SHOW-ME INSTITUTE

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REPEALING THE STATE INCOME TAX BY 2020

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Missouri's economy has steadily fallen behind the rest of the nation in recent decades. In 1970, per capita income in Missouri lagged behind the nation by about 5.5 percent. The gap has grown to about 7.5 percent today. The average Missourian takes home a substantially smaller paycheck than the average American worker.

There are other signs that Missouri's economy is underperforming the rest of the nation. Job creation has been more robust in the rest of the nation than in Missouri: in 1970, 2.4 percent of all jobs in the United States were located in Missouri. Today, it has slipped to just 2.1 percent. Migration statistics tell the same story: the Missouri side of the Saint Louis metropolitan area lost 15,629 people to other states between 2000 and 2004, while the Illinois side of the metropolitan area gained 3,073 people. The Missouri side of the Kansas City metropolitan area gained only 733 new residents, compared with 13,121 new residents on the Kansas City side. Jobs, investment, and residents are all fleeing to states with more dynamic economies.

Taxes and Growth

The causes of economic growth are complex, but there is widespread agreement among economists that high taxes are a serious impediment to economic growth. Economists have done numerous studies demonstrating that high taxes discourage hard work and investment and retard economic growth. For example, in a 2004 study, Nobel prize-winning economist Edward Prescott found that high marginal tax rates cause European workers to work fewer hours. The same harmful effects can be observed here in the United States. Between 1957 and 1997, real personal income almost quintupled in the 10 states with the lowest average state and local tax burdens, while it less than tripled in the ten states with the highest burdens.

Missouri vs. the Nation: Total Income and Its Growth, 1995-2005

	TOTAL INCOME, 2005	PERCENT GROWTH, 1995-2005
Missouri	216	23.75
United States	12,403	34.33
BORDER STATES		
Arkansas	87	28.86
Illinois	560	22.67
Iowa	114	25.20
Kansas	105	30.39
Kentucky	140	22.78
Nebraska	70	24.36
Oklahoma	121	37.09
Tennessee	227	32.12
STATES WITH NO INCOME TAX		
Florida	674	56.64
Nevada	111	74.20
New Hampshire	56	32.82
South Dakota	31	37.42
Tennessee	227	32.12
Texas	982	53.21
Washington	269	36.92
Wyoming	27	45.28

Total income is in billions of current dollars.
Growth is adjusted for inflation.

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High marginal income tax rates are particularly pernicious because they target labor and investment, both of which are highly mobile resources. These effects can be seen most clearly if we examine the nine states without an income tax. During the 1990s, nearly 2.9 million Americans moved out of the 41 states with an income tax and into the 9 states without an income tax. The favorable tax climate has fueled blistering economic growth. Between 1995 and 2005, Nevada saw its total real income grow by 74 percent. Florida and Texas saw their incomes grow in excess of 50 percent. During that same period, income for the nation as a whole grew by 34 percent, and Missouri saw only 24 percent income growth. Every single one of the states with no income tax enjoyed faster economic growth than Missouri.

Comparing Missouri's Tax System to the Competition

Missouri's tax system can best be described as average. Figures from the non-partisan Tax Foundation show that state and local government in Missouri consumes 9.9 percent of personal income in the state, which puts it slightly below the national average of 10.6 percent. Most of the states neighboring Missouri are in a similar position; six of the eight states have tax burdens between 9.6 percent (Oklahoma) and 10.9 percent (Illinois). The two outliers are Nebraska, which labors under a 11.6 percent tax burden, and Tennessee, which has a tax burden of only 8.7 percent of personal income.

Growth statistics confirm the predictions of economic theory: the only two neighboring states with lower tax burdens than Missouri—Tennessee and Oklahoma—are also Missouri's fastest-growing neighbors. Between 1995 and 2005, when real personal income grew by only 24 percent in Missouri, Tennessee enjoyed growth of 32 percent, and Oklahoma enjoyed 37 percent growth. At the opposite extreme, the two highest-tax states in Missouri's back yard, Illinois and Nebraska, have been stuck in the same economic doldrums as Missouri with 23 and 24 percent growth, respectively.

Various organizations have released reports ranking the tax systems of the 50 states, and they tell a similar story: Missouri's tax system is only average. According to the Tax Foundation's 2007 Business Tax Climate index, Missouri has a better business tax climate than any of its neighbors. However, its ranking of #15 hardly puts it at the head of the class nationally, and it only narrowly beats neighboring Tennessee (#18) and Oklahoma (#21). Bloomberg Wealth Manager magazine produces a "wealth friendliness" ranking that examines how the tax system affects high-net-worth individuals. That index ranks Missouri at #30, about average among its neighbors and below average nationwide. Finally, the Small Business Survival Committee ranks Missouri #18, behind Arkansas and Tennessee and slightly above average nationwide. There is plenty of room for improvement in Missouri's tax system.

A Roadmap for Income Tax Elimination

We offer a plan that will allow Missouri to become the tenth state in the Union without an income tax. We calculate that the income tax can be phased out in 14 years without reducing real per-capita spending.

Our plan takes advantage of the fact that even with constant tax rates, government revenues tend to grow faster than population and inflation. For example, if spending growth had been capped at the rate of population growth plus inflation in 1991, government spending in fiscal year 2004 would have been $12.8 billion. Instead, spending has ballooned to $22.0 billion dollars during that period. The difference—$9.2 billion—would have been available to finance tax cuts. Indeed, with income taxes bringing in only $3.9 billion in 2004, there would have been more than enough room in the

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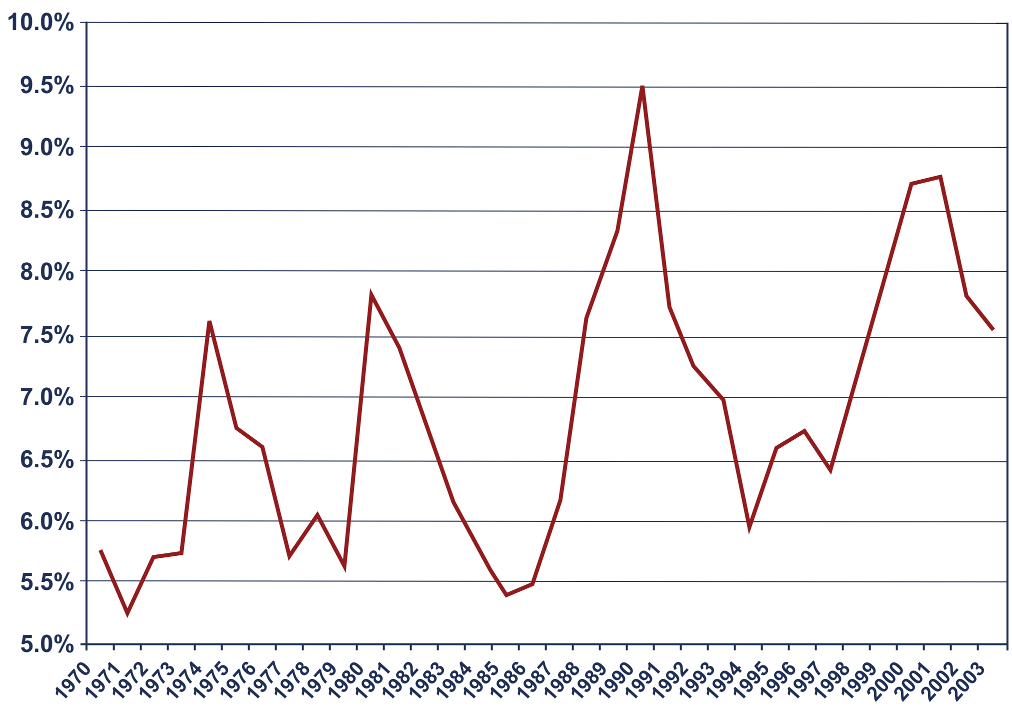
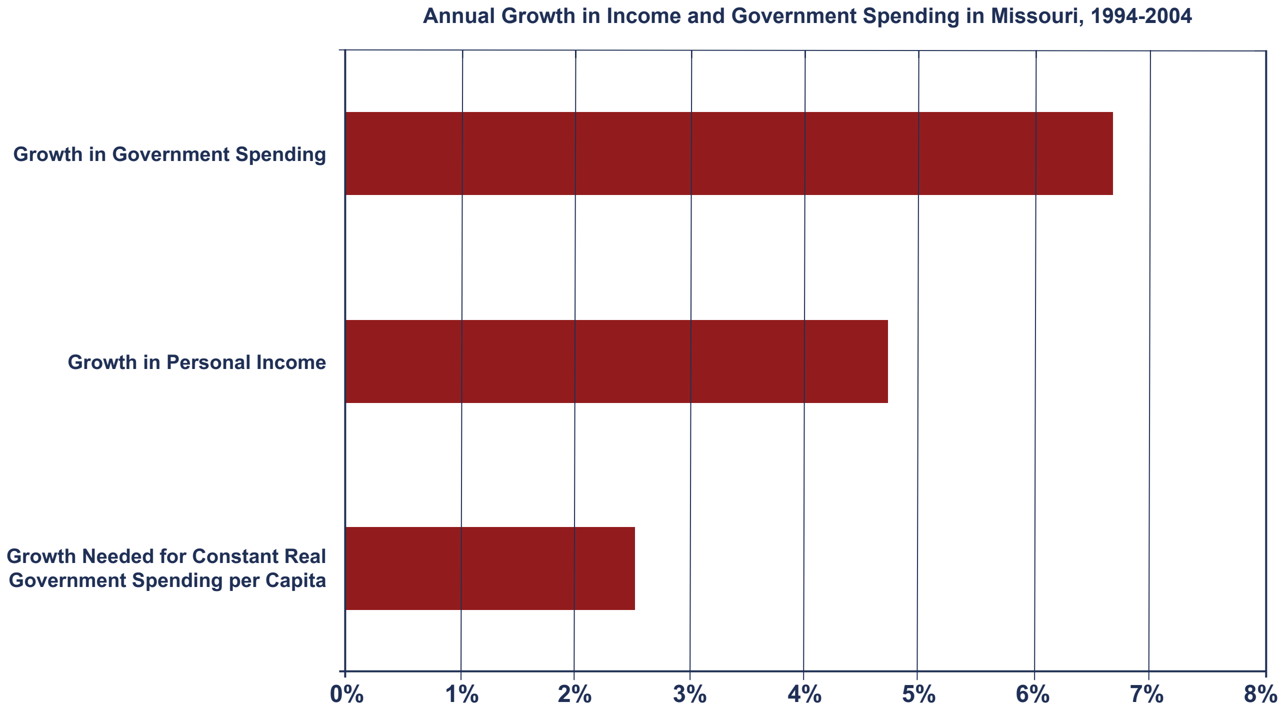
Missouri Growth Deficit, 1970-2003
1-(MO Per Cap Pers Inc/US Per Cap Pers Inc)





budget to eliminate the income tax without cutting spending.

Under our plan, Missouri would enact two constitutional amendments. The first would be a Tax and Expenditure Limitation (TEL) that would limit government spending to the rate of growth of population plus inflation. The second would mandate annual cuts in income tax rates that would bring tax rates down to zero in 14 years and prohibit the taxation of income thereafter. The simplest plan would be to implement a six percent flat tax in the first year, and then to reduce the rate by 0.43 percentage points each year.

Conclusion

The announcement that Missouri residents will enjoy steadily falling income tax rates is likely to set off an economic boom in the state. The promise of no income tax in 14 years would give Missouri a distinct advantage over most of its neighbors. Businesses considering relocation would have a good reason to give the state a second look.

The nation is currently in the midst of a robust economic expansion, giving Missouri a golden opportunity to join the nine states that currently have no income tax. All nine of those states have had healthier economic growth over the last decade, suggesting that eliminating the income tax would give Missouri's economy a much-needed shot in the arm.

For more details, please see Show-Me Policy Study no. 4, which is available at www.showmeinstitute.org.

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