INSTITUTE ON TAXATION AND ECONOMIC POLICY

Written Testimony Submitted to the Missouri of House of Representatives
Tax Reform Committee
Regarding House Bill 581
March 16, 2011

Thank you for the opportunity to submit this written testimony. My name is Kelly Davis. I represent the Institute on Taxation and Economic Policy (ITEP), a Washington-DC-based nonprofit research group. ITEP's research focuses on federal and state tax policy issues, especially as they affect lower- and middle-income taxpayers.

My testimony focuses on House Bill 581, which would create a Missouri Earned Income Tax Credit (EITC). In particular, my testimony will discuss the impact of this bill on the overall fairness of Missouri's tax system.

The Problem: Missouri Taxes Are Regressive

In November of 2009, ITEP released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. The study found that Missouri's tax system is regressive. This means that when we measured the impact of all the Missouri state and local income, property, sales and excise paid by Missourians at different income levels, we found that low- and middle-income taxpayers paid substantially more of their income in tax, on average, than the wealthiest taxpayers. In particular, the study found that:

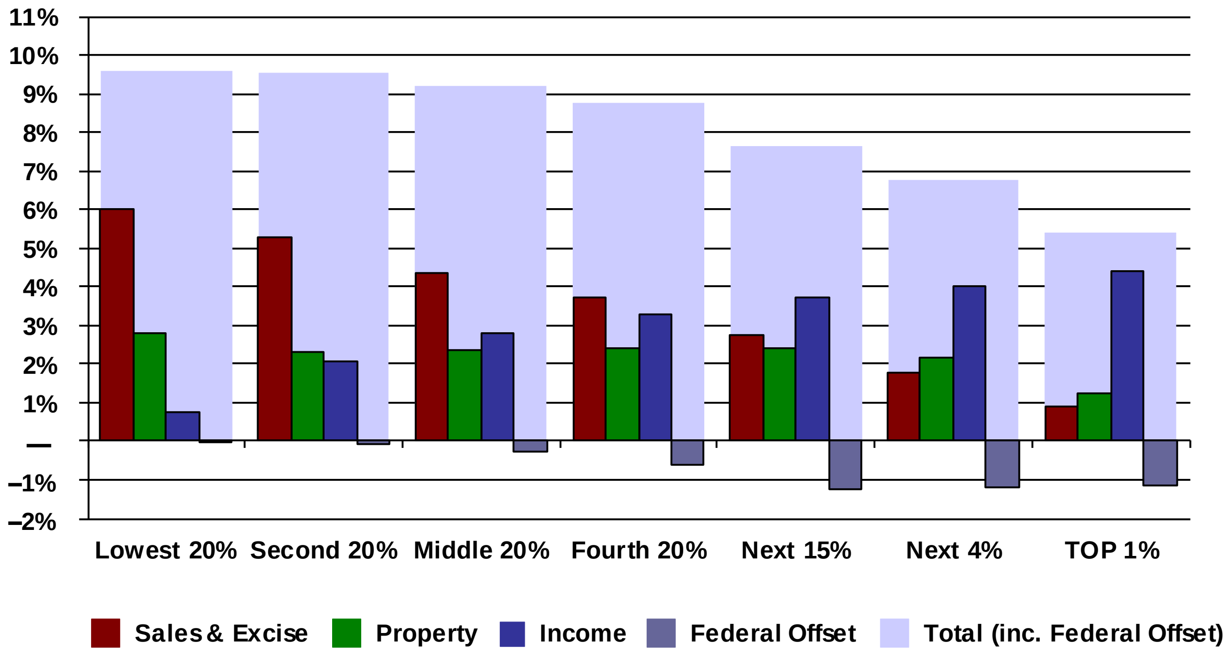
- The poorest twenty percent of Missourians paid an average of 9.6 percent of their income in Missouri state and local taxes;
- Missourians in the middle 20 percent of the income distribution paid an average of 9.2 percent of their income in Missouri taxes, after accounting for their ability to deduct their state income and property taxes on their federal tax forms;
- The wealthiest 1 percent of Missourians paid just 5.4 percent of their income in Missouri taxes after accounting for the federal-state tax interaction.

The study found that the unfairness of Missouri's tax system was due to two main features of the state and local tax structure. First, Missouri relies on regressive sales, excise and property taxes which tend to fall most heavily on low-income taxpayers. Second, the one progressive tax that can be used to offset the unfairness of these other taxes (the personal income tax) is less progressive in Missouri than in most other states.

Missouri

State & Local Taxes in 2007

Shares of family income for non-elderly taxpayers



The Federal Earned Income Tax Credit: A Tool for Tax Fairness

One relatively inexpensive option for reducing the unfairness of state tax systems is a targeted low-income tax credit such as the Earned Income Tax Credit (EITC). Twenty-three states and the District of Columbia already offer an EITC.

The federal EITC essentially provides a "matching grant" for the earnings of low-income taxpayers. For each dollar of earned income up to $12,590 (in 2010), single parents with two children (for example) get an extra 40 cents from the federal EITC. Since only the first $12,590 counts toward the credit, the maximum federal credit for these taxpayers is $5,036. Single parents earning over $12,590 get no additional credit.

Because the credit is designed to provide tax relief to the working poor, there are income limits that restrict eligibility for the credit. The credit amount starts to fall for single parents when income exceeds $16,450, and is completely eliminated for single parents earning over $40,363.

The federal credit is **refundable:** if the credit exceeds a taxpayer's income tax bill, the excess amount is paid as a tax refund. The credit was designed this way because policy makers recognized that the income tax is not the only federal tax paid by low- and middle-income workers. For example, these taxpayers usually pay much more in payroll taxes than in income taxes. By making the EITC refundable, Congress ensured that it could be used to help offset all federal taxes paid, not just the income tax. Refundablity is even more important at the state level because the credit can help to offset sales and excise taxes which represent a much larger share of income for low and middle class taxpayers.

The federal EITC is an effective anti-poverty strategy, lifting millions of people each year above the federal poverty line. It is also recognized by lawmakers of all political affiliations as an important way of rewarding work; legislation expanding the federal EITC has been approved by each of the last five Presidents, beginning with President Reagan and including President Obama.

A Solution: The Case for a Missouri EITC

Missouri currently doesn't offer an EITC. Yet, the case for an EITC is even stronger at the state level than at the federal level. Unlike federal taxes, state and local taxes are regressive, as previously noted, largely due to the impact of sales and property taxes on low income families. A refundable EITC is the most effective targeted tax relief strategy currently used by states to reduce the unfairness of these taxes.

A refundable EITC is the most effective targeted tax relief strategy currently used by states to reduce the unfairness of sales and property taxes.

Who Would Benefit From Introducing an EITC?

House Bill 581 would introduce a refundable 20 percent EITC. This new credit would provide a tax cut for families who currently receive the federal EITC.

- Missourians in the poorest 20 percent of the income distribution who qualify for the EITC would see a tax cut averaging $331.
- Missourians in the second 20 percent of the income distribution who qualify for the EITC would see a tax cut averaging $617.

This bill would make Missouri's tax system less unfair. The proposal would reduce Missouri revenues by approximately $200 million in 2010. Eighty percent of the benefits would go to the poorest forty percent of Missourians —exactly the income groups who pay the largest share of their income in Missouri taxes under current law.

But the bill, on its own, would not eliminate the fundamental unfairness of Missouri's tax system. HB 581 would make Missouri's tax system somewhat less regressive overall—but low-income Missourians would still pay substantially more of their income in tax than would higher-earning income groups. Creating a Missouri EITC would be an important first step towards a fairer tax system, additional reforms of income, sales and property taxes would need to be enacted for Missouri to achieve even the most basic overall tax fairness goals.

Conclusion

A refundable Earned Income Tax Credit is among the best-targeted options available for lawmakers seeking to make state taxes less unfair. HB 581 represents an important step toward greater tax fairness in Missouri.

Again, thank you for the opportunity to submit this testimony.

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 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. *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.