THE CENTER FOR LEGISLATIVE ANALYSIS
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Conformity Must Be Coupled With Tax Reform

Virginia Should Follow Lead of Congress: Double Standard Deduction, Cut Corporate Tax Rates

Introduction

November 19, 2018 – Amazon's recent decision to locate one of its headquarters in Northern Virginia is good news for that region and likely to have a multiplier effect on the Northern Virginia economy. But for much of the rest of Virginia, still suffering from the loss of manufacturing and tobacco jobs, a broader approach is needed.

Economic growth comes from businesses having more funds to invest and individuals having more money to spend for their families. Recent federal tax changes result in an automatic state tax increase, but also provide an opportunity for the Commonwealth of Virginia to reform its tax code in order to encourage investment and allow families to keep more of what they earn.

This requires action by Virginia's General Assembly and, for some, a failure to act may be seen as a "back door tax increase." We support providing expansive tax relief to millions of Virginia taxpayers by doubling the standard deduction, currently lower than nearly all of our neighboring states. And we support a reduction in the corporate tax rate, increasing Virginia's competitiveness and encourage companies to move here, stay here, and grow here.

The Problem

For Virginians, the average individual federal tax cut resulting from the Tax Cuts and Jobs Act (TCJA) has been estimated at $1,430. When it took effect almost a year ago, more than 90 percent of wage earners started receiving higher take-home pay. Hundreds of businesses in Virginia had more dollars to give employees bonuses, higher salaries, or to invest in the business. Unemployment dropped; economic growth rose.

The federal law broadened the tax base while reducing tax rates. While those base-broadening provisions flow to Virginia through conformity, the corresponding rate reductions will not. The net result for individual Virginians, according to a study by the state, is a $532 million tax increase in 2019, growing to $546 million in 2024. Businesses paying corporate income tax will see a 40 percent tax increase by 2024 for an additional $404.5 million in taxes. In some cases, but not all, the state tax increase counteracts the benefit to taxpayers from the federal changes. Some people will see both state and federal taxes rise.

Table 1 presents the estimated Virginia revenue imapcct of the idividual, business and international provisions of the TCJA for Fiscal Years 2018 to 2024.

Table 1: Estimated Virginia Revenue Impact of the TCJA, Fiscal Years 2019–2024

($Millions)

	2019*	2020	2021	2022	2023	2024	Total
Individual Provisions	532.1	443.8	466.7	492.5	520.0	546.1	3,001.3
Business Provisions	29.4	114.6	181.5	300.3	417.2	398.2	1,441.3
International Provisions	32.6	52.7	5.5	5.8	6.0	6.3	108.8
Total, All Provisions	594.2	611.1	653.7	798.7	943.2	950.6	4,551.4

*Due to the likely timing of Virginia's conformity to the federal provisions, the full revenue impact for Taxable Year 2018 is recognized in FY 2019.
Source: Governors Report on Conformity Revenue Impacts

The Solution

To reduce the impact of state tax increases on at least some individuals and businesses, and to maintain the full economic benefit of the federal tax cuts in Virginia, the 2019 Virginia General Assembly should pass emergency legislation to:

1. Conform Virginia's tax code to the provisions of the federal Tax Cuts and Jobs Act.
2. Increase Virginia's standard deduction to no less than $6,000 per individual and $12,000 per joint-filing couple, double the current amount.
3. Reduce the Corporate Income Tax to 5.5 percent for 2018 and to 5.0 percent for 2019.
4. Index Virginia's individual tax brackets, personal exemptions and standard deduction to the measure of inflation used for federal tax indexing, beginning with tax year 2020.
5. Create a mechanism to track and segregate any additional revenue resulting from the TCJA, to allow for additional adjustments or tax reforms if possible.

Steps 2 and 3 will save taxpayers (and reduce state conformity tax revenue) $515 million in the first year and $580 million in the second. That will eliminate most of the $594 million tax increase in 2019 and $611 million tax increase in 2020 that otherwise would result if Virginia merely conforms with the federal tax changes. The estimated financial impacts do not exceed the projected TCJA conformity impact, and thus will not require any adjustments in the state's current General Fund budget. There may be revenue to support some additional minor tweaks.

Due to the accelerating impact of conformity, outlined below, in future years additional changes should be considered to return additional funds to Virginia's families and businesses. Strong consideration should be given to continuing the same path, further increasing the standard deduction and further reducing the corporate income tax. It would be ideal if Virginia's standard deduction eventually equaled the federal amount of $24,000 for a family.

Both steps are sound tax reforms.

Because of its low standard deduction and exemptions, Virginia's personal income tax has a disproportionate impact on lower-income workers. Most surrounding states with an income tax provide substantially higher standard deductions shielding family income from tax. More than 60 percent of Virginia taxpayers – 2.3 million returns – already take the standard deduction, and the percentage making that choice is expected to grow to 2.8 million returns, so doubling the amount provides a broad benefit particularly appealing to lower-income taxpayers. The following chart shows the amount of income shielded from tax for a couple with one child taking the standard deduction combined with that state's personal exemptions. With the proposed $12,000 standard deduction amount added to its existing $930 personal exemption, Virginia comes more in line with its neighbors.

Table 2:
Taxable Income Threshold, Couple plus One Child, Standard Deduction + Personal Exemptions

Virginia Current	**$8,790**
Virginia Proposed	*$14,790*
Maryland	$13,600
District of Columbia	$24,000
North Carolina	$17,500
South Carolina	$24,000
Georgia	$16,400
West Virginia	$6,000
Tennessee	No Income Tax
Federal Taxes	$24,000

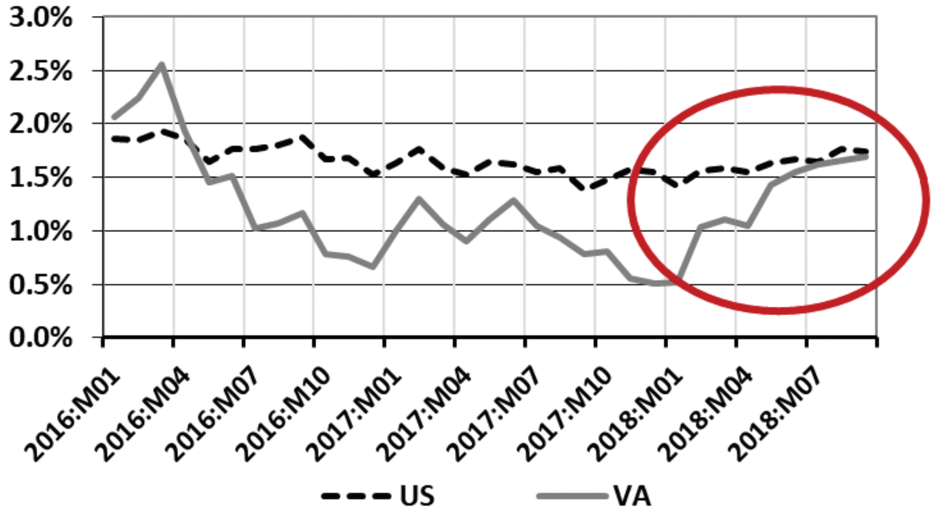
For corporations, where the conformity tax represents a higher percentage increase in tax liability, cutting the tax rate mirrors the action taken by Congress. It cut the federal rate 40 percent, from 35 to 21 percent, and this recommendation cuts the state rate only 16 percent. The General Assembly should consider further cutting the corporate income tax rate to 4 percent, perhaps in two more steps during 2020 and 2021, if the conformity revenue estimates prove correct.

Both steps will have positive economic benefits.

As the response to TCJA has clearly demonstrated, increasing or decreasing taxes has an impact on the economy. Additional tax payments by families or businesses reduce income available for other expenses or investment. The proposed tax reforms in this paper prevent an un-legislated state tax increase that is an automatic side effect of conforming to federal rules. The focus is on preventing the economic dampening effect of a $594 million state tax increase, an impact that continues to grow as time passes.

This dampening effect would come at a particularly bad moment. The Virginia Economic Development Partnership has noted surveys by site consultants ranking Virginia's top competitors higher in nearly every category, including the corporate tax environment, where bordering states Tennessee and North Carolina out pace the Commonwealth. Partly because of this, Virginia has lagged the nation in coming out of the most recent recession, particularly in private sector employment growth.

Table 3: Year-Over-Year Change in Non-Farm Employment



Source: Mangum Economics

Providing more funds for families and businesses to spend or invest creates new jobs, new investment and greater disposable income. Our dynamic economic model, developed for the Thomas Jefferson Institute by the Beacon Hill Institute, demonstrates that reducing the tax burden on our individuals and corporations as outlined in this paper – rather than increasing the tax burden as the state says will be the case (see Table 1 above) without tax cuts – will prevent the loss of 12,000 jobs, a decrease in investment of $172 million, and will maintain $1 billion in real disposable income that would otherwise disappear.

Table 4: Effects of Doubling the Standard Deduction and Reducing the Corporate Income Tax by 1% Fiscal Years 2018 to 2021

	2018	2019	2020	2021
State Tax Revenue Change ($, mil.)	(494)	(550)	(569)	(608)
Local Tax Revenue Change ($, mil.)	25	33	37	71
Total State & Local Tax Revenue Change ($, mil.)	(468)	(518)	(532)	(537)
Private Employment (jobs)	11,264	11,881	12,879	13,221
Investment ($, mil.)	108	172	184	193
Disposable Income, real ($, mil.)	949	1,017	1,091	1,108

Source: Virginia State Tax and Modeling Program developed for the Thomas Jefferson Institute by the Beacon Hill Institute

Comparison to Other Proposals

Governor Ralph Northam has proposed that Virginia convert its existing **Earned Income Tax Credit**, which tracks the federal EITC, into a refundable process that would provide state cash payments to claimants when their allowed EITC credit is higher than their tax liability. No details have been provided on how many Virginia taxpayers would benefit from that, or by how much. But Governor Northam's proposal would only benefit individuals or families who owe zero state income tax under current law. These in most cases would be people for whom the existing low standard deduction is already adequate to eliminate tax liability, so they would not benefit from a higher standard deduction unless their income grows.

However, providing a higher standard deduction would do just that, continue to protect them from owing tax as their income grows. The EITC works in the opposite way, fading on a sliding scale as their income grows. EITC refunds are an annual, one-time lump payment similar to a tax refund. Raising the standard deduction would also change withholding tables, providing a financial boost with every pay check.

Several legislators have noted that one reason conformity produces additional state tax collections is many Virginians are expected to stop taking itemized deductions. The new federal standard deduction is $24,000 and state and federal forms must use the same method.

These legislators are proposing a **Virginia Itemized Deduction Election**, allowing itemized deduction on the state level while claiming the standard deduction on their federal forms. Taking this step would also greatly reduce the revenue impact of conformity and would more closely match the benefit to people who are paying higher conformity taxes.

However, this maintains – or increases – complexity, when the goal of tax reform should be to promote simplicity. The value of itemized deductions is still going to change unless Virginia also elects to stay with the itemizing rules existing prior to 2018, many of which were changed by Congress at the federal level. For many (but not all) of these taxpayers, the proposed additional standard deduction will counteract much if not all their higher tax liability. Those taxpayers with high itemized deductions will continue to use that method on both their state and federal returns.

A **third option** would be to **reduce the tax on the two bottom tax brackets** to zero percent, shielding the first $5,000 of taxable income. The current tax on those two brackets is only $120 but taking that step would provide that tax cut to every taxpayer, whether taking the standard deduction or itemized deductions. For most taxpayers the additional standard deduction would reduce the tax bill by $345.

Any or all these steps could be taken in conjunction with a higher standard deduction, with the limiting factor the amount of additional revenue that conformity to the TCJA will produce. To remain within that limit, choices are necessary.

Conclusion

In summary, our judgment is that doubling the standard deduction is the best of the various choices for individual taxpayers with the current projected revenue. It is the step taken by the Congress, which was seeking to move people away from itemized deductions. It also aligns Virginia with most surrounding states that use the income tax but do so with higher standard deductions for individuals and couples. Reducing the corporate income tax is the best step for business taxpayers and will help make Virginia more competitive. And all of this can be done using the "revenue windfall" that will come from conforming our state tax code to the federal tax code and will not impact the current General Fund budget.

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