No Shortcuts

Cutting Income Taxes to Offset Sales Tax Increases on Low-Income Virginians is a Dead End

The Commonwealth Institute

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Transportation funding proposals that expand the sales tax to transportation-related services will hit low-income people hardest, and the income tax breaks proposed to offset them won't provide adequate relief. As a consequence, any new sales tax must be coupled with targeted mechanisms that effectively offset these increases for Virginia's low- and middle-income families.

This brief explains why cutting income tax rates for Virginians, while well intentioned, doesn't do the job of providing tax relief from the sales tax increases they would see and points legislators toward a better road to get where they want to go.

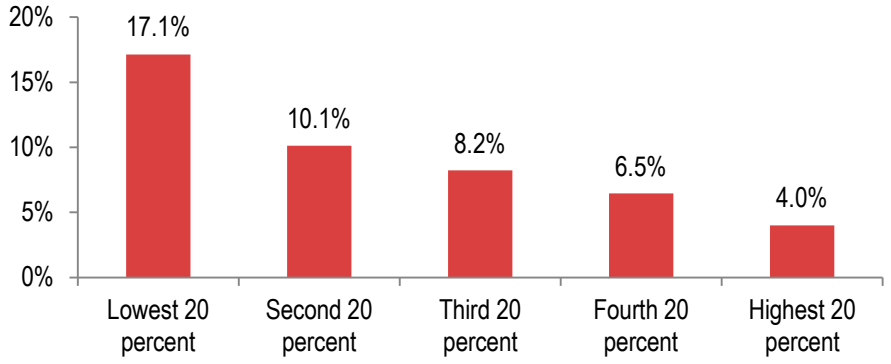
Taxes as a Share of Income

Anyone who has a vehicle has to put gas in it, fix it when it breaks and otherwise maintain it. But people with low-incomes spend a far greater share of their income on these necessities than people with high incomes – four-times greater in fact. That means taxes paid on those services and related items take four-times as much of their income, too.

Nationally, households in the lowest 20 percent of the income distribution (those with an average income of $9,805) spend about 17 percent of their income on the types of transportation needs targeted for the sales tax expansion included in multiple transportation proposals currently being considered by the General Assembly. By contrast, households in the highest 20 percent (those with an average income of $161,292) spend just about four percent of their incomes on the same transportation items.

Transportation Spending Higher in Lower Income Households

Share of income spent on gas, maintenance and repairs, and vehicle rental, leases, licenses, and other charges



Source: TCI analysis of Consumer Expenditure Survey, U.S. Bureau of Labor Statistics, 2011

Regardless of income level, transportation ranks in the top four spending areas among all households, along with other necessities like housing, food, and health care.

Wrong Exit

Over the years, Virginia has made significant improvements in alleviating state income taxes for working families. As a result, three-quarters of Virginia's poorest residents would see no relief under the income tax cuts included in various transportation proposals.

> **Cutting income tax rates for Virginians, while well intentioned, doesn't do the job of providing adequate tax relief from the sales tax increases for low- and middle-income people.**

While cutting income tax rates, as proposed, would reduce income taxes for about 73 percent of all Virginians, just 1 out of every 4 of Virginia's lowest income residents (those earning less than $21,000 a year) would get relief. In fact, over a third of all the cuts under this scenario would go to the wealthiest 20 percent of Virginia households, missing the goal of giving tax relief to low-income Virginians.

The Right Road

The good news is there are ways that Virginia can provide targeted relief to better offset the effect of the gas and sales tax increases on low and middle-income families across the state.

Cutting income tax rates costs a lot of money. For example, estimates show that reducing the rates for three income tax brackets would cost over $500 million a year. But providing more targeted tax relief for low- and middle-income families could cost far less – likely just over $100 million.

Two options for reducing the negative effects of broad-based tax increases on moderate- and low-income Virginians include:

Refundable Earned Income Credit
Making Virginia's Earned Income Credit (EIC) refundable would be one way to offset part of the disproportionate impact on lower-income Virginians of any new sales or excise tax increases. By making the earned income credit refundable, workers whose credit is greater than the income tax they pay would receive their remaining credit in the form of a refund, which would help offset a portion of the other taxes they pay. Numerous studies have found that the federal version of this credit is a strong incentive to work, boosting workforce participation among single mothers and low-wage working mothers, reducing cash welfare assistance, and lifting families out of poverty by helping them make ends meet. Refundability is critical to bringing the state's earned income credit to its full potential.

Tax Rebate
Another option for off-setting the impact of new transportation taxes is to provide a straight rebate to low-income households. Five states (Arizona, Hawaii, Idaho, New Mexico, and Oklahoma) have some form of rebate designed to offset sales and excise taxes. Most of the rebates are a flat dollar amount per family member and are only available below a certain income threshold. All of these rebates are refundable in order to help the lowest income, hardest-hit families. While the particular details of such a rebate program would need careful attention – for example, to avoid a "cliff effect," a gas tax rebate should phase out near the income limit – such a program would provide a simple way to give the tax relief to low-income Virginians that legislators seek.

Two ways Virginia can provide targeted relief to better offset the effect of the gas and sales tax increases: make the earned income credit refundable; create a straight rebate.

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