ITEP Institute on Taxation and Economic Policy
1311 L Street, N.W. • Washington, D.C. 20005 • Contact: Matt Gardner
(202) 626-3780 x 24

Impact of the Tennessee Tax Structure Study Commission's Tax Reform Recommendations on Tax Fairness in Tennessee

December 14, 2004

Tennessee's tax system is regressive, requiring low- and middle-income families to pay more of their income in tax than wealthier Tennesseans. A tax reform plan recently proposed by the Tennessee Tax Structure Study Commission would reduce the state sales tax, repeal local sales taxes, cut business taxes, and introduce a personal income tax. This analysis looks at the fairness of the current Tennessee tax system and estimates the impact of the Commission's proposed reforms on the regressivity of the tax system.

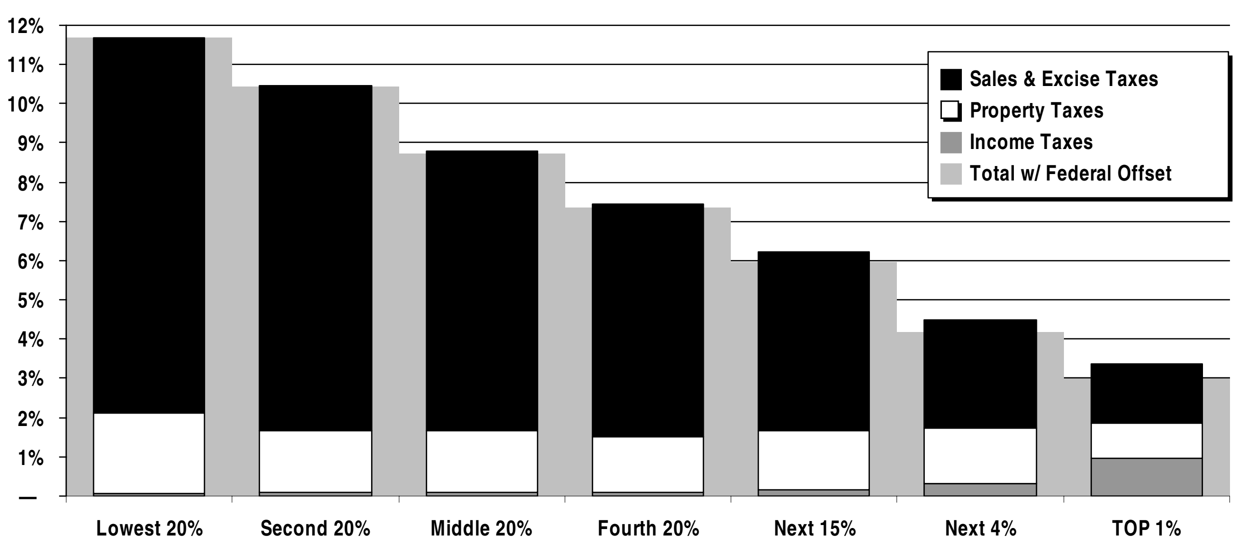
What Makes the Tennessee Tax System Regressive?

A January 2003 ITEP report, *Who Pays*, found that Tennessee had the third most regressive tax system in the nation. The report showed that the poorest twenty percent of non-elderly Tennessee families paid, on average, 11.7 percent of their income in state and local taxes. By contrast, middle-income Tennesseans paid 8.8 percent of their income in tax, while the very wealthiest 1 percent of Tennessee taxpayers paid just 3.4 percent of their income in state and local taxes. In other words, the poorest Tennesseans paid three times more of their income in tax than did the very wealthiest families.

The ITEP report identified two principal reasons for the unfairness of the Tennessee system. First, Tennessee is one of only nine states that do not levy a broad-based personal income tax. Second, Tennessee relies more heavily on sales taxes than most other states. Because sales taxes hit low-income taxpayers hardest, and income taxes are the only major progressive tax used by states, this imbalance makes the tax system especially unfair.

Incidence of Tennessee State & Local Taxes

Shares of family income for non-elderly taxpayers



What the Tax Structure Study Commission Proposal Would Do

The Commission's proposal would make the following changes to the state's tax system:

- **Reduce the statewide general sales tax rate to 6 percent**. Currently, the state sales tax rate is 7 percent, and local governments are allowed to levy up to 2.75 percent more, for a maximum combined rate of 9.75 percent. The Commission proposes to eliminate all local sales taxes and reduce the statewide tax rate to 6 percent.
- **Reduce the statewide sales tax rate on groceries to 4 percent**. The state sales tax currently allows a slightly lower tax rate for groceries than for other purchases (6 percent versus 7 percent). The Commission would expand this tax preference, lowering the food tax to 4 percent (compared to 6 percent for other purchases).
- **Reduce the business franchise tax**. Tennessee's corporate franchise tax currently taxes businesses on their property or net worth at a 0.25 percent rate. The Commission would cut the tax rate in half, to 0.125 percent, and would remove property from the tax base.
- **Repeal the "Hall Tax" and enact a graduated personal income tax.** The proposed income tax would exempt the first $30,000 of income for married couples ($15,000 for singles) and would allow an additional $2,000 exemption for each dependent. Income would be taxed at rates ranging from 3.5 to 6 percent; married couples with taxable incomes over $100,000 (and singles with taxable income over $50,000) would pay at the top rate.

The following table shows the distributional impact of the Commission's plan:

- The poorest 80 percent of the income distribution would see, on average, a cut in state and local taxes under the Commission's plan, with the largest tax cuts going to the very poorest taxpayers.
- The wealthiest 20 percent of Tennesseans would, on average, see an increase in state and local taxes under the plan.

Impact of Tennessee Tax Reform Commission Proposals

All Tennessee Taxpayers, 2003

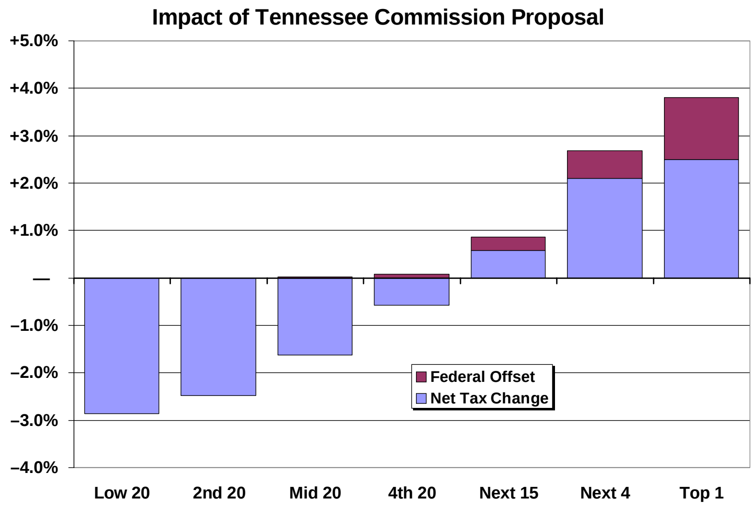
2003 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $14,000	$14,000 – $24,000	$24,000 – $38,000	$38,000 – $61,000	$61,000 – $117,000	$117,000 – $250,000	$250,000 – Or More
Average Income in Group	$9,000	$19,000	$30,000	$48,000	$80,000	$162,000	$699,000
State Tax Change as % of Income, All Taxpayers in 2003							
Repeal Hall Income Tax	–0.0%	–0.0%	–0.0%	–0.0%	–0.0%	–0.1%	–0.4%
New Graduated Income Tax	—	+0.3%	+0.7%	+1.4%	+2.4%	+3.7%	+4.9%
Reduce General Sales Tax Rate to 6%	–2.3%	–2.3%	–1.9%	–1.5%	–1.2%	–0.7%	–0.5%
Reduce Grocery Tax to 4%	–0.6%	–0.4%	–0.4%	–0.3%	–0.2%	–0.1%	–0.0%
Reduce Corporate Franchise Tax	–0.0%	–0.0%	–0.0%	–0.0%	–0.0%	–0.1%	–0.1%
Total	**–2.9%**	**–2.5%**	**–1.6%**	**–0.5%**	**+0.9%**	**+2.7%**	**+3.8%**
Federal Offset	—	–0.0%	–0.0%	–0.1%	–0.3%	–0.6%	–1.3%
Net state/federal impact of Proposals	**–2.9%**	**–2.5%**	**–1.6%**	**–0.6%**	**+0.6%**	**+2.1%**	**+2.5%**
Average State Tax Increase	$ –244	$ –463	$ –488	$ –237	$ +691	$ +4,337	$ +26,641
Federal Offset, avg $	$ —	$ –0	$ –7	$ –39	$ –221	$ –928	$ –9,156
Net state/federal impact of Proposals	**$ –244**	**$ –463**	**$ –495**	**$ –276**	**$ +470**	**$ +3,409**	**$ +17,486**

SOURCE: Institute on Taxation and Economic Policy, December 2004

How the Commission's Plan Affects Federal Income Taxes

The Commission plan would also have a substantial impact on the *federal* income taxes paid by Tennesseans. Taxpayers itemizing their federal income taxes would be able to write off their tax liability under the graduated income tax. As a result:

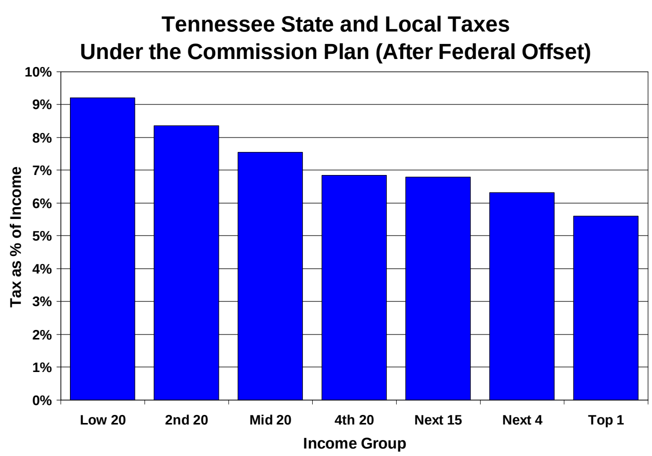
- Wealthier Tennessee itemizers would be able to reduce their state income tax liability by up to a third in 2003.
- The federal income taxes paid by Tennessee residents would go down by $440 million.



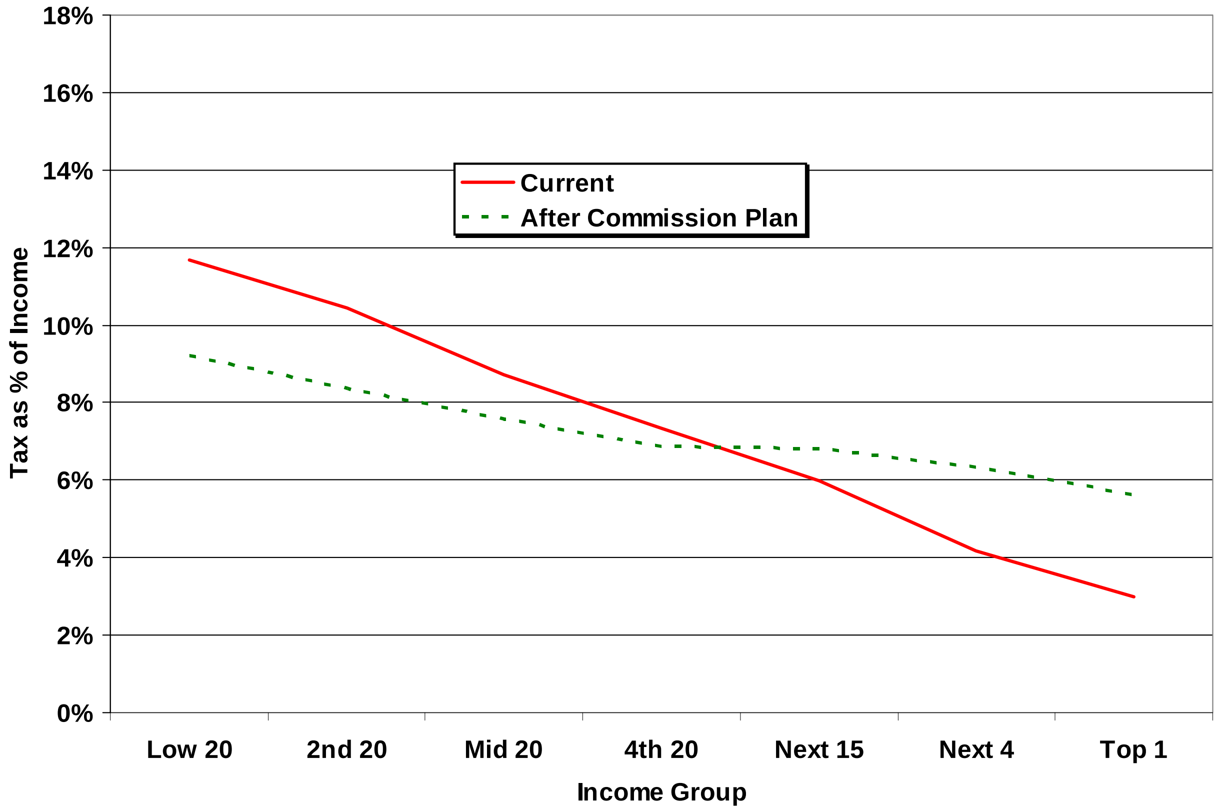
The main impact of this "federal offset" is to reduce the impact of the income tax on wealthier Tennesseans. As the chart at right shows, a substantial part of the initial state income tax increase on Tennessee itemizers would be offset by federal tax cuts.

How the Commission's Plan Would Affect Tax Fairness in Tennessee

The tax reform plan outlined by the Commission would change the fairness of state and local taxes in Tennessee. The chart at right shows the incidence of the Tennessee tax system (including the "federal offset") in 2002 after implementing the Commission's plan. As the chart shows, the Tennessee tax system would be much less regressive if the plan were enacted. However, low-income Tennesseans would still pay more of their income in taxes than taxpayers in all higher income groups, on average, if the plan were fully implemented. In other words, the Commission's plan would go a long way toward reducing the unfairness of the Tennessee tax system—but even if these ambitious reforms were enacted, the very poorest Tennesseans would still pay more of their income in tax than wealthy Tennesseans.



APPENDIX: STATE AND LOCAL TAXES BEFORE AND AFTER IMPLEMENTING THE TAX STRUCTURE STUDY COMMISSION PLAN (NON-ELDERLY TENNESSEANS AFTER FEDERAL OFFSET)



About ITEP: ITEP is one of the leading research and education organizations in the country working on government taxation and spending policy. Since its founding in 1980, ITEP's work has played a key role in educating the public and informing federal and state tax policy. ITEP's website is http://www.itepnet.org .

The analysis presented here was conducted using the ITEP microsimulation tax model. Since 1996 ITEP has used this model to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data that is extrapolated to the year being analyzed. This is the type of tax model used by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, the Congressional Budget Office, and many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. Included in the sample are federal tax returns, with statistically valid samples from every state and the District of Columbia. A sampling of records from the U.S. Decennial Census five percent sample (which contains a random sample of five percent of all census forms received by the Census Bureau) are also included, and statistically matched with the tax return records. Other data sets are used to impute detailed expenditures for each record and other information. The data on the records is extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and government and other widely respected macro data sources. (A complete description and methodology for the ITEP model is available on request.)