To Tax or Not to Tax Is Not the Question, but How to Tax

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INTRODUCTION

On local call-in shows around the state of Tennessee, talk show hosts have drummed up a fury among listeners passionately fighting a state income tax. Spectacles, not seen since the anti-war protests of the 1960s, were promoted by talk radio in their own schemes to generate revenue. Major newspaper stories told of partisan politics, scare tactics, last minute compromise, likely vetoes, and little trust in government officials resulting in no fundamental restructuring of the state's financial plan for providing state and locally provided public services. To one degree or another, the story is similar across states addressing tax reform. [8,-10,13,15,18-23,27,30,32,33]

The problem is that very few publicized comments are supported by a comprehensive set of facts. Consequently, selective editing and sensationalizing overwhelms voters and legislators. Few journalists attempt to address the details of tax reform issues focusing rather on the politics. The few attempts address tax reform proposals as a "beggar thy neighbor" issue focusing on the incidence of a specific tax rather than addressing the overall impact of inter-jurisdictional tax structures. The question often posed is to tax or not to tax to balance a specific budget. However, that is not the question. The question is how to tax to better manage and distribute taxpayer burdens and adequately fund the services demanded by the public at-large.

McLure [24] wrote in 1964 " No local, state, or federal government conducts its finances in an economy closed to the outside." Popular public finance textbooks [1,12,16] reiterate current research and theory regarding the integration of inter-jurisdictional taxes and avoidance strategies. In a recent interview with David Brunori [5], William Fox, Tennessee's designated expert on tax matters, reiterated the research and trends suggested in most public finance textbooks: the demand for individualized services, greater factor mobility, and decentralized government. Fisher [12] notes the public's familiarity with state and local services. Yet, despite the public's familiarity, less is understood about the institutional details because of complex jurisdictions, the relative size of individual payouts, and a lack of consensus on the roles that people want government to play in their lives. Consequently, the tax debates and resulting tax structures in states, like Tennessee, seem to forget some basic public finance principles when it comes to state taxes.

New economic studies tend to focus on welfare benefits or capital formation of various tax structures. In a recent book assessing state sales and income taxes, Zodrow [34] finds that state income taxes generate increased welfare compared to other taxes. Zodrow focuses on Texas, another state without an income tax. Heckman et. al. [14] found in simulation models estimating the impact of tax reform on human

capital formation that progressive or proportional income taxes generated higher human capital formation than dependence on consumption taxes and created less wage disparity. Fernandez and Rogerson [11] using another simulation model determine that state financing schemes for education generate greater welfare gains than local schemes. However, voters and legislators have not been persuaded. Because tax reform typically arises during budget debates, the focus narrows to two things: some presumed mismanagement of public funds or who pays a specific tax, not the changing responsibilities of state and local governments or total taxpayer burdens.

The overwhelming responsibility of state and local governments remains education. However, there is a growing trend to decentralize many other public service responsibilities and there is increasing competition among states and localities to generate increased economic prosperity. Consequently, state and local tax structures now must acknowledge four realities: more local responsibility, particularly for education results, a continued need to direct resources to the most economically disadvantaged, a need to maintain a stable economic base, and an ability to manage the interdependence of state, local, and federal tax liabilities. For poorer taxing jurisdictions, these realities require that they keep scarce monetary resources within those states and localities.

This paper examines how several southern states have structured the local, state, and federal tax burden for its residents. The conclusion is that the states with the least taxes collected using combined property and income taxes are "starving" themselves locally concentrating on sales tax collections, while allowing hundreds of millions of dollars to leave these states through federal income taxes. Additionally, these funds flowing to Washington are not necessarily returned proportionally through federal spending.

DATA & METHODOLOGY

Rather than focusing on overall state welfare gains or designing a complicated general equilibrium model, we have chosen to focus on analyzing tax burdens and public spending patterns by state. Furthermore, to avoid the debate proliferated by the Tax Foundation and the Center on Budget and Policy Priorities on the relevancy of an aggregate median versus mean taxpayer, we analyze tax burdens by the seven income groups provided by IRS. [28,6,7]

To analyze tax burdens in each state and state funding resources, we use data aggregating individual 1997 IRS taxpayer returns by seven income groups (based on adjusted gross income). IRS reports aggregate data by sources of income, deduction categories, and number of tax returns filing a particular category for each income group and the total state. By using bounded income groups, these average calculations of aggregate data are likely to be more representative. We are not attempting to reconstruct a specific tax return.

The database allows us to estimate average federal income tax liabilities and average reported deductible taxes such as property and state income taxes. For our comparisons, we use an effective tax liability rate calculated as the ratio of total tax liability and adjusted gross income reported for each income group. We then compare the estimated tax payments using US aggregate rates for each state to determine the potential leakage. For estimates of individual payments for each group, we use the ratio of total tax liability and total taxpayers and the ratio of deducted taxes and number of taxpayers itemizing deductible taxes.

To calculate state and local sales taxes, we focus our final analysis on five of the income groups that are well defined and bounded. State and local sales taxes are more complicated to calculate because of

jurisdictional differences and incidence. To estimate sales taxes by income group, sales tax rates for various goods and services are applied to estimated expenditures by income group reported by the Bureau of Labor Statistics. We realize that the sales tax estimates are based on approximations of expenditure patterns by various income groups. We use 1996 expenditure pattern data and available estimates of state sales tax rates. Local sales tax rates are estimated based on the share of state and local sales tax proceeds reported by the US Census in the 1996 Combined State and Local Revenues and Expenditures. Although the local component varies from county to county, these estimates are in the ballpark for the purposes of this paper. This report is also used to analyze available state and local financial resources along with the 1997 Consolidated Federal Funds Report.

FINDINGS

As economists have pointed, out a central benefit of a state income tax is the deductibility on federal tax returns. Sales taxes and user fees are not deductible; therefore, there is no matching federal support. Actually only one southern state does not tax income, Florida. Tennessee's income tax, however, is restricted to interest and dividends and generates only 1% of total state and local taxes. Thus, Tennessee is often referred to as a "non-income tax" state. Based on 1997 IRS reported data, 83-93% of US taxpayers with adjusted gross income over $75,000 itemized their deductions. Incidentally, these taxpayers represent 10% of the returns filed, 35% of income reported in the US, and 64% of the income taxes paid. However, if we look at data for the six southern states reported in Table 1, 87-98% of those taxpayers living in states with an income tax itemize compared to only 66- 80% in Florida and Tennessee depending upon income range.

This translates into higher average effective federal income tax rates for higher income Florida and Tennessee taxpayers and a resource drain on these states. Based on a comparison of the average effective tax rate for a US taxpayer and taxpayers in each state, the average taxpayer in every income group pays less than the average US taxpayer in North Carolina, Virginia, and South Carolina and most income groups in Kentucky. In the case of Florida and Tennessee, any average taxpayer reporting income over $30,000 pays more than comparable taxpayers elsewhere. The disparity becomes greater when comparing taxpayers across the south.

On average, southern states generate less federal income taxes because of income distribution, but we have demonstrated that this is not true of specific income groups. A comparison of the effective tax rate for an average US taxpayer in six income ranges that pay federal income taxes (over $20,000 to over $200,000) suggests that there is a federal tax leak on the order of $350-500 million dollars from Tennessee. On the other hand, Kentucky and South Carolina, with slightly worse income distribution compared to Tennessee, are able to keep $70-200 million at home and North Carolina, with about the same income distribution, keeps at least $400 million at home. In the south, these differences approach a $1 billion differential, which could be available for families to spend locally or be redirected to local taxes for locally funded programs such as education.

Table 1

Difference in 1997 IRS Tax Liability for Residents of Select Southern States by Income Group

State and Item	Under $20,000	$20,000 under $30,000	$30,000 under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more

	(thousands of returns and millions of dollars)						
United States							
Return Distribution	44%	15%	18%	12%	5%	4%	1%
AGI Distribution	9%	9%	18%	19%	11%	14%	20%
SSI Distribution(1)	2%	17%	34%	24%	10%	9%	3%
Percent Itemizing	6%	18%	39%	65%	83%	91%	93%
Effective Tax Rate	6.0%	8.6%	10.8%	12.5%	15.1%	18.6%	28.1%
SOUTH CAROLINA							
Adjusted gross income (AGI)	$7,768	$6,760	$11,338	$11,485	$5,930	$6,524	$7,764
Taxes Deducted	$67	$88	$330	$568	$366	$435	$504
IRS Tax Liability	$385	$570	$1,184	$1,381	$877	$1,203	$2,099
Effective Tax Rate	5.0%	8.4%	10.4%	12.0%	14.8%	18.4%	27.0%
Taxes Paid Relative to US Average	-$83	-$12	-$39	-$57	-$17	-$14	-$82
Return Distribution	48%	16%	17%	11%	4%	3%	1%
AGI Distribution	13%	12%	20%	20%	10%	11%	13%
SSI Distribution	2%	17%	35%	25%	10%	8%	3%
Percent Itemizing	4%	18%	42%	72%	89%	95%	97%
VIRGINIA							
Adjusted gross income (AGI)	$10,816	$10,973	$22,108	$24,418	$15,732	$22,060	$20,533
Taxes Deducted	$115	$181	$709	$1,211	$962	$1,470	$1,267
IRS Tax Liability	$626	$943	$2,353	$3,019	$2,333	$4,028	$5,625
Effective Tax Rate	5.8%	8.6%	10.6%	12.4%	14.8%	18.3%	27.4%
Taxes Paid Relative to US Average	-$26	-$1	-$31	-$38	-$39	-$86	-$145
Return Distribution	40%	15%	19%	13%	6%	6%	1%
AGI Distribution	9%	9%	17%	19%	12%	17%	16%
SSI Distribution	2%	15%	32%	25%	12%	11%	3%
Percent Itemizing	5%	20%	43%	70%	87%	95%	98%
NORTH CAROLINA							
Adjusted gross income (AGI)	$14,739	$13,634	$24,200	$24,726	$13,415	$16,214	$19,659
Taxes Deducted	$121	$203	$751	$1,284	$878	$1,169	$1,437
IRS Tax Liability	$783	$1,163	$2,546	$3,000	$1,989	$2,987	$5,348
Effective Tax Rate	5.3%	8.5%	10.5%	12.1%	14.8%	18.4%	27.2%
Taxes Paid Relative to US Average	-$105	-$10	-$63	-$95	-$33	-$36	-$175
Return Distribution	45%	16%	18%	12%	5%	4%	1%
AGI Distribution	12%	11%	19%	20%	11%	13%	16%
SSI Distribution	2%	17%	35%	24%	10%	8%	3%
Percent Itemizing	5%	19%	42%	72%	90%	96%	98%
KENTUCKY							

Adjusted gross income (AGI)	$6,984	$6,084	$11,802	$11,755	$5,756	$6,042	$7,423
Taxes Deducted	$85	$88	$383	$653	$396	$425	$463
IRS Tax Liability	$382	$515	$1,231	$1,433	$867	$1,147	$2,079
Effective Tax Rate	5.5%	8.5%	10.4%	12.2%	15.1%	19.0%	28.0%
Taxes Paid Relative to US Average	-$39	-$9	-$42	-$39	-$1	$20	-$6
Return Distribution	48%	15%	18%	12%	4%	3%	1%
AGI Distribution	13%	11%	21%	21%	10%	11%	13%
SSI Distribution	2%	19%	38%	24%	8%	7%	3%
Percent Itemizing	4%	17%	39%	70%	88%	94%	96%

Table 1 Continued

Difference in 1997 IRS Tax Liability for Residents of Select Southern States by Income Group

State and Item	**Under $20,000**	**$20,000 under $30,000**	**$30,000 under $50,000**	**$50,000 under $75,000**	**$75,000 under $100,000**	**$100,000 under $200,000**	**$200,000 or more**
		(thousands of returns and millions of dollars)					
TENNESSEE							
Adjusted gross income (AGI)	$9,865	$9,590	$17,334	$16,724	$8,568	$10,065	$15,283
Taxes Deducted	$95	$36	$105	$152	$109	$152	$183
IRS Tax Liability	$566	$829	$1,883	$2,178	$1,395	$2,046	$4,414
Effective Tax Rate	5.7%	8.6%	10.9%	13.0%	16.3%	20.3%	28.9%
Taxes Paid Relative to US Average	-$28	$4	$14	$84	$103	$169	$120
Return Distribution	46%	16%	18%	11%	4%	3%	1%
AGI Distribution	11%	11%	20%	19%	10%	12%	17%
SSI Distribution	3%	18%	36%	24%	9%	8%	3%
Percent Itemizing	3%	11%	24%	45%	66%	77%	75%
FLORIDA							
Adjusted gross income (AGI)	$27,891	$26,507	$45,918	$44,712	$25,473	$34,096	$68,469
Taxes Deducted	$385	$293	$700	$818	$575	$914	$1,620
IRS Tax Liability	$1,670	$2,242	$4,954	$5,786	$4,053	$6,684	$19,665
Effective Tax Rate	6.0%	8.5%	10.8%	12.9%	15.9%	19.6%	28.7%
Taxes Paid Relative to US Average	-$12	-$39	$3	$190	$213	$326	$427
Return Distribution	47%	16%	17%	11%	4%	4%	2%
AGI Distribution	10%	10%	17%	16%	9%	12%	25%
SSI Distribution	3%	17%	33%	24%	10%	10%	4%
Percent Itemizing	6%	18%	34%	53%	69%	78%	79%

Source: IRS

To determine how these differentials occur, in Table 2 we compare total itemized taxes from IRS returns with state and local tax collections. Tennessee taxpayers are only able to deduct about 35% of actual property and income taxes and less than 10% of their combined state and local tax burden including sales tax. These percentages compare to 60-70% and 35-40% estimates for taxpayers in other southern states and the US.

Table 2

Amount of Taxes Itemized as Deductions on Individual 1997 IRS Returns and State and Local Government Tax Collections for 1996

	1997 IRS Returns	**1996 S & L Property, & Income Taxes**	**1996 S & L Property, All Sales, & Income Taxes**	**Percent Deducted S & L P&I**	**Percent Deducted S & L P&S&I**
		(Millions of dollars)			
United States	$224,038	$356,283	$605,276	63%	37%
South Carolina	$2,359	$3,767	$6,476	63%	36%
Virginia	$5,915	$9,148	$14,008	65%	42%
North Carolina	$5,843	$8,387	$14,502	70%	40%
Kentucky	$2,494	$3,963	$7,174	63%	35%
Tennessee	$833	$2,380	$8,455	35%	10%
Florida	$5,306	$11,813	$29,391	45%	18%

Source: US Census state and local government revenues and expenditures

The last piece of the puzzle is to examine the combined tax burden for taxpayers. By examining the fairly well-defined middle and upper income groups that pay taxes (excluding the less than $30,000 and greater than $200,000 groups) in Table 3, we see that Tennessee and Florida taxpayers increasingly pay more federal income tax; up to about $2000 more for taxpayers in the $100,000-200,000 bracket. Sales taxes also increase by income group to about $1000 more than paid in states with income taxes. On the other hand, Tennessee and Florida taxpayers pay $1000 to up to $7000 less in the deductible taxes compared to income groups in the states with income taxes. The property and income tax estimates are based on the IRS returns actually filing deductible taxes. Unfortunately, we are unable to compare user fees, an alternative to tax funding.

Across the income groups, taxpayers pay more in across all jurisdictions in the income tax states. It appears taxpayers in states with a state income tax pay an additional $1000-$4000 depending upon income group. Consequently, tax reform is not a simple matter of tax shifting. The question becomes does the state get its fair share of federal spending to offset higher taxes or should taxpayers be willing to pay potentially additional taxes for local services.

In Table 4, we compare federal spending and individual tax collections. The clear winners in the south at the federal taxing and spending game are South Carolina, Virginia, and Kentucky. These states save taxes and gain spending. This translates into Virginia being the wealthiest state in the south with the greatest resource base from both local and federal resources. Although Tennessee appears to be average in federal spending per tax dollar, the spending estimates are inflated by TVA spending. TVA is a regional user fee-based federal agency rather than tax-based agency. Unfortunately, the data did not allow us to remove TVA's budget. We did remove US Postal Service and social security payments.

A second question that arises is what is the tax, user fee, and federal spending mix utilized by these southern states. To address this question, we have compiled additional summary statistics on population and income, revenue sources, and expenditure mixes for each state in Table 5. State and local government use of federal spending is primarily related to income support programs. The poorer states rely slightly more on federal funds.

Despite the radio battleground on taxes, all the southern states rely less on taxes than other states. Services such as utility services have increased funding from non-deductible user fees. The data in Table 5 also indicate that these southern states all fall below the US average state and local government expenditures per capita and collect fewer taxes per capita. If we exclude public power, then Kentucky and Tennessee spend the least per capita. Tennessee not only spends the least, but collects the least taxes on either a per capita or dollar of income basis. In the case of Tennessee, it is not clear what facts critics and talk radio hosts use to drum up anti-tax sentiment.

As indicated in Table 5, South Carolina, Virginia, and North Carolina collect over 50% of local and state taxes from combined property and income taxes. Florida actually collects a very high percentage of its taxes from property. However, if property is owned outright or a relatively large number of residents rent, then taxpayers may not have enough deductions to itemize to offset those taxes or higher rents. Therefore, it takes a mix close to 50% in both property and income taxes to drive itemization and the ability to offset local tax burdens with federal tax deductions. Tennessee collects less than 25% its tax burden in the deductible property and income taxes.

Of all the states, Tennessee relies the most on general and specific sales taxes. Florida is second. Unlike Tennessee, Florida residents believe that this is a way to pass on the local tax burden to out-of-state tourists. It is true that Florida is a very popular tourist destination. However, up to 40% of Florida's tourist activity is by Florida residents. [31] Tourist dollars do help stem some of the out-of-state flow of money from federal income taxes, but even in Florida much of the sales tax dollar shifting is only among Florida residents. For states like Tennessee, out-of state tourists in Tennessee may contribute $.6 million in tax revenues. [29]

Table 3

Tax Payer Comparisons by State and Income Group 1996-1997

	IRS Income Tax	State & Local Sales Taxes ***	State & Local Property, Income Other IRS Deducted Taxes
$30-50,000			

South Carolina	$4,082	$995	$2,727
Virginia	$4,179	$904	$2,906
North Carolina	$4,120	$782	$2,888
Kentucky	$4,090	$1,033	$3,218
Tennessee*	$4,250	$1,469	$1,039
Florida*	$4,216	$1,138	$1,857
$50-75,000			
South Carolina	$7,307	$1,301	$4,116
Virginia	$7,548	$1,164	$4,294
North Carolina	$7,371	$1,034	$4,367
Kentucky	$7,387	$1,366	$4,801
Tennessee*	$7,891	$1,921	$1,277
Florida*	$7,842	$1,505	$2,176
$75-100,000			
South Carolina	$12,710	$1,561	$5,903
Virginia	$12,749	$1,401	$6,050
North Carolina	$12,669	$1,249	$6,227
Kentucky	$12,750	$1,650	$6,711
Tennessee*	$13,950	$2,305	$1,677
Florida*	$13,646	$1,817	$2,861
$100-200,000			
South Carolina	$24,060	$1,821	$9,255
Virginia	$23,976	$1,646	$9,245
North Carolina	$24,285	$1,570	$9,824
Kentucky	$24,934	$2,073	$9,884
Tennessee*	$26,921	$2,688	$2,621
Florida*	$26,008	$2,284	$4,616

*** Because of limited number of itemized returns these estimates may be low.**

***Based on estimated expenditures by income by US Bureau
Of Labor Statistics, state sales tax rates, and % distribution
Of all sales tax collections between each state and its local governments.

Table 4

Individual Federal Income Tax Liability and Federal Spending

	1997 IRS Returns	1996 (1) Federal Direct Grants	1997 (1) Federal Direct Grants	1997 (2) Federal Spending	Percent of Tax Liability Grants	Percent of Tax Liability Spending
		(Millions of dollars)				
South Carolina	$7,698	$3,276	$3,302	$13,495	43%	175%
Virginia	$18,925	$3,813	$4,335	$44,309	20%	234%
North Carolina	$17,817	$5,800	$6,798	$23,531	33%	132%
Kentucky	$7,653	$3,378	$3,829	$15,236	44%	199%
Tennessee	$13,311	$4,964	$5,111	$20,662	37%	155%
Florida	$45,054	$9,360	$9,411	$55,144	21%	122%

(1) Based on US Census 1996 state and local government revenue and expenditure estimates.

The Consolidated Federal Funds Report 1997 estimates are the source of total spending.

(2) excludes US Postal Service and Social Security Payments

Table 5

Comparison of Combined State and Local Government Revenues and Expenditures 1996

	US	FL	KY	NC	SC	TN	VA
Population (7/1/96, millions)	265.3	14.4	3.9	7.3	3.7	5.3	6.7
Personal Income (CY95, billions)	$6,098	$327	$73	$152	$70	$111	$159
Income Per Capita (thousands)	$22.99	$22.69	$18.73	$20.73	$18.87	$20.79	$23.77
Total S&L Expenditures per capita	$5,268	$4,763	$4,288	$4,640	$4,829	$4,842	$4,349
Excluding Public Power Revenue	$5,135	$4,604	$4,202	$4,374	$4,554	$4,184	$4,317
And Trust Fund Expenditures	$4,725	$4,389	$3,880	$4,125	$4,267	$3,965	$4,104
S&L All Taxes per capita	$2,597	$2,330	$2,166	$2,251	$1,981	$1,878	$2,341
S&L All Taxes per $1000 income	$113	$103	$116	$109	$105	$90	$98
TAX DISTRIBUTION							
Property taxes	30%	35%	17%	21%	27%	23%	31%
Individual Income taxes	21%	0%	30%	30%	25%	1%	28%
Corporate Income taxes	5%	3%	3%	6%	3%	5%	2%
General Sales taxes	25%	35%	21%	23%	27%	47%	17%
Specific Sales/ Licenses/Other taxes	19%	27%	28%	20%	18%	24%	23%
Total Tax Share of General Revenues	70%	65%	69%	69%	62%	66%	69%
Federal Gvt Share of Total Budget	16%	13%	18%	16%	18%	18%	12%
USER FEE/ INCOME SHARE OF COST							

Higher Education Fees	41%	32%	47%	35%	41%	32%	51%
Utility /Sewer/Waste Fees	77%	95%	88%	87%	91%	98%	81%
Hospital Fees	72%	75%	74%	86%	100%	86%	88%
Parks & Rec/Conservation Fees	20%	9%	22%	11%	20%	18%	14%
Housing & Community Development Fees	16%	17%	15%	20%	15%	18%	15%
PER CAPITA EXPENDITURES							
Welfare per capita	$729	$513	$718	$626	$692	$709	$493
Highways per capita	$298	$318	$306	$262	$196	$280	$339
Public Safety per capita	$404	$500	$229	$342	$306	$303	$373
General Government	$459	$420	$284	$313	$301	$312	$310
Higher Education Expenditures per capita	$380	$257	$364	$464	$412	$356	$392
K-12 Education Expenditures per capita	$1,053	$948	$886	$872	$935	$800	$1,001
Public Electric Power Revenue per capita	$134	$158	$86	$266	$275	$658	$32
Source: US Census Data							

CONCLUSION

Rather than state and local tax reform, the state's congressional delegation could develop strategies to leverage additional federal resources. Federal tax reform is another option to make higher local taxes more palatable for taxpayers as government responsibility is decentralized. At a minimum 12% of state and local budgets are funded by federal funds. Direct grants to the states account for 20% of federal income taxes collected in these states. With increased decentralization and federal tax reform, states could be held accountable for collecting these amounts locally and administering programs accordingly. These strategies at least may control the leakage of a state's scarce resources to federal initiatives that may not match local priorities. Lotteries or increased reliance on user fees, which more explicitly price services to consumers, are attractive options among the no new taxes proponents, however, these funding sources do not offer any federal tax sharing potential.

Southern states across the board spend less at the state and local level than the US average and Tennessee is among the lowest. Local spending cuts or higher user fees will likely only increase the financial burden to acquire services or do without. To cut expenditures requires a comprehensive public discussion on public service priorities; otherwise, it is not clear what to cut. Yet, these are not the facts presented by government officials, the news media, or talk radio.

Despite a politically complex tax reform process, the data suggest compelling arguments for tax reform in states like Tennessee. There is a great deal of money at stake. Shifting the difference of up to $1000 in sales taxes to income taxes would not generate a comparable property and income tax deduction as indicated in other states to re-coop the up to $3000 federal tax savings per tax payer. For example, the $100,000-200,000 Tennessee or Florida taxpayer pays about $3000 less in over all taxes despite the fact that those states lose close to $3000 per taxpayer in federal income taxes. Consequently, it will take both shifting old taxes and directing all new taxes towards a mix of property and income taxes to control the leak in federal tax dollars. In the case of Tennessee, local governments also levy sales taxes and they levy the residential property tax. This means that both the state and local governments with taxing authority need to be part of the redesign of taxes and the development of a more comprehensive financial plan.

Based on the estimates in Table 3, there is not much money to be extracted from the federal tax burden of the individual taxpayer with AGI below $50,000. Tax reform schemes, however, can and should consider income of $50,000 and above for developing a taxpayer pool. In Tennessee, for example, about 20% of 1997 taxpayers reported adjusted gross incomes above $50,000 accounting for about 58% of the total adjusted gross income in the state, 27% of the population, and only about 45% of the taxpayers claiming social security benefits. This mix of taxpayers should give an adequate tax base to redesign an effective state and local tax system that can raise taxes and redistribute tax burdens to prevent leakage of money from the state via federal income taxes. However, simply adding a tax here or there or removing items from taxation will probably not generate the necessary results.

Without change, the result of tax structures, like Tennessee's, will resemble a leaky air mattress. The problem can readily be seen and felt, but is difficult to fix. Thus to tax or not to tax is not the question, but how to tax to keep from waking up on the hard ground.

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