

**Joint Legislative Audit and Review Commission
of the Virginia General Assembly**



**Replacing Income Tax Revenues
with Sales and Use Tax Revenues**

**Staff Briefing
Aris Bearse
September 13, 2004**

Introduction

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Presentation Outline

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- Introduction**
- Background**
- Experiences of States that Do Not Levy Personal Income Taxes**
- Impacts of Replacing Personal Income Tax Revenues with Sales and Use Tax Revenues in Virginia**

Study Mandate

- **House Joint Resolution 172 (2004) directs JLARC to “collect data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues”**
- **The information is to be summarized for consideration by the House Committee on Finance and the Senate Committee on Finance**

Study Issues

- **How do states that do not levy a personal income tax compare with Virginia in terms of revenue reliability and tax equity?**
- **What sales tax rate would be required in Virginia to replace personal income tax revenues with sales and use tax revenues?**
- **How would Virginia's distribution of tax burdens across income groups change if personal income tax revenues were replaced by sales and use tax revenues?**

Research Activities

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- **Data analysis**
 - Tax structures of the 50 states
 - Tax incidence analysis of the 50 states
- **Case studies**
- **Structured interviews**
 - Virginia Department of Taxation staff
 - Staff from non-profit tax policy organizations
- **Document reviews**
 - Tax policy literature
 - *Code of Virginia*

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Principles of Tax Policy

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- **Reliability**
 - **Stability**
 - **Sufficiency**
 - **Predictability**

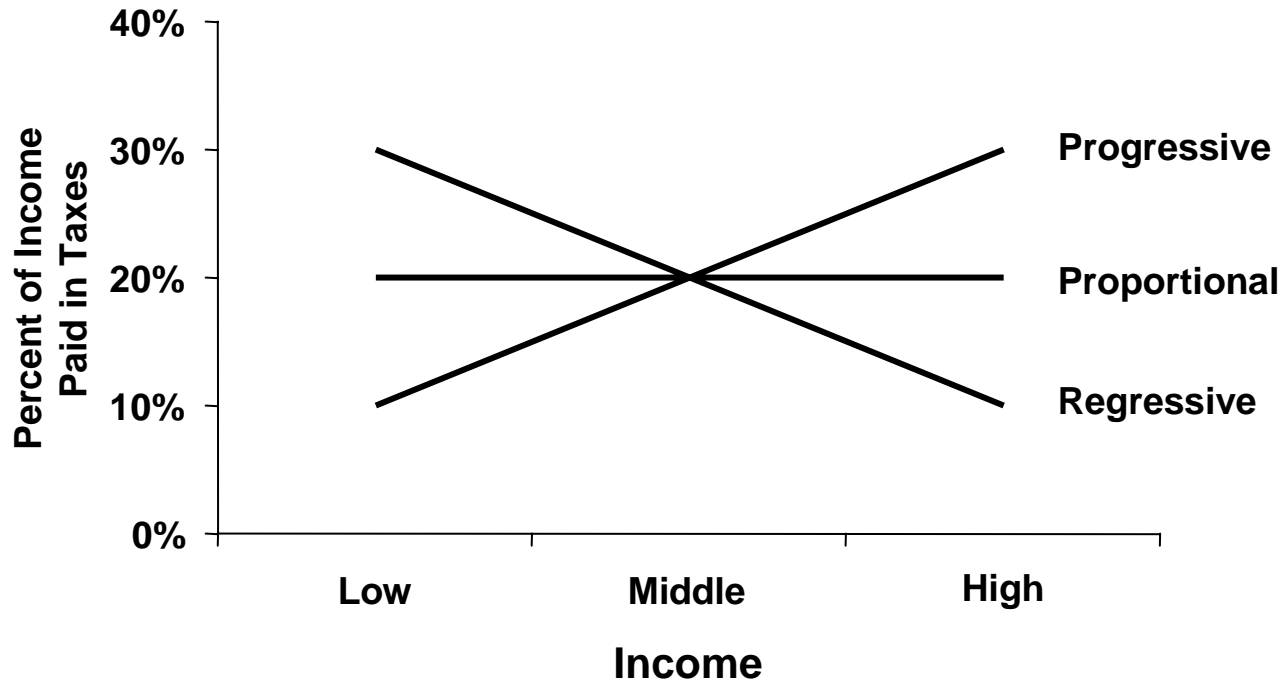
- **Minimal effects on the economy**

- **Ease of compliance and administration**

- **Equity**
 - **Horizontal**
 - **Vertical – progressive, regressive, or proportional**

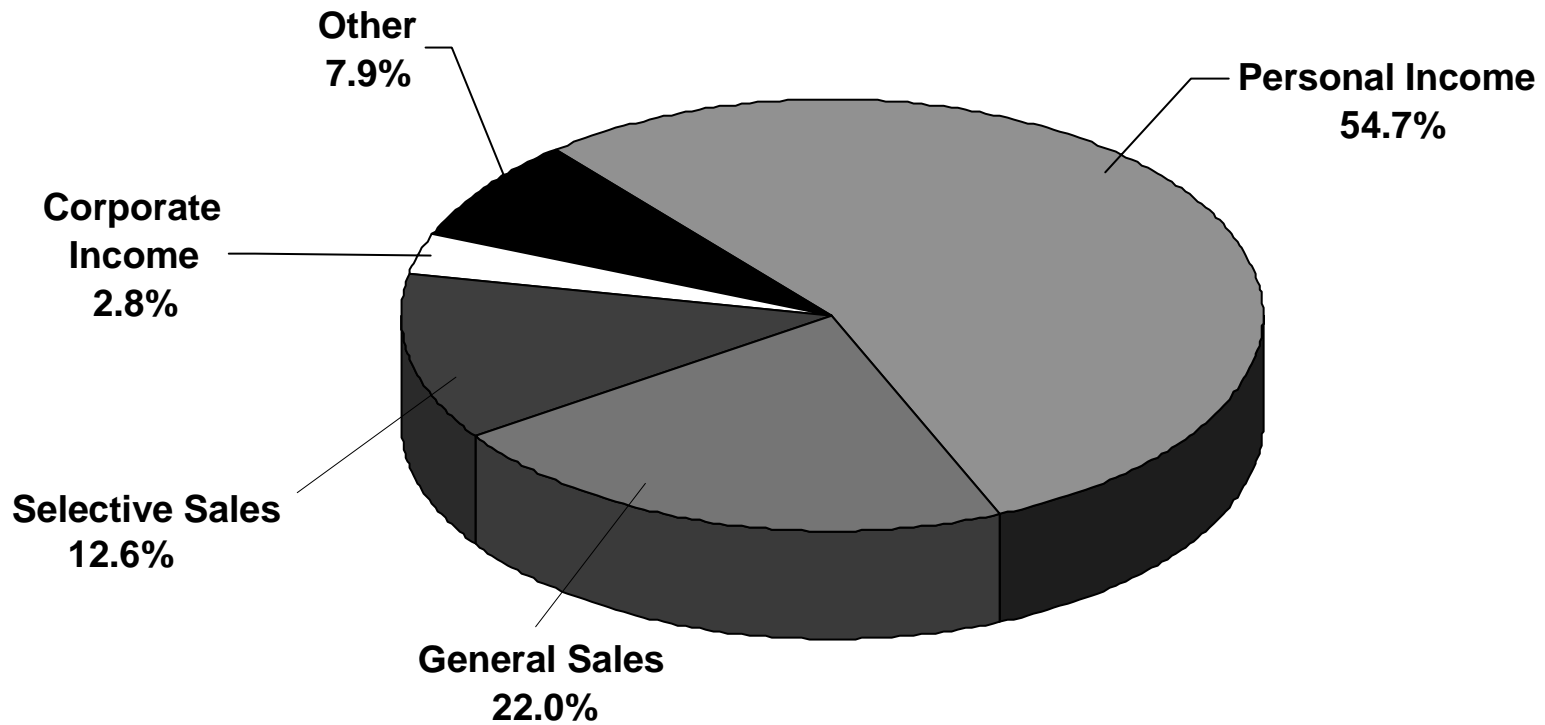
Principles of Tax Policy (continued)

Illustration of Vertical Equity Principles



Virginia's Tax Structure

Virginia General Fund Tax Revenues (2003)



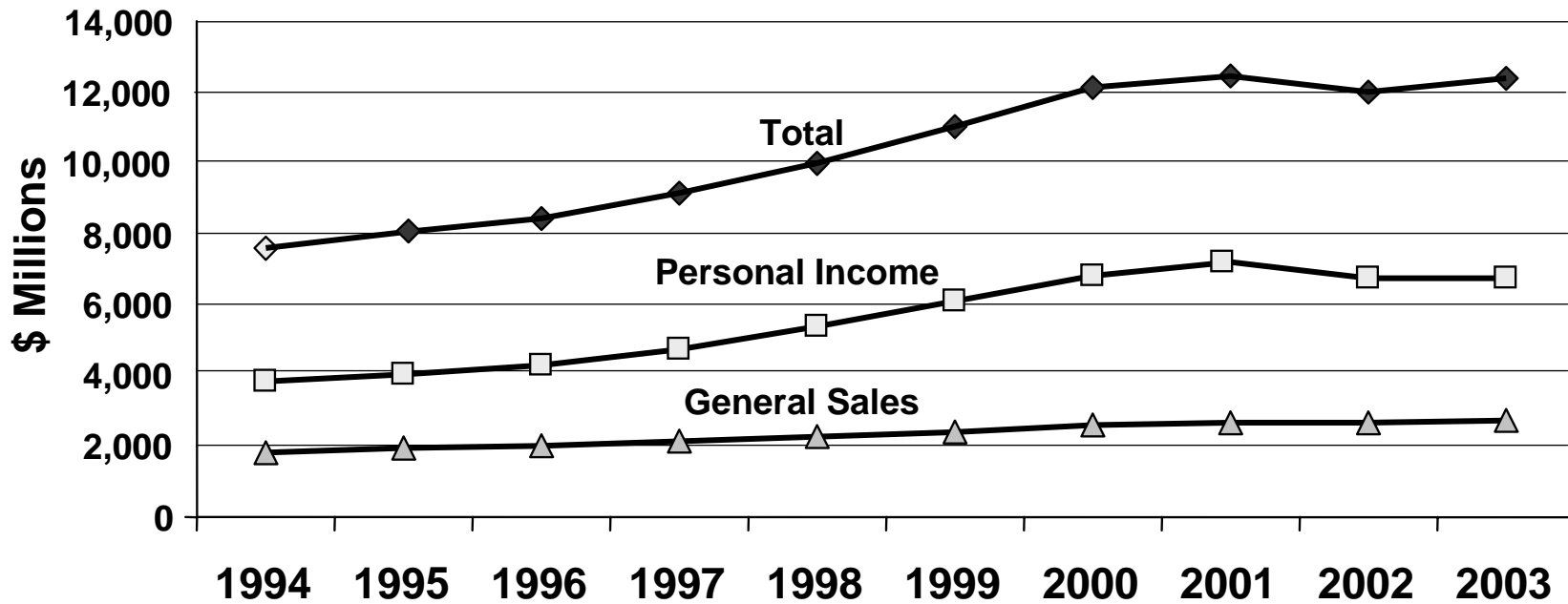
Total = \$12.35 Billion

Source: *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2003.*
Report of the Comptroller to the Governor of Virginia.

Virginia's Tax Structure

(continued)

Growth in Personal Income and Sales and Use Tax Revenues (1994-2003)



Source: *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2003.*
Report of the Comptroller to the Governor of Virginia.

2004 Changes to Virginia's Tax Structure

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■ Changes to personal income tax

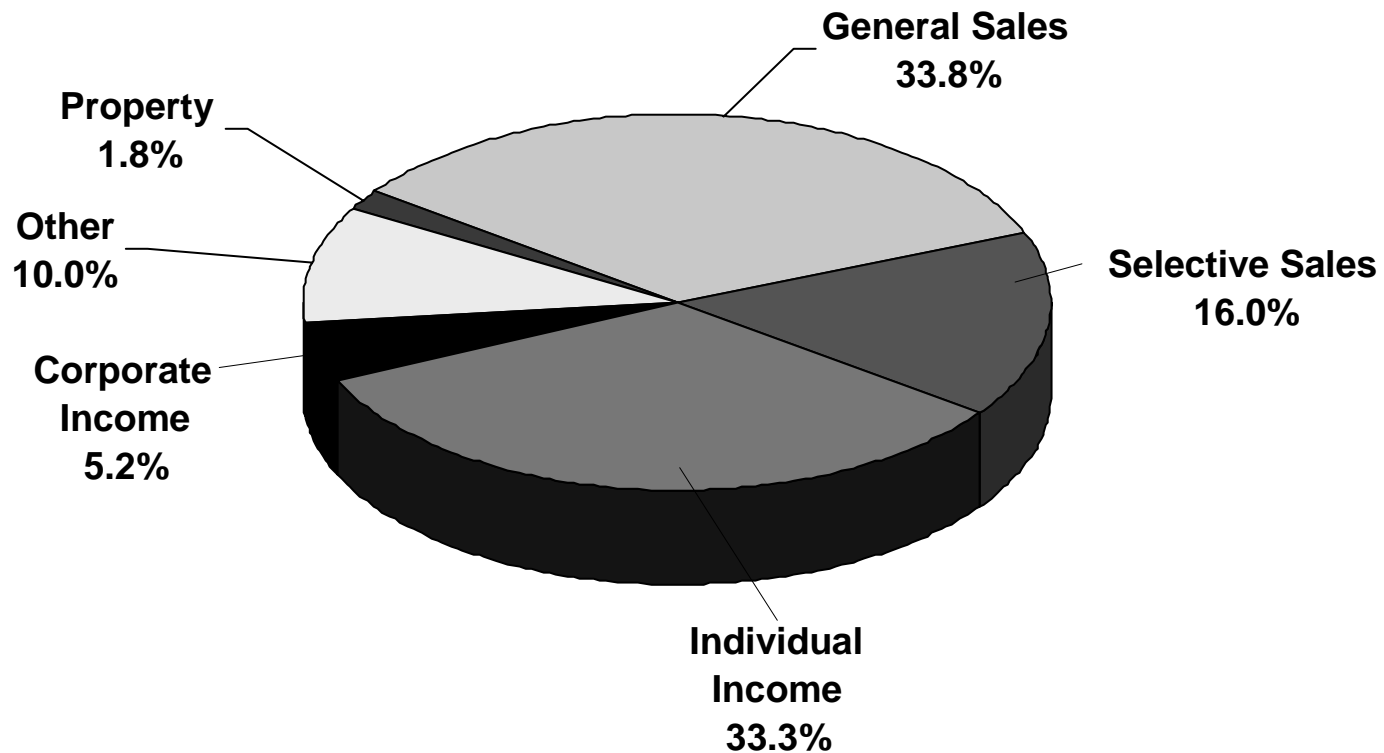
- Increased standard deduction for married couples
- Increased personal exemption
- Adjusted earned income tax credit
- Implemented means test for age deduction
- Raised filing threshold

■ Changes to sales and use tax law

- Increased sales and use tax rate from 3.5% to 4.0%
- Reduced sales tax on food
- Eliminated sales tax exemptions for certain public service corporations

Tax Structures in the 50 States

U.S. Total State Tax Collections by Source (2003)

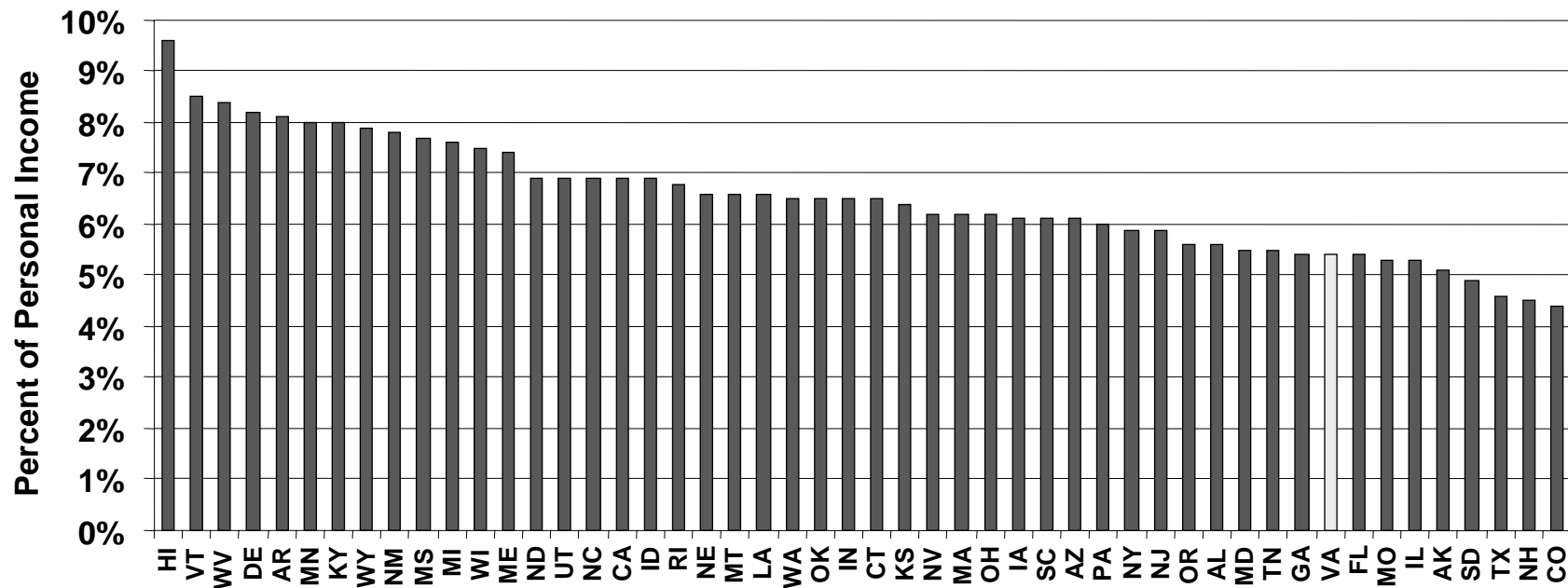


Source: U.S Bureau of the Census.

Tax Structures in the 50 States

(continued)

State Tax as a Percentage of Personal Income (2003)

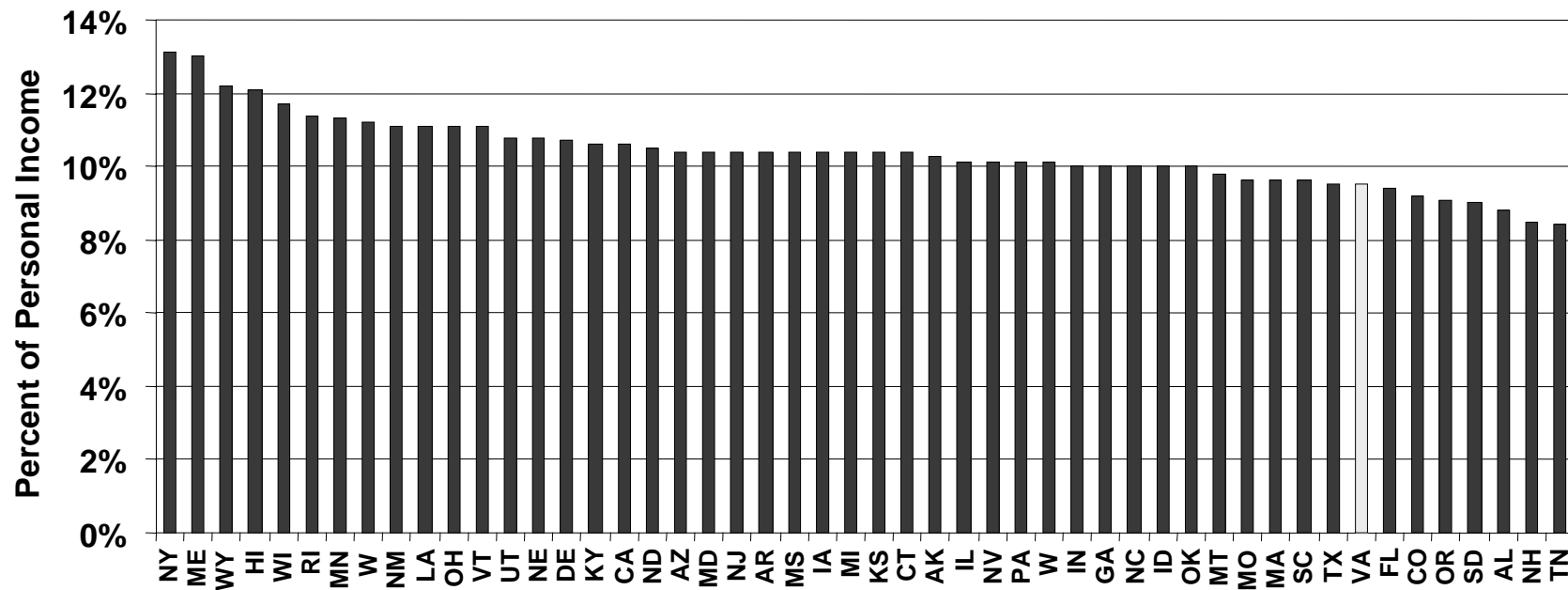


Source: U.S Bureau of the Census and Bureau of Economic Analysis.

Tax Structures in the 50 States

(continued)

State and Local Taxes as a Percentage of Personal Income (2002)



Source: U.S Bureau of the Census and Bureau of Economic Analysis.

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States That Do Not Levy Broad-Based Personal Income Taxes

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- **Seven states levy no personal income taxes**
 - Alaska
 - Florida
 - Nevada
 - South Dakota
 - Texas
 - Washington
 - Wyoming

- **Two states levy taxes only on capital gains and interest income**
 - New Hampshire
 - Tennessee

Lessons Learned from Non-Income Tax States

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- **Several of the states have unique characteristics**
 - **Alaska and Wyoming derive significant revenues from oil and mineral severance taxes**
 - **Florida has a large number of tourists**
 - **Nevada receives gaming percentage fees from its many casinos**

- **Unique characteristics are not necessarily required**

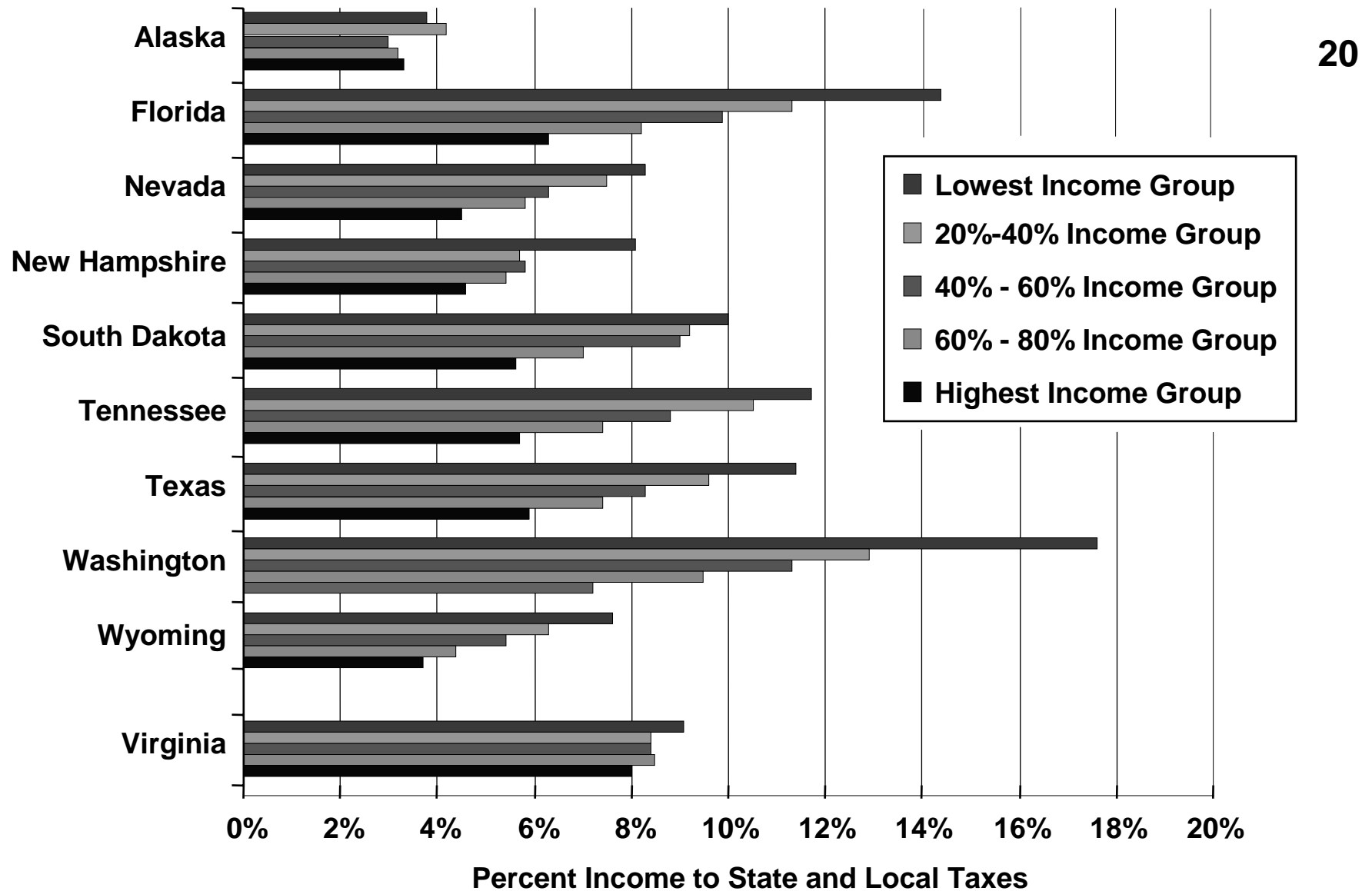
Lessons Learned from Non-Income Tax States

(continued)

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- **Most of the states tend to have regressive tax structures**
 - **Sales and use taxes are regressive, as lower income families spend a higher proportion of their income on consumption than higher income families**
 - **Six of the nine states derive one-half or more of their tax revenues from sales and use taxes**

Percentage of Family Income Paid Toward State and Local Taxes (2002)



Source: *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*. The Institute on Taxation and Economic Policy. January 2003.

Lessons Learned from Non-Income Tax States

(continued)

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- **States have experienced difficulties expanding the sales tax base**

- **States with high sales tax rates are vulnerable to revenue loss from Internet sales and out-of-state sales**
 - **Inability of states to collect use taxes from Internet sales**
 - **Vulnerability to residents purchasing goods in neighboring states with lower sales tax rates**

Lessons Learned from Non-Income Tax States

(continued)

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- **Most of the states have considered implementing a personal income tax**
 - Need to address structural deficits or inequities
 - Proposals defeated by legislatures or voters

- **Dependence on a single source results in revenue unreliability**
 - Most pronounced in Alaska
 - Need for a diversified portfolio of revenue sources

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Increasing Sales and Use Tax Revenues to Replace Income Taxes

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■ Increase the sales tax rate

- One percent increase in sales tax rate would produce approximately \$908 million annually
- Assumes higher rate would not affect total sales

■ Expand the sales tax base

- Virginia has a narrow sales tax base relative to other states
- Applying sales and use taxes to services would capture a large sector of the economy (60 percent)

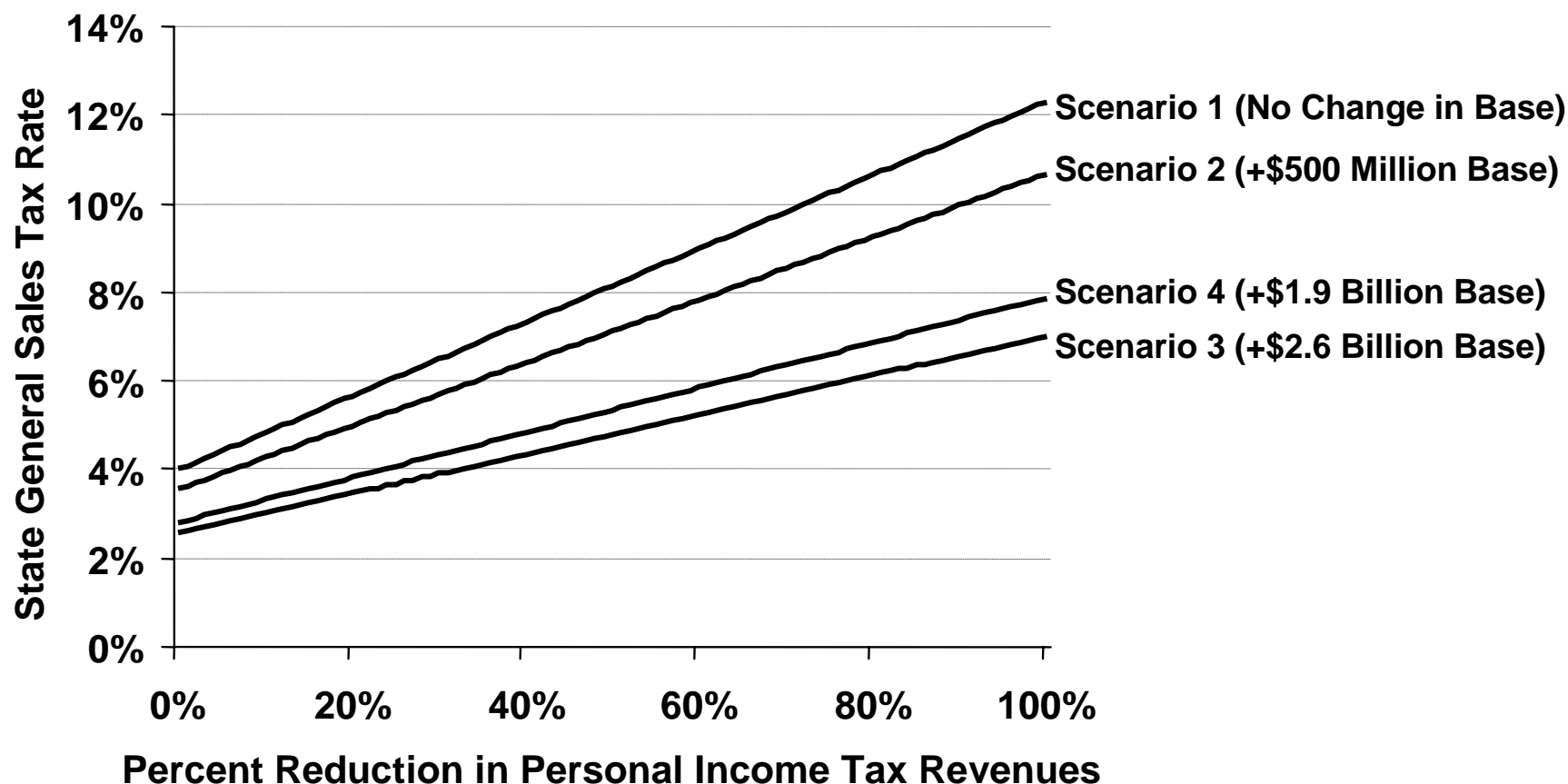
Increasing Sales and Use Tax Revenues to Replace Income Taxes (continued)

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- **Four scenarios were developed to estimate the required sales tax rate increase to replace lost income tax revenues:**
 - ***Scenario 1*** – maintaining the current tax base
 - ***Scenario 2*** – Expanding the base by \$500 million through repealing media, commercial and industrial exemptions
 - ***Scenario 3*** – Replacing all personal income tax revenues while not increasing the rate beyond 7.0 percent (achieved through expanding the base by \$2.6 billion)
 - ***Scenario 4*** – Expanding the base by \$1.9 billion through applying the sales tax to a broad range of services

Increasing Sales and Use Tax Revenues to Replace Income Taxes (continued)

Replacing Personal Income Tax Revenues with Sales and Use Tax Revenues (FY 2006 Forecast)



Impacts on the Virginia Tax Burden

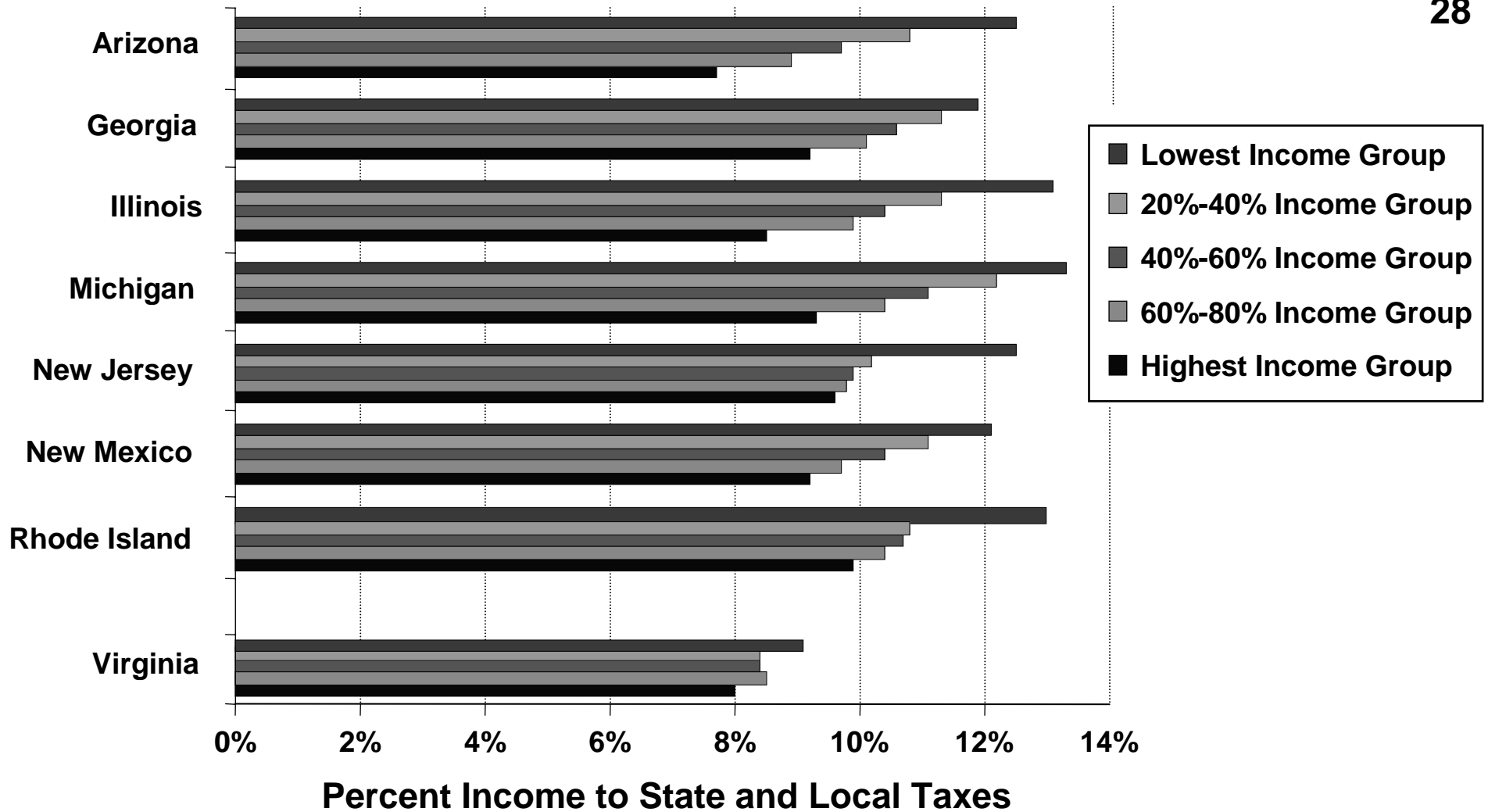
- Replacing income tax revenues with sales and use tax revenues will affect the distribution of the tax burden across income groups
- Virginia’s current State and local tax distribution is nearly proportional across income groups

<u>Income Group</u>	<u>Percent of Personal Income Paid in Taxes</u>
Lowest fifth	9.1%
20 – 40 percentile	8.4%
40 – 60 percentile	8.4%
60 – 80 percentile	8.5%
Highest fifth	8.0%

Virginia's Tax Burden Compared to Other States

State and Local Tax Distribution - Selected Regressive States (2002)

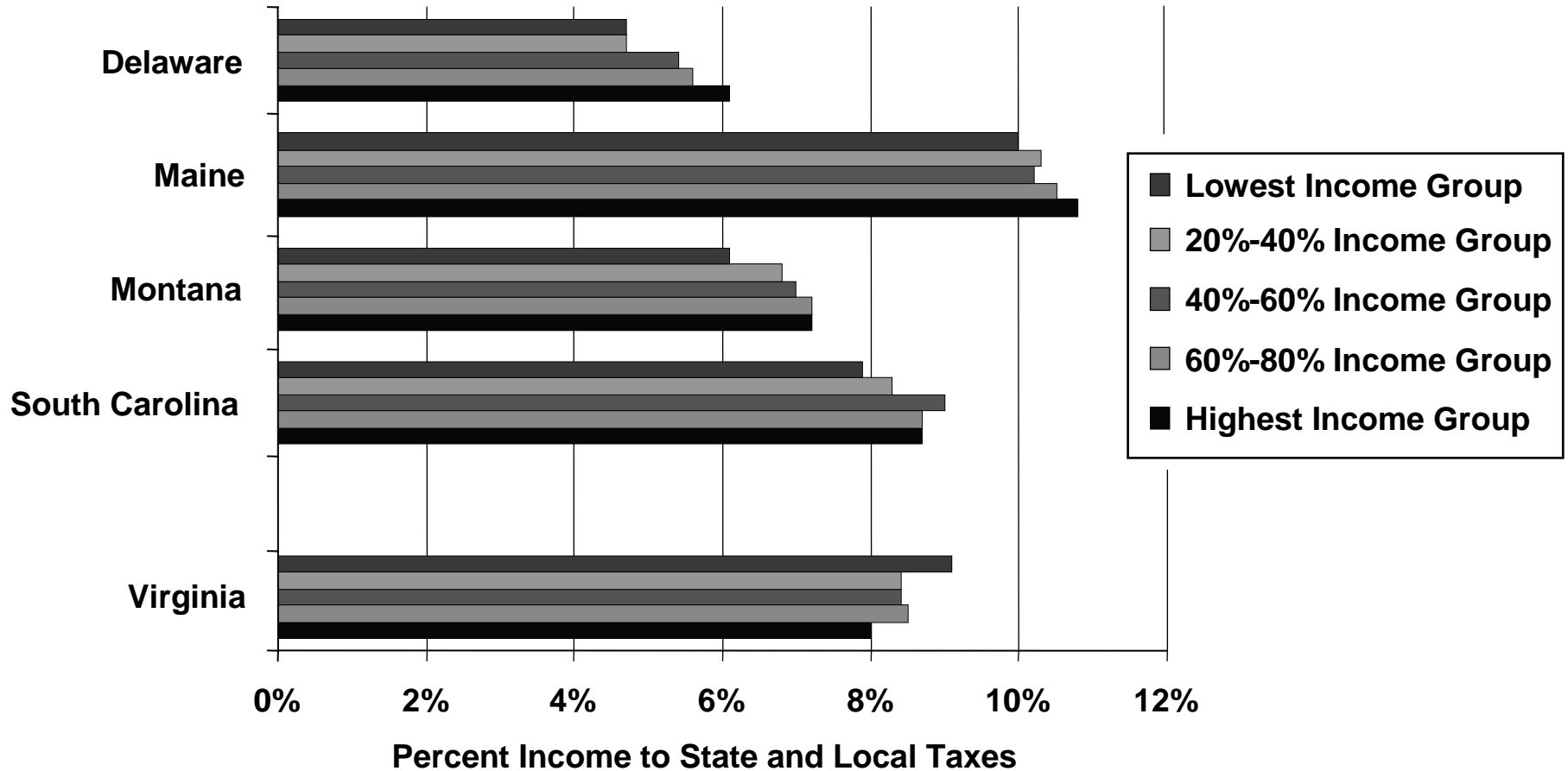
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Virginia's Tax Burden Compared to Other States (continued)

State and Local Tax Distribution - Selected Progressive States (2002)

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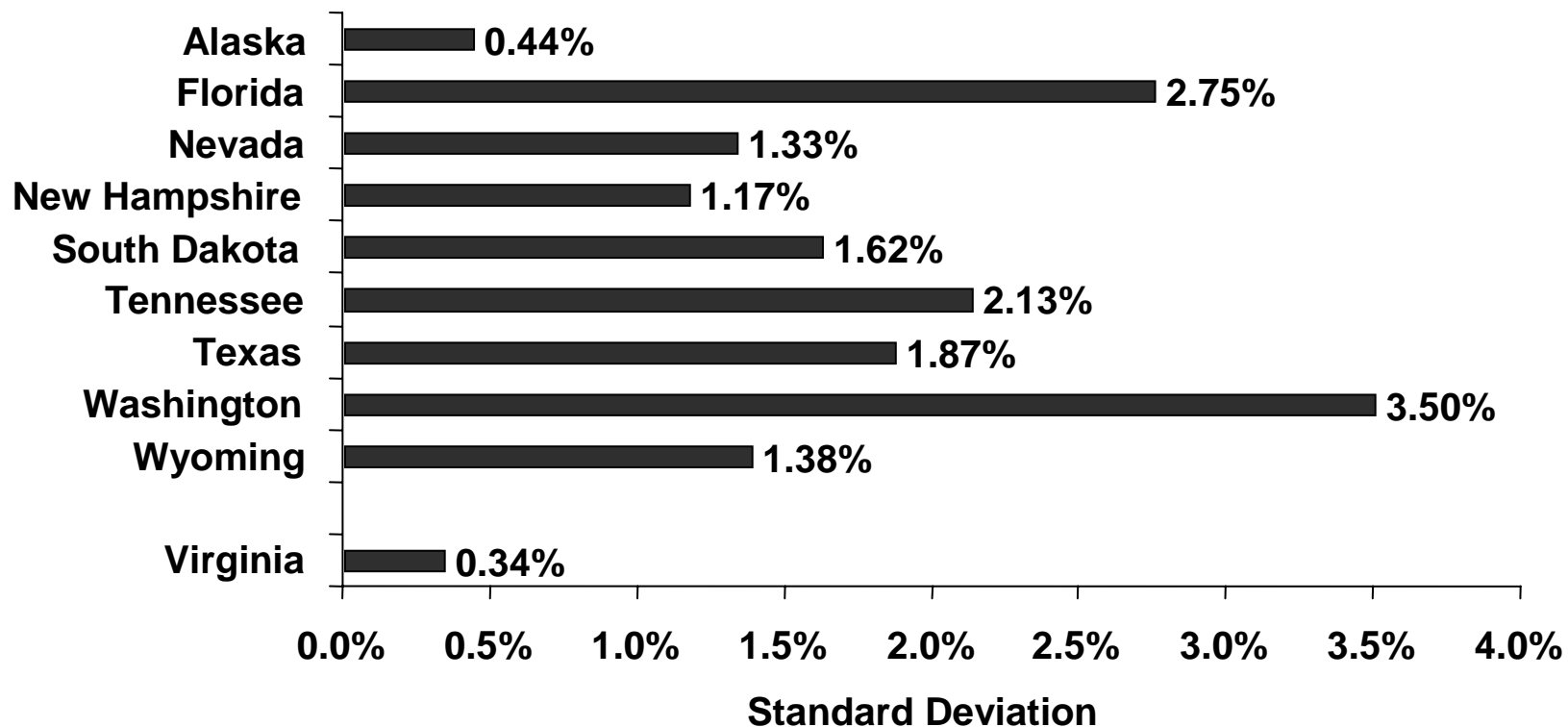
Virginia's Tax Burden Compared to Other States (continued)

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- **Virginia's state and local tax structure distributes the burden across income groups more equally than all but nine states**
 - **Standard deviation was used to measure how widely the tax burden varies across income groups for each state**
 - **Virginia had a standard deviation of 0.34%**
 - **The average standard deviation was 0.93%**

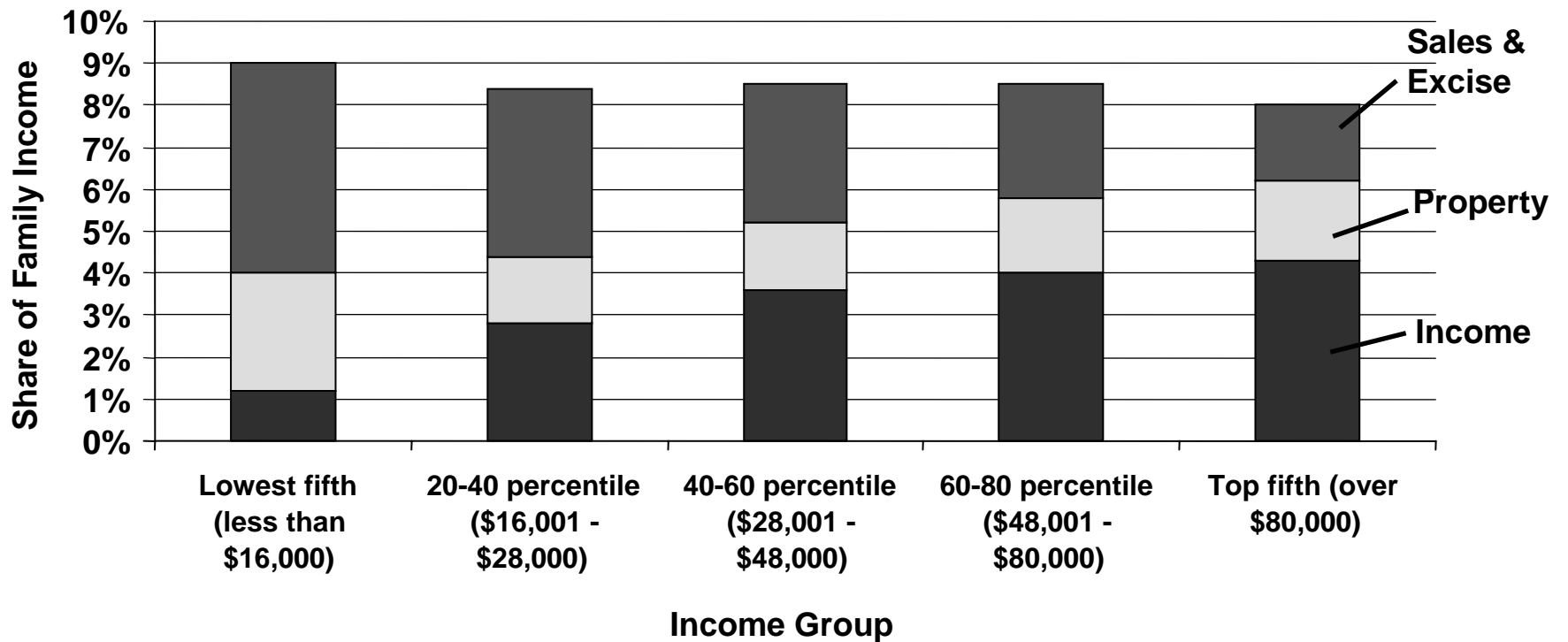
Virginia's Tax Burden Compared to Non-Income-Tax States

Standard Deviation of Differences in Tax Burdens Among Income Groups (2002)



Impacts on the Virginia Tax Burden

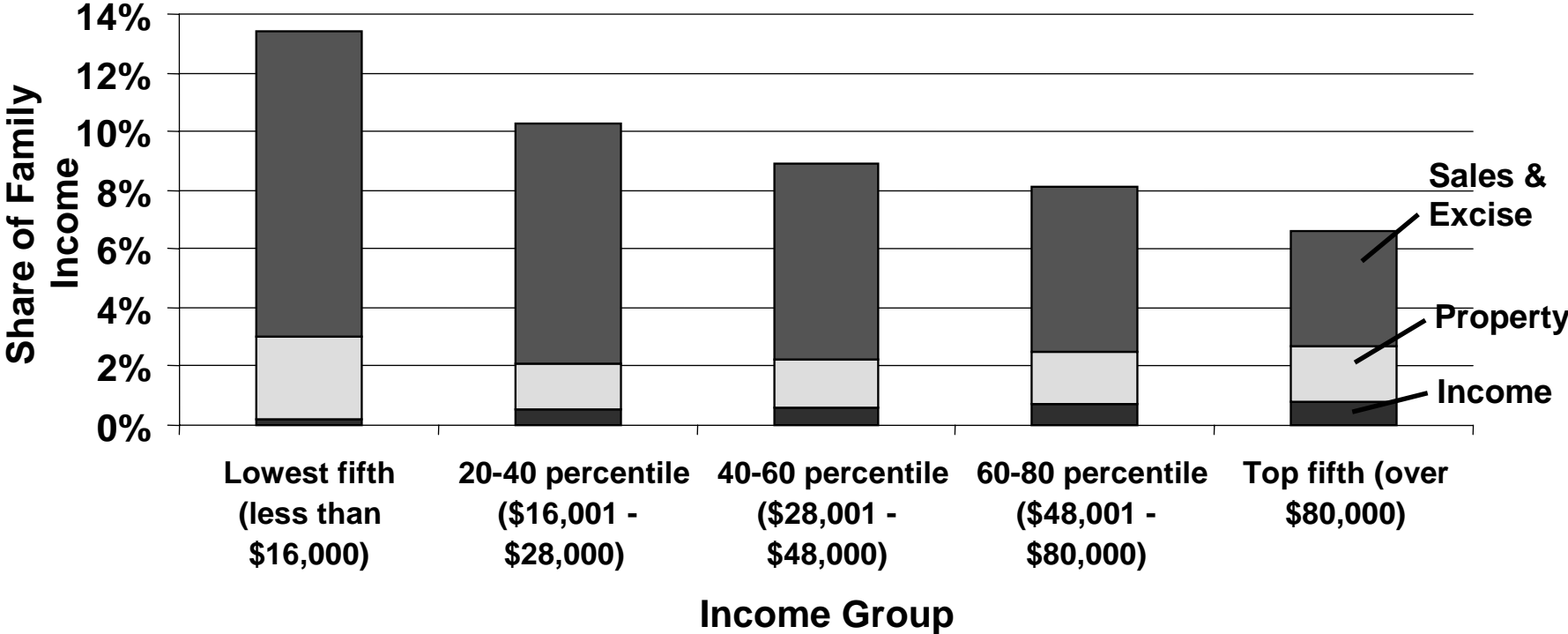
Distribution of Virginia State and Local Taxes (2002)



Source: *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*. The Institute on Taxation and Economic Policy. January 2003.

Impacts on the Virginia Tax Burden (continued)

**Redistribution of State and Local Taxes in Virginia:
Replacing \$6.35 Billion of Income Tax Revenues with
Sales and Use Tax Revenues (Scenario 4)**



Source: *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*. The Institute on Taxation and Economic Policy. January 2003.

Conclusions

- **Replacing all personal income tax revenues with sales and use tax revenues would require a state general sales tax rate in excess of 7.0 percent, which is currently the highest rate in the nation**
- **A portion of income tax revenues could be replaced with sales tax revenues by expanding the sales tax base, increasing the sales tax rate, or both**
- **Any replacement of income tax revenues with sales and use tax revenues would result in Virginia's tax structure not distributing the tax burden across income groups as equally as it currently does**