Iowa Fiscal Partnership

February 2009

The Revenue Roots of Iowa's State Budget Crisis

Understanding the causes of Iowa's current budget crisis is crucial to crafting good policy. Calls for "belt tightening" in the state budget, however, have tended to focus only on general fund spending and appropriations, characterizing the fiscal crisis as a "spending problem." That doesn't hold up to serious examination. Evidence from the past 24 years shows that general fund spending is actually lower today as a share of the Iowa economy than it was in the 1990s. The problem facing Iowa now and next year is that revenue reductions, primarily in the form of business tax credits, have grown substantially over the last decade while phased-in tax cuts have further reduced available revenues for ongoing general fund responsibilities.

The current fiscal crisis affecting Iowa and 45 other states is also rooted in a severe national economic downturn that has depressed tax revenues states depend on in developing their annual budgets. At the same time, needs for many of the services that states provide have increased, driving up state costs for Medicaid and other safety-net programs just when the state has the least flexibility to respond.

To best respond to this crisis, Iowa policymakers must examine all options when it comes to balancing the state budget. This means sensibly drawing down reserves (rainy day funds), making targeted rather than broad cuts to state services, and looking at the revenue as well as expenditure side of the state budget. These actions must look to balancing the budget in the immediate biennium (State Fiscal Years 2010 and 2011) but also to putting into place longer-term strategies that create a sustainable revenue base for essential services funded through the general fund.

Creating a sustainable foundation for the Iowa budget requires a serious review of tax policy and the largely unexamined growth in business-oriented tax breaks that have been enacted over this period. An examination of overall state revenues and expenditures in the context of overall state economic growth reveals a much different picture of state "spending" than is usually recognized. Figure 1 provides a long-term analysis of state general fund spending in relation to state economic growth as measured by personal income from FY1994 through FY2008 (both income and expenditures are indexed to a value of 100 in FY1995).

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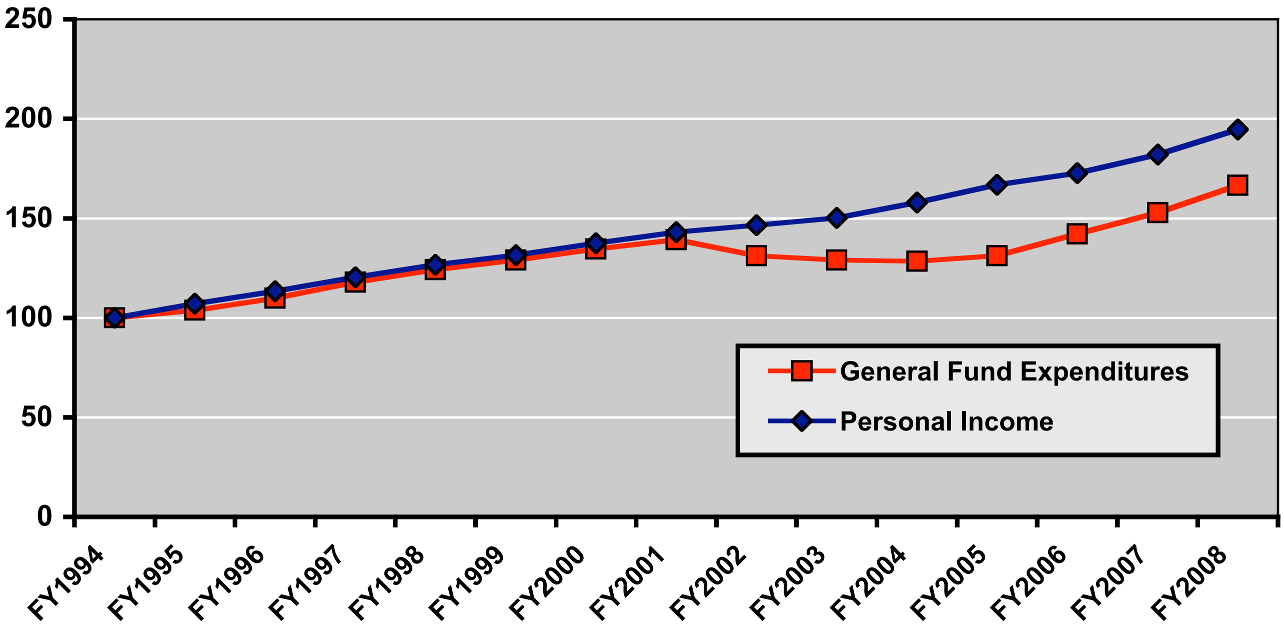
Figure 1. General Fund Spending Lags Behind Iowa Economic Growth



Source: Bureau of Economic Analysis, National Association of State Budget Officers State Expenditure Report

Between 1994 and 2001, growth in general fund spending was closely aligned with economic growth. During that period, Iowa ranked as an average tax and average spending state on most state comparisons.[1] However, during the late 1990s, as the national and the Iowa economy both expanded rapidly, Iowa lawmakers enacted a series of tax cuts that were based on increases in revenue caused by this growth. These tax cuts proved to be unsustainable over a full economic cycle.

When the economic downturn came in 2001, Iowa faced a budget crisis as revenue growth declined dramatically. However, Iowa's response to this budget crisis differed from that of most other states. During the period of fiscal crisis between 2001 and 2004, while many other states raised taxes to cope with declining revenues, Iowa not only cut spending substantially, but continued to enact tax cuts.

An analysis conducted by the Iowa Department of Management showed that tax changes that took effect between FY1996 and FY2004 resulted in $650 million in reduced general fund revenue in FY2004, more than enough to cover the budget shortfalls that existed during the recession.[2] The largest of these changes was the 10 percent rate reduction in state income taxes, implemented in FY1998 with an annual cost of $241 million in 2004, primarily benefiting upper-income Iowans. Since 2000, the Department of Revenue reports that over 40 new tax expenditures have been enacted, the majority directed to stimulating business growth and development and many open-ended in nature, growing substantially in size over time.[3]

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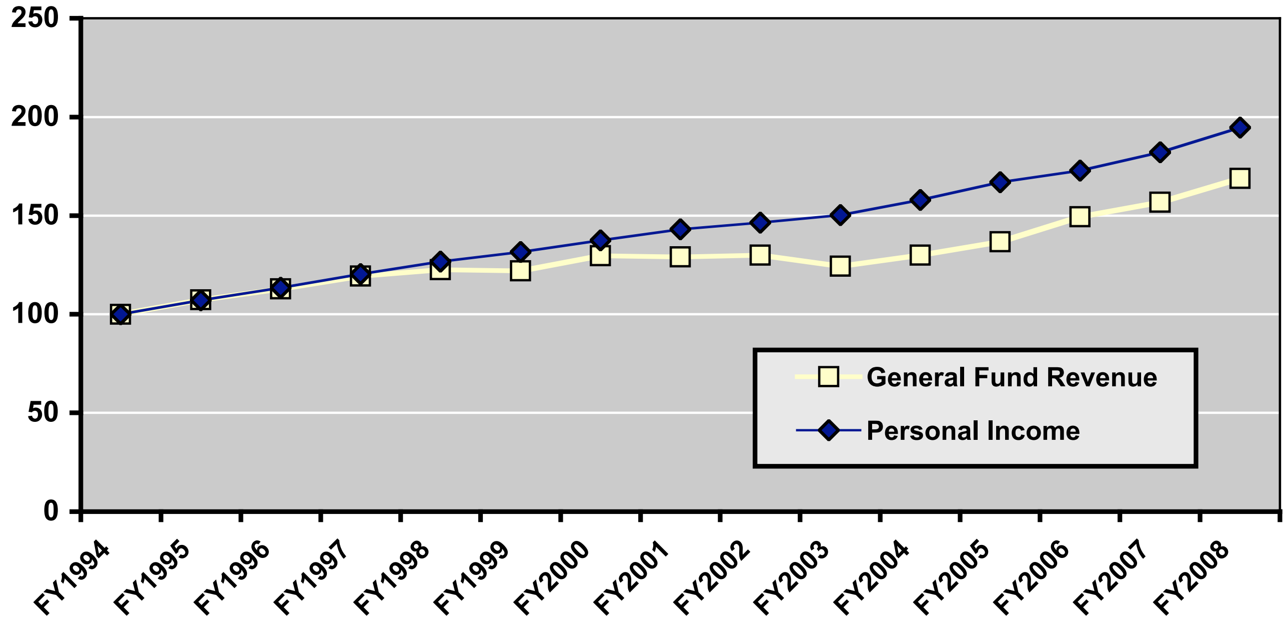
[1] For a discussion of how Iowa's tax and expenditure decisions compare to other states during the period leading up to and including the previous fiscal crisis, see the Iowa Fiscal Partnership's 2004 report, *The State Fiscal Crisis, 2001-2004: Comparing Responses of Iowa and Other States*. Available from: http://www.iowapolicyproject.org/2002-2004docs/040929a-50-STATE.pdf.

[2] Income and sales tax cuts only; see appendix two in *Everything You Ever Wanted to Know about Closing Tax Loopholes and Balancing Iowa's Budget. . . But Were Afraid to Ask* by the Iowa Policy Project and the Child and Family Policy Center, February 2004. Available from: http://www.iowapolicyproject.org/2002-2004docs/040204-loopholes-guide.pdf.

[3] Iowa Department of Revenue, *Tax Credits Tracking and Analysis Program 2007 Report to the General Assembly,* December 2007. Available from: http://www.iowa.gov/tax/taxlaw/IDRTaxCreditReportDec2007.pdf.

Figure 2 shows that the erosion in tax revenue in relation to state economic growth began even earlier than the decline of state general fund expenditures, with the divergence beginning in FY1998.

Figure 2. Tax Cuts Prevent Revenue from Keeping Up with Economic Growth



Source: Bureau of Economic Analysis, Revenue Estimating Conference

The Legislative Services Agency estimates that changes to the tax code enacted just since the 2004 legislative session are costing the general fund $150 million in FY2010.[4] The most expensive of these changes is the 2007 exemption of retirement income from income taxes, which disproportionately benefits wealthy Iowans and will cost the state general fund more than $58 million in FY2010. If not modified, by the time this tax change is fully phased in, in FY2015, it will cost the general fund more than $156 million a year. The major share of the benefit will go to retired Iowans with incomes above $80,000 per year.[5] Even without the continued phase in, these retirees pay much less in income taxes than working Iowa families with children — households that have similar incomes but more financial obligations.

Combined with the tax cuts that took place during the fiscal crisis of the early 2000s, these changes have severely restricted growth in state revenues. During FY2008, both general fund revenues and expenditures were lower as a share of the economy than before the previous recession, indicating that the Iowa budget has never recovered from the last state fiscal crisis (see Table 1). General fund spending, which averaged 6.24 percent of the Iowa economy (again, as measured by personal income) from 1994 to 1999, has averaged just 5.25 percent over the past five years, a drop of 16 percent.

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[4] Legislative Services Agency. "Future General Fund Revenue Impact of Enacted Legislation." Issue Review, January 21, 2009.

[5] For a full discussion of changes to the way Iowa taxes senior income, including equity concerns, see Peter Fisher's analysis for the Iowa Fiscal Partnership, "Untaxing Seniors: A Solution in Search of a Problem," February 2006. Available from: http://www.iowapolicyproject.org/2006docs/060222-ifp-rettax.pdf.

Table 1. General Fund Revenue and Spending Have Declined As a Share of Personal Income, FY1994-FY2008

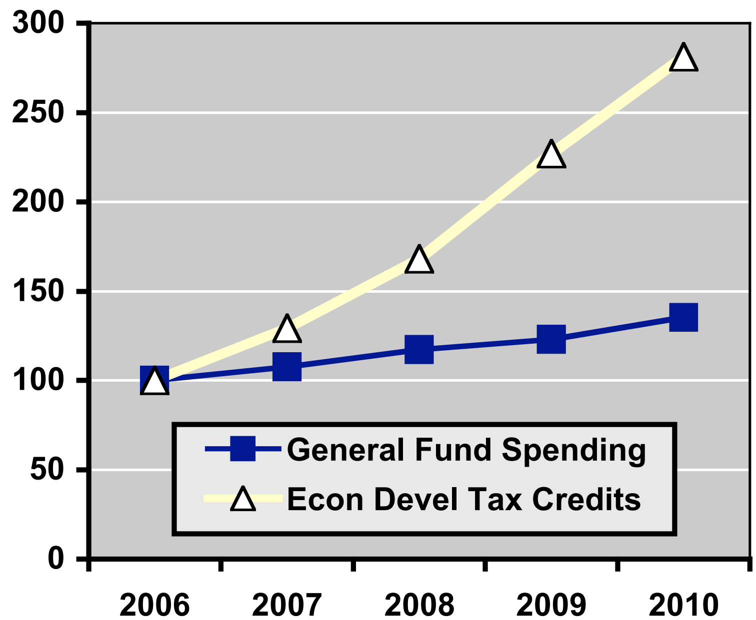
Fiscal Year	General Fund Revenue	General Fund Spending
1994	6.54%	6.37%
1995	6.55%	6.17%
1996	6.50%	6.16%
1997	6.48%	6.23%
1998	6.33%	6.24%
1999	6.08%	6.25%
2000	6.09%	6.23%
2001	5.89%	6.20%
2002	5.80%	5.70%
2003	5.41%	5.47%
2004	5.38%	5.18%
2005	5.36%	5.01%
2006	5.65%	5.24%
2007	5.63%	5.35%
2008	5.67%	5.45%

Source: Revenue Estimating Conference; National Association of State Budget Officers, State Expenditure Report; Bureau of Economic Analysis

Compounding these budget imbalances is the growth in state liability for business tax credits. This category of spending has increased dramatically over the past several years. Unlike appropriations, these business tax expenditures also face little legislative scrutiny or oversight once they are approved. Plus, their fiscal impacts are often substantially under-estimated. Unlike appropriations, which set ceilings on what can be spent, uncapped tax credits that operate automatically through the tax code can increase dramatically in size and yet are not subject to legislative discretion on an annual basis. Figure 3 shows the growth in such business tax credits over just the last four years.

The majority of this tax-credit spending occurs through five programs: the Research Activities Credit, the Enterprise

Figure 3. Dramatic Growth in Economic Development Tax Credits Far Exceeds General Fund Spending Growth



Source: Iowa Department of Revenue, Contingent Liabilities Report, December 2008 and National Association of State Budget Officers, State Expenditure Report

Zone Program, the Iowa Industrial New Job Training Program,[6] the High Quality Job Creation Program, and the New Jobs and Income Program.[7] Renewable energy credits and credits to ethanol and biodiesel producers and distributors also are a growing segment of economic development tax expenditures. Table 2 provides a breakdown of the economic development tax credits.

Table 2. Economic Development Tax Credits Grow Rapidly, FY2006-10

	Actual (millions of dollars)			Estimated (millions of dollars)	
	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
High Quality Job Creation Program	$0.0	$0.0	$8.5	$59.7	$87.6
Research Activities Tax Credit	$33.9	$38.7	$49.1	$62.7	$74.7
Enterprise Zone Program	$29.2	$39.7	$53.1	$62.2	$68.6
Iowa Industrial New Job Training Program (260E)	$29.5	$39.1	$39.3	$39.8	$40.4
Venture Capital Tax Credits	$0.6	$1.1	$1.0	$2.9	$24.4
Renewable energy credits	$0.0	$0.0	$16.9	$19.5	$19.6
Ethanol, biodiesel and soy-based oil credits	$5.6	$7.0	$9.6	$11.7	$19.0
New Jobs and Income Program	$30.5	$39.6	$31.7	$26.7	$17.2
Historic Preservation and Cultural District Tax Credit	$2.6	$5.4	$6.2	$8.9	$16.8
Film, Television, and Video Project Promotion Program	$0.0	$0.0	$0.6	$8.1	$10.8
Other credits*	$12.3	$15.9	$26.7	$25.3	$26.8
Total economic development tax credits	$144.3	$186.5	$242.7	$327.6	$405.9

*Accelerated Career Education Tax Credit, Wage-Benefits Tax Credit, Endow Iowa Tax Credit, Agricultural Assets Transfer Tax Credit, Economic Development Region Revolving Fund Tax Credit, Targeted Jobs Tax Credit from Withholding, Redevelopment Tax Credit.

Source: Iowa Department of Revenue, Contingent Liabilities Report, December 2008

Proponents of these credits argue that they produce jobs and economic activity, but national research generally shows that such tax credits have very marginal impacts upon business growth and development.[8] In fact, business tax credits also often run counter to "free market principles" regarding economic growth. Although they have a significant cost to the state, the size of these business tax credits in the end is very small in relation to other business costs — labor, transportation, and goods and materials. Businesses also make decisions related to availability of skilled and dependable workers and an infrastructure that supports economic life, which requires investments in education, human services, public safety, transportation, and sanitation. State expenditures also contribute to economic growth; teachers, for instance, pay taxes and buy houses and otherwise contribute economically.

The point is that tax expenditures and business tax credits are by far the fasting growing part of the state expenditure-revenue equation and need to be subject to much greater scrutiny and review. Their role in creating current fiscal shortfalls needs to be recognized and a response made. The Governor took a first step in this direction by proposing a cap on all uncapped business tax credits and eliminating the option

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[6] According to the Department of Revenue's descriptions of these tax credit programs, the Iowa Industrial New Jobs Training Program is a partnership with Iowa's community colleges that assists businesses creating new positions with employee training. These companies divert withholding taxes that would otherwise be remitted to the Department of Revenue to a community college to pay for the training of employees.

[7] No new awards have been made in the New Jobs and Income Program since FY2005, so remaining liabilities in that program are the result of awards made before that time. This program has been replaced by the High Quality Job Creation (HQJC) Program, which made its first awards in FY2006 and began seeing claims beginning in FY2008. The HQJC Program is administered by the Iowa Department of Economic Development and provides credits to companies making qualifying investments in jobs and capital in Iowa.

[8] See, for example, Robert Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Washington, DC: Economic Policy Institute, 2004; and Alan Peters and Peter Fisher, "The Failures of Economic Development Incentives." *Journal of the American Planning Association*, 70 (1): 27-38.

to double the size of the state Research Activities Credit. The General Assembly should build upon that platform.

Labeling the fiscal crisis a "spending problem" and calling for spending cuts runs counter to evidence regarding the growth in state expenditures and in revenue cuts. Spending through the tax code, particularly in the form of uncapped business credit programs but also in terms of long-term commitments to expand tax cuts without an offsetting source for financing them, represents a major contributor to structural budget instability in Iowa and needs to be addressed.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint fiscal policy initiative of two nonprofit, nonpartisan Iowa-based organizations, the Child & Family Policy Center in Des Moines and the Iowa Policy Project in Iowa City. IFP reports are available at www.iowafiscal.org.