

Investing for Growth, Enhancing Our Prospects: Tax Reform in Mississippi



In any given year, the state of Mississippi and its residents accomplish a lot. Through the collective investment of our tax dollars, we maintain over 10,000 miles of roads, help educate more than 800,000 children and adults from kindergarten to university and support more than 7,000 law enforcement officers in our local communities.

With tax reform discussions underway, it is important to ask questions that will allow us to move ahead as decisions are made regarding our future. Questions like:

- What does it take to run a modern state?
- What resources are needed to maintain and update the public systems we use every day?
- What new public structures and innovations might require new revenues or new approaches?

As we engage in the tax reform process, it is important to raise questions like those above to ensure that Mississippi has the necessary resources to move forward in the years to come. The bulletin *Investing for Growth, Enhancing our Prospects* highlights the existing challenges and opportunities offered by good tax reform. Key takeaways include:

1) A good tax system should be balanced and make work pay. When work pays, Mississippians grow their local economies. Mississippi's tax system, however, is not balanced. Working families

with lower incomes pay a higher percentage of their income towards state and local taxes than families with higher incomes.

2) A good tax system creates opportunities for economic growth.

Opportunities for investment in the state's future arise when revenue systems rely on diverse sources of funding that grow with the economy, rather than over-emphasize revenue collection from any one source. Currently, Mississippi's tax system is not as diversified as it could be and struggles to fund its public structures from year to year. By generating enough revenue to pay for services while making investments for future growth, the state can maximize the return on its greatest asset – its people.

3) A good tax system is accountable to the people who fund it – the taxpayers. To enhance accountability, system upgrades are needed to answer basic questions about tax credit effectiveness and the impact of tax changes on different groups of Mississippians.

Through strong fiscal systems that allow for investment in the people of Mississippi, the state will realize strong returns by enhancing our capacity to compete in the global marketplace.

Make Work Pay in Mississippi

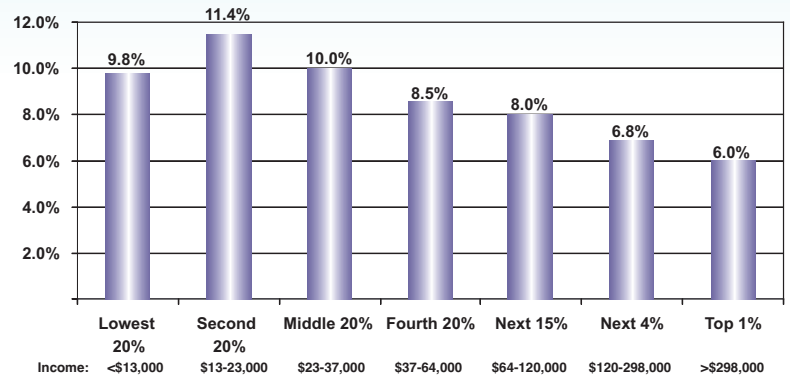
Tax systems can be broken down into three categories:

- **Progressive** – A tax system is progressive if persons with higher incomes pay a higher percentage of their income in taxes than those with lower incomes. Most income taxes, including the federal income tax, are designed to be progressive. A progressive tax system bases taxes on the taxpayers' ability to pay.
- **Proportional** – A tax system is proportional if all persons, regardless of income level, pay the same percentage of their income in taxes.
- **Regressive** – A tax system is regressive if persons with lower incomes pay a higher percentage of their income in taxes than those with higher incomes. Sales taxes are regressive because families with lower incomes tend to spend a larger fraction of their income on taxed goods than do higher-income families.

Mississippi's taxes have some progressive elements and some regressive elements. As a whole, Mississippi's state tax policies are regressive. Mississippi's tax system is regressive because the state relies heavily on regressive sales taxes. The income tax, while slightly progressive, is not progressive enough to counteract the regressive elements of the sales tax. According to data from the U.S. Census Bureau, the state's sales tax ranks 10th highest (among the 46 states with sales tax) and the income tax ranks 40th (among the 43 states with income tax) in taxes as a percentage of personal income. Thus, of the states with an income tax, only three states have lower income tax collections as a percentage of personal income than Mississippi.

Figure 1 shows the amount of state and local taxes paid as a percentage of income for different income groups. Those earning between \$13,000 and \$23,000 per year pay the highest percentage of their income in state and local taxes.

Figure 1: State and Local Taxes Paid as a Percentage of Income by Income Groups



Source: Institute on Taxation and Economic Policy, September 2007

Are low- and moderate-income persons paying their fair share of taxes? Shouldn't we consider federal taxes as well as state and local taxes?

According to data from the Institute on Taxation and Economic Policy, persons in Mississippi with income below \$64,000 pay more as a percentage of total state and local taxes collectively than their share of total state income. Adding federal taxes into the evaluation masks the effects of the state's regressive tax system on low-income working families. The state should do what is in its control to improve the tax system for working families. Helping working families keep more of their paycheck encourages personal responsibility and helps low income families move up the economic ladder by making work pay.

Recommendations for Making Work Pay

Index Standard Exemptions and Deductions to Inflation

Income tax exemptions and deductions should be adjusted each year for inflation. None of the standard individual exemptions or deductions have been updated since 2000, and some have not been updated since 1981. As a result, working persons in poverty are now subject to income taxes.

Enact a State Earned Income Tax Credit

A State Earned Income Tax Credit (EITC) for Mississippi would reduce the income taxes owed and provide a wage supplement for more than 366,000 working families living in or near poverty in Mississippi. Local economies would see a boost through EITC spending.

Reduce the Tax on Groceries by Half

A reduction of sales taxes on groceries from 7% to 3.5% would increase the fairness of the state's regressive sales tax. It would improve the bottom line for working families who struggle to make ends meet and spend a larger portion of their income on necessities like groceries. Mississippi is one of only two states that tax groceries at the full sales tax rate without providing any offsetting measures.

Shared Prosperity - An Adequate Tax System

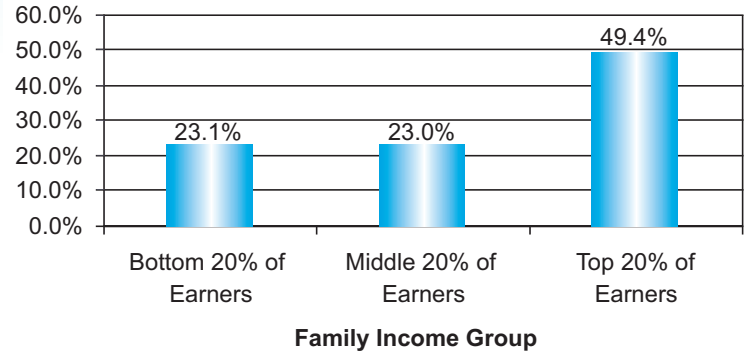
A tax system is considered adequate if it collects enough revenue to pay for the programs required by residents and policy makers. Each year, providing the same level of services becomes more expensive as the costs of goods and labor increase. If revenues do not keep up with these increased costs, the state must either raise taxes or cut services. Revenue shortfalls could lead to reduced health care for seniors and children, fewer resources for K-12 and higher education and fewer troopers on our highways.

The adequacy of a state's tax system also affects its competitiveness among states for economic growth. In July 2007, Forbes released a special report titled *2007 Best States for Business*. The report ranked all 50 states on 30 metrics in the following six categories: business costs, labor, regulatory environment, economic climate, growth prospects and quality of life. Mississippi's overall ranking was low at 43rd. However, Mississippi ranked very high in the category of business costs at 13th. The business costs category took into account the costs of labor, energy and taxes. Mississippi's rank in the business costs category even outranked Virginia, which had the overall top ranking. Mississippi's overall ranking was brought down, not by high taxes, but by low educational attainment, school quality, health and income – all of which depend on a strong revenue system.

The adequacy of Mississippi's tax system is currently threatened by a slowing of revenue growth from Hurricane Katrina recovery and recent projections of an economic downturn. As spending for hurricane recovery has slowed, revenue growth has also declined, and the state is encountering challenges generating enough revenue to maintain the level of spending that the post-hurricane recovery made possible. Subsequent years of cuts may be on the horizon in the absence of changes to the adequacy of Mississippi's system of taxes.

One way that tax systems become adequate and stable is by capturing areas of growth in the economy. At the very least, those areas should not be removed from taxation by large cuts. When it comes to income in Mississippi, growth has been largest for high-income families. Figure 2 shows that the top 20% of earners in Mississippi have experienced a growth of over 49% in their income during the last two decades, while the bottom and middle 20% of earners saw less than half of that growth at about 23%. Eliminating or significantly reducing the income tax on high-income earners would jeopardize the adequacy of the state tax system and, in the long run, harm Mississippi's competitiveness for economic development.

Figure 2: Mississippi's Highest-Income Families Had Greatest Income Gains over the Last Two Decades

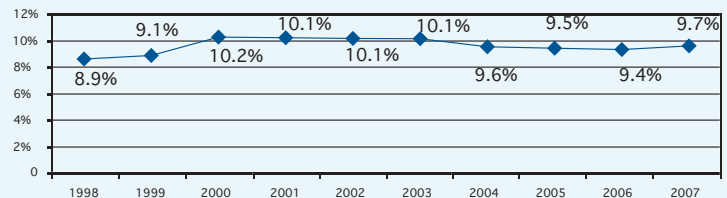


Source: Center on Budget and Policy Priorities and Economic Policy Institute "Pulling Apart: A State by State Analysis of Income Trends," 2008

Is state spending growing out of control?

Spending has remained relatively constant in relation to the state's economy measured by the State Gross Domestic Product (GDP). Why talk about spending in a brief on tax reform? Notions about spending affect our thinking about taxes, and taxes affect the amount available for spending.

State Source Spending as a Percentage of State GDP FY 1998 - 2007



Source: MEPC Analysis of Data from the Mississippi Joint Legislative Budget Committee State of Mississippi Budget (1998-2007); Mississippi Institutions for Higher Learning, Mississippi Economic Review and Outlook, December 2007

Recommendations for Adequacy

Strengthen the Income Tax and Make It More Balanced

A revision of the state's income tax brackets is necessary to make the income tax more balanced and to improve the adequacy of the income tax. Currently, Mississippi's income tax brackets are mostly flat. Income taxes should be progressive to balance regressive sales taxes.

Broaden the Sales Tax Base to Include All Household Services

A comprehensive sales tax on services purchased by households would strengthen the sales tax base and help the state's tax system keep up with areas of growth in the economy.

Increase the Cigarette Tax

The state should increase cigarette taxes. For at least the short-term, a tax increase would contribute to the adequacy of Mississippi's tax system. In the long-term, if tobacco use declines, the state will see other benefits, such as a reduction of Medicaid costs for treatment of tobacco related illnesses.

Enact Combined Reporting

Combined Reporting would close a loophole in corporate income taxes in Mississippi that allows companies to shift some of their income that should be taxed in Mississippi to other states. This loophole threatens an important revenue source for the state and places Mississippi-based companies, large and small, at a disadvantage.

A Tax System Accountable to Taxpayers

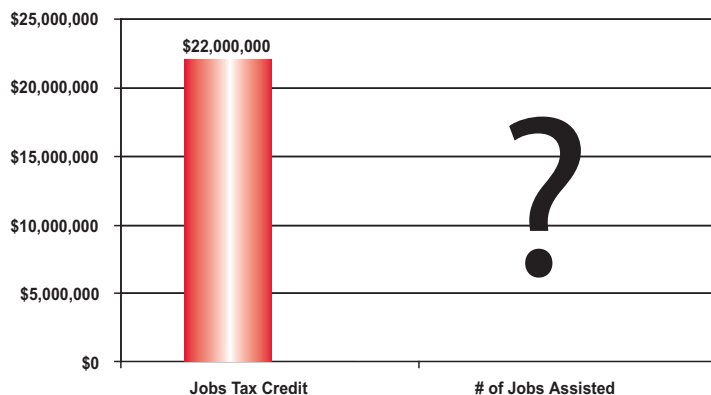
The accountability of a tax system hinges on its transparency. Transparency indicates whether or not information about the tax system is easy to obtain. Available information should include who or what is being taxed, the process for making tax decisions and how tax revenue is collected and spent. Transparency is impacted not only by the amount of tax data available, but also by the systems available to analyze that data. Furthermore, transparency addresses the manner in which this information is made available to the public. In Mississippi, strides have been made recently by lawmakers in spending transparency. It is equally important to make information on tax collections and the impact of taxes on persons of different income groups available to the public.

The transparency of Mississippi's tax system could be improved. Problems with transparency in Mississippi exist because of the lack of infrastructure to analyze and compile data. This lack of available data keeps policy makers and the public from being able to determine the effectiveness of current tax policies and to evaluate the impact of tax proposals.

One example of the lack of available data for accountability concerns the Jobs Tax Credit. The Jobs Tax Credit provides a credit of up to 10% of a company's payroll against corporate income taxes. The most recent tax expenditure report estimates that in FY 2008, the state will provide Jobs Tax Credits of \$22 million. However, there is no efficient way to answer questions about the number of jobs that are created through the credit, due to the way it is reported in the tax filing system (Figure 3). A system that made the incentive impact information publicly available and easily accessible would increase accountability and ensure the overall effectiveness of the program.

The state of Mississippi also does not have the capacity to analyze how the current tax system or tax proposals would affect different income groups. In a few states, like Texas, every proposed tax change must include an analysis of whom the change will affect by income group and by how much. Figure 4 provides an example of how tax incidence analysis is used in Texas. Without this capacity, the state might enact changes that would have an unintended detrimental effect on a specific income group.

Figure 3: Data Unavailable to Determine Number of Jobs Created by Jobs Tax Credit



Source: Mississippi 2008 Tax Expenditure Report and the Mississippi State Tax Commission

Figure 4: An Example of Tax Incidence Analysis in Texas

Tax Incidence by Income Group Current Law vs. [Texas] House Bill 4 Fiscal Year 1999				
Family Expanded Income Group \$Dollars	Current Law Tax Incidence \$Millions	H.B. 4 Tax Incidence \$Millions	Change in Tax Incidence \$Millions	Percent Change in Tax Incidence
0 < 10,000	\$1,712.9	\$1,666.4	(\$46.5)	-2.7%
10,001 < 20,000	\$2,737.2	\$2,689.2	(\$48.0)	-1.8%
20,001 < 30,000	\$1,751.3	\$1,714.6	(\$36.7)	-2.1%
30,001 < 50,000	\$5,492.0	\$5,359.4	(\$132.5)	-2.4%
50,001 < 75,000	\$6,001.1	\$5,812.2	(\$188.9)	-3.1%
75,001 < 100,000	\$3,826.4	\$3,682.0	(\$144.5)	-3.8%
100,001 < 200,000	\$3,956.6	\$3,810.6	(\$146.0)	-3.7%
Over 200,000	\$2,393.3	\$2,319.7	(\$73.6)	-3.1%
Total	\$27,870.9	\$27,054.1	(\$816.8)	-2.9%

Source: Texas Legislative Budget Board, Tax Equity Note Analysis of House Bill 4, February 17, 1997, as published in the Center on Budget and Policy Priorities "Developing the Capacity to Analyze the Distributional Impact of State and Local Taxes: Issues and Options for States" by Michael Mazerov, 2002

Recommendations for Accountability

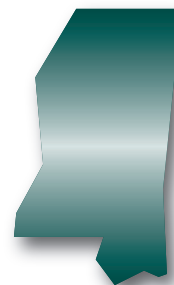
Implement Tax Incidence Analysis

Tax incidence analysis would provide the capacity to evaluate Mississippi's current state tax system and any proposed changes to the tax system. Implementation of tax incidence analysis would provide economic analysis to answer two important questions about tax proposals, including how much money the proposal will cost (or generate), and who will pay more (or less) because of the change. This would require enhanced infrastructure and an upgrade of the information technology system at the Mississippi State Tax Commission.

Improve Reporting and Data Collection on Tax Credits

Current systems at the State Tax Commission do not allow for collection and analysis of data on the effectiveness of tax credits. Systems should be upgraded with the goal of making data on tax credit effectiveness public.

More detailed information about the recommendations will be available in the Mississippi Economic Policy Center's upcoming report *Tax Reform for Working Families*. If you have any questions or would like additional information, please visit our website at www.mepconline.org.



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