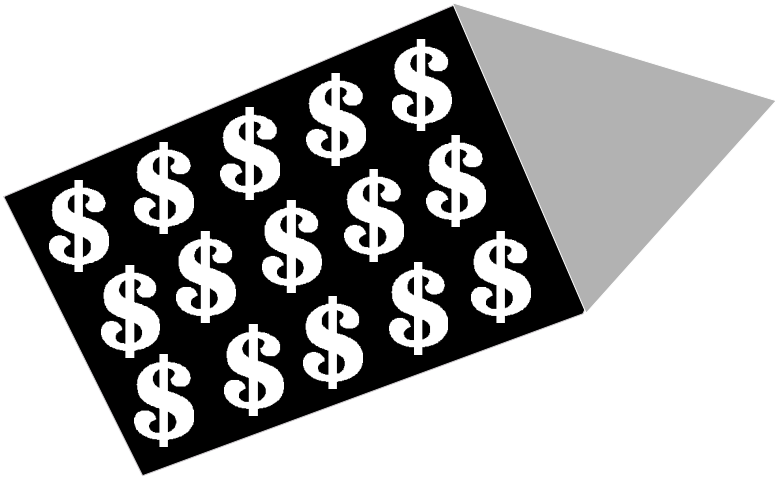
Staff Report

State Shared Taxes in Tennessee



The Tennessee Advisory Commission on Intergovernmental Relations

March 2000

State Shared Taxes on Tennessee

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EXECUTIVE SUMMARY

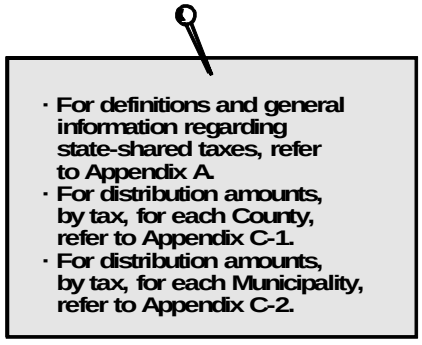
This report explores the significance of state-shared taxes in Tennessee and the fiscal impact of eliminating such revenue sharing with local governments. This issue was discussed at the December 1999 meeting of the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) at which time the TACIR staff was directed to prepare this report. The Commission discerned that state-shared taxes are a critical issue in the face of a major state fiscal crisis. This crisis has prompted some policy makers to suggest that part of the solution may lie in reducing the level of state-shared taxes provided to local governments.

This report focuses on the following state tax sharing topics:

- the importance of state-shared taxes to the state and the local governments;
- volatility and growth trends;
- statutory sharing requirements and restrictions;
- distribution methods; and
- the history of state-shared taxes in Tennessee.

Cities and counties have relied on state-shared taxes to varying degrees for more than one hundred years. Over that time, the amounts and types of taxes shared have grown and now total over $700 million. Their importance to local governments varies from tax to tax and from place to place. Each tax has it own unique distribution formula—in some cases they favor counties, in some cases cities, and in some cases both are treated alike. Some have restrictions on how they can be used. In addition, the amounts generated by some taxes are more volatile than others, fluctuating widely from year to year. The more volatile taxes make less reliable sources of revenue for recurring obligations. Consequently, the impact on local governments of such volatility varies, depending on the relative importance of the different shared taxes to the local revenue stream. To put the potential impact of a loss in state-shared taxes in perspective, this report presents information on how property tax rates would be affected[1]—and how reliable the revenue from property taxes could be—if cities and counties chose that source to replace state-shared taxes.

Taxes Subject to Sharing



As shown in Table *i*, Tennessee shares portions of 13 taxes with its local governments. State gasoline and motor fuel taxes made up more than one-third of all state-shared taxes in fiscal year 1999. Both cities and counties receive these funds each year. Allocations from the state sales and use taxes, which are distributed only to cities, made up another

[1] This information was developed by the University of Tennessee's County Technical Assistance Service (CTAS) and the Tennessee Municipal League (TML), at the request of the TACIR. These two agencies and the TACIR worked together to ensure the accuracy and objectivity of this report.

quarter of the total. Ten other taxes made up the remaining 38 percent.

Table *i*. Distributions of State-Shared Taxes and Percent of State Total, Fiscal Year 1998-99

State-Shared Revenues By Source	Total Amount Distributed	Percent
Alcoholic Beverage Tax	$4,748,931	0.7%
Beer Excise Tax	2,993,946	0.4%
Corporate Excise Tax[1]	24,374,866	3.4%
Gasoline Tax & Motor Fuel Tax[2]	255,444,850	35.8%
Gross Receipts Tax-TVA Replace. Rev.	65,965,764	9.2%
Special Petroleum Tax	11,897,000	1.7%
Hall Income Tax	57,508,845	8.1%
Mixed Drink Tax	14,573,477	2.0%
Sales and Use Tax	182,745,185	25.6%
Crude Oil & Natural Gas Severance Tax & Coal Severance Tax	600,992	0.1%
Subtotal	**$620,853,856**	**86.9%**
Beer Wholesale Tax[3]	$90,739,293	12.7%
Subtotal	**$711,593,149**	**99.7%**
Distributions to County Technical Assistance Service, Municipal Technical Advisory Service, UT Center for Government Training, and the TACIR[4]	$2,467,021	0.3%
Total	**$714,060,170**	**100.0%**

Sources: TN Department of Revenue and Tennessee Malt Beverage Association

[1] Local governments commonly refer to their distributions from this tax as Bank Excise Tax distributions.

[2] The Tennessee Department of Revenue reports the Gasoline Tax and Motor Fuel Tax distributions as one category.

[3] Data on the distribution of the 17% wholesale beer tax has traditionally not been included in the data released by the Department of Revenue. While the tax is a state levy, it has been treated in statistical releases as a local tax since local governments retain most of the revenue (96.5%).

[4] These distributions to non-local government entities are reported by the TN Department of Revenue under the category of municipal distributions.

Significance to the State

The significance to the state of state-shared taxes is readily apparent when one examines the amounts of recent distributions and projected future distributions, as well as state-shared allocations as a percent of total fund allocations.

During fiscal year 1999, the State of Tennessee shared over $711 million dollars with its local governments. An additional $2.5 million in state-shared revenue was distributed to various state agencies, including the Municipal Technical Advisory Service, the University of Tennessee Center for Government Training, the County Technical Assistance Service, and the TACIR. The Budget of the State of Tennessee estimates that state-shared tax distributions will total $671.3 million in fiscal year 2001. This amount includes distributions to the various agencies in addition to local governments, but it does not include beer wholesale tax

distributions, a state-shared tax often excluded in reports because 96.5 percent of its collections are returned to local governments. Although this tax is collected and remitted by the beer wholesalers, it is still a state tax, with the Department of Revenue responsible for its administration. Wholesalers retain three percent of the gross tax to defray their costs associated with collecting and remitting the tax; the Department retains one half of one percent to cover administration expenses. TACIR staff, using a simple growth estimate, estimated that beer wholesale tax distributions in 2001 will equal $94.3 million. Adding this estimate to the State Budget estimate produces an estimate of $765.6 million for total state-shared distributions for fiscal year 2001.

1998 is the latest year for which fund allocation data is currently available. According to the Department of Revenue's forthcoming *Biennial Report* for fiscal years 1997 and 1998, Tennessee allocated $596 million dollars to its local governments during fiscal year 1998. This amount represented almost nine percent of all state revenue collected by the Department of Revenue and almost twenty percent of otherwise unrestricted revenues allocated to the general fund ($3,034,680,000—derived by subtracting from the total the amount shown as earmarked in Table *ii*).

The proportion of state-shared taxes to all state revenue is even larger when one includes distributions from the beer wholesale tax. Adding the $89 million in beer wholesale tax distributions to local governments for 1998 to the $596 million in allocations increases state-shared amount to $685 million. This increases the proportion of state-shared taxes to total revenue to over 10 percent, and the percent of otherwise unrestricted revenues to nearly 23 percent.

Table *ii*: Allocation of Tennessee Tax Collections by Fund, 1998

ALLOCATED TO GENERAL FUND	**$ 2,438,597,000**
Share of Total Funds Allocated	36.12%
ALLOCATED TO OTHER EARMARKED FUNDS	**3,716,863,000**
Share of Total Funds Allocated	55.05%
ALLOCATED TO COUNTIES FUND	**250,632,000**
Share of Total Funds Allocated	3.71%
ALLOCATED TO MUNICIPALITIES FUND	**345,451,000**
Share of Total Funds Allocated	5.13%
Sum of shares of county & municipal funds	8.84%
TOTAL ALLOCATED	**$ 6,751,543,000**

Source: TN Department of Revenue *FY 1997 & FY 1998 Biennial Report*, forthcoming.

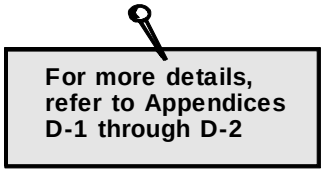
Significance to Local Governments

This report discusses four separate measures of the significance of state-shared taxes to local governments:

- the ratio of selected state-shared taxes to total local revenue from local sources;
- the ratio of selected state-shared taxes to county general fund balances;
- the ratio of selected state-shared taxes to total budgets for selected local governments; and
- the maximum potential impact on local property taxes that could occur with the withholding of state-shared taxes.

Those sections are followed by a discussion of the elasticity of local property taxes and their reliability as a replacement for state-shared taxes.

The Ratio of State-Shared Taxes to Local Own-Source Revenue



The first measure, the ratio of selected state-shared taxes to total local revenue from local sources, was analyzed using data from the Office of the Comptroller's 1997 report, *County and Municipal Finances For Fiscal Year Ended June 30, 1995*. Although not as recent as some of the other data used in this report, this data set was the most comprehensive available for both county and municipal governments. The metropolitan governments of Nashville/Davidson County and Lynchburg/Moore County were treated separately from other local governments.

State-shared taxes included in the analysis are:

- the sales tax (only shared with cities),
- corporate excise tax,
- mixed drink tax,
- Hall income tax,
- beer excise tax,
- alcoholic beverage tax, and
- state sharing of TVA payments.

Distributions from the beer wholesale tax are excluded since *County and Municipal Finances* reported such collections as revenue from local sources. While gasoline and other highway fund taxes are shared with local governments, they were excluded from the analysis in this section in order to focus attention on the importance of shared taxes on general government finance (excluding highway and road finance). A summary of a study completed on state-shared highway funds, including simulations on alternative methods for distributing highway funds to local governments, is located in Appendix I.

For fiscal year 1995, included state-shared taxes amounted to less than three percent of county revenues from local sources, but more than ten percent of municipal revenues from local and county sources. However, these statewide percentages mask the variability among local governments in their dependence on state-shared taxes. Percentages for particular localities varied from 1.4 to 35.5 percent among 93 counties and from 2.9 to 1,256.7 percent for cities. The highest county percentage was for Stewart County, which received a large distribution from TVA payments ($104 per capita, compared to a statewide county average of $15). The fourteen highest city ratios were for cities that did not impose a property tax. The highest percentage for a city with a property tax is 142.1 percent.

Six counties received amounts equal to more than ten percent of their local own-source revenue, and 63 cities received amounts equal to 50 percent or more of their local own-source revenue. Twenty-seven of those cities received amounts from state-shared taxes that exceeded their total local own-source revenue. Appendix D gives specific information for all cities and counties for fiscal 1995. Figures for the five most and least state-shared tax dependent counties are shown in Table *iii-a*. Figures for the five most and least state-shared tax dependent cities, of those that impose a property tax, are shown in Table *iii-b*.

Table *iii-a*. Most and Least State-Shared Tax Dependent Five Counties, Ranked by Ratio of Distributions to Revenue from Local Sources, FY 1995

	Distributions to Counties ($000s) (1)	Revenue from Local Sources ($000s) (2)	Ratio of Column 1 to Column 2 (Percent) (3)
TOP FIVE COUNTIES			
Stewart	1,176	3,309	35.5%
Meigs	644	2,925	22.0%
Union	534	3,751	14.2%
Benton	813	6,735	12.1%
Grainger	550	5,372	10.2%
BOTTOM FIVE COUNTIES			
Knox	3,774	244,878	1.5%
Hamilton	2,968	196,484	1.5%
Rutherford	1,058	71,720	1.5%
Williamson	1,147	80,577	1.4%
Madison	804	57,087	1.4%

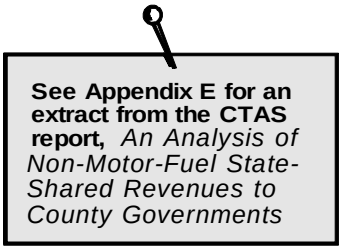
Table *iii-b*. Most and Least State-Shared Tax Dependent Five Municipalities (with Property Taxes), Ranked by Ratio of Distributions to Revenue from Local Sources, FY 1995

	Distributions to Municipalities ($000s) (1)	Revenue from Local Sources Plus County Funds ($000s) (2)	Ratio of Column 1 to Column 2 (Percent) (3)
TOP FIVE MUNICIPALITIES			
New Hope	48	34	142.1%
Morrison	35	26	134.8%
Normandy	7	6	129.4%
Mitchellville	13	13	97.1%
Belle Meade	1,293	1,498	86.4%
BOTTOM FIVE MUNICIPALITIES			
Friendship	40	605	6.6%
Tullahoma	1,157	18,435	6.3%
Kingsport	2,922	51,723	5.6%
Berry Hill	59	1,423	4.2%
Alcoa	460	15,821	2.9%

Sources: FY 1995 data from Department of Revenue and State Comptroller's Office.

Clearly, cities that receive more from state-shared taxes than they do from local revenue sources would have difficulty surviving without that revenue or without raising tax rates substantially. Even where the percentages are small, the dollar amounts may nevertheless be significant. It is impossible to tell from statistics on revenues how those funds are being used, and their loss may be more significant than the statistics would seem to indicate.

The Ratio of State-Shared Taxes to County General Fund Balances



The second measure, the ratio of selected state-shared taxes to county general fund balances, was analyzed in a University of Tennessee County Technical Assistance Service (CTAS) report. The CTAS report used county audit reports to examine the allocation of state-shared taxes to the various county fund types. CTAS developed this analysis to test the perception that state-shared revenues to counties are allocated mostly to general funds, and to illustrate the potential impact on county fund balances that could accompany the loss of state-shared taxes. While the CTAS report provides a comprehensive analysis of the relationship between state-shared taxes and county fund balances, no comparable information is available for municipal governments. This is due partly to the large number of municipal governments, and partly to differences in the methods used by municipal governments to report financial statistics.

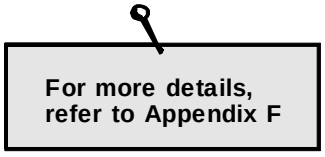
The shared revenues covered in the CTAS analysis included the corporate excise tax, the Hall income tax, TVA payments, and the state alcohol-related taxes including the beer excise tax, the mixed drink tax, and the alcoholic beverage tax. Motor fuel-related taxes were not

included because these shared revenues are required to be allocated to the county highway funds. This analysis also excluded the beer wholesale tax.

The CTAS analysis found that the loss of state-shared revenues would have serious implications to county government finances and counties' abilities to provide services. This is especially true for counties with small tax bases. The overall fiscal impact to counties, analyzed in terms of fund balances in the county general fund and the general purpose school fund for the year ending FY 1998, yielded the following findings:

- Thirty-three counties received non-motor-fuel-related shared revenues that were greater than 50 percent of their general fund balances.
- Fifteen counties received non-motor-fuel-related shared revenues that were more than 50 percent of their general-purpose school fund balances.
- Ten counties would have an immediate general fund deficit without the non-motor-fuel-related shared revenues.
- Six counties would have an immediate general-purpose school fund deficit without the non-motor-fuel-related shared revenues.

The Ratio of State-Shared Taxes to Local Government Budgets



TACIR staff conducted a simple analysis of the importance of state-shared taxes to 39 selected local governments. This analysis, found in Appendix F, calculated state-shared taxes as a percentage of total local budgets for selected county and municipal governments for fiscal year 1999. TACIR collected the local government budget data through telephone interviews of local government officials because no official source containing this information exists. The governments included in this analysis were the county and municipal governments in Shelby, Davidson, Knox, Hamilton, Haywood, White, and Unicoi counties.

By reporting state-shared taxes as a percent of local budgets for the four most populous counties and for one smaller county from each Grand Division, the analysis provides a useful sample for comparisons across Tennessee. However, its application is limited by the lack of readily accessible financial data for most Tennessee local governments. The results of the analysis reflected substantial variation in the importance of state-shared taxes. The importance of state-shared taxes varied from only 2.07 percent for Hamilton County to 60.91 percent for Haywood County. The results for municipalities varied from only 8.54 percent for Germantown to 118.38 percent for Forest Hills. Metropolitan Nashville/Davidson County's state-shared taxes represented 7.03 percent of its total fiscal year 1999 budget.

Local Property Taxes as a Replacement for State-Shared Tax Revenue

Where state-shared taxes play a relatively large role in funding local budgets and where the property tax bases are relatively small, the property tax increases required to replace lost state revenue could be quite large. The options for local governments are fairly limited, and, as explained below, the suitability of property taxes as a replacement for state-shared taxes varies widely.

If the State withheld or significantly reduced currently shared state tax revenue, many local governments would likely consider raising property tax rates, their only sizable source of unrestricted revenue. Other local taxes, such as the local option sales tax and wheel taxes, are limited by one or more of the following three major restrictions:

- a requirement for a referendum,
- a statutory cap on the rate of taxation, and
- in the case of local option sales taxes, a requirement that half of all collections be spent on public elementary and secondary education

Many local governments have raised property taxes to fund capital improvement plans to satisfy state class size mandates for schools. At the same time, local governments face continued threats to the property tax base because of recent reductions in personal property assessments resulting from actions addressing complaints of discriminatory assessment.

Consequently, as property tax bases decline, higher tax rates are required to replace local revenue or provide new needs.

Further complicating the issue of replacing lost state revenue with higher property taxes is the issue of the elasticity of local property taxes. While the elasticity of statewide property assessments has been estimated at a favorable 1.08, the elasticity of individual local property taxes is much less. For most local governments, local property taxes grow at a much lower rate than the local economy.

Potential Maximum Impact on Property Tax Rates

As shown in Table *iv*, state-shared taxes distributed to municipalities that impose a property tax account for over $420 million, with the balance of $15.3 million distributed to municipalities that do not impose a property tax. If state-shared taxes were withheld, and municipalities were to attempt to replace all state-shared taxes through an increase in property taxes, 185 municipalities would need to double their current property tax rates to maintain their current levels of spending. This translates into an average increase of $366 in property taxes on a $100,000 home and an increase of $5,861 on commercial property worth $1,000,000.

For the potential maximum impact on property taxes for each municipality, see Appendix G.

Table *iv*. Municipal Property Tax Rate and State-Shared Tax Summary, 1999

Total municipalities:	350
Municipalities with no property tax:	89
Total state-shared taxes to municipalities:	$435,847,352
State-shared taxes attributed to municipalities with prop. tax:	$ 420,552,882
State-shared taxes attributed to municipalities with no prop. tax:	$ 15,294,470
Number of municipalities that would Need to double their current prop. tax rate to maintain current spending	**185**

Source: Property data from State of Tennessee, Comptroller of the Treasury, 1998 Tax Aggregate Report and other Sources; State-Shared Tax data from Department of Revenue, Fiscal Services Division

For the potential maximum impact on property taxes for each county, see Appendix H.

As shown in Table *v*, county governments received over $275 million in state-shared taxes in FY 1999. If state-shared taxes were withheld, and county governments replaced all state-shared taxes through an increase in property taxes, they would on average need to increase property taxes $1.11 per $100 of assessed value in order to maintain revenues. Under this scenario, 36 counties would need to increase their property tax rate by over 50 percent, 16 counties would need to increase their rate by over 75 percent, and six counties would need to more than double their rate in order to offset the loss of state-shared taxes. Property tax liabilities would increase, on average, $278 on a home appraised at $100,000 and $4,441 on a commercial property appraised at $1,000,000.

Table *v*. County Property Tax Rate and State-Shared Tax Summary, 1999

Total Counties:	95
Total State-Shared Taxes (excluding severance taxes) to Counties:	$275,144,805
Number of counties that would need to increase their current prop. tax rate by 50% to maintain current spending it they no longer received state-shared taxes:	36
Number of counties that would need to increase their current prop. tax rate by 75% to maintain current spending it they no longer received state-shared taxes:	16
Number of counties that would need to double their current prop. tax rate to maintain current spending it they no longer received state-shared taxes:	6

Source: Property data from State of Tennessee, Comptroller of the Treasury, 1998 Tax Aggregate Report and other Sources; State-Shared Tax data from Department of Revenue, Fiscal Services Division. Due to security concerns related to the low volume of filers, severance taxes are not included in the total shown here.

The Elasticity of the Local Property Tax

The income elasticity of the property tax base in Tennessee (total local property assessments) has been estimated at 1.08. This means that, over the long run, the statewide local property tax base grows faster than the Tennessee economy, as measured by the growth in personal income. Consequently, if the State were to adopt a state-level property tax as a new revenue source (something that was considered during 1999) the revenue it would generate would grow slightly faster than personal income.

While a state-level property tax would represent a new, more elastic source of revenue for Tennessee, this does not mean that local property taxes are equally elastic. The elasticity of local property taxes will be very different for two reasons:

1. County property values (and therefore assessments) and county personal income grow at different rates. Some grow more slowly than the statewide average, some at the same rate, and some at rates higher than the statewide average.
2. In contrast to most state and local taxes that have fixed tax rates but growing tax bases (from a combination of inflation and real growth), local property tax rates are generally **reduced** following reappraisals of property.

Therefore while some counties have been fortunate enough to have growing property tax bases and have been able to tap into this growth, most counties have not. For most, the local property tax has proven to be an inelastic source of revenue with which to fund local government operations.

Growth, Volatility, and Trends of State-Shared Taxes

Existing state-shared taxes differ considerably in their ability over the long run to generate revenue growth sufficient to fund growing levels of needed state and local expenditures. In addition, shared taxes vary significantly in their response to changes in economic conditions,

especially during recessions. The evidence from data covering the period 1988 through 1998 shows the following:

1. Of the taxes shared with local governments, franchise and excise taxes (this combined amount is used to measure volatility since adequate corporate excise tax data is not available), sales and use taxes, motor vehicle fuel taxes, and Hall income taxes exhibit the highest estimated average annual rates of growth (6.4 percent, 5.9 percent, 4.9 percent, and 4.7 percent respectively).
2. The gasoline tax, which represents the single largest shared tax source, exhibits little growth over time, largely because it is imposed on the volume of the product sold, not its price.
3. The Hall income tax, while representing an important source of growing shared revenue to city and county governments, is the most volatile shared tax source.

The standard deviation (used as the measure of volatility) for each tax can be compared to the estimated volatility of Tennessee personal income. All taxes, except for the beer tax, exhibit more volatility over the period than Tennessee personal income. So, the ups and downs of economic activity affect all taxes, just as it affects personal income. Some taxes simply exhibit more volatility during economic fluctuations than personal income (which, as expected, fluctuates over the business cycle). The estimated growth and volatility measures in the table can be interpreted in relation to the values calculated for Tennessee personal income.

Table *vi*. Growth and Volatility of Tennessee State-Shared Taxes, 1988-1998, Ranked High to Low by Annual Rate of Growth

Tax	Annual Rate of Growth	Volatility	Rank
Franchise & Excise (Combined)	6.4%	7.3%	1
Sales and Use	5.9%	3.1%	2
Motor Vehicle Fuel	4.9%	4.5%	3
Hall Income	4.7%	10.3%	4
Mixed Drink	2.5%	2.8%	5
TVA Payments	1.8%	2.5%	6
Beer Tax	1.6%	1.0%	7
Gasoline Tax	1.4%	2.0%	8
Special Petroleum	1.4%	3.6%	9
Alcoholic Beverage	-0.1%	2.1%	10
Total for 10 taxes	5.2%	2.1%	
Baseline:			
Tenn. Personal Income	6.3%	1.1%	

Source: TACIR

Note: Average annual growth calculated by regressing the natural log of a tax on a linear trend (a constant was included). The estimated coefficient is reported as a percent. The volatility (measured as trend deviation) reported is the standard deviation of calculated residuals. Due to data limitations franchise and excise taxes are combined and treated as one tax in this analysis.

State-shared taxes to local governments in Tennessee have exhibited three long-run trends:

- the distribution of state taxes to county and municipal governments has declined as a percent of total state taxes between 1970 and 1998 (see Table *vii*);
- however, categorical grants, the other major type of intergovernmental aid to local governments, have been increasing; and

- the gap between county and municipal distributions has widened over the twenty-eight year period. In 1970, both were allocated just over $41 million in distributions. By 1998, municipal distributions had grown to over $346 million, while county distributions lagged behind at $250 million.

Table *vii*: Allocation of Tennessee Tax Collections by Fund, Selected Years, 1970-1998 ($000s)

	1970	1998
ALLOCATED TO COUNTIES FUND	41,286	250,632
Share of Total Funds Allocated	6.27%	3.71%
ALLOCATED TO MUNICIPALITIES FUND	41,730	346,451
Share of Total Funds Allocated	6.34%	5.13%
Sum of shares of county & municipal funds	12.61%	8.84%
TOTAL ALLOCATED	658,214	6,751,543

Sources: TN Dept. of Revenue *Biennial Reports* (1998 data from *FY 1997 & FY 1998 Biennial Report of the Dept. of Revenue*, forthcoming).

Distribution Methods

Tennessee uses four methods for distributing shared tax revenues, including

- situs-based distributions, which are distributions to the jurisdictions in which the taxes are collected,
- distributions based on population, also referred to as per capita-based distributions,
- distributions based on land area, and
- distributions based on equal shares [for example, each of the 95 counties would receive 1/95 of the revenue].

Table *viii* shows which distribution method is used for each state-shared tax and whether the tax is distributed to cities, to counties or to both.

Table *viii*. Distribution Recipients and Basis of State-Shared Taxes with Local Governments, FY 99

Tax	Distribution Recipient	Distribution Basis
Alcoholic Beverage	Counties, Selected Cities	**Population and Land Area.** County share is based ¼ on area and ¾ on population; 30% of the amount distributed to counties of more than 250,000 population having a contained city of 150,000 shall be paid to the city.
Beer Excise ($3.90 per barrel)	Counties, Cities	**Population and Equal Shares.** Cities share on a population basis and counties share equally.
17% Wholesale Beer Tax	Counties, Cities	**Situs** of retailer making wholesale purchase.
Corporate Excise (Corporate Income tax)	Counties, Cities	**Situs** of bank deposits and level of property taxes.
Gasoline	Counties, Cities	**Population, Land Area, and Equal Shares.** County share based ¼ on population, ¼ on county area, ½ is shared equally. Cities' shares based on population.
Income, Hall	Counties, Cities	**Situs**. Based on situs of taxpayer.
Mixed Drink	Counties, Cities	**Situs** of collection.
Motor Fuel	Counties, Cities	**Population, Land Area, and Equal Shares.** County amounts based on ¼ on population, ¼ on county area, and ½ is shared equally. City shares based only on population.
Sales & Use	Cities	**Population** of cities.
Severance – Coal	Counties	**Situs** of severance.
Severance -- Crude Oil & Natural Gas	Counties	**Situs** of wellhead severance.
Special Petroleum Products	Counties, Cities	**Population.**
TVA Payments	Cities, Counties	**Population, Land Area, and Equal Shares.** County share based 43% on population, 43% on area, and 14% on TVA owned land; city share based on population.

Sources: Tennessee Code Annotated, TN Department of Revenue.

Restrictions on Use by Local Governments

State-shared taxes can be restricted or unrestricted. Approximately $264 million of the total of $711 million distributed to cities and counties in fiscal year 1999 was restricted in some manner. The cities and counties that receive these revenues have limited discretion in how

such funds can be spent. By contrast, they have considerable discretion in spending the remaining $447 million.

Table *ix* shows which state-shared taxes are restricted and which are not. Shared highway taxes, including the gasoline and motor fuel taxes and the special petroleum tax, represent a majority of restricted revenue. These funds can be used only for roads, and to a very limited extent, mass transit. Half of the revenues from the mixed drink tax must be spent on education. Cities and counties that receive restricted revenues have come to rely on them for those purposes and make adjustments in how they allocate other taxes to allow them to do so.

Table *ix*. Restricted and Unrestricted State-Shared Taxes in Tennessee

State-Shared Tax	Restricted	Restriction
Alcoholic Beverage Tax	No	NA
Beer Excise Tax	No	NA
Beer Wholesale Tax	No	NA
Corporate excise Tax	No	NA
Gasoline Tax	Yes	Roads & Mass Transit
Motor Fuel Tax	Yes	Roads & Mass Transit
TVA Payments	No	NA
Special Petroleum Tax	Yes	Roads
Hall Income Tax	No	NA
Mixed Drink Tax	50% is earmarked	Education
Sales and Use Tax	No	NA
Coal Severance Tax	Yes	Education & Highway/ Stream Cleaning
Crude Oil and Natural Gas Severance Tax	No	NA

Sources: Tennessee Department of Revenue, TCA

SUMMARY OF MAJOR FINDINGS

- In Fiscal Year 1999:
  - Tennessee shared over $711 million dollars with its local governments.
  - $264 million was restricted, or earmarked (local governments had to use the money for specific purposes).
  - $447 million was unrestricted, or unearmarked.

- Of the taxes shared with local governments, franchise and excise taxes (combined), sales and use taxes, motor vehicle fuel taxes, and Hall income taxes exhibit the highest estimated average annual rates of growth (6.4 percent, 5.9 percent, 4.9 percent, and 4.7 percent respectively).

- The gasoline tax, which represents the single largest shared tax source, exhibits little growth over time.

- Hall income taxes, while representing an important source of growing shared revenue to city and county governments, is the most volatile shared tax source.

- In fiscal year 1995, state-shared taxes (excluding highway and beer wholesale taxes) amounted to only three percent of county own-source revenue but over 10 percent of city own-source revenue (including city funds returned by counties).
  - For particular localities, the ratio of state-shared taxes to local own-source revenue varied substantially:

    Counties: 1.4 to 35.5 percent

    Cities: 2.9 to 1,256.7 percent (the range was 2.9 to 142.1 percent for cities with property taxes).
  - Six counties received state-shared tax amounts equal to more than 10 percent of their own-source local revenue.

- 63 cities received state-shared tax amounts equal to 50 percent or more of their own-source local revenue. Twenty-seven of those cities received amounts from state-shared taxes that exceeded their total own-source local revenue.

- A University of Tennessee County Technical Assistance Service (CTAS) analysis of state-shared taxes and county fund balances found that the loss of state-shared revenues would have serious implications to county government finances:
  - 33 counties received non-motor-fuel-related shared revenues that were greater than 50 percent of their general fund balances,
  - 15 counties received non-motor-fuel-related shared revenues that were more than 50 percent of their general-purpose school fund balances,
  - 10 counties would have an immediate general fund deficit without the non-motor-fuel-related shared revenues, and
  - six counties would have an immediate general-purpose school fund deficit without the non-motor-fuel-related shared revenues.

- If state-shared taxes were withheld, and municipalities were to attempt to replace all state-shared taxes through an increase in property taxes, 185 municipalities would need to double their current property tax rate (at a minimum) to maintain their current level of spending.

- If state-shared taxes were withheld, and county governments were to attempt to replace all state-shared taxes through an increase in property taxes:
  - 36 counties would need to increase their property tax rate by over 50 percent,
  - 16 counties would need to increase their rate by over 75 percent, and
  - six counties would need to more than double their rate.

- An evaluation of the tax elasticity of each county's property tax base, where an elasticity of less than one indicates a tax base that will grow slower than the economy, shows that:
  - 19 counties have estimated elasticities below 0.75,
  - 30 with estimated elasticities greater than 0.75 but less than 1.0,
  - 20 with estimated elasticities greater than 1.0 and less than 1.25, and
  - 26 with estimated elasticities greater than 1.25.

Table *x*. Selected Characteristics of State-Shared Taxes

Tax	Recipient	FY 99Amount	Restrictions on Use	Volatility	1988-1998 Growth Rate	TCA Citations
Sales and Use Tax	Municipalities	$182,745,185	None	3.1%	5.9%	67-6-103
	Counties	n/a	n/a			
Gasoline Tax and Motor Vehicle Fuel Tax[1]	Municipalities	$85,268,285	Roads & Mass Transit	4.5% (Motor Fuel), 2.0% (Gasoline)	4.9% (Motor Fuel), 1.4% (Gasoline)	54-4-103, 54-4-203, 67-3-2001/2005/2008
	Counties	$170,176,565				
Special Petroleum Tax	Municipalities	$7,318,000	Roads	3.6%	1.4%	67-3-2006
	Counties	$4,579,000				
Hall Income Tax	Municipalities	$47,681,096	None	10.3%	4.7%	67-2-119
	Counties	$9,827,750				
TVA Replacement Revenue	Municipalities	$18,905,133	None	2.5%	1.8%	67-9-101/102/103
	Counties	$47,060,631	None			
Beer Excise Tax	Municipalities	$1,496,973	None	1.0%	1.6%	57-5-205
	Counties	$1,496,973				
Beer Wholesale Tax	Municipalities	$72,927,481	None	Not Measured		57-6-103
	Counties	$17,811,812				
Alcoholic Beverage Tax	Municipalities	Approximately $1,000	None	2.1%	-0.1%	57-3-306
	Counties	$4,748,931				
Corporate Excise Tax	Municipalities	$9,836,980	None	Not Measured		67-4-2017
	Counties	$14,537,886				
Mixed Drink Tax	Municipalities	$9,668,220	1/2 to Education	2.8%	2.5%	57-4-306
	Counties	$4,905,258				
Crude Oil and Natural Gas Severance Tax	Municipalities	n/a	None	Not Measured		60-1-301
	Counties	$66,531				
Coal Severance Tax	Municipalities	n/a	n/a	Not Measured		67-7-110
	Counties	$534,480	1/2 Education, 1/2 Hwy/Stream Cleaning			
Total[2]		**$711,593,149**				

[1] The Department of Revenue reports distributions for these two taxes as one category.

[2] Does not include $2.47 million in "municipal" distributions to non-municipalities.

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I. INTRODUCTION[2]

During a December 1999 meeting, the members of the Tennessee Advisory Commission on Intergovernmental Relations (TACIR), acting upon Chairman Robert Rochelle's motion, directed the Commission staff to provide a single, comprehensive source of information on state-shared taxes. The Commission further directed the staff to seek assistance from other agencies, both public and private, in the preparation of the report. This report, developed in cooperation with the Tennessee Municipal League and the University of Tennessee's County Technical Assistance Service, is the result of that guidance. In it, the following topics are reviewed:

- the importance of state-shared taxes to the state and the local governments;
- volatility and growth trends;
- statutory requirements and restrictions;
- distribution methods; and
- the history of state-shared taxes in Tennessee.

It is imperative that legislators and other policy makers have access to this type of detailed information, particularly in light of Tennessee's current fiscal crisis. Tennessee's fiscal crisis is the result of two factors: the state's dependence on the sales tax in combination with continued erosion in the sales tax base; and increased demand for state and local services as a result of economic and population growth. Tracking the historical relationship between state tax revenue in Tennessee and economic growth, as measured by personal income, shows that periodic sales tax rate increases were required to sustain needed expenditure levels. During inflationary, low-growth periods, the sales tax-dependent revenue system in Tennessee barely matched the growth in personal income, even with frequent sales tax rate increases. During low inflation, high-growth periods, the revenue system performed somewhat better, but once again, only with periodic increases in the sales tax rate.[3] Faced with this fiscal crisis, some policy makers have suggested a partial solution may lie in retaining all or part of the state revenue currently shared with local governments.

Faced with a fiscal crisis, some policy makers have suggested retaining all or part of state-shared tax revenues

Tennessee suffers from a structural budget deficit. This occurs when a given level of government services and activities cannot be financed over a long-run period with existing tax bases and tax rates. If the sales tax rate had not been increased in 1984 and 1992, and the base

[2] This paper draws extensively from *State Intergovernmental Aid to Local Governments in Tennessee*, a paper written by Stanley Chervin and presented at a meeting of the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) during the summer of 1998. This version has been extensively updated using input from Dr. Chervin, material prepared by Dr. Reuben Kyle, et al., and research prepared by the staffs of the University of Tennessee County Technical Assistance Service (CTAS), the Tennessee Municipal League (TML), and the Tennessee Advisory Commission on Intergovernmental Relations.

[3] Green, Harry A., Lynne Holliday, Stanley Chervin, et al., *Financing Tennessee Government in the 21st Century*, Tennessee Advisory Commission on Intergovernmental Relations, January 1999, p. iii.

expanded in 1984, a funding gap of $1 billion (unadjusted for inflation) would currently exist in the state budget.

A recent interstate comparison concluded that Tennessee did indeed have a structural deficit, and ranked the state 46th in projected state surplus versus deficit positions.[4] Tennessee's inelastic revenue system coupled with its above-average student enrollment and population projections were identified as the main causes for the projected deficit.[5]

Inelasticity refers to the inability of a revenue system to grow as fast as a state's economy, and thus as fast as increased demands for services. The inelasticity of Tennessee's tax system has impacted and will continue to impact local governments in the future. State education funding cuts during 1991 showed the propensity for local governments to turn to the property tax to compensate for reduced state dollars. Property taxes account for more than half of local revenues for education in nearly three-fourths of Tennessee's school systems. Many local governments have raised property taxes to fund capital improvement plans to satisfy state class size mandates. A future fiscal crisis would therefore make it more difficult for local legislative bodies to make up lost state revenues with further increases in property taxes. Additionally, local governments are facing threats to the property tax base because of recent reductions in personal property assessments resulting from litigation over discriminatory assessment practices.[6]

Cities and counties have relied on state-shared taxes to varying degrees for more than one hundred years. Over that time, the amounts and types of taxes shared have grown and now total over $700 million. Their importance to local governments varies from tax to tax and from place to place. Each tax has it own unique distribution formula—in some cases they favor counties, in some cases cities, and in some cases both are treated alike. Additionally, some have restrictions on how they can be used. The amounts generated by some taxes are more volatile than others, fluctuating widely from year to year. The more volatile taxes make less reliable sources of revenue for recurring obligations. Consequently, the impact on local governments of such volatility varies, depending on the relative importance of the different shared taxes to the local revenue stream. This report also presents information on how property tax rates would be affected[7]—and how reliable the revenue from property taxes could be—if cities and counties chose that source to replace state-shared taxes.

[4] Hovey, Hal, *National Perspectives on Tennessee Taxes*, Briefing Papers presented at the December 8-9, 1998 meeting of the Tennessee Advisory Commission on Intergovernmental Relations, Nashville, Tennessee, p. D-3. Only Hawaii, New Mexico, Wyoming, and Alaska had higher (worse) rankings.

[5] Green et al., p. iv.

[6] Ibid., p. iv.

[7] This information was developed by the University of Tennessee's County Technical Assistance Service (CTAS) and the Tennessee Municipal League (TML), at the request of the TACIR. These two agencies and the TACIR worked in partnership to ensure the accuracy and objectivity of this report.

II. TAXES SUBJECT TO SHARING

Tennessee shares portions of thirteen taxes with its local governments. As shown in Table 1, state gasoline and motor fuel taxes made up more than one-third of all state-shared taxes in fiscal year 1999. Both cities and counties receive these funds each year. Allocations from the state sales and use taxes, which are distributed only to cities, made up another quarter of the total. Ten other taxes made up the remaining 38 percent.

Tennessee shares portions of thirteen taxes with its local governments

Table 1. Distributions of State-Shared Taxes and Percent of State Total, Fiscal Year 1998-99

State-Shared Tax	Total Amount Distributed	Percent
Alcoholic Beverage Tax	$4,748,931	0.7
Beer Excise Tax	2,993,946	0.4
Corporate Excise Tax[1]	24,374,866	3.4
Gasoline Tax & Motor Fuel Tax[2]	255,444,850	35.8
Gross Receipts Tax-TVA Replace. Rev.	65,965,764	9.2
Special Petroleum Tax	11,897,000	1.7
Hall Income Tax	57,508,845	8.1
Mixed Drink Tax	14,573,477	2.0
Sales and Use Tax	182,745,185	25.6
Crude Oil & Natural Gas Severance Tax & Coal Severance Tax	600,992	0.1
Subtotal	**$620,853,856**	**86.9%**
Beer Wholesale Tax[3]	$90,739,293	12.7%
Subtotal	**$711,593,149**	**99.7%**
Distributions to County Technical Assistance Service, Municipal Technical Advisory Service, UT Center for Government Training, and the TACIR[4]	$2,467,021	0.3%
Total	**$714,060,170**	**100.0%**

Sources: TN Department of Revenue and Tennessee Malt Beverage Association

[1] Local governments commonly refer to their distributions from this tax as Bank Excise Tax distributions.

[2] The Tennessee Department of Revenue reports the Gasoline Tax and Motor Fuel Tax distributions as one category.

[3] Data on the distribution of the 17% wholesale beer tax has traditionally not been included in the data released by the Department of Revenue. While the tax is a state levy, it has been treated in statistical releases as a local tax since local governments retain most of the revenue (96.5%).

[4] These distributions to non-local government entities are reported by the TN Department of Revenue under the category of municipal distributions.

Appendix A provides definitions and general information pertaining to each state-shared tax. Appendices B-1 and B-2, respectively, provide fiscal year 1999 data on the distribution of the wholesale beer tax among counties and cities. While the tax is a state levy, and is treated as such in this report, it has been treated in other statistical releases as a local tax, since local governments retain most of the revenue (96.5 percent). Although this tax is collected and remitted by the beer wholesalers, it is still a state tax, with the Department of Revenue responsible for its administration. Wholesalers retain three percent of the gross tax to defray their costs associated with collecting and remitting the tax; the Department retains one half of one percent to cover administration expenses. Appendix C-1 provides data for fiscal year 1999 on the distribution of other state-shared taxes to individual counties. Appendix C-2 provides similar data on distributions to municipalities. Appendix C-3 provides the distribution data summed for county areas, while appendices C-6 and C-7, respectively, compare the county and city percents of total state-shared taxes to their percents of total state population.

III. SIGNIFICANCE OF STATE-SHARED TAXES TO THE STATE GOVERNMENT

The significance to the State of state-shared taxes is readily apparent when one examines the amounts of recent distributions and projected future distributions, as well as state-shared allocations as a percent of total fund allocations. During fiscal year 1999, the State of Tennessee shared over $711 million dollars with its local governments. An additional $2.5 million in state-shared revenue was distributed to various state agencies, including the Municipal Technical Advisory Service, the University of Tennessee Center for Government Training, the County Technical Assistance Service, and the TACIR. The Budget of the State of Tennessee estimates that state-shared tax distributions will total $671.3 million in fiscal year 2001. This amount includes distributions to the various agencies in addition to local governments, but it does not include beer wholesale tax distributions. TACIR staff, using a simple growth estimate, estimated that beer wholesale distributions in 2001 will equal $94.3 million. Adding this estimate to the State Budget estimate produces an estimate of $765.6 million for total state-shared distributions for fiscal year 2001.

1998 is the latest year for which fund allocation data is currently available. According to the Department of Revenue's forthcoming Biennial Report for fiscal years 1997 and 1998, Tennessee shared $596 million dollars with its local governments during fiscal year 1998. This amount represented almost nine percent of all state revenue collected by the Department of Revenue and almost twenty percent of otherwise unrestricted revenues allocated to the general fund ($3,034,680,000—derived by subtracting from the total the amount shown as earmarked in Table 2).

The proportion of state-shared taxes to all state revenue is even larger when one includes distributions from the beer wholesale tax. Adding the $89 million in beer wholesale tax distributions to local governments for 1998 to the $596 million in allocations increases state-shared amount to $685 million. This increases the proportion of state-shared taxes to total revenue to over 10 percent, and the percent of otherwise unrestricted revenues to nearly 23 percent.

Table 2: Allocation of Tennessee Tax Collections by Fund, 1998

ALLOCATED TO GENERAL FUND	**$ 2,438,597,000**
Share of Total Funds Allocated	36.12%
ALLOCATED TO OTHER EARMARKED FUNDS	**3,716,863,000**
Share of Total Funds Allocated	55.05%
ALLOCATED TO COUNTIES FUND	**250,632,000**
Share of Total Funds Allocated	3.71%
ALLOCATED TO MUNICIPALITIES FUND	**345,451,000**
Share of Total Funds Allocated	5.13%
Sum of shares of county & municipal funds	8.84%
TOTAL ALLOCATED	**$ 6,751,543,000**

Sources: TN Department of Revenue *FY 1997 & FY 1998 Biennial*, forthcoming).

IV. SIGNIFICANCE OF STATE-SHARED TAXES TO LOCAL GOVERNMENTS

Assessing the importance of state-shared taxes to local governments has proven difficult for several reasons. Current data with which to establish the relative importance of shared revenues to local government finance is not available. There is also some disagreement over the proper statistic or statistics to use in measuring the relative importance of shared taxes to local governments.

This report discusses four separate measures of the significance of state-shared taxes to local governments

Determining how local expenditures are impacted by the availability of state-shared taxes is problematic. Evaluating differences in expenditure levels among cities and counties is difficult because of differences in needs among cities and counties and differences in preferences. Whether or not a city or county is spending conservatively or extravagantly is not easily determined. The interdependency of county and city governments (and special school districts) varies among counties, further muddying the fiscal waters when comparing revenue and expenditure patterns among local governments.

This report discusses four separate measures of the significance of state-shared taxes to local governments:

- the ratio of selected state-shared taxes to total local revenue from local sources;
- the ratio of selected state-shared taxes to county general fund balances;
- the ratio of selected state-shared taxes to total budgets for selected local governments; and
- the maximum potential impact on local property taxes that could occur with the loss of state-shared taxes.

Those sections are followed by a discussion of the elasticity of local property taxes and their reliability as a replacement for state-shared taxes.

A. The Ratio of State-Shared Taxes to Total Local Own-Source Revenue

The first measure, the ratio of selected state-shared taxes to total local revenue from local sources, was analyzed using data from the Office of the Comptroller's 1997 report, *County and Municipal Finances For Fiscal Year Ended June 30, 1995*. Although not as recent as some of the other data used in this report, this data set was the most comprehensive available for both county and municipal governments. Due to their consolidated structures, the state's two Metropolitan Governments, Metro Nashville/Davidson County and Metro Lynchburg/Moore County, were analyzed separately from the other counties and municipalities (see below).

State-shared taxes included in the analysis are the sales tax (only shared with cities), corporate excise tax, mixed drink tax, Hall income tax, beer excise tax, alcoholic beverage tax (primarily shared with counties), and state sharing of TVA payments. Distributions from the beer wholesale tax are excluded since *County and Municipal Finances* reported such collections as revenue from local sources. While gasoline and other highway fund taxes are shared with local governments, they were excluded from the analysis in this section in order to focus attention on the importance of shared taxes on general government finance (excluding highway and road finance). A summary of a study completed on state-shared highway funds, including simulations on alternative methods for distributing highway funds to local governments, is located in Appendix I.

Revenue from local sources includes property taxes, tax equivalent payments, local sales tax, local beer and alcohol taxes, licenses and permits, interest on investments, excess fees and fees in lieu of salary, and other local source revenues.[8] The data for cities also includes county redistribution to cities of sales tax funds to which cities are entitled and city portions of county property taxes earmarked for education (for cities that provide K-12 education services).

1. County Results

Table D-1 (in Appendix D) presents data for the 93 non-Metro counties. The average weighted ratio of shared tax revenue to total revenue from local sources was only three percent. The average (unweighted) ratio for the 93 counties was 5.6 percent. The median ratio for the 93 counties was 4.8 percent.

Table 3. Five Most and Least State-Shared Tax Dependent Counties, Ranked by Ratio of Distributions to Revenue from Local Sources, FY 1995

	Distributions to Counties($000s) (1)	Revenue from Local Sources ($000s) (2)	Ratio of Column 1 to Column 2 (Percent) (3)
TOP FIVE COUNTIES			
Stewart	$1,176	$3,309	35.5%
Meigs	644	2,925	22.0
Union	534	3,751	14.2
Benton	813	6,735	12.1
Grainger	550	5,372	10.2
BOTTOM FIVE COUNTIES			
Knox	3,774	244,878	1.5
Hamilton	2,968	196,484	1.5
Rutherford	1,058	71,720	1.5
Williamson	1,147	80,577	1.4
Madison	804	57,087	1.4

Sources: FY 1995 data from Department of Revenue and State Comptroller's Office.

[8] Catchall category used in Comptrollers Report.

Several counties had extremely high ratios, statistical outliers,[9] necessitating a more detailed analysis of the data to explain such extreme values. Extremely high (over 10 percent) ratios (in Table D-1, column 3) were found for: Stewart County (35.5 percent), Meigs County (22.0 percent), Union County (14.2 percent), Benton County (12.1 percent), Grainger County (10.2 percent), and Decatur County (10.1 percent).

Since a majority of local expenditures are closely tied to population (education, public safety, etc.), each shared tax source was adjusted by county population to discover whether any of the extreme values in Table D-1 reflected unusually large specific tax distributions.

The data in Table D-2 (in Appendix D) point immediately to one prime suspect for the unusually high ratios identified in Table D-1, namely, distributions of TVA payments. State sharing of TVA payments dominates state-shared taxes with counties (see Table 4).

All the counties identified in Table D-1 with unusually high ratios had corresponding high per capita TVA payments. Other counties with relatively high for per capita TVA payments (such as Henry, Humphreys, Loudon, Perry, Polk, Rhea, and Van Buren, see Table D-2) also had relatively high ratios in Table D-1.

Table 4. Distribution of State-Shared Taxes with Counties (Fiscal Year 1994-95 Data)

Tax	Shared With Counties	Percent
Corporate Excise	$12,666,871	19.0%
Mixed Drink	$1,803,907	2.7%
Hall Income	$7,206,421	10.8%
Beer Excise	$1,376,707	2.1%
Alcoholic Beverage	$4,164,413	6.3%
TVA Replacement	$39,374,887	59.1%
Total	**$66,593,206**	**100.0%**

Source: Tennessee Department of Revenue.

Since TVA payments dominate state tax sharing with counties, the obvious question that arises is why such sharing is not more closely or consistently related to county population. The answer lies in the details of the Tennessee statutes that spell out how TVA payments are distributed.[10]

[9] An outlier in a dataset is an observation that is considerably different than other observations (as well as the average) and may signal either an error in measurement or entry.

[10] T.C.A. Title 67, Chapter 9. Distribution detail is not for the faint of heart.

The distribution of TVA payments was significantly modified in 1977. Prior to the change, almost all TVA payments in lieu of taxes went to the state general fund. Such payments had been growing strongly in the years just preceding the legislative change in 1977.[11]

The amendment that changed the distribution required that 48.5 percent of TVA payments in excess of the amounts paid the state during fiscal year 1977-78 be distributed to counties and cities.[12] Counties were to receive 70 percent of this amount, with the balance to cities (30 percent).

The key in understanding why the distribution to counties is so uneven (on a per capita basis) lies in the details for determining how much each county receives. The statutes require that approximately 43 percent of the amount to be distributed to counties be based on population, approximately 43 percent based on area, and the balance based on the percent of TVA owned land in a county to total TVA owned land in Tennessee.[13]

As a result of these requirements, some extreme per capita distributions result for reasons that have nothing to do with population. Stewart County reflects the most extreme result of the distribution procedure mandated by the statutes. Not only does Stewart county have a relatively large land area, a large portion of Steward County consists of the Land Between the Lakes, owned by TVA. Explanations for other extreme per capita TVA payments are expected to be similar, although not as dramatic. Whatever the reasons behind the distribution procedure established in the law, the results clearly favor rural areas over counties with large metropolitan populations.[14]

2. City Results

Table D-3 (in Appendix D) presents calculations for 318 cities. Cities for which no audit data was available or for which the population data was ambiguous were excluded from the calculations.[15] The average weighted ratio of shared tax revenue to total revenue from local sources (including the county funds already mentioned) was 10.1 percent, three times the ratio for counties. The average (unweighted) ratio was 45.9 percent, and the median ratio 24.1

[11] The payments were modified by Chapter 181, Public Acts of 1977. Federal law requires TVA to pay 5% of its gross power proceeds to states in which it operates. Fiscal year 1978-79 was the first fiscal year impacted by the change.

[12] It further required that 48.5% of any growth be distributed to the state, and that a minor amount equal to 3% of any growth go to impacted TVA areas.

[13] T.C.A. 67-9-102 (a)(1).

[14] The change in the distribution of TVA funds may have been very intentional, given that cities, but nor counties, participate in the sharing of state sales taxes.

[15] The 1997 report by the Office of the Comptroller on city and county finances did not report data for all cities. Population data used in the report was from the U.S. Census. However some cities occasionally hold special census intended to increase their share of state-shared taxes. Such "new population" figures occurred for a few cities in 1995 and were used for official distribution purposes. These few impacted cities were excluded from the calculations in the city section of the analysis.

percent. These summary city statistics clearly show a much higher degree of dependence by cities on state-shared taxes than by counties.

The amount of variation in the ratio values was much higher than for counties. The coefficient of variation[16] for the city values was 206.1 percent versus only 78.0 percent for counties. This high variability is clearly evident in the number of cities with extremely high ratios (see Table D-3 in Appendix D). Twenty-seven cities in Table D-3 have ratios in excess of 100 percent, with another thirty-eight cities with values in excess of 50 percent, but less than 100 percent. The fourteen highest city ratios were for cities that did not impose a property tax. The highest percentage for a city with a property tax is 142.1 percent.

Table 5. Five Most and Least State-Shared Tax Dependent Cities, and Five Most State-Shared Tax Dependent Cities with Property Taxes, Ranked by Ratio of Distributions to Revenue from Local Sources, FY 1995

	Distributions to Municipalities($000s) (1)	Revenue from Local Sources Plus County Funds ($000s) (2)	Ratio of Column 1 to Column 2 (Percent) (3)
TOP FIVE MUNICIPALITIES			
Centertown	$19	$2	1256.7%
Viola	8	9	817.3
Silerton	6	1	466.6
Burlison	22	7	343.7
Orme	9	3	268.6
BOTTOM FIVE MUNICIPALITIES			
Friendship	40	605	6.6
Tullahoma	1,157	18,435	6.3
Kingsport	2,922	51,724	5.6
Berry Hill	59	1,423	4.2
Alcoa	460	15,821	2.9
TOP FIVE MUNICIPALITIES WITH PROPERTY TAXES			
New Hope	48	34	142.1%
Morrison	35	26	134.8%
Normandy	7	6	129.4%
Mitchellville	13	13	97.1%
Belle Meade	1,293	1,498	86.4%

Sources: FY 1995 data from Department of Revenue and State Comptroller's Office.

For the most part, cities with ratios in excess of 50 percent are small cities with populations under 2,500. Three major exceptions include Belle Meade (a ratio of 86.4 percent and a population of 2,848), Forrest Hills (a ratio of 210.1 percent and a population of 4,519) and

[16] A statistical measure of the relative amount of variation in a variable. It is computed as the ratio of the standard deviation to the mean value.

Oak Hill (a ratio of 111.9 percent and a population of 4,408). Another choice of population limit would have resulted in a different set of cities. However some of the largest ratios are for extremely small cities, raising the question of whether some small cities would even exist if it were not for the state-shared-taxes made available to them.

The relatively higher level of dependence of cities on state-shared taxes is not too surprising given the types of taxes that are shared and the predominant method used to distribute these funds. Table 6 reflects the important role of sales taxes in the overall program of state tax sharing with cities. Sales taxes represented over 67 percent of all distributions to city governments in fiscal year 1995 and are distributed, with two exceptions,[17] on the basis of population. Sales taxes represent the major source of shared taxes for most cities.

While sales tax distributions represent the single largest source of state-shared taxes to most city governments, there are exceptions. Table D-4 (in Appendix D) provides detailed 1995 per capita distributions for the 318 cities included in the analysis. Such detailed data clearly shows the relative importance of each source of shared taxes.

The amount of variation shown for each tax (coefficient of variation) varies from a high of 424.2 percent for distributions from the Hall income tax to a low of 12.2 percent for beer tax distributions. The variation in the distribution of sales taxes is distorted by two cities, Pigeon Forge and Gatlinburg. If these two cities were excluded, there would be little difference in the per capita distributions of shared sales taxes. Beer tax and sales tax distributions (with the exception of the two cities mentioned) are based on population.

Table 6 Distribution of State-Shared Taxes to Cities (Fiscal Year 1994-95 Data)

Tax	Shared With Municipalities	Percent
Corporate Excise	$6,975,959	3.2%
Mixed Drink	$7,587,985	3.5%
Hall Income	$25,843,436	11.9%
Beer	$13,911,353	6.4%
T.V.A. Replacement	$16,331,534	7.5%
Sales and Use	$146,869,239	67.5%
Total	$217,519,506	100.0%

Source: Tennessee Deparment of Revenue, Biennial Report for fiscal year 1995, p. 73.

Extreme per capita amounts shown in Table D-4 are generally easily explained by either the statutes or a combination of the statutes and unique situations that apply in specific cities.

[17] With exception of Pigeon Forge and Gatlinburg.

Income tax sharing distributions are made on the basis of taxpayer residence. The high per capita distributions found in Belle Meade ($393), Brentwood ($36), Cumberland Gap ($107), Forrest Hills ($62), Lookout Mountain ($460), Oak Hill ($40), Ridgeside ($46), Rockford ($73), Signal Mountain ($49), and Walden ($41), reflect a combination of high concentrations of wealthy households within a single city or the presence of a few extremely wealthy households in a relatively small city.

The distribution of TVA payments to cities is based for the most part on population. Therefore its distribution is much less variable than for Hall income taxes. The few exceptions to this general rule result from hold harmless provisions built into the distribution procedures that impact relatively small cities.

Only two cities receive distributions from the sales tax that are not based on population. The sales tax distribution statutes contain special language that results in the extremely high per capita values for Gatlinburg ($483) and Pigeon Forge ($1,052).[18] All other cities received approximately $50 per capita (in fiscal 1995).

Per capita mixed drink tax sharing and per capita excise tax distributions are heavily impacted by history, demographics, and in the case of mixed drink sales, local option choices concerning legal mixed drink sales. Mixed drink sales and the distribution of state-shared mixed drink taxes are heavily impacted by the size of the market. Not surprisingly, the highest per capita distribution of mixed drink taxes is to Gatlinburg, a city with a fairly small population in relation to the average tourist population that frequents the resort location.

The per capita distribution of excise taxes relates to bank profits and the distribution of bank deposits. Neither mixed drink nor excise tax distributions represent a large absolute amount and are of importance to only a few small cities.

3. Metro Government Results

Metropolitan Nashville/Davidson County and Metropolitan Lynchburg/Moore County were reviewed separately from the other local governments, due to their consolidated structures. Metro Nashville's state-shared taxes represented 4.13 percent of their local own-source revenues, while Metro Lynchburg's represented 8.05 percent of their local own-source revenue (see Appendix D-5).

B. The Ratio of State-Shared Taxes to County General Fund Balances

The second measure, the ratio of selected state-shared taxes to county general fund balances, was analyzed in a University of Tennessee County Technical Assistance Service (CTAS)

[18] T.C.A. 67-6-103(a)(3)(B).

report. The CTAS report used county audit reports to examine the allocation of state-shared taxes to the various county fund types. CTAS developed this analysis to test the perception that state-shared revenues to counties are allocated mostly to general funds, and to illustrate the potential impact on county fund balances that could accompany the loss of state-shared taxes. While the CTAS report provides a comprehensive analysis of the relationship between state-shared taxes and county fund balances, no comparable information is available for municipal governments. This is due partly to the large number of municipal governments, and partly to variations in reporting among those governments.

The shared taxes covered in the CTAS analysis included the corporate excise tax (referred to by CTAS as the bank excise tax), the Hall income tax, TVA payments, and the state alcohol-related taxes including the beer excise tax, the mixed drink tax, and the alcoholic beverage tax. Motor fuel-related taxes were not included because these shared revenues are required to be allocated to the county highway funds. This analysis also excluded the beer wholesale tax.

The CTAS analysis found that the loss of state-shared revenues would have serious implications to county government finances and counties' abilities to provide services. This is especially true for counties with small tax bases. The overall fiscal impact to counties, analyzed in terms of fund balances in the county general fund and the general purpose school fund for the year ending FY 1998, yielded the following findings:

- Thirty-three counties received non-motor-fuel-related shared revenues that were greater than 50 percent of their general fund balances.
- Fifteen counties received non-motor-fuel-related shared revenues that were more than 50 percent of their general-purpose school fund balances.
- Ten counties would have an immediate general fund deficit without the non-motor-fuel-related shared revenues.
- Six counties would have an immediate general-purpose school fund deficit without the non-motor-fuel-related shared revenues.

An extract from the CTAS study is located at Appendix E.

C. The Ratio of State-Shared Taxes to Local Government Budgets

The TACIR staff conducted a simple analysis of the importance of state-shared taxes to 39 selected local governments. This analysis, found in Appendix F, calculated state-shared taxes as a percentage of total local budgets for selected county and city government for fiscal year 1999. TACIR collected the local government budget data through telephone interviews of local government officials, as no official source containing this information exists. The analysis included all county and municipal governments in Shelby, Davidson, Knox, Hamilton, Haywood, White, and Unicoi counties.

By reporting state-shared taxes as a percent of local budgets for the four most populous counties and for one smaller county from each Grand Division, this selection provides a useful

sample for comparisons across Tennessee. However, its application is limited by the lack of readily accessible data for most Tennessee local governments. The results of the analysis reflected substantial variation in the importance of state-shared taxes. The importance of state-shared taxes varied from only 2.07 percent for Hamilton County to 60.91 percent for Haywood County. The results for municipalities varied from only 8.54 percent for Germantown to 118.38 percent for Forest Hills. Metropolitan Nashville/Davidson County's state-shared taxes represented 7.03 percent of its total fiscal year 1999 budget.

D. Local Property Taxes as a Replacement for State-Shared Tax Revenue

Where state-shared taxes play a relatively large role in funding local budgets, and where the property tax bases are relatively small, the property tax increases required to replace lost state revenue could be quite large. The options for local governments are fairly limited, and the suitability of property taxes as a replacement for state-shared taxes varies widely.

If the State withheld or significantly reduced currently shared tax revenue, many local governments would likely consider raising property tax rates, their only sizable source of unrestricted revenue. Other local taxes, such as the local option sales tax and wheel tax, are limited by one or more of the following three major restrictions:

- a requirement for a referendum
- a statutory cap on the rate of taxation
- in the case of local option sales tax, a requirement that half of all collections be spent on public elementary and secondary education

Many local governments have raised property taxes to fund capital improvement plans to satisfy state class size mandates for schools. At the same time, local governments face continued threats to the property tax base because of recent reductions in personal property assessments resulting from actions addressing complaints of discriminatory assessment. Consequently, raising local property taxes is becoming increasingly difficult.

Further complicating the issue of replacing lost state revenue with higher property taxes is the issue of the elasticity of the local property tax bases. Statewide, the elasticity has been estimated at a favorable 1.08. Because this measure is greater than one, the property tax base can be expected over the long run to grow faster than the State's economy as measured by the growth in personal income. However, at the local level, property taxes vary widely in their elasticity or responsiveness to economic growth.

The next two sections provide a discussion of the fiscal impact on local governments of the loss of state-shared tax revenue, first for municipal governments, and then for county governments. They show that **if property taxes were used to totally replace current state-shared revenue, 185 municipalities and six county governments would need to more than double their rates in order to offset the loss of state-shared revenues.** Staff members of the Tennessee Municipal League prepared the analysis of the impact on city

finances and the staff of the University of Tennessee's County Technical Assistance Service prepared the analysis of the impact on county finances. TACIR staff updated and adapted both analyses for this report. Those sections are followed by a discussion of the elasticity of local property taxes.

First a note about the property tax equivalent data presented in Appendices G and H: The impact of replacing state-shared taxes with property tax increases has been calculated for each county and each city that currently imposes a property tax.[19] These appendices show the "property tax equivalent" for each municipality and county expressed as a dollar amount for each $100 of assessed valuation.[20] These rates are based on the latest available data on property assessments and distributions of state-shared taxes. Appendices G and H also show the percentage increase these tax equivalent rates would produce. The percentage increases were calculated by adding the property tax equivalent rate required to replace all state-shared taxes to the 1998 rate and dividing the combined rate by the 1998 rate. To better illustrate the impact of a complete loss of state-shared taxes, these appendices include two additional columns with examples showing how large the increases would be in actual property tax bills. The first column shows the additional property tax liability for a home valued at $100,000.[21] The second column shows the additional property tax liability on a commercial property valued at $1,000,000.[22]

1. Impact on Municipal Governments

State-shared tax distributions to cities in FY 1999 totaled more than $435 million. Based upon total assessed values for the entire state, the aggregate property tax rate required to offset state-shared tax amounts is $1.00. However, the property tax is imposed locally, not at the state level; therefore, the average of the individual municipalities' property tax equivalent rates, which is $1.47 per $100 of assessed valuation gives a better indication of the true impact of replacing state-shared taxes by raising local property taxes. That average applied to a home valued at $100,000 would result in a property tax increase of $366. If applied to a commercial property valued at $1,000,000, the increase would be $5,861.

State-shared taxes distributed to municipalities that impose property taxes account for over $420 million. The balance of $15.3 million in distributions to municipalities goes to those that do not impose a property tax. As shown in Table 7 and detailed in Appendix G, 185 municipalities would need to more than double their property tax rates to replace a complete loss of all state-shared taxes.

[19] It is not possible to calculate "property tax equivalents" for municipalities that do not currently impose a property tax, as assessment data is not maintained for such municipalities.

[20] Since "Total 1998 Assessment" data refers to assessed value rather than appraised value, there is no need to account for assessment ratio differences across property categories (eg. Residential at 25%, Commercial at 40%, etc.)

[21] Because of the 25% residential assessment ratio established by the Tennessee Constitution (Section XX), the calculations are based on the rate per $100 of an assessed value of $25,000.

[22] Because of the 40% commercial assessment ratio established by the Tennessee Constitution (Section XX), the calculations are based on the rate per $100 of an assessed value of $400,000.

Table 7. Municipal Property Tax & State-Shared Tax Summary, 1999 (Extracted from Appendix G)

Total Municipalities:	350
Municipalities with no Property Tax:	89
Total State-Shared Taxes to Municipalities:	$435,847,352
State-Share Taxes Attributed to Municipalities with Prop. Tax:	$ 420,552,882
State-Share Taxes Attributed to Municipalities w/no Prop. Tax:	$ 15,294,470
Number of Municipalities that Would Need to Double Their Current Prop. Tax Rate:	**185**

Source: Property data from State of Tennessee, Comptroller of the Treasury, 1998 Tax Aggregate Report and other Sources; State-Shared Tax data from Department of Revenue, Fiscal Services Division

2. Impact on County Governments

As shown in Appendix H and Table 8, county governments received more than $275 million in state-shared taxes in FY 1999. If state-shared taxes were withheld, counties would on average need to increase property taxes $1.11 per $100 of assessed value in order to replace the entire loss state-shared taxes with property taxes. If that should happen, 36 counties would need to increase their property tax rates by more than 50 percent, 16 counties would need to increase their rates by more than 75 percent, and six counties would need to more than double their rates.

Appendix H also shows the increased in property taxes for a home appraised at $100,000 and for a commercial property appraised at $1,000,000. The average increase for counties in taxes would be $278 on a $100,000 home, and $4,441 on a $1,000,000 commercial property. The largest residential increase would be in Pickett County, with an increase of $922 in property tax on a $100,000 home, while the smallest increase would be in Davidson County, where the increase would be $31. The largest commercial increase would also be in Pickett, with an increase of $14,758 for a $1,000,000 commercial property, and the smallest increase would be in Davidson, where the increase would be $497.

Table 8. County Property Tax and State-Shared Tax Summary, 1999 (Extracted from Append. H)

Total counties:	95
Total state-shared taxes (excluding severance taxes) to counties:	$275,144,805
Number of counties that would need to increase their current prop. tax rate by 50% it they no longer received state-shared taxes:	36
Number of counties that would need to increase their current prop. tax rate by 75% it they no longer received state-shared taxes:	16
Number of counties that would need to double their current prop. tax rate it they no longer received state-shared taxes:	6

Source: Property data from State of Tennessee, Comptroller of the Treasury, 1998 Tax Aggregate Report and other Sources; State-Shared Tax data from Department of Revenue, Fiscal Services Division
Due to security concerns related to the low volume of filers, severance taxes are not included in the total shown here.

3. Elasticity of the Local Property Tax

Further complicating the issue of replacing lost state revenue with higher property taxes is the issue of the elasticity of local property taxes. Statewide, the income elasticity of the property tax base in Tennessee (total local property assessments) has been estimated at 1.08.[23] This measure implies that over the long-run, the statewide local property tax base grows faster than Tennessee personal income. Therefore a state property tax would generate a flow of revenue to the state that would grow slightly faster than personal income. This would represent a new elastic source of revenue for the state.[24]

However, the elasticity measure calculated for a statewide property tax base is not an appropriate measure of the elasticity of each county's property tax base nor of each county's property tax. This follows for two reasons:

1. County property values (and therefore assessments) and county personal income grow at different rates. Some grow more slowly than the statewide average, some at the same rate, and some at rates higher than the statewide average. An evaluation of the tax elasticity of each county's property tax base (using a comparable period of time to that used in calculating the elasticity of a state property tax base) shows that 19 counties have estimated elasticities below 0.75, 30 with estimated elasticities greater than 0.75 but less than 1.0, 20 with estimated elasticities greater than 1.0 and less than 1.25, and 26 with estimated elasticities greater than 1.25. See Table 9 for elasticity coefficients for each county.

2. In contrast to most state and local taxes that have fixed tax rates but growing tax bases,[25] local property tax rates are initially **reduced** following reappraisals of property. This is a result of state law that requires local officials, after a reappraisal, to calculate a new 'certified property tax rate.' The certified property tax rate is that rate which if applied to the new value of appraised property, produces the same amount of tax as during the previous year (before reappraisal).[26] This certified tax rate cannot be increased until the local government publicly advertises its intent to exceed the certified tax rate.[27] As a result of this requirement, raising a local tax rate after a reappraisal program back to its

[23] *Income Elasticity of Tennessee's Tax System*, Tennessee Advisory Commission on Intergovernmental Relations (TACIR), July 1999, p. 9.
[24] A revenue source with tax elasticity greater than or equal to 1.
[25] From a combination of inflation and real growth.
[26] T.C.A. 67-5-Part 17. The process excludes the value of new construction, improvements and deletions.
[27] The elasticities for each county are based on regressions that use local assessments and local personal income. County personal income data was obtained from the Bureau of Economic Analysis at website http://www.bea.doc.gov/bea/regional/reis/cal_3.htm. Assessment data is from various issues of *Tax Aggregate Report of Tennessee*, a publication of the State Board of Equalization. For the regression procedure used, see TACIR, p. 4. The regression results are somewhat distorted because of varying reappraisal cycles and dates among the counties. Reappraisals occur every 4-8 years, with more frequent reappraisals occurring in the largest counties (by population). The data used to measure total county assessments is therefore less than ideal because of its failure, on an annual basis, to properly reflect the growing nominal value of property.

previous level is politically difficult and therefore historically infrequent. Tax rates after reappraisal years do tend to drift back up as local governments attempt to tap more of the growth in the tax base that was denied to them during the years between reappraisals. However the process of catch-up is never complete. The result is that the local property tax system is somewhat hamstrung in its ability to deliver revenue growth equal to the underlying growth in property values.

Table 9. Local Property Tax Elasticity Analysis: County Elasticity Coefficients

County	Elasticity Coefficient	County	Elasticity Coefficient
Anderson	1.2919	Lauderdale	1.0748
Bedford	1.4219	Lawrence	0.7426
Benton	0.7450	Lewis	1.6222
Bledsoe	0.5621	Lincoln	1.4096
Blount	1.3655	Loudon	1.0661
Bradley	0.6967	McMinn	0.8367
Campbell	0.9629	McNairy	0.8129
Cannon	0.8272	Macon	0.6645
Carroll	0.9392	Madison	0.9313
Carter	1.1439	Marion	0.7122
Cheatham	1.4757	Marshall	1.4649
Chester	0.7610	Maury	0.8852
Claiborne	0.8611	Meigs	1.6178
Clay	0.7833	Monroe	1.6566
Cocke	0.7203	Montgomery	1.6487
Coffee	1.0066	Moore	0.7957
Crockett	0.5165	Morgan	0.7392
Cumberland	1.8812	Obion	0.9062
Davidson	0.8233	Overton	0.8934
Decatur	0.9773	Perry	1.2797
DeKalb	1.5867	Pickett	0.9222
Dickson	1.5624	Polk	0.6049
Dyer	1.6755	Putnam	1.3499
Fayette	0.9706	Rhea	1.2513
Fentress	0.4818	Roane	1.0661
Franklin	1.3143	Robertson	1.2243
Gibson	1.0496	Rutherford	0.8721
Giles	1.0446	Scott	0.8535
Grainger	0.5223	Sequatchie	0.5761
Greene	0.8698	Sevier	1.7711
Grundy	0.8102	Shelby	1.2763
Hamblen	0.8178	Smith	1.1726
Hamilton	1.0509	Stewart	1.2035
Hancock	1.0559	Sullivan	0.8469
Hardeman	0.9258	Sumner	1.3164
Hardin	0.6633	Tipton	1.1682
Hawkins	1.4167	Trousdale	0.7784
Haywood	0.7902	Unicoi	1.5916
Henderson	1.0588	Union	1.0385
Henry	0.6611	Van Buren	0.4624
Hickman	0.6424	Warren	0.9372
Houston	1.3623	Washington	1.1065
Humphreys	1.0303	Wayne	0.5361
Jackson	0.9206	Weakley	1.3109
Jefferson	1.1833	White	1.0976
Johnson	0.8901	Williamson	1.5783
Knox	0.9189	Wilson	1.2498
Lake	0.2996	**Statewide Total**	**1.0798**

Some recent data supports this assertion. Table 10 shows the before and after property tax rates following recent reappraisals in Tennessee's four largest metropolitan counties. Reappraisals in the Metropolitan Government of Nashville/Davidson County, Hamilton County, and Knox County, all resulted in lower property tax rates after reappraisal than before. Shelby County was the exception.

Table 10. Results of Recent Reappraisals

County	Reappraisal Year	Tax Rate In Year Prior To Reappraisal	Certified Rate After Reappraisal	Tax Rate Actually Levied
Davidson/Nashville	1997	$4.50	$3.58	$4.12
Hamilton	1997	$3.22	$2.93	$2.93
Knox	1997	$3.16	$2.77	$2.77
Shelby	1998	$3.16	$2.82	$3.54

Source: Comptroller of the Treasury

The Metropolitan Government of Nashville Davidson County completed a reappraisal program in 1996. The tax rate in the year prior to reappraisal was $4.50 per $100. The certified tax rate after reappraisal was only $3.58. Since the Metropolitan Government needed more funds than would otherwise have been generated by the after-reappraisal certified tax rate and the now larger tax base, the local government council voted to raise the tax rate above the certified rate to $4.12 per $100. However this rate was still less than the tax rate in the previous year. In fact, the tax rate for fiscal year 1998-99 ($4.24) is still less than the rate ten years earlier (in fiscal year 1989-90 the tax rate was $4.81).

The result of the statutory requirement mandating the calculation of a certified tax rate and its publication following reappraisal and the infrequency of reappraisals leaves most local governments without a means to fully utilize the underlying elasticity of the property tax base itself. Therefore the elasticity of most local property taxes is effectively less than the elasticity of the local property tax base.

Two additional pieces of information are offered in support of this argument. Table 11 presents data showing that the average[28] nominal property tax rate in Tennessee over the period 1986-1995 actually declined. Therefore the growth of property tax revenue and the income elasticity of property taxes failed to keep up with the corresponding values for the property tax base (total assessments).

[28] Not true for each and every county.

Table 11. Local Property Tax Statistics

Year	Total Assessments	Total Local Property Taxes	Average Nominal Tax Rate Per $100
1986	$28,732,578,324	$1,125,415,000	$3.92
1987	$31,134,356,650	$1,199,640,000	$3.85
1988	$32,505,221,504	$1,319,588,000	$4.06
1989	$36,466,514,084	$1,457,942,000	$4.00
1990	$38,312,173,230	$1,548,196,000	$4.04
1991	$43,109,173,565	$1,631,126,000	$3.78
1992	$44,671,882,962	$1,743,162,000	$3.90
1993	$49,593,317,405	$1,857,901,000	$3.75
1994	$51,685,778,729	$1,933,185,000	$3.74
1995	$53,915,043,325	$1,987,360,000	$3.69

Source: Comptroller of the Treasury

As a final evaluation of the growth limitations built-into the local property tax (as distinct from the local property tax base), a regression was run[29] to estimate the income elasticity of local property tax revenue. While such a regression normally requires that the tax data be adjusted (downward) to remove the impact of tax rate increases[30], this was not done in this regression, (as the next sentence demonstrates, such adjustment wasn't necessary). Despite using unadjusted data (for the period 1986 through 1995, a period during which a few individual county (and city) property tax rates rose despite the restrictions imposed by the reappraisal process), the estimated income elasticity for total local property taxes[31] was only 0.97.

[29] By TACIR staff.

[30] In fact there were not many cases for which this was true, given the difficulties involved in raising nominal tax rate as already discussed.

[31] Property tax data from **County and Municipal Finances**, an annual publication of the State Comptroller's Office.

V. GROWTH, VOLATILITY, AND TRENDS OF STATE-SHARED TAXES

A. Growth and Volatility

The taxes shared with local governments exhibit different growth patterns over time as well as differences in their volatility over the business cycle. The more volatile taxes make less reliable sources of revenue for recurring obligations. While this issue has been partially addressed elsewhere,[32] it is included since the long-run growth and short-run volatility of state-shared taxes is a vital concern for local as well as state government.

Table 12 includes estimates of the annual rate of growth and volatility of all state taxes shared with local governments in Tennessee. The estimates were calculated using data for fiscal years 1987-88 through 1997-98. Volatility was measured using trend variability, a statistical measure of the relative volatility or variability of a tax over the business cycle. The growth estimates are consistent with those of a previous study on Tennessee' s tax structure, although measured using a different procedure. Of the taxes shared with local governments, franchise and excise taxes (combined), sales and use taxes, motor vehicle fuel taxes, and Hall income taxes exhibit the highest rate of long-term growth (6.4 percent, 5.9 percent, 4.9 percent, and 4.7 percent respectively). Most of the remaining taxes reflect low growth, a pattern consistent for taxes that are based on unit sales (gallons, cartons, etc.) and not price.

The more volatile taxes make less reliable sources for recurring obligations

The standard deviation (used as the measure of volatility) for each tax can be compared to the estimated volatility of Tennessee personal income. All taxes, except for the beer tax, exhibit more volatility over the period than Tennessee personal income. So, the ups and downs of economic activity affect all taxes, just as they affect personal income. Some taxes simply exhibit more volatility during economic fluctuations than personal income (which, as expected, itself fluctuates over the business cycle). The estimated growth and volatility measures in the table can be interpreted in relation to the values calculated for Tennessee personal income.

[32] The long-run elasticity of Tennessee taxes is analyzed in detail in TACIR, *Income Elasticity of Tennessee's Tax System*, July 1999, Nashville. For additional detail, see Richard F. Dye and Therese J. McGuire, "Growth and Variability of State Individual Income and General Sales Taxes," *National Tax Journal*, Vol. XLIV, No. 1, March 1991 pp. 55-66.

Table 12. Growth and Volatility of Tennessee State-Shared Taxes, 1988-1998, Ranked High to Low by Annual Rate of Growth

Tax	Annual Rate of Growth	Volatility	Rank
Franchise & Excise (Combined)	6.4%	7.3%	1
Sales and Use	5.9%	3.1%	2
Motor Vehicle Fuel	4.9%	4.5%	3
Hall Income	4.7%	10.3%	4
Mixed Drink	2.5%	2.8%	5
TVA Payments	1.8%	2.5%	6
Beer Tax	1.6%	1.0%	7
Gasoline Tax	1.4%	2.0%	8
Special Petroleum	1.4%	3.6%	9
Alcoholic Beverage	-0.1%	2.1%	10
Total for 10 taxes	5.2%	2.1%	
Baseline:			
Tenn. Personal Income	6.3%	1.1%	

Source: TACIR

Note: Average annual growth calculated by regressing the natural log of a tax on a linear trend (a constant was included). The estimated coefficient is reported as a percent. The volatility (measured as trend deviation) reported is the standard deviation of calculated residuals. Due to data limitations franchise and excise taxes are combined and treated as one tax in this analysis.

Local governments benefit from the sharing of taxes that grow well over time (such as the state sales tax and Hall income tax), but suffer somewhat from sharing taxes that grow little over time (and represent an inelastic source of revenue). In Tennessee, cities have the advantage of receiving the lion's share of unrestricted shared taxes, with the major source being the sales and use tax, one of the fasting growing state-shared taxes.

Counties on the other hand receive no share of the state sales tax and depend for their largest sources of shared revenues on two of the slowest growing elements, gasoline taxes and TVA payments.

All taxes respond somewhat to changes in economic activity. The values in Table 12 for volatility reflect the different sensitivity of taxes to the business cycle. The highest values reflect the higher volatility. Franchise and excise taxes are relatively volatile because of the volatility of corporate profits (the dominant tax base for combined franchise and excise taxes). The Hall income tax, which has become more dependent on dividends and capital gains (earned in mutual funds), also reflects a high degree of volatility over the business cycle.

Table 13 shows summary data for state-shared taxes for fiscal years 1987-88 and 1997-98. In Table 13, the coal severance tax and the gas and oil severance tax are combined and labeled severance. The increase in shared-taxes over the ten-year period from FY 1988 to FY 1998 reflects both higher tax rates (especially for petroleum taxes) and tax base growth.

Table 13 State-Shared Taxes, FY 1987-88 and FY 1997-98
(Figures in Millions of Dollars)

	FY1987-88			FY1997-98		
Shared Tax	County	City	Total	County	City	Total
Alcoholic Bev	4.8	0.0	4.8	4.8	0.0	4.8
Beer Excise	1.3	1.3	2.6	1.4	1.4	2.9
Beer Wholesale	14.6	50.3	64.9	17.5	70.8	88.4
Corporate Excise	7.2	4.4	11.6	14.1	9.0	23.1
Gasoline	104.9	52.6	157.5	143.4	71.7	215.2
TVA Payments	31.4	12.6	43.9	43.0	16.8	59.8
Income	6.7	20.8	27.5	10.0	47.6	57.5
Mixed Drink	3.6	6.8	10.4	5.5	8.4	13.9
Motor Fuel	17.2	8.6	25.8	23.1	11.6	34.7
Sales	0.0	98.9	98.9	0.0	172.6	172.6
Severance	1.4	0.0	1.4	0.7	0.0	0.7
Special Petrol.	4.6	7.4	12.0	4.6	7.4	12.0
Total	197.6	263.7	461.2	268.2	417.3	685.4

Source: "Biennial Report," Tennessee Department of Revenue, Reports for FY86 & 87 and FY97 & 98.

Note 2: Severance includes both the Coal Severance Tax and the Gas and Oil Severance Tax.

B. Trends

State-shared taxes to local governments in Tennessee have exhibited three long-run trends.[33] First, as shown in Table 14, the distribution of state taxes to county and municipal governments has declined as a percent of total state taxes between 1970 and 1998.[34] In 1970, the amount shared with cities and counties represented 12.6 percent of total tax collections.[35] By 1998, that share had fallen to less than nine percent. The primary reason for this decline has been the relative rise in the importance of state sales tax collections to the state budget. The sales tax rate has been increased from 3 percent to six percent over this period. The additional revenues resulting from the rate increases were directed into the general fund. Although a portion of the additional revenue does benefit local governments (cities), the increased distributions resulted primarily from growth in the tax base, not in the state tax rate.

Second, although state-shared taxes have declined as a share of total tax collections, categorical grants, the other major type of intergovernmental aid to local governments, have

[33] These comments and the data in Table 14 are made on the basis of data that excludes wholesale beer tax collections.

[34] This trend was observed by Dr. Reuben Kyle in *Sharing Taxes between State and Local Governments in Tennessee,* a draft report prepared for the TACIR. The latest report of state financial data available at the time his study was being prepared was for Fiscal year 1995-96. TACIR staff have updated his analysis using 1998 data provided by the Department of Revenue.

[35] Taxes collected by the Department of Revenue only.

been increasing. Over the 28-year time period, Tennessee tax revenues in the General Fund and earmarked revenue in the General Fund increased in relative share. The combined share of both funds was slightly less than 69 percent in 1970 and over 77 percent by 1998. A significant contributing factor to this trend is the growth of funds earmarked for education.

The distribution of intergovernmental aid to local governments for K-12 education in Tennessee is accomplished through the Basic Education Program (BEP). The BEP has been the primary funding mechanism since 1993. State intergovernmental categorical aid for education has grown dramatically over the years as the state has increased funding for local education through earmarked tax increases and increases from unrestricted portions of the state general fund. The linchpin of the program is the BEP funding formula that reflects many of the key elements considered and partly recommended by the Tax Modernization and Reform Commission in the early 1970s—specifically a formula that considers need, ability, and effort in establishing the level and distribution of state dollars among the school systems of the state. A key element of the program is a requirement that local governments share in the cost of the Basic Education Program. Once the local share has been determined, the State funds the balance through intergovernmental transfers.

Table 14: Allocation of Tennessee Tax Collections by Fund, Selected Years, 1970-1998 ($000s)

	1970	1980	1990	1995	1998
ALLOCATED TO GENERAL FUND	191,304	749,664	1,417,803	1,980,171	2,438,597
Share of Total Funds Allocated	29.06%	40.53%	33.98%	34.56%	36.12%
ALLOCATED TO GENERAL FUND EARMARKED REVENUE	260,019	641,895	1,601,906	2,408,148	2,825,215
Share of Total Funds Allocated	39.50%	34.71%	38.39%	42.03%	41.85%
Summed Shares of Allocation to General Fund and Earmarked Funds	68.57%	75.24%	72.37%	76.60%	77.97%
ALLOCATED TO HIGHWAY FUND	98,221	188,745	518,915	511,590	577,869
Share of Total Funds Allocated	14.92%	10.21%	12.44%	8.93%	8.56%
ALLOCATED TO SINKING FUND	25,588	92,568	128,638	216,142	213,719
Share of Total Funds Allocated	3.89%	5.01%	3.08%	3.77%	3.17%
ALLOCATED TO COUNTIES FUND	41,286	68,266	211,258	238,045	250,632
Share of Total Funds Allocated	6.27%	3.69%	5.06%	4.16%	3.71%
ALLOCATED TO MUNICIPALITIES	41,730	100,503	241,811	290,672	346,451
Share of Total Funds Allocated	6.34%	5.43%	5.79%	5.07%	5.13%
Sum of shares of county & municipal funds	12.61%	9.13%	10.86%	9.23%	8.84%
TO MISCELLANEOUS	2,037	9,776	54,480	86,270	99,056
Share of Total Funds Allocated	0.31%	0.53%	1.31%	1.51%	1.47%
TOTAL ALLOCATION	658,214	1,849,437	4,172,821	5,729,043	6,751,543

Sources: TN Department of Revenue *Biennial Reports* (1998 data from *FY 1997 & FY 1998 Biennial Report of the Department of Revenue*, forthcoming).

The third trend is that the gap between county and municipal distributions has widened over the twenty-eight year period. In 1970, both were apportioned just over $41 million in distributions. By 1998, municipal distributions had grown to over $346 million, while county distributions lagged behind at $250 million.

The data in Table 14 are expanded upon in Table 15. Table 15 provides detailed data for each tax source (including the 17% beer wholesale tax) for 1980, 1990, and 1999. As shown in Table 15, every state-shared tax source for municipal and county governments, except severance taxes, the special petroleum products tax, and the alcoholic beverage tax, have increased over the almost thirty year period covered in the table. Since 1990 alone, state-shared taxes to local governments increased 43.5 percent.

State-shared taxes apportioned to county governments increased from $226,946,000 to $275,635,000 between 1990 and 1999, while state-shared tax apportionments to municipal governments increased from $286,555,000 to $437,023,000 over the same period. The largest gain for county governments resulted from the combined distribution of the gasoline tax and the motor fuel tax, which increased from $143,206,000 to $170,177,000. The largest gain for municipal governments was for the sales and use tax, which increased from $109,268,000 to $184,482,000. Municipal governments also experienced large nominal gains from increased local shares of the Hall income tax, which increased from $27,020,000 to $47,681,000.

Table 15. State-Shared Revenue Distribution by Source, 1980, 1990, and 1999 ($000s)

Note: To allow comparisons to earlier years, amounts shown here include state-shared distributions to non-local government entities (CTAS, MTAS, UT Center for Govt. Training, and the TACIR).

State-Shared Revenues By Source	1980	1990	1999	% Change, 1990-99
Alcoholic Beverage Tax	$4,913	$4,799	$4,750	-1.02%
Beer Excise Tax	$2,046	$2,578	$2,994	16.14%
Beer Wholesale Tax[1]	$45,625	$70,431	$90,739	28.83%
Corporate excise Tax	$0	$11,509	$24,374	111.78%
Gasoline Tax & Motor Fuel Tax[2]	$69,026	$188,821	$255,445	35.28%
Gross Receipts Tax-TVA Replace. Rev.	$12,355	$50,203	$66,577	32.62%
Special Petroleum Tax	$11,957	$11,897	$12,017	1.01%
Hall Income Tax	$9,397	$35,883	$57,509	60.27%
Mixed Drink Tax	$5,892	$10,923	$14,573	33.42%
Sales and Use Tax	$54,010	$109,268	$184,482	68.83%
Severance Taxes[3]	$0	$1,264	$601	-49.29%
Total	**$215,221**	**$497,576**	**$714,061**	**43.51%**
State-Shared Revenues to Counties By Source	1980	1990	1999	% Change, 1990-99
Alcoholic Beverage Tax	$4,907	$4,796	$4,749	-0.98%
Beer Excise Tax	$1,023	$1,289	$1,497	16.14%
Beer Wholesale Tax[1]	$11,311	$15,688	$17,812	13.54%
Corporate excise Tax	$0	$7,361	$14,538	97.50%
Gasoline Tax & Motor Fuel Tax[2]	$53,589	$143,206	$170,177	18.83%
Gross Receipts Tax-TVA Replace. Rev.	$9,209	$36,132	$47,061	30.25%
Special Petroleum Tax	$4,579	$4,579	$4,579	0.00%
Hall Income Tax	$1,947	$8,863	$9,828	10.89%
Mixed Drink Tax	$2,221	$3,768	$4,905	30.18%
Severance Taxes[3]	$0	$1,264	$601	-49.29%
Total	**$88,786**	**$226,946**	**$275,737**	**21.52%**
State-Shared Revenues to Municipalities By Source	1980	1990	1999	% Change, 1990-99
Alcoholic Beverage Tax	$6	$3	$1	-66.67%
Beer Excise Tax	$1,023	$1,289	$1,497	16.14%
Beer Wholesale Tax[1]	$34,314	$54,743	$72,927	33.22%
Corporate excise Tax	$0	$4,148	$9,836	137.13%
Gasoline Tax & Motor Fuel Tax[2]	$26,965	$71,540	$85,268	19.19%
Gross Receipts Tax-TVA Replace. Rev.	$2,800	$14,071	$19,516	38.70%
Special Petroleum Tax	$7,378	$7,318	$7,438	1.64%
Hall Income Tax	$7,450	$27,020	$47,681	76.47%
Mixed Drink Tax	$3,671	$7,155	$9,668	35.12%
Sales and Use Tax	$54,010	$109,268	$184,482	68.83%
Total	**$137,617**	**$286,555**	**$438,315**	**52.96%**

Sources: TN Department of Revenue and Tennessee Malt Beverage Association

[1] Data on the distribution of the 17% wholesale beer tax has traditionally not been included in the data released by the Department of Revenue. While the tax is a state levy, it has been treated in statistical releases as a local tax since local governments retain most of the revenue (96.5%).

[2] The Tennessee Department of Revenue reports the Gasoline Tax and Motor Fuel Tax distributions as one category.

[3] Combined amounts for Crude Oil and Natural Gas Severance Tax and Coal Severance Tax.

VI. RESTRICTIONS ON USE BY LOCAL GOVERNMENTS

State-shared taxes can be restricted or unrestricted. Approximately $264 million of the total of $711 million distributed to cities and counties in fiscal year 1999 was restricted in some manner. The cities and counties that receive these revenues have limited discretion in how they can spend them. The remaining $447 million could be treated as general revenue and spent however they chose. Table 16 shows which state-shared taxes are restricted and which are not. Shared highway taxes, including the gasoline and motor fuel taxes and the special petroleum tax, make up the largest part of the restricted revenue. These funds can be used only for roads and mass transit. Half of the revenues from mixed drink tax must be spent on education. Cities and counties that receive restricted revenues have come to rely on them for those purposes and make adjustments in how they allocate other taxes to allow them to do so. Table 16 also lists the applicable Tennessee Code Annotated citation for each state-shared tax.

Approximately $264 million of state-shared taxes are restricted in some manner

Table 16. State-Shared Taxes, Recipients, Restrictions, and Citations

Tax	Recipient[1]	TCA Citation[1]	Restrictions (Yes/No) [1,2]
Sales and Use Tax	Municipalities	67-6-103	No
Gasoline Tax	Municipalities	54-4-203, and 67-3-2001	Yes, See Note 1
	Counties	54-4-103, and 67-3-2001	
Motor Fuel Tax	Municipalities	54-4-203, 67-3-2005, and 67-3-2008	Yes, See Note 2
	Counties	54-4-103, 67-3-2005, and 67-3-2008	
Gasoline Inspections Tax (Special Petroleum)	Municipalities and Counties	67-3-2006	Yes, See Note 3
Hall Income Tax	Municipalities and Counties	67-2-117, and 67-2-119	No
Gross Receipts Tax - TVA Payments	Municipalities and Counties	67-9-101, 67-9-102, and 67-9-103	No
Beer Excise Tax	Municipalities and Counties	57-5-205	No

Beer Wholesale Tax	Municipalities and Counties	57-6-103, and 57-6-201	No

Table 16. State-Shared Taxes, Recipients, Restrictions, and Citations (Continued)

Tax	Recipient[1]	TCA Citation[1]	Restrictions [1,2]
Alcoholic Beverage Tax	Counties	57-3-306, 57-9-205, 12-2-207, and 12-2-209	No
	Municipalities and Counties	57-9-115, and 57-9-201	
Corporate Excise Tax	Municipalities and Counties	67-4-2017	No, See Note 4
Mixed Drink Tax	Municipalities and Counties	57-4-301, and 57-4-306	Yes, See Note 5
Crude Oil and Natural Gas Severance Tax	Counties	60-1-301	No
Coal Severance Tax	Counties	67-7-110	Yes, See Note 6

RESTRICTIONS AND NOTES:

Note 1: Counties and municipalities must qualify for this allocation by remitting a certification to the Department of Revenue. Also, funds must be spent on streets and roads, with spending for mass transit restricted to no more than 22.2%. A population restriction of sorts is placed on municipal distribution calculations. A premiere-type tourist city with a population of 1,100 or more shall receive funds based on a population of 10,945.

Note 2: County portion earmarked for county highway fund.

Note 3: A local government fund of which 38.1 percent is for county roads and the remainder is for city roads (less a grant to the University of Tennessee Center for Government Training).

Note 4: Distribution based on situs of bank deposits.

Note 5: One half of the allocation to cities and counties is earmarked for education.

Note 6: Coal funds are to be used 1/2 for county education systems and 1/2 for stream cleaning projects.

Sources: 1. State of Tennessee 1999-2000 Budget Document. 2. State of Tennessee Department of Revenue.

VII. DISTRIBUTION

Tennessee uses four methods for distributing state-shared taxes. They are as follows:

1. Situs- or origin-based distributions: refer to distributions of state taxes that are directly shared with local governments based on the situs (location) of the activity that was taxed or the situs or residence of the taxpayer.

2. Population or per capita-based distributions: next to situs-based distributions, this is the simplest method for distributing shared taxes. To a certain degree, per capita-based distributions result in some revenue equalization among the recipients. Tax base-wealthy local governments tend to lose; tax base-poor areas tend to gain from per capita redistribution programs. For example, the sales and use tax in Tennessee is distributed on a per capita basis; if a city has a large sales tax base, it likely collects more per capita in sales taxes than it receives back when the money is distributed based on the city's share of the state's population.

3. Land Area: distribution is based upon the land area of a county. For example, portions of revenue from the gasoline tax (approximately 25.4 percent) and the motor fuel tax (approximately 17.5 percent) are distributed to counties for highway funding. One quarter of this distribution is based upon their land area. The assumption is that the larger a county's area, the larger its needed road network.

4. Equal Shares: local governments receive equal shares of the distribution, regardless of their collections or other factors. For example, 10.05 percent of beer excise tax collections are distributed to counties. Each county receives an equal share, 1/95th of the total amount distributed to counties.

Table 17 on the next two pages provides a detailed description of currently shared state taxes, the amounts involved during fiscal year 1998-99, and the method of distribution.[36]

[36] Data supplied by the Tennessee Department of Revenue.

Table 17. Distribution of State-Shared Taxes with Local Governments, FY 99

Tax	Amount Shared	Distribution Recipient	Formula Determining State Revenue Shared	Distribution Basis
Alcoholic Beverage	$4.8 million	Counties, Selected Cities	After a $.04 per liter spirits share of tax to a distiller's home county (Moore & Coffee), 17.5% of the balance of spirit and wine gallonage taxes to counties. From the county distribution, $192,000 is earmarked for UT-CTAS.	**Population and Land Area.** County share is based ¼ on area and 3/4 on population; 30% of the amount distributed to counties of more than 250,000 population having a contained city of 150,000 shall be paid to the city.
Beer Excise ($3.90 per barrel)	$3.0 million	Counties, Cities	10.05% to cities and 10.05% to counties.	**Population and Equal Shares.** Cities share on a population basis and counties share equally.
17% Wholesale Beer Tax	$90.7 million[37]	Counties, Cities	After 0.5% of tax for Dept. of Revenue and 3.0% of tax for wholesaler vendor's compensation, the balance goes to local governments.	**Situs** of retailer making wholesale purchase.
Corporate Excise (Corporate Income tax)	$24.4 million	Counties, Cities	County and city amounts based on bank earnings in lieu of intangible personal taxes on banks and banking institutions.	**Situs** of deposits and level of property taxes.
Gasoline	$217 million	Counties, Cities	Complex formula results in approximately 12.7% of total collections going to cities, and 25.4% to counties.	**Population, Land Area, and Equal Shares.** County share based ¼ on population, ¼ on county area, ½ is shared equally. Cities' shares based on population.
Hall Income	$57.5 million	Counties, Cities	3/8ths of tax goes to local governments.	**Situs**. Based on situs of taxpayer
Mixed Drink	$14.6 million	Counties, Cities	Of the 15% gross receipts tax, ½ is returned locally.	**Situs** of collection
Motor Fuel	$38 million	Counties, Cities	Approximately 8.8% of total collections to cities and 17.5% to counties.	**Population, Land Area, and Equal Shares.** County amounts based on ¼ on population, ¼ on county area, and ½ is

[37] Data for fiscal year 1999 provided by the Department of Revenue from information supplied to them by the Tennessee Malt Beverage Association.

Tax	Amount Shared	Distribution Recipient	Formula Determining State Revenue Shared	Distribution Basis
				shared equally. City shares based only on population.

Table 17. Distribution of State-Shared Taxes with Local Governments, FY 99 (Continued)

Tax	Amount Shared	Distribution Recipient	Formula Determining State Revenue Shared	Distribution Basis
Sales & Use	$183.0 million	Cities	Approximately 4.3% after an allocation to the Transportation Equity Fund. Also a grant earmarked to UT-MTAS is from the cities share.	**Population** of cities.
Severance -- Coal	$0.6 million	Counties	97% of tax collections to counties.	**Situs** of severance
Severance -- Crude Oil & Natural Gas	$0.05 million	Counties	33% of tax collections to counties.	**Situs** of wellhead severance
Special Petroleum Products	$12.0 million	Counties, Cities	Of a $12,017,000 local government fund, about $7.4 million is for county roads and $4.1 million Is for cities streets. Of the city share, an amount is earmarked for UT Center for Government Training.	**Population**
TVA Payments	$66.6 million	Cities, Counties	51.5% of TVA payments in excess of amount paid to state in FY 1977-78. Approx. 65.9% to counties, 28.3% to cities, and 5.8% to TVA construction-impacted local areas.	**Population, Land Area, and Equal Shares.** County share based 43% on population, 43% on acreage, and 14% on TVA owned land; city share based on population.

Sources: Tennessee Code Annotated, TN Department of Revenue.

VIII. HISTORY

A. Early History

The sharing of taxes in Tennessee (at least in concept) is as old as the State's Second Constitution. The Constitution of 1834 provided that:

> "It shall be the duty of the General Assembly, in all future periods, of this Government, to cherish literature and science. And the fund called the Common School Fund, and all the lands and proceeds thereof, dividends, stocks, and other property of every description whatever, heretofore by law appropriated by the General Assembly of this State for the use of common schools, and all such as shall hereafter be appropriated, shall remain a **perpetual fund**, . . . "[38]

Early examples of state-shared taxes in Tennessee include the sharing of state poll taxes (as early as 1883), auto registration fees, and the sharing of gasoline tax revenue soon after the tax was first passed (in 1923). The original Hall Income tax passed in 1929 (at a 5 percent rate) required that 45 percent of collections be earmarked for distribution to counties and municipalities.

When the state sales tax was first passed in 1947, it required that a portion of receipts be shared with counties for education and that cities be given a share (based on population). It was soon after the sales tax began to generate large sums of unexpected revenues that criticisms arose over the methods used to distribute the surplus sales tax collections. Cries of an "unjust and indefensible situation"[39] arose when studies showed that some rural areas were receiving (on an A.D.A.[40] and per capita basis) ten times the amounts received by metropolitan areas. Revenue sharing in Tennessee continues to generate its share of controversy.

B. Tax Modernization and Reform Commission

The most thorough and exhaustive investigation and evaluation of state-local fiscal relations occurred as a result of the creation of the Tennessee Tax Modernization and Reform Commission (TTMRC). Chapter No. 746 of the Public Acts of 1972 created the TTMRC

> " . . . to study the alternatives to present state and local tax structures in the State of Tennessee. The areas of study shall include alternative methods of financing public school systems; the fiscal relationship between the state and local governments; the fiscal relationship between the state and the

[38] *A Financial History of Tennessee Since 1870*, page 7.
[39] Ibid., pp. 180-181.
[40] Average daily attendance.

> federal government; methods by which the state and local tax structure could be made responsive to economic growth; and methods by which the state and local tax burden could be distributed more equitably."[41]

Given such a broad mandate, it is not surprising that much of the TTMRC's work was related to the overall question of state aid to local governments, especially assistance in the area of financing local education. The TTMRC addressed this challenge from two different directions: it separately addressed (1) the overall problem of financing public school education and (2) the related but separate question of general state financial support to local governments. In this report, we will review the TTMRC's work related to general state financial support.

The TTMRC noted that Tennessee distributed funds to local governments as a result of statutory tax sharing. Some of the tax-shared funds were (--and still are) restricted or earmarked for use in specific local programs, -some were not. To a large extent, the types of such aid and the method for their distribution had not changed much since 1973 when analyzed by the TTMRC. Therefore a full description of such tax sharing is provided later in this report. The report also reviews the TTMRC's recommendations for changes in the method for distributing such aid and the reasons for their recommendations.

Since the TTMRC felt that the purpose of state-shared tax revenues should be to help local governments finance general local government needs, the

> " . . . equitable method of distribution should be related to the needs of the local governments, as estimated from various economic and demographic indicators, for example, population, income, area, and miles of road. In this way, more aid should be distributed to those government units in which the estimated needs are greater." [42]

In addition to considerations of actual need, the TTMRC's research staff felt that additional considerations should include measuring both the ability of local governments to raise their own revenue (tax ability) and their actual effort relative to their ability (tax effort) to do so.

The TTMRC asked its staff to evaluate various distribution methods and provide comparative data on distributions that would result. These distributions were then compared to actual distributions based on then current law. The TTMRC's recommendations in this area of state and local relations were as groundbreaking as their recommendations for changes to the overall tax structure. The TTMRC's recommendations included the following:

> (1) Repeal all current tax-sharing arrangements involving the sales tax, income tax, beer tax, and liquor taxes, and replace them with a program of general revenue sharing of the state sales tax. The TTMRC felt that the sales tax base would provide those sharing in the distribution with a more

[41] Chapter No. 746, Public Acts, 1972**.**

[42] **State Financial Assistance To Local Governments: Education, Highways, and General Government Assistance Programs**, page 151.

elastic source of revenue than was being provided by the various taxes that local governments then shared.

(2) The amounts to be shared in Recommendation (1) should be distributed using a single formula that takes into consideration need, ability, and effort. The relevant variable used to measure need should be population. The measurement of ability should be based on an index that reflects a county's ability to pay as measured by its personal income and taxable property base. Its effort should be measured by its relative taxing effort (versus state average effort).

(3) Since the recommendations of the TTMRC were made in the context of an overall dramatic overhaul of the state tax structure, including a personal income tax, additional revenues were expected as part of the changes recommended. Because of this the TTMRC also recommended that, given the two recommendations above, additional funds be used to hold harmless any local governments that would otherwise suffer from their recommended new distribution of shared-tax revenues.

(4) The TTMRC recommended several items related to distributions of gasoline and motor fuel taxes. In general, the TTMRC recommended long-run shifts in the distribution of highway money for local governments from one based on a combination of equal shares and land area to one based on population only.

Index of Appendices