

The Virginia NEWS LETTER

Richmond, We Have a Problem: Modernizing Virginia's Outdated Revenue System

by Sara C. Okos

Introduction

While recession-driven unemployment is clearly at the center of Virginia's continuing fiscal shortfalls, the downturn also has revealed some serious underlying challenges with the state's revenue system. The commonwealth has failed to update state income tax brackets and rates for nearly 25 years, ignoring the impact of inflation on brackets and changes in income distribution. Additionally, the state sales tax has not kept pace with consumer spending trends, which have shifted dramatically from goods to services and to purchases made over the Internet. Compounding these problems, old and ineffective tax breaks and credits adopted to incentivize certain actions or behaviors are not regularly evaluated for their effectiveness, despite a price tag estimated to be in the billions of dollars every year.

The ongoing sluggishness of the economic recovery will continue to impact state and local budgets for some time as general fund revenues are not bouncing back to levels needed to meet the ongoing and elevated demand for public services. Virginia faces an over \$800 million shortfall in the upcoming 2012-2014 biennium, but many of the tools used to balance the state budget in recent years are no longer available.¹ Funding from the federal American Recovery and Reinvestment Act of 2009 (ARRA)—henceforth referred to as “the federal recovery act”—is over. Virginia's Revenue Stabilization Fund, often called “the rainy day fund,” is



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mostly depleted. The state is bumping against its debt service limit. Unwinding many of the budget and financial tactics used during the recession (like borrowing from the Virginia Retirement System, requiring high-volume retailers to remit sales taxes early, and shifting Medicaid payments around to limit state liabilities) will require funding off the top of the general fund, prior to any allocation to program areas. In addition, the prospect of significant cuts in federal spending over the next few years as part of federal deficit reduction measures could spell even more trouble for the commonwealth. These factors present serious risks to critical state investment in key areas like education, health care, and economic development—all of which play important roles in positioning Virginia for the best possible future.

What Virginia needs is a 21st century revenue system for a 21st century economy. This article provides an overview of the issues the state faces in raising the resources necessary to meet public needs and introduces key reform ideas for strengthening Virginia's path to economic recovery. Discussion is restricted to the state's general fund because the governor and General Assembly have the most discretion over this component of the state's budgetary resources and because the fund's primary sources of revenue are those that typically affect the lives of Virginia's residents and businesses most significantly and directly.²



The Recession Posed Significant Challenges and Continues to Have Lingering Effects

Like the rest of the country, Virginia was battered by what has become known as the Great Recession. Between fiscal years 2007 and 2010, state budget shortfalls totaled over \$11 billion, creating fiscal challenges of historic proportions.³ For the very first time in recorded history, Virginia experienced back-to-back declines in revenues in fiscal year (FY) 2009 and FY 2010. In FY 2009 alone, the 9.2 percent decline in revenue was more than double the declines of the previous recession in the early 2000s (see **Figure 1**).⁴ On top of these declines, Virginia's revenue growth in FY 2011 that closed this past June, two full years after the official end of the recession, was not enough to bring the state back to pre-recession revenue levels.

Many macroeconomic factors are at play in driving these recessionary revenue declines, but employment declines are the most critical component. Virginia faces a much more challenging situation coming out of this recession than it did for the two previous recessions. While employment was slower to decline this time than it was in 2001 and 1990, this was a much longer downturn, and it dug a much a deeper employment hole.⁵ As shown in **Figure 2** the cumulative loss in jobs since the start of the Great Recession began in December 2007 was more than two and a half times that of the 2001 recession (-4.5 percent versus -1.6 percent). Even the 1990 recession, which was deeper than the 2001 recession, saw only a 2.8

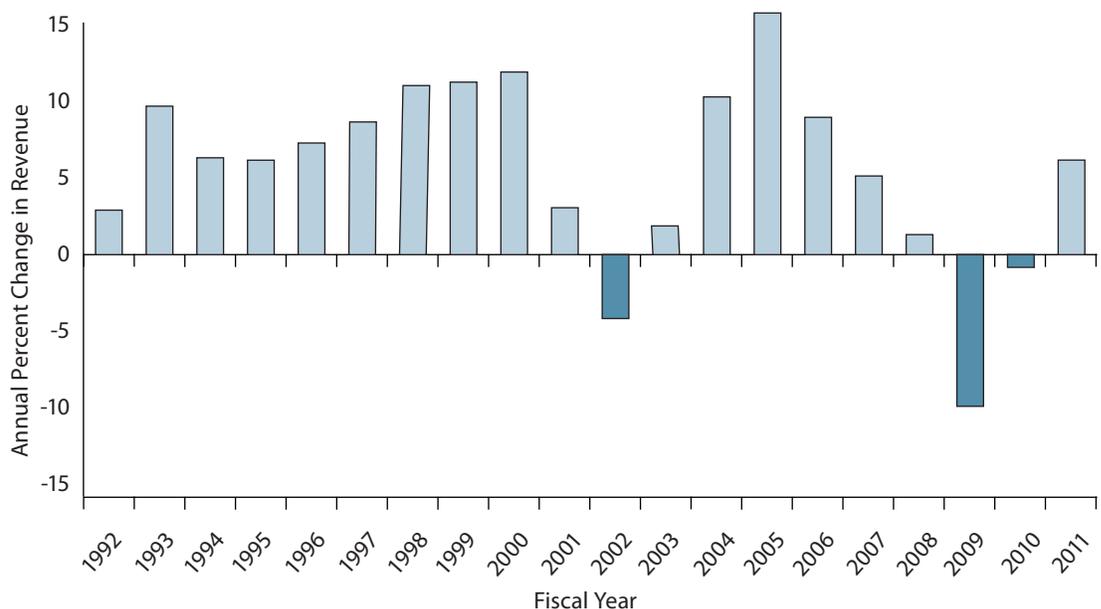
percent total decline in employment at its lowest point. Now, almost four years beyond the start of the Great Recession, employment levels in Virginia remain 3.4 percent below where they were at the beginning of the downturn.

Virginia's statewide unemployment rate still hovers well over 6 percent, yet the unemployment rate provides an incomplete picture of the true employment challenges facing the state.⁶ Since the start of the recession, total nonfarm employment in Virginia is down over 106,000 jobs, but when the growing size of Virginia's working age population is considered, the hole gets even deeper.⁷ Given the state's 4.7 percent growth in the working age population since the start of the recession, Virginia needed to add an additional 176,000 jobs just to keep up with normal growth in the state's working-age population (see **Figure 3**).⁸ This places Virginia's "effective" jobs gap at nearly 282,000. At Virginia's current rate of job growth—about 3,000 jobs per month, on average—we aren't even keeping up with growth in the work force.⁹

Virginia's job shortfall has significant implications for revenue collections. Nearly seven out of every ten general fund dollars are collected through the individual income tax.¹⁰ Higher unemployment means that fewer Virginians are earning income, which means the state has a lower taxable base. On top of that, during times of economic downturn, purchases of big-ticket durable goods decline dramatically. Because sales and use tax collections depend heavily on the purchase of

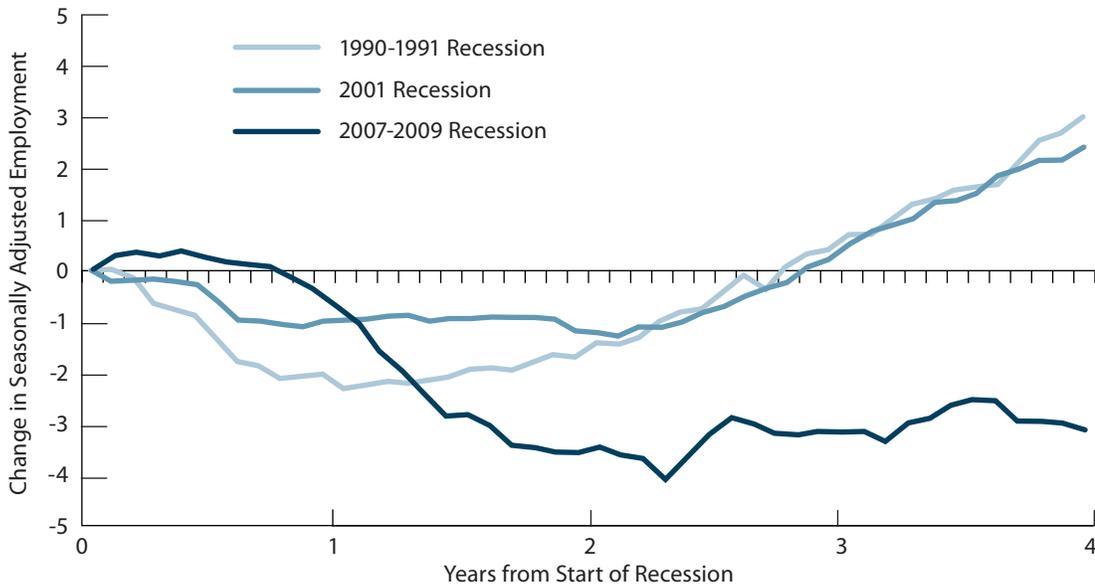
“Virginia faces a much more challenging situation coming out of this recession than it did for the two previous recessions.”

Figure 1: Virginia General Fund Revenue Annual Changes, FY 1992 to FY 2011



Sources: Virginia Secretary of Finance, GACRE Appendix (December 17, 2010) and Presentation to Joint Money Committees (August 14, 2011) http://www.finance.virginia.gov/KeyDocuments/JMCmaterials/GACRE_Book_2010.pdf and <http://www.finance.virginia.gov/KeyDocuments/JMCmaterials/JMC-Aug2011.pdf>

Figure 2: Comparison of Change in Virginia Nonfarm Payroll Employment Since Start of Recession for the Past Three Recessions



Source: Data from Bureau of Labor Statistics, Current Employment Statistics. <http://www.bls.gov/sae/data.htm>

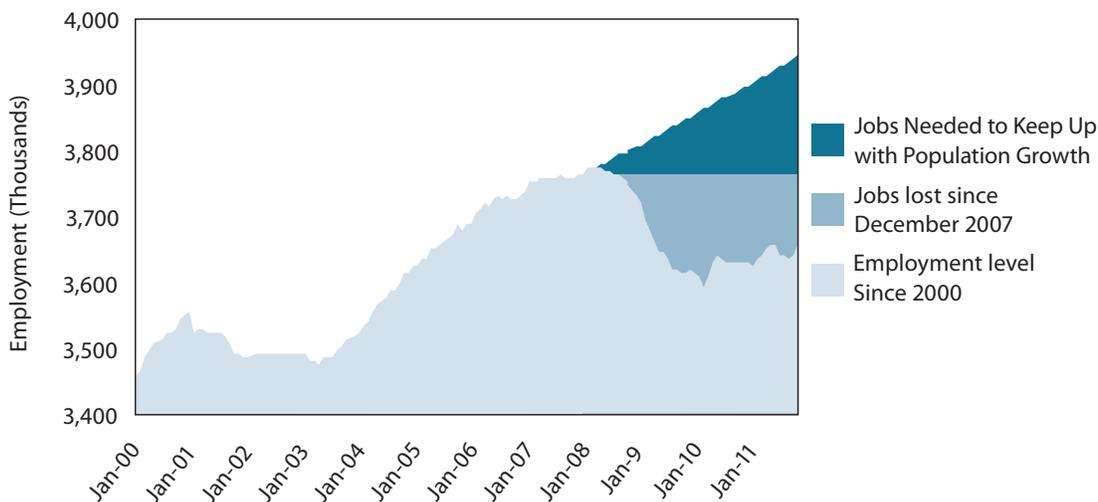
these types of goods, collections take a double hit during recessions when sales of these items plummet. As the second largest single source of general fund revenues, the sales and use tax generally yields about two in every ten general fund dollars.¹¹ Together, the individual income tax and the sales and use tax account for roughly 90 percent of annual general fund collections. This suggests that until Virginia can make significant progress in growing jobs and getting its residents back to work, we are likely to continue to struggle with lagging revenue collections.

To put these revenue challenges in context, it is illustrative to look at the other side of the

budget-balancing equation, which is state spending. The recession not only drove down Virginia’s revenue collections, but it dramatically increased needs among the state’s residents and local governments. As Virginia’s families lost jobs and saw cuts in their pay due to involuntary cuts in hours worked, their need for such public programs as food stamps, temporary assistance for needy families (TANF), and Medicaid grew substantially. So just at the time when the state’s ability to cope with funding the needs of our citizens diminished, those needs grew. Between calendar years 2007 and 2010, the number of Virginia households receiving TANF increased 14 percent, the

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Figure 3: Actual Nonfarm Payroll Employment Versus Nonfarm Payroll Employment Needed to Keep Up With Population Growth Since December 2007



Source: Based on a Commonwealth Institute analysis of Bureau of Labor Statistics, Local Area Unemployment Statistics (LAUS) <http://www.bls.gov/lau/ststadsadata.txt> and Bureau of Labor Statistics, Current Employment Statistics, <http://www.bls.gov/sae/data/htm>

number of Medicaid recipients increased 18 percent, the number of Virginia households receiving home heating assistance increased 35 percent, and the number of unemployed Virginians increased 135 percent.¹²

How We Dealt with Budget Shortfalls During the Great Recession

Virginia addressed the revenue shortfalls of the Great Recession through a mix of strategies, including cuts to programs and with relief through the federal recovery act, along with resources from the rainy day fund, some tax policy tweaks, and a variety of other transfers, one-time measures, and accounting gimmicks (see **Figure 4**).

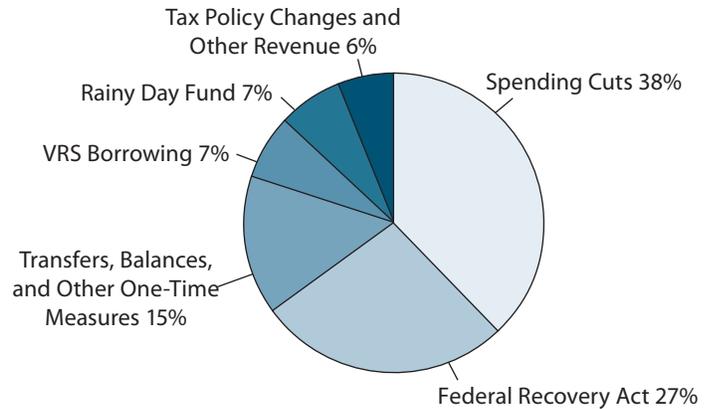
An analysis of the \$11 billion shortfall¹³ shows that 38 percent of the \$11 billion shortfall over the course of the recession was closed through spending cuts to programs. These cuts included: reductions in state support for kindergarten through twelfth grade public education and reductions in the reimbursement rates to doctors and nurses, hospitals, and nursing homes who treat people on Medicaid. Another 27 percent came from federal recovery act funds that acted as substitute general fund dollars, allowing Virginia to protect public elementary and secondary education and to cope with rising Medicaid enrollment, among other things. **Figure 5** shows how these federal recovery act dollars were used to fund key general fund priorities and excludes any transportation funds.

It's worth noting that a variety of tax policy changes, though minor, closed another 6 percent of the shortfall. Among these changes were minor reforms of the sales tax dealer discount program, the reinstatement of an accelerated sales tax program, and some tweaks to the way we peg our tax code to the federal code. Seven percent of the gap was closed by borrowing from the Virginia Retirement System by deferring state payments to the system and the remaining 15 percent of the gap was closed by deferring other transfers and various one-time measures.

Virginia's Surplus and What it Really Means

This past August, Governor Bob McDonnell proudly announced a \$545 million surplus when he reported Virginia's end-of-year finances for

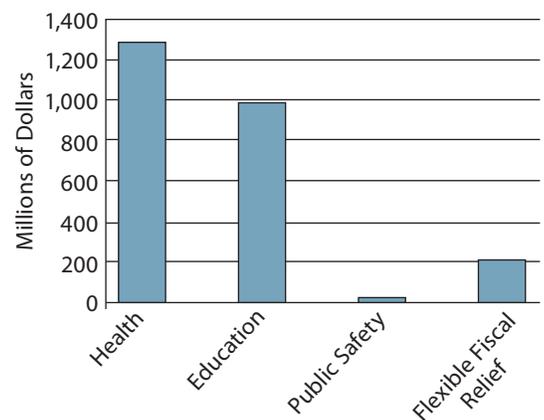
Figure 4: Strategies Used to Close Virginia's Recent Budget Gaps



Sources: The Commonwealth Institute staff analysis of joint post-session summaries by the staffs of the Senate Finance Committee and House Appropriations Committee, May 2009, June 2010, and May 2011. <http://leg1.state.va.us/091/bud/FinalSum/FullReport.pdf> and http://sfc.virginia.gov/pdf/Post_Session_2011/PDF/CompleteDocument_SFC.pdf Additional ARRA Medicaid and ARRA extension data from a presentation by the Secretary of Finance to the Joint Money Committee August 2010, Review of General Fund Revenues and the Virginia Economy for Fiscal Year 2010 <http://www.finance.virginia.gov/KeyDocuments/JMCmaterialJointLegislativepdf> and a 6/15/2010 email to the Commonwealth Institute staff from Senate Finance Committee staff.

fiscal year 2011.¹⁴ This comes on the heels of a \$403 million surplus in the previous year when, despite a 0.7 percent decline in general fund revenues, we ended up with tax collections in excess of expectations because we had projected a decline of 2.3 percent.¹⁵ Unlike the surplus of 2010, the surplus of 2011 resulted, at least partially, from revenue *growth* above projections. This sounds like reason to celebrate—and it is—but before declaring victory, it's both important and enlightening to unpack what the surplus does—and does not—mean. At the end of the day, or in this case the end of the fiscal year, all a surplus really means is that more money came in to the state than was expected or less money went out in the form of expenditures than was expected. In this case,

Figure 5: Estimated Allocation of Commonwealth of Virginia-Administered Federal Relief Funds



Source: The Commonwealth Institute analysis of joint post-session summary by the staffs of the Senate Finance Committee and House Appropriations Committee, May 2009 (<http://leg1.state.va.us/091/bud/FinalSum/FullReport.pdf>)

“Virginia addressed ... revenue shortfalls ... through a mix of strategies, including cuts to programs and with relief through the federal recovery act, along with resources from the rainy day fund, some tax policy tweaks, and a variety of other transfers, one-time measures, and accounting gimmicks ...”

Virginia's 2011 surplus is the result of both these factors.

When the governor and the General Assembly built the budget during last year's legislative session, they built it based on a particular set of economic assumptions about what revenues would look like during the fiscal year and future fiscal years. Typically, the governor's economic advisors and revenue forecasting team (Joint Advisory Board of Economists and Governor's Advisory Council on Revenue Estimates) develop different scenarios based on more and less optimistic assumptions. Due to continuing uncertainty in Virginia's tepid economic recovery, the assumptions that were selected were not the most optimistic available, and so when tax collections came in above the expected level by about \$311 million, the state could boast a surplus. The remaining \$245 million of the surplus came from the fact that agencies ended up spending less than was appropriated to them. Again, when less money goes out than is expected, we have a surplus.

A few related and underlying policy issues are worth considering, however. First, Virginia's budget relied heavily on federal recovery act dollars. The recovery act brought over \$3.1 billion in resources to support general fund spending priorities in the commonwealth during the downturn. But this key lifeline has run out.

Second, we've employed some creative accounting gimmicks—like the accelerated sales tax program. Through this change, we've required high-volume businesses to remit their state sales taxes early based on estimates of *future* sales. This was a one-time accounting trick to shift future revenue into the current budget window. While this maneuver only helped balance the budget the year the change was made, it actually set us back so that when we finally fully unwind the gimmicks, there will be a negative revenue impact that year. On top of those issues, we can't ignore the fact that we've skipped the normally required payments to the Virginia Retirement System.

Thirdly, over \$4 billion has been cut out of the budget, and we continue to have very large transportation funding needs. Virginia has a history of diverting funds from the Transportation Trust Fund to the general fund and vice versa.¹⁶ Just last session, sales tax diversion legislation was proposed to redirect \$150 million annually from the general fund to transportation projects in Northern Virginia and Hampton Roads.¹⁷ One component of Governor McDonnell's recently released 2012 Transportation Plan proposal is an increase in the dedicated transportation allocation of the sales tax from 0.5 percent to 0.75 percent over the next eight years.¹⁸ Although this policy

would increase resources for highway spending, it would be at the expense of general fund spending because no new revenue would be involved. Until the state is able to secure additional dedicated revenues for the maintenance and construction of Virginia's transportation system, this public priority will continue to compete with a host of others—education, health care, and public safety, for example—for general fund dollars.

So while elements of the recent surpluses in 2010 and 2011 are signs of progress, they should not distract us from the fact that despite the revenues coming in above projections, they are still not rebounding to the level where they need to be in order to support the ongoing needs of the state.

Upcoming Challenges in the 2012-2014 Biennium

This month, Governor McDonnell will release his first full biennial budget, covering fiscal years 2013 and 2014. Assuming a continuation of the funding levels included in the budget passed by the General Assembly during the 2011 session, adjusted for the state's own projections of any spending changes in fiscal years 2013 and 2014, current revenue forecasts leave the state falling short by about \$800 million over the course of the upcoming 2012-2014 biennium.¹⁹ More specifically, this \$800 million shortfall estimate is derived by adjusting the spending levels included in Chapter 890 for any anticipated spending changes included in the Department of Planning and Budget's Six Year Plan and marrying that spending information up with the revenue growth anticipated by the December 2010 Governor's Advisory Council on Revenue Estimates (GACRE) revenue forecast. This gap between the need for public services and the resources available to pay for them only grows when the costs of restoring cuts to K-12 public education or Medicaid provider rates to doctors and hospitals are factored in.

In early October of this year, the governor issued a memo to state agencies requesting that they provide 2, 4, and 6 percent cut recommendations.²⁰ As the governor and the General Assembly work to craft the 2012-2014 budget this winter, they will continue to face difficult choices about the funding priorities of the commonwealth. In many ways, balancing the 2012-2014 budget will be even more challenging than balancing past budgets during the depths of the downturn. The easier budget cuts have already been made, and the last of the federal recovery act dollars, which protected K-12 education and health care from more debilitating cuts during the

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recession, will run out by June 30, 2012, the end of the current fiscal year.

The deferred payments to the Virginia Retirement System freed up over \$820 million in resources during the recession, but those deferrals mean that Virginia now faces an increased obligation in this spending area going forward. There is a plan to pay these back, but it will cost the state an additional \$75 million per year. In addition, as a result of higher than expected revenue collections mid-session, Governor McDonnell proposed advancing the contributions to the fourth quarter of fiscal year 2012, one quarter earlier than initially planned.²¹

While it was entirely appropriate to draw down rainy day resources during the recession, the fund's balance is mostly depleted. More importantly, to the extent that revenues continue to tick upwards, we will be on the hook for replenishing the fund. As mandated in its constitution, Virginia must make a deposit into the rainy day fund when the growth in individual income tax, sales and use tax, and corporate income tax revenues exceeds the average growth rate over the previous six years. The size of the deposit must equal one-half of the revenue growth in excess of the previous six-year average.²² Because the recession resulted in declines for these key revenues, it will not take much growth to trigger the mandatory deposits in the next few years. So even though we aren't "out of the woods" yet and needs remain high and the state faces ongoing budget shortfalls to meet those needs, the constitution requires we start making deposits into the fund now.

The bottom line is that many of the tools Virginia had at its disposal in managing its fiscal problems during the recession simply aren't available anymore and other strategies that played a key role in balancing the budget are starting to place demands on returning revenue. So any way we look at it, the fiscal challenges facing the state are not likely to lessen any time soon. Furthermore, while the recession was clearly at the center of the commonwealth's continuing fiscal shortfalls, the downturn also has revealed some serious underlying challenges with the state's revenue structure. Broadly speaking, Virginia is in a situation where the current revenue structure is not producing resources that are adequate to fund ongoing needs.

Underlying General Fund Revenue Challenges

There are four challenges, in particular, that are limiting the ability of Virginia's general fund revenue structure to produce adequate resources to fund key public priorities like education, health

care, and public safety. Three of the challenges deal with Virginia's largest sources of general fund revenue—the individual income tax, the sales and use tax, and the corporate income tax. The fourth challenge cuts across multiple revenue streams supporting the state's general fund.

Individual Income Tax Challenges

The health of Virginia's general fund is very closely linked to individual income tax collections as the largest single source of general fund revenue. While the current structure of the individual income tax is progressive in nature, in practice it works out to be relatively flat. Although there are four brackets, the highest tax rate—5.75 percent—kicks in for taxable income over \$17,000. This means, effectively, that over 60 percent of Virginia taxpayers pay the top marginal rate.²³

The reason for this relatively flat structure has a lot to do with a shifting income distribution and an unresponsive tax code. The last time Virginia updated the basic rate structure was 1987.²⁴ Median household income in the state looked quite different in 1987 than it does today—just under \$30,000 in 1987, compared to nearly twice that amount in 2010.²⁵ In order to align revenue growth with growth in the economy, we need to pay closer attention to trends in income growth. As higher-earners experience higher growth rates, Virginia would benefit from altering its individual income tax brackets and rates to reflect the realities of today's modern economy, demand for public services, and income distribution in the state.

Sales and Use Tax Challenges

Virginia's retail sales and use tax dates back to 1966, but despite a recent update to the rate, the base has been continually eroded by increased exemptions and the failure of the state to respond to the realities of today's economy and consumption patterns.

As part of the 2004 tax reform package passed under Governor Warner, the state sales tax rate was raised to 4 percent,²⁶ and the rate on food purchased for home consumption was reduced by 2 percent. Like the exemption for non-prescription drugs enacted in 1998, Virginia's partial exemption for groceries was intended to assist lower income taxpayers, but because these exemptions are available to all consumers, including visitors and high-income households, they provide relief inefficiently.²⁷ Estimates indicate that the partial food exemption reduces Virginians' annual sales tax liability by an average of \$82 dollars and that the non-prescription drug exemption saves Virginians an average of \$38 per year.²⁸ Furthermore,

by chipping away at the sales tax base, these exemptions have increased the volatility of the state's sales tax collections because grocery and non-prescription drug purchases are more stable than many of the items left in the tax base.

Beyond the effect of increased exemptions, there are two major shifts in consumption patterns that are severely limiting Virginia's sales tax collections. The first of these shifts has to do with the purchase of services versus goods. One of the most profound shifts in the United States economy has been the growth of the service industry. In 2010, services made up over two-thirds of personal consumption expenditures, a significant increase from 54 percent in 1980.²⁹ The reason this is so important is that Virginia's sales tax mainly applies to the purchase of goods. There are some important exceptions like food services and drinking places, accommodation, and amusement, gambling and recreation, yet a large number of potentially-taxable services are not currently taxed in Virginia. As more and more income is shifted from the purchase of goods to the purchase of services, the potential revenue from the purchase of services is lost. To counter this trend, a number of states have expanded their sales taxes to cover particular services, but not Virginia. According to a 2007 survey by the Federation of Tax Administrators, Virginia is one of the states that includes the fewest number of potentially-taxable services in its sales tax base.³⁰

Another issue related to the sales tax has to do with purchases made over the Internet, as opposed to in traditional brick-and-mortar stores. According to national data, the share of total retail sales that is attributable to e-commerce has risen from less than 1 percent in 2000 to 4.3 percent in 2010 as shown in **Figure 6**.³¹ Currently, federal law prohibits states from requiring out-of-state

vendors to collect state sales and use taxes on in-state sales if the vendor has no physical presence in the state. The most cited illustration of this conflict is the online retail giant, Amazon. Although state sales taxes are legally due on purchases made over the Internet, states must rely on customers to remit these taxes directly to the state. Because it is so difficult to enforce, this arrangement costs states millions of dollars a year in lost revenue. Estimates place the revenue loss that will occur in Virginia during the current fiscal year from untaxed Internet sales at \$207 million.³² This represents roughly one-quarter of all estimated retail sales and use taxes due on Internet sales.³³

These issues pertaining to the income and sales tax create significant challenges for collecting adequate revenue to fund Virginia's public services. They also illustrate quite clearly how our current revenue system was designed for yesterday's economy.

Corporate Income Tax Challenges

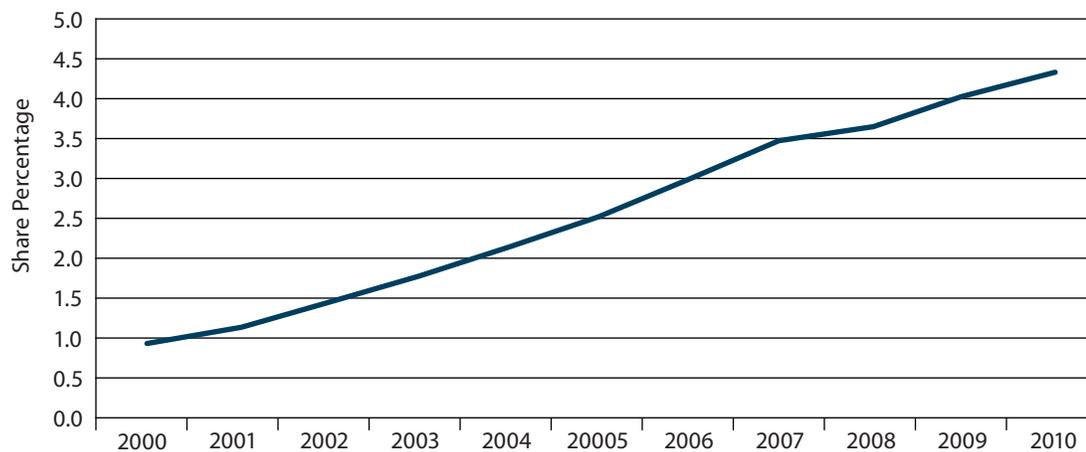
Virginia's corporate income tax is a flat 6 percent. As shown in **Figure 7**, the corporate income tax is a particularly volatile source of revenue, but behind the individual income tax and the retail sales and use tax, it is the third largest single source of general fund revenue. In looking at the mix of total income tax collections coming from individuals versus corporations, the share of total income taxes paid by corporations has declined. More specifically, since the late 1970s, the share of total income taxes paid by corporations has been cut by more than half.

Tax Expenditure Challenges

An additional tax policy issue creating challenges for our state's revenue system—one that cuts across the income and the sales tax—deals with

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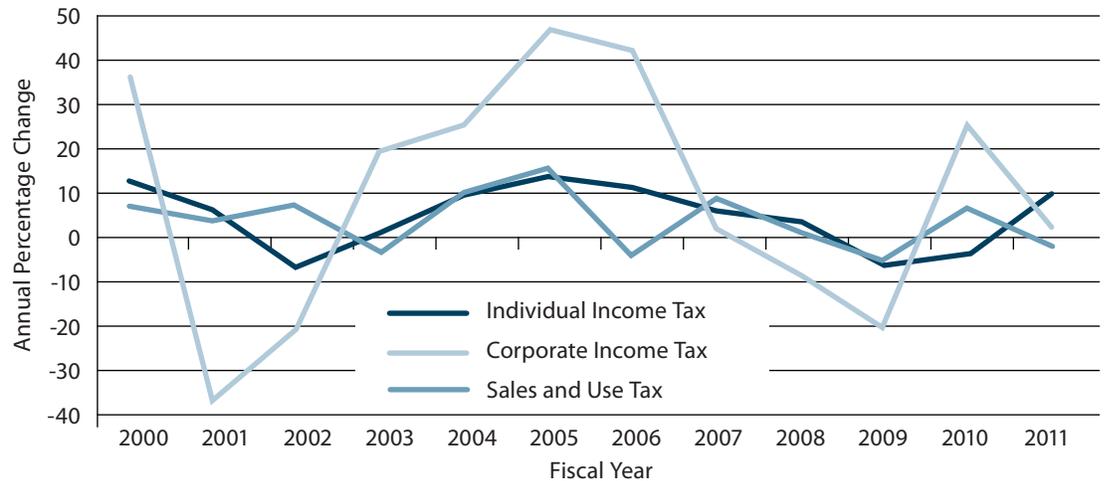
Figure 6: E-Commerce as a Share of Retail Sales in the United States, Calendar Years 2000 to 2010



Sources: U.S. Census Bureau, *The 3rd Quarter 2011 Retail E-Commerce Sales Report*, Table: “Estimated Quarterly U.S. Retail Sales (Not Adjusted): Total and E-commerce.” (November 17, 2011)

“In recent years... spending through the tax code has cost the commonwealth over \$2 billion per year.”

Figure 7: Annual Growth in Key Virginia General Fund Revenue Sources, Fiscal Years 2000 to 2011



Source: Virginia Secretary of Finance, 2010 GACRE Report Appendix, http://www.finance.virginia.gov/KeyDocuments/JMCmaterials/GACRE_Book_2010-appx.pdf

what is often called *tax code spending*, or *tax expenditures*. A tax expenditure refers to any tax exemption, exclusion, deferral, credit, or reduced rate that results in preferential tax treatment of certain types of income or behavior. The foregone tax revenue from such preferential treatment constitutes a tax expenditure.

While there are two sides to Virginia’s expenditure budget, direct appropriated spending and tax code spending, generally only the appropriated side gets the attention. In recent years, however, spending through the tax code has cost the commonwealth over \$2 billion per year.³⁴ Unlike core public investment areas like public safety, education, and health care, these special tax breaks are not subject to the annual appropriations process, and are all but invisible, meaning you can read the budget cover to cover and you won’t find most of them within its pages. The laws that create tax expenditures usually allow them to continue for an indefinite period regardless of the effect on the state’s financial situation. This means that once these special tax preferences get on the books, they operate, essentially, on autopilot.

Because Virginia does such a poor job monitoring them, we rarely know whether they are achieving their desired policy goals, who is benefitting from them, or whether our initial cost estimates have proven accurate. A good example of this is the Land Preservation Tax Credit. This credit began in 1999 and allows property owners that place their land in a preservation structure to claim a tax credit against their income taxes. A 2002 expansion enables the sale of the credits if they exceed a taxpayer’s liability. As a result of the expansion, the program’s cost skyrocketed: a program that cost under \$4 million in 2001 grew to over \$80 million in 2006.³⁵ For this and other

reasons, the General Assembly placed a “cap” on the program to limit the expenditures from the general fund to \$100 million a year in 2006. Because a large number of credits had already been “booked” before the cap was enacted, costs have continued to exceed this cap and the program is expected to cost \$150 million in the current fiscal year.³⁶

Virginia has created or changed more than 60 tax expenditures since 1990.³⁷ They range from familiar programs, such as the rollback of the car tax, to more obscure ones, such as the credit for equity and subordinated debt investments. Just this past session, the General Assembly passed 20 various tax expenditure bills, either creating new or renewing or expanding existing tax expenditures that ranged from credits or deductions for wine production and spaceport activities to teleworking, long-term care insurance, and clean fuel vehicle job creation. Whether this is money well spent is a fair question. Unfortunately, Virginia doesn’t provide policymakers or the public enough information to come up with meaningful answers.

Updating the System: Potential Solutions and Lessons from Other States

Fortunately, Virginia is not the first state to grapple with these revenue challenges. So, we have the experiences and efforts of a number of other states to look to and learn from as we determine what might work here and how we can better align our revenue system with the needs of our state. What are changes we can make to our current revenue system to bring it up to speed with the realities of today’s income distribution and consumption patterns and to broaden tax bases? I will discuss four revenue structure changes that should be considered

and adopted: (1) update the individual income tax, (2) adjust the sales and use tax to better reflect economic activity, (3) modify the corporate income tax, and (4) better manage tax code spending.

1. Update the Individual Income Tax Structure

Virginia has not changed the brackets or rates of its individual income tax in over two decades, and the system's basic structure dates back to the early-to-mid-20th century. The result of this is what is referred to as bracket creep: as incomes increase, even just at the rate of inflation, more and more people shift into the highest bracket and more and more of their income is taxed at the highest rate. In addition to the outdated basic structure of the individual income tax, Virginia does not follow the federal practice of indexing the standard deduction or personal exemption for inflation either, meaning that their values decrease over time. As a result of these factors, what we call the "effective tax rate," basically, the average tax rate found by dividing tax liability by a person's taxable income, increases as income grows.

Income is growing in two different ways that are both worth noting but which have different implications for how we structure tax brackets and rates. First, with inflation, a dollar today is worth a whole lot less than a dollar 20 years ago, meaning that if that top bracket had kept up with inflation it would be about \$33,383 today. By failing to adjust our brackets for inflation, we are pushing more taxes on individuals and families who are less favorably situated to handle them.

But there is another issue at play surrounding income growth and our outdated individual income tax structure. In looking at real earnings over the past 20 years, growth has been concentrated among upper-earners. In 2010, the first year of the economic recovery, Virginia's highest 10 percent of wage earners experienced real wage growth that exceeded the cumulative real wage growth of the bottom 10 percent of Virginia wage earners over the course of the past 30 years.³⁸ This means that by failing to adjust income tax brackets and rates to capture this high-end growth—the epicenter of income growth in our economy—our revenue system has not grown in tandem with the economy. While revenue collections will grow under our current system, by sticking with an outdated structure, Virginia is missing an opportunity to better align its system with growth in the overall economy.

2. Adjust Retail Sales and Use Tax to Reflect Consumer Activity

Our shift in consumption from goods to services, and from purchasing in real stores to online

retailers has highlighted some major gaps in our current sales and use tax structure. Virginia ranks at the bottom of the barrel when it comes to the number of services included in the sales tax base. In a recent study of the taxation of services, the Federation of Tax Administrators looked at a possible 168 potentially-taxable services. According to the study, the majority of states with a sales tax responded that they tax, on average, 40 of the 168 potentially-taxable services included in the survey. Virginia taxes a mere 18 under the sales and use tax, including such personal services as diaper service, gift-wrapping, and tuxedo rental.³⁹

Yet because different services represent different size pieces of the total consumption pie, simply comparing the number of services that a state taxes presents an incomplete illustration of the true degree to which services are included in a state's sales tax base. One other measure of the breadth of a state's sale tax is calculated by dividing the implicit sales tax base by state personal income. This measure indicates the extent to which the sales tax encompasses economic activity in a state. In 2009, the average across all states was 40 percent, but Virginia's sales tax breadth was just 27.8 percent.⁴⁰

Unfortunately, while there are no precise state-level estimates available, national studies suggest that for states with a starting point as low as Virginia in terms of the services they already tax, a move to more comprehensive taxation of all "feasibly-taxable" services—that is, all household services other than health care, housing, education, legal, banking, public transit, and funeral service—could increase sales tax revenue by more than one-third.⁴¹ Based on the last three years of data on the state's revenue collections that could mean as much as an additional \$900 million a year.

Aside from the revenue impact of a move toward taxing more services, there are other reasons why this type of tax policy change makes sense. For instance, there is only so much room in which we can raise the sales tax rate, but if we are to ensure the long-term viability of this revenue source, we must look to the base. By broadening the base, Virginia can work to ensure that it does not see slow growth in sales tax collections in the future.

Related to that point, bringing services into the sales tax base could reduce the year-to-year volatility of sales tax collections. Because sales tax collections are currently dominated by purchases of "big-ticket" durable goods such as appliances and furniture, when the economy softens, the sale of these items often declines sharply. Some limited research finds that purchases of some services do not fall as sharply as durable goods purchases

"Virginia ranks at the bottom of the barrel when it comes to the number of services included in the sales tax base."

“Virginia is not without options of its own to tackle the challenges presented by remote sales.”

when the economy slows, nor do they rise as rapidly when the economy is booming.⁴² Thus, to the extent that more services are included in the base, Virginia could see a slight decrease in the volatility of this major state revenue source.

Additionally, expanding the taxation of services will make the sales tax more equitable. Sales taxes are already quite regressive, meaning that lower-income Virginians pay a larger share of their income in these taxes than higher-income Virginians. This is because low and moderate income households spend a larger share of their incomes buying the things necessary to meet basic needs. Those things are more likely to be subject to the sales tax. Based on 2007 data, households in the bottom fifth of Virginia’s income distribution pay approximately 4.9 percent of their income in sales and excise taxes. This contrasts to just 2.6 percent among the top 20 percent of households.⁴³ By treating the taxation of goods and services differently, Virginia is not doing anything to mitigate this problem.

While a move toward taxing more services may yield the biggest bang for the buck, there are sizable political challenges at play that make the viability of this option questionable. Expanding Virginia’s taxation of services is not our only option for modernizing and strengthening the sales tax, however. Sales taxes are already due on purchases made over the Internet from retailers with no physical presence in the state, but the problem is the fact that Congress, effectively, has banned states from requiring out-of-state vendors to collect the tax. Early this November, bipartisan federal legislation was introduced that would, if passed, authorize states to require sales tax collection from remote vendors with annual sales above \$500,000.⁴⁴ While it is unclear whether this new effort will be successful, such authorization could produce substantial benefits for the revenue collections of states that choose to take advantage of it. Even if this effort fails, Virginia is not without options of its own to tackle the challenges presented by remote sales. Rather than just waiting for Congress to act, a number of states have already taken action of their own to chip away at untaxed Internet sales.

The most popular legislative approach, commonly referred to as an “Amazon law”—Amazon is typically pegged as the main target—requires retailers to collect sales tax if they have marketing deals with “affiliate” sellers who are physically present in the state. An affiliate would be any business that places links on their Web sites to the retailer’s site and receives a commission when someone follows the link and buys something from the retailer. This approach is most often

associated with New York, but it has been tried in a number of other states with varying degrees of success.

Amazon continually threatens to terminate its relationship with affiliates, and the concept of an Amazon law creates an interesting political situation in which affiliate small businesses are pitted against brick-and-mortar small businesses. The Amazon law concept was introduced here in Virginia by Republican Senator Emmett Hanger during the 2010 session. Though the fiscal impact was estimated by the Department of Taxation to be somewhere around \$17 million, the bill was not successful.⁴⁵

The New York-style Amazon law is not the only way to tackle this problem. In Colorado, for example, rather than requiring that online dealers collect sales taxes, the law requires firms that sell at least \$100,000 of goods annually to Colorado residents but which do not collect Colorado tax on those sales to do three things. First, any such retailer selling to a Colorado resident without collecting sales tax must notify the resident that “sales or use tax is due on certain purchases” and “that the state of Colorado requires the purchaser to file a sales or use tax return.” Second, the Colorado law requires the dealer to send all Colorado purchasers an annual report summarizing all of their purchases from the retailer for the year. Finally, the Colorado law requires the retailer to report in-state purchases to the Department of Revenue.

Regardless of the specific approach, there are strong arguments in favor of taking action on this front that make chipping away at untaxed Internet sales an attractive reform option for Virginia. First, an Amazon law—or some version of it—doesn’t impose a new tax. It simply helps Virginia collect the sales taxes that are already legally due and does so by removing the challenge of calculating and remitting the tax from the individual over to the businesses that sell the goods and are already collecting and remitting sales taxes in other transactions. In addition, an Amazon law reduces the competitive disadvantage faced by Virginia’s local merchants and those Internet sellers who do collect sales taxes. Despite being located out of state, remote sellers still benefit from the public services in their customers’ home states. One such public service is the transportation system used to ship goods to customers. Finally, an Amazon law reduces the disproportionate impact of sales taxes on Virginia’s low-income individuals and families.

3. Reform the Corporate Income Tax

Beyond modernizing the individual income and sales taxes, there are reforms Virginia could

enact that would close loopholes in the corporate income tax. Virginia has struggled with volatile corporate income tax revenues in recent years. According to the Department of Taxation, more than 60 percent of corporations in the state had zero corporate income tax liability in 2008.⁴⁶ Part of what is driving these trends is the fact that business has gone global. A 2010 review of the corporate income tax prepared by the Joint Legislative Audit and Review Commission (JLARC) found that in fiscal year 2006, 87 percent of corporate income tax collections were paid by multi-state corporations.⁴⁷ The related problem for state revenue collections is that these large, multi-state corporations are able to use complicated accounting techniques to reduce their tax bills in Virginia. But all companies doing business in Virginia benefit from the many public services funded by tax dollars—a productive workforce, a means of transporting their products to and from the marketplace, and a legal system to protect their property rights, to name just a few.

There are specific reforms that can help guarantee that corporations pay their fair share. Enacting something called mandatory combined reporting is one example. Large, multi-state corporations with subsidiaries in different states are able to shift income between states in order to take advantage of jurisdictions in which taxes are lower or where corporations aren't taxed at all. Because state corporate income tax revenues take a hit as a result of these practices, 24 states have passed laws that require companies to add up—or combine—all of their income from all their subsidiaries and apportion it to the states where the money was made. While corporations have the option of filing a combined return in Virginia, in order to see revenue gains such reporting must be made mandatory. Such a change would not be new territory for corporations because they are already filing this way when they file their federal return.

In addition to enacting mandatory combined reporting, Virginia could act to limit the amount of corporate income that goes untaxed by reforming something called the “nowhere income” loophole. Virginia used to have a rule on the books that if income was generated by a Virginia corporation in another state where that company was not deemed to have “nexus” or a sufficient business presence, then that income would be “thrown back” to Virginia for tax purposes. We repealed this “throwback rule” in 1981. The result is that multi-state corporations are able to book income in creative ways that leave it untaxed because—for tax purposes—it is “nowhere.” By reinstating such a policy, Virginia can close this loophole, and level the playing field among all Virginia businesses.

4. Better Manage Tax Code Spending

Given the commonwealth's continuing fiscal challenges, it is more important than ever for policymakers to examine the state's tax expenditure programs with the same level of scrutiny applied to its appropriations. Virginians have a right to know if the money that goes into the plethora of deductions, credits, deferrals, and preferential rates that are sprinkled throughout our tax code are achieving real results, or whether they could be better spent in other ways to create jobs and a strong economy. By reforming the tax expenditure process, Virginia can bring in new revenue, while also building public trust through heightened transparency and accountability.

Virginia can take a significant step forward in this area by regularly publishing a tax expenditure report that is accessible to the public and broad in scope with detailed information. Some type of reporting is currently undertaken by 41 states, including Virginia.⁴⁸ But Virginia's efforts fall short on a number of measures. Right now we report periodically on exemptions relating to the retail sales and use tax, and we produce a report of corporate income tax preferences that includes only a fraction of the total preferences available to businesses in Virginia. We could benefit greatly from a more comprehensive and regularly produced report that becomes a key component of the budget process.

In order to be useful, a tax expenditure report must include several key features. It should contain the intended purpose of each tax break, who benefits and how much they get, and an estimate of total cost. A solid tax expenditure report can shed light on underperforming programs or those that cost far more than was anticipated when the tax break was established. Such a report can also highlight programs that are meeting or exceeding expectations and that yield a high return on investment.

The Joint Legislative Audit and Review Commission just published a study of the effectiveness of tax preferences in Virginia this past November and found that a number Virginia's tax preferences designed to promote economic development are not achieving their intended goals, while others aimed at providing financial assistance achieve their goals but are not efficiently targeted.⁴⁹ Again, this was a much-needed effort, but the effort cannot end there. We must keep monitoring and evaluating. A few states—Washington, Minnesota, Connecticut and Oregon, in particular—already do a great job with tax expenditure reporting and Virginia should look to them as we go down this path of heightened transparency around tax code spending.

“By reforming the tax expenditure process, Virginia can bring in new revenue, while also building public trust through heightened transparency and accountability.”

“Today, most tax expenditures are, in effect, permanent. Requiring an active process to renew tax breaks increases the likelihood that there will be an analysis of cost and effectiveness.”

Beyond simply reporting, another reform idea would attach a sunset provision to any new tax preference legislation. This means that every tax break approved by the legislature would include a date on which it would expire unless it is renewed. Today, most tax expenditures are, in effect, permanent. Requiring an active process to renew tax breaks increases the likelihood that there will be an analysis of cost and effectiveness.

Finally, it's worth noting that there is evidence that this kind of reform resonates with the legislature. The Senate Finance Committee, which hears all of the bills that deal with tax expenditures, released a policy statement this past session regarding how they intend to handle future tax credit bills brought before the committee.⁵⁰ Some of the key pieces of this policy statement involve attaching sunset provisions to tax credit bills, taking up all the tax break bills during the final week for committee action, capping the share of tax liability that can be eliminated with a credit, and requiring fiscal impact analysis of a bill in order for it to be taken up by the committee. Now there are good and not-so-good ideas on that list, but it's a start. And it illustrates the growing realization of the high costs and serious budget implications of the myriad of special rates, credits, and deductions we have on the books.

Conclusion

Virginia faces a persistent and long-term revenue problem. While much of the current fiscal challenges facing the state are driven by unprecedented, recession-led unemployment, the recession has exposed key structural weaknesses in the state's revenue system. By adopting a number of key reforms in personal and corporate income taxes, modernizing sales and use taxes to reflect an increasingly service-driven economy, and better managing tax code spending, Virginia can address not only the massive revenue shortfall in the coming biennium, but it can also position itself for economic success when prosperity returns.

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Editors note: When available, web links for sources are shown. At the time of publication all of the links worked. However, some links may be unstable and may not work with certain browsers. If you cannot open a link in your default browser, then try another. For example, if you cannot open a link with Microsoft Internet Explorer, try Firefox, Chrome, or Safari.

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