

## Vision for 2010

Our vision for 2010 is a state-local tax system that is perceived to be, and in fact is, equitable, neutral, simple, competitive, and predictable. A tax system with these virtues will be a positive factor in people's decisions about where to reside, where to work, and where to start and operate a business, and it can be and should be marketed as such. To the extent that Iowans believe their taxes are satisfactory in these respects, they will be more likely to support government in general and to comply with tax laws in particular. Government's costs of administering and enforcing taxes will be lower. Government will be seen as a positive factor in our society, rather than as a barrier to economic progress, a source of inefficiency, and a perennial candidate for downsizing. Although there are many actions that could be taken to move Iowa's tax system closer to this vision, the most effective actions would be to:

- Broaden the bases of the income, sales, and property taxes and make balanced use of these taxes.
- Establish a tax-free threshold for sales, income, and property taxation equal to 150 percent of the poverty line income.
- Forgo tax competition aimed at encouraging particular types of business or the location of businesses in particular areas, except under conditions of documented market failure.
- Finance government as much as possible with fees and charges that are directly related to the use of public services and facilities. In particular, fees and charges should be used instead of income, sales and property taxes to finance government activities such as road construction and maintenance, traffic control, parking, municipally supplied water, garbage collection, and sewage treatment.

These actions are defined in greater detail below following a discussion of the broad principles of taxation: equity, neutrality, simplicity, competitiveness, and predictability.

### Principles of Taxation

While taxation will always be a controversial subject, there is considerable agreement that tax policy should be guided by broad principles, among which the more important are equity, neutrality, competitiveness, simplicity, and predictability.

#### Equity

Taxes distribute the costs of government among individuals. To be fair or equitable, individuals' tax burdens should be related to their *ability to pay* taxes. Persons with equal ability to pay should bear equal tax burdens – equals should be treated equally. And persons with greater ability to pay should bear greater tax burdens – overall tax burdens should be *progressive*. In the case of income taxation, equal-treatment-of-equals requires that tax rates not depend on how income is earned or received. For example, income from particular types of investment should not be taxed at a lower rate than income from other investments or income from labor. Nor should income from particular sources be exempt from taxation. Similarly, for sales taxation equal-treatment-of-equals requires that all *final* sales be taxed at the same rate. That is, a person's sales tax payments should not depend on which products and services she decides to buy. And in the case of property taxation, equal-treatment-of-equals requires that the tax levy, as a percentage of market value, not depend on the type of property or where it is located. In short, equal-treatment-of-equals

requires that a person's tax burdens not depend on how she earns or spends her income or the type or location of her property.

### Neutrality

Virtually all taxes alter economic activity as individuals adjust their behavior in an attempt to reduce their taxes. When tax rates depend on how income is received and spent, individuals will try to reduce their tax burdens by earning lightly taxed forms of income and spending that income on lightly taxed products and services. Lightly taxed economic activities will therefore be expanded at the expense of heavily taxed activities. Such tax-induced changes in economic decisions are ordinarily undesirable distortions of market activity; they are barriers to the efficient working of markets. The magnitude of these distortions increases as tax rates increase.

To minimize the distorting effects of taxes, all tax bases should be as broad as possible and all components of each base should be taxed at the same rate. Further, tax rates should be as low as possible, which requires, in turn, *balanced use* of the three major taxes – income, sales, and property. An important exception to these rules arises when relatively high taxes are needed to curtail the use of products that have undesirable side effects on others than the users of the products. An example is the "gas guzzler" tax on large cars, which is imposed to reduce air pollution; another example is the tax on alcoholic beverages, the consumption of which may lead to property damage and loss of life.

Neutrality also requires that taxes not be used to encourage particular industries or types of firms. Reducing taxes for one group of businesses necessarily implies higher taxes for other businesses and individuals or lower public services. Neutrality requires that taxes not be used to manipulate the economy – for example, to try to attract industry. If it is decided, in contrast to this general rule, that subsidies or incentives are justified by market failure, the subsidies/incentives should be provided by direct appropriations in the budget rather than by tax abatements. Then the subsidies and incentives would be a visible and subject to annual review as the budget is prepared.

### Competitiveness

The potential influence of taxes on the location of businesses has led to tax competition, whereby states and localities try to use low tax rates to attract businesses. Even if a state does not wish to engage in tax competition, it must nevertheless try to keep its tax rates on *mobile* businesses in line with those in other, particularly neighboring, states.<sup>1</sup> When gauging the effect of taxes on a state's competitiveness, the relevant question is how taxation of *mobile* businesses varies from one state to another. For example, would an Iowa manufacturing enterprise pay lower tax rates on its income and property if it were located in another state? This question cannot be answered by comparing broad measures of tax burdens such as the share of taxes collected by property taxes, or taxes as a percentage of personal income, or taxes per capita. More specifically, the fact that property taxes account for a larger share of total revenue in Iowa than in some neighboring states does not mean that *mobile* industrial and commercial enterprises would be subject to higher property tax rates in Iowa than in those states. Neither does it mean that owners of similar residences, say homes with market value of \$100,000, would face higher taxes in Iowa than in those states.

Although a state cannot set tax rates without regard for what other states are doing, the importance of taxes in location decisions can be easily overstated. Relatively high taxes may not

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<sup>1</sup> Mobile businesses can change the location of their operations. For example, a manufacturer of agricultural equipment could operate in virtually any state. In contrast, farming and mining are *immobile*.

be a barrier to business if public service levels are also relatively high. Good schools, safe streets, and high quality public infrastructure may offset high taxes. Further, numerous studies show taxes are typically among the less important of the many factors that enter into businesses' location decisions.

### **Simplicity**

Complex taxes are costly for governments to administer and enforce, and they are costly for taxpayers to comply with. Taxpayers incur compliance costs as they keep records, file tax returns, and make tax payments as called for by tax laws. Administrative, enforcement, and compliance costs increase with the number of taxes imposed and the complexity of those taxes. Base broadening is the most effective means of reducing these costs. It does so by eliminating the complex rules and distinctions needed to implement the exemptions, deductions, and credits that narrow tax bases.

### **Predictability**

Taxes affect the profitability of investments, many of which are long-term, requiring a commitment of resources for years, if not decades. Having a stable tax system would make it easier for businesses to predict future taxes, thereby facilitating planning for long-term investments. In contrast, the current practice of introducing major tax legislation in virtually every session of the Iowa General Assembly complicates business planning.

## **Goals/Objectives**

The broad goal of tax policy should be to develop a tax system that is consistent with the principles stated above. What specific actions can be taken to achieve this goal? Rather than attempting a complete listing of such actions, we focus on those with the greatest potential for improving Iowa's tax system.

### **Broaden tax bases**

The most important actions would be to broaden the bases of the income, sales, and property taxes and make balanced use of these taxes. The objectives in base broadening should be to eliminate income tax preferences and loopholes, to expand the sales tax base to include all *final* sales of products and services, and to eliminate property tax exemptions and abatements. With broader bases, there would be fewer artificial distinctions in how various types of sales, income, and property are taxed. Reducing such distinctions would simplify the tax system, decrease tax-induced distortion of market activity, and tax individuals more fairly. With these changes, taxpayers would more likely "buy into" and support the tax system and government in general. It would be easier for taxpayers to comply with taxes, and easier for government to administer and enforce them.

Ideally, all components of each base should be taxed at the same rate, so that a person's taxes do not depend on how she earns or spends her income or the type or location of her property. Broader bases would mean lower tax rates, which would increase competitiveness and reduce market distortions. And some base-broadening measures, in particular expanding the sales tax base to include services, would increase elasticity.

### Balanced use of major taxes

Making balanced use of the three major taxes, especially keeping use of each tax in line with what other states are doing, would reduce market distortions and help maintain competitiveness. Over the past 5 decades, the property tax share of total state and local taxes has decreased, while the income and sales tax shares have increased. In fact, over the past 25 years property taxes have not increased rapidly enough to keep up with inflation; property taxes have not increased in *real* (inflation-adjusted) terms. Continued reliance on property taxes should be accompanied by policies that reduce the wide variation in property tax rates across taxing jurisdictions. Variations in tax exempt prosperity and disparities in new growth should be redressed with tax sharing strategies on a statewide, regional or county-wide basis.

### Limit taxes on low income persons

Individuals and families do not have the ability to support government until they have enough income to meet their basic needs; that is, they do not have *ability to pay* taxes until their income passes the threshold at which they can buy the necessities of life. One possible estimate of this *tax-free threshold* is the *poverty line income*, which is currently about \$18,000 for a family of four. Of course, the tax-free threshold could be, and probably should be, set higher than the poverty line income. At a minimum, then, an equitable tax system would not ask individuals and families to pay sales and income taxes until their income exceeds the poverty line income.

For the income tax, this can be accomplished by setting the standard deduction and personal exemptions for individuals and each family type so that they total at least the poverty line income. To set a similar tax-free threshold for the sales tax, the average amount of sales tax paid by individuals and families at the poverty line income would be rebated. The rebate could be implemented as a *refundable* sales-tax-credit on the state income tax, as explained below. The standard deductions and exemptions and the sales-tax-credit would have to be adjusted each year to keep up with inflation. A similar credit could be provided for low-income renters.

### Implementing policies to achieve objectives

A number of issues and questions will arise in the implementation of policies to achieve the above objectives. Some of the more important are discussed in this section.

#### Sales tax

Broadening Iowa's sales tax base, in particular by including services in the base, would make the tax more equitable, less distorting of economic decisions (more neutral) and less complex. Broadening the base would also increase the *elasticity* of the sales tax; it would make sales tax revenues more responsive to economic growth because services account for an increasing share of consumer purchases.

The criterion for including sales of services, or any other currently untaxed sales, in the tax base should be that the sales are to consumers rather than to businesses. All *final* sales should be taxed, regardless of where or how they are purchased, with the exception of goods and services purchased by businesses and either used in the conduct of business or re-sold. The products purchased by businesses are taxed indirectly when the businesses sell final products and services to consumers. For example, when consumers' purchases of bread are taxed, the milling and baking equipment as well as the wheat and other ingredients used in making bread are also taxed because their cost is included in the final selling price of the bread. Taxing the equipment and ingredients and then taxing the bread when it is sold would lead to "tax pyramiding," which

occurs when inputs are taxed and then the products made with those inputs are also taxed. With a tax rate of 5 percent, the tax on a \$1 loaf of bread should be \$.05. However, if inputs and the final selling price are both taxed, there is tax pyramiding and the tax on the bread will exceed \$.05. Similarly, fertilizer, feed, fuel, and machinery used in agricultural production should not be taxed because farm products will be taxed when they are made into and sold as consumer products.

Some services and products are bought by both consumers and businesses -- for example legal services and computers. Distinguishing between taxable sales (to consumers) and nontaxable sales (to businesses) is often difficult at the time and place of sale. This difficulty is best overcome by taxing *all* sales at the time of sale and having businesses apply for refunds on purchases that were subject to tax.

It is often argued that a number of products and services, such as food, medicines, and medical services, should not be taxed because they are necessities and account for a relatively large share of spending by low-income persons. Taxing these items makes the sales tax *regressive*. But omitting these items from the tax base is not the best way of dealing with this problem. Instead, tax administration and compliance would be easier if all such sales were taxed, and individuals were then allowed to file for a *refundable* tax credit equal to the average amount of sales tax paid on purchases of necessities. To illustrate, suppose purchases of necessities average \$1000 per person per year. Then a credit of \$50 would essentially refund a 5 percent sales tax paid on those purchases. The credit could be means-tested, meaning that it would diminish as a person's income increases. A means-tested credit that is fairly liberal for low-income persons reduces the regressivity of the sales tax more effectively and with less revenue loss than exempting purchases of necessities from taxation. This credit approach would be especially desirable if medical services are to be taxed.

### Income taxes

Broadening Iowa's individual and corporation income tax bases by reducing tax preferences would make the taxes more equitable, more neutral, and less complex. However, in the absence of corresponding changes in federal taxes, administration and compliance costs might increase because Iowa's tax bases would not conform with the federal bases. In the interest of simplicity, serious consideration should be given to making the Iowa tax a proportion of the federal tax.

### Property tax

Iowa like most states exempts a number of types of property from taxation, and it taxes other types at preferential rates. Reducing the number of these exemptions and preferences would be justifiable on grounds of equity, neutrality, and simplicity. It would increase the property tax revenue available at any tax rate. Unfortunately, we lack reliable estimates of the total value of exempted property, so we are left in doubt about how much revenue could be obtained by eliminating specific exemptions. Up-to-date values for exempt property, abated property, and preferentially assessed property, which could be obtained by requiring county assessors to list and appraise such property on a yearly basis at full market value, would be a valuable contribution to the tax policy process.

Local government revenues could also be increased by requiring payments in lieu of taxes for services received by exempt properties. Exempt properties -- hospitals, retirement and nursing homes, private colleges, public universities and community colleges, church-owned property not used for religious purposes, prisons, post offices, racetracks -- receive many if not most of the government services received by taxable commercial and industrial properties. In the case of hospitals and retirement and nursing homes, the exempt properties are engaged in

economic activities that are alternatives to and in competition with taxpaying enterprises. Many of the public services that are needed and used by tax-exempt properties -- police and fire protection, waste disposal, sewage collection and treatment -- are financed largely with property taxes. Even handed treatment of for-profit, non-profit, and charitable enterprises would therefore require that exempt properties pay for the public services they receive.

There are two distinct approaches to determining the amount of such payments. One is to assign assessed values to exempt properties and require that owners pay taxes based on those values to finance city and county services that benefit their properties. The alternative is to charge exempt properties according to either 1) the estimated *value* of the local government services that they receive or 2) the estimated *cost* of providing those services. This second approach would be a major departure from present practice, since it would require that local governments institute new record keeping and cost accounting systems.

### User charges and fees

Many government activities can be *and should be* financed by charges, fees, and special taxes that are closely related to the use of public services and facilities. Examples include roads and highways, traffic control, parking, municipally supplied water, garbage collection, and sewage treatment. The user charge, fee or tax should be at least as great as the cost generated by the use of services and facilities. For example, charges for water should reflect as accurately as possible the cost of treating and distributing the water. Similarly, road user fees should cover the cost of building and maintaining roads.

Financing in this manner is desirable for several reasons. 1) It is equitable because persons and businesses are simply paying for the public services and facilities that they use in their day-to-day activities. 2) It lessens the burden of general taxes (income, sales, and property), and reduces the economic distortions implicit in the use of those taxes. 3) Because individuals and businesses are paying directly for services and facilities they use, they are less likely to call on government to provide excessive (economically inefficient) services and facilities. In contrast, when services are financed with a general tax, individuals and businesses do not see a direct cost *to them* of asking for more roads, more parking, etc.

User fees may not be appropriate when use of a government service or facility by an individual is beneficial for the community at large. Use of libraries is a case in point. We all benefit when our fellow citizens are well educated and informed. It may therefore be undesirable to limit access to libraries by charging fees. The same argument can be made for free provision of public health services such as vaccinations. And this is, of course, the main rationale for free elementary and secondary education.

### Property tax incidence

Property taxes are collected from property owners. The burden of Iowa property taxes is therefore initially on the owners of Iowa property. This initial distribution of tax burdens is termed the *impact* of the tax. The ultimate distribution (*incidence*) of burdens will differ, however, from this initial distribution. That is, property tax burdens may be shifted to individuals other than the owners of the property on which the tax is levied.

Shifting occurs when property taxes lead either to higher prices of goods produced with property or to lower incomes for labor and other resources employed in the production of those goods. In the first case, burdens are shifted to buyers (consumers) of goods produced with property; in the second, burdens are shifted to resource owners. The latter occurs, for example, when taxes on a factory's buildings and equipment result in lower rents for owners of the land on which the factory is located or lower wages for factory employees.

Forward shifting is likely to be slight if the goods produced by taxed businesses are traded in a national market. Prices in this case are set nationally and cannot be increased in response to tax (cost) changes in Iowa (or any other small state). For example, property taxes on Iowa manufacturers of household appliances cannot be passed on to consumers in the form of higher prices for those products. In contrast, forward shifting is possible and likely when the taxed enterprises produce goods and services that are only traded locally and must be produced locally; taxes on local retail and service establishments and rental housing are, for example, likely to be reflected in prices and rents.

The extent of shifting varies by type and use of property. Shifting results from the adjustments that owners of mobile capital make in response to the tax.<sup>2</sup> Therefore, shifting does not occur if property owners cannot adjust the use or location of their property in response to the tax, or if they do not find it profitable to do so. For this reason, there is general agreement that taxes on land are not shifted, and that taxes on agricultural property do not lead to higher prices for agricultural products. There is likewise agreement that on taxes owner-occupied residences are not shifted; because individuals are at the same time landlords and renters, taxes cannot be shifted forward in higher rents.

Taxes on other classes of property (commercial, industrial, and utility) are likely to be shifted in varying degrees. Forward shifting of taxes on utility property is likely because the product is obtainable only from the local producer. For the same reason, taxes on commercial property that is used in production of locally marketed goods and services are likely to be shifted forward to a significant degree. In contrast, industrial property is used in large measure to produce goods that are traded in national markets, and for that reason, significant forward shifting is not likely. Some commercial property is also used to provide services that are nationally traded, e.g. property used in the financial and insurance sectors. To the extent that taxes on commercial and industrial property are not shifted forward, they are borne in some combination by employees of the taxed enterprises, owners of land used by the taxed enterprises, and all owners of capital (property). Taxes on the land component of industrial and commercial property are, as explained above, not shifted and are therefore borne by landowners.

There has long been uncertainty and debate about the shifting and incidence of property taxes, especially those levied on commercial and industrial businesses. There is, consequently, no universally agreed on answer to the question: Who bears the burden of property taxation? However, there is agreement that taxes on agricultural property and owner-occupied residences, which accounted for over half of Iowa property taxes, are not shifted. Some fraction of the remaining classes of property is land, the taxes on which are likewise not shifted. It is therefore quite unlikely that more than 40 percent of the taxes levied on Iowa property are shifted from property owners.

Property taxes, whether shifted or not, may be borne by nonresidents as well as resident Iowans. When taxes are borne by nonresidents, they are said to be *exported*. Taxes that are not shifted may be borne by nonresident owners of Iowa property. When shifted forward, taxes may be borne by nonresident buyers of goods and services produced with Iowa property. When comparing the incidence of Iowa's major taxes (income, sales, and property), it is important to take into account how they differ in the extent of exporting. Furthermore, when revenues from the sales tax

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<sup>2</sup>Among types of property, land and natural resources (e.g. mineral deposits) are *immobile*. In contrast, reproducible property (buildings, equipment, and other improvements) is *mobile* in the sense that the amount of such property within a taxing jurisdiction can over time be increased or decreased in response to property taxes. Reproducible property can therefore be retained within a jurisdiction only if its owners realize an after-tax return that is competitive with what they could earn elsewhere.

or the individual income tax are used to provide property tax relief, it is important to recognize that overall tax burdens on resident Iowans will increase because the exported share is greater for the property tax than for the income and sales taxes.

### Property tax capitalization

Property taxes decrease the net (after tax) income accruing to owners of land, buildings, and other taxable real property located in Iowa.<sup>3</sup> This decrease in income tends to be capitalized into the market value of immobile property -- principally land. That is, when property taxes on land are increased, land values fall by the *present value* of the current and expected future increases in property taxes. Similarly, land values increase when property taxes are decreased. As a result of capitalization, current owners of land bear the burden of any *increase* in the taxes that they (and any prospective buyer of land) expect to be levied on the land in the future. Changes in taxes that are expected to persist into the future generate windfall gains and losses for *current* owners of land -- gains if expected taxes decrease and losses if they increase. Capitalization has important implications for equity of *changes* in taxes, credits, and exemptions. For example, to the extent that current property taxes on land were accurately foreseen at the time present owners acquired the land, the present owners bear none of the burden of the property taxes being currently collected. Furthermore, reducing those taxes (through an increase in credits) would generate windfalls for current owners.

### Tax base erosion

Preventing further narrowing or "erosion" of sales, income, and property tax bases would promote equity and neutrality just as surely as broadening tax bases. Tax base erosion occurs when tax preferences are granted for any reason. However, the primary source of erosion in recent years has been tax competition -- the use of tax incentives in an effort to attract businesses to the state.

### Interstate coordination of tax policy

Reducing tax competition will require interstate agreements to forego use of tax breaks to attract businesses. Without such agreements, tax competition is likely not only to lead to further erosion but also to be a significant barrier to efforts to broaden tax bases. Tax competition at the local level, and the resulting erosion of the property tax base, could be reduced by assessing and taxing industrial property on a statewide basis and distributing the revenues to local governments on the basis of an equalizing formula. Since all industrial property would be taxed at the same statewide rate, the property taxes paid by a manufacturing or other industrial enterprise would not depend on its location within the state. And there would be no opportunity for local governments to under assess business property and to offer property tax abatements in an effort to attract footloose businesses.

### Tax-exempt businesses

Businesses and organizations that are currently exempt from some or all taxes because they are engaged in nonprofit or charitable activities should be taxed in the same manner as for-profit businesses. Even if it is desirable to subsidize the activities of these organizations, it is inefficient and unfair to do so by taxing them differently than other businesses. If a business is to be subsidized because its activities generate benefits for the public, then the subsidy should be directly related to the magnitude of the public benefits. There is no reason to think that such

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<sup>3</sup> This is the effect of the tax taken alone. To the extent that the tax pays for services that directly benefit property owners, net income need not be reduced.



public benefits are related to the amount of taxes that the exempt business would otherwise pay. Yet, that is the assumption implicit in current practice.