ITEP Institute on Taxation and Economic Policy
1311 L Street, N.W. • Washington, D.C. 20005 • (202) 626-3780

The Distributional Impact of SB 1374's Personal Income Tax Changes

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The Missouri personal income tax currently applies a graduated rate structure with tax rates ranging from 1.5 percent to 6 percent of taxable income. This rate structure is applied to a tax base that starts with federal adjusted gross income, but allows a variety of special deductions and exemptions that allow some Missourians to reduce their taxable income. One current proposal for simplifying the Missouri income tax, Senate Bill 1374, would conform more closely to federal adjusted gross income by eliminating almost all exemptions and deductions, and would apply a flat rate of 4.5 percent to all Missouri taxable income. This analysis estimates the distributional impact of this proposal.

Senate Bill 1374 would eliminate several Missouri tax exemptions, including:

- The state's deduction for federal income taxes paid, which is currently capped at $5,000 per taxpayer.
- The state exclusion for pension benefits.
- All itemized deductions.

The bill would also replace the standard deduction and personal exemption with a deduction of $10,000 for single taxpayers, $15,000 for heads of household and $20,000 for married couples. The following chart shows the distributional impact of SB 1374. The analysis shows that:

- The largest benefits from this proposal would accrue to the wealthiest Missourians, both in absolute dollar amounts and as a share of income. The wealthiest 1 percent of Missourians—those earning over $283,000 in 2004—would realize an average state tax cut of more than $6,000 from this proposal.

Impact of SB 1374 "Flat Tax" on Missouri Personal Income Tax Burdens By Income Level

All Missouri Taxpayers, 2004

2004 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $15,000	$15,000 – $26,000	$26,000 – $44,000	$44,000 – $68,000	$68,000 – $124,000	$124,000 – $283,000	$283,000 – Or More
Average Income in Group	$9,400	$20,500	$34,300	$54,700	$88,200	$170,300	$749,400
Tax Change as a % of Income	+0.0%	–0.0%	+0.1%	–0.0%	+0.0%	–0.2%	–0.8%
$ Average Tax Change	$ 0	$ –2	$ 25	$ –23	$ 14	$ –259	$ –6,088
% of Total Tax Cut	0%	1%	-7%	7%	-3%	15%	88%

SOURCE: *Institute on Taxation and Economic Policy Microsimulation Tax Model, March 2004*

- The wealthiest 1 percent would collectively realize 88 percent of the benefits from this proposal.
- Most other Missourians would be virtually unaffected by this proposal. On average, each of the four poorest income quintiles (that is, the poorest eighty percent of Missourians) would see their state income tax burdens change by less than $25.

This proposal would also have a substantial impact on the *federal* income taxes paid by Missourians. This is because Missouri taxpayers who itemize their federal income tax returns are allowed to write off their state income taxes. Any cut in state income taxes that affects itemizers will therefore reduce the amount of itemized deductions Missourians can claim on their federal return—and will increase the overall federal tax burden on Missourians. ITEP estimates that this "federal offset" effect would increase federal taxes paid by Missourians by about $31 million if this proposal had been implemented in 2004—meaning that roughly 18 percent of the $176 million in state income tax cuts under this proposal would never be realized by Missourians, but would be collected directly by the federal government in the form of higher federal income taxes for Missouri itemizers. This effect is especially pronounced for wealthier Missourians who are more likely to itemize their federal income taxes and who pay at higher marginal tax rates. For the wealthiest 1 percent of Missouri taxpayers, more than 28 percent of the Missouri tax cuts from this proposal would be offset by federal income tax hikes.

Some provisions of SB 1374's income tax changes would help to simplify the state's income tax structure substantially. For example, conforming the state's income tax base more closely to federal adjusted gross income would reduce the number of special exemptions available to Missouri taxpayers—and would simplify the process of calculating and collecting Missouri taxes. However, SB 1374's move from a graduated rate structure to a flat tax rate should not be mistaken for a tax simplification measure. Under either a graduated rate structure or a flat tax, Missourians will likely use a tax table to look up their income tax liability. From an administrative perspective, the real value of SB 1374 for income tax simplification is its elimination of costly and complicated targeted tax deductions such as the deduction for federal income tax payments.

About ITEP: *ITEP is one of the leading research and education organizations in the country working on government taxation and spending policy. Since its founding in 1980, ITEP's work has played a key role in educating the public and informing federal and state tax policy. ITEP's website is http://www.itepnet.org*

The analysis presented here was conducted using the ITEP microsimulation tax model. Since 1996 ITEP has used this model to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data that is extrapolated to the year being analyzed. This is the type of tax model used by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, the Congressional Budget Office, and many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. Included in the sample are federal tax returns, with statistically valid samples from every state and the District of Columbia. A sampling of records from the U.S. Decennial Census five percent sample (which contains a random sample of five percent of all census forms received by the Census Bureau) are also included, and statistically matched with the tax return records. Other data sets are used to impute detailed expenditures for each record and other information. The data on the records is extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and government and other widely respected macro data sources.(A complete description and methodology for the ITEP model is available on request.)