Iowa Fiscal Partnership

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Responding to the Economic Crisis

The Task for Iowa Lawmakers

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Iowa lawmakers are almost certain to face immediate and severe budget challenges when they reconvene in January. Revenue shortfalls for the rest of this fiscal year, which ends in June 2009, definitely will affect next year's budget.

The Revenue Estimating Conference, which meets December 12, will provide an official picture of the state's finances heading into the 2009 legislative session. A deficit in excess of $500 million is expected for FY2009-10. This deficit could approach or even exceed 10 percent of the new state budget.

Iowa is not alone. At the national level, the Center on Budget and Policy Priorities estimates likely state budget deficits for FY2009-10 of at least $100 billion, much higher than the deficits states faced in the last state fiscal crisis from 2001 to 2003.

These budget shortfalls are partly a consequence of the national economic recession. Unlike the national government, states cannot run deficits, which means that expenditures on services cannot exceed expected revenues. However, during a recession, revenues decline for several reasons. Layoffs and rising unemployment force incomes down, so income-tax revenue declines. Sales-tax revenue also drops as consumers spend less. State corporate income tax revenue declines as companies make less profit.

At the same time the state takes in less revenue than anticipated, demand for state services continues and, in some cases, grows in a recession. For instance, Medicaid spending, a large share of the state budget, grows as more individuals become eligible for the program.

States prepare for periodic downturns by building their reserve funds and, most importantly, by creating sound revenue systems that can weather the valleys of a business cycle. Iowa has healthy reserve funds, but our revenue system has not fared so well. State lawmakers have cut taxes and diverted revenues when times were good, assuming they didn't have to look to the future. Across-the-board income- tax rate cuts in the late '90s disproportionately benefited upper-income taxpayers; these and other tax cuts enacted between 1996 and 2004 cost the state nearly $1 billion in annual revenue.[1] Additional tax cuts passed in 2006 disproportionately benefit upper-income Iowa seniors and will cost the state $118 million by 2014 when they are fully phased in. Furthermore, business tax credits have been growing by leaps and bounds; they totaled about $80 million in FY2005, but are expected to grow to over $350 million by FY2010.[2]

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As Iowa lawmakers consider how to address these deficits, noted economists such as Nobel Prize Laureate Joseph Stiglitz emphasize that cutting state programs, particularly those that serve lower- and middle-income families, threatens to deepen a recession. Cuts in safety-net programs also make these families vulnerable to falling into deep poverty, which is difficult to escape. In an article with Congressional Budget Office Director Peter Orszag, recently named by President-Elect Barack Obama to head the Office of Management and Budget, Stiglitz wrote:

> Basic economic theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction. [...] Tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy.[3]

Maintaining safety-net services is particularly important in an economic crisis. If anything, Medicaid needs additional funding support at a time when people are losing their jobs and no longer have access to employer-sponsored health coverage. An economic stimulus package expected from Congress in early 2009 will include substantial relief to states, particularly through additional federal matching support for Medicaid. But this relief is not expected to cover all of Iowa's projected deficit and will require Iowa lawmakers to maintain the current Medicaid program.

Where should Iowa lawmakers go to address the impending state fiscal crisis and the 2009-10 budget shortfall?

Stiglitz and Orszag suggest considering tax revisions that affect higher-income families and businesses. A poll conducted during the last fiscal crisis showed that Iowa voters also strongly support temporary increases in taxes on the most well-to-do (families making over $200,000 per year) over cutbacks that affect working, retired and lower-income Iowans.[4]

Before considering tax increases, Iowa has the opportunity to seriously examine tax loopholes and current state expenditures and tax credits that have grown in size over time. While state appropriations receive annual scrutiny by the General Assembly, tax credits, once enacted, do not require annual review or action but simply stay on the books. Often, they grow in size over time, as tax accountants and attorneys find new ways to make use of them. The first place to look for revenue to close the state budget shortfall needs to be the state's tax code and its various tax expenditures and breaks.

The Iowa Fiscal Partnership has reported that several of these tax credits and tax provisions need review and reform. These should be at the top of the list for consideration as lawmakers search for ways to address the 2009-10 budget shortfall and ensure that Iowa does not maintain a structural budget deficit going into the future. Importantly, each of these reforms also would have the least impact on prolonging Iowa's recession, as each primarily comes from individuals and corporations with the greatest wealth:

- *Combined reporting*. Require multistate corporations to provide unified reporting of their income for tax purposes to prevent their use of tax loopholes to avoid paying Iowa income taxes (yields up to $80 million in revenue in normal economic times and eliminates an unfair advantage multistate corporations can employ over local businesses)[5];
- *Research activities credit*. Limit the credit amount any one corporation can claim to $250,000 per year (yields $30 million in reduced state expenditures to large Iowa corporations, who already benefit by having their Iowa corporate income tax liability eliminated by the credit)[6];

- *Capital gains total exclusion.* Limit the Iowa capital gains total exclusion to up to $100,000 in preferential treatment (yields $25 million in revenue)[7]; and
- *Senior Social Security tax exemption:* Freeze the total phase-out of the Social Security tax exemption and restructure these provisions to provide equity of tax treatment of higher-income ($80,000 plus income) seniors and working families while providing additional relief to low- and fixed-income seniors (yields $15-20 million in revenue)[8].

Enacting all these reforms would generate, in normal economic times, up to $165 million in revenue for the state and strengthen our revenue system so that it can weather this economic storm.

In addition to these reforms, the High Quality Job Creation Program, the Enterprise Zone Program, and the Iowa Industrial New Jobs Training Program all deserve detailed scrutiny and review.[9] Ideally, lawmakers should work to modernize Iowa's tax system and enact broader individual income tax reform that would simultaneously address several of these tax provisions while restructuring Iowa's income tax to be fairer and simpler.[10]

At a minimum, however, lawmakers need to examine the particular tax loopholes, credits and expenditures described above as a first step in balancing the 2009-10 budget. Coupled with potential federal assistance through the coming economic stimulus package, this would go a long way to balancing the budget without cutting essential public services.

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[1] Iowa Department of Management, spreadsheet titled "State of Iowa General Fund Tax Cuts FY1996-2004."
[2] Iowa Department of Revenue, *Tax Credits Contingent Liabilities Brief,* October 3, 2008. Business tax credits include enterprise zone credits, the research activities credit, jobs credits, the new capital investment program, ethanol and renewable energy credits, venture capital credits, and a few other minor programs.
[3] Citation in: Johnson, N. (2008). *Budget Cuts or Tax Increases at the State Level: Which is Preferable During an Economic Downturn?* Center on Budget and Policy Priorities: Washington, D.C.
[4] Iowa Fiscal Partnership (2004). *Iowa Voters and Taxes: Strong Public Support for Maintaining Services.*
[5] Fisher, P. (2007). *Leveling the Playing Field: Restoring Fairness to Iowa's Corporate Income Tax.* Iowa Fiscal Partnership.
[6] Gullickson, A., & Harris, A. (2008). *Iowa's Research Activities Tax Credit Tax Credit Program Evaluation Study.* Iowa Department of Revenue; and Elias, V. (2008). *Perks for the Most Profitable: Research Credits: Iowa Tax Policy Gone Awry.* Iowa Fiscal Partnership.
[7] Iowa Fiscal Partnership (2008). *A Capital (Gains) Offense: Unnoticed But Lasting Change Undermines Iowa's Tax Code.*
[8] Fisher, P. (2006). *Untaxing Seniors: A 'Solution' in Search of a Problem.* Iowa Fiscal Partnership; and Iowa Fiscal Partnership (2006). *Retirement Tax Breaks: The Policy Issues for Iowa.*
[9] Bruner, C. & Crawford M. (2006). *Securing Iowa's Economic Future: Strengthening Skills, Work Supports and Economic Security for Working Families.* Iowa Fiscal Partnership; and *Revenue Estimating Conference Tax Credits Contingent Liabilities Brief, op. cit.*
[10] Bruner, C. & Crawford, M. (2005). *Iowa's Personal Income Tax: Reform for Iowans at Any Age.* Iowa Fiscal Partnership.

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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. IFP work is supported by the Stoneman Family Foundation and the Annie E. Casey Foundation.