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Show-Me Institute

Advancing liberty with responsibility by promoting market solutions for Missouri public policy

Why a Sales Tax Is Better for Missouri Than an Income Tax

By Rex Sinquefield and Jack Naudi

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By most measures, Missouri is not a high-tax state. Its property and corporate tax rates are among the lowest in the country. It doesn't have an inheritance tax. In a study for the American Legislative Exchange Council (ALEC), economist Arthur Laffer, financial journalist Stephen Moore, and Jonathan Williams, director of ALEC's Tax and Fiscal Policy Task Force, rank Missouri's economic outlook at 23rd among states.[1]

But all isn't well. Missouri's economic development and growth rates are chronically below average. During the past 10 years, employment has grown 8.8 percent nationally, while Missouri has boosted jobs by only 6 percent. In their study, Laffer, Moore, and Williams provide one explanation for the state's lagging performance: Missouri's personal income tax rates. The highest rate of 7 percent, which includes the state's top marginal rate of 6 percent plus a

Show-Me State Warning Signs

- National 10-year growth rate, 8.8 percent
- Missouri 10-year growth rate, 6 percent
- 7-percent income tax (in St. Louis and Kansas City), 32nd highest in nation
- Kansas portion of Kansas City and Illinois portion of St. Louis growing faster than respective Missouri portions

Sources: Arthur Laffer and Stephen Moore, "Rich States, Poor States," American Legislative Economic Council, 2009; and: Richard Vedder and Stephen Moore, "Repealing the State Income Tax by 2020," Show-Me Institute, Dec. 11, 2006.

Taxes matter because they affect behavior, often in detrimental ways. Studies have found that older people flock to states without an inheritance tax, and that high capital gains taxes reduce investment rates.

1-percent earnings tax imposed in Kansas City and Saint Louis, places the Show-Me State at 32nd nationally.[2]

For comparison, look at the nine states without an income tax: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. We're impressed with the body of evidence showing that those nine states have grown faster than states with income taxes. From 2000 to 2004, nearly 1.3 million Americans moved out of the 41 states with income taxes and into the states without them.[3] From December 1998 to December 2008, the nine no-income-tax states added more than 3.2 million non-farm jobs, a 13.8-percent increase that is more than double the national job growth rate. Only two of the no-income-tax states did not exceed the national job growth rate.[4]

We don't naively believe that growth in those nine states can be attributed exclusively to their lack of income taxes, but it is likely one crucial factor. We're also not arguing that Missouri is in dire straits. But we are convinced that in order for Missouri to catch the next wave of growth and business expansion, it needs to take a hard look at the no-income-tax models. Studies suggest that income tax rates are a factor in business growth and location.[5][6] And Missouri has a further reason for shedding the income tax: Its two large urban centers border other states. A study for the Show-Me Institute concluded that the non-Missouri portions of the Saint Louis and Kansas City metro regions are growing faster than the Missouri sections.[7] That's not surprising. Faced with a choice, businesses and individuals will follow their financial interests.

Why Not an Income Tax?

- Lowers net pay of workers
- Reduces productivity
- Can reduce company profits
- More easily avoided than sales taxes
- Too many tax credits provide loopholes

ANTI-GROWTH TAX

Taxes matter because they affect behavior, often in detrimental ways. Studies have found that older people flock to states without an inheritance tax, and that high capital gains taxes reduce investment rates. It comes as no surprise that states without income taxes outperform those with income taxes.

It's important to understand the economic arguments against an income tax, because too often this type of tax is erroneously portrayed as a fairer tax than others. In addition, many proponents tout a progressive income tax as the fairest of all, because low-income earners pay smaller marginal tax rates than those earning high incomes. But we side with economists such as Richard Vedder[8] and Dean Stansel,[9] who say that an income tax is a huge drag on growth.

An income tax lowers the net pay of workers, providing them with less of an incentive to work. An income tax won't push salaried workers and full-time employees paid hourly into working fewer hours per week, but it will discourage part-time workers from adding hours. And it will act as a brake on overtime hours, cutting productivity.

Profit-maximizing companies don't pay workers more than their marginal value. So, the higher the state income tax rate, the lower the return in wages to employees. It makes a lot more sense to let the price system allocate the demand for and the supply of workers. Getting income taxes out of the equation increases both efficiency and worker compensation.

Another side of this argument is that Missouri workers are likely to demand higher pay than they would absent an income tax, in order to match the higher after-tax income they could earn in other states. As a result, Missouri businesses end up paying more for the same work done by similar employees in other states. Of course, most businesses will respond rationally, by hiring fewer workers. Or they will shed workers to make up for the higher salaries. Those are the only options that allow firms to stay competitive with businesses based in lower-tax states.

Second, the income tax is inherently unfair, because it is relatively narrow in scope and cannot be avoided. By definition, the tax applies only to those with reported earned income. That provides an incentive for individuals to find creative ways to duck the tax by not reporting some or all income. The income tax creates an incentive for people to become tax dodgers.

For those who abide by the law, and pay their taxes willingly, the income tax cannot be avoided — except by leaving the state. This is hardly the type of tax that makes sense when competition among states has become cutthroat. Missouri needs to maintain an attractive playing field for business and job creation across the board.

Along those same lines, removing the income tax also would eliminate the favoritism mechanism behind many of the state's tax credit programs. Designed to lure and keep businesses, these programs do little more than shift money from the many and give to the few. They don't work because they require the state to pick winners and losers among businesses.[10]

We're impressed by another set of significant economic numbers. States with no income taxes have the lowest overall tax burdens, according to data compiled by the Tax Foundation. Indeed, the correlation is virtually one to one. The eight states with the lowest tax burden are those without income taxes. The ninth no-income-tax state, Washington, has the 16th-lowest overall tax burden.[11]

The level of tax burden in any given state makes a significant difference. A variety of studies have concluded that a high overall tax burden stunts growth. Citing figures from the Bureau of Economic Analysis, Richard Vedder, an economics professor at Ohio University, and Stephen Moore write that "from 1957 to 1997 real personal income rose 390 percent in the 10 states with the lowest average state and local tax burdens, compared with only 177 percent for the 10 states with the highest burdens."[12]

THE TENNESSEE MODEL

Tennessee serves as an interesting model for the no-income-tax argument. During the last 35 years, as states have become more competitive — and businesses and individuals more mobile — the lack of an income tax has been a major boon to Tennessee's economy. There's no starker way to show that than to compare Tennessee with a border state, Missouri. Consider a commentary written earlier this year by Show-Me Institute Executive Vice President Joseph Haslag.[13]

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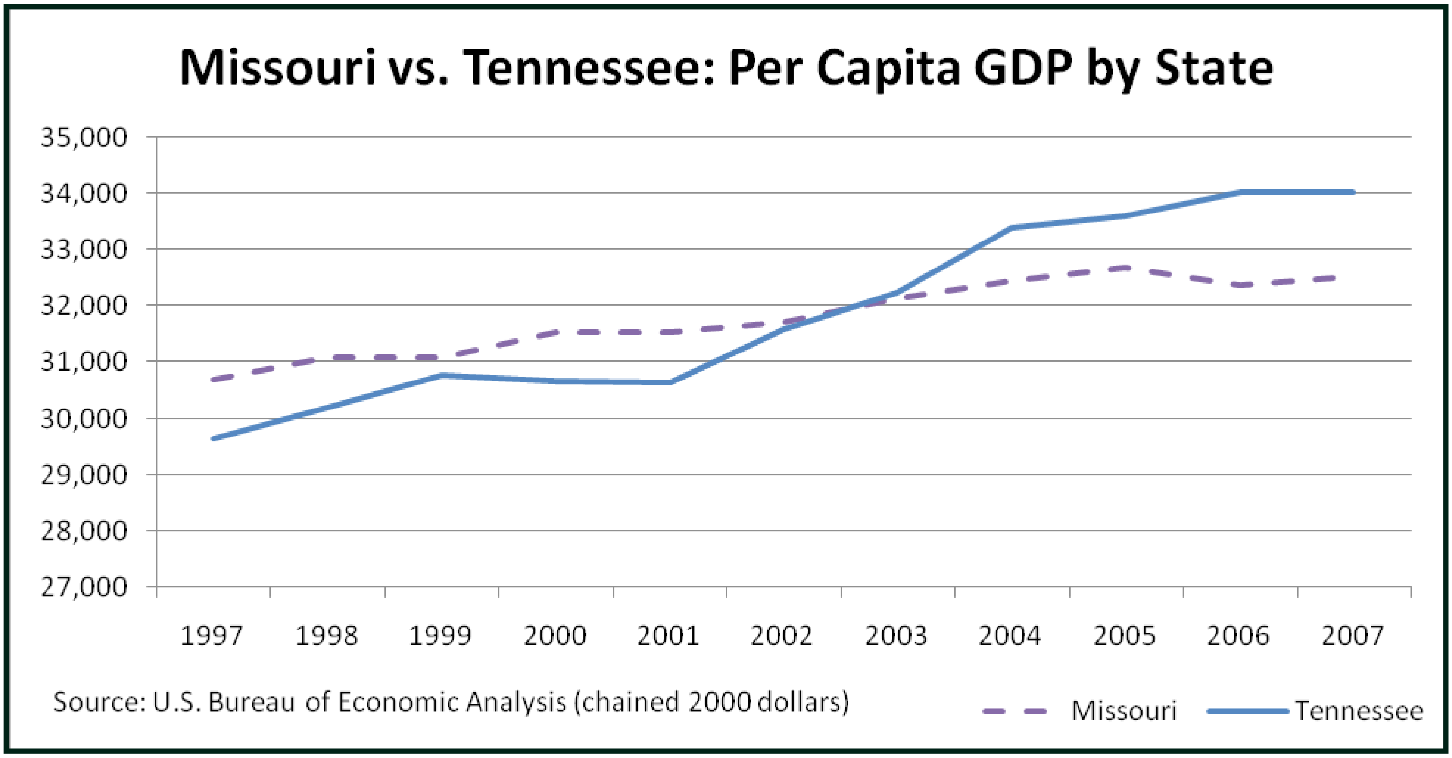

Missouri is growing, but far more slowly than Tennessee. More than 146,000 people migrated to Tennessee from other states from 1995 to 2000, but Missouri's net migration during that same time frame was less than a third of that figure, or about 46,000.

After World War II, Haslag pointed out, Missouri's economy was much stronger, more diverse, and healthier than Tennessee's. Although Tennessee steadily caught up, Missouri still enjoyed an economic advantage for more than 50 years. In 1997, its gross state product per capita — the value of goods and services produced in the state divided by population — was $30,688. Tennessee's was $29,647. Today, the positions are reversed, with Tennessee at $34,117 and Missouri at $33,326. Tennessee's annual growth rate during the last decade was 0.6 percent higher than Missouri's.[14]

Missouri is growing, but far more slowly than Tennessee. More than 146,000 people migrated to Tennessee from other states from 1995 to 2000, but Missouri's net migration during that same time frame was less than a third of that figure, or about 46,000.[15] The economic disparity between the two states keeps widening despite similarities in geography, contract law, and property rights laws.

Tennessee is also leaping ahead of its neighbor to the north, Kentucky, a state with arguably closer cultural ties than Missouri. Adjusted for inflation, gross domestic product per capita in Tennessee grew by 13.8 percent from 1997 through 2007, while Kentucky's per capita income rose just 7.6 percent, and Missouri's grew 6.2 percent — the third-slowest rate in the nation over that period of time.[16]

A BETTER TAX

Most of the nine states without income taxes rely heavily on sales taxes. The two exceptions, Alaska and Wyoming, get a majority of their revenue from oil and gas royalties. Missouri has room to increase its state sales tax rate, which includes a base rate of 3 percent, plus another 1.225 percent from two special sales taxes.

We believe that if the state wants to

Why a Sales Tax?

- Doesn't slow investment
- Stable revenue source
- Individuals can control it

maximize per-capita income and spur growth, a sales tax makes more sense than an income tax. First, a sales tax doesn't slow investment. It doesn't directly add to the cost of doing business. Second, a sales tax provides a more stable source of revenue for the state's coffers than an income tax, because a sales tax is less prone to big economic swings. Third, the sales tax can be managed by individual taxpayers. A family can put off buying a new car, for example, if it can't initially afford the tax. On the other hand, income taxes must be paid regardless of personal budget constraints.

Missouri not only has a low sales tax rate, it is imposed on relatively few products and services. The state taxes 40 items, according to a December 2007 study written by economist Rik W. Hafer for the Show-Me Institute.[17] By comparison, Hafer found, most of the no-income-tax states not only have higher sales tax rates, they impose that tax on more products. Tennessee taxes 79 items at a rate of 7 percent, Washington taxes 170 items at a 6.5-percent rate, and Texas has a 6.25-percent tax on 92 items.[18]

In 2007, Missouri's sales tax generated nearly $2 billion. To replace the income tax fully, the sales tax would have to produce another $4.9 billion. (We hasten to point out that because repeal of the income tax would stimulate overall economic growth, ultimately, we believe a dollar-for-dollar increase in the sales tax is not necessary. For purposes of this paper, however, we'll adopt an immediate revenue-neutral approach.)

If no other items were added to Missouri's sales tax, the rate would have to rise to nearly 11 percent in order to achieve the necessary $4.9 billion, according to Haslag. However, Missouri lawmakers over the years have voted to exempt from the sales tax more than 140 categories of items, such as college athletic event sales tickets, "animals or poultry used for breeding or feeding purposes," and many more.[19] In addition, Missouri does not tax consumer services. If the sales tax applied to all products and services purchased by individuals — which would exclude business-to-business transactions and capital acquisitions by businesses — a general sales tax rate of about 5 percent would suffice, according to estimates by Haslag.

A sales tax can be viewed as regressive, so we favor exempting poor households from the sales tax — perhaps those with household income at or below 150 percent of the poverty level.

A REASONABLE ALTERNATIVE

The country faces difficult financial times, but there is no better time to determine the best method of taxation to capitalize on growth opportunities. There also can be no doubting that Missouri is in a high stakes competition, not just with its nine border states, but every state in the country. It's time for Missouri to put itself in the best competitive position for growth in the 21st century and beyond.

First, a sales tax doesn't slow investment. It doesn't directly add to the cost of doing business. Second, a sales tax provides a more stable source of revenue for the state's coffers than an income tax, because a sales tax is less prone to big economic swings. Third, the sales tax can be managed by individual taxpayers.

NOTES

[1] Laffer, Arthur, and Stephen Moore, "Rich States, Poor States," American Legislative Economic Council, 2009, p. 116. Online here: tinyurl.com/dckyau

[2] Ibid.

[3] Perry, Marc J., "Domestic Net Migration in the United States: 2000 to 2004," U.S. Census Bureau, April 2006. Online here: tinyurl.com/mkh7g ; This is a net migration number. It computes the difference between those who moved in and those who moved out, and it excludes immigrants.

[4] According to state employment, seasonally adjusted, non-farm data from: Bureau of Labor Statistics, U.S. Department of Commerce.

[5] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Personal Income Taxes and the Growth of Small Firms," National Bureau of Economic Research, Working Paper No. 7980, October, 2000. From the abstract: "We find that individual income taxes exert a statistically and quantitatively significant influence on firm growth rates."

[6] Gius, Mark P., and Phillip Frese, "The impact of state personal and corporate tax rates on firm location," Applied Economics Letters, Volume 9, Issue 1, January, 2002, pp. 47–49. From the abstract: "Using a random effects model on a data set of 14000 observations, the present study finds that a state's personal tax rate has a negative effect on firm location."

[7] Vedder, Richard, and Stephen Moore, "Repealing the State Income Tax by 2020," Show-Me Institute, Dec. 11, 2006, pp. 13–14. Online here: tinyurl.com/y9f6mq3

[8] Vedder, Richard, "Rich States, Poor States: How High Taxes Inhibit Growth," Journal of Contemporary Studies, Fall 1982, p. 22. Vedder writes: "It would appear that from the standpoint of maximizing the rate of economic growth, the optimal state and local fiscal policy would be one in which the overall tax burden is comparatively low, coupling high sales taxes with low income and property taxes."

[9] Stansel, Dean, "Sales vs. Income Taxes: The Economists' verdict," Mackinac Center, Feb. 1, 1994. Stansel writes: "Theory as well as the preponderance of empirical evidence suggest strongly that sales taxes have less adverse impact on a state's economy than do income taxes." Online here: tinyurl.com/yagyego

[10] Haslag, Joseph, May 7, 2008, "Lower Tax Rates More Efficient Than Tax Credits," Show-Me Institute. Online here: tinyurl.com/yeos23a ; Haslag writes: "One little mistake, such as picking the second-best instead of the best plant, can also affect the state economy for years to come. With a universe of potential candidates, it is hard to imagine that the state could ever find the best without real competition among the candidates."

[11] "State, Local Tax Burdens, All States, 2008," Tax Foundation, Aug. 7, 2008.

[12] Vedder and Moore, p. 3.

[13] Haslag, Joseph, "Tennessee vs. Missouri: Taxes May Tip the Odds," Show-Me Institute, Sept. 9, 2008. Online here: tinyurl.com/48u7gg

[14] Ibid (entire paragraph). Gross state product measures the market value of all goods and services produced within a state's borders, and then is divided by the population. The numbers used by Haslag were adjusted for inflation with 1997 as the base starting point. Haslag also determined that if Tennessee continued to grow 0.6 percent faster each year than Missouri, then, in 25 years, "the average Tennessean would realize income equal to $48,416 while the average Missourian's income would be $40,975."

[15] Perry, Marc J., "State-to-State Migration Flows: 1995 to 2000." U.S Census Bureau, August 2003. Also, please see note 3 for an explanation of net migration.

[16] "Per-capita real GDP by state (chained 2000 dollars); All industry total," U.S. Department of Commerce, Bureau of Economic Analysis.

[17] Hafer, Rik W., "Should Missouri Eliminate the Individual Income Tax," Show-Me Institute, Dec. 5, 2007, p. 16. Online here: tinyurl.com/yaaztmo

[18] Ibid.

[19] Missouri Revised Statutes include provisions that exclude item categories from the sales tax, the bulk of which are found in Chapter 144. See also Rev. Mo. 209.255, 260.285, 306.016, and 313.821.

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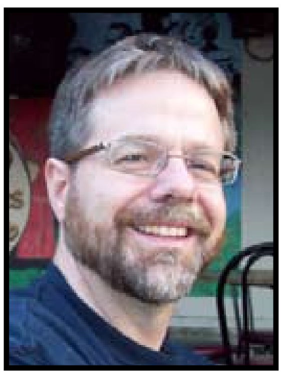
Rex Sinquefield is the cofounder and past co-chairman of Dimensional Fund Advisors Inc. In the 1970s, he coauthored (with Roger Ibbotson) a series of papers and books titled *Stocks, Bonds, Bills & Inflation*. At American National Bank of Chicago, he pioneered many of the nation's first index funds. He received his B.S. from Saint Louis University and his M.B.A. from the University of Chicago. He serves on the boards of numerous cultural organizations, including the Saint Louis Symphony Orchestra, the Saint Louis Art Museum, the Missouri Botanical Garden, and the Saint Louis Opera Theater.



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SHOW-ME INSTITUTE POLICY AREAS

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