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Consequences of Replacing Missouri's Income Tax with a Sales Tax

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Impact on Missouri Revenue:

Missouri's State Income Tax and Sales Tax comprise a significant portion of Missouri General Revenue. For the most recently completed full fiscal year; Fiscal Year 2008, the net revenue from Income Tax Versus Sales tax was:

Individual Income Tax	\$5.210 Billion
Sales and Use Tax	\$1.931 Billion
Total Net General Revenue	\$8.004 Billion (includes all sources)

The most recent Consensus Revenue Forecast for Fiscal Year 2009 estimates the following from these two tax categories:

Individual Income Tax	\$5.083 Billion
Sales and Use Tax	\$1.860 Billion
Total Net General Revenue	\$7.687 Billion (includes all sources)

What this quickly demonstrates is that for the current fiscal year, the **Individual Income Tax** generates approximately **66 Percent of Missouri General Revenue funding**.

In order to replace such a significant amount of general revenue that would be lost if the Individual Income Tax is eliminated, the state Sales Tax would need to be increased from a rate **of 3 percent to a rate of 11.2 percent, or an increase of 8.2 percentage points**.

The new General Revenue Sales tax rate of 11.2 percent would be in addition to the state earmarked rate of 1.225% (that currently flows to Conservation, State Parks and Proposition C Education funding). In addition, the rate would be on top of the prevailing locally imposed sales tax rates which range from 2 to 3 percent range, depending on the taxing jurisdiction.

In other words, in order to replace the Missouri Individual Income Tax with a revenue neutral sales tax, **an aggregate state and local sales tax rate of 15 percent would be required**.

Trends over Time: Sales Tax Revenue less Reliable than Income Tax Revenue:

Both the Sales Tax and Individual Income Tax have been significant contributors to Missouri general revenue for extended periods of time, although each has undergone various modifications. Over time, however, the State Sales Tax has had much more minimal growth than

the income tax. In fact over the last decade (state fiscal year 1999 through state fiscal year 2008) Missouri's **state sales tax revenue increased at less than half the rate of the state income tax revenue on average per year:**

- **Net Individual Income Tax Growth 4.5 percent**
- **Net Sales/Use Tax Growth 2.1 percent¹**

As indicated below, both taxes have undergone significant change over the last several decades. Some of these changes could likely impact the lower growth rate in the Sales Tax. However, what the data indicate incontrovertibly is that if Missouri were to switch from an income tax to a sales tax system, the low growth in sales tax would likely result in a **more pronounced state structural deficit over time, and a less adequate revenue base.**

The Individual Income Tax was established in 1917. The last major revisions were made effective in 1971 when the current tax rate, tax brackets and definitions of taxable income were adopted. Since 1971, the most significant changes have included:

- A \$5000 cap per taxpayer on the Federal Income Tax deduction effective for tax year 1994; and
- An increase of \$900 (\$1200 to \$2100) in the personal exemption and an increase of \$800 (\$400 to \$1200) in the dependent exemption both effective for tax year 2000.

The Missouri **Sales Tax** was first enacted in 1934. The current general revenue sales tax rate of 3 percent has been in effect since 1963 (with the exception of a nine month temporary increase to 3.2 in 1989). Over the last several decades, numerous **exemptions** to the sales tax were enacted including:

- Prescription Drugs;
- Domestic Utilities;
- Food for Home Consumption;
- Motor Fuel (continues to be subject to excise tax); and
- In addition, Missouri has several sales tax exemptions targeted to businesses and manufacturers.

It is also notable that beginning July 1, 2008, all sales tax collected on Motor Vehicle sales is allocated to MO-DOT (prior to July 1, 2005, one half of Motor Vehicle Sales tax was allocated to the general revenue fund and one-half was allocated to MO-DOT).

While difficult to quantify with precision, it is reasonable to assume that the **state sales tax base has also been eroded due to Internet purchasing in recent years.** Consumers purchasing products via the Internet are likely avoiding state and local sales taxes altogether. A recent report from the Center for Business & Economic Research at the University of Tennessee estimates that

¹ Revenue figures and revenue calculations cited above are derived from data published in the 2007 Tax Expenditure Report published by the State and Regional Fiscal Studies Unit at the University of Missouri-Columbia and from revenue reports published by the MO Office of Administration.

Missouri will lose between **\$270 and \$370 million in state** and local government revenue due to Internet and Catalog purchasing in 2008.²

Comparing Missouri with Non-Income Tax States

The States that do not levy a state income tax, and those with very low income tax rates, rely heavily on taxing options that either not available in Missouri or ones that would be difficult to levy (* indicates states that do not have a state income tax):

- **Alaska*** and **Wyoming*** generate well over half of their state revenue from severance taxes on oil and coal;
- **Florida*** utilizes high sales taxes on tourists;
- **Nevada*** utilizes high sales and gaming taxes on tourists; and
- **Texas*** combines severance tax on oil, high sales tax along with the tourist taxes.

The states of **Washington***, **New Hampshire**, **Tennessee**, and **South Dakota*** rely on relatively high Sales and/or Property taxes.

Per Capita Sales Tax Collections in States without a State Income Tax – 2006³

Washington	\$1,576
Nevada	\$1,269
Florida	\$1,151
South Dakota	\$861
U.S. Average	\$758

Absent severance and/or “tourist” type taxes, Missouri has few desirable options to reduce much less eliminate the Individual Income Tax. As previously noted, Missouri receives about 65 percent of its general revenue funding from the State Individual Income Tax. In order to replace that amount, Missouri would need to increase the sales tax by an additional 8 cents. The only other option would be the imposition of a significant state property tax.

Additional “Unintended” Consequences

Federal Law allows for the deduction of State Income Tax or State Sales Tax (one but not both) on the Federal Income Tax Return for individuals filing itemized deductions. Presumably, some of the savings to Missouri income taxpayers from Missouri Income Tax elimination would be offset by **higher federal income taxes**.

Although Missouri has already exempted food for home consumption, domestic utilities and prescription drugs from the state sales tax base, replacing the individual income tax with a sales tax would place a **significant burden for low and middle income families**.

²University of Tennessee Fox Report on E Commerce Loss to States,
<http://www.nga.org/cda/files/0407ecommerce.PDF>

³ State Rankings 2008 published by CQ Press Pg. 341

Summary

Based on these findings, policymakers should avoid replacing the Missouri Individual Income tax with a sales tax. Not only would the sales tax rate need to be increased dramatically to result in the same level of revenue as income tax, it is likely to lead to increased long-term structural revenue inadequacy, and will place an unnecessary burden on Missouri's low and middle income families.

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