



An Outdated Tax System Meets the 21st Century

by Governor Don Sundquist

As you read this, our state nears a critical point of decision about our budget and tax structure. The seeds we sow will determine what sort of harvest we can expect as the 21st century opens.

Will Tennessee remain a place of economic opportunity? Will our rising generation have the education and training to seize such opportunity? Will Tennessee remain a wonderful place to visit and live?

The decisions we make now will help forge the answers.

Our tax system is outdated. Designed in the early and middle decades of this century, it is poorly suited to our citizens' needs and sense of fairness. It relies on sales taxes more than any other state. More than half of the money state government raises comes from sales taxes, and our sales tax burden is the seventh highest.

Even at high tax rates in the best of times, sales tax collections do not grow as quickly as the economy. Tennessee has historically had to boost sales taxes every five to eight years. We get a one-time spike in revenue, but then erosion begins. We're seeing it amid one of the nation's longest sustained economic upswings. When times are hard, sales tax collections fall fast and far, making it more difficult for the state to meet the increased demand for services.

Our business taxes, dating back to the 1920s, cover some kinds of companies but not others and leave untouched much of the service sector, the largest and fastest-growing segment of our economy. We closed some loopholes in the tax law this year, but many remain. Many profitable enterprises pay no Tennessee business tax.

Despite four consecutive record years for business investment and job creation, we are collecting less business tax than we were last year. The state's best economists tell us we will continue to see our business

tax base erode.

Other pressures affect our state budget.

The General Assembly in 1992 passed the Basic Education Program (BEP), obligating the state to phase in a \$1 billion increase in annual spending for schools, paying for it by raising the sales tax half a penny, which produces only about 350 million dollars a year in tax revenue. We have met the BEP funding target only by taking most of the revenue growth the strong economy has produced. Fortunately the economy has been strong for eight years.

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Education has claimed the lion's share of the state's revenue growth but is by no means the only claim on those dollars.

TennCare requires an ever-larger share of our state's budget, but for all its faults, TennCare has saved the state billions of dollars since its creation in 1994. If Tennessee had never started TennCare but remained in the federal Medicaid program, the cost to us would be hundreds of millions of dollars more than we pay for TennCare, and we would be covering 400 thousand fewer Tennesseans. We operate TennCare under a federal waiver. Washington provides two-thirds of the money, but we must provide the other third. Like health care costs in general, TennCare costs have risen. We're working to reform TennCare, but as

we do, we have no choice but to put up our share of the money.

We've had to invest a considerable amount of money in new prisons. In the early 1980s, when Tennessee built no prisons, our system became overcrowded. The federal courts took over the prison system, requiring the state to spend hundreds of millions of dollars on improvements and release felons early to relieve overcrowding. No one wants that to happen again.

Our state is under a federal court order to improve our system of mental health and mental retardation services.

With just the previous four items, our state's revenue growth is more than spoken for.

Inflation adjustments alone add \$55 million a year to our K-12 education budget just to allow school systems to continue what they're doing. To fully fund the BEP requires a total of \$73 million.

Improvements would require even more. A meaningful pay raise for teachers would require \$50 million, apart from any measures to reduce disparity in salaries between well-off and distressed school districts.

Only 20 percent of Tennesseans have gone to college, and about 16 percent have earned college degrees, well below the national average. The Council for Excellence in Higher Education says Tennessee needs to invest more than \$400 million over the next few years or risk falling further behind our neighbors in the south, to say nothing of the nation.

Those who regard a good education as the gateway to opportunity can only view these challenges with alarm, yet these are the challenges our state is attempting to meet with a tax system that fails, in the best of times, to keep up with growth.

My political ideal has always been limited government, focused on fundamental

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and important things. Tennessee's state government comes nearer that ideal than any other state. We rank 47th nationally in state spending and 50th in taxes.

We have done a very good job of restraining governmental spending growth—we've cut it in half. We have reduced the size of the bureaucracy and are among the nation's top six states in using technology to improve efficiency and service. Two-thirds of the recommendations made by the Commission on Practical Government have been, or are in the process of being, implemented. We are in the third year of a government-wide strategic planning process that includes reforming children's services and welfare, cleaning up truck safety enforcement, eliminating paperwork, curtailing state travel and cell phone usage, and even ordering white trucks for DOT instead of having them painted orange.

Making government work smarter, better, and at less cost has been our approach since I took office. We continue to streamline operations and scrutinize spending, but we have a problem that cannot be solved by management skill or budgetary finesse. Without relief, our state cannot meet the basic needs of our citizens.

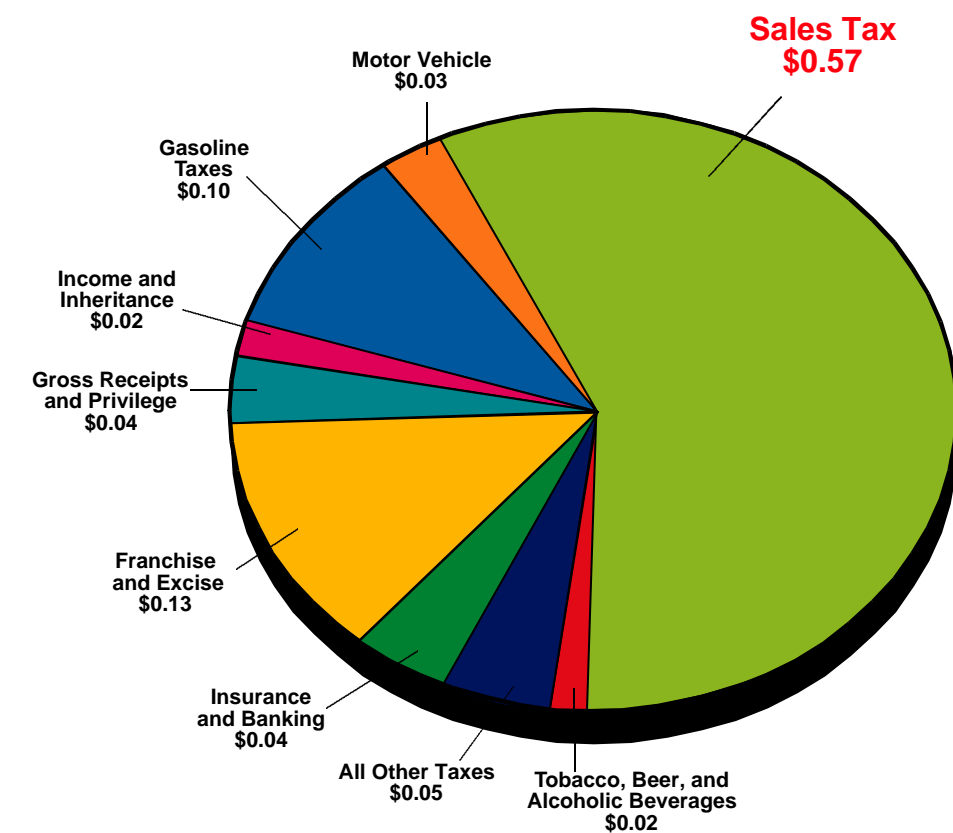
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People say, "Why can't you just tighten your belts and cut the budget some more?"

Let's look at the budget. We count a lot of things other states don't—the federal funds we receive and the money collected in college tuition and special purpose fees.

Some money is counted twice. We lease offices through the Department of Finance and Administration, which bills each agency using that space. Those funds show up in each departmental budget and again as payments to the Department of Department of Finance and Administration.

Some states have a separate budget for



capital projects. We don't.

The budget isn't as big as it appears. When you look closely, we have far less discretion than most people imagine.

The state budget is roughly \$16.5 billion. Subtract from that \$5.6 billion in federal funds Tennessee receives. These are pass-through funds—how much we get and what we spend it on is entirely up to the federal government, but it shows up in our budget as revenue received and money spent.

Subtract from the \$10.9 billion left the amount of current services expenses, such as tuition payments to state schools. This is pass-through money which shows up as income (though it's paid by students directly to the college) and as spending (though it's spent by the institution).

Tuition is going up at every Tennessee college and university. Next year that will show up in the budget looking like several hundred million dollars of new revenue and spending, but it's not. Current services costs in this budget are about \$2.4 billion.

Subtract from the \$8.5 billion left the amount we spend on bonds and debt service—obligations we must meet. Tennessee has one of the lowest amounts of bonded indebtedness in the nation; we spend less than 1 percent of our budget on debt serv-

ice. This year, that's about \$500 million, leaving \$8 billion.

We have to fund TennCare. This year, our cost is about \$1.4 billion dollars, leaving \$6.6 billion.

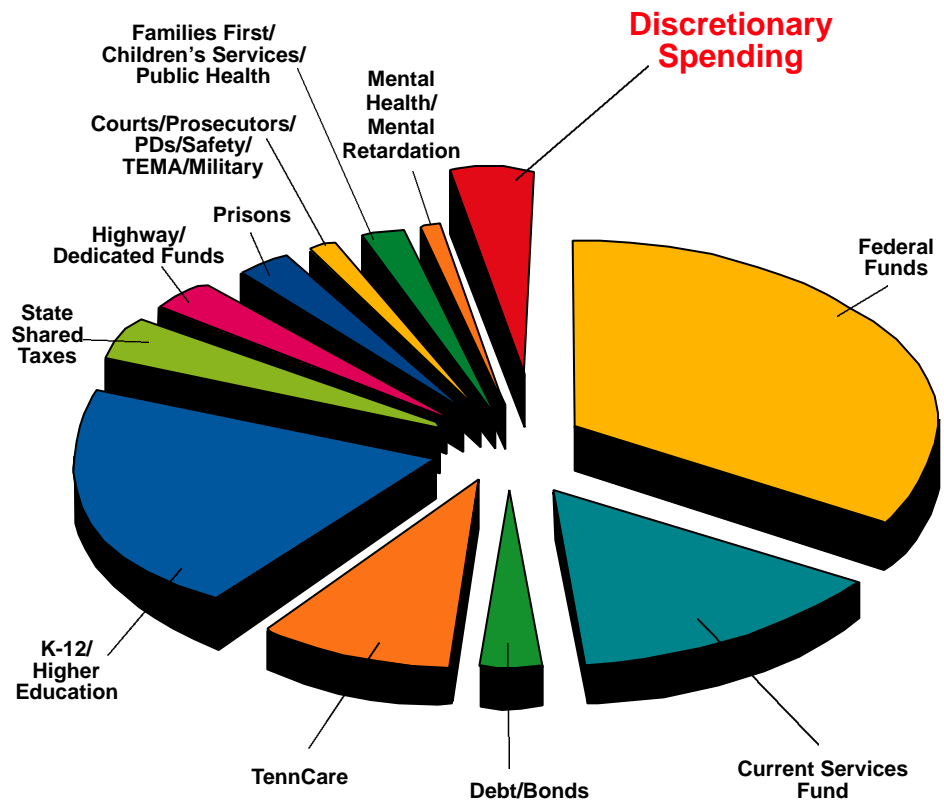
No one says we should cut funding for public schools. Most people agree our system of public higher education needs to be improved. Schools and higher education account for about \$3.5 billion, leaving \$3.1 billion.

There are a few other items we probably can't touch. By law, cities and counties are entitled to a share of some taxes the state collects. If we changed the law and cut out local governments, they would make up the difference by raising local taxes. Let's assume we continue the state shared taxes, which this year are more than \$600 million. We're down to less than \$2.5 billion.

The state collects about \$800 million each year in taxes and fees dedicated to specific purposes; the highway fund accounts for most of it, but various user fees are also included. We can't touch that \$800 million. We're down to \$1.7 billion.

Corrections cost us more than \$400 million annually. We really cannot cut that without a return to overcrowding, mandatory early release of felons, and the possi-

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bility of a federal court take-over. We're down to less than \$1.3 billion.

Other costs are associated with public safety and health: the military (which carries federal obligations), Tennessee Emergency Management Agency (TEMA), Department of Safety, parole board, court system, prosecutors, and so forth, which cost \$300 million. We have less than \$1 billion left.

Families First is one of the nation's most successful welfare reform programs. Consolidation of children's services has helped the state do a better and more efficient job of protecting children in danger and dealing with children in trouble. All of us want to see public health programs continue. Combined, these cost about \$300 million annually, leaving less than \$700 million.

Our mental health and mental retardation services system is under court order or consent decrees. We're obligated to spend what's budgeted—about \$115 million. We're down to about \$600 million for everything else: economic development; tourism, agriculture, and workforce development; environmental protection; veterans affairs and human services; capital projects; and the basic operation of state government—revenue collection, regulation and oversight of financial institutions and other businesses, the Personnel, General Services, and Finance and Administration departments; the Attorney General's office, comptroller, treasurer, secretary of state, governor's office, and General Assembly operations.

Those areas would absorb the biggest portion of any cuts but cannot absorb the \$3 or \$4 hundred million dollars in cuts it will take to balance next year's budget. The General Assembly balanced this year's budget with accounting gimmicks and one-time funds, and so we begin next year's budget guaranteed a deficit of about \$380 million.

It is not an encouraging picture and has every potential to worsen. Saving TennCare will require additional funds, school funding must rise at least \$55 million to keep pace with inflation and \$73 million to fully fund the BEP, our colleges and universities need \$400 million over the next five years to compete, we must deal with teacher pay equalization, and we must build a prison and probably a juvenile facility in the next three or four years.

This is no longer a situation we can finesse or a matter of cutting a little "waste, fraud, and abuse." What's required is fun-

damental change in our tax code. Ideally, such change would enable us to repeal the tax on grocery food and reduce the overall tax burden on middle class families; require something of those who currently pay no taxes; impose low tax rates and enable us to remain one of the nation's least taxed states; be elastic; and produce enough revenue to enable us to protect education, health care, public safety, and the well-being of older citizens and those in genuine need. Our administration is studying alternative ways to accomplish this, as are the General Assembly's Business Tax Study Committee and private groups.

Experts have warned that the day of reckoning is coming. That day is at hand. Something must give. How we meet this challenge will determine whether our state enters the 21st century prepared to compete.

History repeats itself. Tennessee faced a similar crisis seventy-six years ago, when the state relied on a property tax for most of its money. This was fine when agriculture drove the economy. By the Roaring '20s, most Tennesseans weren't farmers, and business and industry drove the economy. The tax burden fell heavily on some Tennesseans but not at all on others. The state found itself unable to fund the modest serv-

ices of that era during a time of plenty.

In 1923 Governor Austin Peay pushed through tax reform that adapted our tax structure to the 20th century economy. He replaced the property tax with others that applied more broadly and at low rates. His actions stabilized the budget and made possible improvements that ushered in a season of progress for Tennessee: better funding for public education, the first state funds for colleges and universities, the first good roads spanning our state, and the beginnings of our state park system and the Great Smoky Mountains National Park.

We cannot afford to drift 20 years into the next century before adapting our tax structure to the realities of the economy in the information age. We can't afford to waste any time. Let's not wait for a financial catastrophe to do what we must.

We can see the iceberg up ahead. We have time to turn the ship. The stakes are high, the choices hard. Our state's future depends on whether we're up to the challenge and willing to meet it together. ■

Since Don Sundquist became Tennessee's governor in 1995, the state has experienced four consecutive record years of economic development.