Testimony of Kelly Davis
Institute on Taxation and Economic Policy
Regarding House Bill 567
February 18, 2009

Thank you Chairman Smith and members of the Committee for the opportunity to appear today. My name is Kelly Davis. I am the Midwest Director for the Institute on Taxation and Economic Policy (ITEP). ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony today focuses on one bill introduced in the Missouri House of Representatives: HB 567, which concerns reforming the state's individual income tax structure. In particular, my testimony will discuss the impact of this bill on the overall fairness of Missouri's tax system. This bill would make the overall tax structure more equitable and fair for Missouri's most needy citizens.

Features of HB 567

Broadens Brackets, Adds New Top Rates
Introduces $150 per person refundable credit
Eliminates the deduction for fed. income taxes paid

The Problem: Missouri's Regressive Tax Structure

In January 2003 ITEP released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.[1] This study found that the current Missouri state and local tax structure is regressive, requiring lower- and middle- income taxpayers to pay a larger share of their income in state and local taxes than the wealthiest taxpayers. In particular, the study found that: the effective state and local tax rate on the wealthiest one percent of Missouri families was just 5.3 percent of income after the federal offset is taken into account, substantially less than the 9.9 percent tax burden on Missourians in the middle of the income distribution and the 9.3 percent effective tax rate on the very poorest 20 percent of Missouri residents.

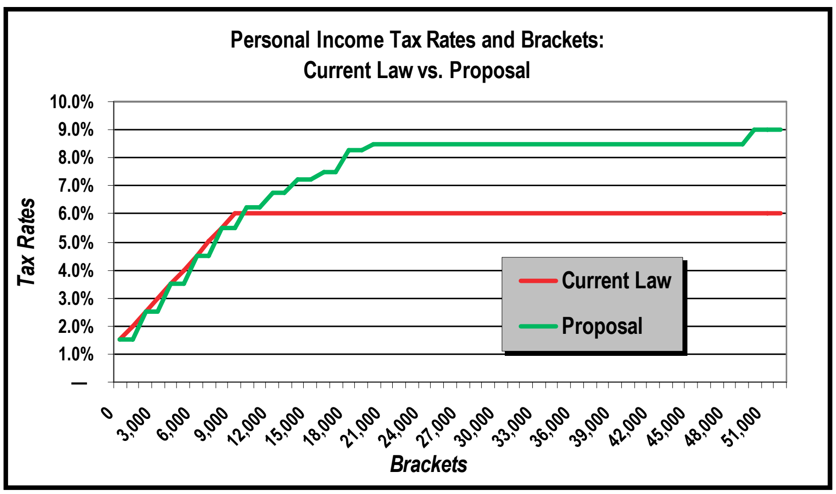
The study also found that the regressivity of the Missouri tax structure was

[1] Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition,* January 2003.

partially due to the state's relatively flat income tax rate structure. In fact, nearly 60 percent of Missourians pay at the highest income tax rate of 6 percent on taxable income over $9,000. Because of this essentially flat-rate structure, Missouri's income tax does little to offset the inherent regressivity of the state's sales, excise, and property taxes. So while Missouri does not have a tax system that relies exceptionally heavy on sales and excise taxes, these taxes are the most unfair taxes. Sales and excise taxes take 7.1 percent of income from the poorest Missourians but just 1.1 percent of income from the wealthiest - effectively imposing a tax rate seven times higher on the poorest Missouri taxpayers than on the rich. HB 567 focuses on expanding the rates and brackets of the individual income tax, introducing a refundable credit, and eliminating the deduction for federal income taxes paid.

HB 567: Individual Income Tax Reform

This proposal reforms the current individual income tax and introduces more progressive and graduated rates and brackets. These wider tax brackets range from 1.5 percent to 9 percent and ensure that low- and middle- income taxpayers pay at lower tax rates, compared to the very wealthiest Missourians. On average, eleven percent of all Missouri families will pay at the top income tax rate of 9 percent for taxable income above $50,000 compared to the 57% of Missourians who paid at the top rate in 2007. The green line in the chart above shows the tax rates and brackets proposed compared to the red line, current law.



This bill would also eliminate the deduction for federal taxes paid. Missouri is one of only seven states that allows a deduction for federal income taxes paid. Current law allows Missourians to subtract up to $5,000 of federal income tax liability ($10,000 for married filers). This is a costly and poorly targeted deduction that offers no benefit to the many low and middle income Missourians who don't owe federal income taxes. This proposal eliminates the deduction completely. The deduction is most beneficial for wealthier taxpayers who have a higher "ability to pay."

Finally, HB 567 introduces a new refundable low-income credit that provides targeted tax relief for those Missourians who are most in need. The proposal provides a tax credit of $150 per family member. (In other words, an eligible single taxpayer would receive a $150 tax credit, while an eligible family of four would receive $600.) The credit is phased out over a straight line for single higher-income taxpayers between $30,000 and $50,000 of Federal Adjusted Gross Income. For married couples the phase out of the credit begins at $60,000 and the credit is fully phased out at $80,000. Perhaps most important for low income Missourians, the credit is refundable which means that low income Missourians can use the credit to offset the other, regressive taxes they pay.

Revenue Impact of HB 567

This bill increases state revenues by about $1.3 billion. Federal taxes for itemizers are reduced by $264 million (through the federal offset) for a net tax increase on the wealthiest Missourians of $1.046 billion. The federal offset is an important component of this legislation.

HB567 Revenue Impact (Millions) Tax Year 2007	
State Tax Increase:	$1,310
Federal Tax Cut	-$264
Overall Tax Change	$1,046

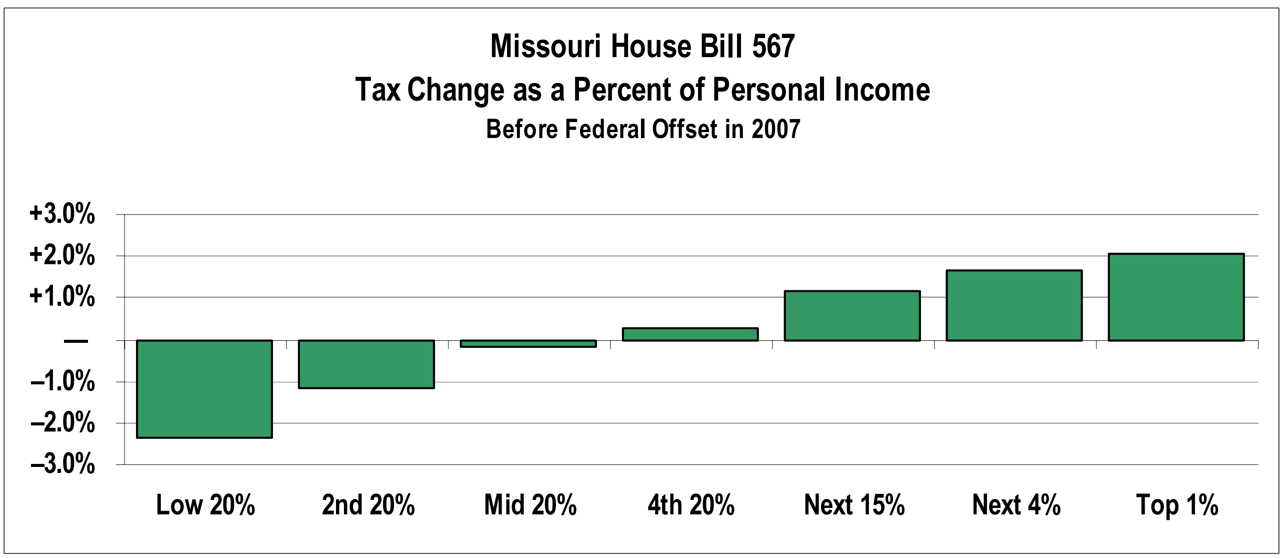
Federal income tax rules allow taxpayers to claim itemized deductions for certain expenditures that affect their ability to pay taxes. For example, you can use these deductions to offset part of the cost of charitable contributions, mortgage interest payments for homeowners, and state and local income and property tax payments. These deductions make it less costly to pay state or local taxes. The ability to deduct or "write off" these taxes on your federal tax forms means that if you itemize your federal taxes, some of your state taxes are being directly offset by federal tax cuts.

The practical impact of being able to write off these state and local taxes is that if you itemize your federal income taxes, your state income tax and property tax bills are never really as big as they appear. Some portion of the state taxes you pay initially will be directly offset by federal income tax cuts when you file your federal tax forms.

This bill does a very good job of taking advantage of the federal offset. The tax increase imposed by this individual income tax reform is targeted to the wealthiest 40 percent of the income distribution. These wealthy Missourians are also more likely to itemize and pay tax at higher federal rates, which means they can write off a larger percentage of their state tax hike. In fact, 20 percent of the added state revenue from this tax hike would be paid for not by Missourians, but by the federal government.

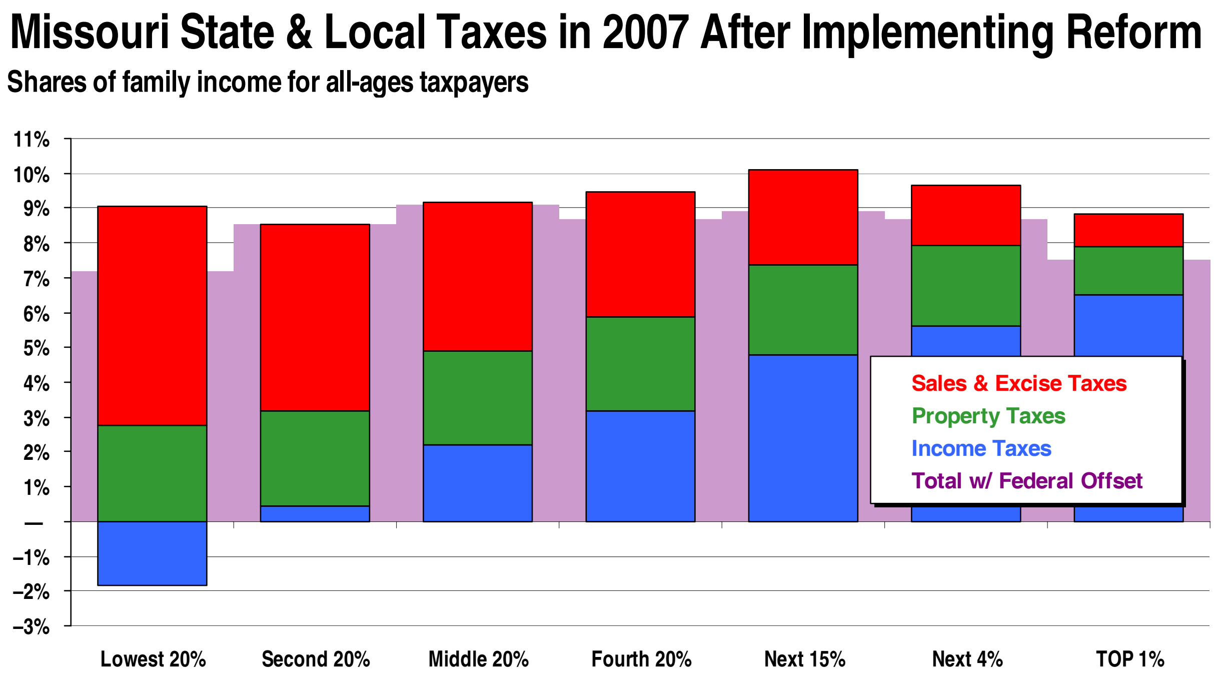
HB 567's Impact on Missourians of Different Income Levels

The following graph illustrates the percent of tax change by income level under House Bill 567.



The proposal would result in an average tax cut for the poorest 60 percent of the income distribution. The poorest 20 percent of Missourians, those with an average income of $9,000 would experience an average tax cut equal to 2.4 percent of their income which equates to an average tax cut of $224. While the middle twenty percent would see an average tax cut of 0.1 percent of their income, an average tax cut equal to $55. The wealthiest 1 percent of taxpayers would experience an average tax hike of 2.1 percent of their income - this tax hike however would be partially offset by federal tax cuts.

HB 567's Impact on Overall Regressivity



The chart above shows the impact to Missouri state and local taxes overall considering the introduction of HB 567. Note the tax structure created when HB 567 is taken into account is closer to a proportional tax system than the regressive tax structure described earlier in my comments. In large part because of the federal offset and the very nature of regressive sales and excise taxes the wealthiest 1 percent of Missourians are still paying the smallest percentage of their income in state and local taxes.

Conclusion

Though this bill would make the Missouri tax system less regressive, it is important to note that the Missouri tax system would remain somewhat regressive overall after implementing this bill. This is because the bill does nothing to reduce Missouri's reliance on regressive sales and property taxes. However, this bill can be considered a step in the right direction for tax adequacy and equity. Thank you for the opportunity to testify.

Appendix: About ITEP and the ITEP Tax Model

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by 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. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with 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); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2003, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study was released jointly with Citizens for Tax Justice. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations.