Overview of Budgetary Policy and Governor's Tax Reform Proposals

Combating a national downturn in the economy

From the outset, Virginia's 2002-2004 biennial budget was challenged by a national economy that was falling into recession and the "wash out" of the stock market bubble. Even though the state's revenue estimates were significantly lowered during the 2002 General Assembly session, it was apparent by May 2002 that the state would experience a revenue shortfall for fiscal year 2002. That shortfall ($216 million) was covered by cash reserves at the end of the year that were obligated in future years. Hence, a budgetary shortfall rolled forward into the 2002-2004 biennium as an immediate fiscal problem.

Given the size of the revenue shortfall in fiscal year 2002, there was also no escape from the conclusion that economic growth in Virginia was significantly weaker than what was assumed in the budget for the 2002-2004 biennium. A reforecast of general fund revenues for the biennium substantiated that outcome. By the end of the 2003 legislative session, Governor Warner and the General Assembly had to deal with a total budgetary shortfall of almost $6.0 billion accumulated from the downward spiral of events affecting the three-year period in 2002, 2003, and 2004.

To balance the budget, the Governor and the General Assembly cut spending by a combination of across-the-board and targeted budget reductions (averaging 20 percent on state agencies), by initiating government-wide efficiencies in the areas of technology and procurement, and by imposing limited fees on certain services. The state workforce shrank by 4,200 employees from the level it registered when the Governor was inaugurated and 12 agencies and 58 boards and commissions in state government were eliminated. In essence, the budget challenge was met principally by an effort to reduce state spending wherever possible and to streamline state government operations. Taxes were not raised.

Closing out fiscal year 2003

The resolve of Governor Warner and the General Assembly paid off during fiscal year 2003. Last August, the Governor announced that preliminary year-end results for 2003 indicated that general fund revenue, including lottery proceeds and other transfers, exceeded the official revenue estimate for the year by $55 million—the first revenue surplus since 2000. This resulted in a positive budgetary balance sheet, despite the worst economic conditions in well over a decade.

Looking ahead to the 2004-2006 biennium

The fiscal struggles of state governments during fiscal years 2002 and 2003 prompted the federal government to get involved. The Jobs and Growth Tax Relief Reconciliation Act of 2003 provided temporary, but significant, relief to the states in the form of federal flexible grants that could be spent on essential, budgeted services and increased reimbursements for the Medicaid program over a 15-month period. Virginia's benefit from this federal action is projected to amount to about $400 million during the state's fiscal year 2004. When coupled with the positive results from the end of fiscal year 2003, the bottom line is one of optimism for 2004. Indeed, the amended budget introduced for the last six months of the 2002-2004 biennium projects a budgetary balance of $358.4 million on June 30, 2004, as the Commonwealth begins the 2004-2006 biennium.

While such projections for fiscal year 2004 are welcome news, they are temporary. The increased federal aid from the Jobs and Growth Tax Relief Reconciliation Act of 2003 is expected to end in fiscal year 2004 and it is readily apparent that no extension is in the offing. Moreover, Virginia faces major cost increases starting in 2005:

- as the state's share of cost of the Standards of Quality for public education is re-calibrated for the 2004-2006 biennium,
- as higher education enrollment continues to increase,
- as the medical costs that drive the funding of Medicaid and health insurance for state employees rise faster than general inflation,
- as the state responsible offender population in the correctional system begins to increase,
- as car tax refunds continue to go up, and
- as other demands for public sector services come to the forefront with the expectations of better economic times.

Rising costs and spending pressures on state government overshadow the slowly improving economy.

Independent fiscal projections in the fall of 2003 indicated that the state faces a budgetary shortfall in excess of $1.0 billion in 2004-2006, despite a recovery in the state's economy. These projections assumed consistent economic growth in every year during the projection period and no funding for new programs or initiatives. For example, under the projections, car tax refunds are held at the current 70 percent level rather than moving to a 100 percent as promised, and no attempt is made to reduce the sales tax on food from its present level even though current law calls for a roll back over time.

The fiscal pictures presented by these independent projections are important because none suggest that dramatic cuts in state spending will correct the long-term fiscal problem facing the state. If the car tax and food tax commitments are kept, as required by law, and the budget is reduced by $1.0 billion or more to address the immediate imbalance, the divergence between resources and spending would recur in future years as spending growth for core services and commitments continues to outpace the growth in projected resources. This happens because the revenue side of the equation continues to absorb the impact of 50 different tax breaks granted since 1995. Many of these breaks grow over time, thereby reducing the growth of revenue just as pressures on the spending side of the equation escalate.

Therefore, to address the longer-term structural imbalance in the budget, Governor Warner is proposing a package of tax reform actions as the centerpiece of his budgetary policy.

Reforming Virginia's tax structure

Early in 2003, Governor Warner re-affirmed the view that tax reform should be a top priority for the 2004 legislative session. Numerous gubernatorial and legislative commissions had concluded that Virginia's tax code was in need of serious re-examination. Among the issues cited are that:

- Virginia is too dependent on the individual income tax, which comprises about 62 percent of general fund revenues – a percentage that has been steadily increasing over the last 30 years. Only three other states are more dependent on individual income tax than Virginia.
- Key features of the individual income tax have been unchanged for almost 20 years; the bottom two income tax brackets have remained unchanged since 1926.
- Virginia's top marginal income tax rate of 5.75 percent begins at $17,000 – below the poverty level for a family of four.
- Analysis of Virginia's income tax compared to the 42 states that levy a broad-based income tax showed that Virginia's income tax places higher tax burdens on middle income individuals and families compared to most other states, and lower income tax burdens on upper income individuals and families.
- Over the past five years, over 50 tax preferences have been added to the tax code, mak-

ing tax laws more complicated, shifting the tax burden from more favored groups and behaviors to less favored groups and behaviors, and making compliance with tax laws more complicated for citizens.

- Corporate tax loopholes have enabled large multi-state corporations to avoid paying Virginia corporate income taxes, even though they earned substantial profits on activity in Virginia. In 1999 – one of the peak years of the economic boom – 21 of the top 50 corporate employers subject to the corporate income tax paid no corporate income tax in Virginia.
- Virginia's sales and use tax is levied almost exclusively on goods, while Virginia's economy is becoming increasingly services-driven.
- Virginia's necessary decision to de-conform from federal tax provisions, which would have had a negative impact of more than $300 million during the most serious fiscal crisis in at least two decades, was creating hardships for many small businesses.

Against the backdrop of substantial prior analysis that had been conducted on Virginia's tax code by both gubernatorial and legislative commissions was the recognition that Virginia would face a budget shortfall of more than $1.0 billion during the 2004-06 biennium, and continuing budget shortfalls through the remainder of this decade, caused principally by:

- Resurgent growth of eight percent per year in Medicaid, over 70 percent of which is spent to provide long-term care for the elderly, blind, and disabled;
- The Commonwealth's constitutional commitment to fund the Standards of Quality, and the reality that over 100,000 new students would enroll in public schools by the end of the decade;
- Projected average growth of more than four percent per year in the number of adult inmates, at a time when prison capacity is seriously stressed;
- Continuing growth in the number of vehicles and the value of cars, which would together combine to swell the cost of personal property tax relief, even at the current reimbursement level of 70 percent;
- Aging roadways that require increasing maintenance, depleting resources originally intended for construction; and
- The continuing effect of absorbing the fiscal impact of the 50 different tax preferences granted since 1995, many of which grow over time.

Objectives of tax reform

Given these conditions, Governor Warner resolved to develop a tax reform plan that would meet three fundamental objectives:

1. Make Virginia's tax code fairer,
2. Preserve Virginia's fiscal integrity, and
3. Keep the Commonwealth's commitment to education.

In late November, Governor Warner announced a tax reform plan that would meet those objectives. Through the plan, an estimated 65 percent of Virginia's working individuals and families would receive tax relief. Key features of the plan include:

- Lowering the income tax for most Virginians.
- Reducing the food tax by 1.5 cents and adding one cent to the sales tax.
- Closing corporate loopholes.
- Increasing Virginia's lowest-in-the-nation state cigarette tax to pay for health care needs, and giving counties the ability to levy an additional tax, up to a cap.
- Fulfilling the promise to end the car tax.
- Eliminating the estate tax for working farms and family-owned businesses.
- Ending the unfair accelerated sales tax collection for retailers.
- Providing incentives for small and mid-size businesses to invest.

- Proposing reforms to the age deduction provided to seniors, while preserving the tax benefit for current seniors.
- Easing the tax burden on military, reservists, and National Guard families.
- Streamlining collection of the state sales tax.

These key features are summarized in the attached table.

Incorporating tax reform into the budget

With the tax reform package, the Governor's budget recommendations for the 2004-2006 biennium preserve core services in state government while they address the longer term issue of structural balance. Moreover, the budget recommendations continue efforts to capture efficiencies and to streamline state government operations with savings and spending reductions totaling $184.3 million in savings for the biennium.

The most significant budgetary actions include:

- Funding the Standards of Quality for elementary and secondary education;
- Providing for enrollment growth and base adequacy at the institutions of higher education;
- Covering Medicaid inflation and utilization growth and rebasing provider reimbursement;
- Returning the insurance license tax revenues premium tax to the Priority Transportation Fund, as promised;
- Funding the debt service requirements for projects approved by the last two sessions of the General Assembly; and
- Maintaining the required contributions to the employee retirement and employee health insurance plans.

In addition, steps are taken to replenish the state's rainy day or Revenue Stabilization Fund. The withdrawal planned from the fund in fiscal year 2004 ($128.5 million) is eliminated and another deposit ($87 million) is made to the Fund in fiscal year 2006. At the end of the 2004-2006 biennium, the balance in the fund is thereby projected to increase to more than $350 million, including interest.

Individual Income Tax

Effective January 1, 2005 unless otherwise noted

Item	Current Structure	Governor Warner's Plan
Personal and Dependent Exemption	$800	$1,000
Standard Deduction ***Single*** ***Married Filing Jointly*** ***Married Filing Separately***	 $3,000 $5,000 $2,500	 $4,000 $8,000 $4,000
Rates and Brackets For taxable income:	 $0-$3,000 2% $3,001-$5,000 3% $5,001-$17,000 5% $17,001-over 5.75%	 $0-$3,000 2% $3,001-$7,000 3% $7,001-$20,000 5% $20,001-$100,000 5.75% $100,001-Over 6.25%
Filing Threshold ***Single*** ***Married Filing Jointly*** ***Married Filing Separately***	 $5,000 $8,000 $4,000	 $7,000 $14,000 $7,000
Age Deduction	$12,000 for individuals 65 or older and $6,000 for individuals age 62 through 64, regardless of income	Individuals currently receiving the $12,000 deduction (i.e., are currently at least 65) are **not** affected. Filers who turn 65 on or after January 1, 2005 will receive an age deduction based on their income. The age deduction for these individuals will be reduced by $1 for every $2 above $50,000. Married couples who turn 65 on or after January 1, 2005 will reduce their deduction by $1 for every $2 above $75,000. The current $6,000 deduction for individuals who are 62-64 may be claimed only by filers who turn 62 on or before January 1, 2005.
Military Family Tax Relief Act	Virginia does not conform	Virginia will conform for all affected tax years -- allowing federal tax relief to apply to the Virginia income tax. Examples of this tax relief are a deduction that allows people who serve in the National Guard to deduct up to $1,500 in expenses for overnight travel associated with their duty, and a capital gain exclusion for military personnel who sell a home owned for less than two years.

Sales Tax

Item	Current Structure	Governor Warner's Plan
Sales Tax	Current combined state and local rate of 4.5%	1% increase in sales tax, excluding food, to a combined state and local rate of 5.5% effective July 1, 2004.
Sales Tax on Food	Current combined state and local rate of 4.0%	1% reduction in food tax rate, effective July 1, 2004; an additional 0.5% reduction in food tax rate, effective July 1, 2005.
Streamlined Sales Tax Statute	Virginia has not adopted the provisions of the multi-state Streamlined Sales Tax agreement, which is intended to simplify and standardize sales tax laws across the states.	Adopt the Streamlined Sales Tax (SSTP) statute (without the sourcing rules), effective July 1, 2006. This does not allow taxing of access to the Internet. If Congress enacts legislation, the SSTP would allow states to collect sales taxes on goods purchased over the Internet. Under existing state law, sales taxes are owed on Internet purchases, but states have no means to ensure collection.

Business Tax Provisions

Effective January 1, 2004 unless otherwise noted

Item	Current Structure	Governor Warner's Plan
Accelerated Sales Tax Collections	Sales tax dealers with annual sales of $1.3 million or more must make a prepayment in June of 90% of their June sales tax liability.	This requirement is repealed, effective July 1, 2004. Affected dealers will not have to make an accelerated payment in June 2005.
Close Intangible Holding Company Loophole	Virginia must currently prove that transactions with intangible holding companies improperly reflect Virginia income.	Effects of transactions with intangible holding companies will be eliminated from the corporate income tax computation.
Eliminate "nowhere income" loophole by adopting a "sales throwback" rule	Virginia currently does not require that sales shipped from a Virginia site be included in computing Virginia tax if the corporation is not subject to tax in other states.	The sales throwback rule would treat sales made into states where the corporation is not taxable as Virginia sales, ensuring that profits from goods shipped from Virginia are taxed in Virginia, unless they are taxed in another state.

Item	Current Structure	Governor Warner's Plan
Pass-Through Entities	Currently, federal law provides that pass-through entities be taxed at the ownership level. However, most are not required to provide information to Virginia that identifies their owners. At present, only S corporations are required to file an annual informational income tax return with Virginia.	All other pass-through entities (partnerships & limited liability companies) will be required to file an annual informational income tax return with Virginia.
Deductions for Equipment Purchases (Federal Conformity to § 179 Expensing)	Virginia allows businesses to deduct as a business expense up to $25,000 in equipment or similar purchases.	Virginia will conform to new federal law for all affected tax years, allowing businesses to deduct up to $100,000 in equipment or similar purchases each year.

Other Tax Reform Provisions

Effective January 1, 2004 unless otherwise noted

Item	Current Structure	Governor Warner's Plan
State Cigarette Tax	Rate of 2.5 cents per pack	Increase rate by 22.5 cents to a total of 25 cents per pack, effective July 1, 2004.
Local Cigarette Tax	Authority to impose is limited to cities, towns, and two counties.	Allow all localities to impose a cigarette tax up to a maximum rate of 50 cents per pack. Localities currently levying the tax at a rate above 50 cents per pack may continue to levy their existing tax, but may not increase it. Counties will be given authority to levy a local cigarette tax in increasing amounts over three years: July 1, 2004 – up to 20 cents per pack (cpp) July 1, 2005 – up to a total of 35 cpp July 1, 2006 – up to a total of 50 cpp
Car Tax Relief	Reimbursements are currently frozen at 70% of liability.	Increase reimbursements to 77.5% for CY 2005, 85% for CY 2006, 92.5% for CY 2007, and 100% for CY 2008, subject to the same conditions as are in the Code of Virginia now for revenue growth.

Item	Current Structure	Governor Warner's Plan
Estate Tax	Tax is imposed on the transfer of taxable estates in excess of $1.5 million.	Effective for deaths occurring on and after January 1, 2004, the tax is imposed only on the transfer of taxable estates in excess of $10 million. No tax is imposed on estates if the majority of the estate consists of an interest in a closely held business or a working farm.