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FAIR TAXES FOR WEST VIRGINIA: CHALLENGES AND OPPORTUNITIES

"The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776

Summary

The decision to reform West Virginia's tax system offers opportunities and challenges. Like many states, West Virginia is experiencing better fiscal times than the period between 2001 and 2004, although it would not be wise to assume that current surpluses will continue indefinitely.

The state's long-term fiscal health will depend on a stable and equitable tax system that balances preserving public investments and needed services with encouraging private investment and entrepreneurship. A prudent approach would be revenue neutral in both the long – and short-term. In the immediate future, there is an opportunity to make the system fairer for all West Virginians.

Points for consideration:

The need to protect investments in education and infrastructure. Numerous studies of business location show that basics such as access to inputs, suppliers and customers along with public investments, such as good schools and infrastructure are top factors affecting business location decisions. Good public schools and strong higher education institutions are powerful engines of economic development and are vital in workforce development and in helping individuals escape poverty. A recent study by Marshall University's Center for Business and Economic Research found that investments in early childhood education alone "will be a very positive factor influencing the future economic development of West Virginia, probably more important than any other effort currently underway." [1]

According to the West Virginia Budget Office, in Fiscal Year 2005, public K-12 and higher education accounted for 60.2 percent of general revenue appropriations. [2] Other public investments that benefit the economy as a whole include health care, a clean environment, transportation infrastructure, public safety, and libraries.

Recommendation: Any changes to our tax system should at least maintain and if possible increase the state's investments in education and infrastructure.

The need to protect services for vulnerable West Virginia families. In 2006, Health and Human Resources accounted for 21.5% of general fund appropriations. [3] This is understandable: around one out of five West Virginians receive benefits from the Medicaid system alone, which is only one part of the DHHR budget and constituency. Unfortunately, cash assistance for needy families was cut by 25% in 2004 and there have been additional cutbacks in the number of people eligible to receive services such as in-home Medicaid coverage for the elderly and people with disabilities. Tax reductions financed by cuts in assistance to vulnerable individuals and families will make West Virginians worse off rather than better off and could reduce the amount of federal funds coming to the state.

Recommendation: Changes to the tax system should not cause harm to children, the elderly, the poor, the sick or people with disabilities by depriving agencies of adequate program revenue.

The need for equity. A fair tax system is one that demonstrates both "vertical" and "horizontal" equity. Vertical equity means that people with greater ability to pay should pay more. Horizontal equity means that people in similar situations with the same ability to pay should pay equally.

West Virginia's tax structure currently lacks vertical equity. Currently, low income families in West Virginia pay a greater percentage of their incomes in taxes than do high income families. According to the Institute on Taxation and Economic Policy, the richest West Virginia taxpayers—with average incomes of $207,000—pay 8.7% of their income in state and local taxes (the rate drops to 6.5% after federal itemized deductions), compared with 9.7% for those with incomes between $20,000 and $33,000 and 9.3% for families earning less than $6,900.[4]

Regarding horizontal equity, while personal consumption has shifted from goods toward services, many services are currently exempt from the state sales tax. For example, a person who purchases financial management software pays a sales tax while someone who purchases services from a financial planner does not.

Recommendation: Take this opportunity to make the state tax system fairer both vertically and horizontally.

The need to provide fairer, less regressive tax levels for low income working West Virginians. The Census Bureau reported that West Virginia has the lowest median household income in the nation.[5] Low income families in our state are taxed on annual incomes as low as $10,000, a level lower than virtually all other states. In addition, West Virginia now has the highest income tax on single parent, two child families with income at the poverty line; the highest income tax on families of three with full time minimum wage earnings; and is the only state that levies income tax on a families of four with full time minimum wage earnings.[6]

Options for targeted tax relief might include raising the state tax threshold or following the lead of the 18 other states that have created state Earned Income Tax Credits [7] which are set at some fraction of the federal tax credit.

Recommendation: Families living in or near poverty should be the first priority if taxes are to be cut.

Given the uncertain future, alternative sources of revenue and elimination of unproductive tax exemptions and loopholes should be utilized to pay for reductions or eliminations to existing revenue streams. The surpluses the state is currently experiencing are not likely to continue indefinitely.[8] If some taxes are going to be reduced or eliminated, other options should be considered, such as taxing some services currently exempted from sales taxes; closing unfair corporate tax loopholes such as passive investment companies [9]; increasing sales taxes on soft drinks, cigarettes and smokeless tobacco; preserving a state estate tax on large inheritances; increasing by a small percentage the income tax rates for high income brackets [10]; and/or ensuring that we adequately tax natural resources.

Recommendation: Consider raising alternative sources of revenue. Working West Virginians would wind up losing more than they gain if the repeal of some taxes means cuts to schools, higher education, and social services. Current surpluses, which are unlikely to last, should be placed in reserve funds, used for one-time investments or otherwise used in a way that will not endanger future revenues.

The connection between state taxes and business location is weak. Perhaps surprisingly, state taxes rank low in factors affecting business locations. According to Robert Ady, who heads the Ady International Company, which specializes in site selection, economic development, and incentive negotiations "[I]n the facility location process, taxes are not relatively important when compared with other cost factors such as labor, transportation and utility and occupancy costs…In summary, site selection data do not suggest any correlation between low taxes and positive economic growth, or between high taxes and slow growth. The location requirements are too many, the process too complicated and other factors too important to justify a strong relationship."[11] Further, studies have shown that state "corporate income taxes as a share of total taxes declined by 4.6 percentage points from 1989-2002, surpassing the US average of 4.1 percentage points."[12]

Recommendation: Carefully weigh costs and benefits in evaluating corporate tax cuts.

Carefully evaluate tax breaks and expenditures. In 2001, a study of economic development tax incentives by the Wise administration found that in the period between 1988 and 1997, West Virginia gave more than $900 million dollars in tax breaks to businesses but these incentives did not directly yield a large number of jobs.[13]This is not an isolated case. According to Greg LeRoy, founder of Good Jobs First, state and local government spend an estimated $50 billion a year on tax breaks to corporations to promote economic development but often receive little in return.[14] A 2003 study by the same group documented that many state and local governments have recognized that giveaways without accountability are an expensive and useless luxury and have adopted strict job quality standards which employers must meet to receive economic development assistance.[15]

Speaking of his days as CEO of Alcoa, former Bush administration Secretary of the Treasury Paul O'Neill told Congress, "I never made an investment decision based on the tax code. If you are giving money away, I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements; they do it because they can see that they are going to be able to earn the cost of capital out of their own intelligence and organization of resources."

Recommendation: State government should consider regularly compiling and making public all economic development related tax breaks, credits and incentives, including both the costs in lost revenues and an evaluation of how these programs have performed in creating good jobs.

To ther than competing on the basis of unproductive tax breaks, we should compete based on our assets: a supply of skilled and motivated workers, a strong infrastructure, good schools, colleges, and universities, and an exceptional quality of life.

END NOTES

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