BACON'S REBELLION
The Op/Ed Page for Virginia's New Economy

The Incredible Expanding Budget Surplus

I hate to tell you, "I told you so," but… I told you so. Virginia is awash in black ink. The new budget numbers should energize the low-tax movement.

By James A. Bacon

The tremors that shook California last week were mere teacup rattlers compared to the earthquake that buckled the political landscape in Richmond Friday. If you relied upon the political seismographs of Virginia's Mainstream Media, you might not have noticed the shifting of the tectonic plates. But the aftershock will reverberate through November's House of Delegates election and well into the 2006 General Assembly.

The Washington Post buried the 12-paragraph story, "Virginia Tax Revenue Outpacing Forecast," on page B-4 Friday. While *The Richmond Times-Dispatch* gave front-page coverage to Rep. Robert C. Scott paying off some $80,000 in credit card debt, it apparently overlooked the testimony of John M. Bennett, the state's finance secretary, to the Senate Finance Committee. I couldn't find news coverage anywhere in Friday's newspaper or on the *T-D*'s website.

But here in the *Bacon's Rebellion* insurgency command bunker, it's very big news when the Warner administration's budgetary point man acknowledges that, for 11 of 12 months of the current fiscal year, state revenues are running 15.2 percent ahead of last year -- and 4.9 percent ahead of forecasts.

There are two reasons why the Incredible Expanding Budget Surplus is very big news. The first is that it vitiates the justification for the $1.4 billion in tax increases passed in 2004 by the General Assembly at the behest of Gov. Mark R. Warner. The second is that it induces a healthy skepticism of the long-term forecasts that Senate Finance Chair John H. Chichester is using to justify another tax increase to fund expanded transportation spending.

The Warner administration, as you may recall, had done a creditable job of handling Virginia's financial affairs through the recent recession. Warner, Bennett and the rest of his financial team acted quickly and aggressively to stem the rising tide of red ink, and they reformed accounting systems, especially in the Virginia Department of Transportation, to give a much more accurate picture of how revenues and expenses were matching up. If Warner had topped off those achievements by completing the nitty-gritty work of cutting costs by streamlining government, he could have completed his term as governor as an hero indisputably worthy of national office. But he didn't. He chose to expend his political capital on increasing taxes--taxes that we now know we didn't need.

Although the budgetary situation had stabilized by late 2003 and early 2004, Warner and Chichester raised the specter of a looming, long-term "structural budget deficit." Revenue increases from economic growth, they argued, would prove insufficient to cover the state's pressing needs in education, Medicaid, transportation, mental health, etc.

I didn't buy their logic. As I wrote in "The Horror! The Horror!" back in February 2004:

Thanks to stronger-than-forecast economic growth, Virginia will carry over a larger surplus and have a broader tax base than forecast ... [in Warner's] proposed 2005-2006 budget. ...

The Warner administration based the current, fiscal 2004 budget on the assumption that General Fund revenues would grow by 4.6 percent. According to the secretary of finance's December 2003 monthly revenue report, the administration now is projecting 6.7 percent revenue growth. That means Virginia is on track to run up a surplus of approximately $250 million this year.

Secretary of Finance John Bennett has built equally conservative assumptions into his budget forecasts for General Fund revenues for the next two years. Under a no-tax-increase scenario, revenue growth looks like this:

Fiscal 2005 – 5.3 %
Fiscal 2006 – 5.1 %

These rates of growth represent a deceleration from this year's growth, even though Virginia, like the nation as a whole, is in the expansionary phase of the business cycle. These estimates also are much lower than rates Virginia experienced during the last economic expansion, which reached levels -- admittedly unlikely to be repeated -- of 14.7 percent in 1999 and 11 percent in 2000.

However, there is a good chance of seeing better-than-anticipated revenue growth in 2005. In just the past month, economists have revised their growth forecasts sharply upward. The Warner budget for fiscal 2005 is predicated on real growth in domestic product of 3.8 percent. The Conference Board Economic Forecast has projected that U.S. growth could reach 5.7 percent this calendar year, which overlaps six months with Virginia 's fiscal 2005.

In a $12 billion budget, every extra percentage point of revenue growth translates into $120 million. If the Warner administration has underestimated near-term economic growth –- based as it was on now-obsolete information -- Virginia could run up hundreds of millions of dollars in unbudgeted revenues over the next two years.

Please forgive me for quoting myself at such length, but I do believe that I have been totally vindicated by events and, therefore, write with some credibility on the topic. If anything, I was too tempered in my criticism: The gusher of black ink was even more bountiful than I had dared predict.

The foreseeable result of these surging revenues was a massive budget surplus this fiscal year. On the eve of the 2005 General Assembly session, the ballooning size of the surplus was evident to all. By December 2004, Warner was forecasting that FY 2004 revenues would exceed the budget by $918.7 million. He neglected to observe that those additional revenues exceeded the roughly $700 million a year in revenues that the new taxes were expected to yield on an ongoing basis, and that he could have financed his entire spending plan, including the goal of pumping hundreds of millions of dollars into education, simply by leaving well enough alone.

To his credit Warner did not funnel the funds into expanded programs, but used them mainly to eliminate jinky budgetary practices left over from the recession years, and to fund mainly one-time expenses, primarily in transportation. The General Assembly, for the most part, went along.

But it seems that Warner's bean counters have underestimated revenues yet again, meaning that, even after spending nearly an extra billion extra dollars this year, the Commonwealth still will be floating in surplus funds in June when the 2005 fiscal year ends. Further, it is predictable that, although this year's 15 percent revenue growth is not sustainable, revenues still will come in way ahead of Bennett's conservative forecast for 2006.

The surplus is massive -- equivalent to a year's worth of the kind of modest economic growth that Bennett was plugging into his budget models back in 2004. When Bennett closes the books on FY 2005, Virginia will have pulled in more revenue than he had forecast for FY *2006*! Even if revenue growth slows from its torrid pace, as surely it must, it still will be faster than Bennett was assuming when he was supplying the numbers and charts that Warner used to scare legislators and public into passing the tax increase.

For that and other reasons, I would argue that the structural budget deficit of Warner's fears now has become a structural *surplus.* In fact, economic growth has been so strong that Virginia would be enjoying chronic budget surpluses even if it had never passed the $1.4 billion biennial tax increase at all.

This new fiscal reality should have far-reaching political repercussions. Luckily for a half dozen Republican House of Delegates incumbents who faced challenges from the low-tax wing of the GOP, the news of the Incredible Expanding Budget Surplus did not surface until after the primary elections. Had the news broken a couple of weeks earlier, the challengers surely would have used it to flagellate the incumbents who'd broken ranks with the GOP House leadership and capitulated on the 2004 tax hike.

As it is, the Incredible Expanding Budget Surplus is so huge that it cannot be swept under the rug. It will generate big headlines in June when the state closes out its books. Most GOP candidates can use that surplus to flay Gov. Warner and his Democratic allies running for election in the House. The facts have shifted so strongly in favor of the low-tax movement that we actually may see a revival of discussion about which taxes need *cutting*.

The Incredible Expanding Budget Surplus also undercuts those who want to raise taxes in 2006 to pay for more road and transit projects. The case for increasing taxes is built on two long-term projections.

One widely disseminated chart projects that highway maintenance costs are increasing at such a rapid rate that there will be no state funds--not one dime--left over for new road construction by 2019. Indeed, maintenance costs are projected to start eating into federal highway construction dollars allocated to Virginia.

Now, I don't know who generated these numbers or who prepared this chart. But the Virginia public may be forgiven if, after witnessing the difficulty of the Warner administration had in forecasting General Fund revenues one year out, it mistrusts a chart forecasting fiscal calamity *15 years* out. Such forecasts are essentially political documents embedded with unstated assumptions and fine print designed to make the case for higher taxes.

The other long-term projection is the VTrans2025 study of Virginia's transportation needs for the next 20 years. Page 14 of this report asserts that Virginia faces $108 billion in "unmet transportation needs" -- mostly highway and public transport projects which cannot be funded from currently existing revenue sources. Proponents of a tax increase have bandied about this number uncritically and, to this point, no one in the low-tax movement has seen fit to question it.

But such numbers are based on econometric models loaded with assumptions that are never made public. Among those assumptions are projections of population growth, economic growth and driving habits. Again, given the administration's dismal track record in projecting budget revenues one year out, the public can be forgiven if it treats 20-year forecasts of complex demographic and economic phenomenon with a soupcon of suspicion.

I would humbly suggest that Gov. Warner needs to spend less time leading the National Governors Association and thinking about his bid for the United States presidency, and more time tending to developments back home. If he doesn't do some fancy maneuvering, he may find that the signature accomplishment of his term--the 2004 tax hike--will be repudiated shortly after his departure from office in January 2006.

I also would caution Sen. Chichester and his allies in the state senate. It may be two more years before they face the wrath of Virginia voters in another election. But if they press for another massive tax increase on top of the 2004 levies and two years of enormous surpluses, their credibility will be shredded. There will be electoral payback.

Apologists for an ever-growing government will do their best to change the subject away from the flawed budgetary projections by reciting the usual litany of unmet needs, from underpaid teachers to inadequate mental health facilities. Some of these concerns are legitimate, and there are ways to address them, which I will enumerate in future columns. But the case is building that the General Assembly should give taxpayers their money back. The Incredible Expanding Budget Surplus has decisively altered the terms of political debate.

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Read more columns by Jim Bacon at
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