Executive Summary

A Chronic Budget Crisis: Can Iowa Keep Its Promises?

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January 2005

Iowa Fiscal Partnership

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For state legislators, there is no more important responsibility than passing a yearly budget. The budget determines the investments that Iowa will make in education, health care, public safety, infrastructure, the justice system and the workforce, all of which underpin a healthy economy. Iowans are rightly proud of the quality of life in this state, and understand that it depends in no small part on the quality of our public education system, our roads, and other public services. Yet Iowa is now at a crossroads; the state's ability to keep its promises in the coming years will depend crucially on how clearly we recognize the problems we face and take responsibility for solving them.

From 1996 until 2001, Iowa and the entire country experienced an economic boom, which increased personal income and caused state tax collections to swell. During this period, Iowa was quicker than most states to enact tax cuts and slower than most to expand spending. In fact, tax cuts enacted during that time – when fully phased in – will reduce general fund revenue by $700 million annually.

Since the economy routinely cycles between periods of growth and retraction, budget discipline must apply equally to tax cuts and to spending increases. In the late 1990s, legislators enacted unsustainable tax cuts based on temporary surges in revenue. This failure to budget over the full economic cycle is the primary reason for the state's shaky financial situation over the last several years. The tax cuts, combined with Iowa's changing economy and demographics, have resulted in a mismatch between revenues and expenditures, which the recent recession has only amplified.

As this and other reports in this budget series show, Iowa's response to the financial crisis – cutting services, adopting new tax cuts, and raiding special funds – has likely extended the state's financial problems into the future. Few, if any, government services were left unscathed by the budget cuts and the severely curtailed spending deepened the recession by pushing up unemployment. Cuts in state spending caused layoffs in the public sector, in the companies that operate under contracts with the state, and in other companies due to the multiplier effect of more unemployed Iowans with less income to spend. As Nobel Laureate economist Joseph Stiglitz has noted, reductions in state spending during a recession can be more harmful than tax increases. By enacting additional tax cuts *during the recession*, Iowa worsened its own financial position.

Instead of seeking permanent sources of revenue, Iowa turned to finite revenue sources. The Senior Living Trust Fund, the Healthy Iowans Tobacco Trust, the Endowment for Iowa's Health Account and 38 other funds, most of which were intended for vastly different purposes, were raided to shore up general fund budget gaps. These dollars are no longer available for their intended purposes, and many funds – most notably the Senior Living Trust Fund – are precariously close to broke.

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As we look to the future, we face the challenge of replenishing the funds that were raided, at the same time that shifting demographics, a changing economy, and an outdated tax system are likely to put further strains on the state's finances. Iowa's sales tax has not adjusted to the new economy, corporate income tax collections have declined substantially, and we may well face declining federal revenue in the near future. Furthermore, as Iowa's population ages, a greater share of Iowans will be drawing primarily on income from pensions and Social Security, which already is taxed at a substantially lower rate than the same amount of earned income, reducing revenues at the same time that strains on the Medicaid system increase. Seniors account for a large share of total Medicaid expenditures, primarily because of nursing facility costs, and Iowa's population over age 65 is projected to grow 57 percent between 2000 and 2025.

These trends suggest that the state will continue to be hobbled by budget deficits in the future unless Iowa takes corrective action now. In order to meet its responsibilities to all Iowans, the state needs to modernize its tax system by closing tax loopholes, broadening the sales tax base and fixing the personal income tax.

How Iowa Balanced the Budget: FY2001- FY2005

Like a family, state government must live within its means. As with almost all states, the Iowa Constitution prohibits deficit spending. A projected deficit requires that Iowa increase revenues, reduce spending or take other measures before it adopts a budget. The general fund is the primary operating budget for state government. In addition, there are other funds that are typically dedicated for specific purposes. For example, the Road Use Tax Fund collects gasoline tax revenues, which, according to the Iowa Constitution, can only be spent for road construction, maintenance, and related purposes. Other non-general funds, such as the Senior Living Trust Fund, the Rebuild Iowa Infrastructure Fund and the Endowment for Iowa's Health Account were established for specific purposes, but the General Assembly can depart from those original intentions.

Faced with cumulative general fund budget gaps of over $3 billion between fiscal 2001 and 2005, the state cut $1.4 billion in services and made $2 billion in transfers from sources outside of the general fund (see Figure 1).[1] In turn, services that were funded by these other (non-general fund) sources had to be scaled back. In Figure 1, Iowa's fully funded budget for 2001 is based on fiscal 2000 appropriations plus built-in costs for 2001, as estimated by the Legislative Services Agency.[2] Following the same methodology, each year's fully funded budget is estimated based on the previous year's actual appropriations plus built-in costs and an amount sufficient to pay for all of the services that were shifted to non-general funds during the previous year.[3] This method provides a conservative estimate, since it automatically ratchets down the base if there are cuts in the previous year. This is why a "fully funded budget" required fewer dollars in 2004 and 2005.

During this period, the state permanently eliminated some of its responsibilities, including part of the Educational Excellence program and two property tax replacement credits, which cut a com-

[1] About $657 million of the $2 billion were revenue transfers, which are transfers of money from a special fund to the general fund (see Figure A-3 in the Appendix). The rest were expenditure transfers, which are transfers of funding responsibilities (programs and services) from the general fund to special funds (see Figure A-1 in the Appendix).The state also de-appropriated $85.2 million from the general fund for the Endowment for Iowa's Health Account, which is not counted as a transfer but has the same effect as a revenue transfer.
[2] Built-ins are estimated by the Legislative Services Agency. They are a standing appropriation required by the Code of Iowa, an entitlement program, or an appropriation for a future fiscal year that increases or decreases compared to the prior year.
[3] Programs and services shifted to non-general funds are known as expenditure transfers. The authors took care to ensure that some expenditure transfers were not double counted as built-ins.

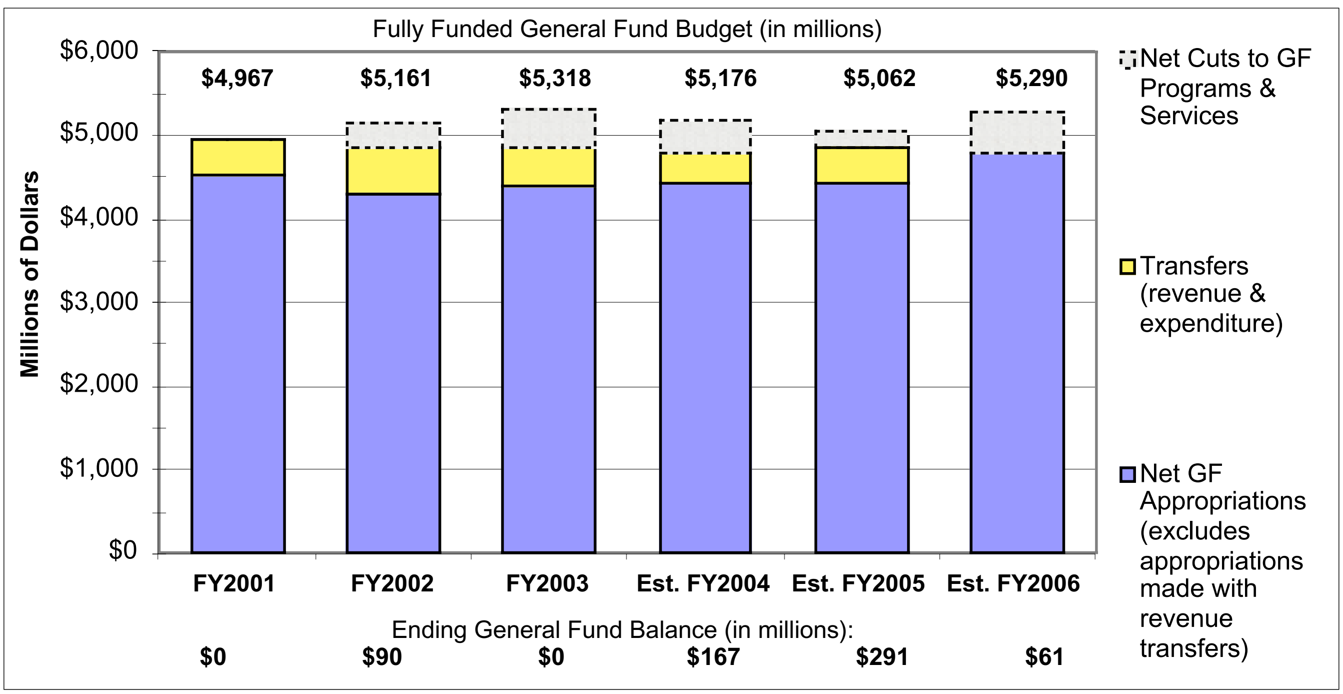
bined total of $119 million from the budget.[4] The number of full-time state workers decreased by 1,585 employees between FY2001 and FY2003, and additional workers were laid off by private contractors and providers due to the state budget crisis.

By 2005, cuts to key programs and services were still not fully restored in such areas as education and child and family services:

- Higher education spending is $124 million short of its 2001 level;
- The state match for the K-12 Instructional Support Program continues to be capped at $14 million, forcing property taxpayers to pick up the balance;
- Over one-third of the state's mental health institutes' beds have been closed;
- The state ended its long-time emergency assistance program;
- Despite a 20 percent increase in child abuse cases, the child welfare budget remained flat.

Furthermore, of the money that was borrowed from special funds (represented by the "transfers" in Figure 1), none has been replaced. State law requires that a portion ($118 million) be reimbursed

Figure 1. How Iowa Balanced the Budget, FY01-FY05 (and a projection for FY06)



Source: Legislative Services Agency, Fiscal Services Division

Notes: Revenues are based on December 2004 Revenue Estimating Conference projections. A fully funded budget is equal to the previous fiscal year's GF appropriations (before reversions) + net built-in increases + an amount to pay for all of the GF services that were shifted to non-general funds during the previous year. Since a "fully funded budget" is based on the previous year's actual GF appropriation, cuts in one year can reduce the base budget in the next year. School aid and other standing appropriations and entitlement programs are automatically added back as built-ins. However, other cuts, such as the across the board cuts, and cuts to higher education and property tax credits ratchet down the base, and therefore reduce the amount that constitutes a fully funded budget in the next year.

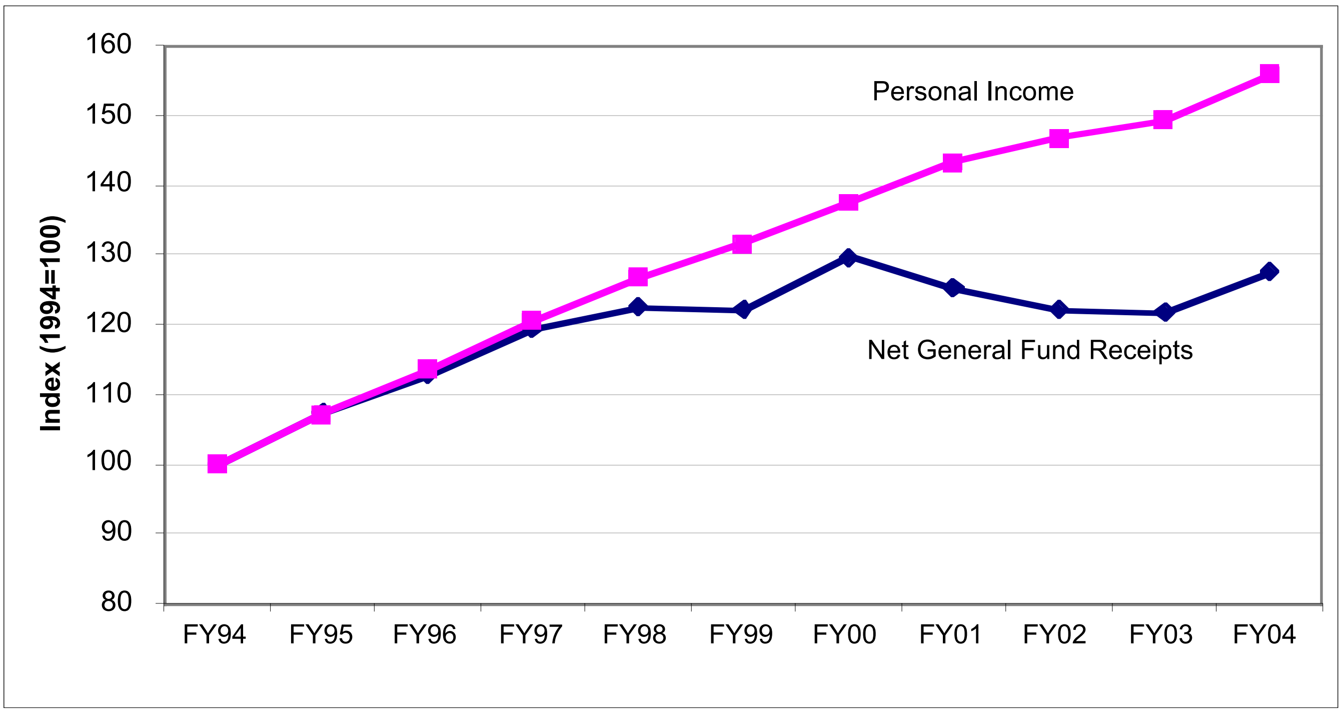
[4] The Machinery & Equipment Property tax credit replacement was permanently eliminated, cutting about $42 million from the budget between 2001 and 2005. The Property Tax Replacement credit was also permanently eliminated- cutting $52 million from the budget between 2001 and 2004.

to the Senior Living Trust Fund and $172 million be reimbursed to the Endowment for Iowa's Health Account. With the state already facing a projected shortfall for 2006, revenues will be insufficient to repay these amounts in 2006.

What Happened to Revenues?

A comparison of personal income growth with revenue growth shows that tax cuts, rather than a weak economy, are the main culprit for the fall-off in revenues in the last several years. Between 1994 and 1997, personal income and general fund receipts grew together. However, since 1997, personal income has continued to climb while general fund revenues declined (see Figure 2).

Figure 2. The Divergence of Personal Income Growth and General Fund Revenue Growth



Source: Legislative Services Agency, Fiscal Services Division, State of Iowa; Bureau of Economic Analysis.

Notes: Numbers are indexed to 100 in order to provide relevant units of comparison. General fund receipts are on an accrual basis. In order to make comparisons over time, the FY2001-FY2004 figures do not include revenue transfers into the general fund from non-general fund sources.

After suffering through three of the toughest budget years since the 1980s, revenues have begun to recover slightly. However, revenues are growing from the depressed level they reached in the depths of the fiscal crisis. Despite the moderate turnaround, Iowa still is projected to have a budget shortfall for 2006.

Ideally, the tax system should generate excess revenue during economic boom times, with the excess placed in reserves – a rainy day fund. This fund should be sufficient to sustain government services during a recession. Demand for many government services is actually higher during a recession, due to increased need for so-called "safety net" services. When the tax system does not generate sufficient revenue over the course of the business cycle to maintain public services in good times and bad, a state is said to have a "structural deficit." Iowa's tax system and rainy day fund did not permit the state to maintain services and local government support during the current prolonged downturn, and they will not do so in the future without reform.

As it stands now, Iowa needs to collect about $514 million more than is currently projected by the Revenue Estimating Conference in order to afford a fully funded budget in FY06. The state must replenish its two rainy day funds with $292 million and reimburse $290 million to the Senior Living Trust Fund and the Endowment for Iowa's Health Account. Ideally, the state should also, but is not required to, reimburse all special funds for the $2 billion taken since 2001.

The raiding of the Senior Living Trust Fund will be particularly damaging in future years. The Senior Living Trust Fund was established in 2001 and was originally intended as a source of funding to help the elderly to stay in their homes instead of going into nursing facilities. With the fiscal crisis, it has become a popular source of money for programs that previously had been funded by the general fund. Between FY2001 and the end of FY2005, the trust fund will have paid for $490 million in general fund programs, the vast majority of which ($448 million) was for Medicaid. About 88 percent of total trust fund expenditures were spent on Medicaid, while only 3 percent were spent on conversion grants for in-home care (which was the original purpose of the trust fund).

The trust fund was capitalized with deposits from the federal government. However, the federal government is discontinuing these transfers, and the trust fund will no longer receive deposits. As a result, the fund is likely to be depleted by FY2006. Going forward, the important funding that the Senior Living Trust Fund has provided to the Department of Human Services (over $485 million, primarily for Medicaid) and the Department of Elder Affairs (over $31 million between FY2001 and FY2005) will have to be replaced with general fund money.

Outlook and Policy Recommendations

Iowa's response to the state fiscal crisis over the last four years has not addressed the underlying cause of that crisis – the structural deficit that in large measure was the result of large tax cuts enacted from 1995 to 2000 (and exacerbated by further cuts since 2001, despite the recession and budget shortfalls). This structural deficit will worsen, as previously enacted tax cuts continue to be phased in, while service needs and costs continue to rise. Iowa must address this structural deficit and, in doing so, must also recognize that changing demographics and a changing economy require tax modernization. The following is a very broad-brush description of these changes and their implications for tax policy.

1. Changes toward a more service- and information-based economy

The country has moved from a goods-based manufacturing economy to a much more service-based economy. One of the consequences has been that a sales tax based upon goods no longer collects revenue in an amount that reflects consumer spending. Extending the sales tax to a much broader range of consumer purchasing activities is needed to sustain the sales tax as a revenue source that reflects such purchasing.

2. The broadened boundaries for business

In recent years, multi-state businesses have found new and very effective ways of exploiting loopholes in state tax codes. These loopholes allow them to shift taxable income from one state to another to minimize their corporate income tax bill. Moving to combined reporting is one necessary way to ensure that firms conducting business in Iowa are subject to taxation here.

3. The internet and its impact

The growth of the internet as a means for handling commerce has been huge and is expanding. Iowa has taken steps to collect sales taxes on internet sales to Iowans, and this is an important first step. Other forms of commerce, such as telephone service, will also increasingly be handled through the internet. It is critical that states have the authority to tax internet commerce simply for reasons of tax equity, since traditional Main Street retailers must continue to collect the tax from their customers. Failure to do so, moreover, is likely to have significant impacts upon state tax collections.

4. The aging of society and the growth in retirement income

Iowa is continuing to age. In 2000, there were four working-age people (18-64) for every person over 65; by 2020, that figure will decline to fewer than three working-age people. Not only does that put a greater responsibility on those working to support their families, it also places challenges on the state tax system. Those over 65 receive most of their income through Social Security and pension fund benefits. However, this income is taxed at a lower rate than income from work. Iowa law currently exempts from taxes the first $6,000 of pension income ($12,000 if married filing jointly). And because of generous exemptions for Social Security income, over two-thirds of Social Security recipients pay no tax on their benefits, and the remaining recipients pay tax on, at most, 50 percent of their benefits. Tax policies should not exempt more of this income from ever being taxed, at the risk of severely eroding Iowa's income tax base as the population ages. The same holds for a total repeal of the inheritance tax, as, in many inheritances, much of the wealth has never been taxed. Like the situation for the tax on Social Security and pension income, there is a wide misunderstanding of the actual impact of the existing inheritance tax and about who would benefit from repeal.

5. Trends toward the concentration of wealth and income.

Those who have benefited most from economic growth over the last 20 years have been individuals at the very top of the income and wealth scale. Because Iowa's overall state and local tax system is regressive, taking a smaller share of income from those at the top of the scale, most of the income gains have gone to those paying the smallest share of their income in taxes. A flat (proportional) or progressive overall tax system is needed to ensure that state government continues to collect the revenues needed to support basic services. The individual income tax remains the only progressive tax in Iowa's overall tax structure. If the goal is an overall proportional system, the income tax needs to be more progressive in order to compensate for the much larger regressive parts (sales and property) of the tax code.

6. The growth in tax expenditures as a tool for economic development

Particularly when there was strong state revenue growth, the state enacted a number of tax "incentives" marketed as supporting economic growth and development. Unlike appropriations, these tax expenditures are not reviewed annually and do not require re-enactment, nor are they limited in terms of their overall expense to the treasury. Some of the estimates of their cost to the treasury were far below what they eventually cost. Additionally, it has been hard to track their overall costs, let alone determine whether they achieved their economic development justification. The decline in corporate tax revenues is one sign that these tax expenditures have reduced tax collections substantially. These expenditures need to be reviewed on a periodic basis and held up to much greater public scrutiny. They need to be much more transparent than they are currently, with required disclosures of the tax filers who make use of them and the size of their benefits. They should receive at least as much scrutiny as line item expenditures in the state budget.

7. Other trends that will reduce revenues or increase spending needs

- Nationally, the federal deficit is creating new calls to restrict domestic spending and take such actions as block granting Medicaid and Title IV-E (foster care), which is likely to translate into reduced revenues to state governments.
- Federal actions may be taken to restrict state authority to tax – from e-commerce to definitions of taxable connection (nexus) to determinations of taxable income under corporate and individual income taxes.[5]
- The rapid rise in health insurance costs will continue to drive inflation in the cost of state and local government well above increases in the general cost of living and require government to take a larger share of personal income just to maintain services.
- The "sin tax" revenues that Iowa has counted on to balance budgets are not likely to grow with the economy, as tobacco consumption declines and the state reaches the saturation point in gambling revenues.
- The continuing rise in prison populations due to sentencing legislation in the 1990s will continue to drive up corrections expenditures.
- City, county and school budgets will continue to be strained by the urbanization of the population combined with urban sprawl, which leaves rural areas with an aging and expensive infrastructure with excess capacity, while demands for urban services in developing suburbs continue and the fiscal capacity of central cities and older suburbs declines.

It's time for a long-range look at Iowa taxes. The current Iowa tax system requires modernization to reflect dramatic changes in the economy if it is to continue to provide the revenues, in a fair and competitive manner, that state government needs to fulfill its responsibilities. If we do not confront our long-term budgetary problems now, state and local governments will not be able to keep their promises to the citizens of Iowa to maintain the quality of life that they cherish, for themselves and their children.

[5] While Iowa can choose not to couple with federal tax changes regarding deductions and taxable income, this complicates tax filing and is often difficult to achieve politically. Further, it places additional responsibilities on sole state enforcement rather than adherence both to state and IRS regulations and laws.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web at http://www.iowafiscal.org.