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ALL CAUGHT UP:

HOW TAX POLICY MAY HAVE ALLOWED TENNESSEE TO OUTGROW MISSOURI

By Jenifer Zeigler Roland and David Roland

Missouri and Tennessee are border states that resemble each other in many ways. Both are geographically and culturally diverse states, with several of their larger cities located near the states' borders. Geographically speaking, Missouri's 69,709 square miles include a considerable amount of farmland,[1] two major rivers (the Mississippi and the Missouri), and part of the Ozark mountain range. Tennessee is significantly smaller than its neighbor, but its 42,146 square miles also include an abundance of farmland,[2] two major rivers (the Mississippi and the Tennessee), and part of the Appalachian Mountains. Missouri's population is most heavily concentrated in two major metropolitan areas (Saint Louis and Kansas City), but it also has a number of other large cities (such as Springfield, Columbia, and Saint Joseph) spread throughout the state. Similarly, Tennessee's population is most heavily concentrated in its two largest cities (Memphis and Nashville), but with several other large cities (such as Knoxville, Chattanooga, and Jackson) throughout the state. Tennessee's economy is driven primarily by manufacturing, but it also has a thriving tourism industry and significant agricultural output. Missouri has its own substantial agricultural and tourism industries, although its economy relies most heavily on the commercial sectors of its two largest cities.[3]

Despite the states' similarities, Missouri has historically been the more populous and prosperous of the two, owing in part to its aforementioned size advantage and in part to historical factors. Like most southern states, Tennessee's economy was crippled in the wake of the Civil War and took a long time to rebound.[4] Tennessee lacked the industrial infrastructure that had grown in Missouri as the latter became an important crossroads for the nation's commerce. At the same time that Tennessee struggled to

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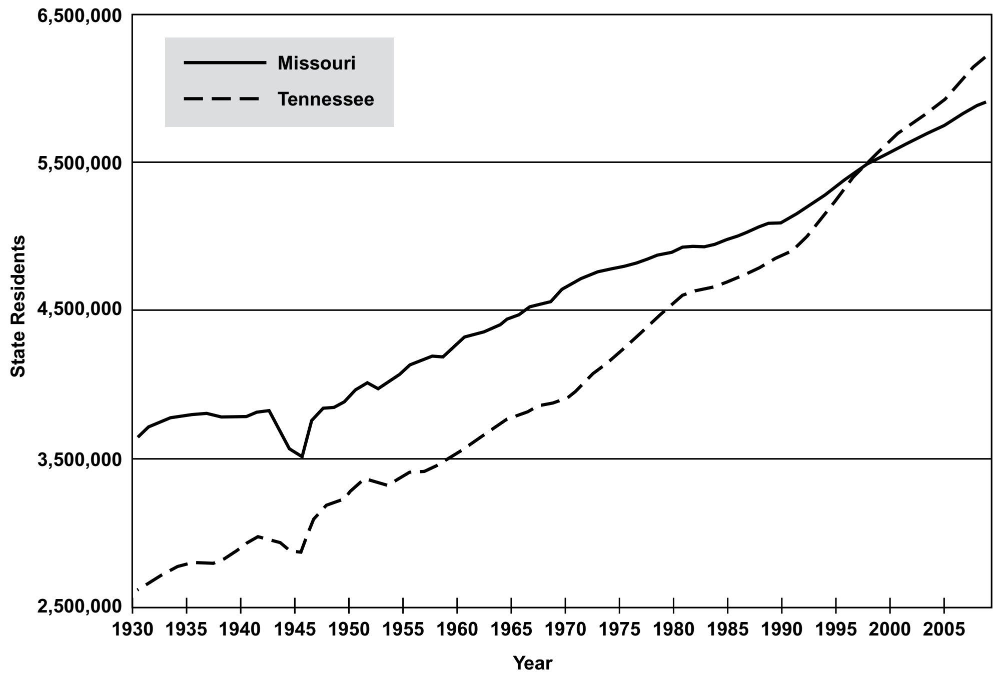
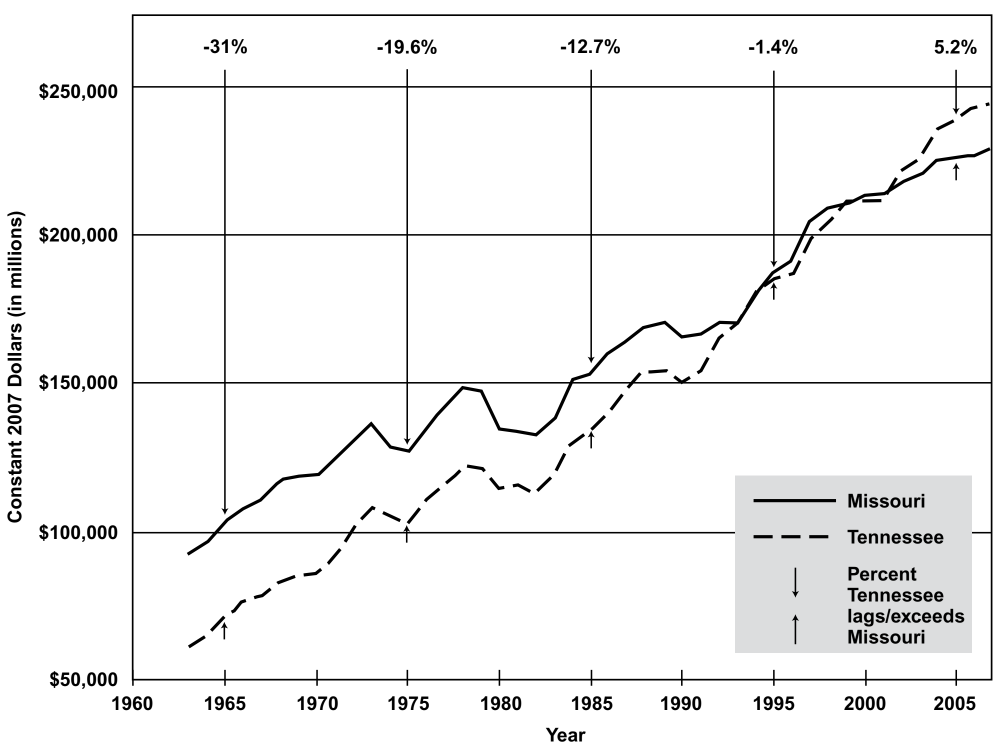
At the same time that Tennessee struggled to modernize its economy, Saint Louis and Kansas City already boasted thriving industries.

Chart 1: Comparative Population Growth in Missouri and Tennessee



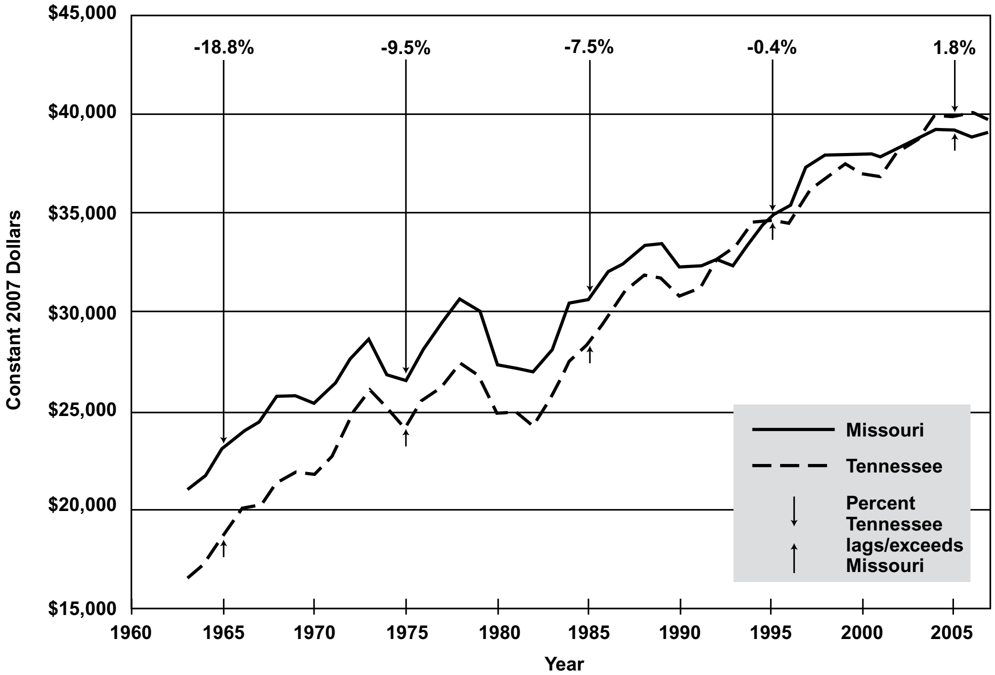
Source: Bureau of Economic Analysis (BEA). "Table SA04 Income and Employment Summary (1958-2008)" and "Table SA04H (1929-1957)." *State Annual Personal Income*. March 24, 2009. http://www.bea.gov/regional/spi/default.cfm

Chart 2: Comparative GDP in Missouri and Tennessee



Source: BEA. "Gross Domestic Products by State: Table NAICS (1997-2008) and Table SIC (1963-1997)." *Regional Economics Accounts*. June 2, 2009. http://bea.doc.gov/regional/gsp/default.cfm?series=NAICS

Chart 3: Comparative Per-Capita GDP in Missouri and Tennessee



Source: BEA. "Per-Capita GDP by State: Table NAICS (1997-2008) and Table SIC (1963-1997)." *Regional Economics Accounts*. June 2, 2009. http://bea.doc.gov/regional/gsp/default.cfm?series=NAICS

modernize its economy, Saint Louis and Kansas City already boasted thriving industries. Tennessee's industrialization hit its stride near World War II, prodded in significant measure by the creation of the Tennessee Valley Authority (TVA), a government agency created as part of Franklin D. Roosevelt's New Deal that turned the Tennessee River into the largest single source of electricity in the United States at that time.[5] Once Tennessee had established the basic transportation and electric infrastructure that was essential to the growth of modern businesses, the state began a sustained trend of economic and population growth that would eventually allow Tennessee to surpass Missouri in terms of population and prosperity.

In 1900, Tennessee's population was only about 65 percent as large as Missouri's. By 1950, that gap had narrowed and Tennessee's population was 84 percent as large. By the end of the century, Tennessee's population had inched ahead of Missouri's, and the most recent estimates suggest that Tennessee's population is now about 5 percent larger than its neighbor to the northwest.[6]

The growth of Tennessee's economy in relation to Missouri's can be measured in several ways. One the most authoritative ways to evaluate a state's economy is to use the gross domestic product (GDP) by state, which calculates the value of goods and services produced within a state each year.[7] The United States Bureau of Economic Analysis (BEA) keeps records of GDP by state as far back as 1963 (see Chart 2). During the course of several decades, the gap between the two states' GDP steadily narrowed. By 1999, Tennessee's GDP had finally caught up to Missouri's, and each

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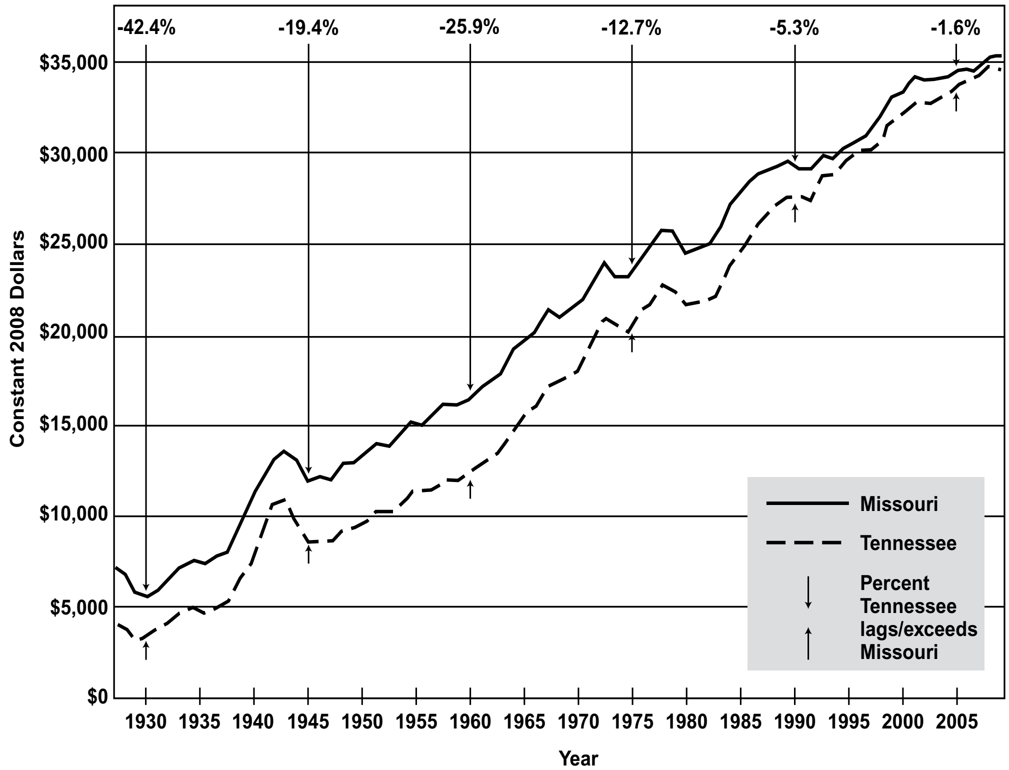
Chart 4: Comparative Per-Capita Personal Income in Missouri and Tennessee



Source: BEA. "Table SA04 Income and Employment Summary (1958-2008)" and "Table SA04H (1929-1957)." *State Annual Personal Income*. March 24, 2009. http://www.bea.gov/regional/spi/default.cfm

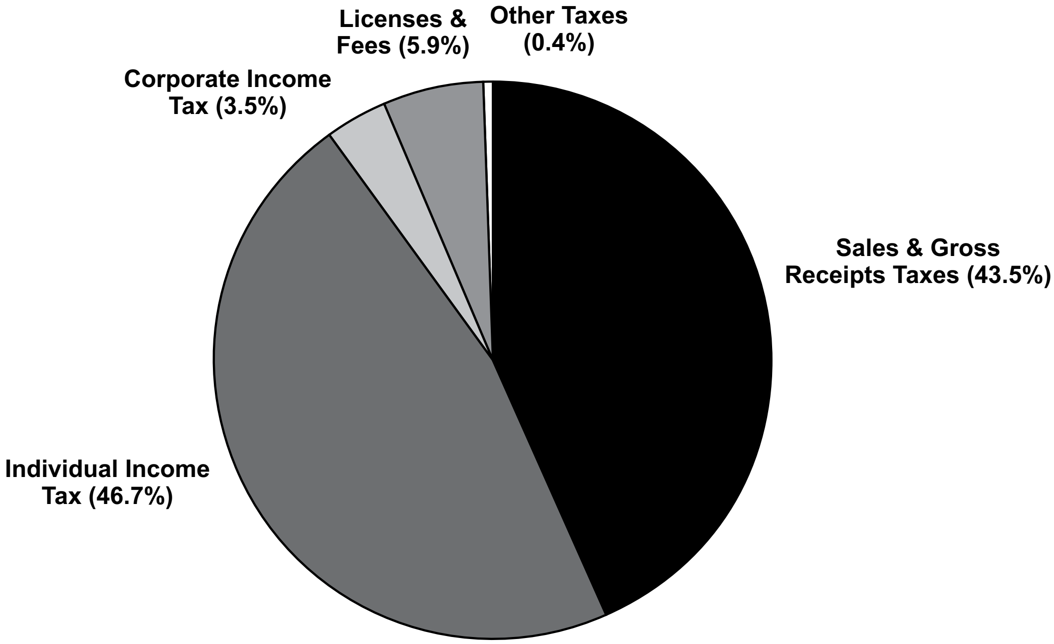
In order to evaluate why Tennessee's economy has grown at a faster rate than Missouri's, it is important to consider the impact of one of the most significant and enduring differences between the two states: macroeconomic tax policy.

state's respective economies remained about the same size until 2002, when the Volunteer State gained a lead that has continued to increase. Tennessee's population growth has certainly contributed to the state's increase in GDP, yet the lead in economic growth exists even when controlling for the difference in population by evaluating per-capita GDP.

Tennessee's personal income growth has also outpaced that of Missouri. In the early 1930s, the average Tennessean earned slightly more than 50 cents for every dollar earned by the average Missourian. A generation later, in the early 1960s, Tennesseans had reduced this income gap, but still only earned about three quarters of an average Missourian's income. By 1990, the difference between the states' per-capita personal income had narrowed to a little more than 5 percent, and, in the last few years, Missouri has clung to a lead of just a few percentage points.

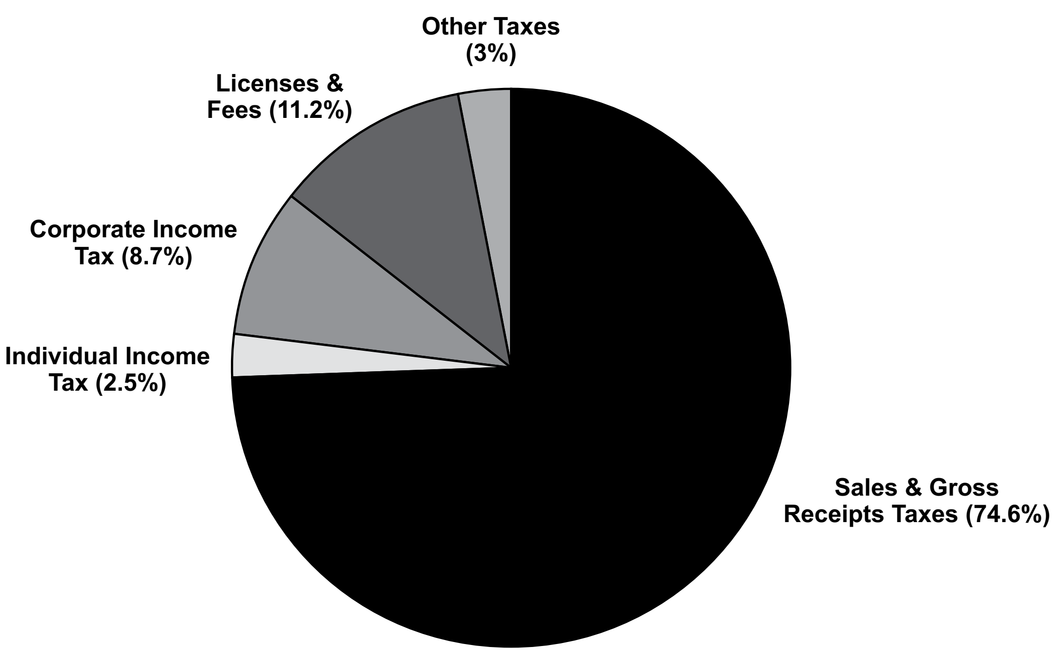
In order to evaluate why Tennessee's economy has grown at a faster rate than Missouri's, it is important to consider the impact of one of the most significant and enduring differences between the two states: macroeconomic tax policy. Missouri instituted a state income tax in 1917. For several years, this tax rate ranged between 0.5 percent and 1.5 percent, but the rate increased in 1931 to 4 percent for any citizen whose annual income exceeded $9,000. In 1971, Missouri's individual income tax rate increased to a maximum of 6 percent, which is where the rate has remained. Furthermore, Missouri's General

Chart 5: Tax Collections by Missouri State Government (2008)



Source: U.S. Census Bureau. *Federal, State, and Local Governments: 2008 State Government Tax Collections*. 2008. http://www.census.gov/govs/www/statetax08.html

Chart 5: Tax Collections by Tennessee State Government (2008)

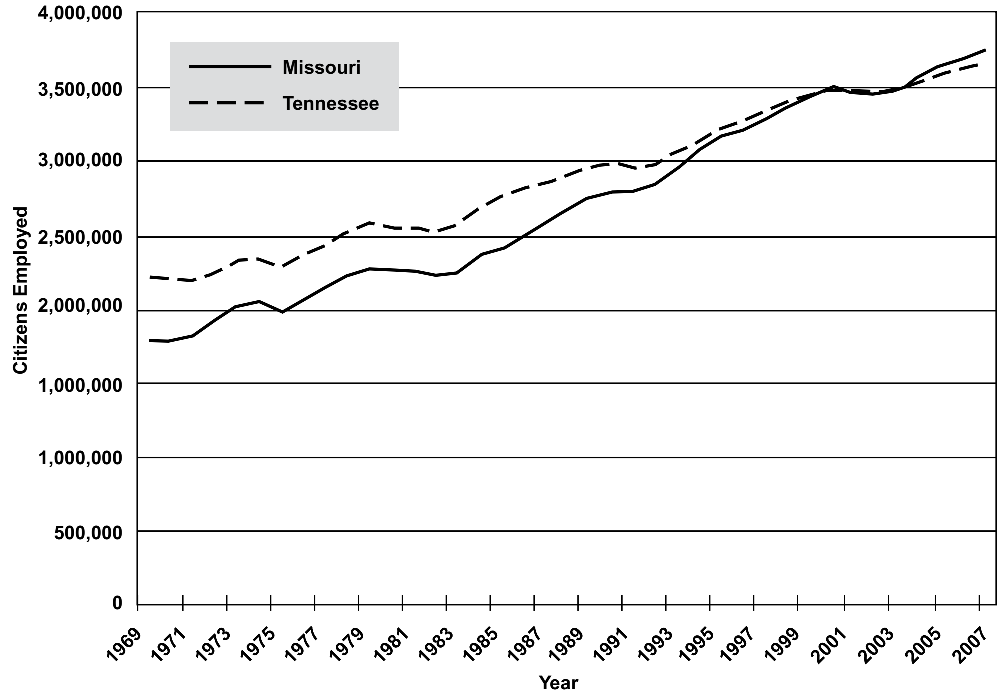


Source: U.S. Census Bureau. *Federal, State, and Local Governments: 2008 State Government Tax Collections*. 2008. http://www.census.gov/govs/www/statetax08.html

Although Tennessee has frequently debated the possibility of imposing a tax on its residents' wages, the state has never implemented one.

A lower overall tax burden is attractive to prospective businesses and residents, because it leaves more money available for consumers to spend on goods and services.

Chart 6: Comparative Employment in Missouri and Tennessee



Source: BEA. "Table SA04 Income and Employment Summary (1958-2008)" and "Table SA04H (1929-1957)." *State Annual Personal Income*. March 24, 2009. http://www.bea.gov/regional/spi/default.cfm

Assembly has authorized its largest cities to levy a local income tax, known as an earnings tax. As a result, those living and working in Kansas City and Saint Louis face an additional 1-percent tax.[8]

In contrast, although Tennessee has frequently debated the possibility of imposing a tax on its residents' wages, the state has never implemented one. Much of the debate has centered on whether the Tennessee Constitution permits the government to tax a resident's wages, with the state's courts tending to conclude that a traditional income tax would not be constitutional. (For further discussion on this topic, see Appendix A.) Thus, although Tennessee does tax some forms of non-wage income,[9] it is frequently considered one of nine states operating without a traditional income tax.[10]

In 2008, Missourians lost an average of 9.2 percent of their income to state and local taxes — $3,508 on an income of $38,084. Tennesseans paid an average of $3,160 in taxes on an income of $38,090 (a state and local tax burden of 8.3 percent).[11] A lower overall tax burden is attractive to prospective businesses and residents, because it leaves more money available for consumers to spend on goods and services. Tennessee's lower tax burden results in an average of several hundred extra dollars remaining in each taxpayer's pocket.

Aside from the relative burden of taxes on each state's residents, it may also be useful to look at the type of taxes that each state uses to draw its revenues. Missouri collects almost half of its state taxes through the individual income tax, while Tennessee does not tax wages (although taxes on other forms of income represent 3 percent of the state's tax revenue). Instead, almost 75 percent of Tennessee's state tax collections derive from sales taxes.[12]

Further comparison between Tennessee and Missouri may reveal the relative advantages and disadvantages of a state's heavy reliance on a sales tax, as opposed to reliance on an income tax. Nationwide, only three states have higher sales tax rates than Tennessee, yet the state ranks within the top 10 states in terms of economic outlook.[13] It seems clear that Tennessee's economic growth is not hindered by its reliance on sales taxes. Compare this situation to Missouri, which has a lower sales tax rate than Tennessee, but one of the 20-highest state income tax rates, and has slipped in both economic growth and population size during recent decades. This may mean that heavy reliance on an income tax as a source of state revenue negatively affects a state's economy. If that's the case, it also suggests that Missouri might be able to stimulate more rapid economic growth by adopting a tax structure that is similar to Tennessee's.

Generally speaking, people and businesses prefer to locate in areas that have a lower tax burden. Even though, as this paper has shown, Tennessee has higher sales taxes than most other states, the fact that it also lacks a tax on wages results in an overall tax burden that is lower than that borne by the citizens of Missouri. The absence of an income tax in Tennessee means that the state's citizens have more money to spend and its business owners have more money with which to hire employees. These factors help to explain why population and employment levels in Tennessee have surpassed those in Missouri. In fact, Tennessee is one of the top 10 states in terms of "net domestic migration" during the last 10 years.[14]

Tennessee's growing population and economy reflect the conventional wisdom that a friendly tax environment attracts both residents and businesses. Although it would overstate the evidence to claim that the absence of an income tax is the only reason Tennessee has outpaced Missouri in terms of both economic and population growth, economic theory suggests that the states' respective tax systems create incentives that may play a significant role. If Missouri does not adjust its tax policy, it seems likely that the state will fall further and further behind Tennessee — and possibly the economies of other neighboring states — both in terms of population and prosperity.

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APPENDIX A

Given that the absence of a state income tax is such a rarity today, it would be useful to consider the historical and constitutional reasons that Tennessee does not levy an income tax on its residents' wages. Throughout the state's history, the question of a state income tax has been frequently and hotly debated. People with opposing opinions on the matter have waged multiple battles in the state legislature, as well as before the Tennessee Supreme Court, arguing about the wisdom and constitutional validity of imposing such a tax.[15] Tennesseans opposed to an income tax argued, among other things, that the state Constitution only permits an income tax to be applied against earnings from stocks and bonds, while advocates of the tax claimed that the Constitution's meaning is ambiguous and that the General Assembly has the power to levy any tax that is not explicitly prohibited by the Constitution.[16]

The first Tennessee case that focused directly on the constitutionality of a traditional income tax was *Evans v. McCabe*, 52 S.W.2d 159 (Tenn. 1932). At issue in Evans was a graduated tax, between 1 and 5 percent, on net earnings from every "gainful occupation, profession or employment," which had been passed during the early days of the Great Depression in an effort to compensate for a sharp decline in the state's revenue streams.[17] Considering the question of the new tax's constitutionality, the Tennessee Supreme Court reasoned that the Constitution's terms distinguished an income tax from other forms of taxation, and only explicitly permit the General Assembly to levy such a tax upon income derived from stocks and bonds. Applying a common rule of construction, the Court determined that where a constitutional provision declares a certain, defined power to be granted, this implies that all related but unmentioned powers are denied — thus, because the drafters of the Tennessee Constitution only granted permission to tax income derived from stocks and bonds, they intended to deny permission to tax income resulting from the pursuit of an "occupation, profession or employment".[18] The Court went on to note that the tax would not pass muster even if it were classified as a tax on property, because that would run afoul of the Constitution's requirement that property must be taxed at a uniform rate.[19] The *Evans* Court unanimously decided to strike down Tennessee's first effort at a tax on wages.

In 1960, another case raised the question of whether Tennessee could implement an income tax. Tennessee courts had previously ruled that the state could tax certain "privileges," which included simply engaging in an occupation, so the General Assembly imposed a tax "upon the privilege of being in receipt of or realizing net earnings in Tennessee." In *Jack Cole Company v. McFarland*, 337 S.W.2d 453 (Tenn. 1960), the Tennessee Supreme Court rejected the legislature's attempt to circumvent the constitutional restrictions announced in *Evans*, determining that every person has a "right to receive income or earnings," so this could not be considered a "privilege" granted by the legislature or subject to taxation.[20] In other words, the state can legally require a citizen to pay a specified fee for the privilege of engaging in a certain kind of business, but the government is not permitted to tax income that citizens earn as compensation for their work. As was the case in *Evans*, the justices were unanimous in their decision.

Despite the Tennessee Supreme Court's two unanimous decisions, attorneys general in the state have, in recent years, argued that an income tax on wages might still pass constitutional muster. In 1981, an opinion published by Tennessee's attorney general challenged the reasoning behind the *Evans* and *Jack Cole Company* cases, stating that the courts should revisit the question of the income tax's constitutionality and suggesting that a tax on wages fell within the authority of the legislature.[21] Another attorney general opinion in 1999 also assailed the continuing authority of the prevailing cases, before arguing that the legislature could craft a bill that would generate something similar to an income tax without stepping beyond the boundaries set by the Tennessee Constitution.[22]

One approach that proponents of a state income tax might take would be to push for a constitutional amendment that specifically empowers the legislature to adopt an income tax. However, public opinion has been weighted so heavily against the adoption of an income tax that such an amendment seems unlikely.[23] Despite statements by the attorney general's office, unless and until the Tennessee Supreme Court is persuaded to overturn the established law regarding the income tax question, *Evans* and *Jack Cole Company* are still the controlling legal cases. As long as the courts continue to abide by the holdings in those cases, any tax on a citizen's earnings would almost certainly be struck down as unconstitutional. If the attorney general's office is correct, however, and the Tennessee Supreme Court would be willing to reinterpret the Constitution's income tax provision, Tennesseans might have to resort to a new anti–income tax provision in order to prevent the tax.

NOTES

1 According to the United States Department of Agriculture, as of 2002, about two thirds of Missouri's total area was dedicated to agricultural uses. See: USDA: Economic Research Service (ERS), *State Fact Sheets: Missouri*, June 30, 2009, www.ers.usda.gov/stateFacts/MO.htm (accessed July 17, 2009).

2 According to the United States Department of Agriculture, as of 2002, about half of Tennessee's total area was dedicated to agricultural uses. See: USDA: ERS, *State Fact Sheets: Tennessee*, June 30, 2009, www.ers.usda.gov/stateFacts/TN.htm (accessed July 17, 2009).

3 These cities and their surrounding counties account for more than half of the state's economic share. See: Missouri Economic Research and Information Center, *Economic Share*, 2009, www.missourieconomy.org/indicators/share/share.stm (accessed July 17, 2009).

4 "Tennessee," *Gale Encyclopedia of U.S. Economic History*. Vol. 2. (Detroit: Gale Group, 2000), 989-991.

5 See: Tennessse Valley Authority, *From the New Deal to a New Century: A short history of TVA*, www.tva.gov/abouttva/history.htm (accessed July 17, 2009).

6 U.S. Census Bureau, 2006 estimate census mid-year SA04, SA04H Line 20: Missouri – 5,842,713 5,911,605; *Tennessee* – 6,038,803 6,214,888. See: U.S. Census Bureau, Tennessee, 2008, quickfacts.census.gov/qfd/states/47000.html (accessed July 17, 2009); U.S. Census Bureau, Missouri, 2008, quickfacts.census.gov/qfd/states/29000.html (accessed July 17, 2009); Population Division of U.S. Census Bureau, *Tennessee*, March 27, 1995, http://www.census.gov/population/cencounts/tn190090.txt (accessed July 17, 2009); Population Division of U.S. Census Bureau, Missouri, March 27, 1995, www.census.gov/population/cencounts/mo190090.txt (accessed July 17, 2009).

7 GDP by state includes a state's total consumption, investment, government spending, and net exports.

8 See: St. Louis Regional Chamber & Growth Association, *Greater St. Louis Taxes at a Glance*, 2009, www.stlrcga.org/x484.xml (accessed July 17, 2009).

9 The state imposes a 6-percent tax on income derived from interest and dividend payments.

10 The others are Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington, and Wyoming.

11 The Tax Foundation applies its own methodology to the Census Bureau's per-capita income figures, arriving at slightly different numbers. The tax burden calculations rely on the Tax Foundation's per-capita income calculations, so those figures are used here. See: Geraldine Pratt, *State-Local Tax Burdens Dip As Income Growth Outpaces Tax Growth*, August 7, 2008, http://www.taxfoundation.org/publications/show/22320.html (accessed July 17, 2009).

12 *2008 Survey of State Government Tax Collections*, U.S. Census Bureau, State Government Tax Collections. See: U.S. Census Bureau, *Federal, State, and Local Governments: 2008 State Government Tax Collections*, 2008, http://www.census.gov/govs/www/statetax08.html (accessed July 17, 2009).

13 Laffer, Arthur B., and Stephen Moore, *Rich States, Poor States* (Washington, D.C.: American Legislative Exchange Council, 2009), 116.

14 *Rich States, Poor States*, Table 1.

15 When Missouri first adopted the income tax, opponents raised similar challenges. In *Ludlow-Saylor Wire Co. v. Wollbrinck*, 205 S.W. 196 (Mo. 1918), a sharply divided Missouri Supreme Court rejected a range of arguments asserting that neither the Missouri Constitution nor the U.S. Constitution permitted the General Assembly's effort to tax citizens' earnings.

16 Article II, section 28, of the Tennessee Constitution addresses the General Assembly's taxation powers, requiring all property taxes to be set at a single, uniform rate and giving the legislature "[p]ower to levy a tax upon incomes derived from stocks and bonds that are not taxed ad velorum."

17 Laksa, Lewis L., "A History of Personal Income Taxation in Tennessee," *Tennessee Historical Quarterly* (Winter 2001).

18 *Evans*, 52 S.W.2d at 161.

19 *Id.* at 162.

20 *Jack Cole Company*, 337 S.W.2d at 455–56.

21 Opinion No. 81-497, 10 Op. Atty. Gen. Tenn. 994.

22 Opinion No. 99-060, 1999 Tenn. AG LEXIS 39.

23 For a decade, whenever an income tax proposal has been considered by the Tennessee General Assembly, those opposed to such a change have been quick to register their displeasure — usually in the form of a stream of cars circling Capitol Hill, honking their horns. See: "Income Tax Dead Now; Governor May Call a Third Session," *The Tennessean*, Nov. 19, 1999, 2A; "Income Tax Leaves Motorists Honking Mad," *The Tennessean*, June 28, 2001, 1A.

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