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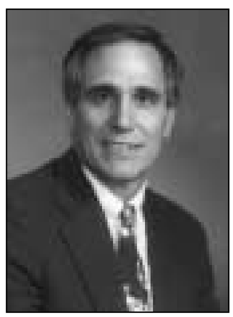
The Virginia
NEWS LETTER

Fixing Virginia's Tax Structure

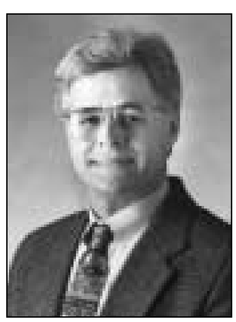
By Thomas R. Morris
and
Robert S. Hodder Jr.

The commission of private citizens appointed by the General Assembly to study state and local tax structures in the Commonwealth has identified a troubling imbalance in the fiscal relations between our state and our local governments. Failure to address the impact of this problem on the fundamental policy concerns of Virginia's citizens may well, in the opinion of the Commission members, "constitute a false economy and merely bequeath to successor generations the necessity of rectifying the deficiencies at added cost."



Thomas R. Morris

The present imbalance between the state and local governments developed for a variety of historical reasons over many decades; that history suggests that remedies may have to be phased in over several General Assembly sessions. But the members of the Commission have come to the unmistakable conclusion that remedies must be sought: state and local government decision-makers must begin the strategic process of readjusting revenue sources and reallocating monies and responsibilities for services between the two levels of government. If no action is taken, the rapidly changing demands of a new century will handicap Virginia's state and local governments.



Robert S. Hodder Jr.

This News Letter provides an overview of the testimony and other information collected by the Commission; it then presents the recommendations that the Commission unanimously endorsed in its final report.

In 1999, the General Assembly established the Commission and directed it to examine "all aspects of state and local tax structure" and "the proper division of revenues and responsibilities for services." With this broad charge, the Commission began meeting in October 1999; it released its final report in December 2000. For the full report, go to www2.institute.virginia.edu/taxstudy.

In the course of its review, the Commission held 10 meetings to receive testimony and to analyze relevant materials.

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Revenue from sales tax is threatened.

To facilitate public comment from all areas of the Commonwealth, meetings were held in Richmond, Manassas, Hampton, Emory, Danville, and Charlottesville. The members of the Commission, who were private citizens from all regions of the state, brought to their deliberations significant experience and expertise in budgeting, finance, taxation, education, and the delivery of public services.[1]

The Commission received testimony from many sources: national research entities, state agencies, state legislators, local government representatives and their organizations, and private citizens.

Local Revenues

The principal source of revenue for localities is the real estate property tax. The testimony from local government officials pointed out that many jurisdictions rely unduly on this revenue source. The level of dependence varied considerably across the state, but in any case the information presented revealed languishing growth in the assessed value of localities' real estate, in contrast to the robust annual growth in taxable individual income, which is the principal source of state revenue. Factor into these circumstances the market value removed by tax-exempt property—approximately $60.7 billion in tax year 1998—and the difficulties of local government finance are evident.

Sales and use taxes are another, though modest, revenue source for localities. The median jurisdictional average of local revenue that Virginia's cities and counties derive from those taxes declined from 8.79 percent of all revenue in 1989 to 6.63 percent in 1998 according to the Virginia Commission on Local Government. This modest revenue stream is threatened, moreover, by ongoing change.

First, the economy in Virginia is increasingly based on services as opposed to the production and sale of tangibles, and those services are not now in the tax base.

Second, the growth in interstate sales via catalogues and e-commerce means that the state is losing sales tax revenues, because those transactions are with firms having no physical presence in the Commonwealth and consequently no obligation to collect sales taxes. One study has estimated that by 2003 this aggregate loss in state and local revenue will be approximately $458 million.

Third, Virginia, like the other states, has over the years constricted its sales tax base through a multitude of exemptions.

These realities point to the uncertainty of the sales and use tax as a source of revenue for Virginia's localities.

A third fiscal concern for Virginia's localities is the practical constraint that the Personal Property Tax Relief Act of 1998 appears to impose on their use of the personal property tax. The personal property tax, levied mostly on the assessed value of vehicles, has been increasingly important to Virginia's localities: The median jurisdictional percentage of total local-source revenue from that tax rose from 14.86 percent in 1989 to 16.37 percent in 1998. Local governments are now concerned that with most Virginia citizens probably conditioned to believe that the 1998 legislation ended their car tax permanently, a political cap has been applied to that revenue source.

All of these trends suggest that the downward pressure on local revenue sources will continue in the early 21st Century. The growth in assessed real estate may continue to languish, sales and use taxes may continue their decline because of both structural economic shifts and e-commerce and catalogue sales, and those trends together with the public's determination to keep their vehicles free of taxes will likely constrict local governments' ability to find the revenues for essential public services.

Local Expenditures

In Fiscal Year 1999, Virginia's counties and cities collectively expended about $13.4 billion to operate and maintain their public services. Those funds came from local, state, and federal sources, but over recent decades the local component has taken on more significance, because federal support has been reduced, beginning in the early 1980s. During the same period, however, between FY1981 and FY1999, the state's contribution to the general revenue of Virginia's counties and cities remained essentially unchanged (decreasing slightly, from 32.1 percent to 32.0 percent). The component of the total raised by the localities meanwhile increased from 56.8 percent to 61.6 percent.

These disconcerting changes in localities' revenue patterns have been accompanied by increased pressures for expenditures. The preponderance of the operational expenditures by Virginia's counties and cities go to public education: in FY1999, approximately $7.4 billion, or 55.8 percent of their total operational outlays. Now, however, other functional areas draw additional local expenditures. Among the rising needs are expenditures for public safety and health and welfare. It is likely that the pattern for Virginia's localities will continue to reflect the pressure to commit more resources outside the realm of public education.

Disparity in Local Conditions

Testimony and information presented to the Commission vividly disclosed sharp variations across Virginia in population growth, resident income, student eligibility for school lunch assistance, the presence of poverty, crime rates, other demographic and social measures—and revenue resources. The Commission's members decided early on that, to address the needs of Virginia's localities, the variation in their circumstances must be fully recognized.

Some local representatives testified about their localities' inordinate burdens in providing for high concentrations of residents who need an array of public safety and health and welfare services. Many of those services are mandated by, but not necessarily funded by, the state or federal government. Such residential concentrations are reflected in the extraordinary variations in local expenditures. For instance, FY1998 data show that for health and welfare, Richmond spent $440 per capita, while Poquoson spent only $60. Similar dramatic disparities exist between localities' expenditures for public safety.

Testimony and information on the operational and the capital costs of education revealed the magnitude of those local expenditures. It bears repeating that as of FY1999 Virginia's counties and cities expended more than half their total operational outlays for their educational programs; in addition they bore debt service costs for education of over $700 million. As of the end of FY1999, Virginia's localities, including the two towns that operate separate school divisions, carried gross debt for education of over $4.6 billion. Moreover, the data suggest that considerable capital costs lie ahead for localities with school rehabilitation needs or with high population growth.

State Intergovernmental Assistance

As noted previously, Virginia's localities bear varying burdens for social services that are mandated by state law as essential to the well-being of the Commonwealth. Where significant concentrations of residents need public health services; mental health, mental retardation, and substance abuse services; foster care; or social services; or are incarcerated, the localities struggle with disproportionately high costs. In recent years, the annual operational costs to localities for state-mandated services by agencies and for local and regional jails have totaled more than $400 million.

In operational support for education, the Virginia state government's support of its public schools is below the national norm. According to the U.S. Bureau of the Census, during 1996-97 funding by the state government in Virginia (including the 1.0 percent sales tax returned to localities for educational purposes) constituted 40.5 percent of the total state public school revenue; for all states collectively the statistic was 48.8 percent. During that fiscal year, Virginia's local governments provided 54.6 percent of the total public school revenue; for all states, local support comprised 44.8 percent of public school revenue.

Government support of public schools is below the national norm.

In the Commission's consideration of possible changes in the state's assistance to localities for public education, two issues were raised. One concerned the formula allocating Basic School Aid. That formula uses the "composite index of local ability to pay" to decide how much a locality will receive toward funding its compliance with the Standards of Quality—minimum state standards for educational services. That "composite index," however, is founded solely upon a locality's comparative ability to raise revenue, and does not factor in the comparative demands on its revenue base for other essential services. Some Virginia localities can devote most of their local revenues to public schools, but others have heavy outlays for other functions: social services, public safety, and public works. Those localities with heavy non-educational expenses due to characteristics of their populations must cut their education budgets. Their students lose ground to students in school districts that can support more teachers and more programs, and can invest in infrastructure such as computer software and hardware.

The second issue concerns the elements of the state Standards of Quality, in particular the number of instructional positions they endorse. To the extent that local school divisions employ more teachers than are prescribed by the Standards of Quality, state appropriations that fund the standards cannot be applied to those additional positions. For school year 1997-98, data indicate that 25,644 teachers, or 25.9 percent of the total employed by local school divisions, were not funded under the Standards of Quality.[2] Clearly state policy and the local school administrators calculate the number of teachers needed for adequate education very differently.

In recent years localities have received state assistance from several programs for school construction and maintenance costs. Nevertheless, the fiscal burden of those costs continues to be borne mostly by the localities. Between FY1990 and FY1999, localities expended more than $5 billion to service indebtedness incurred for school construction and rehabilitation.

State Fiscal Issues

Realistic Revenue Considerations: In planning its fiscal future, the Commonwealth should recognize not only its service needs, but also potential economic difficulty while bearing in mind that the full effect of the recent state tax cuts is yet to be felt.[3] In the future, revenue from the sales tax may not rise at the same pace, and a downturn in the stock market or in economic growth would reduce individual income tax collections. Yet demands will remain on all fronts: among them mental health, social services, and education. In addition, a major demand on state revenues deserves our attention here: transportation services.

Transportation Needs: A staff report to the Senate Finance Committee in November 1999 observed that between 1993 and 1998 the number of registered vehicles increased by 17 percent and the number of vehicle-miles traveled in Virginia increased by 16 percent—more than twice the growth rate of the state's population during the same period (8 percent). The report also noted that the "average daily traffic volume" in Virginia rose by 175 percent between 1992 and 1997, surpassing that in the nation (118 percent). The staff report cited past studies that had documented highway needs in Virginia as "totaling more than $35 billion" and noted that the state's "highway revenues [were] not growing in line with economic growth or with the general fund." Given the magnitude of the documented needs, future administrations and legislatures must seek funding to lessen gridlock, which diminishes economic productivity. This issue is increasingly being discussed by state legislators.

Comparative Fiscal Burdens

A staff report to the Senate Finance Committee's Subcommittee on Tax Policy in 2000 cited data that state and local tax collections in Virginia in FY1998 came to only 9.8 percent of the Commonwealth's total personal income. Only three states collect tax revenues that are smaller percentages of their state personal income. The rate for the top bracket of Virginia's state income tax, its principal revenue source, is 5.75 percent—lower than any neighboring state with a tax on earned income. Further, the Virginia flat rate on corporate income (6 percent) is lower than those in three adjoining states, and lower than the top rate in another (Maryland: 8.25 percent); its general sales tax rate (3.5 percent) is lower than that in any adjoining state, and its excise tax on gasoline (17.5 cents/gallon) is lower than that in any contiguous state except Kentucky (16.4 cents/gallon). These statistics leave no doubt about the latitude in the state's tax structure to improve public investment if the citizenry and the political leadership recognize the need.

In testimony to Commission members by the Institute on Taxation and Economic Policy (ITEP), the tax policy director stated, "Virginia has a regressive tax structure—middle- and low-income families pay a greater share of their income in Virginia state and local taxes than do the wealthy."[4] ITEP presented information showing that state and local taxes in Virginia claim 9.2 percent of the income of families in the $15,000-$26,000 bracket, and 8.6 percent of family income of families in the $43,000-$71,000 bracket, but only 6.9 percent from income of families in the top 1 percent (incomes of $295,000 or more). The regressive tax structure revealed by this information suggests that the Commonwealth could do more to ensure tax equity for those of its residents below the high income levels.

The trends for family income in Virginia also bear on the issue of equity in tax structure and policy. An analysis undertaken by the Center on Budget and Policy Priorities and the Economic Policy Institute found that from the late 1970s to the late 1990s the average income of Virginia families in the lowest 20 percent of the income continuum actually dropped in real terms by 1.4 percent, while that of the top 20 percent of the continuum rose by 42.7 percent. In Virginia, households with the most modest incomes are losing ground to those with the highest incomes. If tax equity is a goal of state policy, legislators should restructure Virginia's tax code.

It is significant that Virginia legislators have recently acknowledged the plight of our low-income residents by acting to alleviate it. Beginning with tax year 2000, the General Assembly has authorized a tax credit of $300 for each individual, spouse, and dependent whose individual or family Virginia adjusted gross income does not exceed the poverty guidelines. This change to the tax code significantly improves the equity of Virginia's individual income tax structure; nevertheless, more progress toward that goal should be considered. The new tax credits are of no help to near-poor families with incomes marginally above the poverty line. The current program creates what has been termed an income tax "cliff": If a family's Virginia adjusted gross income exceeds the federal poverty guidelines by a single dollar, that family must pay the full tax. Second, the current tax credit also is "non-refundable": The tax-paying individual or family is not eligible to receive any portion of the credit in excess of the tax liability. A refundable credit, in contrast, would actually elevate the income of working poor families.

The Business Perspective

Business interests voiced several concerns to the Commission, but appeared to express a consensus judgement about the adequacy of public resources to meet Virginia residents' fundamental needs, and also about the present division of responsibility between the state and its localities. A representative of the Northern Virginia Technology Council told the Commission that "Virginia's existing tax structure is failing in its primary purpose—to raise funds sufficient to meet the public investment needs of the Commonwealth and its localities." Similarly, the chairman of the Virginia Chamber of Commerce's Tax Policy Committee observed that "local governments are without sufficient revenue resources to meet their mandated service responsibilities and the needs and expectations of its citizens, and that the system must be 'modernized' to comport with the realities of a global, information driven economy."

Parallel views were expressed by the chairman of the Virginia Association for Commercial Real Estate, who wrote that his association "shares the concerns of most local governments about the need for increased local revenues to adequately address the impact of residential growth that results from Virginia's economic development successes." The support for tax reform from these private sector organizations strengthened the Commission's conviction that the Commonwealth must undertake fundamental changes in tax policy.

The Commission's Recommendations

The recommendations that follow were unanimously endorsed by the voting members of the Commission. They constitute a balanced and integrated set of proposals for coming to terms with the array of state and local fiscal concerns cited above. Our localities and our state government confront difficult choices in funding the multitude of costly services necessitated by contemporary society. The Commission's proposals listed below highlight such choices.

Education

Quality education is indispensable to the economic and social health of the Commonwealth and constitutes a fundamental concern of our state government. In recognition of the importance of education to the future economic and social health of the Commonwealth, we recommend that the state substantially increase its support for both the operational and the capital costs of the local school divisions. In terms of operational costs, we recommend that the state revise the Standards of Quality to reflect more accurately the prevailing practices of the local school divisions. The state should then assume a full 55 percent of such a revised Standards of Quality foundation program. Further, we recommend that the "composite index" of local ability to pay, which is used to determine the local share of the state prescribed basic educational program, be modified to recognize a locality's comparative fiscal effort. With respect to the capital costs of local school divisions, there is a need for the state to continue to increase, as it has in recent years, its assistance to local governments for the construction and rehabilitation of their school facilities, with particular attention being paid to those confronting inordinate fiscal burdens.

Business interests support tax reform.

Assumption of Mandated Services

Numerous Virginia localities bear inordinate social service costs due to a concentration of residents within their jurisdiction who require such services. To the extent that a locality is unable to address those social service needs mandated by the state and carry out the other general public service requirements of its community, the viability of the Commonwealth is diminished. Accordingly, we recommend that the state government assume full responsibility for the funding of all mandated services provided through the Comprehensive Services Act, the public health departments, the Community Services Boards, the local and regional jails, and the social service/welfare departments. Such services should consist of all those mandated by the state and/or federal governments. In recent years costs for these services have totaled slightly more than $400 million.

Distribution of Individual Income Tax

Virginia's localities are heavily dependent on the real estate property tax. The languishing values of assessed real property in many Virginia localities in recent years, as well as current and prospective economic trends, indicate to this Commission the propriety of broadening the revenue base supporting the Commonwealth's localities. To that end, we recommend that at least 6 percent of the state's annual net individual income tax collections be dedicated for return to Virginia's localities and distributed on a formula that incorporates a variety of measures. Such measures might include residential population, place of filing of tax return, wages by place of employment, and a locality's fiscal effort. However, the establishment of a program enabling localities to share in the growth of the state's individual income tax collections should take precedence over the details of a distributional formula.

This proposed dedication of state income tax receipts to localities should be accomplished initially by statute and subsequently by constitutional provision. Our calculations indicate that this proposal would make available for distribution to Virginia's localities approximately $500 million in FY2002.

Sales and Use Tax

The sales and use tax is a vital component of Virginia's state and local tax structure, and its role in the Commonwealth's fiscal future should be preserved. Three major elements of this issue merit attention. First, it is essential that the state endeavor to equalize the tax differential currently confronted by resident and non-resident businesses. Second, given the growing significance of services in our contemporary economy, we recommend that consideration be given in Virginia to an extension of the tax initially to personal services, amusements, and repair services. Third, we recommend that a moratorium be established by the legislature regarding the granting of any new sales and use tax exemptions and that all existing exemptions be critically reviewed and considered for elimination. Extensive tax exemptions eventually result in pressure to raise tax rates in order to offset the lost revenue.

Regional Transportation

Funding Virginia's growing transportation requirements is a major issue. In recognition of their magnitude, we recommend that funding be derived from fuels, vehicle and related user charges, and that the state's general revenue instruments be reserved for general government purposes. Furthermore, we recommend that greater opportunity be afforded localities to work in concert to address their transportation concerns, including the ability to establish regional transportation entities having broader authority in planning, prioritizing, funding (exclusive of any independent taxing authority), and implementing transportation solutions for their member jurisdictions.

Individual Income Tax Modifications

We recommend that the individual income tax, the Commonwealth's principal revenue source, be modernized to reflect the many changes that have occurred since the basic structure of that tax was established 75 years ago. Accordingly, the Commission recommends that the rate structure of Virginia's individual income tax comprise two brackets, with a rate of 5.0 percent applied to the first $50,000 of taxable income and a rate of 5.75 percent applied to amounts above $50,000.

Another element of Virginia's current income tax structure that merits modification is the size of the tax-free amounts created by the combination of standard deductions and personal exemptions. Specifically, we recommend standard deductions of $7,000 for married couples filing jointly and $3,500 for single persons and married persons filing either separate or combined returns. With regard to personal exemptions, we have determined that exemptions of $2,500 each (with no added exemptions based on age or blindness), in concert with the increased standard deductions, accomplish the goal of removing poverty-level income from the base for most taxpayers.

While we propose that Virginia's individual income tax rates, brackets, standard deductions, and personal credits be reviewed periodically for possible adjustment, we do not recommend that they be indexed for automatic change. Another integral component of the individual income tax recommendations is the termination of the special age deductions currently granted to individuals age 62 to 64 ($6,000) and to those age 65 and over ($12,000). Age alone is not a valid measure of need or hardship. While historically it was true that poverty was a problem strongly associated with aging, this situation has not been the case for many years.

Finally, with respect to the state's individual income tax, we recommend that Virginia expand upon the positive step taken by the General Assembly during the 2000 session to alleviate the tax burden of individuals and families below the poverty level. The current low-income tax credit program provides no assistance to near-poor families with incomes marginally above the poverty line. To rectify this situation, we recommend that Virginia modify its current low-income tax credit arrangement, patterning it after the federal earned income tax credit, which is phased out gradually as individual or family income rises.

Specifically, we envisage a state credit set equal to 20 percent of the federal credit. Further, we recommend that the proposed Virginia credit, like the federal counterpart, be refundable, with any element of the credit not required to offset the tax liability resulting in a payment for the difference being made to the low-income family or individual.

City-County Taxing Authority

The difference between the taxing authority of Virginia's cities and that of its counties has been a source of contention in the Commonwealth for many years. We recommend that this distinction, which is based solely on an historical legalism and which has no relevance to modern service responsibilities, be eliminated and that the taxing authority of Virginia's cities and counties be equalized.

Tax Exemptions and Service Charges

A significant factor affecting the fiscal capacity of many Virginia localities is the concentration of tax-exempt property within their boundaries. While Virginia's Constitution permits the General Assembly to authorize localities to levy service charges on tax-exempt property, it has done so with certain limitations. We recommend a re-examination of the current practice and statutory constraints applicable to such charges. In our view, localities should be required to apply service charges to all tax-exempt property to the extent authorized, and the General Assembly should relax the constraints that now limit the application and amount of such charges.

Permanent Body to Study Fiscal Needs

The breadth and complexity of the issues referred to this Commission for consideration suggest the desirability of the establishment in the Commonwealth of a permanent body to analyze on a continuing basis the fiscal needs and resources of Virginia's state and local governments. We recommend the creation of such a Commission and recommend that the membership be broad-based, with representation from both the public and private sectors, but with a significant majority of the members being from non-governmental entities. While this body should be assisted in its work by the staffs serving the relevant state legislative and executive agencies and local governments, it should also be supported by a small, independent staff.

Equalize the taxing authority of cities and counties.

BPOL and Merchant's Capital Taxes

This Commission was asked to consider during the course of its review proposed state legislation calling for the repeal of the local merchants' capital, and the business, professional, and occupational license (BPOL) taxes. Because these taxes are a vital source of local government revenue, which is already too constrained, the Commission does not recommend the repeal of those taxes in present circumstances.

Economic Development

Regional collaboration in economic development often constitutes the most cost-effective approach to providing essential infrastructure and the most beneficial and equitable manner of promoting a region's economic growth. While this Commission is fully cognizant of the need to maintain appropriate uniformity and administrative simplicity in fundamental state policies, we believe that the state can and should, consistent with that need, give its localities more flexibility to address economic development on a regional basis.

What the Future Holds

The Commission was charged with undertaking a long-range analysis of Virginia's state and local tax structure. Specifically, it was asked to "examine all aspects of Virginia's state and local tax structure to ensure its viability, fairness, and appropriateness for the 21st century." Unlike elected officials responsible for approving budgets in the current cycle, the commissioners were asked to draft a blueprint for a more extended period. In some cases, the Commission's recommendations, outlined above, significantly depart from current funding practices. The Commission members unanimously concluded that such changes are nevertheless warranted, and, where necessary, should be implemented incrementally by the General Assembly.

As the Commission carried out the charge of the state legislature, it discovered structural economic shifts, the need for basic institutional change, pressing local needs, and disparities in the treatment of households with regard to tax equity. Fully aware of the complex web of interaction among the various governmental units and with the citizenry, the commissioners made recommendations for adjusting the tax structure and service responsibilities in ways that would make it more equitable and efficient.

The challenge is to structure the complex tax and public service systems to enable citizens and businesses to compete in the rapidly changing economic order. The recommendations of the Commission make clear that numerous measures should be taken in response to the fiscal concerns confronting the Commonwealth. The expectation of the Commission members is that once citizens of Virginia, representatives of the executive branch, and members of the legislature recognize the documented shortcomings of our governmental structure, action will be taken to rectify the problems within the context of political debate. •

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[1] The members of the Commission were Ms. Elnora H. Allen (Richmond), Mr. Peter N. Chase (Manassas), Mr. Mensel Dean, Jr. (Harrisonburg), Mr. James W. Dyke, Jr. (McLean), Ms. Dorcas T. Helfant (Virginia Beach), Mr. Rodney A. Jordan (Norfolk), Mr. E. Randolph Lail (Kenbridge), Mr. Charles H. Majors (Danville), Dr. Thomas R. Morris (Emory), Dr. John E. Petersen (Arlington), Mr. George B. Pugh, Jr. (Richmond), and Ms. Karen L. Shields (Newport News). The Commission was assisted in its work by the Secretary of Finance, the Honorable Ronald L. Tillet, and the State Tax Commissioner, the Honorable Danny M. Payne. The Commission received staff support from the Weldon Cooper Center for Public Service.

[2] Teresa A. Atkinson, "State Funding for Elementary and Secondary Education in Virginia," presentation to House Appropriations Committee, January 27, 2000.

[3] The Secretary of Finance estimated in a report to the legislature in December 1999 that as of FY2002 the implementation of the Personal Property Tax Relief Act, the repeal of the sales tax on non-prescription drugs, and the planned phased reduction in the state's sales tax on food from 3.5 percent to 2.0 percent would reduce state revenue collections by approximately $855 million, $12.4 million, and $63.6 million, respectively. ("Governor Gilmore's Proposed 2000-2002 Budget.")

[4] Michael Ettlinger, Tax Policy Director, Institute on Taxation and Economic Policy, statement to the Commission, July 10, 2000.

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