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Virginia Gubernatorial Candidates Eye Cumbersome Tax Code

By
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Virginia gubernatorial candidates Ken Cuccinelli (R), Terry McAuliffe (D), and Robert Sarvis (L) made a splash in early May when they rolled out the preliminary details of their tax plans, all of which would make substantial changes to the state tax code. While details are still in flux, below are the candidates' current tentative plans followed by commentary on their impacts on economic activity in the state.

Terry McAuliffe (D)

- Give localities the option to reduce or eliminate the Business Professional Occupation Licensing (BPOL) tax, the Machinery and Tool tax, and the Merchants' Capital tax
- Create task force to identify new revenue sources for localities with aim of maintaining local revenue[1]

Ken Cuccinelli (R)

- Eliminate or reduce the BPOL, the Machine and Tool Tax, and the Merchants' Capital Tax, while maintaining local revenue
- Reduce top individual income tax rate from 5.75 percent to 5 percent over 4 years
- Reduce corporate income tax from 6 to 4 percent
- Ensure government does not grow faster than inflation plus population growth[2]

Robert Sarvis (L)

- Eliminate the BPOL, Machinery and Tool Tax, Merchants Capital Tax, and Car Tax
- Consider eliminating the individual income tax
- Consider reforming property taxes to land-value or two-rate tax
- Eliminate credits and deductions on remaining taxes
- Repeal Governor McDonnell's transportation plan from 2013 session and move instead toward electronic tolling and congestion fees to fund transportation infrastructure[3]

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[1] McAuliffe for Governor, *McAuliffe Proposes Local Tax Reform Plan: Reduce Burdensome Taxes for Virginia's Businesses*, May 3, 2013, http://terrymcauliffe.com/mcauliffe-proposes-local-tax-reform-plan-reduce-burdensome-taxes-for-virginias-businesses/.
[2] Cuccinelli for Governor, *Cuccinelli Unveils Economic Growth & Virginia Jobs Plan*, May 7, 2013, http://www.cuccinelli.com/cuccinelli-unveils-economic-growth-virginia-jobs-plan/.
[3] Sarvis for Governor, *Tax Relief*, http://robertsarvis.com/campaign/tax_reform.

The Antiquated Business Professional Occupation Licensing Tax

The Business Professional Occupation Licensing (BPOL) tax was originally instituted as a way to help pay for the War of 1812 but has remained a component of the Virginia tax code since.[4] The BPOL has long been the subject of criticism by tax experts because it is a gross receipts tax, which are like sales taxes that are levied at every point along the production chain. This is poor tax policy because it leads to tax pyramiding.

Tax Pyramiding

As an illustration, if you were to purchase a car that was built under a gross receipts tax regime, the firm that turned the rubber into a tire would be taxed on the full value of the tire, then the company that added the tire to the car would be taxed on the full value of the car when the manufacturer sells to the dealership, then the value of the car would be taxed when sold to the end consumer. This phenomenon is called tax pyramiding, and it results in low statutory rates at each point the tax is levied, but high effective tax rates at the end of the production structure when the goods are sold to final consumers.

This presents a serious transparency issue, as consumers ultimately bear the burden of the tax—it is baked into the price of the product with each sale between intermediate businesses—but they do not actually see the full burden of the tax on their receipt as they would with a sales tax.

Because gross receipts taxes are levied on transactions between businesses, they also have the strange unintended consequence of encouraging businesses to bring all factors of production in house (vertically integrate) to avoid paying the tax, even if doing so does not make business sense. This is a market distortion that should be avoided. In this way, gross receipts taxes actively disincentivize specialization and trade between firms, which is the very foundation of a market economy, because it allows us to produce more with less resources.[5]

Tax Inequity, Complexity, and Special Interest Issues

Gross receipts taxes create serious equity issues. They disproportionately burden industries with more stages of production, effectively subsidizing industries with fewer stages of production. This fact is well known in Washington State, which has taken the approach of creating different tax rates in their Business and Occupation (B&O) tax for industries with longer supply chains in a clumsy attempt to correct for this market distortion.

Special interests in Washington State, having realized that rates are often toggled by industry, have given up the more noble task of trying to get the B&O tax repealed and instead just focus their efforts on lowering the rate that applies to their particular industry.[6] The Washington B&O tax currently has four major tax

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[4] Michael W. Thompson, *Tax restructuring in Virginia: A Revenue Neutral Path for Improving Our Economy* (Apr. 2012), http://www.thomasjeffersoninst.org/files/3/Tax_Restructure_narrative3.pdf.

[5] John Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, TAX FOUNDATION BACKGROUND PAPER NO. 53 (Jan. 31, 2007), http://taxfoundation.org/article/gross-receipts-taxes-state-government-finances-review-their-history-and-performance.

[6] Chris Grygiel, *The Infamous B&O Tax*, SEATTLE BUSINESS ONLINE, Feb. 2012, http://seattlebusinessmag.com/article/infamous-bo-tax?page=0,0.

classifications but an additional 31 specialized industry classifications. In Fairfax County, Virginia, the BPOL has sixteen separate industry classifications. This adds unnecessary complexity to the tax code, and resources are wasted when firms divert resources away from production to lobby for special treatment under the tax code.

Machinery and Tool, Merchants' Capital, and Car Taxes

Both the Machinery and Tool (M&T) and the Merchants' Capital (MC) tax are business taxes on capital. The Merchants' Capital Tax is an inventory tax (Virginia is one of just thirteen states with inventory taxes[7]), and the Machinery and Tool tax is a business tax on certain types of tangible personal property. Confusingly, Virginia additionally collects a general Tangible Personal Property tax which applies to a broader class of tangible personal property, though it can apply to the same products depending on the locality. In 2010, Virginia relied on these several business capital taxes to collect $376 per capita, the highest of the 39 states that levy taxes on personal property.[8]

The most striking feature of Virginia's local business taxes is that despite their relative modesty in terms of burdens on an individual basis, there are several to keep track of—and different requirements in each locality. For example, only 46 of Virginia's 95 counties levy the Merchants' Capital Tax, but if they do, they are not allowed to also charge the BPOL. Businesses that are subject to the Machinery and Tool Tax are not subject to the Tangible Personal Property Tax on office equipment, furniture, and fixtures.[9] Needless to say, this makes for a complicated filing process, especially for businesses that operate in multiple localities.

Each of these taxes creates severe economic distortions as well. Inventory taxes like the Merchants' Capital Tax are problematic because they dilute the incentive to bring products (inventory) to market, which is the fundamental undertaking of any business venture.[10] This means that they disproportionately affect businesses that have larger inventories, even if those businesses operate on a smaller profit margin than businesses with smaller inventories.

The Machinery and Tool tax is a tangible personal property tax which distorts outlay decisions. Tangible personal property taxes are taxes on capital used to make final products, and they disproportionately affect capital costs over labor costs. This means that businesses are incentivized to hire labor instead of employing machines, even if doing so makes no economic sense otherwise.

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[7] Scott Drenkard & Joseph Henchman, *2013 State Business Tax Climate Index,* TAX FOUNDATION BACKGROUND PAPER NO. 64 (Oct. 2012), http://taxfoundation.org/article/2013-state-business-tax-climate-index.

[8] Tax Foundation calculation based on Virginia 2011 Annual Report, available at http://www.tax.virginia.gov/site.cfm?alias=AnnualReports, and US Census population data. *See also* Ed Gerrish, Joyce Errecart, & Scott Drenkard, *States Moving Away from Taxes on Tangible Personal Property*, TAX FOUNDATION BACKGROUND PAPER NO. 63 (Oct. 4, 2012), http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property.

[9] Virginia Economic Development Partnership, *2012-2013 Virginia Guide to Establishing a Business*, http://www.yesvirginia.org/pdf/flipbooks/Virginia%20Guide%20to%20Establishing%20a%20Business%202012-2013/HTML/index.html.

[10] Indeed, the economist Richard Cantillon first coined the word "entrepreneur" (direct translation: "undertaker") to describe the risky undertaking of bringing inventory to market. *See* Richard Cantillon, *Essai sur la Nature du Commerce in Général (Essay on the Nature of Trade in General)*, http://www.econlib.org/library/NPDBooks/Cantillon/cntNT.html.

The car tax is also a tangible personal property tax but is different than tangible personal property taxes in most states in that it is levied on individuals.[11] The car tax has historically been an unpopular tax in Virginia. In the 1990s, Jim Gilmore (R) famously ran a campaign for governor around the promise to eliminate the tax;[12] however, the tax was never fully phased out and remains a portion of local tax collections.

From a public policy perspective, there is no reason to single out one good in this way to be subject to an annual tax. While broad-based taxes on income, sales, or property can be justified based on the benefit principle (a theory that taxpayers ought to pay taxes based on the government services they enjoy), the car tax simply picks a piece of personal property that many people own and arbitrarily subjects it to a tax.

It is not clear that people with cars should pay more taxes than people that do not have cars. It is even harder to make the case that a tax should be tied to the value of your car, as people with more expensive cars do not necessarily consume more government services than people with less expensive cars. Even though car owners might enjoy more government transportation services, taxes on gasoline and tolls are better estimators of how much they use roads.

Local Government Impact and the Case for the Property Tax

Many of these reforms would take away taxing power of localities, and so it is important to consider the revenue impacts of these policy proposals on local governments. As Table 1 illustrates, the combined revenues of the Tangible Personal Property tax, the BPOL tax, the Merchants' Capital tax, and the Machinery and Tool tax make up substantial portions of the funding for local governments. Large towns in particular rely on these taxes for approximately one-fifth of their total revenue.

Table 1. Select Taxes as a Percent of Revenue by Jurisdiction in Virginia
FY 2010

	For Cities	For Counties	For Large Towns
Tangible Personal Property Tax (a)	8.8%	11.2%	4.4%
BPOL (b)	6.1%	3.6%	12.5%
Merchants' Capital	n/a	0.1%	<0.1%
Machinery and Tool	2.0%	1.4%	2.1%
Total	**16.9%**	**16.3%**	**19.0%**

(a) Includes, but is not limited to, the car tax
(b) Percentages given here are for total business license taxes, of which the BPOL is the largest contributor.
Source: Weldon Cooper Center for Public Service

The Tangible Personal Property tax and the BPOL tax make up sizeable portions of revenue for cities, counties, and towns, while the Merchants' Capital tax and Machinery and Tool tax make up far smaller amounts of local revenue in the aggregate. Certain localities might rely on these taxes more, but many towns

[11] Ed Gerrish, Joyce Errecart, & Scott Drenkard, *States Moving Away from Taxes on Tangible Personal Property*, TAX FOUNDATION BACKGROUND PAPER NO. 63 (Oct. 4, 2012), http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property.
[12] Charles Bierbauer, *Car Tax Opposition Propels Gilmore's Candidacy*, CNN.COM, Oct. 31, 1997, http://www.cnn.com/ALLPOLITICS/1997/10/31/gov.va/.

do not rely on them at all. For example, no cities levy the Merchants' Capital tax, and only 44 of the 95 Virginia counties levy it.[13]

Because such a significant portion of local funding comes from these four tax categories, some sort of revenue replacement mechanism will likely be necessary to combat the public choice problem of localities lobbying the state legislature to maintain these taxes. The state legislature might do well to examine a revenue sharing agreement as these distortionary local taxes are phased out.

Ultimately, local governments should fund their operations out of local revenues. Traditionally, the property tax has made up the lion's share of local operations funding.[14] The property tax is largely disliked by taxpayers, because taxpayers physically cut the property tax check each year, making them intimately familiar with the tax burden. However, this tax transparency is the very thing that tax experts like most about the tax. By contrast, business levies like the Tangible Personal Property, BPOL, Merchants' Capital, and Machinery and Tool taxes are baked into business costs of products, so individuals pay them, though they do not see the tax bill. As a matter of government transparency, taxes like these should be avoided so that taxpayers actually come face to face with the cost of the government services they enjoy. As these businesses are flagged for reduction or elimination, the property tax is a viable alternative to keep up revenue streams.

Virginia's New Transportation Policy

In the 2013 session, Governor McDonnell ushered a transportation bill through the Virginia legislature that is estimated to raise an additional $880 million in revenue per year.[15] The bill has many provisions but is mainly centered on eliminating the state gasoline per-gallon excise tax then replacing it with a special 3.5 percent sales tax to gasoline and dedicating that revenue to transportation funds. The package increases the statewide sales tax from 5 percent to 5.3 percent and increases the sales tax in Northern Virginia and the Hampton Roads region to 6 percent. The plan also increases taxes on car sales, raises licensing fees for electric vehicles, creates a new real estate transfer tax, and prohibits tolling on I-95 south of Fredericksburg.[16]

The plan garnered sharp criticism from policy organizations across the political spectrum from the Competitive Enterprise Institute to the Institute on Taxation and Economic Policy.[17]

The plan was flawed in that it moves Virginia even farther away from the "user pays, user benefits" model of transportation policy. Ideally, states should lean on gas taxes and tolls as much as possible to fund roads

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[13] John L. Knapp & Stephen C. Kulp, VIRGINIA LOCAL TAX RATES, 2011 (Weldon Cooper Center for Public Service 2012), *available at* http://www.coopercenter.org/sites/default/files/econ/TaxRates/taxrates2011/2011TR.pdf.

[14] David Brunori, LOCAL TAX POLICY (Urban Institute Press 2007).

[15] Fredrick Kunkle & Laura Vozzella, *Virginia lawmakers approve sweeping transportation plan*, WASHINGTON POST, Feb. 23, 2013, http://www.washingtonpost.com/local/va-politics/va-lawmakers-approve-landmark-transportation-plan/2013/02/23/712969d8-7de4-11e2-82e8-61a46c2cde3d_story.html.

[16] For full plan details, *see* Joseph Henchman, *Virginia Legislators Approve Increases in Sales Tax, Car Tax, Regional Taxes*, TAX FOUNDATION TAX POLICY BLOG, Feb. 25, 2013, http://taxfoundation.org/blog/virginia-legislators-approve-increases-sales-tax-car-tax-regional-taxes.

[17] Competitive Enterprise Institute, *CEI Blasts Virginia House of Delegates Transportation Vote*, Feb. 22, 2013, http://cei.org/news-releases/cei-blasts-virginia-house-delegates-transportation-vote; Nanette Byrnes, *Virginia plan to end gas tax quickly panned*, REUTERS, Jan. 9, 2013, http://blogs.reuters.com/taxbreak/2013/01/09/virginia-plan-to-end-gas-tax-quickly-panned/.

because doing so connects the users of the roads with the cost of their construction and upkeep. By contrast, funding roads from sources like the sales tax forces all Virginia taxpayers to shoulder the burden of roads, even those that do not use them as much. Unless road users are asked to pay for their use, roads are underpriced, resulting in overuse (congestion) and undersupply.[18]

Corporate Taxes

Virginia currently taxes corporate income at a rate of 6 percent but also offers a slew of distortionary tax credits that lower tax burdens for select industries and companies. There are 39 credits in the code for individuals and corporations, which range in policy goals from promoting activity in economically distressed areas to promoting Virginia's nascent winery industry.[19]

According the Organisation for Economic Co-operation and Development (OECD), corporate income taxes are the most harmful to economic growth, so cuts to the corporate rate can have positive economic effects.[20] However, the biggest problem with the state corporate income tax is the compliance costs associated with it. Businesses spend millions in tax planning and accounting to lower their corporate tax burden, sometimes structuring their businesses in inefficient ways just to lower tax costs.[21] This fact led noted tax expert David Brunori to sum up the Cuccinelli corporate tax proposal to reduce the corporate rate from 6 to 4 percent over four years this way:

> Cuccinelli is making a big deal about this proposal, claiming that it will spur economic growth. I believe that cutting the tax rate by two percentage points will have no effect on anything. It's the existence of the tax, not the burden, that is the problem. Cuccinelli would be far better off boldly proposing repeal of the corporate income tax.[22]

An Individual Income Tax Built for the 1920s

Virginia's individual income tax accounted for 27.8 percent of state and local revenue in 2010, but its structure has not been comprehensively reviewed since the 1920s. Table 2 shows the changes since 1919, when a two rate structure was first adopted.[23] Comprehensive income tax base broadening has never been accomplished in Virginia, and the result is several rather low brackets that confuse taxpayers and distort the labor market. What is more, the brackets are not indexed for inflation, which means that more and more

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[18] *See* Joseph Henchman & Scott Drenkard, *Virginia Governor Proposes Smoke & Mirrors Transportation Financing Plan*, TAX FOUNDATION TAX POLICY BLOG, Jan. 8, 2013, http://taxfoundation.org/blog/virginia-governor-proposes-smoke-mirrors-transportation-financing-plan.
[19] Virginia Department of Taxation, *Tax Credits*, http://www.tax.virginia.gov/site.cfm?alias=TaxCredit.
[20] Jens Arnold, Bert Brys, Christopher Heady, Åsa Johansson, Cyrille Schwellnus, & Laura Vartia, *Tax Policy For Economic Recovery and Growth*, 121 ECONOMIC JOURNAL F59 (2011).
[21] Jason J. Fichtner & Jacob M. Feldman, *The Hidden Costs of Tax Compliance* (May 20, 2013), http://mercatus.org/publication/hidden-costs-tax-compliance.
[22] David Brunori, *Cuccinelli's Corporate Tax Plan Does Not Go Far Enough*, THE TAX ANALYSTS BLOG, Jul. 3, 2013, http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/DBRI-994KBS?OpenDocument.
[23] Weldon Cooper Center for Public Service, John H. Bowman, *Reforming the Individual Income Tax* (July 12, 2002), http://www.coopercenter.org/econ/publications/reforming-individual-income-tax.

income is subjected to higher rates each year as taxpayer incomes increase in the nominal sense due to inflation but not in purchasing power. These automatic tax increases are known as bracket creep.

Table 2. Virginia's Individual Income Tax Brackets through the Years

1919			1926			1948			1972			1987- current		
1%	>	$0	1.50%	>	$0	2%	>	$0	2%	>	$0	2%	>	$0
2%	>	$3,000	2.50%	>	$3,000	3%	>	$3,000	3%	>	$3,000	3%	>	$3,000
			3%	>	$5,000	5%	>	$5,000	5%	>	$5,000	5%	>	$5,000
									5.75%	>	$12,000	5.75%	>	$17,000

The cuts to the top rate that Cuccinelli has proposed are good policy that helps bring the state in line with a flatter treatment of income. Ultimately, however, Virginia is overdue for income tax simplification. Sarvis suggests a potential elimination of the individual income tax, which would certainly simplify matters but would require substantial cuts in spending or shifting to other taxes. Another alternative could be eliminating the arcane lower brackets and replacing them with a generous standard deduction that is inflation adjusted.

Conclusion

The Virginia gubernatorial field has correctly eyed that one of the biggest problems with the state's tax code is cumbersome local business taxes. However, many of Virginia's major taxes are ripe for reform as well, and policymakers would do well to comprehensively examine the entire code.

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