Choices for Iowa
Building a Better Tax System

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September 1998

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This study was funded through a grant from the Joyce Foundation, Chicago, Illinois.

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A state and local tax system plays many roles. First and foremost it provides the means to pay for government services. It also helps define the relationships between a state and its various local governments: county, city, school district. And it defines the relationship of people as individuals with the embodiment of people as a society—government.

Quality government services are critical to the economic and social well-being of any society and any state. Schools and infrastructure are at least as important to economic growth as entrepreneurship and the cost of capital. A failure to recognize this, in favor of feel-good solutions such as tax incentives and business subsidies, can do very real damage to a state's economy.

Iowa has, over time, been investing more in government services. Iowa's recently improved economic situation could not have occurred without this commitment.

But other states also have been enhancing the programs they provide their citizens and businesses. Thus, Iowa has already started to fall behind in some areas and with recent tax cutting and ever more restrictive limitations on revenue raising, risks falling further behind.

The relationship between Iowa's state government and its local governments is increasingly one of the state prescribing the amount and means of local government revenue collection and local government relying on the state for funding. The risk is that if the state government keeps cutting taxes and restricting its own ability to raise revenue, services at all levels of Iowa government will suffer.

What government does is not only important in an economic dollars-and-cents way, but also in terms of quality of life. Good schools are not just about producing high quality cogs for the economic machinery. Good schools are about producing good citizens with a knowledge and appreciation of the world around them. Government is also about providing safe streets, good health services and a clean and healthy environment. These things are important not just because they are attractive to corporations deciding where to locate—which they are—but also because they enhance the lives of the citizens of Iowa. If instead of spending money on things that actually help Iowa's economic and social environment, Iowa's government spends it on tax breaks for wealthy citizens and corporations, that can hurt Iowans in many ways.

The way that government taxes its citizens also affects the quality of life of Iowans. Currently, middle- and low-income Iowans pay a greater share of their income in state and local taxes than do the best-off citizens of the state. As this report documents, there has been a shift in taxes from better-off Iowans and corporations to middle- and low-income families—most recently in the form of tax cuts targeted at the best-off. Government services are important and their costs must be shared. But Iowa has been moving away from taxing based on people's ability to pay.

This report offers an examination of these and other issues pertaining to the tax system of Iowa and the state's economic and social environment. Included in the study is an assessment of the merits and shortfalls of a number of tax reform options. We hope this report will prove to be useful to both the policymakers and the average citizens of Iowa.

SUMMARY OF FINDINGS

Economic and Social Indicators

Between 1978 and 1993, Iowa's real per capita personal income grew by less than one percent—slower than in all but three states—while the nation's real per capita income grew by nearly 18 percent. Between 1993 and 1996, however, Iowa's real per capita personal income grew by 10.6 percent, double the national growth and faster than any other state in the nation.

Despite more jobs, falling population and a low unemployment rate, average salaries have fallen in Iowa, both absolutely and compared to the national average. To a large degree, this reflects an increase in the employment/population ratio. Iowa now ranks fourth in the share of its population that is employed.

As the share of adult Iowans working nears its maximum possible amount, the growth in the employment/population ratio is likely to cease. This will put upward pressure on wages. If Iowa does not have a workforce and non-labor assets of sufficient quality to support high-wage jobs, however, the recent economic growth may stagnate. Thus, it is more important than ever that Iowa invest in its labor and non-labor assets.

The current state of those assets is mixed. Iowa has good roads and ranks about average in the condition of its bridges. Iowa ranks high in several measures of elementary and secondary education. The high school graduation rate is comparatively high, as are the most recent rankings in elementary school proficiency in math and reading. Iowa has for several years also ranked well in pupil-teacher ratios.

But there are indicators that Iowa's commitment to public education has been waning. Expenditures per-pupil have risen at about half the rate of the national average since 1980. Iowa teachers' salaries in 1997 had dropped to 85 percent of the national average—putting Iowa 35th in the country. If these trends are not reversed, it is unlikely that Iowa will continue to do well in primary and secondary educational achievement. This would be a blow to the economic future of Iowa.

Iowa ranked 24th in the percent of population with a college degree or higher in 1996. But the percentage of the population with a graduate degree in Iowa is 6th lowest of any state, and Iowa ranks 33rd in the number of employed doctoral scientists and engineers per 1,000 workers. Currently, the prospects for improving these numbers are good since Iowa ranks high in the number of science and engineering graduate students. As with primary and secondary education, however, without a continuing commitment to higher education, these prospects could quickly change—with serious consequences for Iowa's economy.

Health and the environment are also important to an economy. They contribute directly to the quality and productivity of labor, and businesses are attracted to locations that offer quality health care and good environmental conditions. Iowa generally ranks well in health conditions. There are, nevertheless, areas for improvement. For example, Iowa ranks 5th best among the states in immunization for children aged 19 to 35 months. But 18 percent of such young children in Iowa do not have their immunizations. More generally, access to health care is a problem in Iowa. In 1995, Iowa ranked 44th in the number of physicians per 100,000 of population. And in 1997, 225,000 Iowans had no health insurance.

Air quality in Iowa is good, but water and soil pollution are serious problems. Sixteen percent of surface water discharges were not in compliance with water quality standards, ranking Iowa 40th in the nation. Iowa also ranks relatively high in the number of superfund dump sites and the amount of toxic chemicals released into the environment. Crime, which can discourage economic activity, is low in Iowa.

In sum, economic and social conditions in Iowa are improving after years of decline. This turnaround could not have happened without government investments, particularly those in education and infrastructure. With a potential shortage of skilled workers in the future, however, the need for improving Iowa's labor and non-labor assets has never been greater.

State and Local Spending in Iowa

Iowa ranks 19th in state and local government spending as a share of personal income. Within the region, Minnesota ranks above Iowa, while Nebraska, South Dakota and Wisconsin are similar in their public spending.

- Iowa's rankings in per-pupil spending on K-12 education have declined since 1980. This indicator has fallen from 20th in the country to 29th in 1997. While Iowa used to spend more than the national average on its students, today it spends only 92 percent of the U.S. average.
- Iowa has been spending less on higher education recently, but still ranks fourth among the states.
- Poverty spending has increased largely because of

rising health care costs. But spending on poverty programs has declined relative to other states.

- Highway spending has been and continues to be high—leading to high scores in road quality.
- Spending on public safety has increased since 1980. Iowa's rank among the states has risen from 49th to 36th. This rise has coincided with a decline in violent crime.

Iowa law limits spending to 99 percent of general fund revenue. The remaining one percent and any budget surplus go to a variety of funds. In general, these funds are reserves for "rainy days" and one-time expenditures. These funds are all currently at their targeted levels. In particular the Cash Reserve Fund and the Economic Emergency Fund are both at five percent of general fund revenues.

Iowa's Current Tax System

Iowa cannot be unambiguously described as either a "high tax" or a "low tax" state, since a state's tax burden ranking depends, to some extent, on the measure of tax burden used:

- As a share of total personal income, state and local taxes in Iowa are above the national average and rank 9th in the nation. Small differences in level of taxation make large differences in rank, however. Iowa is only one percent of income higher than the national average in this measure.
- On a per capita basis, Iowa taxes are *below* the national average.
- As a share of gross state product, Iowa's taxes are above the national average, ranking 14th.

Iowa tax system is unambiguously regressive. That is, it requires middle- and lower-income taxpayers to pay a higher share of their incomes in taxes than the very well-off have to pay.

- The poorest fifth of all Iowa taxpayers, with incomes of less than $14,000 per year, pays 11.1 percent of its income in total Iowa taxes.
- Families in the middle of the income scale pay 10.2 percent of their income in Iowa taxes.
- The very best-off Iowans, the top one percent with an average income of $476,000, pay only 8.5 percent of their income in Iowa taxes.

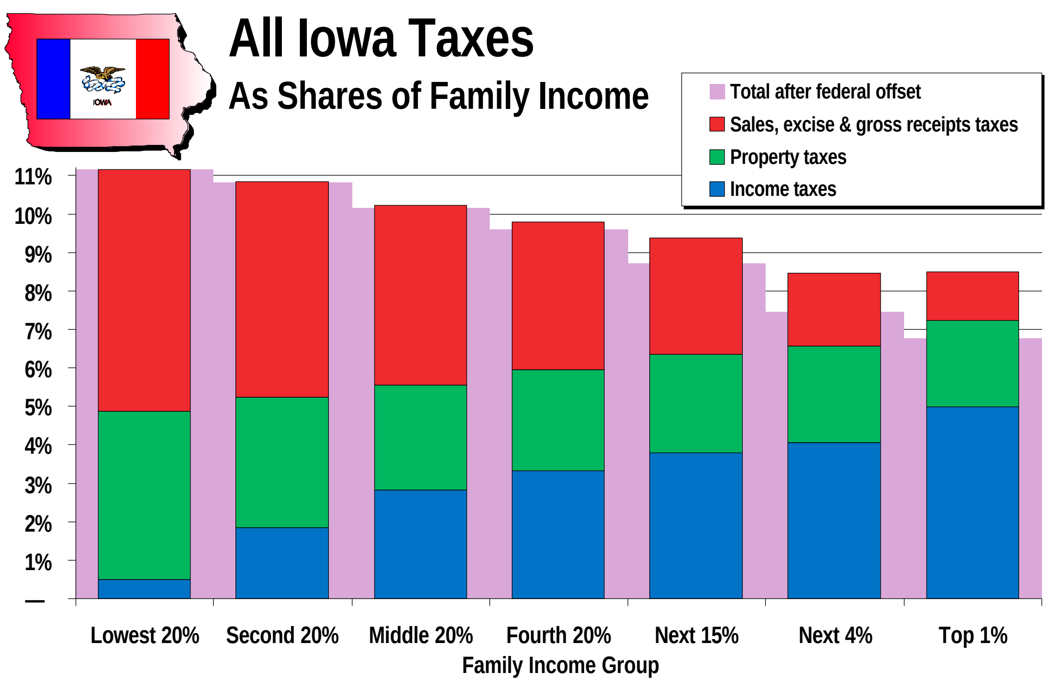
The regressive nature of Iowa's tax system is the result of the interplay between its major taxes: income taxes, property taxes, and sales and excise taxes. These three taxes differ markedly in their impacts on families at different income levels:

- The personal income tax is progressive.
- Property taxes on families are somewhat regressive.
- Sales and excise taxes are extremely regressive.

The regressivity of Iowa's tax system is compounded by interactions with the federal system. The federal itemized deduction for state and local taxes reduces the average tax burden on the top one percent of Iowans by 1.7 percent of income in 1998, while middle-income Iowans see an average reduction of only 0.1 percent. The poorest fifth of Iowans see no tax cut from the federal offset.

Trends in Iowa Taxes

The single most important trend in Iowa's tax system has been its increasing reliance on consumption taxes and a simultaneous movement away from income taxes as a source of revenue. The primary effect of this shift from progressive income taxes to regressive consumption taxes has been to shift Iowa's tax burden from the well-off to the less-well-off.



The sales tax rate has been raised from three percent to five percent in less than 20 years. Excise taxes on gasoline and tobacco products have been increased repeatedly over the same period.

Recent tax law changes have greatly reduced the level and progressivity of Iowa's personal income tax and cut the progressive inheritance tax as well. The 1992 sales tax increase is currently raising about the same amount of revenue as the personal income tax cuts of 1995, 1996, 1997 and 1998 are now costing. This shift from personal income taxes to sales taxes is quite regressive, with the bottom 60 percent of the income spectrum seeing tax hikes and the richest 20 percent getting tax cuts.

The Personal Income Tax

Iowa has experienced relatively slow growth in its personal income tax revenue. In addition, Iowa's income tax is much less progressive than its rate structure would suggest. This is primarily due to its unlimited deduction for federal personal income taxes paid. Alabama and Louisiana are the only other states to allow this unlimited deduction.

Iowa's personal income tax is more complex than that of most states. This complexity is partially the result of many differences between how Iowa defines taxable income compared to the federal income tax rules. Iowa's treatment of married couples, its low standard deduction and several other items add to the complexity of the Iowa income tax. Recent changes in the Iowa personal income tax have made it less progressive and decreased the state's reliance on it.

Iowans pay $230 million less in federal personal income taxes because of the federal itemized deductions they take for their Iowa state income taxes. Shifting away from the state personal income tax to non-deductible taxes like the sales tax causes federal personal income tax payments by Iowans to go up.

Consumption Taxes

Consumption taxes have been growing in Iowa, rising from 3.0 percent of personal income to 3.7 percent from 1985 to 1995. The sales tax rate has increased from three percent to five percent from 1982 to the present. In addition, a local option sales tax has been introduced at a level of up to two percent. Excise taxes have also been on the rise.

Consumption taxes are very regressive. This is because middle- and low-income families spend a much larger share of their income than do the well-off. As a result, low-income Iowans pay five times as large a share of the income in sales and excise taxes as do the wealthy. Middle-income families pay more than three and a half times as much (as a share of income) as do the wealthy.

Property Taxes

In 1997, property taxes totaled 34 percent of all Iowa state and local taxes—the single largest source of public revenue. But Iowa's reliance on property taxes has fallen over the years. As recently as 1985, property taxes collected 39 percent of all state and local taxes. One reason for this property tax decline has been limitations and cuts imposed by the state on local governments. These tax cuts and growth limitations have constrained the ability of local governments to raise revenue to provide important services as they see fit. At the same time that the state has restricted the power of local governments to raise property taxes, the state has granted greater authority for localities to impose sales taxes.

Property taxes are regressive. This is because home values are a much higher share of income for middle- and lower-income families than for the wealthy. It is common for a middle-income family to own a home valued at two or three times their annual income. Since property taxes are based on property values, they represent a larger share of income from middle-income families than from the better-off.

Corporate and Inheritance Taxes

Iowa's corporate income tax has declined sharply. In 1978, it constituted 0.38 percent of gross state product. By 1996, it had declined to 0.27 percent of GSP, and Iowa's rank among the states on this measure had dropped from 28th to 35th. The corporate income tax is a progressive tax that is partially paid by out-of-state shareholders in corporations.

The inheritance tax is paid by inheritors of Iowa property. In 1997 this tax was cut dramatically, fully exempting lineal relatives. The inheritance tax is a progressive tax, and the recent tax changes will primarily benefit those inheriting larger estates. The very largest estates will still have to pay the federal "pick-up tax" to Iowa notwithstanding the recent law change, but many of them will pay less than they would have under Iowa's prior inheritance tax.

Tax Burdens, Business Tax Incentives and Economic Growth

Numerous studies have found that the level of taxation in a state has little impact on economic growth. In fact, a review of the economic performance of states in the region shows that the highest tax states have performed better, by most measures, than the lowest tax states.

The is not a surprising finding. Low-tax strategies for economic development often undermine the ability of government to provide quality services. This can have adverse economic impacts on the quality of labor supply, infrastructure and a host of other items important to growth.

Business incentives tend to be inefficient, rewarding companies for what they would have done anyway. They also distort economic decisions to the detriment of long-term growth. Many business incentives are instituted through "tax expenditures." These tax expenditures are generally enacted without careful review and their success at accomplishing their goals is rarely scrutinized.

Iowa would be well served by adopting better disclosure of tax expenditure information and requiring greater accountability from businesses receiving tax incentives.

Tax Reform Options

This report presents 18 detailed options for tax changes in Iowa, coupled with distributional and revenue analyses of each option and an analysis of its strengths and weaknesses. Some of these proposals increase revenues to pay for public services. Others would require reductions in government programs, and still others would shift taxes among income groups without affecting total state revenues. Readers can evaluate these options based on their own notions of tax fairness.

NOTES ON PRESENTATION

The distributional tables in this report were produced using the Institute on Taxation and Economic Policy Microsimulation Tax Model.[1] The tables look not only at Iowa taxpayers by income levels, but when relevant, at categories of Iowa families, broken down by family type and age. All figures are for 1998.

- 60 percent of Iowa's total population lives in non-elderly married-couple families. These families have 60 percent of Iowa's total income.
- Unmarried non-elderly taxpayers, a group that includes single people with and without children, represent 24 percent of Iowa's population and 21 percent of income.
- Iowa's elderly account for 16 percent of the population and 19 percent of income.

1998 Iowa Family Demographics

	% of Adult Population	% of Total Population*	% of Total Income
Married non-elderly	53%	60%	60%
Unmarried non-elderly	25%	24%	21%
Elderly	22%	16%	19%
Addendum:			
Married, all	67%	70%	72%
Unmarried, all	33%	30%	28%

**Includes dependents.*

When we divide the Iowa taxpaying population into quintiles, we subdivide the top fifth of the taxpayers into three subgroups to aid our analysis. The top 20 percent is both a very important and a very heterogenous group.

- Almost half of all personal income in Iowa goes to the best-off fifth of all taxpayers.
- Taxpayers in the first 15 percentage points of the top fifth earn an average of $75,600. The average income of the top one percent is $476,000.

The Distribution of Income in Iowa
All Families & Individuals in 1998

Income Group		Income Range	Average Income	Share of Total Income
Lowest 20%		Less than $14,000	$8,200	3.8%
Second 20%		$14,000 to $26,000	19,900	9.2%
Middle 20%		$26,000 to $40,000	32,100	14.9%
Fourth 20%		$40,000 to $61,000	48,700	22.6%
Top 20%	Next 15%	$61,000 to $101,000	75,600	26.3%
	Next 4%	$101,000 to $212,000	133,000	12.4%
	Top 1%	$212,000 or more	476,000	10.9%

Finally, in our tables and analysis, we define "income" to include all cash earnings and transfers, including items not included in "adjusted gross income" (such as tax-exempt interest or most social security benefits) or other narrow, tax-law-based income definitions.

[1]The ITEP model is described in the last appendix. For a more detailed description of the model and its methodologies, see ITEP's June 1996 report *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* or contact the Institute.

CHAPTER ONE

ECONOMIC AND SOCIAL INDICATORS

The economic and social well-being of a state is a function of many often interrelated and interdependent factors. Of course, precisely measuring the well-being of a state is difficult.[2] Nevertheless, chosen and evaluated carefully, economic and social indicators can paint a picture of how well a state economy is performing, allow state-by-state comparisons, and show trends over time. Most important, such an analysis can provide useful insights into what can be done to promote greater social and economic well-being in the future.

After reviewing hundreds of indicators, we selected a number of measures of economic and social well-being to help assess the state of Iowa. These indicators are grouped into six categories: General Economic, Infrastructure, Health, Education, Environment, and Crime. The primary criterion for selecting these indicators was their ability to reflect economic and social well-being. But, they were also chosen based on the availability of data over time and the ability to compare data across states. When possible we have compared Iowa to the national average and to neighboring states: Illinois, Minnesota, Missouri, Nebraska, South Dakota, and Wisconsin—and we have looked at trends over time.

Ideally, Iowa would like to be at or near the top in the nation in quality of life and strength of its economy. At minimum, economic and social conditions in Iowa should improve over time. Where Iowa is above average, its lead should be increasing. In those areas where Iowa lags behind the national averages, the gaps between Iowa and the U.S. averages should be narrowing.

Our analysis finds that Iowa went through a long period of economic stagnation and decline that lasted roughly from 1978 through 1993. Although there were periods of progress, for most of that 15 year period Iowa lost ground relative to other states. In 1978, most indicators of economic well-being suggested that Iowa ranked above most of the other fifty states. By 1993, many indicators placed Iowa nearer the middle—and, sometimes, at the lower end—of the fifty-state rankings.

After 1993, there has been a turnaround in Iowa. Indeed, the last five years have been a period of partial economic revival and rebirth. Today, Iowa's rankings on many measures of economic and social attainment are improving. Unfortunately, many of Iowa's citizens have yet to share in this recent prosperity. Whether the process of growth and amelioration stalls or continues and spreads will depend in part on the policies and strategies that the people of Iowa and their elected representatives choose to pursue.

I. General Economic Indicators

Over the last twenty years Iowa has experienced uneven economic growth. The years between 1978 and 1993 were years of economic stagnation and decline interrupted by brief spurts of growth. The five years since 1993 have been years of strong growth. Some of the ground—but not all of it—that was lost from 1978 to 1993 has been regained.

Gross state product (GSP) is one of the best measures of the overall size of a state's economy. It is the sum of the value of all the goods and services

Gross State Product (GSP) and Growth Rates

	GSP Rankings			Growth Rate Rankings	
	1978	1993	1996	1978-93	1993-96
Illinois	4	4	4	41	29
Iowa	**25**	**30**	**29**	**48**	**13**
Minnesota	19	20	18	25	11
Missouri	14	17	16	36	15
Nebraska	35	35	36	39	14
South Dakota	49	46	46	28	10
Wisconsin	16	18	20	33	31

SOURCE: Bureau of Economic Analysis.

[2] First, all the data useful for such an analysis may not be available. Second, time constraints may oblige researchers to be selective in their analysis. Third, for data that are available and that are selected for analysis, judgments may have to be made as to how to interpret them and how to weigh their relative importance. For example, if Iowa has a better educational system than Nebraska while Nebraska provides better medical services to its citizens, in which state are the citizens better off?

produced in a state. In 1978, Iowa had the 25th largest economy among the fifty states. Over the next fifteen years its economy grew more slowly than those of all but two states and by 1993 Iowa had only the 30th largest economy. From 1993 to 1996, however, Iowa ranked 13th in GSP growth.

Another indicator of economic strength is state **personal income.** It is one of the most commonly used measures of the relative affluence of state residents. State personal income measures the total income received by the residents of each state. To facilitate comparisons between states and over time, state personal income is typically divided by state population and adjusted for inflation. The result is what is known as 'real per capita personal income'.

Real Per Capita Personal Income in 1996 Dollars

	1978	US Rank	1993	US Rank	1996	US Rank
Illinois	$22,219	7	$25,140	9	$26,855	8
Iowa	**19,998**	**19**	**20,187**	**36**	**22,330**	**31**
Minnesota	20,099	17	23,487	19	25,699	12
Missouri	18,660	31	21,482	26	22,984	27
Nebraska	19,326	23	21,546	25	22,975	28
South Dakota	17,127	37	19,224	40	20,749	38
Wisconsin	19,552	22	21,963	23	23,390	23
United States	**$19,723**		**$23,202**		**$24,436**	

SOURCE: Bureau of Economic Analysis, US Dept of Commerce, April 1998 (revised). Inflation adjustment by the Institute on Taxation & Economic Policy.

In 1978, Iowa's real per capita personal income was above the national average ($19,998 versus $19,723). Between 1978 and 1993, however, Iowa's real per capita personal income grew less than one percent (slower than in all but three states) while the nation's real per capita income grew nearly 18 percent. As a result, by 1993 Iowa's per capita personal income was well below the national average ($20,187 versus $23,202).

Between 1993 and 1996, however, Iowa's real per capita personal income grew 10.6 percent—double the national growth and faster than any other state in the nation. Although Iowa's per capita personal income remains below the national average, it rebounded from just 87 percent of the national average in 1993 to over 91 percent in 1996. Iowa now ranks 31st in per capita income nationally (as opposed to 36th in 1993 and 19th in 1978)[3].

Agriculture represents a far larger share of Iowa's economy than it does of most other states. Hence, fluctuations in Iowa's farming sector tend to have a big impact on the overall performance of Iowa's economy. Indeed, Iowa's relatively poor economic performance from 1978 to 1993 and its revival since 1993 can be partly attributed to changes in farm production and its attendant effects.

Consider, for example the impact of agriculture on Iowa's GSP. Between 1978 and 1993 farm output fell by well over fifty percent and contributed to declines in trucking and railroad transportation. While farm production accounted for nearly 15 percent of Iowa's GSP in 1978 (versus 2.4 percent for the U.S.), by 1993 it represented only three percent of Iowa's economy. Between 1978 and 1993, Iowa's GSP growth rate would have improved from 3rd slowest to 7th slowest were agriculture excluded.

After 1993 Iowa's agricultural output rebounded sharply. Between 1993 and 1996, Iowa farm production grew nearly 160 percent, more than eight times faster than the rest of the state's economy. By 1996 farm output rebounded to seven percent of Iowa's GSP versus 1.2 percent for the U.S. economy. Were agriculture to be excluded, Iowa's GSP growth rate between 1993 and 1996 would fall from 13th fastest to just 30th fastest.

Sharp fluctuations in farm income also explain a significant portion of the stagnation in Iowa's personal income from 1978 to 1993 and its rebound since 1993. In 1978 farm income accounted for over 10 percent of Iowa's total personal income. Over the next fifteen years farm income shrank by over 80 percent until it represented less than one percent of Iowa's personal income in 1993. Between 1993 and 1996 farm income

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[3]Median household income is another common measure of economic well-being. It measures the income of the typical household—the household in the middle of the income distribution. Median household income data is only available for years beginning in 1984. Iowa's median household income is 6 percent below the national average ($33,209 versus $35,492 in 1996). In 1984, however, Iowa's median income was 11 percent below the national average. Consistent with the data on GSP and personal income, most of the growth in Iowa's median income occurred after 1993.

grew more than six fold and accounted for nearly five percent of Iowa's personal income in 1996.

Given that agriculture still plays an important, even if diminished, role in Iowa's economy, the recent weaknesses in many agricultural prices do not bode well for future economic growth. Preliminary per capita personal income data for 1997 suggest that Iowa's economic growth has been slowing down. This may, in part, be due to weakness in the farm sector.

It should be noted that Iowa's *per capita* personal income has grown significantly faster than its total personal income. This reflects the fact that Iowa has lost population over the last twenty years. Between 1978 and 1987 Iowa's population declined by more than five percent—some 150,000 people. Since 1987 Iowa's population has been growing slowly. Still, for the entire period between 1978 and 1997, Iowa was one of just three states to experience a population decline (2.3 percent or 65,000 people).[4]

Employment growth is another important indicator of the relative health of an economy. The Iowa economy has added about 305,000 new jobs since 1978, growth that is substantially below the U.S. average (20 percent versus 39 percent)[5].

Not surprisingly, the slow job growth is partly attributable to the poor performance in the agricultural sector. Between 1978 and 1996, farm employment fell by nearly 30 percent or almost 50,000 jobs. While farm employment accounted for 11 percent of all jobs in 1978, by 1996 only 6.5 percent of Iowa's jobs were in farming. Other sectors that experienced large job losses include industrial machinery and equipment manufacturing employment (down 32 percent or some 21,000 jobs) and railroad employment (down 61 percent or about 6,000 jobs).

Most of the employment growth in Iowa over the last twenty years has occurred in the service sector. Service employment has grown 72 percent since 1978 (204,000 jobs). Specific areas of strong service employment growth include business services employment (up 177 percent or 59,000 jobs) and health services employment (up 53 percent or 42,000 jobs). Finally, retail trade employment has also grown significantly since 1978 (about 65,000 jobs). Unfortunately, many service and retail sector jobs tend not to pay high wages.

Iowa has lost about 1,000 *manufacturing* jobs, a decline of 0.4 percent, since 1978 (this includes the aforementioned losses in industrial machinery and equipment manufacturing employment as well as gains and losses in other manufacturing sectors). Manufacturing jobs typically spur economic vitality because such jobs tend to be higher paying than most. When manufacturing workers spend their relatively high salaries, sales and earnings are increased throughout the economy.

Although the number of manufacturing jobs has fallen only slightly in Iowa, inflation-adjusted hourly earnings in manufacturing have dropped by a fifth since 1978. With substantially lower wages, manufacturing workers have a smaller positive impact on Iowa's economy. Iowa manufacturing hourly earnings are now only 3 percent above the national average, down from 14 percent above average in 1978.

Notwithstanding slow job growth, the unemployment rate is low and falling in Iowa. This is partially due to the population decline described earlier. The unemployment rate in Iowa in 1997 was 3.3 percent, the lowest rate in more than twenty years and the fourth lowest rate of any state. The most recent unemployment data suggest that the unemployment rate in Iowa fell to an extraordinary low rate of 2.5 percent in June of 1998[6].

Despite a decline in population, 300,000 new jobs, and a very low unemployment rate, average salaries

Unemployment
As a % of the Civilian Labor Force

	1980	US Rank	1997	US Rank
Illinois	8.3%	29	4.7%	14
Iowa	**5.8%**	**10**	**3.3%**	**4**
Minnesota	5.9%	11	3.3%	4
Missouri	7.2%	21	4.2%	11
Nebraska	4.1%	2	2.6%	2
South Dakota	4.9%	6	3.1%	3
Wisconsin	7.2%	21	3.7%	7
United States	**7.1%**		**4.9%**	

Source: U.S. Bureau of Labor Statistics.

[4]US Bureau of the Census.

[5]Bureau of Economic Analysis.

[6]Bureau of Labor Statistics, *Geographic Profile of Employment and Unemployment*.

have fallen in Iowa. Between 1981 and 1996 inflation-adjusted average annual pay fell 3.5 percent in Iowa. Meanwhile, it rose seven percent in the nation as a whole. In 1981, annual pay in Iowa was nine percent below the national average.[7] By 1996, average annual pay in Iowa was fully 18 percent below the U.S. average and lower than the average pay in 40 other states (versus 32 states in 1981). Iowa's falling relative annual pay confirms that many of the new jobs created in Iowa were not "good" jobs; that is, they were not high-paying, high-skilled jobs.

With more jobs, a declining population from which to hire workers, and a low unemployment rate how is it possible that wages have declined and been kept low? The answer to this question involves an understanding of the employment/population ratio. The share of Iowa's adult population that is working has been growing rapidly—more than twice as fast as the national average. As jobs increased and the population declined, unemployment fell. But equally important, the number of adults entering the workforce seeking employment grew very rapidly. This increasing supply of available labor is probably a significant reason why inflation-adjusted average annual pay has been falling absolutely and relative to the national average.

Average Annual Pay for All Workers in 1996 Dollars

	1981	US Rank	1996	US Rank	81-96 ch.
Illinois	$29,253	6	$31,285	8	+6.9%
Iowa	**24,534**	**33**	**23,679**	**41**	**–3.5%**
Minnesota	26,198	23	28,869	13	+10.2%
Missouri	25,848	26	26,608	24	+2.9%
Nebraska	22,827	43	23,291	44	+2.0%
South Dakota	20,884	50	20,724	50	–0.8%
Wisconsin	25,529	27	26,021	27	+1.9%
United States	**$27,080**		**$28,945**		**+6.9%**

SOURCE: U.S. Bureau of Labor Statistics
Inflation adjustment by the Institute on Taxation & Economic Policy

In 1978, the share of Iowa's adult population that was working was six percent higher than the national average. This put Iowa 12th highest among the 50 states. By 1996, Iowa's employment/population ratio had reached 70.8 percent—fourth highest among the states and 12 percent above the national average.

The trend toward fuller employment in Iowa is unlikely to continue at the pace of the last two decades. As the share of adults working nears its maximum possible amount, the growth in the employment/population ratio must slow down. This fact has important implications for the nature of future economic growth in Iowa.

Over the past twenty years, Iowa's below average and falling average annual pay may have helped encourage local employers to hire more workers and may have attracted employers from out of state. But given that Iowa is well above the national average in its employment/ population ratio and given that the growth in Iowa's employment/population ratio is likely to slow down, there is likely to be an increase in wages (relative to the national average) in response to further increases in the demand for labor.

Just as falling and below average pay may have encouraged the recent job and economic growth in Iowa, wages above the national average may hamper job and economic growth *unless* the quality of labor and other assets in Iowa improve. A rising quality of labor and other assets can both *encourage* employers to expand employment opportunities (despite Iowa's wages rising relative to the U.S. average) and *enable* employers to pay higher wages. If this occurs, of course, workers, their families and employers will be better off.

An analysis of economic and job expansion in Iowa over the past twenty years indicates that it has been spurred in large part by growth in the service and retail sectors. The jobs that have been created are, for the most part, low paying and of moderate skill level. This is a problem for Iowa's families.

The residents of Iowa would obviously be better off with high paying and high skilled jobs. Fundamental to the ability of Iowa's businesses to create such jobs is the availability of a healthy, well-educated and skilled labor force. Of course, if wages in Iowa begin to rise relative to wages nationwide, then, to some extent, Iowa businesses can anticipate an in-migration of labor that will help to satisfy the need for skilled labor. Businesses are, however, more likely to locate and expand in areas where needed resources exist than to go where there are shortages and rely on in-migration. Thus, a key challenge facing Iowa policy-makers is how to insure an adequate, growing supply of appropriately skilled labor.

[7] 1981 is the earliest year for which data is available.

With this mixed record on employment and wages, it's not surprising that Iowa's poverty record is mixed. On the bright side, the poverty rate in Iowa in 1996 was below the national average (9.6 percent versus 13.7 percent) and 10th lowest among the fifty states. On the negative side, the poverty rate has improved only marginally over the last few years and is higher than the 9.4 percent rate in 1988. In other words, despite an impressively low unemployment rate, some 270,000 Iowans are still stuck in poverty. This result is not surprising given that average pay has been declining. Iowans are generally able to find jobs. But, unfortunately, too many of the available jobs do not pay wages above the poverty level.

Percent of Persons Below Poverty Level

	1980	US Rank	1988	US Rank	1993	US Rank	1996	US Rank
Illinois	12.3%	19	12.7%	23	13.6%	24	12.1%	22
Iowa	**10.8%**	**14**	**9.4%**	**9**	**10.3%**	**10**	**9.6%**	**10**
Minnesota	8.7%	5	11.6%	18	11.6%	14	9.8%	11
Missouri	13.0%	24	12.7%	23	16.1%	29	9.5%	9
Nebraska	13.0%	24	10.3%	13	10.3%	10	10.2%	13
South Dakota	18.8%	36	14.2%	29	14.2%	25	11.8%	20
Wisconsin	8.5%	3	7.8%	4	12.6%	18	8.8%	7
United States	**13.0%**		**13.0%**		**15.1%**		**13.7%**	

Source: U.S. Bureau of the Census

II. Infrastructure:

The physical infrastructure of an economy is fundamental to its health and growth potential. The infrastructure's role in the economy is similar to the role of the skeletal structure, the nervous system and the cardiovascular system in the human body. Each needs to be in good condition in order for the body to function well. Likewise the various components of the physical infrastructure (roads, bridges, telecommunication networks, etc.) need to be adequately developed and well maintained in order for an economy to grow rapidly and efficiently.

Infrastructure plays a key role in attracting and retaining business. In particular, the adequacy and quality of roads, bridges, and sewer and water treatment systems are among the primary factors that businesses consider when making investment location decisions. Several indicators suggest that Iowa's physical infrastructure is in good condition.

Highway conditions are important to a state's economic health because highways serve as the major link between producers and purchasers of goods and services. Highways are particularly important in a state like Iowa that relies heavily on the transportation of its agricultural and processed goods. Iowa's highways are in better condition than are highways in almost all other states. Only 1.3 percent of Iowa's highways were rated in "poor" condition in 1996, which ranked Iowa 6th best among the states.[8]

Unfortunately, Iowa's bridges do not fare so well. Nearly 34 percent of Iowa's bridges were deemed deficient or structurally obsolete in 1996.[9] This ranked Iowa 23rd— an improvement, however, over its ranking of 35th in 1988 when 48 percent of Iowa's bridges were deemed deficient.

Finally, a measure of the adequacy of Iowa's sewage system shows the state ranking best in the nation in 1992, up from 21st in 1988.[10] Adequate wastewater treatment facilities are important for economic vitality because new and expanding businesses need such facilities.

Although these measures indicate the condition of some of the existing infrastructure, they do not indicate whether this infrastructure is sufficiently comprehensive. Unfortunately, no good statistics are available to provide that information.

III. Education

Education is arguably the single most important factor determining long-term economic growth. The productivity and growth of an economy are directly related to the level of education and training of its workforce. For a state to maintain its economic competitiveness it must develop a workforce that has the skills needed by employers. The workforce, furthermore, must be able to adapt to ever changing economic circumstances. In light of the employment and wage

[8] U.S. Department of Transportation, Federal Highway Administration, Highway Statistics, 1996. Washington, DC: GPO, 1997.

[9] Thirteenth Report of the Secretary of Transportation to the U.S. Congress, *The Status of the Nation's Highway Bridges*, 1996. GPO, May 1997.

[10] The U.S. Environmental Protection Agency, Office of Water, *1992 Needs Survey Report to Congress.*

data discussed earlier, it is particularly important for Iowa to improve the skills of its labor force if it hopes to attract employers, keep its unemployment rate low and experience rising real wages.

Iowa's overall record in education is good. But there are some troubling indications that the state's commitment to educational excellence is ebbing.

Elementary and Secondary Education

Perhaps the broadest indicators of workforce skill levels are measures of educational attainment. In today's economy, a minimum requirement for most jobs is a high school diploma. Iowa's record in providing its citizens with this requirement is very good—but it could be better yet.

In 1996, Iowa ranked 9th in the percentage of its adult population with a high school diploma or higher degree, up from 18th in 1980 (87.4 percent versus 71.5 percent).[11] In addition, Iowa's high school dropout rate (6.6 percent) was the third lowest in the nation and its high school graduation rate of 87 percent in 1994 was the fourth highest in the nation.[12] These indicators bode well for Iowa's future.

Of course, the fact that a growing percentage of Iowa's population is getting high-school diplomas does not tell us much about the quality of the education that Iowans receive relative to other Americans. Although measuring the quality of education is extremely difficult, some data suggest that Iowa's students are achieving at well above average proficiency.

Measurements of math proficiency for fourth and eighth graders in 1996 scored Iowa's students well above average. These measurements ranked Iowa 6th and 1st, respectively, out of the 41 states surveyed. The math test scores of Iowa's students were equal to or better than their scores on similar tests taken in 1990 and 1992. Likewise, a measurement of reading proficiency of fourth graders in 1994 showed Iowa's students performing well above average and ranking 4th out of the 39 states that participated in the reading proficiency study.[13]

Another indicator of education quality is pupil-teacher ratios. Numerous studies have shown that students benefit from smaller class sizes and more individual attention from school staff. Iowa's pupil-teacher and pupil-staff ratios in public elementary and secondary schools are better than the national average. And both of these ratios have improved slightly over the past ten years, although Iowa's relative rankings have remained fairly constant. In 1995, Iowa ranked 16th and 17th in pupil-teacher and pupil-staff ratios, respectively.

Other indicators of education quality suggest that Iowa's commitment to educating its workforce may be ebbing. For example, while in 1980, Iowa spent more than the national average per pupil on its students, today it spends only 92 percent of the U.S. average. With relatively less being invested in Iowa's students and schools, the quality of education may suffer.

Likewise, teachers' salaries in Iowa have fallen further behind the national norm. In 1980, the average annual salary of teachers in Iowa was about 94 percent of the national average. By 1997, Iowa teachers' salaries had fallen to about 85 percent of the US average, dropping Iowa from 26th to 35th. With salaries further below the national norm it may be difficult for Iowa's schools to attract the high quality teachers they need to be competitive in the future.

Pupil-Teacher Ratios in Public Schools

	1989	US Rank	1995	US Rank
Illinois	16.9	27	17.1	35
Iowa	**15.7**	**17**	**15.5**	**16**
Minnesota	17.2	31	17.8	40
Missouri	15.7	18	15.4	14
Nebraska	14.7	9	14.5	7
South Dakota	15.5	14	15.0	11
Wisconsin	15.9	20	15.8	20
United States	**17.2**		**17.3**	

Source: US Dept of Education.

It should be noted that the 1998 Iowa legislature increased the minimum teacher salary from $18,000 to $23,000. This will have a small impact on Iowa's average teacher's pay. Whether there is a long-term impact will depend on whether funding for this initiative comes from an increase in overall school spending or cuts in other parts of the school budget, possibly including cuts in salaries for more experienced teachers.

[11] Bureau of the Census, *Current Population Survey.*

[12] U.S. Department of Education, National Center for Education Statistics.

[13] U.S. Department of Education, National Center for Education Statistics, *National Assessment of Educational Progress.*

Average Annual Salary of Public School Teachers in Constant 1995-96 Dollars	1979-80	US Rank	1995-96	US Rank
Illinois	$ 35,088	9	$ 41,008	12
Iowa	**30,308**	**24**	**32,376**	**34**
Minnesota	31,721	21	36,937	19
Missouri	27,276	39	33,341	29
Nebraska	26,945	41	31,496	39
South Dakota	24,616	49	26,346	51
Wisconsin	31,909	20	38,571	15
United States	**$ 31,837**		**$ 37,846**	

Inflation-adjustment based on the Consumer Price Index prepared by the Bureau of Labor Statistics, U.S. Dept of Labor. Price index does not account for different rates of change in the cost of living among states.

Source: National Education Association

Higher Education

Iowa has made considerable progress in higher education. Without a further substantial increase in the percentage of its population with college degrees or better, however, Iowa will experience difficulty in creating and attracting high-skilled, high-paying jobs in the future.

In 1996, Iowa ranked 24th in the percent of its adult population with a college degree or higher, up from 31st in 1980 (21.3 percent, up from 13.9 percent).[14] On the other hand, the percentage of the population with graduate or professional degrees in Iowa remains the 6th lowest of any state. It is not surprising, therefore, that the pool of highly trained local talent in Iowa is not impressive relative to the rest of the nation.

For example, the number of employed doctoral scientists and engineers per 1,000 workers in 1994 was lower in Iowa than in 32 other states. This was an improvement from a ranking of 43rd in 1989.

The prospects for developing a larger cadre of locally trained, skilled scientists and engineers in the near future should be good. In 1996, Iowa ranked 13th in the number of science and engineering graduate students per one million population. Likewise, in 1996, Iowa ranked 6th in research expenditures per capita at doctorate-granting institutions—up from 10th in 1989[15].

Iowa faces a special challenge in attempting to develop a large, locally-trained pool of highly skilled workers. It has been suggested that Iowa suffers from a significant out-migration of people in their twenties and thirties. Unfortunately, these may include many of the best educated Iowans.

Improving Iowa's education system offers an opportunity to create a critical mass of highly educated workers. The skills offered by such a group can attract business that will, in turn, keep young, educated Iowans from leaving the state.

Without improvements in the quality of Iowa's future labor force, the current boom in the economy may be difficult to sustain. Existing businesses may experience difficulty in finding qualified job applicants. Studies of new business creation have found that many new companies are founded by locally educated and trained individuals.[16] Without appropriately educated individuals, new businesses may fail to develop. By failing to train and retain people locally, Iowa is limiting the supply of skilled individuals it will need to be competitive in the future.

IV. Health:

Health conditions of a state's population and the availability of medical care have major effects on the quality of life. They influence decisions about where to live and where to start a business, and they affect the quality and productivity of labor. Hence, health is important to economic development, as well as a significant measure of a society's general well-being.

Statistics on health and health care cover a wide variety of issues. We have selected indicators that reflect the health of states' populations and the availability of care.

Health Conditions

Many indicators suggest that health conditions in Iowa are better than the national average. Major health problems persist, however, and some are getting worse.

Death rates due to heart disease and cancer, the two

[14]Bureau of the Census, *Current Population Survey.*

[15]National Science Foundation.

[16]See, for example, "The Anatomy of the Location Decision: Content Analysis of Case Studies" by Howard Stafford in F. Hamilton (editor), *Spatial Perspectives in Industrial Organization and Decision Making* (1974).

leading causes of death nationwide, are higher in Iowa than in most other states. Iowa ranks 42nd worst in avoiding deaths due to heart disease[17] and 36th in the cancer death rate.[18] The fact, however, that Iowa's population is older than the national average may explain these poor rankings. In 1996, 15.2 percent of Iowa's population was over the age of 65, compared to 12.8 percent for the nation as a whole.

The infant mortality rate in Iowa is lower than in most states and has fallen at a more rapid rate than has the national average. Between 1980 and 1997, the infant mortality rate declined by over 50 percent in Iowa. The preliminary data for 1997 suggest that Iowa now ranks 5th best, up from 21st in 1980.[19]

The percentage of babies with low birth weight is not only an indicator of current health conditions, but also a predictor of future health (low-birth weight babies tend to have more health problems later on). The percent of babies with low birth weight is substantially lower in Iowa than in the nation as a whole. The gap between Iowa and the national average, however, is narrowing. The share of babies with low birth weights in Iowa rose faster than the national average between 1980 and 1996 (28% versus 9%). In 1980, Iowa ranked 3rd best in avoiding low-birth-weight babies; in 1996 it ranked 14th.

Childhood immunization plays a key role in preventing future illness. In 1995, only 82 percent of Iowa's children aged 19 to 35 months were fully immunized. Although Iowa ranks 5th best among states on this indicator, thousands of Iowa's children are not being appropriately protected from potentially dangerous diseases.

Health Care Availability

An important determinant of health conditions is the availability of health care. Iowa's record in this area is not impressive. In addition, health care may be becoming less available in Iowa.

One way to measure the availability of health care is to calculate the number of physicians per 100,000 population. In 1981, Iowa ranked 45th on this measure, about 32 percent below the national average number of doctors per capita. In 1995, Iowa ranked 44th, about 30 percent below the US average. Iowa ranks lower on this indicator than any of its neighboring states.

Doctors per 100,000 Civilian Population

	1981	US Rank	1995	US Rank
Illinois	186	14	244	11
Iowa	**126**	**45**	**166**	**44**
Minnesota	189	13	239	13
Missouri	165	21	218	21
Nebraska	148	34	199	29
South Dakota	116	48	166	44
Wisconsin	160	26	213	25
United States	**185**		**236**	

Source: American Medical Association.

Health insurance coverage is another good measure of the availability of health services. More of Iowa's residents are covered by health insurance than is typical of Americans as a whole, but the coverage rate is falling. Over the last five years, Iowan's health insurance coverage has declined (from 91 percent to 88.4 percent) and its ranking among the states has fallen, from 7th to 14th best. There are now some 225,000 Iowans with no health insurance.[20]

Percent of Persons Not Covered by Health Insurance

	1990-92	Rank	1996	Rank
Illinois	11.8%	19	11.3%	11
Iowa	**9.0%**	**7**	**11.6%**	**14**
Minnesota	8.8%	6	10.2%	7
Missouri	13.1%	27	13.2%	20
Nebraska	8.7%	5	11.4%	12
South Dakota	12.2%	22	9.5%	4
Wisconsin	7.9%	4	8.4%	1
United States	**14.2%**		**15.6%**	

1990 to 1992 is a three year average.
Source: U.S. Census Bureau

V. Environment:

Environmental conditions, like health conditions, have an obvious impact on the quality of life of citizens. They also influence economic conditions, although their effects on economic conditions are more subtle than their impact on quality of life.

[17]National Center for Health Statistics.

[18]American Cancer Society.

[19]National Center for Health Statistics.

[20]US Census Bureau, March 1997 Current Population Survey.

Businesses, like people, prefer safe, clean, stable communities. Indeed, many businesses require healthy environments in order to thrive. For example, much of the tourist industry could not survive with polluted rivers, lakes, and streams. The old thinking that economic growth and environmental protection were incompatible is giving way to an understanding that they are often complementary—and that a healthy environment is important for long-term, sustainable economic growth.

As the relationship between environmental decay and community health has become clearer, the American public has demanded that its drinking water be safe and the air it breathes be free of dangerous contaminants. It is now understood that the costs associated with maintaining a safe and clean environment in a community frequently pale in comparison to the costs of reestablishing a safe and clean environment. Indeed, the enormous cost of cleaning up the superfund dump sites is one of the most sobering reminders that it is often vastly cheaper to prevent pollution than it is to repair the damage caused by toxins.

Indicators of environmental quality reflect the general conditions of water, air and soil. These indicators suggest that the quality of Iowa's air is excellent while its water and soil conditions are below average. This is not surprising in a state that relies heavily on farm production. Fertilizers and pesticides used in farming tend to seep into the soil and contribute to water and ground pollution. On the other hand, they tend to have little effect on air quality. Since statistics on environmental quality have been collected regularly only recently, it is very difficult to determine whether the quality of Iowa's environment has been improving.

It should be kept in mind that some statistics on pollution are not necessarily perfect indicators of the health risks from pollution in particular states. For example, the negative effects of toxic chemicals released in a state may not be felt in that state because the chemicals may be carried by wind or water to other states. Similarly, the amount of hazardous waste generated in a state does not convey the degree of toxicity of that waste, nor does it indicate how much of that waste escapes into the state's environment. Likewise, the number of dump sites in a state does not reflect the size and condition of each of those sites, although qualifying as *superfund* dump sites does suggest that the sites may be among the worst dump sites in the nation.

In 1997, Iowa was one of 17 states without any areas that violated national air quality standards for ozone or carbon monoxide.[21] Water quality is a more serious concern. In 1997, 16 percent of Iowa's surface water discharges were not in compliance with water quality standards, ranking Iowa 40th in the nation. This was worse than the non-compliance rate in 1990, when nine percent of Iowa's water discharges were in noncompliance (ranking 22nd in the nation)[22].

Adjusted for the size of its population, Iowa had more than its share of the total number of superfund dump sites within its borders in 1996, and ranked 34th on this indicator of pollution.[23] Likewise, in 1993 Iowa released a larger amount of toxic chemicals per capita into its air, water and soil than did all but 17 other states.[24]

In sum, except for air quality, most measures of environmental quality suggest that Iowa is below the national average.

VI. Crime:

Crime affects economic and social well-being. High crime rates discourage economic activity, contribute to community disintegration and cause businesses and families to flee.

The crime rate in Iowa is well below the national average. It is now lower than its 1980 level, and has fallen faster than in the nation as a whole. In 1980, Iowa had the 14th lowest crime rate in the country. By 1995, the state ranked 9th lowest, with a crime rate that was 69 percent of the national average. Iowa's crime rate fell by 23 percent over the period.[25] Iowa's violent crime rate is especially low relative to the rest of the nation—less than half the national average. In particular, Iowa had the 4th lowest rate of rape and the 2nd lowest murder rate in 1995.

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[21] U.S. Environmental Protection Agency, Office of Air Quality Planning and Standards.

[22] U.S. Environmental Protection Agency, Compliance Evaluation Section.

[23] U.S. Environmental Protection Agency, Office of Emergency and Remedial Response.

[24] U.S. Environmental Protection Agency, *1993 Toxics Release Inventory.*

[25] Federal Bureau of Investigation, *Crime in the United States.*

VII. Summary

Improvements in a state's economic well-being are a function of "extensive" and "intensive" development. Extensive development refers to growth that results from increases in the *quantity* of various factors of production. In simple terms, this means that output generally expands in response to increases in employment, factories, machinery, tools, equipment and infrastructure. Intensive development refers to growth that results from improvements in the *quality* of the factors of production. Hence, intensive development refers to output growth in response to improvements in the health, education and training of workers, infrastructure enhancements, and technological innovations.

Some kinds of extensive development are by their very nature limited. For example, increases in employment are limited because as employment grows the pool of potential workers is gradually exhausted; that is, at any given moment there are only so many people available to work. Once full employment is achieved, output expansion due to job growth proceeds only if population grows.

In contrast, there are no known limits to intensive development. The health, education and training of workers can always be improved. Technological advances and infrastructure enhancements have no apparent bounds.

Like all states, Iowa has experienced both intensive and extensive development. One example of Iowa's intensive development is the gain in the educational attainment of its population, although there are danger signs in this area due to recent trends.

The most obvious manifestation of extensive development in Iowa is the dramatic increase in the ratio of its population that is working. This surge in the share of people employed has increased Iowa's output, but at the same time may have kept wages low. Low wages, in turn, may have encouraged employers to hire more workers and expand production.

These and other sources of economic sustenance are critical to Iowa's economic health, and have undoubtedly contributed to the state's economic growth over the last five years.

It should be noted, however, that this path toward economic growth may have run its course: it is highly unlikely that the ratio of Iowa's population working can continue to grow at the pace of the last 20 years. Like other forms of extensive development, this one is limited. Hence, Iowa may be forced to concentrate on ways to further improve the quality of its assets if it wishes to sustain its current economic expansion.

With its unemployment rate very low, an employment/population ratio well above national norms, and the demand for labor strong, it is unlikely that Iowa's wages will continue to fall. Labor shortages are likely to develop and this will put upward pressure on wages. If the quality of the labor force and other critical factors do not improve significantly and average wages in Iowa start to rise, employers may experience declining profits and they will have less of an incentive to expand employment opportunities. Job growth could slow down and the economic expansion of the past five years may slow down.

On the other hand, if the quality of the Iowa labor force and other assets improve, businesses are more likely to remain profitable and employers will be more willing and able to pay higher wages and further expand employment opportunities. Iowa's workers and families will be better off and the economic expansion may continue unabated.

In sum, economic conditions in Iowa have recently improved after years of decline. This turnaround could not have occurred without government investments, particularly in education and infrastructure. But with a potential shortage of skilled workers in the future, the need for improving Iowa's labor and non-labor assets has never been greater.[26] If Iowa's economic recovery is to continue it must invest in its workforce and other assets. This means that further attention must be paid to improvements in health, education, safety, infrastructure and the environment.

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[26] This is particularly true in light of changes that are likely to take place in farming. As noted earlier, Iowa's economic performance is strongly influenced by conditions in the agricultural sector. Farming has historically played a key role in the growth and development of Iowa. Unfortunately, agricultural output fluctuates widely from year to year. In addition, there is a very real possibility that the role of farming in the American and Iowa economy will continue its relative long-term decline. In light of this possibility, it would be prudent to both examine ways to avoid this decline but, at the same time, anticipate that there may well be the further loss of farming jobs in Iowa for reasons outside the control of Iowa policymakers. Hence, to secure a more stable and certain economic growth pattern, Iowa would be wise to, through the means described, make the state a more likely site for non-agricultural development.

CHAPTER TWO

STATE & LOCAL PUBLIC SPENDING IN IOWA

Measured as a share of personal income, Iowa's public spending is in the middle of the pack among all states, ranking 19th in 1995. Per capita, Iowa's public spending ranks 23rd. In 1980, Iowa ranked 20th in both measures.[27] Within the region Iowa spends less than Minnesota as a share of personal income and about the same as South Dakota and Wisconsin.

Direct General Expenditures: 1980 and 1995

	1980		1995		1980		1995	
	As a % of Personal Income	US Rank	As a % of Personal Income	US Rank	Per Capita (1995 $)	US Rank	Per Capita	US Rank
Illinois	14.4%	44	16.1%	46	$ 2,933	24	$ 4,131	27
Iowa	**17.7%**	**20**	**20.2%**	**19**	**3,117**	**20**	**4,210**	**23**
Minnesota	18.6%	13	21.4%	11	3,505	7	5,166	8
Missouri	13.7%	46	15.2%	51	2,368	48	3,336	50
Nebraska	16.9%	25	19.0%	26	2,857	31	4,060	30
South Dakota	20.2%	5	20.1%	20	2,931	26	3,833	38
Wisconsin	18.1%	17	20.1%	21	3,327	14	4,514	15
ALL STATES	**16.1%**		**18.7%**		**$ 2,999**		**$ 4,362**	

Source: Bureau of the Census, Bureau of Economic Analysis.

As discussed in chapter one, sustained levels of public spending are essential to economic and social health. This is a critical time for Iowa to improve the quality of its labor and non-labor assets so that the recent level of economic growth can be maintained.

1995 Iowa State & Local Direct General Expenditures

Education	36.8%
Poverty Programs	14.3%
Health	10.7%
Highways	11.5%
Police, Courts, Corrections, Fire	6.8%
Parks & Natural Resources	3.3%
Debt Service	3.3%
Sewerage	2.4%
Housing & Comm. Development	1.1%
Other	9.9%

[27]The source for this state comparison data is the U.S. Bureau of the Census publication, "Government Finances." 1995 data are the most recent available. 1980 was chosen to use as a comparison year, after verifying that the choice would not result in the reporting of aberrational or distorted trends.

KEEPING THE DATA IN CONTEXT

In comparing spending between states it is important to put statistics in context. For instance, the fact that California spends five times as much as Iowa on highways isn't very informative. California has eleven times as many people and thirteen times as much income—of course it spends a lot more.

In this chapter, we usually use *per-capita spending* and *spending as a share of personal income* as our measures. Per-capita spending tell us how much a state spends on government services relative to its population. Hence, big states' governments don't appear as high spending in this statistic merely because they serve more people.

Spending as a share of personal income gives us a measure of spending relative to what a state can afford. Not only do big states spend more because they have more people, but wealthier states spend more because their citizens demand, and are willing to pay for, more and better services. Also, government services tend to cost more in wealthier states because costs are higher. A wealthy state might appear higher on the per-capita ranking than a poorer state even if it provides the exact same level of service because it has to pay more. Share of personal income statistics account for this to some extent (for a discussion of how personal income is defined for this statistic, see chapter three).

Neither of these measures, however, is any more than a starting point for analysis of state and local government spending because they do not account for the differences in spending needs among states. A sparsely populated state may, for example, need to spend more on highways per-person, or as a percentage of personal income, because it requires relatively more miles of road than other states. Roads in some states take more of a beating from the weather than in other states. Some states have more through truck traffic than others. And some states face higher costs because of their geology.

We have, where possible in this section, tried to put specific government spending programs in a useful statistical context. In many cases, however, useful data is not available so we are left with comparing expenditures not to needs, but to Iowa's population and income.

Education

The single largest portion of state and local spending, over one-third, goes for education. Iowa's past commitment to education has been paying off, with Iowa student achievements in elementary and secondary education appearing to have improved over the last decade and a half. Recent trends indicate, however, that Iowa's state and local governments have been providing fewer of the resources needed to maintain these high levels of student achievement.

While Iowa's expenditures per pupil increased from 1980 to 1995, it did not keep pace with the national average. Ranked 20th in 1980, Iowa slipped to 29th nationally in 1995. While expenditures per pupil were two percent higher than the national average in 1980, Iowa had fallen eight percent below the national average by 1995. Of Iowa's neighbors, only Missouri and South Dakota spent less per student.[28]

Average Undergraduate Tuition, Fees, Room & Board Paid By Students at Public Institutions of Higher Learning for the 1995-96 School Year

	4-Year Schools				2-Year Schools	
	Tuition, Fees, Room & Board	Rank	In-state Tuition Only	Rank	In-state Tuition Only	Rank
Illinois	$ 7,841	33	$ 3,355	37	$ 1,232	20
Iowa	**5,945**	**19**	**2,564**	**27**	**1,785**	**36**
Minnesota	6,734	24	3,229	35	2,050	42
Missouri	6,768	25	3,024	32	1,252	21
Nebraska	5,503	12	2,189	19	1,132	18
South Dakota	5,613	13	2,644	29	3,430	50
Wisconsin	5,839	18	2,614	28	1,835	37
United States	**$7,014**		**$2,848**		**$1,239**	

NOTE: Data are for the entire academic year. Tuition, fees, room & board were weighted by the number of full-time undergraduates in 1995, but are not adjusted to reflect student residency.

Source: U.S. Department of Education, National Center for Education Statistics.

Spending per pupil in public K-12 schools in constant 1994-95 dollars

	1979-80	% of US	Rank	1994-95	% of US	Rank
Illinois	$5,011	114%	11	$6,136	102%	18
Iowa	**4,507**	**102%**	**20**	**5,483**	**92%**	**29**
Minnesota	4,624	105%	19	6,000	100%	21
Missouri	3,751	85%	31	5,383	90%	31
Nebraska	4,165	95%	24	5,935	99%	22
South Dakota	3,696	84%	37	4,775	80%	42
Wisconsin	4,799	109%	15	6,930	116%	12
United States	**$4,401**			**$5,988**		

Source: U.S. Dept of Education, National Center for Education Statistics.

Higher Education

Investment in higher education is also crucial to train Iowa's workforce. While Iowa's rankings have been consistently above national averages, spending per student has fallen since 1980. In 1980, Iowa's per student higher education spending was 41 percent above the national average—ranking 6th highest nationally. Although spending per student fell by 18 percent by 1995, Iowa still spent 37 percent more than the national average, ranking 4th.

Iowa's public institutions of higher learning have lower tuition than those in 24 other states. Average undergraduate Iowa public school tuition in 1996 was $2,564, 10 percent cheaper than the national average.

Affordable tuition is important. Academic qualifications alone will not guarantee attendance at an institution of higher education. Tuition must be paid and costs covered, whether through loans, grants, or out of pocket. The lower the tuition and other associated costs, the more accessible education is for all qualified applicants.

Need-based aid is crucial for those who cannot afford tuition. Per student need-based assistance and grants awarded by the state of Iowa fell from 1990 to 1996. In 1990, Iowa spent an average of $321 on need-based aid ranking the state 7th best. By 1996, Iowa was providing an average of $291, or 8th best.

Average faculty salaries can reflect a state's ability to attract qualified instructors to its universities and colleges. In this regard, Iowa ranked 13th highest nationally in 1996, paying on average two percent higher than the national average for public institutions.

For Iowa to maintain and expand its educated work force, investments in higher education are crucial. The trend towards lower overall spending in this area is worrisome.

[28] Iowa's per-pupil spending has increased since 1995. This, however, has been the trend in most states. Data are not currently available to show whether Iowa has made up, or lost further ground since 1995.

Poverty Programs

The second largest area of state and local spending in Iowa is on poverty programs (14 percent of the budget in 1995). The two biggest poverty programs are Medicaid and the Family Investment Program. Spending on poverty programs in Iowa as a share of personal income has increased as it has in most of the country—primarily because of rising health care costs. Iowa's spending in this area has fallen, however, in relation to the rest of the country. Whereas poverty program expenditures as a share of personal income equaled the national average in 1980, Iowa had fallen below the national average by 1995. This, in part, reflects Iowa's relatively low poverty rate.

Legislation enacted by Congress in 1996 significantly changed the way the federal government assists those in poverty. In the past, much of the federal government's contribution to state poverty programs was tied to a formula based on, among other things, the number of recipients. Under the changes, the entitlement status of some of these programs ended, and the federal contribution is allocated under a block grant formula with funding linked to a base year. In Iowa, the state's funding is tied to 1994 levels.

Although the new arrangement provides Iowa with fewer restrictions on how it can use the federal money, there could be a catch. If the number of persons in need were to increase (say, during a recession), the federal contribution would not necessarily go up proportionately as in the past. This could place an increased burden upon Iowa governments.

Poverty Program Spending
As a % of Personal Income

	1980	Rank	1995	Rank
Illinois	2.0%	16	2.8%	31
Iowa	**2.0%**	**17**	**2.9%**	**27**
Minnesota	2.5%	8	4.0%	6
Missouri	1.4%	42	2.5%	43
Nebraska	1.3%	44	2.7%	36
South Dakota	1.9%	18	2.8%	34
Wisconsin	2.6%	7	3.3%	18
ALL STATES	**2.0%**		**3.1%**	

Source: Bureau of the Census; Bureau of Economic Analysis.

Health & Hospitals

While spending on health and hospitals increased as a share of personal income from 1980 to 1995, reflecting steeply rising health care costs, Iowa fell in the rankings. In 1980, spending on health and hospitals, as a share of personal income, was 1.8 percent (8th highest). By 1995, Iowa ranked 11th (2.2 percent of personal income). This drop is of concern in light of the needs in the health area described in Chapter 1.

Highways

In 1980, highway spending in Iowa, as a share of personal income, was 2.5 percent of personal income (ranking 9th highest). By 1995, Iowa ranked 6th (2.3 percent of personal income). This relatively high level of spending is undoubtedly responsible for Iowa's high scores in road quality.

Public Safety

Spending on police, fire, and other public safety programs has increased as a share of personal income. In 1980, Iowa ranked 49th (0.6 percent of personal income). By 1995 the state ranked 36th (0.8 percent of personal income). This spending increase as a share of personal income has coincided with a 23 percent drop in the violent crime rate during that same time period.

Natural Resources

Expenditures on natural resources, parks and recreation increased as a share of personal income—from 0.5 percent of personal income in 1980 (a rank of 31st nationally) to 0.7 percent of personal income in 1995 (a rank of 22nd).

Interest on the Debt

Spending on state and local debt interest payments increased dramatically from 1980 to 1995. In 1980, Iowa ranked last in interest spending (0.3 percent of personal income). By 1995, Iowa ranked 41st (0.7 percent of personal income). For fiscal year 1997, all state and local governments in Iowa reported total debt of $4.4 billion.

Expenditure Limitations & Special Funds

In addition to Iowa's Constitutional requirement for a balanced budget, Iowa law limits spending in excess of 99 percent of general fund revenue. The remaining one percent and any budget surplus is dedicated to various funds, or is returned to the general fund as follows:

1. The Cash Reserve Fund. This is the first stop for "excess" revenue. Funds from this account can only be spent on nonrecurring emergency expenditures. If the Cash Reserve Fund gets below three percent of general fund revenues, it takes a three-fifths majority of the Legislature to spend those revenues. This fund is deemed full when it reaches five percent of general fund revenues. At $220 million, the fund is currently full. Any amount in excess of the five percent goal (recently, the entire amount coming in) goes to:
2. The Generally Accepted Accounting Principles (GAAP) Deficit Reduction Account. No money will be dedicated to this fund in 1998, because Iowa's GAAP deficit was eliminated in 1995.[29] Excess from this fund (currently the entire amount coming in) goes to:
3. The Economic Emergency Fund (or the "Rainy Day Fund"). This fund is used for emergencies only. The goal for this account is also five percent of general fund revenues. For 1998 this fund is also full with $220 million. Any surplus in excess of the five percent goal flows back to the general fund.

In addition to these funds, there is a Rebuild Iowa Infrastructure Fund. Qualifying infrastructure expenditures include: land acquisition and construction, repair of existing buildings, and recreational trails. Routine maintenance and operational expenses are not included. All gambling receipts in excess of $60 million are automatically dedicated to this fund. In fiscal year 1998, 56 percent of all revenue for this account ($79.9 million) came from gambling receipts. This account also receives interest incurred from both the Cash Reserve Fund and the Economic Emergency Fund.

Summary of Public Spending Issues

While Iowa has a history of moderate levels of funding for government services, recent trends indicate that support for some important programs has been slipping relative to other states.

Iowa's history of commitment to primary and secondary education has been a factor in the state's strong showings in student achievement. Through 1995, however, expenditures per pupil had been on the decline, threatening to undermine Iowa's strong performance.

Although Iowa's commitment to higher education is above the national average in most key categories, recent trends indicate that, here to, support has been declining. Per student expenditures and need-based aid has declined, which could limit Iowa's ability to adequately train the workforce it needs.

With Iowa's economy performing as well as it has in many years, now may be the time to make important public investments. Investments in education, infrastructure and a host of other government services do not necessarily produce immediate payoffs in economic performance. But if they aren't made now, the price may be steep in the years to come.

[29] The "GAAP deficit" is the General Fund deficit using GAAP rules.

CHAPTER THREE

AN OVERVIEW OF THE CURRENT IOWA TAX SYSTEM

This chapter examines overall taxes in Iowa compared to other states, along with trends over the past two decades. It also analyzes the distribution of Iowa taxes by income level.

The Overall Level of Iowa Taxes

Several widely accepted measures exist for comparing tax burden between states. Iowa ranks differently depending on which measure is used:[30]

On a per capita basis, Iowa is below the national average in state and local taxes and ranks 20th highest in the nation;

As a share of total personal income, state and local taxes in Iowa are above the national average and rank 9th in the nation;

As a share of gross state product, Iowa's taxes are above the national average and rank 14th.

Which measure is the appropriate one? Each is instructive, but has certain limitations. Iowa's below average *per capita taxes* ranking tells us, by definition, that Iowans pay less per-person than the national average. But this is to be expected, given that Iowans have less income per-person than the national average. Measuring taxes per capita cannot tell us much about the level of taxation relative to what a state can reasonably afford, the cost of providing government services in the state, or what level of services the public demands.

For this reason, most analysts commonly use taxes as a share of personal income as a benchmark. Because it is widely accepted, generally valid, and the data is readily available, this is the measure of taxes that we use most often in this report.[31]

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[30]We focus here on total taxes raised by states, counties, municipalities, and school districts. Because states vary widely and somewhat serendipitously in the proportion of their revenues raised at different government levels (i.e., state versus local), limiting our analysis to only state (or only local) revenues would greatly distort the relationships among the various states.

State and local taxes include all tax revenues raised by state and local governments, mostly from property taxes, consumption taxes, personal income taxes, and corporate income taxes. Excluded from taxes are (1) offsetting receipts from user fees charged for government-provided services, gross interest income, and amounts paid into employee pension, workers' compensation and unemployment trust funds; (2) a small amount of miscellaneous non-tax revenues; and (3) funds from federal assistance.

The most recent state and local tax figures cited here are for fiscal 1994-95, the latest year for which the U.S. Bureau of the Census has published data for combined state and local taxes for all states. 1996 and 1997 data is sometimes used as noted in this report for trends in personal and corporate income taxes. It should be noted that the Census Bureau's *state only* tax data through fiscal 1996-97 show little or no change in the trend of Iowa's taxes compared to national trends.

[31]Estimates of state-by-state personal income are published by the U.S. Commerce Department's Bureau of Economic Analysis (BEA). BEA's definition of personal income is quite broad, including not only most cash income, but also many types of non-cash income (e.g., food stamps, employee fringe benefits such as health insurance and accrued pension benefits) and certain types of imputed income (primarily the rental value of owner-occupied housing). Personal investment income includes large amounts of imputed investment income (included as part of personal interest), but excludes both realized and unrealized capital gains (which are supposedly reflected in the reported income from the corporate sector of GSP). These departures from the common notion of personal income are not thought to create any significant distortions in state-by-state comparisons.

In computing taxes as a share of personal income, some analysts mistakenly divide *fiscal year* revenues by the *calender year* figures provided by BEA. Since states vary significantly in their economic growth rates (due to, among other things, varying population growth rates), this error can sometimes noticeably change state rankings. In addition, because BEA periodically revises its past estimates of state personal income, figures for taxes as a share of personal income can also change somewhat when the revisions are taken into account. The figures presented in this report for taxes as a share of personal income avoid these common errors by dividing fiscal year tax receipts (as presented by the U.S. Bureau of the Census) by our calculation of fiscal year state-by-state personal income. Also, But measuring taxes as a share of personal income also can produce anomalies, since some taxes do not come out of the pockets of individuals, but instead are paid, at least initially, by businesses. For example, Wyoming's total taxes in 1995 were equal to 11.6 percent of personal income—15th highest in the nation. Much of the taxes in Wyoming are not collected from individuals, however, but from the mineral industry, which largely exports these taxes to customers and owners who do not reside in Wyoming. Thus, although Wyoming ranks 15th in taxes divided by personal income, the citizens of Wyoming really face a considerably lower level of taxation.

Total State & Local Taxes in 1995: Three Measures

	% of GSP	Rank	% of Pers. Inc.	Rank	Per Capita	Rank
Illinois	9.0%	32	10.6%	35	$ 2,627	14
Iowa	**10.0%**	**14**	**12.1%**	**9**	**2,467**	**20**
Minnesota	10.8%	5	12.8%	5	2,998	7
Missouri	8.6%	35	10.1%	42	2,147	36
Nebraska	9.2%	30	11.5%	17	2,399	23
South Dakota	7.7%	46	10.1%	41	1,899	46
Wisconsin	11.2%	4	13.0%	4	2,837	9
ALL STATES	**9.4%**		**11.1%**		**$ 2,514**	

SOURCE: Bureau of Economic Analysis; Bureau of the Census

This brings us to the third measure used in this report: taxes as a share of gross state product (GSP).[32] This measure addresses the "Wyoming problem" by measuring taxes relative to an economy's entire output instead of the portion of output which remains in-state. As a share of GSP, Wyoming taxes, at 7.4 percent, ranked 48th in 1995—much lower than when ranked as a share of personal income.

Comparing taxes as a share of gross state product, almost by definition, probably offers the best measure of the potential impact of a state's taxes on economic activity in a state. We use GSP in this report in comparing state corporate taxes with one another.

State & Local Taxes as a % of Personal Income in 1995

	%	Rank	% different from Iowa
Alaska	18.8%	1	+6.7%
New York	14.7%	2	+2.6%
Dist. of Col.	13.6%	3	+1.5%
Wisconsin	13.0%	4	+1.0%
Minnesota	12.8%	5	+0.7%
Iowa	**12.1%**	**9**	**—**
Kentucky	11.5%	19	–0.6%
Median (Mississippi)	11.0%	26	–1.1%
Virginia	9.8%	48	–2.3%
Tennessee	8.7%	51	–3.4%
US Average	**11.1%**		**–1.0%**

SOURCES: Government Finances, Bureau of the Census; U.S. Dept of Commerce, Bureau of Economic Analysis.

As the table to the left illustrates, small differences between states in their levels of taxation can significantly affect their relative rankings. Despite ranking 9th highest nationally, Iowa's taxes as a share of personal income are:

only one percent of income higher than the median state and 1.1 percentage points above the national average;
closer to the lowest ranked state than to the highest ranked;
closer to the 48th ranked state than the second ranked state; and
closer to the 19th ranked state than the 5th ranked state.

Thus, although looking strictly at its ranking, Iowa might be classified as a high tax state, it actually doesn't have much higher taxes than most states.

None of these aggregate measures of tax burden—per-capita, share of GSP or share of personal income—tells us whether specific groups of taxpayers experience Iowa as a low-tax, high-tax, or average tax state. Taxes can affect taxpayers differently depending on amount of income, sources of income, home ownership, family size, if they live in an urban or rural area, and a host of other factors. For any given taxpayer, the tax burden she or he would owe in another state might be higher or lower than in Iowa, regardless of the other state's *average* tax burden.

Another problem with aggregate measures of tax burden is that they include all taxes collected in the state, regardless of whether the residents of the state pay those taxes or not. In fact, a significant portion of taxes paid by business are not paid by residents, but are "exported" out-of-state and paid by non-residents. Much of the Iowa business tax burden ultimately is paid by non-Iowans through either higher prices on goods and

the personal income figures cited here reflect BEA's April, 1998 personal income revisions.

[32]GSP is described in Chapter 1.

services exported from Iowa or lower returns on profit for out-of-state investors in businesses operating in Iowa. Of course, this works both ways: Iowans pay business taxes imposed by other states. But a state can be a net exporter or importer of business taxes depending on the tax policies it chooses. Thus, the business tax component is another reason these aggregate statistics do not tell the whole story.

The ability to deduct some taxes on federal income tax returns (see above table) also affects tax burdens among states. The more a state relies on deductible taxes—income and property—the lower the federal taxes paid by its citizens. The citizens of states relying more heavily on deductible taxes have lower total tax burdens—state, local *and federal*—than the residents of states relying more heavily on non-deductible taxes (such as the general sales tax). In 1998, Iowans pay over $300 million less in federal income taxes because of the state's reliance on deductible personal income and property taxes than they would if the state relied entirely on non-deductible taxes. In 1995, federally deductible taxes accounted for over half of Iowa's total state and local tax revenue.

The Impact on an Iowa Family with $75,000 of Income of Paying Deductible Instead of Non-Deductible Taxes

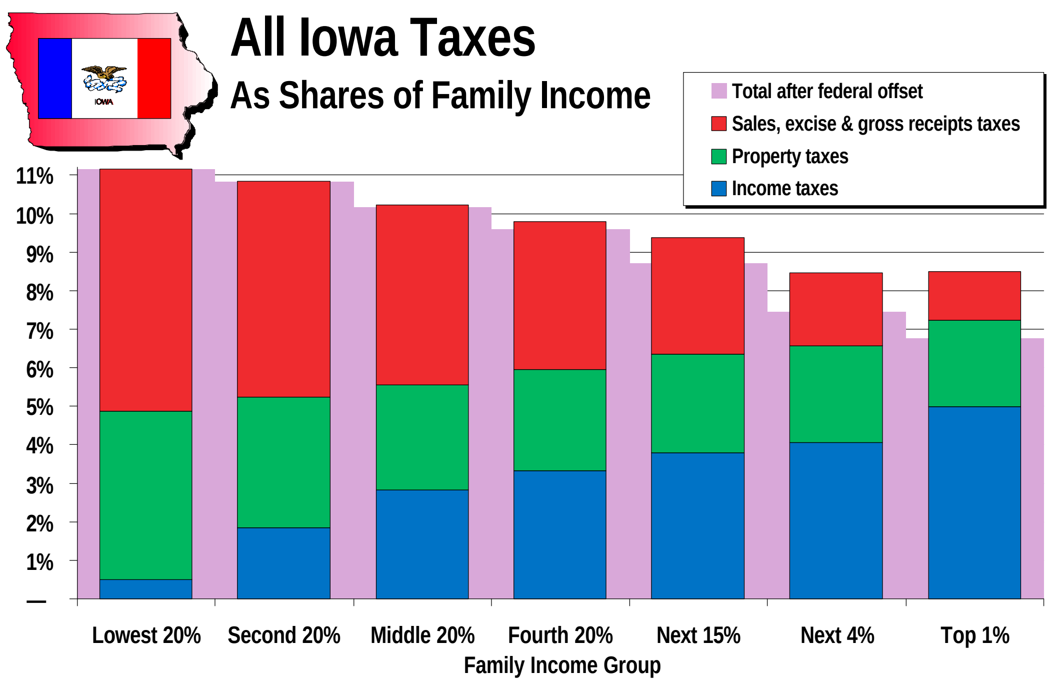
Deductible Taxes		Non-Deductible Taxes	
State Property Tax	$ 1,400		
State Income Tax	2,700	Non-Deductible Taxes	$ 4,100
Total State Taxes	4,100	Total State Taxes	4,100
Federal Income Tax	8,900	Federal Income Tax	9,400
Total	**$13,000**	**Total**	**$13,500**

$500 (12%) of deductible taxes is offset by lower federal tax.

If rankings were available of the net tax impact of state and local taxes, including the amount by which federal taxes are reduced due to the deduction for state and local taxes, the differences between the states would be even smaller than they are in the rankings discussed above. Furthermore, Iowa's ranking would probably be lower because many states ranked near, but below, Iowa rely more heavily than Iowa on non-deductible taxes.[33]

The Distribution by Income Level of Iowa Taxes

Iowa's overall tax system is regressive. It requires middle- and lower-income residents to pay more for government services as a share of their income than it does the wealthy. In 1998, the 20 percent of Iowa residents with incomes under $14,000 pay 11.1 percent of their income in Iowa taxes. The middle 20 percent of Iowa residents, with average incomes of $32,100, pay 10.2 percent of their income in Iowa taxes. The wealthiest one percent of Iowa residents—with average incomes of $476,000—pays 8.5 percent of income in Iowa taxes.



[33]Eight of the ten states immediately below Iowa in taxes as a share of personal income also rank below Iowa in reliance on deductible taxes.

A regressive tax system is problematic because it places the largest tax burden on those with the least ability to pay taxes. A ten percent tax burden on middle- or low-income families cuts directly into their standard of living in a significant way. But a similar level of taxation on wealthy families does not significantly impede their quality of life. The "ability-to-pay" principle is a central argument for a progressive tax structure. A progressive tax system takes a *larger* percentage of the income of the well-off than it does from those with lower incomes. A regressive tax system—like Iowa's—does exactly the reverse.

The regressivity or progressivity of a tax system is determined by the regressivity and progressivity of its component taxes and by the relative degree of reliance on each tax.

Consumption taxes, such as the sales tax, are the chief reason why Iowa's overall tax structure is regressive. Iowa property taxes are also regressive, although to a lesser degree than consumption taxes. Iowa's personal income taxes are progressive, but do not fully offset the regressivity of Iowa's other taxes.

As mentioned earlier, Iowa's income and property taxes can be deducted in computing federal income taxes. But only those taxpayers who itemize their deductions on federal tax returns can take advantage of this. For those who do itemize, their federal tax liability is substantially lowered. Hence, the *net* burden of the Iowa personal income and property taxes, after accounting for the reduction in federal taxes, is lower than it first appears. At the same time, because the benefits of itemized deductions go disproportionately to higher-income taxpayers in higher federal tax brackets, the net distribution of Iowa's taxes are actually more regressive than before the federal deductions.

For instance, taxpayers in the wealthiest one-percent of Iowans have their Iowa tax burden of 8.5 percent offset by a reduction in federal taxes equal to 1.7 percent of income. Thus, the net burden of the Iowa tax system on the wealthiest one percent is 6.8 percent of income. In contrast, for middle-income Iowans, the burden of Iowa taxes is cut by only 0.1 percent—from 10.2 percent to 10.1 percent.

Iowa Taxes in 1998
As Shares of Family Income for All Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$8,200	$19,900	$32,100	$48,700	$75,600	$133,000	$476,000
Income Range	Less than $14,000	$14,000 – $26,000	$26,000 – $40,000	$40,000 – $61,000	$61,000 – $101,000	$101,000 – $212,000	$212,000 or more
Sales, excise & gross receipts taxes	**6.3%**	**5.6%**	**4.7%**	**3.9%**	**3.0%**	**1.9%**	**1.3%**
General sales tax, individuals	3.1%	2.8%	2.3%	1.9%	1.5%	1.0%	0.7%
Excise & gross receipts taxes, individuals	1.7%	1.5%	1.3%	1.1%	0.9%	0.5%	0.3%
Sales, excise & gross receipts taxes, business	1.5%	1.3%	1.0%	0.8%	0.6%	0.4%	0.3%
Property taxes	**4.4%**	**3.4%**	**2.7%**	**2.6%**	**2.6%**	**2.5%**	**2.2%**
Property taxes on families	4.0%	2.9%	2.2%	2.0%	2.0%	1.6%	0.8%
Business property taxes	0.4%	0.5%	0.5%	0.6%	0.6%	0.9%	1.5%
Income taxes	**0.5%**	**1.8%**	**2.8%**	**3.3%**	**3.8%**	**4.1%**	**5.0%**
Personal income tax	0.5%	1.8%	2.8%	3.2%	3.7%	3.9%	4.8%
Corporate income tax	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%
Total before Federal Itemized Offset	**11.1%**	**10.9%**	**10.2%**	**9.8%**	**9.4%**	**8.5%**	**8.5%**
Federal Itemized Deduction Offset	–0.0%	–0.0%	–0.1%	–0.2%	–0.7%	–1.0%	–1.7%
Net Taxes after Federal Offset	**11.1%**	**10.8%**	**10.1%**	**9.6%**	**8.7%**	**7.5%**	**6.8%**

Chapter Four

TRENDS IN IOWA TAXES

Total state and local taxes in Iowa have increased since 1985 as a share of personal income, largely fueled by increases in consumption taxes.[34] In 1985, total state and local taxes were 10.6 percent of personal income, ranking Iowa 20th among the states. By 1995, Iowa's taxes had risen to 12.1 percent of personal income and its rank had risen to 9th. This data, however, does not take into account substantial tax cuts enacted since 1995.

Total Taxes as a % of Personal Income

	1985	Rank	1995	Rank
Illinois	10.0%	31	10.6%	35
Iowa	**10.6%**	**20**	**12.1%**	**9**
Minnesota	12.3%	5	12.8%	5
Missouri	8.3%	50	10.1%	42
Nebraska	9.7%	38	11.5%	17
South Dakota	9.4%	43	10.1%	41
Wisconsin	12.2%	6	13.0%	4
ALL STATES	**10.5%**		**11.1%**	

SOURCE: Bureau of the Census, Bureau of Economic Analysis

There is no question that Iowa's total taxes have risen over the last ten years. But not all Iowa taxes have gone up, and the increases have not been shared equally by all Iowans. The most noticeable trend has been the growth in consumption taxes. The general sales tax—which comprises 70 percent of all consumption taxes in Iowa—has been increased twice since 1982. Both increases were enacted during economic downturns to make up for projected revenue shortfalls.

In response to the 1982 crisis, the sales tax rate was raised from three to four percent. In 1992, Iowa again faced budget shortfalls and again turned to the sales tax, raising the rate from four to five percent.

The state's decision in 1985 to allow localities to implement a one percent local option sales tax has also contributed to greater reliance on consumption taxes. In the 1998 legislative session, another percentage point of local option sales tax was authorized to pay for school infrastructure.

Primarily due to the increases in the state sales tax rate, Iowa's average annual growth rate in per capita consumption taxes from 1985 to 1995 was double the national average and the 7th highest nationally.

The state's increasing reliance on consumption taxes is worrisome because they are regressive—consumption taxes hit middle- and lower-income Iowans harder than the better-off. In addition, by increasing reliance on these taxes, which are not deductible from federal income taxes, Iowans pay more in federal income taxes than they would have if an equivalent amount of revenue had been raised from deductible taxes instead.

Progressive taxes, on the other hand, have been a declining source of revenue. Although the income tax remains Iowa's only major progressive source of tax revenue, it has been cut in each year from 1995 to 1998. These changes have made the personal income tax less progressive. Iowa's inheritance tax—also a progressive revenue source—was reduced significantly in 1997.

Another progressive tax in decline is the corporate income tax. In 1985, it comprised 0.37 percent of gross state product (ranking 28th among the states). By 1996, it comprised 0.27 percent of gross state product (ranking 35th). Thus, a tax borne substantially by well-off, out-of-state shareholders in multi-state corporations has been falling. Lower business taxes mean that Iowa residents must pay a larger share of the tax burden.

Property taxes have grown the least of all major sources of revenue. This is primarily due to growth limitations and cuts in business taxes mandated by the state. Property taxes are not nearly as regressive as consumption taxes and cutting and limiting them has had only a modest impact on the overall regressivity of the tax.

There have also been substantial shifts in non-tax revenues. Federal government aid accounted for 21 percent of Iowa state and local revenue in 1978 and

[34] The year 1985 is selected for comparative purposes in this section due to data availability—before 1985, the Bureau of the Census did not report all consumption taxes together in its state and local revenue reports.

now accounts for 18 percent. User fees and charges have also increased significantly: in 1978 they provided 14 percent of revenue, in 1995 they accounted for 18 percent of revenue.

About half of user fees are for higher education. Other charges include user fees for health care and parks and recreation. These fees often hit middle- and low-income families the most.

Iowa taxes have increased compared to twenty years ago. But that trend is reversing in response to recent tax cuts and tax growth limitations. These new developments threaten the future of important government programs.

In addition, the incidence of who pays Iowa taxes has shifted in recent years. Hikes in the regressive sales tax, coupled with cuts in the progressive personal income and inheritance taxes, and the decline of the corporate income tax, have shifted the tax burden away from the wealthiest Iowans and on to middle- and lower-income residents.

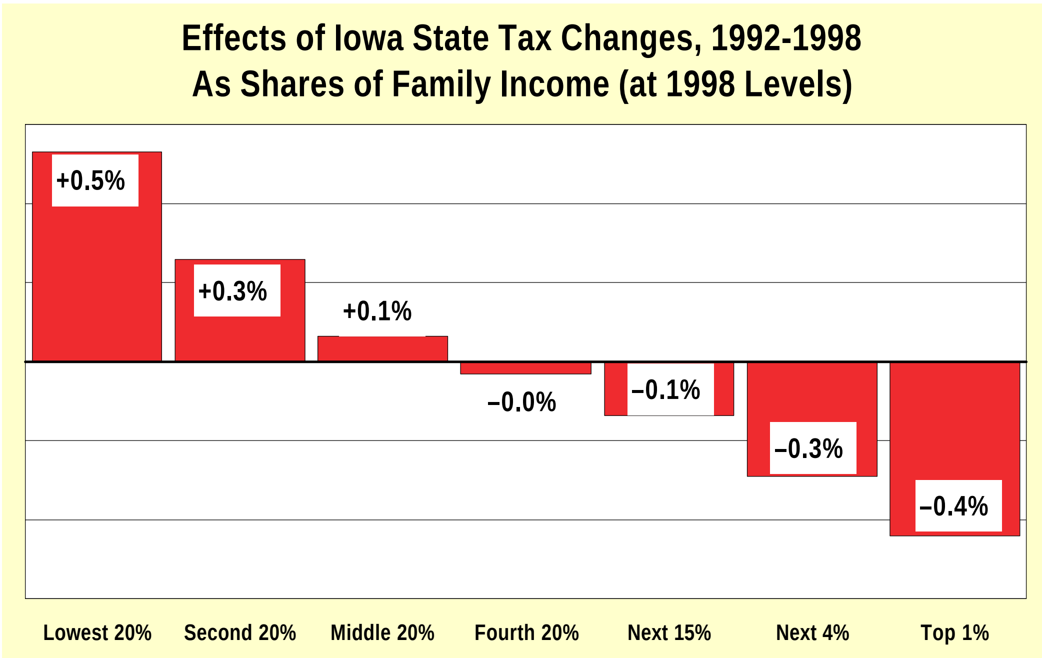
Furthermore, Iowa has been shifting from taxes deductible on the federal tax return to non-deductible taxes. In short, the recent state tax shifting has been raising the federal taxes of Iowans.

Provisions have been put into law, or are under consideration, that make these trends likely to continue and difficult to reverse. Property tax limitations restrain the use of that revenue source by local governments. Laws are in place that will require further cuts in business property taxes into the next century. And now, local governments have been authorized to raise more in sales taxes. Thus a shift from the less regressive property tax to the more regressive sales tax is likely. In addition, the proposed "Taxpayers Rights Amendment" to the Iowa Constitution, discussed in Chapter 10, would make reversal of the shifts described here much less likely.

Although Iowa's shift toward consumption taxes has been ongoing, the 1990s have seen a rapid succession of legislative actions pushing the trend forward. In fact, the entire 1992 state sales tax increase is now being used to pay for the state income tax cuts that followed in 1995 through 1998.

The following chart shows the impact of major Iowa state tax changes starting in 1992. The combination of the sales tax hike and income tax cuts has been approximately revenue neutral; the sale tax hike currently collects as much as the income tax cuts cost. But the impact on the citizens of Iowa has been anything but neutral. Lower- and middle-income families pay higher taxes; those at the top of the income scale pay less.

In addition, Iowa's shift from deductible income taxes to non-deductible sales taxes has caused Iowans to pay an additional $45 million in federal personal income taxes.



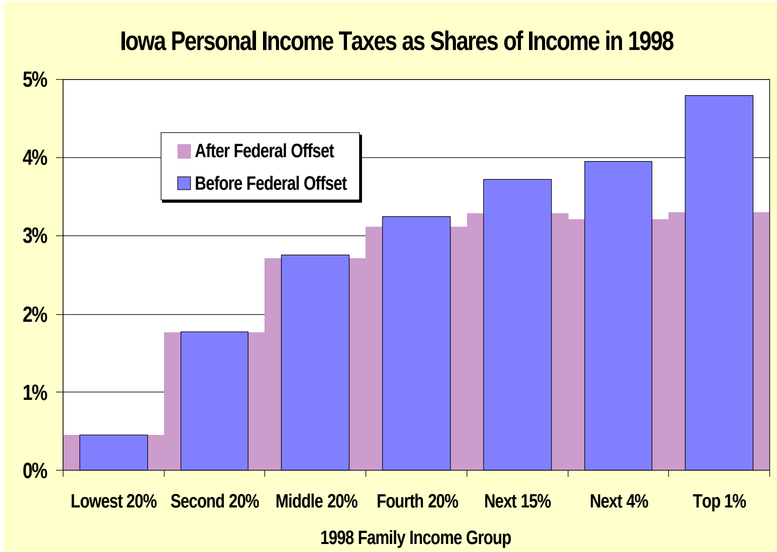
Chapter Five

THE IOWA PERSONAL INCOME TAX

Iowa's personal income tax was enacted in 1934 as a method of relieving rising property taxes during the depression.[35] In 1997, it was the third largest tax in Iowa, constituting 26.1 percent of all state and local taxes.

Since 1985, Iowa's personal income tax has grown more slowly than in other states. From 1985 to 1997, Iowa per capita personal income tax revenues grew 3.2 percent—the 37th lowest growth rate among the states and the lowest growth rate in the region. The national average for this time period was 3.9 percent.

As a share of personal income, Iowa's personal income tax grew from 2.3 percent of personal income in 1985 to 2.6 percent in 1996. These figures do not, however, take account of tax cuts effective in 1998.



Average Annual Inflation Adjusted Growth of Personal Income Tax Revenues: 1985-1997

	Growth rate	US Rank
Illinois	4.8%	21
Iowa	**3.2%**	**37**
Minnesota	3.3%	36
Missouri	6.6%	9
Nebraska	7.5%	6
Wisconsin	4.0%	30
ALL STATES	**3.9%**	

Note: South Dakota has no income tax.

The Iowa income tax is moderately progressive. Taxpayers in the middle 20 percent, with average incomes of $32,100, pay 2.8 percent of their income in personal income tax. The bottom 20 percent of Iowans, with incomes less than $14,000, have an effective tax rate of 0.5 percent. The best-off one percent of taxpayers pay, on average, 4.8 percent of their income in personal income tax.

If the personal income tax were Iowa's only tax, some might find this sufficiently progressive. But in a tax system awash in regressive taxes, Iowa's personal income tax is not progressive enough to keep the overall system from being quite regressive.

The Limited Progressivity of Iowa's Personal Income Tax

Iowa has nine personal income tax rates ranging from 0.36 percent to 8.98 percent. The taxable income brackets are indexed annually for inflation. This range of personal income tax rates would suggest a very progressive personal income tax compared to most other states. Iowa's income tax, however, is actually not nearly as progressive as its rates might suggest.

Indeed, the wealthiest one percent of Iowans, with an average income of $476,000, pay 4.8 percent of their total income in personal income taxes—despite the marginal rate of 8.98 percent. Minnesota, in contrast, has a similar top marginal rate—8.5 percent—but a much higher *effective* top rate. In fact, if Iowa had Minnesota's personal income tax system, the effective rate for the wealthiest one percent of Iowans would be 7.0 percent.[36]

[35] 1997 Annual Report of the Iowa Department of Revenue and Finance, page 22.

[36] Minnesota has a wealthier wealthiest one-percent, with an average income of $775,000 per-year. Hence, the progressive Minnesota income tax actually imposes an effective tax rate of 7.1 percent on the richest *Minnesotans* (source: ITEP Tax Model).

The gulf between Iowa's very progressive rate structure and its slightly progressive effective tax rates is caused by several factors.

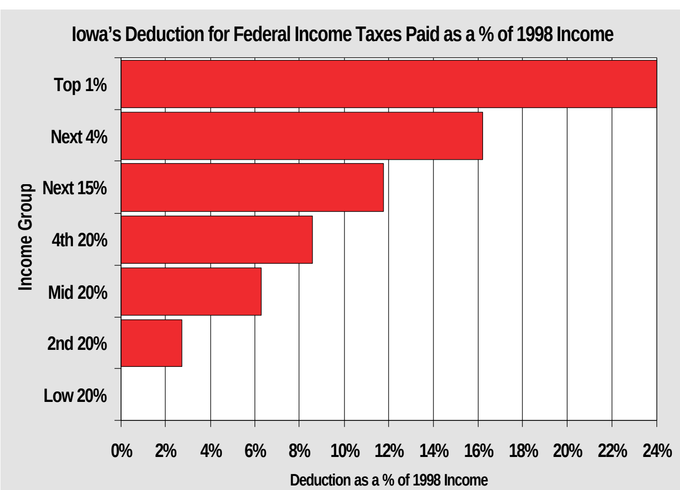
Deduction for federal personal income taxes paid

The Iowa deduction for federal personal income tax payments is the most significant reason for the relative lack of progressivity of the Iowa personal income tax. This deduction has been a feature of the tax since it was adopted.

Of the other states which allow a deduction for federal income taxes (Alabama, Louisiana, Missouri, Montana, North Dakota, Oklahoma, Oregon, and Utah), only Alabama and Louisiana allow a deduction of the full amount.

States That Allow Deduction for Federal Income Taxes Paid	
Alabama	All federal personal income taxes paid are deductible.
Iowa	**All federal personal income taxes paid are deductible.**
Louisiana	All federal personal income taxes paid are deductible.
Missouri	Maximum federal income tax paid deduction is $5,000
Montana	Taxpayers choose between taking the standard deduction and itemizing deductions. If they itemize, the full amount of federal taxes can be deducted UNLESS the taxpayer makes over $124,500. Then, the deductible amount is limited as income increases.
North Dakota	Taxpayers can either take the deduction for federal income taxes paid and apply higher state tax rates, or multiply their federal tax by 14% to get their state liability. 5% choose the deduction option.
Oklahoma	Taxpayers have two options, only one of which allows a deduction for federal income taxes paid. 58% of taxpayers choose the federal tax paid deduction option (which entails higher nominal state tax rates), and the rest forgo the federal deduction in favor of lower nominal state rates.
Oregon	Maximum federal income tax paid deduction is $3,000.
Utah	50% of the federal income tax paid is deductible.

The opportunity to deduct the full amount of federal income taxes paid greatly reduces Iowa's effective tax rates, particularly for high income taxpayers. This is because the federal income tax is progressive. Taxpayers with lower incomes pay less in federal taxes than do people with higher incomes. Hence, lower-income families deduct much less than taxpayers at higher incomes. While the average deduction for the wealthiest one percent of Iowa residents is over $100,000, the average value of this deduction for middle-income families is about $2,000. Low-income families don't pay any federal personal income tax and therefore have nothing to deduct.



It is important to note that only the federal *income* tax—the only federal progressive tax for individuals—is deductible from Iowa taxable income. The various regressive federal excise and payroll taxes are not deductible from the Iowa personal income tax. Deducting federal payroll taxes would be a more progressive option. Three states—Alabama, Massachusetts and Missouri—allow a deduction for federal payroll taxes.[37]

The argument is sometimes made that the federal deduction is important because it prevents "taxing a tax" and thus precludes "double taxation." This argument is something of a red herring. In reality, taxpayers worry more about how much they are taxed than how many times. After all, would you rather pay two one-percent taxes or one twenty-percent tax?

Double taxation is actually a fairly common occurrence. The outcry regarding this particular instance of double-taxation stems not from concern over the violation of a principle of taxation, but from a desire to defend a cherished tax loophole.

Several of the tax change options described in Chapter 10 show the impact of eliminating or reducing this deduction. Eliminating this very costly deduction would permit adoption of significantly lower state income tax rates, other tax reforms or increased investment in government services.

[37]Most of the federal payroll tax applies only to the first approximately $68,000 of earned income. Thus, the amount of the deduction does not increase as income exceeds this cap.

Small Personal Exemptions

Personal exemptions in the federal system and in most state systems are of the greatest benefit to lower-income families. They exclude a fixed amount of income per taxpayer and, typically, per dependent. Because the exemption amount is a greater percent of the income of a low-income family than of a higher income family, they have a larger impact in reducing a lower income taxpayers liability.

For example, a family with $15,000 of income and $10,000 of exemptions avoids taxes on two-thirds of its income because of the exemption. A family with $200,000 of income and $10,000 of exemptions escapes taxation on only one-twentieth of its income.

Instead of exempting a portion of income from tax, Iowa uses an exemption credit to directly reduce the tax liability of taxpayers. Thus, a taxpayer's before-credit tax liability is reduced by $40 per family member (with an additional $40 for each elderly member of the family). This type of exemption credit, used to reduce before-credit tax liability, has a more progressive impact than exemptions used to reduce taxable income. Because the personal income tax is progressive, the credit ends up being a smaller percentage of higher income families' taxes than would an income exemption.

No Credit or Exemption		
Taxable Income	$ 20,000	$ 100,000
Tax (from tax table)	$ 932	$ 7,620
With Exemption, No Credit		
Income	$ 20,000	$ 100,000
– Exemption	4,000	4,000
= Taxable Income	16,000	96,000
Tax (from tax table)	**$ 677**	**$ 7,261**
% Tax Reduction	***–27%***	***–5%***
With Credit, No Exemption		
Taxable Income	$ 20,000	$ 100,000
Tax (from tax table)	932	7,620
– Credit	300	300
= Tax	**$ 632**	**$ 7,320**
% Tax Reduction	***–32%***	***–4%***

Among Iowa's neighbors, only Nebraska uses exemption credits in the same way as Iowa. Nebraska provides $88 per exemption. While a family of four in Iowa receives $160, the same family in Nebraska would receive $352.

Thus, although Iowa's exemption credits are a progressive feature of its tax system, they are small and thus do less to add progressivity to the Iowa personal income tax than do similar features in other jurisdictions. The table below shows what the credit would have to be to offer the same tax reduction as the federal exemption for various numbers of exemptions. Only for a single exemption is the current credit greater than the benefit of the exemption.[38]

Federal Exemptions Equivalent in Credit for Iowa

# of Exemptions	x $2700 Exemption	Credit Equivalent	Current $40 Iowa Credit
1	$ 2,700	$ 23	$ 40
2	5,400	106	80
3	8,100	227	120
4	10,800	358	160
5	13,500	524	200
6	16,200	689	240

Low Standard Deduction

Similarly, Iowa's standard deduction is small. In 1998, Iowa's standard deduction for unmarried and married people filing separately is $1,440 ($3,550 for married people who file together). This deduction is much smaller than the federal standard deduction and the standard deductions of many states. In 1998, the federal standard deduction is $4,250 for unmarried, single people ($7,100 for married couples filing together).

Like the federal income tax, the Iowa income tax provides taxpayers with the option of itemizing their deductions instead of taking the standard deduction—taxpayers choose whichever will give them the largest deduction. Typically, upper-income taxpayers benefit the most from itemizing. Indeed, while only a quarter of all Iowans will itemize deductions on their 1998 tax returns, almost all of the wealthiest one percent of Iowans will itemize.

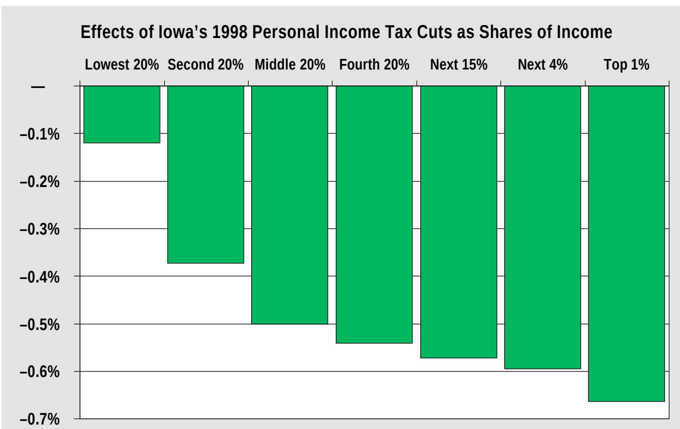
Iowa's small standard deduction shortchanges Iowans who do not itemize their deductions. Since these taxpayers are disproportionately lower-income earners, this progressive feature of Iowa's income tax does less for low- and middle-income families than in many personal income tax systems.

[38]The value of exemptions increases as the amount increases because they are exempting income that would be taxed in higher brackets.

The 1998 Changes in the Iowa Personal Income Tax Reduced the Progressivity of the Income Tax

Effective in 1998, the personal exemption credit is increased from $20 to $40, tax rates are cut across-the-board by 10 percent, capital gains taxes are reduced and the retirement exclusion is increased.

These changes have had a regressive impact. Since the personal income tax is a progressive tax, an "across-the-board" cut benefits the well-off the most. By contrast, an "across-the-board" tax cut in Iowa's regressive consumption taxes would benefit low- and middle-income families the most. (See chapter 10 for analyses of these and related tax change options.)



Cutting capital gains taxes overwhelmingly benefits the best-off. The pension exclusion benefits primarily middle-income senior citizens.

The credit increase does make the personal income tax more progressive. Nevertheless, the overall tax cuts for 1998 are greatest for those with higher incomes. In addition, Iowan's federal taxes were increased by $41 million because of lower deductions on the federal tax return for state income taxes paid.

The impact of these cuts also varies geographically. There are wide differences among Iowa counties in median income. Counties such as Wayne, Appanoose and Howard are unlikely to fare as well under these tax cuts as higher-income counties such as Warren, Dallas and Story.

Selected 1993 Iowa County Median Incomes		% above/below Iowa Median
Warren County	$39,356	+36.3%
Dallas County	35,297	+22.3%
Story County	34,024	+17.9%
Iowa Median	**28,867**	—
Howard County	25,401	–12.0%
Appanoose County	22,125	–23.4%
Wayne County	20,627	–28.5%

Source: U.S. Bureau of the Census.

Complexity of the Iowa Personal Income Tax

In general, state income tax systems become more complex for taxpayers the more they differ from the federal personal income tax system. After all, everyone has to complete their federal tax return anyway and to the extent the state form consists of copying a few numbers from the federal form, it is relatively simple.

The simplest state personal income taxes are those that are calculated as a percent of federal tax due (Vermont and Rhode Island) or which simply require applying a rate table to federal Adjusted Gross Income or taxable income (such as Minnesota). There are always some differences between the federal tax base and state tax bases, mainly because of differences in the restrictions on what the federal and state governments may legally tax. These differences, however, only affect a minority of taxpayers.

Iowa's personal income tax differs significantly from the federal income tax—more so than in most states. This means that Iowa taxpayers have to do more work in order to complete their Iowa tax forms.

Separate Filing for Married Couples

Under the federal tax system, there are substantial incentives for most married couples to file joint tax returns. Federal policymakers felt that treating a married couple as a single economic entity for tax purposes made sense. But in Iowa, there are strong incentives for couples to file under the status *married filing separately*. This requires a recalculation for each spouse of many income and deduction items from what is reported on the federal return jointly.

The cause of the incentive to file separately in Iowa is rooted in Iowa's single tax table. Since Iowa's *marginal tax rate and taxable income brackets* are the same for all filers regardless of status, many married couples gain from splitting their income so that more of their income is in lower tax brackets (see the table to the right).

It is possible to design a tax system which would eliminate this "marriage penalty" *without* Iowa losing revenue or raising married couples taxes (see tax change options in Chapter 10).

Itemized Deductions

Iowa's itemized deductions also add to the complexity of Iowa's personal income tax. Because Iowa's standard deduction is lower than the federal, more people have an incentive to itemize their deductions.

Itemizing on the state return when not itemizing on the federal return makes tax filing more complicated.

Other Complexities

Several other features of the Iowa personal income tax, discussed elsewhere in this chapter, also add complexity to the system. In particular, the differences from the federal income tax rules on retirement income, social security income and capital gains income make the tax system more complex. Each of these items must be re-calculated when filling out the Iowa personal income tax. The alternative tax calculation discussed below also adds complexity.

Other Elements of Note in the Iowa Personal Income Tax

Earned Income Tax Credit

Beginning with the 1990 tax year, lower-income Iowa working taxpayers have been allowed an *earned income credit* equal to 6.5 percent of the federal earned income tax credit (EITC). The federal EITC is designed to offset regressive tax burdens on low-wage workers. In this time of transition in social welfare programs, the need for ensuring that low-income workers do not find themselves living in poverty has never been greater. In 1996, the federal EITC helped lift 4.6 million people in working families out of poverty—including 2.4 million children.[39]

Two factors limit the effectiveness of Iowa's EITC. First, it is a relatively low percentage of the federal credit. Second, Iowa's EITC—unlike the federal credit—is not refundable. Because it is non-refundable, those taxpayers whose EITC exceeds Iowa personal income tax liability (before EITC calculation) do not receive the full

The Advantage of Separate Filing in Iowa: An Example

	Joint Return	Separate Returns: Spouse 1	Separate Returns: Spouse 2
Wages	$ 50,000	$ 35,000	$ 15,000
Interest, dividends, etc.	10,000	4,000	6,000
Total adjusted gross income	60,000	39,000	21,000
Standard deduction	3,550	1,440	1,440
Deduction for federal taxes	6,300	4,800	1,500
Iowa taxable income	50,150	32,760	18,060
Income tax before credits	3,154	1,791	806
Credits	160	80	80
Net tax	**$ 2,994**	**$ 1,711**	**$ 726**
Total net tax, separate filing		**$ 2,437**	
Tax saving from filing separately		**$ –556**	

1998 Earned Income Tax Credit Comparisons

	% of Federal Credit	Refundable?
Iowa	**6.5%**	**no**
Kansas	10%	YES
Maryland (1)	50%	no
Massachusetts	10%	YES
Minnesota (2)	15%, 25% with kids	YES
New York	20%	YES
Oregon	5%	no
Rhode Island	27%	no
Vermont	25%	YES
Wisconsin	4% one kid, 14% 2 kids, 43% 3+ kids	YES

(1) Maryland also has a 10% refundable credit - taxpayers choose whichever provides the largest amount.
(2) For those with children, the amount of credit varies with income. 25% is an estimate of the average.

[39]U.S. Bureau of the Census, March 1997 Current Population Survey. A Refundable Earned Income Tax Credit Will Assist Maryland's Working Poor Families, Elizabeth C. McNichol (COBPP March 16, 1998).

credit. If the personal income tax were Iowa's only tax, this might make sense if the goal was to simply reduce tax liability and not provide further assistance. But for low-income families, the largest components of the tax burden are consumption and property taxes—not income taxes. A refundable credit would help offset *all* taxes paid by lower-income Iowans, not just taxes on income.

In 1998, nine other states—Kansas, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont and Wisconsin have versions of the earned income tax credit. Only Oregon's EITC is uniformly smaller than Iowa's. And six of the states offer refundable EITC's.

Iowa's EITC is a good start to helping Iowa's working poor. Increasing the EITC and making it refundable would help offset regressive Iowa taxes and would increase its effectiveness in encouraging low-income workers to enter the workforce. (Options for expanding the EITC are discussed in Chapter 10.)

Treatment of Retirement Income

Starting in 1995, Iowa has allowed a retirement income exemption. This exemption allows a disabled person or a person 55 or older to exclude a certain amount of retirement income from Iowa taxable income. Effective for 1998, the maximum amount excludable was increased from $3,000 to $5,000 ($6,000 to $10,000 for married couples who file taxes together).

One of the arguments for increasing the retirement exclusion in 1995 was that it would stem the outflow of elderly from Iowa. It is unlikely, however, that relatively small differences in taxes significantly affect people's choices about where to spend their golden years.

Retirement Income Exclusions	
Illinois	All exempt
Iowa	**$5,000 ($10,000 married filing jointly)**
Minnesota	None exempt
Missouri	None exempt
Nebraska	None exempt
South Dakota	No income tax
Wisconsin	None exempt

There certainly is not a strong case to be made for further expansion of this exclusion. Even comparing Iowa to Illinois, which doesn't tax any pension or social security income, only 31 percent of Iowa elderly pay more under the Iowa personal income tax than they would under the Illinois personal income tax. This is because of the already generous exclusions for social security and pension income under Iowa law combined with an exemption credit of greater value than Illinois's exemption and Iowa's allowance of itemized and standard deductions where Illinois allows none. For the mostly better-off elderly who do pay more under Iowa's tax system it is unlikely that the few hundred dollars difference has a substantial impact on where they choose to live.[40]

Social security benefits are not subject to Iowa's personal income tax if the taxpayer's adjusted income is below $32,000 for couples and $25,000 for other taxpayers. For those with incomes exceeding these thresholds, the basic rule is that 50 percent of the social

Marginal Tax Rates and *Taxable* Income

Iowa has a *marginal* rate personal income tax system and the brackets in the tax table refer to *taxable* income. The table below shows how these distinctions matter for a married couple with $100,000 in income.

First of all, only about three-fourths of that income is *taxable income* under the Iowa personal income tax because of deductions, exemptions and exclusions.

Next, although the top rate of 8.98 percent starts at $51,120 of taxable income, of the $74,756 left to be taxed, only $23,636 is taxed at the top rate. The rest of taxable income is taxed at the lower rates. This is how *marginal* tax rates work.

How Iowa's Marginal Tax Rates Work

Iowa Tax Calculation for a Married Couple with $100,000 in Wage Income

Step 1: Iowa Taxable Income = $74,756

Tax in bracket	Tax Calculation at Each Marginal Rate
$4	0.36% x first $1,136 of taxable income
8	0.72% x next $1,136 of taxable income
55	2.43% x next $2,272 of taxable income
256	4.5% x next $5,680 of taxable income
417	6.12% x next $6,816 of taxable income
368	6.48% x next $5,680 of taxable income
772	6.8% x next $11,360 of taxable income
1,350	7.92% x next $17,040 of taxable income
2,122	8.98% x final $23,636 of taxable income
$5,352	***TOTAL IOWA TAX***

Addendum: Percent of total income taxed at 8.98% rate: 23.6%

[40]ITEP Tax Model.

security benefit contributing to adjusted income above the base amount is subject to tax.

This rule reflects the pre-1993 federal law on taxation of social security benefits. Iowa has not conformed to federal changes that increased the amount of social security taxes subject to taxation for people with higher incomes. The federal changes were prompted by complaints about high income people receiving untaxed social security benefits and the need to balance the federal budget. Taxing benefits is equivalent to reducing benefits at higher incomes (for tax simplification examples conforming social security taxation to the federal rule, see chapter 10).

Alternative Tax Calculation

Iowa allows an alternative tax computation for lower-income married and single parent taxpayers. Unmarried taxpayers without children are not eligible. This alternative tax computation addresses a problem resulting from Iowa's income tax threshold. Iowa's threshold exempts those taxpayers with incomes under $13,500 from owing any tax. While a threshold is effective at removing low-income people from paying any income tax, it can create unfair situations as well. For example, an Iowa resident earning $13,499 pays no income tax. But if she earns just $2 more, she will exceed the threshold and have to pay income tax on all her taxable income ($13,501 less deductions and credits). This can mean a tax of as much as $400. Obviously, making a low-income person's tax liability go up $400 with an income increase of $2 is not good tax policy.[41]

The alternative tax calculation ensures that no one pays over 8.98 percent on their income *exceeding* $13,500. This smooths out the cliff effect of the threshold. In our example, instead of owing $400, the taxpayer uses the alternative calculation and owes 9 cents.

Most tax systems that have high thresholds for requiring citizens to pay taxes do so implicitly through higher standard deductions and exemptions. Were these to be raised in Iowa, the explicit thresholds and the alternative tax would be unnecessary.

Local Income Taxes

Upon approval by referendum, school districts may impose a surtax on the state income tax not to exceed 20 percent of state personal income tax liability in conjunction with a property tax hike. The funds are used for school improvements. As of 1997, school districts raised $27 million under this tax.

Deductibility of State Personal Income Taxes on Federal Returns

A notable advantage of state personal income taxes (shared by property taxes) is that part of their cost is, in effect, paid by the federal government. This is because many taxpayers are able to deduct their Iowa income taxes on their federal tax return, lowering their federal personal income tax liability. This has a far more significant impact than is sometimes appreciated. For individuals who itemize their deductions on their federal tax return, between 15 percent and 39.6 percent of state tax liability is offset by lower federal taxes. Iowans pay $230 million less in federal income taxes because they pay their personal income tax instead of a non-deductible tax.

[41]This is referred to as a "cliff effect." Tax liability goes "off a cliff" with a very small step up in income.

Chapter Six

IOWA CONSUMPTION TAXES

Consumption taxes accounted for nearly a third—32 percent—of all Iowa state and local tax revenues in 1997. The vast majority of Iowa's consumption tax revenue is derived from the general sales tax. The five percent state sales/use tax alone accounted for 22 percent of all state and local taxes in 1997. All other consumption taxes in Iowa—including the motor vehicle use tax, excise taxes on gasoline, tobacco and alcohol, and two local option taxes (sales and hotel/motel) collectively represented about 10 percent of Iowa's state and local tax revenue in 1997.

As a share of total taxes, Iowa's sales and excise taxes have risen steadily over the past decade, from 28 percent of total tax revenue in 1985 to 31 percent of total tax revenue in 1995. Consumption taxes rose from 3.0 percent of personal income to 3.7 percent of personal income between 1985 and 1995. The general sales tax increased from 1.7 percent of personal income in 1982 to 2.6 percent in 1995.[42]

Over the past 20 years, Iowa has repeatedly increased general sales and excise taxes. In particular:

- The state sales and use tax rate has been increased twice, from three percent to four percent in 1983 and from four percent to five percent in 1992. This represents a two-thirds increase in the sales tax rate over this 15 year period.
- Since 1978, cigarette excise taxes have been raised five times. The current tax of $0.36 per pack of 20 is almost triple the pre-1981 tax of $0.13 per pack.
- Gasoline excise taxes have been raised *nine times* since 1978, with a net result of increasing the tax per gallon on gasoline from seven cents to 20 cents.

The state's continued willingness to raise sales and excise taxes helps explain the increasing total tax burden on Iowa's families. Unfortunately, much of the burden of this shift to consumption taxes falls on middle- and low-income groups.

Because low-income families spend all of their income and middle-income families spend most of their income to maintain a reasonable standard of living, taxing their consumption imposes a heavy burden. The truly wealthy are able to maintain a very high standard of living while spending a relatively small share of their income. Thus, taxing their consumption does not take nearly as heavy a toll.

While the regressivity of the general sales tax is lessened by exemptions for groceries and prescription drugs, sales and excise taxes remain the most regressive taxes in Iowa:

State & Local Consumption Taxes

	As a % of Personal Income				As a % of Gross State Product				Per Capita (1995 Dollars)			
	1985	Rank	1995	Rank	1985	Rank	1995	Rank	1985	Rank	1995	Rank
Illinois	3.9%	24	3.7%	34	3.3%	21	3.1%	32	$ 822	14	$ 914	18
Iowa	**3.0%**	**44**	**3.7%**	**32**	**2.6%**	**41**	**3.1%**	**36**	**541**	**44**	**763**	**35**
Minnesota	3.7%	30	4.0%	25	3.1%	29	3.3%	23	749	21	937	14
Missouri	3.8%	26	4.1%	23	3.3%	22	3.4%	21	720	23	869	26
Nebraska	3.1%	42	4.0%	24	2.6%	42	3.2%	29	571	42	836	28
South Dakota	4.3%	15	4.7%	15	3.5%	16	3.6%	18	685	27	890	20
Wisconsin	3.5%	35	3.6%	35	3.1%	30	3.1%	33	660	32	792	33
ALL STATES	**3.8%**		**4.0%**		**3.2%**		**3.4%**		**$ 760**		**$ 920**	

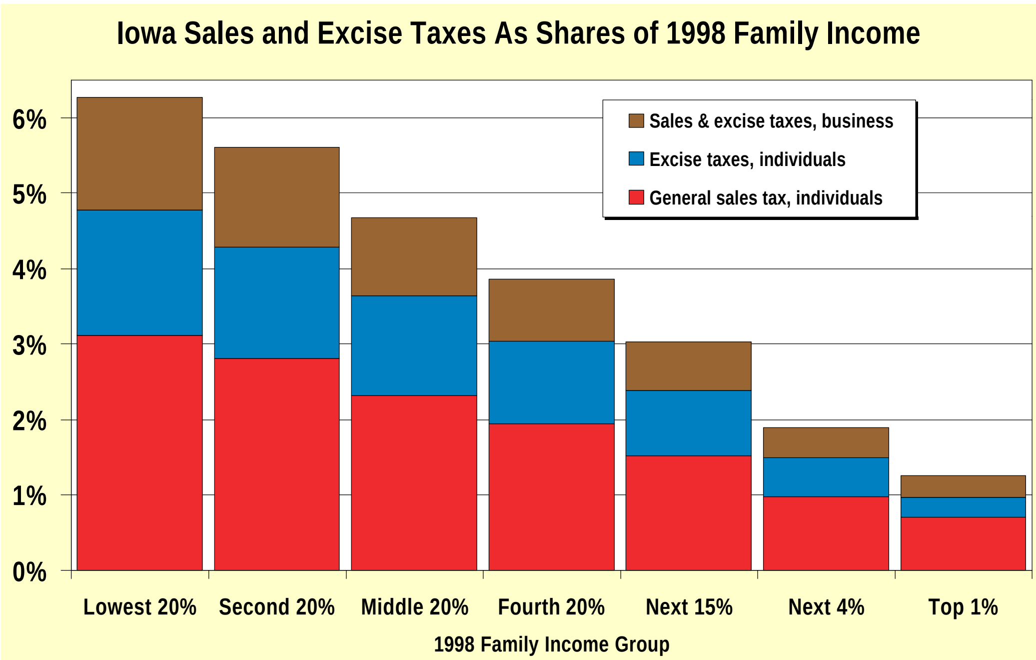
SOURCE: Bureau of Economic Analysis, Burea of the Census

[42] The earliest data available from the U.S. Bureau of the Census for total consumption taxes are from 1985; general sales tax revenue, however, is available for years prior to that. We chose the year 1982 as the base comparative year for the general sales tax because it was the year prior to the 1983 tax increase.

- For the 20 percent of Iowans earning less than $14,000, taxes on consumption amount to 6.3 percent of total income in 1998;
- Iowans in the middle 20 percent pay 4.7 percent of their income on consumption taxes;
- The best-off one percent of Iowa residents, with average incomes of $476,000, pay an effective consumption tax rate of 1.3 percent.

on to out-of-staters in higher prices for Iowa products. Overall, we estimate that a total of 22 percent of total Iowa taxes on consumption are exported out-of-state in these ways. That compares to about 20 percent of income taxes and 47 percent of property taxes that are either exported or offset by lower federal income tax payments due to federal itemized deductions.

Iowans who itemize deductions on their federal income tax can deduct their Iowa income and property taxes—but not consumption taxes. The result is that while Iowans who itemize can expect to receive a "refund" of part of every income and property tax dollar they pay from the federal government, every dollar of consumption tax paid by Iowa residents is a dollar out of their pockets.



This means that low-income Iowans pay nearly five times the effective sales and excise tax rate that the wealthy pay, and middle-income families pay almost four times the wealthy's effective rate.

Hardly anyone would propose an *income* tax that looks like this. The main reason the harsh distributional pattern of consumption taxes is tolerated is that the amount families pay is hidden in the many purchases made throughout the year, rather than being paid in one highly visible lump sum (as income and property taxes are paid).

Exporting of Consumption Taxes

A substantial amount of Iowa's consumption tax revenues are "exported" from the state in the sense that the final incidence of the exported tax rests with residents of other states. Two mechanisms are responsible for exporting part of Iowa's consumption tax burden. First, a small portion of Iowa's sales and excise taxes are paid directly by visitors from out-of-state. Second, a considerably larger share of the sales and excise taxes initially paid by businesses are passed

General Sales Taxes

Iowa's general sales tax was introduced in 1934 at a rate of 2 percent. This rate was temporarily hiked to 2.5 percent from 1955 to 1957, and was permanently increased to three percent in 1967. The rate has been increased twice in the past fifteen years: to 4 percent in 1983, and to 5 percent in 1992.

Iowa Sales Tax Rates Over Time	
1934	Enacted at 2%
1955	2.5%
1957	2.0%
1967	3.0%
1983	4.0%
1993	5.0%

Technically, the Iowa general sales and use tax applies to sales of tangible personal property unless specifically exempted, and sales of certain services where specifically taxed.[43] The trend in Iowa's definition of its sales tax base has been

[43]The Iowa use tax was enacted in 1937 to complement Iowa's sales tax. The Iowa use tax applies at the same rate as the sales tax to goods and services that will be used in Iowa but are purchased outside of Iowa. Use taxes comprised 3.1 percent of all state and local taxes in 1997.

toward broadening the base. When initially introduced, the sales tax applied only to gross receipts from the sale of tangible personal property, gas, electricity, water, communication services, and the sale of admissions to places of amusement and athletic events. The base was extended to include the short-term rental of rooms in 1965, certain services in 1967, and optional service and warranty contracts in 1981. The last major wave of base-broadening, in 1985 and 1992, included snack foods and prepared foods in the definition of taxable goods, and expanded the list of enumerated taxable services to include cable television, landscaping, and building maintenance. The 1992 base expansion added 11 new services to the tax base, including taxidermy, swimming pool maintenance, dating services, and limousine services.

The practice of introducing major exemptions to the sales tax dates only to 1974, when food for home consumption, prescription drugs and medical devices were exempted. The only other major exemptions from the general sales tax are for gasoline and diesel fuel (because these items are subject to a special excise tax at a higher rate), newspapers, and sales of motor vehicles subject to registration (because these items are subject to a "motor vehicle use tax" which is functionally identical to the general sales tax). While the exemptions for food and prescription drugs lessen the regressivity of the general sales tax, the sales tax remains the most regressive of the major taxes imposed by the state of Iowa.

By most measures, the tax base of Iowa's retail sales tax is moderately broad. Only six other states tax a greater number of enumerated services than Iowa, which taxes 94 separate personal, business and professional services.[44] This is due in part to Iowa's greater willingness to tax business services such as advertising, printing, and janitorial and telephone answering services. Indeed, in 1996, Iowa taxed more business services than all but seven states. While it is generally agreed that broadening the sales tax base is a good thing from a horizontal equity perspective—that is, treating all consumption similarly—there are possible pitfalls.

To the extent that a sales tax base is broadened to include additional purchases by businesses, there can be a pyramiding effect where businesses pass on the cost of the taxes to the purchasers of their products. In addition, inequities can be created between companies that keep services in-house—thus avoiding tax—and companies that purchase services from outside sources. Thus, this kind of sales-tax base broadening can have undesirable consequences.

Local Option Sales Taxes

Since 1985, Iowa has allowed cities and counties to enact a *local sales tax*, subject to approval by referendum. The rate of the local tax may not exceed one percent. All purchases subject to the state sales tax are also subject to the local sales tax. 472 cities and 53 out of 99 Iowa counties imposed the local option sales tax in 1997.

In 1978, cities and counties were authorized to impose a *hotel/motel* tax at a rate of up to seven percent. Three counties and 52 cities currently levy this tax at rates ranging from three to seven percent. These two local option taxes collectively raised almost $106 million in revenue in 1997, or about 1.5 percent of all Iowa state and local taxes.

The 1998 Legislature allowed counties and school districts to impose a one percent local option sales tax *in addition to* the already existing local option tax. To impose the tax, a majority of residents in the county or school district must approve the tax by referendum.

Revenues generated by this tax must be dedicated to school infrastructure costs. This will undoubtedly make this option more attractive to voters when offered no other choice for funding needed school construction.

[44] Federation of Tax Administers, *Tax Administrators News*, December, 1996.

Excise Taxes

As previously noted, Iowa's *motor vehicle fuel* excise tax was doubled during the 1980s. The rate has remained unchanged since 1989, but Iowa's gasoline excise tax remains the 20th highest among U.S. states. Including the one cent per gallon "environmental protection charge" on petroleum deposited in storage tanks at retail motor vehicle fuel outlets, Iowa fuel tax collections totaled $430 million in 1997, or six percent of total Iowa state and local taxes.

Gasoline Taxes in 1998

	Per Gallon
Illinois	19.0¢
Iowa	**20.0¢**
Minnesota	20.0¢
Missouri	17.0¢
Nebraska	23.5¢
South Dakota	18.0¢
Wisconsin	25.4¢

Since nearly tripling between 1981 and 1991, Iowa's *cigarette excise tax* rate has remained unchanged. Cigarettes are taxed at 36 cents per pack, and all other tobacco products are taxed at 22 percent of the wholesale sale price. Notwithstanding the lack of a rate hike since 1991, Iowa's cigarette tax is the 23rd highest in the nation. Iowa tobacco taxes collectively brought in nearly $100 million in 1997, or about 1.4 percent of all Iowa state and local taxes.

Cigarette Taxes in 1998

	Per Pack
Illinois	44¢
Iowa	36¢
Minnesota	48¢
Missouri	17¢
Nebraska	34¢
South Dakota	33¢
Wisconsin	44¢

Iowa's *insurance premiums tax* is levied at a two percent rate on the adjusted gross amount of insurance premiums. 1997 revenue from this tax amounted to $106 million, or 1.5% of total Iowa tax revenue.

The *motor vehicle use tax* and *motor vehicle lease tax* are levied as five percent taxes on the sale and lease, respectively, of motor vehicles. These taxes collectively brought in $223 million or 3.1 percent of all state and local taxes in 1997.

The Regressivity of Excise Taxes

Selective excise taxes—gasoline, cigarettes, etc.—are especially regressive, in part because they are generally a fixed amount per unit purchased. These excise taxes hit the poor 38 times as hard as the wealthy, while middle-income people pay about 14 times as much as the rich as a share of income.

Consumption Tax Trends

Over the last 15 years, Iowa has significantly raised taxes on consumption. This shift has made the Iowa tax system more regressive. Recent legislation—allowing counties and school districts to impose local sales taxes of up to two percent—may force revenue-strapped local governments to increasingly turn to regressive taxes to fund important public services. Indeed, as explained in the next chapter, these state laws encouraging increased reliance on local consumption taxes come at the same time that the state has been imposing more strict local property tax limitations.

CHAPTER SEVEN

IOWA PROPERTY TAXES

Iowa's property tax is the oldest source of tax revenue in the state, dating to the 19th century. It is also the largest source of revenue in the state, comprising 34.4 percent of all state and local tax collections in 1997. Iowa's reliance on the property tax has, however, been declining. In 1985 property taxes raised 39 percent of Iowa state and local taxes (9th nationally). By 1995 property taxes had fallen to 35 percent of tax revenue (15th nationally).

Iowa property taxes as a share of personal income increased slightly from 4.1 percent in 1985 to 4.2 percent in 1995. The 1.4 percent a year average annual growth in per capita property taxes in Iowa from 1985 to 1995 was the slowest in the region and slower than all but 9 states nationwide.

Average Annual Growth in Per Capita Property Taxes: 1985-1995

	Growth Rate	US Rank
Illinois	3.1%	19
Iowa	**1.4%**	**40**
Minnesota	2.9%	21
Missouri	5.6%	2
Nebraska	1.5%	39
South Dakota	1.6%	38
Wisconsin	2.5%	31
ALL STATES	**2.3%**	

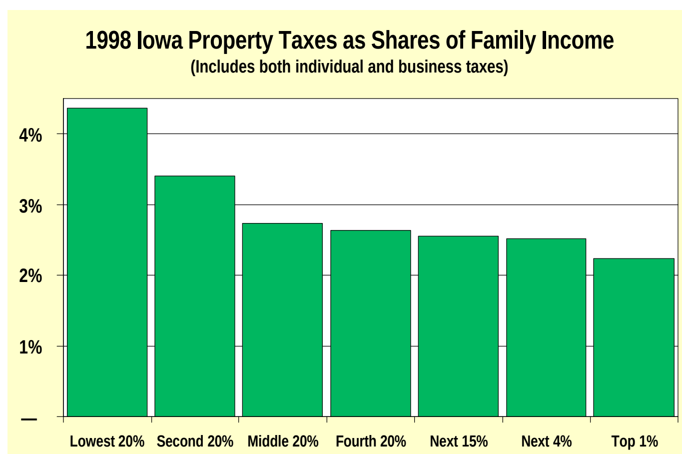
Source: Bureau of the Census

One reason for this slow property tax growth has been limitations and cuts imposed by the state on local governments. These tax cuts and growth limitations have had the effect of constraining localities' ability to raise revenue and provide for essential services as they see fit. While the state has restricted localities' ability to raise property taxes, the state has granted greater authority to impose local sales taxes.

Property taxes are primarily administered and collected by more than 2,000 local authorities—counties, cities, and school districts. Homeowners pay the largest share of all property taxes—42 percent in 1998. Agriculture accounts for 19 percent, commercial real property for 20 percent, utilities for nine percent and industrial real property for four percent. Three percent of property taxes are from personal property such as industrial machinery.[45]

Iowa's property taxes are regressive. The 20 percent of Iowans making less than $14,000 pay 4.4 percent of their incomes on property taxes. The middle 20 percent of Iowans, with average incomes of $32,100, pay 2.7 percent of their incomes in property taxes. The wealthiest one percent of Iowa residents, with average incomes of $476,000, pay 2.2 percent of their incomes on property taxes.[46]

The chief reason that Iowa's property taxes are regressive is that home values are a much higher share of income for middle- and lower-income families than for the wealthy. It is common for a middle-income family to own a home valued at two or three times their annual income. For most middle-income families, it will be the largest and most important single investment in their lifetimes. Since property taxes are based on property value, they end up taking a larger share of income from middle-income families than from the better-off.



[45]For share of total state and local taxes, 1997 data is used because that is the most recent available from the Iowa Department of Revenue. 1998 data is used to detail property tax collections by property classification because that is the most recent available from the Iowa Department of Management.

[46]These data include homeowner property taxes, business property taxes and ad valorem motor vehicle taxes.

Property Taxes by Various Measures

	As a % of Personal Income				As a % of GSP				Per Capita (in 1995 Dollars)			
	1985	US Rank	1995	US Rank	1985	US Rank	1995	US Rank	1985	US Rank	1995	US Rank
Illinois	3.6%	19	4.1%	16	3.1%	17	3.4%	13	$ 753	16	$1,006	12
Iowa	**4.1%**	**14**	**4.2%**	**13**	**3.6%**	**10**	**3.5%**	**10**	**751**	**17**	**864**	**17**
Minnesota	3.5%	21	4.0%	17	2.9%	19	3.4%	14	705	20	939	14
Missouri	1.8%	44	2.6%	38	1.5%	44	2.2%	37	340	41	555	38
Nebraska	4.2%	11	4.3%	12	3.5%	14	3.4%	12	777	14	911	15
South Dakota	4.1%	15	4.1%	14	3.4%	15	3.1%	17	654	23	773	21
Wisconsin	4.3%	9	4.8%	7	3.8%	9	4.1%	7	810	12	1,041	10
ALL STATES	**3.1%**		**3.4%**		**2.6%**		**2.9%**		**$ 618**		**$ 782**	

Source: Bureau of Economic Analysis, Bureau of the Census

Renters, too, pay property taxes—but not directly. Rather, they pay property taxes indirectly in the form of higher rents.

Property taxes are also levied on businesses. A good portion of the business property tax is exported to out-of-state shareholders and owners. This is an important consideration, because without the business property tax, many businesses that utilize Iowa government services would go largely untaxed.

As is the case with Iowa's personal income tax, a portion of Iowa's property taxes on individuals is offset by federal income tax deductions—resulting in a "discount" of about $100 million compared to a non-deductible tax.

Limitations on Property Tax Growth

The state imposes limits on the amount local governments can raise through the property tax. Such limits, of course, restrict the ability of local governments to raise revenue and provide for essential services. In some cases the state has provided funding to offset the revenue loss to the local government. Whether this funding continues is at the discretion of the legislature.

Rollback

State law caps the rate at which the taxable value of property can rise. This limitation, introduced in 1977, is referred to as *rollback*. Rollback is not applied at the level of individual properties. Rather, it applies across entire classes of property (the rate of tax growth in *one* home does not matter, but the tax growth of *all homes combined* does matter). For all property classes except utility property, the growth in taxable value is limited to four percent over the previous year. Utility property is limited to eight percent growth per year. Also, when calculating the rollback percentage, state law links residential and agricultural property value growth. If the property value growth of either classification is less than four percent, the lower actual growth rate between the two is applied to *both* classifications.[47] Rollback is accomplished by reducing the taxable value of each property in a class by the same percentage to bring the total taxable value in the class within the growth rate.

Because rollback limits are applied to classes of property, they cause the relative burden borne by those classes of property to remain fairly constant over time. The decline in the value of agricultural land has, however, resulted in a small increase in the portion of the property tax borne by residential and business property classes.

Levy Rate Limits

Another method of property tax limitation is a state-imposed *tax levy* rate limit. The state sets levy limits for the three types of local governments authorized to levy property taxes: counties, cities, and school districts. Rates in excess of the specified limits are, however, permitted for specified uses. In some cases voter approval is required.

[47]This only applies when a class of property is at 100% valuation, which has been the case with agricultural property. Because the actual value of agricultural property has been fairly stagnant, rollback has not pushed taxable value below actual.

Rate limits have different impacts on areas with valuable property versus areas with less valuable property. Property-rich counties do not need to apply as high a tax rate to raise the same amount of revenue as property-poor areas.

Tax Limits and State Substitution

Iowa also directly restricts the amount of property tax that may be collected. The most general of these restrictions bars counties from collecting more in property tax than they collected in the previous year. There are several exceptions to this limit, including those for debt service, hospitals and emergency management. The most general exception is one that allows additional funds for unusual or compelling programmatic needs. Under this exception, however, collections may only increase by a growth rate based on government purchases.

The limits on property tax collections come in several forms. For example, in 1995 the state increased assistance for locally provided mental health and education services and required counties to reduce their property taxes proportionately and constrain their spending on mental health programs. The state subsidy is set at $95 million annually in perpetuity (out of total property tax collections of about $2.5 billion in 1998).

State aid in funding education also has an impact on property taxes. Iowa's school funding system is beyond the scope of this study. In general, however, the more the state provides in aid to schools, the less schools need to raise through property taxes. The long-term trend has been for the state to pay for a greater share of school finance. The state, however, also places several limitations (to which there are several exceptions) on school property taxes. This limits taxation (and spending) for education. As discussed in chapter 2, the level of school funding, state and local, has declined relative to the rest of the country.

In 1995, business property taxes were cut when the Legislature decided to phase in, over a 10 year period, a total property tax exemption on a businesses' machinery, equipment, and computers. All purchases made after January 1, 1994 are completely exempt from the tax. For purchases made before this date the tax will be phased out by 2004.

The machinery and equipment property tax is collected by local governments. While the state will cover the entire cost of this phase-out through fiscal year 2001, local governments will begin bearing the majority of this state-mandated burden by fiscal year 2003. Indeed, over the 10 year phase-out schedule, local governments will lose $220 million dollars in lost revenue because of this business property tax cut.[48]

Property Tax Credits

Iowa provides several state-funded credits targeted at specific types of properties or people.

Homestead Credit

This credit has been in existence in one form or another since 1937. It is equal to the amount of tax levied on the first $4,850 of the assessed value of the home. This credit ranges from $71 to $246, depending on the local tax levy. $114 million will be claimed in homestead credits in fiscal year 1998.

Beginning in 1998, the state will fund the entire amount of this credit. Prior to this, the state funded most of the credit and local governments paid the rest. For example, in 1997, the state funded 83.6 percent of the credit.

Iowa's homestead credit is progressive because it provides relief based upon a flat amount of the tax levy. The amount of tax on the first $4,850 of home value will mean much more to someone who owns a $35,000 home than for someone with a $100,000 home. It is, however, not adjusted for inflation. Thus, its value in real terms has been declining.

Low-Income Credit

An elderly and disabled property tax credit has been available for homeowners and renters since 1974. This is an income-based property tax rebate, in which the state refunds a percentage of property taxes. The percentage refunded is greater at the lowest income levels. The 1998 Legislative session increased the maximum income to qualify for this credit from $14,000 to $16,500, and this ceiling will be indexed for inflation every year. This credit is fully funded by the state.

The low-income credit is a relatively small credit—only $11.6 million will be claimed in fiscal year 1998. Two limitations, in particular, minimize its impact.

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[48]*Phase-Out of Property Tax on Machinery & Equipment*. Legislative Fiscal Bureau, 1998 Session.

First, it is available only to those with incomes under $16,500. Second, it is available only to the elderly and disabled. Restricting such a progressive credit to such a small population limits its effectiveness.

By law, this credit is also available to all low-income homeowners and renters. It has not, however, ever been funded for groups other than the elderly. Given the relatively modest cost of such a provision (about $25 million), such an extension to this heavily burdened population would be a simple and sensible step. (This is one of the tax reform options discussed in chapter 10.)

Other Credits

In addition to the homestead credit and the low-income credit, there are other, more narrow property tax credits. For example:

The **Military Service Credit**, effective since 1886, is available to veterans of war service. Only $2.8 million will be claimed in fiscal year 1998. The state funds 100 percent of this credit.

The **Agricultural Land Tax Credit**, in place since 1946, is available for farms with 10 acres or more—$29.1 million will be claimed in fiscal year 1998. The **Family Farm Credit** has been available since 1990—$10 million will be claimed in 1998. The state funds 26 percent of these credits—local governments fund the rest.

Property Tax Summary

Iowa's property tax limitation measures have restrained the growth in property taxes for both homeowners and businesses. In the case of the exemption of machinery, equipment and computers exemption, the benefit will go entirely to business.

To some extent, in specific cases, the limits on local taxation have been compensated for by state assistance. Such assistance, however, is not guaranteed into the future, and in some cases, is explicitly scheduled to decline or not keep up with expenses. In addition, as a condition of receiving state aid, local governments are restrained in how much they can spend in the program areas for which they receive state assistance.

Raising the homestead credit and expanding the low-income credit would be a more progressive and less mind-boggling means of reducing Iowa property taxes. The homestead credit is a simple and effective means of relieving homeowner property taxes in a progressive way. The low-income credit has the virtue of extending its relief to renters and targeting it to those most in need.

CHAPTER EIGHT

OTHER IOWA TAXES: CORPORATE & INHERITANCE

The Iowa Corporate Income Tax

The corporate income tax has been a declining source of revenue. It raised 4.1 percent of all Iowa taxes in 1997, down from 4.7 percent in 1978. In 1978, corporate income taxes were 0.38 percent of gross state product, ranking Iowa 28th nationally. By 1996, Iowa's corporate income tax fell to 0.27 percent of gross state product, ranking Iowa 35th.

Corporate Income Taxes as a % of GSP

	1978	Rank	1996	Rank
Illinois	0.31%	39	0.45%	15
Iowa	**0.38%**	**28**	**0.27%**	**35**
Minnesota	0.76%	3	0.52%	12
Missouri	0.25%	44	0.27%	37
Nebraska	0.32%	36	0.28%	34
South Dakota	0.05%	46	0.20%	42
Wisconsin	0.66%	8	0.43%	16
ALL STATES	**0.47%**		**0.40%**	

Source: Bureau of Economic Analysis, Bureau of the Census.

The corporate income tax is, in theory, levied on the profits of corporations. The Iowa tax, however, is largely based on the rules used in the federal corporate income tax. These rules create many loopholes that allow corporations to pay far less than they would if they were being taxed on their true profits. (See Chapter 9 for a discussion of Iowa-specific loopholes).

Businesses that are not incorporated (sole-proprietorships and partnerships) and "S-Corporations" (as defined in federal tax law) are generally not subject to the corporate income tax. When, however, a business entity takes on certain characteristics of a corporation it may be subject to the tax, notwithstanding its non-corporate status.

If all of a corporation's business is conducted within Iowa, then its total net income is subject to tax. If the corporation's business is conducted both in and out of Iowa, a formula is used to allocate a portion of the income to Iowa.

The apportionment factor used is the single factor sales formula, which only includes in taxable income the percent of total sales made within Iowa. Most states, however, use a three-factor formula based upon an average of the percent of total sales, property, and wages which are made or located in the state.

One of the virtues of the corporate income tax is that it is largely exported out-of-state. Because many corporations that pay corporate income tax operate in a multitude of states and have shareholders throughout the world, the burden of the corporate income tax is distributed throughout the country and the world. As a tax on profits, it is generally seen as lowering the return on investment for shareholders more than raising prices for consumers or leading to lower wages for employees. Since shares in corporations are disproportionately held by the wealthy, the corporate income tax is a progressive tax.

The Iowa Inheritance Tax

Since 1896, Iowa has levied a tax on inheritance. Unlike the federal estate tax, Iowa's inheritance tax is levied on beneficiaries. So while the federal tax applies to the owner of the estate, Iowa's tax applies to the individuals who receive money or property from an estate. The amount of the Iowa tax depends on the value of the inheritance and the relationship between the beneficiaries and the donor.

The federal estate tax and Iowa's inheritance tax interrelate. The federal government allows states to collect a portion of the federal tax. This is referred to as the "pick-up" tax, since the states are "picking-up" a portion of the federal estate tax. Every state has an incentive to levy an estate tax in an amount at least equal to this federal pick-up—after all, if a state doesn't levy at least the pick-up tax, the money would simply go to the federal government instead of to the state.

Iowa's inheritance tax applies only if it exceeds the "pick-up" of the federal tax. Both the pick-up tax and the inheritance tax have exemptions. The federal exemption is in the process of being increased over several years. For 1998, the exemption is $625,000 per estate. As a practical matter, because any portion of an estate transferred to a spouse is exempt, the exemption is double this amount for most estates. Because the exemptions on the pick-up tax are so high, the inheritance tax has been greater than the pick-up tax for most estates. Only a few extremely large estates have been subject to the pick-up tax.

Iowa's inheritance tax contributed a relatively small portion—1.5 percent—of all state and local tax revenue in 1997. But inheritance tax revenue is expected to decrease substantially—dropping from $109.3 million in 1997 to $66.6 million in 1999—due to a 1997 law decreasing the number of people subject to the tax.

Before this legislation passed, only spouses of the deceased were exempt from paying the inheritance tax. The 1997 legislation extended the exemption to all lineal relatives—including parents and children—of the deceased.

Before this exemption was granted, these lineal relatives paid nearly half the inheritance tax. Many of these newly-exempted relatives are not Iowa residents: non-residents paid 37 percent of the inheritance tax in 1995.[49]

The 1997 inheritance tax cut was regressive. The exemptions prior to the tax cut already excluded many inheritances from the tax. Before the 1997 changes, over half of the tax liability was on estates worth over $500,000. Now, even with the continuing existence of the pick-up tax on extremely valuable estates, many of these large estates will pay less than they would have under the inheritance tax. Some only slightly less valuable estates will avoid tax entirely. For example, much of the 54 percent of inheritance taxes that used to be paid on estates valued at between $300,000 and $750,000 will no longer be collected. And the tax cut for smaller estates will be small. Estates valued at less than $100,000 accounted for less than five percent of estate tax collections.[50]

One of the arguments put forward in 1997 for reducing the inheritance tax was the heavy burden it is said to put on farmers. With appropriate estate planning the Iowa inheritance tax need not cause heirs to sell the family farm. Even so, farms account for only ten percent of the estate tax. If preserving farms were the true concern of those opposed to the inheritance tax, measures could be taken to relieve that burden while continuing to subject valuable property to the tax.

Iowa's Inheritance Tax Rules, Old & New

	Old Law		New Law	
Type of beneficiary	Exclusion	Tax Rate	Exclusion	Tax Rate
Spouse (or Iowa non-profits)	ALL	No Tax	All	No Tax
Child	$50,000	1%-8%	All	No Tax
Parent, grandchild	15,000	1%-8%	All	No Tax
Other lineal descendants	15,000	1%-8%	All	No Tax
Sibling, son/daughter in-law	15,000	5%-10%	$15,000	5%-10%
Uncle/aunt, niece/nephew, cousin, brother/sister in-law	—	10%-15%	—	10%-15%
Out-of-state non-profits	—	10%	—	10%
For-profit organizations	—	15%	—	15%

[49] *Summary of Data from Selected Sample of Iowa Inheritance Tax Returns*, Iowa Department of Revenue and Finance.

[50] *Id.*

CHAPTER NINE

TAX BURDENS, BUSINESS TAX INCENTIVES AND ECONOMIC GROWTH

Much is often made of the need to cut taxes to encourage economic growth. But there is little empirical evidence that the level of state taxation has a substantial impact on a state's economic well-being.

A recent, comprehensive review of the economic literature on this issue[51] found that:

There is no evidence that state and local tax cuts, when paid for by reducing public services, either stimulate economic activity or create jobs.

There is little indication that state and local tax levels matter much in business location decisions.

State and local business tax incentives and financial inducements are not the only, or even the primary, influence on business investment decisions.

Factors such as the cost and quality of labor, the quality of public services (schools, roads and highways, sewer systems, recreational facilities, higher education, health services, etc.), the proximity to markets, and the access to raw materials and supplies are more important than tax incentives in business location decisions.

There is little evidence that job losses or job transfers from one state to another are a consequence of business tax incentives.

While the benefits of tax cuts and incentives are debatable, their costs are clearer:

Tax cuts and incentives cause state and local governments collectively to lose billions of dollars annually in tax revenues.

Because of reduced revenues, tax incentives force state and local governments to cut back on the quantity or quality of public services. These reductions can damage the economy because businesses often need these public services to thrive. Indeed, there is evidence that state and local tax cuts, accompanied by reductions in public services, cause job loss and economic decline.

Business tax incentives provided to some firms put competing firms at a disadvantage. Hence, increases in output and employment by firms receiving incentives may be at least somewhat offset, and perhaps even outweighed, by the decreases in output and employment of in-state competing firms not receiving comparable subsidies.

An examination of Iowa and its neighboring states appears to bear out these conclusions. Of these seven states, only one consistently posted economic growth rates higher than the national average across a broad range of measures of economic performance. Within the region, Minnesota topped the list in the rate of GSP growth since 1978, personal income growth, employment growth and growth in average annual pay. Minnesota was second to Wisconsin in median income growth.

Minnesota also was at the top of another kind of list —taxes. Minnesota is first or second in the region in several measures of tax burden. Minnesota ranks just behind Wisconsin in taxes as a share of GSP. Minnesota tops the list in two other measures of taxes that often are claimed to have an adverse impact on economic development: corporate income taxes and the top marginal rates for the personal income tax.

Wisconsin is also at, or near, the top in these tax ratings. Median income growth in Wisconsin is tops in the region since 1984. Wisconsin is third in personal income growth and ranks in the middle in GSP and average annual pay growth.

In contrast, South Dakota shows up very low in the measures of tax burden we have used here. But South Dakota is at the bottom of the list in median income growth and second from the bottom in average annual pay growth (falling 0.8 percent). So, if South Dakota's low taxes approach created jobs, it didn't create very good ones for the most part.

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[51] *Do State & Local Tax Incentives Work?*, Dr. Robert G. Lynch, Economic Policy Institute, 1996.

Economic Growth Indicators
(All dollar figures are adjusted for inflation)

Changes in Average Annual Pay, 1981-96		Average Annual Growth in Gross State Product, 1978-96		Average Annual Growth in Personal Income, 1978-96		Average Annual Growth in Median Income, 1984-96		Average Annual Employment Growth, 1978-96	
Minnesota	+0.6%	Minnesota	+3.7%	Minnesota	+2.5%	Wisconsin	+2.1%	Minnesota	+2.4%
Illinois	+0.4%	South Dakota	+3.4%	Missouri	+1.9%	Minnesota	+0.9%	South Dakota	+2.0%
Missouri	+0.2%	Nebraska	+2.9%	Wisconsin	+1.7%	Iowa	+0.8%	Wisconsin	+1.8%
Nebraska	+0.1%	Wisconsin	+2.8%	South Dakota	+1.6%	Illinois	+0.8%	Nebraska	+1.7%
Wisconsin	+0.1%	Missouri	+2.3%	Nebraska	+1.3%	Missouri	+0.7%	Missouri	+1.6%
South Dakota	–0.0%	Illinois	+2.1%	Illinois	+1.3%	Nebraska	+0.4%	Illinois	+1.1%
Iowa	–0.2%	Iowa	+1.7%	Iowa	+0.5%	South Dakota	+0.1%	Iowa	+1.1%
US Ave.	**+0.4%**	**US Ave.**	**+2.5%**	**US Ave.**	**+2.5%**	**US Ave.**	**+0.4%**	**US Ave.**	**+2.0%**

Source: Bureau of Economic Analysis; Bureau of the Census; Institute on Taxation and Economic Policy.

Does this mean that states should increase their tax burdens in order to spur economic growth? No. But it clearly shows that higher taxes are not the kiss of death for economic success. High tax burdens do indicate that a state—such as Minnesota—has placed a high priority on investing in government services that are necessary to cultivate long-term, sustained economic development.

Why Low-Tax Strategies Don't Work

If Iowa offered complete tax amnesty to any new businesses moving into or expanding in the state, there would be little doubt that Iowa would attract a substantial number of corporate immigrants. Of course, the state would also have a very difficult time paying for these incentives and still provide basic government services. The price of granting business tax subsidies might be poorly maintained roads and parks, inferior schools, cuts in police protection, and ineffective social programs.

In fact, Iowa's economy might well be worse off. No executive or corporation wants to relocate or expand in a state with poor or marginal quality of life issues. High crime, poor infrastructure and an unskilled workforce are significant barriers to quality, sustained economic development. And businesses already in Iowa would lose government services they rely on and face new, subsidized, competition.

Fortunately, no one in Iowa is proposing this outlandish scenario. But the fact is that when government funds are used—either in the form of tax relief or spending to subsidize business—there is a cost, either in the form of reduced government services or higher taxes for others.

Because, however, the benefits of business incentives tend to be concentrated while the costs dispersed, this tradeoff is sometimes hard to see. After all, if one teacher is laid off in every elementary school in the state, the impact on education will not be immediately apparent. Over time, among the hundreds of thousands of children sitting in larger classes, there will undoubtedly be some for whom a little less personal attention will make a critical difference. But that impact will be impossible to isolate from all the other influences in their lives.

On the other hand, the 100 employees now working for a hypothetical company moving to Des Moines from

Tax Level Indicators

Total Taxes 1978-96 as a % of GSP		Corporate Income Taxes 1978-96 as a % of GSP		Top Marginal Personal Income Tax Rates in 1998	
Wisconsin	10.8%	Minnesota	0.52%	Minnesota	8.5%
Minnesota	10.3%	Wisconsin	0.50%	Wisconsin	6.77%
Iowa	9.5%	Illinois	0.39%	Nebraska	6.68%
Nebraska	8.8%	Iowa	0.34%	Missouri	6.0%
Illinois	8.7%	Nebraska	0.27%	Iowa*	5.22%
South Dakota	8.0%	Missouri	0.23%	Illinois	3.0%
Missouri	7.5%	South Dakota	0.19%	South Dakota	—
US Ave.	**9.0%**	**US Ave.**	**0.42%**		

*Adjusted for state deduction for federal income taxes.

Source: Bureau of Economic Analysis; Bureau of the Census; ITEP.

Chicago will be welcomed with a ribbon-cutting ceremony. It may be that, overall, the incentive that brought the business to the state does more harm than good, but that won't be the public face of it.

There is a continuum of incentives ranging from extremely targeted to very broad. The most targeted type of incentive is a provision that only benefits one company. An example of a very broad incentive is cutting the corporate income tax rate.

Broad incentives have the virtue of causing less economic distortion. If a state lowers its corporate income tax rate, all profitable companies benefit no matter what their industry, how many employees they have, whether they're new to the state, etc. Thus, the market, instead of the tax law, is more likely to decide where capital is invested and which companies thrive. This makes for a better functioning economy overall.

On the other hand, broad incentives are a very inefficient use of government resources for the promotion of economic development. Most of the revenue loss from lowering the corporate income tax, for example, would go to companies that are already located in Iowa, have no intention of leaving and would have made the same investments in the state with or without the tax cut. Only a small amount will go to inspiring companies to increase or start investing in the state. Thus, for the many dollars of reduction in government services, and the attendant negative economic and social impacts, only a very few dollars go to changing corporate conduct in a way beneficial to the state.

The narrowest of incentives are more akin to a business deal than government policy-making. A legislated benefit for a particular company can be either good or bad for the state. It depends on the terms of the deal. It is, however, highly unlikely that the state will ever get a great deal. Too many states and localities are bidding for business for there to be any bargains. In fact, some have argued that there is almost always at least one community that is willing to over-bid for the business. If this is true, and the high bid usually wins, most deals will cost the victorious community more in lost government services or higher taxes than it receives in benefits from increased private investment.

In between the very broad incentives and the single company deals, there are incentives that are targeted at specific types of companies engaged in specific conduct. These obviously create distortions in economic behavior in favor of certain conduct or types of companies, and create economic inefficiencies. Also, as is the case with broad incentives, a significant portion of the revenue loss will go to compensating activity that would have happened anyway.

These narrow incentives can have two possible consequences. One is that they have no effect on business behavior at all. If that's the case then they are clearly a poor use of public resources. The other possibility is that they do affect business behavior. That, however, could be just as bad. It means that businesses are responding to the incentives of the tax law instead of the market. This is economically inefficient. Under either scenario, therefore, narrow incentives can cause adverse consequences.

The bottom line is that business incentives rarely are as good as they look. There are enormous hidden costs that will often outweigh the limited private investment that such deals attract.

Tax Expenditures

Many business incentives are in the form of "tax expenditures." The congressional Joint Committee on Taxation notes:

> The term tax expenditure is based on the assumption that the objectives of these tax provisions could be accomplished by direct expenditure programs. Tax expenditures, in this view, are analogous to those direct expenditures which have no program spending limits, and which are available as entitlements to individuals and corporations who meet the statutory and regulatory criteria established for the programs.[52]

The essential insight provided by the "tax expenditure" concept is that a law that lowers a taxpayer's tax liability has no different effect in theory than a law that requires a direct payment to the taxpayer. And if the law is designed to accomplish a public-policy goal distinct from the equitable collection of tax revenues, then it is better to evaluate it under the standards we evaluate spending laws than the standards by which we evaluate tax law.

Accomplishing spending program objectives through tax expenditures creates several problems:

- **High Priority**. Tax expenditures are given an exalted status that they do not necessarily warrant. They are not subject to the normal prioritizing that takes place in government budget-making.
- **Distorts the Debate.** New tax expenditures are

[52] *Estimates of Federal Tax Expenditures for Fiscal Years 1991-1995*, Joint Committee on Taxation, March 9, 1990.

often treated in a budget, and rhetorically, as a tax cut. Removing a tax expenditure is treated as a tax hike. This contributes to the growth of tax expenditures at the expense of other spending without well-considered prioritization.

- **Poorly Understood.** Placing spending programs in the tax law often hides their function. The tax expenditure for accelerated depreciation on the corporate income tax, for example, costs millions of dollars per-year. This program, incorporated from federal tax law, essentially gives companies interest free loans when they make capital investments. The public and policy-makers would have a clearer view of this program if it were structured as such through a direct spending program.
- **Limited Oversight.** Tax expenditures are generally entitlements available to those who meet the qualifications set out in law. There is typically only minimal review of applications. Tax expenditures are not routinely evaluated to determine if they are efficiently accomplishing their goals. If, for example, 90 percent of a research and development tax credit on a corporate income tax goes to companies for work they would have done in the state anyway, it is, arguably, an inefficient subsidy. Yet, structured as a tax expenditure, it is unlikely that policy makers would be aware of this. If the program was structured as a direct spending program it is more likely that its effectiveness would be subject to careful review. And it would be more likely to be structured in a way that would target state dollars to where they are most needed.
- **Agency Involvement.** Government agencies with expertise in the area covered by a tax expenditure are typically not involved in their administration. Thus, the agency does not routinely assess whether the tax expenditure is the best way to achieve the agency's policy objectives.
- **Simplification.** Tax expenditures complicate the tax system. The complications go beyond the initial form-filing. Businesses often restructure their affairs and relationships with other businesses to take advantage of lucrative tax expenditures. The inevitable legislative responses to excess utilization of tax expenditures (the Alternative Minimum Tax, for example) adds even more complexity.
- **Wasteful.** Corporations sometimes go to great lengths to take advantage of tax expenditures. For example, those who have more tax expenditures than they can use in a year enter into transactions to transfer their tax benefits to those who can make use of them. The most commonly cited example of this is the trading of the benefits of accelerate depreciation and other investment incentives through leasing deals. The costs of implementing tax avoidance schemes can end up absorbing much of the tax break, making it a very inefficient tool for achieving its original purpose. A substantial portion of what are reported as large tax compliance costs in the United States would probably be more accurately reported as "tax avoidance costs."

Iowa offers business incentives in many ways, including through tax expenditures. Yet, there is no comprehensive system for evaluating these incentives for their effectiveness. Here are several steps that could be taken to ensure that Iowans economic development tax dollars are spent efficiently:

- Iowa could, as do many states, create an annual tax expenditure budget. This would consist of a listing of tax expenditures, their cost to the state and a description of how they work. In addition, information on the types of companies, characterized in a variety of different ways, including size, could be reported.
- Tax expenditures could be subject to automatic sunsetting rules to ensure that they receive periodic review similar to that received by other forms of government spending.
- Agencies could be assigned responsibility for periodically evaluating tax expenditures in their program areas.
- Greater disclosure by companies receiving tax expenditures could be required. This would allow the public and policy-makers to know where their tax dollars are going and to evaluate whether the tax expenditure programs are accomplishing their goals.

These steps would go a long way toward putting Iowa's citizens and policy-makers in a better position to evaluate the state's tax expenditure subsidies.

In addition to these steps, accountability should be built into business subsidies in every way possible. If the program is designed to create jobs, businesses should be required to create jobs. If they fail to live up to their commitment there should be penalties. Many state and local governments are putting more and more conditions on the companies they are subsidizing to ensure that their goals are achieved and that they are building a community of good corporate citizens.[53]

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[53] Grey LeRoy, *No More Candy Store* (1994).

CHAPTER TEN

TAX OPTIONS FOR IOWA

This chapter includes descriptions and analyses of eighteen distinct approaches to reforming Iowa's tax system, as well as a discussion of the proposed "Taxpayer Rights Amendment." Each tax proposal is accompanied by a distributional analysis which measures the net effect on Iowans' tax burden. The proposals are grouped into three general categories: revenue-raising proposals, revenue-reducing proposals and revenue-neutral proposals.

The charts accompanying the text show tax changes as a percent of income by income group. The solid portion of each bar represents the tax change (after taking federal offset into account) for each income group. Where there are federal tax ramifications stemming from a proposal (because of federal itemized deductions for Iowa income and property taxes paid), the accompanying chart also includes dotted lines which show the proposal's effects *before* consideration of the federal offset.

We have presented our data in this way because for those who itemize deductions on their federal tax return, changes in state income tax or property tax can produce substantial changes in federal tax liability. For example, if an itemizing Iowa taxpayer in the 28 percent federal tax bracket has a $1,000 cut in property taxes, the value of her federal itemized deductions will fall by $1,000. This means that $1,000 *more* of this taxpayer's income will be subject to federal tax after the Iowa tax cut. Since this additional income is taxed at 28 percent, federal tax liability increases by $280. So the net *overall* tax cut for this itemizing Iowa taxpayer from a $1,000 cut in state tax liability is actually $720, not $1000.

The charts accompanying the proposals generally describe the tax burden for all families and individuals. The charts describe the *change* in tax burden as a percent of income for each group, rather than the absolute value of the tax burden. The baseline tax burden estimates from which these changes are calculated are included in Appendix A. All sales tax and property tax revenue estimates and distributive analyses are for calendar year 1998. Personal income tax estimates and distributions are for tax year 1998.

TABLE OF CONTENTS FOR OPTIONS

Revenue-Reducing Options

This section offers several revenue-losing tax reform options. These proposals share the advantage of increasing taxpayers' after-tax income and the disadvantage of reducing government funds available for providing public services.

1. Increase The Earned Income Tax Credit

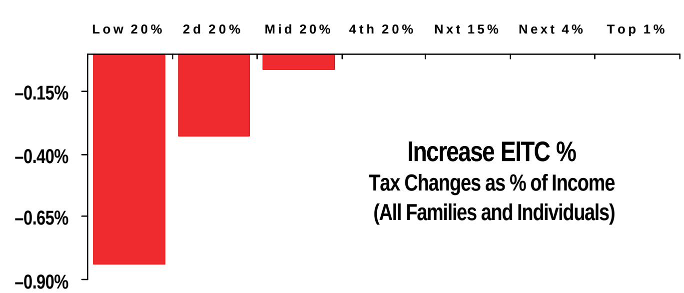
Principal Features

- # Increases Iowa's Earned Income Tax Credit (EITC) from 6.5 percent to 30 percent of the federal EITC.
- # EITC is made refundable.
- # Reduces revenue by $45 million.
- # Targeted at Iowa's lower-income working families.

Discussion

Iowa's EITC is discussed in Chapter 5. It is the second-lowest among the nine state EITC's in place as of 1998. Iowa's EITC is also non-refundable, a trait shared by only two other states with EITC's. This option corrects both of these shortcomings by increasing the value of the credit to 30 percent of the federal credit and by making the credit refundable. With the increase in the EITC, the need for Iowa's filing thresholds and alternative low-income tax calculation is substantially reduced.

Because this credit exclusively affects lower-income



families who rarely itemize deductions on their federal return, the impact of this option on federal tax deductions for state income taxes paid is negligible.

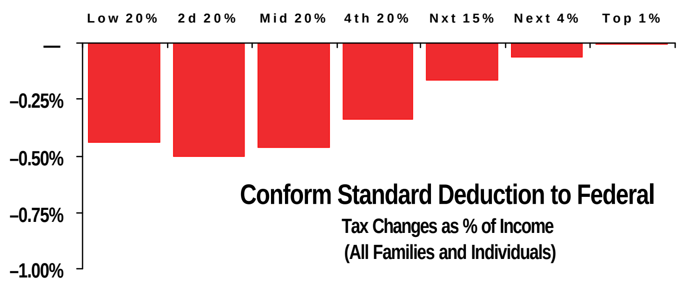
2. Increase the Standard Deduction to Conform with the Federal Deduction

Principal Features

- # Increases Iowa standard deduction from $1,440 ($3,550 for marrieds) to $4,250 ($7,100 for marrieds) in 1998.
- # Reduces Iowa state revenues by $150 million.
- # Larger tax cuts for lower- and middle-income taxpayers.

Discussion

The Iowa standard deduction is low relative to the federal deduction and that of most states. As a result, many Iowa residents who do not itemize on their federal returns *do* itemize on Iowa returns. This makes filing taxes in Iowa more complicated for taxpayers. Iowa's low standard deduction also means that taxpayers who are unable to take advantage of itemization (typically lower-income filers) pay tax on a greater percentage of their income than is common in other states. Changing the standard deduction to mirror the federal deduction addresses both of these problems.



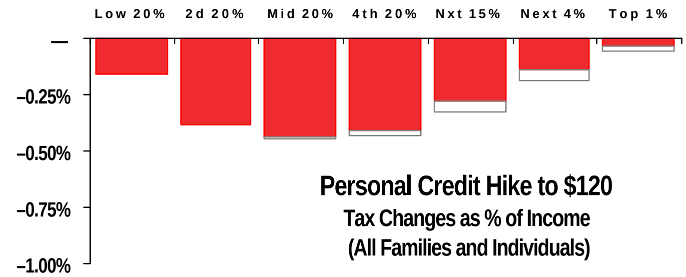
3. Increase the personal exemption credit from $40 to $120

Principal Features

- # Triples exemption credit from $40 per person to $120 per person.
- # Reduces revenues by $180 million.
- # Provides greater tax cuts for lower-income taxpayers.
- # Federal income taxes increase by $20 million.

Discussion

Iowa provides a credit for each member of the family, and an additional credit for each family member age 65 and over. The credit is subtracted from tax liability to compute final personal income tax liability. This proposal triples the current per-person credit from $40 to $120. The result is a tax cut that is greater (as a percent of income) for low- and middle-income taxpayers who owe personal income taxes. Low-income families that currently do not owe income tax do not benefit from this option.



4. Exempt 100 percent of capital gains income from taxation

Principal Features

- # Revenue loss of $150 million.
- # Tax cuts primarily to the wealthy.
- # Federal tax liability increases by $45 million.

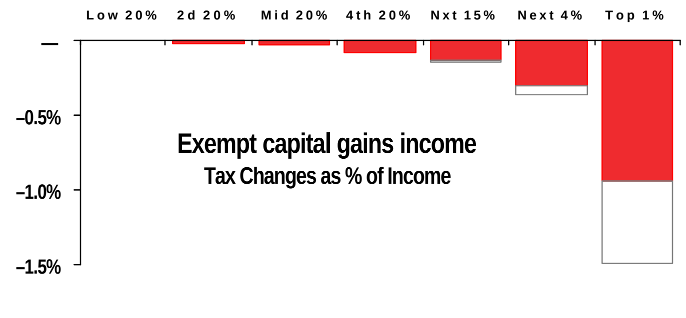
Discussion

Because the wealthy receive a far greater share of capital gains income than middle- and low-income families, this tax cut would benefit better-off Iowans the most.

Proposals to exempt capital gains from taxation on the national level are claimed to encourage economic growth through increased investment. This claim, however, is subject to much debate.

A general, state-level exclusion is highly unlikely to benefit Iowa's economy, since the additional investment (if any) encouraged by the capital gains exemption could take place anywhere in the United States or the world. The linkage between exempting capital gains income and investment in Iowa's economy, therefore, is even more tenuous than the linkage between capital gains tax cuts and economic growth nationally.

Another criticism of option 4 is that a substantial portion of this tax cut would flow not to the pockets of Iowans but to the federal government. In fact, Iowa's federal personal income taxes would go up by $45 million under this option because of the decrease in deductions for state personal income tax paid. While this option reduces state revenues by $150 million, only $105 million of this cut finds its way back into the pockets of Iowans. The rest goes directly to the federal government in the form of increased federal tax liability.



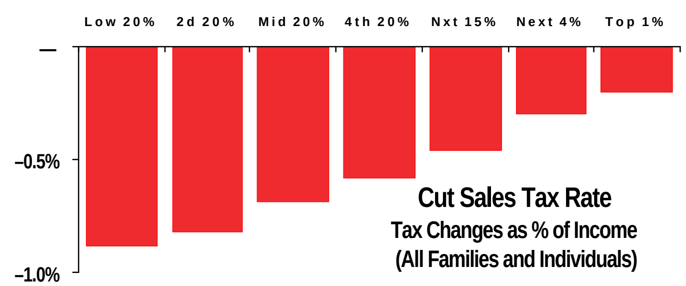
5. Sales Tax Rate Cut

Principal Features

Rate cut from 5 percent to 4 percent.
Revenue loss of $360 million.
Tax cut greater for lower-income families.

Discussion

This plan provides progressive tax relief. Lower- and middle-income Iowans see a significantly greater tax cut as a share of income than do the wealthy. Unfortunately, this plan requires a substantial reduction in state and local government services to pay for it.



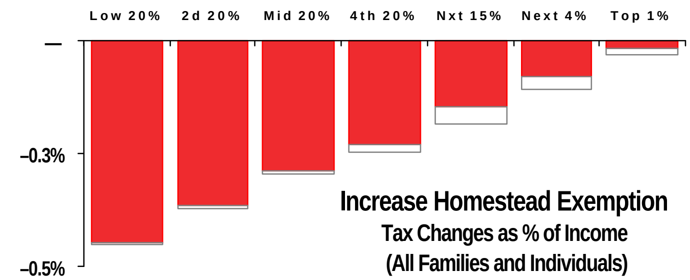
6. Increase Homestead Exemption

Principal Features

Increases homestead exemption from $4,850 to $10,000.
Reduces revenues by $130 million.
Progressive tax cut.
Increases federal tax liability by $11 million.

Discussion

Under current law, Iowa's homestead exemption provides property tax relief equal to the amount of tax levied on the first $4,850 of the assessed value of a taxpayer's home. This proposal increases the homestead exemption amount to $10,000. This exemption increase will have a progressive impact on Iowans' tax burdens, because the amount of tax on the first $10,000 of home value will mean much more to someone who owns, for example, a $35,000 home than for someone who owns a $100,000 home.



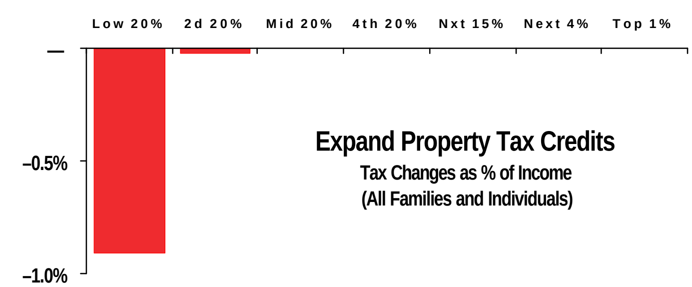
7. Expand the Low-Income Property Tax and Renter Credit

Principal Features

Extends property tax and rent credit to lower-income families.
Lose revenues of $23 million.

Discussion

As discussed in Chapter Seven, Iowa provides a tax credit to those elderly and disabled homeowners and renters with incomes under $16,500. This proposal extends this credit to all low-income Iowa households.



8. Across the Board Personal Income Tax Cut

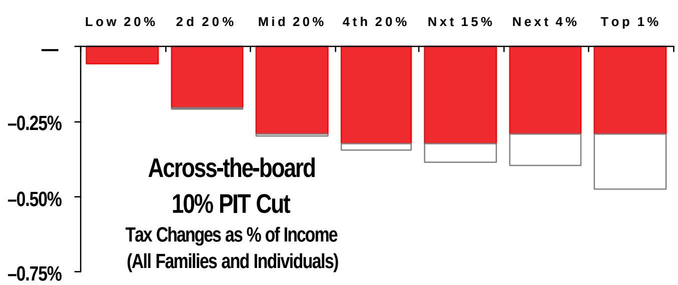
Principal Features

- Cuts tax rates in a proportional manner.
- Reduces revenue by $195 million.
- Federal taxes *increase* by $35 million.

Discussion

"Across-the-board" personal income tax cuts are often misconstrued as even-handed tax cuts. After all, proponents argue, if all tax rates are cut by 10 percent, then everyone gets the same tax break. The flaw in this argument is that the state personal income tax is only a portion of state and local taxes—the most progressive portion. This means that a cut in the personal income tax while leaving other, more regressive, taxes untouched makes the tax system as a whole more regressive. If a 10 percent cut were proposed in *all* state taxes, such a cut would indeed be "across the board" and even-handed. It would also, of course, be tremendously expensive and would do nothing to reduce the regressivity of the current system.

While this option reduces state revenues by $195 million, only $160 million of this cut finds its way back into the pockets of Iowans. The rest goes directly to the federal government in increased federal taxes.



Revenue-Neutral Options

In this section we offer several tax reforms that, while having little impact on total Iowa tax collections, have other significant impacts.

9. Simplify the personal income tax

Principal Features

- Large exemptions result in an increase in Iowa's effective filing threshold.
- Progressive tax relief.
- Tax structure treats married couples fairly.
- Federal taxes cut by $55 million.

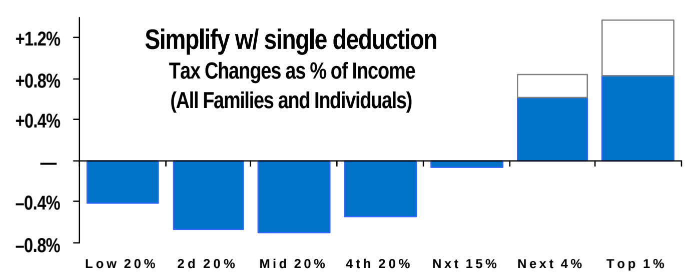
Option 9: Income Tax Simplification

	All Individual Filers	Married Filing Jointly
Exemptions—		
Taxpayer(s)	$12,500	$25,000
Per Dependent	1,700	1,700
Rates on Taxable Income—		
6.0%	Up to $25,000	Up to $50,000
7.5%	$25,000 +	$50,000+

Discussion

This option simplifies Iowa's income tax by starting with federal adjusted gross income and by eliminating deductions, Iowa's pension exclusion, all credits, the alternative minimum tax and federal deductibility. These elements of the Iowa tax are replaced by one large exemption—$25,000 for a married couple and $12,500 for a single person. In addition, $1,700 is exempted for each dependent. The large exemptions result in a higher filing threshold than Iowa's current law. Iowa's nine-rate structure has been compressed into two.

For most taxpayers, this option reduces the current Iowa tax form (with 10 steps and 75 lines) to a total of 3 steps and 6 lines. It is fiscally responsible, since it costs the state nothing to enact. It eliminates the penalty on married Iowans who file jointly. This option increases the progressivity of the tax system by cutting taxes on the bottom 80 percent of the income distribution. The tax hike on the best-off five percent is partially offset by a decrease of $55 million in total federal tax liability. Nearly all of this $55 million goes to the top five percent.



10. New brackets and rates

Principal Features

- # Eliminates deduction of federal income taxes from Iowa income.
- # Reduces top tax rate from 8.98 to 6.5 percent.
- # Federal taxes reduced by $10 million.

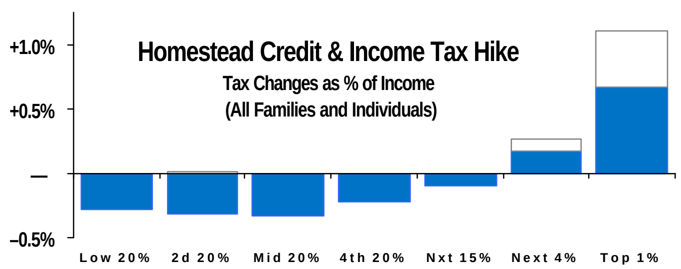
Option 10: New Brackets & Rates

Tax Rates on Taxable Income

Married Filing Jointly	Single	Tax Rate
Up To $30,000	Up to $15,000	4.0%
$30,000 – 60,000	$15,000 – 30,000	5.0%
$60,000 – 120,000	$30,000 – 60,000	6.0%
$120,000 +	$60,000 +	6.5%

Discussion

While merely eliminating the Iowa deduction for federal taxes would constitute a tax increase on the wealthy (for whom the deduction is most valuable), it is largely offset by a significant reduction in the top income tax bracket from 8.98 percent to 6.5 percent. This proposal also ends the penalty on married Iowans filing jointly. This proposal increases Iowa's standard deduction to the federal standard deduction amount, and creates a new tax rate structure, while reducing the number of rates and brackets from nine to four.



11. Increase homestead exemption credit, increase personal income tax

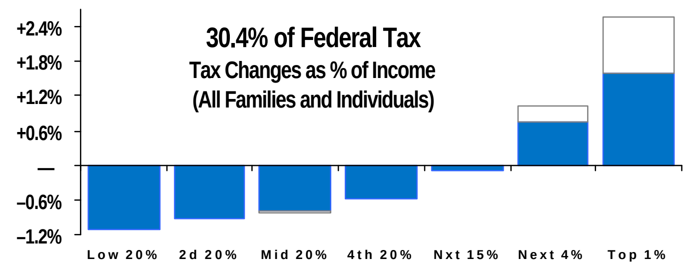
Principal Features

- # Increases homestead exemption from $4,850 to $10,000.
- # New personal income tax rate structure.
- # Standard deduction increased to match the federal deduction.
- # Repeal deduction of federal income taxes.
- # Federal income taxes decrease by $75 million.

Discussion

This option is revenue-neutral with respect to Iowa state tax revenues. A reduction in the moderately regressive property tax is offset by a tax increase in the relatively progressive income tax. The property tax reduction element of this proposal extends the homestead exemption amount to $10,000. As explained in the text accompanying option 6, this exemption increase will have a progressive impact on the tax burden.

To offset the reduction of revenues, the personal income tax is increased by repealing the deduction of federal income taxes. The standard deduction is increased to that of the federal, and a new tax rate structure is applied.



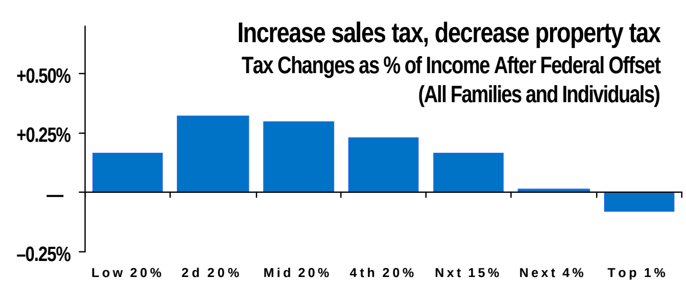
12. Income tax at 30.4 percent of federal personal income tax liability

Principal Features

- # Simplifies Iowa tax calculation.
- # Defines Iowa tax liability as 30.4 percent of federal tax liability.
- # Federal taxes decrease by $100 million.

Discussion

This greatly simplifies Iowa's tax system—taxpayers merely multiply their federal tax liability by 30.4 percent. For most taxpayers, this reduces Iowa's income tax to three steps and just 2 lines. This option has a progressive impact, since the tax is calculated by applying a percentage of a progressive tax.



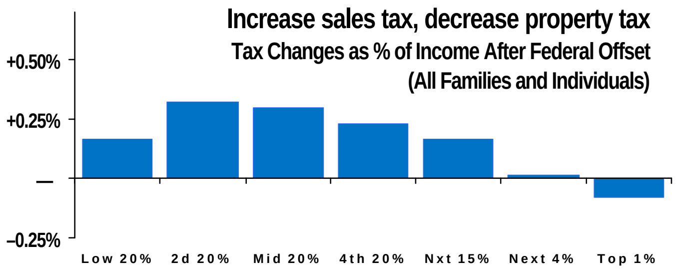
13. Increase sales tax, decrease property tax

Principal Features

- # Increases sales tax rate from 5 percent to 6 percent. Cuts property taxes across the board to be revenue neutral.
- # Federal Taxes increase by $10 million.

Discussion

This option raises taxes on low- and middle-income taxpayers.



14. Eliminate sales tax exemption for groceries, introduce grocery credit

Principal Features

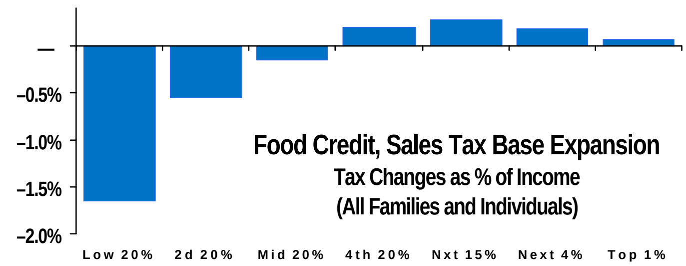
- # Extends sales tax to currently exempt groceries.
- # Introduces $200 per filer refundable sales tax credit

Discussion

This plan provides progressive tax relief while leaving total Iowa tax collections unchanged. The fixed amount of the credit makes it more valuable to those with lower incomes than those with higher incomes.

The plan also represents a different approach to relieving the tax burden on food. Instead of exempting groceries from taxation (as Iowa currently does), this proposal would tax all groceries and provide a credit intended to mitigate the regressivity of a tax on food. An argument in favor of a food credit is that it can be targeted more precisely to benefit those who need it most, while an exemption is available to anyone who purchases food, regardless of their need. While this equity-based argument has some force, in practice food credits tend to be too small to offset the regressivity of the tax on groceries. Experience in other states suggests that even if credits start out as being adequate, their effectiveness is eroded by inflation or legislative neglect.

If the credit is to be administered through the income tax, low-income Iowa taxpayers who would otherwise not have to file tax returns (unmarried taxpayers with income under $9,000 and married couples filing together with income under $13,500) would have to fill out a tax return to receive such a credit. Utilization of such credits for low-income families frequently is low.



Revenue-Raising Options

In this section we offer several revenue-raising tax reform options. A primary value to the public of these proposals is that they increase available funds for public services. The primary objection that can be made against any of these proposals is that those paying more in taxes will have lower after-tax incomes and that higher taxes may have an adverse impact on economic growth.

As the discussion of the economic impact of taxes in Chapter Nine indicates, there is little evidence that higher state taxes have significant adverse economic impacts. The benefits of well-funded public services appear to play at least as significant a role in determining a state's economic well-being.

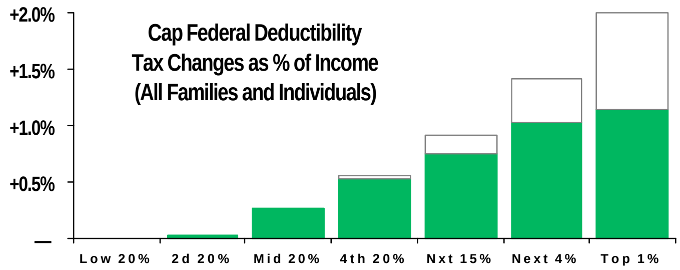
15. Cap deductibility of federal income taxes at $3,000 ($1,500 for singles).

Principal Features

- # Raises $450 million in additional revenue.
- # Progressive tax reduction.
- # Federal taxes decrease by $110 million.

Discussion

This proposal removes one of the most significant impediments to progressivity in Iowa's income tax—the deduction for federal income taxes paid. Iowa is one of only three states to allow taxpayers to deduct the full amount of federal income taxes paid from their taxable state income. Since the federal income tax is progressive, higher-income Iowans deduct significantly more from their Iowa taxable income under current law than do middle-income taxpayers. This significantly lowers the effective tax rate on the wealthiest Iowans.



16. Selected Excise Tax Increases

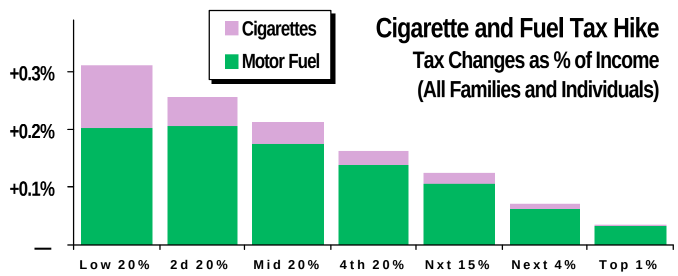
Principal Features

Raise cigarette tax by 6 cents
Raise gasoline tax by 5 cents and diesel tax by 5.5 cents.
Impact of tax increase greatest for low- and middle-income taxpayers.

Discussion

This option raises a total of $120 million to provide additional public services. Either of these tax increases could be earmarked for specific expenditures which are made necessary by the consumption of cigarettes and gasoline. For example, the additional revenues from the gasoline tax could be set aside to pay for road improvements. This tax increase can also be rationalized as a way of improving environmental conditions by raising taxes on the causes of pollution.

This proposal can also be criticized for increasing Iowa's reliance on relatively unstable consumption taxes. Also, higher excise taxes could hurt Iowa retailers in their competition with retailers in neighboring states.



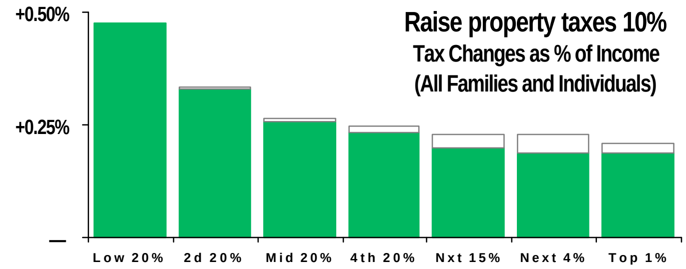
17. Raise property taxes by ten percent across-the-board.

Principal Features

Revenue increase of $110 million.
Moderately regressive tax increase.

Discussion

While property taxes are not as regressive as sales and excise taxes, this option still has a clearly regressive effect on the Iowa tax burden.



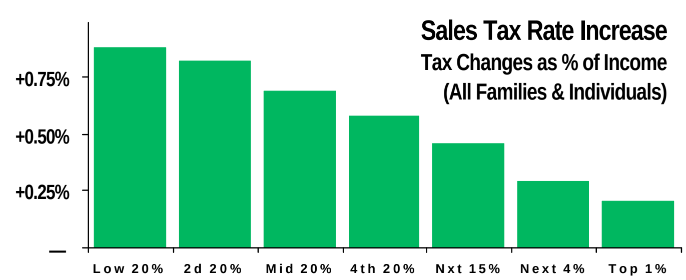
18. Raise General Sales Tax Rate

Principal Features

Raises general sales/use and motor vehicle use tax rate from 5 percent to 6 percent.
Impact of tax increase greatest for low- and middle-income taxpayers.
Revenue increase of $360 million.

Discussion

This option raises $360 million to provide additional public services. The impact of this tax option is clearly regressive; the poorest 20 percent of Iowa taxpayers would pay an extra 0.9% of their income in taxes under this proposal, while the wealthiest 1 percent of taxpayers would pay less than 0.2 percent more as a share of income. Similarly, the middle-income tax hike of 0.7 percent dwarfs the 0.2 percent hike on the wealthiest 1 percent as a share of income.



ADDENDUM: "THE TAXPAYER RIGHTS AMENDMENT"

The "Taxpayer Rights Amendment," as passed by the 1998 Legislature in the form of Senate Joint Resolution 2004, would place spending restrictions in Iowa. In addition to the expenditure limitations outlined in Chapter 2, the proposed amendment would require that any increase in the state personal income tax, corporate income tax, sales tax or use tax be approved by a three-fifths majority of the legislature. In addition, a three-fifths majority is required to impose a new tax. To become ratified, the amendment would have to be passed by the next General Assembly and ratified by the voters.

The "super-majority" requirement in this proposed amendment is particularly troublesome because:

- # It gives a minority of the legislature tremendous power to prevent tax hikes or extract legislative prizes in times where a majority believe revenue increases are needed.
- # The tax system becomes a victim of a constitutional bias against the only progressive taxes in the state's tax policy arsenal. To be sure, the most substantial regressive tax is also restricted. But excise taxes and local property taxes are not. Inevitably, these taxes will grow relative to the personal and corporate income taxes.
- # If passed, the amendment will inevitably shift revenue raising back to local taxes. The state will eventually be unable to sustain the current level of subsidies for local governments. There will be demands for relaxation of property tax constraints—legislation that could be passed with a simple majority vote. In addition, more local governments will be compelled to adopt local option sales taxes. Thus, the transition from progressive income taxes to regressive taxes will be perpetuated—raising taxes on middle- and low-income families relative to better-off Iowans. In addition, efforts by the state to assist less wealthy areas of the state will become less viable.
- # Reversal of the shift, documented elsewhere in this report, from progressive taxes to regressive taxes will be highly unlikely. Although the amendment does allow revenue neutral tax shifting without a three-fifths vote, such tax reform is exceedingly rare. There is rarely the political will to change tax policy unless there is a need to raise money or the opportunity to provide a net tax cut. The process that Iowa has seen is virtually always the way tax policy develops. In poor economic times, taxes are hiked so that government can continue to provide needed services. In good economic times taxes are cut. The three-fifths vote requirement takes away an entire side of the equation. Thus, over time, evolutionary improvement of the tax system is unlikely to occur.
- # The three-fifths requirement makes tax cuts less likely. Experienced, responsible, legislators will be unlikely to support tax cuts, even in times of surplus, if they know that in times of need, the system is biased against raising taxes. The super-majority requirement would make it very difficult for the state to conform its tax policy to the economic circumstances of the time.

In short, the super-majority requirement is likely to thwart the development of good tax policy, lead to higher local property taxes, lead to backroom legislative deals with legislative minorities and make tax cuts in good times less likely.

CHAPTER ELEVEN

CONCLUSION

In this report, we have discussed Iowa's social and economic conditions and its government tax and expenditure policies. The data show that Iowa is in a transitional position in many areas.

- # The state's economy is performing better than it has in a long time, but faces risks.
- # Government services are, in many areas, producing good economic and social results. But the state's commitment to continuing to provide good services is unclear. Restrictions on taxation, existing and proposed, pose serious threats.
- # The state's tax system is firmly regressive and has been made more so by recent tax changes.

While it is a cliché to say in a report like this that "Iowa is at a critical juncture," that indeed appears to be the case. Iowa may choose to pursue a low-tax, low-government-services strategy with the heaviest tax burden on those least able to pay. Or Iowa may choose a tax structure that asks those who have the most to pay the most, and to invest in education, infrastructure and all of the other assets that make a state strong economically and a good place to live.

As Iowa continues to wrestle with these issues, we hope that this report will help Iowa's policymakers and the public to make informed and wise decisions.

Iowa Taxes in 1998

As Shares of Family Income for All Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$8,200	$19,900	$32,100	$48,700	$75,600	$133,000	$476,000
Income Range	Less than $14,000	$14,000 – $26,000	$26,000 – $40,000	$40,000 – $61,000	$61,000 – $101,000	$101,000 – $212,000	$212,000 or more
Sales, excise & gross receipts taxes	**6.3%**	**5.6%**	**4.7%**	**3.9%**	**3.0%**	**1.9%**	**1.3%**
General sales tax, individuals	3.1%	2.8%	2.3%	1.9%	1.5%	1.0%	0.7%
Excise & gross receipts taxes, individuals	1.7%	1.5%	1.3%	1.1%	0.9%	0.5%	0.3%
Sales, excise & gross receipts taxes, business	1.5%	1.3%	1.0%	0.8%	0.6%	0.4%	0.3%
Property taxes	**4.4%**	**3.4%**	**2.7%**	**2.6%**	**2.6%**	**2.5%**	**2.2%**
Property taxes on families	4.0%	2.9%	2.2%	2.0%	2.0%	1.6%	0.8%
Business property taxes	0.4%	0.5%	0.5%	0.6%	0.6%	0.9%	1.5%
Income taxes	**0.5%**	**1.8%**	**2.8%**	**3.3%**	**3.8%**	**4.1%**	**5.0%**
Personal income tax	0.5%	1.8%	2.8%	3.2%	3.7%	3.9%	4.8%
Corporate income tax	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%
Total before Federal Itemized Offset	**11.1%**	**10.9%**	**10.2%**	**9.8%**	**9.4%**	**8.5%**	**8.5%**
Federal Itemized Deduction Offset	–0.0%	–0.0%	–0.1%	–0.2%	–0.7%	–1.0%	–1.7%
Net Taxes after Federal Offset	**11.1%**	**10.8%**	**10.1%**	**9.6%**	**8.7%**	**7.5%**	**6.8%**

Iowa Taxes in 1998

As Shares of Family Income for Married, Non-Elderly Taxpayers

Income Range	Less than $30,000	$30,000 – $60,000	$60,000 – $100,000	$100,000 – $200,000	$200,000 or more
% of couples in group	17.7%	38.7%	32.8%	8.0%	2.1%
Average Income in Group	$20,100	$45,500	$74,500	$129,000	$419,000
Sales, excise & gross receipts taxes	**5.8%**	**4.4%**	**3.1%**	**2.0%**	**1.4%**
General sales tax, individuals	2.7%	2.2%	1.5%	1.0%	0.7%
Excise & gross receipts taxes, individuals	1.8%	1.3%	0.9%	0.6%	0.3%
Sales, excise & gross receipts taxes, business	1.3%	0.9%	0.6%	0.4%	0.3%
Property taxes	**3.6%**	**2.4%**	**2.3%**	**2.3%**	**1.9%**
Property taxes on families	3.2%	2.1%	2.0%	1.7%	0.8%
Business property taxes	0.4%	0.4%	0.4%	0.6%	1.1%
Income taxes	**1.3%**	**3.3%**	**3.9%**	**4.1%**	**5.0%**
Personal income tax	1.3%	3.3%	3.9%	4.0%	4.8%
Corporate income tax	0.0%	0.0%	0.0%	0.1%	0.1%
Total before Federal Itemized Offset	**10.8%**	**10.2%**	**9.3%**	**8.4%**	**8.3%**
Federal Itemized Deduction Offset	0.0%	–0.1%	–0.7%	–1.1%	–1.8%
Net Taxes after Federal Offset	**10.8%**	**10.0%**	**8.6%**	**7.3%**	**6.5%**

Iowa Taxes in 1998

As Shares of Income for Unmarried, Non-Elderly Taxpayers

Income Range	Less than $15,000	$15,000 – $30,000	$30,000 – $50,000	$50,000 – $100,000	$100,000 or more
% of taxpayers in group	36.4%	32.8%	22.9%	5.7%	0.6%
Average Income in Group	$8,250	$22,900	$37,300	$62,500	$306,000
Sales, excise & gross receipts taxes	**6.0%**	**4.7%**	**3.5%**	**2.5%**	**1.2%**
General sales tax, individuals	3.0%	2.3%	1.8%	1.3%	0.7%
Excise & gross receipts taxes, individuals	1.5%	1.3%	0.9%	0.7%	0.3%
Sales, excise & gross receipts taxes, business	1.5%	1.1%	0.8%	0.5%	0.3%
Property taxes	**3.2%**	**2.1%**	**2.0%**	**2.1%**	**2.2%**
Property taxes on families	2.9%	1.8%	1.8%	1.6%	0.7%
Business property taxes	0.3%	0.3%	0.3%	0.6%	1.5%
Income taxes	**1.1%**	**3.3%**	**4.0%**	**4.4%**	**5.3%**
Personal income tax	1.1%	3.3%	4.0%	4.3%	5.1%
Corporate income tax	0.0%	0.0%	0.0%	0.1%	0.2%
Total before Federal Itemized Offset	**10.3%**	**10.0%**	**9.5%**	**9.0%**	**8.8%**
Federal Itemized Deduction Offset	–0.0%	–0.1%	–0.2%	–0.7%	–1.5%
Net Taxes after Federal Offset	**10.3%**	**10.0%**	**9.3%**	**8.3%**	**7.3%**

Iowa Taxes in 1998

As Shares of Family Income for Elderly Taxpayers

Income Range	Less than $15,000	$15,000 – $30,000	$30,000 – $50,000	$50,000 – $100,000	$100,000 or more
% of tax units in group	30.4%	28.5%	23.3%	13.1%	4.2%
Average Income in Group	$9,700	$22,200	$38,100	$58,300	$203,000
Sales, excise & gross receipts taxes	**6.2%**	**5.4%**	**3.8%**	**2.8%**	**1.2%**
General sales tax, individuals	3.2%	2.9%	1.9%	1.6%	0.7%
Excise & gross receipts taxes, individuals	1.5%	1.3%	1.0%	0.6%	0.2%
Sales, excise & gross receipts taxes, business	1.6%	1.3%	0.8%	0.6%	0.3%
Property taxes	**5.1%**	**5.5%**	**4.3%**	**4.2%**	**3.4%**
Property taxes on families	4.5%	4.3%	2.8%	2.4%	1.1%
Business property taxes	0.6%	1.2%	1.5%	1.7%	2.3%
Income taxes	**0.1%**	**0.6%**	**1.3%**	**2.2%**	**4.2%**
Personal income tax	–0.0%	0.4%	1.1%	2.0%	3.9%
Corporate income tax	0.1%	0.2%	0.2%	0.2%	0.3%
Total before Federal Itemized Offset	**11.3%**	**11.5%**	**9.5%**	**9.2%**	**8.8%**
Federal Itemized Deduction Offset	–0.0%	–0.0%	–0.1%	–0.1%	–1.0%
Net Taxes after Federal Offset	**11.3%**	**11.4%**	**9.4%**	**9.1%**	**7.8%**

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, September 1998.

About the Institute on Taxation & Economic Policy and the ITEP Microsimulation Tax Model

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:
IRS 1988 Individual Public Use Tax File, Level III Sample; IRS 1990 Individual Public Use Tax File; Current Population Survey: 1988-93; Consumer Expenditure Survey, 1988-90 and 1992-93; U.S. Census, 1990

Aggregated Data Sources:
Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

Acknowledgments

ITEP would not have been able to build its microsimulation model without the kind cooperation of the staffs of the Congressional Budget Office, the Joint Committee on Taxation, the U.S. Treasury Department and the Internal Revenue Service.

For More Information:

For a complete, detailed explanation of the methodology underlying the ITEP Model, *see Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (ITEP, 1996).

Comparisons with KPMG Peat Marwick's Distributional Analysis for 1993

While this study provides a comprehensive overview of Iowa's tax structure and predicts the incidence of income, sales/excise and property taxes on taxpayers at all income levels, it is not the first to do so. In particular, KPMG Peat Marwick used a similar methodology to derive similar results in their 1993 report "A Study of the Iowa State and Local Tax Structure."

The Peat Marwick study includes seven components of the Iowa state and local tax system, comprising (by their estimate) approximately 90% of state general fund taxes. These include sales and use taxes, personal income taxes, corporate income taxes, excise taxes on motor fuels, cigarettes and alcohol, and property taxes. ITEP's analysis includes the same taxes.

Three problems stand in the way of direct comparisons between ITEP's results and those of KPMG. First, ITEP's study looks at Iowa taxes in 1998, while KPMG estimates the 1993 tax burden. There have been significant changes in the personal income and property taxes of Iowa in these five years.

Second, the two studies use different income categories. Whereas ITEP's breakdown of Iowa's population is based on the distribution of income in Iowa and describes the tax burden on equally-sized "quintiles," or fifths, of the population, KPMG's study breaks down the population into groups by fixed income levels, without regard to the number of taxpayers in each group. This means, for example, that researchers interested in comparing each study's estimate of the tax burden on the poorest Iowans must take into account that ITEP defines the poorest income group as the poorest twenty percent of Iowa taxpayers, which turn out to be those with 1998 income of less than $14,000, while KPMG defines the poorest group as taxpayers with 1993 income under $10,000.

Finally, the KPMG study generally assumes that a higher percentage of business taxes are passed on to Iowa residents than does the ITEP methodology. The ITEP model reports more business taxes being exported to out-of-state owners of business, customers and visitors to the state. This means that KPMG's estimate of the tax burden on Iowans will be higher, other things equal, than ITEP's estimate. This is especially true of the business property tax burden and the corporate income tax burden, and most noticeably affects the overall results for the poorest income groups. For example, ITEP's analysis predicts that business property taxes falling indirectly on the poorest 20% of Iowans amount to less than half a percent of income, while KPMG's estimate (for Iowans making less than $10,000) exceeds five percent of income. The following chart summarizes KPMG's 1993 results. The most comparable ITEP result is the first table in Appendix A.

Considering the differences in income groups and passage of time, the overall results are similar for the top 80 percent of the income spectrum with the KPMG analysis reporting somewhat higher burdens for the reasons described above. At the bottom of the income scale, however, KPMG reports very high tax incidence, apparently due to their assumptions regarding business tax distribution. Across all income groups, KPMG reports a more regressive tax system than the ITEP model, especially with regard to the poorest of Iowans.

Comparisons:

- The **personal income tax** results are quite similar. The only significant difference is in the effective tax rate for the top income group. The lower ITEP result is probably due to the fact that ITEP's top income bracket starts at a considerably higher level than does KPMG's.
- The individual **property tax** results are quite similar for the top 60% of the income distribution. But ITEP predicts a considerably smaller property tax burden than does KPMG, particularly at lower income levels..
- The **individual sales and excise tax** burden results are difficult to compare because KPMG does not disaggregate these tax burdens into individual and business shares. Having said that, the *aggregate* (that is, individual and business) sales and excise tax burden can be compared quite easily. KPMG's results are higher across the board.
- The **corporate income tax** results are noticeably different. ITEP finds that very little of the corporate tax is passed on to Iowans and that the tax is greatest as a share of income for the wealthiest Iowans. KPMG predicts a greater pass-through to individuals at all levels, and predicts that the tax as a share of income is greatest for the *poorest* Iowans.

In summary, there are some difficulties in comparing the tax burden predictions of KPMG to those of this study, most of which are driven by the differing assumptions of business tax incidence in the two models. The net effect of the different treatment of business taxes is that ITEP finds that a lower percentage of business taxes are passed through to Iowa residents, so that the ITEP estimate of tax burden due to business taxes is lower across the board. On the other hand, the tax burden estimates that are least affected by these assumptions—the individual personal income and individual property tax—are broadly quite similar across the two studies. The bottom line is that both studies find that Iowa's tax system is regressive—with the KPMG study finding it more so.

KPMG Estimates of Iowa Taxes in 1993

As Shares of Income for All Taxpayers

Income Range	Less than $10,000	$10,000 – $20,000	$20,000 – $30,000	$30,000 – $50,000	$50,000 – $75,000	$75,000 – $100,000	$100,000- $200,000	Over $200,000
Consumption Taxes	**9.2%**	**6.0%**	**5.1%**	**4.4%**	**3.8%**	**3.2%**	**3.0%**	**1.7%**
Sales and Use Tax	6.6%	4.3%	3.7%	3.3%	2.9%	2.5%	2.4%	1.4%
Excise Taxes	2.6%	1.7%	1.4%	1.1%	0.9%	0.7%	0.6%	0.3%
Property Taxes	**12.2%**	**9.2%**	**6.9%**	**5.1%**	**4.1%**	**3.1%**	**3.1%**	**1.6%**
Property Taxes on Families	7.1%	4.9%	3.7%	2.6%	2.1%	1.6%	1.5%	0.7%
Business Property Taxes	5.1%	4.3%	3.2%	2.5%	2.0%	1.5%	1.6%	0.9%
Income Taxes	**1.7%**	**2.3%**	**3.2%**	**4.0%**	**4.2%**	**4.3%**	**4.6%**	**6.2%**
Personal Income Tax	0.7%	1.6%	2.6%	3.4%	3.7%	3.8%	4.2%	5.9%
Corporate Income Tax	1.0%	0.7%	0.6%	0.6%	0.5%	0.5%	0.4%	0.3%
Total Before Federal Offset	**23.1%**	**17.5%**	**15.2%**	**13.5%**	**12.1%**	**10.6%**	**10.7%**	**9.5%**
Federal Itemized Deduction Offset	–0.2%	–0.4%	–0.2%	–0.6%	–1.1%	–1.0%	–1.5%	–1.6%
Net After Federal Offset	**22.9%**	**17.1%**	**15.0%**	**12.9%**	**11.0%**	**9.6%**	**9.2%**	**7.9%**