

Sales-Tax Sleight of Hand in Iowa

Proposals test limits of authority, defy voters' intent and expectations

By Mike Owen

Recent proposals and actions on Iowa's sales tax would directly cost Iowa schools funding for both facilities and general operations, and most critical services could expect less as well. Aside from fiscal impacts, these proposals ignore existing law or voters' directives, and long traditions in the way we govern ourselves. To many, this is a low road — of lower revenues, services and commitment. We map that road below.

Here we do not review in detail the impact of the sales tax on various types of Iowa households, though we examine Iowa's significant shifts toward regressive taxation (particularly the sales tax) in greater depth elsewhere.¹ Rather, we focus on the revenue and governance issues raised by a recent unilateral action by the Branstad administration for a special sales-tax break, and pending proposals by the Governor and legislators to change intended spending from sales taxes now in place. Each represents a sleight-of-hand either in defiance of existing laws that have not been duly changed, or of promises made to voters who years ago authorized specific tax policy changes with clear expectations on the use of new revenue.

These new, opportunistic approaches are suddenly possible because of Iowa's polarized political landscape. Ironically, they capitalize on what education and environmental advocates had seen as opportunities to progress despite a general lapse of the state's commitment of funding. Only an expectation that lawmakers will not agree to stop the Governor permits him to act unilaterally on a sales tax exemption, a reinterpretation of longstanding existing law to grant manufacturers a special break without prior legislative approval. Only the looming expiration of the school infrastructure sales tax gives the Governor an opportunity to attempt a diversion of that funding from school districts to water programs — an immediate loss to schools in the near term, and insufficient resources for schools and the full range of environmental priorities for the long term.

Meanwhile, policy makers do not follow the dictates of law for school funding, nor the direction of voters on environmental funding. Legislators already routinely dismiss their annual legal deadline for setting state school aid levels 14 months ahead of schools' own budget certification deadlines. And we now see attempts by both the Governor and some legislators to come up with proposals that divert revenue and change the rules for funding of school facility needs. While education advocates have voiced concerns for several years about the state's commitment to funding of public schools, environmental advocates have done the same through five-plus years of legislative inaction following a 2010 electoral victory. That year, voters statewide approved a constitutional amendment directing the first three-eighths-cent sales-tax increase to a trust fund to enhance stewardship of Iowa's land, air and water resources — not all of which are in the Governor's plan.

The Sales Tax Under Current Law

Iowa's state sales tax is part of a three-pronged funding structure to support state and local services and infrastructure: state and local sales and excise taxes; state income tax and local income surtax; and local property tax. State law governs all of these. The state sales tax is 6 percent on applicable purchases and services, with exemptions set by state law. The first five pennies of sales tax per dollar go to the state general fund; the sixth penny is dedicated to school infrastructure or school property tax replacement. That penny is worth about \$435 million to Iowa schools in Fiscal Year 2016.²

New Proposals Reduce Revenues for Services, Either Directly or Indirectly

Each of the imminent or proposed actions summarized below provide less revenue for public education than is provided under current law. These come at a time when the Legislature and Governor have settled Iowa into a trend of holding down the basic building block of school budgets — per pupil cost — in a formula designed to produce equitable funding for a student regardless of his or her school district. These actions give local school districts scant ability to sustain funding over time.

Administrative Change in Sales-Tax Law Without Legislative Approval

The first policy change, an administrative order to be implemented July 1 unless blocked by a veto-proof majority in the Legislature this spring, unilaterally reinterprets existing sales-tax law governing purchases by manufacturers. The Iowa Department of Revenue (DOR) preliminarily estimated the cost of this change to be \$35 million or more in FY2017, which begins July 1. While there has been no official update of that estimate, many have projected it to be higher.³

The governance issue may be of even greater importance than the fiscal impact. One observer with experience in the world of administrative rules, in testimony to the DOR on the proposed rule change, called it “an unprecedented potential shift of institutional, constitutional forces.”⁴ James C. Larew, an Iowa City attorney and former general counsel to Governor Chet Culver, stated:

“The balance of political power changes from one election to the next.

“The balance of constitutional power — the relationship between the Iowa General Assembly and executive departments of our state government — is more serious and more lasting.

“Broad statutory interpretive powers given up by the legislature to an executive agency, in one moment of time, concerning one issue, are not easily later recovered.”

The sharp partisan divide between the Iowa House and Senate appears to be weighing against a reversal of the Governor's new interpretation of longstanding tax law, though about two months into the session there are indications that lawmakers may agree on a compromise that lessens the fiscal impact.⁵ If the Governor's change stands, it leaves an open question of how many other executive-branch reinterpretations of other tax laws may occur with this precedent, and with fiscal impacts of their own.

The following proposals stem in part from pressure for greater environmental funding, and capitalize on school districts' interest in extending a statewide sales tax currently designated for school infrastructure funding but set to expire in 2029. Each proposal would cut into schools' exclusive use of those funds even before the deadline.

Diverting the “Statewide Penny” from School Infrastructure for Other Uses

The so-called “statewide penny” is the sixth cent of Iowa sales tax — the sixth cent per dollar in sales on goods or services, added in 2008. After Governor Branstad first took office in 1983, he proposed and passed an increase in the sales tax from 3 percent to 4 percent. Again, in 1992, he approved an increase in the state sales tax to 5 percent. Meanwhile, beginning in 1998, local school districts were permitted to seek, through authority granted countywide, a 1 percent sales-tax increase to fund school infrastructure. This was known as the School Infrastructure Local Option, or SILO, tax. Frequently, these local referendum campaigns included assurances to voters by school administrators and school board members that the penny would be used for school facilities — and could not be used for salaries or other purposes. In 2008, these local SILO taxes were converted to a statewide tax, with an expiration date of Dec. 31, 2029. The stated legislative intent in the law is that the 1 percent tax “shall be used solely for purposes of providing revenues to local school districts under this chapter to be used solely for school infrastructure purposes or school district property tax relief.”⁶ Further, local districts must follow a voter-approved “revenue purpose statement” governing how the funds — from what is called the Secure and Advanced Vision for Education, or SAVE, fund — will be used within the bounds of the state law.

School officials across Iowa have been seeking an extension — or removal — of that sunset provision because they are allowed to borrow money against those anticipated SAVE revenues. The closer they get to that 2029 date, the more they are limited in long-term borrowing against that revenue source for school infrastructure projects. Schools also have been concerned about the possibility of attempts to scoop revenues from that source for other purposes. The Iowa Association of School Boards made “preserving the integrity of the statewide penny sales tax for school infrastructure,” along with repeal of the 2029 sunset, one of its four priorities for the 2016 legislative session.⁷ Proposals under consideration offer a nod to the latter — extending the law rather than repealing the end date — only by losing the “integrity of the statewide penny.”

Governor’s Plan — Diversion for Water Programs

While the question of school infrastructure is one of many funding challenges for schools as operational budgets have been held down by lawmakers in recent years, environmental advocates have sought more resources to deal with land and water management at a time of serious pollution issues. The latter have been highlighted by a 2015 lawsuit by the Des Moines Water Works against three counties whose ag-based pollution has driven up water treatment costs for their urban and suburban neighbors downstream.

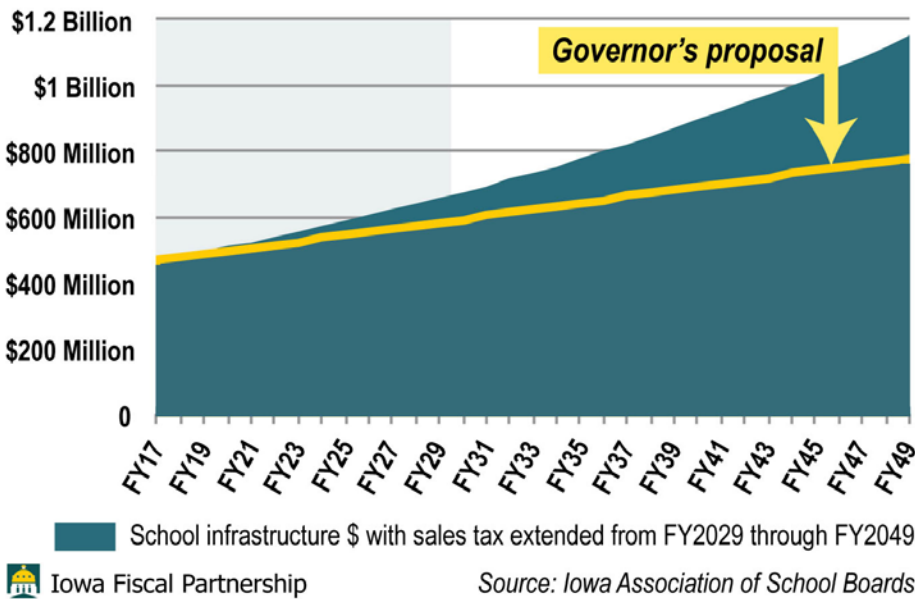
The Governor’s proposal amounts to a bait-and-switch tactic to voters who passed local school infrastructure sales taxes, and to legislators who converted them into a statewide tax in 2008. Iowa Code Chapter 423F, with the same restrictions on the use of revenue.

Voters had approved strategies to address both challenges, for schools and the environment. While the Governor purports to do the same with a different approach, the changes weigh heavily against schools, when compared with current law for the near term and educator-backed proposals for the long term. While he would extend the school facilities sales tax from 2029 to 2049, he would reduce the share of that tax going to schools for the next 13 years, and limit growth to only \$10 million a year statewide — a net loss to schools of \$425.9 million through 2029.⁸ At the same time, he would divert increasing shares of the growth in those revenues through 2049 to water programs — an estimated \$4.7 billion. See Figure 1 below.

Governance:

The Governor’s proposal amounts to a bait-and-switch.

Figure 1. Governor’s plan substantially drops funding for school infrastructure compared to straight sales tax extension, FY17-FY49



Revenues:

The Governor’s proposal reduces sales-tax revenues for school facilities for 13 years. Over time, the Governor’s plan offers far less — about \$4.7 billion less — than a straight 20-year extension of the statewide penny.

The history of this sixth penny of the state sales tax is important, as it established a level of political legitimacy for a tax increase among legislators who have not typically been out front in favor of tax increases. Its roots are in local votes across Iowa, where voters were asked to add a penny per dollar in sales tax to fund improvements to school facilities and equipment. This purpose was expressly stated for those elections. The Legislature in 2008 — following those local, carefully focused ballot issues — converted the local taxes to a statewide sales tax with a common expiration date and the same purpose as that used to sell voters on the tax increases from the outset. It is quite likely that without the local taxes in place, there would have been no political vehicle for establishment of the statewide tax that replaced them.

At the same time the Governor’s plan ignores the historical justification for the sixth penny of sales tax, he has rejected implementation of an alternative for water-quality funding that Iowa voters have given him. The 2010 referendum — passed in the same election that returned the Governor to his office after 12 years away — did not require the passage of a sales tax, but it did designate the first three-eighths of a penny of the next sales tax increase to be used for environmental stewardship. Voters said “yes” to a penny for school infrastructure, and said “yes” to three-eighths of a cent for water and land improvements. Voters have not granted authority for the Governor’s hybrid approach.

House Alternative Proposals to Divert School Revenue

Proposals in the Iowa House offer other ways in which the sales-tax increase is extended, but for uses different from those in the 2008 legislation that created the sixth penny of sales tax and different from those in the local option votes that set up the statewide tax. One, HF2382, builds on the Governor’s proposal for water quality funding, but also includes provisions to permit use of the funds to ease statewide inequities in per-pupil spending* — with restrictions that do not exist

* Iowa school budgets are built based on a per-pupil cost, which varies by as much as \$175 per student from the highest to lowest district. About half of Iowa school districts are at the lowest level, and in recent years this has prompted calls for a

for other general spending — and inequities in transportation spending. The funds could not be used for teacher pay, for example, which is a major share of the cost of educating students. The legislation also carries new requirements for a voter referendum on any school facility project costing over \$1 million, and approval by a supermajority of at least 60 percent. Already, a supermajority is required for a general obligation bond issue against property tax. Adding this requirement for use of the sales tax would further institutionalize minority rule against school facility improvements, even for relatively small-scale construction projects. Other proposals in the House — HF2260, HSB549 and HSB548 — also would impose new limits on spending and divert funding currently designated for school facility improvements under long-accepted restrictions that schools have not contested. HF2260 includes a provision to allow for the use of the funds to help address inequities from district to district in the share of their budgets that go to transportation costs — one issue raised by education advocates about reforms needed in the school funding formula.⁹

The desire of school districts to extend the tax for its currently authorized use is the opening, as noted above, for a host of new restrictions that lawmakers have sought to impose on public school spending authority in the state — with window-dressing solutions for other concerns schools have raised about statewide equity.

Property Tax Impact of Branstad Plan

A notable consequence of this change may well be property-tax increases — in two ways — because less funding would be available in real terms through the SAVE disbursement. First, districts looking for resources will be more likely to increase their Physical Plant and Equipment Levy, if they are not already at the maximum \$1.67 per \$1,000 levy rate. Second, where SAVE funding can reduce the need for, or size of, property tax-based bond issues for facilities, districts might be left with no other option, provided they have the bonding capacity to do so. In both cases, these could cause property-tax increases — even though reductions in property tax have been the driving message behind tax changes by both the Governor and legislators in recent years.

In addition, the sales tax for school infrastructure already provides some property-tax replacement funding, to the Property Tax Equity and Relief (PTER) Fund.¹⁰ The Governor's proposal would reduce that by a total of about \$9 million through 2029 compared to current law, and by about \$102 million overall compared to a simple 20-year extension of the current law.¹¹

Constitutional Amendment Remains in Place

One of the problems with setting tax policy through a constitutional amendment is that policy makers lose flexibility. Diverting other funds now for the purpose designated by the 2010 constitutional amendment may well tie lawmakers' hands in raising revenue in the future. The next three-eighths of each penny raised by a sales-tax increase will go to environmental programs, regardless of action amending the use of the school infrastructure sales tax. In the event of a sales-tax increase in the next five-10 years, it is inevitable that this would set up new competition for revenues between environmental advocates and advocates for other critical services left out of the Governor's plan. Would there be a move to redirect the diversion from the school infrastructure tax? How might this affect bonding arrangements for projects for either water quality or schools? It would be best for lawmakers to address such scenarios before, rather than after, passage of anything along the lines suggested by the Governor.

legislative solution. For more on this issue, see "Building blocks of inequity," Iowa Policy Project blog post, February 2016, <http://iowapolicypoints.org/2016/02/10/building-blocks-of-inequity/>

Conclusion

Transparency is essential for Iowans to understand how and why they are being taxed, and how the revenues will be used. Whatever their perceived merits, the tax policy changes that we examine here are being pursued in defiance of understandings and expectations that exist by both tradition and law. The precedents they offer raise uncertainties for future governance of our state.

Ultimately, the Governor's proposed diversion of school funding to water programs is a response to a short-term challenge in both areas with, at best, long-term uncertainties. More likely it poses a long-term hindrance to school districts' ability to meet facilities needs, and to the funding choices of future legislators and governors.

Finally, while we do not delve deeply with this paper into the tax fairness issues posed by an enhanced focus on the sales tax where revenues are needed, it is well established that Iowa's sales taxes disproportionately affect poorer households. To put even more reliance on this most regressive piece of Iowa's state and local tax structure, which overall is regressive, means policy makers should be looking at offsets to assist low-income families in conjunction with sales-tax increases. None of these proposals make an attempt to balance out fairness issues, which also is true of the solution offered by the 2010 constitutional amendment. Some proposals in the House, in fact, would exacerbate fairness problems, by encouraging local school districts to buy down property taxes with sales-tax revenues.

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¹ *Cementing Inequity: Richest Iowans Pay Lower Tax Rate*, Iowa Fiscal Partnership, January 14, 2015.

<http://www.iowafiscal.org/cementing-inequity-richest-iowans-pay-lower-tax-rate/>

² Iowa Department of Revenue, https://tax.iowa.gov/sites/files/idr/FY16_LOST-SAVE_Estimates.xlsx

³ This Cedar Rapids Gazette account uses an estimate of \$46 million.

<http://www.thegazette.com/subject/news/government/legislative-leaders-still-working-on-tax-code-coupling-20160225>

⁴ Testimony of James C. Larew, Iowa City attorney and former administrative rules advisory and General Counsel to Governor Chet Culver, Dec. 1, 2015. Available here: http://www.iowapolicyproject.org/2015docs/151201-Larew-DOR_RulesTestimony.pdf.

⁵ The Gazette, Cedar Rapids, March 9, 2016: Iowa legislators move forward with compromise on taxes.

<http://www.thegazette.com/subject/news/government/iowa-legislators-move-forward-with-compromise-on-tax-policy-compromise-20160309>

⁶ Code of Iowa, Chapter 423F.1 Legislative intent: <https://www.legis.iowa.gov/docs/code/423F.pdf>

⁷ Iowa Association of School Boards, 2016 Legislative Priorities: http://www.iasb.org/Main/Advocacy_Center3/Advocacy_Agenda/2016_Legislative_Priorities2/Main/Advocacy_Center/IASB_s_Advocacy_Agenda/2016_Legislative_Priorities.aspx?hkey=19e89bb6-0b58-4dca-9bb1-6e279051f829

⁸ Calculations by Shawn Snyder, Finance Support Director, Iowa Association of School Boards.

⁹ See December 2015 testimony to Iowa Legislature School Finance Inequities Committee, <https://www.legis.iowa.gov/committees/meetings/documents?committee=24164&ga=ALL>, and the committee's final report, Jan. 1, 2016: <https://www.legis.iowa.gov/docs/publications/IP/765872.pdf>

¹⁰ Iowa Code Chapter 423F <https://www.legis.iowa.gov/docs/code/423F.pdf>, Iowa Code Chapter 257.16A <https://www.legis.iowa.gov/docs/code/423F.pdf>. The Property Tax Equity and Relief (PTER) Fund receives a state appropriation, plus funds from the Secure an Advanced Vision for Education (SAVE) Fund, after per-pupil allocations are made as a result of the statewide 1 percent sales tax for school infrastructure.

¹¹ Calculations by Shawn Snyder, Finance Support Director, Iowa Association of School Boards.