

# Commentary

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## Tax Credits Aren't Always a Good Idea

By Rex Sinquefeld and Joseph Haslag

The state of Missouri, like other state governments, offers tax credits that can be applied against both corporate and individual tax bills. Presently, the Missouri legislature is considering a so-called “mega-project” tax credit worth, in present value, \$550 million for Bombardier Aerospace, a large Canadian firm, to build a manufacturing plant in Kansas City.

### Summary

Tax credits may seem like a great idea to encourage growth by enticing firms to relocate to Missouri, but the reasoning used to support this type of development is almost certainly wrong. The higher marginal tax rates created by targeted credits actually eliminate more jobs than are created by the tax credit beneficiaries.

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Tax credits sound like a great idea for enticing businesses to expand, relocate, or build in Missouri. With the Bombardier project, though, it might be useful to consider the basic economics of tax credits.

Tax credits can be divided into two broad categories. Those that focus on social goals can be called “public good” credits. The Historic Preservation Tax Credit, for instance, subsidizes renovations for historic buildings. Another example, the Earned Income Tax Credit, is available to assist state residents who are employed but whose annual income is low. Social goals may compete for preference, but show that Missouri recognizes the need to support public goods.

The second category targets economic development, or — as some would put it — “corporate welfare.” Such credits are designed to stimulate economic development. In practice, these credits reduce tax bills for businesses located within the boundaries of the credit. In exchange, the business typically must bring something to the equation, such as offering jobs that pay at or above the area average.

Regardless of whether tax credits are of the public good or economic development variety, they share one common feature: For recipients, tax credits lower their individual or corporate income tax bills, which in turn impacts the state budget.

Missouri's discretionary budget consists of dollars paid into the General Revenue Fund. Individual income, corporate income, sales taxes, and use taxes are the largest contributors to this fund, and tax credits affect the dollar amount collected.

That impact is significant. For the state's fiscal year that ended June 30, 2007, for example, the General Revenue Fund collected \$7.7 billion. In that same fiscal year, Missouri redeemed \$485.6 million in tax credits.

Less flow in the General Revenue Fund results in fewer dollars

available for state programs and potential cuts to programs such as public schools, prisons, and health care. Alternatively, the General Assembly can seek to offset reductions by increasing taxes.

Tax credit proponents contend that no such tradeoffs exist, particularly for economic development credits. Their tenuous argument is built on the proposition that if a business locates in Missouri, the tax base naturally will increase, and any lost revenues from the tax credit will be offset by greater individual income and sales taxes, and through the “multiplier” process as corporate and private income expands.

Unfortunately, this almost certainly is wrong. Historically, the General Revenue Fund receives between three and four cents of every dollar of final goods and services produced within Missouri’s borders. Thus, for every dollar of tax credit, Missouri’s economy has to produce between \$25 and \$33 worth of final goods and services in order for the General Assembly Fund to break even.

This is akin to investing \$1 and receiving a guaranteed \$30 in return. While some projects may offer such robust yields, there are no guarantees. Indeed, in the last century, the average annual return from equities in the United States, after adjusting for inflation, is \$1.07 for every dollar invested. To bank on higher future tax revenues flowing from today’s tax credits is simply folly.

The risk of long-lasting economic damage looms much larger with “mega-tax credits” of the Bombardier variety, which are unprecedented in Missouri. If large corporations such as Bombardier are given lower tax rates, the marginal tax rates for everyone else must become higher in order to raise the same amount of revenue. However, high marginal tax rates actually eliminate more jobs than are created through tax credit beneficiaries.

A much better economic development policy would be to keep a level playing field and lower marginal tax rates for *all* individuals and businesses. Better yet, get rid of the income tax altogether, as our neighbor Tennessee has done and whose growth has outstripped Missouri’s for the last decade.

Letting politicians and state bureaucrats guide private-sector investment is not an economic development policy. It’s an economic stagnation policy.

*Rex Sinquefield received a bachelor’s degree in business from Saint Louis University and an MBA from the University of Chicago, where he studied under Nobel Prize–winning economist Merton Miller. In the 1970s, he coauthored a series of papers and books titled Stocks, Bonds, Bills and Inflation, providing the first seminal data on the performance of the financial market in the United States. Sinquefield, who pioneered many of the nation’s first index funds, retired in 2005 and co-founded the Show-Me Institute, the state’s only free-market think tank.*

*Joseph Haslag is a professor in the Economics Department at the University of Missouri–Columbia and executive vice president of the Show-Me Institute.*

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The author of this commentary is available for interviews. To speak with the author or other Show-Me Institute scholars, please contact:

The Show-Me Institute  
7777 Bonhomme Ave. Suite 2150  
Clayton, MO 63105

Phone: 314-726-5655  
Fax: 314-726-5656

[www.showmeinstitute.org](http://www.showmeinstitute.org)  
[info@showmeinstitute.org](mailto:info@showmeinstitute.org)