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

An Analysis of Two Proposals for Tennessee Tax Reform
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Tennessee's state legislature is currently considering several proposals for increasing state tax revenues to cover newly emerging budget deficits. The following analysis compares the distributional effects of two proposals that would create broad-based income taxes in Tennessee.

One proposal, recently put forth by Tennessee's Governor, Don Sundquist, would replace the existing "Hall tax" on interest and dividends with a broad-based, flat-rate 3.75 percent income tax. The income tax would provide personal exemptions of $5,000 per filer and exclude fifty percent of capital gains from taxation. The Governor's proposal would also eliminate the state sales tax on food, reduce the state sales tax rate on most other taxable items from 6 percent to 3.75 percent, and retool the state's corporate tax structure, among other changes.

Features of the Two Principal Reform Plans

	Governor	"Compromise"
Income Tax		
Taxable Income Level, married filers	Rate	Rate
Under $30,000	3.75%	1%
$30-$60,000	3.75%	3%
Over $60,000	3.75%	5%
Exemption (per filer)	$5,000	$15,000
Capital Gains Preference	50%	none
Sales Tax		
General Rate	3.75%	6%
Rate on Food	0%	0%

A second proposal, recently passed by the Senate Finance Committee, would create a progressive income tax with rates of 1, 3 and 5 percent and a personal exemption of $15,000, and would tax capital gains in the same manner as other sources of income. The proposal would also eliminate the state sales tax on food, but would not change the state's sales tax rate.

As the following table shows, the income tax and sales tax components of these plans have noticeably different distributional consequences. In particular:

- # The Governor's plan provides greater tax relief to the poorest Tennesseans due to the sales tax rate reduction.
- # The compromise bill provides broader tax relief for middle-income families due to the graduated structure of its income tax component.

Sales and Income Tax Provisions of The Two Leading Reform Proposals Change in State and Local Taxes as a share of Personal Income, 2000								
	Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20% Next 15%	Next 4%	Top 1%
	Average Income	$8,100	$ 17,500	$ 28,600	$ 45,300	$ 76,300	$ 158,000	$737,000
Governor's Plan	State Income Tax	+0.6%	+1.4%	+1.9%	+2.4%	+2.8%	+2.8%	+2.3%
	Sales Tax	–2.3%	–2.2%	–1.9%	–1.5%	–1.1%	–0.7%	–0.4%
	Federal Offset	–0.0%	–0.0%	–0.0%	–0.1%	–0.4%	–0.7%	–0.9%
	Net Total	**–1.8%**	**–0.8%**	**–0.1%**	**+0.7%**	**+1.3%**	**+1.5%**	**+1.1%**
Compromise Plan	Income Tax	–0.0%	+0.0%	+0.2%	+0.4%	+1.0%	+2.3%	+3.5%
	Sales Tax	–0.8%	–0.6%	–0.5%	–0.4%	–0.3%	–0.2%	–0.0%
	Federal Offset	—	–0.0%	–0.0%	–0.0%	–0.1%	–0.5%	–1.3%
	Net Total	**–0.8%**	**–0.6%**	**–0.4%**	**–0.0%**	**+0.5%**	**+1.6%**	**+2.1%**

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, November 17, 1999

Both plans would result in a significant reduction in federal personal income tax payments from Tennesse. Because state income taxes can be deducted by taxpayers itemizing deductions on their federal tax returns, an increase in *Tennessee* income taxes results in a *decrease* in *federal* income taxes paid by many Tennessee residents. Under the Governor's proposal, Tennessee residents would see their federal income taxes reduced by approximately $420 million in 2000. Similarly, the "compromise" income tax would result in a federal tax cut of approximately $395 million in tax year 2000.

This is a significant impact. A substantial sum that has been leaving Tennessee in federal tax payments will be retained in the state. And, at the taxpayer level, those experiencing a state tax increase will get a federal tax reduction that significantly lessens the net impact on their total tax liability.

Governor's Plan Tax Effects

Tax Year 2000, All Filers

Income Group	Income Range	Average Income	Tax Change as a % of Income: Tennessee Taxes	Federal IncomeTax Reduction	Net Tax Change
Lowest 20%	**Less than $13,000**	**$ 8,100**	–1.8%	–0.0%	**–1.8%**
Second 20%	**$13,000–23,000**	**17,500**	–0.8%	–0.0%	**–0.8%**
Middle 20%	**$23,000–36,000**	**28,600**	–0.0%	–0.0%	**–0.1%**
Fourth 20%	**$36,000–57,000**	**45,300**	+0.9%	–0.1%	**+0.7%**
Next 15%	**$57,000–110,000**	**76,300**	+1.7%	–0.4%	**+1.3%**
Next 4%	**$110,000–261,000**	**158,000**	+2.2%	–0.7%	**+1.5%**
Top 1%	**$261,000 or more**	**737,000**	+1.9%	–0.9%	**+1.1%**

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, November 17, 1999

Tax Effects of the "Compromise" Plan

Tax Year 2000, All Filers

Income Group	Income Range	Average Income	Tax Change as a % of Income:		
			Tennessee Taxes	Federal IncomeTax Reduction	Net Tax Change
Lowest 20%	**Less than $13,000**	**$ 8,100**	–0.8%	—	**–0.8%**
Second 20%	**$13,000–23,000**	**17,500**	–0.6%	–0.0%	**–0.6%**
Middle 20%	**$23,000–36,000**	**28,600**	–0.4%	–0.0%	**–0.4%**
Fourth 20%	**$36,000–57,000**	**45,300**	–0.0%	–0.0%	**–0.0%**
Next 15%	**$57,000–110,000**	**76,300**	+0.7%	–0.1%	**+0.5%**
Next 4%	**$110,000–261,000**	**158,000**	+2.1%	–0.5%	**+1.6%**
Top 1%	**$261,000 or more**	**737,000**	+3.4%	–1.3%	**+2.1%**

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, November 17, 1999

The overall effect of the two proposals on Tennesseans' state and local tax burden is broadly similar: lower-and middle-income Tennesseans receive a net tax cut or find their tax burden unchanged, while wealthier taxpayers experience a net tax increase. Both proposals also preserve government services by resolving the projected government budget shortfall**.**

Capital Gains Exclusions and Alternatives for Tax Relief

One feature of the Governor's proposal is that it treats capital gains income more favorably than other sources of income by excluding half of it from taxation. As the following table shows, the tax break from this exclusion would almost exclusively benefit the wealthiest Tennesseans. The five percent of Tennesseans earning over $110,000 in 2000 receive 85 percent of capital gains income. The richest 1 percent, with average income of $737,000, receive over 70 percent of all capital gains income. Thus, this provision in the Governor's plan significantly reduces the burden of the income tax on the best-off Tennesseans relative to those at other incomes.

Share of Capital Gains Income
All Filers, 2000 tax year

Income Group	
Lowest 20%	0%
Second 20%	1%
Third 20%	0%
Fourth 20%	3%
Next 15%	11%
Next 4%	12%
Top 1%	73%
ALL	100%
Addendum: Bottom 99%	27%

Current Distribution of Tennessee Taxes

Tennessee currently has a regressive tax system, asking middle- and low-income families to pay a greater share of state and local taxes than the best-off citizens of the state. In fact, in a 1996 study, *Who Pays*, ITEP found that Tennessee had one of the most regressive tax systems in the country. Both of the plans described above would lessen the regressivity of the Tennessee tax system, but would not eliminate it**.**

Tennessee Taxes in 1999
As Shares of Family Income for All Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$7,800	$17,000	$27,700	$43,800	$73,900	$153,000	$716,000
Income Range	Less than $12,700	$12,700 – $22,100	$22,100 – $34,500	$34,500 – $55,600	$55,600 – $106,000	$106,000 – $253,000	$253,000 – or more
Sales, excise & gross receipts taxes	**9.3%**	**9.0%**	**7.5%**	**5.8%**	**4.4%**	**2.7%**	**1.5%**
General sales tax, individuals	5.6%	5.3%	4.6%	3.8%	2.9%	1.8%	1.0%
Excise & gross receipts taxes, individuals	1.4%	1.4%	1.0%	0.7%	0.5%	0.3%	0.1%
Sales & excise taxes, business	2.3%	2.4%	1.8%	1.3%	0.9%	0.6%	0.4%
Property taxes	**2.5%**	**1.9%**	**1.8%**	**1.6%**	**1.7%**	**1.7%**	**1.2%**
Property taxes on families	2.5%	1.8%	1.7%	1.5%	1.5%	1.4%	0.5%
Business property taxes	0.1%	0.1%	0.1%	0.2%	0.2%	0.3%	0.6%
Income taxes	**0.0%**	**0.1%**	**0.1%**	**0.1%**	**0.2%**	**0.4%**	**0.9%**
Personal income tax	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%
Corporate income tax	0.0%	0.1%	0.1%	0.1%	0.1%	0.2%	0.4%
Total	**11.9%**	**11.0%**	**9.4%**	**7.5%**	**6.3%**	**4.7%**	**3.6%**

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, November 17, 1999.

Conclusion

There is a growing consensus that Tennessee must raise revenues in order to cover projected budget shortfalls in the upcoming fiscal year. An important issue facing policy makers is the effect of tax reform on the equity of the Tennessee tax system. Each of the two leading proposals examined here would resolve Tennessee's budget shortfall while substantially reducing federal income taxes paid by Tennesseans. The Governor's proposal provides greater tax relief for the poorest Tennessee taxpayers, while the “compromise” proposal targets its relief to middle-income taxpayers. Both proposals would raise needed revenues in a way that increases the progressivity of Tennessee’s tax structure.

Graphs detailing the results of the analysis follow.

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.ctj.org/itep.

Since 1996 ITEP has used a microsimulation tax 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. 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.)

APPENDIX

Comparing the Plans: Net Tax Changes from Current Law