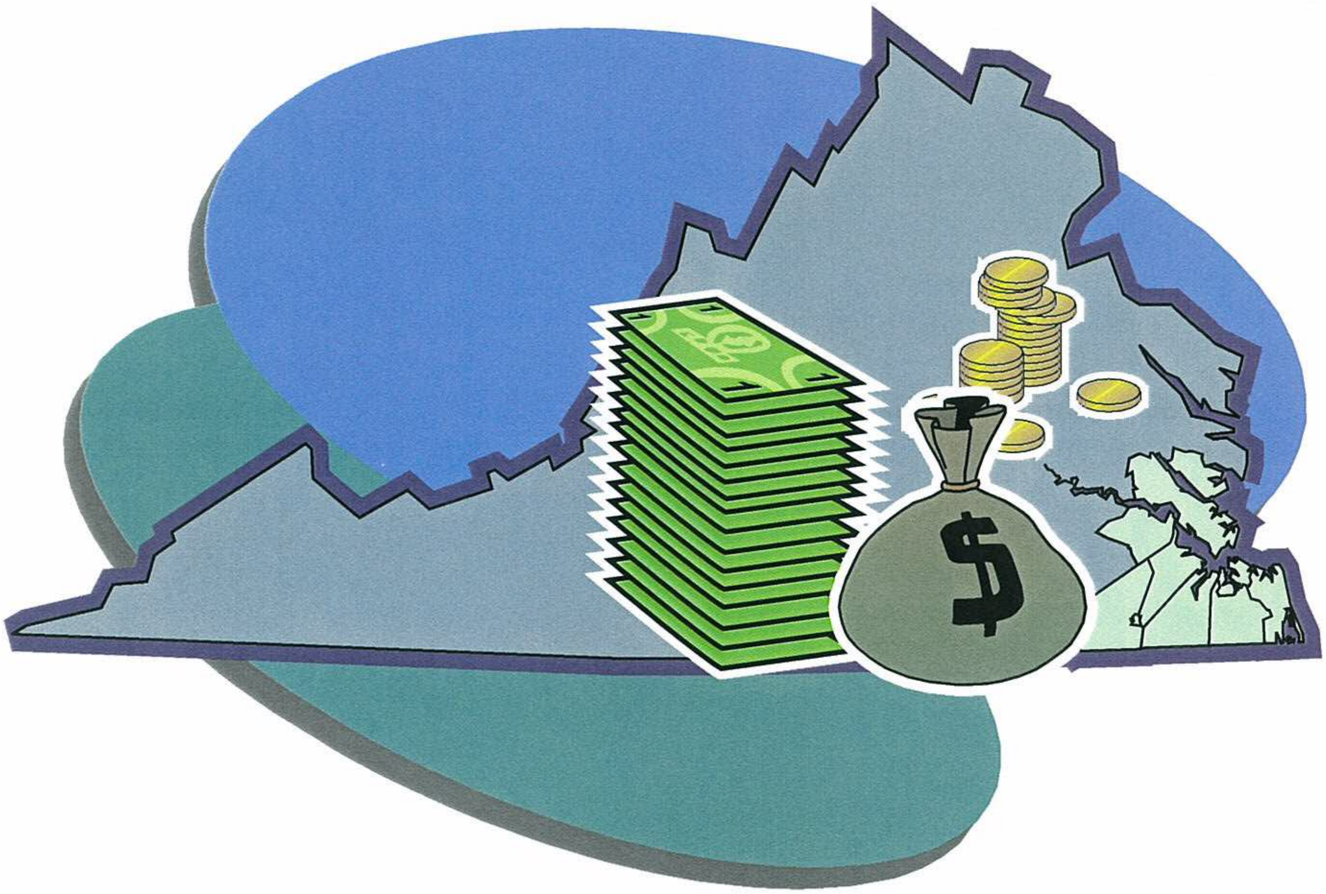
A FISCAL CRISIS IN OUR LOCAL GOVERNMENTS
Part 3



HAMPTON ROADS
PLANNING DISTRICT COMMISSION

July 2000

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Virginia 's tax structure is antiquated. How we're taxed and how our tax money is distributed is critical to the financial health of our cities and counties. Our local governments consistently receive high bond ratings from independent agencies, which reflect sound financial management. Yet they are financially stressed and the state is operating with a surplus.

A recent study by an independent consultant found that cities and counties in Hampton Roads will not be able to keep up with growing expenses by the year 2005 - especially in public education -- unless we make changes in the current tax system.

The Hampton Roads Planning District Commission and an advisory group of financial staff from our local governments reviewed ways to relieve fiscal stress and protect our economic future. The group identified three potential solutions that change Virginia's tax structure and that do not increase taxes.

Potential Solutions to Relieve Fiscal Stress

1
Share Income Tax Revenue

2
Transfer Financial Responsibilities for Shared Services to the State

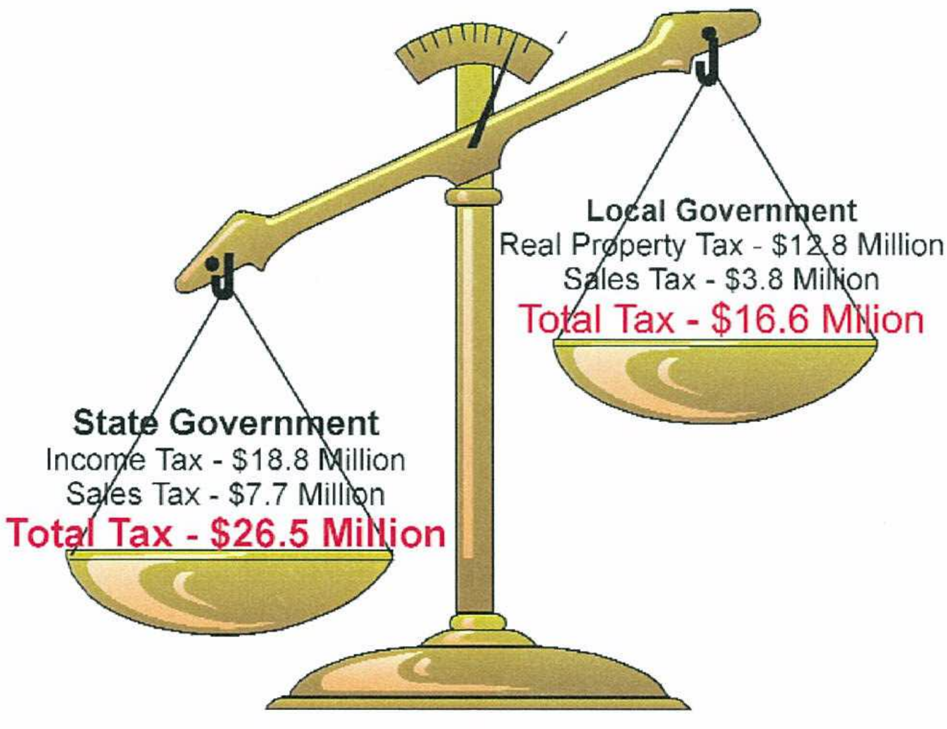
3
Use More State Funds in Construction and Upgrades of Public Buildings

First, the state might share income tax revenue with local governments, as many other states do. Or, second, the state could take over financial responsibilities for some services now paid for by cities and counties where cost increases are higher than local revenue growth. A third option -- the state could put more money into constructing and upgrading public buildings, especially schools.

1 Share Income Tax Revenue

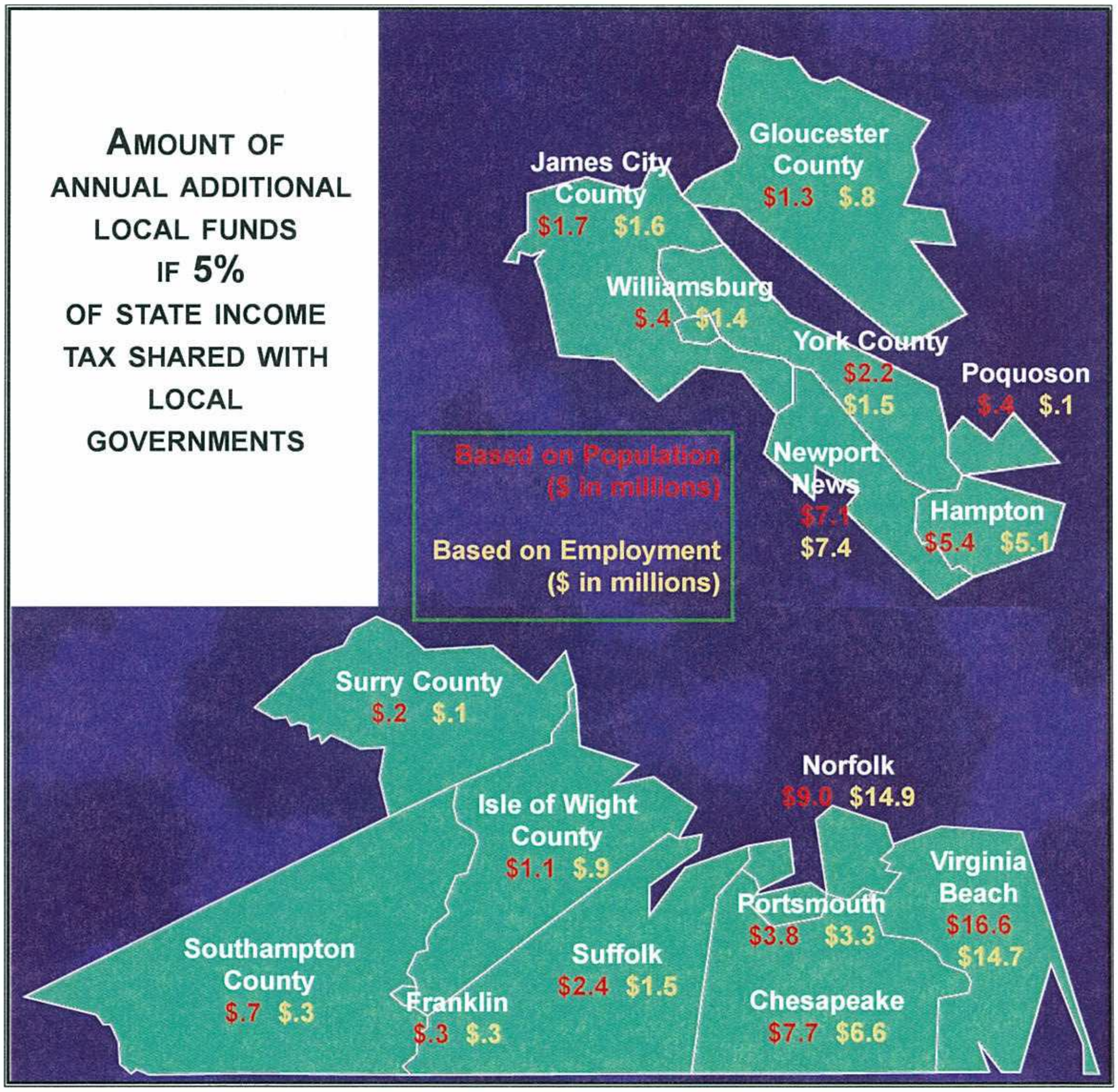
Virginia' s income tax revenue should be shared with local governments throughout the state. Our cities and counties bear costs for securing new economic development projects to help increase their revenues. Yet, the state collects more revenue from economic development through income taxes than our local governments collect through real property taxes.

Total Annual Revenue Impact of Forty-one Economic Development Projects in Hampton Roads



If the state shares only five percent of its income tax revenue with local governments, it will offset about two percent of the money our localities spend each year. How those funds will be distributed to local governments may affect the amount of financial help cities and counties get from the state.

Income tax revenues could be shared with local governments based on where people live or where they work. Because cities and counties vary in population, employment and financial stress, we must choose a way to distribute the money fairly to all localities in Virginia. A community with high population and low employment will benefit more from a distribution based on where people live. And a community with low population and a high number of jobs will gain more from a distribution based on where people work.



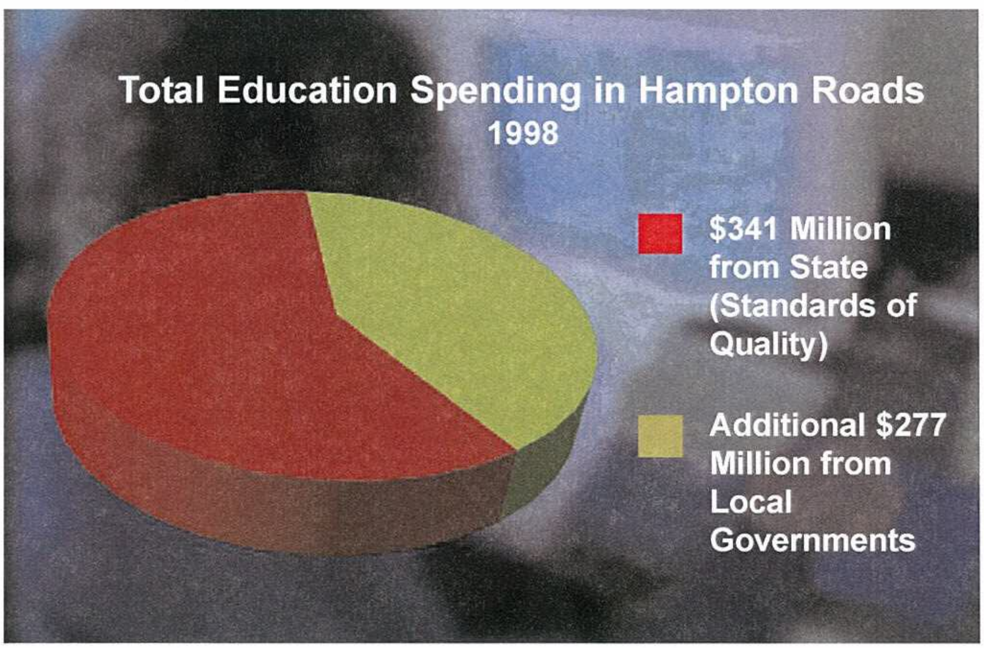
The difference could mean of millions of dollars for some of our localities. For example, based on population, Norfolk would receive an additional $9 million annually. Based on employment, the city would gain almost $15 million each year. Williamsburg would receive $485,000 per year based on population, and almost $1.5 million based on employment. Under both methods, a wide range of revenue would be brought to Hampton Roads localities. Whatever distribution method is chosen, the state must also continue to use special formulas that take into consideration the financial need and fiscal stress of every locality in Virginia.

2 Transfer Financial Responsibilities for Some Services to the State

If we choose to transfer financial responsibilities for some services to the state, it would also reduce the burden on local governments.

Cities and counties share the expense of a number of services with the state, including the high cost of operating schools. According to the state funding formula, local governments in Hampton Roads should only have had to spend $341 million on education to meet Virginia's Standards of Quality in 1998. However, the formula does not cover expenses for the actual number of teachers needed in our school systems, as well as other expenses, such as teacher training and early childhood programs.

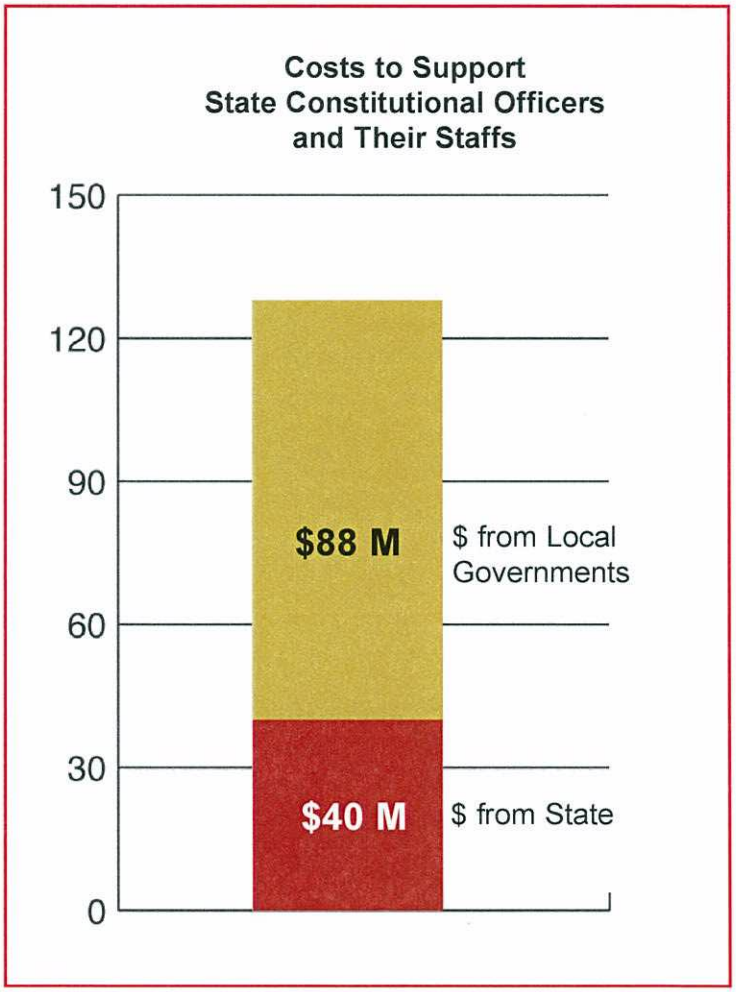
It has cost the cities and counties in our region an additional $277 million to meet the educational needs of our communities.



Local governments also contribute significant funds to jails and juvenile detention centers. They share payment for Commonwealth Attorneys, Commissioners of the Revenue, Treasurers, Sheriffs and Clerks of Court - all state constitutional officers and their staffs who work in our cities and counties providing state and local services.

Over three percent of local government revenues went to the operation of jails and juvenile detention centers in 1999. If the tax structure was changed and thestate funded these services, cities and counties in Hampton Roads would save about $462 million over the next five years.

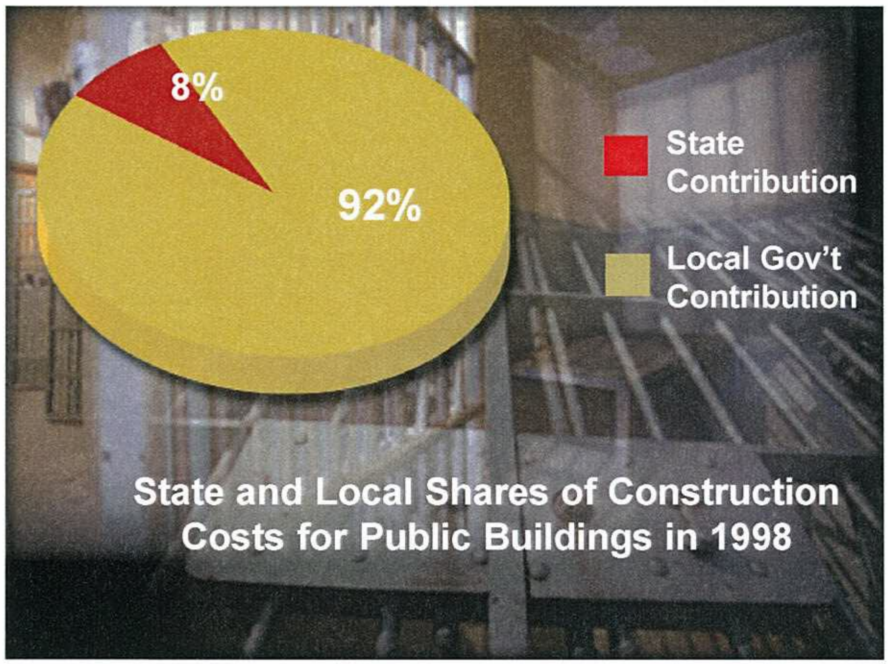
Our local governments spent nearly $88 million in 1999 supporting state constitutional officers and their staffs working in our cities and counties. The state contributed approximately $40 million. If this cost is transferred completely to the state, our local governments will save an estimated $424 million over the next five years.



3 Use More State Funds in Construction and Upgrades of Public Buildings

Virginia's tax structure could also be improved by increasing the state's assistance in the construction of schools and other public buildings.

Our cities and counties are bearing the heavy financial burden of constructing and upgrading schools, especially their technology requirements. Jails, juvenile detention centers and courthouses also place a heavy financial burden on our local governments. In 1998, local governments paid 92% of these costs. The state provided the remaining 8%.



Over the next five years, our cities and counties need, at a minimum, an estimated $627 million to build schools and other public facilities. More state assistance is needed to help ease this financial demand on local government budgets and especially the local real estate tax.

Potential Affect on Local Government Funds

Savings to our local governments through these potential solutions are significant. However, it may not be financially feasible to incorporate all of them into the existing state tax system. We must consider the impact to both our local and state governments. And we must make choices.

Based on 1998 income tax data, if the state shares five percent of its income tax revenues, the cities and counties of Hampton Roads will receive about $59 million of additional funds per year. Redistributing funds to Hampton Roads will reduce the state's General Fund by approximately 0.7%. If all local governments in Virginia receive a 5% share of income tax revenue, the state's general fund will be reduced by about 3%.

In 1998, our cities and counties had to pay $277 million more than what the state feels is an adequate contribution to education in Hampton Roads. Our local governments need additional state support to relieve this extra burden and provide quality schools.

By transferring financial responsibility for jails and detention centers to the state, our cities and counties will gain approximately $91 million in additional funds annually. These funds are only about 1% of the state's General Fund. Our region's local governments spent almost $200 million in 1999 to build schools and other public buildings. If the state increases its assistance to totally fund public construction costs in Hampton Roads alone, it will use an estimated 2% of Virginia's general fund per year. If Virginia takes over the operating costs for state constitutional officers working in local governments, it will save cities and counties in Hampton Roads an estimated $88 million per year and use about 0.9% of the state's General Fund.

Potential Solutions	Estimated State & Local Impact
5% share of state income tax	$59 million to Hampton Roads annually 0.7% of State General Fund
Responsibility for jails and detention centers transferred to State	$91 million to Hampton Roads annually 1%of State General Fund
Responsibility for public construction transferred to State	$200 million to Hampton Roads annually 2% of State General Fund
Responsibility for state constitutional officers' costs transferred to State	$88 million to Hampton Roads annually 0.9% of State General Fund

COMMISSION
to Study
Virginia's
State & Local
Tax Structure

The state has also recognized the need to assess the current tax system and is looking at possible changes. In 1999, a special state task force was created, called the Commission to Study Virginia's State and Local Tax Structure for the 21st Century. The Commission is made up of citizens representing all areas of Virginia. It will submit its recommendations to the 2002 Session of the General Assembly.

Only the General Assembly and the Governor can make changes to our state tax structure. Our state legislators must be convinced of the need for a better, more equitable tax system. It will take a collaborative effort of citizens, PTAs, business associations, chambers of commerce and local governments to make this happen. If we do nothing, our communities will suffer.

The current tax structure is jeopardizing the future of our schools, community services and the economic competitiveness of Hampton Roads. You can help. Get involved. Express your concerns about these tax issues and potential solutions to state legislators and other community leaders.

Part 3
Supplemental Data Index

HAMPTON ROADS
PLANNING DISTRICT COMMISSION
July 2000

Table 1 — Total Government Spending

	State & Local Total	State Share	Total Per Capita	Per Capita Rank	Total as a % of Personal Income	% of Personal Income Rank
Alabama	$19,303	62.8%	$4,517	39	23.7%	19
Alaska	$7,215	78.0%	$11,886	1	49.8%	1
Arizona	$20,028	59.4%	$4,523	38	23.2%	24
Arkansas	$9,661	73.0%	$3,849	50	21.5%	36
California	$187,314	60.5%	$5,876	10	24.6%	17
Colorado	$19,204	53.2%	$5,023	18	21.4%	38
Connecticut	$19,797	68.3%	$6,047	7	19.0%	46
Delaware	$4,218	77.0%	$5,818	11	22.4%	29
Florida	$68,581	53.2%	$4,763	31	21.0%	42
Georgia	$35,129	57.0%	$4,778	29	22.4%	28
Hawaii	$7,570	78.6%	$6,393	3	25.9%	11
Idaho	$5,073	69.0%	$4,267	45	23.1%	25
Illinois	$59,756	57.1%	$5,044	17	20.0%	44
Indiana	$24,272	63.3%	$4,155	47	19.5%	45
Iowa	$13,467	65.7%	$4,722	34	22.7%	27
Kansas	$12,214	59.6%	$4,749	33	21.8%	33
Kentucky	$16,653	71.1%	$4,288	44	22.9%	26
Louisiana	$20,679	67.8%	$4,753	32	25.1%	15
Maine	$6,006	70.6%	$4,832	27	24.1%	18
Maryland	$24,711	62.9%	$4,872	25	18.6%	47
Massachusetts	$36,639	68.1%	$6,014	8	21.5%	35
Michigan	$49,070	71.5%	$5,115	16	21.5%	37
Minnesota	$27,891	62.1%	$5,988	9	25.2%	14
Mississippi	$11,712	70.2%	$4,312	43	26.0%	10
Missouri	$21,614	59.9%	$4,033	49	18.6%	48
Montana	$4,199	74.7%	$4,777	30	26.2%	8
Nebraska	$8,986	50.0%	$5,440	14	25.6%	13
Nevada	$7,951	60.8%	$4,960	21	21.3%	39
New Hampshire	$5,192	62.4%	$4,468	40	17.7%	50
New Jersey	$49,032	65.9%	$6,138	6	20.7%	43
New Mexico	$8,598	78.5%	$5,019	19	28.0%	4
New York	$145,293	56.7%	$7,990	2	28.9%	3
North Carolina	$33,978	62.5%	$4,640	35	22.4%	30
North Dakota	$2,958	69.8%	$4,593	37	24.8%	16
Ohio	$55,041	64.5%	$4,926	24	21.9%	32
Oklahoma	$13,568	68.3%	$4,110	48	22.3%	31
Oregon	$18,459	64.2%	$5,761	12	27.2%	6
Pennsylvania	$60,353	64.1%	$5,006	20	21.2%	40
Rhode Island	$5,582	72.8%	$5,638	13	23.7%	20
South Carolina	$17,864	69.4%	$4,829	28	25.6%	12
South Dakota	$3,082	64.4%	$4,211	46	21.6%	34
Tennessee	$25,759	53.3%	$4,842	26	23.3%	23
Texas	$83,495	55.2%	$4,365	41	21.0%	41
Utah	$9,883	62.4%	$4,941	22	27.8%	5
Vermont	$2,905	71.0%	$4,932	23	23.4%	22
Virginia	**$29,030**	**61.4%**	**$4,349**	**42**	**18.3%**	**49**
Washington	$34,611	60.9%	$6,255	5	26.8%	7
West Virginia	$8,437	77.9%	$4,620	36	26.1%	9
Wisconsin	$26,742	63.5%	$5,183	15	23.4%	21
Wyoming	$3,043	67.8%	$6,326	4	30.6%	2
District of Columbia	$5,817	-	$10,714	-	31.4%	-
U.S.	$1,397,635	61.5%	$269,650	-	22.9%	-

Source: Governing Magazine State & Local Source Book 2000

Table 2 Total Education Spending

	State & Local Total	State Share	Total Per Capita	Per Capita Rank	Total as a % of Personal Income	% of Personal Income Rank
Alabama	$5,796	38.7%	$1,357	40	7.1%	27
Alaska	$1,550	38.3%	$2,554	1	10.7%	1
Arizona	$6,148	25.6%	$1,389	36	7.1%	26
Arkansas	$3,164	36.8%	$1,261	48	7.0%	28
California	$43,799	24.8%	$1,374	37	5.8%	43
Colorado	$6,072	34.5%	$1,588	18	6.8%	31
Connecticut	$5,332	21.1%	$1,629	16	5.1%	49
Delaware	$1,362	41.0%	$1,878	3	7.2%	23
Florida	$18,027	17.1%	$1,252	49	5.5%	46
Georgia	$11,150	29.5%	$1,516	24	7.1%	25
Hawaii	$1,549	100.0%	$1,308	44	5.3%	48
Idaho	$1,810	31.7%	$1,522	23	8.2%	8
Illinois	$17,013	22.1%	$1,436	32	5.7%	44
Indiana	$9,214	35.2%	$1,577	20	7.4%	20
Iowa	$4,633	30.6%	$1,624	17	7.8%	14
Kansas	$4,247	25.7%	$1,651	15	7.6%	15
Kentucky	$5,328	35.4%	$1,372	38	7.3%	21
Louisiana	$5,652	33.9%	$1,299	46	6.9%	30
Maine	$1,788	27.6%	$1,438	31	7.2%	24
Maryland	$7,724	24.9%	$1,523	22	5.8%	41
Massachusetts	$8,055	24.6%	$1,322	43	4.7%	50
Michigan	$17,242	28.4%	$1,797	6	7.5%	17
Minnesota	$8,252	26.9%	$1,772	8	7.5%	18
Mississippi	$3,649	28.0%	$1,344	41	8.1%	10
Missouri	$7,132	23.0%	$1,331	42	6.1%	40
Montana	$1,469	32.7%	$1,671	13	9.1%	4
Nebraska	$2,827	27.7%	$1,711	11	8.0%	11
Nevada	$2,035	25.8%	$1,270	47	5.5%	47
New Hampshire	$1,625	25.4%	$1,399	34	5.5%	45
New Jersey	$14,576	20.5%	$1,825	4	6.1%	39
New Mexico	$2,614	37.5%	$1,526	21	8.5%	6
New York	$32,959	17.3%	$1,812	5	6.6%	35
North Carolina	$10,231	31.2%	$1,397	35	6.7%	32
North Dakota	$1,020	41.0%	$1,584	19	8.5%	5
Ohio	$16,628	26.7%	$1,488	28	6.6%	34
Oklahoma	$4,525	31.8%	$1,371	39	7.4%	19
Oregon	$5,296	23.1%	$1,653	14	7.8%	13
Pennsylvania	$18,025	28.0%	$1,495	27	6.3%	37
Rhode Island	$1,496	29.9%	$1,511	25	6.3%	36
South Carolina	$5,289	37.1%	$1,430	33	7.6%	16
South Dakota	$951	29.3%	$1,299	45	6.7%	33
Tennessee	$6,378	33.3%	$1,199	50	5.8%	42
Texas	$27,859	23.1%	$1,456	29	7.0%	29
Utah	$3,428	38.9%	$1,714	10	9.6%	3
Vermont	$1,043	36.6%	$1,771	9	8.4%	7
Virginia	**$10,023**	**33.3%**	**$1,502**	**26**	**6.3%**	**38**
Washington	$9,428	33.6%	$1,704	12	7.3%	22
West Virginia	$2,653	31.7%	$1,453	30	8.2%	9
Wisconsin	$9,154	24.2%	$1,774	7	8.0%	12
Wyoming	$969	23.0%	$2,015	2	9.8%	2
District of Columbia	$669	-	$1,232	-	3.6%	-
U.S.	$398,858	26.7%	$1,504	-	6.5%	-

Source: Governing Magazine State & Local Source Book 2000

Table 3 Total Highway Spending

	State & Local Total	State Share	Total Per Capita	Per Capita Rank	Total as a % of Personal Income	% of Personal Income Rank
Alabama	$1,147	61.2%	$269	40	1.4%	28
Alaska	$698	84.3%	$1,150	1	4.8%	1
Arizona	$1,241	58.5%	$280	36	1.4%	26
Arkansas	$823	69.7%	$328	23	1.8%	15
California	$6,402	48.2%	$201	49	0.8%	50
Colorado	$1,177	48.8%	$308	28	1.3%	33
Connecticut	$1,017	68.1%	$311	27	1.0%	49
Delaware	$339	72.7%	$468	8	1.8%	17
Florida	$4,580	66.1%	$318	26	1.4%	29
Georgia	$2,052	59.4%	$279	38	1.3%	34
Hawaii	$343	78.7%	$290	33	1.2%	40
Idaho	$439	59.6%	$369	18	2.0%	13
Illinois	$3,602	53.5%	$304	30	1.2%	37
Indiana	$1,466	65.2%	$251	46	1.2%	39
Iowa	$1,380	51.4%	$484	6	2.3%	8
Kansas	$1,338	64.6%	$520	4	2.4%	6
Kentucky	$1,187	80.8%	$306	29	1.6%	20
Louisiana	$1,286	63.3%	$295	31	1.6%	22
Maine	$488	70.1%	$392	15	2.0%	14
Maryland	$1,306	64.3%	$258	44	1.0%	48
Massachusetts	$2,282	72.3%	$375	16	1.3%	32
Michigan	$2,363	37.4%	$246	47	1.0%	47
Minnesota	$1,949	36.8%	$418	13	1.8%	18
Mississippi	$995	61.0%	$366	19	2.2%	10
Missouri	$1,566	58.4%	$292	32	1.3%	30
Montana	$416	77.8%	$473	7	2.6%	5
Nebraska	$719	60.3%	$435	11	2.0%	12
Nevada	$682	51.6%	$425	12	1.8%	16
New Hampshire	$333	61.2%	$286	34	1.1%	41
New Jersey	$2,576	67.3%	$322	25	1.1%	44
New Mexico	$839	75.8%	$490	5	2.7%	3
New York	$5,944	46.6%	$327	24	1.2%	38
North Carolina	$1,920	84.1%	$262	43	1.3%	36
North Dakota	$282	58.9%	$437	10	2.4%	7
Ohio	$2,821	50.3%	$252	45	1.1%	43
Oklahoma	$944	65.4%	$286	35	1.6%	23
Oregon	$1,072	50.4%	$335	22	1.6%	21
Pennsylvania	$2,968	68.3%	$246	48	1.0%	45
Rhode Island	$265	79.2%	$268	41	1.1%	42
South Carolina	$724	82.1%	$196	50	1.0%	46
South Dakota	$385	63.9%	$526	3	2.7%	4
Tennessee	$1,490	63.7%	$280	37	1.3%	31
Texas	$5,125	68.7%	$268	42	1.3%	35
Utah	$544	65.6%	$272	39	1.5%	25
Vermont	$268	59.5%	$456	9	2.2%	11
Virginia	**$2,264**	**80.4%**	**$339**	**21**	**1.4%**	**27**
Washington	$1,995	52.2%	$361	20	1.5%	24
West Virginia	$745	94.7%	$408	14	2.3%	9
Wisconsin	$1,915	37.3%	$371	17	1.7%	19
Wyoming	$303	80.7%	$630	2	3.1%	2
District of Columbia	$89	-	$164	-	0.5%	-
U.S.	$79,094	60.1%	$298	-	1.3%	-

Source: Governing Magazine State & Local Source Book 2000

Table 4 Total Correction Spending

	State & Local Total	State Share	Total Per Capita	Per Capita Rank	Total as a % of Personal Income	% of Personal Income Rank
Alabama	$318	67.7%	$75	45	0.4%	43
Alaska	$147	99.7%	$242	1	1.0%	1
Arizona	$593	75.1%	$134	19	0.7%	10
Arkansas	$202	81.0%	$81	42	0.4%	32
California	$5,979	62.2%	$188	3	0.8%	3
Colorado	$492	68.3%	$129	21	0.5%	23
Connecticut	$464	100.0%	$142	13	0.4%	33
Delaware	$113	100.0%	$155	9	0.6%	17
Florida	$2,522	65.2%	$175	5	0.8%	5
Georgia	$1,069	74.1%	$145	11	0.7%	11
Hawaii	$106	100.0%	$90	35	0.4%	44
Idaho	$124	78.6%	$104	28	0.6%	20
Illinois	$1,196	69.7%	$101	29	0.4%	38
Indiana	$495	70.7%	$85	38	0.4%	40
Iowa	$189	74.9%	$66	48	0.3%	48
Kansas	$223	79.4%	$87	36	0.4%	39
Kentucky	$308	68.3%	$79	43	0.4%	35
Louisiana	$438	71.1%	$101	30	0.5%	25
Maine	$90	71.1%	$72	47	0.4%	45
Maryland	$875	84.2%	$172	6	0.7%	12
Massachusetts	$743	65.1%	$122	24	0.4%	34
Michigan	$1,494	81.1%	$156	8	0.7%	13
Minnesota	$454	56.2%	$98	32	0.4%	37
Mississippi	$244	84.8%	$90	34	0.5%	24
Missouri	$460	67.8%	$86	37	0.4%	42
Montana	$74	90.0%	$84	40	0.5%	31
Nebraska	$139	67.2%	$84	39	0.4%	41
Nevada	$286	52.4%	$178	4	0.8%	6
New Hampshire	$88	69.7%	$76	44	0.3%	49
New Jersey	$1,126	68.5%	$141	14	0.5%	30
New Mexico	$240	72.3%	$140	15	0.8%	4
New York	$3,810	55.3%	$210	2	0.8%	7
North Carolina	$1,056	81.1%	$144	12	0.7%	9
North Dakota	$26	64.4%	$40	50	0.2%	50
Ohio	$1,406	74.9%	$126	22	0.6%	22
Oklahoma	$309	91.4%	$94	33	0.5%	27
Oregon	$435	58.8%	$136	18	0.6%	14
Pennsylvania	$1,684	58.9%	$140	16	0.6%	18
Rhode Island	$116	100.0%	$117	25	0.5%	28
South Carolina	$489	80.1%	$132	20	0.7%	8
South Dakota	$59	74.1%	$81	41	0.4%	36
Tennessee	$532	66.3%	$100	31	0.5%	29
Texas	$3,188	66.3%	$167	7	0.8%	2
Utah	$220	71.6%	$110	26	0.6%	16
Vermont	$43	99.9%	$73	46	0.3%	46
Virginia	**$997**	**62.8%**	**$149**	**10**	**0.6%**	**15**
Washington	$761	65.4%	$137	17	0.6%	19
West Virginia	$104	78.3%	$57	49	0.3%	47
Wisconsin	$639	66.5%	$124	23	0.6%	21
Wyoming	$52	59.8%	$109	27	0.5%	26
District of Columbia	$292	-	$537	-	1.6%	-
U.S.	$37,509	67.4%	$141	-	0.6%	-

Source: Governing Magazine State & Local Source Book 2000

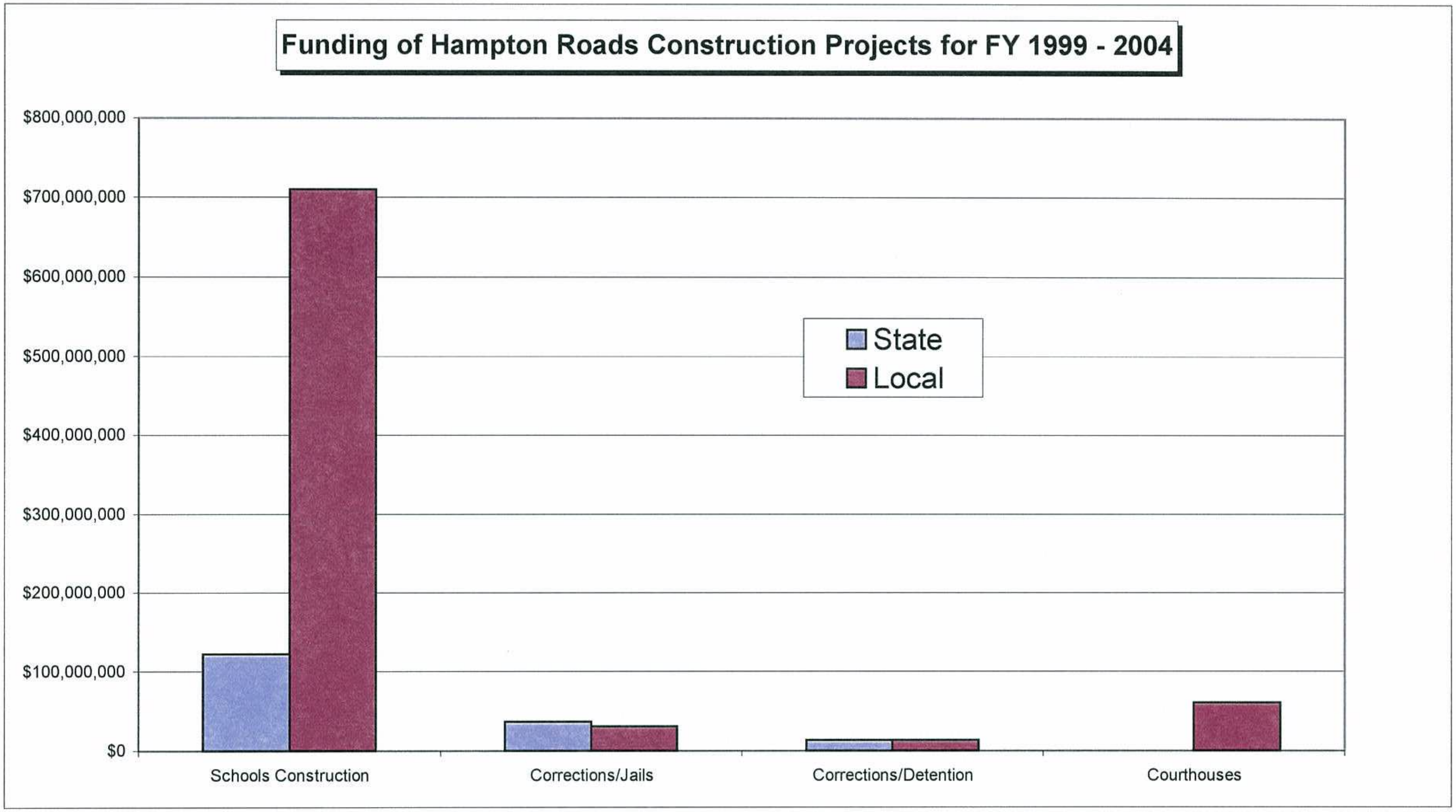
Table 5

States Ranked According to Per Pupil Elementary and Secondary Public School System Finance Amounts

1996-1997

Rank	Total		Federal Sources		State Sources		Local Sources	
-	US	$6,741	US	$433	US	$3,288	US	$3,021
1	NJ	$10,235	AK	$1,120	HI	$5,800	NJ	$5,978
2	NY	$9,343	NM	$695	AK	$5,329	NH	$5,764
3	CT	$8,924	NO	$627	DE	$5,209	CT	$5,361
4	AK	$8,713	MS	$606	MI	$5,178	NY	$5,149
5	MA	$8,061	LA	$603	WA	$4,560	VT	$4,956
6	PA	$8,053	WV	$560	WV	$4,230	PA	$4,463
7	DE	$7,918	MT	$550	WI	$4,187	RI	$4,259
8	MI	$7,879	KY	$521	MN	$3,921	MD	$4,154
9	IN	$7,825	DE	$513	NJ	$3,909	IL	$4,139
10	RI	$7,789	HI	$510	NM	$3,870	MA	$4,122
11	WI	$7,598	NY	$509	NV	$3,860	NE	$4,116
12	VT	$7,497	AZ	$507	IN	$3,849	IN	$3,666
13	MD	$7,375	AL	$503	NY	$3,685	OH	$3,632
14	MN	$7,209	CA	$501	KY	$3,630	**VA**	**$3,616**
15	ME	$6,917	SO	$492	CA	$3,616	ME	$3,433
16	IL	$6,866	MI	$479	KS	$3,608	CO,	$3,166
17	OH	$6,804	AR	$477	MA	$3,578	WI	$3,083
18	WA	$6,794	SC	$465	NC	$3,519	TX	$2,992
19	WV	$6,750	OK	$448	OR	$3,396	MN	$2,992
20	NE	$6,673	FL	$443	AL	$3,341	VVY	$2,970
21	WY	$6,642	TX	$441	GA	$3,320	SD	$2,838
22	**VA**	**$6,622**	WY	$436	IA	$3,274	FL	$2,831
23	HI	$6,468	PA	$433	CT	$3,262	MO	$2,751
24	NH	$6,465	IL	$430	WY	$3,236	OR	$2,683
25	KS	$6,452	RI	$418	OK	$3,181	IA	$2,658
26	OR	$6,435	WA	$398	PA	$3,157	MT	$2,609
27	FL	$6,406	GA	$397	ME	$3,134	NO	$2,528
28	IA	$6,236	TN	$397	FL	$3,132	KS	$2,518
29	CA	$6,167	NE	$397	RI	$3,112	AZ	$2,517
30	GA	$6,123	OH	$395	SC	$3,106	GA	$2,405
31	CO	$6,120	NC	$389	ID	$3,047	SC	$2,350
32	MO	$6,118	MO	$374	AR	$3,033	AK	$2,263
33	NV	$6,019	MA	$362	MO	$2,993	MI	$2,223
34	TX	$6,013	MD	$357	MD	$2,863	DE	$2,196
35	MT	$5,986	OR	$356	UT	$2,839	TN	$2,095
36	SC	$5,920	VT	$354	MT	$2,827	CA	$2,050
37	KY	$5,856	ME	$349	OH	$2,778	WV	$1,959
38	NC	$5,641	NJ	$348	**VA**	**$2,681**	LA	$1,939
39	OK	$5,457	ID	$329	CO	$2,650	NV	$1,917
40	AZ	$5,411	WI	$328	LA	$2,632	WA	$1,836
41	NO	$5,405	KS	$327	TX	$2,580	OK	$1,828
42	AL	$5,320	**VA**	**$325**	MS	$2,487	NC	$1,733
43	NM	$5,315	IN	$310	AZ	$2,387	KY	$1,704
44	SO	$5,182	IA	$306	TN	$2,337	AR	$1,600
45	LA	$5,174	CO	$304	IL	$2,297	ID	$1,514
46	AR	$5,110	CT	$301	NO	$2,251	AL	$1,476
47	ID	$4,890	MN	$297	VT	$2,187	MS	$1,413
48	TN	$4,829	UT	$291	NE	$2,160	UT	$1,408
49	UT	$4,537	NV	$241	SO	$1,851	NM	$751
50	MS	$45,061	NH	$224	NH	$477	HI	$158

Source: *Public Education Finance*, 1997 Census of the Governments



Source: HRPDC Survey of Local Governments April 2000

Chart 1

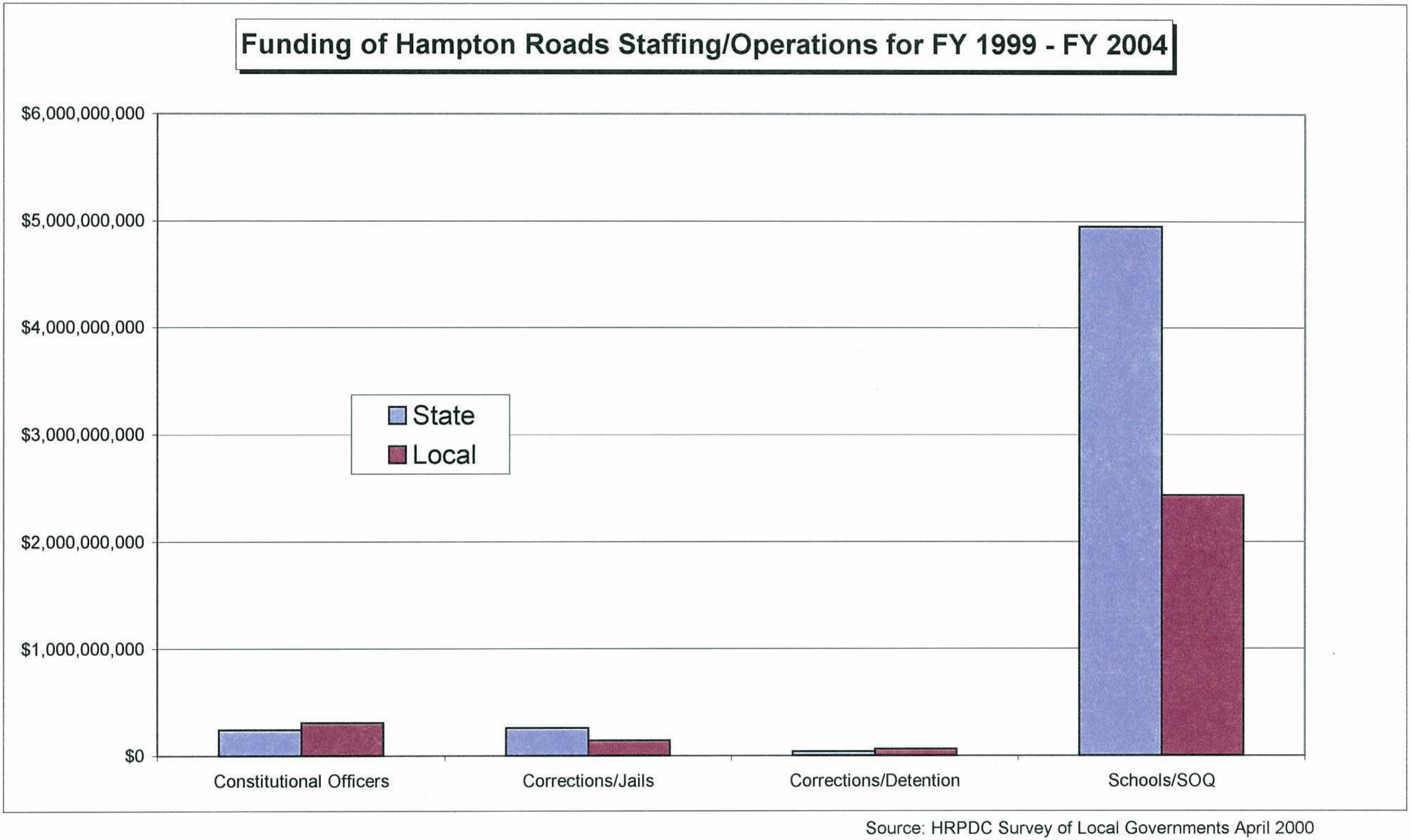
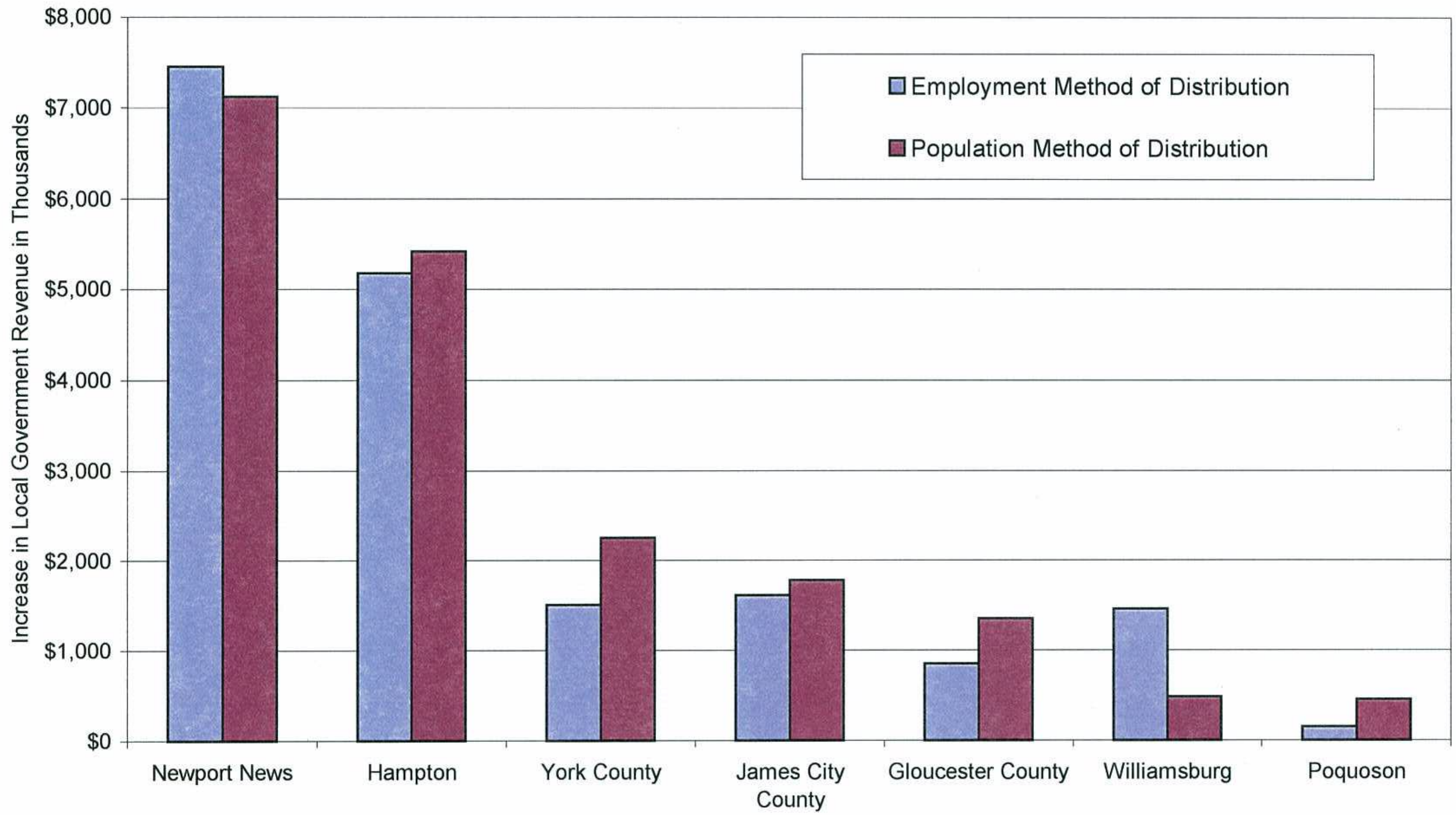

Funding of Hampton Roads Staffing/Operations for FY 1999 - FY 2004
$6,000,000,000
$5,000,000,000
$4,000,000,000
$3,000,000,000
$2,000,000,000
$1,000,000,000
$0
State
Local
Constitutional Officers
Corrections/Jails
Corrections/Detention
Schools/SOQ
Source: HRPDC Survey of Local Governments April 2000

Chart 2

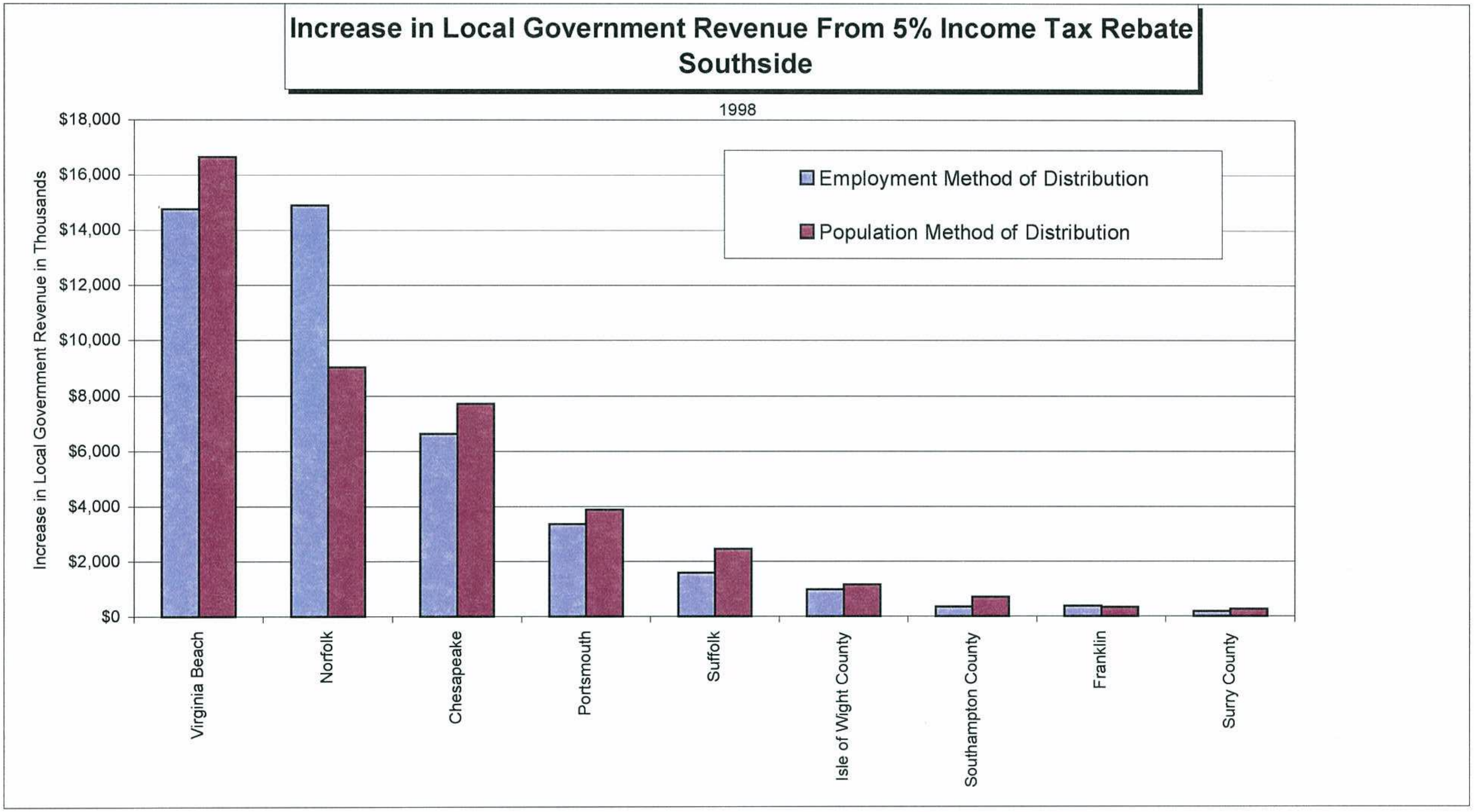
Increase in Local Government Revenue From 5% Income Tax Rebate Peninsula

1998



Source: Virginia Department of Taxation; Weldon Cooper Center for Public Service (pop); Bureau of Economic Analysis (emp)

Chart 3



Source: Virginia Department of Taxation; Weldon Cooper Center for Public Service (pop); Bureau of Economic Analysis (emp)

Chart 4

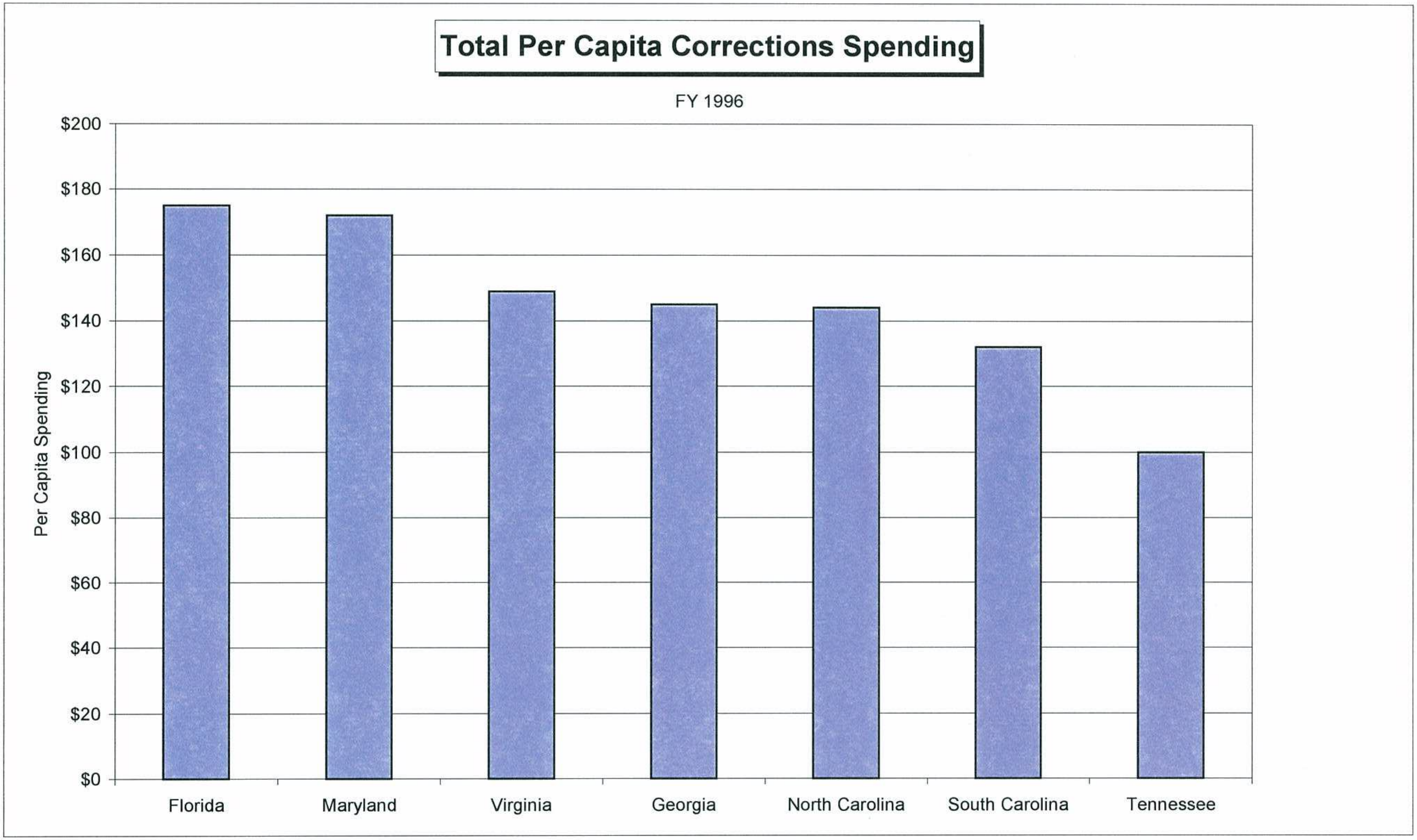
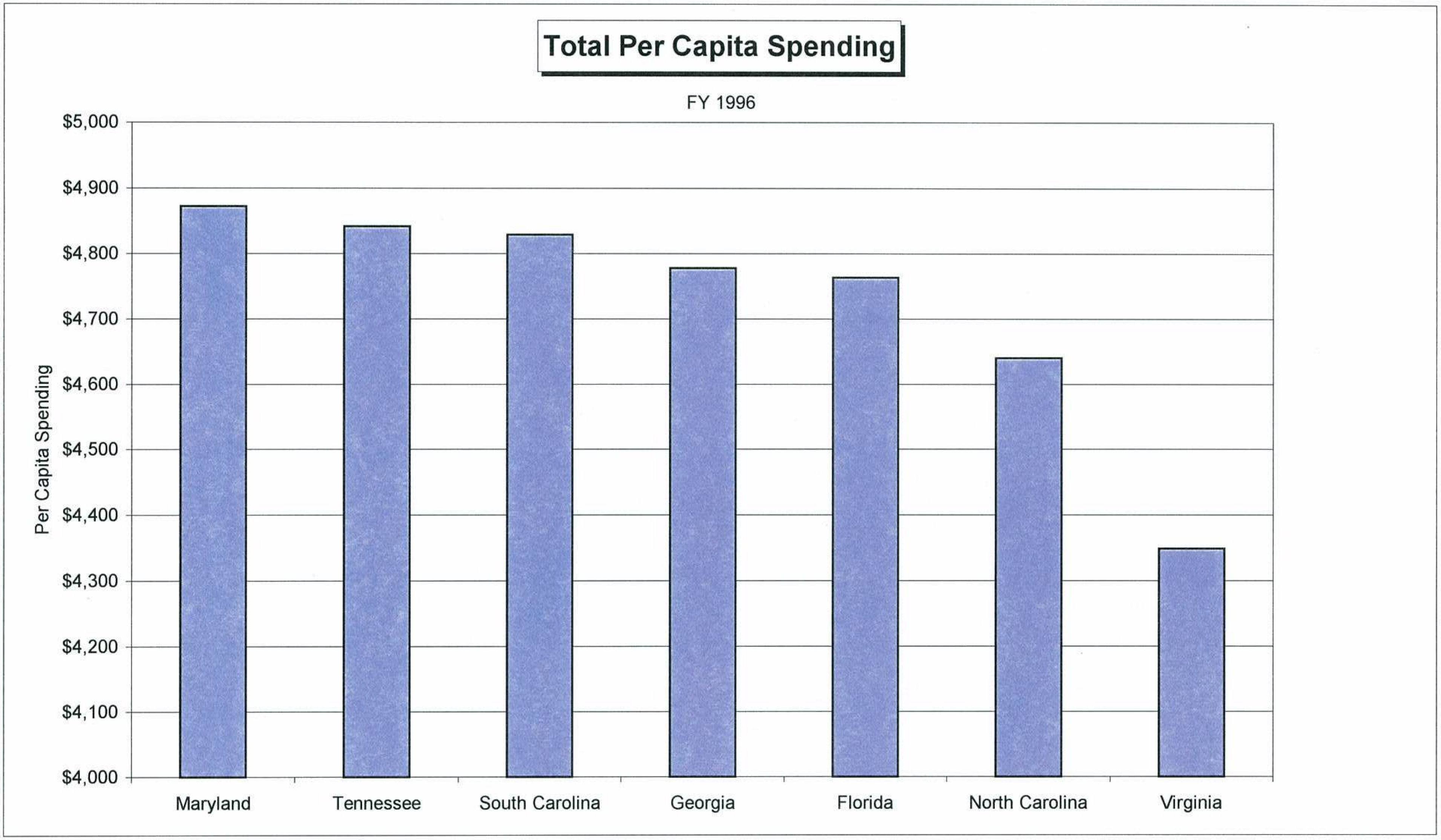


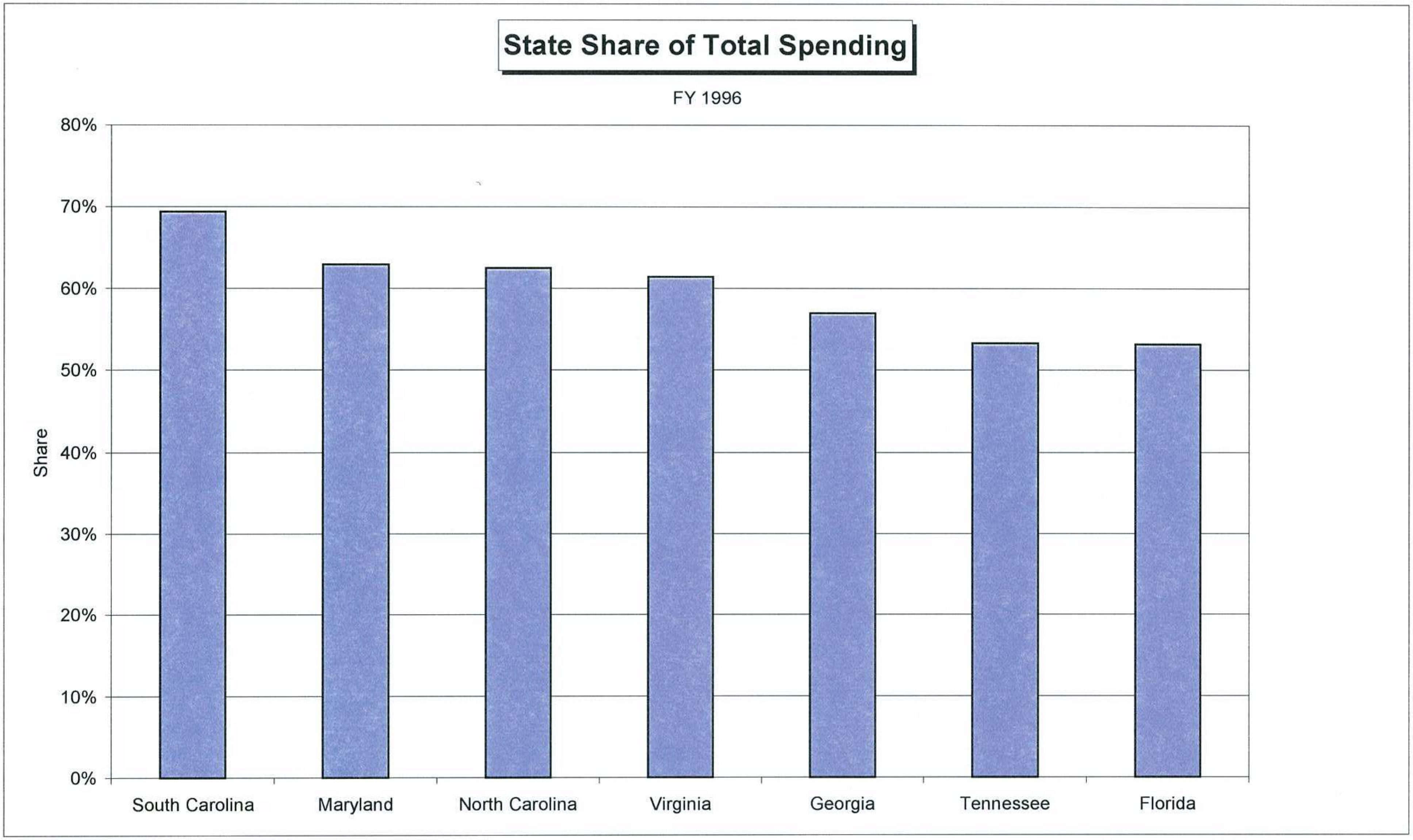
Chart 5

Source: Governing Magazine State & Local Source Book 2000



Source: Governing Magazine State & Local Source Book 2000

Chart 6



Source: Governing Magazine State & Local Source Book 2000

Chart 7

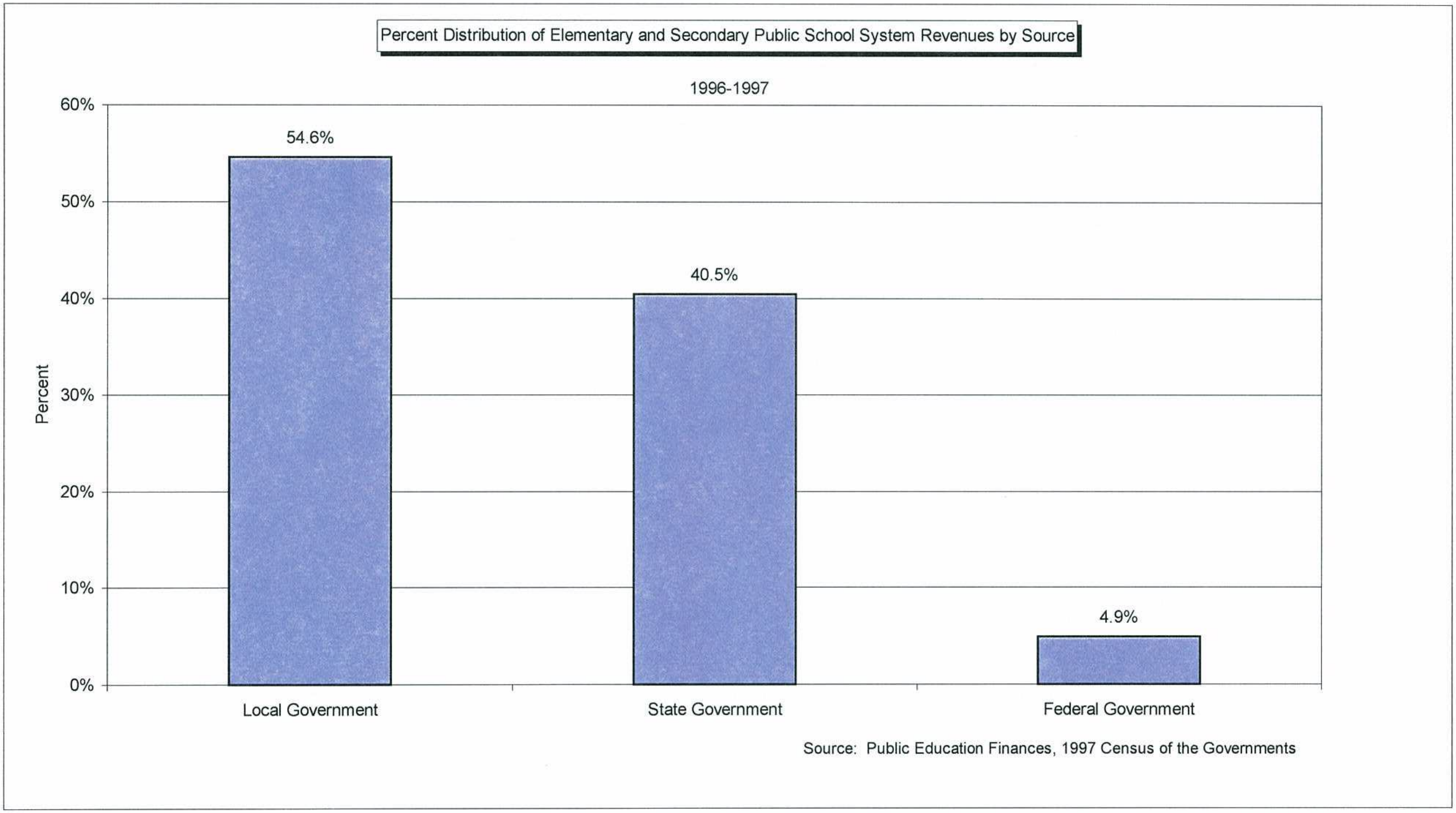
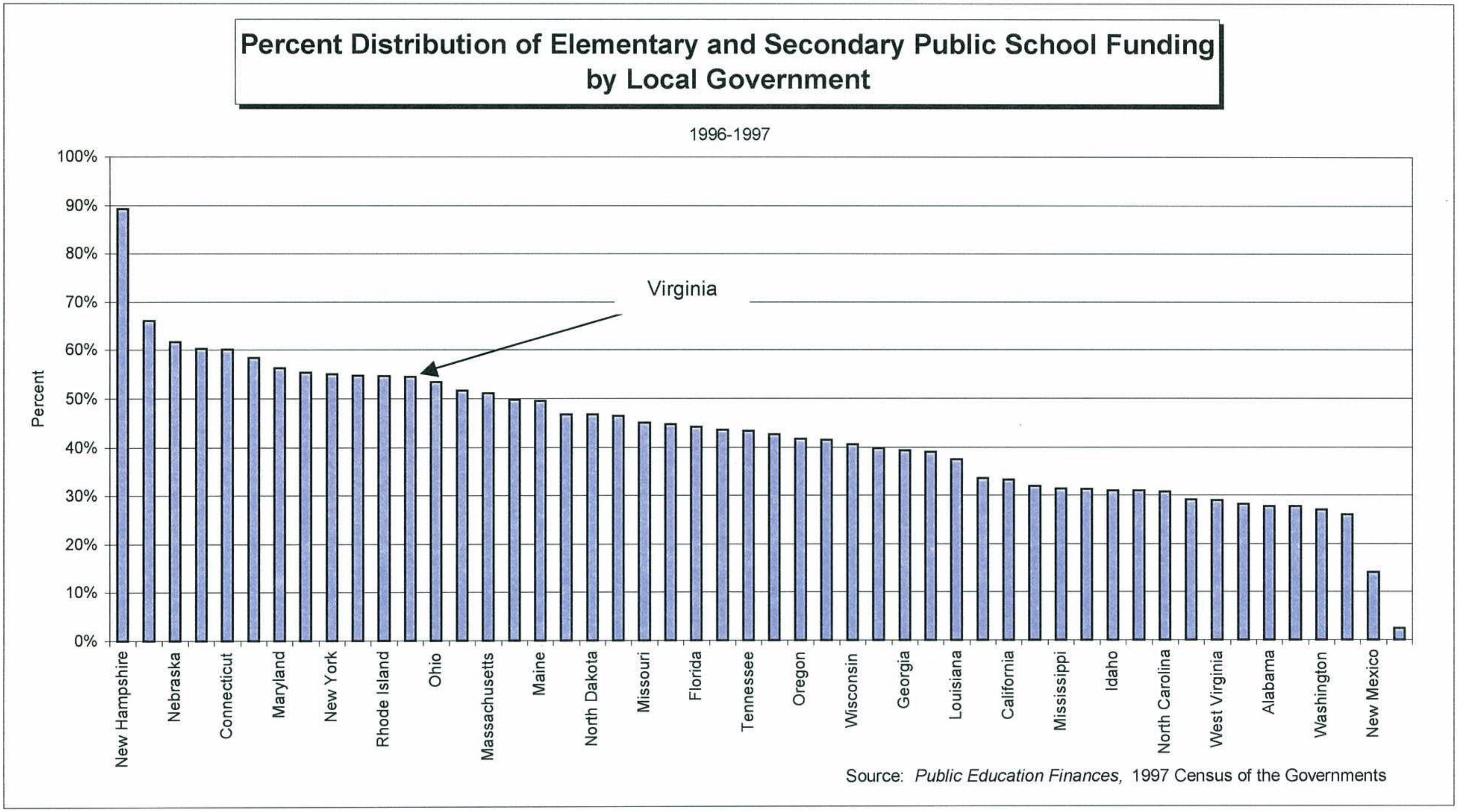

Percent Distribution of Elementary and Secondary Public School System Revenues by Source
1996-1997
Percent
60%
50%
40%
30%
20%
10%
0%
54.6%
40.5%
4.9%
Local Government
State Government
Federal Government
Source: Public Education Finances, 1997 Census of the Governments

Chart 8

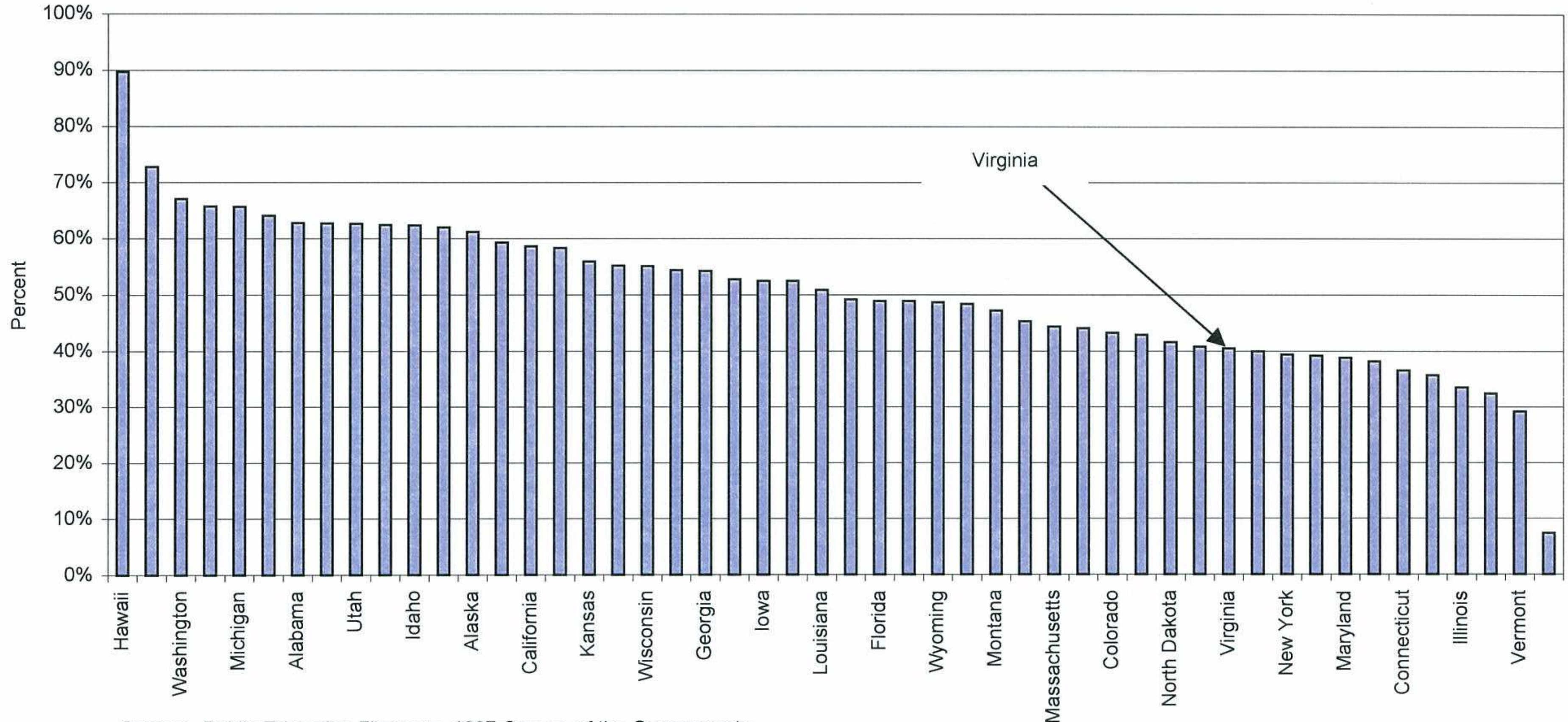


Percent Distribution of Elementary and Secondary Public School Funding by Local Government
1996-1997
Percent
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Virginia
New Hampshire
Nebraska
Connecticut
Maryland
New York
Rhode Island
Ohio
Massachusetts
Maine
North Dakota
Missouri
Florida
Tennessee
Oregon
Wisconsin
Georgia
Louisiana
California
Mississippi
Idaho
North Carolina
West Virginia
Alabama
Washington
New Mexico
Source: *Public Education Finances,* 1997 Census of the Governments

Chart 9

Percent Distribution of Elementary and Secondary Public School Funding by State Government

1996-1997



Source: *Public Education Finances,* 1997 Census of the Governments

Chart 10

Review of Major General Fund Taxes

Senate Finance Committee Staff

June 6, 2000

Virginia's General Fund Taxes

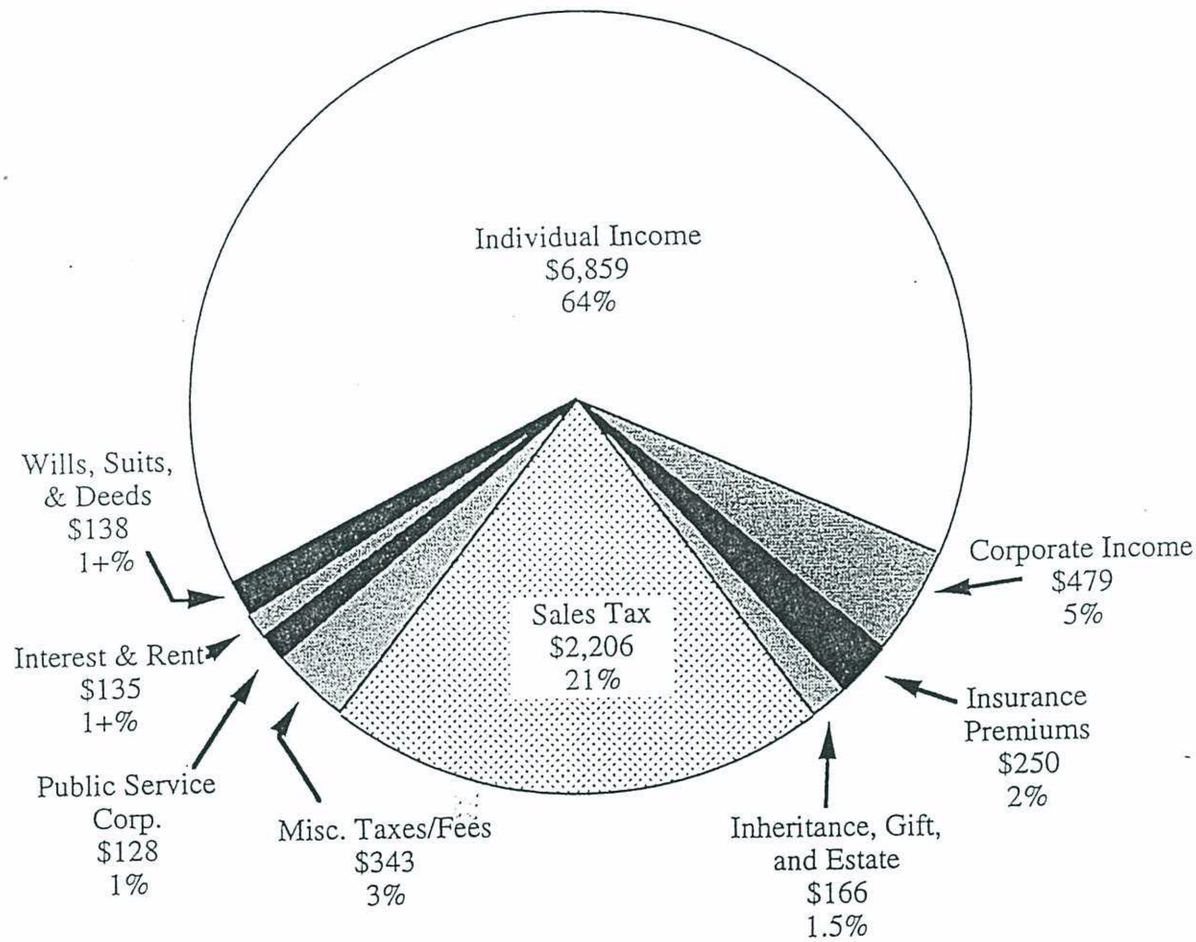
- About 90 percent of Virginia's general fund taxes (excluding Lottery and ABC profits) come from 3 sources:
  - Individual Income taxes;
  - Sale and use taxes; and
  - Corporate Income taxes.

- Virginia continues to become more reliant on individual income taxes, and less reliant on other tax sources.
  - This trend has been apparent for over three decades.

- By all accepted measures of tax burden, Virginia is a low tax state.

- In recent years, the increasing number of tax credits, subtractions, and deductions enacted have made Virginia's tax laws more complex and more difficult to administer.

Major Sources of General Fund Revenue*
FY 2000
($ in millions)

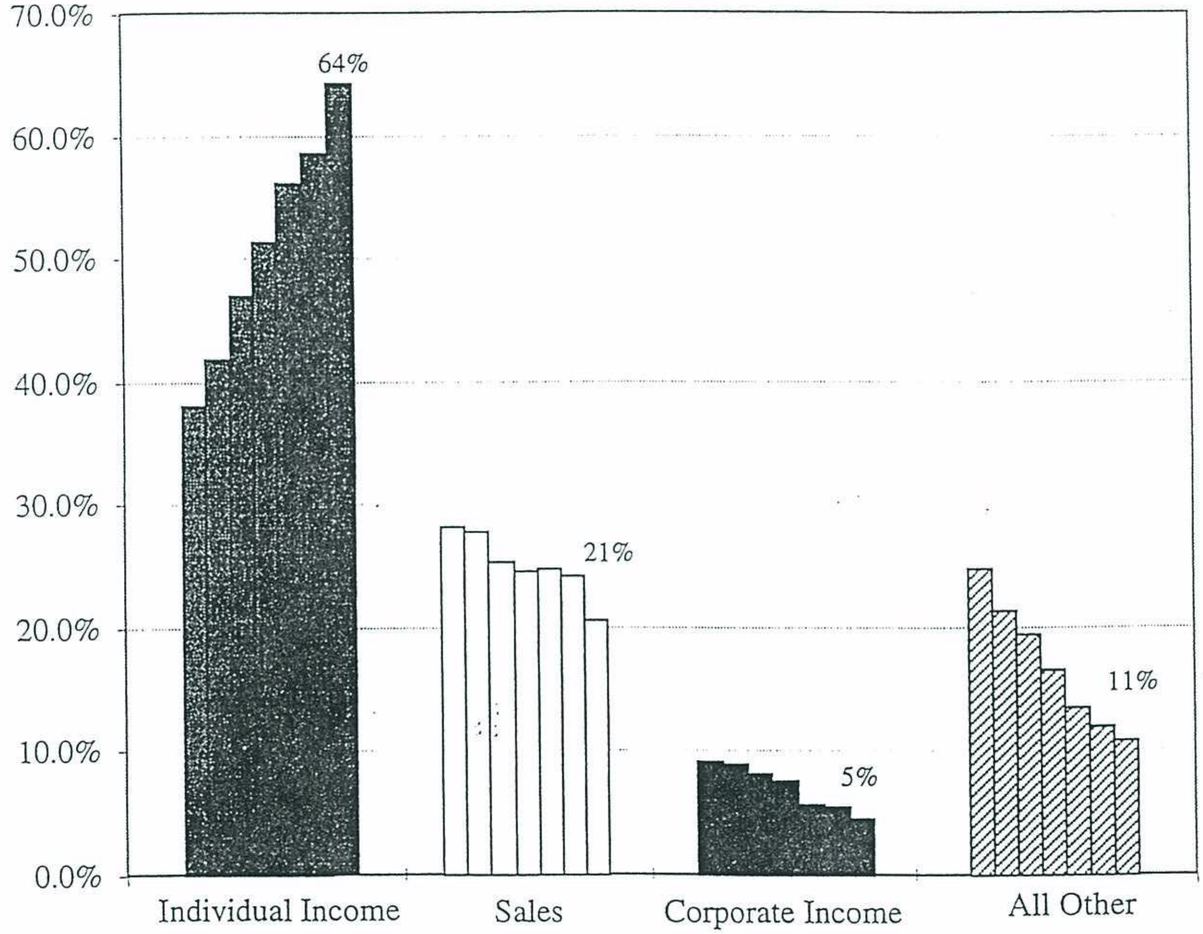


Total General Fund Revenues = $10,697

* Excludes Transfers and Balances

Over Time, the General Fund Has Become Markedly More Dependent on Individual Income Taxes

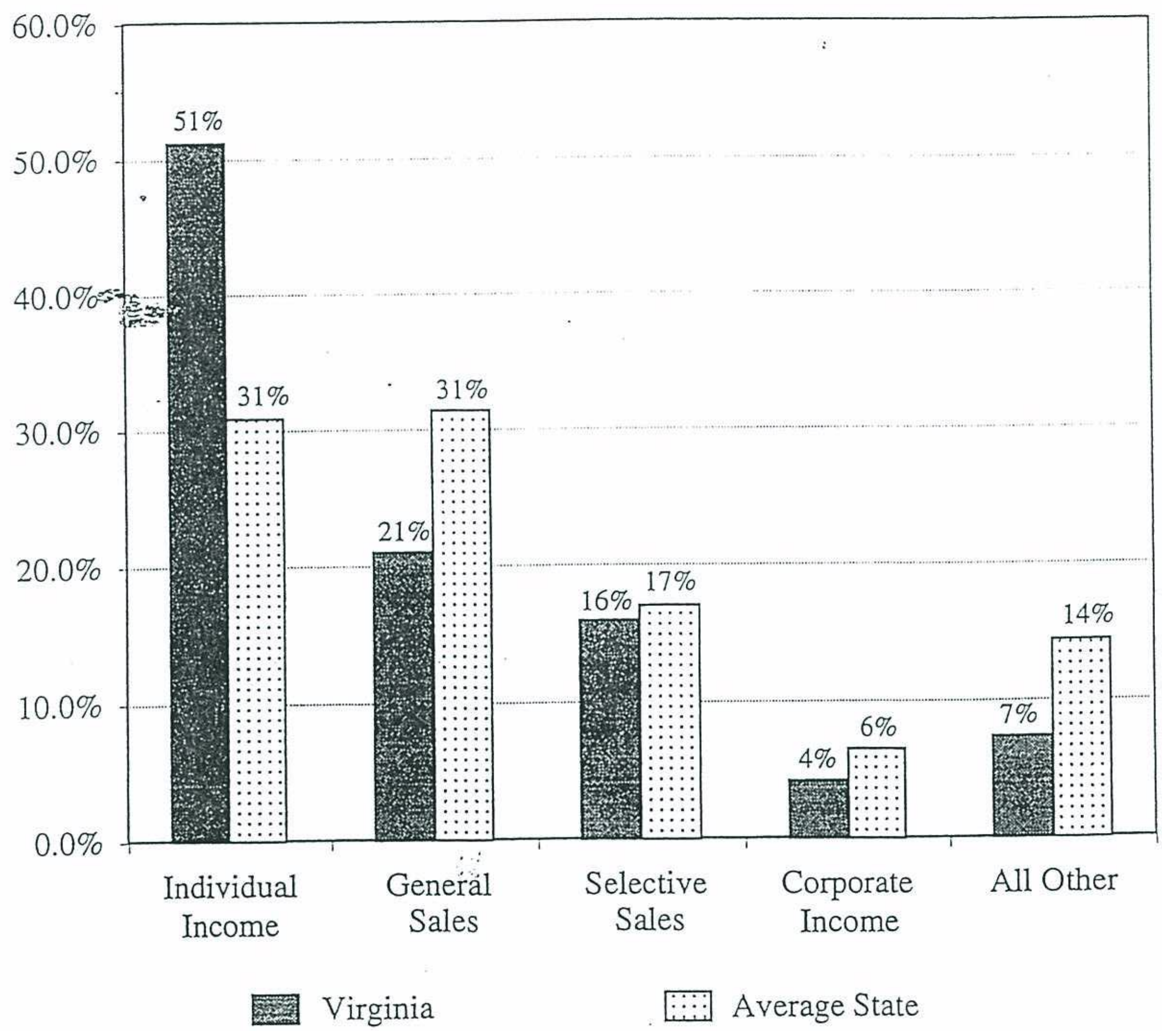
Composition of GF Revenues, FY 70 to FY 00
(5 Year Increments)



- Dependence on Sales Taxes, Corporate Income and Other Sources has declined significantly.

Virginia's Dependence on Individual Income Taxes Is Much Greater than the Average State*

(FY 1998 Data)



- Among the states, only Oregon and Massachusetts rely to a greater degree on individual income tax collections.

* Includes both general and non-general fund taxes.

Most Measures Show Virginia to Have Low Tax Burden and Tax Effort Overall

<u>State Taxes Only (FY 1998)</u>

- Per Capita:
  - Virginia $1,559 (36th)
  - U.S. Average $1,769
- As Percent of Personal Income:
  - Virginia 5.8% (44th)
  - U.S. Average 6.8%

<u>State and Local Taxes as Percent of Personal Income (FY 1996)</u>

- Virginia: 9.8% (47th)
- State Average: 11.3%

<u>State and Local Taxes Per Capita (FY 1996)</u>

- Virginia: $2,341 (27th)
- State Average: $2,593

<u>State and Local Tax Capacity and Effort (1994)</u>

- Tax Capacity: 104.2 (14th)
- Tax Effort: 86.0 (39th)

Tax Policy Principles

- Most literature on tax policy talks about four guiding principles:

  - Equity;
  - Reliability;
  - Efficiency; and
  - Accountability

Equity

- Do people of the same means pay the same taxes?

- Are taxes (together or individually):

  - *regressive* (take a greater share of earnings from low-income payers)?

  - *proportional* (take the same proportion of earnings from all income groups)? or

  - *progressive* (take a greater proportion of earnings from higher income groups)?

- Are taxes economically neutral, or do they favor some types of activities over others, and some industries over others?

Reliability

- Do tax laws remain consistent from year-to-year, to allow taxpayers and businesses to plan for the future?

- Are tax revenues stable over time or are they subject to unpredictable fluctuations?
- Are taxes sufficient to support the desired rate of growth in spending?

<u>Efficiency</u>

- Can taxes be administered at reasonable cost, and with a high degree of compliance?

<u>Acountability</u>

- Are the taxes which are levied hidden, or are they explicitly set out and paid?
- Are credits and exemptions kept to a minimum and reviewed frequently to be sure they are meeting their intended objective?

There is often tension between these principles.

Source: NCSL, <u>Tax Policy Handbook for State Legislators</u>, 1997.

Virginia's Major Tax Sources:

Individual Income Tax

Individual Income Tax

- Virginia is one of 42 states (plus the District of Columbia) that levies a broad-based tax on individual income.
  - 1 state taxes dividends and interest only.
- Virginia applies a graduated income tax on the net income of individuals. Tax liability is determined by:

1) Starting with federal adjusted gross income (FAGI);
2) Applying Virginia-specific additions and subtractions (to get Virginia Adjusted Gross Income (VAGI));
3) Subtracting either the standard deduction or itemized deductions (and child and dependent care deductions);
4) Deducting personal exemptions;
5) Applying tax rates.

Va. Taxable Income	Rate
First $3,000	2%
$3,001 - $5,000	3%
$5,001 - $17,000	5%
$17,001 or more	5.75%

6) Finally, deduct any tax credits.

Calculating the Individual Income Tax

(Based on 1997 State Income Tax returns)

($ in millions)

Federal Adjusted Gross Income (FAGI)	$128,164.1	
Minus:		
Virginia Subtractions from FAGI	$11,836.9	
Age Subtraction ($12,000; $6,000)		$5,681.5
Social Security included in FAGI		1,453.1
Non-resident Income		3,173.2
State Income Tax Refund		674.3
Exempt Interest		518.6
Self-Employment Tax		83.0
Disability Income		6.4
Other Subtractions		246.9
Plus:		
Virginia Additions to FAGI		$419.3
Equals:		
Virginia Adjusted Gross Income	$118,624.6	
Minus:		
Itemized or Standard Deduction	$20,000.1	
Standard ($3,000 single; $5,000 married)		$5,977.1
Itemized (fed. itemized less state income tax)		14,023.0
Minus:		
Personal Exemptions	$4,842.0	
$800 per Exemption		4,496.9
Age and Blind Exemption		345.1
Minus:		
Child and Dependent Care Expenses	$337.8	

Calculating the Individual Income Tax
(Continued)

Equals:		
Taxable Income (Apply Tax Rates)	$94,684.5	
Tax Liability Before Credits	$4,743.5	
Minus:		
Tax Credits (in effect in 1997)	$71.2	
Credit For Taxes Paid to Another State		66.3
Neighborhood Assistance Act		2.3
Enterprise Zone Act		1.6
Recyclable Materials Processing Equipment		0.3
Conservation Tillage Equipment		0.2
Fertilizer and Pesticide Application Equipment		0.2
Rent Reduction Program		0.1
Historic Rehabilitation		0.1
Clean Fuel Vehicle and Refueling Property		<.1
Vehicle Emissions Testing Equipment		<.1
Major Business Facility		<.1
Qualified Business Unit Foreign Source Income		<.1
Equals:		
Tax After Credits	$4,672.3	

Effective Tax Rate on Federal Adjusted Gross Income	3.70%

Source: Department of Taxation. Totals do not add precisely because some filers' subtractions take incomes below the filing threshold of $5,000 for individuals and $8,000 for married, where their VAGI is $0 or negative.

In Computing Income Tax, Virginia Conforms to Federal Definitions of Income

- Like most states, Virginia uses federal tax provisions as the basis for its individual income tax.

  - 36 states conform to some degree to federal tax provisions.

    -- 27 states, including Virginia, use federal AGI as the starting point for computing state tax liability.

    -- 7 states use federal taxable income as the starting point.

    -- 3 states define state tax liability as a percent of federal liability.

    -- 14 states have frozen conformity at a fixed point in time.

- Conforming to federal tax laws makes administration of income taxes more straightforward, and reduces complexity for the taxpayer.

  -- At the same time, however, it makes Virginia's tax policy subject to changes in federal tax law.

  -- It also has led the Tax Department to rely on IRS enforcement efforts to ensure compliance with income tax laws.

Evolution of Virginia's Income Tax

- There have been relatively few changes in the basic structure of the individual income tax over time.

  - The first 2 income tax brackets were established in 1926, and have not been changed.

  - In 1971, Virginia conformed its income definitions to federal law, and raised the top tax rate to 5.75%.

  - In 1987, in response to federal tax changes, Virginia enacted a number of changes:

    -- The minimum filing threshhold was raised from $3,000 to $5,000 ($8,000 married);

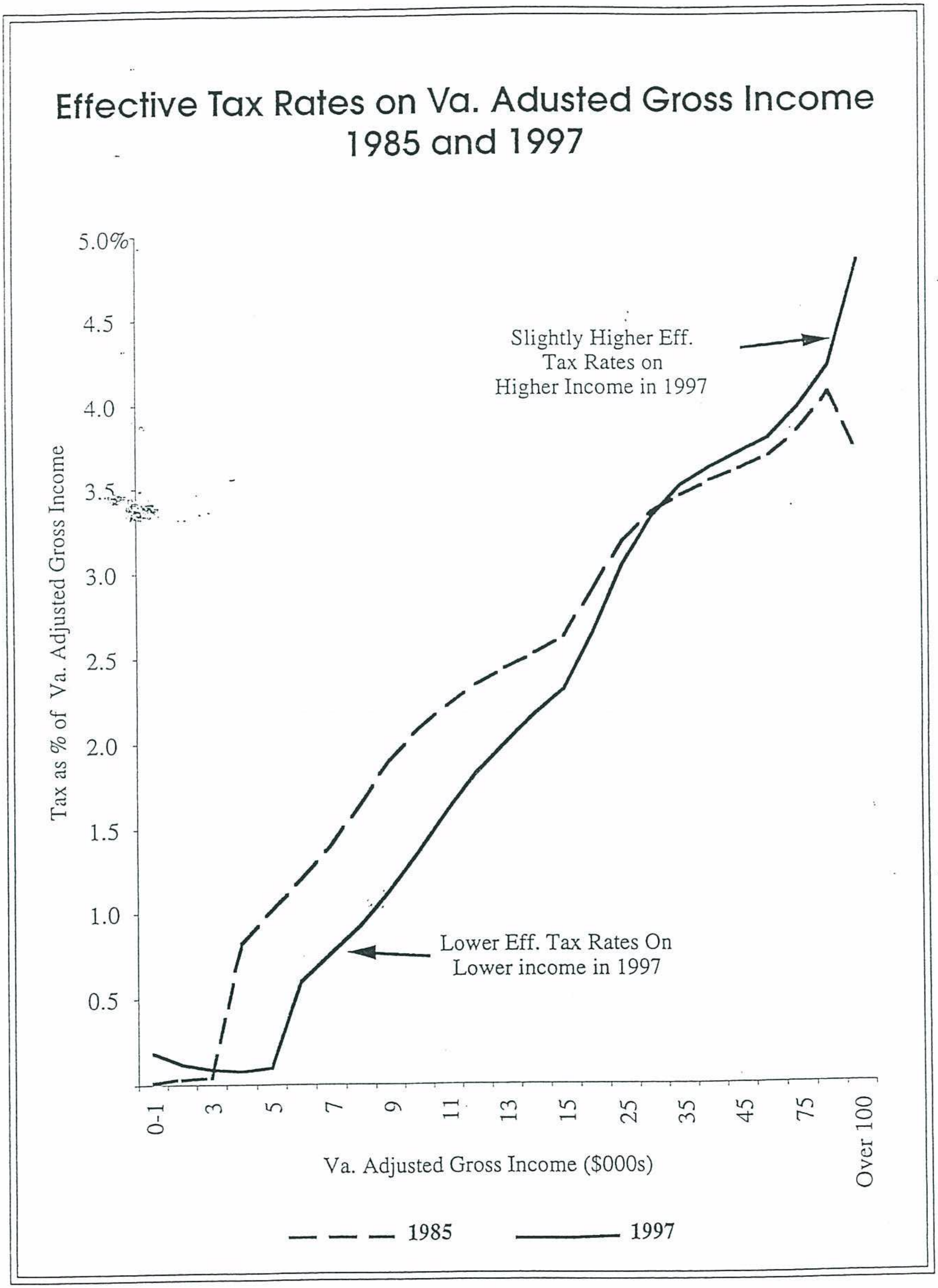
    -- The personal exemption was increased from $600 to $800;

    -- The standard deduction was increased from a maximum of $2,000 to a flat $3,000 ($5,000 married); and

    -- The threshhold for the 5.75% tax bracket was raised from $12,000 to $17,000.

    -- The result of these changes was to reduce the income tax burden at lower income levels.

  - The 2000 action to provide a tax credit to individuals and families below the federal poverty level will reduce further the income tax burden at low income levels.


Effective Tax Rates on Va. Adusted Gross Income
1985 and 1997
5.0%
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
Tax as % of Va. Adjusted Gross Income
Slightly Higher Eff. Tax Rates on Higher Income in 1997
Lower Eff. Tax Rates On Lower income in 1997
0-1
3
5
7
9
11
13
15
25
35
45
75
Over 100
Va. Adjusted Gross Income ($000s)
1985
1997

An Increasing Number of Tax Preferences Have Been Adopted in Recent Years

- Although there have been few changes in basic structure, there is a growing tendency to adopt specific tax preferences in the form of:

  1) *Tax credits*, which directly reduce tax liability, usually dollar-for-dollar;

  2) *Subtractions*, which exclude amounts of income from the determination of tax liability; or

  3) *Deductions*, which reduce the amount of income which is ultimately taxable.

- Such income tax preferences are generally intended to stimulate (or subsidize) certain kinds of economic behavior, or to shift the tax burden away from certain groups.

- In the past three sessions, tax policy actions have been particularly extensive.

  - Between 1990 and 1997, about 15 significant changes were enacted. ("Significant" means having a measurable fiscal impact.)

  - In the 1998, 1999, and 2000 sessions, 50 significant changes were enacted. (Note: Includes all taxes.)

  - For the individual income tax, there are now 22 subtractions and deductions, as well as 26 tax credits.

- The fiscal impact of changes enacted since 1990 (including the car tax) totals about $1.1 billion in FY 2001 and $1.4 billion in FY 2002.

  - The impact will grow to about $3.5 billion in FY 2002-04. (Note: Does not include further food tax reductions.)

Selected Tax Preferences Affecting Individual Income Tax Filers

	Enacted/ Last Amended
Subtraction for up to $600 for Lottery prizes	1989
Subtraction for wages from National Guard service	Before 1990
Subtraction for reward for information	Before 1990
Subtraction for qualified agricultural contributions	1998
Subtraction for Qualified Research Expenses	1993
Subtraction for those aged 65 or older and 62-64	1994
Subtraction of Disablity Income	2000
Subtraction for Contributions to Prepaid Tuition Plan; Deduction for Savings Trust	1998
Subtraction for Military Wages — Up to $15,000	1999
Subtraction for Federal and State Employees — Up to $15,000	1999
Subtraction of Capital Gain for Land Dedicated to Open Space	1999
Subtraction for Unemployment Benefits	1999
Subtraction for Income from Tobacco Settlement	2000
Subtraction for Income Received by Holocaust Victims	2000
Subtraction for Military Pay Received by Medal of Honor Recipients	2000
Deduction for Child Care Expenses	Before 1990
Deduction for Foster Care ($1,000)	Before 1990
Deduction for Contributions to Public School Construction Grants Program	1998
Deduction for Teacher Continuing Education Costs	1999
Deduction for Long-Term Care Health Insurance	1999
Tax Credit for Taxes Paid to Other States	1999
Tax Credit for Taxes Paid to a Foreign Country on Retirement Income	1998
Tax Credits for Providing VHDA Low-Income Housing	1990
Tax Credit for Purchase of Equipment for Purchasing Recyclable Materials	1998
Tax Credit for Providing Rent Reductions	2000
Tax Credit for Historic Rehabilitation	2000
Tax Credit for Equity and Subordinated Debt Investments	1998
Tax Credit for Contributions to Political Candidates	1999
Tax Credit for Retrofitting a Residence with Accessibility Features	1999
Tax Credit for Technology Investment in Tobacco-Dependent Localities	2000
Tax Credit for Research and Development Expenses in Tobacco-Dependent Localities	2000

Tax Preferences (Continued)

	Enacted/ Last Amended
Tax Credits for Riparian Buffers	2000
Tax Credit for Individuals and Families Below the Poverty Level	2000
Tax Credit for Donations Under the Neighborhood Assistance Act	2000
Tax Credit Under the Enterprise Zone Act	1995
Tax Credit for Vehicle Emissions Testing Equipment, Clean-Fuel Vehicle and Job Creation	1998
Tax Credit for Conservation Tillage Equipment	1990
Tax Credit for Fertilizer And Pesticide Application Equipment	1996
Tax Credit for Foreign Source Retirement Income	1998
Tax Credit for Day-Care Facility Investment	1996
Tax Credit for Low-Income Housing	1996
Tax Credit for Employers Hiring Recipients Of Temporary Assistance to Needy Families	1998
Tax Credit for Agricultural Best Management Practices	Before 1990
Tax Credit for Worker Retraining	1997
Tax Credit for Waste Motor Oil Burning Equipment	1998
Tax Credit For Employers Of Disabled Individuals	1999

- Once enacted, tax preferences tend to "fly below the radar screen" from then on.
  - Few have sunsets, and the cost of providing them is deducted from revenue estimates.
  - There is no re-visiting to determine whether their original purpose is being met.
- Tax preferences substantially increase the complexity of administration, given Virginia's status as a conformity state.
- They also shift the burden of supporting government services away from some groups toward the balance of taxpayers.

How Does Virginia's Individual Income Tax Compare to Other States?

- Reliable state-to-state comparisons of individual income taxes are difficult to make.

  - Filing threshholds, standard deductions, personal exemptions, tax rates, and tax credits all interact.

  - Comparisons of individual features (filing threshholds, standard deductions, personal exemptions) are generally not helpful.

    -- 27 states have top marginal tax rates higher than Virginia's 5.75%. Another 2 states have flat tax rates higher than 5.75%.

    -- However, Virginia's top rate begins at $17,000 -- lower than most other states.

- The most commonly cited state-to-state comparisons are taxes per capita and taxes as a percent of personal income.

  - These measures show Virginia in the top quartile of states levying income taxes.

    -- Income Taxes Per Capita (1998):

Virginia:	$796 (12th)
State Average:	$656

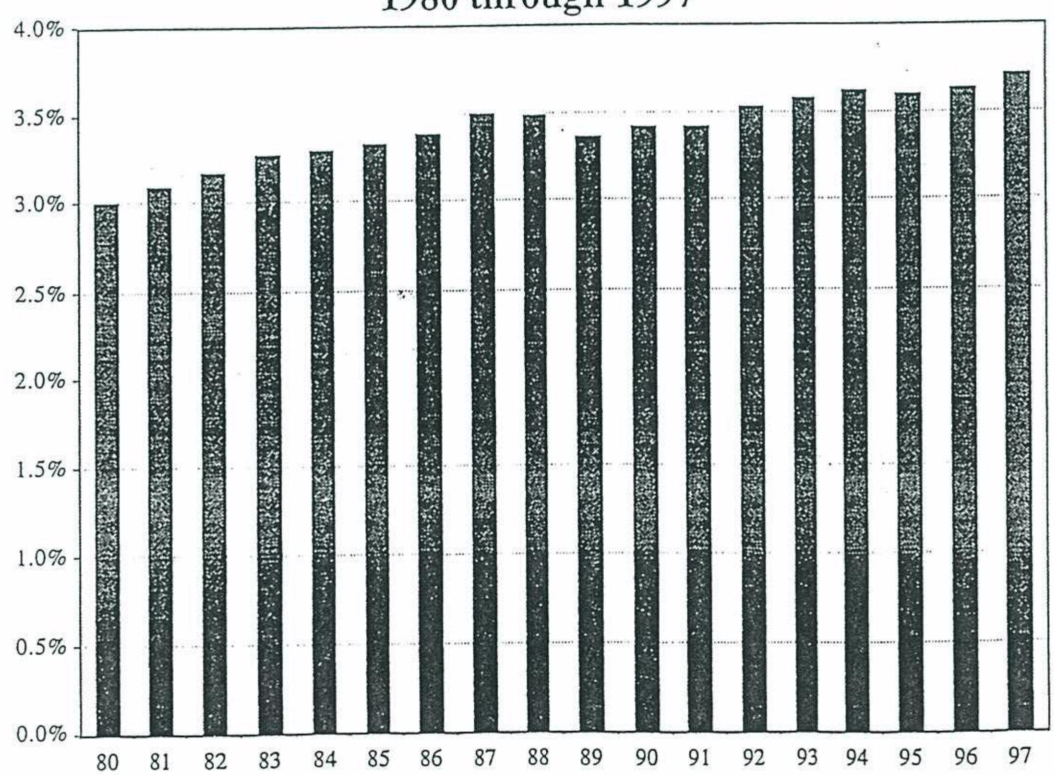
    -- Income Taxes as Percent of Personal Income (1998)

Virginia:	2.9% (13th)
State Average:	2.6%

Impact of Virginia's Income Tax Policies

- Virginia's heavy reliance on individual income tax collections has kept revenue growth high, particularly during the 1980s and most of the 1990s.
  - Income tax growth in the past 2 decades has averaged 9.6% -- compared to 6.8% for the sales tax and 4.7% for the remainder of the general fund.
- Over time, increases in personal income and inflation have produced "bracket creep" -- more income has become subject to the 5.75% tax bracket. As a result, Virginia's overall effective tax rate has increased somewhat over time.

Individual Income Taxes as a Percent of Federal Adjusted Gross Income 1980 through 1997



- Increasingly, income tax is paid by those in the top income tier -- a trend that has been evident for years.

  - 26 percent of the filers pay 74 percent of Virginia's income tax.

Income Taxes Paid By Income Group, 1997

VAGI Classes	% of Returns	% of VAGI	% of Tax Paid
$0 to 9,999	25%	1%	<1%
$10-24,999	25	9	7
$25-49,999	24	20	19
$50-74,999	13	19	18
$75-99,999	6	13	13
$100,000 -	7	39	42

- Virginia's income tax is the principal state tax which remains deductible at the federal level for filers who itemize.

- The effective tax rate for filers 62 and over is markedly lower than for all other filers.

  - The subtraction reduced the tax liablity of individuals 62 and over by about $450 for each of the 530,000 individuals who claimed an age subtraction in 1997.

  - The fiscal impact of this tax benefit will be about $550 million in the FY 2000-2002 biennium.

Virginia's Major Tax Sources:

Corporate Income Tax

Corporate Income tax

- The corporate income is assessed against the net income or profits of a corporation (as opposed to taxing the corporation's gross receipts).
  - The corporate income tax is applicable to all domestic and foreign corporations doing business in Virginia, except public service corporations, insurance companies, banks, and not-for-profit companies.
  - In 1971, Virginia's definition of corporate net income was conformed to the federal government's definition.

- To compute the tax, a flat rate of 6 percent is applied to net income. The rate was last increased in 1971, when federal conformity was enacted. At that time, the rate went from 5 to 6 percent.

- In FY 2000, the corporate income tax will provide about $480 million (about 4.5 percent of the general fund).

Multi-State Corporate Apportionment Formula

- Virginia's corporate income tax is applied only to income earned on economic activity in Virginia.
  - Like most states, Virginia has a formula which apportions a corporation's net income so that different states do not tax the same income.

- The three-factors are averaged to determine Virginia taxable income. Included are:

  1. **Property Factor (25%)**: Virginia property as a proportion of total corporate property;

  2. **Payroll Factor (25%)**: Virginia payroll as a proportion of the corporation's total payroll; and

  3. **Sales Factor (50%)**: Virginia sales as a proportion of total corporate sales.

- Until 1999, the apportionment formula weighted each factor equally.

  - The change was enacted to advantage multi-state corporations whose sales were largely out-of-state, but whose plants and payrolls were more concentrated in Virginia.

  - 29 states use a "double weighted" apportionment formula.

How Does Virginia's Corporate Income Tax Compare to Other States?

- In 2000, 45 states, including Virginia, levy a tax on corporate income.
  - 3 states have no corporate income tax.
  - Michigan levies a single tax on "business activities." Texas levies a franchise tax on "earned surplus."

- Most states, like Virginia, conform to some degree to federal tax provisions governing corporate income. Nevertheless, there is substantial variation in the degree of conformity.
  - Most states use either gross income, adjusted gross income, net income, or taxable income as a starting point for computing corporate income tax.
  - Some states use portions of specific IRS Code sub-sections and adopt other provisions to supplement.

- At a flat 6%, Virginia's corporate tax rate is lower than most states.
  - 21 states levy a flat rate higher than 6%;
  - 14 states have multiple tax brackets that tend to have rates overall greater than 6%;
  - 3 other states levy a flat rate of 6%; 6 levy a flat rate lower than 6%.

An Increasing Number of Tax Preferences Have Been Adopted in Recent Years

- As with individual income tax, an increasing number of subtractions and tax credits affecting corporations have been added to Virginia's tax code in recent years.
  - Excluding basic or technical provisions, there are now 11 subtractions and 24 tax credits affecting corporate income filers.

	Enacted/ Last Amended
Tax Credit for Donations to Neighborhood Assistance	1997
Tax Credit for Conservation Tillage Equipment	Before 1990
Tax Credit for Qualifying Cogenerators & Small Power Producers	1988
Virginia Coal Employment & Production Incentive Tax Credit	2000
Tax Credit for Advanced Technology Pesticide & Fertilizer Application Equipment	1990
Tax Credit for Purchase of Vehicle Emission Equipment	1997
Tax Credit for Purchase of Equipment for Purchasing Recyclable Materials	1998
Tax Credit for Providing Low Income Housing	1998
Major Business Facility Job Tax Credit	1994
Tax Credit for Creating Jobs Involved in Clean Fuel Vehicles	1995
Tax Credit for Purchase of Waste Motor Oil Burning Equipment	1998
Tax Credit for Employing Persons with Disabilities	1999
Coalfield Employment Enhancement Tax Credits	2000
Tax Credit for Qualifying Steam Producers	1995
Tax Credit for Investment in Day Care Facilities	1996
Tax Credit for Agricultural Best Management Practices	1996
Tax Credit for Worker Retraining	1997
Alternate Tax Credit for Purchasing Machinery and Equipment for Processing Recyclable Materials	1998
Tax Credit for Hiring Recipients of TANF	1998
Tax Credit for Land Preservation	1999
Tax Credit for Technology Investment in Tobacco-Dependent Localities	2000
Tax Credit for Research and Development Expenses in Tobacco-Dependent Localities	2000
Tax Credits for Riparian Buffers	2000
Tax Credit for Investment in Enterprize Zones	1995

Impacts of Current Policies

- Corporate income has accounted for a declining share of general fund revenues over time.
  - Corporate profits are highly cyclical, and do not routinely reflect inflation.
  - Since Virginia has a flat rate corporate income tax, inflation has not produced increases in average effective tax rates.
  - Companies are probably more successful than individuals in sheltering gross income from taxation.
  - Increases in the number of tax preferences have constrained growth somewhat.

- Compared to most other states, Virginia derives relatively little revenue from corporate income tax.
  - In FY 1998, Virginia produced about 4.2% of its tax revenue (GF & NGF) from corporate income -- 40th among the states.

- Virginia's corporate income tax is relatively attractive to businesses since:
  - Rates are relatively low.
  - Virginia's conformity with federal laws affords simplicity of reporting.

Selected Potential Policy Issues Involving State Taxes

- As currently constructed, to what degree do the individual income, corporate income and sales taxes meet the basic principles of:

  - *Equity* (between taxpayers of similar means; economically neutral)

  - *Reliability* (year-to-year consistency; stability; and adequacy)

  - *Efficiency* (administratively straightforward)

  - *Accountability* (openly levied and collected; tax preferences reviewed periodically)

- Is the mix of taxes and the degree of reliance on each appropriate?

- Is the taxpayer's overall tax burden, and the burden of each major tax appropriate?

Individual Income Tax

- Should the basic structure of the individual income tax be altered?

  - Filing Threshold;
  - Income Tax Brackets;
  - Standard Deduction;
  - Personal Exemption;
  - Differential between Individual and Married Filers.

Tax Preferences

- Should there be more standard policies for tax credits regarding:
  - Percent of allowable cost for which credits are available?
  - Sunset dates?
  - Periodic review to see that they are meeting their intended objective?
  - Carryover period?
  - Interaction with federal deductions? or
  - Aggregate caps on fiscal impact?
- What impact do tax preferences have on conformity with federal tax law?
- To what degree do tax preferences impact compliance and enforcement efforts?
- How have tax preferences shifted the tax burden from some taxpayers to others?

Sales Tax

- Is the base to which the sales and use tax is applied appropriate?
- Given the changing nature of economic activity, what should the Commonwealth's policy be regarding use taxes?
- How should Virginia address the changing delivery channels for goods and services?

Sales and Use Tax

Overview

- The Virginia sales and use tax is levied on the consumption of goods and services either bought in Virginia or brought into the state.
  - The "sales" tax is levied on retail sale, storage, and rental of goods, transient accommodations, and production and fabrication activities. It applies to intrastate transactions.
  - The "use tax" is imposed on the consumption, distribution, use and storage of goods not subject to the sales tax.
    - The use tax applies to interstate transactions, such as mail orders of more than $100 and purchase of furniture from out-of-state retailers to be used in Virginia.

- The state sales and use tax was first enacted in 1966.
  - In 1968, the 2 percent rate was increased to 3 percent.
  - In 1986, the rate was raised by 0.5 percent, with the proceeds dedicated to transportation.

- For the most part, the sales tax has remained a general fund revenue source. Sales tax proceeds from the 3.5 cents are distributed:
  - 2 cents to the General Fund, without restriction;

- 1 cent to local school divisions for SOQ costs, based upon school-age population; and

- 1/2 cent to the Transportation Trust Fund, to be divided among all modes.

- The portion of the sales tax attributable to watercraft sales and hunting, fishing, and wildlife equipment is collected as a general fund revenue and transferred to the Game Protection Fund. In FY 2000-02, an estimated $31.7 million will be transferred.

- In FY 2000, the sales and use tax will provide $2.2 billion to the General Fund or 21.0 percent of its total.

- Virginia's 3.5 percent sales tax rate is one of the lowest rates among the 45 states that levy a general sales and use tax.

  - State rates vary from 3.0% (Colorado) to 7.0% (Rhode Island).

  - North Carolina's state tax is 4%; Maryland's is 5%; and West Virginia's is 6%.

  - 35 of the 45 states that levy a state sales tax, including Virginia, also allow their local governments to levy a local tax.

- Virginia ranks lowest of the 45 states in both sales tax per capita and sales tax as a percentage of personal income.

State Sales & Use Tax Cost Comparison -- 1996
(State tax only)

	Per Capita	% of Personal Income
Virginia	$ 299	1.3%
Maryland	394	1.5
North Carolina	406	2.0
West Virginia	437	2.5
Hawaii	1,209	4.9
U.S. Average	526	2.3

- Sales taxes are generally regarded as regressive, because taxpayers with lower incomes tend to spend higher proportions of their income on consumption.

- To address this, almost all states have adopted specific exclusions for such necessities as food and prescription and non-prescription drugs:

  -- four states levy a sales tax on food; and

  -- only one state levies the tax on the two types of drugs.

The Sales Tax Base

• Over time, the proportion of tax generated by different categories of retail sales has remained fairly stable, although food for home consumption has declined somewhat.

  - In 1997, food, general merchandise, and lumber accounted for about half of total sales.

Percentage of Sales Tax Revenue Generated

	1980	1997		1980	1997
Food for Home	26%	17%	Auto Parts	6%	5%
Gen'l Merchandise	18%	17%	Apparel	5%	5%
Lumber	10%	10%	Machinery	3%	5%
Other Food	10%	12%	Hotels & Motels	3%	4%
Furniture	6%	7%	Misc./Other	12%	16%

- When it was originally enacted, Virginia's sales tax was based primarily on the sale of goods. Only a limited number of services were taxed:
  - meals served in restaurants and hotels;
  - transient accommodations for less than 90 days;
  - those provided in connection with the sale of tangible personal property; and
  - the fabrication of tangible personal property for consumers who furnished, either directly or indirectly, the materials used in the fabrication.

- As a result, Virginia's original sales tax base differed from the base used in most other states.
  - The sale of food was taxed. Most services were not taxed.
  - The result was a sales tax base that was probably more narrow at inception than in most states levying a general sales tax.

-- In 1998, the Department of Taxation estimated that all sales and use tax exemptions together had an annual impact of about $3.6 billion.

Basic Trends Affecting the Sales Tax

- Three continuing trends have narrowed the scope of the sales tax even more over time.

  1) Services, which are becoming an increasing majority of personal consumption, are largely exempt from the sales tax;

  2) An increasing number of both targeted and broad exemptions have been granted; and

  3) Catalog and Internet sales, which are largely untaxed, have continued to grow.

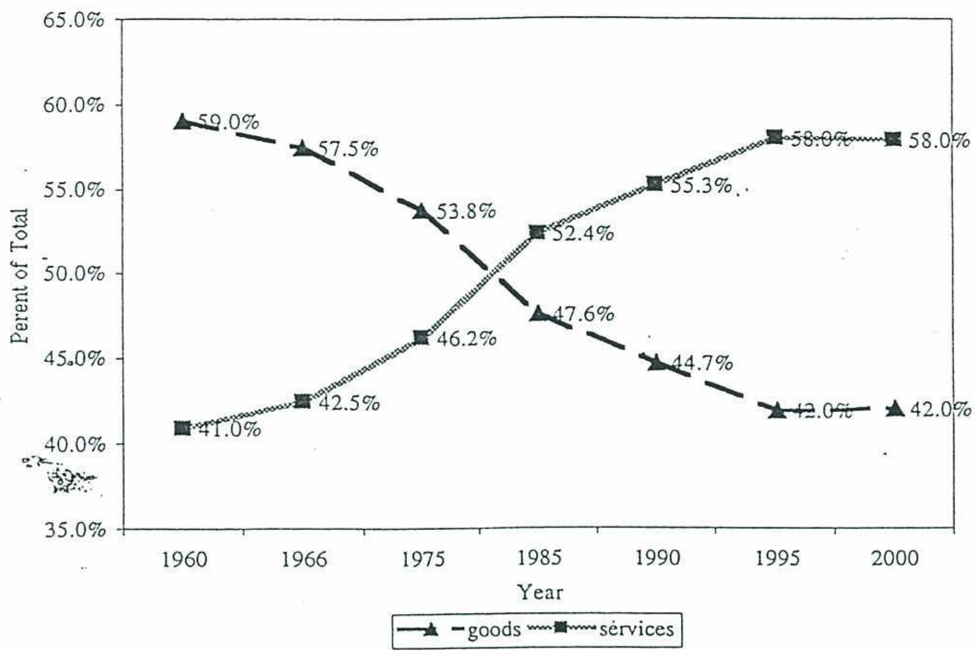
1) Growing Economic Significance of Services

- When the sales tax was enacted in 1966, the purchase of goods accounted for about 60 percent of personal consumption. By the first quarter of 2000, the purchase of goods accounted for only about 42 percent of personal consumption.

  - Many common services today – lawn care, cable tv, health club memberships, and house cleaning, for example, were non-existent or uncommon.

- As personal consumption has trended toward services, the value of the exemption for services has grown.

Components of Personal Consumption



- In 1998, the Department of Taxation reported that the revenue impact of these broad service exemptions was $1.1 billion. [Note: This does not include the exemptions for Internet services that were enacted in 1998.]

• Virginia's sales and use tax continues to reach fewer services than most other states.

- Virginia sales tax is applied to 18 services in 2000, according to the Research Institute of America.

Revenue Impact of Certain Service Exemptions from the Sales Tax -- FY 1999

Service Category	Revenue Impact (in millions)
Travel Arrangements/Services	$ 3.1
Barber/Beauty Shops	244.2
Laundry and Dry Cleaning	15.8
Janitorial and Building Maintenance	26.2
Lawn Care	20.3
Cable and Other Pay TV	2.1
Telephone Services	143.9
Amusement Parts	4.9
Movie Theaters	5.1
Accountants	23.6
Engineers	108.4
Health Professionals	253.5
Legal	71.3
Bank Service Charges	18.3
Computer Software Modifications & Programs	68.9
Total-All Service Exemptions	$1,116.6

- The national average for services taxed is 53.

- The state-to-state variation ranges from no taxation of services in Oregon to 157 taxed in Hawaii.

2) Increasing Number of Sales Tax Exemptions

- In recent years, a growing number of sales tax exemptions have been enacted -- broad-based, special purpose, and narrow.

- Broad-based exemptions include:

  - Non-prescription drugs (enacted in 1990; implemented in 1996), with a state fiscal impact of about $12.1 million per year; and

  - The phased reduction of the sales tax on food from 3.5 to 2.0 percent, each year there is a revenue surplus of at least 1 percent (about $63 million a year for the first .5 percent reduction).

- A number of recent special purpose exemptions granted reflect the changing nature of economic activity. Included in this category are exemptions granted for the sale of:

  - tangible personal property used in basic research or research and development in the experimental or laboratory sense.

  - high speed electrostatic duplicators or any other duplicators that have a printing capacity of 4,000 impressions or more per hour.

  - sub-orbital space facility, space propulsion system, space vehicle, satellite, or space station of any kind.

- Finally, the number of non-profit organizations requesting a sales and use tax exemption continue to grow.

- In 1989, a concerted effort was made to limit the number of exemptions. [Senator Colgan chaired this effort.]

  -- New processes were put in place for considering requests, including a questionnaire requirement, sunset dates, and a <u>Code</u> requirement that exemptions only be considered during long sessions [*The sunset date and long session requirement have been repealed*].

- Nevertheless, exemptions continue to proliferate.

  -- Since 1990, 282 non-profit organizational exemptions from the sales tax have been granted. Of those, 260 have been granted since 1995.

- In 1999, the estimated impact of non-profit organizational exemptions was $11.7 million. Since then, another $1.1 million in exemptions have been added.

Sales Tax Exemptions Granted for Non-Profit Organizations 1990-2000

	Total		Total
1990	9	1996	2
1991	11	1997	56
1992	0	1998	61
1993	0	1999	0
1994	1	2000	76
1995	66		

Total 282

3) The Growth of Catalog and Internet Sales

- Under current Virginia law, Virginia residents who purchase goods from out-of-state vendors are required to report the sale and pay a use tax on purchases.

  - The tax is considered a complement to the sales tax.

  - The original purpose of the tax was to prevent the sales tax from placing Virginia retailers at a competitive disadvantage with retailers located outside of Virginia.

- While Virginia residents are required under law to pay the tax, out-of-state vendors are **not required to collect** the tax.

  -- The U.S. Supreme Court's decision in National Bellas Hess v. Illinois Dept. of Revenue prevents states from requiring the collection of sales tax from out-of-state dealers which have no physical presence ("nexus") within the state.

-- The U.S. Supreme Court effectively re-affirmed its decision in 1992 by deciding not to review a North Dakota court ruling in Quill Corp. v. North Dakota.

- While some out-of-state dealers voluntarily collect and remit sales tax, most refuse to collect the tax. As a result, catalog purchases form out-of-state vendors go largely uncollected.
  - Nationally, mail order catalog sales total an estimated \$55 billion a year with lost state sales tax revenue reaching \$3 to \$5 billion.
  - For tax year 1999, 11,418 individuals paid \$698,800 in Virginia use tax.
  - The payment of use tax by businesses is enforced through periodic sales and use tax audits and by voluntary reporting -- \$251 million was collected in 1999.

- Congressional action placing a limited moratorium on taxing sales of goods over the Internet is an extension of this basic trend.
  - The impact of Internet sales is unknown.
  - More than 90 percent of Internet sales are expected to be business to business in 2003.

The Future of the Virginia's Sales Tax

- As the economy continues to evolve, the nature and scope of Virginia's sales tax will be a central tax policy issue.

- It seems likely that Virginia's sales tax base will continue to narrow.

  - The growth of services is a long-term secular trend which seems related more to lifestyle changes than basic economic conditions.

  - Absent some action, the number of sales tax exemptions requested will continue.

    -- The food tax reduction will eventually reach its full 2 percent.

  - More and more transactions considered retails sales under current rules will seek re-classification as exempt transactions.

    -- AOL exemption; Framatome Technologies, Inc.; and modular housing manufacturers are recent examples.

  - The growth of Internet and catalog sales will continue.

  - Finally, the changing dynamics of business activity will also have a significant impact.

Recent Tax Policy Actions Taken by the General Assembly

- There has been a significant increase in the number of new tax preferences granted.

  – 47 of the 72 tax preferences identified have been enacted since 1995.

    – – 8 new tax preferences were enacted in 2000 (Holocaust victims, Congressional Medal of Honor recipients, low-income taxpayers, sales tax revenue for City of Hampton bonds, natural gas deregulation, partial sale exclusion for the sale of modular buildings, forested buffers tax credit, tobacco farmers)

- Tax preferences have been targeted (granting relief to specific industries) as opposed to broad-based (benefiting all citizens).

  – Of the 72 tax preferences identified, only 3 are broad-based (personal property tax relief, non-prescription drugs sales tax exemption, elimination of the state sales tax on food).

- Of the 72 tax preferences, 25 benefit individuals, 23 benefit businesses, and 24 benefit both.

- Of the 72 tax preferences, 34 are tax credits, 16 are subtractions, 10 reflect sales and use tax relief, and 5 are income tax deductions.

- There is much variety among the tax credits.

  - Sunset dates - 10 of the tax credits have sunset dates, 24 do not.

  - Redeemability - 3 of the tax credits are redeemable.

  - Carryovers

Carryover Periods

Years	Number of Credits
3	4
5	15
10	3
15	1
20	1
No carryover	9

  - Exclusivity - only a handful of the credits have restrictions on claiming other credits.

  - Agreements on the amount of credit - two of the tax credits determine the amount of the credit based upon agreements between the Commonwealth and the investing business (business tax credit and real property investment tax credit for large firms under the Enterprise Zone Act).

-- Percentage of allowable costs for tax credits:

Percent	Number of Credits
5%	1
10%	3
20%	2
25%	6
30%	2
45%	1
50%	5
100%	4
Other basis	11

- There is a demonstrated tendency to revisit certain tax preferences over and over.

  - Prepaid tuition contracts - enacted in 1997, and amended in 1998, 1999, and 2000.

  - Tax credit for taxes paid to other states - enacted in 1972 and amended in 1994 and 1999.

- There is apparent movement away from conformity with federal law.

  - Non-itemizers and those who cannot itemize total costs incurred can do so on Virginia's individual income tax return (e.g. Virginia Public School Construction Grants Program and Fund, deduction for continuing education costs, deduction for child and dependent care services).

  - 3 new subtractions from federal adjusted gross income added in 2000 alone (subtractions for Holocaust victims, Congressional Medal of Honor recipients, and settlement payments to tobacco farmers).

- A number of new tax preferences are deferred and made conditional upon revenue forecasts being met as opposed to "pay as you go".

  – Subtraction for military wages, subtraction for federal and state employee wages, subtraction for unemployment compensation, food tax relief, personal property tax relief, double-weighted sales factor for corporate income taxes, additional withholding allowances, tax credit for land preservation.

- Deregulation in certain industries has led to a change from gross receipts taxation to net income taxation.

  – Telecommunications, natural gas, and electricity providers are now taxed on net income.