A FISCAL CRISIS IN OUR LOCAL GOVERNMENTS

HAMPTON ROADS
PLANNING DISTRICT COMMISSION
2000

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A FISCAL CRISIS IN OUR LOCAL GOVERNMENTS

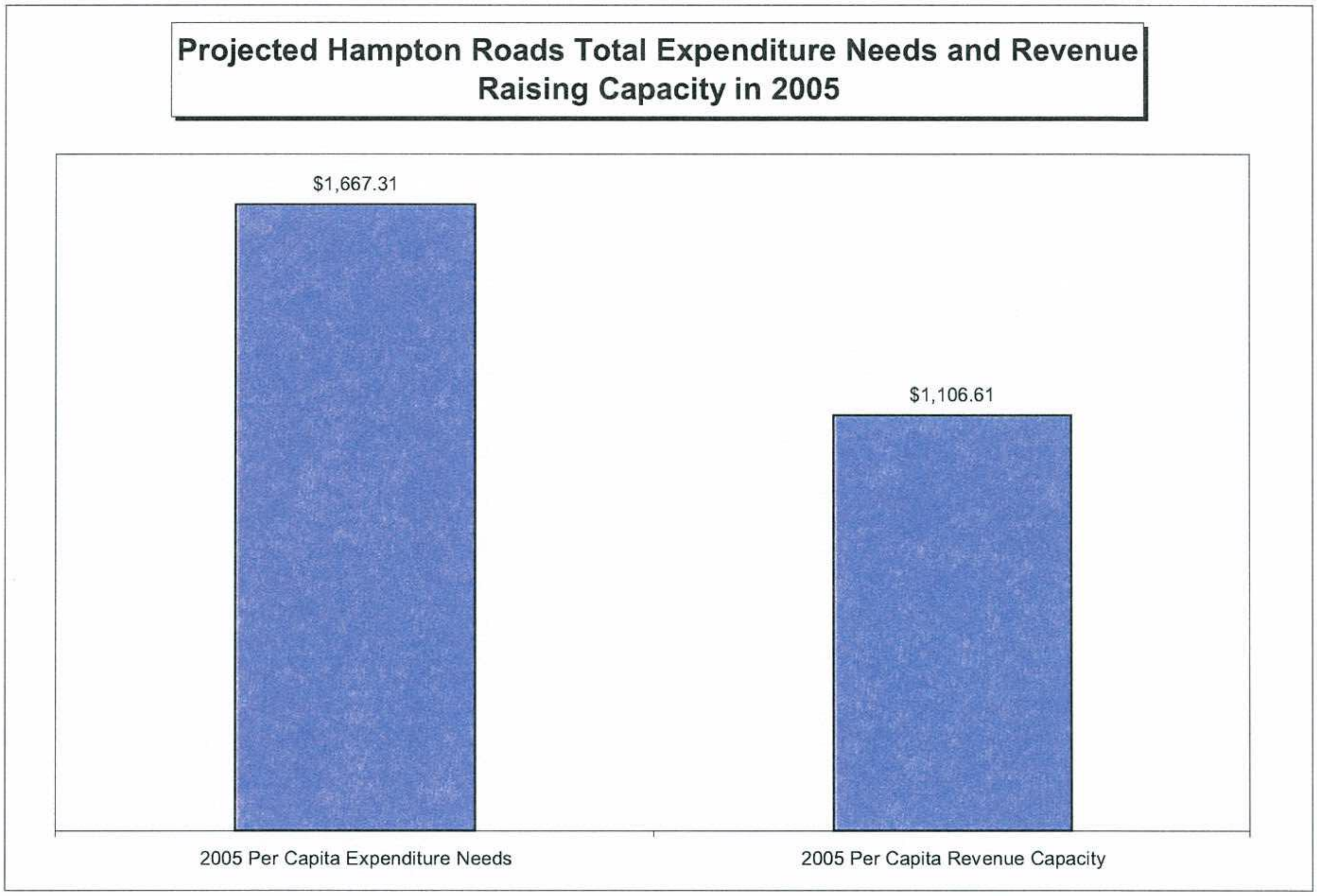
Our cities and counties are facing increasing fiscal pressure. Our communities continue to grow, but the local tax base that provides the revenue to support them is not keeping up. Our local governments are financially strained and becoming more and more challenged to meet the needs of their citizens.

The Hampton Roads Planning District Commission has been exploring this problem of financial stress. According to a recent study, the current fiscal strain is only going to get worse. By the year 2005, our current tax system will not provide local governments with enough funds to meet basic community needs. Without proper funding, our schools will suffer and our overall economy will weaken. The economic health of our local governments affects our competitiveness. If we cannot afford to maintain good schools, safe neighborhoods, and high quality services, we will not be able to draw people and businesses to the area or—as important—keep people from moving out of the region.

Virginia's existing tax structure is causing serious economic challenges to our local governments. Yet the state government continues to operate with a surplus of revenue. Between 1987 and 1997, every city and county in Hampton Roads has had to raise their real estate property tax rates to try and meet the needs of their communities. However, during this same period, the state has not had to raise any tax rates and is even operating with a surplus of funds and cutting taxes. This imbalance is playing a critical part in the fiscal stress felt by our local governments.

The HRPDC has begun a process to provide community leaders and citizens of Hampton Roads with a comprehensive analysis of Virginia's tax structure and how it is impacting our local governments. Over the next several months, the HRPDC is producing a multi-media educational series addressing the current state and local tax system, fiscal stress in Hampton Roads, and possible solutions to relieve the financial strain facing our local governments.

HAMPTON ROADS
PLANNING DISTRICT COMMISSION
January 2000



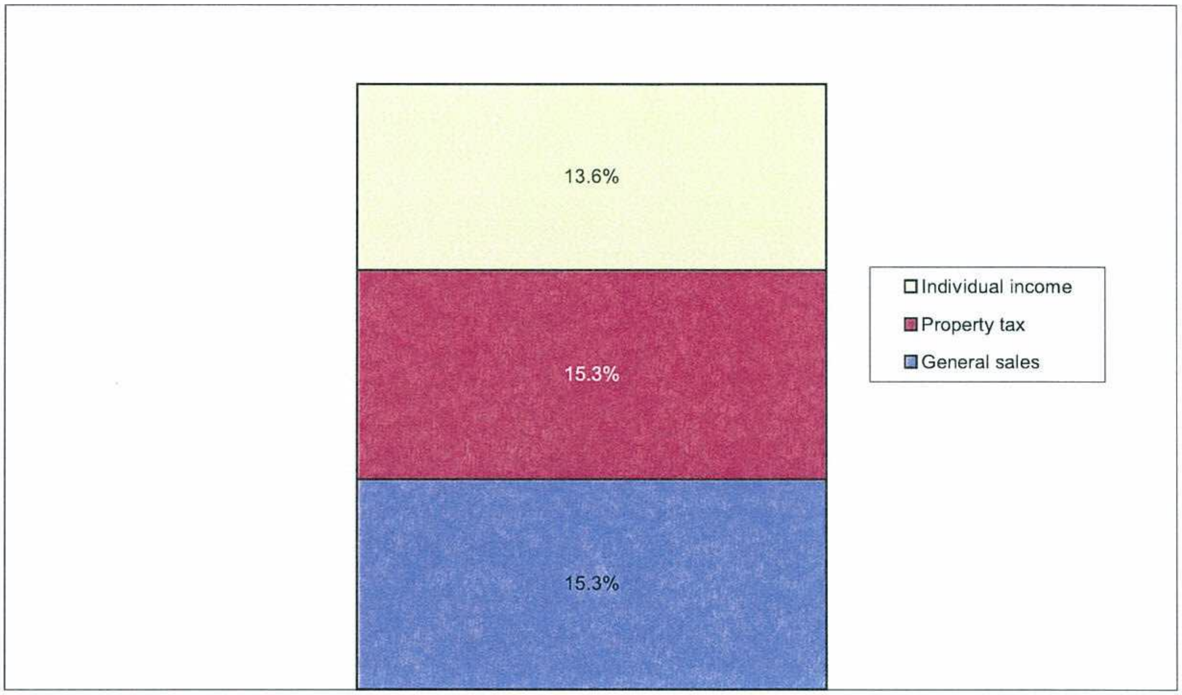
Source: Barents Group L.L.C.

A recent study by an international financial consulting firm, the Barents Group, found that by the year 2005, the current tax system wouldn't supply enough funds for our local governments to meet community requirements. Yet, the state government continues to operate with a surplus of revenue.

Revenue raised by Virginia's taxes is divided between our state and local governments. How that money is allocated is dictated by state law and can only be changed by our state government. Our state government also determines what types of taxes we have. Local governments have few options and little authority over how revenue is raised.

Selected State and Local Tax Revenue as a Percent of Total State and Local Revenue

Fiscal Year 1996



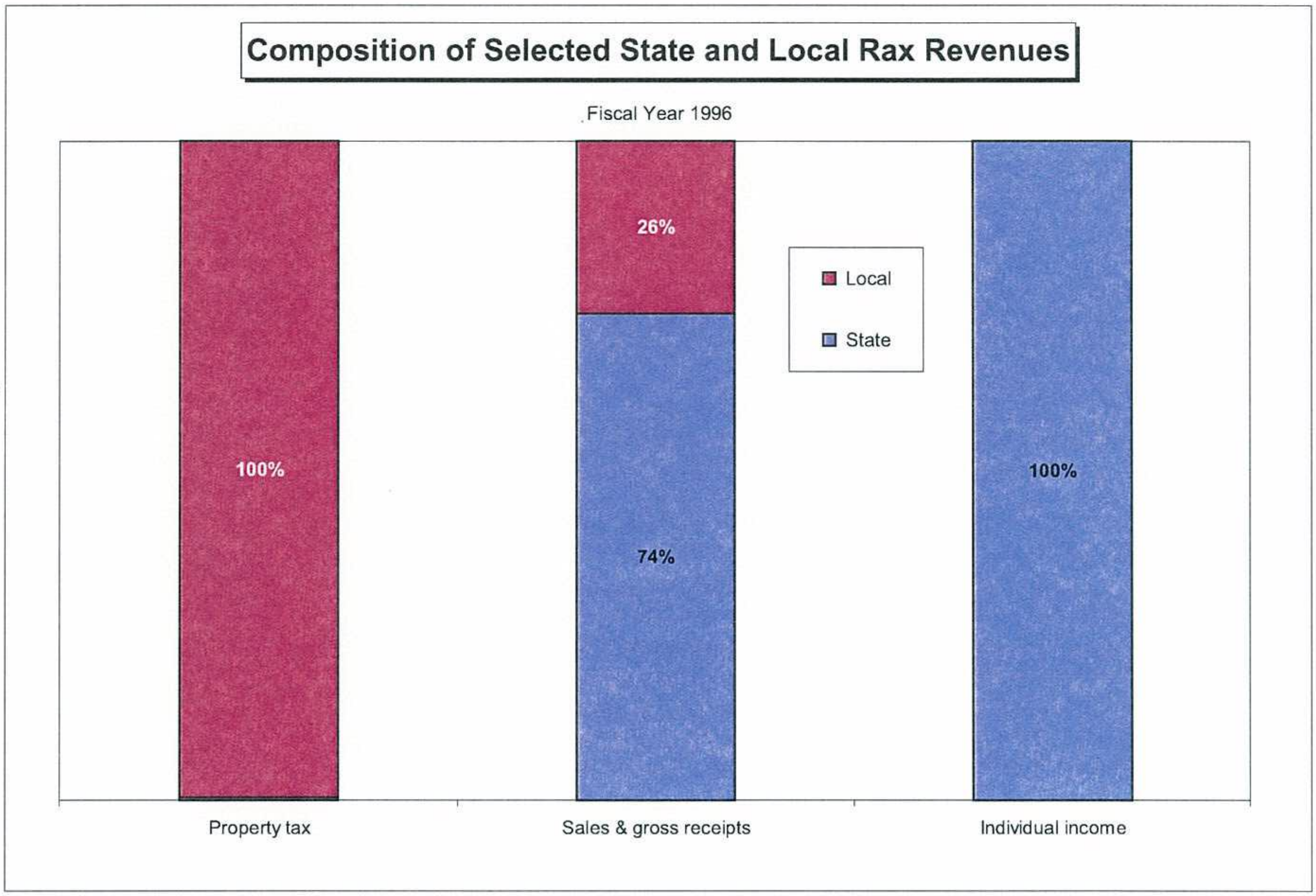
Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Here in Virginia, our state and local governments get a large portion of their money from three major taxes - income tax, property tax and sales tax.

About 28% of state and local government tax revenues come from individual income taxes. Approximately 31% come from property tax, and the other 31% from sales taxes.

The total revenue from these three taxes makes up about 44% of all money coming into our state and local government.

The Governor and General Assembly alone decide how much we pay in income and sales taxes. That is – both the general sales tax, on the purchase of most items and the specialized taxes on items like motor fuels, tobacco, and alcoholic beverages.



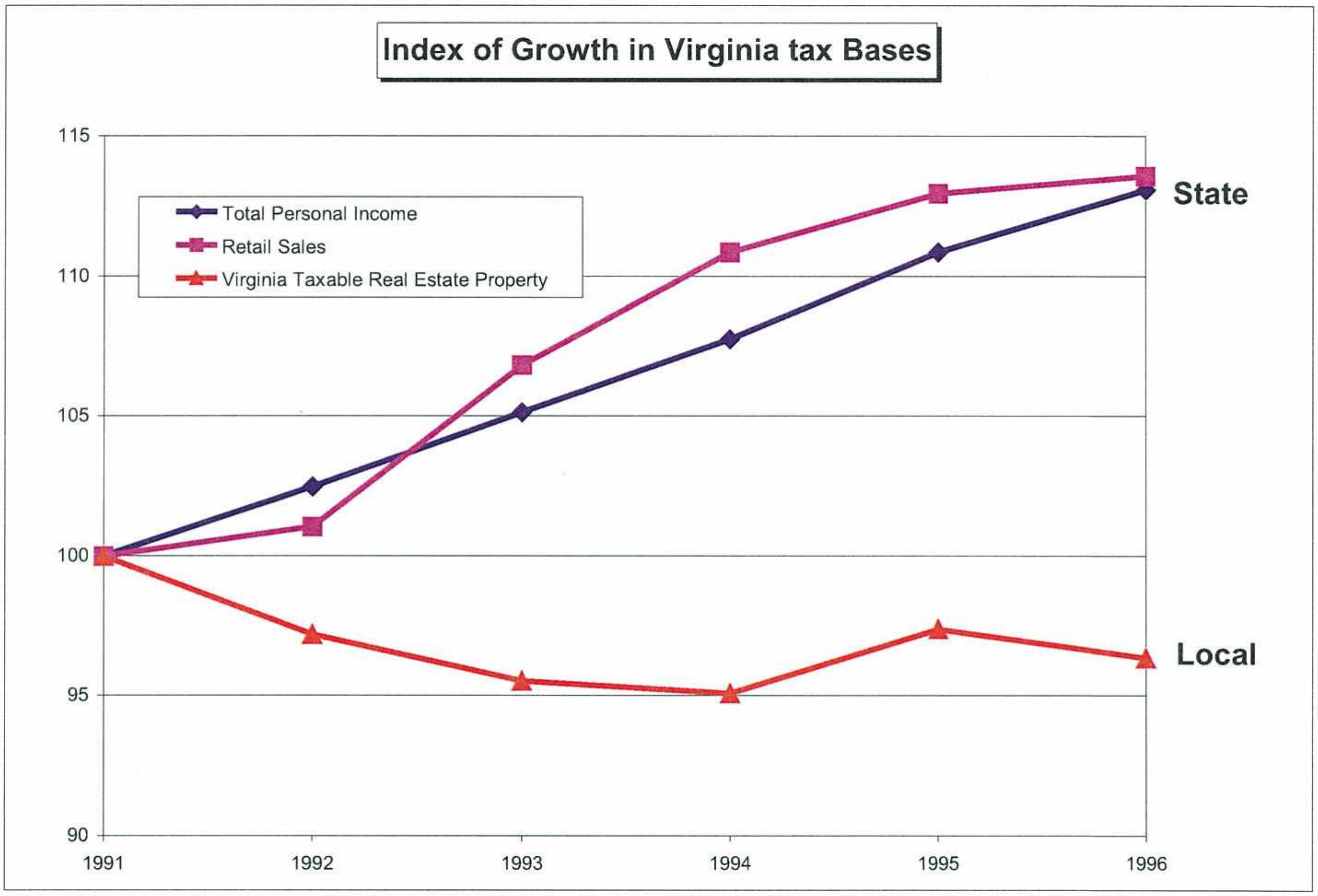
Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

All personal income tax money collected goes to the state.

Most of the money collected as sales tax also goes to the state, although some of it is redistributed to local communities, primarily for education.

Of the three major taxes, local governments are only allowed to control property tax rates. Cities and counties decide how much tax we pay on items like boats, cars, business equipment, as well as real estate – the land and buildings we own.

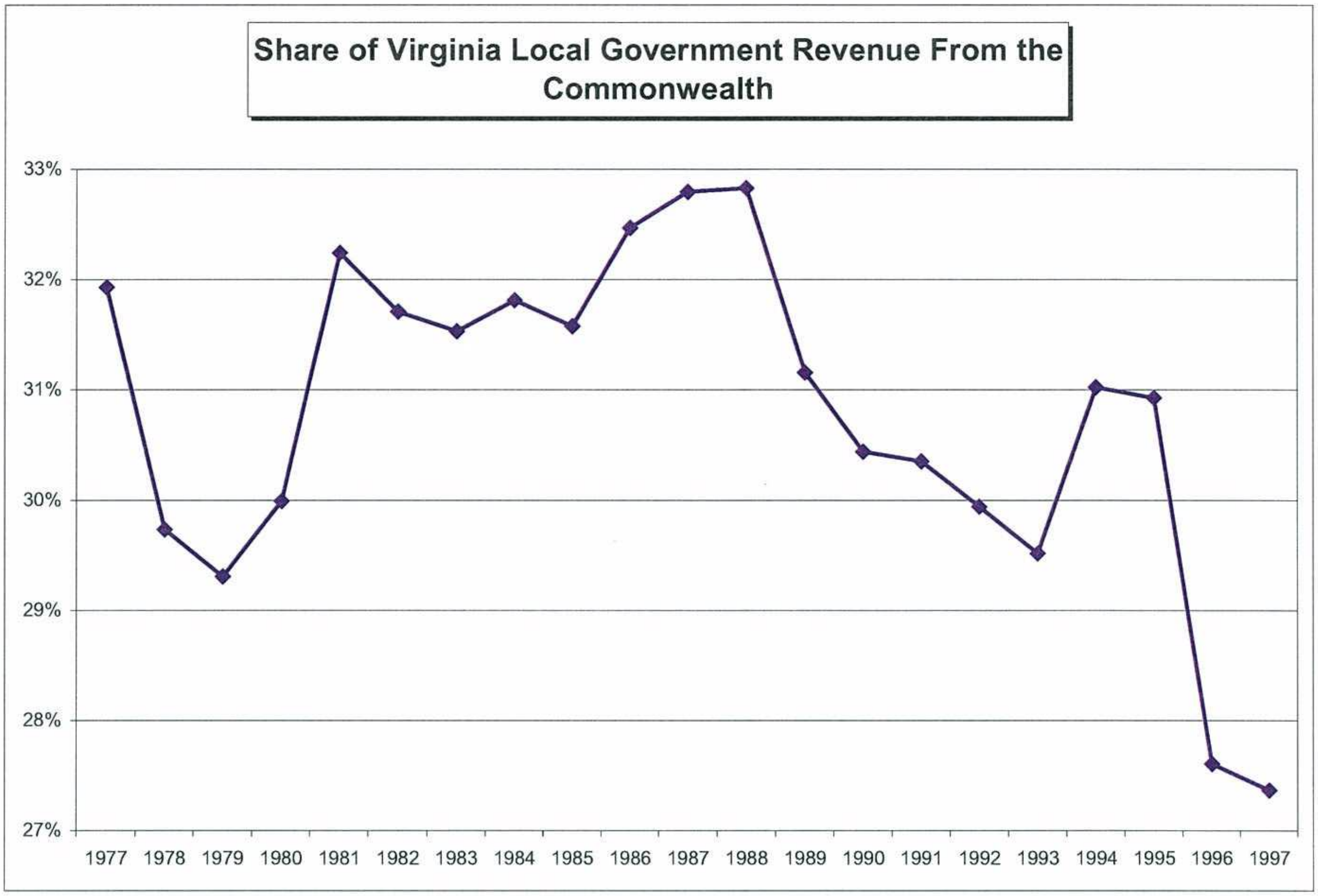
In 1998, property tax revenue was only 22.3% of the total local revenue in Hampton Roads.



Sources: U. S. Department of Commerce, Bureau of Economic Analysis
and Virginia Department of Taxation

Virginia's tax structure is adding significant financial stress to our local governments. Total personal income and total retail sales in Virginia keep growing, which means that the state continues to receive more money in tax dollars.

In contrast, the value of real estate is not even keeping up with inflation, which has been historically low in recent years – and is forcing many localities to raise local tax rates and look for money elsewhere, such as special fees, charges and fines.



Source: Barents Group L.L.C.

Cities and counties do receive state and federal aid for services and programs, such as special education and transportation projects.

However, Virginia's state aid to local governments is small compared to other states. The state's share of local government budgets has decreased 15% since 1989. And our state aid is not growing in step with our communities' needs.

To offset the lack of funds from taxes and aid programs, local government can charge fees, often in the form of utility, storm water and sewer fees.

$$\frac{\text{Money collected from a tax}}{\text{Total personal income of people living in the taxed area}} = \text{Effective Tax Rate}$$

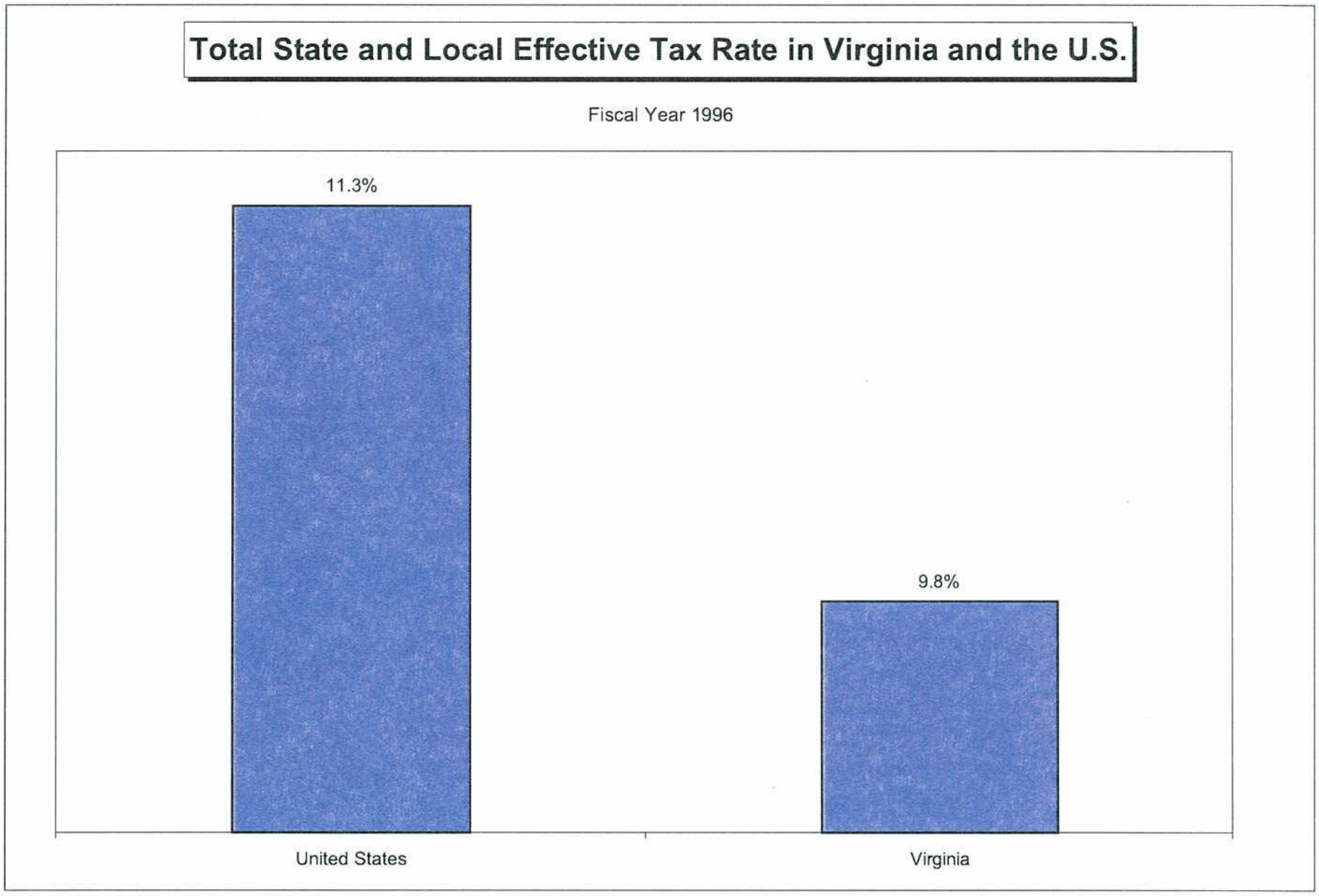
For example:

$$\frac{\text{Community's tax revenue} \quad \$100{,}000}{\text{Total personal income of the community} \quad \$1{,}000{,}000} = 10\% \text{ Effective Tax Rate}$$

Let's look at how our taxes compare to other states and localities. All state and local governments do not have the same tax structures. So, in order to make a fair and consistent comparison, we use what is called an effective tax rate.

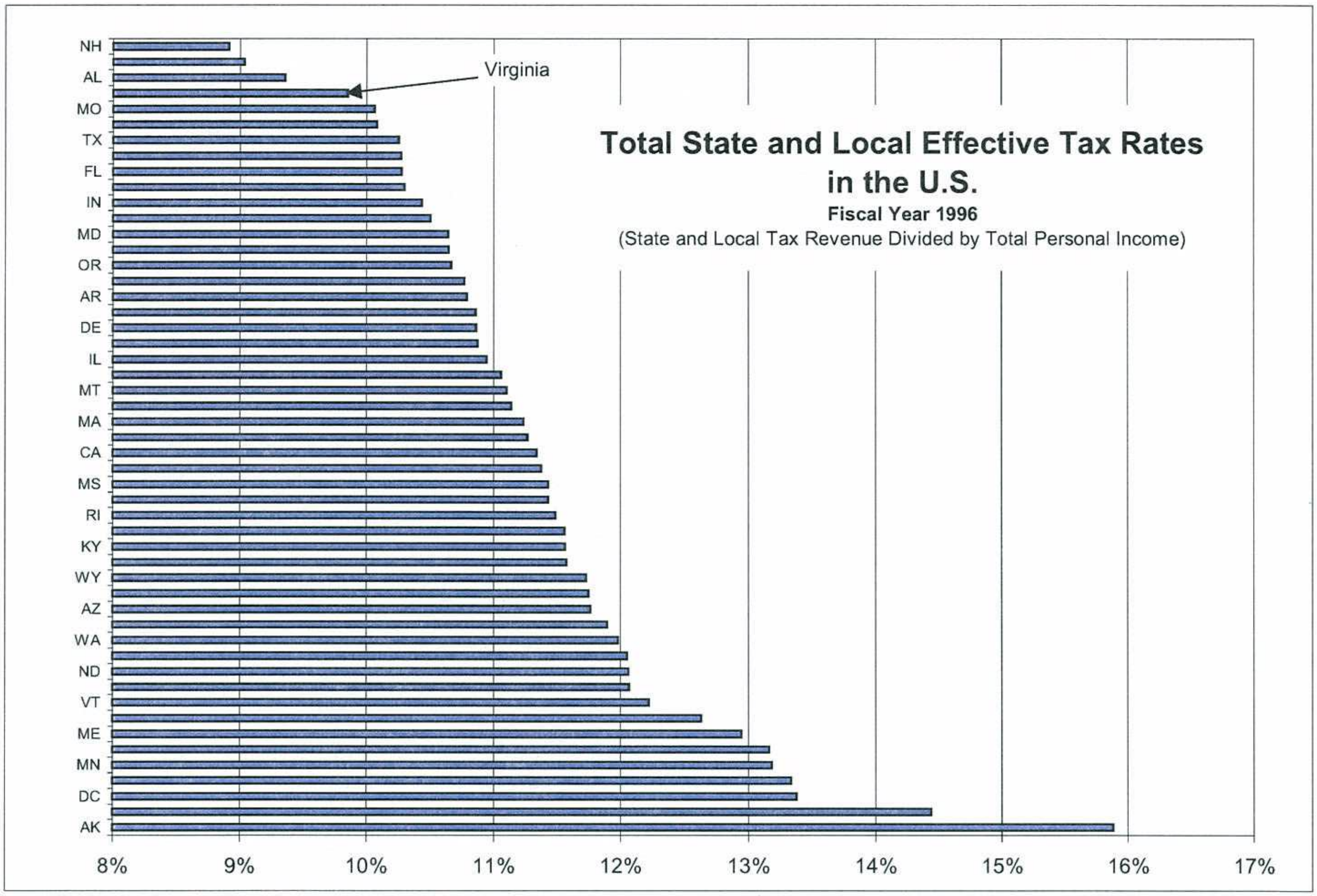
An effective tax rate is: the money collected from a tax divided by the personal income of the people living in the taxed area. It is the percentage of personal income that is paid in taxes.

For example, if a community's tax revenue is one hundred thousand dollars and the total personal income of the community is one million dollars, then the effective tax rates is 10 percent.



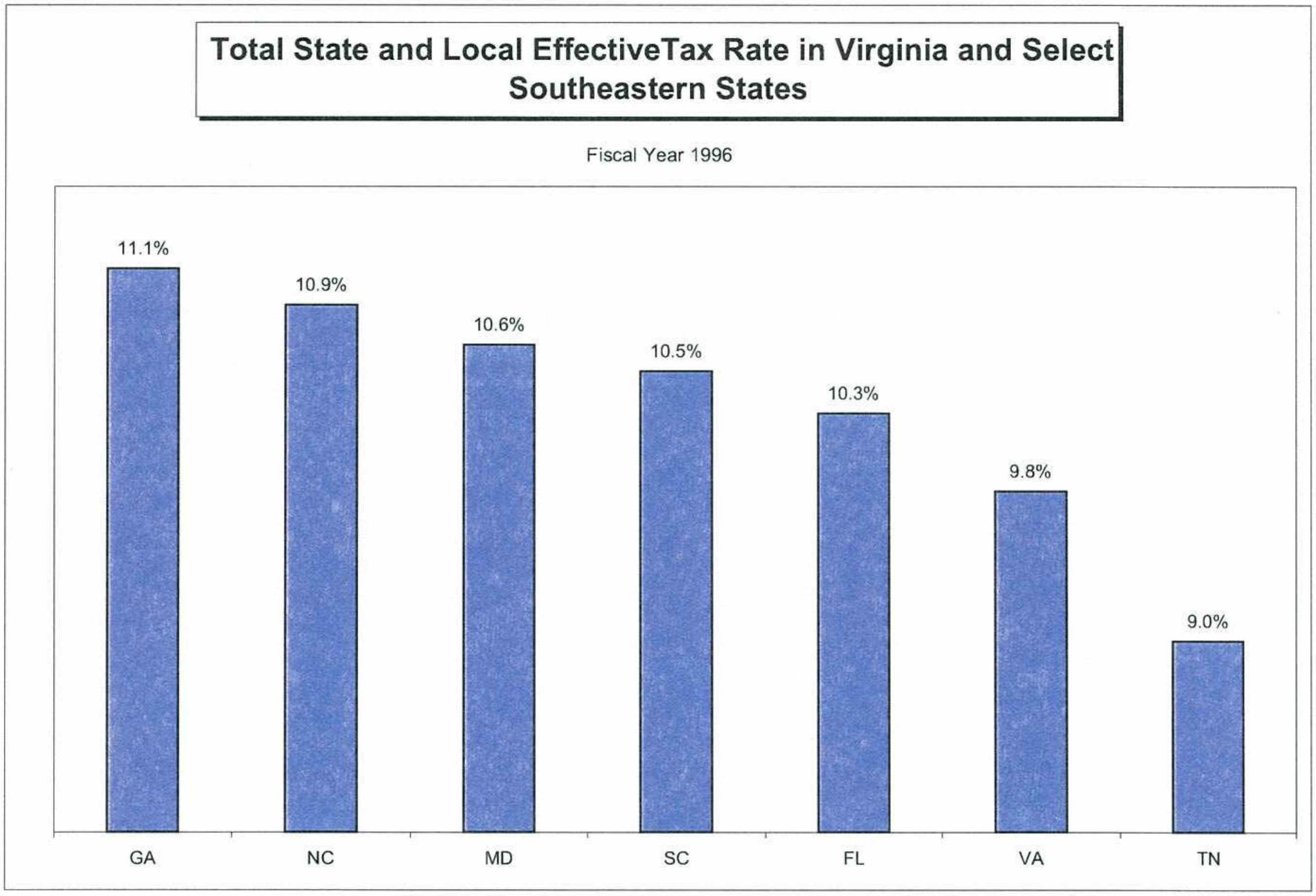
Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Virginia's combined total state and local effective tax rate is well below the national average. The nation, as a whole, is paying slightly over 11.3% of its personal income to state and local taxes. In Virginia, 9.8% of our personal income goes to state and local taxes.



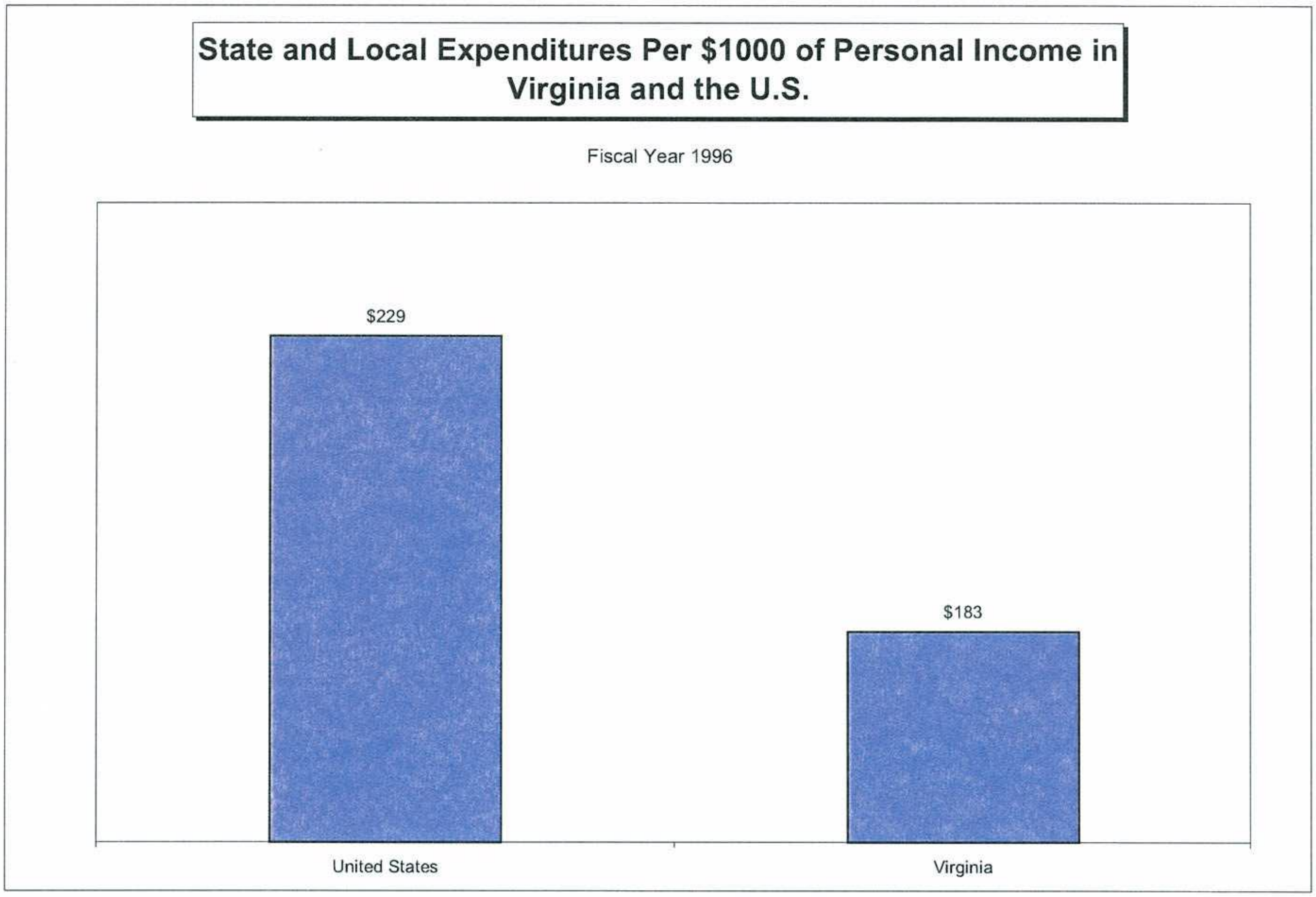
Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Compared to other states, Virginia ranks low in its effective tax rate. New York is the highest, with a total effective tax rate of almost 14 1/2%. There are only three states with a lower effective tax rate than Virginia. New Hampshire is the lowest with a rate of nearly 9%.



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

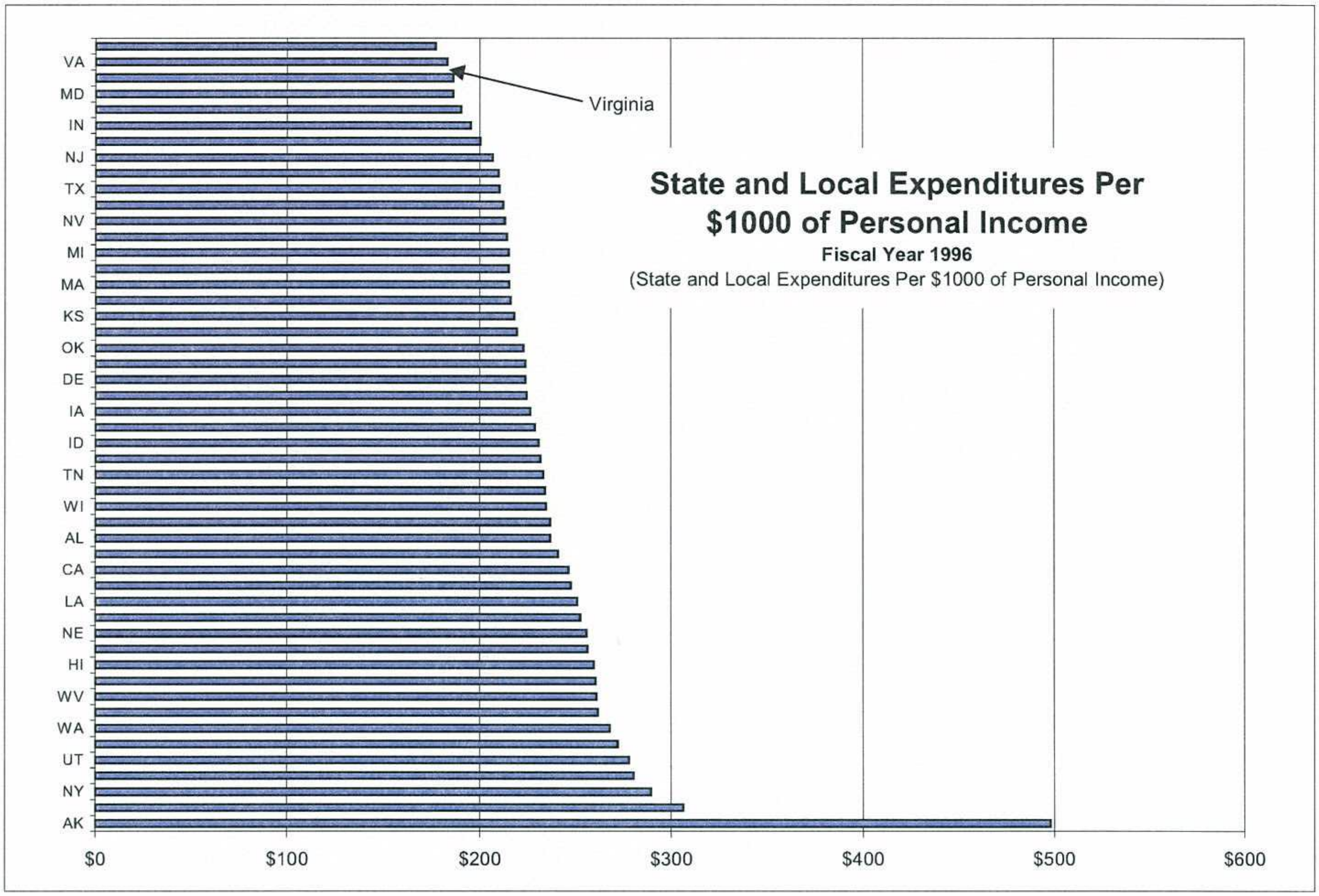
Considering the total state and local tax rates in each of these Southeastern states, only Tennessee has a lower total effective tax rate than Virginia.



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

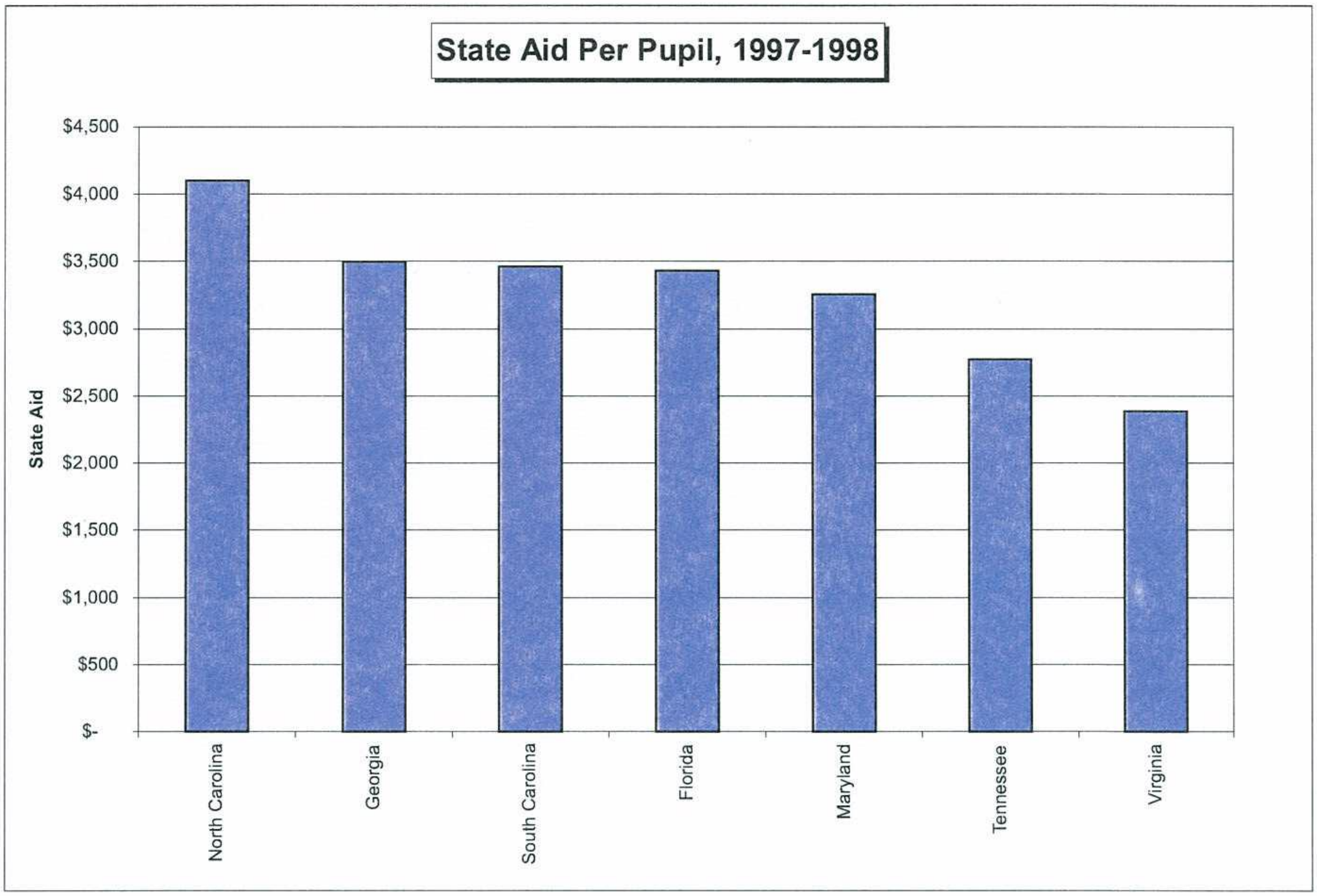
Because Virginia collects fewer state and local tax dollars than the national average, we also obviously spend less on state and local programs like education, mental health and transportation.

For every thousand dollars of personal income earned, Virginia spends $183, while the national average is $229.



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

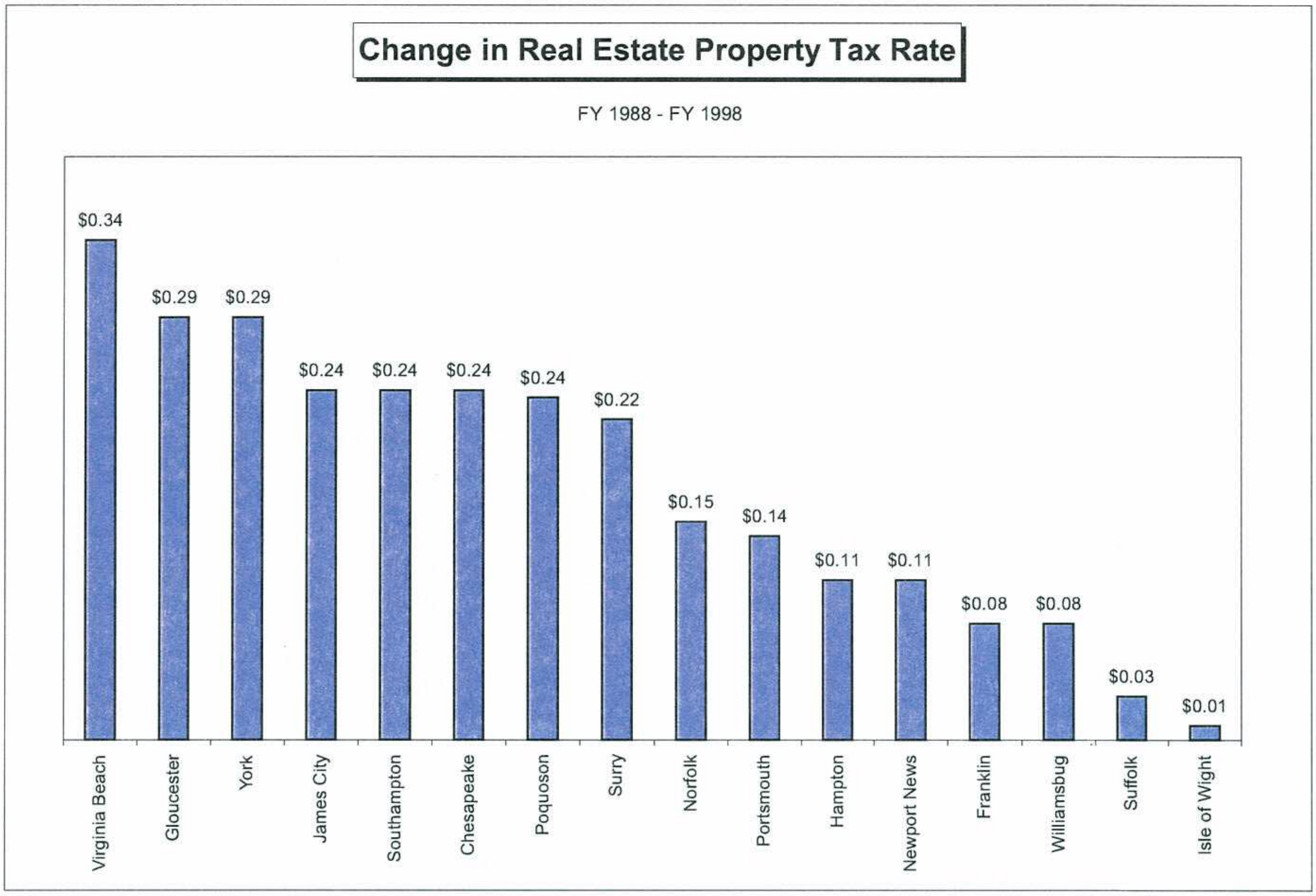
Among all 50 states, Virginia ranks second to last in its total state and local spending. Only New Hampshire spends less than we do on state and local programs.



Source: Congressional Quarterly & State Fact Finder 1999

The highest percentage of our local spending goes to education. The traditional calculation for education funding shows the state paying 55% of education costs and local governments paying 45%. Yet, our local governments pay for 60% of our education costs. We are well below the national average in the amount of state aid we receive per pupil, and we are the lowest among our nearby Southeastern states.

In 1998, an average of over $3,500 was provided in state aid per pupil in the U.S. The State of Virginia gave our local governments about $2,400 per pupil.



Source: Virginia Department of Taxation

Without proper funding, not only do our schools and children suffer, our overall economy weakens. The economic health of our local governments affects our ability to compete. If we can't afford to maintain good schools, safe neighborhoods and quality services, we will not be able to draw people and businesses into the area or, just as important, keep people from moving out of the region.

Our existing tax structure is causing serious economic challenges to local government. Between 1987 and 1997, every city and county in Hampton Roads has had to raise their real estate property tax to try to meet the needs of their communities.

During that same time, the state has not had to raise any tax rates, is operating with a surplus of funds and cutting taxes. This imbalance is playing a critical part in the fiscal stress felt by local government.

In the next presentation, we'll look more closely at the financial stress in our region's cities and counties. We'll examine the sources of their financial pressures and what the future holds.

Part 1
Supplemental Data Index

HAMPTON ROADS
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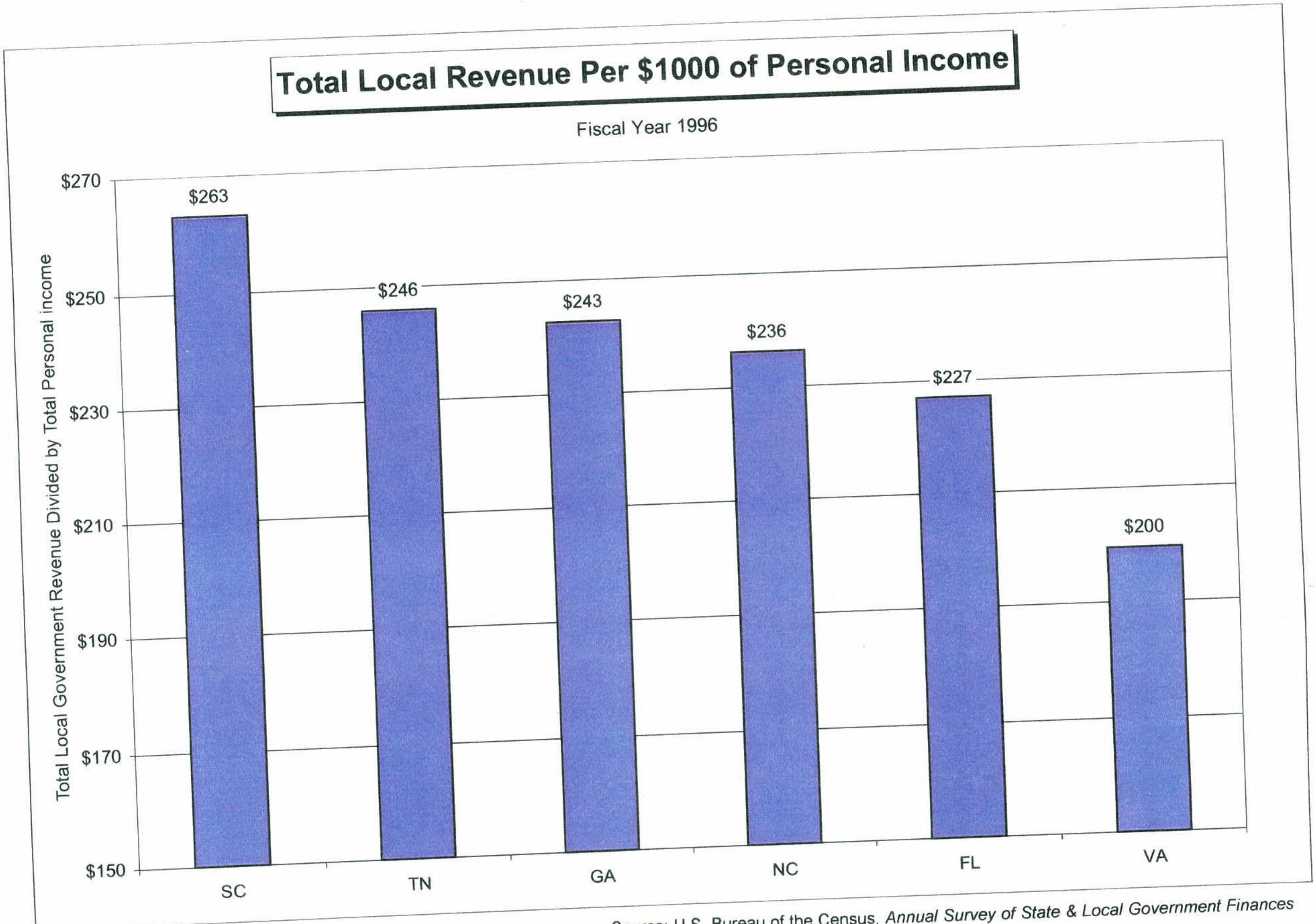
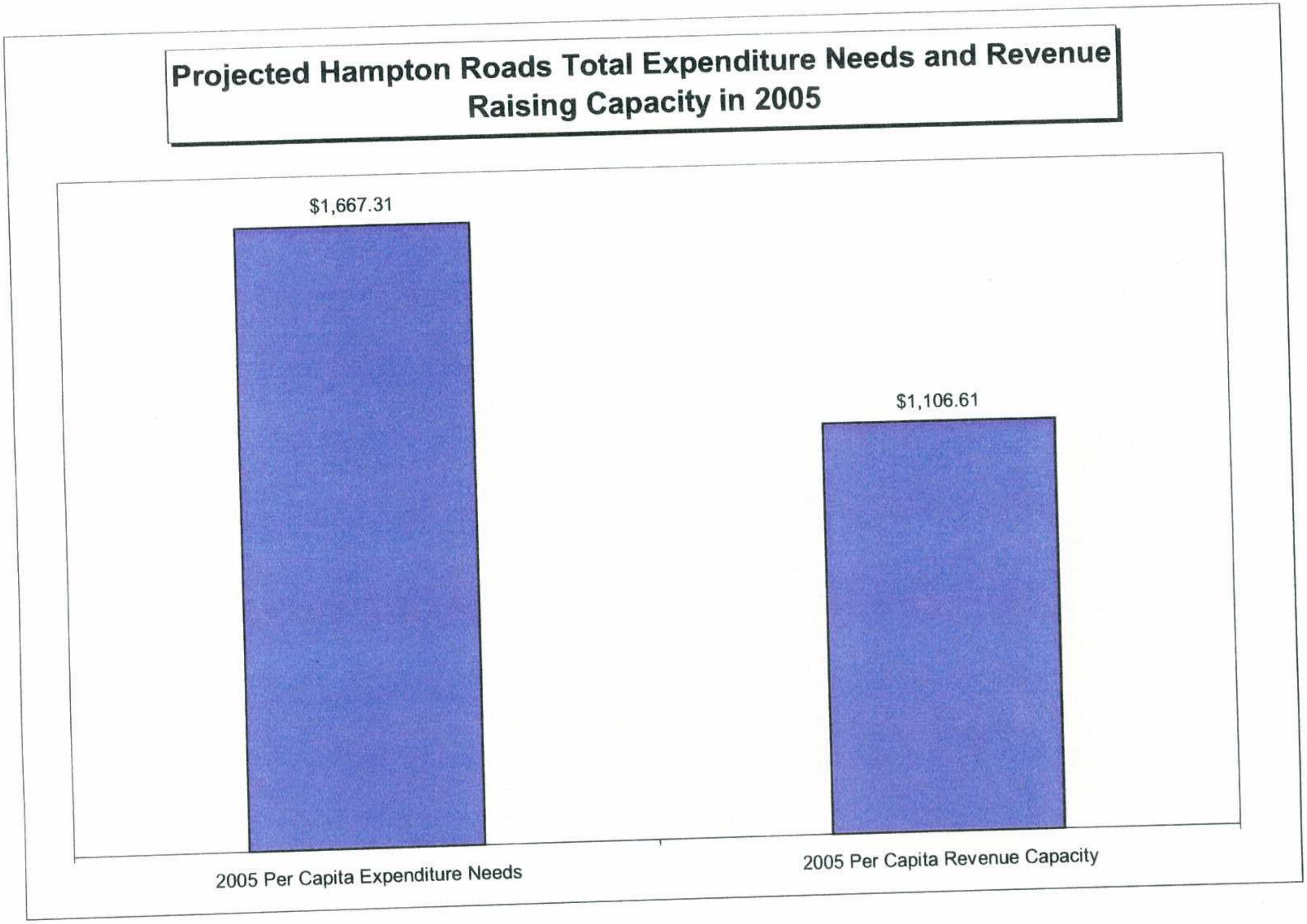
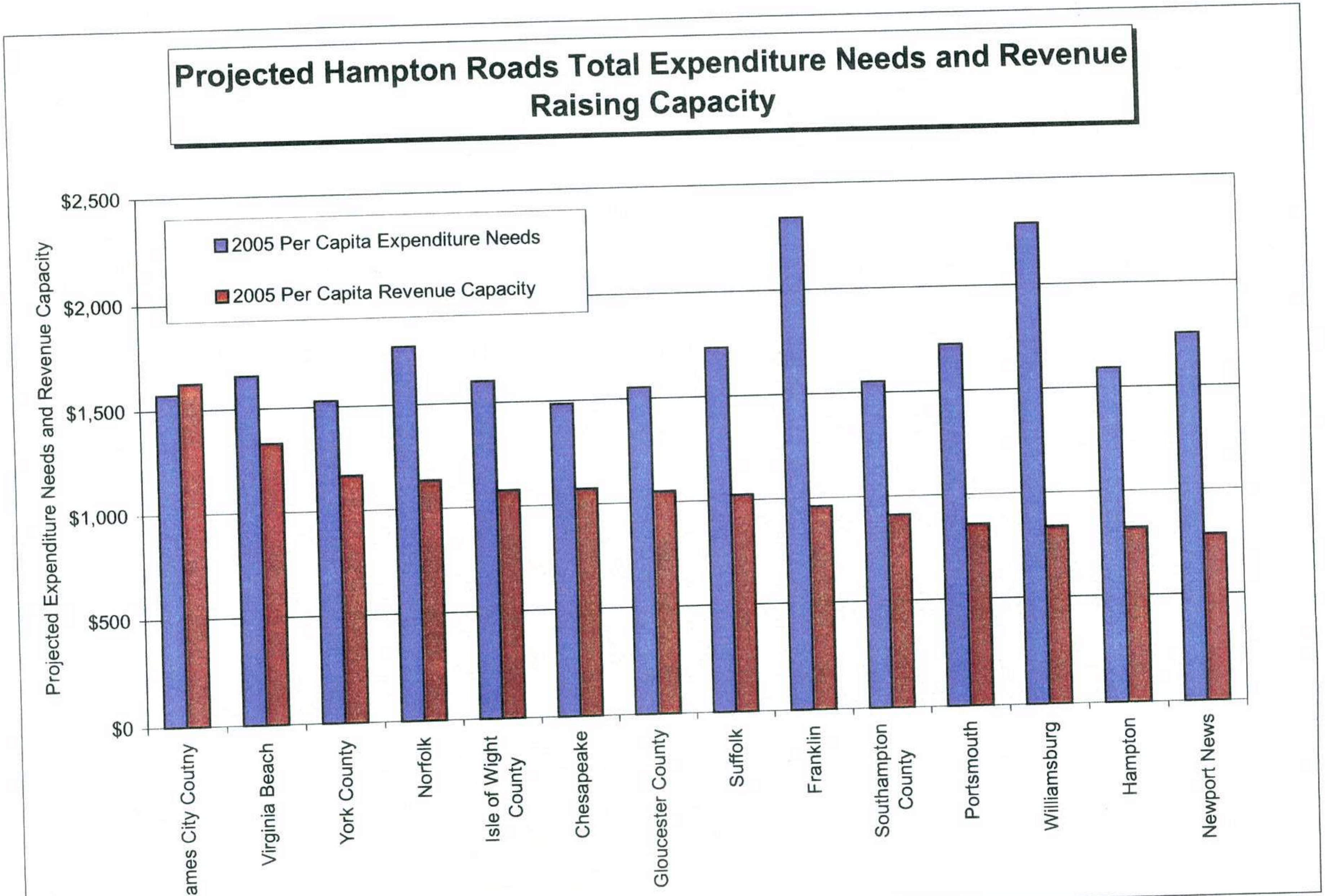

Total Local Revenue Per $1000 of Personal Income
Fiscal Year 1996
Total Local Government Revenue Divided by Total Personal income
$270
$250
$230
$210
$190
$170
$150
$263
$246
$243
$236
$227
$200
SC
TN
GA
NC
FL
VA
Source: U.S. Bureau of the Census, Annual Survey of State & Local Government Finances

Chart 1



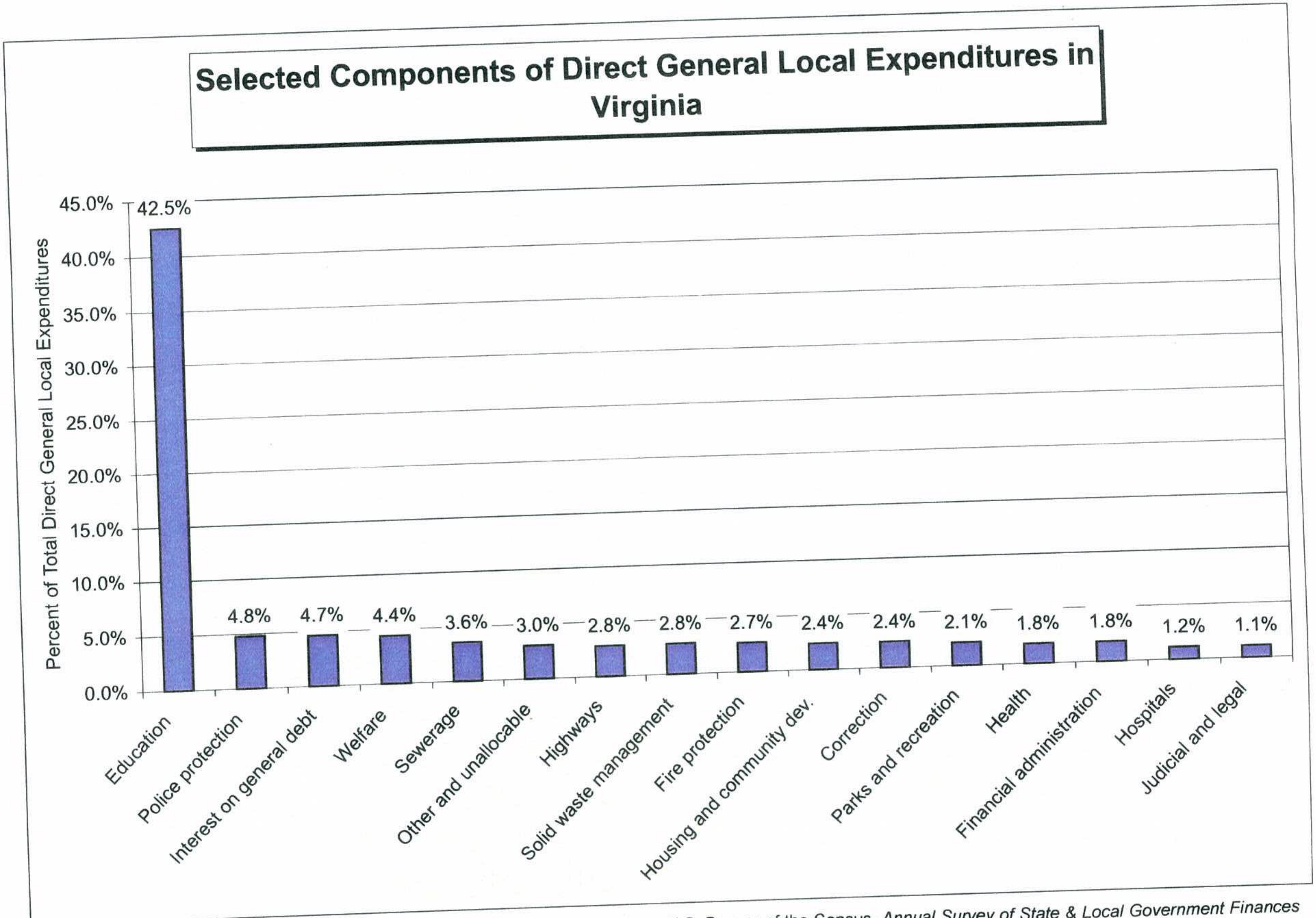
Source: Barents L.L.C.

Chart 2



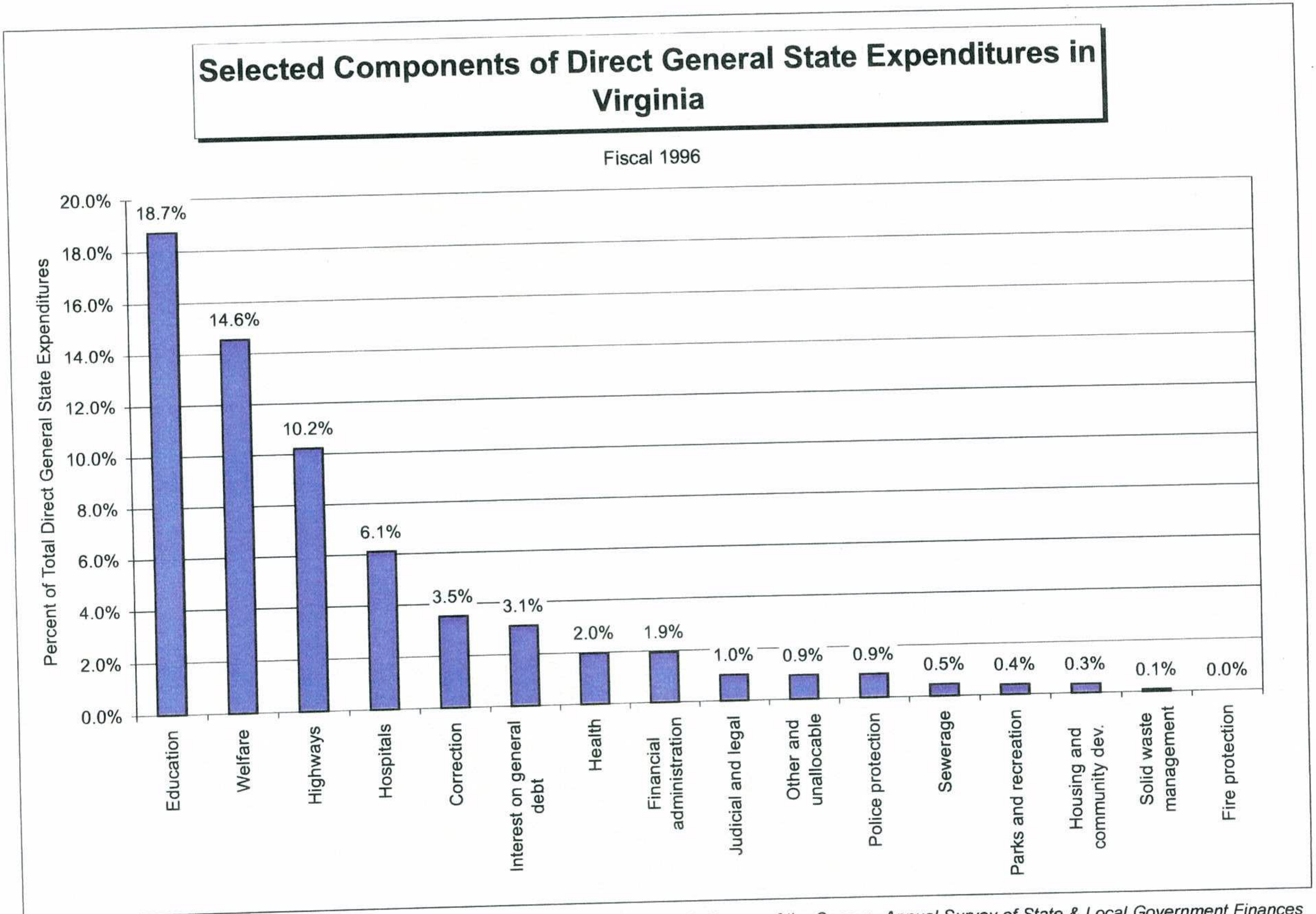
Source: Barents L.L.C.

Chart 3



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Chart 4



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Chart 5

State Government

Revenue in the Commonwealth of Virginia

FY 1996 In Thousands

State Government Revenue
$20,186,626

- Intergovernmental revenue — $3,514,798
  - From Federal — $3,377,115
  - From Local — $137,683
  - Subtotal $3,514,798
- Taxes — $8,900,413
  - Property tax — $18,808
  - Sales & gross receipts — $3,588,976
  - Individual income — $4,300,918
  - Corporate income — $362,830
  - Motor vehicle license — $257,941
  - Other taxes — $370,940
  - Subtotal $8,900,413
- Charges & misc general revenue — $4,315,989
  - Current charges — $2,596,379
    - Inst. of higher education (Includes tuition and fees) — $1,342,706
    - Other education — $17,279
    - Hospitals — $885,601
    - Highways — $35,758
    - Air transportation — $0
    - Parking facilities — $0
    - Sea and inland port facilities — $114,735
    - Natural resources — $2,469
    - Parks and recreation — $7,244
    - Housing and community development — $3,406
    - Sewerage — $0
    - Solid waste management — $0
    - Other charges — $187,181
    - Subtotal $2,596,379
  - Misc. general revenue — $1,719,610
    - Interest earnings — $714,919
    - Special assessments — $0
    - Sale of property — $129
    - Other general revenue — $1,004,562
    - Subtotal $1,719,610
- Utility revenue — $0
- Liquor store revenue — $248,956
- Insurance trust revenue — $3,206,470
  - Unemployment compensation — $435,139
  - Employee retirement — $2,771,331
  - Subtotal $3,206,470

Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Chart 6

Local Government
Revenue in the Commonwealth of Virginia

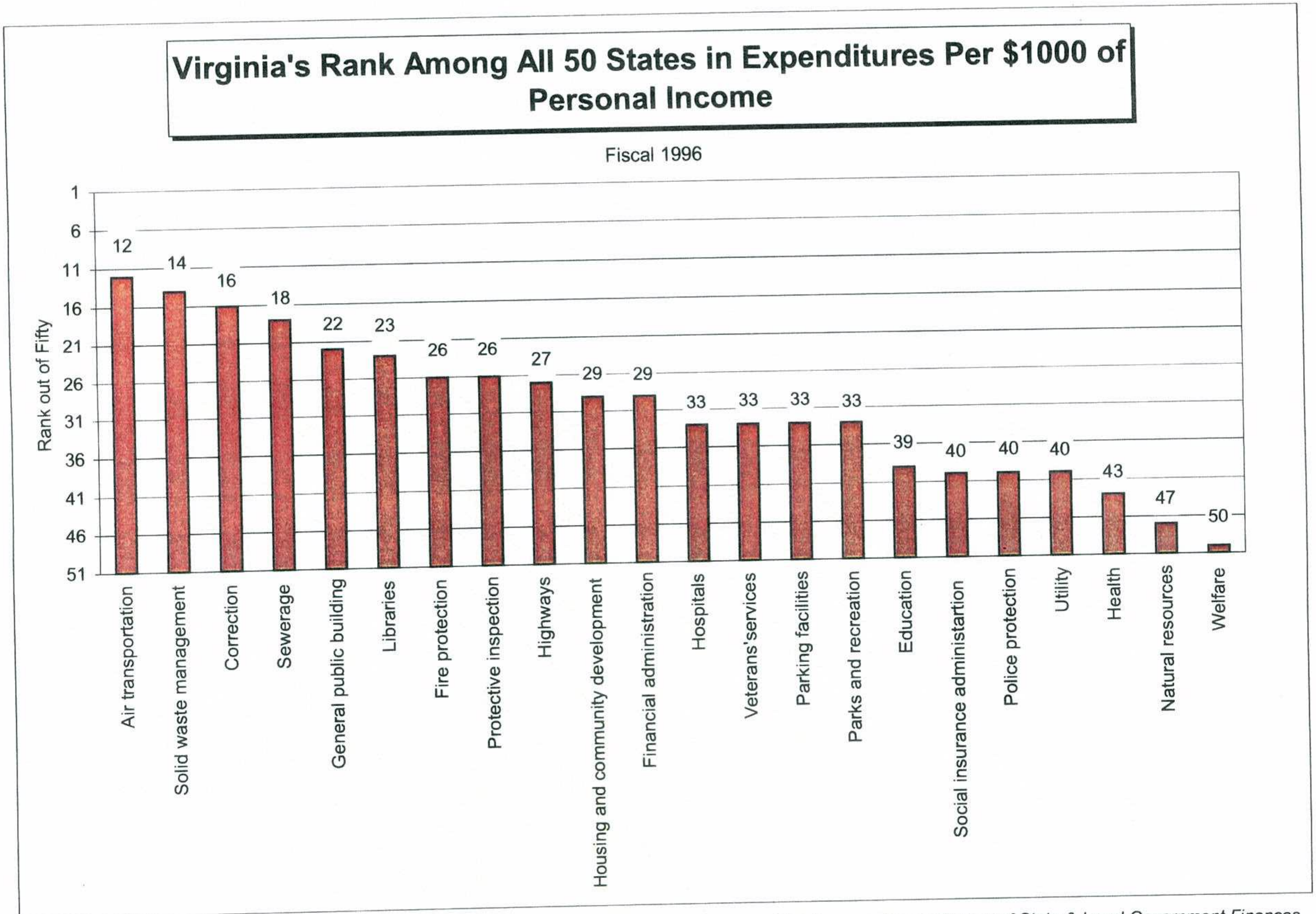
FY 1996 In Thousands

Local Government Revenue $15,933,321

- Intergovernmental revenue — $4,752,136
  - From Federal — $436,079
  - From State — $4,316,057
  - Subtotal — $4,752,136
- Taxes — $6,725,737
  - Property tax — $4,828,194
  - Sales & gross receipts — $1,271,107
  - Individual income — $0
  - Corporate income — $0
  - Motor vehicle license — $105,687
  - Other taxes — $520,749
  - Subtotal — $6,725,737
- Charges & misc. general revenue — $2,720,996
  - Current charges — $1,912,220
    - Inst. of higher education (includes tuition and fees) — $0
    - Hospitals — $236,716
    - Other education — $148,366
    - Highways — $58,597
    - Air transportation — $230,861
    - Parking facilities — $22,804
    - Sea and inland port facilities — $2,161
    - Natural resources — $1,648
    - Parks and recreation — $69,937
    - Housing and community development — $62,814
    - Sewerage — $543,153
    - Solid waste management — $299,821
    - Other charges — $235,342
    - Subtotal — $1,912,220
  - Misc. general revenue — $808,776
    - Interest earnings — $548,404
    - Special assessments — $6,208
    - Sale of property — $13,779
    - Other general revenue — $240,385
    - Subtotal — $808,776
- Utility revenue — $1,057,122
- Liquor store revenue — $0
- Insurance trust revenue — $677,330
  - Unemployment compensation — $0
  - Employee retirement — $677,330
  - Subtotal — $677,330

Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Chart 7



Source: U.S. Bureau of the Census, *Annual Survey of State & Local Government Finances*

Chart 8

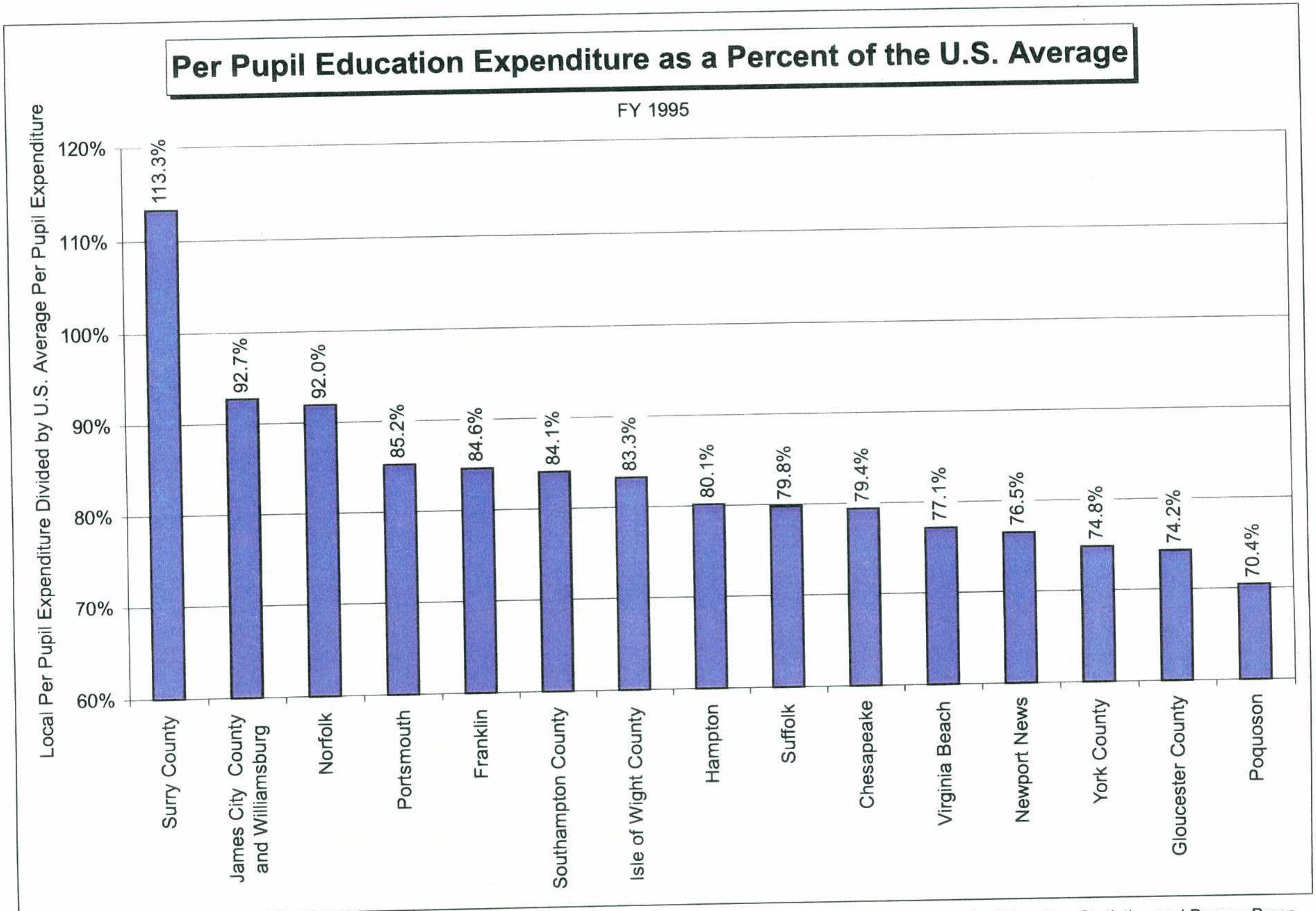


Chart 9

Source: National Center for Education Statistics and Bernan Press, *Education Statistics of the United States*

HAMPTON ROADS TAX STUDY

◆

HAMPTON ROADS PLANNING DISTRICT

Produced for:
The Hampton Roads Planning District Commission

April 1999

BARENTS
GROUP • LLC

2001 M Street NW ◆ Washington DC 20036

Performance of the Hampton Roads and Virginia Economies

As a prelude to the discussion of the structure of the state and local fiscal system, it is important to highlight some of the key economic trends affecting the Commonwealth and the Hampton Roads region. This study compares Virginia's recent economic performance to several competitor states, including Florida, Georgia, Kentucky, Maryland, North Carolina, South Carolina, Tennessee, and West Virginia. Among the most significant trends are the following:

- *Employment growth in the Hampton Roads area has lagged behind the growth in both Virginia and the fast-growing Southeastern states during the 1990s.*

- *Like the rest of the country, the Hampton Roads region has experienced a significant shift in its employment base away from manufacturing and toward services.*

  The shift away from federal government employment, however, is much more pronounced in the Hampton Roads region than in either the rest of Virginia or in the comparison states. This is due largely to the relatively high dependence on federal government employment at the beginning of the decade.

- *Although Virginia has experienced higher per capita income growth than its neighbors, the Hampton Roads region lags behind both the rest of Virginia and the comparison states.*

Structure of the Hampton Roads and Virginia Tax Systems

The effectiveness of state and local revenue systems can by evaluated in terms of their ability to meet important tax policy criteria, including equity, efficiency, stability, administrative ease, and competitiveness. With these criteria as a guide, the study identifies important structural problems in Virginia's state and local tax system and their associated impacts on local governments in the Commonwealth. The study found that:

- *Local taxes in the Hampton Roads region are high relative to those in other states in the Southeast.* Hampton Roads local taxes, compared to personal income, are 10 percent higher than local taxes in the comparison states.

- *In contrast, Virginia state taxes are relatively low.* Virginia's state taxes relative to income are 12 percent below the Southeast average and more than 15 percent below the average for all states.

- *Virginia relies more heavily on the individual income tax and less heavily on the general sales tax than do other Southeastern states or the rest of the country.*

  In 1995, the state received 49 percent of its revenue from individual income taxes while the comparison states averaged 27 percent; the U.S. average was 31 percent. Virginia received 22 percent of its revenue from the general sales tax while the comparison states averaged 37 percent, and the U.S. average was 33 percent.

- *Local governments in the Hampton Roads region are slightly less reliant on the property tax.* Hampton Roads local governments received 67 percent of their tax revenues from the property tax compared to 72 percent among Southeastern states and 74 percent for all states.

- *The burden of "other local taxes" (licenses, excise taxes and user fees), however, is higher in the Hampton Roads region than in either the rest of Virginia or in the comparison states.* Hampton Roads received 25 percent of its total tax revenue from these other taxes in 1995 compared to 19 percent in the rest of Virginia, 14 percent in the comparison states, and 10 percent in the U.S.

- *Compared to all states, Virginia ranks relatively high (15^th^) in state and local individual income taxes compared to income, relatively low (43^rd^) in combined sales taxes and closer to the middle (32^nd^) for property taxes.*

- *State aid to local governments in Virginia is relatively low and has been falling since 1988.*

  Virginia state aid going to local governments (measured relative to personal income) is the lowest among all states in the Southeast. In addition, as explained below, the share of local revenues coming from state aid has declined significantly since 1988.

The main conclusions that should be drawn from these rankings is that, compared to the rest of the region, Virginia is a relatively low-tax state in terms of state taxes, but is a relatively high-tax state in terms of local taxes. This indicates that Virginia's local governments impose relatively higher tax burdens on their residents and businesses to pay for local services, partly because of the relatively low level of state aid to local governments.

Figure ES-1 indicates that the over the past 20 years, the share of state aid in local government revenues has fallen from a peak of 33 percent in 1988 to 27 percent in 1997. Combined with reductions in federal aid, the share of local government revenues from federal and state aid has fallen 13 percentage points since 1977.

As a result of these trends, local governments in Hampton Roads and throughout Virginia now rely more heavily on local property taxes and non-tax revenues (such as user fees) to pay for public expenditures, and local taxpayers are now paying a significantly higher percentage of the costs of local services than they did in 1977.

EXECUTIVE SUMMARY

This study, prepared for the Hampton Roads Planning District Commission, provides a comprehensive analysis of the Virginia state and local tax structure and the revenue and expenditure pressures currently affecting local governments in the Hampton Roads region. The overall objective of the study is to evaluate the ability of local governments in Hampton Roads to pay for expected public services.

The study's findings highlight both the strengths and weaknesses of the Virginia state and local fiscal system in handling the fiscal pressures facing local governments. This study addresses a number of policy questions related to five key dimensions of Virginia's state and local fiscal system:

- **Economic Performance.** How have the economies of Hampton Roads and the Commonwealth of Virginia performed over the last two decades, compared to each other and to other states in the Southeast?

- **Fiscal Structure.** What mechanisms are used by the Commonwealth of Virginia and its local governments to fund state and local expenditures, and how does this structure compare to the tax systems used in other states? How have the state and local tax systems in Virginia responded to economic growth and changes in the structure of the state and Hampton Roads' economies?

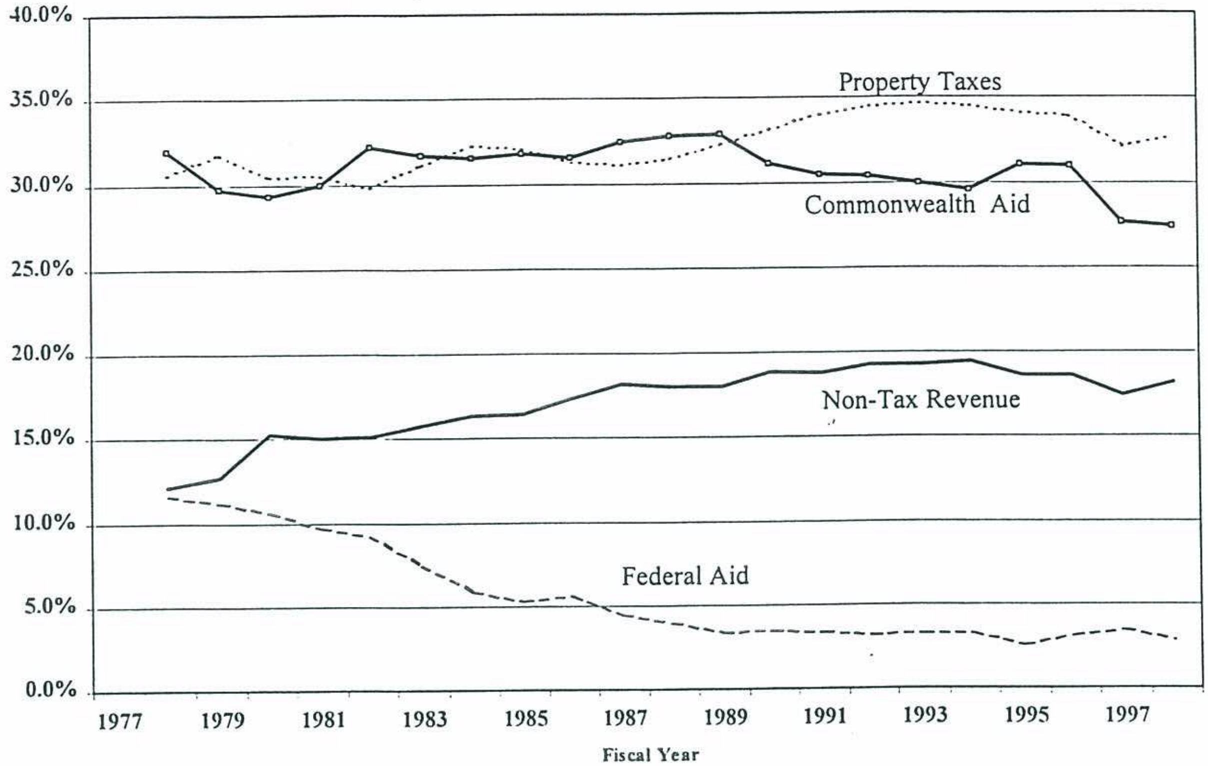
- **Competitiveness.** How competitive are Virginia taxes in general and those of the Hampton Roads region in particular in terms of tax burdens imposed on different types of businesses?

- **Long-term Revenue Adequacy.** Are the revenue sources, including state aid, available to local governments in the Hampton Roads area sufficient to fund expected future service levels without tax rate increases?

- **Policy Options.** What are the policy options that state and local governments in Virginia have to address the major issues identified in this study, and which options are most effective in meeting the tax policy objectives in the Hampton Roads region and the Commonwealth of Virginia?

In addition to identifying how Virginia compares to its competitor states, analysis of each of these dimensions provides insights about the underlying structural relationships between Virginia's state and local governments. A clear understanding of this underlying economic and fiscal structure will provide state and local policymakers with critical information needed to implement policy changes that ensure the long-run stability, fairness and effectiveness of Virginia's state and local tax system.

Figure ES-1
Shares of Virginia Local Government Revenue: 1977-1997



Competitiveness

An important concern of local government officials and taxpayers in the Hampton Roads area is the region's economic competitiveness in increasingly competitive national and international markets. To examine the role of taxes in this competitive environment, Barents Group's Business Tax Competitiveness Model was used to compare Virginia's state and local business tax burdens to those in the Southeastern states and Pennsylvania.

Important findings from the competitiveness analysis are:

- *Virginia's state and local tax burdens are only 7 percent above average for the twelve industries and ten states included in the study.* Virginia ranked second lowest in business income tax burdens and lowest in sales taxes on business purchases of inputs.
- *In contrast, local property tax burdens in Virginia are second highest among the study states.* Local property taxes in Virginia were 70 percent higher than the average for the ten states and pose a competitive problem for local governments in Virginia.
- *Because of the significance of local property taxes, variations in asset distributions and local tax rates create large variations in effective state and local tax burdens across industries and local units of government.* These tax rate differences tend to distort business location choices and can intensify intrastate business tax competition.

Table ES-1 shows the effective tax rates in Virginia and the comparison states by type of tax averaged over twelve manufacturing industries. The effective tax rates measure the difference between pretax and after-tax rates of return on new investments. For example, the table shows that state and local taxes in Virginia, on average, reduce the profitability or return on a firm's investment by 8.53 percent.

Table ES-1
Effective Business Tax Rates By Type of Tax, Twelve-Industry Average

States	Income	Rank	Property	Rank	Sales	Rank	All Taxes	Rank
Virginia	**1.48**	**1**	**5.62**	**9**	**1.42**	**2**	**8.53**	**6**
Maryland	2.22	5	2.12	3	1.39	1	5.73	1
Pennsylvania	3.17	7	0.58	1	2.31	7	6.06	2
Kentucky	3.38	9	1.34	2	1.63	4	6.35	3
North Carolina	2.51	6	2.57	4	2.99	10	8.07	4
Georgia	1.65	3	4.57	7	2.15	6	8.36	5
West Virginia	3.64	10	4.03	6	1.62	3	9.28	7
Tennessee	3.29	8	3.72	5	2.54	8	9.55	8
South Carolina	1.74	2	6.20	10	1.78	5	9.72	9
Florida	2.03	4	4.88	8	2.88	9	9.79	10
Region	**2.63**	--	**3.33**	--	**2.14**	--	**8.10**	--

Source: Barents Group LLC, Business Tax Competitiveness Model

Overall, Virginia's tax structure is slightly less competitive than the average of the comparison states, but four of the other nine states still have higher tax burdens than Virginia. The property tax is almost solely responsible for Virginia's above average tax burdens. Although statutory rates on real property are not out-of-line, Virginia taxes personal property at a higher rate than any of the comparison states. In the Hampton Roads region the statutory tax rate (adjusted for assessment ratio differences) for personal property is double the rate on real property.

The study also found that effective property tax rates differ substantially among local jurisdictions in Virginia. Within the Hampton Roads region, for example, the average effective rate (7.06 percent) for 11 manufacturing industries in Norfolk is more than 50 percent greater than the rate (3.49 percent) in Virginia Beach.

The tax burdens also differ dramatically by industry. The average effective tax rate on paper product manufacturing in the comparison states is 20.85 percent, while the corresponding rate on computer and office equipment manufacturing is 3.99 percent. Interestingly, the pattern in Virginia is even more extreme. The state is least competitive (2nd highest) in paper product manufacturing and most competitive (8th highest) in computer and office equipment manufacturing. The differences among industries in Virginia are largely explained by their differing degrees of reliance on heavily taxed equipment used in the manufacturing process.

Long-Term Revenue Adequacy

Giving the changing economy and demographics of the Hampton Roads region and the Commonwealth, it is important to evaluate the degree to which state and local tax bases can support growing and changing expenditure requirements at both the state and local levels in Virginia. To answer this question, the study compares the expected balance between local expenditure needs and revenue-raising capacity of local governments in the Hampton Roads region through 2005.

Expenditure need estimates measure the expected costs of providing an average level of services to a local government's citizens while accounting for service responsibility and cost differences among local governments. For example, counties in the Hampton Roads region have minimal responsibilities for road maintenance because the state assumes virtually all of the cost. In contrast, independent cities supplement state money with significant expenditures from their own revenues. This difference in responsibility translates into greater transportation expenditure needs in independent cities.

As an example of how cost factors affect expenditure needs, consider the case of public safety. A jurisdiction with a high percentage of the population between the ages of 18 and 35 has greater expenditure requirements or needs than a jurisdiction with a lower such percentage because it is this age cohort that commits a disproportionate number of crimes, thus requiring more police resources. The analysis identified and statistically estimated the magnitude of this and other cost factors for public safety, as well as for education, transportation, and parks and recreation.

After adjusting average expenditure levels for variations in costs and spending responsibilities among local governments, the resulting expenditure needs were projected through 2005 using forecasts of costs, service populations and factors determining the demand for public services. The results of the expenditure needs calculations and projections are shown in Table ES-2. The table shows that:

- *Projected per capita expenditure needs for the expenditure categories included in the study will vary widely within the Hampton Roads region, ranging from $1,530 in York County to $2,340 in the City of Franklin.*

- *Expenditure needs are growing faster in the Hampton Roads region than in the rest of Virginia.*

  From 1996 to 2005, projected annual increases in the Hampton Roads region per capita costs of providing the current level of local public services is 3.0 percent for counties and 3.2 percent for cities, compared to statewide increases of 2.8 percent for counties and 3.0 percent for cities.

Table ES-2
Projected Hampton Roads Total Expenditure Needs and Revenue-Raising Capacity, 2005

	2005 Per Capita Expenditure Needs		2005 Per Capita Revenue Capacity		Need-Capacity Gap
Jurisdiction	Amount (dollars)	Annual Growth Rate	Amount (dollars)	Annual Growth Rate	Amount (dollars)
Counties					
Gloucester	1,553	3.0	1,052	1.9	501
Isle of Wight	1,605	2.9	1,079	1.7	526
James City	1,573	3.1	1,627	2.7	54
Southampton	1,553	2.9	911	2.1	642
York	1,530	3.0	1,170	2.1	360
County Average	1,563	3.0	1,168	2.1	395
Municipalities					
Chesapeake	1,486	2.9	1,074	2.4	412
Franklin	2,340	3.3	961	2.6	1,379
Hampton	1,594	3.2	838	2.1	756
Newport News	1,755	3.2	826	2.0	929
Norfolk	1,778	3.3	788	2.2	990
Poquoson	2,196	3.3	1,136	2.7	1,060
Portsmouth	1,723	3.2	681	1.8	1,042
Suffolk	1,734	3.0	859	0.7	875
Virginia Beach	1,657	3.3	1,025	2.5	632
Williamsburg	2,288	3.3	1,332	1.2	956
City Average	1,855	3.2	947	2.0	903

Source: Barents Group LLC

The study evaluates the fiscal health of local governments by comparing the estimated expenditure requirements to their revenue-raising capacities. Revenue-raising capacity measures the amount of taxes a local government could raise if it applied average tax rates to its actual tax bases. It is a measure of a local government's potential for raising revenues, not its actual tax collections. The results of the revenue capacity calculations and projections for 2005 are shown in the second set of columns in Table ES-2.

The last column in Table ES-2 presents the projected 2005 need-capacity gaps for counties and cities in the Hampton Roads region. It is the relationship between revenue-raising ability and expenditure requirements that determines the overall fiscal health of a local government.
The figures in Table ES-2, combined with the study analysis of the fiscal outlook for local governments in the Hampton Roads region, support the following conclusions:

- *Revenue-raising capacity is projected to grow significantly slower than current-service expenditure responsibilities in the Hampton Roads region through 2005.*

Based on the estimates presented in Table ES-2, growth in local expenditure needs will exceed capacity growth by 0.9 percent each year for cities and 1.2 percent annually for counties in the Hampton Roads region.

- *With expenditure pressures rising faster than local revenue bases, local governments in Hampton Roads will not have the revenue-raising capacity to fund average expenditure needs in 2005 without significant tax rate increases.*

Another finding in the study is that the Hampton Roads population dependency ratio (the ratio of non-working-age population to working-age population) will start to increase in the second decade of the next century and will grow faster than in Virginia or the comparison states. As a result, local governments will face increasing spending pressures for both health care for retirees and public education for children in elementary and secondary schools. This demographic shift will require greater long-run revenue-raising capacity at the local level or increased state aid to meet spending responsibilities.

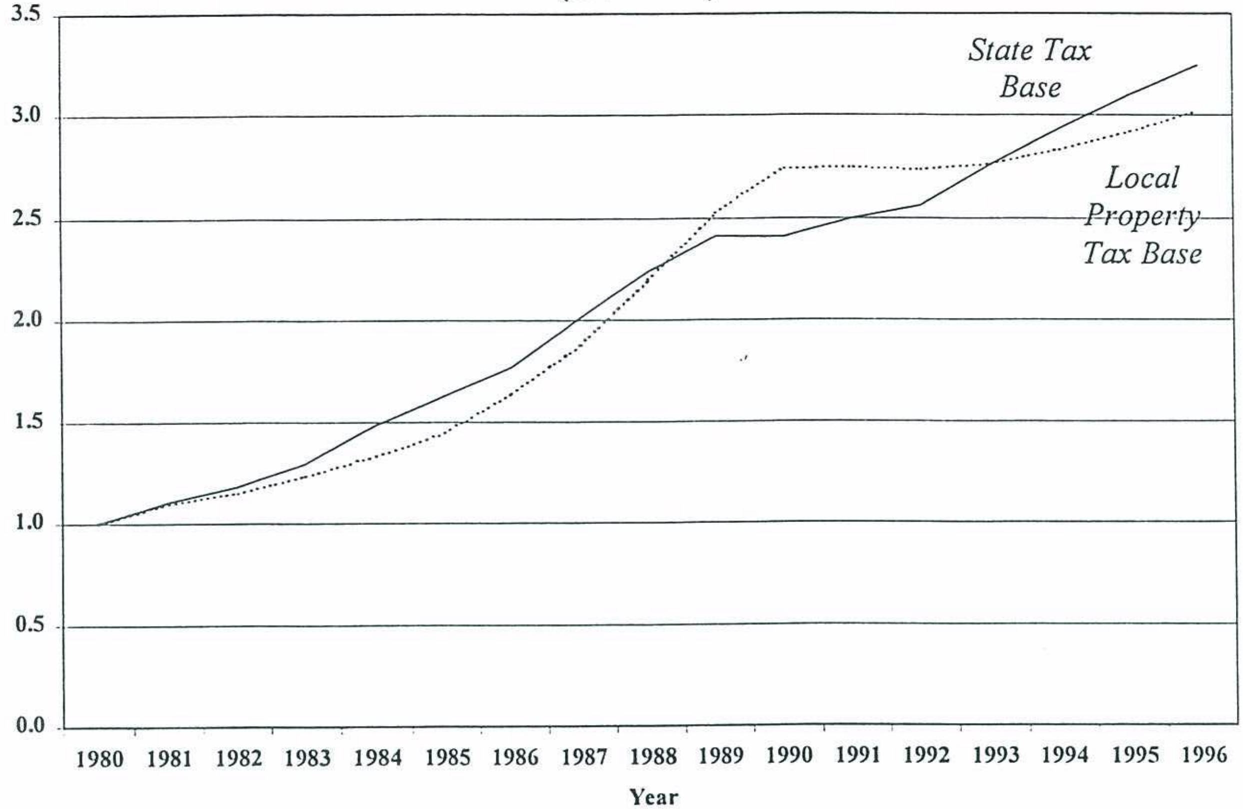
Policy Implications

Although the precise size of the gaps between expenditure needs and revenue-raising capacities cannot be predicted with a high degree of accuracy, the results of this study do strongly suggest that local governments in the Hampton Roads area will not have the local resources needed to support spending requirements over the next decade.

In contrast, the revenue outlook for state tax sources is much brighter. Study results indicate that total state tax revenues actually grow in step with total personal income without the need for any tax rate increases. In other words, a 10 percent increase in state personal income will generate a built-in, automatic increase in combined state taxes of approximately 10 percent. In sharp contrast, the study found that in the 1990s local tax bases, primarily the property tax, are growing slower than personal income. For local taxes, a 10 percent increase in personal income is generating closer to an 8 percent increase in local taxes with no change in tax rates.

Figure ES-2 clearly shows the difference in growth rates for total Virginia state taxes and total local taxes since 1980, including tax base growth and tax policy changes. Each series is expressed as a ratio of the 1980 tax levels so that the growth rates can be compared directly. The diagram shows that local taxes actually grew faster than state taxes through the 1980s, but this pattern has been reversed in the 1990s as the growth of local taxes has been significantly reduced relative to state taxes. The faster growth rate for state taxes is primarily due to the combination of strong individual income tax base growth, including taxable capital gains, and Virginia's relatively heavy reliance on the income tax.

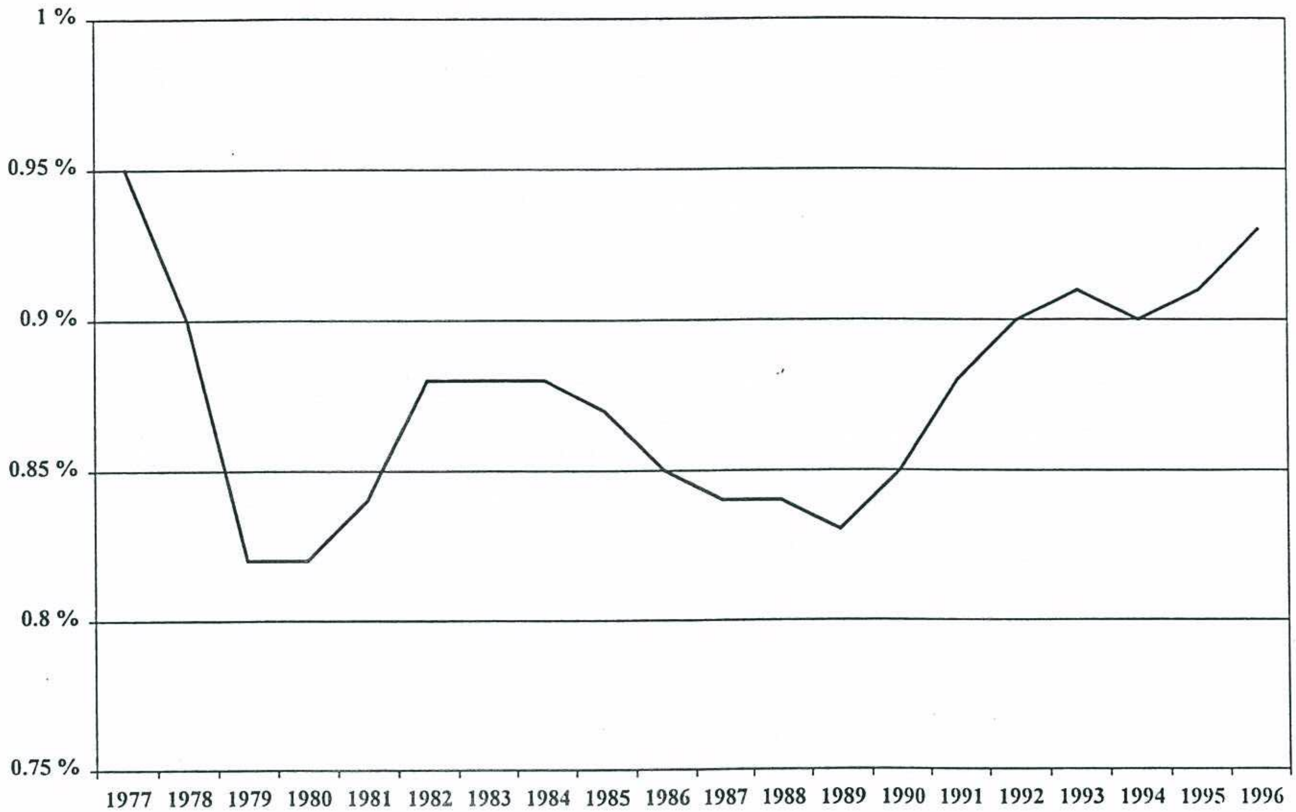
Figure ES-2
Growth of Virginia's State and Local Tax Bases, 1980-1996
(1980 = 1.0)



In contrast, the only local revenue source that has consistently grown faster than state personal income is the personal property tax, which is primarily a local tax on personal motor vehicles. Given that the Commonwealth is phasing down this local tax source and that there is uncertainty as to whether the state-paid replacement revenues will grow at the same rate as the current tax, this change may actually reduce the growth rate in local government taxes and widen the estimated need-capacity gaps.

The cumulative effects of the declining importance of state and federal aid in local revenues, slower-growing local tax bases and continued growth in local expenditure responsibilities can be seen in Figure ES-3. The graph presents Virginia's statewide effective real property tax rate (property taxes as a percent of the market value of real property) over the last two decades. Since 1989, the effective real property tax rate has increased by 12 percent, a clear measure of increasing fiscal pressures on local governments

Figure ES-3
Statewide Real Effective Property Tax Rate
(Percentage of Full Value)



Fiscal Reform Options

The overall conclusion of this study in that there appears to be a fundamental structural imbalance in Virginia's state and local tax system that is leading to increasing fiscal pressures at the local level of government. The solution to this structural problem is to increase the growth rate of local tax revenues or reduce local spending responsibilities.
The following are examples of policy options that could address the problem:

- *Expand the consumption tax base.* Even though the economy is shifting from a manufacturing base to a service base, most services remain outside the reach of Virginia's state and local sales tax. This is a major reason why the sales tax revenue is growing at a rate slower than the economy. By expanding the sales tax base to include services, the Commonwealth could increase the revenues available to local governments, increase overall responsiveness of local revenue sources to economic growth and reduce sales tax regressivity. Local governments could choose to offset the initial tax increase through property tax relief, while still enjoying the long-term benefits of the higher income responsiveness.

- *Allow local governments more tax options.* A local-option income tax, for example, has been discussed and could serve to increase the income responsiveness of the local revenue structure. Nevertheless, this alternative is widely perceived to be undesirable from a competitiveness standpoint, particularly in light of Virginia's already heavy reliance on the state income tax. The same competitiveness concerns also apply to expanding the use of license taxes or gross receipts taxes at the local level.

- *Expand the state aid system.* There are two respects in which the state aid system could be improved. First, the overall amount of state aid could be linked more closely to the growth in state income taxes. A more direct link would allow local governments to share in the higher growth potential of the individual income tax base. Second, the distribution of state aid could be linked more closely to the local governments' need-capacity gaps, as is the case with education aid. At present, state aid reduces the disparity in these gaps by just over 20 percent, but formulas could be devised to eliminate virtually all of the disparities, even if the overall level in state aid were not changed.

- *Transfer greater direct expenditure responsibility to the state level.* This is the solution that has been used for road maintenance in counties. In theory, the state could take over other functions as well, thereby relieving local governments of a portion of their responsibilities while leaving them with the same tax base. This has the disadvantage, however, of reducing accountability for those services to a level at which local voters have little influence.

Given the complexity of Virginia's state and local fiscal system and the structural problems identified in this study, a comprehensive solution to the imbalance in spending responsibilities and revenue-raising capacities will most likely involve elements of all four of these options. The results of this study should support the public discussion of alternatives for strengthening the performance of Virginia's state and local fiscal system in the new millennium.

BARENTS
GROUP • LLC

Projection of Virginia's State and Local Expenditures and Revenues

Prepared for:

Virginia Forward

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September 1999

EXECUTIVE SUMMARY

PROJECTIONS OF VIRGINIA'S FISCAL OUTLOOK

INTRODUCTION

Virginia's economy and fiscal system have undergone significant changes in recent years. Among these changes have been rapid growth in certain regions of the state, a general shift from the manufacturing sector to the service sector, and a movement to reduce tax burdens. These and other changes will have significant impacts on both state and local government revenues and the demand for public services.

The purpose of this report, commissioned by Virginia Forward, is to review the longer-term fiscal outlook for the state and for local governments out to FY2008. In developing this fiscal outlook, the following approach was followed:

- A baseline projection of revenues and expenditures was made using what is commonly called a "current services" approach, whereby current program levels are held constant in real (inflation adjusted) terms and revenues are based on current law. The State's FY2000 budget was used as the starting point for State revenue and expenditure projections and actual FY1998 data were used for developing comparable local government projections.

- The current services baseline data were adjusted to reflect the recommendations of prior legislative and business council studies to include supplemental spending in the areas of Medicaid, higher education, elementary and secondary education, and transportation. These adjustments capture the potential upward pressures on the budget that the state will face as it attempts to maintain parity with surrounding and competing states in the provision of critical public services.

THE VIRGINIA ECONOMY

Despite frictional unemployment associated with a changing employment mix, Virginia's overall employment growth has been healthy. In the period from 1990 to 1997, employment growth averaged 1.5 percent per year. To place this employment growth in perspective, two points are worth noting: (i) it has been much higher in services and retail trade and much lower in manufacturing; and (ii) it has been less than in a set of comparison states[1] or for the US as a whole. These outcomes are reflected in Figures 1 below.

For purposes of projecting economic performance into the future, the Virginia Outlook forecast produced in February by William and Mary's Bureau of Business Research was used through 2007 and was extended one year by Barents Group. Under this forecast, a sustained economic expansion is assumed, with average annual growth in personal income of 5.6 percent during the period 2000-2008.

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[1] Comparison states used in this analysis are the following Mid-Atlantic and Southeastern states: Florida, Georgia, Kentucky, Maryland, North Carolina, South Carolina, Tennessee, and West Virginia.

Figure ES-2
State Expenditure Growth
(in billions of dollars)

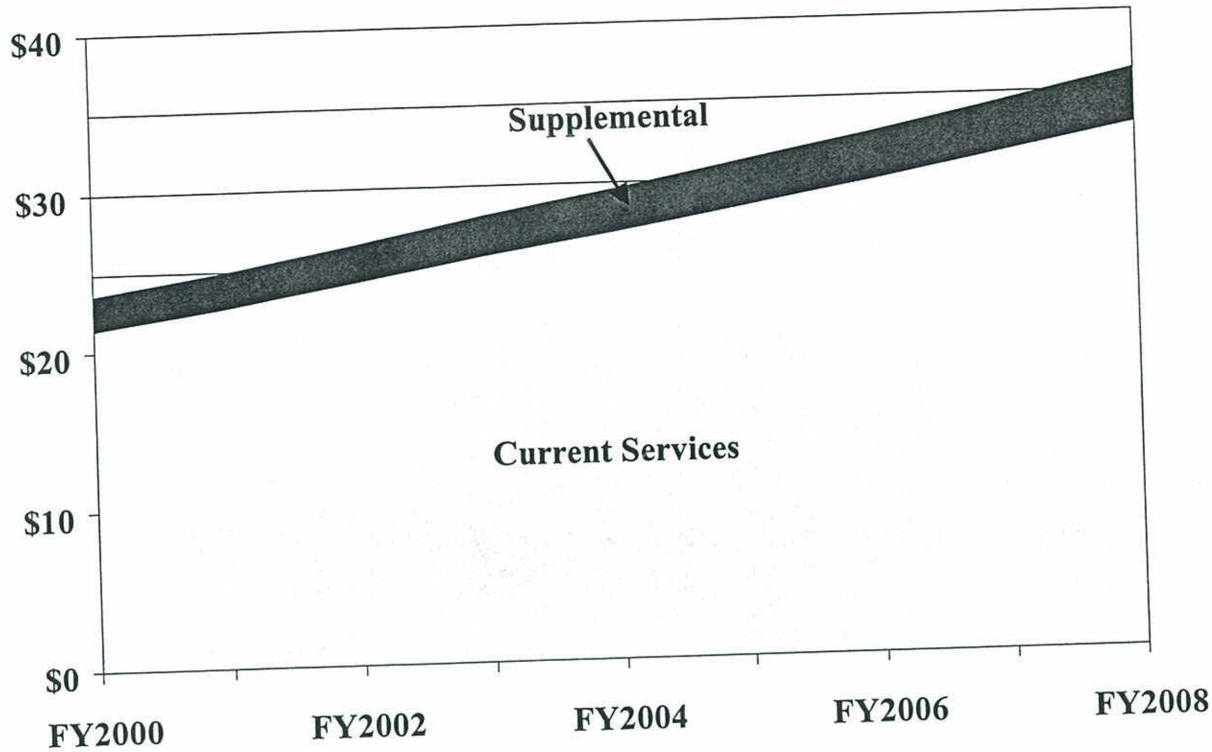
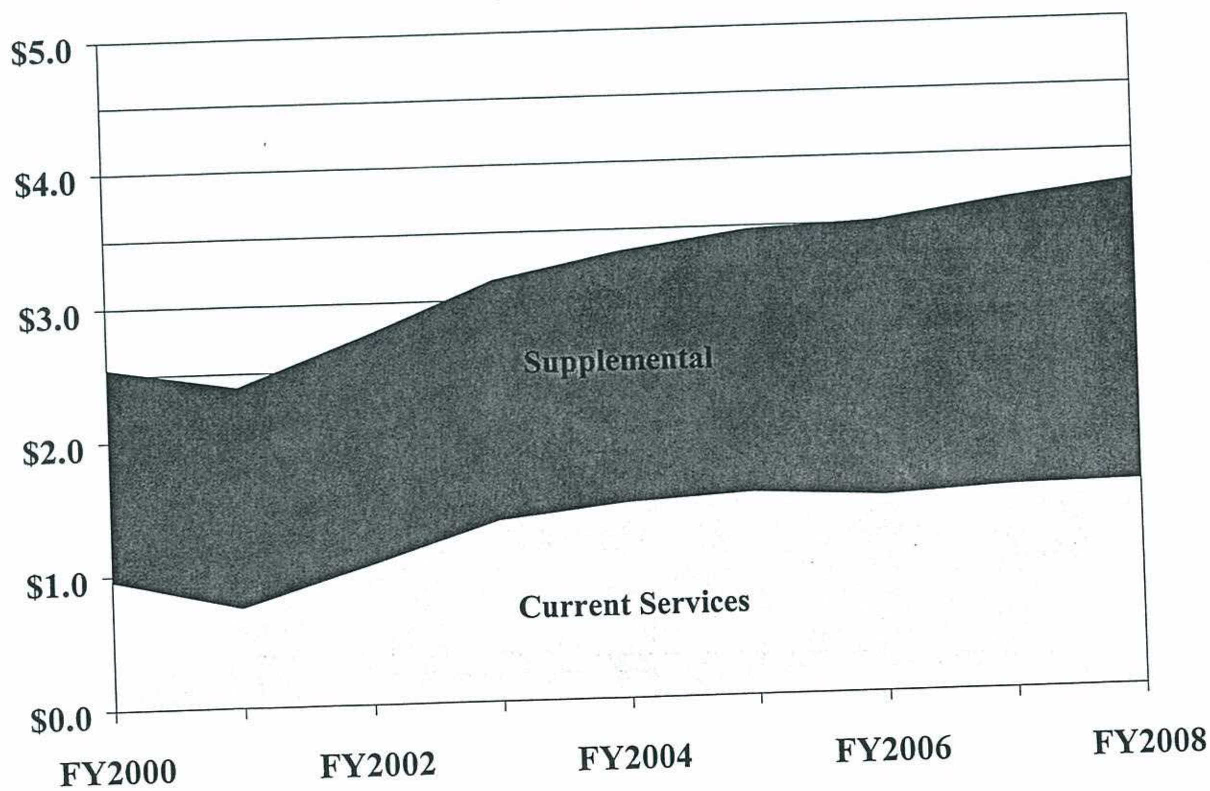


Figure ES-3
State Fiscal Deficit
(in billions of dollars)



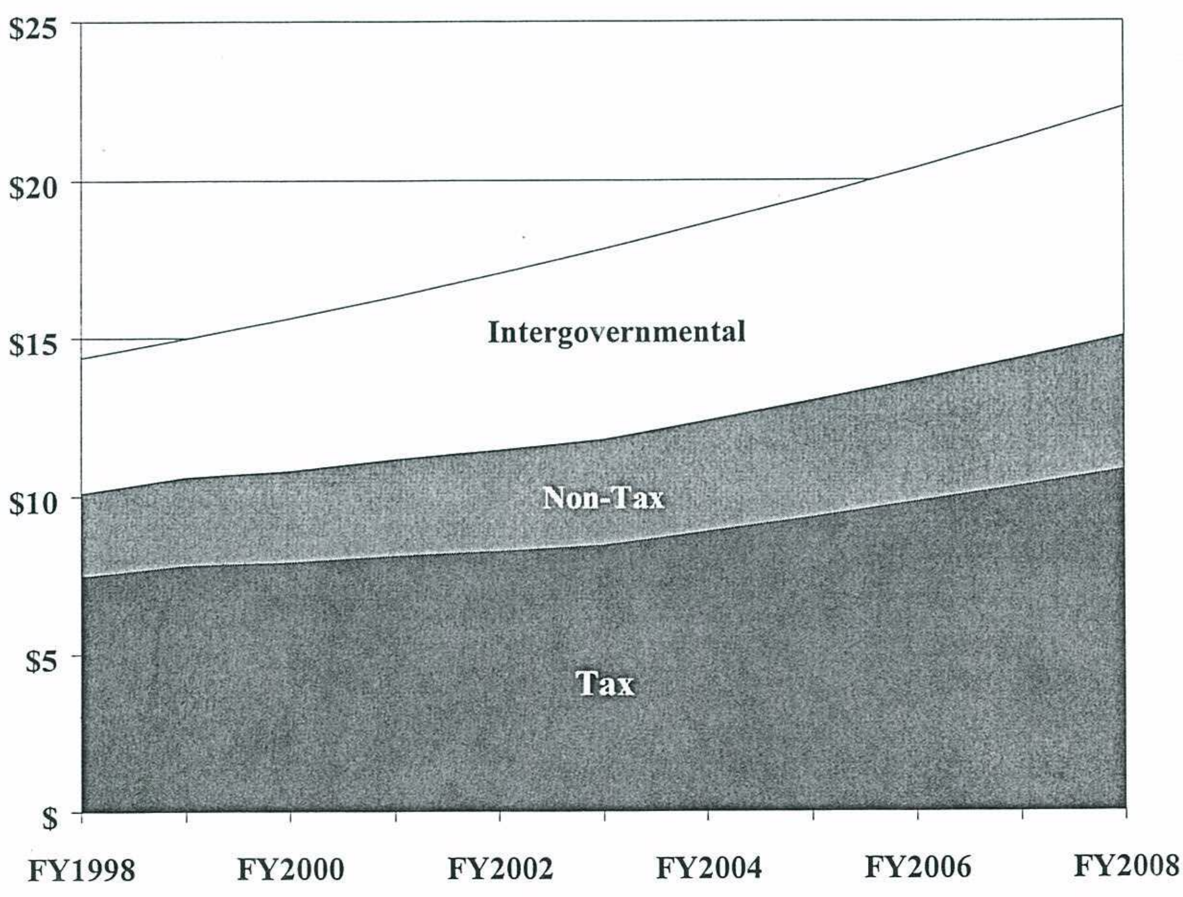
LOCAL GOVERNMENT REVENUE AND EXPENDITURE PROJECTIONS

The analysis of local government revenues and expenditures follows the same general methodology and underlying assumptions outlined above for the State. The report uses 1998 data from the Auditor of Public Accounts report *Comparative Report of Local Government Revenues and Expenditures* as the starting point for developing the projections.

Local Revenues

Local tax revenues in Virginia are projected to grow at 4.0 percent annually through the forecast period, substantially below the growth of State tax revenues (5.7 percent) or personal income (5.6 percent). This lower growth reflects several factors: (i) lower growth in real property values than in personal income, based on historical trends; and (ii) slow growth in personal property taxes, reflecting the car tax relief program. Non-tax revenues, including intergovernmental transfers, grow by 5.9 percent per year and increase in importance over the projection period, in part due to increased State transfers associated with the car tax relief program.

Figure ES-4
Local Government Revenue Projections
(in billions of dollars)



Local Expenditures

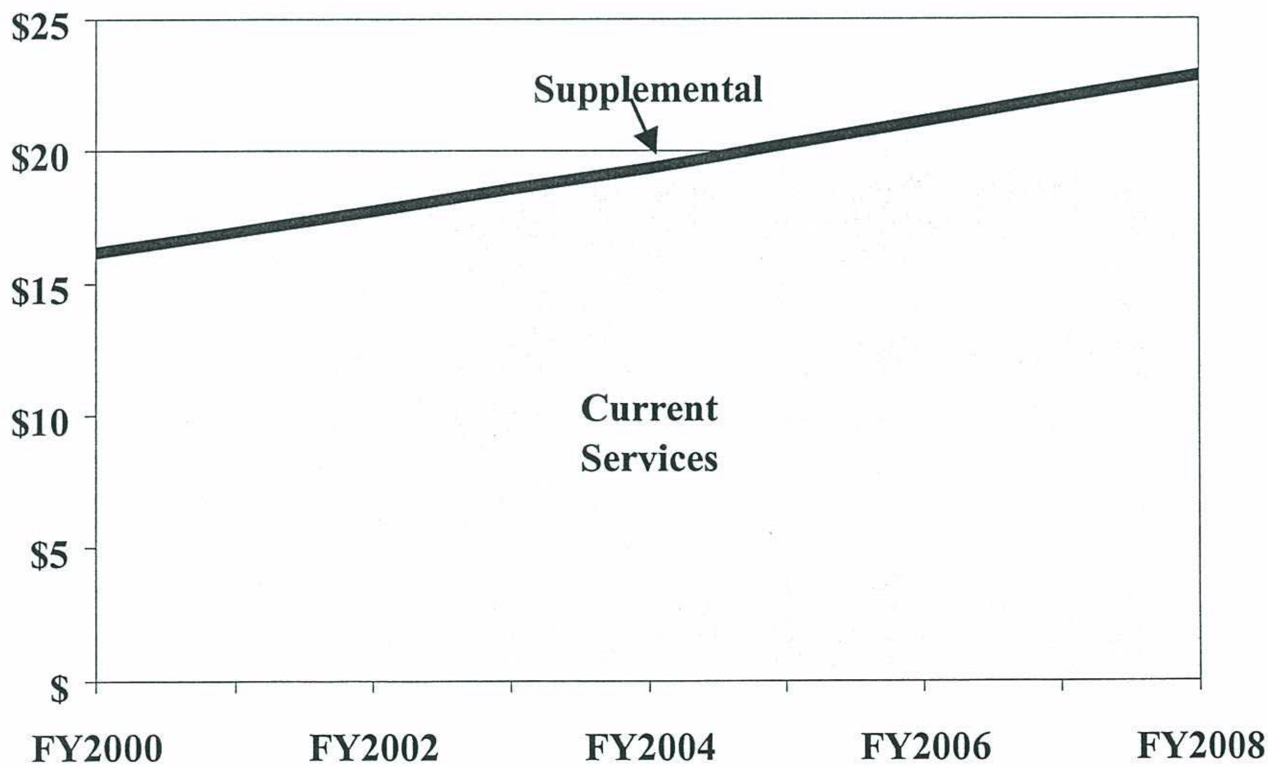
Using the methodology outlined earlier, local government expenditures on a current services basis are projected to increase by an average of 4.5 percent per year, from $16.0 billion in FY2000 to $22.6 billion in FY2008. The slower growth in local spending relative to state spending reflects the projection of low growth in the school-aged population in Virginia over the forecast period. The projections of current services expenditures are modified to reflect two factors:

- First, it was assumed that 10 percent of the increased costs associated with improved highway and road maintenance would be borne by local governments. This would add $43 million to FY2000 spending, and increasing amounts in subsequent years.

- Second, for purposes of developing projections, the service standards established in the 1996 School Facility Status Survey by the Virginia Department of Education were adopted. This study identified a range of educational infrastructure needs which, if addressed, are estimated in this report to add approximately $350 million per year to local government spending over a ten-year period.

Combining the projections of local government current services projections with the identified supplemental spending, total local government spending would rise to $23.1 billion by FY2008, as shown in figure ES-5.

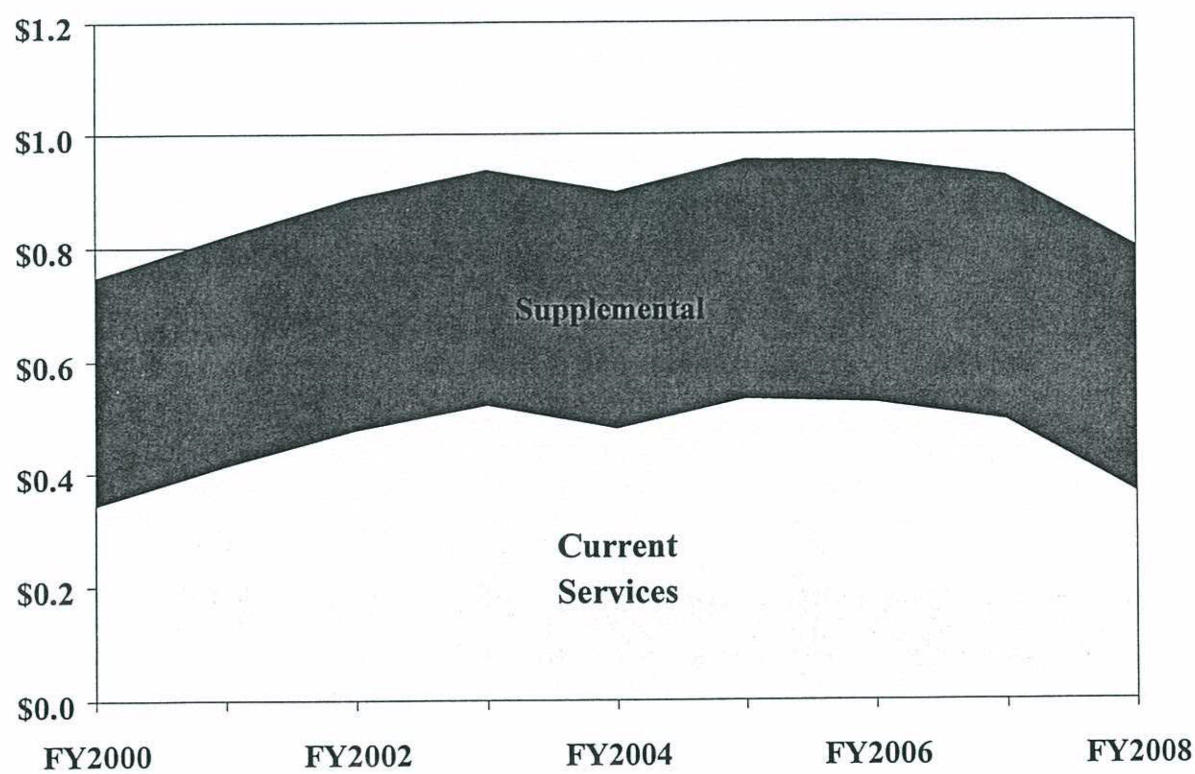
Figure ES-5
Local Government Expenditure Projections
(in billions of dollars)



Local Fiscal Deficit

Measured on a current services basis, there is a local government fiscal gap of approximately $0.3 billion in FY2000, rising to almost $0.5 billion by FY2006. Adding in the supplemental spending outlined above, this gap rises to almost $1 billion by FY2006, before beginning to decline modestly thereafter, as shown in Figure ES-6. This gap represents approximately 4 percent of total revenues, or about 9 percent of local governments' own-source tax revenues.

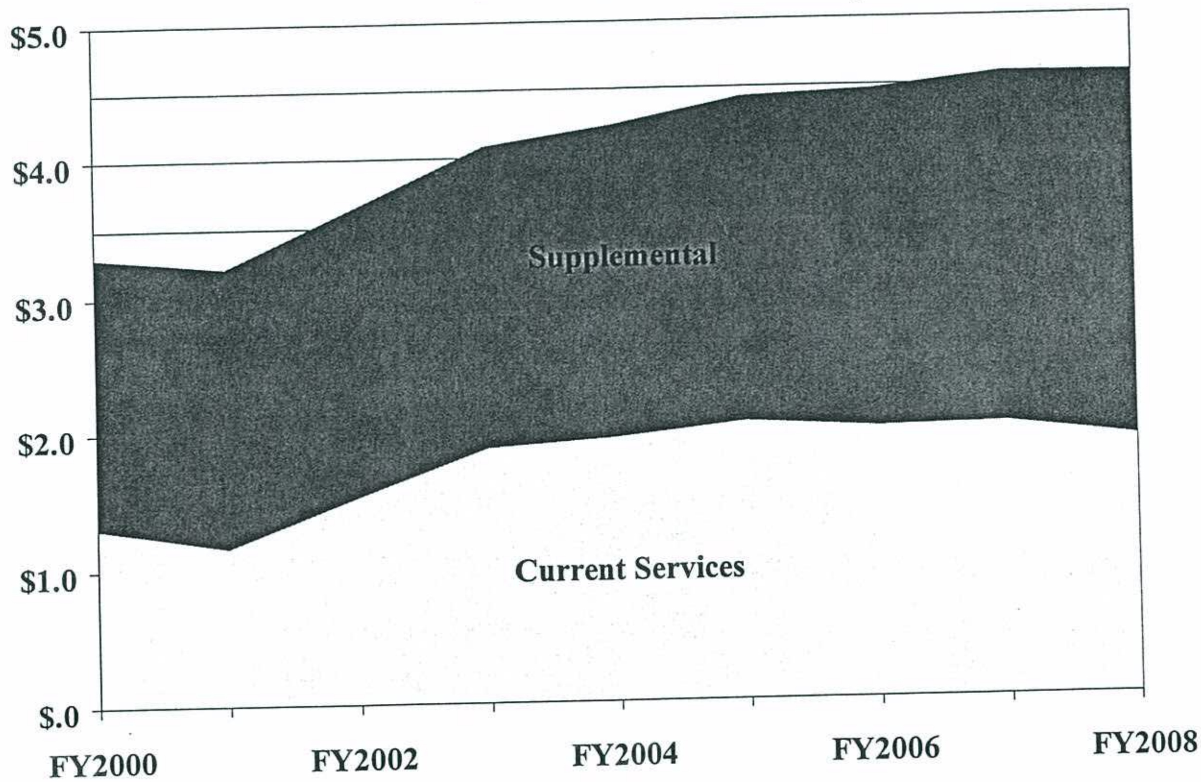
Figure ES-6
The Projected Local Government Fiscal Balance
(in billions of dollars)



CONCLUDING PERSPECTIVE

The purpose of this analysis has been to quantify the longer-term fiscal outlook for state and local government in Virginia based on existing program levels and supplemental needs that have been identified by respected legislative and private sector committees. The validity of the supplemental spending "needs" can be the subject of separate debate, as it has in the past and as it will continue to be in the future, to determine the extent to which these needs can and should be met. The analysis shows that, for state and local government combined, maintaining current spending programs, together with the identified supplemental spending, would result in a fiscal gap that grows to about $4.5 billion annually, as shown below, in Figure ES-7.

Figure ES-7
The Projected State and Local Government Fiscal Deficit
(in billions of dollars)



There is a healthy ongoing debate about fiscal priorities in the State, which can be expected to and should continue. This report highlights that important spending needs that have been identified by different committees – important initiatives in transportation, all levels of education, and Medicaid – cannot even be partially met without some combination of cuts in other spending programs, tax increases, or significant bond financing.

Virginia's State and Local Tax Structure: Recent Performance and Restructuring Options

Prepared for:

Virginia Forward

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2001 M Street N.W.
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December 1999

EXECUTIVE SUMMARY

INTRODUCTION

This report is the second of two documents that were commissioned by Virginia Forward to examine Virginia's economy and fiscal system. The companion volume to this report was released in September and included projections of Virginia's expenditures and revenues through 2008.

The evaluation of Virginia's fiscal outlook requires an understanding of the recent performance of the tax structures currently in place. To achieve this understanding, the report contains four chapters that attempt to describe the current tax system and offer options for its reform. Chapter One presents a description of criteria that are widely used to judge tax systems. Chapter Two investigates the competitiveness of Virginia's business taxes using a business tax competitiveness model. Chapter Three examines the dynamics of Virginia's current state and local tax structure, including a discussion of the growth potential of each system. Chapter Four presents options for strengthening Virginia's state and local tax system through broadening tax bases and examining new taxing options.

VIRGINIA'S CURRENT STATE AND LOCAL TAX SYSTEM

The performance of a state and local tax system can be measured in terms of both the level and the composition of revenue generated and by the degree to which it possesses several desirable characteristics.

The objectives and desirable charactcristics can be divided into three specific areas: efficiency, equity, and effective administration. An efficient tax system is one that minimizes the distorting effects of taxes on the economic decisions of individuals and businesses. An equitable tax system distributes tax burdens, measured relative to taxpaying ability, fairly across taxpayers. The third category, effective administration, focuses on the ability of taxpayers to understand and comply with the tax laws and the ability of tax agencies to uniformly and effectively administer the tax laws. While each tax or proposed change can be evaluated on its own merits, using these criteria, it is the combined impact of all state and local taxes that needs to be examined to determined how well the system is working to meet tax policy objectives.

Tax collection data can be used to compare Virginia's state and local tax system to those in the comparison states. This assessment is based primarily on measures of taxes collected relative to personal income or population. The income measure of tax burdens (taxes per $1,000 of state personal income) adjusts for differences in the ability of states to pay taxes using personal income to measure taxpaying ability.

State and local revenue sources can be analyzed from two perspectives: (1) the relative mix of revenue sources and (2) the level of revenue collections (or tax burdens) compared to other states.

Combined state and local tax collections can rank differently when viewed on a per capita basis or measured against a measure of the ability to pay, such as personal income. In Virginia, total tax collections rank 28th when compared on a per capita basis, but measure near the bottom (48th) when measured against Virginia's high per capita personal income.

Virginia's state-level taxes place it well below the comparison states' average rate per $1,000 of personal income for fiscal year 1996, the last year in which consistent collection data is available for the nation. With $56 of state taxes per $1,000 of personal income, Virginia falls far below the national average of $69 and the comparison states' average of $71 per $1,000 of personal income. By these measures, taxes levied at the state level are 19 percent below the U.S. average and 21 percent below the level in the comparison states. Within the region, Virginia's taxes are less than all states except Tennessee. Additionally, judging both the per capita figure and the per unit of income figure, Virginia's revenue from sales and corporate taxes are low and the revenues from individual income taxes are high, relative to other surrounding states.

Local-level taxes in Virginia are higher than comparison states' both in terms of collections and in terms of the percentage of total state and local tax revenue generated at the local level. These indications of the higher than average burden of local taxes in Virginia help to frame the need for tax restructuring.

BUSINESS TAXES

Although the aggregate levels of business taxes are important, they are often harder to measure against conventional benchmarks. Additionally, when taken in aggregate the overall burden of state and local taxes for businesses may be average, but when viewed as a change on the return to investment, the profit margins of individual firms will be taken into consideration.

For instance, many industries are characterized by high-volume, low-cost, low-margin transactions. When fixed taxes, such as property taxes, are imposed on these types of firms, they can have a significantly greater impact than taxes on high-margin firms. With this in mind, Barents Group used the business tax competitiveness model to simulate a business investment made in Virginia. Property, sales, income, and net worth taxes were calculated for seven states and twelve industries over a 30-year time horizon.

The averages across industries show that Virginia taxes are near the regional average in terms of the burden on business investment, ranking 4th highest overall, next to lowest in sales tax, and lowest in income tax. The tax-specific results indicate that Virginia imposes relatively high property tax burdens and low sales and income tax burdens. These results impact the restructuring options to the extant that state policymakers do not want to discourage business investment by levying taxes that are higher than those in surrounding states.

THE DYNAMICS OF VIRGINIA'S STATE AND LOCAL TAX SYSTEM

One measure of the performance of state and local tax collections is elasticity with personal income. Income elasticity is the percentage change in tax collections relative to the same percentage change in personal income. Higher elasticities with personal income indicate that taxes are more likely to grow as expenditures increase due to inflation.

Our own estimates of state and local tax elasticities show that the state system is very closely ties to personal income, with an income elasticity of 1.01 for the 1977 to 1997 period. This means that a 1 percent increase in state personal income will lead to a 1.01 percent increase in tax collections. The close relationship between personal income and state-level tax collections is largely due to the significant portion of state revenues that are derived from individual taxpayers' income and consumption in the form of individual income taxes and sales taxes. The state tax system has a desirable relationship to personal income in that tax collections are likely to grow with expenditure levels, which are closely tied to personal income levels in that upward changes in personal income are often accompanied by higher inflation.

The local tax system has a weaker link to state personal income because of its heavy reliance on the property tax. Real property taxes, which represented 51 percent of total local tax collections in 1996, are linked solely to assessed values, which are statutorily linked to fair market values. Although some minor adjustments can be made by altering assessment schedules, the property tax does not provide as constant a level of revenue as the state tax system. The personal property tax, while it has a high elasticity with personal income, will likely have far less growth potential once localities exempt the first $20,000 of personal motor vehicle value from property taxation in return for a compensating transfer from the state. The local option sales tax, while a high-growth source of revenue, suffers from its relatively modest contribution to local tax collections and the shrinkage of its tax base as consumer spending shifts away from taxable durable goods to non-taxable services.

RESTRUCTURING OPTIONS

Possible solutions to the structural budget problem at the local level include increasing the level and elasticity of local revenue sources, increasing state aid or reducing the growth of local spending responsibilities. Revenue-side restructuring could be achieved by (1) expanding existing tax bases, such as the sales tax, (2) enacting more local tax options, such as a local income tax, (3) increasing the importance of state aid in funding local government services, including education, or (4) transferring greater direct expenditure responsibilities to the state level. A comprehensive solution may involve all four elements. The following discussion looks at different financing options that could be used to address the state-local fiscal imbalance.

Virginia taxes relatively few services under the retail sales tax. Therefore, the growth in the sales tax base in Virginia is not keeping up with the overall growth in total consumer spending due to the "erosion" of the sales tax base as a result of shifts in the composition of consumer spending. This structural feature of the sales tax system is reducing the rate of growth of both state and local sales taxes in Virginia. An important tax policy issue facing Virginia citizens and elected officials is how to modify the current sales tax to recognize these changes in consumer spending.

Value-added taxes may provide a solution to the eroding sales tax base by taxing the value added to goods and services at each stage of production. Additionally, value added taxes are credited with eliminating some of the non-uniform tax burdens imposed by sales taxes, which have a cascading effect in some industries; that is, industries that cannot exempt the purchases of many inputs may have to increase prices to compensate, resulting in higher effective tax rates on those sales.

Generally, taxes based on gross receipts and property are deemed to be less desirable because they do not consider the ability-to-pay principle. Considering the same principle, taxes on net income are desirable. To resolve the structural problems at the local level, however, an add-on to the state income tax could provide a better remedy than local option individual taxes, which can be difficult to collect because of the mobility of local taxpayers between jurisdictions and difficult to administer because of the complication of apportioning income between small taxing districts. A local add-on to the state income tax could eliminate the complications of income apportionment by using a uniform rate across the state and by transferring funds back to localities based on either point of collection or some distribution formula that would consider both collection location and the local cost of providing services.

SUMMARY OF FISCAL PROJECTIONS

Virginia's economy and fiscal system have undergone significant changes in recent years. Among these changes have been rapid growth in certain regions of the state, a general shift from the manufacturing sector to the service sector, and a movement to reduce tax burdens. These and other changes will have significant impacts on both state and local government revenues and the demand for public services. These impacts are described in the companion volume to this report, "Projections of Virginia's State and Local Expenditures and Revenues."

The companion volume to this report, also commissioned by Virginia Forward, was released in September 1999 and reviews the longer-term fiscal outlook for the state and for local governments out to FY2008. In developing this fiscal outlook, the following approach was followed:

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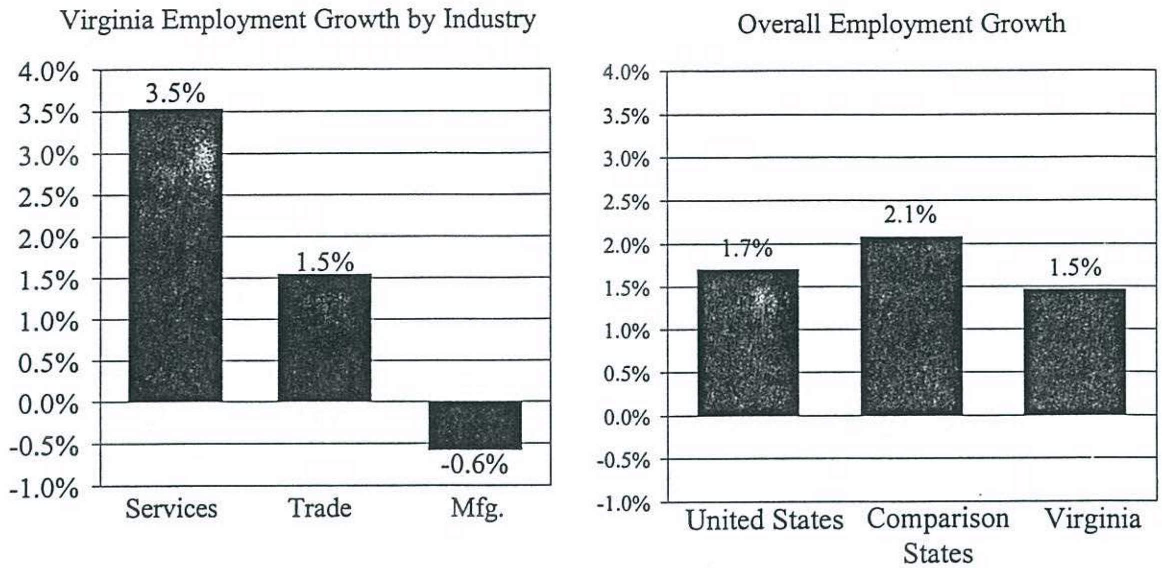
Despite frictional unemployment associated with a changing employment mix, Virginia's overall employment growth has been healthy. In the period from 1990 to 1997, employment growth averaged 1.5 percent per year. To place this employment growth in perspective, two points are worth noting: (i) it has been much higher in services and retail trade and much lower in manufacturing; and (ii) it has been less than in a set of comparison states[1] or for the US as a whole. These outcomes are reflected in Figures 1 below.

For purposes of projecting economic performance into the future, the Virginia Outlook forecast produced in February by William and Mary's Bureau of Business Research was used through FY2007 and was extended one year by Barents Group. Under this forecast, a sustained economic expansion is assumed, with average annual growth in personal income of 5.6 percent during the period 2000-2008.

[1] Comparison states used in this analysis are the following Mid-Atlantic and Southeastern states: Florida, Georgia, Kentucky, Maryland, North Carolina, South Carolina, Tennessee, and West Virginia.

Figure ES-1
Employment Growth, 1990-97
(average annual percent change)



STATE GOVERNMENT REVENUE AND EXPENDITURE PROJECTIONS

State Revenues

State government revenues are projected for the period FY2000-2008 based on the economic projections referenced above and current tax law, which includes the phase-in of a 2-percentage point reduction in the sales tax rate on food. State government revenues are projected in this analysis to grow by an average of 5.5 percent per year, compared to personal income growth of 5.6 percent during the same period. This reflects an estimated 5.7 percent growth in tax revenues and a 5.3 percent growth in non-tax revenues (which includes Federal government grants). This growth is significantly higher than that projected by the State, primarily because the state assumes lower growth in non-tax revenues.[2] The differences are highlighted in Table ES-1 below.

Table ES-1
Projected State Government Revenue Growth
(Percent annual rate)

	Barents Estimate	State Estimate
Tax revenues	5.7	5.2
Non-tax revenues	5.2	2.3
Total	5.5	4.0

[2] It should be noted that both forecasts are subject to revision to reflect changes in economic activity over time. In FY1999, for example, it now appears that the State's revenues were significantly higher than anticipated, an outcome that would mirror comparable results realized by the Federal government. To the extent that this occurred, it was most likely linked to stronger economic performance and higher-than-anticipated incomes. This outcome could relatively easily be reversed during the eight-year projection period, since an economic expansion has been assumed to continue unabated through 2008.

State Expenditures

The foundation for the State expenditure projections, as noted at the outset, is the current services concept. Under this concept, expenditures represent the amounts needed to provide the same level of services to Virginia residents that was provided in the base year (the State's FY2000 budget for this analysis). The current services expenditures reflect adjustments for (1) projected inflation, in order to hold programs constant in "real" terms; and (2) changes in programmatic "drivers" (e.g. numbers of school age children for education expenditures and vehicle miles traveled for transportation expenditures). The report provides a more detailed discussion of the methodology employed and the variables used for the different expenditure categories. The estimates of State expenditures also include increased payments to local governments to reflect, among other things, the increased grants of the car tax relief program.

The current services estimates were modified, as noted at the outset, to reflect prior legislature reports identifying potential spending needs to maintain a sound infrastructure and to maintain parity with other states. The three specific areas where modifications were made are:

- *Higher education*: In November 1998, the Virginia Senate Finance Committee released a report on higher education funding that documented a shortfall in Virginia relative to "peer institutions" in other states. The State's target level of service is the 60th percentile of that provided by these "peer institutions." Operating expenditures were modified to achieve this objective. In addition, capital expenditures were modified to reflect the Virginia Council of State Senior Business Officers report on deferred maintenance of institutions of higher learning.
- *Medicaid*: According to recent legislative studies, Virginia is not providing Medicaid to all eligible residents, nor is it providing the level of service found in surrounding states. The estimates in this report estimate a supplemental expenditure that would (i) match average reimbursement rates of surrounding states and (ii) increase coverage to include 90 percent of eligible residents.
- *Transportation*: For purposes of developing supplemental expenditure projections, the service standards recommended by the Select Committee on Transportation, established by the General Assembly in 1993, were adopted. The projects identified by the Committee were designed to reduce rather than maintain the level of congestion that existed at that time. It was assumed that identified gaps between the Committee's service standard and those that actually exist would be eliminated over a ten-year period.

On a current services basis, State expenditures are projected to increase from \$21.4 billion in FY2000 to \$32.9 billion in FY2008, an average annual increase of 5.5 percent. When supplemental spending for Medicaid, higher education, and transportation are included, spending reaches an FY2008 level of \$35.9 billion. These expenditure growth trends are depicted in Figure 3 below.

State Fiscal Balance

Combining the analysis of revenues and expenditures, one finds the result illustrated in Figure 4. On a current services level, expenditures exceed revenues by about \$0.7 billion in FY 2000[3] and by more than \$1 billion by FY2008. When the supplemental spending identified above is included, the state fiscal gap grows to more than \$3.5 billion by FY 2008.

[3] This estimate excludes the carryover of prior state surpluses; it also excludes any upward adjustments to revenues in FY1999 that could influence near-term revenue projections.

Figure ES-2
State Expenditure Growth
(in billions of dollars)

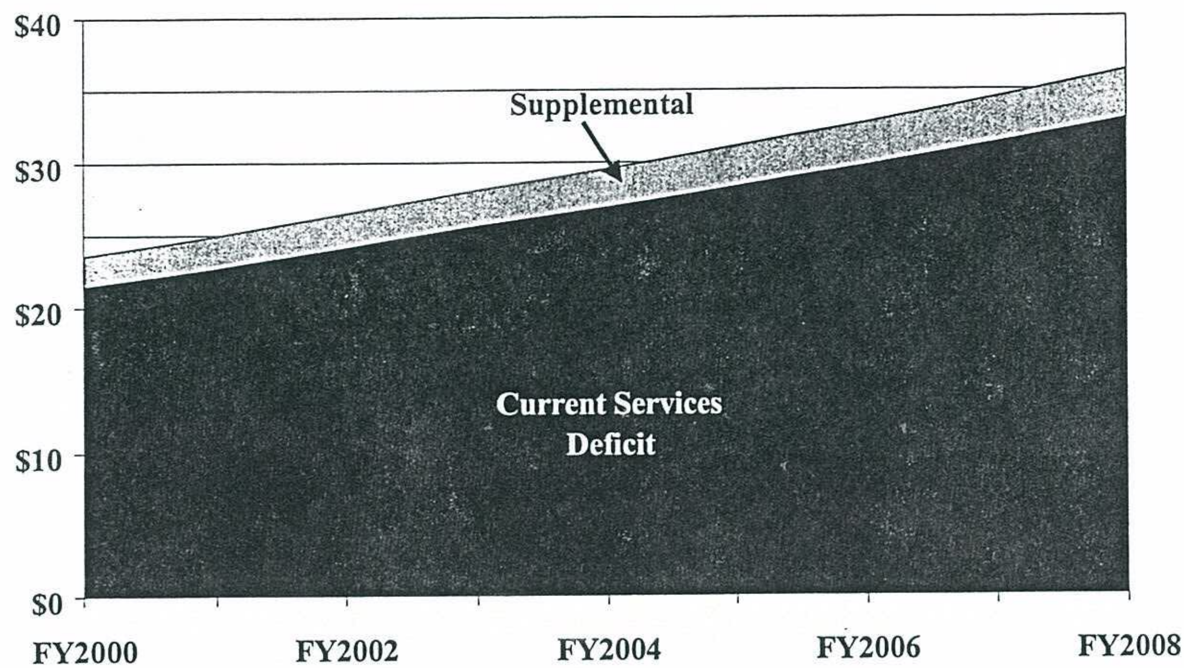
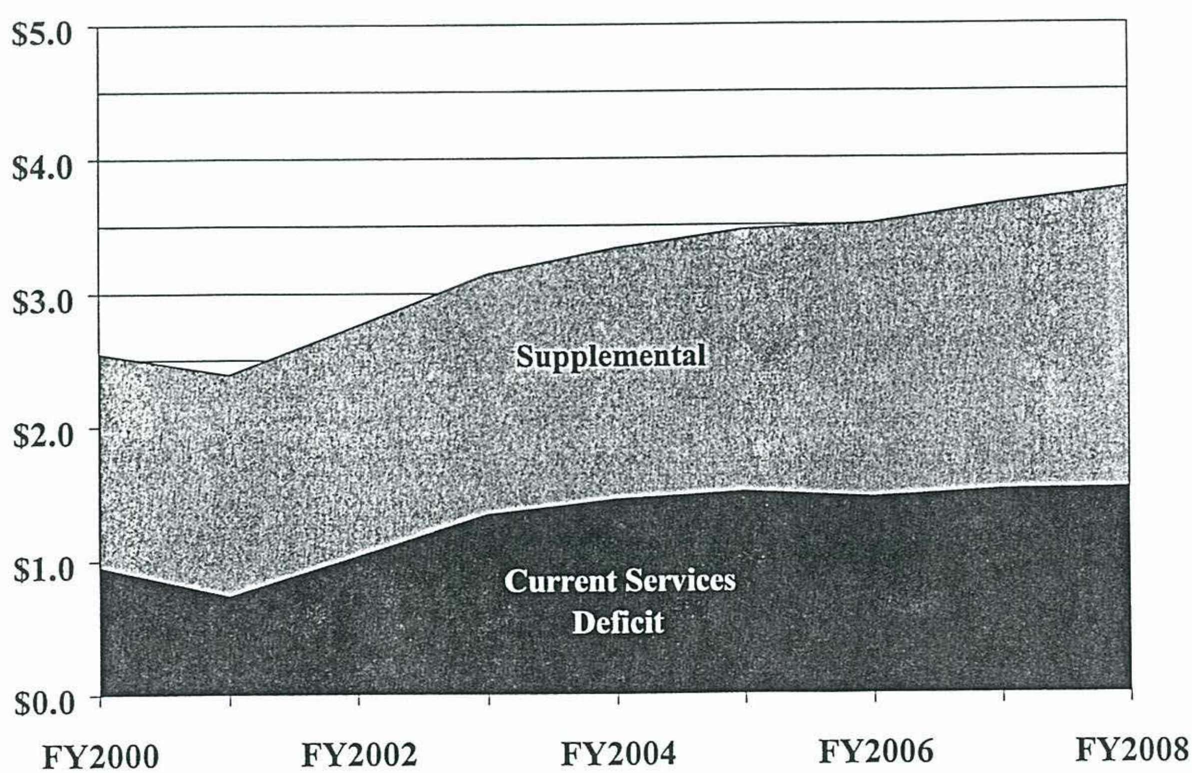


Figure ES-3
State Fiscal Deficit
(in billions of dollars)



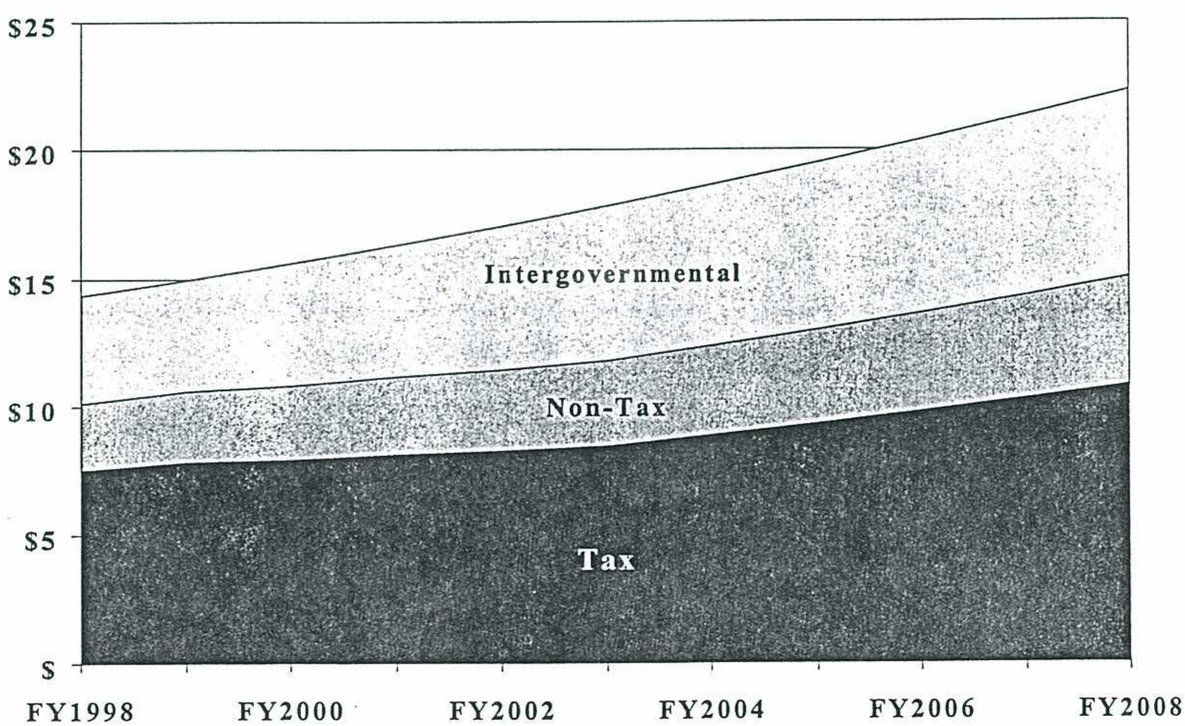
LOCAL GOVERNMENT REVENUE AND EXPENDITURE PROJECTIONS

The analysis of local government revenues and expenditures follows the same general methodology and underlying assumptions outlined above for the State. The report uses 1998 data from the Auditor of Public Accounts report *Comparative Report of Local Government Revenues and Expenditures* as the starting point for developing the projections.

Local Revenues

Local tax revenues in Virginia are projected to grow at 4.0 percent annually through the forecast period, substantially below the growth of State tax revenues (5.7 percent) or personal income (5.6 percent). This lower growth reflects several factors: (i) lower growth in real property values than in personal income, based on historical trends; and (ii) slow growth in personal property taxes, reflecting the car tax relief program. Non-tax revenues, including intergovernmental transfers, grow by 5.9 percent per year and increase in importance over the projection period, in part due to increased State transfers associated with the car tax relief program.

Figure ES-4
Local Government Revenue Projections
(in billions of dollars)



Local Expenditures

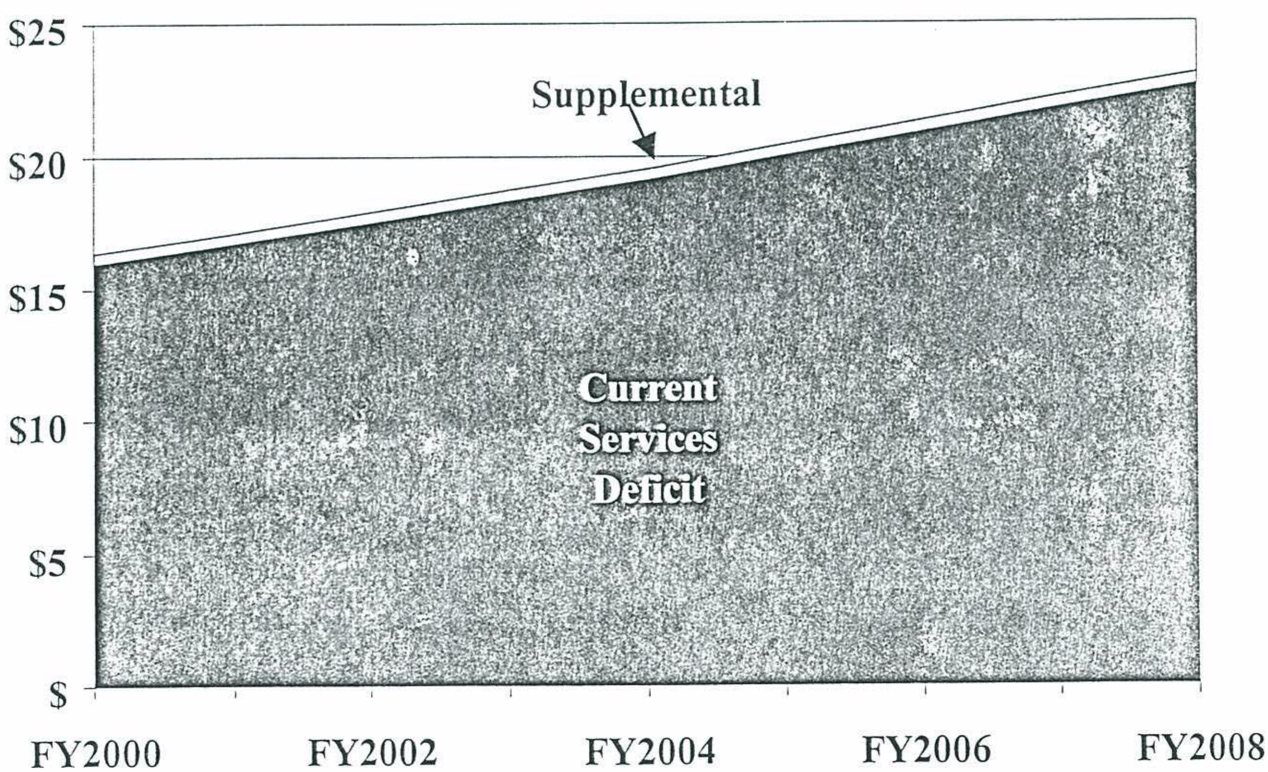
Using the methodology outlined earlier, local government expenditures on a current services basis are projected to increase by an average of 4.5 percent per year, from $16.0 billion in FY2000 to $22.6 billion in FY2008. The slower growth in local spending relative to state spending reflects the projection of low growth in the school-aged population in Virginia over the forecast period. The projections of current services expenditures are modified to reflect two factors:

- First, it was assumed that 10 percent of the increased costs associated with improved highway and road maintenance would be borne by local governments. This would add $43 million to FY2000 spending, and increasing amounts in subsequent years.

- Second, for purposes of developing projections, the service standards established in the 1996 School Facility Status Survey by the Virginia Department of Education were adopted. This study identified a range of educational infrastructure needs which, if addressed, are estimated in this report to add approximately $350 million per year to local government spending over a ten-year period.

Combining the projections of local government current services projections with the identified supplemental spending, total local government spending would rise to $23.1 billion by FY2008, as shown in figure ES-5.

Figure ES-5
Local Government Expenditure Projections
(in billions of dollars)



Local Fiscal Deficit

Measured on a current services basis, there is a local government fiscal gap of approximately $0.3 billion in FY2000, rising to almost $0.5 billion by FY2006. Adding in the supplemental spending outlined above, this gap rises to almost $1 billion by FY2006, before beginning to decline modestly thereafter, as shown in Figure ES-6. This gap represents approximately 4 percent of total revenues, or about 9 percent of local governments' own-source tax revenues.

Figure ES-6
The Projected Local Government Fiscal Deficit
(in billions of dollars)