A Chronic Budget Crisis: Can Iowa Keep Its Promises?

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Preface

This report is the fifth in a series of reports on Iowa's fiscal crisis prepared by the Iowa Fiscal Partnership, a joint initiative of the two nonprofit, nonpartisan organizations, the Iowa Policy Project in Mount Vernon and the Child & Family Policy Center in Des Moines. The principal authors of this report were Elaine Ditsler, research associate at the Iowa Policy Project; Charles Bruner, executive director of the Child & Family Policy Center; and Peter Fisher, research director for the Iowa Policy Project.

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The Iowa Fiscal Partnership

A Chronic Budget Crisis: Can Iowa Keep Its Promises?

For state legislators, there is no more important responsibility than passing a yearly budget. The budget determines the investments that Iowa will make in education, health care, public safety, infrastructure, the justice system, and the workforce, all of which underpin a healthy economy. Iowans are rightly proud of the quality of life in this state, and understand that it depends in no small part on the quality of our public education system, our roads, and other public services. Yet Iowa is now at a crossroads; the state's ability to keep its promises in the coming years will depend crucially on how clearly we recognize the problems we face and take responsibility for solving them.

From 1996 until 2001, Iowa and the entire country experienced an economic boom, which increased personal income and caused state tax collections to swell. During this period, Iowa was quicker than most states to enact tax cuts and slower than most to expand spending. In fact, tax cuts enacted during that time – when fully phased in – will reduce general fund revenue by more than $800 million annually.

Since the economy routinely cycles between periods of growth and retraction, budget discipline must apply equally to tax cuts and to spending increases. In the late 1990s, legislators enacted unsustainable tax cuts based on temporary surges in revenue. This failure to budget over the full economic cycle is the primary reason for the state's shaky financial situation over the last several years. The tax cuts, combined with Iowa's changing economy and demographics, have resulted in a mismatch between revenues and expenditures, which the recent recession has only amplified.

As this and other reports in this budget series show, Iowa's response to the financial crisis – cutting services, adopting new tax cuts, and raiding special funds – has likely extended the state's financial problems into the future. Few, if any, government services were left unscathed by the budget cuts and the severely curtailed spending deepened the recession by pushing up unemployment. Cuts in state spending caused layoffs in the public sector, in the companies that operate under contracts with the state, and in other companies due to the multiplier effect of more unemployed Iowans with less income to spend. As Nobel Laureate economist Joseph Stiglitz has noted, reductions in state spending during a recession can be more harmful than tax increases. By enacting additional tax cuts *during the recession*, Iowa worsened its own financial position.

Instead of seeking permanent sources of revenue, Iowa turned to finite revenue sources. The Senior Living Trust Fund, the Healthy Iowans Tobacco Trust, the Endowment for Iowa's Health Account and 38 other funds, most of which were intended for vastly different purposes, were raided to shore up general fund budget gaps. These dollars are no longer available for their intended purposes, and many funds – most notably the Senior Living Trust Fund – are precariously close to broke.

As we look to the future, we face the challenge of replenishing the funds that were raided, at the same time that shifting demographics, a changing economy, and an outdated tax system are likely to put further strains on the state's finances. Iowa's sales tax has not adjusted to the new economy, corporate income tax collections have declined substantially, and we may well face declining federal revenue in the near future. Furthermore, as Iowa's population ages, a greater share of Iowans will be drawing primarily on income from pensions and Social Security, which already is taxed at a substantially lower rate than the same amount of earned income, reducing revenues at the same time that strains on the Medicaid system increase. Seniors account for a large share of total Medicaid expenditures, primarily because of nursing facility costs, and Iowa's population over age 65 is projected to grow 57 percent between 2000 and 2025.

These trends suggest that the state will continue to be hobbled by budget deficits in the future unless Iowa takes corrective action now. In order to meet its responsibilities to all Iowans, the state needs to modernize its tax system by closing tax loopholes, broadening the sales tax base and fixing the personal income tax.

How Iowa Balanced the Budget: FY2001- FY2005

Like a family, state government must live within its means. As with almost all states, the Iowa Constitution prohibits deficit spending. A projected deficit requires that Iowa increase revenues, reduce spending or take other measures before it adopts a budget. The general fund is the primary operating budget for state government. In addition, there are other funds that are typically dedicated for specific purposes. For example, the Road Use Tax Fund collects gasoline tax revenues, which, according to the Iowa Constitution, can only be spent for road construction, maintenance, and related purposes. Other non-general funds, such as the Senior Living Trust Fund, the Rebuild Iowa Infrastructure Fund and the Endowment for Iowa's Health Account were established for specific purposes, but the General Assembly can depart from those original intentions.

Faced with cumulative general fund budget gaps of over $3 billion between fiscal 2001 and 2005, the state cut $1.4 billion in services and made $2 billion in transfers from sources outside of the general fund (see Figure 1).[1] In turn, services that were funded by these other (non-general fund) sources had to be scaled back. In Figure 1, Iowa's fully funded budget for 2001 is based on fiscal 2000 appropriations plus built-in costs for 2001, as estimated by the Legislative Services Agency.[2] Following the same methodology, each year's fully funded budget is estimated based on the previous year's actual appropriations plus built-in costs and an amount sufficient to pay for all of the services that were shifted to non-general funds during the previous year.[3] This method provides a conservative estimate, since it automatically ratchets down the base if there are cuts in the previous year. This is why a "fully funded budget" required fewer dollars in 2004 and 2005. During this period, the state permanently eliminated some of its responsibilities, including part of the Educational Excellence program and two property tax replacement credits, which cut a combined total of $119 million from the budget.[4]

[1] About $657 million of the $2 billion were revenue transfers, which are transfers of money from a special fund to the general fund (see Figure A-3 in the Appendix). The rest were expenditure transfers, which are transfers of funding responsibilities (programs and services) from the general fund to special funds (see Figure A-1 in the Appendix).The state also de-appropriated $85.2 million from the general fund for the Endowment for Iowa's Health Account, which is not counted as a transfer but has the same effect as a revenue transfer.

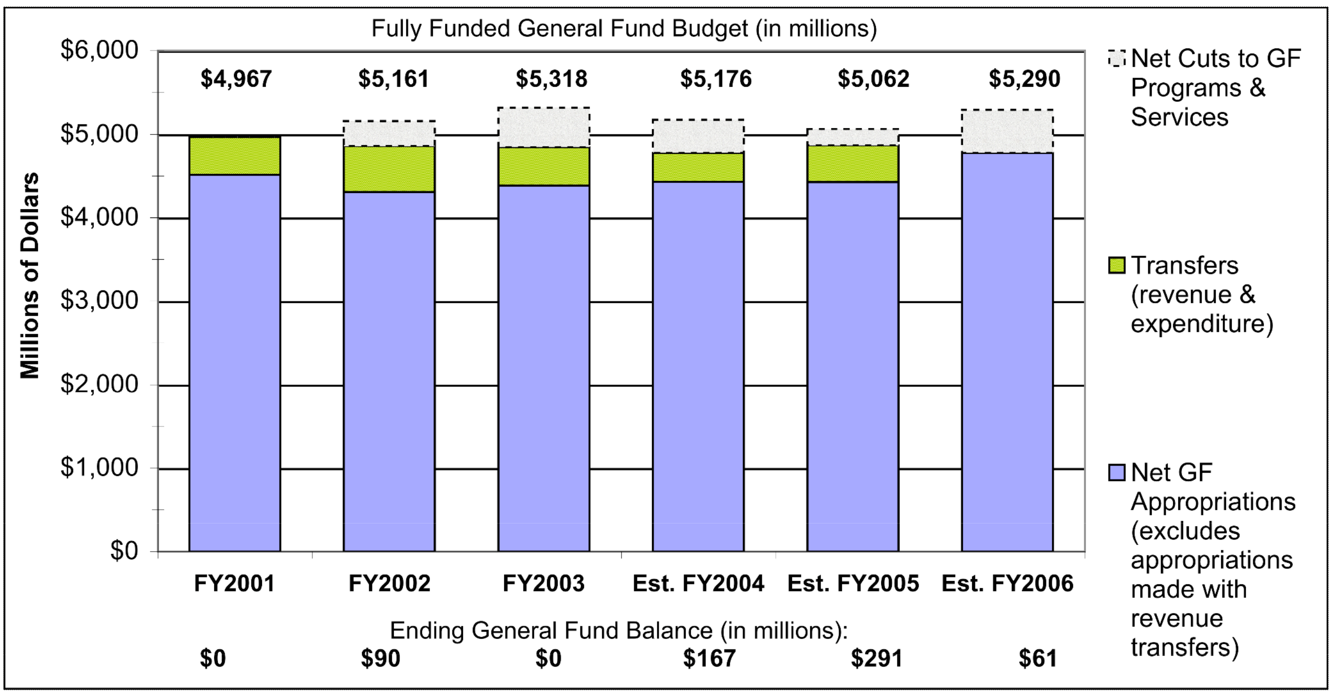
[2] Built-ins are estimated by the Legislative Services Agency. They are a standing appropriation required by the Code of Iowa, an entitlement program, or an appropriation for a future fiscal year that increases or decreases compared to the prior year.

[3] Programs and services shifted to non-general funds are known as expenditure transfers. The authors took care to ensure that some expenditure transfers were not double counted as built-ins.

[4] The Machinery & Equipment Property tax credit replacement was permanently eliminated, cutting about $42 million from the budget between 2001 and 2005. The Property Tax Replacement credit was also permanently eliminated – cutting $52 million from the budget between 2001 and 2004.

By 2005, cuts to key programs and services were still not fully restored in such areas as education and child and family services. Higher education spending is $124 million short of its 2001 level; the state match for the K-12 Instructional Support Program continues to be capped at $14 million, forcing property taxpayers to pick up the tab; over one-third of the state's mental health institute beds have been closed; the state ended its long-time emergency assistance program; and despite a 20 percent increase in child abuse cases, the child welfare budget remained flat. Further, of the money that was borrowed from special funds (represented by the "transfers" in Figure 1), none has been replaced. State law requires that only a portion ($118 million) be reimbursed to the Senior Living Trust Fund and $172 million be reimbursed to the Endowment for Iowa's Health Account. With the state already facing a projected shortfall for 2006, revenues will be insufficient to repay these amounts in 2006.

Figure 1. How Iowa Balanced the Budget, FY01-FY05 (and a projection for FY06)



Source: Legislative Services Agency, Fiscal Services Division

Notes: Revenues are based on December 2004 Revenue Estimating Conference projections. A fully funded budget is equal to the previous fiscal year's GF appropriations (before reversions) + net built-in increases + an amount to pay for all of the GF services that were shifted to non-general funds during the previous year. Since a "fully funded budget" is based on the previous year's actual GF appropriation, cuts in one year can reduce the base budget in the next year. School aid and other standing appropriations and entitlement programs are automatically added back as built-ins. However, other cuts, such as the across the board cuts, and cuts to higher education and property tax credits ratchet down the base, and therefore reduce the amount that constitutes a fully funded budget in the next year.

Revenues

General fund (GF) revenues[5] grew at an average annual rate of 4.4 percent between June 1994 and June 1999, and then slowed to less than 1 percent (0.83 percent) between June 1999 and June 2004.[6] If

[5] General Fund (GF) revenues are revenues that accrue to the state from taxes, fees, interest earnings, and other sources, and that are used for the general operation of Iowa's state government. These revenues are not specifically required in statute or in the constitution to support specific programs and/or agencies.

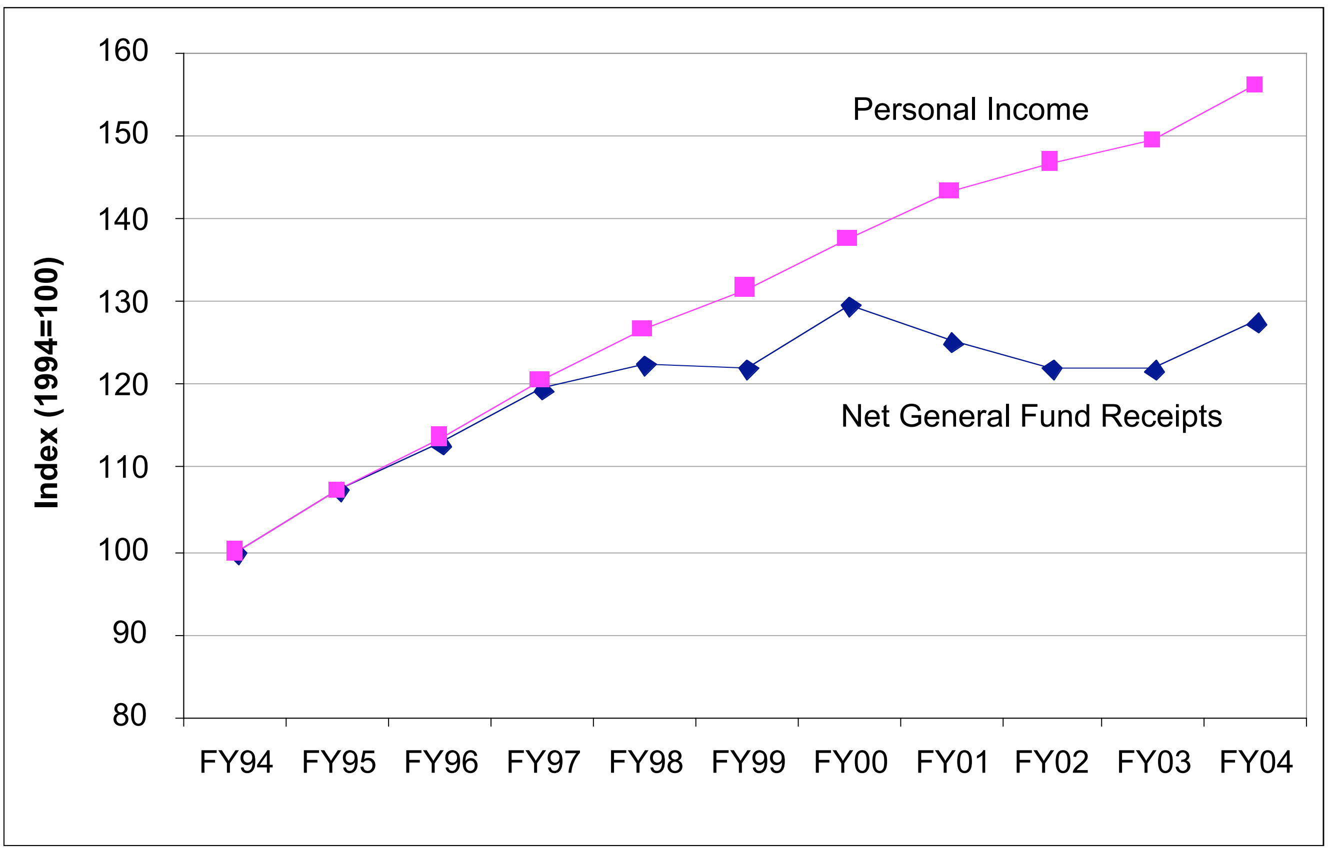
[6] Net of refunds, on a cash basis, and excludes revenue transfers. Estimates are through June because it is the last month of the state fiscal year.

revenue had continued to grow at 4.4 percent during the last five years, Iowa would have taken in about $866 million more than it did. This raises the question: What happened to this $866 million in FY2004 general fund revenue?

According to the Department of Management, tax cuts that took effect between 1996 and 2004 produced $650 million, or 75 percent, of the $866 million in lost GF revenue in FY2004.[7] Tax cuts that triggered the largest reductions in revenue in 2004 were the 10 percent across-the-board (ATB) income tax cut implemented in 1998, the hospital sales tax exemption implemented in 1999, and increased exemptions on pension income implemented in 1996 and 1999. (When fully phased in, the insurance premium tax reduction will be the second largest tax cut, after the across-the-board income tax cut). The remaining $216 million, or 25 percent, of lost revenue can reasonably be attributed to the weak economy.

A comparison of personal income growth with revenue growth also confirms that tax cuts, rather than a weak economy, are the main culprit for the fall-off in revenues. Between 1994 and 1997, personal income and general fund receipts grew together. However, since 1997, personal income has continued to climb while general fund revenues declined (see Figure 2).

Figure 2. The Divergence of Personal Income Growth and General Fund Revenue Growth



Source: Legislative Services Agency, Fiscal Services Division, State of Iowa; Bureau of Economic Analysis.

Notes: Numbers are indexed to 100 in order to provide relevant units of comparison. General fund receipts are on anaccrual basis. In order to make comparisons over time, the FY2001 - FY2004 figures do not include revenue transfers into the general fund from non-general fund sources.

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[7] That is, if pre-1996 tax law and tax rates were applied to the actual sales and income tax base in FY2004, there would have been about $650 million in additional revenue. When fully phased-in, the Department of Management estimates that all tax cuts implemented between 1996 and 2004 will reduce GF revenue by $827.5 million annually.

Structural Deficits

After suffering through three of the toughest budget years since the 1980s, revenues have begun to recover slightly. However, revenues are growing from the depressed level they reached in the depths of the fiscal crisis. Despite the moderate turnaround, Iowa still is projected to have a budget shortfall for 2006.

A state is said to have a "structural deficit" when the normal growth of revenues cannot pay for the normal growth of expenditures from year to year. In Iowa, revenue growth needs to be sufficient to also replace the one-time revenue sources used up over the last few years. The excessive and unsustainable tax cuts during the last 10 years are the single largest reason for Iowa's current deficit problems. The surge in income tax revenues during the late 1990s was partially caused by increases in capital gains due to the run-up in the stock market. According to Harley Duncan, Executive Director for the Federation of Tax Administrators, "Capital gains had become as much as 15 percent of the overall income tax base over the course of the boom of the 1990s, and then almost dried up."[8] That temporary surge in revenue was used as an argument for permanent tax cuts, and the result has been income tax revenues below a level that would sustain normal state spending patterns in normal economic times, let alone in recessionary times.

In addition to the recent tax cuts, other events have contributed to Iowa's structural deficit. These factors include an outdated sales tax, declining corporate income tax collections, a regressive overall tax system, and the aging of Iowa's population. The Iowa Fiscal Partnership has provided a variety of materials to the Governor and the General Assembly that make the case for the need to modernize the tax code in order to address the structural deficit.[9] Five changes in Iowa's economy and society that have impacted tax collections and contributed to the structural deficit are described below.

Iowa's sales tax does not cover many services or an expanding e-commerce sector. First developed in 1934, the sales tax fails to accurately reflect today's service-based economy.[10] The fastest growing part of the economy is the services sector and yet many services remain exempt from the Iowa sales tax. Since the consumption of services is growing faster than the consumption of goods, the sales tax base erodes over time and Iowa's sales tax collects less revenue per dollar of consumption.[11] The sales tax yield was 11.85 percent in 1979. It dropped to 10.75 percent in 2003, and would have been much lower if Iowa had not broadened the tax to include some services already.[12] In order to address this problem, Governor Vilsack proposed an expansion of the sales tax base in 2004 to include more services while lowering the overall rate.[13]

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[8] Smith, Ray A. Wall Street Journal, "Downturn Made State and Cities More Dependent on Property Taxes." August 24, 2004.

[9] In particular, see "Everything You Wanted to Know about Closing Tax Loopholes ... But Were Afraid to Ask." Iowa Fiscal Partnership. February 4, 2004. http://www.iowapolicyproject.org/reports_press_releases/040223-loopholes%20guide.pdf

[10] For a complete list of taxable services in Iowa, see http://www.state.ia.us/tax/educate/78524.html

[11] Consumption of services has risen from 44 percent of total consumption in 1969 to 59 percent of total consumption in 2002. Over the same period, consumption of nondurable goods has declined from 42 percent to 28 percent of consumption, and the consumption of durable goods has also declined slightly. U.S. Dept. of Commerce, Bureau of Economic Analysis, http://www.bea.gov/bea/dn/nipaweb/TableView.asp#Mid

[12] Sales tax yield is equal to net sales tax collections divided by state personal income, after controlling for sales tax rate changes. Personal income figures are from the Bureau of Economic Analysis and are converted to fiscal years. Sales tax collection figures are from the Iowa Department of Revenue and Finance.

[13] This approach was designed to provide long-term stability in tax collections, assuming further movement in consumption away from purchases of goods and toward purchases of services.

Iowa has also been unable to collect taxes on internet and mail-order sales. Up to $130.7 million in state and local tax revenue was lost in Iowa due to untaxed e-commerce in 2003. The amount of foregone revenue will increase over time as internet sales become more commonplace. By 2008, Iowa will lose as much as $266.4 million in revenue due to untaxed e-commerce.[14] Purchases over the internet and from out-of-state companies represent a fundamental shift in the economy that requires tax adjustment and modernization. Iowa has taken the first step to address this change by joining the Streamlined Sales Tax Project, a multistate project designed to simplify sales and use taxes. The movement of internet carriers into providing telephone services is another potential area for erosion of state taxes, by affecting the revenue currently raised on telephone service.

The share of total state taxes contributed by the corporate income tax has declined substantially over the last two decades. The corporate income tax contributed 8.3 percent of all tax revenue in 1979, 6.4 percent in 1989 and a mere 2.8 percent in 2003.[15] A major factor in this decline has been the movement toward more multi-state and multi-national corporations. Iowa has failed to close certain tax loopholes that allow these large corporations to avoid Iowa income taxes. Further, Iowa has enacted several tax cuts for businesses (the insurance premium tax rate was cut to 1 percent, the research activities tax credit was expanded, and tax cuts were implemented for subchapter S corporations) since 1996 that will reduce revenues by at least $133 million annually, when fully phased in.[16]

Iowa's overall state-local tax system is regressive.[17] This means that it takes a greater share of income from low and middle-income taxpayers than from the wealthy. In 2002, Iowa families earning less than $28,000 annually paid about 10.5 percent of their total income in taxes while families earning over $250,000 only paid about 7.9 percent.[18] At the same time, the growth in the economy disproportionately benefited those at the high end of the income bracket. Between 1988-90 and 1998-00, for instance, the percentage share of income earned by the top one-fifth of Iowa families grew from 40 percent to 43 percent.[19] A tax system that is regressive overall will not grow at the same rate as the population or public need if economic growth is concentrated at the top of the income spectrum.

An increasing share of earned income is being placed into tax-deferred retirement and other savings accounts. These include public and private pension systems (such as Social Security, IPERS and employer-sponsored pensions) and federally established retirement savings systems (IRAs, 403B pensions for certain public and non-profit employees, college savings plans, etc). The result of this growth in tax-deferred and tax exempt accounts has been a narrowing of the overall base of income subject to immediate taxation. Some of this income will never be taxed since a great deal of retirement income has been exempted from taxation. Further, federal proposals for "lifetime savings accounts" would expand these exemptions even more. As Iowa's population ages, a greater share of Iowans will be drawing down from their pension systems, which already are taxed at a lower rate than the same amount of earned income. The U.S. Census Bureau estimates that the share of the Iowa population of working

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[14] Bruce, Donald and William P. Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." July 2004. The University of Tennessee, Center for Business and Economic Research.
[15] Census of Governments. State Government Tax Collections. http://www.census.gov/govs/www/statetax.html
[16] Iowa Department of Management.
[17] In Iowa, the fiscal gaps of the early 1990s were closed by raising sales taxes. However, when fiscal conditions turned around in the mid-1990s, Iowa reduced income taxes in ways that mostly benefited higher-income taxpayers. The net effect of this combination of tax changes was to make Iowa's tax system more regressive by increasing taxes for all but the wealthiest 20 percent of Iowans.
[18] "Who Pays: A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, second edition, January 2003. http://www.itepnet.org/wp2000/ia%20pr.pdf
[19] State of Working Iowa 2003.

age will decline from 60 percent to 57.4 percent between 2000 and 2020. The share of the population 65 and older will increase from 14.9 percent to 20.2 percent during the same period.[20]

Ideally, the tax system should generate excess revenue during economic boom times, with the excess placed in reserves – a rainy day fund. This fund should be sufficient to sustain government services during a recession. Demand for many government services is actually higher during a recession, both due to increased need for so-called "safety net" services and increased need for public safety services. A structural deficit occurs when the tax system does not generate sufficient revenue over the course of the business cycle to maintain public services in good times and bad. Iowa's tax system and rainy day fund did not permit the state to maintain services and local government support during the current prolonged downturn.

The last five years would have been dramatically different if Iowa simply had not enacted many of the recent tax cuts. If no tax cuts had taken effect between 1996 and 2001, an additional $1.7 billion in revenue would have flowed into the rainy day funds and the general fund over that time. During the financial crisis from 2001 to 2004, an additional $1.8 billion in revenue would have been generated. The combined $3.5 billion surplus plus any interest earned would have been more than sufficient to cover the cumulative budget gap of $3.1 billion between 2001 and 2005. In fact, Iowa could have adopted 10 percent of the tax cuts and still avoided the budget cuts described in this series of reports.[21]

As it stands now, Iowa needs to collect about $514 million more than is currently projected by the Revenue Estimating Conference in order to afford a fully funded budget in FY06. The state must also replenish its two rainy day funds with $292 million and reimburse $290 million to the Senior Living Trust Fund and the Endowment for Iowa's Health Account. Ideally, the state should also, but is not required to, reimburse all special funds for the $2 billion taken since 2001.

Spending

Iowa used a combination of spending cuts and transfers in order to balance its budget between FY2001 and FY2005. While most other states restored some of the taxes cut during previous times or adopted new tax increases, Iowa chose to do neither. In fact, Iowa was the only state in the nation to *cut* taxes by more than 1 percent of expected revenue in FY2005.[22] And in the September 2004 special session of the Legislature, Iowa continued cutting taxes by adopting federal depreciation and expensing options that will cost Iowa $58 million in FY2005.[23]

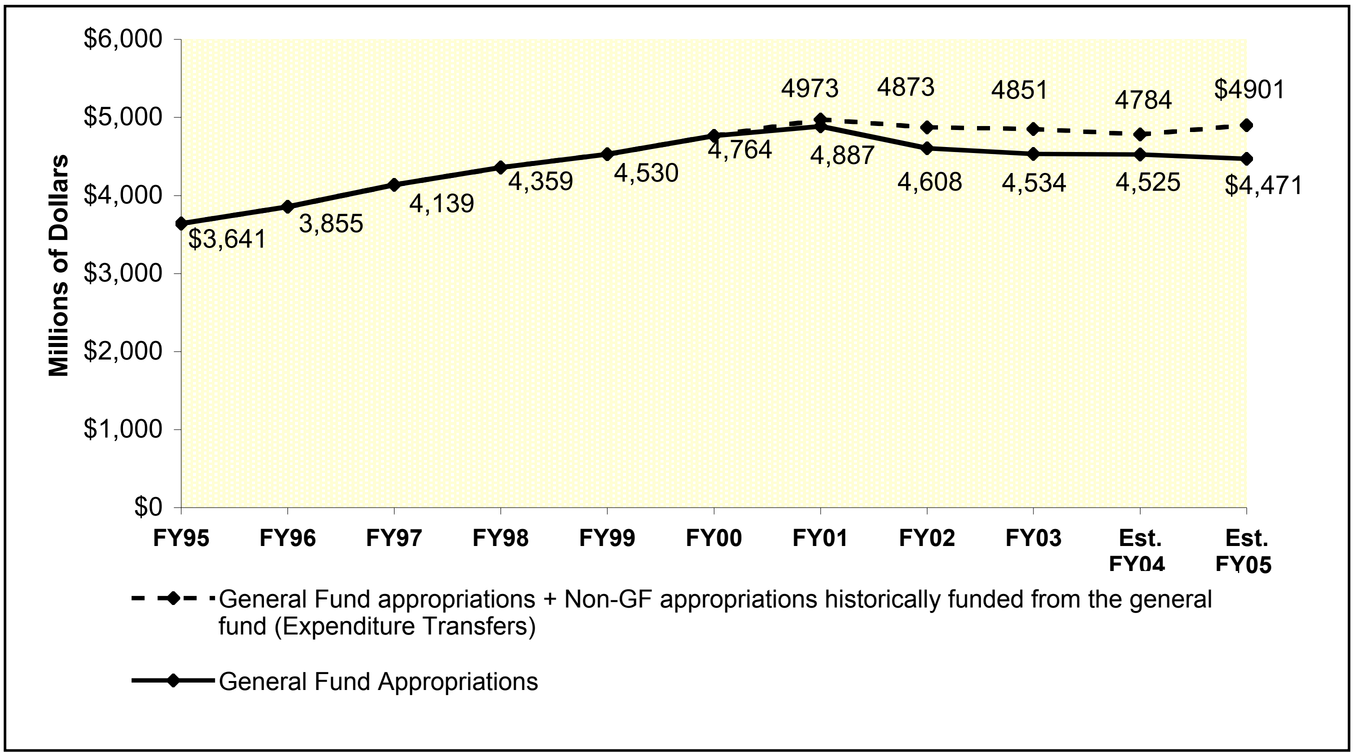
The solid line in Figure 3 shows that general fund (GF) spending has declined by $416 million since FY2001. The dotted line represents expenditure transfers, which are transfers of funding responsibilities (programs and services) from the general fund to special funds. Including these transfers, spending on general fund services in FY2005 was $71.9 million less than in FY2001. These budget cuts resulted in hiring freezes, layoffs, furloughs, delayed investments, and restricted travel and purchases.

[20] United States Census.
[21] Calculated by dividing the cumulative budget gap from FY01-FY05 of $3.1 billion by cumulative revenue lost due to tax cuts of $3.5 billion.
[22] Campbell, Lynn. "Iowa leads U.S. in cutting taxes." The Des Moines Register. July 21, 2004. The news article was based on a report by the National Conference of State Legislatures.
[23] Legislative Services Agency, Fiscal Update, October 29, 2004 (p.1).

The cumulative amount of expenditure transfers since FY2001 – about $1.36 billion – represents money that was cut from non-general fund services in order to pay for general fund services.[24] More than half of the $1.36 billion ($718 million) paid for Medicaid services; $154 million paid for K-12 education; and $160 million paid for property tax replacements. For a complete listing of GF programs that were transferred to non-GF sources, see Figure A-1 in the Appendix.

It is also important to note that between FY2001 and FY2005, $657 million was transferred to the general fund from non-general fund sources. Thus, GF spending (the solid line in Figure 3) would have been even lower if the General Assembly had not ordered these transfers. About half of the revenue transfers were from the rainy day funds. The rest represent funds that were originally intended for other purposes, but were diverted to pay for GF programs and services. Including revenue and expenditure transfers, $2 billion non-GF dollars were used to pay for general fund services between FY2001 and FY2005 (see Figure A-2 in the Appendix).

Figure 3. Funding for General Fund Services (in millions)



Source: Legislative Services Agency, Fiscal Service Division, State of Iowa.

Notes: General fund appropriations are before reversions, but after other adjustments, such as across-the-board reductions, restorations, and supplemental appropriations.

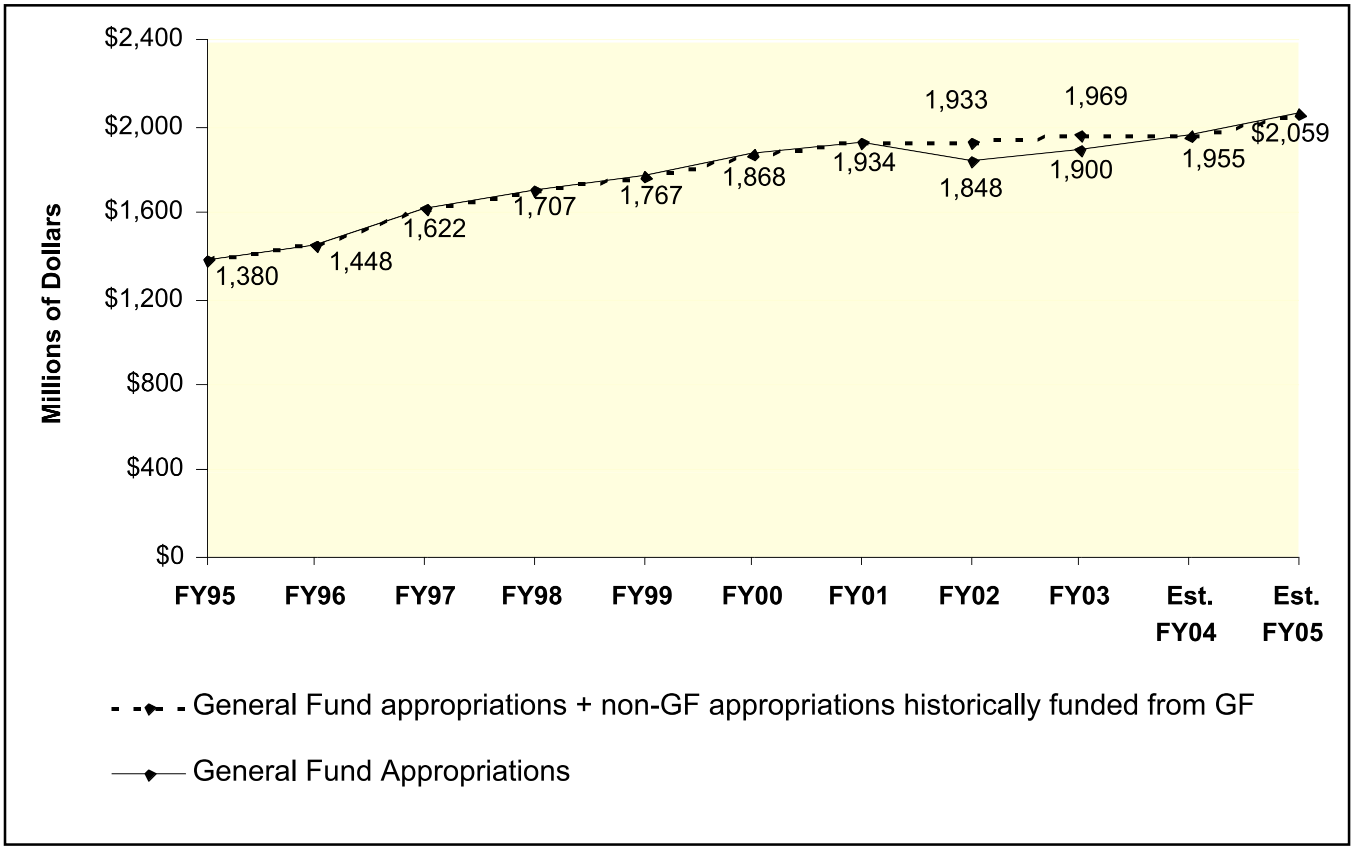
Major Spending Categories

<u>K-12 Education:</u> Iowa's budget crisis has slowed state funding growth for K-12 schools and forced the state to cover $154 million in spending from non-general fund sources (see Figure 4). General fund spending on K-12 education has been sustained better than other spending categories, causing K-12

[24] About $231.3 million of the $1.36 billion in expenditure transfers were to the rainy day funds, which technically were used correctly (to pay for GF expenses during emergencies).

education to increase from 40 to 46 percent of the general fund budget between FY2001 and FY2005. Although K-12 school enrollment has begun to decline slightly, state aid to K-12 school districts—the largest piece of the state budget—will continue to grow as labor costs, especially the cost of health insurance, increase.[25]

Figure 4. Funding for K-12 Education (in millions)



Source: Legislative Services Agency, Fiscal Services Division

Notes: Includes School Foundation Aid, Child Development, Educational Excellence, Early Intervention Block Grant, Instructional Support, Technology-School Improvement, Nonpublic Transportation, AEA 16 Supplemental, Student Achievement/ Teacher Quality, and Empowerment Boards

Higher Education: While K-12 education staved off large cuts, higher education was not so fortunate (see Figure 5). About $63 million in higher education spending was sustained by non-general funds between FY2002 and FY2004, but this was not enough to offset GF cuts. In FY2005, the Legislature allocated about $124 million less for higher education than in FY2001. As a percent of the GF budget, higher education has dropped from 18.9 percent in FY2001 to 17.9 percent in FY2005. These cuts have impacted higher education in a variety of ways, but the most notable effect has been a 62 percent average increase in tuition at Iowa's Regent institutions (FY01-FY05) and 33 percent average increase at Iowa's community colleges (FY01-FY04).[26] The Board of Regents has indicated tuition increases will be likely if the General Assembly does not provide the $40.0 million in additional general funds

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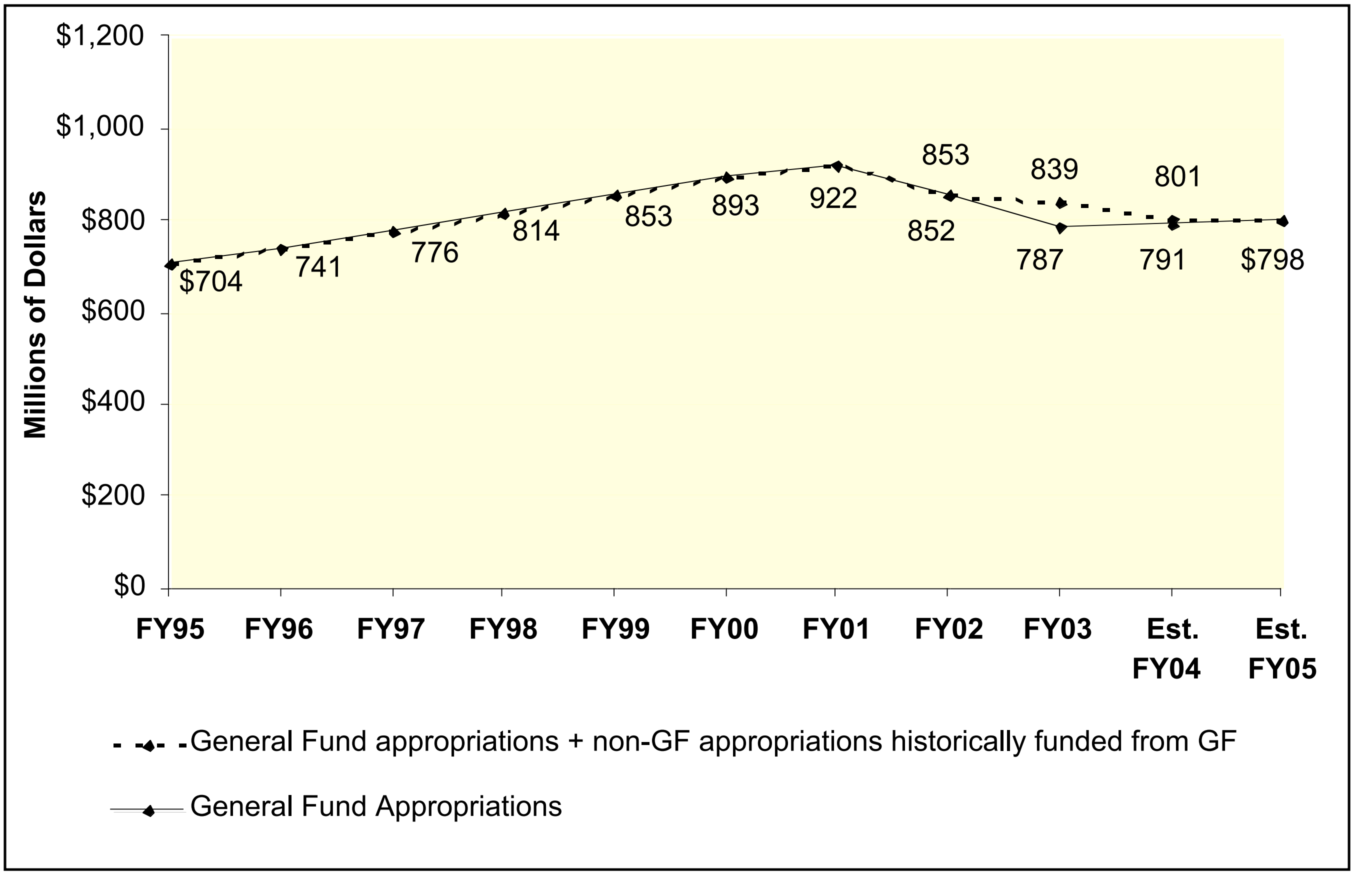
[25] See *Iowa's State Fiscal Crisis and Its Impact on Education: Erosion of Support at All Levels*, Iowa Fiscal Partnership, November 22, 2004.

[26] Jeremy Varner and Elaine Ditsler, *Iowa's Fiscal Crisis and Its Impact on Education: Erosion of Support at All Levels*, Iowa Fiscal Partnership, November 22, 2004.

requested by the Board for FY 2006. An earlier report in this series, *Iowa's State Fiscal Crisis and Its Impact on Education*, provides greater detail about how education has fared during the last several years.

Figure 5. Funding for Higher Education (in millions)



Source: Legislative Services Agency, Fiscal Services Division

Notes: Includes community colleges, Regents, & college aid

Medicaid Services: Medicaid has largely been protected during the fiscal crisis because the General Assembly has shifted the cost of Medicaid to non-general fund sources (see Figure 6).[27] Between FY2001 and FY2005, non-GF sources have paid for 27 percent, or $717.8 million, of total Medicaid costs. The majority of this money, or $456.8 million, was taken from the Senior Living Trust. In fiscal 2005, $134.3 million was appropriated from the Senior Living Trust Fund for Medicaid services – an amount equal to 24 percent of the total state Medicaid appropriation.

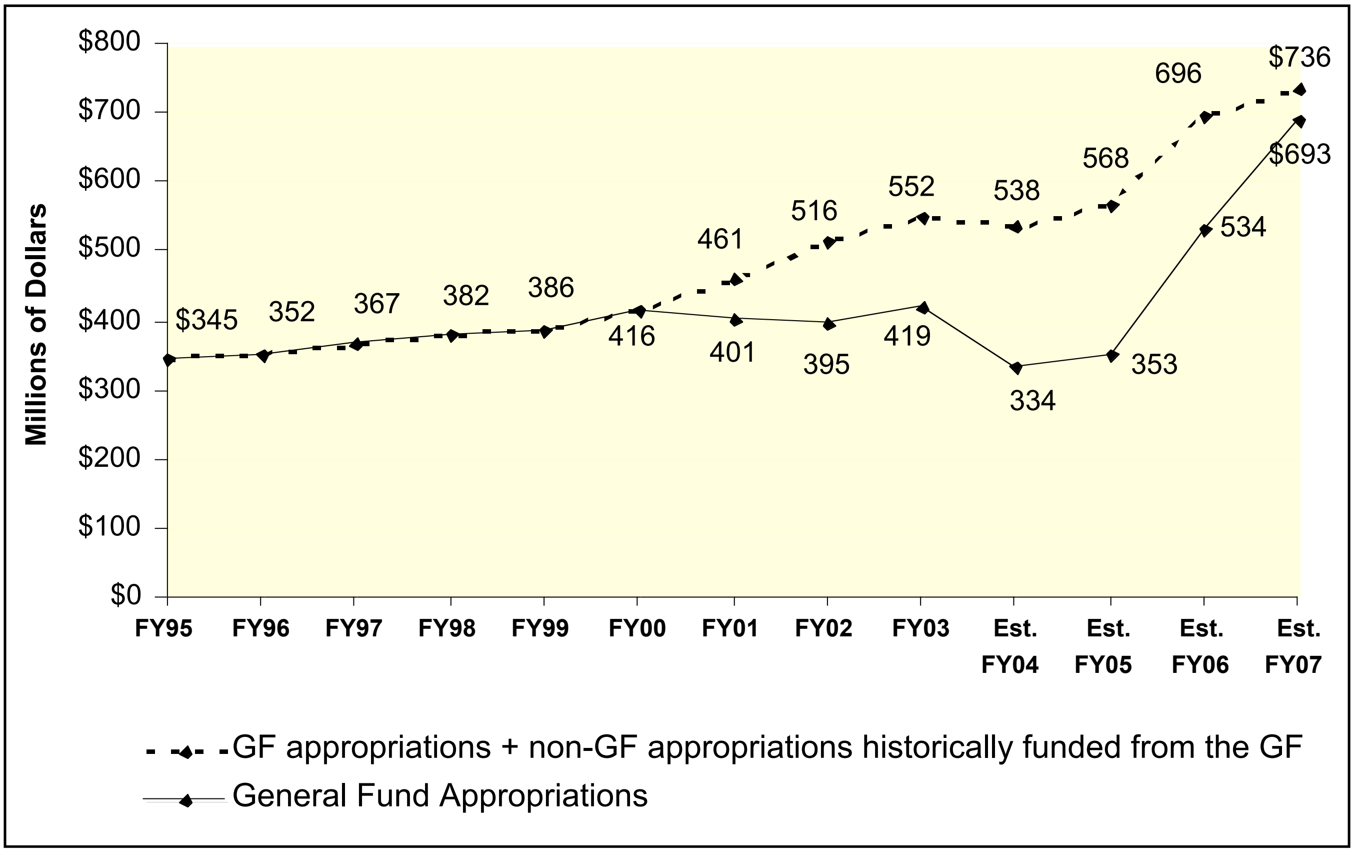
While there were not major changes in the Medicaid program, in terms of persons eligible for service or persons served, and while Medicaid continued to provide a health care safety net, this does not mean that it fully met the increased needs during this period. In fact, the number of uninsured Iowans has increased over the last few years because employers have canceled coverage or raised worker contributions to the point that coverage is unaffordable. Family coverage is increasingly difficult to

[27] These figures include exclude SCHIP. For more information about Medicaid, see *Iowa's State Fiscal Crisis and Its Impacts on Human Services: New Holes in the Safety Net* by the Iowa Fiscal Partnership.

obtain from employers, forcing many children of working parents to enroll in Medicaid (or HAWK-I) or be uninsured.[28]

While Medicaid avoided major cuts or restrictions, the same cannot be said for the rest of the Department of Human Services' programs. Over one-third of the state's mental health institute beds were closed; the state ended its long-time emergency assistance program; and despite a 20 percent increase in child abuse cases, the child welfare budget remained flat (declined in inflation-adjusted dollars) over these years. These impacts are discussed in more detail in another report in this series, *Iowa's State Fiscal Crisis and Its Impact on Human Services: Holes in the Safety Net.*

Figure 6. Funding for Medicaid (in millions)



Source: Legislative Services Agency, Fiscal Services Division

Notes: According to the DHS, the FY2005 appropriation of $568 million for Medicaid will likely be between $52 and $85 million short. FY2006 projection will increase $66 million if federal intergovernmental transfers are eliminated. Excludes SCHIP.

Iowa's Medicaid program is likely to face increased demands in the future if it is to continue to cover children, the elderly, and persons with disabilities for whom there is no other coverage. The elimination of some federal dollars could also increase state Medicaid costs, including the elimination of intergovernmental transfers and their benefits to states, targeted case management options, and coverage of rehabilitative treatment services for children in Iowa's child welfare system. Federal-level proposals to shift more Medicaid costs to the states would also put more demands on Iowa's budget.

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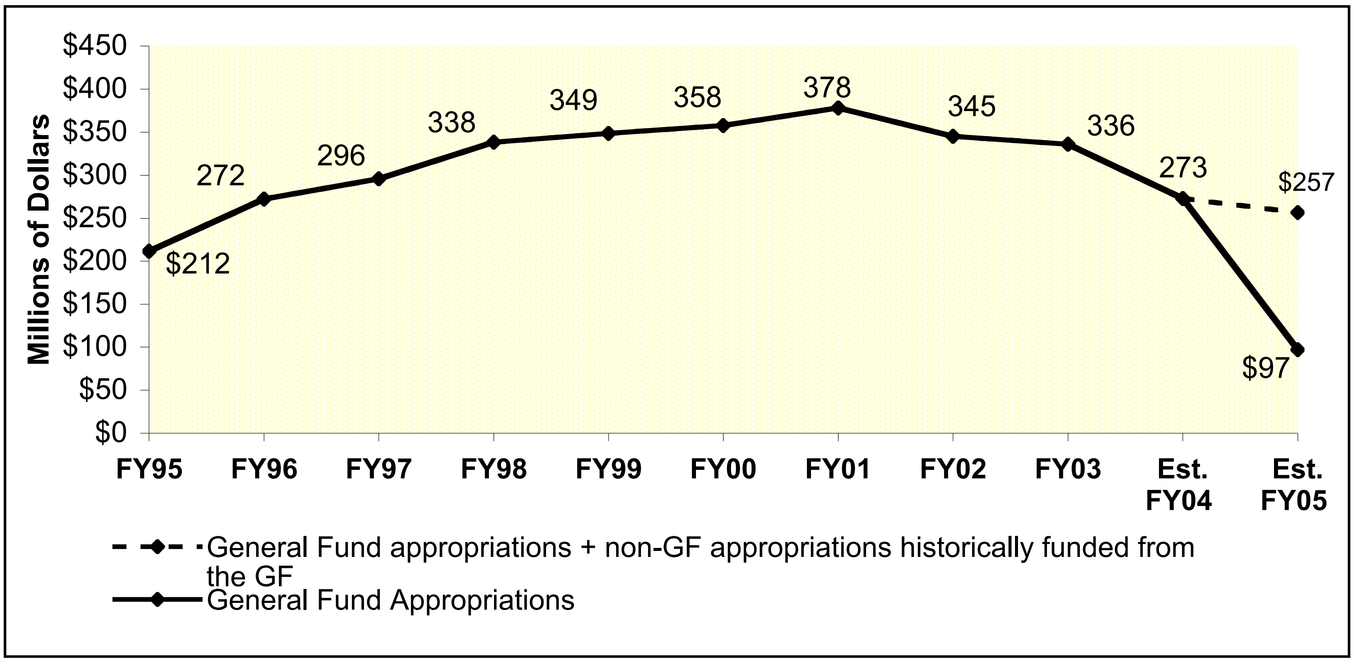
[28] Bruner, C. (2004). The Iowa Health Care Crisis Without Medicaid – The Role of Medicaid and *HAWK-I* in Covering Children. Des Moines, IA: Every Child Counts Network.

Iowa's aging population will place new responsibilities on Medicaid as individuals exhaust their retirement assets and become "dually eligible" for Medicaid and Medicare. In 1999, Iowa ranked fifth in the nation in the percentage of residents over age 65 (14.9 percent) and led the nation in the percentage of residents over age 85 (2.3 percent). According to Census projections, Iowa will have about 533,000 residents over age 65 in 2015 (an increase of 22 percent over the year 2000) and 686,000 residents over age 65 in 2025 (an increase of 57 percent over the year 2000).[29]

While the senior and disabled populations currently account for a small share of the total Medicaid population in Iowa, they account for a large share of total expenditures, primarily because of nursing facility costs.[30] Many of these nursing home patients were solidly middle class people who exhausted their assets and now rely on Medicaid. Nursing and intermediate care facility costs, and their in-home care alternatives, accounted for 39 percent of all Medicaid expenditures in FY2003. Prescription drugs accounted for another 16 percent of all Medicaid expenditures.[31]

Property Tax Replacements: The state has cut the amount appropriated for property tax credits as a result of the state budget crisis (See Figure 7). In FY2005, the Legislature appropriated $118.7 million less than in FY2001. Claims for the Elderly and Disabled Tax Credit, the Homestead Tax Credit, and the Military Credit were pro-rated as a result of state under-funding. Further, the state permanently eliminated the Personal Property Tax Replacement Credit in FY2004 and accelerated the phase-out of the Machinery & Equipment Tax Credit. By cutting property tax replacements and credits, the state

Figure 7. Funding for Property Tax Replacements (in millions)



Source: Legislative Services Agency, Fiscal Services Division

Notes: Includes Mental Health Tax Relief, Machinery/Equip. Tax Replacement, Property Tax Replacement Credit, Livestock Producers Credit, Homestead Tax Credit Aid, Ag Land Tax Credit, Military Service Tax Credit, Elderly & Disabled Tax Credit, and Franchise Tax Reimbursement

[29] "Population, Demographics, and Elderly Services." *Profiles (IHA Annual Fact Book).* 20th Edition. Iowa Hospital Association. http://www.ihaonline.org/publications/profileserv/Section%20VII-%20Population%20Demographics%20and%20Elderly%20Services.pdf

[30] *Medicaid Update*, Issue Review, Iowa Legislative Services Agency, December 19, 2003. http://staffweb.legis.state.ia.us/lfb/docs/IssReview/2004/IRJHV000.PDF

[31] ibid.

passed its budget problems onto local governments, property owners, and renters, which contributed to increases in local property tax rates. Another report in this series, *Iowa's State Fiscal Crisis and Its Impact on Local Governments*, examines how these cuts, coupled with rising costs, squeezed city and county budgets.

Special Fund Balances

In order to balance the budget, some services (particularly under Medicaid) that were historically funded with GF revenues were paid for with special fund (non-general fund) money. Between FY01 and FY05, $2 billion was taken from special funds and used for GF programs (see Figure A-2 in the Appendix).[32] About $657 million of the $2 billion were revenue transfers, which are transfers of money from a special fund to the general fund (see Figure A-3 in the Appendix). The rest were expenditure transfers, which are transfers of funding responsibilities (programs and services) from the general fund to special funds (see Figure A-1 in the Appendix).

As a result of all this shifting of money, special fund balances have declined dramatically, the intent of the special funds has not been realized, and some funds are in danger of being depleted.

Table 1. Ending Fund Balances (in millions)

	FY2001	FY2002	FY2003	FY2004	Estimated FY2005	Projected FY2006	Projected FY2007
Senior Living Trust Fund	60.9	127.0	366.8	286.1	139.4	-11.0	-123.0
Endowment for Iowa's Health	-	22.4	25.8	27.5	39.2	n/a	n/a
Restricted Capital Fund	-	427.7	253.2	110.2	45.8	15.4	0.4
Cash Reserve Fund	235.6	140.1	205.5	159.7	177.4	362.8	362.8
Economic Emergency Fund	169.6	25.2	3.3	3.3	3.3	108.8	120.9
Total	466.1	742.4	854.7	586.8	405.1	476.0	361.2

Source: Legislative Services Agency, Fiscal Services Division

Notes: The Endowment and Restricted Capital Fund were created in FY2002. n/a = not available.

Senior Living Trust Fund

The Senior Living Trust Fund was established in 2001 and was originally intended as source of funding to help the elderly to stay in their homes instead of going into nursing facilities. With the fiscal crisis, it has become a popular source of funding for programs that previously had been funded by the general fund. Between FY2001 and the end of FY2005, the trust fund will have paid for $490.2 million in GF programs, the vast majority of which ($448.3 million) was for Medicaid. About 88 percent of total trust fund expenditures were spent on Medicaid, while only 3 percent were spent on conversion grants for in-home care (which was the original purpose of the trust fund).

The trust fund was capitalized with deposits from the federal government. However, the federal government is discontinuing these transfers, and the Trust Fund will no longer receive deposits. As a result, the fund is likely to be depleted by FY2006 (see Table 1). Going forward, the important funding

[32] This $2 billion figure include expenditure transfers and revenue transfers. Figure A-2 in the Appendix shows the amount of money that was taken from each special fund to pay for GF programs

that the Senior Living Trust Fund has provided to the Department of Human Services (over $485 million, primarily for Medicaid) and the Department of Elder Affairs (over $31 million between FY2001 and FY2005) will have to be replaced with general fund money.

Endowment for Iowa's Health Account (Tobacco Settlement Trust Fund)

The Endowment for Iowa's Health Account was established in 2002 and was intended as a future endowment for health-related programs. About $435 million in state wagering taxes, $139.7 million in general fund appropriations, and $39.6 million from the securitization of a portion of Iowa's tobacco settlement payments was to be dedicated to the Endowment between FY2002 and FY2007. Primarily through long-term interest earnings, this account was to grow to $1.4 billion by 2030.[33] However, a total of $85.2 million for the Endowment was de-appropriated from the general fund between FY2002 and FY2005. Another $130.3 million was transferred to pay for GF programs, $10.9 million was transferred to the Rebuild Iowa Infrastructure Fund, and the majority of some $245.5 million that was appropriated to the Healthy Iowans Tobacco Trust was ultimately spent on general fund programs, primarily Medicaid. As Table 1 shows, the Endowment is estimated to have a balance of $39.2 million in FY2005. Due to reductions in funding and the resultant loss of long-term interest earnings, the Endowment will not grow to $1.4 billion by 2030 as originally planned. Instead of providing a way to pay for the medical expenses of the aging baby boomers, the Endowment only reach a tiny fraction of the $1.4 billion originally planned.

Restricted Capital Fund (Tobacco Settlement Trust Fund)

Like the Endowment, the Restricted Capital Fund was established as a result of the securitization of Iowa's tobacco settlement payments. About $540 million in net tax-exempt proceeds were placed into the Capital Fund in 2002. Appropriations from the Fund initially were required to be used only for depreciable assets, such as for qualified capital projects and debt service. Since FY2001, about $94.1 million was taken from the Capital Fund and used to pay for general fund services. Since the Restricted Capital Fund was established with a one-time infusion of money, the use of these funds for general fund services has led to a rapid decline in the fund balance. The fund is projected to have an ending balance of only $400,000 by the end of FY2007 and to be exhausted in FY2008 (see Table 1).

Rainy Day Funds

Iowa has two reserve funds that receive a portion of tax revenues each year, the Cash Reserve Fund and the Economic Emergency Fund. They are essentially the state's savings accounts. They are resources that are available to the state to deal with unforeseen emergencies or events, such as a major downturn in the economy, a major natural disaster, or other unforeseen occurrences. In 2001, Iowa's reserve funds were filled to their legal maximum for a combined $486 million "in the bank."

Since that time, however, a total of $297.2 million has been taken from the Cash Reserve Fund and $241 million from the Economic Emergency Fund. The FY2005 ending fund balance for the Cash Reserve Fund is estimated at $177.4 million, down from $235.6 million in FY2001. For the Economic Emergency Fund, the FY2005 ending fund balance is estimated at $3.3 million, down from $169.6 million in FY2001.

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[33] *Endowment for Iowa's Health Account: Analysis of Projected Value.* Issue Review. January 28, 2003. Iowa Legislative Fiscal Bureau.

The Public Sector Workforce and Overall Economy

The State of Iowa has unwittingly deepened its own recession by curtailing spending and pushing up unemployment. The result was not only layoffs in the public sector, but also in the agencies and companies who operate under purchase-of-service or other contracts with the state, particularly nonprofit agencies providing human services. Nobel Laureate economist Joseph Stiglitz has noted that reductions in state spending can exacerbate economic recessions because a reduction in government spending is likely to be more harmful to the economy in the short run than an increase in taxes. By pushing up unemployment, the state has caused layoffs at many other businesses as well, due to the cumulative effect of having more unemployed Iowans with less income to spend (the multiplier effect).

The number of full-time state workers decreased by 1,585 employees between FY2001 and FY2003. Additional workers were laid off by private contractors and providers due to the state budget crisis, although there are not specific estimates for those figures. For instance, almost all child welfare and juvenile justice services are provided through purchase-of-service contracts with non-profit providers, many of whom have been forced to reduce staff due to cuts from the state. The authorized (budgeted) number of full-time state employees for FY2004 and FY2005 has increased over the FY2003 number but is still below the FY2001 level. Furthermore actual figures are almost always less than the authorized figures, so it is still unclear whether the state did increase its employees during FY2004.

Table 2. Full-Time Equivalent Employees, State of Iowa

	Actual FY 2001	Actual FY 2002	Actual FY 2003	Budgeted FY 2004	Budgeted FY 2005
Administration and Regulation	2,023	1,888	1,784	1,956	1,969
Ag. and Natural Resources	1,464	1,388	1,374	1,537	1,539
Economic Development	1,096	1,129	1,076	1,271	1,265
Education	26,394	26,626	26,681	26,291	26,281
Health and Human Services	6,773	6,524	6,302	6,759	6,868
Justice System	8,117	7,973	7,569	7,971	8,037
Trans., Infra., and Capitals	3,708	3,436	3,214	3,538	3,517
Unassigned Standing	412	412	401	401	401
Grand Total	**49,987**	**49,377**	**48,402**	**49,725**	**49,878**

Source: Iowa Fiscal Services Division, Legislative Services Agency

Outlook and Policy Recommendations

Iowa's response to the state fiscal crisis over the last four years has not addressed the underlying cause of that crisis – the structural deficit that in large measure was the result of large tax cuts enacted from 1995 to 2000 (and exacerbated by further cuts since 2001, despite the recession and budget shortfalls). This structural deficit will worsen, as previously enacted tax cuts continue to be phased in, while service needs and costs continue to rise. Iowa must address this structural deficit and, in doing so, must also recognize that changing demographics and a changing economy require tax modernization. The following is a very broad-brush description of these changes and their implications for tax policy.

1. Changes toward a more service- and information-based economy

The country has moved from a goods-based manufacturing economy to a much more service-based economy. One of the consequences has been that a sales tax based upon goods no longer collects revenue in an amount that reflects consumer spending. Extending the sales tax to a much broader range of consumer purchasing activities is needed to sustain the sales tax as a revenue source that reflects such purchasing.

2. The broadened boundaries for business

In recent years, multi-state businesses have found new and very effective ways of exploiting loopholes in state tax codes. These loopholes allow them to shift taxable income from one state to another to minimize their corporate income tax bill. Moving to combined reporting is one necessary way to ensure that firms conducting business in Iowa are subject to taxation here. In addition, seeking to ensure that businesses profiting from sales in Iowa establish a taxable connection (nexus) in the state is important, as are other efforts to ensure businesses pay state taxes on all their profits. Some of these issues can be resolved in Iowa legislation, but others may require aggressive action to ensure Congress continues to enable states to collect taxes and establish nexus.

3. The internet and its impact

The growth of the internet as a means for handling commerce has been huge and is expanding. Iowa has taken steps to collect sales taxes on internet sales to Iowans, and this is an important first step. Other forms of commerce, such as telephone service, will also increasingly be handled through the internet. It is critical that states have the authority to tax internet commerce simply for reasons of tax equity, since non-internet-based providers of goods and services are taxed through other channels. Failure to do so, moreover, is likely to have significant impacts upon state tax collections.

4. The aging of society and the growth in retirement income

Iowa is continuing to age. In 2000, there were four working-age people (18-64) for every person over 65; by 2020, that figure will decline to less than three working-age people. Not only does that put a greater responsibility on those working to support their families, it also places challenges on the state tax system. Those over 65 are increasingly well-off through Social Security and pension fund benefits. However, this income is taxed at a lower rate than income from work. Iowa law currently exempts from taxes the first $6,000 of pension income ($12,000 if married filing jointly). And because of generous exemptions for Social Security income, over two-thirds of Social Security recipients pay no tax on their benefits, and the remaining recipients pay tax on, at most, 50 percent of their benefits. The theory is that we should encourage retirement savings by deferring the tax on investment income until those savings are used. However, there have already been some actions taken to exempt this income from taxation in the retirement years as well. This dramatically narrows the base of income subject to taxation and removes the justification made for deferral of taxes on pension savings in the first place. Tax policies should not exempt more of this income from ever being taxed, at the risk of severely narrowing the base from which tax can be collected. The same holds for a total repeal of the inheritance tax, as, in many inheritances, much of the wealth has never been taxed.

5. Trends toward the concentration of wealth and income

Those who have benefited most from economic growth over the last 20 years have been individuals at the very top of the income and wealth scale. The United States has experienced a significant increase in income and wealth inequality over this period, but this has been somewhat masked by the general growth that enabled most people to move ahead. Long-term, however, growing inequality is not considered economically or socially desirable. Further, a state tax system that is regressive (like Iowa's overall system), will not experience growth commensurate with economic activity. A flat (proportional) or progressive overall tax system is needed to ensure that state government continues to collect the revenues needed to support basic services. The individual income tax remains the only progressive tax in Iowa's overall tax structure. It needs to be more progressive in order to compensate for the much larger regressive parts (sales and property) of the tax code.

6. The growth in tax expenditures as a tool for economic development

Particularly when there was strong state revenue growth, the state enacted a number of tax "incentives" marketed as supporting economic growth and development. Unlike appropriations, these tax expenditures are not reviewed annually and do not require re-enactment, nor are they limited in terms of their overall expense to the treasury. Some of the estimates of their cost to the treasury were far below what they eventually cost. Additionally, it has been hard to track their overall costs, let alone determine whether they achieved their economic development justification. The decline in corporate tax revenues is one sign that these tax expenditures have reduced tax collections substantially. These expenditures need to be reviewed on a periodic basis and held up to much greater public scrutiny. They need to be much more transparent than they currently are, with required disclosures of the tax filers who make use of them and the size of their benefits. They should receive at least as much scrutiny as line item expenditures in the state budget.

7. Other trends that will reduce revenues or increase spending needs

- Nationally, the federal deficit is creating new calls to restrict domestic spending and take such actions as block granting Medicaid and Title IV-E (foster care), which is likely to translate into reduced revenues to state governments.
- Federal actions may be taken to restrict state authority to tax – from e-commerce to definitions of taxable connection (nexus) to determinations of taxable income under corporate and individual income taxes.[34]

[34] While Iowa can choose not to couple with federal tax changes regarding deductions and taxable income, this complicates tax filing and is often difficult to achieve politically. Further, it places additional responsibilities on sole state enforcement rather than adherence both to state and IRS regulations and laws.

- The rapid rise in health care costs will continue to drive inflation in the cost of state and local government well above increases in the general cost of living and require government to take a larger share of personal income just to maintain services.
- The "sin tax" revenues that Iowa has counted on to balance budgets are not likely to grow with the economy, as tobacco consumption declines and the state reaches the saturation point in gambling revenues.
- The continuing rise in prison populations due to sentencing reform measures in the 1990s will continue to drive up corrections expenditures.
- City, county and school budgets will continue to be strained by the urbanization of the population combined with urban sprawl, which leaves an aging and expensive infrastructure with excess capacity in rural areas, while demands for urban services in developing suburbs continue and the fiscal capacity of central cities and older suburbs declines.

It's time for a long range look at Iowa taxes. The current Iowa tax system – relying primarily upon sales, income and property taxes – requires modernization if it is to continue to provide the revenues, in a fair and competitive manner, that state government needs to fulfill its responsibilities. As earlier reports have indicated, this requires attention to closing tax loopholes and establishing tax policies based upon recognized principles of tax reform. Further, it requires looking into the future and recognizing the need to modernize the system to reflect dramatic changes in the economy and Iowa life.

Appendix

Expenditure Transfers (GF Expenditures Shifted to Special Funds)

	Cumulative FY01-FY05 (in millions)
Medical Assistance (Medicaid)	$717.8
Property Tax Credits	159.6
ICN and Prison Debt Service	62
Substance Abuse (DPH)	57.3
Tuition Replacement (Regents)	48.9
Elderly Svcs (DEA)	31.8
Soil Conservation Cost Share (Ag)	22
Soil Conservation Division (Ag)	0.6
DHS Programs	17.9
DNR Park Operations	4
Assisted Living/ Adult Day Care	1.6
Capitol Security (DPS)	2.5
Aviation Programs (DOT)	1
Value Based Treatment (DOC)	0.4
K-12 School Foundation Aid	89.9
Student Achievement/ Teacher Quality	63.9
State Employee Salaries	68.1
Indigent Defense (DIA)	2.7
Military Pay Differential	1.8
State Appeal Board	1.5
Unemployment Compensation	1
Elderly Tax Credit	0.5
Performance of Duty	0.4
TOTAL	$1,357.2

Figure A-1. Source: Legislative Services Agency, Fiscal Services Division

Special Fund Revenue Used for GF Programs (Revenue & Expenditure Transfers)

	Cumulative FY01-FY05 (in millions)
Tobacco Proceeds (before securitization)	$96.9
Cash Reserve Fund	297.2
Senior Living Trust Fund	490.2
Healthy Iowans Tobacco Trust	206.3
Hospital Trust Fund	92.5
Restricted Capital Fund	94.1
Environment First Fund	55.1
Rebuild Iowa Infrastructure Fund	43.8
Endowment for Healthy Iowans	130.3
Economic Emergency Fund	241
Underground Storage Tank Fund	57
Regents Demutualization	30
Insurance Premium Tax	10
Terminal Liability Fund	3.5
Physical Infrastructure Assis. Fund	2.5
Strategic Investment Fund	2
Alternative Drainage Assist. Fund	1.1
DNR-Snowmobile Fund	1
Victims Compensation Fund	1
All Terrain Vehicle Fund	0.8
Value Added Agriculture Fund	0.3
Aviation Assistance Fund	0.3
Enhanced Court Collections (Judicial)	4
Reserve Fund Interest	28.4
Demutualization Unclaimed Property	26.7
Prison Infrastructure Fund	31.8
School Infrastructure Fund	22
AEA Balance Transfer	10
Recreation Trails Fund	5.5
Groundwater Protection Fund	5.2
Waste Tire Fund	4.6
Abandoned Property	3.7
Title Guarantee Fund	2.7
Vehicle Depreciation Fund	4.4
Other Fund Transfers	3.5
Risk Pool	1.5
Brucellosis & Tuberculosis Fund	1
DED- Strategic Investment Fund	1
Jury and Witness Fund	1
TOTAL	$2,013.9

Figure A-2. Source: Legislative Services Agency, Fiscal Services Division

Revenue Transfers (Non-GF revenue transferred to the GF)

	Cumulative FY01-FY05 (in millions)
Economic Emergency Fund	$171.1
Cash Reserve Fund	135.8
Tobacco Settlement (before securitization)	64.6
Endowment for Healthy Iowans	51.0
Rebuild Iowa Infrastructure Fund	35.3
Prison Infrastructure Fund	31.8
Reserve Fund Interest	28.4
Demutualization Unclaimed Property	26.7
Environment First Fund	25.9
School Infrastructure Fund	22.0
Underground Storage Tank Fund	10.0
AEA Balance Transfer	10.0
Healthy Iowans Tobacco Trust	6.0
Recreation Trails Fund	5.5
Groundwater Protection Fund	5.2
Waste Tire Fund	4.6
Vehicle Depreciation Fund	4.4
Enhanced Court Collections (Judicial)	4.0
Abandoned Property	3.7
Other Fund Transfers	3.5
Title Guarantee Fund	2.7
Risk Pool	1.5
Brucellosis & Tuberculosis Fund	1.0
DED- Strategic Investment Fund	1.0
Jury and Witness Fund	1.0
Total	$656.7

Figure A-3. Source: Legislative Services Agency, Fiscal Services Division