REPORT OF THE
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

Replacing Income Tax Revenues With Sales and Use Tax Revenues

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

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Preface

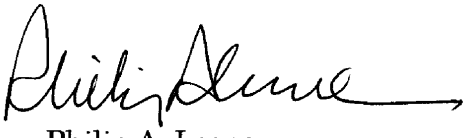
House Joint Resolution 172 of the 2004 General Assembly directed the Joint Legislative Audit and Review Commission (JLARC) to collect data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues. The resolution also directed JLARC to summarize the data and information for consideration by the House and Senate Committees on Finance. This report identifies the states that do not levy a broad-based personal income tax and presents the general lessons learned from the review of those states. The report also assesses the probable impacts to Virginia of replacing personal income tax revenues with additional sales and use tax revenues.

There are nine states that do not levy a broad-based personal income tax. Based on the review of these nine states, several observations may be made. One observation is that several of the states have unique characteristics, such as mineral reserves or a large tourism industry, that enable them to raise revenues without the need for a personal income tax. Other key observations from this report are that most of these states have regressive tax structures, and the states that rely most heavily on sales and use tax revenues also appear to be the most vulnerable to loss of revenues through Internet and out-of-state sales.

In addition to presenting data and information on tax structures of other states, this report also assesses the impacts to Virginia of replacing personal income tax revenues with sales and use tax revenues. This assessment found that it would be impractical to replace all personal income tax revenues with sales and use tax revenues alone. If the sales and use tax base were left unchanged, the sales tax rate required to replace 100 percent of personal income tax revenues would be 12.3 percent, which is significantly higher than the current top state sales tax rate of 7.0 percent. However, the report also found that approximately 82.5 percent of the personal income tax revenue could be replaced by raising the sales tax rate to 7.0 percent while expanding the sales tax base to include most services.

If Virginia were to replace personal income tax revenues with sales and use tax revenues, the State and local tax structure would become more regressive. Currently, State and local taxes are distributed fairly proportionally across income groups in Virginia. The primary reason for Virginia's proportional distribution of taxes is the State's reliance on the personal income tax, which is progressive and offsets the regressive nature of the sales and use, excise, and property taxes.

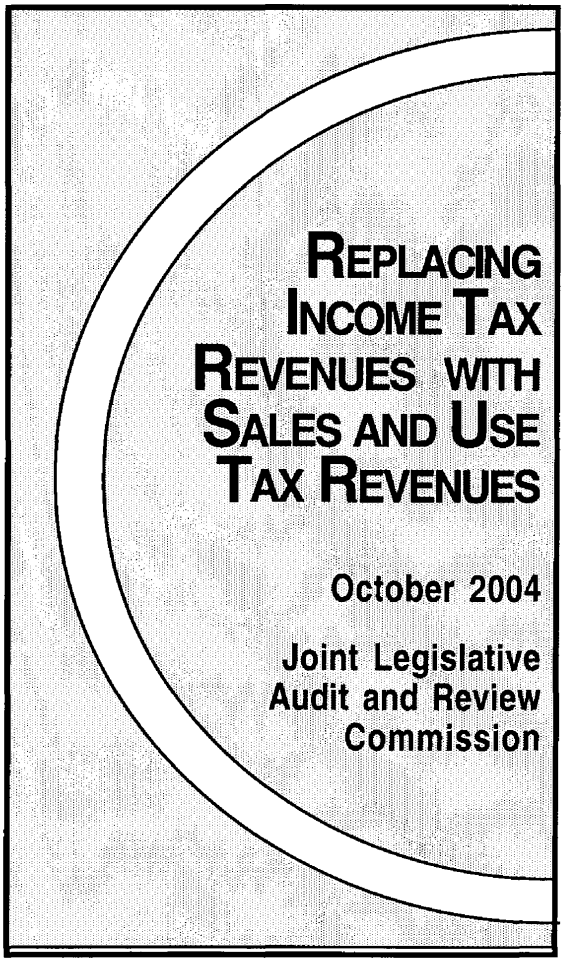
On behalf of the Commission staff, I would like to express our appreciation for the assistance provided by the Department of Taxation staff during this study.



Philip A. Leone
Director

October 29, 2004

JLARC Report Summary



House Joint Resolution 172 of the 2004 General Assembly directed the Joint Legislative Audit and Review Commission (JLARC) to gather data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues. This report provides some background on state tax policy, an overview of Virginia's tax structure, and an examination of tax structures in other states. In particular, this report examines the tax structures of the nine states that do not impose a broad-based personal income tax. The report also addresses the probable impacts on Virginia that would result from eliminating or reducing the personal income tax and replacing the lost revenues with additional sales and use tax revenues.

Virginia's current tax structure is characterized by heavy reliance on the personal income tax, with sales and use taxes also contributing a significant amount of revenue to the Commonwealth. Slightly more than one-half of Virginia's tax revenues are derived from personal income taxes, and the two taxes combined account for more than 75 percent of all revenues. In 2003, Virginia ranked third in its percentage of revenues derived from the personal income tax and 44th in its percentage of revenues derived from the sales and use tax. While Virginia relies on the personal income tax to a greater extent than most other states, Virginia's overall tax burden is relatively low. Virginia's state tax burden in 2003 was 5.4 percent of personal income, which ranked the Commonwealth 42nd among the states. Virginia's combined state and local tax burden was 9.5 percent in 2002, which ranked 43rd among the states.

There are nine states that do not levy broad-based personal income taxes: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Based on a review of these states, several general observations may be made. First, several of the states have unique characteristics that enable them to raise revenues with less need for an income tax. Second, most of these states have regressive tax structures. Third, several of the states have been unsuccessful in their attempts to broaden the sales tax base. Fourth, states with high sales tax rates are particularly vulnerable to revenue losses from Internet and out-of-state sales. Fifth, several of the states have considered implementing an income tax to address revenue needs. And finally, dependence on a single

revenue source appears to result in a revenue base that is unreliable.

Virginia could replace personal income tax revenues with sales and use tax revenues by increasing the general sales tax rate or expanding the sales tax base. If Virginia were to eliminate the income tax completely and the sales tax base were unchanged, the required State general sales tax rate would need to increase from 4.0 percent to 12.3 percent, which appears to be an unrealistic policy for the State. However, if the sales tax base were expanded to include selected services, Virginia could replace approximately 82.5 percent of the lost income tax revenues by increasing the tax rate to 7.0 percent, which is currently the highest rate nationwide. For Virginia to replace 100 percent of income tax revenues while not increasing the sales tax rate above 7.0 percent, the sales tax base would need to expand by $2.6 billion, assuming income tax revenues would be replaced solely by sales and use tax revenues.

Replacing income tax revenues with sales and use tax revenues would change the distribution of the tax burden across income groups. If income tax revenues were replaced by sales and use tax revenues, Virginia's tax structure would become more regressive (that is, taxpayers in the lower income groups would pay a higher proportion of their income in taxes). JLARC staff estimated that Virginia's tax structure would be more regressive than all but two states under the scenario in which 82.5 percent of income tax revenues were replaced by sales and use tax revenues.

Currently, Virginia's distribution of State and local taxes is fairly balanced. In 2002, only nine states distributed their tax burdens across income groups more equally than Virginia. A primary reason for Virginia's proportional distribution of taxes is the State's reliance on the personal income tax for a majority of its revenues. The progressive nature of the income tax balances out the regressive nature of sales and use, excise, and property taxes.

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I. Introduction

House Joint Resolution 172 of the 2004 General Assembly directed the Joint Legislative Audit and Review Commission (JLARC) to gather data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues (Appendix A). The study mandate also directs JLARC to summarize the information for presentation to the House and Senate Finance committees.

The remainder of this chapter provides background on state tax policy in general, with an emphasis on personal income taxes and sales and use taxes. An overview of the current tax structure in Virginia is then presented, followed by a brief discussion of tax structures in other states and countries. The study methods and research activities used to develop this report are presented at the end of this chapter. Chapter II provides a review of the experiences in other states that do not levy broad-based personal income taxes, and Chapter III examines the probable impacts in Virginia of replacing personal income tax revenues with additional sales and use tax revenues.

BACKGROUND

States rely on several kinds of taxes to provide funding for government activities. These taxes vary in terms of the reliability of revenues, the equity of the tax burden, the ease with which they are administered and collected, and their effects on the economy. These measures by which state taxes are evaluated are discussed below, followed by an examination of how income taxes and sales and use taxes compare according to these measures.

Overview of Tax Policy

Tax policies may be evaluated based on the effects they have on: (1) state revenues, (2) the people who must pay the tax, and (3) the economy. The National Conference of State Legislatures identified several principles for the evaluation of state revenue sources in its *Tax Policy Handbook for State Legislators*. A brief description of the major principles is provided below. The major principles include reliability, equity, economic effects, and compliance and administration.

Reliability of Revenues. A tax is reliable if revenues are stable, and if taxes owed by persons and businesses can be predicted with a fair amount of certainty. A revenue source is stable if revenues are relatively constant over time and do not fluctuate dramatically from year to year. The other aspect of a reliable revenue source is that taxpayers must be able to predict with a fair amount of certainty the amount of taxes owed, in order to adequately plan for the future.

Equity of Tax Burden. Equity may be defined in terms of horizontal equity and vertical equity. Horizontal equity implies that persons of the same eco-

nomic circumstances have the same tax burdens. Vertical equity implies that the tax burden does not fall too heavily on any one income group. Tax systems in which lower income groups pay a higher proportion of their income on taxes than higher income groups are said to be regressive. If the tax system requires persons of higher income to pay proportionately more of their income on taxes than persons of lower income, the system is said to be progressive. While progressive tax systems may violate the vertical equity principle in terms of proportionate income, they may also be considered equitable based on ability to pay (that is, the "pain" of the tax is distributed equitably across income groups). For example, a person earning more than $200,000 per year might be able to afford a tax rate that is twice as high as a person earning less than $20,000 per year. In general, tax systems are considered to be inequitable if they are regressive. Tax systems in which the burden is distributed equally across all income groups are said to be proportional.

Effect of Taxes on the Economy. Another principle of a sound tax policy is that the taxes should minimize effects on the economy. Taxes primarily affect the economy in two ways: (1) by influencing the amount of savings, investment, and consumption, and (2) by affecting the competitiveness of businesses that operate in interstate and international markets.

All taxes affect saving, investment, and consumption rates to some degree, because taxes affect prices of goods and services and the amount of disposable income people and businesses have. Unless the government is purposely trying to influence behavior (such as through taxes on alcohol and cigarettes), experts generally agree that taxes should have broad bases and low rates to minimize distortions in the market.

Another way that tax policy can affect the economy is through influencing the competitiveness of businesses that operate in interstate or international markets. Businesses may decide to relocate or choose not to invest in a state if the tax policy is considered to be too onerous or if more favorable tax policies are available elsewhere. Also, consumers may have the ability to purchase goods and services in neighboring states that have lower tax rates, thereby reducing the competitiveness of businesses located in the state.

Compliance and Administration of Taxes. The final principle of sound tax policy is that the time and effort to comply with and administer the tax should be minimized. If a tax is too complex, people and businesses will lose productivity by spending too much time figuring the taxes they owe. This scenario also increases the probability of taxpayers avoiding the tax. Also, if the tax is too complex, valuable time and money will be wasted by the government in collecting the revenue and enforcing compliance with the tax. Thus, the revenue yield from the tax will be less than it could be.

Personal Income Taxes

Personal income taxes are one of the largest sources of tax revenue for the states, comprising approximately one-third of all state tax revenue in FY 2003, according to data from the U.S. Census Bureau. Personal income taxes are levied to

some extent by 43 states. The advantages of the personal income tax are that it is a fairly reliable revenue source, it tends to be more equitable based on ability to pay, and it is fairly easy to administer and comply with. The disadvantages are that it is subject to the business cycle, and it can have some adverse effects on state economies. The personal income tax is evaluated below according to the principles of sound tax policy.

Reliability of Personal Income Taxes. While personal income tax revenue is subject to economic fluctuations, it has been a fairly reliable source of revenue for states. The main advantage of the personal income tax is that this tax revenue tends to grow at a rate faster than the economy; thus it is sufficient, in that tax revenues are likely to keep pace with spending growth. This is due primarily to the graduated rate structure employed by most states. As taxpayers earn more, some will move into a higher tax bracket, and the average tax rate increases.

While personal income tax revenue increased rapidly during most of the 1990s, the recent downturn in the economy has resulted in lower income tax revenues. Just as income tax revenue grows faster than the rate of income in times of high economic growth, revenues will decline during times of economic contraction. One reason for the recent decline in income tax revenue is the downturn in the stock market, which caused earnings from capital gains and dividends to be greatly reduced from their previous highs.

Equity of Personal Income Taxes. The personal income tax has advantages of both horizontal and vertical equity. In terms of horizontal equity, persons earning the same amount of income are taxed according to the same formula. However, deductions, credits, and exemptions may lessen the horizontal equity of income taxes to some extent, as not everyone at a given income level will be eligible for the same deductions, credits and exemptions.

In terms of vertical equity, income taxes are designed to be progressive and help ensure that lower income persons do not pay a higher proportion of their income on taxes than persons of higher income. This is accomplished through a graduated rate structure, where income is taxed at a higher rate at higher levels of income. Even if the income tax rate is flat, the tax may be progressive by including exemptions, deductions, and credits to remove the burden on persons in the lowest income groups.

Some may argue that a graduated rate structure violates the vertical equity principle, as persons in higher income groups must pay a higher proportion of their income in taxes than persons in lower income groups. However, because most taxes are regressive by nature, the progressive nature of the income tax helps to balance the overall tax policy for states that rely on more than one revenue source.

Effects of the Personal Income Tax on the Economy. Personal income taxes can have a negative effect by discouraging businesses from opting to locate in the state and by distorting incentives to work, save, and invest. If the income tax rate is high compared to other states, businesses may not want to locate their operations in the state. Corporate executives in the highest income groups have a disin-

centive to move to states with high top marginal tax rates. Personal income taxes also could discourage the amount that taxpayers are willing to work, as they have some disincentive to move into a higher tax bracket. Similarly, high capital gains tax rates discourage investment.

It should be noted that income tax codes often purposely distort markets to affect behavior. For example, certain savings for retirement and college tuition are exempt from taxes in many states to encourage investment in these areas. Conversely, short-term capital gains are subject to a higher tax rate in some states to discourage speculative investments and encourage people to invest for the long-term.

Compliance and Administration of Personal Income Taxes. Due to the existence of the federal income tax, state personal income taxes are fairly easy to administer and comply with. Most state personal income taxes are linked to the federal income tax, as they are based on federal adjusted gross income, federal taxable income, or simply a percentage of federal taxes owed. Thus, while many taxpayers view the federal income tax as complex and cumbersome, state income taxes are simple to collect once the federal income tax has been calculated. However, it should be noted that if the federal income tax were eliminated, compliance and administration of state income taxes could be very cumbersome.

Sales and Use Taxes

Sales and use taxes represent approximately one-third of all tax revenue collected by the states and, with the personal income tax, is one of the most important sources of revenue for states, with 45 states levying the tax. Sales and use taxes are levied on the purchase of goods and some services. Sales taxes are collected based on a percentage of the price of purchases from retailers in the state, whereas use taxes are collected from residents and businesses in the state based on purchases from out-of-state vendors. The advantages of sales and use taxes are that they provide a fairly stable source of revenue, they capture revenues from everyone who makes a purchase, including non-state residents and persons not reporting income from illegal activities. In addition, sales taxes are relatively easy to collect and administer. The disadvantages include the regressive nature of the tax, market distortions, and difficulties in collecting use taxes. The sales and use tax is discussed below in regard to adherence to the four principles of sound tax policy.

Reliability of Sales and Use Taxes. Sales and use taxes provide a fairly stable revenue source for states that levy the tax, but several factors affect the sufficiency of the tax. The reason for the stability is that tax rates are based on a percentage of purchase prices, and as consumption and prices rise, revenue from the tax will also rise. However, several factors limit the sufficiency of sales and use taxes. One factor is that many services are not taxed, and as spending on services grows in relation to spending on goods, sales tax revenues fail to keep pace with overall consumption. Another factor that affects the sufficiency of sales and use tax revenues is the growing amount of Internet sales, for which states have a difficult time collecting the use tax. The U.S. Supreme Court ruled that states cannot require an out-of-state vendor to collect their sales tax if the vendor does not have a physical presence

in the state. Until Congress determines that the collection and remittance of the state tax does not place an undue burden on the vendors, states can only collect the use tax from these purchases if the vendor voluntarily complies.

A final factor that affects sufficiency is that sales taxes on goods are inelastic, so spending on items such as groceries does not keep pace with income growth. Service purchases tend to be more discretionary, so taxes on services are more elastic (however, this discretionary spending on services may cause tax revenues to be less stable). Several state governments, including Virginia, have raised the sales and use tax rate in order to fund ongoing or new initiatives.

Equity of Sales and Use Taxes. The main equity issue with sales and use taxes is that the tax is regressive. Lower income households pay a higher percentage of their income on sales and use taxes than higher income households. Also, lower income households generally spend a higher proportion of their income on goods instead of services, and goods tend to be taxed more than services. Exempting necessities, such as groceries and medicine, from the sales tax reduces the inequity of the tax, but this also removes a large source of revenue and makes the tax less stable.

Another equity issue with regard to sales and use taxes is that resident vendors are put at a disadvantage relative to on-line vendors. Resident merchants are required to collect sales taxes from consumers and submit these taxes to the state. However, due to the recent Supreme Court ruling, on-line vendors that do not have a physical presence in the state are not required to collect taxes on out-of-state sales, which gives them a competitive advantage over resident vendors.

One equity advantage of the sales and use tax is that it captures revenues from certain people that other taxes do not. Tourists and other non-residents that use state services and place demands on state infrastructures contribute to state revenues through their purchases of goods and services. This factor is especially important for states like Virginia that have a large number of visitors. Another way that sales taxes capture revenue is from persons involved in illegal income-generating activities (for example, purchases made from drug trafficking income) and from those who do not report income from legal activities. With the sales tax, at least these people are forced to contribute some amount of revenue to the state through their purchases of goods and services.

Effects of Sales and Use Taxes on the Economy. Sales and use taxes, like personal income taxes, distort the market by altering the relative prices of goods and services. The market distortions occur from the disparate treatment of goods and services, different tax rates across states, and the inability of states to collect taxes from many on-line retailers. Because goods and services are treated differently in many instances, consumers may opt for services instead of goods. For example, a person or business may choose to have a piece of equipment repaired instead of purchasing a new one, if repair work is not taxed.

Compliance and Administration of Sales and Use Taxes. Compliance and administration of the sales tax is fairly simple, while the compliance and ad-

ministration of the use tax is more complex. For sales taxes, vendors are responsible for knowing which items are taxed and for collecting the taxes from consumers. This makes the administration simple from the state perspective. Because sales taxes are based on sales records, it is not difficult for the state to monitor the appropriate payment of the tax. Also, the use of computer software, bar codes, and product scanners has made it simpler for vendors to comply with the tax.

Use taxes are more difficult to collect because transactions occur with out-of-state vendors, and states may not have authority to force vendors to comply with the tax. Many states have begun to address the problem of use tax collection by joining the Streamlined Sales Tax Project, which is an attempt to simplify the collection of interstate sales taxes by introducing uniform administrative procedures across the participating states. The agreement is an attempt to shift much of the administrative burden from vendors to state governments, in the hope that the federal government will give states the authority to require vendors to collect and remit the use taxes. As of July 2004, 21 states have signed laws to conform to the Sales and Use Tax Agreement. Twenty-one other states are considered to be "participating states" and have been involved in project negotiations.

TAXATION IN VIRGINIA

Virginia relies on several sources for its tax revenue. The two largest sources of tax revenue are the personal income tax and sales and use taxes. Virginia relies most heavily on personal income taxes, with 55 percent of tax revenues being derived from this source. General sales and use taxes accounted for 22 percent of tax revenues. Virginia's tax structure ranks it near the top of states in reliance on personal income taxes and near the bottom of states in reliance on sales and use taxes. The tax structure in Virginia is described in detail below, followed by a discussion of personal income tax and sales and use tax laws in Virginia.

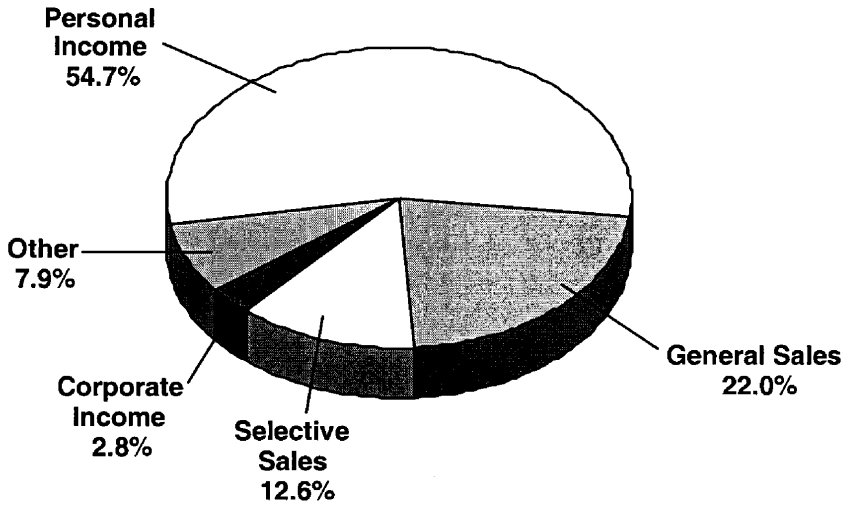
Composition of Virginia Tax Revenue

Virginia's tax revenues in FY 2003 totaled nearly $12.4 billion. More than 75 percent of the revenues were derived from personal income taxes and sales and use taxes. Virginia's composition of tax revenues is characterized by heavy reliance on the personal income tax, with sales and use taxes also providing a significant source of revenues. Figure 1 shows the composition Virginia's tax revenues for FY 2003. Personal income taxes were responsible for 55 percent of tax revenues, while general sales and use taxes were a distant second with 22 percent of the revenues. Other sources of revenue included selective sales taxes on motor fuels, motor vehicles, tobacco, and alcohol, as well as taxes on corporate income, insurance premiums, estates, and various other activities.

Compared to other states, Virginia ranks high in its reliance on the personal income tax and relatively low in its reliance on sale and use taxes. In fact, only two states (Oregon and New York) rely more on the personal income tax for their total tax revenues. In contrast, 43 states rely more heavily on sales and use

Figure 1

Virginia General Tax Revenues by Source (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.

taxes than Virginia. In terms of total state tax collections as a percentage of personal income, Virginia ranks 42nd out of the 50 states.

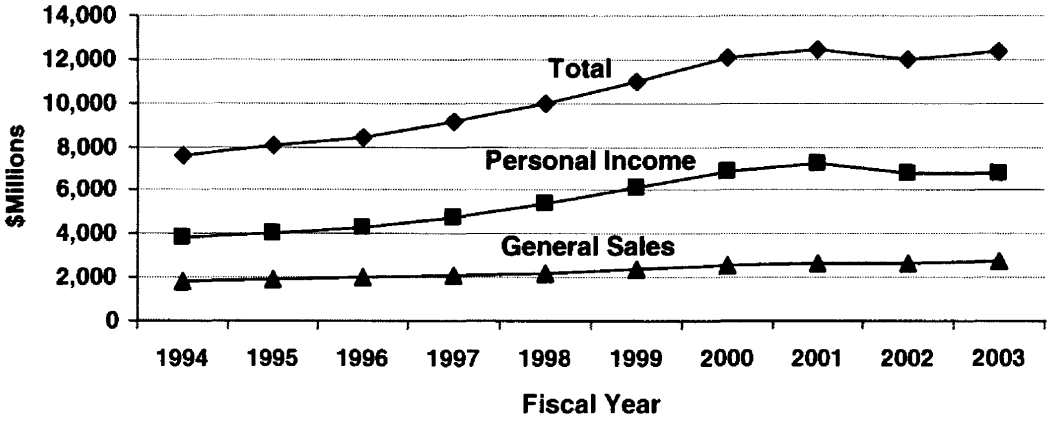
The personal income tax and the sales and use tax have provided fairly consistent revenues in recent years, although the percentage derived from personal income taxes has grown in Virginia over the past 30 years. For example, personal income taxes accounted for less than 43 percent of Virginia state taxes in 1972. Figure 2 shows State tax revenues for the past ten years, with the proportions of personal income and sales and use taxes also shown. The chart shows that personal income tax revenues nearly doubled between 1994 and 2001, while sales and use tax revenues increased by approximately 50 percent. However, the chart also shows that while income tax revenues dipped following 2001, sales and use tax revenues remained fairly constant.

Personal Income Tax Law

Virginia's personal income tax law is set forth in §§58.1-300 to 58.1-549 of the *Code of Virginia*. The *Code* specifies applicable rates, exemptions, deductions, and credits for assessing taxes on income, as well as the process by which a city or county may levy its own income tax. Virginia has four income tax brackets ranging from two percent to 5.75 percent. When calculating taxable income, Virginia uses "federal adjusted gross income" from the federal tax as the base. Table 1 shows the

Figure 2

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.

income tax brackets and their marginal rates. The marginal rate is the rate applied to that portion of income above the specified amount.

The *Code of Virginia* specifies exemptions and exclusions for low-income persons, which make the tax more progressive. Several of these exemptions and exclusions were modified during the 2004 Special Session of the General Assembly, and these modifications are addressed below. Individuals who earned less than $5,000 during the year, and married couples who earned less than $8,000 during the year, do not have to pay State personal income taxes. Also, individuals and families who had annual income not exceeding the poverty guideline, as established annually by the federal government, are eligible to receive a $300 income tax credit for each spouse and dependent. The income tax credit is subtracted from a person's or fam-

Table 1

Personal Income Tax Brackets and Applicable Marginal Rates

Income Bracket	Marginal Tax Rate
$0 to $3,000	2.00%
$3,001 to $5,000	3.00
$5,001 to $17,000	5.00
More than $17,000	5.75

Source: *Code of Virginia.* §58.1-320.

ily's tax liability, as opposed to a deduction, which is subtracted from a person's "Virginia adjusted gross income." The tax credit cannot exceed the total tax liability.

The *Code of Virginia* also specifies a number of deductions that residents can claim to reduce their tax burden. A $900 deduction is granted for each personal exemption allowable to the taxpayer for federal income purposes. Also, a standard deduction in the amount of $3,000 for individuals and $6,000 for married persons is granted to taxpayers who did not itemize their deductions on their federal tax forms. Persons aged 65 and over, and earning less than $50,000 in the year, can claim a $12,000 deduction. This deduction decreases by one dollar for every dollar earned over $50,000. In addition to other specific deductions, taxpayers can deduct up to $2,000 annually from their taxable income the amount that they paid into a prepaid tuition contract.

During the 2004 Special Session, the General Assembly enacted several changes to the current tax law pertaining to personal income and sales and use taxes (House Bill 5018). Significant changes to the personal income tax law included increases in the personal exemption (from $800 to $900), the standard deduction for married couples (from $5,000 to $6,000), and the income threshold at which low-income households are not levied the tax. Also, the bill implemented a means test for persons aged 65 and older to claim the $12,000 deduction, and eliminated the $6,000 deduction for persons aged 62 to 64 years. Exhibit 1 summarizes the changes made to the personal income tax law in 2004.

Certain localities are also authorized to levy an income tax of up to one percent on local residents, if the tax is approved by a voter referendum. This authorization applies to localities with a 1980 population in excess of 500,000 (Fairfax County) and any cities or counties adjacent to the eligible locality, as well as to any city with a 1980 population of at least 265,000 (Norfolk City). Revenue from the local income tax can be used only for transportation purposes. Currently, no localities in Virginia levy a personal income tax.

Sales and Use Tax Law

Virginia's sales and use tax law is set forth in §§58.1-600 to 58.1-639 of the *Code of Virginia*. The *Code* specifies State and local rates on the purchase of tangible property, and it specifies exemptions for certain purchases of goods and services. The State tax rate on general sales and use of tangible property is 4.0 percent of the retail sales price. The current rate became effective August 1, 2004, as a result of action by the 2004 Special Session of the General Assembly. The prior rate was 3.5 percent. Localities impose an additional one percent sales and use tax, which is administered and collected in the same manner as the State sales and use tax. Food for human consumption is taxed by the State at a lower rate and is scheduled to be reduced to 1.5 percent (2.5 percent State and local combined tax) by July 1, 2007.

The *Code* exempts certain purchases of goods from imposition of the sales and use tax. These exemptions are primarily for products purchased by businesses and farmers that are used in the production of final goods for resale. For example, fertilizers and commercial feeds used to grow crops and livestock are not taxed. The

Exhibit 1

Summary of 2004 Changes to Virginia's Tax Policy

Personal Income Tax Law

- Increased standard deduction for married couples from $5,000 to $6,000, effective January 1, 2005. (This eliminated the "marriage penalty," as the individual standard deduction is $3,000.)
- Increased personal exemption from $800 to $900, effective January 1, 2006.
- Families can claim 20% of federal earned income tax credit in lieu of $300 income tax credit, effective January 1, 2006.
- Implemented means test for persons aged 65 and over to claim $12,000 deduction. (Change does not affect persons born on or before January 1, 1939.) Deduction will be reduced by $1 for every $1 that the taxpayer's adjusted gross income exceeds $50,000 ($75,000 for married couples), effective January 1, 2004.
- Eliminated $6,000 deduction for persons aged 62 to 64 years, effective January 1, 2004. (Persons aged between 62 and 64 years as of January 1, 2004 will receive $6,000 deduction until they turn 65, at which point they will be subject to the means test for the $12,000 deduction.)
- Raised filing threshold from $5,000 to $7,000 for individuals and from $8,000 to $14,000 for married couples, effective January 1, 2005.

Sales and Use Tax Law

- Increased sales and use tax rate from 3.5% to 4.0%, effective September 1, 2004.
- Reduced sales tax on food from 3.0% to 2.5% effective July 1, 2005. Will reduce sales tax on food to 1.5% as of July 1, 2007. Eliminated revenue requirement for reductions to occur.
- Eliminated sales tax exemptions for certain public service corporations.

Source: House Bill 5018 of the 2004 Special Session of the Virginia General Assembly.

rationale for exempting these transactions from the general sales tax is that the tax is designed to be imposed only on final products. If intermediate goods used in the production of final goods were to be taxed, then the amount of that tax would be reflected in the cost of the final goods. Thus, the final goods would be taxed twice.

Most services in Virginia are not subject to the sales and use tax. Services exempted from the tax are specified in §58.1-609.5 of the *Code of Virginia*. With few exceptions, any service in which no tangible property is exchanged is exempt from the tax. This includes professional services such as legal, medical and accounting; personal services such as barbershops, dry cleaners, and health clubs; financial services such as investment counseling and insurance; and many other services. For repair work, the tax is assessed on parts but not on labor. Services that are taxed generally include some form of exchange of tangible property, such as diaper or linen services, or they involve the rental or lease of property, such as videotapes. According to the Federation of Tax Administrators, Virginia assesses sales and use taxes on fewer services than all but six states.

In 1999, the Virginia General Assembly implemented the Food Tax Reduction Program, which reduced the sales tax on food by 0.5 percent. The program was designed to gradually lower the tax on food (not including prepared food service) to 1.5 percent. Under the program, the tax on food would be lowered by one-half of one percent each year if revenue collections exceed the official revenue estimate by at least one percent. Since the program was implemented and the first reduction went into place on January 1, 2000, actual revenue collections have failed to exceed the official revenue estimates. Therefore, the tax on food has remained at three percent. However, the 2004 Special Session of the General Assembly removed the revenue requirement and specified that the 0.5 percent annual reduction resume on July 1, 2005. Therefore, the tax rate on food will decline to 1.5 percent (2.5 percent State and local combined tax rate) as of July 1, 2007. Changes to sales and use tax law made by the General Assembly in 2004 are summarized in Exhibit 1 along with the changes to the income tax law.

TAX STRUCTURES IN OTHER STATES AND COUNTRIES

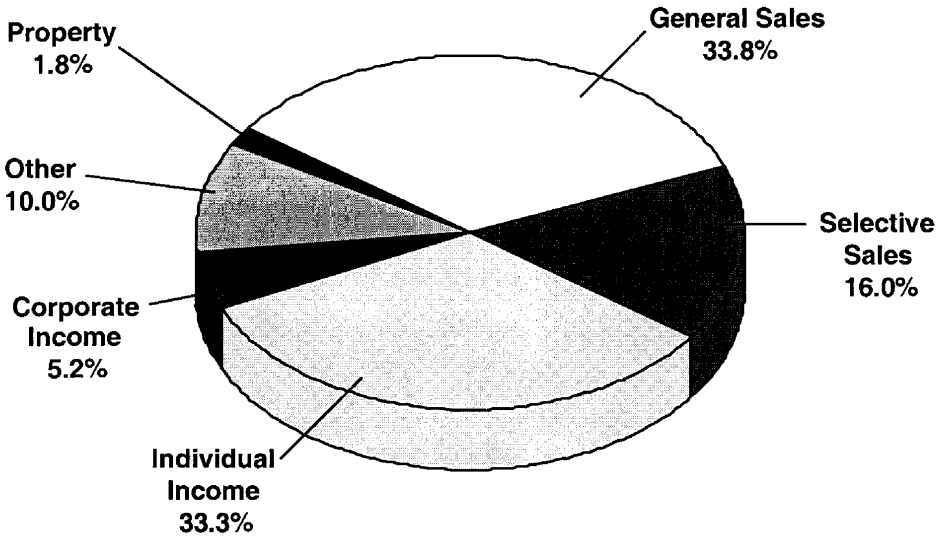
The study mandate contained in HJR 172 of the 2004 General Assembly directs JLARC to collect information and data on tax structures in other states and countries. A brief summary of tax structures in other states and countries is provided in this section. This review found that most states and countries derive revenues from a broad mix of taxes. Only seven states do not tax personal income, and there are no major countries that do not tax personal income. Because the initial review found no major countries operating without an income tax, this report focuses on the experiences of other states that do not levy an income tax.

Tax Structures in Other States

Most states employ a mix of revenue sources to fund government services. The two largest sources of revenue for the states are personal income taxes and sales and use taxes, which together accounted for approximately 67 percent of state tax revenues in 2003. Figure 3 shows the composition of total state tax revenues in the United States in 2003. The fastest growing source over the past 30 years was personal income tax collections, as five additional states initiated personal income taxes

Figure 3

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



Source: U.S. Bureau of the Census.

during that period. General sales and use taxes increased by only about two percentage points over the same period.

Most states levy both personal income taxes and sales and use taxes to varying degrees. In fact, only five states impose no general sales and use tax, and only seven states impose no personal income tax. One state, Alaska, imposes neither tax on its residents. States that rely heavily on personal income taxes generally do not derive a large proportion of their income from sales and use taxes, and vice versa. Some statistical information on the use of personal income taxes and sales and use taxes by the states is included below. In addition to variation in the mix of state taxes, states also vary considerably in the total amount they tax their residents. A brief discussion of the tax burdens among the states is also included below.

Personal Income Taxes Among the States. Personal income taxes accounted for approximately 33 percent of total state tax collections in 2003. Four states, including Virginia, derive more than 50 percent of their tax revenues from personal income taxes, with Oregon being the highest at nearly 71 percent. Seven states levy no personal income tax. These states are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Two other states (New Hampshire and Tennessee) levy personal income taxes only on capital gains and dividend income, and they derive less than three percent of their revenue from this tax. Personal income taxes accounted for at least 17 percent of state revenues in all other states that levied a personal income tax.

Of the 41 states that levy a broad-based personal income tax, there is much variation in the income tax rate, the number of tax brackets, and the income level at which the top tax bracket begins. The tax rates range from a low of 0.5 percent for the lowest income group in Oklahoma to 9.5 percent for the highest income group in Vermont (greater than $319,100). Six states have only one tax bracket for all levels of income, while two states have as many as ten income tax brackets. The average number of tax brackets is approximately five. While states vary considerably in terms of income tax rates and the number of tax brackets, the greatest variation exists in the level of income at which the top rate is applied. For example, the top rate begins at $3,000 in Alabama and Maryland, and $500,000 in New York. Only eight states have statutory provisions to adjust the tax brackets annually based on the rate of inflation, which partially explains the wide variation in brackets across the states.

Sales and Use Taxes Among the States. General sales and use taxes also accounted for approximately one-third of total tax collections among the states in 2003. Six states derive more than one-half of their tax revenues from sales and use taxes, with Washington being the highest at 62 percent. Five states do not levy general sales and use taxes. These states are: Alaska, Delaware, Montana, New Hampshire, and Oregon. Of the states that levy sales and use taxes, the state tax rate ranges from 2.9 percent in Colorado to 7.0 percent in Mississippi, Rhode Island, and Tennessee.

As might be expected, states that do not levy a personal income tax tend to rely more heavily on sales and use taxes. Two notable exceptions are Alaska, which levies neither tax, and New Hampshire, which does not levy sales and use taxes and only taxes income from capital gains and dividends. Table 2 shows the states that do not levy personal income taxes and their associated rank in terms of the percentage of tax revenues derived from general sales and use taxes. Chapter II examines these nine states in much greater detail.

The general state sales and use tax rate alone does not explain the entire sales tax burden on state residents, however, as food exemptions, local sales taxes, and sales taxes on services also factor into the total amount taxpayers pay for consumption. Twenty-nine states exempt food items from the general sales and use tax, and four states (including Virginia) tax food at a lower rate than the general rate. Also, localities may be allowed to levy a sales tax in addition to the state tax. Thus, the total sales tax rate that taxpayers pay will often be significantly higher than the state sales tax rate. For example, Alabama has a state sales tax rate of 4.0 percent, but localities may levy an additional 7.0 percent tax rate, which results in a potential sales tax rate of 11.0 percent. Finally, the number of services that are taxed significantly affects the tax burden on state residents. A few states tax as many as 155 different types of services, while the average number of services taxed is 53, according to the Federation of Tax Administrators. Due to the growing proportion of service expenditures in relation to expenditures on goods, the number of services taxed by a state could have a large impact on the tax burdens of the residents.

State Tax Burdens Among the States. The preceding discussion on personal income taxes and sales and use taxes illustrate different tax policies the states

Table 2

Reliance on Sales and Use Taxes for States that Do Not Levy Personal Income Tax (2003)

State	% Tax Revenues from Sales and Use Tax	Rank
Alaska	0 %	46 (tie)
Florida	56	3
Nevada	53	5
New Hampshire*	0	46 (tie)
South Dakota	53	4
Tennessee*	61	2
Texas	49	9
Washington	62	1
Wyoming	35	19

* State taxes dividends and capital gains, but not wages and salaries.

Source: *Tax Policy Handbook for State Legislators, Second Edition.* National Conference of State Legislatures, April 2003.

employ to derive their revenues, but it does not necessarily address differences in the overall tax burdens imposed on state residents. One measure of the tax burden is the ratio of total state tax collections to total personal income. Another measure is the ratio of total state and local tax collections to total personal income. These tax burden measures are shown in Figure 4 and Figure 5, respectively. Because states differ in how responsibilities are distributed between state and local governments, Figure 5 is probably a better measure of the tax burdens across states, and therefore the discussion of tax equity in the following chapters focuses on state *and local* tax distributions.

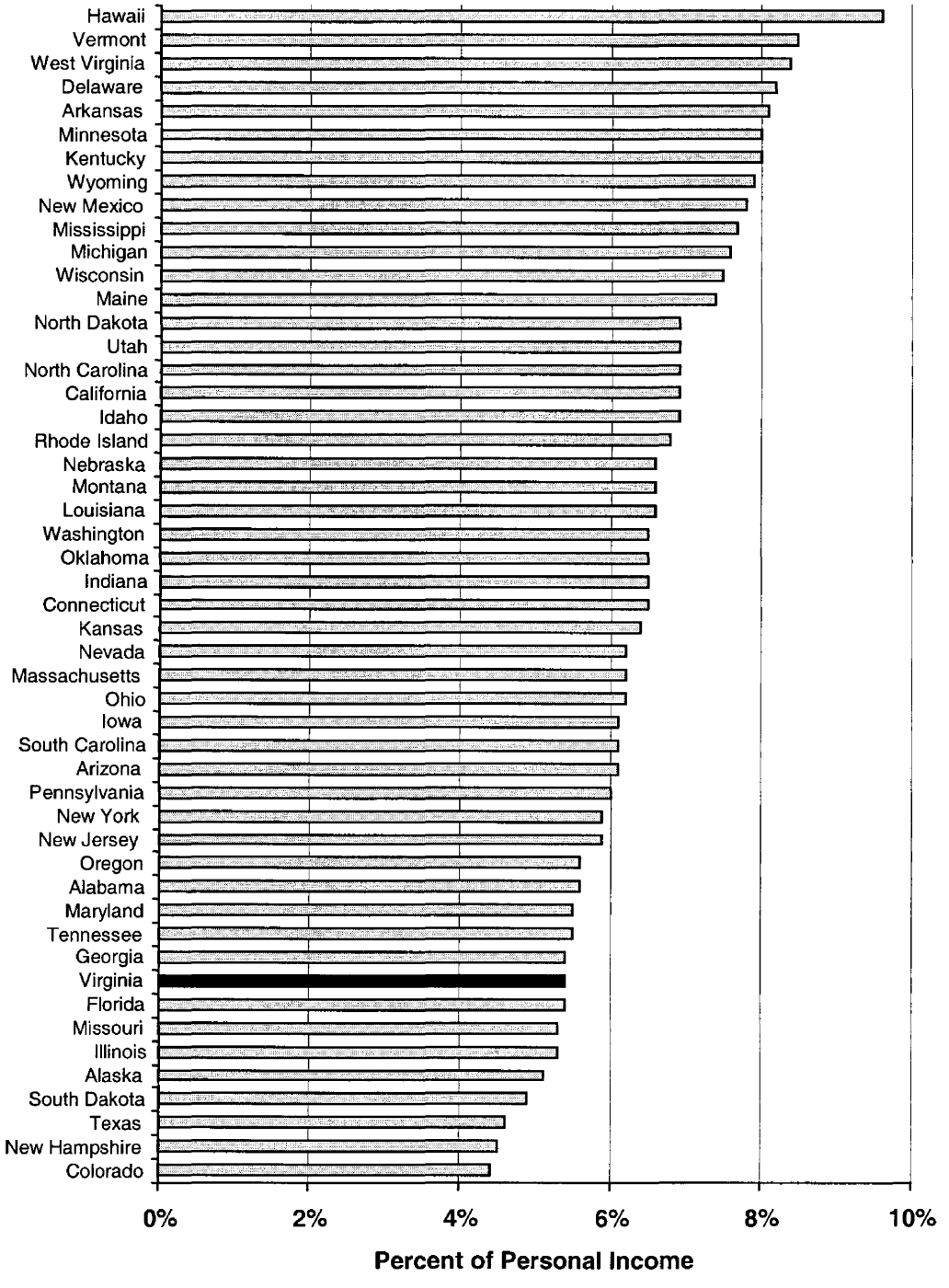
In 2003, the state tax burdens ranged from a high of 9.6 percent of personal income in Hawaii to a low of 4.4 percent in Colorado. Virginia ranked 42nd with a 5.4 percent state tax burden. State and local tax burdens in 2002 ranged from a high of 13.1 percent in New York to a low of 8.4 percent in Tennessee. Virginia's state and local tax burden was 9.5 percent, which ranked it 43rd among the states.

Tax Structures in Other Countries

In addition to gathering information on other states, HJR 172 also directs JLARC to gather information on other countries that have replaced income tax revenues with sales and use tax revenues. While there are several readily available data sources for state tax structures in the United States, tax data for foreign

Figure 4

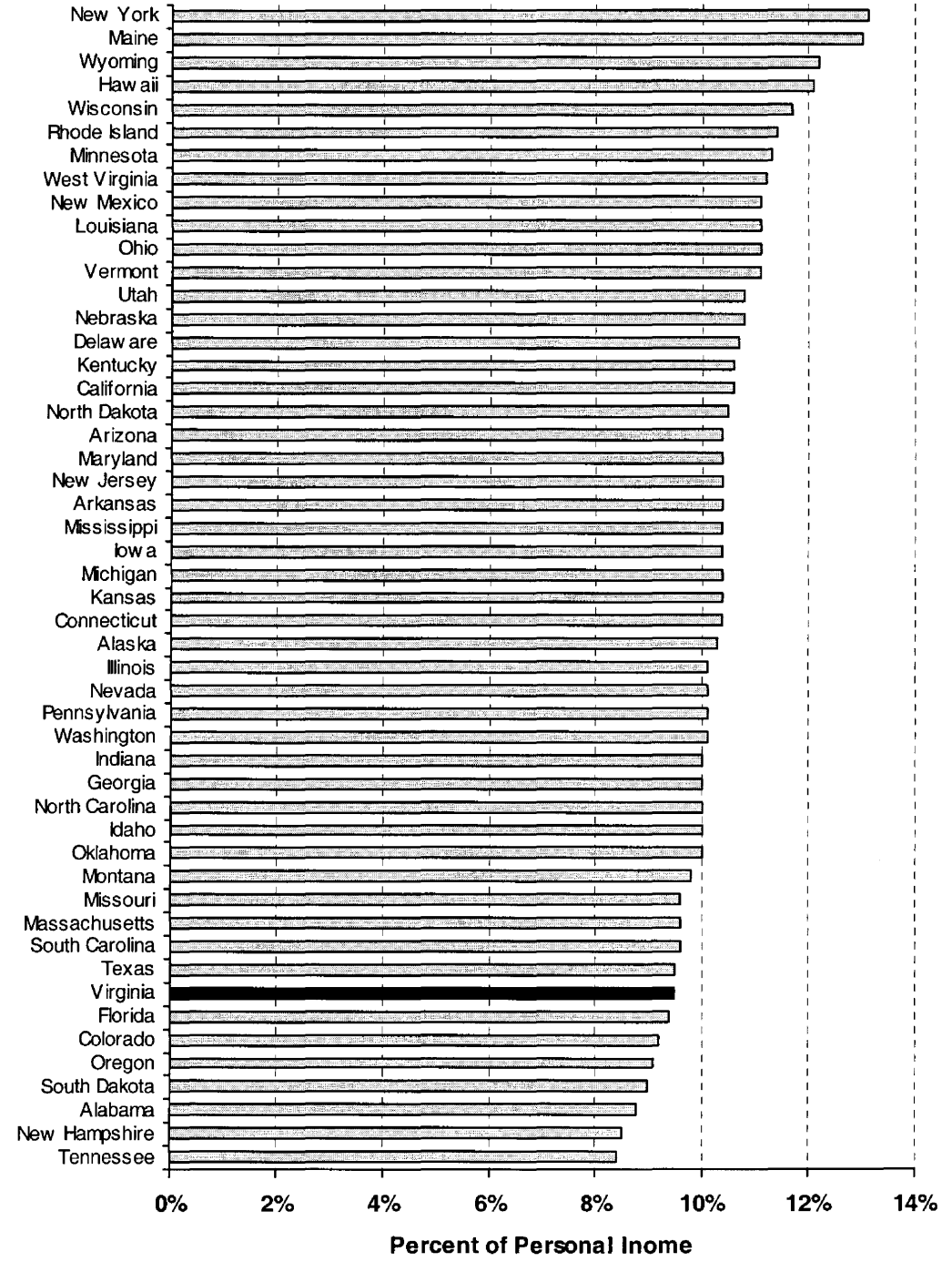
State Tax as a Percentage of Personal Income (2003)



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

Figure 5

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



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

countries is more difficult to locate. However, based on a preliminary review, it appears that every major country levies some form of a personal income tax, albeit with a fair amount of variation in tax rates, the number of tax brackets, and the level of income at which the top tax bracket begins. There do appear to be a few small countries that do not levy a personal income tax on their citizens, such as Monaco, and these countries are generally considered to be "tax shelters" for wealthy individuals.

Every Organization for Economic Cooperation and Development (OECD) country levies a personal income tax on its citizens. The OECD includes most of Western Europe, North America, Japan, Korea, Australia, and Turkey, among others. The top marginal tax rates range from 25 percent in Sweden to 60 percent in the Netherlands. However, there is substantial variation in the level of income at which taxpayers begin paying the top rate. For example, in Ireland, average production workers, as defined by OECD, must pay the top rate of 48 percent, while in several other European countries (including Germany, France, and the United Kingdom) the top rate does not apply until workers earn about twice the average income. In the United States, the top rate does not apply until workers earn ten times the average production worker's income.

JLARC REVIEW

In gathering data and information on other state tax structures, JLARC staff developed three main issues to be addressed:

- 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 higher sales and use tax revenues?

The research activities used to obtain this information are discussed below, followed by the report organization.

Research Activities

This study examined the issues through three main research activities. These activities were: (1) document and literature reviews, (2) data analysis, and (3) structured interviews.

Document and Literature Reviews. JLARC staff conducted a review of tax policy literature from various sources. Sources providing information on state tax structures included the National Conference of State Legislators, the American

Legislative Exchange Council, other state departments of revenue, various tax policy organizations, and state public policy journals. Prior studies on Virginia's tax policy were also reviewed, including reports produced by the Revenue Resources and Economic Study Commission and the Commission on Virginia's State and Local Tax Structure for the 21st Century. In addition, applicable sections of the *Code of Virginia* were reviewed along with recent legislation pertaining to Virginia's tax structure.

Data Analysis. JLARC staff analyzed tax revenue data from all 50 states and the District of Columbia. Staff also analyzed ten-year revenue histories of Virginia and the nine states that do not levy a broad-based personal income tax. Sources for the data included the U.S. Bureau of the Census, the Federation of Tax Administrators, comprehensive annual financial reports of Virginia and other states, and official revenue forecasts of the Virginia Department of Taxation. These data were used to determine the extent to which revenue sources are reliable and equitable, and to estimate the sales tax rate required to replace lost personal income tax revenues. The primary source for JLARC's tax equity analysis is data produced by the Institute on Taxation and Economic Policy, which is a non-profit research organization that works on government taxation and spending policy issues.

Structured Interviews. Structured interviews were conducted with staff from the Virginia Department of Taxation staff, legislative budget staff, various tax policy organizations, and revenue officials from the nine states that do not levy a broad-based personal income tax. These interviews were used to obtain information about Virginia's tax system and state tax policy in general. The interviews with other state revenue officials were also used to gain perspective on the perceived strengths and weaknesses of the individual state tax systems.

Report Organization

This report is organized into three chapters. Chapter I has provided background on the tax structures in Virginia and other states, and an overview of state tax policy principles. Chapter II presents the information gathered from the nine states that do not levy personal income taxes and discusses the lessons learned from the review of these states. The information on these states is also presented in separate profiles for each state in Appendix B. Chapter III presents JLARC's analysis of possible impacts on Virginia from replacing personal income tax revenues with sales and use tax revenues.

II. Experiences of States That Do Not Levy Personal Income Taxes

In reviewing alternative tax structures, this report focuses on the states that do not impose a broad-based personal income tax. As mentioned in Chapter I, there are currently nine states in this category. This chapter examines the tax structures of these states in depth, including the composition of tax revenues, the reliability and stability of tax revenues over time, average tax burdens, the equity of the tax distributions, and perspectives of tax officials in these states regarding the advantages and disadvantages of their tax structures. Based on the experiences these states have had without an income tax, several lessons may be learned that could be helpful to lawmakers when determining the appropriate tax policy for Virginia. These observations are also presented within this chapter.

NINE STATES IMPOSE NO BROAD-BASED PERSONAL INCOME TAXES

Specific information was gathered on each of the nine states that do not impose a broad-based individual income tax. The nine states are:

- Alaska
- Florida
- Nevada
- New Hampshire
- South Dakota
- Tennessee
- Texas
- Washington
- Wyoming

The information collected for each state includes 2003 tax revenues, ten-year histories of general fund revenues, a breakdown of state and local tax burdens across income groups, and general sales and use tax statistics. Additionally, the profiles include information regarding the states' tax policies and perspectives of tax officials and experts in the states. This information is summarized in separate profiles for each state in Appendix B.

The profiles provide a snapshot of each state's tax structure and recent revenue experiences. A chart in each profile depicting the breakdown of tax revenue sources illustrates how each of the states derives its revenues without imposing a broad-based income tax. The charts show that most of the states rely heavily on general sales taxes. Six of the nine states derive one-half of their tax revenues or more from general sales taxes. Of the remaining states, Alaska and Wyoming rely heavily on oil and mineral revenues, and New Hampshire relies heavily on selective sales and property taxes.

The ten-year revenue history chart contained in each profile tracks general fund tax revenues over the period between fiscal years 1994 and 2003. These charts are provided to illustrate a sense of the stability and reliability of the state tax structures. With the exception of Alaska, which is greatly affected by changes in oil prices, revenues generally increased steadily throughout the ten-year period, with a

slowdown in revenues coinciding with the downturn of the national economy beginning around 2000. General fund revenues, rather than total tax revenues, are shown because these revenues represent discretionary funds, and programs supported by the general fund are more likely to be affected by fluctuations in the fund. Also, because Virginia's income tax revenues are deposited in the general fund, this is the fund that would be most affected by replacing income tax revenues with sales and use tax revenues.

The final chart contained in the state profiles shows the average state and local tax burden in 2002 for each income group. These charts are presented to provide a sense of the equity or fairness of tax structures within each state. The burden is expressed as the percentage of personal income that is spent on state and local taxes for the average taxpayer in the income quintile. By including local taxes in the analysis, differences among the states in terms of the split between state and local services are eliminated. For example, property taxes are treated the same whether they are collected at the local level or the state level. Also, inclusion of local taxes provides a more complete picture of the actual tax burdens faced by individuals and families within the states, as it captures local sales taxes and other local taxes.

Other information contained in the profiles includes basic demographic and taxation statistics for the states, as well as additional notes gathered from interviews with tax officials and budget experts located in the states. These statistics show per capita rankings, sales tax rates, expansiveness of the sales tax, and the maximum local sales tax rate that may be applied. The additional notes provide unique perspectives on the strengths and weaknesses of the state tax structures, as well as tax policy issues confronted by state lawmakers.

LESSONS LEARNED FROM STATES THAT DO NOT IMPOSE PERSONAL INCOME TAXES

Several lessons and observations may be gleaned from the review of states that do not impose broad-based individual income taxes. First, several of the states have unique characteristics that enable them to raise revenues with less need for an income tax. Second, states that rely heavily on sales and use taxes tend to have more regressive tax structures than other states. Third, several of the states have been unsuccessful in their attempts to broaden the sales tax base. Fourth, states with high sales tax rates are particularly vulnerable to revenue losses from Internet sales. Fifth, several of the states have considered implementing an income tax to address revenue needs. And finally, dependence on a single revenue source appears to cause unreliability. Each of these observations is discussed below.

Several States Have Unique Characteristics

Several of the non-income tax states have unique characteristics that have assisted them in raising revenues without imposing personal income taxes. Alaska and Wyoming both derive a large proportion of their revenues from oil and mineral

reserves. In fact, Alaska derived 62 percent of its revenues in 2003 from oil and other natural resources severance taxes, with the vast majority coming from oil revenues. Prior to 1979, when oil revenues from the pipeline began accumulating, Alaska had an income tax. This tax was repealed as it was no longer considered necessary to maintain government operations. Wyoming derived 35 percent of its total tax revenues in 2003 from oil and mineral severance taxes. Tax officials in both states claimed that severance taxes from these resources have allowed residents in their states to enjoy low tax burdens and no income tax.

Florida and Nevada are two other states with unique characteristics that have helped enable them to forego implementing an income tax. These states have a large number of tourists from which to collect revenues. Florida estimates that tourists account for 15 to 20 percent of sales tax collections. Nevada also receives large numbers of tourists due to its casinos, which are assessed a gaming percentage fee tax. In 2003, the gaming percentage fee tax accounted for more than 30 percent of Nevada's general fund revenues. According to a Nevada state tax official, an income tax would not adequately capture the revenues generated from tourism and gambling.

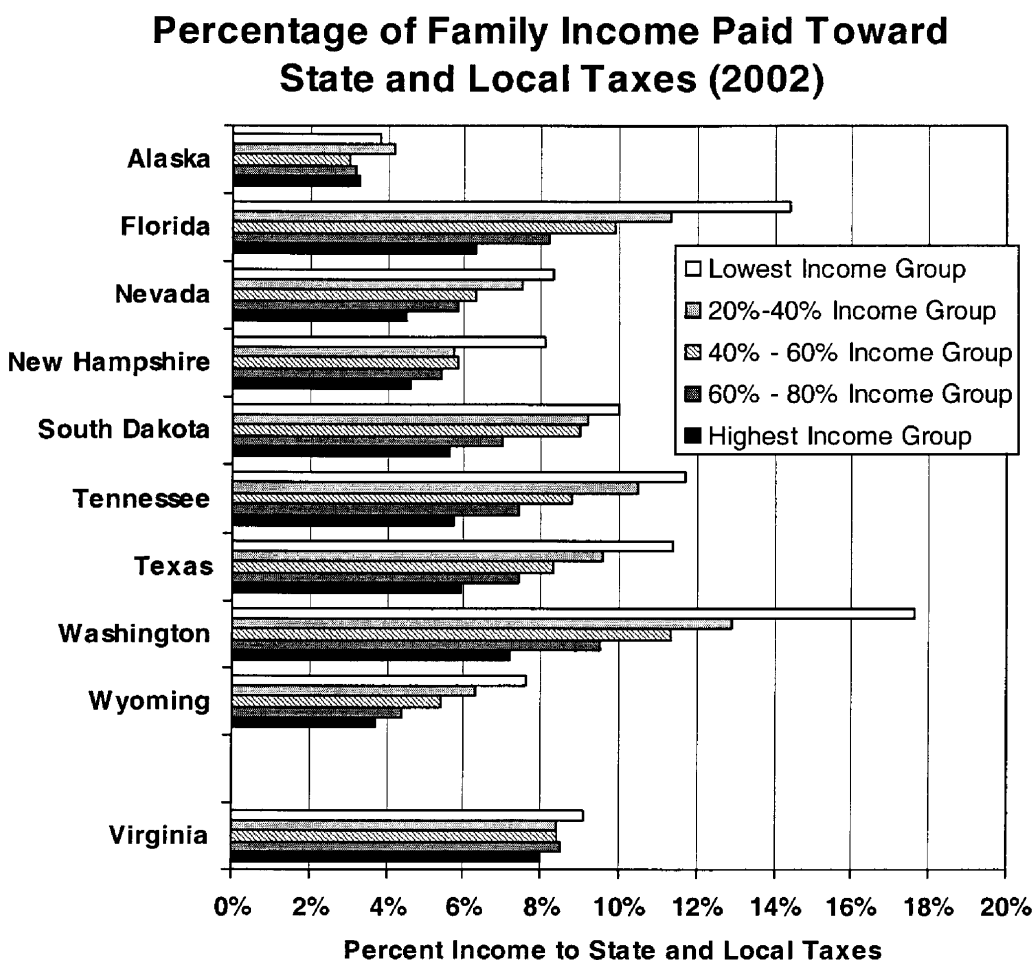
While four of the nine states have unique characteristics that make not having an income tax more feasible, the remaining five states do not appear to have such characteristics. The fact that these states also do not impose personal income taxes indicates that, while having unique revenue sources helps eliminate the need for an income tax, such sources are not necessarily required. Tennessee, Texas, and Washington derive a majority of their revenues through high sales tax rates, while South Dakota raises a majority of its revenues through a very broad sales tax base. New Hampshire has no sales tax but derives its revenues primarily from selective sales (for example, alcohol and cigarette sales), property, and corporate income taxes.

Most States Tend to Have Regressive Tax Structures

Because most of the nine states rely heavily on sales and use taxes for government revenues, most of these states have regressive tax structures. General sales taxes and selective sales taxes, collectively known as consumption taxes, are regressive in that lower income people generally spend a higher proportion of their income on consumption than do higher income people. This phenomenon occurs because wealthier people are able to save a larger proportion of their income. Therefore, as consumption taxes become a larger proportion of the overall tax base, the tax structure becomes more regressive.

Figure 6 illustrates the distribution of state and local taxes across income groups for each of the nine non-income tax states and Virginia. For each income group, the average percentage of personal income paid toward state and local taxes is shown. As can be seen by the chart, eight of the nine states appear to have regressive tax structures, as families in the lowest income group pay on average considerably more than families in the highest income group. With the possible

Figure 6



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.

exception of Alaska, these states appear to have significantly more regressive systems than Virginia.

With the exception of Alaska and New Hampshire, these states rely heavily on sales and use taxes. Six of the nine states (Florida, Nevada, South Dakota, Tennessee, and Texas) derive approximately one-half or more of their total state revenues from general sales taxes, so it is not surprising that their tax structures are regressive when using the percent of personal income as the measure. In fact, according to one study, these six states rank among the top ten most regressive state tax systems. The equity of the state tax systems will be discussed in further detail in Chapter III.

States Have Experienced Difficulties Expanding the Sales Tax Base

When states face revenue shortfalls, one way of increasing revenues is by expanding the sales tax base to include services. By taxing services, states can cap-

ture revenues from the growing service sector while broadening the base to make the system more reliable and equitable. The service sector has been growing for decades and now represents approximately 60 percent of personal consumption nationally. As the service sector grows, states may find it difficult for sales tax revenues to keep pace with spending if services are not taxed. This problem is compounded when states rely on sales tax revenues for a large portion of their revenues. In addition, broadening the base to include services may help states make their tax systems less regressive, as higher income people tend to spend a larger proportion of their income on services, and it becomes possible to lower the general sales tax rate on all goods and services due to the broader base. Because of the perceived untapped revenue source from services, several states, including Virginia, have attempted to enact legislation to impose the general sales tax on selected services. However, most states have met with resistance to this action, and the attempts have generally failed.

Florida and Wyoming, in particular, have tried unsuccessfully to implement sales taxes on a broad range of services. In 1986, following a tax study commission, the Florida legislature enacted laws to tax nearly every service in Florida. However, these new taxes were met with massive resistance, led by media advertisers who were being newly taxed by the changes. Facing such opposition, the governor asked the legislature to rescind the laws, which it did only six months after the taxes went into effect. Following the actions in Florida, states have been wary of attempting to impose new taxes on services. Wyoming recently attempted to introduce sales taxes to most services in the state, but the bill failed after concerted efforts from lobbyists. All of the new service taxes were removed from the bill through a series of amendments.

States with High Sales Tax Rates Are Vulnerable to Revenue Loss from Internet Sales and Out-of-State Sales

All states that impose general sales taxes are subject to erosion of revenues due to the growing volume of Internet and other out-of-state sales. However, states with the highest sales tax rates are most vulnerable, as sales tax revenues in these states account for a large portion of their total revenues, and residents in the states are more likely to avoid the tax by purchasing from on-line vendors or merchants in neighboring states. Officials in the seven states that levy sales taxes all stated that Internet sales have hurt their collections, and all have conformed or attempted to conform to the Streamlined Sales Tax Agreement to address the problem. Tennessee and Washington also appear to be particularly vulnerable to residents opting to purchase goods in neighboring states.

Because the non-income-tax states rely heavily on sales and use tax revenues, these states appear to be especially vulnerable to lost revenue from Internet sales. While most of the officials interviewed did not have specific estimates of lost revenue, they all agreed that it was a problem. Washington did estimate that it lost $250 million in tax revenues through Internet, catalog, and phone sales in 2002. An official from another state claimed that the losses were "staggering." Only one state (South Dakota) indicated that revenue losses were not noticeable, and the official

believed this was due to the fact that the state taxes a wide range of services that are not offered through the Internet.

To address the problem of Internet sales, the seven states have all participated in the Streamlined Sales Tax Project. This project is an attempt by the states to standardize sales tax definitions across the states and simplify the remittance of sales taxes from remote vendors. The participating states believe that if enough states conform to the simplified structure, Congress will give states the authority to require Internet vendors to remit the use taxes owed to the states in which the customers reside. Four of the states have enacted laws to fully conform to the Streamlined Sales Tax Agreement. Texas and Washington have enacted laws to mostly conform to the agreement, but have delayed implementation because of problems in moving the tax base from the origin of the sale to the destination of the goods bought, which is a requirement for conformity with the agreement. Apparently, this change causes winners and losers among localities in the states, which has caused opposition to the changes. Florida has introduced legislation to conform to the Agreement, but this legislation has stalled in the legislature.

Several of the state tax officials indicated that the process of changing state tax laws to conform to the Agreement is very onerous, and the process is made more difficult by the fact that there is no guarantee that conformity will ultimately result in the collection of Internet sales taxes. Several of the state tax officials indicated that they believed the Agreement would ultimately lead to greater collection of Internet sales tax revenues, while others were more skeptical. One state tax official stated:

> One major problem with the Streamlined Sales Tax Project is that the "golden ring" is missing. There is no guarantee states will be able to collect taxes from Internet sales even if they conform. Until the reality of change in the federal law, it is very difficult to make changes.

In addition to revenue loss from Internet sales, Tennessee and Washington also appear to be especially vulnerable to residents purchasing goods from vendors in neighboring states. Conversely, New Hampshire appears to benefit from residents in neighboring states traveling to New Hampshire to buy goods because the state has no sales tax.

Tennessee has the highest sales tax rate in the nation at seven percent, and it borders eight states that all have lower sales tax rates. One study has estimated that in 2003, Tennessee lost $34 million in state and local tax revenues from residents in the Johnson City-Kingsport-Bristol metropolitan area traveling to Virginia to purchase retail items. This lost revenue resulted from $354 million in additional retail sales on the Virginia side of the border. These additional sales produced additional state and local tax revenues in Virginia of $16 million.

Washington also has one of the highest sales tax rates in the nation at 6.5 percent and is vulnerable to lost revenue because Oregon, its neighboring state, has no sales tax. Washington estimated it lost $55 million in tax revenues in 1999 from people avoiding the tax by shopping in Oregon.

While Tennessee and Washington experienced losses due to their high sales tax rates, New Hampshire appears to gain revenues from not having a general sales tax and having low taxes on alcohol and cigarettes. According to one legislative budget official, it is common practice for residents of other New England states to travel to New Hampshire and buy liquor and tobacco there. These are two of New Hampshire's largest revenue sources.

Most of the States Have Considered Implementing an Income Tax

Another observation from the review of non-income-tax states is that most of the states have considered implementing a personal income tax to address revenue needs or inequities in their current tax systems. However, in each case, the proposals were defeated either by the legislature or the voters. The reasons cited by state tax officials for the income tax proposals included structural deficits and inequities with their tax structures due to high sales tax rates. The primary reason the proposals were defeated was strong opposition among voters and the consequent opposition among lawmakers in the states. A few examples of states attempting to implement a broad-based income tax are discussed below.

An income tax bill was debated in the Tennessee legislature in 2002. The bill would have instituted a six percent flat income tax and eliminated the sales tax. The rationale for the income tax was that Tennessee's budget had a structural deficit, and the sales tax was the highest in the nation, which meant the tax structure was regressive and the state was losing money to out-of-state vendors. The Tennessee Department of Revenue estimated that an average family of four would save $200 per year under the new tax system. However, many people were viscerally opposed to an income tax, and the bill quickly became a very contentious political issue. Protesters at one point marched on the capital in opposition to the bill and actually threw bricks through a window in the Governor's mansion. The bill was eventually defeated, and the legislature addressed the budget deficit by raising the sales tax by one percent, increasing the corporate income tax by one-half percent, and raising various "sin" taxes.

The state of Washington has had eight tax study commissions review the state's tax structure, and all have recommended implementing an income tax along with a corresponding elimination of the state property tax and a reduction in the state sales tax rate. However, an amendment to the state's constitution would be required to implement an income tax. The amendment has been proposed in a voter referendum six times since 1934, and it has been defeated every time. There appears to be an ingrained opposition to income taxes in Washington, as surveys have shown that the sales tax is the most acceptable tax among residents. According to a Washington state tax official, people do not really notice the sales tax, as it "nickels and dimes" them. Income and property taxes are more "lumpy" and cause greater distress, she said.

Several of the other states have also considered implementing an income tax to some extent. In 2002, the Alaska House voted in favor of an income tax but the Senate rejected it. Also in 2002, a New Hampshire gubernatorial candidate ran on a platform of instituting a broad-based income tax and eliminating the property

tax, but he was defeated soundly. In 1997, a Wyoming tax study commission recommended implementing an income tax, but the legislature did not act on the recommendation. Various groups in Florida and Texas have also proposed an income tax, but these proposals have not been seriously considered due to the need for a constitutional amendment and the likely defeat in a voter referendum.

Dependence on a Single Source Results in Revenue Unreliability

A final observation from the review of non-income-tax states is that heavy dependence on a single source tends to result in unreliability of revenues, which can adversely impact state budgets. This unreliability is most pronounced in Alaska, although budget problems in several of the other states also attest to the need for a diversified portfolio of taxes. The literature also supports the idea that revenue reliability is best achieved through a balanced mix of taxes.

Alaska's instability is caused by its heavy reliance on oil revenues, which fluctuate according to supply and world oil prices. As can be seen in Alaska's profile in Appendix B, general fund revenues fluctuated wildly between 1994 and 2003. Revenues totaled just over $900 million in 1994 and rose to nearly $1.5 billion in 1997 before plummeting to just over $700 million in 1999. Because of the unreliability of Alaska's oil revenues, the state has been forced to spend $4.6 billion of its Constitutional Budget Reserve fund (rainy day fund) to balance its budget. Alaska has used this fund to close its deficit in 11 of the past 14 years. The depletion of the rainy day fund has caused lawmakers in the state to consider an income or sales tax.

Florida, Nevada, Tennessee, Texas, and Washington all rely heavily on sales and use taxes, and all of the states have faced serious budget deficits and been forced to devise short-term solutions to their budget problems. These states are not unique in facing budget deficits over the past few years, as revenues from state income taxes have also been slowed sharply. However, their reliance on sales taxes has also hurt them due to the ongoing erosion of the sales tax base caused by the growing service sector economy and Internet sales. In fact, *Governing Magazine* recently gave each of the states a "one star" adequacy rating out of a possible "four star" rating in a review of the 50 states' tax structures.

Based on the literature regarding tax structures, it is not surprising that these states have unreliable revenues given their heavy reliance on a single source. Much of the literature acknowledges that income and consumption taxes are subject to swings in the economy, and that some taxes are more stable than others. However, the most stable revenue sources, such as property taxes, do not tend to grow as fast during times of economic expansion. Thus, reliability is best achieved through use of a broad mix of taxes, just as reliability of sales tax revenues is best achieved through taxing a broad range of goods and services at a low rate. State tax structures are similar to investment portfolios in that a broad mix of investments is more likely to produce reliable income.

III. Impacts of Replacing Individual Income Tax Revenues with Sales and Use Tax Revenues in Virginia

If the General Assembly wishes to rely less on individual income tax revenues and yet maintain revenue neutrality, it could replace them through increasing the State's sales and use tax revenues that go to the general fund. Increasing sales tax revenues could occur through (1) increasing the general sales and use tax rate, or (2) expanding the sales tax base. JLARC staff developed several scenarios to illustrate the general sales tax rate increases necessary to replace individual income tax revenues, using alternative sales tax bases and other assumptions based on the experiences of other states. This chapter also shows that, according to data from 2002, Virginia's tax structure appears to be less regressive than the tax structures of most other states. However, greater reliance on sales and use tax revenues would likely shift the distribution of the tax burden and make Virginia's overall tax system more regressive.

INCREASING SALES AND USE TAX REVENUES

Increasing sales and use tax revenues could be accomplished by raising the tax rate, expanding the tax base, or through a combination of the two. There are some key issues associated with raising sales tax rates and expanding the sales tax base, and these issues require some assumptions to be made when examining alternative scenarios for increasing sales and use tax revenues. The issues are presented below, followed by a presentation of the estimated sales tax increases under the alternative scenarios.

Raising the General Sales and Use Tax Rate

One obvious method of increasing sales tax revenues is to increase the rate. In Virginia, a one percent increase in the general sales tax rate would be associated with an increase in revenues of approximately $908 million annually, assuming that a higher tax rate does not cause a decrease in sales due to the slightly higher net price. (This estimated increase in revenues is based on the official forecast of sales tax revenue for FY 2006, and assumes that the one percent increase is applied to food as well as to everything else.) The assumption that Virginia merchants would not be hurt by lost sales may not be realistic, however, if the tax rate were to increase so much that customers would be more inclined to shop in neighboring states for lower prices. A higher sales tax rate may also result in greater erosion of taxable sales due to Internet sales, again if the increase is substantial enough to motivate customers to seek ways to avoid the higher net prices.

Broadening the Sales Tax Base

As mentioned in Chapter I, the Federation of Tax Administrators characterizes Virginia currently as being among the states with the narrowest sales and use tax bases in the nation. In addition to the exemption of certain goods purchased by businesses and farmers, most services are also exempt from the sales and use tax.

Applying the sales and use tax to services would capture a growing sector of the economy. According to the U. S. Bureau of Economic Analysis' *Survey of Current Business*, in 1960 less than 47 percent of personal consumption expenditures nationally was on services. By 2003, more than 60 percent was on services. It has been argued that as consumers spend more of their income on services, states taxing these services would see faster growth in sales tax revenue. It has also been argued that extending the sales tax base to services would make sales tax revenues more stable in the long run, because declines in one area of consumption could be at least partially offset by gains in another. A final argument for broadening the base to include services is that this would make the tax less regressive, because consumption by those with higher incomes includes a higher proportion of services than those with lower incomes.

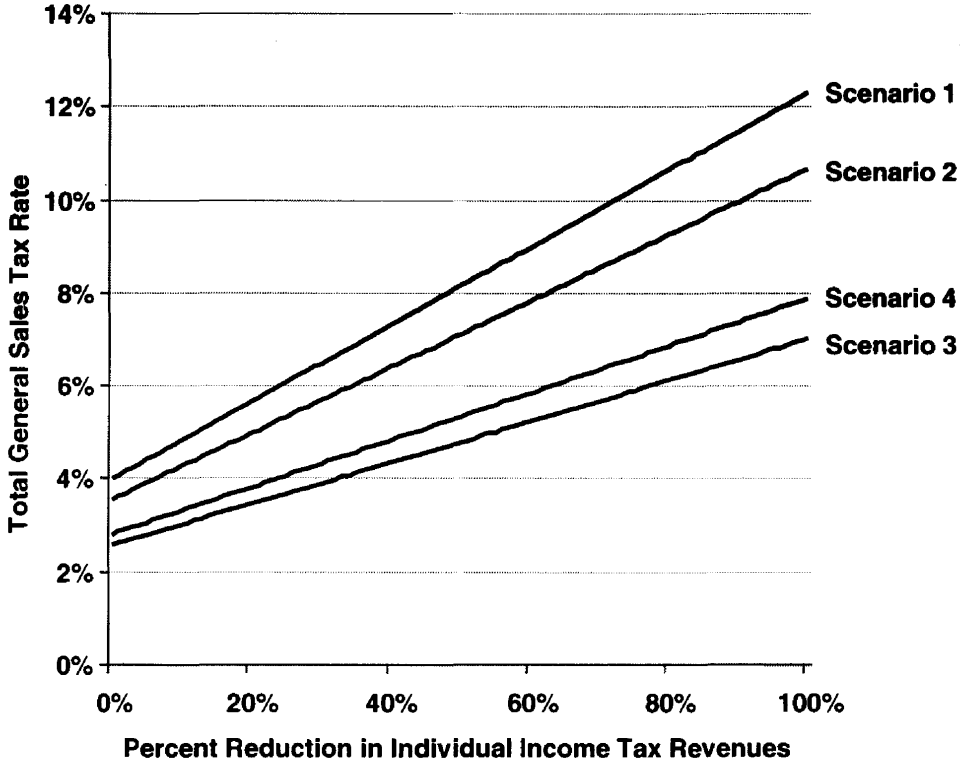
Unlike increasing the tax rate, broadening the sales tax base would also provide additional revenues to Virginia's Transportation Trust Fund and to localities. The one percent local option sales tax and the one-half percent of the sales tax that goes to the Transportation Trust Fund would generate more revenues if the base were expanded. Therefore, if general fund revenues from the personal income tax were to be replaced by additional sales and use taxes achieved by expanding the base, overall tax revenues would increase.

Alternative Sales Tax Scenarios: Estimating Sales Tax Rates to Replace Individual Income Tax Revenue

In estimating the required increase in the sales tax rate to replace revenue lost from an elimination or reduction of the income tax, four scenarios were developed based on the breadth of the sales tax base and the extent to which the sales tax may be raised. The scenarios are: (1) maintaining the current sales tax base; (2) expanding the base by $500 million through repealing media, commercial, and industrial exemptions; (3) expanding the base by $2.6 billion to replace all income tax revenues while not raising the State sales tax rate beyond seven percent; and (4) expanding the base by $1.9 billion, which is the most recent estimate for the amount that would be generated by repealing selected service exemptions identified by the Department of Taxation. These four scenarios were chosen based on the *status quo,* available revenue estimates of the cost of tax exemptions on services, and a reasonable assumption regarding the upper limit of the sales tax rate. Figure 7 shows the required general sales tax rate required to replace individual income tax revenues under these different scenarios. The chart also shows how the general sales tax rate could be reduced under the scenarios that broaden the sales tax base.

Figure 7

Replacing Individual Income Tax Revenues with Sales Tax Revenues (Based on FY 2006 Revenue Forecasts)



Source: JLARC staff analysis.

Key Assumptions Made in Developing the Sales Tax Rate Estimates. Several key assumptions were made for generating the numbers under all four scenarios:

- Taxable sales in Virginia are assumed to be inelastic with respect to the general sales tax rate. In other words, it is assumed that the volume of sales will not change as the general sales tax rate increases. This assumption may be appropriate for food, but probably not for other items subject to the sales and use tax. At this time, there are no reliable quantified estimates of the elasticity available (that is, how much taxable sales would decline as the general sales tax rate increases). Consequently, the tax rates shown could be considered the lower bound of the general sales tax rates required to replace income tax revenue, because they are the sales tax rates that would be necessary under the optimistic assumption that there would be no erosion of the taxable sales base because of general sales tax increases.

- Similarly, taxable sales in Virginia are assumed to be inelastic with respect to reductions in income taxes (that is, taxable sales are not assumed to increase as income taxes decrease). Again, this assumption may be more appropriate for food, but for other items there may be more of an income effect. Given that reliable quantified estimates of income effects on taxable sales in Virginia are not available at this time, this analysis is based on the simpler assumption that taxable sales (in Virginia) remain constant as income tax revenues may be reduced.

- The sales tax rate changes would apply to food as well as other items subject to the sales and use tax, although the differential for food (of a total sales tax rate 1. 5 percent lower in FY 2006) would still apply.

- The numbers are assumed to apply to FY 2006. Consequently, the general sales tax rate (assuming a *status quo* condition of no changes in the general sales tax rate) for revenues going to the general fund in FY 2006 is assumed to be 3.25 percent. The total general sales tax rate (counting revenues going to the Transportation Trust Fund, local governments, and to public schools) under the *status quo* condition is assumed to be 5 percent in FY 2006. The *status quo* sales tax rate on food (in FY 2006) that goes to the general fund is assumed to be two percent, and the *status quo* total sales tax rate on food in FY 2006 is assumed to be 3.5 percent. Food is assumed to be 15 percent of taxable sales.

- Based on official revenue forecasts for FY 2006, the amount of general fund revenues generated by the sales and use tax under the *status quo* condition is $2.98 billion. The total revenue amount generated by the individual income tax is assumed to be $8.09 billion.

Scenario 1: Assuming No Change in Sales Tax Base. The top line in Figure 7 shows the minimum general sales tax rates that would be necessary to replace individual income tax revenues if the sales tax base were not expanded. Assuming taxable sales are inelastic with respect to the sales tax rate and reductions in the income tax, the total State general sales tax rate would have to increase from four percent to 12.30 percent to replace 100 percent of individual income tax revenues.

Scenario 2: Assuming Expanded Sales Tax Base Generating Additional $500 Million. During the 2004 Session, the General Assembly discussed the option of expanding the sales tax base to generate approximately $500 million in additional revenue, through repealing media, commercial and industrial exemptions. Even with this expanded sales tax base (and again assuming totally inelastic taxable sales), the State general sales tax rate would still have to increase to 10.67 percent to replace 100 percent of individual income tax revenues, as shown in Figure 7.

Scenario 3: Maximum Seven Percent Sales Tax Rate, Expanded Sales Tax Base to Replace 100 Percent of Individual Income Tax Revenues. Given that the highest state general sales tax rate in the nation is seven percent, that level may be a realistic upper bound on what Virginia's general sales tax rate

could practically be. Assuming that a seven percent State sales tax rate is the maximum and that 100 percent of the individual income tax revenues are to be replaced, the sales tax base would need to be expanded such that an additional $2.6 billion would be generated under *status quo* conditions. This expansion would almost double currently forecasted sales and use tax revenues for FY 2006. Whether such a massive expansion of the sales and use tax base is possible is doubtful.

Scenario 4: Assuming Expanded Sales Tax Base Generating Additional $1.9 Billion. If the target is modified to replace 82.5 percent (rather than 100 percent) of individual income tax revenues with sales tax revenues, this goal can be accomplished under more feasible conditions: (1) a maximum State general sales tax rate of seven percent; and (2) an expansion of the sales tax base such that an additional $1.9 billion would be generated under *status quo* conditions. According to Department of Taxation estimates, an expansion of this magnitude may be accomplished by applying the sales tax to a broad range of services. South Dakota and Wyoming appear to apply their sales and use taxes in a similar, broad manner.

Alternative Options: Leaving Income Tax Revenues Alone, but Lowering Sales Tax Rates. Figure 7 also shows that by expanding the sales tax base, the General Assembly has alternative options for lowering the sales tax rate instead of replacing income tax revenues.

- Under Scenario 2 (expanding the sales tax base such that $500 million in additional revenues would be generated under *status quo* conditions), the State general sales tax rate could be reduced from four percent to 3.56 percent.

- Under Scenario 3 (expanding the sales tax base such that $2.6 billion in additional revenues would be generated), the State general sales tax rate could be reduced to 2.57 percent.

- Under Scenario 4 (expanding the sales tax base such that $1.9 billion in additional revenues would be generated), the general sales tax rate could be reduced to 2.81 percent.

DISTRIBUTION OF VIRGINIA'S TAX BURDEN

Changing Virginia's tax structure by replacing income tax revenues with sales and use tax revenues will change the distribution of the tax burdens across income groups. When comparing Virginia's current tax structure to those of other states, Virginia's appears less regressive and more proportional in most cases. However, if Virginia's sales tax revenues were to replace income tax revenues, its tax structure would probably become more regressive.

Virginia's Current Tax Structure Distributes the Tax Burden Better than the Tax Structures in Most Other States

Figure 6 in Chapter II shows how state and local taxes affect different income groups in states that do not have an income tax (and Virginia is shown for comparison). The income groups are defined according to quintiles. In Virginia in 2002, for example, the distribution of income, which is used to define the five income groups, is shown in Table 3. Figure 6 shows that in states without an income tax, the lowest income group generally pays the highest percentage of its family income in state and local taxes, followed by the next-lowest income group paying the next-highest percentage of its family income in taxes, and so on.

In contrast, if a state's tax structure were to affect the different income groups equally, each income group would be paying equal shares of its income in taxes. Compared to the other states shown in Figure 6, Virginia appears to come closest (with the possible exception of Alaska) to having the different income groups shouldering an equal tax burden. Consequently, Virginia's tax structure appears to do a better job of distributing the tax burden across income groups than the states that do not impose income taxes.

Table 3

Income Ranges Defining the Five Income Groups in Virginia, 2002

Income Group	Income Range
Lowest fifth	Less than $16,000
20 – 40 percentile	$16,000 - $28,000
40 – 60 percentile	$28,000 - $48,000
60 – 80 percentile	$48,000 - $80,000
Top fifth	$80,000 or more

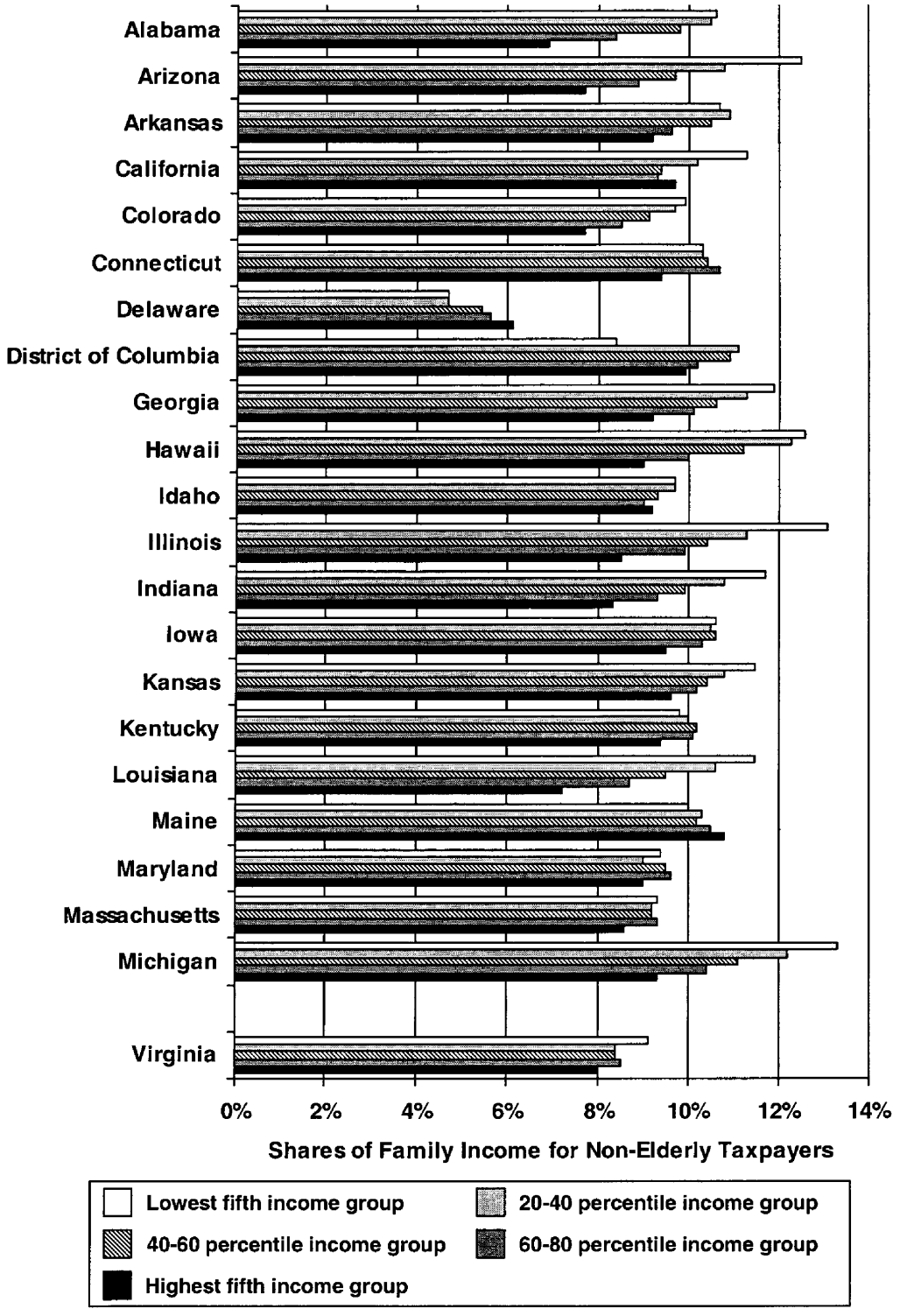
Source: *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States 2nd Edition.* The Institute on Taxation and Economic Policy. January 2003.

However, Figure 8 shows that when comparing Virginia to other states that impose income taxes, the pattern is similar, but somewhat more complex. Some states appear to have tax structures in which lower income groups are clearly paying higher percentages of their incomes in state and local taxes (such as Alabama, Arizona, Georgia, Hawaii, Illinois, Indiana, and many others). There are other states that appear to have the higher income groups bearing a greater proportion of the burden (such as Delaware and Montana). Finally, some of the other states appear to have the different income groups paying roughly equal shares of their income in state and local taxes (such as Idaho, Kentucky, Maryland, and Oregon). However, it is difficult to determine from Figure 8 alone whether these other states are closer than Virginia to imposing equal tax burdens on the different income groups.

Therefore, a single number for each state was calculated to represent the dispersion of the proportion of income paid in taxes among the five income groups.

Figure 8

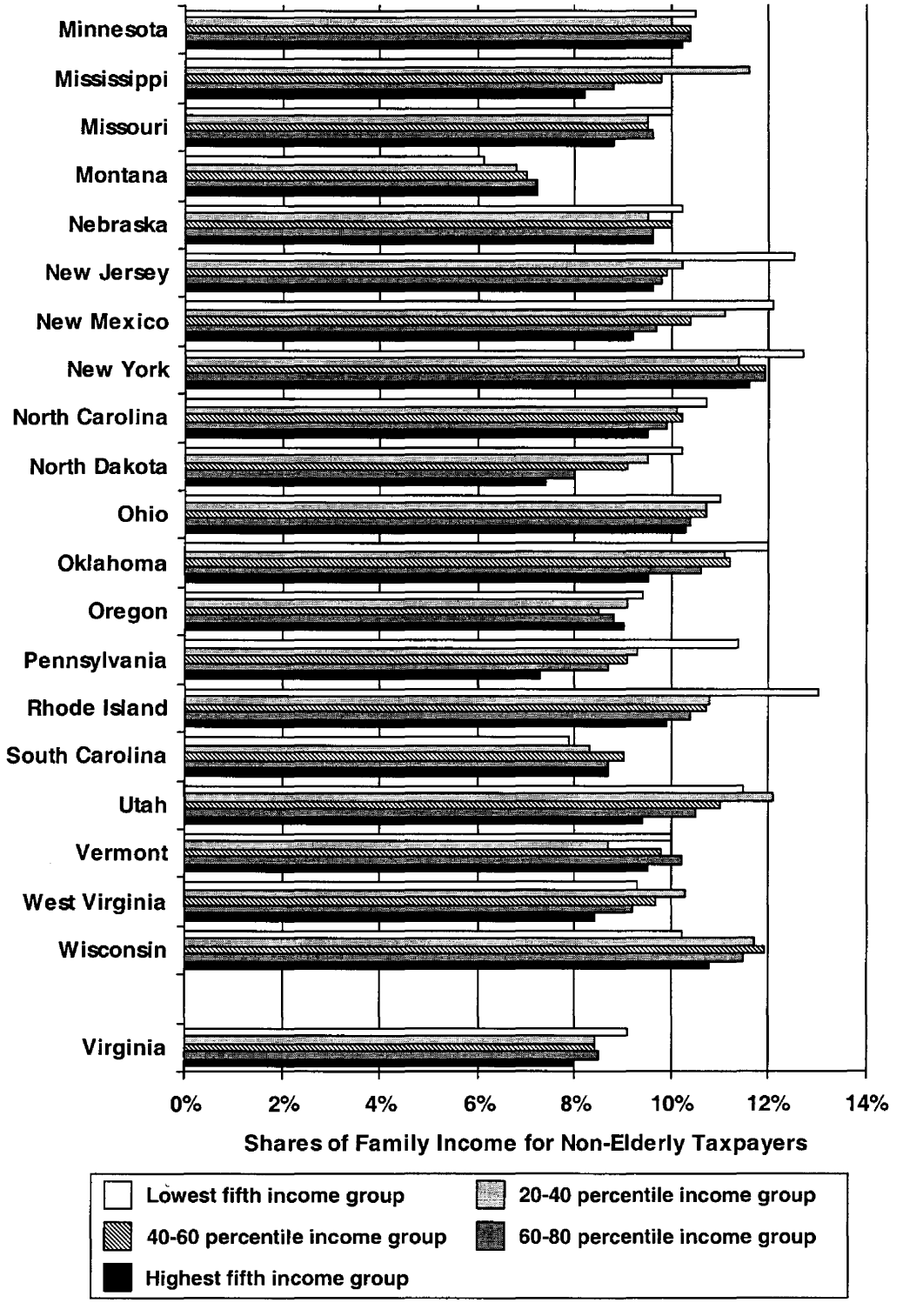
State and Local Tax Distribution – Income Tax States (2002)



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.

Figure 8 (continued)

State and Local Tax Distribution – Income Tax States (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.

That single number is the standard deviation. The standard deviation is a measure of how widely values from the five income groups are dispersed from the average value (the mean taken across all five groups). States with smaller standard deviations have the income groups paying closer to the same proportion of their incomes in taxes. In contrast, states with larger standard deviations have the income groups responsible for more widely varying tax burdens.

Virginia's tax structure appears to be slightly regressive (in Figure 8), reflecting the fact that the lowest income group appears to have a slightly higher tax burden than the highest income group. But the differences are relatively small, as indicated by its relatively small standard deviation. Thus, Virginia's tax structure appears to do a good job of distributing the tax burden across income groups.

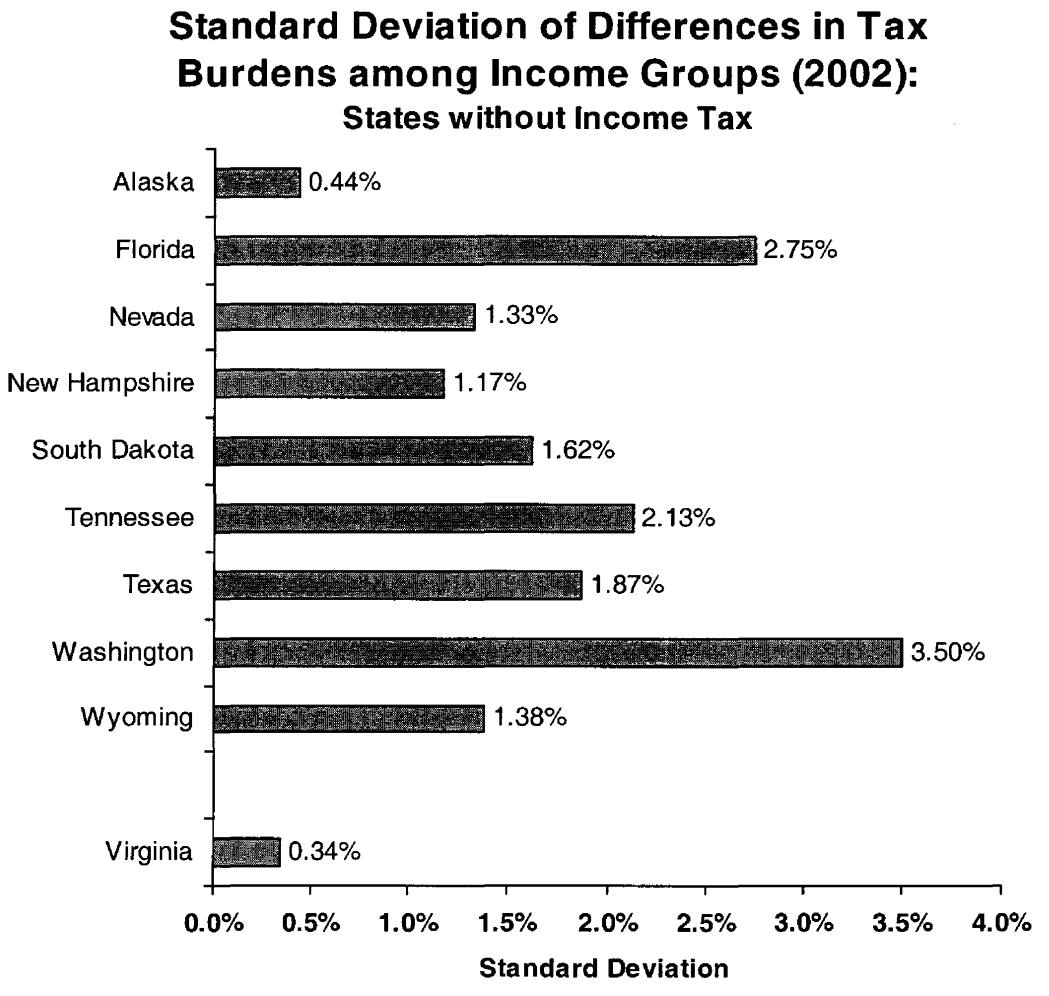
Figure 9 shows that Virginia has a smaller standard deviation than any of the states without income taxes. Alaska comes closest to Virginia in having the different income groups shouldering tax burdens that are closer in magnitude. The chart also shows that states that appear to have highly regressive tax structures (such as Florida, Tennessee, and Washington) also have very high standard deviations, compared to Virginia.

In contrast, Figure 10 shows that states *with* income taxes have more of a mixed story concerning which income groups are carrying a greater tax burden. In comparison to Virginia, these states can be categorized into three groups: (1) states that have more regressive tax structures; (2) states that have less regressive tax structures; and (3) other states that also appear to have greater differences between income groups, but do not fit the patterns of clearly regressive or progressive tax structures.

The first category (states with more regressive tax structures) is the largest. It includes two groups. One group consists of the states with the most clearly regressive tax structures (as shown in Figure 8) and that also tend to have among the highest standard deviations (Figure 10). These states include: Alabama, Arizona, Colorado, Georgia, Hawaii, Illinois, Indiana, Louisiana, Michigan, New Jersey, New Mexico, North Dakota, Oklahoma, Pennsylvania, and Rhode Island.

The other group consists of states that appear to have differences between income groups (like Virginia), but require examination of the standard deviation to determine whether their tax structures are more regressive than Virginia's. In these cases, trying to determine whether one state's tax structure is more regressive than another's on the basis of the patterns shown in Figure 8 alone could be highly subjective. The standard deviations shown in Figure 10 more directly indicate the extent to which different income groups have different tax burdens. The states whose tax structures overall appear to be more regressive than Virginia's (based on Figure 8 and Figure 10) include: Arkansas, California, District of Columbia, Iowa, Kansas, Mississippi, Missouri, New York, North Carolina, Utah, and West Virginia.

Figure 9



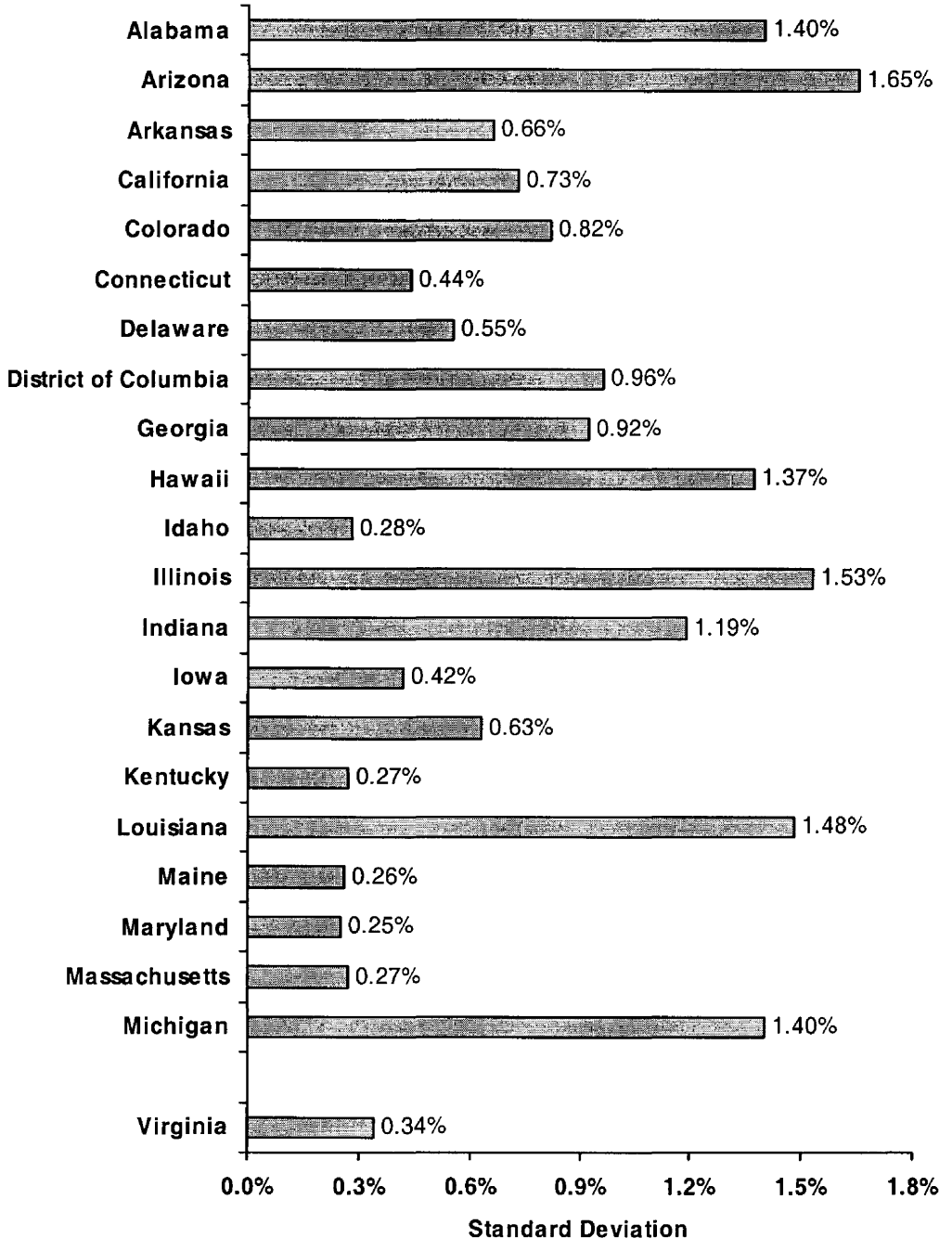
Source: JLARC staff analysis of *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition.* The Institute on Taxation and Economic Policy. January 2003.

The second category consists of states whose tax structures are less regressive than Virginia's. It includes those states with clearly progressive tax structures, as shown in Figure 8. These states also tend to have relatively small standard deviations, compared to the other states shown in Figure 10. These states are: Delaware, Maine, Montana and South Carolina. This category also consists of those states that appear to have slightly less regressive tax structures than Virginia's, primarily on the basis of having smaller standard deviations. These states are: Idaho, Kentucky, Maryland, Massachusetts, Minnesota, Nebraska, Ohio, and Oregon.

The third category includes those states with greater differences in tax burdens among the five income groups (compared to Virginia), but whose tax struc-

Figure 10

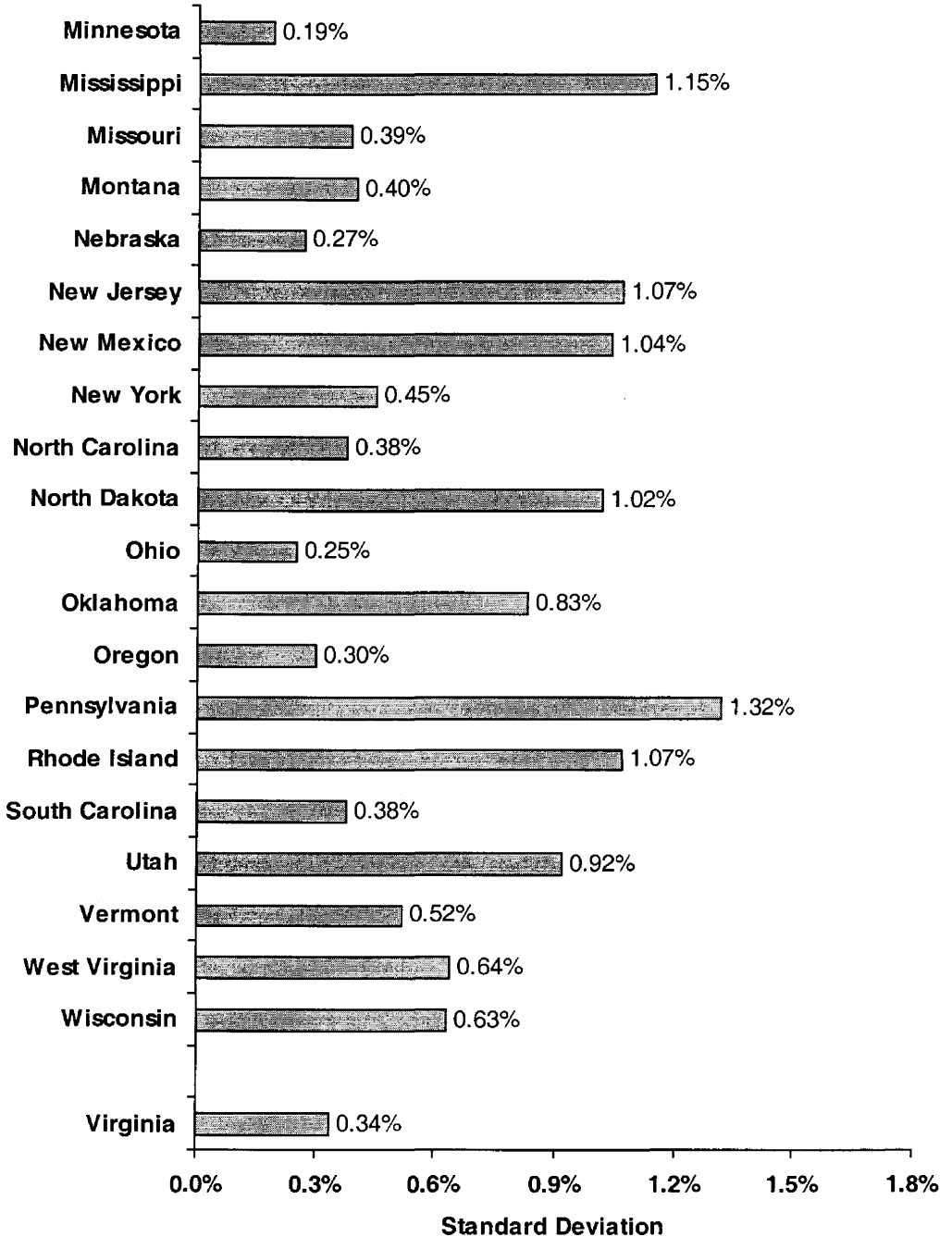
Standard Deviation of Differences in Tax Burdens among Income Groups (2002): States with Income Taxes



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

Figure 10 (continued)

Standard Deviation of Differences in Tax Burdens among Income Groups (2002): States with Income Taxes



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

tures do not appear to fit clearly the pattern of "regressive" or "progressive." These states are Connecticut, Vermont, and Wisconsin.

This comparison of Virginia's tax structure to those of other states is summarized in Exhibit 2. Virginia's tax structure (as it was in 2002) appears to be less regressive than the tax structures of 35 states (that is, all nine states without income taxes, and 26 states with income taxes). However, it is more regressive compared to the tax structures of 12 states that have income taxes. Virginia also has smaller differences in the tax burdens borne by the five different income groups compared to three additional states (with income taxes), but the distribution pattern of these three states cannot be so readily determined to be more or less regressive. Overall, only nine states appear to have tax structures that do a better job of distributing the tax burden equally across all income groups.

Exhibit 2

Other States' Tax Structures Compared to Virginia's

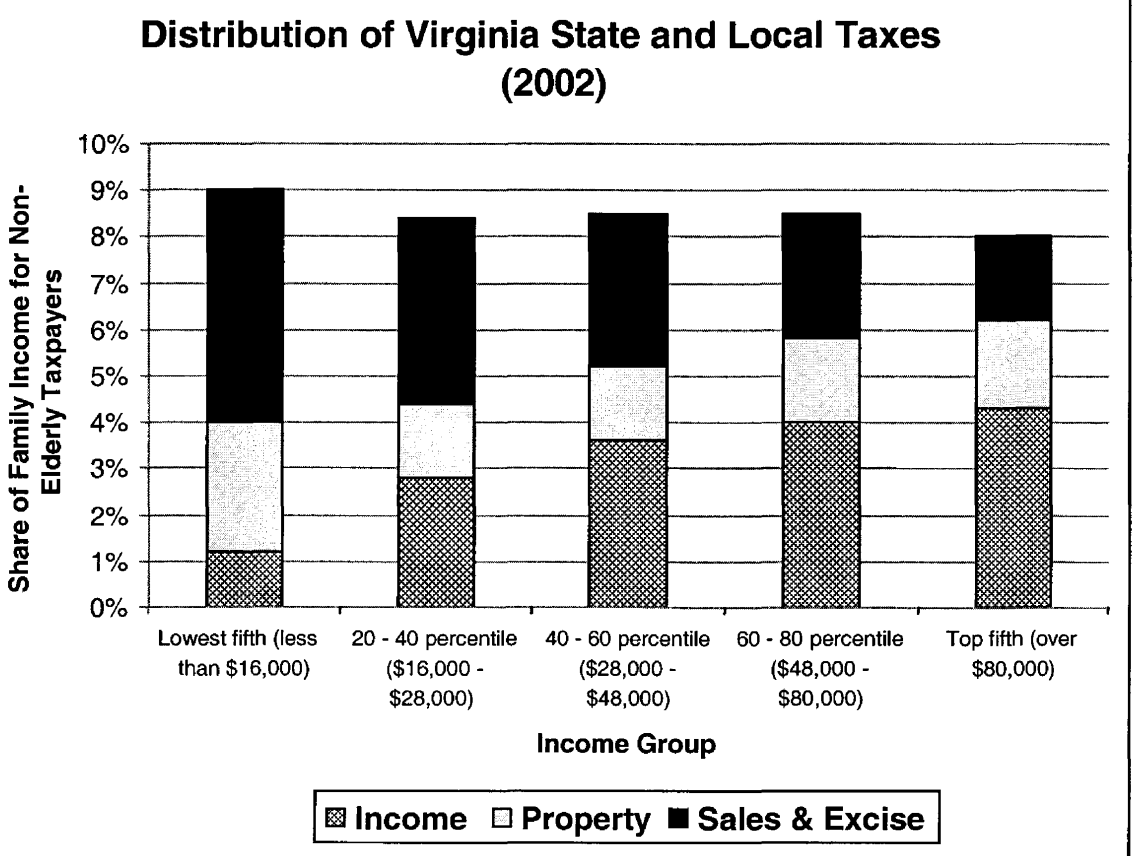
More Regressive	Not Clear	Less Regressive
Alabama, Alaska, Arizona, Arkansas, California, Colorado, District of Columbia, Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kansas, Louisiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island,South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wyoming	Connecticut, Vermont, Wisconsin	Delaware, Idaho, Kentucky, Maine, Maryland, Massachusetts, Montana, Minnesota, Nebraska, Ohio, Oregon, South Carolina

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

Virginia's Tax Structure Becomes More Regressive When Replacing Income Tax Revenue with Sales Tax Revenue

There are several reasons to believe that if Virginia's reliance on income tax revenue decreases as its reliance on sales tax revenue increases, the lower income groups would carry a greater portion of the tax burden than they do now. Figure 11 reflects data on the distribution of three types of State and local taxes in Virginia (sales and excise taxes, property taxes, and income taxes) across the five income groups in 2002. Figure 11 shows that while the total tax burden on the five income

Figure 11

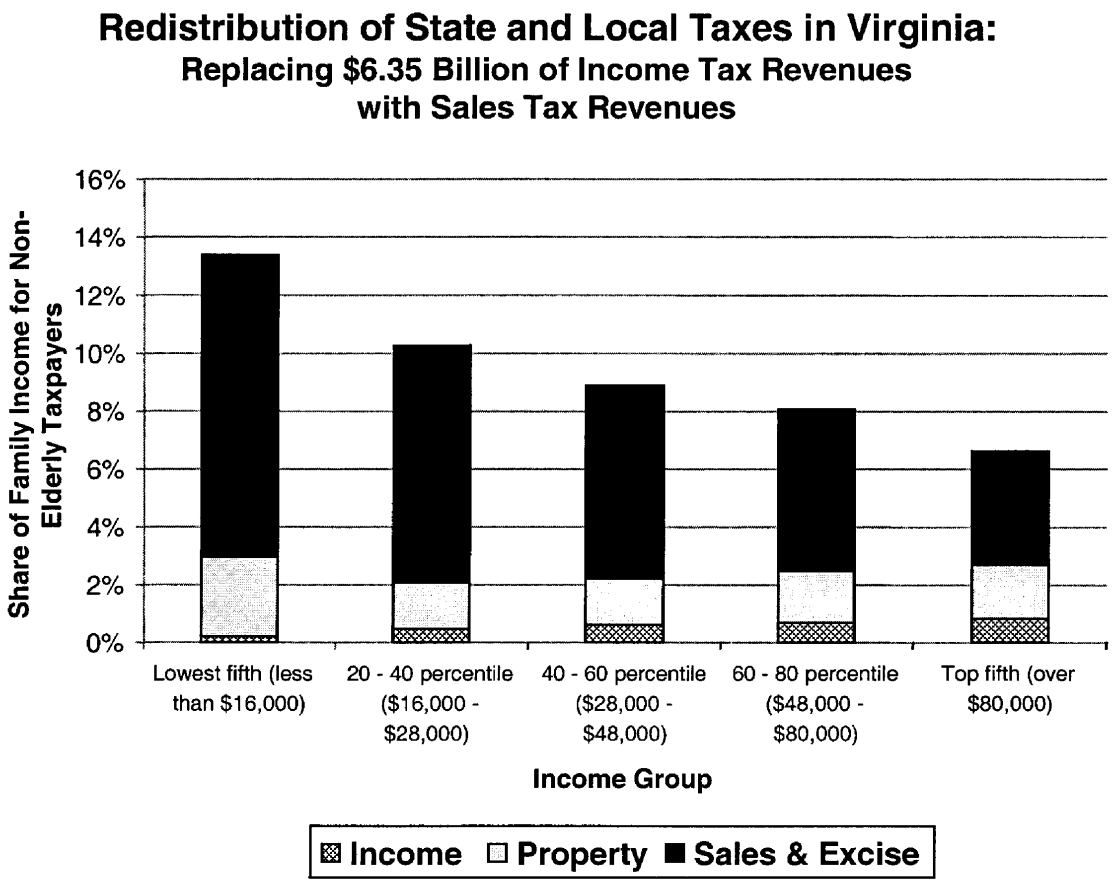


Source: *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition.* The Institute on Taxation and Economic Policy. January 2003.

groups balances out to a roughly even pattern, sales and excise taxes show a clearly regressive pattern, which is offset in large part by the progressive pattern of income taxes. It is clear from Figure 11 that if income taxes are reduced by an equal percentage (such as 25 percent or 50 percent) across all five income groups, the reduction would benefit the higher income groups more than it would the lower income groups. Consequently, even if the other types of taxes in Figure 11 remained unchanged, reducing the income tax revenue would result in Virginia's tax structure becoming more regressive. The tax structure would likely become even more regressive if income tax revenues were replaced with sales tax revenues.

Figure 12 illustrates what the distribution might look like if $6.35 billion of the State's $8 billion income tax revenues were replaced with $6.35 billion in additional sales tax revenues. This situation would be feasible under Scenario 4, in which the sales tax base could be expanded to services and the State general sales tax rate increased to seven percent. A $6.35 billion reduction would decrease income tax revenues by about 82.5 percent. Figure 12 shows that if income tax revenues were evenly reduced by 82.5 percent across all income groups, the progressive component of the tax structure would be greatly reduced. Further, assuming the

Figure 12



Source: JLARC staff Analysis.

five income groups were to pay the additional sales tax in the same proportion as they pay the current sales tax (and using the same assumptions that were used for Scenarios 1 through 4), the regressive component of Virginia's tax structure would increase at the same time. As a result, the total tax burden on the lower income groups would substantially increase, while the total tax burden on the highest income group would decrease. The standard deviation across these five income groups, in this situation, would increase to 2.34 percent -- making Virginia's tax structure among the most regressive in the country. Only Florida and Washington would have more regressive tax structures.

Smaller shifts of revenue from the income tax to the sales tax would also make Virginia's tax structure more regressive, compared to other states. For example, replacing $2 billion in income tax revenue with sales tax revenues (such that income taxes could be reduced by approximately 25 percent) would result in a standard deviation of 0.91 percent among the income groups, meaning that Virginia's tax structure would be more regressive than those of the majority of other states.

CONCLUSION

Several conclusions can be drawn from the illustrative scenarios and other information presented in this chapter. First, it does not appear feasible to replace all personal income tax revenues entirely with sales and use tax revenues. Given the sales tax rates in other states, it would not be realistic to raise the sales tax rate in Virginia far above what is now the maximum rate – seven percent. Even if the sales tax base were expanded to include a broad range of services, the State general sales tax rate in Virginia would need to be higher than any other state's (nearly eight percent) to replace all the personal income tax revenue.

Second, it does appear feasible to replace some income tax revenue with sales and use tax revenue. Virginia relies on personal income tax revenue to a greater extent than all but two states, and on sales and use tax revenue to lesser extent than only six states. Given Virginia's relatively low general sales tax rate and narrow sales tax base, some income tax revenue could likely be replaced by sales and use tax revenue through some combination of raising the rate or expanding the base, without there being a significant effect on the State's economy.

Finally, any replacement of income tax revenues with sales and use tax revenues will likely result in Virginia's tax structure being more regressive. Because the income tax in Virginia is progressive, a reduction in this tax source would benefit taxpayers in the upper income groups to a greater extent than taxpayers in lower income groups. Virginia's current State and local tax structure distributes the tax burden across income groups more equally than all but nine states. The main reason that Virginia's structure is more balanced than most other states is that Virginia relies more on personal income tax revenues than almost all other states. This heavy reliance on the personal income tax balances out the regressive nature of sales and use taxes, excise taxes, and property taxes.

Appendix A

House Joint Resolution No. 172

Directing the Joint Legislative Audit and Review Commission to collect data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues..

Agreed to by the House of Delegates, February 17, 2004
Agreed to by the Senate, March 9, 2004

WHEREAS, the Commonwealth continues on a decades-old pattern of becoming more and more reliant on the income tax relative to the sales and use tax (sales tax); and

WHEREAS, a larger portion of the sales tax than the income tax is paid by nonresidents, illegal aliens, drug dealers, and persons otherwise illegally not reporting income, making the sales tax a fairer tax to law-abiding Virginians; and

WHEREAS, modern economic, social, and technological changes may be more conducive to reliance on a modern-day sales tax rather than on an income tax; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Joint Legislative Audit and Review Commission be directed to collect data and information from other states and countries that have replaced income tax revenues with sales and use tax revenues. In collecting the data and information, the Commission shall summarize such data and information for consideration by the House Committee on Finance and the Senate Committee on Finance.

Technical assistance shall be provided to the Commission by the Department of Taxation. All agencies of the Commonwealth shall provide assistance to the Commission in collecting the information, upon request.

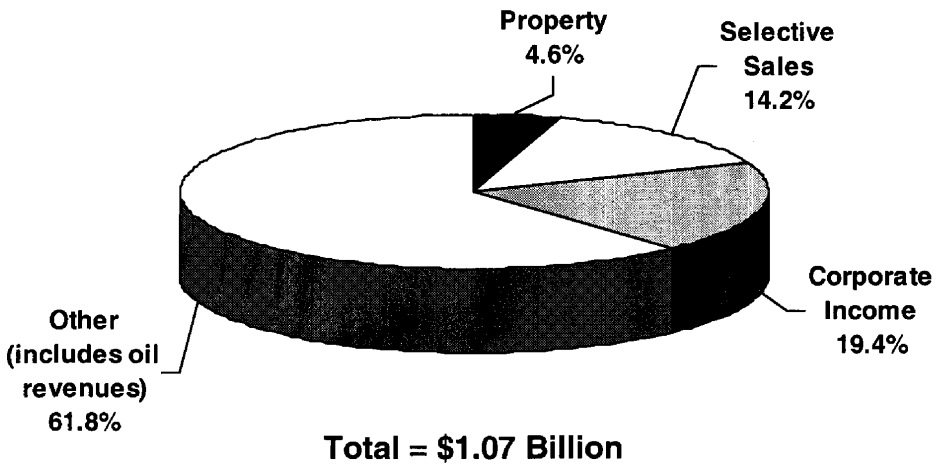
The Joint Legislative Audit and Review Commission shall submit to the Division of Legislative Automated Systems an executive summary and the information collected on other states and countries that have replaced income tax revenues with sales and use tax revenues no later than the first day of the 2005 Regular Session of the General Assembly. The executive summary and information shall be submitted as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents and reports and shall be posted on the General Assembly's website.

Appendix B

Profiles of Non-Income-Tax States

ALASKA

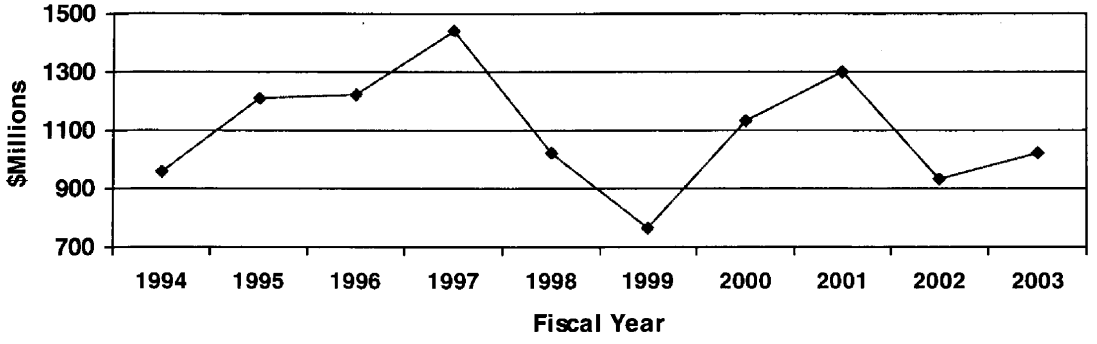
2003 State Tax Collections



Total = $1.07 Billion

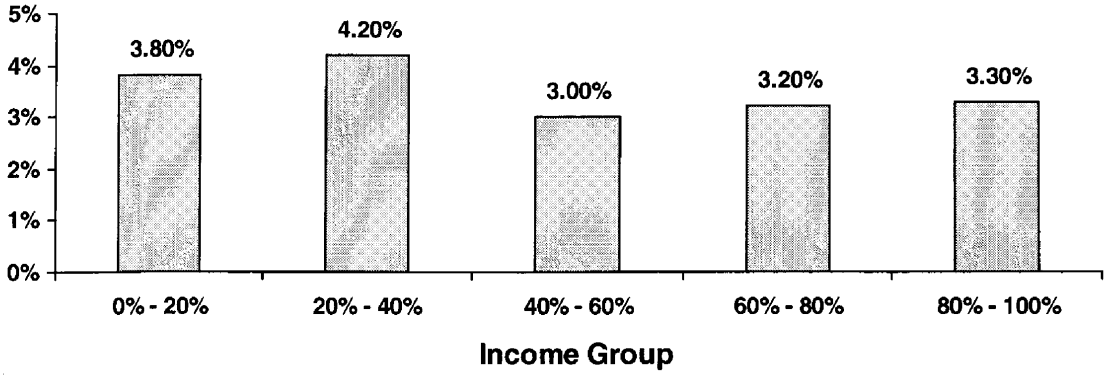
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Alaska Department of Revenue.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	648,818	47
State Tax Revenues per Capita	$1,648	37
State Tax Revenues as a percent of Personal Income	5.1%	46
State General Sales Tax Rate	0.0%	47 (tie)
Per Capita Sales Tax Collections	NA	NA
Number of Services subject to Sales Tax	1	50
Local Option Sales Tax Rate	1% - 6%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	No	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Alaska ever considered imposing a broad-based individual income tax?**

Alaska had an income tax from 1958 to 1979. It was repealed when the oil revenues started coming in. In 2002, the House voted in favor of an income tax, but the Senate voted it down. In the most recent session, there were bills for an income tax, but they did not make it past committee.

- **What do you believe to be the primary advantages and disadvantages of not having a broad-based individual income tax?**

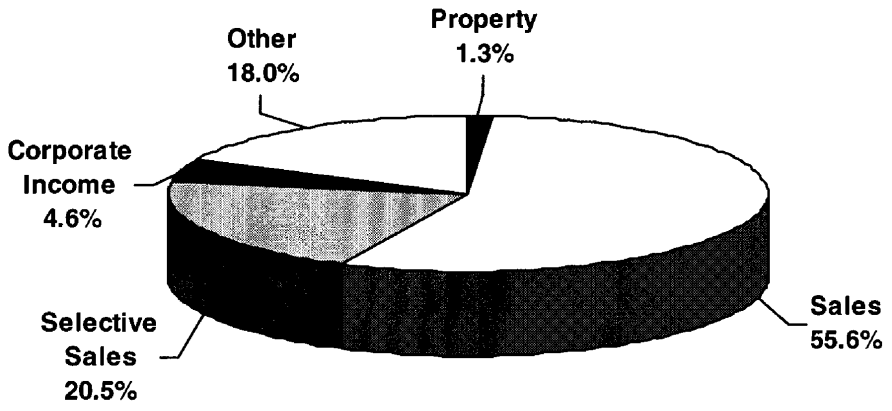
The main disadvantage is that the current system is very unbalanced. Alaska relies on oil taxes for 80 percent of its revenue. When there is a decline in oil revenues, there is a major budget gap. Alaska has had to take substantial amounts of money out of its rainy day fund in eleven of the last 14 years.

- **Has Alaska ever considered imposing a general sales and use tax?**

The Governor (who was elected in 2002) has proposed addressing the budget gap caused by the current imbalance in Alaska's tax structure in two possible ways. The preferred way is to have some of the Permanent Fund earnings go toward government operations. (Currently, the Permanent Fund is a $21 billion dollar state investment account derived from oil taxes. Income from the Permanent Fund so far has only been used to write an annual dividend of about $1,500 to every man, woman and child in the state. It is very popular right now.) A second, less–preferred option proposed by the Governor is to impose a state sales tax.

FLORIDA

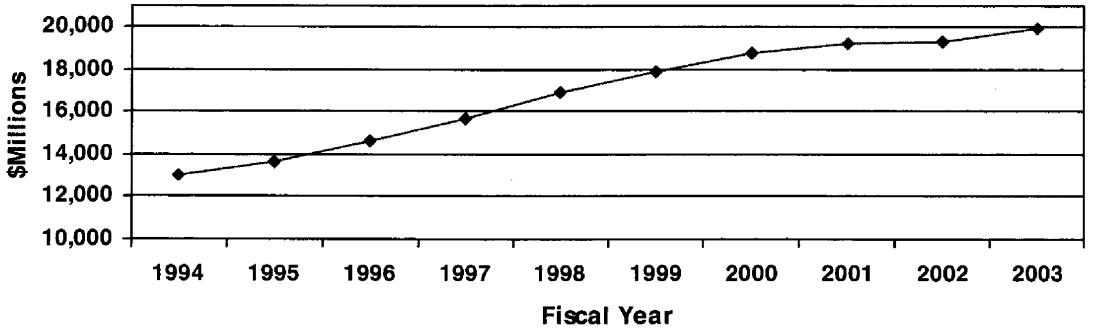
2003 State Tax Collections



Total = $26.9 Billion

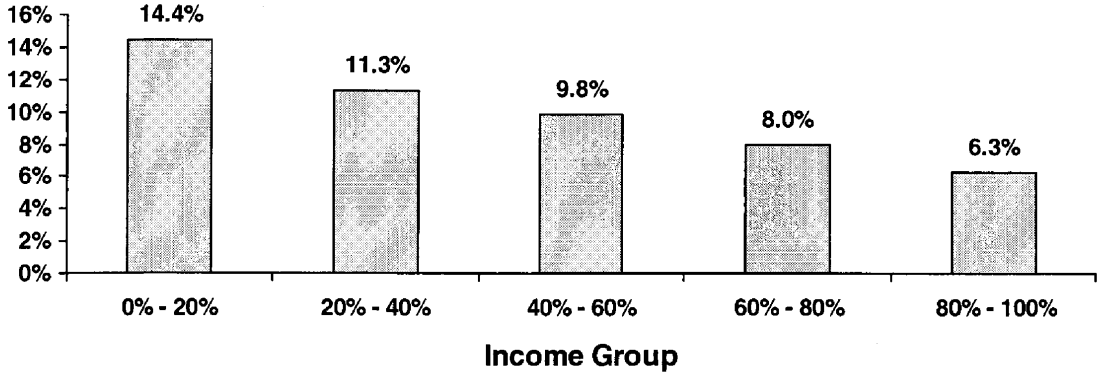
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Florida Consensus Estimating Conference. Revenue Analysis, FY 1970-17 Through FY 2012-13.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	17,019,068	4
State Tax Revenues per Capita	$1,581	40
State Tax Revenues as a percent of Personal Income	5.4%	43
State General Sales Tax Rate	6.0%	9 (tie)
Per Capita Sales Tax Collections	$879	6
Number of Services subject to Sales Tax	64	16
Local Option Sales Tax Rate	1.5%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	No	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Florida ever considered imposing a broad-based individual income tax?**

Various groups talk about changing to an income tax at various times. Florida's constitution prohibits the imposition of an individual income tax. However, there is a constitutional revision commission that looks at issues such as the income tax. If the tax were proposed to voters for a change in the constitution, it would likely be defeated 80% to 20%.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

From a social engineering standpoint, the income tax is much more flexible than the sales tax. It's easier to structure the income tax in a way that provides relief to poor people and focus the tax on one's ability to pay. The sales tax is clumsy when it comes to trying to make taxes more progressive. Exempting food from the sales tax is about the only way to make it less regressive.

The sales tax is easier to administer than the income tax. There are about 500,000 businesses to collect taxes from compared to 10 million households that would need to submit income taxes.

- **Are there unique characteristics to Florida that make not having an income tax more appropriate than in other states?**

Florida has a large tourism industry. Tourists account for about 15% to 20% of sales tax collections. Florida also has a large concentration of senior citizens. Their perception is that they are better off without the income tax, although this may not be the case.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

It's fairly stable. Income tax states had a bad experience from 2000-02 because of the huge drop in capital gains distributions. However, this was one of the few times when income taxes were less stable than sales taxes – it was an aberration. Generally, sales taxes have deeper troughs and higher peaks. The recession in the 1970's was a very tough time for Florida's revenues.

- **Has Florida raised or lowered the general sales tax rate at any time during the past ten years?**

No, but they raised taxes twice in the previous 10 years. In 1983, they raised the rate from 4% to 5% and in 1988 they raised it from 5% to 6%.

- **Has Florida exempted any goods from sales taxes during the past ten years?**

No.

- **Has Florida eliminated any service tax exemptions during the past ten years?**

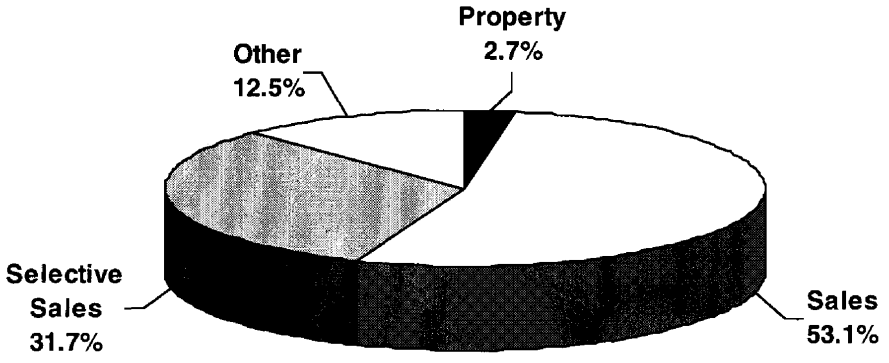
State eliminated securities services exemptions and commercial cleaning service exemptions.

- **Has the growing volume of Internet sales hampered Florida's ability to collect sales and use taxes?**

Yes, and Florida cannot do much about this problem. Florida has signed agreements with many large vendors to get them to voluntarily assess and remit taxes. Florida does not participate in the Streamlined Sales and Use Tax Project, as the legislature was not able to pass the necessary reforms.

NEVADA

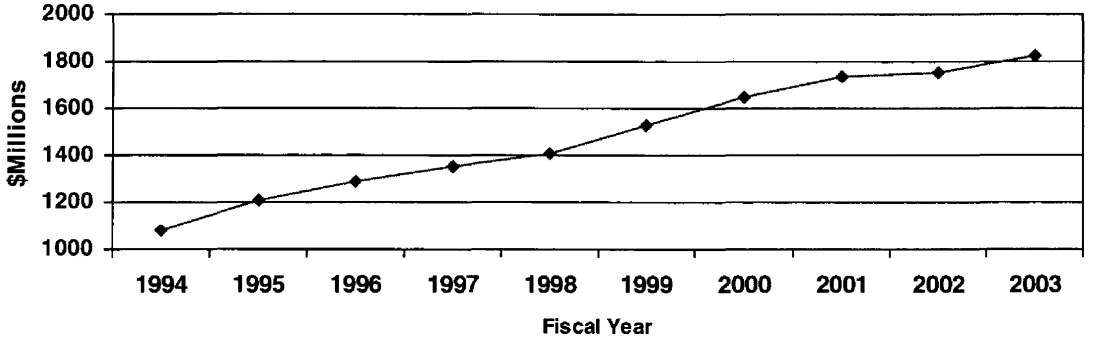
2003 State Tax Collections



Total = $4.13 Billion

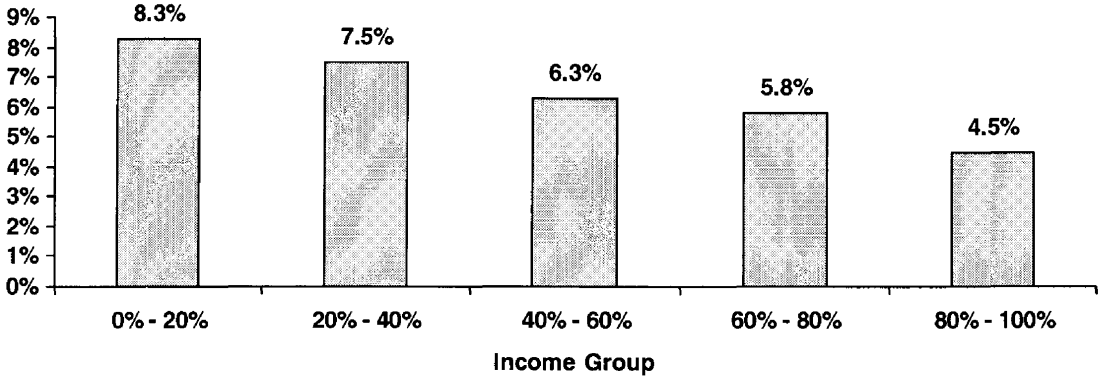
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Nevada Legislative Counsel Bureau. Fiscal Analysis Division.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	2,241,154	35
State Tax Revenues per Capita	$1,843	25
State Tax Revenues as a percent of Personal Income	6.2%	28
State General Sales Tax Rate	6.5%	4 (tie)
Per Capita Sales Tax Collections	$978	3
Number of Services subject to Sales Tax	11	48 (tie)
Local Option Sales Tax Rate	1.0%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	Yes	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Nevada ever considered imposing a broad-based individual income tax?**

No. The state constitution forbids it.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

The primary advantage is that it appeals to the populace. The big disadvantage is that revenues are less dynamic, and more reliant on sources that may not grow as much with the economy.

- **Are there unique characteristics to Nevada that make not having an income tax more appropriate than in other states?**

Nevada relies more on gaming and tourism than other states, and an income tax would not be the best way to collect revenues through those activities.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

Yes, by itself it's a pretty decent revenue source. It grows with the economy. But only one-third of state revenues come from the sales tax.

- **Has Nevada raised or lowered the general sales tax rate at any time during the past ten years?**

The portion going to the general fund has always been two percent. But in the last ten years, the portion of the state sales tax that goes to local schools has gone up to 2 ¼ percent, and the portion that is sent to local governments has gone up to 2 ¼ percent.

- **Has Nevada exempted any goods from sales taxes during the past ten years?**

The legislature has acted to make a handful of exemptions, but all proposed exemptions must go to the voters on a referendum. Voters did not pass the exemptions.

- **Has Nevada eliminated any service tax exemptions during the past ten years?**

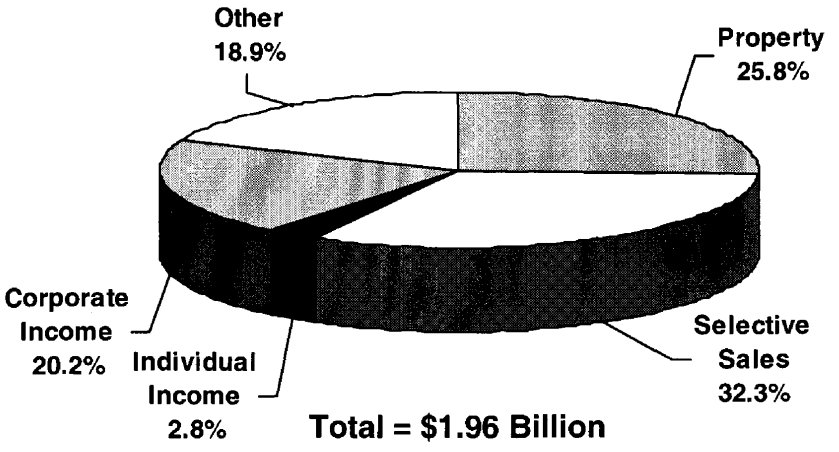
No.

- **Has the growing volume of Internet sales hampered Nevada's ability to collect sales and use taxes?**

It probably has had an effect, but it's hard to detect, because growth in sales tax revenues in the past year has still been in the double digits. The Nevada legislature just recently passed a bill for Nevada's participation in the Sales and Use Tax Project. It may lead to greater collection of sales taxes, but Congress has to act first before anything can really happen.

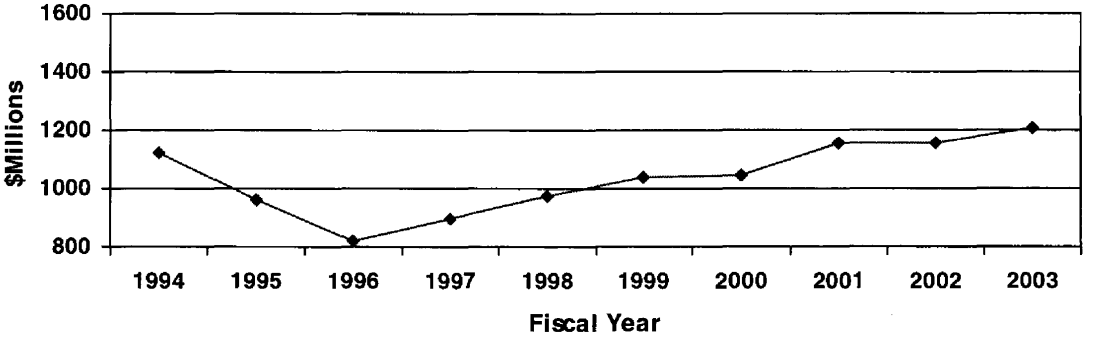
NEW HAMPSHIRE

2003 State Tax Collections



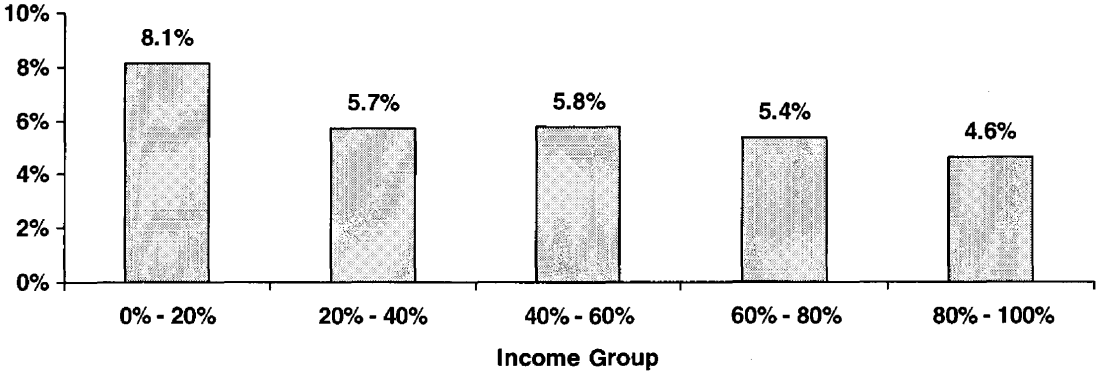
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: New Hampshire Department of Administrative Services. CAFR for Fiscal Year Ended June 30, 2003.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	1,287,687	41
State Tax Revenues per Capita	$1,521	44
State Tax Revenues as a percent of Personal Income	4.5%	49
State General Sales Tax Rate	0.0%	47 (tie)
Per Capita Sales Tax Collections	NA	NA
Number of Services subject to Sales Tax	11	48 (tie)
Local Option Sales Tax Rate	0.0%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	No	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has New Hampshire ever considered imposing a broad-based individual income tax?**

Every gubernatorial election (governors serve two-year terms), the income tax issue is brought up. However, the candidate running on the platform to impose an income tax has never been successful. The reasoning behind candidates trying to impose an income tax is because the property tax is regressive and unpopular.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

No comment.

- **Are there unique characteristics to New Hampshire that make not having an income tax more appropriate than in other states?**

New Hampshire lacks urban areas – there are no large cities. Most of the population lives along the southern border, and this area is "basically a bedroom community for people working in Massachusetts." New Hampshire gets many tourists driving through the state, as they must travel through New Hampshire to get to Maine. Liquor and tobacco sales are a big draw for out-of-state consumers. These are the major revenue sources after business taxes.

- **Has New Hampshire ever considered imposing a general sales and use tax?**

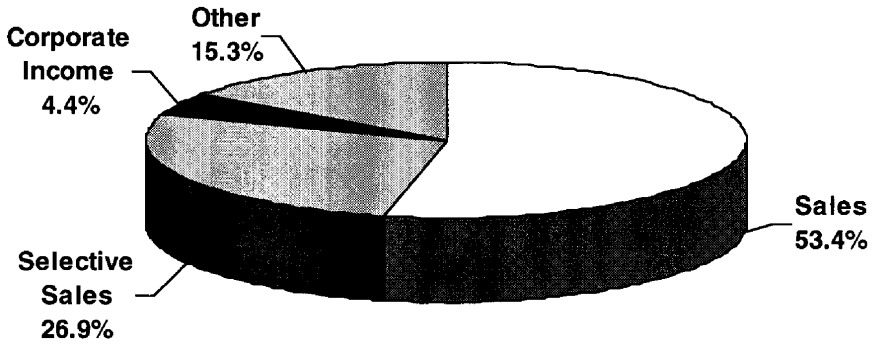
Frequently. There are 400 members in the New Hampshire legislature, so bills invariably get introduced. However, they never make it out of committee. Most bills stipulate that revenues from the sales tax would go to school funding and would reduce the property tax by an equivalent amount.

- **Do New Hampshire merchants receive a significant benefit from out-of-state customers purchasing goods in New Hampshire, due to the lack of a sales tax?**

Absolutely. There are major malls on every border. The leases for merchants in these malls become void if the state ever enacts a statewide sales tax.

SOUTH DAKOTA

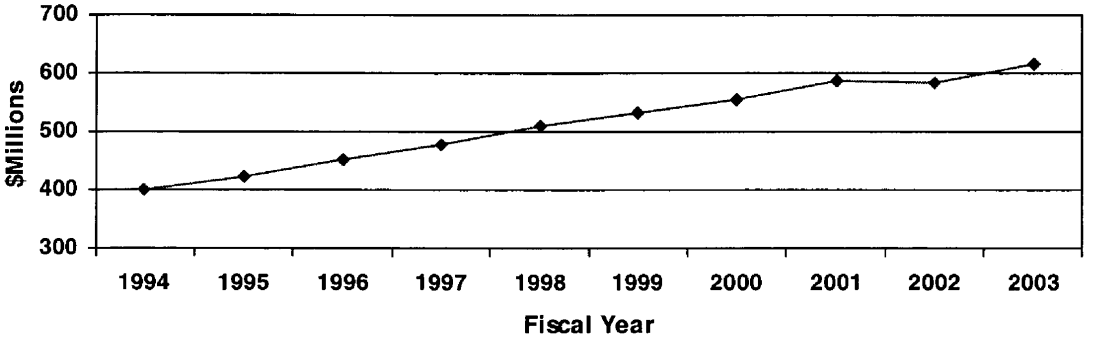
2003 State Tax Collections



Total = $1.01 Billion

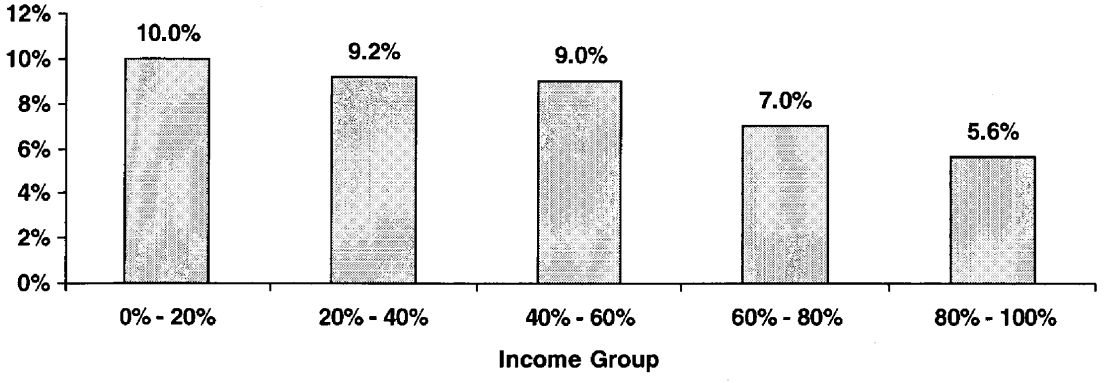
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: South Dakota Department of Revenue and Regulation. Annual Reports 1996-2003.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	764,309	46
State Tax Revenues per Capita	$1,322	49
State Tax Revenues as a percent of Personal Income	4.9%	47
State General Sales Tax Rate	4.0%	39 (tie)
Per Capita Sales Tax Collections	706	16
Number of Services subject to Sales Tax	141	5 (tie)
Local Option Sales Tax Rate	2.0%	
Sales Tax on Food?	Yes	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	Yes	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has South Dakota ever considered imposing a broad-based individual income tax?**

No.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

The sales tax is more stable, so an advantage is that during recessions, sales tax revenues don't go down as much as income tax revenues would. But a disadvantage is that during boom times, sales tax revenues would not increase as much as income tax revenues would.

- **Are there unique characteristics to South Dakota that make not having an income tax more appropriate than in other states?**

Not really, other than South Dakota having strong political opposition to income taxes.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

It is definitely stable, and it seems sufficient.

- **Has South Dakota raised or lowered the general sales tax rate at any time during the past ten years?**

No.

- **Has South Dakota exempted any goods from sales taxes during the past ten years?**

No.

- **Has South Dakota eliminated any service tax exemptions during the past ten years?**

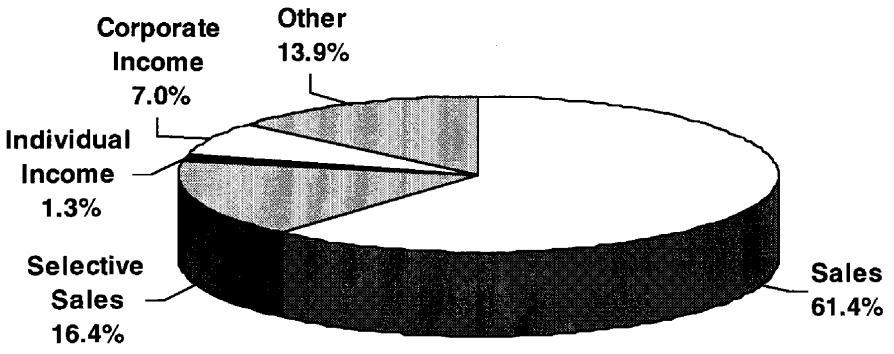
In 1995 there was a big repeal of about 30 exemptions. But the exemption for truckers was put back in recently.

- **Has the growing volume of Internet sales hampered South Dakota's ability to collect sales and use taxes?**

Internet sales must have an impact on sales tax revenues, but sales tax revenues still have been growing substantially. Some of that is because services, which are not carried out over the Internet, are taxed. South Dakota does participate in the Streamlined Sales and Use Tax Project, and this should address concerns about Internet sales.

TENNESSEE

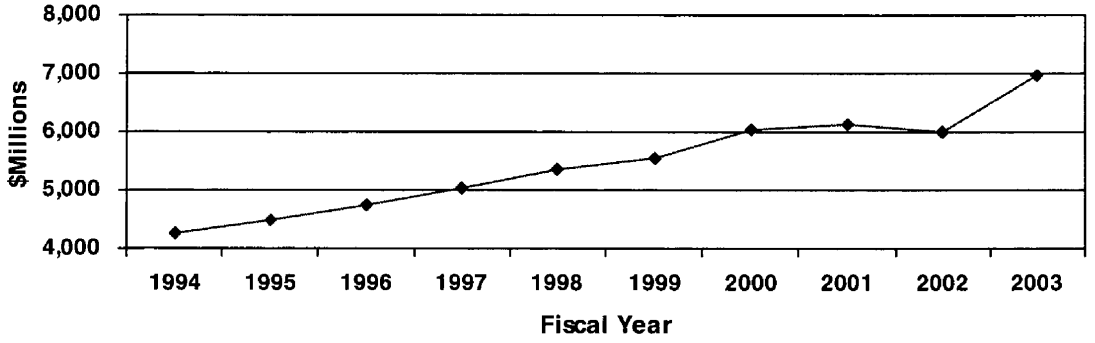
2003 State Tax Collections



Total = $8.81 Billion

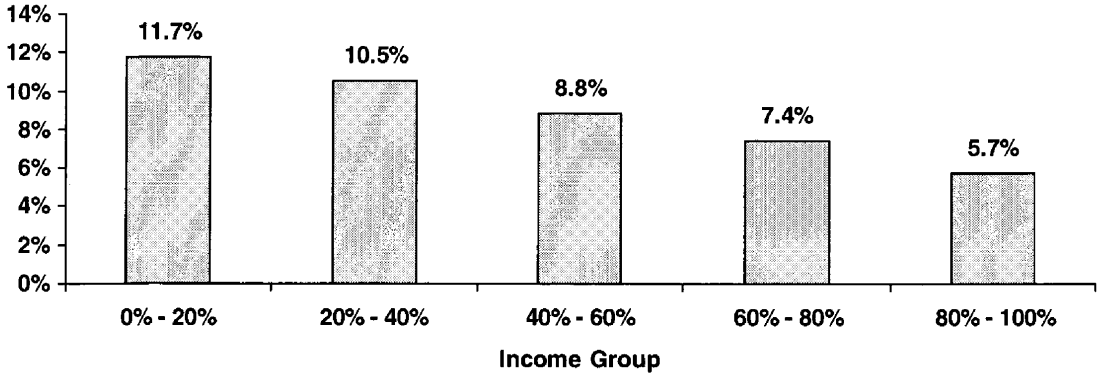
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Tennessee Department of the Revenue.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	5,841,748	16
State Tax Revenues per Capita	$1,508	46
State Tax Revenues as a percent of Personal Income	5.5%	40
State General Sales Tax Rate	7.0%	1 (tie)
Per Capita Sales Tax Collections	$926	4
Number of Services subject to Sales Tax	71	12
Local Option Sales Tax Rate	2.75%	
Sales Tax on Food?	Yes (6.0%)	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	Yes	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **What were the main issues involved in Tennessee's recent consideration of a broad-based individual income tax?**

Tennessee had a structural deficit and ranked very low on several demographic indicators. The argument for the tax was that a broad-based income tax would be better able to respond to dips in the business cycle. The proposal was for a 6% flat income tax, with low tax exemptions, and an elimination of the sales tax. One reason behind eliminating the sales tax is that Tennessee borders seven other states with lower sales taxes, and 50% of the population lives near one of the borders. Tennessee has the highest sales tax in the nation, and most localities add a local option sales tax on top of the state sales tax. The Tennessee Department of Revenue ran models to show the impact on a middle class family of four. Their analysis showed that the average family would save $200 per year with the income tax replacing the sales tax.

However, many people didn't seem to understand this and were vehemently opposed to an income tax. Protesters actually threw bricks through the Governor's window. The income tax is now "off the table" with the current administration. Tennessee has a huge surplus now, as the economy has improved, and the legislature passed tax increases two years ago – 1% increase in general sales tax, ½% increase in corporate income tax, and they also raised several "sin" taxes.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

The primary advantage is from an administrative standpoint – the sales tax is easier and cheaper to administer. Tennessee estimated it would cost about $25-$30 million to administer the income tax. Another advantage is that people don't have to pay the tax in April. One disadvantage is that people in Tennessee don't get to enjoy the deduction of state income taxes on their federal income tax returns. However, there is currently a bill in Congress to allow deduction of state sales taxes.

- **Are there unique characteristics to Tennessee that make not having an income tax more appropriate than in other states?**

Nothing special – Tennessee doesn't have royalties from minerals and fossil fuels like Alaska or Wyoming. It doesn't have the tourist revenue like Florida or the casino revenue like Nevada.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

It is not sufficient. However, the sales tax is more stable than the income tax. With the recent recession, Tennessee started seeing a decline in revenues before other states, but it didn't have the dramatic fall in capital gains revenues like other states. Tennessee was better off at its lowest point than most other states.

- **Has Tennessee raised or lowered the general sales tax rate at any time during the past ten years?**

Yes. In 2002, Tennessee raised the rate from 6% to 7%. Food remained at 6%.

- **Has Tennessee exempted any goods from sales taxes during the past ten years?**

No major exemptions in the last ten years.

- **Has Tennessee eliminated any service tax exemptions during the past ten years?**

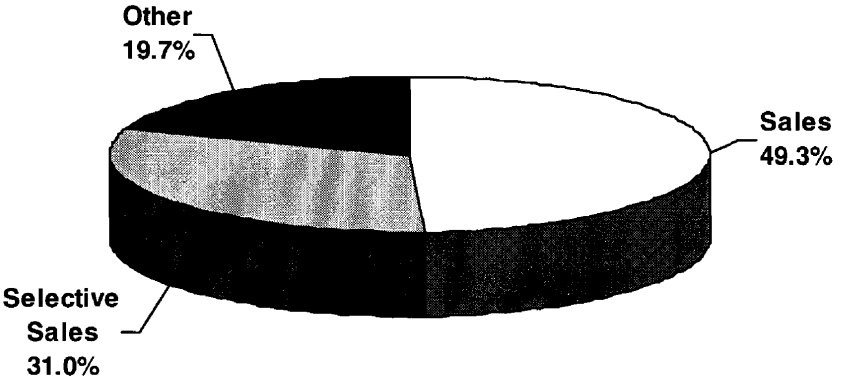
Nothing major was eliminated in the last ten years.

- **Has the growing volume of Internet sales hampered Tennessee's ability to collect sales and use taxes?**

Yes. Tennessee is right on the margin with average state and local sales taxes at between 8.5 and 9.5 percent. Thus, Internet sales are a big issue in Tennessee. Conformance with the Streamlined Sales and Use Tax Project was enacted last year and will become effective on July1, 2005. Tennessee is one of the initial conforming states. This was a huge task, but because of Tennessee's high sales tax rate, lawmakers felt it was imperative that Tennessee conform with and spearhead the effort.

TEXAS

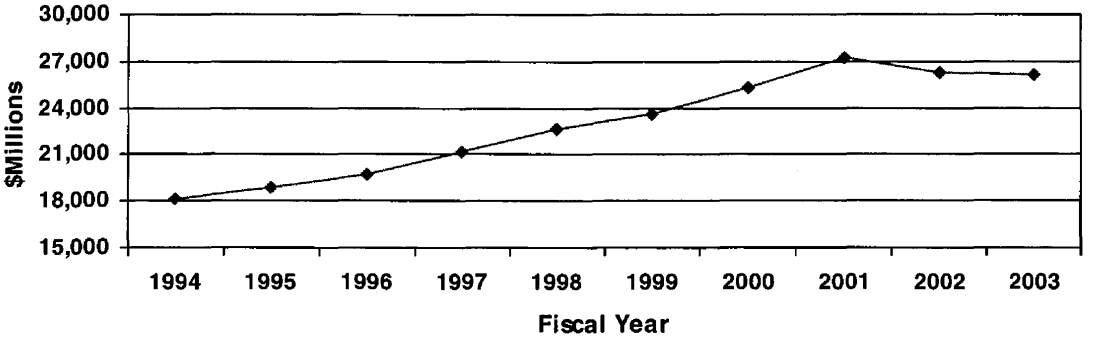
2003 State Tax Collections



Total = $29.1 Billion

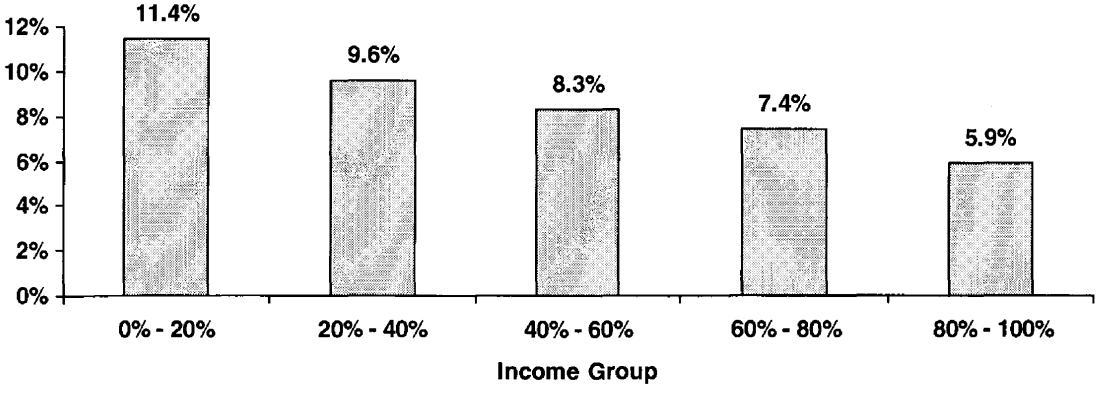
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Texas Department of the Revenue

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	22,118,509	2
State Tax Revenues per Capita	$1,316	50
State Tax Revenues as a percent of Personal Income	4.6%	48
State General Sales Tax Rate	6.25%	7 (tie)
Per Capita Sales Tax Collections	$649	23
Number of Services subject to Sales Tax	78	9
Local Option Sales Tax Rate	2.0%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	No	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Texas ever considered imposing a broad-based individual income tax?**

It has been considered, especially when looking at school financing. However, "It's one of those unspeakable things in Texas politics." A constitutional amendment would be required.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

One advantage is for attracting business to the state. Top business executives may want to relocate to Texas in order to avoid paying income taxes. One disadvantage is that there is a need to expand revenues in Texas, and this is difficult without the income tax.

- **Are there unique characteristics to Texas that make not having an income tax more appropriate than in other states?**

Not really. Texas has been successful without the income tax, possibly because of the high population – they are able to generate revenue from a lot of people.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

It is probably not reliable. Several elected officials have announced the need for change. The Internet is eroding sales tax revenues, as is the changing economy. Thus, it does not appear to be reliable.

- **Has Texas raised or lowered the general sales tax rate at any time during the past ten years?**

They have expanded the base. The last increase in the rate was in 1990.

- **Has Texas exempted any goods from sales taxes during the past ten years?**

Over-the-counter drugs were exempted. Texas also implemented a sales tax holiday during the first weekend in August, in which the first $100 of certain clothing items is exempt.

- **Has Texas eliminated any service tax exemptions during the past ten years?**

No. But the state has implemented partial exemptions for certain services. Twenty percent of data processing, information services is exempt. Also, the first $25 of Internet access service is exempt.

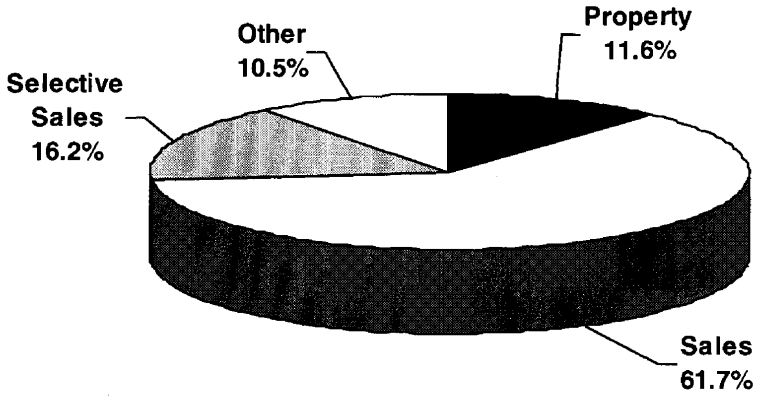
- **Has the growing volume of Internet sales hampered Texas's ability to collect sales and use taxes?**

Yes. Texas has actively participated and is on the governing board for the Streamlined Sales and Use Tax Project. They attempted to conform during the last session, and for the most part, they were successful. However, they postponed implementation due to public response. The main sticking point is moving the tax base from the origin of the sale to the destination. This causes winners and losers among the localities.

One major problem with the streamlined sales tax project is that the "golden ring is missing." There is no guarantee they will be able to collect taxes from Internet sales even if they conform. Until the reality of a change in federal law, it is very difficult to make the changes.

WASHINGTON

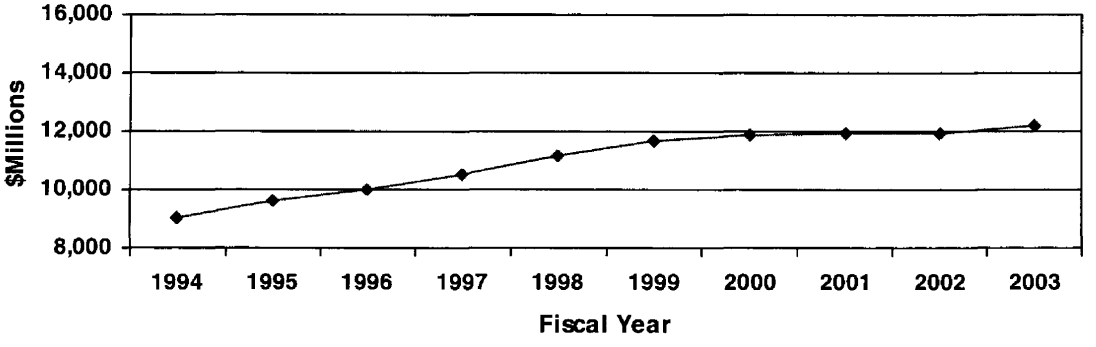
2003 State Tax Collections



Total = $13.0 Billion

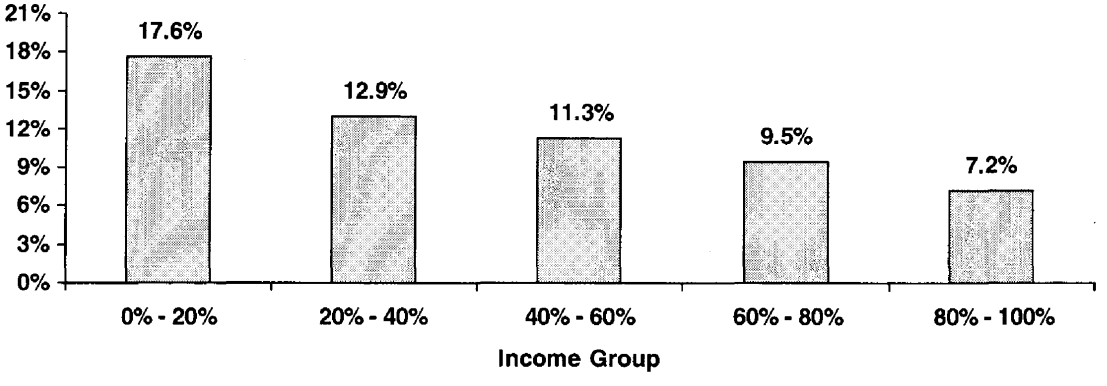
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Washington Department of the Revenue.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	6,131,445	15
State Tax Revenues per Capita	$2,114	12
State Tax Revenues as a percent of Personal Income	6.5%	23
State General Sales Tax Rate	6.5%	4 (tie)
Per Capita Sales Tax Collections	$1,306	2
Number of Services subject to Sales Tax	152	2 (tie)
Local Option Sales Tax Rate	2.4%	
Sales Tax on Food?	No	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	Yes	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Washington ever considered imposing a broad-based individual income tax?**

Yes. There have been eight study commissions since the 1920s, and all have recommended implementing an income tax. However, there is ingrained opposition to the tax, in addition to the Washington Constitution. Various surveys have shown that the sales tax is the most acceptable tax among residents in the state. The sales tax "nickels and dimes" people such that they don't really notice it. Income and property taxes are more "lumpy."

The legislature and Governor enacted an income tax in 1932, but the Washington Supreme Court overturned it, claiming it was unconstitutional.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

A Tax system should be broad-based and fair, and the state should have a balanced portfolio of tax revenues. A balanced structure taxes what people earn, own, and consume.

The sales tax is the most regressive, even though people don't notice it as much. Also, residents cannot deduct sales taxes when paying federal income taxes, although there is a bill in Congress that would allow this. Washington estimated a $500 million tax loss to its residents from not having an income tax. Washington also estimated that the state lost $55 million in tax revenue to Oregon in 1999 from people shopping in that state to avoid the sales tax.

- **Are there unique characteristics to Washington that make not having an income tax more appropriate than in other states?**

Not really. Washington is not a big natural resource state like Alaska or Wyoming.

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

The sales tax is pretty volatile. People don't spend when times are tough. The more progressive the income tax, the less stable it is. Property taxes are the most stable of the major tax sources.

- **Has Washington raised or lowered the general sales tax rate at any time during the past ten years?**

No. The last rate increase was in 1983.

- **Has Washington exempted any goods from sales taxes during the past ten years?**

No.

- **Has Washington eliminated any service tax exemptions during the past ten years?**

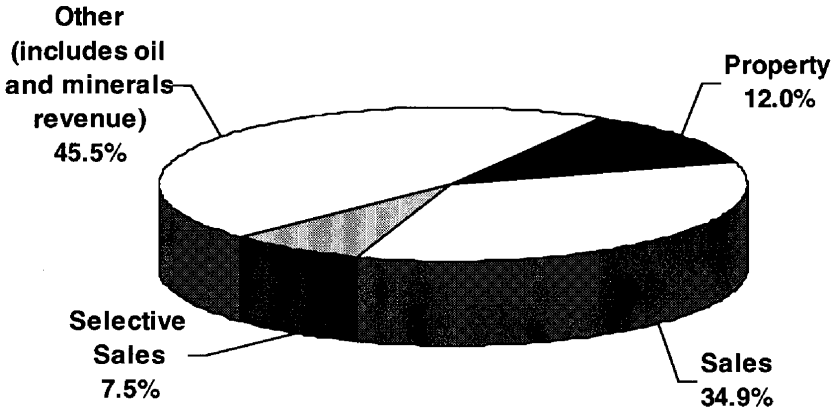
No. All businesses are subject to the business license tax.

- **Has the growing volume of Internet sales hampered Washington's ability to collect sales and use taxes?**

Yes. This is a big problem. Washington estimates it lost $250 million in tax revenues through catalog, phone, and Internet sales in 2002. Washington has not been able to pass all elements of conformity with the Streamlined Sales and Use Tax Project. The sourcing provision has proved difficult to overcome (destination versus origin).

WYOMING

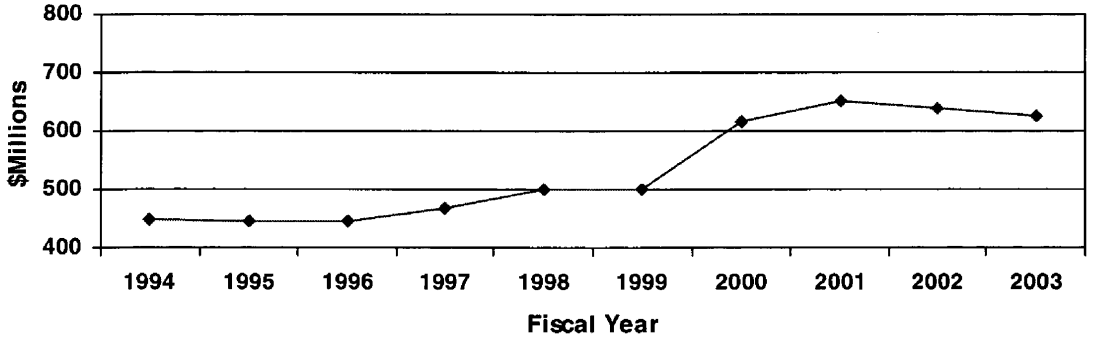
2003 State Tax Collections



Total = $1.22 Billion

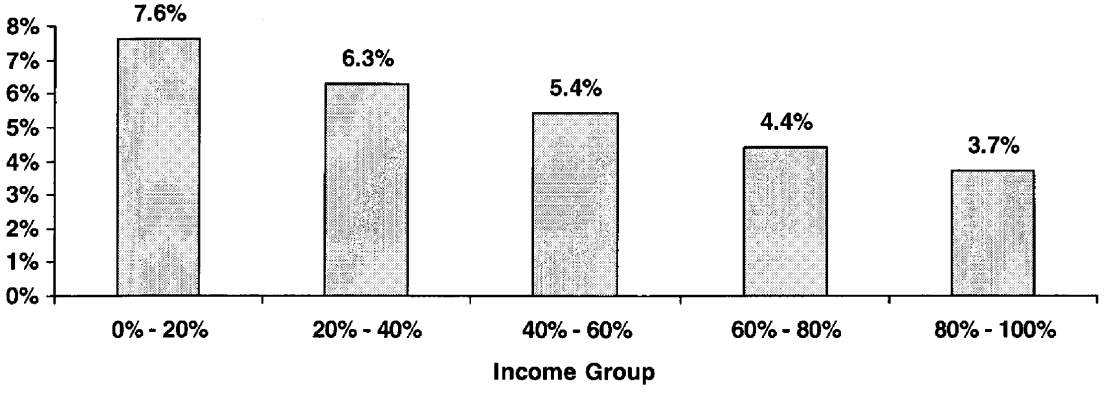
Source: U.S Bureau of the Census.

Ten-Year General Fund Revenue History



Source: Wyoming Taxpayers Association.

State and Local Tax Burden by Income Group (2002)



Source: The Institute on Taxation and Economic Policy.

Key Taxation and Demographic Data

	Value	Rank
Population (2003 est.)	501,242	50
State Tax Revenues per Capita	$2,429	6
State Tax Revenues as a percent of Personal Income	7.9%	8
State General Sales Tax Rate	4.0%	39 (tie)
Per Capita Sales Tax Collections	$847	8
Number of Services subject to Sales Tax	63	17 (tie)
Local Option Sales Tax Rate	2.0%	
Sales Tax on Food?	Yes	
Sales Tax on Prescription Drugs?	No	
Sales Tax on Non-Prescription Drugs?	Yes	

Source: U.S. Census Bureau and The Federation of Tax Administrators.

Additional Notes from Interview with State Tax Official

- **Has Wyoming ever considered imposing a broad-based individual income tax?**

In 1997, the Tax Reform 2000 committee recommended that Wyoming impose an income tax. The legislators on the committee considered it, but nobody else did.

- **What do you believe to be the primary advantages and disadvantages of not having an individual income tax?**

There are three main disadvantages to not having an income tax. (1) It contributes to the lack of citizen concern regarding state government spending. Wyoming has a low tax burden with all the mineral revenues, but a relatively high level of state government spending. (For every $1,500 of taxes paid by Wyoming residents, they receive $7,800 worth of services.) There would be more efficient state government spending if people were paying more in taxes, especially through an income tax. (2) An income tax would make state taxes less regressive than they are now. (3) State income taxes would be deductible from federal income taxes, while state sales taxes are not.

- **Are there unique characteristics to Wyoming that make not having an income tax more appropriate than in other states?**

The mineral revenues enable Wyoming to have high state government spending while having a low tax burden (including zero income taxes).

- **Do you believe the sales and use tax provides a stable and sufficient revenue source?**

They provide a stable source, but they would not be sufficient if it were not for the mineral revenues.

- **Has Wyoming raised or lowered the general sales tax rate at any time during the past ten years?**

Yes. The state raised the general sales tax from three to four percent in 1994.

- **Has Wyoming exempted any goods from sales taxes during the past ten years?**

Farm equipment was recently exempted in order to have Wyoming conform to the Streamlined Sales and Use Tax Project rules.

- **Has Wyoming eliminated any service tax exemptions during the past ten years?**

No, although the state has tried unsuccessfully to remove some exemptions.

- **Has the growing volume of Internet sales hampered Wyoming's ability to collect sales and use taxes?**

Yes. The numbers on the amount of revenues lost due to Internet, catalog, and telephone sales are "staggering." Wyoming was one of the first states to conform to the Streamlined Sales and Use Tax Project. There is a belief that this will lead to the greater collection of sales taxes.

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