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Virginia Tax Re-Structuring: 100 Years Ago, 50 Years Ago, and Now

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VIRGINIA TAX RE-STRUCTURING: 100 YEARS AGO, 50 YEARS AGO, AND NOW

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ABSTRACT

Virginia's state and local financing structure is under pressure. Aged schools have fallen into disrepair in localities without a tax base to back capital improvement bonds. Virginia's commitment in the wake of Brown v. Board of Education to fund equal public education opportunity for all has eroded. As the dominate source of local government funding, the real estate tax adds to housing costs, consuming the largest share of household budgets. This article discusses current and historic Virginia debates on tax equity, economic sustainability, program ramifications, and non-resident cost-sharing. It raises questions about the widening income gap and changes in business activity, as well as Virginia's extreme cost-of-living spread and its fifty-year-old economic measure that determines the level of state funding for each locality's schools. The article provides broad context to help balance tax policy goals, political dynamics, and local realities in the informed debate that needs to take place to support enlightened action by the Virginia General Assembly.

INTRODUCTION

The axiom "taxes are what we pay for civilized society"[1] is usually attributed to Justice Oliver Wendell Holmes although it was not original to him. An earlier version appeared in an 1866 book on Christian ethics: "A man's taxes are what he pays for the protection of his life and property, and for the conditions of public prosperity in which he shares."[2]

I prefer the expanded version. It broadens the focus from an individual creating wealth by sheer force of personal effort to an individual's ability to produce wealth while being supported or limited by the human and physical infrastructure in which they operate. Too often, tax opponents narrowly define "civilized society" as just the first part of the expanded definition: "the protection of his life and property," provided by police, fire services, and courts. They gloss over the second part and the degree to which their prosperity is related to the "public prosperity in which [they] share," provided through education, transportation, and public health.

This discussion of Virginia's tax structure acknowledges that taxation is first and foremost a political exercise heavily influenced by the will of people who are taxed. Theoretically, taxes should be economically relevant, not administratively burdensome, and rationally related to ability-to-pay. In reality, however, our central tax structure does not change unless there is a political

[1] Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927).

[2] JOSEPH ALDEN, CHRISTIAN ETHICS OR THE SCIENCE OF DUTY 139 (Invision et al. eds., 1866).

perception that the change is more "fair" than current policy, and what is "fair" is definitely in the eye of the beholder.

The first tax study I did was as a citizen interested in funding schools. With that as my only vested interest, I concluded that no tax is fair. There was no obvious choice that was going to fund what I, the citizen, wanted. There were valid arguments against every tax. Someone is let off or someone pays too much. Equity can only be achieved when the overall tax structure balances the inequity in one tax with the different inequities in others. The broader the range of taxes, the fairer the overall tax burden carried by each taxpayer will be.

As a long-time elected official, I have learned a parallel lesson from one economic cycle after another. The narrower the range of taxes and the tax base they draw from, the tougher it is to budget responsibly. For example, Virginia benefits more than any other state from federal activity with 30% of its economy driven by federal contracts and employment.[3] Virginia's income tax revenue did not take as hard a hit as other states during the COVID-19 pandemic because the federal workforce centered around the nation's capital is management level with higher incomes and the ability to work from home. However, Virginia experienced the downside of this overdependence when congressional sequestration battles and federal budget cuts kept its economy flat in 2014 compared to 2.2% growth nationwide.[4]

In this article, I discuss the largest sources of Virginia state and local tax revenue through focusing on long-standing, key public policy debates on how to fund basic services throughout the Commonwealth. It is organized around funding issues rather than discussing state taxation and local taxation separately since program support is commonly a shared responsibility. In addition, as an article on tax policy—not just the politics of taxation—each section is a case study in principles of taxation that seldom have wide, informed discussion. Tax cuts make easy political stump speeches while, unfortunately, discussing tax reform is regarded as a third rail of politics that is sure to bring political defeat to those who get near it.

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3 Anne Stauffer & Justin Theal, *How Closely are State Economics Tied to Federal Spending*, PEW TRUST (Mar. 22, 2016), https://www.pewtrusts.org/en/research-and-analysis/articles/2016/03/22/how-closely-are-state-economies-tied-to-federal-spending.

4 JOINT ECONOMIC COMMITTEE, ECONOMIC SNAPSHOT: VIRGINIA (2015), https://www.jec.senate.gov/public/_cache/files/6d1ef336-f41f-4d36-87cb-14b1cce87a3d/virginia.pdf.

I. VIRGINIA'S CORE TAX STRUCTURE: ECONOMIC RELEVANCE

The major sources of state tax revenue for Virginia are the individual income tax (68.4%), the retail sales tax (17.1%), and the corporate income tax (7.4%).[5] Approximately two-thirds of this general tax revenue is used to support state services (except for transportation that is largely funded by dedicated taxes) with the remaining one-third sent to localities, largely to support K-12 education.[6]

The major sources of local revenue in Virginia are the real estate tax (52.1%); other property taxes such as the car tax and business equipment (15.8%); the retail sales tax (6.4%); miscellaneous taxes on business, restaurant meals, etc. (12.1%); and charges for services (8.6%).[7] However, these combined totals mask significant differences in the taxing powers of cities and towns compared to counties.

For the last 100 years, due to Governor Harry F. Byrd's government reforms in the late 1920s, counties have been tied to essentially a colonial tax base of taxing property wealth through the real estate tax and selected tangible property taxes.[8] An exception to the norm this created occurred fifty years ago, in 1966, when a one-cent local retail sales tax was extended to all localities.[9] However, under Byrd's reforms, other possible county taxes have had to be approved by voter referendum, which rarely have been successful.[10] Generally, voters will approve referendums to borrow money but not the taxes to repay it. Consequently, 73.2% of county tax revenue comes from property taxes, with 55.3% generated from taxing real estate and 17.8% from business equipment taxes and the car tax.[11]

In contrast to counties, Virginia cities and towns have long had the

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5 VA. DEP'T OF ACCOUNTS, MAY SUMMARY REPORT ON GENERAL FUND REVENUE COLLECTIONS FOR THE FISCAL YEARS 2021 AND 2022 1 (2022). Note: Throughout this article "retail sales tax" includes "use tax" as it is authorized in Chapter 6 "Retail Sales and Use Tax" of Title 58.1 of the Code of Virginia. VA. CODE ANN. § 58.1-602 (Va. Current through 2022 Spec. Sess. I) (effective until Oct. 1, 2022).

6 H.D. 30, Item 137, Gen. Assemb., 2022 Spec. Sess. I (Va. 2022) (reenrolled).

7 STACI A. HENSHAW, COMPARATIVE REPORT OF LOCAL GOVERNMENT REVENUES AND EXPENDITURES YEAR ENDED JUNE 30, 2021 (2022) (assessing sources of local revenue from Exhibit B and Exhibit B-2). The 2020 General Assembly by passing Senate Bill 588 (Hanger) and House Bill 785 (Watts) finally removed most restrictions on county taxation. S. 588, Gen. Assemb., 2020 Session (Va. 2020); H.D. 785, Gen. Assemb., 2020 Session, (Va. 2020). However, actions by County boards of Supervisors will take time and the latest revenue figures available for this article do not reflect the expanded authority. HENSHAW, *supra.* (assessing sources of local revenue from Exhibit B and Exhibit B-2).

8 VA. DEP'T OF TAX'N, 2020 FISCAL IMPACT STATEMENT ON HB 785 at 2 (2020).

9 Michael S. Deeb & Stuart W. Connock, *Virginia's Sales Tax: Its Origins and Administration*, 46 U. VA. NEWSL. 8, 29 (1970).

10 Larry J. Sabato, THE 2002 U.S. SENATE AND CONGRESSIONAL ELECTIONS 193-95 (CTR. FOR POL. U. VA. ED., 2008).

11 HENSHAW, *supra* note 7.

authority to enact a number of taxes to fund general govern programs simply by the members of the municipality's council voting to do so.[12] These taxes now include a meals tax, hotel/motel room tax, tobacco tax, and amusement tax. Consequently, only 59.3% of city tax revenues comes from property taxes, with 47.1% generated from taxing real estate and 12.2% from business equipment taxes and the car tax.[13]

Taxing business activity is accomplished through a number of taxing and revenue sources at the state and local level. At the state level, the corporate income tax draws from both corporations headquartered in Virginia and from all national and international corporate operations whose activity in a given year has a connection (tax nexus) to Virginia.[14] Increasingly, provisions of Virginia's corporate tax structure reflect federal and international policies on allocating income of the total corporate activity to a given state or country and federal treatment of what is considered a corporate business expense and how it is taxed. Approximately 9% of the adjusted gross income ("AGI") taxed under Virginia's individual income tax is from the business income of partnerships, sole proprietors, and subchapter S-corporations.[15] At the local level, a variety of sources raise revenue from businesses including business license taxes (gross receipts tax), the personal property tax on equipment, machine and tools taxes, bank stock taxes, and fees for permitting and inspections.[16]

II. REAL ESTATE TAXES: CURRENT INCOME VS. WEALTH

The major strength of the real estate tax is its lack of loopholes. If you live or physically operate a business in a locality, the real estate tax assures you will be paying for that locality's services. This is equally true whether you own the real estate or you pay the tax as it is passed on to you in rent.

The major problem with Virginia's real estate tax is that it is based on the property's current market value, which may not reflect the owner's current wealth and ability-to-pay. The first section of Article X in the Virginia Constitution covering Taxation and Finance requires uniform tax rates "upon the

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12 VA. CODE ANN. § 15.2-1104 (2022).

13 HENSHAW, *supra* note 7.

14 *Corporation Income Tax*, VIRGINIA TAX, https://www.tax.virginia.gov/corporation-income-tax#:~:text=Every%20corporation%20that%20is%20incorporated,tax%20return%20(Form%20500) (last visited Sep. 11, 2022).

15 *SOI Tax Stats - Individual Income Tax Stats - 2019 Zip Code Data (SOI)*, IRS, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-statistics-2019-zip-code-data-soi (last visited Sep. 11, 2022).

16 VA. CODE ANN. § 58.1-3000 (2022); VA CODE ANN. § 15.2-900 (2022).

same class of subjects."[17] The real estate tax is a tax on property—not on the owner's income—and the rate must be the same across all property. This is a basic principle that has been in the Constitution since 1851.[18] Its purpose is to protect residents and businesses (collectively and individually) from paying higher taxes because of targeted political efforts by one group against another group to tax one group's property more or exclude them from tax breaks.[19]

There are three constitutional exceptions to real estate tax uniformity throughout Article X from amendments approved by statewide voter referendums.[20] In the first category, localities must totally exempt property owned by religious and non-profit entities, as well as the principal residence of veterans with a one hundred percent service-connected, permanent, and total disability or of the surviving spouse of those killed in action.[21] In addition, localities may exempt real estate taxes on the residence of a surviving spouse of a first responder killed in the line of duty.[22] The second category of exemptions provides an option for localities to promote redevelopment, land conservation, and pollution abatement by partially exempting real estate taxes.[23]

The third category of exemptions addresses the real estate tax's major weakness of not necessarily being related to ability-to-pay. A comprehensive rewrite of Virginia's constitution which became effective in 1971, for the first time, addressed this issue.[24] The rewrite included a new provision providing that localities could partially or wholly exempt the sole residence of low-income persons sixty-five or older. It is notable that this ability-to-pay provision helped gain voter support for the comprehensive constitutional reform[25] in the face of entrenched opposition to other provisions that were drafted to ensure public schools could never again be closed as they had been during the recently ended decade of Massive Resistance to court-ordered school integration.[26]

Within five years of passing this real estate tax relief for low-income

17 VA. CONST. art. X, § 1.

18 Documentary Supplement, *The Virginia Constitution*, 10 WM. & MARY L. REV. 511, 538-39 (1968).

19 *See* Int'l Paper Co. v. Cnty. Of Isle of Wright, 299 Va. 150, 178 (2020).

20 VA. CONST. art. X, §§ 6-6B.

21 *Id.* art. X, §§ 6(a)(2), 6-A.

22 *Id.* art. X, §§ 6(b), 6-B.

23 *Id.* art. X, §§ 6(d), (h).

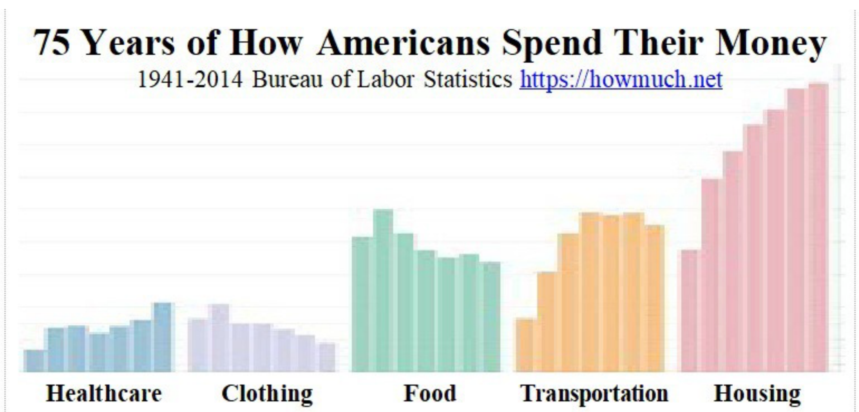
24 A.E. Dick Howard, *Constitutional Revision: Virginia and the Nation*, 9 U. RICH. L. REV. 1, 41-42 (1974).

25 *Id.* at 17.

26 *Id.* at 40.

seniors, relief was also extended to permanently and totally disabled low-income persons.[27] In the almost fifty years since, most local governments have enacted some degree of relief for these two specific groups of low-income residents. Currently, the definition of low-income elderly or disabled, as set by the General Assembly, is up to $75,000 AGI for a married couple and $50,000 for a single homeowner.[28] However, most localities set their income limits below these maximums because revenue losses from expanding the relief would be too great and result in higher real estate tax rate for others.

Virginia's Constitution also requires real estate taxes be applied to the fair market value of the property and state law requires frequent reassessments to keep the values used up-to-date.[29] Relentless increase in housing prices has been the driving force behind housing taking an ever greater share of household income as dramatically shown in the chart "75 Years of How Americans Spend Their Money."[30]



The real estate tax equity problem stemming from housing costs rising faster than income is now endemic. Cost increases are not just about new construction delays related to COVID-19 or about the "McMansions" reflecting what those on the plus side of America's widening wealth gap can spend.

27 City of Virginia Beach Citizen's Taskforce, *Report on the Tax Relief for the Elderly and Disabled Program*, VBGOV.COM 2 (2015), https://www.vbgov.com/government/departments/city-clerk/mayor/Documents/Tax%20Relief%20Elderly_Disabled/01-24-15%20Report%20Relief%20For%20Elderly%20%20Disabled.pdf.

28 *Virginia Subtractions from Income*, VIRGINIA TAX, https://www.tax.virginia.gov/subtractions (last visited Aug. 29, 2022).

29 VA. CONST. art. X, § 1; VA. CODE ANN. § 58.1-3250 (2022)

30 *Unprecedented Spending Trends in America in One Chart*, HOWMUCH, https://howmuch.net/articles/american-spending-past-75-years (last visited Aug. 28, 2022).

The increase in cost of housing actually began with the pent-up demand following World War II and was intensified by the demand for housing as baby boomers started their own families.[31] The result is that, today, ever-escalating housing prices are directly related to the cumulative lack of low-cost housing that has a ripple effect bumping up the price of all low and middle-income housing.[32]

Renters are even more severely impacted because their monthly housing costs are not fixed to the degree that homeowners' mortgage payments are. Between 2013 and 2017, in Virginia, approximately half of rental households were paying 30% or more of their income towards rent with roughly one in five spending more than 50%.[33]

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III. MEALS, HOTEL/MOTEL ROOMS, TOBACCO, AND AMUSEMENT TAXES: REVENUE FROM NON-RESIDENTS AND DISCRETIONARY SPENDING

Although neither cities nor counties can tax income, the taxes that cities have long had the authority to enact—without a referendum and without rate limits—are significantly more related to ability-to-pay than the real estate tax. The taxes on meals, hotel rooms, tobacco, and entertainment events not only tap discretionary spending, but can be a significant source of revenue from non-residents, thus relieving the tax burden on residents.

Decades ago, cities were the center of commerce and their taxing authority reflected that reality. County residents coming into town to shop or work increased the need for services—and it was politically convenient, if not justified, to get tax revenue from these non-residents. Now, hubs of commerce

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31 *75 Years of the GI Bill: How Transformative It's Been*, U.S. DEP'T OF DEFENSE (Jan. 9, 2019), https://www.defense.gov/News/Feature-Stories/story/Article/1727086/75-years-of-the-gi-bill-how-transformative-its-been/.

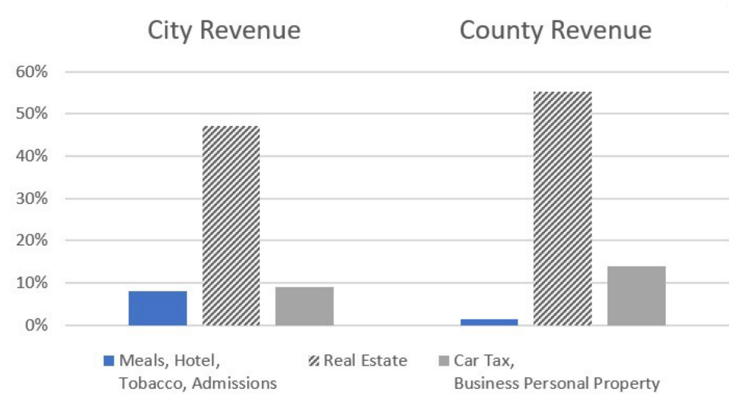
32 JLARC, AFFORDABLE HOUSING IN VIRGINIA (2020). http://jlarc.virginia.gov/landing-2021-affordable-housing-in-virginia.asp.

33 VA. DEP'T OF HOUS. AND CMTY DEV., INITIAL ANALYSIS AND RECOMMENDATIONS TO REDUCE EVICTIONS IN VIRGINIA 5 (2020), https://www.dhcd.virginia.gov/sites/default/files/Docx/verp/evictions-initial-analysis-and-recommendations.pdf.

34 *Id.*

draw from well beyond their location and, increasingly, are found outside cities. Whether it is Fairfax County's Tysons Corner mixed use development (which was the twelfth largest employment center in the nation in 2008), suburban shopping malls, or fast-food stops lining Virginia's interstate corridors, all of them represent the potential for real estate tax relief from taxes on non-residents.

Counties are now home to 70% of Virginia's population.[35] The largest counties dwarf most cities. Of the ten most populous jurisdictions, only four are cities.[36] In part because of this shift, the 2020 General Assembly finally gave counties the funding options that cities have had to raise general fund revenue from taxing restaurant meals, hotel and motel stays (transient occupancy tax), tobacco, and event admissions.[37]



As shown in the chart above[38], these taxes have reduced the pressure on cities to increase real estate and car tax rates, as opposed to counties having to draw upon those major sources as the only rates a county had authority to adjust.[39] To get the "equal" taxing authority legislation passed in 2020, the tax rates that counties now have the authority to enact were capped at forty cents a pack on cigarettes, 6% on meals, 10% on admissions, and counties were required to spend the first 3% of any hotel/motel tax rate on tourism

35 *July 1, 2021 Population Estimates for Virginia and its Counties and Cities*, WELDON COOPER CTR. FOR PUB. SERV. (Jan. 2022), https://demographics.coopercenter.org/sites/demographics/files/media/files/2022-01/PopulationEstimates_July2021_VA_CooperCenter_0.pdf.

36 *Virginia Counties (Ranked by 2020 Total Population),* U.S. CENSUS BUREAU (2020), https://public.tableau.com/shared/Y2C32Z6WK?:showVizHome=no.

37 VA. CODE ANN. § 58.1-3819 (2021).

38 HENSHAW, *supra* note 7. (Derived using data in Exhibit B and Exhibit B-2).

39 *See id.*

before a rate over 3% can used for other government functions.[40] In contrast, cities and towns retain the unlimited authority they have enjoyed for the last century. Nevertheless, rather than the colonial focus on property wealth, all localities now have the authority to enact taxes more in keeping with their local economy and to address the ability-to-pay of their residents through taxes on discretionary spending and non-residents.

Of the four taxes that counties can now enact to relieve the pressure on the real estate tax, by far the largest revenue producer is the meals tax. All cities have a meals tax and it generates almost 6.9% of city tax revenue.[41] In contrast, currently, the meals tax generates only 1% of county tax revenue, due to the fact that only six counties with populations over 100,000 have a meals tax (Henrico, Arlington, Stafford, Spotsylvania, Albemarle, and Montgomery).[42]

IV. THE MAKE-UP OF RETAIL SALES TAXES IN VIRGINIA: GENERAL VS. DEDICATED TAXES

In the 2022 General Assembly Session, Virginia's retail sales tax was the focus of great debate.[43] Both the outgoing Democratic governor, Ralph Northam, and the incoming Republican governor, Glenn Youngkin, supported fully ending the sales tax on groceries as had many legislators and governors before them.[44] In 2022, there was a unique, very large budget surplus that seemed to have the potential to finally make this progressive reform possible.[45]

In 2005, the portion of the tax on groceries was removed which was levied

[40] H.D. 785, 2020 Gen. Assemb., Reg. Sess. (Va. 2020); S. 588, 2020 Gen. Assemb., Reg. Sess. (Va. 2020).

[41] HENSHAW, *supra* note 7 (Derived by dividing meals tax revenue of $408.4 billion collected by cities in Exhibit B-2 by total tax revenue of $5.9 trillion collected by cities in Exhibit B).

[42] *Id.* (Derived by dividing meals tax revenue of $142.3 billion collected by counties in Exhibit B-2 by total tax revenue of $14.2 trillion collected by counties in Exhibit B).

[43] Jenna Zibton, *Virginia Lawmakers Talk About Success, Challenges While Budget is Still in Limbo*, WSLS 10 NEWS (Apr. 19, 2022, 1:25 PM) https://www.wsls.com/news/local/2022/04/19/virginia-lawmakers-talk-about-success-challenges-while-budget-is-still-in-limbo/.

[44] Gregory S. Schnieder, *Northam Proposes Scrapping Virginia Grocery Tax and Sending One-Time Rebates to Taxpayers*, THE WASH. POST (Dec. 14, 2021), https://www.washingtonpost.com/dc-md-va/2021/12/14/northam-grocery-tax-cuts-budget/.

[45] Press Release, Glenn Yougnkin, Virginia General Fund Finishes the Fiscal Year 2022 with Surplus of Nearly $2 Billion, GOVERNOR OF VA. GLENN YOUNGKIN (July 21, 2022), https://www.governor.virginia.gov/newsroom/news-releases/2022/july/name-937532-en.html#:~:text=Virginia%20General%20Fund%20Finishes%20the,billion%20general%20fund%20revenue%20surplus.

under the state sales tax used for general fund appropriation.[46] The renewed attempt to remove the remaining 2.5-cents tax on groceries raised challenging problems rooted in the historic policy decisions of why each of the three dedicated portions of the 2.5-cents were originally adopted. As will be discussed in the following sections: 1-cent was adopted to guarantee funding of public schools; 1-cent to address local needs while maintaining a statewide uniform rate; and 0.5-cents to address the inadequacy of funding all transportation infrastructure by the gas tax.

V. 1-CENT OF THE STATE RETAIL SALES TAX: GUARANTEED PUBLIC SCHOOL FUNDING

In 1966, enacting a sales tax was a major break with Virginia's racial past that had culminated in Massive Resistance to school integration. In 1954, the United States Supreme Court ended separate-but-equal public education through Brown v. Board of Education of Topeka. The reaction throughout Virginia, especially in rural areas, was to abandon public schools rather than integrate.[47] Under an official doctrine labeled "Massive Resistance," the Governor and General Assembly cut off state funds and closed any public school that attempted to integrate and supported private schools with state tuition grants.[48] Although most localities kept their segregated public schools open, Prince Edward County did not reopen its public schools on an integrated basis until 1964, when the U.S. Supreme Court unanimously outlawed Virginia's tuition grants to private education.[49]

It was auspicious that the next session of the General Assembly after the U.S. Supreme Court ended Massive Resistance was shaped by another 1964 landmark decision, *Reynolds v. Sims*,[50] that required state legislatures to be apportioned roughly on the basis of population. Under a new one-man-one-vote apportionment, the November 1965 election added a total of twenty-

[46] The rate in most of Virginia is 5.3 cents composed of a total 4.3-cent state tax and a 1- cent local tax. In addition, in certain regions the total rate is 6 cents with the additional 0.7 cents for transportation; in specific counties the total rate is 6.3 cents with the additional 1 cent for school capital; and in the Historic Triangle the total rate is 7 cents with the additional for three separate purposes. VA. DEP'T TAX., Retail Sales and Use Tax, Bulletin No. VTB 05-7 (2005), 2005 Va. Tax LEXIS 79 at *1-2.

[47] Harrison v. Day, 106 S.E.2d 636, 639-640 (Va. App. 1959) (summarizing the purpose of the challenged legislation).

[48] *Massive Resistance Time Period 1925 to Today*, VA. MUSEUM OF HIST. AND CULTURE, https://virginiahistory.org/learn/historical-book/chapter/massive-resistance (last visited Sep. 4, 2022).

[49] Griffin v. County School Bd. of Prince Edward County, 377 U.S. 218, 233 (1964) (holding that federal courts were proper in enjoining Virginia from offering tuition grants).

[50] Reynolds v. Sims, 377 U.S. 533, 571-573 (1964) (holding that state legislatures have to apportion based on population).

eight new urban members, resulting in a House evenly divided between rural and urban and the Senate with eighteen urban senators out of forty.[51] Moreover, in the 1965 race for governor, Mills Godwin's winning platform featured improving public education.[52]

Such recognition of the need to improve public education was a major departure from Byrd machine policies that had dominated Virginia politics since the 1920s. Not only had Byrd personally driven the policy of Massive Resistance to school integration—even coining the phrase—but as governor he had set Virginia's focus on road-building and business development and not on public education. The Byrd organization's control of governors and legislators to follow kept that focus.[53]

To carry out this major change in direction for Virginia, Governor Mills Goodwin introduced a sales tax bill in 1966 that directed 1-cent of the proposed sales tax back to localities based on school age population. There were other changes, but the General Assembly did not change that initial provision of returning 1-cent of the state sales tax—not based on those enrolled in public school—but based on school age population. This represented a momentous declaration that the state's role in strengthening education was through public—not private—schools. While parents certainly could choose to continue to send their children to private schools, their choice would not reduce this major commitment of state funds for the public schools.

For over fifty years, § 58.1-638(B)(C)(D) of the Virginia Code has been the instrument that automatically passes on the revenue from 1-cent of the state sales tax to localities.[54] § 58.1 states the Treasurer of Virginia "shall" make the distribution upon the basis of populations ages five to nineteen among the counties and cities "as soon as practicable after the close of each month." This statutory language has been the guaranteed foundation of school funding that local governments rely on in putting together and adopting local school budgets.

As a result, in the 2022 action to remove the sales tax on groceries, local governments were deeply concerned that under the Governor's proposed

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[51] *See Historical Elections Database, 1965 to 1965, House of Delegates*, VA. DEP'T OF ELECTIONS, https://historical.elections.virginia.gov/elections/search/year_from:1965/year_to:1965/office_id:8 (last visited, Sep. 12, 2022); *Historical Elections Database, 1965 to 1965, Senate of Virginia*, VA. DEP'T OF ELECTIONS, https://historical.elections.virginia.gov/elections/search/year_from:1965/year_to:1965/office_id:9 (last visited, Sep. 12, 2022).

[52] Deeb & Connock, *supra* note 9, at 30-33.

[53] Ronald Heinemann, *Harry F. Byrd (1887-1996)*, ENCYCLOPEDIA VA., https://encyclopediavirginia.org/entries/byrd-harry-f-1887-1966/ (last visited Sep. 4, 2022).

[54] VA. CODE ANN. § 58.1-638 (2022).

budget, backfilling an estimated 18.2%[55] loss in revenue from not taxing groceries would depend annually on a new state budget appropriation that would always have to compete with other priorities. Finally, at the end of the three-month extended session needed to agree on the budget, the bill to remove the state sales tax on groceries and essential personal hygiene products was re-written to provide a statutory guarantee of an amount covering the grocery tax shortfall.[56] The amended language continues to send sales tax revenue every month to localities based on school age population, as it has since 1966, but the amount is automatically adjusted so that it is "equal to the revenue that would have been distributed" under "B, C, and D of § 58.1-638" if groceries and personal hygiene products were still taxed.[57]

VI. 0.5-CENT OF STATE TRANSPORTATION RETAIL SALES TAX: DIVERSIFIED REVENUE

The first expansion of the sales tax came two decades after its adoption in 1966 when the 1986 Special Session on Transportation added a 0.5-cent sales tax earmarked by statute in § 58.1- 638(A) to fund transportation.[58] The importance of this diversified funding for transportation was underscored in 2005 in the effort to completely remove the state sales tax on groceries, which, along with the 1-cent returned based on school age population, was left untouched. Public school and transportation needs were too great to take the hit of losing the substantial revenue generated by the grocery tax.

The importance of the sales tax as source of transportation funding rests on the fact that traditionally the gas tax is charged on the number of gallons purchased. The gas tax is not based on the price (*ad valorem*) and, therefore, revenue does not increase with inflation as it does for all other major taxes, including sales, property, and income.[59] In contrast, Virginia's gas tax was set in 1986 at 17.5 cents per gallon when the price averaged $1.61 a gallon.[60] It did not change over the next three decades as the price reached as high as

55 COMMONWEALTH OF VA. DEP'T OF TAX'N, 2022 FISCAL IMPACT STATEMENT ON HB 90, 2022 Reg. Sess., at 2 (2022).

56 H.D. 90, 2022 Spec. Sess. 1 (Va. 2022).

57 *Id.*

58 H. Journal, 1986 Reg. Sess., 123, 126 (Va. 1986); VA. CODE. ANN. § 58.1-638(A) (1986) (amended 2022).

59 *State and Local Backgrounders: "Motor Fuel Taxes,"* Urban Inst., https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/motor-fuel-taxes (last visited Nov. 16, 2022).

60 *Fact #915: March 7, 2016 Average Historical Annual Gasoline Pump Price, 1929-2015,* OFF. ENERGY EFFICIENCY & RENEWABLE ENERGY (Mar. 7, 2016), https://www.energy.gov/eere/vehicles/fact-915-march-7-2016-average-historical-annual-gasoline-pump-price-1929-2015.

$3.80 a gallon.[61] With no tax increase to track this inflation and parallel inflation in maintenance and construction costs, fewer and fewer projects could be funded.

When Virginia no longer had funds to cover the matching state funds required to draw down federal highway money, the 2013 General Assembly finally acted. However, the gas tax was not increased; instead, the major sources of immediate new revenue came from raising the sales tax on vehicle purchases from 3% to 4.15% and increasing the state sales tax dedicated to transportation by 0.3-cents on non-grocery purchases.[62] Even though gas reached $3.78 a gallon during the during March of the 2013 session,[63] the General Assembly only converted the 17.5 cents per gallon tax paid when sold at retail to a comparable tax of 3.5% on the price when sold at wholesale. The assumption was that, while this change to an *ad valorem* tax at wholesale would not address the crippling inability to address the decades-long, inflation-driven backlog of maintenance and construction work, the change would address future inflation.

However, because there was no floor set on the wholesale price that would keep it comparable to a 17.5 cents per gallon tax, the 2013 tax change actually resulted in a reduction in Virginia's gas tax revenue. Immediately after the 2013 General Assembly acted, the world price of oil sent gas prices plummeting.[64] In Virginia, prices reached a low of $2.15 and remained under $3 per gallon.[65] By 2020, the comparable tax on the wholesale price was just 16.2 cents per gallon and total gas tax revenue collections fell even though vehicle miles traveled on Virginia roads continued to increase.[66] From 2016 to 2018, despite the fact that vehicle miles of travel increased by 3.2%, state fuel tax collections actually decreased by 0.4%.[67]

The 2020 General Assembly had to deal with the untenable fact that, as a user fee, gas tax revenue now did not even reflect road use, as well as not

[61] *See id.*; *Fuel Tax Rates for Prior Periods,* VA. DEP'T OF MOTOR VEHICLES, https://www.dmv.virginia.gov/commercial/#taxact/historical_rates.asp (last visited Sep. 12, 2022).

[62] H.D. 2313, 2013 Sess. (Va. 2013).

[63] *U.S. All Grades All Formulations Retail Gasoline Prices (Dollars per Gallon)*, U.S. ENERGY INFO. ADM', https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=emm_epm0_pte_nus_dpg&f=m (last updated Aug. 30, 2022).

[64] Brad Plumer, *The surprising reasons why gas prices have fallen sharply*, WASH. POST (Nov. 13, 2013), https://www.washingtonpost.com/news/wonk/wp/2013/11/13/the-surprising-reasons-why-gas-prices-have-fallen-so-much/.

[65] *Virginia Total Gasoline Wholesale/Resale Price by Refiners (Dollars per Gallon)*, U.S. ENERGY INFO. ADM' https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=EMA_EPM0_PWG_SVA_DPG&f=M (last updated May 1, 2022).

[66] VA. ACTS OF ASSEMBLY, Ch. 766, § 58.1-2217(A) (2013).

[67] COMMONWEALTH OF VA. OFF. OF THE SEC'Y OF TRANSP., TRANSPORTATION FUNDING SUSTAINABILITY, Reg. Sess., at 2 (2019).

tracking inflation, by re-structuring and re-setting the base. The percent tax on the wholesale price passed in 2013 was converted back to a per gallon tax that would still be collected on the number of gallons sold at wholesale to greatly reduce the burden of collecting from the thousands of retailers.[68] Inflation would be captured by adjusting the tax per gallon annually by same percent as the growth, if any, in the consumer price index. Unlike in 2013, after three decades, the gas tax also was raised 10 cents per gallon tax in two five-cent increments on July 1, 2020 and July 1, 2021.[69] The first inflation adjustment occurred on July 1, 2022 and, based on the Consumer Price Index for urban consumers (CPI-U) 7% increase, Virginia's gas tax went up to 28.54 cents per gallon. Despite this increase for inflation, Virginia's gas tax is still less than the national average and it is the third lowest among bordering states with Kentucky at 26 cents per gallon and Tennessee at 27 cents per gallon.[70]

The reason Virginia's gas tax is relatively low is that under the precedent established by the 1986 Special Session, Virginia's total transportation infrastructure is funded almost equally by a 4.14% tax on vehicle sales, by a 0.5-cent dedicated retail sales tax, and by the gas tax.[71] Estimates for FY2024 are $1.119 billion from taxing car sales; $1.076 billion from a 0.5-cent retail sales tax; and $1.450 billion from gas taxes.[72]

Commonwealth Transportation Fund Revenue
FY2024 estimate in billions

Motor Fuel Taxes	4.14.% Vehicle Sales Tax	0.5 cent Retail Sales Tax	Other taxes and fees
$1.450	$1.119	$1.076	$0.756

This diversity of funding has pros and cons. It could be argued that, as the cost of maintenance escalated and congestion grew to crisis proportions, the

68 COMMONWEALTH OF VA. DEP'T OF PLAN. AND BUDGET, 2020 FISCAL IMPACT STATEMENT, H.D. 1414, Reg. Sess., at 8 (2020).

69 VA. CODE ANN. § 58.1-2217(A) (2022).

70 FED'N TAX ADM'R, STATE MOTOR FUEL TAX RATES (2022).

71 VA. DEP'T OF TRANSP., FISCAL YEAR 2022 COMMONWEALTH TRANSPORTATION FUND BUDGET 4 (2021), https://www.virginiadot.org/about/resources/budget/CTF_Final_FY_2022_Budget.pdf; VA. DEP'T OF TRANSP., VIRGINIA'S STATEWIDE MULTIMODAL LONG-RANGE TRANSPORTATION PLAN - PHASE 3 AND FINAL REPORT TO THE GENERAL ASSEMBLY 111 (2004), https://www.virginiadot.org/projects/vtrans/resources/revisedphase3reportforctb.pdf.

72 COMMONWEALTH TRANSP. BD., FY 2023-2028 COMMONWEALTH TRANSPORTATION FUND (CTF) SIX-YEAR FINANCIAL PLAN 5 (2022), https://www.ctb.virginia.gov/resources/2022/june/pres/5.pdf (The Retail Sales Tax $1.315 billion estimate was reduced by 18% to $1.076 billion to reflect the General Assembly action on June 17, 2022 that removed the tax on groceries. Motor Fuel Taxes include $69.5 million Road Tax paid by large interstate trucks under the International Fuel Tax Agreement.)

retail sales tax and vehicle sales tax saved basic transportation in Virginia during the three decades it took to finally raise the gas tax. These two taxes are on the price of the item taxed and, therefore, they tracked inflation. In contrast, the revenue from collecting 16.7 cents on each gallon of gas—no matter what the price of a gallon was—fell further and further behind in covering the effect of inflation on maintenance and construction costs. The counter argument is that this mitigation from having diverse funding delayed timely action on the gas tax.

A second, but equally important, policy consideration of having diverse funding sources is the distribution of the tax burden. The vehicle sales tax is paid solely by Virginia residents, the retail sales tax is paid mostly by residents, and the gas tax falls equally on residents and non-residents because it is tied to road use. Arguably, as part of the heavily traveled east coast corridor and home of major tourist attractions, Virginia should fund more of its transportation infrastructure with the gas tax, so that costs are shared more by the 20-30% of non-residents who use Virginia's roads. Indeed, the 2020 reforms better connecting the gas tax to past and future inflation will, over time, move Virginia to a better balance of residents and non-residents carrying the cost of providing and maintaining an adequate transportation infrastructure. The outcome would be in line with the many states who periodically increased their gas tax while Virginia did not.

A third tax policy issue around diverse funding is accurately tying relevant user fees to a government service. Alternatives to gasoline and diesel-powered vehicles are becoming more prevalent, and some argue that this makes the gas tax obsolete as a user fee.[73] While true in the long run, this is an overstatement. In fact, Virginia is in a time of transition. In 2019, electric vehicles accounted for just two percent of passenger vehicles in Virginia.[74] However, even though they are projected to increase to 46% of Virginia passenger vehicles by 2040[75], this is still less than half of all road users. For those users (including commercial trucks), fuel consumption remains the best proxy for their road use.

On the other hand, while hybrids, electric, and other fuel-efficient vehicles serve an extremely important public policy goal of reducing carbon dioxide emissions, like any fossil fuel vehicle, alternative fuel vehicles contribute to

73 Pete K. Rahn, *The Gas Tax is Obsolete. Here's a Better Idea,* POLITICO (Jun. 23, 2021), https://www.politico.com/news/agenda/2021/06/23/gas-tax-better-idea-495572.

74 VA. OFF. OF THE SEC'Y OF TRANSP., SUSTAINABILITY OF TRANSPORTATION REVENUES 8 (2019), https://rga.lis.virginia.gov/Published/2020/RD54/PDF.

75 *Id*. at 7–8.

the need for functioning road infrastructure.[76] In response, Virginia's 2020 transportation funding reform established an annual user fee equal to 85% of the amount of gas tax that would be paid by the average driver of a vehicle rated at 23.7 miles per gallon.[77] Alternatively, owners can track their own mileage rather than use the state average.[78] This fee is expected to contribute $62.7 million by FY24 compared to over $1 billion from the gas tax[79] and the fee will increase as the gas tax increases with inflation.

Eventually, it is anticipated that technology will allow a national means of taxing road use based directly on miles driven and vehicle weights.[80] Such tracking would eliminate the need for gas consumption as a user fee proxy. It would also allow accurate apportionment of resident and non-resident taxes to the state where their miles are driven, which has long been the means of apportioning gas taxes for interstate trucks based on self-reporting. Until then, the gas tax remains a critical user fee.

Another tax policy question integral to the 1986 Special Session on Transportation is whether there is a general benefit that legitimately should be funded by general tax revenue. At Governor Gerald Baliles' request, all five living prior governors actively participated with senior legislators in developing recommendations prior to the 1986 Session.[81] This broad, high-level perspective of Virginia's total transportation needs led to including funding for transit, ports, and airports as crucial to economic development throughout the Commonwealth. That commitment justified the group in ultimately getting behind enacting the 0.5-cent sales tax as a broad-based tax dedicated to meeting Virginia's total transportation needs.[82]

The 2022 General Assembly removed the sales tax on groceries from the 0.5-cent sales tax dedicated to transportation, but it did not provide any replacement for the 18.2% projected revenue loss.[83] Although there was significant opposition to the resulting ongoing cut of over $130 million[84] annually, particularly on behalf of transit, the debate got over-shadowed by three

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76 *Paying for the Roads: Electric Vehicle Road Usage and Registration Fees*, PLUG IN AMERICA, https://pluginamerica.org/policy/ev-road-usage-fees/ (last visited Sept. 1, 2022).

77 COMMONWEALTH OF VA. DEP'T OF PLAN. AND BUDGET, *supra* note 68.

78 *Id.*

79 COMMONWEALTH TRANSP. BD., FY 2023-2028 COMMONWEALTH TRANSPORTATION FUND (CTF) SIX-YEAR FINANCIAL PLAN, *supra* note 72.

80 Nancy Singer, *FHWA Awards $18.7 Million to Eight Projects to Explore New Highway Funding Methods*, U.S. DEP'T TRANSP. (Mar. 16, 2021), https://highways.dot.gov/newsroom/fhwa-awards-187-million-eight-projects-explore-new-highway-funding-methods.

81 Vivian Watts, *Meeting Virginia's Transportation Challenge*, 64 U. VA. NEWSL. 73, 73 (1987).

82 *Id.* at 74.

83 COMMONWEALTH OF VA. DEP'T OF TAX'N, 2022 FISCAL IMPACT STATEMENT, H.D. 90, Spec. Sess. I, at 1 (Va. 2022).

84 *Id.* at 2.

separate attempts by Governor Youngkin to cut the 26.2 cents per gallon gas tax to counter sky-rocketing prices, which had reached $4.32 per gallon in March 2022 compared to $2.90 a year earlier.[85] His proposed gas tax holiday would have cost at least $400 million with an ongoing loss of at least $40 million from his proposal to cap any annual inflation adjustment at 2%.[86]

VII. THE 1-CENT LOCAL RETAIL SALES TAX: UNIFORM ADMINISTRATION

In addition to adopting a state source of revenue in 1966 that was significant enough to support a modern public education system, uniformity was another major policy concern behind adopting the retail sales tax.[87] Although cities had the power to adopt a retail sales tax, only the city of Bristol, Virginia had adopted one before 1964 because a state sales tax was being collected across its border with Bristol, Tennessee.[88] Then, in 1964, Norfolk broke precedent with a 2-cent sales tax and in 1965, all six Hampton Roads cities followed suit, as well as Petersburg, Williamsburg, Suffolk, Charlottesville, and Richmond.[89] While Henrico County also tried to enact a sales tax, in a June 14, 1965 ruling, the Virginia Supreme Court ruled that counties lacked this authority.[90]

As noted earlier, the 1966 General Assembly for the first time was elected based on population and was virtually evenly split between urban and rural members.[91] Rural areas would benefit from the proposal in the introduced bill to return 1-cent of the state sales tax to localities on the basis of school age population. Urban areas, on the other hand, would benefit far more from monies returned based on point of collection.

The resolution of the conflicting urban and rural interests lay in Virginia being a Dillon Rule state under which localities only have powers specifically granted them by state law. In the legislative compromise, cities lost the

[85] Press Release, Governor Glenn Youngkin Proposes Gas Tax Holiday for Struggling Virginian's, GOVERNOR OF VA. GLENN YOUNGKIN (Mar. 16, 2022), https://www.governor.virginia.gov/newsroom/news-releases/2022/march/name-930124-en.html.

[86] COMMONWEALTH OF VA. DEP'T OF TAX'N, 2022 FISCAL IMPACT STATEMENT, S. 6001, Spec. Sess. I, at 2 (Va. 2022).

[87] T.J. Reed, *A City's Sale Tax: Norfolk's First Year*, 42 U. VA. NEWSL. 9, 11 (1965).

[88] *Id.* at 10-11.

[89] Reed, *supra* note 87.

[90] *Id.*

[91] Charles A. Kromkowski, *The Virginia Elections and State Elected Officials Database Project, 1776-2008*, http://vavh.electionstats.com/ (Information can be downloaded from this source that includes the year this piece is specifically referencing).

unlimited freedom to enact a local sales tax and instead, all cities and counties were given uniform authority to enact a sales tax limited to 1-cent.[92] This uniformity acknowledged the funding pressures on urbanizing counties to provide expanded services; in addition, it resolved administrative and economic competition issues about whether tax is collected where the item is purchased or where it is delivered. Furthermore, retailers' concerns were addressed about ease of collection and not having to deal with different items being taxed or exempt based on conflicting local ordinances. Local governments were willing to accept the state dictating a uniform definition of what was to be taxed in exchange for not bearing the cost of setting up individual tax collecting capabilities which could be centralized in the state under uniformity.

Granting the authority to enact a local sales tax statewide also eased concerns of individual elected officials over the politics of raising taxes and, by May 1969, all local governments in Virginia had adopted a 1-cent local sales tax.[93] As intended, the 1-cent local sales tax and the 1-cent state sales tax returned on the basis of school age population passed in 1966 established a substantial foundation to boost local public school funding.[94]

Faced with reducing the base that applies to all children equally statewide by 18.2%, the 2022 General Assembly ultimately decided to use its annual budget allocation authority to restore the 20% loss of revenue to localities due to removing groceries from the 1-cent state sale tax distributed on the basis of school age population.[95] The legislature chose not to exercise its Dillon Rule authority over local governments through removing groceries from the local sales tax. Therefore, after January 1, 2023, there will continue to be a tax on groceries—reduced from a total of 2.5-cents to the 1-cent local tax.[96]

VIII. STATE/LOCAL SHARING SCHOOL FUNDING: EQUALIZATION

The third element of public school funding stems from critical new language in Section 2 of the 1971 Virginia Constitution Article VIII that establishes a constitutional obligation to fund quality public education for every child of school age in state and local budget appropriations of general revenues:

92 Deeb & Connock, *supra* note 9 at 30.
93 *Id.*
94 *Id.* at 32.
95 *See* H.D. 30, 2022 Gen Assemb., Special Sess. (Va. 2022).
96 *See* VA. CODE ANN. § 58.1-611.1(B) (2022). *See also* VA. CODE ANN. § 58.1-605 (2022).

> ...The General Assembly shall determine the manner in which funds are to be provided for the cost of maintaining an educational program meeting the prescribed standards of quality, and shall provide for the apportionment of the cost of such program between the Commonwealth and the local units of government comprising such school divisions... Each unit of local government shall provide its portion of such cost by local taxes or from other available funds.[97]

By the 1974-75 school year, a new formula was put into use to apportion the share of each locality's basic school funding that would be covered by the state. The formula, which had been developed by the Governor's Task Force on the Financing the Standards of Quality, started with a calculation intended to determine a locality's ability-to-pay its share of K-12 costs, termed "Local Composite Index" (LCI).[98] The same calculation of local revenue capability first used in the early 1970s is still used today.

In concept, the LCI was based on the make-up of local government revenue. In practice, it falls far short of accurately reflecting local tax revenues due to three major shortcomings. First, the weighting of local revenue sources is based on total revenue of all localities without reflecting the expanded taxing authority of cities.[99] Second, it uses AGI as a proxy for all taxes other than real estate and sales taxes.[100] Third, its weighting of 50% real estate values, 10% sales tax revenue, and 40% AGI reflects statewide local revenue sources in 1970—50 years ago—and this weighting has never been updated.[101]

In 1970, cities constituted a larger share of Virginia's economic activity and population than today, as well as having expanded taxing powers.[102] The 40% measured by AGI as a proxy for other taxes is, therefore, over-weighted compared to today's balance, which would be more weighted towards county revenues. Even worse, using AGI as a proxy is punitive to all localities since no locality is allowed to tax income. It is particularly punitive to high-income counties that not only have no ability to tax AGI, but until the General Assembly acted in 2020, did not even have the authority to tax discretionary

97 VA. CONST. art. VIII, § 2.

98 Richard G. Salmon & Ralph J. Shotwell, *Virginia School Finance Reform: Status Quo Maintained*, 3 J. EDUC. FIN., 524, 524-5 (1978).

99 VA. GEN. ASSEMB. JOINT LEGIS. AUDIT & REV. COMM'N., REVIEW OF ELEMENTARY AND SECONDARY SCHOOL FUNDING 128 (2002).

100 *Id.*

101 *See id.*

102 *See generally Virginia Population Estimates*, WELDON COOPER CTR. FOR PUB. SER., https://demographics.coopercenter.org/virginia-population-estimates (last visited Sep. 13, 2022) (providing access to excel documents of Virginia's 1970 and 2020 census data that demonstrate a population shift). According to the University of Virginia Weldon Cooper Center for Public Policy, Population Estimates, the 1970 census count of Virginia's population living in cities was 41.3% compared to 30.1% in the 2020 census count.

income through taxes routinely used by cities since the 1930s.

In 2000, the General Assembly's research body, the Joint Legislation Audit and Review Commission (J-LARC), was directed to undertake an extensive study of school funding.[103] The preface of its report released in 2002 reads:

> The study mandate stemmed in large part from local government concerns that their taxpayers are overburdened with meeting legitimate education costs which are not recognized by State funding practices. In addition, since most state funding for education is provided based on local ability-to-pay, a reduced state role in sharing costs tends to most negatively impact education funding levels in poorer localities. In Virginia, the percentage contribution in FY 2000 to education costs from State funds (including State sales tax, other SOQ funds, and non-SOQ funds) was about 42 percent, ranking Virginia 40th in the nation. In contrast, Virginia ranked 13th in the average percentage contribution made from local funds.[104]

This study and others that followed have tended to focus on educational concerns rather than "legitimate education costs which are not recognized by State funding practices." Government finance issues have seldom been broadly discussed. Indeed, the J-LARC recommendations in the 2002 report for changing the LCI calculation were never acted on, even the recommendation to update the 50% real estate values / 40% AGI / 10% sales tax collections weighting that still reflects 1970 local revenues. The basic political reason for such inaction is that all localities benefit to some degree by increasing state responsibility for "legitimate education costs," while changing state share of a locality's funding with more relevant measures of ability-to-pay creates winners and losers.

J-LARC has again been directed to study school funding, both in its study of the income tax as related to local tax authority to raise revenue based on AGI and in its comprehensive study that will be comparable to what was undertaken in 2000.[105] The comprehensive study is due, in part, to the fact that Virginia's rank of 40th in K-12 state support, noted in the 2002 preface above, has not improved. The J-LARC education study is also driven by endemic education challenges in poorer communities recently highlighted by the COVID pandemic.

[103] S.J. Res. 232, 2000 Gen. Assemb., Reg. Sess. (Va. 2000).

[104] VA. GEN. ASSEMB. JOINT LEGIS. AUDIT & REV. COMM'N., *supra* note 99, at 136-37.

[105] *See id.*

IX. STATE FUNDING OF SCHOOL CONSTRUCTION AND TRANSPORTATION: TAX UNIFORMITY

The 2013 Transportation Funding legislation marked a major shift in Virginia's tax structure by breaking the precedent—set when the sales tax was enacted in 1966—of an equal tax rate in all localities.[106] Along with increasing the state retail sales tax earmarked for transportation by 0.3-cents and increasing the tax on vehicle sales, the 2013 General Assembly's response to the Commonwealth's most dire congestion was to enact regional taxes dedicated to transportation. In Northern Virginia's Planning District 8, the transportation taxes included an additional 0.7-cent sales tax.[107]

The setting aside of local sales tax uniformity in 2013 unleashed use of a sales tax to fund other local needs. As of 2022, there are four different sales tax rates charged in localities throughout the Commonwealth.[108] A total of thirty-one cities and counties now have an additional 0.7-cents dedicated to regional transportation in the Richmond region, Hampton Roads, and Northern Virginia.[109] In 2018, an additional 1-cent was authorized in three of these localities with 50% of the revenue directed regionally to promote tourism in the Historic Triangle and 50% going back to the local general fund budgets of James City County, Williamsburg, and York County.[110] In 2019, the General Assembly gave Halifax authority for a referendum to enact an additional 1-cent sales tax for the construction or renovation of schools.[111] In 2020, the General Assembly extended the authority to seven additional counties and one city for a total of nine localities, six of which have had successful referendums prior to November 2022.[112]

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[106] *Sales Taxes in Virginia*, VA. PLACES, http://www.virginiaplaces.org/taxes/salestaxes.html (last visited Sep. 12, 2022).

[107] The full 2013 package of additional taxes dedicated to congestion mitigation transportation funding in Planning District 8 were a retail sales tax of 0.7-cents, a 2.0% transient occupancy tax, and a grantors fee on sales of real property equal to $0.15 per $100 of the value property sold. *Summary of HB 2313 Revenues and Appropriations of States; Changes to Revenues Collected and Distribution, Report.*, LIS (Jan. 18, 2013), https://lis.virginia.gov/cgi-bin/legp604.exe?131+sum+HB2313.

[108] *Retail Sales and Use Tax*, VA. TAX, https://www.tax.virginia.gov/retail-sales-and-use-tax#:~:text=The%20sales%20tax%20rate%20for%20most%20locations%20in%20Virginia%20is%205.3%25 (last visited Sep. 12 2022).

[109] *See id.*

[110] *Tax Bulletin 18-3: Retail Sales and Use Tax Rate Increase in the City of Williamsburg and the Counties of James City and York*, VA. DEP'T OF TAX'N (May 11, 2018), https://www.tax.virginia.gov/sites/default/files/inline-files/tb-18-3-historic-triangle.pdf.

[111] *Tax Bulletin 20-6: Additional Sales and Use Tax in Halifax County*, VA. DEP'T OF TAX'N (Apr. 29, 2020), https://www.tax.virginia.gov/sites/default/files/inline-files/tb-20-6-additional-sales-use-tax-in-halifax-county.pdf.

[112] *Sales Tax Increase in Central Virginia Region Beginning Oct. 1, 2020*, VA. TAX, https://www.tax.virginia.gov/news/sales-tax-increase-central-virginia-region-beginning-oct-1-2020#:~:text=Starting%20Thursday%2C%20Oct.,the%201%25%20local%20option%20tax (last visited Sep. 12, 2022).

However, the 2022 effort to extend school capital funding authority to all counties and cities did not pass due to both technical and political problems. Technical problems arose because the 2022 legislation simply included all cities and counties under the 2019 provisions of § 58.1-605.1 that had been crafted for poor rural counties dealing with only a couple of very old schools or a limited need to expand capacity.[113] This wording is of limited or no use to cities and counties that have outstanding, ongoing bond debt covering the construction and renovation for many equally old schools or new schools needed in quick succession to handle overcrowding. The 2019 provision limiting the additional 1-cent sales tax to the length of the bond or to no more than twenty years is not applicable to such ongoing debt.

In addition, when annual sales tax revenue exceeds the annual bond debt service, the 2019 wording prohibits it being used for any other purpose. This creates challenging if not untenable administrative requirements of adjusting annual sales tax revenues and debt service payments to match the required details that voters have had to authorize in § 58.1-605.1(B)(1)(i).[114] Sales tax collection by many retailers and nationwide online sites does not lend itself to repeatedly changing rates.

The political importance of revising the 2019 taxing structure so that it can apply to all localities is tied to the fact that the $3.2 billion cited to stress the magnitude of the problem was generated from a Virginia Department of Education survey of all 132 school division plans to renovated old school buildings, from reconstruction to replacing roofs and windows to updating heating, air conditioning, electrical, and IT capability.[115] A $25 billion price tag that is sometimes cited refers to actually replacing all of the over 1000 schools in Virginia that are at least fifty years old and is inflated by the inclusion of schools that were soundly constructed and have been properly renovated.

The pressure to shape an inclusive solution to local school construction funding was relieved when the 2022 General Assembly enacted major new state funding for school construction and modernization.[116] The state budget surplus enabled passing a new $450 million competitive grant program to buy down project costs from 10% to 30% in areas with inadequate tax bases

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[113] S. 472, 2022 Sess. (Va. 2022) (left in House Fin. Comm. Mar. 8, 2022).

[114] VA. CODE ANN. §58.1-605.1 (2022) (§58.1-605.1(B.1.ii) may allow a work-around by putting a combined referendum before the voters that authorizes both project specific debt as well as pay-as-you-go capital projects to be funded for the limit of 20 years that the additional sales tax can be authorized).

[115] VA. DEP'T OF EDUC., VDOE RESPONSES TO FOLLOW-UP REQUESTS FROM THE SEPTEMBER 29, 2021 COMMISSION MEETING (2021); *See* Jackie DeFusco, "*A Dire Situation": Aging Virginia Schools Want COVID Relief Funds to Cover Construction Costs,* WRIC ABC 8 NEWS (June 3, 2021), https://www.wric.com/news/a-dire-situation-aging-schools-want-covid-relief-funds-to-cover-construction/.

[116] Markus Schmidt, '*A Gigantic Stride*,' CARDINAL NEWS (June 9, 2022), https://cardinalnews.org/2022/06/09/a-gigantic-stride/.

and the most severe school infrastructure problems.[117] The budget also includes $400 million to give each jurisdiction at least $1 million for planning and design as well as for pay-as-you-go capital improvements.[118] In addition, the Literary Fund, which constitutionally has been a source of loans for school construction since the 1800s, was reformed.[119] The Fund was increased from $80 million to $200 million and the maximum loan is now $25 million instead of the out-of-date $7.5 million that had little current relevance considering that the average cost of a new 800-student elementary school in Virginia is over $30 million.[120]

X. LOCAL TAX OPTIONS: ADEQUACY, STABILITY, ABILITY-TO-PAY

If the 2022 state assumption of public school capital costs is adequately funded in future state budgets, it could result in refocusing Virginia's tax structure discussion back to basic questions of current local authority: Can the tax structure raise adequate revenue? Does it draw from a broad enough base to be resilient to economic downturns in different sectors? Does it reflect ability-to-pay?

Despite the 1966 precedent, the fact that, in 2018, three localities got an additional general fund revenue source from half of the 1-cent Historic Triangle sales tax could be a precursor to increasing the 1-cent sales tax rate for all localities.[121] In the 2022 Session, local governments convincingly argued that they could not take the loss of revenue from ending the grocery tax and, for most, it would directly translate to increasing real estate taxes. Therefore, the sales tax on groceries will still be 1-cent from the local sales tax base that was left untouched.

The House approach to making up the local revenue loss from state revenues was a bridge too far for Senate budget appropriators. Rather than double the hit on state general funds, appropriators chose only to make up the 18.2% loss on the 1-cent state sales tax sent to localities based on school age population.[122] As with the 1966 compromise, rather than diverting state funds to

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[117] *Editorial: Proposed State Budget Could Make Some Southwest Virginia Wishes Come True*, THE ROANOKE TIMES (June 5, 2022), https://roanoke.com/opinion/editorial/editorial-proposed-state-budget-could-make-some-southwest-virginia-wishes-come-true/article_318b1572-e2c7-11ec-afec-7bd2bcba418c.html.

[118] *Id.*

[119] *Id.*

[120] VA. DEP'T OF EDUC., 2020-2021 NEW ELEMENTARY SCHOOL ANNUAL COST DATA REPORT (2021); Va. Code § 22.1-147 (2022); *See also id.*

[121] S. 942, 2018 Sess. (Va. 2018).

[122] *See* H.D. 30, 2022 Spec. Sess. 1 (Va. 2022).

the most urbanized areas by backfilling the local sales tax, the state obligation remained on the 1-cent returned of school age population.

A basic argument for why Virginia should remove the sales tax on groceries was that only twelve other states tax groceries. However, of the forty-six states and D.C. that have a sales tax, Virginia's state sales tax rate is only thirty-ninth[123] and its combined state/local rate is forty-first.[124] The move to end the grocery tax as a tax cut in 2022 was made possible by an extraordinary budget surplus. In addition to one-time federal COVID-19 funds, much of the historic surplus that was materializing was from underestimating tax revenues when the current budget was passed in March 2021. The worst case projection of tax revenues did not materialize as a result of higher income jobs experiencing little unemployment, the focus of personal discretionary spending shifting to retail goods, and historic stock market gains. After protracted debate, those whose goal is to permanently reduce taxes were overridden by concerns that the current tax revenue increases would not be ongoing, making it far more difficult to balance other pressing needs with backfilling an 18.2% local grocery tax revenue loss from the state general fund. To completely eliminate the grocery tax, the option of increasing the local sales tax rate to cover the revenue loss would bring Virginia more in line with the nine states of the thirteen that do not tax groceries, but that have higher tax rates than Virginia's.[125]

Another sales tax alternative affecting state, local, and transportation revenues is to join most other states by broadening the sales tax to include consumer services. Virginia's state budget does not have a diverse tax revenue base compared to other states.[126] Virginia's dependence on revenue from individual income taxes is the fifth highest of all states that have an income tax.[127] In contrast, the retail sales tax only raises 20.4%—the third lowest of

123 *See State Sales Tax Rates*, SALES TAX INST. (Sept. 1, 2022), https://www.salestaxinstitute.com/resources/rates (39th after ranking sales tax from highest to lowest of all states who have sales tax).

124 *See* Janelle Fritts, *State and Local Sales Tax Rates, 2021*, TAX FOUND. (Jan. 6, 2021), https://taxfoundation.org/2021-sales-taxes/ (41st after ranking combined sales tax rate from highest to lowest of all states who have sales tax).

125 *See* Eric Figueroa & Julian Legendre, *States That Still Impose Sales Taxes on Groceries Should Consider Reducing or Eliminating Them*, CTR. ON BUDGET PRIORITIES (Apr. 1, 2020), https://www.cbpp.org/research/state-budget-and-tax/states-that-still-impose-sales-taxes-on-groceries-should-consider*; see also State Sales Tax Rates, supra* note 123.

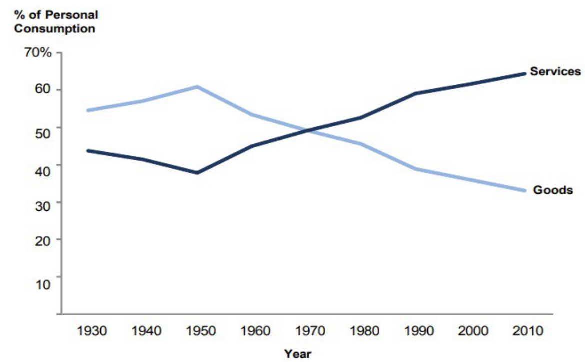
126 *See How States Raise Their Tax Dollars, FY 2020*, THE PEW CHARITABLE TRUSTS (May 13, 2021), https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2021/how-states-raise-their-tax-dollars-fy2020.

127 *See id.; But cf.* COMMONWEALTH OF VA., DEP'T OF ACCOUNTS, SUMMARY REP. ON GEN. FUND REVENUE COLLECTIONS FOR THE FISCAL YEARS 2021 AND 2022 (Feb. 18, 2022) (showing a differing percentage of tax revenue from individual income, sales, and corporate income tax) (The tax revenue groupings in the PEW Institute state comparisons differ from those used in the Virginia Secretary of Finance Revenue Report for May 2022: Individual income 68.4%; Sales 17.1%; Corporate income tax 7.4%).

all states that have a state sales tax. Virginia's revenue from the corporate tax equals the state average of 4.9%.[128] Of the forty-six states and D.C. with a retail sales tax, Virginia is one of only five that tax fewer than twenty services—principally, a tax on vehicle rentals and on set-up charges if they are included in the price of an item.[129]

Not taxing services does not reflect the modern economy. Fifty years ago, in the 1970s, the amount people spent on services began to exceed what they spent on goods; now, the ratio of spending on services compared to goods is more than two to one.

Figure 3: Personal Consumption of Services Exceeds Personal Consumption for Goods



Source: JLARC staff analysis of Bureau of Economic Analysis data on annual personal consumption expenditures 1930-2010.

As a pure budgetary issue, as J-LARC observed in its 2012 report on closing tax loopholes, modernizing the sales tax base to apply to more transactions would "enhance the reliability of revenue collections" because it would more accurately track consumer activity.[130]

Most importantly, taxing services would greatly improve the progressivity of the sales tax. It is unfair, or at least illogical, to tax buying a lawnmower but not using a lawn service, buying detergent but not taking clothes to the cleaners, buying exercise equipment but not gym fees, and engaging a caterer but not an upholsterer. Indeed, taxing the discretionary spending that is made possible as incomes increase, arguably, would be more progressive than

[128] *See How States Raise Their Tax Dollars, supra* note 126.

[129] Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues*, CTR. ON BUDGET AND POL'Y PRIORITIES, June 2003, at i, v; *See also* 23 VA. ADMIN. CODE § 10-210-4040 (2022) (stating taxable services in Virginia).

[130] VA. JOINT LEGIS. AUDIT AND REVIEW COMM'N, REV. OF THE EFFECTIVENESS OF VIRGINIA TAX PREFERENCES, at 19-20 (2012).

ending the grocery tax which benefits high-end Wegmans shoppers far more than Walmart shoppers.

In addition, taxing services would raise the revenue to counter the impact of ending the grocery tax on the revenue that was dedicated to education, local governments, and transportation. Broadening the sales tax base would be a permanent solution that is not subject to annual budget debates about competing government priorities. House Bill 1343 introduced in 2022 proposed applying the sales tax to consumer services—excluding healthcare, business-to-business transactions, professional services requiring state licensure, construction trades requiring local permits, and home services by individuals not engaged through a third-party employer or contractor.[131] The fiscal impact statement made the following state revenue estimates: (1) an increase of over $400 million to general fund, since groceries have not been included in that portion of the sales tax since 2005; (2) a net gain to transportation of over $30 million after deducting the loss from ending the grocery tax on the 0.5-cent portion of the sales tax earmarked for transportation; and (3) a net loss of $50 million on the 1-cent going to K-12 rather than the over $250 million that will now have to be annually appropriated.[132] The $50 million could readily be addressed by increasing the amount in § 58.1-638(B) by a small percentage from the currently stipulated "one percent."

The estimate for local tax revenues is that taxing services would make up about two-thirds of the revenue loss if the grocery tax was removed.[133] Full restoration by increasing the local tax rate would be part of a broader discussion of whether all local governments need more diversification from the dominance of real estate taxes. This discussion was started with the 2018 precedent of enacting a 0.5 cent local general fund sales tax increase for three jurisdictions in the Historic Triangle and it was expanded with the 2019 and 2020 increased sales tax authority for rural counties without an adequate local tax base to construct or renovate schools.

XI. VIRGINIA'S CHALLENGE: TRACKING LOCAL MARKET COSTS

Along with consumption and wealth, income is the third basic component of taxation. Taxing income has been segregated as a state tax only since the Byrd reforms of the late 1920s that designated roads as a state responsibility,

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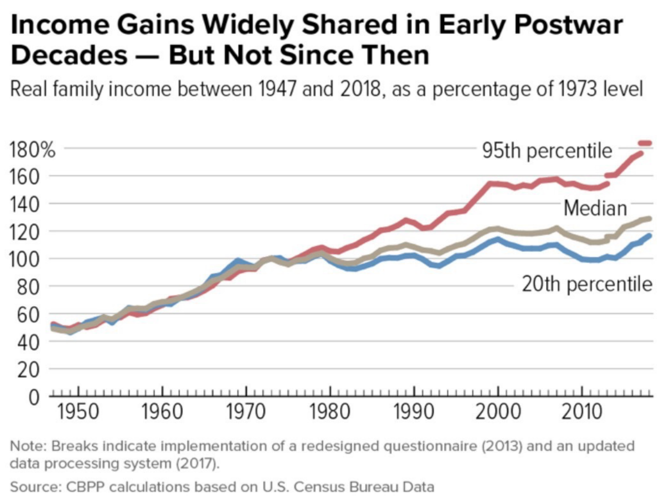
131 *See* H.D. 1343, 2022 Gen. Assemb. Reg. Sess. 2022 (Va. 2022).

132 *See* COMMONWEALTH OF VA. DEP'T OF TAX'N, FISCAL IMPACT STATEMENT, H.D. 1343 Introduced, Reg. Sess. 2022 (2022).

133 *See id.* (FY2024 Local Government revenue is $184.8 million ($177.0 + $7.8) versus the $267.8 grocery tax revenue loss as projected in this FIS).

requiring greater funding through the income tax, and education as a local responsibility funded by segregating the property tax as a local tax only.[134] This major element of the century-old Byrd concept of government finance has been the least challenged. However, the discussions of the adequacy of the local tax base to fund program expansions that have been heightened by recent sales tax proposals and the extension of city taxing authority underscore the need to revisit Virginia's local tax structure—a half-century after it was last revised in 1966 and a century after it was put in place in the late 1920s.



In Virginia as a whole, many localities have urbanized populations that require expanded government services. At the same time, throughout the nation, relentless growth of income inequality[135] has left many of Virginia's core cities and rural counties with a growing proportion of residents who cannot meet basic needs and a decreasing tax base to help them. Whether the local tax base authorized in Virginia has the progressivity, resiliency to weather varying economic cycles, and relevance to modern lifestyles and business activities needs to be re-examined.

Segregating the income tax as state-only has never been enshrined in the Virginia Constitution; it is simply a provision of State Code § 58.1-300. This statutory authority was only overridden once, in 1989, as part of

[134] *See The Byrd Organization*, VA. PLACES, http://virginiaplaces.org/government/byrdorg.html (last visited Sep. 13, 2022).

[135] *See* Chad Stone et al., *A Guide to Statistics on Historical Trends in Income Inequality*, CTR. ON BUDGET AND POL'Y PRIORITIES (Jan. 13, 2020), https://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality.

transportation funding reforms launched during the Baliles administration. A two-year regional process had been undertaken to adopt the first Northern Virginia transportation plan. The local income tax was passed as a means to pay for projects in that plan because the projected cost was well over the new state funding adopted in the 1986 Special Session. The nine cities and counties of Northern Virginia, as well as Norfolk, were given the authority to conduct referendums for up to a one percent piggy-back local income tax dedicated to transportation.[136] Because a local income tax was seen as a one-time influx of money to advance certain transportation projects, a locality could only use it for 5 years. Therefore, it could not be used as a source of borrowing and the authority was never used. In 2013, the omnibus transportation bill finally replaced the limited income tax authority, which each local government would have had to adopt, with state adoption of several regional taxes to be collected only in defined regions of high congestion with the revenues to be allocated by a regional body to mitigate that congestion.

In the twenty-five years that the narrow local income tax authority sat on the books, efforts were made to amend it to give all localities broad authority to enact a local income tax for ongoing needs. None made it out of committee. However, the General Assembly is taking a fresh look at the state income tax, which could open the door for new consideration of whether it should remain segregated as a state-only source of revenue.

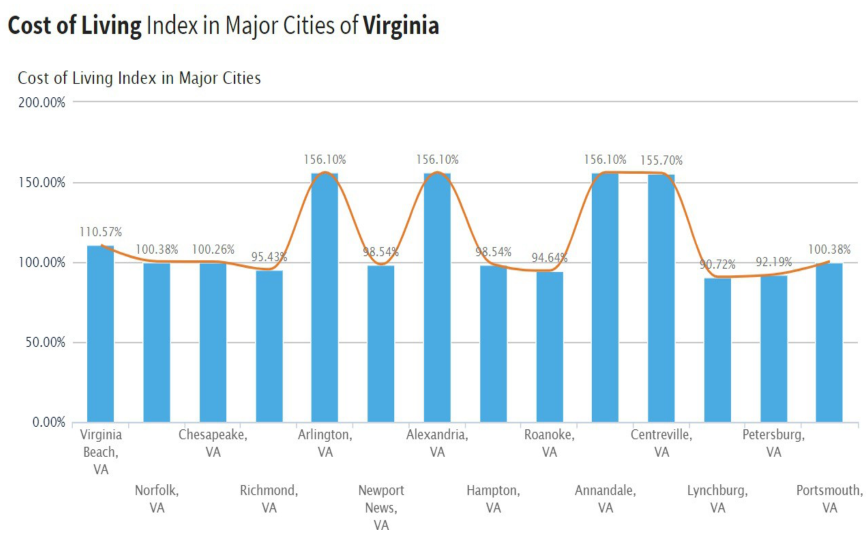
In 2021, the General Assembly directed J-LARC to undertake a major study of the Virginia income tax that will be released before the 2023 Session. The study is focused on issues of progressivity dealing with graduated tax brackets; the zero tax floor; standard deduction, annual indexing; earned income tax credit; equity of personal exemptions, deductions, and credits; and business tax provisions. The 2022 General Assembly added use of adjusted gross income in the school funding formula to this study.

The discussion of a zero tax floor, standard deduction, personal exemption, and earned income tax credit all focus on increasing progressivity by reducing taxes paid by those with lower incomes. In contrast, graduating tax brackets focuses on increasing taxes paid by higher incomes. Virginia's individual income tax has four tax rates on four brackets of AGI. In 2020, twenty-three states had at least one tax rate higher than Virginia's 5.75% and only three of them start their top rate below where Virginia starts at $17,000. Four start their top rate at over $1 million, five start their top rate at an amount between $200,000 and $1 million, and five at an amount between $30,000 to

[136] John Ward Anderson, *Fairfax Starts Wheels Turning for an Income Tax Referendum,* WASH. POST (Feb. 28, 1989), https://www.washingtonpost.com/archive/local/1989/02/28/fairfax-starts-wheels-turning-for-an-income-tax-referendum/651dbbaf-0504-44db-9729-d5355cbfcaf6/.

$60,000.[137]

Graduated rates assume that the higher the income, the larger portion of that income that can go to taxes without undercutting what the taxpayer needs to meet basic living expenses. While this assumption is generally true as tax theory, cost-of-living differences across Virginia create a distinct problem. Virginia's range in cost of living across the Commonwealth (shown in part by the chart for urban areas) is second highest in the nation.[138] It takes a 50% higher income to cover the same basic living expenses in Northern Virginia than in the rest of Virginia.[139] Because of this, increasing the tax rate on incomes over $50,000 would be as punitive to low income households in Northern Virginia as increasing the tax rate on incomes over $35,000 would be on households elsewhere.



While the J-LARC study is not specifically directed to consider a local income tax, the importance of the study to the issue is twofold. First, if Virginia were to authorize a local income tax, it would be administered by the state as an additional percent charged ("piggy-backed") on the state tax

[137] Timothy Vermeer & Katherina Loughead, *State Individual Income Tax Rates and Brackets for 2022*, THE TAX FOUND. (Feb. 15, 2022), https://taxfoundation.org/state-income-tax-rates-2022/.

[138] Jeremy Ney, *Cost of Living and Inequality: Do You Make Enough Money to Cover Your City's Costs*, AM. INEQ. (July 21, 2021), https://americaninequality.substack.com/p/cost-of-living-and-inequality.

[139] *Cost of Living in Virginia*, SALARY.COM, (Aug. 29, 2022) https://www.salary.com/research/cost-of-living/va.

returns from the residents of the county or city that adopted one. Therefore, equity changes that might be made to the Virginia individual income tax would be mirrored in any local tax; conversely, localities could not make structural changes in their local tax.

More significantly, the J-LARC discussion may put new focus on the one-sidedness of state revenue raised on the highly inflated incomes of Northern Virginia not being reflected in covering the highly inflated costs of providing state-supported services in Northern Virginia. For example, state police assigned to Northern Virginia get over a 25% salary differential while computation of state teacher salary support in Northern Virginia results in less than a 5%. This results from the school funding formula reducing any cost-to-compete salary supplement by a locality's LCI.

As discussed earlier, 40% of the LCI calculation of a locality's ability-to-pay an appropriate share of the cost of educating its children is driven by the adjusted gross income (AGI) of its residents. The catch-22 is that local governments do not have the authority to tax AGI and yet, their LCI assumes they do, resulting in lower state education support. For high cost-of-living areas with commensurately inflated AGIs and program costs, this is especially punitive.

Changing the LCI to keep inflated incomes from reducing the state support of commensurately inflated costs would definitely produce winners and losers and it has been politically impossible to get majority support. It may be time to give localities the authority to actually tax the AGI used to reflect their ability-to-pay. Eleven states have local income taxes. Maryland's average rate is the highest at 2.69% of AGI; Kentucky's average rate is 1.48%; Ohio, New York, and Pennsylvania are the other states with rates over 1%.[140]

CONCLUSION – LOOKING FORWARD

In 1966, Virginia broke with fifty years of history in funding public education. Twenty years later in 1986 and thirty years after that in 2013, Virginia broke with the past in funding transportation. The first two decades of the twenty-first century have been marked by increasing realization of the urgency of dealing with unaddressed problems in healthcare, mental health, affordable housing, and environmental deterioration, as well as education challenges exacerbated by growing income inequality. Government budgets are challenged. Thoughtful leadership is needed to build funding solutions on sound principles of government finance that are structured to strengthen state

[140] Vermeer & Loughead, *supra* note 137.

and local program capabilities and that, at the same time, address Virginia's historic and widening challenges of local and individual ability-to- pay through balanced solutions that strengthen the economy throughout the Commonwealth.

