Policy Brief

Tax Policy and Economic Growth in Iowa: Who Gained in the 1990s?

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By Peter S. Fisher and Charles Bruner

Iowa, like the rest of the nation, experienced a sustained period of strong economic growth in the 1990s. During this period, the Iowa General Assembly also enacted a number of tax changes, including very significant tax reductions in the latter part of the decade. This report examines the overall size of the economic growth and the tax changes, with a particular emphasis upon how these have affected Iowa families at different income levels.

Economic Growth

During the 1990s, the size of Iowa's economy, as measured by the value of goods and services produced each year (gross state product), rose from $54.2 billion to $84.2 billion, or 55%. Personal income rose nearly as much, 53%, while the inflation rate (as measured by the consumer price index), was only 29%. This was a period of substantial real economic growth.

This growth was not spread equally across Iowa's population. Most gains went to individuals and families at the top of Iowa's income earners. Table 1 shows changes in the average incomes of Iowa families between the late 1980s and the late 1990s, by income quintile.

Table 1
Average Income of Iowa Families, 1988-1990 to 1998-2000
(Adjusted for inflation)

	Average Income		Change 1988-90 to 1998-2000		
Income group	1988-1990	1998-2000	Amount	Percent change	Percent of total change
Poorest fifth	$ 14,736	$ 16,586	$ 1,850	12.6%	3.2%
Next-to-bottom fifth	30,715	34,094	3,379	11.0%	5.8%
Middle fifth	43,633	49,940	6,307	14.5%	10.9%
Next-to-highest fifth	58,199	69,013	10,814	18.6%	18.7%
Richest fifth	96,250	131,668	35,418	36.8%	61.3%

Source: Analysis of data from the U.S. Census Bureau's Current Population Survey by the Center on Budget and Policy Priorities and the Economic Policy Institute, January 2002.

As Table 1 shows, the majority of Iowa's families – those in the lowest-earning 60% of families

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– experienced modest income gains during this period. On average, their incomes rose 12.7% after accounting for inflation. Meanwhile, incomes of the richest fifth of Iowa families increased almost 37% over the period. In fact, this group received 61% of all the gain in income earned by Iowans during the 1990s, and the top 40% of families accounted for 80% of the income gains.

Iowa Tax Revenue and State Tax Reductions

As a result of the growth in the state's economy, Iowa's tax base also grew. State general fund receipts grew more rapidly than the economy in the early 1990s, due to the increase in the sales tax. On the other hand, from 1994 through 2000, net state revenues grew 30% while state personal income increased 36%.

State revenue grew more slowly than the economy in the latter 1990s because the Iowa General Assembly enacted a number of tax reductions, particularly from 1995 through 2000. The overall effect of the state tax reductions enacted during that six-year period has been estimated at about $500 million on an annual basis (for the fiscal year, ended June 30, 2001).[1] The additional penny on the sales and use tax, on the other hand, increased state revenue by $335 million in fiscal 2001.[2] Most of the state tax reductions were cuts in state income taxes, totaling $405 million. Selective cuts in the sales and use tax and in registration fees totaled $50 million and the inheritance tax repeal for linear descendants totaled $34 million to $50 million.

The result of these tax changes was to increase the importance of the regressive sales tax relative to the progressive individual income tax.[3] Sales and use tax revenues increased from 30.1% of gross state tax collections in 1991 to 37.9% in 2001, while the income tax fell slightly from 44.3% of tax collections to 42.6% over the same period. (The remaining share of state tax revenues comes from the corporate income tax, the insurance premiums tax, tobacco and alcoholic beverage taxes, the inheritance tax, motor fuel taxes and other minor taxes.)

About 56% of the reduction in the state income tax ($228 million in fiscal year 2001) was due to a 10% across-the-board cut in rates that was enacted in 1997. The remainder of the reductions resulted from increased pension income exclusions ($49 million), increases to the personal and child/dependent credits ($48 million), changes in the Iowa capital gains allowance ($21 million), health insurance deductions for the self-employed ($15 million), and other changes ($43 million).

While a 10% across-the-board cut in rates may appear to affect all taxpayers equally, it actually provides larger absolute reductions in rates and taxes to those with the highest incomes (because the income tax is progressive). It is possible to show, in rough fashion, the overall effect of the 10% cut and most of the other income tax changes enacted between 1995 and 1999 by

[1]The Iowa Department of Management has estimated the total at $488 million, while figures from the House Democratic Caucus staff, drawn from the nonpartisan Legislative Fiscal Bureau's analysis, indicate a total of $507 million. The difference is largely due to estimates for the repeal of the inheritance tax for lineal descendants, where Management shows a cost of $34 million vs. $50 million for the House staff. During the same period, the Iowa General Assembly increased state spending on local property tax relief measures. These property tax reductions, accomplished by replacing local funding with state funding, cost the state $286 million to $332 million in fiscal year 2001 (depending on whose figures are used). Thus the total of cuts in state taxes and state-funded local tax relief is about $774 million to $839 million.

[2] From Dept. of Revenue and Finance Annual Report for Fiscal Year 2001: $1,937 million in net sales and use tax collections (after refunds) less $261 million in local option sales and hotel/motel tax receipts, times 20%.

[3] A regressive tax is defined by economists as one that takes a larger share of the incomes of lower income groups than it does of upper income groups. A progressive tax is one that takes a larger share of the incomes of upper income groups than it does of lower income groups.

examining how tax burdens changed for different income groups during that period.[4]

Table 2 uses Iowa Department of Revenue data to compare tax payments for 1995 with tax payments for 1999 by tax filer income level.[5] This table is compiled on a household basis; that is, married couples filing separately are combined into one household or tax filer by adding their adjusted gross incomes (AGI) and tax payments together. In-state tax filers are shown by adjusted gross income levels, while out-of-state tax filers (many with only a small portion of their income attributed to Iowa) are shown only as a group, although most are in higher income levels.

Table 2
Comparison of 1995 and 1999 Iowa Individual Income Taxes and Rates
(Married Couples Filing Separately Combined into One Household)

AGI Class	Average Tax Rate 1995	Average Tax Rate 1999	Average Tax Rate Change	Add'l 1999 taxes if 1995 rates applied	Average 1999 tax savings per return	Percent of filers	Percent of tax cuts
In-State Tax Filers							
$ 1-9,999	0.41%	0.31%	-0.10%	$ 1,488,802	$ 5	20.3%	0.4%
$ 10-19,999	1.99%	1.62%	-0.37%	12,583,951	57	16.0%	3.3%
$ 20-29,999	3.36%	2.85%	-0.51%	23,292,457	128	13.2%	6.2%
$ 30-49,999	3.91%	3.37%	-0.55%	54,925,741	215	18.5%	14.5%
$ 50-74,999	4.36%	3.74%	-0.62%	67,689,524	378	13.0%	17.9%
$ 75-99,999	4.70%	4.03%	-0.67%	37,791,472	569	4.8%	10.0%
$ 100,000+	5.47%	4.78%	-0.69%	89,434,408	1,473	4.4%	23.7%
All classes*	3.99%	3.65%	-0.34%	287,206,355	228	91.7%	76.0%
Out-of-State Tax Filers							
All classes*				90,647,049	794	8.3%	24.0%
All Filers							
All classes*				377,853,404	287	100.0%	100.0%

*Those with no AGI are included in the total number of filers; however, it was not possible to estimate the 1999 tax burden at 1995 rates for such filers. Source: Iowa Department of Revenue and Finance statistics.

As Table 2 shows, those in the $10,000-$20,000 AGI class on average paid about $57 less in taxes on their 1999 income than they would have if the 1995 average tax rate had still applied. Those in the next highest group, $20,000-$30,000 averaged only a little more, $128 per household in tax savings. (These tax savings also represent the revenue lost to the state.) Households with AGI over $100,000, on the other hand, enjoyed an average tax savings of nearly $1,500. While representing only 4.4% of all tax filers for the 1999 tax year, those filers with incomes over $100,000 received approximately 24% of all the income tax benefits, nearly $90 million per year in total. Furthermore, another 24% of the tax cuts went to non-residents, also predominantly upper-income tax filers. In fact, 90% of the tax cuts going to non-residents went to those with AGI over $100,000.

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[4] Several tax changes made in 1994 and in 2000 are not represented in available data. The Department of Revenue did not have comparable data for the 1994 tax year and the 2000 tax year data is not yet available.

[5] These are approximations based on the available data showing the average tax rate by AGI class (total taxes paid divided by total AGI). Since some of the tax changes altered the definition of AGI, the actual effects of the tax changes by income class will differ somewhat from these percentages. For example, the increases in the amount of pension income excluded from AGI reduced taxes but also reduced AGI. Therefore, some of the households with lower taxes in 1999 are shown in lower AGI groups than they should be if AGI had been defined the same way both years. As a result, the tax changes actually were skewed towards the upper income groups to a greater degree than shown here.

The highest income families in Iowa not only were the prime beneficiaries of economic growth in the 1990s, but also received a disproportionate share of Iowa's income tax reductions. Furthermore, the sales tax increase of 1992 increased the tax burden, in relative terms, on lower income households more than on upper income households.[6] Thus, the net effect of tax policy in the 1990s was to make the overall tax system more regressive.

Table 3 shows the approximate effects of the two major tax changes — the increase in the sales tax in 1992 and the 10% cut in income taxes in 1997 — on Iowa families by income class. (Table 3 includes all families, not just income-tax filers, as in Table 2, but Table 3 does not include all of the income tax cuts.) For the bottom 80% of the population, the net effect was an increase in taxes. For the richest 20%, taxes were reduced; the richest 1% saw their taxes fall by $1,872 per year.

Table 3
Effect of One-Cent Sales Tax Increase and 10% Income Tax Cut on Iowa Families in 1998

Income	Average	Average Sales Tax Paid			Average Income Tax Paid			Net
Group	Income	at 4%	at 5%	Change	Without cut	With cut	Change	Change
Lowest 20%	$ 8,200	$ 203	$ 254	$ 51	$ 46	$ 41	$ (5)	$ 46
Second 20%	19,900	446	557	111	398	358	(40)	72
Middle 20%	32,100	591	738	148	999	899	(100)	48
Fourth 20%	48,700	740	925	185	1,732	1,558	(173)	12
Next 15%	75,600	907	1,134	227	3,108	2,797	(311)	(84)
Next 4%	133,000	1,064	1,330	266	5,763	5,187	(576)	(310)
Top 1%	476,000	2,666	3,332	666	25,387	22,848	(2,539)	(1,872)

Note: Income groups, amount of sales tax paid at 5% and amount of income tax paid with the 10% cut in place are based on the table "Iowa Taxes in 1998 As Shares of Family Income for All Taxpayers," on Page 23 in *Choices for Iowa: Building a Better Tax System,* Institute on Taxation and Economic Policy, September 1998. Sales tax paid at 4% is simply 80% of the 5% amount. Income tax without the cut is the tax with the cut divided by 0.9.

Discussion

As Iowa faces a slowdown in the economy and consequent decline in state revenue collections, Iowa's tax system deserves re-examination. Iowa families who received the fewest gains from economic growth and the smallest tax reductions over the last decade were those with low and moderate incomes; most were working full time. These also are the people with the most need for safety-net services when laid off from work and unable to find employment.

Clearly, the current budget woes of the state are attributable both to the recession and to state tax policies. The tax cuts of the 1990s have left the state with insufficient revenue at a time when service needs are increasing. Had some of the tax cuts been foregone, not only would the state be able to balance its budget, but the annual deposits into the rainy day fund would have been larger. The fund could then serve its purpose as a counter-cyclical balance. When the economy declines, Medicaid payments and demands on the state's social services system increase. Instead of having the funds to sustain these programs just when they are needed most, the state is now in the position of cutting them.

While some have argued that it is fiscally irresponsible to use the rainy day fund for ongoing

[6] This effect was moderated slightly by the exemption of utilities from the sales tax in the 2001 legislative session.

expenditures, recession-induced increases in expenses are precisely what rainy day funds were designed to address. When the recession is over, these expenses will return to normal levels, levels that can be funded with normal receipts. The fund can then be replenished over the ensuing non-recessionary years.

The primary beneficiaries of both the economic boom and state tax reductions in the 1990s currently are the ones being sheltered from any of the consequences of a downturn in the economy. They have the most capacity to contribute to addressing the economic downturn and meet the needs of those most affected by that downturn. Before balancing this year's budget on the backs of the poor, a concerted examination of Iowa's tax system, to ensure its progressivity and productivity, is needed.

Tax Policies for Difficult Times

The tax system must generate sufficient revenue to meet state obligations, while recognizing who is able to pay taxes. Expansion and refundability of the state earned income tax credit (EITC) could assist working families with dependents who struggle the most to raise their children. Iowa's credit is now just 6.5% of the federal EITC, although Iowans pay about a quarter as much in state income taxes as they do federal taxes. But unlike the federal credit, Iowa's is not refundable. Increasing the state EITC to 20% of the federal and making it refundable would cost the state approximately $38 million.

An expanded EITC also would begin to better recognize the cost of raising children within Iowa's individual income tax system. Iowa provides the least recognition of the cost of raising children or caring for dependents of any state individual income tax, and very much less than the federal income tax system. Iowa offers a dependent credit of only $40 per child, compared with a federal credit of $400 per child plus a personal exemption of nearly $2,500 per child (an exemption worth more than $350 for a tax filer in the 15% tax bracket).[7]

As the state attempts to deal with revenue shortfalls this fiscal year, and probably next year as well, tax increases will be politically difficult. The tax most likely to be raised, if any, is the sales tax. It is important that any such increase should be accompanied by measures to reduce the regressivity of the sales tax and reverse the trend of the 1990s, where the highest income households received large tax cuts while the rest gained little or saw their taxes increase.

Such tax relief measures should consist of a refundable income tax credit for lower and middle-income households. This could be a credit based on a schedule of sales taxes assumed to be paid by income class, an expanded and refundable EITC, or expanded and refundable personal and dependent credits. Without refundability, little or nothing will have been done for those families and individuals who pay higher sales taxes because of the 1992 increase but saw no benefit from the income tax cuts.

[7] Many Iowa families with children actually pay more Iowa income tax than families without children and the same income. This is because Iowa allows federal deductibility and, because of the federal system's recognition of the cost of raising children, they have less federal taxes that they deduct, which more than offsets the value of the $40 credit.