# BUDGET AND TAXATION



## *The Problem*

Each year, the State of Tennessee spends hundreds of millions of tax dollars on what it calls "economic development." In reality, this money is siphoned from hard-working taxpayers and businesses and handed over to other private businesses, which is nothing more than corporate welfare. Despite the image that lavish ribbon-cutting ceremonies create, Tennessee's current corporate welfare programs have failed taxpayers and the business community. It is time for the state to end this practice and to let consumers decide the winners and losers in business.

***Recommendations***:

- ★ Eliminate the FastTrack Infrastructure Development and Job Training Assistance Programs and make it unlawful for public funds to be given to private businesses.
- ★ Allow the private sector to determine the winners and losers in business, not tax dollars.

## *Analysis*

Tennessee has two primary methods of distributing tax dollars to private companies, both managed by the Tennessee Department of Economic and Community Development (TDEC). The FastTrack Infrastructure Development Program permits companies to apply for grants that fund infrastructure improvements. TDEC claims that this program provides incentives for businesses "to locate or expand in the state and to create or retain jobs for Tennesseans."[42] The other method is called the FastTrack Job Training Assistance Program, and it "bankrolls the planning, development and implementation of a customized training program for recipient companies."[43]

The state allocated $41.2 million for fiscal year 2008-2009 for these two programs.[44] An internal audit conducted by the Comptroller of the Treasury just a few years ago proves that these programs are unsuccessful and a waste of tax dollars. The audit indicated that "[i]t is unclear whether the [FastTrack Infrastructure Development Program] has been successful in encouraging job creation and retention or encouraging businesses to locate or expand in the state."[45] The FastTrack Job Training Assistance Program fared even worse in the audit. The Comptroller's office found that there does not "appear to be a connection between the amount of assistance given to a company and the number of jobs created or the wage level" thereof.[46]

Instead of providing a boost for the state's economy (or even recouping the $42 million wasted), these programs force Tennessee businesses to subsidize their competition. For example, Mayfield Dairy Farms, a staple in the Tennessee dairy business, has produced milk and ice cream from its Tennessee farm for nearly a century. Mayfield and its employees have been paying millions in taxes to the state for the entire duration. In 2005, TDEC shelled out $216,000 in tax dollars, which includes money paid by Mayfield, to Blue Bell Ice Cream to offset the infrastructure costs of a new distribution facility in the state. Thus, the Mayfield Company was literally forced to "subsidize a Texas corporation that will compete directly with Mayfield."[47] This unfair and anticapitalist situation occurs dozens of times each and every year under the guise of "economic and community development."

### *Detailed Recommendations*

- ★ The General Assembly should put an end to the practice of corporate welfare, which forces Tennessee companies to subsidize their competitors and wastes taxpayers' money on failing projects.

- ★ The General Assembly should prohibit the use of tax dollars to fund special treatment of businesses, including money spent on infrastructure, relocation, and training costs. These costs should be borne by the companies, not taxpayers or competitors of the recipient companies.

- ★ Rather than handing out "economic development" grant money, the General Assembly should create a business climate conducive to economic growth. Lowering tax and regulatory burdens will allow businesses to invest more and create more jobs, and would attract businesses to Tennessee. This approach would do far more to expand business opportunities than TDEC's failed corporate welfare schemes ever can.

### *The Problem*

Tennessee, like every other state, is facing a serious economic downturn. The state budget is in the red, as are the budgets of many Tennesseans. Citizens across the state are reallocating incomes and eliminating the purchase of discretionary items. Though many items can be done without, food is a necessity for everyone. Unfortunately for all who must continue to feed themselves and their families, the money spent on groceries includes a significant 5.5 percent sales tax on purchases made in Tennessee.

The governor and state legislators should be alleviating the burdens of struggling Tennesseans during this time of need, rather than seeking revenue sources for pet projects. Reducing or eliminating the sales tax on food, and offsetting the reductions with spending cuts, would be more fiscally and morally responsible than levying taxes on necessities to fund unnecessary government programs.

***Recommendations***:

- ★ Reduce or eliminate the sales tax on food for all Tennesseans.
- ★ Offset the revenue shortfall by eliminating unnecessary pork barrel projects.

### *Analysis*

Every time someone purchases an item in Tennessee, seven cents of every dollar spent goes directly to the government through the state sales tax.[48] Groceries are taxed at an only slightly lower rate of 5.5 percent.[49] Of all fifty states and the District of Columbia, Tennessee has the third highest food tax rate in the nation; only Mississippi and Idaho tax food at a higher rate.[50]

The General Assembly of Tennessee reduced the sales tax on food slightly in 2007 from 6 percent to 5.5 percent, but this reduction was not enough considering the enormous tax burden imposed upon families.[51] According to the Tennessee Department of Revenue, Tennesseans spent almost $8.6 billion on food from July 2007 to June 2008.[52] Of this amount, taxpayers were on the hook for $493 million in taxes, enough money to provide groceries to every Tennessean for nearly a month.

The tax on food is "among the most regressive and least just taxes imposed by the Tennessee state government. Since grocery items are a necessary cost to any family, people who are poor or live on fixed incomes spend a larger portion of their income on food and, therefore, a larger portion of their income on taxes applied to that food."[53] This is precisely why all but fifteen states refuse to tax their citizens on the purchase of necessities like food.

Not only does Tennessee's regressive food tax disproportionately impact poorer families, it leads to Tennesseans buying groceries in border states. In 2005, the *New York Times* published an article titled "High Tax on Food in Tennessee Sends Shoppers to Other States."[54] It highlights a Hixon woman who travels over 50 miles round-trip to purchase her groceries in Georgia.[55] Of the eight states that border Tennessee, only one has a higher tax rate on food, while several others impose no tax at all on the necessity.

Just as with cigarettes and gas, Tennesseans travel across state lines to save money on food. They will continue to do so until state leaders acknowledge that a lower tax rate on these items will not only keep Tennesseans in state for grocery shopping, but will also make non-residents into customers, thereby contributing to our state sales tax revenue.

### *Detailed Recommendations*

- ★ Tennesseans should not pay a tax on items of necessity. This is especially true in times of economic strife, when families must operate on tighter budgets. The General Assembly should alleviate the tax burden of all Tennesseans by permanently reducing or eliminating the sales tax on food. This reduction would free up much-needed resources for Tennesseans, while at the same time attracting residents of neighboring states to spend money in Tennessee and contribute to the state's tax base.

- ★ Lowering or eliminating the sales tax on food could potentially lead to reduced revenues for the state. Instead of taking the sales tax reduction proposal off the table due to the current budgetary crisis, legislators should offset any reduction with spending cuts. For guidance on where to start, legislators can look to the Tennessee Center for Policy Research's annual *Pork Report* for state budget fat-trimming recommendations.

### *The Problem*

Now that the state is facing difficult financial times, there likely will be enhanced calls for an income tax on labor. Rather than cutting excessive spending during hard times, some legislators look for alternative sources of revenue through increased taxation. A personal income tax on labor is considered an attractive potential revenue source by many legislators.

Income tax proponents assert that the state's current tax structure is unstable, necessitating an income tax to protect the state during times of economic upheaval. Legislators must keep in mind that even if a tax based on personal income enhances short-term revenue, it will have a damaging long-term impact on the state.

***Recommendations***:

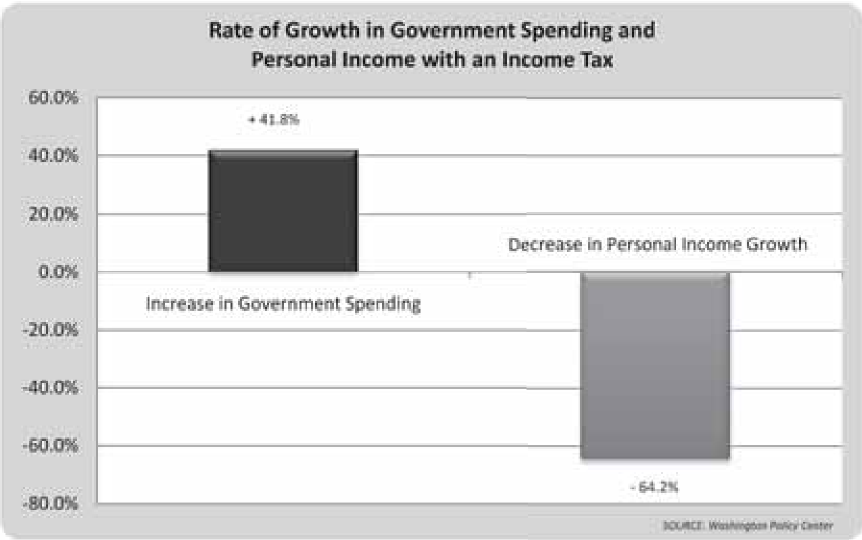
- ★ Resist any effort to impose a state income tax on Tennessee citizens.
- ★ Thwart attempts by income tax proponents to exhaust alternative revenue sources in preparation for another income tax battle.
- ★ Lower the overall tax burden of Tennesseans, stimulating economic growth.

### *Analysis*

A study conducted by Texans for Fiscal Responsibility determined that each day 20,000 taxpayers flee states with income taxes in order to settle in one of the nine states without an income tax.[56] This, coupled with Tennessee's geographic proximity to its eight border states, would make implementing an income tax a recipe for disaster.

Enacting an income tax would potentially drive hundreds of thousands of Tennesseans to other states, halt population increases, and stall the state's economy. Conversely, remaining income tax-free preserves Tennessee's economy and encourages population growth by enticing neighboring citizens to move into the Volunteer State. Rather than ignoring Tennessee's geographical position and its effect on revenue generation, as it did when increasing the cigarette tax in 2007, Tennessee should strategically capitalize on the situation by remaining the only state in the Southeast free from a personal income tax on labor.

Unlike the sales tax, which only affects personal consumption, the income tax stifles job creation, private investment, wage and salary increases, and productivity. Additionally, the income tax leads to rapid increases in government spending.[57] Studies show that government increases at a much faster rate in states with an income tax than in those without, even as the personal income growth rate in those states declines. For example, states that have implemented the income tax since 1967 have seen nearly a 42 percent increase in government spending and a 64.2 percent decline in personal income growth (see "Rate of Growth in Government Spending and Personal Income with an Income Tax," below).[58]




Reliance on unstable revenue sources also leads to increased support of a state income tax. Officials in the governor's administration consistently lure legislators into implementing new tax increases by inflating the projected revenue from those sources, and then later claiming the sources of revenue are unstable when actual numbers do not meet the flawed projections. A perfect example of this is the cigarette tax increase imposed by the 105th General Assembly, which brought in $57 million less than projections for fiscal year 2007-2008.[59] Unfortunately, money allocations were based on the erroneous projections, creating a budget shortfall. By allowing budgetary decisions to be based on inflated revenue projections, legislators find themselves forced into finding new revenue sources. Eventually, the only untapped "new revenue source" will be personal income.

### *Detailed Recommendations*

- ★ The 106th General Assembly, despite facing difficult financial times, should refuse to consider a personal income tax, which would send the state's economy further into recession. Tennessee should remain one of the few states that does not impose an economically-devastating income tax on its citizens. By so doing, legislators will avoid making the state's economy worse and will ensure the continued attraction of citizens from other states.

- ★ Income tax proponents consistently propose new and unstable taxes, artificially inflating the projected revenue from those taxes to convince legislators to support them. Once proven to be an unreliable source of revenue, the proponents begin calling for the imposition of an income tax as a "last resort." The efficacy of new revenue sources and projected revenues, along with the methods used to predict those numbers, should be scrutinized more closely *before* implementation of applicable statutes. Legislators should no longer be hoodwinked by income tax proponents recommending ill-advised or unstable sources of revenue as part of a long-term effort to impose an income tax on Tennesseans.

- ★ During a financial crisis, the most effective methods of restoring economic growth are lowering the tax burden and cutting government spending. Just as millions of Tennessee families must adapt spending habits to tough economic times, our government should learn to live within its means. Even Governor Bredesen appears to understand this. "I don't think you should ask people for more tax money when times are tough," noted the governor in a recent interview.[60] Cutting both wasteful spending and unnecessary tax burdens will boost the state's economy, whereas increasing taxes will prolong and increase economic despair.

### *The Problem*

While a tax on income from labor is unconstitutional in Tennessee, the state does allow one form of taxation on a type of income. Since 1929, the state has collected a tax on interest from bonds, notes and stock dividends.[61] The tax is referred to as the Hall Income Tax, named after the senator who sponsored it. The tax raises very little in revenue, but makes Tennessee an unwelcoming place, particularly for retirees and the wealthy, who would make significant contributions to the state economy.

***Recommendations***:

- ★ Repeal the Hall Income Tax to encourage the wealthy and retired to move to Tennessee.
- ★ Offset any reductions in revenue resulting from the elimination of the Hall Income Tax with spending cuts.

### *Analysis*

The Hall Income Tax is projected to generate $262 million in revenue for the current fiscal year,[62] representing a mere 2.2 percent of the state budget.[63] Although it comprises a very insignificant portion of state revenue, the tax has serious negative consequences. Because it targets only interest and dividends from stocks, bonds, and notes, it is essentially a tax on investors. Levying the tax serves to repel retirees and the wealthy, the groups who invest most often, from Tennessee. The Hall Income Tax also results in fewer investments by Tennessee residents and even encourages them to relocate elsewhere to avoid the sizeable 6 percent tax rate.[64]

The Hall Income Tax resembles the federal capital gains tax. A 1995 study conducted by the Cato Institute found that reducing the federal capital gains tax would "substantially raise tax collections and increase tax payments by the rich; increase the rate of capital formation, economic growth, and job creation through the year 2000; unlock hundreds of billions of dollars of unrealized capital gains, thus promoting more efficient allocation of capital; [and] expand economic opportunities for the most economically disadvantaged workers by bringing jobs and new businesses to capital-starved areas, such as America's inner cities."[65] The state tax on interest earned stifles investment in similar ways. Eliminating the Hall Income Tax would thus lead to capital formation, economic growth, and the efficient allocation of capital. It would also draw wealthy investors and retirees into Tennessee to contribute to the economy.

Any revenue shortfall created by eliminating the tax could be offset by spending cuts. In 2008 alone, the Tennessee Center for Policy Research identified nearly $270 million in wasted tax dollars in the annual *Tennessee Pork Report*.[66]

If legislators are serious about making Tennessee an economically robust state, eliminating the Hall Income Tax is a necessity.

### *Detailed Recommendations*

★ The General Assembly should repeal the Hall Income Tax because it stifles investment. Tennesseans should be encouraged to invest in stocks, bonds, and notes. Levying a tax on income from these sources deters savings and investment in our state economy. Further, it discourages the wealthy and retirees from settling in Tennessee, and even persuades Tennesseans to move elsewhere in search of more investor-friendly conditions.

- ★ The General Assembly should cut wasteful spending to offset any reduction in revenue collections that might result from eliminating the Hall Income Tax. Eliminating wasteful spending and encouraging investment will attract investors to Tennessee and create a more robust economy.

### *The Problem*

Families across Tennessee are facing tight economic times, and volatile gas prices play a significant role in strained family budgets. Gasoline taxes should be low enough to attract customers from bordering states, thus reducing the burden of state residents, while allowing for the funding of necessary road construction and maintenance projects.

***Recommendations***:

- ★ Lower the gasoline tax so it is competitive with surrounding states.
- ★ Permanently eliminate the requirement of an automatic increase in the state gasoline tax to offset reductions in the federal gasoline tax.

### *Analysis*

Tennessee has a gasoline tax of 21.4¢ per gallon. When added to the federal tax of 18.4¢, Tennessee drivers spend nearly forty cents in tax for every gallon of gasoline purchased. Taxes comprised roughly twelve percent of the average gasoline price in Tennessee the past year, making gasoline one of the most highly taxed goods in the state. Interestingly, the amount of money collected as gasoline tax by the federal and state governments is more than the profits actually earned by oil companies. A study conducted by the American Petroleum Institute discovered that taxes accounted for thirteen percent of the price of oil, while companies' earnings accounted for barely half that amount.[67]

Not only does the government drive up gas prices more than the oil companies themselves do, but Tennesseans, in particular, are paying dearly at the pump. Among the twelve states in the Southeast region, Tennessee's state-imposed gasoline taxes are the fourth highest. Only Arkansas, North Carolina and West Virginia tax gasoline at a higher rate.[68]

Tennessee is bordered by eight other states. Because of potential competition for customers among the closely-situated states, it behooves Tennessee to pay close attention to the gasoline tax rates of its border states. Of the eight, six have a lower gasoline tax rate than the Volunteer State. This means that, rather than bringing out-of-state drivers into the state to fill up on gasoline and increase state revenue, Tennessee's "prohibitive gas tax is forcing thousands of Tennesseans across state lines in search of cheaper gas."[69]

By lowering the gasoline tax to a more competitive rate, Tennessee could actually position itself to collect greater revenue. Rather than creating a "gas exodus" of Tennessee drivers, a reduced gasoline tax would encourage "Tennesseans to spend their gas money at home and [create] a role reversal by drawing neighboring states' residents to Tennessee's gas pumps."[70]

A final problem with Tennessee's current gasoline tax scheme is the state law mandating that any decrease in the federal gasoline tax be offset by an equivalent increase in the state tax.[71] Even if Congress decided to alleviate drivers' onerous tax burden by reducing the federal gasoline tax, Tennesseans would continue to pay the same amount in tax at the pump. Facing pressure from taxpayers in 2008, the General Assembly claimed to have eliminated this regressive law, but actually just suspended it until July 1, 2009, after which it will return to full effect absent legislative action this session.[72]

***Detailed Recommendations***

★ The 106th General Assembly should reduce the burden of taxpayers by lowering the gasoline tax. Tennessee has the ability to compete with neighboring states for gasoline tax revenues because of its high number of border states. By reducing the gasoline tax, Tennessee will serve as a magnet for surrounding states' citizens looking to fill their gas tanks more cheaply. This will ease the burden on Tennessee drivers by imposing the tax on more out-of-state motorists. Additionally, a reduced gasoline tax will encourage Tennesseans to remain in the state when purchasing fuel, resulting in increased tax revenues.

★ The General Assembly should eliminate the requirement that the state gasoline tax increases to offset any reduction in the federal gasoline tax. In the event that Congress reduces the tax burden on motorists, Tennesseans should benefit from the decision. Not only does the policy hurt Tennessee motorists, but it could potentially make Tennessee the state in the Southeast region with the highest gasoline tax.

### *The Problem*

In 2007, the General Assembly increased the cigarette tax to $0.62 per pack.[73] While this figure is only higher than the tax in fifteen other states, it is extraordinarily high when compared with surrounding states. The disproportionate tax rate drives Tennessee smokers to neighboring states to purchase cigarettes and discourages non-Tennesseans from making purchases in the Volunteer State. Both phenomena reduce revenues that could be generated with a more reasonable cigarette tax rate.

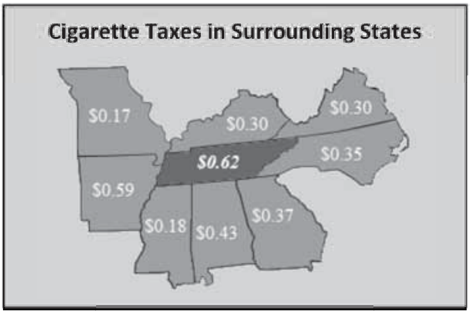
Members of the General Assembly have asserted that the cigarette tax increase was necessary to fund education programs.[74] Funding education with revenue from cigarette taxes means legislators have hung the fate of the state's children around the necks of smokers.[75]

***Recommendations***:

- ★ Lower the cigarette tax to an amount comparable to that of neighboring states to generate more revenue.
- ★ Recognize the unintended consequences of a high cigarette tax.

### *Analysis*

Tennessee is surrounded by eight other states, and every Tennessee citizen is within a ninety minute drive from at least one other state. As a result of this unique geography, Tennesseans are able to leave the state to make purchases; conversely, there are millions of non-residents who can easily visit Tennessee to shop. Consumption taxes, including sales, gasoline, and cigarette taxes, make up a significant portion of the state's revenue. It is, therefore, extremely important to




implement tax rates on consumption that will simulateneously keep Tennesseans in the state and attract non-residents from the eight surrounding states.

Currently, Tennessee has the highest cigarette tax of the nine relevant states. In fact, aside from the tax in Arkansas, Tennessee's cigarette tax is nearly twenty cents higher than that in any other of the nine states, and is nearly double the average for the area.

Not only does Tennessee fail to take advantage of its geographic placement to maximize cigarette tax revenue, but smuggling is an unintended consequence of high cigarette taxes, according to Dr. Michael LaFaive of the Mackinac Center for Public Policy. Cigarettes are a natural smuggling product because "[t]hey represent a product people want, are very lightweight, and possess large tax differentials between locations."[76] Cato Institute scholar Edward Hudgins estimates that cigarette smuggling was a $17 billion business in 2000 alone.[77]

Disturbingly, smuggling rings are far more dangerous than one might expect. In 2000, the Federal Bureau of Investigation conducted "Operation Smokescreen," in the process discovering that smugglers purchased cigarettes in low-tax North Carolina and shipped them to high-tax Michigan, selling them to convenience stores at a considerable discount. Profits from the operation could be traced to Mohamad Hammoud, an individual with alleged links to Hezbollah, recognized by the United States as a terrorist organization.[78] By keeping its cigarette tax higher than that of surrounding states, Tennessee could well be enticing smugglers into business who have ties to disreputable organizations.

In addition to smuggling, cigarette taxes are "both regressive—since smokers tend to represent a lower-income demographic—and punitive."[79] Robert Levy, a senior fellow at the Cato Institute, argues that the "social costs of smoking are already covered by existing taxes" and therefore cigarette taxes serve only to punish smokers for an activity disliked by the majority.[80]

### *Detailed Recommendations*

- ★ In order to compete with surrounding states for revenue, the General Assembly should lower the cigarette tax to give Tennesseans and out-of-state residents the incentive to purchase cigarettes within the state.

- ★ The General Assembly also ought to lower the cigarette tax to eliminate smuggling operations and to avoid relying on punitive and regressive taxes for education funding.

### *The Problem*

In the 1970s, several states established bottle deposit redemption programs, whereby a surcharge is placed on every bottle sold within that state. Thereafter, the consumer can obtain a refund for returning the bottle(s) to a drop-off site. Most systems cover all bottles, including those used for alcoholic beverages, nonalcoholic carbonated and noncarbonated beverages, and even water. These systems are paid for by a disguised tax on consumers, and are a cumbersome and uneconomical approach to dealing with recycling problems. Even though these programs are now widely acknowledged to be ineffective at dealing with recycling needs compared to less costly programs, some Tennessee legislators have recently attempted to enact one of these antiquated programs right here in the Volunteer State.

***Recommendations***:

- ★ Reject any attempt to create a bottle deposit redemption system.
- ★ Opt instead for a more economical, cheaper, and more effective recycling solution, such as a curbside recycling program.

### *Analysis*

While bottle deposit redemption programs may increase the overall number of containers recycled, any increase will “come as a detriment to consumers and existing recycling programs.”[81] A study conducted by the Solid Waste Agency of Northern Cook County in Chicago found that a bottle deposit redemption program would be bad for Illinois for three reasons: (1) it would increase prices on bottles to cover infrastructure and handling costs, resulting in a hidden tax to consumers; (2) it would cost more than three times the existing state's effective curbside recycling programs; and (3) it would remove valuable commodities from those existing programs, increasing the cost of curbside programs dramatically.[82]

Requiring either consumers or producers to pay a "deposit" on the front-end, the government is essentially levying a disguised tax that the consumer pays. Additional costs, even if borne by distributors, will result in increased prices of bottles. Thus, consumers will be left footing the bill for those programs, even though there are more effective and cheaper alternatives. In fact, as the Vice President of Coca-Cola Bottling New England acknowledged more than four years ago, "[C]onsumer preference and advancements in recycling are leading us away from a redemption system and towards enhanced curbside recycling."[83] Thus, even industry insiders acknowledge that bottle deposit redemption programs are inefficient and archaic methods of recycling.

### *Detailed Recommendations*

- ★ The General Assembly should not attempt to solve recycling problems with an antiquated bottle deposit redemption program. Consumers should not have to bear increased hidden taxes under schemes that did not work in the 1970s and will not work today.

- ★ If the General Assembly wants to improve recycling problems in the state, it should consider newer, more efficient alternatives, such as expanding curbside recycling programs. These programs are tailored towards modern consumer demands, in contradistinction to the inefficient bottle deposit programs of three decades ago.