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*Tennessee sales tax slumps in current downturn*

*By Dave Flessner*

The slowdown in consumer spending this year is hitting Tennessee's state government harder than most states, according to tax collections and budget reports through the first quarter of 2008.

Unlike the last recession six years ago, when Tennessee's sales tax-dependent state budget fared better than the rest of the country, the Volunteer State is shouldering a bigger drop this year from the housing slump and its related decline in taxable consumer spending.

"This is a housing and durable goods slowdown, which has cut our sales-tax collections," said William Fox, director of the Center for Business and Economic Research at the University of Tennessee. "In the 'tech bust' in 2001 and 2002, stock investments and capital gains were hit much harder and that hurt states with a personal income tax much more."

With sales-tax collections falling below year-ago levels in each of the first four months of this year, Gov. Phil Bredesen worried last week that the economic downturn has yet to hit bottom. On Monday, Gov. Bredesen will outline plans to the Tennessee General Assembly to trim the state's budget and cut more than 2,000 jobs from state government.

State Sen. Randy McNally, R-Oak Ridge, chairman of the Senate Finance, Ways and Means Committee, said the slump in tax collections for Tennessee's state government could end up being as bad as any time in his 30 years in the Legislature.

"I think this has the potential of being the worst that I've ever seen," he said. "Certainly, this will be one of the more difficult budgets we've had to develop."

A new study by the Rockefeller Institute of Government found states such as Tennessee, which rely heavily upon sales-tax collections and aren't rich in increasingly valuable oil, gas or coal resources, are struggling with budget shortfalls.

**"We're clearly seeing that states that depend on the sales tax are suffering more than those with a broader tax base," said Robert B. Ward, deputy director of the Rockefeller Institute. "State sales-tax collections around the country were essentially flat or even down a little bit in the first quarter of 2008, whereas income-tax collections for states was up about 4.7 percent."**

Tennessee sales-tax collections were 0.7 percent below year-ago levels in the first three months of 2008 — the first year-over-year drop in such tax collections in seven years. Preliminary figures for April showed the biggest monthly decline in sales-tax collections for Tennessee in 47 years.

Dr. Fox projects sales-tax collections will grow a meager 2 percent in the fiscal year that begins July 1 and the State Funding Board projects that, without cutbacks, Tennessee's state government could face a shortfall next year of up to \$585 million.

In the first eight months of the current fiscal year, Tennessee's sales-tax collections were \$117.7 million less than expected and corporate income taxes were \$86.5 million below projection, according to the state Department of Revenue.

But Dr. Fox said Tennessee still is faring better than some other states in the Southeast. In neighboring Georgia, tax revenues so far this year grew through March by only 1.6 percent, below Tennessee's 1.87 percent gain. Georgia has a more balanced tax structure with collections from personal income, sales and property for state government.

Georgia is not faced with as much of an immediate budget-cutting problem this year, however, because the \$1.5 billion general-fund reserve in the Peach State is nearly twice as high as Tennessee's.

Georgia's sales-tax collections also are down this year and income taxes are growing at the slowest rate in five years, according to Georgia Department of Revenue data.

Alan Essig, executive director of the Georgia Budget and Policy Institute, said Georgia's shortfall in tax collections still is not nearly as bad as the 2001-2002 recession when the tech bubble burst and income-tax collections turned negative.

"We had two consecutive years of revenue decline during that recession, which was the first time that had happened in Georgia since the Great Depression," Mr. Essig said.

#### **Tax rates & stimulus checks**

Some of the decline this year in sales-tax collections in Tennessee reflects changes the state adopted in better times, when lawmakers expected a stronger economy.

The state's sales tax on food was cut by 1 percent in January, costing the state about \$3 million a month, Dr. Fox said. Tennessee sales-tax revenues will take another hit when April tax collections are reported in the next month because of the tax-holiday weekend April 26-27 for clothing, computers and school and art supplies. That is expected to have cost the state about \$10 million in lost taxes.

Combined with a later Easter this year, last month's tax collections also are projected to remain below those from a year ago.

"Unfortunately, the housing slump is not at the bottom yet, and that makes it pretty hard to know for sure when the downturn stops," Dr. Fox said.

Sales-tax revenues should get a boost this month from the \$2.3 billion in tax-rebate checks being given to Tennesseans, Dr. Fox said. Experts predict the checks likely will generate from \$40 million to \$80 million in additional sales-tax revenues for the state from extra sales.

"I think that will give us a little pick-up some in the third quarter, but it may slow again in the fourth

quarter," Dr. Fox said. "We probably won't continue to have a negative quarter by the end of the year, but it will probably still be very weak growth in the fourth quarter.

#### **State budget squeeze**

The slowdown in tax revenues comes as states face higher costs for health care, fuel and most commodities.

"It's a classic nutcracker effect," Mr. Ward said. "Employee-benefit costs, Medicaid expenses and higher oil prices are pushing up costs for most states more than what they are seeing in tax-revenue growth."

Despite the tight budget, legislators said there is no groundswell of support for any tax increase or tax reform at this time.

"I don't see any sentiment for raising taxes," Sen. McNally said. "That has proved to be very unpopular."

In the 2001-2002 recession, a slowdown in the economy, combined with former Gov. Don Sundquist's effort to adopt an income tax, created a budget impasse in the summer of 2002 that threatened to shut down state government. Ultimately, after rejecting a proposed income tax, lawmakers agreed to increase the state's sales tax from 6 percent to 7 percent.

"Part of the problem in 2002 is that we dug our own hole and continued to dig it," Sen. McNally said.

By 2002, Tennessee had depleted most of its reserve funds and its main Rainy Day Fund fell below \$100 million. Tennessee's main reserve today has more than \$750 million. Gov. Bredesen has said he wants to maintain or build that reserve, even during the downturn.

State Sen. Bo Watson, a Hixson Republican, said state tax revenues grew from 2002 through 2007 before falling this year.

"It's going to be a challenging budget year, but we are in a position to manage our way through it," Sen. Watson said. "The good thing about a sales tax is that, while it hurts you during a recession, it can rebound quickly when spending recovers."