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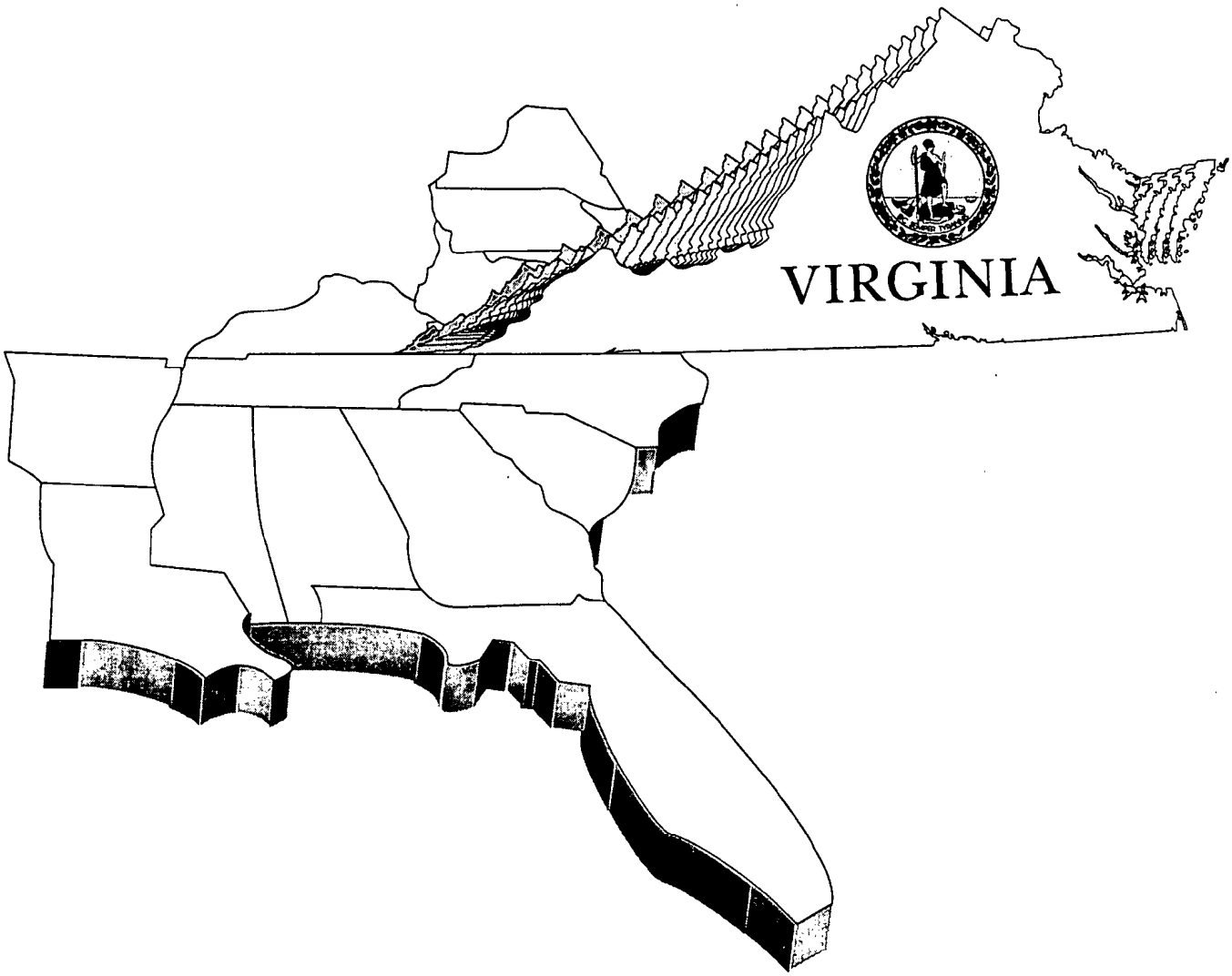
A Tax Reform Agenda for Virginia

by Dean Stansel



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Foreword

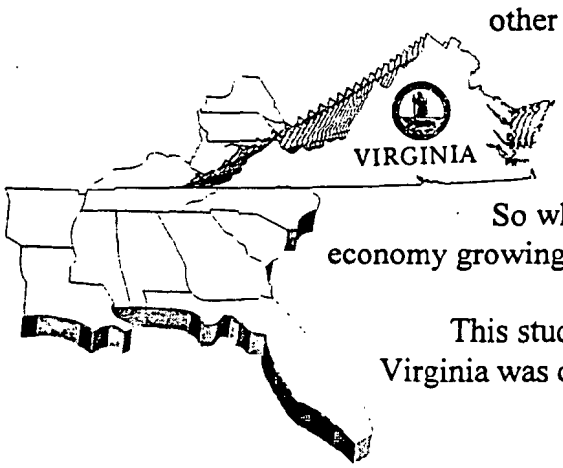
Taxes raise the blood pressure of those who pay them, and usually of those who vote for them as well. That's why tax increases usually occur in non-election years.

This report offers an alternative to raising taxes to meet our state's spending priorities. We know that taxes will be taken from us. But can our state government reduce the individual income tax burden and still perform its legitimate functions? Can our state government accomplish its priorities and lessen the individual income tax rate at the same time?

Virginia should be one of the fastest growing economic "powerhouses" in the country. Just look at what we have to offer.

Virginia is strategically placed halfway between New York and Atlanta. Our climate is temperate: not too cold and not too hot. We have the best deep water port in the world. Our interstate highway system is excellent, although improvements in our road system are needed in our more urban areas. Our universities and colleges, both public and private, are among the top ranked. We have a right-to-work law. Virginia offers great recreational facilities from the mountains to the ocean: skiing, golfing, hunting, fishing, hiking, camping, and all sorts of water sports. Some of the best hospitals in the world are here in Virginia and others are within a one-hour drive of northern Virginia or our southern border.

And we in Virginia enjoy an association those giants who preceded us: George Washington, Thomas Jefferson, Patrick Henry, James Madison, James Monroe, William Henry Harrison, John Tyler, Zachary Taylor, Woodrow Wilson, Chief Justice John Marshall, George Mason, Robert E. Lee and Stonewall Jackson. And with those giants in other states who were originally Virginians: men like Daniel Boone, Sam Houston, and Meriwether Lewis and William Clark. Being a "Virginian" is indeed something special.



So why aren't we doing better? Why isn't our economy growing faster?

This study on Virginia's taxes examines those issues. Virginia was compared to the other 16 states in the U.S.

Commerce Department's southeast and mideast regions, excluding the District of Columbia -- from New York and Pennsylvania down the east coast to Florida.

This report reflects the research and opinions of its author and not necessarily those of the Thomas Jefferson Institute for Public Policy or its Board of Directors. This study is presented to encourage a full and open debate on the subject of taxes here in Virginia and to urge our elected officials to seriously discuss the tax cut issue in a careful and thorough manner. Since the tax cut debate in 1995, there are now two more years of experience in 39 states which have cut taxes and the economic results need to be reviewed and analyzed. This report does that and should initiate an open and fair discussion about future tax cuts in our state.

Virginia has a long-developed reputation as a low-tax, business-friendly state. But like any reputation, it takes time to build, care to maintain, and can be harmed by inattention and pride. The Thomas Jefferson Institute for Public Policy believes that the facts and figures shown in this report require our elected leaders to carefully review our tax burden and make changes if and where appropriate to insure that Virginia's competitive status becomes one of the best in the country.

Some in Virginia feel that the state's "normal" response to the need to place more resources in an area such as education should be to raise taxes. Some feel the "normal" response to the idea of cutting a specific tax should be to raise another tax to "offset the loss to the state or locality".

However, in the past three years 39 states have enacted a net reduction in state taxes at least once. Virginia is one of 11 states which has not. And four of the these eleven states have no personal income tax to begin with. The states whose economies are moving quickly today are, in most cases, those that have recently reduced the tax burden on their citizens.

The January 20, 1997 cover story of *TIME* magazine, "Where The Jobs Are", was fascinating for what wasn't mentioned. Virginia wasn't mentioned. Of the 18 states highlighted in that article only two have not cut taxes within the past three years. And one of these, Nevada, does not have a state income tax.

Clearly, more goes into the decision to move a business to Virginia, or expand an existing business, than tax rates -- transportation, the public school system available to employees, the "quality of life" in the area, cost of utilities, and labor policy. Families that decide to move to Virginia look at a number of variables in making their decision -- schools, location, proximity to work, public safety, all go into the decision-making process. But high taxes can and do force people and businesses to move as we have seen in states like California in the early '90's.

Reviewing our tax structure and our tax policy needs to be done as Virginia strives to remain competitive in the coming years. And although taxes may not be the only factor in determining whether a business moves to, or expands in, Virginia it is an important factor in

that process. So the need to reform our taxes should be carefully looked at as we work to maintain Virginia's "low-tax, business friendly" reputation in the years ahead.

Although Virginia's overall tax burden is low compared to the other states in the southeast and mideast regions, the burden of our individual income tax is very high. In fact, this tax is over 30% higher in Virginia than the national average. And it is the individual income tax that most directly impacts on the spending and investing habits of the working people in our society.

Tax cuts should not be dismissed with a wave of the hand by those "who know better." Tax cuts are working in other states and they should be seriously discussed for improving our economy here in Virginia.

The goal of our elected officials should be to make sure that the next time a leading magazine carries an article about the best places to find jobs, Virginia is obvious by its inclusion in that article rather than by its exclusion.

But some will say, "What about the need to increase education funding? How can we cut taxes and adequately fund public education?"

Although budget management is the focus of another study that will be released this summer by the Thomas Jefferson Institute, let me outline some quick thoughts about funding true education priorities in our state.

The Thomas Jefferson Institute is not prepared to confirm that the $6.3 billion dollars reported by the Virginia Department of Education as needed for public school construction and repairs in grades K-12 is a realistic figure. And the plea by the Virginia Business Higher Education Council for another $200 million this year for our colleges and universities may or may not be needed. But for the purpose of this tax study the Thomas Jefferson Institute is willing to accept these two figures as accurate. So how do we pay for these needs and still cut taxes?

If $6.3 billion is needed for K-12 in our public schools, then here is a proposal that could create the needed funds over the next ten years. If the state of Virginia agreed to match dollar-for-dollar the money localities put up for construction and repair of their schools, the state would spend $3.15 billion over the next ten years, or $315 million a year. The current year's budget is $17.5 billion. That requires a "re-tooling" of the current budget expenditures of only 1.8% to find the needed money. Of course, as annual budgets increase, that percentage becomes smaller. This should not be a difficult decision for our legislature and our governor if these needs in our public schools are indeed top priority. A 1.8% readjustment of the budget to fund this "great need" is not too much to expect from the legislature. Tax increases are not required.

What about the $200 million needed in higher education? There was a budget surplus this year of nearly $300 million and the legislature decided to fund other "needs" as

well as putting additional money into higher education, the state health insurance fund and the new state employee payment system. But if higher education is really important, and if the need that has been stated for $200 million is real, then the legislature could have paid for this increase out of the surplus and still covered the other two "crises" mentioned above. Priorities are the issue, not money. Tax increases are not required.

Another potential category to find additional funds would be to carefully review the staffing situation in our state. According to the most recent available figures from the U.S. Census Bureau, Virginia has the second highest ratio of government employees to people of the eleven states that have total populations of between 5 and 8 million people. These eleven states were selected because the most fair comparison to make is of states with similar populations. Of the four states closest to us in population (North Carolina, Georgia, Massachusetts and Indiana), all have lower ratios of state employees to total population than does Virginia. Since the average Virginia state employee is paid $31,500 in salary and benefits, Virginia can save between $325 million and $842 million each year simply by bringing this ratio into line with other states which have similar populations as ours. This area of personnel management needs to be carefully reviewed and analyzed. Once again, in looks as if tax increases are not required to fund the education "needs" outlined earlier.

And one other area where additional monies are available to the state is uncollected taxes, fines and payments to the Virginia state hospitals and the Department of Mental Health, etc. Over $600 million of uncollected funds fall into these categories annually. If these funds could be collected, or if a large percentage could be collected, this would significantly help pay for any tax cuts proposed in this study.

Tax cuts that improve the economy are good for everyone -- for the taxpayer, for the business environment, for the employers and the employees, for our children and for the state. A growing economy leads to growing state revenue without increasing the tax burden on the citizens.

This study is offered as the first of many by the Thomas Jefferson Institute for Public Policy. It offers possible solutions to a serious problem faced by our commonwealth: how do we improve our economy for the long term?

We ask for public comment and we look forward to seeing a mature debate take place on this issue by our elected leaders and other opinion leaders in our commonwealth.

Michael W. Thompson
Chairman and President
Thomas Jefferson Institute for Public Policy
February 1997

A Tax Reform Agenda for Virginia

by Dean Stansel

Executive Summary

Tax cuts continue to take center stage in many state capitals across America. For the third straight year, tax actions in the fifty states will result in a net decrease in overall state revenues. Twenty-seven states cut taxes in the 1996 legislative session, with the largest reductions coming in the personal income tax. In 1995, twenty-eight states cut taxes. In fact, there are only eleven states that have failed to enact a net state tax cut in at least one of the past three years. Virginia is one of those states.

Virginia has long held a reputation as a low-tax, business-friendly state. However, in an era when many states are aggressively reducing their income tax burdens, Virginia is not. By standing still, Virginia risks falling behind.

In fact, the most recent evidence indicates that economic growth in Virginia has been less than robust. According to data from the U.S. Department of Commerce and Department of Labor, over the most recent 12 months:

- Population growth in Virginia was 0.9%, right at the U.S. average.
- Real personal income growth in Virginia was 2.1%. That was 22% below the U.S. average and ranks Virginia 31st among the 50 states.
- Employment in Virginia has actually declined by 0.7%, ranking Virginia 49th. Only four other states saw a decline in employment over the last 12 months.

This study examines an abundance of evidence on taxes and spending in Virginia and in the 16 other states within the Southeast and Mideast regions. The major findings include:

- Since 1982, per capita state and local revenue in Virginia has increased by 42.7% in real terms (after adjusting for inflation), nearly one-third faster than the U.S. average.
- From 1982-96, state revenues in Virginia have increased by 78.5% in real terms. Real personal income has only increased by 53.3%, and population by only 21.5%.
- Virginia's per capita personal income tax burden is 36% above the U.S. average and the 5th highest in the 17-state region.
- Since 1993 that per capita income tax burden has risen 11.7% in real terms, more than three times faster than the U.S. average and by far the highest growth rate in the region.
- Since 1982, per capita state and local spending for interest on general debt has increased by 90.1%, the fourth fastest growth in the region, and more than one-third faster than the U.S. average.
- The number of state government employees per 10,000 residents in Virginia is 16% above the U.S. average.

In recent years many states have been able to reduce their personal income taxes without throwing their budgets out of balance by simply slowing the growth of--not reducing the level of--state spending. And they have subsequently seen their economies

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Dean Stansel is a fiscal policy analyst at the Cato Institute in Washington, D.C.

improve. As the competition for businesses and jobs becomes more intense, those states' experiences provide lessons that Virginia should not ignore. With a less than robust economy, an above average personal income tax burden, and a substantial budget surplus, the time is right for Virginians to get the tax relief they deserve. This study recommends a 20% cut in Virginia's personal income tax rates. By merely slowing the growth of spending to the rate of inflation plus population growth, that 20% tax cut could take effect today without throwing the budget out of balance. In fact, it would produce a budget surplus in the years ahead.

A Tax Reform Agenda for Virginia

Introduction

Tax cuts continue to take center stage in many state capitals across America. For the third straight year, tax changes in the fifty states will result in a net decrease in overall state revenues in FY 1997.[1] Twenty-seven states cut taxes in the 1996 legislative session, with the largest reductions coming in the personal income tax. In 1995, twenty-eight states cut taxes. In fact, there are only eleven states that have failed to enact a net state tax cut in at least one of the past three years. Virginia is one of them. Table 1 shows that recent economic growth in nearly all of those eleven states has been below the national average.

While Virginia has long been known as a low-tax, business-friendly state, that reputation could change if it continues to ignore the nationwide trend toward reducing the burden of government. With other states moving aggressively to cut taxes, Virginia could begin to fall behind in the competition for businesses and residents. In fact, there are already signs that this may be happening. The most recent state economic data shows that over the last year Virginia ranks only 31st in income growth and 49th in employment growth.[2]

Using data from the U.S. Census Bureau, the most reliable source of state-by-state government finance data, this study documents the above average growth of government revenues in Virginia and it reveals the categories in which that growth has occurred.[3] It also examines the level of Virginia's tax burden and finds that of all taxes in Virginia, the state income tax is the one most out of line with the rest of the nation. The per capita personal income tax burden is 36 percent above the U.S. average. In contrast, Virginia's per capita property tax burden (local real estate plus personal property tax)--which some have suggested should be reduced in exchange for an increase in other taxes--is 10 percent below the national average. Virginia's above average revenue growth and income tax burden should both be reduced.

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[1]National Governors' Association and National Association of State Budget Officers, Fiscal Survey of the States, various editions, and National Conference of State Legislatures, State Tax Actions, various editions.

[2]As of early February 1997, the most recent state personal income data was for the third quarter of 1996 (from the U.S. Department of Commerce, Bureau of Economic Analysis), and the most recent employment data was for December 1996 (from the U.S. Department of Labor, Bureau of Labor Statistics).

[3]The Census Bureau's annual reports on government finances are superior to other sources because they account for every type of outlay and all sources of revenue. Other reports provide data only for state general funds, for instance, which makes state-by-state comparisons problematic because states vary widely on how much of their budget is in the general fund and how much is in other, non-general funds. Unfortunately, the Census Bureau's reports are always several years behind. The bulk of the data in this report comes from three Census Bureau annual publications: Government Finances, which provides state-by-state data for the combined state and local level of government spending and revenue, State Government Finances, which provides state-by-state data for the level of state government spending and revenue, and State Tax Collections, which provides state-by-state data for the level of state government tax revenues only (i.e. excluding non-tax sources of revenue such as user fees, interest, tuition, etc.). As of early February 1997, the most recent fiscal year issue available for those reports was 1993, 1994, and 1995 respectively.

Table 1
Economic Growth in No-Tax-Cut States, 1994-96**

	Personal Income Growth 1994-1996III	Rank		Employment Growth 1994-Dec. 96	Rank
Nevada*	21.1%	1	Alabama	6.7%	9
Alabama	12.8%	21	Nevada*	12.2%	2
South Dakota*	12.7%	22	Tennessee*	4.5%	23
Tennessee*	12.7%	23	Vermont	4.3%	25
U.S. Median	**12.5%**		**U.S. Median**	**4.2%**	
Vermont	12.4%	26	South Dakota*	4.1%	27
Rhode Island	12.0%	30	North Dakota	4.0%	28
Virginia	**11.5%**	**35**	Hawaii	2.8%	36
North Dakota	10.2%	45	Alaska*	2.7%	38
Wyoming*	8.1%	48	**Virginia**	**2.7%**	**39**
Hawaii	5.4%	49	Wyoming*	2.5%	40
Alaska*	5.4%	50	Rhode Island	1.1%	49

*No state personal income tax.
**Refers to the eleven states that did not enact a net tax cut in at least one of the past three years (1994, 1995, and 1996). (According to National Association of State Budget Officers, Fiscal Survey of the States, November 1994, October 1995, and November 1996 editions.)

In looking toward the future, Virginia should follow the lead of states such as Arizona, Massachusetts, Michigan, and New Jersey which have cut income taxes, reduced the growth of spending and subsequently seen their economies expand. Based on the experiences in states such as those, this report recommends a variety of time-tested tax and budget reforms. By taking steps now to reduce the income tax burden and hold spending growth in check, Richmond can help to assure that Virginia maintains its reputation as a low-tax, business-friendly state, and can help keep the state economy on the path to prosperity.

Virginia's Tax Burden

In our increasingly mobile society, it is easier than ever before for businesses and residents to relocate. As a result, the relative burden of state taxes is more important than ever to state economic development. Table 2 shows how Virginia's state tax burden compares to those of its neighboring states.[4] Clearly, the overall state tax burden in Virginia is still below average.[5]

- In 1995, state taxes in Virginia consumed $58.44 of every $1,000 of personal income. This is 16% below the U.S. average and the 2nd lowest in the region.
- On a per capita basis, Virginia's state tax burden was $1,327, which was 13% below the U.S. average and 7th lowest in the region.

Table 3 shows a similar picture, when local taxes are taken into consideration.

- In 1993[6], state and local taxes in Virginia consumed $98.58 of every $1,000 of personal income. This is 13% below the U.S. average and the 3rd lowest in the region.
- On a per capita basis, Virginia's state and local tax burden was $2,073, 10% below the U.S. average but 6th highest in the region.

In addition to the overall level of the tax burden, the composition of that burden can be an important influence on the economic growth rate of states. Not all taxes have the same impact on economic growth. Personal income taxes are considered to be the most harmful to the economy. And, multi-rate progressive income tax systems (like Virginia's) as opposed to single-rate flat income taxes (like those in states including Massachusetts, Michigan, and Pennsylvania) are particularly harmful.

The reason for this can be best explained with the example of an individual deciding whether or not to work overtime or invest in a new business venture. In states like Florida and Texas, where there is no state income tax, individuals know that they will be able to keep a dollar's worth of income for every dollar's worth of work or investment earnings (ignoring, for simplicity's sake, the federal income tax). In states with flat income taxes individuals know that the state will take a fixed percentage, say 5 percent, of every

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[4]Throughout this report, "region" and "neighboring states" will be used to refer to the 17 states in the Southeast and Mideast regions, as defined by the U.S. Department of Commerce, Bureau of Economic Analysis.

[5]The 1995 state tax figures in this section come from U.S. Census Bureau, State Tax Collections. The fiscal year 1995 edition was the most recent available as of early February 1997.

[6]The 1993 state and local tax figures in this section come from U.S. Census Bureau, Government Finances. The fiscal year 1993 edition was the most recent available as of early February 1997.

Table 2
1995 State Tax Burdens

	State Taxes Per $1,000 Personal Income 1995	Rank*		Per Capita State Taxes 1995	Rank*
Kentucky	$91.59	1	Delaware	$2,215	1
Delaware	$90.38	2	New York	$1,891	2
West Virginia	$88.68	3	New Jersey	$1,713	3
Mississippi	$84.77	4	Kentucky	$1,628	4
North Carolina	$81.02	5	Maryland	$1,599	5
Arkansas	$80.48	6	North Carolina	$1,588	6
South Carolina	$72.46	7	**U.S. Average**	**$1,519**	
New York	$71.95	8	Pennsylvania	$1,513	7
U.S. Average	**$69.54**		West Virginia	$1,494	8
Pennsylvania	$67.73	9	Arkansas	$1,366	9
Alabama	$65.93	10	Mississippi	$1,334	10
Georgia	$65.24	11	**Virginia**	**$1,327**	**11**
Maryland	$63.65	12	Georgia	$1,317	12
Florida	$61.11	13	Florida	$1,312	13
New Jersey	$60.62	14	South Carolina	$1,297	14
Louisiana	$59.92	15	Alabama	$1,194	15
Virginia	**$58.44**	**16**	Tennessee	$1,124	16
Tennessee	$57.14	17	Louisiana	$1,077	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.
Source: Cato Institute, based on U.S. Census Bureau, State Tax Collections. (Note: Fiscal year 1995 edition was the most recent available as of early February 1997.)

Table 3
1993 State and Local Tax Burdens

	State & Local Taxes Per $1,000 Personal Income 1993	Rank*		Per Capita State & Local Taxes 1993	Rank*
New York	$147.40	1	New York	$3,655	1
New Jersey	$114.46	2	New Jersey	$3,051	2
U.S. Average	**$112.95**		Maryland	$2,566	3
West Virginia	$112.23	3	Delaware	$2,336	4
Maryland	$109.89	4	**U.S. Average**	**$2,300**	
North Carolina	$109.86	5	Pennsylvania	$2,260	5
Kentucky	$109.73	6	**Virginia**	**$2,073**	**6**
Mississippi	$109.31	7	Florida	$2,041	7
Pennsylvania	$108.06	8	Georgia	$1,998	8
Georgia	$107.82	9	North Carolina	$1,975	9
South Carolina	$106.39	10	Kentucky	$1,817	10
Florida	$103.84	11	West Virginia	$1,752	11
Louisiana	$103.18	12	South Carolina	$1,736	12
Arkansas	$101.58	13	Tennessee	$1,706	13
Delaware	$101.32	14	Louisiana	$1,685	14
Virginia	**$98.58**	**15**	Arkansas	$1,590	15
Tennessee	$94.94	16	Alabama	$1,553	16
Alabama	$93.04	17	Mississippi	$1,535	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: Fiscal year 1993 edition was the most recent available as of early February 1997.)

additional dollar they earn, so they will get only 95 cents worth of income for every dollar's worth of work or investment earnings. Finally, in states with progressive income taxes individuals will see the state take an increasing percentage of their additional earnings. So as they move into higher and higher brackets, they will get to keep a smaller and smaller share of every additional dollar they earn. Thus, personal income taxes lower individuals' incentives to work, save, and invest because they reduce the return that individuals will get from such activities. That effect is stronger with multi-rate progressive income taxes than with single-rate flat income taxes.

Corporate income taxes and other taxes on businesses have a similar but less pronounced negative impact on economic activity. While all taxes are harmful to economic growth, property taxes do not have as much of a negative impact on economic activity as income and business taxes. The impact of the various forms of consumption taxes is even weaker.

Table 4 shows how the burden of specific state taxes in Virginia compares with the U.S. average. Table 5 compares the combined state and local burden of specific taxes in Virginia with the U.S. average.

While Virginia's overall tax burden is below average, the personal income tax is well above the U.S. average. This is particularly troublesome because, as described above, the income tax is the form of taxation that is most harmful to economic growth. Table 5 also shows that Virginia's local property tax burden (real estate plus personal property tax) is below the U.S. average. This is noteworthy since some suggest sharp reductions in the personal property tax in exchange for an increase in other taxes.

Table 6 shows how Virginia's personal income tax burden compares with those of its 16 regional neighbors.

- In 1995 Virginia's personal income tax consumed $28.71 of every $1,000 of personal income. That is 31% higher than the U.S. average, and is the 4th highest in the region.[7]
- On a per capita basis, Virginia's personal income tax burden was $652 (or $2,608 for a family of four), 36% above the U.S. average and 5th highest in the region.

Table 7 shows how Virginia's property tax burden compares with those of its 16 regional neighbors.

- In 1993 Virginia's property taxes consumed $31.21 of every $1,000 of personal income. That is 13% below the U.S. average, but is the 5th highest in the region.
- On a per capita basis, Virginia's local property tax burden was $656 (or $2,624 for a family of four), 10% below the U.S. average but also 5th highest in the region.

Virginia should be commended for having an overall tax burden that is below the national average. However, as Figure 1 shows, Virginia's per capita personal income tax burden is substantially above the U.S. average. The state's heavy personal income tax burden should be a top concern as Virginia prepares for the challenges of the 21st century.

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[7]It should be noted that since several states in the region have local income taxes, Virginia's regional rank is not as high when state and local income taxes are combined. However, since the state/local figures are only available through FY1993, the more recent state tax figures were used in Table 6.

Table 4
1995 State Tax Burden in Virginia

	Virginia				U.S. Average	
	State Taxes Per $1,000 Personal Income 1995	Percent of U.S. Average	Per Capita State Taxes 1995	Percent of U.S. Average	State Taxes Per $1,000 Personal Income 1995	Per Capita State Taxes 1995
Total Taxes	$58.44	84%	$1,327	87%	$69.54	$1,519
Personal IncomeTax	$28.71	131%	$652	136%	$21.88	$478
General Sales Tax	$12.78	55%	$290	58%	$23.04	$503
Selective Sales Taxes (other than motor fuel sales tax)	$5.62	82%	$128	86%	$6.82	$149
Motor Fuel Sales Tax	$4.52	102%	$103	106%	$4.43	$97
License Taxes	$2.86	63%	$65	65%	$4.55	$99
Corporate Income Tax	$2.45	48%	$56	50%	$5.07	$111

Source: Cato Institute, based on U.S. Census Bureau, State Tax Collections. (Note: Fiscal year 1995 edition was the most recent available as of early February 1997.)

Table 5
1993 State and Local Tax Burden in Virginia

	Virginia				U.S. Average	
	State & Local Taxes Per $1,000 Personal Income 1993	Percent of U.S. Average	Per Capita State & Local Taxes 1993	Percent of U.S. Average	State & Local Taxes Per $1,000 Personal Income 1993	Per Capita State & Local Taxes 1993
Total Taxes	$98.58	87%	$2,073	90%	$112.95	$2,300
Property Tax	$31.21	87%	$656	90%	$35.92	$731
Personal IncomeTax	$26.32	112%	$554	116%	$23.48	$478
General Sales Tax	$16.08	61%	$338	63%	$26.44	$538
Selective Sales Taxes (other than motor fuel sales tax)	$9.08	102%	$191	106%	$8.86	$180
Motor Fuel Sales Tax	$4.78	104%	$101	107%	$4.62	$94
Corporate Income Tax	$2.68	53%	$56	55%	$5.03	$102

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: Fiscal year 1993 edition was the most recent available as of early February 1997.)

Table 6
1995 State Personal Income Tax Burdens

	State Personal Income Taxes Per $1,000 Personal Income 1995	Rank*		Per Capita State Personal Income Taxes 1995	Rank*
New York	$36.90	1	New York	$970	1
North Carolina	$33.32	2	Delaware	$784	2
Delaware	$31.99	3	Maryland	$674	3
Virginia	**$28.71**	**4**	North Carolina	$653	4
Kentucky	$28.63	5	**Virginia**	**$652**	**5**
Maryland	$26.85	6	New Jersey	$571	6
Georgia	$26.42	7	Georgia	$533	7
South Carolina	$25.19	8	Kentucky	$509	8
Arkansas	$24.85	9	**U.S. Average**	**$478**	
West Virginia	$23.04	10	South Carolina	$451	9
U.S. Average	**$21.88**		Arkansas	$422	10
New Jersey	$20.23	11	Pennsylvania	$408	11
Alabama	$19.25	12	West Virginia	$388	12
Pennsylvania	$18.28	13	Alabama	$349	13
Mississippi	$16.09	14	Mississippi	$253	14
Louisiana	$13.60	15	Louisiana	$244	15
Tennessee**	$0.98	16	Tennessee**	$19	16
Florida	No Tax	N/A	Florida	No Tax	N/A

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

**While Tennessee does not have a broad-based personal income tax, it does impose a tax on certain interest and dividend income.

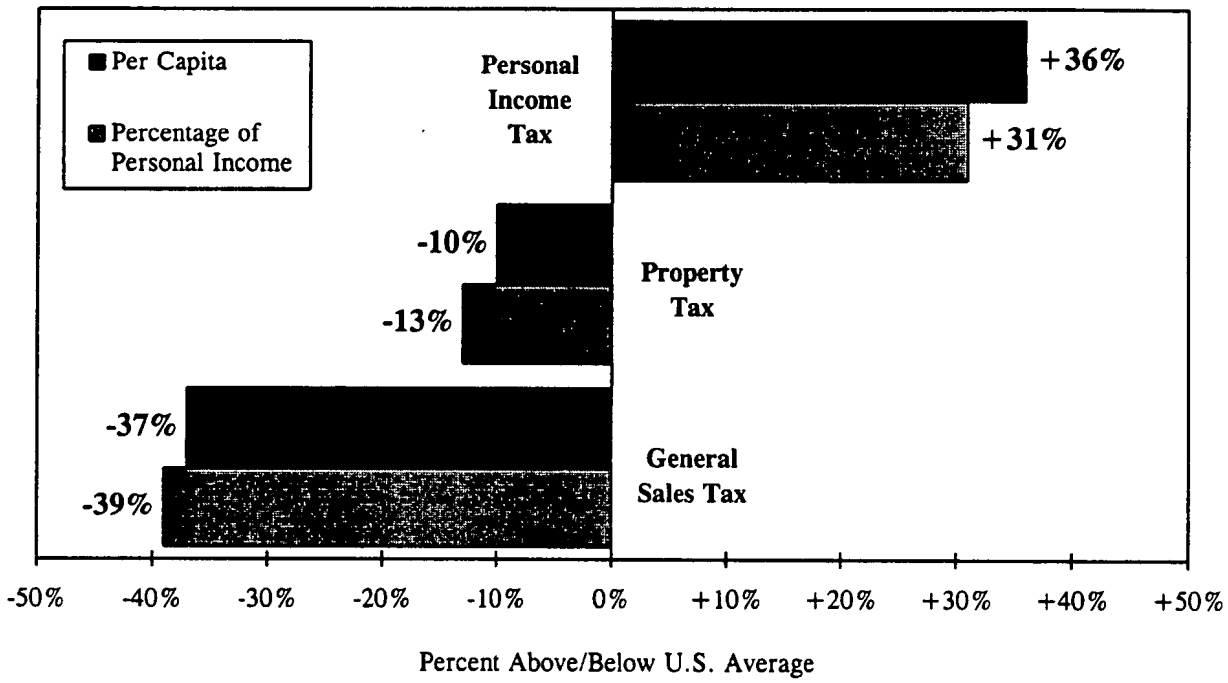
Source: Cato Institute, based on U.S. Census Bureau, State Tax Collections. (Note: Fiscal year 1995 edition was the most recent available as of early February 1997.)

Table 7
1993 State and Local Property Tax Burdens

	State & Local Property Taxes Per $1,000 Personal Income 1993	Rank*		Per Capita State & Local Property Taxes 1993	Rank*
New Jersey	$51.39	1	New Jersey	$1,370	1
New York	$48.04	2	New York	$1,191	2
Florida	$37.60	3	Florida	$739	3
U.S. Average	**$35.92**		**U.S. Average**	**$731**	
Georgia	$31.64	4	Maryland	$728	4
Virginia	**$31.21**	**5**	**Virginia**	**$656**	**5**
Maryland	$31.16	6	Pennsylvania	$638	6
South Carolina	$31.06	7	Georgia	$586	7
Pennsylvania	$30.49	8	South Carolina	$507	8
Mississippi	$27.68	9	North Carolina	$424	9
North Carolina	$23.60	10	Mississippi	$389	10
West Virginia	$20.65	11	Tennessee	$371	11
Tennessee	$20.64	12	Delaware	$347	12
Kentucky	$18.48	13	West Virginia	$322	13
Louisiana	$16.79	14	Kentucky	$306	14
Arkansas	$16.64	15	Louisiana	$274	15
Delaware	$15.05	16	Arkansas	$260	16
Alabama	$10.99	17	Alabama	$183	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.
Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: Fiscal year 1993 edition was the most recent available as of early February 1997.)

Figure 1
How Virginia's Tax Burdens Compare to the U.S. Average



Personal Property Tax

Some are suggesting that the unpopular annual tax on personal property (automobiles, boats, computers, and other possessions) should be repealed and replaced with an increase in the state sales tax. Recent surveys indicate public support for such a reform. Proponents of this change say that because citizens must pay the personal property tax in one lump sum every year, it is too burdensome. They argue that replacing it with an increase in the sales tax, whose burden is spread over the course of the year, would be easier for taxpayers. That is precisely the reason why this is a bad idea. Making the tax burden less visible is a recipe for even higher taxes.

The federal income tax was increased substantially--the top rate was raised to 94 percent--during World War II as a temporary, emergency measure to fund the war effort. To make that increase more palatable, in 1943 the government began withholding money from every employee's paycheck throughout the year. This was also presented as a temporary measure.[8] That federal income tax withholding system is still with us today, and it has been adopted at the state level as well. The federal income tax burden rose quickly from only 0.9 percent of Gross Domestic Product (GDP) in 1940 to 5.9 percent by 1950. Today it stands at 8.5 percent of GDP.[9] It seems unlikely that the tax burden would have expanded so dramatically if Americans had continued to pay their federal and state income tax bills in one lump sum every year.

Making the tax burden less visible has allowed our elected officials to expand government into many areas not originally contemplated. Keeping, in some form, a highly visible, locally-collected personal property tax provides Virginians with an annual reminder of just how much their government costs them. This method of paying taxes serves as a "check" on government and should continue. However, one thing that could be done is to take steps to reduce the burden of this tax on small business. Perhaps, the first $30,000 of business equipment (i.e., computers, electronics, manufacturing equipment, etc., not company cars) could be exempted from the tax. Since most of the state's with which Virginia competes for jobs and residents do not levy a similar tax[10], this could help make Virginia more competitive.

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[8] For a more detailed discussion of the withholding tax, see Charlotte Twight, "Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change," Cato Journal, Vol. 14, No. 3, 1/1/95, pp. 359-96, and Robert Higgs, Crisis and Leviathan: Critical Episodes in the Growth of American Government (New York: Oxford University Press, 1987).

[9] U.S. Office of Management and Budget, Historical Tables, Budget of the U.S. Government, Fiscal Year 1997, pp. 31-32.

[10] Small Business Survival Committee, Washington, D.C.

Revenue Growth in Virginia

Although Virginia's overall tax burden on its citizens is still below average, that burden has been growing faster than the national average. More importantly, as Figure 2 shows, revenue growth in Virginia has outpaced the growth of both population and personal income. That means, taxes have been increasing faster than Virginians' ability to pay them. Furthermore, while other states have been aggressively cutting taxes in recent years, Virginia has not moved in that direction. This combination has allowed other states to gain ground in relation to our state. If this trend continues, Virginia's reputation as a low-tax, business-friendly state may be in jeopardy.

Table 8 shows how the real growth (after adjusting for inflation) of state and local revenues in Virginia compares to the growth in its neighboring states.[11]

- From 1982-93, state and local general revenue as a share of personal income increased by 6.7% in Virginia. That was 60% faster than the U.S. average, and ranked as 7th highest in the region.
- On a per capita basis, real state and local general revenue went up by 42.7%, also 7th fastest in the region, and 27% above the national average.

The specific sources of that revenue growth are shown on Tables 9 and 10.

- The state income tax has been the fastest growing state-level tax, increasing by 89% from 1982-95 in real terms. That outpaced the U.S. average by 15 percentage points.
- State sales tax revenue growth has also outpaced the U.S. average by 15 percentage points, going up by 81% from 1982-95, after adjusting for inflation.
- While Virginia's property tax burden is below the U.S. average, it's real growth has outpaced the U.S. average by 23 percentage points, rising by 77% from 1982-93.

The above average increase in Virginia's personal income tax is of particular concern because of the harmful effect that tax has on economic growth. Furthermore, in recent years many of the states with which Virginia competes have been taking steps to reduce their personal income tax burdens. As a result, Virginia's recent personal income tax growth compares unfavorably with that of the other states in the region. (See Table 11. Figure 3 graphs the real increase in the per capita personal income tax burden from '93 to '95.)

- In the past two years alone, personal income taxes in Virginia as a share of personal income have gone up 9.1 percent, four and a half times faster than the national average. That growth was the fastest in the region.
- On a per capita basis, Virginia also leads the region in the growth of its personal income tax burden with a real increase of 11.7 percent, more than three times the U.S. average.

Virginia's above average revenue growth should be a cause for concern. However, the state's heavy personal income tax burden and its rapid recent growth should be particularly troublesome.

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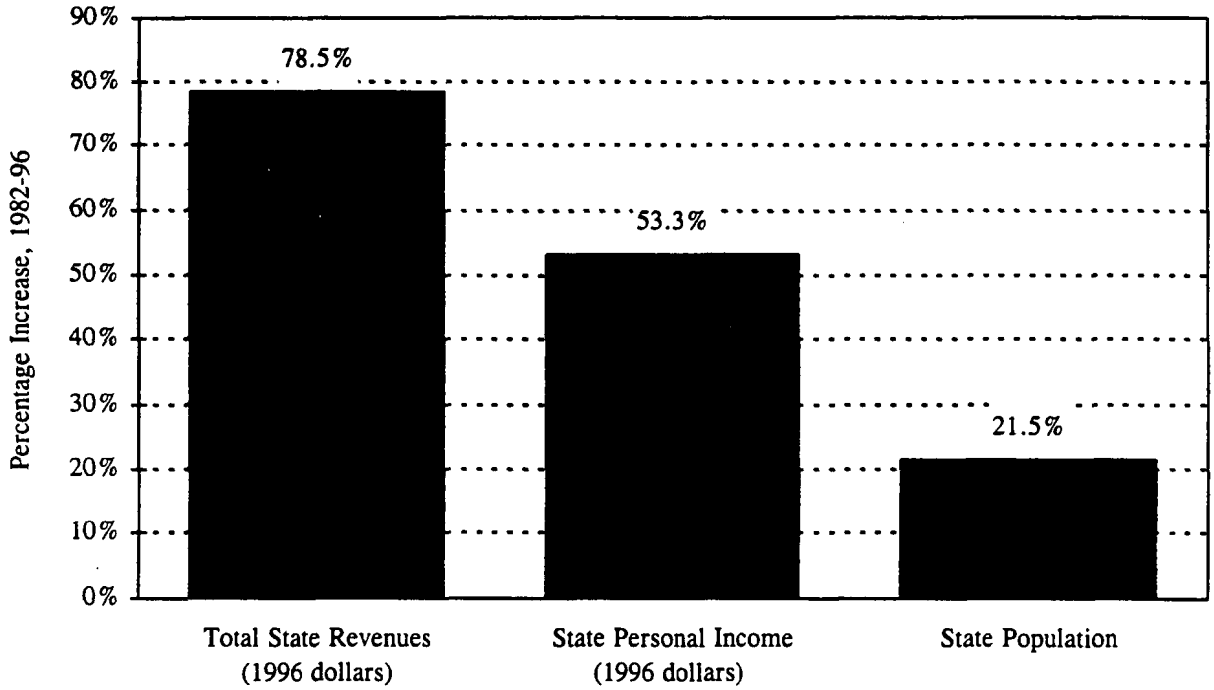
[11]The state and local revenue and tax figures in this section come from U.S. Census Bureau, Government Finances. The fiscal year 1993 edition was the most recent available as of early February 1997.

Figure 2
State Revenues Grew Faster Than Incomes and Population, 1982-96



Sources: Commonwealth of Virginia, Department of Accounts; U.S. Department of Commerce, Bureau of Economic Analysis and Census Bureau.

Table 8
1982-93 Growth of State and Local General Revenue

	State and Local General Revenue per $1,000 State Personal Income Real Increase 1982-93	Rank*		Per Capita State and Local General Revenue Real Increase 1982-93	Rank*
Florida	21.9%	1	New Jersey	55.6%	1
Kentucky	15.4%	2	Kentucky	51.4%	2
North Carolina	9.9%	3	North Carolina	50.8%	3
South Carolina	9.8%	4	Florida	50.6%	4
Arkansas	9.3%	5	Tennessee	48.2%	5
Mississippi	7.6%	6	South Carolina	46.9%	6
Virginia	**6.7%**	**7**	**Virginia**	**42.7%**	**7**
New Jersey	6.6%	8	Pennsylvania	42.1%	8
Pennsylvania	5.5%	9	New York	42.1%	9
Tennessee	4.7%	10	Arkansas	41.5%	10
U.S. Average	**4.2%**		Georgia	40.1%	11
West Virginia	3.8%	11	Alabama	39.9%	12
Alabama	3.7%	12	Delaware	39.1%	13
Georgia	3.1%	13	Mississippi	35.7%	14
Delaware	0.9%	14	**U.S. Average**	**33.5%**	
New York	-1.4%	15	West Virginia	29.1%	15
Louisiana	-1.9%	16	Maryland	28.2%	16
Maryland	-4.6%	17	Louisiana	9.7%	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

Table 9
1982-93 Growth of State & Local Taxes in Virginia

	Thousands of 1993 dollars				
	1993	1982	Real Increase 1982-93	Real Increase in U.S. Average 1982-93	Virginia's 1982-93 Increase Compared to U.S. Average (% pts.)
Total Taxes	$13,425,365	$8,248,921	63%	49%	+14
Property Tax	$4,250,076	$2,404,647	77%	53%	+24
Individual Income Tax	$3,584,765	$2,165,154	66%	62%	+4
General Sales Tax	$2,190,138	$1,349,717	62%	53%	+9
Selective Sales Taxes (other than motor fuel sales tax)	$1,237,144	$873,022	42%	39%	+3
Motor Fuel Sales Tax	$651,148	$488,859	33%	53%	-20

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

Table 10
1982-95 Growth of State Taxes in Virginia

	Thousands of 1995 dollars				
	1995	1982	Real Increase 1982-95	Real Increase in U.S. Average 1982-95	Virginia's 1982-95 Increase Compared to U.S. Average (% pts.)
Total Taxes	$8,783,939	$5,111,894	72%	55%	+17
Individual Income Tax	$4,315,545	$2,284,656	89%	74%	+15
General Sales Tax	$1,920,623	$1,059,261	81%	66%	+15
Selective Sales Taxes (other than motor fuel sales tax)	$845,417	$569,916	48%	38%	+10
Motor Fuel Sales Tax	$679,151	$514,035	32%	54%	-22
Corporate Income Tax	$367,832	$279,566	32%	31%	+1
License Taxes	$429,699	$260,288	65%	64%	+1

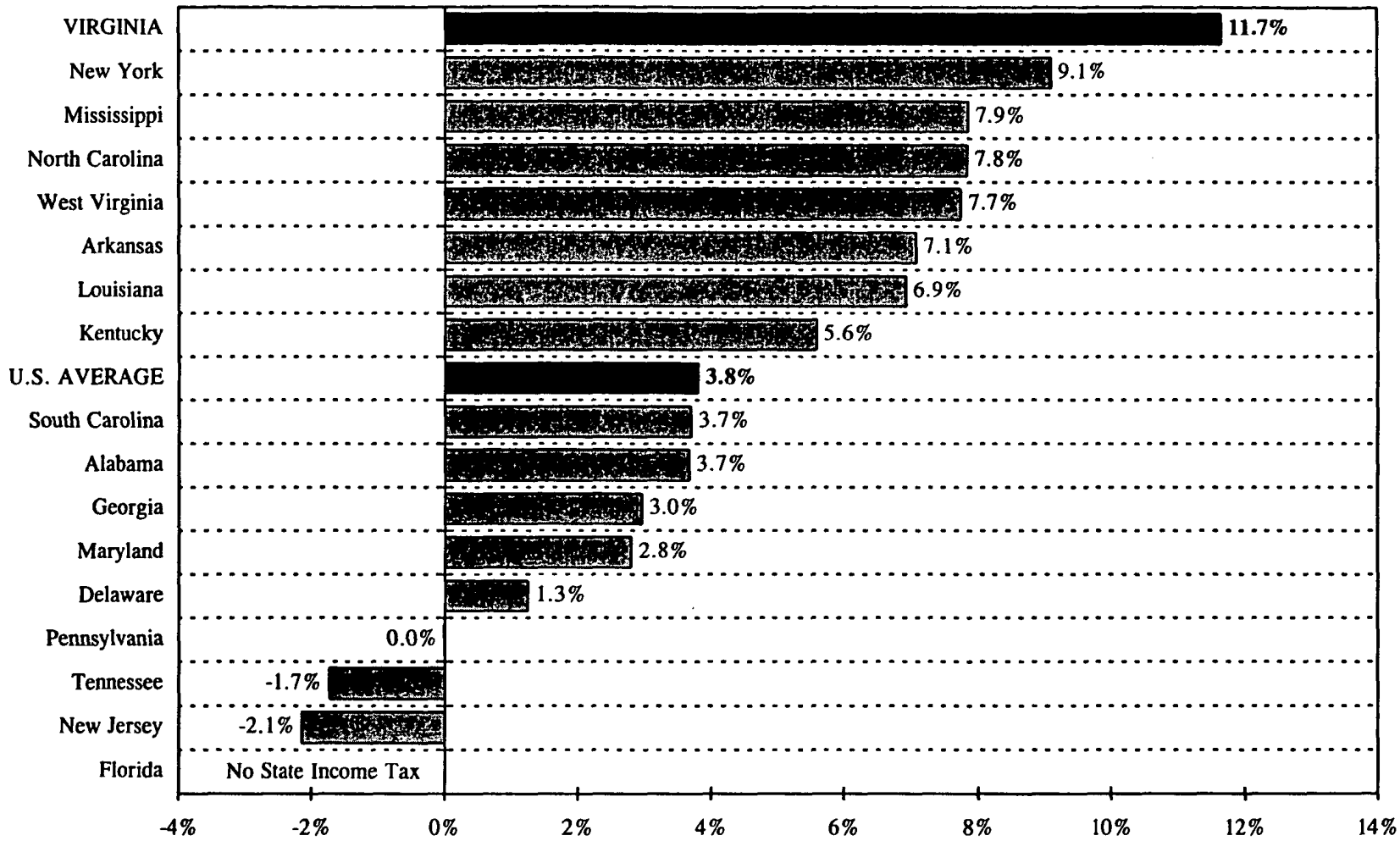
Source: Cato Institute, based on U.S. Census Bureau, State Government Finances, 1982 edition, and State Tax Collections, 1995 edition. (Note: 1995 edition was the most recent available as of early February 1997.)

Table 11
1993-95 Growth of State Personal Income Tax Burden

	State Personal Income Taxes per $1,000 State Personal Income Real Increase 1993-95	Rank*		Per Capita State Personal Income Taxes Real Increase 1993-95	Rank*
Virginia	**9.1%**	**1**	**Virginia**	**11.7%**	**1**
New York	8.6%	2	New York	9.1%	2
West Virginia	5.3%	3	Mississippi	7.9%	3
North Carolina	4.3%	4	North Carolina	7.8%	4
Arkansas	4.2%	5	West Virginia	7.7%	5
Kentucky	3.7%	6	Arkansas	7.1%	6
Louisiana	2.4%	7	Louisiana	6.9%	7
U.S. Average	**2.0%**		Kentucky	5.6%	8
Mississippi	1.5%	8	**U.S. Average**	**3.8%**	
Alabama	0.8%	9	South Carolina	3.7%	9
Maryland	0.8%	10	Alabama	3.7%	10
Delaware	0.5%	11	Georgia	3.0%	11
South Carolina	-0.2%	12	Maryland	2.8%	12
Georgia	-0.3%	13	Delaware	1.3%	13
Pennsylvania	-1.2%	14	Pennsylvania	0.0%	14
New Jersey	-2.6%	15	Tennessee**	-1.7%	15
Tennessee**	-5.3%	16	New Jersey	-2.1%	16
Florida	No Tax	N/A	Florida	No Tax	N/A

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.
**While Tennessee does not have a broad-based personal income tax, it does impose a tax on certain interest and dividend income.
Source: Cato Institute, based on U.S. Census Bureau, State Tax Collections. (Note: Fiscal year 1995 edition was the most recent available as of early February 1997.)

Figure 3
Real Increase in Per Capita Personal Income Tax Burden, 1993-95



Budget Growth in Virginia

Virginia's rapid revenue growth has fueled an expansive growth in government budgets. Just 15 years ago, total annual state expenditures in Virginia amounted to $6 billion. Today with an FY1997 budget of $17.5 billion that figure has nearly tripled. That increase has well outpaced the growth of population, income, and inflation.

Table 12 shows how the growth of state and local government spending in Virginia compares with that of it's regional neighbors.[12]

- When measured as a share of personal income, state and local spending in Virginia increased by 7.2%.
- On a per capita basis, real state and local spending in Virginia increased by 38.1% from 1982-93, just below the national average.

While overall budget growth since 1982 has been slightly below the national average, it has varied over that period. Figure 4 shows the annual growth of the state budget for every year since 1982.

Table 13 shows where Virginia's state and local budget growth has occurred.

- State and local spending on housing and community development[13] has been the fastest growing component in Virginia budgets, increasing by 142% in real terms from 1982-93, more than triple the national average. However, this area still represents only about 1.5% of total spending.
- Interest on general debt has also been a high growth area, rising by 124% in real terms, 50% faster than the U.S. average. Interest on debt now takes up more than 5% of state and local budgets.
- The largest element of government spending in Virginia is still elementary and secondary education. This area saw a 63% real increase from 1982-93, compared to the U.S. average of 52%. But since total spending increased by 66%, spending on elementary and secondary education actually declined as a share of total spending.
- The second largest component of government budgets is welfare, which has increased by 91% after adjusting for inflation, just below the national average.
- Real spending on higher education in Virginia increased by 56% from 1982-93, 20% faster than the U.S. average. However, due to faster growth in other categories, spending on higher education declined as a percentage of total spending.

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[12]The state spending figures in this section come from U.S. Census Bureau, State Government Finances. The fiscal year 1994 edition was the most recent available as of early February 1997. The state and local spending figures in this section come from U.S. Census Bureau, Government Finances. The fiscal year 1993 edition was the most recent available as of early February 1997.

[13]Defined by the Census Bureau as "construction and operation of housing and redevelopment projects, and other activities to promote or aid housing and community development."

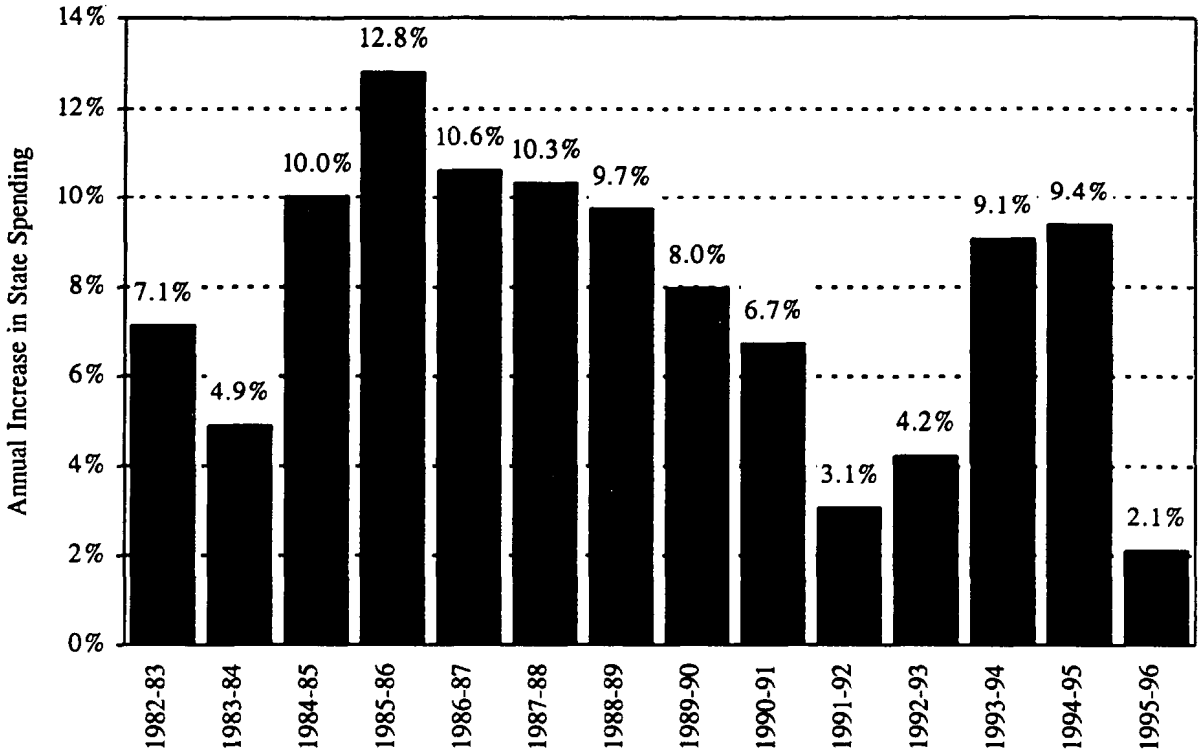
Table 12
1982-93 Growth of State and Local Expenditures

	State and Local Expenditures per $1,000 State Personal Income Real Increase 1982-93	Rank*		Per Capita State and Local Expenditures Real Increase 1982-93	Rank*
Florida	21.0%	1	New Jersey	57.7%	1
West Virginia	17.9%	2	New York	51.3%	2
Arkansas	16.8%	3	North Carolina	49.8%	3
Louisiana	15.3%	4	South Carolina	49.4%	4
Kentucky	15.0%	5	Florida	48.3%	5
New Jersey	14.9%	6	Pennsylvania	45.6%	6
Pennsylvania	14.7%	7	Arkansas	45.5%	7
South Carolina	14.7%	8	Kentucky	41.9%	8
U.S. Average	**12.0%**		West Virginia	41.0%	9
New York	11.7%	9	**U.S. Average**	**38.5%**	
North Carolina	10.9%	10	**Virginia**	**38.1%**	**10**
Virginia	**7.2%**	**11**	Georgia	36.5%	11
Mississippi	5.3%	12	Alabama	34.6%	12
Alabama	2.6%	13	Delaware	34.6%	13
Georgia	1.4%	14	Tennessee	30.9%	14
Delaware	0.7%	15	Mississippi	28.9%	15
Tennessee	-2.6%	16	Louisiana	28.4%	16
Maryland	-4.1%	17	Maryland	24.6%	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

Figure 4
Annual State Budget Growth in Virginia, 1982-96



Source: Commonwealth of Virginia, Department of Accounts.

Table 13
1982-93 Growth of State & Local Expenditures in Virginia

	Thousands of 1993 dollars			Real Increase in U.S. Average 1982-93	Virginia's 1982-93 Increase Compared to U.S. Average (% pts.)
	1993	1982	Real Increase 1982-93		
Total general expenditure	$22,034,785	$13,286,452	66%	57%	+9
Increased as a percentage of total spending					
Housing and community development	$349,945	$144,632	142%	44%	+98
Interest on general debt	$1,177,091	$525,186	124%	83%	+41
Welfare	$2,715,076	$1,423,948	91%	92%	-1
Health	$724,096	$394,841	83%	102%	-19
Correction	$707,854	$394,301	80%	134%	-54
Parks and recreation	$330,721	$193,442	71%	42%	+29
Police protection	$807,381	$478,174	69%	46%	+23
Declined as a percentage of total spending					
Elementary & secondary education	$5,758,142	$3,532,220	63%	52%	+11
Governmental administration	$1,329,802	$818,915	62%	58%	+4
Fire protection	$385,591	$238,084	62%	50%	+12
Higher education	$2,192,184	$1,404,353	56%	42%	+14
Hospitals	$1,175,545	$813,784	44%	38%	+6
Highways	$1,618,687	$1,178,534	37%	32%	+5
Sewerage	$544,513	$448,892	21%	40%	-19

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

- Real highway spending increased by 37% from 1982-93, just above the national average. Highway spending also declined as a share of total spending.

Virginia's state and local budget growth has occurred primarily in the following areas: interest on debt, welfare, and health care. In contrast, spending on education, hospitals, and highways has actually declined as a percentage of total state and local spending.

The rapid increase in spending for interest on government debt is of particular concern because it means that more and more of the burden of current spending will be imposed on future generations. Table 14 shows how the growth of interest spending in Virginia compares to that in its neighboring states.

- From 1982-93, state and local spending for interest on general debt went up by 47.6 percent when measured as a share of personal income. That is almost one and a half times faster than the U.S. average, and the 4th fastest growth in the region.
- On a per capita basis, real state and local spending for interest on general debt went up by 90.1%, also 4th fastest in the region, and substantially above the national average.

Table 15 shows how the growth of state and local government debt in Virginia compares to the growth in its regional neighbors.

- From 1982-93, state and local debt as a share of personal income increased 29.2 percent, the 3rd fastest growth in the region.
- On a per capita basis, state and local debt went up by 66.4%, also 3rd fastest in the region, and substantially above the national average.

Another measure of the size of government is the number of government employees. Table 16 shows the number of full-time equivalent government employees per 10,000 residents.[14]

- In 1995, Virginia had 174.9 state government employees per 10,000 residents. That was 16.1% above the U.S. average.
- When local governments are included, Virginia had 563.6 state and local government employees per 10,000 residents in 1994 (the most recent year available). That was the 7th most in the region and was 4.6% above the U.S. average.

The figures in this report show that Virginia seems to have shifted its priorities away from more traditional areas of government spending on infrastructure and moved in the direction of government spending programs that serve primarily to redistribute taxpayer resources. (See Table 13 in particular.) Most of the spending areas from which businesses and residents see the most direct benefits--highways, education, hospitals--are receiving a declining portion of total spending. At the same time, areas of spending from which most

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[14] The government employment figures come from U.S. Census Bureau, Public Employment. As of early February 1997, the most recent state and local figures were for 1994, and the most recent state figures were for 1995. To adjust for variations from state to state in the proportion of part-time to full-time workers used, the Census Bureau's figures refer to "Full-time Equivalent Employees," which is simply the total number of employee hours worked divided by a full-time work schedule.

Table 14
1982-93 Growth of State and Local Spending for Interest on General Debt

	State and Local Spending for Interest on General Debt per $1,000 State Personal Income Real Increase 1982-93	Rank*		Per Capita State and Local Spending for Interest on General Debt Real Increase 1982-93	Rank*
Florida	110.8%	1	Florida	158.4%	1
Mississippi	63.2%	2	Georgia	105.3%	2
Georgia	52.5%	3	Mississippi	99.8%	3
Virginia	**47.6%**	**4**	**Virginia**	**90.1%**	**4**
Kentucky	43.1%	5	South Carolina	86.1%	5
South Carolina	42.9%	6	Kentucky	76.6%	6
Louisiana	42.0%	7	North Carolina	73.6%	7
U.S. Average	**32.7%**		Delaware	72.4%	8
Pennsylvania	30.5%	8	Alabama	70.6%	9
Alabama	30.1%	9	Pennsylvania	65.7%	10
Delaware	29.0%	10	**U.S. Average**	**64.0%**	
North Carolina	28.5%	11	Louisiana	58.1%	11
Maryland	15.1%	12	New Jersey	55.3%	12
New Jersey	13.1%	13	Maryland	49.6%	13
Arkansas	12.3%	14	Arkansas	39.9%	14
West Virginia	7.9%	15	New York	37.2%	15
New York	1.3%	16	West Virginia	29.0%	16
Tennessee	-5.8%	17	Tennessee	26.6%	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

Table 15
1982-93 Growth of State and Local Debt

	State and Local Debt per $1,000 State Personal Income Real Increase 1982-93	Rank*		Per Capita State and Local Debt Real Increase 1982-93	Rank*
Florida	74.3%	1	Florida	113.6%	1
North Carolina	32.9%	2	North Carolina	79.7%	2
Virginia	**29.2%**	**3**	**Virginia**	**66.4%**	**3**
Pennsylvania	26.7%	4	New York	61.1%	4
U.S. Average	**22.0%**		Pennsylvania	60.8%	5
Mississippi	19.7%	5	**U.S. Average**	**50.8%**	
New York	18.9%	6	Kentucky	46.7%	6
Kentucky	18.9%	7	Mississippi	46.6%	7
Louisiana	13.9%	8	New Jersey	45.7%	8
Georgia	8.2%	9	Georgia	45.6%	9
New Jersey	6.1%	10	Delaware	34.3%	10
Arkansas	2.6%	11	South Carolina	31.1%	11
West Virginia	1.7%	12	Arkansas	27.8%	12
South Carolina	0.7%	13	Louisiana	26.8%	13
Delaware	0.5%	14	Alabama	25.3%	14
Alabama	-4.5%	15	Maryland	23.6%	15
Maryland	-4.8%	16	West Virginia	21.5%	16
Tennessee	-16.2%	17	Tennessee	12.6%	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.
Source: Cato Institute, based on U.S. Census Bureau, Government Finances. (Note: 1993 edition was the most recent available as of early February 1997.)

Table 16
Number of Government Employees in Virginia

	State Government Employees per 10,000 Residents 1995	Percent of U.S. Average	Rank*		State & Local Government Employees per 10,000 Residents 1994	Percent of U.S. Average	Rank*
Delaware	306.9	203.6%	1	Mississippi	627.0	116.4%	1
Louisiana	213.8	141.9%	2	New York	621.7	115.4%	2
South Carolina	212.6	141.1%	3	Georgia	606.6	112.6%	3
West Virginia	191.4	127.0%	4	Louisiana	597.2	110.8%	4
Kentucky	190.3	126.3%	5	Alabama**	572.8	106.3%	5
Alabama	190.1	126.1%	6	South Carolina	571.3	106.0%	6
Arkansas	189.2	125.5%	7	**Virginia**	**563.6**	**104.6%**	**7**
Mississippi	186.1	123.5%	8	Arkansas	552.0	102.4%	8
Virginia	**174.9**	**116.1%**	**9**	North Carolina	551.7	102.4%	9
Tennessee	160.6	106.6%	10	New Jersey	543.7	100.9%	10
Maryland	160.6	106.6%	11	Delaware	540.3	100.3%	11
North Carolina	159.4	105.8%	12	**U.S. Average**	**538.8**		
Georgia	156.5	103.8%	13	Kentucky	524.4	97.3%	12
U.S. Average	**150.7**			West Virginia	509.8	94.6%	13
New York	141.9	94.2%	14	Tennessee	507.8	94.2%	14
New Jersey	135.6	90.0%	15	Florida	499.4	92.7%	15
Pennsylvania	125.9	83.5%	16	Maryland	497.2	92.3%	16
Florida	121.4	80.6%	17	Pennsylvania	427.9	79.4%	17

*Refers to rank amongst the 17 Southeast and Mideast region states. Highest growth rate is ranked 1, lowest is ranked 17.

**State and local figure for 1994 was not available for Alabama, so 1993 figure was used.

Source: Cato Institute, based on U.S. Census Bureau, Public Employment. (Note: As of early February 1997, the most recent state and local figures were for 1994, and the most recent state figures were for 1995.)

Note: To adjust for variations from state to state in the proportion of part-time to full-time workers used, the Census Bureau's figures refer to "Full-time Equivalent Employees," which is simply the total number of employee hours worked divided by a full-time work schedule.

Virginians see little direct benefits--interest on debt, welfare, health care, housing and community development--are receiving an increasing share of total spending. Further, more and more of Virginia's spending has been financed with government bonds, which will force future generations to bear a larger and larger share of the burden of today's spending programs. That approach has Virginia headed in the wrong direction.

Taxes and State Economic Growth

There is increasing evidence that state tax and budget policies can have a significant impact on the relative economic performance among states. Studies have consistently shown that states with high and rising tax burdens tend to suffer through economic decline, while those with lower and falling tax burdens are more likely to enjoy robust economic growth. For instance, a 1993 study by the Joint Economic Committee of Congress examined the economic growth records in the 10 states that had raised taxes the most in fiscal years 1990 through 1993 and the 10 states that had cut taxes the most over that same period.[15] The top ten tax-hiking states experienced a net gain of only 3,000 new jobs, an increase in the unemployment rate of 2.2 percentage points, and a $484 real decline in personal income per family of four. In contrast, the top ten tax-cutting states saw 653,000 net new jobs, an increase in the unemployment rate of only 0.6 percentage points, and a $300 real increase in personal income per family of four.

The contrast was even greater when only income tax changes were considered. (As was noted earlier, the income tax is inordinately high in Virginia.) The top ten income tax-hiking states experienced the net loss of 182,000 jobs, a 2.3 percentage point increase in the unemployment rate, and a $613 real decline in personal income per family of four. The top ten income tax-cutting states saw 975,000 net new jobs, an increase in the unemployment rate of only 0.3 percentage points, and a $148 real increase in personal income per family of four.

Other studies have found similar correlations between high taxes and slow economic growth.[16] Unfortunately, some states have learned that lesson the hard way. For instance, at the beginning of the 1990s, the national recession presented many states with huge budget shortfalls when revenues came in slower than expected. Rather than restraining the growth of spending, some states like California, Connecticut, and New Jersey enacted record tax hikes

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[15]Stephen Moore, "Taxing Lessons from the States: Why Much of America Is Still in a Recession," Joint Economic Committee of the U.S. Congress, October 1993. Note that since fiscal years start before calendar years, the tax figures are for fiscal years 1990-93, but the economic growth figures are for calendar years 1989-92.

[16]See for instance, Richard Vedder, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee of the U.S. Congress, December 1995; Zsolt Becsi, "Do State and Local Taxes Affect Relative State Growth?" Economic Review, March/April 1996, Federal Reserve Bank of Atlanta; and Stephen Moore and Dean Stansel, "Tax Cuts and Balanced Budgets: Lessons from the States," Cato Institute Fact Sheet, September 17, 1996.

in an effort to close their budget gaps. In the years that followed, only a fraction of the projected revenue increases ever materialized. In fact, tax collections actually fell as those state's economies went into a tailspin. Only after significant tax cuts and budget restraint in recent years have California, Connecticut, and New Jersey seen their economies turn around.

Table 17 examines the employment growth rates of 11 states--California, Connecticut, New Jersey, and eight others--that enacted the largest tax hikes in response to budget crises in the early 1990s. As the table indicates, in all 11 of those states, the employment growth rate fell after the tax hike. Before the tax hike, six of the 11 states had employment growth rates above the U.S. average. After the tax hike, all but one of the 11 states had growth rates below the U.S. average. Further, in all 11 states the employment growth rate relative to the U.S. average fell after the tax hike.

A contrasting approach to the recession-induced budget shortfalls of the early 1990s was taken by states like Arizona, Massachusetts and Michigan. Rather than raising taxes, those states chose to focus on spending restraint to close their budget gaps. As a result, they were able to enact substantial pro-growth tax cuts soon thereafter. Subsequently, Arizona, Massachusetts and Michigan all experienced economic revivals, avoiding the prolonged recessions that afflicted tax-hiking states like California, Connecticut and New Jersey.

Table 18 examines the employment growth rates of Arizona, Massachusetts, and Michigan--which all chose the spending restraint/tax cut approach to budget crises in the early 1990s--and seven other states that, because they too have exercised spending restraint, have been able to enact the largest tax cuts in recent years. As the table indicates, in all 10 of those states, the employment growth rate went up after the tax cut. Before the tax cut, eight of the 10 states had employment growth rates below the U.S. average. After the tax cut, six of the 10 had growth rates above the U.S. average. Further, in every one of those 10 states the employment growth rate relative to the U.S. average went up after the tax hike.

In recent years, many states have borrowed from these experiences and revived their economies with a combination of budget restraint and income tax cuts. In fact, in each of the past two years, more than half the states have cut taxes, with the largest reductions coming in the personal income tax.[17] The recent fiscal and economic experiences in a few of those states is summarized below:

Arizona: Under Gov. Fife Symington, taxes have been cut by $1.5 billion since 1992. Income tax rates have been cut by 20 percent (from a previous range of 3.8 to 7 percent to the current range of 3 to 5.6 percent), and the corporate income tax has been cut as well. Over that time period job creation, population, and new business creation have grown substantially faster than the national average. In contrast, employment had actually fallen in Arizona in the two years prior to Symington's tax cuts.

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[17]National Governors' Association and National Association of State Budget Officers, Fiscal Survey of the States, various editions, and National Conference of State Legislatures, State Tax Actions, various editions.

Table 17
State Employment Growth Before and After State Tax Hikes
(Number of residents employed, in thousands)

1991 Tax Hikes

	Residents Employed (1,000s)			Average Annual Increase			
State	1987	1991	1995	1987-91	Relative to U.S. Total	1991-95	Relative to U.S. Total
California	12,946.0	14,004.2	14,205.9	1.98%	+1.01	0.36%	-1.31
Connecticut	1,695.0	1,716.2	1,614.9	0.31%	-0.66	-1.51%	-3.18
Maine	561.0	593.4	605.1	1.41%	+0.44	0.49%	-1.18
Maryland	2,301.0	2,463.0	2,584.1	1.72%	+0.75	1.21%	-0.46
North Carolina	3,128.0	3,307.7	3,478.6	1.41%	+0.44	1.27%	-0.40
Pennsylvania	5,333.0	5,419.0	5,495.1	0.40%	-0.57	0.35%	-1.32
U.S. Total	112,440.0	116,877.0	124,900.0	0.97%		1.67%	

1990 Tax Hikes

	Residents Employed (1,000s)			Average Annual Increase			
State	1986	1990	1994	1986-90	Relative to U.S. Total	1990-94	Relative to U.S. Total
Florida	5,265.0	6,077.7	6,354.0	3.65%	+1.80	1.12%	+0.05
Kentucky	1,534.0	1,662.2	1,725.9	2.03%	+0.18	0.95%	-0.12
Massachusetts	2,941.0	3,032.9	2,976.7	0.77%	-1.08	-0.47%	-1.54
New Jersey	3,712.0	3,860.7	3,739.4	0.99%	-0.86	-0.79%	-1.86
New York	7,872.0	8,375.1	7,980.5	1.56%	-0.29	-1.20%	-2.27
U.S. Total	109,597.0	117,914.0	123,060.0	1.85%		1.07%	

Source: Cato Institute calculations, based on data from the U.S. Bureau of Labor Statistics.

Table 18
State Employment Growth Before and After State Tax Cuts
(Number of residents employed, in thousands)

1995 Tax Cuts

	Residents Employed (1,000s)			Average Annual Increase			
State	1991	1995	Dec-96	1991-95	Relative to U.S. Total	1995-Dec. 1996	Relative to U.S. Total
California	14,004.2	14,205.9	14,487.9	0.36%	-1.31	1.32%	-0.25
Connecticut	1,716.2	1,614.9	1,654.2	-1.51%	-3.18	1.61%	+0.04
New York	8,095.7	7,955.3	8,080.1	-0.44%	-2.11	1.04%	-0.53
North Carolina	3,307.7	3,478.6	3,605.9	1.27%	-0.40	2.43%	+0.86
Pennsylvania	5,419.0	5,495.1	5,625.5	0.35%	-1.32	1.58%	+0.01
U.S. Total	116,877.0	124,900.0	127,855.0	1.67%		1.57%	

1994 Tax Cuts

	Residents Employed (1,000s)			Average Annual Increase			
State	1990	1994	Dec-96	1990-94	Relative to U.S. Total	1994-Dec. 1996	Relative to U.S. Total
Georgia	3,118.3	3,283.5	3,633.2	1.30%	+0.23	4.13%	+2.59
New Jersey	3,860.7	3,739.4	3,863.4	-0.79%	-1.86	1.31%	-0.23
U.S. Total	117,914.0	123,060.0	127,855.0	1.07%		1.54%	

1992 Tax Cuts

	Residents Employed (1,000s)			Average Annual Increase			
State	1988	1992	Dec-96	1988-92	Relative to U.S. Total	1992-Dec. 1996	Relative to U.S. Total
Arizona	1,556.0	1,673.3	2,072.5	1.83%	+1.26	4.87%	+2.99
Massachusetts	3,052.0	2,875.8	3,051.3	-1.48%	-2.05	1.33%	-0.55
Michigan	4,198.0	4,245.0	4,648.4	0.28%	-0.29	2.04%	+0.16
U.S. Total	114,968.0	117,598.0	127,855.0	0.57%		1.88%	

Source: Cato Institute calculations, based on data from the U.S. Bureau of Labor Statistics.

California: No state has turned around its fortunes as dramatically as California in recent years. In 1990, the state enacted a $7 billion tax increase, the largest in the history of the 50 states. That tax hike package included an increase in personal income tax rates and an imposition of a new top rate of 11 percent. In the years that followed, the new revenue that the state expected the tax hike to bring in never materialized. In fact, tax collections actually fell because the state sunk deeper into recession as upper income families and entrepreneurs moved out. The already ailing economy continued to decline. From 1990 to 1993 the state lost 400,000 jobs. In 1996, the income tax hikes were allowed to expire as scheduled. Since then California has gained nearly 200,000 jobs and the unemployment rate has fallen sharply.

Connecticut: In 1991, Connecticut became the 41st state to adopt a personal income tax. That was also the largest tax increase in Connecticut history. It has caused an exodus from the state. Connecticut is one of only two states to lose population in the 1990s. In 1995, Gov. John Rowland enacted a $200 million income tax cut, paid for by holding budget growth to the rate of inflation. He has cut the general assistance welfare budget, public housing aid, and transportation funds and imposed a hiring freeze. The tax cuts have helped pull the Connecticut economy out of the depths of the early 1990s recession that devastated the state's insurance, defense, and banking industries--a recession exacerbated by the introduction of a state income tax. From 1990 to 1995, 125,000 jobs were lost. Since June 1995, nearly half of those lost jobs have been recovered.

Georgia: Under Gov. Zell Miller, Georgia has enacted a series of tax cuts. In 1996 Miller signed a $500 million tax cut, exempting food from the sales tax. In 1994, Miller approved a $100 million tax cut for families with children by raising the dependent exemption from $1,500 to $2,500 and an income tax cut for senior citizens with retirement income. (Increases in income tax exemptions tend to be politically popular. However, reductions in income tax rates have a more positive effect on economic growth, because they directly increase the marginal incentive to work, save, and invest, whereas increases in exemptions do not.) This tax-cutting state is booming economically. In the 1990s, Georgia has by many measures enjoyed the fastest growth rate of any state east of the Mississippi. (As can be seen on Table 19.) Employment has grown more than twice the national average since 1990.

Massachusetts: Gov. Michael Dukakis's last budget contained a series of tax increases designed to close a $1-billion-plus budget shortfall. That shortfall was closed in William Weld's first two years as governor through tight spending restraint, privatization of state services, and a reduction in the public payroll. In 1991, Weld enacted an income tax rollback--the first of eight tax cuts he pushed through in his first term. He also canceled several Dukakis tax hikes. Since then, the state has regained all of the 150,000 jobs lost during the 1990-91 recession--and the budget is now running a surplus.

Michigan: Gov. John Engler inherited a $1.5 billion deficit in 1991 and quickly closed the gap through an aggressive budget-cutting agenda. He ended a general assistance program for 75,000 employable adults, slashed 6,000 workers from state payrolls, ended low-priority programs such as funding for the arts, and privatized homeless services and other state activities. In 1991 Engler enacted the first of 15 tax cuts. The largest and most controversial was a school financing/tax restructuring program under which local property taxes were sharply reduced and the state sales tax was raised by 2 percentage points. The

income tax rate has also been cut and the personal exemptions have been increased. The economy is now surging in Michigan, and the unemployment rate is lower than at any time since the mid-1960s and well below the national average at 4.7 percent. In the two years before Engler's tax cutting, the state had no net new jobs. Since then, Michigan businesses have created 400,000 new jobs.

New Jersey: Last year Gov. Christine Todd Whitman made good on the final portion of the three-year 30 percent income tax cut she promised in the campaign of 1993. She completed the $1.2 billion tax cut one full year ahead of schedule. The typical middle-income family will now pay about $300 less per year in state income tax. Whitman's tax cuts were a reversal of the progressive tax increases enacted by her predecessor Jim Florio. Since she took office, more than 90 percent of the jobs lost during the Florio years have been recovered. Personal income in the state grew by 4.5 percent last year after virtually no growth in the Florio years.

New York: In 1994 George Pataki narrowly defeated Gov. Mario Cuomo by running on a platform of Whitman-style income tax cuts. Pataki's 20 percent income tax cut that passed in 1995 will reduce New Yorkers' tax bills by $2 billion a year--a tax cut as large, in dollar terms, as those enacted by all of the rest of the states combined. Pataki also overhauled the state's antiquated workmen's compensation system, which costs New York businesses 30 percent more than the national average. After losing over 400,000 jobs from 1990 to 1995, New York has regained nearly half of those since Pataki's tax cut was enacted.

North Carolina: In the early 1990s, North Carolina's budget began to expand rapidly. Under Gov. Jim Hunt, total state expenditures increased from $17.3 billion to $19.0 billion in 1993--an enormous 10 percent increase in just one year. That increase went towards more funding for schools, day care, apprenticeship programs, and health insurance coverage. Since 1995 the spending spree has ended and budget growth has slowed to only slightly faster than the inflation rate. In 1995, Hunt pushed through a $400 million tax cut that included an income tax cut and elimination of the state intangibles tax. Job growth has more than doubled since the tax cuts, and the state's economy is flourishing.

Pennsylvania: During the 1990-91 recession Gov. Robert Casey enacted a $2 billion income tax increase, raising the rate from 2.1 to 2.8 percent. (Pennsylvania has a flat tax with one single rate.) From 1990 to 1995, there was virtually no net job creation in Pennsylvania. In 1995, his first year in office, Gov. Tom Ridge pushed through a $200 million business income tax cut and a workmen's compensation reform measure that is expected to reduce those premiums by as much as 10 percent. In 1996, he endorsed a reduction in the franchise tax and a $1,000 tax credit for new hires. He has also been tight-fisted on spending. His 1996 budget allowed spending to grow by just 0.6 percent. In 1997, for the first time in a quarter century, the general fund budget spends less than the year before. That combination of tax cuts and budget restraints has coincided with a net gain of more than 120,000 jobs through the first 11 months of 1996.

Virginia's Record of Economic Growth

The experiences of the states described above that have cut taxes and seen their economies expand can be duplicated in Virginia. In fact, since Virginia is not in a major economic decline--as many of those other states were--the task is less difficult. Using the most recent available data from the U.S. Department of Commerce and U.S. Department of

Labor, the standard sources for state-by-state economic data, Table 19 shows the 1990s economic growth record in Virginia and its regionally neighboring states.[18]

- The number of residents employed in Virginia grew by 7.8 percent from 1990 through December 1996, just above the U.S. average.
- Personal income in Virginia went up by 12.2 percent from 1990 through the third quarter of 1996, after adjusting for inflation. That was also below the U.S. average.
- Virginia's population increased 7.4 percent from 1990 to 1996, the 17th fastest growth rate in the nation.

However, the 1990-96 numbers do not tell the whole story. The economic growth figures over just the last year show that Virginia may be starting to fall behind.[19] As Table 20 shows:

- The number of residents employed in Virginia actually declined by 0.7 percent from December 1995 through December 1996, ranking Virginia behind all but one of the 50 states.
- Personal income in Virginia went up by 2.1 percent from the third quarter of 1995 through the third quarter of 1996, after adjusting for inflation. That was below the U.S. average of 2.7 percent, and ranked Virginia 31st in the nation.
- Virginia's population increased 0.91 percent from 1995 to 1996, right at the U.S. average.

As a methodological note, it should be pointed out that the Bureau of Labor Statistics produces two series of state employment growth data, a survey of individuals and a survey of payroll establishments. The former, which is most commonly used and is used herein, measures how many state residents are employed. The latter measures how many employees are on the payrolls of non-agricultural employers in the state. By surveying individual residents, the first series provides a more comprehensive and more accurate estimate of how many state residents have jobs. The second series has two main flaws. It excludes a substantial sector of the economy, the agricultural industry, and it can result in double

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[18]The figures in Table 19 are the most recent available data (as of early February 1997) from the U.S. Department of Commerce and U.S. Department of Labor, the standard sources for state-by-state economic data. The annual state population estimate for 1996 (from the Department of Commerce, Bureau of the Census) is available and has been used. However, annual figures for 1996 have not yet been released for state employment or state personal income. The most recent state employment data is for December 1996 and was released (by the Department of Labor, Bureau of Labor Statistics) on February 5, 1997. (The annual estimates for 1996 are scheduled to be released on March 13, 1997.) The most recent state personal income data is for the third quarter of 1996 and was released (by the Department of Commerce, Bureau of Economic Analysis) on January 28, 1997. (The fourth quarter data is scheduled to be released on April 28, 1997.)

[19]The figures in Table 20 refer to the annual change over the most recent available 12 month period as of early February 1997. For state population, that refers to the change in the annual average from 1995-96. Howver, since annual averages are not yet available for state employment or state personal income, those growth figures refer to the December 1995-December 1996 period and the third quarter 1995-third quarter 1996 periods, respectively.

Table 19
Economic Growth in Virginia in the 1990s

	Employment Growth 1990-12/96	U.S. Rank		Personal Income Growth* 1990-1996:III	U.S. Rank		Population Growth 1990-96	U.S. Rank
Tennessee	17.1%	6	Georgia	25.4%	6	Georgia	13.0%	6
Georgia	16.5%	8	North Carolina	24.2%	7	Florida	10.6%	11
Alabama	15.7%	9	Arkansas	21.9%	10	North Carolina	10.0%	12
Arkansas	13.2%	17	Tennessee	21.7%	11	Tennessee	8.8%	15
Louisiana	10.8%	23	Mississippi	20.9%	12	Delaware	8.3%	16
Florida	10.7%	24	Alabama	17.3%	16	**Virginia**	**7.4%**	**17**
Mississippi	9.5%	27	Florida	17.1%	17	Arkansas	6.6%	19
North Carolina	8.5%	29	Kentucky	16.3%	19	**U.S. Average**	**6.4%**	
Delaware	8.5%	30	Louisiana	16.2%	20	Maryland	5.7%	23
United States	**8.4%**		Delaware	14.9%	23	South Carolina	5.7%	24
Virginia	**7.8%**	**33**	South Carolina	13.8%	27	Alabama	5.6%	25
Kentucky	7.7%	34	**U.S. Average**	**13.0%**		Mississippi	5.4%	26
Maryland	7.6%	35	**Virginia**	**12.2%**	**29**	Kentucky	5.2%	28
West Virginia	7.5%	36	West Virginia	10.3%	36	New Jersey	3.2%	38
South Carolina	7.4%	37	New Jersey	8.3%	40	Louisiana	3.2%	39
Pennsylvania	2.7%	43	Pennsylvania	8.2%	41	West Virginia	1.9%	43
New Jersey	0.1%	47	Maryland	7.5%	43	Pennsylvania	1.4%	44
New York	-3.5%	49	New York	5.0%	47	New York	1.0%	46

*Reflects real growth in personal income, that is, growth after adjusting for inflation.
Sources: U.S. Department of Labor, Bureau of Labor Statistics (employment figures); U.S. Department of Commerce, Bureau of Economic Analysis (personal income figures); and U.S. Department of Commerce, Bureau of Census (population figures).

Table 20
Recent Economic Growth in Virginia, 1995-96*

	Employment Growth 12/95-12/96	U.S. Rank		Personal Income Growth** 1995:III-1996:III	U.S. Rank		Population Growth 1995-96	U.S. Rank
Alabama	4.93%	4	North Carolina	5.8%	2	Georgia	2.01%	4
Georgia	4.69%	5	Georgia	5.0%	3	North Carolina	1.67%	9
Louisiana	3.96%	8	Arkansas	4.1%	9	Florida	1.52%	11
Maryland	3.68%	10	Kentucky	3.7%	12	Tennessee	1.39%	13
Florida	3.35%	12	Florida	3.2%	15	Delaware	1.09%	15
North Carolina	3.20%	16	New Jersey	2.9%	20	Arkansas	1.01%	17
Tennessee	2.46%	24	Delaware	2.8%	22	**U.S. Average**	**0.91%**	
Pennsylvania	2.37%	26	Alabama	2.8%	23	**Virginia**	**0.91%**	**20**
West Virginia	2.36%	27	**U.S. Average**	**2.7%**		South Carolina	0.87%	21
United States	**2.23%**		South Carolina	2.2%	29	Mississippi	0.74%	27
Kentucky	1.98%	29	**Virginia**	**2.1%**	**31**	Kentucky	0.70%	29
New York	1.73%	32	Mississippi	2.0%	32	Maryland	0.65%	31
Delaware	1.51%	36	Pennsylvania	1.9%	35	Alabama	0.63%	32
Mississippi	1.25%	39	Tennessee	1.8%	38	New Jersey	0.48%	34
Arkansas	1.23%	40	Maryland	1.8%	39	Louisiana	0.29%	45
New Jersey	1.23%	41	New York	1.7%	40	West Virginia	0.03%	47
South Carolina	0.21%	45	Louisiana	1.4%	45	New York	-0.03%	48
Virginia	**-0.70%**	**49**	West Virginia	0.8%	47	Pennsylvania	-0.03%	49

*As of early February 1997, the most recent data available for state employment was for December 1996 (released February 5, 1997), for state personal income was for the third quarter of 1996 (released January 28, 1997), and for state population was the annual estimate for 1996 (released December 30, 1996).

**Reflects real growth in personal income, that is, growth after adjusting for inflation.

Sources: U.S. Department of Labor, Bureau of Labor Statistics (employment data); U.S. Department of Commerce, Bureau of Economic Analysis (personal income data); and U.S. Department of Commerce, Bureau of Census (population data).

counting. That is, because it simply counts how many people are on payrolls, when individuals have more than one job, they are counted twice.

A state-by-state ranking in the November 1996 issue of Governing magazine provides further evidence of Virginia's less than robust growth.[20] Virginia ranks only 33rd in the Economic Momentum Index, which compares changes in population, employment, and personal income to the national average. The November 18, 1996 issue of Financial World magazine also contained a ranking of the states.[21] Virginia was ranked 27th in terms of "economic potential."

And, a recent study by the American Electronics Association found that Virginia's taxpayers may not be getting their money's worth from Richmond's high-profile efforts to attract technology industry jobs.[22] That study showed that from 1990 to 1995 the growth rate of high-tech jobs in Virginia was 5 percent, ranking Virginia only 25th in the nation.[23]

One of the reasons that economic growth may be slowing in Virginia is that while other states have been aggressively cutting their income taxes, Virginia has not yet done so. In 1994, Gov. George Allen proposed a five-year $2.1 billion tax cut, but it was defeated in the state legislature. And now, two years later we see other states like Georgia, New Jersey, New York, and North Carolina, which have cut income taxes, are gaining ground. Even Maryland is now considering a 10 percent state income tax cut. In that environment, by standing still, Virginia is losing ground.

How to Improve Virginia's Economic Picture

Virginia should draw upon the lessons of other states like Arizona, Georgia, Michigan, New Jersey, and North Carolina, and take steps now to reduce the income tax burden--which is currently 36 percent higher than the national average and amongst the five highest in the region. By so doing, Virginia can prevent its economy from falling behind in the coming years and can avoid jeopardizing its reputation as a low-tax, business-friendly state.

Specifically, Virginia should take the following three steps.

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[20] "Hal Hovey's State Scoreboard," Governing, November 1996, p. 53. (Note: Hal Hovey is the president of State Policy Research, Inc. in Columbus, Ohio and editor of State Policy Reports and State Budget and Tax News.)

[21] Kurt Badenhausen and Kristine Auns, "(Where) To Be, Or Not To Be," Financial World, November 18, 1996, pp. 58-65.

[22] "Cyberstates: A State-by-State Overview of the High-Technology Industry," American Electronics Association, January 30, 1997.

[23] Ibid, cited in: "Virginia Lags in High-Tech Hiring," Washington Post, January 30, 1997, p. D-2.

1) Reduce personal income tax rates by 20 percent.

State income taxes are highly destructive to new business and job creation. Virginia can attract new enterprises and employment opportunities by reducing its income tax rates by 20 percent, bringing the rates down from the current range of 2 to 5.75 percent to a range of 1.6 to 4.6 percent.[24] Virginia's per capita personal income tax burden would fall from the 16th highest in the nation to close to the average. It would then be the 27th highest nationally, and the 11th highest in the region.

Critics of state tax cuts often contend that lower state taxes mean higher local tax burdens, thus leaving taxpayers no better off. That claim is most prominently made about the tax cuts enacted by Gov. Christine Todd Whitman in New Jersey. However, a recent study by the Manhattan Institute concluded that local property tax increases replaced less than one-third of the income tax cuts signed into law by Governor Whitman.[25] Even if the critics are correct and there was a dollar-for-dollar offsetting increase in local taxes as a result of a state tax cut, citizens would still be better off. Since local officials are closer to the people than are politicians and bureaucrats in the state capital, residents have more influence over them. And, since local officials are "on the scene," they have more direct knowledge about how to spend the taxpayers' money wisely. Shifting more revenue raising and spending decisions closer to the people would be a step in the right direction. Furthermore, as was discussed earlier, that Virginia's state income tax burden is well above the national average, while its local property tax burden is below the national average.

Finally, many tax cut opponents will say that "we can't afford a tax cut," or that tax cuts "cost too much" and will require huge spending cuts. The idea seems to be that allowing taxpayers to keep more of their own earnings somehow denies the state its rightful funding, as if Virginian's hard-earned tax dollars belong to the state first, not to the taxpayers themselves. Given the size of Virginia's budget and the above average number of employees on the payroll, spending reductions are certainly in order. (The Thomas Jefferson Institute for Public Policy will publish later this year a two volume study on downsizing state government. Volume II will be an agency-by-agency review of the budget with recommendations as to where activities could be cut, consolidated, and eliminated

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[24]The effect on each of the brackets would be as follows:

Taxable Income	Current Rate	New Rate
$0-$3,000	2%	1.6%
$3,000-$5,000	3%	2.4%
$5,000-$17,000	5%	4%
Over $17,000	5.75%	4.6%

[25]Timothy Goodspeed and Peter Salins, "New Jersey Income Tax Cut Led to Savings, Not Rise in Local Taxes," Manhattan Institute for Policy Research (New York), Center for Civic Innovation, Civic Report No. 1, March 1996.

altogether.) However, as will be demonstrated later, huge spending cuts are not required to "pay for" a tax cut of this size. In fact, the overall level of spending can continue to increase. Simply slowing the growth of current spending--not reducing the overall level of spending--is all that is required to enact a 20% income tax cut without throwing the budget out of balance.

2) Enact a one-year budget freeze.

The Virginia state budget for fiscal year 1997 is roughly $17.5 billion. As was shown earlier in Figure 2, state revenue has been growing faster than population and income for at least the last 15 years. A one-year freeze would allow residents' incomes to temporarily catch-up with state spending growth, and it would help pay for the recommended tax cuts. A spending freeze would require tough choices and a serious re-prioritization of spending. However, if just $500 million worth of spending could be eliminated, then the rest of the budget would be able to keep pace with inflation in FY 1998, rather than being frozen at current year (FY 1997) levels . (That is, a pared down budget of $17 billion could grow at the rate of inflation in FY1998, roughly 2.8 percent, and still not exceed the overall FY 1997 level of spending $17.5 billion.) Furthermore, we note that a spending freeze is not unprecedented. Several states, such as Massachusetts and Michigan, have recently employed a budget freeze for two or more years to rein-in the growth of their budgets and to pay for tax cuts. Only a one-year freeze is recommended for Virginia.

3) Implement a constitutional budget cap.

Virginia should follow the example of the 23 states that have thus far implemented some form of tax and expenditure limitation (TEL) in an effort to keep the growth of their budgets in line.[26] TELs establish an explicit limit on the annual growth of the state budget. The most common form is to prohibit the state budget from growing faster than state personal income. However, those TELs which limit the growth of spending to the growth rate of state population plus inflation are more stringent, and have been adopted most recently in Colorado (1992) and Washington state (1993). To ensure its longevity, Virginia should enact such a measure as a constitutional amendment.

The recommendations listed above have not gone untested. As was described in detail earlier, many states have cut taxes and slowed the growth of spending in recent years. Those states' economies are now moving in a more positive direction. Virginia could see those same results by enacting these three reforms.

Reducing Virginia's excessive personal income tax burden by cutting marginal rates would allow Virginians to keep more of what they earn. After all, who is best equipped to decide how to spend Virginians' hard-earned dollars, politicians, bureaucrats, and blue-ribbon commissions in Richmond? Or the citizens of Virginia themselves? The enhanced

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[26]For a detailed look at the effectiveness of tax and spending limits, see Dean Stansel, "Taming Leviathan: Are Tax and Spending Limits the Answer?", Cato Institute Policy Analysis No. 213, July 25, 1994.

freedom that a 20 percent reduction in personal income tax rates would give Virginians provides a compelling argument by itself. However, in addition to that, the lessons of other states that have enacted rate reductions of this magnitude--for instance, Arizona, New Jersey, and New York--tell us that the growth of the overall economy will expand as well. The key question is: will the tax reductions throw the budget out of balance or require huge spending cuts?

Tax Cuts and Balanced Budgets

Anytime a substantial tax cut is proposed, tax cut opponents claim that it will require massive reductions in spending. Those claims often go unchallenged. Even with the 20 percent income tax cut recommended above, spending would not have to be reduced at all. In fact, after a first year budget freeze--not a reduction, but just holding spending at the same level--it could be allowed to increase at the rate of inflation plus population growth. It is true that the growth rate of spending would have to be reduced, but the overall level of spending could continue to increase.

Table 21 shows how this would work. The table illustrates the estimated static impact of an across-the-board 20 percent cut in Virginia's personal income tax rates. Using the Virginia Department of Taxation's own projections for state personal income tax revenue, a 20 percent tax cut would result in Virginians paying $962 million less in income taxes in FY 1998 than they would have at the current rates. The savings would be $1,009 million in FY 1999, $1,069 million in FY 2000, and $1,131 in FY 2001. This amounts to a savings of $563 per family of four in 1998 alone.

Note that this is static analysis. It does not account for any increased economic growth from the tax cut, or any corresponding increase in state revenue. Since reductions in tax rates increase consumers' incentives to work, save, and invest, economic theory tells us that the tax cuts would spur economic growth. The real-life experiences discussed earlier in other states such as Arizona, Georgia, Michigan, New Jersey, and North Carolina have confirmed that. (See Table 18) Thus, the revenue losses in later years would likely be smaller due to rising incomes from a more prosperous economy.

The budget savings that would be produced by the recommended spending reforms--a 1st-year spending freeze and implementation of a spending cap prohibiting state expenditures from rising faster than the growth rate of population plus inflation--are also shown on Table 21. If Virginia's population continues to grow at an annual rate of 1.2%--the average rate at which it has grown in the 1990s--and inflation remains at 2.8 percent per year, these spending reforms would result in spending being $963 million lower in FY 1998 than if spending growth had not been restrained. The savings would be $1,278 million in FY 1999, $1,621 million in FY 2000, and $1,994 million in FY 2001.

As Figure 5 shows, these spending reforms do not reduce the level of spending, they merely slow the rate at which spending would increase. Spending could rise by 12.5 percent between FY 1997 and FY 2001, or by nearly $2.2 billion. Nevertheless, as Table 21 shows, in every year the budget savings exceeds the static impact of the 20% income tax cut. Therefore, the budget would not only remain in balance, but there would be a budget surplus every year, starting at $1 million in FY 1998, but growing to $864 million by FY 2001. And that does not include the budget surplus of more than $250 million that was announced in recent weeks.

Table 21
Estimated Impact of a 20% Income Tax Cut and Slower Spending Growth, FY 1997-2001

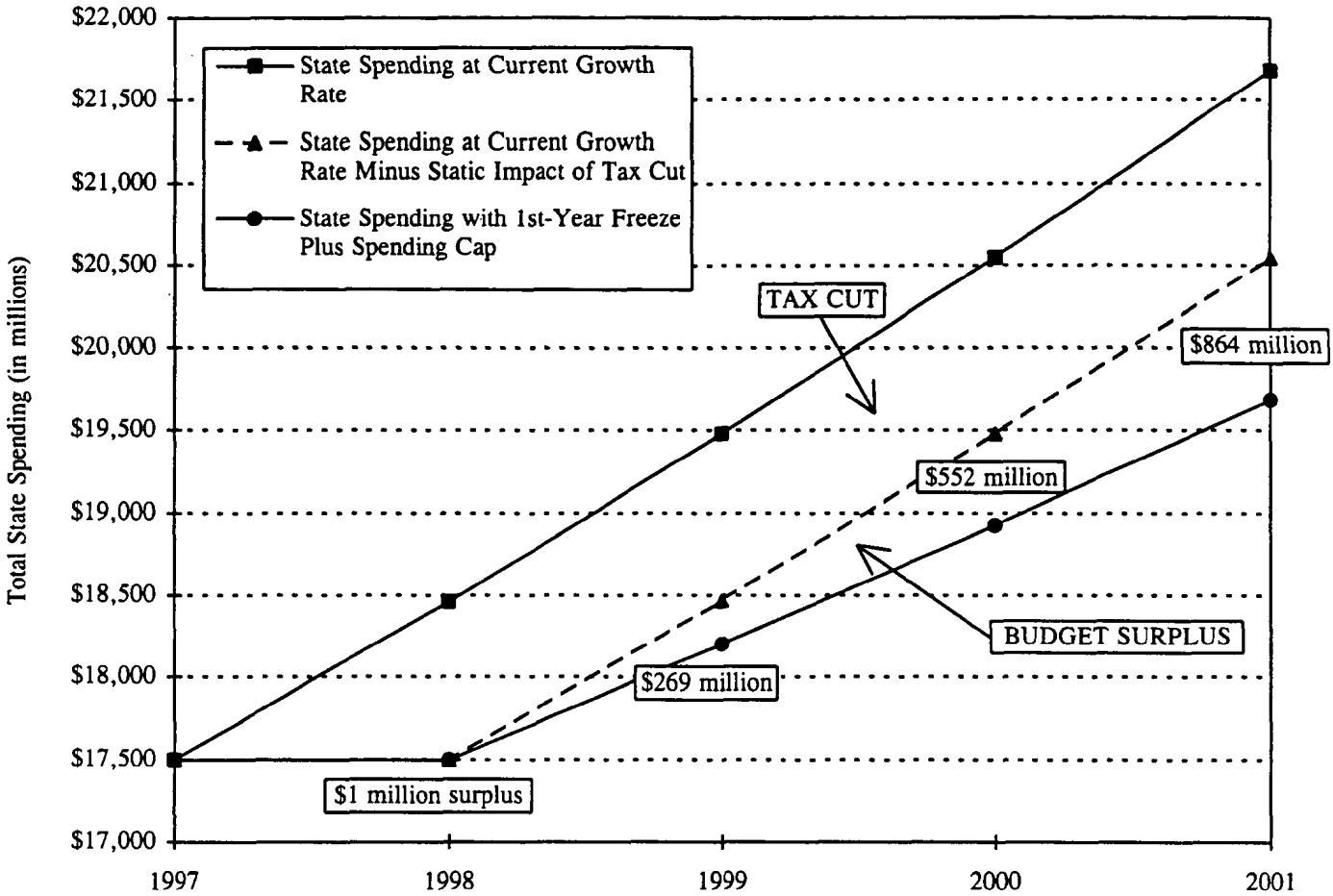
	Millions of Dollars					cumulative difference
	1997	1998	1999	2000	2001	FY 1998-2001
	*Projected State Personal Income Tax Revenue**					
At current rates	$4,561	$4,809	$5,047	$5,346	$5,654	
With 20% tax cut	$4,500	$3,847	$4,038	$4,277	$4,523	
Total taxpayer savings		*$962*	*$1,009*	*$1,069*	*$1,131*	*$3,040*
	*Projected State Spending**					
With no change	$17,500	$18,463	$19,478	$20,549	$21,679	
With 1st-yr. freeze + TEL**	$17,500	$17,500	$18,200	$18,928	$19,685	
Budget savings		*$963*	*$1,278*	*$1,621*	*$1,994*	*$3,862*
BUDGET SURPLUS		$1	$269	$552	$864	$1,685
Taxpayer savings per family of 4 (in actual dollars, not millions)		$563	$584	$611	$638	

Sources: Ronald L. Tillett, Secretary of Finance, Commonwealth of Virginia, speech to the Joint Money Committees, December 20, 1996, "Governor Allen's Proposed Amendments to the FY1996-98 Budget: Fiscal Policy, Economic Assumptions, and Revenue Estimates," pp. A5-A7; and Commonwealth of Virginia, Department of Planning and Budget.

*The personal income tax revenue projections come from Secretary of Finance, pp. A5-A7. The Department of Planning and Budget does not release future projections of total state spending. The listed spending projections are from the author's calculations based on historical levels of spending growth in Virginia. (Specifically, the average annual growth rate of total state spending in the 1990s, 5.5%, was used to project spending levels in FY1998, 1999, and 2000.)

**The recommended TEL would be a spending cap prohibiting state spending from rising faster than the growth rate of population plus inflation. The estimates contained herein use a projected population growth rate of 1.2% per year (the average annual population growth rate in Virginia in the 1990s) and a projected inflation rate of 2.8%.

Figure 5
Budget Impact of a 20% Income Tax Cut and Slower Spending Growth



So, despite what tax cut opponents say, Virginia can and should cut personal income tax rates by 20% starting today without making severe cuts in spending or throwing the budget out of balance. In fact, spending can be allowed to increase by 12.5% over the next four years and there would be a budget surplus each and every year. This is not voo-doo economics. To the contrary, all of these calculations assume that there will be no improvement in economic growth after the tax cut. If economic growth does indeed expand--as both economic theory and the experiences of other states tell us it will--then the budgetary picture outlined above would be even brighter.

More Pro-Growth Tax and Budget Reforms for Virginia

In addition to the measures recommended above, there are a variety of other pro-growth tax and budget reforms that have been used successfully in other states. Five of those are outlined below.

1) Enact a flat tax.

Income taxes are harmful to economic growth because they reduce the economic return that individuals receive from their work, savings, and investment, and thereby reduce the incentives to engage in such activities. Progressive, multiple-rate income tax systems--like Virginia's--are especially harmful because at the margins every extra dollar that one earns is taxed at a progressively higher rate. That is not the case with a flat tax, that is, an income tax with a single rate. There are currently six states that have a single-rate income tax. (Those states are Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania.) One study found that personal income growth rates were more than one-fourth higher in flat-tax states than in states with progressive income taxes.[27] Virginia could eliminate a substantial barrier to better economic growth by going to a single-rate flat tax instead of its current progressive four-bracket system.

2) Eliminate the state capital gains tax and estate tax.

In order to minimize taxpayer disincentives to save and invest, the optimal capital gains tax rate for any state is zero. In fact, a handful of states--such as Florida and Texas--have no capital gains tax. If for political reasons the capital gains tax cannot be eliminated in Virginia, then at least it should be reduced. State lawmakers can attract new business investment into the state by reducing to zero the capital gains tax for all new enterprise or investment in Virginia. Colorado, Massachusetts, and Mississippi have enacted such provisions in recent years.[28] This would have only a minor impact on revenues, but could potentially have a very large impact on economic growth. Similarly, estate taxes and

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[27]Richard Vedder, '"State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee of the U.S. Congress, December 1995.

[28]Raymond Keating, "Eliminate State Capital Gains Taxes, Too," Small Business and the Economy, Issue #4, January 1995, Small Business Survival Committee, Washington, D.C., pp. 3-4.

inheritance taxes punish economic activity, by levying often confiscatory tax rates on accumulated wealth. Several states including New York are currently considering the elimination of their estate and/or inheritance taxes. Virginia should do the same.

3) Index all provisions of the income tax code.

Inflation is a thief that robs all Americans of their purchasing power. A number of states and the federal government have held taxpayers harmless to inflation by indexing their tax code. However, Virginia is one of the 29 states that has not indexed its taxes to inflation.[29] The state government should not benefit from inflation at the expense of the taxpayer. All exemptions, deductions, and tax brackets should be indexed to inflation, so that the tax burden on our citizens remains steady. This change in Virginia's tax code would have a minimal budget impact in the short term but would permanently protect taxpayers from the inflation penalty. For example, Virginia's tax brackets have remained virtually the same since 1971, when a new top rate of 5.75 percent was added for all taxable income over $12,000. Since then, the level at which that top bracket applies has been raised several times to its current level of $17,000. However, if the tax code had been indexed for inflation in 1971, the 5.75 percent rate would now apply only to taxable income over $46,500. Even if indexation had only taken effect in 1990, the last time the top bracket was increased, the top bracket would be $21,000 today. That same effect applies to the personal exemption since it too is not indexed for inflation. If the exemption had been indexed only in 1988, when it was increased to its current level of $800, it would be worth $1,100 today.

4) Require a supermajority of both houses of the legislature to approve all new and increased taxes.

Thirteen states currently have some form of supermajority requirement for new or increased taxes.[30] By requiring more than a simple majority to raise existing taxes or impose new ones, supermajority requirements merely ask that legislators reach a broader consensus--usually a two-thirds majority--on the necessity for higher taxes and the wisdom of the spending those taxes will fund. This has the benefit of requiring a stricter prioritization of state spending. Such measures were adopted in Nevada, Oregon, and South Dakota in 1996 and have been considered by 18 state legislatures in the past two years. Some states have gone further. For instance, Colorado (1992), Missouri (1996) and Washington state (1993) have passed measures which require that all tax hikes and any new taxes be approved by the voters. Voter approval is considered to be substantially more difficult to achieve than a supermajority of the state legislators. Last November, Floridians went even further by passing a measure that requires a supermajority of voters to approve any new taxes.

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[29]Federation of Tax Administrators, Washington, D.C.

[30]Those 13 states are Arizona (1992), Arkansas (1934), California (1979), Colorado (1992), Delaware (1980), Florida (1971), Louisiana (1966), Mississippi (1970), Nevada (1996), Oklahoma (1992), Oregon (1996), South Dakota (1978 and 1996), and Washington (1993).

5) Increase the state income tax personal exemption.

Some states have reduced their personal income tax burdens by raising the level of the personal exemption. This reduces the amount of an individual's income that is subject to the tax. This approach tends to be politically popular. However, it does not have as large of an impact on economic growth as an equivalent reduction in marginal tax rates, because it does not directly effect individual's incentives to engage in additional work, saving, and investment. In contrast, a reduction in tax rates does directly increase an individual's incentive to earn that next dollar of income by allowing them to keep more of it than before the rate cut. (Increasing the personal exemption could, indirectly, have that same effect, but only in cases where it causes taxpayers to fall into a lower tax bracket.)

Conclusion

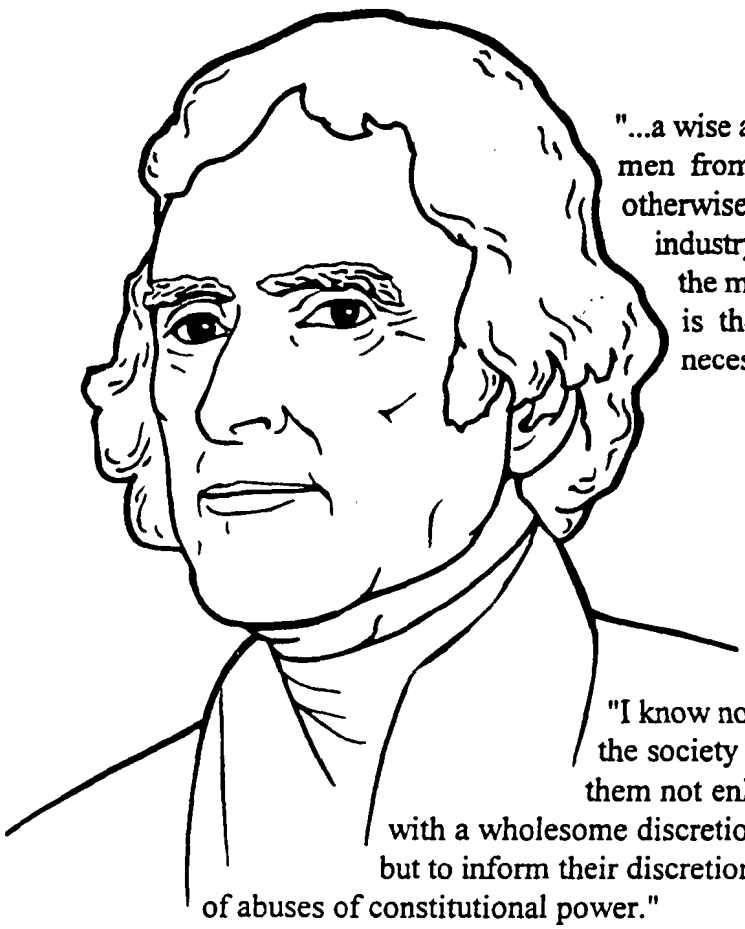
Virginia has a long-standing reputation as a low-tax, business-friendly state. However, that reputation may be in jeopardy if Virginia continues to ignore the national trend toward reducing state taxes. In recent years many states with which Virginia competes for businesses and residents have been aggressively reducing their state income tax burdens. Virginia has not done so. In that environment, by just standing still Virginia is losing ground. There are already signs that this may be having an impact on Virginia's economy. The most recent state economic data shows that over the last year Virginia ranks only 31st in income growth and 49th in employment growth.

While the overall tax burden in Virginia is below average, the state's per capita income tax burden is 36% above the U.S. average, and it is the 5th highest amongst the 17 states in the Southeast and Mideast regions. Further, in recent years Virginia's per capita income tax burden has grown more than three times faster than the national average, and at, by far, the fastest rate in the region. Virginia should address that disparity now by reducing its personal income tax.

This study recommends a 20% cut in Virginia's personal income tax rates. Despite what tax cut opponents say, this can be achieved without making severe cuts in spending or throwing the budget out of balance. In fact, spending can be allowed to increase by 12.5% over the next four years and there would be a budget surplus each and every year. With a less than robust economy, an above average personal income tax burden, and a substantial budget surplus, the time is right for Virginians to get the tax relief they deserve.

About the Author

Dean Stansel is a fiscal policy analyst at the Cato Institute in Washington, D.C. His expertise encompasses a broad variety of budget and tax issues including state tax limitation measures, the tax and spending records of America's governors, state tax cuts and economic growth, devolution of federal powers to the states, unfunded federal mandates, corporate welfare in the federal budget, and replacing the federal income tax with a national sales tax. Stansel's works include "Tax Cuts and Balanced Budgets: Lessons from the States," a September 1996 Cato study on the impact of state tax cuts; a widely-publicized biennial Cato report, "A Fiscal Policy Report Card on America's Governors" (both coauthored with Cato's director of fiscal policy studies, Stephen Moore); and a Cato study on state tax and expenditure limitations (TELs), "Taming Leviathan: Are Tax and Spending Limits the Answer?" He also has produced state tax and budget analyses for numerous state think tanks. Stansel has testified before the U.S. Congress as well as several state legislatures and has appeared on many radio and television shows. His articles have appeared in the Wall Street Journal, Investor's Business Daily, Chicago Tribune, and Washington Times; and his work has been cited in the New York Times, Wall Street Journal, and Washington Post. Stansel received his undergraduate degree in economics from Wake Forest University and did his graduate studies at George Mason University.



"...a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities."

Thomas Jefferson -- 1801

"I know no safe depository of the ultimate powers of the society but the people themselves and if we think them not enlightened enough to exercise their control with a wholesome discretion, the remedy is not to take it from them, but to inform their discretion by education. This is the true corrective of abuses of constitutional power."

Thomas Jefferson -- 1820

Thomas Jefferson Institute for Public Policy
8107 Long Shadows Drive
Fairfax Station, Virginia 22039
703/690-9447