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WRITTEN TESTIMONY SUBMITTED TO THE MISSOURI SENATE GOVERNMENTAL ACCOUNTABILITY AND FISCAL OVERSIGHT COMMITTEE REGARDING SENATE JOINT RESOLUTION 29

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Thank you, Chairman Purgason and members of the Committee for the opportunity to submit written testimony. My name is Matthew Gardner. I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group based in Washington, DC. 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 Senate Joint Resolution 29, which is intended to eliminate the state's personal and corporate income tax, local earnings taxes, and state sales tax and replace the lost revenue with a new state sales tax that taxes virtually all personal consumption, while exempting all spending by businesses. The bill would also introduce a sales tax rebate that is intended to offset the impact of the new sales tax on spending below the poverty line; this rebate is also intended to be fully paid for by revenue from the new sales tax.

In evaluating SJR 29, policymakers should have a clear understanding of how broad the tax base could actually be under such a plan, what the tax rate would actually have to be in order to make the plan revenue-neutral overall, and how the plan overall would affect Missourians at different income levels. My testimony presents estimates on each of these important points, and discusses difficulties associated with implementing the plan as described. The main findings presented in the testimony are that the revenue-neutral tax state sales tax rate under SJR 29 would likely have to be over 11 percent, more than twice as high as the bill's language specifies, and that this plan would result in a tax increase for most low- and middle-income Missourians while cutting Missouri taxes for the very best-off taxpayers.

ESTIMATING THE TAX BASE UNDER SJR29

The language of SJR 29 states that the "tax base" (that is, the types of retail sales that would be taxed under SJR 29) includes virtually all purchases of goods and services (except for higher-education tuition and fees) made by individual consumers, and excludes all purchases made by businesses. SJR 29 sets the tax rate under this new, broader sales tax at 5.11 percent, but it also leaves room for lawmakers to adjust the rate to achieve a revenue-neutral plan overall if the initial rate is inadequate. There is reason to be concerned that such an adjustment might be necessary; when very similar legislation was introduced last year as House Joint Resolution 36 of 2009, the official fiscal note for HJR36 estimated that at a 5.11 percent rate, this "tax swap" would leave a revenue shortfall ranging between $2.2 billion and $6.5 billion annually.

The uncertainty about how high the tax rate would have to be under this proposal is due in part to the fact that no state has ever attempted to tax personal consumption—or exempt business consumption—as universally as SJR 29 seeks to do. Put another way, it's hard to know what the value of the tax base (the value of all taxable consumption) would be under this plan.

The United States Bureau of Economic Analysis (BEA) publishes annual estimates of nationwide Personal Consumption Expenditures (PCE), which can be used to derive a reasonable estimate of the potential tax base under SJR 29. (BEA does not publish state-by-state estimates of PCE, which is why our analysis uses the national estimates.) The table at right shows how the BEA's national estimate of PCE can be used to derive a sensible estimate of the potential tax base under SJR 29.

- Nationwide, personal consumption expenditures in 2008 totaled **$10.13 trillion**.
- The only explicit exemption from the tax base provided in the statute is higher education tuition and fees, which totaled **$135 billion** in 2008.
- PCE also includes a broad category of spending that would be virtually impossible to tax—and that most people wouldn't even think of as spending. For accounting purposes, the BEA includes the "imputed rental value" of owner-occupied homes as a category of spending. The idea is that if you're a homeowner, you're producing a service (the rent-free use of a home) that is consumed by you and your family. Even if it made sense to tax this "service," it would be practically almost impossible to do so. Subtracting this item reduces the tax base by **$1.212 trillion**.
- Personal consumption expenditures also include a wide variety of spending that is not made directly by individuals, but by government or nonprofit entities on behalf of individuals. The most obvious such type of expenditure is health care, where reported PCE in 2008 included federal and state government spending on behalf of individuals totaling about **$889 billion** in 2008. It would likely be illegal for the Missouri sales tax to apply to federal spending, and would be counterproductive for the Missouri sales tax to apply to spending by the Missouri government.

Determining the Tax Base Under SJR 29 Using Personal Consumption Expenditure (PCE) Data

Nationwide PCE, 2008 ($Bill)	10,130
Subtract from PCE:	
Higher education spending	-135
Imputed Rental Value of Homes	-1,212
Health Spending by Govt	-889
Food Stamps	-33
Spending by Charities	-279
Free Financial Services	-271
Interstate transportation (air, ground)	-62
Foreign Travel	-125
Add to PCE:	
Foreign Travel to US	139
Home Sales	477
Base assuming no avoidance	7,740
Subtract for tax avoidance (10%)	-774
Taxable PCE	6,966
Missouri share of Pers. Inc., 2008	1.72%
Likely Missouri Taxable PCE	120.0

- Similarly, food spending in PCE includes food stamps provided by the federal government, which states cannot legally tax. This reduces the potential base by **$33 billion**.
- In addition, spending by charities on behalf of individuals amounts to **$279 billion**, and the value assigned to free checking and other free financial services amounts to **$271 billion**; each of these categories of spending would be administratively difficult to include in the Missouri sales tax base, primarily because each category would be hard to value but also because few Missourians would view these items as part of their personal "spending."
- Nationwide, individuals spent about **$62 billion** on interstate air and ground travel, which states are not allowed to tax.
- Because PCE includes spending by Americans in other countries **($125 billion**), and excludes spending by tourists from other countries visiting the U.S. **($139 billion**), the former must be subtracted and the latter must be added to PCE.
- Finally, individual spending on new homes is excluded from BEA's measure of personal consumption. If the intention of lawmakers is to include this spending in the tax base, the value of this spending (about **$477 billion** in 2008) must be added back.

The net impact of these subtractions and additions is to reduce potentially taxable personal consumption expenditures from $10.1 trillion to about $7.7 trillion.

Even modified in this way, the BEA consumption data doesn't reflect one of the hard realities of sales tax administration: tax avoidance. Every tax in existence faces compliance problems, driven both by unreported cash transactions and the growing role of untaxed Internet-based purchases. The Minnesota Department of Revenue regularly analyzes the extent of sales tax evasion in that state, and has estimated that the state loses about 10 percent of its potential sales tax revenue to tax avoidance. We use this 10 percent estimate to approximate the likely revenue loss due to sales tax avoidance under SJR 29, which reduces the potential base by $**770 billion** to $6.9 trillion.

Of course, in all likelihood, the problem of sales tax avoidance would be even worse under the sales tax proposed by SJR 29, for two reasons: first, the sales tax rate would almost certainly be substantially higher than the state sales taxes levied by Minnesota or any other state currently, and second, the tax would, in theory, apply to a variety of personal consumption items that no other states currently tax.

While the BEA data does not include state-specific estimates, a reasonable approximation of Missouri's share of national GDP is its share of personal income, which in 2008 was 1.72 percent. By this measure, the likely Missouri tax base under SJR 29 would be about $120 billion in 2008 (that is, 1.72 percent of nationally taxable PCE).

In tax year 2009, reflecting the recent economic slump, Missouri retail sales fell substantially. For this reason, the 2009 tax base under SJR29 would likely be substantially lower than the 2008 tax base. However, because there are no reliable estimates of total personal consumption expenditures for 2009, our estimate assumes no change between the 2008 and 2009 tax bases. This likely overestimates the actual 2009 yield of the proposed sales tax.

Estimating the Tax Rate Under SJR29

The sales tax base estimate given above tells us most—but not all—of what we need to know in order to estimate the revenue-neutral sales tax rate under SJR 29. The legislation states that the tax rate should be set at a level that is sufficient to completely pay for repealing personal and corporate income taxes. The tax rate must also be sufficient to pay for a "sales tax rebate" designed to offset the sales taxes paid on income below the poverty level. While the language of HJR 29 is inconsistent on this point—the proposed ballot language in section B of the bill says that the rebate would be given to "each qualified family" while Section A says that the rebate will be given "to each qualified household," we assume here, following the intention of similar legislation in 2009, that the legislative intent is to allocate the credit to families and individuals, not to households.

According to SJR 29, the rebate is calculated by multiplying the poverty guidelines for a given family by the sales tax rate. So, for example, because the 2009 poverty level for a single person is $10,830, the annual rebate amount for a single person would be $10,830 times the tax rate. This means that statewide, the cost of the rebate is the sum total of all income below the poverty line, multiplied by the tax rate.

This means, of course, that the cost of the rebate can't be determined until the tax rate is known—but because the tax rate must be set in a way that exactly pays for the rebate and the eliminated taxes, the tax rate can't be known until the cost of the rebate is known.

For this reason, the necessary rate must be calculated algebraically, and this can be done in a straightforward way given the poverty guidelines and our estimate of the new sales tax base. Since the revenue from the new tax needs to equal the lost revenue from repealed taxes plus the cost of the rebate, we can solve for the rate using the following equation:

(base x rate) = (cost of repealed taxes + cost of rebate)

or

($120 billion x rate) = ($9.0 billion + ($39.33 billion x rate))

From this, it can be calculated that the break-even sales tax rate would be 11.2 percent. Based on an ITEP Microsimulation Tax Model calculation, we estimate that a rebate based on this tax rate would cost $4.4 billion in tax year 2009. The cost of the rebate will likely grow each year since poverty levels are indexed annually. Under SJR 29, the state would annually dole out almost as much in tax rebates as the state currently collects in personal income taxes.

Added to the $9.0 billion in repealed taxes to be replaced (a figure that includes the current state sales tax), this means that the new sales tax would

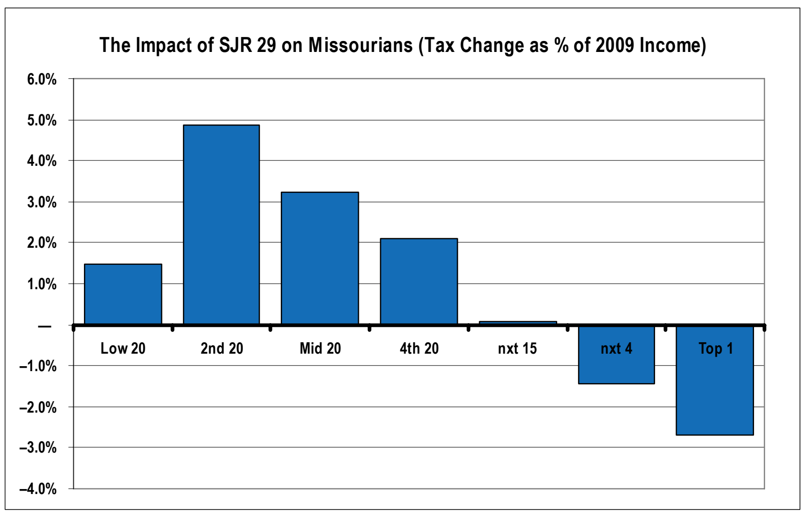
Determining the Needed Tax Rate Under SJR29	
Taxes to Replace ($ Billions)	9.0
Rebate at 11.2% Tax Rate	4.4
Total Revenue to Replace	13.4
Likely Tax Base	120.0
Required State Tax Rate	11.2%

need to raise a total of $13.4 billion if implemented in tax year 2009. And since $13.4 billion is 11.2 percent of our estimated tax base ($120 billion), 11.2 percent is the tax rate that would be required for SJR 29 to achieve its stated revenue-raising goals in 2009.

Notably, a Missourian in any part of the state would likely pay substantially more than 11.2 percent sales tax on any transaction, because SJR29 leaves intact existing local sales taxes, and mandates that local governments should adjust their tax rates so that, using the new, broader base, their sales tax revenue yield remains unchanged. Under this approach, Missouri's average local sales tax would decline from the current 2.8 percent to 1.9 percent. This means that the statewide average combined state and local sales tax rate, applied to all items of personal consumption except for higher education tuition and fees, would be about 13.1 percent.

IMPACT ON MISSOURIANS

This section estimates the impact of the SJR 29 tax swap on Missourians at different income levels if fully implemented in tax year 2009 at an 11.2 percent tax rate. As the chart at right shows, the net impact of repealing the personal income tax, corporate income tax, local earnings taxes and the basic state sales tax, and creating a new 11.2 percent consumption tax that will be revenue-neutral in combination with the proposed sales tax rebate, is a regressive tax change. It would fall most heavily on lower- and middle-income families, while giving tax cuts to taxpayers in the top five percent of the income distribution.



Specifically:

- The poorest twenty percent of Missourians would see a tax increase, on average, of 1.5 percent of their income, or about $154.
- Families in the middle 20 percent of the income distribution would, on average, see a tax increase of 3.2 percent of their income.
- In fact, every income group in Missouri would, on average, see their taxes go up under SJR 29—except the best-off 5 percent of the income distribution.
- The very best-off 1 percent of Missourians would see a net state tax cut of 2.7 percent of their income, on average. This translates into a tax cut averaging over $25,000 for each family and individual in this income group.

How can it be that a "revenue-neutral" tax change results in state tax increases for 95 percent of Missourians, on average? This result is driven by several features of SJR 29's tax swap:

- Under current state and local sales tax rules, a substantial part of Missouri sales taxes are paid not by individual consumers but by multi-state businesses. These business sales taxes are generally passed through to consumers of these businesses' products, wherever they live. The practical impact is that a substantial share of the business sales tax reduction that would result from SJR 29 would benefit consumers living in states other than Missouri. The same is true of the proposed corporate income/franchise tax repeal: the benefits would go largely to shareholders in other states, not to Missourians.
- Because the expanded sales tax base would apply entirely to personal consumption, the added sales tax under this plan would be paid entirely by Missouri residents and, to some extent, by non-residents visiting Missouri. The net impact of this business-for-consumer sales tax swap is that consumers in other states would pay less sales tax—and consumers in Missouri would pay more.
- The personal and corporate income taxes, uniquely among the taxes levied by Missouri state and local governments, fall most heavily on the best-off taxpayers. Repealing these taxes creates a huge tax cut for the best-off Missourians, and the sales tax increases on these best-off taxpayers under SJR 29 offset only a small part of this tax cut. In order to be remain revenue-neutral, this large tax cut for the best-off Missourians must be paid for by the rest of the state's residents—specifically, low- and middle-income Missourians.

COMPLICATIONS OF SJR 29: 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.

Some advocates of shifting to a consumption may be doing so with the goal of achieving a more reliable revenue stream. But it's far from obvious that heavy reliance on sales taxes (or especially low reliance on income taxes) is a recipe for fiscal prosperity, or 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 mid-year budget gaps for fiscal year 2010. New Hampshire's budget shortfall is approximately 2.4 percent of the state's general fund budget, or $38 million. Washington State has no tax on income and has one of the largest projected budget shortfalls in the country – nearly $3 billion or 8.4 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 Mid-Year Budget Gaps in States Without a Broad Based Income Tax

	Shortfall (Millions)	% of General Fund Budget
Alaska	N/A	N/A
Florida	$147	0.6%
Nevada	$67	2.2%
New Hampshire	$38	2.4%
South Dakota	N/A	N/A
Tennessee	$96	0.9%
Texas	N/A	N/A
Washington	$2,600	8.4%
Wyoming	$32	1.7%

Source: CBPP, Recession Continues to Batter State Budgets; State Responses Could Slow Recover 12/23/09

In a number of these states, the fiscal situation would be even worse if they didn't have special and unique revenue streams that aren't available in Missouri. For example, Alaska, Texas and Wyoming have an abundance of taxed natural resources which bring in significant revenue. Nevada relies quite heavily on tourist and gambling revenue. Florida also relies on revenue generated from the tourist industry. Missouri simply doesn't have these unique traits that are associated with many of the states without broad-based income taxes.

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 SJR 29, 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 average state and local sales tax rate of 7.05 percent is squarely in the middle of the sales tax rates levied by neighboring states. A state and local sales tax rate averaging 13 percent would certainly be the highest sales tax levied in the region.

Lastly, if retail sales taxes are always tax-exempt when businesses make purchases, and always taxable at over 11 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 is the second consecutive year in which Missouri lawmakers have been presented with a plan to replace personal and corporate income taxes with a nearly-universal tax on personal consumption. As was true in 2009, some very basic questions remain unanswered about how such a tax would be implemented. As introduced, the text of SJR 29 specifies a tax rate of 5.11 percent (which could be altered by the legislature) as the rate that would likely make this plan "revenue neutral" overall. Our analysis of the potential tax base under SJR 29's expanded consumption tax suggests that the bill's authors have dramatically underestimated the necessary tax rate, and that in fact a state tax rate of more than 11 percent on virtually all consumer spending would be required to achieve this basic goal. Our analysis also shows that the "tax swap" envisioned by SJR 29 would, if implemented at this 11.2 percent rate, result in substantial state tax increases on middle- and low-income Missourians, coupled with large tax cuts for a small number of the very best-off taxpayers.

Thank you for the opportunity to submit this testimony.

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