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SHOULD MISSOURI ELIMINATE THE INDIVIDUAL INCOME TAX?

By R.W. Hafer

During the past several decades, economic growth in Missouri has stagnated. Missouri ranks 37th among U.S. states in gross state product (GSP) growth and 31st in personal income growth. The state fares almost as badly in new job creation. One possible reason for this decline is that the state's business landscape is not conducive to the kind of economic growth or job creation that other states enjoy. This view has prompted policymakers to adopt legislative policies in recent years that are designed to stimulate growth — such as instituting industry-specific tax credits or tax abatements, in hopes of attracting new businesses.

The general failure of these incentives has signaled the need for new approaches in promoting favorable business conditions in Missouri. That is, rather than making marginal changes to attract specific firms or industries, a much more effective approach would be to alter the tax structure in a way that would encourage a wide variety of

individuals and firms to relocate to the state, without diminishing government services. One way to do this would be to eliminate (or simplify) Missouri's income tax system, which imposes substantial costs on Missouri businesses and individuals.

Income Tax Complexity

Missouri hasn't always relied on an income tax to generate funding. For most of the state's history, government operations got along fine without it. During the past 90 years, however, the Missouri tax code has become increasingly complex. Starting in 1917 with a flat tax rate of 0.5 percent on incomes greater than \$3,000, Missouri's income tax has evolved into a complex structure that includes 10 separate income brackets — more than any other state in the nation — and a maze of credits, exemptions, and deductions that have made business compliance increasingly burdensome.

Economic theory suggests that

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income taxes — particularly complex ones, such as Missouri's — distort the labor market by raising nominal wages and spurring unemployment. Empirical studies have confirmed this theory, finding that states with low income taxes also tend to experience comparatively faster economic growth. For example, one academic study found that some states experienced relative reductions in the growth of their per capita incomes, after raising their income tax rates to higher levels than their neighbors. Also, economists have long calculated the additional business costs (such as hiring tax attorneys and accountants) that tax compliance imposes on society.

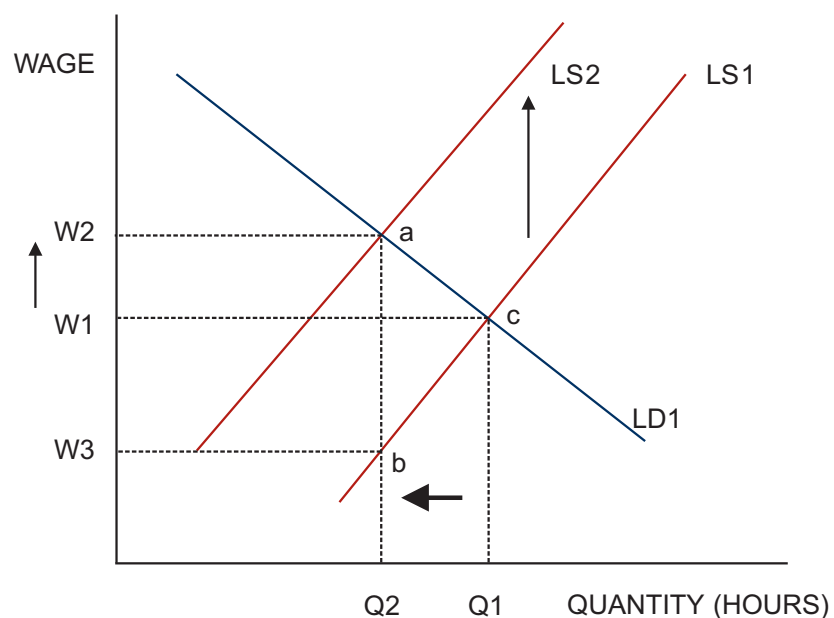
Because of the negative consequences that income taxes entail, policymakers are beginning to explore the possibility of reducing or eliminating Missouri's income tax system, replacing it with taxes that have fewer distortionary effects.

Principles of Taxation

When a tax is imposed on an activity, it generally has the effect of diminishing the amount of that activity. The same is true with a tax on income. The figure below shows how income taxes affect the labor market — and, by extension, the economy as a whole — by altering labor's supply and demand, and increasing wage costs.

In the figure, the vertical axis represents wages and the horizontal axis represents quantity of work, measured in hours. Firms determine their demand for labor based on worker productivity and the market demand for the workers' output. Because labor is an input to the production process, though, the cost of labor rises or falls as firms alter their labor usage. The downward-sloping labor demand curve (LD1) in the figure below demonstrates how the quantity of labor demanded decreases as the cost of that labor increases. In contrast, the labor

Effect of Income Tax on Labor Market



LS1: Labor supply curve with no income tax
LS2: Labor supply curve with income tax



supply curve (LS1) demonstrates that as wages increase, the number of laborers who are willing to work increases. In the absence of an income tax, the amount of labor supplied and the amount of labor demanded will reach the equilibrium “market-clearing” price at point c.

But to see how an income tax affects the labor market, compare the figure’s second labor supply curve (LS2) to the original supply curve (LS1). The income tax directly impacts an individual’s decision to trade between hours of leisure and hours spent working. This is because the income tax reduces the worker’s after-tax income for a given amount of labor. When the tax is imposed, the labor supply shifts upward to LS2, reflecting the higher wage that workers will require in order to keep their real wages (that is, their take-home pay after income taxes) the same as it was before the tax was imposed. Because the demand for labor hasn’t changed, however, this shift in the labor supply curve causes the market-clearing wage to increase from W1 to W2, moving the equilibrium point to a. So, this higher

wage leads to a reduction in the quantity of hours “purchased” by the firm (Q2), which reduces the economy’s production output.

This decrease in hours worked represents a significant cost to the economy. Firms, workers, and the economy as a whole would be better off at the non-tax, market-determined wage. An income tax creates an economic disincentive, causing workers to spend more time at leisure, and firms to hire fewer workers than they would have otherwise.

Alternative Sources of Tax Revenue

Theory and evidence both suggest that eliminating the income tax would be economically beneficial for Missouri. But what does the experience of other states demonstrate? Currently, there are seven states without individual income taxes: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. A comparison of tax collections as a percentage of revenue for Missouri, non-

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**Percent of Total Tax Collection by Tax Type
Missouri and Selected States (2005, per capita)**

STATE	PROPERTY	SALES	SELECTIVE SALES*	INDIVIDUAL INCOME	CORPORATE INCOME	LICENSE	OTHER
Alaska	2.3	---	10.7	---	31.7	5.4	49.9
Florida	0.9	56.2	19.0	---	5.3	5.6	13.1
Nevada	3.0	45.0	33.6	---	---	14.1	4.4
New Hampshire	19.4	---	34.9	3.3**	23.6	10.1	8.7
S. Dakota	---	56.0	25.4	---	4.4	13.5	0.7
Tennessee	---	61.1	15.3	1.6**	8.1	10.9	3.1
Texas	---	49.9	29.0	---	---	13.7	7.5
Washington	10.7	61.6	16.8	---	---	4.9	5.9
Wyoming	10.4	30.0	6.9	---	---	6.2	46.5
Average	7.8	51.4	21.3	2.4	14.6	9.4	15.5
Missouri	0.2	31.8	16.4	42.1	2.2	6.7	0.5
All other	1.6	29.0	13.9	40.4	6.5	6.1	2.5



**Replacing
income tax
revenue with
sales tax
revenue would
diminish the
negative effects
of income taxes.**



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income-tax states, and all other states is presented in the table on the previous page.

The table shows that for most of the states without an income tax, state tax revenue is largely derived from sales taxes. In Florida, Nevada, South Dakota, Texas, and Washington, for example, more than 50 percent of state revenues come from sales taxes (both general and selective). In contrast, Missouri relies on state sales taxes for only 34 percent of its general revenue, suggesting that if Missouri were to eliminate its individual income tax, sales taxes would likely increase. Furthermore, because property taxes in Missouri (as a percentage of revenue) are generally lower than the state average, they too might increase.

It is important to note, however, that although state sales taxes might increase, it is more likely that Missouri would extend its sales tax to additional goods rather than raising the tax rate itself. Missouri's state sales taxes are currently among the lowest in the nation, and are imposed on only half as many goods as in states without an income tax. Furthermore, Missouri's state spending per capita is lower than in most non-income-tax states, implying that a significant amount of the revenue that might be lost after eliminating the state income tax could be recovered simply by extending the number of purchased goods that are taxed, which means that government services would not have to decrease. Most importantly,

though, replacing income tax revenue with sales tax revenue would diminish the negative effects of income taxes and provide a more competitive environment for attracting new businesses to the state.

Conclusion

Missouri is not advancing economically as quickly as states that do not levy a personal income tax. In terms of income, jobs, output, and number of firms created, Missouri has tended to lag behind other states. While additional factors certainly contribute to this, evidence suggests that the presence or lack of a state income tax helps explain many of these observed differences.

States without personal income taxes rely more heavily on revenue from other sources, particularly state sales taxes, which have fewer negative economic effects. These states also, on average, continue to provide quality public goods, without a decrease in state or local spending. It is clear that altering or even eliminating Missouri's individual income tax could improve the state's economic condition.

The historical record is littered with the failures of governments in predicting future growth industries with any degree of accuracy. A far better approach would be to eliminate the state income tax, which would make the entire state of Missouri a more competitive and dynamic location for business expansion.

***For more details, please see Show-Me
Policy Study no. 11, which is available at
www.showmeinstitute.org.***