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TESTIMONY OF KELLY DAVIS
BEFORE THE MISSOURI SENATE WAYS AND MEANS COMMITTEE
REGARDING HOUSE JOINT RESOLUTION 36
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Thank you, Chairman Vogel and members of the Committee for the opportunity to appear today. My name is Kelly Davis. I am the Midwest Regional 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 House Joint Resolution 36, which would eliminate the state's individual and corporate income taxes and attempts to replace the lost revenue with sales tax revenue generated through an increased rate and broader base. The bill would also introduce a sales tax rebate to offset some of the sale tax increase on Missourians.

Our analysis demonstrates that this bill would raise taxes on middle class workers and their families, would require a tax rate of 12.5 percent to achieve the outcomes specified in the bill, and would not make Missouri's tax structure immune to economic downturns. In the time I have remaining, I'd like to explain each of these findings in more detail.

THE NEW SALES TAX RATE

The legislative language of HJR 36 specifies that expanding the sales tax base to include all personal consumption (while excluding all business consumption) and increasing the basic state sales tax rate would be sufficient to pay for repealing personal and corporate income taxes and offering a "sales tax rebate" for every Missouri family. The legislative language on HJR 36 does not say what the combined sales tax rate in Missouri would have to be to make the bill revenue neutral overall, but does specify that the basic sales tax rate would be increased from 3 to 5.11 percent. The bill also specifies that, due to the expanded sales tax base, the additional current state sales tax rate of 1.225 percent, as well as local sales taxes currently averaging 2.8 percent, should be reduced in such a way that collections from these taxes would be unchanged.

The official fiscal note for HJR 36 notes that a 5.11 percent basic state tax rate would not be sufficient to make the bill revenue-neutral overall, and predicts an annual revenue loss of between \$2.2 and \$6.6 billion from changing the rate to 5.11 percent.

HJR 36 would need to produce at least \$12.5 billion annually. Repealing the individual and corporate income taxes alone would cost the state nearly \$5.5 billion. The expanded sales tax would also need

to raise \$4.8 billion of new revenue to pay for a “sales tax rebate” for all Missourians, in addition to the \$2.2 billion the 3 percent tax current raises.

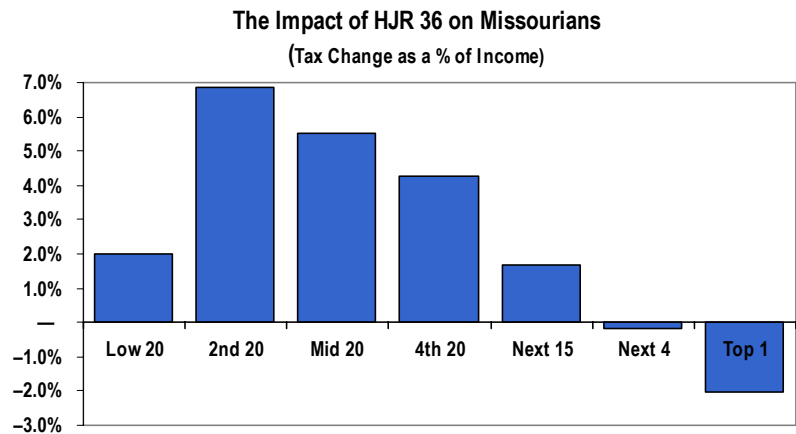
At present, Missouri’s total average state and local sales tax rate is 7.1 percent. ITEP estimates that making HJR 36 a revenue neutral tax change would require a new state and local average sales tax rate of 12.5 percent. This includes an increase in the basic sales tax rate of 3 percent to 9.9 percent (almost twice as high as the 5.11 percent rate prescribed by the bill). The additional 1.225 percent sales tax would be lowered to 0.8 percent, while Missouri’s average local sales tax would decline from 2.5 percent to 1.8 percent.

Missouri Sales Tax Rates: Current Law and HJR 36			
	Current Rate	Under HJR 36	Change
Basic State Sales Tax	3.0%	9.9%	+6.9%
Additional State Sales Tax	1.225%	0.8%	-0.4%
Avg. Local Sales Tax	2.8%	1.8%	-1.0%
Combined	7.1%	12.5%	+5.4%

The “sales tax rebate” offers families living below the federal poverty level a full exemption for items subject to the sales tax. Yet, many families in poverty actually spend more than they actually earn in income and taxes paid on those purchases won’t be subject to the sales tax rebate. According to HJR 36 the sales tax rate is multiplied by the federal poverty level for any family and the result is the rebate amount. For example, in 2007 the poverty level for a family of four was \$20,640. Multiplying that amount by the 12.5 percent sales tax rate results in a rebate amount of: \$2,580. ITEP estimates the total cost for the rebate in 2007 is \$4.7 billion, which is between the \$3.1 and \$7.5 billion estimate presented in the official fiscal note. The cost of the rebate will likely grow each year since poverty levels are indexed annually. Under HJR 36, the state would annually dole out almost as much in tax rebates as the state currently collects in personal income taxes.

IMPACT ON MISSOURIANS

HJR 36 increases taxes on the poorest 95 percent of the income distribution and in particular middle-income families. The middle twenty percent of the income distribution, those with an average income of \$37,000 experience an average tax hike of \$2,036, the equivalent of 5.5 percent of their income. Because the sales tax



rebate is based on federal poverty levels (\$10,210 for singles and \$13,690 for married couples in 2007), the credit doesn’t do enough to help middle income Missourians who are also impacted by regressive tax changes proposed in HJR 36. The poorest twenty percent of Missourians, those with an average income of \$9,000, would experience an average tax hike equal to 2.0 percent of their income or \$190.

The wealthiest Missourians, anyone in the top 5 percent of the income distribution, will a tax cut on average, under this plan. Upper income Missourians would benefit the most from HJR 36. For example, the top 1% of Missourians are the biggest “winners” from this legislation. Those with an average income of over \$1 million would experience an average tax cut of \$22,864.

COMPLICATIONS OF HJR 36: SALES TAX DEPENDENCY AND TAX AVOIDANCE

Nutritionists always recommend a balanced diet filled with a variety of fruits, vegetables, and proteins. State governments function best on a similar principle of balanced revenue sources. It’s ideal for states to have a mix of sales, property and income taxes.

Now is an especially poor time to put all of Missouri’s revenue eggs in the sales tax basket. Earlier this month the Rockefeller Institute released a study which found that state sales tax collections experienced their worst decline in 50 years during the fourth quarter of 2008.¹ In fact, the Institute found that sales tax collections declined in forty-two of the fifty states. They estimate that sales taxes were down 6.1 percent and expect sharp declines to continue into 2009. When economic times are uncertain, people spend less and this leads to less revenue for states. This is especially grim news for states that rely heavily on sales taxes to generate large portions of their total revenue collections.

There is also little evidence that states without an income tax weather the economic storms better. The chart to the right shows the nine states without broad based income taxes and their projected budget gaps for fiscal year 2010. Tennessee’s budget shortfall is approximately 9 percent of the state’s general fund budget, or \$856 million. Washington State has no tax on income and has one of the largest projected budget shortfalls in the country – over \$3 billion or 18.5 percent of their general fund budget. While it’s certainly true that states with an income tax are also experiencing difficult times, there is ample evidence to show that simply not having an income tax does not make a state immune from tough economic times. In fact, eliminating an entire revenue stream would only make Missouri more susceptible to economic uncertainty.

Estimate of FY10 Budget Gaps in States Without a Broad Based Income Tax

	Shortfall (Millions)	% of General Fund Budget
Alaska	N/A	N/A
Florida	\$2,500	11.2%
Nevada	\$1,067	37.6%
New Hampshire	N/A	N/A
South Dakota	\$82	6.7%
Tennessee	\$856	9.0%
Texas	\$2,100	5.1%
Washington	\$3,177	18.5%
Wyoming	N/A	N/A

Source: NCSL, Update on State Budget Gaps: FY 2009 & FY 2010, 2/20/09

In a number of these states the situation would be even worse if they didn’t have special and unique revenue streams that aren’t available in Missouri. For example, Alaska and Wyoming have an abundance of natural resources that are taxed which bring in significant revenue. Similarly, Texas relies heavily on revenue generated from oil. Nevada relies quite heavily on tourist and gambling

¹ Boyd, Donald J. and Dadayan, Lucy, *Sales Tax Decline in Late 2008 Was the Worst in 50 Years, Early Data for 2009 Show Further, Sharp Drop in Tax Revenues for Most States*, Nelson A. Rockefeller Institute of Government, Albany, NY, April 2009. ITEP

revenue. Florida also relies on revenue generated from the tourist industry. Missouri simply doesn't have the natural resources or industries that are associated with many of the states without broad-based income taxes.

Eliminating the state income tax would also put Missouri at odds with the national trend toward taxing income. For example, states like Tennessee and New Hampshire are debating taxing income more broadly to generate needed revenue.

Claims of people or businesses radically changing their behavior due to a state's tax structure are often exaggerated. Nonetheless, given that such a large share of Missouri's population lives near states with sales tax rates much lower than what would result under HJR 36, it is not unreasonable to expect that a number of Missourians would consider shopping in bordering states in order to avoid the tax. This would harm both the state's economy, and its revenues. According to the State Sales Tax Clearinghouse Missouri's current state and local sales tax rate is 7.1 percent. As the chart to the right shows there are some states neighboring Missouri with higher average tax rates like Oklahoma and Tennessee and others like Iowa and Kentucky who have average sales tax rates that are slightly less. An average 12.5 percent sales tax rate would certainly be the highest sales tax levied in the region.

Average State & Local Sales Tax Rates for Nearby States

Arkansas	8.20%
Illinois	8.40%
Iowa	6.80%
Kansas	6.95%
Kentucky	6.00%
Missouri	7.10%
Nebraska	6.00%
Oklahoma	8.10%
Tennessee	9.40%
Missouri under HJR 36	12.50%

Source: State Sales Tax Clearinghouse
www.thestc.com/STRates.stm; 4/28/09

Expanding the sales tax base is usually good public policy. As state economies shift from goods to service based it's necessary that state revenue collections reflect these trends. Yet, expanding the sales tax base to this extreme without adequate low income tax relief is guaranteed to create hardship for young Missourians who may just be entering the workforce and purchasing their first cars or paying rent. Missouri seniors and others living on fixed incomes will certainly be disadvantaged when doctor's visits and prescription drugs are taxed.

Lastly, if retail sales taxes are always tax-exempt when businesses make purchases, and always taxable at 12.5 percent when individuals make purchases, then consumers will have a clear incentive to arrange to have purchases made through their employers or other businesses in an effort to avoid the tax. This could reduce the yield of the tax by an undetermined amount, making it even harder for the bill to achieve revenue neutrality.

CONCLUSION

This bill would make the Missouri tax system more regressive and especially burdensome for those living on fixed incomes. There is also no guarantee that Missouri would have been better able to weather the current economic storm had the state's income tax been eliminated. While Missouri's current tax structure isn't without its flaws, eliminating the state's most progressive taxes and

relying solely on sales tax revenue will not ensure the state's tax structure treats people of different incomes fairly or is sustainable over the long term.

Thank you for the opportunity to testify.

BACKGROUND ON ITEP

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. ITEP's full body of research is available at www.itepnet.org.