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Discounting Iowans' Taxes 15% Creates 18,000 New Jobs

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Iowans for Discounted Taxes! comissioned the Beacon Hill Institute at Suffolk University to study the fiscal and economic effects of a proposed tax policy to discount state and local taxes in Iowa.

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Introduction

Across the nation, states faced falling tax revenues in Fiscal Year (FY) 2010. Even before Governor Chet Culver implemented "a 10% across-the-board cut that whacked $564.5 million from executive-branch agencies," the state of Iowa saw general fund appropriations fall by 3.2%.[1] As the new calendar year began, so did debate about the next fiscal year budget in Iowa. Due to the continued decrease in state tax receipts, officials expected between a $400 million and $1 billion gap for FY2011.[2] As recently as February 1, the gap was estimated to top $1.25 billion.[3]

The state unemployment rate stands at 6.6%, the highest level since September 1986, and double rates that were seen as recently as mid 2001. As this rate has increased, so have concerns about the overall economy, manifesting in a more cautious consumer. As discretionary spending falls, the sales tax base shrinks. In addition, income tax receipts declined as unemployment grows.

In Governor Culver's FY2011 budget for Iowa, a comprehensive review of the state government found $341 million in government inefficiencies, justifying a reduction of that amount to the annual budget.[4] Legally required to balance the state budget, Governor Chet Culver set forth a plan to narrow the gap by $1.011 billion. Cutting state spending by $520 million in addition to $150 million received from the federal government would supplement the $341 million in cost reductions from eliminating inefficiencies.[5] To bridge the budget gap, states have relied on spending cuts and federal aid. But Governor Culver is also addressing government inefficiencies.

The Governor's plan includes one-time cost savings, such as joining multi-state lawsuits on escheat of unclaimed bonds, to adjustments that will produce savings year after year. Some examples include the consolidation of numerous areas of the state government, eliminating the least efficient state printing shops and negotiating statewide contracts.

The cost of these inefficiencies tell another story — one that has less to do with the vagaries of state revenue and more to do with the fact that this spending has crowded out private

[1] General Assembly of Iowa, Legislative Service Agency, "FY 2011 General Fund Budget Projection," November 25, 2009, http://www.legis.state.ia.us/lsadocs/IssReview/2010/IRDLR000.PDF (accessed February 16, 2010).
[2] Rod Boshart, "Budget deficit to dominate Iowa legislative sessions," *Quad City Times,* January 3, 2010, http://www.qctimes.com/news/local/government-and-politics/article_17d57778-f81d-11de-bdf9-001cc4c03286.html (accessed February 16, 2010).
[3] Butch Heman, "Kettering, Roberts question governor's budget," *Daily Times Herald,* February 1, 2010, http://www.carrollspaper.com/main.asp?SectionID=1&SubSectionID=1&ArticleID=9595. (accessed February 16, 2010).
[4] Office of the Governor, "Fiscal Year 2011 Iowa Budget Recommendations," January 27, 2010, http://www.dom.state.ia.us/state/files/budget_recommendations/FY11/FINAL_FY11BUDGETREPORTRevised3%20FINAL1272010.pdf (accessed February 16, 2010).
[5] Ibid.

investment. The most effective way to curb these structural inefficiencies (estimated at 6.4 percent of the FY2011 budget) is to "starve the beast" by not making revenues available in the first place. Whether or not taxes are raised or programs cut, structural inefficiencies should be eliminated. As most business owners in the private sector know, competition forces managers to squeeze out duplicative or superfluous spending to meet the bottom line. In government, public managers face no such hurdles; in practice the inefficient spending continues once state revenues recover.

Iowans for Discounted Taxes! (IDT) argues that the elimination of inefficiencies identified by the Governor demonstrates that Iowa can afford tax relief in the form of across the board 'tax discounts' for its citizens. The tax discount would work similar to discounts consumers receive at retail stores. For example, if an item priced at $100 is discounted by 10%, then the new price of the item would be $90. The same principle would apply to tax rates. A 6% sales tax levied on a $100 item would yield $6 in sales tax revenue, but a 10% sales tax discount (6% - (10% x 6%) = 5.4%) would yield at the rate of 5.4% and $5.40 in sales tax revenue on the same item.

The Beacon Hill Institute at Suffolk University (BHI), at the request of IDT, analyzed the fiscal and economic impact of different levels of tax discounts. We considered tax discounts of 5, 10 and 15 percent applied to three major tax categories; state sales tax, state income tax, and local property taxes, including both commercial and personal property.

Results

The tax discounts would act to reduce the overall tax burden in Iowa as well as total state and local tax revenue collections. This would put more money into the pockets of Iowa's taxpayers and businesses, which would provide a boost to the state's private economy leading to an increase in employment, income and investment. Table 1 displays the results against the baseline scenario of no tax change.

Table 1: Economic Effects by Tax Discount

	5%	10%	15%
Change in Private Jobs	10,079	18,810	27,865
Change in Government Jobs	(2,727)	(6,015)	(9,151)
Net Change in Jobs	7,352	12,795	18,714
Baseline Investment, ($m)	118	234	349
Disposable Income ($m)	540	905	1,307
Disposable Income per Capita ($)	60.65	100.17	152.19

A tax discount of 5% would lead to a net increase of 7,352 jobs, which would boost disposable income by $540 million, or $60.65 per capita. Businesses would increase investment by $118.20

million. A 15% tax discount would lead to a larger net job creation of 18,714, a $349.43 million increase in investment and an increase in disposable income of $152.19 per capita. The 10% tax discount in the three major tax categories would result in changes to the economic indicators that fall between the other two discount levels, also shown above.

BHI also analyzed the static and dynamic effects to Iowa state revenues. The static revenue decreases are calculated by multiplying the tax discount, 5, 10 or 15 percent, by the projected revenue collections. This static revenue decrease, however, does not tell a whole story. When taxes are reduced, the state becomes more competitive, resulting in increased economic activity. For example, a reduction in sales taxes by 5% enables cheaper prices for goods, thus, at the margin, more goods would be sold, increasing the sales tax base. Moreover, the increased economic activity would also raise incomes, which would, in turn, boost personal income tax collections. In this case, the dynamic revenue loss would be less than 5%.

Table 2 displays our estimates of the static and dynamic revenue changes. Under a 5% tax discount, sales and income tax revenues would drop by $144 million and $141 million respectively, for a combined state level static tax revenue loss of $285.52 million. A 5% discount on local commercial and personal property taxes would yield a static revenue loss of $180.79 million. A 10% tax discount in the state sales and incomes taxes would produce a static decrease of $571.02 million combined, while a local level 10% decrease in property tax rates would lead to a revenue drop of $361.58 million. Further, a 15 percent tax discount would

Table 2: Revenue Effects by Tax Category for FY2011

	5%	10%	15%
Static Revenue Change ($m)			
Sales Tax	(144.32)	(288.63)	(432.95)
Income Tax	(141.20)	(282.39)	(423.59)
Property Taxes	(180.79)	(361.58)	(542.37)
Total	**(466.30)**	**(932.61)**	**(1,398.91)**
Dynamic Revenue Change ($m)			
State			
Sales Tax	(103.86)	(213.14)	(324.79)
Income Tax	(131.34)	(261.53)	(388.83)
Other Revenue	55.79	102.63	152.31
Total	**(179.41)**	**(372.04)**	**(561.30)**
Percent of State Revenue	-2.61	-5.42	-8.17
Local			
Property Taxes	(165.94)	(338.32)	(512.03)
Percent of Local Revenue	-4.25	-8.66	-13.11
Total State and Local	**(345.35)**	**(710.36)**	**(1,073.33)**

deliver a total static revenue loss of $1,398.91 million, $542.37 million from local property tax and $856.54 from state discounts.

The dynamic revenue losses would be less than the static, due to the positive effects of a lower tax burden on businesses and households. For the 5% discount on sales and income taxes the dynamic revenue loss would be only $179.41 million or 2.61% of total revenue, due, in part, to a rise in other state tax revenues of $55.79 million. The dynamic effects would shrink the loss to $165.94 million, or 4.25% of local property tax revenue. The 10% tax discount would result in a 5.42% decrease in state taxes, or $372.04 million, while local property taxes would decline by $338.83 million or just 8.66%. The 15% discount on the state taxes would lead to only an 8.17%, or $561.30 million revenue loss, while a 15% discount on local property taxes would reduce receipts by $512.03 million or 13.11%.

Conclusion

Current economic circumstances, with high unemployment, would suggest the largest discount of 15% on income and sales taxes. This level would create the largest number of jobs, grow the Iowa economy, and provide relief to taxpayers who are concerned about their finances. As for IDT's proposed discount on property taxes, cities and counties should consider a 5% discount in order to provide taxpayer relief, taking advantage of the opportunity to grow their local economies by becoming as competitive as possible. Discounts of up to 15% on property taxes should be considered by cities and counties that are stronger financially, or those that simply choose to be as aggressive as possible in stopping the loss of current residents and businesses to other states, and especially for the purposes of attracting new ones.

Whichever states, counties and cities seize the initiative to begin discounting taxes will have the advantage in maintaining current residents and businesses, but especially in attracting new ones to grow their economies and tax bases.

From a fiscal standpoint, the elimination of $341 million in inefficient government spending implies that when the state economy rebounds, there will be excess revenue, and thus room to discount taxes. If Iowa lawmakers implemented an across-the-board 10% discount in the state personal income and sales tax, the combined revenue loss would be $372.04 million dollars. Thus, we conclude that Iowa's state and local governments can afford to implement 10% tax discount, with little changes in public services provided.

Methodology

To identify the economic effects of the tax discounts and understand how they operate through a state's economy, BHI utilized its STAMP (State Tax Analysis Modeling Program) model. STAMP is a five-year dynamic CGE (computable general equilibrium) model that has been programmed to simulate changes in taxes, costs (general and sector-specific) and other economic inputs. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world. It is general in the sense that it takes all the important markets, such as the capital and labor markets, and flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and capital). This equilibrium is achieved by allowing prices to adjust within the model. It is computable because it can be used to generate numeric solutions to concrete policy and tax changes.[6]

BHI used four STAMP models — New York State, Indiana, South Carolina and Virginia— to garner an approximate effect that a 5, 10 or 15 percent reduction in major tax categories would have on state economic indicators. In each of these models, BHI reviewed changes to the state income tax, state sales tax, and local property taxes on both commercial and personal property to approximate tax change elasticities for each economic variable.[7] The calculated economic effects enabled BHI to estimate the effect to specific Iowa economic variables, such as private employment, investment and disposable income.[8]

BHI then calculated the static revenue decrease of the given tax reductions, 5, 10 or 15 percent, in each of the tax categories, and solved the model for each of the four states. An average of percent changes to each of the economic variables was then applied to the 2009 economic variables for Iowa. Each estimate represents the change that would take place in the indicated variable against a "baseline" assumption about the value of that variable for each of the tax reduction policies.

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[6] For a clear introduction to CGE tax models, see John B. Shoven and John Whalley, "Applied General-Equilibrium Models of Taxation and International Trade: An Introduction and Survey," *Journal of Economic Literature* 22 (September, 1984): 1008. Shoven and Whalley have also written a useful book on the practice of CGE modeling entitled *Applying General Equilibrium* (Cambridge: Cambridge University Press, 1992).

[7] Department of Iowa Revenue, "Gross Collections, Net Collections, Refunds, Fiscal Year 2009," http://www.iowa.gov/tax/educate/0978508add.pdf (accessed February 19, 2010).

[8] We used data from these two Bureau of Labor Statistics sources. See "State and Metro Area Employment, Hours, & Earnings," http://www.bls.gov/sae/; "Occupational Employment Statistics," http://www.bls.gov/oes/. We also used data from the Bureau of Economic Analysis, "National Economic Accounts," http://www.bea.gov/national/Index.htm; and "Regional Economic Accounts," http://www.bea.gov/regional/ (accessed February 19, 2010.)

Additionally, since the major tax categories make up various levels of total revenue in the four states that are analyzed, a simple linear regression was used to determine the dynamic effect on Iowa revenue. For example, a state where the income, sales and property taxes make up 80% of revenue would experience different revenue effects from a 5% cut than a state where those taxes made up 90% of revenue.

The Beacon Hill Institute Team

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The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

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