



Tax Reform Options and Implications

by John Morgan

Tennessee's tax system can be described as inelastic, regressive, and inefficient—inelastic in that tax collections don't grow as fast as the general economy and the related demand for services

(known as a structural deficit), regressive in that poorer citizens pay a larger share of their income in state taxes than do wealthier ones, and inefficient in that Tennessee taxpayers cannot deduct most state taxes from income for federal tax purposes.

Taxes in Tennessee can also be described as low, in that individuals pay

less of their income in state and local taxes than citizens in almost any other state.¹ When only state taxes are considered, Tennessee ranks 46th of 50 states.² State per capita expenditures in Tennessee are lower than in 46 states.³ The low taxes and inelastic tax system force state decision-makers periodically to address new or enhanced

sources of revenue just to maintain state funded services.

Last fall the Sundquist administration concluded the current tax system could not adequately address even the minimal needs of state programs, and the accelerating deterioration of the corporate tax base became more apparent. The governor proposed a significant restructuring of business taxes as part of the fiscal year 2000 budget. Although the initial proposal and subsequent modifications thereof were not adopted, the lively discussion that ensued during the regular and special sessions of the General Assembly focused renewed public attention on the state's tax structure.

After \$81 million in cuts to the original proposal and some modifications to the application of current corporate and sales taxes, the General Assembly adopted, and the governor approved, a budget for fiscal year 2000. The legislature's Joint Business Tax Study Committee was charged with conducting a comprehensive review of the state tax system. The governor discussed the possibility of a special legislative session on tax reform this fall.

This essay identifies options likely to be considered by decision-makers and discusses pros and cons of each.

Do nothing

Some suggest the revenue problem is really a spending problem. Implied is that state government should shrink to fit revenues generated by the current system and that required growth in some programs should be accomplished by reducing others. This argument is rarely accompanied by any serious discussion of exactly which state programs should be reduced. The implications of this option are significant.

Tennessee enjoys the distinction of being among the lowest taxing and spending states, but the array of services offered by state and local government in Tennessee is similar to that offered by other states. Therefore, Tennessee ranks low in terms of state spending on various programs.⁴

Since the adoption of the Basic Education Program (BEP), state funds dedicated annually to K-12 education have grown by over \$1 billion.⁵ Maintaining the BEP at full funding will require annual increases of \$60-\$70 million (or more given the record level of enrollments). Even with this large new investment and commitment to full funding, Tennessee lags behind the south and the nation in expenditures per pupil. In FY 1997, expenditures per pupil in public

elementary and secondary schools in Tennessee were \$5,011, exceeded by every southern state except Alabama, Arkansas, and Mississippi.⁶ Tennessee lags behind the southern states and the nation in percentage of the adult population with high school diplomas. According to the Southern Regional Education Board (SREB), in 1998 77 percent of adults in Tennessee were high school graduates, compared to 79 percent in SREB states and 83 percent in the U.S.⁷

Tennessee's system of public higher education has fared even worse in recent years. Between 1989 and 1994, state tax funds appropriated to higher education increased 21 percent, which compared favorably with SREB states (19 percent) and the nation (11 percent). The next five-year period shows a significant deterioration in position. From 1994 to 1999, Tennessee increased state tax funding for public higher education by only 14 percent, compared to 30 percent for SREB states and 29 percent for the U.S.⁸

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Tennessee is behind the south and the nation in percentage of adult population with a four-year college degree—16.9 percent, compared to the U.S. (24 percent) and SREB (21 percent).⁹ The Governor's Council on Excellence in Higher Education noted that, if Tennessee is to move toward the national average in higher educational attainment, significant new enrollment in the state's public higher education institutions is required. The relative diminishment of state support for public higher education results in higher registration fees. Fees at state four-year institutions increased for the current academic year from 8 to 15 percent, and there were no significant increases in state-funded student financial aid. Enrollment is unlikely to increase sufficiently to meet educational attainment goals in the face of such increases.

In Tennessee's FY 2000 budget, over 94 percent of state tax expenditures are in five areas: education, transportation, law and public safety, social services (including healthcare), and payments to local governments. Under the current revenue system, any increase in one of these areas must be

funded at the expense of another. State tax dollars spent on transportation programs are derived primarily from highway user taxes such as the gasoline and diesel fuel tax. The legislature could choose to divert a portion of these tax revenues to general government purposes; such a choice would have a significant impact on the state's ability to meet identified needs for new construction and maintenance of existing highways and bridges. The state could reduce the level of state taxes currently shared with local government, with the likely consequence of increased pressure on local property tax rates. State shared taxes represent an amount about equal to a \$1 property tax.

People think that, if the state could "just get control of TennCare," the budget problem would be resolved, but restructuring TennCare will not change the performance of the state's tax system. From a state cost perspective, TennCare has been successful. Using as a benchmark the average increases in Medicaid costs experienced by southern states since the last full year Tennessee operated a traditional Medicaid program (1992-93), Tennessee spent about \$121 million less in state funds on Tenn-Care in fiscal year 1999 than it otherwise would have.¹⁰ Over 500,000 Tennesseans who would not have been eligible for Medicaid coverage enjoy comprehensive health insurance benefits. The federal government helps pay the cost of insurance for previously uninsured and uninsurable Tennesseans.

Absent a redefinition of the role of state government, further reductions in state spending are undesirable and unlikely to be successful. Even should decision-makers reach a consensus on which state services to abandon, budgetary relief afforded by such a strategy will likely be short-lived.

Raise Sales and/or Corporate Tax Rates

One choice is to raise the tax rates under the current tax structure, historically the most commonly used strategy to deal periodically with the structural deficit.

The advantages of raising rates of existing taxes are several. The amount of new funding needed would be realized through the existing collection and tax administration mechanisms, increased administrative costs and efforts associated with creating new taxes or significantly reconfiguring existing taxes would be avoided, and taxpayers understand existing sales and corporate tax structure. Decision-makers could

choose to allocate increased revenue burden to individual and business consumers through the general sales tax or selective sales taxes on items such as tobacco and alcohol. The new revenue burden could be placed directly on business taxpayers by increasing franchise and/or excise tax rates.

Disadvantages of raising existing tax rates are numerous. Continued reliance on existing taxes does not correct the structural deficit or improve efficiency. Increasing the selective sales taxes on alcohol and tobacco will render the system more inelastic since consumption of these items grows very slowly. Higher sales tax rates will make the system more regressive. Further increases in the general sales tax will likely accelerate the movement of retail activity to other states.¹¹ The combined state and local general sales tax rate in Tennessee (maximum of 8.75 percent) is already higher than any state that borders Tennessee. Kentucky, Georgia, and North Carolina levy no state sales tax on grocery foods. This is complicated by the growth in retail sales through catalogs and over the Internet, which would be expected to increase as the potential for savings (by avoiding taxes) increases. While taxable goods and services purchased out of state and consumed in Tennessee are subject to a use tax equal to the applicable sales tax, the enforcement of the use tax against individuals is difficult.

Raising corporate tax rates is problematic. Tennessee already relies more heavily on corporate taxes than any other southern state and many other states in the nation. Further reliance on corporate taxes would likely impede economic development, especially if there is a perceived likelihood for further tax changes in the future.

Expand the Tax Base for Existing Taxes

The general retail sales tax applies to most goods and a variety of services purchased in Tennessee. More services are sales-taxed in Tennessee than in any surrounding state. Most services, especially business, professional, and health services, are not subject to the general sales tax. Some categories of goods are partially or completely exempt from sales tax, including gasoline and other motor fuels, energy used for residential purposes, and industrial and farm equipment and machinery.

The Department of Revenue estimates expanding the sales tax base to include all

services and eliminating all sales tax exemptions would increase revenue by over \$2.5 billion. Decision-makers could pick and choose which services to cover or which exemptions to eliminate. Alternatively, rates applied to previously untaxed sales could be varied as needed.

Expanding the sales tax base would improve the elasticity of the tax system; as the base is broadened, more overall economic activity will be captured. As the economy grows, so will tax collections. Depending on which services are taxed and/or exemptions eliminated, the regressivity of the system may be improved.

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The corporate or business tax base could be expanded. The initial and subsequent business tax reform proposals of the governor earlier this year were designed to capture previously untaxed business activity by eliminating tax strategies designed to avoid or reduce taxes and expanding state business taxes to partnerships and sole proprietors. Including more business activity in the overall tax base would improve elasticity and permit broader deductibility of state taxes from federal taxable income.

The disadvantages of tax base expansion are significant. While improving elasticity, base expansion is not likely to solve the structural deficit. Depending on which services are taxed or exemptions eliminated, the system could become more regressive. A tax on medical services would fall disproportionately on lower income families as a share of family income. Application of the sales tax to services, especially professional services, would place Tennessee practitioners at a pricing disadvantage compared to out-of-state competitors. Some services, such as tax preparation, could be facilitated through Internet-based mechanisms.

Expansion of sales taxes to services and elimination of major exemptions would disproportionately impact businesses since

most currently untaxed services are those purchased by businesses. Business consumption already accounts for a third or more of current sales tax collections, so the risk of over-taxing business (discouraging investment and job creation) is increased. Many perceive the expansion of current business taxes to partnerships and sole proprietors as equivalent to an individual income tax, but one that would only be selectively applied.

A Broadly Applied Gross Receipts Tax

Some states, notably Hawaii and Washington, raise significant revenue through the levy of a gross receipts tax applied to virtually all businesses. The tax rates are usually low and may be differentiated based on the type of business activity taking place.

Gross receipts taxes tend to be very elastic since they capture most business activity. A fairly low tax rate may generate significant revenue. Since gross receipts taxes are levied against business activity, they are deductible from income before federal taxes are applied and achieve a higher degree of efficiency.

Problems with broad-based gross receipts taxes are similar to those of tax base expansion. Gross receipts taxes tend to distort economic activity because of the cumulative effect of levying the tax on intermediate steps in the production of a good or service. For example, a gross receipts tax will bias businesses toward performing legal services in-house since the purchase of those services from outside would be implicitly subject to the tax.

A Statewide Property Tax

Under the state constitution, the legislature may impose a property tax against real property as well as tangible and intangible personal property. Mechanisms are established for assessing and collecting real and business personalty taxes since the property tax is the predominant source for local taxes in Tennessee. The revenue potential is great. A tax rate of \$1 per \$100 of assessed value would raise more than an estimated \$737 million.¹² The property tax may be more progressive since wealth and income are closely related. The property tax is deductible from income for federal income tax purposes.

The disadvantages of a statewide property tax are practical and political. Property taxes are an important source of local

funding; encroachment upon this local prerogative could impact local governments' ability to generate sufficient own source revenue. The property tax, though lower in Tennessee than most states, is perceived by many as too high, and attempts to raise it higher will be politically difficult. The lack of a homestead exemption in Tennessee's constitutional property tax scheme probably contributes to this perception.

Almost half of Tennessee property taxes are paid by businesses, some of which are already taxed heavily compared to other states. Reliance on a statewide property tax may result in Tennessee's being viewed by businesses as an unattractive location.

Fundamental Tax Reform

Tennessee's tax structure has been the subject of numerous studies. In the early 1970s the Tax Fairness and Modernization Committee concluded Tennessee would be well served by a system of taxes that incorporated a broad-based personal income tax.¹³ The Special Joint Legislative Task Force on State and Local Tax Structure replicated this finding, issuing three proposals in its final 1985 report that would have lowered the sales tax rate, made some adjustments to the sales tax base, simplified business taxes, and imposed a state personal income tax.¹⁴ Today's tax system is nearly identical to the 1985 system. Although sales tax rates have increased, the structural characteristics, including the deficit, continue.

The Business Tax Study Committee will consider a personal income tax as a potential component of a reformed state tax system. Personal income taxes have significant revenue-raising potential; are elastic and can be designed to achieve any desired level of progressivity through the use of exemptions, credits, and rates, graduated or not; are deductible from income for federal tax purposes; and could serve as a replacement for the sales tax on grocery food as well as a partial substitute for the remaining current sales tax, making Tennessee more competitive with adjoining states. The imposition of a personal income tax would allow the current tax levied on income from dividends and interest to be repealed. Under most likely scenarios, most Tennesseans would pay less in state taxes under a reformed system than they do now.

The disadvantages of tax reform plans incorporating a personal income tax are mostly political. A new administrative mechanism will be required to administer the tax, but the state tax could possibly be

piggybacked on the federal income tax collection systems. The idea of a personal income tax has historically been unpopular in Tennessee, and attempts to enact one have met with significant opposition.

Taxpayers probably don't realize how much retail sales tax they pay annually; if they were required each year to remit a full year's accrued sales taxes (rather than pay incrementally with each purchase), attitudes toward sales taxes and personal income taxes might be different.

Individuals express concern that the income tax rate, if imposed, will be incrementally increased or that the sales tax, if lowered as part of a tax reform plan, will be restored. Any discussion of tax reform will probably include consideration of mechanisms for limiting future tax rate increases.

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Conclusion

Tennessee is at its oft-visited crossroads where the demand for government services intersects with a structurally deficient tax system. The direction taken this time may determine the course of state government for the next generation. Failure to raise new revenues will place essential services in jeopardy, forcing a reprioritization of the role of state government. Failure to raise new revenues in a manner that exhibits better elasticity, treats all taxpayers more fairly, and provides a more efficient structure with which to leverage our resources will lead us back to the crossroads once again. And again. And again. ■

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Notes

1. U.S. Census Bureau and Bureau of Economic Analysis, 1996 data.

2. U.S. Census Bureau and Bureau of

Economic Analysis, 1998 data.

3. U.S. Census Bureau, 1997 data.

4. Caution should be used in comparing budgets from one state to another. The division of service responsibility among layers of government may differ greatly. In some states, local governments share funding responsibility for Medicaid, while they do not in others (Tennessee, for one). Budgeting practices differ from state to state. Some states, like Tennessee, establish budgetary control over virtually all revenues and expenditures, including interdepartmental transactions, higher education tuition and fees, the value of food stamps, etc. Others states treat similar items as "off budget." The terms and conditions of various federal programs dictate the purposes for which federal funds may be spent. In many instances the states merely serve as conduits for federal programs. It is probably more useful to consider state-funded expenditures rather than total budget when thinking about how government spending changes from year to year.

5. The state sales tax was increased by one-half cent in 1992 to help fund the BEP. On an annual basis, revenue generated by a half-cent sales tax is about \$370 million. The remainder of new state taxes dedicated to K-12 education has come from normal year-to-year growth.

6. Based on telephone interviews with National Center for Education Statistics Common Core Data fiscal coordinators of the respective states.

7. *Southern Regional Education Board, Tennessee: Trends and Forecasts at a Glance*, 1998/1999, page 9. The SREB states include: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

8. *Ibid.*

9. *Ibid.*, page 16.

10. Calculated from information compiled by the Louisiana Legislative Fiscal Office from surveys of the 16 states in the Southern Legislative Conference.

11. For discussions of this phenomenon, also known as "leakage," see TACIR's *Understanding Tennessee's Tax System: Problems and Issues*, March 1998, pp. 25-28.

12. Division of Property Assessments, Comptroller of the Treasury.

13. Citizens' Commission on Tax Fairness and Modernization.

14. TACIR, p. 11.