Iowa Fiscal Partnership

BACKGROUNDER

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Intro to 2018: Sensible improvements for Iowa tax policy

As Iowans look ahead to potential changes in the state's tax structure, there are areas clearly ripe for reform to assure better fairness and revenue adequacy, often without raising taxes or rates:

- **Reining in business tax credits** that are growing much faster than other state spending, and displace resources for traditional priorities of our state. The Special Tax Credit Review Panel in 2010 made serious recommendations for better accountability.
- **Tightening tax-increment financing rules**, which let cities and counties divert property tax dollars from schools and other public services in ways not envisioned when this tool was created. The reduced property tax revenue to schools forces higher costs to the state.
- **Eliminating federal deductibility** to reduce selected income-tax rates — but not reducing revenues or causing greater inequities in Iowa's overall tax system.
- **Protecting the Earned Income Tax Credit**, which has been under attack at the federal level in ways that would reduce its effectiveness at the state level as well.
- **Plugging tax loopholes** across the board, in the corporate income tax (with combined reporting) and in the sales tax code, which has a litany of special interest exemptions that demand a review.

Aside from reform of existing programs, **new proposals** likewise should follow widely accepted principles for tax policy (box at right). This includes any sales-tax increase designed to implement the **proposed 3/8 percent sales tax** for air, land and water protection and enhancement in keeping with a 2010 constitutional amendment passed by voters.

Any tax changes especially must recognize concerns of revenue adequacy in these troubled budget times, and of equity and fairness. These principles are threatened by many trial balloons that have been floated at the Statehouse for tax policy changes in 2018.

Recognized Principles for Evaluating State Tax Policy and Proposals

The following are long-recognized principles for evaluating state taxes, used previously in Iowa as a basis for tax reform discussions.

FAIRNESS. Taxes should be based upon ability to pay; and those with similar ability to pay should have similar tax responsibilities.

PUBLIC BENEFIT AND ECONOMIC EFFICIENCY. Tax incentives should promote some public purpose. Incentives that serve no public purpose can distort private economic decisions, making the economy less efficient.

REVENUE ADEQUACY. Taxes must be capable of producing sufficient revenues to finance essential state and local public services.

COMPETITIVENESS. A state's overall tax system should not be significantly out of line when compared to other states.

STABILITY AND PREDICTABILITY. A tax base should be as stable and predictable over the business cycle as possible.

SIMPLICITY. The tax system should be easy for citizens to understand and taxpayers to comply with, and it should be easy for the government to collect the tax and audit for compliance.

TRANSPARENCY AND ACCOUNTABILITY. Those who spend money or promote or use tax expenditures should be accountable for their proper use, with public disclosure that enables independent review.

Tax credits, loopholes and exemptions

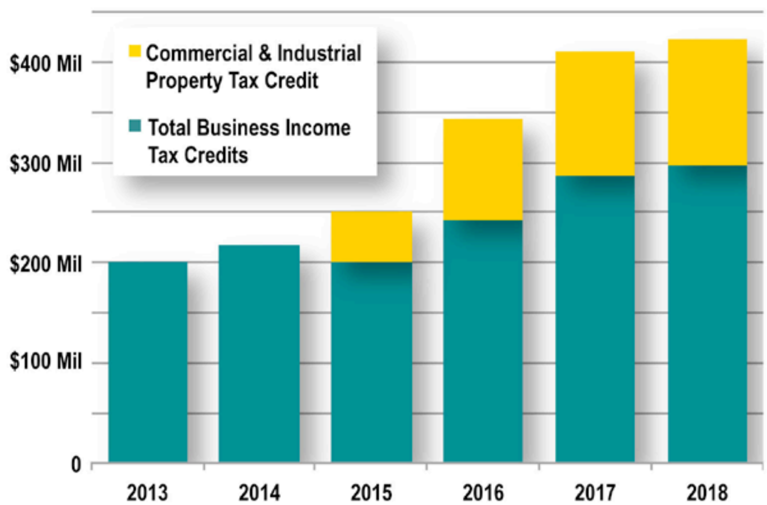
Iowa business tax credits challenge our ability to raise revenues adequate to address traditional Iowa priorities. In addition, they compound other tax inequities. By themselves, tax credit reforms would not resolve all revenue needs or fairness issues, but they are the low-hanging fruit toward such goals.

The effectiveness of many business tax credits has been questioned in studies by the Iowa Department of Revenue, academic research, and the Iowa Tax Credit Review Panel of 2010.[1] This issue increasingly has become recognized in the media, among advocates for critical public services, and by legislators on both sides of the aisle. A 2017 study bill (HSB187) would have ended tax-credit refundability — a costly feature of Iowa's most lucrative business credit, the Research Activities Credit (RAC). Refundability in 2016 permitted a handful of very large companies to receive checks totaling over $35 million from the state because the amount of their tax credits exceeded the amount of income taxes due. They paid no state income tax.

Business tax credits total over $400 million this year.[2] This includes $125 million for a credit that was part of the massive commercial property tax cuts of 2013. (Considering all the provisions of the 2013 cuts, they now cost the state treasury $300 million annually.[3]) Just a portion of these breaks would go a long way to solving the state's perennial budget problem. The graph at right shows existing business income tax credits and the new property tax credit together cost the state twice as much as the credits cost in 2013, leaving less to spend on critical public services.

Cost of Iowa Business Tax Credits Doubles in Five Years

Combined Cost: Business Credits, New State-Funded Property Tax Credits



Source: Iowa Department of Revenue, Contingent Liabilities Reports, Table 9: March 2017 and previous years; Summary of FY2018 and FY2019 Budget and Governor's Recommendations, LSA Fiscal Services, Jan. 14, 2017, p. 218

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Separate are the issues of **tax loopholes**, where individuals or companies have learned to exploit seams in the tax code to legally avoid taxes that lawmakers presumably intended to collect. A 2003 IFP paper looked at several of these issues, including the idea of collecting sales and use taxes on internet and mail-order purchases.[4] Purchasers are supposed to voluntarily report and pay the tax, but rarely do so, because the sellers do not generally collect it.

Since internet purchases are undoubtedly made disproportionately by middle- and upper-income taxpayers, the failure to collect internet sales taxes makes the sales tax more regressive. Requiring sellers to collect the tax will not only increase state revenues and stabilize the sales tax base, but will have a mildly progressive effect on the overall tax system. It will also level the playing field; traditional Main Street businesses have always collected the tax. Such a change might be more likely with Amazon's commitment late last year to begin collecting tax on sales in Iowa.[5]

IFP also has reported extensively on corporate tax loopholes and the prospect of plugging them with "combined reporting," as 25 states do, including all of Iowa's neighbors except Missouri.[6] The

Iowa Department of Revenue in the past has estimated the savings that could be achieved by plugging those loopholes at between $60 million and $100 million. Combined reporting has been discussed at the committee level in the past and included in at least one budget by two governors, but has not been a part of any major legislation reaching the floor of either house.

Broad tax-system restructuring

Based on comments by legislative leaders and new Governor Kim Reynolds, far-reaching changes in Iowa's tax structure may be considered in 2018. As recently as 2015, Senate Republican Leader Bill Dix was talking about steps toward full repeal of the state corporate and individual income tax.[7] At the time, he was in the minority but he now is majority leader and sets the Senate agenda. Reynolds as she took office in May signaled that tax changes are a priority for her, to lower income-tax rates and simplify a "patchwork of exemptions, deductions and credits."[8]

In addition, the sales tax could become a focus for an increase, due to the 2010 voter approval of the Natural Resources and Outdoor Recreation Trust Fund, which will receive the first 3/8 percent of any sales-tax increase approved by lawmakers. Advocates are promoting that funding, and some have proposed raising the sales tax a full 1 percent, and putting the balance toward other uses — some suggesting service improvements, and others suggesting it as a means to reduce other taxes. Any such changes should be considered in light of the tax principles noted above — any increase in sales tax should be offset by low-income supports such as the EITC because the sales tax affects lower-income Iowans disproportionately. Further, lawmakers should not use the regressive sales tax to "buy down" the only progressive state tax, the income tax. Changes in the income tax, such as suggestions for a middle-income tax cut, should assure that principles of fairness and revenue adequacy for state priorities are not diminished.

How to use savings — not new cuts

There is a real danger that dollars saved from capping or reducing business tax credits, or removing sales-tax exemptions or income-tax deductions, would not be used to improve education, reduce student debt, clean our water, or restore funds cut from public safety and the courts. Instead, some would cut taxes further, to address a non-existent problem of competitiveness of Iowa taxes.

- **First, Iowa taxes consistently are average or below among the 50 states.** One report ranked Iowa business taxes fourth lowest in the country.[9] State and local taxes overall are about 5.9 percent of Iowa personal income in Iowa; the U.S. average is 6.0 percent.[10]
- **Second, taxes have little or nothing to do with people's decisions to move from one state to another.** Research consistently finds taxes have a negligible effect.[11]
- **Finally, state and local taxes on business are too small to have a significant effect on business investment and location decisions.** All state and local taxes on businesses combined represent about 1.8 percent of total business costs on average for all states.[12]

Conclusion

Real tax reform would eliminate wasteful spending on tax breaks that provide little or no economic benefit, would transform a regressive system into one that fairly apportions the cost of public services based on ability to pay, and would assure a stable revenue stream to fund education and other public services important to ordinary Iowans.

[1] The Department of Revenue's evaluation studies can be found here. Reviews of academic research include those by the Iowa Policy Project's Peter Fisher on the website *Grading the States*, and by Wiliam Gale, Aaron Krupkin, and Kim Rueben. "The Relationship between Taxes and Growth at the State Level: New Evidence." *National Tax Journal,* vol. 68, no. 4, December 2015, pp. 919-941. The Iowa Tax Credit Review Panel report can be found here.

[2] "A Spotlight, Not a Floodlight, on Business Breaks." Iowa Policy Points blog.

[3] This includes $152 million estimated for FY 2017 for the Commercial and Industrial Property Tax Replacement; $125 million for the Business Property Tax Credit; and an additional $25 million in state School Foundation Aid necessitated by the reduced assessment of commercial and industrial property. See *Summary of FY 2018 and FY2019 Budget and Governor's Recommendations*, LSA - Fiscal Services, January 12, 2017, p. 218; *Summary of FY 2017 Budget and Governor's Recommendations*, LSA - Fiscal Services, January 14, 2016, p. 63.

[4] "What Would Real Tax Reform Look Like?" Peter Fisher and Charles Bruner, Iowa Fiscal Partnership, October 2003: http://www.iowapolicyproject.org/2002-2004docs/031021-tax_reform.pdf

[5] *"Online retail giant Amazon to charge sales tax in Iowa,"* KCCI-TV, Dec. 9, 2016. http://www.kcci.com/article/online-retail-giant-amazon-to-charge-sales-tax-in-iowa/8484549

[6] *Leveling the Playing Field*, Iowa Fiscal Partnership, Peter Fisher, April 2007 http://www.iowapolicyproject.org/2007docs/070411-IFP-loophole.pdf; note, South Dakota does not have combined reporting but also does not have a corporate income tax. Among Iowa's neighbors that do have corporate income taxes, only Missouri does not have combined reporting.

[7] "Senate GOP Leader Dix: Abolish Iowa income taxes," *The Des Moines Register*, Dec. 9, 2015. http://www.courier-journal.com/story/news/politics/2015/12/09/senate-gop-leader-dix-abolish-iowa-income-taxes/77065748/

[8] "Kim Reynolds becomes Iowa's first female governor," *The Des Moines Register,* May 24, 2017. http://www.desmoinesregister.com/story/news/2017/05/24/kim-reynolds-takes-oath-office-becomes-iowas-first-female-governor/341857001/

[9] Ernst and Young, LLP and the Council on State Taxation, *Total State and Local Business Taxes: State-By-State Estimates for Fiscal Year 2015*, December 2016 . Anderson Economic Group, *2016 State Business Tax Burden Rankings*, 7th Edition, May 2016. KPMG and the Tax Foundation, *Location Matters: The State Tax Costs of Doing Business*, 2015. Ernst and Young, LLP and the Council on State Taxation, *Competitiveness of State and Local Business Taxes on New Investment*, April 2011.

[10] Today's Virtual House Graphic: Risky Fix to Non-Problem. Iowa Policy Points blog.

[11] See *Taxes Have Little to do with People's Decisions to Move to or From a State*. On IPP's Grading the States website.

[12] See *State and Local Business Taxes are Not Significant Determinants of Growth*. On IPP's Grading the States website.

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