

Choosing the Right Stream

*How Iowa Can Keep Clean Water
Priorities and Funding Equity Together*

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July 2019

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We gratefully acknowledge the support of the **McKnight Foundation** and the **Fred and Charlotte Hubbell Foundation**. Views expressed are solely the perspective of the authors and the Iowa Policy Project.

We thank the Institute on Taxation and Economic Policy for calculations of the impact of sales-tax changes on Iowans at various incomes. **We also thank these individuals** who graciously reviewed this report and provided thoughtful insights in advance of publication: **Ingrid Gronstal Anderson**, Water Program Director, Iowa Environmental Council; **Alicia Vasto**, Water Policy and Advocacy Specialist, Iowa Environmental Council; and **Adam Mason**, State Policy Director, Iowa Citizens for Community Improvement. The authors alone are responsible for the report.

The Iowa Policy Project

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Choosing the Right Stream: How Iowa Can Keep Clean Water Priorities and Funding Equity Together

By itself, the sales tax diverts attention from needed, larger reforms

By David Osterberg, Peter Fisher and Natalie Veldhouse

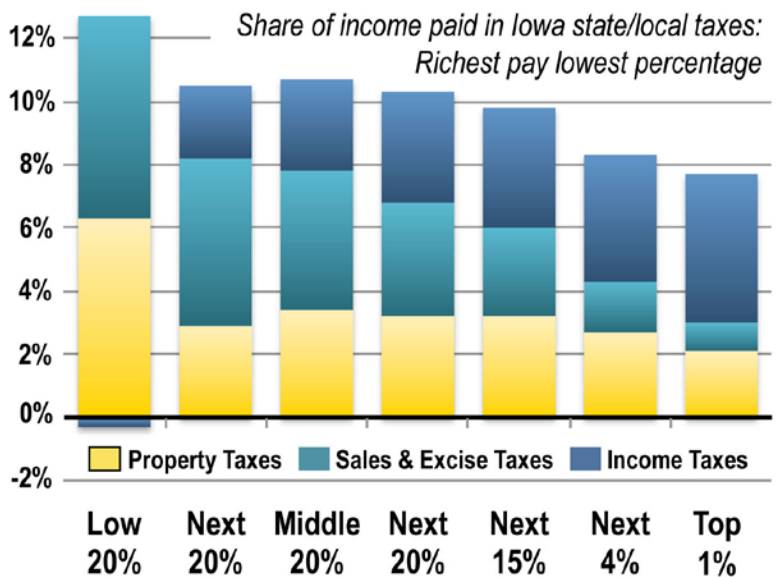
Iowa's investment — or lack of investment — in water quality is a perennial issue driven by growing attention to pollution by the state's most prominent industry, agriculture. Nine years ago, Iowa voters responded with overwhelming approval of a constitutional amendment creating a Natural Resources and Outdoor Recreation Trust Fund. The funding source was to be a new sales tax dedicated to natural resources programs, many to improve water quality.

The trust fund remains empty and other action to improve water quality has been scant. In 2013, under pressure from the federal government, the state rolled out the Nutrient Reduction Strategy (NRS), supposedly to reduce nutrient pollution by about half, but with no deadlines or enforcement mechanisms. The NRS did include new programs to work with landowners to voluntarily change farming practices. Five years after that, in January 2018, the new governor put her first signature on a law to allocate more funding into water quality programs.

While some programs received funds through programs designed to implement the NRS, other water quality programs were eliminated or reduced. Thus, overall funding of water quality programs had not even reached the funding level of 2008 or 2009.¹ The 2018 legislation finally brought new money to the table, but not by expanding the budget pie. It put no new sources of funding into the package. Instead, it pitted existing uses of those funds for programs such as education and supports that benefit low- and moderate-income Iowans, and working families against conservation practices. Depending on the sales tax as the only source of new revenue also has equity problems.

As we illustrate below, not finding new sources to fund water quality or depending on sales taxes create funding equity issues. Such policy also eases the tax load on polluters who are not required to deal with the problems they create.

Figure 1. Iowa's upside down tax system



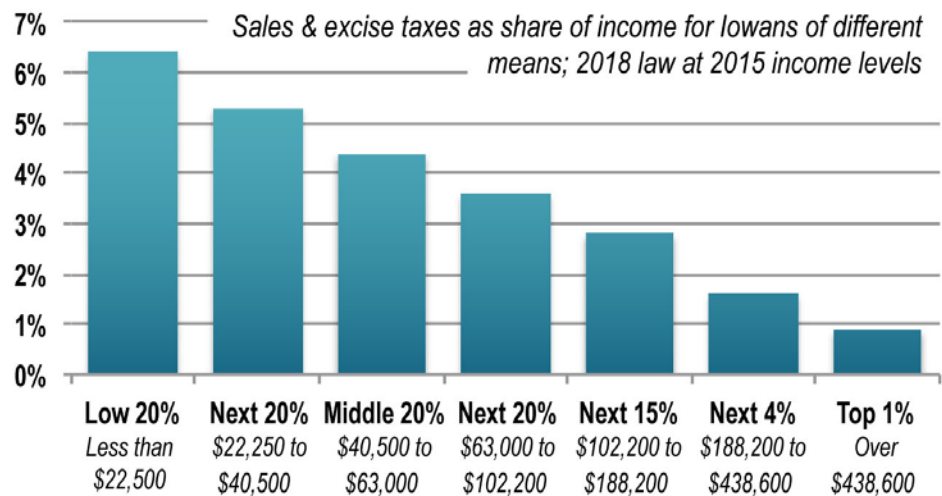
Iowa Fiscal Partnership

Source: Institute on Taxation and Economic Policy, www.itep.org

Sales tax: Equity as an afterthought

To begin with, the entire Iowa tax system is regressive — the lowest-income families pay a larger percentage of their meager income in state and local taxes than higher-income families (Figure 1). The sales tax has doubled in Iowa since 1983 — the year it was raised a penny from 3 cents² on the dollar. It was raised again in 1992 and 2008. Meanwhile, the other major state revenue source, income tax, has been cut in various ways over the last 20-plus years, with major rate reductions in 1997 and 2018, and more targeted reductions at other times. This inclination to look to sales tax to fund services, rather than income tax, may be understandable as advocates seek what they perceive to be a politically achievable way to find a revenue source for their priorities. However, it drives much of the unfair structure of the tax system. Iowa is not alone. Most state tax systems are regressive since they, too, depend so much on sales taxes — some even more than Iowa.

Figure 2. Low-income Iowans pay greater percentage in sales, excise taxes



Iowa Fiscal Partnership

Source: Institute on Taxation and Economic Policy

Filling the trust fund, the most prominent proposal to improve water quality, again puts the sales tax front and center. Of the three main sources of state and local taxes — property, income and sales — the sales tax takes a larger proportion of income from low-income households than higher-income ones. While Iowa exempts most food and prescription medicine from the sales tax, a tax on purchases hits lower income families harder. Higher income families are able to save and so do not spend as much of their income as do lower-income households on things subject to the sales tax. Thus, a sales-tax increase disproportionately affects lower-income households (Figure 2).

What can we do about the funding equity problem?

That voters overwhelmingly approved the trust fund, to be funded by sales tax, not only shows public desire for better water quality and recreation, but also their acceptance of a sales-tax solution. Yet clearly, using a new sales tax as the source for water quality spending, or diverting more general fund dollars for that purpose at the expense of other critical services, creates a funding equity problem. How can Iowa fund water quality efforts without taxing a larger share of low-income families or diminishing other services that offer a step up the ladder of opportunity and family prosperity?

Two options already part of Iowa law could cushion the effect of a sales tax increase on low-income Iowans. Combining a boost to the Earned Income Tax Credit (EITC) and the Disabled and Senior Citizen Property Tax Credit and Rent Reimbursement Program (Rent Reimbursement) can offset the tax consequences of a sales-tax increase for low- to moderate-income Iowans. The EITC helps working Iowa families whereas Rent Reimbursement addresses Iowans unable to work due to age or disability.

Using the Earned Income Tax Credit

The Trust Fund is designed to take three-eighths of the next penny increase in the sales tax. Sales tax increases in Iowa over the past 50 years have all been an even cent.³ The next change will likely be the same. So, if the tax is raised by 1 cent, there will be funds that can be tapped to reduce the unequal effect on low-to-moderate income families — to restore funding equity.

As noted above, one funding equity adjustment is to increase the state EITC. As the Institute on Taxation and Economic Policy and others note, the EITC can be an effective tool:

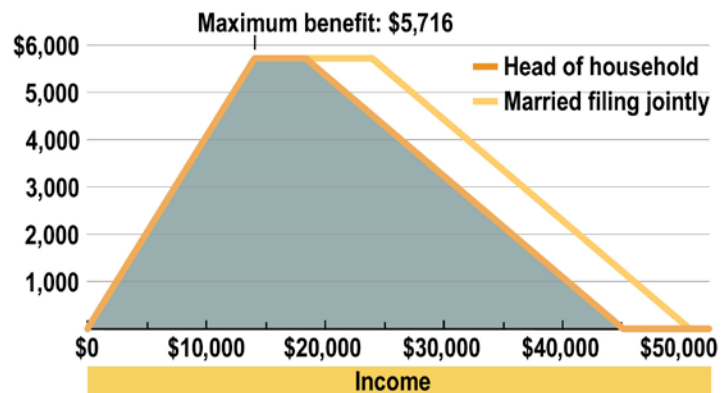
The Earned Income Tax Credit (EITC) is a policy designed to bolster the earnings of low-wage workers and offset some of the taxes they pay, providing the opportunity for struggling families to step up and out of poverty toward meaningful economic security. The federal EITC has kept millions of Americans out of poverty since its enactment in the mid-1970s. Over the past several decades, the effectiveness of the EITC has been magnified as many states have enacted and later expanded their own credits.⁴

Iowa allows a refundable credit equal to 15 percent of the federal EITC. Compared to other states, Iowa's percentage is about average but 12 states set their credit higher.⁵ Figure 3 shows the effect of the federal EITC on the take-home pay of low-wage workers.⁶ As a low-income worker's salary increases to a certain level, so does the amount of the federal credit to a maximum level (\$5,716 in 2018 as shown in Figure 3). After some level of earnings the credit is reduced gradually until it ceases.

According to the Urban Institute-Brookings Tax Policy Center,⁷ the average federal EITC payment in Iowa was \$2,251 in the 2016 tax year. Fifteen percent of this amount, or \$338, is eligible as a credit against Iowa taxes. This well-designed support program's percentage could increase to reflect the new sales tax's effect on low- and moderate-wage workers.

Figure 3. EITC boosts income, then phases out

Earned Income Tax Credit, Households with Two Children, 2018



Note: Assumes all income is from earnings (as opposed to investments, for example).

Source: Internal Revenue Service

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Using the Disabled and Senior Citizen Property Tax Credit and Rent Reimbursement Program

Iowa could enhance another existing program to offset the regressive nature of the sales tax that currently makes it more difficult for low-income taxpayers to make ends meet.

The Disabled and Senior Citizens Property Tax Credit and Rent Reimbursement Program ... provides certain low-income citizens with property tax assistance. Homeowners qualify for a property tax credit, while renters qualify for reimbursement of the portion of rent which constitutes property taxes paid.⁸

In 2016, more than 32,000 Iowans filed claims for rent reimbursement with an average claim of \$567.⁹ History shows that expanding this longstanding program is achievable, with previous expansions in 2007 and 2013, and logistically it is a simple and understandable change in the complex world of taxes. Increasing the size of the credit and/or raising the income eligibility

ceiling to reflect inflation over the past several decades would help offset the 1-cent increase in the sales tax, and ensure funding equity in funding the trust fund.

Amount of the sales tax increase to low and moderate-income lowans

The Institute on Taxation and Economic Policy (ITEP) calculates state and local taxes paid by each quintile of a state's population.¹⁰ This organization has calculated the additional tax that would be paid by the lowest two income quintiles (income up to \$43,000 per year).¹¹ These Iowa taxpayers would pay on average \$124 yearly if sales tax were increased by 1 percent to fill the trust fund and provide revenues for other state purposes.¹² To help just those families who are eligible for the rent reimbursement and property tax reduction program, the size of the average credit could be increased by \$124. Increasing the state EITC to 20.5 percent of the federal credit would provide a full offset for the average working family eligible for the EITC. The cost of these offsets would be just under \$4 million for the 32,000 who receive the rent and property tax credit.¹³ The increase in the EITC to 20.5 percent from 15 percent would cost less than \$26 million.¹⁴ If policy makers wanted to go further with the EITC approach, they could consider making seniors 65 and over eligible for that benefit,¹⁵ and/or expand the EITC for low-income childless workers.¹⁶

A different alternative — taxing the polluter

Another more equitable tax source for water quality funding is to remove the exemption from the already existing sales tax for agricultural fertilizer. Data compiled by Iowa State University as part of the NRS program demonstrates that more than 90 percent of Nitrogen (N) and two-thirds of Phosphorus (P) in Iowa waters come from nonpoint sources, almost all from agricultural runoff. Fertilizer used in the agricultural sector is the source of the contamination, so it is odd that the normal Iowa sales tax does not apply to the N or P used in agriculture. An urban Iowan will pay sales tax at the local hardware store to purchase a bag of garden fertilizer. While the state sales tax rate is 6 percent, inputs to agricultural production are exempt. (There is a small fee already on chemicals, including N and P for groundwater protection programs, but no general sales tax).

Iowa farms use a lot of fertilizer. The USDA's latest Census of Agriculture (2017) shows about \$1.8 billion spent on "commercial fertilizer, lime and soil conditioners" in Iowa that year.¹⁷ Canceling the exemption and taxing such a large input would bring a substantial source of water quality funding: about \$110 million annually.¹⁸

Farmers have exemptions from normal sale tax on many inputs for their operations. However, they do pay tax on one such product. Just like others, farmers pay a use tax on pickups used on the farm and off, to pay for the impact their vehicles impose on the roads we all use.^{19 20} Since agricultural fertilizer applied on the farm also flows into rivers and lakes, costing everyone, a tax on fertilizer follows the same logic as a fee on pickups.

How to do this in a struggling farm economy is an issue that bears on the political ability to actually get it done. It is difficult to know how much of the additional tax would be paid, ultimately, by fertilizer manufacturers or by dealers and farmers. Introducing this solution at a time of low corn and soybean prices, as is currently the case, may have unintended effects on small farmers. It is true that the problem grew amid higher commodity prices when producers could have more easily afforded to pay more for conservation efforts. In fact, during times of high commodity prices, new acres were planted on marginal ground where better stewardship would have kept them from row crop production, increasing nutrient pollution. A solution is to phase out the tax exemption over several years.

Consider one final point. Since the topic of this paper is funding equity, placing the cost of pollution on the chemicals that pollute Iowa waters also follows the “polluter pays” principle that is standard in much of environmental policy.

Conclusion

Iowans have demonstrated at the ballot box that they are willing to pay more to enhance outdoor recreation and improve state waters. It is possible to do that and not, at the same time, make the lowest-income Iowans bear a disproportionate share of the cost of fixing a problem they did not create. Two possibilities that each could bring in more than \$100 million annually are available. Expanding tax benefits for lower-income families as the general sales tax is increased, or applying the sales tax to all fertilizer, can lead to improved water quality — and a fairer tax system.

¹ David Osterberg and Natalie Veldhouse, “Lip Service: Iowa’s Inadequate Commitment to Clean Water.” April 2019. Iowa Policy Project. <http://iowapolicyproject.org/2019docs/190424-WQfunding.pdf>

² Iowa Department of Revenue, “Iowa Tax Rate History.” Accessed May 10, 2019 <https://tax.iowa.gov/iowa-tax-rate-history>

³ Ibid.

⁴ Institute on Taxation and Economic Policy. Rewarding Work Through State Earned Income Tax Credits in 2017. September 2017 <https://itep.org/rewarding-work-through-state-earned-income-tax-credits-in-2017/>

⁵ Institute on Taxation and Economic Policy, “Rewarding Work Through State Earned Income Tax Credits.” September 2016.

https://itep.org/rewarding-work-through-state-earned-income-tax-credits-2/?gclid=CjwKCAjwza_mBRBTEiwASDWVvs99xAGBa5qmhDZF_TtXitA51mlFgamBWlzQfM0GCiK16KZ6_MgvPhoCNtMQAvD_BwE

⁶ Center on Budget and Policy Priorities, “Policy Basics: The Earned Income Tax Credit.” April 2018.

<https://www.cbpp.org/research/federal-tax/policy-basics-the-earned-income-tax-credit>

⁷ Urban-Brookings Tax Policy Center, “EITC Claims by State” <https://www.taxpolicycenter.org/statistics/eitc-claims-state>

⁸ Cole Unger, “Iowa’s Disabled and Senior Citizens Property Tax Credit and Rent Reimbursement Program Expenditure Projections Study.” August 2012. Iowa Department of Revenue. <https://tax.iowa.gov/sites/files/idr/PTCandRRPForecast.pdf>

⁹ Analysis from the Iowa Department of Revenue. Retrieved May 2019.

¹⁰ Institute on Taxation and Economic Policy. Who Pays. 6th edition. Iowa. October 2018. <https://itep.org/whopays/iowa/>

¹¹ Institute on Taxation and Economic Policy.

¹² General Sales tax plus sales and excise on businesses for the lowest quintile is 5 percent of the \$12,000 average income. The same sales taxes for the second quintile is 4.5 percent of the \$33,000 average income. The average current state and local sales tax (at a rate of about 6.8 percent) for the bottom 40 percent is therefore \$1,049. Increasing the tax by a penny would therefore increase the average tax paid by the bottom 40 percent of taxpayers by about \$154..

¹³ \$124 for each of the 32,000 who receive the credit equals \$3,968,000.

¹⁴ \$124 for each of the 209,000 taxpayers who receive this credit equals \$25,916,000.

¹⁵ Elizabeth McNichol, Center on Budget and Policy Priorities, “States Should Target Senior Tax Breaks Only to Those Who Need Them, Free up Funds for Investments,” June 19, 2019. <https://www.cbpp.org/research/state-budget-and-tax/states-should-target-senior-tax-breaks-only-to-those-who-need-them>

¹⁶ Chuck Marr, Brendan Duke, Yixuan Huang, Jennifer Beltran, Vincent Palacios, Arloc Sherman, Center on Budget and Policy Priorities, “Working Families Tax Relief Act Would Raise Incomes of 46 Million Households, Reduce Poverty,” April 10, 2019.

<https://www.cbpp.org/research/federal-tax/working-families-tax-relief-act-would-raise-incomes-of-46-million-households>

¹⁷ United States Department of Agriculture 2012 Census of Agriculture, “Chapter 2, Table 3. Farm Production Expenses: Fertilizer Totals, Incl Lime & Soil Conditioners-Expenses measured in \$.” 2019. https://www.nass.usda.gov/Quick_Stats/CDQT/chapter/2/table/3/state/IA

¹⁸ \$1,845,469,000 X 6 % = \$ 110,728,140. The total in the 2017 Census of Agriculture was much smaller than the 2012 figure \$2,587,059,000.

¹⁹ Iowa Department of Revenue, “Iowa Tax/Fee Descriptions and Rates.” N.D. “Iowa Department of Revenue, Iowa vehicle purchase and lease. (undated) “These vehicles are subject to a one-time registration fee equal to 5% of the sales or lease price.”

<https://tax.iowa.gov/iowa-tax-fee-descriptions-and-rates#MVUT>

²⁰ A use tax is imposed by most states on vehicle purchases. The Iowa use tax is collected by the county where the car is registered, regardless of where it was purchased, to prevent shopping for lower taxes. A similar arrangement with surrounding states could be utilized for fertilizer purchases.