Policy Report

The Iowa Policy Project — Child & Family Policy Center

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What Would Real Tax Reform Look Like?

By Peter S. Fisher and Charles Bruner

In 2003, the Governor and legislative leaders agreed to tackle tax reform and to base this reform on tax principles – including fairness, competitiveness, simplification and revenue adequacy. In the end, however, the Governor never offered a specific proposal, and the Republican leadership presented income tax and property tax packages that failed on all tax principles to represent true reform. The income tax bill (ultimately vetoed by the Governor) would have simply shifted taxes away from the wealthiest Iowans and eroded the state's ability to support essential services, actually calling for tax increases on the lowest 40 percent of working Iowans.

What would real tax reform look like? We begin by looking at the principles that should guide tax policy, and then assess how Iowa's current tax system stands up when evaluated against these principles, and how tax changes enacted over the past 12 years have worsened the system instead of improving it. Then we examine the components of the final bill passed in special session that would have altered the income tax, the local property tax and the sales tax. What would these tax provisions have accomplished? Finally, we outline what we consider to be true reform proposals for the personal income tax, the corporate income tax, the sales tax and the property tax.

Principles for Evaluating Tax Policy

The following principles should be used to evaluate the tax system and proposals for tax changes:

1. **Fairness.** Taxes should be based on one's ability to pay; those with similar ability to pay should have similar tax burdens.
2. **Competitiveness.** Iowa's overall tax system should allow the state to be competitive for business and for labor.
3. **Public Benefit and Economic Efficiency.** Tax incentives should promote some public purpose. Incentives that serve no public purpose can distort private economic decisions, making the Iowa economy less efficient.
4. **Revenue Adequacy.** Taxes must be capable of producing sufficient revenues to finance state and local public services.
5. **Stability and Predictability.** Other things equal, a tax base that is more stable and predictable over the business cycle is preferred.
6. **Simplicity.** The tax system should be easy for citizens to understand and taxpayers to comply with, and it should be easy for the government to collect the tax and audit compliance.
7. **Accountability.** Those who spend money should be accountable to those who provide the funds, through taxes or otherwise.

In addition, it is important to note the value of a balanced tax system. For example, the property tax base offers stability, but responds slowly to economic growth. The income tax grows with the economy, but also rises and falls with the business cycle. To rely heavily on either would tie us to a revenue stream that is either too volatile or too slow to respond to growth. All four components of the tax system – individual income, corporate income, property and sales – have a role to play.

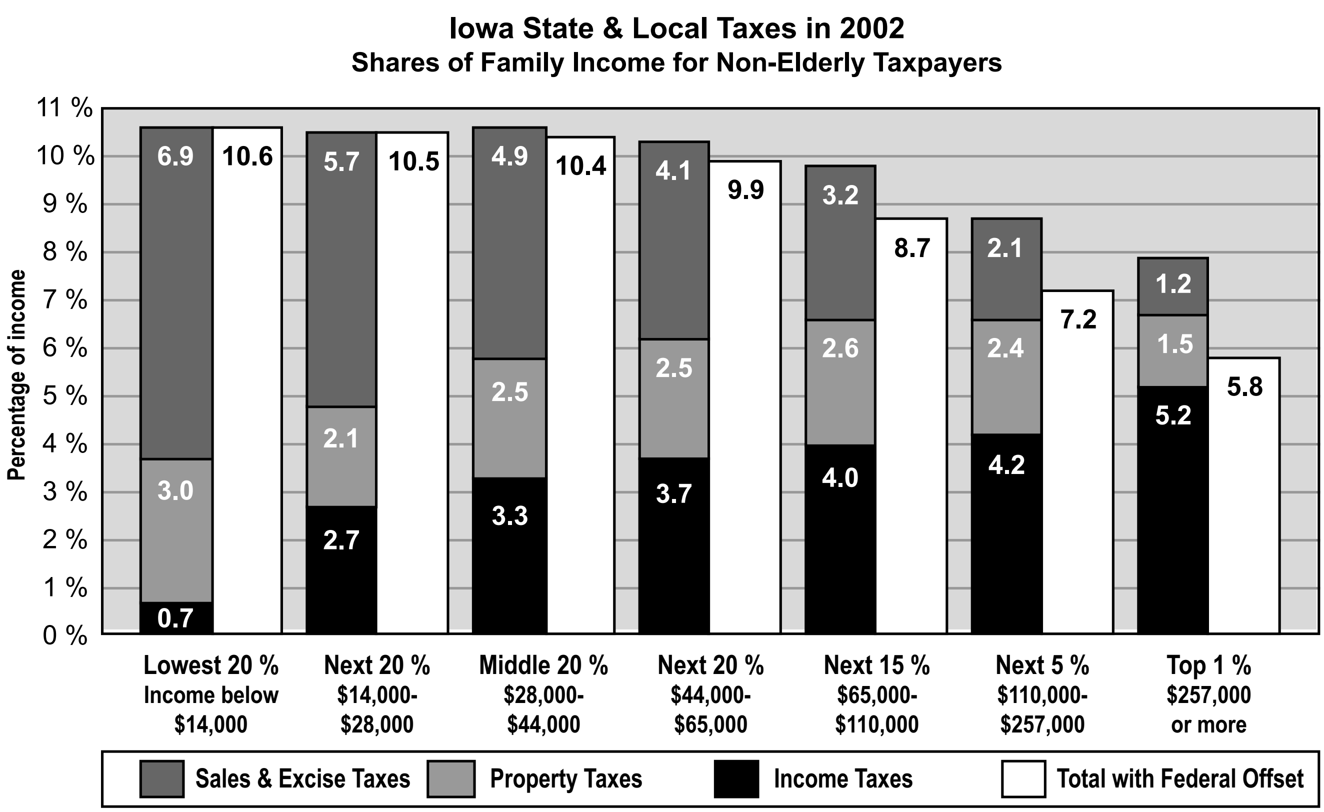
It is also important that a change in any one tax be evaluated on the basis of how it affects overall state and local tax burdens. For example, even a moderate income tax reduction could aggravate the already regressive structure of Iowa's state and local tax system, which taxes lower-income people at a higher percentage of income than it does higher-income people. Cutting income taxes or adopting a flat income tax moves the tax system further from proportionality, not closer.

The Current Tax System

Recent debates about taxes have been dominated by claims that this or that tax makes Iowa uncompetitive. Consideration of basic fairness has received so little attention that major tax changes have been presented and voted on without any attempt to even conduct the analysis necessary to determine who would gain and who would lose, and how these shifts measure up against a standard of fairness. Here we focus on these two issues by presenting the basic data on who pays Iowa taxes, and debunking the competitiveness arguments.

Who Pays Iowa Taxes?

Iowa's state and local tax system is regressive. It takes a smaller percentage of income from higher income families than from lower income families. As the chart below shows, in 2002 the bottom 60 percent of Iowa families (in terms of income) paid about 10.6 percent of their income in state and local income, sales and property taxes, while the richest 1 percent paid only about 7.9 percent of their income.



Source: Institute on Taxation and Economic Policy

The regressivity of Iowa's tax system was worsened by major policy changes in the 1990s. In 1992, facing a budget crisis precipitated by the recession, the state raised the sales tax from 4 percent to 5 percent. Then in 1997, facing a budget surplus, lawmakers enacted a 10 percent across-the-board cut in the income tax. The net effect of these two changes was to increase slightly the tax burden on the bottom 80 percent of Iowa taxpayers, while granting substantial tax relief to the top 20 percent. The richest 1 percent saved about $1,800 per year. Also during the 1990s, city and county sales taxes proliferated to the point where the average sales tax in Iowa in 2003 is nearly 6.5 percent, compared to 4 percent 12 years earlier. The effect of all these changes has been to increase reliance on the regressive sales tax and reduce reliance on the income tax, the only progressive component of the state-local tax system in Iowa.

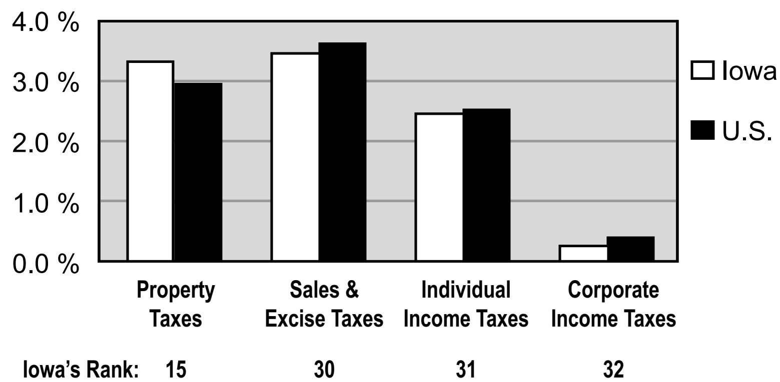
Taxes and Competitiveness

Competitiveness doesn't mean that Iowa must have lower taxes than *everyone* else; it means we should be in the ballpark, so we're not driving business away. Lower taxes than *anyone* means lower services than anyone – "Let's be like Mississippi." So where does Iowa stand? Iowa is, in fact, average in state and local tax burden, no matter how you measure it: overall state taxes, overall local taxes, income taxes, property taxes, sales taxes. The exception: Iowa's corporate income tax is substantially *lower* than average.

Despite repeated claims by legislative leaders, cutting personal income taxes will do nothing for state economic growth. Iowa is not the federal government – we can't run a deficit, we have to balance the budget. For every dollar we cut in taxes, putting a dollar in the hands of consumers to spend, we cut a dollar in state or local spending, taking a dollar out of the hands of a state employee to spend, or taking a dollar away from a private firm providing services to government.

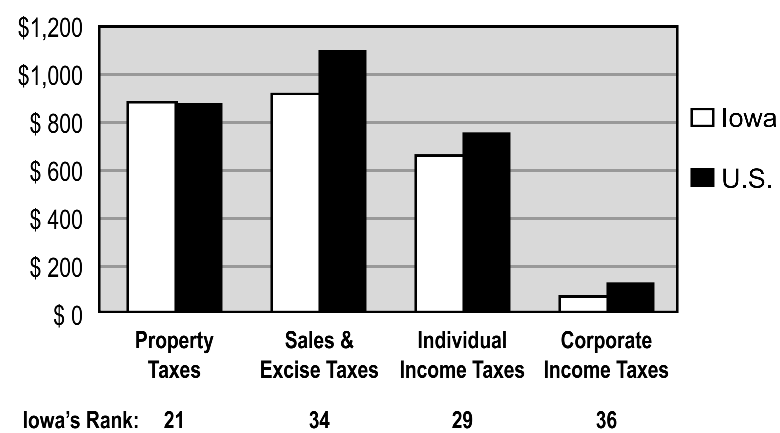
Will cuts in personal taxes increase business investment? Businesses locate where they make the most profit, and part of that involves minimizing costs. But personal income taxes are not even a business expense; they are paid by employees. The only way personal taxes become a business expense is if personal taxes are so high that employees take notice and demand higher pay to compensate. But, as we said before, Iowa's income taxes are just average. Even if Iowa income taxes were 50 percent higher than some other state, the average corporation could compensate every employee with offsetting higher pay and

Particular Taxes as a Percent of Personal Income: Iowa and U.S. Average, 2000



Source: U.S. Census, Government Finances

Burden of Particular Taxes, Per Capita: Iowa and U.S. Average, 2000



Source: U.S. Census, Government Finances its total costs would rise just two-tenths of a percent. This is too small a difference in costs to possibly affect any significant number of business investment decisions. Much larger differences in costs, through corporate income tax incentives, have been shown to matter very little or not at all for the majority of investment decisions.

Furthermore, why should tax policy be driven by comparisons with a small neighbor, South Dakota? Why not look at Minnesota and Wisconsin, which for a long time have had higher and more progressive income taxes than Iowa, and have also for a long time had rates of economic and population growth that far exceed Iowa's.

Finally, it must be recognized that cutting taxes means cutting services; in the long run, this harms Iowa's economy and growth potential. Research shows that the quality of services does matter to business, particularly infrastructure expenditures and education. And when the era of labor shortages reappears, we will remember that attracting a labor force is important, too, and the quality of life and public services are important in our ability to do that.

Tax Changes Approved by the 2003 Legislature

Income Tax

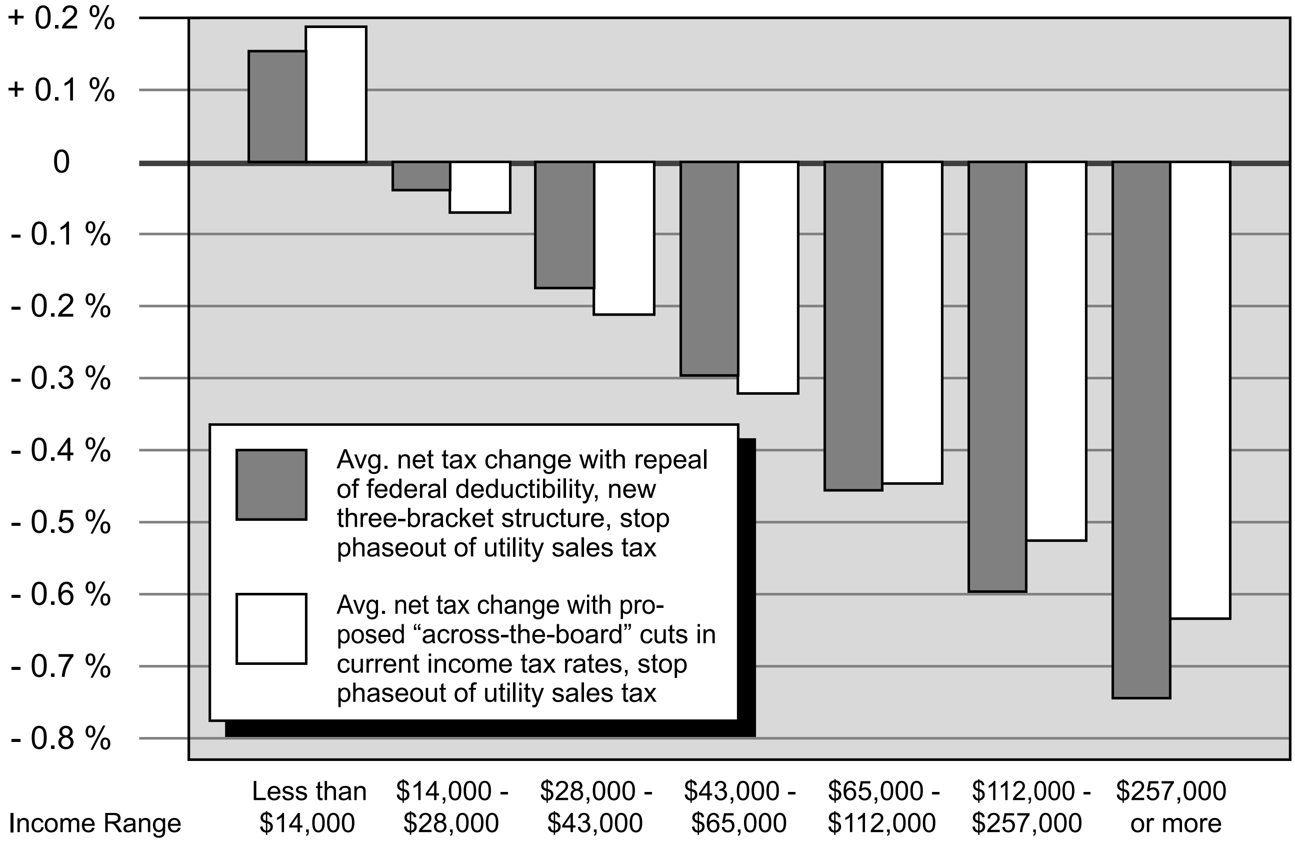
The major piece of tax legislation passed by the 2003 Iowa Legislature (but line-item vetoed by the Governor) was a massive cut in income taxes phased in over the next several years. Once again, the only progressive component of the tax system was the one that legislators attempted to cut. Once again, tax relief was targeted at the high end of the income distribution. At the top 1 percent – Iowa taxpayers earning an average of $561,400 a year – the average tax cut when fully phased in would be $3,730. At the bottom 20 percent, with an average income of $8,500, the cut would be $8. At the next 20 percent, with an average income of $20,800, the cut would be $60.

The bill passed by the House and Senate also provided for the option of a three-bracket structure, without a state tax deduction for federal income taxes paid, if the state Constitution were amended to allow 41 House members or 21 senators (40 percent plus one vote in either House) to block a tax increase. Under that structure, the top 20 percent of income earners would see a bigger tax break. The $561,400 earner would gain another $621, with a $4,351 tax cut.

To make matters worse, the income tax cuts were coupled with a freeze in the phaseout of the sales tax on utilities. The utility sales tax phaseout passed in 2001 promised tax relief across the spectrum of Iowa taxpayers. In fact, the middle 60 percent of Iowans get a comparable percentage of the relief from this measure. In contrast, the bill would have rolled back that broad relief in order to finance relief targeted at the highest-income earners. The lowest-income Iowans – the 20 percent with less than $14,000 income – would pay higher taxes under the bill for each of the next five years. This is because the higher sales taxes they would pay on utilities would be three to five times the small amount they would save on income taxes. In addition, the next 20 percent of Iowans would pay slightly higher taxes over the next three years because the higher utility sales tax burden would exceed their income tax cut.

The figure on the following page illustrates how the income-tax cuts that were approved by the Legislature would affect people at various income levels when combined with a utility sales-tax freeze.

Impact of Two Income Tax Cuts, Fully Phased In, Coupled with Freeze in Phaseout of Utility Sales Tax – Tax Change as a Percent of Income



Source: Institute on Taxation and Economic Policy, June 2003

Sales Tax

The only true reform instituted by the Legislature was to put Iowa into conformance with a multistate agreement on the sales tax that will allow the state to begin collecting sales and use taxes on internet and mail-order purchases. Since internet purchases are undoubtedly made disproportionately by middle- and upper-income taxpayers, the failure to tax internet sales actually made the sales tax more regressive. This reform measure will thus not only increase state revenues and stabilize the sales tax base, but will have a mildly progressive effect on the overall tax system.

Property Tax

The governor threw out the challenge to the Legislature in January to completely overhaul the property tax system, replacing it with something fundamentally different. The Legislature struggled with a variety of reform proposals during the session, but in the end rushed through an ill-conceived plan that would do little or nothing to simplify the property tax system, would replace the objective market value standard for assessing buildings with an arbitrary square-footage tax, and would impose uniform rates of land assessment throughout a county (so that an acre of swamp would be valued the same as an acre of prime downtown commercial land). The system will be less fair and will have harmful unintended consequences on property markets. It will be tested in three counties, so there is hope that it will never actually be implemented.

An Agenda for Real Tax Reform

Real, progressive reforms to Iowa's tax system should begin with a recognition that the current system fails when evaluated against tax principles. It is not fair – higher income taxpayers pay a smaller percentage of their income in taxes than lower- and middle-income taxpayers, and there are many instances where individuals and business in like circumstances are taxed differently. The overall system fails to generate adequate revenue; there are "structural deficits" in the system, meaning that surplus revenues generated in good times, if put into a rainy day fund, would not be adequate to sustain state and local budgets during a recession. The corporate income tax and the sales tax in particular suffer from an eroding base, due to loopholes in the income tax and failure to modernize the sales tax base. Elements of the property tax system fail on multiple grounds, notably a lack of accountability, as well as unfairness and economic inefficiency. Here we propose what we think are the most important reforms that should be on the public agenda to address these problems.

Corporate Income Tax: Closing the Loopholes

There are two major loopholes in Iowa's corporate income tax that should be closed both on grounds of fairness and to restore revenues that have been lost to the increasing use of tax avoidance strategies by corporations. These loopholes could be closed by requiring "combined reporting" (a measure proposed by the Governor but not taken up by the Legislature) and by requiring "throwback sales" to be counted.

Combined Reporting

One way for multistate corporations to reduce state taxable income is by paying royalty income to a "parent" company in a tax haven state. Other states have taken one of two tracks to eliminate such tax avoidance: requiring combined corporate reporting for the corporations or specifically disallowing a deduction for royalty income. Iowa has neither provision in place.

Under combined reporting, now in place in 16 of the states with corporate income taxes, a firm is required to combine the income of all of its related affiliate corporations prior to having that income apportioned. This is a very effective way of preventing a range of tax avoidance strategies that involve shifting profits from a corporation's operations in states where it is taxed to its affiliates in states where it is taxed lightly, or not at all.

One of the most common strategies, particularly among retailers, is to set up a shell corporation in Delaware or Nevada. The shell corporation is incorporated in Delaware as a subsidiary of the parent corporation and then acquires the corporate logo or trademark. All retail stores are then required to pay royalties to the Delaware firm. The royalties are deductible as a business expense in the states where the firm actually does business, thus reducing the firm's taxable income in those states. Since Delaware does not tax royalty income, this scheme converts taxable income in states where the stores are located to tax-free income in Delaware.

Such tax avoidance schemes significantly impact Iowa Corporate Income tax revenue. Among the major U.S. firms that are known to use "intellectual property holding companies" to avoid paying state income taxes are the following businesses with a substantial presence in Iowa: American Greetings Corporation, Budget Rent-A-Car, Burger King, CompUSA, ConAgra Foods, Dress Barn, Gap, Home Depot, Honeywell International Inc. and Subsidiaries, Kmart, Kohl's, Long John Silver's, Marsh Village Pantries, Marsh Supermarkets, Payless Shoes, Radio Shack, Sherwin-Williams, The Limited Brands, Tyson Foods, Circuit City Stores, Staples, and Toys "R" Us.

The Iowa Department of Revenue estimates that combined reporting would generate $30 million in revenue in fiscal year 2004 and $40 million in 2005, taxes now being lost because of increasing exploitation of this loophole. Closing this loophole, as an increasing number of states are doing, would not affect Iowa's competitive attractiveness. Almost all of the firms on the above list are retail corporations. They locate stores where the market is, and are not going to be dissuaded from opening new Iowa outlets simply because Iowa decides to join the list of states plugging a tax avoidance loophole. Toys "R" Us cannot sell toys to Iowans from stores in Florida. Further, combined reporting would put all Iowa businesses on an equal footing, in particular by not giving an additional advantage to large multi-state retail organizations over in-state retailers who have no way to use this scheme or to other multi-state corporate citizens who have thus far not resorted to such tax avoidance strategies. Thus it improves fairness while shoring up revenues.

Throwback Sales

Any corporation doing business in Iowa and in other states is taxed only on the portion of its total income that is apportioned to Iowa. Iowa relies on "single-factor apportionment," meaning that the destination of the firm's sales is the only factor used in the apportionment formula (whereas most states rely on payroll and property as well). For example, if 20 percent of the firm's sales are destined for Iowa, then 20 percent of its profits are taxed in Iowa.

The majority of states with corporate income taxes (24 of 45) have a "throwback" provision. If Iowa were to adopt the throwback rule, a firm shipping goods from Iowa to another state where it has no tax nexus would have to count those sales as Iowa sales for purposes of apportionment; the sales are "thrown back" to the state of origin. Without the throwback provision, such sales are not counted by any state and the firm has tax-free "nowhere income." This creates an inequity when compared to comparable corporations without such "nowhere income," who are taxed on all their income. The absence of a throwback provision is a major loophole in a state such as Iowa, with single-factor apportionment. In other states, the payroll and property factors would result in some apportionment of such "nowhere income" since the goods are produced in-state.

There are no estimates of the revenue that would be raised by adopting the throwback rule, but it is likely to be significant. This reform would again treat like corporations more equally and have no detrimental effect on competitiveness.

Personal Income Tax: Making it Family Friendly

Iowa's income tax provides far less recognition of the cost of raising a family than does the federal income tax. For a middle-income Iowa family, facing a marginal income tax rate of 7.92 percent, the $40 Iowa credit is equivalent to an exemption of just $505, compared to the federal income tax which currently provides a $3,000 exemption per dependent, nearly six times as large. To put it another way, if Iowa allowed the same dependent exemption from income as the federal, but retained Iowa tax rates, that middle-income family would save $238 in taxes per child instead of the $40 under Iowa's credit. The result is that families with children can actually end up paying *more* Iowa income taxes than a family with the same income but with no children. This is because the family with children pays much less in federal taxes, which then gives it smaller deductions (due to Iowa's deduction for federal taxes paid) and hence larger Iowa taxable income.

Iowa's income tax could be made more friendly to families by substantially increasing the dependent credit or by increasing the Earned Income Tax Credit (EITC) and making it refundable. These measures would also do a great deal to increase the progressivity of the income tax and reduce the regressivity of Iowa's overall tax system. An increase of $25 in personal exemption credits and an expansion of Iowa's EITC from 6.5 percent to 20 percent of the federal (while making it refundable, as is the federal) would cost about $90 million annually.

Paying for Reform by Eliminating Tax Preferences

These important changes to the income tax could be financed, at least in part, by eliminating or modifying existing tax preferences that serve no useful public purpose. We discuss two such preferences here: the college savings deduction and capital gains treatment.

Currently, Iowa tax filers can deposit up to $11,000 annually into an Iowa college savings account used to pay a child's higher education costs. The earnings accrued on these accounts are tax deferred at both the state and the federal level – similar to an IRA. In addition, Iowa allows a state income tax deduction for the amount that is deposited into each college savings account up to a limit of $2,180 per child per contributor for 2002. Unlike IRAs, however, there is no income ceiling for the tax deduction. This means a deduction for high-income filers who already are in the best position to provide for their children's educational future. An income ceiling on the use of the deduction would better target this tax expenditure to those for whom it can make a real difference.

Iowa provides a special exclusion from income for capital gains on the sale of selected types of property when the taxpayer "materially participated" for 10 years in the property and the property was held for a minimum of 10 years. A major stated purpose for preferential tax treatment of such capital gains was to avoid the forced liquidation of an asset, such as a family farm or family business, when it was sold or taken over by a lineal descendant. Even if preferential treatment is to be provided for this type of capital gain, however, it could be much less than a total exclusion. Fifty percent of such capital gains could be subject to taxation. If the concern remains that lineal descendants would be jeopardized, those gains could be deferred until a future sale in instances where the property is sold to a lineal descendant who also materially engages in the business.

The Property Tax: TIF Reform

The property tax system in Iowa, despite assertions to the contrary, actually functions quite well overall. The rollback system is often criticized for being confusing and for constraining local government revenues, but it has accomplished what was intended: It has prevented a shift in burden from other classes of property to residential property. A component of the property tax system, however, Tax Increment Financing, is in need of serious reform.

Tax Increment Financing is under fire in Iowa, driven by an expansion of its use that has even the Iowa League of Cities proposing modest reforms. Despite disagreements over their effectiveness, TIFs carry important implications for local and state finances as their valuation has increased more than fivefold in the last decade. For example, the state will spend $28 million in fiscal 2003 in state aid to compensate school districts for property value they may not tap due to TIFs.

TIF evolved out of 1950s and 1960s urban renewal laws that focused on the redevelopment of "blighted" urban areas. The belief was that redevelopment would not occur without public help. With TIF, a city might undertake potentially risky investment in blighted areas if it could share the risk, and direct all new revenue from the improved area to pay off the investment. The city and other jurisdictions

– schools, counties, community colleges, for example – would pass up immediate tax revenue for their regular operations, but everyone would benefit in the end. This simple and straightforward argument appeals both to fairness and to efficiency.

So, does it work? That is not clear. While TIFs have been employed widely in Iowa both in blighted areas and for other purposes, little actual detailed analysis has been conducted to determine if they actually stimulated investments that would not have occurred otherwise, or helped residents with the most at stake in seeing blighted areas improved.

The law is flawed. Its looseness has allowed TIF to expand well beyond its original purposes. As one result, TIF projects often start well after the private investment, resulting in a tax break as a reward, not an incentive. It's supposed to work the other way – with TIFs causing the private investment. It also lets a city expand a TIF district, ignoring the original project and allowing continued use of the funds for an unrelated project. TIF district lines can create conflicts of revenues from one school district being used in another. TIF funds may be used for non-profit or governmental projects that won't generate taxes – and thus won't pay for themselves. Plus, cities may use TIF to avoid limits on tax abatements, and avoid voter-approval requirements. All of these are among problems with the current law.

Reforms should start with a moratorium on TIFs and new TIF debt, and all existing districts should expire as of the date the current debt is retired. New projects would have to meet requirements of a new law. TIF should (1) be required to serve a public purpose; (2) be limited in its use; and (3) be structured and approved in a manner to assure accountability. Here are some suggestions:

- Require a finding that the investment serves a public purpose and defend the finding on grounds that private redevelopment would not reasonably be expected to occur "but for" the public investment.
- Require a showing of how a TIF in a blighted area will benefit the residents of that area. Any TIF project that will displace residents should be put to a referendum.
- Prohibit use of TIF to finance tax abatements.
- Limit TIF districts to 15 years.
- Require TIF districts to be drawn within the same tax administration district (only one school district can be part of one district, for example).
- Enact protections to assure other limitations on local government – such as referendum requirements – are not circumvented by use of TIF.
- Require approval of other jurisdictions affected to implement economic development TIF projects, and prohibit use of TIF for retail uses, with few exceptions.
- Prohibit use of TIF as an incentive for a firm to relocate from elsewhere within Iowa.
- Establish wage and benefit standards for employees of any private firm to be assisted by an economic development TIF.

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For more information:

The Iowa Policy Project, the Child & Family Policy Center and the Institute on Taxation and Economic Policy have cooperated on several reports about tax issues in Iowa in 2003. The following papers produced in 2003 are available as free downloads from the Iowa Policy Project website, http://www.iowapolicyproject.org.

Iowa Taxes: Who Pays? Poor, Middle Income Iowans Hit Hardest

Iowa Taxes: Average by Any Measure

Flat Taxes: Not So Simple; Study Examines Fairness, Revenue Issues

Reforming TIF in Iowa; Report Suggests Moratorium, New Limits

Budget Savings Seen in Tax Preferences; Six Places to Close Loopholes

Who Pays with Cigarette Tax Hike, New Income Tax Cuts

Myths vs. Reality: Tax Cuts and Economic Growth

Proposed Iowa Tax Cuts Geared to Wealthiest