

THE COLUMN

Newsletter of
the Virginia Institute
of Government

Fall 2009

New Round of
Regional Budget
Meetings

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Virginia's Tax System Is a Creaky Antique

JOHN KNAPP

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How should Virginia's state and local government tax structure support the new economy in the years ahead? Most likely, we will muddle through as we always have. But a few adjustments could make a big difference.

State and local tax systems are not the product of a sweeping vision that is periodically attuned to changes in the economy. Instead, they are the result of many changes over time—some of them sweeping, such as the adoption of the Virginia individual income tax in 1926 and the sales and use tax in 1966, and many of them minor, such as the carving out of sales tax exemptions for particular groups.

Like all other states, Virginia has taken a severe hit from the recession. In the fiscal year that just ended, the state finished with a \$300 million shortfall. Revenue estimates keep falling, and even when the recession hits bottom, perhaps later this year, the recovery is likely to be slow.

The American Reinvestment and Recovery Act is funneling a huge amount of aid, \$5 billion, to Virginia's state and local governments to mitigate their fiscal problems. However, as the stimulus flow ends in fiscal year 2011, expenditure demands will re-emerge. Thus, the fiscal situation for Virginia state and local governments is dire both in the short and longer terms.

The state's options are limited in a balanced-budget regime: Borrowing can be substituted for tax revenue to finance capital outlays; funds can be shifted from one purpose to another; the state can use its rainy-day fund.

Even so, there will be spending cuts, tuition increases, postponed pay increases, deferred maintenance, and other painful adjustments. The damage being done now will cast a long shadow over public finance for the next several years.

Nonetheless, Virginia's state and local tax structure is unlikely to change radically. Three major components of the tax structure account for about \$7 out of every \$10 of revenue: the state individual income tax (30 percent of state and local tax revenue), the state and local sales and use tax (14 percent) and the local real property tax (25 percent).

STATE INCOME TAX

The income tax rate structure for individuals is an anachronism. The 2 percent rate on the first \$3,000 of taxable income was adopted in 1948 when that threshold was equivalent to \$26,478 today.

Now, more than 96 percent of income tax revenue comes from the two top brackets (5 percent on taxable income from \$5,001 to \$17,000 and 5.75 percent on income over \$17,000).

Moving to two broad brackets and allowing progressivity to be the result of credits and exemptions are possible changes that could be combined with higher rates. A short-term policy to increase revenue during the fiscal crisis would be a temporary surtax on the income tax.

Some recent changes in the economy will have a strong bearing on tax collections in future years. The stock market plummet that began in late 2007 means that future net capital gains will represent a smaller proportion of taxable income.

Another consideration is the Obama administration's health care reform agenda. One idea being floated is to make employer-paid health insurance premiums taxable on personal income tax returns. Since Virginia maintains modified conformity with federal

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“By national standards, Virginia does not impose a heavy tax burden. In 2006, state and local taxes accounted for 10.5 percent of income, ranking Virginia 43rd among the 50 states and the District of Columbia.”

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income tax provisions, the state would have the option of following the same policy, perhaps earmarking the additional revenue for its Medicaid obligations.

SALES AND USE TAX

Over the years, the General Assembly has decreased the sales-tax base by exempting nonprescription drugs, lowering the tax on store-bought food, and establishing “tax holidays” for hurricane preparation and back-to-school purchases. Today, it is very difficult politically to subject more goods and services to a sales tax.

A solution to this problem would be the replacement of the sales tax with a value-added tax, or VAT, a form of taxation popular in Europe but not used in the United States. The VAT taxes an item at each stage of its manufacture or distribution based on the value being added to it. This avoids pyramiding taxation of goods and services that have already been taxed.

State governments have been concerned about the migration of retail sales to the Internet because such transactions are mostly exempt from state and local sales tax. If Virginia had started taxing electronic commerce, it would have collected an additional \$423 million in fiscal year 2008.

PROPERTY TAX

The local real property tax is the most important source of revenue for local governments and a mainstay in their financing of public education. The tax base grew rapidly during this decade until the meltdown of the residential real estate market that began in 2006.

In the boom years, tax rates were lowered to partially offset the rise in market values. As a result, Virginia local government tax revenue from this source rose 101 percent from fiscal years 2000 to 2008, while all other tax revenue rose by 40 percent.

Once the housing market stabilizes, housing prices will rise and new construction will resume, but it is unlikely that we will see the strong growth that benefited local governments in the recent past.

That may lead local governments to rekindle their interest in a local income tax, which must be granted by state legislation. The best way to implement the tax would be to follow Maryland's example of allowing localities to piggyback local income taxes on the state tax.

TRANSPORTATION

Virginia's transportation funding is in very bad condition, with the six-year improvement plan for 2010–2015 anticipating \$3.2 billion less for highway construction than the 2008–2013 program.

Two sources of transportation revenue—the general sales and use tax earmarked for transportation and the 3 percent motor vehicle sales and use tax—should recover with an upturn in the economy. But the 17.5-cents-per-gallon motor fuels tax is unlikely to make a strong comeback.

Higher fuel prices and more fuel-efficient vehicles will be a drag on revenue for the foreseeable future.

As a temporary fix, the cents-per-gallon rate should be increased and then indexed with a highway construction price index. The current rate has been unchanged since 1986, when construction and maintenance costs were much lower. A longer-term solution would be to convert the tax to one based on vehicle miles traveled.

CONCLUSIONS

By national standards, Virginia does not impose a heavy tax burden. In 2006, state and local taxes accounted for 10.5 percent of income, ranking Virginia 43rd among the 50 states and the District of Columbia.

As the world changes, tax policies will be altered, but it is unlikely that the changes in Virginia's policies will be dramatic.

Most of the changes proposed here would be adjustments to existing taxes—and would result in a higher level of taxation. Given the current poor state of the Virginia economy and the prospect of a slow recovery, such changes must be considered by the state's political leaders.

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VIRGINIA INSTITUTE OF GOVERNMENT SERVICES

Email Broadcast Information Service (EBIS)

As all local governments continue focusing on increasing efficiency and cutting costs, we will use our newsletter to highlight EBIS inquiries and responses that address these issues.

The following responses illustrate recent efforts to consolidate school and local government building and grounds functions:

CUMBERLAND COUNTY

- consolidated these functions with exception of grass cutting and school housekeeping, which are contracted out
- transferred maintenance budget from school to county
- adopted work-order system
- reduced school maintenance personnel to one
- consolidated gasoline purchases and facilities and fleet maintenance
- considering consolidation of certain IT, finance, and payroll functions
- works because both boards support effort; and there is collaboration between both administrations



CITY OF MARTINSVILLE

- share resources rather than consolidate functions
- municipal staff handles minor maintenance items and school staff handles HVAC and electrical repairs
- disadvantage: no common supervision
- works well to reduce costs and uses existing space without requiring consolidation

PULASKI COUNTY

- focused on ground maintenance
- converted from contract services to internal service
- merged school and county functions/crews
- school system personnel supervise
- personnel are employed year round
- still working on charge back system and unifying personnel policies for merged school and county employees
- realized improved work quality and maximized flexibility
- works because both governing bodies support "joint services" concept; and both administrations work well together.



Let us help you become more efficient. Contact Tedd Povar at tep3e@virginia.edu or 804/371-0202.

VIRGINIA INSTITUTE OF GOVERNMENT TRAINING PROGRAMS

WEDNESDAY SERIES—Fall 2009

In partnership with Chesterfield County
Classes are held at UVa's Richmond Center from 8:30 am–3:30 pm. Registration fee: \$100 per person. Lunch and materials included. Discount: for every three registrants from the same organization, the fourth person can attend at no cost (all registrations must be submitted together for the same class).
Contact Chris Johnson at 804/371-0202 or chrisj@virginia.edu, or visit www.VaInstituteofGovernment.org.

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For anyone whose job requires making formal presentations

Love 'Em or Lose 'Em—Motivating & Retaining Employees

NOVEMBER 18, 2009
For supervisors, team leaders, managers or directors

Conflict Management

DECEMBER 9, 2009
For supervisors, team leaders, managers or directors



UPCOMING

WEDNESDAY SERIES
FALL 2009

See page 3 for details



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To register:
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VIRGINIA INSTITUTE OF GOVERNMENT SERVICES

Enhanced Regional
Budget Meetings, Fall 09

*Focus is on maintaining fiscal
sustainability*

The Institute is partnering with the Virginia Resources Authority and Springsted, Inc., to hold a series of budget workshops around the state. Their focus is on maintaining the fiscal sustainability of local governments. These are enhanced versions of meetings held by the Institute late last year.

Attendees will have ample opportunity to discuss budget challenges with peers and hear presentations on debt management, capital improvement financing, effective partnerships, and FY11 forecasts.

This program is designed for chief administrative officers, deputies, and finance/budget officers.

These sessions are free of charge, but registration is required.

Hear how your colleagues plan to approach what will be a challenging FY11 budget process. Join us at one of the sessions below.

SCHEDULE

From 8:45 am until 2:30 pm

Blacksburg — September 2

Halifax/South Boston — September 23

Williamsburg — September 25

Manassas — September 30

Harrisonburg — October 2

Richmond — October 7

Space is limited. To register, contact Tedd E. Povar at 804/371-0202 or tep3e@virginia.edu.

