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Why Are We Talking About Higher Taxes?

Wayne D. Purcell and Karen Mundy

State budgets pay for public goods like education, police protection, roads, and clean air and water. When state revenues decline, abrupt spending reductions to maintain the required balanced budget can threaten the quality or existence of state programs. Budget reductions can result in excellent public school teachers leaving, experienced highway department engineers being pushed into early retirement, and award winning college and university faculty finding better opportunities in other states. The "business model" in the private sector suggests laying off workers in tough economic times, but that model may not be appropriate for state financed public programs. Replacing the assembly line worker in the private manufacturing plant when the economy recovers can be relatively easy. But the new college graduate may not be a good replacement for the skilled engineer in the Department of Transportation or for the experienced chemist who oversees toxic spill cleanup for the Department of Environmental Quality.

In the 2004 General Assembly session, the debate is over increased tax revenues to avoid further disruptions of state programs. Elected leaders and people across the state are beginning to see that unplanned reductions in funding threaten the hard-earned progress of earlier years in state programs such as public education, transportation, health care, and environmental quality.

Budgets and the Ability to Pay

Components of the state budget like Medicaid have built-in increases. If state program costs increase faster than state tax revenues, then taxes have to be increased or state programs have to be cut. The costs of maintaining programs have indeed increased faster on occasion than personal incomes, which are good measures of the taxpayers' ability to pay for state programs. A growing divergence between public program needs and the tax revenues coming into the state coffers has spawned the acrimonious but essential debate over tax increases in the 2004 General Assembly.

When tax increases of any type are being discussed, the share of personal income paid in state taxes takes on a new importance. Virginia was compared to surrounding states in the November-December 2003 *Horizons*. The share of incomes being paid in total state taxes was consistently low in Virginia compared to surrounding states of Kentucky, Maryland, North Carolina, Pennsylvania, Tennessee, and West Virginia. At the national level, Virginia ranks 12th in personal income (BEA) but is 41st in percent of income paid in total state taxes (FTA). Against the backdrop of that earlier investigation, we focus in this issue of *Horizons* on the trends in the total state budget, the state general fund, and total personal income since fiscal year 1997.

Total Budget and General Fund

The total state budget (general and non-general funds) increased from \$17.13 billion to \$26.04 billion from fiscal year 1997 to fiscal year 2004, an increase of 52 percent (Figure 1). These budgets are in ***nominal*** dollars. Annual increases averaged \$1.27 billion.

> *Nominal dollars* refer to money that has not been adjusted for the effects of inflation.

The state general fund shows a different pattern when measured in nominal dollars. After increasing an average of \$1.04 billion yearly through fiscal year 2001, the general fund was flat to lower with fiscal year 2004 still slightly below fiscal year 2001. *Decreases in nominal dollar levels in a*

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state general fund are very unusual. When decreases occur, the capacity of the state to maintain programs and services is significantly compromised.

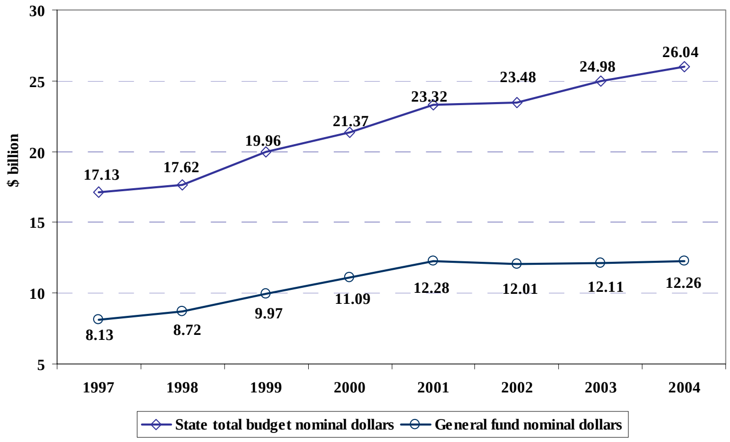

Figure 1. Total state budget and general fund, nominal dollars, fiscal years 1997 - 2004

> The *general fund* is made up of individual income taxes, corporate income taxes, sales and use taxes, and other taxes (insurance premiums, public service gross receipts taxes, and miscellaneous taxes) (Dept Budget & Plan.(a)).

A reduction in the general fund is often offset by an increase in the non-general fund. Increases in the non-general fund often come in the form of user fees, taxing only those who use the services provided. For example, increased tuition at state supported colleges and universities shifts the burden for higher education from the state general fund and the general taxpayer to the families using these institutions.

> The *non-general* fund is made up of federal grants; institutional revenue (patient fees at teaching hospitals, mental health institutions, and fees and tuition paid by students at institutions of higher learning); transportation revenue; unemployment insurance fund; licenses; profits from sale of alcoholic beverages; lottery ticket sales; state property; and earnings on state funds. (Dept Budget & Plan (a)).

The only time the total state budget declined in ***real*** dollars was in fiscal year 2002 (Figure 2). The general fund portion of the total budget, however, decreased by $0.57 billion or 5.1 percent in real dollars from 2001 to 2003. Fiscal year 2004 is still below fiscal year 2001. Trends in costs of state supported services stand in sharp contrast to these general fund budget patterns since many costs increase with, or exceed, the rate of price inflation. The widely publicized budget cuts to an array of state programs and services are tangible evidence of the difficult budget issues that face the Commonwealth when program costs increase faster than state tax revenues.

> *Real dollars* refer to money that has been adjusted for the effects of inflation. In this *Horizons*, all dollar levels are converted to 1997 dollars since that is the first year in the analysis period.

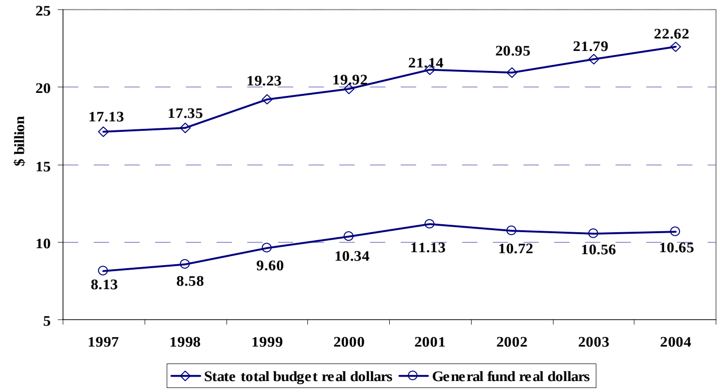

Figure 2. Total state budget and state general fund, real dollars (1997 = 100) fiscal years 1997 - 2004

Personal Income

> *Total personal income* is "the sum of wage and salary disbursements, other labor income, proprietors' income, rental income of persons, personal dividend income, personal interest income, and transfer payments to persons, less personal contributions for social insurance." (BEA).

Total personal income has increased in nominal and real terms across the 1997 to 2003[1] calendar years, but the rate of increase has slowed in recent years (Figure 3). With only modest increases in real dollar incomes in recent years, pre-programmed increases in the costs of state programs started to grow faster than income-related state tax revenues.

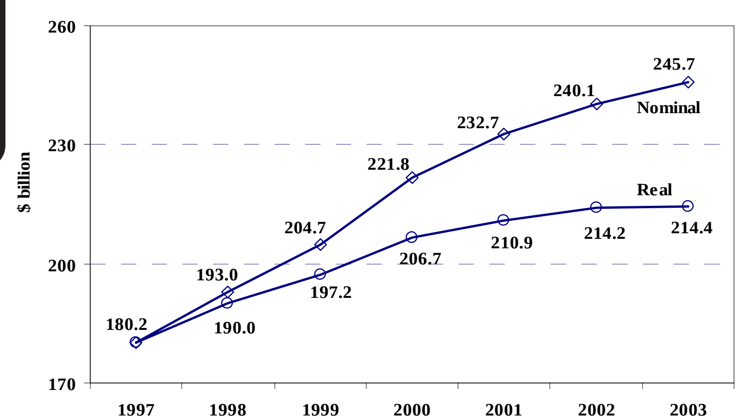

Figure 3. Total personal income, nominal and real (1997 = 100), 1997 - 2003

[1] Data for 2003 are through the second quarter; data for the entire calendar year are not currently available.

Plotting the state general fund in real dollars as in Figure 2, highlights one obvious and important conclusion: *the declines in the general fund in real tax dollars are simply reflecting the modest patterns of growth in personal incomes*. Total personal incomes increased through mid-2003 in real dollars in spite of an economic recession, but the 2003 increase was minimal and taxes paid into the general fund have not kept pace with general fund budget needs.

When the budgets are divided by total personal income, the results document any pressure on the taxpayer. The total state budget, which was 9.5 percent of total personal income in 1997, dipped to 9.1 percent in fiscal year 1998, and then increased to 10.2 percent in 2003 (Figure 4).

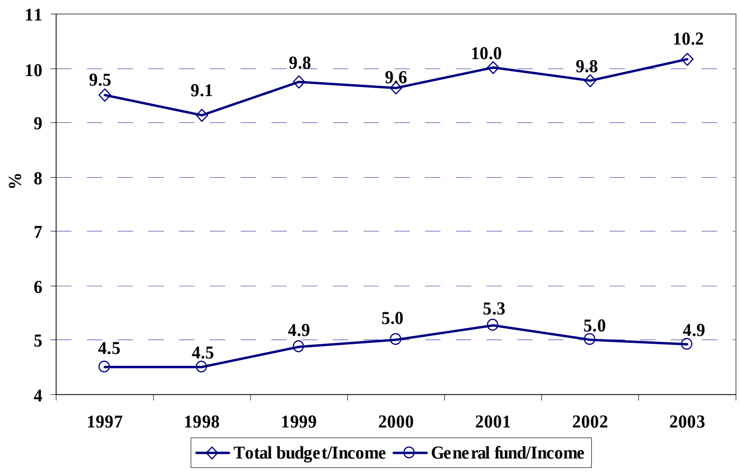

Figure 4. General fund and total budget as a percent of total personal income, 1997 - 2003

Conversely, no clear upward trend is evident in the state general fund as a percent of total personal income. This measure best reflects budget pressures on taxpayers. Declines occurred in 2002 and 2003. Virginia income taxes start with federal adjusted gross income. With changes in federal tax policies that affect federal adjusted gross income and with the weak state economy, state income taxes declined and the real dollar levels going into the state general fund decreased.

Recognizing that the increase in total personal income shown in Figure 3 has come primarily as a result of an increase in population is very important. Per capita incomes in nominal dollars increased across the period, but the increases were small in 2002 and 2003 (Figure 5). In real dollars, per capita income increased slightly from 2000 through 2002, and then decreased in 2003. The typical Virginia family facing increasing health, food, and insurance costs during 2000 to 2003 was feeling cash flow pressures.

A divergence between budget needs and state taxes flowing into the state's general fund means cuts in state programs or increases in taxes or some combination of the two. Cutting

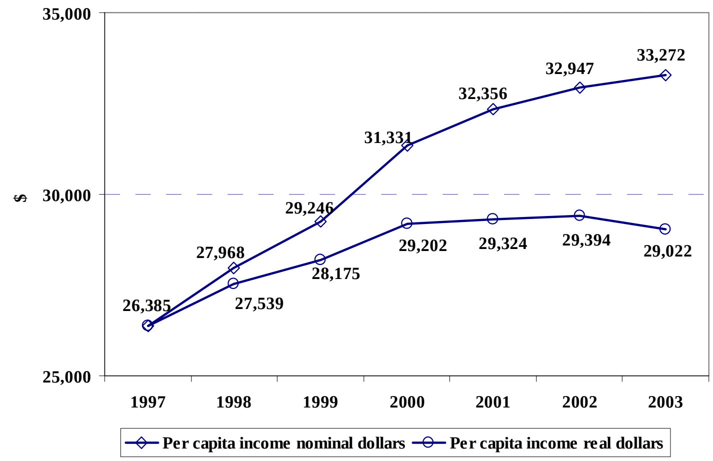

Figure 5. Per capita personal income, nominal and real, 1997 = 100, 1997 - 2003

state programs can decrease the quality of life for Virginians, but raising taxes also influences quality of life. There is a trade-off. The key question is, "Will the typical taxpayer support tax increases to avoid further cuts in state programs?" Virginia ranks 12th in the U. S. in per capita income, above all surrounding states except Pennsylvania, which ranks 6th. And Virginians have some of the lowest total state taxes as a percent of personal incomes in the region and in the U. S. As a percent of income paid in total state taxes, Virginia is consistently lower than all of the six adjoining states except Tennessee (Purcell and Mundy). In 2002, Virginia ranked 41st in the U. S. in the percent of per capita income paid in total per capita state taxes. West Virginia, Kentucky, North Carolina, Pennsylvania, Maryland, and Tennessee ranked 3, 7, 17, 35, 36, and 46 respectively (FTA).

Ongoing Issues

During fiscal years 1997 to 2004, growth in the state budget has come primarily from the 50 to 55 percent of the total budget that is not paid for by the state general fund. Increases in costs of a host of federal programs, like Medicaid and Medicare, cannot be avoided at the state level.

Clearly, tax cuts during the growth years in the economy in the late 1990s are a major factor in the 2004 budget controversy. The 1998 Personal Property Tax Relief Act (car tax repeal) alone is estimated to cost the state as much as $1.4 billion a year when fully implemented, about 5 percent of an annual budget of $28 billion. That tax cut has been a primary reason for the often draconian cuts in state program budgets during the 2002 to 2004 fiscal years. Perhaps because the cuts have been so big and often so visible (as in the closing of DMV offices), the impacts on state programs and services such as education, public safety, transportation, and environmental quality have commanded new and widespread attention. Taxpayers are seeing the need to pay for state programs and services they need and demand. There appears to be increased recognition of the need for long-range planning to bring stability to ongoing investments in our future in the form of roads, education, safety, health care, environmental quality, and other programs that affect everyone's well-being.

Virginia is a low-tax state when state taxes are measured as a percent of incomes, but that fact does not mean the typical taxpayer will support tax increases. If voted on in a statewide referendum, any proposed tax increase is likely to fail. Regional referendums on transportation needs in Northern Virginia and in Tidewater were rejected even though both areas are approaching transportation gridlock. Failure to act on transportation needs threatens the economic future of the entire state.

The referendum results should not be surprising. The ability to examine strategic alternatives, to look into the future, and to evaluate the importance of maintaining investments today that help protect and secure the economic future of the Commonwealth and the quality of life for all its citizens is not easy. The typical taxpayer does not have access to the facts and data needed for such an analysis, and most do not have the analytical skills needed to make sense of information they do have at their disposal. But this type of strategic analysis and planning is not the job of the typical citizen and taxpayer. The elected leaders in the state are the ones who have access to the facts, to research findings, to policy analyses, and to often complex projections of how current patterns, trends, and possible investments might change when making the always difficult but critically important decisions on taxes in a fair and equitable fashion. Public goods like education, public safety, transportation, and a clean environment require a sustained budget commitment over time to avoid program disruptions and a mortgaging of the future well-being of the people of the Commonwealth. For these and many other reasons, everyone in the Commonwealth should be interested in the debate in Richmond in the 2004 General Assembly.

Incomes will not always grow at a rate that matches the increasing costs of state programs, especially in economic recession years. When income growth lags, tax revenues into the state general funds will decrease or grow at a slower rate. *If consistency in the quality and availability of state programs and an ongoing ability to invest in the future of the Commonwealth are important, budgets need to be evened out via policy provisions such as a rainy day fund*. And the temptation to return the benefits of a booming economy to taxpayers via tax cuts must be avoided. When the economy turns down again, the robust flows of revenue into the state coffers will slow and budget deficits appear at the worst possible time—in the middle of an economic recession. Blaming the economic recession for budget deficits after politically expedient cuts in taxes during the growth phase of the business cycle is not an acceptable reason for inaction on budgets. Virginia's working public should not let its elected leadership avoid the tough decisions that easily.

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Virginia Tech's 2004 Farm & Family Showcase Cancelled: Strong Hopes for a 2005 Revived Showcase

Despite consistent growth, which exceeded expectations in its first three years, the *Farm & Family Showcase* at Virginia Tech's Kentland Farm has been cancelled for September 2004. Unexpected weather-related costs, reductions in overall available funding, and rising operational costs have made it necessary to put the event on hold for this calendar year.

The number of visitors in attendance, the variety and number of exhibitors, as well as the ongoing demonstrations and workshops grew with each of the three annual Showcases. Revenues also increased but not sufficiently to counter the unexpected expenses related to last September's rainfall. The upcoming months will be used to evaluate costs and the planning process with an objective to organize an even stronger, more extensive Showcase event for 2005.

The *Farm & Family Showcase* began in 1999 during a planning meeting to bring Virginia farmers and agriculturalists to Tech's largest research facility. As ideas were formed and enthusiasm grew, planners realized that the scope of educational opportunity was as varied as the audiences to be served. The initial *Showcase* of September 2001 attracted 12,000 visitors in two days. The three-day 2003 Showcase served 40,000 visitors from Virginia and the region, with nearly 300 exhibitors from across the country.

The *Farm & Family Showcase* brought together the colleges of Agriculture and Life Sciences, Human Resources and Education, and Natural Resources. The Virginia-Maryland Regional College of Veterinary Medicine, Virginia Cooperative Extension, the Virginia Agricultural Experiment Station, and the Division of Continuing Education also made significant contributions. Featured information targeted the farmer and landowner as well as the homeowner. Most popular were the children's programs. University student organizations served as instructors for the children's programs and were involved in every aspect of the Showcase. State and Federal agencies, sponsors and exhibitors, small-business owners, and industry, and related organizations played a large role in the Showcase.

Pleased with the diversity of visitors, Showcase organizers hope to expand efforts for the ever-increasing numbers of suburban homeowners while continuing to target the traditional commercial agricultural producer. A developing target audience also includes people living on small acreages in rural areas and referred to as "life-style farmers."

Additional information regarding the history and scope of the Showcase can be found at the Showcase website: *www.farmandfamily.vt.edu*

Information on the Kentland Research Farm, its purpose and function within the university can be found at *www.collegefarm.vt.edu*

Individuals and groups interested in participating and/or supporting the 2005 *Farm & Family Showcase* are invited to send comments or questions to

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