Iowa Fiscal Partnership

POLICY BRIEF

March 22, 2011
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Everywhere a Tax Break — Is It Responsible Budgeting?

Iowa lawmakers' agenda raises questions about sustainability, fairness

By Charles Bruner

Despite some perceptions to the contrary, Iowa's overall state spending — three-fourths of which is on education, public safety, and health and human services[1] — has not been on the increase. Both general fund spending and state tax revenues were a smaller share of the Iowa economy in 2008 and 2009 than they were in the first half of the 1990s.[2]

This was even before the 10 percent across-the-board cut in state spending in Fiscal Year 2010. More than many other states, Iowa has enacted tax cuts during the past two decades that have reduced taxes for those at the top of the income ladder, with a particular focus upon business tax incentives. Along with the recession, these tax cuts, and not spending increases, have created Iowa's budget imbalance.

Now, however, revenues have picked up in Iowa and if they continue at the pace we saw through February we can expect to end this fiscal year with a $600 million surplus. The best current estimates indicate that funds available for FY2012 will be only about $100 million short of what is needed to maintain services at current levels, even without dipping into the $600 million in Iowa's rainy day funds.[3] While this is still a somewhat austere budget picture for 2012, the budget can be balanced without cutting state spending below last year's levels and without raising any taxes.

Many lawmakers, however, are calling for additional cuts in state expenditures and investments — in all levels of education (preschool through post-secondary) and in most other parts of the state budget. They are saying that Iowa cannot afford to continue its current funding of public services into the future.

All the facts, however, show that this is not true.

The call for additional cuts in state expenditures makes room for additional tax cuts. Moreover, most proposed tax cuts are directed to tax filers who already have received the lion's share of benefits from prior tax cuts. Collectively, tax cuts being considered could force further cuts in public expenditures in excess of $1.6 billion annually, about one-quarter of the existing state general fund budget. Since K-12 education is almost half of the state general fund budget, this would require huge cuts to public schools, where more than 80 percent of the funding is for teachers, counselors, and other school personnel.

The Iowa Fiscal Partnership has long argued for a balanced approach to state budgeting that takes as hard a look at tax expenditures and tax cuts as it does at public expenditures. All affect the budget bottom line the same. Polls of Iowa voters consistently have shown support for closing tax loopholes

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and eliminating tax breaks that primarily benefit individual and corporate tax filers with the greatest income and wealth. In almost all instances, however, the tax breaks being promoted by lawmakers this session go in the opposite direction, even to the economic disadvantage of small businesses and working Iowans that lawmakers claim they want to benefit.

Here is a quick rundown of tax proposals under consideration so far this year. For each proposal, we identify the real beneficiaries and the impact on the Iowa budget.

Corporate Income Tax: Cutting the top rate in half

Governor Branstad's budget proposes a reduction in the top corporate income tax rate (12 percent for corporations with profits over $250,000) to 6 percent. Three-quarters of the corporate income tax is paid by multistate businesses (financial, information, wholesale and retail trade, etc.) that are not domiciled in Iowa but sell goods and services at a profit in Iowa.[4] Iowa's corporate income tax actually ranks 40th among states in the amount of revenue it collects as a percent of private GDP.[5] Corporations that pay Iowa's income tax do so because they make a profit from sales to Iowans, even if their production facilities and employment are not located in the state. Reducing the corporate income tax rate does not provide a benefit to small, Iowa businesses unless they have very high profits.

Treasury depletion =	$	136.2 M	SFY 2012
	$	223.0 M	SFY 2013

Individual and Corporate Income Tax: Conforming with federal tax law changes

Iowa's income taxes are based upon many of the definitions for exemptions and credits that exist in federal tax law, making Iowa calculations of those deductions and credits very similar (although not identical) to federal law. Iowa routinely enacts an Internal Revenue Code update law that conforms Iowa's definitions to those established federally, with some exceptions. The Department of Revenue and the Governor have recommended coupling with most federal tax exemption and credit changes. While coupling with the federal changes does reduce Iowa revenues, coupling generally makes sense. The revenue losses will, of course, need to be paid for somehow. (The Department of Revenue and the Governor recommended against coupling with one major federal change: the new bonus depreciation provision, which is discussed below.)

Treasury depletion =	$	19.3 M	SFY 2011
	$	38.3 M	SFY 2012
	$	22.0 M	SFY 2013

Corporate Income Tax: Coupling with federal bonus depreciation

The Iowa Senate, in initially passing Senate File 209, went beyond the Governor's coupling recommendation to also enable businesses to "fully expense" all the equipment they purchase in 2011 and half the cost of equipment they purchase in 2012, a federal provision known as "bonus depreciation." Expensing allows a firm to deduct the entire amount of an equipment purchase immediately instead of spreading the cost over a number of years through normal depreciation deductions. This expensing/bonus depreciation provision was a last-minute addition to the federal tax reform legislation passed in December. When Congress has established special bonus depreciation options in the past, most states have chosen not to couple with the provisions, both because of the cost and because the benefits apply primarily to large multistate corporations that make many of those capital equipment purchases outside the state.

Under existing Iowa law expensing is limited to $250,000. The department of revenue and the governor, however, have recommended coupling with the federal increase in this limit (known as Section 179 expensing) to $500,000. In order for a small Iowa business to benefit from the additional deductions allowed if Iowa couples with bonus depreciation, that business would have to make more than $500,000 in capital equipment purchases in 2011 and have profits (before depreciation) larger than $500,000.[6] While at the federal level the Congressional Budget Office estimates that 80 percent of the cost of the expensing provision will be returned in higher tax payments in future years, the fraction may be lower with respect to state corporate income taxes.[7]

While the Senate initially passed SF209 with no retroactivity, the House passed the bill with an amendment making the provision retroactive to the 2010 calendar year, for equipment that already has been purchased. Providing for such retroactivity adds substantially to the cost over 2011 and 2012.

The cost of the Senate version of $126.4 million reduces the amount that lawmakers can budget for general fund expenditures in 2012 by $125.2 million (because general fund spending is limited to 99 percent of revenue). The House version reduces the amount available for 2012 by $222.0 million (99 percent of $224.2).This produces a budget shortage that requires major service cuts (or other revenue increases) to fill.

Treasury depletion/			
No Retroactivity =	$	27.3 M	SFY 2011
	$	99.1 M	SFY 2012
Total		126.4 M	

Treasury depletion/			
Retroactivity =	$	83.2 M	SFY2011
	$	141.1 M	SFY2012
Total		224.2 M	

Personal Income Taxes: Cutting the personal income tax rates by 20 percent

The Iowa House, in House File 194, passed a cut in Iowa personal income tax rates of 20 percent, starting with the 2011 tax year. The personal income tax contributes nearly one-half of all revenue to the general fund (the sales tax is the second largest contributor), so cutting the rate by 20 percent produces about a 10 percent hole in the state budget when its full effect is felt in State Fiscal Year 2013. Moreover, it provides very little assistance to Iowans struggling to get back on their feet: The bottom fifth of tax filers (with incomes under $21,000) get an average of $18, while the top 1 percent of tax filers (with incomes over $358,000 annually) get an average of $6,822.[8] Already, Iowa families with incomes below $100,000 pay a greater share of their income in state and local taxes than those above $100,000[9]; the 20 percent cut would exacerbate that disparity. Any changes to Iowa's personal income tax law need to address the relative needs of working and middle-income Iowa families (with wages or small business income of $80,000 or less), where Iowa's personal income tax is high relative to the federal income tax and the taxes in other states. An across-the-board rate cut does not achieve this.

Treasury depletion =	$	330.0 M	SFY2012
	$	704.1 M	SFY2013

Individual Income Tax: Expanding the EITC from 7 percent to 10 percent of the federal credit

Senate File 209 also raised the state Earned Income Tax Credit (EITC) from 7 percent of the federal credit to 10 percent of the credit. Such an increase benefits approximately 240,000 working Iowa households with incomes below $50,000. For many of these families, the benefit from raising the EITC is much greater than a 20 percent income tax rate cut, although the total cost of EITC expansion to the state treasury in SFY2013 amounts to only 2 percent of the cost of the 20% rate cut. A large share of those 240,000 households currently do not owe any federal income tax, but do owe state income taxes, sometimes in excess of 4 percent of their total income. Raising the EITC and increasing the personal credit allowance are the most effective ways to address current inequities in Iowa's tax code and provide assistance to working Iowans and small business owners. In fact, since Iowa's personal income tax overall is about 30 percent of the federal income tax, the EITC logically should be increased to about 30 percent of the federal credit rate. While increasing the EITC has a cost to the state treasury, there are other features within Iowa's tax code (complete exemption from taxation of certain capital gains profits and refund subsidy checks to large profitable corporations through the research activities credit) that could be revised to make Iowa's tax system more equitable and more than cover the costs for increasing the EITC.

Treasury depletion =	$	14.7 M	SFY 2012 (.1 M2011)
	$	13.7 M	SFY 2013

Individual Income Tax: Excluding active duty military pay from income tax

The Governor's budget also includes a special provision to exclude active military duty pay from the state personal income tax. Obviously, this is an effort to recognize the sacrifice, which sometimes is financial as well as family related, to Iowans who are servicepersons, particularly those called into service overseas in Afghanistan and Iraq. Again, like the EITC, the cost of this provision is quite small in relation to other provisions being considered by lawmakers and would provide an economic benefit, as well as recognition, to families called into service. At the same time, there are Iowans who have chosen active service in the military and have military careers that provide comparable, if not superior, economic benefits to them. A blanket exemption may not be the most efficient or effective way to provide economic support to those families with persons on active military duty who need that assistance.

Treasury depletion =	$	11.9 M	SFY 2012
	$	9.5 M	SFY 2013

Property Tax: Reducing commercial and industrial property taxes by 40 percent over five years

The Governor has proposed reducing commercial and industrial property tax assessments in phases over the next five years until such property is assessed at just 60 percent of actual value. A reduction in assessments by 40 percent would also reduce collections by 40 percent. This loss of revenue for cities, counties and schools will have to be paid for through some combination of greater state obligations (to the extent that the state picks up the cost), lower local revenues, and higher local property taxes on residential and agricultural property. However the cost is distributed, it will be very substantial: Commercial and industrial property accounts for about a third of local property tax revenue. The revenue collected from commercial and industrial property in Iowa in FY2011 totaled $1.49 billion; a 40 percent reduction would therefore amount to nearly $600 million in lost revenue annually at current assessment levels and tax rates, more in future years.

Depletion from Somewhere =	$	600.0 M +	When fully phased in

Summary of Proposed Cuts and Costs to Iowa Governments (Millions of dollars)

	FY2011/2 State Budget *	FY2013 State Budget	Future Total State & Local Budgets**
Corporate Income Tax 6% Top Rate	136.2	223.0	230.0 +
IRC Update	57.6	22.0	22.0 +
Bonus/Dep/ Retroactive	124.3	N.C. ***	N.C. ***
Personal Income Tax Rate Cut 20%	330.0	704.1	704.1 +
EITC to 10%	14.8	13.7	13.7 +
Active Duty Military Pay Exclusion	11.9	9.5	5.0 +
Commercial and Industrial property Tax 40% reduction			600.0 +
Totals	774.8	972.3	1,574.8 +

* The impacts upon both the 2011 budget and the 2012 budget are included, because the costs to the 2011 budget will affect the FY2011 ending budget balance and what funding is available for FY 2012.
** The first two columns speak only to the state general fund budget. The last column includes the property tax reduction and affects both state and local budgets. This would be after the fifth year, when property tax reductions are fully phased in, and the + at the end indicates that these figures will likely grow in size over time, with both inflation and state population and economic growth.
*** As currently in federal law, the expensing/bonus depreciation provisions will have immediate costs and then 80 percent or more will be recovered in subsequent years. This assumes, however, that new expensing/bonus depreciation provisions will not be enacted in future years. In Iowa, there may be some net positive, rather than negative, effects on some budget years after SFY2013, but six years later, assuming no new expensing/bonus depreciation provisions, these will likely will be zero.

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[1] Census of Governments, State Government Finances, Fiscal 2009 (education, health, public welfare, and public safety expenditure as a percent of state general expenditure). http://www.census.gov/govs/state/0916iast.html
[2] See these two Iowa Fiscal Partnership reports, "Getting Public Value Out of Our Public Dollars," October 7, 2010, and "Iowa's Taxes Remain Lower than Average," March 17, 2011. Links: http://www.iowafiscal.org/101006-publicvalue.html and http://www.iowafiscal.org/110317-avgbyany.html
[3] Current year spending (including supplemental appropriations) will be $5.30 billion, with built-in and anticipated increases of $1.28 billion for next year bringing the total FY 2012 spending projection to $6.58 billion. The December Revenue Estimating Conference projected $6.03 billion in receipts for FY 2012; to that should be added $441 million in transfers from the Economic Emergency Fund (assuming revenue growth of 6 percent continues through June) and an adjustment of $77 million for changes in federal tax law and for the governor's recommendations regarding coupling with the federal tax code. This brings total funds available to $6.55 billion, and with the 99 percent expenditure limit implies $6.48 billion available for appropriation, which is just $98 million short of the estimated "constant services budget" spending amount. The rainy day funds (cash reserve fund and economic emergency fund) will be at their statutory limit of 10 percent of projected FY12 revenues, or about $603 million.
[4] Iowa Department of Revenue.

[5] See "Iowa's Businesses Already are Taxed Lightly," Iowa Policy Project, Feb. 9, 2011, at: http://www.iowapolicyproject.org/2011docs/110209-IFP-biztaxes-bgd.pdf

[6] The bonus depreciation deduction can be used only to offset profits; since Iowa firms will already be able to offset $500,000 in profits under the new Section 179 expensing provisions, bonus depreciation provides no benefit unless profits exceed $500,000.

[7] Because expensing a piece of equipment now means the business will not have the depreciation deductions in future years, its taxable income, and taxes, will be higher in the future. However, some businesses will fail and others will move out of state and no longer be taxed in Iowa; for those firms, Iowa will not regain in future taxes what it lost through expensing.

[8] Iowa Fiscal Partnership, "Income Tax Measure Costly, Increases Inequities," February 16, 2011, at: http://www.iowafiscal.org/110216-inctax.html .

[9] "Who Pays Iowa Taxes? New Report Shows Fairness Problems," Iowa Fiscal Partnership news release, Nov. 18 2009. http://www.iowafiscal.org/2009docs/091118-WhoPays-release.pdf

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Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint budget and tax policy initiative of two nonpartisan, Iowa-based organizations, the Iowa Policy Project in Iowa City and the Child & Family Policy Center in Des Moines. Find IFP on the web at www.iowafiscal.org.