WEST VIRGINIA TAX POLICY & SHARED PROSPERITY

Recommendations to Joint Select Committee on Tax Reform
October 20, 2015

presented by
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West Virginia Center on Budget and Policy
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@WVCBP

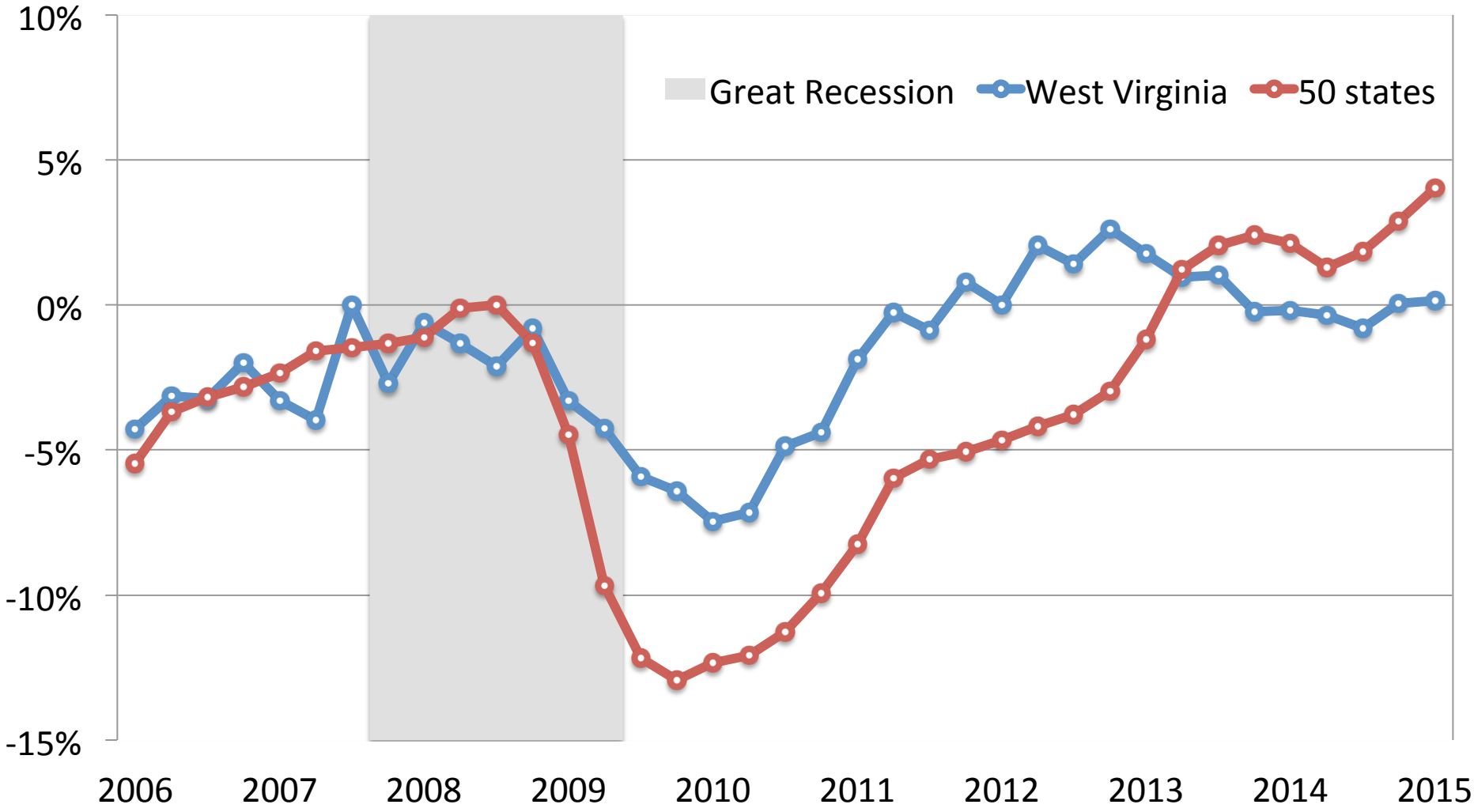
Outline of Presentation

- Overview of West Virginia's Fiscal Health
- Principles of Sound Taxation & Tax Responsibilities
- Link Between Taxes and Economic Growth
- Tax Policy Options
- Recommendations to Improve Budget Transparency & Accountability

The **West Virginia Center on Budget and Policy** is a policy research organization that is nonpartisan, nonprofit, and statewide. Our mission is to use sound research and analysis to advance the well-being of West Virginia communities. The Center is part of the **State Priorities Partnership** and the **Economic Analysis Research Network**.

West Virginia tax revenue growth lags behind most states

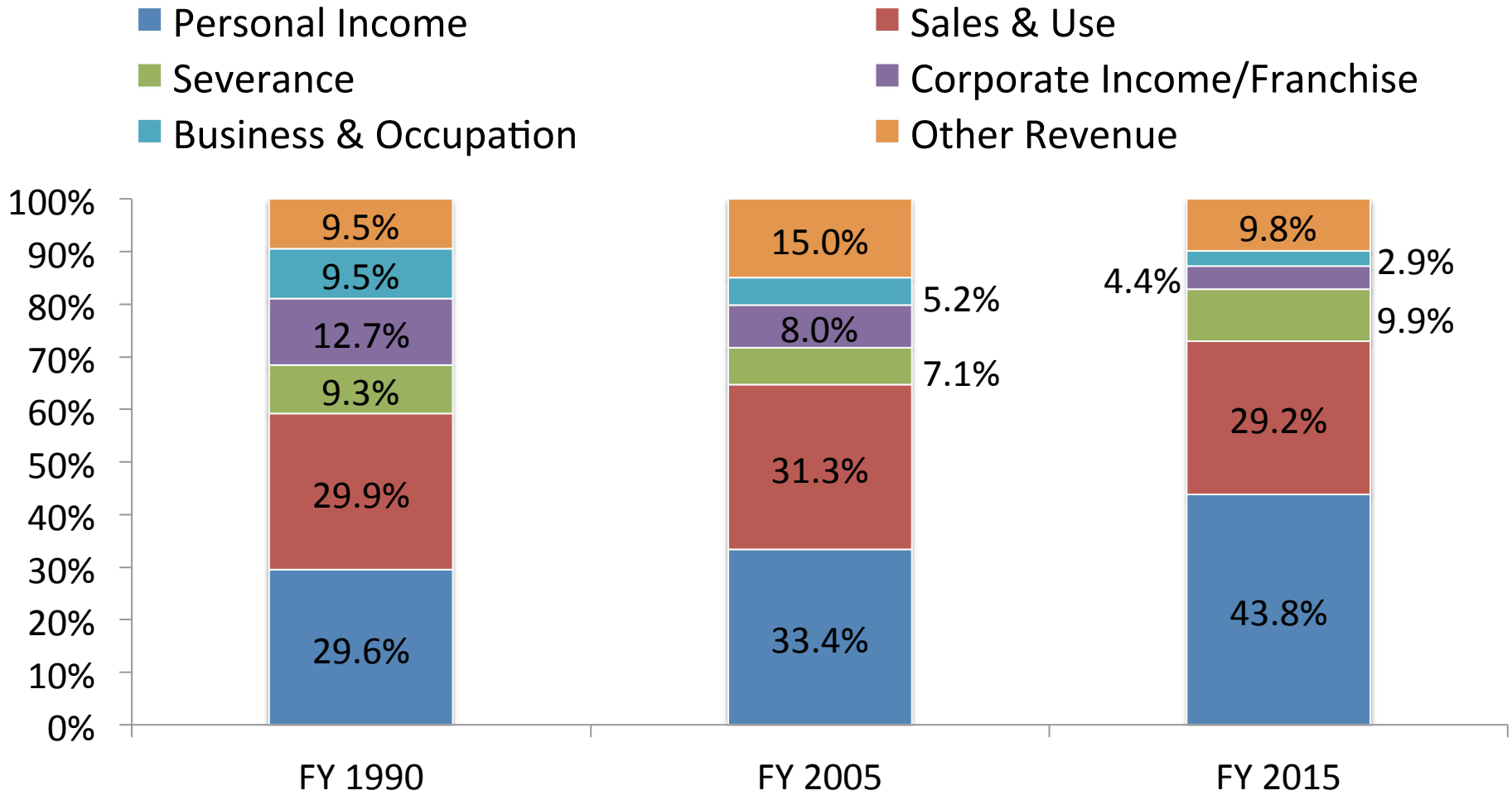
Change in tax revenue from each state's peak quarter, adjusted for Inflation



Source: Pew Charitable Trusts analysis of U.S. Census Bureau, Nelson Rockefeller Institute of Government and U.S. Bureau of Economic Analysis data.

West Virginia relies less on business, more on severance and personal income taxes to fund budget

Revenue as a share of General Revenue Fund

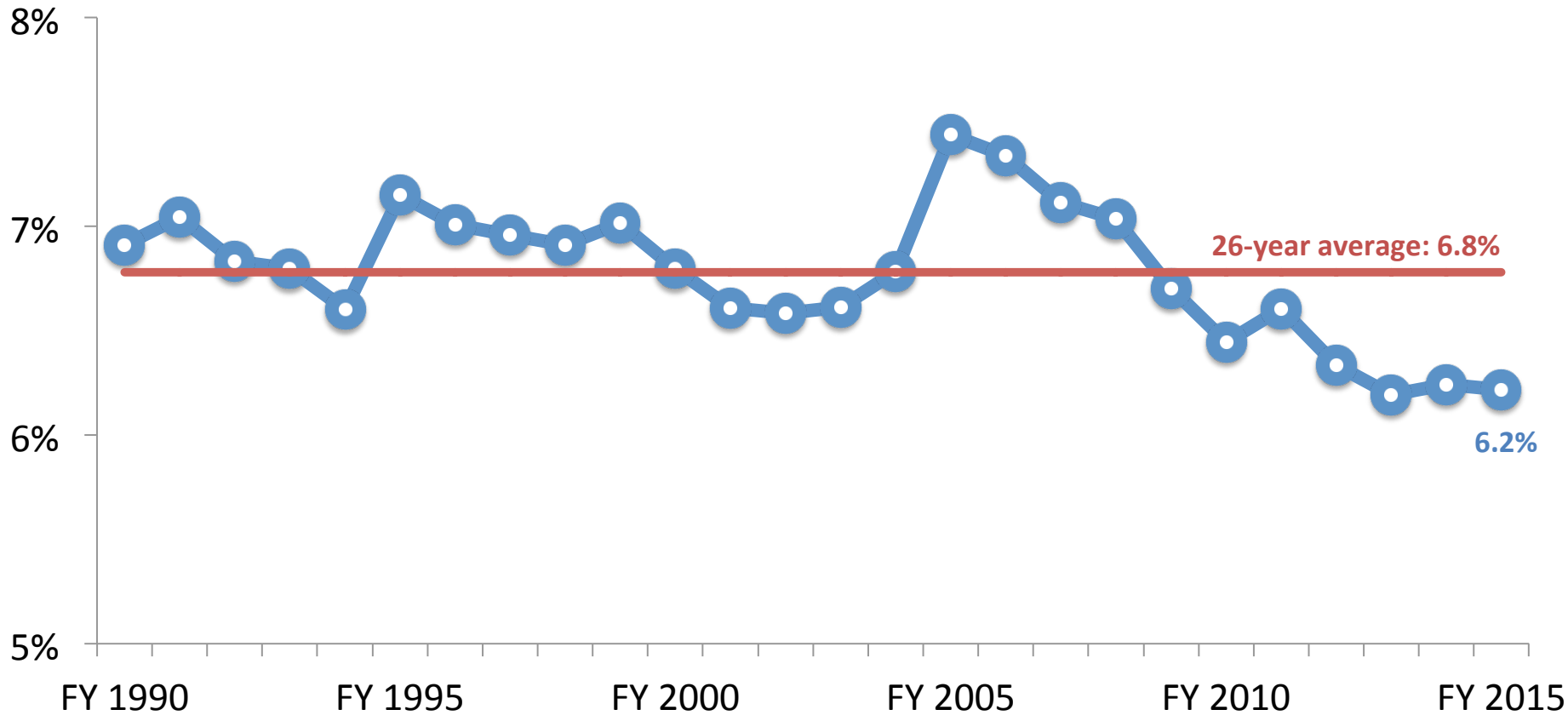


Source: WVCBP analysis of WV State Budget Office data

As state revenue falls relative to economy, WV loses ability to invest

WV General Revenue Fund as a share of state personal income, 1990-2015

At 6.8%, WV GRF collections would have been $445 million more in FY 2015



Source: WVCBP analysis of WV State Budget Office and U.S. Bureau of Economic Analysis data

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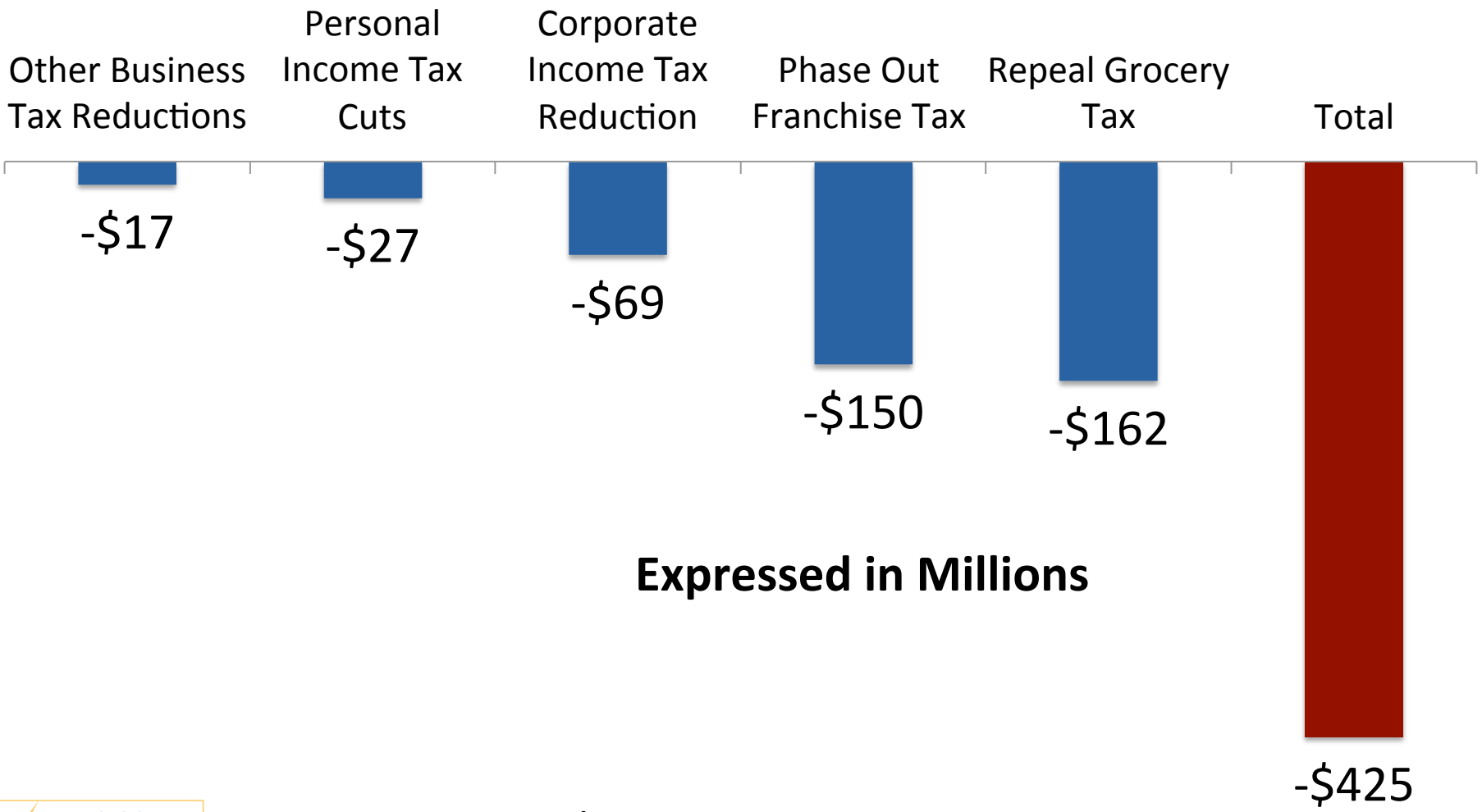
Major tax reductions since 2006 hurting revenue growth



Source: West Virginia Department of Revenue

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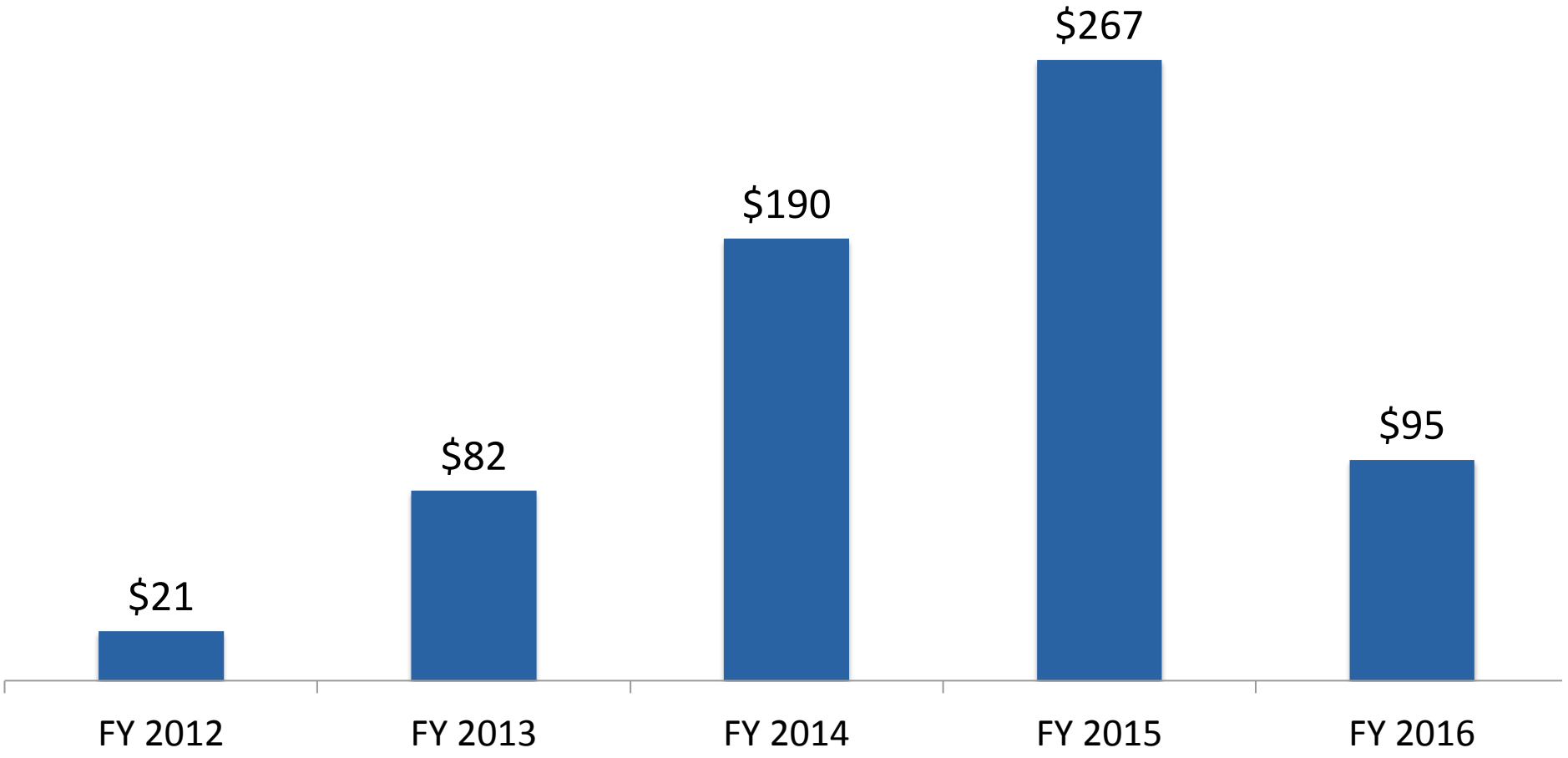
Medicaid has a structural budget deficit

One-time state-source revenue appropriations to Medicaid
(in millions)



Soure: WVCBP analysis of WV State Budget Office data

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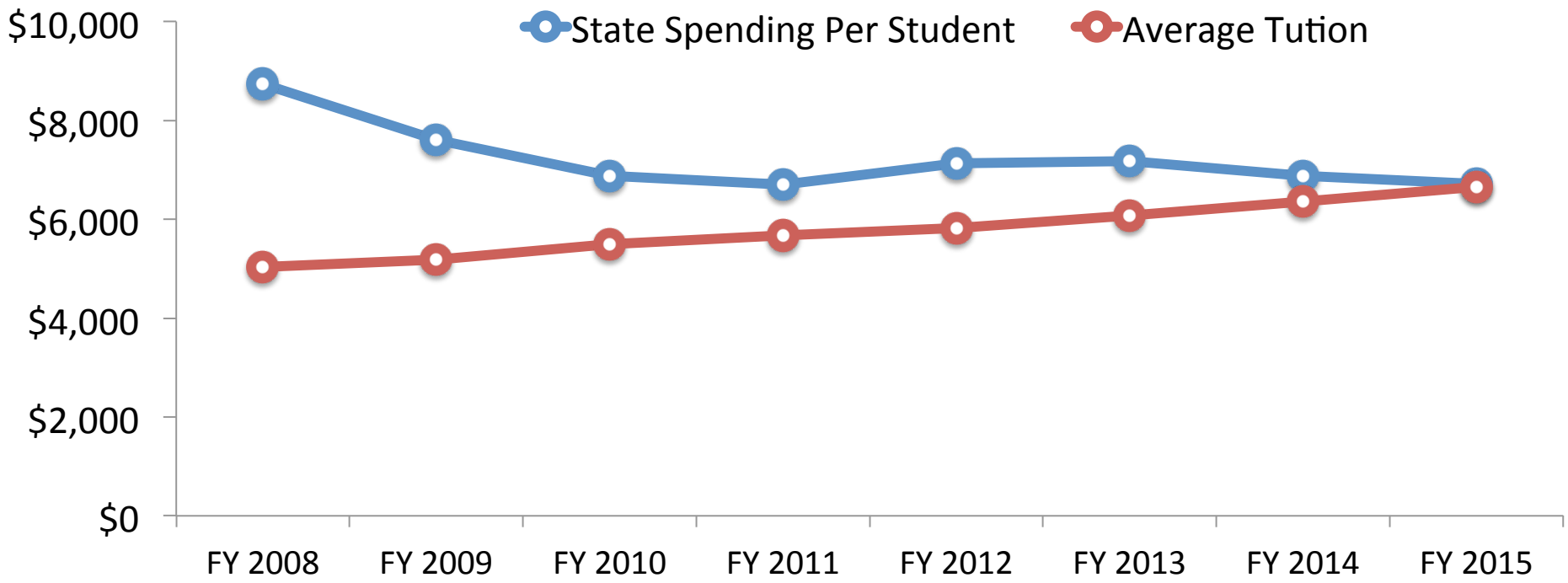
Years of Cuts Threaten to Put College Out of Reach for More Students

Tuition up 32.4% and state funding
down 23% in West Virginia since 2008



Source: Center on Budget and Policy Priorities

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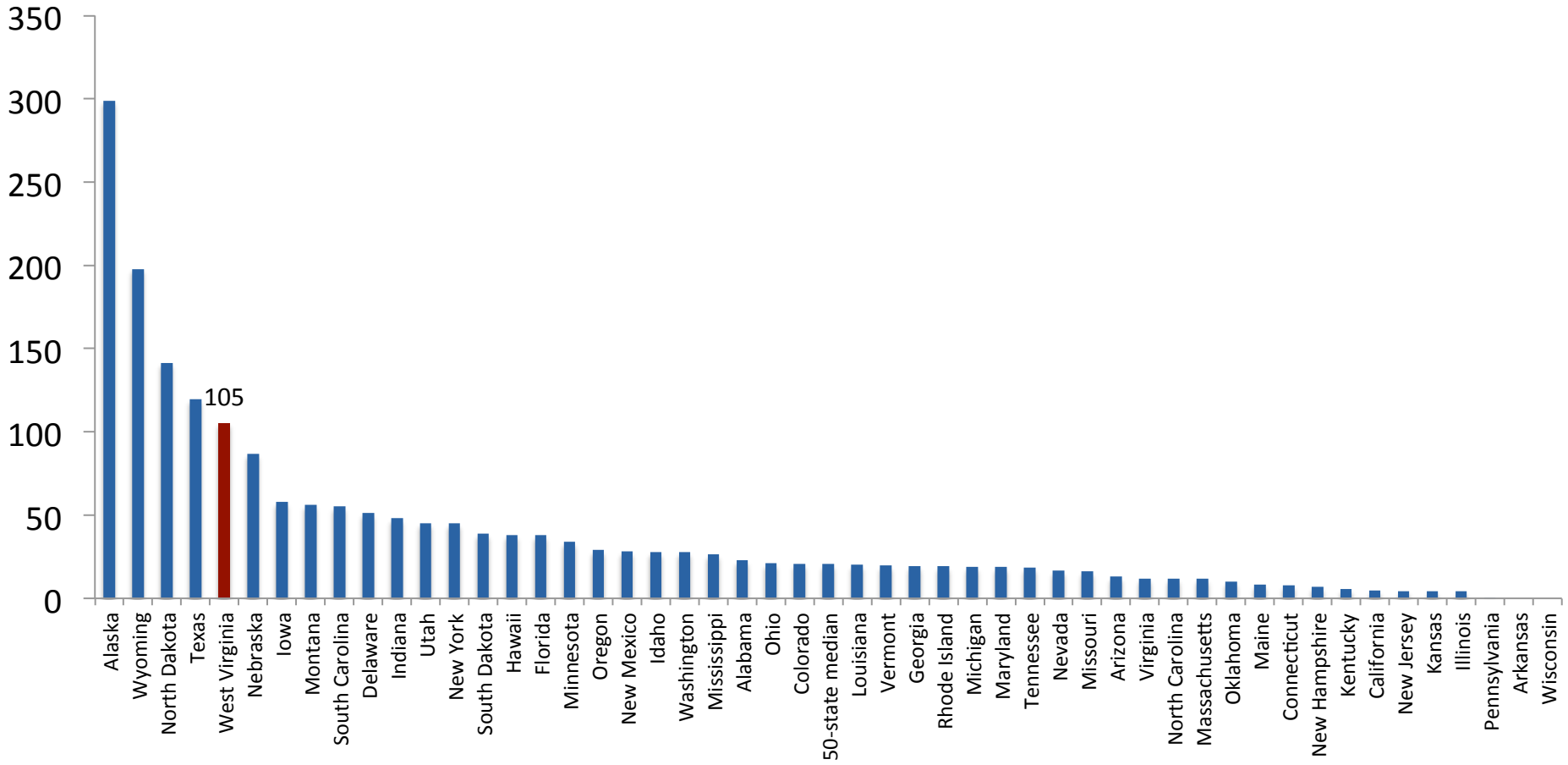
Other major budget challenges

- Public Employees Insurance Agency (PEIA) shortfall of $124 million.
- FY 2016 budget gap of $250 million and FY 2017 budget gap of an estimated $200 million.
- $1 billion in underfunded road maintenance and repair.
- Declining and graying state population.

West Virginia has strong reserve funds

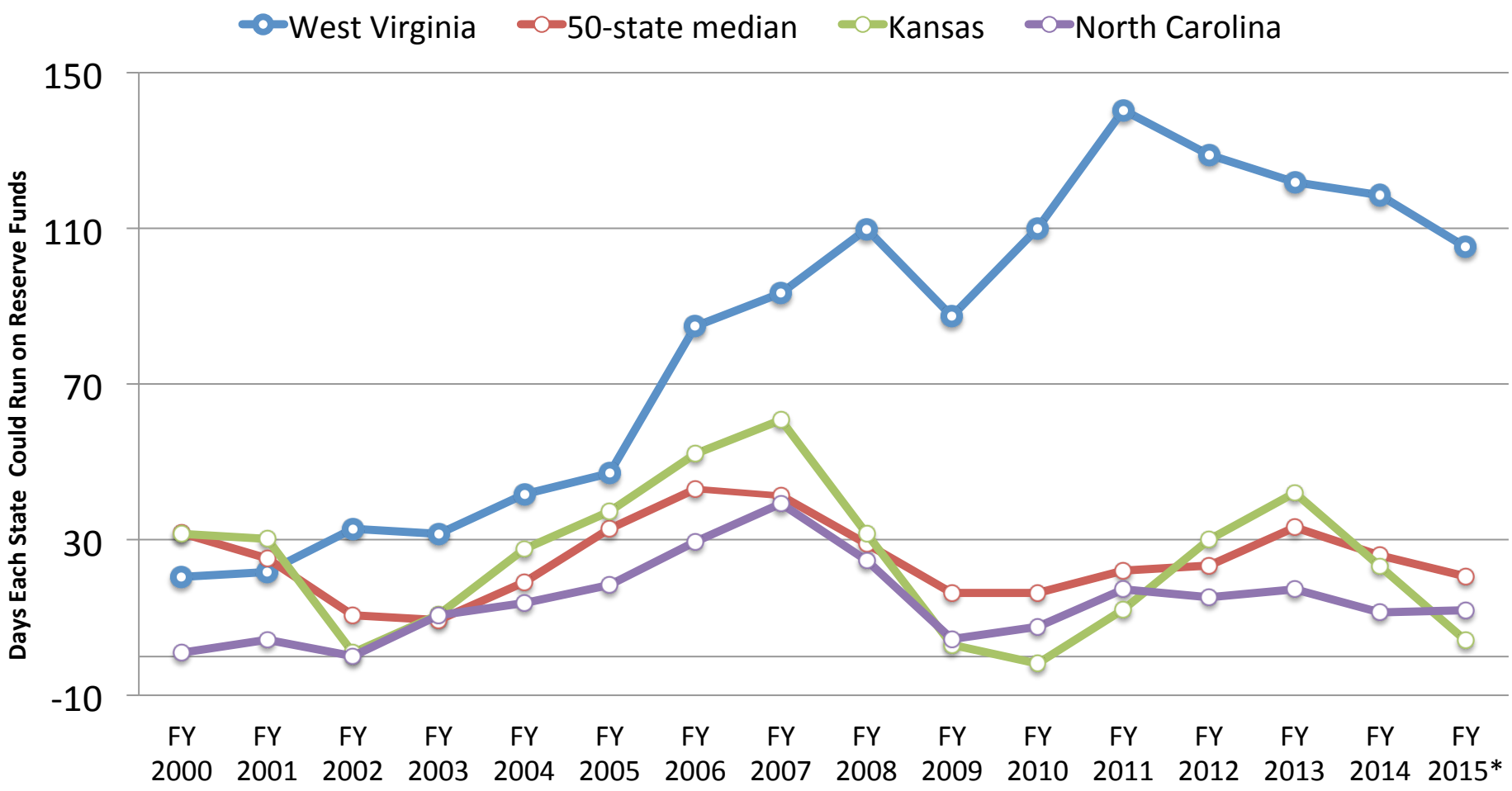
Days' worth of General Fund expenditures in reserve funds, FY 2015



Source: Pew Charitable Trusts analysis of National Association of Budget Officers (NASBO) data

West Virginia reserve funds are declining

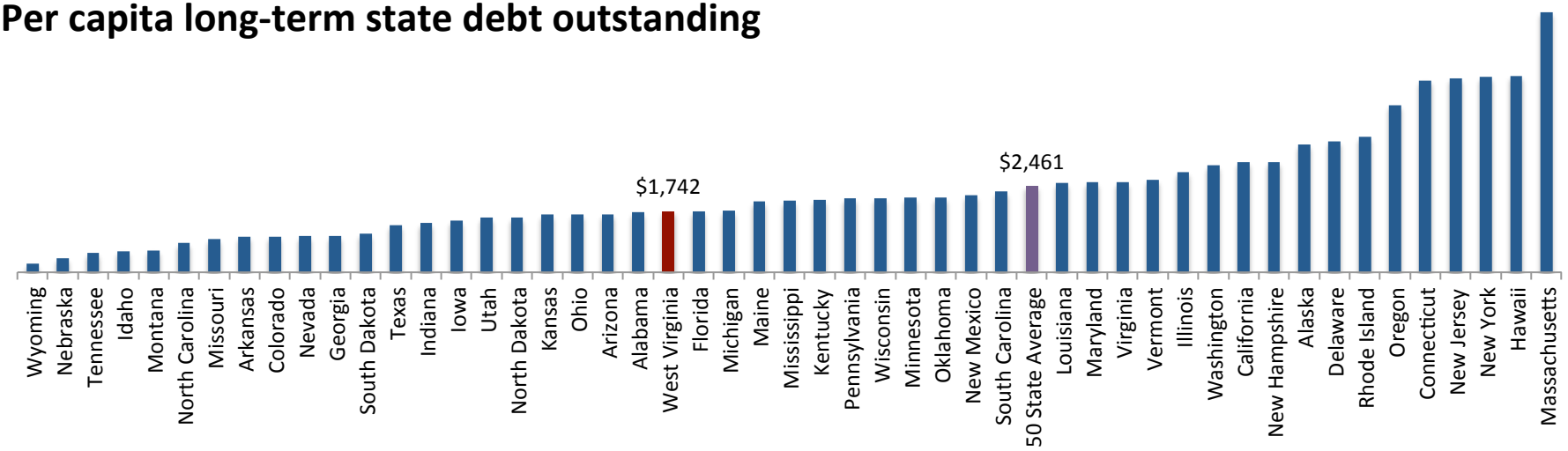
Kansas and North Carolina have weak reserves



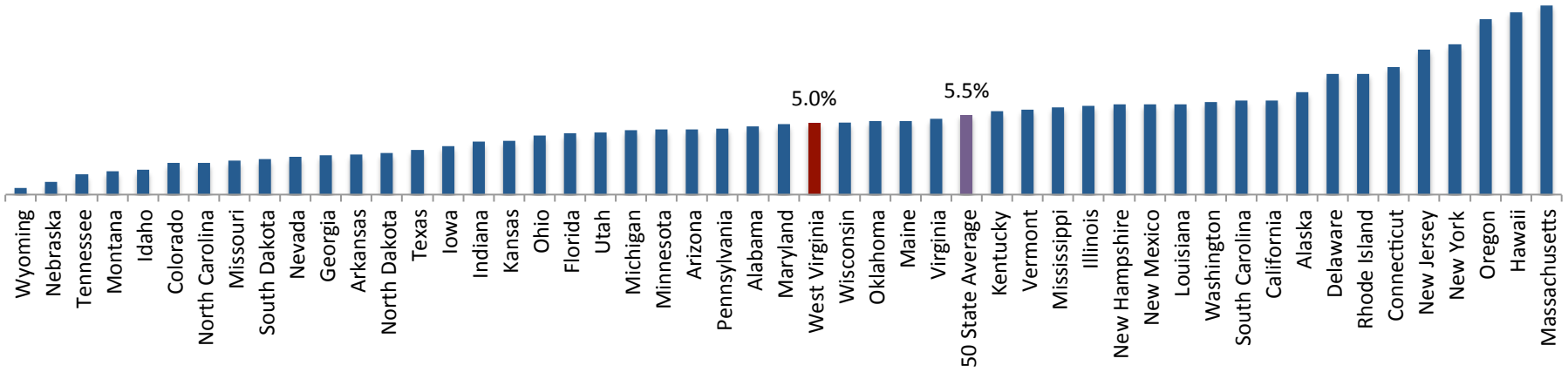
Source: Pew Charitable Trusts analysis of National Association of Budget Officer (NASBO) data
*FY 2015 Estimate

West Virginia's long-term debt is below average (2013)

Per capita long-term state debt outstanding



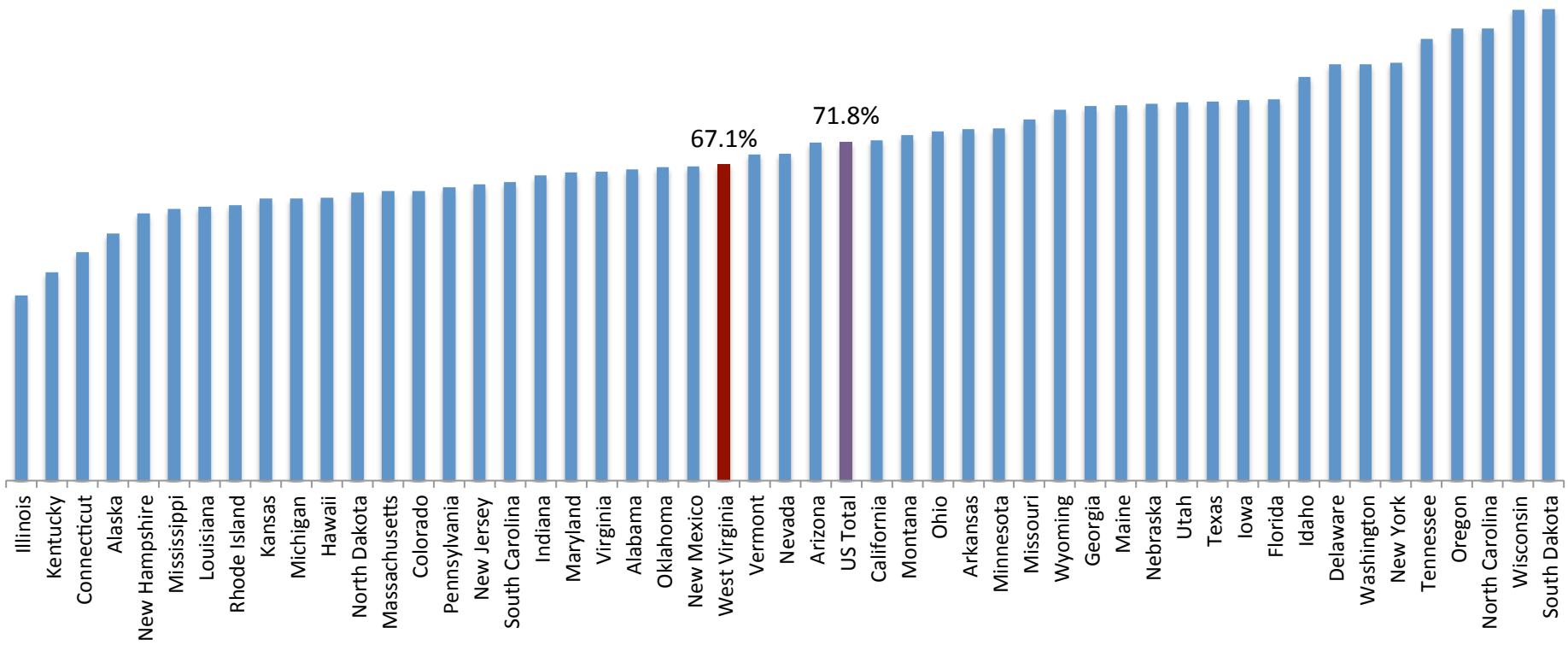
Long-term state debt outstanding as a share of state personal income



Source: WVCBP analysis of U.S. Census Bureau and U.S. Bureau of Economic Analysis data

West Virginia's pension funding ratio below average but greatly improved

Ranking has improved from 50th in 2003 to 27th in 2013



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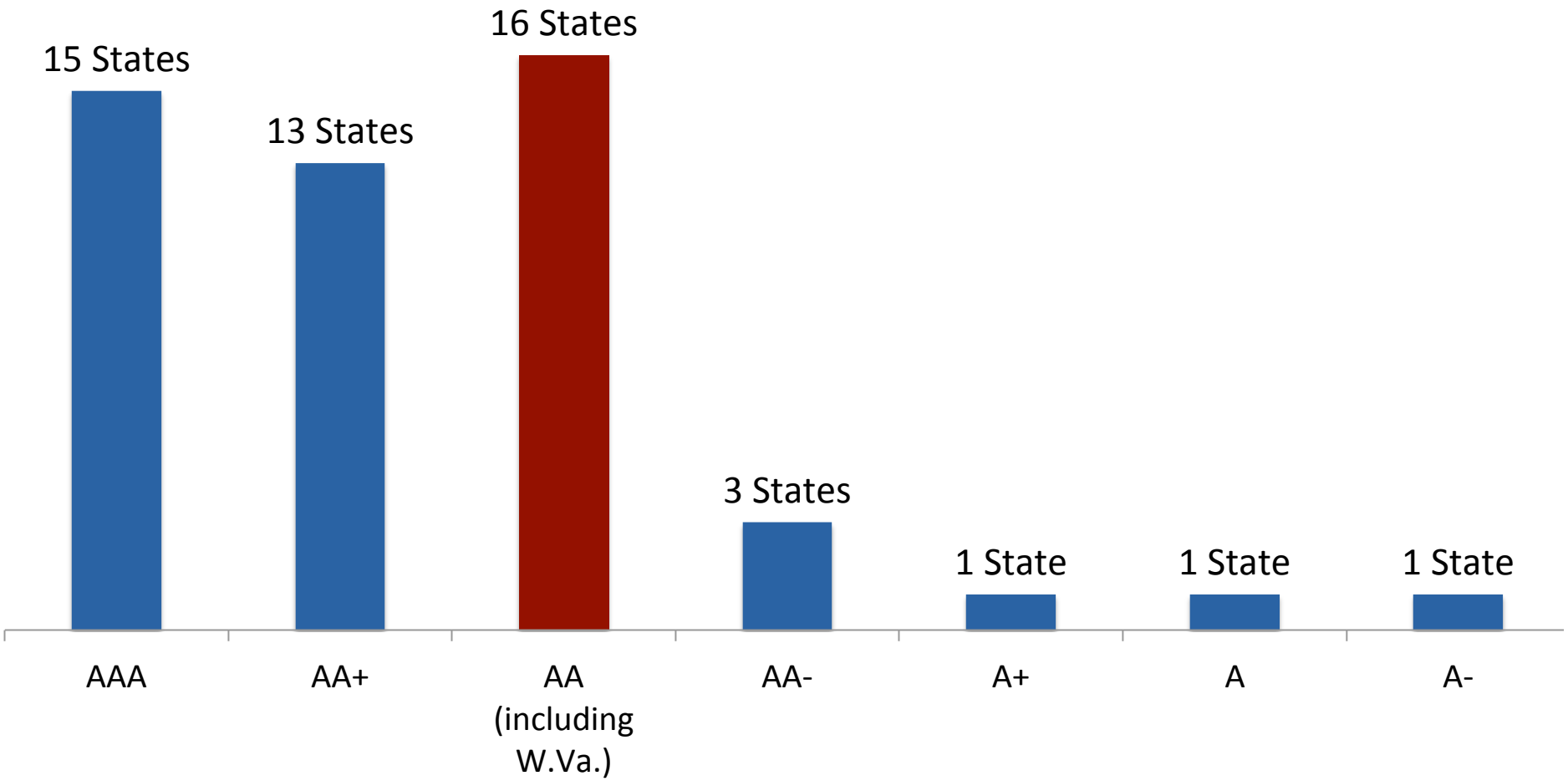
Source; Pew Charitable Trusts

West Virginia's credit score below average

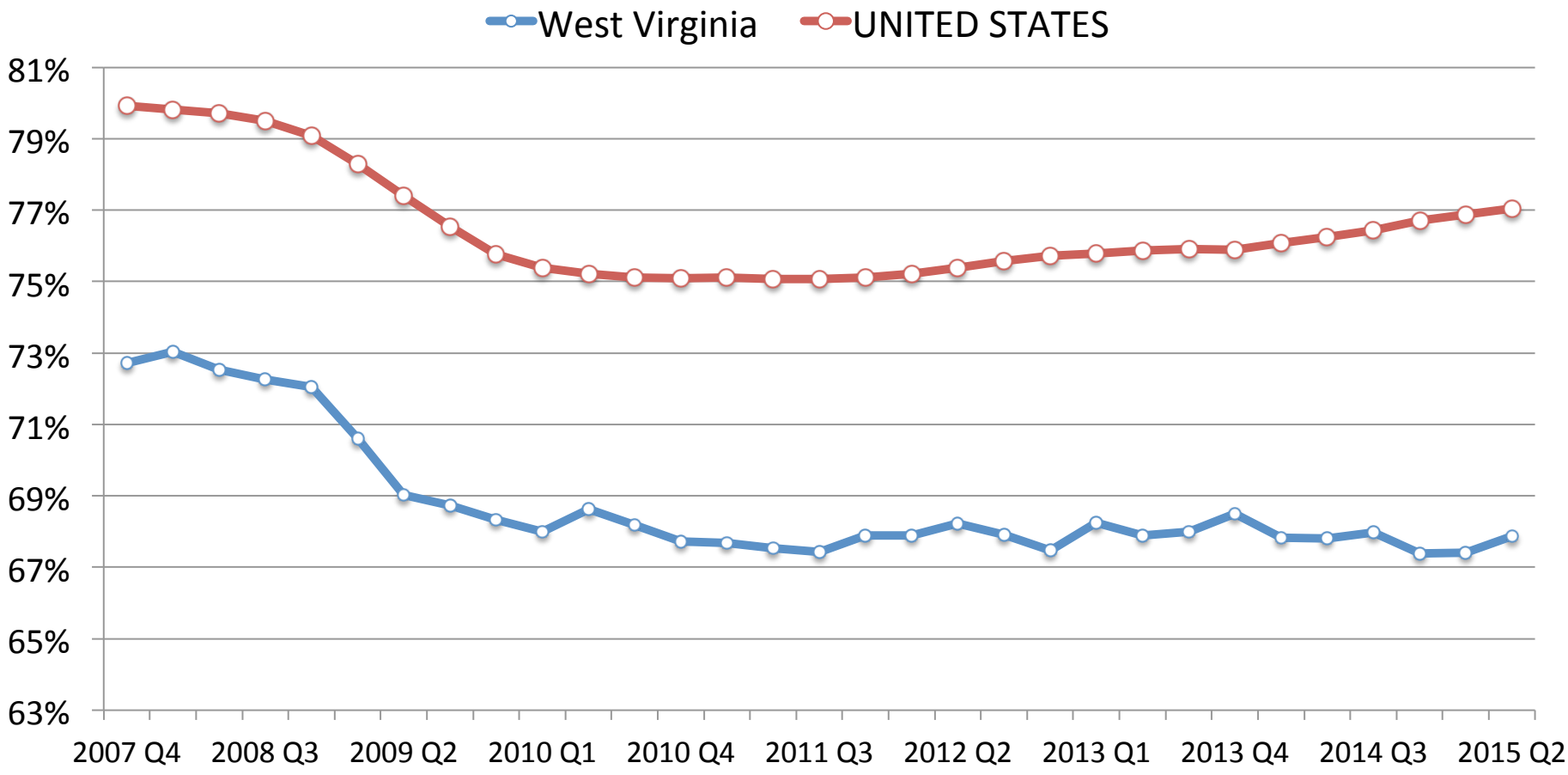
Standard & Poor's (general obligation bonds), 2014



Source: The Pew Charitable Trusts

West Virginia employment rate unrecovered and lowest in nation

Employment to population ratio for those 25 to 54 year olds



Source: Pew Charitable Trusts

Tax Policy Principles

- **Equity**: A fair and equal tax system is one that demonstrates both "vertical" and "horizontal" equity.
  - Vertical equity means people with a greater ability to pay should pay more.
  - Horizontal equity means people in similar situations with the same ability to pay should pay equally.
- **Adequacy**: An adequate tax system raises enough funds to sustain the level of public services demanded by citizens and policymakers in the short and long-term. Two factors that contribute to adequacy of a tax are stability and elasticity.
  - **Stability** means tax revenue grows at a predictable rate (e.g. property tax) and **elasticity** is whether growth in a specific tax keeps up with the economy (e.g. personal income tax).

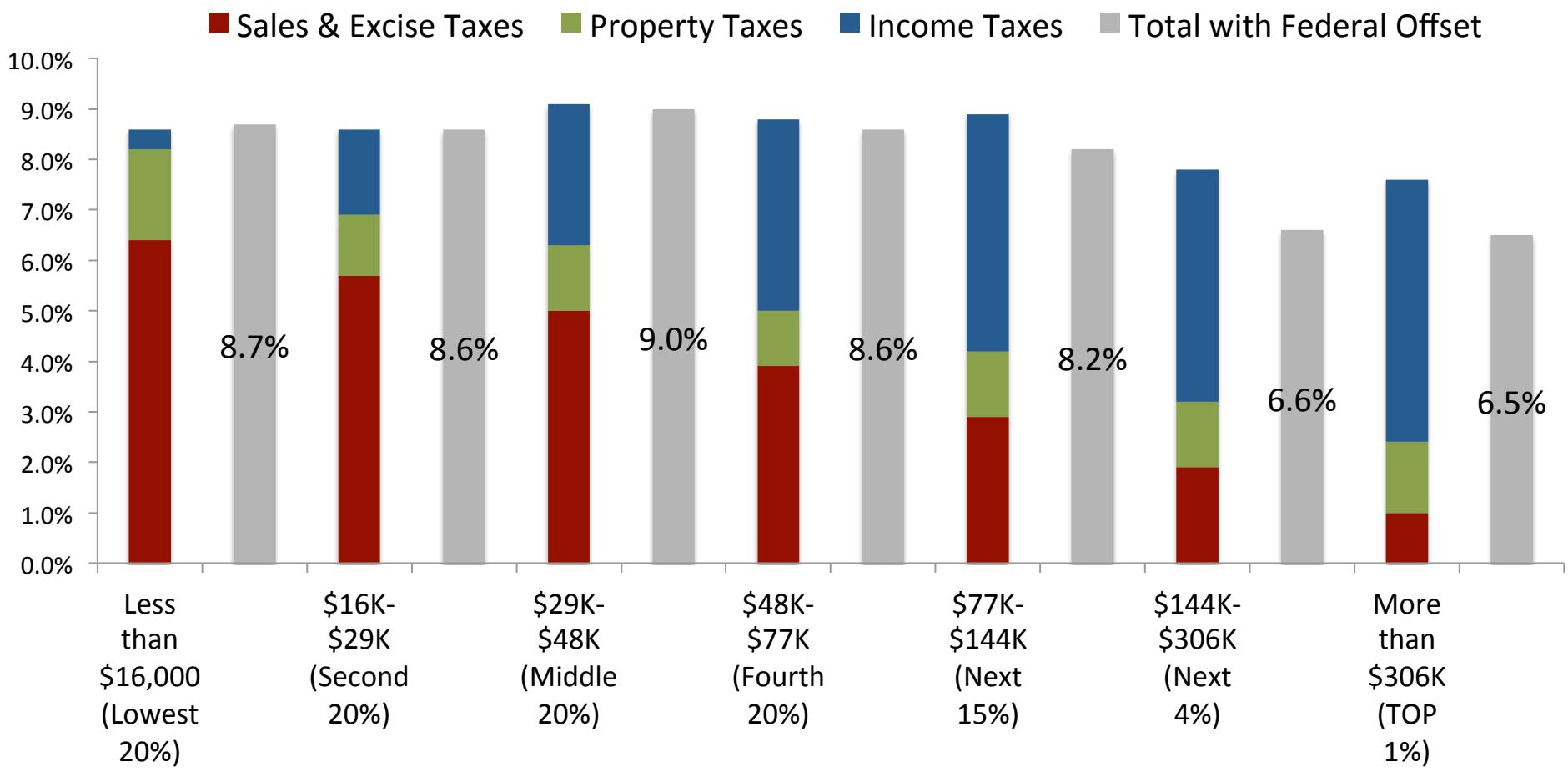
Tax Policy Principles Con't

- **Simplicity & Transparency**: A tax system should be easy to understand, accountable, and transparent. Taxpayers should not have to navigate through complex requirements. Simple tax systems have fewer loopholes.
- **Exportability**: Ensuring that individuals and companies based in other states who benefit from our state's public services pay their fair share (e.g. Motor Fuel Tax).
- **Efficiency**: An efficient tax system encourages neutrality by staying out of the way of economic decisions. In other words, tax rules should not favor one industry or investment over another. For instance, a book purchased online should be subject to the same sales tax rate as a book bought at a local bookstore.

WV has an upside down tax system

West Virginia state and local taxes as a share of income

Non-Elderly Families, 2015



Source: Institute for Taxation and Economic Policy, Who Pays? 2015

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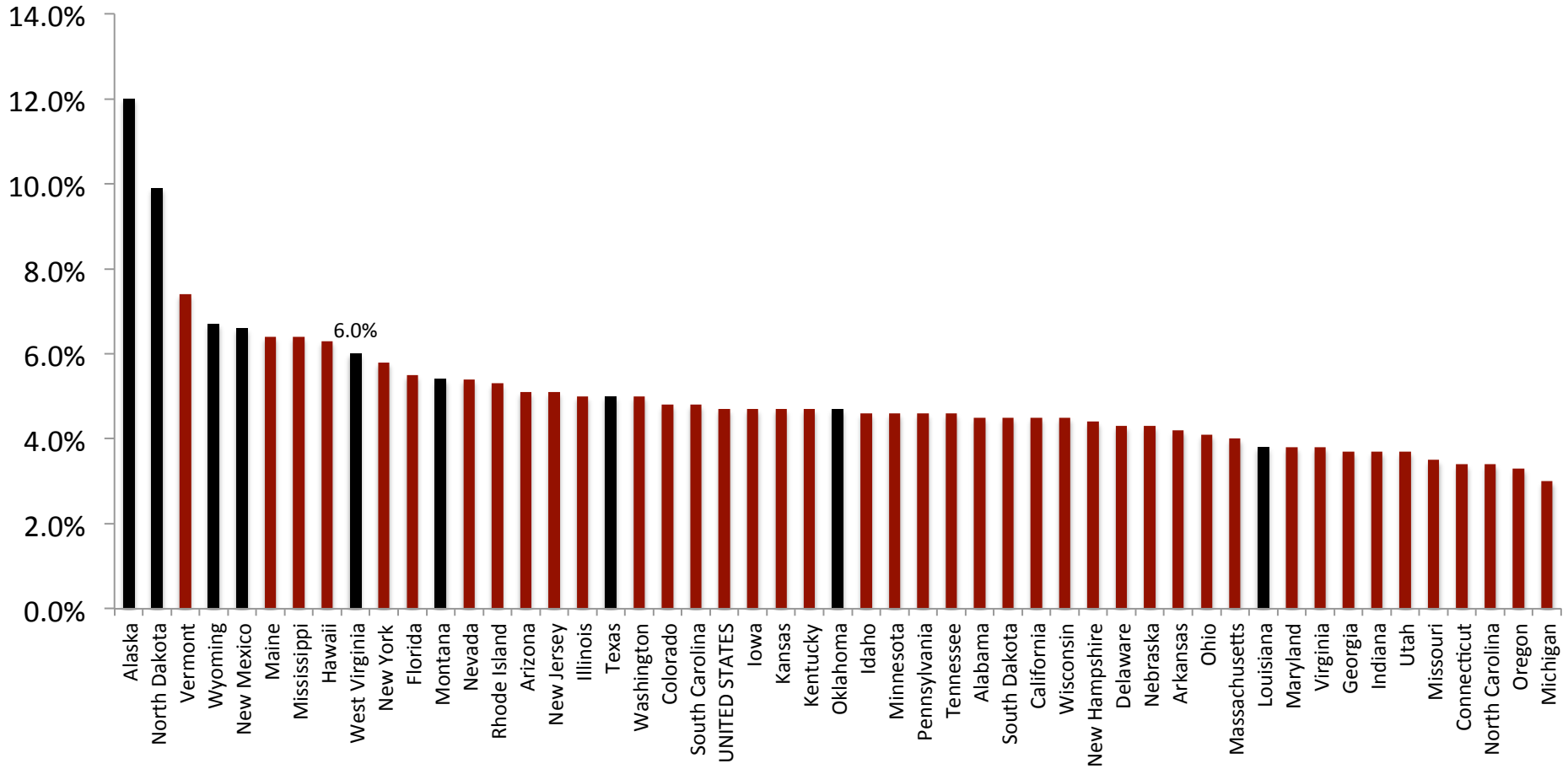
Natural resource extraction states tend to have higher business tax rates

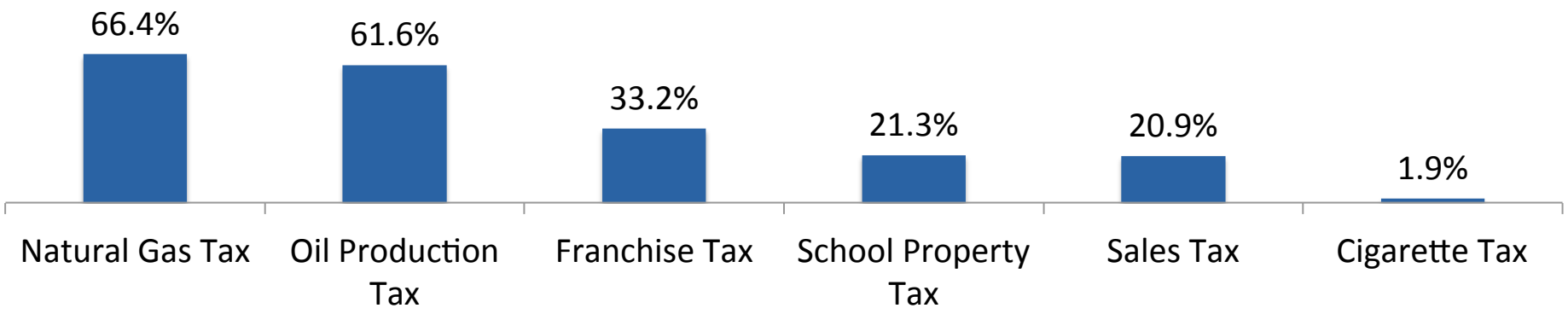
Business taxes as a share of private-sector GDP (2013)



Source: Council on State Taxation, August 2014

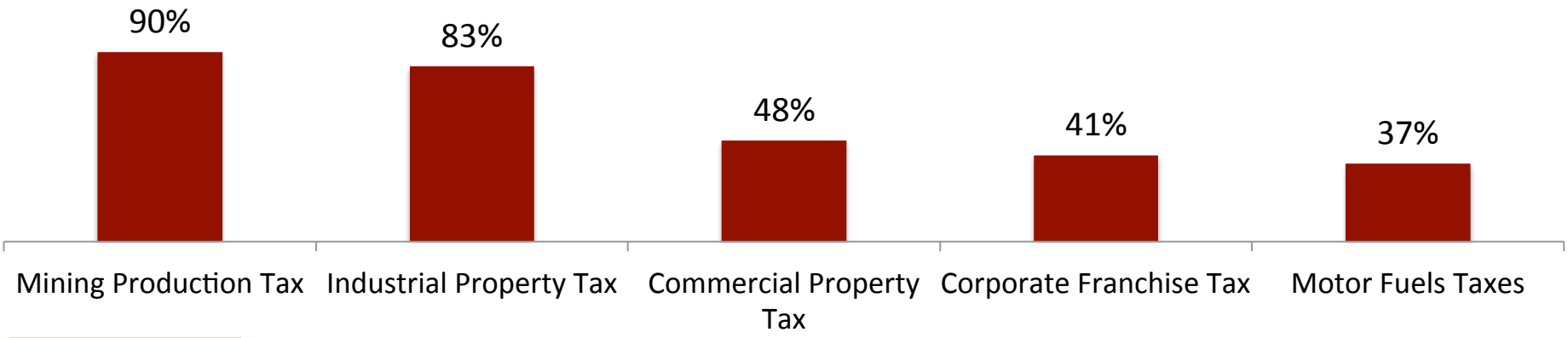
Natural resource production taxes and many business taxes are highly exportable

Percent of Texas taxes paid by non-Texans



Source: Tax Exemptions & Tax Incidence, March 2015, Texas Comptroller

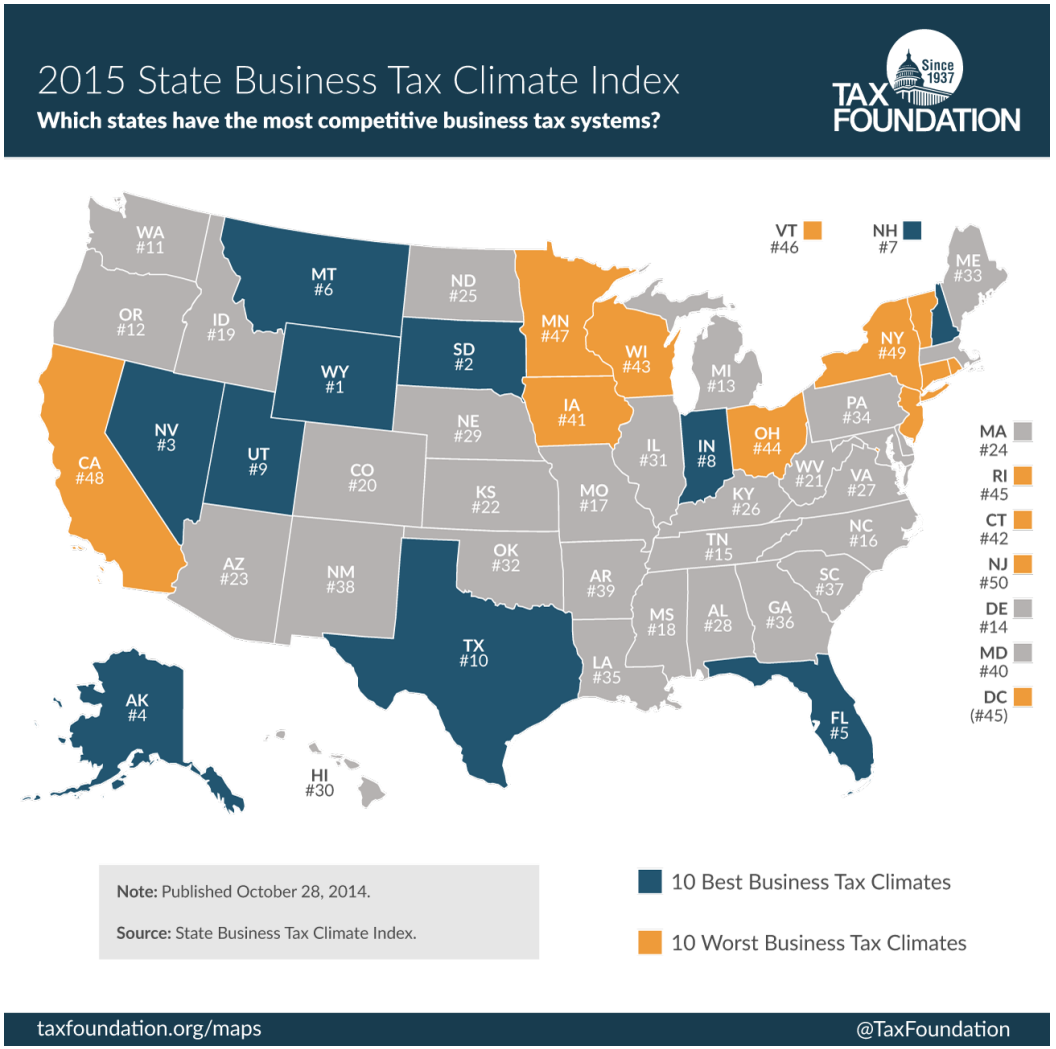
Percent of Minnesota taxes paid by non-Minnesotens



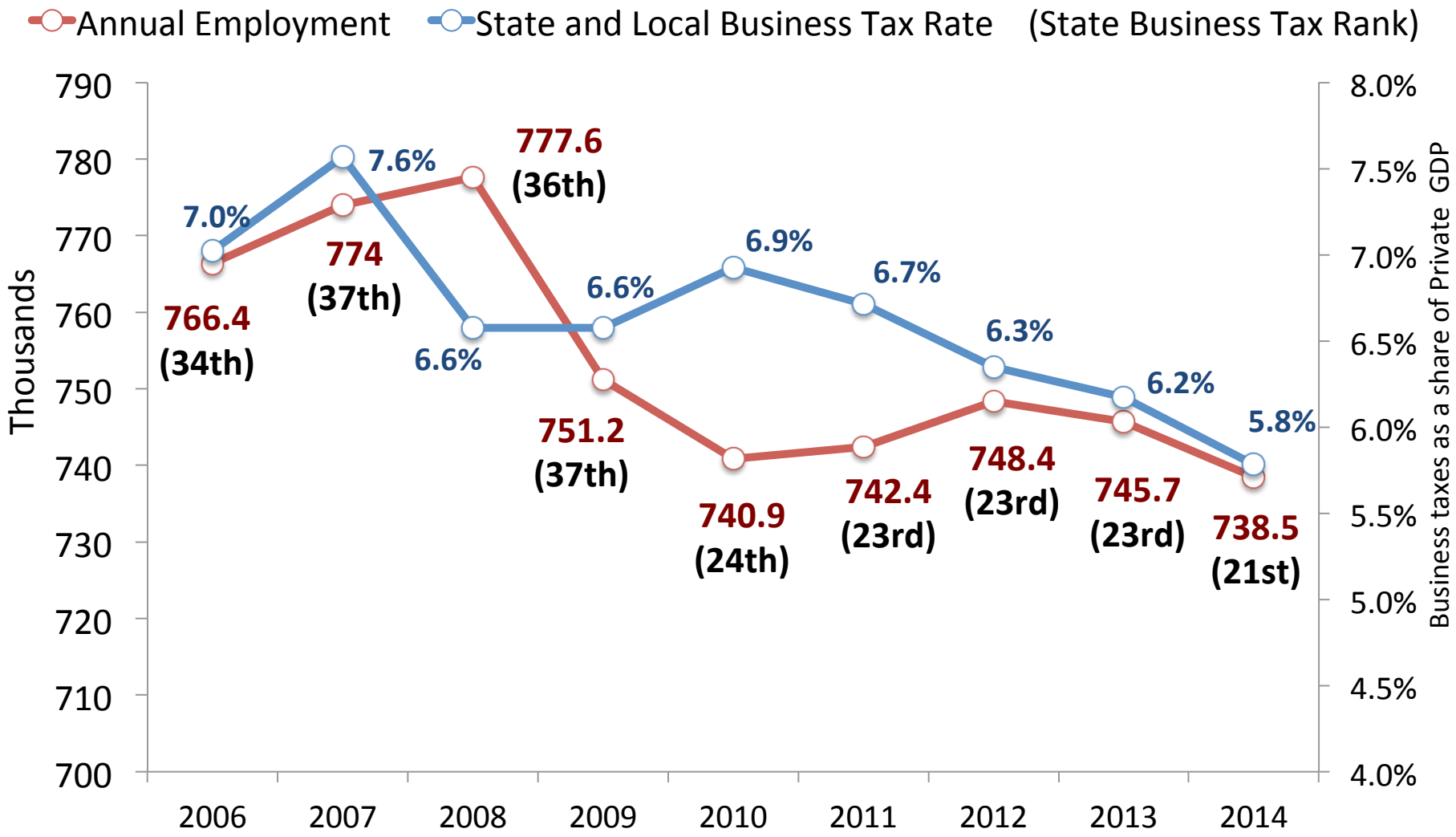
Source:2015 Minnesota Tax Incidence Study. March 9, 2015 Minnestota Tax Research Division

Tax Foundation adjusts for exportability of severance taxes when calculating business tax index

Exportability explains (in part) how natural resource states have higher business tax rates but can have "competitive business tax systems."



Large business tax cuts and improving "business tax climate" not corresponding with job growth in West Virginia



Source: U.S. Bureau of Labor Statistics (LAUS), Council on State Taxation, and Tax Foundation

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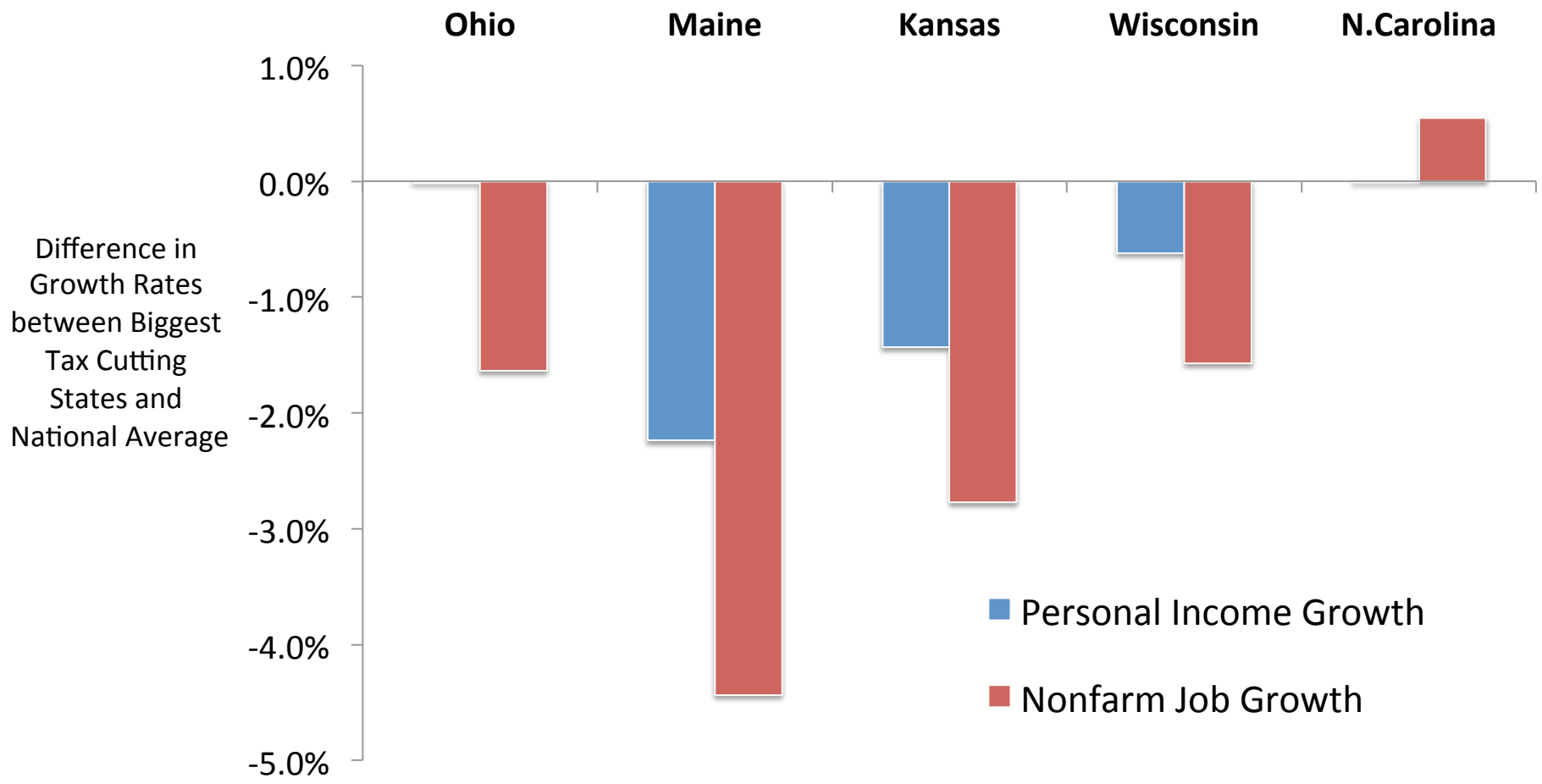
Biggest Tax Cutting States Not Seeing Economic Boom

Total nonfarm and personal income growth since the tax cuts took effect



Source: U.S. Bureau of Labor Statistics, August 2015, and U.S. Bureau of Economic Analysis, 1st Quarter of 2015
Note: Effective dates for tax cuts are June 2013 for Ohio, January 2012 for Maine, January 2013 for Kansas, January 2013 (retroactive from June 2013) for Wisconsin, and January 2014 for North Carolina. For personal income growth, period starts quarter before tax cuts effective and for nonfarm employment month before tax cuts enacted.

Link Between Tax Cuts & Economic Growth

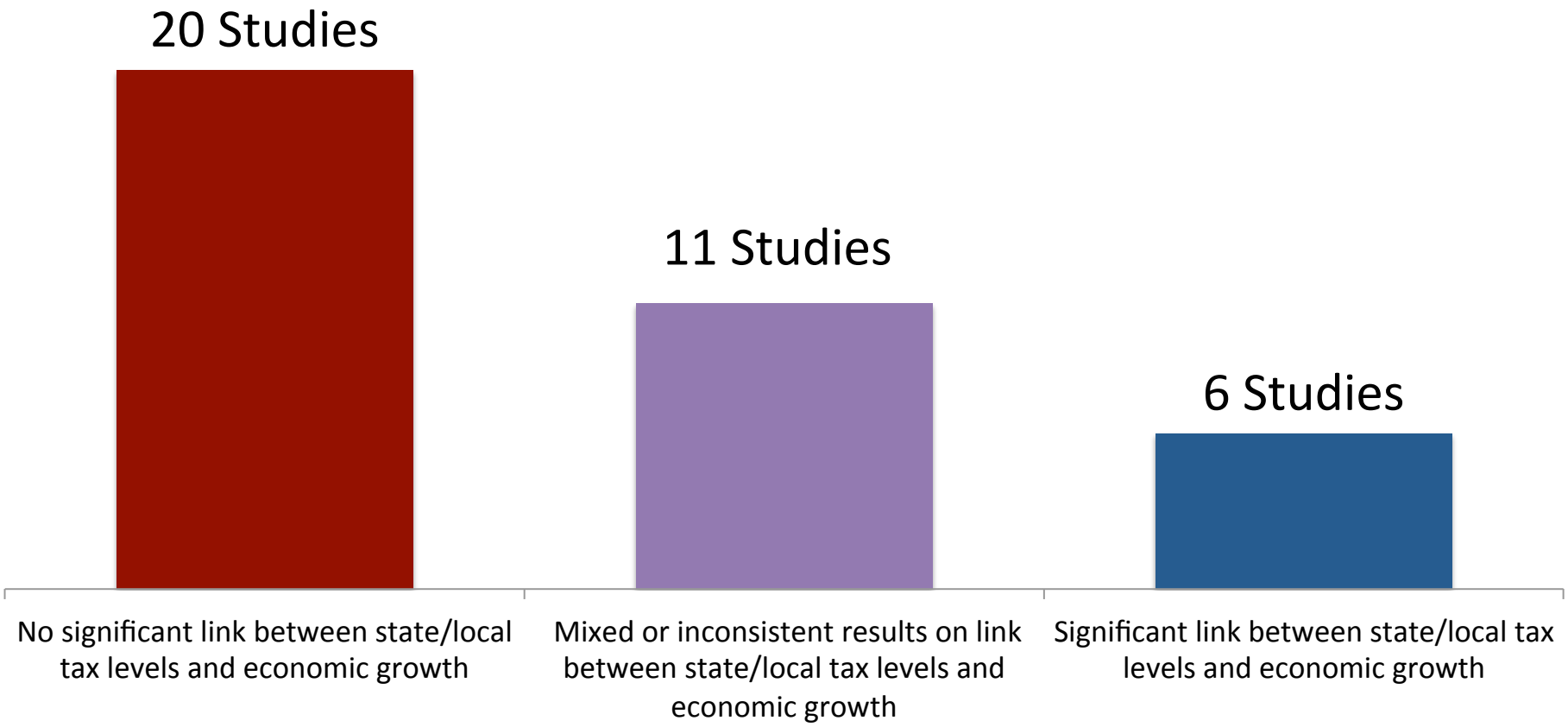
There is no consensus whatsoever that cutting taxes is a good strategy to boost state economic growth and create jobs.

"Clearly, taxes affect behavior; they affect some behaviors more than others. What has not been established is that the level of taxes has a clear and important impact on economic growth. And one reason is that this is not a well-posed question. How government activity affects prosperity depends not only on the level of taxes, but also on what the money is used for."

-- University of Michigan tax economist Professor Joel Slemrod

Most academic research shows state tax levels have little or no impact on economic growth

Number of peer-reviewed articles in academic journals and books since 2000



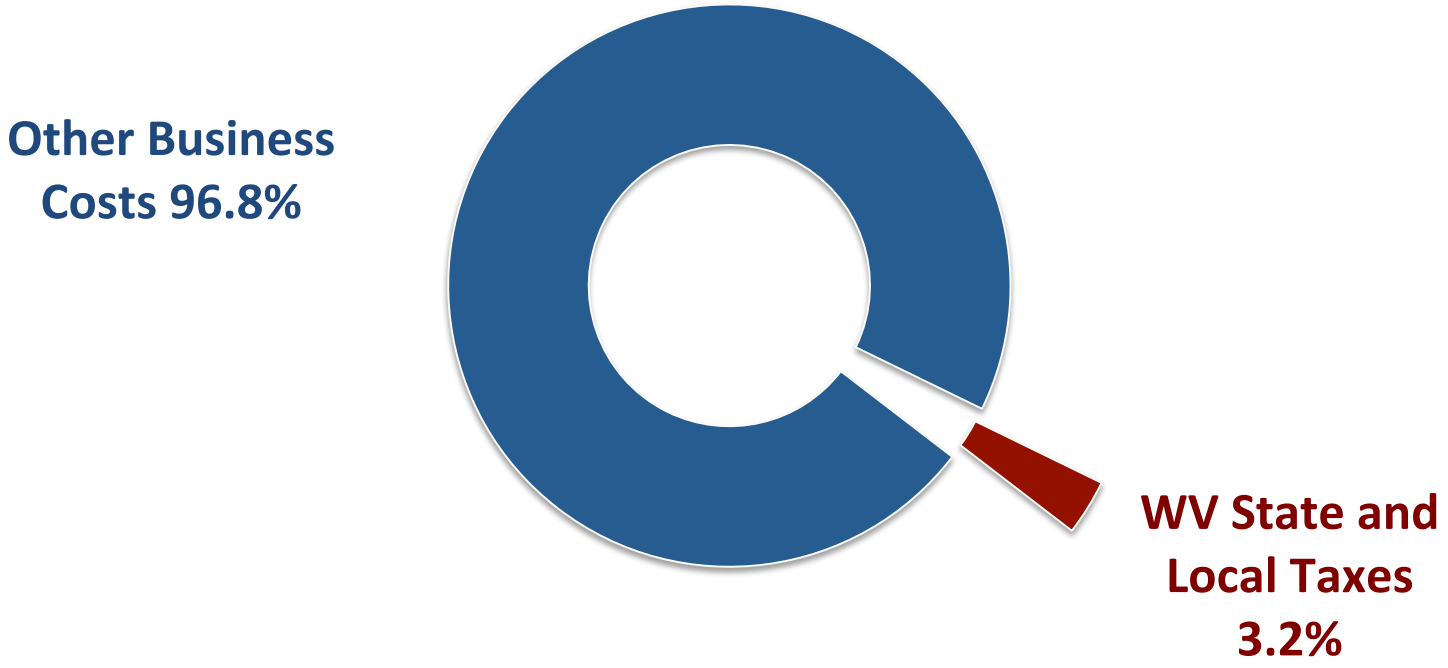
Source: West Virginia Center on Budget and Policy and Center on Budget and Policy Priorities

Why don't business tax cuts work?

The cost of labor, electricity, property, equipment, raw materials and transportation are very often more substantial costs for businesses than taxes and can have a greater impact on profit margins - especially in different states.

Business Taxes Small Share of the Cost of Doing Business

(Source: WVCBP analysis of 2012 IRS, COST, and BEA data)



A skilled and knowledgeable workforce is a higher priority for businesses

- A recent report from the **Center for Business and Economic Research at the University of Kentucky** asked the question, why does Kentucky, a state similar to West Virginia, lag behind the rest of the south when it comes to economic growth? Of all the factors examined in the report – taxes, infrastructure, the size of government, business climate, etc. – *the biggest factor in Kentucky's poor economic performance was its stock of knowledge, particularly its low levels of education among its workers.*
- For businesses looking to locate or expand into a state, the quality of the workforce is one of the most important factors. A survey of corporate executives by **Area Development Magazine** found that *availability of skilled labor was second only to highway accessibility* in the most important site selection factors for businesses.
- Many factors other than taxes can influence state economic growth and business investment, including climate, workforce, regulations, energy prices, economic recessions, federal and monetary policy, quality of life and amenities, consumer demand, public infrastructure and transportation, available sites, proximity to markets and suppliers, access to raw materials, and more.

Source: West Virginia Center on Budget and Policy, Fast Facts

West Virginia Property & Local Tax Options

- **Gradually Restore Regular Education Levy Rates**: The tax rates are nearly 15.5% lower than the rates in place prior to 1992 (*Recommendation was included in WV Early Childhood Planning Task Force, September 2014*).
- **Modernize Excess Acreage Tax**: Since 1905, a corporation purchasing more than 10,000 acres or more of real property in the state is subject to a one-time five cents per acre tax on owning the property. In 1999*, Governor Underwood's Commission on Fair Taxation* (3-694) recommended increasing this tax to 50 cents per acre, making it an annual tax, lowering the threshold to 1,000 acres and allowing a credit against the state's severance tax. Consider a graduated rate structure starting at 50 cents per acre (1,000-2,499) and ending at $5.00 per acre above 250,000 acres. Potential yield = **$10.6 million annually**.
- **Close the Online Hotel Tax Loophole**: West Virginia allows online travel companies like Expedia, Orbitz, and Priceline to collect taxes on only part of the sales taxes due on hotel room bookings. This costs local governments in West Virginia an estimated **$1 to $2 million annually**.

West Virginia Sales & Use Tax Options

- **Expand Sales Tax to Include Digital Downloads**: West Virginia has not updated its sales taxes to cover various goods and services sold and delivered on the internet - including software, music, movies, games, and books – even though West Virginia taxes the sale of identical items sold in physical stores. Estimated yield is **$3.7 million** annually.
- **Expand Sales Tax to Include Barber Shops, Beauty Salons, Nail Salons, Message & Tattoo Parlors and Fitness Centers**: Over the last several decade West Virginia's economy has shifted from producing goods (e.g. steel) to providing services (e.g. retail), but the sales tax has not modernized to keep up with all of these changes. While West Virginia taxes more services than most states, there are many personal services that are exempt from the sales tax for no discernible reason. Estimated yield is **$5.8** million annually.

West Virginia Income Tax Options

- **Scale Back Personal Exemptions:** West Virginians are provided a $2,000 personal exemption for each household member. Unlike the federal government that phases out its personal exemptions, West Virginia does not. If the $2,000 per person exemption were phased out for joint filers between $150,000 and $200,000 and eliminated for those over $200,000, it would increase revenue by an estimated **$9.9 million** and improve the progressivity of our state's personal income tax.
- **Modernize Personal Income Tax Rates & Brackets**: West Virginia's personal income tax schedule has not changed since 1987, when the state's top personal income rate was reduced from 13 to 6.5 percent. West Virginia should adjust its brackets and rates to better reflect modern income levels. This could include adopting a new bracket for higher-income earners and perhaps even lower rates for low and middle-income residents. For example, a new top bracket of 7.4 percent on taxable income above $150,000 would increase revenue by an estimated **$44.8 million.**
- **Create a refundable state earned income tax credit (EITC):** Twenty-six states and the District of Columbia have enacted earned income tax credits to supplement the federal EITC. The EITC is a proven tool to fight poverty, increase labor force participation, help low-income working families make ends meet and has lasting effects such as improving the health, educational achievement, and earnings of children that are EITC recipients. A refundable WV EITC at 15% of the federal credit would **cost approximately $45 million.**
- **Reinstate the Estate Tax:** First enacted in 1904, West Virginia's estate tax effectively ended in 2005 when the state did not decouple from the federal estate tax changes. Today, 21 states collect over $4.5 billion per year from their estate tax while West Virginia collects next to nothing. Reinstating this tax could raise an average of **$15 to $20 million** per year.
- **Close Tax Haven Loopholes**: While West Virginia has closed several corporate tax loopholes by enacting combined reporting, it did not include offshore tax havens beyond the U.S. border. West Virginia should replace its "water's edge" with "world-wide" combined reporting to include offshore tax havens. According to the U.S. Public Interest Research Group, this could generate an estimated **$9.6 million.**

West Virginia Severance Tax Options

- **Extend Workers' Compensation Debt Taxes**: According to the governor's budget report, the workers' compensation debt fund will be paid off by 2016. This debt is currently financed by several revenues sources, including a severance tax on coal (56 cents per ton), natural gas (7.7 cent per MCF), and timber (2.78 percent of gross value). Altogether, these taxes yield about **$80 to $100 million** per year. Because the severance tax is highly exportable, and West Virginia under taxes its mineral wealth compared to many western states, it makes sense to extend all or part of these taxes to help balance the budget and fund important public investments (e.g. roads) and economic diversification.
- **Explore Taxing Exported Shale Gas at a Higher Rate**: A new severance tax incentive, based on a higher rate for natural gas liquids, with a credit to related in-state industries, may encourage ethane cracking and other chemical manufacturing to create in-state jobs while generating additional tax revenue for investment in infrastructure and human capital. If West Virginia increased its severance tax on natural gas liquids from five to ten percent, it would increase revenue by an estimated **$168 million over the next five years**. A portion of this revenue could go into the WV Future Fund.
- **Fund the West Virginia Future Fund**: Legislation passed last year creating the West Virginia Future Fund contained several triggers that have to be met in order for the fund to receive severance tax revenues. The triggers should be removed to allow the fund to build.

West Virginia Lottery & Sin Tax Options

- **Scale Back or Eliminate Greyhound Breeding Subsides**: A recent audit found that the **$29 million** in annual lottery revenue that is used to subsidize greyhound racing in the state only yielded $30 million in sales. The audit concluded, "West Virginia could put the casino supplements to better use for the benefit of West Virginians." Lawmakers should explore drastically scaling back or ending this subsidy.
- **Increase the Tobacco Tax**: The tax on cigarettes was last increased over a decade ago and West Virginia currently has the 46th lowest cigarette tax among the 50 states. West Virginia also has a very low tax on non-cigarette tobacco products. Increasing the cigarette tax to $1.55 per pack and increasing the tax on other tobacco products to 50 percent of wholesale price would provide an estimated **$137.2 million** in additional revenues. Additionally, it could drastically reduce health care costs and prevent deaths, teen smoking, and other chronic health conditions associated with tobacco use. West Virginia could also begin taxing E-Cigarette products. For example, Minnesota taxes electronic cigarettes, and e-juice that contains nicotine, at 95 percent of their wholesale price.
- **Raise Taxes on Alcohol Sales**: West Virginia should explore raising state tax rates on liquor and beer, including raising the sales tax on liquor from five percent to six percent. Increasing the beer barrel tax from $5.50 per barrel to $11.00 per barrel would increase revenue by an estimated **$7.1 million**, and requiring the Alcohol Beverage Control Administration to set higher wholesale prices on liquor and wine could yield an additional **$6.5 million** to the General Revenue Fund.

Improving Transparency & Accountability

- **Tax Expenditures:** While West Virginia is currently not doing enough to properly evaluate its business tax expenditures, there are several ways the state could dramatically improve its evaluations. The WV Tax Credit Review and Accountability Report, the Tax Expenditure Study, and the WV Tax Credit Disclosure List should be published on an annual basis. Company-specific information pertaining to tax credits and incentive programs – including the recipients, amounts, demographics, and job-related outcomes – should be disclosed. All reports should be published in an online, easily accessible, and searchable database. Information identifying amounts of subsides subject to redetermination should be published, and all major business tax incentives should be subject to these provisions.
- **Require Corporate Disclosure of Taxes**: With the end of the Business Franchise Tax in 2015, many corporations are paying nothing in Corporate Net Income Taxes. West Virginia should explore mandating company-specific corporate tax disclosure by all publicly traded corporations and their subsidiaries doing business here, and explore enacting a corporate minimum tax to ensure that all companies are paying something for the government services they receive.
- **Unified Economic Development Budget:** Five states – Rhode Island, New Jersey, Vermont, Texas, and Illinois – have enacted some type of unified economic development budget to compile all on-budget and off-budget economic spending into a single document. This enables policymakers to see how subsidies are distributed from various public agencies between regions, industries, and companies.

Improving Transparency & Accountability Con't

Improve Fiscal Notes

- Fiscal notes should be reviewed and finalized by a neutral and independent source, rather than the affected agency. Establishing an independent Legislative Fiscal Office or allowing the budget division of the Joint Committee on Government and Finance to produce or oversee fiscal notes would eliminate the potential for agency bias. Agencies should be encouraged to provide information, but the primary oversight of the fiscal note should be independent.
- The creation and enforcement of written criteria and standards that fiscal notes must meet should also be a key aspect of the oversight role. While legislative staff exercises some oversight of the fiscal note process, it is informal and subjective.
- The legislative rules governing fiscal notes should be revised, ensuring that fiscal notes are standardized, accurate, and comprehensive. Local impacts should be separated from state impacts, and official estimates backed by data need to be distinguished from uncertain estimates based on limited information.
- All fiscal notes should contain an explanation of the method used to produce the cost estimate and the reasons why the method was used. Costs and offsetting revenues should be fully calculated and explained. All fiscal notes should also describe the assumptions used to determine the estimate. While agencies are currently instructed to do this, these explanations rarely make it into the final fiscal note.
- West Virginia should add a feature to the legislature's website allowing for searchable fiscal note tracking. This would ensure that all fiscal notes are easily found and publicly available.

Improving Transparency & Accountability Con't

Enact Consensus Revenue Estimate: West Virginia's process for estimating revenues is tilted too far toward the Executive Branch. Unlike many states, the West Virginia legislature does not work with the executive branch to produce a consensus revenue forecast. When one branch is excluded from this process, key decision makers are more likely to dismiss or dispute the revenue estimates. Creation of an independent Legislative Fiscal Office would provide nonpartisan oversight of the state's budget and create greater balance in the decision-making process. This office could also provide more accurate fiscal notes and estimates of the costs of proposed legislation.

Enact PAYGO: In West Virginia, as in most states, it is impossible for policymakers to know whether proposed program increases or tax cuts are affordable over the longer term. PAYGO or "pay-as- you-go," is a requirement where the governor and the legislature fully offset over a 5-year period the cost of proposed and enacted increases in spending or reductions in revenues through spending cuts or revenue increases. Together with multi-year projections and current service budgeting, PAYGO could help assure that West Virginia does not use temporary spikes in revenues to enact spending increases or tax cuts that they cannot afford over the long term. It could also minimize the need for deep budget cuts and large tax increases when the economy is weak, particularly if the state deposits revenues that cannot be spent under PAYGO rules in a well-designed stabilization fund.

Improving Transparency & Accountability Con't

Improve Online Transparency: Traditional incremental budgeting in West Virginia can sometimes lead to flawed decision-making; efforts toward performance and program budgeting should be given adequate consideration in budget development. These measures would enhance accountability of the budgeting process. With growth in Internet technology, there is a trend toward revolutionizing transparency and accessibility to information through use of the Internet. West Virginia is not among the leading states in web transparency, and should do more to create a user-friendly web portal that provides citizens the ability to search across all agencies regarding expenditures and other detailed information

Current Services Baseline Budgeting: Preparing a current services budget promotes the goal of improving government efficiency. A regular, thorough examination of each program's costs and caseload can help policymakers and the public identifies inefficiencies and programs that are no longer needed. And it can help "right-size" programs, avoiding either over-funding or under-funding them. By preparing and publishing these current services baselines, West Virginia can help involve a broad segment of its residents in decisions about how their tax dollars are spend, as well as provide policymakers with important information to help them evaluate policy proposals

Improving Transparency & Accountability Con't

Consider Conducting Tax Incidence Analysis: A tax incidence model would allow an objective look at the West Virginia's tax system in terms of income distribution and exportability and it would allow West Virginia to assess the regressivity or progressivity of proposed tax increases and decreases. Several states, including Minnesota, Texas, and Maine, have tax incidence models.

Implement Evidence-Based Policymaking: States across the country are utilizing evidence-based policymaking that allows policymakers to reduce wasteful spending, expand innovative programs and strengthen accountability. This is done through program assessment, budget development, implementation oversight, outcome monitoring, and targeted evaluation. For example, Minnesota recently passed bipartisan legislation that will help state policymakers study the effectiveness of corrections and human services programs and identify those with the greater return on investment.

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Policy Brief

west virginia Center on Budget & Policy

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A Win-Win Marcellus Shale Tax Incentive

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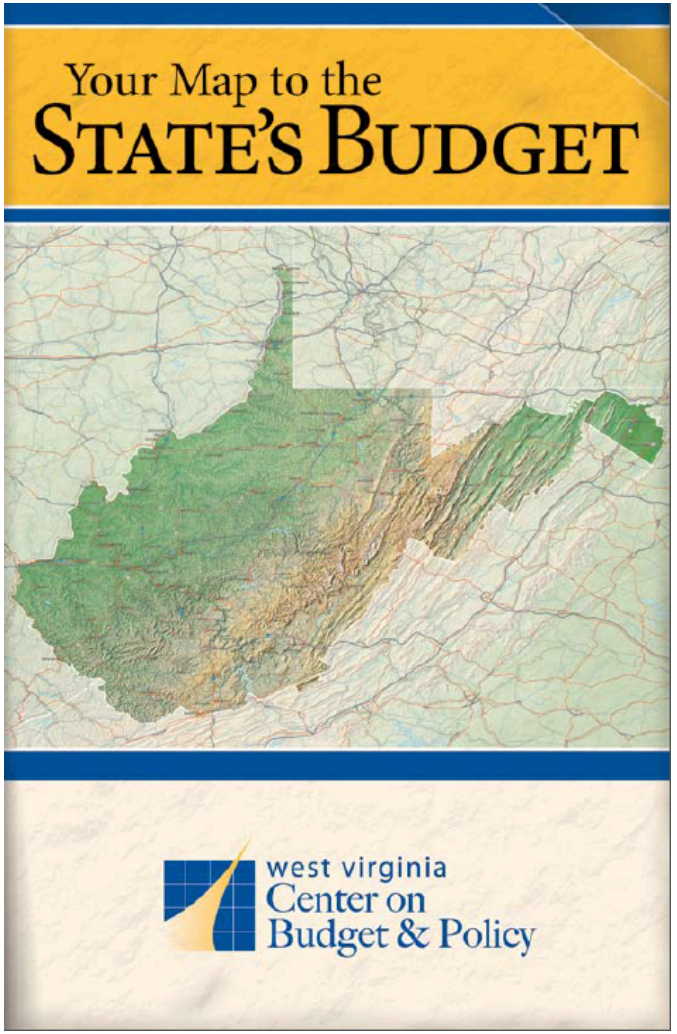
The development of the Marcellus Shale has led to a boom in West Virginia's natural gas production. But aside from the increase in drilling activity and state and local tax revenue, the natural gas boom has not brought with it the jobs and economic growth that many predicted. While the state's natural gas production has increased dramatically over the past several years, West Virginia has lagged behind the rest of the country in terms of job growth and fewer West Virginians are employed today than before the boom. Even in the counties where production has increased the most, job growth has been lackluster.

The capital intensive nature of natural gas drilling can dampen its economic impact, creating fewer jobs than other more labor-intensive industries.[1] However, there may be bigger economic and job opportunities related to chemical-based manufacturing that needs the raw materials found in natural gas liquids, abundant in the Marcellus Shale region.

West Virginia and countless other states have a long history of using tax incentives to boost economic development and jobs. But the impact of the incentives is unclear, including the case of West Virginia's so-called "cracker bill," which failed to encourage the development of an ethane cracker plant or other major downstream activity.

With no large-scale ethane cracker facility and associated chemical-based manufacturing from natural gas liquids produced in West Virginia, other states are profiting on the state's natural resources. As West Virginia Secretary of Commerce Keith Burdette said, after Chesapeake Energy signed a contract to ship 75,000 barrels of ethane a day out of the Marcellus Shale region, "They're shipping out gas that could support investment here."[2]

West Virginia can avoid these past failures while still using tax policy as a tool to encourage economic development. This brief proposes a modification of West Virginia's severance tax that would increase state revenue and also help realize the economic potential of the state's natural gas liquids.

Given that the Marcellus Shale region extends beyond West Virginia, and the overlap of West Virginia's shale economy with those of Pennsylvania and Ohio, policymakers should encourage a three-state dialogue about common severance tax policies that encourage processing within the region.