



Frozen in Time

Virginia's Revenue System Can't Pull Its Weight

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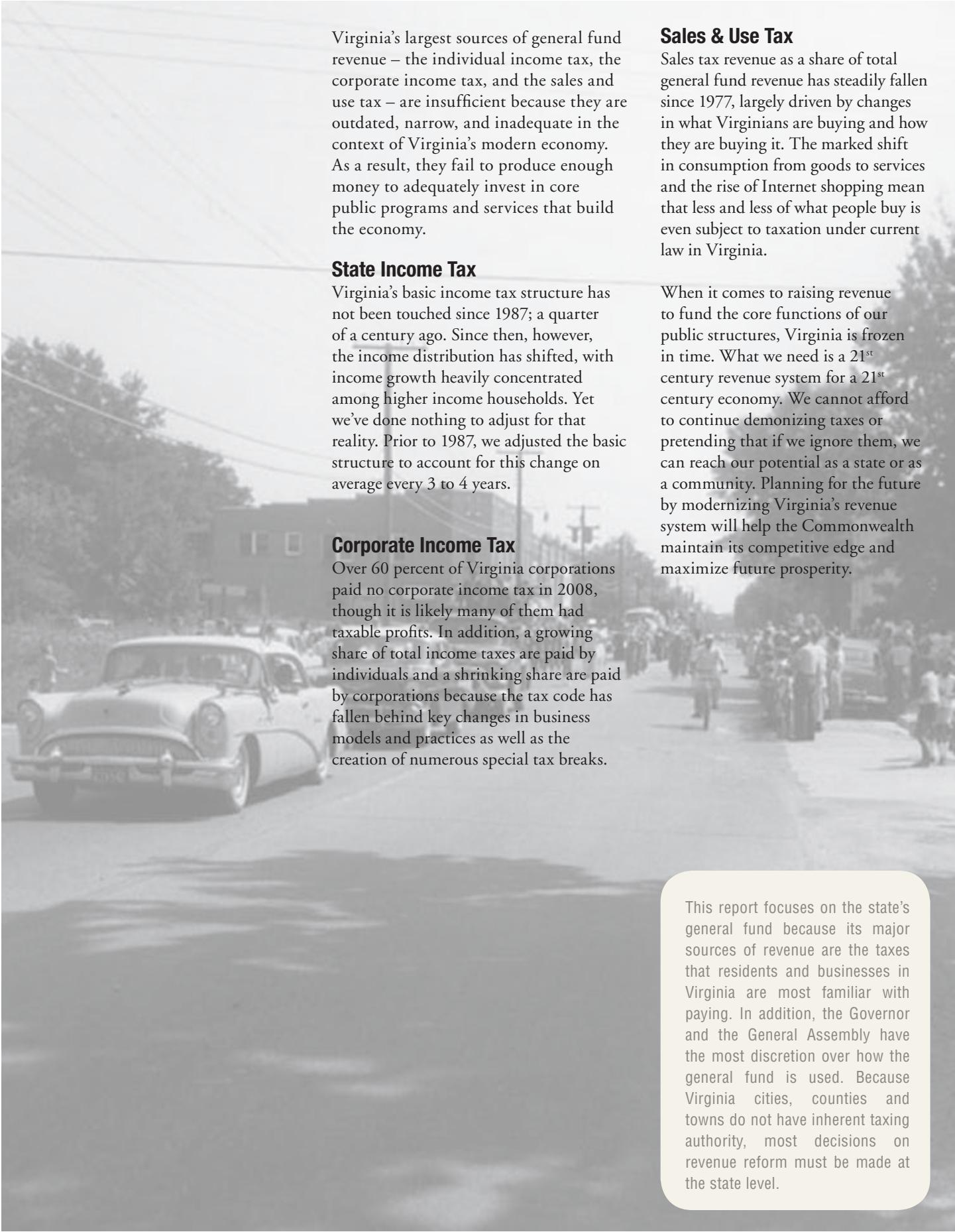
Here's the Problem

To strengthen Virginia's economy and long-term competitiveness, we must invest effectively in education, health care, transportation, and workforce development. But the nature of Virginia's state revenue system makes that impossible. Virginia's taxes were designed for yesterday's economy, and the system is not capable of generating sufficient resources today to keep Virginia moving forward.

The problem runs much deeper than just the impact of the Great Recession. On close examination, Virginia has serious structural problems in the way we raise the resources we need to provide for public services in our state and invest in our future.

- Virginia has grappled with budget shortfalls in 10 of the last 12 years. Reliance on deep cuts, one time budget-balancing tools, and gimmicks got us through the worst of the recession, but the structural problems still exist and will resurface.
- Since the onset of the recession in 2007, state personal income has increased roughly three times as fast as state general fund revenues. But state general fund revenue as a share of personal income has fallen. Had the share remained constant, Virginia would have nearly \$3.9 billion more in general fund resources to invest over the next two years.
- Costly tax breaks, like lowering taxes for certain industries or giving a special break to people who buy certain products, cost Virginia billions of dollars each year. They are baked into the tax code but are not subject to the same regular scrutiny or evaluation as other types of state spending.
- Fully taking into account Virginia's growing population and the rising cost of providing key services, current investment in our economic building blocks like education, health care, and transportation, falls about \$4.8 billion short compared to pre-recession levels.

Virginia has serious
structural problems in the
way we raise the resources
needed to provide for
public services.



Virginia's largest sources of general fund revenue – the individual income tax, the corporate income tax, and the sales and use tax – are insufficient because they are outdated, narrow, and inadequate in the context of Virginia's modern economy. As a result, they fail to produce enough money to adequately invest in core public programs and services that build the economy.

State Income Tax

Virginia's basic income tax structure has not been touched since 1987; a quarter of a century ago. Since then, however, the income distribution has shifted, with income growth heavily concentrated among higher income households. Yet we've done nothing to adjust for that reality. Prior to 1987, we adjusted the basic structure to account for this change on average every 3 to 4 years.

Corporate Income Tax

Over 60 percent of Virginia corporations paid no corporate income tax in 2008, though it is likely many of them had taxable profits. In addition, a growing share of total income taxes are paid by individuals and a shrinking share are paid by corporations because the tax code has fallen behind key changes in business models and practices as well as the creation of numerous special tax breaks.

Sales & Use Tax

Sales tax revenue as a share of total general fund revenue has steadily fallen since 1977, largely driven by changes in what Virginians are buying and how they are buying it. The marked shift in consumption from goods to services and the rise of Internet shopping mean that less and less of what people buy is even subject to taxation under current law in Virginia.

When it comes to raising revenue to fund the core functions of our public structures, Virginia is frozen in time. What we need is a 21st century revenue system for a 21st century economy. We cannot afford to continue demonizing taxes or pretending that if we ignore them, we can reach our potential as a state or as a community. Planning for the future by modernizing Virginia's revenue system will help the Commonwealth maintain its competitive edge and maximize future prosperity.

This report focuses on the state's general fund because its major sources of revenue are the taxes that residents and businesses in Virginia are most familiar with paying. In addition, the Governor and the General Assembly have the most discretion over how the general fund is used. Because Virginia cities, counties and towns do not have inherent taxing authority, most decisions on revenue reform must be made at the state level.

Failing Virginia's Future

A well-structured state revenue system generates the resources needed for essential public services and structures. Virginia must raise enough to do more than maintain even the status quo. It must also support the targeted and strategic investments in our education, health care, and transportation systems that will better position Virginia's economy for robust and sustained growth. But because Virginia's major revenue sources are now so outdated and narrow, the resources they generate are neither keeping up with the state's current needs, nor preparing us for a healthy future.

During the Great Recession, Virginians experienced substantial losses in personal income. A large number of Virginians lost their jobs. Not surprisingly, they bought fewer things. As a result, receipts from the state sales and income taxes collapsed by record-breaking proportions. But the problem cannot entirely be pinned on the national economic calamity. The persistence of Virginia budget shortfalls even before the recent recession reveals severe structural problems with the way the state raises resources.

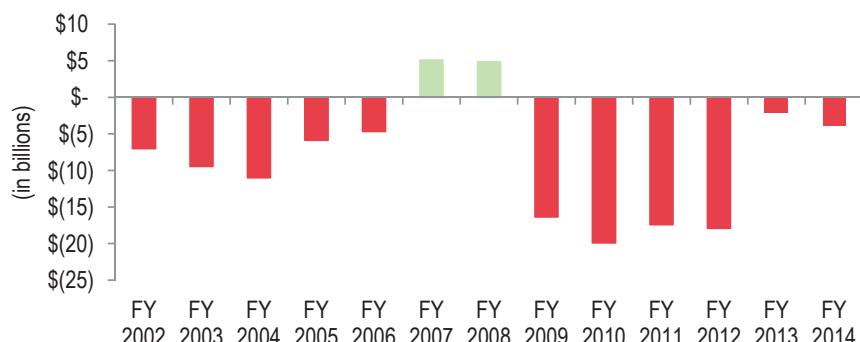
A "budget shortfall" occurs when the state's revenue collections in one budget period fall short of the level needed to deliver the same quantity and quality of services as in the previous budget period. Under this definition, Virginia officials have grappled with budget shortfalls in 10 of the last 12 years ranging from \$214 million to upwards of \$2 billion (Figure 1).

To deal with these shortfalls and balance the budget, lawmakers have mostly cut funding for programs and services, instead of directly dealing with the larger issue of revenues. The result of this has been large gaps between the state's public needs and the resources required to meet them. Fully taking into account Virginia's growing population and the rising cost of providing key services, the state has underfunded K-12 education by \$1.3 billion; health and human services by \$512.2 million; and public safety by \$326.1 million since the start of the recession (between fiscal years 2007 and 2013). Combine these gaps with all the other funding gaps in the budget, and the total gap between what Virginia needs to keep up with population growth and inflation and its current level of investment balloons to about \$4.8 billion.

At this rate, it is clear that Virginia's revenue system will not raise enough money to continue supporting public programs and services even at these reduced levels of investment (Figure 2). Looking forward, Virginia will continue to struggle with budget shortfalls, threatening investment in the very things that help create jobs and ensure a sustained recovery and strong economy.

Ongoing Shortfalls

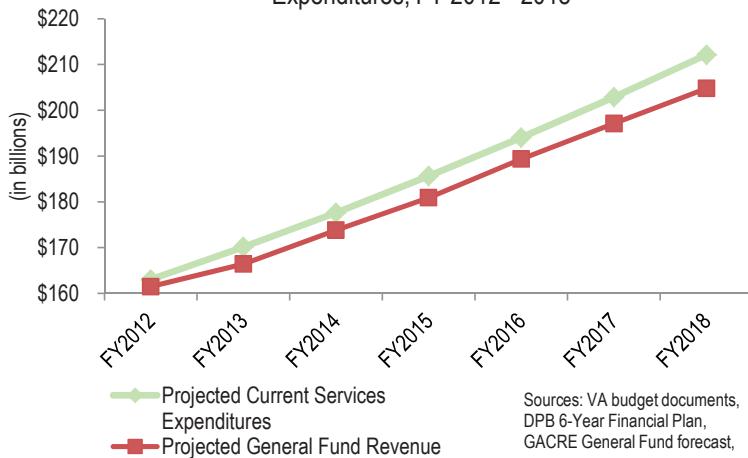
Figure 1: Reported Projected Shortfalls, FY2002 - FY2014



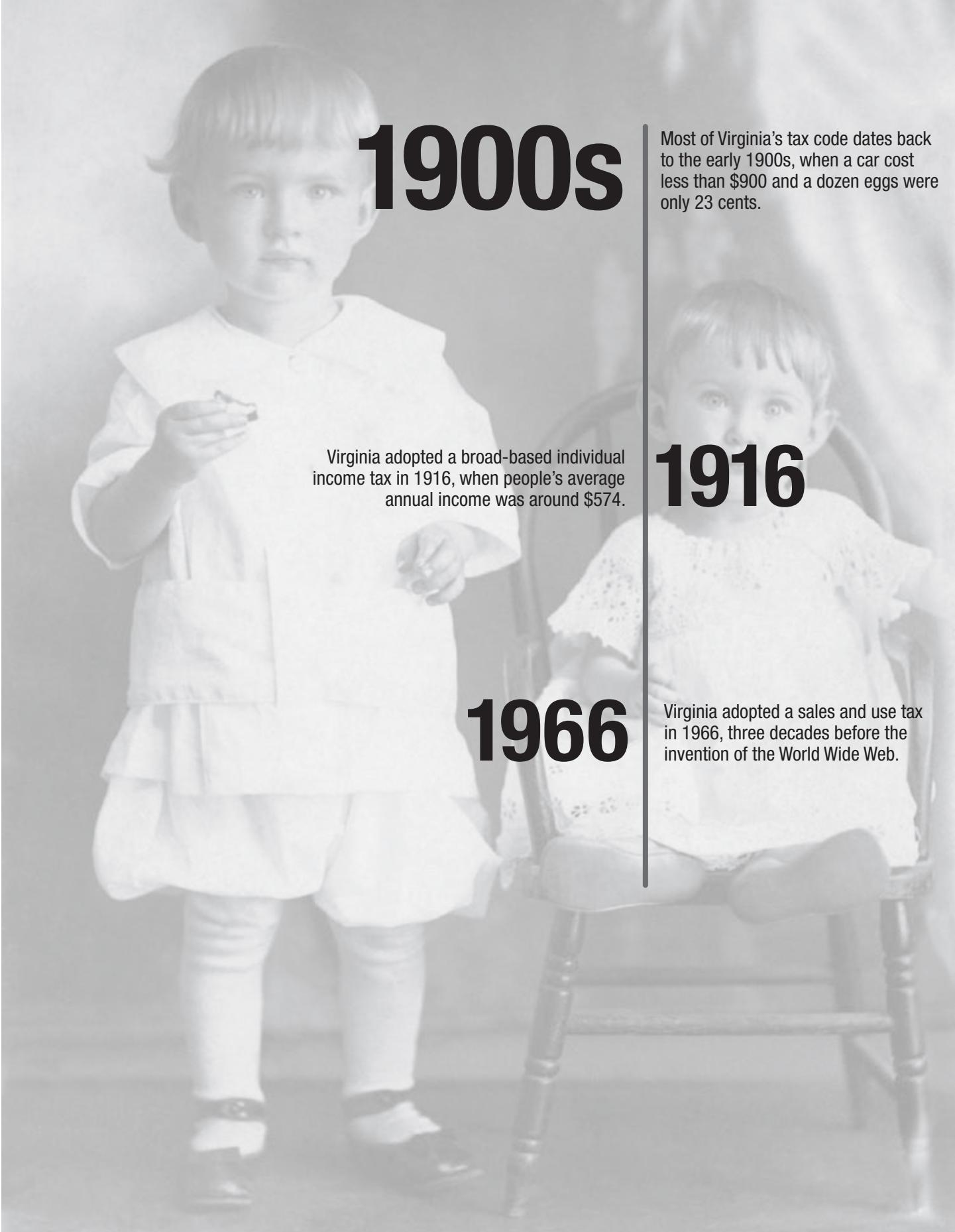
Source: Senate Finance Committee

Can't Keep Up

Figure 2: Projected General Fund Revenue and Projected Current Expenditures, FY 2012 - 2018



Sources: VA budget documents,
DPB 6-Year Financial Plan,
GACRE General Fund forecast,



1900s

Most of Virginia's tax code dates back to the early 1900s, when a car cost less than \$900 and a dozen eggs were only 23 cents.

Virginia adopted a broad-based individual income tax in 1916, when people's average annual income was around \$574.

1916

Virginia adopted a sales and use tax in 1966, three decades before the invention of the World Wide Web.

1966

Opportunities to Chart a Better Course: The Case for Tax Reform

Most of Virginia's tax code dates back to the early 1900s, when a car cost less than \$900, a dozen eggs were only 23 cents and people's average annual income was \$574. At that time, Virginia adopted a corporate income tax that applied to net corporate income. In 1916, two years before the end of World War I, a broad-based individual income tax was adopted. In 1966 – nearly 50 years ago – Virginia adopted a sales and use tax, joining 33 other states that already had one.

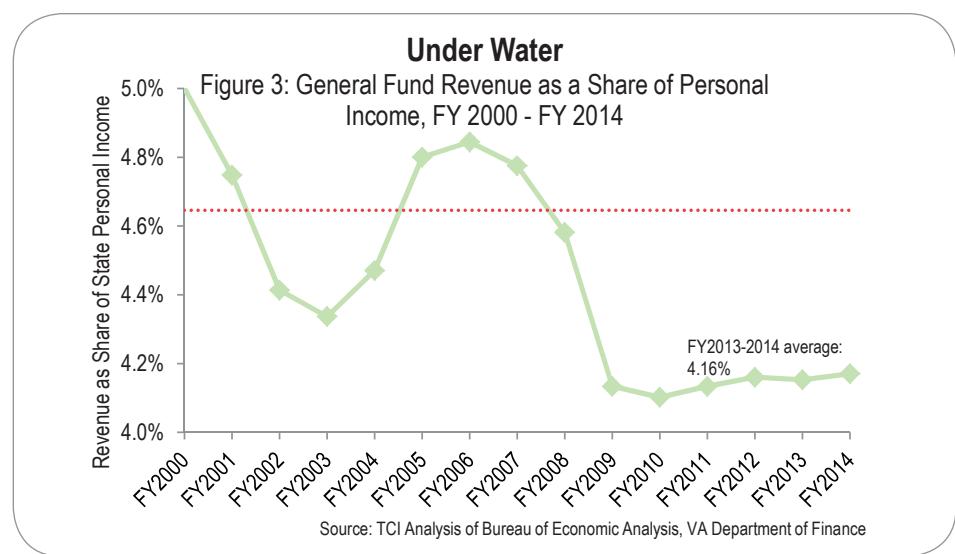
But we live in a very different time now, and our revenue system no longer reflects the way people earn and consume or the way businesses are structured and operate. Key changes, including a shift to a service-based economy, growth of e-commerce, changes in the income distribution, and the proliferation of multi-state corporations, have significantly undercut the ability of Virginia's outdated revenue system to do its job.

But opportunities exist to set Virginia's revenue collections on a more sustainable path. Virginia is a relatively well-off state: it has the 8th highest per capita income in the U.S. Yet our state tax rates for sales and use taxes, personal income and corporate income are among the lowest in the country. That might sound like a good thing, but we all know you get what you pay for. And when it comes to education, public safety and health care, we want the best for Virginia, not the broken bridges and big class sizes that we have now.

Those three taxes – sales and use, personal income and corporate income – are the main sources of revenue for the state's general fund. Over time, support for public programs and services like K-12 education and health care have become more reliant on these particular state taxes. Revenue from the income tax and the sales and use tax, for example, comprised almost 90 percent of the general fund in 2011, up from 80 percent in 2004. At the same time that the general fund is becoming increasingly reliant on these sources, the general fund revenue as a share of personal income has fallen despite the fact that personal income has gone up.

Between fiscal years 2003 and 2007 – the period of economic expansion following the previous recession – Virginia's general fund revenues as a share of state personal income averaged roughly 4.7 percent. Since the onset of the downturn in 2007, state personal income has increased roughly three times as fast as general fund revenues. Yet looking at fiscal years 2013 and 2014, general fund revenues are expected to represent just 4.16 percent of state personal income (Figure 3). Had the share remained constant, Virginia would have about \$3.86 billion more in general fund resources to invest in the public good over the next two years.

Compounding the problem is Virginia's inclination to approve costly tax breaks that deprive the general fund of resources either by eliminating certain income from taxation or providing preferential rates to certain kinds of taxpayers. The formal term is called tax expenditures, reflecting the fact that the impact of these tax breaks on the state budget



is the same is if money were appropriated. Only in this case, the money does not come in at all. To put the operational effect of these tax expenditures in perspective, consider Gov. Mark Warner's 2004 tax reform package that resulted in raising \$1.5 billion in new resources over the 2004-2006 biennium, or \$750 million per year. Simply adding up the cost of five tax preferences enacted or expanded since 2004 wipes out 40 percent of the revenue gains achieved by that tax reform package.

Clearly, Virginia has the capacity to do more with revenue generation to meet the needs of the state's families and workers. By addressing structural flaws in three key areas – the individual income tax, the corporate income tax, and the sales and use tax – we can make the state's system more productive and responsive to the 21st century economy.

Keeping it Equitable: Protecting Virginia's Low- and Moderate-Income Families

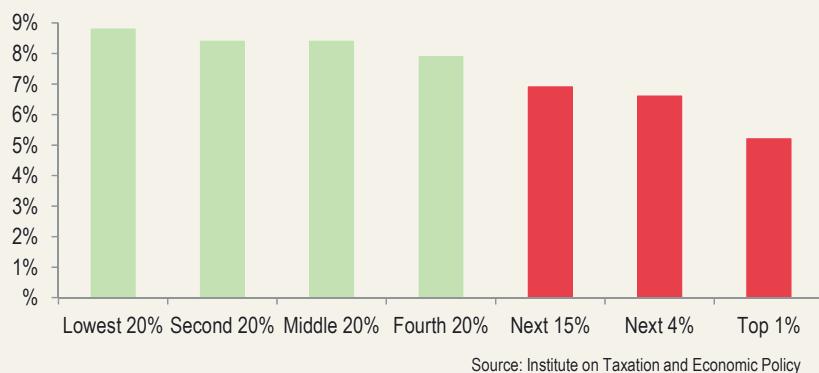
Any conversation about tax reform must take into account the reality that low- and moderate-income families in Virginia pay a greater share of their income in taxes than wealthier households. As income increases, tax liability as a share of total income decreases. As shown in Figure 4, the lowest income bracket – households making less than \$19,000 – pays nearly 9 percent of their income in state and local taxes, compared to 5 percent paid by households at the top – households making over \$529,000. The middle bracket – households making between \$36,000 and \$59,000 – pay 8.4 percent.

Although Virginia's graduated individual income tax to some extent offsets this imbalance – people who make more money pay a higher rate – the end result is still that the less you make, the higher percentage of your income you pay in state and local taxes. Our state's heavy reliance on sales and property taxes explains why. Because low- and moderate-income households spend a greater share of their income buying the basic necessities (like groceries, toiletries, clothing, school supplies, and gas) which are subject to the state's sales and excise taxes, they end up paying a larger share of their incomes in these taxes.

Any increase in a tax that falls more on people as their income is lower should be enacted with corresponding measures to ensure that low-income households are not disproportionately affected. Two options for reducing the effects of broad-based tax increases upon moderate- and low-income Virginians include making Virginia's Earned Income Credit refundable or creating a new direct payment or rebate to all moderate- and low-income families equal to the magnitude of the increase in the particular sales or excise tax.

Low Income, High Burden

Figure 4: Percentage of Income Paid for State and Local Taxes, after Federal Deduction Offset



Source: Institute on Taxation and Economic Policy

Virginia's basic income tax structure is the same as it was in 1987, when cell phones were bricks and cost about \$4,000.

1987

5.75%

The share of taxpayers paying the highest rate in 2010. In 1987, only 38% paid the highest rate.

3-4 Years

Since 1978, average income for households in the top 10% has grown from \$130,419 to \$162,955.

At the bottom, it has declined from \$13,883 to \$12,781. In the middle, it has remained flat. But Virginia hasn't adjusted its brackets.

The highest tax bracket in Virginia – 5.75% – is the 8th lowest in the nation and kicks in at \$17,000. That means a person making \$17,001 pays the same rate as someone making over \$250,000.

59%

Before 1987, Virginia adjusted its tax structure to account for changes in income about every 3-4 years.

Income Shift

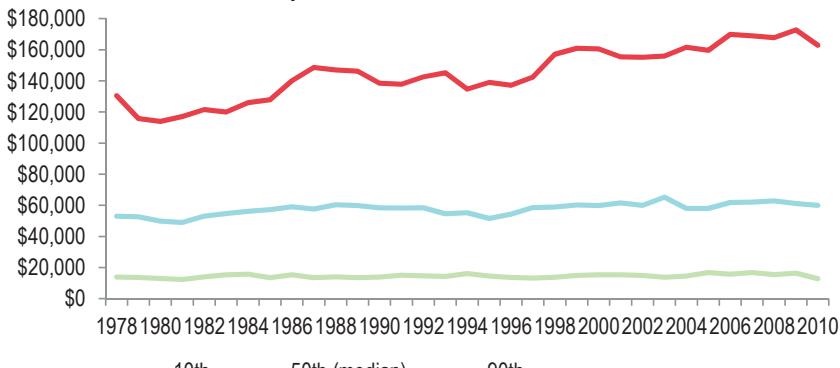


A Closer Look at the State Income Tax

The law addressing Virginia's basic income tax structure is the same as it was in 1987, a quarter century ago. Since then, however, income changes have taken place that call for a readjustment of the tax structure. For example, the way income is concentrated has changed – and continues to change – dramatically. Almost all of the income growth Virginians enjoyed over the past 25 years is concentrated among higher income households. Yet we've done nothing to adjust for that reality. Prior to 1987, we adjusted the basic structure to account for these types of changes on average every 3 to 4 years.

Income Grows at the Top

Figure 5: Income Distribution
Adjusted for inflation, 1978-2010



Source: EPI Analysis of CPS Annual Social and Economic Study

Over the last 32 years, low- and moderate-income households in Virginia have seen slow growth and sometimes even declines in household income, while higher-income households have fared much better (Figure 5). Income for a household in the bottom 10 percent was \$13,883 in 1978. In 2010, it was \$12,781. By contrast, average income for households in the top 10 percent in 1978 was \$130,419 and increased to \$162,955 by 2010.

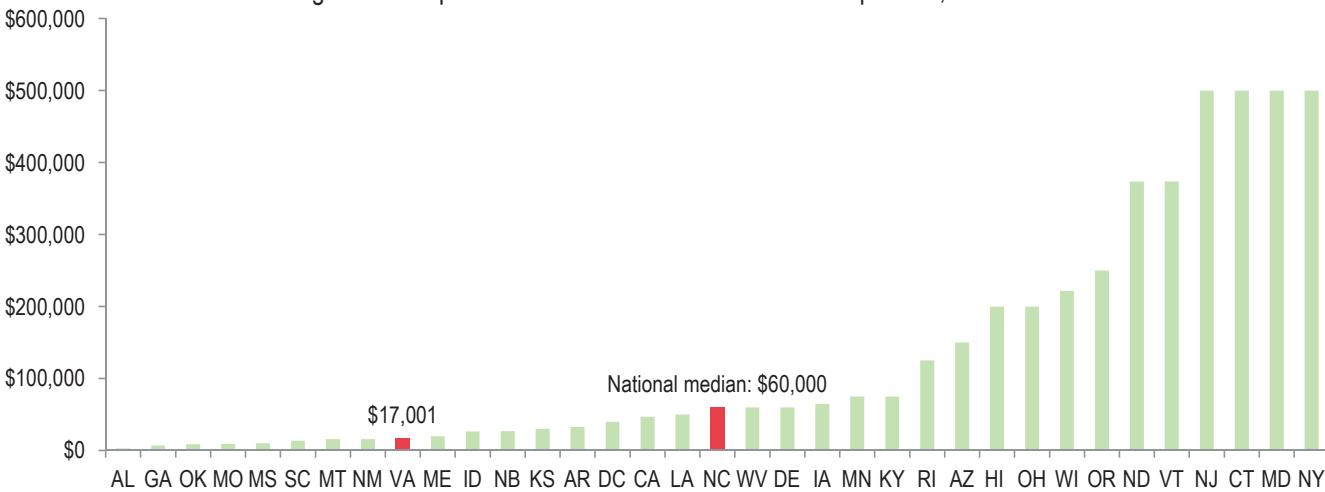
Though Virginia's individual income tax uses a graduated rate structure, rates and brackets remain what they were in 1987, when the top rate of 5.75 percent – the 8th lowest in the country – was set for taxable income in excess of \$17,000 (Figure 6).

That means a family of four with taxable income of \$17,001 is subject the same rate on that last dollar of income as a household of the same size with taxable income of over \$250,000. As a result of this relatively flat rate structure by today's income standards, about 60 percent of Virginia taxpayers now pay the top marginal rate of 5.75 percent. In 1990, when the new rate went into effect, only 38 percent paid the top rate.

Inflation partially drives this phenomenon, known as "bracket creep." As incomes grow with inflation, more and more of a household's income is pushed into the highest tax bracket

Over the Top

Figure 6: Comparison of State Individual Income Tax Top Rates, 2011



Source: Federation of Tax Administrators, State Individual Income Tax Rates updated January 1, 2011

and taxed at the highest rate. But because Virginia does not adjust its income tax brackets, deductions, and exemptions to keep up with inflation (unlike 17 other states and the federal income tax system) their values diminish with time.

This outdated orientation of our rate structure has real consequences for low-and moderate-income households and for the state's finances. Better aligning the brackets and rates with trends in income growth in the state would yield significant new resources for the state and put funding state needs on a more sustainable pathway going forward.

A Closer Look at the Corporate Income Tax

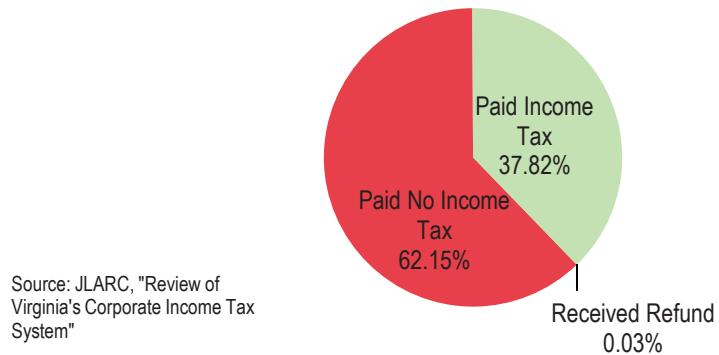
Virginia's corporate income tax is levied on corporate profits. The rate is 6 percent and has remained unchanged since 1972. It is the 7th lowest rate among the 32 states with a flat rate. Since then, key changes in business models and practices, as well as the creation of numerous special tax breaks, have outstripped its ability to adequately account for today's business activity.

Over 60 percent of Virginia corporations paid no corporate income tax in 2008 (Figure 7). It's certainly possible some of these corporations are not making profits and are not subject to paying any tax in a given year, but likely all of them aren't. As a result, a growing share of total income taxes is being paid by individuals as opposed to corporations (Figure 8). In the midst of the Great Recession, individuals paid almost 93 percent of total income taxes compared to corporations, which paid just 7 percent of total income taxes in 2008. Between 1978 and 2008, the share of total income taxes paid by corporations fell more than 50 percent. This means that the cost of providing public services has shifted dramatically from corporations to individuals in our state, yet we know that these services – like an educated workforce and a legal system – are valuable to corporations.

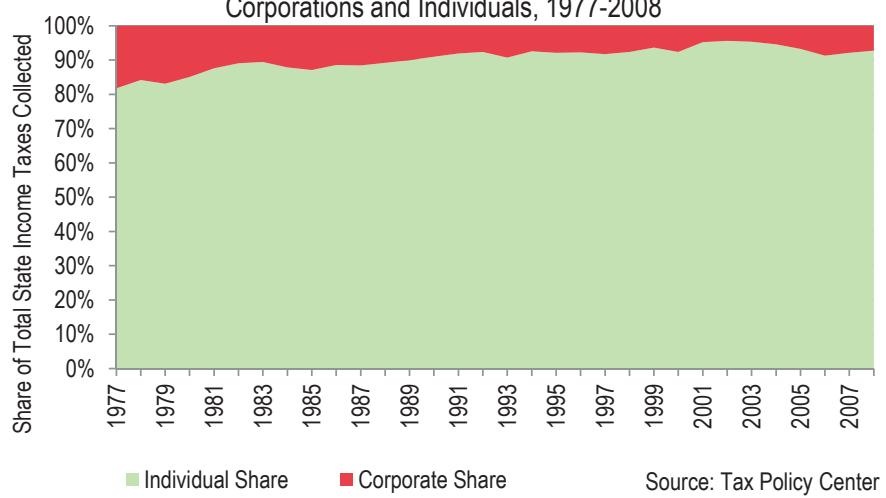
One of the driving forces behind this erosion of the corporate income tax is the fact that larger corporations, especially those that operate in multiple states, are able to deploy teams of accountants to exploit differences in tax policy across the states in which they operate and reduce or eliminate the taxes they pay in any given state.

Some businesses, for example, shift income earned in Virginia to other states that have no corporate income tax, creating what tax experts refer to as "nowhere income." Virginia used to tax such income, but the rules were changed in 1981, and this practice is estimated to cost the state \$19.7 million in the current two year budget.

Sweetheart Deal
Figure 7: Corporations and State Corporate Income Tax Liability, 2008



Not Fair
Figure 8: Share of State Income Taxes Paid by Corporations and Individuals, 1977-2008



Source: Tax Policy Center

Another new costly tax break included in our current corporate income tax structure is the option for manufacturers to choose the tax system they'd prefer – one system that bases the tax you owe equally on three factors (in-state payroll, in-state sales, and property) or one that bases it only on sales, ignoring the other two factors. This tax break is called the Single Sales Factor (SSF). In Virginia, it will be fully phased-in for manufacturers and effective in 2014 and is estimated to cost the state \$64.7 million per year in lost general fund revenue. The Department of Taxation's own analysis showed the bulk of the benefit goes to big corporations: over 75 percent of the total tax break was estimated to go to corporations with tax liability of over \$1.2 million.

Proponents claimed that adopting SSF would create jobs in the state, yet the SSF apportionment formula bears little relationship to state job growth in the manufacturing sector. For example, when you look at manufacturing jobs, you see that states who have adopted this costly tax break have no better track record than other states (Figure 9). The claim of "give us the tax break and we will bring jobs" is simply not supported by the facts.

Single Sales Factor is just one of hundreds of costly tax breaks that result in billions of dollars in lost revenue to Virginia each year. None of these business tax breaks was subject to evaluation for their effectiveness in meeting their intended policy goals, a Joint Legislative Audit and Review Commission study found in 2011. The study concluded that the effectiveness of economic development tax credits was mixed and these costly preferences "appear to have little impact on the outcomes they are intended to promote."

Virginia's Coal Tax Credits – A Cautionary Tale

In 2011, a Joint Legislative Audit and Review Commission study on tax preferences found that their ability to promote economic activity is mixed: "While some tax preferences appear to successfully promote their intended activities, others, including the largest preference examined, appear to have little impact on the outcomes they are intended to promote."

One set of credits the study called out, in particular, was the Coalfield Employment Tax Credit and the Virginia Coal Production and Employment Incentive Tax Credit, which together cost the state \$31.2 million in 2008. Despite being enacted to bolster coal production and employment, it turns out that production and employment declined at faster rates than were predicted if these tax credits had not been enacted.

In other words, they didn't do what proponents said they would; the tax credit didn't work to stabilize production and jobs. For the 66 recipients of these tax credits, however, tax liability declined by a total of 135 percent. And because the average tax credit claimed exceeded the companies' tax liability, they got money back because the credit is refundable. Unfortunately, once enacted and inserted into the tax code, even ineffective tax credits like these often operate on autopilot. Unlike spending that comes through the state budget and is evaluated every year, tax expenditures are rarely evaluated.

Single-Sales Factor No Help on Jobs

Figure 9: Change in Manufacturing Employment for States with Corporate Income Tax: Dec. 2001 - Dec. 2011

State	Change
<i>North Dakota</i>	3.4%
Utah	-0.6%
Iowa	-8.3%
Nebraska	-13.3%
<i>Alaska</i>	-13.3%
Louisiana	-14.4%
Idaho	-14.5%
<i>Kansas</i>	-14.5%
<i>Hawaii</i>	-16.9%
Minnesota	-17.3%
<i>Montana</i>	-17.8%
Wisconsin	-18.3%
<i>Oklahoma</i>	-19.2%
Oregon	-20.3%
Indiana	-20.3%
Arizona	-22.1%
Kentucky	-23.7%
Colorado	-23.8%
<i>Alabama</i>	-24.4%
Connecticut	-24.8%
New Mexico	-24.8%
Missouri [Median State]	-25.6%
Illinois	-25.6%
South Carolina	-26.0%
New Hampshire	-26.5%
California	-26.6%
Georgia	-27.3%
Pennsylvania	-28.1%
Arkansas	-28.7%
Maine	-28.9%
Florida	-28.9%
Vermont	-28.9%
Mississippi	-29.9%
Tennessee	-30.0%
West Virginia	-30.3%
Massachusetts	-30.4%
Virginia	-31.5%
Maryland	-31.5%
New York	-32.7%
<i>Delaware</i>	-33.6%
New Jersey	-33.6%
North Carolina	-34.9%
Rhode Island	-37.4%

Key:

States with Single Sales Factor Formula in Effect Throughout Period in Bold.

States with Equally-Weighted 3-Factor Formula in Effect Throughout Period in Italic.

Source: Center on Budget and Policy Priorities calculations based on Bureau of Labor Statistics data.

1977

The Sales and Use tax accounts for 20% of the state's general fund, which pays for education, public health care and public safety.

20%

Over the last 30 years, consumer spending has shifted from buying goods to buying services. Between 1980 and 2010, the rate of spending on services increased almost 23 percent.

23%

The Federation of Tax Administrators identified 168 services that are taxed by some states. Of those, Virginia taxes just 18.

18

A Closer Look at the Sales & Use Tax

When people buy things in Virginia that are subject to the state sales tax, the state collects 5 percent of the purchase price. This is the 5th lowest rate in the country. Though it accounts for approximately 20 percent of the state general fund, over time the tax has become a declining source of revenue for the state. During times of economic uncertainty, especially during recessions, sales tax receipts often decrease as people shift consumption amounts and patterns. Declines in Virginia sales tax revenues are not solely attributable to swings in the business cycle, however. In fact, sales tax revenues as a share of total general fund revenues have steadily fallen since 1977 (Figure 10).

Sales tax revenue has fallen for several reasons. Over the last 30 years, consumer spending has shifted more toward services that are not taxed and away from goods that are. Between 1980 and 2010, the rate of spending on services increased almost 23 percent. In 1980, spending on services accounted for a little over half of personal consumption. In 2010, that share grew to two-thirds (Figure 11). But the state sales tax has not kept pace with

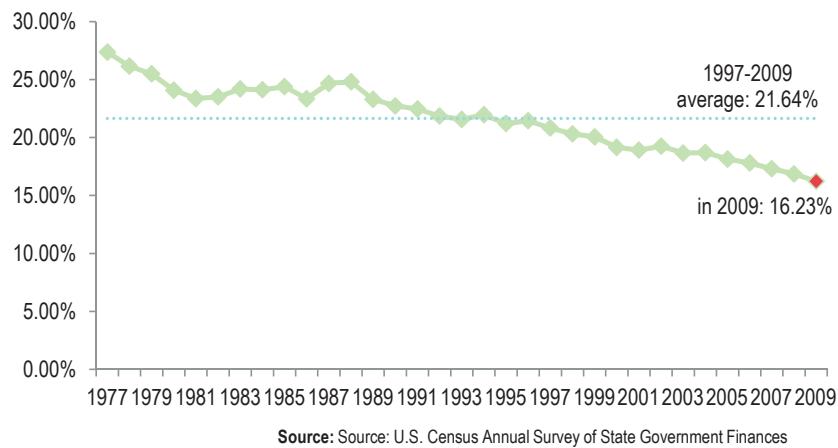
the changing economy. Of 168 services identified by the Federation of Tax Administrators as being taxed by some states, Virginia taxes 18.

In addition, the rise of e-commerce has eroded sales and use tax collections as more people do their shopping online instead of on Main Street – and as a result do not pay sales tax even though

the law says they owe it. The problem is that many online sellers choose not to collect the tax. E-commerce today makes up 4.3 percent of total retail sales across the country – a more than four-fold increase in a little over a decade (Figure 12). And it is projected to rise to 9 percent by 2016. Collection of sales and use tax by online vendors is complicated by a 1992 U.S. Supreme Court decision

Sales Tax Revenue Declines

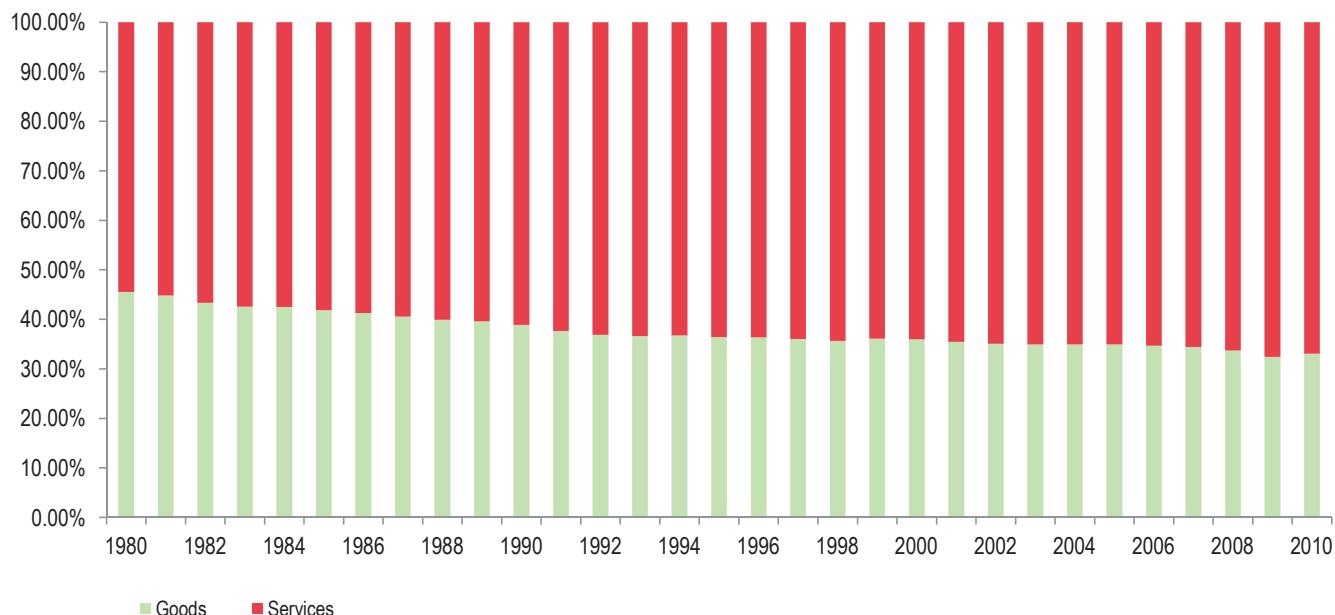
Figure 10: Share of Sales Tax Revenue to General Revenue, 1977 - 2010



Source: Source: U.S. Census Annual Survey of State Government Finances

From Goods to Services, a 30-Year Shift

Figure 11: Share of Personal Expenditures on Goods vs. Services, 1980 - 2010

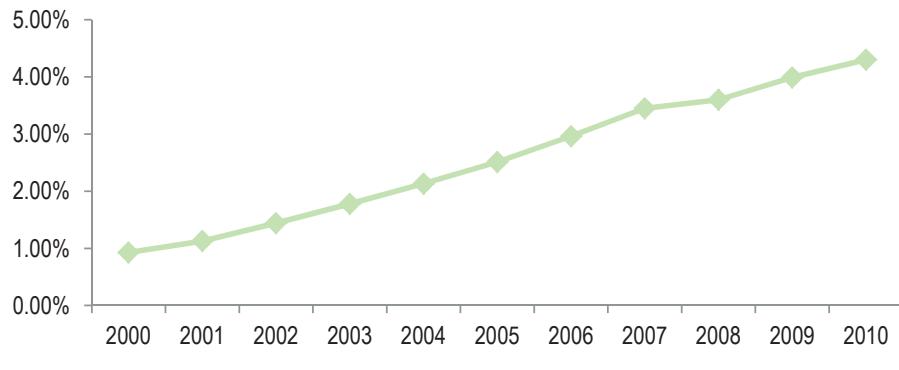


Source: Bureau of Economic Analysis

that ruled that retailers are exempt from being required to collect this tax (even though buyers owe it) in states where they have no physical presence, like a store, office, or warehouse. In 2012, Virginia took a step in the right direction by passing legislation requiring Amazon and other online companies with warehouses in the state to collect sales taxes. Digital goods, however – audio, books, computer programs, and other files downloaded from the Internet (things that didn't exist when the tax system was set up) – are still not taxed.

E-Tail Growth

Figure 12: E-Commerce as a Percent of Total Retail Sales, 2000-2010



Source: U.S. Census Bureau

Virginia's Exceptionally Low Excise Taxes

Excise taxes are levied on specific products. Virginia's excise tax rates are low compared to the rest of the country and its neighboring states.

The state's gasoline tax of 17.5 cents per gallon, for example, was set in 1987. In 2010 dollars, the effective value of the tax was 9.1 cents per gallon. So at its current rate the tax, which is dedicated to road maintenance and construction, falls far short of paying for the kind of maintenance and construction we need.

Another example is the cigarette tax. Virginia has the second lowest cigarette tax in the country. The average state excise tax on cigarettes nationally was \$1.44 per pack in 2011; Virginia's is 30 cents per pack. Even if a locality in Virginia charged 45 cents per pack, one of the few local taxing options permitted by law, Virginia would still have the 5th lowest per pack excise tax in the nation.

Conclusion

Virginia's general fund revenues have fallen short of the levels needed to fund education, public safety, transportation, health and human services, and other public obligations that contribute to a strong economy for over a decade. And they will continue to do so because a maze of obsolete and narrow policies, set between 25 and nearly 100 years ago – and for the most part not updated since – have Virginia frozen in time. Holding fast to a state tax system that was designed for yesterday's economy, not the Virginia of today, is starving the needs of our modern state and jeopardizing our ability to create good jobs and ensure a better future for the next generation. It is time for Virginia to engage in a serious conversation about revenue modernization. It is time to talk taxes.



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