JLARC
JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION

October 18, 2021

Interim presentation: Options to make Virginia's individual income tax more progressive (HJ 567)

Joint Legislative Audit & Review Commission

HJ567 (2021) directs JLARC to study the progressivity of Virginia's individual income tax

- Evaluate the fiscal impact of changes that would make Virginia's individual income tax more progressive
  - tax brackets
  - tax rates
  - credits, deductions, & exemptions
- Identify potential changes to the Code of Virginia or Virginia Tax regulations
- Staff currently planning to present final report at September 2022 JLARC meeting

Research activities

- Reviewing academic literature on tax policy
- Analyzing Virginia's tax system & filing data
- Comparing Virginia's tax system to other states
- Identifying potential options to make Virginia's individual income tax more progressive
- Working with Virginia Tax to model impact of options

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Definition and preliminary analysis of progressivity

Elements of Virginia’s tax affecting progressivity

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Virginia has levied an individual income tax for more than 175 years

- 1843: 1% tax on salaries above $400
- Early 1860s: rate increase to help finance war
- 1948: 2%, 3%, and 5% brackets established
- 1972: 5.75% bracket added
- 1990: income thresholds increased

Virginia’s income tax is a relatively small share of total federal, state, & local taxes

- Limits Virginia income tax effect on overall tax progressivity
- Federal income tax is largest liability for most filers
  - Federal tax brackets & rates much higher than Virginia’s
- Most Virginians also pay other taxes
  - Federal: Social Security (6.2%), Medicare (1.45%)
  - State: sales tax, excise taxes (gas, alcohol, tobacco)
  - Local: property taxes on residences & vehicles

Virginia's individual income tax rates increase along with taxable income

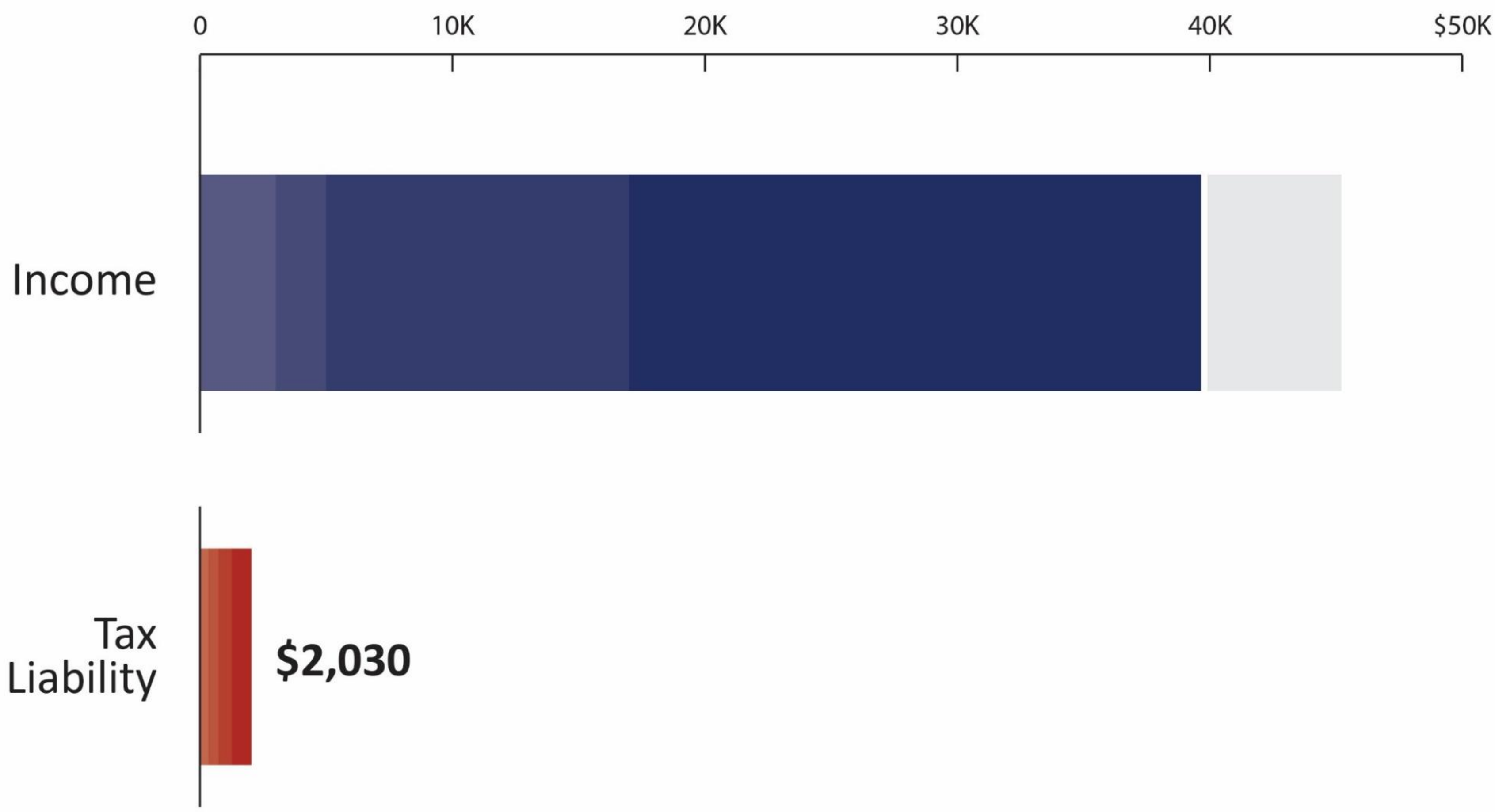
Taxable Income	Rates
$0 to $3,000	2%
$3,001 to $5,000	3% *(plus $60)*
$5,001 to $17,000	5% *(plus $120)*
More than $17,000	5.75% *(plus $720)*

Single filing threshold = $11,950
Married filing jointly threshold = $23,900

Virginia allows a variety of deductions, exemptions, & credits

Standard deductions	Single filer	$4,500
	Married filing jointly	$9,000
Exemptions (example)	Self and spouse	$930
Other deductions & credits (examples)	Age 65 & older deduction	Up to $12,000 if single and $24,000 if married
	Child & dependent care expenses deduction	Up to $3,000 for 1 child, $6,000 for 2 or more
	Credit for Low-Income Individuals / VA Earned Income Credit	$300 per personal & dependent exemption / 20% of federal EITC

Example: Tax liability for single filer with adjusted gross income of ≈$45K



Nearly 4 million individual income tax returns were filed in 2018*

- Most filers (94%) were Virginia residents
- Majority of filers were single (58%)
  - married filing jointly (38%)
  - separately (4%)
- About 10% of Virginia households did not file because their income was below the state's filing threshold**

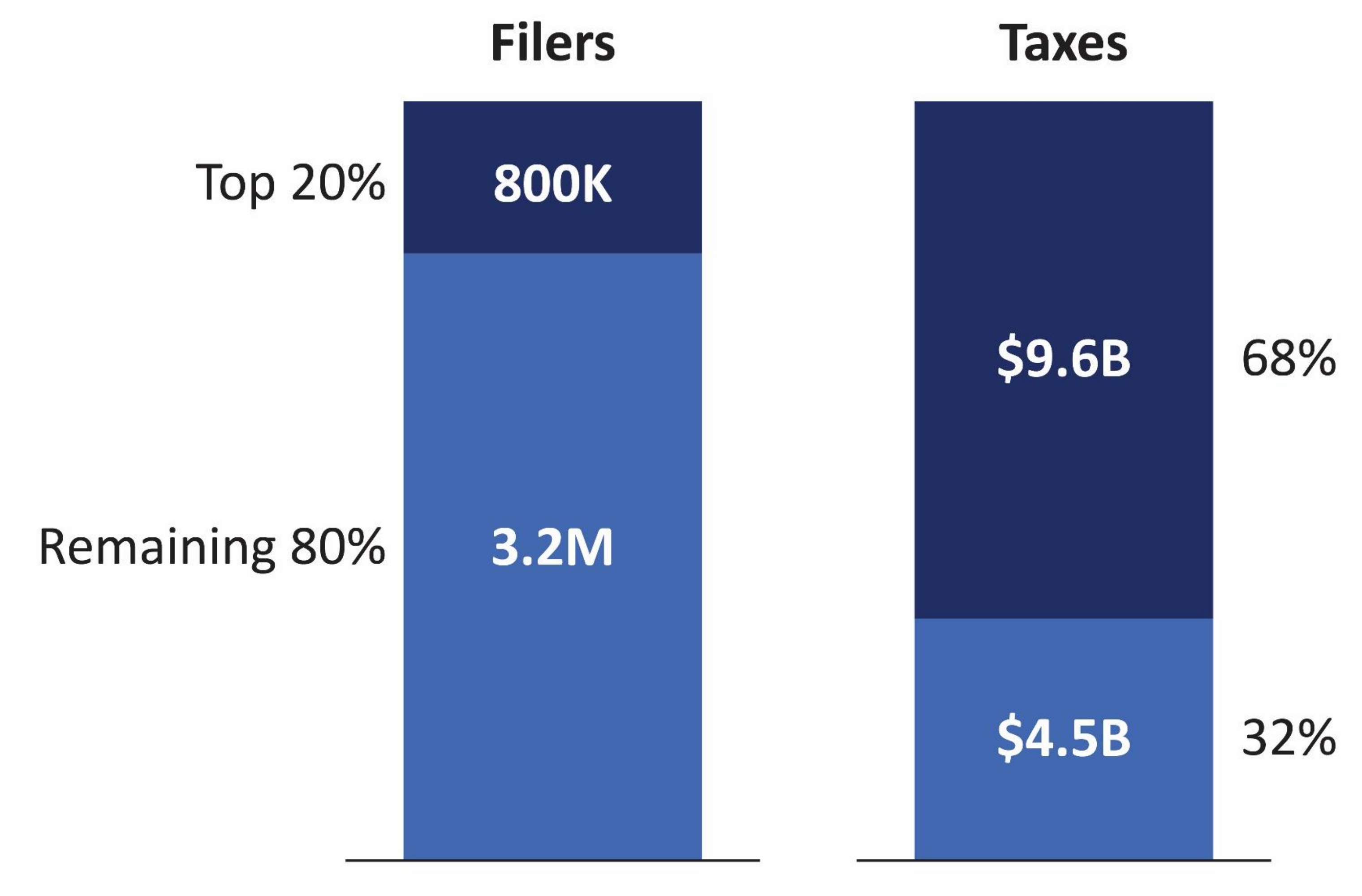
*2018 is the most recent tax year for which complete individual income tax data is available.
**Analysis of Current Population Survey data.

Individual income tax is state's largest source of general fund revenue

- Individual income tax revenue comprised 73% of all general fund revenue in 2020 ($15.3B of $20.9B)
- Individual income tax revenue as share of total general fund has increased from 40% in 1980, 54% in 2000

Sources: Virginia Tax 2020 Annual Report, data for FY19; Bowman 2002.

Top 20% of filers pay 68% of all state income tax



Source: JLARC analysis of 2018 Virginia tax returns.

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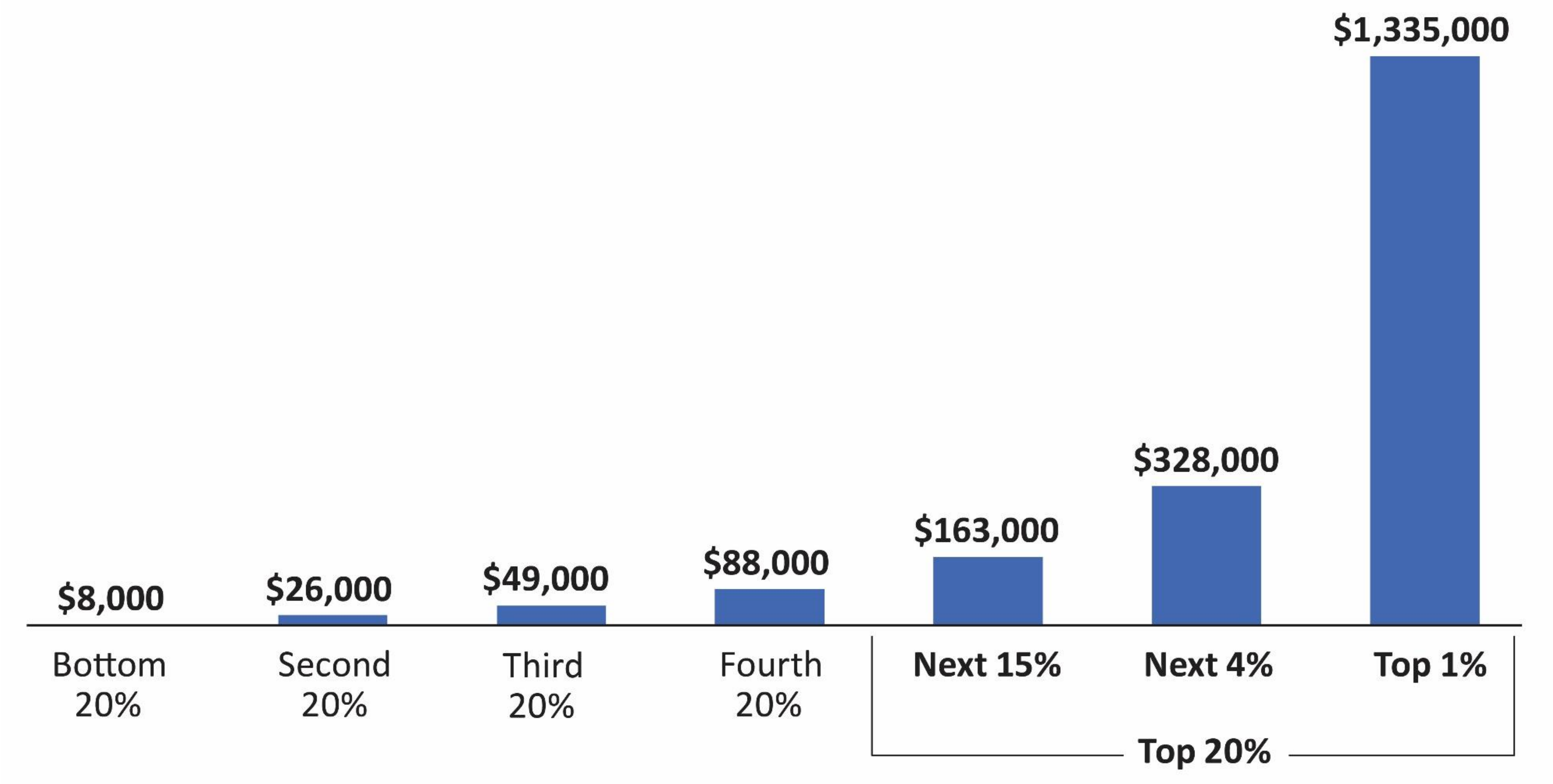
Ability to pay is key principle underlying tax progressivity

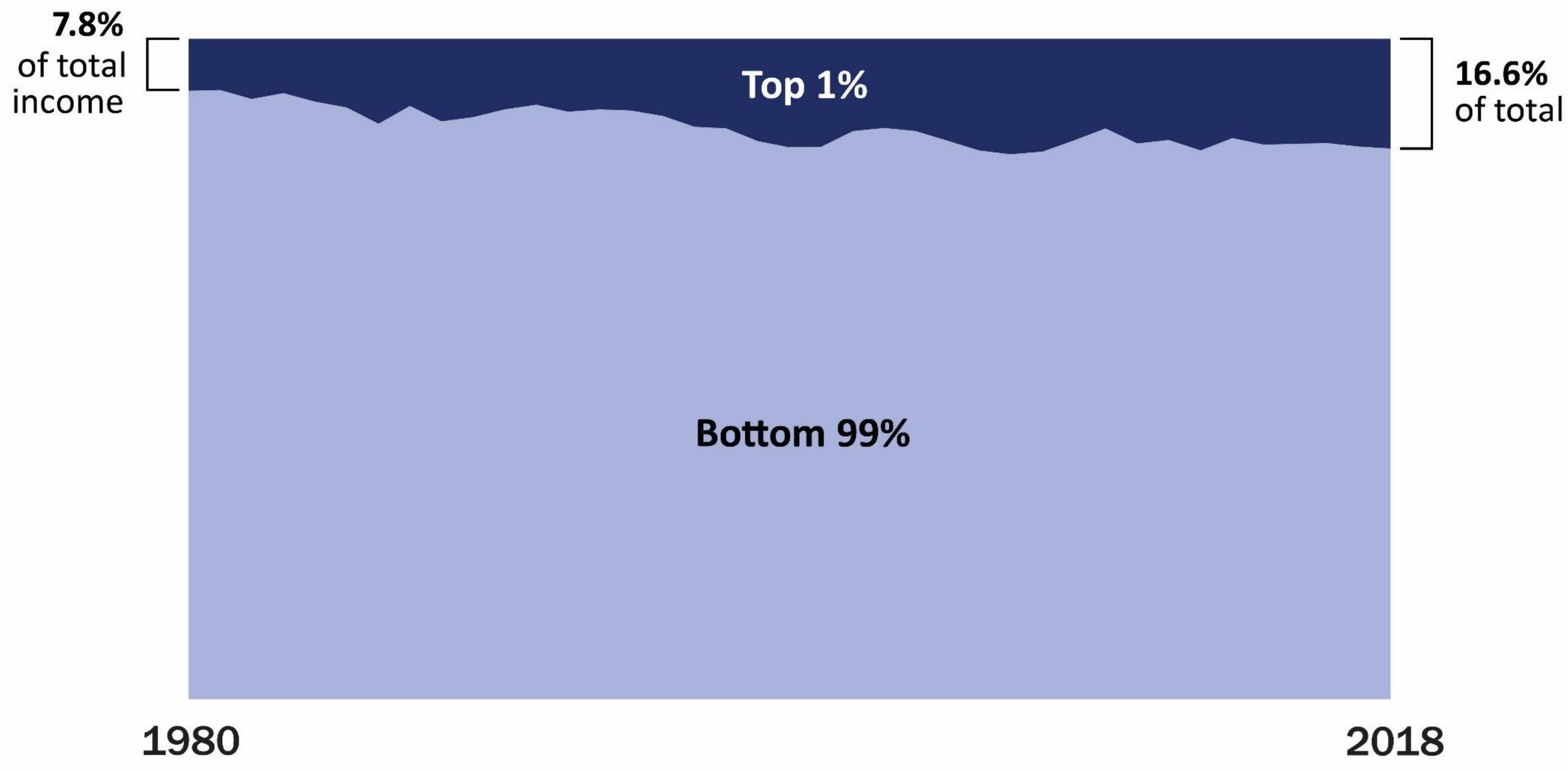
- Lowest income filers have much less ability to pay taxes than the highest income filers
- Income inequality is frequently cited by proponents of tax progressivity as reason for progressive tax systems

Substantial differences in income among Virginia filers, especially among the top 20%



Source: JLARC analysis of 2018 Virginia tax returns. Excludes part-year and nonresident filers, and non-filers.

Top 1% of Virginians' share of total income has more than doubled (1980–2018)



Source: IRS Statistics of Income and CPS data, World Inequality Database.

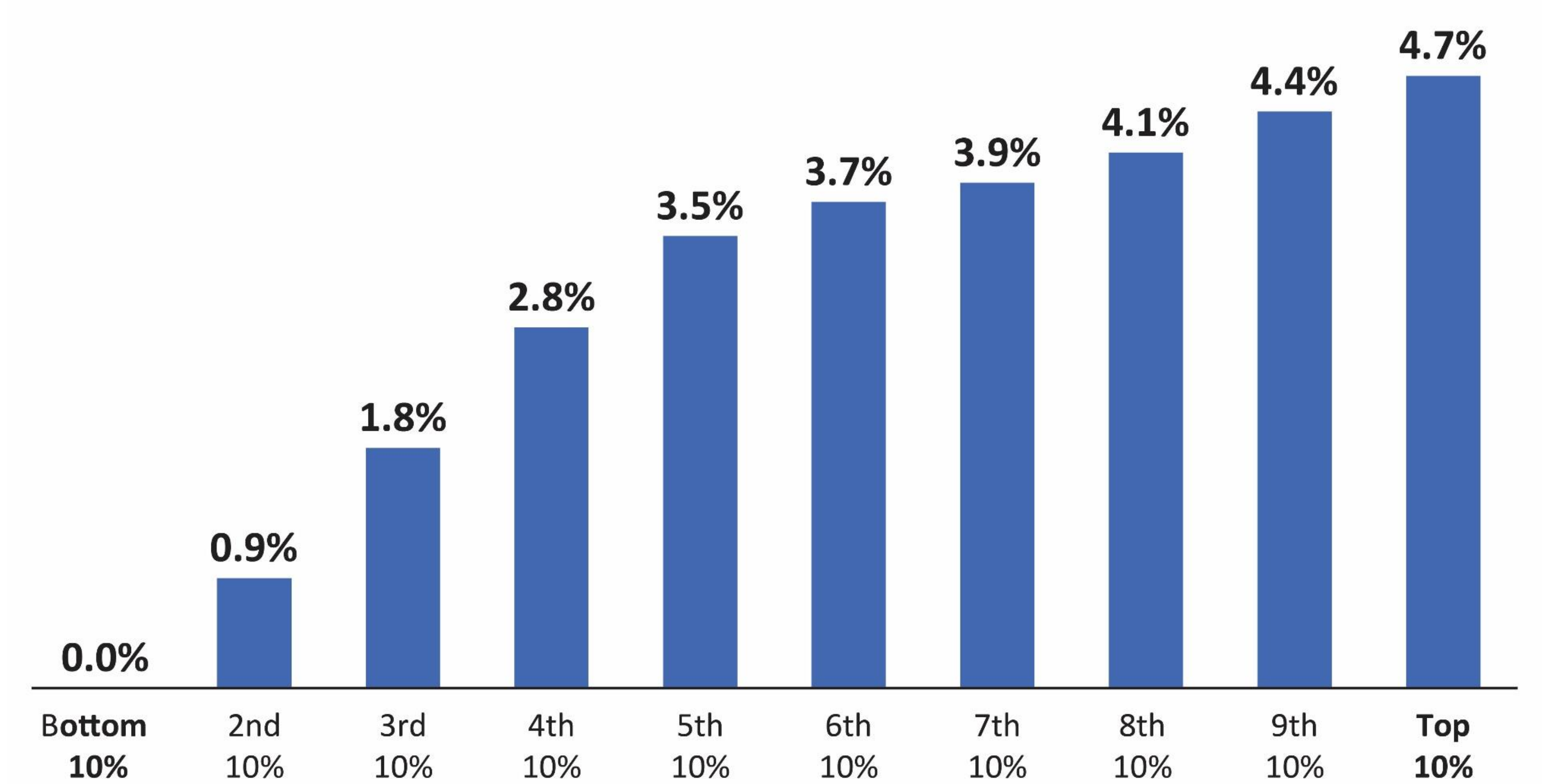
A progressive tax means high income households pay higher tax rates than lower income households

- Analyzing only <u>statutory</u> tax rates and income brackets to assess progressivity can be misleading because of deductions, credits, & exemptions
- <u>Effective</u> tax rates (ETR) paid by each income grouping measure tax progressivity more accurately
  - Gross, not taxable income
  - Rates, not dollar amount of tax

Tax experts use various approaches to measure the *degree* of progressivity

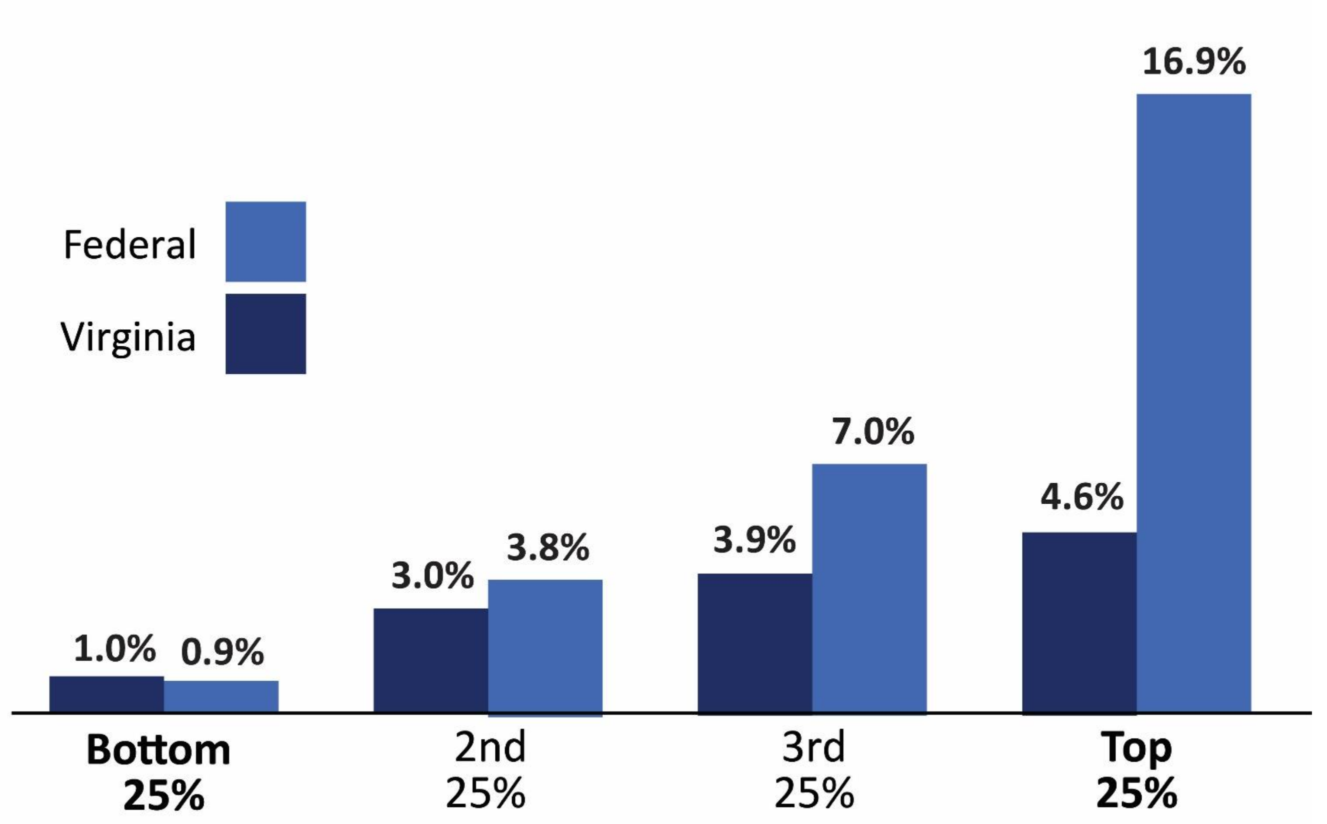
- "Slope" of ETRs among income groupings (quartiles, quintiles, deciles, etc.)
- The difference in ETRs between the top 1% and the bottom 20% (ETR Gap)

Virginia's personal income tax is progressive



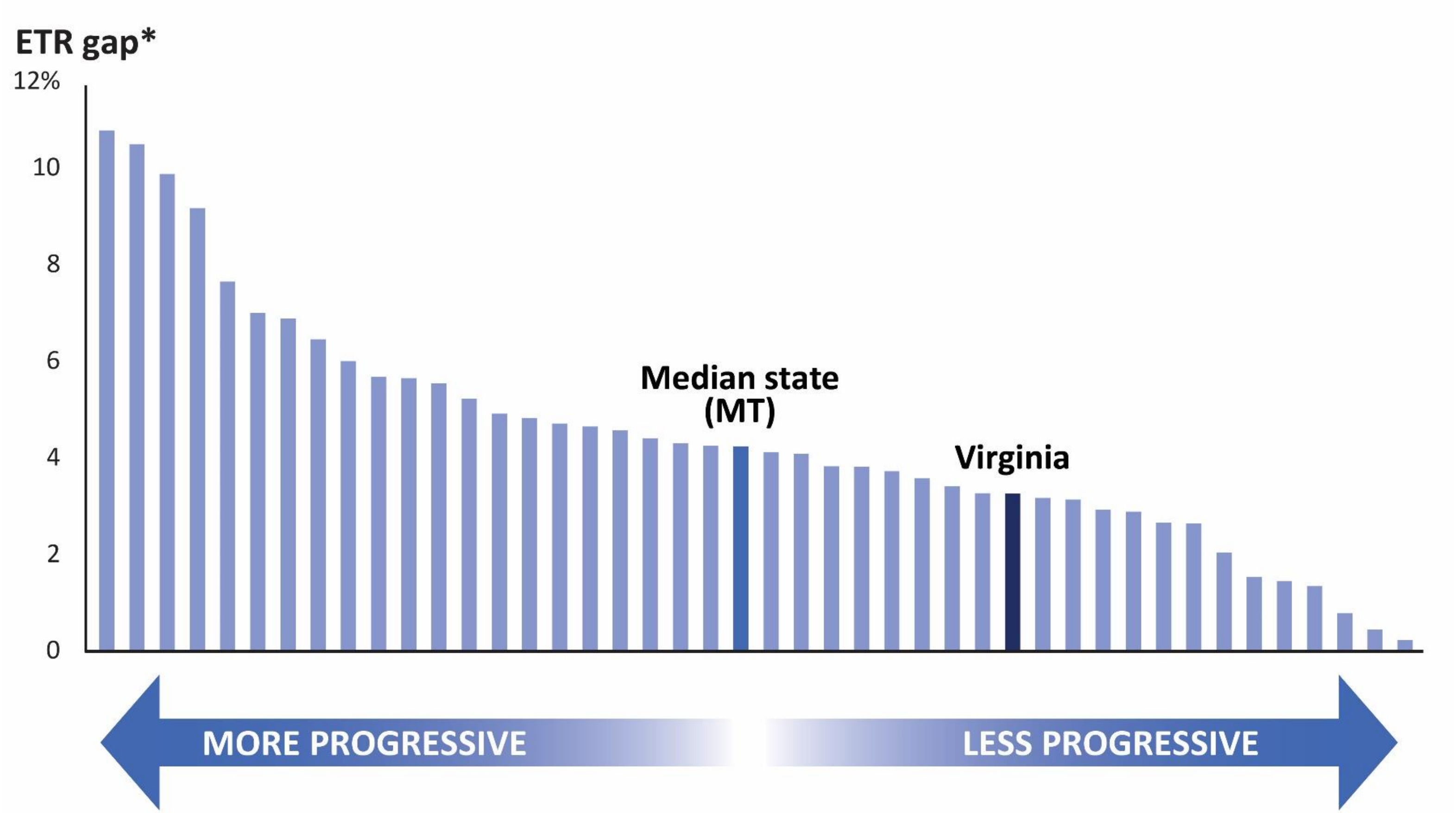
Source: JLARC analysis of 2018 Virginia tax returns. Excludes part-year and nonresident filers, and non-filers.

Federal individual income tax is more progressive than Virginia's tax



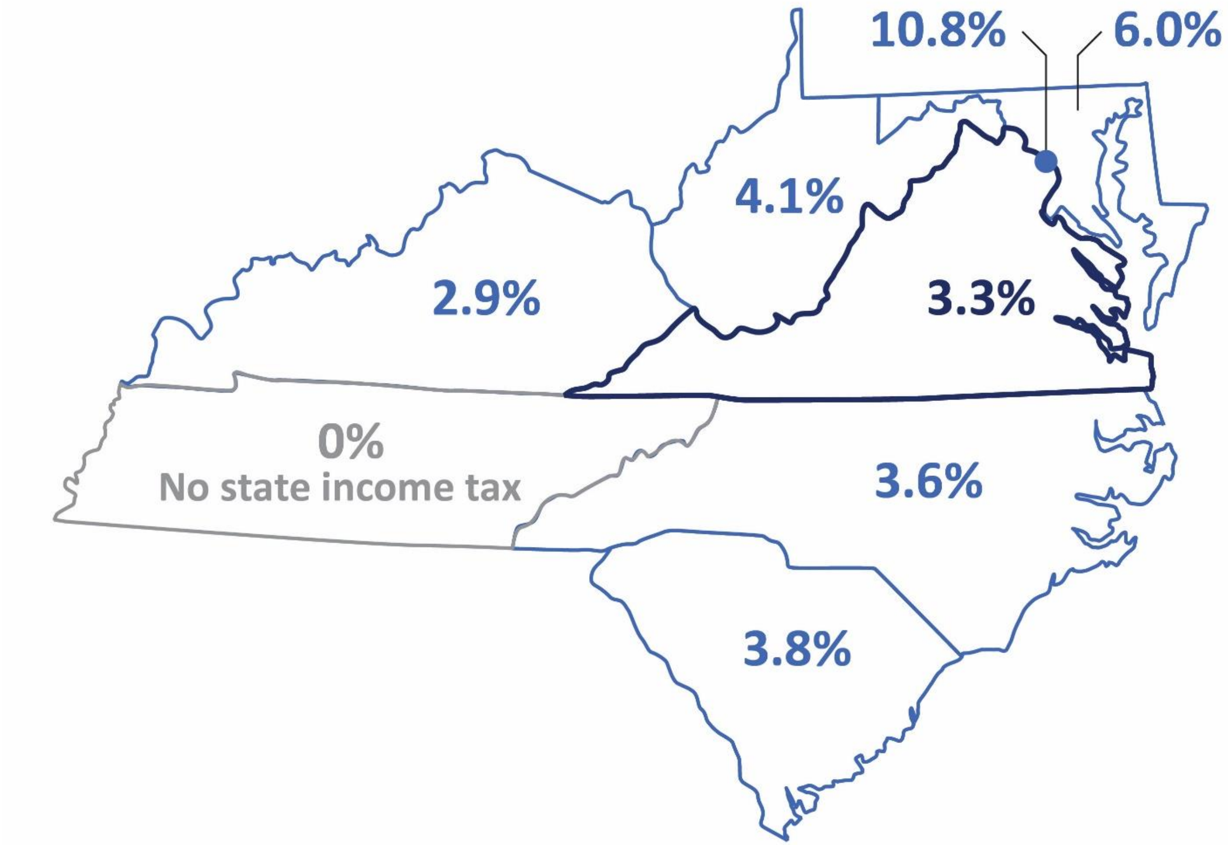
Percentages equal effective tax rates. JLARC analysis of 2018 Virginia tax returns, excluding part-year, nonresident, and non-filers and 2018 IRS Statistics of Income for U.S.

Most states have more progressive individual income taxes than Virginia



Source: Institute on Taxation & Economic Policy (ITEP), 2018.
*ETR gap = percentage point gap in effective tax rate between the top 1% of taxpayers and the bottom 20%.

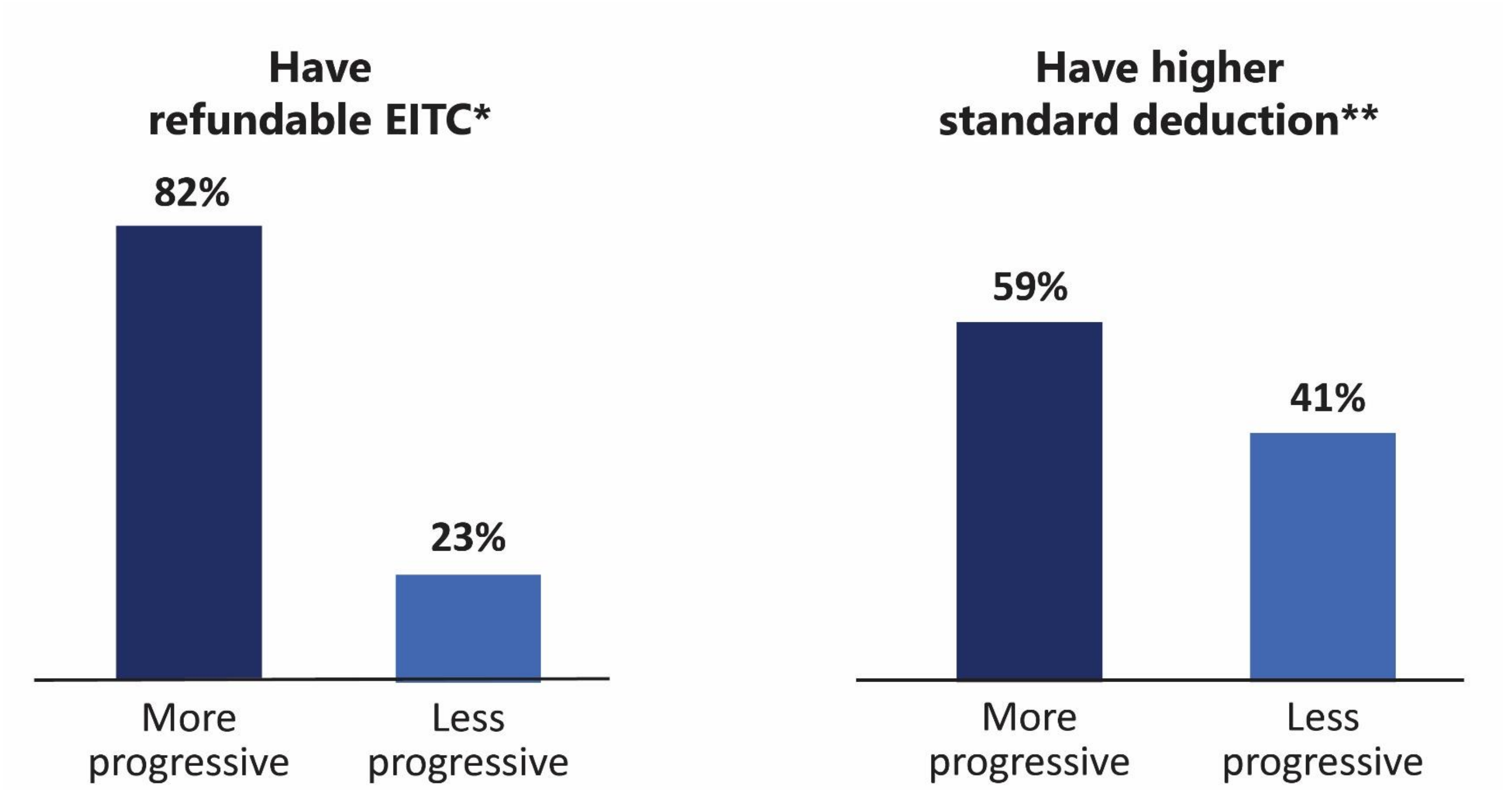
Several states in the region have more progressive income taxes than Virginia



%s shown are ETR gap (top 1% effective rate minus bottom 20% effective rate).

Source: Institute on Taxation & Economic Policy (ITEP), 2018.

States with more progressive income taxes tend to have larger credits and deductions



Source: ITEP, Federation of Tax Administrators, Urban Institute.
*EITC = earned income tax credit.
**Standard deduction is higher than the median standard deduction for states with individual income taxes.

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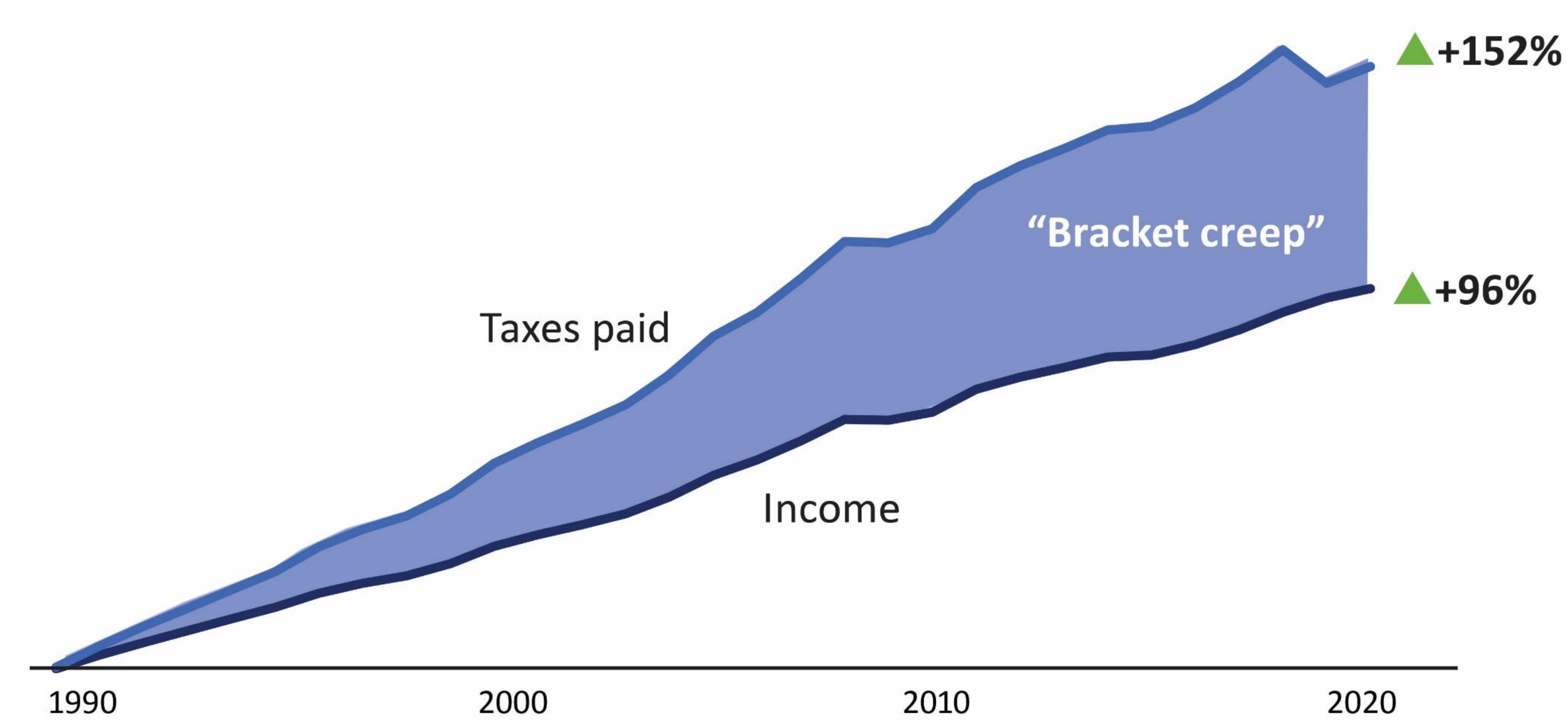
“Bracket creep” has made Virginia’s income tax less progressive over time

- Income tax brackets have not changed in ≈30 years
- Consequently, more Virginians are paying the highest marginal tax rate (5.75%) on a greater portion of their income—because of inflation—even if their real income has remained about the same
- Bracket creep affects all filers, but affects lower income filers the most because more of their income is now subject to highest marginal tax rate

Rising income due to inflation = more taxes being paid (when income brackets remain the same over time)



Note: Analysis based on a single filer in Virginia with median income in 1990.

Low-income tax credits increase progressivity

- Tax Credit for Low-Income individuals created in 2000, Virginia Earned Income Credit in 2006
- Reduce taxes owed for families in poverty and those receiving the federal EITC
  - 330,000 families (9% of all returns) claimed low income credits (2018)
  - Reduced tax liability to $0 for more than 1/3 of these families

Source: JLARC analysis of 2018 Virginia tax returns. Excludes part-year and nonresident filers, and non-filers.

Raising Virginia's standard deduction and filing threshold have also increased progressivity

- Standard deduction for single filer increased from $3,000 to $4,500 (2019)
  - Reduced tax liability for most by $86
  - All filers who don't itemize benefit from higher deduction
- Filing threshold increased from $11,250 to $11,950 (2012)
  - Allowed additional low-income filers to have $0 tax liability

Age deduction for Virginians 65 and older increases progressivity

- Filers meeting age and income requirements* can claim the age deduction
  - $12,000: single filers below $50,000
  - $24,000: married filers below $75,000
- Age deduction claimed by 500,000 filers
- Reduced liability to $0 for about 25% of those who claimed deduction

Source: JLARC analysis of 2018 Virginia tax returns. Excludes part-year and nonresident filers, and non-filers.

*Deduction for taxpayers age 65 and older born after 1939 is reduced $1 for every dollar of income over $50,000/$75,000; taxpayers born prior to 1939 can claim the full amount.

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JLARC staff will continue to research progressivity and identify options to increase it

- Continue to interview experts, conduct data analysis, review research literature
- Identify policy options to increase progressivity
- Work with Virginia Tax to estimate the revenue impact of each option, understand other impacts
- Monitor work of legislative joint subcommittee

Final report will primarily identify policy options for legislative consideration

- JLARC proposes policy options—rather than make recommendations—when
  - decision is a policy judgment best made by the General Assembly (or other elected officials)
  - addressing a report finding *could* be beneficial
  - there is insufficient evidence of a *single* best way to address a report finding
- Whether and how to change state income tax is a policy decision for the General Assembly
- JLARC may make technical recommendations if “good government” or sound tax policy issues arise

Questions? / Comments?

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