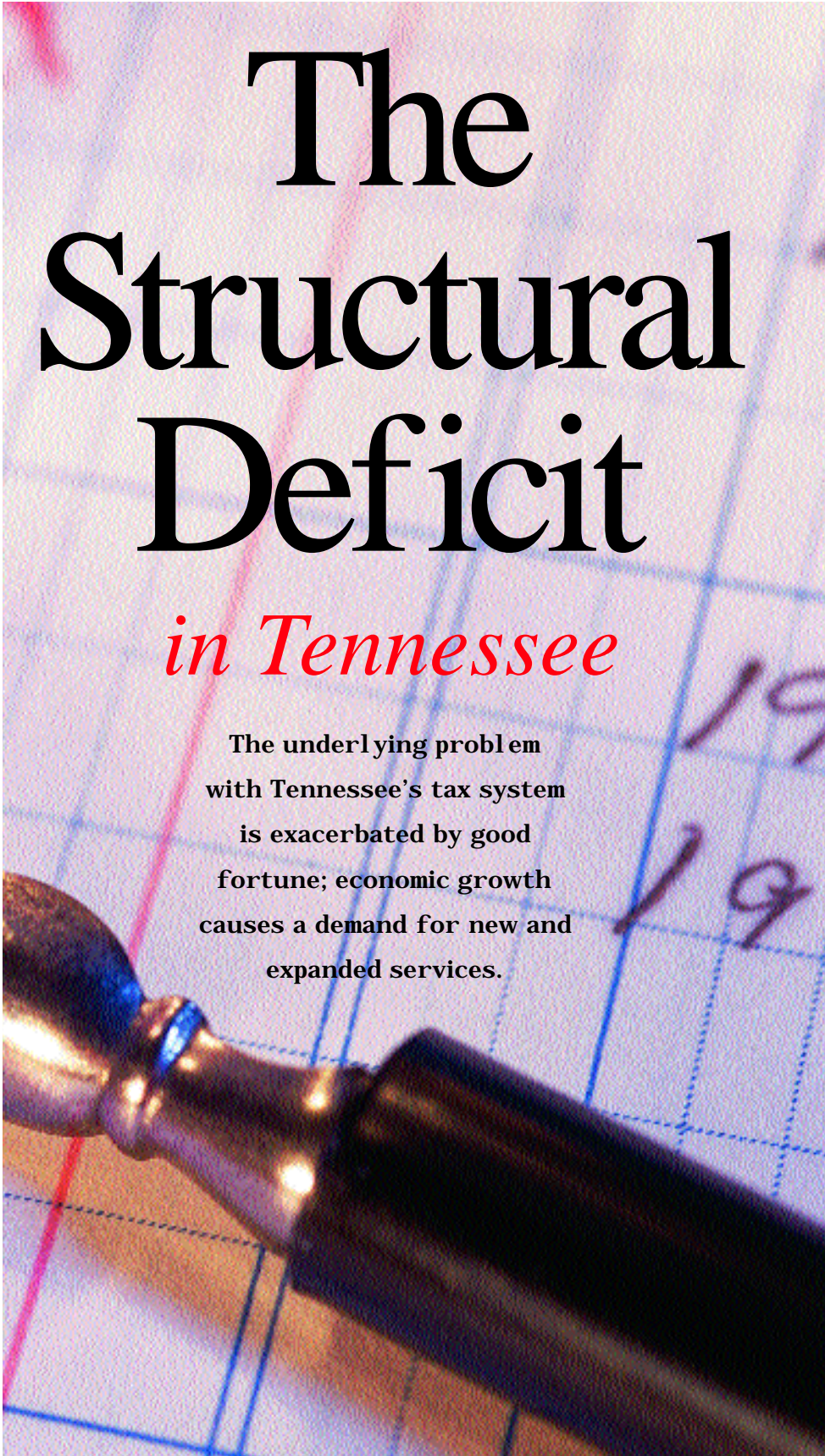




A new name for an old problem



The Structural Deficit *in Tennessee*

**The underlying problem
with Tennessee's tax system
is exacerbated by good
fortune; economic growth
causes a demand for new and
expanded services.**

Nine years ago *Tennessee's Business* published a special edition devoted to Tennessee's revenue and budgetary problems.¹ The lead article in that special edition was written by one of the authors of this paper.² Other articles in that special edition covered specific state and local tax and spending issues and were written by members of the State Senate and House, as well as fiscal experts representing state and local governments and the business sector. Despite extensive discussions on tax reform and a serious attempt by Governor Ned McWherter to sell Tennesseans a tax reform package that included a personal income tax, all attempts at tax reform in the early 1990s failed.

After all options representing serious change failed to generate any public support, the pressing revenue problems then facing state and local governments were temporarily resolved with a half-cent increase in the state sales tax (from 5.5 to 6 percent). The increase in the state sales tax became effective on April 1, 1992. This tax increase and the remarkably robust economic expansion that began in the second quarter of 1991 provided Tennessee with the revenue growth that enabled state expenditures to grow at a conservative rate through 1998.

The most notable aspect of the period that has elapsed since 1990 is that a repeat of the pressing budgetary problems of 1990 and 1991 has not occurred sooner. All of the problems relating to the state and local tax structure that were identified in the special tax issue in 1990 continue to exist and, in most cases, have worsened. In fact, Tennessee's fundamental revenue problems have not changed much in the twenty-five years since they were studied extensively by the Tax Modernization and Reform Commission.³ The problems identified in 1974 were much the same problems identified in 1984 by the Special Joint Legislative Task Force on State and Local Tax Structure⁴ and most recently by the Tennessee Advisory Commission on Intergovernmental Relations.⁵

Tennessee has managed to "get by" since 1990 with a tax structure that should have collapsed under its own weight years ago. Good luck is as welcome in state finance as it is in the game of golf. However, good luck has finally run its course, and the state budget is again facing intense pressures. The problem Tennessee faced in

the early 1990s and faces again today is a fiscal situation called a *structural deficit*. Its meaning and implications are well defined by Michael Kahn in a foreword to a recent publication on state and local government finance as “a condition in which the revenues produced by a state’s tax system (along with its other revenues) are insufficient to maintain existing levels of services. States with structural deficits will be in perpetual fiscal crisis unless they deal with the underlying causes of imbalance in their revenues and expenditures.”⁶

A recent investigation of state and local finances identified eleven states with structural deficits: Texas, New Hampshire, Florida, Tennessee, Arizona, Wyoming, New Mexico, Idaho, Hawaii, Alaska, and Nevada.⁷ Of these eleven states, seven do not have a broad-based personal income tax (Texas, New Hampshire, Florida, Tennessee, Nevada, Alaska, and Wyoming). The projected structural deficits in Idaho, Arizona, and New Mexico result from anticipated above-average growth in demographically driven program expenditures.

To reevaluate the revenue and budgetary problems facing Tennessee, this article will compare the tax structure in 1990 with the tax structure of 1999, discussing program spending pressures, inequities, and problems with the sales tax and business taxes. We hope this article will not be used as a boilerplate to revisit state tax problems in 2009.

Tax Structure: Then and Now

While the sales tax was increased from 5.5 to 6 percent in 1992 and various petroleum taxes were raised (primarily to benefit the highway fund), the state tax structure remains much the same as it was in 1990. Table 1 presents the distribution of collections by the Department of Revenue for fiscal years 1988-89 and 1998-99.

The data show no significant change in the state tax structure between fiscal years 1989 and 1999. Tennessee remains hopelessly dependent on sales and selective sales taxes to fund the state budget. Such taxes are by their nature simultaneously regressive

TABLE 1. DISTRIBUTION OF DEPARTMENT OF REVENUE COLLECTIONS

Tax Source	Fiscal Year 1988-89	Fiscal Year 1998-99
Sales and Use	55.5%	61.6%
Selective Sales	16.9%	13.3%
Excise and Franchise	13.6%	12.8%
Income	2.4%	2.3%
All Other	11.6%	10.1%
Total	100.0%	100.0%
Total Sales and Selective Sales only	72.4%	74.9%

and inelastic. Since no meaningful changes have been made to the tax structure over this ten-year period, no meaningful progress has been made toward dealing with the state’s structural deficit.

Income Elasticity of the Tax System

One of the most important characteristics of a state tax system is its income elasticity. Simply put, income elasticity measures the responsiveness of a tax system over time to changes in the economy (generally measured by growth in state personal income). Tax systems are generally categorized as inelastic, unitary elastic, or elastic, depending on whether state revenue grows slower than, at the same rate as, or faster than state personal income.

While the special tax issue in 1990 did not directly deal with measures of the tax elasticity of Tennessee’s tax system, it did identify the system’s inelasticity as one of the state’s major fiscal problems.⁸ Formal analysis of the income elasticity of Tennessee’s tax system has shown little change between estimates made in 1974⁹ and more recent estimates.¹⁰ A study of the elasticities of state and local general fund taxes conducted in 1998 found that Tennessee had the fifth lowest elasticity in the country.¹¹

TABLE 2. TENNESSEE STATE AND LOCAL TAX BURDEN

Fiscal Year	Per Capita Taxes	Rank	Taxes as % of Personal Income	Rank
1986	\$1,077	46	9.7%	45
1996	\$1,878	50	9.0%	50

Source: 1986 data from *Significant Features of Fiscal Federalism*, 1988 Edition, Volume III, U.S. Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1988, Table R-2, p. 115; 1996 data from Federation of Tax Administrators’s Web site at www.taxadmin.org/fta/rate/tax_stru.html. Rankings include the District of Columbia.

The inability of a tax system to generate revenue growth equal to growth in personal income is frequently the prime suspect behind infrequent but large increases in tax rates and tax bases. When a tax system left to its own devices can’t cut the fiscal mustard, increases in tax rates or tax bases are the only ultimate alternative.¹²

Tax Burdens

While no discernable change occurred in the tax structure, Table 1 by itself conveys no information on whether or not the relative size of the tax burden imposed in Tennessee changed between the two periods. Table 2 presents data showing that while taxes certainly increased over time, Tennessee, then and now, still has one of the lowest tax burdens in the country. In fact, for the latest year (1996) for which there are comparable state and local data for all states, only Alabama had a lower combined state and local tax burden.

Program Size and Growth: Then and Now

Budgetary problems do not materialize from revenue problems alone. A reduction in students (K-12 and college bound), uninsured residents, and crime might allow a state actually to reduce both its taxes and expenditures. However, this unlikely set of events has not as yet occurred in any state. Program cuts are an option for Tennessee but at tremendous future costs. Clearly, a consensus vision for Tennessee in the 21st century does not include a last-place ranking among the states in all economic and social indicators other than tax burdens.

Since 1990, three main programs dominate Tennessee state general fund appropriations: state equalization aid to local governments for funding K-12 education; the state Medicaid (now TennCare) program; and Tennessee’s higher education program. The corrections program, while a distant fourth, should also be mentioned. Table 3 provides data showing the level of general fund appropriations and changes in the relative level and importance of each of these programs over the period 1988-1998.

The data make it starkly clear that growth in these three programs dominated the growth in general fund appropriations. What is also

TABLE 3. GENERAL FUND APPROPRIATIONS FY 1987-88 VERSUS FY 1997-98

Program	Fiscal Year 1987-88		Fiscal Year 1997-98		Percent Change
	Appropriations (In \$Millions)	Percent of Total	Appropriations (In \$Millions)	Percent of Total	
TennCare/Medicaid	\$300.2	9.6%	\$1,169.0	19.5%	289.4%
Education	\$1,227.8	39.3%	\$2,305.4	38.5%	87.8%
Higher Ed	\$636.4	20.4%	\$910.8	15.2%	43.1%
Corrections	\$235.9	7.5%	\$408.8	6.8%	73.3%
Other	\$724.6	23.2%	\$1,186.3	19.8%	63.7%
Total	\$3,124.9	100.0%	\$5,980.3	100.0%	91.4%

Source: *The Budget*, State of Tennessee, 1988-89 and 1998-99 editions. Data refers to estimated figures; see 1999 document, pp. A-18-20.

clear is that continued growth in these programs will occur in the future from a combination of increases in program costs and participants.

The recent history of K-12 funding provides the quintessential example of Tennessee’s structural budget deficit. Facing a Supreme Court order for greater equity in K-12 funding, the General Assembly passed a half-cent increase in the state sales tax. Funding for the education reform program known as the Basic Education Program was to be phased in over six years. While it was clear the half-cent increase could not fully fund the BEP in the out years, there was insufficient support for full funding.

It was widely recognized that the BEP and other education improvements would have to be funded from growth in the sales tax base (taxed at 5.5 percent). Good fortune eventually smiled on Tennessee in the form of a very long economic expansion. However, there has been a general funding problem for the past two years. Good fortune provided by the economic expansion that began in 1991 was overtaken by the structural budget deficit.

Note the illustration in Figure 1. Based on the half-cent sales tax increase alone, the BEP was underfunded by nearly \$600 million in the FY 2000 budget. In fact, since 1992, student enrollment has increased by around 75,000 students statewide, and the half-cent sales tax is barely enough to fund these new students, much less to fund the improvements required to achieve the court-ordered equity mandates.

Medicaid/TennCare appropriations have grown dramatically for three primary reasons. First, as an entitlement program, as more individuals become eligible for the program, they must be automatically included, and the number of Tennesseans eligible for Medicaid has grown over this period. Second, the federal government

provides matching funds for this program in a ratio of approximately two federal dollars to one state dollar. No other significant state program is funded in this fashion. As a result, it is predictable and reasonable for state officials to attempt to maximize such matching funds within the constraints of their available general fund revenues. Finally, medical care and medical care service prices have risen at twice the rate of other consumer goods, automatically forcing up the cost of medical service programs by over 75 percent.¹³

The predictable desire or incentive to maximize the leverage of federal tax dollars in the Medicaid/TennCare program has been greatly responsible for the program’s increased share of general fund appropriations. Between 1988 and 1998, the program, which represented only 9.6 percent of general fund appropriations in 1988, grew to almost 20 percent of general fund appropriations despite the fact that no tax increases passed during this period were specifically earmarked for this program.

In contrast, the state sales tax was increased in 1992 (by .5 percent) with the revenue increase specifically earmarked for education.¹⁴ This helps account for the increase of over \$1 billion in general fund appropriations for education. However, even with the sales tax increase fully earmarked for education, education’s share of general fund appropriations did not change over the ten-year period, remaining at approximately 39 percent.

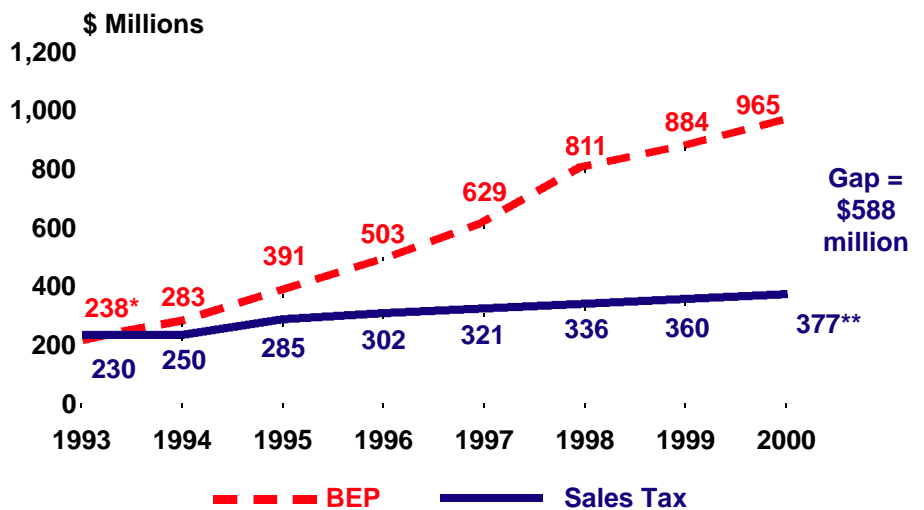
Higher education clearly was the loser over the ten-year period when one considers that the general cost of living increased 38 percent during this time.¹⁵ With total general fund appropriations for higher education rising only 43 percent over this same period, higher education faced a serious challenge just to maintain a given level of services. Since higher education was not the recipient of any new court-mandated expenditure program or lucky enough to benefit from a highly leveraged federal entitlement program, it has suffered disproportionately as growth in general fund tax revenue has been disproportionately diverted to the TennCare and K-12 education programs.

Inequities in the System—Then and Now

The 1990 article mentioned in the introduction identified two major inequities in Tennessee’s tax structure. They were (1) the many and varied tax expenditures that were specific in nature and generally available and used by a limited number of busi-

continued on page 6

FIGURE 1. BEP IMPROVEMENTS COMPARED TO HALF-CENT SALES TAX COLLECTIONS



Notes: * includes \$116 million 1992 budget cut restoration; ** projected.

FIGURE 2. TENNESSEE TAX BURDENS BY FAMILY INCOME

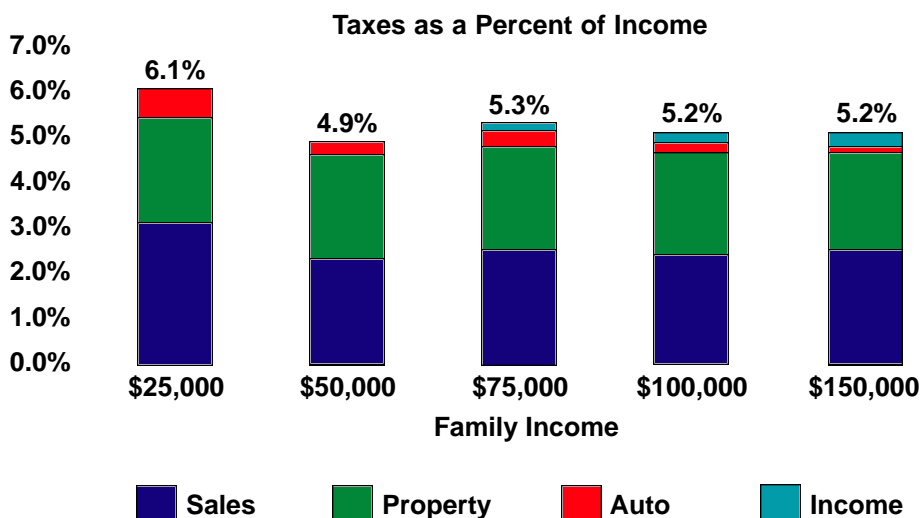
nesses and (2) the preponderance of generally regressive taxes that dominated the tax structure, the most ubiquitous being the general sales tax. The impact of regressive taxes is usually harsher on lower income households than higher income households.

These inequities have not lessened over the years and probably have worsened. In addition to the two general inequities mentioned in the 1990 article, more recent evaluations of the tax structure have discovered severe inequities existing in the tax treatment of businesses.

The inequities in the tax system that result in selective tax reductions for certain businesses or products have worsened over time; the tax statutes are riddled with many more exemptions, credits, or special reduced tax rates than were in existence in 1990. While many of these tax expenditures have legitimate arguments in their defense, there are many other examples of businesses in need of tax breaks, for the best of reasons, that do not receive any.

Many businesses in need of tax breaks do not receive any.

The regressiveness of Tennessee's tax system is most apparent in its impact on families of different income. Using the same data source used in the 1990 special issue,¹⁶ 1997 tax burdens in Tennessee



(measured by the ratio of taxes paid to family income) show a similar impact to those for 1987. Figure 2 shows the relative tax burden for five different Tennessee families.¹⁷ As was true in 1987, tax burdens fall or remain fairly proportional as household income rises, reflecting the regressive nature of Tennessee's taxes.¹⁸

The most recent data also show that Tennessee's tax system remains one of the most regressive in the country (See Figure 3).¹⁹ Using the ratio of the percentage tax burden of a family with \$25,000 of income to the percentage tax burden of a family with \$150,000 of income as a measure of the progressivity or regressivity of a tax system, Tennessee has the most regressive system in the south.²⁰ A ratio of one implies that a tax system is proportional. A ratio of less than one implies a progressive tax structure since families with low

incomes would pay a smaller percent of their income in taxes than would a higher-income family. An index greater than one implies that a lower-income family pays a larger percent of its income in taxes than a higher-income family.

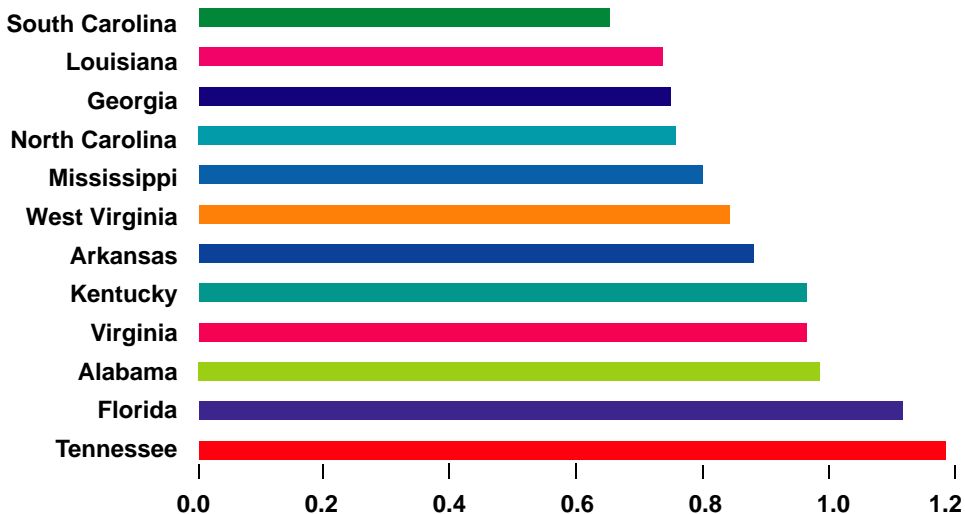
Future Problems: The Sales Tax and Business Taxes—Again

The increase in the level of general fund appropriations (91.4 percent) from 1988 to 1998, especially for the three primary programs discussed earlier, was made possible by revenue growth in the sales tax, Hall income tax, and combined franchise and excise taxes, all of which are primarily general fund revenue sources. However, the primary funding mechanism was the state sales tax, which grew by 90.6 percent.

Since sales tax collections grew by 90.6 percent while Medicaid/TennCare appropriations grew by 289 percent, many state general fund programs did not share equally from the growth in general fund revenues over the ten-year period. With the exception of the K-12 education program, which held its own, most state programs lost relative funding ground to the ever-increasing and highly leveraged Medicaid/TennCare program. The resulting program funding problems can therefore be blamed on a combination of circumstances, a Medicaid/TennCare program that is still searching for a resolution and a state tax structure that is unable to generate the necessary funds to meet the growing program needs of the State of Tennessee.

Tennessee's sales tax problems are not unique; the many problems associated with

FIGURE 3. PROGRESSIVITY/REGRESSIVITY INDEX



the sales tax are discussed elsewhere.²¹ However, the key elements will be noted here:

- Consumer expenditure patterns have shifted over time away from tangible goods toward services; the existing sales tax base does not (in many cases, cannot) include a wide array of services.
- Catalog company and, recently, Internet company sales are frequently not subject to the sales tax jurisdiction of the state.
- Cross-border shopping in states with lower sales taxes (or in states that exempt food) is a growing problem.
- Travel and shopping in states surrounding Tennessee that offer state lotteries, casino gambling, or both have been increasing and impacting sales tax collections in Tennessee.
- The overall impact is an erosion in state and local sales tax collections with a clear long-run effect: the major tax on which the state (and, to a lesser degree, local) government depends to finance general fund programs will not be able to produce sufficient growth in the future to finance state programs.

Regressive taxes are usually harsher on lower- than higher- income households.

Tennessee's other major tax problems involve the current methods chosen to tax business activity in the state. Recent efforts to change this situation resulted in a slightly modified business tax structure but left intact the underlying weaknesses of the business tax system. The key elements of the problem include:

- the unstable nature of business profits
- inequities in current taxation resulting from alternate forms of business organization
- uneven effects of tax incentives
- aggressive state corporate tax planning

The major underlying problem with Tennessee's tax system is the structural budget deficit. This is exacerbated by good fortune; economic growth causes a demand for new and expanded services. For example, K-12 education required

around \$300 million for the 75,000 new students between 1992 and 1998.

The existing sales and business taxes, which constitute nearly 90 percent of state revenues, will not solve the structural deficit. ■

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Notes

1. *Tennessee's Business*. Winter 1990. Business and Economic Research Center, Middle Tennessee State University.

2. Harry A. Green. "Tennessee's Antiquated Tax System: When Will the Crunch Come?" *Tennessee's Business* Winter 1990, pp. 1-8.

3. See *Final Report of the Tax Modernization and Reform Commission*, State of Tennessee, March 1974.

4. Special Joint Legislative Task Force on State and Local Tax Structure, *Interim Report to the Ninety-third General Assembly*, January 1984.

5. See *Financing Tennessee Government in the 21st Century*, Tennessee Advisory Commission on Intergovernmental Relations, Nashville, January 1999.

6. *The Outlook for State and Local Finances: The Dangers of Structural Deficits to the Future of American Education*, Washington D.C., National Education Association, 1998, p. VII. Some states find themselves in the fortunate situation of having a structural surplus; their tax system (generally one with a progressive personal income tax) can be expected to generate revenue in excess of what is needed to maintain current programs.

7. *Ibid.*, p. 2.

8. See article by Lewis Donelson in the special 1990 *Tennessee's Business* issue, "Approaching Zero Hour for Tax Reform," p. 36.

9. See Table 4A, p. 101, *Final Report of the Tax Modernization and Reform Commission*, State of Tennessee, March 1974.

10. Stanley Chervin, *Income Elasticity of Tennessee's Tax System*, Tennessee Advisory Commission on Intergovernmental Relations, Nashville, July 1999.

11. National Education Association, p. 21.

12. Obviously, another alternative is not to spend more, regardless of the consequences (expenditure retrenchment). Since

Tennessee has never been known as a profligate spender, Tennessee's problem has generally been one of trying to catch up with a minimal level of state expenditures rather than making decisions about which luxuries to cut. Therefore, spending cuts or retrenchment are not long-term options, particularly in view of Tennessee's economic and population growth.

13. Based on changes in the consumer price index for medical care and medical care services over the period 1988 to 1998.

14. While the state had been considering increased funding for K-12 in 1991, successful litigation by certain small school systems against the state (*Small School Systems, et al. v. McWherter, et al.*) forced the state to quickly increase funding for K-12 education.

15. Consumer price index for all urban consumers for all items.

16. *Tax Rates and Tax Burdens in the District of Columbia—A Nationwide Comparison*, an annual publication of the government of the District of Columbia.

17. Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia—A Nationwide Comparison*, 1997, pp. 8-12.

18. Survey data for households with income lower than \$25,000 are generally less reliable than data for higher income households. This is a frequent problem with most attempts to measure tax burdens for all households. However, it is generally believed that households with incomes lower than \$25,000 have a higher relative tax burden than shown in Figure 1 for the lowest income household.

19. Care must be taken not to confuse a regressive tax system with a high tax system. While Tennessee's tax system is correctly categorized as regressive, it does not mean that Tennessee imposes high taxes. The same study referenced as a source for Figure 2 also shows that taxes paid by the hypothetical Tennessee family of four with \$25,000 of income was lower than in forty-one other taxing jurisdictions (includes 50 states and the District of Columbia).

20. Government of the District of Columbia, Table 2, p. 14. The progressivity index rises as a system becomes more regressive and falls as it becomes more progressive.

21. See Chervin, *Income Elasticity of Tennessee's Tax System*, and *Financing Tennessee Government in the 21st Century*, Tennessee Advisory Commission on Intergovernmental Relations, January 1999.