

June 15, 2018

ABOUT

2018 Tax Policy Decisions: Funding Virginia's Investments

On May 30, the General Assembly finally reached agreement on a new budget to fund Virginia's public services over the next two years. Significantly, the budget expands the Medicaid program to provide health care coverage for hundreds of thousands more Virginians while also making key investments in areas like early childhood education and K-12 education.

In any state budget, the other side of the equation is the revenues to pay for these investments in Virginia's families and communities. To cover the state share of the costs of Medicaid expansion, the new budget includes a provider assessment on private acute-care hospitals. The revenue from this assessment will be placed in a special fund dedicated to health care, so it will not impact Virginia's "general fund," which is the regular tax revenues that the General Assembly can use for K-12 schools and other investments.

Virginia's general fund (GF) will be impacted by several other tax policy decisions and some updated estimates. The biggest of these is that the final budget agreement included a reforecast to the state's general fund revenue projections based on higher-than-expected income tax withholding in the current fiscal year. This update added \$120 million in available GF revenues.

The state budget also included a number of tax policy decisions – several related to newly enacted legislation – that are expected to affect the revenue picture.

The budget extended existing limits on the state's Land Preservation and Historic Rehabilitation tax credits. These two provisions will provide an additional \$26.2 million over the next two fiscal years. TCI has long called for more accountability and limits around the state's various tax breaks. In the absence of wider reforms, continuing these limits represents a step in the right direction.

The budget included \$450,000 in new revenues that will result from the recently enacted SB 249. The legislation makes all-terrain vehicles (ATVs), mopeds, and off-road motorcycles subject to the motor vehicle sales and use tax. Previously, these purchases were subject to the retail sales and use tax. This tweak means that purchases of these vehicles made outside of Virginia will be subject to the state tax upon titling.

The General Assembly passed annual tax conformity legislation (HB 154 and SB 230) to update the state tax code to incorporate some federal tax changes from the previous year. This update will decrease state revenues by \$3.3 million over the two-year budget. As we noted last week, the General Assembly's next decision around tax conformity will be much more significant, because lawmakers will need to decide how the state responds to the federal tax law passed in December.



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Several other budget provisions related to recent legislation are likely to reduce state revenue over the longer term by creating or reviving tax breaks for businesses. These tax breaks are intended to help communities coping with job losses and declining populations. This is an important goal, but these types of business-focused tax breaks do not have a proven track record of success.

The new business tax cut (HB 222 and SB 883) is available to certain businesses if they choose to locate in select localities. However, as an economic development strategy, tax cuts are not an effective means of attracting businesses. In addition, these tax cuts give qualifying businesses an unfair advantage over existing businesses in those areas, negating potential economic gains of these policies. Although the law includes several guard rails to prevent abuse from companies trying to game the new tax break, it remains to be seen whether these provisions will be sufficient. Legislators passed this proposal despite their own analysts stating that the revenue impact from it is unknown.

This is not the first time that Virginia has used tax breaks as a means to promote employment. Although the locality-specific tax cut for businesses is new to Virginia, the state already has a long history of providing tax cuts to specific industries. For example, the state enacted a single-sales factor (SSF) apportionment system for taxing manufacturers in 2009. Although this provision was sold as a way to boost manufacturing employment and has cost the state about \$240 million over the four years since it has been fully implemented (or about \$60 million annually), there is not a strong relationship between SSF and state manufacturing employment. Since fully implementing SSF, Virginia's growth in manufacturing still lags many of our neighbors (Kentucky, North Carolina, and Tennessee), which speaks to the importance of broader aspects of a state economy than just a tax break for achieving solid job growth.

In addition, between 1988 and 2016, Virginia spent over \$800 million, after adjusting for inflation, on coal tax credits. During that same time, coal mining employment fell by over 74 percent according to data from the Department of Mines, Minerals and Energy. The decline had accelerated in recent years even though Virginia spent more than \$10,000 per job, per year between 2012 and 2016 after adjusting for inflation. The state's research arm concluded that the coal tax credits reduced the tax liability for mine operators, but the credits did not appear successful in boosting Virginia coal production and employment. The reinstated Coalfield Employment Enhancement Tax Credit (HB 665 and SB 378) does not have a revenue impact for the next two-year budget period, because it cannot be claimed until FY 2022, but is expected to cost Virginia between \$5 and \$7 million per year when it does go into effect.

Virginia's overall revenue system still faces structural challenges that will need to be addressed if the state is to meet its commitments to provide high-quality schools, infrastructure, and other public services. The erosion of key revenue



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sources will remain an ongoing issue until lawmakers pursue broader tax reforms so that our revenue system is more aligned with the modern economy. Yet this past session shows that real progress can be made. By instituting a hospital provider assessment, extending limits on a couple of large tax preferences, and investing additional revenues across the budget, the General Assembly was able to make large, meaningful investments, particularly in health care and education – critical foundations for building thriving communities.

– *Chris Wodicka, Policy Analyst*

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