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West Virginia's Mediocre Tax Rankings Are Not Good Enough for Some Looking at Reform

The experts who testified before the latest meeting of the Joint Select Committee on Tax Reform disagree on some points about West Virginia's tax system, but a few common themes emerged about changes the state should make. One is that it would make sense for the state to go to a higher and broader sales tax and depend less on taxes on income and business inventory. Another is that, if West Virginia wants to promote economic development, tax reform is just one tool that much be accompanied by other changes, such as streamlined regulations and policies.

The experts agreed that tax reforms in recent years have made West Virginia more attractive than it had been, but they differed over how well those changes have positioned the state for competition for business growth.

"We look pretty good," Jennifer Shand, director of the Center of Business and Economic Research at Marshall University, told the committee. "Certainly in terms of overall business climate with our neighboring states, [we're] running ahead of the pack."

But Joseph Henchman, vice president for legal and state projects at the Tax Foundation, said that's not good enough.

> ***"I would be very careful about just trying to beat Ohio and Pennsylvania and Kentucky. I would think much broader than that because businesses are thinking much broader than that, and individuals are thinking much broader than that." – Joseph Henchman***

"Regional competitiveness certainly matters, but in a day when technology allows communication and travel to be about as instantaneous as it has ever been and where people can work just about anywhere they want to work and businesses can locate about anywhere they want to locate, you need to look at things in a national or even…a global context," he said. "I would be very careful about just trying to beat Ohio and Pennsylvania and Kentucky. I would think much broader than that because businesses are thinking much broader than that, and individuals are thinking much broader than that."

Henchman said West Virginia's tax system is not pretty good. "I think it's middle of the pack," he said. "It's not terrible. It was terrible, but now it's middle of the pack."

A good tax system should reflect the strengths of a state and attempt to overcome its weaknesses, Henchman said. He noted that South Dakota has used a broad-based sales tax while avoiding an income tax to overcome its weaknesses. By contrast, he said, New York has heavier taxes but benefits from having major airports, the advantages of New York City and other attributes. His point was that New York's tax system would not work in South Dakota, nor would South Dakota's tax system be the best one for New York.

Henchman suggested comparing West Virginia to three other mountainous, largely rural states: Tennessee, Vermont and Colorado. Tennessee has no income tax but has a high sales tax. Vermont has very high income, business and property taxes. Colorado is in the middle with all the major taxes, but all of them are broad-based with low rates.

As others did, Henchman pointed out that states very rarely do tax reform in isolation from other reforms.

West Virginia's ranks better for tax climate than other factors.

His colleague, Jared Walczak, a policy analyst for the Tax Foundation, said their organization ranked West Virginia 19th highest for taxes paid by residents at 9.7 percent in fiscal year 2011. He also offered these comparisons:

West Virginia's State Business Tax Climate Index

Overall: 21st	
Corporate: 17th	(6.5 percent after reduction)
Individual: 26th	(Graduated, high regionally)
Sales: 25th	(Well-structured tax base; 6.07 percent)
Unemployment Insurance: 23rd	
Property: 25th	(Low rates but includes inventory & equipment)

Location Matters

Corporate Headquarters: 42nd
Research & Development Facility: 48th
Retail Store: 35th
Call Center: 43rd
Distribution Center: 33rd
Capital-Intensive Manufacturing: 43rd
Labor-Intensive Manufacturing: 47th

Walczak said the drivers of those rankings include: the “throwout” rule, double-weighted sales factor apportionment, income-producing activity sourcing rules, and property tax on inventory and equipment. (Throwout and throwback laws are used by states to require companies to pay taxes on income not taxed in other states.)

Recent tax reforms in West Virginia have included: reduction in the corporate income tax to 6.5 percent, phase-out of the business franchise tax and rollback of tax incentives. Walczak said changes that should be considered to encourage growth include: phase-out of local business-and-occupation taxes, collapsing and reduction of individual income tax rates and brackets, indexing brackets to inflation, removing business personal property from the tax base, and repealing the “throwout” rule. In regard to such proposed changes, he offered these items:

- West Virginia’s top individual income tax rate is the highest in the region.
- Property taxes are 28 percent of the business tax burden.
- Personal property taxes are 43 percent of Class III & IV property tax collections.
- West Virginia is one of only two states with a throwout rule. (New Jersey is the other.)

Marshall professor sees reasons for optimism.

Shand offered a SWOT – strengths, weaknesses, opportunities and threats – analysis of West Virginia’s tax system, although she chose to finish on a high note by saving the opportunities for last. She said West Virginia’s tax system is not too bad in comparison to other states. It ranks in the middle of the states on many measures.

West Virginia’s strengths include:

- Modest marginal tax rates and total burden.
- A 6.5 percent top rate individual income tax, which was 24th in 2012 for state and local income taxes per capita ($946).
- A 7 percent corporate income tax rate, ranking 18th in 2012 for corporate income taxes per capita ($104).
- A 6 percent sales tax rate.
    - 25th ranking in general sales and excise taxes per capita ($1,446).

However, Shand said, West Virginia ranked among the top 10 states for high gas taxes in 2012, while its cigarette tax was among the 10 lowest.

On property tax collections, she said, West Virginia stands out in the opposite way by having the seventh-lowest property tax collections per capita. They were about $773 per capita in 2012.

Shand presented this chart using figures compiled by the Tax Foundation:

Rankings and Neighbors

Dimension	WV	KY	OH	PA	MD	VA
Overall Business Climate	21	26	44	34	40	27
Corporate Tax	17	29	26	46	16	6
Individual Income Tax	26	30	47	17	45	39
Sales Tax	25	11	32	24	8	6
Unemployment Insurance Tax	23	45	5	50	21	37
Property Tax	25	17	20	42	41	26

Because of that chart, Shand said, West Virginia's tax system looks "pretty good." She added, "There's nothing that sticks out as an immediate disadvantage."

"There's nothing that sticks out as an immediate disadvantage." – Jennifer Shand

West Virginia's weaknesses include:

- Local capacity
- Severance taxes
- Coordination among taxes and credits
- Exportation of tax burden
- Subsidization of public services
- Social service versus infrastructure spending

Shand said West Virginia performs well in terms of business costs and economic climate, but not so well in other categories. She offered this chart, using rankings from *Forbes Magazine*, to support that statement:

Rankings and Neighbors on Best States for Business

Dimension	WV	KY	OH	PA	MD	VA
Business Costs	22	14	30	42	41	24
Labor Supply	50	46	48	33	5	2
Regulatory Environment	48	24	6	21	36	1
Economic Climate	18	29	22	20	16	12
Growth Prospects	50	30	36	38	32	33
Quality of Life	39	34	11	7	8	5

West Virginia's threats include:

- Increasing demand on state for social services, driven largely by an aging population
- Declining tax base
  - Working age population falling
  - Employer/workforce alignment deficiencies

West Virginia's opportunities include:

- Assessing the objectives of tax policy:
  - Revenue generation?
  - Altering incentives?
  - Provision of services or infrastructure?
- Pursuing alignment among tools and objectives
  - Different priorities have different funding mechanisms
  - Evaluation of mechanisms and outcomes
    - For example: tax incentives for economic development
- Coordination among jurisdictions and agencies

> ***"If you only look at tax policy, West Virginia looks pretty good from the 10,000-foot view. But there are other factors that matter. In many cases, the other factors that matter are those very priorities that tax revenue is intended to fund." – Jennifer Shand***

"Tax policy is one consideration," Shand said. "It is an important consideration, but in terms of the scope of things, if you only look at tax policy, West Virginia looks pretty good from the 10,000-foot view. But there are other factors that matter. In many cases, the other factors that matter are those very priorities that tax revenue is intended to fund." She said those factors include education, quality of life and transportation infrastructure.

Objectives of tax policy matter, Shand emphasized. Likewise, she said, taxes must be aligned and coordinated at all levels of government.

“Certainty is important for planning,” Shand said. “If you don’t know what’s going to happen tomorrow, how can you plan for next week even?”

Making changes on the margin that lead to uncertainty can be very counterproductive, she said, so policymakers should make sure that the rules are consistent and that people know what they are.

“Tax policy is one consideration for economic growth,” Shand said. “It is one lever that you have at your disposal to affect the environment potentially, but there are other factors involved in economic growth development.”

WVU professor welcomes tax reform.

John Deskins, director of West Virginia University’s Bureau of Business and Economic Research, said he is “quite excited” by the prospects for tax reform in West Virginia.

“The first way to enable West Virginians to prosper is to create jobs in the state,” he said. “To achieve that goal, we must work to make our state attractive from an economic development perspective both to out-of-state businesses that might consider moving to West Virginia but also to small businesses that might start up and grow here in West Virginia. Sound tax policy is one component of making our state attractive from that perspective.”

Deskins encouraged tax reform committee members to think big. “The tax system, as we all know, was generally designed a long time ago and lots changed over time,” he said. “We know that the economic environment has changed a lot over time. It’s certainly not the case that what worked in the 1940s or 60s or 80s is what necessarily works today given the dynamics in our overall economy. So I would say think about fundamental reform, not just tweaks on the margin. Don’t keep any particular component or aspect of our tax system just because we’ve always done it that way. Think big. Think fundamental reform.”

> ***“`Don’t keep any particular component or aspect of our tax system just because we’ve always done it that way. Think big. Think fundamental reform.” – John Deskins***

West Virginia faces many long-term challenges, such as the poor health outcomes of many West Virginians and a job-skills mismatch, Deskins said. “Tax policy is the one thing that we could potentially fix today,” he said. “In the course of the next year, we could potentially make a better tax climate overall.”

Others have warned legislators against making many big changes in the tax system too quickly. They often have cited the troubles Kansas is experiencing from big tax cuts that have left the state with too little revenue to fund government expenses. Deskins offered his own warning.

"Improving our tax climate is not likely to be a silver bullet," he said. "Research that has looked into the degree to which people respond to tax policy generally…finds that changes are not going to be big enough to make West Virginia an economic powerhouse overnight. Things take longer than that. But improving tax policy will make a difference, and over time, a more sound tax structure will help our state grow."

Deskins said the three guiding principles of sound tax policy are simplicity, efficiency and fairness.

"A simpler structure is inherently valuable, but it also promotes more transparent government, it helps reduce compliance costs, and it helps reduce tax evasion," he said. "Further, it's more difficult for businesses to manipulate the tax system in efficient and potentially unfair ways with a simpler structure. Push for simplicity."

"We want to minimize the degree to which taxes affect family and business decision-making." – John Deskins

Designing a more efficient tax structure should be the primary focus, Deskins said. "The basic premise here is that people will more often than not make the right decisions for themselves if left alone," he said. "We want to minimize the degree to which taxes affect family and business decision-making."

Such decisions include where to live, where to work, how much to work, whether to buy a home or rent one, how much to save, whether to start a small business, whether to move an existing business, and how much risk to tolerate, Deskins said. His suggestion to the committee was to develop a system with a broad tax base and a low tax rate. Such a system would alter people's purchasing decisions less than a system that has many loopholes and exemptions coupled with higher rates on what is left to tax.

Fairness is a vaguer term because what seems fair to one person might not seem fair to another, Deskins said. Fairness is based more on value judgments than on scientific analysis, he said.

One consideration for policymakers is horizontal equity, which is a tax system that treats people in similar economic circumstances in a similar way, Deskins said. It is straightforward in theory but sometimes gets messy in practice, he said.

"The more complicated component of this question relates to how taxes should affect those across the income spectrum," Deskins said. That is called vertical equity. Some people argue for a progressive system, while others argue for a proportional system, he said, and a tax system can even be regressive. The federal tax system is highly progressive, he said.

"Compared to the federal government, it's more challenging for states to impose a progressive tax structure." – John Deskins

"Compared to the federal government, it's more challenging for states to impose a progressive tax structure," Deskins said. "If a state were to impose a system that is highly progressive, a change will likely encourage the outmigration of higher-income individuals and businesses and perhaps even the in-migration of lower-income individuals if the progressive structure is coupled with generous government benefits. This pattern may not be sustainable."

The big difference between consumption taxation and income taxation is that a consumption tax does not tax savings, he said. "There's good reason to believe that heavier reliance on consumption taxation would do more to promote savings," Deskins said. Citing noted economist Douglas Holtz-Eakin, he said that an income tax is based on what one puts into society, while a consumption tax is based on what one takes out of society.

"A strong argument can be made that basing a tax on what one takes from society is preferred – that that approach might do more to encourage savings and work," Deskins said. Eliminating the income tax in favor of a heavier sales tax is not feasible, but a move toward more reliance on the sales tax than the income tax might be preferred, he said.

Deskins offered a few other principles for legislators to consider:

- Avoid taxes on mobile tax bases. Business inventory is fairly mobile. "A large business can shift its actual physical inventory across state borders with relative ease," he said. "As such, a tax on business inventory seems to me to be in some ways inconsistent with the basic principle that we should rely on less-mobile tax bases and not attempt to try to tax bases that are more mobile."
- Benefits of taxes paid should correspond to the tax itself to the extent possible. "If gas tax revenue goes to pay for transportation infrastructure, the tax is closely tied to benefits received," Deskins said. It seems more like a user fee than a tax, he said, and that leads to more efficient, less distortionary taxation. Toll roads also are another example of that. "Toll roads also have the added benefit of allowing us to export our tax burden to out-of-state residents," Deskins said.
- The cigarette excise tax is levied on a product that creates costs to society. "In this rare case, a tax which distorts behavior may actually help curb smoking and reduce that negative external cost," he said. "This is one of the rare cases in which a tax can actually generate a better outcome versus what we're normally finding." However, he said, a cigarette tax tends to fall more on lower-income individuals, which could challenge the idea of fairness, but it is up to policymakers to balance fairness and efficiency.

- Relative roles of state government versus local governments should be considered. "We tend to lean heavily on the state government in West Virginia," Deskins said. "We lean less heavily on local governments compared to what you see in the nation on the average. We do have significant differences in economic outcomes across our state. The regions of our state differ in terms of economic strengths and weaknesses. They differ in terms of challenges and opportunities. In many cases, these differences are very stark." He said the regions should be allowed to tailor strategies to their particular economic circumstances. "This move may involve some devolution of decision-making power with regards to taxing," he said.

Business dean wants a more agile system.

Zito Sartarelli, dean of the WVU College of Business and Economics, told the committee that he has been very concerned about West Virginia's economic development. He said five things are critical for economic development in the state:

- Natural resources – "We've been at it for many, many years and we'll continue to be at it for many more years," Sartarelli said.
- Human resources – "The role that universities play in that is very important," he said.
- Capital formation – "That is an issue that this state has had for many, many years," Sartarelli said. "Government sometimes cannot solve that. It can help but cannot solve it."
- Technology – "How do we make sure that our institutions of higher learning – universities, institutes, et cetera – are in the forefront of creating new technologies because this is the 21st century?" he asked. "And how do we make sure that we benefit from it at Marshall and WVU and many other universities around the state?"
- Policies – This includes a wide range of issues from legalities to taxation to regulations. "There's no silver bullet," Sartarelli said. "Taxation is a very complicated subject matter. It's difficult to be fair, to be comprehensive, but it's important as we are trying to attract investment into the state as well as encourage our existing firms in the state to expand and create more jobs."

"It's important for us to be very agile and very effective." – Zito Sartarelli

In addition to taxation, regulatory issues can be very important in economic development, he said. "It's important for us to be very agile and very effective," Sartarelli said.

Two states that are useful to look at are Tennessee and North Carolina, he said. Tennessee was not a good place to go several decades ago, but now it is very successful, Sartarelli said, and North Carolina is even better. In 1980, North Carlina was the 15th largest state in terms of gross domestic product. Today, it is ninth. By contrast, Michigan was ninth in 1980 and has slipped down to 14th or 15th. Sartarelli said North Carolina did tremendous work with its Research Triangle in terms of attracting investment even while losing three major industries: tobacco, textiles and furniture.

"Today, it's a very powerful financial state, very powerful manufacturing base [and] very powerful high-tech [state]," he said about North Carolina.

Noting that West Virginia has two major universities, Sartarelli said, "We should turn these two universities into great sources of technology development."

Another proposal he offered is that it is OK to concentrate certain development in certain parts of the state. "Each part of the state has its own peculiarities, some more prone to phenomenal development, some less so," he said.

Delegate Bob Ashley, R-Roane, said West Virginia has areas of haves and have-nots, adding that he represents one of the have-not areas. "We need help in figuring out what to do to make these rural areas attractive to manufacturing," he said, noting that the past 25 years have not been kind to some parts of the state.

Sen. Ron Stollings, D-Boone, expressed concern for areas like his where coal mining is declining. He said, "If we could only have gone back in time and spent our severance tax more wisely – that is developing infrastructure and post-mining land sites – then the haves about to become have-nots would not be so have-not-ish." In Kentucky, 50 percent of coal severance tax revenues stayed local, but only 6 percent to 7 percent stayed local in West Virginia, he said.

"This is not rocket science, but it is close to it." – Zito Sartarelli

Shand said that relates to tax objectives and making sure the state's tools are sufficient for what its objectives are. "It does require a little bit of attempting to be forward looking, which is a challenging thing to do," she said.

Sartorelli added, "This is not rocket science, but it is close to it." He said clustering economic development makes some sense.

Business pay good share of taxes in West Virginia.

Ferdinand Hogroian, senior tax and legislative counsel for the Council on State Taxation presented these findings about West Virginia from a study done by his organization and the accounting firm Ernst & Young for fiscal year 2013:

- West Virginia businesses paid 50.4 percent of all state and local taxes (national average: 44.9 percent).
- Business share of local taxes is much higher: 75.1 percent in West Virginia vs. 51.4 percent for the national average.
- Largest category was property tax (27.6 percent of business tax total), followed by severance & local gross receipts tax (21.4 percent), excise tax (20 percent), sales tax (13.6 percent), and corporate income tax (6.7 percent).

- West Virginia business taxes amounted to 6 percent of gross state product (national average: 4.7 percent).
- "Tax benefit ratio" for West Virginia is \$1.4 of business tax for each \$1 of business benefit (assuming 50 percent of education spending benefits business). The national average ratio is \$1.2 to \$1.

Problems Hogroian cited with West Virginia's corporate net income tax are that it is volatile and has high levels of complexity and uncertainty relative to the burdens of administration and compliance. Lowering the rate to 6.5 percent has mitigated some of the tax's negative effects, he said.

On the state's sales and use taxes, Hogroian said, they are intended to be imposed on final consumption, not business-to-business transactions. West Virginia is rated the second lowest, or second best, state in terms of taxing business-to-business transactions, he said. But Hogroian suggested that more precision is needed when reviewing "tax expenditures" to avoid taxing business-to-business transactions. He also recommended putting importance on the multi-state effort to develop streamlined sales tax provisions to capture taxes for online transactions and following best practices in reducing compliance costs for taxpayers.

The Council on State Taxation has given West Virginia a grade of B for tax administration. But Hogroian cited these concerns about that issue:

- High interest rates on underpayments (9.5 percent);
- Higher interest rate for underpayments than overpayments;
- Corporate return filing burden: return due date is same as federal (insufficient time to prepare state return); no definition of "final determination" triggering requirement to report a federal change, and insufficient time to report a federal change to the state; and
- Transparency: no letter rulings published to Tax Division website.

In regard to property tax administration items, Hogroian said, the problems include: no *de minimis* exclusion, unequal assessment, interest rate differential, insufficient appeal period, "clear and convincing" burden of proof, and inability to escrow/defer payment of disputed tax.

Another concern of Council on State Taxation is unclaimed property. Hogroian said the purpose of the unclaimed property law is to reunite owners with their property, not to raise revenue. His organizations recommendations for West Virginia include:

- Exempt business-to-business transactions.
- Provide an independent, prepayment appeals process.
- Ban contingent fee audits by private audit firms on behalf of the state.
- Exempt gift cards from escheatment.

On business personal property tax, Hogroian said it hurts state competitiveness for new investment, both for new and expanding facilities. He said business personal property taxes are increasingly being limited, decreased, or repealed across the nation. State-level gross receipts taxes are rare, but local gross receipts taxes remain prevalent, he said. Gross receipts taxes ignore ability to pay and are anticompetitive with similar effects as sales tax on business inputs, he said. In addition, Hogroian said, the administrative complexity of local gross receipts taxes creates additional barriers to investment.

States increase reliance on sales taxes.

Mandy Rafool of the fiscal affairs policy staff at the National Conference of State Legislatures provided the committee with an analysis of tax changes in several states and then spoke about the trends in tax policy across the nation. In the near term, more cuts in corporate income taxes are expected, she said.

"We think that sales tax expansion is inevitable as the base continues to shrink relative to sales." – Mandy Rafool

"We think that sales tax expansion is inevitable as the base continues to shrink relative to sales," Rafool said. The trend is for states to tax more services and online sales, she said.

"More and more states are paying attention to credits and exemptions," Rafool said. "Five or six years ago, most state lawmakers didn't even know what their tax exemptions were and if their state produced a tax exemption report. And now we see policymakers demanding making special tax review committees." She noted that Oregon is requiring all tax credits to be reviewed every six years.

More changes in transportation funding are expected, Rafool said. "Gas tax is no longer providing enough revenue, and states are starting to get creative in how they're going to fund their highways," she said.

Another big concern for many states is revenue forecasting volatility, which is the inability to forecast revenue accurately, Rafool. Many officials are blaming it on the Millennial generation for having much more erratic residential and consumer behaviors.

At the end of the meeting, one of the committee's co-chairman, Senate Finance Chairman Mike Hall, R-Putnam, said that some of the speakers who recommended changes in property taxes, including the business inventory tax, don't understand that such changes would require constitutional amendments. "So we have a complicated problem that we may or may not be able to fix," he said.

However, Hall also said, "There are many areas of possible reform. Some have interpreted reform as cut taxes. That's not really what the committee is about. It's about looking at the code and getting into the weeds of it."

The tax reform committee's next meeting is scheduled for June 9. Speakers are expected to include representatives of counties and municipalities, *Unleashing Capitalism* author Russ Sobel, and West Virginia Commerce Secretary Keith Burdette. On June 29, the committee will devote its meeting to the subject of property taxes. Committee leaders plan no meetings in July but are still considering whether to meet in August.