



State Tax Policy: Everything you wanted to know about tax ...but were afraid to ask

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Disclaimer:

The information presented is the opinion of the presenter and does not necessarily reflect the views of PFM Group Consulting or its Managing Directors

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Topics for Discussion

- Taxation: why and what we tax
- Principles of tax policy
- State and local tax methods
- Iowa in comparison to other states
- Current issues and key battlegrounds
- Crystal ball predictions for Iowa



Why Tax?

- “I like to pay taxes. With them, I buy civilization.” Justice Oliver Wendell Holmes, Jr.
- The problem with paying for public, non-excludable goods:
 - A **public good** (or **service**) may be consumed without reducing the amount available for others, and cannot be withheld from those who don't pay for it.
 - Examples are national defense, environmental protection, street lighting.
 - In these cases, general taxes are the optimal way to provide them.
- Taxes provide consistency/reliability that other methods may not
 - Some services can be market-based and fees/charges can support them.
 - In many cases, the charges/revenues are ‘lumpy’ and don't work in practice when service levels need to remain constant.



What to Tax

- Nearly all Iowa taxes are levied against wealth, income or consumption

Wealth: real property tax, inheritance tax.

Income: personal income tax, corporate income tax, bank franchise tax.

Consumption: general sales and use tax; excise taxes, such as on cigarettes/tobacco products, motor fuel, alcohol, insurance premiums.

- Arguments for ways to tax:

Wealth: income redistribution, ability to pay (often problematic on property tax).

Income: income redistribution, ability to pay (or not), broad-based.

Consumption: you can choose to consume (somewhat), can be structured to diminish or mitigate 'bad' choices (cigarette, alcohol taxes), can be broad-based.



What to Tax (continued)

- Arguments against taxing:

Wealth: hard to define what exactly constitutes 'wealth' – property tax is an example for those on a fixed income or areas with significant valuation growth.

Income: discourages productive activities (saving, investment, economic growth), including work.

Consumption: generally the most regressive form of tax (because lower income households spend far more of their income on taxable consumption so pay more of their income in consumption taxes than higher income households).



How to tax (principles to tax by)

- **Equitable** (treat similar and dissimilar taxpayers fairly)
- **Efficient** (to the extent possible not interfere with market decisions)
- **Sufficient** (broad base)
- **Stable** (structure as a whole not susceptible to business cycle revenue swings)
- **Balanced** (rely on a mix of taxes that impact a variety of taxpayer groups and react differently throughout the business cycle)
- **Understandable** (taxpayers should be able to comply with tax rules and regulations and they should also be easy to administer)
- **Exportable** (a reasonable share of the tax burden should be borne by visitors who consume services but otherwise do not pay for them)



Current Major Taxes

- Broad-based personal/individual income tax
 - Imposed in 41 states (exceptions are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, Wyoming)
 - Republican Governors are pushing to eliminate their income tax, including Mississippi and West Virginia
 - Iowa will (in 2026) be one of 12 states with a flat rate (the others are Arizona, Colorado, Idaho, Illinois, Indiana, Kentucky, Michigan, Mississippi, North Carolina, Pennsylvania, Utah)
 - Still the largest source of state tax revenue – 40 percent of state tax collections in 2021

- Sales Tax
 - Imposed in 45 states (exceptions are Alaska, Delaware, Montana, New Hampshire, and Oregon)
 - Most states that impose it also allow a local sales tax (exceptions are Connecticut, Indiana, Kentucky, Maine, Maryland, Massachusetts, and Michigan)
 - Second largest source of state tax revenue – 29 percent in 2021



Other Taxes

- Corporate income tax
 - Imposed in 44 states
 - Has been a declining revenue source for many years – no state now gets 10 percent of its share of tax revenue from this source
- Excise taxes
 - As opposed to a general sales tax with one rate, excise taxes are imposed at varying rates depending on the good or service
 - The ‘big three’ have historically been alcohol, motor fuel, and tobacco products
 - Joined in many states by gaming and recreational marijuana
 - Often (but not always) considered a Pigouvian (sin) tax, where the tax is meant to either reduce consumption or provide revenue to ameliorate the negative externalities (harms) associated with it
 - Excise tax rates can be a significant add to the final cost – in some cases, converted to a general sales tax, be in the range of 50-100 percent
 - They are often seen as expedient ways to balance a state budget



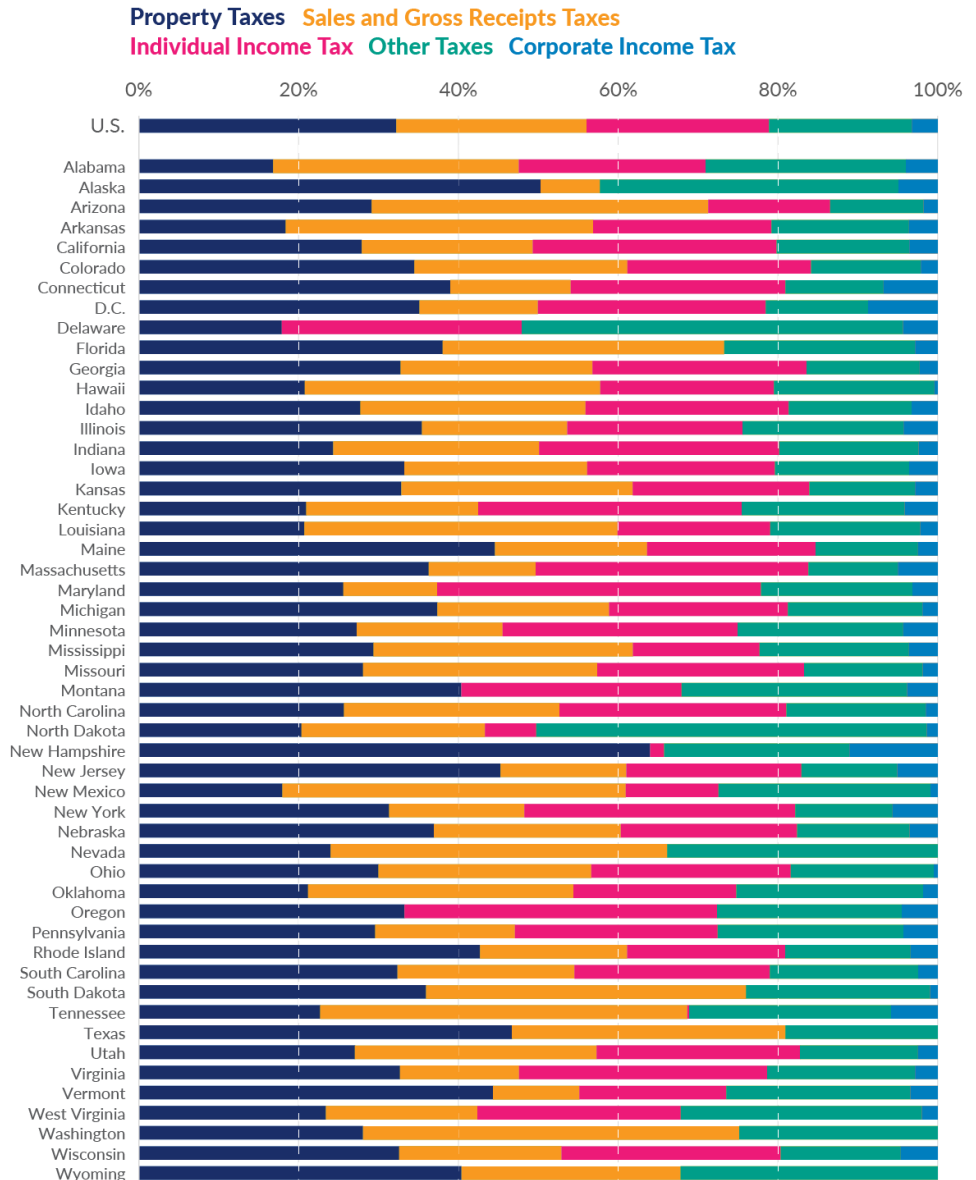
The current state tax landscape

How Does Your State Collect Tax Revenue?

Sources of State and Local Tax Collections by State, FY 2020

State-only Tax Sources

Tax	All States	Iowa
Property	1.8%	0.0%
Sales and Use	29.2%	33.9%
Excise	14.1%	12.9%
License	5.1%	9.3%
Personal Income	39.8%	36.1%
Corporate Income	7.2%	6.7%
Other	2.8%	1.1%
Total	100.0%	100.0%



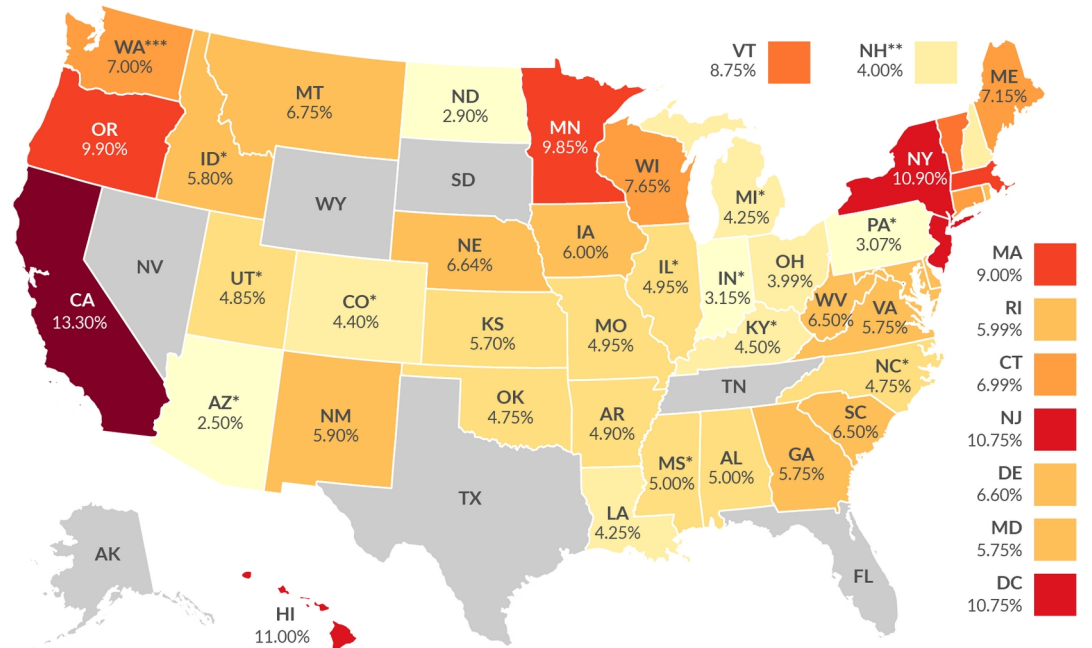
Sources: U.S Census Bureau (state-only tax sources)
Urban Institute (state-local tax collections)



Income tax in Iowa and the U.S.

Top Marginal State Individual Income Tax Rates (as of January 3, 2023)

- Iowa is transitioning to a flat rate of 3.9% in 2026
- This is accomplished in stages, from 6.0% in 2023 (see chart to the right)
- It is reduced to 5.7% in 2024, 4.82% in 2025, and a single flat rate of 3.9% in 2026 and beyond
- It's notable that the 4.82% rate in 2025 would be the lowest among its surrounding states.



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.
(*) State has a flat income tax.
(**) State only taxes interest and dividends income.
(***) State only taxes capital gains income.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.



TAX FOUNDATION

@TaxFoundation



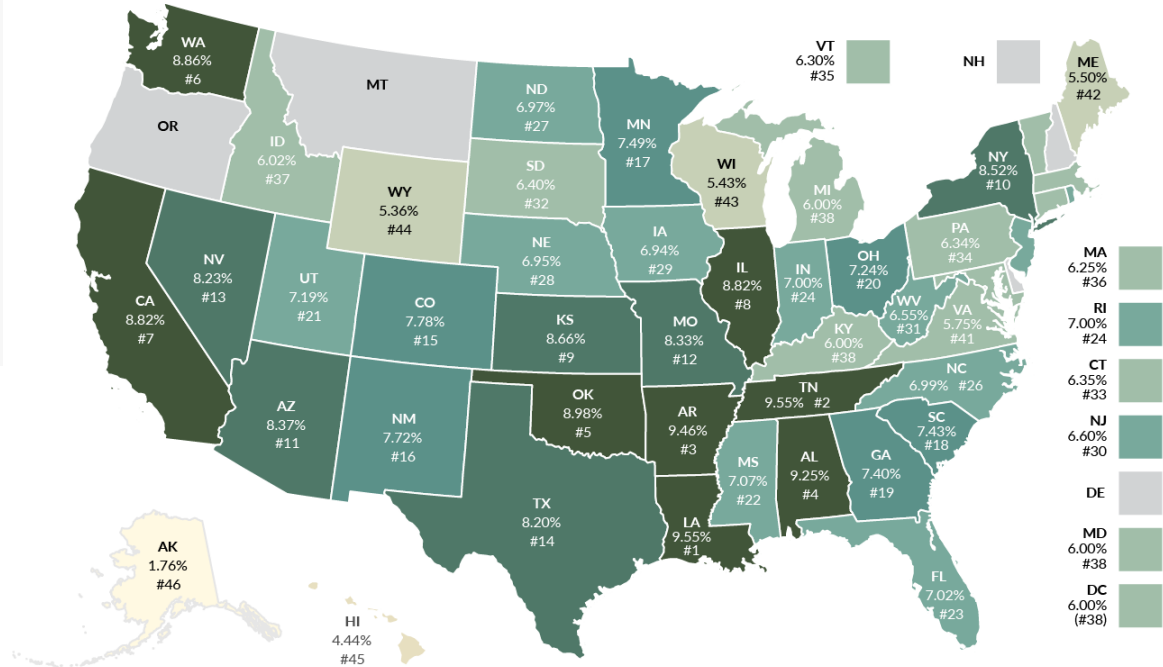
Sales tax in Iowa and the U.S.

History of Iowa Rate Changes

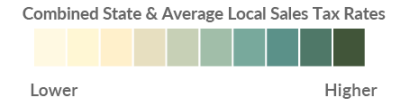
Effective Date of Change	Sales and Use Tax Rate
April 1, 1934	2.0%
July 1, 1955	2.5%
July 1, 1957	2.0%
October 1, 1967	3.0%
March 1, 1983	4.0%
July 1, 1992	5.0%
July 1, 2008	6.0%

- Iowa is currently generally competitive on sales tax rates, with only two neighboring states having lower rates.
- Of course, that is in the current tax mix, where personal and corporate income taxes have a larger share than they will have in future years.

Combined State and Average Local Sales Tax Rates, January 2023



Notes: City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate. The sales taxes in Hawaii, New Mexico and South Dakota have broad bases that include many business-to-business services. D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would rank if included.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations; State Revenue Department websites





Major Taxes are under Pressure: Income Tax

- Conservative's bane;
 - In theory, it reduces the incentive to work and invest;
 - In practice, it appeals to the conservative base
 - They support efforts to either reduce rates or go with one flat tax rate - Iowa
 - Often coupled with increase in sales tax to make it revenue neutral – future Iowa
- Liberal's darling;
 - In theory, it's equitable because of 'ability to pay' issues
 - In practice, it appeals to the liberal 'working class' base
 - Lately, advancing millionaire's tax brackets
 - Also seek to reduce high-earner deductions (capital gains taxes, mortgage interest deduction on high end property
 - Couple with refundable low-income tax credits to offset regressive sales taxes



"I spend 30% of my day working for the tax man, so that's the part of my day when I goof off."



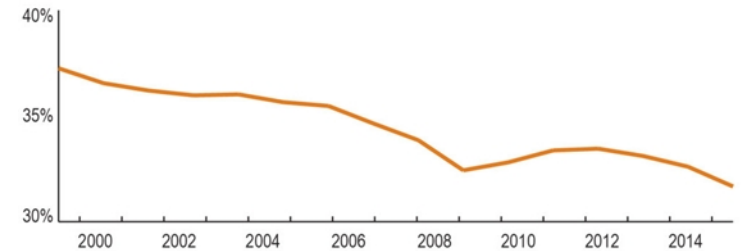


Major Taxes are under Pressure: Sales Tax

- Conservative's darling;
 - In theory, it's productive because you're only taxed on what you consume;
 - In practice, higher income individuals pay a smaller percent of their income as sales tax
- Liberal's bane;
 - In theory, it's regressive, because lower income households pay a higher percent of their income in sales taxes
 - In practice, it 'crowds out' more progressive taxes
- Under pressure – base erosion
 - Won a major battle around collection of sales tax on out-of-state remote sales (Wayfair), but fear that the issue will re-emerge, in Court or Congress
 - Major concern is lack of taxation of services, which are now the majority of consumption
- Under pressure – demographic changes
 - Population is getting older – we consume less
 - Rate increases are making some combined state/local rates uncompetitive

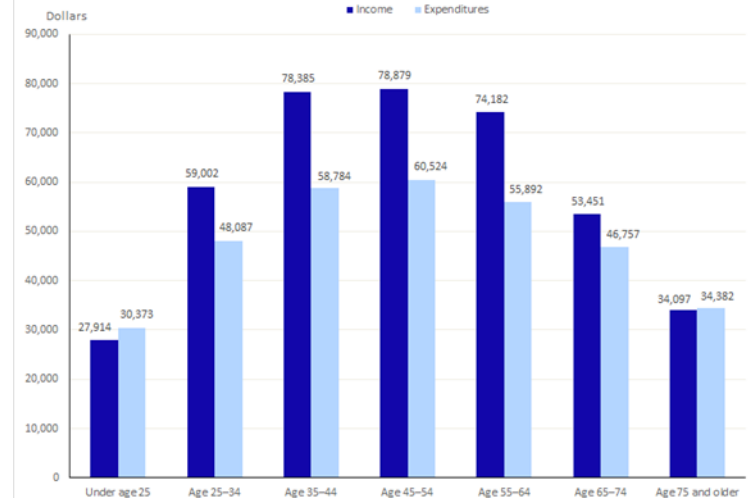
Shifting Away from Goods

Spending on goods as share of personal consumption expenditures



Source: TCI analysis of BEA state personal consumption expenditures data

Chart 1. Income and expenditures, by age of reference person, 2013



Source: U.S. Bureau of Labor Statistics.



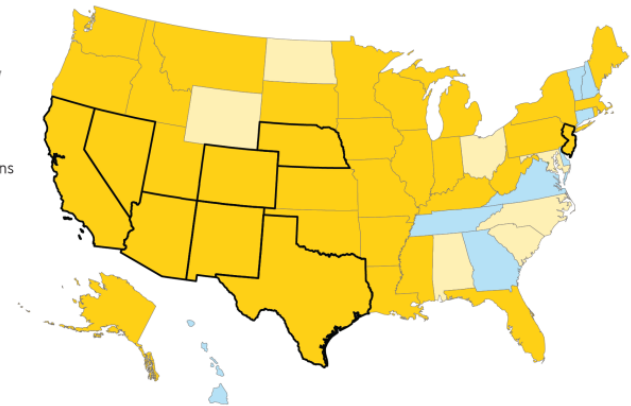
Major Taxes are under Pressure: Property Tax

- Nobody's favorite
 - Liberals: it's regressive and a poor excuse for a wealth tax;
 - Conservatives: rising property values make it easy to 'hide' tax increases;
- Yet an efficient method of raising revenue
 - Real property is fixed, so the tax is very hard to avoid
 - Highest collection rate of any major tax
 - Broad use (all 50 states) so harder to 'pick and choose' locations that do not apply it
 - Benefits theory – it supports local services that benefit property owners
- Under pressure: political football
 - Nearly every state limits them in some way
 - Property tax protests have become more common – and sophisticated, particularly for commercial property



Most states impose binding property tax or expenditure limitations on cities
Municipal tax and expenditure limitations by state

- No property tax limitations
- Non-binding property tax limitations
- Binding property tax limitations
- Expenditure limitations





Iowa Tax Landscape

- Significant erosion in the revenue base because of changing from a progressive to a flat income tax rate structure
 - REC projects actual general fund revenue reductions in both this and next fiscal year
 - That generally only occurs in recessions
 - The Reynolds tax cuts rely on 'spending down' the budget surplus, but that is one-time money largely built on federal revenue largesse
- Shifting from a structure more balanced between income and consumption to more focused on consumption
 - REC projects reduction in personal income tax collections of 5.9% in FY23 and 8.8% in FY24
 - REC projects reduction in corporate income tax collections of 4.4% in FY23 and 7.0 percent in FY24
 - REC projects increase in sales tax collections of 5.5 percent in FY23 and 5.5 percent in FY 24
 - The relative mix between personal income and sales tax is narrowing
 - In FY21, personal income tax versus sales tax was a 61-39 percent split; the estimate for FY24 is a 57-43 percent split
 - My guess is that by FY26, it will be closer to 50-50
- There is no plausible scenario where, given new spending and income tax cuts, there will not be a need for a broad-based tax increase in the next 3-4 years
- If a tax increase is necessary, my money is on a general sales tax increase – although base expansion (digital consumption) is (remotely) possible



Iowa Revenue Estimating Conference: Scary Numbers

REVENUE ESTIMATING CONFERENCE
ESTIMATE OF GENERAL FUND RECEIPTS
March 10, 2023
(\$ in millions)

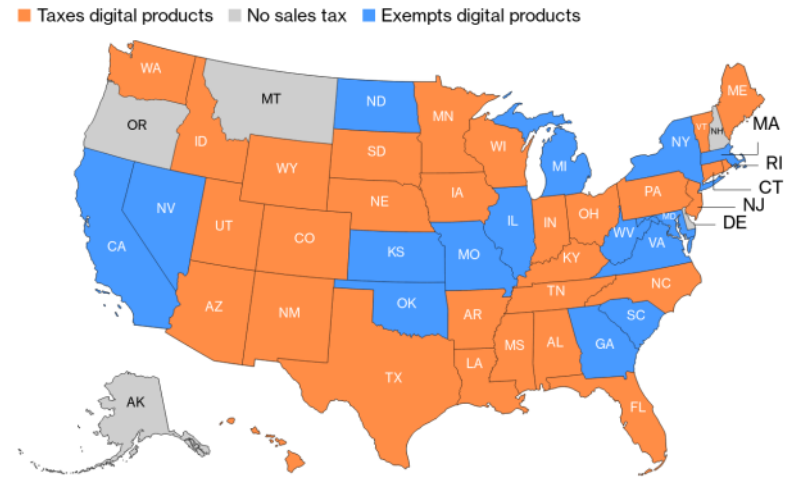
	FY21 ACTUAL	FY22 ACTUAL	% Change FY 22 Act vs. FY 21 Act	12/22 REC FY23 ESTIMATE	% Change FY 23 Est vs. FY 22 Act	03/23 REC FY23 ESTIMATE	% Change FY 23 Est vs. FY 22 Act	12/22 REC FY 24 ESTIMATE	% Change FY 24 Est vs. FY 23 Est	03/23 REC FY 24 ESTIMATE	% Change FY 24 Est vs. FY 23 Est
TAX RECEIPTS											
Personal Inc. Tax	5,434.5	5,780.1	6.4%	5,576.6	-3.5%	5,634.4	-2.5%	5,247.8	-5.9%	5,136.2	-8.8%
Sales/Use Tax	3,512.3	3,853.7	9.7%	3,984.9	3.4%	3,720.3	-3.5%	4,203.9	5.5%	3,924.7	5.5%
Corporate Income Tax	983.8	919.0	-6.6%	952.2	3.6%	961.0	4.6%	910.6	-4.4%	893.3	-7.0%
Inheritance Tax	94.5	97.7	3.4%	93.4	-4.4%	93.4	-4.4%	66.8	-28.5%	63.7	-31.8%
Insurance Premium Tax	144.0	151.0	4.9%	151.4	0.3%	157.5	4.3%	151.6	0.1%	156.8	-0.4%
Beer Tax	17.7	13.6	-23.2%	12.8	-5.9%	12.8	-5.9%	13.1	2.3%	12.8	0.0%
Franchise Tax	69.9	72.4	3.6%	61.4	-15.2%	64.1	-11.5%	59.2	-3.6%	51.4	-19.8%
Miscellaneous Tax	22.9	68.7	200.0%	27.8	-59.5%	257.0	274.1%	26.4	-5.0%	131.6	-48.8%
Total Tax Receipts	10,279.6	10,956.2	6.6%	10,860.5	-0.9%	10,900.5	-0.5%	10,679.4	-1.7%	10,370.5	-4.9%
OTHER RECEIPTS											
Institutional Payments	7.1	11.6	63.4%	10.0	-13.8%	10.0	-13.8%	10.0	0.0%	10.0	0.0%
Liquor Profits	146.4	152.9	4.4%	149.5	-2.2%	151.5	-0.9%	151.0	1.0%	151.5	0.0%
Interest	2.5	3.6	44.0%	23.0	538.9%	79.4	2105.6%	27.6	20.0%	83.4	5.0%
Fees	29.9	30.7	2.7%	28.6	-6.8%	28.6	-6.8%	28.4	-0.7%	28.4	-0.7%
Judicial Revenue	86.5	88.2	2.0%	88.4	0.2%	88.4	0.2%	88.4	0.0%	88.4	0.0%
Miscellaneous Receipts	70.8	75.2	6.2%	59.8	-20.5%	59.8	-20.5%	61.1	2.2%	61.1	2.2%
Racing & Gaming	2.2	2.3	0.0%	2.3	0.0%	2.3	0.0%	2.3	0.0%	2.3	0.0%
Total Other Receipts	345.4	364.5	5.5%	361.6	-0.8%	420.0	15.2%	368.8	2.0%	425.1	1.2%
Total Gross Receipts	10,625.0	11,320.7	6.5%	11,222.1	-0.9%	11,320.5	0.0%	11,048.2	-1.5%	10,795.6	-4.6%
Accruals (net)	(274.9)	(47.2)		43.0		145.2		38.3		223.3	
Refunds	(1,114.5)	(1,028.8)	-7.7%	(1,095.3)	6.5%	(1,095.0)	6.4%	(927.4)	-15.3%	(842.2)	-23.1%
School Infrastructure Transfer	(560.4)	(571.3)	1.9%	(680.0)	19.0%	(749.7)	31.2%	(663.0)	-2.5%	(655.8)	-12.5%
Total Accrual General Fund Receipts	8,675.2	9,673.4	11.5%	9,489.8	-1.9%	9,621.0	-0.5%	9,496.1	0.1%	9,520.9	-1.0%
Transfers											
Lottery	99.0	95.2	-3.8%	99.0	4.0%	103.0	8.2%	103.0	4.0%	103.0	0.0%
Other Transfers*	26.4	34.8	31.8%	26.4	-24.1%	26.4	-24.1%	26.4	0.0%	26.4	0.0%
Total Transfers	125.4	130.0	3.7%	125.4	-3.5%	129.4	-0.5%	129.4	3.2%	129.4	0.0%
Net General Fund Revenues	8,800.6	9,803.4	11.4%	9,615.2	-1.9%	9,750.4	-0.5%	9,625.5	0.1%	9,650.3	-1.0%
Estimated Gambling Revenues Transferred											
To Other Funds	314.8	349.9	11.1%	317.6	-9.2%	335.0	-4.3%	285.8	-10.0%	312.0	-6.9%
Amount of Interest Earned on Reserve											
Funds (transfer to RIF)	1.9	2.4	26.3%	9.0	275.0%	18.0	650.0%	15.0	66.7%	20.0	11.1%

03/22 REC FY25 ESTIMATE	% Change FY 24 Est vs. FY 23 Est
9,741.3	0.9%



Changing Economy Creates Tax Structure Tension

- Digital consumption is on the rise
 - Things we used to purchase or rent as physical goods are now delivered digitally
 - Entertainment (movies, videos, books, music)
 - Business and personal programs/software (tax preparation, accounting and financial suites, salesforce and other platforms)
 - As these erode the consumption tax base, more than half the states now tax them, but the extent varies.
 - Maryland made the first foray into taxing digital advertising, and lots of states are waiting to see how it plays out
 - It has been challenged in court, and the first round of decisions largely went to the industry
 - I suspect some form of the tax could pass constitutional muster



Source: Avalara

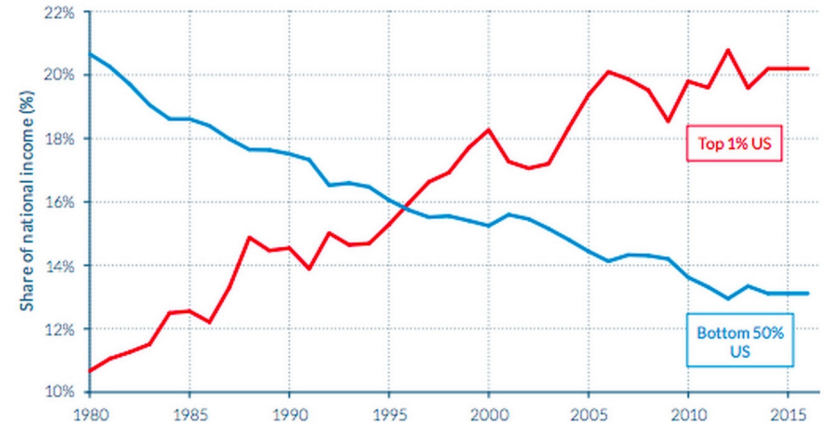
BloombergTax





Wealth Tax Opportunities (or lack thereof)

- Income inequality is getting growing attention
 - Most efforts to use the tax structure to address it is at the federal level
 - This includes taxing capital gains as ordinary income
 - Also includes modifying the stepped-up basis for property transferred at death
- Targeted wealth taxes are more difficult to impose and administer
 - Most efforts to use the tax structure to address it is at the federal level
 - However, Washington state has several wealth tax proposals, primarily exempting wealth of the first billion dollars
 - Wealthy are mobile and have significant resources – likely requires broad-based (maybe even international) taxation



Source: WID.world (2017). See wlr2018.wid.world for data series and notes.
In 2016, 12% of national income was received by the top 1% in Western Europe, compared to 20% in the United States. In 1980, 10% of national



Summary - National

- The major tax sources are all under pressure, and probably always will be (hardly anybody loves to pay taxes)
- Changes in consumption and how the economy works suggests that digital taxation will be the next big battleground
- In the meantime, excise taxes will be the practical choices for state and local governments needing to balance budgets
- The income tax (particularly directed at the wealthy) and sales tax (mostly as a substitute for income tax) will continue to be the major political fight between liberals and conservatives
- Broader wealth taxes are tempting but difficult to pass or administer



Summary – Iowa

- The Reynolds Administration has made cutting taxes its top priority – and they have done so
- The income tax rate cuts, couple with exemptions for pension income and elimination of the inheritance tax, will significantly reduce state revenue
- This will make the structure more regressive and also less diversified
- Meanwhile, there is new and major spending to subsidize private K-12 education – and the costs associated with it will fully kick in at the same time as income tax cuts to establish a flat rate
- The state, like all consumers, must also deal with inflation
- This is a ‘perfect storm’ come FY2026
- There is no plausible scenario that suggests Iowa won’t be facing a significant structural deficit in the next few years
- A recession could accelerate/amplify this budget deficit situation
- Some of the suggested remedies – such as efficiency measures on state spending are minor changes that won’t materially impact the budget.