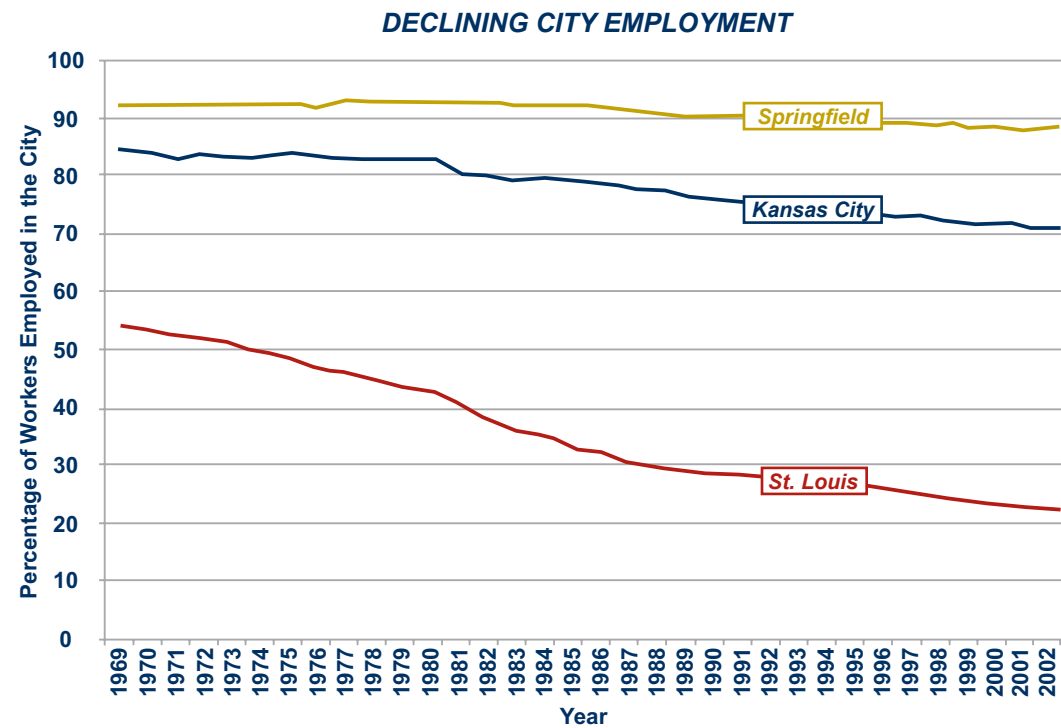


The evidence—both in Missouri and nationwide—suggests that an earnings tax redistributes jobs and investment from a city to its suburbs.



7777 BONHOMME AVE.
SUITE 2150
ST. LOUIS, MO 63105

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the city has built-in advantages such as convenient access to businesses in the city's downtown, the most profitable place to invest initially will be in the city. However, as the market becomes more crowded, the profitability of new capital invested in the city will begin to drop, and some investors will begin investing in the suburbs.

We can expect that to occur even without an earnings tax—which explains the growth of the Springfield suburbs. However, an earnings tax greatly accelerates the process and permanently lowers the rate of return on capital invested in the city. In a city with an earnings tax, diverting investment to the suburbs becomes profitable sooner than it would have without the earnings tax.

The model predicts that once a city with an earnings tax reaches a certain

size, it will stagnate, with all subsequent development occurring in the suburbs.

That is a good description of the plight of St. Louis over the last three decades. The model can also account for Kansas City's experience. It seems that Kansas City has not yet reached the growth ceiling imposed by the earnings tax. However, my model predicts that the city's growth will not continue forever. At some point, Kansas City, too, may reach a maximum size, and subsequent investment will occur only in the suburbs. Kansas City's leaders would do well to study how St. Louis has fared in recent decades, and consider whether it's a record they wish to emulate.

For more details, please see *Show-Me Policy Study no. 1*, which is available at www.showmeinstitute.org.



THE MISSION OF THE SHOW-ME INSTITUTE IS TO RESEARCH, DEVELOP, AND ADVANCE PUBLIC POLICIES THAT ENHANCE ECONOMIC GROWTH AND OPPORTUNITY FOR ALL RESIDENTS OF MISSOURI.

Joseph H. Haslag is an associate professor of economics at the University of Missouri, Columbia. He holds a master's degree in economics from the University of Missouri and a Ph.D. from Southern Methodist University.

POLICY

BRIEFING

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HOW AN EARNINGS TAX HARMS CITIES LIKE ST. LOUIS AND KANSAS CITY

By Joseph H. Haslag

On the surface, an earnings tax seems like an ideal way for a city to raise revenue. After all, cities—especially their downtown business districts—possess substantial competitive advantages relative to the surrounding suburbs. Many businesses need to be located near clients, customers, and complementary businesses. Hence, many city policymakers have traditionally assumed that they could impose a small earnings tax with minimal economic damage.

In practice, this analysis is too simplistic. Although some existing businesses will not be willing or able to move to avoid the earnings tax, new investment is more mobile. When deciding where to start a new business, entrepreneurs will choose to locate where their rate of return—after taxes—is the highest. Moreover, as more and more businesses choose to locate outside of the city's downtown, the convenience of a downtown location begins to diminish.

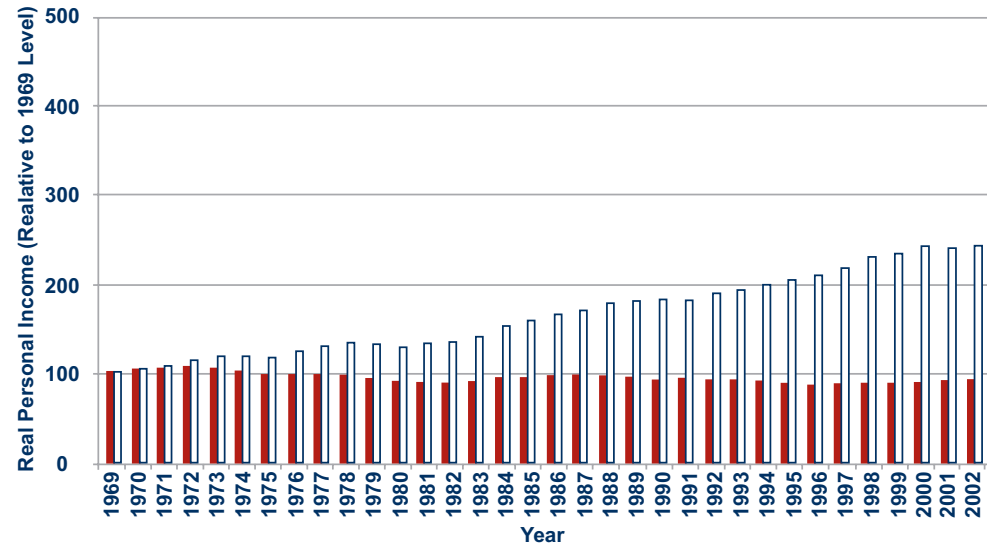
Improvements in transportation have worsened the problem: over the last half-century, freeways and widespread automobile ownership have made both residents and businesses more mobile. As a result, the cost of locating businesses in the suburbs has declined. The competitive advantages of a city's downtown have declined with it.

The Earnings Tax in Missouri

Ironically, the increased mobility of residents was a major motivation for Missouri's adoption of an earnings tax. In the postwar years, families began purchasing cars and moving to the suburbs, causing a decline in property tax revenues. In 1947, the Missouri legislature responded by authorizing cities with populations of at least 70,000 to levy an earnings tax. The tax rate was capped at 1 percent. Both St. Louis and Kansas City chose to enact an earnings tax, in the belief that businesses would prove less mobile than residents.

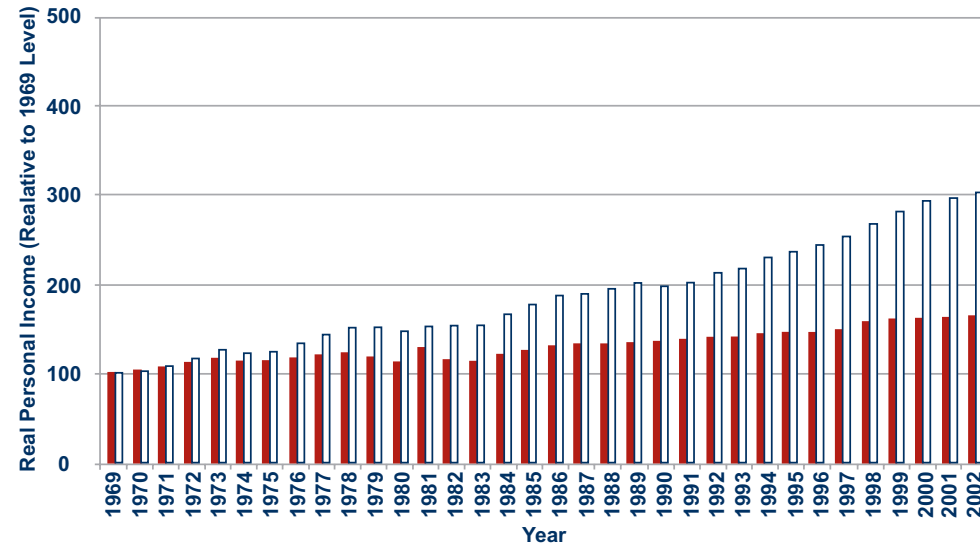
ST. LOUIS

Income for City (red) and Suburban Metro Area (white)



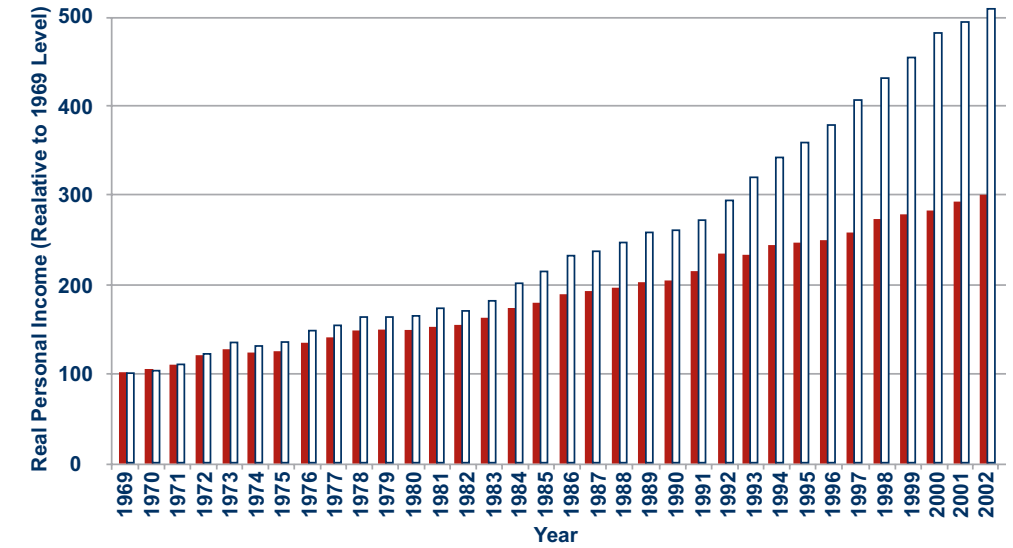
KANSAS CITY

Income for City (red) and Suburban Metro Area (white)



SPRINGFIELD

Income for City (red) and Suburban Metro Area (white)



If bad tax policy drives St. Louis and Kansas City residents into the suburbs, the state of Missouri will lose tax revenue to Illinois and Kansas.

The effects of an earnings tax should be of particular interest to Missouri policymakers because the St. Louis and Kansas City metropolitan areas each straddle a border with a neighboring state. If bad tax policy drives St. Louis and Kansas City residents into the suburbs, not only will the cities lose tax revenue to neighboring suburbs, but the state of Missouri will lose tax revenue to Illinois and Kansas.

Missouri also makes an interesting case study for the economics of the earnings tax because in addition to two cities with an earnings tax—St. Louis and Kansas City—the state also has a third major city—Springfield—that has chosen not to impose an earnings tax. This presents an opportunity to compare the economic performance of the Springfield area with the performance of its larger neighbors to look for clues about the economic impact of this tax.

Economic Performance of Missouri Cities

A good way to evaluate the economic performance of a region is by looking

at growth of total personal income.

By comparing the total income of city residents to that of suburban residents, we can gauge how well a city's economy has performed relative to the rest of its Metropolitan Statistical Area (MSA).

Of the three metropolitan areas under consideration, St. Louis has fallen the furthest behind its suburbs. Total real income in the city of St. Louis actually declined between 1969 and 2002, while in the suburbs, it increased about two and a half times. In contrast, Springfield has been the most successful at keeping pace with its suburbs, although it too has seen its share of MSA income fall slightly. Real income in Springfield tripled between 1969 and 2002, while it quintupled in the Springfield suburbs. Kansas City's performance has been middling. The city's total real income in 2002 was one and a half times its 1969 level—while its suburbs increased threefold.

Similar trends can be seen in employment data. In 1969, more than half of all employment in the St. Louis metropolitan area was located in the city of St. Louis. By 2002, only 22 percent of

the area's workers had jobs in the city. Kansas City has had greater success at keeping employment in the city. In 1969, about 83 percent of jobs in the Kansas City MSA were located within the city limits. That number fell to 70 percent in 2002. Springfield has done the best job of competing with its suburbs for new investment—the city's share of the region's jobs dropped by only about four percentage points during the same period.

National Evidence

These statistics suggest that the earnings tax might be driving businesses and residents out of St. Louis and Kansas City. But, of course, many other factors could explain the discrepancy. It might be explained by other policy variables—such as the regulatory climate or education system—or by purely accidental characteristics of the three cities.

However, I find the same relationship between the earnings tax and economic performance in statistics across the nation. I perform two regressions using data from 101 of the largest metropolitan areas: one from the 1990 census, and

the other from the 2000 census. In 23 of those metropolitan areas, the central city has an earnings tax. I find that an earnings tax is systematically associated with lower city per-capita income relative to the surrounding suburbs. For example, consider the city of St. Louis, which had a 2000 per capita income of \$19,518. My regressions suggest if St. Louis's earnings tax had been one percentage point higher, its per capita income would have been \$995 smaller.

Modeling the Impact of an Earnings Tax

Thus, the evidence—both in Missouri and nationwide—suggests that an earnings tax redistributes jobs and investment from a city to its suburbs. When an earnings tax is imposed only in the city part of a metropolitan area, as it is in St. Louis and Kansas City, it discourages new investment in that part. I present a model of capital investment in an MSA that accounts for this process. In the model, investors seek to deploy their capital where they can obtain the greatest after-tax rate of return. Because

An earnings tax is systematically associated with lower city per-capita income relative to the surrounding suburbs.