TAX RATES

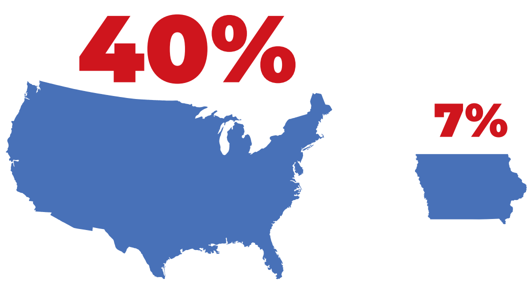
HIGH TAX RATES DETER ECONOMIC GROWTH AND PRODUCTIVITY

TEF IOWA POLICY REPORT

Tax Rates Matter
Iowa's tax rates are some of the highest in the country.

It is no secret that states compete with each other on multiple fronts for businesses and people. Tax rates, both corporate and personal, can quickly communicate how serious a state is about its desire to grow its population and its economy. While Iowa's economy is doing well, when judged by the low unemployment rate, improvements can still be made to make our state more attractive to families and workers. The fact that Iowa has some of the highest tax rates in our region certainly contributes to our slow population growth. While the nation's population has grown by more than 40 percent since 1980, Iowa's population has only grown 7 percent over that same period of time.

Population growth since 1980



Lower tax rates don't just increase the number of people and business in a state, they can also make that state more productive. Daniel J. Mitchell, a noted economist, offers three points about pro-growth tax policy:

1. Economic growth occurs when we increase the quantity and/or quality of labor and capital.
2. Taxes increase the cost of whatever is taxed, and people respond by doing less of whatever is being taxed.
3. To get more prosperity, tax rates on productive behaviors such as work, saving, investment, and entrepreneurship should be lowered.

Tax Rates Matter

Tax rates matter. This should be a simple economic truth, but unfortunately, the argument for why tax rates matter often does not register with people. They matter because the old economic adage is true: the more you tax something, the less of it you will get. Taxes confiscate an individual's property earned through hard work. Every dollar the government takes in taxes is one less dollar available for families and businesses to use in the free market.

> **Every dollar the government takes in taxes is one less dollar available for families and businesses to use in the free market.**

Iowa's tax rates are some of the highest in the nation. The Tax Foundation ranks Iowa's business climate as one of worst in the country (45 out of 50). High tax rates deter economic growth and productivity, especially for entrepreneurs. Why does that matter? A study published by the Federal Reserve, Entrepreneurship and State Taxation, examined the impact of tax policy on entrepreneurship. That study discovered that high corporate tax rates deter entrepreneurship and concluded that new business will "contribute disproportionately to both gross and net job creation, play a major role in business cycles, and account for an outsized share of innovation and aggregate productivity growth that raises living standards."

Iowa's overall Business Tax Climate ranks

45th

out of 50

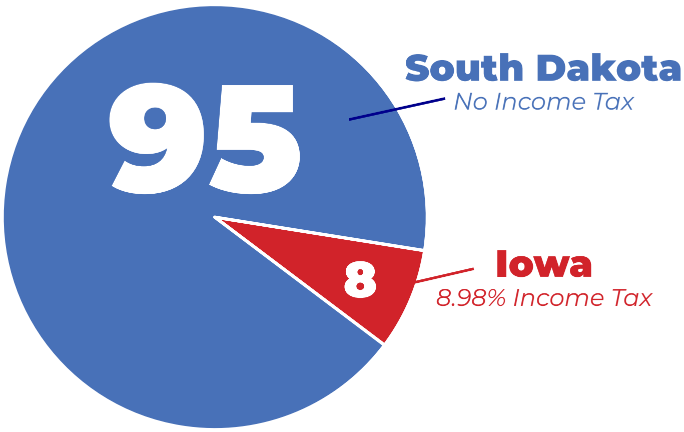
Source: Tax Foundation

The Entrepreneurship and State Taxation study went on to state "increases in corporate tax rates have a statistically and economically negative effect on employment among startup firms." Iowa has seen this play out along its own border with South Dakota, a state that does not have an income tax. The Iowa Department of Revenue examined changes in the health care industry between 2006 and 2015 in the

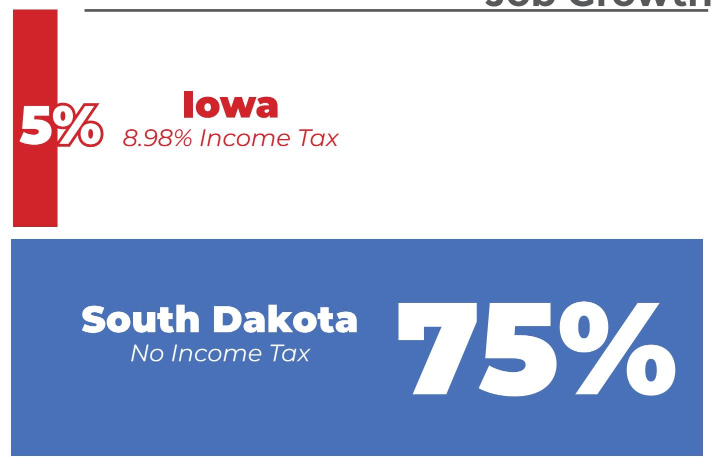
Iowa Compared to South Dakota

Border counties between 2006 to 2015

New Health Care Facilities



Job Growth



Iowa and South Dakota border counties. Over that ten year period, 95 new health care establishments opened in South Dakota, while only 8 were opened in Iowa. Those South Dakota counties realized 75 percent job growth compared to just 5 percent on the Iowa side. The Kauffman Foundation's Indicators of Entrepreneurship found South Dakota's new entrepreneur growth rate outperforms Iowa. Out of every 100,000 adults, Iowa only sees 200 new entrepreneurs, while South Dakota has 310 new entrepreneurs. Given that data it is not surprising that the same Tax Foundation Study that ranked Iowa as one of the worst states for its overall business climate, ranked South Dakota's business climate as the third best in the country.

Since entrepreneurship and small businesses are some of the main drivers of economic growth, it is particularly concerning to discover that there is a decline in entrepreneurship across the country. The Tax Foundation noted that "fewer people are deciding to become entrepreneurs, who are the source of new businesses and generate most net new jobs." Tax rates impact the behavior of entrepreneurs and small businesses in terms of the risks, jobs created, and investments that they make or do not make on a regular basis. The Tax Foundation recommended policymakers should seriously "consider the impact of the tax code on the entrepreneurial community as a vehicle for accelerating economic growth and dynamism."

The Tax Foundation recommended policymakers should seriously "consider the impact of the tax code on the entrepreneurial community as a vehicle for accelerating economic growth and dynamism."

Out-migration of Iowans (2015-2016)

Florida, Texas, and South Dakota
do not have state income tax.

Tax rates not only impact entrepreneurs, but also population. States that have lower tax rates tended to see more in-migration. A Cato Institute study measured the impact of tax reform and population. In the Midwest, South Dakota "has enjoyed net in-migration in four of the past nine years," while surrounding states, including Iowa, experienced net out-migration. In fact in 2015-2016 Iowa lost over 9,000 people to Florida, Texas, and South Dakota — all states that do not have an income tax. This demonstrates tax rates matter, and individuals, entrepreneurs, and businesses will vote with their feet to find states that have a low tax and regulatory climate.

If Iowa wants to keep and attract more people, foster a friendlier business climate, and provide more economic opportunity, freedom, and job creation, the legislature must continue to work towards lower tax rates. "Most modern studies of growth differentials among American states, for example, show that high taxes (and regulations) are negatively associated with economic performance, while high government spending isn't positively associated with economic growth," wrote John Hood, who serves as Chairman of the John Locke Institute.

Governor Kim Reynolds signing the 2018 income tax reform bill.

Iowa's Unfinished Tax Reform

During the 2018 legislative session, the Iowa legislature passed a tax reform measure that began the process of lowering rates, increasing conformance with the federal tax code, and modernizing the state sales and use tax. It was the first major tax legislation passed by the legislature in 20 years. This tax reform provided relief for many taxpayers and increased Iowa's economic competitiveness.

Some of the changes that legislation brought to Iowa's tax code included the collection of sales tax on goods and services that are purchased online. Many of these purchases were subject to use taxes that were not being collected which was causing Iowa to lose an estimated $100 million in uncollected taxes. The 2018 reform also increased Section 179 deductions for small businesses, expanded 529 education savings plans, and permitted a 25 percent deduction of federal business income (QBI), among other reforms. Regarding Iowa's numerous and complex tax credits, the legislation calls for an extensive review.

Iowa's individual income tax rate did see some minor rate changes in 2019 as a result of the reform, but more significant rate changes will not occur until 2023. For tax rates to be lowered again, Iowa's general fund revenue must average 4 percent growth for four years in a row, meaning our state's revenues for Fiscal Year 2022 must reach a minimum of $8.3 billion. This growth may be difficult to achieve; since 1996, net receipts equaled or surpassed 4 percent growth only 11 times.

IOWA'S TAX RATES ARE STILL TOO HIGH AFTER 2018's TAX REFORM

TOP STATE INDIVIDUAL INCOME TAX RATE	
South Dakota	No Income Tax
North Dakota	2.90%
Indiana	3.23%
Michigan	4.25%
Illinois	4.95%
Ohio	4.997%
Kansas	5.50%
Missouri	5.90%
Iowa ***(2023 RATE)***	***6.50%***
Nebraska	6.84%
Wisconsin	7.65%
Iowa	**8.53%**
Minnesota	9.85%

Iowa currently has a 8.53% top rate until 2023

Iowa currently has a 12.00% top rate until 2021

TOP STATE CORPORATE INCOME TAX RATE	
South Dakota	No Income Tax
Ohio	0.26% Gross Receipts Tax
North Dakota	4.31%
Michigan	6.00%
Indiana	6.25%
Missouri	6.25%
Kansas	7.0%
Nebraska	7.81%
Wisconsin	7.90%
Illinois	9.50%
Minnesota	9.80%
Iowa ***(2021 RATE)***	***9.80%***
Iowa	**12.00%**

If the revenue target is met the top rate would fall to 6.5 percent, which is far better than our current top rate of 8.53 percent. If the revenue target is not met for 2023, then rate reduction will not occur until that target is reached. This will not only be harmful to taxpaying families and businesses but overall economic growth as well. It also opens the possibility of a future legislature undermining tax reform by eliminating the revenue trigger and perhaps the planned, future tax cut.

> **It would be far better for Iowa to work towards a top individual income tax rate of 4 percent.**
>
> **Iowa's corporate tax rate should be cut in half to 5 percent.**

Therefore, the Iowa legislature could consider revising and lowering the future tax rate. A tax rate of 6.5 percent is an improvement on the current 8.53 percent, but it is still high in comparison to other Midwestern states. It would be far better for Iowa to work towards a top income tax rate of 4 percent.

On the corporate side, Iowa suffers from the highest corporate tax rate in the nation at 12 percent. As previously noted, this deters business start-ups and is harmful to economic growth. In 2021, under the 2018 tax reform plan, Iowa's corporate tax rate will be lowered to a top rate of 9.8 percent, which will tie Minnesota as the second-highest corporate tax rate in America, trailing only Pennsylvania's 9.99 percent. To be truly competitive, Iowa's corporate tax rate should be cut in half to 5 percent.

How Could It Be Accomplished?

Even once the desire to cut tax rates is present, it is important to remember that tax reform itself is a complex process. North Carolina and Indiana were able to make their respective states more competitive by lowering tax rates, broadening the tax base, and simplifying the tax structures. Tax reform needs to be prudent and a state legislator from North Carolina stated tax reform is an "evolution and not a revolution." Gradual rate reductions are not necessarily bad policy. An Indiana lawmaker advised other state policymakers to "act boldly and implement slowly." This is especially true since Iowa must balance its budget, which means tax rate reduction cannot occur unless spending is

North Carolina and Indiana were able to make their respective states more competitive by lowering tax rates, broadening the tax base, and simplifying the tax structures.

addressed. Policymakers could consider tax shifting or revenue-neutral tax reform to avoid slowing down the growth of spending, but this method loses most of the pro-growth impact.

Iowa policymakers can learn from states such as North Carolina and Indiana that tax policy can lead to greater economic growth and competitiveness. While North Carolina is the "gold standard" for state tax policy--demonstrating that tax rate reductions can be combined with slowing the growth of state spending--while still providing for the priorities of government. The gradual tax rate reductions which occurred in both states are examples for Iowa to follow. Our state has the opportunity to develop tax policies that will lower both the individual and corporate income tax rates. While achieving these tax rate goals will not be easy, it is important to continue the positive trends in Iowa's economy that began when federal tax reductions were delivered by the Tax Cuts and Jobs Act and President Donald Trump's efforts to unshackle the economy from excessive regulations.

> **It is vital Iowa's policymakers continue the work to lower tax rates, which also means revising and lowering the required 4 percent revenue growth trigger.**

It is vital Iowa's policymakers continue the work to lower tax rates, which also means revising and lowering the required 4 percent revenue growth trigger. Lower tax rates will make Iowa more competitive, create an atmosphere beneficial to entrepreneurs, allow taxpayers to keep more of their hard-earned income, and expand economic liberty.

SMALLER GOVERNMENT
SMARTER SOLUTIONS

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

tefiowa.org @tefiowa @tefiowa