



# ***10 Reasons to Oppose Virginia Sales Tax Increases***

**by Chris Edwards and Peter Ferrara**

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Northern and southeastern Virginians will vote in referenda this November to approve or reject increases in the retail sales tax to fund transportation projects. Northern Virginians will decide whether to increase the sales tax from 4.5 percent to 5.0 percent, an 11 percent increase. Virginians in the Hampton Roads area will decide whether to increase the sales tax from 4.5 percent to 5.5 percent, a 22 percent increase.

Proponents of tax increases point to unmet transportation needs to support their cause. Yet state spending increased 13 percent in 1999, 7 percent in 2000, and 9 percent in 2001. If key transportation needs have not been met, the problem is not a lack of funds but legislators who have not properly prioritized the budget.

If the sales tax referenda are passed, the state government will have a strong incentive to

reduce what it would otherwise spend on transportation in northern Virginia and Hampton Roads. By some measures, northern Virginia already gets the short end of the stick with regard to the state budget.

Tax increases are not just bad budget policy; they are also bad economic policy. Since higher taxes reduce economic growth, an added cost of higher sales taxes would be lower incomes for Virginians. During the 1990s Virginia taxes grew faster than incomes, and local property taxes have soared recently.

Even modest restraint in nontransportation spending could save enough money to fund priority highway projects without tax increases. Further, the state could adopt a spending growth cap that channels excess future tax revenues to transportation needs and tax cuts.

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**Support for sales tax increases illustrates the failure of state politicians to live within their means.**

## **Introduction**

Citizens of northern Virginia will vote this November on a proposal to raise the general sales tax rate in that region from 4.5 to 5.0 percent, an 11 percent increase.<sup>1</sup> In southeastern Virginia, or Hampton Roads, citizens will vote on a similar proposal to raise the sales tax in that region from 4.5 percent to 5.5 percent, a 22 percent increase.<sup>2</sup> The proceeds from those tax increases and subsequent bond issues are to be used for transportation projects only in those areas paying the higher taxes.

The ballot questions are one-sided, as they only allow a tax increase option, not an option to control state spending to free funds for transportation. Ironically, the Virginia political establishment has long been opposed to popular referenda, but this year elected officials have allowed citizens to vote only for an increase in the size of the government. The last significant referendum on taxes was a 1987 Fairfax County vote on increasing the restaurant meals tax to fund education. That referendum was defeated.

In 2003 state transportation spending of \$3.3 billion will be funded from a remarkably complex array of taxes and fees.<sup>3</sup> (All budget data are for state fiscal years, which end on June 30). Major funding sources include federal grants, half of a percentage point of the state's general sales tax, a gasoline tax of 17.5 cents per gallon, a motor vehicle sales tax of 3 percent, motor vehicle license fees, and many other fees and taxes. The current Virginia general state sales tax is 3.5 percent, but localities add an additional 1.0 percent for a total of 4.5 percent.

The proposed sales tax increases have been pushed by developers and other business interests in northern Virginia, led by the Northern Virginia Roundtable. In a recent statement, the Roundtable called for increases in state individual and corporate income taxes, gasoline taxes, and sales taxes.<sup>4</sup> Clearly, developers directly benefit from expanded construction funding for highways and mass transit. Virginia's governor Mark Warner, who has long been supported by those groups, pushed the sales tax referenda through the

legislature and is now campaigning for passage of the proposed tax increases.

The sales tax referendum is a classic political con game. Politicians insist that there is no money left in the budget for whatever the most important issue happens to be for voters. If voters' top priority is highways, then politicians insist there is no money left for them and claim that higher taxes are needed. If voters' top priority is education, then politicians insist there is no money for it without more tax increases. The reality is that the support for sales tax increases illustrates the failure of state politicians to live within their means after large tax revenue and spending increases during the 1990s.

The sales tax proposals come at a particularly bad time, as the economic slowdown has reduced the ability of families and businesses across the state to pay more taxes. Indeed, supporters of the tax increase face strong grassroots opposition in Virginia this year. Citizens opposed to higher taxes, and liberals and environmentalists who believe that more highway construction will lead to more urban sprawl and pollution, are against the sales tax increases.

If Virginians examine the state budget, they will find that they already pay more than enough in taxes to finance all the basic services of state government, including roads and highways. Slowing the growth rate in overall state spending in future years would free funds for transportation and allow a full phase-in of the car tax repeal.

This report discusses 10 reasons why Virginia does not need a sales tax increase. Reasons 1 to 9 have to do with the current budget situation in Virginia. Reason 10 is that tax increases have not only budget implications but also important economic effects. Since tax increases reduce economic growth, the sales tax referenda are about more than funding highways. They are also about preserving Virginia's strong economy. Finally, we provide some policy options that Virginia legislators should consider instead of tax increases. It turns out that reasonable limitations on general fund spending growth would leave more than enough funds for essential transportation projects and further tax cuts in the years ahead.

## 10 Reasons to Oppose a Sales Tax Increase

### 1. State Spending Has Grown Excessively

State spending in Virginia soared during the 1990s as the economic boom flooded state coffers with tax revenue and prompted legislators to expand programs beyond sustainable levels. During nine boom years from 1992 to 2001, state spending (general and nongeneral funds) rose an average of 6.8 percent per year.<sup>5</sup> By contrast, inflation grew at just 2.6 percent annually and Virginia's population grew at 1.2 percent annually during that period. Figure 1 shows that recent spending increases have been particularly large, including increases of 13.3 percent in 1999, 7.0 percent in 2000, and 9.1 percent in 2001.<sup>6</sup>

Although legislators were forced to slow spending growth to just 0.7 percent in 2002 because of stagnant tax revenue, they have enacted a 7 percent increase in spending for 2003. Despite cries of large budget shortfalls, the May budget plan for the 2003–04 biennium

included more than \$2 billion in “new spending.”<sup>7</sup> As soon as politicians anticipate money coming in the door, new spending projects are found to expand state government.

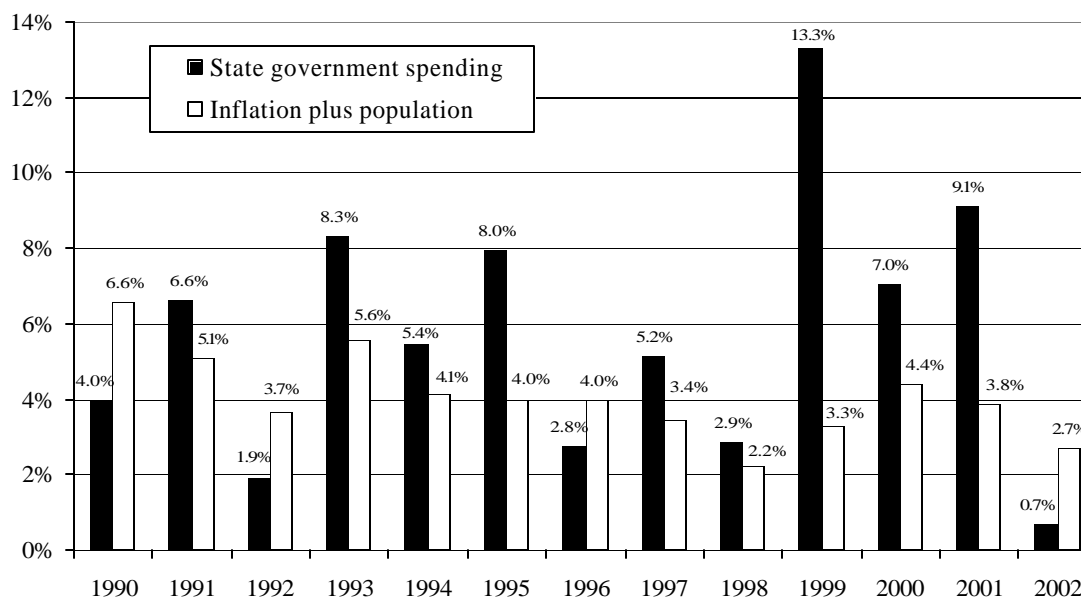
Virginia voters should ask why it is that, after the 1990s spending boom and planned increases next year, there is no money left to solve transportation problems in northern Virginia and Hampton Roads. If transportation is a top spending priority, legislators and the governor should begin to reduce spending, or slow spending growth, in other budget areas in order to reallocate funds to highway projects.

### 2. Tax Revenues Rose Quickly during the 1990s

Virginia has a history of fiscal conservatism; its overall tax load has been somewhat below the average of the 50 states. But in the late 1990s large tax revenue increases pushed Virginia closer to the midpoint.<sup>8</sup> Unless budget restraints are imposed, Virginia may ultimately lose its low-tax advantage and become less economically competitive.

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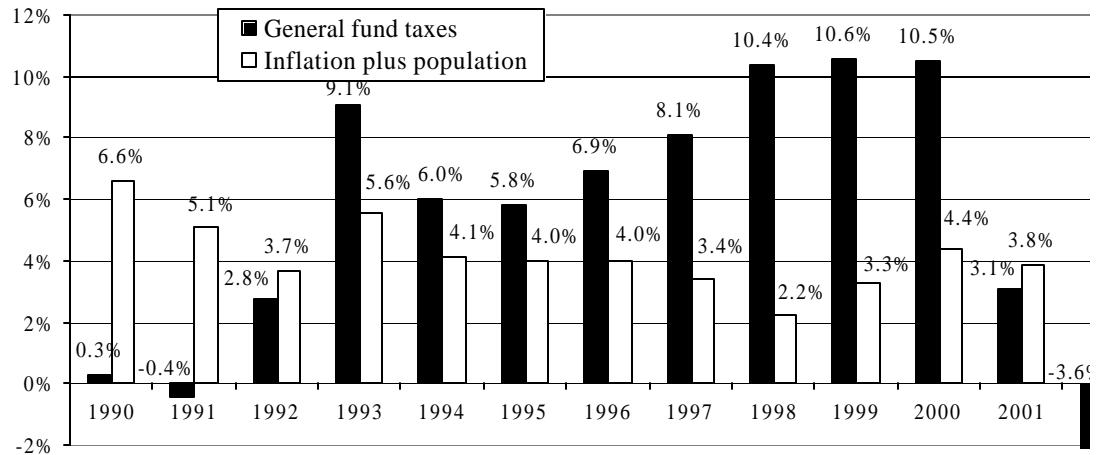
**Figure 1**  
Growth in Virginia Spending vs. Growth in Inflation Plus Virginia Population



Source: Virginia Department of Planning and Budget, [www.ddpb.state.va.us/budget/budget.htm](http://www.ddpb.state.va.us/budget/budget.htm).

Notes: Spending is total fiscal year operating budget (general and nongeneral funds). Inflation and population growth are estimated for 2002 and 2003.

**Figure 2**  
**Growth in Virginia Tax Revenue vs. Growth in Inflation Plus Virginia Population**



Source: Virginia Department of Planning and Budget, [www.ddpb.state.va.us/budget/budget.htm](http://www.ddpb.state.va.us/budget/budget.htm).  
 Note: Inflation and population growth are estimated for 2002 and 2003.

**Tax revenue grew faster than inflation plus state population every year from 1993 through 2000.**

In 2003 general fund taxes of \$11.2 billion will fund a bit less than half of the state's expenditures of \$25.1 billion. The primary general fund taxes are the individual income tax, the corporate income tax, and the sales tax. The other half of state expenditures is funded by federal grants, fees, and other taxes. As noted, numerous taxes and fees are devoted to funding transportation.

General fund tax revenue grew faster than inflation plus state population every year from 1993 through 2000, as shown in Figure 2.<sup>9</sup> In 1998, 1999, and 2000, tax revenue growth exceeded 10 percent annually.

During the economic boom from 1992 through 2001, tax revenues almost doubled with an increase of 97 percent. By comparison, Virginia's population rose 12 percent, and the consumer price index, which measures inflation, increased 26 percent.

During economic expansions, Virginia's tax revenues tend to rise faster than incomes, thus creating a hidden tax increase. In the late 1990s revenues from the income tax and capital gains tax rose particularly quickly. For citizens to remain in the same position rela-

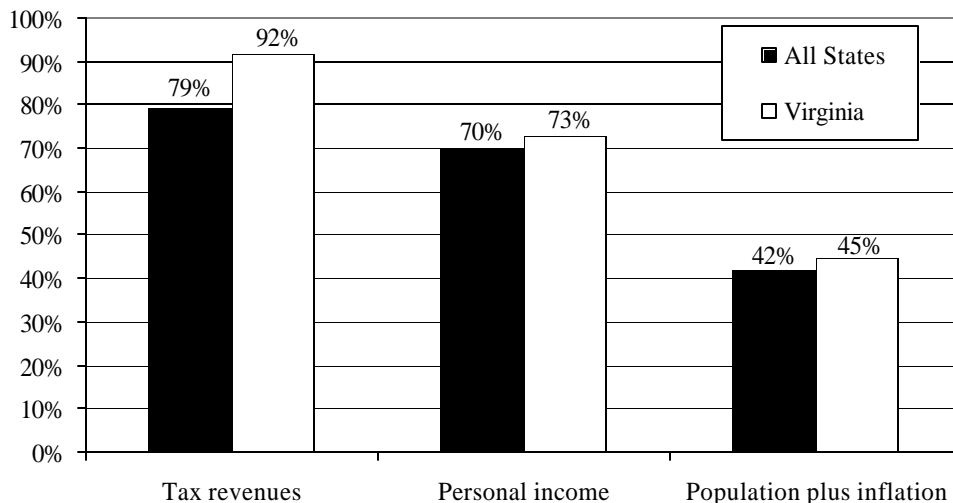
tive to the government, tax cuts are needed every few years to return the excess revenues. As the economy recovers, state coffers will begin filling up again, so the state government simply needs to be patient and focus on reviving the state's economy, rather than pursue tax increases that could have the opposite effect of damaging the recovery.

### **3 Overall Taxes on Virginians Are Too High**

On average, Virginia households pay 31 percent of their income in taxes to the federal, state, and local governments.<sup>10</sup> That makes Virginia 25th among the states in terms of total taxes as a percentage of income. A decade ago Virginia ranked 35th among the states by this measure.<sup>11</sup>

The average Virginia family pays more in taxes than it spends on food, clothing, and housing combined.<sup>12</sup> This is important because proponents of tax increases are always quick to point out the added "needs" of the state budget. But Virginia citizens have their own needs, which they have difficulty meeting with only 69 cents on the dollar after taxes. State budget needs filled by tax increases mean fewer resources available for Virginia families to use

**Figure 3**  
**Growth of Taxes, Income, and Population Plus Inflation, 1990–2000**



Source: U.S. Bureau of the Census, government finance data, [www.census.gov/govs/www/state.html](http://www.census.gov/govs/www/state.html).  
 Note: All figures are nominal, or current, dollars.

to meet their own needs, thus reducing their economic freedom.

Figure 3 shows that between 1990 and 2000 state taxes in Virginia increased 92 percent, compared to income growth of 73 percent. Population growth plus inflation in Virginia grew 45 percent during that period. Virginia’s tax growth outpaced the 50-state average by 13 percentage points in the 1990s. Although state taxes have risen quickly across the country, Virginia taxes have risen more quickly than those of most states. The proposed Virginia sales tax increases would make the problem of excess tax growth worse in the years ahead.

Moreover, this tax increase would come on top of soaring property tax increases in northern Virginia and other regions. In Fairfax County, where 1 million northern Virginians live, property tax revenues, which soared 8.5 percent in 2001 and 13.2 percent in 2002, will increase 12.6 percent in 2003.<sup>13</sup> As property values have exploded, local governments have been flooded with extra cash from homeowners. For example, Fairfax County property tax assessments for 2003 went up an average of 15 percent. Since the chair of the

Fairfax County Board of Supervisors, Kate Hanley, who said she did not plan to raise taxes, was reelected in 1999, the annual property tax bill for the average Fairfax family is up about \$1,000 by one estimate.<sup>14</sup>

Similar trends have occurred in other counties. In Loudoun County, tax revenues on real property soared 63 percent between 1999 and 2002.<sup>15</sup> In Arlington County, tax revenues on real property increased 34 percent in the last three years.<sup>16</sup>

In addition, the scheduled final elimination of the car tax in Virginia has been delayed because of the state’s budget imbalance. This will cost Virginia taxpayers roughly \$300 million for every year of delay.<sup>17</sup> So imposing a sales tax increase now would be piling tax increase on tax increase.

**4 The State Budget Can Be Reprioritized to Fund Transportation**

As discussed, state funding for transportation primarily comes from federal grant money, one-half cent of the state sales tax, the gasoline tax, and other taxes. In regions of rapid growth, such as northern Virginia,

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**Virginia should begin using more current general fund revenues to help finance roads and highways.**

those revenues may be insufficient to keep up with growing transportation demands. A first step toward a solution would be to change priorities in order to devote more state transportation funds to faster growing regions, rather than divert money to slow-growth regions. Indeed, the state auditor recently recommended that the state change the current method of regional allocations of transportation funds to better fulfill statewide priorities.<sup>18</sup>

In addition, the state should begin using more current general fund revenues to help finance roads and highways. The state has started using small amounts of general fund revenues for transportation through the Priority Transportation Fund in recent years, and this policy should be expanded upon. Unfortunately, the 2003 budget goes in a reverse direction by raiding \$317 million of transportation monies to fill the general fund budget gap, instead of cutting general fund spending.

Since Virginia's operating budget totaled more than \$23 billion in 2002, 7 percent planned spending growth in 2003 means a \$1.6 billion increase. By contrast, the proposed sales tax increase in northern Virginia would raise about \$123 million in the first year.<sup>19</sup> Thus, trimming less than 1 percent of annual growth in the overall budget would be enough to fund added transportation needs without a tax increase. In the policy options section below, we detail how the excess annual growth in the general fund would obviate the need for a sales tax increase by providing funds for transportation improvements, as well as room for future tax reductions.

**5. The State Budget Is Already Unfair to Northern Virginia**

The current structure of the Virginia budget creates an unfair fiscal balance for northern Virginia. Northern Virginia gets the short end of the stick when it comes to state aid and transfers to local governments. According to professor John Knapp of the University of Virginia, for every dollar in taxes

that northern Virginia sends to Richmond, the region gets back only 46 cents in state aid.<sup>20</sup> His calculations show that in 2000 northern Virginians paid about 39 percent of state taxes, but local governments in northern Virginia received just 18 percent of all state aid. Thus, it is unfair to ask taxpayers in northern Virginia to pay more for improved highways when the state already siphons off their tax payments to other parts of the state.

Further evidence of the state budget's unfairness to northern Virginia is the fact that the region's population is 26 percent of the state total, but it pays about 39 percent of Virginia's taxes. Fairfax County alone pays 27 percent of state income taxes but has just 14 percent of the state's population.<sup>21</sup> The state income tax penalizes residents of northern Virginia, where both incomes and living expenses are high. Also, as capital gains tax revenue soared in the 1990s, this extra state cash intake came at the expense of the high-tech industry concentrated in northern Virginia. Northern Virginians should seek a more equal share of the state budget to help solve the region's transportation problems, rather than impose an additional burden on taxpayers.

**6. New Sales Taxes May Cause the State to Redistribute the Transportation Budget**

A big danger of targeted sales tax increases in two regions of the state is that it is likely that the legislature will reduce what would have otherwise been spent on transportation in northern Virginia and Hampton Roads in future years. State transportation money could be directed to other parts of the state, or even to nontransportation uses. Other regions may well argue in the future that northern Virginia and Hampton Roads have more than enough transportation funds and that state money should be spent elsewhere.

Some state leaders are already telling their constituents outside the referenda regions to hope the referenda pass because that will free more state money for them. Virginia secretary of transportation Whitt Clement told a crowd in Danville on May 2 that "money from the sales tax referenda will finance

transportation projects in those regions. Failure of the referenda could result in alterations to Virginia's transportation funding formulas, thus steering more dollars to areas of exploding growth. That would be to the detriment of rural areas."<sup>22</sup> In other words, Clement said that if the referenda do not pass, more state money will have to be devoted to northern Virginia and Hampton Roads. But if the referenda do pass, more state money can be spent in rural areas.

The problem was even recognized by the *Washington Post*, which editorialized that "supporters of the [tax] increase emphasize that it is not to be a bailout of the state; the legislation authorizing the referenda prohibits Virginia from cutting the amounts allocated to Northern Virginia for road construction. That may prove hard to police."<sup>23</sup>

Furthermore, there is no guarantee that the increased sales tax revenues will be fully used for higher transportation spending, on net. Indeed, the state seems to be going in a reverse direction with the recent diversion of half a percentage point of the current sales tax, which had been used to fund transportation, to nontransportation purposes. In 2002, \$317 million will be diverted.<sup>24</sup> The funds are to be replaced with further issuance of debt instruments called federal reimbursement anticipation notes (FRANs), thus increasing burdens on future taxpayers.

### **7. Passage of the Referenda Would Spur Demand for More Tax Increases Later**

The state has a habit of understating the future costs of transportation projects to get as many started as possible, as noted by the state auditor.<sup>25</sup> After projects are well under way, the true costs become evident and the state demands more cash from taxpayers. The federal government plays a similar game with national defense procurement. In Virginia, the proposed sales tax increase and related debt issuance may create the demand for future tax increases after underfunded long-term projects are begun. After all, Governor Warner is saying that the higher taxes will be just a "downpayment on gridlock improvements."<sup>26</sup>

A long-planned widening of Lee Highway (U.S. 29), for example, had been estimated to cost \$85 million.<sup>27</sup> The project was dropped by the Virginia Department of Transportation earlier this year. But the northern Virginia sales tax referendum includes the project but earmarks only \$25 million for the job. Another example is \$350 million debt to be issued for a Dulles corridor railroad line. That is only about one-tenth of the funds needed to complete such a project. Once those projects are started, residents can expect the state to come back and demand further tax hikes.

Overall, about 40 percent of funds to be raised in northern Virginia would go to mass transit rather than highway improvements, thus not reducing congestion directly, if at all. For example, the Dulles Toll Road is not generally congested now, but a new Dulles rail line could spur further development along the corridor and add to congestion, not reduce it. Money would also be devoted to new rail cars for the Metro and Virginia Railway Express. Rather than burden northern Virginians with tax increases, users of those services should pay a greater share of their own transportation costs.

Another concern is the pro-tax political effect that would result from passing the sales tax increase referenda. Voter support for reducing congestion may be mistaken as support for higher tax levels. As a result, the legislature may be more receptive to tax increase proposals in the future if the referenda are supported. Besides, the general sales tax was hiked from 4.0 percent to 4.5 percent for transportation in 1986. Taxpayers were told then that the tax increase would solve traffic congestion problems. But it turned out that the tax increase simply fueled added growth in state spending.

### **8. VDOT Should Be Reformed before Its Budget Is Increased**

A recent investigation by the Virginia state auditor found that VDOT grossly mismanages its \$3.3 billion budget.<sup>28</sup> As the *Washington Post* summarized, the auditor "has drawn a devastating portrait of poor management,

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failing computer systems, irresponsible spending and sloppy planning.”<sup>29</sup> For example, state figures show that in the past three years transportation construction cost estimates averaged 86 percent higher at contract award than when projects were originally conceived.<sup>30</sup>

Governor Warner says he will take steps to fix those problems. But it would be prudent to spend a few years creating a leaner and more efficient transportation operation in the state before hundreds of millions of new dollars are sent into VDOT’s fiscal black hole. Adding new money now would reduce the incentive for much-needed reforms.

Although a new Northern Virginia Transportation Authority has been established to manage the new sales tax funds, that authority will not have the manpower or expertise to handle the actual road building. In the public sector, only VDOT has the capability to build and manage the highway projects funded by sales tax increases.<sup>31</sup> But rewarding poor performance with new funds is the wrong way to manage any agency, public or private.

**9. Increasing Virginia’s Debt Is Bad Fiscal Policy**

Passing the proposed sales tax increases may result in increases in other taxes down the road as Virginia’s debt load increases and borrowing costs rise. The referendum in northern Virginia would allow \$2.8 billion in bonds to be issued, and the Hampton Roads referendum would allow \$5.9 billion in bonds.

The bonds would be issued by special transportation authorities in each region. Only the new sales tax revenues are to be used to pay interest and principal on the bonds. Since the revenue available to pay for the bonds is limited, the bonds will be riskier for investors, and the state may have to pay higher interest rates than it does on normal state bonds.

However, state taxpayers in general may ultimately be at risk for the bonds if sales tax revenues are insufficient to cover bond payments. That could occur if an economic slowdown reduces sales tax receipts. The state would probably not let the bonds default because that would be an embarrassment

and threaten the state’s high bond rating. So, while only new sales tax revenues are to be used to service the bonds, that could be amended in the future to make all state taxpayers responsible.

Additional bond issuance could affect both the state’s and local governments’ credit ratings, even without a default. The added risk caused by billions of dollars of new debt for transportation may lead to higher interest rates on other government debt. Local governments could be affected because bond agencies consider the total debt load of communities when evaluating local debt issues.

As a general rule, debt financing should be a tightly controlled method of state government financing. That is because debt makes it easy for legislators to unfairly push costs onto future generations. Bond financing, particularly bond financing under special authorities, is dangerous because the costs are hidden from the taxpayers. Transportation financing in Virginia is already terribly confusing, as is the proliferation of bond financing techniques. Adding further special regional debt mechanisms will create more headaches for citizens seeking to understand their state government.

As noted, the proliferation of debt evades tough budget choices by pushing costs onto future taxpayers. A recent example was the maneuver to divert to the general fund the proceeds of the half cent of the general sales tax that is supposed to fund transportation. This \$317 million of transportation money will be replaced by the fancy FRANs debt device. In the current six-year transportation plan, Virginia proposes issuing \$659 million in new FRANs.<sup>32</sup> FRAN issuance began in 2000 with \$375 million of debt issues.<sup>33</sup> The state auditor recently warned that FRANs provide cash in the short term but “can actually make the cash flow situation worse in the future.”<sup>34</sup> FRAN debt service will rise from 5.7 percent of federal transportation money in 2002 to 24 percent by 2005.<sup>35</sup> State transportation debt service is an increasing share of state revenue, which suggests that the billions of dollars of new debt issuance proposed under the referenda is unwise.



### 10. Tax Increases Reduce Economic Growth

A growing number of economic studies indicate that regions with high taxes have slower economic growth than regions with lower taxes. Capital, labor, and consumers in search of the best economic climates are increasingly mobile across both state and international borders. As a result, governments must maximize their efficiency and not let their tax rates get out of line with those of neighboring jurisdictions.<sup>36</sup> Tax increases will result in fewer businesses, slower economic growth, and a shrinking tax base.

If sales taxes in Virginia rise, consumers buying expensive items will have an added incentive to do business in sales tax-free

Delaware or elsewhere. Virginia would also undermine its current advantage in comparison with surrounding states that have higher sales taxes. In addition, regional sales tax increases would put northern Virginia and Hampton Roads at a tax disadvantage in comparison with other areas within Virginia.

Table 1 provides data comparing economic growth and state and local tax levels in the 10 highest-tax jurisdictions and the 10 lowest-tax jurisdictions. The tax measure used in the analysis is average 1980-99 state and local tax revenues as a percentage of personal income.<sup>37</sup>

Economic growth is measured as the increase in real, or inflation-adjusted, state personal income during the 19-year period. The results

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**Table 1  
State and Local Taxes vs. Income Growth, 1980-99**

Jurisdiction	Taxes as a Percentage of Income, Average 1980-99	Change in Personal Income, Real Increase 1980-99
Highest-tax jurisdictions		
Alaska	18.6%	46%
D.C.	13.7%	27%
New York	13.6%	57%
Wyoming	11.6%	12%
Maine	11.6%	61%
Hawaii	11.5%	45%
Minnesota	11.4%	72%
Wisconsin	11.3%	48%
New Mexico	11.1%	71%
Vermont	11.0%	70%
Average	12.5%	51%
Lowest-tax jurisdictions		
South Dakota	9.2%	61%
Indiana	9.0%	48%
Virginia	9.0%	85%
Nevada	8.9%	191%
Texas	8.9%	86%
Missouri	8.8%	55%
Florida	8.6%	110%
Alabama	8.4%	61%
Tennessee	8.2%	81%
New Hampshire	7.9%	103%
Average	8.7%	88%

Source: Authors' calculations based on U.S. Bureau of the Census data.

**If future general fund spending growth were limited to this baseline, excess revenues would be generated that could be devoted to transportation and tax reductions.**

show that average real income growth was 51 percent during the period for the 10 highest-tax jurisdictions but 88 percent for the 10 lowest-tax jurisdictions.

Other studies have found a similar relationship between taxes and economic growth. A 1995 study by the Joint Economic Committee of the U.S. Congress looked at state taxes and personal income growth from 1960 to 1993. The study concluded that “higher state and local taxes had a distinct and significant negative effect on personal income growth. . . . That is, when state and local taxes were raised, personal income growth slowed markedly. By the same token, states with lower taxes enjoyed substantially higher personal income growth.”<sup>38</sup> Relatively low-tax states grew nearly one-third faster than high-tax states, according to the study.

A 1996 study by Zsolt Becsi of the Federal Reserve Bank of Atlanta looked at state and local taxes compared with state income growth from 1960 to 1992. The study found that incomes in the poorer states tended to slowly catch up to incomes in the wealthier states over time. When the study controlled for that factor, it found that tax rates were negatively related to economic growth during the period. The results held true for both marginal tax rates and overall state and local tax levels.<sup>39</sup>

At the international level, a recent survey of academic studies on investment by James Hines of the University of Michigan Business School concludes that taxation significantly influences the location of foreign direct investment, research and development, and other activities that promote economic growth.<sup>40</sup> Similarly, a recent International Monetary Fund study found “strong evidence” that foreign direct investment flows were affected by taxes.<sup>41</sup> Another IMF study found that each increase in taxes of 1 percent of gross domestic product would reduce worker output by about 2 percent.<sup>42</sup> A study by Eric Engen and Jonathan Skinner published by the National Bureau of Economic Research looked at growth rates of 107 countries from 1970 to 1985 and found “strong

and negative effects of both government spending and taxation on output growth.”<sup>43</sup>

Low state-level taxes have also been found to be a significant factor in the location of investment flowing into the United States. A recent study by Professor Deborah Swenson of the University of California–Davis found that U.S. states with higher taxes attract fewer new investments and plant expansions from foreign corporations than do lower-tax states.<sup>44</sup>

In summary, Virginians need to consider that proposals for tax increases are not just about whether the state government “needs” more funds for transportation. Tax increases are likely to damage economic growth over the long run. As a consequence, alternatives should be found to meet the priority transportation needs of Virginia without the negative economic side effects of tax hikes.

## **Policy Options**

### **Limit General Fund Spending Growth**

In the 1990s Virginia general fund spending rose much faster than the sum of the growth rate of inflation plus Virginia’s population. Spending growth that keeps pace with the growth of inflation plus population is a baseline that keeps per capita real spending constant. If future general fund spending growth were limited to this baseline, excess revenues would be generated that could be devoted to transportation and tax reductions.

Table 2 compares two transportation funding alternatives with the proposed tax increase in northern Virginia. To be conservative, we have assumed under both options that future tax revenues grow at 5.0 percent, which is less than the average annual tax growth of 5.7 percent from 1990 to 2002, a period that included two recessions. Under Option A, a relatively small transfer of 1 percent of general fund taxes—a fraction of annual revenue growth—would be earmarked for transportation. That would raise a bit less revenue (\$649 million) during the first five years than the proposed sales tax increase would (\$728 million).

**Table 2**  
**Options for Earmarking Excess Tax Revenue Growth to Fund Transportation in Northern Virginia (\$ millions)**

Fiscal Year	General Fund Tax Revenue Growth at 5%	Option A:	Option B		Northern Va. Revenues under Proposed Sales Tax Increase
		1% of General Fund Taxes for Transportation	General Fund Spending Capped at 4%	Excess for Transportation and Tax Cuts	
2003	11,181		11,181		
2004	11,740	117	11,628	112	123
2005	12,327	123	12,093	234	140
2006	12,943	129	12,577	366	147
2007	13,591	136	13,080	510	155
2008	14,270	143	13,603	667	163
2004-08		\$649		\$1,889	\$728

Source: Authors' assumptions and calculations.

Under Option B, general fund spending would be capped at baseline growth of population plus inflation, assumed here to be 4 percent based on historical experience.<sup>45</sup> The difference between revenue growth and the spending cap would grow substantially over time. During the first five years, a general fund spending cap would generate about \$1.9 billion. That would provide funding for transportation projects in northern Virginia and Hampton Roads and money for Virginia taxpayer refunds. If tax revenue growth averages 6 percent annually in future years, such a spending cap would generate even more funds for tax reductions.

In addition to freeing resources for transportation and tax cuts, an overall general fund spending cap would prevent an overexpansion of state government during economic boom periods. If Virginia lawmakers were obligated to refund excess funds to taxpayers during booms, they would be restrained from starting new programs and expanding bureaucracies that could not be supported during slowdowns.

Currently, 26 state governments operate under some sort of tax or expenditure limitation.<sup>46</sup> Those limitations vary widely in effectiveness. Colorado's Taxpayer Bill of Rights (TABOR), in place since 1992, is probably the

most successful. TABOR limits growth of state tax revenues to inflation plus population growth. Revenue increases above the limit are refunded to taxpayers. In addition, TABOR requires that any state or local tax increase be approved by the voters.

The legislature can allow revenues and spending to increase faster than the limit, but it must first get the approval of voters in a referendum. Six such referenda have been held in Colorado since TABOR was adopted, and the public has rejected five of them. TABOR has been popular and beneficial for Colorado and produced rebates totaling \$2.3 billion from 1997 through 2000.<sup>47</sup>

If a TABOR-style limit was in place in Virginia, it would generate excess funds that could be used for transportation and taxpayer refunds. For example, if tax revenues rose 8 percent in one year and the spending growth cap was 4 percent, \$448 million would be generated, given that current general fund revenues are \$11.2 billion. If that were all returned to taxpayers, it would work out to a tax refund of about \$160 for every Virginia household.

**Private Financing Options for Transportation**

Numerous state governments are turning to private financing of new highways and

**An overall general fund spending cap would prevent an overexpansion of state government during economic boom periods.**

**Private financing is available for transportation projects as an alternative to tax hikes.**

other transportation infrastructure as an option to help solve congestion. Innovative privately financed projects have been pursued in Virginia, California, Texas, North Carolina, South Carolina, and other states.<sup>48</sup> The private Dulles Greenway, a 14-mile extension of the Dulles Toll Road, was opened in 1995. It was financed through bonds and private equity and uses an electronic toll system to maximize efficiency for drivers. In Richmond the 895 Connector project, which will also use electronic toll technology, is being financed by private capital in a nonprofit structure.

Fluor Daniel, a leading engineering company, has proposed using private funding to widen the Capital Beltway by four lanes in northern Virginia.<sup>49</sup> The “high-occupancy toll” lanes would be separated from the regular lanes and fitted with electronic technologies for toll paying. While there may be numerous policy reasons to oppose this particular project, it shows that private financing is available for transportation projects as an alternative to tax hikes and (mis)management of funds by VDOT.

Private financing and operation should be as part of the solution to Virginia’s transportation needs. That would allow Virginia families to avoid tax hikes and allow the state to retain its low-tax competitiveness. In addition, taxpayers could avoid having even more money wasted by a mismanaged state transportation agency, and northern Virginians would reduce the risk that their highway dollars were flowing to other parts of the state.

## **Conclusion**

Virginia should devote more of the taxes that citizens already pay to priority transportation projects in northern Virginia and Hampton Roads. That would be feasible if the state earmarked a small additional portion of general fund taxes for transportation or adopted an overall cap on general fund spending growth. In particular, Virginia should consider a budget cap, similar to the successful TABOR restraint in Colorado,

that allows general fund spending to grow no faster than the rate of inflation plus population growth.

As the economy recovers and tax revenues grow, the surplus above a budget cap would be greater than monies that would be raised through a sales tax hike. Excess revenues generated by such a cap could also be used for tax refunds. A budget cap would have the added benefit of preventing the state government from overexpanding during boom years.

In summary, Virginia’s transportation funding needs could be addressed without the negative effects of sales tax increases. Indeed, the proposed tax increases illustrate the failure of state politicians to properly prioritize spending. Given that northern Virginia’s economy has been hit by the national economic slowdown and the high-tech collapse in particular, tax increases would come at a particularly bad time. Virginia has prospered because it is a relatively low-tax state. It is to be hoped that it will remain so.

## **Notes**

1. In northern Virginia the sales tax question will be on the ballot in the counties of Arlington, Fairfax, Loudoun, and Prince William and the cities of Alexandria, Fairfax, Falls Church, Manassas, and Manassas Park.
2. In southeastern Virginia the sales tax question will be on the ballot in the counties of Isle of Wight, James City, and York and the cities of Chesapeake, Hampton, Newport News, Norfolk, Poquoson, Suffolk, Virginia Beach, and Williamsburg.
3. Virginia Department of Planning and Budget, budget data, [www.dpb.state.va.us/budget/budget.htm](http://www.dpb.state.va.us/budget/budget.htm). This figure is spending in the operating budget (general and nongeneral funds) as adopted by the 2002 General Assembly.
4. Northern Virginia Roundtable, “Northern Virginia Roundtable Calls for Special Session of Legislature to Address Virginia’s Unprecedented Fiscal Crisis,” Press release, February 12, 2002, [www.novaroundtable.org/GA/crisispr.html](http://www.novaroundtable.org/GA/crisispr.html).
5. Virginia Department of Planning and Budget, budget data. This figure is spending in the operating budget (general and nongeneral funds) as

adopted by the 2002 General Assembly. A historical time series is available in Virginia General Assembly, Joint Legislative Audit and Review Commission, "Review of State Spending: June 2002 Update," draft, June 10, 2002.

6. Virginia Department of Planning and Budget, operating budget as adopted by the 2002 General Assembly, [www.dpb.state.va.us/budget/budget.htm](http://www.dpb.state.va.us/budget/budget.htm). State spending figures in the last few years include personal property tax relief. The percentage change in spending without the car tax relief would have been roughly 12.4 percent in 1999, 5.9 percent in 2000, and 8.7 percent in 2001 (this calculation simply excludes the "central appropriations" function from the spending totals).

7. Virginia Department of Planning and Budget, "Overview of the 2002-2004 Biennium Budget and Its Impact on Higher Education," May 2, 2002, p. 2, [www.dpb.state.va.us/budget/budget.htm](http://www.dpb.state.va.us/budget/budget.htm).

8. Virginia General Assembly. See also Tax Foundation, "Tax Freedom Day Annual Report," April 2002, [www.taxfoundation.org](http://www.taxfoundation.org).

9. Virginia Department of Planning and Budget, "Governor Gilmore's Proposed 2002-2004 Budget," December 19, 2001, [www.dpb.state.va.us/Budget/budget.htm](http://www.dpb.state.va.us/Budget/budget.htm). See also Virginia Department of Planning and Budget, "Overview of the 2002-2004 Biennium Budget and its Impact on Higher Education." Figures are fiscal years and exclude transfers.

10. Tax Foundation.

11. Ibid.

12. Ibid.

13. Fairfax County, "Adopted Budget Plan FY 2003," [www.co.fairfax.va.us/gov/omb/vo1adobe.htm](http://www.co.fairfax.va.us/gov/omb/vo1adobe.htm).

14. Calculated by the Fairfax County Taxpayers Alliance, Press release, April 1, 2002, [www.fcta.org](http://www.fcta.org).

15. Loudoun County, "FY 03 Draft Fiscal Plan," [www.loudoun.gov/budget/fiscal03.htm](http://www.loudoun.gov/budget/fiscal03.htm).

16. Arlington County, "Proposed Budget FY 2003," [www.co.arlington.va.us/cmo](http://www.co.arlington.va.us/cmo).

17. John Knapp, "The Fiscal Condition of the Commonwealth," Presentation to Conference on Virginia's Future, Richmond, November 29, 2001, p. 2.

18. Virginia Auditor of Public Accounts, "Cash Management and Capital Budgeting Practices of the Department of Transportation," Presentation

to Commonwealth Transportation Board workshop, July 17, 2002, p. 51.

19. This is based on one financing scenario for the sales tax circulated by Salomon Smith Barney, "Northern Virginia Financing Scenario," undated.

20. Knapp, p. 11. Knapp excludes highway taxes and expenditures from his analysis.

21. Virginia Department of Taxation, "Annual Report," Fiscal Year 2001, Table 1.7, [www.tax.state.va.us/publications.htm](http://www.tax.state.va.us/publications.htm).

22. George Whitehurst, "Whitt Promises Transportation Dollars," *Danville Register and Bee*, May 2, 2002, p. 1.

23. "Cuts and Shuffling in Virginia," Editorial, *Washington Post*, April 29, 2002, p. 18.

24. Commonwealth Transportation Board, "Transportation Financing in Virginia," June 19, 2002, p. 35, [www.virginiadot.org/infoservice/ctb-default.asp](http://www.virginiadot.org/infoservice/ctb-default.asp).

25. Virginia Auditor of Public Accounts, p. 41.

26. Quoted in R. H. Melton, "Warner Promotes Tax Vote," *Washington Post*, June 26, 2002, p. B1.

27. Lisa Rein, "VDOT's Help for Route 29 Dead-Ends," *Washington Post*, May 19, 2002, p. C1.

28. Michael Shear, "State Auditor Offers List of VDOT Failings," *Washington Post*, July 10, 2002, p. B1.

29. "Cleaning Up the Mess at VDOT," Editorial, *Washington Post*, July 14, 2002.

30. Commonwealth Transportation Board, p. 41.

31. Michael Shear, "Backers of Va. Sales Tax Increase Downplay VDOT; Foes Highlight It," *Washington Post*, July 12, 2002, p. C1.

32. Commonwealth Transportation Board, p. 36.

33. State of Virginia, Barbara Reese, acting chief financial officer, "Planned Fall 2002 Debt Issues," July 17, 2002.

34. Virginia Auditor of Public Accounts, p. 16.

35. Ibid., p. 18.

36. Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Institute Policy Analysis no. 431, April 12, 2002.

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38. U.S. Congress, Joint Economic Committee, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," December 1995, p. 1.
39. Zsolt Becsi, "Do State and Local Taxes Affect Relative State Economic Growth?" Federal Reserve Bank of Atlanta *Economic Review*, March–April 1996.
40. James Hines, Introduction to *International Taxation and Multinational Activity*, ed. James Hines (Chicago: University of Chicago Press, 2001), p. 1.
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44. Deborah Swenson, "Transaction Type and the Effect of Taxes on the Distribution of Foreign Direct Investment in the United States," in *International Taxation and Multinational Activity*, pp. 89–112.
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46. Michael J. New, "Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations," Cato Institute Policy Analysis no. 420, December 13, 2001.
47. *Ibid.*, p. 12.
48. U.S. Congress, Congressional Budget Office, "Innovative Financing of Highways: An Analysis of Proposals," January 1998; and Reason Public Policy Institute, "Privatization 2002: 16th Annual Report on Privatization," April 2002, [www.rppi.org/apr2002.html](http://www.rppi.org/apr2002.html).
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