Can Virginia Fund the Recent JLARC K-12 Recommendations?

Virginia Association of School Superintendents

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Where Do State Finances Stand Today?

- Fourth year in a row of a large GF revenue surplus above the adopted budget ($1.2 bil. in FY 2024).
- Positive wage and salary growth currently expected in Virginia for the 2024-26 biennium.
- $4.7 billion in mandatory and voluntary GF reserves (17.4% of the GF)
- Virginia Retirement System finances have improved
- Significant unused debt capacity available
- An adopted 2024-26 budget that already funds most *mandatory* requirements.

Conclusion: Excellent chance to significantly increase <u>ongoing</u> state K-12 funding commitments.

Expect at Least $3 Bil. in Additional GF Revenues for the 2024-26 Biennium Budget

- About $500 mil. in new spending available from $1.2 bil. FY 2024 surplus (after $460 mil. in contingent appropriations and mandatory deposits for WQIF and $175 mil. for I-81).
- Revenue forecast <u>should</u> increase by *at least* $2.5 - $3.0 billion due to higher FY 2024 revenue base. For example, 3 percent GF revenue growth in FY 2025 would produce $1.8 bil. in additional GF revenue and 2 percent growth in FY 2026 would produce $700 mil in additional revenue above the current budget forecast.
- New revenue forecast should assume continued economic growth. Inflation is slowing toward 2 percent. Consumer spending and personal income continue to grow at a healthy pace. FY 2024 Virginia wage and salary growth was over 6 percent. Consensus expectations are that wage and salary growth will slow to about 5 percent in FY 2025 and 4 percent in FY 2026.
- However, don't be surprised if the introduced budget makes a conservative economic and revenue forecast. Forecasting the economy <u>is</u> fraught with uncertainty and the forecast for income tax non-withholding is always difficult!

Economic Growth Continues to Perform Better Than Expected in Current Budget

YTD GF Revenue Growth Points to Continued Strong Revenues

Note: Current 2024-26 budget expects *<u>negative</u>* 3 percent GF revenue growth compared to FY 2024 actual

Expect FY 2025 and FY 2026 GF Revenues to Be Significantly Higher than Budgeted

How Does the State Spend Its General Fund?
Adopted State 2024-26 GF Budget ($ Mil.)

K-12 Spending Items Expanded in the 2024-26 Biennium Budget

- 3% salary increase each year *for state share* of SOQ instructional and support positions (localities must provide at least 1.5% for prorated share): $546 mil.
- Expand at-risk add-on and combine with the PIR per JLARC recommendation: $371 mil.*
- Improve English learner staffing standards: $72 mil.
- Expand reading specialist staffing standard: $61 mil.
- $80 mil. each year into school construction fund from casino revenues
- Authorizes $200.0 million in FY 2025 and $50.0 million in FY 2026 in literary fund school construction loans. Language also requires interest rates for these loans to be discounted yet responsive to market rates.

Child Care:

- Use GF support for child care subsidy program after federal funding expires: $436 mil. Use GF to support mixed delivery services after federal funding expires: $58 mil.

* These payments shall be distributed based on the estimated number of At-Risk students, based on (1) the most recent three-year average Identified Student Percentage, applying a 1.25 multiplier factor , and (2) including one quarter of students identified as English language learners. The At-Risk Program shall provide each school division the state share of an 11.0 percent basic-aid add-on per estimated At-Risk student. In addition, the program shall provide each school division the state share of a payment equal to a 0.0 to 37.0 percent basic-aid add-on per estimated At-Risk student, with each school division's add-on percentage determined based upon the school division's concentration of At-Risk students relative to all other school divisions.

State Direct Aid to K-12 Has Grown by Average Amounts Over Time

Reviewing JLARC K-12 Recommendations

According to JLARC, the "State SOQ formula yields substantially less funding than actual division spending and benchmarks". Using FY 2022 data, the study found that Virginia school divisions receive 14 percent less ($1,900 per student) than the 50-state average. Implementing all JLARC recommendations costs about $3.5 billion per year.

- The state SOQ only recognizes 2/3 of actual staff employed by school divisions, with the single largest unrecognized staff category being teacher aides. **($1.86 billion/yr.)**
- The need to cover all higher cost-of-living school divisions with a newer, more accurate cost adjustment. **($595 mil./yr.)**
- The need to use a re-benchmarking process that covers real-time school division costs. **($490 mil./yr.)**
- The prevailing salary cost methodology assumes every school district has equal weighting in the formula, thus skewing SOQ recognized salaries toward lower rural small division salaries rather than much more numerous teacher large division salaries. **($190 mil./yr.)**
- Not restoring the temporary cuts adopted during the 2009 recession, including the support position cap, certain non-personal expenses, and the federal deduct calculation. **($116 mil./yr remaining support cap + $150 mil. other)**
- Inadequate state support for more difficult to educate students, including economically-disadvantaged, English language learners, and special education students. **(<u>Adopted</u> in 2024-26 budget $250 mil./ yr.)**
- Not recognizing the lack of economies of scale and more support needed in small school divisions. **($90 mil. /yr.)**

K-12 Student-Based Funding Model

- **JLARC: A well-designed student-based funding model would be more accurate, more transparent, and easier to maintain over time than Virginia's current staffing-based formula. Implementing a student-based funding formula was estimated to cost $1.2 billion above FY23 funding.**
- JLARC envisions a student-based funding formula starting with the historical cost to educate an average student by school division. Adjustments are then made for cost-of-living, economies of scale and higher cost to educate students (e.g., at-risk, special education, and English learner students). State/local ability to pay is also a factor in the shared cost.
- A student-based formula uses per-student cost assumptions and student enrollment to calculate the total funding obligation. These per student cost assumptions include all staffing and non-staffing costs associated with providing instruction and support, so no additional calculations are needed.
- The vast majority of states (34) use a student-based funding formula that allocates divisions a specified amount of funding per student. Seven states use hybrids of the staffing- and student-based approaches or another approach.
- *In contrast*, staffing-based formula calculations (such as Virginia) are much more complicated. Staffing-based models require numerous calculations to determine funded staff levels. Second, additional calculations determine the cost of compensating those staff. Then non-staffing costs must be added to determine the total funding obligation.

Other Potential New 2024-26 Funding Requests

- Additional teacher salary increases cost $91 million per 1 percent increase per year (currently state SOQ funded at 3%).
- State and state-supported local employee salary increases cost $91 million per 1 percent increase per year (currently state funded at 3%).
- New Medicaid forecast comes out in early November. Also, expect requests for Medicaid funded provider rate increases and additional waiver slots.
- Additional funding requests for mental health care improvements – although significant sums have recently been provided that need to be absorbed.
- Expect Child Services Act sum sufficient pool fund increases of $35 mil. per year
- Calls for higher education financial aid increases and backfill funding for higher ed military tuition reduction losses ($45 million/yr in contingency funding already in budget).
- Requests to scale up community college career and technical education programs.
- Additional childcare funding requests.
- Capital outlay and maintenance reserve requests.
- Economic development site readiness funding.
- Additional Metro aid.
- Climate resiliency funding. Hurricane disaster relief?

Should Virginia Increase Taxes to Fund Its K-12 Obligations?

- Governor Youngkin likely to again ask for tax *reductions* in his introduced budget.

Recent Tax Reductions in Virginia

Virginia is a Low Tax State
When Considering Wealth With Tax Levels

Virginia Tax Rankings Versus Surrounding States

Recent Tax Changes Increased Individual Income Tax Progressivity

- Virginia increased the progressivity of the individual income tax by:
  1) nearly doubling the standard deduction; and
  2) making the state earned income tax credit partially refundable – low-income filers can receive a refund even if they have little or no tax liability.

  ✓ *2022 JLARC report*: Taken together, these changes will make Virginia's income tax 45% more progressive than in 2021 (as measured by change in the "Suits" progressivity index, which measures the progressivity of taxes on all income groups), and more progressive than most other states' income tax.

- These changes reduced taxes for many filers, but especially low and lower-middle income filers. *JLARC*:
  - ➢ Low-income filers (1st quintile of filers, up to $14,000 in income) will see their effective tax rate (percentage of income paid in taxes) decline substantially from 0.8% to -1.2%.
  - ➢ Lower-middle income filers (2nd quintile of filers, $14,000 to $36,000 in income) will see their effective tax rates reduced by half, from 2.4% to 1.2%.

Individual Income Taxes Comprise 2/3 of General Fund Revenue

- Virginia's highest rate— 5.75% for income above $17,000—is substantially less than many states with more progressive rate structures – but starts its highest rate at much lower levels than many states, **thus ultimately relying on income taxes more than most states**.
- Regionally, the highest income tax brackets and rates vary substantially. West Virginia's highest rate is 6.5% of income above $60,000. Maryland's highest rate is 5.75% of income above $250,000. North Carolina has a flat tax rate of 4.50% beginning in 2024, declining to 4.25% in 2025. Tennessee has no income tax.

Policy Option Examples to Raise Revenue:

- **Create a new 7% income tax bracket for $600,000 or more income (top 1% of income filers). Raises about $510 mil. per year beginning in 2026 (and growing by 5% each year)**
- **Create two new income tax brackets: 1) 6% backet for $100,000 to $1 million income and 2) 6.75% bracket for $1,000,000 or more income.**
  - **Raises about $600 mil. per year**
- In tax year 2021, Planning District 8 (NoVA) filed 31 percent of total Virginia tax returns, representing 47 percent of state income tax liability, and 52 percent of state adjusted gross income above $100,000.

Virginia Has a Relatively Low Combined Sales Tax Rate Compared to Other States

(Each 1 percent VA increase would raise $1.6 bil. GF)

Sales Taxes on Services Are Different by State

- Five U.S. states (New Hampshire, Oregon, Montana, Delaware, and Alaska*) do not impose any general, statewide sales tax, whether on goods or services.
- Of the 45 states remaining, four (Hawaii, South Dakota, New Mexico, and West Virginia) tax services by default, with exceptions only for services specifically exempted in the law.
- This leaves 41 states — and the District of Columbia — where services are not taxed by default, but services enumerated by the state may be taxed. Every one of these states taxes a different set of services.
- Virginia is considered to be a state that has a low level of sales tax on services. See https://taxadmin.org/state-taxation-of-services-by-category-2017/

* Alaska has a local sales tax

Sales Tax Exemptions on Services in Virginia Reduce the Sales Tax Base

Virginia Has a Lower Sales Tax Rate and Service Base than Surrounding States

Source: https://www.finance.virginia.gov/media/governorvirginiagov/secretary-of-finance/pdf/12_23Presentation-(with-Appendix).pdf

Sales Tax on "New Economy" Products in Surrounding States

Recent Proposals to Increase Sales Taxes on Services in Virginia

- Original 2024 Session enrolled budget bill added over $1 billion in biennium revenue (over $750 mil. in 2nd yr.) by:
  - Applying retail sales taxes ($157m yr 1 and $393m yr 2) to the purchase of digital services or electronic products in five distinct categories: 1) software application services; 2) computer-related services; 3) website hosting and design; 4) data storage; and 5) streaming services
  - Applying sales tax on business-to-business purchases of "software application services ($144m yr 1 and $360m yr 2)

- June <u>adopted</u> budget compromise eliminated sales tax base expansion on "new economy" services.

- HB 889 (Watts – 2024 Session) proposed applying retail sales taxes to a broad spectrum of services
  - $1.1 billion per year in additional sales tax revenue
  - Repealed local option sales tax on food ($309 mil. reduction in FY 26)
  - Also added $100 mil. in revenues to the CSUT by adding digital streaming services
  - This bill would broaden the sales tax base, including the local option base. Net local revenues from this bill depends on whether the local sales tax on food is repealed.

Data Centers Are Big Business in Virginia

- For FY 2023, data center operators reported to VEDP 792 net new jobs and investment of approximately $23 billion, of which approximately $15.6 billion was equipment or software that was exempt from sales tax.

- Significant local tax revenues result from the tangible personal property in data centers.

- The sales tax exemption for data center equipment is estimated by JLARC to have reduced FY 2023 GF, transportation and local sales tax revenue by $904 mil – and is by far the largest sales tax exemption. Source: https://rga.lis.virginia.gov/Published/2024/RD121/PDF
  - Virginia Code§ 58.1-609.3 (18) provides an exemption for data center operators and their tenants from the Virginia Retail Sales and Use Tax for computer equipment or enabling software purchased or leased for the processing, storage, retrieval, or communication of data. This exemption also applies to any such computer equipment or enabling software purchased or leased to upgrade, supplement, or replace computer equipment or enabling software purchased or leased in the initial investment.
  - In 2019, JLARC found: "The exemption has a sizable influence on data center decisions to locate or expand in Virginia, and it is estimated to have a moderate economic benefit per $1 million in spending by the state. It is reasonable for the state—which has identified data centers as a targeted industry—to continue the exemption."
  - A new JLARC study of data centers is expected to be presented on December 9, 2024.

- Other sales tax exemptions are listed here:
  https://www.tax.virginia.gov/sites/default/files/inline-files/virginia-sales-tax-exemptions.pdf

Appendices

Virginia General Fund Revenue Sources

Non-General Funds are Dedicated for Specific Uses