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MISSOURI'S FISCAL CRISIS REMAINS SEVERE:
Revenue Options are Available as Compared to continued Spending Cuts

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Introduction

The state fiscal crisis that began in fiscal year 2001 has resulted in cumulative shortfalls in the state's general revenue budget in the last four fiscal years totaling more than $2.1 billion dollars. These shortfalls have resulted in significant core cuts and withholds to services in Missouri, particularly in the areas of Social Services, Health Care, Mental Health Care and Education (see Table 1).

The outlook continues to decline, even in the midst of recent gains in the national economy. For the next year, Fiscal Year 2005, the anticipated General Revenue as agreed to in the Consensus Revenue Estimate is $6.392 billion or $789 million dollars below the current year. [1] When incorporating transfers of about $162 million from tobacco settlement funds and other sources, and accounting for mandatory increases in spending to continue current programs, estimated at $281million by the Missouri Office of Administration, the total expected shortfall for Fiscal Year 2005 will be approximately $908 million dollars.[2]

In other words, without Legislative intervention to increase revenue, Missouri will be looking at cutting an additional $908 million dollars from its core programs in the coming year, making the total of Missouri budget core cuts rise to ***over $2 billion in just five years***. The table below describes the core reductions, cuts that have an ongoing impact, that have occurred so far. In addition, the Governor has withheld nearly $900 million in one time mid-year reductions that have frequently led to core reductions.

Table 1: Combined Impact of Budget Cuts for Fiscal Years 2001-2004[3]

	Core Reductions	**Percentage of GR Department Budget***
Social Services	$502.5 million	43%
Health	$29.1 million	45%
Mental Health	$75.2 million	14%
DESE	$140.2 million	5.8%
Higher Education	$152.1 million	15.83%
All Other Departments	$338.9 million	
TOTAL	$1,238,262,292	

* Based on the general revenue allocated in Fiscal Year 2001 per department, which was the base year of the onset of the fiscal crisis.

Nationally, the economy is beginning to show signs of economic recovery with Gross Domestic Product growing at a very strong 8.2% for the last quarter.[4] This should have a positive effect on the Missouri economy and the state revenues collected. How large a factor the economic growth will contribute to the State's fiscal recovery is the larger question. As this paper shows, a growing economy will not necessarily translate into an equal percentage of revenue growth.

Missouri's Economy Grows but Revenue Declines

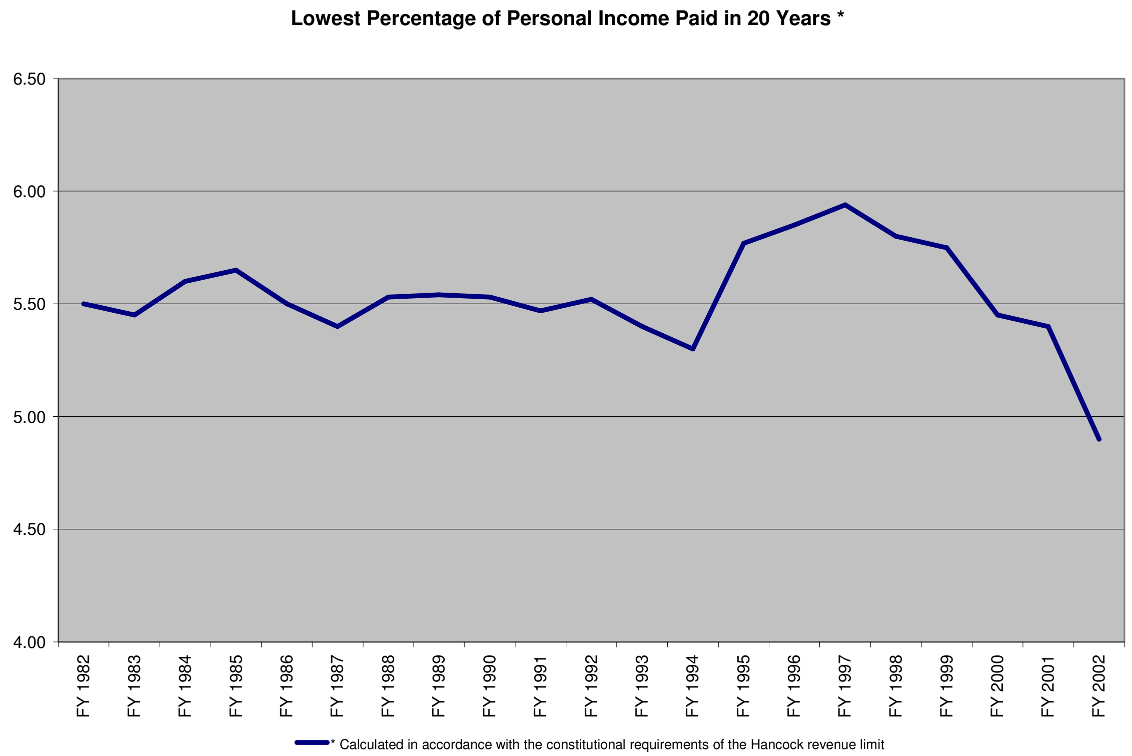
Clearly, the economic decline of the early 2000s had a dramatic impact on the state fiscal crisis. It was brought on in large part because of the September 11th tragedy and the unanticipated capital gains meltdown. However, even within the context of the national recession/economic decline Missouri remained a very productive state. Gross State Product and Personal Income, commonly used economic indicators, both

[1] Missouri Office of Administration, Missouri House and Senate Consensus Revenue Estimate.
[2] James R. Moody and Associates Legislative Newsletter January 9, 2004
[3] Amounts are net totals and were provided by the *Missouri Office of Administration.*
[4] Bureau of Economic Analysis, Gross Domestic Product Figures.

continued to be moderately strong. These indicators show that even with the economic slump, Missouri as a state continued to see growth in its economy, and overall income measures. Total state personal income averaged a 4.22% growth rate in the last five years[5]. Compared to other states Missouri ranked 29th nationwide in personal income.

Personal income growth and increases in general revenue collections generally coincide. However, Missouri's revenue collections during the same five year period demonstrate the opposite. Chart 1 below gives the historical overview of this. General Revenue as a percent of personal income was relatively stable until peaking in 1996 with the sizeable economic growth of the late 1990s, but then begins to fall 1997 and by 2002 reached a twenty-year low. This chart reflects the effect that the Hancock Amendment and recent Tax law changes have had, reducing the amount of personal income the State can collect as revenue.

Chart 1: Historic Review of General Revenue as Percent of Personal Income 1982-2002[6]



Tax Base Has Eroded

The imbalance between personal income growth and general revenue growth signals a structural erosion of Missouri's tax base. This imbalance is most significant when determining the causes of Missouri's fiscal crisis and what it will take for Missouri to climb out of it. In the past five years, a number of factors beyond the economic decline have contributed to the state fiscal crisis. These factors in Missouri include: the Hancock Amendment; state tax cuts of the 1990s; and the more recent federal tax reductions. All have converged to create an unprecedented revenue decline that went well beyond what the economic decline would have created. The following describes those changes and their impact on Missouri's revenue health.

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[5] According to figures from the Bureau of Economic Analysis

[6] Source: *Missouri Office of Administration.*

Implications of Missouri's Hancock Amendment

The Hancock Amendment to the Missouri Constitution passed in 1980 by a vote of the people and is a constitutional lid on the growth of state revenue. While in effect since 1980, Hancock was not actually "triggered" until 1995 when unordinary economic growth spurred large growth in state revenues throughout the country. From 1995-1999 the Hancock lid triggered the return of over $980 million dollars to corporate and individual income tax payers in Missouri.

State Tax Cuts

Most notably the extraordinary economic growth of the 1990s and the resulting Hancock refunds created an artificial confidence in the continued growth of state revenue. This prompted a series of state-based tax reductions. In the second half of the 1990s, Missouri passed 21 new tax credits all implemented in 1998 and beyond. The Legislature also passed 14 new state tax cuts between 1995 and 1999. The fiscal impact of these reductions was severe. The new tax credits cost the state $170 million annually, and the tax cuts cost more than $648.1 million annually, resulting in a combined loss of $818.1 million dollars in the first fiscal year of total implementation - fiscal year 2000. The amount of fiscal impact adjusts annually based on redemption factors and personal income changes, and is expected to equal $962.3 million this year and over $1 billion in 2007. The result being that **Missouri cut its general revenue by more than 11% annually, creating the erosion of the state tax base impacting Missouri today**.

Table 2: State Tax Cuts of the 1990s – *Amounts in Millions*

Year of Implementation	Tax Cut	Annual Cost When Passed[7]	Annual Cost Today	Annual Cost in 2007
1995	Disabled Circuit Breaker*	$2.3	$2.3	$2.3
1997	Sales Tax on Food	$197.4[8]	$259.5	$276.7
1997	Private Pensions*	$71.3	$71.3	$71.3
1997	Maternity and Domestic Violence Centers*	$.9	$.9	$.9
1997	Vending Machines*	$3	$3	$3
1998	Circuit Breaker Expanded*	$35.2	$35.2	$35.2
1998	Dependent Deduction	$66	$79.3	$86.8
1998	Manufacturing Sales Tax Cut*	$70	$70	$70
1999	Personal Exemption	$152.4	$220.8	$264.6
1999	Self-Employed Health Insurance	$6	$6.4	$6.6
1999	Corporate Franchise*	$32	$32	$32
1999	Pension Deduction*	$5.8	$5.8	$5.8
1999	Long Term Care Insurance*	$3	$3	$3
1999	Long Term Care of Elderly*	$2.8	$2.8	$2.8
	Total Annual Cost	**$648.1**	**$792.3**	**$861**
	Annual Cost Including Tax Cuts and Tax Credits	**$818.1**	**$962.3**	**$1,031.0[9]**

[7] Amount in the first full fiscal year of implementation.

* Items with an * indicate that data on current year cost and projections for 2007 were not readily available for this publication. For the purposes of this report, the base year of the tax reduction is used. This information will be updated as projections are made available.

[8] Cost Figures and projections for current year and future years are taken from the *2003 Tax Expenditure Report* prepared by the Economic and Policy Analysis Research Center, Columbia, MO.

[9] These figures are provided without a broader discussion of the economic impacts of their reaction with other changes. A number that takes into account all variables would be difficult to provide.

Additional Federal Tax Reductions Compound Decline

While the predominant factor in the erosion of the state tax base was the state tax cuts, the federal tax cuts of the last three years have compounded the revenue crisis significantly. Missouri, like most states, relies on the federally allowable adjusted gross income as the tax base for personal and corporate income taxes. Therefore, any reduction, or exemption allowed in federal adjusted gross income has causal impact on the Missouri tax base. The range of federal tax cuts passed in the last three years has had and will have an overwhelming effect on Missouri's revenue. Two of the tax changes have created a very significant reduction in the state tax base - Federal Estate Tax Changes costing the state $117 million in fiscal year 2005 and the Federal Accelerated Depreciation for Corporations costing the state $50 million in fiscal year 2005.[10]

Implications

We can attribute some reduction of state revenue to the national economic crisis, but the substantial cause of the ongoing fiscal crisis in Missouri is the state tax cuts of the 1990s combined with the continued structural inadequacy of the Missouri tax base. This can be demonstrated when comparing the expected growth in Missouri's general revenue as compared to last year. The consensus revenue estimate for fiscal year 2005 is $6.392 billion or about the same as the current year when transfers and one-time funds are taken into account.[11] In other words, the 8.2% economic growth in the last quarter has yet to translate into any measurable growth in the estimate for Missouri general revenue in FY 2005.

Missouri also pales in comparison to other states nationwide in terms of rebounding from the economic downturn. Thirty states have chosen to respond to the economic crisis by raising revenue through tax changes. Missouri did not, and as a result is one of only 18 states that are projecting a shortfall for the coming year.[12]

In other words, the structural inadequacy of Missouri's tax base will continue to create a barrier for the state in providing basic state services, including education and health care. Additionally, federal tax cuts and *increasing mandates*[13] will create further fiscal inadequacy. Attached to this report is the current list of "Revenue Raising Proposals" that are expected to be before the Missouri Legislature in the coming Legislative Session.

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[10] Information on the federal tax changes is taken from materials provided by the *Center on Budget and Policy Priorities,* www.cbpp.org

[11] General Revenue in FY 2004 was $7.181 billion, but $814.6 million was one-time funding. The actual General Revenue raised through tax sources would have been the difference or $6.357 billion.

[12] Information from the *Center on Budget & Policy Priorities*, www.cbpp.org

[13] While this paper does not address the increasing mandates from the federal government to states and localities, they do have a rather large fiscal impact. Included within some of the mandates are increased demands for homeland security and increased costs for the *No Child Left Behind* Act. To read more regarding this impact see *"Federal Policies Contribute to the Severity of the State Fiscal Crisis",* Iris Lav, Center on Budget & Policy Priorities, *http://www.cbpp.org/10-17-03sfp.htm*

Policy Options to Restore Fiscal Health

The discussion of the impact of state based tax cuts on the fiscal crisis in this paper should not be interpreted to support the reinstatement of those taxes. In fact, many of the tax credits and tax cuts were very beneficial for Missouri taxpayers and Missouri industries.[14] Rather, this paper is intended to increase understanding of the causes of the state fiscal crisis and that the overarching tax base has been eroded to the point that without intervention or extraordinary economic growth, Missouri's fiscal crisis is likely to continue and will result in the elimination or reduction of basic services for citizens. A more prudent solution would be to create a more sustainable tax base for Missouri's future.

There are many proposals for tax reform that will be before the Missouri Legislature in 2004. The following summarizes some of the proposals including:

- Utilize the Rainy Day Fund
- Decouple from Federal Tax Changes
- Corporate Tax Adjustments
- Cigarette and Tobacco Tax
- Alcohol Tax
- Gaming Taxes
- Sales Tax Adjustments
- Services Tax

Utilizing the State's Rainy Day Fund $250 million: Missouri is one of only a handful of states that has chosen not to dip into the state's rainy day fund during the budget crisis. While the Rainy Day Fund would do little to restore the sustainability of the tax structure, it is would result in some of the immediate need to stabilize the budget in the current year, something more substantial tax changes would not do.[15] The barrier for the legislature in using the Rainy Day Fund has been the repayment requirement. Missouri statute requires that the fund be repaid over a three-year period starting in the next fiscal year. This "pay-back" mechanism is only required in eight states and creates a very real barrier in utilization. A more sensible design for the Rainy Day Fund would be to require "pay-back" only when economic growth creates strong revenue growth.

Decoupling from the Federal Estate Tax and Accelerated Depreciation $167 million: Many states have chosen to decouple from the federal tax code on both the estate tax changes and the accelerated depreciation. Decoupling would allow the state to retain these taxes as it would have had in the pre-2001 federal tax code. Decoupling has the additional benefit of bringing relatively immediate fiscal relief in the fiscal year of passage. Missouri previously chose to decouple on the accelerated depreciation change for one year in 2002. This option has an additional advantage in that taxpayers who benefit from the federal tax cuts still maintain those tax reductions.

Corporate Tax Adjustments $46 million: Significant to the decline of general revenue has been a decline of corporate income tax paid to Missouri. Corporate taxes previously brought in about $500 million in general revenue at their peak, but have declined to $200 million in recent years.[16] The Governor and some Legislative Leaders have proposed adjusting "corporate tax loopholes" to ensure that more tax revenue is collected. Two

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[14] As noted in the 1/12/2004 report from the Missouri Legislative Joint Tax Policy Committee.
[15] Most significant tax alterations would require a vote of the people, delaying the potential fiscal impact they could have. The Rainy Day Fund could be used in the current year.
[16] January 16-22, 2004 Times Newspapers Online: *Legislature Looks to Overhaul State Tax System*, www.timesnewspapers.com/stories/20040116/taxsystem.html

proposals are closing the commonly referred to “Geoffrey Loophole” that currently allows corporations with national franchises to transfer profits to other states, thereby avoiding Missouri tax. Adjusting this could raise about $15 million annually. The second proposal is to adjust how non-Missouri source income is calculated. Currently, Missouri exempts corporate income from out of state investments including stocks from their tax base. An alteration to include this income in the tax assessment could raise $31 million annually.[17]

Increasing the Cigarette Tax, Senate Bill 839, estimated $250 million: Proposed by the Governor and Senator Wayne Goode, the current Bill before the Missouri Legislature would increase the Cigarette tax by forty cents per pack, and would increase the tobacco tax on other products to thirty three cents.

Increasing the Alcohol Tax, House Bill 901, $21-$45 million: Proposed by Representative Deeken, the current bill before the Missouri Legislature would increase the beer, wine and liquor taxes. The amount generated would range from $21 million in its first fiscal year of implementation to $45 million by fiscal year 2007. The revenue would be placed into an “Alcohol Tax Fund” and be used for “alcohol-specific problems”.

Taxes on Gaming, Senate Bill 707, $55 – $66 million: Proposed by the Governor and Senator Matthewson, the current Bill would repeal Missouri gambling loss limits for individuals and would add a 1% surcharge on a gaming boat's adjusted gross receipts (AGR) tax for boats with greater than $20 million AGR.

Increasing the General Sales Tax by 1%, $650 million: Increasing the sales tax on goods has been proposed in recent legislative sessions as a means to increase revenue.

Taxing Services, up to $888 million:* A changing landscape of the economy from a manufacturing base to a more service oriented base and purchasing of citizens through e-commerce and other venues, makes current Missouri sales tax law volatile. One means to increase the stability of the sales tax is to broaden the base of what is taxed, to incorporate more service industries. Missouri currently taxes 11 services including services such as pet grooming, marina services, and residential gas. A more comprehensive approach would make the sales tax a more adequate revenue source for the future; lessen the year to year volatility of the sales tax revenue.[18] **Missouri taxes 11 services already, the $888 million estimate is taken from the Center on Budget & Policy Priorities if Missouri were to tax all readily available services. Another useful number can be taken from the state’s Tax Expenditure Report. When opting out Medical Care and Education of services that are taxed, Missouri could expect to raise $335 million in fiscal year 2004.*

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[17] Governor’s Budget Proposal Fiscal Year 2004, http://www.oa.mo.gov/bp/execbudgetdocs.htm

[18] A caution is that the sales tax is regressive and would impact low income families more significantly. However expanding the taxation of services could actually make the sales tax more progressive, if services that are utilized by more people with wealth, and businesses are the targets of reform. One option is to tax a limited number of more luxury based services. A second option is to tax via a more comprehensive approach, and exempt certain categories of service that meet basic needs, including health care and child care. To reed more about this, see *Expanding Sales Taxation of Services: Options and Issues,* Michael Mazerov, Center on Budget & Policy Priorities: http://www.cbpp.org/3-24-03sfp.htm