

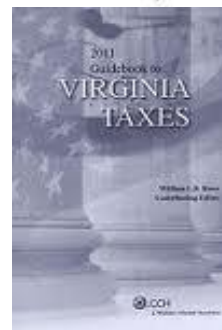
THE THOMAS JEFFERSON INSTITUTE FOR PUBLIC POLICY

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Tax Restructuring in Virginia

A Revenue Neutral Path for Improving Our Economy

By: Michael W. Thompson



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Thomas Jefferson Institute for Public Policy

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Tax Restructuring in Virginia

Revenue Neutral Path for Improving Virginia's Economy

By: Michael W. Thompson

Introduction

Most all economists -- conservatives, liberals, or somewhere-in-between -- agree that low, broadly applied taxes are best for the economy. Such taxes do not distort the market place as do targeted taxes, tax credits, etc.

With that in mind, the Thomas Jefferson Institute has spent two years working with key economists to determine if the current tax system in Virginia can be “re-arranged” in a way that would be revenue neutral and create a stronger and more competitive business climate that would grow our economy over the next few years.

What we found is truly fascinating. By re-arranging some of our current taxes, Virginia could dramatically improve our economy and provide substantial tax relief to our citizens. At the same time we could eliminate three unfair and anti-competitive taxes that have harmed economic growth in our state. All of this can be accomplished in an overall “tax neutral” manner as outlined in this study. This means that the traditional “tax battle lines” should not be present in this policy discussion. Schools and transportation, the safety net and other social programs will not be impacted. There will be no overall tax increase or tax decrease. But by re-arranging the current taxes a substantial improvement in jobs and economic growth can occur.

For many years businesses in Virginia have complained about three taxes that most everyone agrees are unfair and restrict job growth. These taxes are collected at the local government level and are an important piece of those budgets, especially in the smaller jurisdictions. Yet, these are job destroying taxes and have been a large bone in the throat of all businesses, but most particularly small and mid-sized businesses – those that are the backbone to a growing economy. These three business taxes focused upon in this study are outlined below.

The Business Professional Occupation Licensing (BPOL) tax is levied on the gross receipts of a business. Regardless of whether companies make a profit, they must pay this gross receipts tax each and every year. It is an unfair and maddening tax on all businesses, especially on smaller companies and those in the first few years of existence as they struggle to get their sea-legs and begin to make a profit. All businesses object to this tax which is due regardless of whether the business is profitable.

And to make matters worse, this tax was first imposed to pay Virginia's share of the War of 1812! After 200 years, it is time to admit that we have met that war repayment obligation. It is time to remove this tax which everyone understands is a jobs destroyer.

The Machine and Tool (M&T) tax is another unfair tax levied at the local level. It taxes the cost of a piece of machinery regardless of whether that equipment has been expensed out by the business using it. This tax is not only an unfair burden on our manufacturing businesses every year, but can be a significant part of the decision-making process on whether new equipment is purchased

and where a business resides. So equipment that could be used to hire new employees, make a product more efficiently, or give a business a leg up on its competitors is not purchased because of the existence of this Machine and Tool tax in many of our counties and cities in Virginia. And this M&T tax is levied on all qualifying businesses whether or not a profit is made by that business. The removal of this tax could be a significant move to help our state's manufacturing base to be more competitive in today's worldwide economy.

The Merchants Capital (MC) tax is levied in some of our counties and is an inventory tax. It is a nuisance tax determined on the amount of inventory physically in the county or city on a specific day of the year. It is avoided by some companies by merely moving merchandise out of the local jurisdiction on "inventory day." So it is a tax easily sidestepped. This is another tax charged by local government regardless of whether the business has made a profit.

Lt. Governor Bill Bolling's Jobs Commission issued its final report in December of 2010. It made several recommendations and general policy statements among which were these (pages 36-40 of that report can be found in Appendix I of this report):

"Economic development is dynamic and ever-changing and the competition between regions, states and countries for new jobs and investment is intense. As a result, Virginia must continuously examine government policies, particularly our tax policies, to ensure that Virginia maintains its competitive standing."

"Several of Virginia's competitive states have repealed their machinery and tools (M&T) tax, including Alabama, Kentucky, North Carolina, South Carolina and Georgia... Virginia must offer manufacturers a competitive tax environment which will result in job creation and larger capital investment."

"...the Commission believes a repeal of the M&T Tax is in the best interest for both the manufacturers and the Commonwealth..."

"Because the BPOL tax is based on gross receipts, many small business owners believe it is unfair not to consider the burden on businesses when the tax is a derivative of total profits. For example, the BPOL tax is biased against new businesses, which typically experience losses in their early years."

"Any changes to the current BPOL system should address the inherent issue of taxing gross receipts regardless of business profitability while maintaining the revenues for local governments' operations. The Commission understands that repealing BPOL taxes without finding additional revenue sources would be difficult in the current budgetary environment and does not take lightly the static fiscal impact that elimination would have on local governments."

This Thomas Jefferson Institute study was initiated to see if it was possible to eliminate these three business taxes (BPOL, M&T and MC) and design a plan to do this in a revenue neutral manner that could significantly improve our state's economy. This study developed several plans that are outlined below that could dramatically improve the overall economy of our state, eliminate these three taxes, and do it in a revenue neutral basis. "Revenue neutral" means that the amount of money raised from newly imposed taxes will be offset by tax reductions. The tax restructuring idea outlined herein would improve our overall economy beyond the current projected "baseline" for jobs, investment and disposable income over the next 5 or 6 years.

This study is based on the concept that broadening the sales tax to most of the service industries that today do not collect it from their customers would provide the money to eliminate and/or reduce other taxes that would significantly enhance our overall economy. There is no net tax increase suggested in this study. However, the projected increase in employment, investment and personal disposable income would improve Virginia's economy. And a growing economy automatically increases the tax revenue to governments at all levels. As that saying goes, "A rising tide lifts all boats."

This study does not suggest any new business-to-business taxes. The sales taxes in this study are only those that would be collected from the general public by service industries that do not collect them today. And a few of the economic scenarios outlined below also include significant income tax reductions on every taxpayer in Virginia.

Over the years, our elected leaders have voiced opposition to three taxes focused on in this study for elimination, but most especially the BPOL tax. It is probably the most broadly "hated" tax that our businesses face. But since it and the other two taxes outlined above are collected by a number of our counties and cities, elimination of these taxes can only take place in the real world if the localities are assured that they "will be made whole" from other tax funds. If this assurance is provided, then the opposition from the localities could disappear. But these assurances must be real and locked in. These assurances can be provided under the parameters of this study.

This study outlines an idea that might well open up an avenue to eliminate these three local taxes that truly hinder economic growth. The tax restructuring idea outlined in this study can improve our overall economy and provide tax relief for all who pay Virginia state income taxes.

To accomplish this will take political courage and the understanding that a growing overall economy is good for all businesses, all citizens and all governments. This tax restructuring concept will require most of those industries that do not collect sales taxes today from their customers to do so. Some may resist, but an expanding economy along with the elimination of the BPOL tax will make these industries better off along with everyone whose income taxes are reduced or eliminated.

Background

Governor Bob McDonnell has said for years that the BPOL tax is the most unfair business tax and that he would like to find a way, if possible, to eliminate it. In order to do so the local jurisdictions which levy this tax must be made whole: if BPOL is eliminated then the counties/cities need to have at least the same amount of money in additional revenues so that their budgets were not impacted.

During and after the transition and in the early months of the McDonnell Administration the idea of eliminating the BPOL tax came up time and again. And the Thomas Jefferson Institute decided to find out if a reasonable plan could be crafted that would eliminate BPOL and M&T taxes and, at the same time, protect the localities' financial interests and improve our economy on an overall tax neutral basis.

One afternoon former Delegate Jack Rust and I were talking through possible ways to eliminate the BPOL and M&T tax. We wondered how many industries that provide services to the public were exempt from collecting sales taxes and how much the sales tax could be reduced if all

exemptions were eliminated. We only focused on services provided to the end-using public. No business-to-business sales taxes were contemplated as part of whatever tax restructuring ideas we crafted. We agreed that understanding all sales tax exemptions throughout the state's economy would be good to know and help us focus on our goal.

We contacted two top economic groups. In Virginia we talked with Dr. Christine Chmura of Chmura Economics and Analytics in Richmond, the state's best-known and highly respected independent economics firm. Chmura Economics is the gold standard when it comes to credibility and the Jefferson Institute has worked with this group for many years.

We also talked with the Suffolk University economists at the Beacon Hill Institute (BHI) in Boston. The Jefferson Institute previously worked with these Boston economists to build impressive dynamic economic models during the contentious tax battle during Mark Warner's Administration and the transportation funding battle during the Kaine Administration. These models were praised by Republicans and Democrats in the General Assembly. The Executive Director of BHI, David Tuerck, earned his doctorate in economics at the University of Virginia and that adds credibility here in the Old Dominion.

The Beacon Hill Institute's economic model projects the "additional economic activity" that tax and spending policies can have above the current baseline in the areas of employment, investment and disposable income.

Chmura Economics and Analytics and the Beacon Hill Institute's tax model have good track records with policy makers in Virginia. Working with these two economic teams enabled the Thomas Jefferson Institute to create a powerful final product outlined in this study.

Both of these economic groups told us that they thought if all exempt industries collected sales taxes on their services the sales tax rate could probably be reduced to around 2.5% -- a 50% reduction in the current sales tax.

This fascinated Jack Rust and me and we decided that there might be some real potential in looking at the sales tax exemptions at the individual consumer level. We wanted to determine if a rational outline of a potential tax restructuring could be crafted to eliminate the BPOL and M&T taxes. We hoped our research would open the door to a new creative discussion on tax reform here in Virginia

We understood that any tax change had to focus at the services provided to the public and not any sales tax in the business-to-business realm of our economy. We had no interest in entertaining a European style Value Added Tax.

There were four critical groups that had to be "on board" with the concept if this tax restructuring idea had any hope to develop into a change in tax policy. Those four groups were Americans for Tax Reform (ATR headed by Grover Norquist), the Tax Foundation, the Virginia Association of Counties (VACO) and the Virginia Municipal League (VML). I talked with all four groups and received their conceptual "buy in" to this approach we wanted to take: if the result was a "revenue neutral" tax restructuring, ATR would not oppose it; if it broadened the sales tax and broadly lowered the sales tax and/or other taxes, the Tax Foundation liked the concept; and if the counties and cities were indeed "made whole" then VACO and VML would be interested in this restructuring concept. Of course, all wanted to see the final product of our study and any legislation crafted to focus on such tax changes.

The Thomas Jefferson Institute contracted with Chmura Economics and Analytics and the Beacon Hill Institute to help determine the possibility of lowering and broadening the sales tax in order to eliminate the BPOL and M&T taxes. We asked Chmura Economics and Analytics to provide background on all sales taxes in the state and determine total taxes collected at the local government level from the current BPOL and Machine and Tool taxes. And we asked what service industries are exempt from charging the public for their services, how much they would collect in sales taxes if the current rate was charged, and how much BPOL taxes each industry pays today. This information gave us a good starting point to draft some “revenue neutral tax restructuring scenarios” to suggest to the Governor, to our businesses in Virginia and our elected leaders. The Chmura study that was produced is attached in Appendix II of this paper.

The Chmura study included a listing of those service industries that are not required to collect sales taxes from their customers and the amount of BPOL taxes that each industry paid. These numbers were from 2010 and that list is on the next two pages. These are the service industries that are focused on in this study. An explanation of the three digit numbers for the industry listing on the next two pages can be found at the federal government’s North American Industry Classification System (NAICS) link: <http://www.naics.com/search.htm>.

We only looked at services provided to the public and no business-to-business services were a part of any suggested changes in the current tax code. For example, the legal fees for suing a neighbor for placing a fence on your property would require that sales tax be collected. However, the legal fees for reviewing a lease for office space would not have a sales tax associated with the service. The cost of having a couch delivered to a personal home would have a sales tax charged while shipping merchandise to a department store would not.

Next we asked the Beacon Hill Institute to build a dynamic economic model that would allow us to look at possible tax restructuring ideas and how they would impact our state’s economy over the next few years. That dynamic model was built and several scenarios were run though it using the numbers provided by Chmura. The detailed background about how this dynamic model was built is found in Appendix IV of this study.

The Chmura research found that in order to “make the localities whole” for lost tax revenue from eliminating BPOL, M&T and MC taxes the state would have to send \$834.1 million to these local governments. So that is the minimum amount of “new tax money” required to be collected to eliminate these three job destroying taxes and make the localities whole.

When the basic numbers were collected and analyzed by the economists at Chmura Economics, we met with the Governor’s Office to give those advisors a complete briefing as to where we were in our research and analysis. We were assured that the state could guarantee the counties and cities would be made whole if the BPOL and M&T taxes were eliminated and the sales tax broadened to include currently exempt industries. The next step was the completion of the BHI dynamic model and running various economic scenarios through it to see the impact of broadening and lowering the sales tax.

With the assurance that the counties and cities that today impose BPOL, M&T and MC taxes can be made whole by the state, the typical tax battle arguments can be avoided. Our localities will not lose any money in this tax restructuring idea, No money will be “lost” for public schools and locally financed transportation. Indeed, with a growing economy in our future and with

a broaden sales tax imposed on currently exempted industries, the income to the localities will be better than it would be otherwise once true economic growth returns in earnest.

And with the elimination of the three targeted business taxes, economic growth will be stronger than it would be otherwise and, our course, if personal income taxes can also be cut as outlined below, even a stronger economic recovery can take place.

This tax restructuring concept avoids the traditional tax battles. The money on the table will be the same for localities, and the overall economy will grow through business tax elimination and personal state income tax cuts.

With the Chmura study and the Beacon Hill economic model, known as the Virginia STAMP model – State Tax Analysis Modeling Program, we looked at possible scenarios to eliminate the BPOL and M&T taxes and we added the Merchants Capital (MC) tax, an inventory tax that some counties charge. These three taxes are weights on the legs of our businesses. If we eliminate these three taxes our job creators would be better off and our economy would improve. For example, one businessman who owns six gas stations told me that if he did not have to pay the BPOL tax in Fairfax and Prince William Counties he could build two to four more service bays, buy the required equipment and hire more mechanics. This gave us an idea of how our economy would improve if these taxes were eliminated.

When we finished building the dynamic economic model we again met with the Governor’s office for in-depth meetings. We provided initial results from the scenarios run through the dynamic model. These policy leaders were appreciative of the information we provided and complimentary of the work we had accomplished. They said it was very helpful in their planning process and again guaranteed that the localities would be made whole if such a tax restructuring was implemented.

A number of economic scenarios were run through the tax model to determine the results of several “what ifs” toward developing a “revenue neutral” tax restructuring plan. Each scenario improves our economy, eliminates the BPOL, M&T and MC taxes and makes whole the counties and cities that levy these taxes.

These scenarios are outlined below.

Tax Model Results

In order to analyze what kind of potential tax restructuring could be crafted to produce the best “bottom line” results while eliminating the BPOL, M&T and Merchants Capital taxes the Thomas Jefferson Institute produced a series of nine (9) scenarios. These are listed below so that the reader can see how the scenarios were run through the economic model and how our reasoning evolved to see what would happen in our economy. We wanted to understand the economic consequences if the sales tax was expanded to currently exempted service industries and other taxes were reduced and eliminated.

The results from the dynamic model indicate increases or decreases from the current projections for economic growth over the next five to six years. The results for each scenario show changes beyond the current projections. All of the scenarios below eliminate BPOL, M&T and MC taxes with the counties and cities that collect these taxes guaranteed to be made “whole.” This is

accomplished by the state sending the local governments \$843.1 million from the state's additional sale tax income generated by broadening the service industries required to collect these taxes from their customers. Each scenario is "revenue neutral" on day one – any increase in taxes is off-set by tax reductions.

Scenario #1: Sales taxes are expanded to service sectors just enough to eliminate BPOL, M&T and MC taxes in 2012 – specific industries to collect sales taxes from their customers are not selected from the Chmura listing. A total of \$834.1 was taken across the board from current exclusions for this scenario.

The economic results from running the dynamic model showed the following:

- Private employment increases by 900 jobs
- Investment increase by \$431 million
- Real disposable income decreases by \$81 million (negligible to total disposable income in the economy)

Scenario #2: Sales taxes are expanded to all currently exempt service sectors and BPOL, M&T and MC taxes are eliminated. The extra funds from the expanded sales tax collection on services were modeled to lower the sales tax. The economic results would be:

- The current sales tax rate can be reduced to 2.85% (a 43% reduction)
- Private employment increases by 7,000 - 8,200 jobs over baseline in 5-6 years
- Investment increases by \$400 - \$500 million
- Real disposable income decreases by \$300 - \$500 million (negligible to total disposable income in the economy)

After reviewing these results and referring back to the overall Chmura study and talking through these scenarios, we determined that applying the sales tax to the medical/health care field was something that simply would not "fly" in today's world – nor should it. With health care costs rising beyond the rate of inflation and the whole health care debate raging in our society, it seemed prudent to simply agree to keep the health care/medical service sectors of our economy exempt from collecting sales taxes from their customers.

While keeping health care/medical industries exempt from collecting sales taxes from their customers/patients, the results we found from running our dynamic tax model with seven (7) different scenarios are outlined below.

Scenario #3: Sales taxes are expanded to currently exempt service sectors excluding the entire healthcare sector and health insurance premiums while BPOL, M&T and MC taxes are eliminated. The economic results would be:

- Sales tax rate reduced to 3.9% (22% reduction)
- Private employment increases by 12,200 - 13,000 jobs
- Investment increases by \$335 - \$531 million
- Real disposable income increases by \$230 - \$335 million (negligible to total disposable income in the economy)

Scenario #4: Sales taxes are expanded to all current service sectors excluding the entire healthcare sector, elimination of BPOL, M&T and MC taxes, and income tax rates for all brackets is cut by 12% in FY 2012.

- Private employment increase by 40,000 jobs
- Investment increases by \$337 million
- Real disposable income increases by \$1.2 billion

Scenario #5: Sales taxes are expanded to currently exempt service sectors excluding the entire healthcare sector, the BPOL, M&T and MC taxes are eliminated, the lowest personal income tax bracket (\$0 to \$3,000 income level) is eliminated, and the rates for the other brackets are cut by 10% in FY 2012. The economic results would be:

- Private employment increases by 56,000 jobs
- Investment increases by \$350 million
- Real disposable income increases by \$2 billion

Scenario #6: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector, elimination of the BPOL, M&T, and MC taxes, the bottom two tax brackets are eliminated (\$0 to \$3,000 income and \$3,000 to \$5,000 income brackets) and the current top 5.75% rate drops to 5.3% (a 7.8% tax cut) and the next 5.0% rate drops to 4.625% (a 7.5% tax cut) in FY 2012.

- Private employment increase by 77,000 jobs
- Investment increases by \$340 million
- Real disposable income increases by \$2.78 billion

In reviewing these scenarios above, we again looked at the “real world” and at the listing from Chmura Economics and Analytics of current service industries exempt from collecting sales taxes. We made a determination that there were a few of these industries that some might want added to the health/medical as remaining exempt. This was based on the fact that the current economic situation required practical considerations.

So we added to health care/medical industries these additional industries for continued exclusion from sales tax collection: private schools since education is key to creating a more competitive and vibrant economy; day care in order to avoid creating any additional hindrances to securing gainful employment; and banking and finance industries since capital investment is key to rebuilding our economy.

With this new set of exclusions factored into the dynamic tax model, the three (3) additional scenarios below were developed.

Scenario #7: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector and private colleges and private schools, BPOL, M&T and MC taxes eliminated, the lowest tax bracket eliminated and the rates for other brackets cut by 7.5% in FY 2012.

- Private employment increase by 49,700
- Investment increase by \$370 million
- Real disposable income decreases by \$1.8 billion

Scenario #8: Sales taxes are expanded to all exempt service sectors excluding the entire healthcare sector, private colleges and schools, plus the day care services, BPOL, M&T and MC taxes are eliminated, the lowest tax bracket is eliminated and the rates for other brackets are cut by 6.5% in FY 2012.

- Private employment increase by 44,700 jobs
- Investment increase by 355 million
- Real disposable income increases by \$1.7 billion

Scenario #9: Sales taxes are expanded to all current exempt service sectors excluding healthcare, private schools, daycare, and banking/finance, BPOL, M&T and MC taxes are eliminated, the lowest tax bracket is eliminated and the rates for the other personal income tax brackets are cut by 6% in FY 2012.

- Private employment increase by 49,000 jobs
- Investment increases by \$350 million
- Real disposable income increases by \$1.8 billion

Conclusion

For the first time, a truly “revenue neutral” tax restructuring proposal is now on the table to eliminate the BPOL, M&T and MC taxes, make the localities “whole” from a revenue standpoint, and depending on the scenario above remove the bottom tax bracket or two from paying state personal income taxes, and reduce everyone else’s income taxes by up to 10%. All nine (9) scenarios eliminate the three targeted taxes and are revenue neutral.

For years our elected officials have recognized that the BPOL, M&T and MC taxes are unfair and job destroying. These taxes are a drag on job creators and should be eliminated. However, these are taxes localities collect and if these taxes are eliminated, the localities need to be “made whole” in order for their budgets not to be adversely impacted.

This major tax restructuring concept is revenue neutral and yet produces an incredible improvement in our economy. Not only is this fascinating intellectually, but it is truly exciting from a public policy point of view.

Clearly, there are industries listed in this report that will not like the fact that, if the scenarios outlined above were to become policy, they would have to collect taxes from those who seek their services. And this is where the controversy will likely focus.

However, if there is a policy goal to create a better tax structure in our state, to eliminate BPOL, M&T and MC taxes as our Governor and others have advocated for many years, and to do this in a way that can substantially improve our economy, what is outlined in this study is certainly one way to accomplish these goals.

Those industries that would have to collect sales taxes from their customers would no longer pay BPOL, M&T and/or MC taxes. This is an incentive for them to consider this new tax policy idea. And depending on which scenario is selected above, income tax reductions would also impact

everyone in the state, including everyone who works for the businesses that would have to collect sales taxes from their customers under this new tax concept. Of course, other scenarios can be run to determine additional outcomes.

For 200 years Virginia's localities have levied the BPOL tax. It was implemented to pay for the War of 1812 and that payment has long since been made.

Tax restructuring can have a significant impact on our economy as the scenarios that were run through the Virginia STAMP model clearly show.

The sales tax restructuring outlined in this study can achieve three important policy goals: eliminate the three job destroying taxes that business and politicians have belly-ached about for years; produce better economic growth; and do this in a "revenue neutral" manner.

There may be a better plan to accomplish what is outlined above and the Jefferson Institute would be anxious to review it. We are not wedded to one approach on tax restructuring. However, we developed this proposed alternative because our Governor and others have advocated the elimination of the BPOL, M&T and MC taxes, and we wanted to get that accomplished in a "revenue neutral" way.

We hope this report will generate a serious discussion on tax restructuring. The Thomas Jefferson Institute is ready and anxious to participate in that discussion using this study and our dynamic tax/spending model (Virginia STAMP) to assist our public, private and non-profit sector leaders in crafting a better tax system than we have today.

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“... a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities.”

Thomas Jefferson

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