The Tennessee Advisory Commission
on Intergovernmental Relations

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February 1, 2005

The Honorable John Wilder
Speaker of the Senate and Lieutenant Governor
1 Legislative Plaza
Nashville, TN 37243-0026

The Honorable Jimmy Naifeh
Speaker of the House
19 Legislative Plaza
Nashville, TN 37243-0181

Re: Equity in State Shared Taxes

Gentlemen:

During the 2004 session of the General Assembly, the TACIR received a request from the Speaker of the House of Representatives for a study of fairness in state-shared taxes. The resulting study examined each of the taxes that are shared and addressed the fairness of existing formulas used to distribute funds among city and county governments. The study produced five reports:

1. *State Tax Sharing, Fairness, and Local Government Finance in Tennessee* (January 2004).
2. *Hall Income Tax Distributions and Local Government Finance* (April 2004).
3. *The Case of Premiere Type Tourist Resort Cities* (September 2004).
4. *State-Shared Taxes and Cities without Property Taxes* (October 2004).
5. *State Highway Aid to Local Governments in Tennessee* (TBP, February 2005).

Major findings from those reports have been adopted by the Commission and are attached. The published reports have already been provided to your offices under separate cover. Please let us know if you require additional copies of the reports or additional information.

Sincerely,

Representative Randy Rinks
Chairman

Harry A. Green
Executive Director

CC: Commission Members

Major Findings from TACIR's Study of State Shared Taxes Conducted Pursuant to Request from Speaker Naifeh

- While Tennessee (27.4 percent) ranks below the South Region average (29.9 percent) in state intergovernmental aid (as percent of State general revenue), Tennessee (16.6 percent) ranks above the region (8.1 percent) in shared taxes as a percent of intergovernmental aid.

- The level of unrestricted state financial aid (including state-shared taxes) is higher in Tennessee than in other Southeastern states.

- State intergovernmental aid is a smaller share of state general revenue (27.4 percent) than the U.S. average (33.2 percent).

- PC 355 of 2003 added language to several sections of the TCA in order to enact the withholding of state-shared taxes. This language did not amend the original distribution formulae but did add additional calculations to effect the withholding, and did result in defacto changes in the distribution formulae. There is no expiration date on the PC 355 sections effecting these changes in state-shared tax distributions, though it is the stated intent of the administration to restore withheld state-shared taxes.

- Several issues related to equity were observed:

  General Equity

  — In terms of equity (or fairness) in the state tax sharing distribution formulas, those that use population for distribution are the most equitable. No equity principles were discovered that justify using situs or equal shares (by city or county) for distribution purposes.

  — No equity principles were discovered that relate directly to the amount of shared taxes distributed to all city governments compared to the distribution to all county governments. A relevant question is are the needs of city governments (and city residents) greater than the needs of county governments (and non-city residents). In 1970, the amounts distributed were approximately equal. By 2002, city governments were receiving $108 million more than county governments (not counting the wholesale beer tax).

  — Population, or per capita distributions, have long been advocated and used as measures of equity. However, population doesn't always relate to needs. For example, the correlation between population and county area is very low. Likewise, the correlation between population and miles of roads is very low. And, there is no statistical relationship between population and equal shares.

Effort

— A major purpose of cities is to provide services, but there are cities that provide limited services. In 1997 there were 77 cities (or towns) that offered 3 or fewer services to their citizens. By comparison, PC 1101 requires newly incorporating cities to develop a plan of services for the provision of 7 services. Based on Census of Government data (COG 97), only 122 cities of the 344 reporting provide some level of service for all seven service areas required to be included in a newly incorporated city's plan of services.

Property Tax

— Eighty-four cities do not levy a property tax, are low-services cities and are able to maintain that condition because of state-shared taxes. TCA§6-58-112 requires new cities to enact a property tax that produces tax revenue equal to state-shared taxes.

Gasoline and Diesel Taxes

— One-half of county shared gasoline and motor fuel taxes are based on equal shares. This means that the smallest county (whether based on area or population) receives exactly the same amount as the largest county. This distribution contributes to the fact that some counties contribute no local effort towards highway funding, funding their programs entirely from state-shared taxes. Ninety-one (91) counties reported spending $212 million on county roads and highways. Per capita spending ranged from a low of $12.90 in Shelby County to a high of $246.78 in Van Buren County.

Hall Income Tax

— Three eighths (or 38 percent) of the Hall income tax is shared on the basis of situs, or where it is collected. No equity principle that justifies this formula was discovered.

PILOT

— Fifty-seven percent of TVA payments in lieu of taxes distributed to counties is based on area: 43 percent based on county acreage and 14 percent based on TVA area. No meaningful relationship between service needs and the TVA payment distributions was found. The correlation coefficient between population and area is only 0.32. A perfect relationship would be 1.0.

Sales Tax

— Extraordinary sales tax payments are made to “Premier Type Resort Areas.” By statutory definition, there are only two cities that receive these payments: Gatlinburg and Pigeon Forge. With these extraordinary payments and high local sales tax collections, these cities (and Sevier County government) can maintain very low comparative property tax rates, a near average local sales tax rate, and relatively low hotel/motel tax rates. Gatlinburg and Pigeon Forge’s local efforts are higher when revenue from their Special Local Gross Receipts Tax provisions, are included in comparisons. These special provisions allow these two cities to export much of their local burden for services to the tourists whose presence necessitates much of the burden. The Special Local Gross Receipts Tax is authorized by private act; only Gatlinburg and Pigeon Forge have been authorized to collect this tax though other cities have requested authorization. The Premier Type Resort Area tax has the potential to be an effective revenue source for other local governments in Tennessee if the statutory definition could be made more inclusive. Likewise, the Special Gross Receipts Tax could generate additional revenue for local governments if its authorization was expanded.