ASK THE EXPERTS

HOW CAN FREE-MARKET POLICIES LEAD TO BETTER ECONOMIC DEVELOPMENT?

Table of Contents

Iowa would be better served by lowering individual and corporate tax rates than depending on tax credits and incentives to grow the economy.

Tax credits and incentives are often an enticing siren song that lures state and local policymakers. Both are seen as not only necessary for economic growth, but also to help solve a variety of policy problems. The collection of essays that follow will provide some clarity that tax credits and incentives are not always sound policy solutions. Each essay is written by a leading public policy expert that has vast experience in studying the economic impact of tax credits and incentives. These essays will demonstrate that whether at a state or local level, tax credits and incentives often fail to deliver on the intended economic growth. They often create a form of cronyism and are often not the best use of spending taxpayers' dollars.

A business receiving special treatment in the form of a credit or incentive allows governments to pick winners and losers, but lowering tax rates would benefit all businesses

A business receiving special treatment in the form of a credit or incentive allows governments to pick winners and losers, but lowering tax rates would benefit all businesses. With a lower corporate tax rate all businesses will benefit, rather than a selected few. "Other businesses do not receive these kind of tax preferences, and thus the exemptions create an uneven playing field for businesses in the state," noted James Hohman, Director of Fiscal Policy at the Mackinac Center for Public Policy.

Iowa's economy would be better served with lower individual and corporate tax rates than depending on numerous tax credits and incentives for economic growth. As an example, Iowa has the highest corporate tax rate in the nation at 12 percent, yet, this rate could be lowered by eliminating ineffective tax credits and incentives.

> ***"Other businesses do not receive these kind of tax preferences, and thus the exemptions create an uneven playing field for businesses in the state."***
>
> **- James Hohman, Mackinac Center**

Iowa's economy is strong. Nevertheless, some economic challenges remain, such as slow population growth, and perhaps most notable is the need for a greater labor force. It is often assumed that tax credits and economic incentives are needed for Iowa's economic development, to help encourage both workforce development and population growth. The reality is that high tax rates are causing the state to suffer. High tax rates are often camouflaged by tax credits and incentives. It is time for a more thorough review of these handouts. Taxpayers deserve to know, regardless of the program, whether their dollars are being spent wisely. If economic growth is a goal of policymakers, then the best approach is to make Iowa more competitive by lower tax rates and creating a freer economy.

As a part of the 2018 comprehensive tax reform law, the legislature mandated the creation of an interim special Tax Credit Review committee to begin the process of reviewing Iowa's numerous tax credits. This committee is in addition to the Tax Expenditure Committee, which is already charged with reviewing tax credits. At this time the Tax Credit Review committee has only met once, and it is unclear what reform if any will occur.

Iowa uses tax credits not only for economic development, but also for a variety of other purposes that include promotion of renewable energy and redressing socioeconomic inequalities. The use of tax credits and incentives by states is often compared to a nuclear arms race, because all states utilize them and

Iowa also uses tax credits for other purposes such as promoting renewable energy and redressing socioeconomic inequalities.

very few are willing to "disarm." The same is true for localities within a state. Local governments in Iowa utilize incentives for economic growth, especially the use of Tax Increment Financing or TIF.

States and localities are in economic competition. James Hohman argues that it is better for policymakers to realize that "luring businesses from other states with taxpayer dollars leads to a bad kind of competition." Tax rates matter not only for a state's business climate, but to overall economic health. States should compete over their business, economic, and overall quality of life. "It's better to compete over business climate and quality of life rather than courting companies with money from the state treasury," argues Hohman.

From 2007 to 2019, tax credits have increased by $225.3 million. That's a 114 percent increase in just 12 years!

Regardless, all of Iowa's complex and extensive system of tax credits impose costs on other taxpayers — and that cost is growing. From 2007 to 2019, tax credits have increased from $197.6 million to $422.9 million. This is a $225.3 million or 114 percent increase in just 12 years. Increasingly, academics and other researchers across the country are proving how bad these types of tax credits are at creating jobs or growing economies, with a growing array of high-quality studies seriously questioning their effectiveness.

Recently North Carolina's Job Development Investment Grant (JDIG) and One North Carolina Fund (OneNC) were evaluated to see if these programs delivered the intended jobs as promised. The results were disappointing because "just over half of the promised jobs were actually created and about 37 percent of the projects failed to create even one single job." The Michigan legislature repealed a corporate subsidy program "Good Jobs for Michigan," which has "approved $16 billion in subsidies and tax credits since 2001 with little to show for it."

During the first meeting of the Tax Credit Review Committee, State Representative Dave Jacoby (D-Coralville) asked an important question of whether or not data exists that could demonstrate whether or not the benefits of tax credits outweighed the loss in revenue. A staff member from Iowa's Legislative Services Agency replied that the data does not exist. This is a similar conclusion that often emerges from the Tax Expenditure Committee. Often legislators are not provided with sufficient information on whether a tax credit is working or not.

> **Academics and other researchers across the country are proving how bad tax credits are at creating jobs or growing economies.**

It is time for a serious review of Iowa's tax credits and incentives. For more information on Iowa's tax credits and incentives and policy solutions, visit tefiowa.org.

Economic Development Incentives Help Big Business at the Expense of Small Business

by Dean Stansel, Ph.D.

State and local politicians all over the country seem to love to dole out tax dollars to big businesses in an effort to get them to locate in their area. While they routinely argue that those subsidies will benefit the local economy, economic research does not support that conclusion.

State and local economic development incentives may seem to help the local economy, but the offsetting costs are usually ignored. As a result, the overall effect is unclear. Since they typically involve poaching businesses from other areas in the U.S., from the perspective of the nation as a whole, these policies are clearly a net loss.

My colleague, Meg Tuszynski, and I have examined whether or not there was any relationship between economic development incentive programs and five measures of entrepreneurial activity. Like the previous literature in this area, our paper found virtually no evidence of a positive relationship. In fact, we found a negative relationship with patent activity, a key measure of new innovation. The only positive relationship was with the number of large establishments (500 or more employees). We found just the opposite result for small establishments (less than 10 employees).

70% of businesses have less than 20 employees. But their tax dollars are being used against them to lure large direct competitors to the state.

Big businesses win and small businesses lose because the small companies do not have the political and financial capital to have a seat at the table when these subsidies are doled out. Companies that have been serving their local communities and faithfully paying their taxes get punished by having their own tax dollars used against them to lure big businesses from other areas. That puts them at a competitive disadvantage with their new competitors.

Small businesses are the backbone of the economy. According to Census Bureau data, more than 80% of business establishments have fewer than 500 employees; 70% have fewer than 20. These incentives programs make it harder for those entrepreneurs to succeed. That strategy doesn't make sense.

A better strategy would be to get rid of all of those corporate welfare programs and reduce taxes across the board for all businesses, not just big businesses with political influence. According to the Tax Foundation's State Business Tax Climate Index, Iowa ranks only 42nd, behind all of its neighboring states except Minnesota. Iowa's high corporate and personal income taxes are a big reason for that unfriendly business climate.

> **Iowa's high corporate and personal income taxes are a big reason for that unfriendly business climate.**

Iowa has the highest corporate income tax rate in the country: 12%. Only New Jersey comes close with 11.5%. Every other state is below 10%. Twenty are at 6% or below; six of those do not tax corporate income at all. Many small businesses pay under the personal income tax. However, Iowa's personal income tax is also very high. Only six states have top rates higher than Iowa's 8.53%. Among its neighboring states, only Minnesota's rate is higher.

Those high income-tax burdens put Iowa at a competitive disadvantage. Lowering them would help alleviate that problem. And eliminating targeted economic development incentives programs could provide the off-setting spending reductions needed to make that possible. A recent study by the Mercatus Center found that 12 states could reduce their corporate income tax by more than 20% if incentive programs

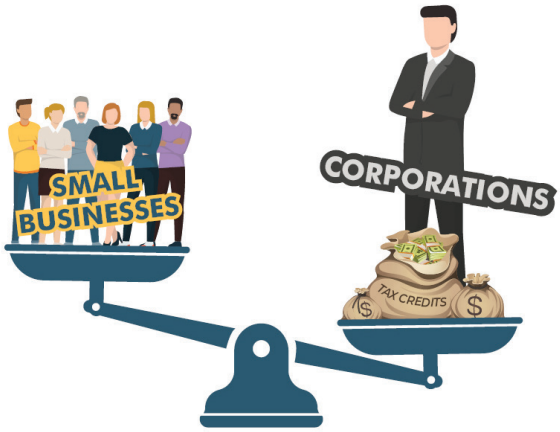
If Iowa eliminated corporate incentives programs altogether it could lower the overall tax rate by 36%

were eliminated. That includes a 36% cut in Iowa. Only six states would see a larger reduction. In those six, the corporate income tax could either be completely eliminated or reduced by more than 90%. These are big savings that would provide substantial tax relief to all businesses, both big and small, not just those with political influence.

The erroneous belief that economic incentive programs are actually beneficial to the economy is a large obstacle to eliminating them. Another recent Mercatus study examined the academic literature on this topic and found that these subsidies have "have little to no effect on where companies choose to invest." If they are not impacting location decisions, then the benefits to the economy are actually much lower than often believed. Furthermore, the cost of the higher taxes needed to fund the subsidies is usually ignored. Correcting for those two errors makes it difficult to conclude that the net effect is positive.

Another barrier to eliminating targeted economic incentive programs is the belief that doing so will make that area lose businesses if other areas do not also eliminate theirs. That is not necessarily true. One study found that 85% of the recipients of subsidies from a local property tax abatement program in Texas were going to invest in Texas anyway, regardless of the incentives packages offered.

Furthermore, more research from the Mercatus Center discusses how several states are already discussing a solution to that problem: the use of an interstate compact, essentially a federal peace treaty between states, to end the arms race of targeted development programs. And, they also found that 49 states (including Iowa) already have "anti-subsidy" clauses in their Constitutions, which technically make these programs unconstitutional.



Rather than handing out tax credits to the few, lowering tax rates for all businesses is a better approach and would level the playing field.

Spending on state and local economic development incentives is a pure loss of wealth to society; the national economy as a whole is harmed. Moreover, there is substantial evidence that the local area does not benefit either. Using scarce tax dollars to help big business at the expense of small business is a poor strategy. Lowering tax rates for all, not just those with political influence, is a better approach. That would provide a more level playing field in which all businesses can thrive.

Dean Stansel, Ph.D., is an economist and Senior Research Fellow at the O'Neil Center for Global Markets and Freedom in Southern Methodist University's Cox School of Business in Dallas.

Economic Development Reform in Iowa

by Patrick Tuohey

Forty-nine states and the District of Columbia have some sort of tax-increment financing program incentivizing companies to do things they otherwise would not do. The concept has merits, but the way it is applied in Iowa and elsewhere has problems. In fact, many local policymakers hate it, but they feel powerless to stop offering these giveaways.

In Iowa, the state legislature must step in and save local leaders from themselves.

There are multiple costs to developing property and, for commercial and industrial development, the cost of the additional tax liability can be considerable—especially if the parcel required a great deal of money just to prepare it for construction.

Most of the time this is all considered part of the cost of development. After all, the private investor is going to reap all the rewards if the investment is successful, so they should bear all the risk. But in some cases, the public has an interest in steering economic development to places where it might not otherwise be profitable. One can easily imagine parts of town where economic neglect and poverty make development less attractive due to higher risks on the return. In these cases, it might make sense for local government to incentivize development to meet a public need. Tax increment financing (TIF) is one such approach.

Bipartisan research from all over the country shows that TIF incentives are unnecessary and costly.

TIF plans return to the developer any tax revenue generated as a result of the new project, such as the increase in property taxes, or sales or utility taxes, to help defray the costs of the development. If this were the end of it, there would likely be no controversy. But in Iowa and around the country, the standards for awarding TIF packages are so lax that deals often support development that is economically feasible without the subsidy.

The result? Local governments using tax dollars to underwrite private investment for well-connected developers and supporters.

Bipartisan research from all over the country shows these incentives are unnecessary and costly. The tax revenue they divert would otherwise support schools, libraries and important public services.

The tax revenue TIFs divert would otherwise support schools, libraries, and important public services.

Across the country, school districts rail against these giveaways that often increase the demands placed on the education infrastructure without any increase in the tax base. In Iowa, as was the case in California before it ended the practice in 2012, affected taxing jurisdictions are made whole by replacement funds from the state. Let's be clear about what this means: Rather than merely impoverishing their own taxing jurisdiction, Iowa municipalities can hand out development favors and send the bill to taxpayers statewide. The taxpayer burden borne by any one TIF may be insubstantial. But taken together, the costs are piling up.

TIF programs also distort private business incentives. Developers are less concerned with projects that are profitable and likely to be successful, and more concerned with projects that make local politicians happy. Projects that may be bad business ideas can and do move forward when taxpayers accept a portion of the risk without asking for any of the reward.

TIF programs distort private business incentives. Developers are less concerned with projects that are profitable and more concerned with projects that make local politicians happy..

TIF applications in Iowa and elsewhere often amount to the Music Man's Harold Hill coming to City Hall saying, "Boy have I got a bad business idea for you! But if taxpayers dive in first, it'll be a great idea for all the other investors!"

No one would ask municipal leaders to manage our personal investment portfolios, yet this is exactly what TIF encourages them to do—use public funds to subsidize private projects that cannot seem to raise their own private capital.

Cities should welcome investment, and remove obstacles relating to red tape and regulations. But in most cases municipalities should not become investors themselves by offering subsidies. State lawmakers must act to make sure that the circumstances under which cities invest in private enterprise are limited, thoroughly vetted, and transparent.

Patrick Tuohey is director of policy at the Better Cities Project, a nonprofit focusing on free-market policy solutions for America's 100 largest cities.

Understanding the Societal Cost of Runaway Tax Credits

by John C. Mozena

Government is gambling with your taxpayer dollars. Using them to create tax breaks and incentives to draw businesses into the state. However, these incentives come with a major price tag and no guarantees of return.

Iowa's massive tax credit programs come at a very real and harmful cost to its ability to provide basic public services. Any meaningful discussion of how much Iowa's state and local politicians are handing out in tax credits must include the context of what governments could have accomplished with the revenues they won't be receiving thanks to those tax breaks, using real-world examples that the average taxpayer and voter can understand.

Economists say that tax credits have "concentrated benefits and diffuse costs." In other words, a very small number of people are benefiting a lot while the costs are spread so widely that the average taxpayer doesn't notice. But those costs are real, as politicians who hand out special tax breaks make up the lost revenues elsewhere on the backs of other taxpayers or in decreased public services instead of trimming the budget to compensate.

> **A massive cost spread out thinly across millions of Iowa individuals and corporate taxpayers is still a massive cost.**

A massive cost spread out thinly across millions of Iowa individual and corporate taxpayers is still a massive cost. When it comes to Iowa's tax credit programs, the examples of what the state could have paid for with those uncollected taxes are stunning.

Iowa's total tax credit bill is $422.9 million. That's what it cost every state and local government agency combined to provide mental health and disability services across the state in 2017.

Or, that tax credit figure is $95 million more than the state spends each year on special education programs in all the state's public schools combined.

Mahatma Gandhi once said, "The true measure of any society can be found in how it treats its most vulnerable members." In that spirit, how does Iowa measure up when its elected officials hand out more in special tax breaks to connected businesses than they devote to caring for some of the most vulnerable members of its communities?

Total Tax Credits Handed Out FY2017

$422.9M

Those Resources Could Have Funded

Mental Health & Disability	$422.9M
Special Ed in Public Schools	$327M
Dept. of Corrections GF Appropriations	$377M

Or, consider what that tax credit cost would fund in terms of protecting society as a whole. For instance, Iowa could cover the entire $377 million General Fund appropriation of the Department of Corrections with the missing tax credit revenues, covering that key piece of prison system funding with $45 million left over.

This is not a partisan problem. Taxpayers, voters and activists who disagree fundamentally with each other

Taxpayers, voters and activists on both sides of the aisle find common ground that costs on everyone for the benefit of an undeserving few is wrong.

on the size and scope of these agencies and who argue hotly over the appropriate role and cost of Iowa's government can find common ground around the idea that increasing the costs on everyone for the benefit of an undeserving few is wrong.

Supporters of tax credit programs argue that we shouldn't call these costs because supposedly the companies would not be operating and paying taxes if not for the incentives. This unserious "free lunch" accounting assumes that no business would build or expand or hire in Iowa if it had to pay full taxes. While Iowa's tax burden is discouragingly high, the fact that the overwhelming majority of Iowa's economy is comprised of companies that pay their taxes regardless makes it clear that this argument has no basis in reality.

The simple fact is that there is no evidence that states that hand out more in tax credits end up with more businesses, more jobs or more economic growth. What truly matters are factors like a skilled workforce, low overall tax burden, simple and predictable regulatory climate, functional infrastructure and other core business requirements. These are all things that benefit every business large and small, not just a favored few.

> **There in no evidence that states that hand out more in tax credits end up with more business, jobs or economic growth.**

Iowa isn't buying prosperity with its tax credits. Rather, it's knocking holes in its budget the size of major public service functions and then increasing the burden on every other taxpayer to fill those gaps.

It's time to have a real conversation about what Iowa values and what its tax credits truly cost.

John C. Mozena is the president of The Center for Economic Accountability.

TEF IOWA

SMALLER GOVERNMENT
SMARTER SOLUTIONS

2610 Park Avenue, Muscatine, Iowa 52761

tefiowa.org @tefiowa @tefiowa @taxediowa