A Commission Report to the
101st General Assembly

Financing Tennessee Government in the 21st Century

Tennessee Advisory Commission
On Intergovernmental Relations

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Executive Summary

Findings and Recommendations

This report contains no recommendations for solutions to future fiscal problems in Tennessee. However, this report has made 26 essential findings about Tennessee's tax and fiscal system. Moreover, a list of potential tax or revenue options are included for legislative review.

Background to the Study

Senate Joint Resolution 139 and Public Chapter 301 (Appendix 1), passed during the 1997 session of the 100th General Assembly, directed the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) to conduct studies on Tennessee's tax system. The initiatives specified that the following issues be addressed: differential sales tax rates; job loss and revenue loss in relation to Tennessee border states; and structural deficiencies of the sales tax base including the implications of the taxation of food. Senate Joint Resolution 389 (Appendix 1) was passed during 1998 allowing the continuation of the study of Tennessee's tax system by TACIR, with findings and recommendations to be transmitted to the General Assembly in January 1999.

Since the passage of SJR 139 and Public Chapter 301, TACIR has conducted and sponsored research resulting in the publication of six reports including this document. Additionally, TACIR meetings and public hearings have been devoted to tax issues. State and national experts in public finance have testified to the Commission, as well as many organizations and individuals with an interest in the tax system in Tennessee.

This report is a culmination of TACIR activities during the study of the State's tax system. It includes some new perspectives on the issues that TACIR has been charged by the General Assembly to address; it highlights ongoing revenue and funding problems in a state that exemplifies national concerns with traditional methods of financing state and local governments. None of these concerns are new. They surfaced during the proceedings of the Special Joint Legislative Task Force on State and Local Tax Structure in 1984-85. However, problems with Tennessee's tax system have become more critical because of national and global economic trends.

Much of the concern is centered on two issues: the dependence on the sales tax to generate revenue for state and local governments in Tennessee, and the increasing threats to it; and, increased demand for state and local services as a result of economic and population growth and the potential for fiscal crisis. Each of the issues has other implications; the threats to the sales tax have equity consequences and compound the intrinsic inequity of the sales tax, and mounting fiscal pressures because of increasing demand for services impedes Tennessee's ability to compete for economic development.

Past and Current Issues Affecting the Sales Tax

Tracking the historical relationship between state tax revenue in Tennessee and economic growth as measured by personal income shows that periodic sales tax rate increases are required to sustain needed expenditure levels. During inflationary, low-growth periods, the sales-dependent revenue system in Tennessee barely keeps up with personal income, even with frequent sales tax rate increases. During low inflation, high-growth periods, the revenue system performs somewhat better, but once again, only with periodic increases in the sales tax rate.

Current economic trends will continue to cause deficiencies in the sales tax because of shifting consumer expenditure patterns, from taxable goods to generally untaxed services. However, expansion of the sales tax base to include more services in the base may not be an option because the types of services that could effectively be taxed do not account for a significant proportion of service activity.

The distribution of income by source in Tennessee has changed dramatically over the past 25 years. Wage and salary income has declined by 12.7 percentage points, while other types of income, such as transfer payments and dividend and interest, have increased. This trend is important in Tennessee because sales taxable purchases tend to be made from wage and salary income.

The Impact of a Structural Deficit on State Programs and Local Governments in Tennessee

A structural deficit occurs when a set of government services and activities can not be maintained with existing tax bases and tax rates.

If the sales tax had not been increased and the base expanded in 1984 and in 1992, a funding gap of $1 billion (unadjusted for inflation) would have occurred in state funding. Tennessee's reliance on the sales tax is expected to result in a future structural deficit; an interstate comparison demonstrates the magnitude of Tennessee's projected structural deficit by giving it a rank of 46th in state and local surpluses (deficits) as a percent of spending. Tennessee's inelastic revenue system coupled with its above-average student enrollment and population projections are the major causes for a predicted future deficit.

Especially at risk from a structural deficit is K-12 education. The consequences of the deficiencies of the sales tax will fall greatest on K-12 education because it is the primary source of funding for K-12 education. Furthermore, enrollment growth funding is absorbing the growth in the sales tax and limiting further program improvements. The shifting emphasis to K-12 education has impacted higher education as well and has led to increases in tuition and fees, potentially affecting the ability of Tennessee public higher education institutions to compete regionally.

The problems with Tennessee's tax system have and will continue to impact local governments in the future. State education funding cuts during 1991 showed the propensity for local governments to turn to the property tax to compensate for reduced state dollars. Property taxes, being the least favored of all taxes, account for more than half of local revenues for education in nearly three-fourths of Tennessee's school systems. Many local governments have raised property taxes to fund capital improvement plans to satisfy state class size mandates. A future fiscal crisis would therefore make it more difficult for local legislative bodies to make up lost state revenues with further increases in property taxes. Additionally, local governments are facing threats to the property tax base because of recent reductions in personalty assessments resulting from complaints of discriminatory assessment.

There is little appeal in turning to the local option sales tax as a means to offset state budget shortfalls. Most recent referenda to pass local option sales tax increases have failed. The revenue potential of the local option sales tax is threatened with problems similar to those faced by the state sales tax: increased levels of untaxed direct marketing sales such as out-of-state mail order and electronic sales. Statutory constraints including the single article limitation and the maximum local option rate also affect the potential of local sales taxes to compensate for state budget cuts.

Equity Issues in the Tax System: Households and Business

Households

Tennessee's overall tax system continues to be regressive because of its dependence on the sales tax and periodic sales tax rate increases. Comparative data place it as one of the 10 most regressive systems in the U.S. It is argued that taxing poorer households relatively more heavily contributes to the inelasticity of the sales tax, particularly when food is included in the base. Furthermore, given the regressive nature of the sales tax and the fact that sales tax revenues largely fund education, a disproportionate burden for funding education is placed on lower income households.

Recent data show that the incomes of lower income households have declined in Tennessee, while the incomes of the highest income households have increased significantly. This trend not only compounds the regressivity in the tax system in Tennessee, but also contributes to inefficiency in the tax system. A possible explanation is the reduction of nondurable manufacturing employment and its importance as a share of income in Tennessee, while at the same time the state is experiencing a surge in services employment.

Business

Two recent tax competitiveness studies provide a significant insight into business tax burdens and tax equity in Tennessee. The Public Affairs Council of Louisiana and the Wisconsin Department of Revenue conducted independent studies of a set of "competitive" states that included Tennessee. Among the findings for Tennessee is that effective tax burdens are not uniform among industries. Moreover, manufacturing industries have the lowest effective tax burdens but these burdens vary significantly among manufacturing firms. This indicates business tax inequity among industries and among business firms in the same industry.

Conversions by some corporations to limited liability companies (LLCs) provide opportunities to reduce state tax liabilities without any substantial changes in the underlying nature of the business. This contributes to potential tax losses and greater tax inequity.

The increased use of tax-reducing strategies is heavily concentrated in large, multistate firms, resulting in additional horizontal and vertical inequities in business taxation in Tennessee.

The Tax System in Tennessee and the Potential Impact of Federal Actions

Tennessee's dependence on federal aid has increased over the last 10 years. Most federal revenue in Tennessee is concentrated in health and social services. Creative program design has contributed to Tennessee's ability to maximize federal dollars for health and social services programs and has freed up state discretionary dollars for K-12 education. However, the increased federal funding has not been without cost. The federal allocation formula for health care and other grant programs has resulted in greater required state appropriations to receive federal funds. The formula is based on Tennessee's increasing personal income and effectively penalizes Tennessee for having a tax system that does not adequately capture economic growth.

Various measurements of interstate fiscal capacity show Tennessee's rank essentially unchanged over time, highlighting Tennessee as a low tax state. However, this characteristic does not bode well in a devolution scenario, where states may be required to take on more responsibilities that were formerly federal, and possibly with reduced federal funding. Tennessee is one of a handful of states poorly positioned to respond to devolution because of its relatively low fiscal capacity.

Tax Leakage Trends and the Impact on State and Local Governments

Internet and Mail Order Sales

Another concern related to the disproportionate reliance on the sales tax is the increasing use of the Internet to make purchases on which no sales tax is collected. It is estimated that this trend could cost Tennessee approximately $21 million in lost revenues by 2002. A greater problem continues to be the inability to impose jurisdiction over the many direct marketing businesses that are not required to collect state and local sales tax because they do not have sufficient nexus (physical presence) in the state of Tennessee. Revenue losses associated with mail order sales are currently estimated to be approximately $77 million and are projected to be $93 million by the year 2000.

In addition to the direct sales tax losses occurring from direct marketing sales, the increased penetration in Tennessee (and other states) by new forms of electronic commerce (the Internet) increases the equity impact of the sales tax. Survey data show that 80 percent of households with incomes greater than $100,000 own personal computers, compared to only 25 percent of households with incomes under $30,000. The average incomes of men and women who make purchases using the Internet are $76,000 and $60,000, respectively. Thus, upper income households tend to utilize various forms of electronic commerce more than lower income households and thereby disproportionately avoid the sales tax burden.

Cross-border Shopping

It is widely believed that Tennessee has a border tax problem because of differential sales tax rates. Currently, no border state has a combined state and local sales tax as high as Tennessee's. Elasticity studies of the sensitivity of border areas to changes in local sales tax rates bear out the theory that rate increases adversely affect retail sales. In a study conducted for TACIR by Middle Tennessee State University, it was indicated that retail sales can be quite sensitive to changes in sales tax rates and may cause consumers to seek other markets. However, it was also pointed out that there is some counter-balancing for "out-leakage" by "in-leakage" in large retail centers in Shelby, Hamilton, and Montgomery Counties. A TACIR analysis compared Hamilton County with bordering Georgia counties and found that there is significant leakage into the Georgia counties.

Gambling and Lottery Issues

Four of Tennessee's neighboring states provide easy access to gambling activities and lottery participation: Kentucky, Georgia, Mississippi, and Virginia. Kentucky and Georgia both report participation by Tennesseans: 12.5 percent of sales in Kentucky and 2.9 percent of sales in Georgia. Since both states have experienced continued growth in lottery sales, it is reasonable to assume that Tennesseans are spending increased amounts each year in these states on lotteries.

In addition to their participation in lotteries, Tennesseans are traveling to Mississippi to engage in casino gambling. Mississippi casino gross gaming revenues grew almost 7 percent in 1997 and are up over 10 percent for the first nine months of 1998. Based on the recent quarterly survey of visitor detail, over 10 percent of visitors to Mississippi casinos are Tennessee residents. It is therefore likely that spending by Tennesseans on casino gambling in Mississippi has also been increasing. However, although the commercial and industrial development in Memphis' cross-border suburbs in Mississippi represent competition for businesses in Tennessee, the development is providing employment and income opportunities for Tennessee residents, especially those from the Memphis area.

Business Tax Leakages

Sales Tax Leakage

Although the potential sales tax loss from mail order and Internet purchases is usually considered minor because of existing use tax reporting requirements imposed on many large businesses, most small businesses not registered with the Tennessee Department of Revenue are just as likely to make such purchases as households, and for similar reasons.

New Business Organizations

An initial study by the Tennessee Department of Revenue (1997) identified over 500 corporations that had converted to limited liability companies (LLCs). However, the data did not substantiate any significant loss of revenue. Franchise and excise taxes were lost as a result of the conversions, but were compensated for by Secretary of State fees on LLCs. A more recent but preliminary study by the Department of Revenue of the impact of LLCs, estimates a revenue loss of $5-12 million per annum. The losses result from existing corporations that converted to LLCs and new businesses choosing the LLC format over the corporate form.

When taxpayers reduce their liabilities through sophisticated accounting strategies or maneuvers, tax reductions are not frequently recognized or easily categorized. The restructuring of operations is an example of this type of activity. The impact of this type of activity is currently being analyzed and evaluated by the Department of Revenue, although it is a fairly recent phenomenon in Tennessee.

Revenue Options for an Uncertain Fiscal Future

Sales Tax Options

In the event of a fiscal crisis, the sales tax rate could be increased. An increase in the state rate from 6 percent to 6.5 percent would generate an additional $352 million in revenue in fiscal year 2000. The state sales tax base could be broadened to encompass more tangible goods: for example, a 6 percent sales tax on gasoline would yield $200 million and on diesel fuel, $49 million; on newspapers, it would generate $10 million.

The sales tax could also be broadened to some services. For example, barber and beauty services would generate $13 million, while veterinary and landscape services would yield $11 million. If the base included all cable TV services, $15 million could be generated. Another $154 million could be raised by applying the state sales tax to residential energy sales.

There are strong arguments against the taxation of business services. The arguments against applying the sales tax to business services include the following: the distortion of market prices, which is inefficient; the distortion of business decisions regarding the efficient combination of resources; the administrative problems that would be created related to nexus issues; and businesses who use taxable business services would be placed at a competitive disadvantage.

The state sales tax base could be broadened to include real property contract services which would generate an estimated $332 million for fiscal year 2000. However, there would be substantial administrative costs to be considered.

The repeal of the vending machine sales tax exemption could potentially generate $15 million for the state and $6 million for local governments. The repeal of sales tax vendor compensation would result in an additional $19 million in state sales tax revenues and $6 million for local governments.

Removing the cap on the price of a single article would generate an estimated additional $157 million for local governments. It should be noted, however, that this potential revenue depends heavily on the sale of big ticket items, a class of purchases very sensitive to economic conditions.

Current law precludes the taxation by local governments of the sale of energy. Although residential energy sales are exempt from state taxation, an estimated $919 million in mostly commercial sales are subject to the state sales tax. If this block of sales were subject to local sales taxes, the potential yield would be approximately $21 million.

Selective Sales Tax Options

The current tax rate in Tennessee on cigarettes is 13 cents per pack. A 5 cent increase, from 13 cents to 18 cents, could generate an additional $30 million in revenue. If a gallonage tax were imposed on soft drink bottlers or distributors, the current gross receipts tax on bottlers would most likely be repealed. The net effect would be additional revenue of $10 to $20 million. Although recently Tennessee reduced overall insurance company taxation, a 25 percent increase on premiums could generate an additional $75 million in the next fiscal year.

The Commercial Lease Tax

Florida raised $656 million from commercial lease taxes in fiscal year 1997. The tax is essentially a sales tax application, with personal dwelling units exempted. The revenue potential from such a tax in Tennessee is estimated to be $40 million. However, exemptions, which would be likely, can substantially reduce this estimate.

Lottery and Gambling

Thirty-seven states currently have state lotteries and generated nearly $12 billion in revenues. Four of the eight states that border Tennessee have a state lottery. Estimates of the potential impact of a state lottery in Tennessee range from $180 million to $302 million. Comparative data from states with lotteries reflect substantial variation in the net amount of revenue that can be expected from a lottery. Removing the constitutional prohibition against a lottery is necessary if a lottery is to be a practical option, a process that could take two to three years under current state constitutional procedures. The actual implementation would take six to nine months.

Casino gambling is available in 23 states with gaming devices, card rooms, and bookmaking available in another ten. However, there are constitutional and statutory barriers to many forms of gambling. Based on tax revenues from gaming from Mississippi River locations, the potential additional revenue from legal gambling activity in Tennessee exceeds $250 million.

Broad-Based Personal Income Tax

A broad-based income tax was passed in Tennessee in 1931 and contained progressive tax rates and included personal exemptions but was declared unconstitutional in 1931. Subsequent attempts have met with little success.

Governor Ray Blanton proposed an income tax in 1976 that repealed the Hall Income tax, reduced the sales tax rate from 4.5 percent to 3 percent, exempted utilities from the sales tax, imposed a personal income rate from 1 to 3.5 percent on federal adjusted gross income with a $1000 personal exemption, and provided a $15 per person credit against the sales tax paid on food.

Governor Ned McWherter made the only other serious attempt at the reenactment of an income tax in 1991-92. It included a reduction in the state sales tax rate from 5.5 percent to 4 percent, an exemption from the sales tax on food for home consumption, a cap on the local sales tax rate at 2 percent, repeal of the single article limitation in the local sales tax law, repeal of the Hall Income tax, and imposition of a 4 percent income tax on federal adjusted gross income with an exemption of $7,000 per person. The proposal and variations of it were presented and discussed across the state by state officials. The response in many areas of the state was negative. The proposal was introduced as a bill in a special session of the legislature, but did not progress.

Expenditure Tax

An expenditure tax was discussed briefly during the attempt to reform the tax system by the McWherter administration. The expenditure tax, or "spending tax" is based on the taxation of household consumption of goods and services, not the level of income. Savings would not be taxed, so households that save would not be taxed on that portion of their incomes. Exemptions and deductions could be provided to construct a more progressive system under the expenditure tax.

Some arguments in support of such a tax include the avoidance of taxing savings twice, it can be used to supplement an income tax, and it avoids all the problems associated with capital gains under current income tax law since the base is consumption and not income. Arguments against an expenditure tax include the fact that consumption is already taxed through the sales tax, there is no experience with the tax in the U.S., and it would be difficult to administer.

State Property Tax

The state property tax in Tennessee was discontinued in 1947, following introduction of the sales tax. Several southern states impose state property taxes. A state property tax rate of 25 cents per $100 of assessed value would generate $169 million in fiscal year 2000. Some states impose value-based taxes on motor vehicle ownership, including nine southeastern states. The effective rates in these states vary from .3 percent in Alabama to 3.75 percent in locations in South Carolina. However, in Tennessee, the Constitution limits the assessment rate on tangible personal property to 5 percent.

If a separate privilege tax were imposed on personal motor vehicles, based on value, the potential tax base in 1999 is $16 billion. An effective privilege tax rate of 1 percent in Tennessee would generate $160 million. The estimate depends heavily on the actual valuation method chosen, however.

Business Tax Reform

Given the current environment of intense interstate tax competition it would be difficult to raise Tennessee business taxes above their current levels. Also, most studies of business taxation in Tennessee have recommended business tax restructuring that does not raise taxes, but distributes the tax burden on businesses more fairly. However, under fiscal pressure, there are some options. The repeal of the corporate excise tax credit would generate $20 million. Increasing the corporate excise tax rate by 1 percent to 7 percent would generate $100 million. Increasing the corporate franchise tax rate by one cent would raise $13 million.

Sunsetting Tax Exemptions

There are over 200 tax exemptions, in the sales tax law alone. The consequence of each has been a loss of tax revenue initially. Reversing tax exemptions is almost impossible. However, a fiscal situation may arise that could force the reconsideration of certain tax exemptions. A list of tax exemptions and their cost to the State and local governments is presented in Appendix 8.

For a copy of the full report please call (615) 741-3012 or fax at (615) 532-2443.