

Iowa Budget Belt-Tightening: Focusing on the Largest Waists

The need to “tighten belts” is front and center as the Governor and General Assembly work to address Iowa’s budget shortfall. Before essential services are cut to the bone, lawmakers need to look for areas where any fat can be trimmed. This belt tightening must give particular scrutiny to those with the largest waists.

In particular, this belt tightening needs to examine tax credits and expenditures as well as general fund spending. While general fund expenditures have declined as a percentage of state personal income (a measure of state economic activity), business tax credits in particular have grown at more than three times the rate of economic growth. This tax-credit growth is largely unchecked and not subject to annual examination or control. [See *The Revenue Roots of Iowa’s State Budget Crisis*, IFP, Feb. 19, 2009.]

Governor Culver’s budget has started this process by recommending a cap on business tax expenditures and a limitation on the magnitude of the Research Activities Credit (RAC). The General Assembly should build upon the Governor’s recommendations when trimming excessive spending from the state tax code.

Four specific actions can be taken this legislative session to address the current budget shortfall, position the state to better assess all tax expenditures, and help address longer-term issues of budget sustainability:

- Establish a cap on business tax credits;
- Establish a cap on the size of individual Research Activities Credits;
- Establish a cap on the amount of capital gains that is totally excluded from income for state income tax purposes; and
- Establish transparency (required disclosure) for all business tax expenditures.

Cap on Business Tax Credits

Governor Culver has recommended a \$200 million annual cap on the amount of business tax credits. His budget estimates this cap will reduce tax expenditures in FY2010 by \$15 million, or 8 percent.

State business tax expenditures have been one of the fastest growing parts of the state budget. Business assistance tax credits, a major component of business tax expenditures, increased from \$144.3 million in FY2006 to \$242.7 million in FY2008, alone. The Department of Revenue has projected that these

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credits will grow to \$405.9 million in FY2010, a 181 percent growth in just four years.¹ Once enacted, these business tax credits are not subject to annual reauthorization and can grow well beyond their intended size and for activities well beyond their intended purpose.

Placing an overall cap on business tax credits is a first step in establishing some control over their unbounded use. The Governor's proposed cap would apply to those credits that are both awarded and uncapped. The General Assembly needs to fashion a cap that truly covers the full range of such credits and is effective in controlling their growth.

Cap on Research Activities Credit

One business tax expenditure in particular, the Research Activities Credit (RAC), deserves additional immediate attention.

Iowa has by far the most expansive and open-ended research activities credit in the country. Designed to encourage research and development, particularly for start-up businesses, the lion's share of the credit goes to a handful of large, multistate corporations whose success relies on investing in research, regardless of whether they receive tax credits. This costs the state \$63 million today and is projected to exceed \$100 million in 2012. Because the credit is refundable, it results in the state writing secret checks to corporations, above and beyond their corporate income tax liability.

Governor Culver has recommended eliminating authority on the part of the Department of Economic Development to double the size of the RAC when awarded in conjunction with other economic development incentives. The Governor estimates that elimination of this Supplemental Research Activities Credit program will save the state of Iowa \$13 million in FY2010. Governor Culver can produce these savings without legislation by directing the Department of Economic Development to cease providing any extra awards.

The General Assembly can go further, however, by limiting the size of the regular (not awarded) Research Activities Credit. If the amount any one corporation could receive annually under the RAC were limited to \$250,000, corporations would still receive a 6.5 percent credit toward their corporate income taxes on up to \$4 million in new investments made in qualifying research activities. The limitation would affect only a handful of corporations but would save the state over \$30 million annually, almost all of which now goes out in refund checks to corporations that have no state corporate income tax liability after the credit is calculated. It also would preserve the credits in full for small or new entrepreneurial firms, which were the reason for providing a credit, since most such firms would not have the capital to spend in excess of \$4 million on research.

Cap on Capital Gains Exclusion

Uniquely generous features of the Iowa tax code mean that certain individuals are never asked to tighten their belts, unlike in other states. Iowa has a capital gains provision, separate from the federal provisions providing partial exemptions from income for long-term capital gains, that totally excludes all income from certain capital gains from state tax liability. This means, for example, that an Iowa taxpayer making a qualifying million-dollar capital gains profit pays no state income tax on that profit, while a family of four making \$30,000 per year pays state income taxes on all their earned income.

¹ Iowa Dept. of Revenue, Contingent Liabilities Report, December, 2008, Table 6. The figures for FY2006 to FY2008 are actual credits claimed on tax returns. The projected figure for FY2010 is a "contingent liability"—an estimate of the credits that will be claimed in those years based on tax credits awarded in earlier years. It does not take into account additional awards made in FY2009 that may be claimed in FY2010.

Simply placing a cap of \$100,000 on the amount of capital gains that could be totally excluded from state income tax would save the state \$20 million annually. This limitation would apply to fewer than 700 taxpayers.

Transparency (Public Disclosure) of Business Tax Expenditures

Iowa currently requires no public disclosure of which corporations or individuals make use of business tax expenditures or the amount of benefit they receive. An increasing number of states have adopted transparency legislation requiring that this information be public. Such legislation does not lead to disclosing proprietary information regarding corporations' specific activities, but it does provide lawmakers and the public with information on who receives them. Individuals and corporations are not required to claim such tax breaks, but when they do, these should be a matter of public record in the same way that public grants, contracts and appropriations are public record.

Transparency legislation is key to effective belt tightening because it begins to make tax expenditures subject to the same scrutiny as appropriations. When tax spending is kept secret, policymakers are left in the dark as to how effective — or ineffective — tax breaks have been and whether they should continue or be cut in order to trim waste from the state budget.

These actions can and should contribute substantially to the actions Iowa lawmakers take to close the state budget shortfall. They also can and should set the stage for continued review and accountability on what has been the fastest growing part of the state budget: business tax expenditures.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint fiscal policy initiative of two nonprofit, nonpartisan Iowa-based organizations, the Child & Family Policy Center in Des Moines and the Iowa Policy Project in Iowa City. IFP reports are available at www.iowafiscal.org.

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