



1616 P Street, NW Washington, DC 20036  
(202) 299-1066

**WRITTEN TESTIMONY SUBMITTED TO  
THE MISSOURI HOUSE WAYS AND MEANS COMMITTEE  
REGARDING HOUSE BILL 2034  
MARCH 18, 2010**

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Thank you 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 one bill introduced in the Missouri House of Representatives: HB 2034, which would reform the state's individual income tax structure. My testimony will discuss the impact of this bill on the yield and fairness of Missouri's income tax. HB 2034 would raise over a billion dollars a year to fund public investments, while cutting taxes in the aggregate for the poorest sixty percent of the income distribution.

**The Problem: Missouri's Regressive Tax Structure**

While balancing the state's budget is likely foremost in the minds of state legislators, there is a very straightforward reason for being concerned that any revenue-raising solution should take tax fairness into consideration: the current tax system falls most heavily on low- and middle-income families. In November of 2009, ITEP released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study found that the effective state and local tax rate on the wealthiest one percent of Missouri families was just 5.4 percent of income after the interaction between state and federal taxes is taken into account, substantially less than the 9.2 percent tax rate on Missourians in the middle of the income distribution and the 9.6 percent effective tax rate on the very poorest 20 percent of Missouri residents.

The study also found that the unfairness of the Missouri tax structure was partially due to the state's relatively flat income tax rate structure. Nearly 60 percent of Missourians currently pay at least some tax at the state's top income tax rate of 6 percent, which applies to 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, its relatively-flat income tax does less to offset the regressive impact of sales taxes than many other states.

### **Provisions of HB 2034**

HB 2034 would mitigate the unfairness of Missouri's tax system in two broad ways. First, the bill would reduce income taxes for low- and middle-income families by expanding the income tax brackets and by introducing a refundable low-income tax credit. Second, the bill would raise revenue by eliminating a tax break (the deduction for federal income tax payments) available primarily to upper-income families, and by increasing the top marginal tax rates on the best-off Missouri taxpayers. 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. Twelve percent of all Missouri families would pay at least some income tax at the new top income tax rate of 9 percent for taxable income above \$50,000 ( by contrast, 58 percent of Missourians who are projected to pay at the current top rate in 2010).

This bill would also eliminate the deduction for federal taxes paid. Missouri is one of only six states that allow 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 2034 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 more regressive taxes (such as sales, excise and property taxes) that they pay.

## Revenue Impact of HB 2034: State and Federal

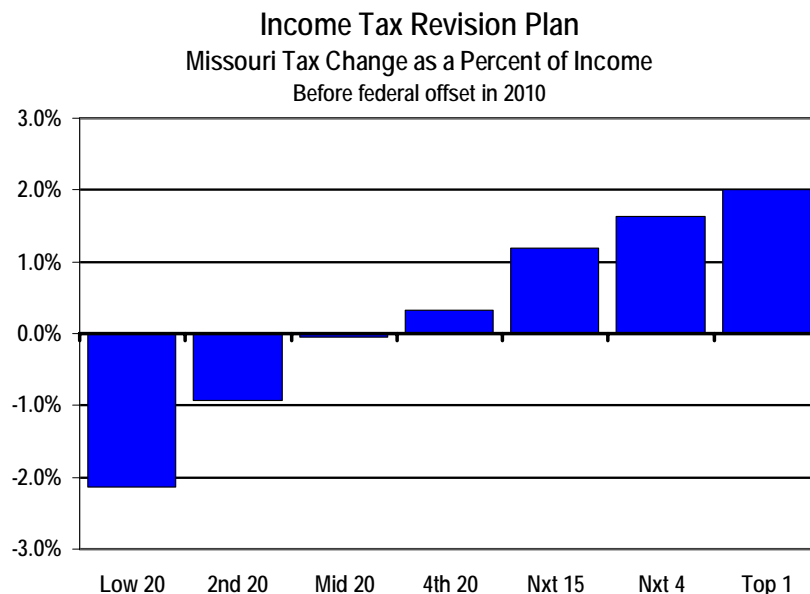
If fully implemented in tax year 2010, HB 2034's income tax changes would increase state revenues by about \$1.3 billion. Federal taxes for itemizers would be reduced by \$235 million, for a net tax increase of \$1.07 billion. In other words, about 18 percent of the new state revenue under this plan would come not from Missouri taxpayers, but from the federal government in the form of reduced federal taxes for Missourians.

This offsetting federal tax change occurs because Missourians who itemize on their federal income tax returns can take a deduction for the state income taxes they pay. This means that if you itemize your federal taxes, some of your state income taxes are being directly offset by federal tax cuts.

This "federal offset" is most beneficial to state residents when states rely on a progressive personal income tax. This is because the best-off taxpayers are most likely to itemize, and tend to pay at the highest federal tax rates. For these taxpayers (assuming they do not pay the federal Alternative Minimum Tax), close to 40 percent of any state income tax hike can be directly offset by a federal tax cut. Because the tax hikes in HB 2034 are targeted to upper-income Missourians, the bill is more effective in leveraging the "federal offset" than would be (for example) a state income tax hike that fell primarily on low-income taxpayers who generally don't itemize their federal returns.

## HB 2034's Impact on Missouri Tax Fairness

The following graph illustrates the percent of tax change by income level under House Bill 2034.



The proposal would reduce taxes, on average, for the poorest 60 percent of the income distribution, with the largest tax cuts going to the poorest 40 percent of the income distribution. As a group, the middle 20 percent of the income distribution would see its state taxes decline very slightly.

The best-off 40 percent of the income distribution would see its income taxes increase, on average, with the biggest tax increases reserved for the top 20 percent (and in particular the top 1 percent) of Missouri taxpayers.

## **Conclusion**

Compared to many other states, Missouri's income tax is relatively flat. The flatness of the income tax has important implications for the fairness of Missouri's tax system overall: the income tax is the only tool available to offset the regressivity of sales, excise and property taxes, so Missouri's relatively-flat income tax results in a tax system that falls most heavily on low- and middle-income families overall. As my testimony has noted, HB 2034 represents a substantial improvement in the fairness of Missouri's tax system. However, while HB 2034 would make the Missouri tax system less regressive, it is important to note that the Missouri tax system would remain somewhat regressive overall even 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.