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\$500 Million Reasons to be Concerned About a Tax Cut in Missouri

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Recent strong revenue growth in Missouri has led to a common misperception that the state has effectively rebounded from the budget crisis of the last six years. In Fiscal Year 2006 revenue grew at 9.2%, well higher than anticipated, allowing the state to carry forward \$300 million in revenue. For the eight months of Fiscal Year 2007 to date, general revenue is continuing to grow at an acceptable rate of 3.6%. Although the growth is much smaller than the previous year, the state will likely end the current year on June 30 with a projected combined “surplus” or “carry-forward” of \$500 million.

However, in looking ahead, projections for the next three years reveal that the state is likely to face several revenue shortfalls. Should an even modest tax cut package be enacted, the state is in jeopardy of falling back into dire financial straits.

A new analysis by the Missouri Budget Project shows these **key findings**:

- Without any significant changes in either spending or tax policies, Missouri will face a \$200 million budget shortfall by 2010;
- Even a “modest” tax cut costing \$100 million per year will result in a \$500 million budget “hole” by fiscal year 2010;
- Missouri policymakers should undertake a comprehensive and overarching analysis of state revenue needs and spending priorities.

Missouri’s Budget Must Grow to Continue Current Services and Fund Long Term Obligations

Most Missourians understand that, similar to a family budget or that of a corporation, the state’s budget needs to grow each year to keep pace with normal inflationary demands. Allocations in

¹ Tom Kruckemeyer of the Missouri Budget Project contributed to the research and data analysis for this report.

the state budget—for services including transportation, construction projects, higher education and health care -- must grow to keep pace with the increasing costs of labor, utilities and other ongoing expenses.

In addition to these normal inflationary demands, the state can face higher cost pressures due to population changes and related needs. For example, items such as health care for Missouri seniors or educational services for children with disabilities can grow at a somewhat higher rate than inflation. As the population changes these needs change and can grow at increased rates.

As evidenced in the recent state budget crisis, without the growth of state revenue, the state loses its ability to meet these ongoing needs, and cannot provide the array of services at the same level as in the past. Since 2001 the state's revenue has been relatively stagnant, and in some years actually declined, resulting in severe cuts to an array of services. State aid to local school districts is now \$600 million under its required funding levels. Higher education receives less money in the current year than it did in 2001 resulting in tuition increases of 60% over 5 years. More than 200,000 Missourians have lost access to public health care. The state is not providing the same level of services it provided just five years ago.

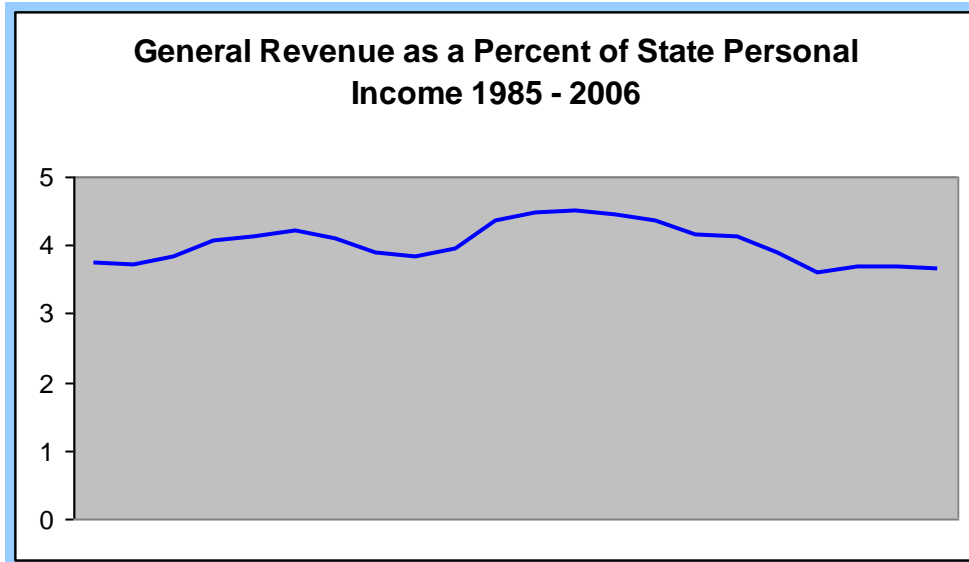
In addition to the holes in services that have been created by the budget crisis, Missouri faces several long-term revenue obligations that have not yet fully impacted the state's budget. These obligations are just now "coming due":

- In Fiscal Year 2008 the state will begin paying the settlement on a telecomm court case. The case will require a \$40 million payment beginning in Fiscal Year 2008, growing to \$60 million in Fiscal years 2009 and 2010;
- The Missouri General Assembly passed a new "School Funding Formula" two years ago that requires the state to invest at least \$100 million more per year over the next several budget years to eventually fill the current \$600 million education funding gap.

As a result, even if Missouri does not make any new investments services or build state infrastructure, the demands on the state's budget will continue to increase, and the state's long- term obligations will need to be paid.

Missouri Revenue Growth Stabilizes

Missouri's revenue, while experiencing a recent short-term "boom" resulting from strong growth in Fiscal Year 2006, remains relatively low by historic standards. In fact, Missouri tax revenues as a percent of personal income are lower today than they were in 1985. Essentially, the state's revenue growth has not been able to keep pace with economic growth in Missouri.



Source: Missouri Budget Project analysis of the Bureau of Economic Analysis Personal Income Figures, compared with State General Revenue Spending

Further, in the first eight months of the current Fiscal Year, Missouri's revenue has slowed to a more "normal" 3.6% growth rate. This indicates that the state has left the very brief "boom" period and is returning to a more "normal" growth pattern in its revenue. Assuming that the next two years will mirror historic trends, the state can likely expect an ongoing general revenue growth rate of about 4% per year.

Will "Normal" Revenue Growth Be Enough?

Assuming that the state legislature does not make any significant changes to Missouri's tax structure, a 4% growth rate in general revenue will result in \$318 - \$330 million in new revenue per year for the next three fiscal years. However, the state's long-term obligations, coupled with the inflationary demands of current services, are expected to quickly surpass the new revenue growth. The following required increases will place pressure on state spending that is expected to exceed state revenue growth in the next three years:

- Payment on the telecomm settlement of \$40 - \$60 million per year,
- Increase for the School Funding Formula of \$108 - \$112 million per year,
- Inflation for all other budgetary items: \$149 - \$155 million per year, and
- Capital improvements payments of \$78 - \$83 million per year.

Given this imbalance, the state's current year "surplus" will be fully utilized by required spending needs in the next two fiscal years. By Fiscal Year 2010, the "surplus" is not only gone, but the state will face a \$200 million budget "hole"-- requiring either tax increases or further budget cuts to critical services.

Even a small Tax Cut would lead to a Massive Budget Shortfall:

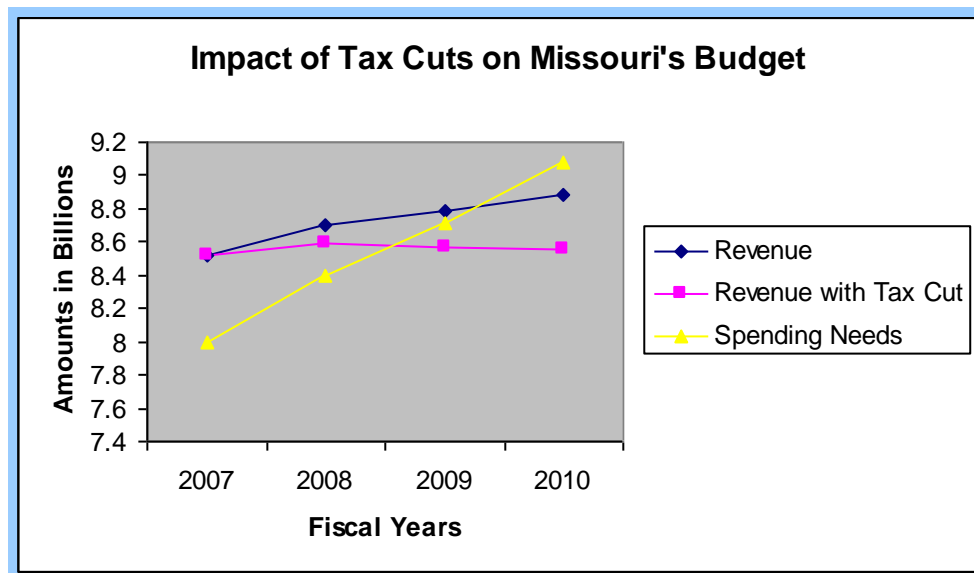
Given the grim nature of the state's revenue situation, it is clear that Missouri needs to conduct a thorough conversation about its budget and spending priorities before any significant changes occur in either spending or tax policies. However, due to the annual budget cycle process in

Missouri, most policymakers are only given partial one-year information rather than a long-term analysis of the budget outlook. As a result, many spending and tax decisions are made in a vacuum.

In the current year alone, nearly 100 tax cuts have been proposed in the General Assembly. The tax cuts range from eliminating the corporate income tax to small tax exemptions for high-income seniors. Most lawmakers reference the “surplus” as their reasoning that the state could fund a tax cut. However, given a comprehensive overview of the budget and projected rapid depletion of the surplus, tax cuts are not warranted.

The tax cut proposal that has the most momentum in the legislature would exempt Social Security benefits from state income tax. This would cost Missouri more than \$100 million in annual general revenue. Legislative advocates of this proposal refer to using the current year revenue “surplus” to pay for the tax reduction. However, as a *permanent tax reduction*, this proposal would require that the state reduce revenue *each year* by \$100 million.

Coupled with the spending needs described previously, a tax cut of even this modest size would have a severe impact. Not only would the “surplus” be fully utilized more quickly, but the state would face a \$500 million budget “hole” by fiscal year 2010, resulting in either tax increases at that time or massive reductions in state services that benefit all Missourians.



Clearly the budget outlook does not warrant significant changes at this time in either Missouri’s spending or tax policies. Policymakers must not allow a short-term revenue “surge” to make changes that carry a long-term negative impact. Now is not the time for a tax cut in Missouri. Instead, Missouri should undertake a comprehensive and overarching analysis of state revenue needs and spending priorities. The quality of life in Missouri and the state’s future economic prosperity deserve such careful consideration