Joint Meeting:
Small Business Commission and
Manufacturing Development Commission

April 2, 2013
Meeting Summary

Introduction

The initial meeting of the joint study being conducted by the Small Business Commission (SBC) and the Manufacturing Development Commission (MDC) to evaluate a restructuring plan to eliminate the business, professional and occupational license (BPOL) tax, the machinery and tools (M&T) tax and the merchants' capital tax began at 10 a.m. on April 2, 2013, in the General Assembly Building. The meeting began with the election of Senator Frank W. Wagner as chair and Senator Frank M. Ruff, Jr., as vice chair.

Amigo Wade, Senior Attorney with the Division of Legislative Services, provided a brief overview of the joint study's charge. House Joint Resolution 755 provided for the Virginia Municipal League (VML), the Virginia Association of Counties (VACO), the SBC, and the MDC to evaluate and develop a plan for a major tax restructuring that would provide for the elimination of the three taxes. While HJR 755 did not pass, the subject matter it encompassed was subsequently referred to the SBC and MDC for study. HJR 755 included three charges: (i) evaluate the Thomas Jefferson Institute for Public Policy's Virginia State Tax Analysis Modeling Program (STAMP); (ii) evaluate lowering and broadening the state sales tax, eliminating lower personal income tax brackets, and eliminating the BPOL tax, M&T tax and merchants' capital tax and consider other tax restructuring plans to accomplish these ends; and (iii) ensure that any proposed plan is mutually beneficial to small businesses, the manufacturing sector, local government, and the Commonwealth and that the provisions are not redundant. Mr. Wade indicated that these charges, though not specifically binding on the joint study, are nonetheless instructive and would be instrumental in providing guidance for reaching the ultimate objectives. Under the terms of the joint study referral, work must be completed in time for the submission of a written report by November 1, 2013.

The joint study proceeded to receive presentations aimed at providing a broad overview of the current status of BPOL, M&T, and merchants' capital taxes as currently administered and collected by localities, economic models for tax restructuring, and prior tax restructuring studies.

Dean Lynch
Virginia Association of Counties

Dean Lynch, CAE, Deputy Executive Director of the Virginia Association of Counties, provided an overview of local government finances. He indicated that local revenues continue to suffer in part due to the fall in real property taxes. Mr. Lynch displayed charts showing local revenue trends since 1990, which indicated steep declines in 2010, and state categorical aid as a percentage of local expenditures from 2000 to 2012, which also indicated a steep decline in 2010. Senator Wagner asked if there was an explanation for the decline and Mr. Lynch responded that the decline could have been caused by discontinued federal stimulus funds, but he asserted that state support unrelated to federal stimulus funds was still down. Mr. Lynch cited several factors that would make it difficult for the Commonwealth to increase its aid for locally administered programs, including continuing slow general fund revenue growth, required Rainy

Day Fund deposits, Medicaid program costs that continue to outpace general fund revenue growth, increasing VRS contribution rates, funds to pay for additional debt service to support capital programs, and transportation funding. Delegate Purkey asked how payroll numbers contributed to increased costs at the local level. Jim Regimbal responded that while he did not have specific numbers, both state and local employment have been declining.

Mr. Lynch went on to state that in FY 2012 local government operating expenditures came to $25.8 billion, noting that most local government expenditures are mandated or regulated by the Commonwealth. Education (K-12) costs provided the largest local government expenditure with 53 percent of the total operations budget. A fiscal survey conducted jointly by VACO and VML found that many localities felt that they will be less able to meet their future financial needs in FY 2013 compared to FY 2012. Mr. Lynch noted that the combination of decreasing revenues and reduced Commonwealth support had required localities to take a wide range of actions to balance their budgets, including (i) delaying or canceling capital outlay, infrastructure, and equipment, (ii) eliminating vacant positions or reducing staff, (iii) reducing staff health care benefits, (iv) increasing tax rates and fees, and (v) across-the-board service cuts. Mr. Lynch asserted that it is important to keep a mix of local revenues in place. To support this assertion, he provided a chart detailing the source of local fund revenues in terms of percentages. Of the $ 17.2 billion in local fund revenue sources included in the chart, real property taxes accounted for $8.9 billion or 51.8 percent.

Mr. Lynch then focused his presentation on how localities used the BPOL and machinery and tools taxes. Regarding the BPOL tax, he noted that all 39 cities, 55 of 95 counties, and all towns levied a BPOL tax or fee with total revenues of $683 million or four percent of their locally generated revenue in FY 2012. Reliance on BPOL revenues varied with ranges up to 10.7 percent in cities, 6.2 percent in counties, and 18 percent in large towns. Regarding the machinery and tools tax, Mr. Lynch stated that 36 of 39 cities, 90 of 95 counties, and 23 of 36 towns levied the tax. The total revenue generated from the tax amounted to $213.7 million or 1.3 percent of their locally generated revenue for FY 2012. Similar to the BPOL tax, localities that levied the machinery and tools tax had a wide range of reliance in terms of revenues. These ranged up to 32 percent in cities, 27 percent in counties, and 36 percent in towns. In order to replace the revenue provided by the two taxes, counties would have to raise their real estate tax rates by 4.8 cents for BPOL revenues and 1.8 cents for M&T revenues; cities, 11.3 cents for BPOL and 3.3 cents for M&T; and towns, 7.2 cents for BPOL and 1.2 cents for M&T. Mr. Lynch also displayed a chart indicting that BPOL and M&T revenues for localities were similar in terms of size as are corporate income tax revenues to the Commonwealth.

The presentation moved to a discussion of the role BPOL and M&T taxes have on the overall business climate of the state. Mr. Lynch asserted that Virginia continues to rank high in independent evaluations of the state business climates. These independent evaluations indicate that cost-of-living and labor costs were the worst rated factors in achieving business growth in Virginia rather than tax policy. Mr. Lynch further noted that according to the independent evaluations, local BPOL and M&T taxes did not materially affect the state's business tax climate.

Michael W. Thompson
The Thomas Jefferson Institute for Public Policy

Michael W. Thompson, Chairman and President of the Thomas Jefferson Institute for Public Policy (TJI), provided an overview of economic models for tax restructuring that had been developed by TJI. Before reviewing the specific models, Mr. Thompson reviewed the goals, objectives, and methodology of TJI's Tax Reform Study. The most important goal was for the resulting structure to be revenue neutral. The TJI Tax Reform Study included three central objectives: (i) establishing a more fair tax structure, (ii) eliminating "job-killing" taxes, and (iii) encouraging economic growth. Mr. Thompson asserted that according to most economists, low and broadly applied taxes are better for the economy, while targeted taxes, tax credits, and special tax exemptions serve to distort the marketplace. Mr. Thompson stated that the TJI Tax Reform Study included policy suggestions from VML and VACO, the Tax Foundation and Americans for Tax Reform and that each of these groups remain at the table. The resulting models included three major conceptual methodologies: first, reducing personal income tax; second, eliminating the BPOL, M&T, and merchants' capital taxes; and third, broadening the sales tax to include services. The broadened sales tax would be collected by the Commonwealth and returned to localities through monthly distributions using a formula that would replace existing revenues from the eliminated BPOL, M&T, and merchants' capital taxes.

Delegate Marshall asked if the elimination of business-to-business taxes covers services provided by attorneys. Senator Deeds stated that the expanded tax on services would include attorneys, barbers, and other professionals who provide services. Delegate Byron stated that while individuals may pay more to have their nails manicured or to get a haircut, it would be offset by lower individual taxes and taxes on goods. Delegate Marshall expressed concern that the restructuring would be revenue neutral to all localities. Mr. Thompson replied that he had been assured by the Secretary of Finance Richard Brown that each locality could be made whole with all the eliminated taxes replaced. Senator Stanley noted that there were already several taxes collected by real estate establishments and that they should be exempted. Senator Barker asked if the money sent back to the locality would be based on what had been paid to the locality by the eliminated taxes. Mr. Thompson replied that it would be based on the larger amount collected from the expanded sales tax. Senator Ruff stated that there would be a number of localities that would impose BPOL, M&T, and merchants' capital taxes to get more money. Mr. Thompson replied that the legislation to implement the restructuring could be crafted to prevent that result. Senator Ruff then asked if any state had moved in the direction of taxing services. Mr. Thompson stated that Florida and Ohio had initiated a tax on services and Kansas, Connecticut, and Michigan had eliminated the BPOL tax, with North Carolina contemplating whether or not to proceed with doing so. Senator Ruff asked staff to find out what other states are doing in terms of taxing services and eliminating BPOL taxes.

Mr. Thompson proceeded to present the various economic models for tax restructuring developed by TJI's Tax Reform Model through a series of nine scenarios.

Scenario #1: Sales taxes expanded to service sectors just enough to eliminate the BPOL, M&T, and merchants' capital taxes.

Scenario #2: Sales tax expanded to all service sectors; eliminate the BPOL, M&T, and merchants' capital taxes and lower sales tax rate to 3.07% (a 42% cut).

Scenario #3: Sales tax expanded to all service sectors; eliminate the BPOL, M&T, and merchants' capital taxes and lower sales tax rate to 3.68% (a 30.6% cut).

Scenario #4: Sales tax expanded to all service sectors, excluding entire health care sector; eliminate the BPOL, M&T, and merchants' capital taxes and reduce personal income taxes by 17%.

Scenario #5: Sales tax expanded to all service sectors, excluding entire health care sector; eliminate the BPOL, M&T, and merchants' capital taxes, eliminate the lowest personal income tax bracket ($0 to $3,000), and reduce all personal income taxes by 10%.

Scenario #6: Sales tax expanded to all service sectors, excluding entire health care sector; eliminate the BPOL, M&T, and merchants' capital taxes, eliminate the bottom two income tax brackets ($0 to $3,000 and $3,000 to $5,000), reduce the 5.0% income tax rate to 4.55% (a 9.0% tax cut), and reduce the 5.75% rate to 5.0% (a 13% tax cut).

Scenario #7: Sales tax expanded to all service sectors, excluding entire health care sector, private colleges, and private schools; eliminate the BPOL, M&T, and merchants' capital taxes, eliminate the lowest personal income tax bracket, and cut other personal income tax brackets by 13%.

Scenario #8: Sales tax expanded to all service sectors, excluding entire health care sector, private colleges and private schools, and day care services; eliminate the BPOL, M&T, and merchants' capital taxes, eliminate the lowest personal income tax bracket, and cut other personal income tax brackets by 12.5%.

Scenario #9: Sales tax expanded to all service sectors, excluding entire health care sector, private colleges and private schools, day care services, and banking/finance services; eliminate the BPOL, M&T, and merchants' capital taxes, eliminate the lowest personal income tax bracket, and cut other personal income tax brackets by 10%.

Mr. Thompson stated that TJI supported the implementation of Scenario #6 because it provided a revenue neutral plan aimed at spurring economic growth. This scenario would (i) eliminate the bottom two tax brackets of the state's individual income tax code, (ii) reduce the remaining two tax bracket rates by 9.0% and 13%, respectively, (iii) eliminate the BPOL, M&T, and merchants' capital taxes, (iv) make localities whole for the revenue loss from the eliminated local taxes, (v) broaden the current sales tax to all service industries, while keeping health care-related services exempt, and (vi) include no business-to-business tax on services. Mr. Thompson noted that the economic consequences over the next five years according to the model built by economists at the Beacon Hill Institute of Suffolk University in Boston, Massachusetts, would provide 79,000 new jobs, a $287 million increase in capital investment, a $2.85 billion increase in disposable income, and an $8.4 billion increase in the Commonwealth's Gross Domestic Product, all without an overall tax increase.

Mark Vucci
Division of Legislative Services

Mark Vucci, Senior Attorney with the Division of Legislative Services, discussed state tax studies relevant to the work of the study. In 2011, the Joint Legislative Audit and Review

Commission (JLARC) reviewed the effectiveness of Virginia's tax preferences. The report subsequently issued by JLARC concluded that sales and use tax preferences reduced tax liability by $7.9 billion per year. Of this amount, $3.5 billion was for services exemptions. JLARC concluded further that eliminating the services exemptions could result in administrative burdens to businesses. The report also included a review of both tangible goods and services exemptions and reported the following expenditure costs of certain exemptions:

1. Professional, insurance, personal, repair, and Internet services account for $3.3 billion annually.
2. Prescription drugs account for $379 million annually.
3. Reduced sales tax on food accounts for $346 million annually.
4. Nonprofit and church purchases account for $184 million annually.
5. Advertising accounts for $85 million annually.
6. Separately stated transportation charges account for $84 million annually.

Mr. Vucci noted that it is easier to collect taxes on some services than on others. For example, it will be relatively easy to collect a tax on a service such as barbering while more difficult to collect a tax on legal services that may involve work being performed across state lines.

The JLARC report also recommended the establishment of a joint subcommittee to conduct a continuing review of the state's tax structure. In 2012, the Joint Subcommittee to Evaluate Tax Preferences was established as a permanent entity in the legislative branch to oversee an ongoing evaluation of tax credits, deductions, subtractions, exemptions, and exclusions. Mr. Vucci explained that the joint subcommittee's work plan contemplated the establishment of an income tax subcommittee to perform a comprehensive review of the Commonwealth's personal and corporate income tax structures.

In addition to the JLARC report and the Joint Subcommittee to Evaluate Tax Preferences, Mr. Vucci also provided a brief overview of studies released in 2003 by the Commission on the Revision of Virginia's State Tax Code and the Streamlined Sales Tax Project Agreement (SJR 347, 2003) and in 2001 by the Commission to Study Virginia's State and Local Tax Structure for the 21st Century (HJR 578 and SJR 401, 1999).

Next Meeting

Chairman Wagner indicated that the next meeting of the joint study will be held on June 14, 2013, in Virginia Beach at a time and location to be announced. The meeting was adjourned at 11:45 a.m.

Presentations and other supporting documents may be viewed or downloaded via the joint study's website: **http://dls.state.va.us/commissions/sbc.htm**.