Testimony of Kelly Davis
Institute on Taxation and Economic Policy
Regarding House Bill 444
January 30, 2007

Thank you Chairman Stevenson 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 444, which concerns excluding Social Security Benefits from the Missouri's income tax. In particular, my testimony will discuss the impact of this bill on the overall fairness of Missouri's tax system.

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 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

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

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. Eliminating tax on Social Security Benefits through House Bill 444 will do nothing to make the Missouri tax system less unfair.

How Social Security Benefits are Currently Taxed

Currently Missouri joins with eleven others in taxing Social Security Benefits. These twelve states tax Social Security Benefits in ways that are similar to how Social Security Benefits are taxed on the federal level. Until 1984, Social Security benefits were not taxed through the federal income tax. However, it was eventually determined that Social Security Benefits should be at least partially taxed like other retirement income.

Most Social Security recipients pay no tax on their benefits under current law. The Social Security Administration has found that less than one-third of current beneficiaries pay federal income taxes on their benefits. Above certain income levels, however, benefits gradually become taxable. The formula is a bit complicated, but for example:

- Couples with $20,000 in annual Social Security benefits and less than $42,000 in total income pay no tax at all on their benefits.
- At higher income levels, a growing portion of benefits must be reported as income. Thus, at $44,000, couples with $20,000 in benefits would be taxed on $1,000, or 5 percent of their total benefits. The share gradually rises, until above $67,000, 85 percent of benefits must be reported. That's the maximum.
- For single Social Security recipients, the phase-in starts at $30,000 for a person with $10,000 in benefits, and rises to the maximum of 85 percent above $44,000 in total income.

Social Security benefits taxable under current law for couples with $20,000 in benefits

Total income	Amount of benefits subject to tax	% of benefits subject to tax
Up to $42,000	$ —	—
44,000	1,000	5%
46,000	2,000	10%
48,000	3,000	15%
50,000	4,000	20%
52,000	5,000	25%
54,000	6,000	30%
55,180	7,003	35%
56,350	7,998	40%
57,520	8,992	45%
58,700	9,995	50%
60,000	11,100	56%
65,000	15,350	77%
67,000	17,000	85%

Why Are Some Social Security Benefits Subject to Tax?

The federal government began taxing a portion of Social Security benefits in 1984, and increased the maximum amount subject to tax to 85 percent in 1993. The idea was to treat Social Security benefits more like other retirement income, such as pensions and IRA distributions. Experts have calculated that 85 percent of Social Security benefits reflected previously untaxed income beyond the already-taxed Social Security contributions that retirees made during their working lives.

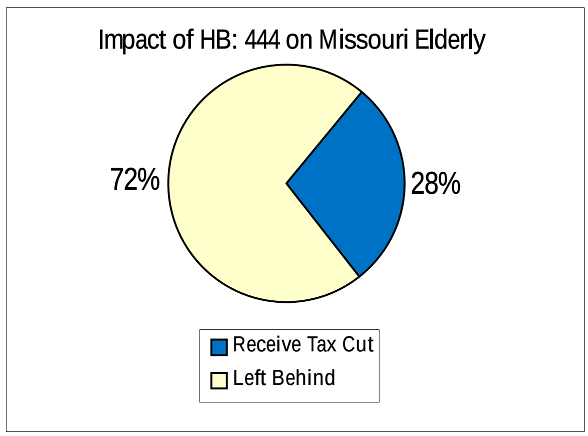
The Proposed Legislation

HB 444's income tax deduction for Social Security benefits would eliminate the currently taxable portion of Social Security benefits from Missouri income tax. The Institute on Taxation and Economic Policy (ITEP) estimates that this proposal would cost $100 million dollars at 2006 income levels. As the number of Social Security recipients and their benefits grow, the cost of the proposal would increase in future years.

Impact on Tax Fairness

ITEP staff have analyzed this proposal with an emphasis on which Missouri taxpayers would benefit from the proposal and which will not.

- Because there are so many Missouri elderly couples and singles who already are exempt from paying tax on their Social Security Benefits, 72 percent of Missourians 65 and older would receive nothing from the proposed tax cut.
- The minority who would benefit in any significant way from the plan are all better-off Missourians.



Conclusion

Lawmakers should be commended for their concern for the well-being of Missouri seniors—especially those on fixed incomes. Ensuring that seniors aren't overburdened by the tax code is a laudable goal that all Missourians can agree on. However, this bill does nothing to make Missouri's tax structure more fair for fixed-income seniors. Regressive sales and property taxes are the real tax fairness culprits. Lawmakers concerned with making Missouri taxes less unfair should focus on these regressive taxes. Legislators interested in assisting poor and middle income seniors would do better to direct their attention to expanding the state's property tax circuit breaker, pension exclusion or introducing another type of means tested targeted tax credit. Finally, House Bill 444 carries a high price tag and will become more costly as more Missourians age.

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.