. However, for many taxes (such as sales and use taxes), applying the same rate leads to lower income consumers paying a greater share of their income in taxes (because they spend more of their income on taxable goods and services than do higher income households).
    - <u>Horizontal Equity</u>: this occurs when taxpayers who are similarly situated pay a comparable amount in taxes. This principle requires that taxes not be arbitrary or disproportionately benefit or harm a particular group relative to their ability to pay or use public services. Of late, this often relates to businesses that deliver similar goods or services in different ways (for example the on-site versus on-line sale of tangible goods).
- **Sufficiency:** A tax should generate enough revenue to pay for public services without the need for continuous or drastic changes in tax rates or the tax base. Sufficiency is often found in taxes with broad application to a large number and variety of taxpayers.
- **Stability:** A tax should be able to withstand economic and other shocks without leading to dramatic swings in revenue collections. This is often a goal of an overall tax policy to maintain a diversified revenue structure to shelter it from short-run fluctuations in any one revenue source.
- **Economic efficiency:** A tax should minimize its effect on economic decisions. In this respect, the New Mexico Legislative Finance Committee has defined an efficient tax structure as one that has a broad tax base and low rates to "minimize economic distortion and avoid excessive reliance on any single tax."[10] Distortions cause a measurable loss in the economic value of production and

[10] New Mexico Legislative Finance Committee presentation, "Tax Policy Principles and Economic Development Tax Incentive Issues," October 29, 2018, accessed electronically at https://www.nmlegis.gov/handouts/RSTP%20102918%20Item%201%20LFC%20Tax%20Policy%20Principles%20and%20ED%20Incentive%20Issues.pdf

consumption, which increases the tax burden on the resident taxpayers. Economic efficiency concerns are often raised by specific tax rates are significantly higher than in neighboring areas.

- **Ease of Administration and Compliance.** A tax should be readily understood by taxpayers and (relatively) easy to administer. This reduces the cost of compliance and generally improves collection rates. For the government collecting the revenue, it also reduces its administrative costs.

There are often trade-offs among tax principles. While the general principles of taxation are logical – and mostly non-controversial – they will sometimes conflict, and it will be necessary to weigh the costs and benefits of adhering to the principles. For example, most state general sales and use taxes have broad application to the purchase of tangible goods, which will promote revenue adequacy and stability. At the same time, they are more burdensome for low-income households, which will have a negative impact on vertical equity.

Sales Tax and Tax Policy Principles

The following discusses the local option sales tax from the perspective of the previously articulated tax policy principles.

<u>Equity</u>
While sales taxes in general are regressive, they are demonstrably less regressive than property taxes. Further, exemptions for basic necessities like groceries and medications mean that a greater portion of a lower income household's consumption is tax exempt. In terms of horizontal equity, all taxpayers pay the same rate for taxable goods and services.

<u>Sufficiency</u>
Racine County currently foregoes local option sales tax revenue, meaning that implementation of a rate will generate net new revenue to assist in addressing budget strain, with estimate revenues of $20 to $25 million annually. Further, sales taxes offer governments an opportunity to 'import' revenue, or 'export' the tax burden, by applying the tax to both residents and non-residents. Unlike the property tax, visitors to Racine County will be subject to the sales tax, expanding the taxpayer base. Further, by not earmarking revenues for a specific use, Racine County can ensure sufficient revenues to meet unforeseen expenditure pressures and allow it to allocate revenues to their highest and best use.

<u>Stability</u>
Taxes with a broad base tend to be more stable, and that certainly applies to sales taxes. It is true that consumption tends to decline during a recession, and that will reduce sales and use tax collections. Further, a lot of goods and services are somewhat elective and may see a decline during a recession. That said, it is not as subject to broad swings as an income tax.

<u>Economic Efficiency</u>
As previously discussed, there will be border effects with the local option addition to the state rate. That said, some taxable goods and services (such as online purchases, electricity, lawn maintenance, etc.) are not subject to border competition, as they are taxed based on the consumer's place of residence. For some taxable goods and services (such as dry cleaning, movie tickets, etc.), proximity to the consumer may be more important than adding 0.5 percent to the price. It is likely that economic efficiency will at least be no greater than for other revenue-raising alternatives, with the caveat that there is no perfect tax. In general, the sales tax base expansion aligns with tax policy principles.

<u>Ease of Administration/Compliance</u>
Sales and use taxes are in place in 46 states, and there are over 13,000 state and local sales tax taxing jurisdictions within the U.S. As a result, they are readily understood by the taxpaying public and the

businesses that must collect them. Further, the tax is collected by the state, so counties effectively ‘piggyback’ on the existing state administrative structure.

There are other advantages of the sales tax that have some general alignment with these tax policy principles. As noted in the NCSL discussion of a high quality system, adding a sales tax will help provide greater balance to the revenue structure. It will also collect the tax from non-residents to support public services, which the real property tax does not do. Visitors consume county services, including law enforcement and the construction and maintenance of county roads. This provides a method for non-residents to support the services they also consume.

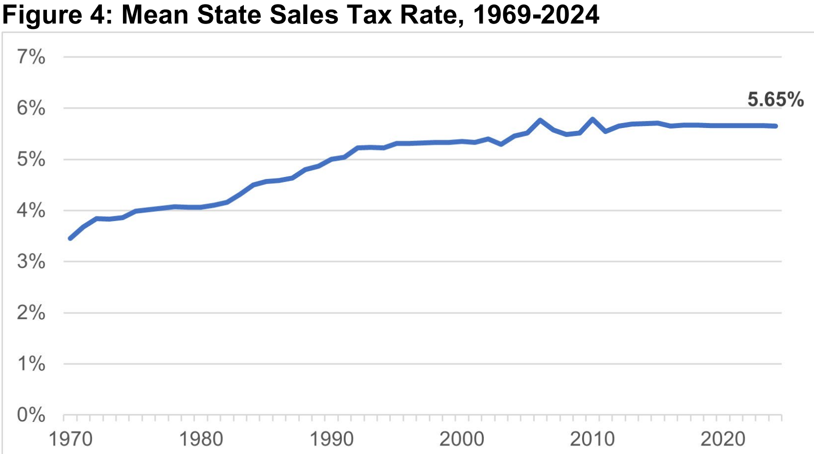
Sales Tax Application

Sales Tax as a Major State Revenue Source

Sales and use taxes are widely used in the U.S., with 45 of 50 states collecting them as their largest or second largest tax revenue source.[11] General sales and use taxes are levied on consumption, which provides a broad tax base. When combined with income taxes, state tax structures can be complementary and raise sufficient amounts of revenue. Because sales and use taxes are collected in literally millions of transactions, they avoid some of the 'pain' associated with income and property taxes, where taxes may be collected infrequently and in large payments.

As previously discussed, the sales and use tax is the second largest tax revenue source for the State of Wisconsin, accounting for 34 percent of its collections in FY 2023. The most common method for increasing tax revenue has been to increase the tax rate, and that has been the case nationally with the sales tax over time. For the sales tax, the rate increases have primarily been a method to maintain overall levels of revenue collection, as both base erosion and reductions in sales tax collection rates have occurred. Figure 4 demonstrates the upward trend nationally in state sales tax rates:[12]

Figure 4: Mean State Sales Tax Rate, 1969-2024



Source: Brookings Institute; Tax Foundation; PFM

It is notable that the state of Wisconsin continues to have a state sales tax rate that is below the mean.

Rise of Local Sales and Use Taxes

Most states allow local governments to collect sales and use tax as well. In total, 38 states allow for local sales and use taxes. The states that do not are split into two groups: those that do not assess state sales and use taxes, and those that assess the tax at the state level but do not allow local sales and use taxes. As noted, five states do not collect a state sales and use tax, and four of those states also do not provide for local sales and use tax (Delaware, Montana, New Hampshire, and Oregon). One of the five (Alaska) allows for local sales and use taxes. There are an additional eight states that have a state sales and use tax but none at the local level (Connecticut, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, and Rhode Island).

[11] The states that do not collect a state sales and use tax are Alaska, Delaware, Montana, New Hampshire, and Oregon (it is notable, however, that Alaska allows local governments to impose the tax). The other major state tax revenue source is the individual/personal income tax, with 41 states imposing that tax. The states that do not are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Alaska and New Hampshire are notable for not having either a state income or sales tax.

[12] Vivean Lea and David Wessel, "The history and future of the retail sales tax," Brookings Institution, July 16, 2018, accessed electronically at https://www.brookings.edu/blog/up-front/2018/07/16/the-history-and-future-of-the-retail-sales-tax/

In fact, sales and use taxes have become the most common local 'second tax' after the property tax. In 2021, local government property taxes raised $609.9 billion of a total of $840.7 billion of local government tax collections. General sales taxes raised the second most, $107.4 billion, followed by individual income taxes ($41.5 billion) and selective sales/excise taxes ($33.4 billion).[13]

As of January 1, 2024, the mean state sales tax rate was 5.65 percent, with a combined state and local rate of 7.16 percent. The table below shows rates and rankings by state. Wisconsin ranks 32nd at the state level and 42nd in the combined state and local category, meaning its state and local sales tax rates are well below the average state.

Table 1: State and Local Tax Rates, as of Jan. 1, 2024

State	State Tax Rate	Rank	Avg. Local Tax Rate	Combined Rate	Rank
Ala.	4.00%	40	5.29%	9.29%	5
Alaska	--	46	1.82%	1.82%	46
Ariz.	5.60%	28	2.78%	8.38%	12
Ark.	6.50%	9	2.95%	9.45%	3
Calif.	7.25%	1	1.60%	8.85%	8
Colo.	2.90%	45	4.91%	7.81%	16
Conn.	6.35%	12	--	6.35%	33
Del.	--	46	--	--	47
Fla.	6.00%	17	1.00%	7.00%	24
Ga.	4.00%	40	3.38%	7.38%	19
Hawaii	4.00%	40	0.50%	4.50%	45
Idaho	6.00%	17	0.03%	6.03%	37
Ill.	6.25%	13	2.61%	8.86%	7
Ind.	7.00%	2	--	7.00%	25
Iowa	6.00%	17	0.94%	6.94%	29
Kans.	6.50%	9	2.15%	8.65%	9
Ky.	6.00%	17	--	6.00%	38
La.	4.45%	37	5.11%	9.56%	1
Maine	5.50%	29	--	5.50%	43
Md.	6.00%	17	--	6.00%	38
Mass.	6.25%	13	--	6.25%	35
Mich.	6.00%	17	--	6.00%	38
Minn.	6.875%	6	1.16%	8.04%	15
Miss.	7.00%	2	0.06%	7.06%	22
Mo.	4.225%	38	4.16%	8.39%	11
Mont.	--	46	--	--	47
Nebr.	5.50%	29	1.47%	6.97%	28
Nev.	6.85%	7	1.39%	8.24%	13
N.H.	--	46	--	--	47
N.J.	6.625%	8	-0.02%	6.60%	30
N.M.	4.88%	34	2.74%	7.62%	17
N.Y.	4.00%	40	4.53%	8.53%	10
N.C.	4.75%	35	2.25%	7.00%	27

[13] "Federal, State and Local Government Revenues by Source, 2021," Urban-Brookings Tax Policy Center, June 30, 2023, accessed electronically at https://www.taxpolicycenter.org/statistics/revenue-government-level

State	State Tax Rate	Rank	Avg. Local Tax Rate	Combined Rate	Rank
N.D.	5.00%	32	2.04%	7.04%	23
Ohio	5.75%	27	1.49%	7.24%	21
Okla.	4.50%	36	4.49%	8.99%	6
Ore.	--	46	--	--	47
Pa.	6.00%	17	0.34%	6.34%	34
R.I.	7.00%	2	--	7.00%	25
S.C.	6.00%	17	1.50%	7.50%	18
S.D.	4.20%	39	1.91%	6.11%	36
Tenn.	7.00%	2	2.55%	9.55%	2
Tex.	6.25%	13	1.95%	8.20%	14
Utah	6.10%	16	1.15%	7.25%	20
Vt.	6.00%	17	0.36%	6.36%	32
Va.	5.30%	31	0.47%	5.77%	41
Wash.	6.50%	9	2.88%	9.38%	4
W.Va.	6.00%	17	0.57%	6.57%	31
Wis.	5.00%	32	0.70%	5.70%	42
Wyo.	4.00%	40	1.44%	5.44%	44
D.C.	6.00%	(17)	--	6.00%	(38)

Source: Sales Tax Clearinghouse; Tax Foundation calculations

As previously discussed, increasing the sales tax rate creates concerns about its impact on economic efficiency and opportunity. As the rate increases, it will impact business and consumer decision making.

This may help explain why no state has a combined state and average local sales and use tax rate over 10 percent. Five states have rates over 9 percent, with Louisiana the highest at 9.56 percent.[14] There is a general belief among tax policymakers that there is a psychological barrier at 10 percent of combined state and average local sales and use tax rates. If this is the case, then it will be difficult for many states (or local governments) to continue to significantly add to current rates without crossing over that barrier.

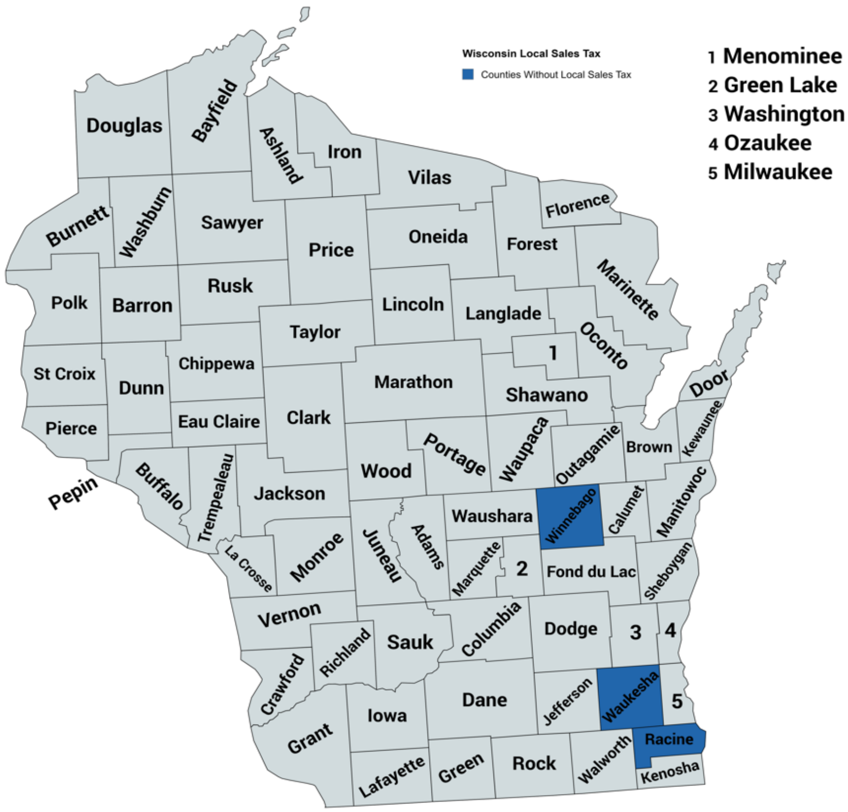
Sales tax rates have been rising in states for a combination of reasons. Some rate increases have been established to offset other taxes. For example, in 1994, the state of Michigan dramatically reduced property tax funding for K-12 public schools by raising the sales and use tax from 4 to 6 percent.[15] Of course, some sales tax increases have been tied to decisions to raise expenditures, and some have been the result of a need for additional revenue, often because of recession-driven reductions in tax collections.

State Sales Tax Rates and Border Effects

Figure 5 shows the three Wisconsin counties, including Racine, that currently do not implement a local option sales tax. Racine County borders Waukesha County, which also does not levy a local option rate.

[14] The other states with combined state and average local rates above 9 percent are Tennessee (9.55%), Arkansas (9.45%), Washington (9.38%) and Alabama (9.29%).
[15] Kathryn Summers, "The Basics of School Funding," Michigan Senate Fiscal Agency, February 2019, accessed electronically at https://www.senate.michigan.gov/sfa/departments/datacharts/dck12_schoolfundingbasics.pdf

Figure 5: Wisconsin Counties Without Local Option Sales Tax



Source: Wisconsin Department of Revenue; PFM

This raises potential concerns about the potential for border effects; there is a significant body of research and studies that suggest that sales along geographic borders can be impacted by the respective geographies' sales tax rates. In general, research on sales tax differentials has found:

- A study using consumption data series for three metropolitan areas along the Tennessee border indicated that a one percent sales tax increase reduced sales by a percentage between 0.44 percent and 3.73 percent, depending on the area.[16]
- There is a limit to acceptable travel distance that is related to the tax/price differential. The analysis in a particular location will have to take into consideration factors that include the ease of travel, travel time, retail establishment numbers and density, etc. One study of border effects along five states in the Midwest (Illinois, Indiana, Ohio, Michigan, and Kentucky) found that border effects for the benefited area extend from 2 to 3 miles from the border, while the disadvantaged area can be as much as 10 to 12 miles.[17]
- In some instances, lower sales tax rates may be mitigated by other factors. A Tennessee study examined the effect of the opening of two new shopping malls in the late 1990s in Tennessee (with

[16] William Fox, "Tax Structure and the Location of Economic Activity along State Borders," National Tax Journal, 1986, pp. 362-374.

[17] William Lilley III and Laurence J. DeFranco, "Impact of Retail Taxes on the Illinois-Indiana Border," Chicago Federal Reserve Bank workshop 'Designing State-Local Fiscal Policy for Growth and Development, July 17, 1996. The paper also noted that the authors found similar 10-12 mile disadvantaged areas in a study related to the States of Massachusetts and New Hampshire.

higher sales taxes) yet found a 15.9 percent decline in sales in neighboring counties, regardless of differing tax rates. In this case, the study suggests that large shopping destinations will provide a strong attraction for many shoppers who prefer the convenience of shopping in one location or multiple choices of stores over the singular purpose of paying lower sales taxes.[18]

Estimating the potential impacts of cross border competition for Racine and Waukesha counties would require extensive study and modeling of many of the factors described in the preceding bullets. To be as accurate as possible, this modeling must consider consumer distance, mobility, demographics, types of shopping locations as well as state and local tax rates. That said, the county sales tax rate is fixed at 0.5 percent, which would equate to 50 cents on a purchase of $100. This low rate ameliorates border competition concerns due to its relatively minimal additional tax burden.

Sales Tax Collection Rates

Having covered issues related to the sales tax rate, another consideration is the sales tax collection rate. For many years, sales tax collection rates were eroded by the rise of e-commerce. In Supreme Court rulings in 1967 and 1992 (*National Bellas Hess, Inc. v. Department of Revenue of Illinois* and *Quill Corp. v. North Dakota*) the Court ruled that physical presence in a state was necessary to require companies to collect sales tax on telephone, catalogue, or Internet sales from its customers. It is notable that businesses and consumers still owe use tax on these purchases. While business compliance (because of the threat of a sales tax audit) was at least somewhat reasonable, non-business consumers rarely paid the tax as sales tax audits of individual taxpayers were rarely conducted – which is an example of a resulting poor collection rate.

As e-commerce became a larger share of consumer purchases, sales tax collections suffered as a result. This became a growing concern for governments relying on this source of revenue, and several states created a new ‘economic nexus’ standard for compelling sales tax collection by out-of-state e-commerce businesses selling to state residents. Economic nexus was established in state sales tax statutes based on some dollar amount of sales and/or some number of taxable sales to state residents in a year, which varied by state. Multiple large e-commerce businesses contested the statutes as in violation of past Supreme Court decisions.

State and local governments received some tax collection good news from the Supreme Court in 2018 when, in *South Dakota v. Wayfair*, the Court ruled that economic nexus was sufficient to compel businesses to collect sales tax from their customers.[19] This led to a significant increase in sales tax collections for many state and local governments, as every state with a sales and use tax has enacted some version of an economic nexus statute.[20] While the *Wayfair* decision has been a positive development, there has still been a gradual but significant reduction in sales tax collections as a share of individual income. Most states initially reacted to this reduction by raising sales tax rates, even though this can create economic efficiency issues.

The Base for State Sales Taxes

As previously noted, the equation for tax collection is the tax base multiplied by the tax rate and multiplied by the collection rate. In determining how sustainable a state’s tax base is, John Mikesell, the former Chancellor’s Professor of Public and Environmental Affairs at Indiana University, developed a methodology to identify the breadth of a state’s sales tax base, which is measured as the state sales tax base as a

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[18]Chervin, Edminston and Murray, “Urban Malls, Tax Base Migration and State Intergovernmental Aid,” Public Finance Review, 2000, 309-334.

[19] South Dakota v. Wayfair, Inc., 585 U.S. ___, 138 S. Ct. 2080 (2018).

[20] For the State of Illinois, economic nexus is established by gross receipts of $100,000 or more or 200 or more transactions in Illinois in a given year. A chart detailing the differing economic nexus standards by state is provided by the Sales Tax Institute: https://www.salestaxinstitute.com/resources/economic-nexus-state-guide

percentage of state personal income.[21] Professor Mikesell did an annual report and ranking of the states for Tax Notes, with the last being in 2018. Since then, the Tax Foundation has used the same methodology to update the state rankings. The 2024 rankings, which come from FY 2022 data, estimates that Wisconsin's state sales tax breadth is 39 percent, which ranks 20th among the states.[22]

Table 2: State Sales Tax Breadth, FY 2022

State	Sales Tax Breadth	Rank	State	Sales Tax Breadth	Rank
Hawaii	119%	1	Md.	36%	26
N.M.	62%	2	Mich.	36%	27
S.D.	60%	3	Ariz.	35%	28
Wyo.	57%	4	Okla.	35%	29
Wash.	56%	5	W.Va.	34%	30
Tex.	52%	6	Ga.	34%	31
Miss.	50%	7	Colo.	33%	32
N.D.	49%	8	Minn.	31%	33
Maine	47%	9	R.I.	31%	34
Tenn.	45%	10	Mo.	30%	35
Idaho	44%	11	N.J.	30%	36
Ark.	44%	12	Ill.	30%	37
Ala.	44%	13	Pa.	29%	38
Utah	44%	14	S.C.	29%	39
Fla.	44%	15	Vt.	28%	40
La.	43%	16	N.Y.	27%	41
Ky.	41%	17	Conn.	27%	42
Nev.	41%	18	Va.	25%	43
Ohio	40%	19	Calif.	24%	44
Wis.	39%	20	Mass.	24%	45
Ind.	38%	21	Alaska	--	--
Nebr.	38%	22	Del.	--	--
N.C.	37%	23	Mont.	--	--
Kans.	37%	24	N.H.	--	--
Iowa	37%	25	Ore.	--	--

Source: Tax Foundation

The table also highlights the issues around state consumption taxes that may lead to pyramiding. Both Hawaii and New Mexico impose business privilege taxes that lead to significant pyramiding – hence the fact that the Hawaii sales tax base is actually larger than state personal income. The same is true, to a lesser extent, with the states of North Dakota and South Dakota. The table places Wisconsin 20th, meaning its sales tax breadth is slightly above average among the 50 states.

[21] John L. Mikesell, "State Retail Sales Taxes: Revenue Performance for Fiscal 2015," Tax Notes State, Mar. 8, 2017, https://www.taxnotes.com/tax-notes-today-state/budgets/state-retail-sales-taxes-revenue-performance-fiscal-2015/2017/03/08/ckzp.
[22] "Facts and Figures: how does your state compare?' Tax Foundation, 2024, Table 21, accessed electronically at https://taxfoundation.org/data/all/state/2024-state-tax-data /

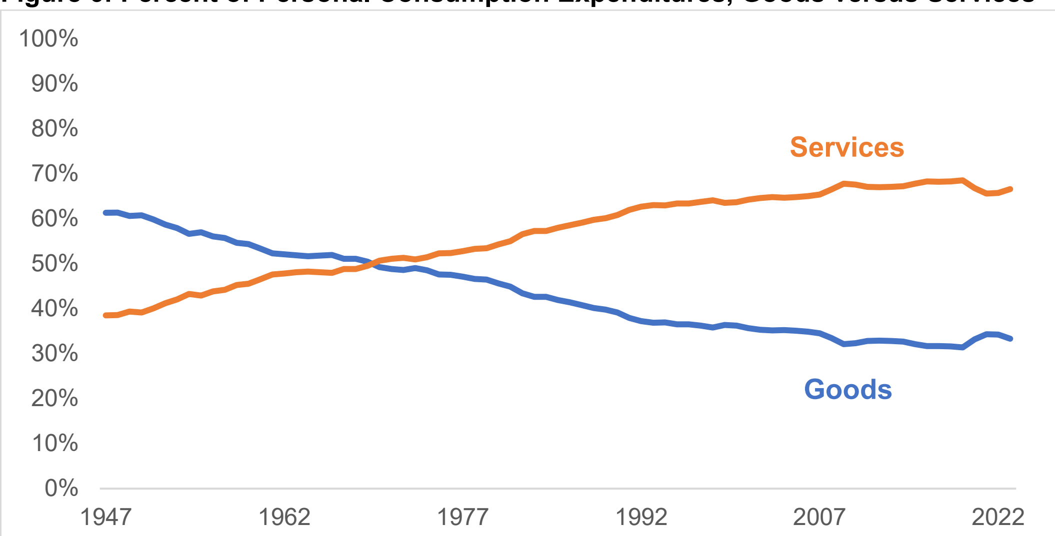
From a tax policy perspective, an overly broad sales tax base (which likely applies to at least the top five states) will have a greater impact on market decisions and economic efficiency. On the other hand, an overly narrow sales tax (which likely applies to at least the bottom five states) will continue to erode the base and may require higher sales tax rates or higher rates on other taxes. It is notable that most of the states with low sales tax breadth have progressive (and high) individual/personal income tax rates.

Applying the Sales Tax to Services

The generally accepted intent of sales tax statutes is to broadly tax consumption, therefore a broad tax base aligns with the commonly accepted tax principle of applying the lowest possible rate to the broadest possible base. When most sales tax laws were passed, in the early part of the twentieth century, most personal consumption was of tangible goods. As a result, these laws were generally written to presume that tangible goods were taxed unless specifically exempted. On the other hand, services were presumed to not be subject to tax unless specifically enumerated. Given that the sales and use tax is meant to tax consumption, this generally fit with spending patterns at the time.

However, over the last six decades, U.S. consumption has flipped – from about two-thirds tangible goods and one-third services to two-thirds services and one-third tangible goods.

Figure 6: Percent of Personal Consumption Expenditures, Goods versus Services



Source: Bureau of Economic Analysis; PFM

As a result, the base subject to taxation has shrunk remarkably. When the response to shrinkage is to increase the rate and allow the base to contract, it flies in the face of generally accepted tax policy best practices. Faced with this concern, more states are expanding the base (or considering it) to include services.

Services generally fall into three categories. Consumer purchased services are the most common category. Examples of these include health clubs, haircuts, lawn care, pet grooming, and admission to concerts or sporting events. The second category would be services that are primarily business-to-business (B2B) transactions. Examples of B2B services include the purchase of software-as-a-service, data center hostings, custodial or trucking services. Finally, there are services that are a mixture of the two (although most commonly purchased by consumers). These would include professional services, such as accounting, legal or tax preparation; it would also include services such as building repair, auto maintenance and repair, and digital downloads. Where services are included in the sales tax base, states tend to focus on consumer purchased services or those that are a mixture of consumer and business-to-business services.

Most states that tax services do not tax strictly business-to-business services. This is based on economic efficiency grounds, as this taxation may result in a form of pyramiding, where the intermediate inputs into a final good or service have been taxed. Likewise, professional services are often not taxed, both those that are business-to-business transactions and services provided to consumers (primarily medical, legal, tax and similar businesses). In this case, the decision not to include those services is both based on pyramiding or economic efficiency arguments. If the sales tax is applied to services business consume (such as accounting or legal services), it may lead large companies to bring those services in-house to avoid paying tax on the services. This can create equity issues, as smaller firms may not have the same ability to avoid the tax. It is also a political issue, as these professions have strong lobbying ability and have effectively blocked this form of taxation in many states.

As previously noted, some services are not generally classified as professional services and are purchased by both consumers and businesses. In general, these are taxed, because administration becomes very difficult when they are separated out for businesses. There is also not the same pyramiding concern, as these are mostly overhead, not direct inputs into a tangible good that will be eventually subject to sales tax.

State Taxation of Services

Among the states with a sales and use tax, Wisconsin is on the high end of the number of services that it taxes. The Federation of Tax Administrators (FTA), which is made up of the Directors of state departments of taxation and/or revenue, has conducted several surveys of its members related to the categories and number of services that are taxed in states and the District of Columbia. The last survey was conducted in 2017. The results of that survey are found on Table 3.[23]

Table 3: Number of Services Subject to State Consumption Taxes, 2017

State	Utilities	Pers. Svcs.	Bus. Svcs.	Comp. Svcs.	Online Svcs.	Admis./ Amuse.	Prof. Svcs.	Repair	Other Svcs.	Total
AL	12	1	6	3	6	10	0	1	3	42
AK	0	0	0	0	0	0	0	0	1	1
AR	16	7	12	1	0	12	0	11	14	73
AZ*	12	2	7	0	5	9	0	2	23	60
CA	2	2	7	1	0	1	0	3	5	21
CO	4	1	2	0	4	2	0	3	3	19
CT	10	9	21	6	8	10	0	10	25	99
DE	9	20	34	6	8	10	9	19	37	152
DC	14	9	17	6	4	10	0	14	17	91
FL	9	4	11	0	2	13	0	15	15	69
GA	10	4	5	2	0	8	0	1	6	36
HI	16	20	34	8	6	14	9	18	42	167
ID	0	3	4	0	4	9	0	6	4	30
IL	12	2	1	1	1	9	0	1	2	29
IN	12	4	3	1	5	3	0	1	7	36
IA	10	15	17	0	1	13	0	13	20	89
KS	10	10	9	1	1	13	0	15	15	74

[23] "State Taxation of Services," Federation of State Tax Administrators, 2017, accessed electronically at https://www.taxadmin.org/sales-taxation-of-services

State	Utilities	Pers. Svcs.	Bus. Svcs.	Comp. Svcs.	Online Svcs.	Admis./ Amuse.	Prof. Svcs.	Repair	Other Svcs.	Total
KY	11	2	4	1	6	8	0	4	4	40
LA*	10	8	5	3	5	9	0	13	7	60
ME	10	1	6	0	5	3	0	4	4	33
MD*	5	3	13	1	0	11	0	4	3	40
MA*	9	1	4	0	1	1	0	2	1	19
MI	12	2	7	1	1	1	0	1	2	27
MN	15	8	11	0	6	12	0	6	9	67
MS	10	5	8	3	7	11	0	13	22	79
MO	8	1	2	1	0	10	0	0	2	24
MT	12	0	0	0	0	1	0	0	4	17
NE	14	10	14	3	6	12	0	12	10	81
NV	0	1	4	0	0	7	0	2	7	21
NH	6	1	0	0	0	0	0	0	2	9
NJ	12	6	17	1	4	7	0	15	22	84
NM*	16	20	32	8	6	14	9	18	41	164
NY	5	5	13	1	1	6	0	14	19	64
NC	12	7	8	0	6	9	0	14	6	62
ND	4	1	4	2	1	8	0	0	2	22
OH	8	11	14	5	8	13	0	11	16	86
OK*	9	3	5	1	0	10	0	0	5	33
OR	0	0	0	0	0	0	0	0	1	1
PA	9	5	16	4	8	2	0	14	9	67
RI	11	1	6	2	1	5	0	3	8	37
SC	4	6	7	4	2	10	0	1	5	39
SD	14	19	28	8	8	13	5	18	39	152
TN	11	10	7	3	6	12	0	14	13	76
TX	12	10	14	8	8	12	1	10	15	90
UT	7	8	6	0	5	11	0	15	12	64
VT	9	2	5	1	6	11	0	2	1	37
VA	1	3	4	0	0	1	0	4	4	17
WA	16	20	33	8	8	13	9	16	44	167
WV	8	18	27	4	5	13	1	13	26	115
WI	11	10	8	3	7	14	0	13	16	82
WY	10	7	5	4	5	6	0	16	13	66
Total	16	20	34	8	8	15	9	19	47	176

** No response, 2007 data reported*
Source: FTA, Taxation of Services Survey, 2017

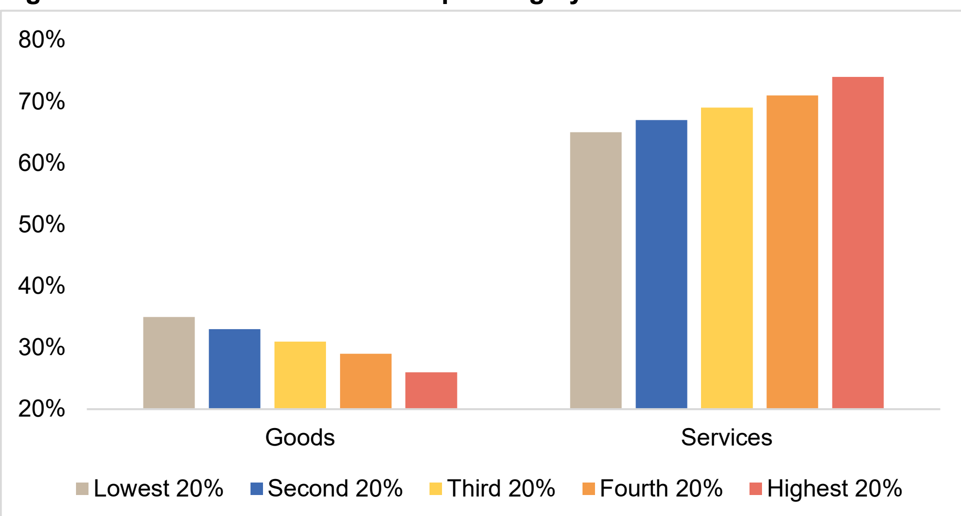
Among the 41 respondents with a sales and use tax, Wisconsin had the 13th most services that were taxed (82). The states with the lowest number of services taxed were Colorado and Virginia (17), while the highest numbers were from Hawaii and Washington (167). The median of the respondents with a sales tax was 64.

Of course, sheer numbers of services that are taxed is not necessarily indicative of revenue collected from those services, as there are a handful of service categories that can make up a large share of the generated revenue. Despite being on the high end of currently taxed services, it is feasible that Wisconsin could add to its total to better align with principles of tax base expansion and to meet changing consumer behavior trends. For example, professional services, all of which are currently untaxed, represent a large potential additional to the sales tax base, however they are both challenging and unpopular to tax. Personal and Business Services offer more options in terms of economic activity and being more commonly taxed in other jurisdictions. Among these, the State of Wisconsin could consider taxing:

- Barbershops and Beauty Parlors
- Employment and Temp Agencies
- Pet Grooming and Veterinary Services
- Personal Instruction

These services are all relatively common to find as taxable in other states. Further, concerns over the regressive nature of sales taxes as it pertains to rate increases are somewhat mitigated by taxable service expansion. The trend of greater service consumption as a percent of total expenditures is especially pronounced at the upper end of the income distribution, with higher income households spending a greater portion of their income on services (Figure 7).

Figure 7: Goods versus Services Spending by Income Level



Most durable goods are currently subject to the sales tax, meaning that a larger share of low-income household purchases are already taxed. Lower income households may purchase affordable goods in lieu of their more expensive service alternatives, such as a book on how to file your taxes instead of hiring a tax professional, or purchasing a pair of sneakers rather than a personal training session. By increasing the sales tax base to include more services, governments can increase their revenues while placing a lesser burden on those with the lowest ability to pay.

Conclusion

Racine County is facing a set of budget circumstances that is not unusual for county governments in the U.S. These include:

- Reduction of federal COVID-19 pandemic assistance.
- State limits on county real property tax levies.
- Concerns related to future state assistance to counties, given tax cuts that have reduced the state budget surplus.
- Constrained operating expenditures, with Racine County spending on average less per capita than Wisconsin counties combined.

Based on these facts, it makes sense to examine possible changes to the county revenue structure that are not constrained by the state. In this case, a county sales tax is the logical starting point for analysis. That analysis finds that:

- Nearly every Wisconsin county has enacted a 0.5 percent sales tax on top of the state's 5.0 percent sales tax.
- Nationally, county sales taxes are the second largest tax source, trailing only real property taxes.
- The expected sales tax collections (likely $20-$25 million a year) would be sufficient to eliminate the projected structural budget deficit for the coming budget year.

When viewed from a tax policy perspective, there are several advantages of the sales tax for Racine County:

- The state sales tax is already collected, so consumers and sellers understand and generally comply with the tax.
- The state collects it and remits to local governments, so there is little county administrative burden.,
- Imposing the tax would broaden the tax base and create additional revenue diversity, which reduces risks (and burdens) associated with the real property tax.

When viewed from a tax policy perspective, the primary disadvantage of the sales tax is the fact that it is regressive – lower income households pay a larger share of their income as sales tax compared to higher income households. This is a fact and should be taken into consideration. There are some factors that moderate this concern:

- The sales tax is not applied to some household necessities, including prescriptions, medical devices, and most groceries.
- It is less regressive than the real property tax.
- The additional increment is small - $0.50 per $100 of taxable purchases.

Another argument against a sales tax is that it may lead consumers to make purchases in locations with lower sales tax rates. Of course, as noted, nearly every Wisconsin county already has a county sales tax. Further, the combined state and local sales tax rates in Illinois (the most proximate other state to Racine County) are much higher than in Wisconsin. And, as previously noted, the additional sales tax increment is likely too small to incent many consumers to travel elsewhere to make taxable purchases.

It has been noted that there is no perfect tax - any tax will reduce economic activity and impose additional costs on consumers. However, when considering all factors, the PFM project team concludes that the benefits to Racine County from imposing the 0.5 percent county sales tax outweigh the negative factors.

There are additional opportunities the county may wish to consider related to revenue diversification. For example, regular and timely analysis of cost of services, including benchmarking with peer governments and subsidized service identification, is necessary for these revenues to consistently meet expenditure pressures for service provision. The County may wish to consider conducting (or having a third party conduct) a fee study. Fee studies can enable county governments to uncover the true cost of services, determine where subsidization is appropriate, and establish market rates for other services, which may enhance County revenue collections.