Missouri Tax Policy & Education Funding

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Executive Summary

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The Missouri Tax Structure
and Education Funding:
A Proposal for Reforms

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Both the Missouri State tax structure and the funding mechanisms for elementary and secondary education have undergone significant changes during the past three decades. The effects of the changes have many faceted.

With respect to the state tax structure, the results, both intended and otherwise have been:

1. an increased reliance on income taxes and less on sales and other sources of revenue,
2. a concerted effort to make the overall state tax structure more progressive,
3. a contraction in the total state tax base and an increase in the complexity of the tax system.

At the local level in Missouri, these changes have been:

1. a reduced reliance on property taxes and a shift to sales taxes for all types of funding - for both operating and capital expenditures,
2. an increased reliance on state revenues for educational funding and a concomitant increase in the complexity of the funding mechanism.

The scope of this study, the overall tax structure and education funding, is necessitated by the interaction and correlation between these two topics. Indeed, all the significant changes in the overall Missouri tax structure during the last 30 years have been directly, or indirectly, caused by changes in the method for funding elementary and secondary education.

While many of the changes have been necessitated by external events, in particular by legal or constitutional considerations, their overall result has been to place the future fiscal stability of the state in serious jeopardy. In order to remedy the many challenges that face Missouri, bold and innovative changes must be made in both the tax structure and the education funding mechanism. With respect to the state tax structure, the primary objectives should be simplification and the broadening of the overall tax base. These two changes alone would reverse the litany of poor fiscal choices the state has made over the past three decades. Secondly, any new or enhanced revenue sources should be chosen such that they offer long run revenue growth potential. This criterion is of special import given the revenue enhancements that have been proposed to remedy the state budgetary crisis, such as higher levies on tobacco products and increased corporation income taxes. It makes no sense whatsoever to enact new taxes that are doomed to fail as a viable source of future revenue. Such a policy will only perpetuate the current budget woes and necessitate even more draconian measures at a later date.

To this end, we offer the following recommendations for the state tax structure;

1. replace the current individual income tax with a new flat-rate levy of 6.75%.
2. repeal the corporation income tax and replace the franchise tax with a new levy on all businesses.

Besides the additional $2.8 billion in state revenues these changes would generate, they would also vastly simplify the overall tax structure and make Missouri much more competitive in attracting new investment and jobs. They would also permit the elimination of many of the failed tax incentive programs that have been enacted over the past twenty years in an attempt to lure business to Missouri. Finally, their enactment would generate significant administrative savings for both the state and, more importantly, for Missouri tax payers.

The lion's share of this new revenue, $2.5 billion, could then be used to create a new funding mechanism for elementary and secondary education. The need to replace the current foundation formula, which is operationally defunct, may be the single most pressing challenge that Missouri faces. Indeed, the formula will be changed by either the citizens of Missouri or, most certainly, by the courts. Given the debacle of court mandated desegregation, it would behoove the state to act promptly on this critical matter. To accomplish this objective, we offer the following recommendations;

1. eliminate property taxes as the primary basis for funding K-12 education and change the school funding mechanism to pure per pupil formula,
2. eliminate all state assessed property taxes as a revenue source for schools,
3. create a special fund for elementary & secondary education to provide for funding emergencies,
4. and cap all municipal and other local property tax rates at their current levels.

Instead of the nearly incomprehensible current funding mechanism, the new formula would simply establish a new per pupil basic guarantee. For the first year, this would be $4,250 per pupil. For the second year, the basic guarantee would be $4,500 and for the third year, $4,750 per pupil. The level would then be indexed to net income tax receipts for subsequent years. Such an approach would not only increase the level of total funding for all districts, but it would also reduce the variability of funding between the richest and poorest school districts. The Savanna school district, for example, would receive an additional $171,000 in the first year, an additional $657,000 in the second and nearly $1.5 million in the third year. As a consequence of the increased level of state funding, the district would have a zero operating levy. Other districts, while still maintaining an operating levy, would see a dramatic decrease in the tax rate. Knox Co. R-I, for example, would not only receive additional total funding but also be able to reduce its operating tax rate to $1.03 from its 2002 level of $3.67.

The implementation of these reforms would have profound implications. First, they would completely eliminate the school operating levy in 351 of Missouri's 521 school districts and dramatically reduce the rates in 132 of the remaining 170 districts. Secondly, they would decrease the complexity of the tax structure and the funding mechanism for elementary & secondary education. Third, the new formula would reduce the inequity across school districts, and allow many less wealthy districts to build newer, more adequate facilities. They would also lower utility rates across the state and create substantial administrative savings.

The combination of the tax and education funding recommendations have several joint benefits. First, they would preserve all federal tax deductions and enhance the ability to export federal tax burdens to other states. This aspect of tax policy is seldom given the consideration it is due. The objective of any tax should be to generate the required level of revenue with the least possible disruption or loss in efficiency. Thus, it makes little sense to impose a tax that fails this test. The educational reform enacted in Michigan provides a salient example. Faced with a funding crisis similar to the one now in Missouri, Michigan opted to replace much of its property tax, which is deductible on the federal income tax, with a higher state sales tax that is not deductible. As a result, federal individual income tax liability for Michigan residents increased by an additional one billion dollars in the year following this change. To a lesser extent, this trend towards replacing deductible taxes with those that are not has been common in many states, including Missouri. One need only to look at the growing significance of dedicated state and local sales taxes in Missouri to see the consequences of such policy. While the sales tax may be more palatable to taxpayers, it is certainly poor fiscal policy to needlessly increase the tax burden on Missourians.

Finally, the adoption of these changes would permit a balanced and reasonable growth in state expenditure programs. As we have seen during the past three years, the rate of spending in Missouri has far outpaced the ability of the tax structure to provide the required revenue. Until this point has been adequately addressed, it will be impossible to return to a budget process that is fiscally sound. And while these recommendations are not a panacea for all of the problems, both current and future, that the state faces, we believe that their adoption is essential to the long term vitality of the state.