MORE MYTHS AND MISINFORMATION ABOUT TAX REFORM IN WEST VIRGINIA

By
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The tortured road to comprehensive tax reform in West Virginia remains littered with, and seriously impeded by, a plethora of myths and misinformation involving such fundamental issues as whose property is being taken in the form of taxes and how taxes actually operate and affect private economic activity.

First, there are the wholly nonsensical assertions that the ever-so-minimal baby steps toward relief from, and ultimate repeal of, the personal income tax, as presently being considered, are, somehow, designed to "redistribute" the State's wealth to higher income individuals.[2] Such a contention fails at every level of analysis.

At the most fundamental level, its underlying premise is that the funds, used to pay taxes for government operations, are not the property of the citizens required to remit them. That perspective reflects such an extreme commitment to the primacy of the role of government in our society that it would, effectively, turn on its head the Constitution's mandate that the powers of government reside in the people.

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[2] "Ted Boettner: Senate tax plan is upward redistribution (Gazette)" Charleston Gazette-Mail, June 3, 2017.

Thus, the wealth redistributionists, who would take your hard-earned money to use it for public salaries and services, would now claim, in an audacious display of sophistry, that allowing you to keep some of it is somehow a nefarious endeavor.[3] In doing so, they would effectively deny that it is the constitutional right of the people (not of their government) to engage in the free market for the purposes of earning income and acquiring, using and, absent a lawful process equally applicable and protective of all people, keeping their property, regardless of how much or how little they have.

Further, in the redistributionists' critiques of both proposals for income tax reform and for broadening the base (and increasing the rate) of the sales tax, their simultaneous focus, on the higher amount of dollars, that reduction of the progressive income tax rates would yield in "savings" for higher income taxpayers, and on the lower percentages of their incomes spent by such individuals on taxable purchases, fully exposes the illogic of their arguments against both.

The theoretical underpinning of the progressive income tax is what the economists refer to as the diminishing marginal utility of each additional dollar of income. That is, the Equal and Uniform Taxation mandate of the West Virginia Constitution is not offended by a graduated tax which takes a higher percentage of the amounts by which some citizens' income exceeds the income of others. That, so the theory goes, is because the loss of more of those additional dollars of income is deemed to be less of an economic burden to those with more income. However, the economic theory, let alone the constitutional rule, would not allow, regardless of differences in their total income, taking a greater percentage of the first dollars of one citizen's income than of the same lower portion of another's. Consider the following example.

[3] Indeed, that is the same mindset that uses the term "tax expenditure study" as a label for reports of the fiscal effect of various tax exemptions, credits, deductions and discounts.

Assume there is an annual 6% tax on all the annual income of citizens earning a total of $50,000 or more, a 4% tax on all the income of citizens receiving a total of more than $30,000, but less than $50,000 in annual income, and a 2% tax on all the income of those who received total annual income of $30,000 or less. Then, further assuming that the timing by which A a school teacher with a total annual salary of $60,000, earns her income is, due to her election to be paid on a 12-month basis, perfectly ratable over the calendar year, but B, an older school teacher, who is retiring at the end of the school year and moving to Florida, receives all of his total annual income of $30,000, in the first six months (i.e. A and B both earn $5,000 per month, or $30,000 by the end of June). As a result, A would be taxed three times as much as B is taxed on the same amount of income each receives in the first six months of the year. Such a structure would, thus, violate both the economic principle of diminishing marginal utility of each additional dollar and the legal rule of equal and uniform taxation.

Rather, an economically sound and legally permissible progressive income tax structure would avoid such a perverse outcome by only taxing each added layer of one's income at the successively higher rates. Thus, if the tax structure in the example were modified to reflect that approach, A and B would be taxed at 2% on their first $30,000 of income (or $600 each), A would be taxed at 4% on the layer of her income over $30,000 but under $50,000 (another $800) and at 6% on the layer of her income over $50,000 (another $600), for a total of tax on A of $2,000 and on B of $600). Accordingly, even though A still pays more than three times the amount of tax that B pays, on only twice as much income, the economic principle and rule of equal and uniform taxation are honored.[4]

[4] Though a flat, single-rate income tax on all income, regardless of amount, would still honor the theory on which progressive income tax is based, if such a tax would only tax the income of a few citizens above a high level, and exempt all others, it would run afoul of, at least, the spirit of the constitutional rule, not to mention, its revenue yield would be insufficient to fund even the most minimal scale of government operations.

However, precisely because a progressive income tax rate structure works both ways, any lowering of its rates inherently lowers the number of dollars, higher income citizens have to pay the government, more than it reduces the number of dollars paid by a lower income taxpayer.[5] Mr. Boettner, the leading cheerleader for the redistributionists in the Legislature and the media, unwittingly admitted this inherent aspect of progressive income taxes when, in a recent interview, he called for, among other improvements, "efforts to limit itemized deductions" from the personal income tax.[6]

Despite the facts that West Virginia's personal income tax presently includes no itemized deductions, as that term is used for income tax purposes, and there are no known proposals to adopt any, Mr. Boettner's reference still makes complete sense from the redistributionist perspective precisely because of the same principle inherent in progressive income tax structures. That is, since such deductions come "off the top" (of total income), they reduce the upper portion of the income of those with more of it and, thus, cause less of that income to be taxed in the higher rate bracket. As a result, such deductions give more relief in terms of dollars to higher income individuals than they do for those not taxed at those higher levels in the first place.[7]

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[5] Thus, from the corrected example, if the applicable rates were reduced by 1 percentage point each (resulting in rates of 1% on first $30,000, 3% on income above $30,000 but below $50,000, and 5% on income of $50,000 and more), A's taxes would be reduced to $1,400 for a savings of $600, compared to B's savings of $300.

[6] Rusty Marks, "Whether Eliminating Income Taxes Will Help West Virginia Depends On Who You Ask." The State Journal, June 1, 2017.

[7] Through his absolutely correct contention, that progressive income tax deductions provide more relief to higher bracket taxpayers, doubtless, Mr. Boettner would find it strange to be in bed (philosophically) with John H. Cochrane, Senior Fellow at Stanford's Hoover Institution who, in calling for an end to it, likened the mortgage interest deduction from federal income tax to having the government send an annual check to homeowners with mortgages – the higher the income, the larger the mortgage, the bigger the check. Cochrane, "Here's What Genuine Tax Reform Looks Like." The Wall Street Journal (Dec. 23, 2015). Now, there's a "tax expenditure" and "upward redistribution" of wealth that would, as Mr. Cochrane predicts, bring "rioting in the streets." Which protest would, no doubt, be led by Mr. Boettner and his redistributionist allies.

Further, the immutable economic truth (of diminishing marginal utility of each additional dollar) is even more compelling when considered in the context of consumption taxes.

Thus, it is beyond obvious that, simply because they have more dollars to spend (making the additional dollars in the upper layers of their wealth less dear to them), people with more income spend more dollars than those with less. They fact, that such greater consumption in terms of dollars by higher income individuals is a lower percentage of their total income, is utterly irrelevant to the need for sufficient tax revenue dollars to fund the government. Yet, in opposing expansion of the base and raising the rate of the sales tax, the redistributionists, by instinct, assert that point as, somehow, demonstrating the inadequacy of sales tax base expansion (or rate increases) to help address the State's projected budget shortfall.[8]

In doing so, they would also deny the simple fact that, if, through income tax relief, and personal property tax relief, many businesses (and higher income retirees) would be attracted to West Virginia, its tax base would be greatly expanded. First, in support of that denial, they point to the utterly unproven and counter-intuitive contention that West Virginia's economy and tax base were not enhanced by the earlier reduction of the corporation income tax rate and the elimination of the business franchise tax. However, the simple fact is that recent public revenue projections were not fully realized largely because of external economic and regulatory influences causing declines in the natural resource production and gaming industries. Thus, only by ignoring those inconvenient facts could the redistributionists try to "prove" their theory about the inadequate or even adverse economic and fiscal implications of real tax reform – past or present.

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[8] Though an explanation of the many provisions of current and proposed tax laws, designed to fully mitigate the potential regressive effect of broader and higher consumption taxes on the purchases of life necessities by lower income individuals, is beyond the scope of this article, they are fully expounded in the author's "Fair 55 Tax Reform Plan for West Virginia" available at www.ppfwv.org.

However, in addition to that non-sequitur about the effect of earlier business tax relief, in their unrelenting opposition to it, the redistributionists also ignore the fact that personal income tax reduction/repeal brings relief, not just to their favorite villains, to-wit: high income individuals, but to the vast majority of businesses in this State which, being organized as pass-through entities for income tax purposes, currently pay only that tax on all their business profits.[9] Also, respecting business taxation, but more misunderstood than ignored, are the subjects of the so-called "direct use tax" and how consumption taxes work in the case of business purchases.

As to the former, a profound misunderstanding of the basics of the imposition of the sales and use taxes on business purchases is manifested in the label "direct use tax." There is no direct use tax. Rather, in current law, there is, for certain major industries (e.g. manufacturing, mining, transportation, transmission and communications), an exemption from those taxes for purchases of goods and services for direct use in the essential operations of such industries.

Thus, a manufacturer can purchase raw materials which are incorporated into its finished product without paying sales or use tax. However, that same manufacturer would have to pay the tax on its purchases of office supplies for its administrative office because those, more generic expenditures, were not for direct use in the manufacturing process itself. The tax policy rationale for such a distinction is avoidance of "pyramiding" taxes within the price paid by the

[9] Indeed, that is why, if some temporary additional revenues from business are needed to keep the State's fiscal boat afloat, any business advocates, worthy of the label, should join the redistributionists and the rest of the government expenditure community, to strongly favor a temporary increase of the corporation net income tax, which is, for the most part, paid only by the few publicly traded mega-corporations operating in the State and which is not paid by the small businesses that often are the darlings of rhetoric across the entire political spectrum. To those constituencies, that approach would be preferable on both economic and equitable grounds because the business taxation alternatives, such as the so-called "Commercial Activities Tax," fall on all businesses, large and small, profitable and non-profitable, alike.

final purchaser of the finished manufactured product, which, presumably, will also bear the incidence of the consumer sales tax or use tax imposed on that last stage transaction [10]

Since loss of the "direct use" exemption results in more tax being paid and, thus, has the same economic effect as a tax, there are those who would ask, "why quibble about the labels?" The answer lies, not so much in whether there is even the most superficial accuracy in such an alternative "label" (there is, barely), but in whether use of it satisfies the need, in policy-making, to adequately understand the basic legal principles and economic consequences governing the tax structure (it does not). For example, in the income tax context, both "deductions" and "credits" result in less tax being paid, but the former merely reduces the tax base to which the tax rate is applied to determine tax liability, and the other reduces the final tax liability itself. Thus, by using those terms interchangeably one would be wholly unaware of the disparate legal and economic consequences they yield.

For example, the true economic value of a $500 income tax deduction is the result of multiplying that amount by the upper rate bracket in which the taxpayer's income falls. From our earlier example, that means a $30 tax savings for A for a $500 deduction (6% X $500 = $30), but only a $10 tax savings for B (2% X $500 = $10). However, the economic value of a $500 credit is just that ($500) to any taxpayer (e.g. A and B) with at least that much pre-credit liability.

By the same token, references to the "direct use tax" are, at least, comparable in the degree of misunderstanding and susceptibility to misinformation, that, in the current policy

[10] If, as according to universal consensus, it is legitimate to impose taxation on all who benefit from the protections and services of government, it might be asked "why omit, as part of the taxable measure of those benefits, the value of goods and services created in the earlier stages of production, distribution, etc. before the final use of such goods and services?" Although the mythology about the inherent harm done, absent anti-competitive effects, by taxing such business inputs, is beyond the scope of this article, suffice it to say here that blurring the distinction between elimination of an early-production tax exemption, and the actual operation of that tax, is not helpful in understanding the latter's ultimate economic consequences. See, e.g. Caryl, "Piercing Three State Tax Policy Myths Enshrouding Public Finance Reality" Public Policy Foundation of West Virginia, Inc. (May, 2017), at www.ppfwv.org.

debate, also attends the issue of taxing non-medical professional services to businesses.[11] For example, any legislator, who was led to believe that imposition of sales tax on such services would create a competitive disadvantage for their providers, fails to appreciate the nature and effect of both standard use tax enforcement and market-based sourcing of consumption taxes.

Specifically, whether selling goods or services for the use and benefit of an in-state business, the seller is merely the State's agent in collecting any tax imposed on such transactions, and if, because the seller operates from an out-of-state location, the tax is not collected, the business purchaser still owes the complimentary use tax on it. Thus, through an effective use tax audit program, non-compliance by in-state business purchasers is readily detected and resolved.[12]

Likewise, in circumstances, involving the provision of services, the benefits of which are delivered by in-state professionals to their clients at out-of-state locations, no West Virginia sales or use tax can be imposed due to the market-based sourcing rules. Illustrating both of these critical elements of consumption tax administration when applied to professional fees, we consider the circumstances of a hypothetical West Virginia-based professional firm, Winken, Blinken & Nodd (a/k/a WBN) with clients and professional service competitors in other states.

Thus, if, preying on ignorance of the applicable rules, one of WBN's out-of-state competitor seeks to perform services for one of WBN's current business clients, even if the work would be performed at the competitor's out-of-state office, but the result of the work (e.g. a

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[11] Professional medical services, and, indeed. all healthcare services and retail sales of medicines, etc., are omitted from this discussion, and should not be considered for imposition of consumption tax, due to the general absence of market discipline in the pricing and allocation of the same and the overwhelming incidence of third-party payment (as to much of which, some level of government is the payor).

[12] The related but separate issue of consumption tax avoidance/evasion in non-business (i.e. retail) cross-border purchases, and the myths about the high incidence of such avoidance/evasion, and about the irresolvable immunity from enforcement of the avoided/evaded taxes on such purchases, are addressed in both "Piercing Three Myths, etc." and in "The Fair 55 Tax Reform Plan, etc." *supra.* Indeed, the latter work proposes the progressive creditable use tax device as a simple, but revolutionary, tax law provision designed to be wholly effective in thwarting the adverse economic and revenue effects of <u>both</u> cross-border <u>and</u> internet retail sales/use tax competition.

written or electronic media-based report) is delivered for the use and benefit of the client in West Virginia, that client would still owe, to this state, the consumption tax imposed on the value of such services rendered in the state. That is so, notwithstanding whether the competitor voluntarily collected and remitted the tax or the client paid it either voluntarily or due to a routine audit of its records by the West Virginia Tax Department.

Alternatively, if the competitor's work required its physical presence in West Virginia, so that delivery of the benefits of that work to the client's West Virginia location is not disputed (particularly, upon full compliance with professional in-state practice licensing rules), both the client's voluntary use tax payment, and the competitor's satisfaction of its related sales or use tax collection and remittance duties, would be even easier to effect.

On the other hand, if the roles were reversed so that if WBN provided services to an out-of-state client, where such a tax on professional services was not imposed, even if WBN's work were performed here, so long as the delivery of the benefit and use of those services (e.g. a written or electronic media-based report) is to the client's out-of-state location, the same market-based sourcing rules would preclude WBN's having to charge West Virginia tax to that client.

Thus, by understanding the actual operation of consumption taxes, particularly their use tax enforcement and market-based sourcing aspects, it becomes apparent that contentions, about the anti-competitive effect of their imposition on non-medical professional services to business customers, are either ill-conceived or are based on misinformation, or both.[13]

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[13] A far more legitimate example of an anti-competitive tax on business is the West Virginia severance tax on coal production. Specifically, coal is a raw commodity, its price, including the nation's highest severance tax when sold by a West Virginia producer, is, due to that added cost, put at a direct competitive disadvantage with the same commodity produced in neighboring states which do not add such a burden. That competitive disadvantage is only slightly mitigated in the case of West Virginia coal production sold to utilities with out-of-state customers. That is so, because, regardless of the pass-through of all the heavily taxed cost of such coal, via the separate gross receipts tax on power generation and sales (the so-called "export power tax"), the existence of <u>any</u> demand elasticity for electric power, whether in regulated or unregulated out-of-state markets, inherently precludes full economic neutrality as to the relative tax burdens on coal based on the situs of its production.

Therefore, because the road to comprehensive tax reform has taken so many twists and turns, in order to safely and successfully transverse it, we would all be far better served if we can clean the windshield of the myths, misstatements and misinformation presently blurring the view.