



EXECUTIVE SUMMARY

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Iowa's Aging Population *Implications for the State Budget, 2008-2030*

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By the year 2030, Iowa, like most states, will look significantly older: There will be more seniors, and a smaller share of young people. This report examines the financial challenges facing the state of Iowa in the coming 20 years as a result of these demographic changes, which can be expected to affect state revenues and key categories of spending. By 2030, about 22 percent of Iowa's population will be over 64 years of age, ranking Iowa 12th highest in the proportion of senior citizens. Iowa's total population is projected to increase only 1 percent between 2000 and 2030, a consequence of Iowa's aging population, the outmigration of younger persons, and fewer births. Iowa's 1 percent growth rate exceeds only West Virginia and North Dakota, which are projected to lose population over the same period.

In this report we provide projections of state revenues and key categories of spending. On the spending side, we focus on state Medicaid, K-12 education and higher-education spending. These public services account for about two-thirds of the state general fund. On the revenue side, we focus on individual income and sales tax revenue. In fiscal year 2006, 83 percent of state tax receipts came from individual income taxes and sales and use taxes. Taxes, in turn, accounted for 90 percent of general fund receipts.

State Spending Growth

The aging of the Iowa population between now and 2030 means that a smaller share of the population will consist of school-age children (ages 5 to 18), which might be expected to moderate increases in education spending as a share of the economy. However, the population share of school-age children is expected to decline only slightly, from 17.3 percent in 2007 to 16.4 percent in 2030.¹ Furthermore, it is expected that the trend toward a greater percentage of school-age children attending public schools will continue. Over the same period, Census projections indicate that 18- to 24-year-olds will also represent a declining share of the population, falling from 10.2 to 8.4 percent, but the share of this group attending post-secondary institutions is expected to grow from 56 percent in 2008 to between 74 and 80 percent.² In addition, public expenditure per K-12 pupil has risen faster than the general rate of inflation, as has the cost of higher education, and these trends are expected to continue. As a result, state education spending, both K-12 and post-secondary, is projected to increase as a share of the Iowa economy (state GDP) over the next 10 to 20 years, despite a decline in young people as a share of the population.

Enrollment in elementary and secondary schools is expected to decline by 2.4 percent from 2007 to

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2020, but per pupil spending is expected to rise an average of 5.1 percent per year. As a result, state aid for K-12 schools is likely to grow by more than 50 percent over this period. Added to this will be the spending on the new statewide voluntary preschool program for 4-year-olds. This program is expected to rise from \$15 million in fiscal year 2009 to \$109 million per year by 2014, where it will remain through 2020. Overall, state spending on K-12 education would rise from 1.62 percent of state GDP to about 1.86 percent by 2020.

Our projections indicate that state spending on higher education will grow along with the state economy, remaining about 0.62 percent of state GDP, between now and 2020. However, if cost and enrollment trends continue through 2030, the growing numbers of 18- to 24-year-olds after 2020 will push spending higher as a share of the Iowa economy, possibly as high as 0.70 percent of state GDP by 2030.

It is often assumed that the aging of the population will have a large effect on state Medicaid spending, since the share of the population age 65 to 84 will increase from 12.1 percent in 2007 to 18.9 percent by 2030, and the share that is 85 or older (where much of long-term care spending occurs) will grow from 2.6 to 3.6 percent. While the aged currently account for about 12 percent of all Medicaid enrollees, they account for 25 percent of Medicaid spending, most of which goes to long-term care. However, the growth in the size of the aged Medicaid population is not the major contributor to the anticipated growth in Medicaid spending. In fact, the share of the population age 65 and over that is enrolled in Medicaid nationally is expected to decline from its current level of 12.2 percent to 10.0 percent by 2030, and spending per aged enrollee is expected to increase more slowly than spending per enrollee in the other Medicaid categories.

The projected growth in overall Medicaid spending is largely attributable to rising health-care costs generally, as national health expenditure is projected to increase from 15.7 percent of GDP in 2006 to 24.7 percent of GDP by 2025 (and to 34.2 percent by 2045). New technologies and prescription drugs are the primary reasons why health spending has grown more rapidly than GDP.³ In addition, the share of all children who are Medicaid enrollees, the share of adults age 18 to 64 who are Medicaid enrollees, and the share of the total population who are disabled enrollees, are all expected to grow (the latter share growing most rapidly). It is as a result of these latter trends, more so than the rising share of the population that is aged and the cost of long-term care, that Iowa total Medicaid spending is expected to rise in real terms from \$2.2 billion in fiscal 2007 to \$5.5 billion by 2030 (in 2006-07 dollars). As a share of the state economy, Medicaid spending from state funds is expected to rise from about 0.60 percent to nearly 1.13 percent over this period.

State Revenues

The aging of the population will probably produce a decline in state income tax revenue of 2 to 3 percent in Iowa, due largely to the adoption of tax preferences for seniors. If there were no elderly preferences in Iowa's income-tax code, the very small projected increases in total population combined with the aging of the population would increase income-tax revenues for a period of time, reaching a peak in 2015 at \$2.27 billion. The revenue gain from aging (assuming no elderly tax preferences) occurs in part because the demographic shift increases the number of taxpayers, the old being more likely than the young to file and owe income taxes. The increase in revenue occurs despite the fact that effective tax rates (taxes as a percent of adjusted gross income) are lower for the elderly, even in the absence of special preferences by age.

However, under 2006 law, with elderly tax preferences fully phased in, the effect of population aging by the year 2030 is a \$40 million reduction in income-tax revenue. This represents a drop of 2.0 percent compared to revenues in that year with a fixed (2003) age distribution.

The aging of the population in Iowa will not have a substantial effect on per capita sales-tax revenues through the year 2030. This is largely because the overall demographic shift will on balance favor higher-spending age groups (which includes those age 65 to 74) relative to lower-spending age groups (which includes younger adults). Aging by itself will probably produce a small decline in sales-tax revenue in Iowa, less than one-half of 1 percent. However, Iowa will fare worse in this regard than most other states; only seven states will experience larger declines in revenue through the year 2030. This appears to result from a sales tax base in Iowa that excludes more of the purchases of the elderly and lower-spending age groups than in most states.

Conclusions

As Iowa's population ages over the next 20 years, the Medicaid population will grow, and Medicaid spending will consume a larger share of the state budget and of the state economy. The growth in health-care costs is the critical factor here, more so than the aging of the population. At the same time, the declining share of the population that is of school age is not likely to produce a dividend for the state in terms of declining state spending on education. In fact, spending on K-12 education is likely to increase as a share of the state economy over the next 10 years.

An even more important determinant of future state fiscal health, however, is state tax policy. While the growth in Medicaid spending is driven largely by health-care costs and demographics, states have considerable control over the future path of income- and sales-tax revenues.

In order to fund state spending that is rising as a share of the state economy, state revenue will also have to rise relative to the economy. In the past 15 years, Iowa state taxes have actually been declining as a share of state GDP, due largely to aggressive tax cutting in the late 1990s, and continued tax cuts through the recession of 2001 and the subsequent recovery. These tax cuts together add up to a total of about \$1.1 billion in annual revenue losses resulting from tax reductions enacted over a 10-year period. This represents about one-sixth of the state's general fund.⁴ The continued phase-in of additional tax preferences for seniors over the next several fiscal years will further cut into revenue.

Other factors will likely contribute to continued slow growth in state tax revenues in the coming years. In particular, the cost of business tax credits has grown dramatically. In Fiscal Year 2001, about \$100 million in tax credits were awarded to businesses, a number which had increased fivefold by 2007.⁵ Most of these credits had an economic development purpose; the largest are the enterprise zone credits, the High Quality Job Creation Program, the Research Activities Credit, and the Industrial New Jobs Training Program. Projections indicate that in excess of \$400 million in liabilities for tax credits already awarded will be felt each year from Fiscal Year 2010 through 2012. The actual amounts will no doubt be substantially higher as new credits are proposed and awarded. These tax-credit expansions have contributed to a substantial decline in revenue from the corporate income tax, which accounted for over 7 percent of state tax revenue in the early 1980s, but less than 3 percent in recent years.⁶

The sales-tax base continues to be eroded by two trends: the rising share of expenditures on services (generally not taxed) rather than goods (generally taxed), and the rising share of purchases made over the internet, where taxation is spotty, at best. Nationally, the sales-tax base represented 51.3 percent of

all sales in the median state in 1990; by 2006 the base had declined to just 42.1 percent of sales.⁷ This represents a rather alarming decline over a period of just 16 years. Estimates of losses in state sales-tax revenue for Iowa due to internet purchases range from \$155 million to \$243 million, depending on the growth in internet sales⁸

Iowa faces a fiscal future of rising costs and stagnant revenues. All told, tax cuts enacted since 1996 and tax credits awarded or to be awarded will take \$1.5 billion or more out of the budget each year for the foreseeable future, a sum equal to almost a quarter of the state's general fund. Even if Iowa tax revenue were to stabilize at about 5 percent of state GDP, this would hardly keep up with growth in general fund spending. If education and Medicaid spending, which currently account for about 67 percent of the state's general fund, rise from 2.9 percent to 3.4 percent of GDP by 2020, then other programs will have to be cut or additional revenue sources will have to be found. Alternatively, the state will have to find ways to cut education and Medicaid services to keep them from consuming a larger share of the state budget.

¹ U.S. Census Bureau, population estimates program (2007) and population projections program (2030).

² This assumes that the share of 18-24 year olds attending public universities in Iowa grows at the same rate as this share is projected to grow nationally. Given that Iowa's share is already higher than the national (56 percent versus 46 percent) this share may not grow as rapidly, but may top out sooner.

³ D. M. Cutler and M. McClellan, "Is Technological Change in Medicine Worth It?" *Health Affairs*, Sept./Oct. 2001 20(5):11-29

⁴ The fiscal year 2009 general fund budget calls for \$6.1 billion in spending.

⁵ Iowa Department of Revenue, "Revenue Estimating Conference Tax Credits Contingent Liabilities Brief," April 2, 2008.

⁶ See *Restoring Fairness & Revenue: Reform Measures for Iowa's Corporate Income Tax*. Iowa Fiscal Partnership, November 2006. <http://www.iowapolicyproject.org/2006docs/061128-ifp-CIT-2pgr.pdf>

⁷ John L. Mikesell, "State Retail Sales Tax Burdens, Reliance, and Breadth," *State Tax Notes*, July 12, 2004; and John Mikesell, "State Sales Taxes in Fiscal 2006: Adding Diversity to the National Revenue Portfolio," *State Tax Notes*, Sept. 3, 2007.

⁸ Bruce, Donald and William F. Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," *State Tax Notes*, August 2004.

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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>.

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