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List of states with no income tax will grow by one

David M. Kall | Thursday, June 16, 2016

Tennessee is set to become the eighth state without an income tax, if the legislation that Governor Bill Haslam signed into law in late May remains intact for the next six years. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming are the seven states that currently have no income tax, either on wages or interest and dividend income.

As it now stands, Tennessee imposes a 6 percent tax on interest and dividend income over $1,500 by way of the “Hall income tax,” (HIT) named for the senator who sponsored the legislation that became law in 1929. New Hampshire is the only other state that does not tax wage income, though it does tax interest and dividend income over $2,400 for single filers and $4,800 for those filing jointly.

Tennessee’s measure calls for a gradual reduction of the HIT by 1 percent each year until 2022, at which time it will have been eliminated. One condition/underlying assumption of the reduction is that state revenue growth will exceed three percent over the previous fiscal year.

The fiscal note reveals the following impact:

Decrease State Revenue – Net Impact:

- For fiscal year 2017-18: $43,468,500
- For fiscal year 2018-19: $86,954,900
- For fiscal year 2019-20: $130,445,900
- For fiscal year 2020-21: $163,054,000
- For fiscal year 2021-22: $164,139,600
- For fiscal year 2022-23: $165,225,200
- For fiscal year 2034-24 and subsequent years: $166,310,800

Decrease State Expenditures

- For fiscal year 2024-25 and subsequent years: $500,000

Increase Local Revenue – Net Impact:

- For fiscal year 2017-18: $606,000
- For fiscal year 2018-19: $1,229,900
- For fiscal year 2019-20: $$1,858,400
- For fiscal year 2020-21: $2,319,600

Decrease Local Revenue –Net Impact:

- For fiscal year 2021-22: $28,741,600
- For fiscal year 2022-23: $59,802,900
- For fiscal year 2034-24 and subsequent years: $90,864,200

In What Just Happened in Tennessee, the Institute on Taxation and Economic Policy (ITEP) criticizes the legislation for its regressive nature, because it helps only a small number of the wealthiest Tennesseans. According to ITEP's analysis:

> “The highest-income 5 percent of households will receive 61 percent of the tax cut while only 14 percent of the benefit will flow to the 95 percent of Tennesseans who earn less than $173,000 per year. The remaining 25 percent actually ends up going to the federal government as Tennesseans will lose the ability to write off their Hall tax payments on their federal tax returns and will pay more in federal taxes as a result.”

Citing data from the U.S. Census Bureau Survey of State and Local Government Finance for fiscal year 2012-13, ITEP notes that the HIT generates 1.3 percent of state and local tax revenue in Tennessee. Localities receive a share of about three-eighths of total Hall tax revenues, so officials worry that they will be forced to increase property taxes, cut services, or both. The state will likely have to do something similar, which ITEP asserts will be difficult because Tennessee already ranks very low in education spending and total state and local spending as a share of personal income, 48th and 43rd respectively.

Beyond this, Tennessee has the second highest reliance on general sales taxes to fund government in the country. For this reason, ITEP argues the HIT reduction means that the state's budget situation is likely to grow increasingly difficult if taxpayers' consumption habits continue to shift away from taxed goods and toward often untaxed services and Internet purchases.

Finally, ITEP laments the fact that Tennessee's regressive system, in which the state captures more income from the lowest-income residents than it does from the wealthiest, will only get worse; it is already more regressive than all but six other states.

ITEP concedes that “[a]nti-tax advocates in other states might mistake this year's action in Tennessee as an indication that their state may be able to eliminate its own income tax.” But because the Hall tax only applies to certain types of dividend and interest income, combined with the fact that it includes “generous exemptions that keep the vast majority of Tennesseans from paying anything at all,” the Hall tax is modest in comparison to the more broad-based income taxes that some want to repeal in other states. As stated above, the Hall tax only accounts for 1.3 percent of Tennessee's state and local tax revenue, while personal income taxes make up 15 percent of tax revenues in Arizona, 21.7 percent in Oklahoma, and 22.9 percent in Kansas.

Ultimately, although the legislation has the potential to reduce the adequacy and fairness of Tennessee's tax system, its full effect will not be realized until 2022, time in which it could be modified.

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