State and Local Taxes in West Virginia: Do We Pay Too Much?

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Overview

One question that is frequently asked is, "How do tax burdens in West Virginia compare with other states?" Particular concern relates to tax burdens on business. Updated data is now available, which allows for comparisons that are more current. The Federation of Tax Administrators (FTA) keeps a running update on state and local taxes as data becomes available from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis.[1] The Tax Foundation (TF) has provided its annual burden rankings[2] and the Council on State Taxation (COST) recently released its estimates of tax burdens on business for all 50 states.[3] An earlier study prepared by TF compared the taxes in all 50 states that would be paid by a set of representative firms.[4]

Recognition should be given that West Virginia is a state with a high need for governmental services and a low fiscal capacity to supply those needs. There are reasons why West Virginia must struggle to meet the demands for governmental services placed upon the State and its local governments.

- Median household income of only $41,821 (48th in the nation)[5]
- An aged population of 16 percent (well above the national average of 13 percent) [6]
- A mountain terrain with a sparsely settled population (77.1 people per sq. mile, 31st in US)[7]
- High school/college completion rates below the national average[8]

Data speaks for itself, but how it is interpreted will vary widely depending on the predetermination of the user. The purpose of this paper is not to opine on whether taxes in West Virginia are too high or too low or if taxes on business in the State act as a barrier to economic growth and job creation. Instead we attempt to synthesize completed research to facilitate a discussion of West Virginia's taxes based on reliable information rather than opinion and prejudice.

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[1] Federation of Tax Administrators. http://www.taxadmin.org/fta/rate/
[2] Malm, E and Prante, G (October 2012) "Annual State-Local Tax Burden Ranking" *Background Paper #58*
[3] Phillips, A., Cline, R., Sallee, C., Klassen, M. and Sufranski, D (2013) "Total state and local business taxes: State-by-state estimates for fiscal year 2012 Ernst & Young and Council on State Taxation.
[4] KPMG (Sept 2012) *Location Matters: A comparative analysis of State Tax costs on business,* Washington DC: Tax Foundation.
[5] U.S. Census Bureau, "State Median Income 2011." www.census.gov/hhes/www/income/data/statemedian
[6] U.S. Census Bureau, "Demographic Profiles: Census 2010." http://2010.census.gov/new/press-kits
[7] U.S. Census Bureau, "Resident Population Data: 2010." www.census.gov/2010census/data/
[8] U.S. Census Bureau, 2007-2009 "American Community Survey (ACS) 3-year Public Use Microdata Sample (PUMS) Data."

Results

Using the results from these studies, which are detailed below, the following conclusions are supported:

- When measuring taxes as a percent of state personal income, West Virginia is ranked well above the national average and 7th highest in the nation.
- Considering state and local revenue from all sources (taxes, fees, lottery licenses, etc.) compared to state personal income, West Virginia was again above the all-state average at 13th highest.
- West Virginia ranked higher in state and local tax burden when measured against state personal income than any surrounding state.
- When state and local taxes are adjusted by residency of the taxpayer rather than by governmental unit receiving the payment, West Virginian's burden falls below the national average and is lower than or equal to all surrounding states.
- In terms of total effective business tax rates, state and local taxes on business are well above the national average as well as the state and local tax burden in all surrounding states (by this measure West Virginia ranks fifth highest in the nation).

Using a representative firm study where the state and local tax burden is determined for identical but hypothetical firms in various states, West Virginia's rankings are among or the highest in the nation.

One finding in the FTA report concerned taxes paid by non-residents to West Virginia governments. If taxes paid are assigned by residency of the taxpayer and not by the state to which they are paid, the burden in West Virginia drops below the national average and is lower or equal to surrounding states. West Virginia is capable of exporting part of its tax burden to non-residents.

Overall State and Local Tax Burdens

Using Census Bureau data, the FTA has ranked all 50 states based on state and local revenue as a percentage of the personal income[9] in the state using total state and local tax collections[10] and all revenue collected[11]. For 2012, West Virginia ranked 13th highest using taxes only but 7th highest using the own source measure. West Virginia's percentage of personal income using only taxes collected at the state and local level were 11.3 percent (see Figure 1) with total own source collections amount to 17.5 percent of personal income (see Figure 2), which is the broadest measure of ability to pay.

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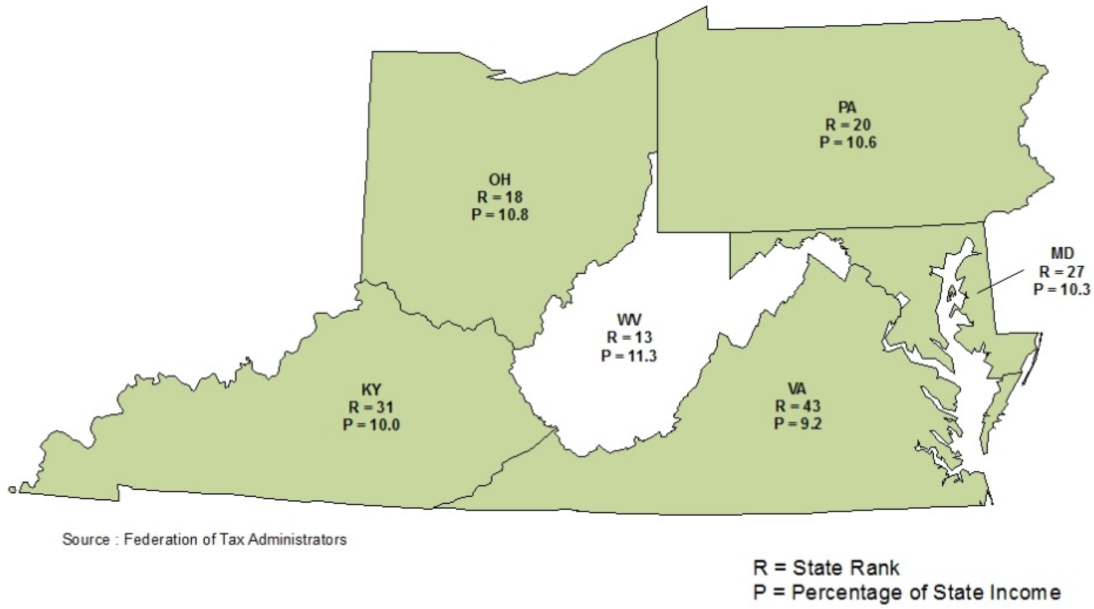
[9] Personal income includes money income before taxes and does not include value of noncash benefits like employer provided health insurance, food stamps or Medicaid. http://www.census.gov/hhes/www/income/data/comparability

[10] Taxes included are sales and gross receipts, property, individual income, corporate income, severance, motor fuel and taxes on alcohol and tobacco. Barnett, J and Vidal P., (September 2012) "State and Local Government Finances Summary: 2010" U.S. Census Bureau, US Department of Commerce.

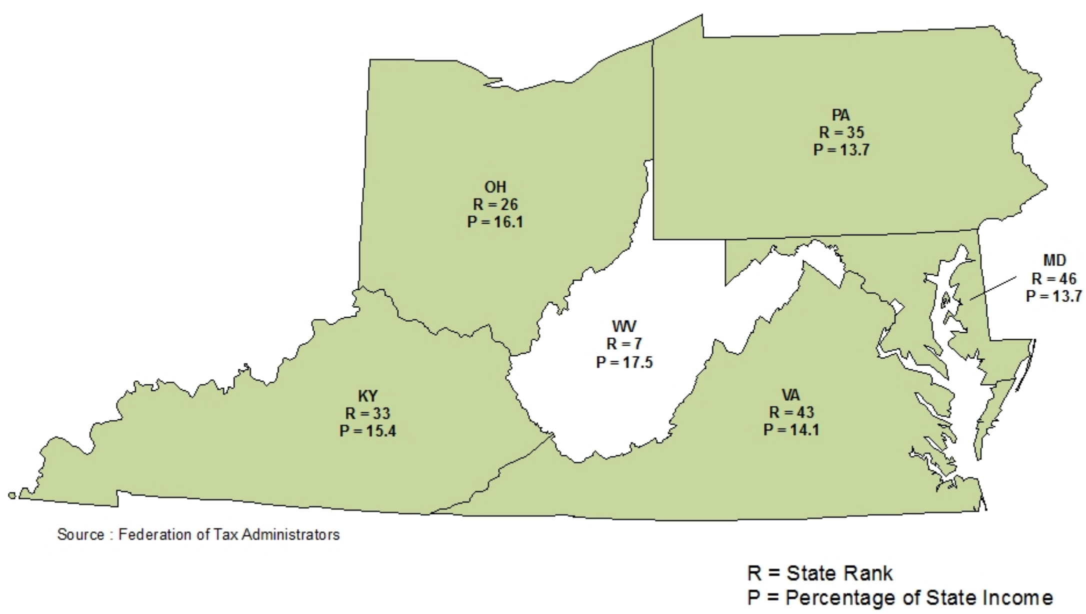
[11] Own source income includes in addition to taxes fees, licensees, tolls and earning from "public enterprises" such as lotteries, state liquor stores or utilities.

Figure 1 Rankings of Taxes Paid to State and Local Governments by Percentage of State Income



The rank and percentages were higher than all the surrounding states. Kentucky ranked 31st among the 50 states using total taxes at 10 percent of income and 33rd using all own source revenue at 15.4 percent. Maryland's ranking on the two measures placed it 27th for total taxes (10.3 percent of personal income income) and 46th for total own source revenues (13.7 percent of personal income).

Figure 2 Rankings of Total Own Source Income Paid to State and Local Governments by Percentage of State Income



Despite being viewed by some as a high tax state, Pennsylvania ranked 20th in burden using the total tax measure (10.6 percent of personal income) and 35th using all own source income (13.7 percent of personal income). Virginia tallied 43rd among the 50 states using total taxes (9.2 percent of personal income) and 43rd using own source revenue (14.1 percent of personal income). Ohio comes in at 18th (10.8 percent of personal income) and 26th using total own source revenue (16.1 percent of personal income).

<u>Adjusting for Taxes Paid Out of State</u>

The FTA report has been criticized for using the U.S. Census Bureau's figures without adjustment. The TF report (using 2010 data) deals with one of the issues: taxes paid by residents in one state to another state. The TF report had two objectives: the first was to determine what percentage of state income residents are paying in state and local taxes and, second, whether those taxes are paid to their state of residency or to other states.

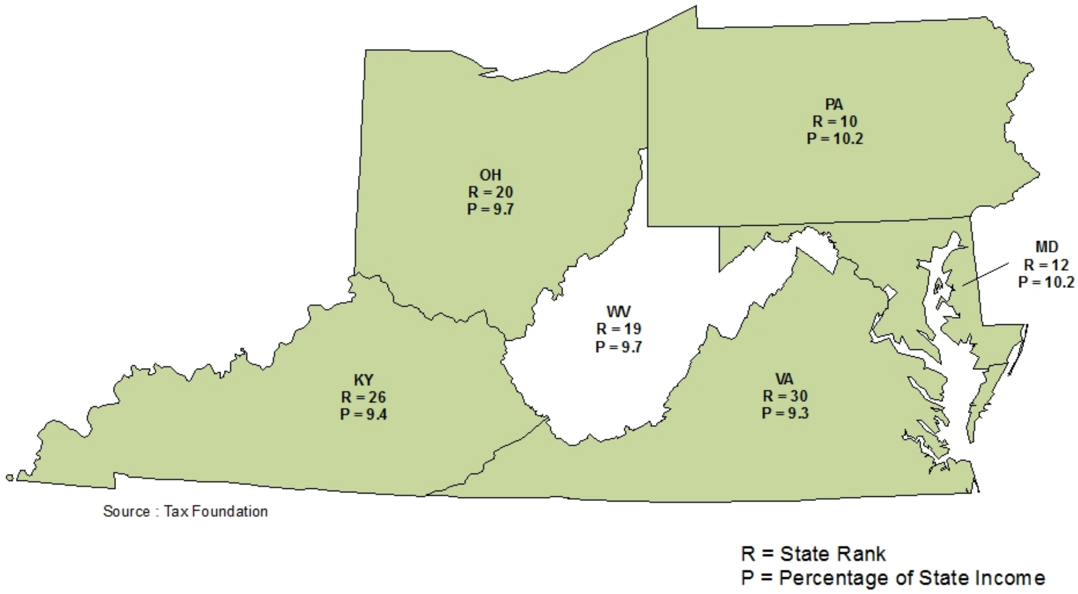
For their purposes, TF counts taxes as paid by residency of the taxpayer, not by the level of government to which the tax is paid. For example, an income tax paid by a resident of one state to another state because it is the location of their employment would be calculated as a burden for an individual based on their residency. The TF attempts to assign taxes based on the residency of the taxpayer for vacation homes and sales made while the taxpayer is out of state, such as on vacation, as well as income earned in a state other than residency. The reliability of these estimates is based on the assumptions applied to the data. Different assumptions would yield different results.

The idea of shifting taxes to non-residents ("beggar-thy-neighbor" in tax lingo) has accelerated in recent years as states have sought to raise more revenue without burdening their own residents. Tourist taxes such as those on hotels, restaurant meals, rental cars and local sales taxes in resort areas have become fashionable. The TF finds in most of these cases, "…tax exporting is a wash from the tax collector's perspective…a state collects the same amount from nonresidents as its own residents pay to out-of-state governments."

However, this is not true for states with significant revenues from the severance of resources such as Alaska, Wyoming, West Virginia and recently North Dakota. States with significant numbers of second or vacation homes use relatively high property taxes as a way of getting "outsiders" to pay. States such as Nevada and Hawaii that focus on tourists are also able to benefit from tax exporting.

What the TF study shows is that state and local tax burdens adjusted for residency as a percentage of state income for West Virginia was 9.7 percent (see Figure 3), slightly below the national average of 9.9 percent. Ohio's burden was identical to West Virginia's with Maryland and Pennsylvania's being higher at 10.2 percent. Virginia came in at 9.3 percent and Kentucky at 9.4 percent. Going from greatest burdens to least: Pennsylvania ranked 10th highest in the nation with Maryland close behind at 12th. West Virginia was 19th, barely ahead of Ohio at 20th. Kentucky was slightly below the median state at 26th and Virginia was 30th.

Figure 3 State and Local Tax Burdens as a Percentage of State Income Adjusted by State of Residence



Since 1977, (the first year TF did this report) there have been some changes in the tax burdens although West Virginia's has remained constant at 9.7 percent. Pennsylvania also has been virtually constant, moving from 10.3 to 10.2 percent of income, as was Kentucky, moving from 9.6 percent to 9.4. Virginia has dropped by a half percent from 9.8 to 9.3 with Maryland's burden also decreasing from 11.0 percent to10.2. Ohio has seen significant growth from 8.8 percent of state income to 9.7, although that percentage has dropped in recent years. For the average of all states, the burden of state and local taxes has declined from 10.3 percent to 9.9.

What is interesting is how the rankings of the states regarding tax burdens have changed. West Virginia's rank has moved up from below average at 29th to above at 19th. Kentucky has risen in the rankings from 30th to 26th with Ohio making the most spectacular jump from being 40th to 20th among the states. Virginia decreased its position from 25th to 30th while Maryland remained well above average, moving from 11th to 12th over the time period.

Tax Burdens on Business

The COST report provides some light on the issue of how much state and local taxes burden business. Their data reflects a collection period from June 2011 to July 2012 and is not directly comparable to the 2010 data used in the other reports. In addition, the COST estimates are based on Gross State Product (GSP)[12], which is a broader definition than personal income used in the other studies.

Business taxes included in the COST study were property taxes on business property, general sales taxes on business inputs, corporate net income, unemployment insurance, business and

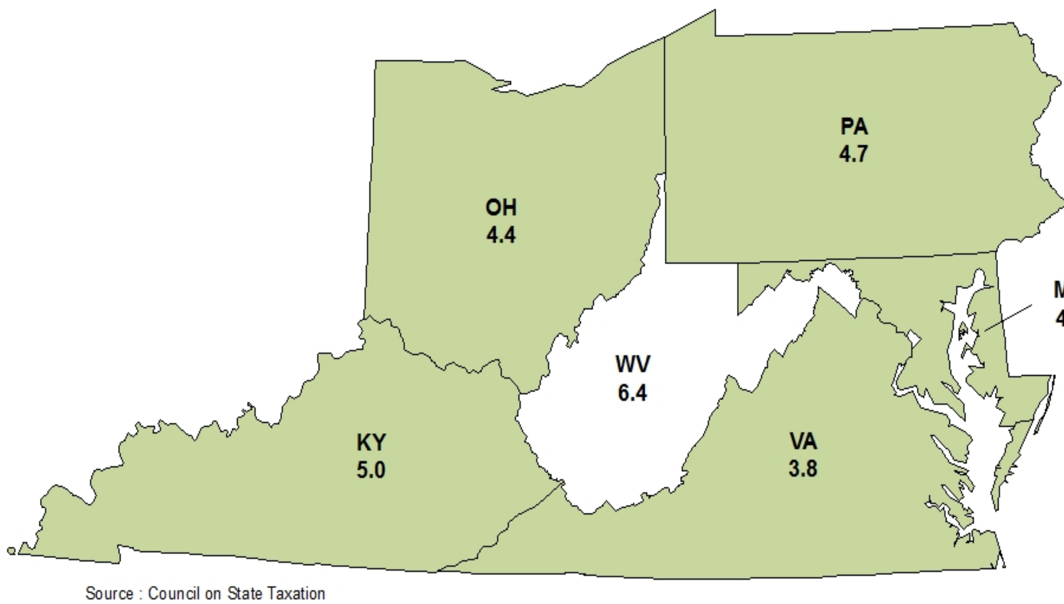
[12]As used in the COST report, private Gross State Product (GSP) is the total value of a state's annual production of all goods and service by its private sector for a given time period.

corporate licenses, excise taxes, individual income tax on business income, public utility taxes, severance taxes, insurance premium taxes and other levies. Interstate comparisons are difficult as state and local tax structures vary considerably as to what is used as a base, the rates applied and what is covered or exempted.

In making interstate business tax comparisons, COST uses an estimate of total effective business tax rate (TEBTR) which is compared to GSP. This produces an "average" tax rate that does not represent the tax on any particular industry or the marginal tax on new business startups or investment. Using this approach business taxes as a percent of GSP for the 50 states averaged 4.8 percent.

West Virginia's percentage of 6.4 (see Figure 4) was higher than Virginia's 3.8 percent, Pennsylvania's 4.7 percent, Ohio's 4.4 percent, Maryland's 4.0 percent and Kentucky's 5.0 percent. Only four states (North Dakota 13.3 percent, Alaska 17.9 percent, Wyoming 9.1 percent and Vermont 7.3 percent) placed greater burdens on business than did West Virginia according to this study. All of the other states, excepting Vermont, rely, as does West Virginia, on severance taxes on their mineral wealth.

Figure 4 Comparative Tax Burdens on Business: West Virginia and Surrounding States as a Percentage of State Gross Product



<u>State and Local Tax Burdens by Firm Type</u>

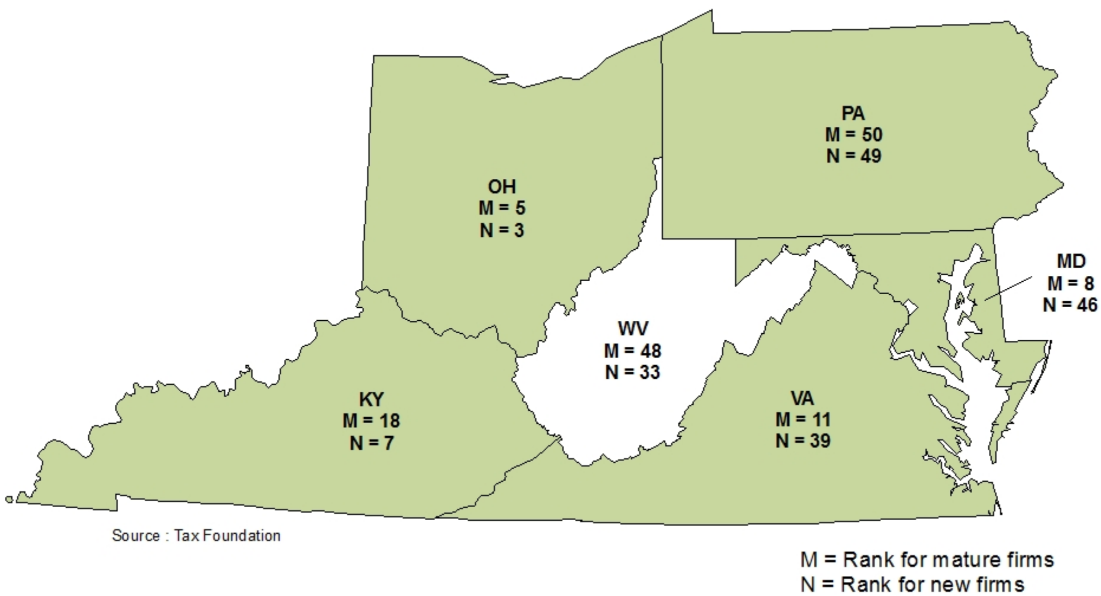
In a recently released report the TF took a different approach.[13] Seven hypothetical representative firms[14] representing a wide range of business activities were "created" and the

[13] KPMG (Sept 2012) *Location Matters: A comparative analysis of State Tax costs on business,* Washington DC: Tax Foundation.
[14] Corporate headquarters, R&D facility, retail store, call center, distribution center, capital-intensive manufacturing, and labor-intensive manufacturing.

state and local taxes which would be paid by each firm were calculated and the resulting burdens were displayed. The TF further broke down firms as being "mature" (older than 10 years) and "new" (3 years old and eligible for incentives). The premise of their study was that firms, when considering location, do not look at aggregate burdens but ask the question, "What would my firm pay?"

Using the TF approach West Virginia ranks poorly compared to surrounding states (with the exception of Pennsylvania). For mature firms, the West Virginia ranking was 48th of the 50 states (see Figure 5) and for new firms the rank was 33rd. This compares to Kentucky ranks of 18th for mature firms and 7th for new firms. Ohio ranked 5th for mature firms and 3rd for new firms. Virginia ranking for mature firms was 11th and for new firms 39th. Maryland was 8th for mature firms but 46th for new entities. Pennsylvania had the lowest ranking of any state in the nation, ranking50th for mature and 49th for new firms.

Figure 5 State and Local Tax Burdens on Hypothetical Firms: West Virginia and Surrounding States



The reasons cited for West Virginia's relative low ranking was the 8.5 percent corporate income tax rate and the throw-out rule[15] on apportionment. For mature firms the report stated,

> "West Virginia ranks 49th for both labor-intensive and capital-intensive mature manufacturing where the total tax costs are 54 and 88 percent above the national average, respectively. The main factor is that the State has one of the highest

[15] The "throwout" or "throwback" rule refers to how a state treats corporate income earned by firms operating in more than one state. Under state apportionment formulas sometimes, there is "nowhere income" that no state has taxed. Under a throwout rule, that income is fully taxed by the state of the origin of the sale. Under the West Virginia approach (used also only in New Jersey) the throwout rule excludes from overall sales any sales that are not assigned to any state. Institute on Taxation and Economic Policy (August 2011) "Nowhere Income" and the Throwback Rule". http://www.itepnet.org/pdf/pb39throw.pdf

> income tax burdens in the nation; sixth-highest for labor-intensive manufacturing and the highest for capital-intensive manufacturing."[16]

By way of contrast the report comments:

> "For new operations, West Virginia ranks 11th for capital-intensive manufacturing with a total tax cost that is 44 percent below the national average. The main driver is that the State has the sixth-lowest property tax burden largely because of a generous property tax abatement. The State also has an above-average investment tax credit that offsets an otherwise high income tax burden. For similar reasons, the State ranks 16th for labor-intensive manufacturing."[17]

Concluding Thoughts

Caution should be employed in applying these results to public policy. Taxes taken together are not the prime determinant of firm location, but they do matter depending on the type of firm seeking to locate or expand. If other factors such as location, access to resources, quality of work force and amenities are equal, then individual firms will look at state and local tax burdens in making their location decision. It cannot be assumed that state and local taxes do not matter and are of no consequence.

For a low fiscal capacity state with high demands for state services, a careful balancing act is required. The quality of public services is important in spurring economic growth and attracting industry. But for some of the types of firms the State is seeking at attract, the state and local tax burden may be a barrier. This seems to be particularly true for manufacturing firms. Certainly a detailed analysis of tax consequences on the State's prospects for growth is warranted.

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[16] KPMG. 164

[17] *Ibid*.