Show-Me Institute

POLICY BRIEFING

NUMBER 5 JANUARY 24, 2007

HOW TO REPLACE THE EARNINGS TAX IN SAINT LOUIS

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In a previous report, I showed that residents and businesses move from the city to the suburbs to avoid paying an earnings tax. Saint Louis imposes an earnings tax and lags behind its suburbs in personal income growth. I concluded that Saint Louis should eliminate its earnings tax to attract new residents and promote economic growth.

In this report, I show how Saint Louis could replace the earnings tax with a tax on land. A land tax has virtually no effect on the location decisions of residents and businesses. The supply of land can be considered fixed, so a tax on land lowers its value but does not distort taxpayers' decisions. Taxpayers cannot lower the supply of land to avoid paying the tax. A land tax does not cause people to substitute away from land or to use less land than would be optimal. Therefore, a land tax does not hold back economic growth like an earnings tax does.

Saint Louis could phase out the earnings tax over a period of ten years, gradually replacing it with a land tax. The transition would be revenue neutral for the city government, and eliminating the earnings tax would cause land to be used more efficiently, thus increasing its value and the revenue it would bring in. The resulting economic growth would also increase revenues from other taxes such as sales taxes, and those revenues would make up for some of the lost earnings tax revenue.

Benefits of Land Taxes

Governments around the world use land taxes to collect revenue. Nations that have implemented land taxes include Hong Kong, Singapore, and Taiwan. Many cities use land taxes as well. Washington, D.C. and Fairhope, Alabama have land-value taxes, as do several cities in Pennsylvania.

Economists have used statistical analysis to study the effects of land taxes. One study followed Pennsylvania cities that have a two-tiered land tax for a 22-year period. A two-tiered land tax imposes one tax rate on land and another rate on structures built on the

The earnings tax can be phased out without reducing city revenues. *Photo courtesy of Lizzie Kucharski.*

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land. The study found that cities that imposed two-tiered land taxes had higher levels of construction spending than cities that did not impose land taxes. This evidence implies that replacing a less efficient tax with a land tax will cause new investment and growth.

Another study examined investment in Pittsburgh. While neighboring cities turned to inefficient taxes to fund public services, Pittsburgh relied on a higher land tax and enjoyed faster economic growth. Pittsburgh's history shows that cities that avoid distortionary taxes have an advantage over other locations in the competition for resources.

Modeling the Saint Louis Economy

Economists also use models to predict the effects of changes in tax policy. Models have shown that inefficient taxes such as income taxes can be replaced by relatively low land taxes without decreasing tax revenue.

I simulate the elimination of the earnings tax in Saint Louis using a model. I consider current employment levels and revenues from property, earnings, and sales taxes. The model demonstrates the effects of changing fiscal policy on the Saint Louis economy.

A land tax is a good alternative to the earnings tax. Saint Louis can gradually eliminate the earnings tax over a ten-year period. A gradual phase-out would give the city economy time to grow in response to the decrease in the earnings tax rate. This would allow Saint Louis to replace the earnings tax with a lower land tax than it would have to impose if the earnings tax were completely eliminated in the first year.

Saint Louis imposes an earnings tax of 1.5 percent. I propose that Saint Louis phase out the earnings tax in ten years by lowering it to 1 percent in year one, to 0.5 percent in year six, and to 0 in year ten. The city could replace the lost revenue by imposing a land tax of 4.75 percent in year one, raising it to 7.58 percent in year seven, and raising it to 10.04 percent in year ten.

The model shows how replacing the inefficient earnings tax with an efficient land-value tax would stimulate the city economy. In the absence of the distortionary tax, resources are used more productively. In the long run, the number of people employed in Saint Louis would nearly double. A greater proportion of the land would be used for commercial activity, and investment in physical capital and structures would increase. These investments would cause economic growth, resulting in higher sales tax and property tax revenues. The higher revenues from sales and property taxes could offset some of the loss in earnings tax revenue if the earnings tax were phased out over several years.

Additional Revenue Sources

Saint Louis could replace the earnings tax with lower land taxes if it found additional sources of revenue. One option is partnering with Saint Louis County. If the city and county agreed to better coordinate the public services they provide, the city could realize significant savings. If Saint Louis replaced all but $80 million of the earnings tax revenue from other sources, it could keep the land-value tax rate at 4.65 percent.

Another possible revenue source is the state government. Because Saint Louis straddles the state border, the state

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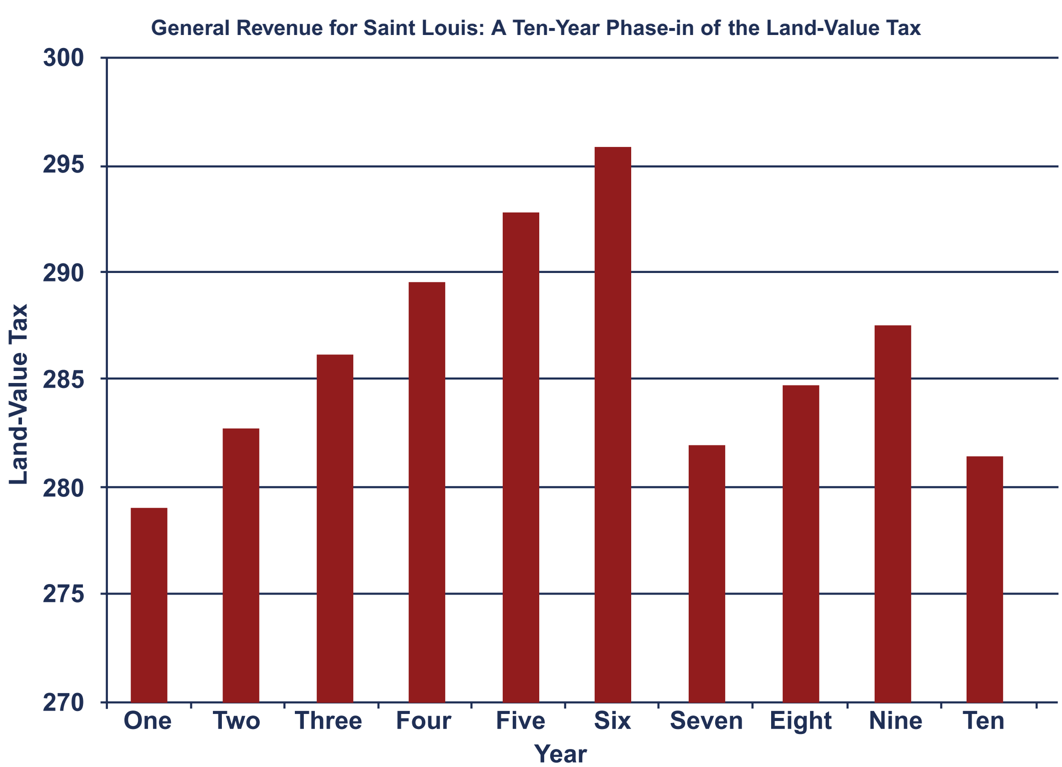

loses tax revenue when the city earnings taxes drive residents and businesses into out-of-state suburbs. It would make sense for the state government to help Saint Louis phase out its earnings tax, because the phase-out would bring new resources and taxpayers to the state.

A sales tax is a possible alternative to the earnings tax, but it would be a bad policy for Saint Louis to adopt. The model shows that replacing the earnings tax with a sales tax would be difficult. People can avoid paying city sales taxes by buying goods in the suburbs. Therefore, the sales tax rate would have to be very high to bring in as much revenue as the earnings tax. Saint Louis would have to impose a sales tax of 20 percent to make up for the lost earnings tax revenue.

Eliminating the earnings tax could spark an economic revival in Saint Louis. *Photo courtesy of Sean Biehle.*

Phasing out the earnings tax would allow the Saint Louis economy to grow and prosper.

Effects on Representative Households

We can see how replacing the earnings tax with a land tax would change the tax bills of residents by considering three representative households. Household A has income of $200,000 subject to the earnings tax and land with an assessed value of $15,000. Household A's earnings tax bill would decline by $2,000 because the earnings tax imposed on individual workers in Saint Louis is 1 percent. Household A would pay a land tax of $1515, and its total tax bill would decline by $485.

Household B has no income subject to the earnings tax and owns land with an assessed value of $6,000. Household B's tax bill would rise from $0 to $606.

Household C has income of $50,000 subject to the earnings tax and land with assessed value of $12,000. Household C's earnings tax bill would decline by $500. Household C would pay a land tax of $1212, and its total tax bill would increase by $712.

These examples show that a household's tax burden will increase if its income is small and its assessed land value is relatively large. Therefore, the land tax may need to be phased in over several years.

Phasing out the earnings tax would allow the Saint Louis economy to grow and prosper. The city can institute a land tax to make up for the lost earnings tax revenue without burdening its economy with other distortions.

For more details, please see Show-Me Policy Study no. 5, which is available at www.showmeinstitute.org.

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