The Economic Effects of 1997 and 1998 Iowa Tax Law Changes

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Introduction

During 1997 and 1998 the Iowa Legislature enacted and Governor Branstad signed into law a number of reductions in State taxes. Included among these law changes were a 10% reduction in individual income tax rates, a partial repeal of the inheritance tax, and increases in a number of income tax credits and exclusions. Leading up to the 1997 Legislative Session, tax revenues net of refunds increased by $200 million (5.4%) or more each of the preceding three fiscal years. Given the strength of the national economy at the time, there existed an expectation for continued strong revenue growth even after the tax cuts went into effect. In fact, many of those that supported the legislation believed the tax cuts would stimulate the State's economy enough to generate additional tax revenue.

The belief that tax cuts will stimulate additional economic growth has led to some state legislatures and to Congress requiring fiscal analysts to incorporate behavioral effects into their estimates of the impacts of proposed tax law changes. This augmented fiscal impact estimation is commonly referred to as "dynamic scoring." [1] Currently, in Iowa neither the Legislative Services Agency (LSA) nor the Department of Revenue (DOR) dynamically score their fiscal impact estimates. Nevertheless, there exists an interest in determining after the fact how tax law changes have affected the State's economy. That is the purpose of this paper.

The first section of the paper summarizes major tax law changes enacted during the 1997 and 1998 sessions of the Iowa General Assembly. Section Two presents the fiscal impact estimates prepared at the time the legislation was under consideration. Section Three analyzes the actual impacts of the law changes on State tax revenues. The economic impacts of the legislation are described and analyzed in Section Four. The paper concludes with a discussion of the implications of the paper's findings for how future fiscal impact estimates may be improved.

1997 and 1998 Tax Legislation

Two major tax bills were enacted during the 1997 session of the Iowa General Assembly. House File 388 reduced the tax rate for each of Iowa's nine individual income tax brackets by 10 percent. Prior to the law change Iowa's tax rates ranged from 0.40% on the first $1,112 of taxable income to 9.89% on taxable income over $50,040. [2] With the law change the bottom rate decreased to 0.36% and the top rate decreased to 8.98%.

Senate File 35 eliminated the State inheritance tax for direct ascendants (e.g., parents, grandparents, great-grandparents, etc.) and descendants (e.g., children, grandchildren, great-grandchildren, etc.) of the deceased person, and for stepchildren. Previous to the law change only the surviving spouse was exempt from inheritance tax. Children could receive bequests tax free of up to $50,000, but beyond that amount they paid inheritance tax based on a graduated rate structure ranging from 1 percent to 8 percent. Parents, grandchildren, and other lineal descendants previously enjoyed only a $15,000 exemption and they paid inheritance tax at rates of from 1 percent to 8 percent on the value of bequests in excess of the exemption amount. Grandparents received no exemption and paid inheritance tax on the full value of bequests at rates ranging from 10 percent to 15 percent. Similarly, stepchildren were required to pay inheritance tax on the full value of bequests at rates ranging from 5 percent to 10 percent.

During the General Assembly's 1998 session a single bill, House File 2513, made four major changes to the State's individual income tax. Division I of the bill increased the exclusion for capital gains income in determining Iowa adjusted gross income. The most significant change made by this division involved totally exempting capital gains from the sales of real property and tangible personal property associated with the sale of a business. Previously the exclusion amount for capital gains income arising from such transactions was 45 percent of the gain up to a maximum of $17,500 in aggregate for all involved property owners. Division II of the bill increased the pension income exclusion amounts from $3,000 to $5,000 for single taxpayers and from $6,000 to $10,000 for married taxpayers filing joint returns. Division III of the bill increased the personal credit amounts from $20 to $40 for estates and trusts, single individuals, and married taxpayers filing separate returns and from $40 to $80 for unmarried heads of household and for married taxpayers filing joint returns. Division IV of the bill increased the credit for tuition and textbooks for kindergarten through 12th grade students from 10 percent to 25 percent of the first $1,000 of qualifying expenses per dependent. In addition, the definition of qualifying expenses was broadened to cover many types of expenses associated with participation in extracurricular activities.

All of these law changes had effective dates of January 1, 1998.

Fiscal Impact Estimates

The official responsibility for preparing fiscal impact estimates for proposed legislation rests with the Legislative Services Agency. [3] For the 1997 and 1998 Legislative Sessions the LSA used a model developed for that agency by KPMG – Peat Marwick/ the Barents Group to estimate the impacts of the individual income tax law changes. For these bills the Department of Revenue also prepared estimates. The LSA model used blended sample data derived from federal and State tax returns filed by Iowa taxpayers. The Department of Revenue model simulated the proposed law change impacts using all returns from a base tax year. The difference between the databases used by the two models resulted from a restriction placed on legislative access to actual tax return information. As a result, the LSA and Department of Revenue fiscal impact estimates were slightly different.

The Department of Revenue did the only fiscal impact estimate for Senate File 35. This was because information from inheritance tax returns is not maintained in an automated information system. Consequently, estimation of the impact of the legislation to partially repeal the inheritance tax was based on a sample of returns compiled by the Department of Revenue. Restrictions on access to these data prevented the Legislative Services Agency from making its own estimate.

The following table summarizes the fiscal impact estimates released by LSA for House File 388, Senate File 35, and House File 2513. Amounts are in millions of dollars.

Bill No. and Description	**FY 1998**	**FY 1999**	**FY 2000**
H.F. 388: 10% Individual Income Tax Rate Reduction	$ 103.0	$ 202.0	NA
S.F. 35: Inheritance Tax Partial Repeal	$ 19.0	$ 45.7	NA
H.F. 2513: Capital Gains Exclusion	$ 0.0	$ 18.0	$ 18.5
H.F. 2513: Pension Income Exclusion	$ 0.0	$ 20.0	$ 18.0
H.F. 2513: Personal Credit Increase	$ 0.0	$ 28.8	$ 26.2
H.F. 2513: Tuition/Text Credit Increase	$ 0.0	$ 3.8	$ 3.8
Total Estimated Impacts	$ 122.0	$ 318.3	NA

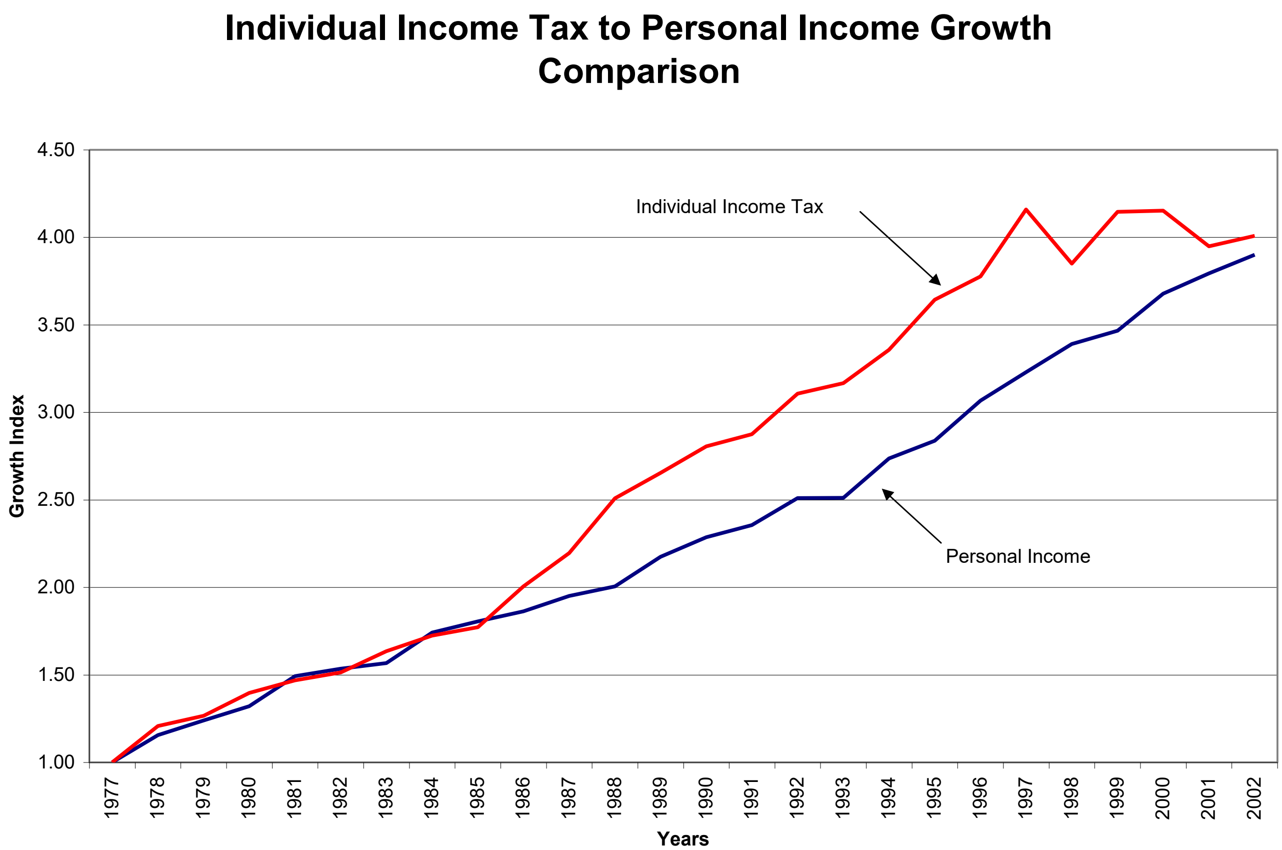
Generally, fiscal impact estimates are only made for two years beyond the legislation's proposed effective date. However, when a proposed law change would be implemented over several years longer range fiscal impacts are estimated.

Since House File 2513 was not enacted until near the end of the 1998 legislative session and because most of its features only affected final returns, its impact on tax receipts was not expected to be significant until the spring of 1999. Similarly, for Senate File 35, since inheritance tax returns are not due until nine months after a person's death, the impact on State tax receipts was assumed to not begin until October 1998. Even for the 10 percent individual income tax rate reduction a few months lag was expected between the effective date of January 1, 1998 and when tax receipts would begin to show the full impact of the law change. This is because not all payroll agents immediately adjust withholding tax rates when a law change occurs, and more importantly those taxpayers required to make estimate payments generally base their payments early during a tax year on their prior year's tax liability.

Actual Law Change Fiscal Impacts

During the five years preceding implementation of the law changes, Iowa individual income tax revenues increased from $1,403.0 million for tax year 1992 to $1,878.2 million for tax year 1997, which equaled an average annual rate of increase of 6.0 percent. Following the law changes individual income tax revenues decreased to $1,810.2 million by tax year 2002, which equaled an average annual rate of decrease of 0.7 percent.[4] Over the same periods Iowa personal income increased at an average annual rate of 5.2 percent during the five years preceding the law changes and increased by an average annual rate of 3.8 percent the five years following the law changes. Absent of law changes revenues generated by the

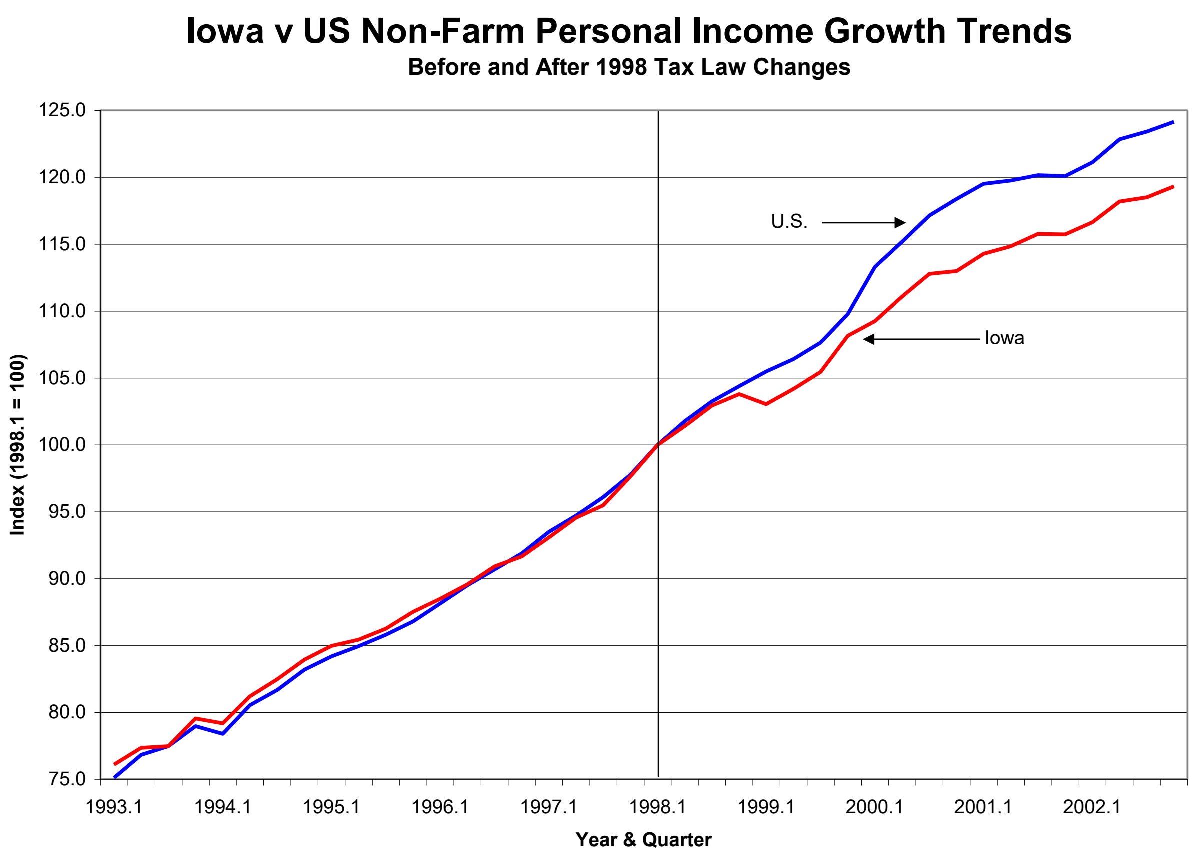
State's individual income tax should grow at a faster rate than personal income given the tax's progressive rate structure. This relationship is apparent in following chart.



From 1977 through 1997 the growth of individual income tax revenues exceeded the growth of personal income in Iowa by 28.8 percent. In comparison, from 1998 through 2002 the growth of individual income tax revenues lagged behind the growth of personal income by 9.5 percent. If individual income tax revenues had continued to grow relative to personal income at the rate that existed prior to the1998 tax law changes the amount of tax generated during 2002 would have equaled approximately $622 million (34.4 percent) more than what was collected.

Economic Impact Analysis

Conventional wisdom holds that tax cuts stimulate economic growth. However, evidence shows this was not the case following the 1998 individual income tax and inheritance tax reductions. As shown in the following chart, during the five years preceding the tax cuts U.S. and Iowa non-farm personal income grew at approximately the same rate. During that period U.S. and Iowa non-farm personal incomes increased by 28.4 percent and by 28.0 percent, respectively. However, over the next five years U.S. non-farm personal income continued to increase at only a slightly lower rate of 27.0 percent, while Iowa's growth in non-farm personal income from 1998 through 2002 equaled only 22.2 percent.



This finding begs the question “Why did Iowa’s economy all of a sudden begin to slowdown in 1998 while the remainder of the nation continued to grow at about the same rate as during the prior five years?” The only significant event that occurred that year that distinguished Iowa from the remainder of the nation was the implementation of the tax cuts enacted during 1997 and 1998. As the chart shows, almost immediately after the start of 1998 the rate of growth for Iowa’s non-farm personal income began to fall below the rate of growth for the nation. The slowdown remained modest during 1998, but as stated earlier the revenue impacts of most of the tax cuts did not start showing up until near the middle of 1998 and some not until the spring of 1999. Furthermore, the impact of reduced revenues on State and local government expenditures did not begin to show-up until after the start of fiscal year 1999.

There exist three reasons the tax cuts likely caused the slower growth in Iowa’s non-farm personal income. First, much of the benefits of the individual income tax cuts were realized by high income taxpayers. For example, over 24 percent of the savings resulting from the 10 percent individual income tax rate reduction was realized by the 3 percent of taxpayers with $100,000 or more in adjusted gross income. The capital gains and pension income exclusion law changes also benefited upper income taxpayers disproportionately. This concentration of tax savings among high income taxpayers may not always have an adverse impact on personal income growth in the State. However, from 1997 through 1999 returns on investments in the stock market were at historically high levels. During 1997, 1998, and 1999 returns on equity investments as measured by the Standard & Poor’s 500 Index averaged 30.8 percent, 18.0 percent, and 22.4 percent, respectively. As a result it is likely much of the tax savings that was realized from the individual income tax cuts got invested outside Iowa.

Second, a study of inheritance returns showed that prior to the passage of Senate File 35 over one-third of bequests went to beneficiaries living outside Iowa. Thus, over the five year period following the elimination of the inheritance tax for lineal ascendants and descendants and for step-children about $60 million in tax savings went to non-residents.

Third, the tax cuts resulted in reductions in State and local government spending below the levels that would have likely resulted if the tax cuts had not occurred. This is supported by national statistics that show that while State and local government employment nationally decreased by 6.8 percent between 1997 and 2002, State and local government employment in Iowa decreased by 16.1 percent over the same period. If State and local government employment in Iowa had only decreased by as much as the national average public payrolls would have been about $40 million higher during 2002. This reduction in public sector employment likely depressed personal income growth in the State because most State and local government spending occurs within the State. On the other hand, most high value consumer goods (i.e., automobiles and SUVs, electronic appliances, furniture, and building materials for homes) for which sales experienced significant growth during the period from 1998 through 2002 are produced outside Iowa.

In summary, the tax law changes enacted during 1997 and 1998 appear to have resulted in a significant reduction in the rate of growth for non-farm personal income. By 2002 Iowa non-farm personal income was $2.9 billion (3.6 percent) below the level it would have been at if Iowa had maintained equity with the nation as a whole. This translates into $986 less in personal income per Iowan. In addition, if Iowa's personal income growth had kept pace with that of the nation as a whole approximately $180 million more in State General Fund taxes would have been collected during fiscal year 2002.

Conclusions

Tax law changes do not always affect economic activity in the way expected prior to their enactment. Tax increases can stimulate increased economic growth, while tax reductions can have the opposite effect. This is particularly true at the state level because money and commerce flow freely across state borders.

How tax law changes will affect the economy of the state enacting them depends on a variety of factors. These include:

- How the benefits or costs of the law changes are distributed between residents and non-residents.
- How the benefits or costs of the law changes are distributed among taxpayers with different levels of income and wealth.
- How the benefits or costs of the law changes are distributed among different types and sizes of businesses.
- The relative attractiveness of investment opportunities inside and outside the state.
- The degree to which consumer goods and services are produced inside versus outside the state.

The tax law changes enacted during 1997 and 1998 by the Iowa General Assembly appear to have caused a slowdown in the State's economy relative to the remainder of the nation. A number of factors explain why this occurred. First, much of the tax savings resulting from the law changes was realized by high income taxpayers. Second, at the time the tax cuts were enacted the rate of return on stock investments was at historically high levels and attracted money out of the State. Third, for many of the types of consumer goods for which sales experienced strong growth from 1998 through 2002 (i.e., building materials, home furnishings, appliances, and motor vehicles) Iowa content is low, generally under 15 percent. Fourth, at least one-third of the benefit of the inheritance tax law changes and slightly over 4.0 percent of the individual income tax law changes went to non-residents. Fifth, Iowa's public sector has shrunk too a greater extent than the remainder of the nation.

These findings do imply that fiscal impact estimates can be wide of the mark when tax law changes result in significant impacts on a state's economy. The additional $180 million in tax revenue that would have been collected if Iowa's economy had continued to keep pace with the remainder of the nation equals 4.4 percent of net general fund tax revenues for fiscal year 2002. However, this finding does not equate to an endorsement of the use of dynamic scoring when doing fiscal impact estimates. This is because most existing programs used to adjust fiscal impact estimates for behavioral effects on the economy are not yet sophisticated enough to take into consideration linkages between a given state's economy and the remainder of the nation. Nor do they take into consideration cyclical variations in investment opportunities. Therefore, the best fiscal analysts can be expected to do at this time is to use their understanding of the economy to identify how law changes may affect taxpayer behavior at the time the changes are implemented and convey this information to policy-makers in their fiscal notes. Finally, more effort should be put into ex post assessments of how past law changes have affected the economy and what economic feedback effects on the fiscal impact actually resulted. These findings can then be used to better judge how future law changes will affect the state's economy and tax revenues.

Notes

1. U.S. Congress, Joint Economic Committee, "Understanding the CBO's Dynamic Analysis," (April 1, 2003); Sullivan, Martin A., "Practical Aspects of Dynamic Revenue Estimation", (The Heritage Foundation, June 14, 2004)
2. By statute the lowest Iowa individual income tax rate equals 0.36 percent on the first $1,000 of taxable income and the highest rate equals 8.98 percent on table income over $45,000. However, annually tax brackets are indexed for inflation.
3. At the time the legislation discussed in this paper was enacted the legislative staff organization responsible to preparing fiscal notes was know as the Legislative Fiscal Bureau. Legislative agencies were reorganized during 2003 and now fiscal notes are prepared by the Fiscal Division of the Legislative Services Agency.
4. Individual income tax revenue amounts are tax year amounts and are net of refunds.