

# **Missouri Tax Policy & Education Funding**

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## **The Missouri Tax Structure and Education Funding**

Financing state government entails three basic fiscal functions – taxing, spending and debt management. Traditionally, state governments have been primarily concerned with only two issues in this area – the incidence and/or equity of the tax structure and the welfare implications of spending programs.

The scope of state government fiscal policy is also much more limited than that of the federal government, which has been expanded to encompass such areas as economic stabilization, the redistribution of wealth and the preservation of the environment. While state activities such as economic development incentives may be classified as a type of stabilization function, the balanced budget constraints of most state constitutions severely limit the ability of states to undertake meaningful growth and counter cyclical programs. And although it is seldom acknowledged, the ability of states to undertake programs that have a significant effect on the distribution of wealth is also extremely limited due to the mobility of people and capital.

This study focuses on only a subset of state fiscal policy – the tax structure and education funding. The former is included because of the many changes that have occurred during the past two decades and the apparent lack of any forethought as to their consequences. The focus on education funding is prompted by two considerations - the fact that it constitutes the largest single expenditure program in Missouri and the fact that the most meaningful tax changes during the last twenty years were directly related to education.

The sections on tax policy cover the period from 1970 through 2002. This time horizon (32 years) was chosen with considerable care. First, it spans all the meaningful changes in the current tax structure. Secondly, it presents an insightful historical perspective on the current fiscal situation in Missouri and the implications for the future.

The review of tax policy consists of three sections:

1. History of major tax changes and state tax policy in Missouri
2. State-by-state comparisons for 1980, 1990 and 2000
3. Current and future revenue adequacy and recommendations for future changes

The sections on education funding cover the period from 1980 through 2002. The rationale for choice of the time horizon for these sections is similar to that for the sections on tax policy. First, it too spans all the major changes in education funding in Missouri. Secondly, it provides a very meaningful perspective on the changing mix of state and local funding. And lastly, it also provides some implications for the future given the current mix of state and local revenue sources.

The review of education funding in Missouri consists of three sections:

1. History of major funding changes
2. State-by-state comparisons for 1980, 1990 and 2000
3. Revenue adequacy of the current state/local funding mix and recommendations for funding changes

The final section of this study presents a recap of the tax and funding recommendations, all related fiscal notes and the effect on the overall tax incidence.

## The Missouri Tax Structure

Taxes are compulsory payments associated with particular activities. They are required in order to provide the revenues used to purchase the labor and capital necessary to produce government-supplied goods and services.

Tax revenues are a function of two factors: the tax base and the tax rate structure. This may be conveniently expressed by the following formula:  $T = B \times R$ , where **T** represents the amount of the tax, **B** the tax base and **R** the tax rate.

The tax base is typically defined by the type of activity on which the tax is levied. The most commonly used tax bases at the state level may be grouped into three broad categories: income, consumption and wealth. The tax rate structure is defined by the relationship between tax collections and the tax base over some given time period, or alternatively by the behavior of tax rates as the value of the base changes.

Tax rates are established and calculated as the ratio of taxes paid to various values of the base. Two different calculations are utilized in this respect. The first is simply total tax receipts divided by the value of the tax base. This is referred to as the **average** tax rate. The second is the ratio of additional tax collections to additional values of the base as the base increases. The latter is referred to as the **marginal** tax rate. There are three possible relationships between marginal tax rates and the base. If the rate remains constant as the tax base increased, the rate structure is said to be proportional. Such taxes are commonly called “flat rate” levies. If tax rates increase as the base increases the structure is said to be progressive. And alternatively, if rates decline as the base increased the structure is said to be regressive.

It is important to note that the terms proportional, progressive and regressive are often used in a much different context. Sales taxes, for instance, are commonly said to be regressive even though the tax rate structure is proportional, or invariant to different values of consumption. The reason for this is that the terms proportional, progressive or regressive have come to be defined not with respect to the tax base, but with respect to income. Thus, although the sales tax rate does not decline as consumption increases, the ratio of the tax base (consumption) to income declines due to the fact that the saving rate increases with income.

### Tax Bases and Rate Structures in Missouri

Missouri utilizes all three common tax bases – income, consumption and wealth. The first income tax in Missouri became effective on July 1, 1917. The tax rate was a flat rate levy of 0.5%. The state individual income tax retained its proportional rate structure until mildly progressive rates, ranging from 1 percent to 4 percent, were adopted in 1931. The current individual income tax rate structure became effective on January 1, 1971. The minimum marginal rate is currently 1.5 percent and the maximum is 6 percent. The tax base of both the individual and corporation income taxes was defined by state statute until 1973 when the federal definition of income was adopted.

The use of consumption taxes in Missouri is typical of most states, consisting of a general sales tax and excise taxes on specific goods and services. The first general revenue sales tax became effective in

1934. The tax rate was 0.5%. The rate was increased to 1.0% in 1935, 2% in 1937, and to the current 3% in 1963. The state has also enacted three additional dedicated sales taxes for education, parks and conservation. The major excise taxes in Missouri are those on motor fuels, cigarettes, alcoholic beverages and insurance premiums. All state consumption tax bases are defined by state statute and all utilize proportional tax rate structures.

The state has also utilized the typical mix of wealth taxes. These are levies upon either the total wealth of an individual, such as the inheritance or estate tax, or a subset of personal or business assets, the most common of which is the property tax. Although the state levies a three cent dedicated property tax, the vast majority of these taxes are utilized by local government entities – in particular school districts.

## **Principles of Taxation**

The term “state tax policy” is in essence, no more than a reflection of the prevailing attitudes about a choice between alternative tax bases – income, consumption or wealth - and alternative tax rate structures – proportional, progressive or regressive. Historically, these choices have tended to be measured against certain commonly held principles. And while it is true that these choices must be tailored to suit the conditions of the time, there are some generalizations about taxes that have validity anywhere and at any time.

To highlight this point, consider Adam Smith’s canons of taxation, which were first published in 1776. First, said Smith, taxes should be fair or equitable. Secondly, taxes should be certain, “clear and plain to the contributor and every other person.” Third, they should be convenient as to the time and manner of their levy. And, finally, they should be economical – not too expensive to collect and not onerous or discouraging to the taxpayer.

The two “C’s” – certainty and convenience – are obviously as valid today as they were in 1776. The more complex or uncertain the tax structure, the less likely is it that individuals can understand and intelligently vote on changes. The less certain the tax structure, the less likely that individuals will be inclined to vote for additional funding for any issue, no matter the merits of the particular case. And the less convenient it is to pay a particular tax liability, the less likely that individuals will be inclined to expand its use – as is the history of the property tax in Missouri.

Likewise, the issue of “fairness” or equity is still very germane. Taxes on income are “good” while levies on consumption (sales taxes) are “bad.” Taxes on wealth are both “good” and “bad.” If you have managed to amass a substantial stock of wealth, these taxes are not appealing. If you have not, they may be considered more desirable. However, since “hope blooms eternal,” taxes on wealth have never been popular regardless of ones current income status.

In addition to these time-tested criteria, the modern economies of today have added a few additional ones. The first of these is the degree of control over the tax base. This issue has become increasingly important in the age of fiscal federalism. Unlike the property tax base or the tax base for many excise levies that are often uniquely defined by state statutes, the tax base for the income or the estate tax is typically defined by federal government statutes. The current discussion in Missouri and other states about “decoupling” underscores this modern aspect of tax policy.

The second is the treatment of multi-jurisdictional income and sales. While income taxes, both individual and corporate, have always been subject to allocation rules, the sales tax has come under recent scrutiny due to the growth of interstate catalog and Internet sales.

Another criterion of the times is that of tax base volatility and the ability to accurately forecast future revenues. Levies such as the property tax on real and personal property are very stable and relatively easy to project, due primarily to the fact that the tax base is a stock as opposed to a flow. Income taxes, on the other hand, are much more volatile. This aspect has received considerable attention of late with respect to both the corporation and the individual income tax. Because both of these include capital gains in their respective tax bases, the wild fluctuations in stock prices have made at least a portion of these levies nearly impossible to predict.

There is also the issue of taxes on business, and in particular, whether a state has a good image, i.e. is it tax friendly or not. Since business, via jobs and income, is the true underlying base for all taxes, states have become extremely competitive in their programs to attract or keep business within their boundaries. The growing proliferation of investment incentive credits in Missouri and other states bears testimony to the recent concern with image and whether or not a state is considered “business friendly.”

Another issue in the formulation of tax policy is that of public trust. Up until 1980, the formulation of tax policy in Missouri was solely at the discretion of elected officials. The only constraint was the traditional one, i.e. what was considered politically feasible. However, with the passage of the Hancock Amendment (Constitution of Missouri, Article X, Sections 16 – 24) additional constraints were imposed on state and local governments.

At all levels of government, Article X mandates that all tax and fee increases be approved by a majority vote. At the state level it imposed an additional constraint on the level of total spending and tax revenues. In effect, the Hancock Amendment limits the growth of state tax revenues to the growth in personal income. Tax revenues in excess of the limit must be refunded to taxpayers based upon their income tax liability. The only means of circumventing these provisions is to subject any new tax to a popular vote.

As a result of its passage, elected officials have become increasingly reluctant to promote any new general revenue taxes. Indeed, other than two temporary tax rate changes that were the result of fiscal exigencies, the only new state taxes levied in Missouri since 1971 have been for dedicated purposes – elementary and secondary education, conservation and parks.

And finally, there is the issue as to whether the formulation and adoption of tax policy is reactive or proactive. The proactive approach necessitates a long run perspective. It also entails the adoption of strategies to deal with short-run revenue deficiencies and surpluses. The reactive posture, while much simpler, only requires that state leaders fix problems. Since the latter are usually perceived as being random and short-lived, the optimal political approach is to simply ignore the issue. This, unfortunately, has been the case in Missouri.

Although Adam Smith’s canons of taxation are still very relevant to the formulation of tax policy, the complexities of the modern economy have made its formulation and adoption far more difficult. Simply looking at the equity, the convenience, the degree of certainty or the administration expenses of the tax

structure is not sufficient. Factors such as volatility, degree of control and “corporate image” are just as important.

The formulation of state tax policy has evolved into an art form, requiring greater and greater amounts of data and more insightful analysis and value judgments. The latter is required because the adoption of tax policy commonly involves a choice between competing criteria. For example, while the sales tax is certainly convenient, it may not be considered by some to be equitable. While the property tax may be deemed to be equitable by many, it is certainly neither convenient nor economical to collect. And while adopting the federal definition for a particular tax base may make it more certain, it surely reduces the degree of control.

## Major Sources of Tax Revenue

Table I presents major sources of state revenues for both the general fund portion of the state budget and for total state receipts excluding intergovernmental transfers, such as federal funds, and insurance trust receipts, such as unemployment taxes.

**Table I**  
**Total and General Fund Revenues**

|                            | 1980      |           | 1990      |           | 2000       |           |
|----------------------------|-----------|-----------|-----------|-----------|------------|-----------|
|                            | Total     | GR        | Total     | GR        | Total      | GR        |
| Sales Tax                  | \$792.3   | \$730.4   | \$1,898.8 | \$1,274.1 | \$2,787.5  | \$1,814.9 |
| Individual Income Tax      | \$603.3   | \$707.5   | \$1,790.6 | \$2,006.8 | \$3,550.3  | \$4,461.0 |
| Corporation Income Tax     | \$135.1   | \$125.8   | \$221.5   | \$245.9   | \$265.5    | \$448.3   |
| Inheritance & Estate Taxes | \$26.3    | \$26.3    | \$42.0    | \$42.7    | \$129.9    | \$137     |
| Insurance Premium Tax      | \$64.1    | \$60.6    | \$152.5   | \$114.8   | \$209.7    | \$160.7   |
| Corporation Franchise Tax  | \$27.3    | \$24.6    | \$61.7    | \$54      | \$89.7     | \$18.7    |
| Liquor & Beer Taxes        | \$28.9    | \$26.8    | \$26.1    | \$25.7    | \$29.0     | \$29.7    |
| Cigarette Taxes            | \$61.2    | 0         | \$78.3    | 0         | \$112.0    | 0         |
| Interest Receipts          | \$114.3   | \$50.5    | \$424.2   | \$21.7    | \$763.6    | \$36.8    |
| Other Receipts             | \$691.3   | \$80.2    | \$1,486.8 | \$176.3   | \$3,292.2  | \$223.2   |
| <b>Total</b>               | \$2,514.1 | \$1,838.6 | \$6,182.5 | \$4,157.7 | \$11,229.4 | \$8,308.1 |

*Notes: Total Revenue excludes intergovernmental transfers and trust funds; GR (General Fund Revenue); in millions*

**Source:** Missouri Department of Revenue; U.S. Department of Commerce, Bureau of the Census

The amounts listed under the **Total** columns represent major sources of revenue deposited to all state funds. The amounts under the columns labeled **GR** represent similar data but only include those revenues deposited to the General Revenue fund.

The amounts in the two columns differ for several reasons. First, like nearly all governmental entities, the state accounting system in Missouri utilizes a multitude of special funds, or “cookie jars” to segregate tax revenues and other receipts. In fact, the Missouri general revenue fund is just one of over 400 separate funds that comprise the state accounting system. Secondly, the source of the information differs. The data for General Revenue fund receipts is from the Missouri Department of Revenue. The



information for total receipts is from the U.S. Bureau of the Census. The latter are included here for illustrative purposes but are discussed in greater detail in the sections on state-by-state comparisons of revenues and expenditures. The third reason for the differences is the alternative definitions of revenue used by the two agencies. The Department of Revenue data is compiled on the basis of gross receipts, i.e., prior to any refunds. This is due to the fact the state accounting system treats refunds as expenditures as opposed to reductions in tax revenues. The Census Bureau, however, reports net tax receipts, i.e., after refunds. For some tax sources, the differences are miniscule. For others, such as the state individual income tax, they are markedly different because of the magnitude of income tax refunds.

The reason for the use of multiple specialized funds, or “cookie jars,” appears to be primarily a matter of public trust. After all, Missouri is the “Show Me” state. Given the age of computerized accounting systems, it is certainly not a matter of necessity. The amounts listed for sales tax revenues in Tables I and II provide an excellent illustration of this issue.

**Table II**  
***Total Sales Tax Receipts***

|                 | <b>1980</b>    | <b>1990</b>      | <b>2000</b>      |
|-----------------|----------------|------------------|------------------|
| General Fund    | \$681.3        | \$1,211.3        | \$1,667.0        |
| Motor Vehicle   | \$56.0         | \$126.6          | \$235.8          |
| General Revenue | \$49.1         | \$62.8           | \$110.8          |
| Other           | \$6.9          | \$63.4           | \$125.0          |
| Conservation    | \$31.5         | \$54.0           | \$86.9           |
| Education       | \$0.0          | \$406.3          | \$689.2          |
| Highway Use     | \$15.7         | \$24.7           | \$49.8           |
| Parks & Soils   | \$0.0          | \$49.4           | \$70.5           |
| <b>Total</b>    | <b>\$784.5</b> | <b>\$1,872.3</b> | <b>\$2,799.2</b> |

*Note: In millions*

**Source:** Missouri Department of Revenue

Prior to 1972, all sales tax revenues with the exception of motor vehicle tax on private transactions (person-to-person) were deposited to the state general fund. Thus, new or used motor vehicle sales via a dealer are General Revenue receipts, but the sales tax on transactions between individuals are arbitrarily deposited to the State Highway Fund under the category “Highway Use” taxes.

On November 2, 1976 voters approved the passage of a constitutional amendment that authorized a new special one-eighth cent sales tax dedicated for conservation purposes. Because of past misunderstandings and abuses of the public trust, the amendment also authorized the establishment of a special fund for the tax receipts and mandated their use exclusively for specific purposes. Indeed, this may have been essential to the passage of the amendment. This provision, in essence, removed the new revenue source from any legislative control. The same was also true of the passage of the other two dedicated state sales taxes, Proposition C in 1982 and the Parks and Soils sales tax approved in August of 1984.

While such limitations on the use of public funds may seem to be a guarantee that the monies are used solely for the intended purposes, this is not actually the case. The reason for this is that revenues are fungible, that is, they can be moved from one fund to another. For instance, let us suppose that General Revenue funding for a particular function, such as conservation, was originally funded at a level of \$10 million. Now a dedicated tax equivalent to \$5 million is passed solely for conservation purposes. One would tend to believe that total funding for conservation would now be \$15 million. However, due to competing expenditure objectives or priorities, the legislature now reduces the General Revenue support to only \$9 million. Total spending for conservation projects is now \$14 million, which is obviously larger than before the passage of the dedicated tax. However, the increase in funding for conservation programs is only 40 percent, not the 50 percent that might have been imagined by voters due to the passage of the new tax. Indeed, since the general fund portion of state revenues comprises the bulk of the discretionary monies available to the state it is easy to understand how and why such changes in the mix of funding levels occurs. The discussion of gaming revenues and education expenditures later in this report will provide an additional example of the issue of “fungible.”

### **Tax Policy in General**

From any vantage point, popular, administrative or legislative, Missouri has had the reputation of being a relatively “low tax” state. While the tax structure has been “tweaked” on many occasions, the primary sources of revenue have been little changed since the 1930’s, which saw the passage of both the current state income and sales taxes. Moreover, many of the current tax sources were first adopted by initiative petition as opposed to legislative action. This includes the fuel tax, the cigarette tax and the education sales tax.

Another point worth noting is the seeming tacit delineation of tax bases between the state and local governmental entities. Beginning in 1971 with the passage of the City Sales Tax Act, the state legislature began to phase out the state’s dependence upon consumption taxes, relegating these to cities and counties. The latter in turn relinquished their use of property taxes, relegating these to school districts. The next two decades saw the culmination of this trend with the passage of Proposition C and the SB 380.

### **Sales Taxes**

Up until 1980, sales tax comprised the single largest source of both total and general fund revenues. However, beginning in 1980, the base of this tax has been systematically reduced by the exclusion of certain purchases. The first exclusions were for prescription drugs and domestic utilities, which were exempted as of January 1, 1980. In addition, the 1980 changes also dedicated one-half of motor vehicle sales taxes to the State Motor Fuel Fund. The largest exclusion, food for home consumption, became effective October 1, 1997. Table III presents the General Revenue loss estimated due to these exclusions.

**Table III**  
**Major General Fund Sales Tax Exclusions**

|                    | <b>1980</b>   | <b>1990</b>    | <b>2000</b>    |
|--------------------|---------------|----------------|----------------|
| Prescription Drugs | \$4.6         | \$15.9         | \$43.7         |
| Domestic Utilities | \$22.1        | \$42.4         | \$57.2         |
| Motor Vehicles     | \$6.8         | \$62.8         | \$139.1        |
| Food               | \$0.0         | \$0.0          | \$239.4        |
| <b>Total</b>       | <b>\$33.5</b> | <b>\$121.1</b> | <b>\$479.4</b> |

*Note: In millions*

**Source:** State and Regional Fiscal Studies Unit

Although sales taxes are no longer the largest source of state general revenue, this portion of total sales tax understates their importance to the state. As the figures in Table I demonstrate, the state receives over one billion dollars in sales taxes that are deposited in other funds.

The reduced reliance on general revenue sales taxes and the expanded use of them for dedicated purposes is due to several factors. First, like any proportional consumption tax, the sales tax is regressive when compared to income. As a result, it has become the liberal whipping boy of alternative tax sources and an anathema to the state legislature despite its general approval.

Secondly, it is by far the most popular tax source with voters. Every survey conducted over the past two decades has consistently ranked the sales tax as the most preferred tax source for new expenditure programs. The reasons typically given for this popularity are its convenience and the belief that it is fair, “everybody has to pay.” Thirdly, Missouri has historically had a relatively low sales tax rate. In 1980 for instance, among states that levied a sales tax, only Oklahoma had a state tax rate lower than the three percent levy in Missouri. However, because of Missouri’s expanded use of this tax source during the 1980’s, ten states had lower state rates as of 2000.

Another reason for the waning interest in sales taxes as a source of state revenue is their growing importance as a revenue source for local governments. Indeed, the sales tax now represents the single largest source of local revenue for cities and counties.

Prior to 1985, property assessment practices in Missouri were both antiquated and haphazard. As a consequence, the assessed valuation of Missouri property value was understated and did not grow at rates sufficient to fund local revenue demands. During the period 1970 to 1979, for instance, total assessed value in Missouri increased from \$11.3 billion to \$17.3 billion, an annual average growth rate of 4.8%. Inflation during this period, however, averaged 7.1% per year. Thus, in real term total assessed value actually declined at an average of 2.6% per year. In order to meet their budgetary demands, local governmental entities – counties, cities and school districts – were forced to rely on ever increasing property tax levies. Because of their heavy reliance on this revenue source, school districts were particularly impacted. (This aspect of the problem is discussed in considerable detail in the section on education finances.)

In order to help alleviate this situation, Missouri cities were given the option of levying a local sales tax beginning in 1971. County governments were granted the same privilege beginning in 1980. The

pressure on property tax rates also prompted the enactment of Proposition C in 1983, which levied a 1% sales tax for schools and prodded the Missouri legislature to force county tax assessors to modernize assessment practices and perform biennial assessments.

## **Income Taxes**

Income taxes now represent the largest source of state revenue, comprising nearly 60 percent of all general revenue fund receipts. The analysis of this tax is divided into three subsections – the tax base, deductions and tax rates.

### Individual Income Tax Base

Up until 1972, the definition of income for both individuals and corporations was defined by Missouri statute (see the 1971 individual income tax return in Appendix A-3). As a result, the state had nearly total control over the income tax base. Beginning in 1973, however, the state adopted the federal definitions for gross and adjusted gross income (AGI). While this simplified the state tax, it also substantially lessened the degree of control over this source of revenue.

The change to the federal definition of income has been a double-edged sword for the state. When the federal government expands the definition of federal AGI, state AGI increases proportionally. However, the opposite is true when the federal government contracts the definition of income. Table IV presents examples of selected federal changes along with the estimated revenue impact on Missouri individual income tax liability.

**Table IV**  
***Estimated Revenue Effects of Selected Federal Changes  
on the Definition of Adjusted Gross Income***

| <b>Year</b> | <b>Description</b>  | <b>State Revenue Effect</b> |                |
|-------------|---|-----------------------------|----------------|
| 1979        | One half of unemployment compensation taxed   | +                           | \$1.0 million  |
| 1982        | Liberalization of IRA contributions and “marriage penalty” adoption                       | -                           | 36.8 million   |
| 1984        | Social Security income taxed  | +                           | \$9.5 million  |
| 1987        | “Marriage penalty” repealed, IRA rules tightened, all of unemployment compensations taxed | +                           | \$69.4 million |
| 1990        | One half of self-employment tax exempted  | -                           | \$9.2 million  |

**Source:** State & Regional Fiscal Studies Unit

The most memorable of these were the 1987 changes, which were roundly decried by many as “the windfall”. Indeed, the State Treasurer at the time (who would later run for Governor) erected a large “barometer” outside his office in the Capitol that depicted the millions of dollars flowing into the state coffers. The fact that the enactment of these federal provisions in 1982 reduced state tax receipts by hundreds of millions of dollars went unpublicized.

## Corporation Income Tax Base

The tax base for the state corporation income tax is Missouri's prorated amount of federal taxable income. The appropriate allocation of corporate multi-state income has always been a matter of some contention since there is not one universally accepted method of apportioning income amount taxing jurisdictions. As a result, arbitrary allocation rules have been adopted by all states. Probably, the most commonly accepted method, and the one adopted by many states, is the three-factor allocation formula that is specified in the Multi-State Tax Compact.

This formula uses three equally weighted components- payrolls, property and sales. This formula is advantageous to corporations with little or no physical presence in a particular state, i.e., low payrolls and little property. However, it is disadvantageous to corporations with a large physical presence, i.e., those with large payrolls and a significant portion of their physical assets. Since the latter tend to have substantial political influence, many states have modified the three-factor allocation formula to reduce the tax liability of these corporations. The most common technique for accomplishing this is to either double weight the sales portion of the formula or to provide a single-factor alternative based solely upon sales. Missouri utilizes the later. Table V presents a tabulation of Missouri corporation income tax returns for 2000 stratified by apportionment method.

**Table V**  
***Missouri Corporation Income Returns by Apportionment Method: 2000***

| <b>Method</b>    | <b>Number of Returns</b> | <b>All Sources</b> | <b>Missouri Sources</b> | <b>Missouri Share</b> |
|------------------|--------------------------|--------------------|-------------------------|-----------------------|
| 100% Missouri    | 33,610                   | \$735.9            | \$735.9                 | 100.0%                |
| 3 Factor         | 9,337                    | \$38,545.4         | \$460.1                 | 1.2%                  |
| 1 Factor (Sales) | 1,406                    | \$4,009.1          | \$349.5                 | 8.7%                  |
| Other            | 154                      | \$493.7            | \$16.0                  | 3.2%                  |

*Note: In millions*

**Source:** State & Regional Fiscal Studies Unit; Missouri Department of Revenue

Table VI presents taxable income reported on Missouri corporation income tax returns for the period 1990 through 2000. The amounts under the column labeled "All Sources" represent total taxable income. The amounts under the column labeled "Missouri Sources" represent taxable income after apportionment. Column 3 represents Missouri's share of total corporation income. What is very disquieting is the trend in Missouri's share. After peaking in 1992 at 5.5 percent, the share has fallen to only 2.7 percent in 2000. Given that each one percent share represents approximately \$125 million in tax liability, it is of little wonder why the corporation income tax has become a much smaller portion of general fund revenues. Further, this decline in Missouri's share has occurred despite the enactment of a plethora of tax incentives designed to make Missouri more competitive with other states.

**Table VI**  
**Missouri Corporation Taxable Income**

| <b>Year</b> | <b>All Sources</b> | <b>Missouri</b> | <b>Share</b> |
|-------------|--------------------|-----------------|--------------|
| 1990        | \$85,885.6         | \$3,600.8       | 4.2%         |
| 1991        | \$76,094.3         | \$3,569.0       | 4.7%         |
| 1992        | \$76,084.7         | \$4,176.4       | 5.5%         |
| 1993        | \$102,540.1        | \$4,395.5       | 4.3%         |
| 1994        | \$137,547.4        | \$6,234.6       | 4.5%         |
| 1995        | \$147,640.9        | \$6,692.5       | 4.5%         |
| 1996        | \$162,340.4        | \$6,814.2       | 4.2%         |
| 1997        | \$173,184.2        | \$6,423.4       | 3.7%         |
| 1998        | \$176,832.0        | \$5,541.9       | 3.1%         |
| 1999        | \$192,839.1        | \$6,214.6       | 3.2%         |
| 2000        | \$173,885.2        | \$4,627.2       | 2.7%         |

*Note: In millions*

**Source:** Missouri Department of Revenue

### Income Tax Deductions

Changes in federal income tax laws also affect Missouri receipts in two other ways. First, since Missouri allows taxpayers to itemize deductions, changes in federal statutes have a direct impact on Missouri taxpayers who itemize. For instance, up until 1977, gasoline taxes were deductible. However, because of flagrant taxpayer abuse, this deduction was disallowed beginning in 1978. As a result, Missouri itemized deductions were reduced by \$50 million, thereby increasing revenues by approximately \$3 million. Similarly, the deduction for sales taxes paid was disallowed beginning 1987 – the year of “the windfall.” This change resulted in an additional \$24.7 million in new revenues to the state.

The second way federal income tax statutes affect state tax revenues is due to the deductibility of federal income taxes on state returns. Until 1994, this deduction was unlimited. As a result, every federal tax increase reduced state income tax liability and every federal tax reduction increased state revenues. SB 380, which is discussed in greater detail later, capped this deduction at \$5,000 per taxpayer.

One possible explanation for the declining state share of total corporation income may be related to the passage of SB 380. Up until 1993 corporations could deduct all federal income taxes paid on their Missouri return. However, beginning in September of 1993, this deduction was capped at 50 percent. The effect of this change was to increase corporate tax liability by between \$45 million to \$64 million per year in addition to the 25 percent tax rate increase also contained in SB 380. It would appear that corporations responded to this increase in their tax liability by moving new investment or operations outside the state.

### Tax Rates

Missouri individual income tax rates range from 1.5 percent on the first \$1,000 of taxable income to a maximum of 6.0 percent on taxable income over \$9,000. The marginal tax brackets and tax rates for the individual income tax have not been modified since 1971. The corporation income tax rate is a flat 6.25 percent, which became effective September 12, 1993. The rate was a flat 5.0 percent prior to this date

except for the period 1990 to 1991 when temporary graduated rates ranging from 5.0 percent to 6.5 percent were in effect.

### **Other Taxes**

The only two other general fund taxes of significance are the insurance excise tax and the current estate tax. The latter, which became effective 1980, replaced the inheritance tax that Missouri had imposed since 1917. With the transition to the estate tax approach, Missouri in essence delegated all control over this revenue source to the federal government. The phase-out and repeal of the federal estate tax, which began in 2002, will eliminate this revenue source over a three-year period. And because of its complexity, high collection costs and the interstate competition for wealthy senior citizens, it will be difficult, if not impossible to resurrect at the state level.

The excise tax on insurance premiums, called the “County Foreign Insurance,” tax is the oldest continuous tax in Missouri. The tax is a levy of 2% on most insurance premiums. Because of retaliatory provisions adopted by Missouri and all other states, it is extremely difficult to change either the base or the tax rate for this revenue source.

Missouri also levies the typical assortment of “sin taxes”, i.e. alcohol and tobacco taxes. All alcohol taxes are deposited to the General Revenue Fund and all tobacco related taxes are earmarked for dedicated purposes – elementary and secondary education and health initiatives.

## State Tax Policy by Decade: The Recession Prone 70's through the Roaring 90's

### The Recession Prone 70's

These years were not the nation's or Missouri's finest hour. Federal fiscal policy was mired in the on-going struggle to fund the "Great Society." As a consequence, marginal tax rates remained high (the maximum was 70 percent) and personal exemption and standard deduction amounts were kept low. Monetary policy was truly nonexistent. Because of this utter lack of any coherent policy, inflation soared, averaging 7.1 percent. It was also the time of the O.P.E.C. oil embargo and the imposition of price controls. Home mortgage interest rates were double digit and the housing market was chaotic.

The decade featured two recessions, a mild one in 1970 and a major one in 1974 to 1975. The only consistently strong industry was autos, which averaged sales of 10.1 million units per year. The Missouri economy was mixed. Despite high levels of employment in manufacturing, the unemployment rate averaged 4.9 percent for the decade. Bolstered by the high inflation rates, nominal personal income grew at an astonishing average rate of 9.9 percent per year. Adjusted for price growth, the rate was only 2.7 percent.

**Table VII**  
**Major State Tax Changes: 1970 to 1979**

| <b>Description</b>                         | <b>Effective Date</b> |
|--|-----------------------|
| Accelerated Income Tax Collections         | 01-1-1970             |
| Accelerated Sales Tax Collections          | 01-1-1970             |
| Increased Individual & Corporate Tax Rates | 01-1-1971             |
| Increased Alcohol Tax Rates                | 01-1-1971             |
| Accelerated Withholding Collections        | 01-1-1973             |
| Imposed Conservation Sales Tax             | 07-1-1977             |

Source: State & Regional Fiscal Studies Unit

Tax policy during the decade was dominated by the influence of the 1970 recession. The state's first response was to accelerate income and sales tax payments. This was followed the following year by the enactment of one of the three largest tax increases in the state's history. The latter, which doubled alcohol tax rates and increased both the individual and corporation maximum marginal tax rates by 50 percent, generated an additional \$108 million in General Fund revenues. While this may not seem large compared to current tax receipts, adjusted for inflation, these increases would have generated \$468 million using fiscal year 2002 prices.

The year 1973 was remarkable for two reasons. First with the acceleration of withholding payments, income taxes were collected on a monthly basis for the first time. More importantly though, was the adoption of the federal definitions of income for both the individual and corporation income taxes. This change in essence "coupled" the state income taxes to their federal counterparts.



## The Transition Era – the 80’s

The decade of the 1980’s is extremely important with respect to both federal fiscal and monetary policy. The Federal Reserve, which had attempted to control everything - price levels, GDP growth, the value of the dollar and interest rates - during the previous ten years, finally realized the futility of their actions. Instead of their multiple goals, they adopted a single, more realistic objective – the control of inflation. As a result, they were able to reduce the inflation rate from 7.5 percent in the first half of the decade to 3.6 percent in the last half.

Federal fiscal and tax policy also underwent substantial changes. The maximum marginal individual income tax rate was reduced from 70 percent to 50 percent in 1982 and lowered again to 28 percent in 1988. As a result of “bracket creep” due to the horrendous inflation during the period 1974 through 1981, tax brackets, exemption and standard deduction amounts were finally indexed to the consumer price index beginning in 1985.

**Table VIII**  
**Major State Tax Changes: 1980 to 1989**

| <b>Description</b>                          | <b>Effective Date</b> |
|---|-----------------------|
| Utility & prescription sales tax exclusions | 01-1-1980             |
| Accelerated Withholding Collections         | 10-1-1982             |
| Imposed Prop C Sales Tax                    | 01-1-1983             |
| Accelerated Sales Tax Collections           | 02-1-1984             |
| Imposed Parks and Soils Sales Tax           | 07-1-1985             |
| Government Pension Income Tax exclusion     | 01-1-1989             |
| Temporary Sales Tax Increase                | 10-1-1989             |

Source: State & Regional Fiscal Studies Unit

State Tax policy during the decade was dominated by three factors – (1) the passage of the Hancock Amendment, (2) the tacit adoption of a “no new taxes” posture by both the legislative and the executive branches and (3) property tax and school finance reform. Although the decade began and ended with recessions, these did not have the impact on state tax policy like those of the previous economic downturns. The aftershocks of the 1980 recession were handled with two collection accelerations, withholding remittances in 1982 and sales taxes in 1984.

The exclusion of domestic utilities and prescription drugs from the sales tax in 1980 was motivated by purely political considerations surrounding the 1980 gubernatorial race. In a very real sense, this may have been one of the worst examples of the lack of statesmanship in the history of Missouri. All parties to the enactment of these exclusions were aware of the impending downturn in economic activity. Yet, despite this knowledge, they decided to reduce state revenues. While the high rate of inflation at the time, particularly on fuel costs, may have given them a reason to consider the passage of these exclusions, the gloomy economic outlook and its potential effect on state revenues should have relegated this change to the “might have been” category.

The other enigma of the decade is the treatment of pension income. Prior to 1989, only specific state and local pensions were excluded from the state income tax. However, as a result of the U.S. Supreme

Court decision in the case of *Davis vs. Michigan*, it became necessary to either exclude federal pensions from the state income tax, tax the previously exempt state and local pensions, or some comprise between these two extremes. The actual comprise enacted exempted a maximum of \$6,000 of public pensions per taxpayer. This choice, however, ultimately led to the partial exclusion of all pensions – both public and private. The cost to the state for this exclusion totaled \$55.0 for the 2000 tax period.

The final chapter of this saga came in June of 1989, when a second court ruling, this one by the Missouri Supreme Court, determined that the treatment of federal pensions was illegal and ordered the state to pay refunds to federal retirees back to 1985 totaling \$158 million. In order to fund this ruling the state imposed a temporary nine month general revenue fund sales tax hike from 3.0 to 3.2 percent and a two year increase in the corporation income tax. In hindsight, the adoption of alternative one and an offsetting increase of just over \$13 million in state and local pensions would have been far less expensive.

By far the most significant tax changes of the decade were the 1982 passage of Proposition C and the overhaul of property tax assessments. Prompted by a growing unrest with increasing property tax levies, voters approved a new source of school funding – a one percent statewide sales tax levy. The receipts from this new tax source are categorized as “local revenue” and deposited to the State School District fund. They are distributed to local school districts based upon the number of pupils. Proposition C also mandated property tax levy rollbacks equivalent to one-half of the new sales tax receipts unless a higher levy was authorized by popular vote.

In conjunction with these changes in school funding, the legislature also initiated a series of property tax reforms, including statewide reassessment of all property, biennial reassessments, a new three tier real property classification scheme and the replacement of the merchants and manufacturers levy with a new commercial surcharge. The combination of these changes – Proposition C and the property tax reforms – constituted the largest total tax increase in state history.

**Table IX**  
***Property and Sales Tax Receipts***

| Year | Average<br>Tax<br>Rate | Statewide Assessed Valuation |             |             | Tax<br>Liability | Proposition C<br>Sales Tax<br>& Fair Share<br>Tax |
|------|------------------------|------------------------------|-------------|-------------|------------------|---|
|      |                        | Total                        | Real        | Tangible    |                  |   |
| 1980 | 4.15                   | \$14,408.60                  | \$11,355.00 | \$3,053.60  | \$598.00         | \$0.00  |
| 1983 | 4.26                   | \$16,068.90                  | \$12,171.80 | \$3,897.10  | \$684.50         | \$97.20   |
| 1984 | 4.32                   | \$16,828.30                  | \$12,547.00 | \$4,281.30  | \$727.00         | \$314.50  |
| 1985 | 2.91                   | \$28,117.80                  | \$22,530.80 | \$5,587.00  | \$818.20         | \$335.20  |
| 1990 | 3.01                   | \$36,928.40                  | \$28,547.20 | \$8,381.20  | \$1,111.50       | \$429.20  |
| 2000 | 3.86                   | \$59,344.10                  | \$43,450.70 | \$15,893.40 | \$2,290.70       | \$667.30  |

*Note: in millions*  
**Source:** State & Regional Fiscal Studies Unit

Table IX presents average school tax rates and statewide-assessed valuation for the period 1980 to 2000. While the first Prop C revenues were collected and distributed in the 1982-83 school year, the real impact of the reforms was not seen until 1985. The combination of new sales and tobacco taxes in conjunction with the newly assessed property values increased school funds from a level of \$598 million in 1980 to nearly \$1.2 billion in 1985, despite a 30% reduction in the average tax rate.

### **The Roaring 90's**

These years may have been the zenith of economic expansion in Missouri since the boom following the end of World War II. After a litany of disasters in the period 1990 to 1992, that included major plant closings and corporate down-sizings, the state economy experienced an almost explosive growth pattern for the next six years. Nominal personal income expanded at an average rate of 5.4 percent. Adjusted for inflation, income growth was nearly 3 percent while real payrolls expanded at 3.2 percent. Unemployment averaged only 4.9 percent and for the first time since the 1940's the state witnessed net in-migration.

**Table X**  
***Major State Tax Changes: 1990 to 1999***

| <b>Description</b>                             | <b>Effective Date</b> |
|--|-----------------------|
| Increased Corporate Tax Rates                  | 01-01-1990            |
| Limited Corporate Income Tax Deduction         | 09-01-1993            |
| Limited Individual Income Tax Deduction        | 01-01-1994            |
| Exempted Food from GR Sales Tax                | 11-01-1997            |
| Expanded pension deduction to private pensions | 01-01-1998            |
| Increased Property Tax Credit                  | 01-01-1998            |
| Increased Dependency Exemptions                | 01-01-1998            |
| Pharmaceutical Drug Tax Credit                 | 01-01-1999            |
| Increased Taxpayer Exemptions                  | 01-01-1999            |
| Additional Exemption for 65 & older dependents | 01-01-1999            |

**Source:** State & Regional Fiscal Studies Unit

By far the most significant policy and tax change of the decade was the passage of SB 380. This legislation, which was enacted in response to a court order involving school funding, established the Outstanding Schools Trust Fund and capped the federal income deductions on both the individual and corporation income taxes and raised the corporation income tax rate by 25 percent. This action resulted in additional revenues of nearly \$500 million in the 1994-95 fiscal year. However, because this tax increase was not approved by popular vote, the resultant increase in state revenues exceeded the permissible growth under the Hancock Amendment, the Total State Revenue (TSR) limit, and triggered the refund provisions delineated in Article X of the state constitution.

**Table XI**  
**Revenue Limitation Amounts and Refunds**

| Fiscal Year | Total State Revenue Limit (TSR) | Refunds |
|-------------|---------------------------------|---------|
| 1994        | -\$386                          | 0       |
| 1995        | \$147                           | \$147   |
| 1996        | \$229                           | \$229   |
| 1997        | \$319                           | \$319   |
| 1998        | \$167                           | \$179   |
| 1999        | \$99                            | \$99    |
| 2000        | -\$458                          | 0       |
| 2001        | -\$509                          | 0       |
| 2002        | -\$547                          | 0       |

*Note: in millions*

**Source:** Missouri Office of Administration

SB 380 was also significant from another tax policy vantage point. In addition to the fact that it was enacted without voter approval, making it the first major tax increase so adopted since 1971, SB380 made the tax structure extremely more progressive, since it only affected single individuals earning over \$50,000 and married couples with over \$70,000.

**Table XII**  
**Income Tax Liability before Credits**

| Tax Year | Single Returns<br>\$50,000 & Over |       |         |       | Combined Returns<br>\$70,000 & Over |       |         |       |
|----------|-----------------------------------|-------|---------|-------|-------------------------------------|-------|---------|-------|
|          | Number<br>of Returns              | Share | Amount  | Share | Number<br>of Returns                | Share | Amount  | Share |
| 1993     | 28,088                            | 4.8   | \$96.9  | 27.4  | 140,012                             | 15.2  | \$646.4 | 46.4  |
| 1994     | 31,961                            | 5.3   | \$143.6 | 34.0  | 156,943                             | 16.9  | \$868.7 | 53.3  |

*Note: millions*

**Source:** State & Regional Fiscal Studies Unit

Table XII presents number of returns and tax due before credits for tax years 1993 and 1994 stratified by filing status and income level. For individuals, the effect of SB 380 was to reduce the deduction for federal income taxes paid by placing a ceiling on the amount of the deduction - \$5,000 for single returns and \$10,000 for combined returns. This change resulted in a reduction of over \$3 billion in this deduction.

What was not so obvious was the change in tax shares that resulted from the imposition of this limitation. For resident single filers with AGI of \$50,000 and over, the share of tax liability rose from 27.4% to 34%. For combined returns with AGI of \$70,000 and over, the increase was even larger. The need to make annual refunds because of the Total State Revenue (TSR) limit was much debated by the legislature. Some members argued that it made little sense to collect taxes only to refund them the following year. Others argued that since refunds are nearly costless and those paying the tax received the refunds, it made little sense to alter the state tax structure, especially since the “good times” would

not last forever. Unfortunately, the latter group was in the minority. Thus, beginning in 1997, the legislature and executive branches embarked on a course of action to eliminate the need for refunds by enacting a series of new tax credits, sales tax exclusions and increased deductions. The alternative of reducing tax rates was apparently never given serious consideration. As a consequence, they were able to redirect the bulk of the mandatory refunds from those who paid the additional income taxes to other individuals. The only problem was that they were far too generous – giving back over \$850 million. The net result has been the revenue shortfalls and budget problems of the past two years.

### **The New Millennium**

Missouri entered the 22<sup>nd</sup> century like it had the last three, with a recession. Income growth slowed and unemployment rates edged upward. New job growth declined, particularly in manufacturing which actually lost over 49,000 jobs, and net out-migration replaced the inflow of the previous eight years. Despite warnings of the possible downturn, the legislature still enacted additional tax reductions, leaving the state in a precarious fiscal situation. The implosion of the stock market in 2001 coupled with major federal tax changes, including the elimination of the estate tax, and the uncertainty following 9-11 make the outlook for the immediate future very bleak.

**Table XIII**  
***Major State Tax Changes: 2000 to 2002***

| <b>Description</b>               | <b>Effective Date</b> |
|----------------------------------|-----------------------|
| Increased Taxpayer Exemptions    | 01-01-2000            |
| Additional Insurance Deductions  | 01-01-2000            |
| Limited Accelerated Depreciation | 01-01-2002            |

**Source:** State & Regional Fiscal Studies Unit

## Comparisons with Other States: 1980 – 2000

The formulation and adoption of state tax policy is influenced by many factors. The primary ones, however, are philosophical in nature – (1) what is the appropriate level of state and local government expenditures and (2) what is the appropriate mix of state and local tax shares. While these points may seem obvious, they seldom receive adequate discussion or review.

The scope of state government, excluding programs mandated by the federal government, is basically a function of the prevailing sentiment on the mix of public versus private involvement in the provision of goods and services. Some states such as Arkansas, Delaware, Michigan and Hawaii have tended to provide many services via government programs. Other states, particularly those in the Midwest have tended to offer only the more basic ones. In a very real sense, this observation lends considerable credence to the Tiebout hypothesis that persons will tend to associate with those who share similar views on tax and expenditure philosophies – or to put it more succinctly, that “birds of a feather flock together.” Thus, individuals who prefer a broad range of publicly provided services will move to those states that provide them. Individuals who prefer a narrower range of public services will gravitate to states that only provide more basic services. Missouri is in the latter group.

Once the overall level of state and local government involvement and spending has been established, the next consideration is that of the mix between the two – should the state be the dominant provider or should the provision of most services be funded locally? This delineation is particularly relevant for education funding.

As with the issue of the overall level of government, this tends to be one that is regional in nature. Individuals who desire that fewer, as opposed to more, services be provided by the government will also tend to prefer that they be so at the local level. In this regard, they are probably expressing a desire to have and maintain greater control over both. Individuals who prefer more government involvement tend to favor a more central administrative focus, and hence, more control at the state level.

A common feature of many tax structure discussions is a comparison of tax bases and tax rates with other states. Since states vary greatly in both population and personal income, a typical technique is to rank the states based upon specific tax revenues per capita and per \$1,000 of personal income. The latter is often referred to as a measure of tax capacity, or how much revenue could reasonably be expected given tax rates that were near the national averages. Rankings of tax rates are referred to as a measure of tax effort. While this is of some interest with respect to comparisons for image purposes, it is of little other value.

The reason for this is that the rankings primarily reflect the overall spending philosophies of the states and their mix of state and local services. States that have a high level of expenditures will have a concomitantly high level of taxes and vice versa. States that have traditionally provided the bulk of government services at the local level will tend to have lower state expenditures and taxes. States that provide a larger portion of most services at the state level will have relatively higher levels of state taxes.

**Table XIV**  
*State Tax Receipt Rankings per \$1,000 of Personal Income: 2000*

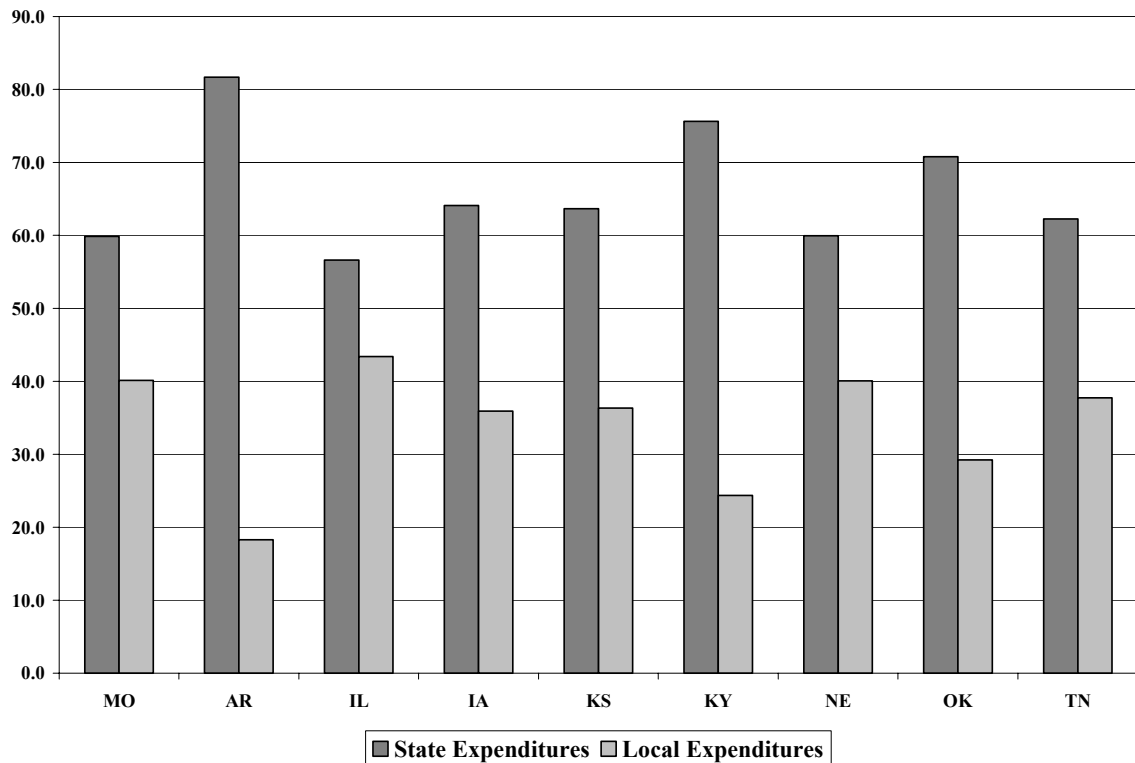
| State     | Ranks             |             | Sales Tax |               | Income Taxes |               |           |               |
|-----------|-------------------|-------------|-----------|---------------|--------------|---------------|-----------|---------------|
|           | Per Capita Income | Total Taxes | Tax Rate  | Receipts Rank | Individual   |               | Corporate |               |
|           |                   |             |           |               | Tax Rate     | Receipts Rank | Tax Rate  | Receipts Rank |
| Missouri  | 29                | 44          | 4.225     | 34            | 6.000        | 31            | 6.250     | 46            |
| Arkansas  | 47                | 8           | 4.625     | 8             | 7.000        | 26            | 6.500     | 22            |
| Illinois  | 10                | 42          | 6.250     | 38            | 3.000        | 36            | 4.800     | 6             |
| Iowa      | 33                | 25          | 5.000     | 23            | 8.980        | 30            | 12.000    | 32            |
| Kansas    | 28                | 28          | 4.900     | 20            | 6.450        | 25            | 4.000     | 26            |
| Kentucky  | 39                | 11          | 6.000     | 23            | 6.000        | 16            | 8.250     | 28            |
| Nebraska  | 25                | 31          | 5.000     | 26            | 6.680        | 28            | 7.810     | 31            |
| Oklahoma  | 42                | 19          | 4.500     | 35            | 6.750        | 19            | 6.000     | 39            |
| Tennessee | 35                | 46          | 6.000     | 7             | NA           | NA            | 6.000     | 19            |

NA - Not Applicable

Source: U.S. Department of Commerce, Bureau of the Census; State & Regional Fiscal Studies Unit

Table XIV presents fiscal year 2000 per capita income, selected maximum tax rates and national rankings by revenue source for Missouri and the eight states contiguous to Missouri. The most populous and richest is Illinois, which is of course dominated by Chicago. The least populous state is Nebraska and the poorest is Arkansas.

**Figure I**  
*State and Local Revenues by Share: 2000*



**Table XV**  
**State and Local Tax Revenues: 2000**

| State     | Total        | State Government |       | Local Government |       |
|-----------|--------------|------------------|-------|------------------|-------|
|           |              | Taxes            | Share | Taxes            | Share |
| Missouri  | \$14,313,873 | \$8,571,548      | 59.9  | \$5,742,325      | 40.1  |
| Arkansas  | \$5,961,335  | \$4,870,561      | 81.7  | \$1,090,774      | 18.3  |
| Illinois  | \$40,256,016 | \$22,788,799     | 56.6  | \$17,467,217     | 43.4  |
| Iowa      | \$8,090,525  | \$5,185,394      | 64.1  | \$2,905,131      | 35.9  |
| Kansas    | \$7,616,353  | \$4,848,235      | 63.7  | \$2,768,118      | 36.3  |
| Kentucky  | \$10,172,414 | \$7,694,610      | 75.6  | \$2,477,804      | 24.4  |
| Nebraska  | \$4,972,968  | \$2,981,047      | 59.9  | \$1,991,921      | 40.1  |
| Oklahoma  | \$8,251,421  | \$5,840,022      | 70.8  | \$2,411,399      | 29.2  |
| Tennessee | \$12,431,196 | \$7,739,590      | 62.3  | \$4,691,606      | 37.7  |
| Average   |              |                  | 66.1  |                  | 33.9  |

*Note: in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

As mentioned previously, these rankings represent little more than the overall spending and tax philosophies of the states. Arkansas, for instance, which has a per capita ranking of 47<sup>th</sup> and a total tax ranking of 8<sup>th</sup>, is an excellent example. On the surface, it would appear that Arkansas must have an abnormally high tax effort compared to their capacity. However, Table XIV presents only the state portion of total state and local revenues. Arkansas, unlike Missouri and Illinois, has negligible local tax revenues, only 18.3 percent of total state and local taxes compared with Missouri's 40.1 percent and Illinois' 43.4 percent. The primary contributing factor to this is the method of financing elementary and secondary education. While both Missouri and Illinois rely heavily on local revenues sources, 46.2 and 57.5 percent respectively, Arkansas only receives 8.5 percent of education revenues from local sources. The same is true for Kentucky and Oklahoma, which derive 69.7 and 65.8 percent of their elementary and secondary expenditures from state government. The influence of the choice of funding source for education is discussed in greater detail in the section on education funding.

**Table XVI**  
**Elementary and Secondary Education Expenditures: 2000**

| State     | Total Expenditure | State        |       | Local        |       | Per    |         |
|-----------|-------------------|--------------|-------|--------------|-------|--------|---------|
|           |                   | Expenditures | Share | Expenditures | Share | Capita | \$1,000 |
| Missouri  | \$6,474,946       | \$3,480,735  | 53.8  | \$2,994,211  | 46.2  | \$115  | \$42    |
| Arkansas  | \$2,605,399       | \$2,384,028  | 91.5  | \$221,371    | 8.5   | \$97   | \$44    |
| Illinois  | \$16,465,749      | \$7,004,682  | 42.5  | \$9,461,067  | 57.5  | \$132  | \$42    |
| Iowa      | \$3,621,038       | \$2,315,425  | 63.9  | \$1,305,613  | 36.1  | \$124  | \$47    |
| Kansas    | \$3,081,647       | \$2,383,869  | 77.4  | \$697,778    | 22.6  | \$114  | \$42    |
| Kentucky  | \$3,948,267       | \$2,753,835  | 69.7  | \$1,194,432  | 30.3  | \$97   | \$41    |
| Nebraska  | \$2,068,284       | \$905,003    | 43.8  | \$1,163,281  | 56.2  | \$121  | \$44    |
| Oklahoma  | \$3,811,679       | \$2,509,252  | 65.8  | \$1,302,427  | 34.2  | \$110  | \$47    |
| Tennessee | \$5,699,080       | \$2,842,633  | 49.9  | \$2,856,447  | 50.1  | \$100  | \$39    |
| Average   |                   |              | 62.0  |              | 38    | \$112  | \$43    |

*Note: in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census



## Current and Future Revenue Adequacy

For several years, there has been a debate in Missouri as to whether the State has a revenue problem or a spending problem. The answer is both.

The 1990's were a time of fiscal exuberance in Missouri. Revenues increased dramatically, due in part to the strength of the economy, a rising stock market, and in particular, to the additional revenues that resulted from the enactment of SB 380.

The rapid growth in revenues also precipitated a concomitant growth in new and expanded state expenditure programs. But more importantly from a long run vantage point, the windfall revenues precipitated a methodical contraction of the overall tax base. The passage of SB 380 also contributed to the enactment of an additional constitutional amendment, commonly referred to as the Carnahan Farm Bureau Amendment that has eliminated the ability of the State to raise revenues without a popular vote.

**Table XVII**

|                    | <u>1999</u> | <u>2000</u> |       | <u>2001</u> |       | <u>2002</u> |       |
|--------------------|-------------|-------------|-------|-------------|-------|-------------|-------|
|                    | Receipts    | Receipts    | % Chg | Receipts    | % Chg | Receipts    | % Chg |
| Sales              | \$1,690     | \$1,774     | 4.9   | \$1,801     | 1.5   | \$1,815     | 0.8   |
| Individual, Gross  | \$4,083     | \$4,266     | 4.5   | \$4,583     | 7.4   | \$4,461     | -2.7  |
| Withholding        | \$2,860     | \$3,004     | 5.0   | \$3,216     | 7.0   | \$3,347     | 4.1   |
| Other              | \$1,224     | \$1,262     | 3.2   | \$1,367     | 8.3   | \$1,114     | -18.5 |
| Less Refunds       | \$413       | \$605       | 46.5  | \$607       | 0.3   | \$706       | 16.3  |
| Net                | \$3,670     | \$3,661     | -0.3  | \$3,976     | 8.6   | \$3,755     | -5.6  |
| Corporation, Gross | \$521       | \$521       | 0.2   | \$437       | -16.1 | \$467       | 6.8   |
| Less Refunds       | v180        | \$197       | 9.4   | \$146       | -25.9 | \$174       | 19.2  |
| Net                | \$341       | \$324       | -4.7  | \$291       | -10.2 | \$293       | 0.6   |
| Estate             | \$121       | \$139       | 15.0  | \$157       | 13.0  | \$137       | -12.6 |
| Insurance Premium  | \$146       | \$147       | 1.0   | \$139       | -5.4  | \$161       | 15.4  |
| Other              | \$867       | \$807       | -6.9  | \$712       | -11.8 | \$757       | 6.3   |
| Total Revenues     | \$6,907     | \$7,133     | 3.3   | \$7,391     | 3.6   | \$7,330     | -0.8  |
| Less Refunds       | \$750       | \$999       | 33.2  | \$1,001     | 0.2   | \$1,117     | 11.5  |
| Net                | \$6,157     | \$6,134     | -0.4  | \$6,390     | 4.2   | \$6,214     | -2.8  |
| Total Expenditures | \$6140      | \$6321      | 2.9   | \$6,721     | 6.3   | \$6,626     | -1.4  |
| Over/Under         | \$17        | -\$187      |       | -\$331      |       | -\$413      |       |

*Notes: in millions*

**Source:** State & Regional Fiscal Studies Unit

The cumulative effects of the actions became obvious in the 2000 fiscal year. While gross General Fund Revenue receipts increased by 3.3 percent, net receipts, excluding refunds, actually declined by 0.4

percent. Coupled with the 2.9 percent growth in General Fund expenditures, this caused a current year spending deficit of \$187 million.

As seen in the summary figures in Table XV, the situation deteriorated further in the 2001 and 2002 fiscal years that witnessed deficit spending levels of \$331 million and \$413 million respectively.

The executive and legislative response to these deficits can best be described as “denial.” While the 2002 fiscal year deficit was partially the result of extraordinary events, the 2001 deficit surely was not. In particular, the 6.3 percent increase in expenditures during the midst of a national and statewide recession is certainly difficult to fathom.

The further problems of the 2003 fiscal year budget and the bitter harangue surrounding 2004 budget underscore the need for review of both sides of the budget process. It is certainly obvious that the State cannot fund its current expenditure programs given the revenue structure in place. And there is no white knight on the horizon that will cure this malaise. In fact, just the opposite is true. The nearly quarter billion dollar reduction in income tax receipts due to the lackluster performance of financial markets will not be reversed in the foreseeable future. And the possibility of further federal tax changes that will result in additional State revenue losses is a distinct reality. The question is, “What Can Be Done?”

#### Recommendations for Tax Reform

The first step should be a comprehensive review of the largest and fastest growing state expenditure programs, in particular, elementary and secondary education, Medicaid and corrections. Unless the rate of increase in these particular programs is somehow slowed, it will be impossible to maintain a balanced General Fund budget even if additional revenues are found.

Take for example the budgets for just three programs - Medicaid, corrections and education. If the rates of growth in these programs were to continue at the same levels they have exhibited during the past four years, it would require annual growth in General Fund revenues of over \$500 million per year. Based on a general fund budget of approximately \$7.4 billion, this implies that general fund revenues must grow nearly 7 percent just to fund the increase in these three programs.<sup>1</sup> The probability of this given the current state tax structure is nil.

Although there has been much discussion of alternative revenue sources to fill the estimated \$750 million budgetary shortfall, there has been little discussion of the true underlying problem, the overall tax structure in Missouri. And more importantly, there has been no discussion of the adequacy of the proposed stopgap revenue enhancements to sustain the budget for more than one year.

The proposed increase in cigarette and tobacco product taxes provides an excellent example. The potential new revenue from this source, which has been estimated to be as high as \$250 million is surely not sustainable in the long run. In fact, it is a well known fact that base line cigarette tax receipts have been on a decade long decline. Thus, while this revenue source would be of short run help, it offers no additional monies in future years.

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<sup>1</sup> For an excellent discussion of these programs and their effect on the state budget, see Missouri Budget Problems, Causes and Possible Solutions, James R. Moody & Associates, January 2003

Another potential revenue source that has been bandied about is the elimination of the single-factor allocation option that is available to corporations. Although it has been referred to as a loophole, this is not the case. It is merely an alternative to another arbitrary allocation formula that is utilized primarily by corporations with little or no physical presence in Missouri. But most importantly, such a change would have very detrimental effects on both capital formation and job growth. From this perspective the enactment of such a change would substantially reduce long-term revenue growth.

Unless Missouri is willing to undo many of the tax reductions enacted over the past ten years, there is only one source of substantial new revenue available – the individual income tax. While the sales tax may be the most palatable to Missourians, it suffers from two major drawbacks. First, it is regressive with respect to income, a fact that will certainly attract much attention and opposition. Secondly, as mentioned previously, sales taxes are not deductible in calculating federal income tax liability.

If the intention is to simply increase general fund revenues, this can be accomplished almost painlessly via the state individual income tax. Our recommendation is to replace the existing individual income tax with a new flat rate single deduction levy. The new single deduction would replace the current taxpayer and dependency exemptions, the standard or itemized deduction amount, the pension modification and all other miscellaneous modifications. The new single deduction would be based entirely upon filing status: \$10,000 for single filers, \$20,000 for joint filers, \$15,000 for head of household returns and \$5,000 for taxpayers who are claimed on another return. Such a change would have at least three compelling arguments in its favor.

First, it would vastly simplify the tax, reducing the actual return to just four lines and permitting most taxpayers to use a post card sized return (see appendix A-3 for a facsimile of the new form). Secondly, this alternative would substantially broaden the base of the tax, from \$71 billion to \$94 billion. It would also preserve the full deductibility for itemized federal filers and reduce administrative costs substantially, both those of the state and those of the tax taxpayer.

The only issue is that of the appropriate tax rate. The break-even levy, one that would generate approximately the same revenue as the current system, is four percent. Our recommendation, however, is a tax rate of 6.75 percent. This would permit even greater tax reform and generate nearly \$2.8 billion in new revenues that could be used to offset other tax reductions.

The specific tax offsets we recommend are the following:

1. Eliminate the corporation income tax and change the corporation franchise tax to a levy on all businesses regardless of their legal definition. Net cost of this recommendation is approximately \$50 million.
2. Eliminate the state assessed portion of property taxes for school operating purposes – net cost of this recommendation is approximately \$115 million.
3. Use \$2.4 billion of the new revenues to reduce local school operating levies. As documented in the portion of this report on education funding, this change has the potential to eliminate completely the operating levy in 351 school districts and drastically reduce it in another 132.

As is evident from the recent pattern of corporate income tax receipts, this revenue source offers little in the way of long term aid. Net fiscal year 2004 receipts from this source are projected to be less than \$125 million. The decade long decline in this source of revenue, despite the plethora of investment incentives, provide ample evidence to the perception that Missouri is no longer a business friendly state. The simplest remedy for this is to eliminate the corporate income tax. The only downside to this action is the necessity to replace the income that would be lost. The positive aspects of such a change, however, would more than compensate for the minimal revenue loss.

First, it would permit broad administration savings, not only for the Department of Revenue, but also for the Department of Economic Development that could eliminate more than half of its programs. Secondly, such a change would send a strong and clear message to the corporate sector.

The expansion and redefinition of the corporate franchise tax to a fee on all businesses is also needed. This would not only “level the playing field,” but also provide for additional state revenues. There is no possible justification to treat limited liability corporations and partnerships in a manner different from traditional corporations.

The elimination of school operating levies on state assessed property is also a long-term desirable feature of tax reform. This portion of the property tax that applies primarily to utilities and railroads is both arbitrary and capricious. The elimination of these levies would permit substantial cost savings to the affected companies and reduced utility bills to all residents and businesses.

## Education Funding in Missouri

Of all the State funding programs, there is none more debated or more complicated than the mechanism used to distribute money for funding elementary and secondary education. Commonly referred to as the “foundation formula” or merely “the formula,” it is essentially an arithmetic contrivance that attempts to achieve vertical financial equality among the over 500 school districts within Missouri.

Since its inception in 1955, the foundation formula has undergone many revisions – some due to changing economic circumstances, some due to court rulings and some due to the modifications in the manner in which real and personal property is taxed in Missouri. The underlying rationale for the formula is based on two sections of the Missouri Constitution:

Article I, Section 2

“...that all persons are created equal and entitled to equal rights and opportunities under the law...”

and Article IX, Section 1(a)

“...the General Assembly shall establish and maintain free public schools for the gratuitous instruction of all persons...”

Thus, the Missouri Constitution not only mandates that the State shall provide free public schools, but also that it provides equal educational opportunity for each child.

The courts have interpreted that “equal education opportunity” for each child implies an “equal” amount of funding for each student. While “equal” in this context has not been regarded as the “same,” multiple rulings have mandated that the dispersion of funding per student be within reasonable bounds. To the extent that local resources do not meet this criterion, the courts have further decreed that the state must provide additional funding to those school districts that have limited fiscal means. The latter, however, is itself the product of two components: (1) the property tax base and (2) the property tax rate. The first of these, the tax base, is a measure of local capacity. The second is a measure of local effort. Thus, the criterion that per pupil funding for education be within “reasonable” bounds, implies that given a “reasonable” local effort the local capacity must be within a reasonable tolerance range. If this is not the case, then the state must augment the local capacity to the extent necessary to achieve the minimally acceptable level of equality. It is this issue that has generated the ongoing debate about education funding both in Missouri and nationwide.

In a sense, this controversy is the result of historical happenstance. Prior to the twentieth century, the only means available to finance public education was the property tax. In the agriculturally based economy of the time, with income and wealth spatially dispersed, it provided what was considered to be both an adequate and equitable amount of funding. However, as population and wealth began to coalesce into the metropolitan areas of the state and the need for higher levels of educational attainment became apparent, the adequacy and the equity of this funding source deteriorated. In the 21<sup>st</sup> century, it has become an anachronism.

## School Funding in Missouri

Historically, Missouri, like all other states has relied heavily on local revenue sources to fund education, with the preponderance of these monies coming from local property taxes. Table XVIII contains total state and local expenditures for elementary and secondary education for the period 1960 to 2000. In 1960, for instance, Missouri spent just over \$300 million on local schools. This amounted to \$70 per capita or \$32 per \$1,000 of personal income. Local tax sources accounted for 68.4 percent of all local school expenditures. By 2000, total expenditures had increased to nearly \$6.5 billion. The share financed by local revenue sources, however, had shrunk to 46.2 percent. Per capita expenditures increased to \$1,128 and expenditures per \$1,000 of personal income rose to \$42.

**Table XVIII**

***Nominal Elementary and Secondary Education Expenditures: 1960 - 2000***

| Year | Total     | Per     |         | State     |       | Local     |       |
|------|-----------|---------|---------|-----------|-------|-----------|-------|
|      |           | Capita  | \$1,000 | Amount    | Share | Amount    | Share |
| 1960 | \$302.1   | \$70    | \$32    | \$95.5    | 31.6  | \$206.6   | 68.4  |
| 1970 | \$783.2   | \$167   | \$44    | \$317.1   | 40.5  | \$466.1   | 59.5  |
| 1980 | \$1,689.5 | \$343   | \$37    | \$823.9   | 48.8  | \$865.6   | 51.2  |
| 1990 | \$3,658.1 | \$719   | \$40    | \$2,121.1 | 58.0  | \$1,537.0 | 42.0  |
| 2000 | \$6,474.9 | \$1,128 | \$42    | \$3,480.7 | 53.8  | \$2,994.2 | 46.2  |

*Note: in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

The decade of the 1960's is of special interest, since it reflects the first effects of the increased state participation in local school funding. As anticipated, the state share increased substantially, rising from 31.6 percent to 40.5 percent. What is more striking, however, is the overall growth of education funding during the decade, which expanded at an average annual rate of 15.9 percent. Even adjusted for inflation, the growth rate in total expenditures averaged an astonishing 9.8 percent per year, nearly three times as large as the rate in any of the following decades. On a per pupil basis, expenditures increased from \$400 to \$789, an average growth of over 9.7 percent per year.

On the surface, the decade of the 1970's would appear to have been a mere continuation of the previous ten years. The state share on total elementary and secondary education funding continued to expand, rising to 48.8 percent. Nominal spending rose to nearly \$1.7 billion, an average annual growth of 11.6 percent. Spending per pupil rose to \$1,935, averaging over 14.5 percent per year for the decade. The problem, unfortunately, was the horrendous inflation that buffeted this period.

**Table XIX**

***Real Elementary and Secondary Education Expenditures: 1960 - 2000***

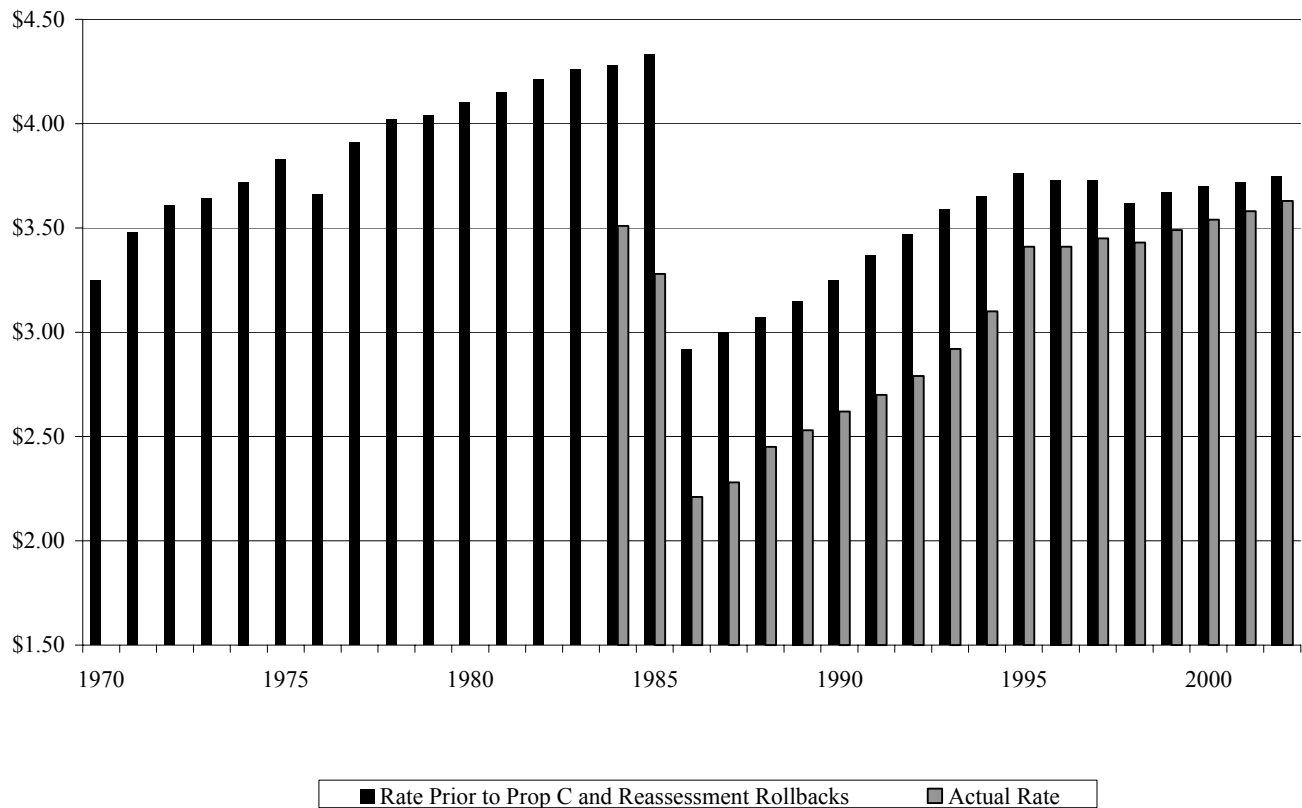
| Year | Total   | Per    |         | State   |       | Local   |       |
|------|---------|--------|---------|---------|-------|---------|-------|
|      |         | Capita | \$1,000 | Amount  | Share | Amount  | Share |
| 1960 | \$1,021 | \$236  | \$109   | \$323   | 31.6  | \$698   | 68.4  |
| 1970 | \$2,019 | \$431  | \$112   | \$817   | 40.5  | \$1,201 | 59.5  |
| 1980 | \$2,050 | \$417  | \$44    | \$1,000 | 48.8  | \$1,050 | 51.2  |
| 1990 | \$2,799 | \$546  | \$31    | \$1,623 | 58.0  | \$1,176 | 42.0  |
| 2000 | \$3,760 | \$655  | \$25    | \$2,021 | 53.8  | \$1,739 | 46.2  |

*Note: in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

After adjusting for inflation, which averaged 11.2 percent per year during the 1970's, real expenditures for education increased only 0.1 percent. On a per pupil basis, the growth was 1.5 percent only because of the lower enrollment figures of the decade. Real local funding actually declined from the 1970 level by 1.2 percent, substantially negating the 2.2 percent real increase in state funding. As mentioned previously, the underlying local funding problem was the property tax assessment procedures of the time that were unable to provide adequate tax revenues despite large increases in operating tax levies. The response to this dilemma was two-fold – the passage of two dedicated state taxes for education, the Proposition C sales tax and the Fair Share cigarette tax, and the complete overhaul of the property tax system.

**Figure II**  
*Average School Tax Rates*



As a result of these changes, the decade of the 1980's witnessed a return to the real gains of the 1960's. Bolstered by the new state revenues dedicated to education, the state share of elementary and secondary education funding rose to 58 percent. Nominal funding increased an average of 11.7 percent per year and spending per pupil rose to \$4,525, an average annual gain of 13.4 percent. In real terms, total education funding grew by 3.7 percent per year and spending per student reached \$3,462, an average annual growth of 4.7 percent, again due to the decline in total enrollment. The problem of this decade was not the overall level of education funding, but the uneven growth in funding between school districts that was a consequence of the new property assessment procedures.

The most significant change during the final decade of the century was the enactment of the Outstanding Schools Act in 1993 that vastly altered the formula for distributing state funds for elementary and secondary education. This act had two primary purposes – the redistribution of funding between school

districts and the enhancement of education funding. As discussed in the section on the funding formula, the new state distribution mechanism was designed to reward less wealthy districts that demonstrated above average tax effort. As a consequence, this caused the rate of growth in local funding to surpass that of state support. The higher annual growth rate in local funding, 4.7 percent, compared to the average growth in state funding of 2.5 percent had the effect of actually lowering the state share of the total to 53.8 percent. And although total funding for education reached new plateaus, \$6.5 billion or \$7,235 per pupil, the uneven growth across school districts has precipitated new ferment that must eventually lead to a reversal of this decline in the state's share of education funding.

### **Comparisons with Other States: 1970 - 2000**

Tables XXII and XXIII contain state and local education expenditures for Missouri and the eight contiguous states. Although the mix of state versus local spending exhibits varying patterns over this time span, there are certain aspects of education funding that have remained remarkably consistent. The most notable is the average level of funding per \$1,000 of personal income, which has a range of only six dollars over the 30 year period. Iowa and Nebraska have consistently spent more for education, ranking 1st and 2<sup>nd</sup>, while Tennessee and Kentucky have typically spent the least. With the exception of 1980, Missouri expenditures for education have been within one dollar of the average for the nine states.

On a per capita basis, however, the range of elementary and secondary spending has broadened considerably over the period. In 1970 the range was only \$94. In 1980 it had expanded to \$165 and by fiscal year 2000 to \$351. With the exception of 1980, Missouri expenditures for education on a per capita basis have been slightly above average for the region.

The most interesting trend over this period is the changing share of state funding which has grown from an average of 45.1 percent in 1970 to 62.0 percent in fiscal year 2000. Arkansas in particular has spear-headed this movement, with the state share of total funding increasing from a level of 58.9 percent in 1970 to 91.5 percent in 2000. The other leaders in this trend towards increased state funding, especially in the period 1990 to 2000, are Kansas and Nebraska. Missouri and Illinois, on the other hand, actually decreased the level of state support during the last decade.



**Table XX**  
**State and Local Elementary and Secondary Education Expenditures**  
**1970 – 2000**

**1970**

| State     | Per    |         | Total<br>Amount | State   |       | Local     |       |
|-----------|--------|---------|-----------------|---------|-------|-----------|-------|
|           | Capita | \$1,000 |                 | Amount  | Share | Amount    | Share |
| Missouri  | \$167  | \$44    | \$783.2         | \$317.1 | 40.5  | \$466.1   | 59.5  |
| Arkansas  | \$121  | \$42    | \$233.6         | \$137.7 | 58.9  | \$95.9    | 41.1  |
| Illinois  | \$182  | \$40    | \$2,026.7       | \$847.6 | 42.4  | \$1,167.7 | 57.6  |
| Iowa      | \$215  | \$56    | \$607.6         | \$242.8 | 40.0  | \$364.8   | 60.0  |
| Kansas    | \$189  | \$49    | \$423.8         | \$156.8 | 37.0  | \$267.0   | 63.0  |
| Kentucky  | \$138  | \$43    | \$445.4         | \$284.7 | 64.5  | \$158.1   | 35.5  |
| Nebraska  | \$179  | \$47    | \$265.8         | \$60.0  | 22.6  | \$205.8   | 77.4  |
| Oklahoma  | \$142  | \$41    | \$363.4         | \$175.4 | 49.0  | \$185.5   | 51.0  |
| Tennessee | \$136  | \$43    | \$534.2         | \$271.7 | 50.9  | \$262.5   | 49.1  |
| Average   | \$163  | \$45    |                 |         | 45.1  |           | 54.9  |

*Notes: Amounts are in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

**1980**

| State     | Per    |         | Total<br>Amount | State     |       | Local     |       |
|-----------|--------|---------|-----------------|-----------|-------|-----------|-------|
|           | Capita | \$1,000 |                 | Amount    | Share | Amount    | Share |
| Missouri  | \$343  | \$37    | \$1,689.5       | \$823.9   | 48.8  | \$865.6   | 51.2  |
| Arkansas  | \$327  | \$43    | \$748.3         | \$444.4   | 59.4  | \$303.9   | 40.6  |
| Illinois  | \$405  | \$37    | \$4,630.2       | \$2,549.2 | 55.1  | \$2,081.0 | 44.9  |
| Iowa      | \$465  | \$48    | \$1,355.3       | \$722.8   | 53.3  | \$632.5   | 46.7  |
| Kansas    | \$388  | \$39    | \$920.0         | \$468.0   | 50.9  | \$452.0   | 49.1  |
| Kentucky  | \$314  | \$38    | \$1,149.8       | \$884.2   | 76.9  | \$265.6   | 23.1  |
| Nebraska  | \$414  | \$45    | \$651.6         | \$137.1   | 21.0  | \$514.5   | 79.0  |
| Oklahoma  | \$358  | \$37    | \$1,087.6       | \$647.4   | 59.5  | \$440.2   | 40.5  |
| Tennessee | \$300  | \$36    | \$1,380.9       | \$683.6   | 49.5  | \$697.3   | 50.5  |
| Average   | \$368  | \$40    |                 |           | 52.7  |           | 47.3  |

*Notes: Amounts are in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

**Table XX (cont.)**  
**State and Local Elementary and Secondary Education Expenditures**  
**1970 – 2000**

**1990**

| State     | Per    |         | Total<br>Amount | State     |       | Local     |       |
|-----------|--------|---------|-----------------|-----------|-------|-----------|-------|
|           | Capita | \$1,000 |                 | Amount    | Share | Amount    | Share |
| Missouri  | \$714  | \$40    | \$3,658.1       | \$2,121.1 | 58.0  | \$1,537.0 | 42.0  |
| Arkansas  | \$593  | \$41    | \$1,395.4       | \$915.4   | 65.6  | \$480.0   | 34.4  |
| Illinois  | \$718  | \$35    | \$8,217.4       | \$3,505.8 | 42.7  | \$4,711.6 | 57.3  |
| Iowa      | \$749  | \$43    | \$2,082.1       | \$1,231.2 | 59.1  | \$850.9   | 40.9  |
| Kansas    | \$772  | \$42    | \$1,915.4       | \$996.0   | 52.0  | \$919.4   | 48.0  |
| Kentucky  | \$541  | \$35    | \$1,998.6       | \$1,563.4 | 78.2  | \$435.2   | 21.8  |
| Nebraska  | \$808  | \$45    | \$1,277.8       | \$332.8   | 26.0  | \$945.0   | 74.0  |
| Oklahoma  | \$669  | \$41    | \$2,105.2       | \$1,281.9 | 60.9  | \$823.3   | 39.1  |
| Tennessee | \$545  | \$32    | \$2,663.6       | \$1,172.9 | 44.0  | \$1,490.7 | 56.0  |
| Average   | \$679  | \$39    |                 |           | 54.1  |           | 45.9  |

*Notes: Amounts are in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

**2000**

| State     | Per     |         | Total<br>Amount | State     |       | Local     |       |
|-----------|---------|---------|-----------------|-----------|-------|-----------|-------|
|           | Capita  | \$1,000 |                 | Amount    | Share | Amount    | Share |
| Missouri  | \$1,128 | \$42    | \$6,474.9       | \$3,480.7 | 53.8  | \$2,994.2 | 46.2  |
| Arkansas  | \$972   | \$44    | \$2,605.4       | \$2,384.0 | 91.5  | \$221.4   | 8.5   |
| Illinois  | \$1,323 | \$42    | \$16,465.7      | \$7,004.7 | 42.5  | \$9,461.1 | 57.5  |
| Iowa      | \$1,236 | \$47    | \$3,621.0       | \$2,315.4 | 63.9  | \$1,305.6 | 36.1  |
| Kansas    | \$1,144 | \$42    | \$3,081.6       | \$2,383.9 | 77.4  | \$697.8   | 22.6  |
| Kentucky  | \$975   | \$41    | \$3,948.3       | \$2,753.8 | 69.7  | \$1,194.4 | 30.3  |
| Nebraska  | \$1,206 | \$44    | \$2,068.3       | \$905.0   | 43.8  | \$1,163.3 | 56.2  |
| Oklahoma  | \$1,102 | \$47    | \$3,811.7       | \$2,509.2 | 65.8  | \$1,302.4 | 34.2  |
| Tennessee | \$998   | \$39    | \$5,699.1       | \$2,842.6 | 49.9  | \$2,856.4 | 50.1  |
| Average   | \$1,120 | \$43    |                 |           | 62.0  |           | 38.0  |

*Notes: Amounts are in millions*

**Source:** U.S. Department of Commerce, Bureau of the Census

## Property Taxes and the Formula

The shortcomings of the property tax as the primary source of education funding have long been recognized and were the primary reason for the adoption of the original foundation formula. Although there are many possible measures of the variation in local per pupil property tax capacity, perhaps the broadest and simplest is merely total county assessed valuation divided by the fall headcount enrollment.

**Table XXI**  
***Total Assessed Valuation per Student by County***  
**1970 – 2002**

| Year | Low      | High      | Range     | Ratio |
|------|----------|-----------|-----------|-------|
| 1970 | \$2,262  | \$22,928  | \$20,766  | 10.1  |
| 1980 | \$4,750  | \$37,734  | \$32,984  | 7.9   |
| 1984 | \$5,425  | \$77,643  | \$72,218  | 14.3  |
| 1985 | \$8,894  | \$83,967  | \$75,073  | 9.4   |
| 1990 | \$12,821 | \$103,430 | \$90,609  | 7.1   |
| 1995 | \$16,321 | \$117,906 | \$101,583 | 7.2   |
| 2000 | \$22,933 | \$156,160 | \$133,227 | 6.8   |
| 2002 | \$25,683 | \$187,371 | \$161,688 | 7.3   |

Source: State & Regional Fiscal Studies Unit

In 1970, for example, total assessed valuation per student ranged from a low of \$2,262 to a high of \$22,928, a range of nearly \$21,000. The ratio of the highest per student valuation to the lowest was 10.1. By 1984, the last year prior to statewide reassessment, the range had increased to over \$72,000 and the ratio of highest to lowest had risen to 14.3. Although the current property tax assessment practices that became effective in 1985 have not reduced the range of assessed valuation per student, they have dramatically reduced the ratio of the highest to the lowest per student valuation.

While these data provide a glimpse of the problems inherent in utilizing local wealth as the primary means of funding education, a sharper focus is presented by looking at the variation between school districts.

**Table XXII**  
***Local Assessed Valuation per Student by School District***  
**1990 – 2002**

|                       | 1990     |           |           |       | 2002     |           |           |       |
|-----------------------|----------|-----------|-----------|-------|----------|-----------|-----------|-------|
|                       | Low      | High      | Range     | Ratio | Low      | High      | Range     | Ratio |
| Eligible Pupil        | \$9,915  | \$354,180 | \$344,265 | 35.7  | \$19,426 | \$350,985 | \$331,559 | 18.1  |
| Fall Headcount        | \$9,177  | \$332,790 | \$323,613 | 36.3  | \$19,399 | \$339,318 | \$319,919 | 17.5  |
| Avg. Daily Attendance | \$10,350 | \$363,580 | \$353,230 | 35.1  | \$20,345 | \$356,696 | \$336,351 | 17.5  |

Source: State & Regional Fiscal Studies Unit

Table XXII presents three alternative measures of local capacity for the period 1990 – 2002. These are constructed by dividing locally assessed property, excluding state assessed utilities and railroads, by the three alternative measures of enrollment – eligible pupils, fall headcount and average of daily

attendance. Because of the changes in the definition of eligible pupils over this time period, the latter two measures are more consistent.

What is striking about these data compared to the aggregated county figures in Table XXI are both the range and ratio of high to low valuation. Using the fall headcount enrollment, the 1990 range was \$323,613 or a ratio of highest to lowest of 36.3. This range is over 3.5 times the aggregate county figure and the ratio of highest to lowest per pupil valuation is over 5 times higher. While these differences have since narrowed, the individual district range is still twice as high as the county aggregate in 2002 and the ratio of high to low valuation is still 2.4 times as large.

What should be obvious from these data is that it is extremely difficult, if not impossible, to construct a fair or equitable funding mechanism for education based upon local property wealth when the richest district can generate over 17 times the same revenue as that of the poorest district using the same local effort. One need only to examine the formula for funding elementary and secondary schools in Missouri to obtain a sense of the problems inherent in using the property tax as the principal source for education funding.

### **The Formula**

The foundation formula, both past and present, represents an attempt to equalize the wide variation in local wealth while still maintaining the property tax as a significant source of education funding. One must wonder why the insistence on keeping such an inherently flawed premise has endured. The rationale would appear to be two-fold.

First, the local property tax is viewed as a stable revenue source, unaffected by the vagaries of the economy or financial markets. Secondly, and perhaps more important, it is perceived as being subject to local control. Since property taxes are a levy on a stock as compared to a levy on a flow, such as sales or income taxes, it will be a stable source of revenue in all but the most extraordinary of circumstances. The question, however, is whether this single characteristic is sufficient to offset the limitations of this tax source in the long run.

The perception that the property tax is subject to a substantial degree of local control is probably its strongest attraction to local school boards and administrators. Although the entire assessment process and permissible tax rates are determined by state statute, there still persists the notion that the property tax is somehow under local control. The “bogeyman” of local school administrators has long been the belief that the larger the share of education revenues provided by the state, the greater the level of state control. And despite the ever expanding role of the state in financing local schools, the perception has not only endured, but has been prominent in the manner in which the foundation formula has been crafted and evolved.

## The Formula in Theory and Practice

While it is true that the formula has changed since its inception in 1955, its underlying premise and application has not. In essence, the formula reflects just two factors – tax capacity and tax effort. The measure of effort, the operating tax levy, has changed only slightly. The measure of tax capacity, however, has undergone several iterations. Although the complexity of the formula has grown over time, its basic form may be reduced to the following:

$$\mathbf{BE} = \mathbf{A}\{\mathbf{NS}, \mathbf{NSP}, \mathbf{OPL}\} \text{ less } \mathbf{B}\{\mathbf{AV}, \mathbf{INF}, \mathbf{OLS}\}$$

where

BE is the basic entitlement,  
NS is the number of students,  
NSP is the number of poor students,  
OPL is the operating tax levy,  
AV is the assessed valuation,  
INF is the district income factor,  
and OLS is other local revenue sources.

The first group of factors, the A portion, reflect need and effort and are positively related to the level of state aid. Historically, this part of the formula has determined the basic level of funding prior to any consideration of local capacity. The remaining factors, the B portion, reflect wealth, income or tax capacity and have a negative correlation with state aid. These factors form the deduction portion of the formula, both past and present.

Prior to 1994, the number of students, referred to as eligible pupils (EP), was calculated as the average of average daily attendance (ADA) and the mean of the September and January membership count. Beginning with the enactment of the Outstanding Schools Act in 1993, the number of students has been calculated as the regular ADA plus two times the summer school ADA. The measure of poor or needy students was also changed by the act from the number of students qualifying for Aid to Families with Dependent Children (AFDC) to the number who qualify for the free or reduced lunch program. Historically, the deduction for other local revenue sources has consisted of two basic elements – (1) the local property tax base multiplied by some tax levy and (2) the sum of other local revenues - fines, forfeitures, escheats and financial institution tax receipts. This deduction was modified in 1984 to include one-half of the district's Proposition C sales tax receipts and again in 1994 to include federal reimbursements, Fair Share cigarette taxes and Free Text Book monies. The treatment of Proposition C sales tax receipts as a local revenue source bears some comment. These monies, which are collected via a statewide one percent dedicated sales tax, are allocated to school districts based upon the district's share of eligible pupils. In reality, these are state funds. Their classification as a "local" source of revenue is purportedly the result of fears that these receipts might have been subject to the Hancock revenue limitations. Given subsequent court ruling, this has become a moot point although they are still classified as local revenue.

The role of the district's assessed valuation and income in determining the basic entitlement also underwent change due to the enactment of the Outstanding Schools Act. Before 1994, the formula incorporated assessed valuation in two calculations, first as a deduction and then as an add-on. The

deduction portion was simply the district's total assessed valuation multiplied by the statewide pupil-weighted tax levy times an adjustment factor of 0.57. The larger the assessed valuation in the district, the smaller was the basic entitlement. The second use of assessed valuation was in the portion of the formula known as the Guaranteed Tax Base (GTB) Add-On.

The GTB was calculated as the assessed valuation per eligible pupil of the district containing the 90<sup>th</sup> percentile of all pupils in the state from a low to high ranking of all districts. The district's add-on was then calculated as the difference between the GTB and the district's assessed valuation per student multiplied by the district's operating levy less 0.57 times the statewide pupil-weighted tax levy times the district's income factor. This portion of the formula was included to assist less wealthy districts that had above average tax rates, or alternatively, above average effort adjusted for the relative income in the district.

Whereas the GTB was merely an add-on to the basic entitlement under the old formula, it became the driving force in the current formula adopted in 1994. First, the definition of the GTB was changed from the assessed valuation per eligible pupil of the district containing the 90<sup>th</sup> percentile to the district containing the 95<sup>th</sup> percentile. Further, the GTB was also specifically included in the calculation of the amount of funding each district receives for the free and reduced lunch portion of state aid.

In a real sense, the current formula represents a regression from the trend of greater state funding. The old formula, pre-1994, may be represented by the following:

$$\text{BE} = [(\text{EP} * 0.75 * \text{SEF}) + (\text{AFDC} * 0.25 * 0.75 * \text{SEF})] \\ - \text{Local Taxes plus GTB Add-on}$$

where

- BE is the basic entitlement,
- EP is the number of eligible pupils,
- SEF is the State Expenditure factor and
- AFDC is the number of children on the rolls of AFDC.

The starting point for the formula was the State Expenditure Factor (SEF), which was defined as total current state expenditures per eligible student. Local taxes consisted of the sum of total equalized assessed valuation, financial institution tax receipts, fines, forfeitures and escheats and one-half of Proposition C sales tax revenues. The GTB Add-on was calculated as follows:

$$\text{Add-on} = (\text{GTB} - \text{AV}/\text{EP}) * (\text{OPL} - 0.57 * \text{INF} * \text{PWL})$$

where

- GTB is the Guaranteed Tax Base
- AV is the district's assessed valuation
- INF is the district's income factor and
- PWL is the statewide pupil weighted average operating tax rate.

The GTB Add-on only applied to those districts that had assessed valuation per pupil below the GTB level and whose operating levy was above the income adjusted statewide average.

The final portion of the old formula was the “prior year constraint” or “limited apportionment” calculation. It was this portion of the formula that in fact determined the actual level of state aid.

$$\text{State Aid} = [(\text{BE} / \text{EP} - \text{Prior Yr State Aid} / \text{EP}) * \text{Adj Factor} + \text{Prior Yr Aid} / \text{EP}] * \text{EP}.$$

The critical factor in this calculation was the Adjustment Factor that was set by the State each year to control the overall size of state funding. The problem was not so much the formula and its components, but the amount of funding available for elementary and secondary education.

Because this formula was never fully funded, the adjustment factor was quite small, averaging only 2 percent during the last five years of the formula’s use. In fact, because of variances in the level of state revenues, it was negative in two of those years. Thus, although the old formula utilized a conceptual model that should have equalized expenditures per district, the overall lack of funding caused actual district aid to be primarily a function of the level of funding in the 1986-87 base year period. Because of the inequities that arose out of the application of this formula, it was declared unconstitutional in a judgment rendered by Circuit Court of Cole County on January 15, 1993.

If the old formula was considered overly complex, the current one that was adopted in 1994 set an even higher standard for obfuscation. This formula may be depicted as follows:

$$\begin{aligned} \text{BE} = & [\text{EP} * \text{Max} (\text{OPL}, 2.75) * \text{GTB}/100] + \text{EP} * (\text{Eq OPL} - 2.75) * \text{GTB}/100] \\ & - [(\text{AV}_{1994} * \text{INF} * \text{Eq OPL}) + (\text{AV} - \text{AV}_{1994}) * \text{Adj INF} * \text{Actual OPL}] \\ & - \text{Local Tax Sources} \\ & + [(\text{FRL} * 0.20 * \text{GTB}/100 * 2.75) + (\text{FRL} * 0.30 * \text{GTB}/100 * (\text{OPL} - 2.75))]. \end{aligned}$$

As noted previously, the concept of the Guaranteed Tax Base (GTB) was elevated to increased prominence in the current version of the formula. The local tax sources now include additional elements and the portion of the formula related to the number of poor students now uses the number of students eligible for the free and reduced lunch program (FRL) as opposed to the number eligible for AFDC. Although its form is considerably different than the previous version of the formula, it still contains the same basic two elements – local tax capacity and local tax effort.

The first line of the current is a measure of equality or need, based upon the Guaranteed Tax Base and the district’s total operating levy. It has been broken into two components to reflect the minimum levy constraint (\$2.75 per hundred dollars of assessed valuation) contained in the current statutes. Lines two and three reflect measures of local tax capacity – assessed valuation and other local revenue sources. Line four is also a measure of capacity, reflecting the number of children who qualify for the free and reduced lunch program.

There are several components of the current formula, however, that render it non-operative in the long run. The first is the definition of eligible pupils. One would think that the determination of the number of pupils in a district would be a simple matter. The issue, however, is the treatment of pupils enrolled in summer school program. Eligible pupils is defined as the sum of the average daily attendance of school term plus two times the average daily attendance for summer school. Thus a student who attends summer school is in fact counted three times – one for the regular school year and twice for attending

summer school. This obviously inflates the amount of state aid a district receives in line 1 of the current formula, thereby increasing the state share education funding.

The second issue is the use of two different income factors in line 2 of the formula. The first use, labeled INF, is equal to  $[1 + 0.3 * (\text{Income Ratio} - 1)]$  where the income ratio is defined as the ratio of Missouri adjusted gross income per return divided by the statewide average adjusted gross income per return. For the portion of line 2 that deals with the change in assessed valuation since 1994, an adjusted income figure is utilized that is defined as the maximum of the actual income factor or one. This in essence, reduces the amount of the local property tax deduction thus increasing the amount of the basic entitlement.

The third issue is the use of two different operating levies – the actual levy and the adjusted or equalized tax levy. The actual tax levy is as its name implies it is the legal tax levy of the district and is used in the deduction portion of the formula – line 2. The equalized or reassessment calculated levy that is used in line 1 is higher since it is calculated as if no mandatory roll-backs have occurred. As with the definition of eligible pupils and the income factor, this also inflates the state portion of school funding.

The final, and most important issue, is the measure of the GTB. Table XXIII contains the actual GTB used in the formula for fiscal years 1994 through 2004. Additionally, it contains the values for the 90<sup>th</sup> and 95<sup>th</sup> percentiles as used in the original version of the current formula and the previous formula. The latter are based upon the prior year equalized assessed valuation per eligible pupil.

**Table XXIII**  
***Guaranteed Tax Base***

| <b>Fiscal Year</b> | <b>Actual</b> | <b>Pct. Chg.</b> | <b>95th Percentile</b> | <b>Pct. Chg.</b> | <b>90th Percentile</b> | <b>Pct. Chg.</b> | <b>Statewide Average</b> | <b>Pct. Chg.</b> |
|--------------------|---------------|------------------|------------------------|------------------|------------------------|------------------|--------------------------|------------------|
| 1993-94            | 108,833       |                  | 106,828                |                  | 75,403                 |                  | 49,808                   |                  |
| 1994-95            | 111,192       | 2.17             | 111,192                | 4.09             | 77,928                 | 3.35             | 51,755                   | 3.91             |
| 1995-96            | 111,192       | 0.00             | 115,165                | 3.57             | 78,039                 | 0.14             | 52,161                   | 0.78             |
| 1996-97            | 112,597       | 1.26             | 121,495                | 5.50             | 83,444                 | 6.93             | 54,851                   | 5.16             |
| 1997-98            | 113,340       | 0.66             | 127,903                | 5.27             | 94,812                 | 13.62            | 56,405                   | 2.83             |
| 1998-99            | 119,163       | 5.14             | 136,283                | 6.55             | 99,169                 | 4.60             | 60,828                   | 7.84             |
| 1999-00            | 122,652       | 2.93             | 145,592                | 6.83             | 101,578                | 2.43             | 62,756                   | 3.17             |
| 2000-01            | 130,789       | 6.63             | 154,632                | 6.21             | 106,365                | 4.71             | 67,076                   | 6.88             |
| 2001-02            | 134,855       | 3.11             | 158,191                | 2.30             | 108,694                | 2.19             | 69,494                   | 3.60             |
| 2002-03            | 139,507       | 3.45             | 173,791                | 9.86             | 121,450                | 11.74            | 74,614                   | 7.37             |
| 2003-04            | 147,022       | 5.39             |                        |                  |                        |                  |                          |                  |

Source: State & Regional Fiscal Studies Unit

What is obvious from these data is the impossibility of funding the basic formula at any where near the intended levels contained in SB 380. In the 2002-03 fiscal year, for example, the GTB would have had to be \$173,791 per eligible pupil if the 95<sup>th</sup> percentile calculation was used. This would have represented an increase of \$34,284 per student over the actual value used for that year. In percentage terms, it would have been an increase of 24.6 percent.



Several other inferences may also be gleaned from these data. The annual growth rates of both the 95<sup>th</sup> and 90<sup>th</sup> percentile amounts are substantially above the growth of the statewide-assessed valuation per pupil. This reflects the fact that the increase in any measure of this statistic will be driven by the changes in the wealthiest districts, which but with few exceptions, are located in St. Louis County. Given the nature of the property tax system in Missouri, this is unavoidable.

Prior to 1985, Missouri assessed all property at one-third of estimated market value. However, as a result of the property tax reforms that became effective that year, Missouri began using a three-tiered property assessment procedure. Agricultural property is now assessed at 12 percent of value, residential at 19 percent of value and commercial property at 32 percent of value. As a consequence, areas with high concentrations of residential and commercial property will have a much larger influence on the overall average than rural areas that have a high concentration of agricultural property. The turnover rate and the growth rates will also be higher in the wealthier urban areas, contributing to their influence on any measure of property value per student.

The question becomes then, whether to “tinker” with the existing funding formula, which has become non-operational, or to replace it with a formula that is more equitable and sustainable in the longer run.

### **Recommendations for Education Funding Reform**

Any new education funding formula should at a minimum accomplish four goals:

1. Less complexity
2. Greater equity
3. Long run sustainability
4. Combine categorical funding programs

The easiest method to accomplish all of these is to change the method of funding education from one based upon local wealth to a state financed formula based upon a pure per pupil basis. This would obviously simplify the funding mechanism and better allow local school boards and administrators to plan for the future. Given the wide dispersion in local property values, such a formula if properly funded, would also substantially increase equity. Combining the plethora of state categorical funding programs into a single add-on would also give local school boards greater control over how the state funds could be expended.

As proposed previously in the section on tax reform, the simplest means to all of these ends is to replace the property tax as the major source of education funding with a new flat rate individual income tax. While such a change would not eliminate all local operating levies, it would drastically diminish the importance of the property tax as a source of school funding.

## Specific Recommendations

1. Combine teachers and incidental levies
2. Combine all of the following categorical programs into a single add-on based upon the number of pupils
  - a. Proposition C sales taxes
  - b. Fair Share cigarette taxes
  - c. Free Text Book
3. Create a new “rainy day” fund for education funding
4. Eliminate state assessed property from the school funding program
5. Phase in the new per pupil funding scheme over a three year period
  - a. First year funding per pupil - \$4,250
  - b. Second year funding per pupil - \$4,500
  - c. Third year funding per pupil - \$4,750
  - d. Index subsequent year increases to the change in individual income tax receipts
6. Force high expenditure districts to lower operating levies dollar for dollar to be eligible to participate in the new formula

Albeit, some of these changes are merely of a bookkeeping nature, their adoption would substantially simplify overall education funding. To get a better understanding of these recommendations, we have selected eight school districts to demonstrate the effects of the proposed new funding formula. The districts chosen were Savannah R-III, Jefferson City, Knox Co. R-I, Neosho R-V, Ripley Co. R-IV, Kirkwood R-II, Ladue and Sikeston R-VI. The smallest district is Ripley Co. R-IV, which is also the poorest district in Missouri. The largest district is Jefferson City and the wealthiest district is Ladue in St. Louis County. Three of these, Jefferson City, Kirkwood and Ladue are classified as “hold-harmless” districts. This classification in essence simply means that the level of state funding these districts received during the 1992-93 base year is the primary determinant of the current level of state funding. The basic form of the recommended new formula may be shown as follows:

$$\text{NBE} = \text{EP} * \text{BG}$$

where

NBE is the new basic entitlement,  
EP is the number of eligible pupils and  
BG is the new per pupil basic guarantee.

For the first year of the new formula the base guarantee (BG) is the lesser of \$4,250 per pupil or one-third of the difference between this amount and the current level of property taxes plus the current basic entitlement. For the second year, the new BG is the lesser of \$4,500 per pupil or two-thirds of the difference between this amount and the sum of projected property taxes and the basic entitlement. For the third year, the BG is simply \$4,750 times the number of pupils. The Savannah R-III school district provides a representative example of the formula. All of the calculations are based upon the detailed financial records for the 2001-02 fiscal year. The property taxes and number of eligible pupils have been projected using the historical growth patterns of the past five years. The state basic entitlement has been frozen at its fiscal year 2002 level, reflecting the uncertainty over the level of state funding.

For 2002 for instance, the Savannah school district would receive an additional \$171,193 in funding over the amount they currently generate from total property taxes and the state basic entitlement. The calculation is as follows:

$$\begin{aligned} \text{NBE} &= 1/3 * [\text{New base} - \text{Old base}] + \text{Old base} \\ &= 1/3 * [10,034,250 - 9,520,670] + 9,520,670 \\ &= 9,691,863 \end{aligned}$$

For the 2003 fiscal year the districts would receive an additional \$656,827 computed as follows:

$$\begin{aligned} \text{NBE} &= 1/3 * [\text{New base} - \text{Old base}] + \text{Old base} \\ &= 1/3 * [10,741,500 - 9,756,260] + 9,756,260 \\ &= 10,413,087 \end{aligned}$$

For the third year of the phase-in the district would receive full funding of \$11,461,750, an increase of \$1,455,765. Since the district would receive more total revenue under the new formula, it would be compelled to reduce its operating tax levy to zero.

Not all districts, however, would have zero operating levies. These districts would be required to reduce their operating levy by 97.5 percent of the difference between their existing levy and the equal yield levy under the new formula. Knox Co. R-I, for example, would still retain an operating levy, although it would be substantially lower (\$1.03) than the current levy of \$3.67. In the Kirkwood school district the levy would be reduced from \$3.10 to \$1.24 and in Ladue, the wealthiest district in the state, the levy would fall from \$2.56 to \$1.63. In the aggregate, the new formula would completely eliminate the operating levy in 351 of Missouri's school districts and reduce it by more than 75 percent in another 132 districts. Table XXI contains the detail for the selected districts. Data for all districts in the state are contained in Appendix C-5.

**Table XXIV****Savannah R-III**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 2,336                  | 2,361       | 2,387       | 2,413       |                    |             |             |
| Operating Levy  | 3.130                  | 3.130       | 3.130       | 3.130       | 0.000              | 0.000       | 0.000       |
| Property Taxes  | 3,704,238              | 3,926,492   | 4,162,082   | 4,411,807   | 0                  | 0           | 0           |
| Basic Aid       | 5,594,178              | 5,594,178   | 5,594,178   | 5,594,178   | 9,691,863          | 10,413,087  | 11,461,750  |
| Revenue Per EP  | 3,981                  | 4,032       | 4,087       | 4,147       | 4,105              | 4,362       | 4,750       |

**Jefferson City**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 7,776                  | 7,722       | 7,668       | 7,615       |                    |             |             |
| Operating Levy  | 2.920                  | 2.920       | 2.920       | 2.920       | 0.000              | 0.000       | 0.000       |
| Property Taxes  | 26,216,721             | 27,499,836  | 28,845,749  | 30,257,535  | 0                  | 0           | 0           |
| Basic Aid       | 4,547,414              | 4,547,414   | 4,547,414   | 4,547,414   | 32,304,333         | 34,135,054  | 36,171,250  |
| Revenue Per EP  | 3,956                  | 4,150       | 4,355       | 4,571       | 4,183              | 4,452       | 4,750       |

**Knox Co. R-I**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 601                    | 584         | 568         | 552         |                    |             |             |
| Operating Levy  | 3.670                  | 3.670       | 3.670       | 3.670       | 1.114              | 1.079       | 1.066       |
| Property Taxes  | 1,836,327              | 1,908,353   | 1,983,204   | 2,060,991   | 579,042            | 583,261     | 598,549     |
| Basic Aid       | 1,066,813              | 1,066,813   | 1,066,813   | 1,066,813   | 2,482,000          | 2,556,000   | 2,622,000   |
| Revenue Per EP  | 4,829                  | 5,094       | 5,370       | 5,666       | 5,242              | 5,527       | 5,834       |

**Neosho R-V**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 4,098                  | 4,161       | 4,226       | 4,292       |                    |             |             |
| Operating Levy  | 2.750                  | 2.750       | 2.750       | 2.750       | 0.000              | 0.000       | 0.000       |
| Property Taxes  | 6,205,924              | 6,578,280   | 6,972,977   | 7,391,356   | 0                  | 0           | 0           |
| Basic Aid       | 7,175,607              | 7,175,607   | 7,175,607   | 7,175,607   | 15,064,008         | 17,394,195  | 20,387,000  |
| Revenue Per EP  | 3,266                  | 3,305       | 3,348       | 3,394       | 3,620              | 4,116       | 4,750       |

**Table XXIV (continued)**

**Ripley Co. R-IV**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 203                    | 205         | 207         | 209         |                    |             |             |
| Operating Levy  | 2.750                  | 2.750       | 2.750       | 2.750       | 0.000              | 0.000       | 0.000       |
| Property Taxes  | 122,337                | 125,298     | 128,331     | 131,437     | 0                  | 0           | 0           |
| Basic Aid       | 461,228                | 461,228     | 461,228     | 461,228     | 681,434            | 817,520     | 992,750     |
| Revenue Per EP  | 2,878                  | 2,861       | 2,848       | 2,836       | 3,324              | 3,949       | 4,750       |

**Kirkwood R-II**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 4,672                  | 4,724       | 4,776       | 4,829       |                    |             |             |
| Operating Levy  | 3.310                  | 3.310       | 3.310       | 3.310       | 1.318              | 1.291       | 1.271       |
| Property Taxes  | 28,063,403             | 29,747,207  | 31,532,039  | 33,423,961  | 11,848,229         | 12,298,379  | 12,829,687  |
| Basic Aid       | 839,398                | 839,398     | 839,398     | 839,398     | 20,077,000         | 21,492,000  | 22,937,750  |
| Revenue Per EP  | 6,186                  | 6,475       | 6,778       | 7,095       | 6,758              | 7,075       | 7,407       |

**Ladue**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 3,122                  | 3,073       | 3,025       | 2,978       |                    |             |             |
| Operating Levy  | 2.560                  | 2.560       | 2.560       | 2.560       | 1.620              | 1.636       | 1.655       |
| Property Taxes  | 28,923,596             | 30,659,012  | 32,498,553  | 34,448,466  | 19,401,174         | 20,771,244  | 22,275,903  |
| Basic Aid       | 422,756                | 422,756     | 422,756     | 422,756     | 13,060,250         | 13,612,500  | 14,145,500  |
| Revenue Per EP  | 9,401                  | 10,114      | 10,883      | 11,710      | 10,563             | 11,367      | 12,230      |

**Sikeston R-VI**

|                 | <b>Current Formula</b> |             |             |             | <b>New Formula</b> |             |             |
|-----------------|------------------------|-------------|-------------|-------------|--------------------|-------------|-------------|
|                 | <b>2002</b>            | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2003</b>        | <b>2004</b> | <b>2005</b> |
| Eligible Pupils | 3,813                  | 3,773       | 3,734       | 3,695       |                    |             |             |
| Operating Levy  | 2.920                  | 2.920       | 2.920       | 2.920       | 0.000              | 0.000       | 0.000       |
| Property Taxes  | 5,939,238              | 6,127,604   | 6,509,017   | 6,814,088   | 0                  | 0           | 0           |
| Basic Aid       | 7,827,279              | 7,827,279   | 7,827,279   | 7,827,279   | 14,708,339         | 15,980,765  | 17,551,250  |
| Revenue Per EP  | 3,611                  | 3,722       | 3,839       | 3,962       | 3,898              | 4,280       | 4,750       |

Source: State & Regional Fiscal Studies Unit