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Report to the Governor and the General Assembly of Virginia

Options to Make Virginia's Individual Income Tax More Progressive

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JLARC
JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION

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Contents

Summary: Options to Make Virginia's Individual Income Tax More Progressive

WHAT WE FOUND

Recent changes to individual income tax will make it far more progressive

During the 2022 legislative session, Virginia made two changes to the individual income tax that will make it much more progressive. The standard deduction was nearly doubled, and the state earned income tax credit will now be partially refundable. Making earned income tax credits refundable—so that low income filers can receive a refund even if they have little or no tax liability—is what many experts say is the single most important element in establishing a progressive tax. Taken together, these changes will make Virginia's income tax 45% more progressive than in 2021 (as measured by change in the "Suits" progressivity index, which measures the progressivity of taxes on all income groups), and more progressive than most other states' income tax.

WHY WE DID THIS STUDY

House Joint Resolution 567 (2021) directs the Joint Legislative Audit and Review Commission (JLARC) to study increasing the progressivity of Virginia's individual income tax system.

ABOUT TAX PROGRESSIVITY AND VIRGINIA'S INDIVIDUAL INCOME TAX

A progressive tax is one in which the share of income paid in taxes rises along with income. Under a progressive tax, higher income filers pay a higher percentage of their income in taxes than lower income filers.

Virginia's individual income tax consists of four income brackets, with gradually higher rates assessed in each bracket. In recent years, more than four million individual income tax returns have been filed annually in Virginia. Revenue from the individual income tax is by far the largest source of state general fund revenue.

The more progressive individual income tax will reduce taxes for many filers, but especially low and lower-middle income filers. Low income filers (first quintile of filers, up to $14,000 in income) will see their effective tax rate (percentage of income paid in taxes) decline substantially, from 0.8% to -1.2%. Lower-middle income filers (second quintile of filers, $14,000 to $36,000 in income) will see their effective tax rates reduced by half, from 2.4% to 1.2%.

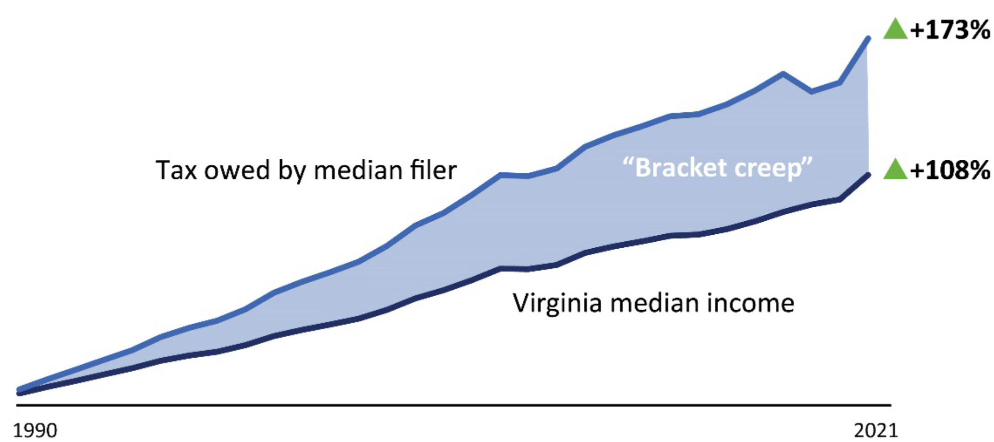
State could increase progressivity by further reducing taxes of lower income filers

As directed by the study resolution, JLARC has identified options the General Assembly could consider to make the individual income tax more progressive. Though Virginia has substantially reduced taxes for low and lower-middle income filers, it could further reduce the tax burden for these filers and make the income tax even more progressive. For example, the state's minimum income filing threshold could be increased, reducing the number of Virginians required to file income taxes. Increasing this threshold would make the income tax 16% more progressive and is estimated to reduce state income tax revenue by about 2% (See Figure, Option 2).

State could increase progressivity by reducing taxes on lower-middle and middle income filers

The General Assembly could also increase the individual income tax's progressivity for lower-middle and middle income (third quintile, $36,000 to $68,000 in income) filers by updating the tax brackets to account for inflation. Virginia's income tax has become less progressive over time, because the income tax brackets have remained the same since 1990. During this time, Virginia median income rose 108%, but income taxes owed by a single filer with median income increased 173%. This difference is due to a much higher percentage of each filer's income being taxed at Virginia's highest rate of 5.75% on income of more than $17,000. Tax experts refer to this dynamic as "bracket creep." Incomes rise over time, but income tax brackets do not.

Taxes owed have far outpaced median income, because income brackets have not been changed since 1990



SOURCE: JLARC analysis of Virginia tax brackets and data on Virginia income, U.S. Census, 1990–2021.
NOTE: Adjusted for inflation.

The state could alleviate this bracket creep by adjusting the income brackets by the cumulative rate of inflation since 1990. Doing so would increase progressivity by 23% (See Figure, Option 3). Because this would address 32 years of inflation, this option is estimated to result in a substantial one-time, 6% reduction in revenue.

The state could increase progressivity even further by adjusting the income brackets based on inflation since 1990 *and* creating a new and more progressive rate structure. The more progressive structure would feature a lower rate for low income filers (1% vs. 2%) and a higher rate for high income filers (6.5% vs. 5.75%). This option would increase progressivity substantially and do so in a cost-efficient manner, because revenue would only decline about 2% (See Figure, Option 4).

The state could also develop completely new income brackets and rates, specifically designed to result in a very progressive income tax by adding brackets and increasing the span between the highest and lowest tax rates. This option would be by far the largest increase in progressivity of all 11 options identified by JLARC. Though this option would increase progressivity the most, it is estimated to reduce revenue by about 4% (See Figure, Option 5).

State could increase progressivity through higher tax rates for higher income filers

The core reasons cited for income tax progressivity are the (i) substantial and growing income differences between high and low income households and (ii) high income households' much greater ability to pay taxes. The state could, therefore, consider raising taxes on higher income filers to increase the progressivity of the state's income tax. Some other states with more progressive taxes, such as California, levy much higher rates on high income filers than Virginia.

The state could create a new income bracket for the top 1% of filers by income (about $600,000 or more in income) and apply a 9% tax rate. This option would increase progressivity by 38% (See Figure, Option 10). Alternatively, the state could create a new income bracket with a 10% rate that would apply only to approximately 17,000 filers with more than $1 million in income. This option would increase progressivity by 37% (See Figure, Option 11). Both of these options are estimated to raise an additional 6% in revenue.

These (and several other) options that raise additional revenue could be paired with options that would lower revenue to minimize or eliminate revenue impacts to the general fund.

Progressivity could be preserved over time through indexing brackets to inflation

The federal government and many states regularly adjust their income brackets, standard deductions, and personal exemptions to account for inflation and reduce bracket creep. The majority of states that tax wage income make regular (usually annual) adjustments for inflation. Virginia could maintain the progressivity of its income tax over time by updating its income brackets annually based on inflation.

JLARC identified 11 options to increase progressivity

	Change in progressivity: Progressivity index	Change in progressivity: High – low rate gap	Income group primarily affected (L M H)	Change in state revenue
Create new brackets & new more progressive rates (**Option 5**)	+115%	+27%	L M	↓ -4%
Adj brackets for inflation & new progressive rates (**Option 4**)	+57%	+14%	L M	↓ -2%
Add new top 1% bracket with 9% rate (**Option 10**)	+38%	+27%	H	↑ +6%
Add new ›$1M bracket with 10% rate (**Option 11**)	+37%	+27%	H	↑ +6%
Increase standard deduction to the federal amount (**Option 7**)	+30%	+2%	L M	↓ -6%
Adjust income brackets for inflation since 1990 (**Option 3**)	+23%	+1%	L M	↓ -6%
Increase the tax filing threshold (**Option 2**)	+16%	+2%	L	↓ -2%
Add new top 1% bracket with 7% rate (**Option 9**)	+15%	+11%	H	↑ +2%
Add new brackets with 6% & 6.75% rates (**Option 8**)	+13%	+8%	H	↑ +3%
Increase the personal exemption amount (**Option 6**)	+10%	+1%	L M	↓ -2%
Increase refundable portion of EITC (**Option 1**)	+2%	+8%	L	↓ -0.2%

$ $ $ (L) Reduce taxes on lower income filers

$ $ $ (L M) Reduce taxes on lower & middle income filers

$ $ $ (H) Raise taxes on higher income filers

Progressivity index = the share of the total state income tax burden across all income groups, as measured through the "Suits index."
High – low rate gap = difference between effective tax rates of top 1% and bottom 20% income groups.

The list of policy options is available on page v.

Policy Options: Options to Make Virginia's Individual Income Tax More Progressive

JLARC staff typically make recommendations to address findings during reviews. Staff also sometimes propose policy options rather than recommendations. The three most common reasons staff propose policy options rather than recommendations are: (1) the action proposed is a policy judgment best made by the General Assembly or other elected officials, (2) the evidence indicates that addressing a report finding is not necessarily required, but doing so could be beneficial, or (3) there are multiple ways in which a report finding could be addressed and there is insufficient evidence of a single best way to address the finding.

This report only includes policy options because changes to the individual income tax are a policy judgment best made by the General Assembly and governor.

Increasing progressivity by reducing taxes primarily on low income filers

POLICY OPTION 1
The General Assembly could reduce effective tax rates of low income filers by increasing the amount of the earned income credit that is refundable from 75% to 100%. (Chapter 3)

POLICY OPTION 2
The General Assembly could reduce effective tax rates of low, lower-middle, and middle income filers by increasing the filing thresholds from $11,950 to $27,180 for single filers and $23,900 to $54,360 for joint filers. (Chapter 3)

Increasing progressivity by reducing taxes primarily on lower-middle and middle income filers

POLICY OPTION 3
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by adjusting income brackets to account for inflation since brackets were last updated in 1990. (Chapter 4)

POLICY OPTION 4
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by (i) adopting new tax rates of 1%, 2%, 4.5%, and 6.5%, and (ii) applying each rate to the existing four bracket structure updated to account for inflation since brackets were last updated in 1990. (Chapter 4)

POLICY OPTION 5
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by (i) adopting new tax rates of 1%, 1.5%, 3.5%, 5.5%, 6.5%, and 7.5%, and (ii) applying each rate to a new six bracket structure based on the current income distribution. (Chapter 4)

POLICY OPTION 6
The General Assembly could reduce effective tax rates, in particular for lower-middle and middle income families, by increasing the personal exemption for a filer, their spouse, and each dependent from $930 to $2,000. (Chapter 4)

POLICY OPTION 7
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by increasing the standard deduction to the federal amounts ($8,000 to $12,950 for single filers and $16,000 to $25,900 for joint filers). (Chapter 4)

Increasing progressivity by raising taxes on higher income filers

POLICY OPTION 8
The General Assembly could increase effective tax rates of higher income filers by creating a (i) new $100,000 to $1 million income bracket with a tax rate of 6% and (ii) new more than $1,000,000 income bracket with a tax rate of 6.75%. (Chapter 5)

POLICY OPTION 9
The General Assembly could increase effective tax rates of higher income filers by creating a new $600,000 or more income bracket with a tax rate of 7%. (Chapter 5)

POLICY OPTION 10
The General Assembly could increase effective tax rates of higher income filers by creating a new $600,000 or more income bracket with a tax rate of 9%. (Chapter 5)

POLICY OPTION 11
The General Assembly could increase effective tax rates of higher income filers by creating a new more than $1,000,000 income bracket with a tax rate of 10%. (Chapter 5)

Maintaining progressivity over time

POLICY OPTION 12
The General Assembly could preserve the progressivity of the individual income tax over time by indexing income brackets to inflation. (Chapter 6)

1 Virginia's Individual Income Tax

House Joint Resolution 567 from the 2021 General Assembly directs the Joint Legislative Audit and Review Commission (JLARC) to study increasing the progressivity of Virginia's individual income tax system. The resolution directs JLARC to identify and evaluate the impact of potential changes to the individual income tax (tax brackets, tax rates, credits, deductions, and exemptions) to make the tax more progressive. (See Appendix A.)

The JLARC study team used several quantitative and qualitative methods for this project. The team reviewed research on tax policy and how other states structure their income tax. The team also interviewed tax policy experts and other stakeholders to help understand the progressivity of Virginia's current individual income tax and potential changes to make it more progressive. The team obtained tax data from Virginia Tax to analyze trends and patterns in taxation by income level and also coordinated with Virginia Tax to model the impact of potential changes. (See Appendix B.)

The General Assembly has created a legislative **Joint Subcommittee on Tax Policy**. The subcommittee is to evaluate the impact of potential changes considering fairness, certainty, convenience, efficiency, simplicity, and neutrality.

Virginia's income tax consists of income brackets, rates, and deductions, exemptions, and credits

Since 1990, Virginia's individual income tax has featured four income brackets with a different rate applied to income within each bracket (Table 1-1). Individuals with Virginia adjusted gross income at or above a specific threshold ($11,950 for single filers and $23,900 for married filers) are required to file an income tax return.

Virginia has had an income tax for more than 175 years. Virginia has levied an individual income tax since 1843, when the state began levying a 1% tax on salaries above $400. In the early 1850s, the state shifted to a graduated rate structure that taxed salary income and investment income at different rates.

TABLE 1-1
Virginia's individual income tax has four income brackets with higher rates for each bracket

Virginia 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

SOURCE: Virginia Tax.

Taxable income is the amount of income remaining after all applicable exemptions and deductions.

Virginia's income tax also allows filers to take deductions, exemptions, and credits that reduce their tax liability. These include a standard deduction based on whether someone is filing individually or jointly; personal exemptions for the filer and any qualifying dependents; and other deductions and credits based on specific circumstances (which are discussed as relevant throughout this report). Filers use state tax Form 760 (or 763 for nonresidents) and any necessary additional schedules to file.

Virginia's income tax is paid by four million filers

Changes to individual income taxes can affect a substantial number of individuals. In contrast with more narrow taxes (e.g., excise taxes on certain goods), income taxes are broad-based taxes. In Virginia, everyone with income at or above the filing threshold is legally required to file an individual income tax return (including residents and nonresidents with income earned in Virginia).

In recent years, more than four million individual income tax returns have been filed annually in Virginia. The majority of these returns are by single filers (59%), and the remainder (41%) are by married filers. The vast majority of married filers file a joint return; 4% file a separate return.

These four million filers reported just under $78,000 in Virginia adjusted gross income, on average (2019). Filers were liable for about $3,500 in state income tax, on average. This liability accounted for about 4.5% of average adjusted gross income for all filers. (These figures exclude households that paid no state income tax because their taxable income was below Virginia's filing threshold and had little or no income withheld by their employer.)

For federal tax purposes, **adjusted gross income (AGI) is gross income minus any adjustments.** The Internal Revenue Service defines gross income as all income, including income from wages, investments, businesses, and retirement distributions. Adjustments are reductions to income such as student loan interest or qualifying contributions to retirement accounts.

Virginia requires filers to add or subtract some forms of income from federal AGI to arrive at their Virginia AGI.

Virginia income tax comprises 70% of Virginia general fund revenue

State income taxes are typically one of the main revenue sources for states, in addition to federal funding, sales or excise taxes, corporate income taxes, and other forms of taxation.

State individual income tax revenue is by far Virginia's largest source of general fund revenue. Total revenue collected through the individual income tax was about $17.2 billion in FY21, which accounted for approximately 70% of all general fund revenue collections. The second largest general fund revenue source, the retail sales and use tax, accounted for about 17% of general fund revenue. The corporate income tax was the third largest general fund revenue source, accounting for about 6%.

Virginia has become increasingly reliant on the individual income tax over time. Since 2000, the tax has grown from about 63% of total general fund revenues to about 70% (Table 1-2).

TABLE 1-2
Individual income tax's share of total general fund revenue has grown

	2000	2005	2010	2015	2020
Individual income tax revenue	$6.9B	$8.4B	$9.1B	$12.3B	$15.4B
Total general fund revenue	10.8B	13.8B	14.3B	17.9B	21.9B
Individual income tax as % of total general fund	**63.1%**	**60.7%**	**63.5%**	**69.0%**	**70.1%**

SOURCE: JLARC analysis of Virginia Tax revenue reports, 2000–2020.
NOTE: General fund revenue amounts shown represent general fund revenue collected by Virginia Tax and other state agencies.

State income tax is one tax among other federal, state, and local taxes

The state individual income tax makes up a relatively small portion of an individual's total tax liability, which limits the General Assembly and governor's ability to substantially affect individuals' tax burden. Virginians may pay several federal, state, and local taxes each year. These taxes are on income, purchases, or the value of property.

Virginia ranked **27th among states in total state tax per capita** at $3,072 (2019).

In addition to the state income tax, Virginians' income is subject to the federal income tax (10% to 37% depending on income) and Social Security and Medicare taxes (7.65%). The federal income tax has much higher rates than the Virginia income tax; consequently, the federal tax typically comprises the majority of an individual's total income taxes. For example, the Virginia income tax would be about one-fifth of the average Virginian's total income tax liability (Table 1-3).

TABLE 1-3
State income tax is typically small percentage of total income taxes paid

	Federal income tax	Soc. Sec. & Med. taxes	Virginia income tax	Total income tax
$	$10,148	$5,967	$3,915	$20,030
% of total income tax	51%	30%	**19%**	100%

SOURCE: JLARC analysis of hypothetical tax liability for 2021.
NOTE: Assumes single filer with no dependents earning about $78,000 annually.

Some localities have higher sales taxes than the state's 5.3% sales tax: Northern Virginia, Hampton Roads, and Central Virginia (6%), Williamsburg, James City, and York (7%), and Danville Charlotte, Gloucester, Halifax, Henry, Northampton, and Patrick (6.3%).

In addition to income taxes, Virginians also pay state and local taxes on the value of purchases (e.g., tangible goods, accommodations, and certain services) or property. The state sales tax is typically 5.3%, but is higher in certain regions or localities (sidebar). Localities also tax property such as real estate and vehicles at different rates. For example, a homeowner in Richmond pays $1.20 for every $100 of the assessed value of their home, or 1.2%.

2 Income Tax Progressivity

A progressive tax is one of three tax structures that describe how taxes are distributed across taxpayers (sidebar). A progressive tax is generally defined as one in which the percentage of income paid in taxes rises with income. The rationale for a progressive tax is ability to pay: individuals with higher incomes have a greater ability to afford taxes than lower income taxpayers, after paying for basic necessities such as housing, food, and medical care.

Income levels discussed in this chapter and throughout this report are generally referring to the quintiles of Virginia's income distribution. "Low income" refers to the bottom 20th percent of all income. "Lower-middle income" refers to the second 20th percent, and "middle income" is the middle 20th percent. "Upper-middle income" refers the fourth 20th percent. "High income" is usually all (or a subset) of the top 20th percent of all income.

Taxes can be progressive, proportional, or regressive. With *progressive* taxes, the percentage of income paid in taxes increases as income increases. With *proportional* taxes, or flat taxes, the percentage of income paid in taxes remains the same as income increases. With *regressive* taxes, the percentage of income paid in taxes decreases as income increases.

Difference between low and high income is substantial and has steadily grown over time

Proponents of progressive taxation cite the substantial differences between those with higher and lower income as the reason for progressive taxes. As in all states, there are substantial differences in income in Virginia. Virginia filers in the bottom 20th percent of income reported an average income of about $5,400. In contrast, filers in the top 20th percent of income reported on average $287,000 in income—more than 50 times as much as those in the bottom 20th percent (Table 2-1).

TABLE 2-1
Substantial differences exist between lower and higher income filers in Virginia

	Bottom 20th	Second 20th	Middle 20th	Fourth 20th	Top 20th
Average income	$5,411	$24,502	$50,688	$94,994	$286,857
Multiple of bottom 20th	-	4.5x	9x	18x	53x

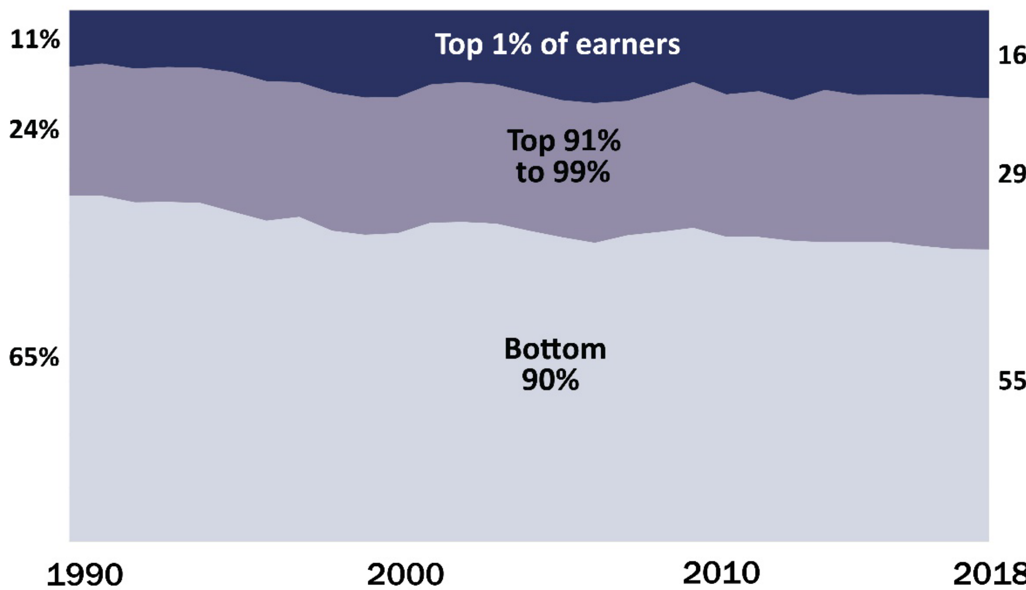
SOURCE: Estimated 2022 income, PolicyLinks Microsimulation model.
NOTE: Figures shown are averages within income quintiles.

This review will not address benefits from government services. Some tax policy experts view taxation in the context of benefits received in return for taxes paid. This review will not conduct this analysis because of the speculation required to make assumptions about the benefits higher income tax filers receive from government (e.g., public safety, transportation infrastructure, enforcement of property rights, etc.)

Income is heavily concentrated among high income filers in Virginia, though slightly less so than nationally. (Proponents of progressive taxation frequently cite the difference in income between the top 1% and other groupings.) In 2018, the top 1% of filers in Virginia accounted for 16% of all individual income in the state. Nationally, the top 1% of filers accounts for 20% of all income.

Over time, the top 1% of income earners' share of total income in Virginia has grown (Figure 2-1). Concurrently, the bottom 90% of income earners' share of total income decreased from 65% to 55% since 1990. This long-term shift of income concentration to higher income earners has also been occurring nationally and globally. Multiple factors have contributed to this trend, including economic changes that have disadvantaged lower income, lower skilled workers, such as advances in automation and other technologies and globalization.

FIGURE 2-1
Top 1% of earners' total share of Virginia income has grown



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

Recent changes will make Virginia's income tax more progressive

Effective tax rates are the most accurate way to determine the progressivity of taxes. The effective rate is the actual tax rate paid after accounting for deductions, exemptions, and credits. Most filers are able to use one or more of these deductions, exemptions, or credits, which allow them to reduce their taxable income. These enable some filers to lower their income substantially. For example, Virginia filers benefited from, on average, nearly $15,000 in deductions and exemptions. This reduced their adjusted gross income by an average of 17%.

With a progressive income tax, effective tax rates increase as income rises. Filers in the lowest income group pay the lowest effective tax rates, and effective tax rates increase for each higher income group. Tax experts use a variety of measures to quantify tax progressivity; this report will primarily use two of these measures:

- *Progressivity index* measures the relative tax burden of each income group. (Researchers refer to this as the Suits index; see sidebar.) This measure focuses equally on all filers regardless of income level and is a comprehensive measure of progressivity across all income groups.
- *High – low rate gap* measures the difference between the effective tax rates of low income and very high income filers. This measure is the difference between the effective tax rates of the top 1% of filers and the bottom 20% of filers. A larger difference between the two indicates a more progressive tax system. This measure excludes middle income taxpayers, only measuring the lower income and the very highest income filers, because proponents of progressive taxation cite this income gap as a basis for levying progressive taxes.

The Suits index calculates the share of the total state income tax burden across all income groups. A fully progressive tax system would receive an index score of 1 (e.g., the highest income filer pays 100% of taxes). A fully regressive tax system would receive a score of -1 (e.g., the lowest income filer pays 100% of the taxes).

No actual tax system receives a score of 1 or -1; however, the relative difference in the Suits index between two tax systems (or from a change to a tax system) is indicative of a more or less progressive tax system.

Virginia's income tax has been progressive and will become more progressive after recent changes

Virginia's individual income tax is progressive because filers pay higher effective tax rates as their taxable income rises. The income tax's progressivity is partially the result of the lower income tax rates applied to lower income brackets, but also the proportionally greater effect that deductions, exemptions, and credits have in reducing taxes for lower income filers.

Virginia made two changes to its individual income tax in 2022 that will make the tax much more progressive (sidebar). First, the standard deduction will increase from $4,500 to $7,500 (or $8,000 depending on state revenue collections) for single filers and from $9,000 to $15,000 (or $16,000 depending on revenue collections) for married filers. Second, the state earned income tax credit will be partially refundable for the first time. The state earned income credit is 20% of the federal Earned Income Tax Credit, and 75% of the state credit will now be refundable (corresponding to 15% of the federal credit) for Virginia residents. Making part of the credit refundable allows low income filers to receive the credit even if they do not have tax liability. This means some low income filers will have negative effective tax rates, because they receive a refund greater than their liability (or even their income in some cases). A refundable tax credit is essentially a tax subsidy for low income filers.

Changes to Virginia's income tax for 2022 are retroactive to tax year 2022 and are projected to reduce state revenue about 2% that year.

Projections assume standard deductions of $8,000 and $16,000. The earned income tax credit remains nonrefundable for nonresidents.

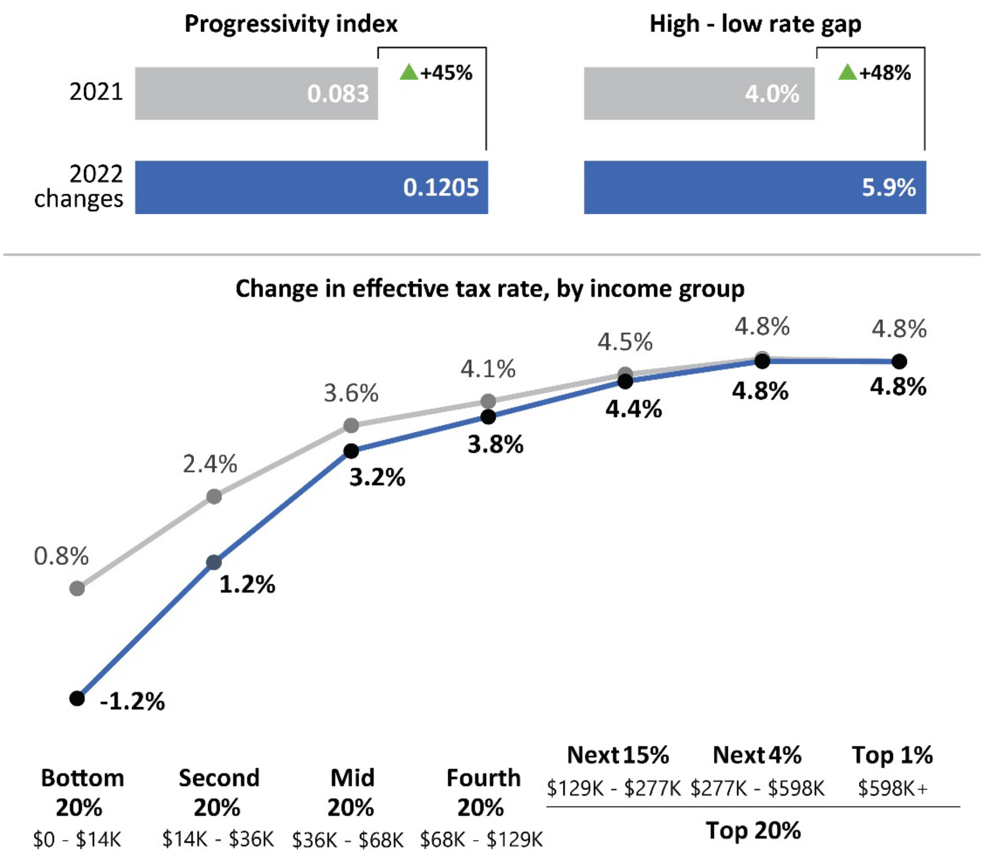
Many experts say a refundable earned income tax credit is the single most important element of a progressive income tax. Virginia is now among many states that use refundable credits to subsidize low income filers. As of early 2022, 30 states and the District of Columbia have established an earned income tax credit, 27 of which are refundable.

Virginia's income tax is now substantially more progressive, based on both the progressivity index and the high – low gap measure (Figure 2-2). The progressivity index will increase 45%. The high – low gap measure will increase 48%, primarily because of the substantial reduction in effective tax rates for low income filers, which results from the earned income credit will be partially refundable. Low income filers will see their effective tax rate decline substantially from 0.8% to a negative 1.2%. Lower-middle income filers (the second 20th percentile) will see their effective tax rates reduced by half, from 2.4% to 1.2%.

Another important element of Virginia's tax progressivity is that an estimated 10% of Virginians with incomes below the filing threshold have historically not filed income tax returns. They have zero tax liability and are therefore similar to those in the lowest income group who did file. However, households that pay no income tax in a given year do pay sales and other taxes and fees. (In the 2022 legislative session, the 1.5% state tax on groceries was eliminated.)

FIGURE 2-2

Virginia's income tax has become more progressive because of 2022 changes



SOURCE: JLARC analysis of tax filing data by income quintile and modeling of how 2022 changes are projected to change effective tax rates by income quintile.
NOTE: Income shown above is JLARC analysis of adjusted gross income. Top 20% is disaggregated because of more substantial income differences within the quintile.

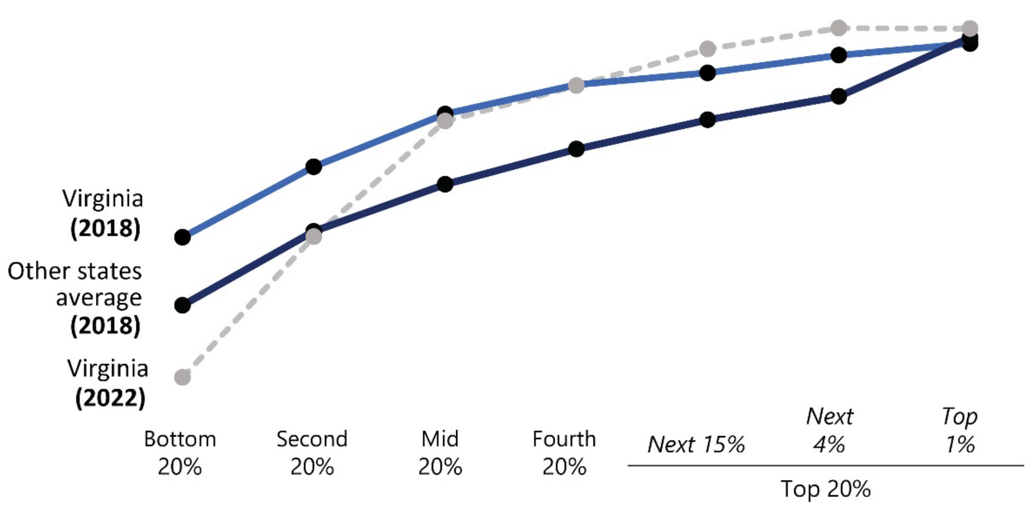
Virginia's income tax historically has been less progressive than average of other states but after 2022 changes will be above average

Most states (41), including Virginia, levy an income tax on wage income. Seven states have no income tax, including Florida, Texas, and Tennessee. New Hampshire only taxes dividend and interest income, and Washington taxes the capital gains income of high income filers. States that do not levy an income tax collect revenue through other taxes and fees, especially sales or excise taxes. Of the 41 states that tax wage income, 32 have a graduated rate structure, and nine have a flat tax (a single tax rate).

Virginia's income tax has been less progressive than other states' income taxes until recently, according to the Institute on Taxation and Economic Policy (Figure 2-3). As of 2018 (the latest year for which national data on effective tax rates by state is available), Virginia's individual income tax was less progressive than most states (based on the high – low income rate gap measure). Virginia's income tax has also been less progressive than the tax in neighboring states of Maryland, North Carolina, and West Virginia. It has also been substantially less progressive than the District of Columbia's income tax.

FIGURE 2-3

Virginia's income tax has historically been less progressive than average, but 2022 changes make Virginia's income tax substantially more progressive



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.
NOTE: Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+. Top 20% is disaggregated because of more substantial income differences within the quintile.

However, the changes made in 2022 will result in Virginia's income tax being more progressive than the average of other states. Because effective tax rates of the lowest income filers in Virginia will be negative, Virginia will be more progressive on the *high*

– *low gap* measure. Effective tax rates of higher income filers will remain essentially the same. (Note that in Figure 2-3 they appear to increase, in part because of the effect of inflation between 2018 and 2022).

3 Increasing Progressivity by Decreasing Taxes on Lower Income Filers

HJ 567 directs JLARC to "study increasing the progressivity of Virginia's individual income tax system." Whether and how to change the individual income tax is a policy decision for the General Assembly and governor. To inform consideration of whether and how to change the income tax to make it more progressive, this report:

- identifies options to change various elements of the state individual income tax to make the tax more progressive;
- estimates how effective tax rates for each income group and state revenue would change if each option were implemented (sidebar); and
- ranks the impact of these options on two measures of progressivity, one that considers all income groups and one that only considers the highest and lowest income groups (sidebar).

The impact of each option was estimated using the same software used by Virginia Tax to estimate the cost of tax policy changes. Virginia Tax provided JLARC staff with temporary, secure access to its PolicyLinks Microsimulation model. See Appendix B for more information.

JLARC staff identified 11 options the General Assembly could consider if it wishes to make the state individual income tax more progressive. These options were identified through (i) elements of the income tax noted in the study resolution, (ii) proposed changes during recent legislative sessions, (iii) characteristics or features of other state income taxes, and (iv) staff analysis of tax filing data. All options are compared with the new 2022 baseline projections for state income tax revenue, which include increasing the standard deduction and making the state earned income tax credit partially refundable.

Two measures of progressivity are used throughout this report. The *progressivity index* is the share of the total state income tax burden across all income groups, as measured through the "Suits index." The *high – low rate gap* is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Chapter 3 includes two options the state could consider to increase progressivity by lowering the effective tax rates of low and lower-middle income filers. However, changes in 2022 substantially reduced the effective tax rates for these filers, so these options would provide only modest additional tax reductions.

Both options would reduce revenue from baseline income tax revenue projections. However, because lower income filers account for a small percentage of total revenue collections, the projected reductions in revenue are relatively small. These options could be paired with options in Chapter 5 that increase effective tax rates for higher income filers—all of which would collect more revenue—to reduce or eliminate reductions in general fund revenue. For example, the filing threshold could be raised to decrease taxes on low income filers, and a 7% rate could be levied on the top 1% of filers. Raising the filing threshold would lower revenue by about 2%, but a new 7% rate on higher income filers would increase revenue by about 2%.

Option 1: Virginia could further expand its newly refundable earned income tax credit

States with more progressive income taxes typically provide a state refundable earned income tax credit (EITC). Tax policy experts indicate that refundable low income credits are a cost effective way to make tax systems more progressive. Refundable low income credits allow very low income filers to receive a tax subsidy if they have little or even no tax liability. This increases the difference between the tax rates of very low income and high income filers, making a tax system more progressive. The federal earned income tax credit substantially increases the income of working families who are close to the poverty level (Case Study 3-1).

More than 500,000 Virginia filers claimed the federal EITC in 2019; an estimated 290,000 filers claimed the state EITC. The median federal EITC of Virginia filers was $2,100. The average state EITC amount was $350. This was in 2019 *before* the state credit was made refundable.

CASE STUDY 3-1

Virginia's EITC is 20% of the federal EITC. So assuming a couple in Virginia has two children, earns $25,000, and files jointly:

Federal taxes – The couple is eligible for the maximum federal EITC of $6,164; a 25% increase in their after tax income.

Virginia taxes – The couple is eligible for $1,233 from Virginia's EITC, which is 20% of their federal EITC amount. Because 75% of the Virginia EITC is now refundable, this family could receive $925 even if they have no tax liability after taking all available deductions and exemptions.

As of 2022, 30 states (and Washington, D.C.) offer an EITC, with an additional three states set to offer a credit starting in 2023. The average state EITC is about 25% of the federal EITC, making Virginia's credit of 20% of the federal EITC close to the average across states. Twenty-seven of those states, now including Virginia, make all or part of their credit refundable.

Virginia could increase the portion of the EITC that is refundable from 75% to 100% (Option 1). This would be in addition to the changes made in 2022 to make 75% of the credit refundable. Like the current rules, the credit would only be refundable for residents. Option 1 would increase progressivity by further raising the subsidy provided to low income filers. Tax liability would be unchanged for other households. In Case Study 3-1, the family would receive the full $1,233 instead of $925.

On progressivity measures, Option 1 would increase the progressivity index (which measures all income groups) only slightly, by 2%. However, the high – low gap measure would increase 8%.

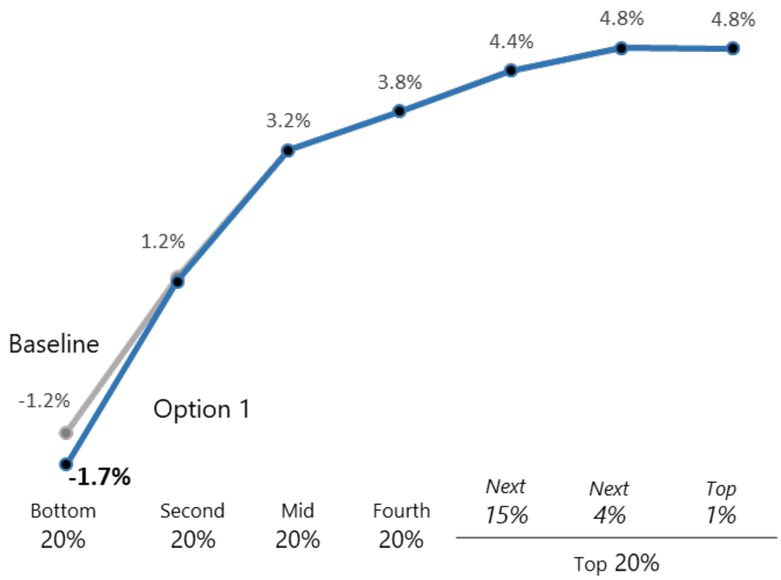
This option is a relatively inexpensive way to increase Virginia's income tax progressivity. Because lower income filers contribute proportionally little to total revenue, state income tax revenue is estimated to decrease only $36 million from baseline revenue projections (far less than 1%). This estimate includes the higher subsidy that would be provided to low income filers.

Option 1: Increase refundable portion of EITC to 100%

Increase the refundable portion of the EITC from 75% to 100%

Effective tax rates, by income group

Low income filers receive more back when they file



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

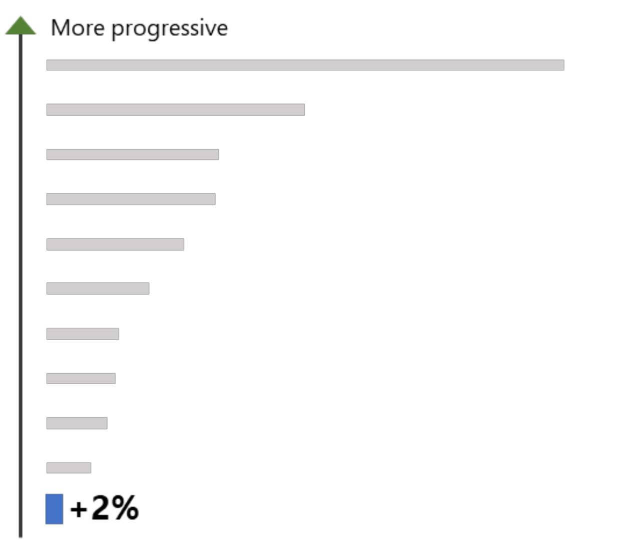
State revenue

Estimated <u>$36M less</u>

Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

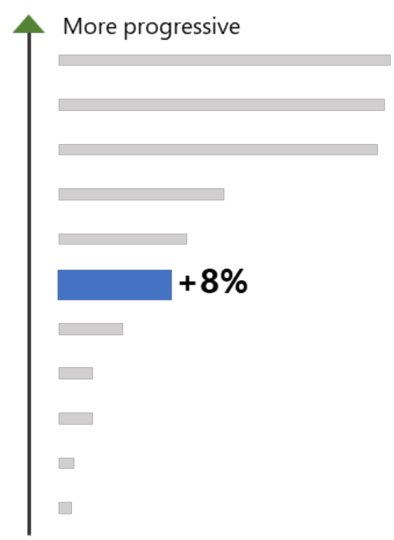
<u>Least</u> progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

<u>6th most</u> progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Refundable low income credits are in part intended to help households afford basic necessities, such as food and housing. Given the recent increase in prices of basic necessities, Virginia could consider making the credit larger than 20% of the federal EITC, as approximately 10 states have done.

Even if income tax liability is reduced to zero for low income filers (or if they receive a subsidy), low income filers still pay other taxes. Sales and excise taxes in particular usually represent a higher percentage of income for very low income filers compared with higher income filers. (In 2022, Virginia eliminated the state sales tax on groceries, further reducing total taxes paid by low income households.)

POLICY OPTION 1
The General Assembly could reduce effective tax rates of low income filers by increasing the amount of the earned income credit that is refundable from 75% to 100%.

Option 2: Virginia could raise filing threshold so fewer low, lower-middle, and middle income Virginians file

Option 2 would raise the income threshold for determining whether a state income tax return must be filed. Currently, single filers must file a return if they have $11,950 or more in Virginia adjusted gross income (AGI), and joint filers must file if they have $23,900 or more. These thresholds could be increased so that fewer lower income filers are required to submit a tax return. One benchmark that could be used to raise the filing threshold is the federal poverty level. For example, Virginia's filing thresholds could be raised to twice the federal poverty level, which would be $27,180 for a single filer and $54,360 for joint filers. These changes would raise the filing threshold by about 125%. These filing thresholds are pre-tax income, not taxable or after tax income.

Option 2 would moderately improve the progressivity of Virginia's individual income tax and would lower taxes for far more filers than Option 1. The progressivity index would increase 16%, but the high – low gap measure would increase only 2%. The smaller increase in the high – low gap is because low income filers would only see their effective tax rates decline from -1.2% to -1.3%.

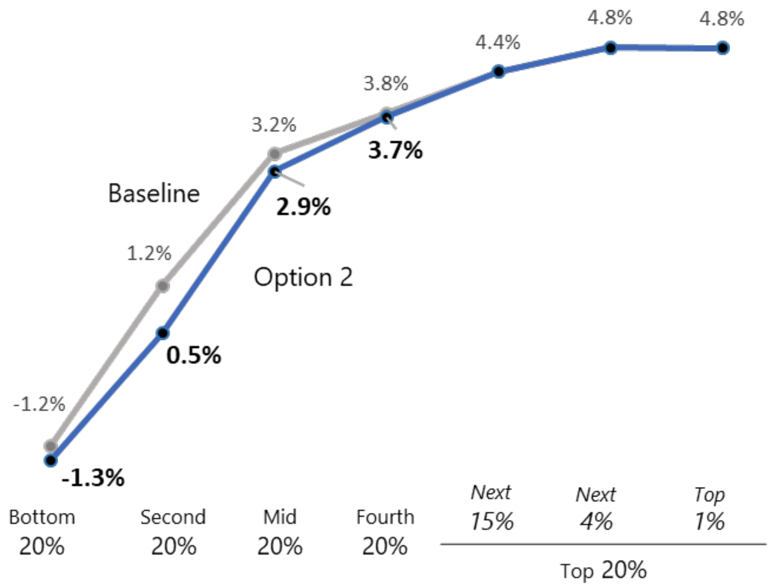
No low income Virginians would be required to file (but they still may file to receive the refundable credit). Fewer lower-middle income filers would be required to file, and so would have no tax liability. For example a single filer with $20,000 in Virginia AGI would owe about $425 under current policy but would owe nothing if the filing threshold was increased. Some middle income filers who file jointly would also not be required to file.

Option 2: Increase the tax filing threshold

Increase filing thresholds to be based on poverty levels (2x FPL); from $11,950 to $27,180 for single filers and from $23,900 to $54,360 for joint filers

Effective tax rates, by income group

Lower-middle & middle income filers pay less



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

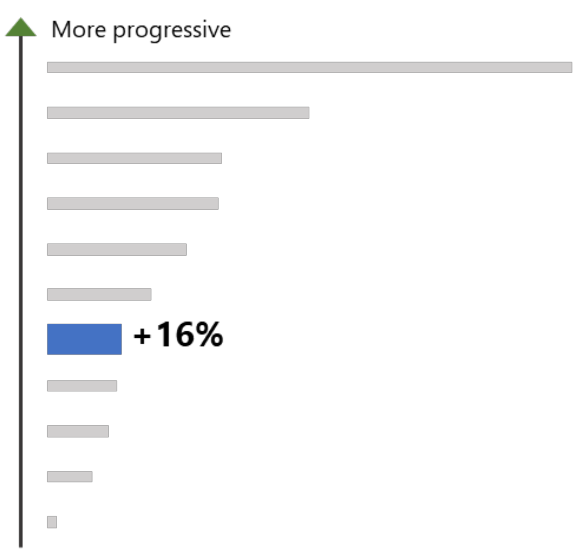
State revenue

Estimated $326M less

Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

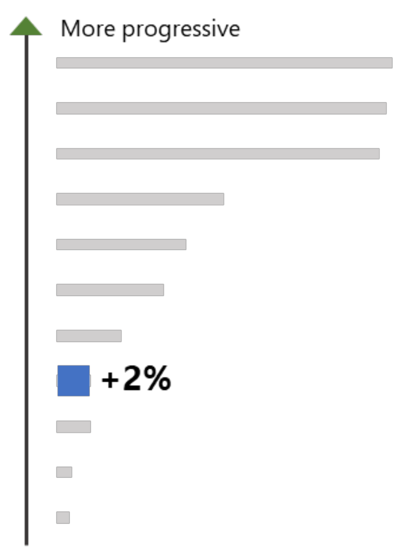
7th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

8th most progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 2 is estimated to decrease state revenue $326 million, 2% less than the baseline revenue projections. This estimated reduction is substantially larger than for Option 1 because it would affect far more filers who currently have some tax liability.

POLICY OPTION 2

The General Assembly could reduce effective tax rates of low, lower-middle, and middle income filers by increasing the filing thresholds from $11,950 to $27,180 for single filers and $23,900 to $54,360 for joint filers.

4 Increasing Progressivity by Decreasing Taxes on Lower & Middle Income Filers

HJ 567 directs JLARC to "study increasing the progressivity of Virginia's individual income tax system." Whether and how to change the individual income tax is a policy decision for the General Assembly and governor. JLARC staff have identified five policy options the state could consider to increase progressivity by lowering taxes, primarily for middle and lower income filers. Each option would collect less revenue compared with baseline income tax revenue projections. Several options result in substantial reductions in revenue but substantial increases in progressivity of the income tax. These options could be paired with options in Chapter 5 that increase effective tax rates for higher income filers—all of which would collect more revenue— to minimize or eliminate revenue reductions. For example, the personal exemption could be increased to $2,000 and a 7% rate could be levied on the top 1% of filers. Increasing the personal exemption would lower revenue by about 2%, but a new 7% rate on higher income filers would increase revenue by about 2%.

The impact of each option was estimated using the same software Virginia Tax uses to estimate the cost of tax policy changes. Virginia Tax provided JLARC staff with temporary, secure access to its PolicyLinks Microsimulation model. See Appendix B for more information.

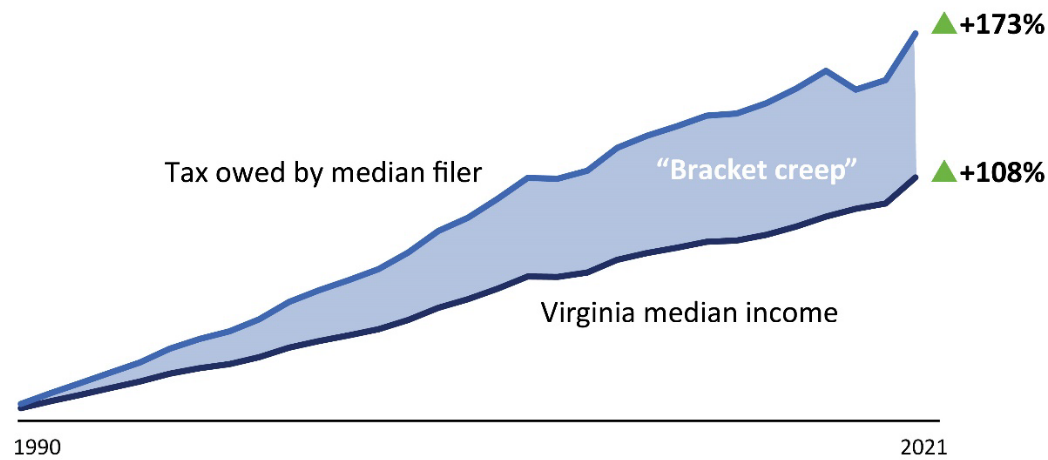
Option 3: Virginia could adjust its income brackets to account for long-term effects of inflation

Virginia's income brackets have not changed since 1990, which has resulted in its income tax becoming more regressive as incomes increase over time. Tax experts refer to this dynamic as "bracket creep," where a higher percentage of income is taxed at the highest rate. This means that more taxpayers have income eligible to be taxed at the highest rate, and that taxpayers are paying tax on a larger percentage of their income at the highest rate.

Since 1990, taxes owed have risen faster than income, because income brackets have remained the same. For single filers making the median income, their income rose 108%, yet their taxes owed rose 173% (Figure 4-1). This is because more of their income has been taxed at higher rates, especially at Virginia's top marginal rate of 5.75%. In 1990 none of a median single filer's income would have been taxed at 5.75%. However, by 2021 nearly half (47%) of this individual's income would be taxed at 5.75%—solely attributable to inflation. Bracket creep affects low income households more because the vast majority of higher income was already being taxed at the top rate of 5.75%.

Regional differences in income. JLARC explored the possibility of different income brackets (or other changes to taxes) to account for regional differences in cost of living. However, the administrative infeasibility of implementing an option precluded JLARC from including specific options. Regional differences in cost of living are accounted for to some extent in the tax system, because areas with a lower cost of living tend to have lower income, and therefore tax filers pay less in income tax.

FIGURE 4-1
Taxes owed have risen faster than income because income brackets have stayed the same



SOURCE: JLARC analysis of Virginia tax brackets and data on Virginia income, U.S. Census, 1990–2021.
NOTE: Inflation-adjusted.

Option 3 would increase Virginia's income tax brackets to account for inflation since 1990. For example, the top bracket of $17,000+ would more than double to $35,348+ (Table 4-1). The current rates could remain the same.

TABLE 4-1
Virginia's income brackets could be adjusted for inflation since 1990

Brackets (current)	Brackets (adj. for inflation since 1990)	Tax rate
$0 to $3,000	$0 to $6,237	2%
$3,001 to $5,000	$6,238 to $10,395	3%
$5,001 to $17,000	$10,396 to $35,347	5%
$17,001+	$35,348+	5.75%

SOURCE: U.S. Bureau of Labor Statistics, Consumer Price Index for all Urban Consumers, 1990–2021.

The **progressivity index** is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

The high – low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

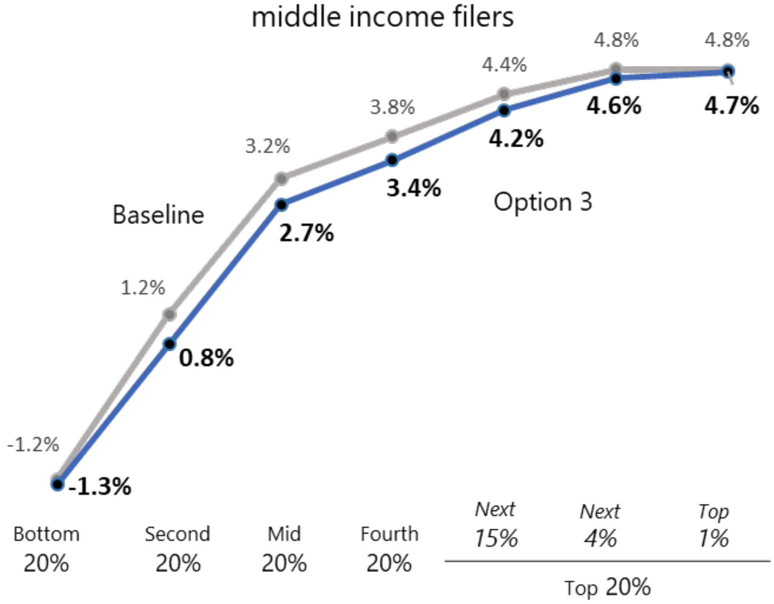
Option 3 would increase the progressivity index, which considers all income groups, but have little effect on the difference between the highest and lowest income groups. The progressivity index would increase substantially, 23%. High – low rate gap progressivity, though, would increase only 1% because many filers in the lowest income group already pay no income tax and would be unaffected by new brackets. Middle income filers would see the largest percentage increase in after-tax income, about 0.5% ($231) on average.

Option 3: Adjust income brackets based on inflation since 1990

Maintain current rates; Increase brackets to $6,237, $10,395, and $35,347

Effective tax rates, by income group

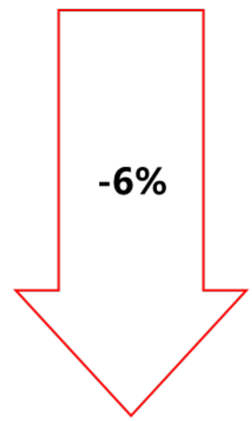
All groups pay less, especially lower-middle & middle income filers



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

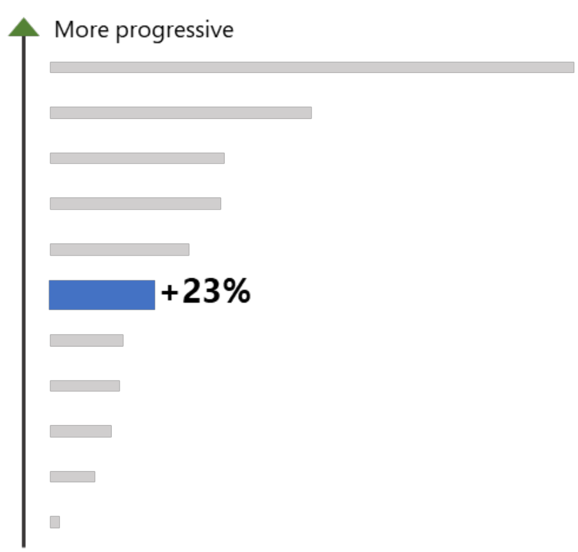
Estimated $959M less



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

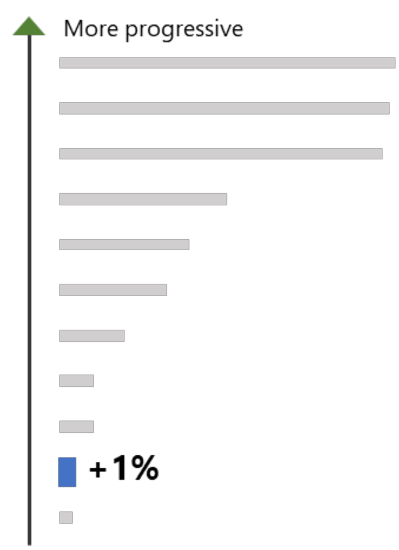
6th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

10th most progressive option (tie)



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 3 would reduce state income tax collections by an estimated $959 million (6%) from the baseline income tax revenue projections. This large revenue decline is due to the length of time (32 years) since the income brackets were last updated and the resulting increase in the proportion of income taxed at the highest rate. Average annual inflation between 1990 and 2021 was 2.4%, but the compounded annual growth in prices was 3.5%.

POLICY OPTION 3

The General Assembly could reduce effective tax rates of lower-middle and middle income filers by adjusting income brackets to account for inflation since brackets were last updated in 1990.

Another way to reflect rising incomes in tax brackets is to use current income data to create new tax brackets for lower income taxpayers, who are most affected by bracket creep. Rather than adjusting the current income brackets for inflation since 1990, the state could create new brackets that reflect the current distribution of actual income in Virginia. For example, the first bracket could be set at the first decile of income (i.e., about $5,000). The second bracket could be set at the second decile of income (i.e., $5,000 to about $14,000) and so on. Doing so would have a similar impact on progressivity and state revenue as adjusting the brackets based on inflation.

Option 4: Virginia could adopt a moderately more progressive rate structure

If Virginia wants to make its income tax more progressive, it could also create a more progressive tax rate structure. Taxes can be made more progressive by lowering the bottom tax rate and increasing the top tax rate. Virginia's current rates span from 2% to 5.75%, a difference of 3.75 percentage points between the lowest and highest income brackets. Virginia's current span is below the national average rate span of 4.2 percentage points.

Virginia could increase the span between its lowest and highest rates by (i) decreasing its lowest rate from 2% to 1% and (ii) increasing its highest rate to the median of other states—6.5%. This would increase Virginia's rate span from 3.75 to 5.5 percentage points.

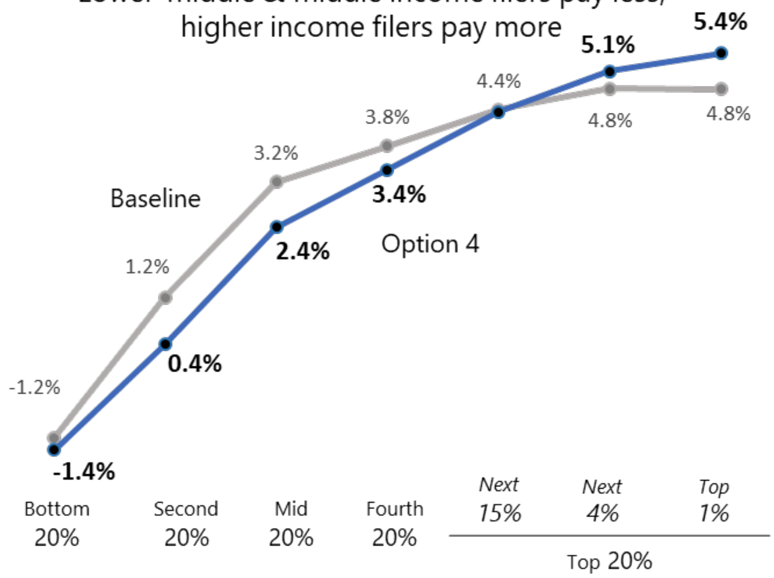
This option would use income brackets updated based on inflation (as in Option 3) in combination with a new rate structure that is more progressive than the state's current rates (Table 4-2).

Option 4: Adjust brackets for inflation since 1990 and adopt new moderately more progressive rates

Up to $6,237 @ 1%; $6,238 to $10,395 @ 2%;
$10,396 to $35,347 @ 4.5%; and $35,348+ @ 6.5%

Effective tax rates, by income group

Lower-middle & middle income filers pay less,
higher income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

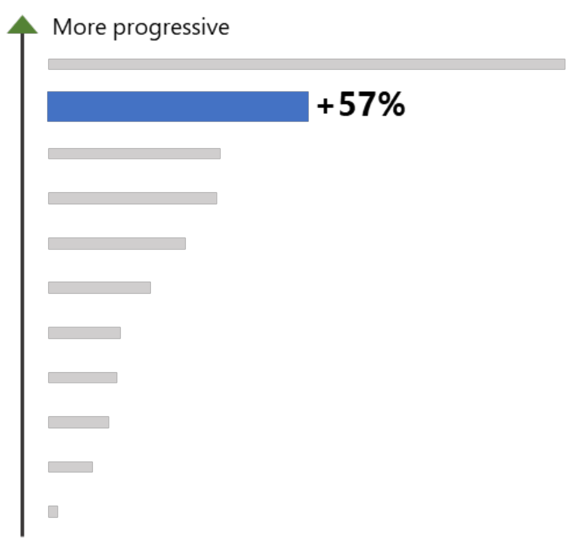
State revenue

Estimated $309M less

Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

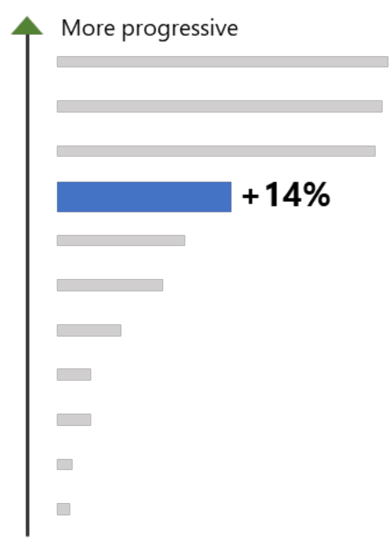
2nd most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

4th most progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

TABLE 4-2
Virginia's income brackets could be updated to account for inflation since 1990, and rate span could be widened to be more progressive

Brackets (current)	Rates (current)	Brackets (adj. for inflation since 1990)	Rates (more progressive)
$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%

SOURCE: Virginia Tax and JLARC analysis.

Option 4 would represent a substantial increase in progressivity. It would be the second largest increase in the progressivity index—57%. It would be the fourth largest increase in the high – low rate gap—14%. For all filers except higher income filers, effective tax rates would decrease and after tax income would increase. Lower-middle and middle income filers would see their effective tax rates drop substantially—from 1.2% to 0.4%, and 3.2% to 2.4%, respectively. Depending on their income level, higher income filers would pay more. Filers in the top 1% of income would see their effective tax rates increase from 4.8% to 5.4%.

Option 4 is an especially cost-efficient way to increase progressivity. The option substantially increases progressivity but does not reduce revenue as much as Option 3 (or Option 5, discussed next). Option 4 would reduce income tax revenue an estimated $309 million (2%) compared with the baseline projections.

POLICY OPTION 4
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by (i) adopting new tax rates of 1%, 2%, 4.5%, and 6.5%, and (ii) applying each rate to the existing four bracket structure updated to account for inflation since brackets were last updated in 1990.

Option 5: Virginia could adopt a much more progressive rate structure using six income brackets

States with very progressive individual income taxes, such as California, Hawaii, and New Jersey, have more brackets and a wider span between the lowest and highest rates than Virginia. Using only four brackets somewhat limits Virginia's ability to widen the span between the highest and lowest rate. Virginia could create additional income brackets using the state's current income distribution (roughly based on income deciles for low to middle income filers). Additional brackets would help create a more progressive tax structure than Option 4, because it would be easier to create a wider span between high and low tax rates without large rate increases between brackets.

Virginia could use six income brackets and apply a rate structure with a span of 6.5 percentage points between the lowest and highest rates (Table 4-3). This span would be wider than the average difference of other states but still narrower than seven states. California, for example, uses nine income brackets and a rate span of more than 11 percentage points.

TABLE 4-3
Virginia's income brackets could reflect actual income amounts, and rate span could be widened to be substantially more progressive

Brackets (current)	Rates (current)	Brackets (based on income deciles)	Rates (more progressive)
$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%

SOURCE: Virginia Tax and JLARC analysis.

Option 5 would represent the largest increase in progressivity of all 11 options identified by JLARC. It would be by far the largest increase in the progressivity index—115%—and two times as progressive as the second most progressive option. It would also be the largest increase in high – low rate gap—27%. Effective tax rates would decrease and after tax income would increase for most filers. Middle income filers would see their effective tax rates drop substantially—from 3.2% to 1.8%.

For a married taxpayer with an annual income of $50,000 (approximately the average for the middle income group), this would translate into a $770 reduction in tax liability—a 1.5% increase in after tax income. In contrast, a married taxpayer with an annual income of $300,000 (approximately the average for the highest 20% of taxpayers) would see their tax liability increase by about $2,700, a 0.9% reduction in income (assuming the standard deduction and two personal exemptions).

Option 5 is a relatively cost-efficient way to increase progressivity. The option substantially increases progressivity but does not reduce revenue by as much as Option 3. Option 5 would reduce income tax revenue an estimated $666 million (4%) compared with the baseline projections.

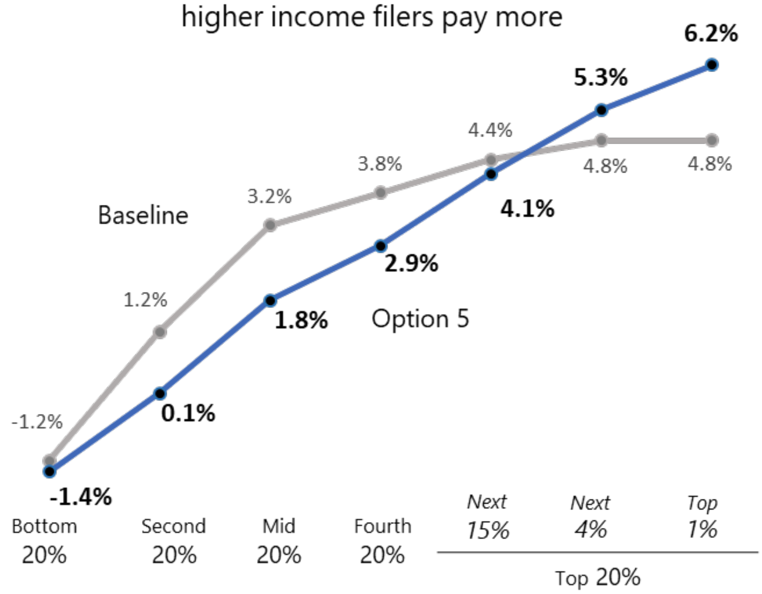
POLICY OPTION 5
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by (i) adopting new tax rates of 1%, 1.5%, 3.5%, 5.5%, 6.5%, and 7.5%, and (ii) applying each rate to a new six bracket structure based on the current income distribution.

Option 5: Create new brackets using current income, and adopt new substantially more progressive rates

Up to $5K @ 1%; $5K to $14K @ 1.5%; $14K to $36K @ 3.5%;
$36K to $50K @ 5.5%; $50K to $93K @ 6.5%; and $93K+ @ 7.5%

Effective tax rates, by income group

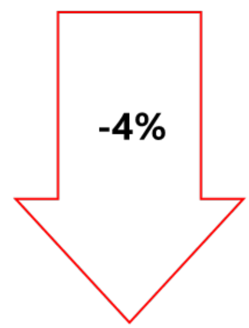
Lower-middle & middle income filers pay less,
higher income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

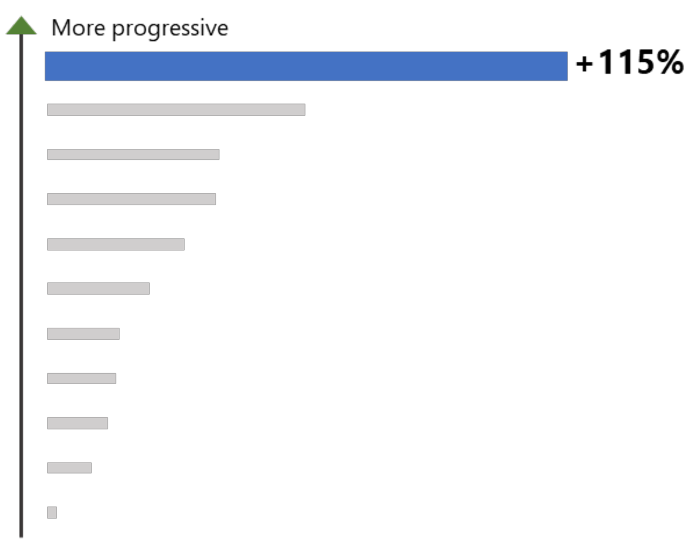
Estimated <u>$666M less</u>



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

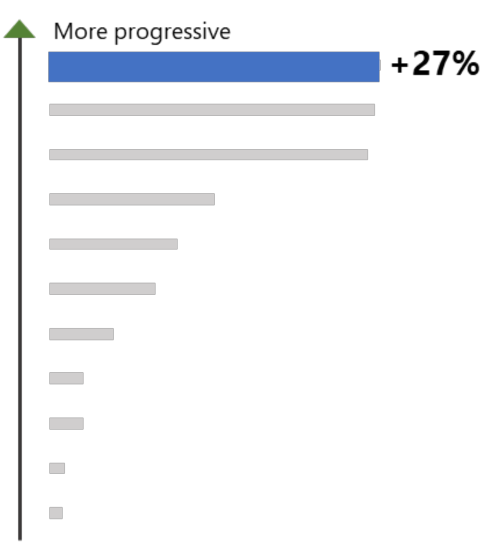
<u>Most</u> progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

<u>Most</u> progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 6: Virginia could increase the personal exemption to $2,000

Filers are allowed to take a personal exemption for themselves, their spouse, and each dependent, so increasing the personal exemption would increase progressivity, primarily because it accounts for household size. All filers would benefit from increasing the personal exemption, but this option would be particularly beneficial for families with multiple dependents.

Option 6 would increase the personal exemption from $930 to $2,000. Filers could take this exemption for themselves, a spouse, and each dependent they can claim. For example, under this option joint filers with two children could claim $8,000 in exemptions rather than $3,720 they can claim currently. This option would not change personal exemptions for being blind or over the age of 65.

Option 6 would slightly increase progressivity. The progressivity index would increase 10%, but the high – low rate gap would increase only 1%. Most filers would see their tax liability decrease but by relatively small amounts. Lower-middle and middle income filers would see their liability reduced by about 0.2% on average ($59 and $98, respectively). Progressivity of this option would be higher if the higher exemption amount was not applicable to higher income levels.

However, filers with more dependents would benefit substantially more from this option. About one-third of recent Virginia tax returns included an exemption for at least one dependent. These filers took, on average, about 1.7 exemptions in recent years. This option would result in a more substantial reduction in tax liability for lower-middle or middle income filers with dependents. For example, a family of four with $50,000 in income could see their liability drop by about 0.5% ($250).

Option 6 is estimated to reduce revenue collections by $387 million (2%) compared with the baseline revenue projections.

POLICY OPTION 6

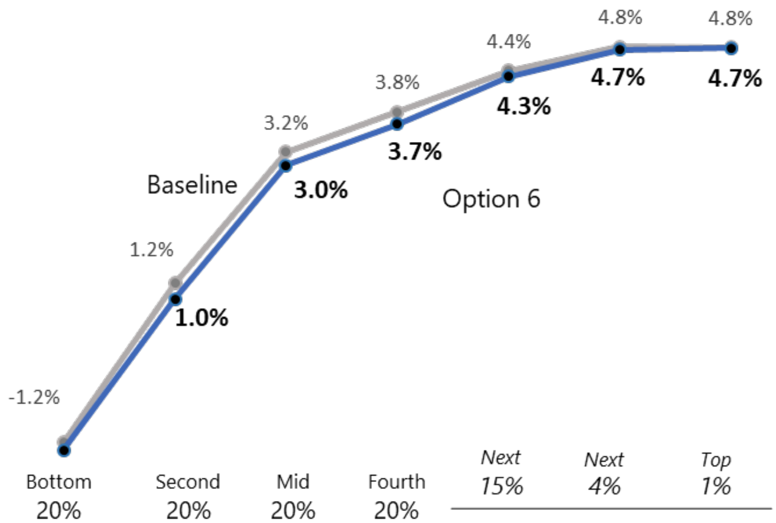
The General Assembly could reduce effective tax rates, in particular for lower-middle and middle income families, by increasing the personal exemption for a filer, their spouse, and each dependent from $930 to $2,000.

Option 6: Increase the personal exemption amount

Increase the current personal exemption amounts
($930 for self, spouse, and dependents) to $2K

Effective tax rates, by income group

Most filers pay slightly less (but filers with multiple dependents could pay substantially less)



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

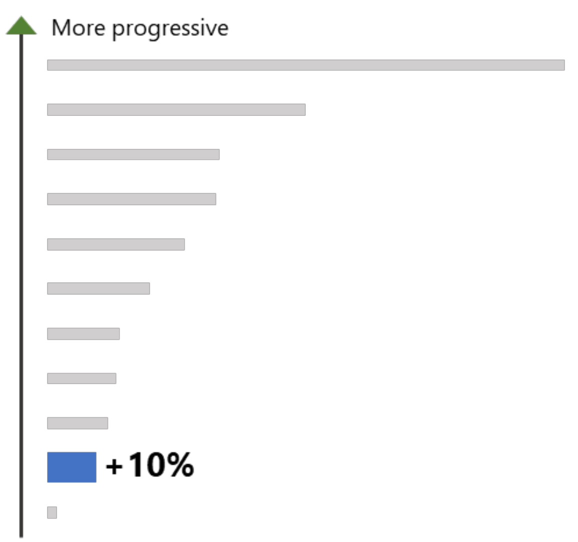
State revenue

Estimated <u>$387M less</u>

Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

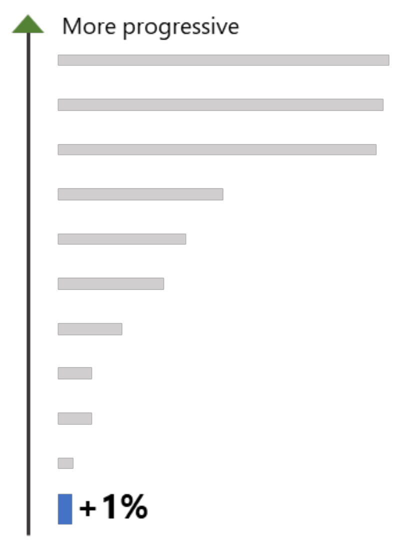
<u>10th most</u> progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

<u>10th most</u> progressive option (tie)



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 7: Virginia could further increase the standard deduction to the federal deduction

Virginia recently increased its standard deduction to $8,000 for single filers and $16,000 for married couples filing jointly. As noted in Chapter 2, this, along with making the state earned income tax credit partially refundable will substantially increase the progressivity of Virginia's income tax. Virginia could further increase the deduction to reduce tax liability, especially for lower and middle income filers.

Option 7 would increase the standard deduction to the 2022 federal amounts of $12,950 for single filers and $25,900 for married filers. Virginia would join nine other states, including South Carolina, Maine, and Colorado, which use the federal standard deduction amount.

Option 7 would increase progressivity over all income groups but have only a slight effect on the difference between high and low income taxpayers. The progressivity index would increase substantially by 30%, but the high – low income progressivity rate gap would increase only 2%. All filers who take the standard deduction (more than 80% of filers) would see their liability decrease somewhat. Lower-middle and middle income filers would see the largest decrease in effective tax rates. Their after tax income would increase, on average, by about 0.7% and 0.6%, respectively ($172 and $282).

The state would collect substantially less income tax revenue, an estimated $944 million (6%), under Option 7 than the baseline revenue projections.

POLICY OPTION 7

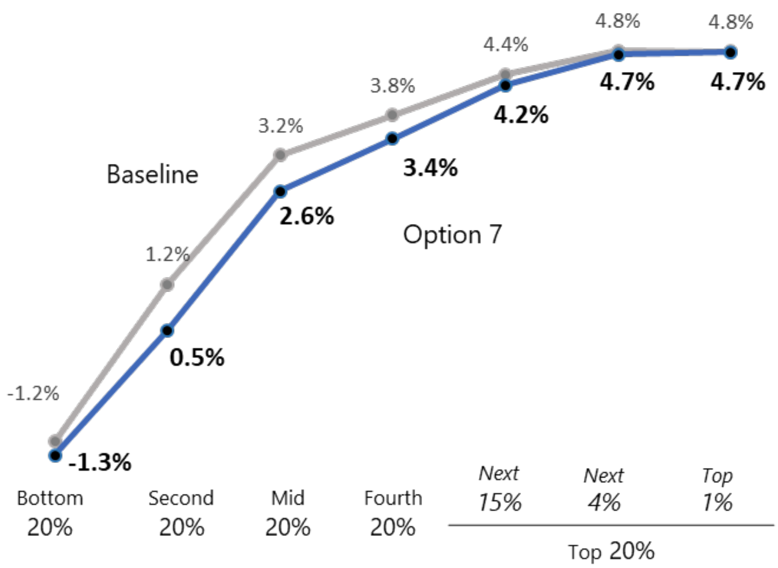
The General Assembly could reduce effective tax rates of lower-middle and middle income filers by increasing the standard deduction to the federal amounts ($8,000 to $12,950 for single filers and $16,000 to $25,900 for joint filers).

Option 7: Increase the standard deduction to the federal amount

Increase standard deduction from $8,000 to federal amount of $12,950 for single filers, and from $16,000 to federal amount of $25,900 for married filers

Effective tax rates, by income group

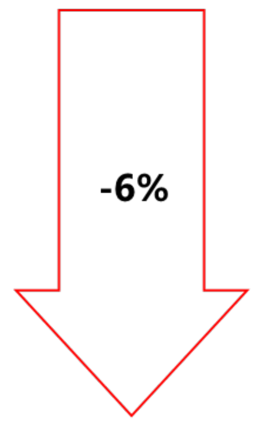
All income groups pay less, especially lower-middle & middle income filers



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

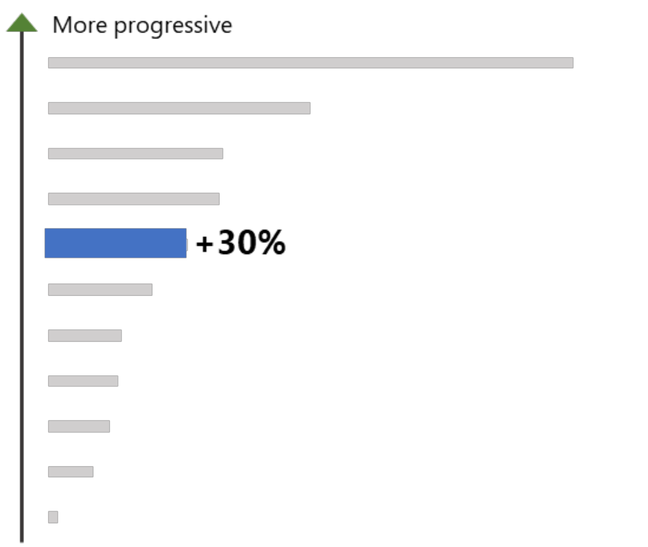
Estimated $944M less



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

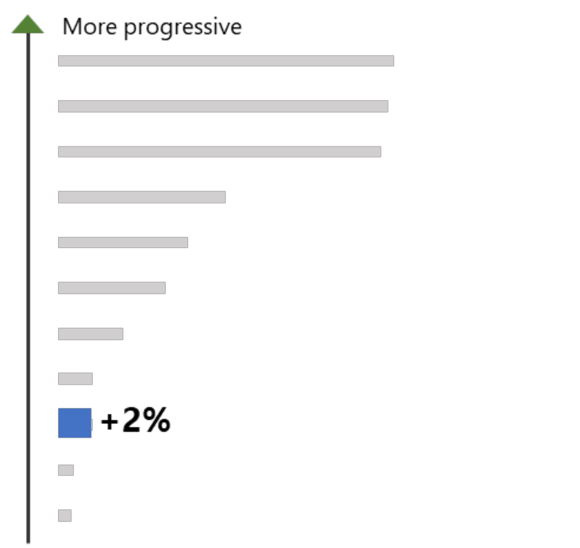
5th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

9th most progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

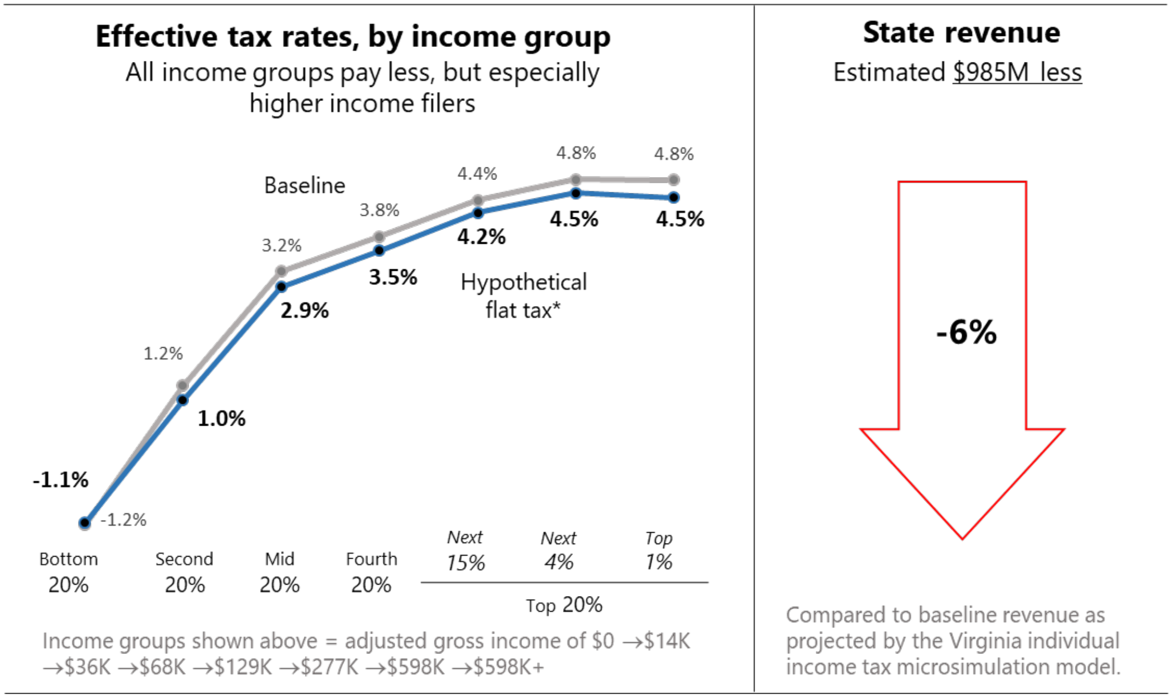
Flat taxes tend to be regressive but can be made somewhat progressive through large deductions

A few states are adopting flat income taxes rather than having different rates for separate income brackets. Flat taxes by definition are not progressive because they have no income brackets, and all filers pay the same rate. Flat taxes, however, can become somewhat progressive if combined with substantial deductions that benefit lower income filers. Several states have recently changed or are in the process of changing to flat tax systems. North Carolina has a flat 4.99% rate as of 2022, which when paired with its higher standard deductions, results in a somewhat progressive tax. Georgia and Iowa have recently begun to transition to a flat tax, which will eventually feature rates of 4.99% and 3.9%, respectively.

It would be difficult for Virginia to transition to a flat tax that is more progressive than its current structure after the 2022 changes, especially when viewed through the high – low income rate gap measure. For example, if Virginia were to replace the current progressive income tax with a flat tax featuring a single 5.4% rate and higher standard deductions (using the federal amounts):

- effective tax rates would decrease more for higher income filers than for lower income filers (Figure 4-2);
- progressivity as measured through the high – low rate gap would decline 5% (though as measured by the progressivity index would increase 4%); and
- the lower flat rate in combination with higher deductions would reduce revenue by an estimated $985 million (6%) compared with baseline projections.

FIGURE 4-2
A flat tax with higher deductions would lower taxes more for higher income filers and substantially decrease revenue



SOURCE: JLARC analysis of modeling through the PolicyLinks microsimulation model.
NOTE: Hypothetical flat tax assumes 5.4% rate for all filers (derived by assuming revenue neutrality) and then applying the federal rather than current state standard deduction amounts to achieve some degree of progressivity.

5 Increasing Progressivity by Increasing Taxes on Higher Income Filers

HJ 567 directs JLARC to "study increasing the progressivity of Virginia's individual income tax system." Whether and how to change the individual income tax is a policy decision for the General Assembly and governor. JLARC staff have identified four policy options the state could consider to increase progressivity by raising taxes on higher income filers. This would leave the effective tax rates paid by middle and lower income filers the same but increase progressivity overall. Each option would collect more income tax revenue over baseline revenue projections. These options could be paired with options in Chapters 3 and 4 that lower effective tax rates for middle and lower income filers—all of which would collect less revenue—to both increase progressivity and minimize or eliminate the revenue impact to the state. For example, the standard deduction could be increased to the federal amount and a 9% rate could be levied on the top 1% of filers. Increasing the standard deduction would lower revenue by about 6%, but a new 9% rate would increase revenue by about 6%.

The impact of each option was estimated using the same software Virginia Tax uses to estimate the cost of tax policy changes. Virginia Tax provided JLARC staff with temporary, secure access to its PolicyLinks Microsimulation model. See Appendix B for more information.

Virginia could increase progressivity based on greater ability of high income filers to pay taxes

As noted in Chapter 2, proponents of progressive taxation cite the substantial differences between those with high and low income as the reason income tax systems should be progressive. These proponents believe that the large (and growing) difference in income means that individuals with higher income have an increasingly greater ability to pay taxes.

Some other states with more progressive income taxes levy much higher rates for higher income filers. Virginia's highest rate is below the median top rate of 6.5% among the 33 states with a progressive personal income tax. Virginia's highest rate—5.75% for income above $17,000—is substantially less than some states with much more progressive state income taxes. For example

- California – 13.3% for income above $1 million for single filers,
- Hawaii – 11% for income above $200,000 for single filers,
- New Jersey – 10.75% for income above $1 million, and
- New York – 10.3% for income above $5 million (and 10.9% for income above $25 million).

Regionally, the highest income tax brackets and rates vary substantially. West Virginia's highest rate is 6.5% of income above $60,000. Maryland's highest rate is 5.75% of income above $250,000. North Carolina has a flat tax rate of 4.99% (reduced in 2022 from 5.25%). Virginia's highest rate is much less than the District of Columbia's, which taxes income above $1 million at 10.75%.

Nearly half of the states with income taxes have changed their top income tax rates in recent years. Between 2018 and the end of 2021, 10 states decreased, and three states increased their top tax rates. Likely reflecting the substantial rise in state revenues nationwide, at least four more states have decreased their top rates this year (as of September 2022).

An important consideration when raising tax rates on high income filers is whether higher rates could encourage these taxpayers to move out of state or use other methods to reduce their tax liability. In general, the larger the increase relative to (i) current rates and (ii) other states' rates, the more likely high income filers may consider these options. Recent research, based primarily on state tax increases on high income taxpayers in California, is inconclusive. One study found a 0.8% increase in outmigration of high earners after a large increase in California's top rate. Another study, though, found little or no evidence of increased outmigration. Even if high earners do not move out of state, some may change the way their income is reported to reduce their tax liability.

Option 8 – Virginia could adopt new 6% bracket for $100,000+ and new 6.75% bracket for >$1 million

Higher income filers have more investment income than lower income filers. JLARC considered an option to tax investment income at a higher rate. Analysis revealed, though, that increasing rates on higher income filers also taxes more investment income at higher rates. Consequently, JLARC staff have not proposed an option to specifically tax investment income at differing rates than wage or business income.

This option would add two new income brackets and rates to Virginia's current structure. In addition to the current 5.75% rate for income above $17,000, there would be two additional income brackets. The first would be for taxable income between $100,000 and $1 million to be taxed at 6%. The second would be for income above $1 million to be taxed at 6.75%.

These new rates for higher income filers result in modest increases in progressivity. The progressivity index, which measures progressivity across all income groups, would increase 13% under this option. The high – low rate gap would increase 8%. Because the new rates are not substantially higher than the current highest rate of 5.75%, the increase in effective tax rates for filers at these income levels would also be relatively modest. Very high income filers in the top 1% would see their tax rate increase from 4.8% to 5.2%, on average. Their tax liability would increase by, on average, about $7,300 (0.5%).

Under Option 8, Virginia is estimated to collect an additional $434 million (3%) annually compared with the baseline revenue projections.

POLICY OPTION 8

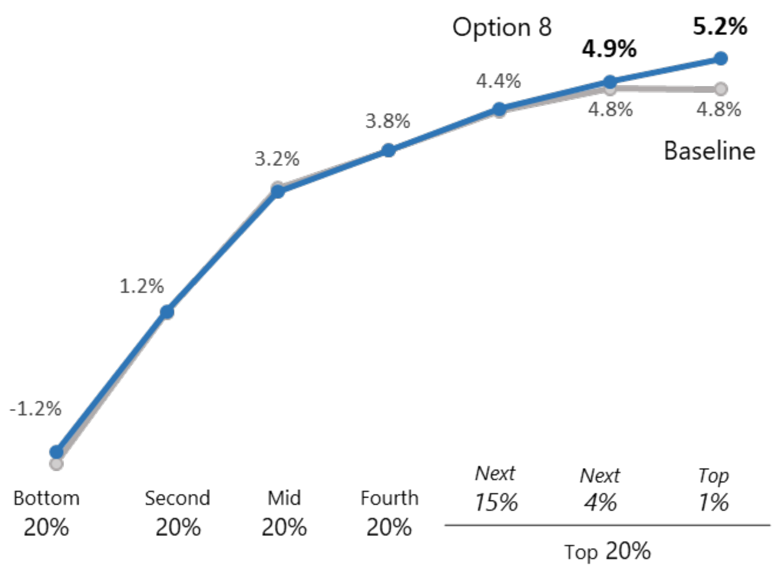
The General Assembly could increase effective tax rates of higher income filers by creating a (i) new $100,000 to $1 million income bracket with a tax rate of 6% and (ii) new more than $1,000,000 income bracket with a tax rate of 6.75%.

Option 8: Add new brackets with 6% & 6.75% rates

Maintain current brackets & rates; add a new $100K to $1M bracket @ 6% and add a new ›$1M bracket @ 6.75%

Effective tax rates, by income group

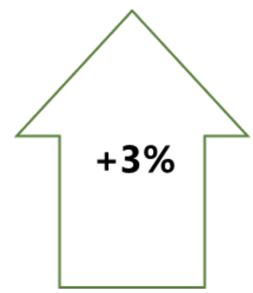
Only higher income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

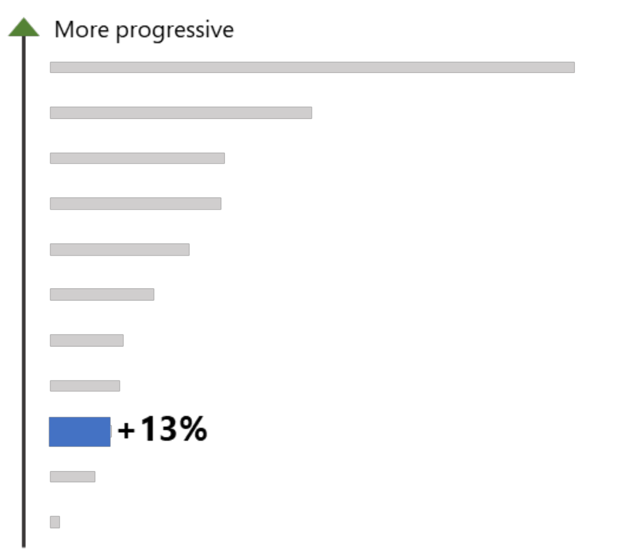
Estimated $434M more



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

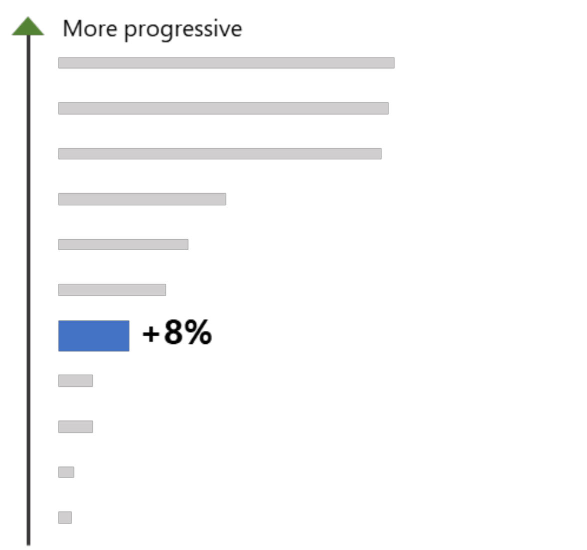
9th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

7th most progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 9: New 7% bracket for filers in top 1% of income (about $600,000 or more)

Option 9 would add a new income bracket and rate to the current structure that applies only to filers in the top 1% of income. Option 9 would create a new bracket for taxable income of $600,000 or more with a rate of 7%. This option would increase the progressivity index 15%, similar to Option 8, and would increase the high – low rate gap measure 11%. The top 1% of filers would see their effective tax rate increase from 4.8%, on average, to 5.4%. Their tax liability would increase by, on average, about $9,200 (0.6%) based on adjusted gross income of about $1.5 million. Because the new 7% rate would apply to the approximately 43,000 filers in the top 1%, it produces slightly less additional revenue than Option 8. Virginia is estimated to collect an additional $401 million (2%) if Option 9 were implemented, compared with the baseline projections.

Summary graphics for options 9 through 11 are grouped at the end of this chapter.

POLICY OPTION 9
The General Assembly could increase effective tax rates of higher income filers by creating a new $600,000 or more income bracket with a tax rate of 7%.

Option 10: New 9% bracket for filers in top 1% of income (about $600,000 or more)

Option 10 would create a new bracket for taxable income of $600,000 or more with a rate of 9%, representing a substantial increase from the current 5.75% rate. Option 10 would result in one of the largest increases in progressivity of all options presented in this report. The progressivity index would increase 38%. Though lower income filers would pay the same in taxes, the increase in taxes paid by very high income filers is enough to substantially increase the high – low rate measure (27%). These top 1% of filers would see their effective tax rates increase to, on average, 6.3%. Their tax liability would increase by, on average, about $24,000 (1.7%). Because of this substantial rate increase, under Option 10, Virginia is estimated to collect the most additional revenue of all options presented by JLARC—an additional $1.04 billion (6%) compared with baseline revenue projections.

Not allowing higher income filers to itemize deductions. JLARC explored the possibility of requiring all filers to take the standard deduction, rather than itemize deductions. Higher income filers tend to itemize more than lower income filers. Disallowing itemizing deductions, though, did not materially affect progressivity (but would increase revenue by about 5%).

POLICY OPTION 10
The General Assembly could increase effective tax rates of higher income filers by creating a new $600,000 or more income bracket with a tax rate of 9%.

Option 11: New 10% bracket for income of more than $1 million

This option is similar to Option 10, but even more focused on only the very highest income filers. Option 11 would create a new bracket for taxable income of more than $1 million with a rate of 10%. This change would make Virginia's highest income bracket and rate among the nation's highest (very close to the District of Columbia's but not as high as California's).

Changing how Virginia taxes business income. Business income is reported on Virginia form VK-1 and currently taxed at the same rate as wage or investment income. Because taxing business income distributed to individuals could alter (or discourage) small business activity, JLARC staff did not explore options to tax business income at a higher rate.

Option 11 would also result in substantial increases in the progressivity of Virginia's individual income tax. The progressivity index would increase 37%, and the high – low rate gap would increase 27%. Filers with more than $1 million in income would see their liability increase by, on average, about $58,000 (2%), based on an adjusted gross income of about $2.6 million.

Because the new 10% rate would only apply to the approximately 17,700 filers with more than $1 million in income, it would produce slightly less additional revenue than Option 10. The option is estimated to produce the second most additional revenue of all JLARC options—an additional $1.02 billion (6%).

POLICY OPTION 11

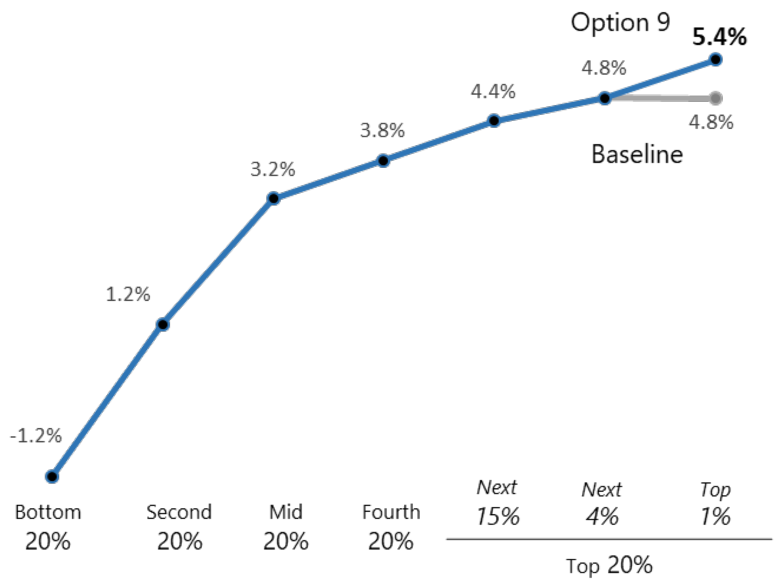
The General Assembly could increase effective tax rates of higher income filers by creating a new more than $1,000,000 income bracket with a tax rate of 10%.

Option 9: Add new top 1% bracket with 7% rate

Maintain current brackets and rates; add a new $600K+ bracket (≈top 1% in Virginia income) @ 7%

Effective tax rates, by income group

Only very high income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

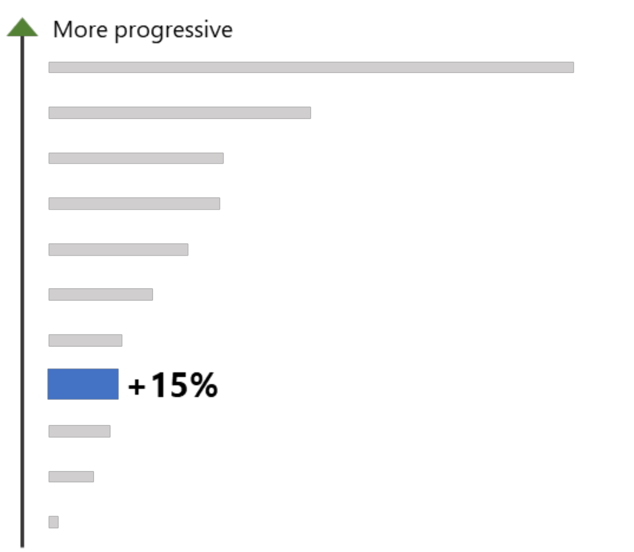
State revenue

Estimated $401M more

Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

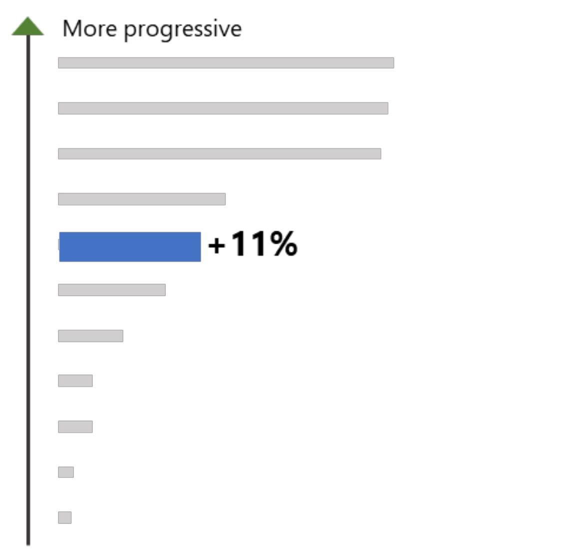
8th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

5th most progressive option



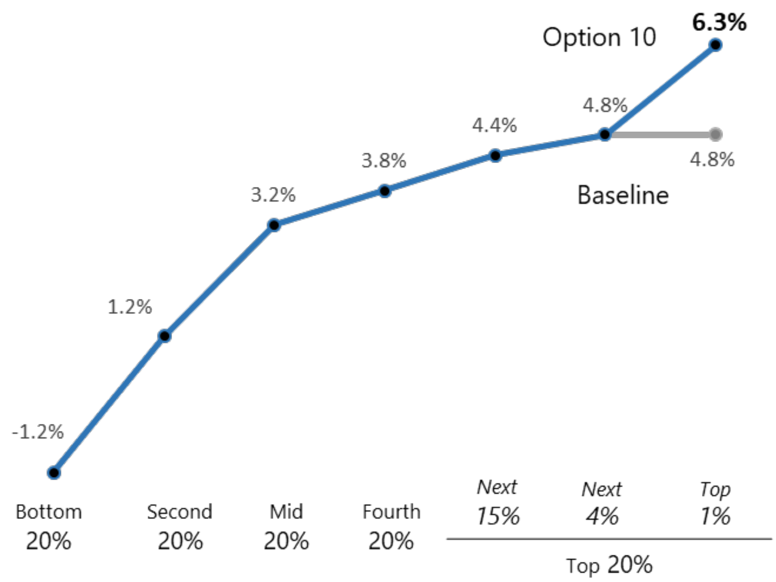
High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 10: Add new top 1% bracket with 9% rate

Maintain current brackets and rates; add a new $600K+ bracket (≈top 1% in Virginia income) @ 9%

Effective tax rates, by income group

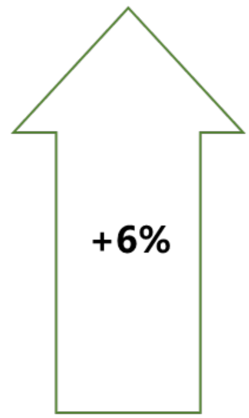
Only very high income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

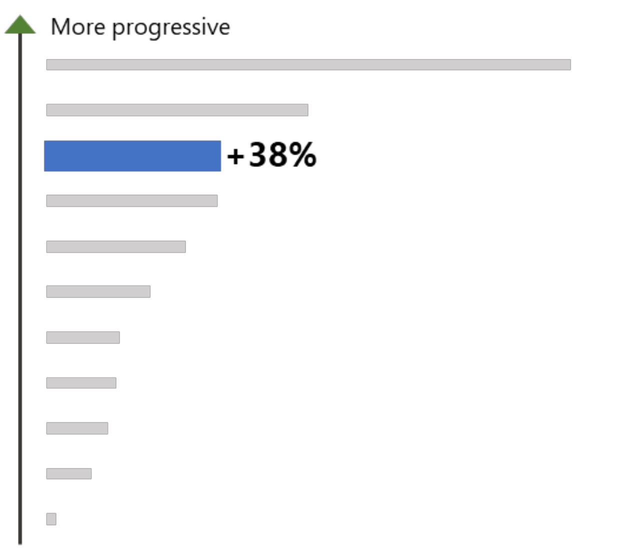
Estimated $1.04B more



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

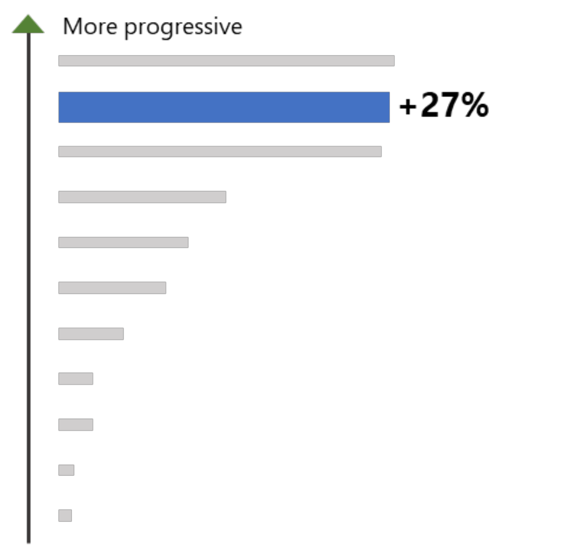
3rd most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

2nd most progressive option



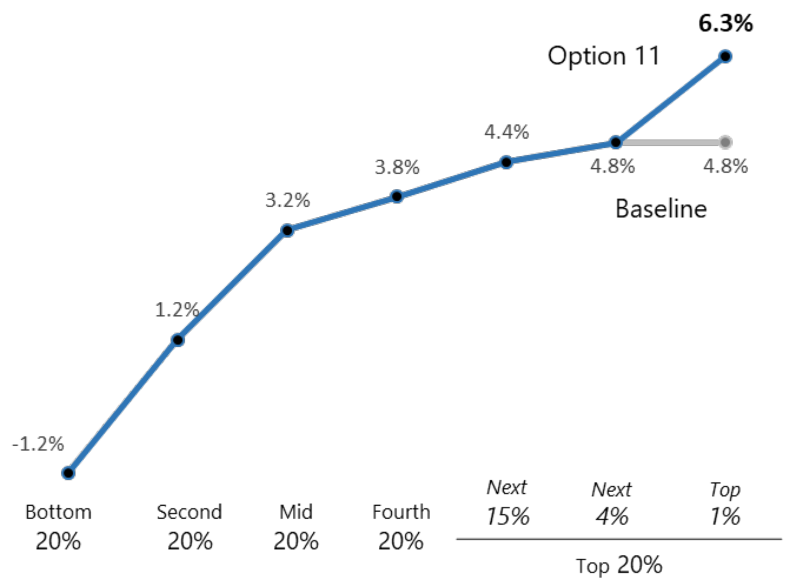
High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

Option 11: Add new ›$1M bracket with 10% rate

Maintain current brackets and rates; add a new ›$1M bracket @ 10%

Effective tax rates, by income group

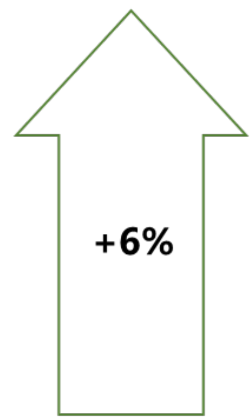
Only very high income filers pay more



Income groups shown above = adjusted gross income of $0 →$14K →$36K →$68K →$129K →$277K →$598K →$598K+

State revenue

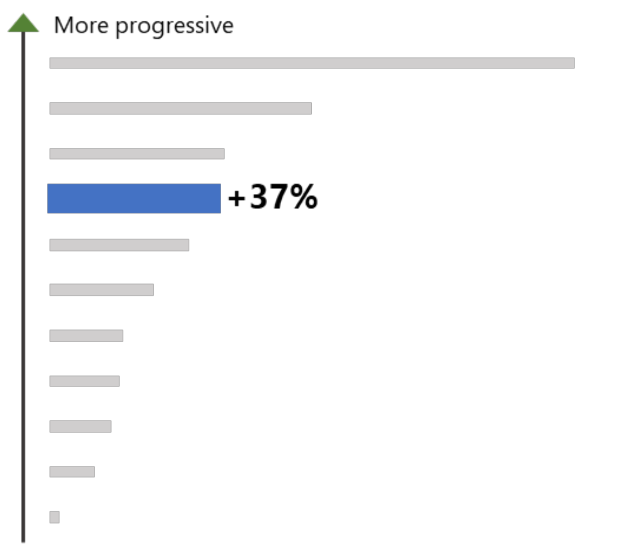
Estimated $1.02B more



Compared to baseline revenue as projected by the Virginia individual income tax microsimulation model.

Progressivity index

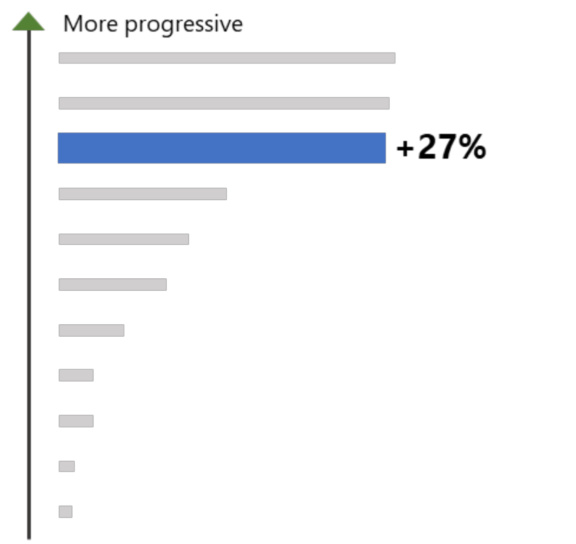
4th most progressive option



Progressivity index is the share of the total state income tax burden across all income groups, as measured through the "Suits index."

High – low rate gap

3rd most progressive option



High - low rate gap is the difference between the effective tax rates of the top 1% and bottom 20% income groups.

6 Maintaining Progressivity Over Time

Virginia does not index its income brackets or other tax features (e.g., filing threshold or deductions) to inflation or income growth. This has resulted in a slow, steady reduction in the progressivity of Virginia's income tax since 1990, when income brackets were last increased. This occurs because as incomes grow, more filers pay the highest tax rate if the income brackets do not change. Virginia's income tax is 23% less progressive than it would have been if income tax brackets had been indexed to a measure of inflation or income growth beginning in 1990, when they were last increased.

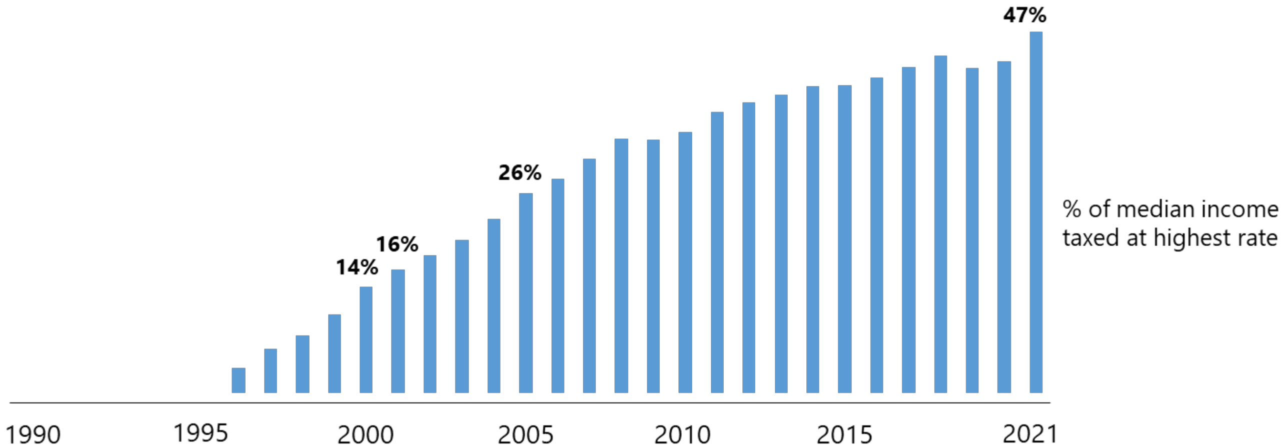
HB 1343 (Watts) and HB 289 (McNamara) would have indexed the income tax to inflation. During the 2022 Session, bills were introduced, but left in committee, that would have indexed the income tax to inflation.

The decline in progressivity in a single year of not indexing tax features is fairly small—but over time the effect becomes significant. Aside from the current high inflation rates, inflation historically grows at an average of 2% to 3% annually. However, this effect compounds and becomes more substantial after just a few years. For an individual filer making the median Virginia income, this results in a steady increase in the percentage of income taxed at the top 5.75% rate. For example, from 2000 to 2001, the percentage of median Virginia income taxed at the top rate increased slightly from 14% to 16%. By 2005, though, the percentage had already risen substantially to 26% (Figure 6-1).

Keeping income brackets static for a long period of time results in a large revenue impact if brackets are eventually updated. For example, Option 3, which would adjust income tax brackets based on inflation since 1990, would reduce income tax revenue by 6% ($959 million).

However, adjusting income brackets annually only slightly reduces revenue each year. For example, if Virginia's income tax brackets were increased for inflation each year after TY22, revenue in TY23 (the first year brackets would be inflated) is estimated to be about 0.1% lower ($10.4 million) than what it would have been before indexing. Each year after that, revenue would continue to decline slightly from the prior year, depending on inflation, but the revenue decrease each year compared to TY22 would grow. However, revenue forecasts would be adjusted to account for the indexing as part of state tax policy, and the inflation-adjustment would become part of the new baseline.

FIGURE 6-1
Not updating income brackets results in more of median income being taxed at the top rate



SOURCE: JLARC analysis of tax brackets, rates, and median Virginia income, U.S. Census, 1990–2021.

If the General Assembly changes the income tax to make it more progressive, indexing at least the income brackets to inflation, in particular, would preserve the impact of those changes over time. Tax experts cite indexing key parts of tax systems to inflation or income growth as a best practice. The federal government and many states regularly adjust brackets, standard deductions, and personal exemptions to account for inflation and reduce "bracket creep". The majority (24) of states that tax wage income make some regular (usually annual) adjustment for inflation. Thirteen states, including Virginia, do not adjust for inflation. States with flat taxes (that is, the same tax rate for all incomes) do not have income brackets to adjust for inflation. The IRS adjusts income tax brackets and the standard deduction for inflation annually. (The federal income tax does not currently have a personal exemption requiring indexing.)

POLICY OPTION 12
The General Assembly could preserve the progressivity of the individual income tax over time by indexing income brackets to inflation.

Appendix A: Study resolution

HOUSE JOINT RESOLUTION NO. 567

Directing the Joint Legislative Audit and Review Commission to study increasing the progressivity of Virginia's individual income tax system. Report.

WHEREAS, the individual income tax should be based on the fundamental principles of fairness and progressivity; and

WHEREAS, the Virginia individual income tax made up 69 percent of the general fund revenues for fiscal years 2020 through 2022, and changes to it can have major budgetary impacts; and

WHEREAS, Virginia does not collect any tax from taxpayers whose Virginia adjusted gross income is less than $11,950 for an individual and $23,900 for joint filers, and these zero tax bracket amounts have not changed since 2012; and

WHEREAS, after subtracting personal exemptions, deductions, and credits, the taxable income that remains above the zero tax bracket threshold is taxed at rates of two percent of the amount that is $3,000 or less; three percent of the amount in excess of $3,000 but no more than $5,000; five percent of the amount in excess of $5,000 but no more than $17,000; and 5.75 percent of any taxable income over $17,000, and these dollar thresholds and rates have not changed since 1990; and

WHEREAS, Virginia provides personal exemptions to reduce the taxable income for state income tax purposes, including those for dependent children and for seniors and blind taxpayers, while other states have moved away from income tax exemptions to avoid choosing who among a wide variety of taxpayers deserves such a tax break; and

WHEREAS, the standard deduction primarily results in alleviating tax liabilities of low-income and moderate-income individuals who do not have the necessary income to make expenditures on items that could be deducted; and

WHEREAS, as the federal standard deduction has grown to be much greater than Virginia's, a number of middle-income taxpayers must pay more in Virginia taxes to achieve the lowest combined federal and state tax total bill because Virginia is one of 13 jurisdictions that does not allow taxpayers to claim the standard deduction on their state returns if they itemize deductions on their federal returns; and

WHEREAS, a tax credit is a dollar-for-dollar subtraction from the taxes owed by a taxpayer, notwithstanding the income tax bracket in which the taxpayer falls, while a deduction reduces the amount of income on which taxes are calculated, which results in a higher dollar benefit the higher the tax rate; and

WHEREAS, many businesses, such as pass-through entities, S corporations, limited liability companies, partnerships, and sole proprietorships, are subject to the Virginia individual income tax, rather than the Virginia corporate tax, and almost all of the more than 25 individual income tax credits available to taxpayers focus on economic incentives, rather than progressivity; and

WHEREAS, only three tax credits for research and development, agricultural best management practices, and motion picture production are refundable tax credits; however, for most businesses, the value of a nonrefundable tax credit is not lost because almost all business tax credits may be carried over to future tax years; and

WHEREAS, Virginia's earned income tax credit is a principal element of progressivity and it is not refundable, which results in the lowest-income families not receiving the same dollar benefit as other qualifying taxpayers; and

WHEREAS, graduated rates assume that the higher the income, the more taxpayers can pay in taxes without undercutting basic living expenses; however, in Virginia, determination of the dollar amounts to which graduated rates apply is complicated by the fact that Virginia has the second-highest cost of living spread in the nation and basic living expenses differ greatly in different areas of the Commonwealth; and

WHEREAS, basic living expenses and the consumer price index are largely driven by the housing index, and the lower the income, the less flexibility there is to reduce housing costs; and

WHEREAS for all income levels, since the 1940s, the cost of housing has increased more than any other category of household spending and nationally now approaches twice the amount spent on either food or transportation; nevertheless, since tax year 2018, federal tax deductions are severely reduced for local real estate taxes which, in Virginia, are the major source for funding local government services; and

WHEREAS, 16 other states and the federal government adjust tax bracket dollar amounts, zero tax thresholds, the standard deduction, and personal exemptions annually for inflation to counter their income tax structure from becoming incrementally more regressive; and

WHEREAS, numerous legislative proposals are made annually to change Virginia's income tax structure and modify its application; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, that the Joint Legislative Audit and Review Commission be directed to study increasing the progressivity of Virginia's individual income tax system. In conducting its study, the Joint Legislative Audit and Review Commission (JLARC) shall evaluate the fiscal impact of amendments to tax brackets, tax rates, credits, deductions, and exemptions, as well as any other factors it deems relevant to making Virginia's individual income tax system more progressive and fair in response to economic dynamics. JLARC shall recommend whether the General Assembly should amend the Code of Virginia or administrative regulations of the Department of Taxation and shall make any other appropriate recommendations.

Technical assistance shall be provided to JLARC by the Department of Taxation. JLARC shall consult with staff of the House Committee on Finance, the House Committee on Appropriations, the Senate Committee on Finance and Appropriations, and any other stakeholders deemed appropriate. All agencies of the Commonwealth shall provide assistance to JLARC for this study, upon request.

The Joint Legislative Audit and Review Commission shall complete its meetings by November 30, 2022, and the chairman shall submit to the Division of Legislative Automated Systems an executive summary of its findings and recommendations no later than the first day of the 2023 Regular Session of the General Assembly. The executive summary shall state whether JLARC intends to submit to the General Assembly and the Governor a report of its findings and recommendations for publication as a House or Senate document. The executive summary and report shall be submitted as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents and reports and shall be posted on the General Assembly's website.

Appendix B: Research activities and methods

JLARC staff relied on a variety of research methods to review and identify options to make the state's individual income tax more progressive. Information sources included academic research literature, information published by tax experts and organizations, data from Virginia Tax, and access to the microsimulation model used by Virginia Tax.

Staff reviewed academic research literature to better understand tax progressivity and how changes in taxes can change filer behavior. Staff reviewed literature about the basis for and concepts related to tax progressivity. Staff also reviewed academic research literature about whether state income tax increases in California were associated with high income residents moving to another state.

Staff reviewed information about other states and information published by organizations about state income taxes. Staff reviewed other states' statutory tax structures and tax department websites to obtain information about other states' individual income taxes. Staff also reviewed and relied upon information from organizations that compare state income tax structures, income brackets, and rates, especially the Institute for Taxation and Economic Policy and the Tax Foundation. Staff reviewed and used information about income distribution from the Internal Revenue Service and World Inequality Database.

Staff interviewed people knowledgeable about Virginia taxes and tax policy more broadly. Staff interviewed tax policy, economic evaluation, and revenue estimation staff at Virginia Tax. Staff also interviewed staff with organizations in other states that conduct and publish tax policy research about key concepts related to progressive taxation.

Staff obtained and analyzed information about Virginia's individual income tax filing trends and patterns. This included data from Virginia Tax revenue reports between 2000 and 2020 about historical revenue from the individual income tax, characteristics of Virginians filing the individual income tax, and general fund revenue. This also included actual tax filing data for 2018 and 2019 about individual filing characteristics (e.g., single, joint filers), income levels, use of deductions, exemptions, and credits, and tax liability.

Virginia Tax granted two JLARC staff access to the model it uses to estimate the impact of changes in tax policy. Virginia's model was developed by Chainbridge Software, LLC, which has been involved in the development and delivery of tax policy analysis tools for state governments for several decades. The PolicyLinks model matches federal and Virginia income tax returns for 2018, the most recent tax year in which data is available. The databases are extrapolated to future taxable years, and the tax policy changes are simulated to assess the resulting change in Virginia tax revenues. In addition to changes in Virginia tax revenue, simulation output includes changes to income and taxes by income group (which can be modified), enabling JLARC staff to estimate changes in tax liability and effective tax rates by income group, and changes in overall income tax progressivity. PolicyLinks is updated annually, thus simulation results for a given tax year will vary depending on the year in which the simulation was run.

Appendix C: Agency responses

As part of an extensive validation process, the state agencies and other entities that are subject to a JLARC assessment are given the opportunity to comment on an exposure draft of the report. JLARC staff sent an exposure draft of this report to Virginia Tax and the secretary of finance.

Appropriate corrections resulting from technical comments are incorporated in this version of the report. This appendix includes a response letter from Virginia Tax and the secretary of finance. A letter from the study patron, Delegate Watts, is also included.

COMMONWEALTH of VIRGINIA

Stephen E. Cummings
Secretary of Finance

P.O. Box 1475
Richmond, Virginia 23218

October 7, 2022

Hal E. Greer, Director
Joint Legislative Audit and Review Commission
919 East Main Street, Suite 2101
Richmond, VA 23219

Dear Director Greer:

Thank you for the opportunity to review and comment on the draft JLARC report, *Options to Make Virginia's Individual Income Tax More Progressive*. As always, the staff of JLARC have done a thorough job of analyzing the facts.

A priority of Governor Youngkin's administration is to lower the cost of living for Virginians, and your report recognizes that the changes to Virginia's individual income tax enacted during the 2022 legislative session will substantially reduce the tax liabilities of low- and moderate-income taxpayers. In particular, the General Assembly adopted amendments to the general appropriation act proposed by Governor Youngkin that include a near doubling of the standard deduction, from $4,500 to $8,000 for individuals and from $9,000 to $16,000 for married taxpayers filing a joint return. In addition, the state portion of the grocery tax was eliminated, providing much needed relief to families for whom food is a large share of their budget, particularly in these times of record high inflation. These changes will significantly lower the tax burden on Virginia taxpayers, especially for low- and middle-income Virginians. While not income taxes, taxes that are particularly regressive, such as the grocery tax, gas tax, and the carbon tax disguised as RGGI, continue to burden those Virginians who can least afford it.

With regard to the options presented in the report, while your analyses are fact-based and consistent with your legislative mandate, policymakers considering such options should also take into account the impact these changes may have on Virginia's competitive position. The tax burden on Virginia families is a critical factor in businesses' decisions to create well-paying, high-quality jobs in the Commonwealth.

As I'm sure you are aware, the states that Virginia primarily competes with for jobs and capital investment – North Carolina, South Carolina, Georgia, Tennessee, Texas and Florida – either have no individual income tax or are aggressively reducing income tax rates in an effort to attract and retain talent and reduce the cost of living for their residents. Neither Tennessee, Texas nor Florida impose a tax on personal income, while South Carolina, North Carolina and Georgia have taken actions in recent years to significantly reduce personal income tax rates. For example, North Carolina converted its graduated income tax system with a top marginal rate of 7.75 percent to a flat tax rate of 4.99 percent in taxable year 2022 and intends to reduce the individual income tax rate further to 3.99 percent in taxable year 2027. Similarly, Georgia lowered its tax rate to 5.49 percent effective with taxable year 2024 with plans to reduce the rate by an additional tenth of one percent annually to 4.99 percent, while South Carolina has enacted a plan to reduce it top marginal rate from 7 percent to 6 percent.

The result of these changes, many of which were implemented in the past few years, is that these competitor states have proven more resilient, growing jobs faster and recovering from the pandemic more quickly. These low-tax competitor states, generally to our south, have seen jobs grow to well above pre-pandemic levels, while Virginia and many high-tax states, like Pennsylvania, New York, New Jersey and Maryland, have yet to recover all the jobs lost during the pandemic.

Again, thank you for considering our comments and recognizing our efforts toward promoting the Commonwealth as the best place to live, work, and raise a family.

Sincerely,

Stephen E. Cummings

Stephen E. Cummings
Secretary of Finance

COMMONWEALTH of VIRGINIA

Department of Taxation

October 6, 2022

Mr. Hal E. Greer, Director
Joint Legislative Audit and Review Commission
919 East Main Street, Suite 2101
Richmond, Virginia 23219

Dear ~~Mr.~~ Hal Greer:

Thank you for the opportunity to review and comment on the exposure draft report: *Options to Make Virginia's Individual Income Tax More Progressive*. We believe the report is well done and will be useful to the members of the General Assembly going forward. We do not have any comments, besides minor technical corrections, which have been transmitted separately to your office as requested.

Thank you again for the opportunity to review the draft report. Should you have any additional questions, please feel free to contact me.

Sincerely,

Craig M. Burns
Tax Commissioner

c: The Honorable Stephen E. Cummings, Secretary of Finance

COMMONWEALTH OF VIRGINIA
HOUSE OF DELEGATES
RICHMOND

VIVIAN E. WATTS
8717 MARY LEE LANE
ANNANDALE, VIRGINIA 22003

THIRTY-NINTH DISTRICT

COMMITTEE ASSIGNMENTS:
COURTS OF JUSTICE
TRANSPORTATION
FINANCE
RULES

December 15, 2022

Hal E. Greer, Director
Joint Legislative Audit and Review Commission
919 East Main Street, Suite 2101
Richmond, Virginia 23219

Dear Director Greer:

I commend you and the staff for your study of the progressivity of Virginia's individual income tax and presentation of options. The concise analysis of multiple options with clear graphic presentation of relative budget impact, progressivity over income quintiles, and impact spread between low and high incomes establishes a solid foundation for informed discussion.

With the hope, as patron of House Joint Resolution 567 (2021), that this letter will be included with Agencies Responses in Appendix C, I offer the following:

1. For readers not immersed in tax law, using "income" rather than "taxable income" throughout the Report can be misleading. It would avoid misconceptions if an initial margin note explained that throughout the report "income" means taxable income. It is not until page 6 that the statement is made "deductions, exemptions, or credits allow most filers to reduce the taxable income...on average, nearly $15,000."
2. On page 3, the margin note giving Virginia's rank "among states in state tax per capita" should be expanded to clarify that this is total state taxes. It also is relevant to include, since this is an analysis of income progressivity, Virginia's ranking per $1000 of income, which is lower.
3. On page 17, noting "Regional differences in cost of living are accounted for to some extent in the tax system, because areas with a lower cost of living tend to have lower income, and therefore tax filers pay less in income tax" should be balanced with noting that low income in high cost of living areas, however, pay taxes at higher rates. This is relevant to options to raise existing rates and brackets given that it takes 50% more to cover basic living costs in Northern Virginia. The 2nd quintile rather than stopping at $36,000 would include filers over $50,000 and the 3rd quintile rather than stopping at $68,000 would include filers over $100,000.

Again, I commend JLARC for producing an important basic document to support informed public policy. On behalf of many legislators who consult JLARC reports years after their initial publication, I thank you.

Sincerely,

Vivian Watts

Delegate Vivian E. Watts

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