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The Case against a Tennessee Income Tax

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On November 2 the Tennessee legislature will convene a special session to debate reform of the state tax system. The center of the controversy is whether Tennessee should adopt a personal income tax, as proposed by Gov. Don Sundquist, to close an estimated $400 million budget shortfall.

This study finds that a personal income tax in Tennessee would likely have two negative economic effects. First, an income tax would almost certainly reduce economic growth and job creation in the state. The absence of an income tax in Tennessee gives Tennessee a large competitive advantage over other states with which it competes for jobs and businesses. We find, for example, that Kentucky, a state very similar to Tennessee except that it has an income tax, has had considerably weaker economic performance since 1980. Between 1980 and 1998 the per capita economic growth rate of Tennessee was 47 percent compared to 36 percent in Kentucky.

The second negative effect of a state income tax would be to trigger much faster growth in state expenditures. That has been the almost universal pattern in other states after they enacted a state income tax. Yet the premise of pro–income tax forces in Tennessee that the state's revenues have been growing too slowly is contradicted by the evidence. In the 1990s, even without an income tax, Tennessee's per capita tax receipts have grown 12th fastest among the 50 states. Tennessee's tax revenues have climbed at twice the rate of inflation plus population growth. The legislature should be cutting taxes, not introducing new ones.

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Introduction

Tennessee is currently one of nine remaining states without a personal income tax.[1] That status may change later this year.

Tennessee's Republican governor Don Sundquist has called for a special session of the state legislature to consider tax reform alternatives. One objective of this special session is to close a state budget shortfall estimated at between $300 million and $500 million. The longer-term objective is to totally restructure the tax system in order to permanently raise more tax revenues. Sundquist has proposed a 3.75 percent personal income tax. This proposal is also supported by many business groups, the teachers union, and several leading academics in the state.[2]

It is noteworthy that in running for reelection in 1998 Sundquist never even broached the subject of an income tax with Tennessee voters. In 1994 when he first ran for governor, he pledged "never" to support an income tax.[3] There is also serious debate as to whether a state income tax would violate the Tennessee Constitution. In 1932 in *Evans v. McCabe*, the Tennessee Supreme Court held that an income tax was unconstitutional, though a 1981 Attorney General Opinion suggests otherwise.[4] Leading the charge against the income tax have been the Tennessee Family Institute and a number of state taxpayer organizations.[5] A recent poll suggests that by about a three-to-one margin, Tennessee residents are opposed to an income tax.[6]

Supporters of a personal income tax make three arguments in favor of this new tax. First, they argue that the Tennessee tax system is regressive, with a heavier share of the tax burden borne by low-income residents than in most other states. Second, they argue that the tax system is inelastic, meaning that tax receipts do not rise as fast as the state economy. Finally, they maintain that to improve the quality of education in Tennessee more spending and tax revenues will be necessary.

This study assesses the wisdom of a state income tax. The first section examines the recent budget and tax trends in Tennessee. We refute the underlying premise of "tax reform" advocates by showing that Tennessee's structural deficit problems are a result of a huge growth in state expenditures, not insufficient revenues. Next the study explores the potential fiscal and economic impact of introducing an income tax in the state. We show that the likely effect for the state would be higher state spending and lower economic growth. We conclude from this evidence that of all the options available to close the state budget deficit, introducing an income tax in Tennessee would likely be the single most economically harmful one. Tennessee derives large economic benefits from not having an income tax, and it should not forfeit those benefits.

Finally, we make a series of positive recommendations about how Tennessee could improve its fiscal climate. These recommendations include (1) tax and expenditure limits prohibiting the state budget from growing faster than personal income; (2) voter approval of any tax increase approved by the legislature; (3) a two-thirds supermajority requirement to raise taxes or debt; (4) reform of the TennCare program, which is the major source of the budget deficit; and (5) a half-cent reduction in the state sales tax rate.

How Tennessee's Budget Compares

The Tennessee budget shortfall has been caused exclusively by excessive spending, not insufficient revenue gains. To understand why this is the case, it is helpful to review the overall fiscal trends in the states and compare them with those in Tennessee.

Today, almost without exception, state governments are awash in tax revenues. Between 1992 and 1999 state revenues grew by more than 50 percent.[7] If over the period 1992 to 1998 states had restrained their spending and tax collections to inflation and

Table 1
Total State Expenditure (millions of 1997 dollars), 1990–97

State	Increase, 1990–97	Rank	1997	Rank	1990	Rank
U.S. Total	**27.2%**	---	**$893,827**	---	**$702,591**	---
Oregon	58.8%	1	$12,388	27	$7,803	29
Texas	52.9%	2	$48,887	3	$31,974	3
Mississippi	51.5%	3	$9,006	31	$5,943	31
Arkansas	48.1%	4	$7,685	32	$5,188	34
Georgia	46.5%	5	$21,975	13	$15,004	14
Idaho	46.1%	6	$3,674	43	$2,515	44
Utah	43.9%	7	$6,818	36	$4,738	37
Nevada	42.6%	8	$5,130	39	$3,598	41
Florida	40.4%	9	$37,464	5	$26,687	8
Missouri	39.1%	10	$14,230	21	$10,229	22
Tennessee	**38.4%**	**11**	**$14,284**	**20**	**$10,323**	**21**
West Virginia	38.1%	12	$7,145	34	$5,174	35
North Carolina	37.9%	13	$22,864	11	$16,576	12
New Mexico	37.7%	14	$7,059	35	$5,125	36
New Hampshire	37.2%	15	$3,324	45	$2,423	46

Sources: Bureau of the Census; and authors' calculations.

population growth, the state tax burden would be $75.2 billion lower today, or $278 less per person.[8]

The inflation-adjusted figures show that the states now spend roughly $600 more per person than they did in 1990. Over the past four years, two out of every three dollars of revenue surpluses have been spent on new and expanded government programs. Only about one-third of the surpluses has been returned to taxpayers.[9]

How does Tennessee fit into this general national picture of fiscal expansion? On the one hand, Tennessee remains a low-tax and low-spending state. Tennessee ranks in the bottom 10 among the 50 states in almost all categories of overall tax burden and spending burden. Taxes and spending are about $1,000 and $650, respectively, per person below the national average.[10] This status as a low-tax state confers large comparative economic advantage to businesses and residents in the state. Over the past 10 years, Tennessee has ranked in the top 10 in almost all measures of economic health, such as new-business start-ups in the 1990s. The Small Business Survival Committee ranks Tennessee as having the ninth-best climate for business. It notes that Tennessee's low tax burden is one of the state's most important business-friendly policies. The after-tax rate of return on capital and investment in Tennessee is one of the highest in the nation.[11]

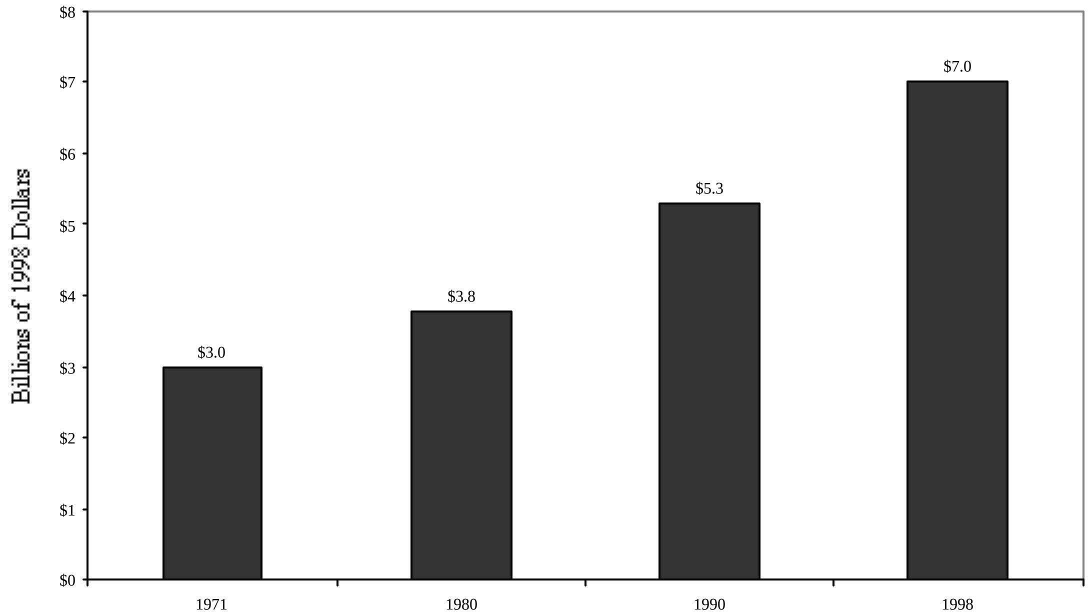
However, there are indications that Tennessee's comparative advantage on fiscal policy is slowly eroding. The trend data indicate that in recent years state lawmakers in Nashville have relied on huge surges in tax receipts to build up the budget at a rapid pace.

Since 1990, Tennessee has substantially outspent other states, and its tax burden has risen more rapidly than all but a handful of states (see Tables 1 and 2).

With respect to expenditures, Tennessee ranks 11th in overall growth of spending from 1990 to 1997. The national average for

The Tennessee budget shortfall has been caused exclusively by excessive spending, not insufficient revenue gains.

Figure 1
Tax Revenue, FY71 to FY98



Sources: Bureau of the Census; Center for the Study of the States; and Cato Institute.

Tennessee's low tax burden is one of the state's most important business-friendly policies.

inflation-adjusted spending growth was 27.2 percent. In Tennessee the budget grew in real terms by 38.4 percent.

It is true that Tennessee has experienced a boomlet in population gains over this period, which accounts for some of the extra spending—but not all of it. When we adjust for population growth, we find that per capita budget growth in Tennessee in the 1990s has risen 12th fastest of the 50 states.

Taxes, meanwhile, have grown at twice the rate of population plus inflation over the period 1992 to 1998. To be precise, from 1992 to 1998 Tennessee revenues rose by 54.5 percent, whereas population and inflation grew by just 24.7 percent. In 1999 the state government of Tennessee collected $1.4 billion *more* than it would have if tax collections had been restrained to personal income growth. If this extra tax collection had been distributed to the families of Tennessee, the typical family of four would have received a $1,000 tax rebate in 1999 (see Table 3).

The argument has been made by Governor Sundquist that intergovernmental expenditures account for the large rise in overall expenditures. But that proposition is unsupported by the data. From 1990 to 1997 total state spending rose by 70 percent, and total state spending minus intergovernmental spending rose by 72 percent. Not much difference.[12]

It is sometimes instructive to take a long-term view of state budget trends to get a historical perspective of state government. Figure 1 shows that in 1971 state tax collections equaled $3 billion in inflation-adjusted terms. By 1998 the budget increased to around $7 billion. By the next fiscal year, 2001, even without an income tax, the tax take in Tennessee will climb to $8 billion. In less than 30 years, the state tax collections have increased eightfold.

In fact, our analysis shows that Tennessee has had robust gains in tax collections (11th fastest in the nation).[13] A state budget deficit has emerged because those revenue gains have not been able to keep pace with a decade-long budgetary expansion. The major source of the

Table 2
Per Capita Total State Expenditure (millions of 1997 dollars)

State	Increase, 1990–97	Rank	1997	Rank	1990	Rank
U.S. Total	**18.6%**	---	**$3,340**	---	**$2,817**	---
Mississippi	43.0%	1	$3,298	26	$2,306	41
Oregon	39.9%	2	$3,819	13	$2,730	29
Arkansas	38.2%	3	$3,046	33	$2,204	45
West Virginia	36.3%	4	$3,935	12	$2,887	21
Texas	34.1%	5	$2,515	50	$1,876	50
Missouri	32.0%	6	$2,634	48	$1,995	49
New Hampshire	30.1%	7	$2,834	42	$2,179	46
Nebraska	29.2%	8	$2,898	38	$2,242	44
Pennsylvania	29.0%	9	$3,269	29	$2,533	32
Kentucky	28.1%	10	$3,313	24	$2,586	30
Georgia	27.3%	11	$2,935	37	$2,306	42
Tennessee	**26.1%**	**12**	**$2,661**	**47**	**$2,111**	**47**
Illinois	25.3%	13	$2,968	36	$2,369	39
Florida	24.7%	14	$2,557	49	$2,050	48
Kansas	24.0%	15	$2,889	40	$2,330	40

Sources: Bureau of the Census; and authors' calculations.

spending acceleration has been social services and health care—two components of spending that add little value to the economic competitiveness of the state. In particular, TennCare, the state's alternative to Medicaid introduced at the start of this decade, has experienced rampaging costs, as discussed below.

Has the Spending Spree Continued in Recent Years?

All of the above data come from the U.S. Bureau of the Census state fiscal reports through 1998. This is the best data available for making interstate comparisons on taxes and spending. What about the most recent Tennessee budgets? Have the trends of excessive taxes and spending continued?

Using the Tennessee Senate Finance and House Ways and Means committee data we examined the most up-to-date general fund figures for the period 1997–2000. We find no discernible change in the trend of spending and taxing. In FY98 the budget rose only slightly. But in 1999 and 2000 Tennessee had one of the largest increases in expenditures of any state. Table 4 shows that from 1997 to 2000 state spending rose by 15 percent versus 12 percent growth of population and inflation in Tennessee. Tax collections slightly outpaced population growth plus inflation (13 percent versus 12 percent).

There is some question as to whether the Tennessee Constitution even allows for this rapid growth in expenditures. According to Article 2, Section 8 of the state's constitution:

> In no year shall the rate of growth of appropriations from state tax revenues exceed the estimated rate of growth of the state's economy as determined by law. No appropriation in excess of this limitation shall be made unless the General Assembly shall, by law con-

Since 1990, Tennessee has substantially outspent other states, and its tax burden has risen more rapidly than all but a handful of states.

Table 3
States Saw $75 Billion Revenue Windfall in 1998 (tax revenue figures in millions of dollars)

	Actual Tax Revenue 1992	Actual Tax Revenue 1998	Actual 1992–98 Increase	1992–98 Population Growth	1992–98 CPI Growth	1992–98 Population Growth + Inflation	Est. 1998 Revenue with Pop. Growth + Inflation Cap	1998 Revenue Windfall	1998 per Capita Revenue Windfall
U.S. Total	$327,822	$476,250	45.3%	6.0%	16.3%	22.3%	$401,004	$75,246	$278
Tennessee	$4,526	$6,991	54.5%	8.3%	16.3%	24.7%	$5,642	$1,349	$248

Sources: Bureau of the Census; Center for the Study of the States; Cato Institute.

taining no other subject matter, set forth the dollar amount and the rate by which the limit will be exceeded.

We should also note that there are at least eight states that are prohibited by law or by state constitution from spending or taxing faster than population growth and inflation, as Tennessee has done throughout the past decade.[14]

Where Has the Tennessee Budget Expanded Most?

In Table 5 we present the component breakdown of the state budget from 1990 to 2000. The data is disturbing from the standpoint of promoting economic growth because Tennessee's budget has inflated in precisely those areas that provide Tennessee workers and residents with the least economic return for their tax dollars. The preponderance of the spending hikes has not been devoted to schools, roads, bridges, prisons, and other items that are infrastructure enhancements—although even those items of the budget have grown fairly rapidly. Instead, the inflated areas of budget growth have been in unproductive income-transfer spending: health, welfare, government salaries, and debt service.

The TennCare Time Bomb

TennCare was first introduced in the early 1990s. The program moved the entire Medicaid system in Tennessee from a traditional fee-for-service plan to a health maintenance organization plan. Its supporters touted it as a cost-saving plan. More Tennessee residents would be served, but cost controls would trim the rapid growth in health care costs of the 1990s. The program was launched under the previous governor, Ned McWherter.

Today, the claim that TennCare will save money for state taxpayers could hardly be more thoroughly contradicted by the actual financial results of the program. From the very outset, TennCare has been crippled by a raging inflation in its costs. Even as the national rate of Medicaid expenditure growth mercifully started to slow, TennCare's health care costs accelerated. Cost control features crumbled as caseloads rose.

Table 6 presents the devastating comparative data between TennCare and nationwide Medicaid spending. From 1994 through 2000, TennCare's cost will have risen by 59 percent versus 23 percent for the rest of the states. If TennCare's costs had simply grown at the rate of the national average since 1994, the state budget would be almost $1 billion lower in 2000.

This finding has been confirmed by other analyses. A 1997 study by the Citizens

Table 4
Tennessee State Budget

	FY94	FY97	FY98	FY99	FY 2000*	1994–2000, %Change	1994–2000, Population Change + Inflation*	1997–2000 % Change	1997–2000, Population Change + Inflation*
Total	$12,325,910,200	$14,529,392,000	$14,553,138,200	$15,996,204,990	$16,702,916,460	36%	25%	15%	12%
State	6,226,346,300	7,140,369,900	7,392,089,800	7,987,938,890	8,292,539,160	33%		16%	
Federal	3,946,512,900	4,754,841,600	4,900,817,800	5,246,264,700	5,866,777,400	49%		23%	
Bonds	361,800,000	524,600,000	135,800,000	352,500,000	137,726,000	-62%		-74%	
Other	1,791,251,000	2,109,580,500	2,124,430,600	2,409,501,400	2,405,873,900	34%		14%	
State Revenue									
Total	$5,938,158,100	$6,933,501,400	$7,346,687,300	$7,555,600,000	$7,801,300,000	31%	25%	13%	12%

Sources: Senate Finance and House Ways and Means Committee Staff, FY94–FY99 Green Book, March 1999, p. 44; and Cato Institute.
* Year 2000 data based on forecast of inflation and Bureau of the Census estimate of population growth.

for a Sound Economy Foundation rated the fiscal health of state Medicaid programs. Tennessee received a grade of D minus, one of the five worst in the nation.[15]

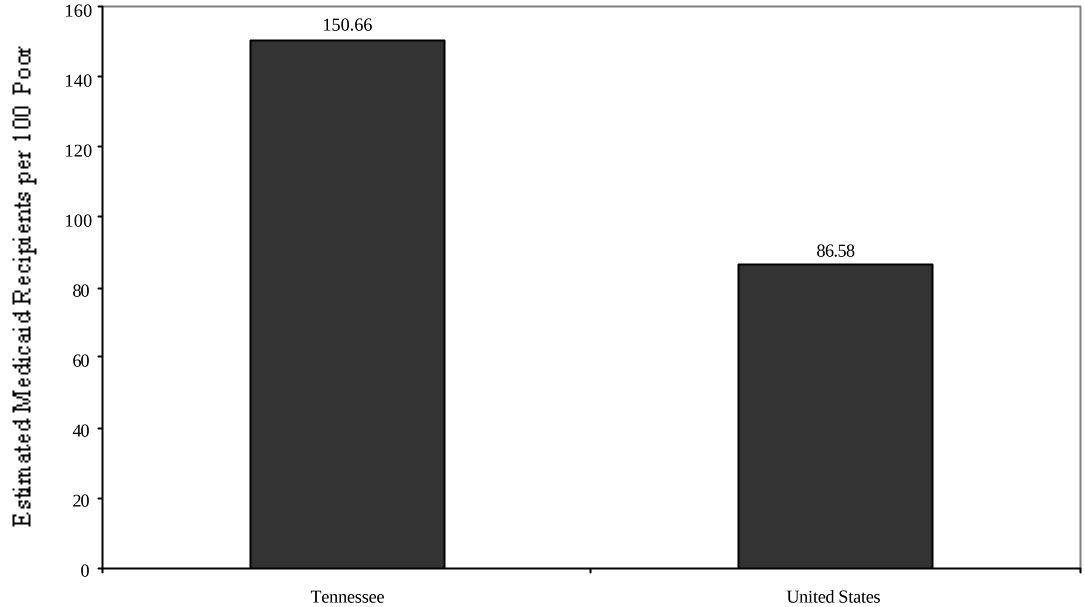
One reason that TennCare has been unable to constrain costs has been the moral hazard problem associated with free health care. The lure of free care has created a stampede of new entrants into the program—some dropping their private insurance voluntarily. One result of TennCare that the Citizens for a Sound Economy study found was that TennCare has the highest ratio of recipients to poor people in the nation.

More recent data on Medicaid and poverty rates for 1997 and 1998 show that the trend of TennCare's financial problems and overenrollment has deteriorated. Nationwide about 86 of every 100 poor people receive Medicaid. In Tennessee, incredibly, for every 100 poor residents, there are 151 recipients of TennCare (see Figure 2). In other words, almost one-third of those receiving TennCare are technically not considered poor. Another financial problem saddling the TennCare program includes massive fraud, such as payments to dead people and payments to out-of-state residents.

Even advocates of TennCare concede that its caseloads have shot up astronomically. State Comptroller John Morgan recently stated that there are "over 500,000 Tennesseans who would not have been eligible for Medicaid coverage who enjoy comprehensive health insurance benefits" under TennCare.[16] Simply eliminating the inflated caseloads for TennCare would single-handedly bring the budget back into balance—even if no other corrective fiscal actions were taken.

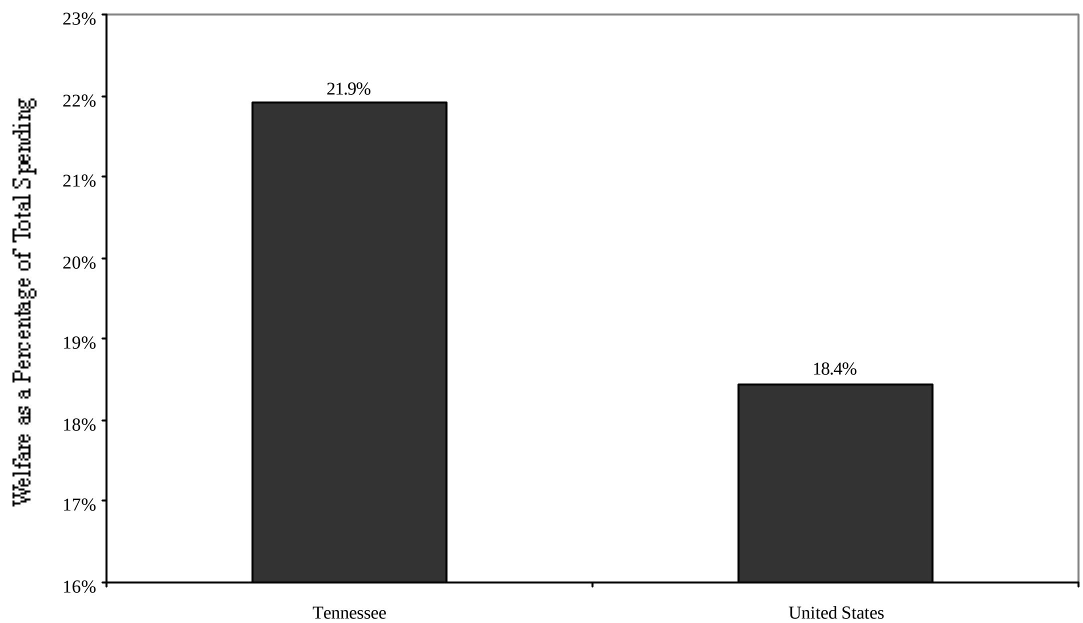
Figure 3 shows the proportion of total current state and local direct general expenditures going for the broad category "welfare" in FY96, the last year comprehensive Census data were reported, including both state and local governments (the proportion of the welfare function performed at the local level varies from state to state, so the appropriate data for comparison purposes should include local government). In Tennessee, welfare absorbs about a 20 percent larger proportion of total current expenditures than it does in the rest of the nation. Also, a larger proportion of the income of the residents of Tennessee went to support welfare than was the case nationwide. The dominant reason for this is the Tennessee Medicaid program, TennCare. In Tennessee, the coverage under this medical assistance program is wildly out of line with standards nationwide.

Figure 2
Estimated Medicaid Recipients per 100 Poor, 1997–98



Source: U.S. Department of Commerce; U.S. Department of Health and Human Services; and authors' calculations.

Figure 3
Welfare as a Percentage of Total Spending: 1996



Source: Bureau of the Census.

Table 5
Categories of Spending in Tennessee State Budget

	FY90	FY99	FY 2000	% Change
General government	$314,364,900	$599,125,440	$687,716,300	119%
K–12 education	1,628,486,700	2,904,929,300	2,982,357,500	83%
Higher education	1,044,935,100	1,809,891,200	1,906,859,800	82%
Health and social services	2,263,784,100	6,311,688,400	7,079,604,800	213%
Law, safety, and correction	488,692,900	838,562,000	878,132,700	80%
Resources and regulation	224,413,000	470,382,850	624,414,800	178%
Transportation, business, and economic development	1,101,459,800	1,445,666,100	1,475,061,700	34%
Debt service	120,248,000	271,810,000	262,480,860	118%
Counties and cities	434,700,000	608,400,000	641,800,000	48%

Sources: Tennessee General Assembly Fact Books, FY89–90, FY98–99, and FY99–00.

Why New Taxes Are Not Necessary

Governor Sundquist and Tennessee legislators allege that their budgets are rising because they are facing increased demands to spend in the 1990s.[17] For example, Sundquist argues that with the renewed emphasis on states' rights and federalism under the Republican Congress, the federal government is devolving more spending responsibilities to the states—in such areas as welfare and criminal justice—without a commensurate increase in resources.

The truth is, however, that federal spending on grants to states and localities has been growing, not falling. Federal grants to state and local governments did decline in the 1980s, from $155.7 billion in 1980 to $144.7 billion in 1990 after adjusting for inflation—a reduction of 7.1 percent. Real federal aid remained level throughout the mid-1980s and has surged since 1987. From 1990 to 1998, federal aid rose by almost half in real terms, from $144.7 billion to $215.9 billion.[18] So real federal aid is about 40 percent higher now than it was in 1980.

It is true that there are certain high-priority areas of Tennessee's budget where the public is demanding more funding. One of those areas is law enforcement. As the public continues to adopt a "lock 'em up" attitude toward criminals, Tennessee's spending on prisons, police, and the courts has almost doubled. Tennessee is also under a court-ordered school financing equity requirement that has caused education funding to surge.

Yet there are factors that have generated substantial budgetary savings for states in the 1990s and should be contributing to shrinking state budgets. Most of these factors are related to the robust U.S. economy.

The first factor is declining interest rates. Tennessee is a net borrower on a large scale. The state borrows to fund highways, school construction, prisons, and other capital spending. In 2000 the state paid $262 million in debt-service costs.[19] But long-term interest rates over the past six years have fallen by some 200 basis points. Hence, the cost for Tennessee to service its debt has fallen in recent years.

The second factor has been the impact of a strong economy and welfare reform legislation on welfare caseloads. Welfare reform has been an astonishing success story in the states and at the national level. Following the lead of the states, the federal government in 1996 adopted work requirements, time limits, and new eligibility restrictions for welfare benefits.

In Tennessee, for every 100 poor residents, there are 151 recipients of TennCare. In other words, almost one-third of those receiving TennCare are technically not considered poor.

Table 6
Medicaid versus TennCare

	FY94	FY99	FY 2000	% Change
TennCare Expenditures*	$2,731,828,998	$4,013,117,200	$4,338,070,000	59%
Total nationwide Medicaid spending	$131,000,000,000	$156,000,000,000	$161,000,000,000	23%

Sources: Tennessee General Assembly Fact Books, FY94–95 and FY99–00; and National Association of State Budget Officers.
* TennCare began on January 1, 1994.

The result has been that welfare rolls have fallen by 42 percent nationwide since 1994.[20] Tennessee has been a laggard in this regard because of programs like TennCare, which attract new clients. Since welfare is the second-largest component of the Tennessee budget, there should have been tens of millions of dollars of expenditure savings from reduced payments.[21] Unfortunately, Tennessee has misallocated much of those savings into new areas of spending—such as day care, job training, and TennCare.

We should add that welfare remains quite generous in Tennessee and usually pays more than a typical starter job.[22] A woman with two children receiving the full array of welfare benefits in Tennessee—including food stamps, Temporary Assistance to Needy Families, TennCare, public housing, and utility subsidies—receives the equivalent income of $6.60 per hour.[23]

New revenues and budgetary savings have simply helped finance an explosion of expenditures in other areas of state budgets.

A third economic factor benefiting the states financially has been the steady decline in unemployment. Each year states spend about $20 billion on unemployment benefits.[24] Today the unemployment rate is at its lowest level in 20 years, and it is especially low in Tennessee, where the problem is not a shortage of jobs but a shortage of workers. The increase in workers' payments into unemployment compensation systems and the decline in the number of unemployed people drawing benefits have created huge and in some cases unprecedented surpluses in state unemployment insurance trust funds.

Finally, and most importantly, over the next 25 years, the state of Tennessee will receive huge payments in the tobacco litigation settlement. In November 1998, 46 states, including Tennessee, reached an agreement with the tobacco industry on a $206 billion settlement of their suit over the medical treatment costs of smoking-related illnesses.[25]

This massive windfall will provide a steady stream of extra cash into the state coffers over the next two decades at least. Ultimately, the tobacco settlement money should be used to cut other taxes, such as the overall sales tax. Clearly, the state does not need to be raising other taxes at precisely the moment it is receiving hundreds of millions of dollars a year from tobacco companies.

When all of these factors are taken together, it would be reasonable to expect that Tennessee's budget situation would be strong. Pressures on expenditures are falling. Revenues are surging. Unfortunately, new revenues and budgetary savings have simply helped finance an explosion of expenditures in other areas of state budgets.

Is a Tennessee Income Tax Desirable?

One of the lead options for closing the budget shortfall in Tennessee is to adopt a personal income tax. Proponents of the state income tax say that the plan would have several positive effects:

1. It would increase state revenue, thus closing future budget shortfalls.
2. It would help alleviate inequities in the

Table 7
1990s Economic Growth in 10 Highest-Tax States and 10 Lowest-Tax States

State	1990 per Capita State Tax Revenue (1997$)	U.S. Rank	Population Growth 1990–97	U.S. Rank	Real Personal Income Growth 1990–97	U.S. Rank	Employment Growth 1990–97	U.S. Rank
U.S. Total	$1,446		7.3%		16.5%		9.1%	
High-Tax States								
Alaska	$3,435	1	10.2%	13	6.1%	47	15.8%	12
Hawaii	$2,578	2	6.7%	23	3.6%	50	3.8%	43
Delaware	$2,074	3	9.3%	16	17.3%	21	7.0%	35
Connecticut	$1,968	4	-0.6%	49	10.0%	40	-6.0%	50
New York	$1,953	5	0.8%	47	7.5%	46	-1.6%	49
Massachusetts	$1,913	6	1.7%	43	11.2%	36	3.2%	46
Minnesota	$1,910	7	6.8%	21	18.1%	17	11.9%	20
Washington	$1,861	8	14.5%	7	25.5%	10	18.0%	7
California	$1,782	9	7.8%	18	7.7%	45	4.5%	42
Wyoming	$1,657	10	5.8%	28	13.4%	34	6.7%	37
High-Tax States Total			5.5%		9.9%		3.9%	
Low-Tax States								
New Hampshire	$658	50	5.5%	30	15.2%	29	5.6%	40
South Dakota	$882	49	5.9%	26	17.9%	18	14.1%	14
Texas	$1,061	48	14.0%	8	27.0%	8	15.8%	11
Tennessee	$1,066	47	9.8%	15	24.6%	11	13.3%	16
Colorado	$1,141	46	17.8%	5	34.3%	3	24.6%	4
Mississippi	$1,142	45	5.9%	25	22.8%	13	9.1%	30
Alabama	$1,159	44	6.7%	22	18.2%	16	17.3%	8
Nebraska	$1,176	43	4.8%	35	15.1%	30	10.9%	24
Arkansas	$1,180	42	7.2%	20	21.9%	14	9.5%	29
Missouri	$1,184	41	5.4%	33	15.4%	26	13.2%	17
Low-Tax States Total			10.5%		23.7%		14.9%	

Sources: Bureau of the Census; and authors' calculations.

business tax structure.

3. It would increase "tax fairness" by placing a greater share of the tax burden on wealthier Tennessee residents.
4. It would finance a reduction in the state sales tax rate, thus reducing lost retail sales to out-of-state vendors.

But each of these arguments avoids the central point: Tennessee derives substantial economic gains from being one of nine non–income tax states. There is substantial evidence that if Tennessee were to adopt an income tax, its growth rate would be lower than it would be without an income tax. By reducing economic growth, an income tax will surely make the tax burden on businesses heavier, not lighter; it will make the tax struc-

The negative relationship between taxes and growth at the state level is still as pronounced as ever.

People voted with their feet to leave the jurisdictions that taxed their productive activities for those places that did not—at a rate of 38 per hour, for over eight years.

ture more unfair for the poor because there will be fewer economic opportunities and lower after-tax wages; and it will accelerate state spending, thus perpetuating deficits.

How State Taxes Influence Economic Growth

There is increasing evidence that state tax and budget policies can have a significant effect on the relative economic performance among states. Studies have consistently shown that states with high and rising tax burdens are more likely to suffer through economic decline, while those with lower and falling tax burdens are more likely to enjoy robust economic growth.[26] For example, a 1996 study by the Federal Reserve Board of Atlanta examined state economic performance from 1960 to 1992 and found that "Tax rates [average and marginal] are negatively related to growth and are sufficiently variable over time to reasonably explain variations in growth rates."[27]

A study by the Joint Economic Committee of Congress examined the economic growth records in the 10 states that had raised taxes the most in FY90 through FY93 and the 10 states that had cut taxes the most over that same period. The top-10 tax-hiking states experienced a net gain of only 3,000 new jobs, an increase in the unemployment rate of 2.2 percentage points, and a $484 real *decline* in personal income per family of four. In contrast, the top-10 tax-cutting states gained 653,000 net new jobs, an *increase* in the unemployment rate of only 0.6 percentage points, and a $300 real *increase* in personal income per family of four.[28]

The contrast was even greater when only income tax changes were considered. The top-10 income tax–hiking states experienced cumulatively the net *loss* of 182,000 jobs, a 2.3 percentage point increase in the unemployment rate, and a $613 real *decline* in personal income per family of four. The top-10 income tax–cutting states gained cumulatively 975,000 net new jobs, an *increase* in the unemployment rate of only 0.3 percentage points, and a $148 real increase in personal income per family of four.[29] Other studies have found similar correlations between high taxes and slow economic growth.

We have updated the 1993 Joint Economic Committee analysis using Census Bureau data through 1997. We find that the negative relationship between taxes and growth at the state level is still as pronounced as ever. Table 7 shows our findings. The 10 states with the highest per capita state tax burdens in 1990 experienced economic growth that was at most half the rate of the 10 states with the lowest per capita state tax burdens.

- Population growth was 10.5 percent in the lowest-tax states versus only 5.5 percent in the highest-tax states.
- Real personal income grew by 23.7 percent in the lowest-tax states but by only 9.9 percent in the highest-tax states.
- Job growth was 14.9 percent in the lowest-tax states compared to only 3.9 percent in the highest-tax states.

We also found that state tax hikes are associated with worsening instead of improving bond ratings. A comparison of tax-raising and tax-cutting states in the early 1990s found that in the tax-cutting states, the average Moody's bond rating in 1995 was between Aaa and Aa. In the tax-raising states, the average Moody's bond rating was between Aa and A1. Moreover, the tax-cutting states had much larger budget reserves (7.1 percent of state expenditures) than did the tax-increasing states (1.7 percent).[30]

Because state tax cuts can stimulate economic development, whereas state tax hikes can retard it, revenue growth is often faster than anticipated in the tax-cutting states and slower than anticipated in the tax–raising states. After California's record $7 billion tax hike in 1991, actual revenue growth came in below projections for each of the next three years. The same was the case in New Jersey. New York is perhaps the most amazing story of all. Tax increases in the late 1980s produced anemic revenue growth for the state treasury. But revenues have been climbing so rapidly since Gov. George Pataki's tax cuts in 1995 that according to the Empire Foundation, a New York taxpayer watchdog group, "Even when the final and deepest phase of New York's income cut was implemented [in 1997], the state's resurgent economy generated more income tax revenue under Gov. George Pataki than it ever did under former Gov. Mario Cuomo."[31]

While sales taxation is directed at consumption, income taxation is directed at output, since incomes are created in the production of output. One sure legal way to avoid income taxes is to be unproductive, that is, to stop earning income. Another legal means of tax avoidance is to move out of the state. Thus states with high income taxes will have less productive activity inside their borders, as individuals reduce work effort or move.

Migration patterns across states confirm the theory: Americans do move from high- to low-tax states in very large numbers. From April 1, 1990, through June 30, 1998, on net 2,686,958 native born Americans moved from the 41 states that had comprehensive individual income taxes to the nine states, including Tennessee, that did not.[32] People voted with their feet to leave the jurisdictions that taxed their productive activities for those places that did not—at a rate of 38 per hour, every hour, day and night, for over eight years.

Economic theory suggests that the imposition of an income tax in Tennessee would also promote capital flight. The reduction in labor supply implicit in the out-migration of population, other things equal, will tend to increase market-wage rates, raising the cost of doing business and ultimately squeezing profit margins for firms competing in interstate commerce. Consider a pilot who is contemplating taking a job at Federal Express in Memphis at $70,000 annually. Before the income tax, he considers that sum reasonable compensation and agrees to go to work for FedEx. Suppose, however, that a 5 percent income tax is imposed. After some exemptions and deductions, that tax exacts a $2,000 net cost on the pilot (whose federal tax liability will also fall somewhat because of deductibility of state income taxes against the federal tax). At the margin, the imposition of the tax makes the position less attractive at a salary of $70,000, and he declines the offer. Only by increasing the salary to, say, $73,000, can FedEx obtain the needed pilot, raising labor costs in this example by about 4 percent. A personal income tax will raise labor costs for Tennessee businesses, increasing incentives to move elsewhere or not to locate in Tennessee.

Case Study: Tennessee versus Kentucky

The impact that taxes have on economic growth is perhaps most vividly seen by looking at the experience of Tennessee and its neighbors. Of the Volunteer State's eight neighbors, Kentucky has the longest border and is probably the state most similar to Tennessee in most respects, including, historically at least, economically. For example, in 1980, per capita income in the two states differed by only eight dollars (0.1 percent).

Kentucky's income tax was a key factor in its relative stagnation.

One way in which Kentucky deviates markedly from Tennessee, however, is in tax policy. In 1980 state and local taxes as a percent of personal income were about 10 percent higher in Kentucky than in Tennessee, with the critical difference being that Kentucky levied a personal income tax and Tennessee did not. From 1980 to 1996, Tennessee maintained its low-tax climate, with taxes as a percent of personal income actually falling slightly. By contrast, Kentucky went in the opposite direction: taxes rose more than in any of the nine states bordering Tennessee (including Tennessee). Kentucky's income tax burden expanded enormously. By 1996 taxes per $1,000 in personal income were $117.29 in Kentucky but only $90.42 in Tennessee. The Kentucky tax burden was nearly 30 percent higher than in the Volunteer State.

What happened to the economies of the two states? Both grew, but Tennessee's percentage growth in real output per capita was more than one-third larger than Kentucky's (see Figure 4). Whereas in 1998 dollars Tennessee's income per capita was a minuscule $16 higher than in 1980, by 1998 the income disparity had grown to $2,064. It now takes the typical Kentuckian 13 months to make the income that a resident of Tennessee makes in a year.

For two reasons, Kentucky's income tax was a key factor in its relative stagnation. First, as stated above, dollar for dollar, income taxes are worse than other taxes, since they are a direct burden on production and income. Second, over time, income tax revenues typically rise faster than incomes, so the overall tax burden tends to rise automatically in states relying on income taxes, unlike with states where sales, property, and other forms of taxation dominate. Since, dollar for dollar, private sector activity is more efficient and growth-inducing than public sector spending, the effect of income taxes' increasing the size of the public sector also retards economic growth in the long run.

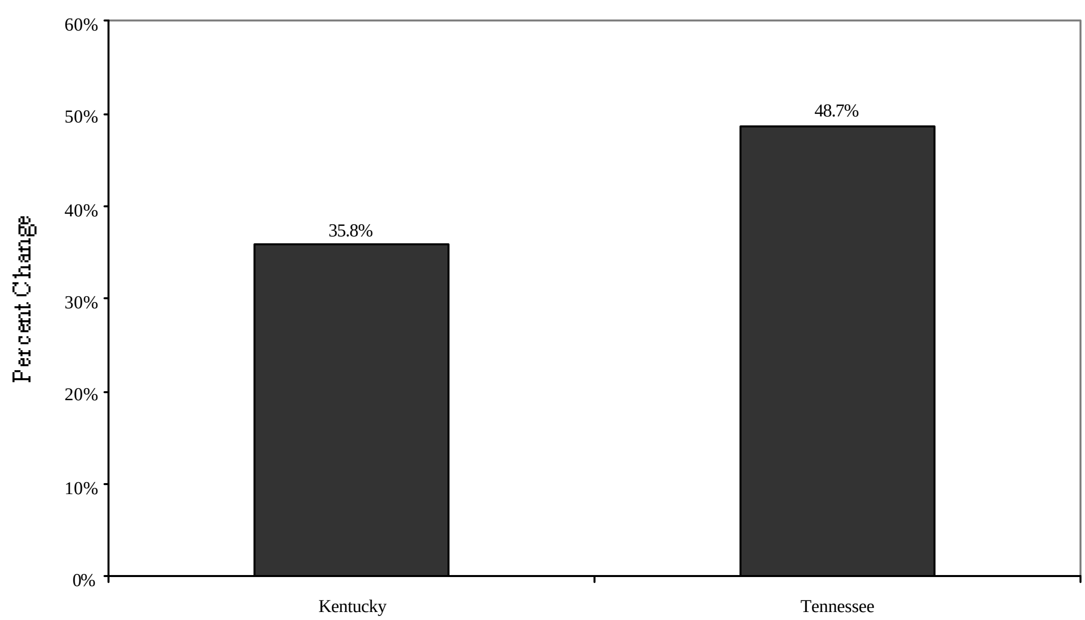
The Impact of Income Taxes on State Budgets

One almost certain impact of a state income tax in Tennessee will be to further accelerate the rise in the state budget. Income tax enthusiasts have even admitted that an income tax is necessary to fund some $582 million in new program expansions in the 2000–2001 state budget.[33]

A landmark study by economist Thomas Dye of Florida State University has documented that when states introduce an income tax, the impact has been almost uniform.[34] First, governmental expenditures rise dramatically; second, the overall tax burden

There is no truth to the claim that school funding is being short-changed in Tennessee.

Figure 4
Economic Growth, 1980–98



Sources: U.S. Department of Commerce; authors' calculations.

Table 8
The Growth of the Basic Education Program

	FY90	FY99	FY 2000	% Change
K–12 education	$1,628,486,700	$2,904,929,300	$2,982,357,500	83%

Sources: Tennessee General Assembly Fact Books, FY89–90, FY98–99, and FY99–00.

"The unanimous conclusion is that there is no connection between school funding and school performance."

rises (i.e., income taxes are never full substitutes for other taxes); and third, the economic growth rate of the state falls.

Taxes and Schools

One rationale for the state income tax is that it will fund more and better schools in Tennessee. It is understandable that politicians are sensitive to this argument. Public opinion polls consistently show that education is a top priority in our society. But the reality is that there is no evidence that higher funding leads to better schools.[35] If more money were the answer to improving education, then the highest-spending states would have the finest education systems in the land and the lowest-spending states would be performing poorly. But Tennessee officials who believe that increased education funding is the solution to better school performance may be interested to learn that in 1997 the 10 highest-spending states spent twice as much as the 10 lowest-spending states, but average SAT scores in the more frugal states were 16 percent higher than in the big-spending states.[36]

There is no debate that America's schools need to do a better job of educating our children if the nation is to remain internationally competitive in the next century. Spending more money on the public schools, however, has been tried in earnest for decades, and it has yielded at best mixed results. As education analysts John Chubb and Terry Moe of the Brookings Institution have noted: "As for money, the relationship between it and effective schools has been studied to death. The unanimous conclusion is that there is no connection between school funding and school performance."[37]

The famous Kansas City school experiment of the 1980s and 1990s tells a cautionary tale to education officials in Tennessee who believe that deluging schools with money will magically lead to better performance. Kansas City spent $2 billion to improve its public schools, raising per pupil expenditures to $11,700, but after 10 years found almost no achievement-based results. In fact, after 10 years of this massive infusion of funds, test scores continued to fall, and white flight from the inner-city schools accelerated.[38]

Tennessee has been repeating this experiment with the same unpromising results. Table 8 shows that the passage of the Basic Education Program (BEP) in Tennessee in 1992, designed to increase school-financing equity, has led to a more than $1 billion increase in state spending on K–12 schools over the past eight years.[39] There is no truth to the claim that school funding is being shortchanged in Tennessee.

New solutions, including choice in education, charter schools, teacher pay for performance, and ending tenure to get rid of bad teachers, would seem to be much more promising ways for improving the Tennessee schools than simply writing larger checks to an ailing public school system.

Policy Recommendations

A Tennessee personal income tax appears

If tax collections had grown only at the pace of population growth plus inflation, the average Tennessee family of four would have paid $1,000 less in state taxes in 1999.

highly inadvisable to us on both fiscal and economic grounds. The result will be slower growth and higher government spending. So what positive steps should be taken to improve the tax system in Tennessee?

1. Adopt tax and expenditure limitation measures. These measures should by law restrain tax collections and spending increases to personal income growth in the state. The evidence suggests that states with tax and expenditure limitations have done a better job restraining state government growth than states without such disciplining measures.[40]

   California, Colorado, Missouri, and Washington each have constitutional tax limitations that restrict the growth of revenues to the rate of population growth plus inflation. These states generally require that any revenue in excess of that amount be rebated to the people. For example, in 1997 Colorado rebated $140 million in tax revenues to taxpayers, while Missouri gave back $318 million in rebate tax credits.[41]

   A Tennessee tax and expenditure limitation should require the state legislature to rebate excess tax collections to Tennessee families and businesses on a pro-rata basis at the end of each fiscal year.
2. Reform TennCare: The program is bankrupting the state with stampeding costs and the most inflated enrollment of any Medicaid program in the nation. Tennessee should return to conventional Medicaid coverage and reimburse only for essential medical services. If TennCare cannot be dismantled for political reasons, the only way to restrain costs is to cap overall expenditures and place a ceiling on overall enrollment.
3. Reduce corporate welfare spending. The state of Tennessee now spends nearly $1.5 billion a year on "economic development." Some of those activities, such as transportation improvements may be necessary. But others, as in the area of special spending concessions for businesses, are unnecessary. The best economic development program for Tennessee is its lack of an income tax.
4. Freeze state government hiring and salaries. In the 1990s Tennessee has had the 13th-largest increase in state-local government employment. Meanwhile, state government compensation is at least 20 percent higher than what is paid to comparably skilled private sector workers.[42] A salary and hiring freeze, until the budget crisis is over, would allow private sector compensation to "catch up" with the compensation paid to government workers.
5. Reserve the tobacco litigation settlement money for closing the budget shortfall, not for new spending. Tennessee is scheduled to receive hundreds of millions of dollars over the next 25 years in lawsuit funds from the tobacco companies. This revenue windfall should provide ample funds to help balance the budget without any new taxes.
6. Require a supermajority vote to raise taxes. Thirteen states, including Arizona, California, and Nevada, have adopted measures requiring that any tax increase by the legislature must pass by a supermajority vote in both houses. Most require a two-thirds vote, but others require three-fourths or three-fifths. Those measures have been highly effective at deterring routine tax increases during nonemergencies.[43] Supermajority requirements are most effective when they are applied to all tax increases—whether they apply to income taxes, business taxes, sales taxes, or excise taxes.
7. Reduce the sales tax by at least one-half of 1 percent. Tennessee loses retail sales because of cross-border activity. On this point almost all participants in the tax reform debate agree. If the recommendations in this analysis were adopted, a surplus would emerge large enough to begin lowering the state sales tax. The

"static" revenue loss will not be equal to the actual revenue impact of this tax rate reduction. Some of the reduction in tax revenues from a lower rate will be recouped through increased retail sales.

Conclusion

Despite Governor Sundquist's claims that his administration has been fiscally conservative, the truth is that the budget crisis in Tennessee is a result of steady and ultimately unsustainable budget increases over the past decade. In the 1990s the state budget has grown by roughly 75 percent in nominal terms and by about 45 percent in real terms. The spending acceleration has been particularly pronounced in recent years, even as budget deficits loomed on the horizon. Tax collections have increased at a robust pace—in fact, a pace that most other states would be very pleased if they could equal. If tax collections had grown only at the pace of population growth plus inflation (as is required by law in many states), the average Tennessee family of four would have paid $1,000 *less* in state taxes in 1999.

Clearly, more revenues—through an income tax or any new redesigned tax system—will do little to reinstall fiscal discipline in Nashville. What is needed is a series of fiscal reforms aimed at slowing future expenditures.

Notes

1. The other eight are Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming.

2. For a summary of the arguments in favor of the Tennessee income tax, see "The Tax Reform Issue," *Tennessee's Business* 9, no. 2 (1999).

3. "Spend Then Tax," *Wall Street Journal*, August 20, 1999.

4. See *Evans v. McCabe*, 164 Tenn. 672; 52 S.W.2d 159 (1931); and Tennessee Attorney General Opinions (OAG 507), September 2, 1981.

5. See the latest report by the Tennessee Family Institute, "A Tennessee Income Tax: The Dread Enemy of Prosperity," Nashville, Tennessee, July 6, 1999.

6. John Shiffman, "Voters Don't Buy Tax Crisis; 'Tennessean' Poll Shows Income Tax Unpopular," *Tennessean*, April 25, 1999, p. 1A.

7. Stephen Moore and Dean Stansel, "The State Spending Spree of the 1990s," Cato Institute Policy Analysis no. 343, May 13, 1999.

8. Ibid.

9. Ibid.

10. Ibid.

11. Small Business Survival Committee, *Small Business Survival Index 1999* (Washington, D.C., 1999).

12. U.S. Bureau of the Census, *State Government Finances* (various editions); and authors' calculations.

13. Moore and Stansel, "The State Spending Spree of the 1990s."

14. Dean Stansel, "Taming Leviathan: Are Tax and Spending Limits the Answer?" Cato Institute Policy Analysis no. 213, July 25, 1994.

15. Richard Vedder, Lowell Gallaway, and Robert Lawson, "Fifty State Medicaid Report Card" (Washington, D.C.: Citizens for a Sound Economy, 1995).

16. "The Tax Reform Issue."

17. See Don Sundquist, "An Outdated Tax System Meets the 21st Century," *Tennessee's Business*, pp. 17–19.

18. Budget of the U.S. Government—Historical Tables, FY99, Table 12.1, pp. 203–4.

19. Tennessee General Assembly Fact Book, FY99–00.

20. Ron Haskins, "Welfare Reform Is Working," *American Enterprise*, January–February 1999, pp. 62–65.

21. Ibid.

22. Stephen Moore, Michael Tanner, and David Hartman, "The Work versus Welfare Trade-Off," Cato Institute Policy Analysis no. 240, September 19, 1995.

23. Moore and Tanner.

24. George C. Leef, "Unemployment Compensation: The Case for a Free-Market Alternative," *Regulation* 21, no. 1 (Winter 1998): 19–26.

25. Constitutional scholar Robert Levy has argued that those tobacco settlements are inconsistent with justice and the rule of law. "Most damning," says Levy, "the settlement rewards attorneys general and their co-conspirators in the plaintiffs' bar, who have retroactively subverted the law to punish the sale of a legal product by a deep-pocketed and unpopular industry—without notice, opportunity for fair trial, or evidence. By eliminating the requirement to prove that smoking caused a particular injury, and by rejecting all claims that smokers are personally responsible, the states have effected a shakedown—no better than extortion—grounded on this repugnant rule: the states need money; the industry has money; ergo, the industry pays and the states collect." Robert Levy, "Tobacco Extortion: Round 3," *San Diego Tribune*, November 29, 1998. Those issues notwithstanding, Tennessee is receiving a budget windfall from the settlement.

26. See, for instance, Richard Vedder, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee of the U.S. Congress, December 1995; Zsolt Becsi, "Do State and Local Taxes Affect Relative State Growth?" *Economic Review* 18, no. 2 (March–April 1996); and Stephen Moore and Dean Stansel, "Tax Cuts and Balanced Budgets: Lessons from the States," Cato Institute Fact Sheet, September 17, 1996.

27. Becsi.

28. Vedder.

29. Vedder.

30. Moore and Stansel, "Tax Cuts and Balanced Budgets."

31. Newsletter, Empire Foundation, Albany, New York, April 1997.

32. U.S. Bureau of the Census, http://census.gov. For details, see the "Population Estimates" section of that Web site.

33. R. Clayton McWhorter, "An Appeal for Tax Reform," *Tennessee's Business*, p. 13.

34. Thomas Dye, "The Economic Impact of the Adoption of a State Income Tax in Tennessee," National Taxpayers Union and the Tennessee Family Institute, October 1999.

35. See, for instance, Eric Hanushek, "Impact of Differential Expenditures on School Performance," *Educational Researcher*, May 1989.

36. National Center for Education Statistics, *Digest of Education Statistics, 1997*, U.S. Department of Education, Tables 133 and 168, pp. 136 and 171. The 10 highest-spending states by 1994–95 per pupil spending were New Jersey, New York, the District of Columbia, Alaska, Connecticut, Rhode Island, Massachusetts, Maryland, Pennsylvania, and Delaware. The 10 lowest-spending states were Utah, Mississippi, Idaho, Tennessee, Alabama, Arkansas, New Mexico, Louisiana, North Dakota, and South Dakota.

37. John Chubb and Terry Moe, "Letting Schools Work," *NY: The City Journal* (Autumn 1990).

38. Paul Ciotti, "Money and School Performance: Lessons from the Kansas City Desegregation Experiment," Cato Institute Policy Analysis no. 298, March 16, 1998.

39. V. J. Sailors, "Education: Investing in Our Children," *Tennessee's Business*, pp. 28–29.

40. For a comprehensive examination of the effectiveness of state tax and expenditure limitations, see Stansel.

41. Daniel Wood, "States Make New Year Less Taxing," *Christian Science Monitor*, December 23, 1997, p. 1.

42. Wendell Cox and Sam Brunelli, "America's Protected Class: The Excess Value of Public Employment," *State Factor* 20, no. 7 (June 1994).

43. See Stansel.

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