Beacon
CENTER OF TENNESSEE

Made of Money

Tennessee's Tax Cuts, Growing Surplus, and Future Opportunities

Introduction

More Money, Fewer Problems: Tennessee's Tax-Cutting History

"Moving to Tennessee is the new American Dream." At least, that's how one new state resident told a Los Angeles news station after moving here from California.[1] In many people's eyes, he's not wrong: Tennesseans are flourishing. Even a majority of Tennesseeans believe that the state government is a model for other states to follow.[2] Due to decades of fiscal conservatism and strong free market policies, Tennessee is growing like never before. For example, Tennesseans pay the fewest taxes per capita nationwide. The state has the nation's lowest per capita debt, and second lowest tax burden after Alaska.[3] Therefore, moving to Tennessee is an automatic pay raise for so many that it can even help recruit and retain professional athletes and coaches.[4]

Outside of taxes, the state recently made national news for protecting workers' rights by enshrining Right to Work policies in the state constitution.[5] Once known mainly for moonshine and music, Tennessee—particularly Nashville—is now a growing tech hub due to several reforms, including allowing the testing of autonomous vehicles, allowing delivery robots to be tested on sidewalks, and prohibiting local governments from regulating the operation of online marketplaces.[6] These reforms have helped create such a culture of innovation that one study found that since 2015, Nashville has had the fastest-growing tech workforce in the country.[7]

All these successes have some people asking: Is Tennessee, rather than Texas, the red-state model?[8]

Measure	U.S.	Florida	Texas	Tennessee	Georgia	California	New York
Economic Freedom of North America (2020) [26]	7th (World)	1st	4th	4th	8th	49th	50th
State Migration Trends, Most Inbound (2022) [27]	--	1st	4th	11th	12th	41st	50th
State Business Tax Climate (2023) [28]	--	4th	13th	14th	32nd	48th	49th
State Economic Outlook (2023) [29]	--	9th	13th	11th	12th	45th	50th
State & Local Spending Per Capita (2022) [30]	--	46th	37th	45th	48th	4th	2nd
S&L Spending on Public Welfare Per Capita (2020) [31]	--	47th	44th	31st	49th	5th	1st
S&L Tax Burden Per Capita (2022) [32]	--	11th	6th	3rd	8th	46th	50th
S&L Property Tax Collections Per Capita (2020) [33]	--	22nd	39th	4th	19th	36th	46th
Composite Cost of Living Index (Q1:2023) [34]	--	31st	17th	10th	12th	49th	48th
Avg. U-3 Unemployment Rate (2003-22) [35]	6.0%	5.8%	5.6%	6.1%	6.3%	7.2%	6.2%
Avg. Labor Force Participation Rate (2003-22) [36]	64.0%	60.7%	65.1%	61.8%	64.4%	63.5%	61.5%
Avg. Annual Nonfarm Payroll Growth (2003-22) [37]	0.8%	1.4%	1.8%	1.0%	1.1%	1.0%	0.6%
Avg. Top 5% Income Shares (2003-18) [38]	36.9%	44.6%	36.8%	33.6%	34.2%	39.4%	47.1%
Official Poverty Measure (2019-21) [39]	11.2%	12.5%	12.9%	12.2%	13.1%	11.0%	12.3%%
Supplemental Poverty Measure (2019-21) [40]	9.6%	11.9%	10.4%	9.1%	10.2%	13.2%	12.1%

Table 1. Comparison of Largest States for Measures of Economic Freedom and Outcomes.

While not receiving as much national attention as Texas or Florida, Tennessee has become one of the freest and most prosperous states in the country. Notes: Dates in parentheses are for that year or the average of that period. Data shaded in red indicate "best," and blue indicates "worst" per category by state. Comparisons and sources are similar to those in a report by the Pelican Institute for Public Policy.

While the state has implemented reforms in tech and innovation policy, labor policy, regulatory reform, and other areas, it is in tax policy that Tennessee has distinguished itself and solidified its pro-growth environment and reputation. Tennessee voters in 2014 amended the state constitution to prohibit lawmakers from ever proposing an income tax.[9] Then came repealing the Gift and Death taxes, which were phased out in 2016, saving taxpayers roughly $200 million combined per year.[10] In 2021, Tennessee finished its phase-out of the Hall Income tax, a $300 million annual tax on the income derived from stocks and bonds—marking only the second time in America's long history that a state has fully repealed an income tax.[11] In 2022, Tennessee made national news as the first, and only state thus far, to decouple from the impending "innovation tax," a provision of the Tax Cuts and Jobs Act that set to expire the deduction for business investment in research and development.[12] Tennessee, like most states, automatically conforms to the federal tax code, meaning that had state lawmakers not unlinked the tax code from federal law, Tennessee companies would have been simultaneously hit with tax hikes at both the federal and state levels.

Most recently, lawmakers passed the single largest tax cut in the state's history with the Tennessee Works Tax Act, which addressed arguably the least-competitive aspects of all of Tennessee's taxes on businesses.[13] This included:

Reforming the Business Tax

Tennessee is one of only seven states that has a gross receipts tax (called the Business Tax), which punishes small businesses and startups and drives up prices for consumers. Lawmakers raised the exemption on sales from $10,000 to $100,000. Now 140,000 of Tennessee's smallest businesses will no longer have to pay this expensive and onerous tax.

Reforming the Franchise Tax

A tax on a company's net worth or property regardless of profit, Tennessee's Franchise Tax punished companies that hold large amounts of property. Now a company's first $500,000 in property will be exempted from the tax.

Streamlining corporate income tax

Tennessee was one of the dwindling number of three-factor apportionment states. There will now be a three-year transition period to make Tennessee one of the growing number of single-sales-factor states, which will streamline company tax liabilities and stop punishing businesses located in Tennessee.

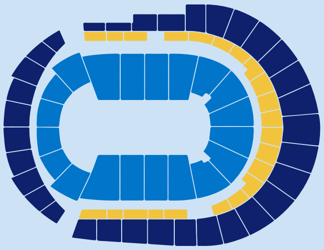
Adopting the Tax Cut and Jobs Act provision around bonus depreciation

Previously, 18 states allowed the immediate expensing of all business investments. In Tennessee, it took up to 15 years for the state to acknowledge the full cost of a business's investment. The Tennessee Works Tax Act coupled Tennessee with bonus depreciation provisions of the Tax Cut and Jobs Act, which will allow businesses to recover costs and reinvest more quickly in the state economy.

Overall, the Tennessee Works Tax Act is projected to save Tennessee taxpayers more than $400 million in its first year and another $150 million ongoing in relief for small businesses. Raising the exemption for the Business Tax alone will benefit enough small business owners to fill all the professional sports stadiums in Nashville (Figure 1).

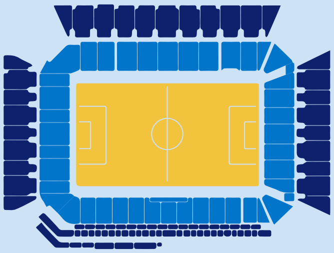
Tennessee Works Tax Act

As one part of the recently passed tax cut, 140,000 business owners no longer have to pay the Business Tax. Those business owners would completely fill:



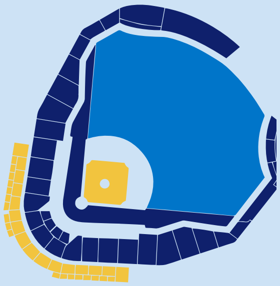
Bridgestone Arena

Capacity: 20,000



Geodis Park

Capacity: 30,000



First Horizon Park

Capacity: 10,000

New Titans Stadium

Capacity: 55-60,000

Even filling all the stands, there would still be 20-25,000 additional business owners to tail gate in the parking lot.

Figure 1. Exempting an estimated 140,000 businesses from the Business Tax will not only help Tennessee's smallest businesses, but due to the nature of gross receipts taxes, help relieve inflationary pressure on consumers.

The Baby Steps of Government Budgets

All of these tax cuts over the past decade have been made because Tennessee lawmakers have held to conservative budgeting. By keeping the growth of spending down over time, state government has not grown beyond the average taxpayer's ability to pay for it. This paves the way for returning surplus tax revenues to residents through tax cuts that can be used productively in the Volunteer State's economy. For three years now, Beacon has published the Conservative Tennessee Budget (CTB), which sets a threshold for the new state budget to increase by no more than the rate of population growth plus inflation above the previous year's budget. This benchmark was chosen because research shows when government spending falls below this line, it encourages economic growth.[14] Since 2011, Tennessee has held its budget at or below the CTB until the past few years. These recent budgets, in which appropriations grew faster than the rate of population plus inflation, were the high point of federal pandemic-related funding.[15] For the 2024–2025 fiscal year, as long as the state's budget stays below $59.45 billion, Tennessee lawmakers will be positioned to continue to return over-collections to taxpayers through additional tax cuts.[16]

Rainy Day? More like a Windfall

We can be certain that continuing to remain fiscally responsible will lead to enough revenue for further tax cuts. While Tennessee has historically collected revenues above estimates, the state's surplus has exploded since the pandemic. In fact, monthly revenues have exceeded projections by nearly 20 percent, on average, since May 2020.

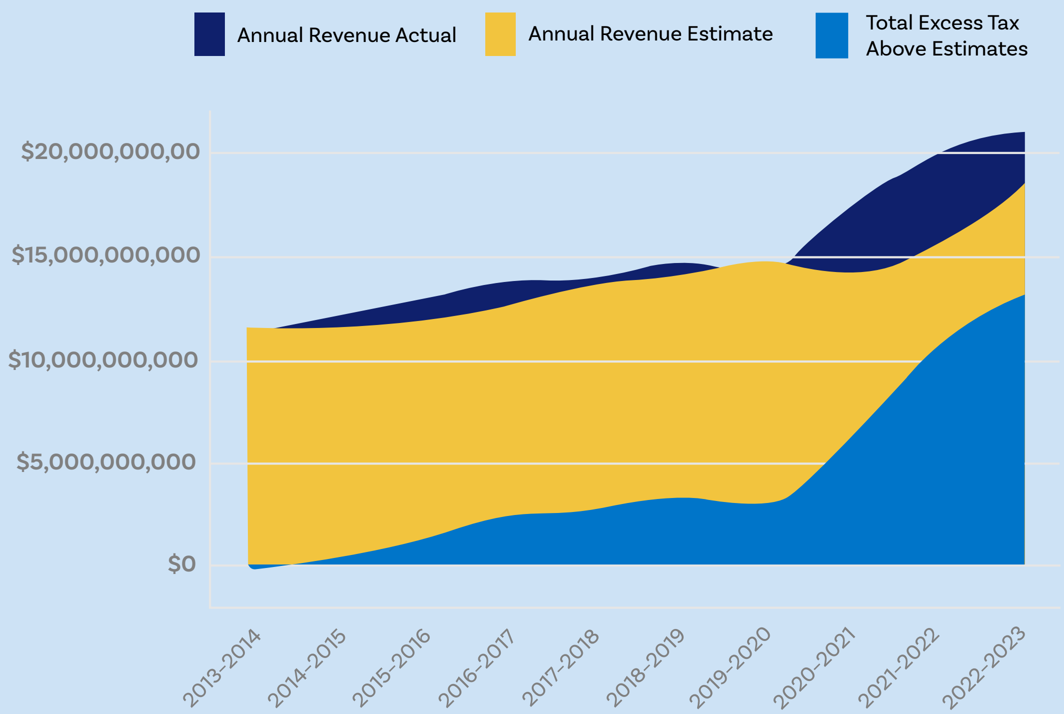


Figure 2. Since Fiscal Year 2014, the state has collected nearly $14 billion over estimates, with $10 billion alone coming since Fiscal Year 2021. Source: Dept. of Finance and Administration Estimated Tax Revenues and Dept. of Revenue Monthly Tax Collections.

These strong revenue collections exist despite the economic uncertainty of the pandemic and fears of an impending recession. Additionally, these surpluses show how conservative budgeting and tax cuts create a more resilient economic environment that can better weather uncertainty. These revenues do not even include the more than $20 billion the state received in federal pandemic-relief funding.[17] Overall, as long as state policymakers maintain fiscal responsibility, there is considerable opportunity to—and no excuses not to—pass these excess revenues back to everyday Tennesseans. While it may have been understandable for a year or two not to recognize these revenue levels as permanent, three years of consistent surpluses is long enough to consider permanent reforms. Especially after the recent Tennessee Works Tax Act, these savings for businesses statewide should fuel further investment and lead to an even stronger economy and therefore more revenues.

More Opportunities to Cut Than a Slasher Film

If strong revenues continue, what priorities should state policymakers keep in mind, and what opportunities to cut exist? First, policymakers could look to strengthen the state's rainy-day fund. While this has grown to historic levels, with more than $2 billion expected by the end of the fiscal year, as a percentage of general fund expenditures, Tennessee's savings are surprisingly below average, coming in 36th out of 50 states at 8.7 percent.[18] To reach the median of 12.2 percent, Tennessee would need to set aside an additional $724 million. After fully funding the rainy-day coffers, policymakers should look to further cut taxes. While the temptation would be to use sales tax holidays and other temporary relief, overcollections previously discussed provide ample funds to make permanent tax cuts. First, policymakers should build on the reforms of the Tennessee Works Tax Act and fully repeal the Business Tax. While a full repeal of $325 million would seem like a large hole in the state's budget, it represents less than 1.5 percent of state funds and a mere two to three months' of the recent surplus collections.[19] Meanwhile, this modest cut in state revenue would have a several-fold greater impact on businesses. According to a recent study, fully repealing the Business Tax would be an effective marginal tax cut of nearly 10 percent for Tennessee businesses.[20]

Next, policymakers could make the bonus depreciation pairing with the Tax Cut and Jobs Act permanent. This provision is set to phase down through 2026; however, state policymakers should unlink from this schedule and allow for 100 percent bonus depreciation going forward.[21] Making this permanent would cut Tennessee businesses' marginal effective tax rate (METR) by roughly 50 percent, for little cost in state revenue.[22] This is because changing when business investments can be written off shifts the timing of the deductions, not their overall amount, yet still provides flexibility and liquidity to Tennessee businesses.

An additional option for policymakers to return excess revenues to the general public would be to switch from sales tax holidays to permanently cutting the sales tax on groceries. This year, the state created a three-month sales tax holiday on groceries, estimated to cost $288 million.[23] Lawmakers could permanently cut the sales tax on food from four percent to three percent. This tax cut for all Tennesseans would even cost less than the three-month sales tax holiday at roughly $170 million per percentage cut.[24]

In all, policymakers have an array of options to return excess funds to Tennessee taxpayers, whether they are businesses or individuals. In cutting the Tennessee Works Tax Act, policymakers addressed the worst components of all the state's taxes on businesses, but none were eliminated. Likewise, individuals received temporary relief through a three-month sales tax holiday set to begin this summer. Policymakers could build on the largest tax cut in the state's history by fully repealing the Business Tax and cutting the sales tax on groceries. Even if the latter was completely eliminated, while the combined cost of these two would equal around one billion dollars, that is not even half of this year's surplus collections over estimates.[25]

Conclusion

To Boldly Go Where No State Has Gone Before

For more than a decade, Tennessee has been flourishing like never before. Due to a record of conservative budgeting, lawmakers have been able to cut multiple taxes, from the Death and Gift Tax to the Tennessee Works Tax Act, and many others in between. These reforms have put more money in Teneseeans' pockets and in the productive private sector, bringing unprecedented levels of prosperity. Tennesseans are now some of the freest and least taxed citizens in the entire country. This freedom and prosperity has led to even larger-than-expected surpluses, especially since the pandemic. With strong surpluses for multiple years now, it is time to recognize these surplus funds and find new ways to return them to taxpayers.

First, policymakers should look to strengthen the state's rainy-day fund to at least the national average in terms of a percentage of expenditures. From there, they should look to provide further tax relief to businesses and individuals. Tennessee received national attention as the second state ever to repeal an income tax; it could make further history by repealing the Business Tax. While it represents a smaller portion of state revenue, this would have an exponential impact on Tennessee businesses. Additionally, by permanently adopting the bonus depreciation provisions of the Tax Cut and Jobs Act, policymakers would provide additional flexibility for Tennessee businesses for little to no expense, as it merely shifts when capital expenses are deducted. Then for individuals, policymakers could look to pair these further cuts for businesses by trimming the sales tax on food. Even a mere 25 percent cut in the sales tax on groceries, from four to three percent, would provide certainty and consistent relief for taxpayers for less than most sales tax holiday programs.

Yet opportunities to go even bolder exist as well. For not even half of this year's surplus, the state could fully repeal a tax on businesses and the tax on one of the most basic necessities for individuals. Repealing these two taxes would make Tennessee the undisputed leader in returning money to taxpayers and make history yet again. And chances are, the resulting growth and prosperity would bring us back here in several years, asking "What's next?" And that would be a good problem to have.

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