PUBLIC POLICY RESEARCH CENTER

Policy Brief 15

The Missouri structural budget crisis

February 2006

By: **Mark Tranel, Ph.D.**
Director, Public Policy Research Center, University of Missouri -- St. Louis

Missouri's capacity to fund services is chronically out of balance, because the revenue system has not been modified in what it taxes and how it taxes

Public Policy Research Center
One University Boulevard, 362 SSB
St. Louis, Missouri 63121-4499

(314) 516.5273 TEL
(314) 516.5268 FAX

pprc@umsl.edu EMAIL
http://pprc.umsl.edu WEB

In the debates about the current state of the Missouri budget, the structural deficits caused by an out-of-date revenue system are often overlooked. As the economy cycles up and down and various services are prioritized either for additional funding or for cuts, attention is drawn to the budget crisis of the moment. Missouri's capacity to fund services is, however, chronically out of balance because the revenue system has not been modified for decades in what it taxes and how it taxes.

While Missouri is not unique in having an antiquated revenue system, it is distinctive in being one of the states most at risk for a widening gap between revenue and expenditures due to its out-moded system.[1]

There are four structural issues causing the revenue deficiency in Missouri:

1. failure to adapt the revenue system to the change in consumer spending
2. failure to adapt the revenue system to the expansion of electronic retail sales
3. failure to change the dependency of the State revenue system on standards in the federal revenue system
4. the erosion of corporate tax collections

<u>Changing Consumer Spending</u>

Over the past thirty years, there has been a dramatic change in how people spend their money. Spending on services (e.g. medical care, internet and cell phone, utilities) has increased from 44 to 59 percent of all consumption, while spending on nondurable goods (e.g. clothing, food) has declined from 42 to 29 percent of consumption.

Because the revenue system was established at a time when people spent more on goods than on services, and because the system has not been adjusted to the change in consumer spending, Missouri fails to collect approximately $800 million a year.

The sales tax produces about 28 percent of Missouri's revenue.[2] In 1990 the sales tax applied to just over 53 percent of all sales. By 2003 the sales tax applied to only 40 percent of all sales. At present Missouri taxes only 11 out of 40 household services, compared to Arkansas' 22, Iowa's 27, Nebraska's 20, and Tennessee's 27.

As consumers continue to shift their spending habits more to services rather than goods, Missouri will continue to fail to capture revenue from a significant portion of economic activity. By taxing

[1] Lav, Iris J., Elizabeth McNichol, and Robert Zahradnik. 2005. *Faulty Foundations: State Structural Budget Problems and How to Fix Them*, Washington, D.C.: Center on Budget and Policy Priorities.
[2] http://www.oa.mo.gov/bp/budg2006/GR_Budget_Pies.pdf

services that are readily adaptable to sales tax-type reporting and collections, Missouri could realize an additional $888 million.

Spending on Services -- medical care, internet, utilities -- has increased from 44 to 59 percent of all consumption, while spending on nondurable goods -- clothing, food -- has declined from 42 to 29 percent

Electronic Retail Sales

In addition to *what* people buy, there has been a significant change in *how* they buy. When people purchase goods, everything from clothing to electronics to golf clubs, electronically rather than from a Missouri merchant, they avoid paying sales tax.

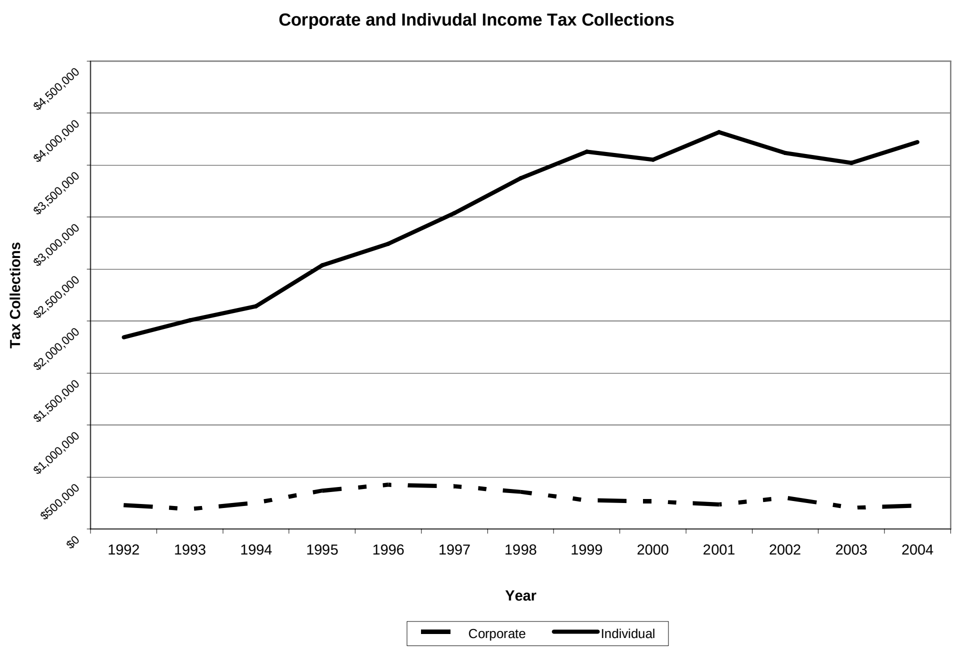
It has been estimated that within the next few years this change in consumer behavior will cost Missouri over 3 percent of its revenue collections, approximately $300 million.[3]

Federal Cuts

Missouri's estate tax credit was established as equivalent to the federal credit rate. When the federal tax credit was phased out between 2002 and 2005, the Missouri estate tax was defacto eliminated. This is an example of how a number of Missouri revenue sources are 'coupled' to federal revenue sources. The process of not making state revenue dependant on federal standards is called 'decoupling.'

The fact that the State has taken no action to decouple from the federal tax code on the estate tax changes, as well as accelerated depreciation, artificially depresses Missouri revenue by about $167 million.

Figure 1



Corporate Tax Erosion

In 1993 net income taxes paid by approximately 67,000 Missouri corporations contributed $229 million dollars in state revenue. Twelve years later, in 2004, corporate net income taxes contributed $224 million in state revenue. Over that same time period individual income taxes more than doubled in their contribution to state revenue, from $1,844,044 million to $3,720,749. If corporate tax contributions kept pace with individual contributions, Missouri would receive about $250 million in additional revenue.

[3] Bruce, Donald and William F. Fox. 2001. "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," http://cber.bus.utk.edu/ecomm/ecom0901.pdf

As show in Figure 1, corporate net income tax collections have been held constant for more than a decade while individual income tax collection have steadily risen. This is in part due to a national trend of corporations using a variety of techniques to shelter income, exempting it from tax liability. There are several Missouri tax policies that also contribute to the disparity between corporate and individual income tax collections. For example, Missouri corporations deduct 50 percent of their federal tax payment in the process of computing taxable income. And a number of loopholes have been created granting specific companies or types of industry deductions or exemptions.

<u>The Fiscal Impact</u>

The Missouri structural deficit from these four items is approximately $1.6 billion.

Unless action is taken to counter the trends that have lead to these structural disparities Missouri will face even greater revenue losses in the future. In budget discussions, attention often is limited either to not raising tax rates or to the unmet need for state services, and the structural issues receive little consideration. Appropriate action in these four areas can produce needed revenue without imposing new taxes or raising the rates of existing taxes.