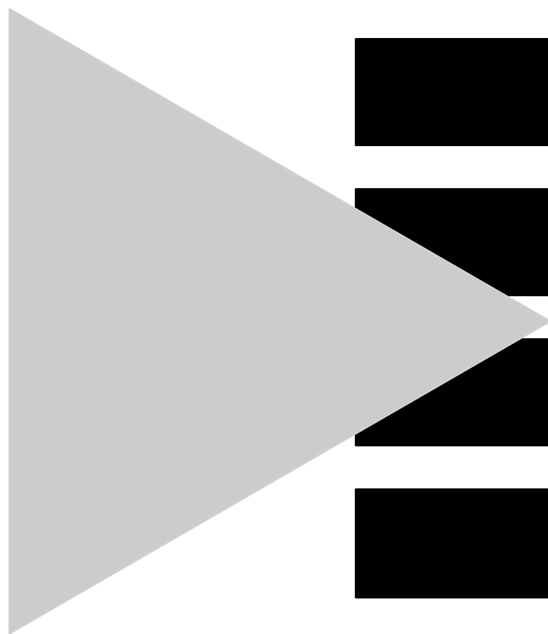
An Information Report

National Perspectives on Tennessee Taxes



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TACIR
Publication Policy

Information Reports, Staff Briefs, and Technical Reports are issued in pursuit of the Commission's mission to promote discussion and deliberation about important public policy issues. The purpose of these reports is to share information and research findings as directly and broadly as possible in an attempt to promote understanding of specific issues.

Only reports clearly labeled as "Commission Reports" represent the official position of the Commission.

National Perspectives on Tennessee Taxes

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This report was prepared by Dr. Hal Hovey and presented to the Commission in December 1997. This report does not necessarily reflect the views of Commission members and staff. In keeping with TACIR's publication policy, this report is circulated for informational and educational purposes.

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FOREWORD

During the 1997 session of the 100th General Assembly, the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) was directed to study Tennessee's tax system. Senate Joint Resolution 139 (Crutchfield) directed TACIR to conduct "a study of differential sales tax rates, job loss, and revenue loss in relation to Tennessee border states and other relevant tax issues." Additionally, Chapter 301 of the Public Acts of 1997 directed TACIR to study the "structural deficiencies of Tennessee's sales tax base, including the implications of sales and use taxation of food items intended for off-premises preparation and consumption."

The fiscal environment that led to this was one of frustration over the relationship between a robust economy and a sluggish tax and revenue system. A question that has been frequently asked is "If the economy is so hot, why is Tennessee State Government in a fiscal crunch?"

There has been a great deal of speculation in recent years about the loss of revenue to Tennessee's eight border states. In recent years, the State of Georgia has adopted a lottery and phased-out the sales tax on food. North Carolina is currently considering a lottery and has eliminated the sales tax on food. Virginia and Kentucky both have lotteries and exempt food from taxation. Newspaper and television coverage have increased public awareness of a possible relationship between the availability of gambling, lotteries in particular, and revenue and job loss to other states.

During the past year, TACIR has conducted research and received testimony on various aspects of Tennessee's revenue system. Also, a TACIR subcommittee, chaired by Senator Ward Crutchfield, conducted a two-day public hearing in Chattanooga, particularly focusing on the issue of cross-border tax leakage.

Additionally, the Commission received testimony from a number of experts. Among them was Dr. Hal Hovey of State Policy Research, Inc. In addition to oral presentations on back-to-back days, Dr. Hovey prepared a short report for the Commission pertaining to "National Perspectives on Tennessee Taxes."

To promote a greater understanding of the issues concerning Tennessee's tax structure, the Commission is distributing this report. However, nothing in this report necessarily reflects the views of any Commission member or staff. This report is an information report and does not represent the official position of the Tennessee Advisory Commission on Intergovernmental Relations.

Senator Robert Rochelle Chairman	**Harry A. Green, Ph.D.** Executive Director

INTRODUCTION

This report was prepared for the Tennessee Advisory Commission on Intergovernmental Relations and was discussed on December 8 and 9, 1997. It is designed to put information in the hands of Commission members in a reasonably convenient form and to facilitate discussion of issues about Tennessee's tax system.

This report was prepared using two guidelines:

” **Multi-State Perspectives**: The report seeks to summarize information about the fiscal practices and policy experiences of other states and to deal with national policy issues and trends.

Facts And "Near-Facts": Much of the material, particularly the tables, can be considered reporting of facts. All observers should be reporting exactly the same information.

The rest reflects expert opinions. While these are not policy preferences nor political positions, not every expert observer would necessarily reach exactly the same conclusions. For example, some might interpret trends in state tax policy somewhat differently or use somewhat different economic assumptions in calculating structural deficits for each of the states.

Some opinions about facts are universally (or nearly universally) shared by experts but are inconsistent with beliefs held by non-experts or urged on state officials by interest groups. Examples are the discussion of the impacts of tax policy on economic development or the methods for predicting the net effect of legalized gambling on state and local revenues.

STATE TAX COMMISSIONS, TASK FORCES, AND STUDIES

Introduction

The establishment of special commissions, task forces, and other groups to study and report on state policies and tax systems is a common practice in most states.

No one keeps an exact count, but the average state probably commissions at least one of these studies every five years. In states where dissatisfaction with the current tax system is widespread, it is not uncommon to see at least one such study commissioned every other year. In recent years, Alabama and Texas have provided examples.

Characteristics

These groups vary substantially in many respects including:

- **Composition**: Some commissions are composed entirely of persons from outside state government; others include some state officials but most members are from outside government; yet others draw much of their membership from the legislature and executive agencies.

- **Staffing**: Some have been staffed entirely by regular staffs such as personnel working for legislative fiscal offices and state revenue departments. Some establish their own professional staffs. Some have been operated solely through outside contractors.

- **Budgets**: Some groups have received only enough money to pay for travel expenses, meetings, and report publication. Others have had budgets of a million dollars or more.

- **Scope**: The charters of some commissions have been restricted by explicit instructions to focus on particular taxes or issues. A common pattern is typified by the Tennessee study — a relatively broad scope supplemented by quite specific identification of issues of particular concern. Some charters have been broader than taxes alone — including such other policy concerns as economic competitiveness, total levels of spending, and/or overall state-local relations.

- **Length Of Study**: Commissions are usually asked to report shortly before the beginning of a legislative session in which taxes are expected to be a major topic. This means that study length is sometimes as short as the time between the end of one legislative session and the beginning of the next. Many commissions have gotten underway slowly and have received extensions of time to develop their reports.

- **Operating Assumptions**: Regardless of their charters, commissions have generally concluded that the issues of how best to raise money and how much money to raise should remain separate. Many have kept their reform recommendations "revenue neutral" so the net effect of all their recommendations is to leave revenues unchanged. They have dealt with possible needs for additional revenues in several ways. One is to offer alternatives to deal with explicit assumptions (e.g., should the legislature chose to increase revenues by $x, we recommend it adopt tax increase y). Another is to assume adoption of some broad policy such as keeping revenues a constant percentage of personal income or replacing the revenues from repeal of a particular tax.

- **Impact On Policy**: The impact of tax studies has ranged from none to massive. In many cases, the impact has occurred well after the completion of a commission's work. This is particularly common when a commission recommends changes with substantial political hazards for elected officials. Such changes are typically enacted only under the pressure of some sort of fiscal crisis.

Lessons Learned

It is impossible to draw general conclusions for a particular commission, such as the Tennessee Commission, from the experiences of other commissions. The purpose of each of the commissions varied widely from the others and not all observers are using the same criteria to decide whether a particular commission was successful.

There are several situations in which commission efforts result in no policy change. This has been considered a satisfactory outcome by those establishing commissions, though not necessarily by citizen-members of such commissions. One such situation arises when a legislature decides not to tackle a difficult issue and establishes a commission to avoid the appearance of total inaction. Such commissions achieve their purpose merely by existing. In some other cases, tax studies are commissioned for reasons similar to the motivations of people taking physical examinations. In those cases, a diagnosis (conclusion) of no major problems is welcomed.

Commissions that have failed totally fall into two groups. The first includes those commissions taking such an academic approach to dealing with issues that their reports are little more than public finance textbooks. Their recommendations are often insufficiently specific to be translated into bill form and frequently overlook the realities which must be faced by legislative bodies (e.g., recommending repeal of a local tax, recommending an increase in a state tax, and ignoring issues of exactly which local governments get what replacement revenues from the state). The second contains the commissions expected to produce consensus among interest groups on issues where the groups' interests show massive differences.

CRITERIA FOR A "GOOD TAX SYSTEM"

There is substantial agreement on the characteristics of good tax policy. The principles can be summarized by saying state tax systems should:

- Provide appropriate and timely revenues,
- Distribute burdens equitably,
- Promote economic efficiency and growth,
- Be easily administered, and
- Ensure accountability.

These criteria are described in more detail in Chapter 3 of Financing State Government In The 1990s, a joint statement of organizations of the nation's governors, legislators, budget officers, tax commissioners, and legislative fiscal staffs.[1]

[1] Also see Harry A. Green, et al, *Understanding Tennessee's Tax System: Problems and Issues*, (Tennessee Advisory Commission on Intergovernmental Relations), March 1998.

STRUCTURAL DEFICITS

Introduction

Structural deficits are mismatches of spending and revenues built into a government's tax system and spending patterns.

Structural deficits and *structural surpluses*, their opposite number, are calculated by projecting a government's spending and revenue and comparing the two. These projections are called *current service* or *baseline* projections. Not all states make such projections. Not all states having such projections make them public. And not all projections use the same methodology.

Having a structural deficit means a government cannot continue its current spending patterns without raising taxes. The shortfall is often called a *budget gap*. Conversely, a structural surplus means that current taxes will generate enough revenue to pay for current services with some money left over, sometimes called a *fiscal dividend*. This money could be used to add new spending, or cut tax rates, or some combination of the two.

Structural deficits and surpluses differ from *cyclical deficits and surpluses*. The effects of strong economic growth are so positive for most governments that they will show a temporary cyclical surplus in a year of economic boom even if they have a structural deficit. Likewise the impacts of recession are so negative that even states with a structural surplus over the long term may show a deficit in a recession year. Federal and state long-term budget projections do not include predictions of recessions and booms on the theory that they average out in the long-run and their exact timing is impossible to predict.

Projecting Future Budgets

All projections of current service budgets depend on predictions of (assumptions about) factors affecting spending and revenues such as: (1) economic growth, (2) inflation in general, (3) inflation in particular kinds of prices such as health care, and (4) numbers of people likely to be receiving government services.

Projecting revenues for long periods uses the same methods used to project revenues for short terms, such as for the next year's budget.

Projecting spending depends on forecasting workloads and prices. Put another way, it involves predicting the number of service-units to be delivered and the unit costs of delivering that service. For example, school spending projections are based on forecasting the number of students and cost per pupil.

Projected spending takes what governments now do as predictors of what they will do, assuming implicitly that all arguments for change are rejected. So no spending is shown to do things many people think should be done like paying public employees more relative to private employees, expanding park systems, reducing class sizes, or providing free community college education to all students who maintain good grades.

Nor are any savings shown to make corrections many people think should be made such as paying public employees less or reducing their pensions, cutting someone's definition of low priority programs or waste, or getting governments out of some activities they now pursue.

Projections For All States

State Policy Research, Inc. has projected spending and revenues for state and local governments combined in each of the 50 states, allowing comparisons of structural deficits and surpluses in each. This is the first time such calculations have ever been made using a nationally uniform approach. The research will be published early next year by its sponsor, the National Education Association. The results summarized in this paper are preliminary and subject to change. Changes, described at the end of this paper, will affect the rankings of certain states other than Tennessee significantly and may affect the exact size of the structural deficits and surpluses shown for each state.

No changes contemplated will affect the basic conclusions for Tennessee:

- ☹ Tennessee has a structural deficit problem. Its revenues from existing taxes will grow more slowly than personal income, forcing a constant shrinkage of state and local government relative to the private economy unless tax rates are increased.
- ☹ Tennessee has a worse structural deficit problem than any of its eight neighboring states.
- ☹ Tennessee has a worse structural deficit problem than any major state (state with more than two million residents) in the nation.
- ☹ Tennessee's tax system does a poorer job of capturing revenues from economic growth than the systems of any of its neighboring states.
- ☹ In capturing economic growth, Tennessee's tax system ranks 46th among the 50 states. Only the tax systems of Florida, Nevada, Texas, and Washington do less well at capturing growth.

Summary Comparisons

Table 1 shows the preliminary calculation of structural deficits (-) or surpluses (+) for state and local governments in each of the 50 states, assuming the nation's economy continues its steady growth and each state's economy continues its past performance relative to the national average. Tennessee's neighbors are underlined.

This table is designed to feature how each state compares to the other states, not as a direct forecast of each state's structural deficit, so the national average was set at a structural balance. The table is saying that *even if economic growth and federal aid increased enough so that on average states had no structural deficit,* Tennessee would have a structural deficit of 9% seven years after a balanced budget year. For example, if state and local budgets in Tennessee can be viewed as balanced in FY 1998, state and local tax increases of 9% will be required to continue current spending patterns in FY 2005.

Table 1
State And Local Surplus As Percent Of Spending In Year Seven Of Fiscal Projections
Results If National Average Shows No Surplus Or Deficit

RANK	State	%	RANK	State	%	RANK	State	%
1	Iowa	7.4%		**United States**	**0.0%**	34	Arizona	-3.8%
2	Nebraska	6.1	18	North Carolina	-0.1	35	Rhode Island	-4.0
3	North Dakota	6.0	19	South Dakota	-0.2	36	Maryland	-4.2
4	Kansas	4.9	20	New York	-0.4	37	Georgia	-4.2
5	Illinois	4.7	21	Missouri	-0.6	38	South Carolina	-4.4
6	Oklahoma	2.9	22	Washington	-0.7	39	Florida	-4.5
7	Minnesota	2.5	23	Louisiana	-1.2	40	Colorado	-4.5
8	Wisconsin	2.3	24	Massachusetts	-1.3	41	Texas	-4.6
9	Ohio	2.0	25	Delaware	-1.6	42	New Hampshire	-4.7
10	California	1.7	26	Indiana	-1.7	43	Utah	-4.7
11	West Virginia	1.3	27	Virginia	-1.9	44	Montana	-6.5
12	Pennsylvania	1.3	28	New Jersey	-2.2	45	Idaho	-8.8
13	Oregon	1.3	29	Arkansas	-2.5	**46**	**Tennessee**	**-9.0**
14	Kentucky	1.3	30	Mississippi	-2.8	47	Hawaii	-9.0
15	Michigan	1.1	31	Nevada	-3.0	48	New Mexico	-10.5
16	Connecticut	0.9	32	Vermont	-3.5	49	Wyoming	-11.2
17	Maine	0.8	33	Alabama	-3.8	50	Alaska	-16.1

No plausible scenario of Tennessee economic growth allows Tennessee to do so well that it can grow its way out of the structural deficit problem. Compared with the rank of 46 and the projected 9% deficit, the two other scenarios studied produced Tennessee ranks of 39th and 44th and deficits of 6.3% in both scenarios.

The calculation of the national surplus or deficit (assumed to be zero on the table above) and the surplus or deficit for each state is sensitive to assumptions about future federal aid. The baseline scenario prepared by State Policy Research, Inc. is the best single number now available for thinking about Tennessee finances. It assumes Congress and the President will follow the fiscal plan they recently adopted. The assumption causes the national average and each state to be about 5.5% less than shown on the table. So, the conclusion is that Tennessee's state and local structural deficit over seven years is about 14.5% of projected spending.

Why Does Tennessee Have A Big Structural Deficit?

The projected Tennessee structural deficit is the mathematical result of projecting spending and revenues, comparing the two, and finding a *budget gap* or structural deficit equal to the excess of projected spending over projected revenues. Because Tennessee shows a bigger gap than any other major state, there must be something in its spending, its revenues, or some in each that explains the difference from the average state.

To make a long story short, the answer isn't spending. By the standard national projections used in the study, the demographic factors driving spending such as population and school enrollment in Tennessee will grow somewhat faster than the national average. But Tennessee's economy and thus tax bases will grow a little faster too. In these characteristics, Tennessee is similar to neighboring states which don't show the same large structural deficits.

The Tennessee structural deficit problem comes from its revenues, not its spending pressures. In sweeping terms, Tennessee's spending for maintaining current services will grow about as fast as Tennessee personal income grows. So if revenues also grew about as fast as personal income, state and local taxes would remain about the same percentage of personal income they are today.

(Economists use the term *elasticity* to describe the relationship between tax revenue growth and personal income growth. For example, if revenue growth from a particular tax were exactly equal to personal income growth, that revenue source would be said to have an elasticity of one.)

Taxes of most states don't grow quite as fast as personal income, which is the main reason why the projections show state and local governments nationally with small structural deficits, on average. There are many causes of this and about as many cures, all spelled out in the publication Financing State Government In The 1990s, endorsed and published by the organizations of the nation's governors, legislators, tax commissioners, and state budget directors. In summary, state taxes are typically tied to slow-growth pieces of the economy (e.g., sales of goods, wage and salary income, income of corporations, physical property) and don't reach much of the fast-growth pieces (e.g., sales of services, retirement income, income of non-corporate businesses, and intellectual property and information systems).

Table 2 shows the elasticity for the tax systems in each of the states. The national average means that an increase of 1% in personal income means on average an increase of 0.96% in state and local tax revenues.

Tennessee doesn't rank well in tax system elasticity. It is 46th in the nation and behind every one of its neighboring states. The differences make a difference. In an average year, Georgia and North Carolina legislators find budgeting easier than Tennessee legislators. In good years like 1996 and 1997, legislators in Georgia and North Carolina can debate how much extra revenue to use for tax cuts and how much for spending enrichments while Tennessee legislators struggle to maintain balanced budgets.

The main factor causing differences between Tennessee and its neighbors is the mix of revenue sources. It is important because different revenue sources have different ability to respond to economic growth. For example, revenues from sales taxes don't grow as fast as the economy grows. State sales taxes primarily are levied on sales of goods, but not services which are growing as a share of consumer spending. Specifically for every 10% growth in personal income, state and local governments will only get an 8.6% increase in sales tax revenues.

RANK	State	Index	RANK	State	Index	RANK	State	Index
1	Oregon	104.4	18	New York	98.5	34	Mississippi	94.1
2	Idaho	103.3	19	New Jersey	98.5	35	Connecticut	93.8
3	Montana	103.2	20	New Mexico	97.4	36	South Carolina	93.4
4	Kentucky	103.1	21	Arizona	97.2	37	Missouri	93.1
5	Delaware	102.7	22	Massachusetts	96.9	38	Alabama	93.1
6	Iowa	102.1	23	Kansas	96.7	39	North Dakota	92.6
7	Ohio	102.0	24	Colorado	96.3	40	Pennsylvania	92.4
8	Hawaii	101.8		**United States**	**96.2**	41	Illinois	92.0
9	Maine	101.7	25	Rhode Island	96.1	42	Alaska	90.6
10	California	101.5	26	Utah	95.8	43	New Hampshire	90.3
11	Wisconsin	100.7	27	Vermont	95.6	44	Wyoming	88.9
12	North Carolina	100.1	28	Virginia	95.2	45	South Dakota	88.5
13	West Virginia	100.0	29	Oklahoma	94.8	**46**	**Tennessee**	**88.5**
14	Minnesota	99.7	30	Louisiana	94.7	47	Florida	88.4
15	Georgia	99.0	31	Maryland	94.4	48	Texas	88.1
16	Arkansas	98.9	32	Michigan	94.3	49	Washington	87.6
17	Nebraska	98.6	33	Indiana	94.2	50	Nevada	87.5

Table 2
Elasticity Index For State And Local General Fund Taxes
Index Of 100 Means Revenues Grow Proportionally With Personal Income

On the other hand, rising incomes result in income tax collections that grow faster than personal income. Most state income taxes have fixed dollar personal exemptions. As income rises, these exemptions are used up and all the growth in income is subject to tax. Also in states with graduated income tax rates, additional income is taxed in higher brackets with higher rates. Nationwide, a 10% growth in personal income will produce about a 12.2% growth in state and local income tax revenues.

The mix of taxes varies greatly among the states. The typical state gets about a third of state and local tax revenues from personal income taxes, but a few states don't have such taxes and the tax in Tennessee doesn't reach the largest income source, wages and salaries. This is the recipe for being near the bottom of the table. Conversely, the way to be on top is to rely heavily on a graduated income tax and have no sales tax, which is what makes Oregon rank number one.

Alternatives To Deal With The Problem

Raising Taxes: One policy course for Tennessee would be to raise the money to finance current spending patterns. That policy works this way.

- **Maintain Current Services**: For example, provide schools and teachers to handle added public school and university students and provide teachers raises just large enough to keep up with the average wage and salary increases in the private sector.

  Do Not Increase Any Services Or Adopt New Programs: For example, do not make classes smaller, nor raise teacher salaries relative to those of private sector

workers, or buy lots of new equipment and supplies, like computers, except through savings from buying less of something else, like textbooks.

⓪ **Do Not Cut Any Existing Taxes**

① **Raise State And Local Taxes By About 2% A Year**: Revenue will automatically grow with the Tennessee economy. As more houses and offices are built there will be more property to tax. As inflation increases prices of houses, the property tax base and thus revenues from existing property taxes will rise. Growing personal incomes and inflation will cause sales tax revenues to increase. This revenue is already in the projections. The extra 2% has to come from increasing rates of sales, property and other taxes or adding to the tax base by such actions as ending exemptions of various kinds or taxing something new like wage and salary income or sales of services.

Cutting Spending Growth: The alternative to raising taxes to cover the cost of maintaining current services is to cut services to correspond to what current taxes will raise. This is not quite as horrible as the word "cut" implies because the projections have spending increases built into them that Tennessee doesn't have to make. For example, increasing enrollments could be handled by increasing class sizes and increasing compensation costs for state and local workers could be held to inflation alone, denying these workers the real (inflation-adjusted) increases in living standards that private sector workers will enjoy. The state could attempt a similar squeeze on compensation of workers the state pays indirectly, such as workers in hospitals, nursing homes, and child care agencies.

Obviously, state policy could combine tax increases and spending cuts. For example, maintaining a moratorium on tax cuts and expanded programs, raising taxes about 1% a year, and squeezing current service budgets by about 1% a year would work — mathematically at least.

Other Choices: There are other ways to deal with the problems shown by these projections. Three major policies are involved.

First, about 38% of the structural deficit projection for Tennessee is federally related. That is, by planning to cut its spending on "discretionary" grants the federal government is planning to shift the burden of paying for its share of increased spending for inflation and workload changes to state and local governments. For example, the federal government now pays 8-9% of Tennessee school costs. If it covered its 8-9% share of the costs of serving more students and inflation-driven increases in teacher pay and other costs, it would still cover about 8-9% of costs in FY 2000, FY 2005, and beyond. If it follows its budget plan, it won't cover its share of these costs, so Tennessee will have to do so while watching the federal share drop to something like 7-8% and even lower as the years go by.

If federal officials can be convinced to pick up additional costs or at a minimum maintain the current federal share, the outlook for all states and local governments gets better. However, to achieve this federal officials would have to abandon their balanced budget targets or make huge cuts in defense and other federal spending.

Second, the Tennessee government can raise money without raising taxes. At a minimum, governments can raise existing charges to match inflation, charging more for everything from getting a copy of a birth certificate to attending a state university. Charges could be raised

considerably more than inflation would suggest — making, for example, the cost of attending the University of Tennessee more like those of going to private universities. Charges could be levied for things that are now free, such as for textbooks or extra-curricular activities for public school students and for admission to all state parks.

Third, governments can simply stop doing some things or do them so badly that people start paying for them with their own money. In many parts of the nation, this is gradually happening with institutions like downtown improvement associations that provide security and street cleaning in downtown shopping areas and gated residential communities that often maintain their own roads, provide their own recreation, and maintain their own police forces.

Technical Notes

When officials of individual states make projections, they incorporate specific changes in spending when they are known, such as changes in debt services based on scheduled new borrowing and any repayment of old bonds. Individual state and federal projections would normally include future changes in spending patterns, such a multi-year programs to increase education quality, and future tax rate changes, such as multi-year tax reduction plans, if they have already been enacted into law. The projections made for all states in this paper do not reflect these.

For comparisons involving 50 states, considering state government in isolation from local government makes for misleading comparisons because of differences in state-local divisions of tax sources and spending responsibilities. For example, 100% of school spending in Hawaii is state-financed while only about 10% of school spending in New Hampshire is state-financed. Some differences between state and local spending are meaningless. For example, nearly all states require a minimum tax on property to finance schools. In some states, this is a statewide property tax, in others it is a tax which school districts must levy to receive state aid. In some states, it is a mixture of the two.

From a national perspective, balancing state budgets without having to worry about local budgets is a trivial problem. Roughly half of state spending is for aid to local governments. All but a few states could easily balance their state budgets simply by allowing no increases in local aid. The difficult problem in dealing with structural deficits comes when likely spending and revenues are considered together, as they obviously must be to consider financing of education and other important functions. Consideration of state and local finances together implies that states have substantial control over local taxes. Please see the section titled "State-Local Fiscal Relations" for more information.

The revisions from the data presented in this report to the report to be published by the National Education Association will affect the exact size of structural deficits presented in certain tables and the rankings of certain states not including Tennessee or other states with large structural deficits. All revenue calculations reflect measures of economic growth trends. The period chosen for calculating trends happened to include an unusual federal crop support payment causing artificially high economic growth and revenue projections for states where grain and/or corn production is a significant factor in total personal income. Selecting a different period will move the affected states somewhat downward in the comparisons of structural deficits but nowhere near Tennessee.

The presentation of structural deficits shown in Table 1 does not reflect the implementation of the federal aid cuts scheduled mostly in FY 2000 and subsequent years under the budget compromise approved by Congress and the President in 1997. Reflection of those assumed cuts will cause the fiscal outlook for all states to appear worse, but is unlikely to have significant effects on the relative rankings of individual states.

INTERSTATE ECONOMIC COMPETITION AND STATE TAX POLICY

Competition Intense

Introduction: Competitive considerations have heavy and pervasive impacts on state policies. Concerns over non-competitive tax burdens translate into pressures to keep spending, and thus taxes, low. Concern over the effects of taxes on economically attractive, mobile taxpayers encourages states to minimize taxes on footloose firms, high-income households, and affluent retirees. Competition for economic development motivates huge outlays for industrial parks, sports stadiums, convention centers, highways, and other programs.

The Economic War Among The States: State officials are in constant economic competition with each other. Candidates for state offices campaign on platforms including promises of enhancing their state's economic development — bringing more jobs, higher incomes, and fiscal dividends for state and local governments. They point with pride to signs of economic success such as statistics on increased employment and examples of new plants. They seek track records including not losing existing employers to the lures of other states, encouraging the growth of existing firms, and drawing new employers to their state. Their challengers leap on signs of failure such as high unemployment, plant closings, layoffs, and even losses of professional sports teams. Business groups lobby states to eliminate signs of what they call a "poor business climate."

The Competitive Environment: Interstate competition is based in the reality of the open economy which the U.S. Constitution guarantees to citizens of every state. It protects the rights of individuals to move to any state and enjoy the privileges of long-time residents. It permits firms from any state to sell in every state, free from tariffs and quotas, and subject to no higher taxes nor more stringent regulations than in-state firms. It permits firms to establish new plants anywhere and to abandon a state entirely for any reason — including dissatisfaction with policies of that state. Attempts by states to shelter their markets from interstate competition are consistently overturned by federal courts as violations of the Commerce Clause of the Constitution.

Changes in technology and the nation's economy have been increasing the impact of competitive factors on state policies and are likely to continue to do so. Reductions in the weight-to-value ratio of goods, in transportation costs and speed, and in communications cost have liberated producers from the need to be in close proximity to customers. Whole industries — beer, potato chips, dairy products, hardware vendors, and banks — have been shifting from locally based businesses to national firms. Deregulation of public utilities is reducing the ability of state and local governments to continue policies which have imposed disproportionate taxes on them.

Competition For Jobs: There is strong evidence that decisions of firms to locate, expand, and remain in particular states are heavily influenced by state policies including state and local tax levels. Firms planning to establish new plants or contemplating moves routinely solicit competitive offers from states. There are many examples of firms relocating or deciding to put their new plants in different states because of home-state taxes they consider too high.

Nearly all states respond to these solicitations for offers to draw new plants, often with tax concessions tailored to the soliciting firm. But offering such concessions only to firms considering relocation produces criticisms of state officials for not pursuing even-handed policies. More important, it induces all footloose firms to consider moves if for no other reason than to induce concessions from home states.

Competition Affects Tax Policies

The impact of interstate competition has been apparent in tax policy perceived as affecting firms' location decisions. In legislative sessions in 1997 and each of the two previous years, at least 20 states passed legislation to reduce business taxes in some way in order to encourage economic development. In addition, nearly all states allow local officials to offer concessions reducing or eliminating local taxes. The changes in Tennessee taxes shown in the Tennessee Department Of Revenue paper Business Taxes: Current Structure And Options For Change are typical of the kinds of changes being made by most states.

Successive moves of this type suggest that taxation of footloose firms, particularly those in manufacturing, is gradually being reduced. State policies have been moving in the direction of ending: (1) sales taxes on equipment and supplies using in constructing new facilities, (2) property taxes on manufacturers' inventories, machinery, and equipment, (3) for limited times, property taxes on new plants and expansions, and (4) corporate profit taxes associated with out-of-state sales. In addition, states are enacting special tax concessions for particular industries such as oil and gas exploration and production, processing of agricultural commodities, aircraft maintenance, banking, and insurance.

The adoption of business tax concessions follows a familiar pattern of competitive behavior. Typically states faring the worst in economic competition — that is, states with low per capita incomes or slow economic growth — are the first to break new ground in reducing business taxes. For example, property tax abatements for new plants were pioneered by the depressed Southeast in the 1940s. Subsidies were offered to lure particular plants to Pennsylvania and other Northeastern states two decades later. And the concept of crediting employers with income taxes paid by employees was introduced by Alabama and Kentucky in the 1990s. Adoption of any new tax concession by one state quickly produces clamors in other states to match the competition.

All efforts to limit this competition by agreements among the states have failed. Agreements among neighboring states — such as one covering the three states in the New York City areas and one covering Arkansas, Louisiana, and Mississippi — have not lasted beyond the governors who made them.

Attempts by the National Governors' Association to produce consensus have been blocked by governors of "have not" states, who have viewed them as attempts by states successful in economic development to lock in their gains. Suggestions that interstate economic development competition be limited by federal laws have met two major obstacles. First, there are serious

technical problems in defining exactly what policies would be limited and how. Second, state officials have opposed such moves as a federal foot in the door to limit state policy flexibility, particularly in controlling tax policy.

Impact Of Taxes On Economic Development

Academics and consultants continue to produce scholarly analyses of the fundamental question of whether state and local taxes make any difference to success in economic development. The answers continue to be less than clear guides to policy. For example, a recent review for the District of Columbia Tax Revision Commission by three prominent economists who have done studies of the topic concludes:

> The studies of the effects of taxes on economic development and business location appear to have come to a consensus that taxes "matter." But that consensus is not wholly satisfying for two related reasons. First, while the majority of the results from the many high-quality empirical studies of this issue find taxes to be a statistically significant factor, several others come to the opposite conclusion. Second, because of the somewhat scatter-shot nature of the findings, it is difficult for researchers to give advice to policy-makers, who are anxious to know whether their tax policies and tax incentives are likely to be effective economic development tools.

Tennessee's Competitive Status[2]

The comparisons of Tennessee with neighboring and particular competitor states suggests that the overall level of Tennessee taxes is much more likely to be a competitive plus than a competitive minus.

Taxes On Individuals: The level of taxes on individuals is low enough that it is difficult to imagine Tennessee losing residents to other states based on tax differentials. Because Tennessee has no income tax while its neighbors have such taxes, it is reasonable to expect that individuals with jobs in Tennessee would have strong tax reasons for living in Tennessee. So concerns over the impact of tax policies on individual living patterns boils down to concern over cross-border shopping, as discussed in the section on border tax issues and options.

Business Taxes: In general, Tennessee's relatively low level of spending and taxes gives it a natural advantage relative to many competing states, such as states of the industrial Midwest. It offers potential advantages over most of Tennessee's neighbors as well.

Part of that advantage is lost because of the mix of Tennessee taxes. The personal income tax, which Tennessee lacks and competitors have, inherently puts all of its burden on households and none on businesses. By not using it, Tennessee is forced to rely more heavily on sales and property taxes. As implemented in Tennessee and other states with such taxes, they raise a substantial percentage of their total revenues from business.

This difference, however, doesn't necessarily make Tennessee taxes on business a barrier to success in economic development.

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[2] Also see Harry A. Green and Cliff Lippard, *Competitive Edge: The Tax and Business Climate in Tennessee*, (Tennessee Advisory Commission on Intergovernmental Relations, January 1998.)

The impact of taxes on economic development potential varies significantly with the types of business involved. The costs faced by labor-intensive businesses, like agricultural processing, are extremely sensitive to special payroll taxes for Unemployment Compensation and Workers' Compensation and to worker-related regulation such as occupational health and safety, minimum wage and hours legislation, and arguably to state laws affecting the likely success of union organizing drives. The costs faced by capital-intensive businesses, like auto-making and petroleum refining, are highly sensitive to property taxes and significantly sensitive to corporate income taxes. For some types of firms, such as those in biotechnology, taxes don't have much impact on the total cost or profit picture. They may be much more sensitive to other aspects of state policy such as pollution control regulations and higher education training of potential workers in their fields.

It is possible to conduct detailed research on the sensitivity of the costs of different types of firms to the taxes of Tennessee and competitor states. However, a much less expensive way to find these answers is simply to listen to testimony of business leaders in these firms.

HOW TENNESSEE COMPARES: BASIC TABLES

Introduction

This section provides comparisons of Tennessee with other states in some basic governmental finance statistics.

Tax Burdens

Table 3 compares Tennessee with eight neighboring states (highlighted) and the rest of the 50 states in the two widely used measures of state and local tax burdens.

Tennessee had per capita taxes of $1,759 in FY 1994 (latest data available). This was 73% of the national average of $2,403. Tennessee ranked 46th in the nation by this measure. Two neighboring states were lower — Arkansas $80 less and Mississippi $106 less. The rest were higher.

Tennessee state and local taxes were 9.7% of personal income. This was 83% of the national average of 11.7%. Among neighboring states, only Missouri (9.6%) had lower burdens by this measure.

These comparisons strongly support a conclusion that there is nothing in the *level* of Tennessee taxes likely to create a non-competitive situation for the state in relation to other states. If jobs, retail sales, or residents are being lost to other states for tax reasons, the loss must be attributable to the *mix* of taxes, not the level.

Spending Levels

Tennessee's low taxes correspond to low spending relative to national averages. (Data on spending comparable to the information on taxes shown in Table 3 are readily available but not presented in this paper.) It is hard to argue from comparisons with other states that Tennessee governments spend too much. Using comparative data — by no means the only way to look at

the issue — it can be argued that Tennessee spends too little. That is, it is conceivable that other states might be at a competitive advantage by having stronger education systems, better roads, etc.

Table 3
State And Local Tax Revenues, FY 1994

State	Per Capita	Per Capita Rank	Percent Personal Income	Rank, % Income
Alabama	$1,602	50	9.4%	50
Alaska	3,225	3	14.2	2
Arizona	2,177	29	12.4	12
Arkansas	1,679	48	10.6	43
California	2,404	17	11.1	34
Colorado	2,245	25	10.7	42
Connecticut	3,441	2	12.3	13
Delaware	2,494	14	11.6	23
Florida	2,186	28	10.8	41
Georgia	2,115	32	11.2	31
Hawaii	3,185	5	13.7	4
Idaho	1,959	37	11.5	24
Illinois	2,474	16	11.0	35
Indiana	2,119	31	11.1	33
Iowa	2,297	22	12.6	9
Kansas	2,310	21	11.7	20
Kentucky	1,930	39	11.5	25
Louisiana	1,720	47	10.4	44
Maine	2,351	19	12.5	10
Maryland	2,657	9	11.2	32
Massachusetts	2,835	6	11.6	22
Michigan	2,552	11	12.4	11
Minnesota	2,733	7	13.1	6
Mississippi	1,653	49	11.4	29
Missouri	1,852	41	9.6	49
Montana	1,952	38	11.4	27
Nebraska	2,290	23	11.7	21
Nevada	2,354	18	10.9	38
New Hampshire	2,190	27	10.0	47
New Jersey	3,216	4	12.1	16
New Mexico	2,102	34	13.2	5
New York	3,854	1	15.5	1
North Carolina	2,110	33	11.5	26
North Dakota	2,030	35	11.9	17
Ohio	2,204	26	11.2	30
Oklahoma	1,846	42	10.9	37
Oregon	2,266	24	11.9	18
Pennsylvania	2,342	20	11.0	36
Rhode Island	2,498	13	11.7	19

Table 3, continued State And Local Tax Revenues, FY 1994				
State	**Per Capita**	**Per Capita Rank**	**Percent Personal Income**	**Rank, % Income**
South Carolina	1,801	45	10.8	40
South Dakota	1,819	44	10.2	45
Tennessee	**1,759**	**46**	**9.7**	**48**
Texas	2,027	36	10.8	39
Utah	1,920	40	12.2	14
Vermont	2,482	15	12.9	8
Virginia	2,162	30	10.1	46
Washington	2,596	10	12.1	15
West Virginia	1,839	43	11.4	28
Wisconsin	2,699	8	13.7	3
Wyoming	2,513	12	12.9	7
United States	**2,403**		**11.7**	

The Mix Of Revenue Sources And Tax System Balance

One commonly cited criterion is that state tax systems should be "balanced." There is no fixed definition of balance, but those who use the term definitely look for states to use all three major tax bases of state and local tax systems: property, income, and consumption (sales). Evaluations of balance look for each of these tax bases to account for roughly 25-40% of the total revenues from the three but use different definitions of exactly what the share of each should be.

The primary argument for balance is that without it states will have extraordinarily high rates for the taxes they rely on excessively. For example, a state with no sales tax, such as Oregon, will need high income and property taxes. A state without an income tax will need extraordinarily high sales taxes, as Tennessee has. Lack of balance also exaggerates whatever problems are associated with a heavily relied upon tax source, such as the low elasticity of the sales tax.

Table 4 compares the total revenues collected from each major tax state and local tax source as a percentage of the taxes collected from all three sources.

Personal income taxes accounted for 23.4% of state and local revenues in FY 1994, but only 1.3% in Tennessee. Sales taxes accounted for 40.7% of revenues from the three taxes but over 70% of revenues in Tennessee. Property tax reliance is below 20% in several Southern states and 27% in Tennessee.

To provide a basis for comparing state tax systems (including local taxes), State Policy Research, Inc. has developed a simple index of tax system balance. It relates the relative reliance on each of the three tax bases in each state to the national average reliance on each of the three. The index is the sum of the differences between the state's percentage and the average percentage for each of the three revenue sources. The best possible index score is zero, which would occur if a state's relative reliance on each tax source was identical to the national average. The scores appear in Table 5.

Tennessee ranks 47th in the nation in tax system balance and is below every one of its neighbors in this tax policy criterion.

Table 4

Percentage Of Big Three Tax Revenues From Each Of The Three, FY 1994

State	Income	Sales	Property	State	Income	Sales	Property
Alabama	24.8%	60.8%	14.3%	Montana	26.5%	18.6%	54.8%
Alaska	0.0	24.9	75.1	Nebraska	21.1	38.4	40.5
Arizona	17.4	49.0	33.6	Nevada	0.0	74.3	25.7
Arkansas	26.1	57.0	16.9	New Hampshire	1.7	22.4	75.9
California	26.7	41.9	31.4	New Jersey	19.4	30.0	50.6
Colorado	25.3	39.9	34.8	New Mexico	20.3	64.3	15.3
Connecticut	22.5	33.4	44.1	New York	32.8	30.4	36.9
Delaware	54.8	20.3	25.0	North Carolina	32.3	43.0	24.7
Florida	0.0	58.6	41.4	North Dakota	13.2	50.8	36.0
Georgia	26.1	41.7	32.2	Ohio	32.9	35.7	31.4
Hawaii	27.3	54.9	17.7	Oklahoma	26.7	53.3	20.0
Idaho	29.5	40.2	30.3	Oregon	44.8	11.6	43.7
Illinois	19.2	38.3	42.5	Pennsylvania	28.9	36.2	34.9
Indiana	30.7	30.7	38.5	Rhode Island	23.0	31.4	45.6
Iowa	26.3	35.2	38.5	South Carolina	26.3	41.3	32.4
Kansas	22.9	41.6	35.5	South Dakota	0.0	54.1	45.9
Kentucky	34.5	45.9	19.6	**Tennessee**	**1.3**	**72.1**	**26.6**
Louisiana	15.7	63.7	20.6	Texas	0.0	57.4	42.6
Maine	22.9	33.3	43.7	Utah	27.4	44.9	27.7
Maryland	40.8	29.1	30.1	Vermont	22.0	31.0	47.0
Massachusetts	37.3	23.6	39.0	Virginia	30.2	35.0	34.8
Michigan	23.2	29.3	47.5	Washington	0.0	66.9	33.1
Minnesota	31.3	35.6	33.1	West Virginia	24.4	51.7	23.9
Mississippi	16.1	57.7	26.2	Wisconsin	29.0	30.4	40.7
Missouri	26.9	47.1	26.0	Wyoming	0.0	42.8	57.2
United States	**23.4**	**40.7**	**35.9**				

Table 5
Index Of State Tax Balance, FY 1994

RANK	State	Index	RANK	State	Index	RANK	State	Index
1	Kansas	1.8	18	Rhode Island	19.4	34	Hawaii	36.3
2	Colorado	3.7	19	Missouri	19.7	35	Arkansas	37.8
3	South Carolina	7.0	20	Indiana	19.9	36	Alabama	43.1
4	Georgia	7.4	21	North Dakota	20.5	37	Montana	44.1
5	California	8.9	22	Wisconsin	20.6	38	Louisiana	46.0
6	Nebraska	9.2	23	New York	20.7	39	South Dakota	46.9
7	Pennsylvania	11.0	24	Vermont	22.2	40	Florida	46.9
8	Iowa	11.0	25	North Carolina	22.4	41	Texas	46.9
9	Idaho	12.0	26	Michigan	23.3	42	Wyoming	46.9
10	Illinois	13.3	27	West Virginia	24.0	43	New Mexico	47.2
11	Virginia	13.5	28	New Jersey	29.4	44	Washington	52.3
12	Minnesota	15.7		**United States**	**30.2**	45	Oregon	58.2
13	Maine	15.7	29	Oklahoma	31.7	46	Delaware	62.7
14	Utah	16.3	30	Kentucky	32.6	**47**	**Tennessee**	**62.9**
15	Connecticut	16.5	31	Mississippi	34.0	48	Nevada	67.2
16	Arizona	16.6	32	Massachusetts	34.2	49	Alaska	78.4
17	Ohio	18.9	33	Maryland	34.7	50	New Hampshire	80.0

Balance Between Households And Business

From time to time, statistics on the relative shares of state and local taxes paid by businesses and households are cited in comparing state tax policies. State Policy Research, Inc. believes that these statistics are not useful for any analytic purpose, though they are sometimes useful in tax policy debates. {For the detailed reasoning behind this conclusion, see Issue 17 of State Policy Reports (1997).} The rankings of states are largely determined by their mix of businesses, not by their tax policies. Because 100% of severance taxes and taxes on farms are counted as business taxes, states with a high proportion of their economic activities in agriculture or oil and gas will have high business shares regardless of their tax policies.

Such statistics were once produced routinely by the U. S. Advisory Commission on Intergovernmental Relations, but the series was dropped well before the Commission went out of existence. The most recent compilation, which appears in Table 6, was prepared by Institute on Taxation and Economic Policy.

Tennessee is 11th in the nation in the percentage paid by business. Viewed from a business perspective, Tennessee ranks 39th and all of its neighbors have better rankings. Of the eight neighboring states, four are in the top seven in the nation for low percentage of taxes paid by business. The source of the difference is Tennessee's high reliance on property and sales taxes, which fall more heavily on business than the personal income tax which Tennessee doesn't use while its neighbors do.

Table 6
Percentage Of State And Local Taxes Paid By Business, CY 1995

RANK	State	%	RANK	State	%	RANK	State	%
1	Alaska	88.4	18	New York	41.4	34	Arkansas	36.3
2	Wyoming	65.8	19	Rhode Island	41.3	35	Idaho	36.3
3	Texas	54.0	20	Mississippi	40.8	36	Missouri	36.2
4	Washington	50.6		**Average**	**40.7**	37	Kansas	35.9
5	Florida	46.6	21	Maine	40.5	38	Utah	35.8
6	North Dakota	46.6	22	New Mexico	40.2	39	Massachusetts	35.6
7	Illinois	46.2	23	Delaware	39.4	40	South Carolina	35.4
8	Montana	45.9	24	Georgia	38.9	41	Nevada	35.2
9	Indiana	45.5	25	California	38.7	42	Oregon	34.9
10	Louisiana	44.9	26	Pennsylvania	38.4	43	Oklahoma	34.3
11	**Tennessee**	**44.4**	27	Vermont	38.4	44	Wisconsin	33.3
12	South Dakota	44.2	28	Iowa	38.1	45	Kentucky	32.8
13	West Virginia	44.2	29	Nebraska	37.7	46	Ohio	32.7
14	Arizona	43.4	30	Connecticut	37.6	47	North Carolina	31.7
15	New Hampshire	42.5	31	New Jersey	37.6	48	Alabama	31.4
16	Minnesota	42.1	32	Colorado	37.0	49	Virginia	30.7
17	Michigan	41.8	33	Hawaii	37.0	50	Maryland	25.6

Corporate Income Taxes

Corporate income taxes (which have different names in the states that collect them) are the single most identifiable business tax, though total collections of sales tax and property tax

revenues from business exceed corporate income tax collections in nearly every state. Table 7 provides an indication of the amounts collected by state governments (local taxes on corporate income are rare) in FY 1996.

Table 7
Per Capita Corporate Income Tax Collections, FY 1996

RANK	State	$	RANK	State	$	RANK	State	$
1	Alaska	538	18	Wisconsin	112	34	Ohio	72
2	Delaware	229		**United States**	**111**	35	Iowa	71
3	Michigan	228	19	Arizona	101	36	Missouri	70
4	Massachusetts	202	**20**	**Tennessee**	**100**	37	Florida	70
5	Connecticut	196	21	Kansas	99	38	South Carolina	68
6	California	183	22	Georgia	98	39	Maryland	65
7	New Hampshire	155	23	New Mexico	95	40	Maine	57
8	Indiana	153	24	Oregon	94	41	Hawaii	55
9	Minnesota	151	25	Arkansas	91	42	Virginia	54
10	New York	150	26	Utah	88	43	Colorado	54
11	New Jersey	145	27	Rhode Island	88	44	South Dakota	52
12	Pennsylvania	141	28	Montana	86	45	Alabama	51
13	Illinois	137	29	Nebraska	77	46	Oklahoma	50
14	West Virginia	129	30	Vermont	76	47	Nevada	0
15	Idaho	128	31	Louisiana	75	48	Texas	0
16	North Carolina	128	32	Mississippi	74	49	Washington	0
17	North Dakota	115	33	Kentucky	73	50	Wyoming	0

Relatively low per capita corporate income tax collections are not indications of low taxes on business. For example, the Census data, and thus the table, show no taxes for Texas. But the state has a franchise tax which is viewed by businesses in Texas as imposing heavy burdens. The tax was originally developed as a tax on corporate assets, not income, but has been restructured so that income is the tax base for most companies.

Other Comparisons Of Competitiveness Of Business Taxes

The most appropriate comparisons of state tax systems affecting business are complex calculations which mirror the calculations that businesses make themselves when deciding where to locate new production facilities. These calculations cost on the order of $150,000 for a study of a single state. Such a study calculates taxes on about a dozen industries in each of a dozen competitor states. The existing one most useful in Tennessee was recently conducted for a North Carolina commission on economic competitiveness. It includes Tennessee as one of the competitor states, and thus provides data comparing Tennessee with many other states.

Conclusion

In most of the states where concerns about taxes discouraging economic development are great, overall tax levels and spending are high. New York is a good example. In those states, modifying the mix of taxes and/or granting large tax concessions to particular industries are viewed as dangerous choices because they result in raising other already high taxes. Fixing the

tax systems of such states is like rearranging deck chairs on the Titanic. The real solution to the problem of taxes hurting competitiveness is probably to reduce spending and taxes.

Tennessee doesn't face that problem. In relation to other states, the relative low tax burdens provide substantial room for rearranging existing tax burdens without requiring any tax to be so high that it would create competitive problems with most other states.

BORDER TAX ISSUES AND OPTIONS

In broad terms, each state competes with every other state for new plants, residents, and the business provided by people temporarily in a state as vacationers, business travelers, snowbirds, and shoppers. These broad issues of economic competition are considered in the section on interstate economic competition and state tax policy.

Geographic proximity matters in most of these situations. For example, Minnesota's Mall of America is more attractive to shoppers from Iowa than those from California. New Jersey's casinos are more attractive to New Yorkers than to residents of Utah. A regional distribution center to serve stores in Tennessee might be established in Tennessee or the Atlanta area, but not in Denver.

The importance of geographic proximity varies with distance in most situations, but the differences are not black and white. So there is no such thing as a unique problem associated with border communities, nor is "leakage" of possible tax revenues confined to them.

However, competitive situations in communities near the boarders of states with significantly different tax structures are more readily apparent than other competitive situations and therefore often draw particular attention. As a result, there is constant discussion of whether a particular state should adopt special policies for these situations. Prominent examples are to be found in many multi-state metropolitan areas such as in the three states around New York, Chicago, and Philadelphia, and the two states near Kansas City, St. Louis, and many other cities. Tennessee's border concerns aren't unique.

While there are constant calls for special treatment of border communities, these calls are usually rejected by state legislatures for two reasons. First, special tax concessions in border communities raise constitutional issues in many states because otherwise equal citizens and firms are being treated unequally in state policy. Second, there is no obvious place to draw the lines around such policies. For example, a border municipality might be losing 25% of possible business to another state, another municipality in the same county might be losing 10%, the whole county 12%, and a neighboring county 8%. There is a difficult issue of whether to use special border taxes just in municipalities on the border, in entire counties, etc. No matter where the line is drawn, it creates a border problem for the first county not given special treatment. If taxes are dropped in Border County to match a neighboring state, then Near-Border County residents have a new incentive to do business in Border County.

State Policy Research, Inc. knows of only a few examples of special treatment of taxes in border communities. The policies of Texas are adjusted for Texarkana, part of which lies in Texas and part in Arkansas. From time to time, Vermont has allowed differential liquor prices and taxes to compete with low prices of state-owned stores in New Hampshire. Also, some states have apparently uniform policies but apply them non-uniformly to deal with border

situations. For example, New Jersey is much more aggressive in making tax concessions for office space in the New York City area than elsewhere in the state.

TRENDS IN STATE TAX POLICY

Introduction

The level or burden of state and local taxes has remained remarkably stable at about 11% of personal income for 30 years. So in broad terms, the changes in tax policy have consisted of increasing reliance on some tax sources while decreasing reliance on others.

Until about 1990, state tax policies were following general patterns that had lasted for several decades. Reliance on sales taxes was being increased slowly, primarily by increases in rates. Reliance on personal income taxes was being increased fairly rapidly. Most of the increases were associated with: (1) the tendency of income tax revenues to rise faster than personal income with no increase in tax rates and (2) adoption of income taxes by additional states. Reliance on property taxes was being reduced. These changes were interrelated with a gradual shift from reliance on local taxes, primarily the property tax, to finance schools to having a greater percentage of school costs paid by states.

Since 1990, there has been no overriding feature of tax policy changes equivalent to the earlier shift from local property taxes to state sales and income taxes. Both the percentage of state and local tax revenues raised by states and the mix of revenues raised by sales, property, and income taxes have remained relatively stable. There is no overwhelming trend in any direction, though there are some hints of trends shown by the generalizations below.

Personal Income Taxes

Adoptions: The last adoption of a personal income tax in a state without one was Connecticut early in the 1990s. For the status of proposals for income taxes in states without them see the section on state-local fiscal relations.

Changes: By basing a successful 1993 campaign for governor of New Jersey on a promise to reduce the state income tax by 30% Christie Whitman made cutting income taxes a popular proposal for candidates in the 1994 gubernatorial races. Victories by some of the gubernatorial and legislative candidates using the theme and strong state finances made cutting income taxes popular in 1995, 1996, and to a lesser degree 1997. The interest in income tax cuts has probably about run its course. Polls in New Jersey suggest that Whitman got little credit from New Jersey voters for the 30% cuts. She has promised that her tax cutting priority in the new term will be property tax reductions.

Sales Taxes

Reflecting public opinion, which objects to sales taxes less than income or property taxes, little of the tax cutting over the past few years has affected sales taxes. The three largest examples of cuts — Georgia, Missouri, and North Carolina — have involved whole or partial elimination of the portion of the sales tax levied on food.

Even in the state tax cutting environment of the last three years, there have many serious proposals to raise sales taxes. For example, sales tax increases were a part of Governor Bush's tax plan in Texas, which failed this year, and Governor Voinovich's Ohio plan for school finance equalization, which also failed. Wyoming legislators will likely raise their sales tax if and when they decide they can't fund compliance with a state supreme court decision on school finance without raising taxes.

Local option sales taxes have become quite popular, with the option being offered in more states each year. More local governments are adopting the tax for the first time, and many are raising rates.

Property Taxes

A high percentage of legislators and governors have expressed a desire to cut property taxes, which are the least popular of the three major tax sources — income, property and sales. Several states — notably South Carolina, South Dakota, and Wisconsin — have financed large rollbacks of property taxes with state revenues. Many states have financed more selective property tax relief. Voter initiatives to limit property taxes have been a major factor in the fiscal policies of Oregon and potential initiatives have encouraged consideration of property tax relief in other states.

Taxes Affecting Economic Competition

Concerns over making or keeping states economically competitive have been a major factor causing state tax changes over the past decade. The changes affecting business taxes are covered in detail in "Interstate Economic Competition and State Tax Policy." Competitive concerns have also led states to abandon their estate and inheritance taxes — except for the taxes that can be 100% credited against federal estate taxes. Extra state taxes remain in only a few states.

Excise Taxes

States have been increasing their gasoline taxes and other highway user charges such as vehicle registration fees and drivers' license fees. These moves are continuing as many states are in the midst of highway construction programs which cannot be sustained without further increases. States have been increasing taxes on cigarettes and tobacco products, both to raise additional revenues and discourage smoking.

As deregulation continues to affect natural gas, telecommunications, and electric power, states have been forced to reconsider special excise taxes on companies providing these services. The trend is toward eliminating special public utility taxes in favor of treating companies in these industries more comparably to companies engaged in manufacturing.

FEDERAL IMPACTS ON STATE TAXES AND SPENDING

Reliance On Federal Aid

Federal aid to state and local governments in FY 1994 (latest data) amounted to about one-fifth of their total revenues or about $828 per capita. As shown in Table 8, Tennessee's reliance on federal aid is slightly above average.

Since FY 1994, federal aid has grown rapidly, probably constituting a larger percentage of state and local budgets now than it did then. Much of the growth has been concentrated in federal funds flowing through state governments, particularly Medicaid.

The Outlook For Federal Aid

The future outlook for state and local finances nationwide and in Tennessee is highly sensitive to the future course of federal grants, as discussed in "Structural Deficits."

In 1997, the President and Congress sent conflicting signals on the future outlook for grants supporting state and local activities.

Their decisions on the FY 1998 federal budget and on federal tax law changes were highly supportive of state and local spending. Federal grant levels were increased in nearly every program. A major new program of federal grants supporting state spending on health care for low and moderate income children was established. New federal tax credits and deductions will substantially reduce the burden of higher education tuition on many American families, making it easier for states to increase the share of higher education costs covered by tuition. Scholarships for low-income students (Pell Grants) were expanded and state pre-paid tuition programs made more attractive by changes in federal tax laws affecting them.

At the same time, Congress adopted a multi-year plan for balancing the federal budget that achieves the projected balance only by significant future-year cuts in "domestic discretionary" programs. These cuts are not detailed by program, so it is impossible to estimate exactly how heavily they would affect grants to state and local government relative to their impacts on direct federal outlays such as support of the National Park Service, the IRS, and Congress itself. Many state and local officials fear that the reductions would disproportionately fall on federal grants.

In the coming years, federal officials will have to reconcile the two policies they favored in 1997 — increasing federal spending for popular programs and balancing the federal budget. It is impossible to predict the outcome of this reconciliation.

Federal Tax Policies

Federal officials continue to discuss sweeping tax reform measures, such as adopting a national consumption tax. Many state and local officials fear that enactment of such reforms would jeopardize current state and local tax systems and revenue-raising ability. However, there is no immediate prospect that such changes will be adopted.

Table 8
Impact Of Federal Grants On State And Local Revenues, FY 1994

Rank	Per Capita	Per Capita Rank	Percent Revenue	Rank,Percent
Alabama	$783	27	22.6%	14
Alaska	1,655	2	15.0	46
Arizona	693	40	19.0	31

Arkansas	816	20	25.4	8
California	969	14	21.6	18
Colorado	671	44	16.7	42
Connecticut	865	18	16.9	41
Delaware	749	35	15.3	45
Florida	582	48	14.9	47
Georgia	698	39	18.3	35
Hawaii	1,028	10	19.3	28
Idaho	676	43	18.8	32
Illinois	686	41	17.4	39
Indiana	760	32	19.6	27
Iowa	772	30	18.6	33
Kansas	702	38	17.4	38
Kentucky	804	21	22.8	13
Louisiana	1,167	4	28.9	1
Maine	948	15	23.1	11
Maryland	664	45	15.9	44
Massachusetts	944	16	19.8	25
Michigan	794	25	18.3	34
Minnesota	791	26	16.4	43
Mississippi	978	13	28.0	4
Missouri	733	36	22.3	16
Montana	1,044	9	26.0	7
Nebraska	727	37	18.0	36
Nevada	553	49	14.0	48
New Hampshire	835	19	21.3	19
New Jersey	663	46	13.3	50
New Mexico	874	17	20.4	23
New York	1,236	3	19.8	26
North Carolina	749	34	20.5	22
North Dakota	1,123	5	26.2	6
Ohio	802	22	20.8	20
Oklahoma	648	47	19.2	29
Oregon	988	11	22.5	15
Pennsylvania	795	24	20.0	24
Rhode Island	1,083	8	24.4	10
South Carolina	799	23	21.7	17
South Dakota	985	12	26.8	5
Tennessee	**772**	**29**	**23.0**	**12**
Texas	685	42	19.0	30
Utah	765	31	20.7	21
Vermont	1,092	7	25.2	9
Virginia	497	50	13.9	49
Washington	778	28	17.5	37
West Virginia	1,094	6	28.6	2
Wisconsin	749	33	17.2	40
Wyoming	1,726	1	28.1	3
United States	**$828**		**19.6%**	

State and local revenue-raising ability is also affected by federal actions affecting individual state and local taxes. Most of the federal policies under serious consideration would reduce state flexibility in taxation. Examples include proposals to ban or limit state taxes on the Internet and various restrictions on state taxing power included in proposals for deregulation of the electric utility industry.

STATE-LOCAL FISCAL RELATIONS

States have so much control over local finances that they can effectively dictate local tax policies including what can be taxed as well as minimum and maximum rates. This means that subjects such as state tax policies, burdens of business taxes, tax burdens on rich and poor, and state and local structural deficits can appropriately be considered together.

Those who agree with these statements can skip the rest of this briefing material. It just shows examples of various ways states exercise their power over local finances.

Limiting Local Taxes

In general, local governments can't levy a tax without state authorization to do so. Even if local taxing autonomy is recognized, state statutes can bar local governments from tapping certain tax bases.

Many states limit local taxes. Nearly all prescribe how taxes and tax rate increases can be enacted, such as whether a vote of the people is required. Most exempt certain parts of a possible tax base from the reach of local taxes. Some place absolute limits on rates, such as the maximum rate of a local option sales tax and maximum property tax levies.

Requiring Local Taxes

States can effectively mandate local taxes by making eligibility for state aid contingent on local governments levying them. For example, Florida requires local governments to levy certain gasoline taxes and Arkansas requires local income taxes in some school districts. Such moves can become quite elaborate. For example, in the 1990s, California: (1) allowed its temporary 0.5% sales tax surcharge to expire, (2) induced nearly every county to adopt a new 0.5% local option tax leaving taxpayers paying the same amount as before, and (3) adjusted state aid to counties to leave both state and county finances in about the same condition as before the shift.

The subject is highly complex, but states can effectively mandate local property tax increases through their school aid formulas, as Georgia and other states have done. The mechanism can be as blatant as a requirement of a minimum local tax effort to receive state aid and as subtle as increasing the tax rate assumed in calculating the local effort subtraction in school foundation formulas.

Moving Money Around

States have great flexibility in moving tax base and spending among local governments. The classic case is Texas. State officials wanted the revenues and tax policy consequences of a statewide property tax for schools, but the state constitution forbids such a tax. The effect is achieved by a complex device which gives school districts the option of choosing among five alternatives. If they don't choose one, the state merges them with another district. The options include sending local property tax money to the state for redistribution to other districts, sending it to a neighboring poorer district by transferring some tax base to that district, or paying the cost of educating pupils from another district.

States can also move property tax money by how they distribute state-assessed revenues from such entities as railroads, pipelines, and electric transmission lines. They can do even more. For example, Mississippi decided that the tax base represented by the Grand Gulf nuclear power plant shouldn't just go to the district where the plant is located. So it distributes property taxes on the plant to every taxing jurisdiction where power from the plant is sold — a large part of the entire state.

California, facing a fiscal crisis in the early 1990s, effectively shifted much of it to cities and counties. It moved substantial chunks of property taxing authority from municipalities and counties to independent school districts. It then took credit for the added school district revenues as though they were increases in state aid.

Dividing State And Local Money-Raising

Local governments spend most of the total amount of money spent by state and local governments. They get much of what they spend from state aid. The division of money-raising responsibility between state and local government is shown in Table 9.

Table 9
Percentage Of State And Local Tax Revenues Raised By State Government, FY 1994

RANK	State	%	RANK	State	%	RAKK	State	%
1	Delaware	82.0	18	Utah	66.0	34	Louisiana	59.0
2	Hawaii	79.7	19	California	65.8	35	Georgia	58.9
3	New Mexico	78.6	20	Massachusetts	64.3	36	Florida	58.4
4	Arkansas	77.1	21	Arizona	63.8	37	Ohio	58.0
5	Kentucky	77.1	22	Iowa	63.6	38	Vermont	57.8
6	West Virginia	76.2	23	Alaska	63.5	39	Oregon	57.8
7	Mississippi	75.4	**24**	**Tennessee**	**63.0**	40	Nebraska	57.7
8	Idaho	72.5	25	Kansas	62.3	41	Rhode Island	57.7
9	Oklahoma	70.9	26	Wyoming	61.8	42	Maryland	57.0
10	Alabama	70.6	27	Wisconsin	61.4	43	Virginia	56.8
11	North Carolina	70.5	28	Indiana	61.3	44	Illinois	53.5
12	Washington	70.2	29	Pennsylvania	60.7	45	New Jersey	53.1
13	Montana	69.5	30	Connecticut	60.7	46	Texas	52.3
14	Nevada	69.4	31	Maine	60.5	47	Colorado	50.7
15	Minnesota	69.3	32	Missouri	60.0	48	South Dakota	50.3
16	North Dakota	68.3		**United States**	**59.9**	49	New York	47.5
17	South Carolina	68.2	33	Michigan	59.2	50	New Hampshire	33.6

Tennessee finances are significantly less centralized than five of the neighboring states, but less centralized than three neighbors and the national average.

Conclusion

There are obvious reasons why state officials would in certain circumstances want to treat local fiscal problems and local tax decisions as though the state had no control over them. But state elected officials gain no advantage from not understanding that they can control local tax policies and fiscal situations should they choose to do so.

Home Rule States

Some states accord broad autonomy to designated "home rule" local governments under the provisions of state constitutions. In those states, somewhat different devices are used to produce the equivalent of direct state directives. For example, the state can do what the federal government does in dealing with the autonomy of states — make intergovernmental aid contingent on acceptance of certain conditions.

GAMBLING

Introduction

The pros and cons of legalizing the many forms of gambling are well known. They are not covered in this brief comment. The two aspects of the changing economics of gambling that are covered — economic development impacts and government revenue effects — are not well understood.

In the days when only a few states offered a few forms of legalized gambling, it was possible to capture large revenue gains from legalizing gambling. These gains were so large that they covered both substantial new revenues for state and local governments and large profits for the private companies involved.

The rapid growth of legalized gambling has made the business much more competitive. Many states and communities now offer gambling. Also, many competing forms of legal gambling are available such as lotteries, pull-tabs, card rooms, slot and video poker machines, keno, casino games, horse and dog tracts, jai-alai, off-track betting on horse races, big-money charity bingo, and more.

The increasing availability of gambling and the increasing competition have changed the economics of legalizing gambling. The early entrants, both governments and companies, enjoyed economic successes that are not available to later entrants and are increasingly difficult for early entrants to retain.

Immediate Economic Development Impacts

Most of the time, state and local economic development is like a poker game among a few neighbors. It is a *zero-sum game*. That is, one neighbor may win, but his or her winnings must be equal to the losses of the other players. Considered together, the players will leave the game with exactly the amount they brought to the game. For the group of poker players to be better off as a group, they need what poker players call *fresh money* or *new money on the table*. Likewise residents of a state don't improve their situation just because one firm selling to in-state residents expands, as another firm must be experiencing equal and opposite changes, or contractions. The important question is whether new income is generated by selling out-of-state, or drawing out-of-state tourists, or getting residents to spend in-state money they formerly spent out-of-state.

Early ventures in gambling, such as the first state lotteries and casinos in Nevada and New Jersey, drew substantial out-of-state money. As gambling has spread, newer entrants to the business are serving more local markets. By serving those local markets they are drawing some money back into local spending that previously went out-of-state. They are also drawing some out-of-state money of their own. But there is less and less of each as gambling becomes more widespread. This means new instances of gambling legalization have less economic development significance than older ones.

Immediate Revenue Impacts

The government revenues associated with out-of-state customers are appropriately calculated by taking the gross taxes and fees attributable to out-of-state customers and subtracting the government costs associated with serving them. These costs are normally small in relation to revenues.

The government revenues associated with in-state customers are a different matter. Because the success of gambling (or any other new product or service) will not create new personal income in the local economy, spending on gambling must come at the expense of spending on something else. That something else may also be taxed. For example, part of the revenues of a new casino may come from reduced spending on furniture and appliances. In this case the appropriate calculation considers taxes on gambling as a plus, but has an offsetting minus for lost sales taxes on furniture and appliances.

For legalized gambling today, government taxes and fees would be in a range of 10-45% which is well above taxes on alternative purchases. So increases in government revenue would appropriately be predicted from legalization, but the increases are not equal to the expected government revenues from gambling.

Long-Term Considerations

Anyone who is willing to predict that the geographic spread of gambling will continue should also recognize that the profits and taxes from existing gambling will be reduced. For example, availability of a Georgia lottery makes the Florida lottery less attractive and adoption of a Tennessee lottery would make the Georgia lottery less profitable.

Anyone who is willing to predict that the types of legal gambling available will increase should also recognize that the profits and taxes from existing gambling will be reduced. For example, lottery adoptions have cut into horse track revenues, video poker cuts into lottery revenues, and casino games cut into video poker and tracks.

Competition has the same effect on gambling as on any other industry. As competition becomes more intense, it is no longer possible for the early entrants to maintain extraordinarily high profits nor for governments to take significantly larger shares of gross revenues than competing governments do. If governments or private companies try to take larger profits or higher taxes than competitive conditions permit, they lose customers and eventually lose profits and tax revenues.

The marketplace effects can already be seen nationwide. Price competition in gambling takes the form of what the bettors consider as better odds. Viewed from the perspective of governments this is the ratio of winnings to amounts bet. That ratio has been declining for several forms of gambling including most state lotteries and video poker and slot machines in areas where competition exists. The competitive impacts can also be seen in the increasing use of the gambling equivalent of frequent flyer plans. Members get special prizes, access to machines with better payouts, and various freebies. All of these decrease the amounts states can take as taxes and companies can take as profits.

The effects of competition can also be seen in the casualties. Horse racing is one example. The industry has fallen on such hard times that states have been reducing their taxes to keep tracks open. As a result, nationwide, the tax revenue generated by a dollar lost in a horse racing bet is now lower than the tax revenue generated by a dollar spent on toilet paper or shampoo. The New Orleans casino is another example. The venture failed without opening —basically because Louisiana tried to extract more from it than the casino could earn, given the competition from nearby Mississippi casinos.

Conclusions

These economic considerations alone do not lead to a conclusion that adopting legalized gambling is a good or bad idea in Tennessee or elsewhere.

They do support a conclusion that the net contribution of legalized gambling to government tax revenues is less than the gross government revenues expected.

They also support a conclusion that competition will, over time, force down the percentage of gambling revenues that can be taken by government. So after initial market penetration by any newly legalized gambling form is complete, a gradual decline in government revenues should be expected.

TAX REFORM IN STATES WITHOUT PERSONAL INCOME TAXES

Introduction

Seven states do not tax personal income in any form. They are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and Tennessee tax certain forms of investment income but do not tax wages and salaries. This paper covers the situation in the eight states other than Tennessee.

This section mostly is a summary of the situation in each state. Two concluding sections deal with: (1) a summary of the outlook for tax changes in these states and (2) possible ideas for Tennessee coming from the discussions that have occurred in other states without income taxes.

Alaska

Alaska's finances are not comparable to those of other states. The state has the nation's highest spending but gets roughly 85% of its money from taxes on oil and gas. There is no general sales tax and no personal income tax. Notwithstanding this, the state has enough money to write a check of over $1,000 every year to every resident. The perpetual fiscal issue is how to make the transition to the time when the oil fields are depleted. From time to time, prominent leaders, including at least one governor, suggest enacting low rate income taxes to start the transition, but there are no prospects for passage of major new state taxes on individuals until the threat of oil depletion appears more serious than at present.

Florida

The economic calculations involved in evaluating an income tax in Florida are significantly different from those involved with Tennessee and most other states without income taxes. Much of Florida's economic activity comes from non-residents, snowbirds (winter residents) and tourists, who would not have to pay a Florida income tax. Much of Florida's economic base comes from retirees moving down from the Northeast. Two features of the tax system — no tax on personal income and no estate or inheritance tax — are generally believed to be major reasons for success in attracting affluent retirees.

For decades, Florida didn't have significant government finance challenges because tourists and retirees made few demands on most government services and none on education. Now many of the young, childless people who came to Florida to provide tourist services, health care, home repair, and construction have school age children, producing massive demands for new public spending. As a result, state and local tax increases are constantly on the agenda and tax cuts aren't seriously discussed.

Public opinion is overwhelmingly opposed to a personal income tax. Organized business is publicly comfortable with the idea as are some state leaders interested in industrial development. Spending oriented groups, such as public employees, like the idea. A constitutional amendment would need to be approved to make it possible for the legislature to adopt an income tax.

Some years ago the state expanded its sales tax to most consumer and business services. Adverse reaction, particularly to taxing certain business services (e.g., advertising in national magazines distributed in Florida) was intense, leading to the repeal of the measure on its effective date. There is widespread fear of revisiting the issue of taxing services.

In the next several years, Florida is likely to continue to deal with its fiscal challenges by a combination of policies: (1) below-average spending in public employee salaries, infrastructure, social programs, etc., (2) high reliance on local option taxes, (3) special excises on utility services, gasoline, tobacco, etc., (4) raising user charges for government services, and (5) forcing government-like spending into the private sector by such devices as impact fees charged developers, making developers pay for and dedicate roads and schools, and indirectly encouraging provision of government services by quasi-governments such as downtown development districts and homeowner associations in gated communities. Even if faced with extreme fiscal stress, state officials are likely to raise sales tax rates or revisit selective taxation of services before considering a personal income tax.

Nevada

Nevada has been enjoying the nation's most rapid economic growth and realizing automatic revenue growth which has outpaced the cost of providing current services. Government and civic leaders recognize this situation to be temporary and have commissioned various studies showing this to be true. But there isn't strong pressure to act on these conclusions until a fiscal problem appears, which it will when the construction boom concentrated in the Las Vegas area ends. Until then, a personal income tax won't be seriously discussed.

New Hampshire

New Hampshire's political culture and fiscal practices are sharply different from nearby neighbors, Massachusetts and Vermont. Fiscal responsibility is strongly concentrated in local governments, which cover about 90% of their school costs versus less than 50% nationwide. There is no statewide general sales tax and no income tax on wages and salaries. Dividends and interest are taxed. For decades, the litmus test for successful statewide candidates has been "taking the pledge" which refers to a promise not to support enacting either a sales or an income tax. The current governor and most legislators have taken this pledge.

The state handles the resulting inability to match spending levels of other states in several ways including: (1) less spending in nearly every category and (2) good fortune in some aspects of its demographics, such as a low poverty population and low crime rate. Despite these factors, the state faces constant shortfalls and was one of the few to adopt any form of tax increase in 1997.

New Hampshire has pioneered in a business activity tax, a kind of value added tax that reaches the business activity of partnerships and proprietorships. Those willing to increase state spending substantially, but who object to a sales or income tax, will likely look to raising this tax and selective excise taxes. A substantial block of the electorate appears willing to support a statewide tax if enacted as part of a package substantially reducing the state's high property taxes. However, enactment is improbable until a gubernatorial candidate runs on such a platform and wins.

South Dakota

The politics of taxes in South Dakota have been built around the concept of reducing property taxes, not directly around the concept of adopting new revenue sources such as an income tax.

It is relatively easy to qualify voter initiatives for the ballot in South Dakota. A group called Dakota One is constantly talking about initiatives that would roll back or eliminate property taxes. Because these don't provide replacement revenue, they are typically opposed by school groups and many state leaders as irresponsible. In 1994 a Dakota One initiative to cap property taxes at 1% of assessed value got 49% of the popular vote.

Partly as an attempt to head off passage of the initiative proposal the governor campaigned on a platform of rolling back school property taxes by 30%. After his election, the legislature managed a 20% rollback using a combination of normal revenue growth and increases in a variety of taxes and levies on gambling revenues. The governor has concluded that the other 10% cannot be attained in the near future.

As a practical matter, eliminating the property tax support of schools in South Dakota nearly equates to adopting an income tax, though it isn't popular to say so. The state is one of three small states (Hawaii and New Mexico are the others) which already has extensive sales taxation of services, so broadening the sales tax base has more limited possibilities than in Tennessee. The state's economy is so small and agriculturally oriented that proposals for value added and business activity taxes present much more difficult conceptual problems than in a state like Tennessee or Texas. What might be an economically sensible concept of such a tax has little political appeal because it would impose substantial burdens on family farmers, which is a prime source of the pressure to reduce property taxes.

Dakota One already has enough petition signatures to put a measure on the 1998 ballot that would eliminate property taxes for schools without providing any source of alternative funding. A group called the South Dakota Coalition for Tax Reform, reflecting views of education spending groups and others, is urging the legislature to put a measure on the ballot that would resemble one appearing on the Michigan ballot in 1994. The legislature would eliminate or nearly eliminate property tax support of schools. Voters would be given the option of replacing the revenues through several different plans. Presumably one would be enacting an income tax and the other would be raising the sales tax. Legislative leaders have said publicly they think it unlikely that this proposal will be adopted in the 1998 session. The fall-back position for the Coalition is putting a measure on the ballot that would urge the legislature to consider such plans.

The viable alternatives for the 1998 legislative session appear to be: (1) doing almost nothing except making a few changes in the tax system such as capping the annual rate of increases in assessed value or (2) rolling back property taxes by raising the sales tax rate from 4% to 5%.

Texas

Texas state government finances depend heavily on the sales tax and on revenues from oil and gas which become less significant every year because production is declining and the revenues become a smaller share of the fiscal picture as the Texas population, economic activity, and government spending expand. Property tax reliance is high, creating the expected objections from voters. There are also issues around property taxes unique to the Texas "Robin Hood" approach to school finance.

There is broad but quiet support for an income tax among elected officials. The concept has public support from many business leaders, nearly all spending groups, and a variety of opinion leaders. Leaders of all political persuasions agree that the state and local tax system needs reform.

In 1994 Governor Bush campaigned on about five major themes, one of which was property tax relief. In the 1995 legislative session he made proposals on all themes but the tax issue which he suggested needed more study and consensus building. Between 1995 and 1997 various groups sought to build consensus on reform but largely failed. In 1997, the governor (R) proposed raising the sales tax and a variety of taxes on business and using the proceeds to roll back property taxes. Legislative leaders (mostly D) complemented the governor for making the proposals, mostly agreed that something along the general lines of the proposals needed to be done, and started work on the details of writing and enacting a bill. This work was the major issue of the 1997 session. Ultimately the idea of raising any tax to cut property taxes failed. A significant number of legislators balked at the idea of raising the sales tax to cut property taxes and another group egged on by business opposition didn't like the idea of making the state's business climate worse in the name of reducing homeowner property taxes.

Nearly every state leader is now taking the position that tax reform is necessary but the time won't be ripe until there is broader public support. Operationally, this probably means when the state is faced with a need to increase taxes just to fund current services. This will probably occur in 1999 as the state faces a structural deficit, and growing pressure to do something about property taxes. The state dug itself a fiscal hole by using a one-time surplus from the last biennium to fund property tax relief in this biennium. A national recession in 1998 would guarantee a Texas fiscal crisis in 1999.

Washington

Washington's tax system is quite unique with no personal income tax, a business and occupations (B&O) tax (basically a gross receipts tax), and steep sales taxes. Reform proposals have been around for decades. They generally move in the direction of shifting the state's system to patterns prevalent in other states by repealing the business and occupations tax, enacting a personal income tax, and adopting a corporate income tax. Ending the B&O tax nearly requires the enactment of a personal income tax to avoid windfalls from eliminating taxes on non-corporate businesses when the B&O tax is repealed. The prevailing tax reform proposals have highly complex interactions with the finances of three major Washington economic interests (Boeing, the lumber industry, and Microsoft) which make some economic and political issues associated with reform proposals unique to Washington.

None of these questions have been relevant for the past several years because the state's strong economic performance is generating more tax revenue than the state can constitutionally spend, so the current issue is which taxes to cut.

Wyoming

Wyoming has a huge resource base and not much need for public spending, so it operates quite comfortably with low taxes (e.g., no personal income tax, a 3% sales tax) and still manages to rank in the top five states in spending levels. There is general consensus that if the state should raise taxes it should raise the sales tax rate.

Summary: Prospects For Action In The Eight States

In every state without an income tax, there is a group of advocates for adopting an income tax. The core of this group is: (1) education interests, particularly teachers, who want more money for education and see major barriers to raising sales and property taxes and (2) a few people who like the income tax on broad public policy grounds or as a way of relieving what they view to be excessive taxes on agriculture or business. In some of the states income tax proponents are few and quiet, seeing little hope in the near term of achieving their objectives. In some, they are numerous and enjoy considerable support from interest groups and elected officials who will go public on the issue only if and when the proposal appears to have strong chances for passage.

Interest in an income tax is academic only and will remain so for the foreseeable future in Alaska and Wyoming. By national standards they don't need to spend more and could easily find ways to raise additional revenues without an income tax if they wanted to spend more. Interest in an income tax is academic now in Nevada and Washington because of strong revenue growth from existing taxes associated with outstanding performance of their private economies.

In both Florida and Texas, state officials are constantly bumping against revenue constraints preventing them from doing what most would like to do, such a relieving property taxes in Texas and school construction in Florida. Texas debated large tax increases this year and will revisit the subject. Florida recently completed a special session which considered but rejected possible tax increases. Without the motivation of a massive fiscal crisis, neither state is likely to reconsider major tax policy issues until 1999.

In South Dakota, tax reform (local code for enacting an income tax) may well be thrust on the state's elected officials by a voter initiative rolling back property taxes without providing replacement revenue. In New Hampshire, statewide sales and income taxes are forbidden subjects under campaign pledges most state elected officials have taken. Serious consideration of enacting either tax is unlikely unless and until a candidate open to such a plan becomes governor.

Possible Ideas For Tennessee

From these states and the most recent enactments of income taxes (Connecticut, New Jersey, and Ohio), there are some conclusions Commission members may find relevant:

- **There is no way to slide comfortably into an income tax.** Attempts to gain widespread consensus by studies, regional hearings, etc. have all shown that passing an income tax won't ever be done by consensus, even in the face of a state fiscal crisis. Passage happens when some prominent political leaders say this is the best way, admit that it will cause some people to pay substantially more than before, make the case that it is nonetheless a good idea, and collect enough votes to pass the measure.

  Considerable brain power has gone into trying to find things that have the economic and revenue effects of an income tax but can be called something else. This doesn't work but some approximations have enjoyed considerable support.

- **There is under-taxation of non-corporate business in states with corporate income taxes but no personal income tax.** Nearly everyone interested in taxes in Texas is now convinced that non-corporate businesses, such as accounting firms, law firms, and limited partnerships with large holdings (e.g., some hotels and in Texas a computer company) represent a loophole. They don't pay any corporate income taxes because they aren't corporations and don't pay any personal income taxes because nobody does. Corporations feel discriminated against, which they are. Spending groups see possible additional revenue, which is there. Public support for closing loopholes used by rich lawyers and similar professionals is reasonably strong.

  The concept finding considerable appeal in Texas was some form of tax on partnerships and proprietorships that would be somewhat comparable to the tax corporations would pay if engaged in the same activities. Applying this concept has lots of problems.

- **Some form of value added tax always gets serious discussion. None have been enacted with that name, but "business activity taxes" have been.**

- **One obvious alternative to a state income tax is a local option wage-based tax.** Such taxes do exist (e.g., Philadelphia, St. Louis) but normally in states with state income taxes, not in states without. A few states have widespread local income taxes. Examples, Arkansas, Maryland counties, New York City, and municipalities and a few school districts in Ohio and Pennsylvania. Many large Ohio cities had local option income taxes before the state income tax was adopted.

BUSINESS ACTIVITY TAXES

Introduction

The concept of taxing value added continues to receive substantial attention at the federal and state levels.

Eliminating the federal corporate income tax and substituting a value added tax for it and perhaps for all or part of the federal individual income tax interests many people for many complex reasons. The most lasting one is economic competition. Nearly all the major industrial nations have value added taxes. This and the provision of the international agreement on trade and tariffs means: (1) when Mercedes sells a German-made car in Germany, the price includes a value added tax of over 10% but when it sells the same car in the U.S. the 10% is subtracted but (2) when Ford sells an American-made car in the U.S. the price includes U.S. and state corporate income taxes and when it sells the same car in Germany the corporate income tax burden cannot be subtracted.

A value added tax was adopted in Michigan several decades ago for a different reason. Most corporate income tax revenue in Michigan came from the production of vehicles, vehicle parts, and capital goods, like machine tools — all subject to business cycles. Some years, nearly all these manufacturers would have losses and with no income to tax would pay no state corporate income taxes, at a time when the state government most needed revenues. In good years, these companies would make large profits and pay large sums to the state. By shifting its tax base from profits to value added, Michigan reduced the volatility of its revenues.

Value added taxes have been seriously considered for other states, such as Louisiana, and have some highly respected advocates such as a prominent former director of the National Association of State Budget Officers. This family of proposals typically involves using a value added tax as a replacement for the corporate income tax and, in some instances, other taxes.

Business activity taxes are conceptually similar to value added taxes but are normally discussed as overlays to existing corporate income taxes and in the few states without corporate income taxes.

What Is Value Added?

The easiest way to think of value added by a firm is to subtract the value (cost) of what it buys from other firms from its total revenues. For example, the value added by a car manufacturer is its selling price of a car minus what it pays to the companies that make the axles, sold the paint, transported the cars to the dealers, etc.

Another way to think of value added is as what a company pays out to anyone other than its suppliers. That is the sum of: (1) compensation of its employees and (2) payments to providers of capital including interest and the components of profits or return on equity which are retained earnings and dividends.

Firms differ greatly in the in the percentage of their revenues associated with value added. A huge percentage of the revenues of grocery stores, for example, goes into paying producers of cereal, meats, frozen goods, and its other suppliers. Only a tiny percentage of the revenues of

accounting firms goes to pay suppliers of office space and paper clips; most goes to employee salaries.

A Business Activity Tax

The simplest business activity tax asks a business to report its value added by activities in a state and pay a small percentage of that (e.g., 0.25%) as state tax. A different approach asks for this payment only if it is larger than what is owed under the corporate income tax. This approach doesn't change the tax liability of most profitable corporations but provides a minimum tax for corporations experiencing losses and non-corporate business forms such as partnerships.

New Hampshire has such a tax. Nevada has seriously considered one and may have enacted it. The concept had considerable support in Texas in 1997 and probably would have been enacted except for a problem that exists in Texas but doesn't exist in Tennessee. The Texas Constitution bars any tax based on income, so the Tennessee tax on dividends and interest would be unconstitutional in Texas. As applied to a company selling professional services, the value-added tax base is almost identical to what an income tax base would be. For sure, any Texas business activity tax would have been tied up in court and might have been declared contrary to the state's constitution.

For more detail on business activity taxes and proposals that some form of this tax be adopted in Tennessee, see the Tennessee Department of Revenue paper, Business Taxes: Current Structure And Options For Change.

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Hal Hovey is the President of State Policy Research, Inc. and the editor of its twice-monthly newsletters State Policy Reports and State Budget & Tax News. These publications, now in their 15th and 16th years respectively, have no sponsorship or advertising. Subscribers are primarily state legislative and executive fiscal offices, state tax and economic development agencies, officials of large local governments, individual state elected officials, bond buyers and rating agencies, state organizations interested in fiscal topics, and associations and individual organizations, higher educational institutions, and health care providers. SPR, Inc. also produces an annual data book (State Fact Finder published Congressional Quarterly Press) comparing all 50 states on hundreds of factors such as tax levels and spending patterns and the data appearing in the State and Local Sourcebook, published annually as a supplement to Governing magazine.

Hovey has a BA from Wabash College, graduate work in political science and economics at Harvard, and both a Ph.D. in political science and economics and a law degree from The George Washington University. He has published two books and many articles and reports. He frequently publishes articles and special reports.

His early work experience was in the federal government with the Office of the Secretary of Defense and Office of Management and Budget. He then worked for a trade association of electric companies and moved to the Battelle Memorial Institute where he became head of the Public Policy Economics Division. In these jobs he was involved in the analysis of federal and state programs, including major projects on federal "impact aid" for schools in areas with large federal installations, state school construction programs, and federal economic development programs.

He first became involved in state tax policy when he served, through Battelle, as the staff director of a select committee on tax reform of the Ohio legislature. Over a two-year period in the late 1960s, the committee developed a proposal for a comprehensive revision of Ohio's state and local finances including enactment of taxes on personal and corporate income, rollback of business and individual property taxes, and revision of the state's methods of financing schools.

He was appointed Ohio's Finance Director in 1971. In that capacity he was the state's top budget official and directed administrative functions such as purchasing and information systems. He was the lead drafter of the comprehensive tax reform plan enacted by the Ohio legislature in late 1971. He became the Illinois budget director in 1973.

In 1975, he resumed consulting on state, local, and federal fiscal and management topics. His federal clients have included the U.S. House Budget Committee, General Accounting Office, Office of Management and Budget, Congressional Budget Office, and Treasury Department. Much of this work was associated with intergovernmental fiscal issues.

He served as a senior fellow for public finance on the staff of the National Governors' Association in the early 1980s. In that role, he was constantly involved in fiscal federalism issues, particularly in federal tax policy and grants management. He did the state-by-state fiscal analyses of the Reagan Administration's proposals, and the governors' counterproposals, in the negotiations over "sorting out" the federal system. He helped to institutionalize this function and

the related data bases in what has become Federal Funds Information For States which continues to operate under the joint control of the National Governors' Association and National Conference of State Legislatures.

He has done considerable work for a variety of individual states and local governments. His major projects included developing budget procedures for several governments, serving as staff director of a state government reorganization commission in Connecticut, heading a management review of the New York City central budget and management agencies, and tax policy work in several states.

He is considered to be a non-partisan expert on fiscal issues. Over two decades he has done work for the National Conference of State Legislatures and/or the National Governors' Association every year, which is significant because both rotate their chair positions between political parties annually. He is in demand at annual meetings of state officials. He usually moderates panels at the annual meetings of the nation's legislators; and runs the fiscal panel for Governing magazine's annual conference on the state outlook.

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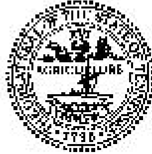

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