BACON'S REBELLION
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Triumph of the Political Class

Despite gushing state revenues from economic growth and tax hikes, the special interests still want more. Don't believe their spin on the budget. Here's the straight story.

By James A. Bacon

Virginia's political class has executed one of the most extraordinary turn-arounds in living memory. Only two years ago, citizens voted decisively against referenda in Northern Virginia and Hampton Roads that would have raised taxes to build a bevy of transportation projects. Defeated by rag-tag bands of ill-funded opponents, the pro-tax coalition of pundits, elected officials and business interests slinked into hiding.

Look at where we are now. Under the guise of "tax reform," Virginia's political class stitched together a Frankenstein of a tax increase expected to raise about $750 million a year. No sooner had the taxes gone into effect than it became evident that a rebounding economy was generating a surplus, which had reached about $248 million by October, the fourth month of the fiscal year. Sniffing the chum, special interests are churning the waters in a feeding frenzy over how to divvy up the surplus. Meanwhile, the developer/road builder axis reportedly has raised $1 million to push for a second round of tax hikes, this one dedicating revenues for road and transit projects.

Never in my 25 years observing the political economy of the Commonwealth have I seen anything like it. Having abandoned whatever philosophical coherence it ever possessed, Virginia's political class is engaged in an unadorned money grab. It is folly to think that capitulating to the latest demands will still the clamor about "unmet needs" or ease the pressure for yet more taxes. Nothing is ever enough for these guys. Raising taxes only ratchets up the cost of state government to a new and higher plateau.

Desperate measures are called for. Unless citizens assert themselves before the next session of the General Assembly, the special interests will engorge themselves at the expense of taxpayers and the long-term economic health of the Commonwealth. Citizens need to push back now, and we need to push back hard.

It was clear to a few observers during the tax debate in early 2004 that the case for a tax increase was a weak one. Faithful readers of *Bacon's Rebellion* may recall the series of columns I published critiquing (and, in my mind, debunking) the arguments of the tax advocates. In light of recent fiscal developments, I hate to say I told you so, but.... I told you so. The evidence now is conclusive.

The justification for taxes had two components: (1) Confronting a "$6 billion budget shortfall" resulting from the recession, the Warner administration had cut everything from state government that could reasonably be expected to cut; and (2) Unfunded needs in education, corrections, transportation and other areas meant that Virginia faced a long-term "structural" deficit that could not be overcome by a cyclical rebound in the economy and state revenues. Only a tax increase, the argument went, would provide the revenue to address these core needs.

Having addressed the myth of the "$6 billion budget shortfall" earlier, I will not rehash the issue at length. (I refer the reader to my previous columns, "What's a 'Budget Shortfall'?" and "Paper Cuts" for the gory details.) I merely invite readers to compare expenditures in the fiscal 2001/2002 biennium with those in the fiscal 2003/2004 biennium.

(in $ millions)			
	Fiscal 2001-2002	Gilmore Proposed Fiscal 2003-2004	Warner Amended Fiscal 2003-2004
Total	**$45,424**	**$49,386**	**$49,227**

(Note: These numbers combine General Fund and non-General Fund expenditures for each biennium.)

As can be seen, in the 2003-2004 biennium, total state spending actually increased by about $3.8 billion, or about 8.3 percent. What's more, the final expenditures for fiscal 2003-2004--as amended by Gov. Warner and the General Assembly--fell short of Gov. Jim Gilmore's proposed expenditures by a meager $160 million.

I'm not belittling the tough decisions that the Warner administration made to get through the financial crisis. The Governor did cut nearly 5,000 employees from the state payroll, or about 4.2 percent of the workforce--although, after cost of living increases, payroll declined only a tad more than one percent. The Governor also did pursue significant reforms in state government IT, procurement, facilities management and transportation project management--although the savings during the years in question were trivial.

My point is that, despite the political theater, state spending continued to surge. Contrary to the line pushed by politicians and pundits, state government never went on a starvation diet. While Gov. Warner was cutting administrative overhead on the one hand, he and the legislature were adding back more than $3 billion in "required" spending--Medicaid, car tax reimbursements, education, prisons--on the other. To pay for these increases in fiscal 2003 and 2004, lawmakers enacted $420 million in new "fees", drew down the Rainy Day Fund by $841 million and resorted to about $1.5 billion through "alternate sources of funding" and "resource adjustments", most of which can be described as one-time revenue sources and accounting gimmicks. That's *before* they raised taxes $750 million a year.

As for their contention that a cyclical recovery in revenues cannot sustain the long-term obligations of state government, the Governor and his allies have been proven wrong. Even while the General Assembly was haggling over how much to increase taxes, Secretary of Finance John Bennett was informing the Governor--and the general public through his website--that Fiscal 2004 revenues were coming in faster than predicted. A number of lonely voices, including this columnist, warned that the Governor's revenue forecasts were too conservative.

As it turned out, fiscal 2004 closed with a budget surplus of approximately $350 million. Fortunately, the Governor and General Assembly put the money to good use, preferring to accelerate contributions to the Rainy Day Fund and otherwise reverse some of their previous accounting legerdemain rather than expand programs or dole out the money in pork barrel.

As the broader U.S. economic recovery gained momentum, the surplus continued to grow. On November 11, Bennett reported numbers to the Governor suggesting that revenues were running about $248 million ahead of estimates after just the *first four months* of fiscal 2005. "Revenues have grown 11.5 percent above the same period last year, well ahead of the annual estimate of 4.5 percent growth," he wrote. (Click here to read the report.) Annualized, state revenues are running roughly $750 million ahead of estimates--coincidentally, very close to the expected gain in new tax revenues. There's no telling yet how the final numbers will shake out--there's good reason to think that the margin of surplus will diminish over the year--but the excess revenues are bound to be significant.

The vast majority of that surplus originates from the "old" tax base--the tax base that existed before the 2004 tax cuts. In other words, most of that surplus would have occurred in the absence of this year's revenue enhancements. <u>The irrefutable conclusion: Virginia's political leadership could have gotten two-thirds of its $750 million per year in extra tax revenues simply by relying upon economic growth!</u> If they'd been patient enough to wait one more year before phasing in all the new spending, they could have financed the entire tax cut.

Warner's fallback position is that, well, revenues are looking better *this* year, but the picture still looks bleak a few years out. As quoted by Michael Shear of *The Washington Post* ("Virginia Could Spend Years in the Red," November 7, 2004), the Governor said on WRVA's "Ask the Governror" that Virginia could face a $252 million shortfall in fiscal 2007 and $31 million in fiscal 2008.

I have two responses. First, Governor, please share your revenue assumptions. What rates of economic growth are you basing that forecast on? You low balled the budget surplus last year. You low balled it again this year--forecasting revenue growth of <u>less than half</u> of what actually transpired. With that kind of track record for short-term projections, the onus is on you to convince the citizenry that you aren't under-estimating revenue growth in the out years.

The second response is this: What about your vaunted re-engineering of state government? Your own cost-cutting commission chaired by Richmond Mayor-elect L. Douglas Wilder estimated that the state eventually could achieve $1 billion a year in savings by reforming the way the state did business. As noted above, your administration has made important progress in executing these reforms. The savings were minimal in the years in which the new systems were being implemented, but they should grow steadily in the out years. Please tell us, Governor, how much savings do you expect to generate on the expenditure side? How much of those savings are included in your long-term budget forecast?

My guess, Governor, is that you haven't included any significant savings from your reforms in your long-term forecast. Any such savings would be "speculative". The "conservative" approach would be to hold off booking such savings until they have been achieved. Please let me know if I'm wrong.

<u>Here's my analysis: Virginia does not face a long-term, structural budget deficit. With the tax increase in place, Virginia faces a chronic structural *surplus* that will last until the next recession.</u>

Here's the irony: Warner could have been an undisputed hero in every corner of the state. Virginia's strong economic growth, which consistently out-performs the national average, combined with his re-engineering of state government, would have been sufficient to meet Virginia's core budgetary needs over the long term. That includes funding the K-12 schools' Standards of Quality. That also includes meeting obligations to the fast-inflating Medicaid program, an expanding prison inmate population, 100,000 new students in K-12 schools and a growth in the state's car tax reimbursements due to the growing number and value of cars.

Throw $750 million a year in tax increases on top of economic growth and re-engineering, however, and it's clear that Virginia will be dealing with chronic budget surpluses--or it *would* be dealing with budget surpluses were it not for the political reality that politicians always find a way to spend the extra money. Now Gov. Warner and his indispensable legislative ally, state Senate Finance Chair John Chichester, R-Fredericksburg, have a new problem: Their Frankenstein monster could turn on them. Every special interest in the state is lining up to claim a piece of the surplus. If the surplus transmutes into more generously funded programs, "structural" spending commitments could well make the Governor's fears of future budget deficits a self-fulfilling prophecy.

Fiscal policy in in the 2005 session of the General Assembly should be guided by three core principles:

- **Give it back.** The state doesn't need the $750 million a year in new taxes. Repeal the 2004 tax hikes--or pass a comparable sum back to taxpayers in the form of other tax cuts.

- **Fund increased state spending out of economic growth and re-engineering of government processes.** Growth in General Fund revenues has averaged a hair more than 6.5 percent annually over the past 22 years, a period covering two full economic cycles. If that rate of growth continues--as it should if we don't botch the business climate with higher taxes--the General Fund should rack up $780 million a year in new revenues just through economic growth. If the state squeezes out an extra $100 million a year each year in savings through through re-engineering the bureaucracy, the Commonwealth should have ample resources to meet its needs over the next decade.

- **Not one dime for transportation without land use reform.** Virginia's transportation system probably does need more money. But without reforming the scattered, low-density pattern of development, which compels Virginians to drive more frequently and drive greater distances, spending more money on roads and transit is pouring money down a rat hole. The changes can't be cosmetic. They must be fundamental, encompassing sweeping changes to zoning regulations, subdivision ordinances, comprehensive plans, transportation funding priorities, the structure of property taxes and, ultimately, the configuration of local government in the state.

Of the three principles, the third undoubtedly will prove the most difficult because land use reform cannot be enacted with the passage of a single piece of legislation. At the same time, it is the most essential. Overhauling Virginia's dysfunctional human settlement patterns is an effort that will take decades of unremitting focus. But the payoff--lower costs of state and local government, reduced traffic congestion, a superior quality of life--make it imperative.

I don't know of a single politician of any prominence who embraces all three of these principles. Perhaps one will emerge from the shadows. Until that time comes, it's up to us, the citizenry, to build the case for cutting taxes and reforming state/local government. The first test of resolve will begin January when the special interests converge on Richmond. We cannot afford to fail, or the Commonwealth may get locked in to higher spending levels forever.

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Read more columns by Jim Bacon at
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