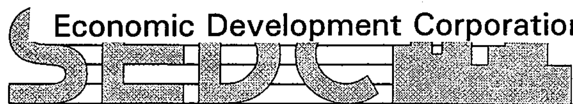
3. Handout from Mr. Kenneth Beekley, Executive Vice President, Siouxland Economic Development Corporation.



SIOUXLAND ECONOMIC DEVELOPMENT CORPORATION

To: Iowa Targeted Jobs Withholding Tax Credit Study Committee
From: Kenneth A. Beekley
Executive Vice President
Subject: Economic Impact of Comparative Business Tax Climates
Date: October 24, 2005

COMMENT

Much of the coverage of economic development in the media involves the efforts to attract business to a particular location (state or community). In such instances states and communities often provide generous packages of assistance intended to lure the development to their area. In a much less reported manner each state is constantly competing with neighboring states and, at times, with states from other regions or even with other countries. While there is probably no better example of this than in Siouxland where three states converge within a single contiguous urban area, it is generally true for all border communities. The competitiveness of the Iowa business tax climate relative to Nebraska and South Dakota is much more critical in Sioux City than in a central Iowa community such as Des Moines. Similarly, communities along the Mississippi River in eastern Iowa are concerned with Iowa's business tax climate compared with those in Minnesota, Wisconsin, Illinois, and Missouri.

A significant factor in the competition among states or communities is the business tax climate which reflects both the tax burden and the structure and complexity of the tax system. State legislators need to be vigilant in ensuring the competitiveness of their respective business tax climates and make changes that will improve their position for the long-term. Two truths must be remembered as follows:

1. **Taxes matter to businesses and competition, domestic and foreign, forces businesses to constantly search for more tax-friendly environments.** Taxes affect plant location or relocation, job growth and retention, and the long-term health of the economy. Taxes are a cost of doing business and increases are passed on to customers in the form of higher prices, workers through lower wages or lost jobs, or the owners through lower profits. At the risk of stating the obvious, a state with lower tax costs is simply more attractive to business investment.

2. **States do not legislate tax changes in a vacuum.** Every tax law (increases or decreases) changes that state's competitive position relative to its immediate neighbors, its portion of the country or even foreign locations. While there are many non-tax factors involved in any state's business climate (access to market or raw materials, workforce availability/quality, and others),

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over time investment tends to flow to more business-friendly environments from those that are less so in terms of tax climate. If we look at mass layoffs during the 2nd quarter of 2004, 75% of the events (90 out of 119) were associated with intra-company movement of work, with more than 70% of these involving reassignment to other plants within the United States. In the 25% where the work was reassigned to another company under contract (outsourcing), only half involved foreign locations with the other half reassigned to other companies within the United States. **In total, therefore, between 70% and 75% of the mass layoffs resulted in transfers to another U.S. location.**

State lawmakers have direct control over their tax systems and its treatment of business. The ideal tax system would be one that is neutral to business activity (a level playing field for all business types) where decisions are based upon the merits of the transaction without regard to tax implications. In reality, however, tax-based distortions are unavoidable to some extent and the goal should be to minimize the instances where decisions are dictated by government fiscal policy and maximize economic-based decision-making (raw product costs, transportation, etc.).

There are two components of state tax neutrality, one is the variation in tax treatment among economic activities within each state (taxes favor one economic activity or industry at the expense of others) and the second is tax competition among individual states. While tax competition is contrary to the principle of neutrality, it is thought to be the most effective restraint on state and local taxes.

Attached are two research studies on comparative business tax climates that rank the individual Siouxland states, as well as the remaining states bordering Iowa, as follows:

State Business Tax Climate Index
2004

	Overall Rank	Corporate Income Tax Index Rank	Individual Income Tax Index Rank	Sales & Gross Receipts Tax Index Rank	Unemployment Insurance Tax Index Rank	Fiscal Balance Index Rank
Iowa	28	43	30	15	28	17
Nebraska	35	42	28	34	16	32
South Dakota	1	1	1	43	30	3

	Overall Rank	Corporate Income Tax Index Rank	Individual Income Tax Index Rank	Sales & Gross Receipts Tax Index Rank	Unemployment Insurance Tax Index Rank	Fiscal Balance Index Rank
Illinois	23	23	11	42	41	18
Minnesota	48	31	38	36	32	48
Missouri	11	13	23	29	9	4
Wisconsin	41	20	32	31	31	44

Note: Rankings are among the 50 states.
Source: Tax Foundation, "State Business Tax Climate Index", October 2004.

From this, it appears that Iowa's business tax climate is least competitive with those in South Dakota and Missouri, more or less comparable with Illinois, somewhat favorable compared to Nebraska, and vary competitive relative to Minnesota and Wisconsin.

Small Business Survival Index
2005

	Overall Rank	Maximum Personal Income Tax Rate	Maximum Capital Gains Tax Rate	Maximum Corporate Income Tax Rate	Property Tax as a % of Personal Income	Sales & Gross Receipts Tax as a % of Personal Income
Iowa	41	25	42	49	38	23
Nebraska	32	35	39	33	36	21
South Dakota	1	1	1	1	33	38
Illinois	23	10	12	28	40	20
Minnesota	47	42	44	48	28	26
Missouri	18	27	32	12	12	28
Wisconsin	27	34	11	34	44	19

Note: Rankings are among the 50 states and the District of Columbia.
Source: Small Business & Entrepreneurship Council, "Small Business Survival Index 2005: Ranking the Policy Environment for Entrepreneurship Across the Nation", October 2005.

While this measurement gives somewhat different results relative to Illinois and Wisconsin, it does confirm the State Business Tax Climate Index in terms relative to the other states, especially with respect to South Dakota and Missouri. The Small Business Survival Index includes a broader range of factors as set out below:

Small Business Survival Index
2005

	Overall Rank	Adjusted Unemp. Ins. Tax as a % of Ave. Inc.	Electric Utility Costs	Workers Comp. Premiums	Crime Rate	Gas Tax	Number of Bureaucrats per 100 Res.
Iowa	41	47	18	9	16	28	42
Nebraska	32	6	5	14	25	42	48
South Dakota	1	19	18	10	2	30	29
Illinois	23	31	23	29	23	19	8
Minnesota	47	49	14	31	18	21	20
Missouri	18	32	11	30	35	9	22
Wisconsin	27	34	30	19	14	50	13

Note: Rankings are among the 50 states and the District of Columbia.
Source: Small Business & Entrepreneurship Council, "Small Business Survival Index 2005: Ranking the Policy Environment for Entrepreneurship Across the Nation", October 2005.

The first of these, conducted by the Tax Foundation measures the impact of tax competition on economic neutrality by comparing state tax rates in four taxes of special concern to businesses, including:

- The Corporate Income Tax
- The Individual Income Tax
- The Sales and Gross Receipts Tax, and
- The Unemployment Tax

It also examines state tax collections and budgetary institutions in what is termed, The Fiscal Balance Index. The 2004 State Business Tax Climate Index compares the states on each of the previous aspects of their systems and then addressing the results to obtain a final overall ranking. Among those states that have any of the major taxes,

"well-designed", more neutral systems include the following characteristics:

1. The Corporate Income Tax - (which, by the way, is the tax most significant to foreign companies considering a U.S. location) – While having no tax is perfectly neutral, among those that do tax corporate income the highest rated systems have "relatively low, single-rate systems".

2. The Individual Income Tax - (which is relevant for business types taxed as individuals such as proprietorships, partnerships, S-corps. and influences an individual's decision to become a self-employed entrepreneur and impacts the labor available to business) – As with corporations, states imposing no tax have a perfectly neutral system. States that do tax individual income rank better if they have a "flat, low tax rate". States that score poorly have complex, multiple rate systems.

3. The Sales and Gross Receipts Tax Index – Those states without a state sales or gross receipts tax rank highest. Among those with a sales tax those that rank highest are those that best avoid tax pyramiding and maintain low excise taxes. They tend to have average or below-average tax rates, exempt most business input items (manufacturing equipment, for example) and avoid business receipts taxes.

4. The Unemployment Insurance Tax - Unlike the other taxes, every state has the UIT and there are no perfect or even nearly perfect systems. All are complex, variable rate systems with varying wage bases. The highest rated states have comparatively "lower minimum and maximum rates and a wage base at the federal level". They tend to "have simpler experience formulas and charging methods, and they have not complicated their system with benefit add-ons and surtaxes."

5. The Fiscal Balance Index – This index ranks the states based upon current state tax collections and the rules each state uses to control the growth of spending and tax revenues. States that rank highest have tax collections that are below the national per capita average of $1,884 and below the average of 5.62% of income. Tough tax and expenditure controls (constitutional or statutory limits on growth) also improve a state's ranking.

In light of the individual tax rankings, what then are the states with the best business tax climates? They include the following:

1. South Dakota
2. Florida
3. Alaska
4. Texas
5. New Hampshire
6. Nevada
7. Wyoming
8. Colorado
9. Washington
10. Oregon

From these results, several significant findings emerge, including:

1. Corporate Income Tax – The absence of a corporate income tax is a dominant factor in determining the business tax climate. **All four states without a corporate income tax are among the top ten business tax climates. Among these with a corporate income tax, three have just one bracket and a moderate rate.**

2. Individual Income tax – **All of the seven states without an individual income tax rank in the top ten.** Again, a low flat rate among those with an individual income tax is preferable to a high maximum rate and multiple brackets.

3. Sales and Gross Receipts Tax – Of the five states without a general sales tax, three are in the top ten. Four of the remaining seven rank near the middle, with the remaining three (including South Dakota) having some of the least competitive sales tax systems.

4. Unemployment Tax – All of the states have unemployment tax systems that violate the principle of tax neutrality, even these states with the best overall business tax systems. Only two of the top ten states overall rank in the top 15 rankings in the UIT index.

5. Fiscal Balance – **Seven of the states with the best business tax climates also scored in the top ten on fiscal balance**, evidencing their low tax burden and fiscal discipline.

Generally, states in the top ten overall in terms of business tax climate do so by raising sufficient tax revenue without at least one of the three overall taxes (corporate income, personal income, or sales). Only Colorado among the top ten imposes all three major taxes. It achieves its high ranking by keeping all of its taxes

simple and at low rates, and by having one of the most effective tax and expenditure limitation measures. What can those persons responsible for Iowa's fiscal policy learn from the business climate studies? Assuming Iowa continues to impose all three of the major taxes, it might prove beneficial to consider the impact of tax simplification in terms of reducing the number of tax brackets and lowering the applicable rates. This would improve its rankings for both corporate and personal income tax, as well as its "fiscal balance" ranking.

Lastly, while each of these studies results in somewhat different results, due primarily to the broader range of factors considered in the Small Business Survival Index, it is true to say that there is a fair degree of agreement between the indices due to the importance of tax policies in both instances. **Nine of the top ten states in each index (90%) are found within the upper half of all states in the other index.** This is significant in light of the empirical differences in development of the states comprising the upper half of the indices from those comprising the lower half. Such observations include the following:

1. From 1990 to 1999, low tax states (rank order 1 through 25) gained 2.05 million people in terms of **net domestic migration**, while high tax states (rank order 26 through 50) lost 890,000. This pattern continued since 2000. From 2000 to 2002, low tax states gained 729,000 and high tax states lost 371,000 in net domestic migration. In his June 3, 2003 report in which this data was contained, Professor Richard Vedder noted that "the in-migration into states without income taxes was impressive – as was the out-migration from high-tax states." He also suggested that the economic analysis from which his conclusions were drawn "increases our confidence in the basic conclusion that high taxes in general are perceived as lowering the quality of life in a locality, leading to out-migration."

Locally, this is confirmed by the following:

	Net Migration (No. & Rate)			
	1990 – 2000		2000 - 2003	
Woodbury County, IA	-1,382	-1.4%	-2,986	-2.9%
Union County, SD	2,069	20.3%	311	2.5%
State of Iowa	48,996	1.8%	-12,200	-0.4%
State of South Dakota	23,557	3.4%	-1,532	-0.2%

Source: U.S. Census of Population (1990 & 2000). 2003 estimate by the U.S. Census Bureau.

2. A March 2005 study commissioned by the U.S. Small Business Administration (SBA) entitled "Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data" noted: "We find convincing evidence that marginal tax rates have important effects on decisions to enter or remain in entrepreneurial activity. Taken together, our empirical results suggest that policies aimed at reducing the relative tax rates on entrepreneurs might lead to increases in entrepreneurial activity and better chances of survival." Simply put, raising the cost of entrepreneurship leads to less entrepreneurial activity, while lowering the cost of such activity leads to more entrepreneurship.

Locally, this is confirmed by the following:

	Number of Establishments			
	1990	1995	2000	2003
Woodbury County, IA	2,681	2,842	2,932	2,842
Union County, SD	207	328	400	418

	Percentage Change			
	1990 – 95	1995 – 00	2000 – 03	1990 - 03
Woodbury County, IA	6.0%	3.2%	-3.1%	6.0%
Union County, SD	58.5%	22.0%	4.5%	101.9%

	Number of Establishments			
	1990	1995	2000	2003
State of Iowa	73,130	78,464	80,890	81,078
State of South Dakota	20,492	22,708	23,783	24,468

	Percentage Change			
	1990 – 95	1995 – 00	2000 – 03	1990 - 03
State of Iowa	7.3%	3.1%	0.2%	10.9%
State of South Dakota	10.8%	4.7%	2.9%	19.4%

Source: U.S. Census Bureau, "County Business Patterns", 1990 – 2003.

In both instances, Woodbury County performs worse than the State of Iowa, while Union County performs better than the State of South Dakota. This suggests that Union County benefits by being adjacent to Iowa, and especially Woodbury County; while

Woodbury County is adversely impacted by being adjacent to South Dakota. At the same time, the State of South Dakota (low tax state) performed better than the State of Iowa (higher tax state). While these are only two measurements of economic activity, similar results would emerge if population, net housing units, or job creation were considered. **In a 2004 analysis of the 118 smallest metro areas conducted by the non-profit Milken Institute, Sioux Falls, SD ranked 10th, higher than any such area in Iowa; while Sioux City ranked 112th.**

Thank you for your attention and affording me the opportunity to present this information.