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GOVERNOR

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TO THE SECRETARY OF STATE OF THE STATE OF MISSOURI

Herewith I return to you Senate Substitute for House Bill No. 253 entitled:

AN ACT

To repeal sections 32.087, 66.601, 66.620, 67.395, 67.525, 67.571, 67.576, 67.578, 67.581, 67.582, 67.583, 67.584, 67.712, 67.713, 67.729, 67.737, 67.738, 67.745, 67.782, 67.799, 67.997, 67.1300, 67.1303, 67.1305, 67.1545, 67.1712, 67.1713, 67.1775, 67.1959, 67.1971, 67.2000, 67.2030, 67.2525, 67.2530, 94.578, 94.605, 94.660, 94.705, 143.011, 143.021, 143.071, 143.151, 143.221, 144.010, 144.014, 144.030, 144.032, 144.043, 144.049, 144.054, 144.069, 144.070, 144.080, 144.083, 144.100, 144.140, 144.210, 144.285, 144.517, 144.526, 144.605, 144.655, 144.710, 144.1000, 144.1003, 144.1006, 144.1009, 144.1012, 144.1015, 221.407, 238.235, 238.410, 644.032, RSMo, and to enact in lieu thereof seventy-nine new sections relating to taxation, with penalty provisions, effective dates for certain sections, and an emergency clause.

I disapprove of Senate Substitute for House Bill No. 253. My reasons for disapproval are as follows:

Senate Substitute for House Bill No. 253 is an ill-conceived, fiscally irresponsible experiment that would inject far-reaching uncertainty into our economy, undermine our state's fiscal health, and jeopardize basic funding for education and vital public services. At the same time, the legislation would increase taxes on prescription drugs and college textbooks, provide special treatment for some businesses while discriminating against others, and make our tax code less economically efficient and less fair. For these reasons and to protect the long-term economic prosperity of our state, Senate Substitute for House Bill No. 253 does not receive my approval.

Over the past four and a half years, we have balanced our state budget and made strategic investments in economic development. We have enacted targeted tax cuts for small businesses that create good jobs, and we are eliminating the outdated franchise tax on employers and the income tax on military pensions for our veterans. But along with these targeted tax cuts, we have maintained steady, fiscal discipline by reducing spending to ensure balanced budgets. Not only has this protected our spotless AAA credit rating, Missouri families and businesses are reaping the benefits as our economy continues to grow. Our exports over the past two years set an all-time record, and the most recent jobs report showed Missouri employers added another 12,000 jobs, while our unemployment rate dropped to 6.6 percent—the forty-fourth consecutive month it has been at or below the national average. In every corner of our state, businesses large and small are deciding to invest and expand in Missouri because of our stable, predictable business climate and our skilled, productive workforce.

Senate Substitute for House Bill No. 253 would veer Missouri irretrievably off this steady course and abandon our strong tradition of fiscal discipline. With a premise based on unproven assumptions, careless drafting, and an utter disregard for long-term consequences, Senate Substitute for House Bill No. 253 would irreparably damage vital public services, including the very educational system that provides the skilled, productive workforce employers demand.

I. Missouri Is Already a Low Tax State

Like most Missourians, I support keeping taxes low and predictable. Indeed, I am proud that, with or without Senate Substitute for House Bill No. 253, Missouri will continue to have among the lowest taxes in the nation. In a September 2011 report, the State Auditor recognized that Missouri has the seventh-lowest state taxes as a percentage of personal income. In 2012, the Federation of Tax Administrators ranked Missouri the fifth-lowest in per capita state taxes in the country, representing a lower tax burden than all of our surrounding states. Moreover, a 2012 report by Ernst & Young and the Council on State Taxation ranked Missouri's effective business tax rate as the eighth-lowest in the country. Not only are Missouri taxes among the lowest in the nation, our low tax climate is stable and predictable. This encourages businesses to grow and invest here with certainty that their tax burden will not constantly shift on the whim of policymakers testing out the latest fad. This stability also gives businesses and consumers the confidence that they will not see higher property taxes or sales taxes to stave off cuts to education and vital public services when risky experiments with the income tax fail to live up to their billing.

II. The Fiscal Note Dramatically Understates the Cost of the Bill

The cost of Senate Substitute for House Bill No. 253 would be far greater than that estimated by the fiscal note. Although the fiscal note for the Senate Substitute assumes a cost of between \$492 and \$692 million annually when fully-phased in—a considerable amount—the bill's true cost would exceed \$800 million annually. The fiscal note estimate failed to account for the full cost of the business income exemption because it only considered "self-employment income" reported on the federal 1040 form even though additional business income would also be exempt. In addition, the fiscal note estimate of \$344 to \$544 million annually in new sales tax revenue from enactment of the Federal Marketplace Fairness Act (FMFA) greatly exceeds even the highest estimate of \$210 million in published studies on the issue. When taking into account the drafting errors in the FMFA provision of Senate Substitute for House Bill No. 253, discussed more fully below, Missouri could see an immediate \$1.2 billion revenue loss in a single year. Perhaps even more significant than the overall cost of this experiment is the inability to undo the downward spiral Senate Substitute for House Bill No. 253 would set in motion, which could swallow even basic funding for the priorities Missourians share.

III. The Bill Would Irreparably Harm Education and Vital Public Services

Although Missourians expect to have low and predictable taxes, they also want good jobs, quality schools, and safe and healthy communities, and they are not willing to gamble these priorities on unproven experiments. With our taxes already among the lowest in the nation, the additional reductions called for by Senate Substitute for House Bill No. 253 would leave a gaping budget hole for decades to come, requiring cuts of such magnitude that meeting even our basic obligations for K-12 education, for our colleges and universities, for public safety and for other vital services would be out of reach.

The level of reductions necessary to accommodate Senate Substitute for House Bill No. 253 would be the equivalent of closing all of our state prisons, eliminating entirely the Department of Mental Health, or cutting all funding to our colleges and universities. Senate Substitute for House Bill No. 253 would undermine the very foundation of our long-term economic growth and our strongest economic development tool—our educational system. This bill could decimate vital public services like scholarships for high school seniors to attend college, affordable child care for Missouri working families, assistance for foster parents to provide abused and neglected children a loving home, the chance for children with severe disabilities to meet their full potential, home-delivered meals and transportation to doctor's appointments for needy seniors, and the safety of Missourians, with fewer patrolmen and more violent criminals on our streets. This is the Missouri our children would inherit if Senate Substitute for House Bill No. 253 became law and foisted upon them with full force this fiscally irresponsible folly.

IV. The Bill Would Increase Taxes on Prescription Drugs

In addition to its staggering long-term consequences, the problems with Senate Substitute for House Bill No. 253 stemming from its careless and haphazard drafting would begin wreaking havoc immediately. One need look no further for evidence than its elimination of the long-standing sales tax exemption on prescription drugs. With this provision alone, the General Assembly has voted to impose a $200 million tax increase on Missourians in need of prescription medication—Missourians who are suffering from cancer, from heart disease, and from other life-threatening conditions. In place since 1979, but eliminated in an instant, this exemption may have gone unnoticed by some members of the legislature in their haste to get this bill to my desk, but it will surely be noticed by the sick Missourians forced to pay the bill.

V. The Bill Would Increase Taxes on Textbooks

Senate Substitute for House Bill No. 253 would also add to the tax burden of Missouri families by eliminating the state sales tax exemption for college textbooks. This would increase the cost of college for Missouri students, when other provisions of the bill would reduce revenue available to fund our colleges and universities.

VI. The Bill's Revenue Triggers Do Not Apply To Two of the Most Costly Provisions

In response to concerns about the bill's overall cost and its impact on education and vital public services, proponents of Senate Substitute for House Bill No. 253 have pointed to various revenue "triggers" that must occur before tax reductions in the bill can take effect. Proponents claim that these triggers would protect against shortfalls because revenue collections would have to grow by more than $100 million before taxes are cut. In other words, if state revenues do not grow enough, then no additional taxes are cut. This is simply not true. Two of the most expensive provisions in the bill—the tax reduction tied to enactment of the Federal Marketplace Fairness Act (FMFA) and the business income exemption—are not tied to any revenue trigger whatsoever and will begin reducing revenues regardless of whether revenue collections are going up or going down.

a. The Business Income Exemption Would Take Effect During Fiscal Year 2014

Senate Substitute for House Bill No. 253's exemption for pass-through entity business income is not subject to any trigger whatsoever and therefore would begin impacting education and vital public services in the fiscal year that will begin July 1, 2013. This provision alone would cost $230 million annually by the fifth year and will occur regardless of whether revenue collections are going up or going down.

b. The FMFA Provision is Not Tied to Any Revenue and Applies Retroactively

Extremely troubling is Senate Substitute for House Bill No. 253's provision that would reduce the maximum income tax rate by .5% immediately upon enactment of the Federal Marketplace Fairness Act (FMFA). This immediate drop in the tax rate would force an estimated $300 million cut to education and vital public services, regardless of whether revenues are otherwise increasing or decreasing, since this trigger has no tie to revenue collections whatsoever. While proponents of Senate Substitute for House Bill No. 253 estimate that the FMFA might ultimately generate additional sales tax revenue, any additional revenue from the FMFA would not occur simply upon federal passage of the FMFA; instead, Missouri would also have to meet all of the requirements of the FMFA, which could not occur until 2015 at the earliest, if at all. This means that while there would be an immediate loss of an estimated $300 million annually upon enactment of the FMFA, any additional revenue to offset this decline could be years away.

Even more troubling are the drafting problems in this provision that allow the reduction in tax rates to apply retroactively to prior tax years. Specifically, the change in Section 143.011.2, RSMo, would require a .5% reduction to the maximum tax rate upon enactment of the FMFA for all tax tables in Section 143.011.1, RSMo. Intentional or not, the effect of this change to all tax tables in Section 143.011.1, RSMo, could enable taxpayers to seek refunds of taxes previously paid for up to three prior tax years (due to the three year statute of limitations for filing amended returns). All told, this could obligate the state to pay out tax refunds of approximately $300 million per year for taxes paid during the last three tax years—for an additional fiscal impact of $900 million—all coming in the same year as the immediate approximately $300 million loss described above.

With both of the above issues, this single provision of Senate Substitute for House Bill No. 253, could reduce funding for education and vital public services by as much as $1.2 billion in Fiscal Year 2014 if the FMFA were to pass this year. This significant additional cost is not reflected in the bill's fiscal note.

VII. The So-Called Revenue "Triggers" Provide Only A False Sense of Security

Even for provisions of the bill where revenue triggers would apply, they provide little protection from cuts to education and vital public services.

a. The Triggers Fail to Prevent Cuts During an Economic Downturn

The revenue triggers are drafted to allow for permanent changes in the tax code based on a prior year's increase in revenue collections. This is fiscally irresponsible because it could result in a reduction in tax rates even during the depths of an economic recession. For example, if Senate Substitute for House Bill No. 253 had been in effect at the time, the more than $100 million revenue collection increase in Fiscal Year 2008 would have triggered tax rate reductions in Fiscal Year 2009. This would have meant that tax rates would have been reduced despite the fact that there was a $553 million reduction in revenue in Fiscal Year 2009 due to the economic recession. Had Senate Substitute for House Bill No. 253 been in effect, steep cuts to education and vital public services could not have been avoided, as the tax reductions would have continued blindly with no way to turn off the experiment once it had begun.

b. The Triggers Ignore Tax Refunds

The revenue triggers are drafted based on overall revenue "collections" and therefore fail to factor in tax refunds. This will further reduce available revenue because a significant amount of tax refunds would reduce any increase in collection to the point that very little new revenue would remain to offset the fiscal impact of the tax reduction triggered. Looking at actual historical collection data, there are a number of years where revenue *collections* may have increased by $100 million, but the *actual revenue* available after refunds did not. For example, in Fiscal Year 2000, revenue collections increased by $221 million, but, after refunds, actual revenues were up by only $6 million. Nevertheless, if Senate Substitute for House Bill No. 253 were in effect at that time, tax reductions would have occurred despite the fact that the cost of the reductions would far exceed actual revenue available.

VIII. The Bill Rewards Economically Inefficient Activity

The business income exemption within Senate Substitute for House Bill No. 253 is fraught with problems that will reward tax avoidance activities even if they are economically inefficient.

First, the critical term "business income" is not adequately defined, which, in addition to enabling the cost of this exemption to be underrepresented in the bill's fiscal note, would provide a strong incentive for creative accounting to game this new exemption by classifying as much income as possible as exempt, even to the point of forming a "business" simply to gain the new tax exemption. This rewards tax avoidance activity without concomitant economic activity and thereby makes our tax code less efficient.

Second, the exemption provides preferential treatment to select Missouri businesses, while discriminating against the majority of others based solely on the paperwork the businesses filed to organize. Businesses organized as "pass-through entities"—e.g. certain LLCs, partnerships—would see half their income exempt within five years, while the majority of business would see just a few tenths of a percent shaved off their tax rate over the next decade. Preferential tax treatment for selected businesses would create a perverse incentive for businesses to restructure solely for tax avoidance and not for economic efficiency. This kind of manipulation through the tax code unduly interferes with the free market by incentivizing economically inefficient behavior. There is simply no principled economic justification for the tax code to pick winners and losers based solely on elevating the form of a business's organizational structure over its economic substance.

IX. The Bill Would Create Uncertainty For Existing Investments

Not only would the business income exemption lead to economically inefficient activity, the other reductions in Senate Substitute for House Bill No. 253 could undermine business confidence in investments that have relied on previously-authorized state incentives based on retained withholding tax. Reduced withholdings for employees as a result of a lowered personal income tax would lessen the value of such incentives and impact debt service on financing long-ago secured. Injecting this uncertainty into our economy at a time when our stable, predictable business climate and rock-solid fiscal discipline are paying dividends would undermine confidence in the investments businesses have already made and jeopardize our ability to effectively compete for additional investments in the future.

X. The Bill Would Make Our Tax Code Less Fair

Ultimately, one of the most striking aspects of Senate Substitute for House Bill No. 253 is its lack of fundamental fairness. No legislation that gives two individual taxpayers with identical incomes—one who owns a business and one who works at one—such drastically different tax exemptions can be called fair. No legislation that would gut K-12 education in exchange for letting LLC shareholders call half of their income exempt can be called fair. No legislation that would give the lobbyists who helped write the bill a 50% tax cut, while shaving just .5% off his mechanic's tax rate over the next decade can be called fair.

In accordance with the above stated reasons for disapproval, I am returning Senate Substitute for House Bill No. 253 without my approval.

Respectfully submitted,

Jeremiah W. (Jay) Nixon
Governor