



## Options to Make Virginia's Individual Income Tax More Progressive (HJ 567)

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## HJ 567 (2021) directs JLARC to study the progressivity of Virginia's individual income tax

- Identify options to make Virginia's individual income tax more progressive
  - tax brackets
  - tax rates
  - credits, deductions, & exemptions
- Evaluate options' impact on the general fund

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## Research activities

- Reviewed academic research literature on tax policy
- Analyzed Virginia's tax system & filing data
- Compared Virginia's tax system with other states
- Identified potential options to make Virginia's individual income tax more progressive
- Worked with Virginia Tax to model impact of options

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## In brief

Changes to Virginia's individual income tax in 2022 will make the tax more progressive than in prior years.

As directed, JLARC staff identified options to make the individual income tax more progressive. Seven options would reduce taxes on low, lower-middle, and middle income filers. Four options would raise taxes on high or very high income filers.

These options could increase progressivity by up to 115%, and are estimated to collect between 6% less and 6% more revenue than baseline projections.

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# In this presentation

## Background

Recent changes to individual income tax

Increasing progressivity by

- reducing taxes on lower income filers
- reducing taxes on middle & lower income filers
- raising taxes on higher income filers

Maintaining progressivity over time

# Virginia's individual income tax features four income brackets with higher rates for each bracket

<b>Taxable Income</b>	<b>Rates</b>
\$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

# More than 4 million individual income tax returns filed annually in Virginia

- Most filers (94%) were Virginia residents
- Majority of filers were single (59%), most others were married filing jointly
- About 10% of Virginia households did not file because their income was below the state's filing threshold\*
- Filers reported about \$78,000 in Virginia adjusted gross income, on average (2019\*\*)
- Filers were liable for about \$3,500 in Virginia state income tax, on average, or about 4.5% of adjusted gross income

\*Analysis of Current Population Survey data.

\*\*2019 is the most recent tax year for which complete individual income tax data is available.

## Substantial differences between low & high income filers is basis for tax progressivity

	Bottom 20th	Second 20th	Middle 20th	Fourth 20th	Top 20th
Average income	\$5,400	\$24,500	\$50,700	\$95,000	\$287,000
Multiple of bottom 20th	-	4.5x	9x	18x	53x

- Differences between low & high income filers have grown over time

Note: Figures shown are averages within income quintiles as estimated by the PolicyLinks Microsimulation model.



# Report uses income quintiles to show effect of changes on differing levels of income

Income quintile		Income \$ range	Referred to as ...
Bottom 20%		Up to \$14,000	Low income
Second 20%		\$14,001 to \$35,999	Lower-middle income
Middle 20%		\$36,000 to \$67,999	Middle income
Fourth 20%		\$68,000 to \$128,999	Upper-middle income
Top 20%	Next 15%	\$129,000 to \$276,999	High income
	Next 4%	\$277,000 to \$597,999	High income
	Top 1%	\$598,000 or more	High / Very high income

## Review uses two measures of progressivity

- **Progressivity index** = relative tax burden of each income group
  - uses the “Suits index”
  - focuses equally on all income groups
- **High – low rate gap** = the difference in the effective tax rates of very high income and low income filers
  - effective tax rate of the *top 1%* of filers minus the *bottom 20%* of filers
  - larger difference indicates a more progressive tax system

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- raising taxes on higher income filer

Maintaining progressivity over time

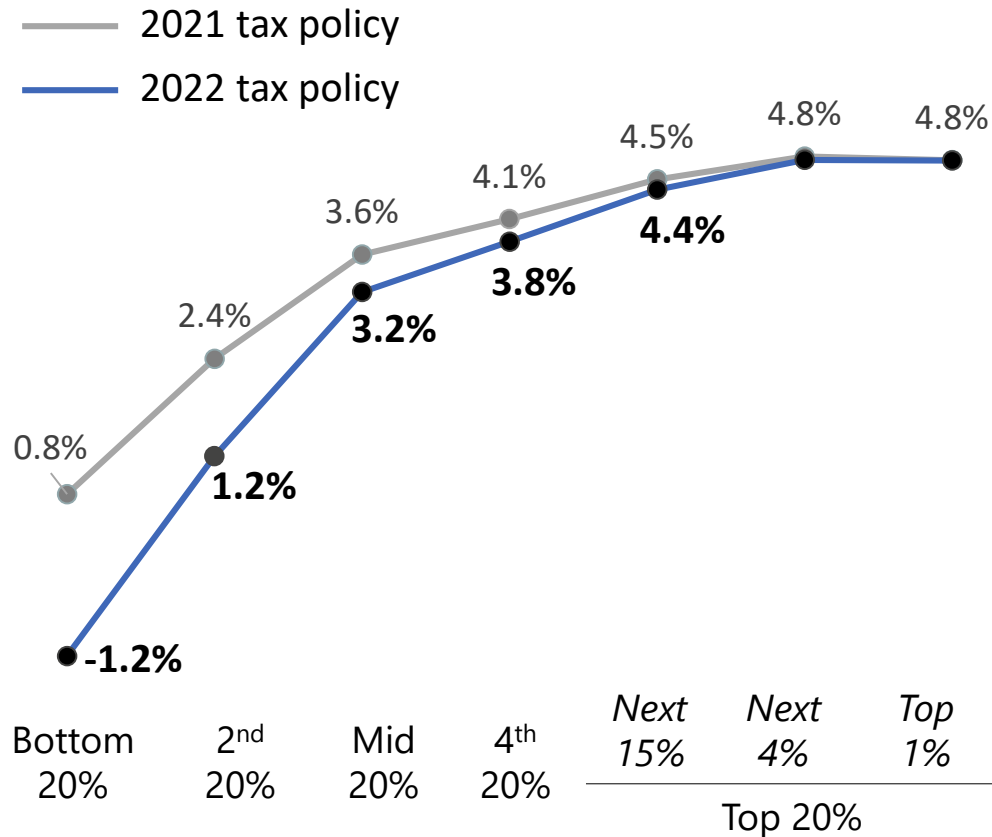
# 2022 General Assembly and governor made two changes to Virginia's individual income tax

- Standard deduction will increase
  - Single filers: \$4,500 to \$8,000\*
  - Married filers: \$9,000 to \$16,000\*
- State earned income credit will now be partially (75%) refundable
  - Refundability will allow low income filers to receive a credit even if they do not have tax liability
  - Refundable credits are an important element of progressive income taxes, according to experts

\*Dependent on state revenues

# 2022 changes will make Virginia's individual income tax more progressive

Effective tax rates, by income group



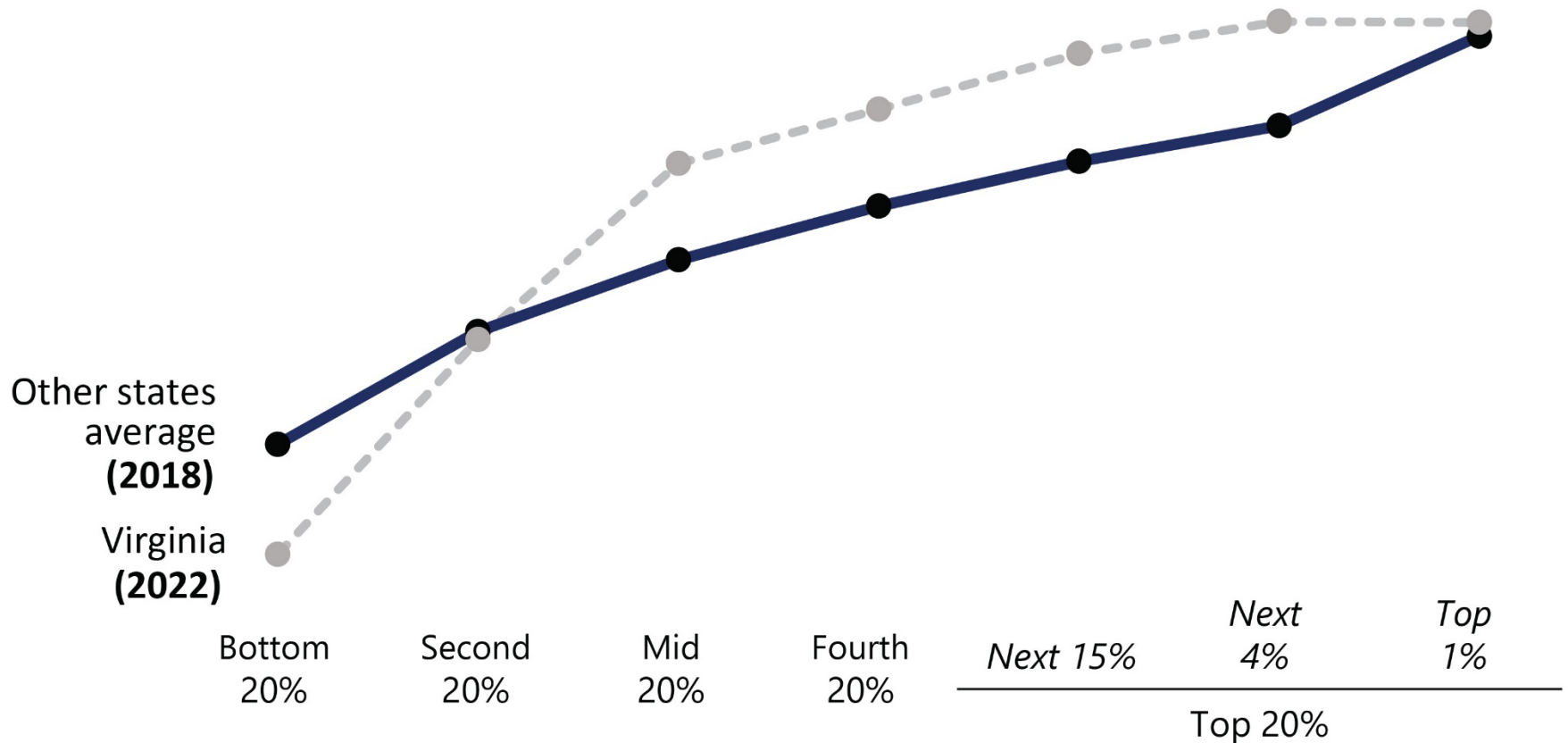
Progressivity index (% change)



High – low rate gap (% change)



# 2022 changes will make Virginia's individual income tax more progressive than average of other states



Source: Who Pays?, Institute on Taxation and Economic Policy (2018) using latest data available, and projections made using the Virginia Individual Income Tax Microsimulation Model.

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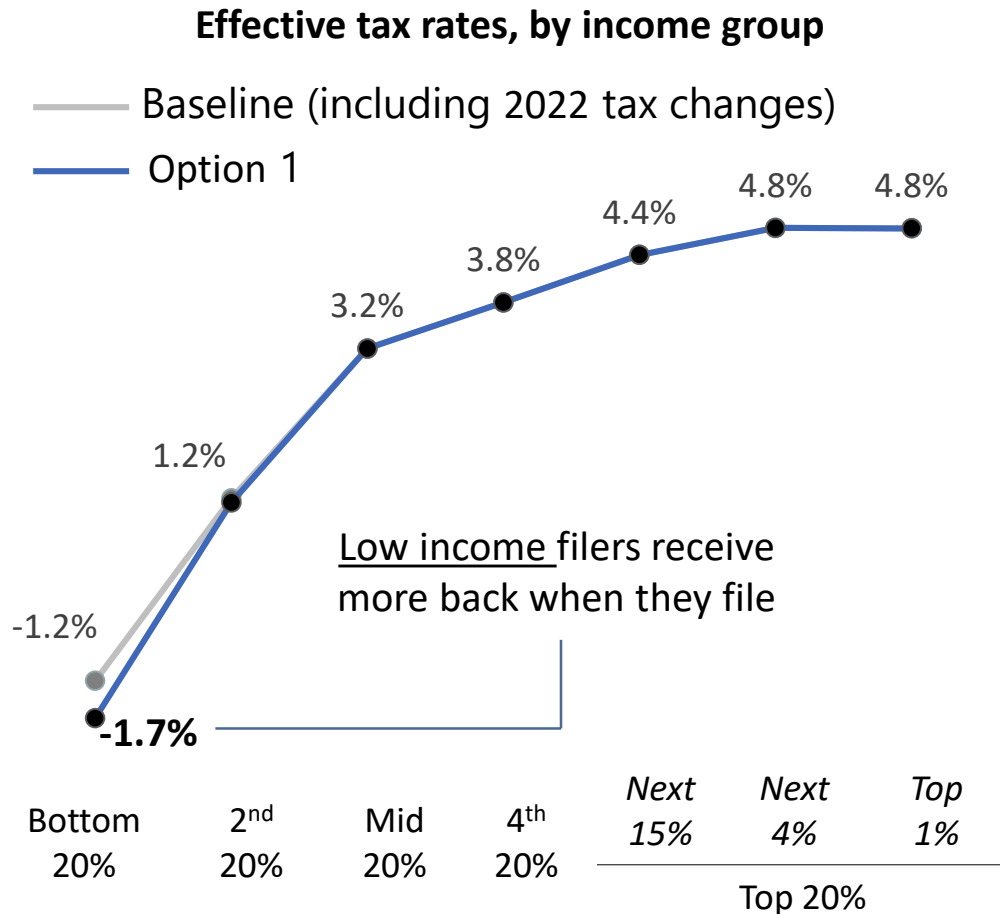
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## Finding

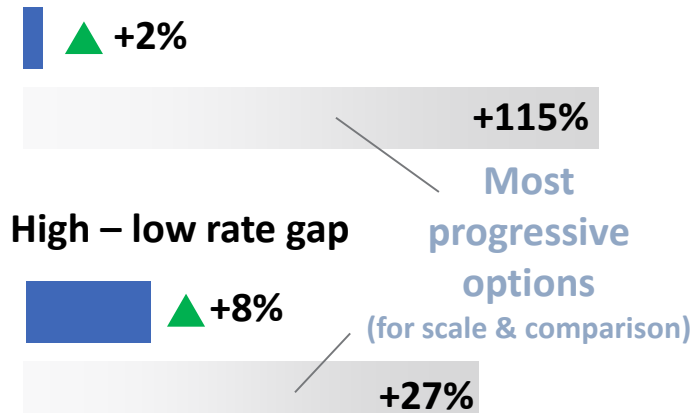
Virginia could make the individual income tax more progressive by increasing the refundable portion of the earned income tax credit or raising the filing threshold.



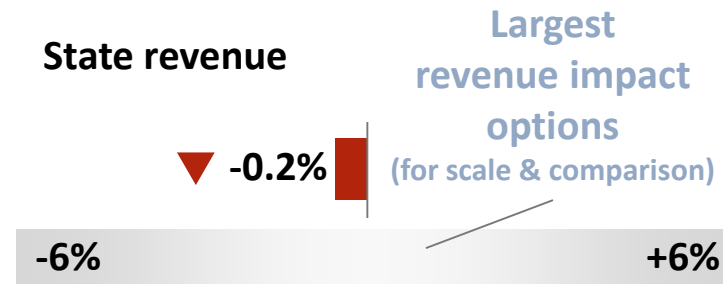
# Option 1: Increase the refundable portion of the EITC from 75% to 100%



## Progressivity index

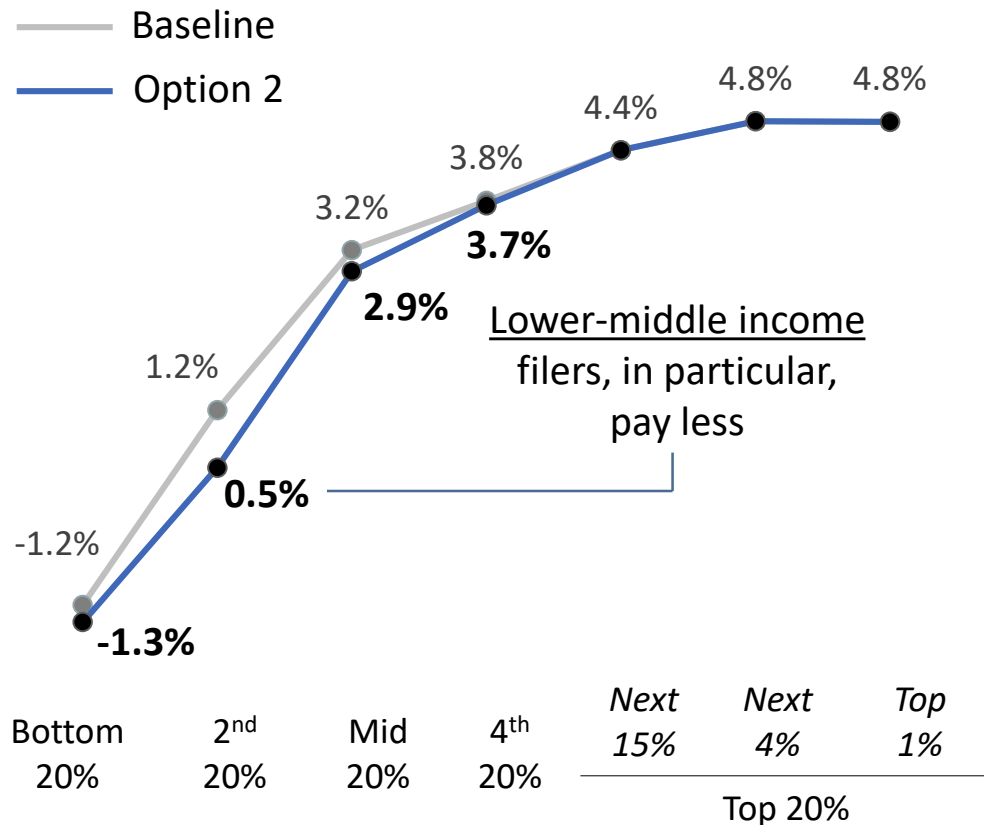


## State revenue



# Option 2: Increase the tax filing threshold to \$27,180 (single) and \$54,360 (joint)\*

Effective tax rates, by income group



## Progressivity index



## High – low rate gap



## State revenue



\*Current thresholds: \$11,950 (single), \$23,900 (joint).

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Increasing progressivity by

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- raising taxes on higher income filers

Maintaining progressivity over time

# Not updating Virginia's income tax brackets since 1990 has steadily reduced progressivity over time

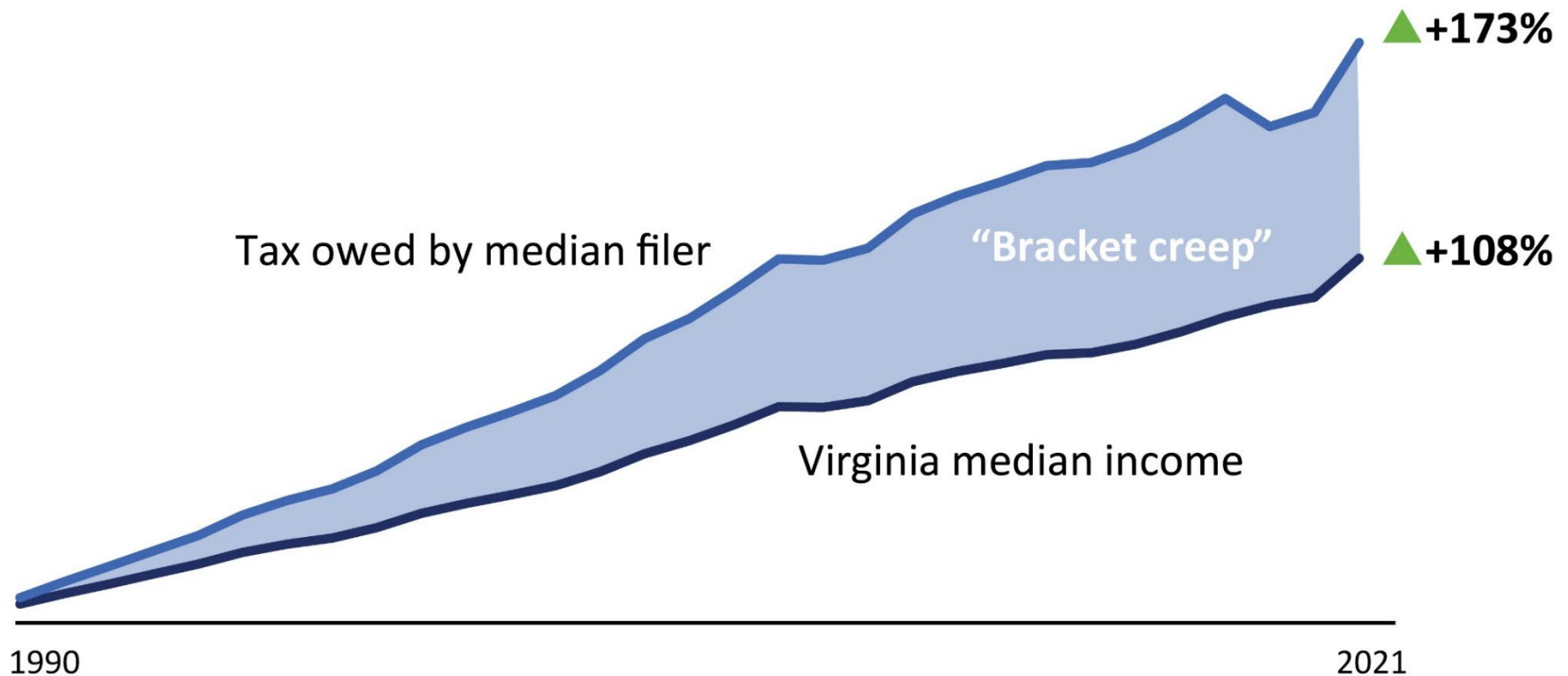
- Income brackets have remained the same since 1990
- Incomes have risen substantially, so a higher percentage of income is in the highest tax bracket\*

	1990	2021
Taxable income of median single filer	\$14K	\$30K
% of median income in highest tax bracket	0%	47%

- “Bracket creep” has particularly affected lower-middle income households

\*Highest tax bracket includes income of more than \$17,000 and is taxed at 5.75%.

# Taxes owed have risen faster than income because of “bracket creep”



Adjusted for inflation.

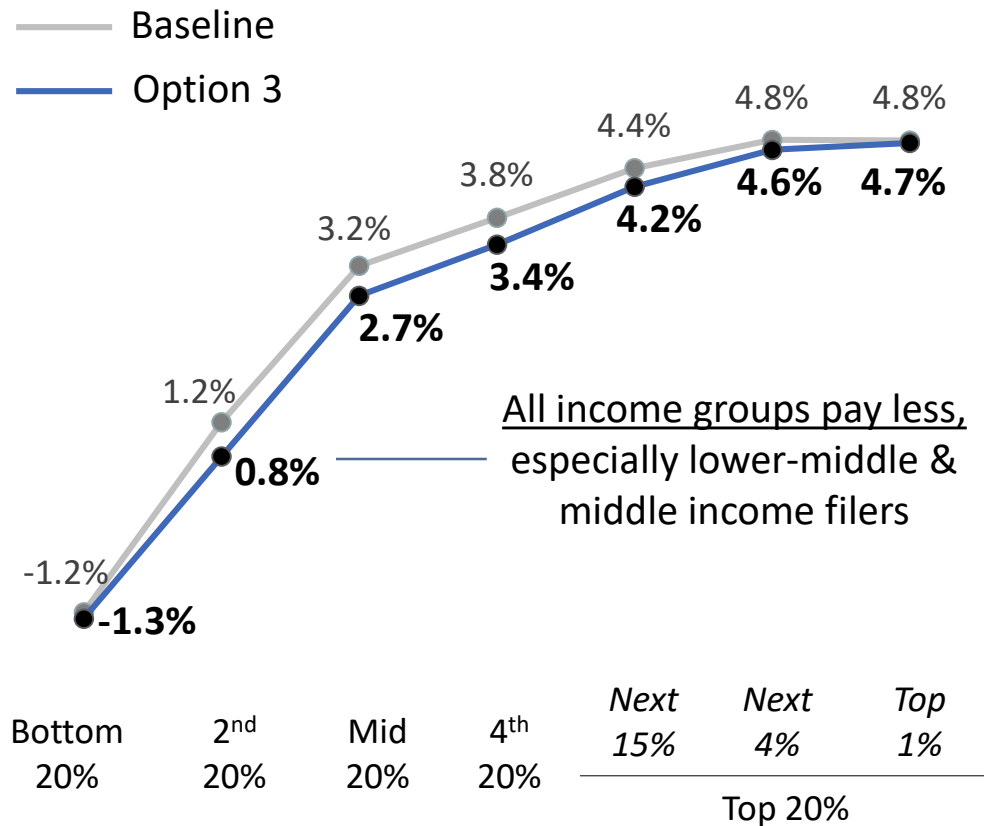
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## Finding

Virginia could make the individual income tax more progressive by adjusting income brackets to account for inflation since 1990.

# Option 3: Adjust income brackets based on inflation since 1990

Effective tax rates, by income group



Progressivity index



High – low rate gap



State revenue



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## Finding

Virginia could make the individual income tax more progressive by changing income brackets and adopting a more progressive tax rate structure.

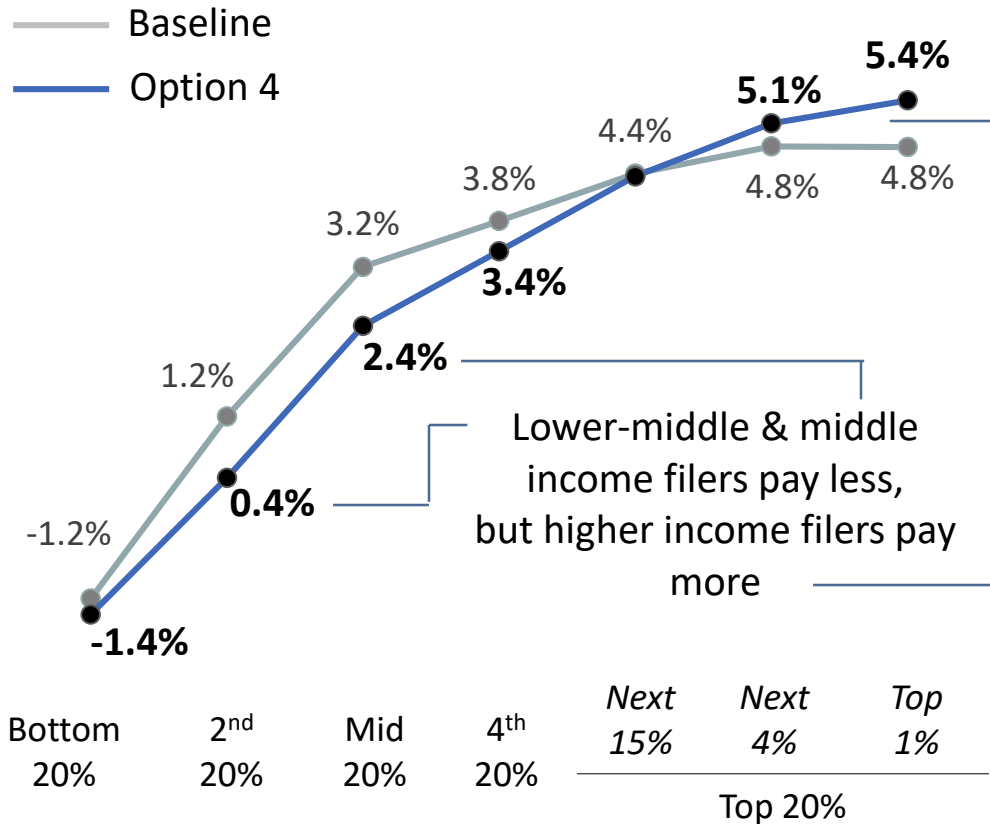


## State could update brackets based on inflation since 1990 & adopt a more progressive rate structure

Current		New	
<i>Brackets</i>	<i>Rates</i>	<i>Brackets</i>	<i>Rates</i>
\$0 to \$3,000	2%	\$0 to \$6,237	1%
\$3,001 to \$5,000	3%	\$6,238 to \$10,395	2%
\$5,001 to \$17,000	5%	\$10,396 to \$35,347	4.5%
\$17,001+	5.75%	\$35,348+	6.5%

# Option 4: Adjust brackets for inflation since 1990 & adopt moderately more progressive tax rates

Effective tax rates, by income group



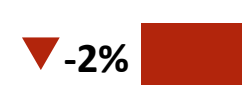
Progressivity index



High – low rate gap



State revenue

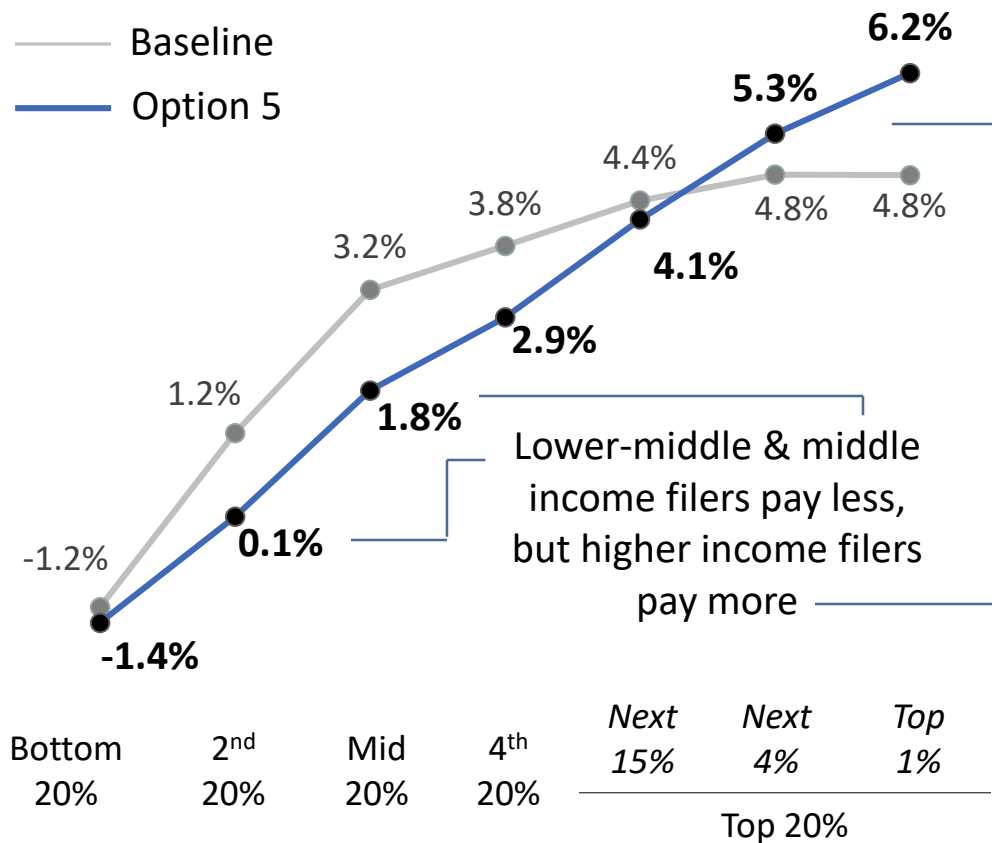


## State could create more brackets based on current income distribution & adopt progressive rates

Current		New	
<i>Brackets</i>	<i>Rates</i>	<i>Brackets</i>	<i>Rates</i>
\$0 to \$3,000	2%	Up to \$5,000	1%
\$3,001 to \$5,000	3%	\$5,001 to \$14,000	1.5%
\$5,001 to \$17,000	5%	\$14,001 to \$36,000	3.5%
\$17,001+	5.75%	\$36,001 to \$50,000	5.5%
		\$50,001 to \$93,000	6.5%
		\$93,001+	7.5%

# Option 5: Create new income brackets & adopt substantially more progressive tax rates

Effective tax rates, by income group



Progressivity index



High – low rate gap



State revenue



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# In this presentation

Background

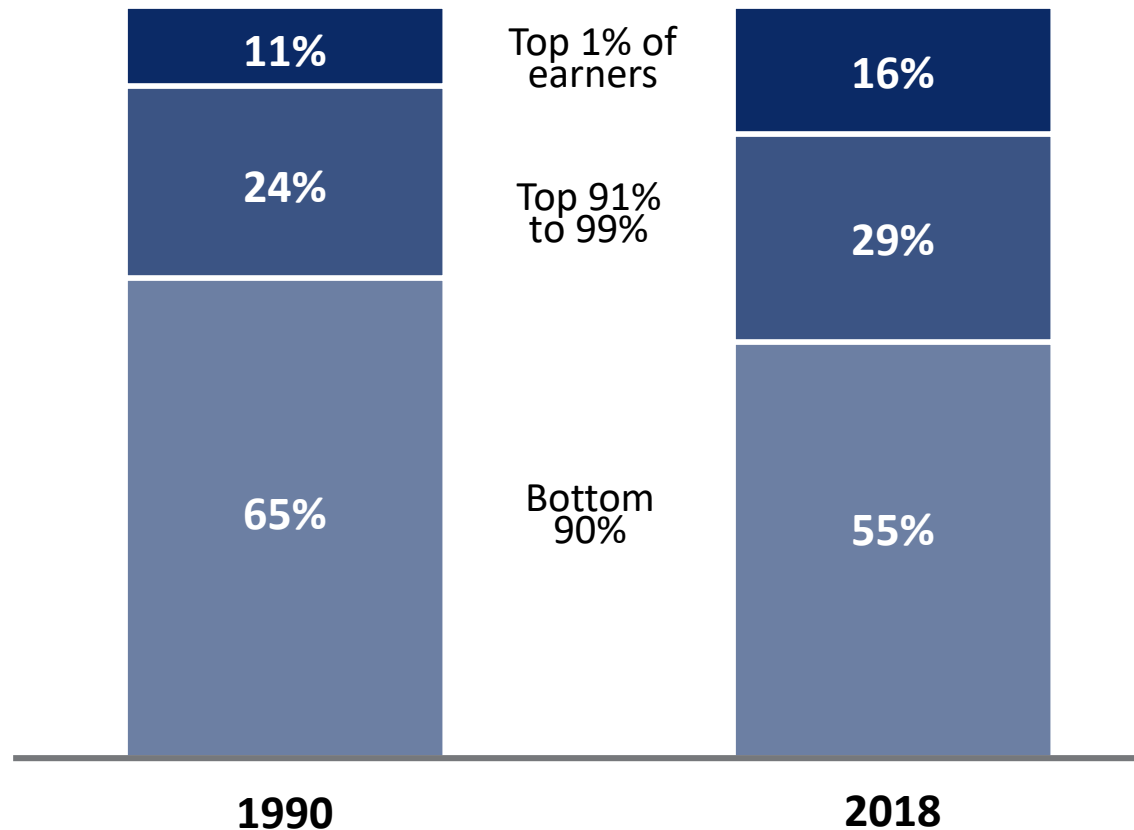
Recent changes to individual income tax

Increasing progressivity by

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- raising taxes on higher income filers

Maintaining progressivity over time

# Proponents of progressivity cite widening income gap as basis for taxing higher income filers more



## Virginia's top rate is less than the national average and substantially less than several states

- Virginia's top rate is below the average top rate of other states with graduated income taxes (5.75% vs. 6.5%)
- Virginia's top rate is substantially less than several other states with more progressive state income taxes
  - California – 13.3% for income above \$1 million
  - Hawaii – 11% for income above \$200,000
  - New Jersey – 10.75% for income above \$1 million
  - New York – 10.3% for income above \$5 million (and 10.9% for income above \$25 million)

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## Regionally, highest income brackets and rates vary

- West Virginia - 6.5% for income above \$60,000
- Maryland - 5.75% for income above \$250,000
- D.C. – 10.75% for income above \$1 million
- North Carolina - 4.99% flat tax at all income levels (reduced in 2022 from 5.25%)



## Larger increases more likely to change behavior, but research on effect of raising top rate is inconclusive

- In general, the larger the increase relative to (i) current rates and (ii) other states' rates, the more likely high income filers may consider moving out-of-state or changing filing behavior
- Recent research, based primarily on state tax increases on high income taxpayers in California, is inconclusive
  - One study found an 0.8% increase in high income earners moving after a large increase in California's top rate
  - Another study, though, found little or no evidence of an increase in moving out of state

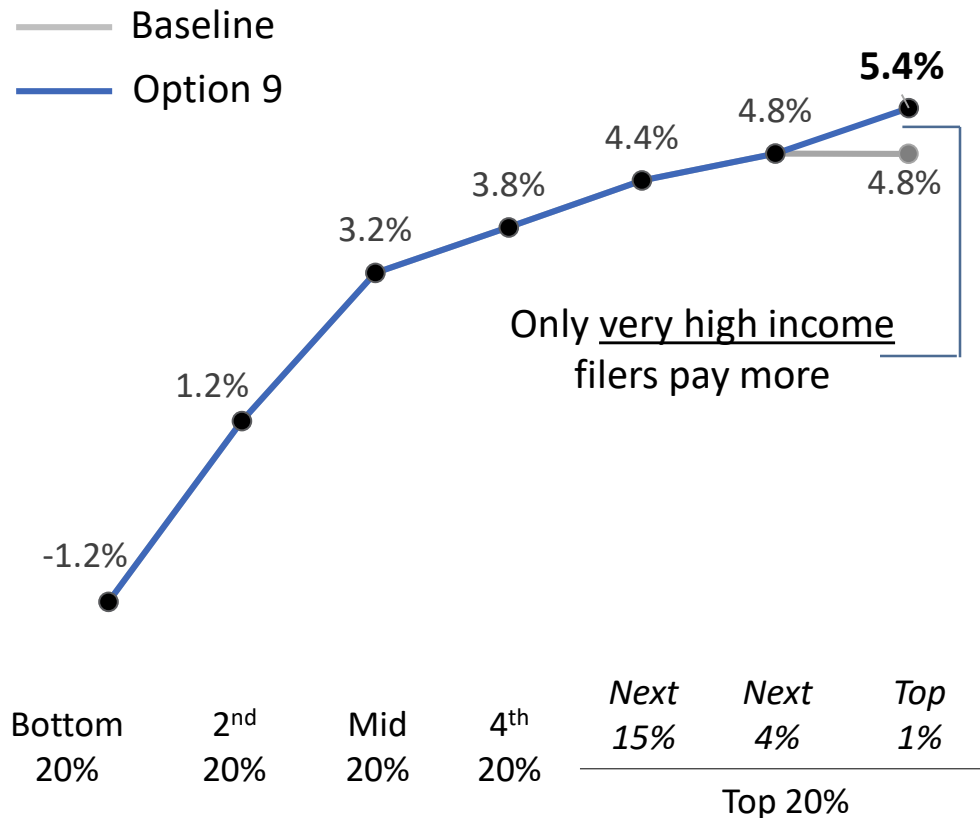
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## Finding

Virginia could make the individual income tax more progressive by creating new income brackets at high or very high income levels and applying higher tax rates to the new brackets.

# Option 9: Add new top 1% income bracket (\$600k+) with a 7% tax rate

Effective tax rates, by income group



## Progressivity index



## High – low rate gap

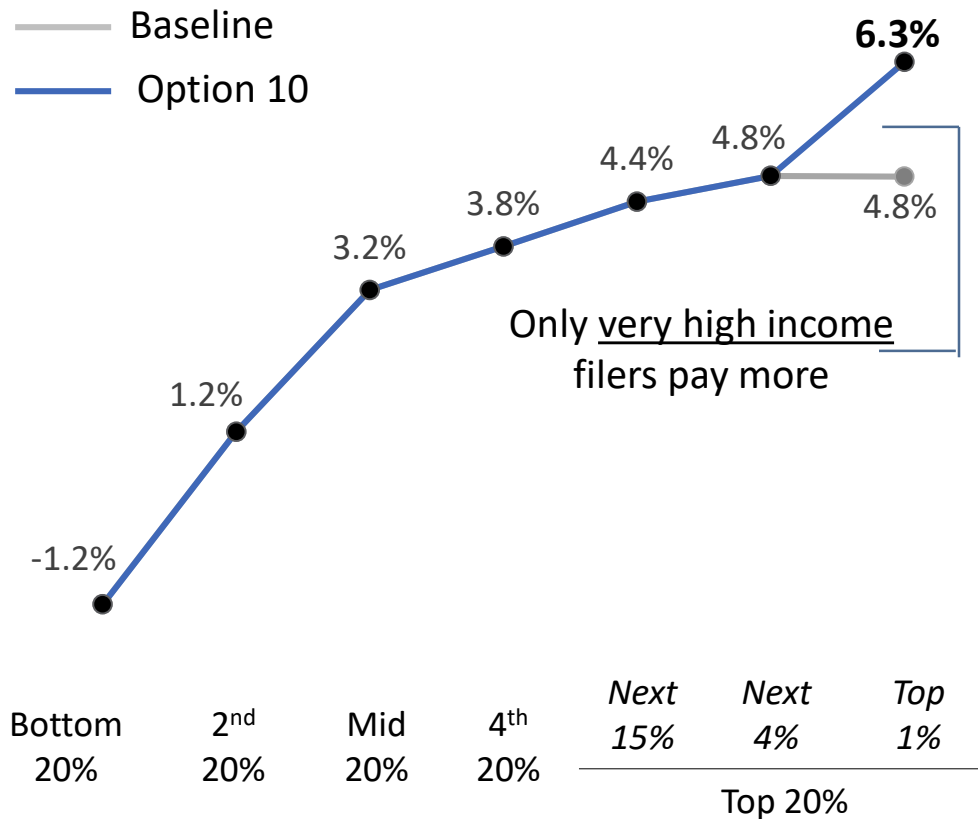


## State revenue



# Option 10: Add new top 1% income bracket (\$600k+) with a 9% tax rate

Effective tax rates, by income group



Progressivity index



High – low rate gap



State revenue



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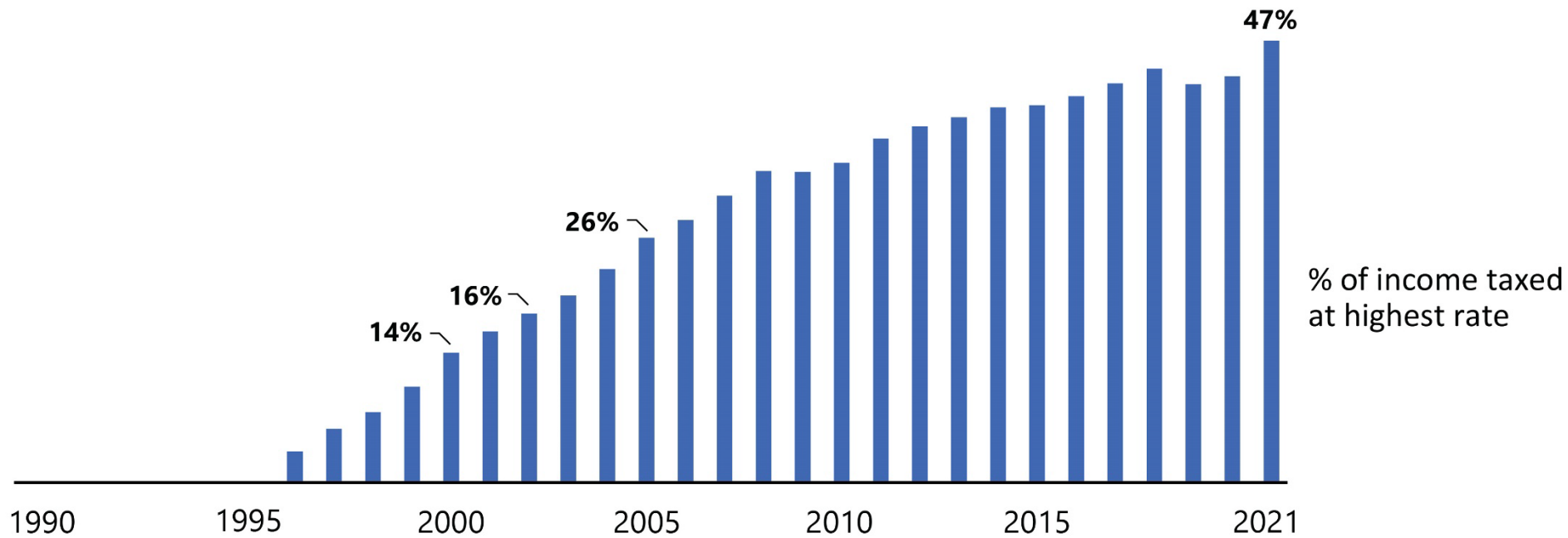
Maintaining progressivity over time

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## Finding

Regularly adjusting income brackets to account for inflation would maintain the progressivity of Virginia's individual income tax.

# Higher percentage of median income has steadily been taxed at highest rate since 1990



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## Adjusting income brackets for inflation is progressive and used by many states

- Federal income tax brackets are regularly adjusted to account for inflation
- Majority (24) of states with graduated individual income taxes make some regular adjustments for inflation to brackets














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## Policy option

The General Assembly could preserve the progressivity of the individual income tax over time by indexing tax income brackets to inflation.

# Key Findings

Option # and description	Change in progressivity		Change in state revenue
	Progressivity index*	High – low rate gap	
#5: New brackets & new more progressive rates	<b>+115%</b>	<b>+27%</b>	 -4%
#4: Adj brackets for inflation & new progressive rates	<b>+57%</b>	<b>+14%</b>	 -2%
#10: New top 1% bracket with 9% rate	<b>+38%</b>	<b>+27%</b>	 +6%
#11: New >\$1M bracket with 10% rate**	<b>+37%</b>	<b>+27%</b>	 +6%
#7: Increase standard deduction to federal**	<b>+30%</b>	<b>+2%</b>	 -6%
#3: Adj income brackets for inflation since 1990	<b>+23%</b>	<b>+1%</b>	 -6%
#2: Increase the tax filing threshold	<b>+16%</b>	<b>+2%</b>	 -2%
#9: New top 1% bracket with 7% rate	<b>+15%</b>	<b>+11%</b>	 +2%
#8: New brackets with 6% & 6.75% rates**	<b>+13%</b>	<b>+8%</b>	 +3%
#6: Increase the personal exemption amount**	<b>+10%</b>	<b>+1%</b>	 -2%
#1: Increase refundable portion of EITC	<b>+2%</b>	<b>+8%</b>	 -0.2%

\*Options shown in order of largest to smallest increase in the progressivity index.

\*\*Option not highlighted in presentation but included in written report.

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## JLARC staff for this report

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