TAX FOUNDATION
Since 1937

SPECIAL REPORT

March 2004
No. 127

The Path to Reforming Virginia's Tax Code

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Executive Summary

The last time Governor Mark Warner campaigned for a tax increase was in 2002, when despite a campaign promise not to raise taxes, he supported a referendum in Northern Virginia to raise the sales tax. That referendum was soundly defeated, and many pundits concluded that if voters in Virginia's most liberal, high-income region would not support higher taxes, the issue was decided for quite a while.[1]

However, by late 2003, Warner had announced his campaign for "tax reform," claiming Virginia's tax system was outdated and that he needed to "strengthen Virginia's competitiveness."[2]

The Tax Foundation's tax reform proposal would catapult Virginia into the ranks of the top ten state business tax climates in the nation.

Two questions about taxes cover the waterfront:

- How much is collected as a percentage of what the people earn? and
- Are taxes collected efficiently and fairly so that the tax system does not distort the taxpayers' economic decisions?

Economists refer to these two issues as the tax burden and tax neutrality.

In Virginia, the combined state-local tax burden has been moderate by national standards, ranging from 8.9 percent to 9.5 percent of income during the last decade. Meanwhile, the national average has ranged from 9.6 percent to 10.2 percent.

Measured by its tax neutrality—whether a state's tax system maintains a "level playing field" for all types of economic activity—Virginia ranks roughly in the middle of the pack on a nationwide comparison.

Governor Warner was right that many worthwhile improvements could be made to the state's tax code, but when he unveiled the details of his so-called reform, it was mostly indistinguishable from dozens of tax increases proposed or enacted by various states over the last 20 years. It includes higher income taxes, higher sales taxes and higher taxes on specific products. Smaller, targeted tax cuts are included in the mix. Among the details are a few meritorious changes that would simplify tax collection and would qualify as reforms, but they are trivial compared to the overall impact of the plan. In fact, as flawed as the current tax code is, the Virginia legislature would actually be better off keeping the current tax structure intact than passing the Warner or Chichester plan unamended.

Despite this disappointing proposal, fundamental tax reform is always possible. True tax reforms foster economic growth by keeping rates low and the tax base broad so that citizens' economic decisions are not prejudiced by the tax code. True tax reforms make the tax system simpler, both to enforce and to comply with, because tax compliance is a deadweight loss to the economy. Finally, true tax reforms keep the overall tax burden in check, mindful that regional competition is unavoidable, and business will expand where taxes are most reasonable.

The Tax Foundation proposes a revenue-neutral tax reform plan for Virginia that would maximize growth in the state economy by:

- replacing the current income tax structure (4 brackets with rates up to 5.75 percent) with a flat 6-percent income tax, the same rate as the corporate income tax;

- repealing the state and local sales tax;
- repealing the estate tax and the local business, professional and occupational tax (BPOL); and
- raising the fuel tax.

While many taxpayers might point out that economic growth could be helped more by a plan that lowered taxes, some would argue for higher taxes. A revenue-neutral plan has one overriding advantage. It removes the suspicion that "reform" is just a fig leaf to cover a tax cut or a tax increase.

The Tax Foundation's reform proposal, outlined above and described in greater detail in this report, would catapult Virginia into the ranks of the top ten state business tax climates in the nation.

Virginia's Current Tax Climate

No tax proposal is made in a vacuum. One must assess every proposal against the background of the current tax climate. Therefore, it is appropriate to measure where Virginia currently ranks in relation to other states. How well does Virginia's tax system compete in the region and the nation in terms of tax burden and tax neutrality?

Measuring the percentage of state income taken by state and local taxes is one of the best ways to measure the tax system's drag on the economy. Among the eight states in the region, Virginia's 8.9 percent tax burden is arithmetically average but ranks a respectable third. Delaware and Tennessee have the lowest state-local tax burdens in the region. Compared nationwide, Virginia's tax burden is below the national average of 9.7 percent and has ranked from 36th to 41st highest during the past decade. See Table 1.

Virginia's tax burden increased to 9.5 percent of income in the boom year of 1998 and fell to 8.9 percent during the sluggish economy of 2002. These fluctuations are part of a "feast or famine" pattern of state revenue typical of states like Virginia that rely heavily on an income tax that has several progressively higher rates. When the economy dips and people earn less, they fall into lower income tax brackets. The result is that state revenue drops even faster than the economy. When this happens, state government's long-term spending obligations and inflexible workforce make it hard to balance the budget. During boom times, the opposite happens. State coffers overflow, prompting new spending initiatives that are unsustainable in the long term.

Measuring tax collections per capita instead of as a percentage of income does not change Virginia's rank. Total state taxes per capita in Virginia were $1,752 in 2002, below the national and regional average, and the third lightest tax burden among the eight states of the region.

When specific taxes are singled out of the total, one can see which aspects of the Virginia tax system bring in the most revenue. Virginia's per-capita individual income tax collections, for instance, are substantially higher than both the regional and national averages, ranking it the highest in the eight-state region. The state's corporate income tax, however, is the lowest in the region and well below the national average. The sales tax burden, similar to North Carolina's, is also lower than the national and regional averages, but obviously the regional competition in this category is won by Delaware, which has built

Table 1
How Virginia Stacks Up: Tax Burdens

	State and Local Taxes as a Percentage of Income (2003)	Individual Income Taxes Per Capita (2002)	Corporate Income Taxes Per Capita (2002)	General Sales and Gross Receipts Taxes Per Capita (2002)	Total State Tax Collections Per Capita (2002)	State Business Tax Climate Index Rank (Lower is Better)
Virginia	8.9%	$920	$42	$384	$1,752	21
Delaware	7.3%	$888	$312	$0	$2,692	15
Kentucky	9.4%	$654	$74	$914	$1,948	35
Maryland	9.5%	$862	$66	$493	$1,983	31
North Carolina	9.5%	$873	$80	$386	$1,867	24
Pennsylvania	9.1%	$546	$97	$888	$1,795	19
Tennessee	7.7%	$25	$87	$806	$1,345	10
West Virginia	9.7%	$574	$122	$534	$1,971	39
Regional Average	8.9%	$668	$110	$629	$1,919	NA
U.S. Average	9.7%	$643	$90	$622	$1,854	NA

Sources: U.S. Census Bureau; Bureau of Economic Analysis; and Tax Foundation.

its economy by collecting no sales taxes. A simple comparison of statutory rates confirms that Virginia's tax system competes well in the region. See Table 2.

The Tax Foundation's State Business Tax Climate Index combines all these measures of state tax systems with several others such as tax code complexity. By that yardstick, Virginia's tax system ranks as the 21st best tax climate in the nation—the middle of the pack. Comparing Virginia with only its border states plus nearby Delaware and Pennsylvania, it ranks fourth out of eight.

Virginia's tax code shares a fault found in many states: a long list of extraneous exemptions, deductions and credits that benefit targeted groups of taxpayers or companies. A great deal of the acrimony that accompanies every tax debate is generated by the frantic lobbying of groups that might lose their tax preferences, advantages that have no basis in sound policy but have been purchased through the political process. In fact, those groups are the worst enemy of fundamental tax reform, and ultimately, the worst enemy of economic prosperity.

Virginia could certainly be in far worse shape, but it has a long way to go before it can be considered one of the top 10 best states in which to open a business. Tax reform needs to remove as many tax-related economic distortions as possible, but perfection is not possible, so in the current campaign for tax reform, legislators need to focus on the elements of the current tax system that are particularly hard on the economy.

Table 2
How Virginia Stacks Up in the Region: Tax Rates as of December 31, 2003

State	Individual Income Tax Rates and Brackets for Single Filers(a)	Standard Deduction		Personal Exemptions		Highest Local Income Tax	Corporate Income Tax	State Sales Tax	Highest Local Sales Tax
		Single	Joint	Single(b)	Dependents				
Virginia	2.0% > $0 3.0% > $3K 5.0% > $5K 5.75% > $17K	$3,000	$5,000	$800	$800	None	6.0%	3.5%	1.0%(h)
Delaware	2.2% > $2K 3.9% > $5K 4.8% > $10K 5.2% > $20K 5.55% > $25K 5.95% > $60K	$3,250	$6,500	$110(c)	$110(c)	1.25%	8.70%	None	None
Kentucky	2.0% > $0 3.0% > $3K 4.0% > $4K 5.0% > $5K 6.0% > $8K	$1,830	$1,830	$20(c)	$20(c)	2.25%	4.0% > $0 5.0% > $25K 6.0% > $50K 7.0% > $100K 8.25% > $250K	6%	None
Maryland	2.0% > $0 3.0% > $1K 4.0% > $2K 4.75% > $3K	$2,000(d)	$4,000(d)	$2,400	$2,400	3.15%	7.0%	5%	None
North Carolina	6.0% > $0 7.0% > $12,750 7.75% > $60K 8.25% > $120K	$3,750	$6,100	$1,050 (e)	$1,050 (e)	None	6.9%	4.5%	3%
Pennsylvania	2.8% > $0(f)	None	None	None	None	4.4625%	9.99%	6%	1%
Tennessee	6.0% > $0(g)	None	None	$1,250	None	None	6.5%	7%	2.75%
West Virginia	3.0% > $0 4.0% > $10K 4.5% > $25K 6.0% > $40K 6.5% > $60K	None	None	$2,000	$2,000	None	9.0%	6%	None
Dist. of Col.	5.0% > $0 7.5% > $10K 9.3% > $30K	$1,000	$2,000	$1,370	$1,370		9.975%	5.75%	

(a) Applies to single taxpayers and married people filing separately. Most states double brackets for married joint filers.
(b) Except for Delaware, married-joint filers receive double the single exemption. Joint filers in Delaware get the same $110 tax credit.
(c) Tax Credit.
(d) The standard deduction is 15 percent of income with a minimum of $1,500 and a cap of $2,000 for single filers, married filing separately filers and dependent filers earning more than $13,333. The standard deduction is capped at $4,000 for married filing jointly filers, head of household filers and qualifying widowers earning more than $26,667.
(e) Exemptions are based on federal standard deductions but are adjusted according to income and filing status.
(f) Tax rate rises from 2.8% to 3.07% in 2004.
(g) Applies to interest and dividend income only.
(h) Statewide with no higher rate permitted.
Sources: State tax forms and instructions, Commerce Clearing House, Federation of Tax Administrators. For nationwide comparisons, see "State Tax Collections and Rates," *Tax Foundation Special Report,* No. 128, March 2004.

Principles of Fundamental Tax Reform

The goal of fundamental tax reform should be to make a state's tax climate more conducive to job creation, business expansion, and long-term economic growth. Each state is constantly competing with its neighbors for capital, start-up companies and business expansion. One of the most complete reviews of the academic literature on the subject (Bartik 1991) concludes that taxes have quite large and significant effects on business activity.[3] Indeed, states aren't just competing with each other but with the rest of the world. A 2001 study examined the effects of state corporate income taxes on the location of foreign direct investment in the U.S. and determined, "[For] foreign investors, the corporate tax rate is the most relevant tax in their investment decision."[4]

In short, tax reforms that keep tax burdens in check and make a state more conducive to economic growth should be the benchmark against which any tax reform plan is measured.

The Tax Burden

One major element of state tax competition is the size of the state's overall tax burden — the percentage of a state's income taken in taxes. For many years, the Tax Foundation has published estimates of each state's combined state and local tax burden as part of its well-known Tax Freedom Day report.[5] These estimates include adjustments for many complex ways that states shift tax burdens to non-residents, making the estimates more valuable to the policy debate than raw collection data. Numerous studies over the past 20 years have pointed out the statistical correlation between comparatively low tax burdens and economic growth.[6]

Tax Neutrality

While businesses have always taken note of tax burden estimates, the structure and complexity of a state's tax system can be as important to a business as the amount of taxes levied on a business.

In 2003, the Tax Foundation designed the State Business Tax Climate Index to objectively measure how conducive each state's tax system is to business.[7] The touchstone of the Index is neutrality, meaning that if a state's tax system maintains a "level playing field" for all types of businesses and business transactions, it would be considered "neutral" and it would be rated highly.

An economically neutral tax system benefits and punishes all businesses equally, so it serves as an excellent measure of each state's tax friendliness to all business activity, not just small businesses or large businesses, capital-intensive or service-intensive, existing companies or start-ups. Therefore, if a state's tax burden is relatively low and the state's tax system does not favor some economic activities while penalizing others, we conclude that the state's economy will be comparatively efficient, producing more jobs and yielding higher incomes for everyone. On the other hand, if a state's tax system is filled with extraneous exemptions, deductions, credits and special rates targeted at specific industries or groups of people, we conclude that the state's economy will be comparatively inefficient, overtaxing productive activity while rewarding political influence.

The State Business Tax Climate Index is a composite of five specific indexes devoted to major features of a state's tax system, features that definitely influence business decisions or the economy in general: the corporate income tax, the individual income tax, the sales and gross receipts tax, the state's tax burden, and the administrative complexity of the state's tax system as measured by its conformity with other systems.

The common characteristics of states that rank poorly are:

- multiple-rate corporate and individual tax codes that impose above-average tax rates;
- above-average sales tax rates that do not exempt business inputs, such as computer software and office equipment;
- high overall state/local tax burdens that have grown faster than taxpayers' incomes; and
- tax codes that impose considerable compliance costs and double-taxation on businesses.

An Analysis of Governor Mark Warner's Tax Plan

Unfortunately, Governor Warner's tax plan for Virginia does not rise to the challenge of true tax reform. It does not fundamentally change the state's tax code and misses an opportunity to improve Virginia's business tax climate.

Instead of rearranging the state's tax system to promote economic growth, his proposal raises taxes on the engines of economic growth — businesses that hire and sell in Virginia. With its provision to establish a new, higher rate on individual income over $100,000, the plan would be especially hard on business

owners who file their business taxes through their individual tax returns (sole proprietorships, partnerships and S corporations).

The Warner proposal's higher sales and income taxes will hit Northern Virginia harder than any other region. With its high cost of living, and correspondingly high salaries, Northern Virginia is filled with dual-income married couples who do not live a wealthy lifestyle but have a family income above $100,000 and would therefore fall into the new, higher top income tax bracket.

Several small tax cuts are part of the plan, but overall, the proposal amounts to a substantial tax increase on the Virginia economy, $500 million annually. That's four times larger than the Northern Virginia sales tax hike that failed by referendum in 2002, but it is not as large as some competing proposals.

As flawed as the current tax code is, the Virginia legislature would actually be better off keeping the current tax structure intact than passing the Warner plan unamended.

The Warner plan makes dozens of changes to the code. These are the six biggest:

- raising the state sales tax rate by one cent in July 2004 (bringing the total state rate to 4.5 percent, and the state-plus-local rate to 5.5 percent) but lowering the rate on food by 1.5 percent in July 2005 (bringing the total state rate on food to 2.5 percent);
- creating a new top personal income tax bracket of 6.25 percent, which kicks in at $100,000 of taxable income, but raising the standard deduction to $4,000 per person and the personal and dependent exemption to $1,000;
- eliminating some so-called loopholes in the corporate income tax;
- raising the cigarette tax by 22.5 cents per pack (bringing the total state rate to 25 cents per pack) while allowing localities to levy an additional tax up to a maximum rate of 50 cents per pack;
- continuing the phase-out of the state personal property (car) tax; and
- preserving the estate tax for estates valued at over $10 million after January 2004, with special exemptions for family farms and businesses.

In all, the governor estimates that these changes will increase total state revenue by roughly $1 billion over two years.[8] Whether the extra tax collections would be spent wisely or not, the governor's plan is disappointing as "tax reform." It simply would not make the system simpler or more conducive to economic growth. The proposal's four principal changes bear further analysis.

Sales Tax Increase

Governor Warner's call for a 5.5 percent sales tax rate would give Maryland (with its 5.0 percent state sales tax) a slight competitive advantage, potentially driving retail activity away from Virginia. Lower-tax jurisdictions are favored by both retail outlets and consumers. At every state boundary, cross-border shopping occurs when tax differentials are significant and driving distances are reasonable.

For instance, 30 percent of all income in Virginia is concentrated in the counties of Fairfax and Arlington, and the city of Alexandria. These residents are already making significant purchases in tax-free Delaware even though it is more than two hours away. Raising Virginia's sales tax will give even more incentive to this traffic, and it can't help that Maryland, just a few minutes away, would also have a slight advantage.

Income Tax Increase

The creation of a new sixth income bracket at a rate of 6.25 percent on taxable income over $100,000 brings Virginia further away from the ideal of a tax system that treats all businesses and individuals equally. This "soak the rich" mentality would actually penalize healthy income and business growth.

This income tax increase would disproportionately affect households in Northern Virginia where both salaries and the cost of living are much higher than in the rest of the state. Most families with over $112,000 in adjusted gross income will have taxable income over $100,000 and pay this new rate. Census Bureau data show that Northern Virginia has a higher-than-average concentration of households with income of $100,000 and above.[9] According to numbers from the governor's office, the average income for married two-earner taxpaying couples is $130,346 in Alexandria, $128,124 in Arlington, $135,478 in Fairfax, and $121,470 in Loudoun County.

The new top 6.25 percent income tax bracket would also affect individually-owned businesses in the state. When compared to the national average, Virginia has a disproportionately high concentration of business owners paying their business taxes through the personal income tax code who could be captured in this new higher tax bracket. To illustrate, consider how many individual state tax returns list taxable business income. Nationally for tax year 2001, of all personal income tax returns that declared net business income, 12 percent

had adjusted gross income of $100,000 or more. In Virginia, by contrast, the ratio was around 16 percent—that's over 70,000 businesses.[10] These are not large corporate entities, but small businesses that provide a large share of Virginia's total employment: in 2001, 95 percent of all firms in the state employed 100 people or less.[11]

This is not just a problem in expensive suburbs. The farming community would be hurt by this new tax bracket as well. Of all personal income tax returns filed by farms in tax year 2001, over 14 percent—over 6,600 farms—had adjusted gross income of $100,000 or over.[12]

In addition, this new top rate perpetuates an imbalance between the top rates in the personal and corporate income tax codes. When the state levies different income tax rates on corporate and individual income, it can create an incentive to game the system and report one type of income instead of the other. This phenomenon is well documented at the federal level.[13] Setting Virginia's top personal income tax rate higher than the corporate rate could encourage shifting of income to the corporate code.

Virginia retailing could enjoy the same advantage as Delaware by repealing its state sales tax.… Of course, in a revenue-neutral plan, the repeal of one tax must mean replacing the revenue. In the Tax Foundation proposal, the main vehicle is a reformed income tax.

Corporate Tax Changes

Two specific proposals to change how Virginia treats corporate income have gotten some press lately. The first of these proposals would affect companies that set up "intangible holding companies" in states like Delaware and Nevada which have favorable corporate laws and preferential tax treatment for income from intangible assets, like copyrights and patents. The companies that set up these holding companies are typically multi-state corporations who transfer ownership of their trademarks and patents to these holding companies. When they subsequently rent their patents back from the holding companies, they are entitled to deduct the expense on their Virginia tax forms. If Virginia eliminates this write-off — as many other states are considering doing — it will simply spur these multistate corporations to restructure operations, potentially to Virginia's detriment, especially if those companies move some operations out of Virginia as a result.

The second change also involves companies that operate in many states. Under the Warner proposal, a company located in "State A" making sales into "State B" where the company is not subject to tax will be required to add the value of those sales into the taxable base in Virginia. This proposal is called a "throwback rule." While some might demagogue the current law as a "loophole," it is far from being a sneaky accounting gimmick used to evade taxes or an unintended consequence of legislative action. The current law was actively and deliberately created by the Virginia state legislature in 1980. Incidentally, the "throwback" rule is the one main component of the Warner plan that is opposed by the Virginia Chamber of Commerce, which recently showered praise on the rest of the Warner proposals.[14]

Both of these proposals would probably not raise the amount of revenue their supporters claim. Companies will simply restructure their operations in response to these tax changes. While it is unclear exactly what impact these changes will have on the state economy, it is clear that corporations will always structure themselves to take optimal advantage of differentials in tax treatment between states. This is another natural by-product of tax competition.

Estate Tax Changes

Warner's plan would greatly diminish Virginia's estate tax by establishing a $10 million exemption and enacting special provisions for family businesses and farms. This is commendable because the estate tax is known to be a highly inefficient tax. It penalizes people for saving by taxing previously taxed assets upon the death of the owner. Of course, taxing capital this way hinders capital formation, and with capital as mobile as it is, even a limited estate tax would adversely influence business activity in the state.

The estate tax's notorious complexity results in an appallingly low ratio of revenue to administrative costs. As a recent study by the Joint Economic Committee of the U.S. Congress notes, "For every dollar of tax revenue raised by the estate tax, another dollar is squandered in the economy simply to comply with or avoid the tax."[15]

Keeping even a vestige of this tax, therefore, is counterproductive and reduces Virginia's ability to attract and retain businesses. A better public policy would be to make Virginia an attractive retirement option for high net-worth individuals, not to persuade them to flee the state in old age.

As some of Virginia's competitor states follow the lead of the federal government and fully phase out the estate tax by 2010, Virginia's decision to keep it in any form would be a competitive disadvantage.

Would Warner's Plan Make Virginia More Competitive?

There are a few worthwhile elements in the Warner proposal. The widening of the income tax brackets for middle-income earners gives some middle-income families more opportunity to earn income without being subject to a higher marginal tax rate. In addition, the estate tax is mitigated, and the phase-down of the local car tax is continued.

Taken as a whole, however, Warner's recommendations would not improve Virginia's business tax climate. Our analysis of the Warner proposal based on the Tax Foundation State Business Tax Climate Index shows that Virginia would not budge from its current rank of 21st in the nation in terms of tax climate. The three principal culprits are:

- the new higher top income tax bracket, which would disproportionately hit dual-income married couples in urban areas like North Virginia and small businesses throughout the state;
- the sales tax rate increase, which would result in higher tax payments by almost all consumers; and
- the $1 billion overall tax burden increase, which will hinder the states' economic growth.

An Alterative: The Chichester Proposal

The recent proposal by Senate Finance Chairman John Chichester includes several tax changes similar to those of the Warner plan, but the overall tax increase would be much larger.[16] Like Warner's, Chichester's proposal would establish a new, higher top personal income tax rate, and it would raise the sales tax by 1 cent. Chichester's plan would go further, though, applying the sales tax to wholesale gasoline purchases, raising the per-gallon fuel tax and preserving the car tax. On the other hand, it would eliminate the entire estate tax.

The main difference is in magnitude. The Chichester tax increase is over twice as large as Warner's, amounting to an estimated $2.5 billion during the biennium. Most of the faults of the Warner plan are compounded in Chichester's plan, particularly the size of the tax increase itself. Warner's tax hike is comparatively moderate, resulting in about a 4 percent revenue increase while Chichester's is over 9 percent. A tax hike of this magnitude would hurt Virginia's business tax climate much more severely than Warner's proposal.

The Tax Foundation's "6 and 6" Proposal

The Tax Foundation proposes that Virginia repeal inefficient, unfair taxes and rely on two 6-percent taxes on income, both individual and corporate.

Generally speaking, states that rank high in terms of tax competitiveness manage without at least one of the major taxes: a personal income tax, a corporate income tax or a sales tax. For instance, Wyoming, Nevada, South Dakota and Florida have among the best business tax climates because they levy no personal income tax. Oregon, Delaware and Montana greatly improve their business tax climates by forgoing the sales tax. New Hampshire keeps its tax burden remarkably low by having neither a sales tax nor a tax on wages, though income from interest and dividends is taxed. Alaska remains competitive overall despite having the worst corporate tax system in the nation because it levies neither an individual income tax nor a sales tax.

Other states that collect all three traditional types of state tax — on corporate income, individual income and general sales — are still able to remain competitive by keeping their rate structures simple and fair. A case in point is Colorado which also minimizes economic distortion by equalizing its personal and corporate income tax rates.

Thus, there are at least two effective ways to reform a tax system:

- lowering all tax rates to a manageable level, as Colorado has done, maintaining the "three-legged stool" approach of keeping a sales tax, a personal income tax and a corporate income tax, all at low, flat rates; or
- eliminating a major tax in a revenue-neutral fashion.

Keeping these principles in mind, the Tax Foundation has designed a tax reform named

the "6 and 6 Plan." It is revenue-neutral, and it follows the principles of fairness, simplicity and neutrality in a way that takes Virginia's regional competition into account. It even lowers the amount of federal taxes paid by Virginians.

The "6 and 6" plan proposes:

- eliminating the state and local sales tax;
- replacing the current, 4-bracket income tax with a 6-percent flat tax on wages beyond a per-person allowance of $3,700;
- maintaining the current 6-percent flat tax on corporate income;
- eliminating the estate tax;
- eliminating the local business, professional and occupational license tax;
- raising the state gasoline tax by 7 cents per gallon to replace the revenue from the proposed elimination of the half-cent of the sales tax that is currently dedicated to transportation funding.

This tax proposal is neither a tax cut nor a tax increase, and this simpler tax system would maximize Virginia's chances for economic growth.

Repealing the State and Local Sales Tax

Because Virginians have been paying sales taxes since 1966, most of the state's taxpayers do not remember a time when daily purchases did not involve the state. It may seem bold to repeal such a fixture of the tax system, but that boldness is exactly what is missing from all the so-called reform plans offered by the governor and various legislators. There is certainly nothing sacred about the sales tax. It inflicts numerous problems on the taxpaying public, from its uneven application to its cumbersome enforcement. In fact, there is not even a general agreement on the definition of a "taxable good." Is a haircut a taxable good, for instance?

The unavoidable difficulty of administering a sales tax is defining the "sales tax base," the list of all items that will be taxed. Ideally, the list should include all goods and services purchased by the final users, but not those purchased by businesses. If "business inputs" are taxed, then the price of the good to consumers will include the tax already paid. When consumers pay for the good, an additional level of tax is assessed at the register, resulting in "pyramiding" or double taxation. Defining what to tax is easier to do in theory than in practice.

Of course, through political influence, various exemptions to the sales tax have been granted: a lower rate on food benefits grocers and their customers, especially the ones who spend a high fraction of their income on food. Virginia also exempts drugs, both prescription and non-prescription. Such exemptions have the inevitable effect of lowering overall revenue and creating pressure for a higher sales tax rate on other goods.

As shoppers from Maryland, Virginia, Pennsylvania and New Jersey can attest, Delaware's zero tax rate on sales is a magnetic draw. Legally, those travelling shoppers should pay the use tax when they return home with their purchases, but it is completely unenforceable. State tax officials all over the country are expending great energy in an effort to "streamline" sales tax collection, the heart of which is interstate enforcement of sales tax collection. Despite these efforts, the enforcement problems with sales taxes are growing worse, not better.

Virginia retailing could enjoy the same advantage as Delaware by repealing its state sales tax. Even though Virginia's 4.5 percent rate is comparatively low, its neighbors have similar rates, so no significant competitive edge is gained under the current system. Under these circumstances, the only way to create a decisive comparative advantage in the region, and to solve a host of tax collection problems at the same time, is to eliminate the sales tax altogether.

Of course, in a revenue-neutral tax reform plan, the repeal of one tax must mean replacing the revenue with some other tax. In the Tax Foundation proposal, the main vehicle for boosting revenue is a reformed income tax.

Replacing the Current, 4-bracket Income Tax with a 6-Percent Flat Tax

Here's where the first 6 of the "6 and 6 plan" comes from. The 6 percent income tax rate would be Virginia's only personal income tax rate, and would be accompanied by a replacement of the current complex system of deductions, exemptions, and credits.[19] Instead, every individual listed as a tax filer or a dependent would be entitled to a per-person allowance of $3,700. To put it another way, the "zero bracket"—the amount of income that is exempt from taxation—would amount to $14,800 for a family of four. This is a more generous zero bracket than the current system ($8,200 for a family of four) and Governor Warner's proposal ($12,000 for a family of four).[20] Coupled with the elimination of the sales tax, this proposal would result in an overall tax cut for many low-income families.

The second 6 in the "6 and 6" proposal is the current 6 percent flat corporate income tax rate on corporate income. The current

corporate tax system is quite competitive, not least because it applies one rate consistently to all corporate income independent of the company's net profit. This existing 6 percent rate is lower than the state-level rate in Maryland (7 percent), North Carolina (6.9 percent), West Virginia (9 percent), Delaware (8.7 percent), and Pennsylvania (9.99 percent).

The equalizing of the top tax rates on personal and corporate income has a beneficial side effect. It removes the incentive for people to rearrange their financial affairs to produce more business income instead of personal income or vice versa. Such tax avoidance schemes cause economic distortions, making the state economy less efficient and hurting revenue.

Opponents of income taxes might well point to Tennessee as a better model than Delaware. While Delaware has helped its tax climate with a zero tax rate on sales, Tennessee forgives taxes on wages and salaries. For Virginia, that would a far more difficult reform. Over 55 percent of the state government's revenue comes from the income tax while the national average is only 37 percent.[17] Conversely, Virginia depends on sales for only about 20 percent of its revenue while other states collect an average of about 32 percent on sales. Clearly, the sales tax is more expendable in Virginia. In fact, under current law, the sales tax rate would have to be hiked to over 14 percent to replace the revenue of a repealed income tax.[18] That would be the highest sales tax in the nation, and would make Virginia one of the worst places to open a business, to say nothing of its political chances.

One final bonus of abandoning sales taxes in favor of income taxes is federal deductibility. State income tax payments are deductible on the federal 1040 form. Years ago sales taxes were also deductible, but those days of saving receipts are long gone, so by replacing sales tax revenue with income tax revenue, Virginia would be saving its itemizing taxpayers an additional $390 million in federal write-offs every year.

Repealing the Estate Tax

As discussed previously, the estate tax is essentially a double tax on capital creation and accumulation, a key component of economic growth, and it punishes small business owners. Capital is highly mobile, and encouraging the growth of capital in Virginia is vital. For that reason alone, eliminating Virginia's estate tax is an essential aspect of tax reform.

In addition, however, people currently spend a great deal of money on financial planning to avoid the estate tax. This is money that could go to productive investments. In addition, as numerous states conform their tax systems to the recent federal phase-out of the estate tax, Virginia would gain even greater comparative advantage by eliminating its estate tax immediately instead of waiting until 2010.

Repealing the Local Business, Professional, and Occupational License Tax

While not as widely discussed as the income or sales tax, the business, professional, and occupational license tax (or BPOL tax) is one of the most odious taxes on businesses in the state of Virginia. Assessed at the local level, the BPOL is what economists call a "gross receipts tax." That is, the tax is assessed on the total amount of revenue collected by a business without regard to profit or loss. No deductions are allowed against it for the costs of doing business. As a result, this a bad tax for all seasons: it hits especially hard in economic downturns when a business may not be making a profit and every extra dollar out the door may have to come at the expense of a salaried worker. At such times, the BPOL becomes a greater burden than the corporate income tax even though its statutory rate is much lower.

When coupled with the sales tax, the BPOL creates a form of double taxation known as tax pyramiding. That is, not only is the BPOL tax assessed on the cost of making and delivering a product to market, but the cost of that tax, folded into the price of the good, is passed onto the consumer who is then charged a sales tax on top of the price already inflated by the BPOL tax.

In short, this tax creates a drag on doing business in Virginia and should be eliminated in a broad-based approach to reforming the tax system to maximize the economic growth potential of the state.

Raising the Gasoline Tax

The flat income tax discussed above recoups most of the revenue lost from the proposed sales tax repeal but not all of it. Currently, a half-cent portion of Virginia's sales tax finances transportation projects. To replace that revenue, the Tax Foundation's "6 and 6" plan includes a hike in the gasoline tax of 7 cents per gallon. Admittedly, this would be a hardship for people who use the roads most, and that is not a high-income group. One could easily imagine that cutting spending on nonessential programs within the budget to divert more funds to highway construction would be preferable. Similarly, one could imagine savings achieved by privatizing some roadways,

but such savings are not always politically or practically feasible.

The second-best option is to shift the funding responsibility for transportation programs on to the one tax that most resembles a user fee: the gasoline tax. Under the current system, a portion of the cost of building roads is paid for by taxpayers who may not even own or drive a car. In addition, the real cost of highway projects is hidden when it is spread over multiple taxes, most of which have no relationship to the frequency of use of those highways. Raising the per-gallon gasoline tax to 24.5 cents from its current 17.5-cent level would align the costs of road building more closely with payments from those that benefit. This transparency might also encourage political support for reform of the highway budgeting system, which could result in lower taxes in the future.

Table 3
Impact of Tax Reforms Proposals on Two-Earner Families of Four Who Take the Standard Deduction

Current Law

	Family of Four Earning		
	$35,000	$68,000	$150,000
Income Tax Paid	$1,080.00	$2,922.00	$7,637.00
Sales Tax Paid (goods)	$625.55	$939.65	$1,720.17
Sales Tax Paid (food)	$186.67	$234.19	$352.27
Car Tax Paid	$128.36	$128.36	$128.36
Fuel Tax Paid	$137.81	$203.49	$271.93
Total	$2,158.39	$4,427.69	$10,109.73

Warner Proposal

	Family of Four Earning		
	$35,000	$68,000	$150,000
Income Tax Paid	$810.00	$2,580.00	$7,295.00
Sales Tax Paid (goods)	$764.56	$1,148.46	$2,102.43
Sales Tax Paid (food)	$116.67	$146.37	$220.17
Car Tax Paid	$0.00	$0.00	$0.00
Fuel Tax Paid	$137.81	$203.49	$271.93
Total	$1,829.04	$4,078.32	$9,889.53
Tax Savings	$329.35	$349.37	$220.20
Tax Savings Compared to Current Law	15%	8%	2%

Tax Foundation Proposal

	Family of Four Earning		
	$35,000	$68,000	$150,000
Income Tax Paid	$1,212.00	$3,192.00	$8,112.00
Sales Tax Paid (goods)	$0.00	$0.00	$0.00
Sales Tax Paid (food)	$0.00	$0.00	$0.00
Car Tax Paid	$128.36	$128.36	$128.36
Fuel Tax Paid	$192.94	$284.89	$380.71
Total	$1,533.30	$3,605.25	$8,621.07
Tax Savings	$625.09	$822.44	$1,488.66
Tax Savings Compared to Current Law	29%	19%	15%

Sources: Authors' calculations based on the Consumer Expenditure Survey, 2002; U.S. Department of Health and Human Services data; U.S. Department of Energy data; Virginia Department of Taxation data; and the Governor Mark Warner Tax Calculator, http://taxreform.governor.virginia.gov/

Cigarette Taxes and the Car Tax

Two major components of the Warner proposal that are not addressed in this study or affected by the "6 and 6" proposal are the local vehicle tax and the state and local cigarette taxes. While both of these taxes have lately been the focus of some high-profile tax debates, they have much less impact on the state's overall business tax climate, the improvement of which is the goal of the Tax Foundation's plan.

Why the Tax Foundation Proposal Would Improve Virginia's Tax Competitiveness

According to the State Business Tax Climate Index, the Tax Foundation's "6 and 6" proposal could propel Virginia into the ranks of the top 10 best states in which to open or expand a business. It does this by:

- creating a simpler and flatter tax system;
- repealing the sales tax, attracting out-of-state retail customers and keeping Virginia retail customers in state;
- eliminating distortions and complexities of the current system by equalizing the personal and corporate income tax rates;
- repealing the BPOL and estate taxes, two taxes that hinder business and capital growth; and
- keeping Virginia's overall tax burden in check.

How Families Would Fare Under Each Proposal

How would this proposal affect two-earner families of four in North Virginia? Tables 3 and 4 outline the taxes that would be paid each year after the full phase-in of the Warner and Tax Foundation proposals, compared with the current system.[21]

Table 3 illustrates the tax situations of families who are assumed to take the standard deduction. While the Warner proposal provides a 2-percent tax cut for the family earning $150,000, the Tax Foundation proposal cuts that family's taxes by 15 percent. The Warner proposal cuts taxes 15 percent for the family earning $35,000 and 8 percent for the family earning $68,000. The Tax Foundation proposal provides tax cuts of 29 percent and 19 percent, respectively—about twice as large as the tax cut provided by the Warner plan. In fact, between 40 and 60 percent of the tax

savings come exclusively from the phase-out of the car tax in the Warner plan.

It must be noted that the Tax Foundation proposal will differentially affect those families who itemize their tax forms because the "6 and 6" plan, due to its nature as a flat tax, would eliminate all extraneous deductions and credits. The loss of popular deductions, such as the mortgage interest deduction, would result in income tax increases for high-income families. However, even after making reasonable estimates about the rate of itemization, the Tax Foundation plan results in a small tax cut for some of those families who lose the current slate of deductions, while the Warner plan results in slight tax increases, mainly because of sales taxes. See Table 4.

Table 4
Impact of Tax Reforms Proposals on Two-Earner Families of Four Who Itemize Deductions

Current Law

	Family of Four Earning		
	$150,000	$200,000	$225,000
Income Tax Paid	$6,501.38	$8,902.00	$10,102.31
Sales Tax Paid (goods)	$1,720.17	$2,196.09	$2,434.05
Sales Tax Paid (food)	$352.27	$424.27	$460.27
Car Tax Paid	$128.36	$128.36	$128.36
Fuel Tax Paid	$271.93	$362.58	$407.90
Total	$8,974.11	$12,013.30	$13,532.89

Warner Proposal

	Family of Four Earning		
	$150,000	$200,000	$225,000
Income Tax Paid	$6,331.88	$8,732.50	$9,932.82
Sales Tax Paid (goods)	$2,102.43	$2,684.11	$2,974.95
Sales Tax Paid (food)	$220.17	$265.17	$287.67
Car Tax Paid	$0.00	$0.00	$0.00
Fuel Tax Paid	$271.93	$362.58	$407.90
Total	$8,926.41	$12,044.36	$13,603.34
Tax Savings	$47.70	– $31.06	– $70.45
Tax Savings Compared to Current Law	1%	– 0.3%	– 0.5%

Tax Foundation Proposal

	Family of Four Earning		
	$150,000	$200,000	$225,000
Income Tax Paid	$8,112.00	$11,112.00	$12,612.00
Sales Tax Paid (goods)	$0.00	$0.00	$0.00
Sales Tax Paid (food)	$0.00	$0.00	$0.00
Car Tax Paid	$128.36	$128.36	$128.36
Fuel Tax Paid	$380.71	$507.61	$571.06
Total	$8,621.07	$11,747.97	$13,311.42
Tax Savings	$353.04	$265.33	$221.47
Tax Savings Compared to Current Law	4%	2%	2%

Assumes taxpayers itemize at an average rate of 16.5% of adjusted gross income.

Sources: Authors' calculations based on the Consumer Expenditure Survey, 2002; U.S. Department of Health and Human Services data; U.S. Department of Energy data; Virginia Department of Taxation data; and the Governor Mark Warner Tax Calculator, http://taxreform.governor.virginia.gov/

Even in those cases where the "6 and 6" plan results in higher tax burdens, the overall efficiency gains achieved by eliminating the state and local sales tax and transitioning to a flat income tax would set the stage for further economic growth in Virginia, creating many long-term benefits.

In addition, the Tax Foundation plan is revenue neutral, meaning it does not raise the overall tax burden on the Virginia economy. On the other hand, Warner's proposal would increase the tax burden by $1 billion, so while it might provide benefits to some families, it raises taxes on the economy as a whole, endangering the growth of the state, and would have adverse trickle-down effects on those families, such as fewer job opportunities and stagnant economic growth.

Conclusion

The best hope for Virginia to lead the region in economic growth for years to come would be to enact proposals that flatten tax rates, make the tax system more friendly to the creation of capital, and eliminate local barriers to entrepreneurship.

Virginia can become one of the top ten most competitive states in the U.S. if tax reformers follow these simple rules:

- reduce the number of taxes that are levied;
- eliminate the taxes that most hinder the formation of capital and businesses, and that hinder economic growth in the state;
- root out distortions due to discriminatory tax rates and rules;
- resist the temptation to increase the overall tax burden.

Any legislative proposal that meets these criteria is deserving of the name "tax reform." Fundamental reappraisal of the state's tax code is a worthy pursuit, and legislators would be best served by undertaking true reform instead of waylaying the state's economic potential by enacting a plan that merely masquerades as reform.

Notes

[1] R.H. Melton, "Voters Reject Roads Tax: Defeat Is a Major Loss for Gov. Warner," *Washington Post,* November 6, 2002, p. A1.

[2] Quoted from Governor Mark Warner's tax reform website, http://www.governor.virginia.gov/Initiatives/TaxReform/index.htm.

[3] Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991.

[4] Claudio Agostini and Soraphol Tulayasathien, *Tax Effects on Investment Location: Evidence of Foreign Direct Investment in the United States.* Office of Tax Policy Research, University of Michigan Business School, 2001.

[5] See J. Scott Moody, "America Celebrates Tax Freedom Day," *Tax Foundation Special Report,* No. 122, April 15, 2003.

[6] Studies on the beneficial effects of cutting state tax burdens include Zsolt Besci, "Do State and Local Taxes Affect Relative State Growth?" *Economic Review,* Federal Reserve Bank of Atlanta, March/April 1996; Gerald Scully, "The Institutional Framework and Economic Development," *Journal of Political Economy,* June 1988; Robert Carroll, et al., "Personal Income Taxes and the Growth of Small Firms," *National Bureau of Economic Research Working Paper W7980,* October 2000; Ross Gittell, Allen Kaufman, and Marvin Karson, "The New Economic Geography of the States," *Economic Development Quarterly,* May 2000. A fairly comprehensive review of the literature appears in Richard Vedder, "Taxes and Economic Growth," *Taxpayer's Network,* September 2001.

[7] See Scott A. Hodge, J. Scott Moody, and Wendy P. Warcholik, "State Business Tax Climate Index," *Tax Foundation Background Paper,* No. 41, May 2003.

[8] Ibid.

[9] Authors' calculations based on U.S. Census Bureau, *Profile of Selected Economic Characteristics: 2000,* Census 2000 Summary File 3, available at: http://quickfacts.census.gov/qfd/states/51000.html.

[10] Authors' calculations based on Internal Revenue Service Master File.

[11] Authors' calculations based on US Census Bureau, *Statistics of U.S. Business: 2001,* available at http://www.census.gov/csd/susb/susb01.htm.

[12] Authors' calculations based on Internal Revenue Service Master File data, April 2003.

[13] See Stephen Slivinski, "The Corporate Tax Burden," *Tax Foundation Special Report,* No. 126, November 2003.

[14] See "Virginia Chamber of Commerce Statement on Virginia's Fiscal Dilemma," January 22, 2004, available on the web at http://www.vachamber.com/Board_Statement_Fiscal_12204.htm.

[15] See Joint Economic Committee, "The Economics of the Estate Tax: An Update," June 2003, p. 6. This study provides a discussion and review of the academic literature on the subject.

[16] See Michael D. Shear and Chris L. Jenkins, "Leading GOP senator proposes big Virginia tax increase," *Washington Post,* January 13, 2003, p. A1. available at http://www.washingtonpost.com/wp-dyn/articles/A11234-2004Jan12.html.

[17] See David Hoffman, "State Tax Collections and Rates," *Tax Foundation Special Report,* No. 121, March 2003.

[18] Authors' calculations based on Virginia Department of Taxation data.

[19] It is important to note that this proposal assumes that all current deductions, exemptions and credits would be eliminated, including such popular deductions as the home interest deduction. The goal of a flat tax is to tax wages beyond a threshold of a per-person allowance, and a broad base is essential. The current structure of deductions subsidizes some behaviors and exempts others, causing economic distortions and unfairness in the tax code. Thus, a true flat tax system relies upon a streamlining of the tax code as well as a broadening of the tax base that moves toward taxation of all consumption. The "6 and 6" proposal does not address the changes that need to be made in the corporate income tax to make it a true flat tax, completely removing the tax bias in favor of corporate income. For details, see Robert Hall and Alvin Rabushka, *The Flat Tax: Second Edition* (Hoover Institution Press: Stanford, California, 1995).

[20] This calculation assumes a married couple filing jointly who declare two dependents.

[21] The examples in Table 3 assume the following: the parents are non-smokers; they do not itemize deductions on their tax forms; they do not own a home; they own 2 cars garaged in Fairfax County; and they file their taxes jointly. This tax calculation does not include the tax savings from eliminating the estate tax. The examples in Table 4 also assumes non-smokers with two cars, but instead of taking the standard deduction, it is assumed that their itemized deductions equal 16.5 percent of adjusted gross income. The data on car tax payments due and taxable goods and food sales is taken directly from the Governor Mark Warner tax calculator, http://taxreform.governor.virginia.gov/.

SPECIAL REPORT (ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4–12 pp.
Annual subscription: $50
Individual issues $10

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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