What West Virginia Needs to Do in Order to Compete in the 21st Century

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A briefing delivered on the floor of the West Virginia House of Representatives on December 11, 2006, regarding West Virginia's recent tax reform and the need for continued reform.

Introduction

Thank you for providing me the opportunity to speak with you today about your tax reform effort. I always enjoy the opportunity to help state lawmakers craft the most effective legislation possible to help spur growth and economic performance.

The work by the Tax Modernization Project and the subsequent proposal by the governor—later passed by the legislature and signed into law by the governor—are a good start to begin putting West Virginia on the right track towards increased economic development.

However, more needs to be done in order to ensure that West Virginia can compete on a national and international level in an increasingly competitive marketplace. West Virginia should aim to be to the United States what Ireland is to Europe. Ireland lagged behind the rest of Europe for years, but 10 years ago it dramatically revamped its tax code with broad bases and low rates, and after only 10 years it is known as the Celtic Tiger.

Government Statistics

As all of you know, West Virginia lags on most economic indicators—48th in personal income per capita at $26,029, which is only 75 percent of the national average. Only Mississippi and Louisiana have lower per capita incomes.

Equally alarming, West Virginia ranks 49th in output per capita. These figures are reported by the Bureau of Economic Analysis in the Commerce Department.

The situation does not look better when we examine recent historical trends. Using data from the Bureau of Economic Analysis for personal income and output, the Census Bureau for population and the Bureau of Labor Statistics for employment, it is obvious that West Virginia's growth performance on important measures of economic well being are, to put it gently, below average.

West Virginia's personal income per capita grew at the 38th fastest rate in the six-year period from 2000 to 2005. Not in the slowest group, but not an encouraging statistic either. West Virginia did fare better on output however, growing 22nd fastest. However, West Virginia ranks poorly on employment, where it grew 46th fastest—although "growth" is an improper term since West Virginia was one of only 10 states that actually lost employment in that time span. Equally troubling was that population grew 49th fastest from 2000 to 2005.

Obviously people and jobs are not flocking to West Virginia and therefore output and income are not growing either.

Looking at neighboring states—Kentucky, Maryland, Ohio, Pennsylvania and Virginia—shows that it is partly a regional problem and partly a West Virginia problem.

In terms of income, West Virginia is growing more slowly than Kentucky, Maryland and Virginia. Maryland has the 9th fastest rate of income growth nationally since 2000. On the other hand, Ohio and Pennsylvania incomes grew even more slowly.

In terms of output growth, Maryland and Virginia have the 9th and 10th fastest rates in the six-year span, but in Pennsylvania, Ohio and Kentucky output grew even more slowly than in West Virginia.

In terms of employment, West Virginia's 46th fastest growth rate nationally places it last in its region as all five regional neighbors have faster growing employment figures.

Lastly, only one state, North Dakota, grew more slowly in population from 2000 to 2005. The polar opposite of West Virginia was Virginia, which showed exemplary growth in both employment and population, growing 7th and 11th fastest nationally respectively.

West Virginia also has one of the highest unemployment rates in the region. Virginia's rate is 2.9 percent, Maryland's 4 percent, Pennsylvania 4.3 percent. West Virginia ties with Ohio at 5.1 percent and Kentucky has a 5.2 percent rate. These figures are as reported by the Bureau of Labor Statistics for October 2006.

It may be argued that these states have larger, more diverse economies than West Virginia. Well, let's look at states with similar economies—heavily dependent on mining like Montana, South Dakota and Wyoming.

All three states are growing rapidly. Unemployment is below 3.5 percent in all three. All three have income growth rates in the top 10 nationally, far outpacing West Virginia. And all have excellent rates of output, employment and population growth that far exceed West Virginia's growth performance.

Being dependent on mining is not hurting these states, as they are all growing rapidly. All three, however, have two characteristics in common that differentiate them from West Virginia: exemplary tax climates and low tax burdens.

Taxes Matter

The economic data from government sources are hard to dispute, so the question now remains: What can you as lawmakers do to improve these numbers and help West Virginian residents and businesses?

Some experts will actually submit to you that taxes do not matter to economic development. I am sure that you may even hear from or read papers by well-respected economists like Robert Tannewald of the Boston Federal Reserve, or Michael Wasylenko of Syracuse University, or Richard Pomp of the University of Connecticut that taxes don't matter or are of little consequence to businesses. These scholars are convinced that tax considerations are trivial compared to such public finance issues as expenditures on roads and infrastructure, crime prevention and of course health care and education.

Well, West Virginia's roads seem superior already, and in every crime category, West Virginia ranks very well. Over the past 20 years it has become evident that increased spending on education does not guarantee improved results, and states are somewhat powerless to deflect the costs of health care.

Furthermore, increased spending on these programs can take years to pay dividends, if they ever do. It takes years to build new roads, and it can take generations for improved education to pay dividends for a state. And do not forget that just because a child is well-educated in one state, there is no guarantee they will remain in that state.

From the Tax Foundation's perspective, taxes matter greatly to businesses and individuals. There is a growing literature that shows taxes are of significant consequence to business location decisions. Economists like Timothy Bartik, Mihir Desai of Harvard and the National Bureau of Economic Research, and Glenn Hubbard of Columbia Business School and formerly of the President's Council of Economic Advisers have all recently found that taxes matter to business location. The literature and research is finding more and more that taxes matter.

The Tax Foundation gets phone calls regularly from site location offices trying to build nationwide tax databases. Surely they would not call if taxes did not matter to businesses

We are certain that when a state improves its tax climate it will reap economic benefits immediately because businesses will take the opportunity to expand, new businesses will open and others may move to the state. Businesses will not be the only benefactors of the improved climate as state residents will be grateful for the tax relief and the new jobs and opportunities.

The great advantage of this tax-centric approach from a lawmaker's perspective is that in one legislative session you can change the tax system and instantly have a tangible impact on the state's economy.

The Tax Foundation's Tools for Policy Analysis

The Tax Foundation has two well-established and well-respected tools for analyzing policy at the state level. First, we have calculated the state and local tax burden for each state since 1970. This tells us how much tax, as a percentage of state income, a state's residents pay in state- and local-level taxes.

Second, we just released the fourth edition of our State Business Tax Climate Index, which measures the competitiveness of each state's business tax climate by assessing five major components of each state's tax system: corporate tax, individual income tax, sales tax, unemployment insurance tax and property tax.

The tax burdens measure how much a state taxes, and the Index measures how its tax system collects that burden.

Neither measure paints a bright picture for West Virginia.

Tax Burdens

The Tax Foundation's tax burden measure is the best resource for determining the actual burden state and local taxes are placing on each state's residents.

The Census Bureau's ranking of state tax collections is often cited in discussions of state tax burdens, but the Tax Foundation's figures are better from a policy perspective for several reasons.

First, we include state and local tax data because some states accomplish at the local level what others do at the state level.

For instance, New York and Louisiana have substantial local-option sales taxes that significantly increase the tax burdens in those states. Ohio and Pennsylvania are other places where local taxes are significant. Local sales and income taxes are substantial in Ohio, adding to their already substantial tax burden. In Pennsylvania, most localities have income taxes and many have sales taxes. And of course most property taxes are levied on the local level. So local taxes matter.

Census eventually does report local tax collections, with a significant delay, but the Tax Foundation estimates for the current year have proven accurate and facilitate current legislative action. The Tax Foundation reports current year estimates, whereas Census often has a two-year lag time, and the Tax Foundation reports the burden in calendar year form instead of fiscal year—the time span taxpayers generally measure their tax burden in.

Second, the Tax Foundation measures economic incidence and Census measures legal incidence. Legal incidence measures where taxes are collected. We measure who is actually paying the taxes instead of simply where they are collected. For instance, many companies are located in Delaware, but Delaware residents do not pay the tax burden for all these companies. The taxes are paid by consumers, employees and shareholders of these companies who are located across the country. The Tax Foundation accounts for this.

Alaska is an excellent example of this as well. Census says Alaska residents pay the most state taxes in per capita dollars. However, Alaska residents often receive rebates at tax time that exceed their entire state tax liability because of the Alaska Permanent Fund. We rank Alaska as having the lowest tax burden in the country, which is more accurate. Large oil companies are charged severance taxes in Alaska, but the tax is paid by consumers, shareholders and employees across the country.

Furthermore, we measure tax burdens as a percent of a state's income, which is the proper way to measure burdens. Per capita dollar figures—like Census reports—tell us only the amount residents in each state pay; they reveal nothing about the burden those dollar figures actually impose on taxpayers.

West Virginia residents pay 10.6 percent—the national average—of their income in state and local taxes—the 21st highest percentage nationally. Regionally, Ohio has a much higher state and local tax burden. Maryland and Kentucky are slightly lower but still have higher burdens than West Virginia. Pennsylvania and Virginia have lower burdens—Virginia significantly lower.

Regionally and nationally, then, West Virginia is in the middle of the pack. However, this is not good enough for a state that so badly lags behind the rest of the nation and its regional competitors.

Compared to states that similarly rely on mining activities, West Virginia's 21st highest tax burden is significantly higher than Wyoming at 33rd, Montana at 42nd and South Dakota at 45th.

Historically, West Virginia's state and local tax burden has been above average. In 1970, the first year the Tax Foundation calculated state and local tax burdens, the state's burden was 9.6 percent—29th highest. By 1975 it had climbed to 10.5 percent—11th highest. In 1980, the burden was down to 9.9 percent and ranked 15th. In 1984 and 1985 West Virginia reached its high-water mark when it ranked 6th nationally with 11.1 percent of its income going to state and local taxes. Since that time, the burden has receded somewhat. In 1990 it ranked 26th, taking 10 percent of the state's income, and in 1995 it ranked 28th. In 2000 it jumped to 16th by taking 10.6 percent and has ranked 21st since 2004, taking between 10.3 percent and 10.7 percent of income.

The tax burden in West Virginia is too high. It is high nationally, regionally and compared to similar states. The time to finally take steps to fix this problem is now.

State Business Tax Climate Index

Lowering the tax burden alone is not enough to get West Virginia on track. More needs to be done to bring West Virginia into the 21st century.

The tax burden a state collects is not the entire picture of its tax landscape. How a state collects its tax burden is as important as how much it collects. A state with a high tax burden could in fact collect it in an economically efficient way, thereby limiting the damage its tax system does to the economy. Unfortunately for West Virginia this is not the case.

The Tax Foundation's State Business Tax Climate Index measures the competitiveness and business-friendliness of each state's tax system by analyzing five components of each state's tax system to compute an overall ranking for each state: corporate tax, individual income tax, sales tax, unemployment insurance tax and property tax.

Generally, the states that score best on the Index, as I will refer to it, are those that go without one of the three major taxes: corporate tax—usually the corporate income tax; individual income tax; and sales tax.

A quick glance at the top 10 states in the Index shows that each state goes without at least one of the three major taxes, and three states—Nevada, South Dakota and Wyoming—go without two. None of these three states taxes income on the individual or corporate level.

Besides going without one of the major taxes, the way a state can score well is to levy broad-based, low-rate tax systems that are simple and promote growth.

West Virginia ranks 34th nationally on the Index. Regionally, the picture is no better for West Virginia. Maryland ranks 29th, Pennsylvania 22nd and Virginia ranks 13th. Kentucky and Ohio continue to damage their business tax climates and therefore rank lower then West Virginia at 39th and 49th respectively.

As you continue your tax reform efforts, be mindful of the recent so-called tax reforms in Kentucky and Ohio. They are models of how not to approach tax reform. Both states instituted gross receipts taxes, a tax that is inimical to both business in a state and a state's competitive position.

West Virginia has actually been down this road before. In 1921, West Virginia instituted the country's first gross receipts tax. Because of damage the tax was inflicting on the economy, it was repealed in 1987.

West Virginia's repeal of its gross receipts tax is evidence that in the past 20 years attitudes have changed about whether taxes matter. Indiana repealed a longstanding gross receipts tax in 2002 as well. It is hard to imagine that 30 or 40 years ago such taxes would have been repealed because they were economically harmful.

A recent paper from the Tax Foundation lays out why gross receipts taxes are economically harmful. It finds that gross receipts taxes create wide disparities in effective tax rates between industries and between companies in the same industry, treat importers and exporters differently and create non-neutralities by encouraging companies to consolidate for tax purposes rather than economic factors.

Of course, tax collectors love gross receipts taxes because they raise ample amounts of revenue. Ohio is seeing collections well above expectations from its Corporate Activities Tax.

Any further tax reform in West Virginia needs to avoid the siren song of a gross receipts tax and focus on broadening tax bases and lowering rates. Tax reform plans that do not simplify and lower taxes are akin to rearranging the deck chairs on the Titanic.

West Virginia's Index ranking trails the other mining states. Montana ranks 8th, South Dakota 2nd and Wyoming 1st.

West Virginia ranks poorly because it levies all the major taxes, has high rates and doesn't do a good enough job of keeping its tax bases broad.

Looking at the five component indexes individually can help to pinpoint those areas where West Virginia needs to improve to increase its rank.

Corporate Tax Index

West Virginia ranks 26th on the Corporate Tax Component Index—a middle-of-the-road score.

It is important to remember that when companies remit taxes, people pay taxes. Corporate income tax does not come out of the ether; it comes out of the pockets of three stakeholder groups: consumers, employees, and shareholders.

Beware of pushing your tax burden to companies, with promises of "sparing" the people, because you will be indirectly taxing West Virginia shareholders through lower returns to their investments, West Virginia consumers through higher prices and West Virginia employees through lower wages and fewer jobs.

West Virginia could rank higher if it were not for the very high 9 percent top rate. This is one of the highest rates in the country, and the small quarter-of-a-point decrease just passed will do little to improve West Virginia's score.

On the Corporate Tax Index we rank states based on their top corporate income tax rate and the "flatness" of the tax's structure. We also rank states on their gross receipts taxes; of course West Virginia doesn't have one so it is not penalized and the flat rate system also helps West Virginia's score.

Currently, the 9 percent rate is the 9th highest in the country and the 2nd highest in the region. Only Pennsylvania's 9.99 percent rate is higher.

When the rate is lowered to 8.75 percent in January 2007 it will only move West Virginia up four places, to the 13th highest top corporate rate. It will move past California at 8.84 percent, Connecticut at 9 percent, Maine at 8.93 percent and Rhode Island at 9 percent. Connecticut will move ahead of West Virginia, however, on January 1 because its 20 percent corporate surtax will expire and its rate will fall back to 7.5. So realistically West Virginia has the 12th highest corporate income tax rate as of January 1st.

This isn't good enough. You need to target one of your regional competitors to gain an advantage. Ohio's rate will continue to fall as its Corporate Activities Tax phases in, so it's a difficult comparison, but why not go after Kentucky and Maryland's 7 percent rate? This will make the state more competitive in the region and improve your competitiveness with the region's best rate—Virginia at 6 percent. This will also help to lower the state's tax burden in a job-creating way.

West Virginia's Corporate Tax Index ranking is in the middle of the pack despite that high rate because you do a good job of taxing companies based on their average profitability instead of a snapshot of their fiscal year profitability. You could do better, however, if you lifted the $300,000 cap on carry-back deductions.

Ultimately, without a more substantial rate cut, West Virginia will not improve greatly on the Corporate Tax Index.

Individual Income Tax
The most heavily weighted part of the Index is the Individual Income Tax component. This is bad news for West Virginia because it is where you rank worst: 41st.

Individual income taxes are included in the State Business Tax Climate Index because more and more businesses are paying taxes on the individual side because of the explosion of S-Corps, LLCs and Limited Partnerships. Also, businesses have to pay employees who pay the tax and it is harder to attract good workers in places where taxes are high. In addition, depending on the sensitivity of labor to after-tax wages, businesses may actually pay a portion of an employee's income tax.

There are a few reasons why West Virginia ranks poorly, but the most important is the 6.5 percent rate that sits atop five brackets. Flat, low-rate systems score the best, so in order to improve competitiveness you need to seriously consider lowering and flattening out the rates.

Currently, the 6.5 percent rate kicks in at $60,000-$62,000 when taking account of exemptions. States that score the best have top rates that kick in at either very low or very high levels of income. If the top rate kicks in at a low level of income then it is essentially a flat tax, and if the top rate only applies to very high levels of income then it affects few taxpayers.

West Virginia would be best served by flattening its system. If it doesn't become a flat tax, competitiveness would be best served by increasing the level of the kick-in to a much higher income threshold so the top rate applies to fewer taxpayers.

West Virginia's top 6.5 percent rate ranks 20th highest in the country. Only Ohio's 6.58 percent top rate is higher in the region, but that is falling and is actually lower now due to recent legislative acceleration of its phase-down. So West Virginia has the highest rate in the region.

I should note that local option income add-ons are not included in this current analysis for simplicity's sake. However, local option income taxes are significant in Ohio, Pennsylvania, Maryland and Kentucky. These local add-ons can drive the rate higher.

The point remains the same however: West Virginia needs to stop taxing income at such high rates. Why not go after Kentucky at 6 percent or Virginia at 5.75 percent to increase the state's competitiveness and help West Virginia workers?

A lower individual income tax rate will help to lower the tax burden for all West Virginians as well.

The current income tax system also has three base issues that are detrimental to competitiveness. First, there is a significant marriage penalty because the brackets for married people are not double that of singles. Second, there is an AMT, and last, the brackets, standard deduction and exemptions are not indexed for inflation. Fixing these three problems would be a significant improvement to West Virginia's business friendliness.

Sales Tax

On the Sales Tax Component Index West Virginia ranks 20th—its second-best score on the five component indexes.

West Virginia scores highly because of a moderate rate—6 percent, relatively low excise taxes, and relatively few business-to-business taxes.

You have recently passed a bill lowering the sales tax rate on groceries from 5 percent to 4 percent and finally 3 percent in 2008. All income levels will benefit from this preferential rate since everyone buys groceries, but the group that will benefit the most is undoubtedly grocers.

One reason West Virginia scores well in the Sales Tax Index is because it does include groceries and gas in its sales tax base. There is no economic justification to exclude any end-user products or services purchased by consumers from the sales tax base. All exclusions do is riddle the base with holes, putting upward pressure on the rate. It is better for your economy and for taxpayers to keep the base broad and the rate low.

You can certainly have a rational tax code and a progressive overall fiscal system. You do this by sticking to the principles of broad-based, low-rate taxes on the tax side, and accomplish progressivity on the expenditure side by giving transfer payments to those you deem needy.

Unemployment Insurance Tax

West Virginia ranks 34th on the Unemployment Tax Index and can score better by lowering rates and making sure businesses are not hit with higher rates when they are struggling financially.

Property Tax

Lastly, West Virginia ranks 19th on the Property Tax Index—its best score on the five indexes. It accomplishes this by having very low property taxes and avoiding many of the asset-transfer taxes, like estate or gift taxes.

The property tax cuts you passed for seniors will help lower property taxes but the difference will undoubtedly be made up elsewhere. If property tax cuts are necessary for one group, why not all groups?

There are only two reasons to target tax cuts for seniors. First, it could be a crass political move aimed at buying votes. It is unfair to target a tax cut at a particular group because they are politically important. This just pushes the tax burden onto a less politically favored group. It will be economically beneficial to keep all tax bases broad by avoiding tax breaks for politically connected groups.

Second, senior citizens who rely on Social Security income and own a home potentially could lack the cash flow necessary to pay the property tax on their home, and could face a situation where selling the home is the only way to pay the tax. The tax code should not be used to avoid this situation however. A direct expenditure program is a better method for helping seniors.

West Virginia could do even better in the Property Tax Index if it abolished the capital stock tax or franchise tax—an outdated tax many states do without. Only 22 states have one, and this greatly impairs West Virginia's competitiveness.

The recent drop in the rate from .7 percent to .55 percent, or 7 mills to 5.5 mills, is a good start, but once again, like the corporate income tax rate reduction, it doesn't do enough to significantly increase West Virginia's ranking. Full repeal is needed for such movement. A low rate is good, but a zero rate also eliminates the administration and complexity costs imposed by the franchise tax.

The state can certainly afford it, as in the 2007 fiscal year you are projecting a balanced budget, and, combined, the corporate income tax and the business franchise tax only take in 8.3 percent of your total revenue, of which I'm sure the franchise tax is a tiny portion. Certainly there are some expenditures that can be cut to make this growth-promoting tax cut a reality.

Conclusion

West Virginia has badly needed tax reform to help spur economic development for years. You, the legislature, and the governor have taken the appropriate first steps, but more needs to be done.

If you work to further lower the rate on corporate income, abolish the franchise tax, lower individual income taxes and keep the tax bases broad, West Virginia will be in a better position to compete regionally with Pennsylvania and Virginia and place itself in a better position nationally.

Thank you for your time and I would be glad to answer any questions you have.