

# **Revenue-Raising Options for Missouri**

**Prepared By**

**Citizens for Tax Justice  
1311 L Street, NW, Washington, DC 20005  
202-626-3780  
[www.ctj.org](http://www.ctj.org)**

**For:  
Missourians for Tax Justice**

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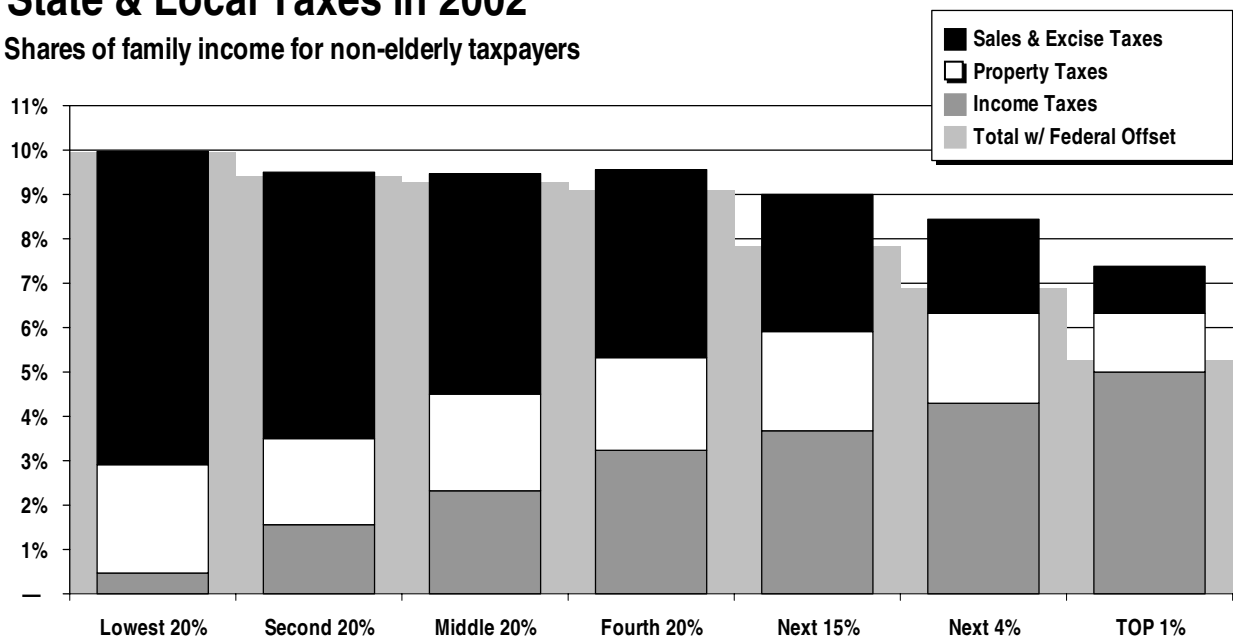
Missouri is at a crossroads. After years of budget surpluses, the state now faces ballooning fiscal shortfalls that threaten the state's ability to provide critical public services: recent estimates suggest that legislators crafting the fiscal year 2004 budget must make up about \$700 million in revenues through budget cuts or tax increases.

Missouri is also facing an ongoing tax equity crisis. State policy makers have chosen to finance government services with a tax structure that requires low-income taxpayers to pay the highest effective state and local tax burdens—and allows the wealthiest taxpayers to pay the lowest effective tax rates.

These dual crises will force lawmakers to make tough decisions about tax and spending policy in 2003—but also represent an historic opportunity to make the tax system less unfair. This analysis looks at Missouri's current regressive tax structure, and identifies various options available to legislators seeking to solve the state's current fiscal shortfall without worsening the inequities in the current tax structure.

## State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



## Distributional Impact of the Current Missouri Tax System

In January of 2003, the Institute on Taxation and Economic Policy released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.<sup>1</sup> One of the findings of the study was that in 2002, Missouri had a *regressive* tax structure—in other words, that middle- and low-income Missourians paid a higher share of income in Missouri

<sup>1</sup>*Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. McIntyre, Denk, Francis, Gardner, Hsu and Sims (Institute on Taxation and Economic Policy, 2003).

state and local taxes than did the better-off. In particular, the study found that:

- The poorest twenty percent of Missourians paid 10 percent of their income in Missouri taxes, while the wealthiest one percent of taxpayers paid only 7.4 percent of their income in state and local taxes.
- After taking account of the deductibility of state income and property taxes on federal tax forms, the effective tax rate on the wealthiest Missourians was 5.3 percent—just over half the effective tax burden on the very poorest Missourians.

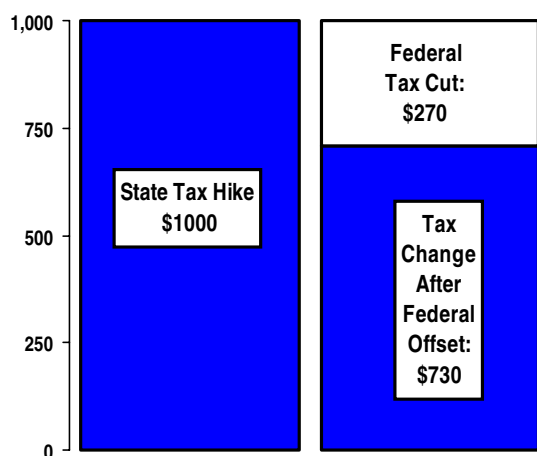
The study showed that the state’s regressive tax structure was due to two factors: first, the state relies heavily on regressive taxes such as the general sales tax and excise taxes on cigarettes, alcohol and gasoline. Second, the state’s personal income tax, while progressive (higher-income taxpayers pay at higher rates), is not sufficient to make up for the regressivity of other Missouri taxes. As a result, the tax system as a whole is regressive.

## Revenue-Raising Options

The results of the January 2002 ITEP study have clear implications for revenue-raising in Missouri: if policy makers choose to fund state services by increasing sales and excise taxes, the Missouri tax system will become even more regressive. If, on the other hand, the state chooses to increase its reliance on progressive income taxes, the tax system as a whole will become less regressive. This section explores the distributional impact of various alternatives for revenue raising.

For each option described below, the accompanying bar charts show the impact of these options on each Missouri income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent bar shows each proposal’s effect *before* consideration of federal tax changes. We have presented our data in this way because for those Missourians who itemize deductions on their federal tax return, changes in state income taxes can produce offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Missourians, including federal and state taxes. The following example shows how to interpret these charts.

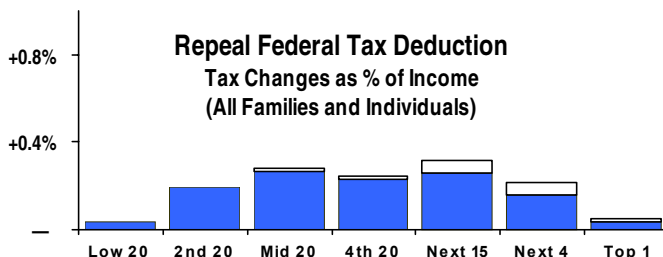
Suppose an itemizing Missouri taxpayer in the 27 percent federal tax bracket is subject to a \$1,000 increase in Missouri income taxes. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer’s income will be subject to federal tax after the Missouri tax increase. Since this last increment of income was originally taxed at 27 percent, this person’s federal tax liability decreases by \$270. So the net *overall* tax hike for this itemizing Missouri taxpayer from a \$1,000 hike in state tax liability is actually \$730, not \$1000. Our distributional analysis of this proposal



(the second column in the chart at right) shows that taxpayers do not pay the full \$1,000 tax hike, since \$270 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the additional tax burden on Missourians from the proposal.

### 1. Eliminate the Deduction for Federal Income Taxes Paid

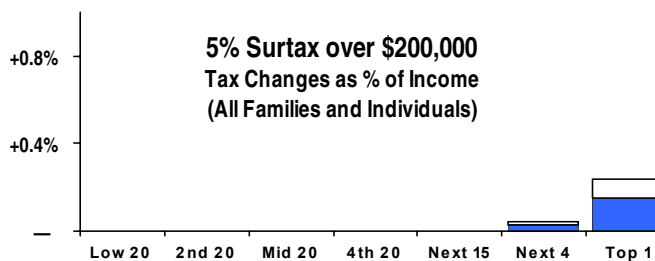
Missouri is one of just nine states that allow a deduction for federal income taxes paid. This deduction allows Missourians to reduce their Missouri taxable income by the amount of federal income taxes calculated on their federal income tax forms, with the deductible amount capped at \$5,000. The deduction has a regressive impact on the Missouri tax system because the federal income tax is sharply progressive: low-income Missourians pay at lower tax rates.



- This proposal would have increased state tax collections by almost \$300 million if implemented in tax year 2002. However, the overall *federal* tax burden on Missourians would actually decline by \$41 million, because federal itemizers living in Missouri would be able to deduct larger amounts of state income tax. In other words, fourteen percent of the added state revenues from this plan would be paid not by Missourians, but by the federal government.
- Eliminating the deduction for federal income taxes paid would make the income tax somewhat more progressive. Since low-income Missourians tend to pay relatively little federal income tax, the impact on these taxpayers is relatively small. At the other end of the spectrum, the impact on the very wealthiest taxpayers is also relatively small, since these taxpayers generally pay much more than the \$5,000 limit on the current federal income tax deduction. Over the remainder of the income spectrum, the plan is progressive.

### 2. Enact a Five Percent “Surtax” on Taxable Income over \$200,000

One approach to a “targeted” income tax hike is a surtax on taxpayers earning above a certain income level. Governor Bob Holden proposed such a surtax in his “State of the State” address in January, suggesting a 5 percent surtax on Missourians with taxable income over \$200,000.



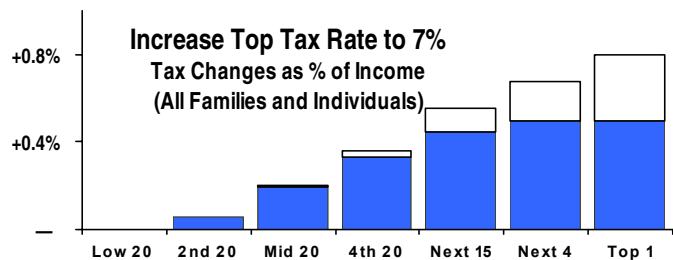
- Because this tax increase is limited to Missourians with very high incomes, the impact of this change is quite progressive. Less than two percent of taxpayers would be affected by this change. Virtually none of the taxpayers in the poorest ninety five percent of the income distribution would be affected by this change.

- Missouri tax collections would increase by about \$50 million under this plan.
- The narrow targeting of this proposal means that the state revenue yield is smaller than the impact of an “across the board” income tax hike such as the one modeled below. But this narrow targeting also means that 35 percent of the plan’s costs—more than a third—would be paid not by Missourians but by the federal government in the form of federal tax cuts for Missouri itemizers.

### 3. Introduce a New Top Income Tax Rate of 7 Percent Over \$25,000.

This option adds a new top tax bracket above \$25,000 of taxable income. The marginal tax rate on income above this threshold is 7 percent.

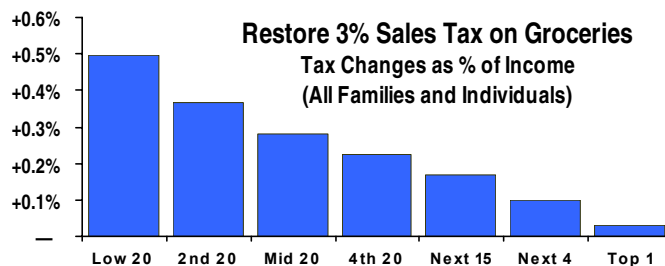
- The plan’s impact is progressive. While all income groups receive, on average, an income tax hike, that hike is smallest as a percentage of income for low- and middle-income Missourians.
- This plan would have increased state revenues by \$410 million in tax year 2002.
- More than a quarter of the state tax increases from this plan would be offset by federal income tax cuts.



### 4. Restore State Sales Tax on Food

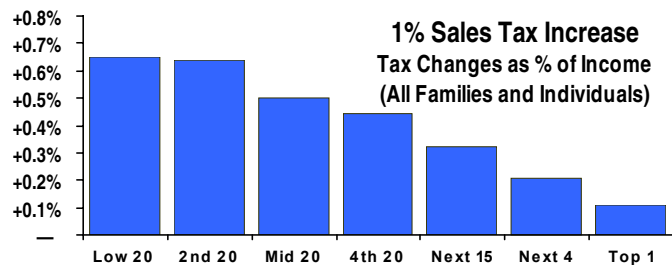
Missouri is one of several states that have recently reduced the regressivity of their state sales tax burden by applying a reduced tax rate to sales of groceries. Since 1998, Missouri has taxed groceries at 1.225 percent, while most other items are taxed at 4.225 percent. This option funds Missouri services by eliminating this partial exemption.

- This option makes the tax system more regressive. Taxing groceries is extremely regressive because a high portion of the income of poorer families is spent on “essentials” such as food. The largest tax increase, as a share of income, is paid by the very poorest Missourians under this proposal.
- This plan would have increased state revenues by \$325 million in 2002.
- Because sales taxes are not deductible on federal income tax forms, none of the additional state taxes paid by Missourians under this plan would be offset by federal tax cuts.



## 5. Increase State Sales Tax Rate by One Percent

This option would increase the state sales tax rate by one percent, from 4.225 to 5.225. Sales taxes are the most regressive of the major taxes levied by state governments—and the principal reason for the overall unfairness of the Missouri tax system. By increasing the state’s reliance on this unfair revenue source, this plan would make the tax system even more regressive.

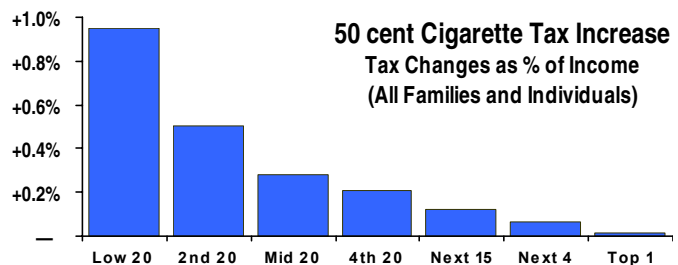


- This option makes the tax system more regressive. The largest tax hike, as a share of income, would be borne by the poorest Missourians.
- This option increases Missouri tax revenues by \$640 million. Since sales taxes are not deductible on federal income tax forms, there is no offsetting federal income tax cut from this change.

## 6. Increase Cigarette Tax by 50 Cents per Pack

Cigarette taxes have been one of the most popular revenue-raising options for lawmakers in the past year. These “sin” taxes have been hiked in almost twenty states in the past twelve months.

- Excise taxes are generally the most regressive taxes. This tax hike would impose the greatest burden on the lowest-income taxpayers.
- This option increases Missouri tax revenues by \$300 million. Since cigarette excise taxes are not deductible on federal income tax forms, there is no offsetting federal income tax cut from this change. Moreover, the state revenue gain from this plan is somewhat uncertain, since higher cigarette taxes may encourage a decline in smoking.



## Summary

Missouri faces a short-term fiscal challenge. State policymakers must decide how best to modify the state’s tax structure to make up the state’s projected \$700 million revenue shortfall, while ensuring the long-term adequacy of the tax structure.

Missouri also faces a tax equity crisis: ITEP’s recent *Who Pays* study found that Missouri’s tax system is regressive, applying the very highest effective tax rates to the poorest Missourians.

This analysis has shown that some revenue-raising options currently available to state policymakers would address both of these problems, increasing Missouri state tax

revenues in a way that does not worsen the inequities of the state tax structure. In particular, changes that focus on the personal income tax will have a progressive impact on the state tax system—and will be partially paid for by the federal government due to the federal deductibility of state income taxes.

The analysis has also shown that using sales and excise taxes to balance the Missouri budget would make the state tax system even more unfair.

We hope this analysis helps inform state policy makers as they make these important decisions.

## APPENDIX I: DETAILED DISTRIBUTIONAL RESULTS

### Revenue Raising Options for Missouri

#### All Missouri Taxpayers, 2002

Income Range	Less Than \$14,000	\$14,000 – \$25,000	\$25,000 – \$42,000	\$42,000 – \$67,000	\$67,000 – \$123,000	\$123,000 – \$282,000	\$282,000 – Or More
Average Income in Group	\$9,000	\$19,700	\$33,200	\$53,100	\$87,000	\$171,400	\$773,900

#### Eliminate Federal Income Tax Deduction

Tax Change as % of Income	+0.0%	+0.2%	+0.3%	+0.2%	+0.3%	+0.2%	+0.1%
\$ Average Tax Change	\$ +3	\$ +38	\$ +93	\$ +131	\$ +277	\$ +371	\$ +398

#### Personal Income Surtax Over \$200,000 of Taxable Income

Tax Change as % of Income	—	—	—	—	—	+0.0%	+0.2%
\$ Average Tax Change	\$ —	\$ —	\$ —	\$ —	\$ —	\$ +69	\$ +1,850

#### New 7% Top Tax Rate Over \$25,000 of Taxable Income

Tax Change as % of Income	—	+0.0%	+0.0%	+0.1%	+0.4%	+0.6%	+0.8%
\$ Average Tax Change	\$ —	\$ +0	\$ +2	\$ +55	\$ +312	\$ +997	\$ +6,028

#### Eliminate 3% Sales Tax Exemption for Groceries

Tax Change as % of Income	+0.6%	+0.4%	+0.3%	+0.3%	+0.2%	+0.1%	+0.0%
\$ Average Tax Change	\$ +53	\$ +84	\$ +116	\$ +150	\$ +179	\$ +218	\$ +284

#### Increase State Sales Tax by 1 Percent

Tax Change as % of Income	+0.7%	+0.6%	+0.5%	+0.4%	+0.3%	+0.2%	+0.1%
\$ Average Tax Change	\$ +29	\$ +63	\$ +83	\$ +117	\$ +141	\$ +177	\$ +424

#### Increase Cigarette Tax by 50 Cents per Pack

Tax Change as % of Income	+1.0%	+0.5%	+0.3%	+0.2%	+0.1%	+0.1%	+0.0%
\$ Average Tax Change	\$ +85	\$ +100	\$ +93	\$ +111	\$ +108	\$ +114	\$ +107

SOURCE: Institute on Taxation and Economic Policy, April 2003

## APPENDIX II: ABOUT THE ITEP MODEL

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The data presented in this report were drawn from the Institute on Taxation & Economic Policy (ITEP) Microsimulation Tax Model. ITEP has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

*The Personal Income Tax Model* analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

*The Consumption Tax Model* analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

*The Property Tax Model* analyzes revenue yield and incidence of current state and local

property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

*The Corporate Income Tax Model* analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

**Local taxes:** The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

### **Addendum: Data Sources**

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

#### *Micro-Data Sets:*

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

#### *Partial List of Aggregated Data Sources:*

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

*A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP Internet site at [www.itepnet.org](http://www.itepnet.org).*