

**Everything You Wanted to Know
About Closing Tax Loopholes
and Balancing Iowa's Budget...**

...But Were Afraid to Ask



**A One-Hour Crash Course on
Balancing Iowa's Budget**

updated February 2004

About This Report

This guide was developed by the Iowa Policy Project and the Child and Family Policy Center. IPP and CFPC are partners in the State Fiscal Analysis Initiative coordinated by the Center on Budget and Policy Priorities and involving research and policy organizations from twenty-seven states. Information about SFAI can be found on the Center for Budget and Policy Priorities' website: www.cbpp.org

IPP and CFPC have produced a number of other reports on tax and fiscal policies, available at www.iowapolicyproject.org and www.cfpciowa.org.

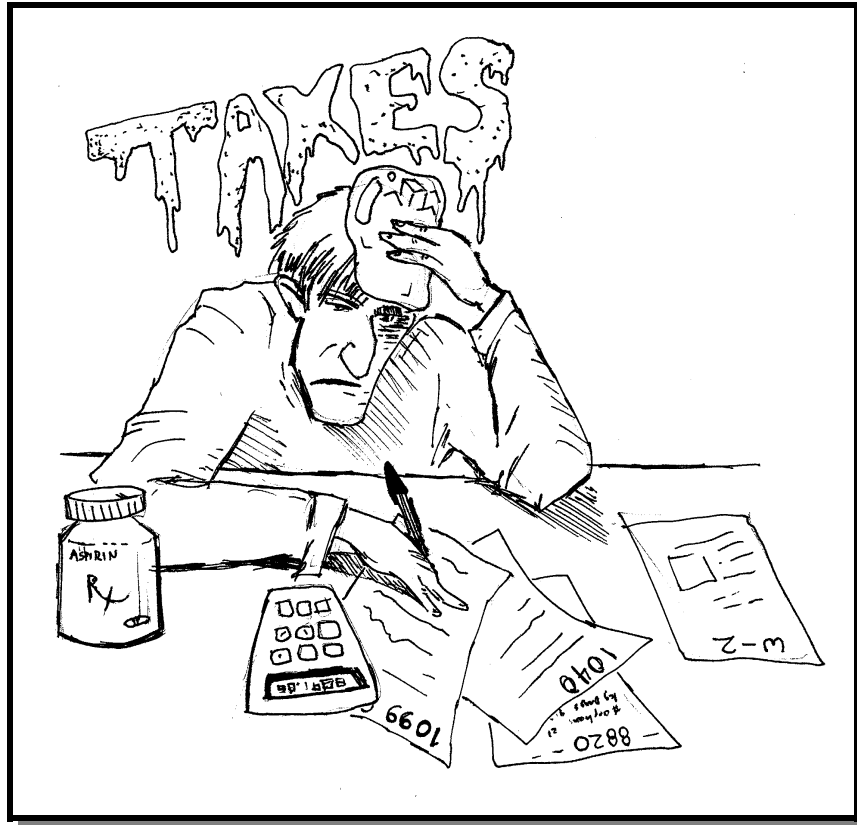
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Everything You Wanted to Know About Closing Tax Loopholes and Balancing Iowa's Budget

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Introduction: Everything You Wanted to Know About Closing Tax Loopholes and Balancing Iowa's Budget

Nobody likes to pay taxes. Yet we all know that taxes are a part of life. They are needed to:

- operate our schools and educate our children
- fund police and fire departments and protect our communities
- regulate our businesses and protect the environment

Not many of us want to know too much about our tax system; simply getting our own income taxes completed and other taxes and fees paid can be headache enough. The tax system is a complicated system of income taxes, property taxes, excise taxes (cigarette, liquor and gasoline taxes) and sales taxes.

Unfortunately, we do need to know something about our tax system. We need to know enough to hold our elected officials accountable for making it a fair tax system that funds the services we need.

The problem with taxes is that "the devil often is in the details." Many of the things that make our tax system complicated are provisions that are enacted to benefit a few people or businesses, little "tax loopholes" that one by one may seem small, but taken together can really add up. Woody Guthrie once wrote in a song, "Some will rob you with a six gun, and some with a fountain pen." When it comes to our tax system, the fountain pens have been busy.

Over the last 10 years, the Iowa General Assembly passed tax cuts that, when fully phased in, will reduce state revenue by over \$800 million dollars annually. What most people don't know, however, is that the biggest share of these tax cuts went to the wealthiest Iowans (earning over \$200,000 per year). This was the same period when the wealthiest

Iowans also were the biggest beneficiaries of the country's economic growth; their income went up three times faster than that of the average Iowa family. In short, from 1990 to 2000, "the rich got richer... and the rich got tax breaks."

Now, with the recession and slowdown in the economy after the economic boom, as well as tax cuts that have reduced revenues, the state of Iowa has been forced to cut funding – for schools, for services to children and the elderly, and to local governments to fund police and fire departments.

Politicians don't want to talk about the "T" word – taxes – because they say the public opposes any tax increases. But not all taxes were created equal. Even if we didn't have a budget problem that was threatening our schools and our local services, we should examine our tax system regularly and carefully. We should eliminate tax loopholes that do not serve a public benefit, and we should make the tax system more fair.

This guide is about Iowa's tax system. It highlights a few of the most costly and indefensible (e.g. bad) tax loopholes. Following the description of these tax loopholes is a discussion of what has happened to our tax system overall and how that has threatened Iowa's ability to provide needed services.

The bottom line of this guide is simple: *Iowa needs to close tax loopholes and make our tax system more fair.* Our hope is that, if enough people make this message clear, our Governor and our state legislators will make these needed changes to our tax laws.

Part One: Tax Loophole Enemies We Need to Capture

Beauty is in the eye of the beholder, and so are tax loopholes. One person's tax loophole is another person's justified tax exemption. At least that is what lobbyists argue in order to get a tax loophole enacted into law.

Yet any tax exemption needs to be justified in terms of serving a broader public need. While state expenditures for services must be scrutinized, debated and voted on every year, tax exemptions simply go on the books and stay there, year after year, unless repealed by the General Assembly. Tax exemptions need to be scrutinized periodically, perhaps by a citizen's commission, to determine if they do in fact serve a public purpose or simply drain the treasury for the benefit of a few.

In the short term, however, and that means now, this legislative session, there are some tax loopholes that clearly are unjustified and need to be closed. We have identified seven as the "most wanted tax loophole enemies" and describe each below. They may have esoteric names, but they have simple impacts; they rob the state treasury of funds needed to maintain essential public services.



- Corporate income tax treatment of "passive investment companies"
- Corporate income tax "nowhere" income provisions
- Estate tax repeal
- Capital gains special treatment
- College savings exemptions for the wealthy
- Hog confinement property tax exemptions
- "De-Nexed" corporate profits



Tax Loophole Enemy Number One: Corporate Income Tax Treatment of Passive Investment Companies (PICs)

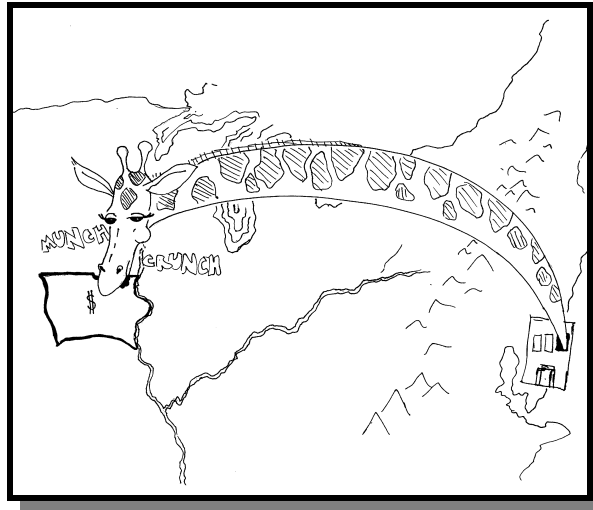
You might wonder why over 600 corporations have their headquarters in a not very large building in Wilmington, Delaware. How could the CEOs and other top staff of that many corporations fit into one building? The answer is simple: These are shell corporations. They have no real staff, and their only function is to serve as a tax-free haven for corporate profits.

One of these corporations is Geoffrey, Inc., a subsidiary of Toys “R” Us. Yes that’s right, they named the company after Geoffrey Giraffe. Since Geoffrey isn’t real, he doesn’t take up any space. All he does is own the Toys “R” Us trademark, and collect royalties on it. A pretty easy day’s work for a stuffed animal, or for anyone.

Here’s how the tax loophole works. As an example, consider Toys “R” Us, which the *Wall Street Journal* has identified as one of the companies that has used this loophole in at least some states. Toys “R” Us is required to pay state income taxes on the profits it makes from its stores. In determining what profits are *taxed* by a state, however, Toys “R” Us can deduct from its profits the royalties its stores pay to Geoffrey for use of the Toys “R” Us name.

Geoffrey is incorporated in Delaware, and this is where the loophole occurs. Why? Because Delaware does not tax royalty income. Thus, if Toys “R” Us were to use this loophole, its profits earned in Iowa disappear, and part of its Iowa tax burden goes with it. Geoffrey, Inc. and hundreds of other Passive Investment Companies, or PICs, have been established in Delaware, where they can shift profits that would have been taxable in Iowa and many other states. In Delaware, those profits go tax free. It is a tax avoidance scheme, and it is perfectly legal. (Incidentally, Geoffrey Inc. can transfer these profits back to the parent corporation Toys “R” Us in the form of nontaxed dividends or it can loan the money back and let Toys “R” Us deduct the interest and escape further taxation!)

Fourteen states (including Illinois, Nebraska and Minnesota) have closed this PIC loophole by requiring “combined reporting” of profits. Under combined reporting, all profits from the instate business (such as the Toys “R” Us stores) and any out-of-state subsidiaries (such as Geoffrey, Inc.) must be combined and reported on the Iowa return, including any royalties earned by the PIC



subsidaries. The royalty deduction no longer reduces the company’s taxable profits because it is added back in as income for the subsidiary. The company then is taxed fairly on what are legitimate profits made in the state.

Below is a list of large, multi-state businesses that the *Wall Street Journal* identified as using these loopholes in at least some states in which they do business:

- American Greetings
- Budget Rent-A-Car
- Burger King
- Comp USA
- ConAgra Foods
- Dress Barn
- Gap
- Home Depot
- Honeywell International
- K-Mart
- Kohls
- Long John Silver’s
- Payless Shoes
- Radio Shack
- Sherwin Williams
- Stanley Works
- The Limited Brands
- Tyson Foods
- Circuit City Stores
- Staples
- Toys “R” Us

This practice not only robs the Iowa treasury, but also is unfair to local businesses that compete with these companies for sales, and to other national corporations doing business in Iowa that have not resorted to the PIC device to avoid state taxes. Local businesses pay taxes on all their profits; they have nowhere to shift them.

It is not possible to know for sure which companies are using PICs to avoid taxes in Iowa, because tax records are not public information. Iowa did make an effort to close this loophole in 1995, when Iowa law was changed to define intangible property as subject to the corporate income tax. Half the companies that Iowa has assessed taxes on as a result of this change have refused to pay and are appealing this action as unconstitutional, however, claiming no taxable “nexus” in or connection to the state. Combined reporting is needed to completely close the PIC loophole and withstand legal challenges.

Tax Loophole Enemy Number One takes a huge chunk out of Iowa’s tax revenue. Iowa Department of Revenue estimates vary, depending upon the tax year examined, but show this loophole and others that could be resolved by combined reporting to be in the \$25 million—\$40 million range. That’s real money that could be used to support state and local services.

\$25—\$40 million





Tax Loophole Enemy Number Two: Corporate Income Tax “Nowhere” Income Provisions

When it comes to large corporations that do business around the world, tax preparation can get pretty complicated. They have to file federal returns and returns in all the states (and other nations) where they do business and are taxed.

Their staffs of tax attorneys and accountants are not paid simply to add and subtract accurately and to make sure to dot all the “i’s” and cross all the “t’s.” They are paid to make sure these corporations pay as little in taxes as possible.

One of the things these corporations have to do when they file state tax returns is to apportion the corporation’s income among the states in which they do business. They have to follow each state’s rules to determine how much of their nationwide income is assigned to Iowa and how much is assigned to California, Missouri, or Kentucky. The rule in Iowa is actually quite simple; it is based on how much of their sales are in Iowa. If 10 percent of the corporation’s sales are in Iowa, 10 percent of their income is taxed by Iowa.

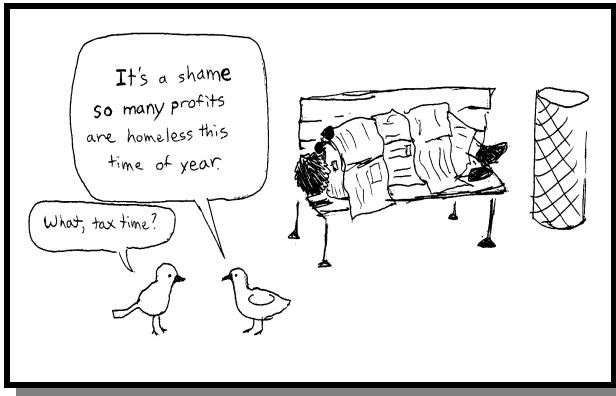
When they add up all the income they report from all the states, it should add up to the same income they report to the federal government, the IRS.



Only it doesn’t.

There is some income that is taxed at the federal level, but is not taxed at the state level. This has been called “nowhere income.” It is earned, all right, but it seems to come from nowhere. This happens when a corporation earns income in a state where it does not have a “taxable nexus” (see Tax Enemy Loophole Number 7 for a discussion of this “de-nexused” income). In the process of apportioning income to Iowa, that income will not be assigned to Iowa and will go untaxed.

Let's take a simple example. Suppose John Deere makes a tractor in Waterloo and sells it to a dealer in Illinois. The income on that tractor gets taxed in Illinois because the sale is in Illinois, not Iowa, and John Deere has a tax nexus (it owns lots of property) in Illinois. But



suppose instead Deere ships the tractor to a state where the company has no facilities, and no tax nexus. The income on that tractor doesn't get taxed in that state (no nexus) and the profits don't get taxed in Iowa either (because the sale is outside of Iowa). That is nowhere income.

This "nowhere income" really deserves a home. Twenty-four states have provided a home by requiring that this "nowhere income" be apportioned or "thrown back" to the state where the income originated. In our example, the profits on the tractor shipped to the nowhere state get thrown back to Iowa, because that's where the tractor was produced. All of John Deere's profits thus get taxed somewhere.

Most Iowa businesses get their income from their sales and activities in Iowa. Yet they also may compete with multi-state corporations that make profits all over the country. To be fair, both should be taxed on all the income they make.

\$10—\$15 million



Giving this "nowhere income" a home would also give the Iowa state treasury a much needed \$10 million—\$15 million in additional revenue.



Tax Loophole Enemy Number Three: Estate Tax Repeal

Everyone has heard the saying, “the only sure things in life are death and taxes.” After what the U.S. Congress and the Iowa General Assembly have been doing, however, this should now read, “the only thing sure in life is death or taxes.”

Under current law, the Iowa estate tax is being phased out and will be totally eliminated in a few years, as a result of Iowa’s coupling with the federal estate tax law phase-out.

When members of the public are polled, they generally say they do not like the estate or death tax. It seems kind of heartless, to come to collect taxes after a loved one has died. They may think that it will be a lot of headache and additional paperwork, as well. Most of that paperwork comes, however, from probate and the necessary work dividing up the estate according to the last will and testament.

In fact, only the richest three percent of all Iowa estates pay any estate tax at all. When people die and leave assets, these assets do have to be given out, which is the reason for having a will. Generally, people give their assets to their loved ones, sons and daughters and grandchildren.

In 2005, the first \$1.5 million of any estate that is given to heirs is exempt from any estate tax. This means that each parent can give, tax free, \$1.5 million to his or her heirs, \$3 million in all for a couple. Any money that is given to charity also is absolutely free from tax. After the \$3 million and charitable exemptions, the remaining money is subject to a tax rate; less than half of the remainder ever goes to government. This is why there are estate planners – they help make sure that taxes on estates are minimized.

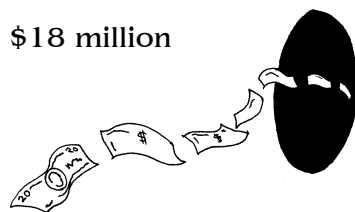
Now one of the arguments against the estate tax is that it is “a tax on a tax.” People earned the money and paid taxes on it as they earned it, so they shouldn’t be taxed again. In fact, a good portion of the wealth

in big estates (the three percent that are subject to the estate tax), may never have been taxed. It could be IBM stock that was bought at \$10 a share, or it could be property or a business whose value has grown over the years. Taxes on these assets are deferred until they are sold, or until taxed as part of an estate. Furthermore, if the estate tax is repealed, the taxes will never be paid. Again, the first \$1.5—\$3.0 million is not taxed, however the income is made.

A second argument against the estate tax is that it can mean a parent cannot pass a farm or business on to his or her sons and daughters. The estate tax will require that the farm or business be sold. This is really an “urban legend” (or, in the case of farms, a “rural legend”). There are no circumstances where the tax has forced such sales (remember, we are talking about BIG estates here). Iowa’s own authority on agriculture, Neil Harl, has not been able to find any instances of farmers trying to pass their farmland on to their heirs to continue farming who couldn’t because of the tax. Of course, there might be several sons or daughters with each getting a share of the estate and it might have to be sold in order to distribute the money, but that is a family, and not an estate tax, issue.

In fact, if there is any tax on the estate, that means the value of the business or farmland would be big enough to make refinancing very available. Further, the Iowa estate tax could easily be changed to allow for deferral of any taxes as long as the business or farm was still run within the family. That would make more sense than not taxing it altogether.

The estate tax repeal benefits only the very wealthy. Somehow, it has been sold as a people’s issue, but it is not. Stopping the phase-out and repeal of the estate tax, which 17 states have done, would save the Iowa treasury \$18 million in 2004–5.





Tax Loophole Enemy Number Four: Capital Gains Special Treatment

“This legislation has become a Christmas tree!” a legislator bemoans. That means the legislation has been loaded down with “special interest” amendments or “ornaments,” little gifts to various groups or individuals. This can occur in spending bills, where it is sometimes known as “pork” (as in “pork barrel legislation”), but it also occurs in tax bills. In spending bills, it usually involves a one-time expenditure, but in tax bills it can go on and on, year after year.

In the 1980s, Iowa created an income tax Christmas tree that actually contained Christmas trees! Here’s what happened.

The federal government enacted massive tax cuts, particularly by lowering top income tax rates, but it also eliminated a special provision that taxed capital gains at a much lower rate than other income or profits. The exchange for lowering rates was to eliminate provisions that would “shelter” income from taxation, and capital gains were one of these shelters. A “capital gain” is the profit individuals or corporations receive when they sell something that has gone up in value—like stocks or real estate or an entire business. Unlike wages or earnings from dividends or savings accounts, people are not taxed on gains they make from investing in businesses until they actually realize (sell) the gain. When they sell, they have to pay income taxes on the profit they made. Since the profit may be over a number of years, it can be a much larger sum than if it were taxed year to year.

Until the federal change, there was a partial exemption on capital gains income in the federal income tax code, and Iowa’s income tax went along with that exemption. The rationale for the exemption in the first place was to encourage people to invest for the long term.

When that partial exemption was repealed at the federal level, some legislators in Iowa still wanted to continue it at the state level. In a “compromise,” Iowa established its own capital gains provision that only applied to sales of businesses where the taxpayer had “materially

participated” for ten years, and some ornaments including capital gains on cattle and horses used for breeding, other breeding stock, and timber held for more than one year, including evergreen trees such as Christmas trees. The logic was that Iowa should support people who built up their own businesses.

Only the law didn’t provide a partial exemption on these profits, it provided a *total* exemption. This is now profit in Iowa that is not taxed at all at the state level. Later, the federal government reinstated some preferential treatment for capital gains taxes, and Iowa went along, but it did not change (and actually expanded) its special total exemptions.

While there may be some benefit to providing a limited capital gains benefit for home grown businesses, the exemption shouldn’t be total and it should have some maximum size attached to it. Cutting this capital gains exemption down to size could reduce the drain on Iowa’s treasury by at least \$20 million—\$35 million.

\$20—\$35 million





Tax Loophole Enemy Number Five: College Savings Exemptions for the Rich

A college education is important, but it is expensive as well (particularly since recent budget cutbacks have forced Iowa universities and community colleges into double-digit tuition increases). People are urged to plan ahead and save for their children's higher education.

Congress and the Iowa General Assembly have established special tax provisions to encourage such saving. Most of these are, in some measure, "income-tested," meaning they are limited to people with certain incomes. The reasoning is that, when people have a great deal of income, they do not require incentives to do such saving.

One of these tax provisions, however, does not have an income limitation on eligibility. It is known at the federal level as the "529 savings plan," a tax plan that states can develop and use. You can find a lot of information about it on the web, much of it extolling 529 plans for their tax avoidance, rather than their education, virtues. A 529 plan allows people to deposit funds in a special education account for their children (or grandchildren), with earnings on that money not subject to any tax, until the time the money is withdrawn (when it is taxed at the student's, rather than the parent's or grandparent's, tax rate). In other words, it is a way of sheltering dividend or capital gains income, nearly entirely.

That is how the federal system operates, but the Iowa General Assembly went one step further. In addition to sheltering the appreciation of these assets from taxes, Iowa offers an immediate income tax deduction on the first \$2,200 of money put into a savings account. For a family making \$25,000 a year, that is worth about \$100 per year in reduced state income taxes. For a family making \$250,000 a year, it is worth about \$200 per year in reduced state taxes. While the family making \$25,000 per year would have to scrape to put aside this money, the family making \$250,000 a year can get a deduction for the \$2,200 contribution for each child, and each parent can give the money. With two kids and two parents, that could add up to \$800 in lost state income tax.

Those kids in that \$250,000 family will probably be able to go to college (even one of those Ivy League colleges) anyway, whether or not their parents have a 529 plan.

Can you guess who uses this opportunity to shelter income?

Many states set an income limit on who is eligible for the College Savings Plan deduction. If Iowa set a reasonable limit (say \$100,000 for an individual, \$150,000 for a two-parent family), that would save the state treasury \$1 million—\$2 million. That could provide full scholarships to Iowa, Iowa State, or the University of Northern Iowa for 200 students who really needed the help. Which would do more to assure that kids in Iowa have access to the higher education they deserve?

\$1—\$2 million





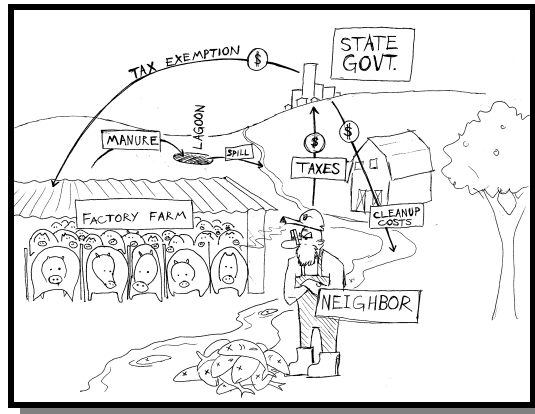
Tax Loophole Enemy Number Six: Hog Confinement Property Tax Exemptions

It used to be that family farmers raised a lot of the hogs in Iowa, but that is no longer the case. Now it is corporations establishing big hog confinements, which also produce a lot of concentrated waste (in layman's terms, manure).

This waste has to be stored somewhere, and that has led to the building of anaerobic lagoons (in layman's terms, manure pits). They have to meet certain federal requirements (which many feel are not strong enough), including some equipment to control pollution.

Now these hog lot confinements strain local government resources. They put wear and tear on local roads and produce health risks and costs. The property taxes they pay do not cover these costs.

Whatever you think about these hog lots, the economics show they don't pay their fair tax share.



Yet, when the Iowa General Assembly extended pollution control property tax exemptions to agriculture in 1988, this included the equipment on these manure pits.

The result is a property tax exemption that involves a further loss of property taxes for the very local governments that need to deal with the additional costs that hog lots produce. The cost in lost property tax revenues statewide is about \$5 million annually.

That's a smell that needs to be eliminated.





Tax Loophole Enemy Number Seven: “De-Nexed” Corporate Profits

Most people have not heard about PL 86-272, enacted by Congress in 1959. It deals with an arcane word, “nexus.” “Nexus” means “connection” and applies to whether a business can be considered to have a “connection” to a state and therefore be subject to that state’s corporate income tax. PL 86-272 states that a business is not doing business in a state:

- if it is only soliciting orders for sales of goods (through salespeople working out of their homes or doing sales and nothing else),
- if orders are sent out-of-state for approval, and
- if orders are filled by shipping goods in from out-of-state.

If a business has a physical presence, such as a store, or it installs or repairs what it sells, it does have a “nexus” and can be taxed. Yet businesses can have fleets of traveling salespersons and sell hundreds of millions of dollars of goods in the state and make millions of dollars of profit by doing so, but not be taxable by the state. This also applies to a subsidiary selling an important manufactured part to a single other business assembling that into a finished product.

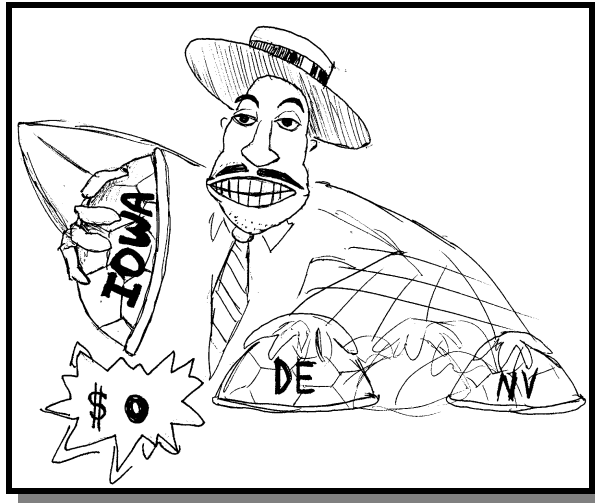
This is a huge loophole. Businesses can establish sales fleets to travel and market their goods, without establishing a nexus. If they also need to install or service what they sell (computers, manufacturing equipment, medical equipment), they can create a separate limited liability partnership (LLP) subsidiary to do the installation and service, therefore keeping the profits from their sales free of Iowa income tax. (Can you guess whether the sales company or the servicing company is making a profit?).

Of course, the company does have to pay taxes in the state where it does have that taxable nexus (which might be Nevada, where there is no corporate tax).

This is kind of like the old shell game, but don't ever go looking for any money to be underneath the shell that ends up on the spot marked "Iowa."

The good news is that PL 86-272 only applies to the sale of goods, and not to services or intangibles (although some in corporate America want to extend it to sale of services and intangibles). The bad news

is that PL 86-272 is a federal law, and the Iowa General Assembly cannot change that.



Still, there is something Iowa government can do. Iowa government is a significant purchaser of a lot of goods and services. Iowa could insist, in its procurement policies, that goods are purchased from corporations, or limited liability partnerships, or whoever, that actually have a taxable nexus in the state. (At a minimum, it could require that businesses state whether or not they do have a taxable nexus in the state, as a start of some public accountability.) That is giving profits made in Iowa an appropriate Iowa home.

We do not have any estimate of what this would bring into the state, because we do not know how much we are losing today, which should make us all nervous.



Conclusion

When all these tax loopholes are added together, the drain on Iowa's treasury is pretty significant:

Corporate Tax Treatment of Passive Investment Companies	\$25—\$40 Million
Corporate Tax "Nowhere Income"	\$10—\$15 Million
Estate Tax Repeal	\$18 Million
Capital Gains Special Tax Treatment	\$20—\$35 Million
College Savings Exemptions for the Wealthy	\$1—\$2 Million
Hog Confinement Property Tax Exemptions	\$5 Million
"De-Nexed" Corporate Profits	\$???
Total	\$79—\$115 + Million

These loopholes need to be closed, and that is something that can happen this legislative session. The next part of the guide shows why we need to do this now, to begin to balance next year's state budget.

This loophole closing is not a one-time deal, however. We need ongoing overall scrutiny of Iowa's tax code for such tax loopholes and tax expenditures that do not serve a public purpose. Remember, this is not a complete list of tax loopholes; it is only a start. Iowa citizens need to be involved in this work and oversight, if we are to have a truly fair tax system.

Part Two: A Broader Look at Needed Changes to Iowa's Tax System to Address Iowa's Budget Needs

Closing loopholes is one important aspect of tax reform, but the whole Iowa tax system also needs to be reviewed and changed. This part of the Guide discusses Iowa's tax system, in the context of Iowa's budget needs. Iowa government does not tax just for the sake of taxing, it does so to fund schools, services, and support local governments.

Again, most folks do not want to become Iowa state budget experts. Yet folks need to know something about the budget, if they are to hold their elected officials accountable for making good use of the tax money that is collected and, more importantly, assure that the tax system collects money from the most appropriate sources.

This section addresses three things about Iowa's budget and tax system:

- Where we are today – and what's in store for 2005
- How we got to where we are – and who were winners and losers
- What we need to do – and why we need true tax reform

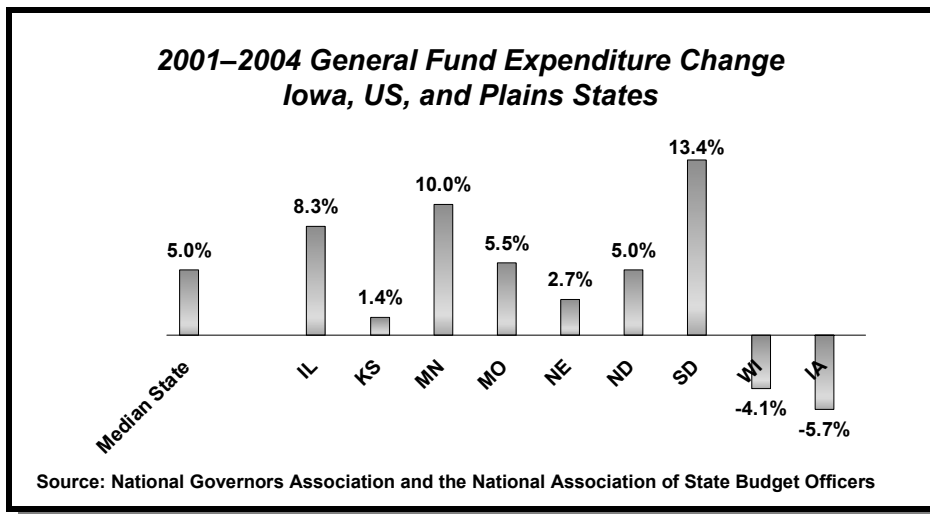
Where We Are Today – and What's In Store for 2005

Over the last decade, when times were good, the Iowa General Assembly cut a whole variety of taxes. Not all the cuts received the attention they deserved, but they were enacted and they are here now.

When times got tougher (the recession), these tax cuts continued to be in place (and some were still being phased in and getting even larger). The result was that Iowa government did not have enough revenues coming in to match what it had been spending on services. In short, in boom times, the Legislature acted like the grasshopper in the ant and the

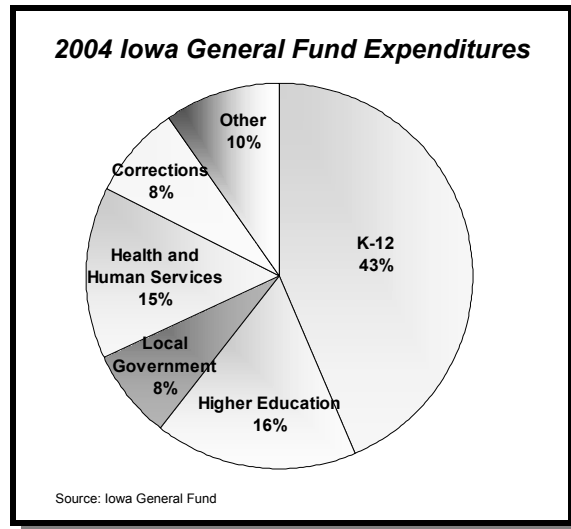
grasshopper story, and pretended there would never be a winter. In 2001, winter came. Revenues stopped growing and the state had to cut back. And Iowa's cutback was more severe than almost any other state. In fact, Iowa was one of only a handful of states to see its general fund expenditures actually decline in each of the last three years. Iowa's 2004 state expenditure is actually 5.7 percent smaller than it was in 2001. If you add in the impacts of inflation, the spending reduction is over 10 percent. That is a lot of belt tightening.

The Chart below shows how Iowa's spending over this period compared with neighboring states and the average state in the country. A lot of people talk about cutting the fat out of state government to make that belt tightening possible, but people also don't want to cut out into the muscle or the bone. That is counter-productive, if not downright dangerous.



So people need to know what is in the state budget. It turns out that most of the budget goes to the education of our children, support to local governments, the care of our seniors and children and those with disabilities or special needs, and public safety for our citizens.

The pie chart shows how much of the current Iowa general fund budget goes for these things.



Schools are the largest part of the budget pie. In the first couple of years of state expenditure cuts, many schools were able to address budget shortfalls with their reserves or through property taxes instead of state aid. Now, however, many schools are laying off staff and giving in to larger class sizes. The public generally wants to see more investment, not less, in education, but state budgeting now is going in the opposite direction.

State universities and community colleges are the next largest piece. Our state's long-term economic growth is dependent upon Iowa's children going beyond a high school diploma. The results of the cutbacks to date, however, have been that students face drastically higher tuition and more difficulty getting into the classes they need. Tuition hikes are an indirect form of tax increase on working families wanting to help their children get ahead, as most parents know.

Spending on health care and human services is another large chunk, and this is where people are most likely to think there is waste. More than

half of this funding, however, goes to provide nursing home care for the elderly or to treat abused and neglected or delinquent children. People may not know it, but only federal (no state) funds now go to providing cash payments to welfare recipients. Since 1996, the amount and number of people on the state welfare program (Temporary Assistance to Needy Families – TANF) has declined by nearly two-thirds, with expenditures equivalent to less than 1 percent of the state budget!

Spending on local governments is another chunk – one that goes to relieving property taxes through paying homestead and elderly and disabled tax credits and providing for mental health services.

The prison part of the pie chart is the one that has been growing the most over the last decade and grew even with the overall decline in state spending over the last three years. Further, corrections officials project it will continue to grow, given current laws and the level of prevention activities in the state. The best way to stop its growth, however, is through investing in education and stopping delinquency before it starts; this requires state spending in those areas.

The pie chart shows that, overall, schools, community colleges and universities, health and social services for children and the elderly and disabled, aid to local governments, and corrections account for 90 percent of state spending. (The rest includes natural resources and park services, environmental regulation, state troopers, banking and insurance regulation, public health and sanitation services, and economic development, among other things.)

So that is the budget today, for 2004. When people talk about cutting the fat out of budgets, it is important for them to name the specific places where that fat is stored. Too often, the “fat” ends up being muscle and bone, an essential service for many lowans.

Next year, the Governor and the General Assembly will need to decide on the 2005 state budget. By law, next year’s budget must be based upon nonpartisan revenue estimates, which are established by the state’s Revenue Estimating Conference. These individuals project what growth will occur in the state and what tax revenue will result from that growth,

under current tax laws.

In October 2003, the Revenue Estimating Conference made its projections for 2005. In short, they predicted another shortfall in revenue that will require cutbacks in spending, unless taxes are raised.

Here's a balance sheet describing the shortfall that exists for next year's budget:

<i>Iowa's 2005 General Fund Budget Picture</i>		
• Estimated FY 2004 General Fund Budget		\$4,482.8M
• Statutory Revenue Commitments for FY 2005 Budget over FY 2004 Budget (school aid allowable growth, local property tax credits, Medicaid entitlements, etc.)	+	\$ 358.0M
• Total Required for "Hold the Line" FY 2005 Budget	=	\$4,480.8M
• Projected Funds Available for FY 2005 Budget under current tax structure		\$4,504.8M
Structural Budget Gap		\$ 336M
<small>Sources: Revenue Estimating Conference and the Governor's Budget Hearing Presentation</small>		

That's a pretty big shortfall – \$336 million. That's 8% of the current budget. At the public school level, that is one teacher out of every twelve. At the human services level, that's one senior in a nursing home out of twelve, or one abused child out of twelve. You get the point. Can we do away with any of the current commitments we have made, without sacrifice? Some may argue that we don't need to fund the school aid formula, or pay for increased costs of Medicaid, or meet our commitment to local governments or public employees. But that is just a bait and switch game. Schools have to pay increased utility bills, and they have to pay teacher salaries that they have bargained for, so their costs go up and they need allowable growth – or will be forced to make further cuts (read that as larger classes and fewer teachers and staff).

The state has to pay for nursing home care, and the costs of care continue to rise. Either we have to do away with homestead and elderly and disabled tax credits, or someone has to cover the cost of those exemptions. We have to pay our corrections officers and workers in mental health institutions and other public employees; if we don't fund their salary adjustments we will be forced to have fewer of them providing those services. There is no free lunch.

So not finding the \$336 million has pretty big implications to what kind of education and services we provide. Closing tax loopholes is the first place to start, but it doesn't get us all the way there.

Therefore, we have to look at the whole tax system. In doing this, we also have to look at how we got to where we are.

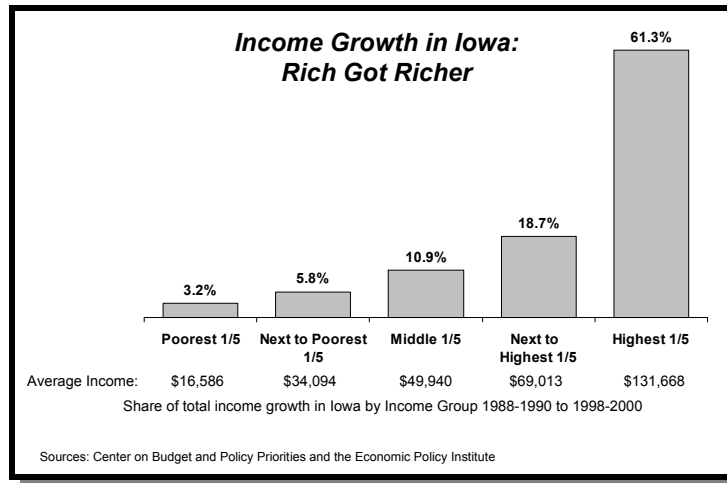
How We Got to Where We Are

The real reason we got into this tight spot is that, during the boom period of the 1990s, the state cut a lot of taxes. This boom period, however, did not affect everybody equally, nor did taxes get cut evenly.

In fact, while most people benefited from the economic growth in the 1990s, the richest benefited far more than anyone else. The gap between the incomes of the wealthiest Iowans, and the working class widened. The table below shows just where the income gain in the 1990s went.

While the average income of the middle fifth of all Iowa families grew by 14.5 percent between the late 1980s and the late 1990s, the average income of the top fifth of families grew by 36.8 percent. In dollar terms, the middle income family's income increased by \$6,307, while the top income family's income increased by a whopping \$35,418.

At the same time, however, the tax cuts also went to those at the top.



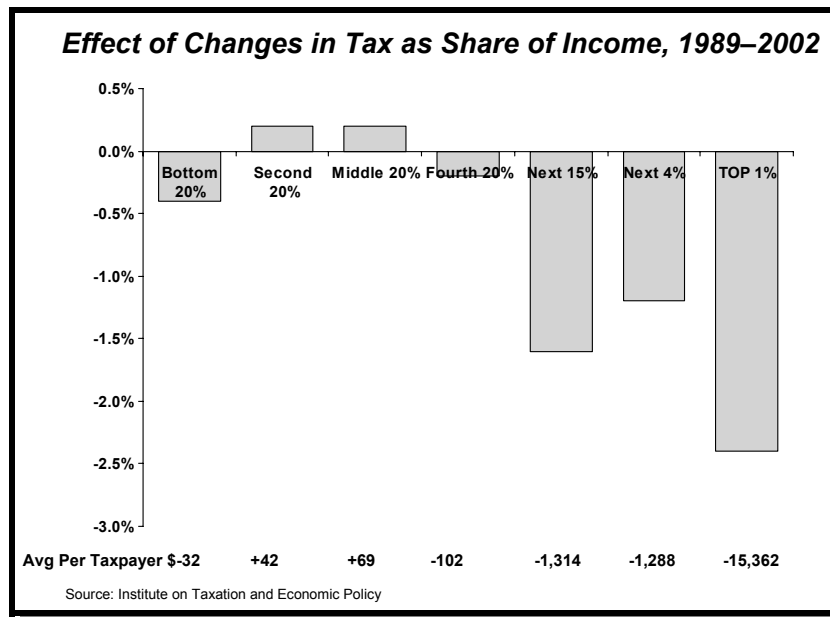
The 10% cut in income tax rates enacted by the General Assembly in 1997 cut \$240 million from the state treasury, but it did not benefit everybody equally. It was sold as being a fair way to cut taxes, cutting everyone the same.

In fact, however, the income tax is the only tax in the state that actually taxes wealthy people at somewhat higher rates than working people. The biggest benefit from the income tax cut went to the wealthiest Iowans (and for that matter, a whole bunch of wealthy non-Iowans). Again, an Iowa family making \$30,000—\$50,000 a year got a state income tax cut of around \$215, while the average cut to Iowans making more than \$100,000 a year was nearly seven times greater, \$1,473.

The income tax also is one way to get tax dollars from out-of-staters who make money in Iowa. The 10 percent income tax cut actually cut taxes more on these out-of-staters (\$57 million) than it did on all Iowa taxpayers making \$48,000 or less per year, combined. Go figure.

The 10% across-the-board income tax cut was the biggest tax cut enacted, but there were many other cuts as well (see the chart at the end of this guide) and most also benefited the wealthy far more than the rest of us.

Overall, through the 1990s, the effect of all of Iowa's tax changes (including a sales tax increase in the early '90s to deal with the budget shortfall caused by the recession then) was to shift Iowa's tax burden substantially to the working, middle-class. The table below shows the change in taxes that occurred over the period from 1989 to 2002 in Iowa.

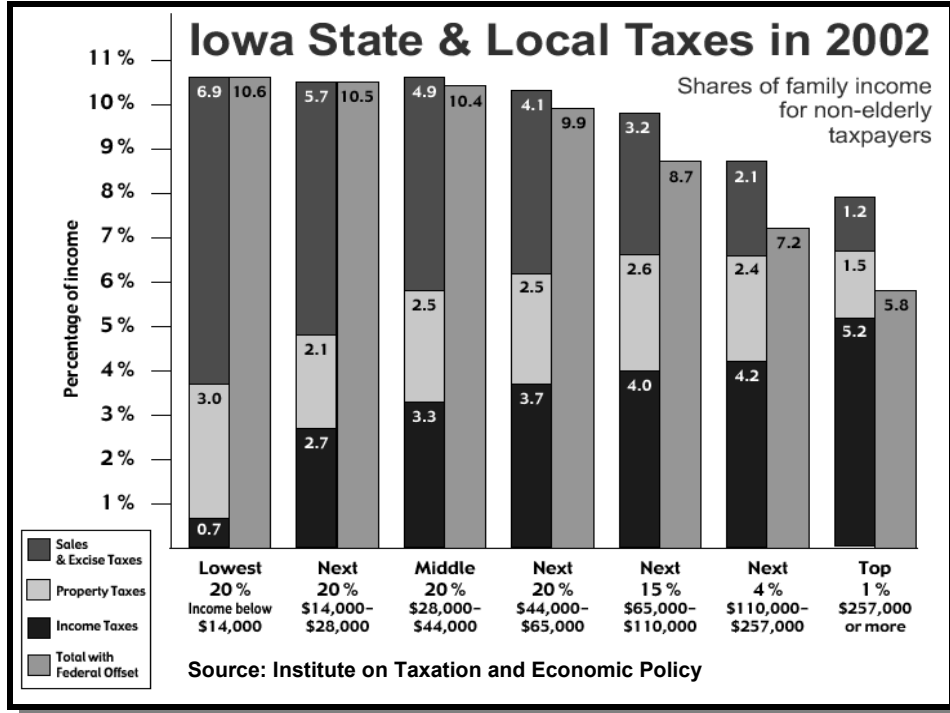


Between 1989 and 2002, only those with incomes that put them in the top one-fifth of Iowa families saw their taxes decline in any real sense. And they received whopping reductions. That 2.4% reduction in taxes on the top 1% of Iowa taxpaying families ranked No. 1 among all states in the country for helping out the rich; South Carolina ranked a distant second at 1.6%. The average reduction in state and local taxes for the lucky 1% in Iowa was \$15,362. Those in the bottom 20% got \$31, while those in the middle 20 percent paid \$69 *more*.

Sometimes, when those of us concerned about tax equity point out who is paying taxes and who is benefiting from tax cuts, we are accused of starting “a class war.” It seems to us, however, that the war has been

going on for some time and the rich have been winning; all we are doing is reporting from the front lines.

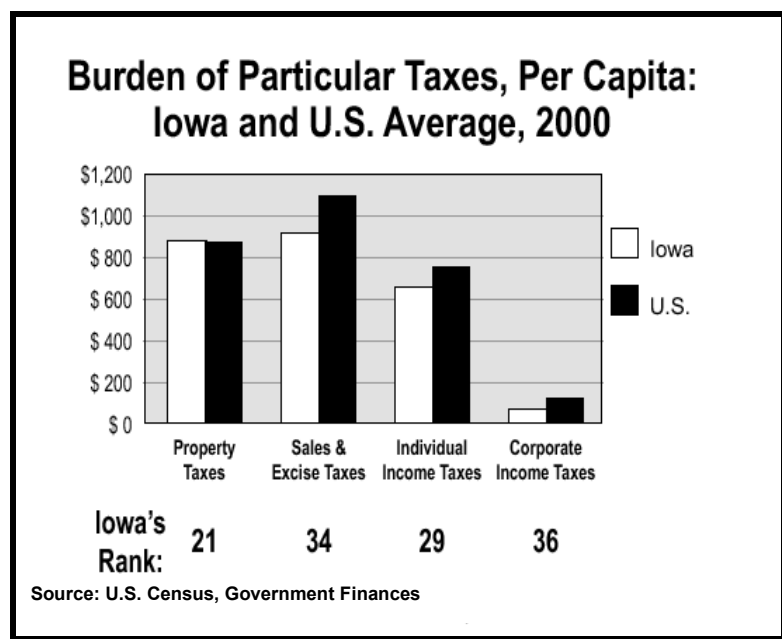
Now these tax shifts in the 1990s might have been justified if Iowa's taxes were way out of whack, and if we had been soaking the rich for the last 50 years. But that has not been the case. The wealthy in Iowa today pay a much smaller share of their income in state and local taxes than do those in the working and middle class. They were paying less of their share *before* the tax cuts in the nineties, and they are paying even less of their share since the tax cuts.



Again, a break out of the taxes that different people pay in Iowa shows that, while the wealthy pay a little more of their income in income taxes, they pay a smaller share for sales and excise and property taxes. Overall, they pay a smaller share of their much larger incomes to support state and local governments than do the rest of us.

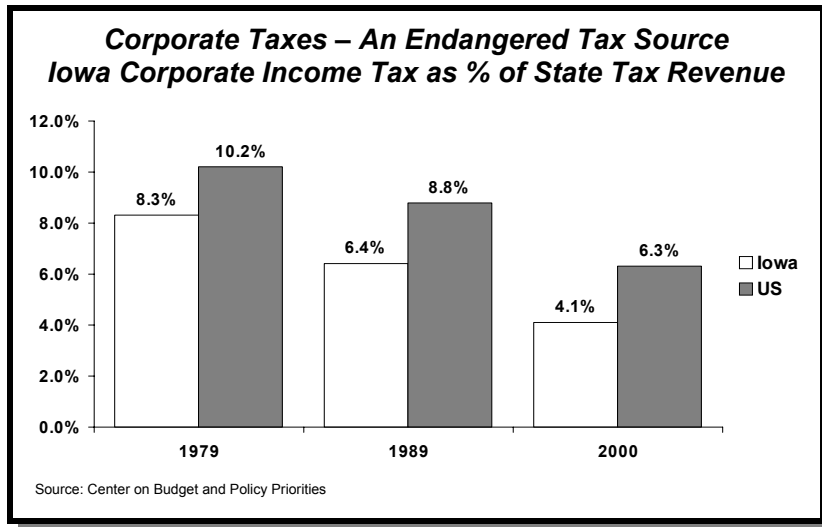
Again, it could be that Iowa's taxes are much more than any other state's, and we needed to cut them (even if we did so in the wrong way). Again, however, that is simply not the case. Iowa's taxes were average before the tax cuts, and they are average now. The property tax is slightly higher than in other states, and the sales and income taxes are lower.

Oh, yes, the corporate income tax is also lower. Further, the corporate income tax has been going down, as a share of state revenue. That is not because we have cut the corporate income tax rates, but simply because less corporate income is being taxed (see Tax Loophole Enemies #1, #2, and #7).



This last chart (whew!) shows just how much the corporate income tax has declined, as a share of Iowa's revenue. While the decline has occurred in other states, Iowa's decline has been even greater.

This is not over, of course. Some tax cuts are still being "phased in" (we couldn't afford their size even at the time the General Assembly voted them in). The premium tax on insurance, for instance, is just starting to be phased out, which will cost another \$110 million when it is finally eliminated.



So, how did we get to where we are?

- First, we cut a lot of taxes, particularly for the rich.
- Second, we let our corporate income tax decline.
- Third, we simply didn't plan enough for winter, and winter came.

What We Need to Do

This January, when the General Assembly re-convenes, it will have to pass next year's state budget – to fund our schools and state services, and to support local governments.

We have described the crunch that legislators need to face – too many needs and too little revenue.

They need to start using the “T” word, and they need to redo some of the tax cuts they made before. In doing so, they also need to start with some recognized tax principles in mind.

In the end, taxes need to:

- **Be fair** (based on ability to pay and treating similar taxpayers similarly)
- **Be adequate** (get the revenue the state needs)
- **Be competitive** (not drive business or individuals out)
- **Be simple** (not be too complicated to calculate or collect)
- **Be stable and predictable** (grow with the economy and with need)
- **Be accountable** (ensure people or businesses pay for costs they produce)
- **Promote a public purpose** (not simply provide benefits to special interests)

Clearly, closing tax loopholes is the first place to start. Closing these seven tax loopholes is consistent with these tax principles would move our tax system in the direction of being much fairer. But that gets Iowa only part way to the \$370 million it needs to maintain necessary services.

Balancing the state's budget while preserving essential services will require other tax changes as well. Again, these can start by examining the tax cuts that contributed to Iowa's budget problems.

No one enjoys raising, or even paying taxes. But Iowa needs revenue. And we need to make our tax system fair. It is not just about raising revenue – it is about making the tax system one that people believe is fair.

The Governor and the General Assembly have a big job ahead of them. Iowa citizens need to make sure those policy makers know how important it is to close tax loopholes and find ways to make our tax system fairer in order to balance the overall budget.

Appendix

Appendix One
2004 Iowa General Fund Expenditures, By Category

Total State Budget for Fiscal Year 2004 (not including 2.5% cut)	\$ 4,558,730,625
K-12 Education	
Vocational Education, Secondary	\$ 3,012,209
Student Achievement	\$ 44,275,000
Educational Excellence	\$ 56,891,336
Early Intervention Block Grant	\$ 30,000,000
Instructional Support	\$ 14,798,227
School Foundation Aid	\$ 1,827,537,551
Nonpublic Transportation	\$ 7,799,550
K-12 Education Total	\$ 1,984,313,873
Higher Education	
College Aid Commission	\$ 52,817,549
Community Colleges	\$ 139,260,763
University of Iowa	\$ 278,819,387
Iowa State University	\$ 230,805,202
University of Northern Iowa	\$ 79,495,123
Higher Education Total	\$ 781,198,024
Local Government Payments	
MHDD Community Services	\$ 17,757,890
MHDD Growth Factor	\$ 19,073,638
MH Property Tax Relief	\$ 95,000,000
Machinery and Equip Tax Replace	\$ 10,081,685
Homestead Tax Credit Aid	\$ 105,585,004
Elderly and Disabled Tax Credit	\$ 16,651,800
Ag Land Credit	\$ 35,497,624
Livestock Credit	\$ 1,815,735
Military Tax Credit	\$ 2,569,712
M & E Property Tax Incr.	\$ 1,200,000
Local Government Payments Total	\$ 305,233,088
Human Services	
Economic Assistance	\$ 41,670,672
Medical Services	\$ 390,179,086
Child and Family Services	\$ 120,531,054
MH/MR/DD/BI (not including MHDD Community Services, or MHDD Growth Factor)	\$ 63,207,915
Managing and Delivering Services (Field Ops, General Admin, Volunteers)	\$ 61,571,022
Human Services Total	\$ 677,159,749

Corrections and Law Enforcement

Corrections Institutions	\$	189,440,997
Dept. of Corrections Central Office	\$	5,057,106
Community Corrections	\$	56,737,810
Public Defender	\$	16,330,999
Indigent Defense Appropriation	\$	19,851,587
Law Enforcement Academy	\$	1,047,629
Dept. of Public Safety		
(includes \$37,339,586 for State Patrol)	\$	60,697,572
Corrections and Law Enforcement Total	\$	349,163,700

As a percent of SFY 2004 State Budget (not including 2.5% cut)

K-12	43.53%
Higher Education	17.14%
Local Government Payments	6.70%
Human Services	14.85%
Corrections and Law Enforcement	7.66%
Total	89.87%

Source: 2003 Session Fiscal Report, Fiscal Services, Legislative Services Agency,
August 2003

Appendix Two
State of Iowa General Fund Tax Cuts FY 1996 to FY 2004
Plus Projected Full Phase-In of Enacted Cuts, Millions of \$

	Fiscal Year Took Effect	FY 2004 Cost	Additional Cost of Phase-In
Income Tax			
10% Across the Board Rate Cut	1998	\$ (234.30)	
Insurance Premium Tax Phase-Out	2004	\$ (12.20)	\$ (108.10)
Pension Tax Increased Exemption	1996&1999	\$ (61.92)	
State Inheritance Tax Repeal	1998	\$ (34.30)	
Federal Estate Tax/State Collection	2003	\$ (26.10)	\$ (18.10)
Increased Personal Exemption	1999	\$ (32.12)	
Capital Gains Tax Changes	1999	\$ (20.57)	
Dependent Credit Increase	1996	\$ (17.32)	
Health Ins. Deduction Self-Employed	1996	\$ (11.80)	
Tax Treatment of Chapter S Corps	1998	\$ (10.00)	
Income Tax Indexing Tax Brackets	1996	\$ (6.00)	
Tuition and Textbook Tax Credit	1997&1999	\$ (11.70)	
IPERS Pre-Tax Benefit	1999	\$ (8.80)	
Other*	Various	\$ (19.49)	
Income Tax Total		\$ (506.62)	\$ (126.20)
Sales and Use Tax			
Phase Out Sales Tax on Utilities	2001	\$ (53.00)	\$ (37.00)
Hospital Sales Tax Exemption	1999	\$ (63.80)	
Internet Sales Tax Exemption	2000	\$ (11.66)	
Machinery and Equipment Tax Ex.	1998&1999	\$ (5.45)	
Sales Tax Holiday	2001	\$ (1.70)	
Miscellaneous Sales Tax Ex.**	Various	\$ (7.78)	
Sales and Use Tax Total		\$ (143.38)	\$ (37.00)
Property Tax Replacements			
School Foundation Increase/TAG GF	1997&2000	\$ (82.96)	
Mental Health Property Tax Relief	1996-pres	\$ (114.07)	
Fully Fund Property Tax Credits	1998		
M&E Property Tax Replacement	1996-pres	\$ (11.00)	
Property Tax Total		\$ (208.03)	
Total of All Cuts/Relief		\$ (858.03)	\$ (163.20)
Current Plus to Be Phased-In Cuts			\$(1,021.23)

* Other under Income Tax includes: New Jobs and Income Program Tax Incentives, Educational Savings Plans, Historic Preservation Tax Credit, Research Activities Tax Credit, Enterprise Zones Tax Credit, and Active Military Duty Tax Relief

** Miscellaneous Sales Tax Exemptions include: Argon Gas Sales Tax Exemption, Aircraft Parts Sales Tax Exemption, Printers Sales Tax Exemption, Leased Cars Use Tax Exemption, Greenhouse Sales Tax Exemption, State Fair Sales Tax Exemption, Aircraft Sales Tax Exemption, Foundry Sand Sales Tax Exemption, Ag Association Sales Tax Exemption

Source: Iowa Department of Management, General Fund Tax Cuts FY 1996-2002

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