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Taxes and Tax Talk Everywhere

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Cumulative budget deficits exceeding $6 billion through the 2003 General Assembly session are focusing attention on taxes across the Commonwealth (Warner). The $6 billion is almost one-quarter of the 2004 annual budget for the Commonwealth. Taxes, tax policy, equity and fairness in taxation, and revenue needs for essential public services have been discussed in Virginia for decades, but the huge budget deficits are bringing a sense of urgency to the dialogue in late 2003.

Total state budgets have increased 52.0 percent since fiscal year 1997 (Table 1). Driving the budget increases are increases in health and human resources and transportation, up 55.5 and 55.3 percent, respectively, since 1997. Increases in student numbers have helped push the education budget up 47.6 percent across the same period, and public safety is up 48.4 percent. Most of the growth in these principal parts of the total budget is difficult or impossible to avoid. Education, public health and human resources, transportation, and public safety have accounted for about 85 percent of the budget for each biennium.

Table 1. State budget 1997 – 2003 and proposed 2004, general and non-general funds.

Fiscal Year	Total Budget	Education	Health & Human Resources	Transportation	Public Safety	Other
	-----	-----	----- *Billion$* -----	-----	-----	-----
1997	17.13	6.75	4.40	2.19	1.28	2.52
1998	17.62	7.04	4.50	2.36	1.35	2.37
1999	19.96	7.91	4.81	2.85	1.52	2.87
2000	21.37	8.32	5.36	2.75	1.69	3.24
2001	23.32	8.78	5.83	3.22	1.93	3.56
2002	23.48	8.97	6.08	3.03	1.91	3.49
2003	24.98	9.55	6.75	2.95	1.90	3.83
2004	26.04	9.96	6.84	3.40	1.90	3.93

Source: Web-Bud Database

On November 27, 2003 Governor Mark Warner announced his plan for tax reform (*www.governor.virginia.gov*). Changes are proposed in cigarette taxes, in the statewide sales tax, in the state income tax for varying levels of income, and in other areas of the existing tax code. Since education, health and human resources, transportation, and public safety make up 84.9 percent of the 2004 budget, these four areas received much of the attention in the Governor's plan and will receive most of the attention in the coming debate. Progressive and regressive taxes will be discussed. And inevitably, Virginia will be compared to surrounding states.

Virginia ranks 41st in the nation in percent of personal income that goes to taxes. It ranks 12th in per capita income. "Taxes ought to be based on people's ability to pay them, which means that the share of income paid in taxes should rise as income grows . . ." says Robert McIntyre of the Institute on Taxation and Economic Policy. When taxes take a larger share of higher incomes, they are *progressive* taxes. When taxes take a larger share of lower incomes, they are *regressive* taxes.

How Virginia compares to surrounding states is always of interest in any discussion on taxes and tax policy as is the relationship between rural and urban Virginia. In this issue of *Horizons,* we look at selected taxes and show Virginia's position compared to the states having common borders with Virginia: North Carolina, Tennessee, West Virginia, Pennsylvania, Kentucky, Maryland (the Region) and rural and urban Virginia.

The Region

Over the 11-year period from 1992 through 2002, Virginia has enjoyed the second highest per capita personal income in the Region, which is also higher than the average for the US (Figure 1). Maryland has been consistently higher by about $2,500. At the other end of the spectrum are Kentucky and

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A ***regressive tax*** is one where everyone, regardless of income level, pays the same dollar amount. Such a tax causes lower-income people to pay a larger share of their income than wealthier people pay. Regressive taxes include the fixed excise taxes on tobacco, alcohol, and gasoline; user fees for licenses; admission to museums and parks; and tolls for roads, bridges, and tunnels. Sales taxes can also be regressive because they usually take a larger percentage of income from low-income groups than from high-income groups for basic needs such as food and clothing.

A ***progressive tax***, based on the concept of ability to pay, takes a larger percentage of income from high-income groups than from low-income groups. A progressive tax system might, for example, tax low-income taxpayers at 5 percent, middle-income taxpayers at 7.5 percent and high-income taxpayers at 10 percent. Source*:* Internal Revenue Service

West Virginia. Personal income, as defined by the Bureau of Economic Analysis, is the sum of wage and salary disbursements, other labor income, proprietors' income with inventory valuation and capital consumption adjustments, rental income of persons with capital consumption adjustment, personal dividend income, personal interest income, and transfer payments to persons, less personal contributions for social insurance (Social Security and Medicare). Per capita income in Virginia increased steadily until 1999 when it dropped in 2000 to nearly the same level as 1998. In 2001, it again began to increase. This pattern is consistent across the Region.

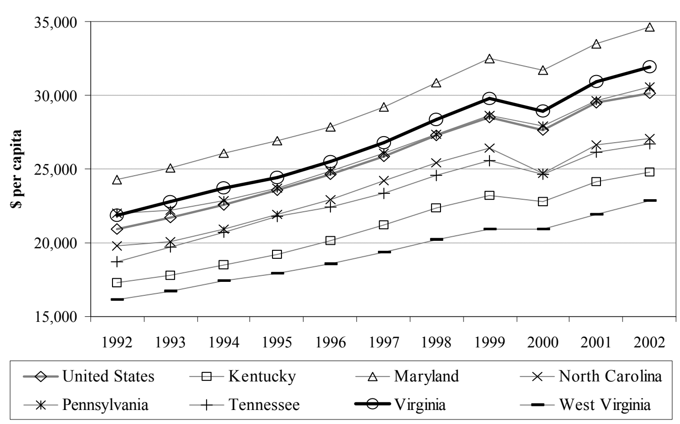

Figure 1. Per capita income, 1992 - 2002

In contrast to per capita income, per capita total taxes put Virginia second from the bottom, ahead of only Tennessee, and below the US average (Figure 2). Total per capita taxes in Virginia are composed of property taxes, sales and gross receipts taxes, licenses, individual income taxes, and other taxes. Property taxes, sales and gross receipts, and individual

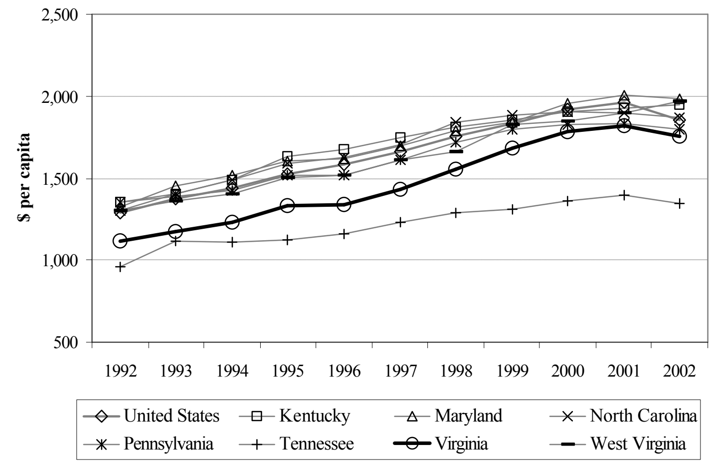

Figure 2. Per capita total taxes, 1992 - 2002

income taxes account for the largest portion of the revenue collected at state and local levels.

As a percent of income, total taxes in Virginia are the second lowest in the Region (Figure 3). Only Tennessee is lower. At its peak, total taxes as a percent of income in Virginia was slightly above 6 percent. Generally, Virginia is around 5.5 percent. While Kentucky and West Virginia have the lowest per capita incomes, they have the highest total taxes as a percent of income in the Region.

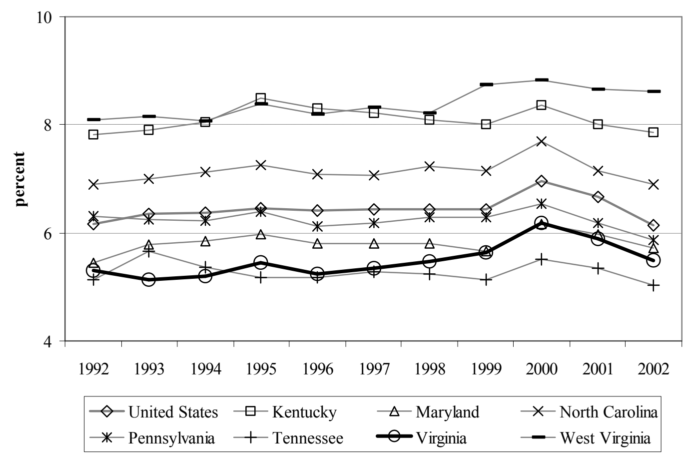

Figure 3. Total tax as percent of income, 1992 - 2002

Individual income taxes make up, on average, 50.4 percent of total tax revenue in Virginia. Although Virginia's per capita income tax has been the highest in the region since 1999, it has averaged less than $800 per capita, slightly above Maryland's $750 average (Figure 4). At its highest, Virginia per capita income taxes were $1,004 or 3.25 percent of personal income. As with many other states including Kentucky, Maryland, and West Virginia in the Region, Virginia's income tax starts with the federal adjusted gross income. North Carolina bases its income tax on federal taxable income. Changes to federal tax policy also affect income tax revenues in these states. Changes were made to the federal tax code in 2000 to reduce taxes in 2001. The impact can be seen as tax revenues dropped in 2002 as the result of these tax changes coupled with a general slowing of the economy. Tennessee charges an income tax on interest and dividends only and averages $25 per capita (not shown on Figure 4).

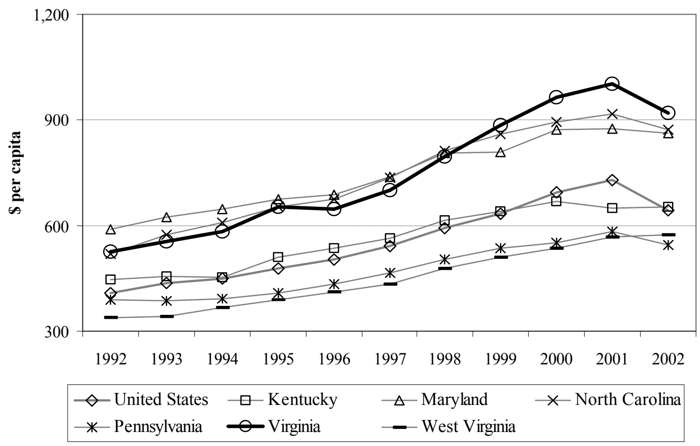

Figure 4. Income tax as percent of income, 1992 - 2002

The second major component of total taxes is the sales and gross receipts tax. Sales taxes are regressive in that they usually affect lower income individuals more than higher income individuals. Since 1992 in Virginia, per capita total sales taxes have grown steadily in spite of a 0.5 percent decrease in the sales tax on food (Figure 5). Virginia has the lowest per capita total sales taxes in the Region. Localities are permitted to collect a 1.0 percent general sales tax in addition to the 3.5 percent the state collects. Several states have higher state and local total sales tax rates than Virginia, but food is frequently exempt from the general sales tax in states with higher sales tax rates.

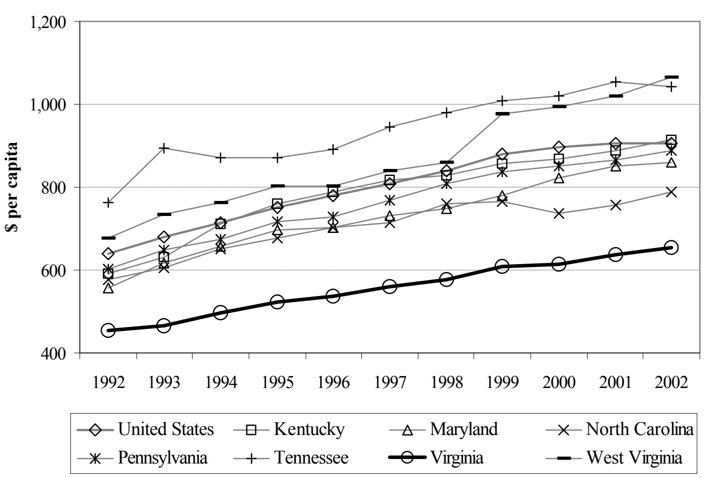

Figure 5. Per capita sales and gross receipts tax, 1992 - 2002

Included in the total sales tax are several specific sales taxes. Some of the specific sales taxes are paid by people visiting Virginia or traveling through Virginia to other places. For example, the motor fuels tax is paid by anyone purchasing motor fuel in Virginia, whether he/she is resident or transient. The motor fuel tax on gasoline in Virginia is 17.5¢ per gallon and 16.0¢ per gallon on diesel fuel (Figure 6). Kentucky has the lowest in the Region. In 2001, Pennsylvania, which earlier had the lowest per capita motor fuel tax in the Region, raised its motor fuel tax and is now third highest. West Virginia raised its motor fuel tax in 2002, making it the highest in the Region.

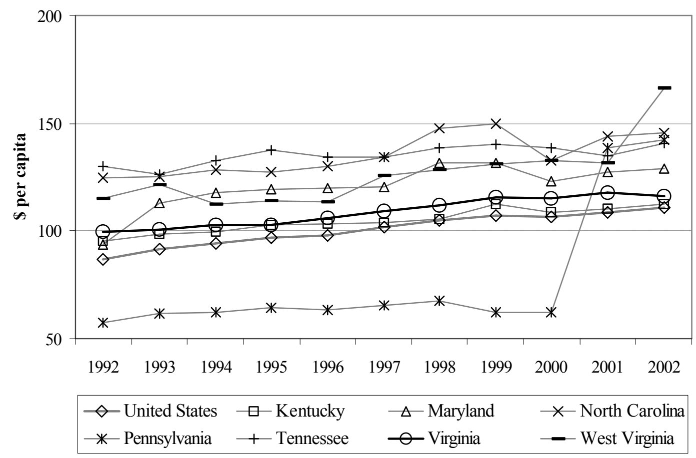

Figure 6. Per capita motor fuel tax, 1992 - 2002

The tax on cigarettes in Virginia has been 2.5¢ per pack since 1969. Some localities can levy an additional 2¢ to 15¢ per pack tax. Kentucky was the second lowest with 3¢ per pack, which increased to 55¢ in August 2003 (Figure 7). North Carolina has a 5¢ per pack cigarette tax. Tennessee, like Virginia, Kentucky, and North Carolina, is one of the major tobacco producing states. Its tobacco tax is 20¢ per pack. The other neighboring states have taxes of 55¢ per pack (West Virginia) and $1.00 per pack (Pennsylvania and Maryland).

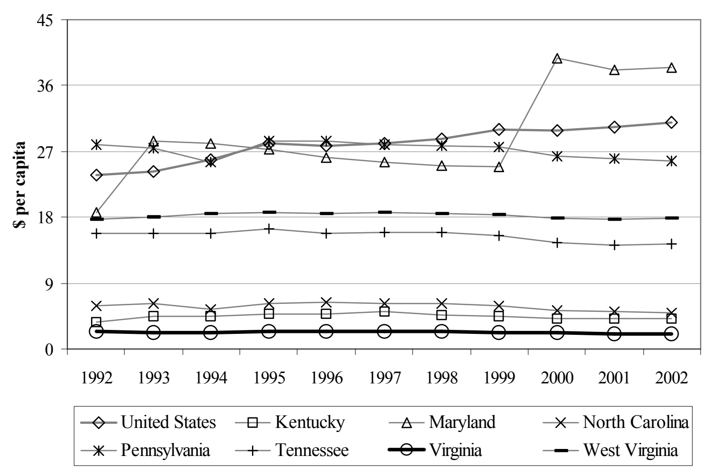

Figure 7. Per capita tobacco tax, 1992 - 2002

The alcoholic beverage tax varies significantly from state to state and is based on product: beer, wine, or liquor. Kentucky, Maryland, and Tennessee do not have state controlled sales of liquor. The revenue from the state liquor stores (Alcoholic Beverage Control—ABC stores) in the other states is generated from various taxes, fees, and net liquor profits. All states in the Region charge sales tax in addition to any other taxes on beer, wine, and liquor. On a per capita basis, North Carolina has higher alcoholic beverage taxes than Virginia, with all other states in the Region lower than Virginia. This revenue has increased slightly since 1992; in Virginia, it is just over $18 per capita (Figure 8).

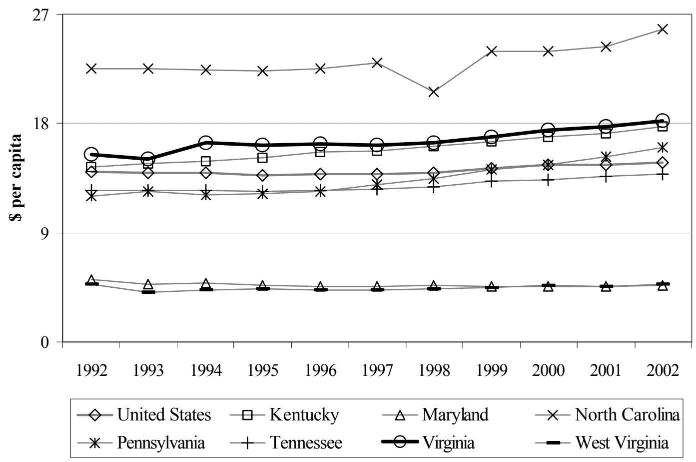

Figure 8. Per capita alcoholic beverage tax, 1992 - 2002

Rural Virginia and Urban Virginia

The efforts of the Rural Virginia Prosperity Commission brought attention to a diverging pattern of incomes, economic activity, and overall well-being in rural versus urban Virginia. One definition of rural used by the Commission in its final report (*www.rvpc.vt.edu*) was those counties with a population of 120 or fewer people per square mile. Using that definition, we examined rural versus urban taxes and trends.

For the Commonwealth as a whole, incomes are rising. But per capita Virginia Adjusted Gross Income (Va. AGI) is rising faster in urban Virginia than rural Virginia (Figure 9). Since 1997, the gap between per capita urban and rural Va. AGI has widened each year.

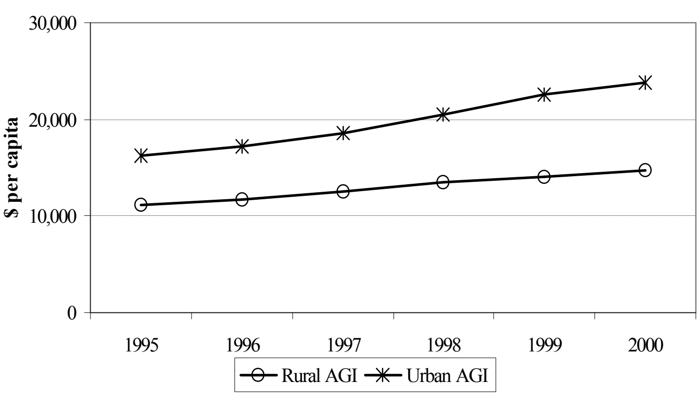

Figure 9. Rural and urban Va. AGI, 1995 - 2000

Income, sales and use (sales tax), real property, and tangible personal property taxes constitute the greatest portion of total taxes collected in the Commonwealth. These four taxes are used as a proxy for "total taxes" in examining the differences between rural and urban. As with Va. AGI, total taxes have been rising and the gap between rural and urban has been widening (Figure 10).

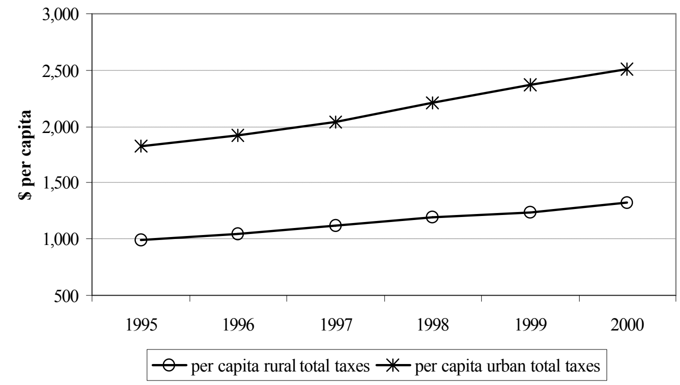

Figure 10. Rural and urban per capita total taxes, 1995 - 2000

These per capita measures are useful, but a more informative measure is the relationship between taxes and income. As a percent of Va. AGI, total taxes have been higher in urban areas than in rural areas. However, since 1995, the urban percentage has been falling while the rural percentage has been flat to rising (Figure 11). By 2000, total taxes as a percent of Va. AGI in urban areas had *decreased* by 7 percent compared to 1995 while total taxes as a percent of Va. AGI had *increased* by 2 percent in rural areas. Given the significantly lower incomes in rural Virginia, the tendency for the two curves to converge suggests that total taxes in Virginia may be increasingly regressive.

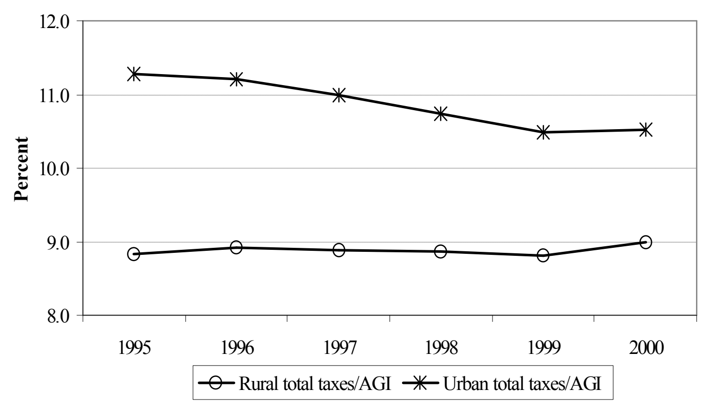

Figure 11. Rural and urban total taxes as percent of Va. AGI, 1995 - 2000

When the components of total taxes are considered individually, the same patterns are seen in the relationship between rural and urban taxes as a percent of Va. AGI. In 1999, the urban income tax as a percent of Va. AGI dropped sharply while the rural income tax as a percent of Va. AGI continued to rise (Figure 12). Since 1995, the difference in the sales tax as a percent of Va. AGI in urban and rural areas has continued to decrease (Figure 13). Real property taxes as a percent of Va. AGI are essentially flat in rural Virginia but have declined steadily in urban areas (Figure 14). Tangible personal property taxes as a percent of Va. AGI show a very different pattern from all the other taxes. Rural Virginians pay a greater percentage of their Va. AGI for tangible personal property (cars, trucks, mobile homes) than do urban Virginians (Figure 15). In spite of the reduction in the "car tax," the percentage paid by both rural and urban Virginians increased from 1999 to 2000 and the gap between the two areas narrowed.

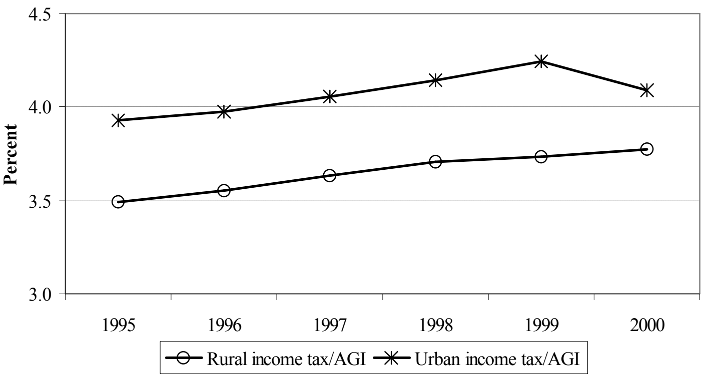

Figure 12. Rural and urban income tax as percent of Va. AGI, 1995 - 2000

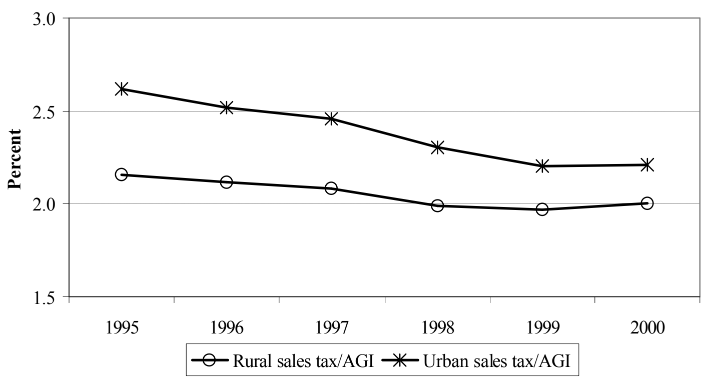

Figure 13. Rural and urban sales tax as percent of Va. AGI, 1995 - 2000

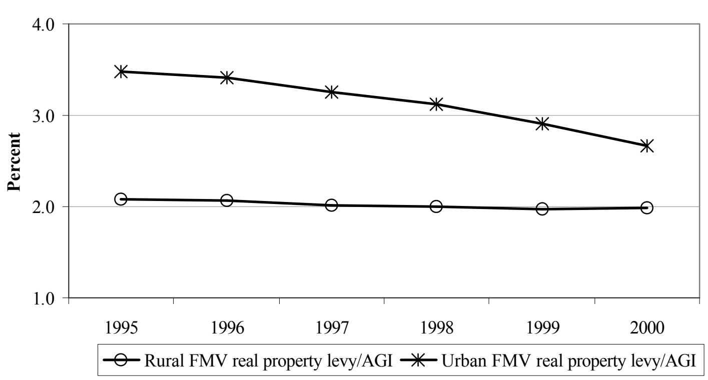

Figure 14. Rural and urban real property tax levy as percent of Va. AGI, 1995 - 2000

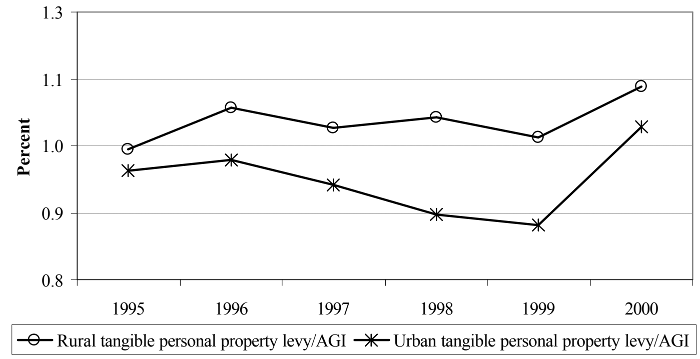

Figure 15. Rural and urban tangible personal property tax levy as percent of Va. AGI, 1995 - 2000

Conclusions

Compared to its neighbors, Virginia has generally higher per capita incomes and lower per capita total taxes. Taxes support public goods such as education, highways, and public safety. Such services would not be provided at the same level or with the same attention to continuity over time if left to the private, for-profit sector. Ultimately, the public goods and services provided by the state or by local jurisdictions will depend on the willingness of the citizens of the Commonwealth to pay state and local taxes.

During difficult budget times, a business model approach emerges that calls for cuts in spending for state and local services just as the business has to cut back when business is bad. The business model correctly focuses attention on the need for efficiency and good management. This focus may be too narrow where public goods are concerned, however.

The excellent teaching faculty in a K-12 school district or the long-term plans for state highway improvement or the contribution of colleges and universities to economic development or the financial support for the amenities that improve our quality of life may need a longer term perspective than sole attention to the "bottom line" of the traditional business model. As the debate on tax policy unfolds with the approach of the 2004 General Assembly session, the notion of a public good should be included. The long-range implications of short-term decisions on the budget, taxes, and tax policy should be kept in mind.

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