

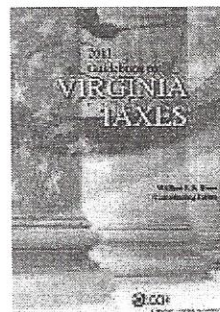
THE THOMAS JEFFERSON
INSTITUTE FOR PUBLIC POLICY

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Tax Restructuring in Virginia

A Revenue Neutral Path for Improving Our Economy

By: Michael W. Thompson



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Updated October 2013 with new modeling scenarios

Thomas Jefferson Institute for Public Policy

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Tax Restructuring in Virginia

Revenue Neutral Path for Improving Virginia's Economy

The attached report is an update to two previous studies on this topic by the Thomas Jefferson Institute for Public Policy.

The keys to remember for this significant tax restructuring:

- 1) Sales tax collections are broadened to the service industry.
- 2) There are no sales taxes on the health care industry. This industry remains exempt in all the examples in this study.
- 3) There are no business-to-business taxes suggested in this study.
- 4) The cutting and elimination of personal income tax brackets are an important piece to the economic growth contemplated in this study.
- 5) This study eliminates the BPOL, M&T and MC taxes now collected at the local level by many counties, cities and towns.
- 6) The localities that collect these taxes are made whole so that their budgets are not impacted. This is key to this tax restructuring idea.
- 7) The overall tax restructuring outlined herein is, in each modeling scenario, revenue neutral on day one.
- 8) The economic impact of this tax restructuring of the current tax code can have a very positive results with tens of thousands of new jobs and investment created over the next 5-6 years.



Michael W. Thompson
Chairman and President

Tax Restructuring in Virginia

Revenue Neutral Path for Improving Virginia's Economy

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| <i>October 2013 Update – Previous updates: April 2012 and April 2013</i> |
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Introduction

Most all economists agree that low, broadly applied taxes are best for the economy. Such taxes do not distort the market place as do targeted taxes, tax credits, etc.

In April of 2012, the Thomas Jefferson Institute published its first version of an exciting idea called, “Tax Restructuring in Virginia – A Revenue Neutral Path for Improving Our Economy.” And a year later, in April 2013, we updated that study with the new sales tax figures.

This is the third edition of our study and includes 14 modeling scenarios showing how the tax changes can impact our state's economy.

This report has generated a great deal of interest and support for this basic idea: broaden the sales tax to services that do not now collect it from their customers, except those that are part of our health care system; no new business-to-business taxes; significantly reduce personal income taxes; eliminate three business taxes that limit economic growth -- the Business Professional Occupation Licensing (BPOL), Machine and Tool (M&T), and the Merchants Capital (MC) taxes; and make whole the localities that collect any of these three taxes. These are the non-variables in this tax restructuring plan.

Before proceeding with this effort, we approached four groups all of which gave us an initial “we are interested in this idea” go-ahead. These groups were the Tax Foundation in Washington DC that has been studying taxes since the 1930's, Americans for Tax Reform that is an influential group in the General Assembly and which supports either tax reductions or revenue neutral tax plans, and the two critically important local government organizations -- the Virginia Association of Counties (VACO) and the Virginia Municipal League (VML).

And we initially approached five major business organizations for their “buy in” to the concept: the National Association of Independent Business (NFIB), the Virginia Manufacturers Association (VMA), the two major retailing groups – the Virginia Retail Federation and the Retail Alliance, and a group of gas station owners in Northern Virginia called the Virginia Gas Marketers Council. We then put together a “working group” of some 60 key people representing a broad set of interested industries interested in this idea. All await final legislation before “committing” to any specific support.

The Thomas Jefferson Institute has spent two years working with key leaders to determine if the current tax system in Virginia can be “re-arranged” in a way that would be revenue neutral and create a stronger and more competitive business climate that would grow our economy over the next few years.

And in 2013, the General Assembly asked the two key legislative commissions to look at this tax restructuring plan and to hold joint public hearings around the state. These two legislative entities are the Small Business Commission and the Manufacturing Development Commission.

Further background on this tax restructuring idea can be found in our two previous reports. Chmura Economics and Analytics of Richmond produced the study providing us with the figures by specific service industry that do not collect sales taxes and how much those industry would produce if taxes should they collect sales taxes from their customers (see pages 2-A and 2-B of this updated report). And the economists at the Beacon Hill Institute at Suffolk University in Boston developed the tax-and-spending model that they have produced in the past for us and that has received bi-partisan praise for its results. The full Chmura report and the background on the Beacon Hill tax model, known as a STAMP model (State Tax Analysis Modeling Program) can be found on our website with our first report in April of 2012.

Tax Model Results

In order to analyze what kind of potential tax restructuring could be crafted to produce the best “bottom line” results for our economy, the Thomas Jefferson Institute produced a series of scenarios through its dynamic economic model. The results of these scenarios show the economic impact that can be achieved when this basic tax restructuring is considered.

Each of these scenarios has five non-variables: The broadening of sales taxes never includes those associated with health care; there are no new business-to-business taxes involved; each scenario eliminates the BPOL, Machine and Tool (M&T) and Merchants Capital (MC) taxes; each scenario is based on making the localities that receive income from these three business taxes whole (a cost of \$899 million according to the Secretary of Finance) so that no budget impact is produced on these counties, cities and towns; and the overall tax restructuring is revenue neutral. These are key to this entire effort and are the basis for the economic impact scenarios detailed in this study.

We have developed the additional scenarios in this update (Scenario #8 through #14) over the past many months based on discussions we have had with various stakeholders and legislative leaders and from the comments made at the joint hearings held by the Small Business Commission and the Manufacturing Development Commission.

Additional scenarios can be run through our dynamic economic model for those interested in seeing the outcome of new combinations.

Scenario #1: Sales taxes are expanded to currently exempt service sectors excluding the entire healthcare sector, BPOL, M&T and MC taxes are eliminated, and the sales tax rate is reduced to 3.68% (30.6% reduction). The economic results would be:

- Private employment increases by 8,200 - 10,600 jobs
- Investment increases by \$615 million
- Real disposable income increases by \$683 - \$865 million
- Real state GDP decreases by \$537 million

Scenario #2: Sales taxes are expanded to all current service sectors excluding the entire healthcare sector, elimination of BPOL, M&T and MC taxes, and income tax rates for all brackets are cut by 17%. The economic results would be:

- Private employment increase by 45,000 jobs
- Investment increases by \$258 million
- Real disposable income increases by \$1.0 billion
- Real state GDP increases by \$4.8 billion

Scenario #3: Sales taxes are expanded to currently exempt service sectors excluding the entire healthcare sector, the BPOL, M&T and MC taxes are eliminated, the lowest personal income tax bracket (\$0 to \$3,000 income level) is eliminated, and the rates for the other brackets are cut by 10%. The economic results would be:

- Private employment increases by 61,000 jobs
- Investment increases by \$274 million
- Real disposable income increases by \$1.8 billion
- Real state GDP increases by \$6.6 billion

Scenario #4: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector, elimination of the BPOL, M&T, and MC taxes, the bottom two tax brackets are eliminated (\$0 to \$3,000 income and \$3,000 to \$5,000 income brackets) and the current top 5.75% rate drops to 5.0% (a 13% tax cut) and the next 5.0% rate drops to 4.55% (a 9.0% tax cut). The economic results would be:

- Private employment increase by 79,000 jobs
- Investment increases by \$287 million
- Real disposable income increases by \$2.85 billion
- Real state GDP increases by \$8.4 billion

After reviewing these scenarios, we wanted to add specific industries back to the “exempt” status to see what the results would be on the economy.

So we added to the health care these additional sectors for continued exclusion from sales tax collection: private schools since education is key to creating a more competitive and vibrant economy; day care in order to avoid creating any additional hindrances to securing gainful employment; and banking and finance industries since capital investment is key to rebuilding our economy.

With this new set of exclusions factored into the dynamic tax model, the three (3) additional scenarios below were developed.

Scenario #5: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector and private colleges and private schools, BPOL, M&T and MC taxes eliminated, the lowest tax bracket eliminated and the rates for other brackets cut by 13%. The economic results would be:

- Private employment increase by 49,700
- Investment increase by \$273 million
- Real disposable income increases by \$1.8 billion
- Real state GDP increases by \$6.5 billion

Scenario #6: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector, private colleges and schools, plus the day care services, BPOL, M&T and MC taxes are eliminated, the lowest tax bracket is eliminated and the rates for other brackets are cut by 12.5%. The economic results would be:

- Private employment increase by 59,800 jobs
- Investment increase by \$274 million
- Real disposable income increases by \$1.7 billion
- Real state GDP increases by \$6.4 billion

Scenario #7: Sales taxes are expanded to all current exempt service sectors excluding healthcare, private schools, daycare, and banking/finance, BPOL, M&T and MC taxes are eliminated, the lowest tax bracket is eliminated and the rates for the other personal income tax brackets are cut by 10%. The economic results would be:

- Private employment increase by 46,600 jobs
- Investment increases by \$427 million
- Real disposable income increases by \$1.5 billion
- Real state GDP increases by \$4.9 billion

We then wanted to see what the results would be if we excluded from the broadening of sales taxes the real estate industry. Since the sale of homes is a leading indicators going into recessions and coming out of recessions, it seemed that excluding real estate might be something that our elected officials would want to consider.

Here are the scenarios for maintaining the current sales tax exclusion on health care services and adding to that sales tax exclusion the real estate industry.

Scenario #8: Sales tax base expanded to service sector excluding the entire healthcare and real estate sectors, elimination of the BPOL, M&T and MC taxes, all income tax brackets are cut by 5.5%. The economic results would be:

- Private employment increase by 24,600 jobs
- Investment increase by \$413 million
- Real disposable income increases by \$570 million
- Real GDP increases by \$2.09 billion

Scenario #9: Sales tax base expanded to service sector excluding the entire healthcare and real estate sectors, elimination of the BPOL, M&T and MC taxes, the bottom two tax brackets are eliminated (\$0 to \$3,000 income and \$3,000 to \$5,000 income brackets) and the other two brackets are reduced by 1%. The economic results would be:

- Private employment increase by 52,200 jobs
- Investment increase by \$442 million
- Real disposable income increases by \$2.17 billion
- Real GDP increases by \$4.36 billion

And in our discussions with business and elected leaders, we were asked to model what would happen if the elimination of some or all of the sales tax on food for home consumption was modeled into this tax restructuring idea. Here is what we found.

Scenario#10: Sales tax base expanded to service sectors excluding the entire healthcare and real estate sectors, elimination of the state's portion of the tax on food for household consumption (\$221 million), elimination of the BPOL, M&T and MC taxes, and cut all income tax brackets by 3%.

- Private employment increase by 9,700 jobs
- Investment increase by \$445 million
- Real disposable income decrease by \$159 million
- Real GDP increases by \$875 million

Scenario #11: Sales tax base expanded to service sectors excluding the entire healthcare sector, eliminate the state's portion of the sales tax on food for household consumption (\$221 million), eliminate the BPOL, M&T and MC taxes, and cut all income tax brackets by 10.5%.

- Private employment increase by 54,400 jobs
- Investment increase by \$420 million
- Real disposable income increases by \$2.12 billion
- Real GDP increases by \$4.32 billion

Scenario #12: Sales tax base expanded to service sectors excluding the entire healthcare sector, eliminate the state's portion of the sales tax on food for household consumption (\$221 million), eliminate the BPOL, M&T and MC taxes, eliminate the bottom two income tax brackets (\$0 to \$3,000 and \$3,000 to \$5,000 income brackets) and the remaining two brackets are cut by 4.5%.

- Private employment increase by 78,400 jobs
- Investment increase by \$447 million
- Real disposable income increases by \$3.43 billion
- Real GDP increases by \$6.35 billion

Scenario #13: Sales tax base expanded to service sectors excluding the entire healthcare sector, eliminate the entire sales tax on food for household consumption (\$369 million), eliminate the BPOL, M&T and MC taxes, eliminate the bottom two tax brackets (\$0 to \$3,000 income and \$3,000 to \$5,000 income brackets) and cut the remaining two brackets are by 3%.

- Private employment increase by 68,500 jobs
- Investment increase by \$439 million
- Real disposable income increases by \$3.07 billion
- Real GDP increases by \$5.52 billion

Scenario #14: Sales tax base expanded to service sectors excluding the entire healthcare sector, eliminate the entire sales tax on food for household consumption (\$369 million), eliminate the BPOL, M&T and MC taxes, and cut all income tax brackets by 7%.

- Private employment increase by 49,600 jobs
- Investment increase by \$440 million
- Real disposable income increases by \$1.541 billion
- Real GDP increases by \$3.15 billion

From the perspective of jobs creation, the scenarios listed below are ranked in order from that with the most jobs created to the least jobs created over the next 5 to 6 years:

| | |
|--------------|-------------|
| Scenario #4 | 79,000 jobs |
| Scenario #12 | 78,400 |
| Scenario #13 | 68,500 |
| Scenario #3 | 61,000 |
| Scenario #6 | 59,800 |
| Scenario #11 | 54,400 |
| Scenario #9 | 52,200 |
| Scenario #5 | 49,700 |
| Scenario #14 | 49,600 |
| Scenario #7 | 46,600 |
| Scenario #2 | 45,000 |
| Scenario #8 | 24,600 |
| Scenario #1 | 10,600 |
| Scenario #10 | 9,700 |

Clearly, from the modeling with our sophisticated STAMP model, the idea behind this tax restructuring idea can have a significant impact on our state's economy. Broadening the sales tax collection to services not now required to collect that tax, and using these monies to reduce other taxes, can have a very positive impact on our future.

Conclusion

For the first time, a truly “revenue neutral” tax restructuring proposal is now on the table to eliminate the BPOL, M&T and MC taxes, make the localities “whole” from a revenue standpoint, and depending on the scenario above dramatically cut income taxes and/or food taxes on our citizens.

This major tax restructuring concept is revenue neutral and yet produces an incredible improvement in our economy. Not only is this fascinating intellectually, but it is truly exciting from a public policy point of view.

If the policy goal is to create a better tax structure in our state, to eliminate BPOL, M&T and MC taxes as our Governor and others have advocated for many years, and to do this in a way that keeps our localities whole from their “lost income” from the three business taxes, this plan outlined herein can substantially improve our economy..

Those industries that would have to collect sales taxes from their customers would no longer pay BPOL, M&T and/or MC taxes. This is an incentive for them to consider this new tax policy idea. And depending on which scenario is selected above, income tax reductions would also impact everyone in the state, including everyone who works for the businesses that would have to collect sales taxes from their customers under this new tax concept. Of course, other scenarios can be run to determine additional outcomes.

Tax restructuring can have a significant impact on our economy as the scenarios that were run through the Virginia STAMP model clearly show.

The sales tax restructuring outlined in this study can achieve five important policy goals: cut income tax rates and entire income tax brackets; eliminate the three job destroying taxes that business and politicians have belly-ached about for years – BPOL, M&T and MC taxes; keep the localities whole that levy these taxes today so that their budgets are not impacted; produce better economic growth; and do this in a “revenue neutral” manner.

We hope this updated report will continue to generate a serious discussion on tax restructuring. The Thomas Jefferson Institute is ready and anxious to participate in that discussion using this study and our dynamic tax/spending model (Virginia STAMP) to assist our public, private and non-profit sector leaders in crafting a better tax system than we have today.

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“... a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities.”

Thomas Jefferson, 1801

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