TESTIMONY

January 16, 2014

MISSOURI'S TAXING ENVIRONMENT: SOME IDEAS FOR REFORM

By Michael Rathbone

Testimony Before The Missouri Senate Ways and Means Committee

To the Honorable Members of This Committee:

My name is Michael Rathbone and I am a policy researcher for the Show-Me Institute, a nonprofit, nonpartisan Missouri-based think tank that supports free-market solutions for state and local policy. The ideas presented here are my own. This testimony is intended to provide a framework for understanding how tax structure fits into the economic development landscape, both in theory and in practice. The focus of this testimony is on income taxes in Missouri.

Where We Stand Now

Missouri is not doing well economically and has fallen behind its sister states in economic growth. As noted in our policy paper, "Cutting the Ties That Bind: End Missouri's Corporate Income Tax," Missouri's economic performance is in the bottom tier nationally.[1]

Over the past 16 years, Missouri has slipped behind the rest of the country in economic growth. Tables 1, 2, and 3 show Missouri's economic performance compared to other states in the nation.[2]

What Policymakers Need to Understand About Taxes and Tax Structure

While a state's tax policy is not the sole determinant of a state (or a nation's) economic performance, it can and does affect economic performance. Taxes affect the decisions that people make about spending and investing their money. In addition, tax rates affect where people work and employ their capital. The factors of production — the sources of income — are mobile. Once that is recognized, it

Over the past 16 years, Missouri has slipped behind the rest of the country in economic growth.

Michael Rathbone is a policy researcher at the Show-Me Institute, which promotes market solutions for Missouri public policy.

TABLE 1: REAL GDP

Area	1997 Index	2012 Index
North Dakota	100	146.30
Oregon	100	134.40
Idaho	100	120.72
Arizona	100	119.64
Utah	100	119.26
South Dakota	100	118.12
Texas	100	117.90
Nevada	100	112.92
Colorado	100	111.88
Virginia	100	109.94
Wyoming	100	109.31
Maryland	100	108.23
California	100	107.97
North Carolina	100	106.79
Washington	100	106.63
New Hampshire	100	103.78
Florida	100	103.21
Minnesota	100	103.10
Massachusetts	100	102.13
District of Columbia	100	101.95
Montana	100	101.80
Vermont	100	101.42
Nebraska	100	101.25
Oklahoma	100	100.14
New York	100	99.25
Iowa	100	98.41
Delaware	100	98.19
Kansas	100	98.02
Georgia	100	97.67
New Mexico	100	97.44
Tennessee	100	97.04
Arkansas	100	96.31
Indiana	100	94.52
Alabama	100	94.19
South Carolina	100	94.10
Hawaii	100	93.83
Rhode Island	100	93.15
Wisconsin	100	92.01
Maine	100	90.65
New Jersey	100	90.03
Pennsylvania	100	90.02
Illinois	100	89.35
Mississippi	100	88.80
Connecticut	100	88.23
Alaska	100	88.13
Louisiana	100	88.03
West Virginia	100	87.32
Kentucky	100	86.99
Missouri	100	85.64
Ohio	100	80.44
Michigan	100	74.67

TABLE 2: REAL GDP PER CAPITA

Area	1997 Index	2012 Index
North Dakota	100	156.43
Oregon	100	131.13
South Dakota	100	121.46
Vermont	100	111.41
Massachusetts	100	110.16
Maryland	100	109.21
New York	100	108.94
New Hampshire	100	107.61
Idaho	100	107.01
Wyoming	100	106.86
Iowa	100	106.56
California	100	106.16
Nebraska	100	105.95
Virginia	100	105.60
District of Columbia	100	105.39
Minnesota	100	105.12
Rhode Island	100	104.71
Montana	100	103.77
Kansas	100	103.06
Texas	100	102.83
Oklahoma	100	101.95
Utah	100	101.94
Washington	100	101.02
Colorado	100	99.78
Arizona	100	99.57
Pennsylvania	100	99.29
Indiana	100	99.14
West Virginia	100	98.57
Maine	100	98.53
Alabama	100	98.23
Arkansas	100	97.79
Wisconsin	100	97.42
Louisiana	100	97.37
Illinois	100	97.36
North Carolina	100	96.54
New Jersey	100	96.11
New Mexico	100	95.48
Tennessee	100	95.17
Mississippi	100	95.12
Connecticut	100	94.76
Hawaii	100	94.01
Florida	100	93.42
Delaware	100	92.64
Ohio	100	90.47
Kentucky	100	90.38
Missouri	100	89.74
South Carolina	100	88.53
Georgia	100	87.12
Michigan	100	85.32
Alaska	100	85.03
Nevada	100	83.13

TABLE 3: NON-FARM EMPLOYMENT

Area	1997 Index	2012 Index
North Dakota	100	127.07
Nevada	100	117.73
Wyoming	100	117.40
Texas	100	116.16
Utah	100	116.03
Alaska	100	114.95
Idaho	100	113.31
Arizona	100	112.87
Montana	100	110.59
District of Columbia	100	109.91
South Dakota	100	108.01
Colorado	100	106.77
Hawaii	100	106.52
Florida	100	105.89
Virginia	100	105.81
Oklahoma	100	104.34
Maryland	100	104.04
New Mexico	100	103.89
Washington	100	103.81
Nebraska	100	102.50
New Hampshire	100	101.44
California	100	100.77
North Carolina	100	100.61
New York	100	100.20
Minnesota	100	100.17
Vermont	100	99.90
Georgia	100	99.33
West Virginia	100	99.19
South Carolina	100	99.08
Delaware	100	98.55
Iowa	100	98.31
Kentucky	100	98.18
Kansas	100	97.90
Arkansas	100	97.76
Oregon	100	97.70
Maine	100	97.61
Pennsylvania	100	97.10
Tennessee	100	96.99
Massachusetts	100	96.69
New Jersey	100	96.48
Wisconsin	100	95.98
Louisiana	100	95.79
Rhode Island	100	94.61
Indiana	100	93.82
Connecticut	100	93.25
Missouri	100	93.21
Alabama	100	92.54
Illinois	100	91.44
Mississippi	100	90.91
Ohio	100	87.96
Michigan	100	83.31

is easier to understand how tax rates affect economic growth.

Taxes on capital are considered to be among the most economically harmful.[3] People's savings fund projects all over the country — indeed, all over the world — because loans can cross political boundaries with electronic ease. Taxes on capital pose a problem for governments because capital is so movable. For a given return to a project, the after-tax return is highest wherever the tax rate is the lowest. Accordingly, if a company or a person wants to avoid being taxed on income, typically they just need to move the capital out of the taxing jurisdiction.[4]

More to the point, evidence suggests that the structure of taxes highly affects economic growth. In a study conducted for the Organisation for Economic Co-operation and Development, Jens Arnold assessed what the best and worst tax structures are for national growth.[5] He found that (emphasis added):

> . . . [a] stronger reliance on income taxes seems to be associated with significantly lower levels of GDP per capita than the use of taxes on consumption and property. Within income taxes, those on corporate income seem to be associated with lower levels of GDP per capita than personal income taxes. In fact, **corporate income taxes appear to be the least attractive choice from the perspective of raising GDP per capita.**

Arnold's conclusions about income taxes are not isolated to trans-national circumstances. In an analysis of Missouri's tax structure, Show-Me Institute Chief Economist Joseph Haslag found that a land tax would cause less economic harm than income taxes, and among income taxes, income taxes on capital are the most harmful.[6] Haslag also found that if the state replaced its income tax with a revenue neutral sales tax, it would realize faster economic growth.[7]

What Other States Are Doing Consistent With These Conclusions

While Missouri officials contemplate the state's economic future, Missouri's neighbors are pro-actively taking steps aimed at promoting economic growth. In 2012, Nebraska passed a modest tax cut.[8] In 2013, Nebraska cut taxes further, including elimination of its Alternative Minimum Tax.[9] Arkansas also passed a law in 2013 that would lower income tax rates starting in 2014.[10]

Kansas' recent reforms may pose the immediate threat to Missouri. In 2013, Kansas reduced its top individual income tax rate to 4.9 percent, which is nearly 20 percent below Missouri's top rate of 6 percent. In 2014, Kansas' income tax rates will decrease even more.[11] Perhaps more importantly, Kansas *completely eliminated* its tax on the non-wage income of businesses organized as limited liability companies, S-corporations, and sole proprietorships. Sometimes referred

While a state's tax policy is not the sole determinant of a state (or a nation's) economic performance, it can and does affect economic performance.

to as "pass-through entities," these companies often are small businesses whose incomes are taxed at the individual level rather than at the company level.

Kansas' tax move is a radical departure from what has grown into a political and policy norm that treats taxes on business income as a significant component in American governments' budgets. However, we know this about businesses and their capital: (1) business location decisions depend on after-tax rates of return, the level of valued government services (including infrastructure), and other business considerations; (2) Kansas has raised the after-tax rate of return for income that passes through businesses organized as LLCs, S-Corps, and the like; and, (3) as it stands today, Kansas' expenditures on state services will see a decline, although the cuts to services may not necessarily constitute "valued" services for business location decision-making.[12]

It is not true that Missouri's income taxes are among the lowest in the country.

Why Missouri Cannot Sit Idly By

The stakes could not be higher for Missouri. In a previous publication, Haslag and Show-Me Institute economist Michael Podgursky estimated that more than $3 billion worth of annual Missouri LLC income sits along Missouri's 11-county western border, and those businesses likely are paying attention to Kansas' tax reforms and considering the costs and benefits of moving across the border.[13] If the value of Kansas' tax cuts is larger than the value of services lost, then Missouri is at risk of losing millions, if not billions, of dollars in economic activity to its Jayhawk neighbors.

Is Missouri Already a Low-Tax State?

In his veto letter of Missouri House Bill 253, Missouri Gov. Jay Nixon claimed that Missouri is a low-tax state.[14] However, the governor is measuring overall tax burden. It is not true that Missouri's *income* taxes are among the lowest in the country. As of 2013, Missouri had the 21st-highest income tax rates in the country.[15] Of its neighbors, Missouri ranks fourth out of nine states.

These rankings do not take into account the effects of earnings taxes, which are present in Missouri's two largest cities, further worsening Missouri's position relative to other states.

Moving Missouri Forward

I co-authored a paper about eliminating the corporate income tax strictly through the elimination of economic development tax credits.[16] Using data from fiscal year 2012, the paper showed that even if tax credit issuances were matched dollar-for-dollar with the lost corporate income tax revenue, there *still* would be tax credits remaining for some current tax credit programs. Based on data from fiscal year 2013, reducing economic development tax credits dollar-for-dollar with lost corporate

income tax revenue would result in only a slight reduction in state net general revenue.

A subsequent paper analyzed the economic benefits that Missouri might realize if it eliminates the tax on pass-through entities.[17] If the state prefers to eliminate the tax on pass-through entities instead of the corporate income tax, it can negate **some** of the lost revenue by eliminating the issuance of economic development tax credits.

While political considerations may favor such preferential taxing schemes, a more sound public policy would be to treat business income the same through the tax code, whether those businesses are organized as S-corporations, C-corporations, or otherwise.

Tax reforms for pass-through entities and C-corporations may appear daunting when taken alone, However, by combining the proposal to eliminate taxation on pass-through income and C-corporations with reform of tax credits, the gap for achieving revenue neutrality while eliminating the taxes would be narrowed considerably — and considerably more defensible from the growth and policy viewpoints. With additional broadening of the tax base, the revenue impact of these cuts would be even smaller.

Conclusion

Intransigence on fundamental tax reform is not an attractive option for Missouri, especially as other states start taking these tax structure lessons to heart and overhaul their tax systems. Missouri cannot afford to continue supporting an economic development status quo. Other states are reforming their taxes to promote growth. Will Missouri?

If the state prefers to eliminate the tax on pass-through entities instead of the corporate income tax, it can negate some of the lost revenue by eliminating the issuance of economic development tax credits.

NOTES

[1] Ishmael, Patrick, and Michael Rathbone. "Cutting the Ties That Bind: End Missouri's Corporate Income Tax." Show-Me Institute Essay. October 2012. View online here: http://showmeinstitute.org/publications/essay/taxes/864-end-corp-income-tax.html.

[2] These numbers are updated from what was published in a previous Show-Me Institute publication. For more on how we determined these values, see: Ishmael, Patrick, and Michael Rathbone. "Passing through Missouri: Left Behind on Taxes?" Show-Me Institute Essay. Feb. 8, 2013. View online here: http://showmeinstitute.org/publications/essay/taxes/902-passing-through.html.

[3] Arnold, Jens. "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence From a Panel of OECD Countries." Organisation for Economic Co-operation and Development, Economics Department Working Papers No. 643. Oct. 9, 2008. Also: McBride, William. "What is the evidence on taxes and growth?" Tax Foundation. View online here: http://taxfoundation. org/article/what-evidence-taxes-and-growth. Dec. 18, 2012. Retrieved Jan. 23, 2013.

[4] As with most general statements, there will be exceptions. Here, we would note that individuals are taxed by residence and corporations can be taxed by domicile, and that in practice, the ease of avoiding income taxes through the movement of capital will be affected by the facts of the given case.

[5] Arnold, Jens. "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence From a Panel of OECD Countries." Organisation for Economic Co-operation and Development, Economics Department Working Papers No. 643. Oct. 9, 2008.

[6] Haslag, Joseph H., and Haleigh Albers. "What Makes a Good Tax Structure?" Show-Me Institute Essay. October 2013. View online here: http://showmeinstitute.org/publications/essay/taxes/1042-what-makes-a-good-tax-structure.html.

[7] Casteel, Grant, and Joseph Haslag. "Income Taxes vs. Sales Taxes: A Welfare Comparison." Show-Me Institute Essay. December 2010.

[8] Schulte, Grant. "Nebraska governor signs tax cuts into law." Associated Press. April 11, 2012. View online here: http://news.yahoo.com/nebraska-governor-signs-tax-cuts-law-192039852.html.

[9] Schulte, Grant. "Governor signs 3 Neb. tax cut measures into law." Associated Press. June 4, 2013.

[10] Hickey, Chris. "New Arkansas Laws Taking Effect in 2014." UALR Public Radio. Jan. 1, 2014. View online here: http://ualrpublicradio.org/post/new-arkansas-laws-taking-effect-2014.

[11] Kraske, Steve, and Zach Murdock. "Brownback signs Kansas tax cut measure." *Kansas City Star*. June 13, 2013. View online here: http://www.kansascity.com/2013/06/13/4290891/brownback-signs-tax-bill.html.

[12] Anderson, Steve. "Questionable Benchmarks Betray Real Facts." Kansas Policy Institute blog post. Dec. 9, 2013. View online here: http://kansaspolicy.org/KPIBlog/113122.aspx.

[13] Haslag, Joseph, and Michael Podgursky. "More Bad News for Missouri Competiveness." Show-Me Institute. View online here: http://www.showmeinstitute. org/publications/commentary/ taxes/809-more-bad-news.html.

[14] Nixon, Jeremiah "Jay" W. "Veto of Senate Substitute for House Bill No. 253." Governor of Missouri. June 5, 2013. View online here: http://governor.mo.gov/newsroom/pdf/2013/HB253veto.pdf.

[15] The Tax Foundation. "State Individual Income Tax Rates 2000-2013." April 1,2013.

[16] Ishmael, Patrick, and Michael Rathbone. "Cutting the Ties That Bind: End Missouri's Corporate Income Tax." Show-Me Institute Essay. October 2012. View online here: http://showmeinstitute.org/publications/essay/taxes/864-end-corp-income-tax.html.

[17] Ishmael, Patrick, and Michael Rathbone. "Passing Through Missouri: Left Behind on Taxes?" Show-Me Institute Essay. Feb. 8, 2013. View online here: http://showmeinstitute.org/publications/essay/taxes/902-passing-through.html.

PERSONAL NOTES

4512 West Pine Blvd. I Saint Louis, MO 63108 I 314-454-0647 I www.showmeinstitute.org

View State Government Spending: showmeliving.org
Read Our Blog: showmedaily.org
Use Our Interactive Database: showmedata.org
Find Us on Facebook: facebook.com/showmeinstitute
Follow Us on Twitter: twitter.com/showme