TAX CREDITS

STATE GOVERNMENT IS PICKING WINNERS AND LOSERS

TEF IOWA POLICY REPORT

Iowa competes with 49 states for businesses and people.

What policies will allow Iowa to be more competitive and attract more people, businesses, and entrepreneurial activity?

Iowa is confronted with some serious economic problems. Whether it is slow population growth, a growing divide between rural and urban communities, or a shortage of labor, Iowa needs economic growth and we are in competition with 49 other states for businesses and people. The question is what types of policies will allow Iowa to be more competitive and attract more people, businesses, and entrepreneurial activity? Creating economic growth in Iowa will require policymakers to embrace free-market and limited government policies. These include lowering Iowa's high individual and corporate tax rates, reducing burdensome regulations, and fostering a business environment that encourages entrepreneurship. States that are reducing tax rates, controlling spending, and reducing regulatory burdens are seeing both economic growth and increases in population.

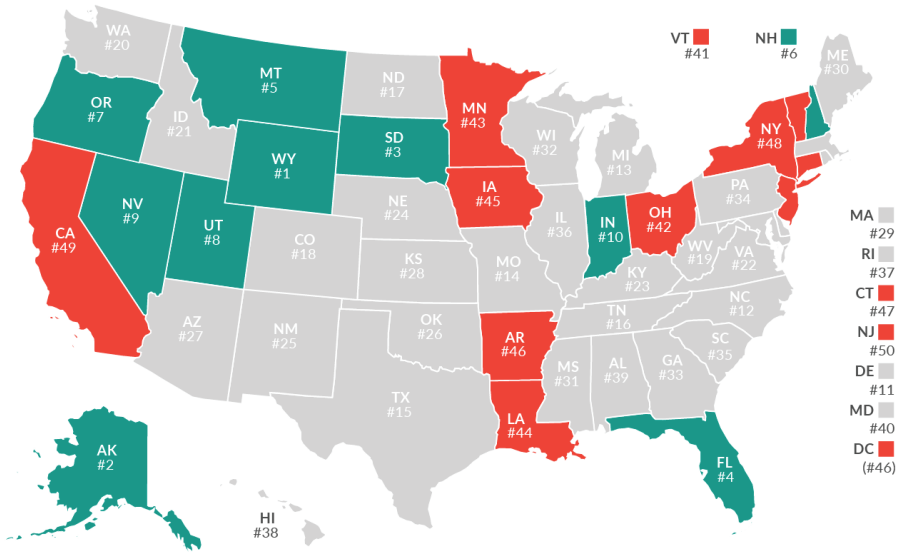
Iowa must decide whether to follow a path of economic development or economic growth. Dr. Roy Cordato, Senior Economist and Resident Scholar at the John Locke Institute, describes a policy based on economic development as targeting "specific localities, regions, and businesses for special privileges at the expense of the rest of the state." Economic development utilizes state and local tax credits and incentives in the hopes of spurring economic growth. The idea is that businesses need incentives to locate or expand, or to create new jobs, and in response the credits and or incentives used will create a multiplier effect, which will lead to economic growth.

An economic growth policy is the direct opposite. "Economic growth policy would seek to create an environment that encourages private-sector entrepreneurship by removing government from the resource allocation picture entirely," argues Cordato. Economic growth depends on policies that encourage entrepreneurship and a healthy environment for all business, not just selected recipients. "Our growth over time depends heavily on our rate of entrepreneurship, the rate at which people. Natives or newcomers, create and expand new businesses in our state," wrote John Hood, who serves as Chairman of the John Locke Foundation. Entrepreneurship and small businesses are often generators of jobs and economic growth.

Economic growth depends on policies that encourage entrepreneurship and a healthy environment for all business, not just selected recipients.

Currently, Iowa relies more heavily on the economic development model rather than economic growth model. The Tax Foundation ranks Iowa in the top ten

2019 State Business Tax Climate Index



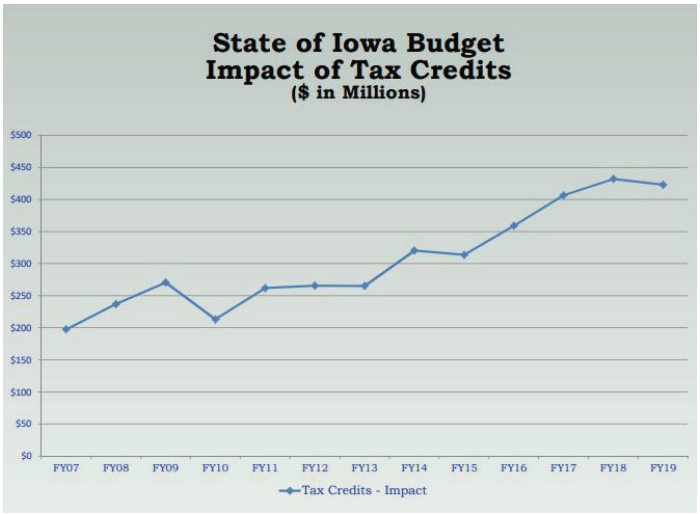
Note: A rank of 1 is best, 50 is worst. Rankings do not average to the total. States without a tax rank equally as 1. D.C.'s score and rank do not affect other states. The report shows tax systems as of July 1, 2018 (the beginning of Fiscal Year 2019).
Source: Tax Foundation.

TAX FOUNDATION @TaxFoundation

worst states for business climate. Iowa's high tax rates not only discourage economic growth, but they make our state less competitive. South Dakota has no state income tax and Iowa is losing ground to our neighbor because they have a more competitive tax climate. It will be difficult for Iowa to achieve economic growth with a combination of high taxes rates and a reliance on tax credits and incentives. Tax credits and incentives may create some sporadic economic growth, but this is not sustainable.

Iowa's tax credits and incentives are too complicated.

Iowa has a complicated system of tax credits and incentives. Iowa uses tax credits not only for economic development, but also for a variety of other purposes that include workforce development, promotion of renewable energy, leveling out socioeconomic inequalities, among others. The State Auditor of Iowa reports that the cost of these various tax credits has also increased overtime. From Fiscal Year 2007 to Fiscal Year 2019 tax credits in Iowa have increased from $197.6 million to $422.9 million, which is a $225.3 million



State Auditor, State of Iowa FY19 Budget Review, July 2018

increase in just 12 fiscal years. Some of the fastest growing tax credits include:

Fiscal Year 2019

- $69.1 million for Research Activities Tax Credit
- $68 million for Earned Income Tax Credit
- $64.5 million for Historic Preservation Tax Credit
- $43.1 million for High Quality Job Program
- $17.1 million for Workforce Housing Tax Incentive

Iowa's Legislative Services Agency (LSA) reported that the Iowa Economic Development Authority (IEDA) since January 2011 has aided 376 projects. LSA notes that "from January 2011 through June 2017, the IEDA Board awarded $66 million in direct financial assistance and $563 million in tax credits." These incentives and tax credits are "intended to bring projects to Iowa that are expected to result in 57,319 direct, indirect, and induced jobs and $14.3 billion in capital investment for Iowa's economy." The objective of these IEDA incentives and credits are meant to help "companies of all sizes relocating to or expanding in communities around Iowa."

Overall, IEDA administers 25 various programs that deal with economic development. Some of these programs include Enterprise Zone, Entrepreneurial Ventures Assistance, Grow Iowa Values Fund, High Quality Jobs Program. LSA reports that since Fiscal Year 2003 "a total of almost 1, 200 projects have been awarded direct financial assistance, totaling over $343.3 million" based upon the various 25 IEDA programs. These IEDA investments are expected to "include over 72,000 jobs" and $17 billion in project costs when completed. The question that must be asked is whether Iowa is receiving enough benefit in terms of economic growth for the cost? Are the promised jobs being delivered? Taxpayers deserve answers when considering the usefulness of economic development credits and incentives.

From Fiscal Year 2007 to 2019, tax credits in Iowa have increased $225.3 million.

Iowa code mandates that tax credits and incentives be reviewed on a regular basis. The legislature's Tax Expenditure Committee is tasked with reviewing "any tax expenditure available under Iowa law and assess its equity, simplicity, competitiveness, public purpose, adequacy, and extent of conformance with

the original purposes of the legislation that enacted the tax expenditure…" On a five-year rotation basis, the Tax Expenditure Review Committee evaluates tax expenditures.

The Committee's review is dependent upon analysis of each tax credit provided by Iowa's Department of Revenue. The Pew Charitable Trust has praised Iowa's tax credit and incentive review process. A main reason for this praise is the research provided by the Department of Revenue. For each tax credit and incentive the Department of Revenue provides an overview, which includes the "history of the credit or incentive, design, cost, and performance." In addition, the Department of Revenue may also include comparisons with other states who may share similar tax credit and incentive programs. The problem with this process is that policy recommendations are rarely provided, and legislators are not provided with enough information to know whether these programs are working and delivering the intended results.

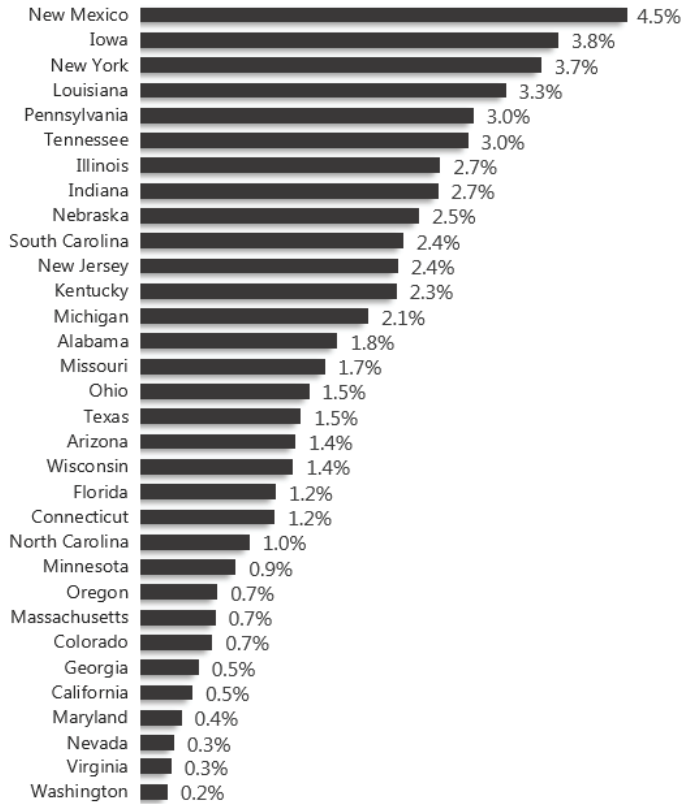
Iowa is in competition with other states for both businesses and people. Iowa, just as with other states, is also utilizing tax credits and incentives to attract economic development. All 50 states are in a perpetual "arms race" with one another to determine who can provide the best incentives in the hopes of attracting (and retaining) businesses and people. While not alone in the use of incentives, Iowa leans heavily on those incentives. Data from the W.E. Upjohn Institute for Employment Research found that between 2013 and 2015 Iowa was one of the states that most relied upon financial incentives. Cities, especially ones that are close to other state borders, turn to incentives, as well.

Are tax credits, grants, and other forms of incentives the best use of tax policy and is it fair to existing businesses?

Because credits, grants, and other forms of incentives are so prevalent across the country, this also means that very few states are willing to terminate tax credit programs for fear of losing out to another state. Businesses, especially large corporations, take advantage of this situation to get the best deal, but it brings into question whether this is the best use of tax policy and whether it is fair to existing businesses within the state.

2013-2015 Average Annual State Tax Incentives

(Shown as % of value added by each state's industries)



NOTE: Data unavailable for states not shown.

NC State University; McDonald, Decker, Johsnon and Allen (2019)

Whether at the state or local level tax credits and incentives often lead to crony capitalism. "The problem is, state grants and giveaways require redirecting money from other taxpayers and businesses, so the good that is done for the recipient company comes at the expense of good not done by all other companies, mom & pop businesses, and taxpayers doing business with them," wrote Jon Sanders, a regulatory specialist with the John Locke Foundation. This results in governments picking winners and losers. It also creates unfairness within taxation and favors one business over another. Plus, the question must be asked whether the recipient of a credit or incentive would have expanded or hired more workers even without the subsidy? James Hohman argues that in the end "it's all public money going to someone's direct private interests. Business subsidies get pocketed by business owners and serve the interests of that business owner."

"Business subsidies get pocketed by business owners and serve the interests of that business owner.

- John Hohman, Mackinac Center

Tax credits and incentives are also an "easy" policy solution for legislators to solve a problem. Economists Peter T. Calcagno and Frank L. Hefner argue that "rather than reform various aspects of fiscal and public policy that could improve economic efficiency, government officials offer firms targeted incentives." In other words, it is easier to utilize tax credits, incentives, abatements, and TIF (Tax Increment Financing) rather than work to reduce corporate and income tax rates and eliminate excessive regulations.

Often big business is the beneficiary of credits and incentives because they have more political clout than small business.

"Lawmakers want to control the discussion about their state's economic performance, and distributing handouts gives them something to point at to bolster whatever story they want to tell," noted James Hohman, Director of Fiscal Policy at the Mackinac Center for Public Policy.

There is no lack of research that has been conducted by academics on this issue either. An overwhelming number of the studies concerning the use of tax credits and incentives seriously question their effectiveness. Richard Florida, who is considered one of the best-known urban policy expert, argues that there is "no relationship between incentives and any meaningful measure of economic performance." Calcagno and Hefner noted that the "literature has demonstrated that these targeted incentives do little, if anything, to promote economic growth, reduce unemployment, or increase personal income." A recent study focusing on state credits and tax incentives that center on job creation, property tax abatements, and research and development found that while some return on investment may occur, they may also damage the fiscal health of a state. Connecticut serves as an example, as described by the Yankee Institute for Public Policy:

> **There is "no relationship between incentives and any meaningful measure of economic performance."**
>
> **-Richard Florida University Professor and Director of Cities at the Martin Prosperity Institute at the University of Toronto**

> One of the most egregious of these uses [state resources] was the state's 'economic development incentives' programs. These programs spend more of the state's income every year than is raised by the administration's 2015 corporate tax increases — the increases that drove away General Electric and other major Connecticut corporations. The results, meanwhile, appear ineffectual: even the corporation that received the most of such incentives has recently announced plans to leave the state.

"Most studies find that startups are more frequent, and more likely to succeed, in states where taxes and regulations are low…Higher government spending doesn't boost entrepreneurship in most studies," noted John Hood. Enough academic studies exist that state policymakers need to seriously consider reforming state tax credits and incentives.

Because of the economic development arms race among states, and the perceived need of these "tools" for economic development, it is difficult for states to abolish or phase-out tax credits and incentives. In 2017 Arkansas repealed InvestArk, which was the investment tax credit. A major reason for the repeal of InvestArk was that it favored large businesses at the expense of smaller firms. InvestArk is an example of a serious issue behind tax credits and incentives: crony capitalism. Tax credits and incentives allow governments to pick winners and losers and it distorts any notion of fairness in terms of economy or taxation.

Often big business is the beneficiary of credits and incentives because they have more political clout than small business. Dean Stansel, Economist and Research Associate Professor at the O'Neil Center for Global Markets and Freedom at Southern Methodist University, argues that "gains for big business and losses for small business occur because

only the big companies have the political and financial capital to have a seat at the table when these subsidies are doled out." As Stansel further explains:

> Small businesses and entrepreneurs get shut out. For companies that have been faithfully paying their taxes and serving their local communities, their own tax dollars are used against them to lure big businesses from other areas to come in and compete with them. This strategy seems counterproductive. Small business is the backbone of the economy. According to U.S. Census Bureau data, more than 80 percent of business establishments have fewer than 500 employees; 70 percent have fewer than 20. These incentives programs make it harder for them to succeed.

70 percent of businesses have fewer than 20 employees.

We need to insure a level playing field for small businesses as they are the backbone of our economy.

"A better strategy would be to eliminate all of those corporate welfare programs and reduce business taxes across the board," wrote Stansel.

If abolishing or phasing out tax credits is difficult or unlikely then states should consider reforms that bring more transparency and accountability. Some states have considered applying sunsets to tax credits, which would require the legislature to re-approve tax credits, with Missouri and Arizona being the most recent example. Oregon has a process that allows tax credits and incentives to expire after six years unless renewed by the legislature. A sunset provision will force legislators to vote on whether a tax credit or incentive should be continued.

One state has put an expiration date on credits and incentives.

A sunset provision would give legislators the ability to evaluate the benefits received and vote on whether the credits or incentives should continue.

Sunsets should also be combined with a rigorous review process of all tax credits and incentives. "Ideally, sunsets would be paired with tax expenditure studies which

If abolishing or phasing out tax credits is difficult or unlikely, then states should consider reforms that bring more transparency and accountability.

attempt to quantify the costs and benefits of each credit, providing legislators with meaningful information on which to base their decisions," noted Jared Walczak, Senior Policy Analyst with the Tax Foundation.

States need to develop a process that will allow policymakers to evaluate the effectiveness of tax credits and incentives. The Pew Charitable Trust has analyzed state tax credit and incentive evaluations programs and found that three factors are needed:

1. Create a process to regularly study tax incentives.
2. Produce high-quality evaluations that draw clear conclusions.
3. Use the findings to inform policy decisions.

Among the states that Pew recognizes for applying these principles, North Dakota and Indiana stand out and would be worth emulating. In North Dakota, the legislature's Taxation Committee has the responsibility of reviewing tax credits and incentives. The Taxation Committee is tasked with holding hearings "between legislative sessions," and this provides an "opportunity for lawmakers to publicly discuss incentives up for evaluation and allow professional, nonpartisan staff to present background information necessary for a proper examination." The Committee also considers "whether an incentive has met its goals and to what extent it rewards behavior that would have occurred

without the incentive." A problem with this approach, which is a problem that Iowa legislators share, is that "legislative staffers have extensive tax policy knowledge but do not have experience conducting sophisticated economic analyses."

Indiana requires an evaluation process on a five-year cycle. Indiana's Legislative Services Agency (LSA) utilizes both a "mix of common sense and quantitative analysis" in their evaluation." One purpose of this is to determine "how much taxpayer activity can be attributed to incentives — a key step for measuring their economic impact." Pew notes that Indiana is "leading other states because it has a well-designed plan to regularly evaluate tax incentives, experience producing quality evaluations that rigorously measure economic impact, and a process for informing policy choices."

> ***Would a business have expanded or added additional jobs without a tax credit?***

Iowa's review process based on the Tax Expenditure Committee and analysis provided by the Department of Revenue does follow the three factors, but more analysis is needed. In addition, legislators do not have enough information to decide whether a tax credit is working.

Although the Department of Revenue does provide analysis a weakness that exists within the current review process is there is rarely "clear conclusions on how to improve incentive programs" and policy recommendations are not made. In addition, more legislative oversight is needed to allow policymakers to evaluate whether a certain tax credit or incentive is working and is benefiting the taxpayers. Policymakers also need additional information from not only state agencies, but also independent reviews that can offer policy recommendations.

As an example, could Iowa's Auditor of State or other agencies such as the Legislative Services Agency be allowed to offer additional information and transparency? Florida tasks the Office of Economic and Demographic Research (EDR) and the Office of Program Policy Analysis and Government Accountability (OPPAGA) to help evaluate economic development incentives on a three-year cycle. Florida requires the EDR to use "economic modeling to study the impact of incentives" and the OPPAGA provides qualitative research, which describes how the various programs work and recommendations for improving the programs. Analysis by both departments provided legislators with information to allow Florida's Enterprise Zone Program to expire, because the analysis not only found a "weaker return on investment," but the program was "mostly moving economic activity from place to place" and not creating economic growth.

> **The recent growth in tax credits demonstrates Iowa's dependence on government subsidized economic development.**

Iowa is in need for a more rigorous review of tax credits and incentives. The skyrocketing cost alone demonstrate that a taxpayer review is long overdue. If the legislature does nothing else, it should require more transparency on all tax credits, as well as stronger requirements for third-party review of the "economic impact" calculations that justify so many of these deals. This also includes information and independent analysis before a potential economic development deal is even made. As an example, would a business expand or add additional jobs even without the tax credit? If the taxpayers of Iowa are being asked to subsidize a business, then it's only appropriate that they be given as much access to relevant information about the deal as any other investor.

Taxpayers are being asked to subsidize businesses. As an investor, they should have accessible information to evaluate the effectiveness of their investment.

It is often argued by proponents of tax credits and

incentives that they are a necessary tool for economic development. This is not necessarily true. "The mistaken belief that these programs actually improve the economy is a big obstacle to eliminating them. Another barrier is the belief that areas that eliminate incentive programs will lose businesses if other areas do not eliminate theirs. That is not necessarily true," argues Stansel.

> **The Mercatus Institute estimates that Iowa could lower the corporate tax rate by 36 percent if corporate welfare was eliminated.**

Iowa would be better served by following a pro-growth policy agenda. The recent growth in tax credits demonstrates Iowa's dependence on government subsidized economic development. It is time to reform Iowa's numerous and complex system of tax credits by increasing transparency, accountability, and eliminating those credits that are wasteful of taxpayer's dollars. Lowering tax rates is by far a better economic incentive for growth rather than subsidizing businesses through credits and incentives. North Carolina, which is the gold standard for state tax reform, has not only lowered tax rates, but in the process has placed "expiration dates on popular corporate tax credits." The Mercatus Institute estimates that Iowa could lower the corporate tax rate by 36 percent if corporate welfare was eliminated.

Lowering tax rates, reducing regulations, and allowing more liberty in the economy will not only make Iowa more competitive with other states, but it will create an environment that encourages entrepreneurship and productivity.

TEF IOWA

SMALLER GOVERNMENT
SMARTER SOLUTIONS

9295 Bishop Dr., Suite 105, West Des Moines, Iowa 50266

tefiowa.org @tefiowa @tefiowa