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Tennessee Trends

The State of Tennessee's Economy

Key Points

- Tennessee's economy has for years outperformed the nation as a whole and all surrounding U.S. states in terms of key macroeconomic figures such as unemployment, GDP growth, and personal income growth.
- However, the state's labor force participation rate is lagging further behind the national average.
- State policymakers should consider additional tax reforms to maintain and further incentivize the state's strong economy. Our modeling suggests the top reforms lawmakers should consider are setting our bonus capital depreciation to 100 percent and lowering the franchise tax rate from 0.25 percent to 0.2 percent.

Escaping the Tax Man: The Impact of Taxes

In 1956, economist Charles Tiebout published his most famous work, "A Pure Theory of Local Expenditures," in which he argued that given different localities, voters and taxpayers would coalesce in communities that meet their desire for public goods.[1] While Tiebout never used the phrase "foot voting," his work laid the foundation for the consensus view that taxes impact people and businesses' decisions. Additionally, unlike other policies and public investments like infrastructure, education, and workforce development, the benefits of tax reform can have a near-immediate impact on an economy. Take Illinois for example, when in 2011 the Illinois legislature passed the largest tax hike in the state's history, increasing their personal and corporate income tax by 67 and 46 percent, respectively.[2] As a result, the state had to cut incentive deals totaling over $235 million to prevent several companies from leaving the state.[3] A study from the University of Illinois found that these tax hikes contributed to a lower level of employment and higher unemployment rates.[4]

On the opposite end of the spectrum, Tennessee for decades has attracted individuals and companies through lower taxes and fiscal conservatism. For example, take the last decade, during which the state sought to cut or eliminate numerous taxes. Tennessee voters in 2014 amended the state constitution to prohibit lawmakers from ever proposing an income tax.[5] Then came repealing the gift and death taxes, which were phased out in 2016, saving taxpayers roughly $200 million combined per year.[6] In 2021, Tennessee finished its phaseout of the Hall income tax, a $300 million annual tax on the income derived from stocks and bonds—marking only the second time in America's long history that a state has fully repealed an income tax.[7] In 2022, Tennessee made national news as the first and only state thus far to decouple from the impending "innovation tax," a provision of the Tax Cuts and Jobs Act that set the full and immediate deduction for business investment in research and development to expire.[8] Now in back-to-back years, lawmakers have passed the single largest tax cut in the state's history with two measures: the Tennessee Works Tax Act in 2023, which addressed arguably the least-competitive aspects of all of Tennessee's taxes on businesses; and a $400 million annual cut to the state's franchise tax in 2024.[9] All of these reforms have led to Tennesseans paying some of the lowest taxes nationwide. The state has the nation's second lowest per capita debt, and third lowest tax burden per capita after Alaska and Wyoming.[10]

Has this different approach led to stronger economic growth and indicators than in neighboring states? This report seeks to highlight the state of Tennessee's economy, the impact of recent tax reforms in Tennessee, and the potential impact of additional reforms that could further fuel the state's economy.

Macro Signals—A Leader of the Pack

How has this emphasis on tax cuts impacted the state's economy? Arguably the most important factor in terms of real impact on everyday Tennesseans is the unemployment rate, and in this area, the state has continued to outperform the country as a whole. After the initial months of the pandemic, the state's economy stayed stronger and rebounded quicker than it would have otherwise, due to the state's approach of balancing lives and livelihoods. Tennessee's unemployment rate has remained lower than the overall U.S. unemployment rate.[11]

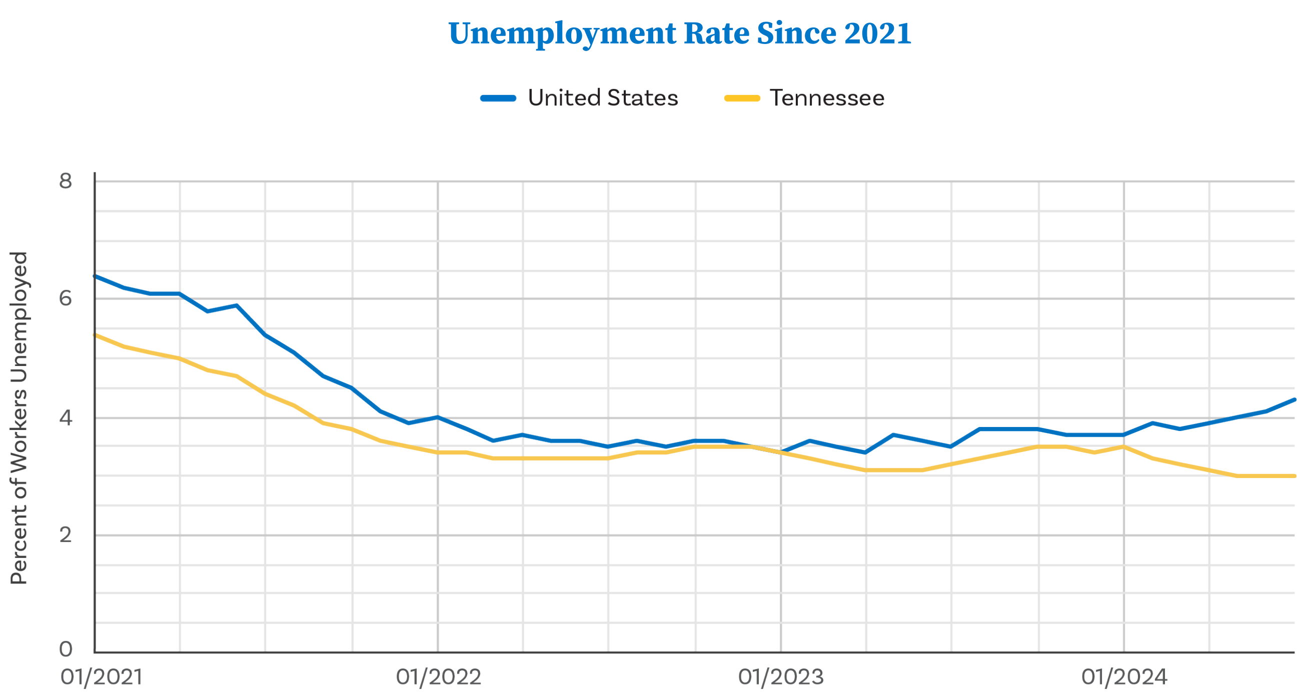

Figure 1. For several years, the state's unemployment rate has remained below that of the national rate. Source: Bureau of Labor Statistics

However, this is not unusual for states in the Southeast. In fact, in 2020 and 2021 alone over two million people migrated to the Southeast and brought over $100 billion of wealth and income with them. Even more notable, Florida, Texas, Georgia, Tennessee, and the Carolinas now add more to the national GDP than the Northeast, historically the most economically productive region of the country.[12] So how does Tennessee compare to some of its southern neighbors? When looking at Tennessee's eight bordering states and the largest economies in the Southeast, we see Tennessee still stands above most of the competition.

Real GDP Percentage Change

	2018	2019	2020	2021	2022	2023	Average	2021-2023 Average
United States	3	2.5	-2.2	5.8	1.9	2.5	2.3	3.4
Tennessee	2	2.1	-1	8.2	3.9	3.2	3.1	5.1
Alabama	1.9	1.9	-1.3	4.4	1.7	2.5	1.9	2.9
Arkansas	2	0.7	0.7	5.9	1.3	2.5	2.2	3.2
Florida	3.5	2.7	-1	9	4.6	5	4.0	6.2
Georgia	3	3.3	-3	6.1	2.6	0.8	2.1	3.2
Kentucky	1.2	2.8	-2.6	4	1.4	3.5	1.7	3.0
Mississippi	-0.1	0.3	-0.6	3.9	0	0.7	0.7	1.5
Missouri	0.9	2.1	-1.7	4.7	2	2.2	1.7	3.0
North Carolina	1.8	2.1	-0.6	5.8	2	2.7	2.3	3.5
Texas	4.8	3.2	-1.7	5.7	2.7	5.7	3.4	4.7
Virginia	2.4	2.5	-1.3	5.4	2.5	2.4	2.3	3.4

Table 1. In recent years, Tennessee has been one of the fastest growing states economically in the fastest growing region in the country, second to only Florida. Source: Bureau of Economic Analysis—Real GDP by state.

But this growth shouldn't be viewed solely at a statewide level, with individual Tennesseans benefiting from this growing economy.

Real Per Capita Personal Income Percentage Change

	2018	2019	2020	2021	2022	Average Percentage Change
United States	2.4	2.7	5.4	4.6	-4.6	2.1
Tennessee	6.4	1.9	6.0	5.2	-5.2	2.9
Alabama	4.4	1.5	6.5	4.1	-4.3	2.4
Arkansas	3.5	-0.4	6.1	4.3	-1.8	2.3
Florida	3.7	4.3	3.5	6.1	-4.3	2.7
Georgia	2.4	3.1	4.9	3.4	-5.6	1.6
Kentucky	2.1	2.2	7.8	5.0	-5.6	2.3
Mississippi	2.7	2.1	8.7	4.4	-7.8	2.0
Missouri	2.0	1.4	7.0	3.5	-2.3	2.3
North Carolina	2.2	4.7	6.6	2.4	-4.3	2.3
Texas	3.3	1.5	2.1	5.8	-2.1	2.1
Virginia	0.4	4.4	3.3	3.0	-3.0	1.6

Table 2: The average Tennessean's income has grown faster than any average incomes of those in other Southeastern states or the national average. Source: Bureau of Economic Analysis—Real Personal Income

While the federal government has not released the most current year's data yet, and while we can see how real income fell in every state in 2022 due to high inflation, over the past several years, incomes in Tennessee have grown faster than the national average, all its bordering states, and the largest economies in the Southeast.

Are there any troubling signs in Tennessee's economy? Arguably the biggest concern is Tennessee's labor force participation rate, which measures the number of people in the labor force as a percentage of the total adult population; it remains lower than the nation as a whole. While the state's labor force participation rate has historically been lower than the national rate, even prior to the pandemic, that gap has grown over the past two years.

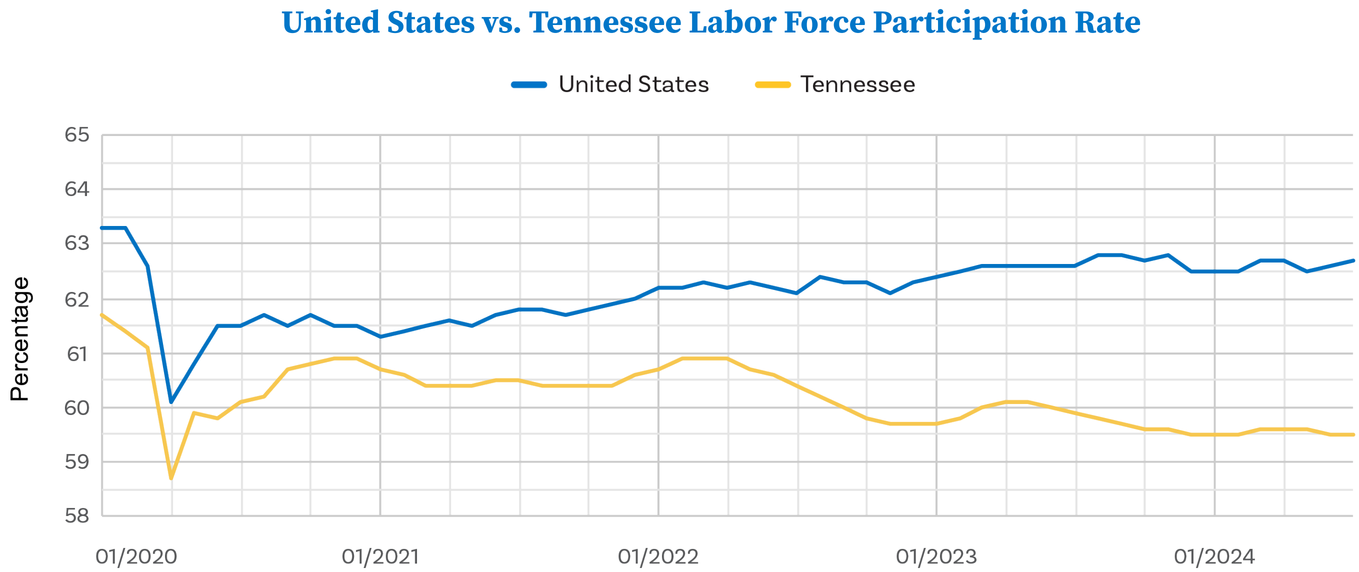

Figure 2: Tennessee's labor force participation rate has steadily fallen behind the national average. Source: U.S. Bureau of Labor Statistics

Some potential solutions for getting more Tennesseans back into the workforce could include reforming its occupational licensing laws. Despite recent reforms, Tennessee has comparatively more stringent occupational laws that make it harder to change professions and get a license after moving to the state.[13]

Additionally, for years after the start of the pandemic, Tennessee's revenue collections dramatically exceeded expectations. The fear of an economic slowdown during the pandemic never occurred, at least when it came to its impact on revenue. In fact, instead of a rainy day, 2020 through 2023 turned into more of a windfall for the state.[14] However, in recent months this years' long trend has reversed, with revenues coming in slightly below projections.

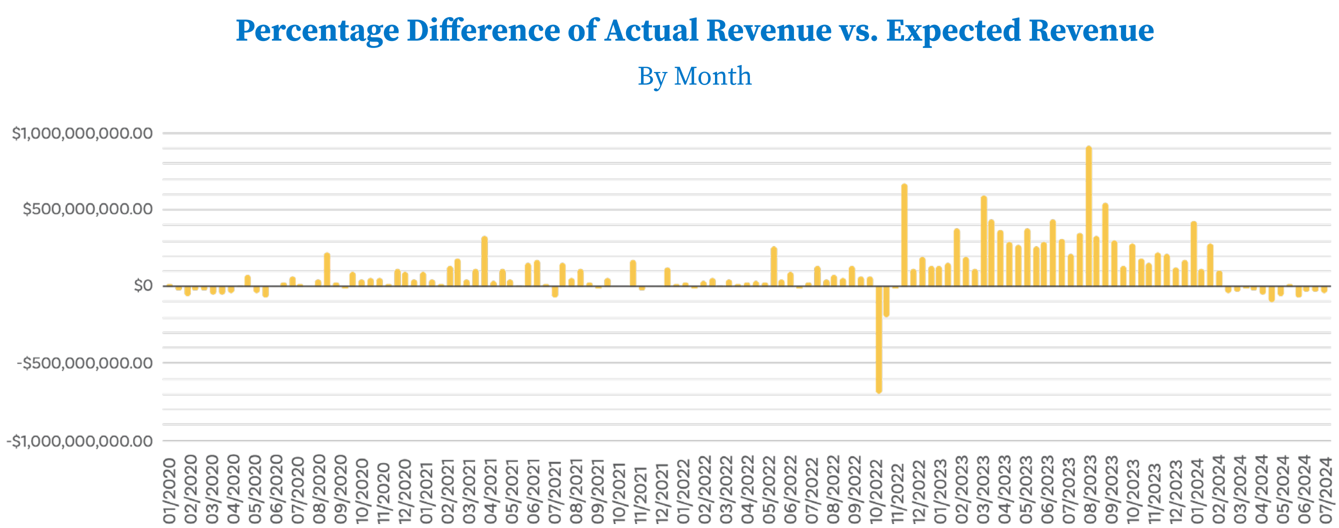

Figure 3: While state revenue historically has slightly exceeded projections, it exploded in the years after the pandemic. However, recent months comprise the longest stretch of underperforming revenue collections in years.

Money in the Bank: State Rainy Day Balances

Budget surpluses, tax revenues, and rainy day funds were at 20-year highs in most states for the three-year period from 2021 to 2023, thanks to a surprisingly resilient U.S. economy.[15] Tennessee is no exception, with a projected record-high rainy day fund balance of $1.8 billion at the end of 2023.[16] Figure 4 shows 2000 to 2023 rainy day fund balances, as well as the total reserves and balances as a percentage of general-fund expenditures for the state of Tennessee and the 50-state median values.

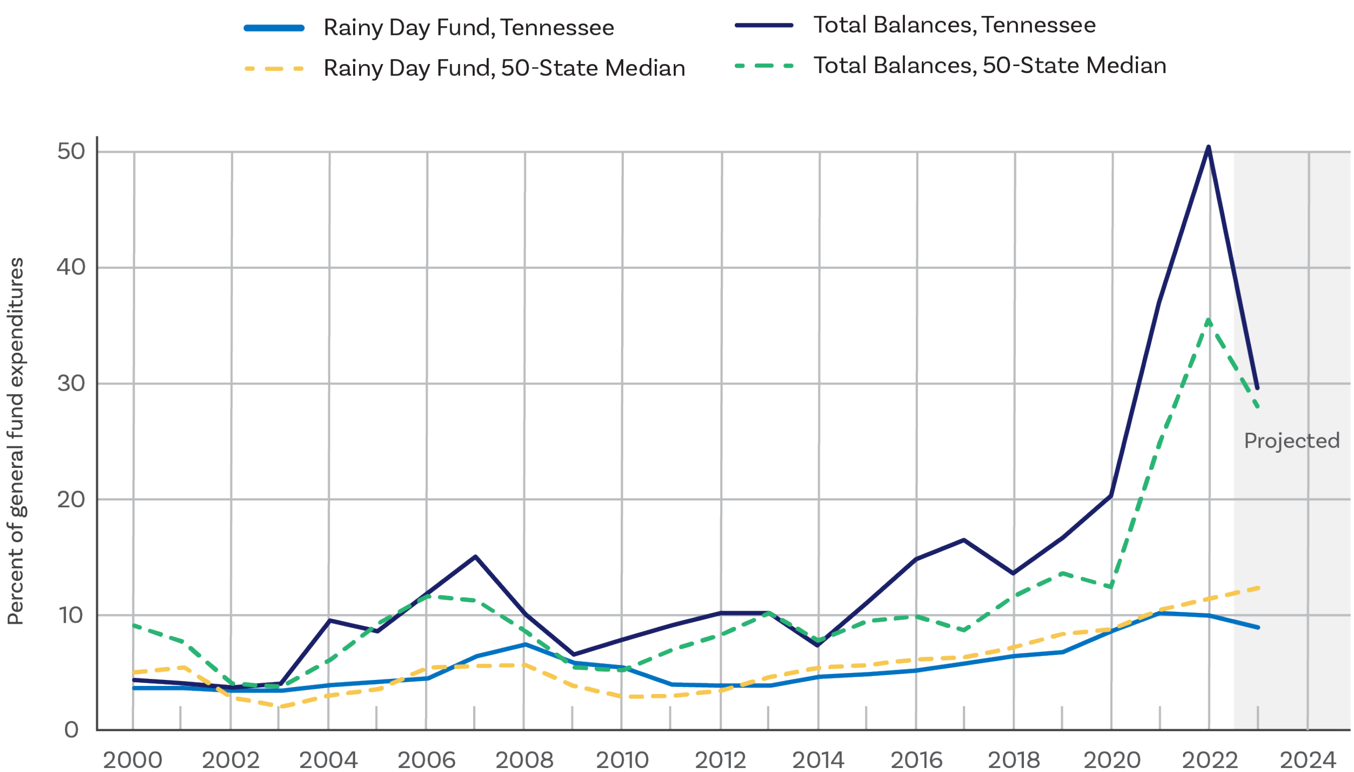

Figure 4. Rainy Day Fund and Total Reserves as Percentages of General-Fund Expenditures, Tennessee and the 50-State Median: 2000–2023

Figure 5 shows the estimated 2023 rainy day fund balances, along with total reserves and balances as percentages of general-fund expenditures for each state, ranked in descending order by total reserves and balances.

Ranked by total reserves and expenditures, Tennessee has the 19th highest balance as a percent of general fund expenditures among all 50 states. And despite the state's significant $1.8 billion in Rainy Day Fund balances, Tennessee ranks 38th in this category among US states.

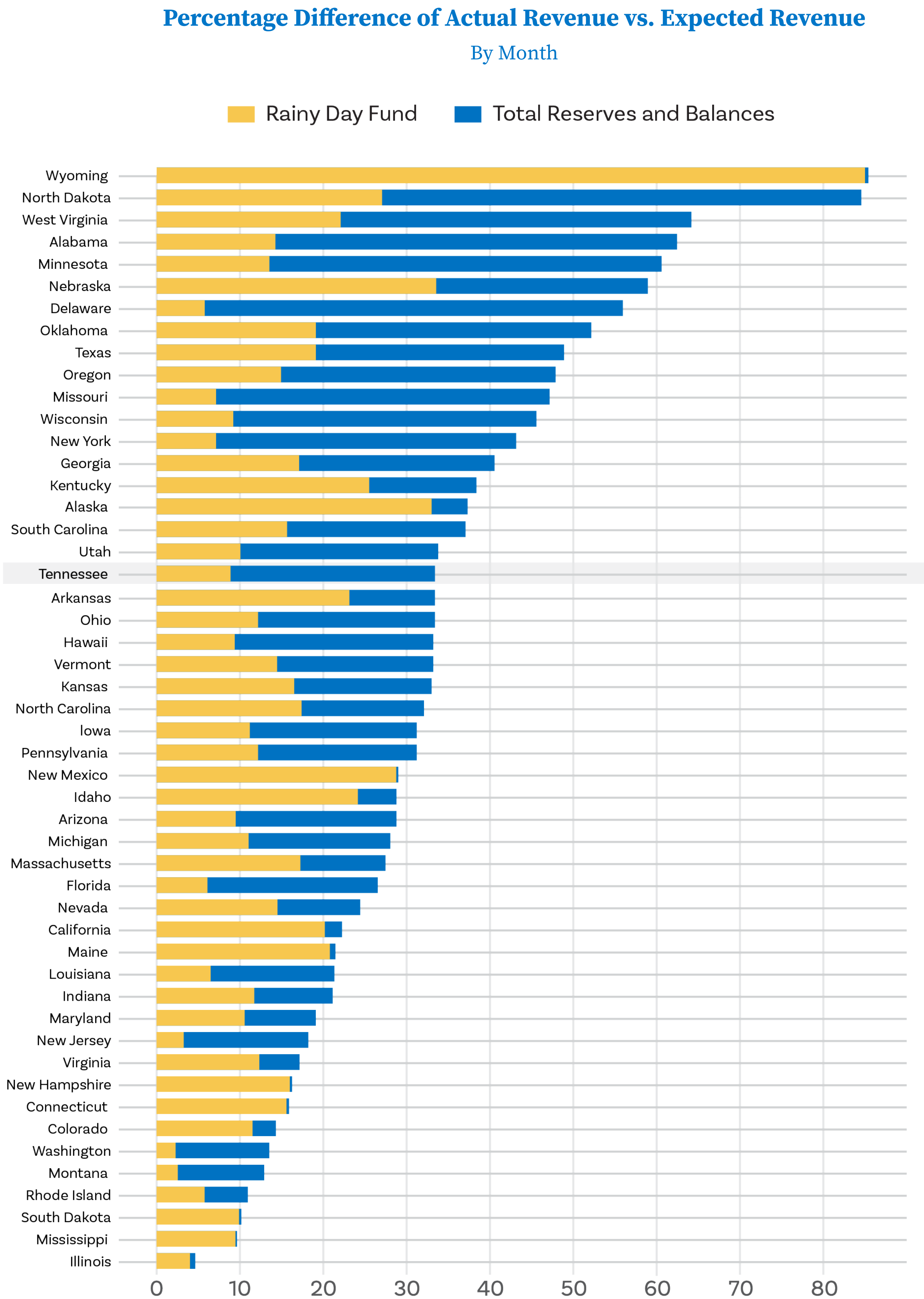

Figure 5. Estimated 2023 Rainy Day Fund Balances and Total Reserves and Balances as Percentages of General-Fund Expenditures

Tennessee Business Tax Landscape

Tempering the optimism from Tennessee's economy performing so well compared to surrounding and competing states are the continuing risks in 2024 of high interest rates, inflation, and potential economic slowdown. As state lawmakers return for the 2025 legislative session, they can consider policy reforms for the state's business tax climate that could continue to support the state's growth and stimulate the economy, while leaving some reserves available for a potential economic downturn in the future in light of recent revenues.

Tennessee imposes three main taxes on businesses and business assets: the excise tax, a corporate income tax; the franchise tax, a wealth tax on businesses; and the business tax, a gross receipts tax.

Excise Tax

The Tennessee excise tax is a tax on business net earnings or income akin to the federal corporate income tax. As shown in Table 3 below, the state excise tax in FY 2023 represented $3.4 billion in state revenue (15.3 percent of all revenue), making it the biggest source of state tax revenue after the sales tax.[17] The Tennessee excise tax rate is currently 6.5 percent, which is tied with Alabama for the highest state corporate tax rate among the eight states that border Tennessee.[18] This makes the state excise tax one of the least competitive components of the state tax code.

The 2023 Tennessee Works Tax Act allowed the calculation of business income for state excise tax to include bonus depreciation, in line with the federal bonus depreciation scale. In the area of state bonus depreciation, Tennessee could implement further reforms with little impact on revenue.[19]

Franchise Tax

The Tennessee franchise tax is a tax on the value of assets used in Tennessee. Essentially, it is a wealth tax on businesses. On this basis, businesses are subject to taxation even if they are not profitable. Until this year, Tennessee's franchise tax rate was 0.25 percent of the greater of net worth or real and tangible property in Tennessee. This "either/or" provision resulted in certain businesses paying more taxes and recently came under fire.[20] This year, lawmakers eliminated this provision, and now the tax is solely based on a company's net worth.[21]

Business Tax

Tennessee's business tax is a tax on qualifying gross receipts of businesses. As such, it imposes higher effective tax rates on low-margin businesses that have high revenues subject to the tax, but also high costs deductible from the tax. From the government's perspective, greater revenue than profits is one attractive feature of a business gross receipts tax. The base is large, and therefore low rates can generate significant revenue. Tennessee state business tax rates vary across industries and by retailer vs. wholesaler status. The state business tax rates range between 0.02 percent (two-hundredths of a percent) and 0.1 percent (one-tenth of a percent).[22] Despite this low rate, the tax generates hundreds of millions of dollars, as shown in Table 3. In addition to the rate's wide variation across industries and classifications, the Tennessee state business tax code includes a large number of deductions, exemptions, and credits, further magnifying the tax rates faced by businesses in the state.[23] To lower the compliance burden of the tax, Tennessee recently exempted the smallest of businesses from the tax, with any company generating less than $100,000 in sales exempt from it.[24]

The low Tennessee state business tax rates understate the true burden of the tax on the state's businesses because business-to-business transactions are not exempted. Therefore, the tax on a given intermediate good compounds as it is sold by one business and used to generate sales from another. This happens unless the supply chain is fully contained within the same business, which means that the Tennessee business tax incentivizes vertical integration. Vertical integration can have negative impacts on industry consolidation, leading to more monopolistic behavior.

We only study the effect of repealing the Tennessee business tax and do not look at the effect of repealing the other gross receipts taxes on utilities and on mixed-drinks businesses. These other gross receipts taxes have a higher tax rate than the business tax, and therefore would have a higher baseline marginal effective tax rate. This makes the broadest gross receipts tax policy reform difficult to compare to the other reforms we study here.

Tennessee Business Taxes: Dollars and Percentage of Total Tax Revenue

Tax Category	FY 2022 ($mil)	FY 2022 (% total state revenue)	FY 2023 ($mil)	FY 2023 (% total state revenue)
Excise tax	$3,016	14.4%	$3,381	15.3%
Franchise tax	$1,518	7.3%	$1,425	6.5%
Business tax	$264	1.3%	$333	1.5%

Table 3. While the state is heavily dependent on the sales tax on consumption, business taxes still comprise a major source of state revenue.[25]

A Model for Reform

We use an open-source model of business investment incentives to quantify and compare the effects of potential Tennessee business tax reforms on both the investment incentives faced by businesses in the state and on state revenues. This open-source structure provides all of our code and source data in a way that is easy to replicate and customize.[26] In this vein, we simulate the effect of changing four different areas of Tennessee's business tax laws using the Open Source Cost of Capital Calculator, both in terms of their impact on state revenue and business incentives for investment.[27]

The model calculates the marginal effective tax rate (METR) on new investments, given the policy and economic characteristics of the average business.[28] METR is therefore a more detailed and broad measure of business investment incentives. This includes the METR on machinery and equipment, buildings, and intangible assets, but we focus here on investment in machinery and equipment financed with retained earnings by a corporate business entity.[29] The METR is a forward-looking measure and takes into account tax rates as well as deductions, such as the depreciation of a capital asset. The METR therefore will vary according to not just tax rates but the availability of investment tax credits, the ability to deduct interest costs, and the rates of capital-cost recovery, among other features of a tax system.

Under current federal and Tennessee law, state and federal taxes combine for an effective marginal tax rate on new investments in machinery and equipment for Tennessee businesses of 13.5 percent, as shown in the "Current law" row in Table 4. Under current law in FY 2025, Tennessee businesses pay the federal corporate income tax, are allowed to deduct 40 percent of bonus depreciation from their taxable income, and pay the Tennessee business tax, excise tax, and franchise tax.

Our model shows decoupling the Tennessee bonus depreciation allowance from the federal bonus depreciation schedule and setting it to 100 percent in 2025 and thereafter results in the largest decrease in METR. This reform also results in reduced state revenues only in the current year, followed by increased revenues in the following years.

When comparing the remaining reforms that we study, we find that reducing the Tennessee franchise tax rate from 0.25 percent to 0.20 percent results in the next largest decrease in METR and only reduces revenue by a modest $285 million.

Effects of Tennessee Business Tax Reforms in 2025 on Business Incentives to Invest and on State Tax Revenue

Reform	Marginal effective tax rate (METR) faced by average businesses	Change in 2025 state tax revenue ($mil)
Current law	13.5%	$0.0
1. Set business capital bonus depreciation to 100 percent	11.8%	unknown
2. Reduce franchise tax rate from 0.25 to 0.20 percent	12.9%	-$285.1
3. Reduce excise tax rate from 6.5 to 6.0 percent	13.3%	-$260.1
4. Repeal business tax	13.3%	-$333.1

Table 4. The changes in 2025 state revenue in the second column of this table assume that the losses equal the amounts of revenue from those policies from FY 2023, shown in Table 3.

1. Decoupling the bonus depreciation from the federal schedule and setting it to 100 Percent

Federal bonus depreciation allows businesses to deduct a percentage of the value of an asset every year as a depreciation expense. The Tennessee Works Tax Act of 2023 allowed the federal bonus depreciation amount to be deducted from business income in the calculation for the excise tax liability. This provides an incentive for businesses to invest sooner because they can deduct some of the cost of assets from their tax liability. But if they deduct those depreciation expenses this year, they cannot deduct them in following years. For this reason, increases in bonus depreciation allowances reduce revenue in the current year, but increase revenue in future years.

The federal Tax Cuts and Jobs Act of 2017 set a schedule of federal bonus depreciation allowance percentages of 100 percent for the years 2018-2022, then 80 percent for 2023, 60 percent for 2024, and 40 percent for 2025. We suggest a reform that decouples the Tennessee bonus depreciation allowance from the federal schedule in 2025 and raises the Tennessee bonus depreciation allowance in 2025 from 40 percent to 100 percent.[30] Using the Cost of Capital Calculator model, we estimate that this change would reduce the METR on the average Tennessee business from 13.5 percent to 11.8 percent. We do not have an estimate for what this reform would cost in state revenue in 2025, but we know that increased state revenue in the years following 2025 would make up for most of those losses.

2. Reduce the franchise tax rate from 0.25 to 0.20 percent

The current Tennessee franchise tax rate is 0.25 percent (a quarter of a percent). In this reform, we estimate the effect of reducing the state franchise tax rate to 0.20 percent would result in a slightly larger reduction of the marginal effective tax rate (METR) on the average Tennessee business from the current 13.5 percent to 12.9 percent. Similar to the excise tax reform, we estimate that this franchise tax reform would result in a $285 million loss of state revenue.

3. Reduce the excise tax rate from 6.5 to 6.0 percent

The current Tennessee excise tax rate is 6.5 percent. In this reform, we estimate the effect of reducing the state excise tax rate to 6.0 percent would result in only modest reduction of the METR on the average Tennessee business from the current 13.5 percent to 13.3 percent, and we estimate that this reform would result in a $260 million loss of state revenue.

4. Repeal the business tax

While the Tennessee business tax would result in a $333 million loss of state revenue, which is larger than that of any of our other reforms, it represents only about 1.5 percent of total state revenue. It is not surprising that this reform results in the smallest reduction in marginal effective tax rates (METR) on the average Tennessee business—similar to that of a small reduction from cutting the excise tax.

Conclusion

Despite recent revenue falling short of expectations, Tennessee's economy is incredibly strong. With stronger GDP growth, stronger personal income growth, and lower unemployment than the majority of surrounding states and the country at large, Tennessee's state of the economy is poised to become stronger. However, there are reforms to the state's business tax climate that lawmakers could consider that would further incentivize faster economic growth and strengthen the state's positive trajectory.

We find that the first reform of decoupling the Tennessee bonus depreciation allowance in the state excise tax calculation from the federal bonus depreciation schedule and setting it to 100 percent provides the biggest reduction in marginal effective tax rates (METR) and biggest increase in Tennessee business investment incentives, only resulting in a temporary decrease in state revenue. The next most effective reform is reducing the state franchise tax rate from 0.25 percent to 0.20 percent, resulting in the next highest reduction in METR and costing a moderate $285 million in state tax revenue. Both of these reforms would incentivize economic investment and growth for modest reductions in revenue, while still protecting the state's reserves.

After taking those actions, lawmakers can further make Tennessee better for businesses by reducing the state's excise tax rate from 6.5 to 6.0 percent, in addition to repealing the business tax. These reforms will make Tennessee more competitive and remove some complexity of varying tax burdens.

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The code for replicating the analyses and creating the images can be run locally on your machine using the Jupyter notebook TN_BusTax2024.ipynb or can be run from your browser using resources in the cloud from this Google Colab notebook. https://colab.research.google.com/drive/1dDKVTEAm4drvNXgHpm617j-82X4xzxKh?usp=sharing

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28. Larry Ozanne and Paul Burnham, "Computing Effective Tax Rates on Capital Income." Congressional Budget Office. December 2006. https://www.cbo.gov/system/files/2022-02/12-18-taxrates.pdf.

29. More specifically, we assume a piece of equipment with a seven-year depreciable life and a rate of physical depreciation of 10.3 percent per year, similar to special industrial machinery (BEA Code EI40).

30. It is worth noting that multiple bills have been introduced in Congress in the last year-and-a-half to extend the tax cuts of the Tax Cuts and Jobs Act. These bills propose to increase the federal bonus depreciation allowance permanently to 100 percent. If this were the case, the Tennessee bonus depreciation allowance would increase to 100 percent automatically, and no reform would be needed.

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The Beacon Center empowers Tennesseans to reclaim and protect their freedoms, so that they can pursue their version of the American Dream. The Center is an independent, nonprofit, and nonpartisan research organization dedicated to providing expert empirical research and timely free market solutions to public policy issues in Tennessee.

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