The Structure of State Taxes in Tennessee

A Fiscal Primer

A joint publication of the

Tennessee Advisory Commission
on Intergovernmental Relations
and
The University of Tennessee
Center for Business and Economic Research

February 2003

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PREFACE

This primer discusses how Tennessee finances its state government. It is a joint publication of the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) and the University of Tennessee, Center for Business and Economic Research (CBER). It has been prepared to serve as a primer, providing a comprehensive, yet accessible overview of Tennessee's fiscal structure. It complements *The Citizens' Guide to the Tennessee Budget*, a recent TACIR publication that served as a primer on Tennessee's budget process.

This primer outlines all of the state's revenue sources and describes all major state taxes. It also provides broad comparisons of Tennessee's tax structure with other southeastern states. Furthermore, it utilizes historical data and interstate data comparisons to determine problems, concerns, and trends related to financing state government in Tennessee.

It is our hope that you find this primer useful whether you are an experienced policy-maker seeking additional knowledge or an interested citizen looking for an introduction to Tennessee's fiscal process and structure.

Representative Randy Rinks
Chairman

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Executive Director
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I. INTRODUCTION

Perhaps the most difficult challenge confronting government anywhere in the world today is how to finance services and balance objectives of policy that are often in conflict with one another. In a sense the answer is simple: taxes. In practice, of course, the answer is not so simple. Tax systems must adequately fund government services, meet the equity and fairness objectives of diverse taxpayer groups, limit distortions that can hurt competitiveness, and minimize administration and compliance costs. Moreover, a tax system should be sufficiently stable to maintain funding across the ups and downs of the business cycle and produce revenue growth that can meet any demand for government services over time. No tax, and no tax system, can achieve these objectives to the satisfaction of all taxpayers. The practical question is how to *best* meet these objectives, based on the preferences of citizens and taxpayers.

Tennessee state government today finds itself reeling on the heels of several years of relatively weak revenue growth and concerns over budget imbalance. While some might attribute recent budget difficulties to the recession, the reality is that Tennessee's problems are long-term, relating both to the structure of taxes and to the economic trends that are beyond the control of policymakers. The recession aggravated the revenue shortfall in the state, it did not precipitate it. Adding to the problems of the past, the state now confronts new challenges to funding government. And the threats are real. One threat is that posed by the emergence of electronic commerce and the resultant loss in state and local sales tax revenue. Tennessee, which relies on the sales tax for well over one-half of its tax revenue, is thus at great risk. Business taxes, in particular the corporate income tax, are also under siege due to creative tax planning and incentives (including the double-weighted sales corporate apportionment formula) which erode collections. The fact is that the world is changing, but Tennessee's tax system is not. The economy is changing, but Tennessee's tax structure is ill equipped to deal with the changes.

This is a report about financing state government in Tennessee. It is timely given that the state legislature has just adopted a budget for 2002/03 following one of the most contentious political debates in the state's history. The changes made to the state tax structure, which included increases in the sales tax rate and corporate income tax rate, will provide short-term budgetary relief. But the changes have not addressed the fundamental weaknesses in state tax structure and in some respects have placed the state at even greater financial risk in the years to come. The purpose of this report is to provide a common foundation and framework for the ongoing debate about taxes in Tennessee. It is intended to complement the recently released report by the Tennessee Advisory Commission on Intergovernmental Relations, *The Citizens' Guide to the Tennessee Budget*. The current report provides an overview of all state revenue sources and descriptions of all major state taxes. Extensive comparisons of Tennessee's tax structure are made to other states in the Southeast. The report draws heavily on historical data and interstate data comparisons to identify major issues, patterns and trends related to financing Tennessee state government. And it discusses the broad goals of tax policy and the ways these goals conflict with one another.

The report is organized as follows: the first section provides a broad overview of all the different revenue sources used by the state to fund public services, including intergovernmental aid. The next section offers a detailed primer on the structure of specific taxes in Tennessee with extensive references and comparisons to other states in the Southeast. This includes a discussion of tax rates and tax bases for all major state taxes administered by the state Department of Revenue, and tax proceeds that accrue to other state departments and agencies. The allocation of revenue to specific funds such as the general fund and highway fund is also briefly addressed. Section four examines the mix of total revenue for Tennessee and other southeastern states, while section five examines the change in the mix of taxes for the southeastern states between 1970 and 2000. Tax burdens in Tennessee and in other states are explored next. The analysis of comparative tax burdens relies on both taxes per capita and taxes as a share of income to illustrate relative tax burdens across taxes and across states. Section seven is an analysis of well-accepted goals for tax policy that have long been used to structure discussion and debate over national and sub-national tax systems. The final section discusses policy goals and policy tradeoffs and summarizes the challenges confronting the state tax structure and state policymakers.

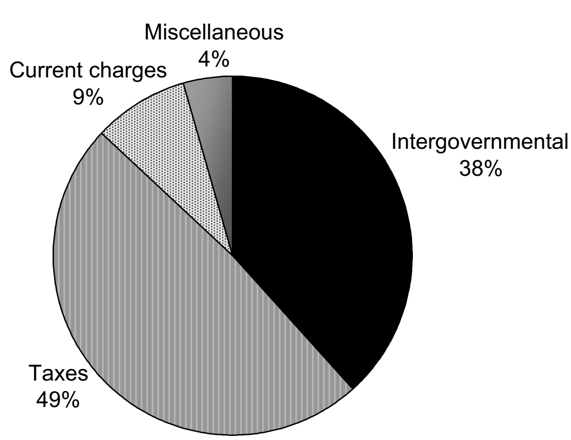
II. AN OVERVIEW OF STATE REVENUES IN TENNESSEE

The term *revenue* can be a confusing concept. The state derives revenue to support expenditures and intergovernmental aid to counties, cities and schools from a wide array of sources. The source of revenue that comes most often to mind is *tax* revenue, including the sales tax and the corporate income tax. As important as tax revenue is to the state, it accounts for less than one-half of total state government revenue, and therefore constitutes less than one-half of the support for service delivery through the state budget. In addition to taxes, total revenue also includes aid from the federal government, charges for services, miscellaneous revenue sources, lottery revenue, and revenue from state-operated utilities, liquor stores, and state unemployment insurance trust funds. Total revenue in Tennessee was $19.0 billion in 2000, of which about 16 percent represented insurance trust fund proceeds. In short, total revenue includes receipts from every possible source accruing to all state departments and agencies, used to fund all of the services the state provides. This includes items many would otherwise not consider part of the state budget, like revenues from the sale of university athletics tickets. Most people do not understand that when these ticket sales increase, so does state revenue, state expenditures (as the revenue is spent by the university) and the size of the state budget.

Figure 1 shows the mix of Tennessee's total *general* revenue for 2000. General revenue, which is total revenue minus revenue from liquor stores, utilities and insurance trust funds, was $15.9 billion for the year, or about 84 percent of total revenue. (Tennessee state government owns no liquor stores and thus received no liquor store nor utility revenue in 2000. TVA in-lieu of tax payments, discussed below, are treated as tax revenue.) Current charges and miscellaneous revenue sources accounted for only 8.6 percent and 4.4 percent of general revenue, while tax revenue represented almost 49 percent of general revenue.

Over one-third of general revenue in 2000 was intergovernmental aid from the federal government. Note that an increase in intergovernmental aid increases the amount of general revenue and increases the size of state spending as well. Some federal aid is earmarked for specific purposes, as with aid received by the Department of Labor and Workforce Development.

Figure 1: Composition of General Revenue for Tennessee State Government, 2000



Source: U.S. Census Bureau

Earmarking sharply restricts the state's flexibility in the use of funds. General-purpose aid can be used with greater discretion by the governor and legislature, although very little of this aid comes to the state. Tennessee has historically placed a disproportionate reliance on federal aid relative to other states in the Southeast, in large part a reflection of the state's relatively low level of own-source revenue collection. The box on page 5 provides some general information on the role of federal intergovernmental aid, while Figure 2 lists the various sources of the state's federal aid for 1999.

State tax revenue is confined to levies imposed by the state and totaled $7.7 billion in 2000. Tax revenue represents only 40.8 percent of total state revenue. A breakdown of major tax revenues is provided in Figure 3. The general sales tax produced 57.4 percent of state taxes, while selective sales taxes accounted for 17.6 percent of revenue. Together, sales-based taxes in Tennessee represented 75.0 percent of all tax revenue in 2000. The corporate income tax and the personal income tax generated 7.9 percent and 2.3 percent of tax revenue in 2000, respectively.

Figure 2: Federal Agencies Providing Aid to Tennessee State and Local Governments: 1999

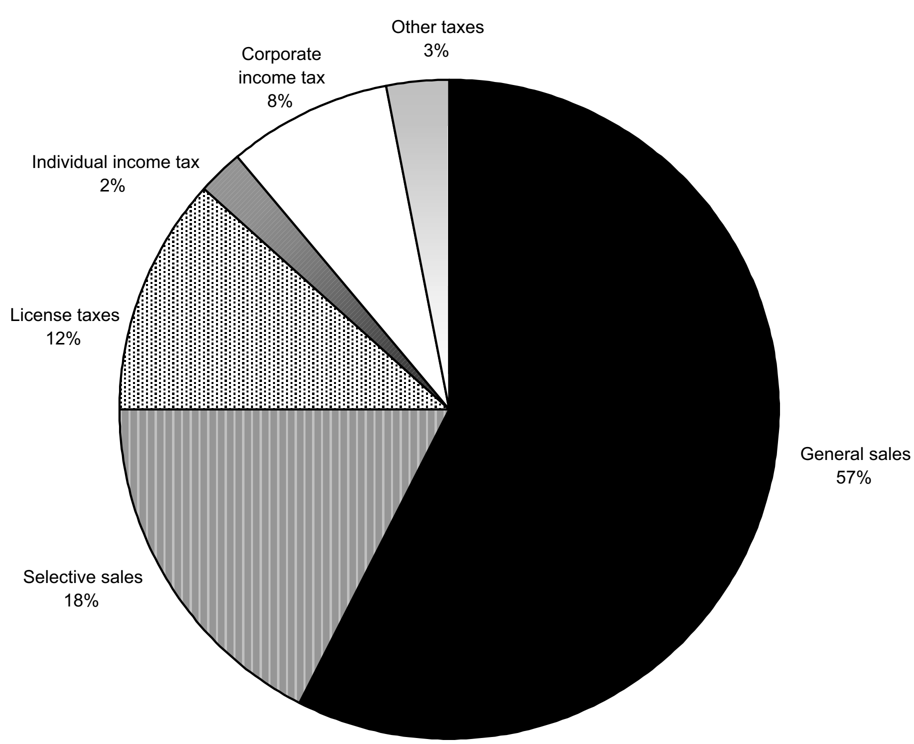
Department of Agriculture, Cooperative State Research, Education, and Extension Service
Department of Agriculture, Food and Nutrition Service
Department of Agriculture, Forest Service
Department of Commerce, National Oceanic and Atmospheric Administration
Department of Education, Office of Elementary and Secondary Education
Department of Education, Office of Bilingual Education and Minority Language Affairs
Department of Education, Office of Special Education and Rehabilitative Services
Department of Education, Office of Vocational and Adult Education
Department of Education, Office of Post Secondary Education
Department of Education, Office of Educational Research and Improvement
Department of Energy
Department of Health and Human Services, Health Resources and Services Administration
Department of Health and Human Services, Center for Disease Control and Prevention
Department of Health and Human Services, Substance Abuse and Mental Health Services Administration
Department of Health and Human Services, Health Care Financing Administration
Department of Health and Human Services, Administration for Children and Families
Department of Health and Human Services, Administration on Aging
Department of Health and Human Services, Office of the Inspector General
Department of Housing and Urban Development, Community Planning and Development
Department of the Interior, Office of Surface Mining Reclamation and Enforcement
Department of the Interior, United States Fish and Wildlife Service
Department of Justice, Office of Justice Programs
Department of Labor, Employment and Training Administration
Department of Labor, Veterans' Employment and Training Services
Department of Transportation, Coast Guard
Department of Transportation, Federal Aviation Administration
Department of Transportation, Federal Highway Administration
Department of Transportation, Federal Transit Administration
Environmental Protection Agency, Office of Air and Radiation
Environmental Protection Agency, Office of Water
Environmental Protection Agency, Office of Enforcement, Compliance and Assurance
Environmental Protection Agency, Office of Prevention, Pesticides and Toxic Substances
Environmental Protection Agency, Office of Solid Waste and Emergency Response
Corporation for National and Community Service
Federal Emergency Management Agency
National Foundation on the Arts and the Humanities, Institute of Museum and Library Services

Source: Budget Information for the States, Executive Office of the President, Office of Management and Budget, Washington, D.C.

Intergovernmental Aid

Intergovernmental aid is the transfer of tax resources from one jurisdiction to another to support the provision of services. Such aid typically has one of two purposes. The first is to address spillovers that extend beyond the political boundaries of states and localities. For example, federal aid might be used to support environmental, transportation and education initiatives that are perceived to be in the broader national interest. A second purpose of aid is to redistribute income from wealthy to poor jurisdictions. Most intergovernmental aid is categorical in nature; i.e., it is tied to specific uses as with Tennessee's education aid to cities and counties. Grants can be lump sum or matching, where a matching grant requires the recipient government's participation in program finance. Aid may be linked to the recipient government's ability (or capacity) to finance services. For example, federal government matching aid to Tennessee in support of the TennCare program depends on Tennessee's per capita income — a measure of Tennessee's wellbeing relative to the nation. States with higher per capita income — and hence greater ability to pay — typically receive relatively less federal assistance. Similarly, aid can hinge on government's tax effort; i.e., the amount of revenue actually derived from available tax bases. For example, state aid received by school districts in Tennessee as part of the Basic Education Program depends in part on district tax effort, as well as capacity.

Figure 3: Composition of Tax Revenue for Tennessee State Government, 2000



Source: U.S. Census Bureau

Table 1 provides a summary distribution of broad categories of total state government revenue, inclusive of federal aid, for Tennessee and the southeastern states (combined) for 1970 and 2000. In 1970, over 30 percent of total state revenue in Tennessee came from the federal government, versus about 27 percent for the southeastern states. By 2000, reliance on intergovernmental revenue by Tennessee increased to 38.4 percent while the Southeast witnessed a much smaller increase of 29.3 percent. Tennessee has benefited from increased funds to support Medicaid, the food stamp program and the Temporary Assistance to Needy Families (TANF) program. Over the same time period, both Tennessee and the region experienced relative declines in own-source tax shares. For the state, the decline was from 58.1 percent of total revenue to 48.6 percent, while for the Southeast the decline was from 61.4 percent to 53.2 percent. Particularly striking is that in 2000 more than one-third of all state government spending in Tennessee was financed on the backs of federal government taxpayers, which, of course, includes Tennessee federal taxpayers. The reduced reliance on own-source taxes took place in Tennessee despite relatively strong growth in total personal income and per capita personal income between 1970 and 2000, suggesting a decline in own-source tax effort on the part of the state. Total charges and miscellaneous fees were a roughly similar share of revenue for the state and the region in 1970, and while Tennessee increased its reliance by 2000, the region did so as well, but by a much larger margin.

Table 1: Distribution of State General Revenue, Tennessee and Southeastern States[1], 1970 and 2000

	1970		2000	
	TN	SE	TN	SE
Intergovernmental	31.6	27.1	38.4	29.3
Taxes	58.1	61.4	48.6	53.2
Total Charges/Miscellaneous	10.3	11.6	13.0	17.5
Charges	-	-	8.6	9.9
Miscellaneous	-	-	4.4	7.6

[1]Southeastern states include Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia.
Source: U.S. Census Bureau.

III. A PRIMER ON TENNESSEE STATE TAXES

The state of Tennessee uses revenue from many different sources, as shown previously, to fund services provided to taxpayers. The state only has limited control over intergovernmental aid. While the state cannot directly influence the structure of aid programs, its choices do affect the total volume of aid. For example, the state's current TennCare program generates more aid than would accrue if the program reverted back to the old Medicaid system. The state has far greater discretion in defining its own tax structure, which includes setting own-source tax rates, defining specific tax bases, and offering exemptions to particular taxpayer groups. Constraints on the structure of taxes exist due to constitutional and other legal limits. Moreover, the state cannot control the way in which businesses and people respond to taxes, as with the use of tax shelters or border shopping. In some instances, policy could be changed to recognize taxpayer responses — as with combined unitary reporting under the corporate income tax and greater enforcement of use tax laws under the sales tax. Policy responses such as these are difficult to get through the legislative process. In addition, government cannot easily respond to all sorts of taxpayer behavior.

Tax policy choices determine, in concert with economic conditions, the productivity of the state's revenue system, revenue stability, tax fairness and so on. In the discussion that follows, a detailed overview of major Tennessee state taxes is provided. (Additional detail is offered in Appendix 1.) Emphasis is placed on tax bases, tax rates and comparisons of bases and rates across states. Knowledge of how the state's major taxes are structured and work in practice is essential to a broader understanding of the fiscal problems and challenges confronting state and local governments in Tennessee.

General Sales Tax

The sales tax is clearly the most important tax instrument for state government in Tennessee, accounting for well over one-half of all own-source tax collections. The sales tax — including its base, rate and administration — is not always well understood by taxpayers. There are really two components to the tax. The first is the familiar sales tax paid by individuals and businesses when they purchase sales-taxable items from firms located in the state.

What is *nexus*?

According to recent rulings by the US Supreme Court, states may not require an out-of-state seller to collect and remit sales taxes on behalf of their residents unless that seller has what is called *nexus*. This concept, while subject to evolving interpretation, has come to mean that the seller must have physical presence in the taxing state.

Supreme Court rulings regarding two sections of the US Constitution have contributed to current interpretations of nexus. Under the Commerce Clause of Article 1, Congress has the sole authority to regulate interstate trade. Under the Due Process Clause of the 14th Amendment, states may not act in such a way as to unduly burden interstate trade. In interpreting both of these as they pertain to interstate commerce, the Court has ruled that nexus means quite different things under each clause.

First, the Court's interpretation of Commerce Clause nexus in *National Bellas Hess v. Dept. of Revenue of Illinois (386 US 753, 1967)* reads that states can only require out-of-state sellers to collect and remit sales taxes on interstate trade if the seller has some physical presence in the taxing state. This was reaffirmed in *Quill Corp. v. North Dakota (504 US 298, 1992)*, in which the Court went a step further to clarify that Due Process nexus is not necessarily synonymous with physical presence. The fact that a state maintains and protects an out-of-state seller's marketplace constitutes Due Process nexus. However, no Commerce Clause nexus (and no requirement to collect and remit sales taxes) exists unless that seller also has physical presence in the taxing state.

In ruling on the *Quill* case, the Court noted that Congress has the sole authority to establish a more formal definition of nexus. A large number of sales-taxing states are currently working toward simplifying the existing sales tax system in hopes of convincing Congress to adopt a more modern notion of nexus, perhaps one that is based more on economic than on physical presence. Until this issue is resolved, state and local sales tax bases remain at risk and will be subject to sustained erosion of sales tax revenue.

The second component is the complementary *use tax*, which applies to goods or services acquired out-of-state for consumption in Tennessee by individuals and firms, acquired from business entities that do not have physical presence (more precisely *nexus)* in the state, or purchased as exempt by businesses but then used for a taxable activity.[1] The absence of nexus for many firms engaged in remote marketing, including traditional mail order business and more recent electronic commerce firms, is one of many threats to the state and local sales tax nationwide. For both the sales and use tax, the tax takes the form of an ad valorem (i.e., percentage) levy on the value of taxable goods and services purchased, net of applicable discounts or trade-ins.

Consumers are liable for payment of the sales tax, although the legal burden falls on businesses to collect and remit the tax on the consumers' behalf. This collection mechanism imposes compliance costs on business entities rather than individual consumers. These compliance costs are invisible to consumers but for businesses they are conspicuous and can be substantial.

Historically the sales tax in Tennessee and in other states was an impost on tangible goods. This initial structure reflected the manufacturing orientation of the economy in the 1930s and 1940s when sales taxes were introduced often as a replacement for wholesale taxes. The tax has never been structured as a true tax only on individual and household consumption—which would include both tangible goods and intangible services—although this is the ideal that the sales tax aspires to.

While businesses receive sales tax exemptions on goods purchased for resale and on inputs directly embodied in manufactured products, many other purchased inputs and expenses are sales taxable. Generally a business will pay sales tax on building materials, supplies, furniture, computer equipment, etc. It has been estimated that businesses pay as much as 37 percent of all state sales taxes in Tennessee. (The state-by-state estimates range from a low of 11 percent in West Virginia to a high of 72 percent in Hawaii.) As shown in Table 2, this places Tennessee roughly in the middle of the southeastern states in the share of sales tax paid by business. In fiscal year 2000/01, total state sales tax collections were $4.6 billion, so the business share of the tax was approximately $1.7 billion. Corporate excise and franchise taxes were $635 million and $468 million the same year. This means that the state sales tax is the single largest *business* tax in the state.

Services and Exemptions. Services have been slow to creep into the sales tax base. One reason is that the inclusion of services in the base requires specific enumeration by state law, which can easily lead to focused political opposition. Many services are consumed heavily by businesses, while others, like medical care, have unique ethical status. Since services are the fastest growing sector of the economy, their omission from the base means the sales tax base is shrinking as a share of the overall economy.

The base of the sales tax in all southeastern states is riddled with exemptions intended to provide tax relief to specific taxpayer groups or encourage specific types of economic activity. Unlike intangible services which are typically exempt unless enumerated for taxation, tangible goods are generally taxable unless enumerated for exemption. (Politically it may be

Table 2: Consumers' Share and Producers' Share of Sales Tax Burden: Tennessee, Southeastern States and the United States

	Consumers' Share (Percent)	Producers' Share (Percent)
Alabama	73	27
Arkansas	60	40
Florida	50	50
Georgia	64	36
Kentucky	54	46
Louisiana	51	49
Mississippi	66	34
North Carolina	62	38
South Carolina	61	39
Tennessee	**63**	**37**
Virginia	70	30
West Virginia	89	11
US	59	41

Note: Estimates are for 1989. Producers' share includes sales to government and nonprofit entities.

Source: Raymond J. Ring, Jr., "Consumers' Share and Producers' Share of the General Sales Tax," National Tax Journal 52 (1999): 79-90.

more palatable to enumerate an exemption than to enumerate a new taxable activity.) Of course, policy towards services could change and be consistent with the taxation of goods. Nonprofit and government entities are tax exempt. While it is generally desirable to exempt business inputs from sales taxation, the actual policy in Tennessee and other states is clearly not consistent with this objective.

Table 3 provides a state-by-state summary of key sales tax exemptions for states in the Southeast. As indicated by the lengthy list of footnotes to the table, the way individual exemptions work is often specific to each exemption and each individual state. Agricultural inputs, including insecticides, fertilizer, seeds, seedlings and plants are exempt in all southeastern states. Machinery receives some form of preferential treatment — either outright exemption from the sales tax base or a lower tax rate — in the majority of states. Specific services like cleaning and repairs have been incrementally added to the tax base in Tennessee. The pattern of incrementally adding services is common across all states with a general sales tax. No state other than Hawaii has sought to apply the sales tax to the use of medical and education services due to concerns over equity and fairness; in New Mexico, both state and local governments apply the gross receipts (i.e. sales) tax to certain medical expenses. Three states in the region, Florida, Georgia and Kentucky, and thirty states nationwide, exempt food purchased at grocery stores; no state in the region has removed clothing from the base of the tax. As desirable as these and other exemptions may appear to certain taxpayer groups, they do have a cost, chiefly forgone revenue and in some instances, e.g., the exemption of food, sharply higher costs for compliance and administration.

Table 3: Sales Exemptions, Southeastern States

	Alabama	Arkansas	Florida	Georgia	Kentucky	Louisiana	Mississippi	North Carolina	South Carolina	Tennessee	Virginia	West Virginia
Insecticide	E	E	E	E	E	E	E	E	E	E	E	E
Fertilizer, seed, etc.	E	E	E	E	E	E	E	E	E	E	E	E
Seedlings, plants, etc.	E	E	E	E	E	E	E	E	E	E	E	E
Clothing	T	T	T	T	T	T	T	T[1]	T	T[1]	T	T
Canned Software	T	T	T	T	T	T	T	T	T	T	T	T
Custom Software	E	T	E	E	E	T	T	E	T	T	E	T
Modified Canned Software	E	T	E	E[1]	E	T	T	E	T	T	E[1]	T
Computer Hardware	T	T	T	T	T	T	T	T	T	T	T	T
Downloaded Software	T	E	E	E	T	T	T	E	E	T	E	T
Drop Shipments												
Primary	E[1]	E[1]	T[1]	E[2]	E[1]	T[1]	no provisions	T[2]	--	T[2]	E[2]	E
Secondary	use tax	use tax	--	use tax	use tax	--	--	use tax	use tax	--	use tax	use tax
Grocery	T	T	E	E	E	T[2]	T	T[3]	T	T	T	T
Vehicle-rent	T[2]	T[2]	T[2]	T	E[2]	E[3]	T[1]	E[4]	T[1]	T[3]	E[3]	T
Lodging	E[3]	T[3]	T[3]	T	T	T	T	T	T	T	T	T
Machinery	T[2]	T[4]	T	E	E	T	T[2]	T[3]	E	E	E	E
Utilities	E	T	E	T	E	E	T[2]	T[3]	E	T[4]	E	E
Farm-Machine	T[2]	E	T[4]	E	E	T	T[2]	T[3]	E	E	E	E
Medicine-nonpres	T	T	T[5]	T	T	T	T	T	T	T	E	T
Medical-services	E	E	E	E	E	E	E	E	E	E	E	E
Medical-devices	T	E[5]	E[6]	E[3]	E	E	T	E[5]	E[2]	E	E	E[1]
Newspaper	T	E	T[7]	T	T	T	E	E[6]	E	E	E[4]	E[2]
Periodical	T	T[6]	T[7]	T	T	T	E	E[6]	T	T	E[5]	T
Occasional Sales												
Motor Vehicles, etc.	T[4]	T	T	E[4]	T[3]	T	T	T[7]	T	T	T[6]	E[3]
Other Sales	E	E	E[8]	E[4]	E[4]	E[4]	E	E	E	E	E[7]	E[3]
Pollution Control Eq.												
Air	E	E[7]	E	E	T	E	T[3]	T[8]	E	E	E	E
Water	E	E7	E	E	T	E	T[3]	T[8]	E	E	E	E
Shipping and Handling												
Shipping	T[5]	T[8]	T[9]	T[5]	T[5]	T	T	T	T[3]	T[5]	T[8]	T
Handling	T	no provision	T	T	T	T	T	T	T	T	T	T
Services												
Cleaning	E	T	E	E	E	T	T	T	T	T	E	T
Transportation	E	E	E	T	E	E	E	E	E	E	E	E
Repair	E	T	E	E	E	T	T	E	E	T	E	T
Professional/Personal	E	E	E	E	E	E	E	E	E	E	E	E
Trade-Ins	E[6]	E[9]	E	E	E	E	E	T	E	E	E	E
Vending Machine Sales												
Food	T	T[10]	T	T	T	E	E[4]	T	E	T	T[9]	T
All other sales	T	T	T	T	T	E	T	T	E	T	T	T

Note: Footnotes appear on the following page, arranged by state.
Source: Commerce Clearing House, Inc. 2001 US Master Sales and Use Tax Guide.

Table 3: Footnotes Arranged by State:

Alabama:

[1]retailer furnishes resale exemption from retailer's sale
[2]reduced rate
[3]subject to state occupancy tax
[4]separate tax on casual sales of cars, trailers, etc.
[5]unless stated separately
[6]exclusion only on motor vehicles, trailers, and ag. machinery

Arkansas:

[1]retailer furnishes resale certificate
[2]separate state tax on rental vehicles
[3]subject to separate state occupancy tax
[4]limited exemption/exclusion available
[5]prescription required for exemption
[6]exempt if by subscription
[7]exempt if required by law
[8]unless billed
[9]exclusion only on aircraft, mobile homes, motor vehicles, trailers, and semi-trailers
[10]subject to special gross receipts and use tax/vending device decal fee

Florida:

[1]supplier collects sales tax from retailer
[2]rental vehicle surcharge may apply
[3]subject to separate state occupancy tax
[4]reduced rate
[5]only specific items
[6]prescription required for exemption
[7]exempt if delivered by mail
[8]exemption allowed for sales not sold in regular course of business of seller
[9]unless changes are separately stated and optional, or shipped FOB

Georgia:

[1]nontaxable personal transaction unless deemed part of sale of tangible personal property
[2]retailer furnished retail certificate
[3]prescription required for exemption
[4]tangible property for business-exempt if total selling price from all such sales during last year <$500
[5]except FOB point sales where purchaser assumes ownership risk

Kentucky:

[1]retailer furnishes KY resale certificate
[2]separate state tax on rental vehicles
[3]vehicle-separate use tax
[4]exempt-property is not used in an activity requiring a seller's permit
[5]unless stated separately from all charges

Louisiana:

[1]retailer must pay to supplier advance payment of the sales tax which the dealer is required to collect upon the sale at retail
[2]reduced rate until 6/02
[3]separate state tax on rental vehicles
[4]exemption allowed for sales not sold in regular course of business of seller

Mississippi:

[1]rental vehicle surcharge may apply
[2]reduced rate
[3]may qualify for reduced rate-manufacturing
[4]exempt-sold through vending machines under a full service sales agreement

North Carolina:

[1]separate alteration charges-exempt
[2]supplier not required to collect sales tax on sales to out-of-state retailer
[3]reduced rate
[4]separate state tax on rental vehicles
[5]prescription required for exemption
[6]exemption-newspapers sold on street or by vendors making door-to-door deliveries
[7]vehicles-separate use tax
[8]may qualify for reduced rate-manufacturing

South Carolina:

[1]rental vehicle surcharge may apply
[2]prescription required for exemption
[3]unless sale is FOB point of origin

Tennessee:

[1]clothing by certain non-profit organizations-exempt
[2]supplier must collect tax from customer
[3]rental vehicle surcharge may apply
[4]reduced rate for manufacturers; residential exemption
[5]unless FOB point of origin and charges stated separately

Virginia:

[1]canned software used in modification - taxable
[2]retailer furnishes resale certificate
[3]separate state tax on rental vehicles
[4]newspapers - exempt if price <$0.75
[5]subscriptions - exempt if sold for at least semiannual basis and second-class mail
[6]vehicles-exempt from sales tax, but subject to separate vehicle tax
[7]exempt-property is not used in an activity requiring a seller's permit
[8]unless stated separately
[9]food and drink sold through vending machines are not subject to county food and beverage tax

West Virginia:

[1]prescription required for exemption
[2]newsstand sales-taxable
[3]exemption allowed for sales not in regular course of business of seller

The state budget provides detail on the revenue loss associated with more prominent sales tax exemptions, as shown in Table 4 for fiscal year 2002/03. The list is not all inclusive, omitting, for example, sales for resale and component-part sales to business that have always been exempt under Tennessee's sales tax. The largest state revenue loss arises from the exemption of gasoline ($241.4 million). Residential energy fuels are second in line, with a revenue loss of $177.0 million. The total cost of these enumerated exemptions to state government is $1.4 billion, while local governments lose over $490 million.

The list in Table 4 is far from complete since it is confined to *enumerated* sales tax exemptions; the list omits the range of untaxed services that would need to be explicitly enumerated for *inclusion* in the sales tax base. The revenue cost of not taxing services, which totals $2.4 billion, is detailed in Table 5. Much of the revenue loss is due to health and education services and services consumed heavily by firms in the course of operating their business (for example, professional and media advertising services).

Table 4: Major Tax Exemptions from Current Sales Tax Base

Tennessee Code Annotated	Tax Source and Description of the Exemption	FY 2002-2003 Estimated Revenue Loss	
		State	Local
	Sales and Use Tax	$1,410,049,000	$490,072,000
67-6-329(a)(1)	Gasoline	241,400,000	90,500,000
67-6-329(a)(2)	Motor vehicle fuel (diesel fuel)	80,400,000	30,100,000
67-6-329(a)(1)	Gasoline/diesel fuel for agriculture	6,300,000	2,300,000
67-6-334	Energy fuels sold for residential use	177,000,000	66,400,000
67-6-206(b)(1)	Energy and water sales to manufacturers (reduced rate)	113,400,000	56,700,000
67-6-206(b)(3)(4)	Energy and water sales to manufacturers for direct processing	43,600,000	560,000
67-6-217	Aviation fuel (reduced rate)	4,600,000	6,900,000
67-6-312,320	Prescription drugs, insulin, and syringes	170,200,000	63,820,000
67-6-319	Prescription drugs samples	9,140,000	3,430,000
67-6-206(a)	Industrial machinery and equipment	126,300,000	11,710,000
67-6-207	Farm machinery and equipment	14,400,000	1,300,000
67-6-102(24)(E)(ii)	Packaging sold for resale or use	74,700,000	28,000,000
67-6-216	Non-material cost of manufacturer homes (reduced rate)	19,900,000	7,500,000
67-6-336	Used factory-manufactured structures	5,600,000	520,000
67-4-506	Vending machines	19,900,000	7,500,000
67-6-212(5)	Cable television (exempt portion)	13,100,000	4,900,000
67-6-316	Prescription eyewear and optical goods	13,160,000	4,900,000
67-6-329(a)(21)	Newspaper (periodical) sales	13,999,000	5,250,000
67-6-329(a)(12)	School books and lunches	13,930,000	5,220,000
67-6-330(a)(3)	First $150 dues for club membership	8,660,000	3,250,000
67-6-313(g),321	Railroad rolling stock	6,750,000	1,500,000
67-6-530	Motion picture production	6,900,000	2,600,000
67-6-329(a)(3-10),(17)	Fertilizers, pesticides, seeds, and related items to nurseries	4,500,000	1,690,000
67-6-329(a)(16)	Magazines and books -- printers' nexus	3,538,000	1,327,000
67-6-303	Motor vehicles sold to non-resident military personnel	3,540,000	275,000
67-6-309(a)	Theater film and transcription rentals	2,860,000	1,070,000
67-6-330(a)(19)	Some physical fitness facility fees	2,272,000	850,000
	All other remaining exemptions	210,000,000	80,000,000

Notes: Local revenue loss calculated based on an average local sales tax rate of 2.25 percent.
Foregone state revenues are calculated using the 6 percent state rate.
Source: State of Tennessee, The Budget, Fiscal Year 2002/03.

Table 5: Major Tax Exemptions from the Sales and Use Tax, Currently Untaxed Services

Service/Product Area Exempted	FY2002-2003 Estimated Loss State	Local*
Administrative and Support Services	$202,500,000	$75,900,000
Collection Agencies and Credit Bureaus	16,500,000	6,200,000
Employment Services	110,800,000	41,600,000
Investigation and Security Services	22,700,000	8,500,000
Mail, Document Reproduction, and Call Centers	12,100,000	4,500,000
Services to Buildings and Dwellings	40,400,000	15,100,000
Construction Services	$495,000,000	$185,600,000
Building, Developing, and General Contracting	171,500,000	64,300,000
Heavy Construction	44,500,000	16,700,000
Special Trade Contractors	279,000,000	104,600,000
Educational Services	$11,800,000	$4,400,000
Educational Services (for-profit)	10,300,000	3,800,000
Educational Services (non-profit)	1,500,000	600,000
Finance, Insurance, and Real Estate	$160,800,000	$60,400,000
Investment Banking, Securities Brokerage, and Related Services	56,400,000	21,200,000
Insurance Agents and Related Services	41,800,000	15,700,000
Real Estate Agents and Brokers	62,600,000	23,500,000
Health Care and Social Services (for-profit)	$499,300,000	$187,200,000
Physicians and Dentists	263,500,000	98,800,000
Other Health Practitioners	32,400,000	12,100,000
Hospitals	68,900,000	25,800,000
Nursing and Residential Care Facilities	78,300,000	29,400,000
Outpatient Care Centers	20,300,000	7,600,000
Medical and Diagnostic Laboratories	14,600,000	5,500,000
Other Selected Health Services	6,400,000	2,400,000
Social and Community Services	14,900,000	5,600,000
Health and Social Services (non-profit)	$300,300,000	$112,600,000
Hospitals	251,100,000	94,200,000
Nursing and Residential Care Facilities	15,500,000	5,800,000
Outpatient Care Centers	17,000,000	6,400,000
Other Selected Health Services	3,300,000	1,200,000
Social and Community Services	13,400,000	5,000,000
Information Services	$43,900,000	$16,500,000
Data Processing Services	10,400,000	3,900,000
Movie Production and Sound Recording Studios	6,900,000	2,600,000
Cable T.V. Subscriptions (exempt amt.)	13,100,000	4,900,000
Newspaper Subscriptions and Sales	13,500,000	5,100,000
Media Advertising Sales	$110,200,000	$41,300,000
Newspaper Advertising	32,800,000	12,300,000
Radio Advertising	16,900,000	6,300,000
Television Advertising (broadcast and cable)	60,500,000	22,700,000
Personal Services	$57,200,000	$21,500,000
Coin-operated Laundry	2,100,000	800,000
Death Care Services	11,900,000	4,500,000
Diet & Weight Loss	1,700,000	600,000
Hair, Nail & Skin Care Services	23,800,000	8,900,000
Non-Profit Amusement and Membership Organizations	17,700,000	6,700,000
Professional and Technical Services	$403,000,000	$151,000,000
Accounting, Tax Return Prep., and Payroll	51,400,000	19,300,000
Advertising and Public Relations	25,100,000	9,400,000
Architectural Services	16,700,000	6,300,000
Engineering Services	68,500,000	25,700,000
All Other Architectural, Engineering, and Related Services	8,900,000	3,300,000
Specialized Design Services	12,000,000	4,500,000
Computer Systems Design and Related Services	36,100,000	13,500,000
Legal Services (profit and non-profit)	96,900,000	36,300,000
Management, Scientific and Technical Consulting	70,800,000	26,500,000
Scientific Research and Development (profit and non-profit)	16,600,000	6,200,000
Transportation Services	$124,600,000	$46,700,000
Couriers and Messengers	62,400,000	23,400,000
Truck Transportation (Local)	46,700,000	17,500,000
Other Transportation	15,500,000	5,800,000
Total Revenue Loss	$2,408,600,000	$903,100,000

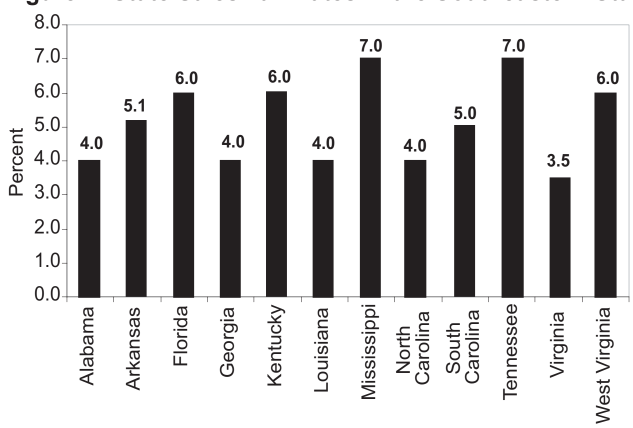
**Local revenue loss calculated based on an average local sales tax rate of 2.25%.*
Source: State of Tennessee, The Budget, Fiscal Year 2002/03.

Together the exemption of tangible goods and the failure to include services in the Tennessee sales tax base will cost the state nearly $4.0 billion and cost local governments nearly $1.4 billion in 2002/03. Forgone revenue is just one problem associated with exempting or failing to tax specific elements of the potential sales tax base. For example, narrowing the tax base may influence revenue stability and taxpayer fairness, and tax rates elsewhere in the tax system may need to be increased to make up for revenue shortfalls. According to accepted standards of tax efficiency and neutrality, the idea is to tax all household consumption and exempt all business inputs from tax, whether the purchase is a good or a service. Given competing tax policy objectives, this ideal will not likely ever be realized in practice.

Sales Tax Rates. General sales tax rates for Tennessee and other southeastern states are shown in Figure 4. Tennessee's 7.0 percent rate exceeds that of all other states in the region except Mississippi that also has a 7.0 percent rate. Reduced sales tax rates are applied to certain purchases in specific states. For example, mobile home sales are subject to reduced tax rates in Alabama and North Carolina, while several states offer lower rates on agricultural and/or manufacturing equipment; Virginia provides for a lower state rate on grocery food. In Tennessee, grocery food is now taxed at a reduced 6.0 percent rate. In addition to Tennessee's high state sales tax rate, there are base variations across key border states that place in-state businesses required to collect the tax at a disadvantage. For example, neither Georgia nor Kentucky include grocery store food in the state sales tax base (although food is subject to local taxation in Georgia).

Seven other states in the Southeast enable local governments—counties and/or cities—to impose local option sales taxes on top of the state rate. Kentucky, Mississippi and West Virginia do not allow local option sales taxes. In Tennessee the maximum combined city and county local option rate is 2.75 percent. The local option sales tax rates for the region are summarized in Table 6. Tennessee's maximum local option rate is used by 30 of Tennessee's 95 counties. Three states allow higher maximum rates than Tennessee, including Alabama (5.0 percent), Louisiana (5.5 percent) and North Carolina (3.0 percent). Tennessee and Arkansas are the only states in the Southeast with *single item caps* for the local option rate. In Tennessee, the first $1,600 of the purchase price is the cap for the local option sales tax; a statewide uniform rate of 2.75 percent is imposed on sales between $1,600 and $3,200, with proceeds going to the state.

Figure 4: State Sales Tax Rates in the Southeastern States



Source: Federation of Tax Administrators.

The maximum combined state and local rates are shown in Figure 5. With Tennessee's recent sales tax rate increase, the state now has the highest combined rate in the region and the second highest in the nation trailing only Oklahoma (9.87 percent). Adding the 5.5 percent maximum local rate to Louisiana's state rate of 4.0 percent produces a combined rate of 9.5. Alabama places third in the region with a maximum rate of 9.0 percent.

Table 6: Local Sales Tax Rates in the Southeastern States

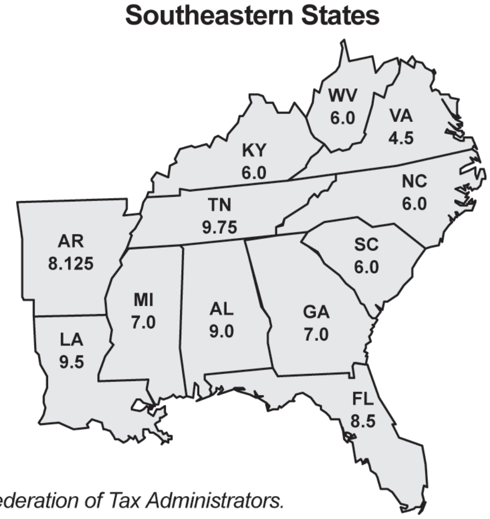
State	Maximum Local Rate (%)	Single Item Cap ($)
Alabama[1]	5.00	none
Arkansas[2]	3.00	2,500.00
Florida[3]	2.50	none
Georgia	3.00	none
Kentucky	none	none
Louisiana	5.50	none
Mississippi[4]	none	none
North Carolina[5]	2.00	none
South Carolina[6]	1.00	none
Tennessee	**2.75**	**3,200.00**
Virginia[7]	1.00	none
West Virginia	none	none

There are exceptions to the above data, for example:

1. 3.5% is the maximum rate for counties while 4.0% is the maximum rate for cities.
2. Additional tax on lodging and restaurant meals may be levied at various rates. Special tourism tax-max 3% in first-class cities. Border cities may have special rates.
3. 2% rate may not be applied in some localities. Additional 1% tax may be levied if 1% or 2% tax has been levied for at least 3 years. Additional 2% tax may be levied on food, drinks, and alcohol in hotels and motels. Additional 1% tax may be levied on food, drinks, and alcohol where consumption is on premises.
4. No local sales tax except special tourism taxes on restaurants and other businesses in certain jurisdictions.
5. Mecklenburg Co. rate 2.5%. Certain cities and counties impose occupancy taxes.
6. Certain counties may impose additional hotel, meal, capital project, and/or transportation taxes.
7. Additional food and beverage tax may be levied.

Source: Commerce Clearing House, Inc. and Federation of Tax Administrators.

Figure 5: Maximum Combined State and Local Sales Tax Rates, Southeastern States



Source: Federation of Tax Administrators.

Selective Sales Taxes

Tennessee imposes a variety of specific levies on enumerated economic activity often referred to as *selective sales* or *special excise taxes*. In Tennessee, selective sales taxes fall on fuel, tobacco, beer, mixed drinks and alcoholic beverages. In general the unique tax treatment of these activities reflects the uniqueness of the activity itself. For example, society more easily accepts levies on cigarettes and alcohol, viewing these as *sin* taxes. In other instances, as with gasoline and diesel fuel taxes, the levies are viewed as *benefit* taxes in the sense that tax payments support services (roads and highways) consumed by the taxpayer. In practice most selective sales taxes are a fixed levy per unit consumed, whereas the general sales tax is a percentage of the purchase price. For example, prior to recent changes, Tennessee's gasoline tax was 20 cents per gallon plus a 1.4 cent inspection fee and the tobacco tax was 13 cents per pack of twenty cigarettes. (See Table 22 for updated tax rates.) This structure of selective sales taxation — i.e., the taxation of units consumed as opposed to the value of consumption — has important implications for potential revenue growth over time. If, for example, gasoline or cigarette consumption does not grow over time, then there will be no growth in tax revenue absent rate increases. In the case of the sales tax, the number of units consumed may not increase, but if the price increases, this will produce more sales tax revenue. In fact, many of the activities subject to selective sales taxation have shown little growth over time, and little growth is expected in the future. Some of this is due to changing tastes and health concerns, as reflected by slow growth in the consumption of tobacco and alcoholic beverages. In other instances, technological change has influenced tax bases, as with improved vehicle fuel economy and slower growth in the demand for gasoline, resulting in slower growth in gasoline tax revenue.

Table 7 shows the rates of gasoline and diesel fuel taxation in the southeastern states. The gasoline tax in Tennessee that generated $569 million in revenue in 2000/01 (more than

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Table 7: Motor Fuel Tax Rates, Southeastern States, January 2002

State	Gasoline (cent/gal)	Additional Gas Tax (cent/gal)	Diesel Fuel (cent/gal)	Add'l Diesel Fuel (cent/gal)
Alabama	16.0[1]	2.0	17.0[1]	2.0
Arkansas	21.5	0.2	22.5	0.2
Florida	4.0[2]	9.9	16.5[2]	9.9
Georgia	7.5	-	7.5	-
Kentucky	15.0	1.4	12.0	1.4
Louisiana	20.0	-	20.0	-
Mississippi	18.0	0.4	18.0	0.4
North Carolina	24.2	0.25	24.2	0.25
South Carolina	16.0	-	16.0	-
Tennessee	**20.0[3]**	**1.4**	**17.0[3]**	**1.4**
Virginia	17.5[4]	-	16.0[4]	-
West Virginia	20.5	4.85	20.5	4.85

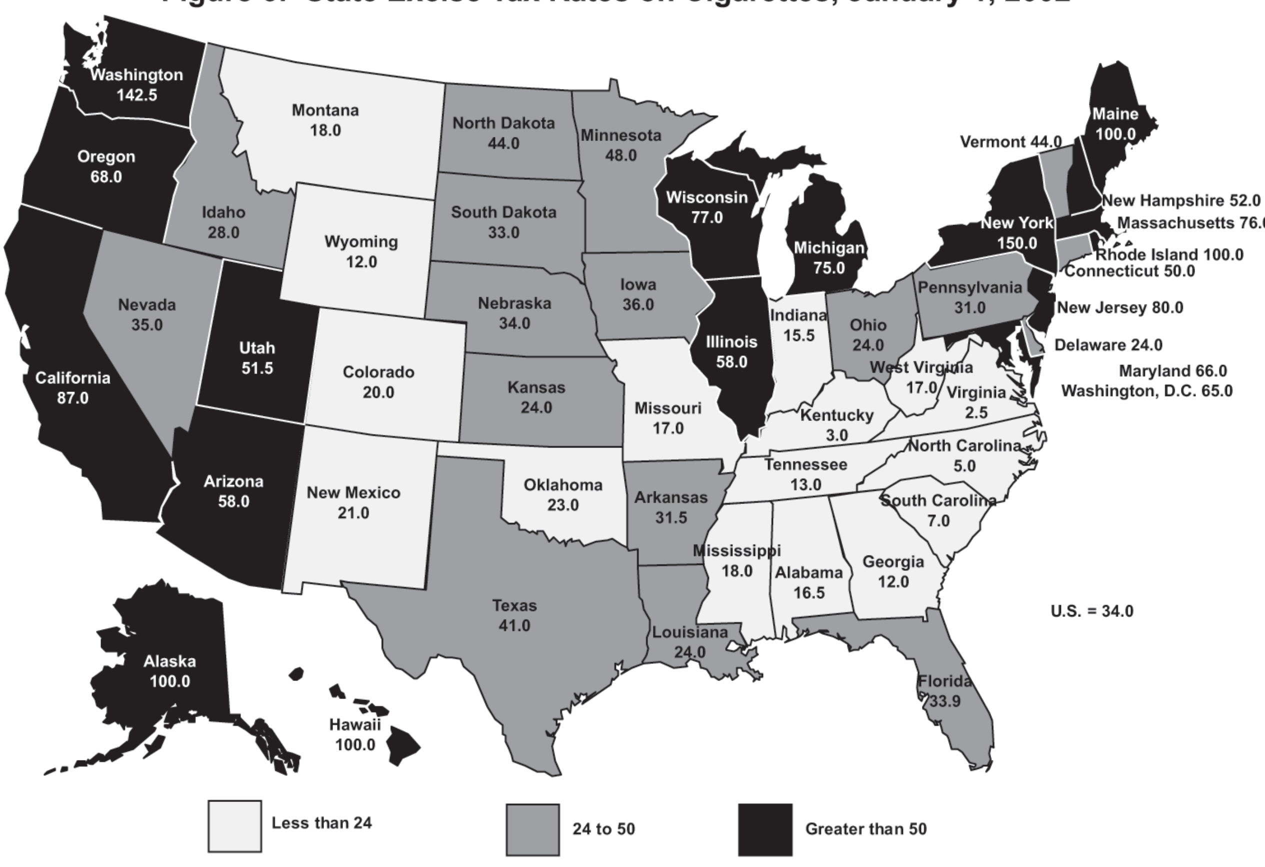
Note: The additional gas tax may apply to motor carriers.
1. Local option tax of 1-3 cents/gallon.
2. Local taxes for gasoline and gasohol vary from 5.5 to 17 cents, plus a 2.07 cent/gallon pollution tax.
3. Local option tax of 1 cent/gallon.
4. Local option tax of 2%.

Source: Federation of Tax Administrators.

one-half of all highway fund revenue) relies on a total rate of 21.4 cents per gallon. West Virginia has the highest state rate (25.35 cents/gallon) while Georgia enjoys the lowest rate (7.5 cents/gallon). As with the gasoline tax, there are two potential diesel fuel levies. The primary tax ranges from 7.5 cents in Georgia to 24.2 cents in North Carolina. Tennessee's rate is 17.0 cents per gallon. The additional tax is levied in eight southeastern states. The top combined rate is in Florida, totaling 26.4 cents per gallon.

As shown in Figure 6, the southeastern states have maintained relatively low rates of taxation on tobacco products, reflecting the region as the home of tobacco production. The average rate in the Southeast is 13.5 cents per pack. Tennessee's pre-reform tax rate of 13 cents placed it in the middle of the southeastern states, but well below the US median of 34.0 cents. The 2.5 cent and 3.0 cent tax rates in Virginia and Kentucky are the lowest in the nation. Alaska, Hawaii, Maine, New York, Rhode Island and Washington all have tax rates of $1.00 or more per pack of cigarettes. Other tobacco products, including snuff, are subject to unique levies. In Tennessee the tax was 6.0 percent of the wholesale price, one of the lowest rates in the nation.

Figure 6: State Excise Tax Rates on Cigarettes, January 1, 2002



In Louisiana, tax rate was scheduled to decrease to 20 cents on July 1, 2002.
Note: Median U.S. rate is 34.0 cents.
Source: Compiled by Federation of Tax Administrators from various sources.

Table 8 shows excise tax rates on beer, wine and distilled spirits as of January 2002. The beer tax rate of 13 cents per gallon in Tennessee was second lowest in the region and lower than the US median of 18.8 cents per gallon. (In addition, the state-enabled 17 percent wholesale tax applies at the local level, producing a substantially higher overall rate.) In contrast, Tennessee's wine tax of $1.10 per gallon was slightly higher than the Southeast median and significantly higher than the $.60 median US rate. Several states directly control liquor sales and have no explicit excise tax on liquor products. Of the remaining states, Tennessee's $4.00 per gallon rate was second from the top in the Southeast and higher than the US median rate of $3.30.

Corporate Excise and Franchise Taxes

Corporate Excise Tax. Defining business taxes is problematic since in many instances both individuals and firms pay the same impost. Businesses in Tennessee pay a variety of taxes, the most familiar of which are the corporate excise (i.e., income) and corporate franchise (i.e., net worth or value of property) taxes. But businesses also pay sales tax on many of their purchases as noted above, as well as gasoline taxes, motor vehicle fuel taxes, and so on. The corporate excise tax generated $635 million or 8.3 percent of Department of Revenue tax collections, while the franchise tax produced $468 million or 6.1 percent of tax collections in 2000/01.

The excise tax is paid by business entities that enjoy limited liability protection, i.e., traditional corporations and S-corporations and (more recently) limited liability corporations (or LLCs). The base of the tax is a measure of corporate or LLC profits, and the rate of taxation in Tennessee is now 6.5 percent. Before the tax rate increases in summer of 2002, Tennessee's last tax rate increase was in 1971 when the rate was increased from 5.0 percent to 6.0 percent. Table 9 shows the rate brackets and tax rates for the corporate income tax for all states in the Southeast. Several states — Arkansas, Kentucky, Louisiana and Mississippi — have *progressive* corporate tax rate structures. In other words, firms with lower levels of corporate taxable income confront lower tax rates than those entities with higher taxable

Table 8: State Excise Tax Rates: Beer, Wine and Distilled Spirits, Southeastern States, January 2002

State	Beer Excise Tax Rate ($/gal)	Wine Excise Tax Rate ($/gal)	Distilled Spirits Excise Tax Rate ($/gal)
Alabama	$0.53	$1.70	*
Arkansas	0.23	0.75	2.50
Florida	0.48	2.25	6.50
Georgia	0.48	1.51	3.79
Kentucky	0.08	0.50	1.92
Louisiana	0.32	0.11	2.50
Mississippi	0.43	0.35	*
North Carolina	0.53	0.79	*
South Carolina	0.77	0.90	2.72
Tennessee	**0.13**	**1.10**	**4.00**
Virginia	0.26	1.51	*
West Virginia	0.18	1.00	*

*Government directly controls the sales of distilled spirits. Revenue in these states is generated from various taxes, fees, and net liquor profits.

Source: Federation of Tax Administrators.

Table 9: Corporate Income Tax Rates and Brackets for Southeastern States

Alabama	Percent
All taxable income	6.50

Arkansas	
1-3,000	1.00
3,001-6,000	2.00
6,001-10,000	3.00
10,001-2,5000	4.00
25,000 and above	6.00

If net income exceeds $100K, entire income is taxed at 6.5 percent.

Florida	
All taxable income	5.50
$5,000 is exempt.	

Georgia	
All taxable income	6.00

Kentucky	
1-25,000	4.00
25,001-50,000	5.00
50,001-100,000	6.00
100,001-200,000	7.00
200,000 and above	8.25

Louisiana	Percent
1-25,000	4.00
25,001-50,000	5.00
50,001-100,000	6.00
100,001-200,000	7.00
200,000 and above	8.00

Mississippi	
1-5,000	3.00
5,001-10,000	4.00
10,000 and above	5.00

North Carolina	
All taxable income	6.90

South Carolina	
All taxable income	5.00

Tennessee	
All taxable income	6.50

Virginia	
All taxable income	6.00

West Virginia	
All taxable income	9.00

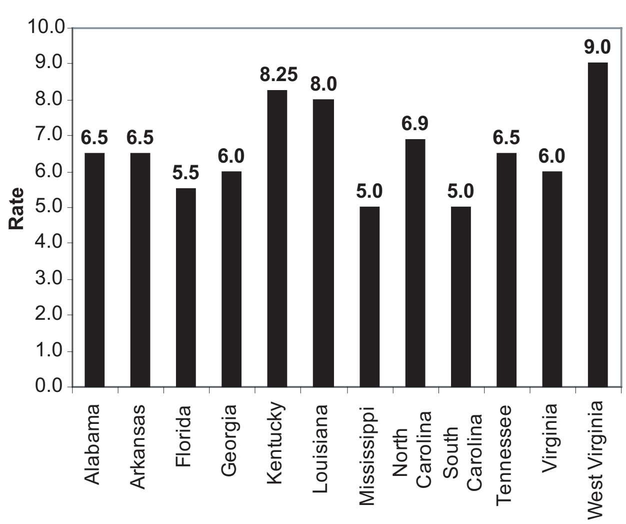
Source: Federation of Tax Administrators.

income. For example, Mississippi has three corporate tax rates: 3.0 percent on the first $5,000 of income, 4.0 percent on income between $5,000 and $10,000, and 5.0 percent on income in excess of $10,000. Figure 7 shows the top corporate income tax rates for states in the region. Four states in the region have top bracket rates that exceed Tennessee's 6.5 percent rate, while five states (Florida, Georgia, Mississippi, South Carolina and Virginia) have lower rates.

Corporate Income Apportionment. Corporations with a multi-state presence generally apportion their total US income across the states in which they operate. Traditionally a uniform three-factor formula was used by each state, defined as the simple average of (i) in-state payroll divided by total payroll; (ii) in-state property divided by total corporate property; and (iii) in-state sales divided by total sales. The uniform rule in principal ensured that all corporate income was allocated across states and potentially taxed — and most importantly taxed only once — by the states. In practice, definitional differences across states may lead to a violation of this principal. Moreover, the three-factor formula applies generally to manufacturing, while other sectors may rely on unique, industry-specific apportionment formulas. Most states have moved away from this equally-weighted formula, increasing the weight given to sales. In fact a small number of states now use a single sales tax factor for corporate income apportionment. Tennessee has a *double-weighted sales tax factor* for corporate income apportionment, the most common system now in place. As shown in Table 10, all states in the Southeast except two have adopted the double-weighted sales factor; Alabama and Mississippi have retained the traditional three-factor apportionment formula.

There are four factors in this double-weighted formula. Payroll and property are treated as they were under the old system, but in-state sales relative to total sales across all market states now appears twice in the formula, effectively receiving a *double* weight, hence the term double-weighted sales factor. The practical consequence is to provide preferential tax treatment to businesses with relatively large payrolls and property holdings in Tennessee,

Figure 7: Top Bracket Rate for the State Corporation Income Tax



Source: Federation of Tax Administrators.

Table 10: State Corporate Income Apportionment Formulas Tax Year 2002

State	Formula
Alabama	Three-Factor
Arkansas	Double weighted sales
Florida	Double weighted sales
Georgia	Double weighted sales
Kentucky	Double weighted sales
Louisiana	Double weighted sales
Mississippi	Accounting/ Three-Factor
North Carolina	Double weighted sales
South Carolina	Double weighted sales
Tennessee	**Double weighted sales**
Virginia	Double weighted sales
West Virginia	Double weighted sales

Source: Federation of Tax Administrators.

and a relatively small volume of in-state sales. Generally these are businesses that produce in Tennessee for export to markets outside the state, as with many manufacturing firms. An example is offered in the box below. As with many economic development incentives, the initial introduction of double-weighted sales factor formulas was quickly followed by the adoption of the same policy in numerous states, simply lowering the tax playing field for many firms with a multi-state presence as states played out the tax competition game and avoided being labeled a high-tax state. In Tennessee the new system is estimated to produce a revenue loss to the state of $39.3 million for 2002/03.[2]

Corporate Franchise Tax. The corporate franchise tax in Tennessee can be viewed as a form of statewide property tax on the corporate firm, including LLCs and other limited liability entities. The base of the tax in Tennessee is apportioned net worth or the value of property owned (and leased) in Tennessee, whichever produces the highest value; the rate of taxation is 25 cents per $100 of value. For entities with a multi-state corporate presence, the double-weighted sales factor formula is used to apportion net worth. Among the southeastern states, Florida has no franchise tax, while Georgia and Virginia impose only filing or organizational fees that are nominal in value. All other states in the region have franchise tax structures similar to Tennessee's in the sense that the base is a measure of the value of the corporate entity. This tax structure is summarized in Table 11. Alabama uses a progressive fee structure with a top rate of $1.75 per $1,000 of net worth. Louisiana, North Carolina and Tennessee have relatively high franchise tax rates, amounting to $3.00/thousand, $1.50/thousand and $2.50/thousand, respectively.

Corporate Income Apportionment Formulas

Consider a firm with a multi-state presence that includes Tennessee. Assume the firm has total property (P) of $100 million, total payroll (W) of $30 million and total sales (S) of $40 million across all states. Also assume that the firm has $7 million of its total property (P_m) in Tennessee, $3 million of its total payroll (W_m) in Tennessee and $1.2 million of its total sales (S_m) in Tennessee. The traditional three-factor formula can generally be written as:

$$1/3\ (P_m/P + W_m/W + S_m/S)$$

Using the specific figures in this example yields:

$$1/3\ (7/100 + 3/30 + 1.2/40) = .067$$

So using the three-factor formula, 6.7 percent of this firm's net income across all states would be allocated to Tennessee for tax purposes, while the remaining net income would be taxed by other states, depending on allocation formulas in use in other states.

When the apportionment formula is adjusted to accommodate double-weighting of the sales factor, the general apportionment formula becomes:

$$1/4\ (P_m/P + W_m/W + S_m/S + S_m/S)$$

Note that the sales factor, S_m/S, now appears twice in the formula.

Using the specific figures in the example,

$$1/4\ (7/100 + 3/30 + 1.2/40 + 1.2/40) = .058$$

In this instance, 5.8 percent—versus 6.7 percent—of total net business income would be taxable in Tennessee. The result is a lower tax burden for the firm under double-weighting of sales. While the change appears small in magnitude, it can have an appreciable impact on taxes paid by corporations and hence taxes received by the state. The explanation for the lower apportionment factor for this hypothetical firm lays in the fact that the sales component is small relative to the average of the other components, benefiting export-oriented firms. Firms with a large in-state sales factor (i.e., larger than the average of their property and payroll factors), on the other hand, will see their tax liabilities increase under double-weighting of the sales component.

Table 11: Corporate Franchise Tax Structure, Southeastern States

ALABAMA	**If taxable income is:** — **Fee per $1,000 of net worth:** Less than 1 — $0.25 1-200,000 — $1.00 200,001-500,000 — $1.25 500,001-2,500,000 — $1.50 2,500,001 and above — $1.75 *Minimum-$100, Maximum-$15,000
ARKANSAS	Domestic: .27% of corporation's outstanding capital stock that is apportioned to AR Minimum - $50, Maximum - $1,075,000 Foreign: .27% of proportion of capital stock representing property owned and used in AR
GEORGIA	Fees ranging from $10 for firms with a capital stock of $10,000 or less to $5,000 for firms with a capital stock of over $22 million
KENTUCKY	$2.10/1,000 of total captial employed in business apportioned to KY Minimum - $30
LOUISIANA	$3/1,000 on the capital stock, surplus, undivided profits, and borrowed capital Minimum - $10
MISSISSIPPI	$2.50/1,000 of the capital used, invested, or employed
NORTH CAROLINA	$1.50/1,000 of whichever is highest: • capital stock, surplus, and undivided profits in NC • investments in NC tangible property • 55% of appraised tangible personal property plus all intangible property in the state
SOUTH CAROLINA	$15 plus $1/1,000 of payment to capital stock and surplus
TENNESSEE	$0.25/100 of net worth Minimum - $100
VIRGINIA	Corporate organizations fee: If number of authorized shares is 1 million or less: $50 for each 25,000 shares If number of authorized shares is more than 1 million: $2,500 fee
WEST VIRGINIA	Corporate license tax: Domestic: graduated from $250 on $5,000 or less of authorized capital stock to $2,500 on $15 million of capital stock Foreign: 74% or higher than above Business franchise tax: greater of $50 or 0.7% of the value of taxpayer's capital

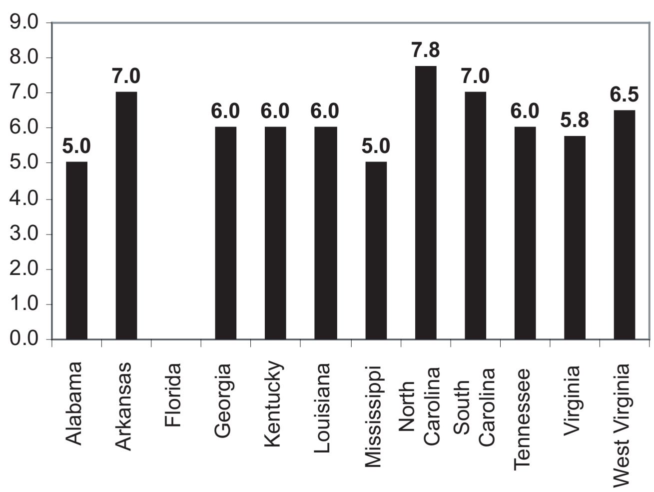
Source: Commerce Clearing House, Inc.

Income and Inheritance/Estate Taxes

Income Tax. Tennessee's Hall Income Tax has a very narrow tax base and therefore produces a modest amount of revenue for the state. The tax base consists primarily of dividend and bond interest. Dividend income includes most mutual fund distributions, although an exclusion exists for mutual fund retirement account distributions. The tax rate of 6.0 percent is generally consistent with the top-bracket income tax rate of other states in the Southeast as shown in Figure 8. Florida is the only state in the region, and one of only seven states in the nation, with no personal income tax whatsoever. All southeastern states with broad income taxes rely on a progressive rate structure where marginal tax rates increase with income. Alabama, Louisiana, Mississippi and North Carolina each have three income bands and three different marginal tax rates. Arkansas, Georgia and South Carolina each rely on six different marginal tax rates. (See Appendix 2.) The pace of progression is particularly rapid in Alabama, Georgia, Kentucky and Mississippi where taxpayers quickly reach the top bracket rates. The effective marginal tax rate in each state depends on deductions, exemptions and other provisions.

Inheritance/Estate Tax. Tennessee imposes both an inheritance tax and an estate (i.e., *pickup*) tax. Tennessee's estate pickup tax is designed to absorb the maximum state death credit authorized under federal law. Distinguishing characteristics of state inheritance/ estate taxes include the volatility of revenue collections and their small contribution to overall state finances. The inheritance tax in Tennessee relies on tax rates that range from a low 5.5 percent to a high 9.5 percent. (Gift tax rates in Tennessee range from a low 5.5 percent and can reach as high as 16 percent depending on the nature of the gift and the beneficiary.) Kentucky is the only other state in the Southeast that operates its own inheritance/estate tax. In Kentucky, *class A* beneficiaries — i.e., closely-related family members — are exempt from state inheritance tax; *class B* and *class C* beneficiaries can confront progressive tax rates as high as 16.0 percent. All other states in the Southeast make use of a pickup tax built

Figure 8: Top Bracket Rate for the State Individual Income Tax, January 2001



Note: Tennessee's rate is limited to dividend and interest income.
Source: Federation of Tax Administrators.

around the federal estate tax. In practice the tax equals the value of the federal death tax credit. The tax does not add to the federal tax burden; in the absence of the state tax, revenue would revert to the federal government. The tax is being phased out over time so states with the estate pickup tax only are already being impacted with lower revenue. The federal government plans on repealing the federal estate tax effective 2009. Tennessee has adjusted its estate tax policy and will not witness a decline in revenue.

Other State Taxes

Other state taxes include several minor gross receipts taxes, a locally-administered business tax shared with state government, privilege taxes, severance taxes, and coin-amusement taxes. The gross receipts tax and the locally-administered business tax use a measure of sales or receipts as the tax base. Virtually all revenue from the gross receipts tax in Tennessee is derived from TVA as in-lieu of tax payments, measured as 5 percent of in-state electricity sales. A much smaller amount of revenue comes from soft drink bottlers, mixing bars and vending machines.

The business tax is a form of local privilege tax that may be levied by both cities and counties. There are a variety of exemptions, including manufacturing firms and professionals. Tax falls on either wholesale or retail sales of specific business entities. Fifteen percent of all locally-generated revenue goes to the state, so in this sense the local business tax represents a form of intergovernmental aid from local governments to Tennessee state government.

The privilege tax category includes a mix of taxes, fees and charges on well over 20 different specific activities or transactions. The most important components of the tax category are the realty transfer and realty mortgage taxes that are fees imposed on the transfer of property and the acquisition of a mortgage. Together these two taxes accounted for well over one-half of all privilege tax collections in fiscal year 2000/01. The $200 tax on selected state-licensed professionals that prevailed in 2000/01 ranks third in revenue importance in the privilege tax category.

Neither the severance nor the coin amusement tax contribute significant revenue to state coffers. The severance tax applies to the extraction of oil, natural gas and coal. The coin amusement taxes are generally lump sum fees on specific types of gaming devices.

Other State Revenue

A number of state agencies other than the Department of Revenue also receive revenue. This includes, for example, the Department of Environment and Conservation that collects a variety of fees related to waste disposal and environmental protection. The Department of Financial Institutions oversees the annual banking fee paid by banks chartered in the state. The Department of Commerce and Insurance collects the insurance company premium tax paid by life, accident and health insurance companies. This levy falls on the gross premiums paid by or on behalf of policyholders in the state. Health maintenance organizations are subject to a unique levy. Other taxes and fees are also levied on various insurance companies.

Other state entities also impose a variety of taxes and fees, all with allocation to the general fund. However, proceeds are often earmarked for specific purposes and cannot necessarily be used to support the provision of general services. For example, hunting and fishing licenses and other fees administered by the Wildlife Resources Agency are earmarked to support the same agency. The boating safety fee is used for support of the boating safety program.

Tax, Revenue and Fund Allocation: 2000/01

The different taxes discussed above, as well as other forms of state revenue, are placed in different funds maintained by the state for accountability purposes and for the support of spending programs. Most state *own-source revenue* (i.e., state taxes, fees and charges as opposed to federal aid) is collected by the Tennessee Department of Revenue (DOR), while a much smaller share of state revenue is collected by other state departments. As shown in Table 12, in fiscal year 2000/01, $7.7 billion in state taxes went to the DOR while $711.3 million in taxes, fees and charges went to other state agencies. The DOR accounted for 91.5 percent of all own-source revenue collected by state government in 2000/01.

State tax revenue is placed in five different funds from which resources are drawn to finance services and provide aid to sub-state units of government. Fund allocations for fiscal year 2000/01 are shown in Table 13. The funds used at the state level are the general, education, highway, sinking, and cities and counties funds. The general fund is used to account for general-purpose revenue. The education fund accounts for education funding. The highway fund is used for state motor fuel taxes and federal highway support. The sinking fund accounts for state debt service. The cities and counties fund is the basis for shared revenues from the state to local governments. The different state taxes have different apportionment formulas, which is clear from Table 13. (Appendix 1 provides additional detail on the specific apportionment formula for different state taxes.) The education and general funds are the most important, accounting for the lion's share of state tax revenue. Almost all of the taxes, charges and fees collected outside the DOR are placed in the state's general fund, financing the general expenditures and services of state government.

Table 12: State Own-Source Revenues, 2000/2001

Source of Revenue *Department of Revenue*	Dollars	Percent of Total Department of Revenue	Percent of Total State Own-Source Revenue
Sales and Use Tax	4,643,337,500	60.65%	55.49%
Gasoline Tax	569,421,100	7.44%	6.81%
Motor Fuel Tax	173,417,700	2.27%	2.07%
Gasoline Inspection Tax	61,486,900	0.80%	0.73%
Motor Vehicle Registration Tax	211,427,600	2.76%	2.53%
Income Tax	199,397,100	2.60%	2.38%
Privilege Tax	160,766,200	2.10%	1.92%
Gross Receipts Tax - TVA	226,334,500	2.96%	2.70%
Gross Receipts Tax - Other	22,266,400	0.29%	0.27%
Beer Tax	15,476,600	0.20%	0.18%
Alcoholic Beverage Tax	30,043,100	0.39%	0.36%
Franchise Tax	467,899,700	6.11%	5.59%
Excise Tax	634,901,600	8.29%	7.59%
Inheritance and Estate Tax	89,676,300	1.17%	1.07%
Tobacco Tax	82,814,000	1.08%	0.99%
Motor Vehicle Title Fees	10,646,700	0.14%	0.13%
Mixed Drink Tax	34,334,500	0.45%	0.41%
Business Tax	21,509,100	0.28%	0.26%
Severance Tax	1,140,700	0.01%	0.01%
Coin-operated Amusement Tax	58,500	0.00%	0.00%
Total Department of Revenue	**7,656,355,800**	**100.00%**	**91.50%**

Other State Revenue	Dollars	Percent of Total Other State Revenue	Percent of Total State Own-Source Revenue
Department of Commerce and Insurance	324,037,900	45.55%	3.87%
Department of Financial Institutions	4,294,700	0.60%	0.05%
Wildlife Resources Agency	36,426,200	5.12%	0.44%
Department of Agriculture	14,152,200	1.99%	0.17%
Regulatory Board Fees	25,984,300	3.65%	0.31%
Tennessee Regulatory Authority	6,962,200	0.98%	0.08%
Secretary of State	13,950,300	1.96%	0.17%
Department of Safety	36,155,000	5.08%	0.43%
State Treasurer	58,520,100	8.23%	0.70%
Department of Education	1,700,600	0.24%	0.02%
Department of Health	4,044,800	0.57%	0.05%
Department of Environment and Conservation	44,969,900	6.32%	0.54%
Miscellaneous Revenue	24,221,900	3.41%	0.29%
Nursing Home Tax	115,909,500	16.29%	1.39%
Total Other State Revenue	**711,329,600**	**100.00%**	**8.50%**
Total State Revenue	**8,367,685,400**		**100.00%**

Source: State of Tennessee, The Budget, Fiscal Year 2002/03.

Table 13: Distribution of Actual Revenue by Fund, Fiscal Year 2000/2001

Source of Revenue ***Department of Revenue***	**Total Revenue**	**General Fund**	**Education Fund**	**Highway Fund**	**Sinking Fund**	**Cities & Counties**
Sales and Use Tax	$4,643,337,500	$1,287,734,600	$3,114,061,800	$0	$38,479,800	$203,061,300
Gasoline Tax	569,421,100	10,407,000	0	253,976,500	87,700,000	217,337,600
Motor Fuel Tax	173,417,700	3,190,700	0	124,742,400	0	45,484,600
Gasoline Inspection Tax	61,486,900	17,819,600	0	31,650,300	0	12,017,000
Motor Vehicle Registration Tax	211,427,600	34,269,200	262,000	176,896,400	0	0
Income Tax	199,397,100	130,329,900	0	0	0	69,067,200
Privilege Tax	160,766,200	160,766,200	0	0	0	0
Gross Receipts Tax - TVA	226,334,500	138,669,600	0	0	0	87,664,900
Gross Receipts Tax - Other	22,266,400	19,834,800	0	2,431,600	0	0
Beer Tax	15,476,600	10,354,600	0	1,947,000	0	3,175,000
Alcoholic Beverage Tax	30,043,100	24,907,100	0	0	0	5,136,000
Franchise Tax	467,899,700	449,899,700	0	0	18,000,000	0
Excise Tax	634,901,600	520,827,400	0	0	99,077,600	14,996,600
Inheritance and Estate Tax	89,676,300	89,676,300	0	0	0	0
Tobacco Tax	82,814,000	587,500	82,226,500	0	0	0
Motor Vehicle Title Fees	10,646,700	8,119,300	0	0	2,527,400	0
Mixed Drink Tax	34,334,500	932,800	16,700,300	0	0	16,701,400
Business Tax	21,509,100	21,509,100	0	0	0	0
Severance Tax	1,140,700	365,700	0	0	0	775,000
Coin-Operated Amusement Tax	58,500	58,500	0	0	0	0
Total Department of Revenue	**$7,656,355,800**	**$2,930,259,600**	**$3,213,250,600**	**$591,644,200**	**$245,784,800**	**$675,416,600**
Other State Revenue						
Department of Commerce and Insurance	$324,037,900	$324,037,900	$0	$0	$0	$0
Department of Financial Institutions	4,294,700	4,294,700	0	0	0	0
Wildlife Resources Agency	36,426,200	36,426,200	0	0	0	0
Department of Agriculture	14,152,200	14,152,200	0	0	0	0
Regulatory Board Fees	25,984,300	25,984,300	0	0	0	0
Tennessee Regulatory Authority	6,962,200	6,962,200	0	0	0	0
Secretary of State	13,950,300	13,950,300	0	0	0	0
Department of Safety	36,155,000	36,155,000	0	0	0	0
State Treasurer	58,520,100	58,520,100	0	0	0	0
Department of Education	1,700,600	0	1,700,600	0	0	0
Department of Health	4,044,800	4,044,800	0	0	0	0
Department of Environment and Conservation	44,969,900	44,969,900	0	0	0	0
Miscellaneous Revenue	24,221,900	24,221,900	0	0	0	0
Nursing Home Tax	115,909,500	115,909,500	0	0	0	0
Total Other State Revenue	**$711,329,600**	**$709,629,000**	**$1,700,600**	**$0**	**$0**	**$0**
Total State Revenue	**$8,367,685,400**	**$3,639,888,600**	**$3,214,951,200**	**$591,644,200**	**$245,784,800**	**$675,416,600**

Source: State of Tennessee, The Budget, Fiscal Year 2002/03.

IV. TOTAL STATE AND LOCAL REVENUE: SOUTHEASTERN STATES

Looking at the state's revenue structure, the broadest perspective is offered by examination of combined state and local government revenues. Total state and local revenue represents all funds used to provide services to residents of the state. Recall from above that *total* revenue includes own-source state and local taxes, fees and charges; own-source miscellaneous general revenue (liquor store, utility and insurance trust revenue); and federal aid to both state and local governments. There have been no broad nor sweeping changes in the relative pattern or mix of total revenue generation for the state and the nation, going back to the mid 1980s. Sales and gross receipts tax collections in Tennessee have slipped slightly as a share of total revenue, while intergovernmental aid's share of the revenue pie surpassed charges and miscellaneous fees in the latter part of the 1990s. But even these trends have been modest.

Table 14 provides a summary of total revenue and its primary components in 1999, for Tennessee and the southeastern states. The broadest category, total revenue, is summarized at the top of the table. Total state and local revenue in Tennessee amounted to $31.4 billion in 1999. Total revenue to state government was $16.9 billion while $18.4 billion accrued to various local government units in Tennessee.[3] *General* revenue (intergovernmental aid, own-source taxes and own-source other revenue) accounted for nearly 75 percent of total state revenue versus 80.9 percent for the southeastern states. Other revenue, confined to utility, liquor store and insurance trust revenue, represented 25.5 percent of Tennessee's total revenue in 1999, over five percentage points ahead of the Southeast average.

Over a quarter of all revenue received by the state and its local governments came in the form of aid from the federal government. This is nearly six percentage points higher than is the case for the southeastern states. One explanation is the relatively smaller size of own-source revenue in Tennessee. A second explanation is that intergovernmental aid, as defined by the US Bureau of the Census, includes TVA in-lieu of tax payments (while the state DOR refers to the same funds as *tax revenue*). But these are not the sole explanations for the state's relatively large amount of federal aid. On a per capita basis, aid in Tennessee totaled $1,050, versus $970 for the US and $885 for the Southeast in 1999. Aid in Tennessee is 4.4 percent of personal income as opposed to 3.7 percent for the Southeast and 3.7 percent for the US. Intergovernmental revenue to Tennessee state government represented 38.0 percent of all revenue versus 28.4 percent for the Southeast. Local governments in Tennessee receive a relatively smaller amount of total revenue in the form of aid (33.8 percent) than their counterparts in the Southeast (36.7 percent).

Tennessee state and local government own-source tax revenue in 1999 was just over one-half of total revenue. At the state level own-source tax revenue accounted for 49.2 percent of total revenue, while taxes represented only 35.9 percent of own-source revenue for local governments in the state. For the state, the most important tax revenue source is the sales tax, accounting for 58.6 percent of total own-source taxes. In comparison, it is quite striking that for the Southeast, sales tax revenue is on average only 38.0 percent of tax revenue. This differential will widen further with the one cent increase in the state's sales tax rate implemented

Table 14: Components of Total State and Local Government Revenue, Tennessee and Southeast, 1999

	TENNESSEE						SOUTHEAST					
	State and Local		State		Local		State and Local		State		Local	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
Total Revenue	**31,367,892**	**100.0%**	**16,903,668**	**100.0%**	**18,400,407**	**100.0%**	**387,781,566**	**100.0%**	**247,755,836**	**100.0%**	**199,655,482**	**100.0%**
General Revenue	23,364,347	74.5%	14,635,487	86.6%	12,665,043	68.8%	313,625,532	80.9%	199,144,736	80.4%	174,110,548	87.2%
Other Revenue (Utility, Liquor Store, Insurance Trust)	8,003,545	25.5%	2,268,181	13.4%	5,735,364	31.2%	74,156,034	19.1%	48,611,100	19.6%	25,544,934	12.8%
Components of General Revenue												
Intergovernmental Revenue	*5,914,305*	*25.3%*	*5,568,436*	*38.0%*	*4,282,052*	*33.8%*	*60,716,012*	*19.4%*	*56,494,911*	*28.4%*	*63,850,853*	*36.7%*
from federal government	5,914,305	100.0%	5,495,256	98.7%	419,049	9.8%	60,716,012	100.0%	54,806,079	97.0%	5,909,933	9.3%
from state government	0	0.0%	0	0.0%	3,863,003	90.2%	0	0.0%	0	0.0%	54,940,920	86.0%
from local governments	0	0.0%	73,180	1.3%	0	0.0%	0	0.0%	1,688,832	3.0%	0	0.0%
Own-Source Tax Revenue	*11,748,362*	*50.3%*	*7,197,491*	*49.2%*	*4,550,871*	*35.9%*	*167,894,734*	*53.5%*	*107,983,187*	*54.2%*	*59,911,547*	*34.4%*
Property	2,684,026	22.8%	0	0.0%	2,684,026	59.0%	42,673,843	25.4%	2,058,705	1.9%	40,615,138	67.8%
General sales	5,543,108	47.2%	4,218,079	58.6%	1,325,029	29.1%	51,097,389	30.4%	40,998,032	38.0%	10,099,357	16.9%
Selective sales	1,583,717	13.5%	1,313,096	18.2%	270,621	5.9%	23,151,940	13.8%	18,202,026	16.9%	4,949,914	8.3%
Individual income	160,180	1.4%	160,180	2.2%	0	0.0%	30,967,462	18.4%	30,141,064	27.9%	826,398	1.4%
Corporate income	571,428	4.9%	571,428	7.9%	0	0.0%	5,760,261	3.4%	5,760,261	5.3%	0	0.0%
Motor vehicle license	297,345	2.5%	215,213	3.0%	82,132	1.8%	3,185,204	1.9%	2,865,405	2.7%	319,799	0.5%
Other taxes	908,558	7.7%	719,495	10.0%	189,063	4.2%	11,058,635	6.6%	7,957,694	7.4%	3,100,941	5.2%
Own-Source Charges, Miscellaneous	*5,701,680*	*24.4%*	*1,869,560*	*12.8%*	*3,832,120*	*30.3%*	*85,014,786*	*27.1%*	*34,666,638*	*17.4%*	*50,348,148*	*28.9%*
Current charges	4,421,420	77.5%	1,393,652	74.5%	3,027,768	79.0%	55,408,279	65.2%	19,876,683	57.3%	35,531,596	70.6%
Miscellaneous general revenue	1,280,260	22.5%	475,908	25.5%	804,352	21.0%	29,606,507	34.8%	14,789,955	42.7%	14,816,552	29.4%

Note: Dollar amounts are in thousands.

Source: U.S. Census Bureau.

in July 2002. Tennessee also relies more heavily on selective sales taxes than the Southeast as a whole. Together the general sales tax and selective sales taxes accounted for 60.7 percent of state and local revenue in Tennessee versus only 44.2 percent for the Southeast. Tennessee's Hall Income tax produces only 2.2 percent of own-source state taxes, in sharp contrast to the Southeast where nearly 28 percent of state tax revenue comes from the individual income tax. The corporate income tax represented 7.9 percent of state tax revenue as opposed to 5.3 percent for the Southeast.

At the local level in Tennessee and the Southeast (as well as the rest of the US), the property tax dominates revenue collections. Property taxes are 59.0 percent of local own-source tax revenue in Tennessee and 67.8 percent of tax revenue across the Southeast. (While there is no state-level property tax in Tennessee, a small amount of property tax revenue accrues to other state governments in the Southeast, including Georgia, Kentucky and Mississippi.) Local sales taxes are relatively more important in Tennessee (29.1 percent of tax revenue) than in the Southeast (16.9 percent of tax revenue). Local governments in Tennessee rely more heavily on motor vehicle license fees, while local governments in the Southeast rely more on other taxes.

Own-source charges and miscellaneous revenue together amounted to nearly 25 percent of Tennessee general revenue. Over three-fourths of this amount represented charges. In the Southeast there is a slightly higher share of own-source charges and miscellaneous revenues.

V. TENNESSEE'S CHANGING STATE TAX PORTFOLIO: 1970 to 2000

The focus now shifts from total state and local revenue to state taxes. The mix of state taxes in Tennessee and other southeastern states has changed markedly over time, as shown in Table 15. In 1970 general sales and gross receipts taxes accounted for 35.1 percent of Tennessee state taxes, growing to 57.4 percent in 2000. This is in sharp contrast to the southeastern states where sales tax reliance; i.e., sales tax revenue as a share of total state tax revenue, was 38.0 percent in 2000, up only slightly from 33.5 percent in 1970. Tennessee's reliance on the sales tax ranked second in the Southeast in 2000, trailing only Florida's tourism-based economy (60.5 percent). The state is similarly out of balance when compared against the US as a whole. In 1970 sales tax reliance in Tennessee was 22nd in the nation; by 2000 the state's ranking had climbed to third in the nation. The lack of a balanced tax system is usually associated with relatively high tax rates for those taxes that are overused. The high tax rates, in turn, generally distort consumer and business behavior.

The state has increased its reliance on the sales tax over time primarily through increases in the tax *rate*, as opposed to broadening of the tax *base*. The sales tax rate stood at 3.0 percent in 1970, rising to 3.5 percent in 1971, 4.5 percent in 1976, 5.5 percent in 1984, 6.0 percent in 1992, and now 7.0 percent. Selective sales taxes — including specific excise taxes on alcoholic beverages, beer, tobacco and motor vehicle fuels — have declined in relative importance over time but remain an important element of state tax structure. Part of the explanation for this reduction in reliance is that many selective sales taxes are imposed on the number of units sold, as with the tax per gallon of gasoline or pack of cigarettes. Moreover, aside from recent changes, rate increases have not been significant over time.

Combining general sales and gross receipts taxes with selective sales taxes offers a clearer picture of the state's overall reliance on sales-based taxes. These taxes together represented 75.0 percent of state taxes in 2000, up from 69.0 percent in 1970. For the US as a whole, these same taxes accounted for 46.7 percent of total state taxes in 2000. Tennessee finds itself near the top in the nation, and second only to Florida in the Southeast, in its reliance on sales-based taxes.

The state's corporate tax burden in Table 15 looks heavy when viewed as a *share* of total state tax revenues, with corporate taxes — inclusive of both franchise and excise taxes — accounting for 15.9 percent of total tax collections in 1970 and 15.5 percent in 2000. (The figures for Tennessee in 2000 are misleading due to a change in the timing of corporate tax payments. Adjusting for this one-time event moves corporate taxes to 14.2 percent of total state taxes.) Closing of the loophole for limited liability companies has helped support corporate tax revenue growth in Tennessee. In terms of relative reliance (i.e., the share of total revenue collected from the tax), the state ranked fourth highest in the nation in 2000. One explanation for this high ranking is the state's smaller pool of *total* tax receipts that would otherwise diminish the *relative* importance of the tax on corporate entities. But this is inadequate in explaining the corporate burden in Tennessee. The evidence presented here and elsewhere in this report suggests a relatively high corporate tax burden in the state.

Table 15: Distribution of State Taxes, 1970 and 2000

	General Sales and Gross Receipts				Selective Sales				Corporate Taxes				Individual Income				Other Licenses				Other Taxes			
	Percent		National Rank		Percent		National Rank		Percent		National Rank		Percent		National Rank		Percent		National Rank		Percent		National Rank	
	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000
Alabama	32.3	26.4	27	37	38.0	23.7	6	9	7.8	8.6	24	19	12.9	32.2	30	30	4.7	3.6	44	25	4.3	5.5	26	18
Arkansas	30.9	35.0	30	16	35.3	13.5	11	33	8.9	6.6	18	32	12.1	30.2	32	33	10.1	3.5	15	28	2.7	11.1	41	10
Florida	46.3	60.5	5	2	34.5	16.6	14	18	3.8	6.3	43	33			46	47	8.7	4.6	21	13	6.7	12.1	15	9
Georgia	35.7	34.3	16	18	29.2	8.3	23	49	10.1	6.0	15	35	19.6	47.1	20	7	4.4	2.7	46	39	1.0	1.6	49	41
Kentucky	38.1	28.2	10	30	26.9	17.4	30	15	6.9	7.9	28	20	17.3	35.1	25	27	5.1	3.1	42	35	5.7	8.3	19	13
Louisiana	19.8	31.6	40	25	27.9	25.5	27	7	8.8	8.7	19	17	5.7	24.3	38	38	3.7	2.2	48	46	33.9	7.7	1	14
Mississippi	46.9	49.5	4	7	29.2	17.3	24	17	7.1	7.4	27	24	9.1	21.4	36	40	3.5	3.3	49	31	4.2	1.1	29	46
North Carolina	22.2	22.1	36	41	32.2	17.5	17	14	13.1	8.9	9	16	22.8	46.6	16	9	6.1	3.6	34	24	3.6	1.2	34	45
South Carolina	35.4	38.5	18	11	32.0	12.3	18	40	9.5	5.9	17	37	17.5	38.3	24	21	4.1	3.5	47	30	1.4	1.5	47	42
Tennessee	**35.1**	**57.4**	**22**	**3**	**33.9**	**17.6**	**16**	**13**	**15.9**	**15.5**	**6**	**4**	**1.8**	**2.3**	**40**	**43**	**9.7**	**4.0**	**16**	**20**	**3.6**	**3.1**	**33**	**30**
Virginia	22.0	19.5	37	44	29.5	14.9	21	24	8.3	5.6	23	40	29.6	54.0	12	4	7.1	2.9	30	36	3.6	3.1	35	31
West Virginia	47.2	27.4	3	36	30.8	26.4	20	5	1.8	7.6	47	22	10.4	28.9	33	36	8.1	4.1	24	19	1.7	5.5	45	16
SE	33.5	38.0			31.6	16.5			8.6	7.6			13.4	28.7			6.3	3.5			6.6	5.6		
US	29.6	32.3			27.3	14.4			10.5	8.5			19.1	36.0			7.0	3.5			6.6	5.1		

Source: U.S. Census Bureau.

The state's narrowly based Hall Income Tax contributed only 2.3 percent of total state taxes in 2000, up from 1.8 percent in 1970. The small revenue contribution reflects the tax's narrow base, which includes only certain forms of dividend and interest income as discussed earlier. The situation in Tennessee is in sharp contrast to several other states in the Southeast, as well as many states around the nation. Eight states in the region have income taxes that account for more than the Southeast average share of 28.7 percent of total tax collections. The states that rely most heavily on the income tax are Virginia (54.0 percent), Georgia (47.1 percent) and North Carolina (46.6 percent). Like the state's corporate income tax rate, the rate applied to taxable income in Tennessee is comparable to that in most other states in the region.

The remainder of state taxes is comprised of *other* licenses (e.g., hunting/fishing licenses, motor vehicle registration fees and the privilege tax on professionals) and *other* taxes (e.g., the severance tax and the inheritance/estate tax). Together these revenue sources contributed 13.3 percent of total state revenue in 1970, versus only 7.1 percent in 2000. For the Southeast the comparable figures are 12.9 percent and 9.1 percent.

VI. COMPARATIVE TAX BURDENS

The analysis of state tax shares is revealing, demonstrating Tennessee's heavy reliance on federal aid and sales-based sources of revenue relative to other states in the Southeast and the nation. As insightful as they are, measures of tax reliance fail to reveal the magnitude of tax *burdens*, i.e., the price residents pay to consume public services. Tax burden is commonly measured in two ways: taxes per capita and taxes as a share of personal income. Neither measure is perfect. For example, taxes per capita fail to capture variations in the ability to pay taxes as measured by income. Moreover, regardless of the measure used, the fact is that some taxes are borne by non-residents of the state, as with taxes paid by tourists, so traditional measures of burden may not perfectly capture the taxes paid by residents of the state. The problem is further complicated by the important distinction between the statutory liability of a tax and who ultimately bears the burden or *incidence* of a tax. For example, corporations may nominally pay income taxes, but some of this tax burden might be shifted forward to consumers in the form of higher prices, or shifted backward to workers in the form of lower wages. In such an instance, the firm's statutory tax liability *overstates* its true economic tax liability or the economic incidence of the tax. With these caveats in mind, the following discussion focuses on taxes, as opposed to taxes plus aid from the federal government, to better capture the burden imposed on Tennessee residents from paying in-state levies. The discussion begins with per capita state and local tax burdens, then turns to tax burdens as a share of personal income.

Per Capita Tax Burdens

Tennessee state and local taxes per capita totaled $278 in 1970, placing Tennessee at 90.6 percent of the average in the Southeast and 65.3 percent of the US average. As shown in Table 16, the Southeast was and continues to be a low tax region. In the Southeast, only Alabama, Arkansas and South Carolina enjoyed lower tax burdens in 1970. The highest

Table 16: State and Local Taxes Per Capita, Tennessee and Southeastern States

	State and Local		Local		State	
State	**1970**	**1999**	**1970**	**1999**	**1970**	**1999**
Alabama	$258	$1,978	$68	$618	$191	$1,360
Arkansas	251	2,298	69	555	182	1,743
Florida	344	2,555	137	1,044	208	1,511
Georgia	311	2,674	106	1,124	204	1,550
Kentucky	298	2,429	80	598	218	1,831
Louisiana	330	2,361	101	906	230	1,455
Mississippi	295	2,154	76	535	219	1,618
North Carolina	310	2,549	76	733	233	1,816
South Carolina	273	2,281	64	731	209	1,550
Tennessee	**278**	**2,083**	**104**	**807**	**175**	**1,276**
Virginia	339	2,799	134	1,144	205	1,655
West Virginia	301	2,361	80	539	220	1,822
Southeast	307	2,449	98	874	208	1,575
US	426	2,925	191	1,132	235	1,793

Source: Calculated from U.S. Census Bureau, Governmental Finances in 1969-1970, Table 17, Census Bureau web site, www.census.gov. Population from Bureau of Economic Analysis web site, www.bea.doc.gov.

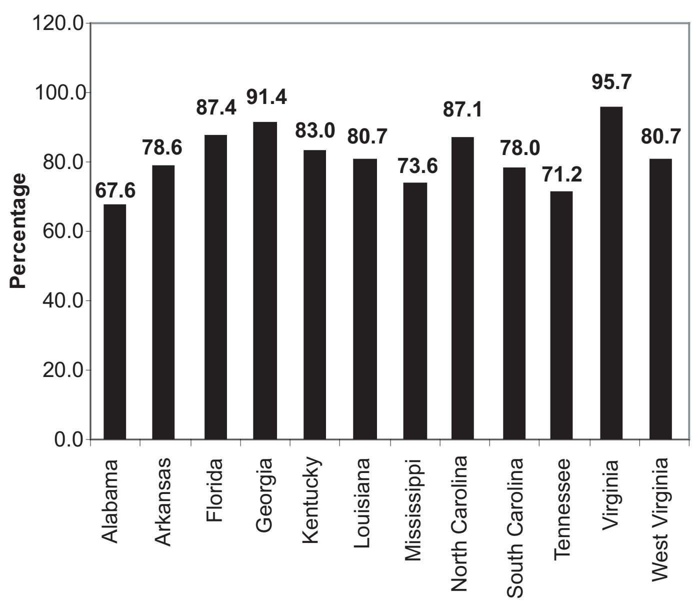
burdens in the region fell on residents of Florida and Virginia. By 1999 the state's per capita state and local tax burden amounted to $2,083, lower than all other states in the Southeast except for Alabama. Tennessee's burden fell to 85.1 percent of the southeastern average but increased to 71.2 percent of the national average. Figure 9 shows state and local tax burdens for states in the Southeast relative to the national average.

Local taxes per capita in Tennessee totaled $104 in 1970, trailing only Florida, Georgia and Virginia. The local burden per capita was 6.1 percent higher than the Southeast average, but only 53.9 percent of the national average. By 1999 local taxes per capita had increased to $807, placing the state at 92.0 percent of the southeastern average and 71.3 percent of the national average. Only four states — Florida, Georgia, Louisiana and Virginia — had higher local tax burdens in 1999. State taxes per capita in Tennessee were the lowest of any southeastern state in both 1970 and 1999. Tennessee state taxes were 81.0 percent of the Southeast average and only 71.2 percent of the US average. On balance the state's relatively low tax burden is offset to some extent by relatively higher local tax burdens, but the state nonetheless is near the bottom in the nation.

Historical data from standard sources do not offer much detail on state and local revenue by specific tax type. Table 17 provides some comparable data for the southeastern states for 1970 and 1999, confined to property tax and other tax collections per capita. Tennessee's state and local non-property tax burden per capita of $202 was 89.4 percent of the Southeast average in 1970; only Arkansas had a lower burden per capita. By 1999 the burden in Tennessee had increased to $1,607, leaving the state at the bottom in the Southeast.

Tennessee's 1970 local property tax burden per capita of $77 placed the state in line with the average state in the Southeast. By 1999 the burden in Tennessee amounted to $476,

Figure 9: State and Local Taxes in the Southeast as a Percent of the National Average, 1999



Source: U.S. Census Bureau.

while the burden in the Southeast had increased to $593 and the burden for the nation had grown to $819. Tennessee's property tax burden in 1999 was 80.3 percent of the Southeast average and 58.1 percent of the US average.

Shifting the focus, Table 18 shows the per capita *state* tax burden and the national ranking for each state in the Southeast in 1970 and 2000. Tennessee's inflation-adjusted tax burden per capita of $678 (in 2000 dollars) in 1970 yielded a ranking of 47th in the nation, the lowest of any southeastern state. (The nominal per capita tax burden in 1970 was $175.05.) Two other states in the Southeast — Alabama and Arkansas — joined Tennessee with rankings in the bottom ten in 1970. By 2000 Tennessee's ranking had fallen to 48th in the nation with a per capita state tax burden of $1,360. Tennessee was one of seven southeastern states that saw rankings for per capita tax burden decline over this long time period. Five states — Arkansas, Kentucky, North Carolina, Virginia and West Virginia — had an increased per capita tax burden ranking over the same time period. Note that for the state inflation-adjusted per capita revenues were up 100.5 percent between 1970 and 2000. During the same time period, Tennessee inflation-adjusted personal income grew 207.9 percent and inflation-adjusted per capita income advanced 109.1 percent.

Tennessee's unbalanced state tax system is somewhat less apparent when looking at sales and gross receipts, and selective sales tax burdens for 1970. In 1970 the state ranked 31st in general sales and gross receipts taxes per capita and 39th in selective sales taxes per capita. But by 2000 the state sales-based revenue imbalance becomes crystal clear, with general sales taxes per capita placing Tennessee near the top with a ranking of 8th place, and the selective sales tax burden per capita increasing to 35th. Together general sales and selective sales taxes totaled $1,021 in Tennessee compared with $896 for the Southeast and $898 for the US. Other tax categories saw more modest swings between 1970 and 2000.

Table 17: State and Local Property and Non-Property Tax Revenue Per Capita, Tennessee and Southeastern States

	State and Local				State				Local			
	Property		Other		Property		Other		Property		Other	
	1970	1999	1970	1999	1970	1999	1970	1999	1970	1999	1970	1999
Alabama	$39	$269	$219	$1,709	$7	$37	$184	$1,323	$33	$232	$35	$386
Arkansas	65	530	186	1,768	0	172	182	1,571	64	359	5	197
Florida	117	882	227	1,672	5	61	203	1,450	112	821	24	223
Georgia	95	674	216	2,000	1	5	204	1,544	94	669	12	455
Kentucky	68	415	230	2,014	8	92	209	1,738	60	322	20	276
Louisiana	65	363	265	1,998	7	6	222	1,449	58	357	43	549
Mississippi	71	492	224	1,662	2	0	217	1,618	69	491	7	44
North Carolina	78	547	232	2,002	5	0	229	1,816	74	547	3	186
South Carolina	61	623	212	1,658	1	2	209	1,548	61	621	4	110
Tennessee	**77**	**476**	**202**	**1,607**	**-**	**-**	**174**	**1,276**	**77**	**476**	**27**	**331**
Virginia	96	824	244	1,975	3	4	202	1,651	93	820	41	324
West Virginia	70	448	231	1,913	0	2	220	1,820	70	446	10	93
Southeast	81	623	226	1,827	4	30	205	1,545	77	593	21	282
US	167	861	259	2,064	5	42	230	1,751	162	819	29	313

Source: U.S. Census Bureau.

Table 18: State Taxes Per Capita by Tax Type, 1970 and 2000, Southeastern States and US

	General Sales and Gross Receipts				Selective Sales				Corporate Taxes				Individual Income			
	1970	Rank	2000	Rank	1970	Rank	2000	Rank	1970	Rank	2000	Rank	1970	Rank	2000	Rank
Alabama	$239	30	$383	43	$281	9	$343	16	$57	30	$124	28	$96	31	$466	37
Arkansas	$219	34	$638	20	$250	27	$246	32	$63	36	$121	31	$86	33	$550	34
Florida	$376	7	$939	5	$280	10	$258	29	$30	43	$97	42		46		47
Georgia	$284	23	$566	29	$232	38	$136	50	$80	18	$100	41	$156	21	$778	17
Kentucky	$322	16	$537	32	$228	40	$332	17	$59	28	$150	19	$146	23	$668	25
Louisiana	$177	41	$461	38	$249	29	$371	11	$79	19	$127	26	$51	38	$354	39
Mississippi	$398	5	$820	7	$248	30	$286	23	$60	27	$123	29	$77	34	$354	40
North Carolina	$202	36	$418	42	$292	8	$331	18	$119	10	$168	14	$207	16	$882	10
South Carolina	$288	20	$613	22	$261	21	$195	48	$77	20	$95	43	$143	24	$610	31
Tennessee	**$238**	**31**	**$782**	**8**	**$230**	**39**	**$239**	**35**	**$108**	**12**	**$211**	**9**	**$12**	**40**	**$32**	**43**
Virginia	$175	42	$349	45	$235	36	$266	27	$66	24	$100	40	$236	11	$965	8
West Virginia	$404	4	$507	35	$263	19	$488	3	$15	47	$141	21	$89	32	$534	35
SE	$271		$625		$256		$271		$70		$125		$109		$472	
US	$271		$621		$250		$277		$96		$164		$176		$692	

	Other Licenses				Other Taxes				Total			
	1970	Rank	2000	Rank	1970	Rank	2000	Rank	1970	Rank	2000	Rank
Alabama	$35	45	$52	42	$32	33	$80	23	$740	40	$1,448	46
Arkansas	$71	20	$65	29	$19	42	$203	10	$708	43	$1,822	27
Florida	$70	23	$71	25	$55	16	$188	11	$811	31	$1,553	43
Georgia	$35	46	$44	45	$8	50	$27	40	$795	35	$1,651	38
Kentucky	$43	44	$59	33	$44	23	$158	12	$846	28	$1,904	19
Louisiana	$33	47	$32	49	$303	1	$112	16	$892	23	$1,457	45
Mississippi	$30	49	$55	38	$35	27	$18	48	$849	26	$1,656	37
North Carolina	$55	39	$68	27	$33	31	$24	44	$908	22	$1,890	20
South Carolina	$33	48	$56	36	$12	46	$23	45	$813	30	$1,591	40
Tennessee	**$66**	**31**	**$55**	**40**	**$25**	**40**	**$42**	**33**	**$678**	**47**	**$1,360**	**48**
Virginia	$56	37	$52	41	$29	36	$55	29	$797	34	$1,787	29
West Virginia	$70	24	$76	19	$15	43	$103	20	$855	25	$1,849	22
SE	$51		$58		$53		$92		$810		$1,644	
US	$64		$68		$61		$99		$918		$1,921	

Note: Figures are in 2000 dollars to control for inflation.
Source: U.S. Census Bureau.

Taxes as a Share of Personal Income

State taxes as a share of personal income is an alternative measure of state tax burden with two particularly important advantages. First, it reflects tax payments relative to state residents' ability to pay, the latter being captured by personal income. Second, personal income is a broad measure of the size of the overall economy, so taxes as a share of personal income reflects the size of tax-financed state government relative to the size of the private sector economy.

Total State and Local Taxes. Combined state and local taxes as a share of personal income, as well as state taxes and local taxes as a share of personal income, are reported in Table 19 for the southeastern states in 1970 and 1999. Combined state and local taxes as a percent of personal income in Tennessee totaled 9.5 percent in 1970, second from bottom place held by Alabama across the Southeast. This compares favorably to the national burden of 11.2 percent and the Southeast regional burden of 10.1 percent in the same year. By 1999 the burden in Tennessee actually slipped to 8.7 percent, moving the state to the lowest among all US states. The state's declining tax burden occurred during the same period that brought slightly higher tax burdens in the Southeast (up to 10.2 percent) and slight shrinkage in the burden for the US as a whole (11.0 percent).

The state's local tax burden was 3.5 percent in 1970, falling to 3.4 percent in 1999. By 1999 six states had lower local tax burdens than Tennessee, versus eight states in 1970. States in the Southeast increased the local tax burden over the time period shown, while the national burden borne by local government taxpayers fell from 5.0 percent to 4.3 percent. Tennessee's state tax burden of 5.9 percent was third from the bottom in 1970. The state tax burden in Tennessee was the lowest of any southeastern state by 1999 and was 80.6 percent of the national average.

Table 19: Taxes as a Share of Personal Income

	State and Local		Local		State	
	1970	1999	1970	1999	1970	1999
Alabama	9.4	9.1	2.5	2.8	7.0	6.2
Arkansas	9.7	11.3	2.6	2.7	7.0	8.6
Florida	9.7	9.9	3.8	4.1	5.8	5.9
Georgia	9.9	10.7	3.4	4.5	6.5	6.2
Kentucky	10.1	11.1	2.7	2.7	7.4	8.3
Louisiana	11.5	10.8	3.5	4.1	8.1	6.7
Mississippi	12.3	11.0	3.2	2.7	9.1	8.3
North Carolina	10.3	10.5	2.5	3.0	7.8	7.5
South Carolina	9.8	10.5	2.3	3.4	7.5	7.1
Tennessee	**9.5**	**8.7**	**3.5**	**3.4**	**5.9**	**5.4**
Virginia	9.6	10.1	3.8	4.1	5.8	6.0
West Virginia	10.7	11.6	2.9	2.7	7.9	9.0
Southeast	10.1	10.2	3.2	3.7	6.8	6.6
US	11.2	11.0	5.0	4.3	6.2	6.7

Source: Calculated from U.S. Census Bureau, Governmental Finances in 1969-1970, Table 17, Census Bureau web site, www.census.gov. Personal income from Bureau of Economic Analysis web site, www.bea.doc.gov.

Property Tax and Non-Property Tax Burdens. Tax burdens as a share of personal income for the property tax and *other* taxes are shown in Table 20. Tennessee's state and local property tax burden matched the Southeast average of 2.6 percent in 1970, but fell to 2.0 percent in 1999, well below that year's southeastern average of 2.6 percent. No southeastern state had a state and local property tax burden in excess of the national average in 1970, while only Florida's burden in 1999 exceeded the national average. Other state and local taxes as a share of personal income totaled 6.9 percent in 1970, falling to 6.8 percent in 1999, well below the southeastern average in both years. The state's local property tax burden in 1970 of 2.6 percent placed Tennessee ahead of the Southeast (2.5 percent) and seven states within the region. The local property tax burden fell in Tennessee to 2.0 percent by 1999, while the Southeast average was unchanged. The other local tax burden in Tennessee was ahead of the Southeast in both 1970 and 1999.

State Tax Burdens by Tax Type. Table 21 shows total *state* taxes and individual taxes as a share of personal income for Tennessee and the southeastern states for 1970 and 2000. In 1970 Tennessee's total taxes represented 5.7 percent of personal income, below the national average of 6.0 percent. Tennessee ranked 31st in the nation and fourth in the Southeast in 1970. By 2000, total state taxes as a percent of personal income had fallen to 5.4 percent, while the national average had moved to 6.7 percent. This placed the state 45th in the nation and last in the region.

Tennessee general sales and gross receipts taxes comprised 2.0 percent of personal income in 1970, while selective sales taxes accounted for 1.9 percent of personal income. Combined sales-based taxes in the state represented nearly 4 percent of state income in 1970, roughly mirroring burdens in 2000. The US saw sales-based taxes as a share of income fall over this same time period with declines in selective sales tax burdens more than offsetting growth in general sales tax revenue. The Hall income tax was up slightly as a share of income between 1970 and 2000. In the Southeast the personal income tax was 0.9 percent of personal income, more than doubling to 1.9 percent in 2000. The corporate tax burden in Tennessee was 0.9 percent of personal income in 1970, ahead of the Southeast and US averages, and second highest in the Southeast. While the corporate tax burden in Tennessee declined slightly by 2000, it declined also for the US and the southeastern states. By 2000 Tennessee's corporate income tax burden was the highest in the Southeast. Revenue from other licenses fell significantly as a share of personal income for Tennessee, the Southeast and the US. The other tax burden in the state has remained at about one-half the burden for the Southeast and nation in both 1970 and 2000.

Table 20: State and Local Property and Non-Property Tax Revenue as a Percent of Personal Income, Tennessee and Southeastern States

	State and Local				State				Local			
	Property		Other		Property		Other		Property		Other	
	1970	1999	1970	1999	1970	1999	1970	1999	1970	1999	1970	1999
Alabama	1.4	1.2	8.0	7.8	0.2	0.2	6.7	6.1	1.0	1.1	1.3	1.8
Arkansas	2.5	2.6	7.2	8.7	0.0	0.8	7.0	7.7	22.5	1.8	0.2	1.0
Florida	3.3	3.4	6.4	6.5	0.1	0.2	5.7	5.6	3.2	3.2	0.7	0.9
Georgia	3.0	2.7	6.9	8.0	0.0	0.0	6.5	6.2	3.0	2.7	0.4	1.8
Kentucky	2.3	1.9	7.8	9.2	0.3	0.4	7.1	7.9	2.0	1.5	0.7	1.3
Louisiana	2.3	1.7	9.2	9.1	0.3	0.0	7.7	6.6	2.0	1.6	1.5	2.5
Mississippi	3.0	2.5	9.3	8.5	0.1	0.0	9.0	8.3	2.9	2.5	0.3	0.2
North Carolina	2.6	2.3	7.7	8.3	0.2	0.0	7.6	7.5	2.4	2.3	0.1	0.8
South Carolina	2.2	2.9	7.6	7.6	0.0	0.0	7.5	7.1	2.2	2.8	0.1	0.5
Tennessee	**2.6**	**2.0**	**6.9**	**6.8**	**-**	**-**	**5.9**	**5.4**	**2.6**	**2.0**	**0.9**	**1.4**
Virginia	2.7	3.0	6.9	7.1	0.1	0.0	5.7	6.0	2.6	3.0	1.2	1.2
West Virginia	2.5	2.2	8.2	9.4	0.0	0.0	7.9	9.0	2.5	2.2	0.4	0.5
SE	2.6	2.6	7.4	7.6	0.1	0.1	6.7	6.5	2.5	2.5	0.7	1.2
US	4.4	3.2	6.8	7.8	0.1	0.2	6.1	6.6	4.3	3.1	0.8	1.2

Source: U.S. Census Bureau.

Table 21: State Taxes as a Share of Personal Income, 1970 and 2000, Southeastern States and US

	General Sales and Gross Receipts		Selective Sales		Corporate Taxes		Individual Income		Other Licenses		Other Taxes		Total Taxes	
	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000	1970	2000
Alabama	2.15	1.66	2.52	1.49	0.52	0.54	0.86	1.02	0.31	0.23	0.29	0.34	6.65	6.27
Arkansas	2.08	2.98	2.38	1.14	0.60	0.56	0.82	2.56	0.68	0.30	0.18	0.94	6.74	8.49
Florida	2.54	3.49	1.89	0.96	0.21	0.36	0.00	0.00	0.47	0.26	0.37	0.70	5.48	5.76
Georgia	2.22	2.10	1.82	0.51	0.63	0.37	1.23	2.88	0.27	0.16	0.06	0.10	6.24	6.12
Kentucky	2.71	2.30	1.92	1.42	0.49	0.64	1.23	2.87	0.36	0.25	0.41	0.68	7.13	8.17
Louisiana	1.52	2.03	2.14	1.64	0.68	0.56	0.44	1.56	0.29	0.14	2.61	0.49	7.68	6.43
Mississippi	4.09	4.00	2.54	1.39	0.62	0.60	0.79	1.73	0.31	0.27	0.36	0.09	8.71	8.08
North Carolina	1.64	1.61	2.38	1.28	0.97	0.65	1.68	3.41	0.45	0.26	0.26	0.09	7.39	7.31
South Carolina	2.52	2.62	2.28	0.83	0.67	0.40	1.25	2.61	0.29	0.24	0.10	0.10	7.11	6.81
Tennessee	**2.00**	**3.10**	**1.93**	**0.95**	**0.91**	**0.84**	**0.10**	**0.13**	**0.56**	**0.22**	**0.21**	**0.17**	**5.71**	**5.4**
Virginia	1.23	1.17	1.66	0.89	0.46	0.33	1.66	3.23	0.40	0.18	0.20	0.18	5.61	5.98
West Virginia	3.53	2.39	2.30	2.30	0.13	0.67	0.78	2.51	0.61	0.36	0.13	0.48	7.48	8.71
SE	2.18	2.46	2.06	1.07	0.56	0.49	0.87	1.86	0.41	0.23	0.43	0.36	6.52	6.47
US	1.76	2.17	1.62	0.97	0.62	0.57	1.14	2.42	0.41	0.24	0.39	0.35	5.95	6.72

Source: U.S. Census Bureau.

Summary

Several conclusions emerge from this examination of tax burdens. First, based on both taxes per capita and taxes as a share of personal income, taxes in Tennessee are relatively low by regional and national standards. State tax burdens in Tennessee are near the bottom, while local tax burdens are slightly higher, but still low by national standards.

Second, using taxes as a share of personal income shows that the state's relative tax burden has actually declined over time, and *tax-financed* state government is actually smaller today than it was 30 years ago. This has occurred despite policy changes that have increased numerous tax rates, most notably a doubling of sales tax rates. Absent these rate changes, tax revenue growth would have lagged personal income growth by a wider margin, translating into a still smaller state tax-financed state government. Table 22 summarizes major state tax rate increases that have been implemented over the last 30 years. As noted, many tax rates have been increased since 1970 and some new taxes have been introduced, including the tax on professionals under the privilege tax, yet Tennessee's tax structure is nearly the same as it was some 30 years ago.

A third conclusion is that the personal income tax burden in Tennessee is one of the lowest in the nation due to the absence of a broad-based income tax. This makes Tennessee an attractive place to live, especially for wage and salary workers, but shifts the revenue burden to other taxes leading to an unbalanced tax system. In practice this means relatively higher rates and higher burdens for other taxes. This includes the state sales tax and other sales-based taxes which now account for the lion's share of state tax revenue, a share that will likely expand in the years to come. Finally, the state corporate income tax burden appears to be relatively high. A clear conclusion cannot be drawn from the evidence presented here. Instead, a more careful analysis of burdens and the effects of taxes on business rates of return across states is required.

Table 22: Tennessee Revenue Department Tax Rate Increases

TAX		DATE EFFECTIVE
Franchise Tax		
	From 15 cents to 25 cents per $100	3/15/1984
Excise Tax		
	From 5% to 6%	1971
	From 6% to 6.5% (for years ending on or after effective date)	7/15/2002
Income Tax		
	Special 4% rate on TN corporate dividends replaced with usual 6% rate	1/1/1986
Gasoline Tax		
	From 7 cents to 9 cents per gallon	6/1/1981
	From 9 cents to 12 cents	7/1/1985
	From 12 cents to 16 cents	6/1/1986
	From 16 cents to 19 cents	4/1/1989
	From 19 cents to 20 cents	7/1/1989
Special Petroleum Products Tax		
	From $0.01 to $0.014	5/1/1990
Tobacco Tax		
	(New Tax) An enforcement fee of $.0005 per cigarette pack for sale in TN	6/1/1985
	Cigarettes from 13 cents per pack to 20 cents per pack	7/15/2002
	Other tobacco 6.6% of wholesale price	7/15/2002
Beer Tax		
	From $3.40 to $3.90 per bbl.	7/1/1981
	From $3.90 to $4.29 per bbl.	7/15/2002
Motor Vehicle Registration		
	Additional $1 fee for reflecting plates issuance	1975
	$1 fee for reflecting plates to be paid annually	1988
	Truck fees raised and a new class set	1981
	Fees for certain freight trailers and semi-trailers from $20 to $50	5/15/1984
	Most non-commercial fees upped $1	7/1/1985
	Motorcycle & autocycle fees upped from $9.75 to $11.75	7/1/1988
	Additional $.75 added to registration fees	5/12/1987
	Increase in some motor vehicle registrations	7/1/1993
	Safety inspection fees	7/1/1993
	10% increase for commercial vehicles	7/15/2002
Motor Vehicle Title		
	From $3.00 to $3.50	5/16/1989
	From $3.50 to $5.00	7/1/1992
Privilege Taxes		
Litigation taxes	Fees increased upon original suits, criminal cases or appeals in general sessions court	7/14/1975
	Fees increased on certain criminal cases	7/1/1983
	Fees increased (from $17.25 to $20) on criminal cases	7/1/1986
	Tax $6.00 per case	7/1/1989
	Litigation tax increased $2.50 per civil and criminal case	4/1/1992
	Litigation tax increased $10.00 in all civil cases in the circuit courts and chancery courts	7/1/1995
	Litigation tax increased $3.00 in all civil cases in courts of general session	7/1/1995
	Administrative fee -court-appointed counsel -Up to $50 per case	7/1/1997
	Litigation tax increased $1.00 in criminal cases	5/7/1998
Realty Transfer and Mortgage Taxes		
Transfer tax		
	From $.26 to $.28 per $100	7/1/1986
	From $.28 to $.33 per $100	7/1/1988
	From $.33 to $.37 per $100	7/1/1991
Mortgage tax		
	From $.10 to $.115 per $100	7/1/1988

Table 22: Tennessee Revenue Department Tax Rate Increases, continued

TAX		DATE EFFECTIVE
Marriage Licenses		
	Additional $10 state fee	7/1/1984
	Increase from $10 to $15	7/1/1990
Tire Tax		
	$1.00 per tire sold	10/1/1991
Professional Tax		
	$200 per professional per year	6/1/1992
	From $200 to $400	7/15/2002
Used Oil Tax		
	$0.02 per quart	7/1/1993
Rental Cars		
	2% Surcharge on rental cars	7/1/1993
	From 2% to 3%	7/1/1998
Gross Receipts		
Bottlers Tax	From 1.5% to 1.9% of TN gross receipts	7/1/1981
Alcoholic Beverage		
	Brand registration $250 per brand (new tax) on distilled spirits	1979
	Brand registration $250 per brand (new tax) on wine	1979
	TN wine from $.05 to $1.10 per gallon	7/1/1985
	Additional fee of $500 for restaurant or caterer to sell or distribute beverages at other locations in jurisdictions where such sales are authorized	4/23/1998
	Wine from $1.10 to $1.21 per gallon	7/15/2002
	Spirits from $4.00 to $4.40 per gallon	7/15/2002
Sales Tax		
	From 3% to 3.5%	6/1/1971
	From 3.5% to 4.5%	4/1/1976
	From 4.5% to 5.5%	4/1/1984
	From 5.5% to 6.0%	4/1/1992
	From 6.0 to 7.0% (except for food)	7/15/2002
Motor Vehicle Fuel		
	From $0.08 to $0.12 per gallon	6/1/1981
	From $0.12 to $0.14 per gallon	6/1/1986
	From $0.14 to $0.15 per gallon	6/1/1987
	From $0.15 to $0.16 per gallon	4/1/1989
	From $0.16 to $0.17 per gallon	4/1/1990
Severance Taxes		
Coal	First enacted in 1972 at $0.10 per ton	1972
	Rate increased to $0.20 per ton	1974
	Rate to be increased by annual steps to $0.25 per ton but after two steps Rate was set back to $0.20 per ton	10/1/1984
Crude Oil and Natural Gas	From 1.5% to 3% of sales price	7/1/1982
Coin Amusement Tax		
	$100 per device annually	6/1/1984
	Two categories established. Only Class I devices taxed at $350 each	7/1/1985
	Classes abolished	
	Annual Master license tax $500 to $2000; $10 per device	9/1/2002
Services Tax (eliminated, 1996)		7/1/1992
	6.75% of gross charges on selected services	
Business Tax		
	50% increase in tax paid with proceeds to state	9/1/2002

Source: Tennessee Department of Revenue and Center for Business and Economic Research.

VII. EVALUATING TENNESSEE'S TAX STRUCTURE

To this point the discussion has centered on Tennessee's tax structure, the mix and performance of revenue sources, and state and local tax burdens across time and states. But there has been no unifying framework to guide the discussion. In practice the analysis of the tax system for any unit of government requires a systematic framework to offer guidance and structure. In public policy circles, the guiding framework is often referred to as the *requirements of a good tax system*. These criteria date back at least to the days of Adam Smith (*The Wealth of Nations,* 1776) and are used extensively in the US and abroad to structure analysis of tax systems and specific taxes for national and subnational governments. For example, the criteria have recently been used in Oklahoma and New Hampshire to help guide analysis of overall state tax structure and to examine the implications of specific taxes as well.[4] As discussed more fully below, the requirements are (i) revenue adequacy, elasticity and stability, (ii) taxpayer equity, (iii) neutrality, and (iv) simplicity of administration and compliance. A pragmatic approach is taken here where it is recognized that the state must fulfill certain service responsibilities financed by taxes levied on state residents, and at the same time balance the sometimes competing goals of tax policy. In short, the question isn't whether to tax or not, but instead how to best structure the state's tax system to realize various tax policy goals. Unfortunately there is not a single or a simple answer to this question.

Revenue Performance: Adequacy, Stability and Elasticity

Revenue performance is intimately related to the spending side of the budget, both at a point in time and as budgets evolve over time. There are three important dimensions of revenue performance — adequacy, elasticity and stability — and each is addressed here in turn.

Adequacy. The state must have adequate revenues to fund service obligations set by the expenditure side of the budget. Once the state determines the scope of its service responsibilities, the tax system should produce adequate revenues to finance these same activities. At many points in time, Tennessee's revenue system has proven to be inadequate, and the state has struggled to meet its spending obligations. Revenue-spending imbalances have been addressed by a mix of expenditure cuts and tax rate increases. In recent years the state has resorted to budget gimmicks and the use of non-recurring revenues, such as tobacco settlement money, to fund services. Consequences of ongoing imbalances include uncertainty over programmatic funding, state intergovernmental aid and state taxes shared with local governments. An additional price in Tennessee has been a lower state bond rating that increases the cost of debt finance for state and local governments. Given the political realities that dictate each budget cycle, such problems are likely to continue until a revenue system can be put in place that naturally yields adequate revenue to fund state services and aid to local governments, including local school districts. The most recent tax increases adopted in the summer of 2002 will help address the short-term problem of revenue adequacy but will do little to address imbalances over time.

Elasticity. Elasticity is the counterpart to adequacy and captures revenue performance over time and across fiscal years. It is a long-term concept, whereas stability, discussed more fully below, is a short-term concept reflecting revenue performance over the course of the

Elasticity

A tax, or a set of taxes, is deemed to be *elastic* if taxes are responsive to growth in income. More precisely, a tax is elastic or relatively responsive if the *percentage change in tax revenue exceeds the percentage change in income*. In the instance of an elastic tax, the measure of elasticity exceeds 1.0. On the other hand, a tax is *inelastic* if it is unresponsive to growth in the tax base, or if the *percentage change in tax revenue is less than the percentage change in income*. In this instance, the measure of elasticity is less than 1.0. For example, if personal income grew 40.0 percent and sales tax revenue grew 30.0 percent over a ten-year period of time, the sales tax elasticity would be .75 (or 30.0 divided by 40.0), indicating an inelastic revenue response to economic growth. If, on the other hand, sales tax collections advanced 40.0 percent, the elasticity would be 1.0 (or 40.0 divided by 40.0). The concept of elasticity can be applied similarly to all taxes, including the corporate excise and Hall income taxes.

business cycle. Elasticity captures the responsiveness of tax revenue to growth in the tax base, using a constant tax rate and common definition of the tax base. (Alternatively the concept of *buoyancy* is used to reflect revenue responsiveness when tax rates and/or tax bases are subject to change.) In many instances a surrogate measure of the tax base is used, most commonly income. For example, when examining the elasticity of the sales tax, reference is usually made to growth in personal income, where personal income is used as a proxy for the base of the sales tax and a broad measure or barometer of economy-wide growth. The use of a measure like income is not perfect, for example, omitting the way in which out-of-state households and business spending in the state influence taxable sales and sales tax collections. However, to the extent these other factors are reasonably stable over time, the use of income produces a viable measure of tax elasticity.

The importance of elasticity surfaces in the context of financing state services over time and whether the size of government should grow, stay constant or contract vis a vis the economy (as measured, for example, by taxes as a share of state personal income). The practical issue is whether tax revenue grows sufficiently over time to yield adequate revenue growth over time to finance government services, or if discretionary tax rate or base changes are needed. If the demand for government-provided services does not grow appreciably with increases in population and levels of income, then taxes need not show strong growth to meet service needs. However, if the demand for services grows at a stronger rate, then stronger revenue growth will be required to meet spending commitments. So in practice the notion of elasticity is closely interwoven with taxpayer preferences for government services and hence the spending side of the budget, as with its annual counterpart adequacy.

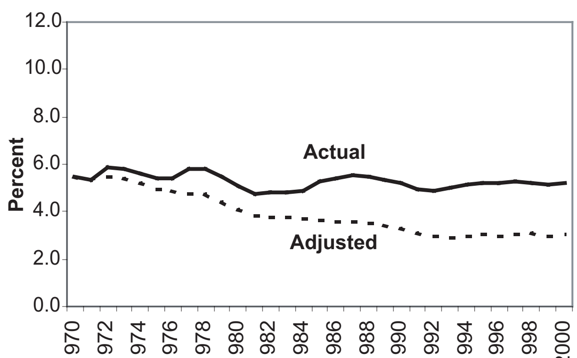
Elasticity in Historical Perspective. In Tennessee, tax-financed state government expenditures have been under 6 percent of personal income for over 30 years, indicating residents' long-term preference for the size and scope of state government. While it is true that many tax rates and tax bases have been increased over time, as shown above, the policy changes have not sustained — let alone increased — the size of state government relative to the economy. This reflects the fact that the state's overall tax structure is inherently inelastic and the tax increases have largely been enacted to support specific program initiatives like the sales tax rate increase to support the Basic Education Program. Sustaining state-financed government services at any given share of personal income requires a tax system with an overall elasticity of approximately 1.0. Some taxes can have lower elasticity, while others can have higher elasticity, but on balance the overall elasticity must be 1.0. A tax system with an elasticity greater than 1.0 would lead to an increase in the size of government relative to the economy absent tax rate cuts, while a system with an elasticity less than 1.0 would see government decline in relative size absent rate increases.

Netting out major tax rate changes offers a revealing picture of the state's underlying revenue elasticity over time. The situation for total state tax revenue is shown in Figure 10. Actual tax collections were just under 6 percent of personal income in 1970, and have slipped somewhat since then. The performance of actual collections reflects the buoyancy of the state's tax system, inclusive of major tax rate increases. But adjusted tax collections — the amount of revenue as a share of income that would have been collected *absent* rate increases — would have fallen by more than two percentage points between 1970 and 2000.

One source of the inelasticity problem is the state sales tax. Its historical trend can help illustrate the magnitude of the problem. Shown in Figure 11 is the sales tax base as a share of income for the US and Tennessee from 1979 to 2000. The long-term pattern is one of decline, a trend that is expected to continue through the foreseeable future. Electronic commerce will add to the woes of the state sales tax in the years to come, causing the base to contract further as a share of the economy. Estimates suggest the combined state and local sales tax loss due to electronic commerce could reach $1.2 billion in 2006.[5]

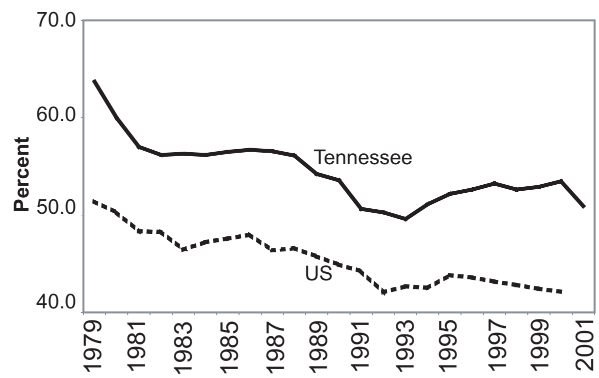
The state's long-term revenue elasticity, from 1970 to 2001, is 0.86. The more recent trend elasticity, which reflects revenue growth over the shorter window between 1988 and 2001, totals 0.80, as shown in Table 23. This trend elasticity likely provides a better guide to expected revenue growth than its longer-term counterpart. There is considerable variation around the state average, both in specific years and specific taxes. The franchise tax shows a trend elasticity of 1.36 versus only 0.77 for the excise tax; the combined franchise and excise tax elasticity is 0.98. Some elasticities are relatively high, a case in point being the privilege tax elasticity of 1.80. In this case — as well as in certain other cases — adjustments for base changes have not been made. For example, the tire tax and litigation taxes under the privilege

Figure 10: Tennessee Total Tax Collections as a Percent of Personal Income, 1970 - 2000



Source: Center for Business and Economic Research calculations.

Figure 11: US and Tennessee Sales Tax Base as a Percent of Personal Income, 1979 - 2000



Note: 2001 data for the US is not yet available.
Source: Center for Business and Economic Research calculations.

tax have not been netted out, overstating the privilege tax elasticity and thus overstating the tax system's overall elasticity as well. The specific excise taxes generally have small elasticities, particularly the beer, alcoholic beverage and tobacco tax elasticities. The sales tax elasticity for the 1988-2001 period is 0.88.

There are three broad options for addressing the state's inelastic tax structure. The first is to simply let government contract as a share of the economy by reducing the scope of service delivery. In practice this would require a decline in the rate of growth of expenditures as the rate of growth of revenue was allowed to slow.

The second option is the path the state has chosen over the course of the past 30 years, simply raise tax rates when additional revenues are needed to maintain tax-financed expenditures as a share of the economy (due to inflation and population growth) and in some cases improve service quality (as with the Basic Education Program adopted in the 1990s). A strength of this approach is that it allows legislative discretion over revenue growth. But discretion can come at a high price as raising rates is not easy in practice. The lack of political agreement in recent years is a case in point. This can compromise funding of specific programs and hurt the state's reputation in the national arena. Moreover there can be real costs as with the reduction in the state's bond rating. Negative economic impacts can surface as well if, for example, businesses choose to locate facilities elsewhere due to uncertainties regarding their future tax liabilities and state support of important services like infrastructure and education. An additional problem is that given the state's narrow revenue portfolio, there simply is little room to further raise rates on existing tax bases. For example, the long-term franchise tax elasticity is 1.04 (see Table 23), but raising the franchise tax rate would push the state's business tax structure out of line with that of most other states and hurt the state's development prospects. The evidence above suggests that corporate excise and franchise taxes are already relatively high. Compounding the problem is that corporate taxes are subject to erosion risks,

Table 23: Trend Elasticities for Major State Taxes, 1988 - 2001

Tax	Trend Elasticity
Sales and Use	0.88
Gasoline	0.22
Motor Fuel	0.72
Gasoline Inspection	0.26
Motor Vehicle Registration	0.52
Income	1.18
Privilege	1.80
Gross Receipts	0.54
Beer	0.24
Alcoholic Beverage	0.04
Franchise and Excise	0.98
Franchise	1.36
Excise	0.77
Inheritance & Estate	1.27
Tobacco	0.01
Motor Vehicle Title	0.34
Mixed Drink	0.58
Business	0.89
Severance	-1.66
Coin Amusement	-2.97
Total	0.80

Source: Center for Business and Economic Research calculations.

including aggressive and creative state tax planning on the part of businesses, and rate increases would simply accelerate the tax's demise in Tennessee. There is clearly room to raise specific license fees and specific excise taxes. While raising these imposts would produce additional revenue, it would actually *reduce* the state's overall revenue elasticity since these same taxes have relatively small elasticities. In addition, there would be an enhanced incentive to engage in border shopping.

The final option is to introduce a new tax with a higher elasticity, or selectively expand existing tax bases to include activities more responsive to economy-wide growth, raising the overall tax system elasticity. Income, payroll, property and gross receipts taxes all can be structured in such a way as to increase the overall tax system elasticity. Similarly the sales tax base could be expanded to include certain (elastic) services, which would increase the sales tax elasticity and thus overall tax system elasticity. But each of these options has undesirable consequences. For example, an income tax means new costs of administration and compliance, while a statewide property tax could prove to be highly unpopular and would encroach on the primary source of local government finance. Taxing services should be accompanied by a separation of consumer versus business purchases (especially if business tax burdens are viewed as high), which would be costly, and many services such as health care are viewed as off limits for sales taxation.

Revenue Stability

Elasticity's short-run, business cycle counterpart is stability. State government would like a tax system that produces a stable and predictable flow of revenue over the ups and downs of the business cycle. Revenue stability avoids the need to cut services or raise taxes during periods of economic contraction and minimizes the accumulation of large surpluses during periods of expansion. But no single tax, nor any overall tax system, is truly stable. During periods of economic decline, income and profit growth slows, in turn depressing revenue growth from a personal or corporate income tax. Similarly, consumers retrench and reduce their purchases of big-ticket items (like homes, home furnishings and automobiles), while businesses respond by postponing spending on new facilities and equipment, depressing sales tax revenue and gross receipts tax collections. Rainy day funds represent a partial solution to the instability problem. Adequate support for a rainy day fund requires some accumulation of revenue during periods of economic expansion.

A properly balanced tax system, one that relies on a variety of taxes that perform differently over the ups and downs of the business cycle, can minimize but not eliminate revenue instability. Similarly, specific taxes, through the choice of the tax rate and tax base, can be designed to minimize but not totally avoid the instability problem. For example, a sales tax that includes services in the base may (depending on the specific services included) be relatively more stable, as spending on services is largely sustained during economic contraction in contrast to usual reductions in the consumption of durable goods. There are some exceptions, including construction services, which tend to be procyclical. On the other hand, an income tax with highly progressive rates could support very strong revenue growth during periods of economic expansion, yet perform very poorly in the face of economic decline.

Figure 12 shows annual elasticities for *overall* state tax revenue, *sales* tax revenue and *other* tax revenue, while Table 24 has annual elasticity measures for all major state taxes. As with the long-term elasticities presented above, the revenue data have been adjusted for major tax rate changes. The revenue instability problem is clearly displayed by high versus low elasticities over time both in Figure 12 and in Table 24. As shown in Figure 12, the elasticities generally are higher in years of economic expansion and smaller in years of contraction. Particularly strong elasticities were in play in the early 1970s and during the boom period of the 1990s. The effect of economic contraction is clearly evident for the recession years of the early 1980s and 1991. The importance of the sales tax is clearly seen in Figure 12, with its growth — in both good times and bad times — typically outperforming other tax revenue categories.

In only five years of the period shown did the overall revenue elasticity exceed unity, indicating a relatively inelastic overall tax structure. Non-sales tax revenue showed an elastic response in only five years (all of which occurred in the 1990s), while sales tax revenue displayed an elastic response in 10 years. As shown in Table 24, the tobacco, gasoline and beer taxes are highly inelastic, while the income tax is highly elastic, with the income tax elasticity exceeding 1.0 in 15 years. A key point to note from the data presented here is the tax system's inelasticity in many years of strong economic growth, not simply in periods of economic stagnation or decline. In practice this means that given the state's tax system, there may be difficulties funding government services even when there is good growth in the economy.

Minimizing instability, given other policy objectives, is the appropriate course, not the entire elimination of instability. The performance of specific taxes over the ups and downs of the business cycle must be analyzed to determine how an overall state tax portfolio

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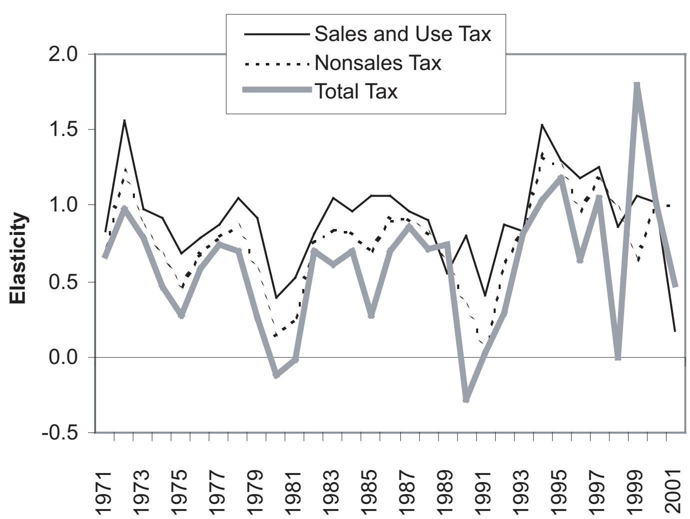
Figure 12: Annual Tax Elasticities, 1971-2001



Source: Center for Business and Economic Research calculations.

Table 24: Growth Rates in Adjusted Revenue Collections Divided by Growth Rate in Personal Income, Major Tax Categories, 1971 - 2000

Tax	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
		Expansion from Trough		Contraction from Peak			Expansion from Trough			Contraction from Peak	Expansion from Trough	Contraction from Peak		Expansion from Trough	
Sales and Use	0.824	1.556	0.979	0.919	0.681	0.791	0.875	1.051	0.918	0.394	0.529	0.821	1.043	0.962	1.068
Gasoline	0.709	0.753	0.518	0.328	0.012	0.421	0.368	0.232	0.281	-0.795	-0.524	0.222	-0.111	-0.015	-0.203
Motor Fuel	1.172	2.034	1.397	0.780	-0.786	1.180	1.164	0.864	0.745	-0.171	0.018	0.560	1.296	1.189	0.355
Gasoline Inspection	0.897	0.653	0.674	0.259	0.074	0.494	0.733	0.267	0.113	-1.005	-0.365	-0.323	0.268	0.501	0.164
Motor Vehicle Registration	0.374	0.734	0.725	0.560	-0.010	0.537	0.896	-0.134	0.471	0.090	-0.092	2.046	-0.192	0.732	0.511
Income	0.231	0.916	0.801	0.692	1.337	1.770	0.101	0.843	0.336	1.698	1.356	2.856	3.402	0.518	1.235
Privilege	1.015	0.744	1.527	0.470	-1.119	2.879	2.128	1.499	0.846	0.021	-0.055	-0.756	1.957	3.173	0.900
Gross Receipts	0.775	2.442	0.355	1.480	2.384	2.220	0.238	5.104	0.298	2.094	1.939	1.808	1.168	0.384	0.563
Gross Receipts - TVA	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Gross Receipts - Other	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Beer	0.757	1.125	0.268	0.620	0.268	0.255	0.454	0.218	0.518	-0.456	0.664	0.414	-1.696	0.627	0.152
Alcoholic Beverage	0.323	0.137	1.606	0.276	0.422	0.456	0.200	0.349	0.235	0.274	0.130	0.354	0.110	0.181	0.048
Franchise & Excise	0.495	1.295	1.512	0.794	1.263	0.216	1.420	0.872	0.628	0.621	-0.007	0.774	0.617	1.825	0.643
Franchise	1.821	2.289	-0.062	0.918	1.026	0.427	0.278	1.301	0.612	0.664	0.344	0.965	2.876	2.359	-0.089
Excise	-0.023	0.837	2.342	0.745	1.358	0.133	1.883	0.724	0.634	0.605	-0.136	0.699	-0.284	1.577	1.004
Inheritance & Estate	0.832	3.434	1.272	-0.458	-0.782	1.008	3.042	3.023	-2.480	-2.272	-0.494	0.854	5.206	0.063	-0.911
Tobacco	0.561	0.454	0.265	0.415	0.287	0.433	0.259	0.331	0.127	0.230	0.376	0.208	-0.026	-0.196	0.404
Motor Vehicle Title	0.568	1.466	0.626	0.210	-0.454	0.858	0.466	-0.021	0.337	-0.189	-0.219	0.216	1.787	0.509	0.081
Mixed Drink	6.358	3.206	3.786	2.284	2.205	1.803	1.733	1.715	1.041	0.957	1.163	1.783	2.015	0.633	0.193
Nonsales	0.666	0.982	0.780	0.467	0.278	0.575	0.742	0.695	0.259	-0.115	-0.013	0.701	0.618	0.692	0.280
Total	0.731	1.220	0.865	0.663	0.458	0.673	0.803	0.861	0.572	0.138	0.264	0.764	0.842	0.836	0.704

Note: Table 24 continues on the next page.

Table 24: Growth Rates in Adjusted Revenue Collections Divided by Growth Rate in Personal Income, Major Tax Categories, 1971 - 2000, continued

Tax	1986	1987	1988 Expansion from Trough	1989	1990	1991 Contraction from Peak	1992	1993	1994	1995	1996 Expansion from Trough	1997	1998	1999	2000
Sales and Use	1.065	0.962	0.897	0.548	0.801	0.040	0.880	0.828	1.539	1.296	1.177	1.250	0.853	1.066	1.021
Gasoline	0.191	1.085	0.050	0.281	0.374	-0.185	0.342	-0.342	1.068	0.147	0.286	0.283	0.626	0.135	0.267
Motor Fuel	0.662	0.284	0.976	0.342	-0.128	-0.420	0.305	0.706	0.864	1.353	0.711	0.036	0.849	1.248	1.255
Gasoline Inspection	0.744	0.097	0.583	0.072	0.447	-1.040	0.295	-0.293	1.592	0.465	0.155	-0.055	0.562	0.522	0.567
Motor Vehicle Registration	0.794	0.218	1.331	0.397	0.130	-0.310	0.436	0.731	0.881	1.252	0.609	-0.128	1.118	0.499	1.509
Income	1.402	0.143	2.035	2.471	1.327	-1.162	-0.520	0.294	0.946	0.103	2.656	2.430	4.398	-0.105	2.127
Privilege	2.979	2.953	-2.314	0.874	1.024	-1.473	4.537	8.139	2.549	-0.061	1.842	1.794	2.364	2.381	-0.482
Gross Receipts	0.051	0.633	0.526	2.083	-2.127	0.056	0.276	0.036	-0.105	1.162	-0.459	1.445	0.055	0.821	1.378
Gross Receipts - TVA	-	-	-	-	-	0.281	0.196	0.110	-0.137	1.174	-0.667	1.182	-0.049	1.470	1.295
Gross Receipts - Other	-	-	-	-	-	-1.759	1.012	-0.603	0.190	1.052	1.437	3.606	0.825	-3.746	2.176
Beer	0.149	0.759	0.293	-0.100	0.189	0.378	0.332	-0.005	0.597	0.213	-0.193	0.807	-0.207	1.220	0.330
Alcoholic Beverage	-0.391	-0.279	-0.178	-0.318	-0.283	-0.274	0.049	-0.014	-0.110	0.160	0.547	-0.160	0.155	0.074	0.525
Franchise & Excise	1.642	1.177	1.686	0.759	-0.544	0.453	0.227	1.357	1.733	2.411	0.711	1.906	0.248	-0.293	3.754
Franchise	3.894	0.735	1.000	0.748	1.859	0.896	1.639	0.049	1.493	1.257	0.477	8.790	-3.681	0.501	10.704
Excise	0.646	1.412	2.035	0.764	-1.674	0.191	-0.644	2.297	1.879	3.100	0.834	-1.681	3.427	-0.713	-0.181
Inheritance & Estate	-1.936	1.422	0.654	3.765	-3.566	6.514	-2.507	6.580	-4.057	3.356	1.687	-0.473	18.211	-5.631	2.413
Tobacco	0.060	0.231	0.077	-0.221	-0.241	-0.270	0.204	-0.069	0.221	0.863	0.049	0.019	0.129	-0.330	-0.403
Motor Vehicle Title	0.851	3.430	0.251	-0.331	-0.111	-0.078	1.378	-0.085	1.783	0.697	0.754	0.352	-0.130	0.849	0.323
Mixed Drink	0.553	0.600	0.500	0.306	0.421	0.171	0.207	-0.027	0.739	0.100	0.633	1.587	0.987	1.299	0.755
Business	2.839	-1.050	1.346	0.901	-0.098	0.828	-0.870	0.415	1.116	1.995	1.241	0.985	1.891	0.165	4.106
Severance	1.235	4.017	0.317	-0.486	-10.069	25.935	-0.616	-9.237	-1.066	-0.260	2.093	1.840	-3.668	-1.447	4.525
Coin Amusement	-5.108	-3.648	-0.253	2.926	-9.343	-14.804	67.684	-1.993	-3.085	-5.876	-4.874	-3.921	-6.657	-1.397	-2.540
Nonsales	0.704	0.865	0.717	0.736	-0.288	0.026	0.289	0.809	1.028	1.187	0.643	1.050	1.183	-0.001	1.798
Total	0.906	0.920	0.819	0.629	0.327	0.034	0.633	0.820	1.330	1.253	0.964	1.171	0.982	0.644	1.318

Source: Center for Business and Economic Research calculations.

can be constructed that produces an acceptable degree of revenue instability. Some taxes will be highly volatile, so tax reliance must be shifted in part to taxes that provide a more stable revenue stream. This is similar to a financial portfolio where high risk and high return investments must be balanced against investments that offer a more certain and stable financial return.

Unfortunately, the best-laid plans can go awry. In practice instability will remain an inherent feature of the state tax system since variations in economic performance translate directly into changes in the size of state tax bases and hence revenue yield. Rainy day funds represent a mechanism to reduce the adverse consequences of revenue instability, in particular the revenue shortfalls that accompany periods of weak economic growth. Rainy day funds are a relative recent fiscal innovation, having been developed in earnest by the states following the wrenching economic downturn of the early 1980s. Since that time growth and expansion have largely characterized the economy's performance. As a result there is insufficient experience with business cycle movements and there is no consensus on the ideal size of a state rainy day fund. A rule of thumb of 5-10 percent of annual operating revenues is emerging as the target level of rainy day funds. In practice the size of the fund should be based on state-specific factors, especially a state's degree of economic volatility, its tax structure and revenue performance over time.

Taxpayer Equity

Fairness in taxation is an essential element of a fiscal system. A tax system that is perceived as unfair can compromise support for public services, alienate taxpayers and pit one taxpayer group against another. But fairness is subjective, so people may — and will — disagree on what constitutes an equitable tax system.

Benefits Taxation. One concept of fairness argues that taxes should reflect the benefits one receives from government services. This is an extension of the logic of the private market where people freely purchase goods based on price and the benefits that will be derived from consumption. The *benefits received* approach is the basis for various user charges, like motor fuel taxes, gasoline taxes and park fees. User fees are a particularly practical means to finance government services that are directly and uniquely received by individual taxpayers. They are less appropriate when government services jointly benefit large groups of taxpayers and the benefits to any one taxpayer are obscured. An example would be state-supported environmental protection programs.

Horizontal Equity. User fees and benefit charges are often criticized as ignoring an individual's *ability to pay*. For example, low-income individuals do not have the same ability to pay gasoline taxes and park fees as do high-income individuals. There are two well-accepted measures of tax fairness based on the notion of ability to pay. The first is *horizontal equity,* which is concerned with how similar individuals and households are treated by the tax system. Horizontal equity calls only for the *equal treatment of equals*, something most people would find to be an acceptable measure of fairness. Horizontal equity is violated when two individuals or two households that are otherwise similar bear different tax burdens. In practice, *similar* is often taken to mean the same income.

Horizontal inequities can easily occur under Tennessee's current tax system. For example, two households with the same income and same number of family members may purchase a different mix of sales taxable and non-taxable goods and services and consequently pay a different amount of sales tax. This might reflect a different mix of in-state purchases, or alternatively one household's more intensive use of mail order, Internet, or cross-border purchases. Similarly, the Hall income tax can lead to different income tax liabilities for two individuals with the same income depending on the source of income. An individual whose earnings consist of wage income in Tennessee would pay no state income tax, but another individual with the same amount of taxable dividend income would potentially incur a tax liability. (These examples assume that individuals bear the economic incidence or burden of the sales and income taxes.) In general horizontal inequities result from incomplete and uneven tax bases, and subsequent taxpayer choices.

Vertical Equity. The second notion of fairness based on ability to pay is *vertical equity*, or the way that taxpayers with different abilities to pay — typically measured by income — are treated by the tax system. A tax is said to be *progressive* if taxes as a share of income rise as income grows, *regressive* if taxes as a share of income fall as income grows, and *proportional* if taxes remain a constant share of income. Unfortunately, it is impossible to make an objective statement on whether a tax should be proportional, progressive or regressive, as fairness lies in the eye of the beholder. Progressive taxes were popular decades ago as governments sought to redistribute income away from higher income taxpayers towards the lower end of the income distribution. But there has been significant movement away from progressive taxation due to the adverse incentive effects they can engender, including the incentives to work and save. Progressive taxes may also encourage an exodus of high-income taxpayers to lower-taxed places of residence. Regressive taxes are viewed by many as unfair since the poor pay a higher share of income in tax than is the case for higher income taxpayers, even though higher income taxpayers generally pay more in *total* taxes.

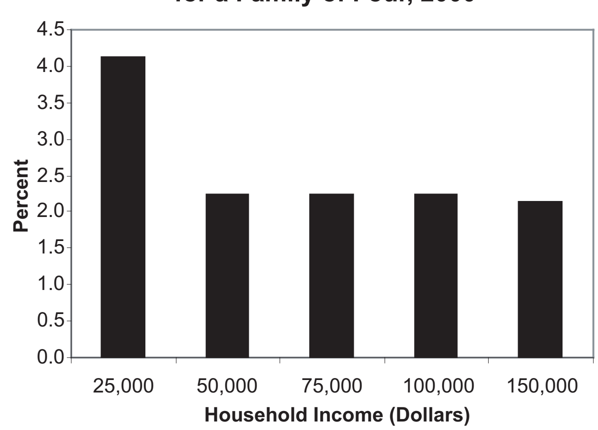
Vertical Equity and Specific Taxes. Sales and selective sales taxes are generally viewed as having a regressive tax burden.[6] A primary reason is that lower income people spend essentially all they earn, often draw down savings and borrow to support current spending, so that spending may actually exceed income. Therefore, they will confront relatively high sales tax burdens *vis* a *vis* current income.[7] Higher income individuals, on the other hand, save some income, thus avoiding a sales tax burden on the saved share of income and may spend more on non-taxable services (such as education tuition). These same individuals then would have a lower tax burden relative to income. The sales tax burden can be made less regressive by exempting those items that lower income households disproportionately consume, such as food and clothing. Primary drawbacks of such exemptions include the higher costs of administering and complying with the tax system and the inability of such exemptions to target only low income households, making such exemptions very costly in terms of lost revenue.

Income taxes can be progressive, regressive or proportional depending on how they are designed. The ultimate burden of the income tax depends on its rate and base structure, as well as the presence of any credits, deductions, exemptions, and so on. As an example, consider a flat-rate tax applied to all monetary income, with special provisions for itemization confined to higher income households. Such a tax would produce a regressive tax burden, since lower income households pay a flat rate on all income, while the higher income households would pay tax on only a portion of total income. As another example, a flat-rate income tax of 4.0 percent with an exemption per taxpayer of $20,000 would yield a mildly progressive tax despite the flat rate. In this instance an individual earning $10,000 per year would pay no tax, whereas an individual earning $30,000 would pay $400 in tax (or 1.33 percent of income) and an individual earning $100,000 would pay $3,200 in tax (or 3.2 percent of income). The Hall income tax in Tennessee is likely to be at least mildly progressive even though the rate is 6.0 percent, in part because of the exemption available to taxpayers. More generally, higher income households typically earn more of their total income from the non-wage taxable components of the base than is the case for lower income households. Yet due to the small role played by the Hall tax in Tennessee state government finances, it likely adds little progressivity to the state's overall tax system.

Recent evidence shows that owners of corporations likely pay most of corporate income taxes.[8] Corporate franchise and excise taxes are likely borne more by higher income than by lower income individuals, since the former have historically owned a larger share of total equity holdings. But this is changing more and more as middle-to-low income households have increased their access to the stock market, especially through accumulations in tax-deferred retirement accounts. It is generally agreed that corporation and business taxes are inappropriate means of achieving equity objectives, particularly at the state level, since many businesses are highly mobile and there are tax planning opportunities that can reduce business tax liabilities.

Little work has been undertaken to document the degree of regressivity or progressivity inherent in Tennessee's tax structure, so heavy reliance must be placed on the general considerations noted above. The District of Columbia does comparative analysis of state tax burdens for a small set of major taxes, using a family of four in the largest city in each state as a reference point. Figure 13 shows the results of their analysis of the sales tax for the City of

Figure 13: Burden of Tennessee Sales Tax for a Family of Four, 2000

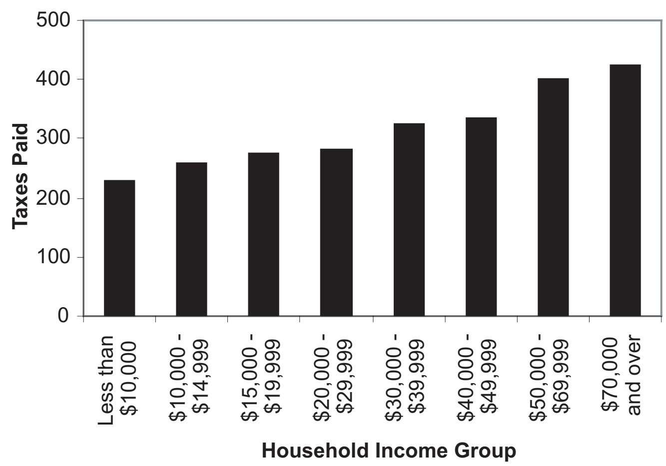


Note: Data for City of Memphis.
Source: Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison. Government of the District of Columbia, August 2001.

Memphis in 2000. Note that for all income classes the tax burden as a share of income is less than the actual state sales tax rate, reflecting several factors including savings and the purchase of non-taxable items. The figure indicates a significantly higher tax burden on households with $25,000 in income versus those in higher-income groups. In fact, the average tax burden for families with incomes of $25,000 (4.13 percent) is nearly 84 percent higher than the burden for a household earning $50,000 per year. Compared to the highest income group shown ($150,000 per year), the lower income household pays a 93.9 percent premium. Unfortunately the analysis offers no guidance on household tax burdens for taxes other than the sales tax.

Tax Policy and Tax Equity. The best means of addressing equity and fairness through the tax system is to focus directly on specific taxpayers. In practice this typically requires some form of *direct* tax like an income tax that is linked to a person or a household, as opposed to an *indirect* tax like the sales tax that is linked to a specific market transaction. Using a direct tax, policy can focus on the specific circumstances of the taxpayer. By using an indirect tax, policy is complicated because the targeted group may be difficult to identify or distinguish from other taxpayers since the tax is collected by vendors. For example, relief might be provided through a vehicle tax. But the typical vehicle tax offers no information on personal or household characteristics. A similar case is the sales tax and the well-intentioned policy proposals to remove food and clothing from the tax base to reduce regressivity. The policy can in fact help low-income households, but not without cost. As noted elsewhere, all households benefit, not only low-income households, so forgone revenue is higher than would otherwise be the case. This problem is illustrated in Figure 14 that shows estimates of the amount of sales tax paid on food consumed at home by different income groups. For the lowest income class, households earning less than $10,000, annual sales tax paid on food is $229. Middle income households, those with incomes between $30,000-$40,000, pay $324 annually in sales tax on grocery food. Those earning more than $70,000 per year pay $425 in sales tax, 86 percent more than the lowest income household. Eliminating the sales tax on

Figure 14: Tennessee State and Local Sales Tax Burden on Food Consumed at Home Households of Four, by Income Group



Note: Assumes combined state and local tax rate of 8.4 percent.

Source: Consumer Expenditure Survey and Center for Business and Economic Research calculations.

food, or applying a reduced rate to food purchases, would certainly help low-income families, but would also provide substantial benefits to higher-income families as well.

It is still feasible to provide low-income relief through an indirect tax, but different mechanisms are needed. For example, some states provide relief by offering credits under an income tax or through rebate programs. Another example would be to provide low-income taxpayers with encoded magnetic cards that could include sales tax credits. Low-income households might be identified using Social Security records that include information on earnings. Such a system would give rise to some additional costs of administration and compliance, but this would likely be less than the costs required to distinguish between grocery and non-grocery food sales. Like any system, of course, magnetic cards might be abused. In general, the strengths and weaknesses of alternative means of providing low-income tax relief should be identified to help guide policymaking.

Neutrality and Economic Development

It is often said that the ideal tax system should not distort the decisions made by people and businesses, i.e., the tax system should be *neutral*. In practice the goal is to minimize distortions given other tax policy objectives. For example, an ideal tax system should not influence where people live or what they buy or how much they work or save. Similarly, an ideal tax system should not alter how much a firm invests or where a firm chooses to locate its investment. The reality is that virtually all taxes influence the behavior of households and businesses. A considerable body of research has been undertaken to estimate the effects that taxes have on private sector decision-making. Most of this research, including that pertaining to Tennessee, shows that while higher taxes do discourage economic activity, the private sector responses are typically quite modest.[9] So while policymakers must be concerned about the distortionary effects of state taxes, this should not become a preoccupation that takes precedent over other tax policy goals.

The notion of neutrality is in conflict with a separate policy goal, namely the promotion of economic development. In recent years neutrality seems to have been displaced by concerns over competitiveness and the desire to promote economic growth. Most state and local governments deviate from pure neutrality and use part of their tax system to encourage economic development, as with the double-weighted sales apportionment formula used by Tennessee under the corporate excise and franchise taxes. In such instances the policy goal is not neutrality with respect to other taxing jurisdictions, but instead a potentially lower tax burden that will encourage job and income creation in Tennessee.

Tennessee's low overall tax burden should help temper any tax-induced distortions and non-neutralities relative to other states. But the state's narrow tax portfolio means some tax rates will be relatively high. The sales tax likely creates some distortions, given the high state and local sales tax rates that prevail in Tennessee, distortions that will grow with the new seven percent state rate. The high rate encourages border shopping, as well as acquisitions through electronic commerce and mail order vendors, for both households and businesses. Moreover, the sales tax falls heavily on the non-resale purchases of businesses, with firms accounting for over one-third of all sales taxes collected in the state. Evidence of relatively high corporate tax burdens also has been presented in the discussion above, and the recent increase in the excise tax rate will push business tax burdens higher still. Together the sales tax burden on business, coupled with high corporate tax burdens, can be expected to distort and discourage economic activity, although the exact magnitude of the problem has not been identified.

The key to relatively good tax structure neutrality is to have broad tax bases and low tax rates. To the extent allowed given service delivery requirements on the expenditure side of the budget, this will support low effective tax rates (e.g., taxes as a share of personal income). Achieving this objective requires a variety of potential taxing instruments and the policy discipline to avoid granting preferences to specific taxpayer groups to ensure broad tax bases.

Simplicity of Administration and Compliance

Ease of administration and simplicity in compliance are long-standing attributes of a good tax system. Yet in practice taxes are costly to the state to administer and are costly to households and businesses to comply with. Tax complexity is the primary source of high administrative and compliance costs and arises from special provisions in the tax system, including multiple tax rates/brackets, exemptions, deductions, preferential treatment of specific taxpayers groups and so on. A tax with a single rate and uniform base, on the other hand, is relatively easy to administer and comply with. The special provisions that yield complexity often arise from the pursuit of other tax policy goals, such as tax equity (e.g., the removal of food from the sales tax base or preferential rates for the acquisition of food) and economic development (e.g., targeted sales tax exemptions for business).

The Tennessee tax system is probably no more difficult to administer and comply with than the tax systems of other states. In fact, the absence of a state income tax means that taxpayers in Tennessee enjoy substantial compliance savings over their counterparts in states with income taxes. The savings are probably not as high as some would think, given that individuals must still comply with a federal personal income tax and its reporting requirements. Tax simplification has not surfaced as a significant tax policy issue in Tennessee in recent years suggesting that state residents are not overly concerned with issues of tax complexity. But it should remain an important consideration in analyzing potential changes to state tax structure.

Other Tax Policy Considerations

Other policy goals can surface in the design, analysis and reform of a state tax system. One is political acceptability. This is not a policy goal per se, but captures the attitudes and sentiments of individuals towards a tax system, and thus influences the practical structure of taxation. Some states, for example, have never chosen to add food to the base of their state sales tax and would never consider doing so. Maine is one such example. It is simply politically unacceptable, and this can be important in driving the debate about tax structure. Similarly, in Tennessee there has never been a broad-based levy imposed on income. Political opposition to an income tax in Tennessee has overwhelmed the debate about taxes and has for many people dominated other goals for state tax structure.

Another goal that often surfaces is the ability to export taxes to taxpayers in other jurisdictions. This is often the basis for tourism taxes and taxes on raw materials (such as severance taxes on coal in Wyoming and on petroleum and gas exported from Alaska). Exporting would also be possible through the personal income tax, although in a somewhat different form, namely itemization under the federal income tax. By itemizing state personal income taxes (along with other items that can be itemized), taxpayers in one state are able to shift part of the income tax burden to all federal taxpayers. This same option is not available for state sales taxes.

Exporting taxes sounds like a good idea, but it may not be easy to do in practice. The question is: Who ultimately pays the taxes? That is, what is the incidence of the tax? For example, tourism taxes may be borne by local landowners or local workers if the taxes cause tourists to seek alternative travel destinations and depress tourism spending. Exporting taxes also breaks the linkage between taxes paid and benefits received from government, as exists with other levies of state government.

VIII. SUMMING IT ALL UP

This report has covered considerable ground. The task now is to try to pull it all together. This section summarizes the policy tradeoffs that surface in the design of a good tax system and offers some thoughts about the future direction of state tax policy in Tennessee.

Policy Tradeoffs

A good tax system would be easy to construct if the criteria set out above — the requirements of a good tax system — were not in frequent conflict with one another. A good example is what is referred to as the equity-efficiency tradeoff discussed above in the context of regressivity and progressivity. In order to provide low-income household tax relief through an income tax, revenue losses must be made up by imposing higher taxes on high-income households. The high-income households may respond by working and saving less since the rewards to these efforts may be reduced, or by leaving the state for a place of residency with a lower tax bill. Another example is the potential exemption of food from the base of the sales tax. An adverse consequence would be reduced stability of the sales tax and the overall state tax system since expenditures on food are relatively stable. Revenue losses would also have to be made up through higher tax rates somewhere else in the fiscal system.

A state's residents must make choices regarding the various criteria of a good tax system and how the criteria should be weighted in practice. If competitiveness is the most important policy objective, then it should be pursued to some extent at the expense of other policy objectives. If vertical equity is a primary goal, it may be legitimate to pursue it even if there are relatively high costs. The fact is that the tax system needs to reflect the preferences and tastes of residents. This is why the tax systems of the 50 states differ so markedly.

The Challenge Confronting Tennessee

An important challenge confronting Tennessee is to decide on the goals and acceptable trade-offs for the state tax structure. There has been little change in Tennessee's tax system over the past several decades aside from rate increases, suggesting that state residents by and large accept the current structure. But there have been dramatic changes in the economic environment within which the tax system operates, especially in recent years. Today the state confronts many of the same risks that other states confront, and policy must respond to these risks. The sales tax base is eroding and there is no end in sight. The future of business taxation, especially for multi-state entities, also has an uncertain future. The federal government has chosen not to help state and local governments on both counts. The federal government has not addressed the long-standing mail order sales problem or the more recent problem of collection of sales tax on electronic commerce. Today the federal government has not closed corporate tax loopholes, particularly tax avoidance schemes that rely on off-shore ownership of otherwise domestic corporate entities. This is the environment in which tax systems now operate.

Any changes to state tax structure must be sensitive to this external environment, as well as to existing features of state taxes in Tennessee. Tennessee's tax structure has important strengths and weaknesses. One the greatest strengths is the low overall tax burden in the state and the actual decline in the state burden over time. Low taxes reduce distortions and allow taxpayers greater discretion with the income they earn. But low taxes translate into low levels of spending. For some this is a strength as well. For others it means relatively lower spending on valued services. But in the final analysis, you get what you pay for. Another strength of the state tax system includes relatively modest costs of administration and compliance, at least with respect to most other states. Administration and compliance costs are an unfortunate price to pay to fund and provide government services.

The tax system also has several important weaknesses. First, the tax system is currently inelastic and will become more inelastic in the future as the sales tax base and business tax base erode further. Rate increases are increasingly difficult, both from a political perspective but also in terms of avoiding excessive distortions in economic activity. Rate increases enacted early in fiscal year 2002/03 leave the state with little further flexibility.

Second, the neutrality of the tax system is violated by relatively high sales tax rates that encourage border shopping and the use of electronic commerce. The sales tax burden on business is substantial, as is the corporate tax burden on incorporated businesses. These distortions, aggravated by recent rate increases, will hamper future economic growth in the state.

Third, the tax system is regressive due to the state's heavy reliance on sales-based taxes. There is no easy or practical means of mitigating this burden under the state's current tax structure which relies so heavily on indirect taxes. While some progress might be made, for example, by simply exempting food and/or clothing from the sales tax base, there is no means to make up for the resulting revenue shortfall.

These are some of the more important features of the state's tax system that have surfaced in the discussion above. Different people will potentially arrive at different conclusions.

What Is the Solution?

The solution to Tennessee's long-standing revenue problem depends on how one interprets the facts and on how one defines the problem. Many believe there is no revenue problem, and to the extent there is a problem, it falls on the spending side of the budget. The state is spending too much and there is too much waste in state government. But from an interstate perspective of tax burdens, it doesn't appear that in total Tennessee's taxes and spending are out of line. Even if spending is in some sense too high, it will prove difficult to identify specific spending cuts and difficult to address problems on the revenue side of the budget, like revenue inelasticity and a regressive tax system.

Most residents of Tennessee would like to sustain relatively low tax rates. Relatively low taxes can in fact be sustained, while at the same time the state seeks to address the problems identified above and potentially other problems as well. But this again represents a balancing act as competing policy objectives run headlong into one another.

Addressing the revenue inelasticity problem outside of the perennial budget cycle requires the inclusion in the tax base of those items and activities that grow more strongly with economic growth. Personal income, property and gross receipts taxes, as well as the sales taxation of certain services, can enhance state revenue elasticity. Resolving the non-neutrality problem requires broader bases to support lower tax rates that will reduce distortions for households and businesses. Reducing the degree of regressivity calls for less reliance on sales-based taxes, either through exemptions of essential consumption items from the tax base, the use of a direct tax like an income tax that can provide favorable treatment to specific households, or other means such as rebate programs.

None of these options are new or novel. All have been discussed and debated. A long-term solution to the problems confronting Tennessee's state tax structure requires a broader understanding of the current structure and the evolving economic environment within which this same tax system operates. It also requires some agreement on the problems and challenges confronting the state. Hopefully this report lays a foundation for such a broader understanding.

Endnotes:

[1] For example, if a retailer *consumes* inventory purchased at the wholesale level free of tax, such as cleaning supplies and light bulbs, sales tax will due on the used inventory items.

[2] State of Tennessee, *The Budget*, Fiscal Year 2002/03, Table 1-B.

[3] Note that total state revenue plus total local revenue exceeds the combined total for these units of government, reflecting the effect of state aid to local government. In other words, the data reflect a small degree of double-counting for both Tennessee and the southeastern states.

[4] See Robert C. Dauffenbach, et al., "Revenue Neutral Tax Reform for Oklahoma: Issues and Options," *State Tax Notes* July 30, 2001, 341-378 and Robert Tannenwald, "Heat, Light and Taxes in the Granite State," *Regional Review* Q3, 2001, 25-30. Daphne A. Kenyon, "A New State VAT: Lessons from New Hampshire," *National Tax Journal* 49 (1996), 381-399, uses the criteria to examine the business enterprise tax, introduced in 1993.

[5] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," Center for Business and Economic Research, October 2001. *State Tax Notes* October 15, 2001, 203-214.

[6] This discussion assumes that consumers ultimately bear the burden or incidence of the sales tax, as is typically assumed. In reality this may not be the case for at least two reasons. First, retailers operating in border areas where adjacent jurisdictions have lower sales tax rates may be compelled to lower their prices to sustain trade. In this instance the retailer may enjoy lower markups and hence lower profits than their cross-border counterpart. Accordingly, retailers share in the economic burden — or incidence — of the sales tax. Second, many purchases made by businesses are subject to sales tax, and some of this burden may be borne by businesses through lower profits or by workers through lower wages.

[7] Some research has explored *lifetime* income versus current (or calendar year) income, and the way this influences the progressivity or regressivity of taxes. Generally sales and special excise taxes become less regressive when lifetime income is used as a measure of ability to pay. See, for example, Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Burden*, The Brookings Institution, Washington, DC, 1993.

[8] Jane Gravelle, "Who Bears the Burden of the Corporate Tax in the Open Economy?" National Bureau of Economic Research, working paper 8280, May 2001.

[9] For an example of this research applied to the state of Tennessee, see Susan Bott, William Fox and Matthew N. Murray, "The Effects of Public Policy on the Location of Business Activity," prepared for the Tennessee Advisory Commission on Intergovernmental Relations, 1988. Timothy Bartik (1991) offers a useful review of the research on the impact of taxes on economic development.

Appendix Table 1: A Synopsis of Department of Revenue Taxes

Sales and Use Tax

Rate and Source

7.0% is the general state rate that applies to the gross receipts from the sale or use of tangible personal property and specific services, effective July 2002; 6.0% applies to grocery food sales. Local governments may levy up to an additional 2.75% tax on top of this state rate. A single article cap of $1,600 applies to the local rate. A uniform state rate of 2.75% is applied to single article purchases between $1,600 and $3,200, with proceeds accruing to the state. There are four ways in which the tax is levied: a *sales tax* on items sold in Tennessee, a *use tax* on items imported into the state without payment of tax, a *contractors use tax* levied on contractors that install property not otherwise taxed and a tax on the application of self-produced property. The sales tax is levied on consumers but is collected by merchants and remitted monthly. Exemptions to the tax are numerous and complicated. They can be classified into three main categories; exempt transactions, exempt entities and exempt items.

Basis for Apportionment

Education Fund: 0.5% of the gross tax is earmarked solely for the education fund plus 65.0970% of the remaining 5.5% after the allocation to the transportation equity trust fund.

General Fund: 29.0246% of the remaining 5.5% after the allocation to the transportation equity trust fund less amounts paid to premier resorts and 100% of dealer's accounting compensation exceeding $50 per report.

Highway Fund: An amount equal to the tax collections from air, rail and barge fuel sales is earmarked for the transportation equity trust fund.

Sinking Fund: 0.9185% of the remaining 5.5% after the allocation to the transportation equity trust fund, or whatever amount is necessary to meet debt requirements.

Municipalities: 4.5925% of the remaining 5.5% after the allocation to the transportation equity trust fund, less the MTAS (Municipal Technical Assistance Service) grant to the University of Tennessee. Premier resorts receive 4.592% of the tax collected by dealers within their boundaries. Administration: 0.3674% of the remaining 5.5% after the allocation to the transportation equity trust fund.

Franchise Tax

Rate and Source

The franchise tax was originally a form of corporate property tax. Currently it is levied at a rate of $0.25 on each $100 of stock surplus or undivided profits of entities for the privilege of doing business within the state. The tax is remitted quarterly based on the fiscal year of the company. The measure of the tax may be computed using either the equity method or book value method, whichever results in the higher tax. The minimum tax is $100. The tax applies to business entities that enjoy some form of limited liability protection including LLCs, LLPs, limited partnerships, professional registered limited liability partnerships and regulated investment companies. Sole proprietorships and general partnerships are specifically excluded. Taxpayers who are taxed in states other than Tennessee may apportion the tax between Tennessee and other states. Tennessee also applies the tax to out-of-state businesses that have nexus. The same apportionment formula applies. Currently, Tennessee utilizes an apportionment formula that includes three measures of in-state economic activity: utilization of property, payroll and receipts or sales. The sales portion is double weighted, thus benefiting companies that have relatively large amounts of property and payroll in the state and relatively small amounts of sales.

Basis for Apportionment

General Fund: 100% less the amount to the sinking fund.

Sinking Fund: Amount required from general fund apportionment.

Excise Tax

Rate and Source

The excise tax falls on the income of certain business entities and is levied at a rate of 6.5% of net earnings of all business conducted for a profit in the state. The tax applies to businesses that enjoy some sort of limited liability protection. For state excise tax purposes, the company's federal taxable income is used, with certain adjustments including net operating losses, capital losses, dividends, and charitable contributions. The starting point differs for corporations and limited liability entities. Current year losses may be carried forward as many as 15 years in computing net income subject to the tax. Taxpayers who are taxed in states other than Tennessee may apportion the tax between Tennessee and other states. Tennessee also applies the tax to out-of-state businesses that have nexus. The same apportionment formula applies. Currently, Tennessee utilizes an apportionment formula that includes three measures of economic activity: property, payroll and receipts or sales. The sales portion is double weighted, thus benefiting companies that have relatively large amounts of property and payroll in the state and relatively small amounts of sales.

Basis for Apportionment

General Fund: 100% of the remaining balance after cities, counties and sinking fund distribution.

Sinking Fund: Amount required from general fund apportionment.

Cities and Counties: An amount based on bank earnings is distributed on the basis of the situs of bank activity in lieu of intangible personal property taxes on banks and banking associations.

Gasoline Tax

Rate and Source

The tax is levied at a rate of $0.20 per gallon of gasoline sold, stored or distributed in the state. The tax is paid by the distributor or dealer.

Basis for Apportionment

General Fund: Approximately 0.8% of total collections. *Highway Fund:* Approximately 61.1% less an amount to the sinking fund. *Sinking Fund:* Amount required from highway apportionment. *Cities:* Approximately 12.7% based on population. *Counties:* Approximately 25.4% based ¼ on population, ¼ on land area, ½ divided equally.

Motor Fuel Tax

Rate and Source

Includes $0.17 on each gallon of diesel fuel and all fuel other than gasoline, except dyed fuel under IRS rules; a prepaid annual agricultural diesel tax ranging from $56 to $159, based on registered gross weight; $0.13 on each gallon of compressed natural; gas used for motor vehicles on public roadways; and $0.14 on each gallon of liquefied gas used for motor vehicles on public highways which is prepaid as an annual vehicle tax on liquefied gas users ranging from $70 to $114, based on registered gross vehicle weight. Any excess tax due above the flat fee charged must be paid to the state annually.

Basis for Apportionment

General Fund: Approximately 1.2% of total collections.
Highway Fund: Approximately 72.6% less an amount to the sinking fund.
Sinking Fund: Amount required from the highway fund apportionment.
Cities: Approximately 8.4% based on population.
Counties: Approximately 17.5% based ¼ on population, ¼ on land area and ½ divided equally.

Gasoline Inspection and Export Tax

Rate and Source

The tax is levied at a rate of $0.01 for each gallon of gasoline and most other volatile fuels sold, used or stored. In addition, a $0.004 per gallon environmental assurance fee and an export fee equal to 1/20 of one cent on fuels subject to the special petroleum products tax is imposed.

Basis for Apportionment

General Fund: 2% of the balance remaining after local government apportionment of the $0.01 per gallon and the export fee. In addition, 100% of the environmental assurance fee is earmarked for the petroleum underground storage tank fund.
Highway Fund: 98% of the balance remaining after local government apportionment of the $0.01 per gallon tax and the export fee.
Sinking Fund: Amount required from general fund and highway fund apportionments.
Cities and Counties: A local government fund of $12,017,000 of which 38.1% is for county roads and the remainder for city roads (less a $120,000 grant to the University of Tennessee Center for Government Training).

Motor Vehicle Registration

Rate and Source

The tax is primarily comprised of state registration fees on motor vehicles ranging from $13.50 for motorcycles and $20.50 for passenger cars to $1,300 for trucks in the largest weight class. The state taxes are most significant for businesses owning trucks. Trucks are divided into three categories including private, for-hire and joint. Each of the three categories is subdivided into eleven classes according to the maximum gross weight of the truck and load.

Basis for Apportionment

General Fund: 2% of the balance of registration fee revenue after the allocation of $2.75 per vehicle plate to the general fund, of which $1.00 from non-freight registration is earmarked for police pay supplement; and after $2.00 per motorcycle plate to the general fund, earmarked for motorcycle rider safety fund. The exception is special license plates, for which all revenue above the expense incurred in designing, manufacturing and marketing such plates is allocated in the following manner: personalized plates-100% to Arts Commission; specialty earmarked plates-50% to nonprofit organization, state agency or fund earmarked and 40% to Arts Commission; and cultural plates- 80% to Arts Commission. All penalties and fines, except only 20% of overweight-truck fines, earmarked for administration, less an amount required for debt service.
Highway Fund: 98% of the balance registration fee revenue after the allocation of $2.75 per vehicle plate and an additional $2.00 per motorcycle plate to the general fund; 10% of the revenue from specialty earmarked plates and 20% of the revenue from cultural plates; and 80% of the overweight-truck fines.
Sinking Fund: Amount required from general fund apportionment.

Motor Vehicle Title Fees

Rate and Source

$5.00 certificate of title fee and other fees received for the issuance of motor vehicle titles and noting of liens.

Basis for Apportionment

General Fund: Approximately 77% including 50 cents of the $5.00 fee, earmarked for enforcement action against odometer fraud, and a portion of the $1.50 of the $5.00 fee in excess of debt service requirements, earmarked for state parks capital projects.
Sinking Fund: Approximately 23% (including a portion of $1.50 of the $5.00 fee in excess of debt service on a state parks bond issue).

Hall Income Tax

Rate and Source

The tax is levied at a rate of 6% on incomes from dividends on stocks or interest on certain bonds. The first $1,250 on an individual return and $2,500 on a joint return is exempt from the tax. Other specific exemptions include persons over age 65 if their total annual income from all sources is equal to or below a statutory threshold, blind persons, quadriplegics, prisoners of war, non-profit corporations and corporations paying personal property tax on stocks and bonds owned by them.

Basis for Apportionment

General Fund: 5/8 of revenue and an administration expense of 10% of the first $200,000 and 5% of the remainder of the tax.

Cities and Counties: 3/8 of the revenue to local governments based on situs of collection, less general fund administrative apportionment.

Inheritance, Estate and Gift Tax

Rate and Source

Inheritance tax ranges from a rate of 5.5% on the value of net taxable estates of at least $40,000 to a tax of $30,200 plus a rate of 9.5% of the value in excess of $600,000 for decedents dying after 1989. Gifts are taxed at a rates ranging from 5.5% on gifts up to $40,000 to 9.5% on the excess over $440,000 for Class A beneficiaries and from 6.5% on gifts up to $50,000 to 16% on the excess over $200,000 for Class B beneficiaries. Gift tax exemptions of $10,000 and $5,000 are allowed for Class A and Class B donors, respectively. Class A beneficiaries are immediate family members including nieces and nephews for individuals with no children or grandchildren. Class B beneficiaries include all others. The inheritance tax is levied on the estate before it is distributed and constitutes initially a liability of the estate and of the executor or administrator of it. However, if the estate is distributed prior to taxes being paid, those receiving portions of it are liable for the tax. Similarly, the liability of the gift tax initially falls upon the person making the gift; if the tax is not paid, the recipient becomes liable.

Basis for Apportionment

General Fund: 100% of total collections.

Gross Receipts Tax

Rate and Source

Taxes levied principally on the gross receipts of certain types of businesses operating in the state. The primary source of revenue is an in-lieu-of-tax payment by the Tennessee Valley Authority, which is calculated as 5% of gross receipts from the sale of electric power in the state. Other sources include taxes on the following portions of gross receipts: 1.9% of soft-drink bottlers, 3% on gross receipts over $5,000 of intrastate water and electric power distribution companies, 1.5% on manufactured or natural gas intrastate distributors, 15% on mixing bars and clubs. Additionally, it includes a $40 per year firearms dealer permit fee.

Basis for Apportionment

General Fund: 79% of the bottlers' gross receipts tax, 100% of various other gross receipts tax and TVA PILOTs equal to the FY 1977-78 payments and 48.5% of any TVA payments received by the state in excess of the FY 1977-78 amount, less approximately $4.1 million distributed to local governments.

Highway Fund: Approximately 21% of the bottlers' gross receipts tax is earmarked for litter control.

Cities and Counties: 51.5% of the TVA in-lieu-of-tax payments which exceed the state receipts in FY 1977-78, of which 65.9% is designated for counties based ½ on population and ½ on land area, 28.3% for municipalities based on population and 5.8% for impacted areas affected by TVA construction, plus an amount equal to that received by local governments in FY 1977-78 ($4.1 million). Portions of this share are earmarked for TACIR and, under some circumstances, for CTAS.

Privilege Tax

Rate and Source

Various taxes including those on litigation in the courts, domestic protection civil penalties ($50), sex offender tax (maximum $3,000), realty transfer tax ($0.37 per $100 of consideration or property value), mortgage recordation tax ($0.115 per $100 of principal indebtedness), tire tax ($1.00 per tire sold), occupational tax ($400 on certain occupations), $15 marriage license fee, a packaged automotive oil fee ($0.02 per quart), and a 3% surcharge on rental vehicles.

Basis for Apportionment

General Fund: 100% less certain litigation taxes earmarked for various retirement funds. Portions of the tax going to the general fund are earmarked for specific purposes such as the Corrections Institute, indigent defense attorneys' compensation, domestic violence community education programs, Tennessee Housing Development Agency and various park acquisition funds.

Business Tax

Rate and Source

Tax imposed principally by local governments on certain businesses, vocations and operations carried on within the state. 15% of all taxes collected locally are remitted to the state by the collector of each county and incorporated municipality. Business tax increased 50%, July 2002, with revenue accruing to the state.

Basis for Apportionment

General Fund: 100% of the 15% remitted by local governments.

Tobacco Tax

Rate and Source

The tax is levied at a rate of $0.20 per package of 20 plus $0.0005 per cigarette pack enforcement fee. In addition, there is a tax equal to 6.6% of the wholesale price of other tobacco products, license fees of $10 to $20 per location for sellers, distributors and handlers, proceeds of confiscated goods and fines for violations of the Unfair Cigarette Sales Law.

Basis for Apportionment

General Fund: Approximately 0.6% including 4% of taxes from tobacco other than cigarettes, 4% of the proceeds from the sale of confiscated products and 100% of the $0.0005 per pack of cigarettes for enforcement fee, all marked for administration.

Education Fund: Approximately 99.4% including 100% of the cigarette taxes, earmarked for grades 1-12, 100% of the license fees and penalties, and 96% of all other tobacco taxes and the proceeds of sale of confiscated tobacco products.

Mixed Drink Tax

Rate and Source

The tax consists of a license tax of $300 to $1,500 for the privilege of selling alcoholic beverages for consumption on premises and a 15% gross receipts tax on sales.

Basis for Apportionment

General Fund: 100% of the privilege tax.

Education Fund: 50% of the gross receipts tax.

Cities and Counties: 50% of the gross receipts tax, of which ½ is earmarked for education and ½ is distributed to the city and county based on the situs of collections.

Alcoholic Beverage Tax

Rate and Source

The tax is comprised of the following: $1.21 per gallon on wine, $4.40 per gallon on spirits, $1,000 fee for manufacturers, $1,000 for wholesalers, $500 fee for retailers and a fee ranging from $2 to $50 for the representatives of retailers.

Basis for Apportionment

General Fund: 82.5% of distilled spirit and wine gallonage taxes, calculated on the total collections less 4 cents per liter of spirit tax, 100% of license and permit fees, earmarked up to 100% to the Alcoholic Commission Board for enforcement of liquor laws. Additionally, the following shares of proceeds from the sale of confiscated items, all earmarked for criminal injuries compensation and reported under privilege tax collections: 100% from liquor seized by state agents, 50% from vehicles, aircrafts and boats seized by local law enforcement officers, and 50% from other contraband goods seized, less 15% retained for administration as departmental revenue for the Department of General Services. Counties: $0.04 per liter of spirit tax, earmarked for the county in which the distillery is located, plus 17.5% of the balance of spirit and wine gallonage tax, less $192,000 earmarked for CTAS. In counties of 250,000 or more population, 30% of their allocation is paid by the counties and cities of 150,000 or more population. Also, 50% of the proceeds of the sale of contraband goods, less 15% retained as departmental revenue by the Department of General services. Cities and Counties: 90% of the proceeds of the sale of liquor seized by local law enforcement officers, earmarked to city or county employing officer, and 50% of proceeds form the sale of vehicles, aircraft, and boats seized by local officers, earmarked to city or county employing officer.

Beer Excise Tax

Rate and Source

Registration fees imposed on beer wholesalers ($20) and beer manufacturers ($40) and a privilege tax of $4.30 per 31-gallon barrel of beer manufactured or sold in the state.

Basis for Apportionment

General Fund: 67.1% of privilege tax collections with 4% of the total tax earmarked for administration and 0.41% for alcohol and drug treatment programs. In addition, 100% of the registration fees go to the general fund with 50% earmarked for the revenue department and 50% for highway patrol. Highway Fund: 12.8% of privilege tax collections for litter control. Counties: 10.05% of privilege tax collections distributed equally. Municipalities: 10.05% of privilege tax distributed based on population.

Severance Tax

Rate and Source

Tax levied at a rate of 3% of the sales price of severed oil and natural gas in the state and $0.20 per ton of severed coal in the state.

Basis for Apportionment

General Fund: 2/3 of the tax on severed oil and natural gas and 3% of the $0.20 per ton tax on coal plus all the penalties and interest and 1/3 of the tax on severed oil and natural gas distributed to the counties based on population and 97% of the $0.20 gross tax on coal distributed to the county of severance, of which 50% is earmarked for highway and stream cleaning.

Coin-Operated Amusements/ Machine Tax

Rate and Source

An annual fee license tax is imposed on the privilege of owning coin-operated amusement machines for commercial use. Level 1 license: 50 or fewer machines, tax is $500; Level 2 license: 50 to 200 machines, tax is $1,000; Level 3 license: more than 200 machines, tax is $2,000.

Basis for Apportionment

General Fund: 100% of the tax.

Sources: State of Tennessee, The Budget, Fiscal Year 2000/01 and 2000 Tax Guide, Bradord N. Forrister and Bill Buechler, M. Lee Smith Publishers LLC, 2000, Brentwood, TN; Public Acts 2002, Chapter no. 856.

Appendix Table 2: Exemptions, Deductions and Tax Rates for the Personal Income Tax in the Southeast

			Married Rates (filing jointly)		Single Rates	
			Taxable Income	Marginal Tax Rate	Taxable Income	Marginal Tax Rate
Alabama	Exemptions					
	Single	1500	1-1000	2	1-500	2
	Married	3000	1001-6000	4	501-3000	4
	Dependant	300	6001 and above	5	3001 and above	5
Arkansas	Deductions					
	Single	20	1-3099	1	1-3099	1
	Married	40	3100-6199	2.5	3100-6199	2.5
	Dependant	20	6200-9299	3.5	6200-9299	3.5
			9300-15499	4.5	9300-15499	4.5
			15500-25899	6	15500-25899	6
			25900 and above	7	25900 and above	7
Florida	No personal income tax					
Georgia	Exemptions					
	Single	2700	1-1000	1	1-750	1
	Married	5400	1001-3000	2	751-2250	2
	Dependant	2700	3001-5000	3	2251-3750	3
			5001-7000	4	3751-5250	4
			7001-10000	5	5251-7000	5
			10001 and above	6	7001 and above	6
Kentucky	Deductions					
	Single	20	1-3000	2	1-3000	2
	Married	40	3001-4000	3	3001-4000	3
	Dependant	20	4001-5000	4	4001-5000	4
			5001-8000	5	5001-8000	5
			8001 and above	6	8001 and above	6
Louisiana	Exemptions					
	Single	4500	1-20000	2	1-10000	2
	Married	9000	20001-100000	4	10001-50000	4
	Dependant	1000	100001 and above	6	50001 and above	6
Mississippi	Exemptions					
	Single	6000	1-5000	3	1-5000	3
	Married	12000	5001-10000	4	5001-10000	4
	Dependant	1500	10001 and above	5	10001 and above	5
North Carolina	Exemptions					
	Single	2500	1-21250	6	1-12750	6
	Married	5000	21251-100000	7	12751-60000	7
	Dependant	2500	100001 and above	7.75	60001 and above	7.75
South Carolina	Exemptions					
	Single	2800	1-2340	2.5	1-2340	2.5
	Married	5600	2341-4680	3	2341-4680	3
	Dependant	2800	4681-7020	4	4681-7020	4
			7021-9360	5	7021-9360	5
			9361-11700	6	9361-11700	6
			11701 and above	7	11701 and above	7
Tennessee	Exemptions					
	Single	1250	6% on interest and dividends			
	Married	2500				
Virginia	Exemptions					
	Single	800	1-3000	2	1-3000	2
	Married	1600	3001-5000	3	3001-5000	3
	Dependant	800	5001-17000	5	5001-17000	5
			17001 and above	5.75	17001 and above	5.75
West Virginia	Exemptions					
	Single	2000	1-10000	3	1-10000	3
	Married	4000	10001-25000	4	10001-25000	4
	Dependant	2000	25001-40000	4.5	25001-40000	4.5
			40001-60000	6	40001-60000	6
			60001 and above	6.5	60001 and above	6.5

Source: Commerce Clearing House, Inc.

TACIR Members

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Mayor Tom Rowland, Vice Chairman
Harry A Green, Executive Director

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Senator Mark Norris
Vacant
Vacant
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Rep. Randy Rinks
Rep. Larry Turner

Statutory

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Senator Douglas Henry, FW&M
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Executive Branch

Vacant
Vacant

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Sharon Goldsworthy, Mayor of Germantown
Bob Kirk, Alderman, City of Dyersburg
Tom Rowland, Mayor of Cleveland

County

Nancy Allen, Rutherford County Executive
Jeff Huffman, Tipton County Executive
Ken Yager, Roane County Executive
Vacant

Private Citizens

David Coffey, Oak Ridge
Thomas Varlan, Knoxville

Other Local Officials

Brent Greer, TN Development Dist. Assn.
Vacant, County Officials Assn. Tennessee

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