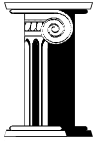

INSTITUTE BRIEF

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Tax Reduction and Economic Growth in Iowa

by David Hogberg and Amy K. Frantz

Public Interest Institute recently released a new Policy Study titled "Tax Reduction and Economic Growth in Iowa," recommending a free-market approach to growing Iowa's economy.[1] What Iowa needs is a plan to increase investment opportunities for all businesses and potential investors. This Policy Study proposes two proven pro-growth policies that the state should follow: exempting capital gains from taxation and cutting personal and corporate income taxes.

This Iowa Legislative Session has seen the proposal of numerous plans to grow Iowa's economy and reform Iowa's tax system, most of which could be described as ineffective and misguided. These proposals involve state government distributing taxpayer funds to the chosen winners in the economic development lottery, making government, rather than the marketplace, the arbiter of what industries will be successful in Iowa. Yet governments have proven far less effective at making good investment decisions than the free market.[2]

Entrepreneurs will be more likely to invest in Iowa if they are able to keep more of the money they earn from doing so. Increasing this investment will lead to more jobs and a stronger economy. Eliminating the capital gains tax and reducing personal and corporate income taxes will promote this investment in Iowa.

Exempting capital gains from taxation would free up investment capital resulting in the expansion of existing businesses and the start-up of new ones. Capital gains taxes reduce the incentive to save and invest by reducing the after-tax return from investment. This has negative effects on business investment, productivity growth, and employment growth.

The Policy Study compares the growth in real personal income and real per-capita personal income in two groups of states: (1) the nine states that exempt capital gains from taxation for individuals and (2) the nine states with the highest average top rates on capital gains, which includes Iowa. For the 1990-2000 period, the average rate of growth in real personal income and real per-capita personal income for the nine states that exempt capital gains is 34.1% and 15.5%, respectively. For the states with the highest capital gains taxes, the rates are 27.1% and 12.8%, respectively. Clearly, states with higher capital gains taxes have, on average, slower rates of personal income growth.

They also perform worse on some other important economic measures in the 1990-2000 period. States that exempt capital gains have higher average rates of employment and population growth (21.9% and 21.2% respectively) than states with high capital gains taxes (14.9% and 13%, respectively). It appears that jobs, and hence people, gravitate toward the states with tax systems that are more investment-friendly.

Iowa performs adequately on only one of the economic measures. With a growth rate of 16.1% in real per capita income, it slightly exceeds the 15.5% average of states that exempt capital gains. But on all

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other measures, not only does Iowa measure lower than the averages of the states that exempt capital gains, *it measures lower than the averages for the states that have high capital gains taxes*.

Another economic development policy that Iowa should pursue is the reduction of income taxes, both personal and corporate. This would increase incentives to work and invest as after-tax income from these activities would be greater. Academic research has shown that income taxes do have an impact on economic growth. Other studies have found that high taxes inhibit businesses from investing, and that taxes are an important consideration in the location decisions of businesses.[3]

Recent evidence from the American Legislative Exchange Council confirms the relationship between reducing state income taxes and higher economic growth. In a study entitled *States Can't Tax Their Way Back To Prosperity: Lessons Learned from the 1990-91 Recession*, author Stephen Moore found that states that cut personal and corporate income taxes in the 1990s had a higher average rate of population, employment, and real personal income growth than states that increased those taxes during the 1990-2001 period.[4]

To stimulate economic growth in Iowa, State Legislators should cut both personal and corporate income taxes. Public Interest Institute's Policy Study proposes simplifying the personal and corporate income tax systems by reducing the number of tax brackets. The simplified personal income tax would exempt the first $5,000 in income and reduce the number of tax brackets from nine to three, cutting tax rates for all Iowans who pay state income tax. The top personal income tax rate would drop to 6% from the current top rate of 8.98%. The proposed corporate income tax cut also reduces the rates for all businesses in Iowa. The number of corporate income tax brackets would be reduced from four to two, and the top corporate income tax rate would be 8%, rather than the current 12% rate.

If State leaders are serious about promoting economic growth in Iowa, they must make the state more hospitable to investment. Reducing the burden on taxpayers is a proven method of spurring economic growth and job creation. Reducing the tax burden will lead to more investment in Iowa, more business creation and expansion, and more jobs. Tax reduction is the key to economic growth in Iowa.

ENDNOTES:

[1]David Hogberg and Amy K. Frantz, "Tax Reduction and Economic Growth in Iowa," Policy Study, No. 03-2, March 2003, Public Interest Institute.
[2]Grant Gulibon, "Budget Basics: Pennsylvania's Economy Loses When Policymakers Try to Pick Winners," *Commonwealth Policy Brief*, Vol.2002, No. 2, The Commonwealth Foundation For Public Policy Alternatives, April 2002; and William B. Conerly, "The Unseen Costs of Ribbon-Cutting: Losses from Economic Development Programs," *Policy Perspective*, No. 1011, Cascade Policy Institute, June 1998.
[3]Timothy J. Bartlik, "Small Business Start-Ups in the United States: Estimates of the Effects of the Characteristics of States," *Southern Economic Journal*, April 1989. William F. Fox and Matthew N. Murray, "Local Public Policies and Interregional Business Development," *Southern Economic Journal*, October 1990. For a detailed review of the literature on tax cuts, see Richard Vedder, "The Effect of Taxes on Economic Growth: What Research Tells Us," Texas Public Policy Foundation, March 29, 2002, <http://www.tppf.org/tax/taxingtexans/part2.pdf> (January 22, 2003).
[4]Stephen Moore, "States Can't Tax Their Way Back To Prosperity: Lessons Learned from the 1990-91 Recession," *The State Factor*, American Legislative Exchange Council, October 2002.

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