

## FISCAL POLICY

### ***Position Statement***

NASW, Iowa Chapter, believes Iowa should prioritize funding to assure safety net services for Iowans in need. One way to protect needed services is to review Iowa's fiscal policies to ensure revenue-generating streams are fair and equitable.

### ***Discussion***

Iowans have felt the recession. In FY 2010, the state of Iowa received estimates from the Revenue Estimating Conference for a projected 7.9% reduction in tax receipts to the state (Iowa Department of Revenue, 2009). The result of the projections included a 10% across-the-board cut to Iowa's state government. In 2010, Governor-Elect Branstad announced a plan to cut state spending by an additional 15% over a five-year period. This cannot be done without Iowa's most vulnerable citizens feeling the pinch.

However, Iowa's fiscal status is improving. The Legislative Services Agency (LSA) reported a \$688.1 million surplus at the end of FY 2012, which represents the third consecutive year the surplus has increased (Legislative Services Agency, 2012). One significant factor attributed to the surplus was the transfer of \$381.4 million from Iowa's reserve funds to the General Fund, an act required by Iowa Code. Once Iowa's reserve funds equal 10% of annual revenues, the remaining funds must be transferred back to the General Fund.

With Iowa's fiscal house in order, the discussion turns to a potential change in policy that may impact tax collections in the state. Republican leaders in the state are calling for support of tax relief components as outlined in the Iowa Strong Initiative, including reform to commercial property tax and individual and corporate income tax. Democratic leaders want to assure any tax compromise also includes relief to low-income earners through the Earned Income Tax Credit.

- *Tax Equity*

General funds collected in taxes are to be used to pay for essential services such as education, public safety, roads and transportation, and safety net services for individuals and families in need. Taxes are assessed through a variety of mechanisms that have differing effects based on an individual's income.

Tax equity is described as the collection of taxes based on the ability of a person to pay. Taxes can be regressive, progressive, or proportional. *Regressive taxes* are taxes that make middle and low-income families pay a larger share of their income in taxes than those with high incomes. Examples of regressive taxes include sales and excise taxes. A 6% tax has a much larger impact on the budget of a family earning \$20,000 per year than it does on a family earning \$200,000 per year.

*Proportional taxes*, also known as flat taxes, take the same percentage of income from everyone, regardless of how much or how little they earn. While the concept sounds fair, the reality is that a family earning \$20,000 per year, with a proportional tax of 5%, would have \$19,000 at their disposal. A family earning \$200,000 per year with a proportional tax of 5% would have \$190,000 at their disposal. While the high-income family would pay a larger tax, in proportion to their remaining disposable income the dent is much less noticeable than it is to the low income family. For that family, the flat tax cuts directly into basic necessities, such as food and housing.

A *progressive tax*, the fairest of the three, is one in which families pay taxes on a graduated schedule. This type of tax is also fair to the middle class, as it more objectively related to what they can afford. One example is found with state income tax. Iowa has a graduated tax schedule with nine brackets, ranging from .36% per dollar earned to 8.98% per dollar earned. However, over time, the graduations have become flatter;

all of the graduations now occur below \$63,000, after that, it becomes a fixed rate. A family earning \$64,000 per year, therefore, will pay the *same* tax rate as a family earning \$200,000 per year, 8.98%. This is similar to a proportional tax; the family making \$64,000 per year will experience a greater hardship to pay the taxes versus the family making \$200,000 per year.

According to a report from the Institute on Taxation and Economic Policy (ITEP, 2011), non-elderly families in Iowa making less than \$20,000 annually will pay 11% of their income in state and local taxes. Middle income families, earning between \$37,000 and \$56,000 annually will pay 10% of their income in state and local taxes, and the top 1% of families earning more than \$365,000 annually will pay only 7.4% of their income in state and local taxes. This is not equitable taxation.

- *Corporate Taxes*

Corporations and businesses in Iowa are responsible for contributing to the tax base through streams such as commercial property taxes and income taxes. While federal corporations are the same in all states, 35%, Iowa has the highest state corporate tax at 12% (Tax Foundation, 2008).

It is noted that Iowa's corporate income tax rate is the highest in the country but this claim fails to tell the whole story. In a report from the accounting firm Ernst and Young, when all business taxes, imposed by both local and state governments, are calculated as a percentage of the state private sector gross domestic product (GDP), Iowa is tied with six other states for 30<sup>th</sup> place, with only 15 states having lower business taxes (IFP, 2011). According to the Iowa Fiscal Partnership (2011):

“The 12 percent tax rate is applied to only a small portion of a company's profits in Iowa. Iowa is one of only four states that allow a portion of federal corporate income taxes to be deducted from income. On top of this, Iowa determines how much of a multi-state firm's profits are taxable in Iowa solely on the basis of sales in Iowa. The majority of states take into account a firm's payroll and property in the state as well as sales. As a result, many large corporations selling nationally and worldwide earn substantial profits on Iowa operations but pay taxes on only a small fraction of those profits. Finally, Iowa offers a range of generous tax credits that further reduce corporate tax liability.”

There are loopholes within the corporate tax structure, which allow businesses to avoid paying taxes in Iowa. One such loophole is profit shifting, which allows companies to shift their profits out of state, in order to avoid Iowa taxes. This loophole is costing Iowa between \$50 and \$100 million in lost revenue each year (Iowa Fiscal Partnership, 2010). However, Iowa based businesses do not have access to these loopholes, and therefore bear a proportionately larger share of taxes than out-of-state based businesses do.

One example of this loophole, according to New Rules (n.d.), is Home Depot. At present, there are ten Home Depots in the state of Iowa. Each of these stores pays a hefty fee to use the Home Depot trademark, which is owned by Homer TLC, Inc. However, Homer TLC, Inc. is a subsidiary of the Home Depot chain and is based in Delaware. The trademark fee paid by each store is deducted as a business expense, but because Delaware does not levy corporate income taxes on earnings from intangible assets such as trademarks, the profits are not taxed in that state (New Rules, n.d.). Therefore, Home Depot avoids paying taxes on its profits in both Iowa and Delaware. Companies known to use the previously mentioned loopholes to avoid paying their fair share of tax to the state include Circuit City, The Gap, Home Depot, Kmart, Kohl's, Limited Brands (which owns Bath & Body Works, Victoria's Secret, The Limited, and other chains), Payless Shoes, Staples, Toys “R” Us, and Walmart.

The answer to loopholes such as these is the mechanism known as “combined reporting.” This system requires a parent corporation and all its subsidiaries to report their financials on one document, or set of documents. In order to collect tax on all profits earned in a state, the state creates a formula that is used to determine the true tax owed to the state by the corporation. The tax is based on the average percentage of the corporation's nationwide property owned, sales made, and payroll paid as these apply to each individual

state. The Institute for Taxation and Economic Policy (2005) describes the procedure as follows: “For example, suppose that the Acme Corporation has located 90% of its property, 30% of its sales, and 90% of its payroll in one state; under the three-factor formula, that state could tax 70% (the average of 90, 30, and 90) of Acme’s apportionable business income.”

The argument against combined reporting is that companies will leave the states, which tax a larger proportion of their profits. However, according to a press release by the Center on Budget and Policy Priorities, in 2008, 31 of the 34 major manufacturers in Iowa examined in a report continue to do business in states with combined reporting. Twenty-three states have adopted combined reporting mechanisms, including many of Iowa’s neighbors: Nebraska, Minnesota, Illinois, Wisconsin, and Kansas. The reality is that corporations do not look solely at the amount of tax they will have to pay when they are exploring the possibility of expanding into a state. Corporations also look at whether the state is a good place for their employees to work and raise families. To that end, businesses examine the essential services provided in the state, such as public safety, education, parks and recreation, environmental protections, transportation, roads, and other services that make living and working in that state desirable (Center on Budget and Policy Practices, 2008). These are the very services that are funded by revenues generated through the tax structure, and threatened when those revenues decrease.

- *Tax Expenditures*

According to the Institute for Taxation and Economic Policy (2011), lawmakers often provide targeted tax cuts to particular groups of individuals or corporations. These special tax breaks are called “tax expenditures” because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks. The state has the option of creating a direct spending program, which would pay businesses directly, or allowing the business to use a tax expenditure which lets the business reduce its tax liability by the same amount. While direct spending would be fairly easy to track, unfortunately, there is virtually no oversight on tax expenditures, and this often results in lower tax collection or abuse of the system, which negatively impacts the essential services to Iowans.

Iowa’s tax credit programs result in lost revenue to the state each year. Three of these programs, the Research and Development Tax Credit (RAC); the Iowa Industrial New Jobs; the Historical Preservation and Cultural and Entertainment District) are projected to cost the state more than \$120 million in revenue during FY2011 (Legislative Services Agency, 2011, p 4). Under the current policy, the RAC program refunds 6.5% of research expenditures to corporations to do research in their industry. This falls below the most common rate of 10%. There are currently 36 states that offer some sort of a research tax credit. Iowa is one of six states that offer a refundable research tax credit (Iowa Department of Revenue, 2011). Additionally, this credit is retroactive – a company has three years to file for the refund and any applicable interest if they have not done so in the past. Therefore, the RAC not only costs Iowa in lost revenue from companies not paying income taxes, but also in any checks that have to be written for refunds.

The RAC’s were initiated to help entrepreneurs starting up small businesses, but now the largest portions go to well-established multi-million dollar corporations with high profits. The latest report from the Iowa Department of Revenue in 2011 shows the effects of RAC in Iowa. The three largest RAC claimants received at least \$33.8 million in tax credit refund checks – Rockwell Collins (\$14,313,898), Deere & Co. (\$11,762,241) and DuPont (\$7,762,928) (IDR, 2011). This is also at a time when these corporations showed high profits. For example, Rockwell Collins reported in fiscal year 2011 a net income of \$175 million, an increase of \$25 million, or 17%, from \$150 million in the same period last year (Tyrdy, 2011). While these companies are not paying anything in Iowa corporate income taxes, the State of Iowa is handing these three companies alone a total of at least \$33 million in checks from the Iowa Treasury. Possible solutions to the RAC are to enforce caps on the amount refundable and eliminate the retroactivity of the credit.

The result of these tax expenditures is the lost revenue to the state to fund essential services for vulnerable Iowans and the lack of oversight into the benefits or results the credits are aimed to produce. There are no regulations requiring this research be completed in Iowa to support job creation and Iowa's economy.

The abuse of tax expenditure programs in Iowa has cost the state millions, including the Iowa Film Tax Credit and the Iowa Fund of Funds. The Film Tax Credit was enacted in 2007 to promote film production in Iowa. In 2009, the program was halted when a state audit revealed more than \$25 million, of the \$32 million, in tax credits were improperly issued. This accounted for 80 percent of the claims involved with the program. The misuse of tax credits resulted in criminal charges against those involved. Taxpayers may still feel the impact of the film tax credits. A man filed a lawsuit seeking \$4.5 million in film tax credits for projects he financed before the halt of the program.

The Iowa Fund of Funds was created in 2002 to create venture capital investments in Iowa. The program was designed to be funded through private investments and secured by contingent tax credits. The fund was originally authorized at \$100 million in tax credits but later reduced to \$60 million, after the film tax credit debacle. Investors could access the tax credits to cover shortfalls if they experienced losses or did not receive the returns required. Investors ended up using the credits to guarantee short-term bank loans, which was not the intent of the program. The tax credits were meant to only be touched if investors lost money or failed to make certain returns. In April 2012, two banks sued the state after the Iowa Fund of Funds defaulted on its loan. In August 2012, Iowa reached a deal with two lenders that will cost Iowa taxpayers \$26 million or more.

The potential for abuse and the lack of transparency and accountability has ramifications of costs to taxpayers. Tax expenditures should be held to the same scrutiny as other programs funded through tax payer dollars. Tax transparency and accountability would allow the state to assure the monies offered companies to do business in Iowa are held to the same set of standards as state spending on programs serving Iowans.

- *Tax Accountability and Transparency*

Transparency and accountability are important to maintain the integrity of the tax structure. It is important for taxpayers to know that tax credits are providing their intended benefits: affording growth and job opportunities to the state. In 2009, legislation was enacted to require public reporting of all credits over \$500,000, including the name of the claimant and the amount received. The requirement for reporting is one step closer to transparency in determining the effectiveness of tax credits in Iowa. The next step should be to ensure that the credits are strategically targeted in order to benefit the whole state.

As with other state programs, funding should be tied to results-based accountability. Legislators and the public want to know their money spent on programming is meeting the needs. Unfortunately, this same scrutiny is not required of tax expenditures, nor is the public aware of the monies being lost by tax credits offered. Iowans should know the money being lost from tax credits and/or paid out in checks written from the General Fund are accomplishing their original goals.

- *Taxpayers Trust Fund*

On April 21, 2011, Governor Branstad signed Senate File 209 into law. The most important element of the bill was the creation of the Taxpayer Trust Fund (TTF). "This fund captures money from unexpected revenue growth after the states cash reserves and economic emergency funds are full." (Campbell, 2012). The trust directs the first \$60 million in revenue above the original revenue estimate into the Taxpayers Trust Fund to be utilized for tax relief measures (Iowa House Republicans, 2012). These funds are separate from the general funds of the state.

"In late March, a three member Revenue Estimation Conference was held, which projected that the State's official revenue estimates would increase by \$50.9 million in Fiscal Year 2012 and \$29 million in 2013." (Campbell, 2012). Consequently, in years past the state was able to spend excess funds on whatever deemed

fit. However, the implementation of the Taxpayers Trust Fund keeps the state from spending these excess funds and creates a form of tax relief for hardworking Iowans (Paulson, 2012).

In 2012, Iowa House Republicans noted there is no requirement that the money in the trust fund must be utilized. If there is no agreement between the House, Senate, and Governor on the use of these funds, the money will remain in the TFF. The funds in the TTF will be appropriated by the General Assembly for tax relief and may be used for cash flow purposes. However, when being used for cash flow purposes all funds allocated must be returned by the end of that fiscal year.

- *Earned Income Tax Credit*

Different from business tax credits, the Earned Income Tax Credit (EITC) was first signed into federal law in 1975 to benefit low income working families, to incentivize work over welfare, and aid in asset building for families. To qualify for EITC, claimants must show earned income in the form of wages, salaries and/or tips. Unfortunately, in some cases wages are so low that individuals and families are still left struggling at the poverty level in spite of a full-time income. Iowa is one of only a few states who tax the working poor who are living at or below the poverty level. In 2012, a family size of 3 living at 100 percent of poverty would earn \$19,090 per year (Families USA, 2012). Iowa began the state EITC at 5% of the federal EITC in 1989. In 2007, that was increased to 7%.

- In 2009, 208,342 Iowa households (representing about 250,000 adults and 260,000 children) received 28.5 million dollars in Earned Income Tax Credits (Jin and Rogers, 2011).
- It is the largest and most effective anti-poverty program (Barry Forman, 1999).
- It gives them additional income to provide child care and other necessities for their family, and puts that money back into the local economies, boosting businesses and sales tax revenue.
- In families with one or two children, it lifts them above the federal poverty threshold. According to the Iowa Fiscal Partnership, in order to do the same for families with 3 or more children, the Iowa EITC must be raised to at least 20% of the federal level. In an effort to begin an incremental increase, the Iowa General Assembly voted twice in 2011, again with bi-partisan support, to increase the EITC to 10%, but Governor Terry Branstad vetoed the bill both times (2011c).

### ***Recommendations***

- Iowa should create tax fairness by ensuring that all individuals and businesses pay based on their resources.
- Iowa must assure policies are in place to allow transparency, and to measure the effectiveness of tax credits passed in legislation.
  - Iowa should place limits on Research Activities Tax credits by eliminating retroactivity of the credit, by limiting and the amount refundable, and by limiting the size of companies who are eligible for them to those with annual profits under \$20 million.
  - Iowa should require a sunset clause for tax credits to ensure they receive continued review.
- Iowa should increase the Earned Income Tax Credit to 20% of the federal EITC.

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