



Policy Report – January 29, 2009

Creating a Tax System for the 21st Century

Why Tennessee's tax system falls short over the long term, and the call to modernize our tax system.

Flawed analysis behind the recent Tennessean news story

On Monday, January 26, the Tennessean ran a news story with the headline, “Tennessee budget doubles in two decades.” In this story, they report that the state budget was \$7 billion in 1988, and that it is nearly \$28 billion now. The Tennessean then suggests the budget should only be \$14 billion now, after adjusting for inflation and population growth.

While we commend the Tennessean for its efforts over the years in educating and informing Tennessee voters about the budget realities facing Tennessee, the analysis they provided in Monday's news story falls short of what we would expect of the Tennessean, our state's largest newspaper. The analysis used, and the news story that resulted from that analysis, distorts the true picture, and even worse, fuels false public perceptions about the growth of government.

The problem with the Tennessean's analysis is that it mistakenly assumes that government should grow at roughly the same rate as inflation and population. While this may sound rational, “inflation” is not the principal factor in determining the cost of providing public services. A much more accurate way to measure how the state budget should be growing is to look at the growth of the budget in relation to the growth in total personal income.

So what's wrong with using inflation? Inflation has to do with the price of a typical basket of “consumer” goods like bread, clothing, furniture, and car parts. The cost of what government does, and the services it provides, however, has little relation to the price of these consumer goods. That's in part because the price of the “consumer” goods used to measure inflation is driven by factors such as automation, economies of scale, and cheap foreign labor. The price of a dress shirt for example has been kept down as new automation technologies reduce the costs of both harvesting the cotton, and weaving the fabric. Shipping those textile factories overseas to countries where workers are paid a few dollars a day has further kept the price of a dress shirt down.

By comparison, the cost of teaching a child to read has little to do with the price of labor in China or the latest automation technologies. It still takes a teacher and a child working together. Similarly, the cost of keeping our streets safe has little or nothing to do with the price of labor in India or the latest robotic technologies. It still takes a real live police officer, paid at American wage levels, working a beat.

In simple terms, our state and local governments spend their money on teachers, police, fire fighters, environmental compliance inspectors, and similar expenses which are much more

closely related to personal income here in America, and more specifically in Tennessee, than the price of a loaf of bread or the cost of a portable MP3 player.

There are other problems with assuming government should grow at the same rate as population plus inflation. Health care inflation, which makes up a significant portion of state expenditures, including both health care safety net programs for citizens, as well as, health care for the many public employees, grows at a much faster rate than overall inflation. Even using population growth has limits because many of the populations driving state expenditures, such as prison populations and seniors, have been growing faster than the overall population in recent years.

For these reasons, almost no credible economist uses inflation plus population to try and project how fast government will, or should, grow from year to year. Instead, economists, from both the left and the right, typically measure taxes and the relative size of governments over time as a percentage of total personal income. Had the Tennessean followed such a widely-accepted protocol, their analysis, and the news story that resulted from it, would have told a very different story.

State & local taxes largely unchanged over the past 30+ years

State and local taxes as a percentage of personal income in Tennessee have remained largely the same over the past 30+ years according to various sources. While TFT would probably disagree with the Tax Foundation on many issues, it's worth noting that even they measure taxes as "a percent of personal income" as shown in the table below.

Combined State and Local Taxes as a Percentage of Personal Income in Tennessee:

1977	1980	1985	1990	1995	2000	2005	2006	2007	2008
9.2%	8.2%	8.4%	8.2%	8.3%	7.8%	8.3%	8.5%	8.4%	8.3%

Data from page 6 of the Tax Foundation report at <http://www.taxfoundation.org/files/sr163.pdf>

Similarly, a 2003 report entitled, "The Structure of State Taxes in Tennessee: A Fiscal Primer," by the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) and the UT Center for Business and Economic Research (CBER), shows that state taxes (local taxes not included) have remained in the 5 to 6 % range from 1970 to 2000. More recent data from 2006 shows state taxes at 5.5% of personal income. This TACIR / CBER data clearly mirrors and supports the Tax Foundation data.

Tennessee is near bottom in overall taxes relative to other states

To assert that Tennessee's taxes are "out-of-control" or that we have a spending problem is simply wrong. Tennessee ranks 49th in state and local taxes as a percentage of personal income. Only one state in the nation has a lower level of state and local taxes than Tennessee.

This “low-tax” reality has had significant and negative impacts on public structures in Tennessee. For example, Tennessee ranks:

- 43rd in financial commitment to public health (per person)
- 44th in financial commitment to elementary and secondary school (per student)
- 48th in financial commitment to higher education by state and local govt. (per person)
- 47th in the “most livable state” index
- 41st in children living above the national poverty line
- 46th in percent of 4th graders who can do 4th grade math
- 48th in percent of adults with a high school degree
- 46th in seniors living above the national poverty line

Data excerpted from Congressional Quarterly Press's State Fact Finder Series: State Rankings 2008.

Sales tax hikes of 1976, 1984, 1992, & 2002 are just treading water

What comes as a surprise to most is that taxes in Tennessee have remained unchanged despite the sales tax increases of 1976, 1984, 1992, and 2002, as the Tax Foundation data (beginning in 1977) and the TACIR/CBER data (beginning in 1970) show. So what's been going on? Aren't taxes going up? The sales tax increases, and the narrative told in our media, would certainly lead one to believe that.

What actually has been going on is that the sales tax “base” has been shrinking due to the shift to a service-based economy (services are typically not subject to the sales tax), the growth of the Internet and on-line shopping, increased mobility (cross-border shopping), and changing spending patterns in general. As a result, for every 10% of economic growth the state experiences, sales tax revenues grow by only about 8%, leading to mounting budget shortfalls over time. Instead of fixing the problem, state legislators have responded by simply raising the sales tax rate every 8 to 10 years to make up for the difference.

Imagine if you were a worker whose hourly wage gets cut every year, and you respond by working more hours each year to make up for the difference. While you may be able to maintain your total wage level this way, you're just treading water and it is simply not sustainable over the long term. The same applies to Tennessee as the combined state and local sales tax rate, already the highest in the nation with an average rate of 9.4%, reaches the breaking point.

This recurring budget crisis is the inevitable outcome of a dysfunctional tax system. The current economic downturn has only sped up and further dramatized a process that would have happened anyway.

Creating a tax system for the 21st Century

Our state policy makers should be focused on developing the kind of long-term plans necessary to strengthen the common good and prepare our state for a 21st Century economy. Instead, our state policy makers are caught in a perpetual cycle of crisis, struggling to get from

one budget shortfall to another, due to an outdated and dysfunctional tax system. This cripples our state's ability to make long-term plans that are vital to the state's future.

This is one of the many reasons that it is essential for legislators to embrace tax modernization and fix the underlying problems with our tax system once and for all. Only then will Tennessee be able to move forward, and begin creating a state ready to take on the challenges of a new Century, and all that that entails.

Central to any modernization of Tennessee's tax code is to reduce the state's dependence on the outdated sales tax. That is why TFT has supported a significant roll-back of the sales tax, along with full repeal of the sales tax on grocery food. In order to put the state on more solid fiscal ground, this revenue would be replaced with a broad-based tax on income that would also replace the current Hall Income Tax on dividends and interest.

Unlike the sales tax, revenues from state taxes on income keep pace with the growth of the overall economy. That's because income taxes are, by definition, tied to the growth of personal income. Additionally, they are unaffected by the long-term dynamics that are eroding our sales tax base, such as changing spending patterns, the growth of Internet shopping, and the shift to a service-based economy.

With a more balanced tax system, including a state tax on income along with a much lower sales tax and no food tax, Tennessee would finally be on solid financial ground with a tax system that can stand the test of time. Additionally, 70 percent of Tennesseans would pay less to the state than they are paying now because the tax share would be distributed more equitably across different income groups. With these steps in place, finally, legislators would be able to move beyond the perpetual cycle of budget shortfalls, and start making the kind of long-term plans necessary for a healthy and vibrant state like Tennessee.

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