

**Appendix D - UNIVERSITY HONORS PROGRAM
SENIOR PROJECT - APPROVAL**

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PROJECT TITLE: Comparison of State Tax Structures
to Determine Successful Models

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

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Comparison of State Tax Structures to Determine Successful Models

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Comparison of State Tax Structures to Determine Successful Models

Abstract

The purpose of this project is to compare and evaluate alternative tax structure models and to determine which models are successful. The report begins with a discussion of current fiscal problems in the state of Tennessee. It then looks closely at Tennessee's current tax structure. Important aspects of this structure include the types of taxes currently used by the state, the percent of funds provided by specific taxes, and the percent of funds devoted to certain services.

The paper then examines the tax structures of several other states, including states in the Southeast as well as states in other regions of the country. The analysis of these states' systems includes the same factors as those examined for the state of Tennessee. Tax rates and tax burdens for the different states are also compared.

The various structures are evaluated and discussed based on the success of state systems and the success of specific types of taxes. Tax systems and individual taxes should meet current and future needs of both the state and taxpayers. Several proposals for the state of Tennessee are also examined. These proposals include modifying the tax structure, implementing programs involving non-tax sources of revenue, and decreasing spending. These proposals could be adopted alone or in combination.

Introduction

Recently, many stories in the media have focused on fiscal problems in the state of Tennessee and possible changes in the state tax structure that could be used to combat these problems. Given this situation, a discussion of alternative tax systems and proposed changes is of interest to people who live and work in Tennessee.

Purpose

The purpose of this report is to compare and evaluate alternative tax structure models and to determine which models are successful.

Scope

This paper will focus on several topics: Tennessee's current economic situation and tax structure, tax structures in selected states across the country and a comparison and evaluation of the different systems, and alternatives that have been proposed or discussed for the state of Tennessee.

This report does not include an analysis of implementation costs or implementation strategies for specific alternatives.

Assumptions

Four important assumptions are necessary to this report:

- The states involved, including Tennessee, will not modify their tax structures before this project is completed. If states greatly change their systems, some comparisons and

evaluations might become invalid.

- General economic and social conditions in the states examined in this paper and in the United States as a whole will not change dramatically. A significant shift in these conditions could alter whether a certain state and its tax system are viewed as successful in meeting the needs of its citizens.
- Specific conditions in a state, such as quality of public education and health care, are related to whether a state is properly meeting the needs of its citizens and, further, are related in some way to state budgets and tax systems. This assumption allows one to evaluate alternative tax systems.
- The tax structures discussed would be feasible for use in Tennessee. This assumption allows one to consider each system separately and based on its own characteristics. A state legislature should investigate further the specific costs and other consequences related to implementing various alternatives.

Limitations

This research project has two limitations:

- Time and money constraints prevented the examination of every possible tax system or even every state's tax system. Instead, several states were chosen in order to get an idea of the types of structures that potentially could be implemented in Tennessee. A broader

study would allow a researcher to better evaluate which systems are most feasible or most successful.

- No precise formula exists to evaluate the success of specific tax structures. Determining successful models is a subjective process. One must choose several criteria that he or she believes are appropriate and evaluate the alternatives based on those criteria. However, developing a firm conclusion about which systems are best is difficult.

Definitions

The following list includes definitions of selected types of taxes with which some readers may not be familiar:

- Use Tax - Similar to a sales tax, a use tax is a tax levied by one's home state on goods purchased in a different state. The amount of the tax is usually the difference between the sales tax rates in the two states, with the tax in the home state being greater.
- Corporate or Excise Tax - This type of tax is essentially an income tax for businesses; it is generally applied to a corporation's net income. An excise tax can also be defined as a tax on the manufacture, sale, or consumption of a commodity. Some states categorize taxes on goods such as tobacco as excise taxes.
- Franchise Tax - A franchise tax is a tax on the assets a business uses; it is levied on the equity or fixed assets of a corporation, whichever is greater.

- Severance Tax - This tax is imposed on the extraction of natural resources.

Background of the Problem

Over the past two years, the fiscal condition of the state of Tennessee has become a concern for both citizens and politicians. Many media stories have focused on the financial situation in the state. At the University of Tennessee, the situation has been emphasized due to what some individuals and organizations perceive as a lack of support for higher education. In addition to worries about funding higher education, state revenues below expectations and a slowing economy also cause concern for people across the state.

In Knoxville, the impact of the state's financial condition on higher education has garnered much attention. Many students and faculty feel that the state government should increase funding for services and facilities at colleges and universities rather than raising tuition. According to state Senator Ben Atchley, "We haven't completely funded the formula for higher education since 1988-89. So we've been robbing them for a long time" (Cate, "Economic Slump Forces Assembly to Reevaluate Budget"). Unfortunately, the situation may not improve in the near future. In January 2001, Douglas Henry, the chair of the state Senate's Finance, Ways and Means Committee said that if the state is forced to cut spending, "Higher education will take the brunt of the hit" (Cate, "Economic Slump Forces Assembly to Reevaluate Budget").

Another issue is that state revenues are below expectations and may not be sufficient to fund planned spending. In October 2000, Tennessee Finance Commissioner Warren Neel announced that, while franchise and excise tax collections had increased by \$19 million in

September, overall state revenues remained \$32 million below projections. These projections are set by the General Assembly, which relies on the numbers in formulating a balanced state budget. Because revenues may not meet expectations, the legislature might be forced to reduce funding for some state departments or programs in order to ensure that the budget remains balanced. Restrictions on renting office space, hiring, and travel are already in place (Sharp, "State Revenue Not Going Up Enough to Fund Planned State Spending").

In addition, the growth in franchise and excise tax collections may not be permanent. Legal changes last year increased revenues for these types of taxes, but officials are unsure about whether the gain will be seen throughout the year or if it is a short-term increase. Decreases in these collections could create further problems for the state (Sharp, "State Revenue Not Going Up Enough to Fund Planned State Spending").

The rate of growth in sales tax collections is also a concern. In order to balance the most recent state budget, the General Assembly arbitrarily raised the estimate for revenue growth to 5.15 percent from the official top range estimate of 4.75 percent. However, sales tax collections increased less than 2 percent in July and August, the first two months of the state's fiscal year; collections would have to grow by at least 6 percent for the remainder of the year in order to meet expectations. Because sales taxes account for over half of the state's revenue, any shortfall in collections significantly impacts the budget. If collections continue to grow by just 2 percent for the rest of the year, the state could face a \$202 million deficit at the end of the fiscal year in June 2001. In addition, because of a court decision in October 2000, Tennessee will not be allowed to levy a tax on credit card companies that could generate approximately \$9 million per year, and the state may have to refund several million dollars to firms that have already paid the tax (Sharp,

“State Revenue Not Going Up Enough to Fund Planned State Spending”).

The national economy has slowed over the past several months, and this situation also negatively affects individual states like Tennessee. According to Neel in a September 2000 news article, “The slowing growth in [tax] collections may indicate a ‘genuine slowdown in the economy,’ which will affect Tennessee more quickly than many other states because of its heavy reliance on the sales tax” (Sharp, “State Revenue Lags \$29 Million Behind Projection”). As this slowdown in the economy has been realized, Tennessee officials need to be aware of the impact on state tax collections. Sales of many goods decrease when economic conditions worsen, and therefore, sales tax collections also decrease.

These issues concern many people in Tennessee, from students and faculty at public universities to the many other individuals and organizations that rely on state funding. In addition to difficulty providing services for citizens, the problems also affect the state in other ways. For example, two bond-rating agencies downgraded Tennessee’s credit rating in response to recent financial problems (Sharp, “State Revenue Not Going Up Enough to Fund Planned State Spending”). As a result, finding investors for its bonds may become more difficult for the state without an increase in interest rates on the bonds. This situation could further reduce funding.

Because of the problems described above, many people are calling for Tennessee officials to make significant changes in the ways the state collects and spends revenue. The state’s tax structure has been the focus of much attention, and many proposed changes involve the tax system. Given this situation, the following discussion of alternative tax systems and proposed changes may be of interest to people concerned about conditions in the state.

Tennessee's Current Tax Structure

In order to better understand and evaluate proposed changes to Tennessee's tax structure, one needs to be aware of some of the main characteristics of the current system. Important aspects to examine include the types of taxes now levied by the state government, the percent of state funds provided by specific taxes, and the percent of funds devoted to certain services.

Types of Taxes in Tennessee

According to the Tennessee Department of Economic and Community Development, Tennessee state and local governments currently employ the following types of taxes to collect revenue:

- Sales and use
- General property
- Local business
- Corporate/excise
- Franchise
- Personal income (Hall Income Tax)
- Unemployment
- Utility gross receipts

Sales and use taxes are levied by both state and local governments. The taxes primarily apply to individual consumers, but some businesses are required to pay the taxes on their purchases as well. The state sales and use tax rate is currently 6 percent. Local governments add to this rate; presently, local rates range from 1 percent to 2.75 percent.

General property and local business taxes are levied by local governments, usually cities and counties. Property taxes apply to any individual or business that owns property within a particular government's jurisdiction and are based on the assessed value of the property. Local business taxes are applied to the gross sales of businesses.

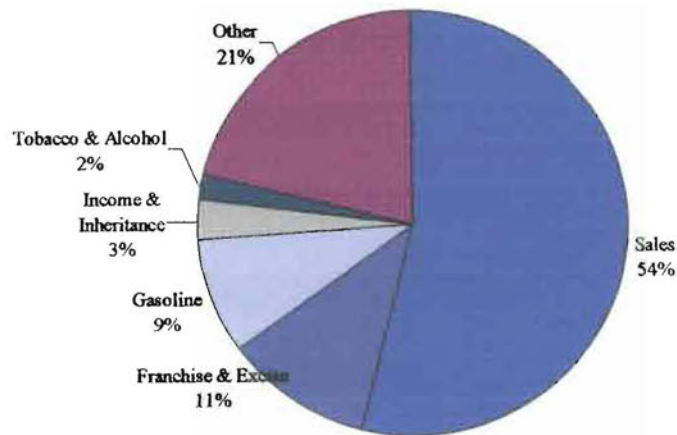
Corporate/excise and franchise taxes are state taxes for businesses. The current rate of corporate/excise taxes in Tennessee is 6 percent of a corporation's or limited liability company's net income. The rate for franchise taxes is \$0.25 per \$100 of net book value of assets.

Tennessee's personal income tax is called the Hall Income Tax. It is a state tax for individuals. Because the tax is applied to interest and dividends rather than to earned income, most Tennesseans do not think of the Hall Tax as a traditional income tax. The rate for this tax is 6 percent of interest and dividends. Interest paid by banks and on Tennessee municipal bonds is exempt, as is the first \$1250 of income for single taxpayers and the first \$2500 of income for married taxpayers filing jointly.

Unemployment and utility gross receipts taxes are state taxes for businesses. The tax rate for unemployment insurance for new employers is 2.7 percent. For other businesses, the rate differs based on how much money the state has to pay out in benefits to the former employees of a specific business. The rate on utility gross receipts is 3 percent ("Tennessee Taxes").

Percent of Funds Provided by Specific Taxes

Another important aspect to consider in examining a state's tax structure is what percentage of tax revenue is provided by specific taxes. As Figure 1 on page 9 shows, Tennessee relies heavily on the sales tax.

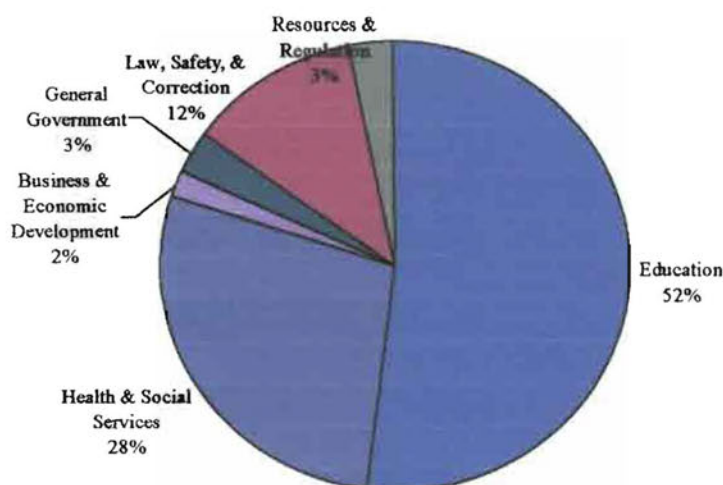
Figure 1. Funds Provided by Specific Taxes in Tennessee

Source: "Tennessee Taxes"

In terms of contributions to revenue, the sales tax is the most important tax to Tennessee (54%). Franchise and excise taxes on businesses are second in importance (11%). Because of the reliance on the sales tax to finance government activities and services, any adjustment to the sales tax rate or base will greatly affect the state, either positively or negatively. For this reason, any reductions in sales tax revenue must be offset by increasing other taxes or by implementing new taxes.

Percent of Funds Devoted to Certain Services

The ways a state spends the revenue generated by taxes is also important. As seen in Figure 2 on page 10, education (52%), health and social services (28%), and law, safety, and correction (12%) are the three types of services to which the most revenue is devoted in Tennessee.

Figure 2. Funds Devoted to Specific Services in Tennessee

Source: "Tennessee Taxes"

In modifying the tax structure, state leaders need to consider what types of services citizens feel are important. In the case of Tennessee, legislators need to plan a system that will allow them to maintain or enhance current levels of services, especially in important areas such as those listed above.

Tax Structures in Other States

In considering a change to Tennessee's current tax structure, examining the tax structures of other states can help one to better understand what options are available to Tennessee's government as well as what types of systems can potentially be successful. Several states were chosen in order to get an idea of the types of structures that could be implemented in Tennessee. While only a few states were chosen for the purposes of this project, a more detailed study would

be necessary to get a comprehensive view of available options. However, the states selected, Alabama, Arizona, Colorado, and North Carolina, represent different areas of the United States and different strategies for dealing with the necessary activity of collecting revenue.

Alabama

The state of Alabama relies on the following taxes as sources of revenue (“State Taxes and Other Major Sources”):

- Sales and use
- Personal property
- Corporate taxes and fees
- Franchise
- Corporate income
- Individual income
- Public utilities
- Motor fuels (diesel) and gasoline
- Beer
- Cigarettes and tobacco
- Ad valorem
- Inheritance and estate
- Privilege license

As in the case of Tennessee, one can also examine what percentage of total funds is provided to the state by the above taxes. As seen in Table 1 on page 12, Alabama’s sources of

revenue are more balanced than are Tennessee's. The state relies much less heavily on its sales tax than does Tennessee (29%), and it receives a greater percentage of funds from individual income taxes (39%).

Table 1. Funds Provided by Specific Taxes in Alabama

<u>Tax</u>	<u>Percentage</u>
Individual Income Tax	39.33%
Sales and Use Tax	29.27%
Gasoline Tax	6.74%
Corporate Income Tax	4.44%
Corporate Franchise Tax	2.12%
Other	18.10%

Source: "State Taxes and Other Major Sources"

Arizona

Arizona relies on these taxes as sources of revenue ("Moving to Arizona"):

- Sales and use
- Property
- Corporate income
- Individual income
- Gasoline
- Inheritance and gift
- Estate
- Severance

As Table 2 shows, Arizona relies relatively heavily on the sales tax (46%), but it also collects a significant portion of its revenue through use of the individual income tax (40%).

Table 2. Funds Provided by Specific Taxes in Arizona

<u>Tax</u>	<u>Percentage</u>
Sales and Use Tax	46%
Individual Income Tax	40%
Corporate Income Tax	9%
Other	5%

Source: "Moving to Arizona"

Colorado

The Colorado government currently employs the following types of taxes to raise revenue ("State Operating Budget"):

- Sales and use
- Corporate income
- Individual income
- Liquor
- Cigarettes and tobacco

As seen in Table 3 on page 14, the greatest portion of Colorado's revenue is provided by individual income taxes (56%). The sales tax is the second most important tax in the state (31%).

Table 3. Funds Provided by Specific Taxes in Colorado

<u>Tax</u>	<u>Percentage</u>
Individual Income Tax	55.9%
Sales and Use Tax	30.7%
Corporate Income Tax	4.6%
Cigarette, Liquor, and Tobacco Tax	1.9%
Other	6.9%

Source: "State Operating Budget"

North Carolina

North Carolina relies on these taxes as sources of revenue ("Tax Information"):

- Sales and use
- Local property
- Corporate income
- Franchise
- Individual income
- Motor fuels
- Driver license
- Highway use

As shown in Table 4 on page 15, North Carolina relies most heavily on the individual income tax (56%). The sales tax provides the second greatest amount of revenue (28%).

Table 4. Funds Provided by Specific Taxes in North Carolina

<u>Tax</u>	<u>Percentage</u>
Individual Income Tax	56%
Sales and Use Tax	28%
Corporate Income Tax	7%
Franchise Tax	3%
Other	6%

Source: "Tax Information"

Comparison of Tax Structures

In addition to studying different states individually, one can compare the state tax structures in order to better understand the range of possibilities. One can compare the types of taxes used by each state government, the percent of funds provided to each state by specific taxes, and the percent of funds devoted to certain services. Other important characteristics of the systems to consider are tax rates and tax burdens; these two items are significant because they affect the actions of both businesses and individual citizens.

Types of Taxes

After examining the tax structures of Tennessee and other states, one can see both similarities and differences in the systems. For instance, most Tennessee taxes are similar to those of other states. Most of the states have sales and use taxes, corporate and individual income taxes in some form, and taxes on tobacco and alcohol products.

However, several differences between the systems are also apparent. One of the more

notable differences is the individual income tax base. Most states tax individual earned income, while Tennessee applies its personal income tax to interest and dividends only. Differences also exist in terms of the types of taxes used by the states. For example, Arizona has a severance tax. This type of tax is more useful to states rich in natural resources. States such as Texas can tax companies that extract oil from the ground. This potentially lucrative tax allows the state to depend less on other types of taxes, such as those on personal income. Therefore, one must consider each state's unique situation in terms of resources and other circumstances in deciding which taxes will best provide for its needs.

Percent of Funds Provided by Specific Taxes

Another important aspect to consider in comparing tax structures is which taxes each state relies on most heavily. Because of the recent debates in Tennessee, the differences in dependence on sales taxes versus income taxes are of interest.

In terms of the portion of revenues provided by sales and use taxes, Tennessee places the most emphasis on these taxes of the states examined in this report. The state gathers 54 percent of its revenue through sales and use taxes. In contrast, North Carolina relies least on the sales tax, collecting only 28 percent of state funds in this manner.

The most dramatic difference can be seen in dependence on individual income taxes. North Carolina and Colorado both receive 56 percent of their funds through this type of tax. Alabama and Arizona gather approximately 40 percent of their revenues through use of the personal income tax. However, less than 3 percent of Tennessee's funds are provided by individual income taxes.

One can also compare each state's reliance on corporate taxes. This category does not show great differences among the states. The percentages of funds gathered from this type of tax range from 5 percent in Colorado to 11 percent in Tennessee.

Percent of Funds Devoted to Certain Services

Most states seem to have a similar distribution of funds to services. The top use is education, with approximately 40 percent to 50 percent of each state's funds devoted to this category of services. Second is health and social services; most states devote approximately 30 percent of their revenues to this use ("Tennessee Taxes," "State Taxes and Other Major Sources," "Moving to Arizona," "State Operating Budget," "Tax Information").

Tax Rates

Another useful comparison is tax rates in the different states. Again, this report concentrates on rates for sales and use taxes, individual income taxes, and corporate taxes.

State sales tax rates range from 3 percent in Colorado to 6 percent in Tennessee. Localities add an additional 1 to 2 percent to the state rate. Colorado exempts food for home consumption from sales taxes, as does Arizona. Arizona also excludes prescription drugs from the tax ("State Sales Tax Rates").

Individual income taxes vary somewhat among the states. In general, all of the states examined here have relatively low rates for personal income taxes. That is, the rates are much lower than the rates used to calculate federal income taxes. North Carolina, Alabama, and Arizona use progressive structures; taxpayers with higher incomes must pay higher rates. In

North Carolina, rates range from 6 percent to 7.75 percent of earned income. Alabama's structure includes rates from 2 percent to 5 percent of earned income. The rates in Arizona range from 2.87 percent to 5.04 percent, and the state also applies its personal income tax to earned income. Colorado uses a flat rate of 4.63 percent of earned income for all taxpayers in the state. In Tennessee, a rate of 6 percent is applied to interest and dividends ("State Individual Income Tax Rates").

Corporate tax rates are essentially the same in the states studied for this report. Arizona and North Carolina have rates of 7 percent, and Tennessee uses a rate of 6 percent. The rates in Alabama and Colorado are 5 percent and 4.63 percent respectively ("State Corporate Income Tax Rates").

Tax Burdens

The tax burden in each state is another significant characteristic to investigate. Two ways to rate the tax burden are to find the average dollar amount of state taxes each person pays and to find the amount of state taxes paid as a percentage of personal income. As Tables 5 and 6 on page 19 show, North Carolina has a relatively high tax burden, while Colorado and Tennessee have relatively low tax burdens. New Hampshire has the lowest tax burden in the United States according to this data.

Table 5. State Taxes Per Capita

<u>State</u>	<u>Ranking</u>	<u>\$ Amount of Taxes</u>
Connecticut	#1	\$2932
North Carolina	#16	\$1887
Arizona	#38	\$1579
Colorado	#43	\$1476
Alabama	#45	\$1380
Tennessee	#47	\$1311
New Hampshire	#50	\$891

Source: U.S. Census Bureau

Table 6. State Taxes as a Percentage of Personal Income

<u>State</u>	<u>Ranking</u>	<u>% of Income</u>
Hawaii	#1	10.0%
North Carolina	#18	7.5%
Arizona	#28	6.7%
Alabama	#34	6.3%
Tennessee	#45	5.4%
Colorado	#47	5.1%
New Hampshire	#50	3.0%

Source: U.S. Census Bureau

Evaluation of Tax Structures

After gathering information on the states, one can then attempt to determine which systems work well and which do not. Ways to evaluate tax structures include examining the success of the state systems as a whole and by examining the success of specific types of taxes.

Success of State Systems

One could look at three main factors in evaluating the success of a state's tax structure:

- Meeting budget
- Meeting current needs
- Planning for future needs

When measuring the success of a tax system in terms of how well the state meets its budget, one can determine whether the state has had a surplus or a deficit in recent years. If many states with similar tax structures had trouble raising enough revenue to cover their expenses, one might be able to determine that depending on those types of taxes is not the best way for a state to meet the needs of its citizens. Most of the states examined in this paper have had surpluses in recent years. For example, Colorado's Office of State Planning and Budgeting estimates that the state's budget surplus will reach \$6 billion over the next six years ("State Operating Budget"). However, because of the exceptional economic conditions in the United States over the past few years, this factor may not provide as much useful information as it would in times of poorer economic conditions.

A state's ability to meet current needs is also important. In examining this factor, one could look at rankings for items such as education and health care. These statistics could give a

general idea about the quality of public schools in the state and the quality of public health care programs. For example, one could use the percentage of fourth grade students scoring below the basic reading level in each state to try to determine the quality of the state's elementary schools. In 1998, the national average was 39 percent. Arizona's rate was 47 percent, Alabama's was 44 percent, and Tennessee's was 42 percent; these rates are all above the national average. The rates in North Carolina and Colorado were 38 percent and 31 percent respectively, both below the national average ("Kids Count Data Online Profiles").

One could try to determine the quality of the state's health care programs by looking at statistics for the percentage of low income children without health insurance in the state. In 1997, the average for the United States as a whole was 25 percent. Arizona, North Carolina, and Colorado had rates above the national average. Arizona's rate was 40 percent, and North Carolina and Colorado both had rates of 27 percent. Alabama and Tennessee had rates below the national average. Alabama's rate was 24 percent, and Tennessee's was 18 percent ("Kids Count Data Online Profiles").

In examining these rankings, one might determine that, for example, Tennessee's government is providing elementary education that is slightly below average but is providing public health care at rates above many other states in the country. Therefore, one could conclude that Tennessee needs to devote more money to education. In some cases, these results could be correct. Tennessee often ranks low in educational rankings provided by other organizations. However, people within Tennessee often criticize the state's public health care program, TennCare, for covering more people than are eligible for the program; the state's high rankings in terms of number of low income children having health insurance could be related to that problem.

Further, having higher taxes and spending more money on a program or service can, but does not always, lead to better conditions and thus higher rankings for a state. For example, New Hampshire has the lowest tax burden and is near the bottom in terms of both revenue and expenditures per person. However, it ranks well above the national average in most of the health and education categories examined for this paper (“Kids Count Data Online Profiles”).

Finally, one could try to measure the success of a state’s tax system by how well the system will be able to adapt to circumstances and needs of the population in the future. Legislators need to forecast such things as growth and future economic conditions and deal with those changes. Also, they should look at certain characteristics of the taxes making up their system. One of these characteristics is tax elasticity, which is the measure of responsiveness of changes in tax collections to changes in economic conditions (“Tax Information”). In other words, tax elasticity measures how adaptable the tax is. In evaluating a tax structure, the taxes included in the system should be as adaptable as possible. Therefore, when economic conditions in the nation and state change, the state will still be able to collect a sufficient amount of revenue.

Success of Specific Types of Taxes

Someone analyzing the success of specific types of taxes could examine these three factors:

- Providing sufficient revenue
- Being fair to taxpayers
- Being acceptable to government and taxpayers

First, a specific tax needs to provide a sufficient amount of revenue in order to be useful to

the state. However, the state must balance this need with the need to avoid placing too heavy a burden on taxpayers. For example, the sales tax provides a great deal of revenue for the state of Tennessee. At the same time, many people feel that this tax alone cannot support all the state's needs and that sales tax rates of 7 percent or 8 percent are too high. Therefore, this factor is not as straightforward as it may seem.

Another important factor in evaluating the success of a specific type of tax is fairness to taxpayers. Many recent debates in Tennessee have focused on whether sales taxes and income taxes are fair. For example, as mentioned above, many people feel that sales taxes are unfair because they are regressive and individuals with low incomes have to pay high rates on basic necessities. To make the sales tax more fair to taxpayers, many states, including Colorado and Arizona, exclude food purchased for home consumption. Arizona and Tennessee are among the states that exempt prescription drugs from the tax. Legislators need to work to plan a tax structure that is fair to citizens of the state while still providing sufficient revenue.

A tax also needs to be acceptable to both the government and to taxpayers. This factor involves the amount of effort required by the state to collect taxes and the amount of effort required by taxpayers to pay the tax. If too much effort is needed, the tax may not be paid and is therefore useless to the government. Sales taxes require relatively little effort. Sellers calculate the tax, collect it from customers, and then remit this amount to government authorities. On the other hand, income taxes require much effort on the part of taxpayers. Many states try to make individual income taxes easier to calculate by using the same base required to calculate federal taxes. Legislators must also take this factor into consideration when planning a tax system for the state.

Discussion of Proposals

As Tennessee officials struggle to find ways to deal with recent financial problems, many people have proposed changes to the current system. Some of these changes include modifying the tax structure, either by altering elements of the current system or by adding new types of taxes. Implementing programs that involve non-tax sources of revenue is another choice. An additional suggestion is to decrease spending in addition to or rather than increasing revenue. These policies could be implemented alone or in combination.

Modify the Tax Structure

Many of the most prominent proposals involve modifying Tennessee's current tax structure in order to provide additional revenue for the state. Changes could involve altering elements of the system by increasing or expanding taxes that exist now, or they could include instituting new types of taxes.

Some suggestions involve increasing existing fees or taxes. Those under discussion include professional privilege fees paid by attorneys and physicians, automobile registration fees, and taxes on alcohol and tobacco ("Legislators Look at New Ways to Work on Budget Problems"). Franchise and excise taxes on the assets and profits of businesses could also be increased (Parker).

Several of the other strategies proposed for dealing with insufficient revenue involve modifying the sales tax in a way that will provide more money to the state. The state sales tax rate is currently 6 percent. Some people have recommended that this rate be increased ("Legislators Look at New Ways to Work on Budget Problems"). They estimate that increasing

the current rate to 6.5 percent could provide an additional \$400 million for the state (Cate, “Economic Slump Forces Assembly to Reevaluate Budget”). Others suggest that the sales tax base be expanded to include transactions that are currently excluded, such as the services of attorneys, physicians, accountants, and engineers. Other exemptions, including those for cable television, radio and television advertising, vending machines, newspaper sales, gasoline and diesel fuel, farm machinery, and prescription drugs, could also be removed (“Legislators Look at New Ways to Work on Budget Problems”).

Plans to increase or expand the sales tax have been criticized, however. Many people consider this type of tax to be regressive. That is, lower income individuals contribute a greater proportion of their income than do higher income individuals. Increasing the rate would increase the cost of many goods and could worsen this problem. Expanding the tax base is also controversial. If the sales tax were expanded to cover services, law firms, accounting firms, and many other individuals and organizations would be forced to collect and remit taxes to the government. Some of these professional groups are politically powerful and may fight efforts to expand sales taxes in this manner. Other people worry that taxing services could lead to increased costs for customers who might not be able to afford higher prices. According to state Senator Tim Burchett, “Putting fees on doctors and lawyers will only lead them to pass [the fees] on to their customers. That can actually hurt those that you’re trying to help” (Parker). Finally, removing exemptions on items such as gasoline and prescription drugs is also unpopular. Some of the goods and services that are currently excluded from sales tax are necessary for many people. For example, some people could be adversely affected by increased prices for goods that are already expensive, such as prescription drugs.

Additional proposals include instituting new types of taxes. One of those being discussed is a statewide property tax, a type of tax currently used only by localities (“Legislators Look at New Ways to Work on Budget Problems”). Another option is a value-based vehicle tax. Other states, such as Georgia, currently use this type of tax, which has the potential to provide a significant amount of revenue to the state. According to state Senator Atchley, more than 5.5 million vehicles are registered in Tennessee, and an average tax of \$100 per automobile would approximate a 0.75 percent increase in the sales tax (Cate, “Economic Slump Forces Assembly to Reevaluate Budget”).

One of the most often mentioned, yet one of the most controversial, proposals is institution of a tax on individual earned income. Suggestions include implementing a flat tax based on a taxpayer’s adjusted gross income calculated for federal tax purposes. The rate of the tax would be relatively low; one recommended rate is 3.75 percent. Depending on filing status, age, and number of dependents, taxpayers would also be eligible for exemptions of several thousand dollars (“Tennessee Comprehensive Tax Reform Bill of 1999”). Other proposals involve payroll taxes or graduated income taxes (Parker).

If new types of taxes, such as a tax on individual earned income, are implemented, many people feel that other elements of the system must be altered in order to avoid imposing too heavy a burden on Tennessee’s taxpayers. Some proposals have included repealing the state sales tax on grocery food and reducing the general state sales tax rate. Others suggest eliminating the Hall Income Tax on interest and dividends. Also, to protect against increasing the tax burden in the future, three-fifths of state legislators could be required to vote for any tax increases before they could be implemented (“Tennessee Comprehensive Tax Reform Bill of 1999”).

Many individuals and organizations strongly oppose institution of a state tax on individual earned income, however. Some people believe that this type of tax would increase the tax burdens of many middle class families. They also believe that a tax on earned income would inhibit economic growth in Tennessee. They claim that by taxing income, the state discourages individuals and businesses from investing in new activities, companies, technologies, and services that would produce additional income (Poole). Further, many people worry that an income tax would reduce the attractiveness of Tennessee as a place for individuals and businesses to relocate.

Proposals to modify the state's tax structure have been criticized for other reasons as well. For example, some people believe that lowering the sales tax in conjunction with implementing an income tax could have negative consequences. Many people from other states come to Tennessee for purposes of business or entertainment. By reducing the sales tax rate, the state reduces the amount of tax it can collect from these out-of-state visitors and tourists. At the same time, the state cannot collect income taxes from these individuals. Therefore, total tax collections from this group of people could be lowered significantly (Poole). However, some proposals have recommended maintaining the current state sales tax rate on hotels and motels, rental cars, amusements, and tobacco and alcohol products ("Tennessee Comprehensive Tax Reform Bill of 1999"). Because visitors from out-of-state are likely to purchase these types of goods and services, the previous problem could be counteracted somewhat.

Implement Programs Involving Non-Tax Sources of Revenue

One way to boost revenue without increasing current taxes or instituting new taxes would be to create a state lottery. Tennessee's state legislature began serious consideration of a lottery

this year; this would require removing a ban on lotteries from the state Constitution. Citizens could be able to vote on the issue as early as November 2002. The General Assembly could then pass a law in 2003 detailing how the lottery would work (“Senate Votes to Remove Lottery Ban”).

Many states have lotteries, and they can potentially increase state revenue by a substantial amount. In some cases, earnings are earmarked for uses such as educational funding or college scholarships. Other benefits of lotteries include the fact that they are not compulsory; individuals only pay if they choose to do so. Also, because lotteries are not mandatory payments, they can sometimes be less controversial politically than taxes are, depending on the organizations involved in the process of implementation.

Lotteries do have negative aspects, however. One argument against the use of lotteries as a source of state revenue is their regressivity. Lower income people tend to buy lottery tickets more often than those with higher incomes. Many individuals consider this situation to be unfair because the people that can least afford to contribute are spending the most money. Also, implementing a lottery in a conservative state such as Tennessee can sometimes be difficult. Many people or organizations have religious or ethical objections to gambling, and those types of groups tend to be fairly powerful in the South. Another argument against lotteries is that they are not always as lucrative as officials project them to be when they are implemented.

A second non-tax source of revenue could involve using some of the money from settlements of lawsuits with the tobacco industry. Tennessee received \$375 million in these settlements (“Legislators Look at New Ways to Work on Budget Problems”).

Decrease Spending

Another option for state officials is to manage funds more efficiently. While the state may need more revenue regardless of its exact spending situation, some people argue that the current system in Tennessee contains many wasteful expenditures. These individuals believe that the state needs to manage its spending more wisely rather than or in addition to increasing revenue.

Some individuals and organizations claim that a significant factor contributing to Tennessee's recent budget problems is increased and irresponsible state spending. Some studies rank Tennessee as having the eleventh fastest state budget growth in the nation between 1990 and 1997. They claim that, after adjusting for inflation, the budget has increased by nearly \$4 billion over that period. Other people, such as State Treasurer Steve Adams, say that state expenditures grew by fifty-eight percent between 1992 and 1999. These people assert that sales taxes have been increased in the past specifically to fund new spending programs (Poole).

Many people believe that reforming specific programs would be the best way to solve Tennessee's financial problems. One common target of critics is TennCare, Tennessee's public health care program intended for individuals who cannot afford or are otherwise ineligible for regular health insurance. For example, many individuals think that some of TennCare's enrollees have died, are in prison, have high incomes, or are ineligible for the program for other reasons (Cate, "State Legislators React to Gov. Sundquist's Proposed Budget"). These people believe that the state is spending much more money on the program than is necessary. Reforming TennCare to make it more efficient and then reducing spending on the program could free additional funds for other programs without raising taxes.

Other people have suggested additional ways for the state to reduce spending. For

example, some people propose that the government privatize certain departments or programs. They believe that private companies and organizations can offer services in a more efficient and cost-effective manner. These individuals say that other states have privatized state functions such as foster care and adoption services and prison construction and operation services with success. People also suggest that the state consolidate some departments, which they believe would increase efficiency while reducing expenses (Poole).

Conclusions and Recommendations

Recently, much media attention has focused on financial problems in the state of Tennessee. People in the state are concerned about funding higher education and other important services, collecting enough revenue to match budgeted expenditures, and developing or maintaining a tax structure that will meet revenue expectations despite a slowing economy. Many individuals and organizations have suggested changes in order to remedy these problems. To better understand the types of changes that could benefit Tennessee, a detailed examination of Tennessee's tax structure, tax structures in other states, and various proposals is necessary.

The first step in analyzing this situation was to look at Tennessee's current tax structure. Important aspects of this structure include the types of taxes currently used by the state, the percent of funds provided by specific taxes, and the percent of funds devoted to certain services.

The next step was to study the tax structures in several other states, including Alabama, Arizona, Colorado, and North Carolina. These structures were then compared and evaluated. They were compared in terms of the types of taxes in each state's system, the percent of funds provided by specific taxes, the percent of funds devoted to certain services, tax rates, and tax

burdens. These comparisons allow one to better understand the range of possible tax structures.

The structures were then evaluated and discussed based on the success of state systems in terms of how well the states met their budgets, how well they were meeting current needs, and how they were planning for future needs. The different tax structures were also evaluated based on success of specific types of taxes; factors in determining success here included the ability of the tax to provide sufficient revenue, the fairness of the tax, and the acceptability of the tax to government and taxpayers.

Finally, various proposals for the state of Tennessee were discussed. These proposals included modifying the tax structure, implementing programs involving non-tax sources of revenue, and decreasing spending. Any of these proposals could be adopted alone or in combination.

Much more study and analysis is needed before choosing a plan for Tennessee. More tax systems and proposals should be evaluated thoroughly. Also, one needs to consider strategies for and costs of implementation. However, one of the first steps the state should take is to eliminate waste and to control spending. Legislators can then consider ways to gather additional revenue. They should plan a system that can meet the budget as well as meet current and future needs of the state and its population. Modifying the tax structure to lessen the reliance on one type of tax, namely the sales tax, could be very beneficial to the state. Further, taxes should be sufficient, fair, and relatively easy to collect. One step toward increased fairness of taxes could be to reduce or eliminate the sales tax on food for home consumption. The process of solving Tennessee's financial problems is potentially long and difficult. However, through study and evaluation of the possibilities, state leaders should be able to make changes that will benefit the state for many

years.

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