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TESTIMONY

February 15, 2012

MISSOURI'S TAX CREDIT CRISIS

By Patrick Ishmael

Testimony Before the Missouri House of Representatives Appropriations Committee

To the Honorable Members of the Committee:

Ladies and gentlemen of the committee, thank you for the opportunity to testify today.

My name is Patrick Ishmael and I am a policy analyst at the Show-Me Institute, a nonprofit, nonpartisan Missouri-based think tank that supports free-market solutions for state policy. The ideas presented here are my own.

Since the late 1990s, Missouri's tax credit system has grown into one of the biggest burdens on the state's annual budgets, expending billions of dollars over the last decade and setting the stage for significant budgetary crises in the near future. In fiscal year 2013, Missouri expects tax credit redemptions to cost the state **as much as the state is spending on its correctional and public safety systems – roughly $700 million**. Put in another context, the entirety of 2013's projected deficit **is less than the state's expected tax credit payout by about $200 million**. Suffice to say, this is real money that legislators will have to understand and grapple with, given the squeeze tax credits have put on the FY2013 budget and will put on state budgets in future years.

So, what exactly is a tax credit?
A tax credit is a direct reduction in a taxpayer's tax liability that the government grants for the performance of a specified activity. In the context of economic development – one of the primary drivers of state tax credit spending – that activity could be something like hiring workers or renovating buildings.

Tax credits are not a panacea for long-term and sustainable economic growth.

In contrast to a tax deduction, which decreases a taxpayer's taxable income, tax credits are applied against a tax liability dollar for dollar. A $100 tax credit would eliminate a $100 tax liability. A $100 tax deduction would only reduce a fraction of that liability.

In short, tax credits are powerful tax reduction tools, and the state has made itself subject to a gargantuan liability as a result of its generous issuance of tax credits over the last decade. Since the late 1990s, the impact of tax credits on the state budget has grown considerably – a $700 million tax credit outlay as we are seeing this year is an enormous expense – and as of FY2011, the state, according to documents that the Division of Budget & Planning submitted to the House, **had well over $2 billion in potential tax credit liabilities still outstanding**, with new tax credits issued annually.

Unfortunately, the state is limited in what it can do to mitigate the direct fiscal impact of tax credits which have already been issued. Former Supreme Court Justice Mike Wolff suggested in a February *St. Louis Post-Dispatch* editorial that the state could decline to honor tax credits for a period of time, thereby liberating money for state programs in the short term that otherwise would have gone toward redeeming tax credits. But while demurring on tax credit redemptions may have the attractive short-term benefit of freeing up money for state programs in the current fiscal year, such a move would not resolve the underlying problem – the issuance of new tax credits and the payment of existing credits – and arguably would make the overall situation worse by delaying when the state's liabilities would have to be paid while the state continues to add new liabilities. Eventually, the state's tax credit bill will have to be paid.

Then there is the question of how well tax credits perform in promoting state interests. Michigan's Mackinac Center for Public Policy reviewed that state's economic development tax credits and found that not only did they tend not to produce net gains in overall employment, but in some cases, tax credits were negatively related to job growth. That is, for every dollar spent in tax credits, the state was actually losing jobs in the industry the credit was targeting. The government can try to pick winners and losers with tax credits, but its track record of doing so is poor because the economy is not a simple creature, and targeted state interventions frequently miss their policy targets.

Like Michigan, Missouri has a central economic development authority that issues millions of dollars in tax credits, and like Michigan, the evidence suggests that Missouri's state tax credit programs are misfiring. Over the last 12 years, the Missouri Department of Economic Development alone has issued more than $2.3 billion in tax credits, with almost half of that amount – more than $1 billion – going to an area of the state where only 5 percent of the population lives – Saint Louis City. Despite this enormous infusion of tax credits, the Saint Louis region's anchor city has continued to slide in population, from 340,000 residents in 2000 to 319,000 residents in 2010. To be clear, many factors contribute to how populations rise and fall, but an economic development plan that steers almost half of its funds to one-twentieth of the population and yet still sees that population decline is an economic development plan in need of review, and likely in need of revision.

Moreover, the fiscal notes for Missouri's tax credit programs have oftentimes been off the mark, and in some cases drastically so. The state estimated that from 2005 to 2009, the Historic Preservation Tax Credit (HPTC) – a Department of Economic Development tax credit program – would cost the state $71.5 million. **In reality, the HPTC cost the state over that four-year period nearly $640 million**, exceeding its fiscal note projection **by more than half a billion dollars**, or roughly nine times what the state expected.

When considering the HPTC's return on investment in tandem with the cost of the program, the record of that tax credit looks even worse. In 2002, the *Southeast Missourian* reported that the DED estimated that for every $1 spent in Historic Preservation tax credits, the state would receive $1.10 in tax revenue – a 10-cent net benefit.[1] Yet by 2011, the state was estimating that the HPTC in fact generated a **23-cent return to the state for every $1 spent**[2] – a net loss to taxpayers, and a drastic reduction in the state's early predictions about the credit.

The end result: For the HPTC, the largest single tax credit in the Department of Economic Development, the government vastly underestimated the program's costs and vastly overestimated its benefits. And that is only one of the five dozen or so tax credits the state administers. For those unfamiliar with it, I would highly recommend reviewing former state auditor Susan Montee's audit of the state's tax credit programs in 2010, which encapsulates some of the problems driving Missouri's tax credit woes very well.

Tax credits are not a panacea for long-term and sustainable economic growth, and while I appreciate arguments in favor of tax credits as a resolver of market failures in theory, in practice, the tax credit story, as I have briefly outlined here, is much different.

Which brings us to today. Given the multi-billion dollar magnitude of the problem, the state needs to get its tax credit situation under control, and get it under control quickly. **So, what can the state do to begin to resolve the problem?**

First, declining to issue new tax credits would provide the state with an opportunity to get the tax credits already in existence under control. There are technical ways of stopping tax credit issuances through the appropriations committee, but good policy suggests that a moratorium on

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tax credit issuances, however achieved, would offer the state with the best opportunity to rein in its tax credit problems.

More broadly, economic development programs should be reviewed in their entirety for their effectiveness, and those that are causing the state to lose money should be reformed and, in some cases, ended. Tax credit reforms could include sunsets, which would phase out a tax credit over time, and funding caps, which would limit how much of a certain tax credit could be issued in a single year or over the lifetime of the credit. Although Missouri's courts do not interpret tax credits as an "expenditure," it is worthwhile for the People's representatives to treat tax credits as such in the budgeting process, treating tax credits as – and as needed, reforming tax credits to be – items to be appropriated, like any other budget item. Money expended in tax credits is money not expended elsewhere in the budget. That is a reality we all would do well to remember.

In conclusion, an analogy: A household budget that accounts for everyone's spending except for a spendthrift's credit card will always be out of balance. For Missouri, tax credits are that oft-overlooked credit card, and until that outlay is held accountable, the state's budgeting problems will continue. This is the crisis facing Missouri today and why tax credit reform is needed. Thank you. I am happy to answer your questions.

NOTES:

[1] http://www.semissourian.com/story/71398.html

[2] http://www.stltoday.com/news/local/govt-and-politics/political-fix/article_9db9cc38-e478-11e0-96dc-001a4bcf6878.html

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