

A FISCAL CRISIS IN OUR LOCAL GOVERNMENTS PART 2

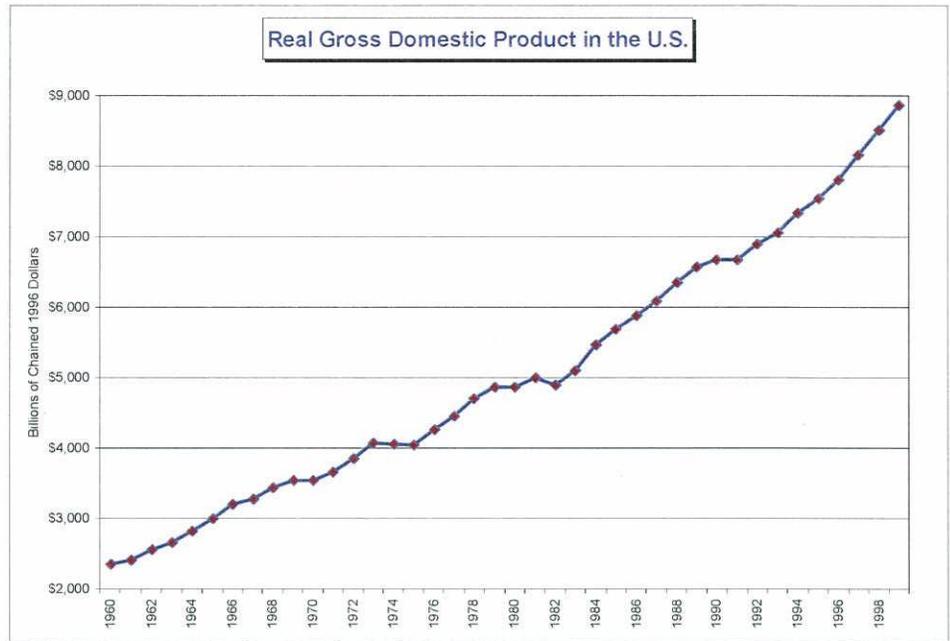


April 2000

E00-01A

As a nation, we're enjoying the longest economic boom in a century. Salaries keep increasing, the stock market continues to rise, and businesses are growing.

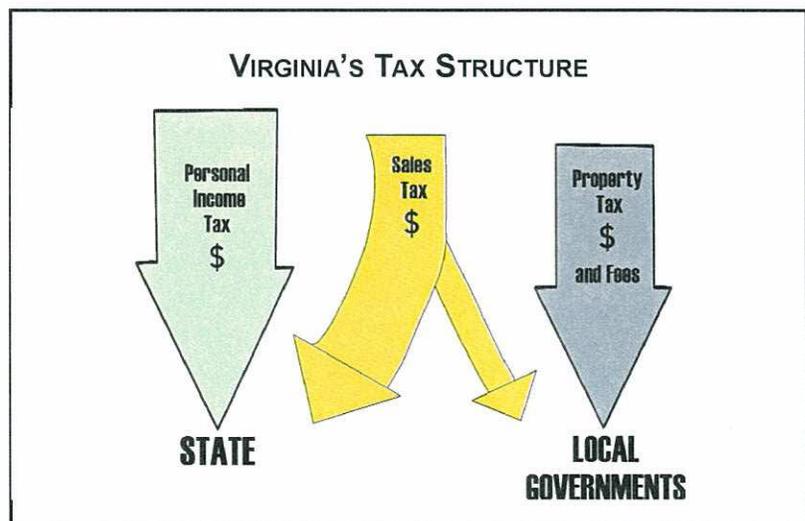
Yet local governments in Virginia are straining financially. The cities and counties of Hampton Roads are not receiving enough revenue to meet the needs of our communities. That's money needed to support our schools, protect the safety of our communities, and enhance the quality of life in Hampton Roads.



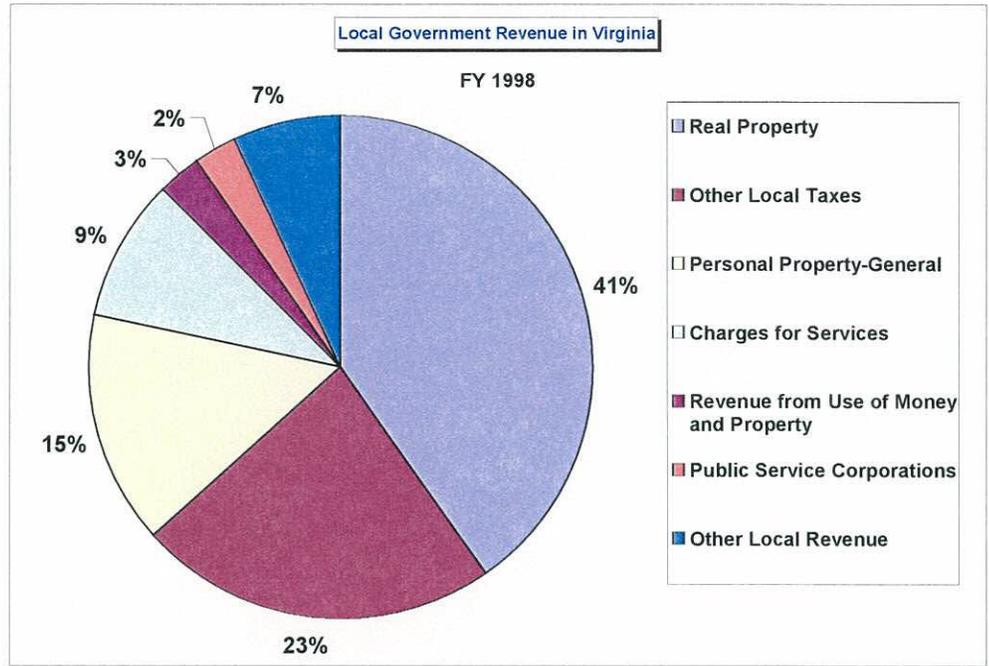
Source: Economic Report of the President

Virginia's current tax structure limits the ability of our cities and counties to raise revenue as the economy expands. All personal income tax money goes to the state. Cities and counties rely heavily on property taxes and fees and receive only a small portion of sales tax revenues.

Since personal incomes and retail sales are growing faster than taxable property values, the state government's revenue is increasing faster than local government revenues. Being dependent on slower growing property tax revenues is putting our cities and counties at a critical financial disadvantage.

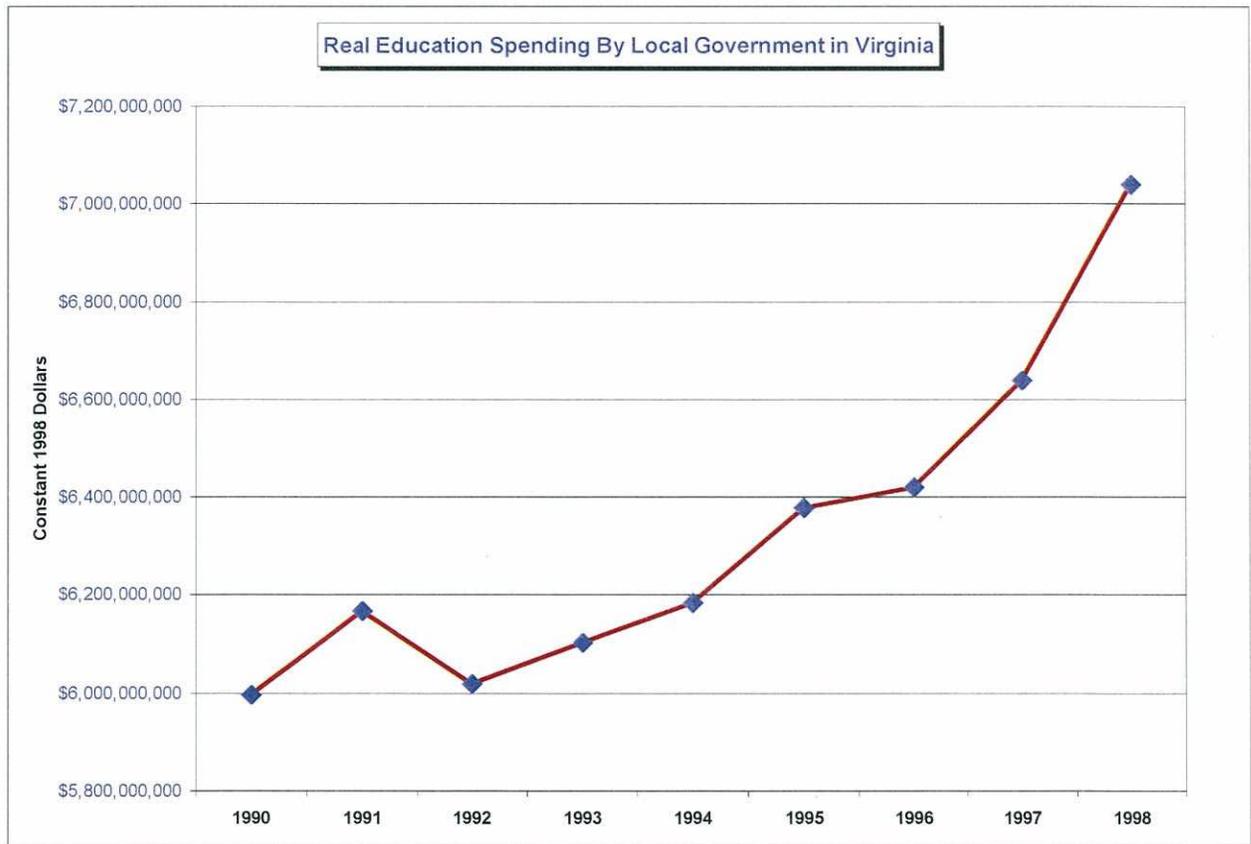


The value of real estate properties strongly affects local government revenues. In 1998, real estate property tax revenue was 41% of all revenue raised by local government in Virginia. The amount of real estate tax paid is based on the value of the property and the tax rate. In the past ten years, real estate values in Hampton Roads have risen slowly and have not kept up with inflation.



Source: Auditor of Public Accounts

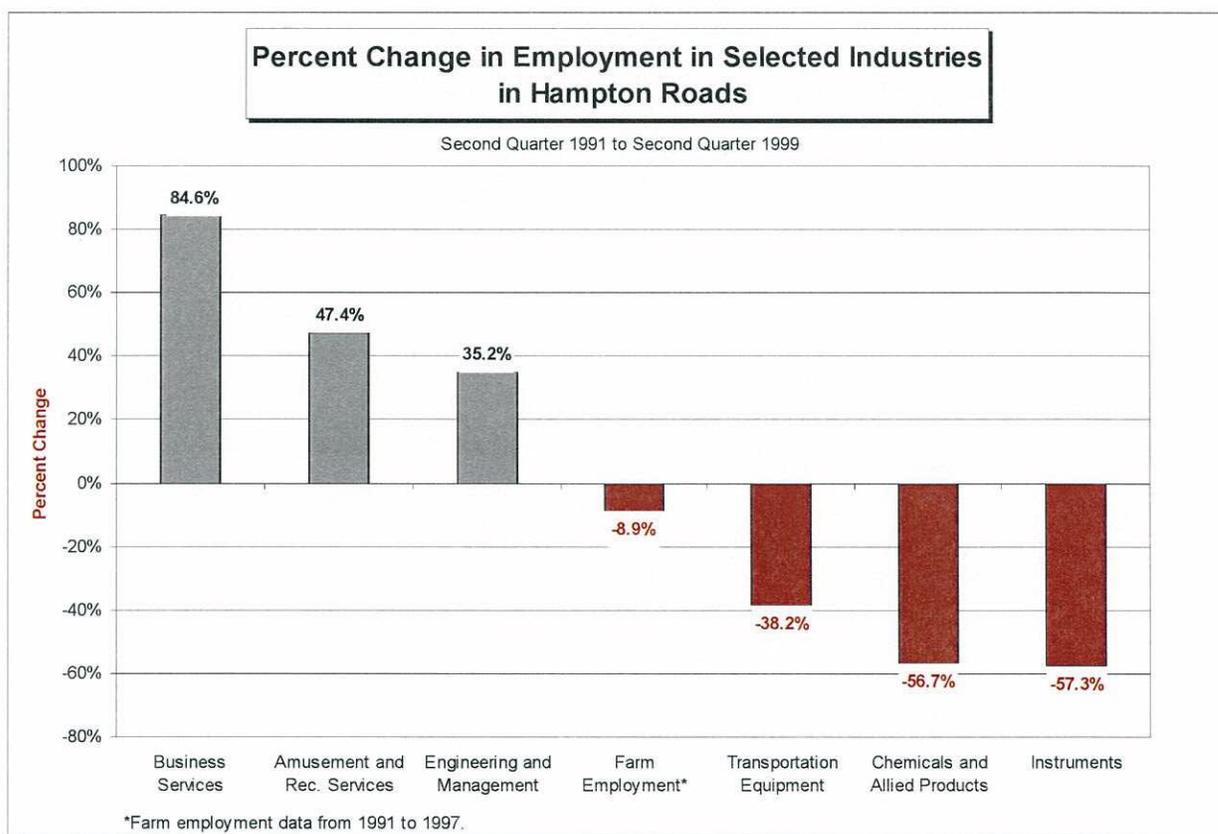
At the same time, costs for services are rising. Education spending by Virginia's local governments has increased 17.4% between 1990 and 1998 — when adjusted for inflation. Property tax revenues are not keeping up with the rising costs of community services.



Source: Auditor of Public Accounts

In addition to real estate, property taxes are also collected on business equipment and vehicles. A change in economic trends has led to slow growth of this tax base, which has contributed to the slow growth in local government revenues.

In the past, manufacturing and agriculture — which require owning a lot of taxable property, have been major industries in Hampton Roads. However, service and retail industries are replacing manufacturing and agriculture throughout the region. For example, employment in business services increased by over 84% between 1991 and 1999; amusement and recreational services were up 47%; and engineering and management services experienced a 35% gain. In contrast, employment in chemical manufacturing dropped 58% between 1991-1999; instrument manufacturing decreased by 57%; and transportation equipment manufacturing, including shipbuilding, is down 38%. From 1991 to 1997, agricultural employment dropped almost 9%. Over a 20-year span (1977 to 1997), agricultural employment dropped 45%.



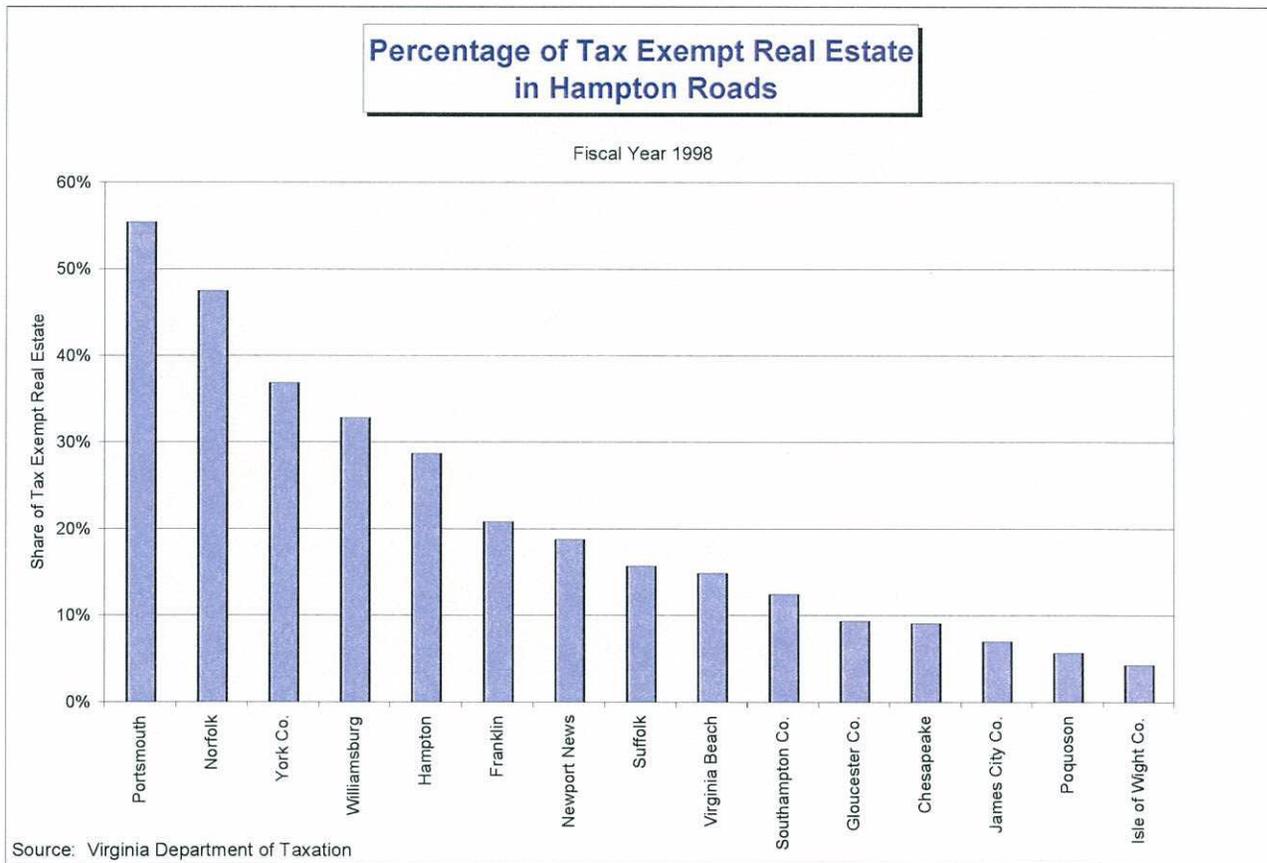
Sources: VA Employment Commission & Bureau of Economic Analysis

Often businesses that provide services do not need as much taxable property as companies that manufacture goods. For example, a manufacturing company may own several buildings for production, distribution and storage. It uses machinery to build and package its products, as well as office equipment to manage the operation. All of this is taxable property. However, a company providing consulting services typically owns only basic business equipment that's taxable — such as computers, telephones, copiers and furniture.

Local governments receive comparatively little revenue from the property taxes of service businesses, while the state receives substantial income tax revenue.

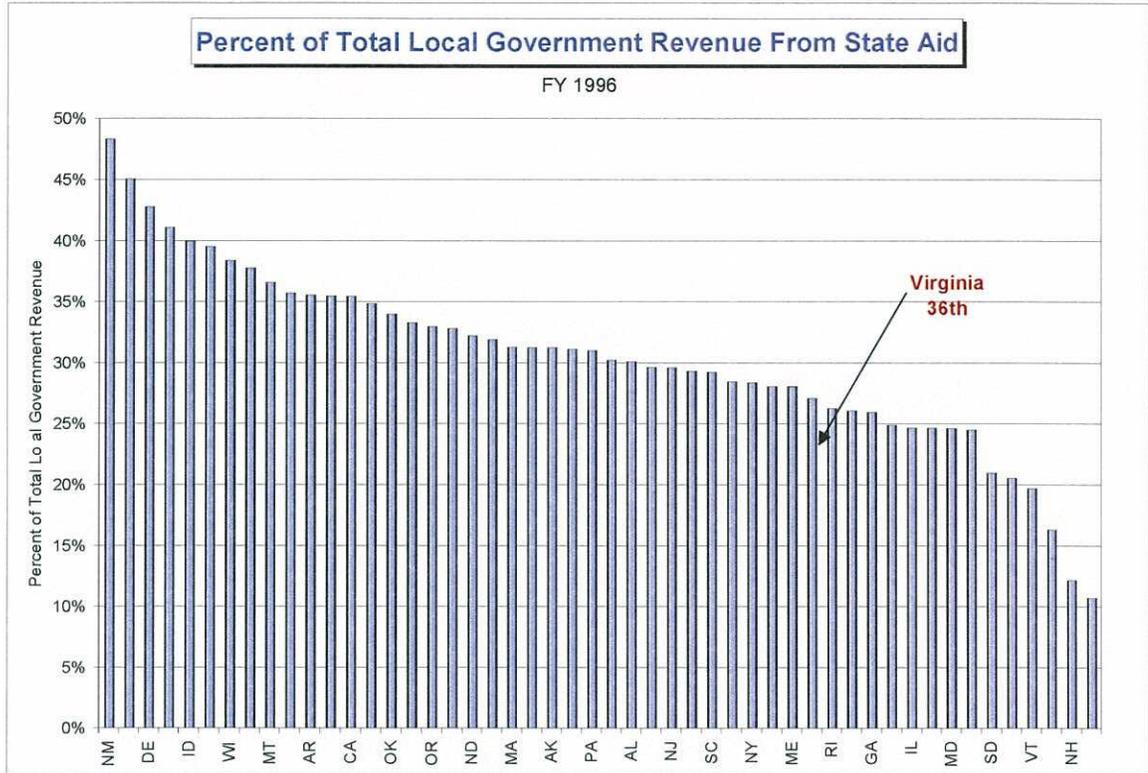
Tax exemptions also limit the revenue that cities and counties receive. Much of the real estate property in our region is tax exempt. Properties owned by the federal and state governments and non-profit groups, such as churches and charitable organizations don't pay real estate property taxes, although sometimes small payments are made in lieu of taxes.

With the number of government installations in Hampton Roads, about twenty billion dollars worth of property is not taxed. The City of Norfolk has over six billion dollars of tax-exempt property. And more than half of the real estate property in Portsmouth is not taxed. Yet local services must be provided to benefit all of the tax-exempt properties throughout the region.



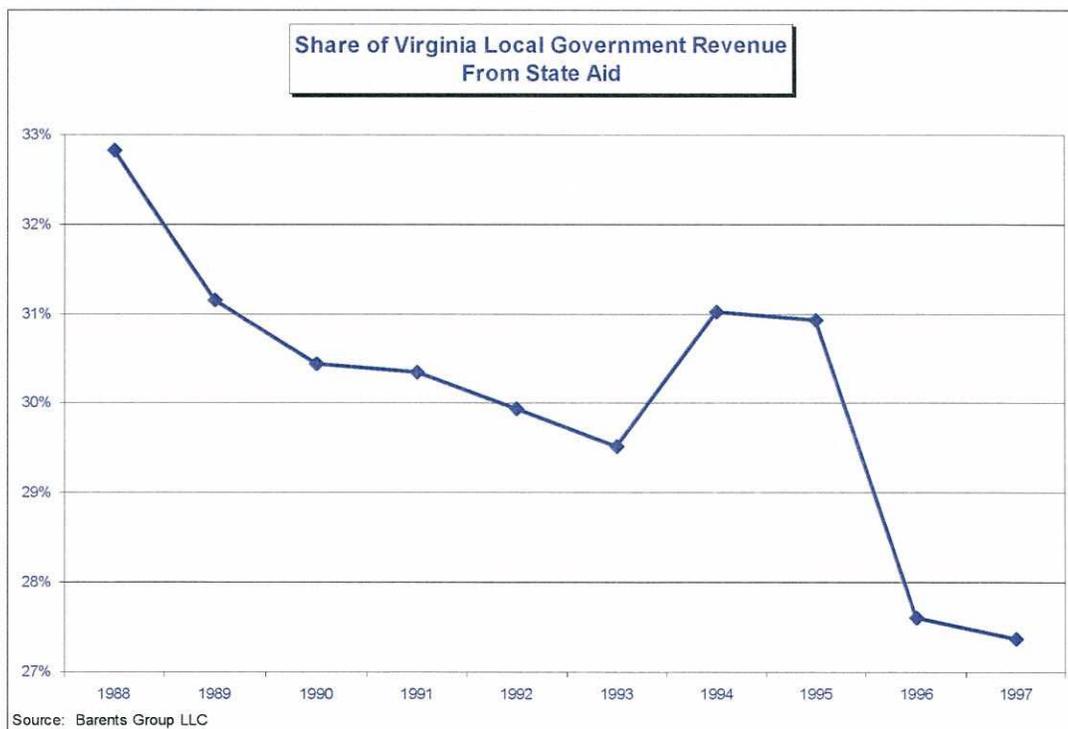
The growth of Internet sales and the increase in mail order business are another threat to local government funds. The U.S. Supreme Court has ruled that states cannot force companies, selling over the Internet, to collect sales taxes. As more and more people make purchases over the Internet and by mail, sales tax revenues could diminish. This could reduce much-needed funding for local education that the state redistributes to cities and counties from a portion of the sales tax revenue.

Another reason for local government's fiscal stress is the small amount of state aid received from the Commonwealth. Out of all 50 states, Virginia ranks thirty-sixth in providing state funds to local cities and counties.



Source: U.S. Census Bureau

And our state aid is declining. In 1988, 33% of the total local revenues in our cities and counties came from state aid. In 1997, that number fell to 27%.



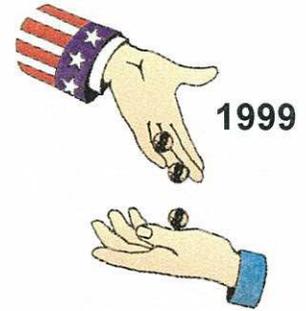
Source: Barents Group LLC



Federal aid has also declined.

In 1977, eleven cents out of every dollar of local revenue came from the federal government.

Currently, the federal government only contributes about three cents out of every dollar.



Federal aid includes providing funds to localities with high military populations to help offset education costs. Under this Federal Impact Aid Program, communities in Hampton Roads were supposed to receive close to 50 million dollars in the 1998-99 school year, but received only 25 million dollars.

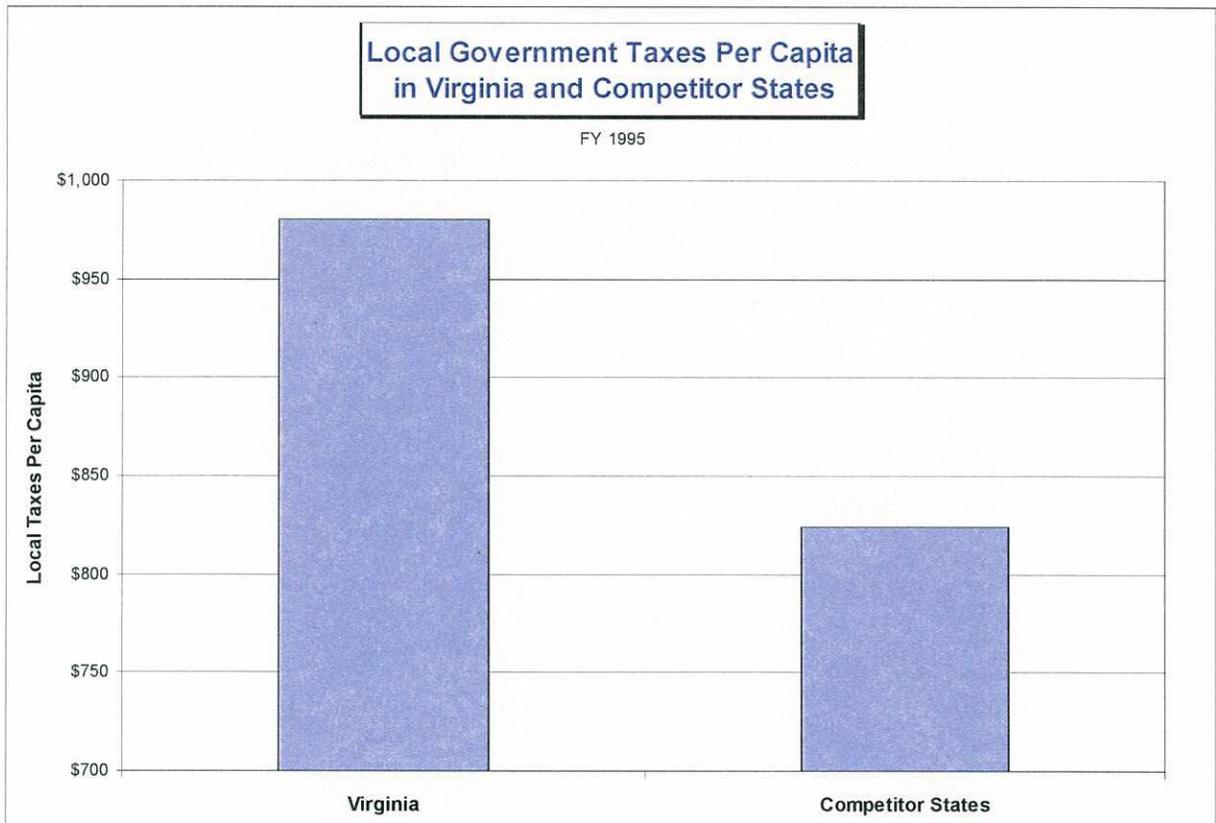
**FEDERAL IMPACT AID FOR HAMPTON ROADS
1998-99 SCHOOL YEAR**

LOCALITY	\$ RECEIVED	\$ IF FULLY-FUNDED	\$ SHORTFALL
Chesapeake	1,400,000	3,400,000	2,000,000
Gloucester County	25,000	223,000	198,000
Hampton	900,000	3,000,000	2,100,000
Isle of Wight County	16,000	65,000	49,000
Newport News	2,600,000	6,400,000	3,800,000
Norfolk	5,400,000	10,000,000	4,600,000
Poquoson	83,000	203,000	120,000
Portsmouth	867,000	2,300,000	1,433,000
Suffolk	24,000	285,000	261,000
Virginia Beach	7,300,000	14,700,000	7,400,000
York County	<u>6,200,000</u>	<u>8,800,000</u>	<u>2,600,000</u>
	22,815,000	490,376,000	\$24,561,000

Source: National Association of Federally Impacted Schools

In addition, under the Individuals with Disabilities Education Act, the federal government was to provide 40% of special education needs for the disabled. However, local governments have never received more than 11%, meaning a loss of about sixty-two million dollars a year in special education funds for Hampton Roads. Our cities and counties are mandated to provide these services, so they have to use local tax dollars.

Our local governments must comply with many regulations, including: standards for education, the environment, transportation, and public health. The state and the federal government establish policy and make these demands without providing our cities and counties with the needed financial support. Unfunded mandates are putting tremendous stress on local governments. Local governments have no one to turn to for funding but local taxpayers.



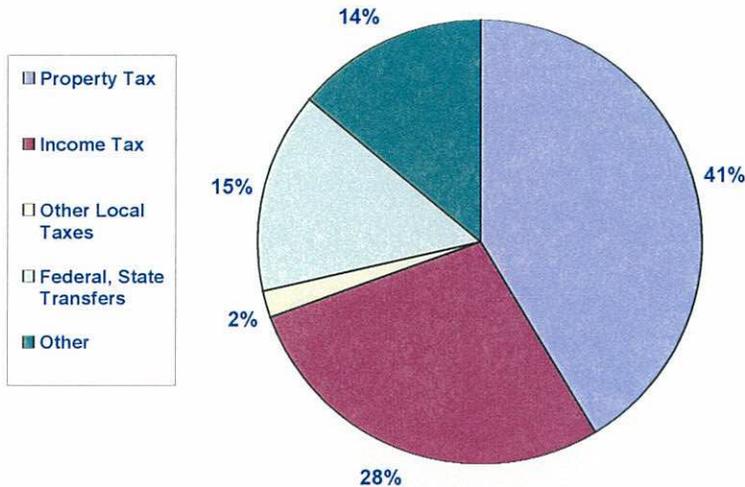
Source: Barents Group LLC

With declining state and federal aid and the current tax structure, cities and counties have had to find money elsewhere. As a result, per capita local taxes in Virginia are 19% higher than nearby Southeastern states.

And higher local taxes reduce the region's ability to compete for new businesses and economic development that could bring more revenue into the region. To say nothing of the unfair burden they place on local taxpayers.

Tax structures in other states are giving local governments more revenue, making them more competitive. For example, let's compare two counties similar in population - Fairfax County in Virginia and Montgomery County in Maryland. In fiscal year 1998, Montgomery County's revenue grew twice as fast as Fairfax County's.

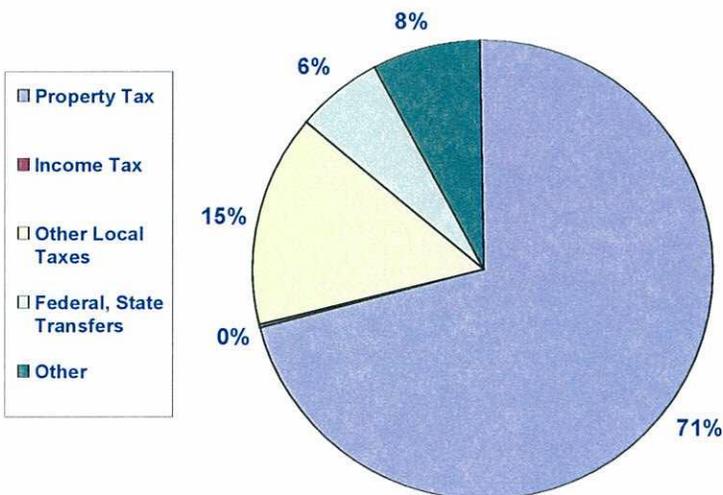
Distribution of Local Government Tax Revenue in Montgomery County, Maryland



Montgomery County's revenues are increasing at a faster rate because they don't depend on property taxes as heavily as Fairfax County. Montgomery County received 28% of their revenue from income tax. Fairfax County received no direct revenue at all from income tax.

Also, 71% of Fairfax County's revenue came from property taxes in fiscal year 1998. In Montgomery County, only 41% of its revenue came from property taxes.

Distribution of Local Government Tax Revenue in Fairfax County, Virginia



Incomes have been rising faster than property values. In Virginia, this means that the state is creating a surplus from sales and income taxes. Yet cities and counties are struggling to make ends meet because of their dependency on property taxes. While we may have enough total tax revenue in Virginia, it is not being distributed fairly to our local governments.

Sources: Fairfax County & Montgomery County

A recent study by an international financial firm, the Barents Group, found that under the current tax system, cities and counties in Hampton Roads will not be able to keep up with growing expenses by the year 2005.

Typically, local governments in Virginia spend the largest portion of their revenue on education, public safety, and health and welfare. Revenues also support public works, parks, recreation, cultural efforts, community development, and administration.

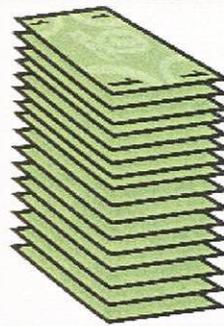
The study estimated how much revenue cities and counties need and how much money they are capable of raising. The gap between revenues and expenses will continue to expand. By 2005, almost all of our cities and counties will not have sufficient revenue.

**PROJECTED HAMPTON ROADS TOTAL EXPENDITURE
NEEDS AND REVENUE-RAISING CAPACITY, 2005**

LOCALITY	2005 PER CAPITA EXPENDITURE NEEDS	2005 PER CAPITA REVENUE CAPACITY	NEED-CAPACITY GAP
COUNTIES			
Gloucester	\$1,553	\$1,052	\$501
Isle of Wight	1,605	1,079	526
James City	1,573	1,627	(54)
Southampton	1,553	911	642
York	1,530	1,170	360
COUNTY AVERAGE	1,563	1,168	395
CITIES			
Chesapeake	\$1,486	\$1,074	\$412
Franklin	2,340	961	1,379
Hampton	1,594	838	756
Newport News	1,755	826	929
Norfolk	1,778	788	990
Poquoson	2,196	1,136	1,060
Portsmouth	1,723	681	1,042
Suffolk	1,734	859	875
Virginia Beach	1,657	1,025	632
Williamsburg	2,288	1,332	956
CITY AVERAGE	1,855	947	903

Source: Barents Group LLC

If the current tax system and trends continue, our counties will need about \$1,600 per person in 2005. However, they will only be capable of raising about \$1,200 per person.

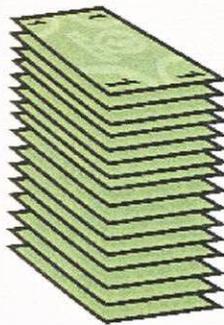


COUNTIES

NEED:
\$1,600 PER PERSON

CAPACITY:
\$1,200 PER PERSON

Our cities, on average, will need about \$1,900 per person. Yet, under the current tax structure, they'll only be able to raise about \$950 per person.



CITIES

NEED:
\$1,900 PER PERSON

CAPACITY:
\$950 PER PERSON

When you add it up, in five years, our cities and counties will be short around \$926 million. There will not be enough funds to provide much-needed services to our communities.

\$926 MILLION SHORTFALL IN 2005



Population is increasing. Mandates and regulations go unfunded. The public demands quality schools, safe communities and good roads. And financial pressure continues to build.

Real estate property values grow slowly. The economy is shifting from manufacturing to service and retail. A large number of properties are tax-exempt. Internet and mail order sales decrease sales tax figures. And federal and state aid is declining. All of these factors put a growing strain on local government's ability to generate funds.

Tax revenues need to be more fairly distributed. It has been reported that the state has a surplus of \$3.4 billion. Yet Virginia's existing tax structure is not giving our cities and counties the revenue they need.

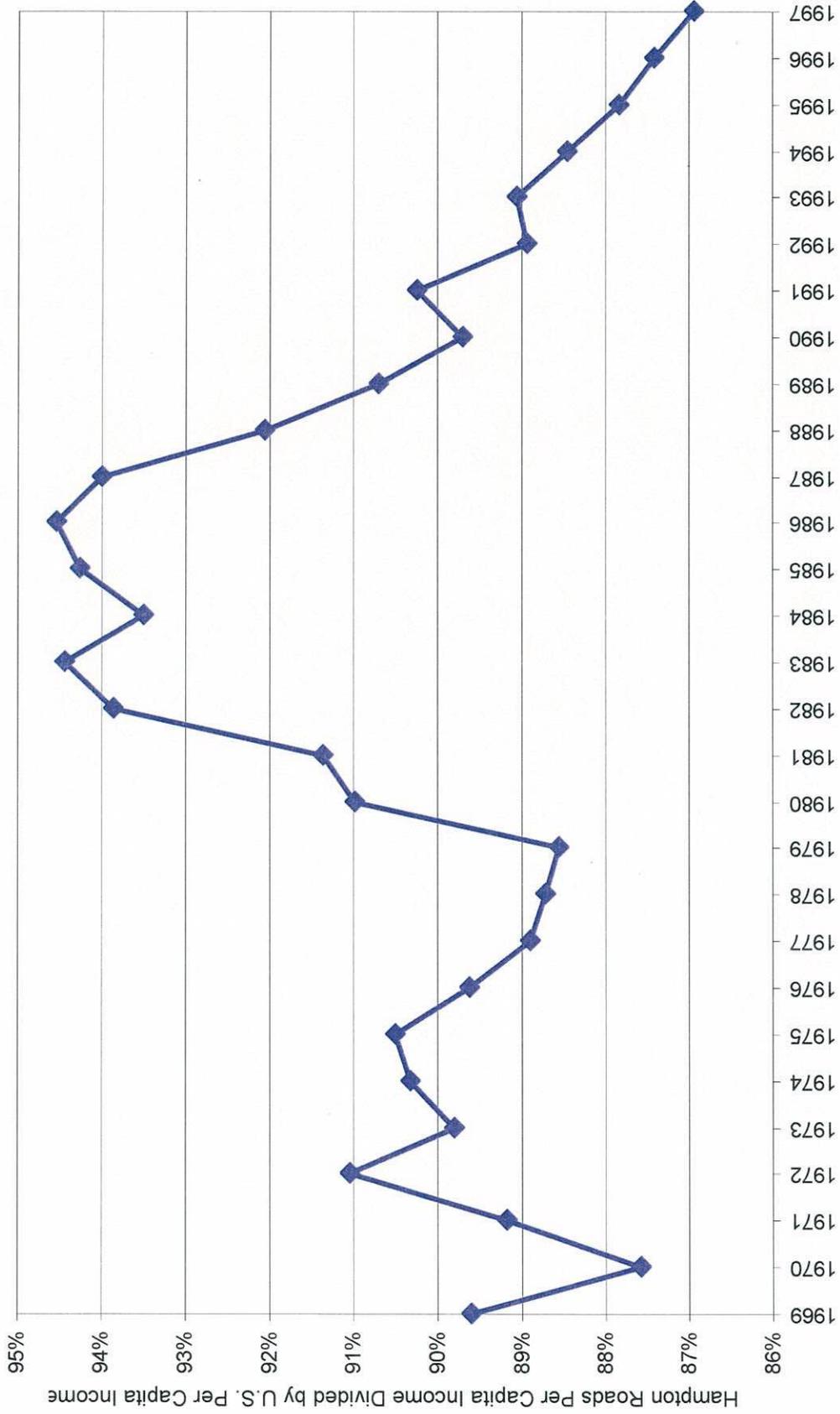
Unless the tax system changes, our cities and counties will be forced in the near future to seek more funds locally, especially through property taxes, or cut back on much-needed community services.

In the next presentation, we'll look at potential solutions to relieve financial stress in our region's cities and counties and examine options that will enable them to generate the revenues needed for the future.

Part 2 Supplemental Data Index

Chart Title	Chart Number
Hampton Roads Per Capita Income Relative to the U.S.	1
Per Capita Income in Metro Areas in Virginia	2
Local Revenue Per \$1000 of Total Personnel Income	3
Total Expenditures by Local Governments in Virginia	4
Percent Change in Real Local Government Expenditures in Virginia	5
Local Government Expenditure on Education Per \$1000 of Personal Income as a Percent of the Virginia Average	6
Revenue Effort in Virginia by Planning District	7
Average Composite Fiscal Stress Index in the Virginia Portion of Virginia Metro Areas	8
Composite Fiscal Stress Index in Hampton Roads	9
Median Home Price in Hampton Roads and Competitor MSAs	10
Change in Real Estate Property Tax Rate	11
Average Increase in Real Property Tax Rates in Each Virginia Metro Area	12
Percent of Localities in Each Virginia Metro Area that Raised Real Property Taxes	13

Hampton Roads Per Capita Income Relative to the U.S.

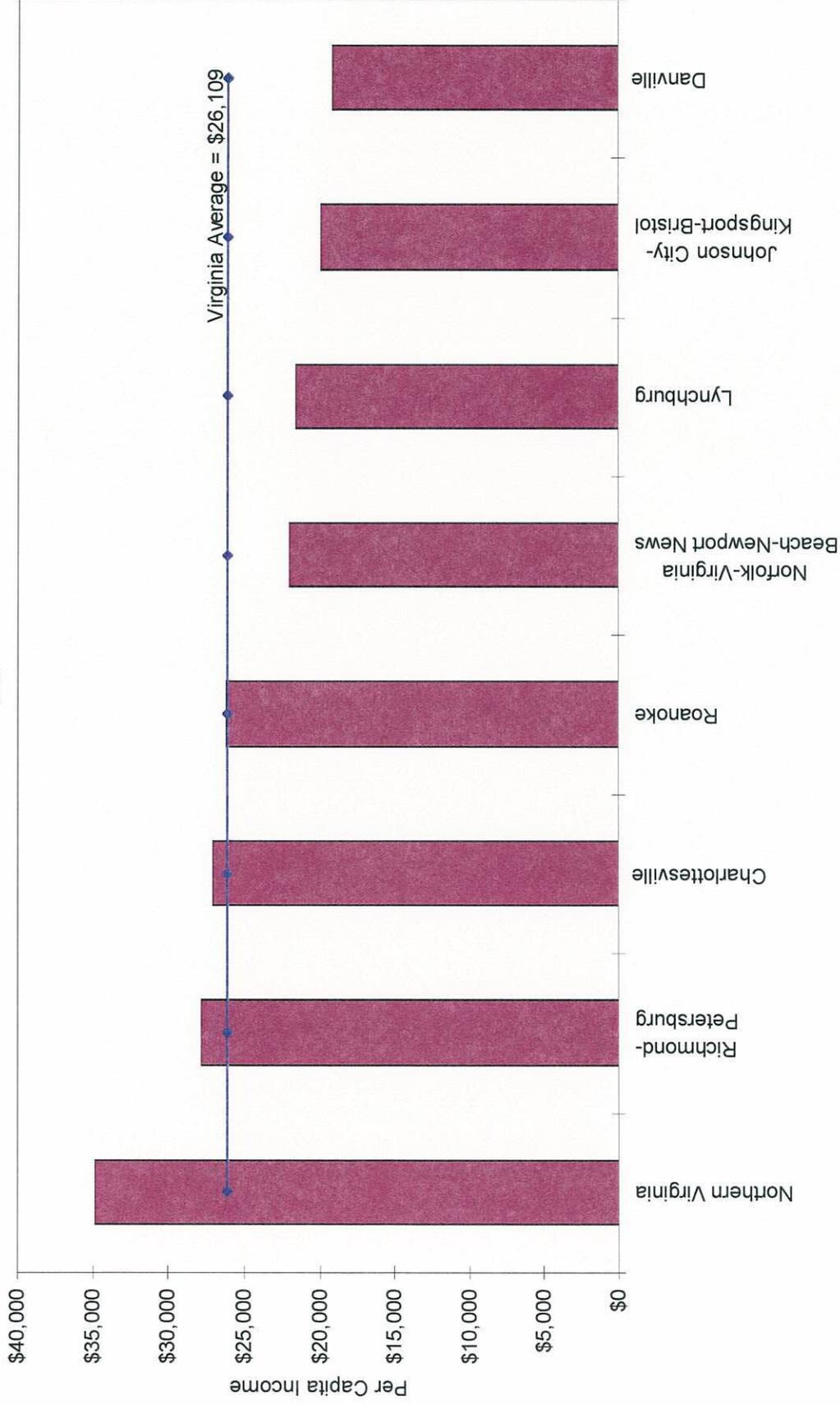


Source: Bureau of Economic Analysis

Chart 1

Per Capita Income in Metro Areas in Virginia

1997

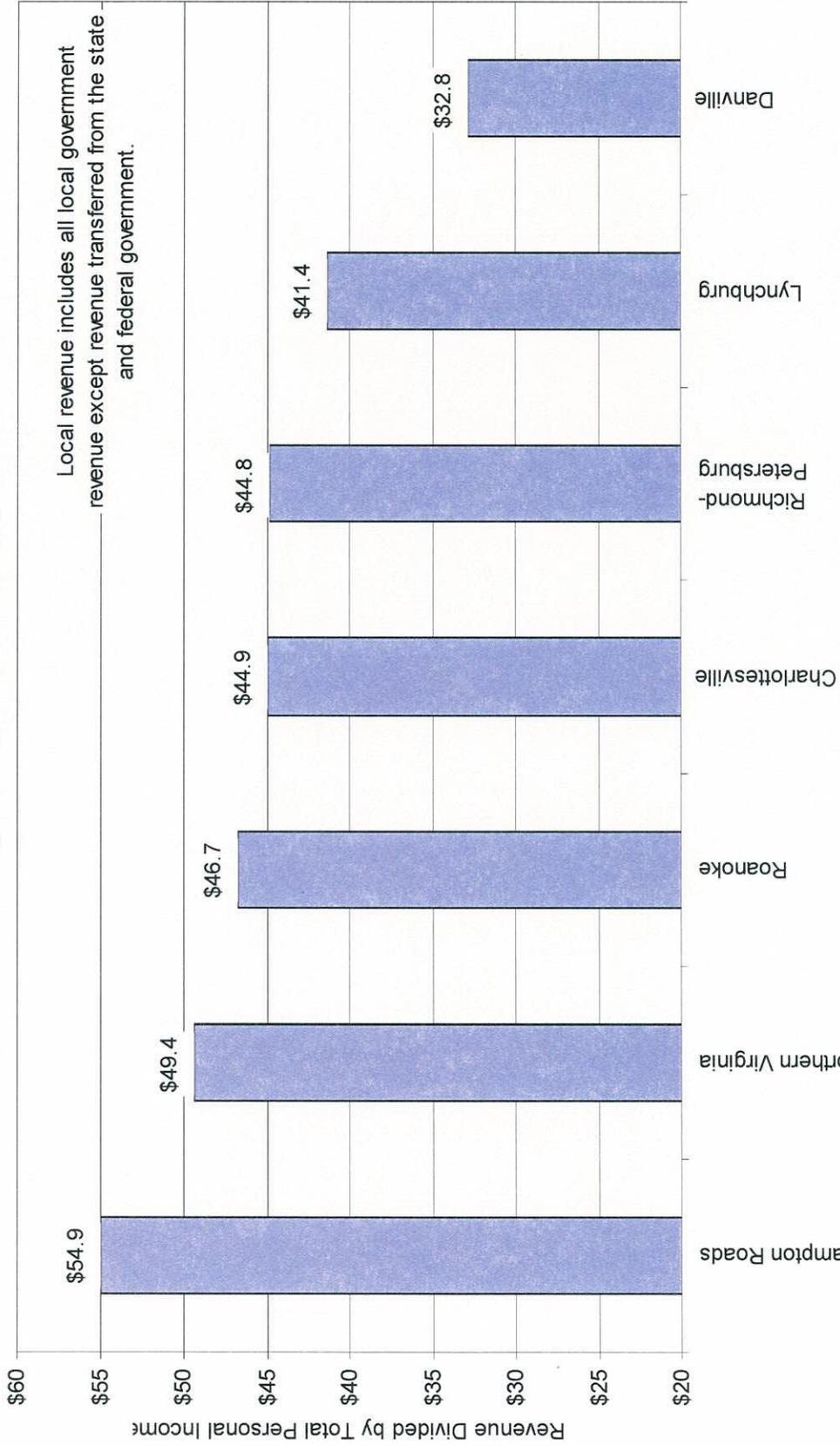


Source: Bureau of Economic Analysis

Chart 2

Local Revenue Per \$1000 of Total Personal Income

Fiscal Year 1998
Virginia Portions of Metro Areas Only



Source: Commonwealth of Virginia Auditor of Public Accounts & Economic Analysis

Chart 3

Total Expenditures by Local Governments in Virginia

FY 1996 In Millions of Dollars

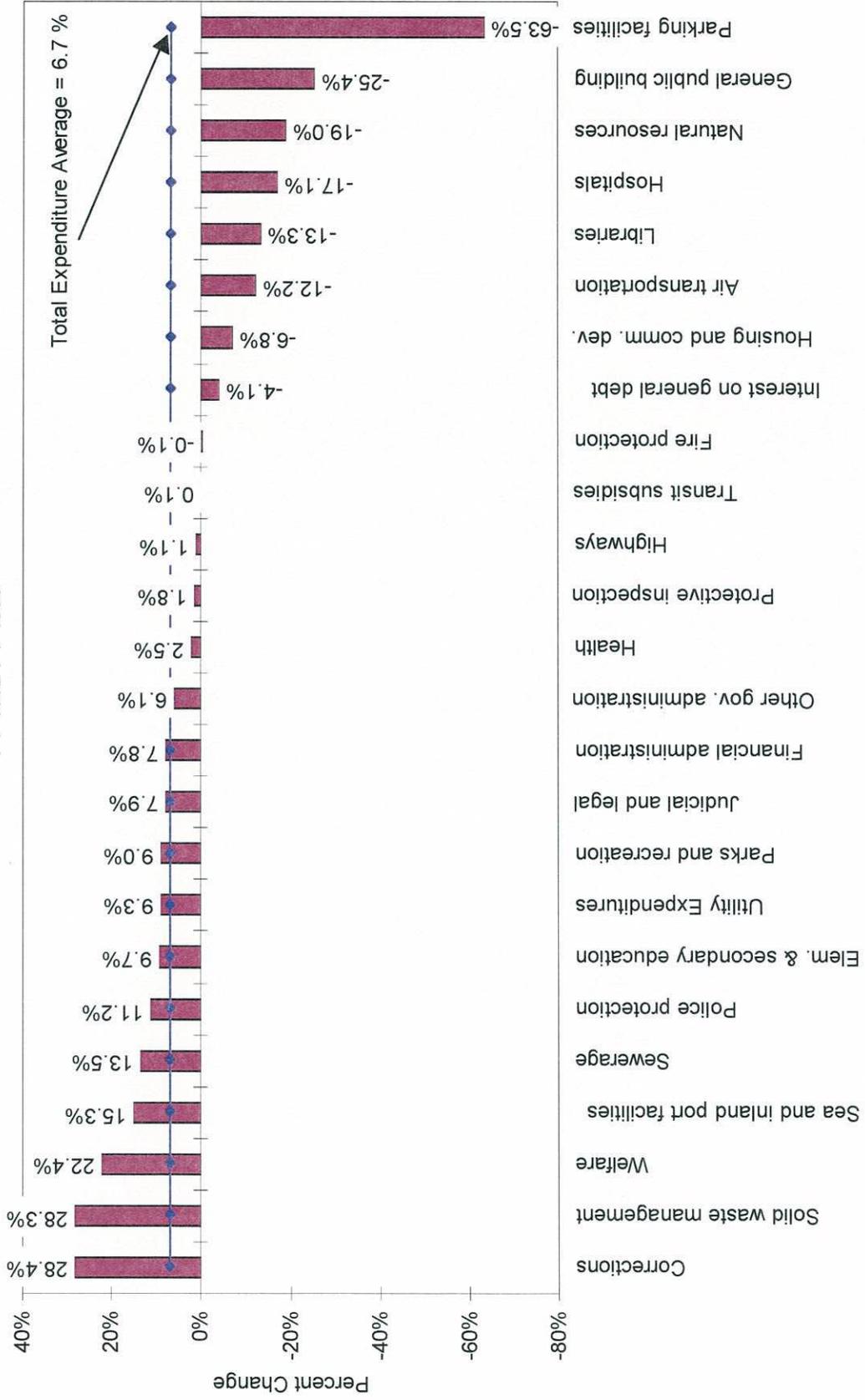


Source: U.S. Bureau of the Census

Chart 4

Percent Change in Real Local Government Expenditures in Virginia

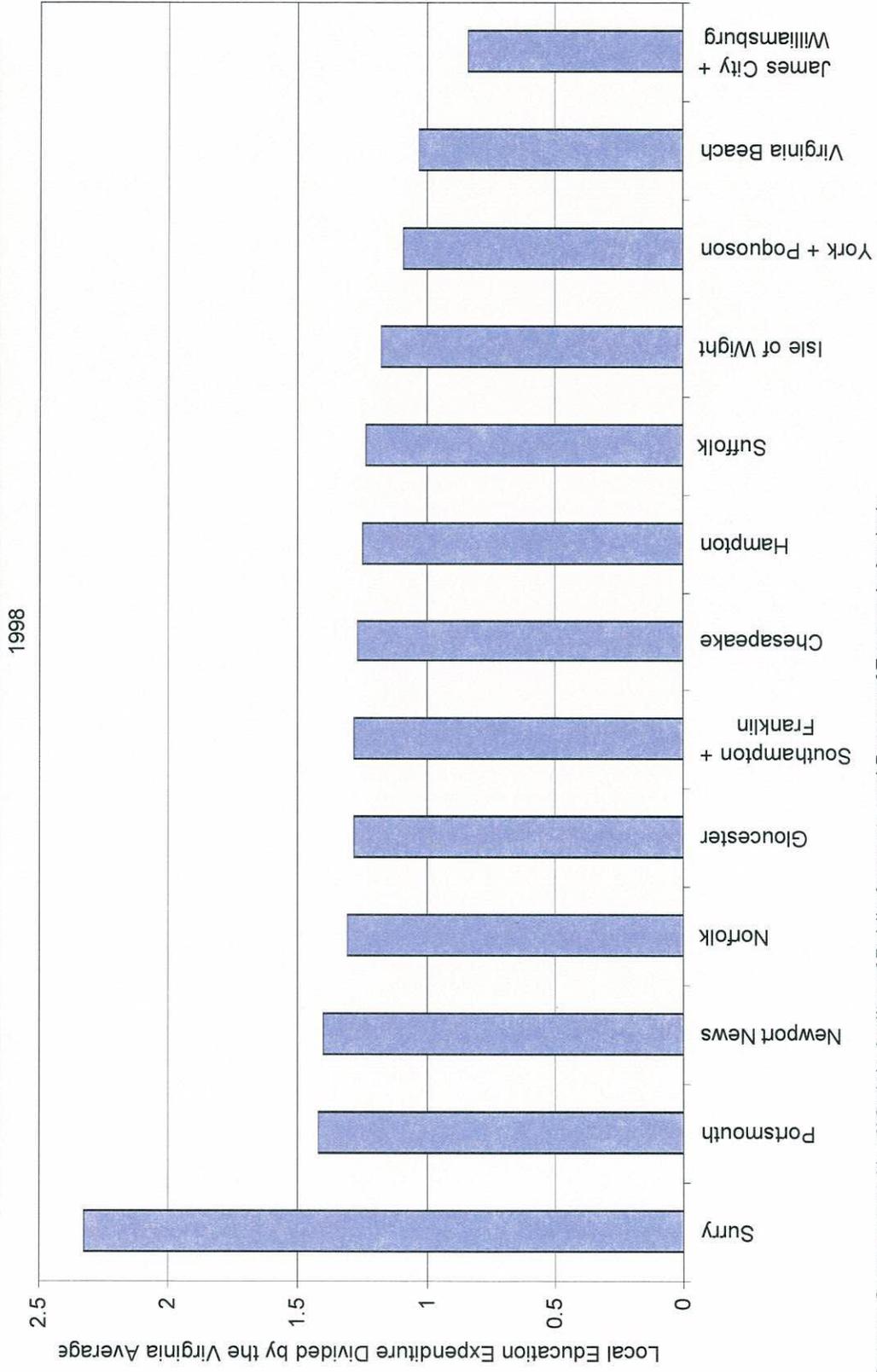
FY 1992-FY 1996



Source: U.S. Bureau of the Census

Chart 5

Local Government Expenditure on Education Per \$1000 of Personal Income as a Percent of the Virginia Average

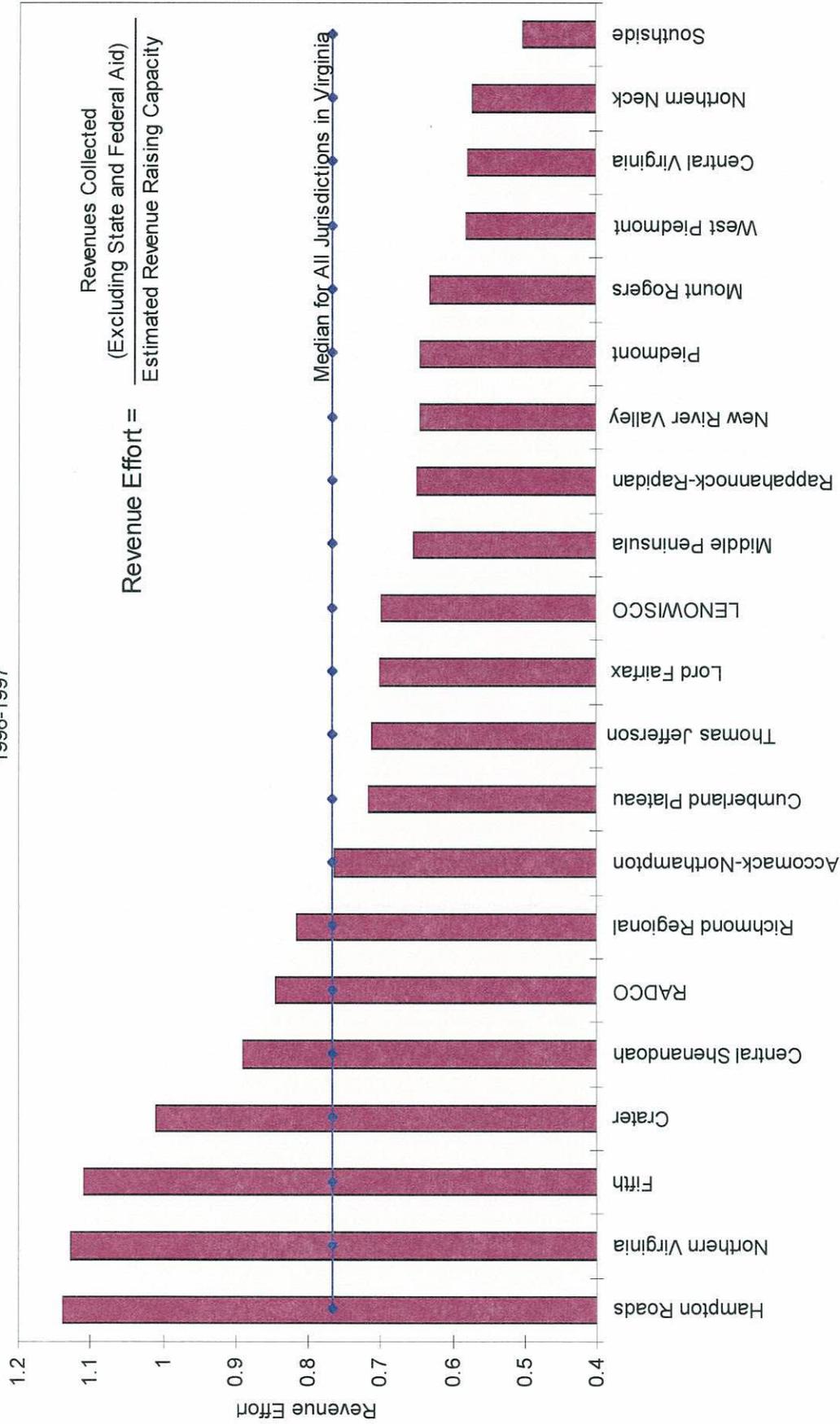


Source: Commonwealth of Virginia Auditor of Public Accounts and Bureau of Economic Analysis

Chart 6

Revenue Effort in Virginia By Planning District

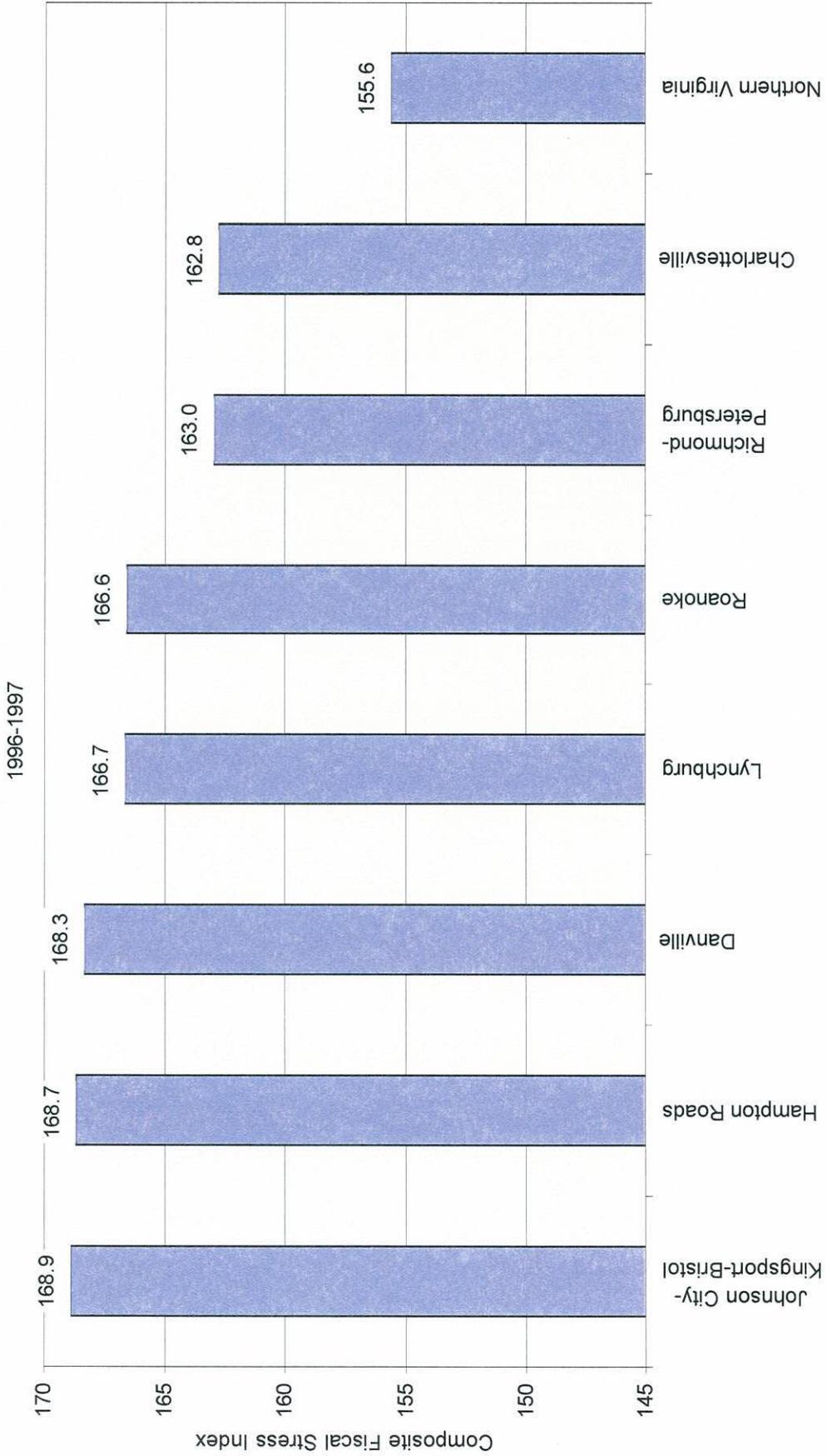
1996-1997



Source: Commonwealth of Virginia Commission on Local Government

Chart 7

**Average Composite Fiscal Stress Index
in the Virginia Portion of Virginia Metro Areas**

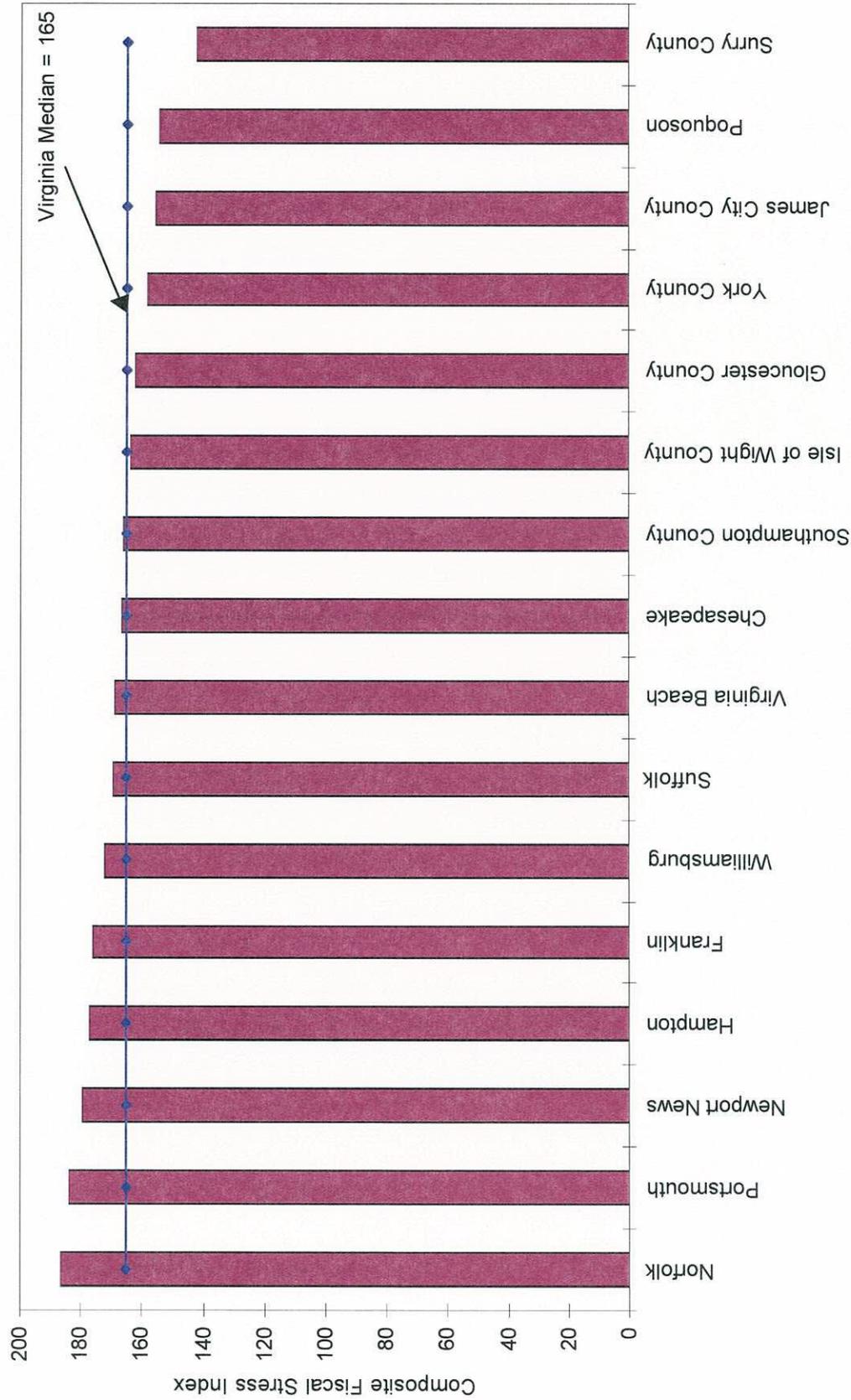


Source: Commonwealth of Virginia Commission on Local Government

Chart 8

Composite Fiscal Stress Index In Hampton Roads

1996-1997



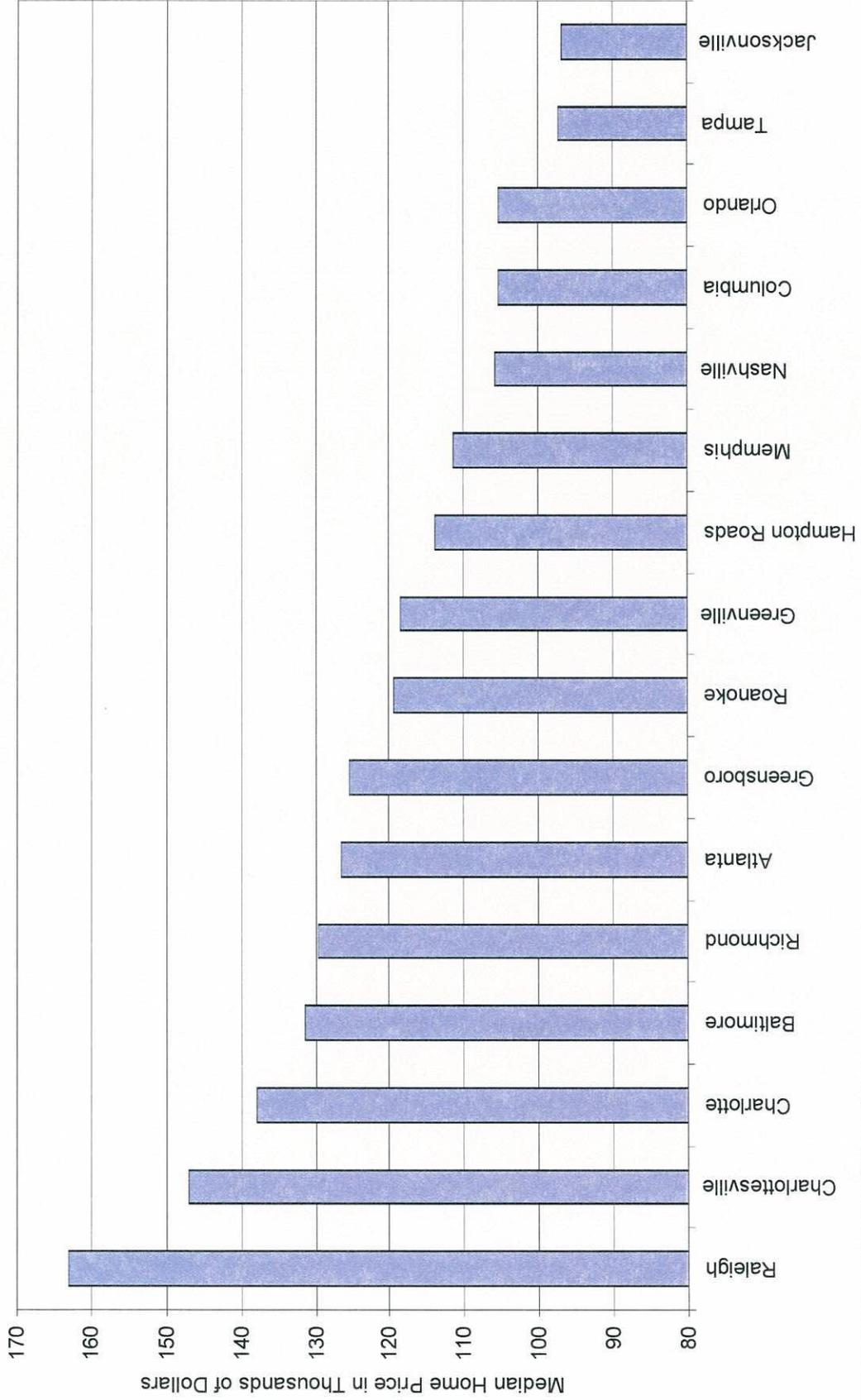
Virginia Median = 165

Source: Commonwealth of Virginia Commission on Local Government

Chart 9

Median Home Price in Hampton Roads and Competitor MSAs

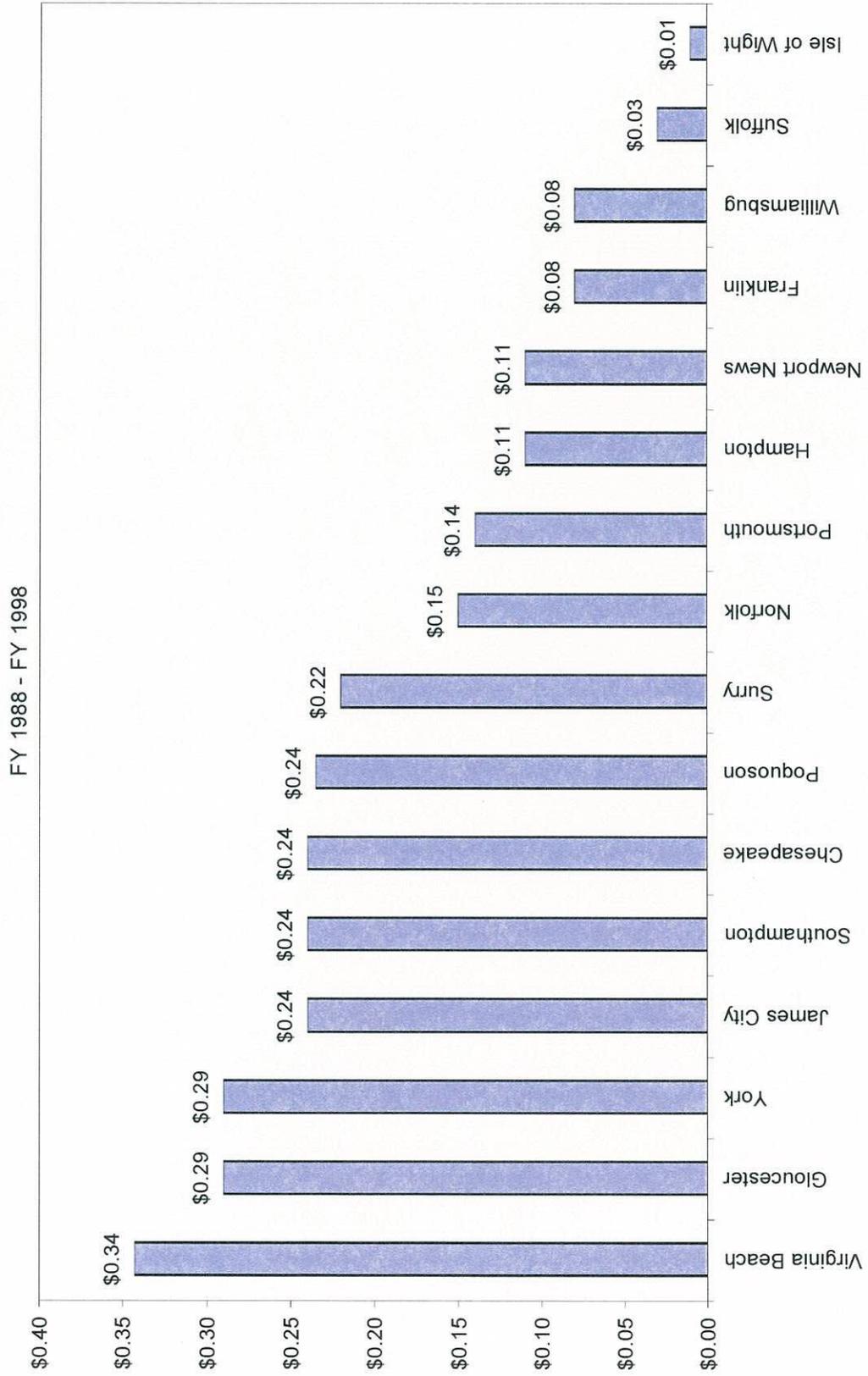
Fourth Quarter 1999



Source: Regional Financial Associates

Chart 10

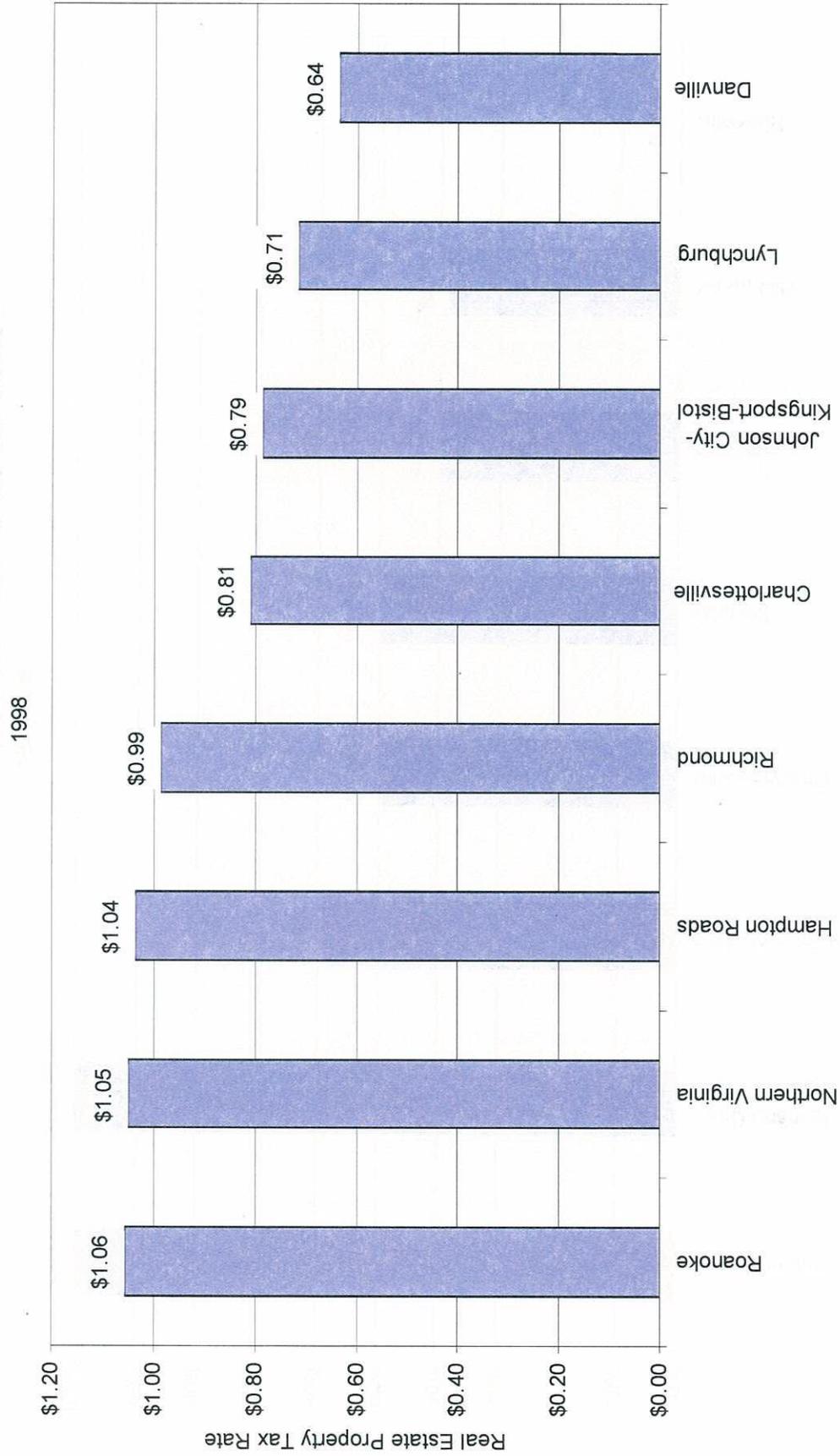
Change in Real Estate Property Tax Rate



Source: Commonwealth of Virginia Auditor of Public Accounts

Chart 11

**Average Increase in Real Property Tax Rates
in Each Virginia Metro Area**



Source: Virginia Department of Taxation

Chart 12