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Are Tax Incentives Part of a Competitive Tax Code?

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Chairperson Hershman, Members of the Commission:

My name is Scott Drenkard, and I'm an economist at the Tax Foundation. For those unfamiliar with us, we are a non-partisan, non-profit research organization that has monitored fiscal policy at all levels of government since 1937. We have produced the Facts & Figures handbook since 1941, we calculate Tax Freedom Day each year, and have a wealth of data, rankings, and other information at our website, www.TaxFoundation.org.

I'm pleased to have the opportunity to speak today on tax preferences in Indiana. While we take no position on legislation, I hope to give a review of our research on preferences across the country and our understanding of the economic literature on the topic.

One of our flagship studies is the *State Business Tax Climate Index*, and this year the big story during our report release was that Indiana ousted Texas from the top ten in our ranking because of a concerted effort in recent years to lower tax rates, slow growth in government spending, and maintain competitiveness in the region. I will take this opportunity to say congratulations; other states struggle to implement these thoughtful, pro-growth reforms.

As a component of our *Index*, we track generally-applicable credits in three categories: credits for job creation, credits for research and development, and credits for investment. In the most recent edition of the Index for fiscal year 2014, we found that 42 states and the District of Columbia offer generally-applicable jobs credits, 40 states offer an R&D credit, and 40 states offer an investment credit. Indiana offers all three. In the coming days, I'm certain you will hear about many more tax preferences in Indiana that fall into many other categories; other states also have many targeted tax credits.

Tax Credits are Not Neutral

Even though credits lower the tax burden of a particular tax filer, in most cases we see them as poor tax policy. Offering a credit actually hurts a state's score in our *Index*, because the report does not measure general tax burdens; it measures how well a state structures their tax code. In a broad philosophical sense, we see credits as creating an uneven playing field. Some businesses might get the benefit of a preference, but other businesses that aren't engaging in whatever activity is deemed "favorable" are stuck paying the full sticker rate of the tax.

Sometimes the privilege afforded to companies through tax preferences is overt. Just this last week, Washington State was in the news because their legislature overwhelmingly approved $9 billion in tax credits for Boeing to begin production of their new 777X plane in the state. Despite this generous package, it is still unclear whether Boeing will ultimately locate in Washington because of labor considerations in the state.

Other times, credits are not given with just one company in mind. Generally-applicable credits for job creation and research and development are not blatant favoritism, but they still normally favor large firms over small firms. By contrast, some other preferences will favor small firms over large firms—neither is desirable. In a robust economy, a variety of firm sizes is expected, because business organization matters for how goods and services are created, sold, and delivered. The tax code shouldn't interfere by favoring one type of structure over another.

The Economic Literature on Tax Preferences

It is in part because of this distortionary economic effect that the academic literature is generally not kind to tax incentive programs. Additionally, states routinely issue reports on the efficacy of credits in their code, and often times they fail to meet even the most basic of cost-benefit requirements.

One of the more egregious examples I've run across was in Massachusetts, where their Department of Revenue found that $14.6 million in incentives was given to filmmakers in 2010, but the program only generated $800,000 in new state revenues. I'm sure there are worse examples, and you might hear some in the coming days.

Of the studies that find that tax expenditures have positive effects—these sometimes are conducted by industries that benefit from a particular preference—there are often problems with the assumptions built into the model. Most of these analyses contain some sort of economic multiplier. Multipliers show that a tax cut has ripple effects throughout the economy and creates economic growth many times over the size of the cut.

I've seen studies where the multiplier is truly unreasonable, but I've also seen studies that utilize moderate multipliers and show a positive job growth result from a tax preference. The rub is that it doesn't matter what size multiplier you use. Most of these studies are misleading because they do not consider a basic economic concept: opportunity cost—or where the money might have been spent elsewhere.

Some will contend that the money currently devoted to tax preferences would be better spent on government programs, but my appraisal is that the most growth could be achieved by closing tax preferences and directing revenues toward lowering rates overall. To me, this seems to be a win-win way to cut rates while avoiding the often difficult political task of adjusting government spending.

Good Tax Exemptions and Credits

I've limited my remarks on academic research here to tax preferences that are enacted to achieve some public policy goal of privilege for one group over another. But some credits or exemptions are necessary to prevent double taxation and you should be aware of those provisions as well—they deserve to be in the code.

Sales tax exemptions for business to business transactions, for example, help to prevent "tax pyramiding," the process whereby taxes stack on top of taxes as a product moves through the stages of production.

Lower tax rates on investment income like capital gains are also justified because they prevent double taxation of income that has already been taxed once through the corporate income tax. Indiana currently taxes capital gains income at the same rate as wage income.

Conclusion

In closing, states are in an interesting position in trying to make themselves attractive to businesses and individuals. The federal government is not much help; we struggle with international competition because we have the highest corporate tax rate in the developed world.

But there are two ways that Indiana can compete with other states, and one is vastly superior to the other. The first way is by trying to pick and choose which groups get competitive rates. The better way is by offering one competitive low rate for everyone. Thank you for your time today, I look forward to your questions.

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One of the oldest think tanks in the United States, the Tax Foundation is a non-profit, non-partisan organization that provides research and analysis on tax policy issues and the size of the tax burden at all levels of government. Based in Washington, D.C., our work advances the principles of simplicity, neutrality, transparency, and stability.

About the Center for State Fiscal Policy at the Tax Foundation

The Tax Foundation's Center for State Fiscal Policy produces timely, high-quality, and user-friendly research and analysis for policymakers and the public, shaping the state policy debate toward economically principled tax policies.